Investor's Delight: Bajaj Hindusthan Ltd. (MSL) – "BUY" Nov. 28, 2014

Bajaj Hindusthan Ltd. (BHL), a part of the 'Bajaj Group', is sugar and ethanol manufacturing company. The Company has fourteen sugar plants, which are all located in the northern Indian state of Uttar Pradesh (UP) with an aggregate sugarcane crushing capacity of 136,000 tcd (tonnes crushed per day) and a distillery capacity to produce 800,000 litres of alcohol per day. BHL is also one of the largest ethanol producers. It is the pioneer of India's fuel ethanol program and is currently producing 38 million liters of ethanol in a year. In anticipation of emerging market demand, the Company has increased its ethanol manufacturing capacity to nearly 218 million liters per year. BHL generates close to 430 MW of power from the bagasse produced in its sugar mills. After meeting its own energy needs, BHL has a surplus of around 100 MW.

The Company supplies a significant part of this surplus power to the UP state grid. BHL recently embarked upon the expansion of its power generation capacity by 450 MW through the setting up of new coal based power plants of 90 MW each in the vicinity of 5 of its existing sugar units. These new projects have been commissioned successfully at an aggregate project cost of around Rs. 23 billion. Besides this, through a Consortium, the Company, in a major diversification move, has also embarked on developing two mega thermal power projects in Lalitpur district of UP, each of which will produce 1,980 megawatts of power, the first being ready for commissioning early 2015. The regulated sugar sector has faced considerable pricing issues recently, especially with respect to UP-based companies while south India-based companies have had it better. After announcement of sugar cane price by the Uttar Pradesh Government together with grant of certain reliefs, Bajaj Hindusthan Ltd has decided to commence crushing operations for the season 2014-15 of all its 14 Sugar Mills in phased manner at the earliest.

Brazil, which accounts for the largest production in the world contributing to over 28% of global production, has witnessed its driest summer in the last seven decades. immediate fallout has been of sugar prices in the futures markets witnessing a definitive upward movement. Indian sugar producers should benefit from such a move given the government supports with the necessary policy changes that should help the sugar industry and further the nation as a whole in terms of exports.

CMP	Rs. 21.3
Target Price	Rs. 35
Face Value	Re. 1
Book Value	Rs. 35
Upside	64%
Sector	Sugar
Beta vs Sensex	2.23
BSE/NSE Code	500032/BAJAJHIND
Bloomberg Code	BJH:IN
52 Week High	Rs. 32.60
52 Week Low	Rs. 11.95
Share Capital	Rs. 639.4 mn
Market Capitalization	Rs. 13,619 mn
Shareholding Pattern (%)	As on Sep. 2014
Promoters	46.13
FIIs	2.35
DIIs	14.33
Others	37.19

We believe the current market price discount all the negatives and pressure of the sector. With due consideration to factors like a) possible revival in sugar industry, b) expectation of favorable policies from new government, c) repayment of foreign currency convertible bonds by the Company aggregating to US$17.7 million, d) 1980 MW Lalitpur project to be by early 2015 which would act as a positive trigger to the stock, e) Government's initiative of ethanol blending in petrol to augur well for the Company, f) reduction of losses in Q2FY15 to Rs. 131 crore from Rs. 509.5 crore in Q2FY14 owing to reduced sugar business loss, higher other income and strong profit in distillery business, g) likely export subsidy of Rs. 3,371 per tonne of sugar, g) cheap valuations – P/BV of 0.60x, we recommend a "BUY" with a target price of Rs. 35 for investors with a horizon of 6-9 months.

Industry background

India has been known as the original home of sugar and sugarcane. India is the second largest producer of sugarcane next to Brazil. Presently, about 4 million hectares of land is under sugarcane with an average yield of 70 tonnes per hectare.

India is the largest single producer of sugar including traditional cane sugar sweeteners, khandsari and Gur equivalent to 23.9 million tonnes raw value followed by Brazil in the second place at 18.5 million tonnes. Even in respect of white crystal sugar, India has ranked No.1 position in 7 out of last 10 years.

