REPORT XIX

DISINVESTMENT COMMISSION

APRIL
2003

'Trikoot - I', IInd Floor
Bhikaiji Cama Place, R K Puram
New Delhi - 110066

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Note: The Tables contained in this Report are based on information received from the management of the PSEs and other sources.

PART - A

1. INTRODUCTION

The Disinvestment Commission was reconstituted vide Government of India, Ministry of Disinvestment Resolution No.11012/1/2000-Admn. dated 24th July, 2001. Thereafter, the Commission submitted six reports (Report Nos. XIII, XIV, XV, XVI, XVII & XVIII). Earlier, during 1996-99, the Commission made recommendations in respect of 58 PSEs which had been referred to it by the Government.

This Report (No. XIX) contains recommendations in respect of the following companies:

(i) Handicrafts and Handlooms Exports Corporation of India Ltd. (HHEC),

(ii) Rural Electrification Corporation Ltd. (REC), and

(iii) State Farms Corporation of India Ltd. (SFCIL).

With this report, the reconstituted Commission has submitted fresh recommendations in respect of 20 companies and review recommendations for 4 companies. All these reports are available in Disinvestment Commission's website titled **www.disinvest.gov.in**

Currently, the following Public Sector Enterprises are under study:

1. Bharat Sanchar Nigam Ltd.
2. Brahmaputra Valley Fertilizer Corporation Ltd.
3. Central Cottage Industries Corporation Ltd.
4. Container Corporation of India Ltd. (Review)
5. Educational Consultants India Ltd.
6. Hospital Services Consultancy Corporation Ltd.
7. Mahanagar Telephone Nigam Ltd.
8. National Film Development Corporation Ltd.
9. National Handloom Development Corporation Ltd.

10. National Mineral Development Corporation Ltd. (Review)
11. National Seeds Corporation Ltd.
12. North Eastern Electric Power Corporation Ltd.
13. Power Finance Corporation Ltd.
14. Water & Power Consultancy Services (India) Ltd.

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PART - B

2. SPECIFIC RECOMMENDATIONS

2.1 HANDICRAFTS AND HANDLOOMS EXPORTS CORPORATION OF INDIA LTD. (HHEC)

INTRODUCTION

The Handicrafts and Handlooms Exports Corporation of India Limited (HHEC) was set up in 1958, as the "Indian Handicrafts Development Corporation Pvt. Ltd." The name was subsequently changed to HHEC and the company was merged with the State Trading Corporation (STC) in 1962. HHEC was subsequently demerged from STC in 1991. It is a Schedule "B" company under the administrative control of the Ministry of Textiles (MoT), with its corporate office located at New Delhi (at Jawahar Vyapar Bhavan).

HHEC was incorporated with the following main objectives: to undertake exports of handicrafts and handloom products, to establish procurement and marketing infrastructure for the sector, to develop market intelligence by conducting market surveys and studies, and to develop markets for Indian handicrafts and handloom products through various distribution channels, such as own offices, fairs & exhibitions, sales depots, buying agents etc.

In FY 1992, the company was designated by the Government of India (GoI) as one of three national agencies for conducting fairs and exhibitions for jewellery outside India. Since 1997-98, HHEC has also been undertaking large-scale bullion imports (primarily gold), which have significantly shored up its top-line. It has been classified as an "Export Trading House".

HHEC has six offices in India, located at Chennai, Mumbai, New Delhi, Kolkata, Srinagar and Bhadohi, and one office each at New York and Tokyo. Over the years, HHEC has built up a network of 23 procurement centres spread across the country with the intention to have a direct contact with the weavers/artisans for procurement of various products (mainly handicrafts and handlooms).

HHEC has two manufacturing facilities, one each at Delhi and Chennai, for the manufacture of ready to wear garments. The Delhi facility for manufacture of ready to wear garments (located at Noida) is currently being revamped into a

Research & Design (R&D) facility cum administrative office (so as to relocate the administrative staff from Jawahar Vyapar Bhavan to Noida). The project is estimated to cost Rs. 61.5 Million (Mn) and is being financed by an equity contribution from GoI to the extent of Rs. 30 Mn (already brought in) and rest through the internal accruals of the company. The construction is expected to be completed by April 2004. The Chennai factory is located at Guindy Industrial Estate.

The company also owns a factory building at Tiruppur, which was set up for the manufacture of knitted garments. However, the same was subsequently leased out and is currently being used by M/s Solo International.

The corporation is also involved in the direct retail sales of handicraft and handloom products in the domestic market, having its retail outlets at the following locations: Crafts Museum Shop, Dilli Haat, and Souvenir Shop at National Museum, New Delhi and Weavers Service Centre, Mumbai.

However, this has never been a key focus area for the company primarily on account of its export focus / mandate. Further, the company has no future plans to develop the direct retail business.

HHEC being a trader, with practically no control over the manufacturing part of the value chain (except for Ready to Wear garments), access to good network of procurement centres becomes a critical success factor in the business.

HHEC has been generating profits since 1992 except during the FY1995 and FY1997. During FY2002, the company clocked a turnover of Rs. 3,363 Mn with a net profit of Rs. 30 Mn. HHEC's net worth as on March 31, 2002 stood at Rs. 229 Mn.

The company has 218 permanent employees on its rolls as of 1st January 2003, consisting of 93 officers and 125 staff.

HHEC is wholly owned by the GoI, with an authorised capital of Rs. 200 Mn and paid-up share capital of Rs. 138.20 Mn, as of March 31, 2002.

Operations of HHEC

HHEC's current activities can be broadly classified as:

Commercial activities

The primary business of HHEC is international trade. It exports various products like Handlooms (fabrics and made-ups), Handicrafts, Ready to Wear Garments and Carpets, and imports bullion (primarily Gold). The commercial activities of HHEC can further be classified in the following manner, based on its importance in the context of the overall objectives for which the HHEC was incorporated.

Core Activities

Core activities or the direct sales of HHEC can be classified into five categories: export of handlooms, export of handicrafts, export of ready to wear garments, export of carpets, and retail sales of above products in the domestic market.

HHEC's major export destinations include European Union, United States, Japan, China, Korea, Israel, Middle East, South Africa, Australia and Italy

Non-Core Activities

Non-core activities or the indirect sales of the company are opportunity-driven and arise primarily due to HHEC being a Government owned company. HHEC is one of the three companies permitted to organise Gems and Jewellery fairs and exhibitions abroad and is one of the 14 canalising agencies in the trade of bullion. These activities comprise: Gems and Jewellery exhibition, import of bullion (primarily Gold), and import of other commodities like silk (currently under restricted list of imports), cotton and timber (both under OGL)

Developmental/Promotional activities

HHEC today operates with the dual objective of creating opportunities/market for Indian handicraftsmen/manufacturers/private exporters by understanding the unique needs of the buyer countries and helping Indian handicraftsmen/manufacturers express them in the form of their products, while running its own operations profitably.

Some of the key achievements on account of the developmental activities undertaken by the HHEC in the past are enumerated below:

- **Moradabad Brass Industry**

HHEC was among the first companies to establish a unit in Moradabad in 1962 for rendering technical advice in the areas of moulding, casting and finishing of Art metalware crafts. Because of HHEC's efforts, the metalware industry received a big push and today the Moradabad region accounts for almost 1/3rd of India's total metalware exports.

- **Bhadohi/Srinagar Carpet Industry**

HHEC had undertaken several development projects in Bhadohi and Srinagar for hand woven carpets in wool and silk. Today, the industry has developed to a stage in which most of the production units are exporting directly to the various countries without the assistance of HHEC or any other GoI agency.

- **Doll Centre, Bangalore**

HHEC had set up a unit in 1959-60 for development of new doll designs as also to impart training to the artisans.

- **Bleeding Madras Checks and Real Madras Handkerchief**

In the 1960s, HHEC had contributed significantly towards the exports of Bleeding Madras checks with renewed designs and modified looms to undertake production in large width.

- **Festivals of India**

HHEC had been instrumental in organising various Textiles and Crafts exhibitions and Indian melas (fairs) as part of Festivals of India, which were held during 1980s in France, U.K. and USA.

The current promotional activities/endeavours of the company include the following: development of tribal ironware from the Bastar region, development of metal carvings from Swami Malai and colonial wooden furniture from Pondicherry, and development of Warli art from Maharashtra.

HHEC also receives grants from the GoI for carrying out the developmental activities for the promotion of handloom and handicraft exports.

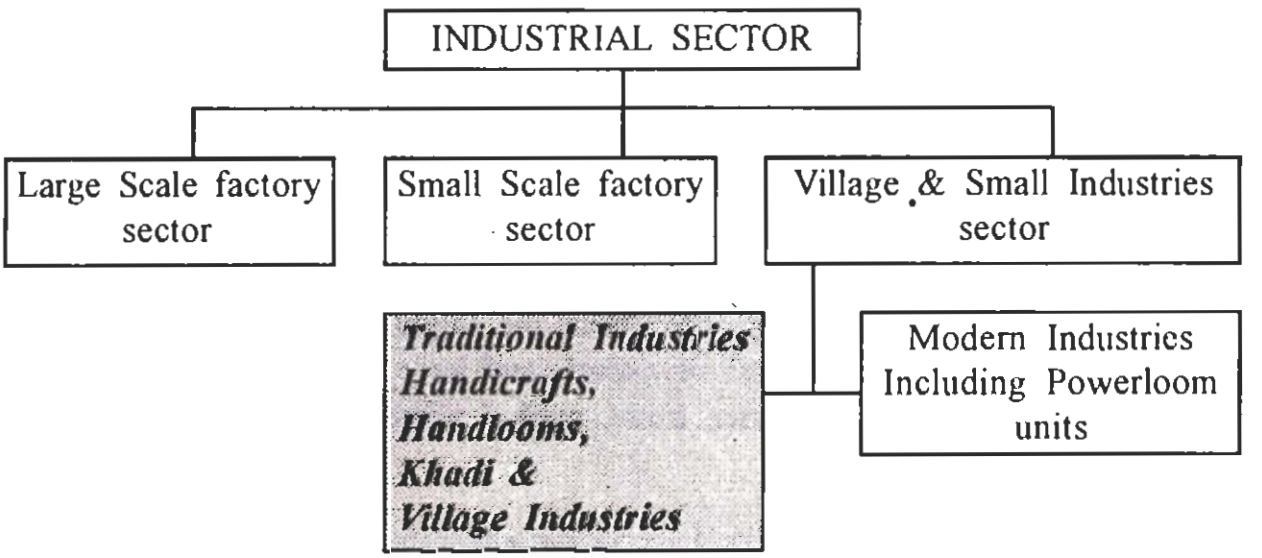
It is evident that during the early years of its incorporation, various promotional and development measures of HHEC contributed significantly to the growth of the country's handicrafts and handloom exports. However, of late HHEC has not been able to contribute significantly to any major product developments so as to create many more success stories like the ones stated above.

INDUSTRY REVIEW

The industry sector in India is broadly segmented into three categories namely: Large scale factory sector, Small scale factory sector, and Village and small industries sector.

The units in the large-scale factory sector and small-scale factory sector are classified on the basis of the upper limit on investment in plant and machinery. The village and small industries sector is further classified into two broad categories namely, the modern small-scale industries and traditional industries. The modern small-scale industries mainly cover small-scale Industry (SSI) units (both, factory/ non-factory sectors) and Powerloom units. The traditional industries' subsectors comprise: tiny and cottage industry segments like handloom, khadi and village industries, handicrafts, sericulture, silk and coir. As the figure below depicts, HHEC primarily caters to the handicrafts and handlooms segment of the Traditional Industry sector.

Composition of the Industrial Sector



Source: ICRA

HANDICRAFTS INDUSTRY

The handicrafts industry plays an important role in the country's economy, by providing employment to 5.7 million persons (as of 2000-01), mainly in the rural and semi-urban areas. Further, the industry is also a significant contributor to the foreign exchange earned by the country and accounts for 4% of the total exports from India (during 1999-00). Handicrafts are defined as "items made by hand, often with the use of simple tools, and are artistic and/or traditional in nature". Broadly, the handicraft industry includes the following products: hand knotted carpets, art metalware, woodware, hand printed textiles, embroidered and crochet goods, shawls & artwares, zari and zari goods, imitation jewellery, and miscellaneous handicrafts. Of these, carpets, art metal ware, hand printed textiles, embroidery and crotchet goods account for a large part of the domestic and export sales.

Handicrafts – Production and Growth

The industry is highly unorganised in nature. It has seen significant growth in production, in the domestic market. The domestic market, which accounted for 43 % of the total production during 2000-01, highlights the growing importance of the domestic market in the handicraft industry, as shown in the table below:

Table 1 - Handicrafts industry: Production & Domestic Market

	1997-98	1998-99	1999-00	2000-01
Estimated Production (Rs. mn.)	1,04,109.6	1,21,754.3	1,39,155.6	1,63,404.4
Domestic Market (Rs. Mn.)	45,359.5	51,030.7	58,559.3	70,699.4

Source: Tenth Five Year Plan, GoI, / ICRA

Substantial majority of artisans and craftsmen are located in Gujarat, Rajasthan, Uttar Pradesh (UP) and in eastern India. However, most of the commercially successful Indian crafts mainly come from the Gujarat-Rajasthan cluster and U.P. These are the major centres of export, and have a much greater level of market development, long-distance trade, market infrastructure, and innovative activity.

The various marketing channels that are being utilised for sales of these products in the domestic market can broadly be classified as following: State/Central

Government owned retail outlets, Private sector retail outlets, Markets/Fairs/ Haats/Crafts Museum, Non Government initiatives/organisations, and Co-operatives.

Most state governments as also the central government have established retail-marketing companies (Handicrafts Development Corporations) whose prime objective is to undertake the procurement, market development and sale of handicraft products.

The private sector retail outlets have also grown in recent years due to the growing demand from the tourists and domestic market. Successful private initiatives include stores such as Fab India, Bombay Stores, Anokhi, Cottage Industries Exposition (CIE) etc. Retailing of specific handicraft products near places of tourist interest has also grown.

Non-government organisations have also been making attempts to provide marketing support to craftsmen from remote areas, with the objective of improving the economic conditions of rural poor. Some successful NGOs include Banascraft, Rural Non-Farm Development Agency (RUDA), and Jawaja. NGOs are often funded through grants from Central/State Governments and multilateral development agencies such as UNIDO, UNDP etc.

Handicrafts Export Scenario

Export of handicrafts accounts for about 4% to 5% of the total exports from the country as shown in the table below. Handicraft exports have increased from Rs. 46,216 Mn in 1995-96 to Rs. 88,785 Mn during 2000-01, translating to a CAGR of 14% (during the same period). Among the total handicrafts exports, carpets account for 26%, embroidery 22% and art metalwork 20%. There are more than 6500 exporters registered with the Export Promotion Council for Handicrafts (EPCH), which is the nodal agency for promotion and development of the export market for handicrafts items/products.

Table 2 - Export of Handicrafts

(Rs. Mn)

Product	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	CAGR for 1995-01
Carpets	14141.5	17795.9	17913.9	20139.4	21360.3	23141.5	10%
Art Metalware	9249.4	9714.6	12146	13241.6	14971.8	17781	14%

...Contd.

Product	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	CAGR for 1995-01
Woodware	1534.6	2187	2218.22	860.4	3489.5	434.4	-22%
HP Textiles	5077.6	6861	8382.4	10339.8	11580.5	12767.5	20%
Embroidered & Crochet Goods	7858	10308.9	9907.5	11594.2	15843.6	19647.8	20%
Shawls & Artwares	143.3	178.2	170.8	181.8	215	272	14%
Zari & Zari Goods	477.3	545.7	703.4	749.5	835.2	1423.2	24%
Imitation Jewellery	775.8	486.5	980.3	1041	1136.4	1216.8	9%
Misc. Handicrafts	6959.4	7870.2	9023.2	12575.7	11164	12100.8	12%
Total Handicraft Exports	**46216.9**	**55948**	**61445.7**	**70723.4**	**80596.3**	**88785**	**14%**
India's Exports	**1063530**	**1188171**	**1301050**	**1397511**	**1595611**	**2035710**	**14%**
Handicrafts as a % of the total exports	**4.3%**	**4.7%**	**4.7%**	**5.0%**	**5.0%**	**4.4%**	

Source: Development Commissioner (Handicrafts), Ministry of Textiles, ICRA

However, India remains a rather small supplier in the world market accounting for less than 2% of the world trade in this sub-sector.

Direction of Exports

The world market for Indian Handicrafts is overwhelmingly concentrated in USA, six European countries, Canada and Japan. The three most important markets for India's handicrafts are USA, Germany, and UK. Far behind these, but growing rapidly, are a few other countries of Western Europe, Japan, and Australia. In carpets, Germany has for long been the most important market for Indian goods. In recent years, there has been some diversification towards USA.

USA is by far the largest market accounting for 30% of the total handicraft exports from the country. India's closest competitor in handicrafts is China.

An earlier study on India's craft exports had compared China and India in hand-knotted carpets. The study had concluded that the China's advantage stems from the fact that the industry there was concentrated in large factories. This has resulted in a higher degree of mechanisation, in key processes such as in shearing and embossing, which, in turn, leads to a better control over delivery schedule, a pre-requisite in the highly competitive export markets.

Major Exporters of Handicraft Products

As mentioned earlier, EPCH is the nodal agency for the promotion and development of the handicrafts products from India. Over the years, the membership of EPCH has witnessed a rapid growth from 35 members in 1986 to 6762 members as on 31st March 2002. This, however, does not include hand knotted carpets, as they form a part of the Carpet Export promotion Council (CEPC). The turnover of the top exporters on an average varies from Rs.150 Mn to Rs 500 Mn.

