

Corporate Performance of Manufacturing Companies: FY04-FY13

The period FY04-13 has been an important phase in India's economic progress with the path being affected by a series of factors including global disturbances as well internal issues related to inflation, interest rates and investment. The growth tendency was typically on the rise during the period up to FY08. The financial crisis and its aftermath had an impact on the pace of growth though positive intervention from the government through fiscal and monetary stimuli brought it back on path. However, in the last three years, there has been a decline in GDP growth rate from 8.59% in FY10 to 4.47% in FY13 which is expected to be only marginally higher in FY14.

There were 4 broad phases that can be carved out during this period: FY04 to FY08 where GDP growth averaged 8.68%, a year of low growth in FY09 when GDP growth was 6.72%, two years of recovery with 8.59% and 8.91% growth in FY10 and FY11 respectively followed by two years of low growth with an average of 5.58%.

While the Indian economy is typically a services oriented one, the government has focused on industry in its New Manufacturing Policy in 2011 which had aimed to take the manufacturing sector to a growth path of 15-16% such that its share in GDP would increase to 25% by 2022. Quite clearly a lot has to be done to move towards this mark given that the industrial sector has grown by just about 1% in FY13 and could be negative in FY14.

In this context, the foregoing analysis looks at the financial performance of the industrial sector over the last decade.

Methodology

The study is based on a series of RBI studies titled "Financial Performance of non-Government-non-Financial companies" from FY04 to FY13. The data for FY12 and FY13 pertain to only large companies¹. However, it is assumed that this would not affect the analysis due to the preponderance of the larger companies in the overall performance of the sector. As the title suggests the companies are in the industrial sector which includes mining, manufacturing and electricity and excludes all services including banks.

The study is divided into three sections.

- Section A analyzes the income and expenditure trends.
- Section B looks at trends in critical profit ratios.
- Section C looks at trends in sources and uses of funds for the sample companies.

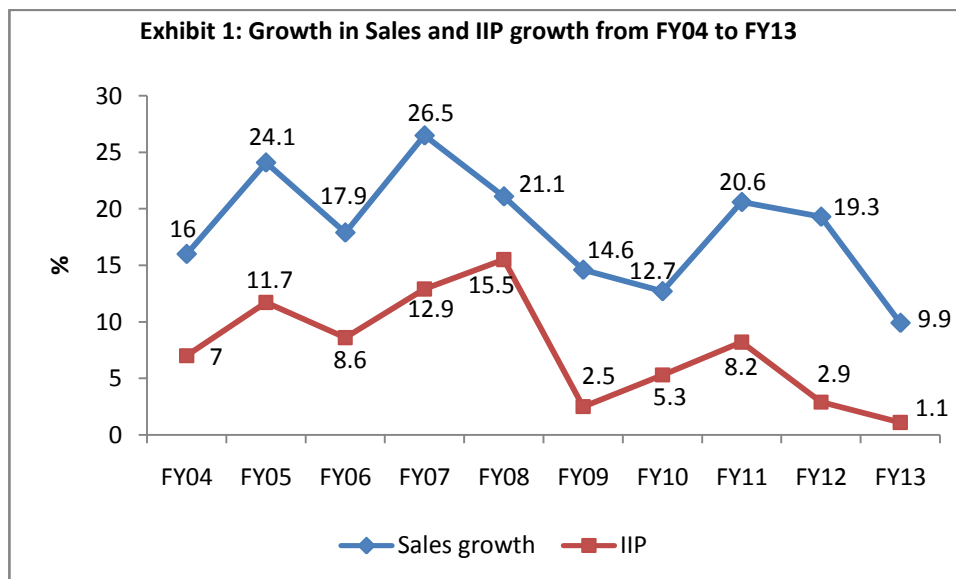
A. Income and Expenditure

o Sales

Growth in sales broadly followed the pattern in growth in the IIP as shown in Exhibit 1. While growth in sales did slowdown in FY08, it was still above 20% and hence could be interpreted as a high growth rate on top of growth of a peak of 26.5% in FY07. Similarly, a recovery in IIP growth in

¹ Large companies are defined as companies with Paid up Capital of Rs 10 million and above.

