



Confederation of Indian Industry

CII Southern Region

Industry and Economic Update

Executive Summary

January-March 2010



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EXECUTIVE SUMMARY

Economic Trends and Outlook

- ❑ Domestic real GDP growth has declined from 7.9% in Q2FY2010¹ to 6% in Q2FY2010, attributable to a 2.8% decline in agricultural output, and 2.2% decline in GDP from 'community, social & personal services' (because of reduced Government spending). However, all other services sectors have reported higher growth in Q3FY2010 as compared with Q2FY2010. Notably, there has been a sharp recovery in GDP from industry from -1.4% in Q4FY2009 to 9.1% in Q2FY2010, and to 14.3% in Q3FY2010, caused by substantially higher growth in manufacturing. Real GDP growth from industry in Q3FY2010 represented the highest quarterly growth since Q4FY2007.
- ❑ Industrial production growth has accelerated from 9% in Q2FY2010 to 13.1% in Q3FY2010 driven by strong recovery in almost all sub-sectors.
- ❑ According to recent advance estimates, real GDP growth is expected to increase from 6.7% in FY2009 to 7.2% in FY2010. The higher growth is primarily attributable to a sharp recovery in manufacturing, which is expected to offset declines or deceleration in agriculture and community, social & personal services. As can be seen from the table below, the recovery in GDP growth for FY2010 is broad-based with seven out of eight sectors/sub-sectors showing a growth rate of 6.5% or higher, compared with three in FY2009. The exception is agriculture and allied sectors where real GDP is expected to decline 0.2% in FY2009.
- ❑ India's economic recovery is also likely to be assisted by the likely developments in the external sectors. As exports have started to grow once again, business investment is projected to rebound. This should eventually feed through to stronger consumption and the economy should return to its earlier growth path by mid-2010.
- ❑ The exceptional contraction of world (and India's) trade from late-2008 has gradually eased and come to a halt by end 2009, with a recovery projected in 2010. The recovery is based on the expectations of improved credit conditions, and stronger GDP growth in developed economies. Trade growth in developing economies is expected to recover earlier reflecting recoveries from the slowdown in growth in these countries. In the developed economies, the recession is projected to bottom out in the second half of 2009. A slow recovery in activity is projected to have started towards the end of 2009, with stimulatory policy settings together with a gradual normalisation of financial conditions and a pick-up in growth in the emerging and developing economies helping support consumption and investment growth which is expected to gather strength in 2010.
- ❑ Global financial conditions appear to have eased in the course of 2009. An increase in risk appetite has led to a rally in stock prices in world and Indian markets. Although cuts in policy

¹ Throughout the document, FY means Fiscal year from April-March. Thus, FY2009 and/or 2008-09 means the period April 2008-March 2009. Statement of year, e.g. 2009 and so on, without a prefix FY means calendar year from January-December. Thus, 2009 or CY2009 means period January-December 2009, and so on. Throughout the document, Q1FY (year) means quarter April-June; and so on. By comparison, 1Q (year) means quarter January-March. Thus, Q1FY2010 means April-June 2009, and so on. 1Q2009 means January-March 2009, and so on. H1FY (year) means period April-September, e.g. H1FY2009 means April-September 2008, and so on. 1H (year) means January-June, e.g. 1H2009 means January-June 2009, and so on.

interest rates, continued provision of ample liquidity, credit easing, public guarantees, and bank recapitalisation have lowered concerns about systemic failure and have supported financial intermediation; confidence in the banking system remains depressed, and institutional lending worldwide and in India could continue to post lower growth through 2009. It could take some more time for the unprecedented fiscal and monetary measures implemented so far to translate into a durable normalisation of financial markets.