Organisation of the Handicrafts Sector in India

The organisation of the Handicraft sector can be classified as under:

- Organisation of the Administrative ministry (Ministry of Textiles) and various Central and State Government Agencies
- Functional classification of the various institutions involved

Organisation of the Administrative Ministry and Central and State Government Agencies

Both the Central and State governments are actively involved in the development and promotion of the handicraft industry. The Ministry of Textiles is the apex body of the GoI that is responsible for the growth and promotion of the handicraft sector, which includes overseeing the formulation and implementation of the policies and programmes for the development of the sector through its various support agencies and specialised services.

The Development Commissioner (Handicraft), is the primary central agency/ body responsible for the promotion and growth of the handicraft industry.

The State Governments are also involved in the development and promotion of the handicrafts industry in their respective States. Almost all states have established corporations for undertaking procurement and marketing of their respective States handicraft products.

Functional Classification of Institutions

The resource requirement of the handicrafts industry can broadly be classified into the following areas: design, technology and technical support; financing;

marketing; and raw material. There are many institutions including non-governmental organizations (like SEWA), cooperative societies (like HP State Handlooms & Handicrafts Apex Cooperative Society), laboratories (like Dye Research Laboratory), Boards (like All India Handicraft & Handloom Board), councils (like Council for Handicrafts Development) and institutes (like Bamboo & Cane Development Institute), besides the DC (Handicrafts) and the Ministry of Textiles, supporting these areas for the growth and development of the handicrafts industry.

Policy Framework

During the period 1950-85, the major thrust of the government policy was to protect the artisans from competition by the organised (machinery driven) players. The Central and State governments also provided support to handicrafts in the area of market-access. Market access was developed through Apex Co-operative bodies and government owned direct marketing organisations like the Himachal Pradesh State Handloom and Handicraft Apex Co-operatives, and the Gujarat State Handicraft Development Corporation. Co-operative societies were encouraged to provide technical support and develop common training and designing facilities.

The policy also classified handicrafts into two categories, that is, one category of products that is intensive in craftsmanship and faced no significant competition from machinery, and other category of crafts that did face actual or potential competition from machinery. In this second category, were included large segments of handloom weaving and a number of 'khadi and village industries' (KVI). In the 1990's, the thrust was shifted from empowerment to capability building. More emphasis was given to building infrastructure, developing a comprehensive information-base, and to enhance and develop the ability of the artisans to make new products and thus becoming efficient businesspersons themselves.

The major policy objectives as highlighted in the Tenth Plan (2002-2007) for the Handicrafts industry include:

- Generation of productive employment to achieve higher standards of living of artisans, individually and collectively, in rural and urban craft clusters;
- Increased foreign exchange earning for the country; and
- Preservation of cultural heritage through research and documentation, region/ craft specific strategies and protection of crafts facing extinction.

The approach adopted for the sector in the tenth plan document signifies a quality shift in terms of:

- Adoption of a comprehensive strategy for facing the challenges posed by post WTO regime, by encouraging development of an appropriate legal protection system, creating a brand image, utilising commercial intelligence, and promoting e-commerce. The main implications for the Handicraft industry, post WTO, would be the lowering of import duties on handicraft products, thereby enabling imports of a number of substitute products;

- Provision of market-driven designs and technology input package to sustain the competitive edge and to gain access to larger market share, both domestic and export markets;

- Provision of adequate finance for meeting working capital needs and development of entrepreneurship in handicrafts sector; and

- Institutional capacity building for better and effective implementation of schemes.

The focus would primarily be on identification of important craft clusters and formation of Self-Help Groups (SHGs), which can act as catalyst for organising the artisans into community enterprises. This cluster approach would focus on sustainable development of handicrafts through integrated and comprehensive package of assistance and participation of craftsperson leading to their empowerment.

Concerns of the handicraft industry include: competition from machine-made products in the domestic market, growing competition from East Asian countries in the export market, decline in availability of raw materials, non-tariff barriers (like those related to child labour, environmental issues, etc.), inadequate availability of credit, and lack of marketing knowledge, skills and services.

Today, HHEC does not figure in the "top exporters" award list of the Export Promotion Council for Handicrafts. HHEC's share of total exports of handicrafts is almost negligible and has over the years increased only marginally from 0.03% in 1997-98 to 0.04% in 2000-01. Its overhead costs are understood to be around 20% to 25% higher than that of the private players, thus affecting its competitive position in the industry. The company also needs to significantly upgrade the

existing skill sets of its employees, especially on the marketing front, which has also contributed to its low turnover.

HANDLOOMS INDUSTRY

Handlooms sector plays an important role in the economy of the country and in preserving its rich heritage and art. The industry provides employment to about 12.4 Mn people, which makes it next to the agriculture sector in terms of employment. The industry is widely dispersed and unorganised and production is mainly done in the private sector, within small units, or under master weavers. Handloom industry has a network of marketing organisations, starting from the corporations and apex level institutions, co-operative societies as well as the umbrella organisation of the Association of Corporations and Apex Societies of Handlooms (ACASH). Private sector trading companies are also involved in the marketing of handlooms.

The research and development efforts in this industry are mainly led by the office of the Development Commissioner for Handlooms and through a network of organisations including four Indian Institutes of Handloom Technology and twenty four Weavers Service Centres (WSCs).

Handloom production and Growth

The total textile production in India was 41,323 Mn square meters in 2000-01. The products include Powerloom, Handloom, Knitted Fabrics and Khadi, Wool & Silk. 63% of the total production was from the power loom sector, followed by 19% from the handloom sector. The table below provides production data for the period 1995-01:

Table 3 - Total Production of Fabrics

(Mn sq. m.)

	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	CAGR
Powerloom Fabrics	19220	21309	22899	22475	24901	26114	6%
Handloom Fabrics	7202	7456	7603	6792	7352	7725	1%
Knitted Fabrics	5038	5533	6394	6276	6374	6909	7%
Khadi, Wool & Silk	431	515	540	559	575	575	6%
Total	**31891**	**34813**	**37436**	**36102**	**39202**	**41323**	**5%**

Source: Ministry of Textiles / ICRA

Handlooms - Exports Scenario

Handloom exports consist of fabrics, floor coverings, made-ups and clothing accessories. Made-ups include a range of products, such as table and bed linen, dish cloths, furnishing etc.

The total export of handloom products has risen marginally from Rs. 18,300 Mn in 1997-98 to Rs. 20,649 Mn in 2001-02 at a CAGR of 4%.

All exporters are required to register with the Handloom Export Promotion Council (HEPC), in order to obtain various concessions that are currently being offered by the GoI. As on April, 2002, HEPC has a total membership of 1819.

HHEC does not figure among the top 30 exporters of the handloom products in the country. The average turnover of the top exporters varies from Rs. 800 Mn to Rs 1200 Mn.

Organisation of the Handloom Sector in India

Ministry of Textiles is the apex body within the Government of India that is responsible for the development of the Handloom sector. Within the Ministry of Textiles, development of the handloom sector is led and coordinated by the Development Commissioner (Handlooms). The state governments are also responsible for the development of the handlooms industry. Almost all states have established corporations and co-operative societies for marketing of handloom products.

In the functional areas of marketing, design, financing/credit, raw material and policy, there are many institutions and organizations – both within the government and outside the government fold (NGOs, cooperative societies, boards and councils, etc.), for the growth and development of the handloom industry.

Policy Framework

The handloom industry has witnessed keen competition from machinery and, therefore, the policies of GoI during 1950 to 1980s centred on protecting the handloom industry.

The new textile policy, 2000, focussed on the following measures for enhancing the competitiveness of the handloom industry:

- Development of training modules for weavers engaged in the production of low value added items, which may not be able to survive the competition consequent on globalisation, with the objective of upgrading their skills to enable them to find alternate employment in the textile or other allied sector;

- Implementation of comprehensive welfare measures to be continued with the State Governments, for better working environment and the social security of the weavers;

- Provision of effective support systems in research and development, design inputs, skill upgradation and market linkages;

- Weavers Service Centres to be revamped in consonance with the contemporary trends, and, using Information Technology for efficacy, their activities suitably dovetailed with activities of centres of design excellence like National Institute of Fashion Technology (NIFT) and National Institute of Design (NID).

- Introduction of innovative market-oriented schemes; and joint ventures to be encouraged both at the domestic and international levels.

The key concerns of the handloom industry include competition from powerlooms, low productivity, lack of innovations in product development, and inadequate design capability, inadequate availability of raw materials (Hank Yarn), credit and market support. Once the textile sector, including handlooms, is brought into full compliance with WTO rules in 2005, with abolition of quotas, handloom industry will be exposed to further competition.

Competitive position of HHEC in the Handloom Industry

HHEC's involvement in export of handlooms started when exporters in the industry were highly fragmented and unorganised. The company was a pioneer in helping exporters develop markets in foreign countries for handlooms.

However, faced with the increasing competition from the private players and the changing external environment, HHEC does not figure in the "top exporters" award list of the respective Export Promotion Councils. Further, HHEC's share in total exports of handlooms is very meagre and has over the years, averaged at about 2%. HHEC's overhead costs are understood to be around 15% to 20% higher than those of the private players, thus affecting its competitive position

in the industry. The inadequate skill sets of its employees, especially on the marketing front, have also contributed to its low turnover.

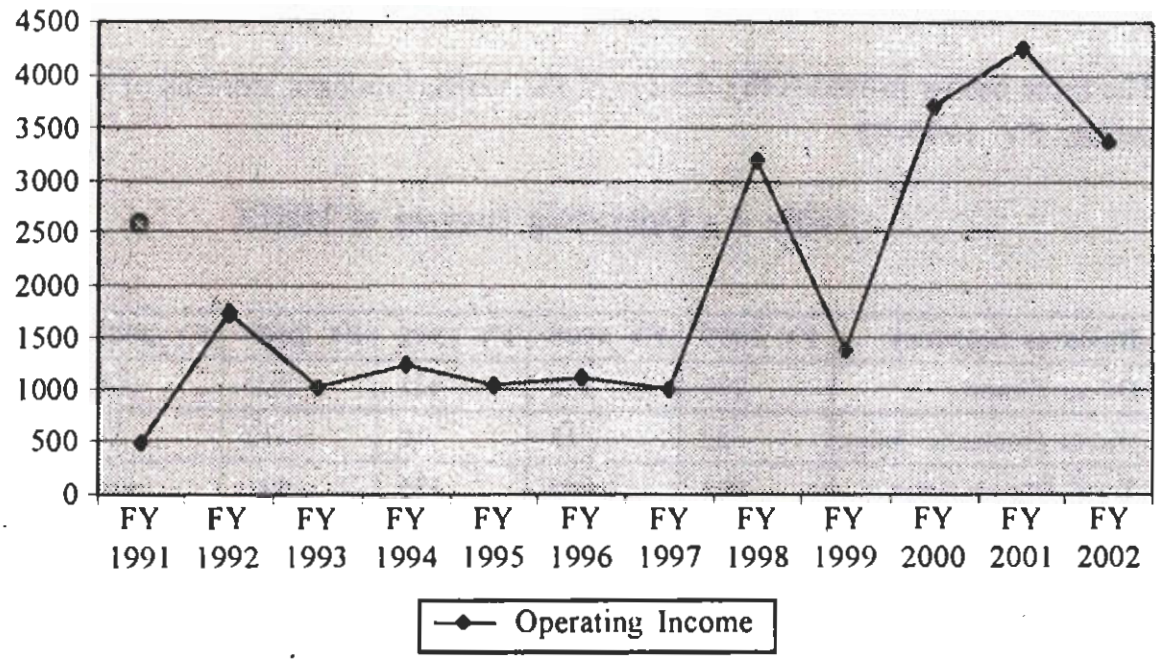
OPERATING PERFORMANCE OF HHEC

Increase in Operating Income on the back of non-core activities

As shown in the figure below, the turnover of HHEC has increased from Rs.482 Mn in 1990-91 to Rs. 3,363 Mn in 2001-02. However, the steep increase in the turnover is mainly due to an increase in the sales of its non-core activities like exports of jewellery and bullion trading (primarily Gold).

Trend in the Operating Income of HHEC

Rs. Mn.



Source: Company Information / ICRA

Increase in turnover in FY1992 was led by an increase in sales from exports of Jewellery (as this was the first year, when this activity was started by HHEC). Thereafter, HHEC commenced the bullion trading business in FY 1998, which led to a sharp increase in its turnover, as depicted above (bullion import sales accounted for 71% of the total turnover of Rs. 3,215 Mn in FY1998). FY 1999 marked a shift in management policy with respect to the bullion trading activity, with the new management deciding against the continuation of that activity. This

led to a decline in the total turnover in FY 1999. However, FY2000 again witnessed a renewed focus on bullion trading activity. A sharp increase in turnover in FY2000 (from Rs. 1,422 Mn in FY 1999 to Rs. 3,735 Mn in FY 2000) was on account of bullion trading (accounted for 34% of the total turnover) coupled with the silk import sales (accounted for 48% of the total turnover).

Currently, silk is placed in the restricted category of items and therefore, silk import business no longer contributes to the turnover of HHEC. However, the bullion trade continues to be a significant contributor to the turnover of HHEC, accounting for about 72% of its total turnover of Rs. 3,363 Mn in FY 2002. The decline in the operating income during FY 2002 (compared to FY 2001) is attributed to the recession and slowdown in the tourism industry after the September 11th events, thereby leading to lower sales of handloom and handicraft items in the domestic and export markets.

The table below provides the details of the various income streams of the company during FY 1997-02.

Table 4 - Operating Income of HHEC

(Rs. Mn.)

Business Segment	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
Direct Exports	379	432	423	579	638	538
Direct Domestic Sales	22	18	12	12	20	32
Total Direct Sales	**401**	**449**	**435**	**591**	**658**	**570**
Indirect Exports (Jewellery)	591	440	419	46	180	290
Indirect Import sales	0	2293	543	3064	3422	2479
Total Indirect Sales	**591**	**2734**	**962**	**3111**	**3602**	**2769**
Other Related Income	**24**	**32**	**25**	**33**	**42**	**24**
Total Income	**1016**	**3215**	**1422**	**3735**	**4303**	**3363**
OPBDIT	-28.32	-4.65	-60.91	0.42	-19.54	-24.27
Non-operating Income	**24.71**	**34.16**	**79.64**	**43.32**	**80.50**	**57.23**
Net Profits	**-16.51**	**20.41**	**15.90**	**40.05**	**60.35**	**32.73**

Source: Company Information / ICRA

As is evident, indirect sales (comprising bullion trading, jewellery, silk imports) continue to be a mainstay of the HHEC's business and contributes a significant portion of HHECs total operating income. The contribution of indirect sales in the total turnover has increased from 58% in FY 1997 to 82% of the operating income in FY 2002. On the other hand, the contribution of direct sales (comprising exports of handicrafts, handlooms, ready to wear garments, carpets and the domestic retail sales) in operating income has remained at around 15% except for an increase in FY 1999, when the contribution was 31%, primarily on account of a steep decline in the bullion trade and consequently in the total turnover in that year.

In view of the fact that the margins on the bullion trade business have declined sharply over the past few years, the operating contribution (without accounting for the overheads) which used to be about 2.5% in FY1998 has come down to almost .08% at present. Further, HHEC is facing severe competition from banks in this business because of the attractive premiums / value added services being offered by the banks.

The key figures of the bullion trading business is summarised in the table below:

Table 5 - Operating Income of HHEC's Bullion Trading Business

(Rs. Mn.)

	FY 2000	FY 2001	FY 2002
Operating Income	1286.70	3039.70	2405.70
Cost of Goods Sold	1293.50	3052.20	2410.10
OPBDIT	**-6.80**	**-12.50**	**-4.40**

Source: Company Information, ICRA analysis

As is evident, the company has been incurring losses at the OPBDIT levels for the last 3 years in the bullion trading activity. It appears that the primary reason for continuing with this activity has been the impact that this activity/business generates in shoring up its top line.

Increasing Contribution of Direct Sales

As mentioned earlier, direct sales form the core business of HHEC, and reflect the main objective behind the establishment of HHEC.

During the period FY 1998 to FY 2002, the direct sales have increased from Rs. 449 Mn to Rs. 570 Mn in FY 2002 at a CAGR of 6%, as shown in the table below:

Table 6 - Trends in the Operating Income (excluding the bullion trade)

(in Rs. Mn)

	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
Export of Handlooms	309	311	495	525	470
Growth (%)	19%	0.64%	59%	6%	-10%
Export of Ready to Wear	98	93	63	79	40
Growth (%)	13%	-5%	-32%	25%	-49%
Export of Handicrafts	19	19	20	34	26
Growth (%)	-19%	0	5%	70%	-23%
Exports of Carpets	6	0	1	0	2
Direct Exports	**432**	**423**	**579**	**638**	**538**
Growth (%)	13%	-2%	36%	10%	-15%
Direct Domestic Sales	**18**	**12**	**12**	**20**	**32**
Growth (%)	-20%	-33%	0	66%	60%
Total Direct Sales	**449**	**435**	**591**	**658**	**570**
Growth (%)	11%	-3%	35%	11%	-13%
Total Indirect Sales	**440**	**632**	**1823**	**562**	**362**
Growth (%)	-25%	43%	188%	-69%	-35%
Other Related Income	32	25	33	42	24
Total Operating Income	**921**	**1092**	**2447**	**1262**	**957**

Source: Company Information / ICRA

Handlooms largest contributor to HHECs direct sales

Within the direct sales, handlooms is the largest export product for HHEC and on average accounts for 80% to 82% of the total direct sales. During the period FY 1998 to FY 2002, the export of handlooms has increased from Rs. 309 Mn to Rs. 470 Mn at a CAGR of 11%. Within handlooms, the main product categories are fabrics and made-ups.