FY10 of 5.3% was associated with a lower growth in sales of the sample companies from 14.6% to 12.7%. The two growth lines otherwise do move almost in the same direction.



Source: RBI

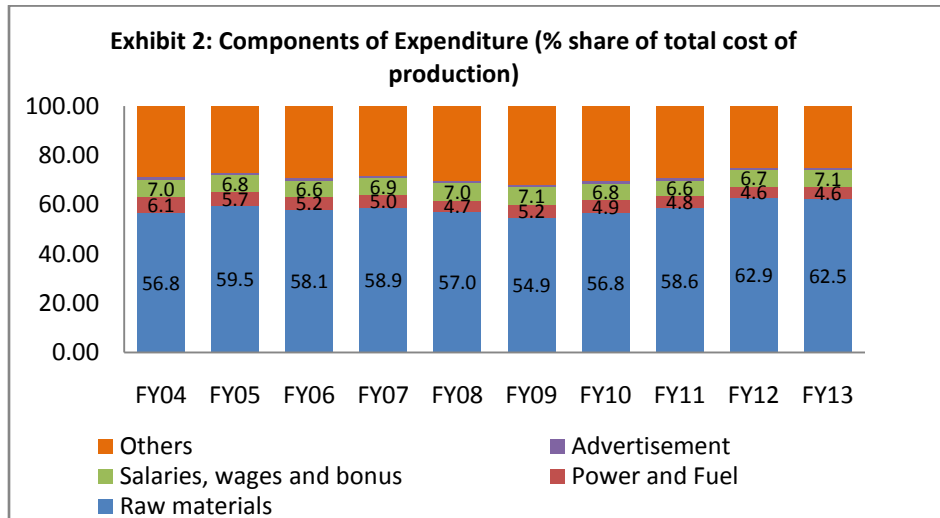
It may be expected that the growth in sales of the manufacturing companies would tend to mimic that of the IIP. As industrial growth in FY14 could be well under 1%, growth in sales could also be expected to be less than 10% this year. CARE's study on corporate performance for the first nine months for a sample of 3,037 companies showed that net sales had increased by 7.6% compared with 9.6% during the same period of FY13.

Composition of Expenditure: The total expenditure of companies includes raw materials, employee cost, maintenance and repairs, power, selling expenses, administrative, advertising etc.

- **Share of Raw Materials:** Raw materials account for the highest share in cost of production (over 50%) between FY04 and FY13. It was highest in FY12 at 62.9% and has been increasing from FY11 onwards (62.5% in FY13). The high share of raw material costs over the years was associated with higher inflation. This is indicative of the fact that high inflation has affected the costs of these companies. Under low growth conditions companies do find it difficult to pass on a large part of this increase in cost to the customers thus resulting in pressure on profit margins.
- **Share of salaries, wages and bonus:** Companies have spent on an average close to 6.8% of their total production cost on salaries, wages and bonuses for employees. Interestingly, there has been no significant rise or fall in the share of employee costs over the years. This is indicative of the control exercised by these companies on the overall wage bill in terms of both absolute headcount as well as growth in remuneration.
- **Share of Power and Fuel:** The overall share of power and fuel stands slightly lower than that of employee costs. The share of power cost has come down progressively over the years albeit gradually. It came down continuously between FY04 to FY08, then rose in FY09 and declined thereafter. Companies have been paying attention to these costs and worked on improving efficiency levels by controlling these costs. Significantly the WPI for fuel components had increased by an average annual rate of above 10% in 6 of

these 9 years. Therefore, while costs did go up, companies did work towards controlling the growth in overall fuel costs at manageable levels.

