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Balrampur
Chini Mills Limited

Annual Report 2002-03

s.t.r.e.t.c.h.

De-risking with a difference

FORWARD-LOOKING STATEMENT

In our report we have disclosed forward-looking information to enable investors to understand our future prospects and make informed investment decisions. This annual report and other written and oral statements that we make periodically contain such forward-looking statements that set out anticipated results based on our plans and assumptions. We have tried, wherever possible, to identify such statements by using words such as 'anticipate', 'estimate', 'expects', 'projects', 'intends', 'plans', 'believes' and words and terms of similar substance in connection with any discussion of future operating or financial performance.

We cannot guarantee that any forward-looking statement will be realized, although we believe that we have been prudent in our plans and assumptions. The achievement of future results is subject to risks, uncertainties and inaccurate assumptions. Should known or unknown risks or uncertainties materialize, or should underlying assumptions prove inaccurate, actual results could vary materially from those anticipated, estimated or projected. Investors should bear this in mind as they consider forward-looking statements. We undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise.

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Corporate information

Secretary
S. K. Agrawala

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Khaitan & Co.
1B, Old Post Office Street
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Bankers
State Bank of India

Auditors
G.P. Agrawal & Co
Chartered Accountants

Registered Office
FMC Fortuna
234/3A, A.J.C. Bose Road
Kolkata-700 020

Factories
Unit 1 : Balrampur
(Including alcohol, bio-compost and co-generation units)
Dist : Balrampur, Uttar Pradesh

Unit 2 : Babhnan
(Including alcohol unit)
Dist : Gonda, Uttar Pradesh

Unit 3 : Tulsipur
Dist : Balrampur, Uttar Pradesh

Unit 4 : Haidergarh
(Including co-generation unit)
Dist : Barabanki, Uttar Pradesh

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concept, research and visualisation by trisys (trisys@vsnl.com)
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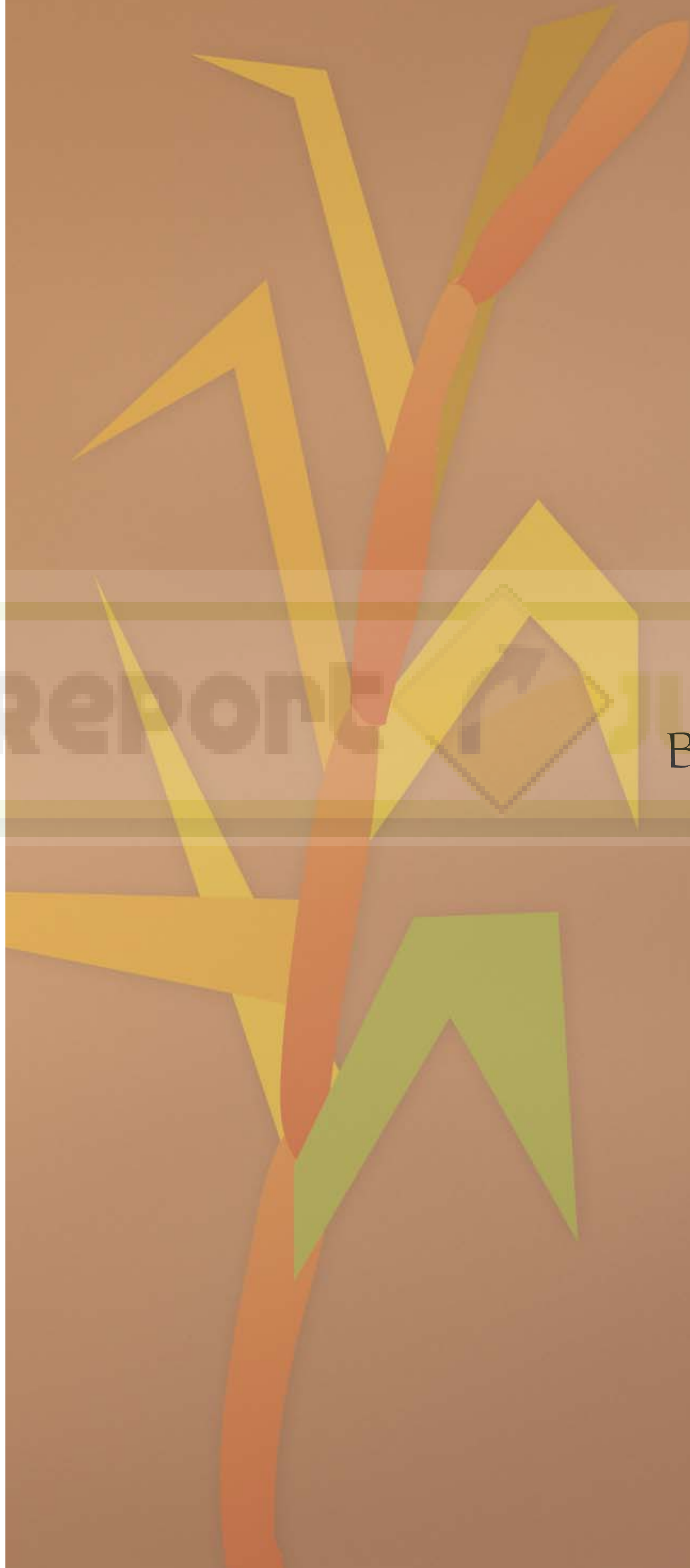