Textiles

- ❑ Following a sharp slowdown in domestic textile and clothing (T&C) production during FY2008 and FY2009, a moderate recovery was witnessed in Q1FY2010, which has accelerated thereafter. Readymade garments production growth seems to have recovered faster than for cotton and synthetic fibre textiles.
- ❑ After five years of increase, India's cotton production is estimated to have declined 5.5% in cotton year (CY) 2009 to 4.93 million tonnes (mt). However, in the wake of increasing prices through 2009 and possible demand recovery in 2009-10, India's cotton production may increase 2% in CY2010. Following a significant decline in domestic fibre consumption in FY2009, cotton and synthetic fibre production and demand has recovered and is expected to increase at near-double digit rates in 2010, driven by demand recovery and stock rebuilding.
- ❑ World and domestic cotton prices had plunged sharply from September 2008 onwards, because of lower expected global demand in 2009, and uncertainty regarding the consequences of the global financial crisis. However, as demand has recovered, prices increased from the latter half of 2009 with significant increases in the latter part. Polyester fibre and yarn have also increased and future price levels are likely to mirror movement in crude oil prices.
- ❑ Following high growth in FY2006-07, India's T&C exports (in rupee terms) increased only 2.8% in FY2008, and around 8% in FY2009, primarily because of sharply lower exports to major markets such as US, European Union (EU), China. During H1FY2010, exports declined 1.4% (yoy) to Rs. 458 billion. Export growth is likely to be low or declining in 2009-10, with exports to US and EU imports likely to grow at a slow rate in 2010.
- ❑ The Indian T&C industry reported a significant deterioration in financial performance during 2008-09 because of various factors enumerated above. However, there seems to be an improvement from Q4FY2009, attributable to a decline in input costs. During Q3FY2010, listed companies with registered offices in the Southern Region reported a 21% (yoy) increase in operating income (OI). On a yoy basis, OI growth has been positive for each quarter of FY2010. Although OI increased 21% (yoy) in Q3FY2010, raw material costs increased 16% (yoy) in Q3FY2010 attributable to increases in prices of both natural and synthetic prices. However, the recent higher increase in raw material costs has been accompanied by a decline in other costs. In fact, the (yoy) rate of increase in operating costs has been lower than the (yoy) rate of increase in OI during Q1FY2010 to Q3FY2010. The industry reported an operating profit of Rs. 1.72 billion in Q1FY2010, followed by Rs. 2.43 billion in Q2FY2010, and Rs. 2.57 billion in Q3FY2010. While operating margins improved from 8.5% in Q1FY2010 to 11.4% in Q3FY2010, net margins improved from -3.8% to -0.1%. Further, although the industry has reported eight successive quarters of net losses, they have declined substantially from Rs. 2,012 million in Q3FY2009 to Rs. 32 million in Q3FY2010. For the next few months, sales and profitability could continue to improve as fabric and garment production units have reported a pick-up in domestic and international demand.

Automotive and Auto Components

- During Q3FY2010, all India auto sector net sales increased 59% (yoy) compared with 20% (yoy) in Q2FY2010. In the Southern region, net sales increased 54% (yoy) in Q3FY2010, compared with 6% (yoy) in Q2FY2010. Although OI increased at high rates from Q2FY2010, raw material costs increased 79% (yoy) in Q3FY2010, reversing four successive quarters of declines. Costs have increased because of base effect and recent sharp increases in metallic and plastic prices. Operating margins for companies in the Southern region increased from 7.7% in Q2FY2010 to 8.6% in Q3FY2010. On an all India basis, operating margins declined from 14.1% in Q2FY2010 to 13.5% in Q3FY2010 primarily because of recent increases in input and employee costs. Nevertheless, operating margins in Q2FY2010 and Q3FY2010 are significantly higher than those realised during FY2008. The lower margins and poorer financial performance for the Southern region is largely because of the dominance of CV companies in the sample of listed companies.
- During Q3FY2010, the all India auto ancillary sector net sales grew by 29% (yoy) compared with a growth of 36% (yoy) in the Southern region. Profits and margins have improved substantially in FY2010 primarily because of higher operating margins. All India the net profits increased to Rs. 9,916 million in Q3FY2010 (compared with net loss of Rs. 374 million in Q3FY2009), while in the southern region they increased by 4,760% (yoy) in Q3FY2010. Net profit margin on an all India basis declined marginally to 6.5% in Q3FY2010 compared to 6.8% in Q2FY2010, while the same for the southern region remained at 7.7% in Q2FY2010 and Q3FY2010.
- India's domestic automotive sales declined 2.8% in FY2009 as the economy cooled and a credit crunch damped demand. However, sales increased 22.1% (yoy) in 9MFY2010 driven by recovery in all segments. Recent recovery in domestic sales has resulted in production increasing 20.1% (yoy) in 9MFY2010, compared with an increase of 3.1% in FY2009. Production increased 9.4% (yoy) in Q1FY2010, followed by higher growth of 12.7% (yoy) in Q2FY2010, and 41.3% (yoy) in Q3FY2010.
- Domestic sales of four wheelers (4W) during 9MFY2010 grew at 23.8% (yoy). Passenger Cars grew by 23.8%, Utility Vehicles grew by 18.6% (yoy) and Multi Purpose Vehicles grew by 35% (yoy). Cumulative sales of Commercial Vehicles (CV) increased 22.3% (yoy) with exceptionally high growth in Q3FY2010. While Medium & Heavy Commercial Vehicles (MHCVs) registered increase of 9.7% (yoy), Light Commercial Vehicles grew at 34.6%. Two wheeler sales growth had recovered from early-2009, and sales growth increased from 2.6% in FY2009 to 21.7% (yoy) in 9MFY2010.
- The period from April-December 2009 saw automobile exports experiencing lower growth rate of 10.4% (yoy) with all major segments (except for MHCVs) reporting deceleration.
- Using the expected growth rates for passenger vehicles, M&HCV's, LCV's, three wheelers and two wheelers and the average prices of these vehicles, it is estimated that the Indian automotive industry which has seen significant growth in the past, is expected to grow at the rate of about 13% per annum over the next decade to reach a size of around USD 165 - 175 billion by 2022. The growth of the auto sector will tremendously boost the share of manufacturing in GDP, exports and employment since the auto sector has deep linkages.