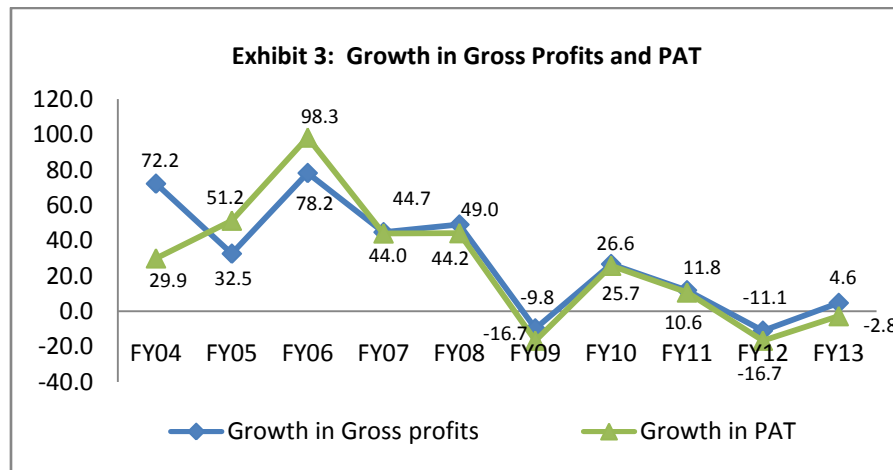
- **Share of advertising cost:** Advertising expenditure has had a miniscule share in the total expenditure basket. The overall share of advertising expense has been around 1.1%. Hence, it does not appear that the force of competition has edged advertising expenses higher.



Source: RBI

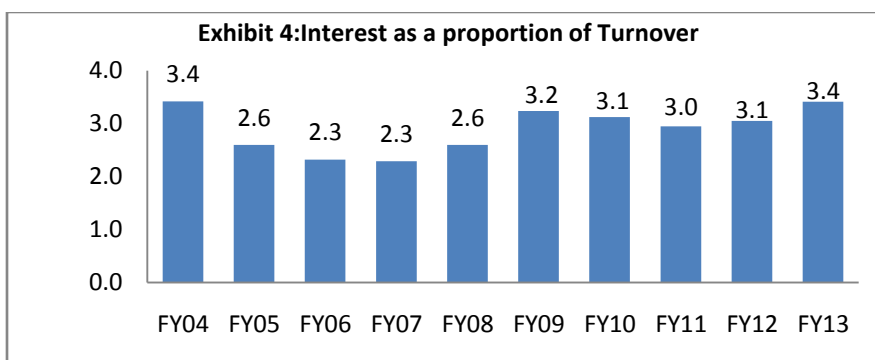
B. Profitability and other ratios

In order to analyse profitability, the growth in gross profits (PBIT) and Profits after Tax (PAT) are examined in the exhibit below. The trends in both measures of profit have been largely identical. There appear to be two phases of growth in profit. The first period is up to FY08 where growth in profits was robust and the sector was upbeat. This was also the period when the IIP growth rate was buoyant and was reflected in sales. However, subsequently the sector did come under pressure and while there was a recovery in FY10 after the decline in profit in FY09, growth in profits has been low and uneven with negative growth once again in FY12.



