Higher oil prices threaten India Inc's profit margins

Weak demand, global slowdown add to their woes

KRISHNA KANT
Mumbai, 25 September

The recent surge in crude oil prices could shave off the gains made by India Inc in profit margins in the past few quarters. Worse, it comes at a time when consumer demand in the country is slipping and major global economies are witnessing a slowdown.

A back-of-the-envelope calculation suggests that the margin expansion accounted for three-fourths of the rise in the listed firms' operating profit between the April-June quarter (Q1) of FY23 and Q1FY24, and only a quarter of profits gains came from revenue growth.

The weakening of consumer demand is also visible in slowing topline growth. The listed companies' revenue growth in Q1FY24 was the lowest in the last nine quarters, and a sharp deceleration in India's nominal gross domestic product (GDP) growth in the June quarter suggests that the slowdown may last for a while.

"The pricing power of companies has weakened in recent quarters due to a slowdown in sales and revenue growth. They will be forced to absorb most of the rise in their input and finance cost from higher crude oil prices, resulting in lower margins in the next few quarters," Dhananjay Sinha, head of research and equity strategy at Systematix Institutional Equity, said.

The price of Brent crude oil is up nearly 24 per cent in the last three months at $92 a barrel from $74.9 a barrel at the end of June. This is a reversal of a year-long trend of a steady decline in crude oil prices, which had crashed nearly 40 per cent from a decade high of $122.8 a barrel at the end of May last year to a low of $72.6 at the end of May 2023.

The sharp decline in crude oil prices in the second half of 2022 and in the first half of 2023 had boosted India Inc's Ebitda (operating profit) margins, resulting in a surge in corporate earnings in the last three quarters (Q3 and Q4 of FY23, and Q1 of FY24), despite a steady deceleration in revenue growth in this period.

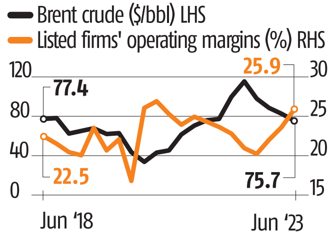
The combined operating profit of 2,936 listed companies in the *Business Standard* sample was up 33.9 per cent year-on-year (Y-o-Y) in Q1FY24 compared to just 8.2 per cent Y-o-Y growth in their combined revenues during the period.

Turn to Page 6

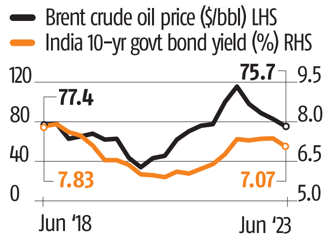
P2
INFLATION MAY EAT INTO MARGINS OF FMCG FIRMS

IMPACT CHECK

Opposite trajectories: Oil price vs corporate margins



Moving in tandem: Oil price vs bond yield



Sources: Bloomberg, Capitaline
Compiled by BS Research Bureau

FROM PAGE 1

Oil prices...

Their Ebitda (earnings before interest, taxes, depreciation, and amortisation) margins expanded by 500 basis points in the period, aided by the 34.6 per cent decline in Brent crude oil price from an average of $115.5 per barrel in the April-June 2022 quarter to an average of $75.7 per barrel in April-June 2023.

On the bright side, however, higher crude oil prices would push up sales realisation and result in higher revenues for companies in sectors such as oil & gas.

A fall in crude oil prices benefits India Inc through two ways -- lower raw material and energy prices and a decline in interest rates.

Historically, there is a negative correlation between the price of Brent crude oil and Ebitda margins of listed companies in India. Similarly, there is a positive correlation between the crude oil price and the yield on the benchmark 10-year government of India bond. Higher oil prices lead to higher yields on the 10-year government securities, which translate into higher lending rates for companies and individual borrowers. The correlation between the crude oil price and corporate margins, and the crude oil price and bond yields, seems to have become stronger in the last three years.

While a decline in raw material and energy prices pushes up the operating profit margins of manufacturers, a fall in interest rate due to the lower crude prices is beneficial to banks and non-bank lenders and companies in capital-intensive sectors such as oil & gas, metals & mining, telecom, cement, automotive, and construction & infrastructure, among others. Moreover, lower interest rates are also conducive for consumption demand, especially for auto and housing sectors.

Conversely, companies take a hit on their margins and profitability when global oil prices rally. For example, companies' operating profit margins had contracted from a high of 26.9 per cent of revenues in Q2FY21 to 20.2 per cent in Q2FY23 as the price of Brent crude surged from an average of $33.9 in the quarter ended June 2020 to an average of $115.7 in the quarter ended June 2022.

Similarly, the yield on the 10-year treasury bonds follows the trajectory of oil prices. Bond yields declined in 2018, 2019 and in the first half of 2020 along with a decline in oil prices in the period. In contrast, bond yields rose in 2021 and in the first half of 2022 in line with a rebound in crude oil prices. The yield is once again up as oil prices have moved northwards.

According to analysts, crude oil prices and bond yields are linked due to the former's big influence on the government's overall tax revenues and its borrowing programme. Lower crude oil prices boost the central government excise duty on crude oil, leading to lower market borrowings and thus lower bond yields and vice versa.

Unlisted firms...

The senior official quoted above said that the government would study whether some of these recommendations could be incorporated via changes in regulations, without changing the law.

Borrowing the provisions from the UK Company Act 2006, the committee recommended: "The auditor shall be under an explicit obligation to make detailed disclosures before resignation and should specifically mention whether such resignation is due to non-cooperation from the auditee company, fraud or severe non-compliance, or diversion of funds."

The committee chaired by secretary, MCA, will deliberate on further changes that need to be made to the company law. The committee was formed as part of the government's objective of promoting ease of living in the country by providing ease of doing business to law-abiding corporations, fostering improved corporate compliance for stakeholders at large, and addressing emerging issues having an impact on the working of companies in the country.

E-games...

Members of the AIGF include online gaming majors like Mobile Premier League, Deltatech Gaming, Nazara, Paytm First Games, and Zupee. Games24x7 and Junglee Games are members of the EGF, while the FIFS includes members such as Dream11 and Fantasy Akhada, in addition to over a dozen fantasy sports startups. Though the industry bodies have hundreds of other online gaming companies as their members, the influence of a few big firms has created concerns about their applications, sources said.

AIGF, EGF, and FIFS did not