June 2nd, 2010

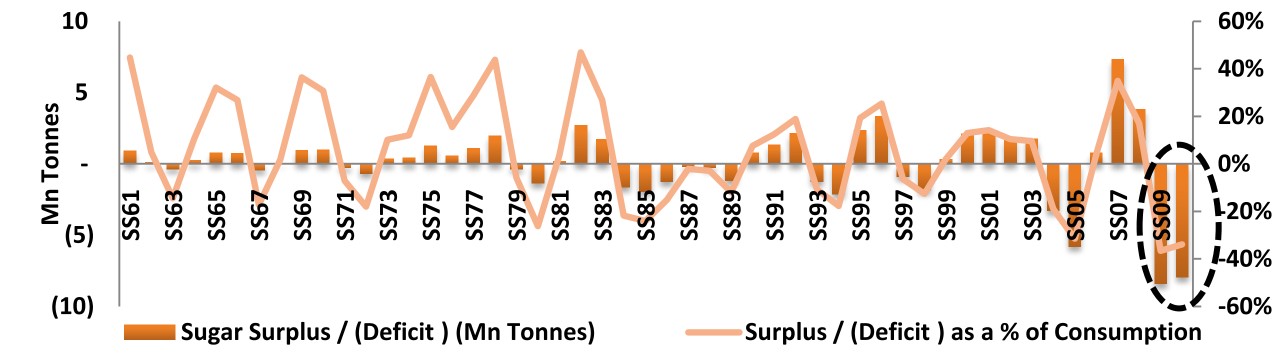
Indian Sugar Sector - Update

Largest ever domestic sugar deficit for two consequent years

In SS09, India faced the most rigorous sugar deficit ever of 7.96mn tonnes, which was expected to extend to SS10 also with almost similar enormity resultant to drought caused by erratic rainfall, translating into the biggest ever up-cycle in the Indian sugar industry. The sugar production in SS10 was initially estimated at 15mn tonnes against the estimated demand of 23mn tonnes, leading to a 7mn tonnes deficit in the world's second largest sugar producer and largest sugar consumer country. This set the domestic sugar prices soaring.

Sugar production in India came down to 14.5mn tonnes in SS09, dropping by nearly 50% from the 28.3 million tonnes produced in SS07. From a record export of about 5mn tonnes of sugar achieved in SS08, India had to contract significant 2.5mn tonnes of sugar import in SS09. With the initial sugar production estimate of 15mn tonnes, India was expected to import 7mn tonnes of sugar equivalent to the deficit.

Chart 1: India - Sugar Surplus/ (Deficit)



Source: Systematix Institutional Research

India permitted duty free sugar imports in February 2009. Global markets, which were already facing low supply due to floods in Brazil, sensed this initial signal of a huge demand supply gap in India and the prices in the international market started moving up since then and touched 29-year high of 30.4 cents on February 1st 2010.

The sugar production estimate was later revised to 16.8mn tonnes and then subsequently 18.5mn tonnes, mainly because of the improved yield per hectare witnessed in the plant cane which comes in the second half of the season and lower diversion to Gur and Khandsari resultant to high prices paid by the millers. Higher than expected production and imports available at zero duty led to softening of sugar prices in the country. Fall in global sugar prices have also contributed to the same. This has been the most extraordinarily volatile scenario where prices moved down from Rs 44 to Rs 29 per kg in a four month period domestically and prices almost halved internationally in the same period.

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Critical Inventory Level

Even with the higher sugar production estimate of 18.5mn tonnes, India is expected to end the sugar year 2009-10 (year ending 30th Sept, 2010) with two and a half month's inventory, which is one of the lowest historically. Thus, there is very low margin of safety between demand & supply in the domestic market. Thus, the domestic sugar prices are not expected to see too much of downside from current levels until fresh supply comes in at the beginning of next crushing season.

The Surplus to Consumption Ratio in SS09 plunged to -35% from the high of 42% two years back; and Closing Stock to Consumption ratio tumbled down to 20% from 45% in the previous year. Though the deficit is expected to continue in SS10E with lower magnitude with the Surplus to Consumption Ratio recovering to -18%; even with the higher revised production estimate of 18.5mn tonnes the Closing Stock to Consumption ratio at 21%, will continue to be almost at previous years' low level of 20%. Due to this, the sugar prices are expected to remain firm around current levels.