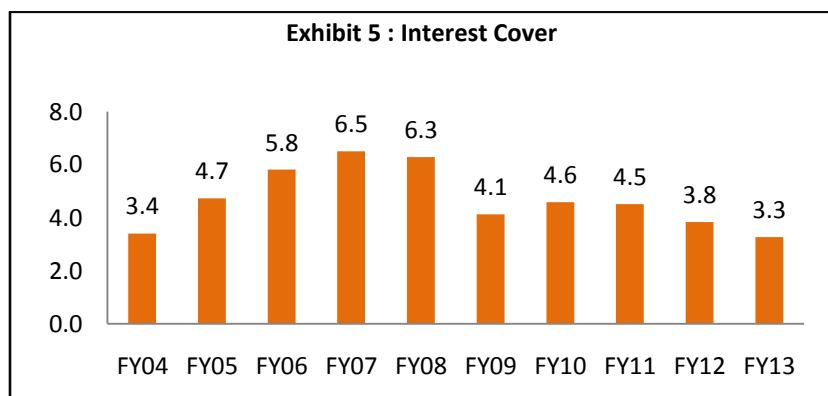
Source: RBI

- **Interest as a proportion of turnover:** The ratio of interest cost to turnover declined between FY04 and FY07 and increased thereafter and stabilized at a higher level. It is intuitive to expect a direct relationship i.e. a rise in the interest to turnover ratio with an increase in lending rates of banks. The PLR of banks had declined between FY04 and FY06 and rose sharply in FY07. It remained at this high level with 25 bps variation till FY10. This was when the ratio increased to 3.1%. This was also the time when companies borrowed funds in higher quantities when the economy was booming. Hence, the absolute debt servicing cost had gone up on larger quantities borrowed. The concept of base rate came in subsequently and this rate increased sharply in FY12 but came down in FY13. However, the interest to turnover ratio has remained quite stable in the range of 3.1-3.4%.



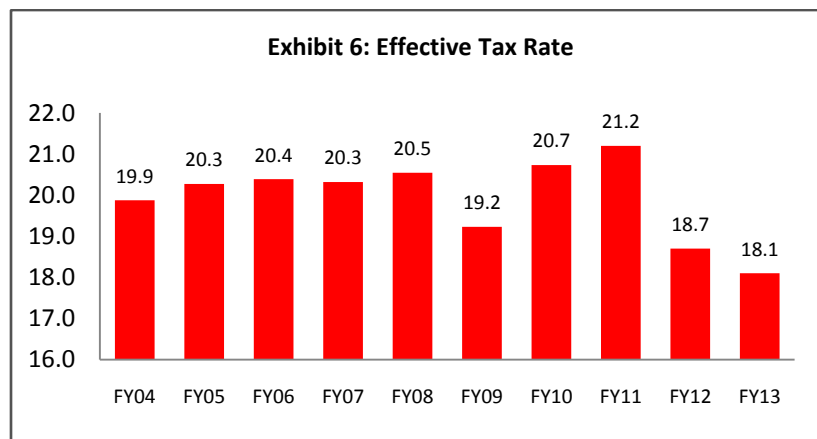
Source: RBI

- **Interest Cover** The burden of debt can be measured by the concept of interest cover which indicates the cover provided for interest payments by profits. Similar to Profit margin, interest cover has also maintained a downward trend since FY09 onwards. It has slid down to 3.3 in FY13 from a high of 6.5 in FY08. However, this continuous decline has resulted in the ratio reaching nearly its same level as at the start of the decade (3.4). This is significant as the cushion provided for servicing debt has been coming down. With the RBI maintaining an aggressive interest rate policy with inflation being high, corporates will be pressurized to meet this commitment. Quite clearly this does indicate the debt strain on the income statements of companies.



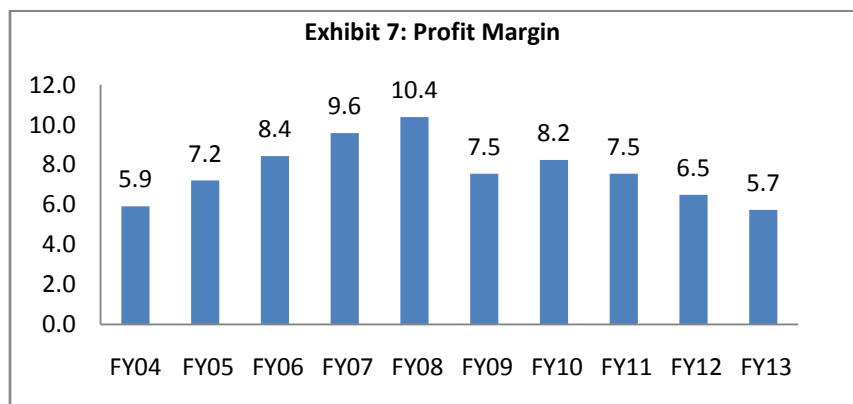
Source: RBI

- **Effective Tax Rate:** The effective tax rate is defined as the tax payments as a proportion of PBT. This ratio has been steady at around 20% between FY05 and FY08 before coming down in FY09 (which was a difficult year for the sector as a whole). There was an increase in FY10 and FY11 but it has come down further to 18.1% by FY13.