Handicrafts – Insignificant contribution to Direct Sales

The contribution of handicrafts to the direct sales over the years has averaged at around 5%. During the period from FY 1998 to FY 2002, the income from handicrafts has increased from Rs. 19 Mn to Rs. 26 Mn. The primary reason for decline in exports of handicrafts in FY 2002 when compared to the exports in FY 2001 was due to a decline in arrival of the foreign buyers in India.

Negligible sales of Carpets

HHEC's export of carpets has been steadily declining over the years and its contribution to the total direct sales is almost negligible, at less than 1%.

Growth in Indirect Sales dependent on External Policy Environment

The indirect sales accounted for 37% of the total operating income in FY 2002 (excluding the bullion trade). Indirect sales consist of import and export trading activities in various commodities and income derived from conducting exhibitions of Indian jewellery abroad. This being an opportunity driven business, depending on the policy directions, the sales have witnessed wide fluctuations in the past. Currently, the largest contributor to the indirect sales is the export of jewellery, which accounts for 79% of the total indirect sales. The table below provides information on HHEC's indirect sales:

Table 7 - Trends in Indirect Sales

(in Rs. Mn)

	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
Indirect Exports (Jewellery)	440	419	46	180	290
Growth (%)	-25%	-4.78	-89%	291%	61%
Import of Silk		213	1778	383	17
Growth (%)			734%	-78%	95%
Import of Cotton and timber					56
Total Indirect Sales	**440**	**632**	**1824**	**563**	**363**

Source: Company Information, ICRA analysis

As mentioned earlier, HHEC is one of three GoI designated agencies that have been authorised to conduct jewellery exhibitions abroad.

In 1999, it was one of the designated agencies for import of Mulberry Raw Silk, as it was placed in the canalised list. In March 2000, Mulberry Raw silk was included in the restricted list of imports. This change in policy manifested itself in the declining sales from import of silk in the years following this policy change. In FY 2002, HHEC diversified into the import of cotton, timber etc. again with the objective of increasing its top-line.

Other Related Income

The other related income accounts for 2.6% of the total turnover of the HHEC and has declined from Rs. 32 Mn in FY 1998 to Rs. 24.5 Mn in FY 2002, as shown below: The main component of other related income is the duty drawback which is an incentive given by the Director General of Foreign Trade (DGFT), Ministry of Commerce to neutralise the incidence of duty on the inputs used in the export product.

Table 8 - Other Income - HHEC

(in Rs. Mn)

	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
Duty Drawback	26.58	22.96	31.65	37.00	24.43
Growth (%)	56%	-11%	43%	19%	-33%
Premium in Import Entitlement	0.00	0.00	1.09	0.28	0.00
Premium in Export Entitlement	5.45	0.00	0.00	0.00	0.00
Insurance claims	0.00	2.05	0.00	4.84	0.06
Total	**32.03**	**25.01**	**32.74**	**42.12**	**24.50**

Source: ICRA analysis

High Operating Costs

The major components of operating expenses of HHEC (excluding bullion trade) are purchases, manufacturing and other trade related expenses and the employee expenses which together accounted for almost 90% of the total operating cost of the company.

The table below provides the break-up of the various costs as a % of the total operating income:

Table 9- Operating costs as Percentage of OI

	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
Purchases	77.5%	78.3%	73.9%	62.8%	77.1%
Employee Costs	9.1%	8.9%	3.8%	6.6%	8.6%
Manufacturing and other trade related costs	4.6%	9.1%	25.5%	12.1%	5.8%
Administrative & other expenses	4.5%	3.6%	2.0%	4.1%	5.2%
Selling & Business Promotion Expenses	7.1%	6.4%	1.8%	5.9%	5.0%

Source: Company Information, ICRA analysis

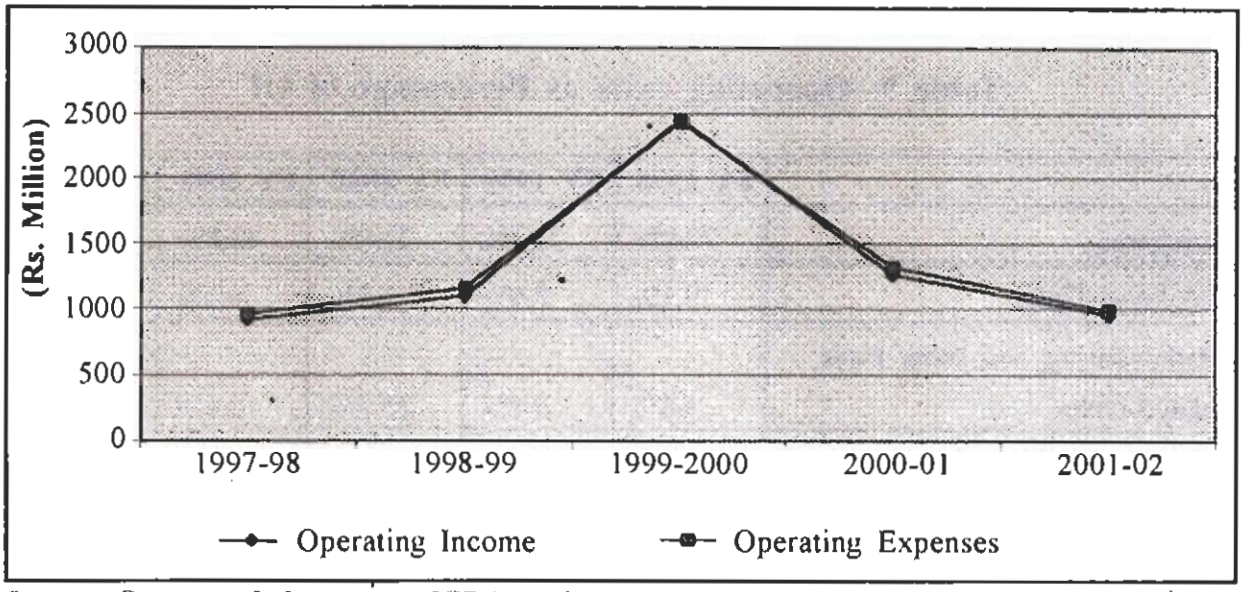
As is evident, the employee cost as a percentage of the total operating income is very high in HHEC. The norm for trading companies with similar activities to HHEC is around 4-6%.

Negative Operating Margins

The company has been incurring losses at the operating level (OPBDIT) for the last 5 years, except during the FY 2000, where it made a marginal operating profit. The position has improved over the years with the operating losses decreasing from Rs. 45 Mn in FY 1998 to Rs. 25 Min in FY 2002. Nevertheless, the operating margins have remained negative (-4.9% in FY 1998 to -2.7% in FY 2002), except during the FY 2000, where the operating margins were positive at 0.20% (this was primarily on account of the import of raw silk in that year). The margins are negative primarily on account of the higher operating costs (as explained earlier) coupled with a near stagnant operating income.

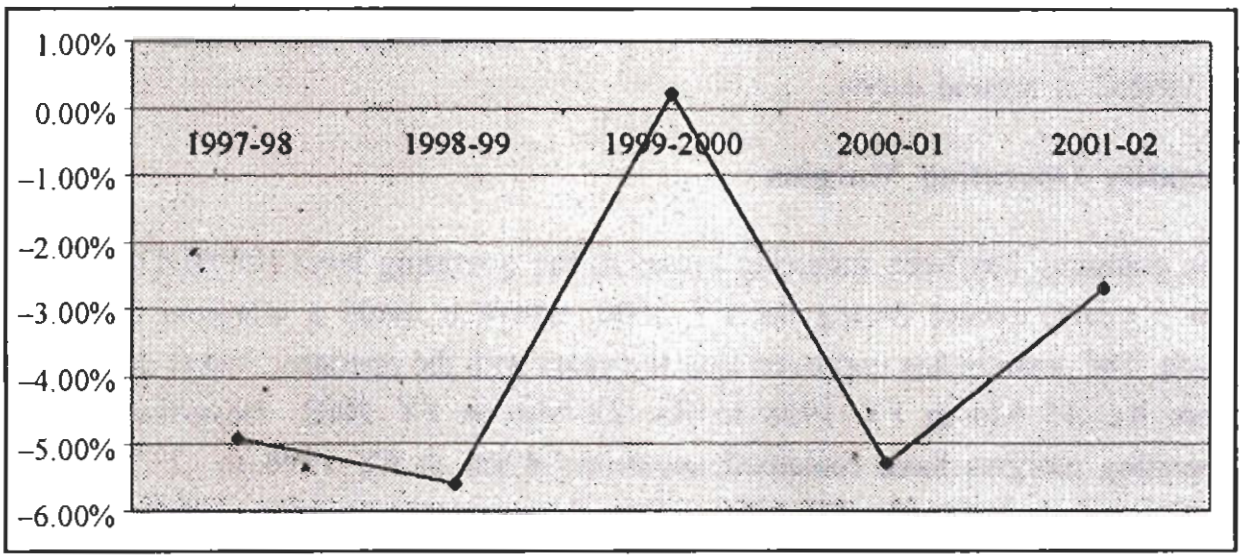
In the figures below, the changes in operating income and expenses, and the operating margins during the same period, are shown:

HHEC-Operating Income & Expenses



Source: Company Information, ICRA analysis

HHEC - Operating Margins



Source: Company Information, ICRA analysis

In this context, it may be mentioned that though the operating margins for HHEC as a whole have been negative for the last 5 years, the operating margins of the company when analysed on a segment-wise basis, exhibit a different trend. The table below provides the segment-wise operating margins for HHEC. As is evident, handlooms and retail sales are the only two segments that exhibit positive margins. Further, in handlooms, the margins have been fairly stable and

consistent over the past few years. This trend is on expected lines, as HHEC over the years, has developed some strength in its handloom business, which has led this business to perform better as compared to any other business activities of HHEC.

Table 10- Segment wise margins

Operating Margins (OPBDIT/OI)	1999-00	2000-01	2001-02	Up to Dec 2002
Handlooms	9%	9%	8%	9%
Handicrafts	-22%	12%	-25%	-4%
Ready to Wear Garments	-2%	0.4%	-28%	-3%
Retail Sales	-9%	-4%	10%	5%
Carpets	33%	-33%	-11%	-25%
Export of Jewellery	-1%	1%	-1%	1%

Source: Company Information, ICRA analysis

FINANCIAL ANALYSIS

The profit and loss account, balance sheet, and key financial ratios of HHEC, depicting its financial performance over the past five years, are shown in the tables below:

Table 11 – Profit & Loss Statement

A. Profit & Loss Statement (with bullion trade)

(Rs. Mn)

Period ending	31.03.1998	31.03.1999	31.03.2000	31.03.2001	31.03.2002
Direct Sales	449.20	435.10	591.20	658.10	570.77
Indirect Sales	2,733.60	962.20	3,110.00	3,602.60	2768.63
Total Sales	3,182.80	1,397.30	3,701.20	4,260.70	3339.40
Other Related Income	32.03	25.01	32.74	42.12	24.50
OPERATING INCOME	**3,214.83**	**1,422.31**	**3,733.94**	**4,302.82**	**3363.90**
Manufacturing and other trade related expenses	184.87	117.74	716.16	411.90	215.32

...Contd.

A. Profit & Loss Statement (with bullion trade) [Contd...]

(Rs. Mn)

Period ending	31.03.1998	31.03.1999	31.03.2000	31.03.2001	31.03.2002
(Accr.)/Decr. to Stocks	17.84	-8.55	-175.88	173.91	8.74
Power and Fuel	1.40	1.14	0.39	0.66	0.68
Employee Costs	83.93	97.58	92.52	83.46	82.14
Purchases	2,824.33	1,165.93	3,007.97	3,526.65	2983.42
Administrative and Other Exp.	41.43	39.80	47.81	51.58	49.49
Selling & distribution expenses	65.70	69.59	44.56	74.20	48.39
COST OF SALES	**3,219.49**	**1,483.23**	**3,733.53**	**4,322.36**	**3,388.17**
OPBDIT	**-4.65**	**-60.91**	**0.42**	**(19.54)**	**-24.27**
Interest and Finance Charges	6.46	1.22	0.33	4.64	0.39
OPBDT	**-11.11**	**-62.14**	**0.09**	**(24.18)**	**-24.66**
Depreciation	2.27	2.07	2.13	2.14	2.15
OPBT	**-13.38**	**-64.20**	**-2.04**	**(26.32)**	**-26.81**
Non - operating Income	34.16	79.64	43.32	80.50	57.24
Cash Adjustments	-0.38	0.47	-1.23	6.17	2.31
APBT	**20.41**	**15.90**	**40.05**	**60.35**	**32.74**
Tax	0.00	0.00	0.00	0.00	2.60
APAT	**20.41**	**15.90**	**40.05**	**60.35**	**30.14**
Dividend - Equity	4.33	5.41	8.27	23.64	27.64
Dividend Tax	0.43	0.59	1.82	2.41	0.00
ACCRETION TO RESERVES	**15.65**	**9.90**	**29.96**	**34.30**	**2.50**
Direct Sales	449.20	435.10	591.20	658.10	570.77
Indirect Sales	440.40	632.40	1,823.30	562.90	362.93
Total Sales	889.60	1,067.50	2,414.50	1,221.00	933.70
Other Related Income	32.03	25.01	32.74	42.12	24.50
OPERATING INCOME	**921.63**	**1,092.51**	**2,447.24**	**1,263.12**	**958.20**

...Contd.

A. Profit & Loss Statement (with bullion trade) [Contd...]

(Rs. Mn)

Period ending	31.03.1998	31.03.1999	31.03.2000	31.03.2001	31.03.2002
Manufacturing and other trade related expenses	42.77	99.64	622.86	153.00	55.42
(Accr.)/Decr. to Stocks	17.84	-8.55	-175.88	173.91	8.74
Power and Fuel	1.40	1.14	0.39	0.66	0.68
Employee Costs	83.93	97.58	92.52	83.46	82.14
Purchases	714.13	854.93	1,809.37	792.75	739.02
Administrative and Other Exp.	41.43	39.80	47.81	51.58	49.49
Selling & distribution expenses	65.70	69.59	44.56	74.20	48.39
COST OF SALES	**967.19**	**1,154.13**	**2,441.63**	**1,329.56**	**983.87**
OPBDIT	**-45.55**	**-61.61**	**5.62**	**-66.44**	**-25.67**
Interest and Finance Charges	6.46	1.22	0.33	4.64	0.39
OPBDT	**-52.01**	**-62.84**	**5.29**	**-71.08**	**-26.06**
Depreciation	2.27	2.07	2.13	2.14	2.15
OPBT	**-54.28**	**-64.90**	**3.16**	**-73.22**	**-28.21**
Non - operating Income	34.16	79.64	43.32	80.50	57.24
Cash Adjustments	-0.38	0.47	-1.23	6.17	2.31
APBT	**-20.49**	**15.20**	**45.25**	**13.45**	**31.33**
Tax	0.00	0.00	0.00	0.00	2.60
APAT	**-20.49**	**15.20**	**45.25**	**13.45**	**28.73**
Dividend - Equity	4.33	5.41	8.27	23.64	27.64
Dividend Tax	0.43	0.59	1.82	2.41	0.00
ACCRETION TO RESERVES	**-25.25**	**9.20**	**35.16**	**-12.60**	**1.09**

Source: ICRA

Table 12 – Balance Sheet

(Rs. Mn)

ASSETS	1.03.1998	31.03.1999	1.03.2000	1.03.2001	31.03.2002
Gross Block	61.15	62.59	64.78	66.19	68.26
Less : Depreciation	-27.73	-29.63	-31.57	-33.83	36.21
Net Block	33.42	32.96	33.21	32.36	32.05
Capital Work in Progress	0.37	0.39	0.06	0.00	0.32
NET FIXED ASSETS	**33.79**	**33.35**	**33.27**	**32.36**	**32.37**
TOTAL INVESTMENTS	**0.01**	**0.01**	**0.01**	**0.01**	**0.01**
Stock in Hand	18.88	20.33	44.38	40.13	27.88
Stock in Transit	8.96	16.78	171.23	0.85	4.61
Raw Materials	3.75	3.04	0.42	1.12	0.87
Spare parts	0.72	0.72	0.69	0.53	0.53
Packing Material	0.11	0.10	0.18	0.10	0.13
TOTAL INVENTORIES	**32.43**	**40.96**	**216.90**	**42.73**	**34.02**
Receivables (More than 6 months)	62.94	34.02	31.63	24.09	21.82
Receivables (Less than 6 months)	79.75	63.65	386.56	779.65	1390.22
Less : Provisions for doubtful Debts	-56.71	-27.75	-30.28	-16.48	-10.16
TOTAL RECEIVABLES	**85.99**	**69.93**	**387.91**	**787.26**	**1,401.88**
Cash and Bank Balances	27.69	89.65	174.76	167.12	155.22
Sundry Deposits	7.48	8.63	7.86	3.20	4.01
Advances recoverable in cash/kind/value to be received	37.29	18.20	25.59	11.37	17.59
Loans & Advances to Staff	25.26	39.52	34.36	36.44	33.50
Insurance Claim Receivable	0.00	2.04	2.54	6.88	2.31
Government Grants	0.30	0.29	1.28	3.14	1.47

...Contd.

Table 12 – Balance Sheet (Contd...)

