



ICRA expects nutrient-based subsidy to have positive impact on credit profiles of cost-efficient DAP/complex fertiliser companies in the long term

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The Government of India (GoI) has recently announced major policy changes for the domestic fertiliser sector, with such changes including among other measures, an increase in the farm gate prices of urea (by 10%), decontrol of retail prices of non- urea fertilisers and a calibrated shift towards a nutrient-based subsidy (NBS) mechanism for non- urea fertilisers. ICRA expects these measures to have a positive impact on the credit risk profiles of fertiliser companies in the long term, as they signal a gradual decontrol of the sector.

In ICRA's view, the key positives for the industry from the latest set of measures include: a marginally lower subsidy requirement because of the increase in farm gate (FG) prices of urea; the possibility of FG prices of DAP/complex fertilisers increasing in the near term because of decontrol; and sustenance of fertiliser demand growth through balanced application of nutrients. Besides, the measures may motivate players to invest in new capacity, something that did not happen during the past decade and led to an increasing reliance on fertiliser imports.

In the short term however, there could be uncertainties for fertiliser companies till such time that the dynamics of the announced policy changes play out fully. Such uncertainties would relate mainly to their ability to pass on any sharp rise in costs to farmers in a scenario of rising commodity prices and fixed fertiliser subsidies, and their ability to source imported raw materials/intermediates cost-effectively.

Overall, if the policy changes are implemented as intended, the cost-efficient fertiliser manufacturers would stand to benefit in the long term by way of higher profitability, in ICRA's opinion. However considering the challenges ahead, ICRA considers the near-term outlook for the sector to be stable, while taking note of the likely positive fallouts of the recent policy pronouncements.

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ICRA believes the increase in the maximum retail price (MRP) of urea would not have any significant positive impact on the profitability of urea players in the near term as the subsidy component of the net realisation would come down correspondingly. Since, the increase in MRP (by Rs. 480/tonne) of urea is low in comparison with the normative cost of production of a large number of industry players, the benefits arising from lower working capital requirement is likely to be marginal.

ICRA also expects the impact of the price decontrol on the working capital of DAP/complex fertiliser manufacturers to be marginal in the near term, given the GoI's assurance that the revised prices of these fertilisers would remain at about the current levels till the 2010 *kharif* season so that there is no immediate impact of the price rise on farmers. However, manufacturers of non-urea fertilisers would enjoy higher pricing freedom post-*kharif* 2010, when the MRP would be a function of the prevailing international prices and the fixed subsidy per nutrient (under NBS).

ICRA notes that any significant increase in the MRP of non-urea fertilisers could have an adverse impact on consumption initially, considering particularly the significant increase in the international prices of DAP during the last few months. ICRA therefore expects the MRP of non-urea fertilisers to be deregulated partly and gradually in the short to medium term, with manufacturers seeking to reduce the proportion of their overall realisation derived from subsidy.

In its new policy, GoI has also approved a shift from the current product-based subsidy mechanism to NBS with effect from April 1, 2010. According to NBS, the subsidy will be fixed individually for each nutrient: Nitrogen (N), Phosphorus (P), Potash (K), and Sulphur (S). However, the subsidy for urea would continue to be determined by the existing mechanism (that is, the New Pricing Scheme) and it would not come under the purview of NBS.

ICRA expects NBS to encourage balanced consumption of fertilisers by eliminating variances in the degree of subsidisation for a specific nutrient across different fertilisers. Further, the GoI has announced an additional subsidy for subsidised fertilisers containing other secondary nutrients and micro nutrients (except S) so as to encourage their consumption along with primary nutrients. This is expected to encourage customisation and development of new fertilizer products for different soil conditions, from hitherto commoditised product offerings by the incumbents. Moreover increase in the MRP of urea would also narrow the per bag price differential between urea and DAP/complex fertilisers, thereby encouraging consumption of the latter.

Since the subsidy for the N and P components in complex fertilisers would remain fixed under NBS irrespective of the feedstock/cost structure, ICRA expects the new policy to be favourable only for players backward integrated into ammonia (gas based) and phosphoric acid.

ICRA also notes that any sharp increases in the prices of fertilisers and their inputs may be required to be passed on to farmers in the form of higher MRPs as the subsidy per nutrient would largely remain fixed under NBS. However, doing so would be a challenge for the industry, given the high price-sensitivity of fertilisers.

In this regard, ICRA expects greater challenges to confront players who trade in imported fertilisers, since in a scenario of rising prices, the potential increase in MRP could be lower than the monthly revision in subsidy under the existing mechanism. Besides, the ability of players to source the key raw materials/intermediates—viz. ammonia, phosphoric acid, rock phosphate, sulphur—in a cost effective manner will be critical to preserve their profit margin. In this

context, players who have joint ventures abroad for manufacturing some of these key intermediates could be better placed than others.

In the case of manufacturers of single super phosphate (SSP), NBS is expected to have a positive impact on them, given that the new policy seeks to make the subsidy on the P content of SSP comparable with that on the corresponding nutrient in DAP. As a result, ICRA expects consumption of SSP to get a fillip resulting in increased interest by the fertilizer manufacturers in this product line, which otherwise was on a decline and was not also remunerative.

Overall, ICRA sees NBS as a step in the right direction and expects it to raise agricultural productivity via balanced use of fertilisers. This in turn could provide for a sustained rise in demand over the longer term, thereby benefiting the industry. Besides, the shift in policy would also lower the fertiliser subsidy burden on the Gol.



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