

Economy

Decoding the surprisingly positive growth in manufacturing in Q2FY21

- ▶ The Central Statistics Office (CSO) released GDP numbers for Q2FY21 on 27 Nov, 2020. Although the economy slipped into 'technical recession' due to negative growth in second consecutive quarter, the contraction in economic activity was much lower than expected (actual: -7.5%, RBI Nowcasting model: -8.6%).
- ▶ The most important driver of better-than-expected GDP growth in Q2FY21 was manufacturing sector. While forecasters estimated manufacturing sector to contract by 12-16% during the quarter, it recorded a positive growth of 0.6%.
- ▶ Positive growth in manufacturing GVA during the quarter when relevant high-frequency indicators (such as IIP manufacturing) contracted was puzzling.
- ▶ To gain better understanding of what drove better-than-expected growth in manufacturing GVA, we analysed 1,945 listed manufacturing companies. Our analysis showed the following:
 - Production volume in Q2FY21 declined for most sectors. However, rising prices of several items led to gross sales either recording positive growth or recording a lower contraction in *value terms* compared to *volume indicators*.
 - Sample companies' total income declined 10% YoY in Q2FY21. However, total expenditure fell at a steeper rate of 14% YoY during the quarter.
 - The fall in expenditure was driven by lower raw material and input costs. Raw material costs declined 18.4% during Q2FY21 while cost of purchase of finished goods declined 13.2%. 'Other expenses' declined 10.7%. The decline in employee expenses was much lower at 2%, indicating that there have not been large-scale job losses and pay cuts in the listed manufacturing space.
 - Out of the 14% YoY decline in expenditure for sample companies, lower cost of 'raw materials' and 'purchase of finished goods' accounted for 9% and 3% respectively while cost savings under 'other expenses' head accounted for 2%. The contribution of lower employee expenses to total expenditure reduction was virtually zero.
 - No significant reduction in employee expenses bodes well for private consumption in the coming quarters.
 - Interestingly, there is an increase in 'stock adjustment' or inventory build-up for manufacturing sector in Q2FY21. Stock adjustment is a function of various factors (including seasonality) and in these unusual circumstances we will refrain from reading too much into this information. However, large inventory build-up in some sectors (metals, textiles, food manufacturing) can keep production muted in these sectors in coming quarters.

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The CSO released GDP data for Q2FY21 on 27 Nov, 2020. Although the economy slipped into 'technical recession' i.e. negative GDP growth for two consecutive quarters, the contraction in economic activity in Q2FY21 was much smaller than expected. Real GDP contracted 7.5% during the quarter (-23.9% in Q1), much smaller than -8.6% estimated by RBI Nowcasting model and street estimate of -8.9%.

The main driver of better-than-expected GDP number was the manufacturing sector. As per Oct 2020 round of RBI Professional Forecasters' Survey, forecasters expected industry (of which manufacturing sector constitutes ~58%) to contract 15.1% in Q2FY21. However, the actual contraction in industry during the quarter stood at just 2.1%. Ahead of the data release, private forecasters expected manufacturing sector to contract by 12-16% in Q2FY21. However, instead of a contraction, the sector grew 0.6% during the quarter.

This came as a surprise to many, especially since relevant high frequency indicators had recorded contraction in Q2FY21. IIP manufacturing, which shares high correlation (~93%) with manufacturing GVA, contracted 6.7% during the quarter. Hence, positive growth in manufacturing GVA was puzzling.

In this note, we look at another important indicator of manufacturing growth – financial performance of manufacturing companies – to understand what drove manufacturing growth and to get early indications of future performance.

Petroleum accounts for one-third of manufacturing sector

To decode better-than-expected performance by manufacturing sector, we first understand the components of manufacturing. Table 1 gives composition of manufacturing sector in India (household + corporate) in current prices for FY19.

Table 1: Manufacturing sector components, FY19

Component	% share in manufacturing GVA (Nominal, FY19)
Food products, beverages & tobacco (Meat, fish, dairy, beverages, tobacco, grain mill)	11%
Textiles, apparel & leather products (Textiles, wearing apparel, leather)	13%
Metal & metal products (Iron & steel, basic precious, ferrous and non-ferrous metals, fabricated metal products)	13%
Machinery & equipment (Computer, electronic, optical and transport equipment)	23%
Coke, petroleum, chemical, pharmaceuticals and related products (Coke & refined petroleum, chemicals, pharmaceuticals, rubber & plastic)	33%
Others (Wood, paper, furniture)	8%

Source: Mospi, I-Sec Research

As Table 1 shows, 'coke, petroleum, chemical and pharmaceuticals' is the largest component of manufacturing, accounting one-third of the sector's GVA. Top contributors in this component are petroleum and chemicals (accounting for 8% each of manufacturing GVA), non-metallic mineral products (7%), pharmaceuticals (6%) and rubber & plastic products (4%).