(Rs. Mn)

ASSETS	1.03.1998	31.03.1999	1.03.2000	1.03.2001	31.03.2002
Advance IT/TDS/ Interest Tax	18.90	13.92	18.55	25.93	15.36
TOTAL OTHER CURRENT ASSETS	**107.91**	**162.67**	**255.04**	**249.53**	**225.45**
Less provision for doubtful loans, advances & deposits	-9.02	-9.58	-9.89	4.55	4.00
TOTAL CURRENT ASSETS	226.32	273.56	859.86	1,079.52	1,661.36
TOTAL ASSETS	**260.12**	**306.91**	**893.13**	**1,111.89**	**1,693.74**
LIABILITIES					
Equity Share Capital	108.20	108.20	118.20	118.20	138.20
Government. Grant-in-aid	0.49	0.87	1.20	1.73	1.49
General Reserve	12.50	20.00	26.00	37.82	40.12
Profit & Loss Account	1.20	3.56	27.55	50.00	50.18
NET RESERVES	14.19	24.43	54.75	89.55	91.79
TANGIBLE NET WORTH	**122.39**	**132.63**	**172.95**	**207.75**	**229.99**
TOTAL LONG TERM DEBT	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**
Cash Credit	5.07	3.23	0.58	1.29	1.40
Short term loan - Banks/ Corporate Bodies/Others	15.93	0.00	0.00	0.00	0.00
TOTAL SHORT TERM DEBT	**21.01**	**3.23**	**0.58**	**1.29**	**1.40**
Total Debt	**21.01**	**3.23**	**0.58**	**1.29**	**1.40**
Acceptances	3.90	0.41	0.00	0.00	0.00
Sundry creditors	68.32	95.19	436.36	788.40	1378.22
Unspent balance of Govt. Grant	5.84	14.76	41.50	27.61	7.50

...Contd.

Table 12 – Balance Sheet (Contd...)

(Rs. Mn)

ASSETS	1.03.1998	31.03.1999	1.03.2000	1.03.2001	31.03.2002
Other liabilities	9.40	25.19	204.52	32.71	16.05
Interest accrued and due on loans	0.03	0.00	0.00	0.00	0.00
TOTAL OTHER LIABILITIES	**87.48**	**135.55**	**682.38**	**848.71**	**1,401.77**
Provision for income tax	0.00	0.00	0.00	0.00	2.60
Provision for Dividend inol. Dividend Tax	5.36	6.26	10.84	26.93	28.17
Other provisions - Gratuity & Leave Encashment	23.87	29.26	26.39	27.22	29.79
TOTAL PROVISIONS	**29.23**	**35.51**	**37.23**	**54.15**	**60.56**
TOTAL CURRENT LIABILITIES	**116.71**	**171.06**	**719.61**	**902.87**	**1,462.33**
TOTAL LIABILITIES	**260.12**	**306.91**	**893.13**	**1,111.89**	**1,693.74**

Source: ICRA

Table 13 – Key Financial Ratios

PROFITABILITY RATIOS	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
OPBDIT/Operating Income	-0.1%	-4.3%	0.0%	-0.3%	-0.7%
OPBDT/Operating Income	-0.3%	-4.4%	0.0%	-0.4%	-0.7%
OPBT/Operating Income	-0.4%	-4.5%	-0.1%	-0.4%	-0.8%
APAT/Operating Income	0.6%	1.1%	1.1%	1.4%	0.9%
APAT/Tangible Net Worth	16.68%	11.99%	23.16%	29.05%	13.10%
Dividend/APAT	23.32%	142.56%	25.20%	43.16%	91.74%
OPBDIT/(Total Debt + Tangible Net Worth)	-3.24%	-44.83%	0.24%	-5.36%	-10.49%
OPBIT/(Total Debt + Tangible Net Worth)	-4.83%	-46.36%	-0.99%	-6.39%	-11.42%

...Contd.

Table 13 – Key Financial Ratios (Contd...)

PROFITABILITY RATIOS	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
APAT/(Total Debt + Tangible Net Worth)	14.23%	11.70%	23.08%	28.87%	13.02%
CAPITALISATION RATIOS					
Short Term Debt/Tangible Net Worth	0.17	0.02	0.00	0.01	0.01
Gross Block/Tangible Net Worth	0.27	0.25	0.19	0.16	0.14
Net Fixed Assets/Tangible Net Worth	0.28	0.25	0.19	0.16	0.14
Operating Income/ Gross Block	96.19	43.16	112.44	132.96	104.95
COVERAGE RATIOS					
OPBDIT/Interest and Finance Charges	-0.72	-49.81	1.26	-2.42	-63.03
PBDIT / Total Debt	1.39	5.94	73.04	52.20	25.19
LIQUIDITY RATIOS					
Current Ratio	1.64	1.57	1.17	1.11	1.14
Quick Ratio	1.41	1.33	0.88	1.06	1.11
Debtors days	10	18	38	67	153
Days Payables	9	30	53	82	169
Days Inventory (as cost of sales)	4	10	21	4	4
Net working Capital/ Operating Income	3%	1%	-1%	0%	1%

Source: ICRA

Positive Net Margins on the back of Non Operating income

As mentioned earlier, the company has been continuously incurring operating losses (except for the FY 2000, where it registered a marginal operating profit). However, the net margins are positive on the back of the high non-operating

income earned by HHEC. The table below summarises the financial performance of the company over the past five years.

Table 14 - Trends in profitability

(in Rs. Mn)

	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
Operating Profit/Loss (OPBDIT)	**(4.65)**	**(60.91)**	**0.42**	**(19.54)**	**(24.27)**
Depreciation	2.27	2.07	2.13	2.14	2.15
Interest & Finance Charges	6.46	1.22	0.33	4.64	0.39
Profit Before Non-operating Income & Tax	-13.38	-64.20-	-2.04	-26.32	-26.81
Non-operating Income	**34.16**	**79.64**	**43.32**	**80.50**	**57.24**
PBT	20.41	15.90	40.05	60.35	32.73
Tax	0.00	0.00	0.00	0.00	2.60
PAT	**20.41**	**15.90**	**40.05**	**60.35**	**30.13**

Source: Company Information, ICRA analysis

Liquidity Position and Working Capital

Though the current ratio of HHEC, which is indicative of the short-term liquidity position of an entity, has been declining over the years, it still is at a comfortable level. The net working capital intensity of the company has witnessed a declining trend and is quite low, contrary to the expectation of a high working capital intensity, for a trading business. The trends in working capital of HHEC over the past years are shown below:

Table 15 - Working Capital and Liquidity Position

	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
Current Ratio	1.64	1.57	1.17	1.11	1.14
NWC/OI	3%	1%	-1%	0%	1%
Receivables (days)	10	18	38	67	153
Creditor (days)	9	30	53	82	169
Inventory (days)	4	10	21	4	4

Source: Company Annual Report, ICRA Analysis

The increase in receivables, and consequently in the creditor days, is on account of the bullion trading activities, where LCs are opened for 180 days. The average creditors' period as days of purchases, excluding the bullion trading is 9 days, while receivables as days of sales (excluding bullion trading), have averaged around 7 days. The working capital requirements of HHEC are low due to the conservative credit and inventory policy being adopted by the company.

The cash and bank balance of HHEC is quite significant and has increased from Rs. 27 Mn in FY 1998 to Rs. 155 Mn in FY 2002. However, the auditor has made significant comments in the Annual Accounts of 2000-2001, which include non-execution of title deed for lands and buildings.

SWOT ANALYSIS

The key success factor of a trading organisation like HHEC lies in it being able to source effectively and also market it to a wide and diversified customer base. The ability of HHEC to execute these functions depends on the quality and quantum of its resources as well as the efficiency of its supporting systems. Accordingly, the following processes constitute the key business processes of HHEC, since the manner the company performs these tasks directly affect the profitability of the business:

- Sourcing/procurement;
- Design and Product Development;
- Sales and marketing;
- Order fulfilment (strict adherence to the delivery schedules etc);
- Information systems;
- Working capital management; and
- Human resource management.

Apart from these internal aspects, changes in the external environment like changing policy framework, competition from other foreign countries, removal of quotas for handloom products, direct exports by manufacturers, growth of powerloom fabric and made-ups, also affect the fortunes of the industry and by extension the performance and prospects of HHEC.

A SWOT analysis of HHEC is presented in the following sections, covering issues spanning its internal and external environment, as highlighted above. The analysis is presented for the two main business activities of HHEC, namely the direct sales (core activities) and the indirect sales (non-core activities).

Strengths

Direct Sales (consisting of export and domestic sales of handicrafts and handloom products):

- HHEC has good physical infrastructure with six domestic branch offices and two foreign offices. The offices are located at premium locations in New Delhi, Mumbai and Chenna;
- Network of offices and HHEC teams posted at the actual places of manufacture give it an advantage of procurement across the country;
- Foreign offices of HHEC can be used to asses market demand and building client relationships;
- Enjoys a reputation in the market of supplying good quality material, and having introduced Pashmina, Sona, Persian Carpets and Muradabad brass in the world markets;
- HHEC is a Government firm and thus is perceived to reduce the risk of buyers, especially the first time ones in the market;
- Has over the years developed trade related skills, with specific strengths in procurement, production monitoring and quality control of handloom products;
- Has a design centre for sample development in Chennai and has, over the years, developed a good library of samples in handloom fabrics.

Indirect Sales (Consisting of export of jewellery and import of bullion and commodities):

- Being a government company, it is one of three organisations with the right to hold fairs and exhibitions of Indian gems and jewellery abroad;

- Canalising opportunities, being a government company, have enabled HHEC to trade in bullion, and raw silk.

Weaknesses

Direct Sales:

- HHEC has no control over manufacturing except for garments; while most of the exporters in the business to have some control over their manufacturing costs by virtue of being into some part of the manufacturing chain;

- In carpets, high inventory carrying norms are followed, whereas HHEC does not carry any inventory;

- HHEC does not have sufficient design capabilities, except for handloom fabrics, while innovative design is the key in all its product categories, especially handicrafts;

- Lack of expertise in Marketing, Finance and Trade functions;

- Lack of standardisation, uniformity within the organisation and across branches;

- No clear pricing policy;

- Being a government company, HHEC needs to adhere to strict government procedures while performing day to day operations. This affect its competitiveness vis a vis private exporters.

Indirect Sales

- In bullion trading, the sole differentiation is service levels, where HHEC is weak when compared to the banks that are into this business;

Opportunities

Direct Sales

- HHEC can perform the role of a buying agent for products where it does not have the manufacturing facilities, especially in the handicrafts segment;

- HHEC has negligible presence in high value items in art metalware and can leverage its brand name and network to introduce these products in the market and enhance its revenue sources;

- With an office in Japan, HHEC can develop markets for its garments in a non-quota era in Japan and neighbouring countries;

- HHEC can leverage its branches located at Chennai, New Delhi and Mumbai to increase sales in the domestic market;

- Up-gradation of its existing manufacturing facilities and technology can reduce its production costs, thus improving its cost competitiveness.

Threats

Direct Sales

- Powerlooms are a threat of HHEC's handlooms business, as they outperform handlooms when it comes to mass production with comparatively easier designs and lower costs;

- Other developing countries, such as Pakistan, China etc., are becoming key procurement centres for madeups (this is mainly due to the increased use of powerloom fabrics for madeups);

- The industry structure has changed over the times and there is a high degree of disintermediation, with buyers directly contacting sellers;

- Strong private players are increasingly dominating market with focus on specific product categories, especially in handicrafts.

DISINVESTMENT CONSIDERATIONS

Disinvestment of HHEC is to be analysed in the following context:

- The developmental and social role being played by the organisation; and

- Economic and commercial rationale.

Developmental role of HHEC – How critical is it?

Before evaluating the importance of the developmental and social role being played by HHEC, it would be essential to understand the focus / direction and objective of the various policies being implemented by the GoI for the sustained and long-term promotion and development of the handloom and handicraft sector. Some of the key objectives of the various policies currently being pursued by GoI are as follows:

- To ensure easy availability of credit to the industry;
- Provide assistance to the industry in developing the domestic and export market;
- Ensure reasonable and better returns to artisans and weavers for their products;
- To promote Research and Development, including development of new designs and products;
- Ensuring availability of raw materials at reasonable and affordable price.
- Development of infrastructure for the industry in terms of setting up Weaver Service Centres (WSCs) etc.;

HHEC was established with the objective of supporting the development of markets for Indian handicraft and handloom products in foreign countries. At the time of its establishment, institutional capacity in the industry was weak, and even the apex GoI institutions, namely, the offices of the Development Commissioner (Handicrafts) and Development Commissioner (Handlooms) were not established. Under the circumstances, HHEC was one of the few agencies involved in implementing the GoI policies in respect of these sectors and as expected, the company had indeed played a "catalytic" role in the promotion of these sectors, especially the handicrafts, in the past.

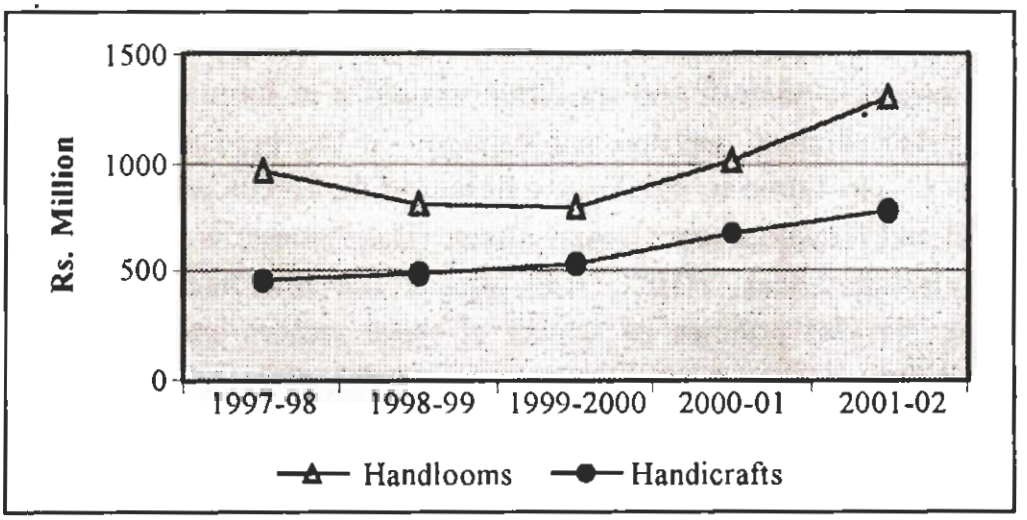
However, as mentioned earlier, over the years, with the industry becoming more mature and organised, this role of HHEC has considerably diminished. This is also demonstrated by the fact that the company has not been able to create any major success stories as it has done in the past. Besides, currently there are

institutions for the implementation of its polices in the handicraft and handloom industry.

It is important, in this context, to evaluate the criticality of the developmental role being played by the company, by analysing the expenditure incurred by GoI during the ninth five year plan (1997-2002) on the promotion and development of the handicraft and handloom industry for various activities, and then reviewing the amount of expenditure that was channalised through HHEC. In this context, it may be noted that the HHEC's ability to promote and develop these sectors by channelising its own funds remains limited / doubtful given its weak financial position.

The total expenditure incurred by GoI during the period FY 1998 to FY 2001 for the handloom and handicrafts industry was of the order of Rs. 5,768 Mn. The allocation for FY 2002 is estimated to be Rs 2,088 Mn. During the period FY 1998-01, the expenditure on the handicraft industry grew by a CAGR of 14%, from Rs. 460 Mn in FY 1998 to Rs. 680 Mn in FY 2001. On the other hand, the expenditure on the handlooms sector grew by a CAGR of 2%, from Rs. 970 Mn in FY 1998 to Rs. 1015 Mn in FY 2001. These figures exhibit the amount spent/ incurred by GoI for the handicraft and handloom industry:

Ninth Five Year Plan Expenditure



Source: ICRA

During the period under review, 57% of the total expenditure in the handicrafts sector was directed towards research and development, training and new product

development. Market development accounted for 13% of the total handicraft expenditure of GoI during the same period, while the balance was accounted for by cluster development, welfare schemes for craftsmen, assistance to the North East region, and State Corporations and Societies etc.

In handlooms, the expenditure was directed towards welfare schemes for destitute weavers, housing and insurance (64%); development of export and domestic markets (19%) and research and development (8%).

HHEC has been receiving grants from GoI for the development of its own business as also towards its efforts in the development of the industry. The objectives for which HHEC has received grants in the past could be broadly classified as product development, market development and establishment expenses.

Table below provides information on the grants received by HHEC from GoI during 1997-98 to 2001-02.

Table 16 - HHEC - Grants Received

(Rs. Mn)

	1997-98	1998-99	1999-2000	2000-01	2001-02
Product Development	0.29	0.75	0.12	1.95	1.35
Market Development	1.51	2.88	2.06	4.24	7.70
Establishment expenses	0.70	21.84	15.07	16.77	7.44
Total	**2.49**	**25.48**	**17.25**	**22.95**	**16.49**

Source: Company Information / ICRA

As is evident from the table, during FY 2002, 45% of the total grants received by HHEC were for its own establishment expenses. Grants received towards market development relate to the expenditure incurred by HHEC in participating in exhibitions and fairs within the country and abroad. The grants received by HHEC for product development relate to the development of specific products, such as Enamel craft and sample development. Overall, the grants received by HHEC for its own establishment expenses have increased by a CAGR of 81%.

The importance of HHEC to GoI for implementing its policies in the handicraft and handloom industry for development and promotion of the sector can be

assessed through the total expenditure of GoI in the handcraft and handloom industry that is being channalised through HHEC. The table below provides information relating to total expenses incurred by GoI and the grants received by HHEC:

Table 17- GoI Expenditure and HHEC Grants

(Rs. Mn)

	1997-98	1998-99	1999-00	2000-01	2001-02
Handlooms – GoI expenditure	970	815	809	1015	1298
Handicrafts – GoI expenditure	460	492	528	680	790
Total	**1430**	**1307**	**1337**	**1694**	**2088**
Grants Rec. by HHEC	2.49	25.48	17.25	22.95	16.49
% of total GoI expenditure	**0.17%**	**1.95%**	**1.29%**	**1.35%**	**0.79%**

Source: ICRA

It is thus be clear that the grants received by HHEC during FY 2001, aggregated to only 1.35% of the total GoI expenditure in the handicrafts and handlooms industry (FY 2001). It may be mentioned that the increase in the grants received by HHEC during the period under review was primarily on account of the compensation that it received for implementation of the VRS scheme in the company. The grants received by HHEC for implementation of the VRS during the period under the review (FY 1998 to FY 2001with FY 2002 figures being only estimates) were Rs.50.32 Mn, out of the total grants aggregating Rs.68.17 Mn received by HHEC from GoI during the same period.