Table 1: India Sugar Demand Supply (Mn Tonnes)

	2006-07	2007-08	2008-09	2009-10E	2010-11E
Opening Stock as on 1st Oct.	4.3	10.9	10.0	4.4	4.7
Sugar Production (Oct-Sept)	28.3	26.3	14.5	18.5	24.0
Imports	0.0	0.0	2.5	4.3	0.0
Total Available Supply	32.6	37.2	27.1	27.2	28.7
Off Take for					
Sugar Consumption (Internal)	20.0	22.2	22.5	22.5	23.0
Exports	1.7	4.9	0.2	0.0	0.0
Total	21.7	27.1	22.7	22.5	23.0
Closing Stock on 30th Sept.	10.9	10.1	4.4	4.7	5.8
Closing Stock as a % of Consumption	55%	45%	19.6%	20.9%	25.1%
Closing Stock (Inventory Months)	6.5	5.4	2.4	2.5	3.0
Y-o-Y Growth in consumption	8.1%	11.0%	1.4%	0.0%	2.0%
Surplus / (Deficit)	8.3	4.1	(7.9)	(4)	1.05
Surplus to Consumption Ratio	42%	19%	-35%	-18%	5%
Imports as % of Consumption			11%	19%	0%

Source: ISMA, Systematix Institutional Research

Government measures to curb prices are being rolled back gradually thus cooling off the downside pressure on domestic sugar prices

The Union government took a series of measures over a period of time, including zero import duty on sugar, allowing imports of raw sugar without imposing an export obligation, imposing restrictions on stocks kept with bulk consumers and then imposing a weekly quota obligation on mills. The collective effect of these measures was to improve availability. The government measures along with a changed production scenario were sufficient to pull prices down.

All these measures have now outlived their utility because they were on a certain premise. The premise having changed, now the Government has gradually started rolling back the tightening measures. If sugar prices do not rule at certain levels, India may not be able to sustainably maintain its production at a level that it meets its domestic requirement in the coming year.

The weekly quota obligation has already moved back to a monthly obligation and bulk consumers can now keep 15 days of stock instead of 10 days earlier. Imposing import duties on white sugar is the next key demand of the industry. Following the low margin of safety between demand & supply and the rollback of government measures, the prices have moved slightly northwards in the past few days.

The government is expected to consider imposition of duty on white sugar import

With respect to the rolling back of the measures taken by the Union Government, the imposing import duty on white sugar is the next key demand of the industry. With the imposition of import duty on white sugar, supply of imported sugar will be cut off. The sugar demand of bulk consumers which is currently being partially catered by the sugar imports, will shift entirely towards the domestic produce. This will give a further boost to the demand.

However the government is expected to watch the progress of monsoon as well as cane planting area before imposition of the import duty, which might take some time.

Demand to revive among bulk consumers

The government has relaxed the stockholding limit on bulk sugar consumers, such as ice-cream and beverage makers, by allowing them to keep the sweetener for 15 days instead of the current 10 days. The decision came amid improved production outlook for the current 2009-10 crop year (October-September) and a sharp fall in sugar prices of about 34% in the last four months.

The demand for domestic sugar is expected to revive among bulk sugar consumers, who account for around 70% of the domestic sugar consumption, as they switch from the imported sugar to domestic sugar. The bulk consumers have mostly exhausted their imports and have started buying from domestic players.