Balrampur Chini Mills reported a 38 per cent decline in its profit after tax in 2002-3. The management was satisfied with this performance.

Because the bottomline could have been far worse.

Had it not been for the prudent and progressive de-risking conducted by the company over the last two decades.

At Balrampur, the difference in the de-risking approach was in its discipline.

It was not occasional, it was ongoing.

Conducted in good years and bad.

This all-weather commitment reinforced the company's business model and helped it stay ahead of competition.

As a result, when realisations reported their sharpest year-on-year decline in five years in 2002-3, the company not only protected a large part of its annual surplus but also performed considerably better than the rest of the Indian sugar industry.

De-risking with a difference

FARM MANAGEMENT

DE-RISKING ENDURES.

At a time when a number of sugar manufacturers were investing in raw material, Balrampur was investing in relationships.

Especially with the thousands of farmers across a command area of nearly 166,000 hectares, who supplied the company with cane for the manufacture of sugar.

At Balrampur, this relationship commenced with the subsidised supply of fertilisers, manure, pesticides and high-yielding seeds. It was sustained through irrigation facilities and technological developments. And complemented by the speedy drawal of cane and its timely remuneration.

As a result, the supply of cane to the company's three factories grew by 356 lac quintals over the last two decades, considerably higher than the average growth for the rest of the industry. This growing inflow of raw material inevitably kick-started the subsequent logical and decisive initiative at Balrampur - incremental capacity.

De-risking with a difference

CAPACITY CREATION

DE-RISKING STRENGTHENS.

When most manufacturers invested with the accruals generated in good years, Balrampur prudently invested in capacity during good times and bad.

With good reason. Much of the Balrampur's insight into capacity was created to counter the sensitivity of the sugar business. Simply because, the company recognised that increased profits would have to come from increased volumes, not increased prices.

Based on this conclusion, the company embarked on a long-term policy of productive asset creation at a low incremental cost. Just about every retained rupee was invested in incremental capacity. Besides, the company capitalised on low asset and acquisition prices in weak markets.

More importantly, the company invested in assets consistently and proportionately. This translated into two manifestations: the company did not invest beyond its means and neither did it under-invest in the face of an industry opportunity.

Balrampur invested Rs 565.83 cr across two decades. This strengthened the company's installed capacity from 1600 tcd (1981) across one plant to a consolidated 29,000 tcd (including proposed 4000 tcd at Haidergarh to be commissioned in November, 2003) across four large manufacturing units.

As a result, Balrampur is not only among the largest sugar manufacturers in India today. It is among the lowest cost producers as well.