It can thus be concluded that HHEC's role in the product and market development for industry has become insignificant over the years, and that there exist other government institutions/agencies (including Export Promotion Council for Handicrafts and Handloom Export Promotion Council) and NGOs which are actively pursuing the implementation of the GoI's policy and its developmental efforts in the sector. The sector has become competitive. Therefore, even if HHEC claims to support about 10,000 weavers and artisans, its support would

appear to be miniscule if the total number of weavers and artisans in the country is taken into consideration.

It is, therefore, felt that disinvestment of HHEC would not affect the social and developmental efforts of GoI towards the sector and that, therefore, there is no rationale for GoI to be in this sector through HHEC.

Economic and Commercial Rationale

HHEC is primarily a trading company and is, therefore, exposed to the commercial risks associated with such a business. As explained earlier, the company's share in total exports of handicrafts is almost negligible and has over the years increased only marginally from 0.03% in FY 1998 to 0.04% in FY 2001. In handlooms, the company's position is a shade better with its market share remaining stagnant at 2% during 1998-2001. However, in both the businesses, HHEC remains, at best, a marginal player in the industry and does not figure among the large exporters of the country.

HHEC's financial performance has been deteriorating over the years, with the company incurring losses at the operating level. The positive net margins registered by the company have been primarily on account of its dependence on the non-operating income. Going forward, the possibility of HHEC incurring higher losses cannot be ruled out, in which case the losses would have to be borne by the GoI.

Therefore, from the point of view of both the developmental and commercial considerations, there is no rationale for HHEC to be in the public sector.

RECOMMENDATION

Based on the analyses above, the Commission recommends that Government of India should disinvest its entire shareholding in HHEC to a strategic buyer through the competitive bidding route.

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2.2 RURAL ELECTRIFICATION CORPORATION LTD. (REC)

INTRODUCTION

REC was incorporated in July 1969 in pursuance of the recommendations of All India Rural Credit Review Committee by RBI. It is a Government of India enterprise and a Public Financial Institution u/s 4A of Companies Act. In 1998, REC was registered as a Non-Banking Financial Company (NBFC) under section 45-1A of the RBI Act. Its main objective has been to finance and promote rural electrification projects all over the country. With private sector participation being low in power generation and almost negligible in transmission and distribution (particularly for non-urban centres), REC lends mostly to State Electricity Boards, State Government Departments, and Rural Electric Co-operatives. The role of REC includes: Financing (enabling access to finance for electrification, with focus on rural/semi-urban areas, by offering loans); Monitoring (monitoring usage of funds lent towards electrification programmes) and Training (providing technical assistance to the power utilities).REC by itself does not undertake development work and acts as a financing channel for power sector by lending to SEBs and rural cooperatives as well as private sector players.

REC is wholly owned by the GoI, with an authorised share capital of Rs.12,000 Million (Mn), divided into 12 million equity shares of Rs.1,000 each. As on 31.3.2002, its paid up capital was Rs.7,806 Mn. Its performance has been rated 'Excellent' for eight consecutive years upto 2000 – 01 by the Department of Public Enterprises.

REC has 17 field offices in the country covering various states. The corporate office at New Delhi looks at matters relating to Planning and Policy formulation, Resource Mobilization, Financial Operations etc. Field offices manage preliminary processing of new schemes, monitoring of ongoing schemes, scrutiny of loan claims and recovery of dues and maintain liaison with SEBs and State Governments for effective implementation of the electrification programme. REC has also set up a Central Training Institute for Rural Electrification at Hyderabad for imparting training to officers of SEBs, State Governments etc. The Corporation had 904 employees on its roll, as on 31.3.2002.

INDUSTRY OVERVIEW

REC activities are focussed on providing financing for the power sector. The problems associated with the power sector are well known. End-user tariffs out of tune with the economic cost coupled with losses and inefficiencies along the chain due to various causes have resulted in revenue realisation per unit of power produced being inadequate to compensate for the average cost of production and supply. Rural electricity schemes are usually more costly to implement than urban schemes owing to a variety of factors like low population density, difficult terrain, and low consumption. The power sector is dominated by the state and central government entities, more so in rural electrification.

Players in Power Generation

The private sector contributed just about 10% of the total installed capacity, with a significant 30% of the capacity being contributed by the central sector, as shown in the table below:

Table 1: Installed generation capacity (MW) as on 31 March, 2002

Ownership	Hydel	Steam	Gas	Diesel	Wind	Nuclear	Total	%Share
State	22636	36302	2662	583	63	0	**62245**	59.3%
Central	3049	21418	4419	0	0	2720	**31606**	30.1%
Private	576	4411	4082	552	1445	0	**11067**	10.5%
Total	**26261**	**62131**	**11163**	**1135**	**1507**	**2720**	**104918**	**100.0%**
% Share	25.0%	59.2%	10.6%	1.1%	1.4%	2.6%	**100.0%**	

Source: Credit Rating Information Services of India Ltd. Advisory Services (CRISIL)

Players in Transmission and Distribution

The state electricity boards (SEBs) are the chief implementing agencies. Private sector participation in transmission and distribution has been active only in the high-density urban areas. BSES (Mumbai), TPC (Mumbai), CESC (Calcutta) and AEC (Ahmedabad) are private sector players concentrated in supplying to urban areas. Distribution privatization was implemented recently in Delhi (in 2002), wherein private players have taken up majority stake in unbundled distribution

companies and the responsibility for supply of power to the respective zones– BSES in two zones and Tata Power in one zone. Rural electric co-operatives have rather very limited impact on the sector.

Distribution privatisation undertaken in Orissa in 1999 is perhaps the only instance of privatisation in rural areas. Although privatization of unbundled generation, transmission and distribution utilities is being planned in Andhra Pradesh, Karnataka and Rajasthan, it is likely that SEBs would continue to be dominant players in the near future.

Financial status of SEBs

SEBs are in a deep financial trouble with losses increasing from Rs.27,250 Mn in 1992-93 to Rs.1,77,940 Mn in 2000-01 (Revised Estimate) and projected to increase to Rs.2,48,350 Mn in 2001-02 (Annual Plan). The financials summarized in table 2 clearly show the dismal state of affairs:

Table 2: Commercial Profit/Loss[1] with subsidy

(Rs. Mn)

	1992-93		1996-97		2000-01	
	Number	**Surplus**	**Number**	**Surplus**	**Number**	**Surplus**
SEBs making surplus	7	4360	6	7310	2	6910
SEBs making losses	12	-31610	13	-54030	17	-184850
Total	**19**	**-27250**	**19**	**-46720**	**19**	**177940**

Source: CRISIL

Only two SEBs are expected to make commercial operating profit (after incorporating the subsidy amount provided by the state) in 2001-02. Moreover, only half the utilities posted a positive Gross Operating Surplus as shown in the table below. Even for SEBs where the Gross Operating Surplus is positive, it is grossly inadequate to meet the interest payments, as shown in table no. 3.

1. The commercial loss of a SEB is the gap between total revenue receivables and total expenditure in a given year. The total revenue includes subsidy given by the State Government in lieu of subsidized power supplies to domestic and agricultural sectors. The total expenditure includes payments towards depreciation and interest payable to the State Government as well as financial institutions.

Table 3: Revenue Surplus and Commercial Loss (2000-01, RE)

(Rs.Mn)

	Number	Gross Operating surplus	Interest payable	Depreciation	States
SPUs making operating surpluses	10	52940	65590	37400	Meghalaya, Himachal Pradesh, Tamil Nadu, Orissa, Punjab, Kerala, Andhra Pradesh, Karnataka, Maharashtra, Rajasthan (Transco.)
SPUs making operating losses	9	-60300	43600	24000	Haryana, Gujarat, UP (Power Corp.), Madhya Pradesh, Jammu & Kashmir, Delhi (DVB), West Bengal, Bihar, Assam
Total	**19**	**-7360**	**109190**	**61400**	

Source: CRISIL

The ability of these utilities to fulfil their debt obligations is highly suspect with most entities close to default grade on a standalone basis. A state government guarantee has become the basic prerequisite for these entities to raise finances from the markets. Unfortunately, the state government guarantee itself may not be good enough given the poor financial condition of most state governments. Moreover, state governments are increasingly being compelled to review the limits to which guarantees are provided.

The poor economics of these utilities manifests itself in a pattern of defaults to the central power sector utilities such as NTPC (on purchase of power) as well as lenders such as REC. Traditionally, SPUs have defaulted more to the central government power generation companies rather than to lenders such as REC, which would result in suspension of loans. However, even NTPC has started taking tough stances to force defaulting states to pay up their dues, which is likely to put greater stress on the financials of the SEBs. This pattern of defaults resulted in build up of dues to Rs.4,14,730 Mn by March, 2001 to CPSUs.

Recognising the serious state of affairs in this critical sector, a mix of one-off restructuring measures and ongoing reform initiatives is being attempted, as highlighted below:

- **Settlement of past dues:** This is a one-time restructuring plan to clean up the historical liabilities built-up by the SEBs. Under a tri-partite agreement, reached between the state government, the Reserve Bank of India (RBI) and the GoI for the settlement of SEB dues, the outstanding dues of the SEBs would be securitised and repaid by the respective state governments. Dues outstanding after partial waiver of interest are to be converted into long-term loans to be repaid by the state governments over 15 years. The state government will issue bonds to the respective CPSUs, which could be traded in the market in a phased manner. While the step would be a significant positive in cleaning up the books of the SEBs, resolving underlying operational problems still remains critical for restoring the health of the sector.

- **Ongoing reform process:** GoI has recently announced a Rs.4,00,000 Mn assistance package encompassing initiatives at the national level, state level, SEB and utility level, distribution circle level, feeder level and the consumer level. The GoI has proposed an outlay of Rs.2,00,000 Mn as reform-linked aid, whereby 50% of the loss reduction achieved by the SEB would be paid by the GoI as an incentive.

Such initiatives are expected to improve the operational and financial performance of the State Electricity Boards.

Rural electrification

- Rural electricity schemes are usually more costly to implement than urban schemes due to, inter alia, low population density, difficult terrain, and low consumption. In addition, low rural incomes lead to problems of affordability. The long distances mean greater electricity losses and more expensive customer support and equipment maintenance. The Distribution Policy Committee, in its report, observes that the need for subsidisation of rural electrification might continue for quite some time due to these problems.

- In terms of village electrification, the number of villages electrified as on 31.2.2002 was 5,08,515 out of the total number of 5,87,258 villages. The number of villages remaining to be electrified is thus 78,743. Moreover, the standards of quality/quantity of power available to the 'electrified' villages need to be improved. It is estimated that on an average, an investment of Rs.2 Mn would be required, to electrify a remote village. The total cost is estimated to be around Rs.1,60,000 Mn. Thus, there is a substantial investment requirement for enhancing rural electrification amounting to Rs.16,000 Mn every year over the next ten years.

- The existing sector framework and industry conditions are not conducive for private sector participation and SEBs are likely to continue to be key players for the next few years. The Electricity Bill has sought to create enablers for increasing private sector participation. It is anticipated that subsequent to the enactment of the Bill, private sector players would be playing a greater role in the implementation of rural electrification projects. However, as the Distribution Policy Committee report observes, privatization itself might not eliminate the need for subsidizing rural electrification.

- The SEBs' credit profile is extremely poor and there is very low appetite for bonds offered by SEBs. Offering state government guarantees is also inadequate on account of the poor financial health of the states themselves. Only a few selective entities are able to raise finances. The financial difficulties of the SEBs are likely to lead to delay in development of rural electrification schemes. Hence, targeted support for rural electrification may continue to be a need for meeting rural electrification objectives.

Financing for Power sector

Although the state power utilities have the size to access the capital market, their poor credit rating makes it difficult to raise funds from the market on a standalone basis. If these SPUs were to raise funds from the market, many of them would not be able to secure funds (even with state government guarantees). Financial institutions such as IDBI have been restricted in lending to SEBs, only for generation funding and activities such as bill discounting. LIC, HDFC, HUDCO, PFC, REC, IREDA, SIDBI, CANFIN, ARDC/IDA,

commercial banks, nationalized banks have been the sources of funds in the past.

Some of the states have created special purpose entities - termed as State Power Finance Corporations (SPFCs) with the objective of raising funds for the power sector development in the state, mostly for funding the SEBs. Again, the funds raised by these entities are guaranteed by the state governments. Thus their ability to raise funds depends on the state governments' financial standing. Given the poor financial health of several states, only a few SPFCs would be successful in raising funds from the market.

REC OPERATIONS

Loan portfolio of REC

REC finances various activities related to development of power transmission and distribution, and generation infrastructure. The key areas for lending are shown in the table below:

Table 4: Disbursement by loan type over 1998-2002

(Rs. Mn)

Loan Type	1998-99	1999-00	2000-01	2001-02	CAGR
Short Term Loans/Bridge Loans	6087	12037	20800	27178	64.70%
Systems Improvement-Meters/ Transformers	0	1356	5908	7101	128.80%
Systems Improvement	4782	5741	5735	6712	12.00%
Normal (including village electrification)	4094	4982	4290	3183	-8.00%
Special Project Agriculture	2464	3270	3116	1859	-9.00%
Japan Bank for International Cooperation Loan	1831	1623	641	581	-31.80%
Minimum Needs Program	2275	1032	92	48	-72.40%
Total	**21533**	**30041**	**40582**	**46662**	**29.40%**

Source: CRISIL

While financing of village electrification and pumpset energization – the traditional activity of the corporation – has been declining, the incremental growth has arisen out of rapid growth in additional activities taken up by REC. As a consequence, REC's disbursements have grown at a Compounded Annual Growth Rate (CAGR) of almost 29.40% in the period 1998-99 to 2001-02 and the asset base has increased at a CAGR of 18.40% during the same period. Some salient features of REC's loans portfolio are:

- Introduced in 1998-99, Short-term loan/bridge loan has become the largest type of loan by disbursement, constituting Rs.27,178 Mn (58%) of the Rs.46,662 Mn disbursed in 2001-02. These loans are provided to State Electricity Boards to fund their working capital requirements and ensure speedy completion of projects.

- REC has also started giving greater emphasis on System Improvement activities. Systems Improvement loans (some of the products introduced in 2000) finance transmission and distribution infrastructure (such as meters, capacitors, transformers, etc.). With disbursement of about Rs.13,813 Mn, these loans constituted about 30% of loans disbursed in the year 2001-02.

- Financing of village electrification has reduced with only 207 villages electrified in 2001-02. This is partially on account of poor financial health of the SEBs leading to lowered priority for these activities and also due to completion of village electrification in several states as per existing definition. However, if the quality of the power were to be considered, then several villages need substantial investment.

- Special Project Agriculture, relating to financing of pumpset energization activities, has also been declining slowly with just 0.13 Mn being energized in 2001-2002 as against 0.25 Mn in earlier years.

- REC has also decided to fund generation and transmission projects of any size, thus easing itself out of the earlier restraint of having to finance only projects of 25 MW and below. REC anticipates disbursing as much as Rs.15,000 Mn per year for generation projects from the next fiscal.

- Disbursement under the Japan Bank for International Cooperation (JBIC) Loan, provided by the international agency for small-generation and other projects is almost completed.

FINANCIAL PERFORMANCE OF REC

Profit & Loss Statement

There are two distinct phases that can be observed clearly in the operations of REC: the period upto 1997-98 and the period post 1998, as shown in the key figures of P & L statement below:

Table 5 – Profit and Loss Statement

(Rs.Mn)

	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
Total fund based income	7,184	7,728	11,267	12,797	13,870	16,386
Interest and Finance						
Charges	6,064	6,504	7,205	8,251	9,341	11,049
Net fund based income	**1,120**	**1,224**	**4,063**	**4,546**	**4,529**	**5,337**
Non-fund based income	9	164	43	86	166	196
Total Net Income	**1,129**	**1,388**	**4,105**	**4,632**	**4,695**	**5,533**
Establishment expenses	45	43	46	54	61	60
Staff expenses	120	136	194	200	253	438
Reported Profit After Tax	**725**	**950**	**2,992**	**3,143**	**3,369**	**3,877**

Source: CRISIL

The growth in the post 1998 phase has been extremely rapid. Net Fund based income grew by more than 300% in just one year (1998-99) as REC introduced a new product, namely Short Term Loan, and also started providing additional thrust on Systems Improvement activity. However, the extent of provisioning is almost negligible in relation to the large amount of outstanding dues, and the financial status of the borrowing entities. Guarantees by state governments are the prime cause for non-performing assets (NPAs) although, REC has rarely, if ever, enforced such guarantees.

The growth in the profits has arisen due to steady growth in the financing of activities outside the core rural electrification activities, such as short term loans. The fact that only 207 villages have been electrified in 2001-02, while short term loans to SEBs have grown at over 64% clearly indicates the dilution of rural electrification focus.

Income

REC derives its income almost entirely from interest on loans provided to SEBs, state government departments, rural electric co-operatives. lease rentals, income from investments, and miscellaneous income form a small part of overall revenues. REC recognizes income including interest/discount or any other charges on Non-Performing Assets only when it is actually realized. Any income recognized before the asset became non-performing and remaining unrealized is reversed. Also, REC does not recognize income from loans outstanding for more than six months. An overview of income from FY 1997 to FY 2002 is given in the table below:

Table 6: Overview of Income

(Rs. Mn.)