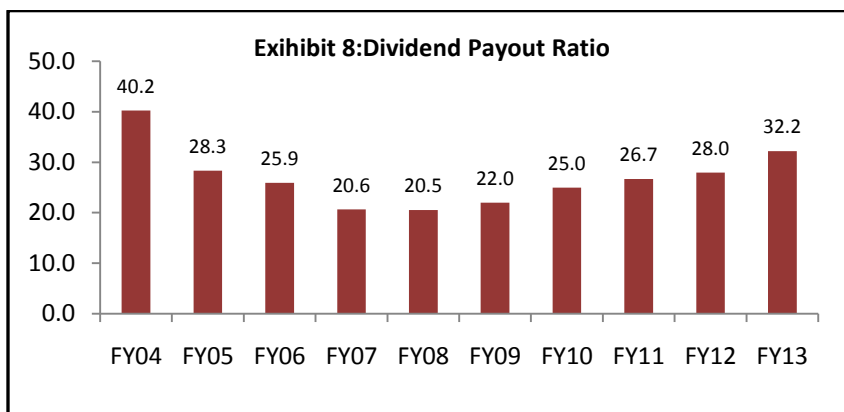
Source: RBI

- **Net Profit Margin:** Profit Margin was on the rise from FY04 to FY08 which can be termed as the pre-financial crisis period. Margin rose from 5.9% in FY04 to 10.4% in FY08 and then has tended to decline. This is a concerning point. It implies that the manufacturing sector has been consistently slowing down in terms of profitability for the last 3 years in a row.



Source: RBI

- **Dividend Payout Ratio:** companies have followed a U shaped pattern in terms of dividend payout. The ratio declined from a high of 40.2% in FY04 to 20.5% in FY08. FY09 has been the turning point from when on a higher proportion of profit has been distributed to shareholder to retain investor confidence. This was notwithstanding the decline in net profit margin (Exhibit 7). Also this has been the time when the stock markets have been relatively robust.



Source: RBI

C. Sources and Uses of Funds

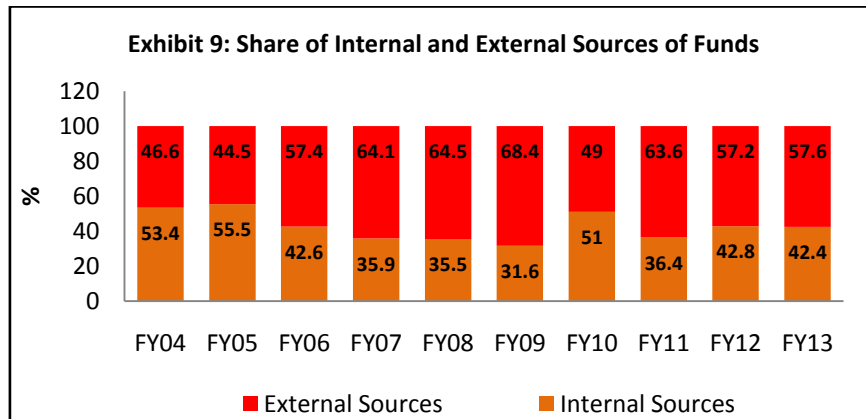
○ Internal and External Sources of funds

The internal sources of funds include paid up capital (bonus), reserves and surplus and other provisions. The external sources on the other hand comprise funds coming into the company from outside and include fresh paid-up capital, borrowings, trade dues and other current liabilities.

The below exhibit depicts the movement in the share of internal and external sources of funds over the last decade. Clearly, external sources of funds dominate over the internal sources of funds for larger part of the period.

Internal Sources: Overall the trend in internal sources has been downward till FY09, then it rose in FY10 to again decline in FY11 following which there has been a marginal steady rise. Intuitively, internal sources would occupy a sizeable share of the total sources of funds when the companies register strong growth which translates into high profits which get transferred to reserves. The converse is true for when profits are low. This is reiterated in the data as internal sources remained the lowest in FY09 which was the most difficult year for the industry in the decade with their share declining to only 31.6%.

