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Professional Risk Opinion

Cement Sector: Battling the cost wave

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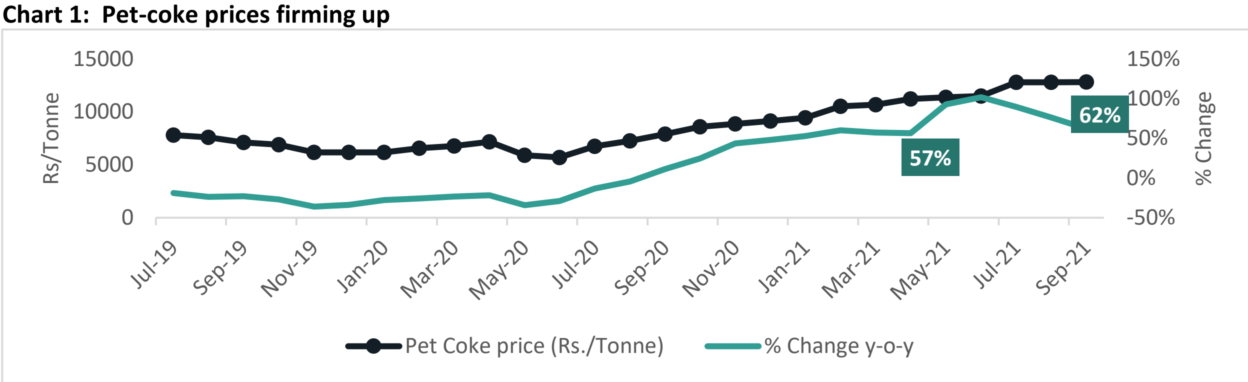
The macros of the cement industry remain positive in the long term driven by revival in demand from the urban housing sectors, upcoming infrastructure projects as well as generous rural demand, though presently the sector is riddled with the cost-side issues. For the month ending September 2021 key cost constituents which are pet coke, international coal and diesel are up 20%,111%, 21% respectively from March 2021 levels. Combined impact of higher input costs on production cost of cement is expected to be around Rs.275 – 290 per tonne. While there is heightened focus on efficiency measures, we believe it would still be insufficient to fully offset the higher energy and freight costs.

The elevated cost inflation coinciding with seasonally weak quarter would pinch margins of the cement players in Q2FY22. With the seasonal demand picking up in October 2021, cement companies have hiked prices across regions in the range of Rs.10-Rs.15 per bag to counter the adverse impact of elevated costs. With cost inflation having firmed up unabated and impacted all the players, it is unlikely that the entire increase can be passed on. The companies are expected to witness decline in PBILDT levels to the extent of Rs 100 - 150 per tonne (200 - 250 bps margin impact) for remaining quarters if the costs remain at elevated levels. As costs head northwards, the higher input costs and freight costs are likely to dent the margins of cement players in FY22 but healthy realisations on the back of strong demand are likely to limit margin contraction.

Increase in input prices, further intensified by ongoing shortage of coal

While there has already been continued increase in coal prices in past one year, pet coke, the other key raw material has also witnessed volatility in prices. The prices of pet coke have increased from Rs.5,697/MT in June 2020 to Rs.10,662/MT during March 2021, and further soared high with average price of Rs.12,802/MT in September 2021 which is 62% higher y-o-y.