IT and IT-Enabled Services

- The contribution of the IT/ITeS sector to the national GDP has grown from 1.2% in 1998 to around 5.8% in 2009 and the sector's share of total Indian exports has increased from less than 4% in 1998 to almost 16% in 2008.

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- ❑ Domestic market expected to witness 12% growth in FY09-10; to reach Rs. 662 billion². Software and Services exports revenues are expected to grow by 13-15 percent and domestic revenues to grow by 15-17% by FY 10-11.
- ❑ Net sales of the industry reported a single digit growth for the third quarter. It grew by just 2% during Q3FY2010. However, the profit performance remained strong as the industry combated with the slowdown by curtailing the expenses. Wage expenses declined by about 3% during this quarter. Companies have posted a healthy 15% growth in PBDIT because of tighter cost management. The companies registered a PAT growth of 14% during this quarter due to an increase in depreciation and tax expenses.
- ❑ Of the top five IT companies, accounting for 70% of sales, two companies reported a fall in sales and three registered a fall in profits at the net level during this quarter.
- ❑ The IT industry is expected to perform well during Q1FY2011. Net sales that have witnessed single digit growth in the last three quarters are likely to grow by 10% during Q1FY2011. Thereafter, the sales growth will pick up in 2010-11 because of an improvement in the global economic scenario and also due to the low base in the previous year. During 2010-11, the profits growth is expected to remain well above 20% on account of tight cost management.
- ❑ The ITeS companies displayed a healthy financial performance during Q3FY2010. Net sales grew by 23%. 12 of the 15 companies that declared their quarterly results reported a healthy sales performance. Total expenses grew by around 16% during this quarter. The industry's profits grew at a faster pace of over 40% as sales growth exceeded the pace at which expenses grew.
- ❑ In the emerging environment, there is also a growing trend among consumers of IT services towards consolidation of technology service providers in order to improve efficiency and reduce costs. Thus success in the competitive bidding process for new consolidation projects or in retaining existing projects would continue to be dependent on a company's ability to fulfil client expectations relating to staffing, efficient off shoring of services, absorption of transition costs, deferment of billing and more stringent service levels.
- ❑ The contribution of the IT and ITeS industry to India's economy and society is significant. As the industry grows in size, it is expected to play a larger role, especially in the marginalised and vulnerable sections of the community. The industry should have at its call – the two essential tools for making this impact – a young motivated work force and technology.
- ❑ The coming years are going to represent a significant shift in terms of business models, service lines, customers and talent structure. There will be increased focus on higher end offerings such as system integration, consulting, business intelligence, knowledge services and vertical specific BPO services.

Pharmaceuticals & Biotechnology

- ❑ The Indian pharmaceutical industry has grown from a turnover of Rs 15 billion in 1980 to about Rs 1,006 billion in FY2010 (September 2009). Globally, India now ranks third in terms of volume of production with 10% of global share and 14th by value. The Indian pharmaceuticals industry's growth has been fuelled by exports, which registered a growth of 25% in FY2009.
- ❑ The US healthcare bill was passed by the US Senate in December 2009. It holds a lot of promise for generic drug manufacturers from India. With emphasis on increasing the coverage and reducing healthcare costs, the bill is going to provide a big fillip to the usage of low-cost generic drugs, besides opening up a larger market by bringing an additional 40 million US citizens under

² NASSCOM

medical insurance coverage.