Traditional sweeteners Gur & Khandsari are consumed mostly by the rural population in India. In the early 1930's nearly 2/3rd of sugarcane production was utilised for production of alternate sweeteners, Gur & Khandsari. With better standard of living and higher incomes, the sweetener demand has shifted to white sugar. Currently, about 1/3rd sugarcane production is utilised by the Gur & Khandsari sectors. Being in the small scale sector, these two sectors are completely free from controls and taxes which are applicable to the sugar sector.

The advent of modern sugar processing industry in India began in 1930 with grant of tariff protection to the Indian sugar industry. The number of sugar mills increased from 30 in the year 1930 - 31 to 135 in the year 1935-36 and the production during the same period increased from 1.20 lakh tonnes to 9.34 lakh tonnes under the dynamic leadership of the private sector.

The era of planning for industrial development began in 1950-51 and Government laid down targets of sugar production and consumption, licensed and installed capacity, sugarcane production during each of the Five Year Plan periods. The targets and achievements during various plan periods are given below.

Sugar production of India, the world's second largest producer and biggest consumer, fell by 3.23 per cent to 23.9 million tonnes till May 15 during current 2013-14 marketing year 2013-14 ending September.

For the entire year 2013-14, sugar production is pegged at 24.2 million tonnes, four per cent less than the last year's level of 25.1 million tonnes.

The annual domestic consumption is estimated at 23-23.5 million tonnes.

Manufacturing Process and Technology

Sugar (sucrose) is a carbohydrate that occurs naturally in every fruit and vegetable. It is a major product of photosynthesis, the process by which plants transform the sun's energy into food. Sugar occurs in greatest quantities in sugarcane and sugar beets from which it is separated for commercial use. The natural sugar stored in the cane stalk or beet root is separated from rest of the plant material through a process known as refining.

For sugarcane, the process of refining is carried out in following steps

- Pressing of sugarcane to extract the juice.
- Boiling the juice until it begins to thicken and sugar begins to crystallize.
- Spinning the crystals in a centrifuge to remove the syrup, producing raw sugar.
- Shipping the raw sugar to a refinery where it is washed and filtered

to remove remaining non-sugar ingredients and color.

- Crystallizing, drying and packaging the refined sugar

Beet sugar processing is similar, but it is done in one continuous process without the raw sugar stage. The sugar beets are washed, sliced and soaked in hot water to separate the sugar -containing juice from the beet fiber. The sugar-laden juice is then purified, filtered, concentrated and dried in a series of steps similar to cane sugar processing.

For the sugar industry, capacity utilization is conceptually different from that applicable to industries in general. It depends on three crucial factors the actual number of ton of sugarcane crushed in a day, the recovery rate which generally depends on the quality of the cane and actual length of the crushing season.

Since cane is not transported to any great extent, the quality of the cane that a factory receives depends on its location and is outside its control. The length of the crushing season also depends upon location with the maximum being in south India.

Sugarcane in India is used to make sugar, khandsari or gur. However, sugar products produced worldwide are divided into four basic categories: granulated, brown, liquid sugar and invert sugar.

Granulated: Granulated sugar is the pure crystalline sucrose. It can be classified into seven types of sugar based on the crystal size. Most of these are used only by food processors and professional bakers. Each crystal size provides unique functional characteristics that make the sugar appropriate for the food processor's special need.

Industry Outlook

a) Current Scenario

Uttar Pradesh accounts for 30% of the sugar production in the country (~70 lakh tones)—about 4 million farmers grow sugarcane in the state. On the other hand, the other two major sugar producing states i.e. Maharashtra and Karnataka who together contribute for almost 50 percent of the country's sugar production.