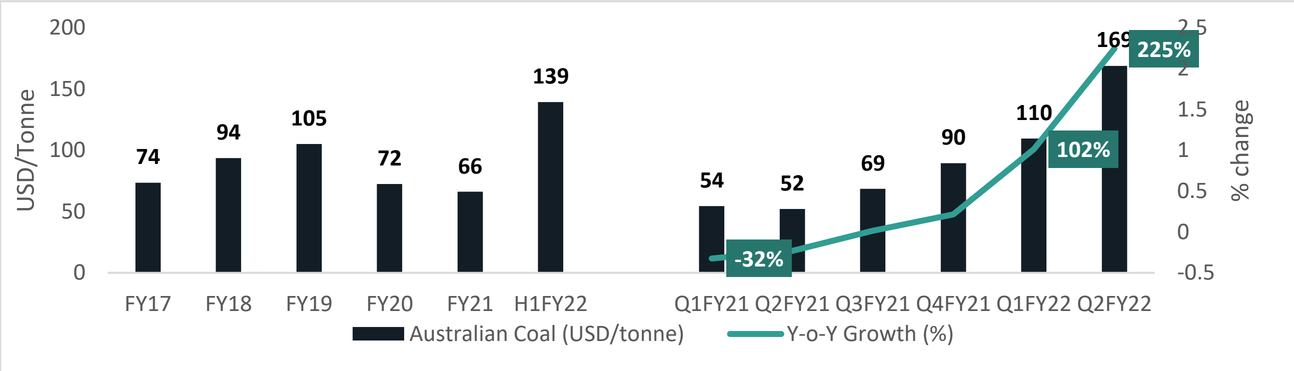
Chart 1: Pet-coke prices firming up



Source: Coal India, CARE Ratings

The issue has been further intensified by acute shortage of coal in the country due to which despatch of coal fell sharply for sectors like cement, steel, sponge iron and other sectors like fertilizers, textile, chemicals etc as collieries prioritised fuel supply to coal-starved power plants to ensure uninterrupted electricity supply. While the national coal companies, Coal India Ltd (CIL) and Singareni Collieries Company Ltd (SCCL), have continued to improve the total despatches over the years, the cement players are faced with acute shortage of coal supply which is largely attributable to unprecedented increase in imported coal prices. The price of imported coal has witnessed more than 100% increase in September 2021 from March 2021-end prices largely attributable to China-related issues of surging power demand, its slower coal production and unofficial restriction on usage of Australian coal by China. Coal stockpiles in China are also at critically low levels, whereas demand is at all-time high which is driving global prices higher as China is importing coal at very high prices to meet its growing domestic demand driven by increased economic activity post pandemic.

Chart 2: Trend in international coal prices



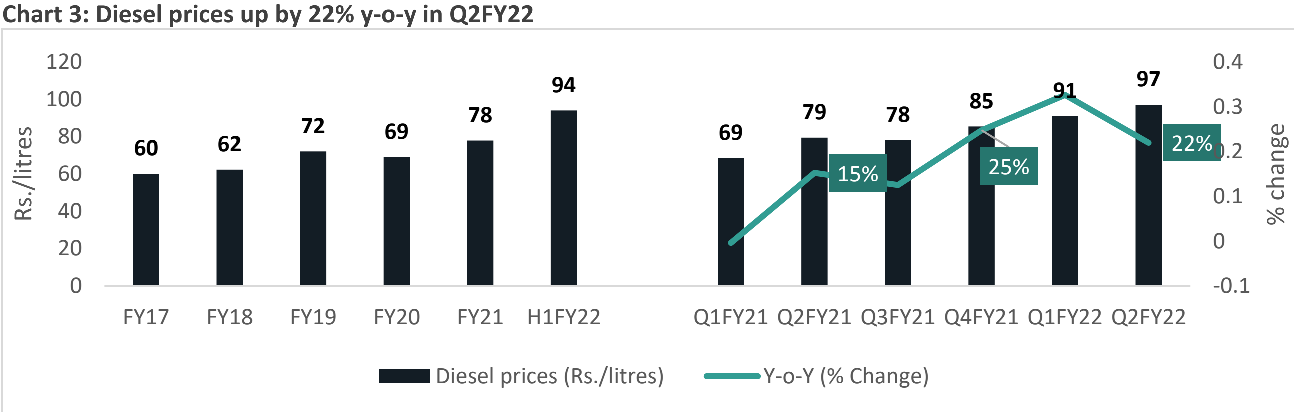
Source: CMIE, CARE Ratings

The full impact of increase in the input costs in FY22 so far remains to be seen as majority of the companies were holding lower-cost inventory of coal so far. This cost is likely to increase by around Rs.175 - 200 per tonne of cement. To reduce their dependence on non-renewable fuels like coal and pet coke, few players are resorting to alternate green fuels such as solar and wind power generation plants, however, the share of the same is still low.

High freight costs- another pinch in the overall profitability

Cement companies incur high transport and logistics cost in both manufacturing as well as distribution process. Procurement and inward movement of raw materials like coal, transportation of clinker to the grinding units and distribution of cement to the markets entail high logistics cost.

