# Demonetization to Hit Unorganized Metal Sector Players Hard

*Already facing a slowdown in rural consumption, base metals demand is likely to decline in short to medium term due to the demonetization of the two high value currency notes. Experts believe that base metals led by copper and aluminium demand would get badly affected due to their consumption being rupee denominated. End consumers normally buy copper and aluminium products largely in cash. Hence, cash driven demand of metals is likely to disappear from the system at least temporarily.*


**- Metalworld Research Team**

## Demonetization

Demonetization is the cancellation of legal validity of a bill approved earlier by the government. The Prime Minister Narendra Modi on November 8, 2016 announced cancellation of legal validity of Indian two large currency notes i.e. Rs 500 and Rs 1000 effective the mid-night same day. Following which, 84 percent of the money in circulation were stopped their legal validity immediately after the announcement. While announcing the decision India's Prime Minister said that the attempt was to curb black money into the system.

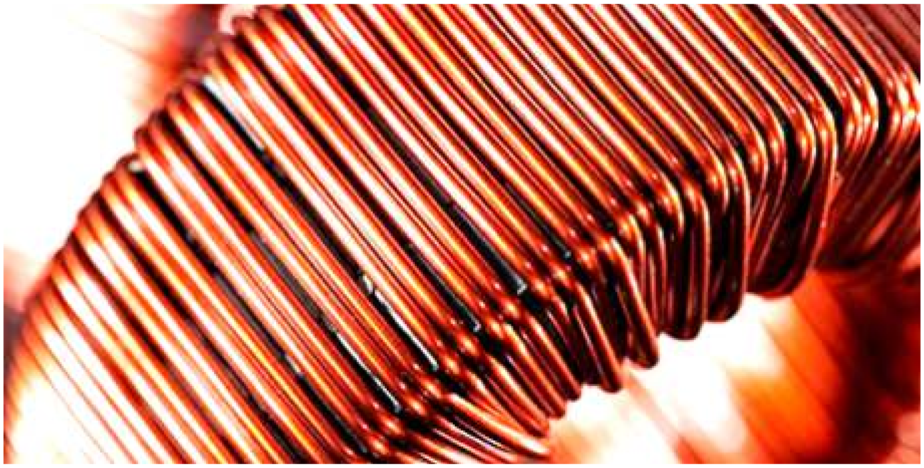
Initially, the government aimed at around a third of Rs 15.5 lakh crore worth of Rs 500 and Rs 1000 notes would not be deposited into banks. But, within the stipulated 50-day of their legal tender into banks witnessed a deposit of around 97 per cent its total value. This means, only 3 per cent worth of Rs 500 and Rs 1000 notes are currently held by common public. But, by the name of curbing black money, the government sucked liquidity from the system which hit the entire spectrum of the Indian economy.

Many economists including the former prime minister Dr Manmohan Singh and the Nobel Prize winner Dr Amartya Sen have forecast that the demonetization to lower India's gross domestic products (GDP) by up to 2 percent.

The worst hit was the portion of the economy that was driven largely by cash. So, the rural economy which was driven primarily on cash was heavily impacted. Consumption of many such products made of metals like copper, aluminium and lead saw steep decline in their demand from rural India due to the lack of liquidity at the hands of consumers. Since, cash driven economy of base metals is estimated at around 50 percent, the demand of around half of base metals – made products came to standstill after demonetization of the high value currency notes in November. Thus, retail demand of metal products was badly hit due to demonetization.

## Unorganised Sector Production To Become Costlier

The demonetisation of high-value currency notes is likely to make operations of unorganised sector costlier. In terms of battery, unorganised players, operating on cash-only model, control an estimated 37 percent of the automotive battery market due to cost-advantage generated primarily through avoidance of tax and labour laws. They will now have to come within the ambit of the formal system, ensuring adherence of statutory requirements such as minimum wages. Hence, their costs will go up and the organised players will benefit, said Gautam Chatterjee, Managing Director and CEO, Exide Industries while announcing commissioning of the company's Rs 700-crore punched grid battery unit in Haldia. The organised players are also expecting the imposition of the Goods and Services Tax (GST) to further squeeze the unorganised sector by reducing the tax load from 28 per cent to 18 per cent. As an immediate impact of the demonetisation, sale of motor-cycle



batteries has dropped by 30 percent in December. However, four-wheeler battery sales and replacement sales have not been impacted. Replacement sales generate a higher profit margin.

Like Exide Industries, many players in the organized sector are likely to benefit on rising cost of manufacturing for the unorganized sector players due to potential shifting from cash to digital payment system. Being all transactions digitally-oriented, the unorganized sector players initially need to install all plants and machineries to initiate the change and incur expenses on transformation. Apart from that, they would require to pay taxes levied on all segments of business. This means, their cost of production would be almost similar to the organized sector players resulting into intensifying competition between unorganized and organized sector players directly.