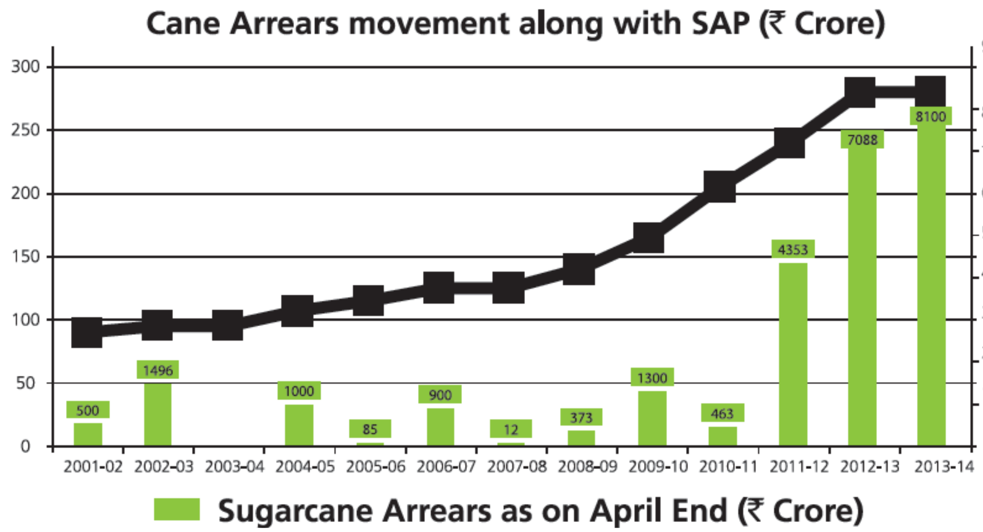
According to Uttar Pradesh Sugar Mills Association (UPSMA), sugarcane prices have risen 70% while sugar prices went up by only 7%, in the last four years. For cane pricing, the central government announces a fair and remunerative price (FRP), while the state government announces a state advised price (SAP). For the 2013-14 crushing season, the FRP was Rs.210 per quintal while the SAP was Rs.280 per quintal. The divergence between FRP and SAP has reached an extent where the industry is not viable anymore. Most sugar mills in Uttar Pradesh have decided to suspend operations in the new crushing season 2014-15 starting October. Although, cane price is fixed by the Union Government, the UP Government is forcing companies to pay a premium to farmers over the cane price. Sugar mills in the State have demanded that the Government link sugar and cane prices. While cane prices in the State have gone up by 70 per cent, sugar prices have moved up barely 7 per cent. Mill owners claim that they lose Rs. 5.5 on sale of every one kg of sugar due to higher cane prices. It's time to revise the cane price formula and link it to sugar prices.

The dual system of cane pricing viz: State Advised Price (SAP) and the central Fair and Remunerative Price (FRP) are quite at variance with each other and affects sugar mills in Uttar Pradesh more severely to the extent that SAP cane prices have become more than sugar realisations. The dual pricing has destroyed the basic level playing field concept that is integral to the success of any business.

The cost of production naturally for UP mills is the highest amongst all states at Rs. 37 per kg as compared to Rs. 28 in Maharashtra the other large sugar producing state. This disparity is simply unsustainable.

According to UPSMA's calculations, the cost of production of sugar in UP is Rs.37 per kilo, the highest in the country, while the price realized at the mill gate is Rs.31.5 per kilo, resulting in a loss of Rs.5.50 per kilo. Interestingly, Uttar Pradesh is the only State which does not have a formula linking sugar prices with that of cane whereas Maharashtra and Karnataka have already adopted and implemented the "linkage formula" as recommended by the Rangarajan Committee for determining the cane price automatically at 70 percent of revenue realized from sugar and first stage by products or 75% of revenue realized from sugar alone. With the dues to farmers hovering about Rs. 4,000-5000 crore, sugar mills in UP are already staring at bankruptcy. Till July 31, 2014 sugar industry has paid Rs. 47,852 crore to cane farmers.