	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
Total Interest Income	6,927	7,582	11,123	12,659	13,629	16,251
Lease rentals & HP	172	64	65	64	69	-57
Income From Investments	86	82	80	74	172	192
Total fund based income	**7,184**	**7,728**	**11,267**	**12,797**	**13,870**	**16,386**
Interest and Finance						
Charges	6,064	6,504	7,205	8,251	9,341	11,049
Net fund based income	**1,120**	**1,224**	**4,063**	**4,546**	**4,529**	**5,337**
Non-fund based income	9	164	43	86	166	196
Total Net Income	**1,129**	**1,388**	**4,105**	**4,632**	**4,695**	**5,533**

Source: CRISIL

Interest and finance charges

REC has access to cheaper funds on account of its ability to raise special types of bonds: REC is one of the three notified institutions permitted to issue Infrastructure Bonds under Sec. 88 of the Income Tax Act. Besides, it is one of the three notified institutions permitted to issue Capital Gains bonds under Sec 54EC of the IT Act; REC is also eligible for issuing bonds qualifying for priority sector investments by banks as indirect finance for agriculture. All these help REC in raising funds at competitive rates. The average interest cost varied between 10.25% and 10.66% over the period FY 2000 - FY 2002.

Operating expenditure

Apart from the interest costs towards borrowing, establishment and staff expenses are the other expenditure. Establishment and staff expenses are around Rs.314.1 Mn constituting an average 0.38% of the average funds deployed. A comparison of Non-interest expenses in 2000-01 for various financial institutions presented below reveals that REC seems to be competitively positioned in this respect. However, the comparison needs to be adjusted for asset quality in relation to the significant level of outstanding dues.

Table 7

	REC	PFC	EXIM	SIDBI	IDBI	HUDCO	ICICI
Non int expenses/ Avg. Total Assets	0.27%	0.23%	0.38%	0.54%	0.24%	0.68%	0.59%
Non int expenses/ Revenues	6.7%	3.8%	11.6%	13.9%	9.5%	36.9%	16.6%

Source: CRISIL

Provisioning for bad and doubtful debts

REC has provided less than Rs.200 Mn for bad and doubtful debts during the period 1996-2002. General provision for sub-standard assets over the period FY 1995 to FY 2001 is around Rs.120 Mn. The Provisions for Bad Debts as a proportion of the Average Total Assets for the years FY 2002, FY 2001, and FY 2000 are 0.010%, 0.012%, and 0.139%, respectively (the writeoffs are mostly for a private project to which REC had extended loans).

However, REC has a very high level of outstanding dues (principal due) amounting to more than 12% of total assets, a significant component (as much as 84%) of which is due for over eight years. The key reasons for this could be that most loans are guaranteed by the state governments and that these guarantees are rarely enforced aggressively. If these overdues had been fully provided for, the provisions would have substantially eroded the net worth of REC.

A comparison of Provisions to Average Total Assets in 2000-01 for various financial institutions presented below reveals the relatively low level of provisioning of REC, despite large overdues:

Table 8

	REC	PFC	EXIM	SIDBI	IDBI	HUDCO	ICICI
Provisions For NPA's/Average total assets	0.01%	0.00%	0.01%	0.46%	1.29%	0.14%	2.43%

Source: CRISIL

It is critical that profitability and asset quality of REC be viewed from the perspective of low provisioning in relation to the outstanding dues, without which financials would seem more favourable than they actually are.

The details of the largest outstanding dues from five state utilities, and the financial status of these states are elaborated below:

Table 9: Overview of Revenues/Deficits/Subsidies for defaulters to REC

(Rs. Mn.)

Borrower	Principal due[2]	Due since	SEB Revenues	Operating surplus of SEB	Interest expense[3]	SEB Net Deficit	State Deficit	RD/RR	Subsidy to SEB
MPSEB	7,814	Apr-95	46,610	-8,560	13,040	-21,600	-29,320	-24%	4330
UPPCL	3,918	Oct-93	59,040	-16,560	2,720	-19,280	-72,520	-24%	0

...Contd.

2. Outstanding dues are figures as on 31 March 2002.
3. 'Interest Expense' is the total interest to be paid by the SEB to all borrowers including REC.

Borrower	Principal due	Due since	SEB Revenues	Operating surplus of SEB	Interest expense	SEB Net Deficit	State Deficit	RD/RR	Subsidy to SEB
WBSEB	1,889	Mar-94	23,870	-2,700	3,830	-6,530	-92,950	-56%	490
BSEB/JSEB	1,517	May-92	22,860	-1,930	1,320	-3,250	-35,490	-31%	0
Chattisgarh SEB	1708	Apr-95	NA	NA	NA	NA	NA	NA	NA
Total	**16,846**		**152,380**	**-29,750**	**20,910**	**-50,660**	**-230,280**		**4820**

Source: CRISIL

It may be noted:

- The key defaulters to REC face large deficits, with inflows inadequate to meet interest payments.
- The state governments are also in very poor financial state, having progressively run up huge revenue deficits.
- The subsidies provided by the states to the SEBs are non-existent/ inadequate to meet the obligations of the SEBs.
- The outstandings are significant from the SEBs point of view; on an average, the principal outstanding to REC alone constitutes around 10% of the SEB's revenues for the above five entities.

REC may not be able to recover the dues considering the poor financial context of these entities. The repayment of dues would have a significant financial impact on these SPUs.

REC suspends disbursement to entities which have defaulted on payments. However, once REC undertakes rescheduling of past dues (sometimes spreading the repayment over a period as long as twenty years), it resumes the lending to these entities. There is a danger of REC being caught in a vicious cycle of restructuring and lending to the same entities despite past defaults. This only leads to an ever-increasing exposure to these entities without any real repayments being made to REC.

Profit after Tax

As discussed earlier, REC has steadily grown its income and PAT in the post 1997-98 period. Its income grew from Rs.7,728 Mn in 1997-98 to Rs.16,386

Mn in 2001-02, while its PAT grew from Rs.950 Mn to Rs.3,877 Mn. A comparison of PAT as a percentage of the total assets and networth in 2000-01 for various financial institutions is presented in the table below:

Table 10

	REC	PFC	EXIM	SIDBI	IDBI	HUDCO	ICICI
PAT (Reported)/ Avg. Total Assets	2.9%	4.6%	2.1%	2.8%	1.0%	0.7%	0.8%
PAT (Reported)/ Avg. Networth	16.7%	17.5%	9.6%	14.8%	7.5%	6.1%	7.0%

Source: CRISIL

It is critical that the growth in profitability and the above ratios should be viewed in the context of the large amount of outstanding dues of REC and the different profiles of borrowers of these institutions.

Ratio Analysis

The net profitability has reduced to 1.81% in FY 2002 from 2.11% in FY 2000 partially on account of mismatch in the adjustment of interest rates on REC's borrowing vis-à-vis disbursements. While REC has lowered interest rates on loans, the interest payments on REC's borrowings from the market are typically adjusted after three years to reflect the lower interest rate regime. This has impacted the net profit margins which have declined over the period 1999-2002. Also, in the case of newly introduced short term loans, the interest spreads could be lower than other loans.

Table 11: Ratio Analysis of REC (%)

	FY 2002	FY 2001	FY 2000	FY 1999
Interest yields on carry business	12.30	12.12	13.13	13.24
Interest cost	10.25	10.27	10.66	10.56
Expenses/Avg funds deployed (AFD)	0.38	0.28	0.31	0.29
Write-offs and provisions/AFD	0.01	0.01	0.14	0.01
Core fee based income/AFD	0.15	0.15	0.09	0.05
Net profit margin	1.66	1.55	2.02	2.37
Net profit margin including core income	1.81	1.70	2.11	2.42

Source: CRISIL

Expenses as a % of the average funds deployed have risen significantly in the year 2002, but are still in line with broad industry indicators.

Balance Sheet

Corresponding to the introduction of Short Term Loans and additional focus towards Systems Improvement activities, REC's asset growth jumped from 7-8% growth levels in the period before 1998-99 to 15-20% growth rates after 1998-99, as shown in the salient features of Balance Sheets for six years, below:

Table 12 – Summary of Balance Sheets

(Rs.Mn)

	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
Loans and Advances	71,480	77,973	88,416	102,774	121,828	141,782
Current Assets	2,454	2,584	2,270	4,801	5,013	9,078
Other Assets	315	266	248	250	210	202
Total Assets	**74,250**	**80,823**	**90,934**	**107,825**	**127,051**	**151,062**
Tangible Networth	11,510	12,837	15,789	18,917	21,476	24,663
Total Borrowings	60,230	65,311	71,085	83,757	98,132	117,515
Current Liabilities	2,509	2,676	4,060	5,151	7,444	8,884
Total Liabilities	**74,250**	**80,823**	**90,934**	**107,825**	**127,051**	**151,062**

Source: CRISIL

REC's Assets

REC's assets are mostly in the form of loans and advances, while fixed assets are less than 0.1% of the total assets, reflecting the predominantly financing activities of REC.

The client portfolio of REC is mostly State Power Utilities (SPUs) i.e. State Electricity Boards (SEBs) and the Electricity Departments (EDs) reflecting the low levels of private sector participation: only 10% of generation capacity is with private sector and distribution privatisation is limited to key urban areas. Most loans are being disbursed to entities in dire financial condition. The table no. 13 details the disbursements made by REC to key utilities which

constitute 90% of the outstanding loans, and highlights their precarious state of finances:

Table 13 : Financial health of REC's borrowers. (Rs.Mn)

	1999-2000		2000-2001		2001-2002		(Mar. '02)
Borrowing entities	**Disburse-ment**	**Commercial Profit/Loss**	**Disburse-ment**	**Commercial Profit/Loss**	**Disburse-ment**	**Commercial Profit/Loss**	**Outstanding**
Andhra Pradesh	2944	-530	5062	-9320	6803	-11940	18305
Rajasthan	0	-1330	7090	6150	0	-24120	16265
Madhya Pradesh	851	-27180	13	-28000	0	-31830	12778
Kerala	2403	-1810	4698	-3480	5222	-4450	12191
Maharashtra	3984	6050	7522	-14040	5583	-35270	12007
Karnataka	2595	760	2709	760	3733	860	10591
UP	0	-25960	0	-17340	0	-18870	9404
Gujarat	3616	-25010	0	-26040	*6101*	-21350	7942
Punjab	0	-17090	5896	-14770	*7540*	-16330	7145
Tamil Nadu	0	-11920	92	-11970	*35*	-22600	5797
Haryana	342	-8350	921	-15480	2511	-15370	4414
Orissa	0	-1870	181	-2120	6883	-2300	4120
West Bengal	0	-7930	4	-10090	0	-10360	3153
Bihar	0	-5110	0	-6700	0	-7530	2531
Assam	30	-2140	0	-3790	0	-3700	2183
Himachal Pradesh	273	-2060	441	-920	554	-480	1853
Jammu & Kashmir	157	-7930	313	-9900	356	-11410	1487
Total	**17195**	**-139410**	**34942**	**-167050**	**45321**	**-237050**	**132166**

Source: CRISIL

REC has outstanding loans of more than Rs.54,789 Mn to the top five loss-making SEBs. Incidentally, the states (Madhya Pradesh, Uttar Pradesh, West Bengal, Bihar), which have largest dues outstanding to REC, are making operating losses. The amount of disbursements made by REC to the SEBs is about twice the amount of repayments actually made by the SEBs in any year, as shown in the table no. 14.

Table 14

(Rs.Mn)

	1999	2000	2001	2002
Disbursements	21,533	30,040	40,581	46,661
Repayments	11,102	15,526	21,626	26,700
Source: CRISIL				

The real test for REC would arise when the growth phase subsides and REC itself reduces its annual borrowings. Simultaneously, SEBs may have to curb their own borrowings and make net payment to REC, unlike in the current situation. REC would face cashflow mismatch as repayment of some loans is delayed and loans have to be rescheduled over a longer repayment period than the tenure of the REC's liabilities. REC also has to bear the interest payments on its borrowings while pardoning outstanding interest on loans to the defaulters. The asset portfolio is also significantly concentrated with top three borrowers accounting for 33% of total loans, as shown in table below. Additional disbursements towards short term loans as well as generation financing would only serve to increase concentration risk for REC.

Table 15: State-wise outstandings of REC

(Rs. Mn)

State	Proportion	31-Mar-02	Proportion	31-Mar-01
Andhra Pradesh	12.9%	18,310	11.6%	14,190
Rajasthan	11.5%	16,260	10.6%	12,900
Madhya Pradesh	9.0%	12,780	12.8%	15,570
Kerala	8.6%	12,190	7.5%	9,130
Maharashtra	8.5%	12,010	7.9%	9,580
Karnataka	7.5%	10,590	7.5%	9,090
Uttar Pradesh	6.6%	9,400	9.0%	10,940
Gujarat	5.6%	7,940	5.5%	6,660
Others	**29.9%**	**42370**	**27.8%**	**33830**
Total	**100%**	**1,41,850**	**100%**	**1,21,890**

Source: CRISIL

Current Assets

The total current assets of the corporation stood at Rs.9,077 Mn, comprising Cash and Bank Balances of Rs.2,251 Mn, Advance Tax paid of Rs.3,590 Mn apart from interest accrued on loans & deposits of Rs.3,144 Mn. REC's other assets of Rs.202 Mn consists of buildings, land and equipment (Book Value).

Liabilities of REC

Sources of funds for REC are a mix of government loans and market borrowings, as shown in the table below:

Table 16: Liabilities of REC

(Rs. Mn)

	FY 1995	FY 1996	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
	Phase I				Phase II			
Equity Share Capital	4,866	5,346	5,826	6,306	6,806	6,806	7,306	7,806
Total Reserves	5,206	4,952	5,684	6,531	8,983	12,111	14,170	16,857
Tangible Networth	**10,072**	**10,298**	**11,510**	**12,837**	**15,789**	**18,917**	**21,476**	**24,663**
Bonds guaranteed by GoI	6,216	6,329	6,580	6,842	6,364	5,913	5,908	5,396
Secured REC Bonds	9,234	9,917	11,410	12,910	14,547	21,855	31,446	61,922
Total Bonds	**15,450**	**16,246**	**17,990**	**19,752**	**20,910**	**27,768**	**37,354**	**67,318**
Loans from GOI	36,394	39,437	42,240	45,559	50,175	55,989	56,678	48,095
Loans from Banks/FI	—	—	—	—	—	—	4,100	2,102
Total Other Borrowing	**36,394**	**39,437**	**42,240**	**45,559**	**50,175**	**55,989**	**60,778**	**50,197**
Total Borrowings	**51,844**	**55,682**	**60,230**	**65,311**	**71,085**	**83,757**	**98,132**	**117,515**
Current Liabilities	2,103	2,140	2,509	2,676	4,060	5,151	7,444	8,884
Total Liabilities	**64,019**	**68,120**	**74,250**	**80,823**	**90,934**	**107,825**	**127,051**	**151,062**

Source: CRISIL

The rapid growth in assets from Rs.80,823 Mn in 1998 to Rs.1,51,062 Mn by 2002 has been funded significantly through market borrowings: the corporation raised as much as Rs.33,600 Mn in 2001-02 as against Rs.16,110 Mn in 2000-01 and a mere Rs.3550 Mn in 1997-98. These funds are raised from the market through bonds secured by charge against specific loans advanced to State Electricity Boards.

The implication of the rapid increase in market borrowing as a proportion of total liabilities vis-à-vis the reduction in GOI loans is that it is critical for REC to manage its cashflows with greater stringency.

It may be noted that of the Rs.53,490 Mn of unsecured liabilities, Rs. 48,095 Mn are loans from the Government of India. Although, REC has mobilised a significant amount of funds from the market through its bonds programme in the last two years, the GOI's funding of Rs.48,095 Mn still accounted for a significant chunk (41% of the total borrowings) as on March 31, 2002. Of the Rs.8,884 Mn of current liabilities, provisions for taxes and dividends accounted for Rs.4,929 Mn, and interest accrued but not due on various bonds and government loans accounted for Rs.3,459 Mn .

Other liabilities

REC has securitised receivables through issue of Pass Through Certificates for APTRANSCO's receivables. These receivables have assignment of state government guarantee as security. Moreover, the Pass Through Certificates are provided with full recourse to REC in case of default by APTRANSCO.

For ready reference, the summarised Profit & Loss statements and Balance Sheets of REC, for the last five years, are shown in the Table below:

Table 17 - The financial statements of REC

Profit & loss statements

(Rs. Mn.)

