

Management Discussion and Analysis

Global sugar industry review

The sugar industry is one of the world's major agro-based industries. Around 75% of the global sugar production comes from the top 10 producers, of which the top three (Brazil, India and the European Union) contribute 40% of the total.

As of May 2010, global sugar production stands at 158.19 million tonnes, increasing just 4.23% over that of the previous year. Owing to lower production, high international prices and lingering impacts of global downturn, the world's global consumption (166.70 million tonnes) posted lower growth rate of 1.66%, compared to last 10 years average of 2.64%. The world sugar economy witnessed a statistical deficit for a second year in a row.

World sugar balance (million tonnes, raw value)

	2009/10	2008/09	Change	
			in million tonnes	in %
Production	158.189	151.769	6.420	4.23
Consumption	166.701	163.983	2.718	1.66
Surplus/deficit	-8.512	-12.214		
Import demand	52.896	50.167	2.729	5.44
Export availability	52.288	49.216	3.072	6.24
End stocks	52.772	60.676	-7.904	-13.03
Stocks/consumption ratio in %	31.66	37.00		

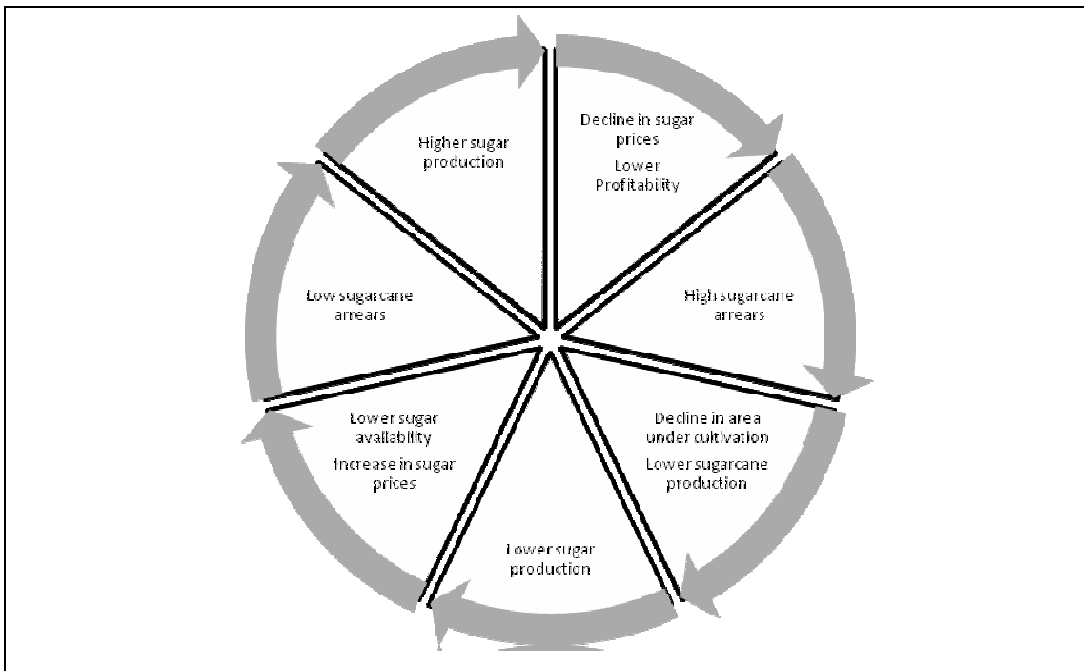
(Source: ISO Quarterly Market Outlook, May, 2010)

Indian sugar industry review

In India, sugar industry is the second largest industry after textiles. The country is the second largest sugar producer in the world (accounting 13% of the world's sugar production). The sub-tropical region (Uttar Pradesh) contributes almost 60% of India's total sugar production, while the balance comes from the tropical region, mainly from Tamil Nadu, Karnataka, Maharashtra and Madhya Pradesh.

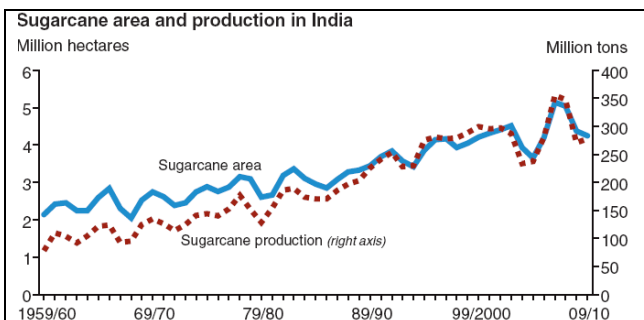
The sugar cycle

The Indian Sugar Industry is cyclical in nature. The industry downtrend starts with improved mill profitability, prompt farmer payment resulting in higher sugarcane acreage and a bumper sugar output. This results in supply exceeding demand, leading to a decline in sugar prices which in turn leads to lower mill profitability, delayed payment to farmers, high sugarcane arrears, lower cane production, all culminating into higher sugar prices.