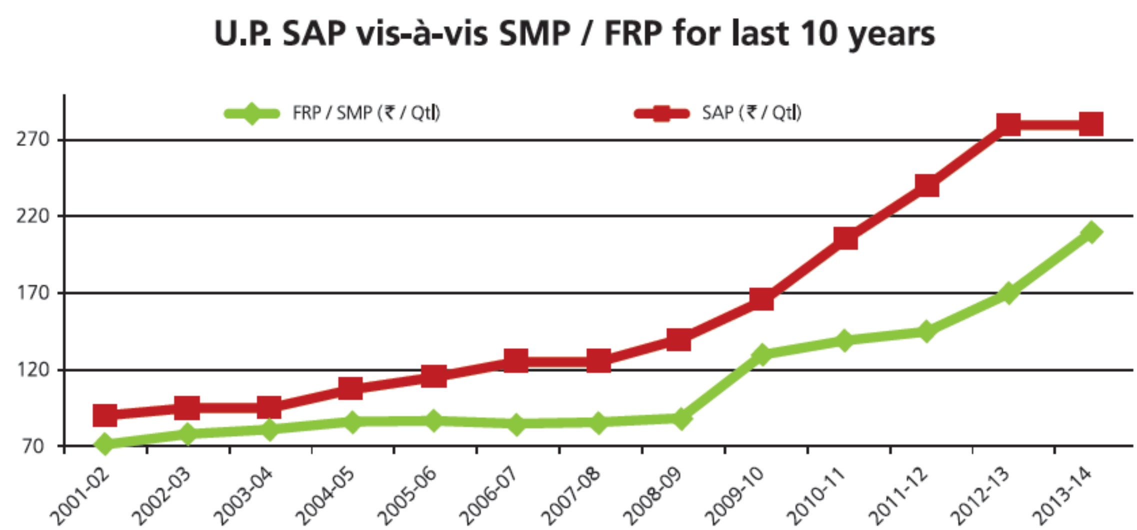
Currently, the industry owes Rs.5,180 crore to the state's farmers in cane price arrears. On 4 August, UPSMA gave notice to the state government stating mills will suspend crushing operations for 2014-15, scheduled to begin in October.



This is a very deleterious issue as sugar mills are unable to repay bank debts as well as for the cane purchased. Over time, the entire UP sugar industry has bleak future if this irrational pricing were to continue. The consequence of such an eventuality would be quite disastrous not only for the mills but the farmers, workers and Small Scale Industry (S&ME) as well, as the sugar industry is the largest in Uttar Pradesh in terms of size and contribution to the farmers' income as well as to the exchequer.

This fundamental flaw has already resulted in mounting cane payment arrears.

The chart below indicates the severity of the problem:



An immediate imperative therefore, is the linkage of cane price to the sugar realisation as has already been adopted by Gujarat, Maharashtra and Karnataka (55% of India's sugar production) and is the norm the world over in sugar producing countries such as Brazil, Australia, Thailand, United States, Mexico, South Africa to name a few.

The UP government needs to enact a law, similar to Maharashtra or the Rangarajan Committee recommendations, and adopt the 'linkage formula' to ensure automatic determination of cane price in relation to revenue realized from sugar and primary by-products of sugarcane, effective from the next sugar season 2014-15," said a statement from UPSMA.

According to Indian Sugar Mills Association, UP is the only major state which fixes SAP. Sugar mills in Maharashtra pay an average price of Rs.255 per quintal to the farmer on account of higher recovery rate of sugar from sugarcane grown in the state. In UP, where recovery rate of sugar from cane is lower than in Maharashtra, a SAP of Rs.280 per quintal is unrealistic. UPSMA alleges that the state government has been using coercive methods. Sugar has been seized and godowns locked, making it even more difficult to generate cash to clear the cane price arrears. FIRs (first information reports) have been filed yet again against senior management as well as against individual promoters, taking the total to over 300, including the past FIRs," reads the statement issued by UPSMA on 4 August. Farmers unions, however, contradict industry opinion on grounds of increasing costs of cultivation and farmers' inability to repay loans due to unpaid arrears from the sale of cane. "Sugar mills got tax relief; they were freed up from supplying the levy sugar to the government last year. Sugar mills in Haryana have no dues to farmers even though the Rs.285 per quintal SAP is higher than in UP. UPSMA has been raising the price issue for the past two years as they don't want the state to revise cane prices," said Dharmendra Malik, UP state spokesman of Bhartiya Kisan Union.

