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India Sugar

Central Government Sops Positive, But New UP Sugar Policy Critical

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- More Sops from Government: The government has decided to create an additional buffer stock of 3m tons for sugar, taking the total to 5m tons. Mills will hold the sugar inventories, and the government will compensate the carrying costs. We expect this move to mitigate pressure on sugar prices to some extent, although we do not expect a strong near-term increase. We maintain our price estimate of Rs14/kg for BJH and BRCM for FY07E and FY08E.

- Near-term supply to remain strong: ISMA estimates FY07E production of 27.2m tons against a demand of 20.1m tons. Despite a 5m ton buffer stock, and potential exports of 2m tons, there will still be a supply surplus, which will hold back sharp price increases. We do not expect supply pressures to ease before the FY09E season, unless there is a weather-related event that disrupts cane output.

- Potential material upsides from UP state government sops: We believe that for BJH and BRCM, potential subsidies from the UP state government could be material. The government had recently withdrawn the state sugar policy, which is expected to be replaced by a new policy. UP mills have demanded lower cane price and subsidies on exports and transportation.

- Stocks to trade near replacement cost: In the current environment, we expect sugar stocks to trade near replacement costs. We have target prices of Rs229 on BJH and Rs88 on BRCM based on our replacement cost analysis.

Figure 1. India Sugar: Valuation Summary

	Ticker	Rating	Price (Rs)	Asset Replacement Cost (Rsm)	Debt (Rsm)	Replacement cost per share (Rs)
Bajaj Hindusthan	BJHN.BO	1M	163.4	49,840.0	15,000.0	229.0
Balrampur Chini	BACH.BO	2M	68.1	26,330.0	5,000.0	88.0

Source: Citigroup Investment Research

See Appendix A-1 for Analyst Certification and important disclosures.

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More sops from Central Government, but UP policy critical

The central government has today given more sops to the sugar industry to arrest the declining sugar prices, which are weighing heavily on the industry profitability and has resulted in fast accumulation of cane arrears to farmers. The government has cleared an additional 3mtons of buffer stock of sugar, over and above the 2mtons that has already been proposed. The sugar mills will hold the buffer inventory and the government will compensate them for the working capital cost of carrying the same. While we believe that this may arrest the price decline, it is unlikely to drive up sugar prices materially. For BJH and BRCM, we believe that the new UP government's sugar policy will be critical for driving a material upside to earnings.

We estimate that despite 5mtons of buffer stock and a potential 2mtons export, supply will still exceed demand in FY07. According to the latest ISMA estimates, total sugar production in FY07 is expected to be 27.2mtons. After stripping off 7mtons for buffer inventory and exports, 20.2mT of supply would still be slightly ahead of the expected demand of 20.1mtons. Therefore we do not expect a sharp up-tick in sugar prices in the near term. We estimate about 27mtons of production in FY08 as well, which is likely to keep prices under check. We expect the sugar cycle to likely turn positive in the FY09 season unless weather-related events disrupt the cane crop output.

Figure 2. Indian Sugar Production and Consumption Trend (Million Tons, Percent)