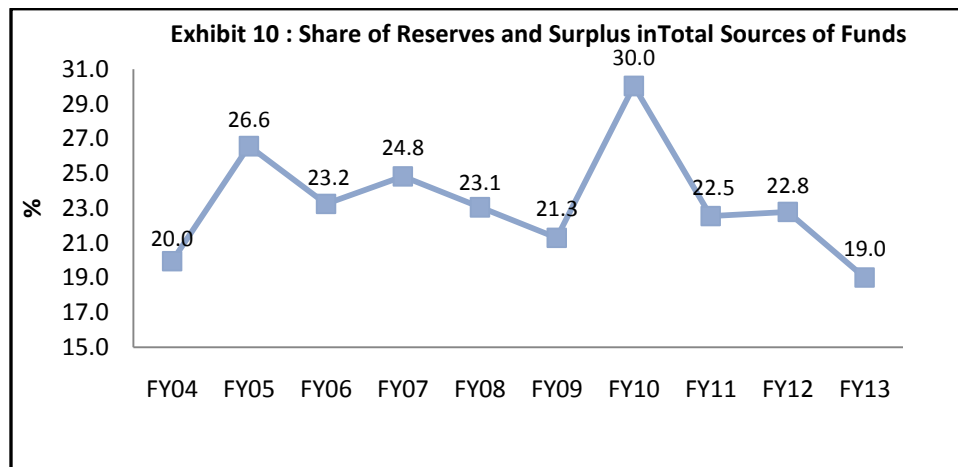
External Sources: On the other hand, external sources have occupied a larger part of the total sources of funds with a share between 44% in the lower bound and 68% in the upper bound. External sources tend to be high either when the company is recording low profits (as it would imply less internal sources of funds) or also when the company is doing well in which case more borrowings would be utilised for further asset creation, purchase of inventories or other investment to that effect. On analysing the trend, it appears as if the data supports the former theory as external sources soared to the highest over the decade in FY09 at 68.4% and were comparatively lower in FY10 which was a year of recovery at 49%. However, during FY04 and FY05, in spite of profit margin being relatively low at 5.7% and 7.2%, external sources were the lowest for the sample period at 46.6% and 44.5% respectively. Growth in fixed capital formation was also positive and averaged 33% per annum in the first 4 years.



Source: RBI

Reserves and Surplus in total Sources of Funds

Reserves and surplus occupy a significant proportion in the total sources of funds (between 19% and 30%). The share was declining from FY04 to FY09 (except in FY05 when it rose to 26.6%) but peaked in FY10 before depleting again in FY11. While the proportion was almost unchanged in FY12 it fell to its lowest in the decade in FY13. The sharp fall in FY13 could be on account of the progressively lower profit margin recorded (5.7 in FY13) by the industry in that year.