b) Key developments

An announcement was made by Minister of State for Finance, that India will not raise the import duty on sugar for now, month after the food minister said there was a consensus to raise the tax to 40 percent from 15 percent. Upon consideration of all relevant aspects, the government had decided not to disturb the import duty structure on sugar for the present. Food Minister Ram Vilas Paswan said on June 23, 2014 that the duty would be raised to help revive business at mills that owe farmers around US$1.84 billion. Currently, India is not importing sugar, as domestic prices are lower than global rates, making overseas purchases unattractive. Traders believe the government would prefer to see the impact of monsoon rains before making changes in the current duty structure, he said. India's parched farms will receive more rainfall next week as the monsoon is expected to continue its wet revival phase.

Measures taken

The government has decided to provide soft loans of Rs. 6,600 crore to enable payment of mounting dues to cane growers and have a 10 per cent blend of ethanol in petrol. The money would go directly into the accounts of farmers so as to avoid any malpractice by the mills. It has also been decided to mix 10 per cent of ethanol in petrol, which would go a long way in helping the sugar industry and the cane growers.

The government on June 2014 announced several measures to bail out the ailing sugar industry: The industry assures of clearing farmers' Rs 11,000-crore dues at the earliest. Of the estimated Rs 11,000 crore of cane arrears across India, a massive Rs 7,500 crore is accounted for by Uttar Pradesh alone, while Tamil Nadu and Karnataka account for a combined Rs 2,000 crore and Maharashtra for only Rs 175 crore. According to Maharashtra State Federation of Cooperative Sugar Factories Managing Director Sanjiv Babar, sugar mills in Maharashtra managed to clear dues with earlier interest-free loans — equivalent to the year's excise duty — provided by the government. But these measures would certainly help increase cash flows for mills, which have been selling sugar below production cost. While the average cost of producing sugar is about Rs 35 a kg, mills have been selling the sweetener at Rs 30.5-31 a kg.

The industry requires cash flows to clear the arrears. The measures taken will certainly help increase the flows. Additionally, sugar mills will be able to use better cane varieties to boost yields. At present, yields in states like Uttar Pradesh is 25-40 per cent lower than potential, as mills lack funds for developing higher-yielding seed

The government extended the interest-free loans given against excise duty paid by sugar mills to five years (from three years). Apart from that, the government has also decided to extend the sugar export subsidy until September 2014.

The sugar industry was estimated to end the current season (on September 30) with carryover stocks of 7.5 million tonnes. This could have a cascading affect on cane farmers, who might be prompted to opt for crop diversion next season. The government had announced interest-free loans to the tune of Rs 6,600 crore, equivalent to the excise duty paid for three years. Of that, around 66 per cent has already been disbursed. An extension of another two years will increase the likelihood of up to Rs 4,400 crore of more interest-free loans being given.

Sugar Export Subsidy

According to reports Rs 3,371 per tonne may be provided as subsidy for exports. The government is also mulling incentives for increasing ethanol productions.

Earlier in February, the government had announced a subsidy of Rs 3,300 for export of raw sugar up to 4 million tonnes during 2013-14 and 2014-15 marketing years (October-September) and decided to review it every two months.

For August-September, the subsidy was Rs. 3,371 per tonne. India had exported 7 lakh tonnes of raw sugar in 2013-14 marketing year that ended last month.

In February 2014, the Cabinet Committee on Economic Affairs had approved a subsidy on the export of raw sugar for shipments of up to 4 million tonnes of raw sugar to bail out the cash-strapped industry. The subsidy was fixed at Rs 3,300 a tonne for February-March.

About 25,000 tonnes of raw sugar could be exported in August-September, according to the sugar directorate. Till date more than 6.20 lakh tonnes of raw sugar have been exported with the subsidy. Subsidy claims for more than 2.50 lakh tonnes have been filed.

Stock Holding Disclosure under SEBI regulations:

- **a) Analyst holding: No**
- **b) Company holding: Yes**
- **c) Directors holding: No**
- **d) Group/Associates Position: Yes**
- **e) Relationship with management: No**

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