YEAR	OPENING STOCK	PRODUCTION	IMPORTS	CONSUMPTION	EXPORTS	CLOSING STOCK	STOCK as % OF CONSUMPTION
1980-1981	0.6	5.1	0.2	5.0	0.1	0.9	18.4%
1981-1982	0.9	8.4	0.1	5.7	0.4	3.3	56.9%
1982-1983	3.3	8.2	0.0	6.5	0.4	4.6	70.7%
1983-1984	4.6	5.9	0.1	7.6	0.7	2.4	31.4%
1984-1985	2.4	6.1	1.2	8.1	0.0	1.6	19.5%
1985-1986	1.6	7.0	1.6	8.3	0.0	1.9	23.0%
1986-1987	1.9	8.5	1.0	8.7	0.0	2.7	30.5%
1987-1988	2.7	9.1	0.1	9.4	0.0	2.4	25.9%
1988-1989	2.4	8.8	0.0	9.9	0.0	1.2	12.4%
1989-1990	1.2	11.0	0.2	10.2	0.0	2.2	21.7%
1990-1991	2.2	12.0	0.0	10.7	0.2	3.3	31.1%
1991-1992	3.3	13.4	0.0	11.3	0.6	4.9	43.5%
1992-1993	4.9	10.6	0.0	11.9	0.4	3.2	27.2%
1993-1994	3.2	9.8	2.0	12.0	0.0	3.1	25.8%
1995-1995	3.1	14.6	0.2	12.3	0.1	5.6	45.6%
1995-1996	5.6	16.5	0.0	13.1	1.0	7.9	60.2%
1996-1997	7.9	12.9	0.0	13.9	0.4	6.5	47.0%
1997-1998	6.6	12.9	0.9	14.7	0.1	5.6	38.1%
1998-1999	5.6	15.5	1.0	15.2	0.0	6.9	45.3%
1999-2000	6.9	18.2	0.4	16.1	0.1	9.3	58.0%
2000-2001	9.3	18.5	0.0	16.2	1.0	10.7	65.8%
2001-2002	10.7	18.5	0.0	16.8	1.1	11.3	67.4%
2002-2003	11.3	20.1	0.0	17.5	1.5	12.5	71.7%
2003-2004	12.5	13.5	0.6	17.9	0.2	8.5	47.5%
2004-2005	8.5	12.7	2.0	18.5	0.0	4.7	25.4%
2005-2006	4.7	18.9	0.0	19.3	0.6	3.8	19.7%
2006-07E	3.8	27.2	0.0	20.1	2.0	8.9	44.3%
2007-08E	8.9	27.0	0.0	20.9	2.0	13.0	62.2%

Source: ISMA; CIR estimates

In the near term we believe that the new UP government sugar policy will be critical to BJH and BRCM's earnings. Recently the new government in UP had withdrawn the old sugar policy formulated by the previous government. The earlier sugar policy entailed capital and operational subsides to companies making investments of Rs3.5bn and above in new sugar capacities in UP. The policy granted 5-year tax exemptions for companies investing over Rs3.5bn and 10-year exemptions for companies investing over Rs5bn. The two key beneficiaries of these subsidies were Bajaj Hindustan (BJH) and Balrampur Chini (BRCM), which had carried out significant capacity expansions over the last 2 years.

Demand of UP Sugar Companies

With spot sugar prices in UP falling below Rs14/kg, sugar companies have started making cash losses on sugar. Following the sharp decline in sugar prices across the country, the central government and various state governments (except UP) have already announced relief measures for sugar mills. The central government has announced a Rs1000 per ton subsidy on sugar exports and is also compensating working capital cost on a 2mtons (and the 3mtons declared recently) buffer sugar inventory created and carried by the sugar mills. Various state governments have provided additional subsidies. Maharashtra has announced an additional Rs1, 000 per ton export subsidy in addition to transport subsidy of Rs2 per ton per km for cane crushed after 160 days crushing period and has also abolished purchase tax. Similar subsides have been announced by states like MP, Karnataka and AP.

UP sugar mills association has recently submitted a memorandum to the state government demanding similar subsidies. The memorandum argues that since sugar prices in UP have declined below Rs14/kg, the UP mills paying capacity for sugar cane has been severely eroded. Based on the association's calculations, in the current environment, the sugar mills have a paying capacity of about Rs870 per ton for cane, against the state advised price (SAP) of Rs1250 per ton. The memorandum also states that UP mills are not being able to pay the farmers for cane, and cane arrears up to mid May have already accumulated to Rs19.7bn. (According to the BRCM management who we met this week, total cane arrears in UP have now increased to Rs25bn, with BRCM's own cane arrears at Rs2.5bn).

