Indian Tile Sector

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NGT order banning coal gasifiers in Morbi cluster to adversely impact the industry's profitability and working capital cycle.

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HIGHLIGHTS

- On March 06, 2019 NGT ordered closure of operations of ceramic units running on coal based gasifiers at Morbi and directed players to switch to piped natural gas (PNG) as a fuel.
- Almost 450-500 units, constituting ~60% of the total units will take a hit. Among these units, those most affected will be the wall tile and soluble salt tile manufacturers as they were meeting nearly their entire thermal energy requirements through coal gasifiers.
- Based on the existing price differential between coal and PNG energy cost, ICRA believes that switching to PNG as a fuel source will increase the fuel expenses by 10-15% and thereby impacting the margins by ~2-3% at operating levels in the near term.
- Switching to PNG from coal will also increase in overall working capital intensity for the players due to reduction in credit period and increase in the procurement cost.
- Price hike across product segments among the industry players is imperative to absorb the rise in production cost. Any price hike by affected units would enhance the profitability of players already operating through PNG.
- The ban on usage of coal gasifiers is a positive for the sole PNG supplier operating at Morbi – Gujarat Gas Limited (GGL) by way of additional sales volumes and profits.

Impact analysis of ban on coal-gasifiers based operations in Morbi cluster

NGT orders shutdown of coal gasifier-based operations in Morbi tile cluster; players to henceforth operate only on piped natural gas (PNG)

The National Green Tribunal (NGT), in its order on March 06, 2019, directed closure of ceramic units running on coal-based gasifiers in the Morbi region. According to the order, units need to dismantle all type of coal gasifiers, even if they were complying with the earlier-set pollution control norms, and adopt PNG as a fuel to continue their operations. The NGT through this order seeks to control the deteriorating air and water pollution in the Morbi-Wankaner region. Following the order, the affected ceramic industry players have proposed to approach the apex court to get a stay on the order passed by NGT.

Almost 60% units in Morbi to be directly impacted; wall and soluble salt manufacturers to be most affected

The domestic tiles industry size is estimated to be around Rs. 28,000 crore for FY2018, with almost an equal share of organised players and unorganised players (majority of them based out of Morbi cluster). The Morbi cluster in Gujarat is the largest tiles manufacturing zone in India and accounts for ~75-80% of India's tiles and sanitary ware products in volume terms, with more than 800 tile factories in the region. Almost 450-500 units of the total units will take a hit as their operations are largely dependent on coal gasifiers. Among these units, those most affected will be the wall tile and soluble salt tile manufacturers as they were meeting nearly their entire thermal energy requirements through coal gasifiers. While the overall production should not get materially impacted due to easy availability of gas connection in the region, the switch from coal to PNG will increase the fuel expenses for players due to the higher cost of PNG in comparison to coal and also to result in increase in working capital intensity due to the lower credit period available on PNG purchase than that of coal purchases.

Profitability to be adversely impacted in near term due to increase in fuel expenses, pending subsequent ability to pass on the rise in cost

The industry had witnessed turmoil when the natural gas cost increased, leading the players to shift from natural gas to coal-gasification plants, which burn coal to generate gas. In 2014, the savings in fuel expenses was ~20-25%, which narrowed down to ~10-15% over the years because of increase in imported coal prices and reduction in imported gas prices from the peak levels. Based on the existing price differential between the coal and the PNG energy cost, ICRA believes that switching to PNG as a fuel source will increase the fuel expenses by 10-15%. The total fuel expenses for most of the units remained significant at around ~25-30% of the operating Income in the past. Moreover, tile players can claim input tax credit of 5% on coal consumption, while on natural gas, benefit of input tax credit is not available to the consumers as it is under VAT of 6% (value added tax structure). Thus, it will be an additional cost burden on tile players on switching to PNG. Given the stiff competition amongst players which limits their ability to immediately pass on the rise in input cost, an increase in fuel cost will impact the overall profit margins of the affected units in the near term.

The industry has already seen sharp price correction of ~30-40% over the past 18 months because of significant capacity addition in the Morbi region and slowdown in the real estate sector. This coupled with the increase in gas price has eroded the overall profit margins of the tile players over the last 12-18 months. The industry players expect a price hike across product segments, in line with the expected increase in fuel expenses, to arrest any further deterioration in profitability. However, the sustenance of an industrywide price hike could be a challenge because of the surplus capacity in the industry. Further, ICRA believes that any such price hike by affected units would enhance the profitability of players already operating through PNG.

Impact on operating profitability

Based on ICRA's analysis and inputs from tile players, the indicative figure as per below table suggests that the switching from coal to PNG as a fuel source will directly impact the operating profit margins (OPM) by ~2-3% in the absence of any price hike.

Illustration (simplified) of the impact on OPM with increase in fuel cost, assuming no hike in sales price (Units in %)

Increase in cost	Existing cost structure	Cost structure post switching to PNG
Total Operating Income (a)	100	100
Cost of fuel (coal) expenses	25	27.5
Cost of manufacturing (b)	**85**	**87.5**
Gross Margin (%) (a-b)	**15**	**12.5**

Source: ICRA's research

Working capital cycle to increase because of limited credit period availability for PNG sourcing

Fuel cost accounts for ~30% of the manufacturing cost. Generally, the credit period enjoyed by tile players from coal suppliers ranges from 30 to 45 days, while for PNG suppliers, the payment has to be done within a fortnight. Thus, the switch to PNG from coal will increase the overall working capital intensity of players as credit period will reduce and the procurement cost would increase. The industry is already working capital intensive and the additional burden will put further pressure on the liquidity of affected players.

Mandatory usage of PNG a positive for City Gas Distribution player - Gujarat Gas Limited

The ban on usage of coal gasifiers is a credit positive for the sole PNG supplier operating at Morbi – Gujarat Gas Limited (GGL). Currently, GGL's PNG sales in Morbi are about 2.5 mmscmd. In the past 3-4 years, volumes of GGL in Morbi have come down from the peak levels on account of the increased usage of gasifiers. Volumes could witness a significant increase by 30-40% in the near term as players will have to switch immediately to PNG. Over the long term, if the ban continues, it augurs well for GGL's PNG volume stability and growth as there aren't many economical and environmentally acceptable alternative fuels to replace PNG. The only risk over the long term to GGL would be on account of its exhausted marketing exclusivity in the region. If third party marketers enter into supply contracts with the industry players or a group of industry players at Morbi, GGL could lose PNG volumes to them even though it will derive income from the network charges.

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