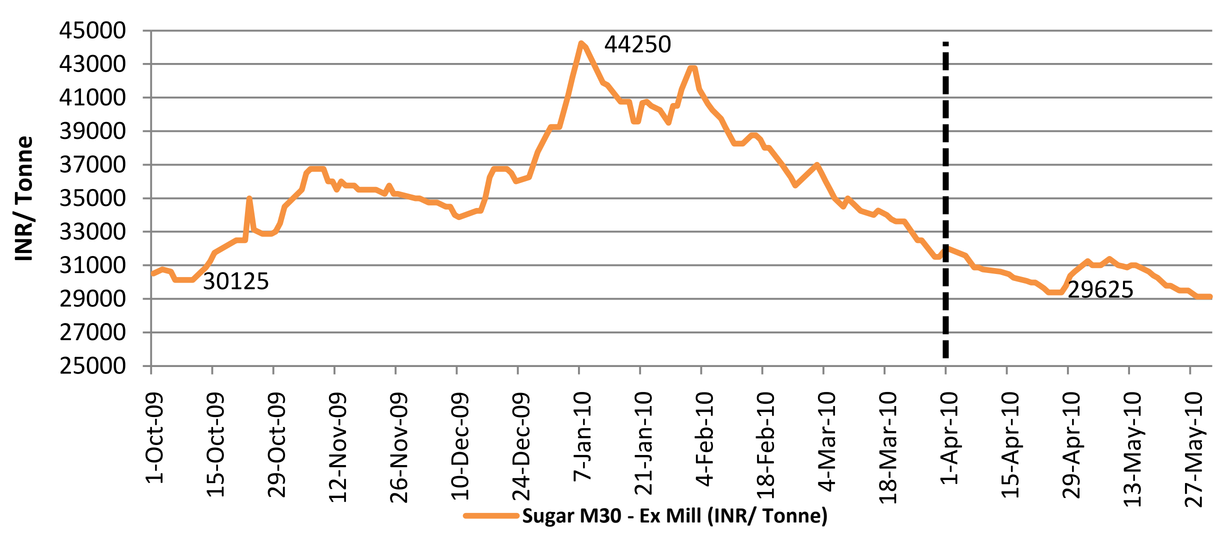
The summer months are the peak consumption months. There has been 29% increase in soft drinks volumes from last month. The increased demand from institutional buyers like cold drinks, dairy industry etc is likely to boost the demand for sweetener and thus contribute in limiting the potential downside from the current levels.

Sugar companies to absorb loss on account of high cost inventory of SS10

Although for SS10, the FRP was 129.84 per quintal and SAP in UP was Rs 165 per quintal, the average cane cost paid by the sugar companies was around Rs 250 per quintal due to scarcity of cane as against an average of Rs 160 per kg in SS09. A lot of players also imported and refined raw sugar for sale in domestic market.

The sugar realization in SS10 has ranged between Rs 29/kg to Rs 42/kg. The sugar players enjoyed supernormal profits of around Rs 8 to Rs 12 per kg on the sugar sold in the initial part of the year as the average cost of sugar in SS10 is around Rs 28/kg to Rs 34/kg. Thus, the sugar players are currently carrying high cost inventory. As India is expected to end the year with two and a half months of inventory, the entire high cost inventory is expected to get exhausted by mid December, when the new season's produce will enter the market. The sugar players' bottom-line is expected to take a hit due to absorption of loss on account of high cost inventory of SS10 until December 2010.

Chart 2: Sugar M30 – Ex Mill (INR/ Tonnes)



Source: Bloomberg,Systematix Institutional Research

Sugar production in SS11E is expected to increase by ~30% to ~24mn tonnes. The Indian Meteorological Department expects the monsoon to be 98% of 50 year average. The consumption demand, with an expected growth of 2% Y-o-Y, is expected to be ~23mn tonnes. Consequently, India is expected to end the year with 3 months inventory.

Hence, with these underlying assumptions, India's production in SS11 will only be sufficient to meet its consumption demand. Thus, even though the sugar realization may soften once the fresh supply of the new sugar season enters the market, we do not expect the prices to dip to such low levels at which the sugar players are unable to recover their cost. For SS11 FRP has been announced at Rs 139.12 per quintal. The average cane cost for SS11E is expected to be around Rs 180 per quintal and average sugar cost is expected to be ~Rs 22-23per kg. We expect the sugar players to make normal profit of around Rs 2-3 per kg on fresh produce in such a scenario.

However, since the margin of safety between consumption demand and production in SS11E is also expected to be very low, even slight variation on either side in any of the factors affecting the production like monsoon, cane acreage etc or any change in consumption demand is likely to impact the sensitive sugar realizations largely & thus may impact the bottomline positively or otherwise.