The second largest component in manufacturing sector is 'machinery and equipment', accounting 23% of the sector's GVA. Within this component, top contributors are transport equipment (10% of manufacturing GVA), electrical and computer equipment (3% each), communication, optical and consumer electronics (1% each) and other machinery & equipment (4%).

Hence, ~56% of manufacturing GVA is concentrated in these two segments.

We analyse performance of listed manufacturing companies during Q2FY21

We deep dive into manufacturing sector's performance during Q2FY21 by analysing financial performance of 1,945 listed companies in the manufacturing space. Table 2 gives details of companies covered in this analysis:

Table 2: Overview of sample companies

Sector	No of companies in sample	Activities	Largest companies in sample
Food	184	Food processing, cigarettes, breweries, coffee, tea, sugar, dairy and vanaspati	ITC, United Spirits, EID Parry, Nestle India, Bombay Burmah, Britannia Industries
Textiles	331	Textiles, leather	Grasim Industries, SRF, Welspun India, PDS Multi, Vardhman Textiles, Arvind Ltd
Metals	231	Steel, Aluminium, Forgings, Ferro Alloys, Zinc	Tata Steel, Hindalco Industries, Vedanta, Coal India, JSW Steel, SAIL
Machinery & Equipment	420	Auto & auto ancillaries, computers, white goods, electric equipment, machine tools, telecom equipment	Tata Motors, M&M, Maruti Suzuki, Motherson Sumi, Hero Motocorp, Bajaj Auto
Coke, petroleum, chemical, pharmaceuticals and related products	488	Petrochemicals, pharmaceuticals, chemicals, plastics	Reliance Industries, IOCL, ONGC, BPCL, HPCL, Vedanta
Other Manufacturing	291	Office equipment, paints, FMCG, glass, paper, packaging, printing & stationary	Hindustan Unilever, Asian Paints, Godrej Consumer, Dabur India, Security & Intel, Uflex
Total manufacturing	1,945		

Source: CapitaLine, I-Sec Research

Table 2 shows ~25% companies in our sample are from 'petroleum, chemicals and pharmaceuticals' segment. Companies from 'machinery and equipment' segment account ~22% of sample followed by 17% from textiles, 12% from metals, 9% from food manufacturing and remaining 15% from 'other manufacturing' (furniture, wood, paper etc).

Ironing out the dichotomy between gross sales and IIP

One of the main reasons why the 0.6% growth in manufacturing GVA was puzzling in Q2FY21 was the 6.7% contraction in IIP manufacturing during the same quarter. Although prima facie the dichotomy is apparent, it should be noted that IIP is based on *volume of production*. Unless we marry IIP data with price data, IIP by itself does not give sufficient and accurate information on a sector's performance in *value terms*. In Table 3, we marry IIP volume data with wholesale inflation data to show contraction in the former does not contradict positive GVA growth.

Table 3: IIP volume and wholesale prices, Q2FY21

Sector	IIP (% y/y)	WPI (% y/y)	Gross Sales of sample companies (% y/y)
Food	-19.6%	4.4%	3%
Textiles	-18.4%	-3.4%	-36%
Metals	-3.0%	0.1%	6%
Machinery & Equipment	-10.2%	1.9%	-5%
Coke, petroleum, chemical, pharmaceuticals and related products	1.4%	-0.4%	-11%
Other manufacturing	-20.5%	4.3%	0%
All Manufacturing	-6.7%	1.2%	33%

Source: CapitaLine, CEIC, I-Sec Research

Table 3 shows that IIP (i.e. production volume) for five sectors viz. food, textiles, metals, machinery & equipment and other manufacturing contracted during Q2Y21. However, prices of food, metals, machinery & equipment and other manufacturing items increased during the quarter. This led to gross sales in these sectors either recording positive growth or recording a lower contraction in *value terms* compared to *volume indicators*. Only in textile sector, both volume and price indicators were negative leading to a steeper contraction in gross sales number compared to IIP number.

Overall, manufacturing deflator (which indicates inflation in manufacturing sector as a whole) in Q2FY21 increased by 1.1% YoY, up from -0.1% YoY in Q2FY20, indicating rising prices of manufacturing goods.