Production and consumption of sugar in India

After consecutive decline in production in 2007-08 and 2008-09, India's sugar production has started increasing. With the increase in the sugarcane output to 274 million tons in Sugar season 2009-10, the production of Sugar is expected to reach at 18.75 million tons by the time the current Sugar season comes to an end in September, 2010. India's sugar is mostly produced from sugarcane, and the swings in production were driven primarily by large swings in the acreage of land cultivated for sugarcane.



(Source: USDA)

The sugar consumption, on the other hand, is estimated to have grown marginally to 23.5 million tons. The growth is on account of rising per capita income and government interventions to adjust stocks and facilitate trade to assure adequate monthly availability. Despite rising price, the sugar demand did not reduce among bulk consumers. Bakeries, soft drinks and local sweet manufacturers accounted for around 60% of the sugar demand.

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India's sugar production and consumption

Million tones	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10(E)
Production	14.00	12.69	19.27	28.3	26.3	14.5	18.75
Consumption	17.29	18.50	18.50	20.0	22.2	22.5	21.5

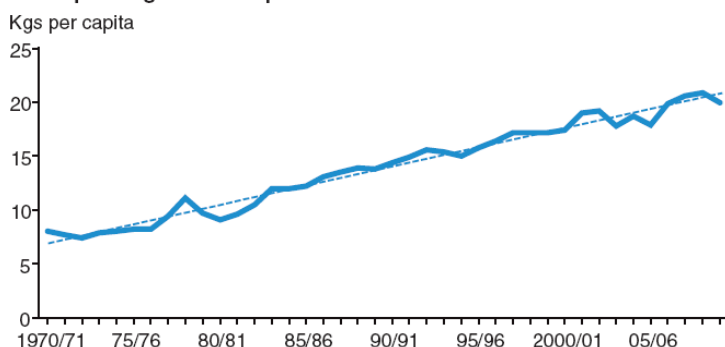
(Source: ISMA)

The industry is highly fragmented with the presence of organised and unorganised players. The unorganised sector usually produces jaggery (unrefined concentrated sugar) or *khandsari* accounting for smaller shares of overall use. The production and consumption of *khandsari* has been declining, while it is a reverse situation in case of jaggery. Its production and consumption are unregulated and tend to rise in years, when higher jaggery prices or increase in payment arrears by sugar mills incentivise farmers to divert sugarcane for jaggery production. During 2009-10, jaggery's market share rose to about 35 % of the total demand of the sweetener, reflecting a drop in sugar production caused by reduced sugarcane plantings.

Box item

India ranks sixth in per capita sugar consumption. India's sugar consumption currently hovers around 20 kg/capita compared to 57.6 kg of Brazil. The lower per capita consumption leads to anticipation of increasing demand in the future, though in the last few years, the per capita consumption is increasing at a steady 3.7 % annually.

Per capita sugar consumption in India



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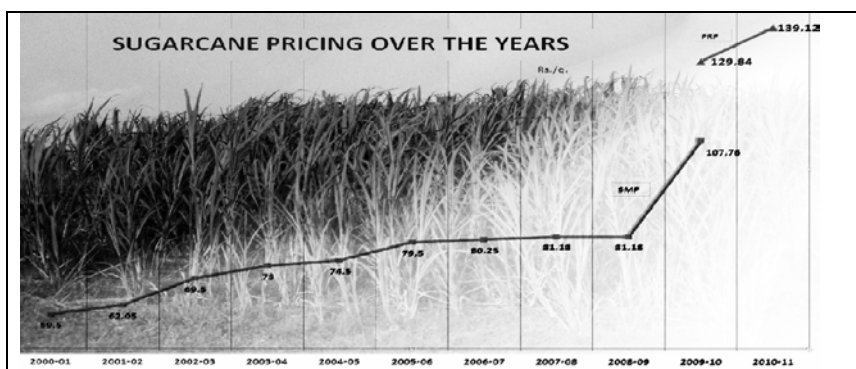
Recovery rate

A higher recovery rate (percentage of sugar produced from sugarcane crushed) ensures higher production. Frequent switching of crops and climatic conditions affect the recovery rate considerably. In India, the recovery varies from the plantation in the subtropical region and tropical region. India's current recovery rate stands at around 10%, compared to Brazil's recovery rate of 13-14%.