Figure 3. Statement showing cane price paying capacity in UP for 2006/07 season (Submitted to the UP govt. by the sugar mills association)

	West UP	Central UP	East UP	Average
Expected Realization (Rs/ton)	13100	12850	13100	13000
Less: Conversion cost (Rs/ton)	3610	3560	3490	3550
Balance available for cane price and taxes	9490	9290	9610	9450
Recovery (%)	9.6	9.7	9.8	9.7
Cane price paying capacity per ton (including taxes)	911	901.1	941.8	916.7
Less: Purchase tax, society commission and driage (Rs./ton)	46	46	46	456
Paying capacity for cane (Rs/ton)	865	855.1	895.8	460.7

Source: UP sugar mills association

The key subsidies demanded by the UP sugar mills association are as follows:

1. Remission of purchase tax on cane
2. Remission of society commission

3. Exemption from payment of entry tax on sugar

4. Exemption from sales tax and administrative charges on molasses

5. A subsidy of total amount of difference between state advised price (SAP) and statutory minimum price (SMP) for the 2006/07 season

6. Export subsidy of Rs1000 per ton over the central government subsidy

We estimate that the total subsidies demanded are slightly over Rs3 per kg of sugar produced. If these demands are met by the UP government, we would expect significant improvement in margins for the sugar companies in UP.

Stocks likely to trade near replacement costs

In the current uncertain environment, we expect BJH and BRCM to trade near their replacement costs. We continue to maintain our replacement cost based target prices of Rs229 for BJH and Rs88 for BRCM.

Figure 4. Bajaj Hindusthan – Replacement Cost Analysis

	Capacity (FY08E)	Replacement cost per unit (Rs)	Replacement cost (Rs Million)
Sugar (TCD)	136000	300000	40800
Alcohol (KLPD)	800	3500000	2800
Co-generated Power (MW)	96	40000000	3840
MDF			2400
Total Replacement cost (Rs million)			49840
Total Debt (Rsm)			17500
Current Market Cap (Rs million)			23,072.1
Price Target (Rs)			229.0
Current Discount to replacement cost (%)			28.7

Source: Citigroup Investment Research

Figure 5. Balrampur Chini – Replacement Cost Analysis

	Capacity (FY08E)	Replacement cost per unit (Rs)	Replacement cost (Rs Million)
Sugar (TCD)	73000	300000	21900
Alcohol (KLPD)	420	3500000	1470
Co-gen Power (MW)	74	40000000	2960
Total Replacement cost (Rs million)			26330
Total Debt (Rsm)			4500
Current Market Cap (Rs million)			16902
Price Target (Rs)			88.0
Discount to replacement cost (%)			22.6

Source: Citigroup Investment Research

Bajaj Hindusthan (BJHN.BO - Rs165.05; 1M)

Valuation

Our target price of Rs229 is based on replacement cost analysis. We were earlier using a P/E based valuation methodology, which we believe is no longer relevant in a sharp sugar price down cycle as well as uncertainty over UP state government sugar subsidies that could significantly alter our earnings estimates. In such an uncertain environment, we believe that asset replacement cost (net of debt) will provide the base valuations to the stock. Our replacement cost analysis for BJH is shown below.

We value the sugar assets of BJH at Rs300,000 per TCD, which for 136,000TCD gives a value of Rs4.08bn. We value the 800KLPD alcohol assets at Rs3.5m per KLPD, arriving at a value of Rs2.8bn for the assets. We value the co-generation assets at Rs3.8bn, based on Rs40m per MW valuation. Stripped off the total debt of Rs17.5bn, the net asset valuation of BJH in our view is Rs24bn or Rs229 per share.

Risks

Although our quantitative risk-rating system, which tracks 260-day historical share price volatility, assigns a High Risk to the stock, we rate it as Medium Risk given that the company has successfully completed its first phase of capacity expansion.

The sugar industry in general and BHL in particular, faces significant risks, some of which are structural in nature. The key downside risks include: (1) regulations and the possibility of government intervention in an industry with little pricing power; (2) sugarcane output is governed by various agro-climatic factors; an adverse climate could lead to crop failures, affecting raw-material availability; and (3) specific to BJH is execution risk, as the company is aggressively expanding capacity. If the impact of these risks is greater than we expect, the share price will likely have difficulty reaching our target price.

The key upside risk would be UP government's planned new sugar policy being more favorable than the earlier policy, which could significantly alter sentiment and drive stock price beyond our price target.

Balrampur Chini Mills (BACH.BO - Rs69.50; 2M)

Valuation

Our target price of Rs88 is based on replacement cost analysis. We were earlier using a P/E based valuation methodology, which we believe is no longer relevant is a sharp sugar price down cycle as well as uncertainty over UP state government sugar subsidies that could significantly alter our earnings estimates. In such an uncertain environment, we believe that asset replacement cost (net of debt) will provide the base valuations to the stock. Our replacement cost analysis for BRCM is shown below.