Over time, Balrampur graduated its capacity-centric derisking initiatives to its next logical point - an integrated complex.

INTEGRATED MANUFACTURE

DERISKING INSURES.

At Balrampur, one of the most important initiatives to de-risk the organisation was taken through the integrated model of manufacture.

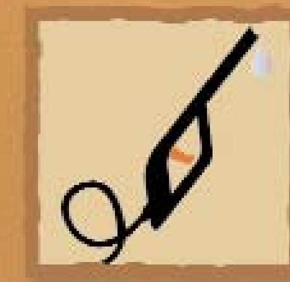
In line with this decision, all prospective greenfield investments in sugar capacity will now be made through the integrated route, not standalone sugar mills.

The company's first integrated complex is expected to be commissioned at Haidergarh (Uttar Pradesh) by November 2003, comprising a 4,000 tcd sugar mill and 20 MW power plant. Besides, the byproduct generated by the sugar operation at Balrampur and Tulsipur will feed the power plant and biocompost units at Balrampur, strengthening the integration process.

The biggest USP of this integrated complex will be the complement of assets - sugar plant, distillery and co-generation power plant - which will make it self-sufficient. The by-products generated from the sugar plant will be used to feed the distillery and the power plant. Even the waste from these units will be used to produce organic manure.

The stable offtake of the materials derived out of the by-products at Haidergarh will enhance the predictability of the company's earnings in good markets and bad, positioning it even more emphatically as a non-cyclic company in a cyclical industry.

VALUE-ADDITION THROUGH ETHANOL



DE-RISKING SUPPLEMENTS.

Conventionally, the molasses generated in the production of sugar would either be sold in its raw form or used as a raw material in the downstream production of alcohol.

Over the last year, Balrampur took its de-risking initiative an important step further. It commissioned a dedicated plant to process its by-product molasses into the manufacture of value-added ethanol.

For an important reason. In 2002-3, the government of India permitted the 5 per cent blend of ethanol in automotive fuel. This was done to facilitate a more complete combustion of fuel, save the country an import bill in fuel costs and enhance the quality of the environment.

As a responsible corporate committed to stable growth, Balrampur allocated a considerable part of its alcohol capacity to the production of ethanol. In view of the vast requirement of the fuel additive, Balrampur Chini commissioned a 40 klpd ethanol production plant in 2002-3 and expects to commission a new 60 klpd plant at Babhnan in November 2003, enhancing the aggregate ethanol capacity to 100 klpd.

An enhanced value-addition and a committed volume of large offtake will enable the company to use the entire molasses in house and translate into a predictable income stream in a volatile industry.

CONVERTING BAGASSE INTO POWER

DE-RISKING PROTECTS.

For the last number of years, the bagasse generated by Balrampur would either be used to generate power for captive consumption or sold as raw material for the manufacture of paper.

Convinced that it would be able to enhance value for the organisation by extending the bagasse into the production of electricity, the company embarked on an important de-risking step: the erection of a 19.55 MW power plant in 2002-3.

The power plant, commissioned at Balrampur in March 2003, is already supplying power to the Uttar Pradesh State Electricity Board. This is expected to generate a revenue of Rs 30 cr in the first full year of generation. Moreover, the power plant complies with all the parameters of Kyoto Protocol and is eligible to receive carbon emission benefits (for the next ten years) under the protocol.

To further leverage the value of this byproduct a 20 MW power plant is presently under implementation at Haidergarh and is expected to be commissioned by November, 2003.

Over the years, this segment of the business is expected to protect the company from the industry volatility through a steady income and incremental cash flow.

QUALITY PRODUCTS. SELECT MARKETS

DE-RISKING ENHANCES.

Since much of the sugar is sold unbranded in India, a number of manufacturers prefer to focus on quantity rather than quality. In such an environment, Balrampur is a distinct contrarian: it has invested consistently in achieving international quality benchmarks leading to a quality product.

This represents an interesting reality: even though Balrampur's sugar is sold largely unpackaged, its product has acquired a reputation for white, clear and uniform crystals.