Pricing

Until the last sugar season (SS), there were two types of pricing that were followed by the sugar mills to remunerate the farmers – State Advised Price (SAP) and Statutory Minimum Price (SMP).

The Commission on Agricultural Costs and Prices (CACP) decides the SMP, whereas the state governments fix the SAP, which is significantly higher than SMP. The difference in pricing led to regional variation in productivity and profitability. To include reasonable margin for both the sugarcane and sugar producers, the Centre replaced the Statutory Minimum Price (SMP) with Fair and Remunerative Price (FRP) in early 2010, for the minimum price to be paid to sugarcane farmers for the sugar season 2009-10. FRP for 2009-10 crop season was fixed at Rs 129.84 per quintal and has been further raised to Rs. 139.12 per quintal for the 2010-11 season. SAP was fixed at Rs. 165 per quintal.



(Source: Press Bureau of India)

Distribution of levy sugar

It is mandatory for the sugar millers to sell a portion of their production to consumers below poverty line through the Public Distribution System (PDS), at a pre-determined below-market price (levy price). Rest of the stock is sold in the free market under monthly release mechanism. Since October 2009 the GOI increased the levy quota from 10% to 20% of the total production as a measure to deal with the shortfall in the domestic sugar production. There was a revision in the pricing as well. After seven consecutive years of unchanged price, the Supreme Court order directed the government to announce a different price for mills that pay SAP to buy sugarcane from farmers. Consequently, the food ministry increased the levy price by 50 % in Maharashtra and 63 % in Uttar Pradesh (UP). The mills across the country will further benefit, as the price of levy sugar will be calculated on the revised SMP.

Sugar trade

The Government regulates the trade of both raw and refined sugar through import tariffs, export quotas and financial support in order to maintain the demand-supply gap. During early 2009, the Government had relaxed the re-export requirement for the Advanced License Scheme in order to deal with the shortfall in domestic supply. Unrestricted duty free raw sugar import was permitted till April 2010, which eliminated the 60% basic ad valorem tariff, the Rs. 950/ton countervailing duty and 3% educational cost from the total tariff. The Government further allowed free import of 1 million tones refined sugar during August-November 2009. Consequently, 2.5 million ton sugar was imported in 2009 and it is further expected to reach around 4.3 million tons in 2010. However, exports on the other hand, declined significantly on account of lower production.

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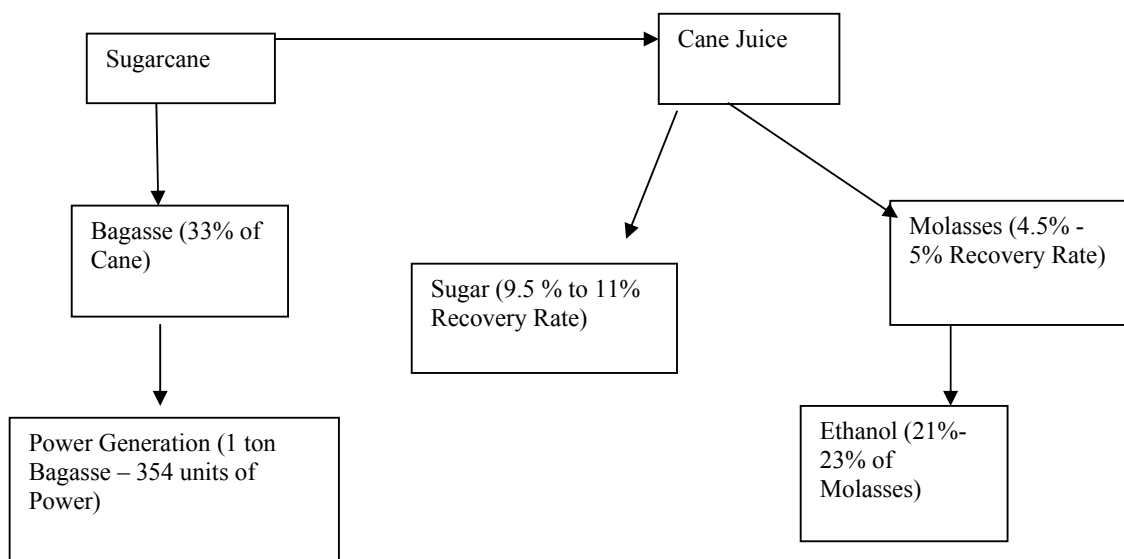
India's sugar trade

Million MT/SY	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10 (E)
Imports	0.04	0.40	2.14	0.00	0.00	0.00	2.5*	4.3
Exports	1.50	0.22	0.00	0.47	1.7	5.0	0.2	0.0

* Import figure for SY 2008-09 includes 1.2 million of unprocessed raw sugar lying with sugar mills. (Source: ISMA)

Sugar by-products and its contribution

The seasonality in Indian sugar production exposes the manufacturers to fluctuating profit margins. However, by-products like molasses and bagasse contribute significantly to the bottom line and diversify the risk. Sugar by-products are classified in the following figure.