We value the sugar assets of BRCM at Rs300000 per TCD, which for 73,000TCD gives a value of Rs1.47bn. We value the 4202KLPD alcohol assets at Rs3.5m per KLPD, arriving at a value of Rs1.47n for the assets. We value the 74MW surplus power co-generation assets at Rs2.96bn, based on Rs40m per MW valuation. Stripping off the total debt of Rs4.5bn, the net asset valuation of BRCM in our view is Rs19.08bn or Rs88 per share.

Risks

Although our quantitative risk-rating system, which tracks 260-day historical share price volatility, assigns a High Risk to the stock, we rate BRCM as Medium Risk given that the company has successfully completed part of its capacity expansion and has raised capital for the remaining capex. We believe execution and financial risks stand mitigated to a large extent. The following risks could impede the stock from reaching our target price:

• Regulations and the possibility of government intervention in pricing in an industry that has little pricing power.

• Sugarcane output is governed by various agro-climatic factors. An adverse climate could lead to crop failures, affecting raw-material availability.

• The company is aggressively expanding capacity and any delay could hurt its near-term profitability.

• BRCM is looking at investing in power generation, which is a highly regulated industry. Any changes in government regulations could hurt business prospects. The key upside risk would be if the UP government's planned new sugar policy is more favorable than the earlier policy, which could significantly alter sentiment and drive stock price beyond our price target.

Appendix A-1

Analyst Certification

I, Princy Singh, research analyst and the author of this report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

Bajaj Hindusthan (BJHN.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Princy Singh (covered since July 21 2005)

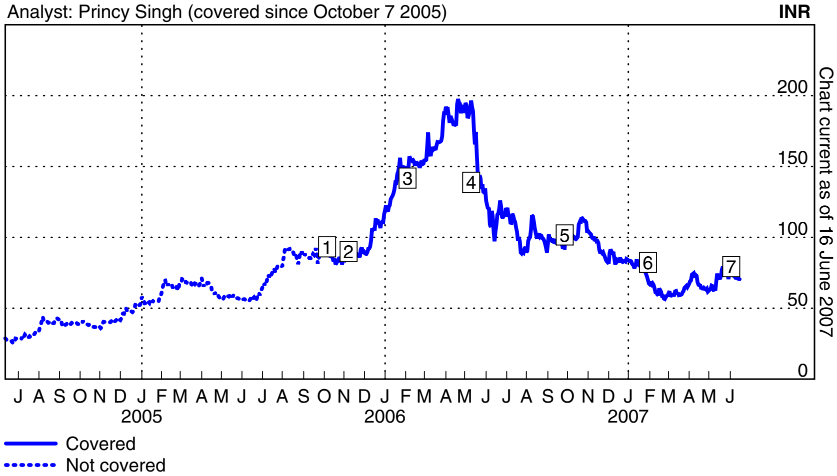
#	Date	Rating	Target Price	Closing Price
1:	21 Jul 05		-	164.45
2:	4 Aug 05	*1H	*216.00	213.35
3:	6 Oct 05	*1M	*280.00	211.80
4:	12 Dec 05	1M	*320.00	237.40
5:	17 Jan 06	1M	*440.00	362.00
6:	3 May 06	1M	*650.00	533.65
7:	27 Sep 06	1M	*467.00	299.00
8:	30 Jan 07	1M	*300.00	NA
9:	4 Jun 07	1M	*229.00	165.70

*Indicates change.

Balrampur Chini Mills (BACH.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Princy Singh (covered since October 7 2005)



#	Date	Rating	Target Price	Closing Price
1:	6 Oct 05	1H	130.00	87.85
2:	8 Nov 05	1H	*138.00	88.45
3:	3 Feb 06	*1M	*170.00	147.05
4:	10 May 06	1M	*245.00	196.50
5:	27 Sep 06	1M	*130.00	92.70
6:	30 Jan 07	1M	*107.00	NA
7:	4 Jun 07	*2M	*88.00	74.30

*Indicates change.

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