Ethanol to boost the performance of Distillery Segment

The 5% ethanol blending program is also expected to come into force in near future. The Empowered Group of Ministers met and decided that ethanol blending program has to be implemented at 5% to begin with and later depending on the availability of molasses to move to 10%. Ethanol price is likely to be revised upwards from Rs 21.5 per liter and announced at Rs 27 per liter.

The Indian sugar industry has ethanol production capacity of ~1280mn liters pa. The 5% blending if made mandatory will create a demand for ~750mn liters of ethanol pa. The Oil Marketing Companies will create a new demand for ~ 50% to 60% of the production. Thus, ethanol blending program is expected to boost the distillery segment revenues as a result of expect higher volumes and higher realizations going forward.

Power – Open access & Coal

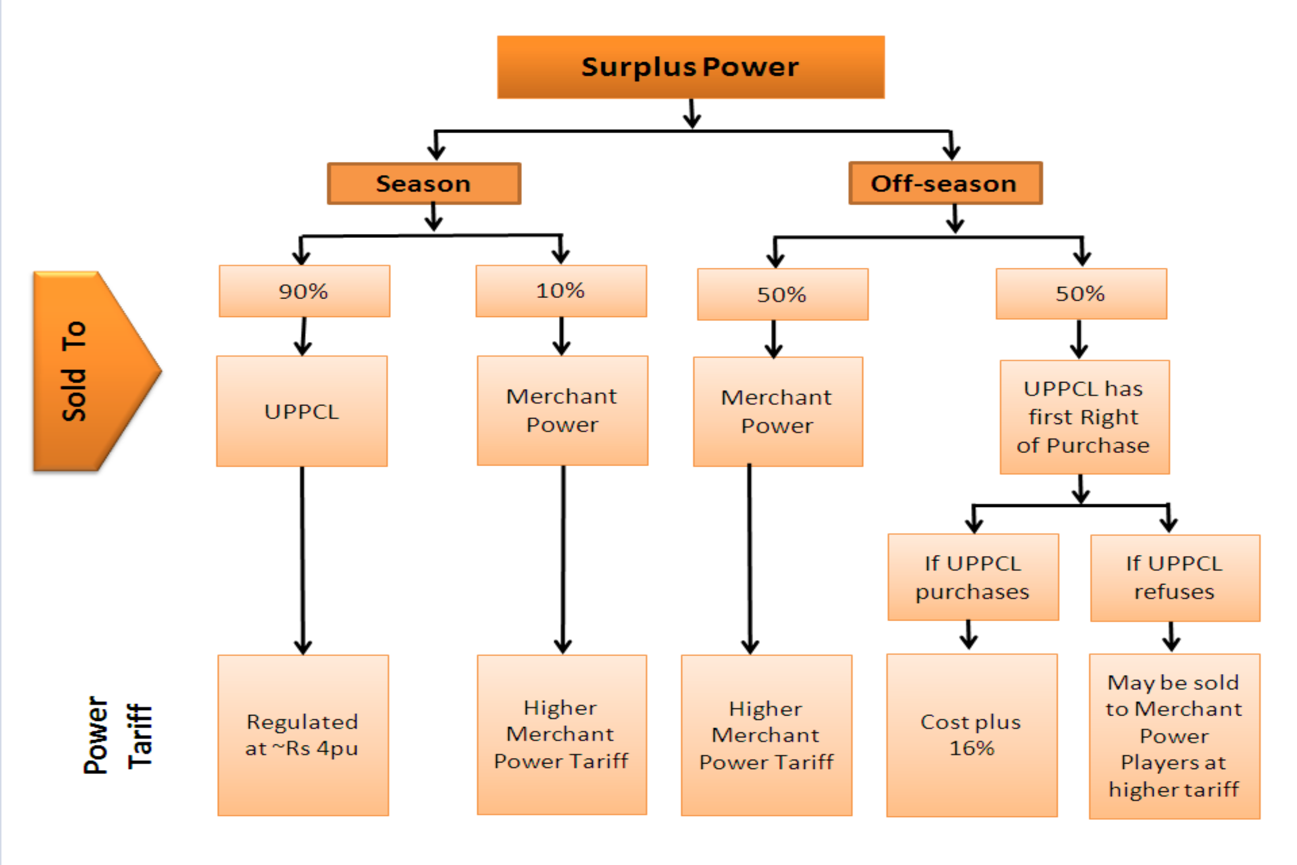
India has an acute shortage of power, which is retarding the nation's progress, leading to a tremendous opportunity loss for industry and the economy.