The Cabinet Committee on Economic Affairs mandated 5 % blending of ethanol with petrol in November 2009. The ethanol blending programme is primarily based on indigenously produced ethanol from sugarcane molasses, which, besides augmenting fuel availability in the country, would also provide better returns for sugarcane farmers. The Ministry also recommended the fixation of an interim ethanol price at Rs 27 per litre for three years in December 2009 which came into effect from August 2010. The final price will be determined by a high-powered committee set up under the Chairmanship of Mr Saumitra Chaudhari. The above recommendations were made after ensuring that even in years of shortage, the production of molasses based alcohol would be enough to meet the 5 % blending requirements.

Bagasse has a very strong demand in paper and biomass-based power projects. Currently, bagasse generation accounts for just 0.6% of the total power generated, but it has the potential to generate 6% of future power requirements in 2017. Due to sugarcane shortage, the production of bagasse was restricted, which further increased the price to Rs. 1,500 per MT.

The State Electricity Regulatory Commission SERCs also supported the cogeneration projects by increasing price and providing permission to sell a part of power produced through open access in the market route. The cogeneration tariff has been increased to Rs. 4 per unit in 2010 from that of Rs. 3 per unit in 2009 by Uttar Pradesh Electricity Regulatory Commission, and it has also permitted companies to sell 50% of the power generated by it to third parties in the offseason. (Source: ICRA Research Report, June, 2010)

PESTEL analysis of Sugar

Political factors: The sugar industry operates under high political influence. The farmers usually deal through co-operative societies, on which the local parties have a strong influence. To protect the interest of sugar producers, the government came up with FRP pricing. The regulation is facing strong opposition from farmers as well as the state governments, as they want to retain the flexibility of having a higher SAP without bearing any additional cost.

Economic factors: Although there is considerable annual volatility, India's sugarcane cultivation area constitutes 2.2-2.7% of India's total cropped area. In FY'2009, 0.7% of India's GDP came from the sugar industry. In addition, the industry usually contributes around Rs. 1,700 crore annually to various state government treasuries by way of excise duties and purchase tax on sugar cane. The contribution of sugar in the value of agriculture output was as high as 6.4% in FY 2006, though in FY 2009 it came down to 4% due to price and production fluctuation in the industry (Source: *The Financial Express*).

Social factors: About 7.5% of the rural population banks on sugarcane farming. The sugar industry directly employs around 2 million workers, and there is also significant indirect employment generation through various ancillary services (Source: *The Financial Express*).

Technological factors: The department of Food and Public Distribution of India is taking initiatives for technological upgradation in sugar mills. Indian sugar mills suffer from lower capacity utilisation. Combined with the Department of Science and Technology, Government of India, it works on improvement of plant efficiencies, energy saving and reduction of utilisation of major inputs.

Environmental factors: Ethanol emits less carbon dioxide than crude oil. The use of ethanol not only benefits environment, but also helps the industry to earn carbon credits.

Legal factors: The industry operates under strict legal regulations. Although in some cases it affects the industry and producers, mostly it ensures financial supports and regulations to balance the domestic demand-supply.

Outlook

Sugar Season 2010-11 is expected to have potentially strong recovery in sugarcane and sugar output that could sharply reduce or eliminate the need for additional imports. With the financial condition of the sugar mills strengthened by high prices for free-sale sugar in 2009, growers may be more responsive to price support policies announced during 2009-10.

Along with sugar, there will also be an increase in demands of ethanol and bagasse, because of the country's socio-economic growth. Proposals related to removal of monthly release mechanism, alignment of sugarcane and sugar prices, establishment of strategic sugar stocks along with a price-band mechanism are under government review. On the other hand, supportive legislations in ethanol and cogeneration sector will result in upward price movements of the aforesaid products. Taking all factors into consideration, the Indian sugar industry is poised for rebound in the coming fiscal.