- ❑ The Drugs & Cosmetics (Amendment) Act, 2008, has come into force from August, 2009. The amendment primarily deals with government's right to regulate and drug considered essential for tackling medical situations deemed endemic as well as increasing the penalties for manufacturing or selling spurious drugs.
- ❑ The southern region is emerging as an investment hub for the pharmaceutical and biotechnology industries in terms of companies headquartered by region. Over the last two decades, Karnataka has established itself as a centre for biotechnology. Tamil Nadu and Pondicherry have more traditional pharmaceutical companies, while Kerala is a globally recognised ayurveda centre. Among all southern states, Andhra Pradesh leads with a number of well established companies, both large and small scale. The industry mix includes traditional pharmaceuticals and biotechnology companies.
- ❑ State wise investments announcements for the southern region in pharmaceuticals and biotechnology indicate that there are many planned or under construction projects with an estimated cost of at least Rs. 45 billion.
- ❑ The key reasons for the emergence of the southern region is a well established strategy for exploiting the existing advantages like strong education base and availability of information technology support as well as developing a new approach to make the sector more competitive. The post-WTO agreement requires thrust on innovation and new processes, which some of the state governments have been able to recognise early on. They have provided for policies that are conducive to doing business, cluster approach and infrastructure support to attract investment.
- ❑ Drugs and pharmaceuticals exports account for over 40% of industry sales. Europe accounts for a large share of the overseas drugs and medicines markets. Lately, many Indian companies have diversified their international base by locating marketing or manufacturing facilities in other regions like Asia, CIS and Russia and Africa. It is important to note that despite slowdown in exports in the other sectors, drugs and pharmaceuticals industry is expected to maintain its 3% share in total exports in FY2010 as it has done in FY2009.
- ❑ Average production trends in bulk drugs and intermediates indicate a steady recovery in FY2008 after negative growth in FY2006. However, in FY2009, production growth was negative again, but capacity utilisations remained at about 60% in FY2009 as compared to about 50% in FY2006. Lower drug releases as well as exchange rate fluctuations were two main reasons, although economic slowdown overseas helped the Indian manufacturers export generic drugs because of price competitiveness in FY2009.
- ❑ Overall, the Indian drugs and pharmaceuticals industry is expected to grow at around 14% per annum in the next two to three years given its competitive advantage in terms of the following: low cost manufacturing, chemical synthesis expertise, number of USFDA approved plants, new collaborations and contract research opportunities.

Chemicals and Fertilisers

- ❑ India manufactures over 70,000 chemicals and is the 12th largest producer of chemicals in the world. Chemicals industry size is estimated to be around 160,000 crore or US\$35 billion. The industry constitutes about 3% of GDP and 18% of manufacturing sector. The industry employs around 1 million people.
- ❑ Currently, India has about 42 MT of installed capacity to produce fertilisers. Of this, about 20 MT is for production of urea and about 13 MT is for Diammonium Phosphate (DAP), and other nutrients. About 7.2 MT capacities have been set up for production of Single Super Phosphate (SSP) fertiliser.

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- ❑ The government has approved the nutrient-based fertiliser subsidy policy which will come into effect from 1st April, 2010.
- ❑ The impact of the Union Budget 2010-11 on fertilisers has been neutral, while the impact on petrochemicals has been negative.
- ❑ During Q3FY2010, net sales of the fertiliser industry declined by a sharp 30% compared to a year ago. Material expenses declined by about 34%. In spite of the sharp fall in the two major cost components of the industry, the total expenses fell by 27%, slower than the fall in income. Total expenses corresponding to goods sold fell by about 31%. The PBDIT margin expanded by 5% to 12% compared to 7% during the previous quarter. Net margin increased to 5% compared to 2% a year ago.
- ❑ During Q3FY2010, total revenues of the caustic soda industry fell by 9.2% compared to the quarter during the previous year. The net margin of the industry contracted to 3.8% from 8.5% during this quarter. Aggregate net sales of seven caustic soda companies fell by 12% in this quarter compared to the same quarter a year ago. Though demand for caustic soda is healthy, a sharp fall in prices due to increase in supplies has pulled down the per unit realisation of the companies, thus adversely affecting revenue growth. Depreciation expenses increased by about 10% during this quarter due to commissioning of new capacities. This has aggravated the fall in net profits to 59% compared to the same quarter a year ago.
- ❑ During Q3FY2010, the aggregates sales of the alkali manufacturing companies were pulled down because of a 20% fall in soda ash prices. The PBDIT of the industry grew by 7% during this quarter after having fallen during the previous four quarters.
- ❑ The pesticide industry grew by 40% in PBDIT and a 150% net profit growth during Q3FY2010. The growth came after three consecutive quarters of decline and is also broad-based. The industry's sales were higher by 10% during this quarter compared to the same period a year ago. The industry suffered a 3% fall in sales during the previous quarter. Raw material cost, the highest cost component was down by 11%. This along with rise in other expenses pushed up the PBDIT by 40%.
- ❑ The demand for petrochemicals like polypropylene (PP) and polyvinyl chloride (PVC) consumption expanded by 20-30% during 2009, supported by the packaging, automotive and infrastructure sectors.
- ❑ Fertiliser demand is at 520.45 lakh tonnes for the year 2009-10. The demand during Kharif 2009-10 was at 254.70 lakh tonnes and 265.75 lakh tonnes for Rabi.
- ❑ Being an intermediate for a host of industries, demand for organic chemicals is related to the demand growth in the end user industries such as PTA, textile, pharmaceuticals, fertilisers, dyes and paints, paper, resins etc.
- ❑ The demand for chemicals and fertilisers is expected to continue to grow moderately over the short to medium term.

Industry and Economic Update has been prepared by ICRA Management Consulting Services Limited (IMaCS) for the Confederation of Indian Industry (CII).

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