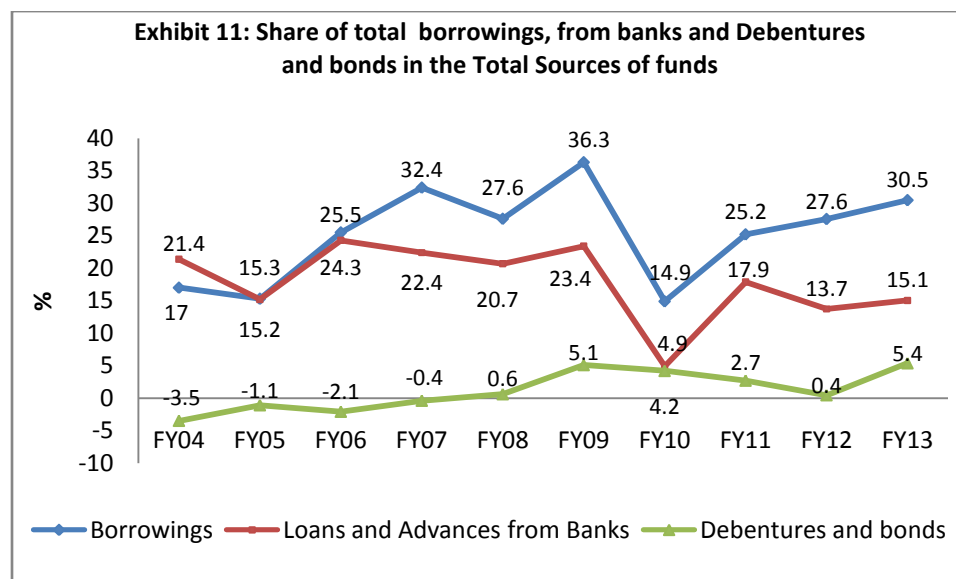


Source: RBI

Other provisions (including depreciation) share in total sources of funds declined continuously from 33.1% in FY04 to 10.2% in FY09 before increasing intermittently to reach 23% in FY13.

○ **External Sources**

The external sources of funds of companies comprise some capital, borrowings, trade dues and other current liabilities. Borrowing further includes bonds and debentures, banks and others. The exhibit below depicts the movement in overall borrowings and the loans and advances from banks only



Source: RBI

- The share of borrowings tended to increase till FY09 and declined in FY10 before resuming an increase in subsequent 3 years. However, the share at 30.5% was still lower than that in FY09.
- Bank borrowings tended to dominate within borrowings and were significantly higher than that of debentures and bonds.
- FY10 was a low for external borrowings as share of bank borrowings also came down sharply.
- Debentures and bonds have tended to become important only after FY10 onwards.

Uses of Funds

Funds of the companies are broadly utilized for gross fixed asset formation, inventories, investments, loans and advances, debtors and cash balances.

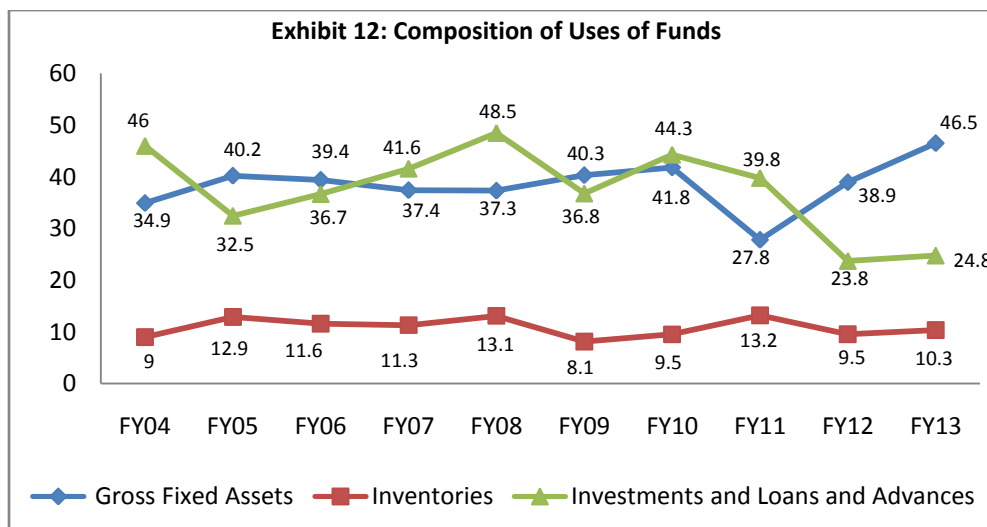
Exhibits 12 and 13 below capture the movements in uses of funds between FY04 to FY13.

- The share of GFA remained largely stable in the first quinquennium at 37.8% but was more volatile in the second quinquennium which was only slightly higher at 39%.
 - The share of plant and machinery has varied between 60-75%.
- The period of slow growth and marginal slowdown in GFA formation between FY05 to FY08 implies that companies refrained from investing progressively in fixed assets. GFA then increased in FY09 and FY10 which is also supported by the relatively higher Gross Capital Formation in manufacturing sector² which

