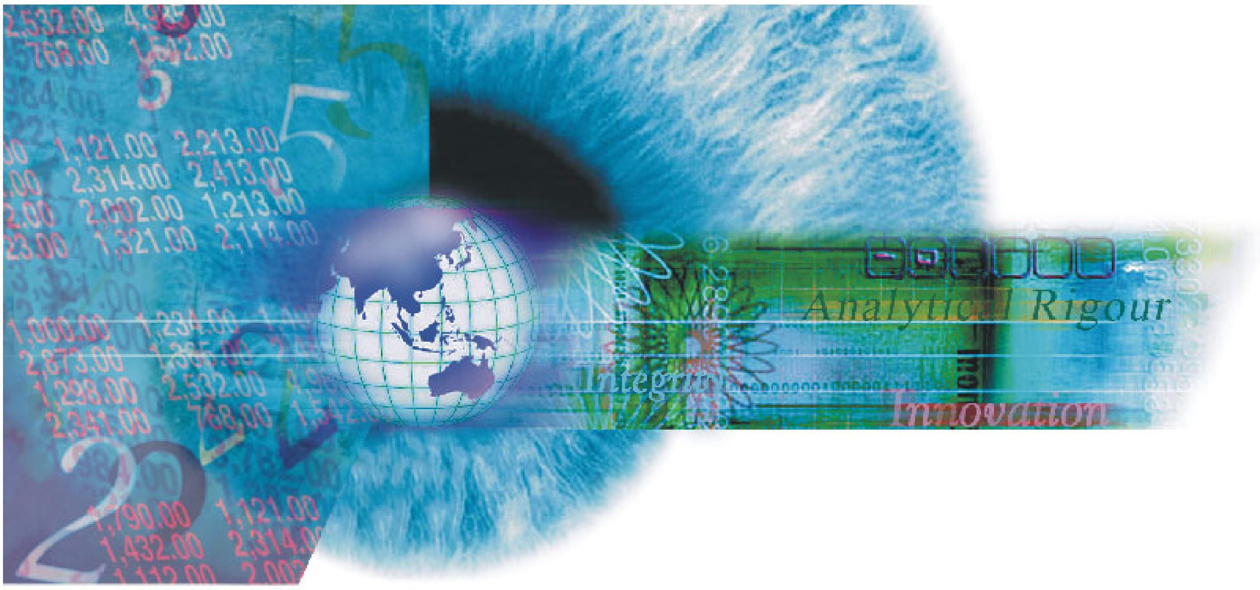

CRISIL RESEARCH

Knowledge for Action

Impact of customs duty cut

January 2007

Macroeconomic impact

With inflation in the fuel group under 4 per cent, primary articles and manufactured products have been the key drivers of the recent spurt in inflation. As both supply and demand side factors are associated with rising inflation, a broad-based approach is required to tame it. The reduction in customs duty in select raw materials and machinery can be viewed as a part of this approach. This fiscal measure will help cap the ability of the domestic producers to hike the prices of these goods. This should not be viewed as a panacea for inflation control but as a step that will essentially help to moderate it in the manufactured products group, which has recently seen a rise in pricing power. The above mentioned measures have the potential to bring down overall inflation by about 20 basis points.

Impact on sectors

Copper 1
Aluminium 1
Zinc 1
Stainless steel 2
Carbon black 2
Cement 2

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Impact of customs duty cut on various sectors

Copper

Impact-Negative

The reduction in the basic customs duty on copper to 5.0 per cent from 7.5 per cent will have a major impact on the copper industry, as landed costs (at current international prices), are expected to decline by around Rs 7,500 per tonne. Since landed costs are now almost on par with domestic prices; domestic prices are likely to witness a similar decline. As a result, PBIT margins of domestic copper manufacturers are expected to fall up to 250-300 basis points from the current levels of 6-8 per cent.

Aluminium

Impact-Neutral

The reduction in the basic customs duty on aluminium to 5.0 per cent from 7.5 per cent will not have a major impact on the aluminium industry as landed costs (at current international prices), are expected to fall by Rs 3,500-Rs 4,000 per tonne. However, the domestic market may not witness a corresponding price decline as landed costs will still be higher than domestic prices by Rs 20,000 per tonne (historically, the difference between landed costs and ex-factory prices has been around Rs 10,000). PBIT margins of domestic aluminium manufacturers will fall by only 100-150 basis points even assuming that prices drop to the extent of the decrease in landed costs. This is very minimal considering margins of more than 45 per cent this year. The customs duty on calcined alumina has also fallen to 5 per cent; however, this is not likely to have a significant impact as most producers are integrated and there is no domestic market for alumina.

Zinc

Impact-Neutral

Following the reduction in the basic customs duty on zinc from 7.5 per cent to 5.0 per cent, the landed cost of zinc is expected to decrease by around Rs 5,000 per tonne at current prices. However, the domestic market will not witness a corresponding price decline, as landed costs will still be higher than domestic prices by Rs 8,000 per tonne (historically, landed costs and ex-factory prices have been at same levels). The drop in prices is not likely to adversely affect margins of players like Hindustan Zinc, with high margins of over 75 per cent this year.

Stainless steel

Impact - Negative

The customs duty on stainless steel has been reduced from 7.5 per cent to 5.0 per cent. The reduction in duty will result in the lowering of landed costs of imported stainless steel by around Rs 4,300 per tonne. Prices in the domestic market are also expected to decline comparably. This will have a marginally negative impact on the alloy steel/stainless steel industry. The operating profit margins of the companies are expected to fall by 200 basis points.

Although duties on the various inputs of the steel industry viz, ferro-alloys, refractories and zinc have been reduced, the cumulative impact of these measures will be marginal on industry profitability.

Carbon black

Impact – Marginally negative

Although carbon black is not imported, the reduction in customs duty from 10 per cent to 5 per cent will have an impact on the industry. The average price for N330 grade carbon black which was Rs 51,200 per tonne (April 2006-January 2007) is expected to decline up to 5 per cent. Player margins are expected to decline by 100 basis points as the duty on carbon black feedstock (average price of Rs 16,500 per tonne for April-November 2006) has also been reduced to the same extent.

Cement

Impact-Neutral

The reduction in the customs duty on portland cement from 12.5 per cent to zero is not expected to have any impact on the domestic cement industry. This is primarily on account of domestic cement prices being lower than landed prices even after the cut in the customs duty. Handling of cement traffic at Indian ports is fairly inadequate and the possibility of importing large quantities of cement in the short-to-medium term appears unlikely. This import duty cut will act as a ceiling to ensure that cement prices do not rise beyond a particular price band.