This superior quality has translated into two distinct advantages: a realisation higher than the prevailing average in good markets and a quicker offtake in sluggish conditions.

As an important de-risked step through the manufacture of quality products, the company introduced branded and packaged sugar for consumers in 2002-03. This represented precious value-addition for the company as well: it entrenched the company's brand recall and enhanced realisations in a competitive market.

The company's consistent manufacture of this quality product has been leveraged through the selection of attractive markets: where a relative undersupply of the material and discerning customers translate into relatively stronger relationship.

De-risking with a difference

STRONG BALANCE SHEET

DE-RISKING INSULATES.

Even as Balrampur continued to invest in its production assets, it did so not just with a respect for how much the marketplace could absorb, but also with a consideration for how much its balance sheet could sustain.

As a result, even though it enlarged its gross block from Rs 4.44 cr to Rs 555.44 cr over two decades, its sense of fiscal discipline ensured that its debt-equity ratio did not at any stage exceed 0.95 (1996-97). As a result, the average interest cover reported by the company during the last two decades represented comfortable liquidity. All new projects were funded with a prudent proportion of accruals and borrowings. All borrowings were made at a cost attractively and affordably lower than the prevailing market rates. The company restructured its debt and financing cost by capitalising on market opportunities with speed and prudence.

Balrampur believes that a conservative balance sheet protects profits in bad years and enhances them when the industry aberrations are corrected. The strength of the company's progressively de-risked balance sheet is reflected in its strong book value of Rs 124 and a conservative debt-equity ratio of 0.57.

AS A COMPANY WE WILL STRIVE TO:

- STICK TO OUR CORE COMPETENCE of manufacturing sugar and allied products.
- RECRUIT AND RETAIN skilled and superior expertise as well as measure and reward excellent performance.
- INCORPORATE THE PRINCIPLES of corporate governance to protect and enhance shareholder value.
- ENSURE THE CONCURRENT DEVELOPMENT of the community in which we are based along with our business growth.

OUR VALUES

INTEGRITY

We demand of others and ourselves the highest ethical standards. Our effort will be directed in making products that are of the highest quality.

TEAMWORK

This is the critical cog, which runs the Balrampur wheel. We know that if we are to succeed we must work together - more effectively and efficiently.

LEADERSHIP

We believe that a leader company is not as much a company which leads others as much as a company which has leaders at every level. This can be achieved only if the company creates growth opportunities, empowers adequately and creates incentives to reward its members.

RESPECT FOR PEOPLE

People have made Balrampur what it is today. Balrampur has a proud record of treating its members well and with dignity; the company expects to live by this philosophy as the cornerstone of its operations.

SHAREHOLDER VALUE

We will strive to maintain global standards of corporate transparency. We will strive to increase shareholder confidence in our management ability; we will strive to deliver a value to our shareowners that is commensurate with our managerial depth and financial solidity.

CUSTOMER FOCUS

We are deeply committed to understanding and meeting the needs of customers.

GROWTH

We strive for a continuous improvement in our performance driven by an aggressive expansion in our assets.

COMMUNITY

We will strive to be seen as a company with a conscience that extends beyond its cash flow - to the bigger challenge of making the world a better place to live in.

'Desperate government action required to assist the Indian sugar industry'

Vivek Saraogi, Managing Director, reviews the decline in profits in 2002-3

Q **How would you analyse the performance of the company during 2002-3?**

As is evident from the numbers, it was a difficult year. The lower profitablity during the year was the result of a sharp decline in free sale sugar realisations – by over Rs 200 per quintal. Even as sugar prices dropped to their lowest level in five years, raw material prices increased by 40 per cent during the same period.

Q **The sugar industry must be among the few industries where raw material prices have strengthened even as realisations have declined in the face of increased demand. Why?**

Before I answer this question, let me state that the sugar industry, with controls and non-controls, represents a highly sensitive balance. It requires a great deal of skill and foresight to maintain a win-win balance. The moment you tinker with the balance for the selective benefit of one group of stakeholders – in this case, the farmers – you compromise this balance. Worse, you create a scenario where even that one stakeholder begins to suffer over time.

