



Confederation of Indian Industry

# **CII Southern Region**

## **Industry and Economic Update**

### **Executive Summary**

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## EXECUTIVE SUMMARY

### Economic Trends and Outlook

- ❑ Domestic real GDP growth has increased from 6.1% in Q1FY2010<sup>1</sup> to 7.9% in Q2FY2010, driven by strong industrial recovery, which offset lower growth in agricultural sector, and modest growth in services sector. GDP growth could recover to around 7-7.5% in FY2010, and growth will be hampered only modestly by deficient monsoons.
- ❑ Industrial production growth has accelerated from 3.8% in Q1FY2010 to 9.1% in Q2FY2010 driven by strong recovery in mining and manufacturing.
- ❑ India's economic recovery is 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 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 strong growth during FY2005-07, there has been a sharp slowdown in domestic textile

<sup>1</sup> 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.

and clothing (T&C) production during FY2008 and FY2009, with the index of industrial production (IIP) for cotton textiles and man-made fibre (MMF) declining in 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 firm prices and possible demand recovery in 2009-10, India's cotton production may increase 2% in CY2010.
- After a period (mid-2004 to late-2006) of strong consumption growth, India's cotton consumption growth slowed down significantly from early 2007. Weak domestic and export demand prospects for 2009 are estimated to have resulted in a 3.3% decline in domestic consumption in CY2009. Similar factors have been behind the decline in MMF production and consumption in FY2009. However, cotton and synthetic fibre production and demand 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 in 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 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 3.6% (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. Exports could also be impacted because of the removal of some safeguards on Chinese exports to these destinations.
- 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 Q2FY2010, listed companies with registered offices in the Southern Region reported a 15% (yoy) increase in operating income (OI). On a qoq basis, OI growth has been positive for the past four quarters, as there were signs of restocking following the sharp decline in sales during late-2008. Although OI increased 15% (yoy) in Q2FY2010, raw material costs increased 16.3% (yoy) in Q2FY2010 attributable to increases in prices of both natural and synthetic prices. However, the higher increase in raw material costs has been accompanied by a decline in other costs. The industry reported an operating profit of Rs. 1.7 billion in Q1FY2010, followed by Rs. 2.08 billion in Q2FY2010. While operating margins improved from 8.5% in Q1FY2010 to 10.1% in Q2FY2010, net margins improved from -3.8% to -0.7%. For the next few months, sales and profitability could improve as some fabric and garment production units have reported a recent modest pick-up in international demand.

### **Automotive and Auto Components**

- During Q2FY2010, all India auto sector net sales increased 20% (yoy) compared with 7% (yoy) in Q1FY2010. The decline in sales had led to a sharp fall in the net profit for the auto companies in FY2009 but these have more than doubled in Q2FY2010 compared to Q2FY2009. Net profit margin has increased to 10.1% in Q2FY2010 compared to 8.7% in Q1FY2010, and 4.7% in Q2FY2009. For the southern region, net margins have improved from 0.2% in Q1FY2010 to 3.4% in Q2FY2010. 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 FY2009, the all India auto ancillary sector net sales grew by 5.2% compared to the previous year, while they have declined by 1.4% (yoy) in H1FY2010. However, net profits and margins have improved substantially in FY2010 primarily because of higher operating margins. While all India the net profits increased 208% (yoy) in Q2FY2010, net profits for listed companies in the southern region increased 209% (yoy) in Q2FY2010. Net profit margin improved marginally to 6.8% in Q2FY2010 compared to 6.4% in Q1FY2010, while the same for the southern region improved to 7.7% in Q2FY2010 compared to 7.4% in Q1FY2010.
- 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.
- The second quarter of FY2010 continued to witness disappointing revenue performances. On the profit front, IT majors performed well but mid-sized and small companies reported fall in profits. The IT industry continued to bear the brunt of the global slowdown during this quarter. The revenue growth of the companies dropped to 3% during this quarter. However PAT grew faster by 11% as the industry dealt with the slowdown by curtailing expenses.
- The PBDIT growth of IT majors was not affected by the dramatic slowdown in net sales. This was because of the sharp decrease in the wage cost and decline in other expenses. IT majors were slow on hiring which was evident from their net employee additions during the quarter that fell by over 75%.
- The ITES industry registered a sharp decline in revenues, reporting a single digit growth of 9%. Total expenses excluding interest, depreciation and tax expenses grew by a mere 4% as a result of which PBDIT grew by 7%. PAT margins of most of the companies contracted this quarter due to

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rise in interest cost and depreciation expenses.