	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
Total fund based income	7,728	11,267	12,797	13,870	16,386
Interest and Finance Charges	6,504	7,205	8,251	9,341	11,049
Net fund based income	**1,224**	**4,063**	**4,546**	**4,529**	**5,337**
Non-fund based income	164	43	86	166	196
Total Net Income	**1,388**	**4,105**	**4,632**	**4,695**	**5,533**
Establishment expenses	43	46	54	61	60
Staff expenses	136	194	200	253	438
Bad debts provided for	0	12	139	14	13

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	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
Profit Before Tax	**1,207**	**3,846**	**4,194**	**4,465**	**5,012**
Reported Profit After Tax	**950**	**2,992**	**3,143**	**3,369**	**3,877**
Dividend	**110**	**500**	**500**	**670**	**1,200**

Balance Sheet of REC

	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
Loans and Advances	77,973	88,416	102,774	121,828	141,782
Current Assets	2,584	2,270	4,801	5,013	9,078
Other Assets	266	248	250	210	202
Total Assets	**80,823**	**90,934**	**107,825**	**127,051**	**151,062**
Equity Share Capital	6,306	6,806	6,806	7,306	7,806
Total Reserves	6,531	8,983	12,111	14,170	16,857
Tangible Networth	**12,837**	**15,789**	**18,917**	**21,476**	**24,663**
Bonds Guaranteed by GoI	6,842	6,364	5,913	5,908	5,396
Secured REC Bonds	12,910	14,547	21,855	31,446	61,922
Total Bonds	**19,752**	**20,910**	**27,768**	**37,354**	**67,318**
Loans from GOI	45,559	50,175	55,989	56,678	48,095
Loans from Banks/FI	—	—	—	4,100	2,102
Total Other Borrowing	**45,559**	**50,175**	**55,989**	**60,778**	**50,197**
Total Borrowings	**65,311**	**71,085**	**83,757**	**98,132**	**117,515**
Current Liabilities	2,676	4,060	5,151	7,444	8,884
Total Liabilities	**80,823**	**90,934**	**107,825**	**127,051**	**151,062**

Source: CRISIL

OPERATING PERFORMANCE

Though REC appears to be in line with industry benchmarks on most parameters, the financial ratios and performance should also be viewed in the context that more than 12% of assets are outstanding dues for REC and do not generate any income. These are outstanding for a period exceeding eight years. The table no. 18 shows the operating performance of various financial institutions:

Table 18: Operating performance of various financial institutions (2000-01)

	REC	PFC	EXIM	SIDBI	IDBI	HUDCO	ICICI
Interest on Loans/Avg. Loans	12.1%	14.4%	9.1%	10.9%	13.6%	12.6%	13.5%
Interest Paid on Borrowings/Avg. Borrowings	10.3%	11.4%	10.1%	9.8%	11.8%	11.9%	11.6%
Net Fund Based Income/Avg. Total Assets	3.9%	5.7%	3.0%	3.9%	2.1%	1.6%	2.3%
Non int expenses/Avg. Total Assets	0.27%	0.23%	0.38%	0.54%	0.24%	0.68%	0.59%
Provisions For NPA's/Average total assets	0.01%	0.00%	0.01%	0.46%	1.29%	0.14%	2.43%
Net Oper. Inc After Prov. For NPA's/Avg. Total Assets	3.7%	5.7%	2.9%	2.9%	1.0%	1.0%	0.5%
PAT (Reported)/Avg. Total Assets	2.9%	4.6%	2.1%	2.8%	1.0%	0.7%	0.8%
PAT (Reported)/Avg. Networth	16.7%	17.5%	9.6%	14.8%	7.5%	6.1%	7.0%
Non Fund Based Income/Revenues	3.5%	3.5%	8.2%	0.0%	18.9%	12.3%	36.5%
Non int expenses/Revenues	6.7%	3.8%	11.6%	13.9%	9.5%	36.9%	16.6%
Net Income (PAT Reported)/ Revenues	71.8%	78.4%	64.8%	73.0%	37.2%	36.0%	21.8%
Dividend/Net profit	22.1%	28.7%	0.0%	0.0%	47.9%	21.6%	88.9%
Net profit/net worth	15.7%	16.5%	9.3%	12.7%	7.5%	5.5%	7.0%
Operating Expenses/Average Total Assets	0.27%	0.23%	0.38%	0.54%	0.24%	0.68%	0.59%

Source: CRISIL

It has to be kept in mind that since no provisions need to be made for outstanding principal, the asset ratios for REC appear more positive th they actually are.

Ratings history

REC has enjoyed the highest safety ratings for the structured obligation programme as well as on a standalone basis. The ratings appear to have been influenced basically by the implicit GoI guarantees to the borrowings of REC.

BUSINESS PLAN FOR REC

The key business plan assumptions for REC have been discussed in this section.

Disbursement projections

REC has been lending to rural electrification (RE) activities, primarily transmission and distribution and small generation projects. However, REC has been considering lending to power generation activities as well and accordingly, its disbursement projections have been made for the following activities:

- Short Term Loans/Bridge Loans,
- Grants and special assistance (pass through financing),
- Existing types of loans (related to rural electricity transmission and distribution and small generation activities), and
- Generation activities.

REC's ambitious projections seem to be influenced mainly by the Ministry of Power blueprint for power sector which estimates investment around Rs. 8,000,000 Mn to augment generation, transmission and distribution infrastructure for power sector. Of this Rs.2,000,000 Mn are required for the augmentation of transmission infrastructure. Assuming that an additional Rs.3,000,000 Mn are required for distribution infrastructure, Rs. 3,000,000 Mn would be required for generation related activities. Thus, it is expected that considerable amount of funds need to be channelled to this sector.

Short Term Loans

Short term loans are loans of duration lesser than a year. These loans have been projected on the basis of the potential working capital requirements of various state utilities. REC's justification in providing such short term loans is that all working capital needs should be financed without restriction to rural/semi-urban related financing requirements. But, with only 207 villages being electrified in 2001-02, much of this working capital goes towards sustaining the SEB operations.

In the last few years, disbursement for short term loans has grown at more than 30% per year. REC could increase disbursements at the rate of 20% per annum

for next two years, 10% thereafter. If, in future, the financial health of some the SEBs improves, the share of REC in working capital finance and spreads would be affected by competition from other financial institutions and banks. Also, these loans being short term loans, the interest spreads could be lower than other loans.

However, it has been assumed REC would not increase the short term Loans beyond the current outstanding loans.

Rural electrification

As mentioned earlier, the number of villages yet to be electrified is about 78,740. It is estimated that on an average, an investment of Rs.2 Mn would be required, to electrify a remote village. The investment could provide solar home systems in at least 60 households and two to four pumps for irrigation or drinking water supply. The total cost is estimated to be around Rs.1,60,000 Mn. The annual investment requirement over a 10-year period is about Rs.16,000 Mn.

The assumptions regarding disbursement of other types of loans are:

- The disbursement under the Minimum Needs Program has been declining over the last few years and is assumed to be stable at existing levels.
- The disbursement under the Systems Improvement funding is assumed to sustain existing growth of around 15%.

Generation Activities

Generation activities, to be introduced in this Financial Year are likely to be a significant growth driver for REC. The following table presents the projected capacity addition as per the Ministry of Power blueprint:

Table 19 : Capacity augmentation over X & XI Plans (MW)

	X Plan	XI Plan	Total
Total Central Sector	28485	36785	65270
Ministry of Power	23000	23500	46500

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	X Plan	XI Plan	Total
Ministry of Coal	210	1500	1710
Department of Atomic Energy	1220	5160	6380
Ministry of Non-Conventional Energy Sources	4055	6625	10680
Total State Sector	8300	10600	18900
Total Private Sector	9400	13500	22900
TOTAL	**46185**	**60885**	**107070**

Source: CRISIL

The demand for loans for REC could be benchmarked using the disbursements made by PFC. PFC disbursed Rs.32,300 Mn and Rs.51,500 Mn in FY 2001 and FY 2002 respectively. It is estimated that an amount of Rs.15,000 Mn could be disbursed by REC from the next year. The implication for REC is that profile of these loans could be slightly longer (Moratorium period of 2.5-3 years, and repayment by the end of the 10th year.). However, the business plan assumes that REC would not undertake any generation financing.

Interest income

The interest income would be a function of the interest rates charged by REC for variety of activities. It has been assumed that the existing spread for various loans types over government securities is sustained.

Other Income

The following are the projections made for other income:

- Income from lease rentals has been assumed to be stable at the average level for last five years (between Rs.60-70 Mn).
- Income from investments has been assumed to grow at existing growth rate.

Repayments of loans

Repayment of existing loans has been assumed as per the details provided in balance sheet and the inputs provided by REC.

Projections for interest cost

No new government loans have been assumed to be taken up by REC. Also no new loans from Banks and Financial Institutions have been assumed to be drawn once existing loans are repaid. The spread between the interest rate offered to REC and the government gilts rate has been assumed to be at existing levels. The spread of AAA rated corporations over gilts is assumed to be sustained for all other borrowings of REC.

Other Expenditure

Other expenditure for REC consists of establishment and staff expenses. While establishment expenses have been assumed to increase at 10%, salary expenses increase has been projected to be 12% based on additional recruitment, hike in salary, etc.

Dividend Policy

REC has paid 22% and 31% dividend in the past two years. However, REC is anticipating considerable offtake for generation funding and anticipates paying dividend at a lesser rate of the reported profits.

Asset classification and provisioning

As shown in the table below, a significant share of the outstandings are due for more than eight years. Most of the loans are guaranteed by the state governments but state government guarantees have not been invoked aggressively so far. Also, no general provisioning is made for these loans. However, interest income from NPAs is not recognized and part interest accrued is written back.

It may be noted that REC does not lend to entities, which have outstanding dues. However, commencement of loans after restructuring of loans and resetting of repayment schedules over much longer duration (as long as twenty years) could significantly understate the extent of the problem of sub-standard assets. A statement of the interest and principal outstanding for the corporation is presented in the table no. 20.

Table 20: Statement of outstanding dues by borrower and financial status as on 31.3.2002 *(Rs.Mn)*

Borrower	Principal	Interest	Total	Due since
MPSEB	7814	7270	15083	Apr-95
UPPCL	3918	5000	8918	Oct-93
WBSEB	1889	3953	5842	Mar-94
BSEB/JSEB	1517	3225	4742	May-92
Chhattisgarh (earlier M.P.)	1708	1355	3063	Apr-95
ASEB	665	1583	2248	Mar-95
Uttaranchal (earlier U.P.)	644	841	1485	Oct-93
Windfarms	173	222	395	Dec-96
Co-operative societies	153	240	393	Mar-95
Manipur	59	76	135	Dec-01
RRVPNL (Rajasthan)	64	24	88	Mar-02
Mizoram	61	26	86	Nov-00
KPTCL (Karnataka)	49	11	60	Mar-02
TNEB	10	17	27	Mar-02
Others	17	10	27	—
Total	**18,739**	**23,853**	**42,591**	

Source: CRISIL

The implication is that a delay in payments by even a couple of SEBs has the potential to create a significant cash flow problem for REC as an increasing proportion of REC's funds are being raised from the debt markets.

The business plan of REC is based mainly on the continuation of status quo. Though REC may be technically correct in not clarifying default affected loans as NPAs, given the unsatisfactory performance of several state governments in honouring their guarantees, such loans, in essence, may be as good as NPAs.

SWOT ANALYSIS

Strengths

- Appraisal capability for rural electrification: REC has experience in development of project specifications, feasibility assessment and monitoring of rural T&D activities.

- Technical Assistance: REC provides technical assistance to SEBs and rural electric co-operatives.

- Importance of the sector: The health of the power sector is critical to the financial health of the states and is likely to be a focus area for Government of India. REC being the nodal agency for a socially desirable cause, is likely to be given support.

- Ability to raise funds: REC has been successfully raising ever-increasing amounts from the financial markets.

Weaknesses

- Poor financial status of borrowers: SEBs and state governments – the implementing agencies for T&D in semi-urban and rural areas are in a poor financial state.

- Concentration Risk: REC's charter of providing finance to power sector presents a significant concentration risk as there is only a limited set of borrowers.

- Appraisal capability for other activities: REC's appraisal capabilities for activities beyond rural electrification may not be very high.

Opportunities

- Investment deficit: Large investments are required to be made in this area as it is a core sector for the development of the economy.

- Sector reform initiatives: The electricity bill has attempted to create enablers for the development of projects through institutions other than the SEBs.

- Restructuring of SEBs: There is a likelihood of increasing focus on reforms of SEBs and eventual improvement of the credit profile.

Threats

- High outstanding dues: REC has significant level of non-performing assets, owed to it by SEBs in dire financial state. The recovery of these loans is

suspect as it is likely to impose significant financial burden on the SEBs. Provisioning levels are very low despite outstanding dues persisting for a period as long as eight years.

- Potential asset-liability mismatch: The concentration risk is significant for REC and delay in payments by a few SEBs could impose cashflow constraints on REC. This is particularly so in the context of the rapid growth in market borrowings of REC.

- Poor demand for loans: SEBs are lowering priority to rural electrification due to financial constraints and low profitability of rural schemes.

- Potential competition: With an improvement of the credit profile, other banks and FIs would compete in a more aggressive manner. REC's offtake of loans and interest spreads would come under threat. Private players would also seek the financing institution, which gives them the most competitive rates.

Key Factors for Success:

The key factors for success, required for operating in this sector and the position of REC vis-à-vis these factors are given below:

Table 21 – Key Success Factors

Key Factors for success	Position of REC	Need for GOI support	Remarks
Ability to raise funds at low rates	✓	✓	REC's government ownership provides comfort to lenders and enables it to raise finances at extremely competitive rates. In addition there is a market for some of REC's bonds as they contribute to the priority sector lending requirements for Banks and FIs.
Asset Quality	✗	✗	REC has significant level of outstandings from SEBs of poor credit standing. A default by even a few SEBs could impose financial constraints and severely afflict REC's Balance Sheet.

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Key Factors for success	Position of REC	Need for GOI support	Remarks
			REC's charter of lending to the power sector creates significant concentration risks. If the SEBs fail to push through reforms fast enough, REC's recovery rates would be severely affected. Such a situation would prove particularly catastrophic when the current growth phase subsides and REC lowers its annual borrowing from the market and starts repaying existing loans.
Ability to generate interest spreads	✔	✗	REC is able to generate profit as few financial institutions would be willing to lend to the SEBs at rates that REC does, as it may not compensate for the significant credit risk. It is because of the poor credit quality of the SEBs across the board that REC is able to borrow at maturities as long as seven years and yet lend for Short Term purposes. In the event that the credit quality of the SEBs improves, REC would not be in a position to compete with other financing options for the SEBs.
Business processes	✗	✗	While REC has capabilities in appraisal of Rural Electrification, Systems Improvement Projects, it may not have the appraisal capabilities comparable to other FIs active in financing other sectors. In terms of recoveries, REC should take all actions aggressively to reduce outstanding dues equivalent to 12.4% of the total assets.

Source: CRISIL

In summary, although on the surface REC seems to be a profitable enterprise, it needs to be recognized that it is operating in a significant risk environment and its continuance based on the existing model is a matter of great concern.

DISINVESTMENT CONSIDERATIONS

Some of the key issues that need to be addressed in respect of REC's future strategy are:

Dual character of REC

The core issues in respect of REC arise out of its efforts to take on a dual character i.e. Development role as an entity supporting rural electrification and Commercial role for financing activities in this sector. Each of these is driven by different objectives, considerations and principles.

Development Role	Commercial Role
The key elements for Successfully discharging the development role are ● Clearly outlined distribution objective, in line with national rural electrification objectives ● Transparency and explicitness in the nature and extent of support.	In contrast, the key elements for successfully performing commercial operations are: ● Disbursement and pricing based on robust appraisal mechanism involving financial and business risk assessment. ● Aggressive recovery mechanisms and enforcement of guarantees
The development character would imply that REC focus on equitability (or any coherent distribution principle) in provision of loans/other support across various states.	The commercial character would imply that REC focus on asset quality and profitability in provision of loans for various activities in the sector.

Under the current operating scheme, there is a danger that yardsticks for one are applied to the other, resulting in neither the development character nor the commercial character being fulfilled to the extent desired. For instance, in provision of loans, commercial considerations and credit quality issues drive the bulk of the disbursements. States, which in the eyes of REC appear to enjoy better credit quality, are provided a disproportionate share of the funds than may be required under the development support objectives.

It is, therefore, critical that the activities of REC be demarcated clearly into two categories: activities it carries out as a development function and the other activities which it considers to be commercial lending operations. The nature and extent of support to the development function should be explicit and transparent.

Mandated role of REC vis-à-vis current focus

As discussed, REC was set-up primarily to finance and promote rural electrification projects all over the country. As the rural electrification projects were considered unviable, there was a need for an agency whose funding of projects was governed primarily by social objectives rather than commercial considerations alone. It was also eminently justifiable for REC, to take up rural electrification projects of size less than 25 MW in rural areas, given its core focus of rural electrification.

But over time, REC has entered into new financing activities, basically in the area of electricity generation and distribution, while continuing with its rural electrification, although with a much diminished focus. In the process REC has begun to operate as a Development Financing Institution (DFI) for providing finance to a wide range of projects in the area of power.

New products introduced in the last few years such as Short Term Loans and Large Generation funding have already begun to account for an increasing share of REC's resources. For instance, Short-term loan/bridge loan has become the largest type of loan by disbursement, constituting Rs. 27,178 Mn (58%) of the Rs. 46,662 Mn disbursed in 2001-02 and it is anticipated that as much as Rs. 15,000 Mn of disbursement would be made under the Large Generation funding activities.

The main justification for diversifying its financing activities appears to have been a desire to earn surpluses from all such activities so that REC could absorb losses that it incurs in funding the rural electrification programmes. REC appears keen that its cross-subsidization strategy should help it to minimize its dependence on budgetary support for financing rural electrification. In the process of such a diversification, REC appears to have significantly deviated from its primary activities as could be noted from the fact that the financing activities mandated by its basic charter now account for relatively much smaller proportion of its aggregate financing activities.

Despite the significant apparent improvement in REC's profitability position, the share of its assistance in favour of rural electrification programmes has not only not improved but, on the contrary, appears to have declined. Therefore, the diversification strategy needs to be reviewed. There is a substantial investment requirement for enhancing rural electrification exceeding Rs. 16,000 Mn every

year over the next ten years. Around 80,000 villages are yet to be electrified and the standards of quality/quantity of power available to the 'electrified' villages need to be improved. The Electricity Bill has incorporated various initiatives to provide additional emphasis on rural electrification, with the objective of enabling local bodies and private sector players in providing electricity to rural areas.

Therefore, the key strategic issue that needs to be answered is whether REC should dilute its development focus with respect to rural electrification (RE) for activities unrelated to rural electrification, which would result in RE being relegated to secondary status.