Company review

Operating performance

The operating performance of the Company, like the rest of the industry, was severally under strain during the year 2009-10. The season 2009-10 started with very firm sugar prices. An ordinance by the Central Government to scrap State Advisory Prices without offering an alternative pricing formula that protects the interests of the farmers resulted in widespread agitation in New Delhi. Under tremendous political pressure, the Central government was forced to withdraw the ordinance. Firm sugar prices at the start of the season and scarcity of sugarcane compelled the sugar industry to pay attractive sugar prices to the sugarcane farmers even higher than Rs 200 per quintal.

However, within a month, there was another public outcry- on consumer prices of sugar and other food items. The Government of India, in an effort to control food inflation implemented several draconian measures:

- a. The levy obligation was increased from 10% to 20% of a sugar factory's production. Furthermore, the levy prices payable to the industry is around Rs. 1820 per quintal as against the cost of production of Rs. 3200 per quintal. This itself has resulted in a huge loss for the Company.
- b. Stock holding limit of 10 days was imposed on traders and bulk consumers. The bulk consumers account for 55% of the consumption of sugar in India. The bulk consumers were exempted from these limits if they were holding imported sugar and not Indian sugar.
- c. Import duty on both raw and white sugar was brought down to zero level.

All these measures had a combined effect of sugar prices crashing in India and lack of demand for Indian sugar. Sugar prices that were ruling around Rs 4000 per quintal came tumbling down to Rs 2500 per quintal with no buyers. The industry that was slowly limping back to revival found itself back in huge losses. The industry association has taken up this matter with the Central Government who are now seized of the seriousness of the problem. In fact the Government has also slowly started relaxing some of the measures like the weekly release mechanism etc to revive sugar demand and sugar prices.

In the above backdrop the operating performance of the Company was as follows:

	Year 2009-10 (Actual)					Year 2008-09 (Actual)				
	Hargaon	Rosa	Narka-tiaganj	Hata	Total	Hargaon	Rosa	Narka-tiaganj	Hata	Total
Sugarcane Crushed (Lac quintals)	102.54	30.58	51.65	29.58	214.35	71.67	29.55	45.16	1.45	147.83
Recovery	9.41	8.51	9.51	9.26	9.28	9.34	8.59	9.02	8.00	9.07
Sugar Produced (Lac quintals)	9.65	2.60	4.91	2.74	19.90	6.69	2.54	4.07	0.12	13.42
Crushing days	120	92	83	85	380	102	86	73	11	272

Internal control

The company has a wide spread internal control system to ensure smooth functioning of each and every department of the organization. The internal control system is totally in alignment with the business nature and the size of the company. It tracks various financial transactions effectively and certifies the compliance with rules and regulations, thus contributing to the operational efficiency of the company.

Human resources and industrial relations

The Company continues to attribute high priority to Human Resources. It is committed to providing an environment that is encouraging, nurturing, appreciative of talent and one in which the employees can work to their potential and grow professionally as well as personally.

Therefore, vigorous efforts were made to upgrade and improve skills and knowledge of Company's employees and to fill up specific knowledge and skill gaps. The Company also continued to maintain cordial relations in all the mills and offices during the year under review.

Risk management

Risks	Mitigation
Farmers switching over to other profitable crops	<ul style="list-style-type: none"> The government has come up with different pricing to ensure a proper remuneration to the farmers; additionally, millers also have the permission to attract farmers with competitive prices, which are higher than the FRP At Oudh, we have introduced farmer friendly initiatives and otherwise share harmonious relationship with them that results in sufficient availability of sugarcane even during the period of low sugarcane output; we also conduct regular training programmes to educate farmers about advanced methods and technologies of sugarcane farming resulting in higher cane yield in the area allotted to us

Higher operating cost affecting the Company's profitability	<ul style="list-style-type: none"> • At Oudh, we have optimized the production through various initiatives; we have further installed latest cutting edge technologies for enhanced operational efficiencies • Our efficient working capital management also ensured improved financial leverage.
Lower recovery rates affecting the sugar production	<ul style="list-style-type: none"> • Enhanced capacity utilization by the units improved over all recovery rates considerably from 9.07% in 2008-09 to 9.28% in 2009-10
Shortage of sufficient electricity affecting the regular plant operations	<ul style="list-style-type: none"> • The company possesses three co-generation plants with a production capacity of 60 MW that suffices the captive needs of the plant ensuring uninterrupted operations besides transferring the surplus power generated to the state grid
Single product dependency for the source of revenue	<ul style="list-style-type: none"> • At Oudh, our revenues are diversified through sugar, ethanol, co-generation of power and food processing segments • The demands for these products are also growing considerably, which is expected to provide a steady return to the Company throughout the year • The proportion of revenues from sugar has gradually declined from []% of total revenues in 2006-07 to []% of total revenues in 2009-10