In order to bridge the growing power demand-supply gap, the government introduced the Electricity Act 2003 and a number of subsequent reforms which created many new opportunities for the country's power sector. As the industrial growth is back on track after the financial crunch and global economic slowdown, cogen facilities will be one of the main sources for securing energy requirement for industries. The UP government introduced the new UP 'Energy Policy 2009' in October 2009 which intends to introduce one such initiative to bridge the gap.

In the new power policy, to enhance the utilisation of the cogeneration plants, UP government has permitted usage of fossil fuel such as coal or gas to generate power in off season and sale of 50% of such generation through Open Access to merchant power players. This has the potential to significantly enhance the generation as well as realization by sugar mills in the offseason.

For the balance 50%, the UPPCL has the first right of purchase, at cost plus 16% basis. In case if the UPPCL refuses to buy such power, the sugar mill is free to sell that portion also to merchant power players. In addition to this, during season also, 10% of the power can be supplied to the merchant power players, for the next ten years.

Chart 3: New UP Energy Policy chart



Source: Systematix Institutional Research

Due to huge scarcity of bagasse and in order to take advantage of the policy allowing open access of power and use of coal, many sugar players converted their boilers to multi-fuel boilers. This has lead to structural change in the industry. The cogen divisions of such players, which used to depend on the availability of bagasse & operate only during the season, will now operate & export power 300 days a year; thus increasing the power units exported substantially. In addition to this, with the grant of open access, the realization for power sold through open access is expected to be higher especially in summers.

Higher by-product gains

With increase in availability of cane sugar, the production of its by-products molasses & bagasse has also increased, thus cooling off their prices significantly. Considerably lower raw material cost along with better realizations in Distillery & Cogen divisions is expected to result into improved margins and hence higher by-product gains per kg of sugar produced.

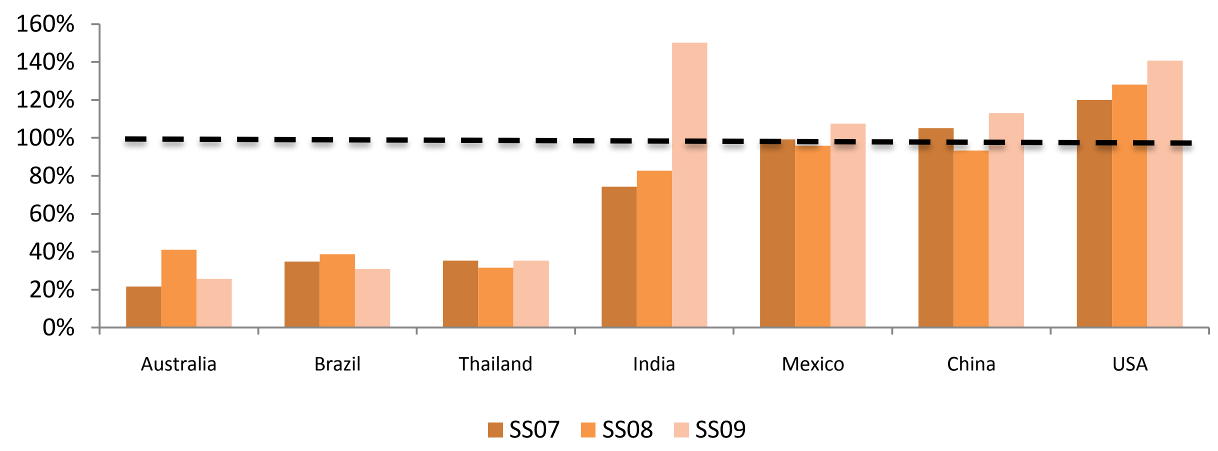
Thus increased availability of bagasse & molasses consequent to huge sugar volumes, low costing, much higher byproduct gains, minimal loss on levy sugar, better realizations for ethanol and power and 300 days of power are expected to collectively elevate the performance of the sugar players going forward.