There are chances that many unorganized sector players would shut down their business in this transformation due to their inability to compete with unorganized sector ones. Being deep pocket of the organized sector players, they would be able to sustain small adversities which would not be the case for unorganized sector players. So, consolidation looks imminent in consumer oriented base metals industry.

## Impact on Hindalco Industries

Satish Pai, Managing Director of Hindalco Industries, said in an interview that the company's majority of raw material movement via railways are not affected due to demonetization of high value currency notes. But, trucks carrying finished goods were affected for the first couple of days. Since the company works with fairly large contractors, things have got back on track and transportation was gradually coming to normalcy.

Meanwhile, a lot of aluminium scrap that is coming to India in huge quantities of about 860,000 tonnes. Small aluminium players, especially the scrap importers, might get affected as they deal in cash trade. Secondary aluminium producers contribute nearly half of India's metal production. Similar is the case for copper producers as well. Hence, the impact on base metals secondary producers would be harsh. Since primary produces work primarily on non-cash transactions, the impact on such primary producers would be negligible.

## Real Estate Sector in Dilemma

The demonetization has put the entire real estate sector in dilemma. The real estate and the infrastructure sectors are notoriously known for dealing in black money. It is no secret that deals involving the sale-purchase of plots, flats, house and commercial properties involve a white component and a black component. While the white component is payments which are received through normal banking channels, black refers to pure cash transactions. In tier 1 cities, no significant effect on the primary market is expected. The primary sales market segment mostly caters to salaried individuals and professionals, and therefore the role of black money remains extremely limited.

Most of these individuals take home loan from financial institutions for purchase of these properties. However, the case may not be same in tier 2 and tier 3 cities where black money can play a much more significant role in primary transactions. Secondary markets are likely to face some initial hiccups, should the demonetisation scheme be successful. Unlike their primary counterparts, secondary market transactions usually have 30-40% cash component especially more so in non-tier 1 areas.

The real estate and infrastructure sector consume nearly a third of metal production in India and hence, any impact on these sectors would have direct bearing on metals demand and consumption.

## Secondary Metal Sector to Hit

Thus, the secondary metals producers which deal largely in cash and operate through imported raw materials, would hit badly due to demonetization. Feared with a

sharp decline in their operational ability, these players have urged the government to provide a level playing field.

Driven largely by the unorganized sector players, the secondary metal producers who contribute to over half of metal availability in India, have urged the government to review inverse tax structure with import duty of 2.5-5% on scrap and none on finished products. India has signed free trade agreements (FTAs) with a number of ASEAN countries that have benefited at the cost of India. While Indian processors import metallic scrap at duty of up to 5%, processors in FTA countries pay no duty for the same.

Since the sources of scrap supply remain the same i.e. western countries and Africa, the cost of raw material procurement works out costlier in India than FTA countries. Since, their energy costs are also lower, the overall cost of secondary metal production in FTA countries is lower than in India. Consequently, metal processing units in FTA countries dump finished products into India resulting into lower capacity utilization of local units here.

Under the Prime Minister Make in India programme, local manufacturing units need to be protected which the government has started with primary metal producers by levying Minimum Import Price (MIP) for steel. Now, secondary metal sector is equally important and hence, needs to be protected with level playing field.

Therefore, the government needs to review this inverse duty structure with high import tax on raw material and low on finished products," said Sanjay Mehta, President Metal Recycling Association of India (MRAI) and Director MTC Group, one of India's largest metal recyclers.

Apart from basic import duty, scrap importers also pay 4 percent of special additional duty. Central value added tax (Cenvat) credit norms are often not met due to inability to achieve required value addition of 15-20 percent. While value addition norm in India is missed by a thin margin, the same is met upto 35 percent on free on board (FOB) value in FTA countries including Malaysia and Thailand.

This has resulted into higher cost of semis and finished products made in India when raw material imported from FTA countries. Most importantly, all metal processing countries including in Asia have exempted scrap import from import duty. Ironically India still continues with the age old practice of levying import duty on raw material despite having imports of finished products duty free.

This has made survival of metal processing units difficult," said Rohit Shah, Director, Heena Metal, a city based scrap importer and metal recycler. A recent Frost & Sullivan report estimated India's foundry production at 9.5 million tonnes as compared to 41 million tonnes in China. India will become a net importer of castings if import duty on scrap is not removed, the report alarmed.

Total demand of metallic scrap in India stood at 20.40 million tonnes on 2014 with an estimated CAGR (compounded annual growth rate) of 11.4 percent which would take overall demand at 39 million tonnes by 2020. Recycling saves energy and also natural resources as this process requires used metal as raw material.

Hence, recycling industry should be granted industry status as the sector has attracted investment worth Rs 10,000 crore. The government should allow import duties and countervailing duties (CVD) to be collected against accumulated in manufacturers profit and loss account as unutilised. Also, secondary metals manufacturers should be allowed to claim SAD in line with traders," said Mehta.