Chart 3: Diesel prices up by 22% y-o-y in Q2FY22



Source: CMIE, CARE Ratings

Majority of cement players operate by setting up a mother plant at limited locations and split grinding units spread out in different regions from where cement is sold. Due to limited connectivity via railways in different parts of the country, the dependence is higher on road transportation, which in turn, leads to high vulnerability to fluctuation in diesel prices. The continued increase in diesel prices has led to unprecedented rise in fuel bills for the cement players. This cost is likely to impact the cost of production by around Rs.100-110/MT of cement.

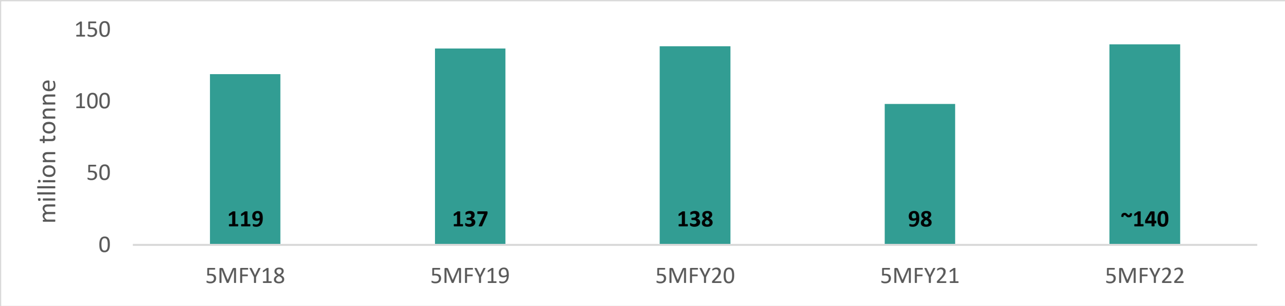
Globally, the oil prices are inching up, which has resulted into increase in the diesel prices and in turn elevated the transportation costs for the industry. Players with lower lead distances are expected to fare better than the ones with lower spread-out infrastructure. Furthermore, a spike in crude oil prices may also have a bearing on the packaging cost. Cement is packed in either high-density polyethylene bags or laminated woven paper bags. Fluctuation in crude oil price may impact the prices of polyethylene bags.

The elevated cost inflation would pinch margins of the cement players as it is unlikely that the entire increase can be passed on. The companies are expected to witness decline in PBILDT levels to the extent of Rs 100 - 150 per tonne for remaining quarters if the costs remain at elevated levels. Although the profitability is likely to moderate, the sector would continue to benefit from the strong demand momentum and firm realisations across regions.

Demand momentum to continue and prices expected to remain firm

The cement industry is expected to ride the upcycle buoyed by high volume growth, majorly driven by revival in demand from the urban housing sectors, upcoming infrastructure projects such as construction of roads, railways, highways as well as generous rural demand. The sector shall also benefit from the pent-up demand due to halt of all new projects during covid era. CARE Ratings expects the overall cement production to reach pre-covid levels by registering a robust mid-teen growth in FY22 over a low base of FY21.

Chart 4: Industry production to transcend to pre-pandemic levels in FY22



Source: CMIE, Office of Economic Advisors, CARE Ratings

Cumulative cement production has increased by around 42% during the first five months ending August 2021 over the corresponding period of the previous year. With healthy growth in volumes coupled with stronger balance sheets, many cement players have planned capacity additions to maintain their market shares. With the strong demand momentum to sustain, the realisations are also expected to remain firm and limit the margin contraction of the cement players amid cost headwinds.

Long-term triggers and things to watch out in the sector

- Demand: Higher government spending on infrastructure and low-cost housing and a favourable-base effect as well as the government's focus on the upcoming elections would spur demand for cement in coming years.
- Capacity utilisation: Utilisation to rise again in the medium term from FY21 levels on the back of improving demand outlook but as new planned capacities of around 100-110 million tonnes gets commissioned over FY22 – FY25E, it is likely to affect utilisation levels to some extent.
- Realisations: The cement prices are expected to largely remain sustained at higher levels, driven by demand drivers, increased consolidation in the industry and the higher input costs which would necessitate passing on of the elevated costs to some extent.
- Costs: As costs head northwards, the higher input costs and freight costs are likely to affect the margins of cement players but healthy realisations on the back of strong demand likely to limit margin contraction.

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