World Sugar Scenario

International Sugar Trade

On an average, around 75% of the sugar produced is consumed within the country of origin and the balance is traded in the international markets. The international sugar trade is dominated by Brazil, Australia and Thailand as their consumption to production ratio is lower than other sugar-producing nations.

Chart 4: Consumption to Production Ratio of Major Sugar Producing countries



Source: Systematix Institutional Research

World Sugar Market witnessed one of its highest volatility during SS09

In SS09, excess rain in Brazil and drought in India crimped cane output from the world's two biggest growers and set the international sugar prices soaring.

Chart 5: World Sugar Production

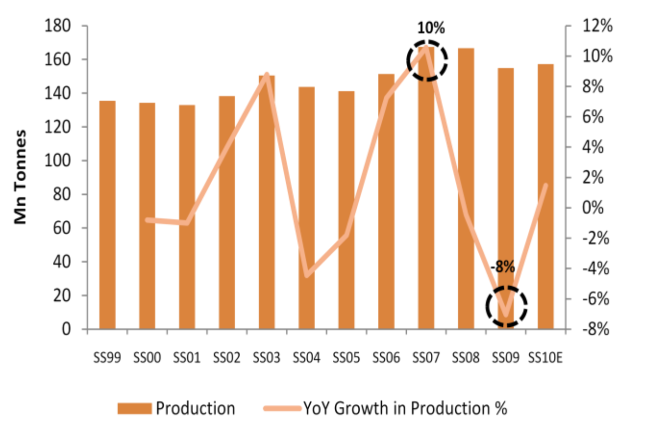
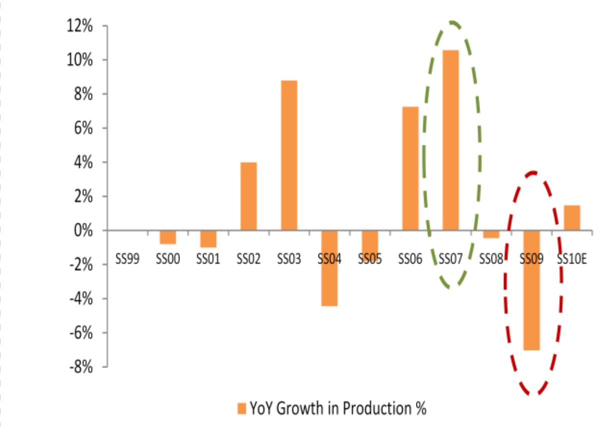


Chart 6: Volatility in World Sugar Production



Source: ISMA, Systematix Institutional Research

Table 2: World Sugar Demand -Supply Scenario (Mn Tonnes)

Marketing Year (Oct-Sept)	SS04	SS05	SS06	SS07	SS08	SS09	SS10E
Opening Stocks	69.0	68.0	61.0	64.0	72.0	74.0	63.0
Sugar Production	144.0	141.0	152.0	167.0	167.0	153.0	157.4
Y-o-Y Growth %		-2%	8%	10%	0%	-8%	3%
Imports	49.0	51.0	54.0	52.0	51.0	54.0	57.9
Total Availability	262.0	260.0	267.0	283.0	290.0	281.0	278.3
Domestic Consumption	142.0	145.0	147.0	154.0	160.0	161.0	165.4
Y-o-Y Growth %		2%	1%	5%	4%	1%	3%
Exports	52.0	54.0	56.0	57.0	56.0	57.0	58.7
Closing Stocks	68.0	61.0	64.0	72.0	74.0	63.0	54.2
Surplus/(Deficit)	2.00	(4.00)	5.00	13.00	7.00	(8.00)	(8.00)
Stock/Consumption Ratio	48%	42%	44%	47%	46%	39%	33%

Source: F.O.Licht, Bloomberg, Systematix Institutional Research

In the past few months, prices plunged as much as 57% from a 29-year high of 30.4 cents on Feb 1st as importers slowed purchases and rising output from Brazil and India, the largest growers, was forecast to erase a global production deficit next year. However, the surplus won't necessarily weigh on world trade as exporters cap sales to replenish stockpiles. Dwindling inventories and lower prices may revive purchases.