²Gross Capital Formation (Manufacturing) at current prices

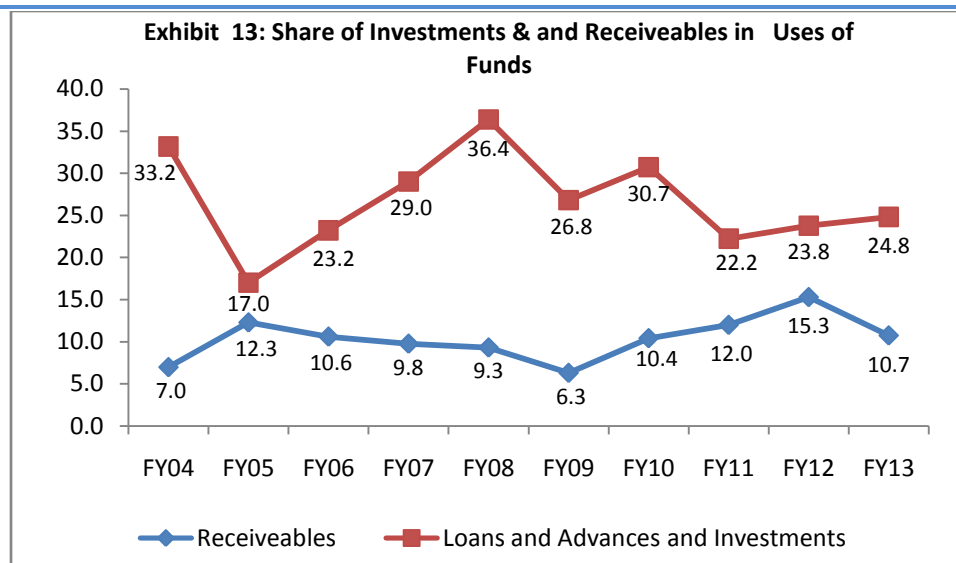
was at 41.2% (y-o-y) during that year. Subsequently, both GFA and Gross capital formation in manufacturing fell in FY11 to 27.8% and 27.93% respectively. Lastly, caution ought to be exercised while interpreting the GFA data for FY12 and FY13 as the upward trend reflected therein could be a result of the GFA of only select companies in those years.

- Inventories as a part of uses of funds have remained between 9-12% between FY04 and FY13. While being range bound overall, they did witness an increase in FY08 and FY11 upto 13.1% and 13.2% respectively. These years also witnessed healthy growth in Industrial production as evidenced in the IIP growth rate of 15.5% and 8.2% respectively. This suggests that companies did spend their resources on building inventories at a time when the industrial sector was booming, proving a direct relation between the two.



Source: RBI

- The share of receivables showed a declining trend between FY05 and FY09 and then started increasing. There is however no discernible relation with the trends in growth in sales or the IIP growth numbers.
- Diversion of funds towards investments and loans has been sharp over the years at an average of around 25-26% in the two five-year periods. Quite significantly this does indicate that funds are being used for financial purposes and not fully towards capital formation. This trend evidently needs to be reversed as a large part of resources are being used for financial purposes.



Source: RBI

To Sum up,

- In terms of income, the current trend in sales is characterised with a downward bias in the last two years. However, the trend is more or less in line with IIP growth over the decade.
- Expenditure has been steadily increasing with the expenses on raw materials being the major contributor. Employee costs have tended to be range bound with no particular upward trend either. Power costs have been kept under control notwithstanding the market conditions.
- Profit margins have been under pressure in the last few years. Interest cover is also diminishing. These two together are arguably the biggest concerns faced by the manufacturing sector.
- In terms of Sources of funds, internal sources have been quite important linked inexorably to the movement in profits. Within external sources, bank borrowings have tended to be more important. However, given the constraints that banks may have in financing capital formation, the bond market will have to evolve and play a more definite role in the future.
- Reversing the previous trend, funds are largely used for the creation of gross fixed assets further to investments and inventories in the last two years. But diversion of funds towards onward lending and investments is still quite significant.

Contact:

Madan Sabnavis

Chief Economist

madan.sabnavis@careratings.com

91-022-67543489

Garima Mehta

Associate Economist

garima.mehta@careratings.com

91-022-61443526

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