Manufacturing companies cut expenditure by 14% during Q2FY21

Soon after Q2FY21 GDP data was released, financial media and analysts pointed out that sharp cost reduction by listed companies appeared to be the most obvious reason for surprisingly higher manufacturing GVA growth.

In this section, we analyse listed companies only in manufacturing space and classify them into the above-mentioned broad categories of manufacturing. In Table 4, we look at their total income, total expenditure and gross income numbers.

Table 4: Financial performance of manufacturing companies, Q2FY21 (% y/y)

Component	Total Income	Total Expenditure
Food	-2%	2%
Textiles	-28%	-33%
Metals	6%	1%
Machinery & Equipment	-5%	-6%
Coke, petroleum, chemical, pharmaceuticals and related products	-16%	-21%
Other manufacturing	0%	-3%
All Manufacturing	-10%	-14%

Source: CapitaLine, I-Sec Research

Table 4 shows that in Q2FY21, income of almost all manufacturing companies (excluding metals) fell in YoY terms. Anticipating lower income amidst the pandemic, most manufacturing companies cut expenditure. In case of 'textiles' and 'coke, petroleum, chemicals and pharmaceuticals' the cut in expenditure was steep at 33% and 21%, respectively. On the other hand, sectors such as food and metals saw modest increase in expenditure.

Overall, the cut in expenditure was steeper than the fall in income. We estimate that for manufacturing sector as a whole, total income declined 10% YoY while total expenditure declined 14% YoY during Q2FY21.

Lower prices of raw materials and inputs drove reduction in expenditure

We analyse the expenditure pattern of manufacturing companies to assess what led to cost reduction. Table 5 share details:

Table 5: Key Financial Parameters – Total Manufacturing (% YoY)

Item	Q2FY20	Q3FY20	Q4FY20	Q1FY21	Q2FY21
Gross Sales	-6%	-4%	-10%	-38%	-7%
Total Income	-6%	-5%	-10%	-39%	-10%
Total Expenditure	-6%	-6%	-1%	-37%	-14%
Raw Materials	-12%	-12%	-11%	-51%	-18%
Purchase of finished goods	-3%	-1%	6%	-52%	-13%
Employee Expenses	2%	3%	1%	-8%	-2%
Other Expenses	-3%	4%	17%	-18%	-11%

Source: CapitaLine, I-Sec Research

Table 5 shows that raw material costs declined 18% YoY during Q2FY21 while costs of purchase of finished goods fell 13% YoY. Hence input costs as a whole fell 16% during the quarter. 'Other expenses' also fell 11%. On the contrary, fall in employee expense was relatively lower at just 2%.

Table 6: Contribution of components to expenditure reduction – Total Manufacturing (%)

Item	Share in expenditure	Q2FY20	Q3FY20	Q4FY20	Q1FY21	Q2FY21
Total Expenditure	100%	-6%	-6%	-1%	-37%	-14%
Raw Materials	49%	-6%	-6%	-5%	-22%	-9%
Purchase of finished goods	20%	-1%	0%	1%	-9%	-3%
Employee Expenses	11%	0%	0%	0%	-1%	0%
Other Expenses	20%	1%	1%	4%	-4%	-2%

Source: CapitaLine, I-Sec Research

Table 6 shows that raw materials account for ~49% of total expenditure of manufacturing companies, followed by purchase of finished goods (20%), other expenses (20%) and employee expenses (11%). We now derive contribution of each of the expense heads to total expenditure. As Table 6 shows, the reduction in total expenditure in Q2FY21 was driven by lower raw material prices and lower 'purchase of finished goods' costs. These two heads collectively contributed 12% out of the 14% reduction in total expenditure (i.e. ~83% of the expenditure reduction). Lower 'other expenses' contributed 2% out of the 14% (i.e. 15% of the expenditure reduction). The contribution of lower employee expenses to expenditure reduction was negligible.

This shows that the cost of reduction by manufacturing companies is driven by lower cost of input material rather than lower wage bill. This has implications for private consumption in coming quarters. Had the cost of reduction been driven by lower wages, workers in manufacturing sector would have had lesser money to spend on goods and services in coming quarters, which would have played a drag on private consumption. However, since the cost reduction is driven by lower material costs, its impact on private consumption is likely to be muted.

Interestingly, there is a modest increase in 'stock adjustment' for manufacturing sector as a whole. 'Stock adjustment' or inventory build-up is significantly higher for some components of manufacturing viz. metals, textiles and food manufacturing. Stock adjustment is a function of various factors (including seasonality) and in these unusual circumstances we would refrain from reading too much into this information. However, large inventory build-up in some sectors could keep production muted in these sectors in coming quarters.

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