We went through such a scenario last year. Even as the government de-regulated realisations, it regulated the raw material pricing. So while it freed the mill owners from seeking whatever price the market offered, it prevented them from extending the same logic to the purchase of cane. So even as cane production increased, so did the price that farmers got for their cane. This increased cane production further. As a result, record sugar was made, free market prices dropped to below the level of the levy, consumption did not increase in proportion and most mill owners incurred losses. Simplistically, let me state that had the government permitted the industry to find its natural equilibrium – a decline in cane prices consequent to a decline in open market price, as is prevalent globally - a win-win proposition would have emerged.

As responsible industrialists who invest periodically in asset upgradation, we are disappointed by this industry scenario. What we feel defeated about is that even though India's sugar industry can emerge as a world-beater in a liberalised trade environment – it generates employment for nearly 4.5 million people and contributes Rs 2000 cr annually to the national exchequer – it has ironically been defeated in its own country by inconsistent official policy.

Q What does the industry want the government to do?

We have been saying this for years: create a long-term sugar policy that prevents ad hoc and opportunistic decisions to be taken. Primarily, such a policy will either incentivise investment or prevent industrialists from investing completely, which is an unambiguous way to the future. Within the scope of this, the government should totally deregulate the industry – the operative word is 'totally' - with no controls on releases and recommended pricing for farmers.

As a result, the government should permit the various market forces to determine the price of sugar and even cane. Conversely, if the government decides to protect farmers through a Statutory Minimum Price that must be paid to farmers for their cane, it must correspondingly protect the industry through a release mechanism that is effective. You cannot have liberalised sugar market with a controlled cane market.

Q How do you think farmers will accept this proposition?

Very favourably because it will represent some sustainability for their income. Let me tell you that farmers are happy growing cane especially if they get Rs. 84 a quintal as they did in the current year in Uttar Pradesh. Their cost of production, all told, is not more than Rs 48 a quintal, so growing cane not only fetches them an excellent return, it also gives them the highest return over all competing cash crops. Besides, it is a hardy crop that is relatively insensitive to changes in rain, sunshine and temperature. I mean there could not be a better rural preoccupation today in select states than growing cane. Just consider, in Maharashtra the farmers were paid Rs.55 to Rs. 64 a quintal, much below the SMP, and even at that level they found it remunerative to grow cane.

Q Isn't it strange that farmers in one part of the country should get a price for their cane considerably lower than farmers in another?

Absolutely. As a nation, we keep talking of a level playing field when it comes to international competition. But when it comes to national competition, we apply an entirely different standard! Let me tell explain how this hurts: the co-operative mills who buy this low-priced cane in Maharashtra eventually make low-priced sugar. This gives them enough ammunition to sell their sugar as far as Guwahati, which is something that has not happened in a freight-sensitive business for years. As a result, a regional aberration in policy implementation translates into a national imbalance.

Q It might then be pertinent to ask how Balrampur reported a profit at all.

Through a proactive re-orientation of our business over the last few years. As a result, less of our profits now come from sugar and an increasing proportion is being derived through the prudent value-addition of our by-products (to produce ethanol and power). For instance, we commenced the production of ethanol in August 2002 and today we supply the material to leading oil companies in the country. We commenced the generation of power in March 2003 and sell our electricity to the state's power grid. On the operational side, we sourced loans at low rates, we maximised the use of low cost accruals for asset investments, we maintained a tight cost control and focused on enhancing operational efficiency. A combination of these factors helped us keep our head above water in the worst of times.

Q Shareholders will want to know why the company is still keen to invest in an integrated complex at Haidergarh?