- ❑ NASSCOM estimates India's software exports to grow 4-7% in 2009-10. Indian software exports, though recovering, were unlikely to return to the 30% growth seen before the economic slowdown and also because of the higher revenue base.
- ❑ The industry's PAT growth is expected to remain healthy due to tight cost management by the IT companies in 2009-10. The decelerating growth in wage cost and lower forex losses will help the industry to post a PAT growth of above 20% during 2009-10. The aggregate growth revenues for the IT industry are likely to grow by a mere 9% in 2009-10.
- ❑ The software exports reported by Software Technology Parks (STPs) increased 15.1% in rupee terms to Rs. 207,358 crore or US\$ 50 billion in 2008-09, as against Rs 180,155 crore or US\$ 43 billion in 2007-08.
- ❑ The Indian IT and ITES Industry are estimated to record a turnover of US\$ 65 billion during FY2010. Exports growing at a rate of between 15% and 18% are expected to reach about US\$ 50 billion contributing to over 75% of industry revenues.
- ❑ 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.

### **Pharmaceuticals & Biotechnology**

- ❑ The pharmaceuticals and biotechnology sector grew by around 7.5% in H1FY2010 as compared to H1FY2009. For the companies headquartered in the south, the growth rate was around 9.1% during this period. Profit growth was around 37.8% and 22.3% for the southern and overall industries, respectively. Fall in power and fuel costs as well as net interest were the key reasons for the marginal improvement in profitability of the industry. The sales growth in FY2009 was around 14% for overall industry and about 18% for the southern industry.
- ❑ The US healthcare bill passed by the US House of Representatives and is awaiting nod from the Senate. The bill 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 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. It has been traditionally located in the western and central regions. 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. 43,613 million.
- ❑ In general, the Indian pharmaceuticals industry has acquired a good reputation, internationally, because of the following reasons: existing strength in organic chemicals synthesis and process engineering, low cost manufacturing base, and presence of educational institutions and trained personnel, development of technology oriented facilities, use of cost effective technologies, and adoption good manufacturing practices. The central government has helped the evolution of the industry through policies such as de-licensing, increased foreign investment limits and policy announcements.
- ❑ 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.
- ❑ 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. However, clarity of policies, drug price control in the domestic market and growing competition from overseas companies remain the key challenges.

### **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 DAP and other nutrients. About 7.2 MT capacities have been set up for production of Single Super Phosphate (SSP) fertiliser.
- ❑ During the quarter, almost all the leading companies reported a double-digit fall in the total income. Although, the industry reported a sharp fall in total income, its performance was satisfactory on the profitability front.
- ❑ During Q2FY2010, 12 fertiliser companies managed to improve their PBDIT margin due to a huge fall in raw material expenses when compared to the total income. The improved PBDIT margin along with a sharp decline in the interest expenses and tax provisions has enabled the fertiliser companies to raise their PAT margins.
- ❑ The alkali companies registered a dismal financial performance during Q2FY2010. Net sales of seven companies fell by double digits. During Q2FY2010, the alkali industry's aggregate sales fell

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by over 14%. Total expenses fell by 8% and thus net profit of the industry fell by over 60%, and the margins nearly halved to 5.5%. The fall in revenues was due to the fall in the price of soda ash and caustic soda.

- ❑ 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.
- ❑ The fertiliser sector, which is currently operating under several constraints including policy-related issues, is likely to see an immediate investment flow of about Rs. 35,000 crore or US\$ 7.5 billion. This amount is towards the creation of additional capacities once the government decontrols the sector.
- ❑ 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.
- ❑ Fertiliser production is expected to grow by 10% in 2009-10 due to availability of natural gas from the KG-basin project. A fall in the raw material prices with moderation in imports would reduce the Government's burden in 2009-10.
- ❑ 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.

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