Low Global Inventories

According to ISO, the global stockpiles are expected to drop to 52.8mn tonnes, or 32% of total consumption, in the year ending September 30th, the lowest ratio in 20 years. The new season will begin with a critically low level of stocks. Inventories in India, the largest sugar consumer, are equal to about two and a half months of consumption. In the U.S., the stocks-to-use ratio is 7.9%, the lowest level in 53 years. The slump may end for sugar, as importers replenish stockpiles and as demand increases for ethanol made from cane.

Whites to remain tight for the next few months

The global refined sugar market is expected to stay in deficit for a few months, with import demand exceeding available exports by 1 million metric tonnes, even as raw-sugar production expands. The deficit is also impacting raw sugar prices indirectly. The shortage is caused by limited refining capacity and the preference of Brazilian millers to produce the raw variety. The demand for whites by Pakistan, Egypt etc is also expected to have added to the demand and hence, the rise in prices.

Production of world's second largest exporter may decline

El Nino delayed rainfall in Thailand which usually starts in May & lowered water levels in the reservoirs. Thailand production for crop year starting November 2010 may decline if drought persists till July. However, if the decline is not significant, it may be made good with the increased production in other countries.

All these factors clubbed together are expected to limit any huge downside to the global sugar prices from current levels for a few months. The global prices are expected to support the domestic prices.

Indian Sugar Industry - Performance Outlook

We do not expect the domestic sugar prices to have too much downside from the current levels until mid December when the high cost inventories of SS10 will get exhausted and the lower cost fresh sugar of the SS11E will be available in the market. We expect the sugar players to absorb losses on account of the sale of high cost sugar inventory until then, contrary to the supernormal profits they recorded in the initial part of the year. However, we expect the realization & margins from by-products to balance the overall performance to an extent. Going forward, we expect the sugar players to make normal profits in sugar business in SS11E. The by-products in distillery & cogen segments will continue to elate the overall performance even in SS11E.

Bull-Bear Scenarios

Table 3: Sugar Scenario Analysis (SS11E)

	Bull Case	Bear Case
Global Demand Supply	Sugar Deficit	Sugar Surplus
Monsoon & Yields	Poor or excessive rainfall may lead to lower yields & hence SS11 production could be lower than the expected 24mn Tonnes.	Good timely monsoon may lead to higher yield & hence bumper crop, thus creating a glut.
Cane Area	Inspite of the handsome cane price paid to farmers, the increase in cane area could be lower than expected due to attractiveness of alternative crops.	Higher than expected increase in cane area could enhance production.
Diversion to Alternate Sweeteners	High diversion due to better price paid by the Gur & Khandsari Units	Low Diversion due to cane price paid by mills being more attractive than that by Gur & Khandsari units.
Recovery Rate	Lower than expected Recovery Rate	Higher than expected Recovery Rate
Consumption	Significant growth in consumption	Consumption Remains Stable or drops
Ethanol Blending Program	5% ethanol blending is made mandatory at Rs 27 per liter	Ethanol blending is not implemented
Power	Buoyant Power Rates under open access	Power rates under open access subdued
	A combination of these circumstances will create a domestic deficit which coincides with the global deficit and hence will result in a sugar up-cycle with prices soaring both internationally & domestically.	**A combination of these circumstances will result in a bumper crop in domestic market along with a glut in the international market and hence will result in a sugar down-cycle with both - international & domestic-prices dipping.**

Source: Systematix Institutional Research

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BUY (B)	The stock's total return is expected to exceed 20% over the next 12 months.
ACCUMULATE (A)	The stock's total return is expected to be within 10-20% over the next 12 months.
REDUCE (R)	The stock's total return is expected to be within0-10% over the next 12 months.
SELL (S)	The stock's is expected to give negative returns over the next 12 months.
NOT RATED (NR)	The analyst has no recommendation on the stock under review.

Industry Views

ATTRACTIVE (AT)	Fundamentals /Valuations of the sector is expected to be attractive over the next 12-18 months.
NEUTRAL (NL)	Fundamentals /Valuations of the sector are expected to neither improve nor deteriorate over the next 12-18 months.
CAUTIOUS (CS)	Fundamentals /Valuations of the sector are expected to deteriorate over the next 12-18 months.

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