For a number of reasons. One, we feel that the current scenario cannot last for long and a policy correction is imminent. Two, we are not investing in sugar as much as we are investing in the profitable manufacture of its by-products. Three, the by-product capacities that we are commissioning will be adequately fed by the raw materials generated within the company, minimising our dependence on external supply sources. Four, it has been our experience that prudent investments made during industry downturns help us get the best bargains in asset prices, which translates into an attractive rate of return as soon as the industry cycle strengthens for the better. Five, we have assured buyers for much of the value-added products that we will make at Haidergarh, which will minimise the extent of the volatile industry impact.

Q Is the industry considering exports as an option?

The government has indicated that it will incentivise export. Again, the industry is awaiting a policy initiative in this regard. I must reiterate that to compete internationally, either the farmer must be prepared to get a lower cane price or the government must be prepared to increase its subsidy. This is exactly what is happening abroad: the EU subsidises the export of sugar to the extent of $ 36 billion each year, which is reinforced with a customs tariff on imports that helps them protect their farmers. In India, the government does neither. Only if the government demonstrates any resolve in doing either, will we consider export seriously.

Overview

Interview with Sri S. L. Jain
Director General, Indian Sugar
Mills Association

A turnaround has happened in India's Sugar Industry.

It's quite amazing how one error can lead to years of misery, affecting large mass of people across the country.

In 1998, the government permitted import of sugar even as there was a surplus inside the country. As a result, nearly three million tonnes of sugar was dumped inside India and even five years later, the Indian sugar industry is suffering from the hangover of that ill-advised decision.

As a I keep saying, *lamho ne qataa ki aur sadiyon ne sazaa paai...*

Cane and sugar prospects cannot be divorced from the larger context of other agricultural commodities.

For instance, the Indian government announced a minimum support price for a number of agricultural commodities without any responsibility on the part of the government to ensure that this minimum support price was indeed being paid to the farmers.

The result: incentivised by the unrealistically high MSP, far beyond the levels recommended by the CACP, farmers overproduced wheat, rice etc. FCI godowns overflowed with these products. Realizations declined and the farmers eventually complained of an income erosion.

On the other hand, the government strengthened the prospects for growing sugar cane by continuing to notify a statutory minimum price for sugar cane, under provisions of Sugar Cane [Control] Order, which inter alia provides that the statutorily fixed cane price payment would have to be made within 14 days and that arrears would be realizable as arrears of land revenue. On top of this, some State Governments who have been politicking on sugar cane prices for years, once again announced the so-called 'State Advised Price' payable by sugar mill owners or those managed by the State Governments, thereby creating a robust security among sugar cane farmers. With declining realizations from other crops and a comforting insurance in the raising of cane, an increasing number of farmers grew more sugar cane than ever in the country's history.

Needless to say, more cane meant more sugar leading to the largest year-on-year decline in realizations that we have seen in living memory.

The three communities that gained from this decline were cane growers (those who were paid in full), consumers, confectioners and other bulk consumers as prices dropped lower than what they were about five years ago.

Cane occupies only 2.8 per cent of the national cultivable area, but as a subject it occupies nearly a 60-70 per cent mind share among India's politicians.

Result: arbitrary interference in the manufacture and marketing of the product within the country.

For instance, during the 2002 Budget speech, Yashwant Sinha, the finance minister, announced that he would withdraw the freesale release mechanism over the course of the year. Fearing that this would cause prices to collapse, a number of sugar producers went to court on the grounds that a regulated release mechanism violated the spirit of the constitution. So on the basis of an interim order - not even a final order - more than 300 out of 425 Indian sugar manufacturers obtained the freedom to sell outside the purview of the existing freesale quotas allotted to them and simultaneously unloaded their inventories in the marketplace. Result: sugar prices lost Rs 3 per kg, which was around 25 per cent of its selling price. This transpired at a time when cane prices increased, so it is not difficult to comprehend why 2002-3 was perhaps the most challenging year in the history of the industry.

My feeling is that when prices declined, the government was happy but when the decline avalanched, it panicked.

For an interesting reason. The millers resisted the increase in cane price and as a result, crushing for the 2002-3 season was delayed by a month-and-a-half. As a result, farmers complained of a harvesting slowdown and a consequent decline in income.