Unsustainability of REC's business model

The issue of whether REC can continue to sustain itself as a commercially viable entity by lending to the heavily loss making SEBs, to which other financial institutions would prefer not to lend in the normal course of business, is examined in greater detail in this section.

Prima facie, REC has a sound balance sheet and has earned very high level of profits year after year. However, on a closer examination of the sources of its high profits and high accumulated reserves, one is struck by the precarious balance sheets and profitability of positions of almost all its borrowers viz. the SEBs, the commercial losses of which are accumulating at an accelerating pace. The SEBs have been servicing loans obtained by them from REC, not generally from their genuine operating surplus but mainly by defaulting on their obligations to other entities like NTPC, CIL etc. from whom they buy electricity and coal. It would appear that the entities would have a strong commitment to honour their obligations to REC only so long as they receive net disbursement assistance from REC.

Hence, even though the recoveries of loans for REC in the past may have surpassed what might be implied by a critical evaluation of the finances of the SEBs, the future repayments to REC are very much suspect. The quality of these assets may deteriorate rapidly because of the following reasons:

a) **REC is currently in a rapid growth mode, which masks serious long-term problems associated with its underlying loans**. The real test for REC would arise when the growth phase subsides and SEBs are required to make

net outflows (repayments exceeding new disbursements) from their internal accruals. The current operations of the SEBs preclude such a possibility in the near future.

In the REC context, the experience of IDBI/SIDBI vis-à-vis the state level DFIs viz. the State Finance Corporations (SFCs) would be relevant.

Until recently, IDBI and SIDBI used to fund the SFCs through their various refinance schemes. As in the case of REC, a central government-owned financial institution providing credit to the state-level entities (SEBs), leading national financial institutions IDBI/SIDBI were providing credit to the state-level entities: State Financial Corporations (SFCs). These entities, set-up to promote small and medium enterprises, expanded sanctions and disbursements at a rapid growth rate of 17-19% p.a during the 1980s. The two national level institutions were major sources of funds for the SFCs. The SFCs were regular in repaying their loans so long as the fresh disbursements of loans from these institutions were larger than the repayments of funds the SFCs had to make to IDBI and SIDBI. Even when the SFCs faced liquidity problems, IDBI/SIDBI received their repayments owing to their high share in financing resources to these institutions and preferred creditor status. Once the level of disbursement of funds from IDBI and SIDBI tapered off/declined, the SFCs started defaulting in their repayments to both SIDBI and IDBI. IDBI/SIDBI experienced a rapid deterioration in the asset quality, with NPAs mounting to as much as 45-55% of total assets.

The similarities to REC's case are very striking: REC is currently in a similar growth phase (mainly since 1998-99) with assets increasing at about 19% p.a. The financial health of the state entities it is financing is as precarious as that of the SFCs, as demonstrated by their defaults to power suppliers such as NTPC. Thus, there is definite risk of the underlying problems of the SEBs starting to manifest in a rapid deterioration of asset quality of REC.

REC has significant repayment obligations over the next five years, with average interest payments exceeding Rs. 6,000 Mn and repayments of upto Rs. 20,000 Mn in some of the years. A default by even a couple of the SEBs in the respect of the payments would impose significant financial constraints on the corporation, especially once the current growth phase of REC subsides.

Given the financial problems of SEBs, these loans have to be rescheduled over a long repayment period (say, as long as 20 years in some cases), which is longer than the tenure of the REC's liabilities (usually around seven years). REC also has to bear the interest payments on its borrowings while pardoning outstanding interest on loans to the defaulters. All these would result in cashflow mismatches for REC, which may require a government bailout as well.

b) SEBs followed a pattern of defaulting on payments for power purchase from central power sector utilities such as NTPC, while at the same time repaying REC loans. Such a strategy is no longer likely to succeed. It may be restated that the SEBs outstanding payments (excluding penalties and interest payments) to CPSUs stood at Rs. 2,57,270 Mn in 2001, i.e. almost twice the size REC's asset base at that time. If the SEBs had paid these dues to the CPSUs, lenders like REC and PFC would have had to bear the brunt of such defaults. Central power sector utilities are increasingly taking a hard stance against defaulting utilities by taking strong measures, as indicated earlier. Clearly, the SEBs are likely to be in a difficult financial position to fulfil their existing repayment commitments as all the creditors start exerting pressure on the SEBs.

Hence, the strength of REC's balance sheet and accumulated profits (reserves) has to be viewed in the context of these strong negatives. So long as the fresh disbursements from REC to the SEBs exceed the repayments in respect of past loans, SEBs will continue to be punctual in servicing their obligations to REC but difficulties may be expected to crop up after this cycle of growing assistance comes to an end and REC's net disbursements to SEBs become negative.

Once the net disbursements to SEBs become negative, the large reserves that REC has built-up during all the years may have to be used for making provisions against the NPAs as soon as the SEBs start defaulting against their repayments to REC. The size of REC's retained earnings is relatively small in relation to its outstanding loans to the SEBs, which can be significantly affected by huge accumulated losses. Hence, any assessment of REC's balance sheet strength or its huge profitability record needs to be viewed from a tempered perspective.

The commercial business segment that REC operates in is of a suspect quality, given the status of the borrowers viz SEBs. Hence, the business model REC

has adopted does not appear to be sustainable since it may eventually find it difficult to raise ever-growing resources from the market for onward lending to entities whose financial position has been becoming weaker and weaker. It is not highly relevant whether GOI offers an implicit or explicit guarantee to REC's evergrowing borrowing programmes. GOI may soon have to evaluate and come to grips with the unviable and unsustainable DFI model and lending strategy of REC.

It is, therefore, desirable that REC dissociates itself from its current lending strategy, unrelated to rural electrification, and concentrates its energies exclusively to its basic charter of rural electrification programmes. For sustaining the socially desirable activities of rural electrification programmes, GoI may need to offer explicit support to REC so that it is not tempted to adopt a strategy of cross-subsidisation.

Risks in additional exposure to the power sector

The credit quality of the SEBs is extremely poor, and loans to these entities should be considered high-risk assets. Additional exposure to these entities by way of large generation financing and short-term loans only increase the balance sheet risks for REC and consequently the Government which is the only shareholder.

REC suspends disbursement to entities which have defaulted on payments. However, once REC undertakes rescheduling of past dues (sometimes spreading the repayment over a period as long as twenty years), it resumes the lending to these entities. There is a danger of REC being caught in a vicious cycle of restructuring and lending to the same entities despite past defaults. As indicated earlier, this only leads to an ever-increasing exposure to these entities without any net repayments being made to REC. Ultimately, GOI may be forced to structure an expensive bailout package in such a scenario.

Given the substantial credit risks of financing to these entities, a key strategic issue is the desirability of REC expanding its balance sheet and take additional exposure for activities other than those mandated under its core objective of rural electrification.

Hence, the divestment strategy in respect of REC would need to be calibrated in reference to these issues.

DISINVESTMENT STRATEGY

Government support to Development Finance Institutions is primarily a matter of government policy prerogative. In the case of REC, the considerations for support would be:

- In the context of the emerging power sector reforms, in what form and to what extent does the GoI intend to support the State Electricity Boards and state governments? Specifically, what are the policy instruments to be used for furthering rural electrification?

- Is REC the relevant channel for providing general support in the context of other institutions in the sector?

- Is REC's commercial character and diversification into generation activities leading to a dilution of its development focus?

These issues are discussed below:

Development role of REC

Support for rural electrification through various mechanisms has been prevalent in several developing and developed countries. Some of the mechanisms attempted to support electrification programs in rural areas include Capital subsidy, Interest subsidy and Providing loans. These mechanisms are discussed below:

Mechanism	Situations in which they are effective
Capital subsidy	The power utilities (private or public) are in a position to raise both debt and equity finance to a large extent. The subsidy is required only to enhance attractiveness of the project and encourage the utility to invest in the project.
Interest subsidy	The power utilities (private or public) are in a position to raise both debt and equity finance. But their credit quality is poor so that the interest rates demanded by financing agencies are very high. The government support is targeted to reduce the interest cost and encourage development of certain projects.

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Mechanism	Situations in which they are effective
Providing loans	The utilities are considered very high-risk borrowers and are not in a position to raise finances from the markets. In this case providing a one-time subsidy or interest rate subsidy would not help, as there are fundamental problems making the utilities default grade.

Source: CRISIL

A mechanism to support the power sector through Capital/interest subsidy might not be effective in an environment in which utilities are considered very high-risk borrowers and are not in a position to raise finances from the markets.

When utilities are considered very high-risk borrowers and are not in a position to raise finances from the markets, the value of the government support is in enhancing the credit quality of the utilities to enable them to borrow. This can be achieved by creating an intermediary structure, which can borrow easily on account of the implicit government support, and lend to the utilities. This is the model currently being followed in REC (and PFC), although this may not have been the original purpose.

It is unlikely that GoI support for rural electrification can be done away with in the immediate future. Providing such support through several financial institutions does not seem to be possible immediately and there would continue to be the need for a nodal rural electrification institution such as REC. However, the support mechanism would need to be based on a well-defined distribution objective. The nature and extent of support should be explicitly recognized and provided for in a transparent manner.

Role of REC vis-à-vis other institutions – Is there a case for merger?

Until recently, REC was restricted only to the small generation projects, whereas PFC's portfolio has been mostly related power generation infrastructure. However, REC is now expanding its generation funding activity beyond the 25 MW size project limit as well, without any restrictions whatsoever. In this background, the question that arises, is whether one institution is adequate to serve the power sector. The following table identifies role of various institutions in financing of the power sector:

	PFC	REC	Banks/FIs
Generation funding	Yes	Yes, small projects	Yes
Transmission & Distribution funding	Yes	Yes	Yes, Limited
Rural Electrification	No	Yes	No
Non-power sectors	No	No	Yes

A clear distinction exists between REC and PFC's focus areas. As and when the financial health of the power sector improves, generation and transmission financing could be undertaken by banks/FIs. But rural electrification projects would be left with only REC to fund, although it may not be a profitable activity. This activity will not be compatible with the commercial objectives of PFC as well as Banks/FIs. Thus there is no rationale for merger of REC and PFC.

REC's commercial operations

Given the additional activities that have been taken up by REC, the issue to be evaluated is whether REC can be developed into a larger institution beyond rural electrification.

Can REC evolve/integrate into a multi-sector Development Financial Institution/Bank?

- The strategic options for REC to evolve/integrate into a multi-sector Development Financial Institution/Bank have significant risks.
- Rural electrification program itself would suffer, as REC's resources would get consumed in implementing such plans leading to a dilution of focus on rural electrification.
- In any case, REC's core objective of rural electrification would be incompatible with the banks' commercial objectives.
- REC would need higher level of skills to compete with DFIs and banks.
- Prudential norms and regulatory risks would be more significant once the nature of the corporation changes and ownership is changed to a non-government entity.

Can REC remain a niche institution lending only to power sector?

The financing activities of REC in different segments of the power sector have grown at an unprecedented rate during the last couple of years. Together with Power Finance Corporation (PFC), REC has also emerged as a major DFI for financing projects belonging to a single sector i.e. the power sector.

However, REC's ambition to grow as power sector DFI appears to be very risky, especially in view of the fact that the financial state of the sector is far from encouraging. So long as the power sector reforms are slow and halting, SEBs will continue to incur huge losses due to, inter alia, underpricing of power and inefficiencies along the distribution chain. As long as these are not dealt with, the viability of power projects will continue to be under great stress.

Therefore, REC's future as a standalone finance institution with significant exposure to SEBs is likely to be difficult. The credit quality of the SEBs is extremely poor and in the event that the SEBs are unable to push through reforms over the next few years, REC would be afflicted by more non-performing assets. It is, therefore, important that REC does not increase its exposure to the SEBs for activities beyond rural electrification.

The Standing Committee on Energy has suggested that REC should also be given a proactive role in the implementation of the rural electrification programme apart from providing funds.

The Electricity Bill, as passed by the Lok Sabha recently, has sought to create enablers for the development of alternate institutions that could invest and develop rural power infrastructure. With the growth of such alternative mechanisms, a greater number of viable rural electrification projects would be developed by non-SEB entities. In case the initiatives in the Electricity Bill and subsequent reforms do not bear fruit, REC would be impacted very negatively and deprived of profitable financing opportunities as REC continues to take exposure to SEBs only.

The implication of focusing only on rural electrification is that the requirement for such an entity may no longer be present as the sector reaches a stage where alternative institutions and private players emerge to develop rural electrification

projects and raise finances from the market. REC needs to appropriately position itself for such a situation.

The new initiatives, independent of the enactment of Electricity Bill, to electrify all non-electrified villages by extension of grid or by setting up stand alone small power generating plants based on any appropriate fuel would open some new opportunity for REC. REC can take a lead role in financing stand alone small projects with attendant minigrids, if the payment mechanisms are properly designed. New technological innovations have made small scale power generation plants cost effective.

Need for private sector partner

The case for a partner in the case of REC arises from the need for greater management skill in furthering rural electrification and enhancing effectiveness of REC's lending operations. The investor for REC in this context could be a development institution, technology partner or players with strategic business interests in the rural areas. Moreover, induction of external directors and presence of strategic investor would help in bringing in corporate best practices into the management of REC.

RECOMMENDATIONS

Based on the analyses above, the Commission makes the following recommendations:

Business Restructuring:

- **REC is currently engaged in two different functions: one being that of a development agent of the government responsible for providing support for promoting rural electrification, and the other being that of an entity carrying out commercial lending operations. These two functions need to be demarcated clearly, especially as they are mutually non-congruent.**

Restructuring in respect of Development function:

- **With reference to the development function, wherever REC has to subsidize projects, it may do so purely as an agency function, the**

underlying principle being that the nature and extent of subsidy are clearly recognized and provided for in a transparent manner.

- The government may immediately undertake a comprehensive reassessment of the rural electrification objectives of REC in the context of the reform initiatives being undertaken in the power sector. The reassessment would be in terms of activities to be supported, mechanism of support and the quantum of support.

- The support mechanism has to be driven by the development goals of the government in respect of rural electrification.

- Such support needs to be be fully funded by the government so that REC's financials are not impacted. These activities would provide a small but steady stream of risk-free income for REC.

Restructuring in respect of Commercial operations:

- The RE operations inherently require government support and the attempts by REC to cross-subsidise such operations by disversification into financing non-RE activities of the SEBs (generation, bridge loans, working capital loans etc.) expose REC to greater risk. Given the precarious financials of the SEBs, such activities cannot be considered as viable and sustainable. Under the circumstances, leveraging REC's balance sheet for such activities should be curtailed and discontinued.

- The withdrawal of REC from SEB-financing would require recapitalisation of REC. However, continuation of REC's business in the current form will only serve to postpone and aggravate such recapitalisation needs.

- With the initiatives under the Electricity Bill, a number of financially viable small projects (such as distributed generation schemes developed with cost-effective technologies, operating with low overheads and minimal losses along the supply chain) would take shape with the induction of private sector participation in the rural electrification sector. Over the years, REC has built valuable experience and insights into planning and financing of rural electrification projects. REC could

leverage its accumulated expertise to capture such opportunities and profit from them. Such development would enhance REC's attractiveness to potential private investors.

- However, it must be cautioned that possible emergence of profit opportunities for REC cannot be regarded as an instrument for cross-subsidising the development activities of REC. Such an approach would once again push REC to a precarious financial position.

Corporate Governance:

- In the interests of enhancing the efficiency of REC's operations, it is critical to strengthen the corporate governance and transparency of the corporation. Independent directors may be appointed to the Board of REC as per recommendations of the report of the Committee on Corporate Audit and Governance (Naresh Chandra Committee) as well as Advisory Group on Corporate Governance set-up by the Governor of RBI (R. H. Patil Committee).

DISINVESTMENT:

Given that the rural electrification objectives and targets are still unfulfilled, the tenth five-year plan horizon may provide the opportunity for achieving these targets. The Conference of Chief Ministers, in March, 2002, under the chairmanship of the Prime Minister, resolved that all villages should be electrified by 2007 and full coverage of households be achieved by 2012.

Once such targets are achieved, the role of REC would diminish considerably. However, the developmental role of REC would continue to be important in the future, albeit on a declining scale. Therefore, disinvestment of majority control is not desirable in the short term.

The Commission, therefore, recommends that the majority stake (at least 51%) in REC be retained by GoI for some time i.e. until the key village electrification targets are fulfilled by 2007.

Meanwhile, disinvestment of REC, leading to its privatization and eventual exit of government from REC, should be undertaken, in phases. As

mentioned above, the government has set two levels of targets, for all villages to be electrified and for all households to be covered, which should form the drivers for the gradual disinvestment process as shown below. The timing of disinvestment needs to be calibrated keeping in view those targets. The transaction documents should be prepared, indicating a clear road map for the future, accordingly.

Phase-I : Upto 49% equity of REC should be disinvested immediately in favour of the partner through a competitive bidding route, giving the partner an appropriate role in the management of REC's affairs, with a view to enhancing the effectiveness of the company. Even after this partial disinvestment, REC would continue to need GoI support for its rural electrification activities.

Phase-II (Upto 74%): The additional equity stake, which makes the partner a majority stakeholder, should be transferred around five years from the timing of disinvestment of the 49% stake, i.e. in effect after 2007. Control premium may be received at that stage of privatization of REC when management control would be transferred to the strategic partner. During this phase, Government should retain at least 26% share, as support for rural electrification would be required till significant level of targets for electrification of households is achieved.

Phase-III (Upto 100%) : The rationale of REC as a specialized entity in this sector will diminish substantially once other financial institutions become active in funding non-RE activities and REC's agency function to support RE-activities is diluted. Moreover, with growing profit opportunities in RE-related activities in the future, REC's attractiveness to private investors would also increase. Therefore, divestment of additional stake should be considered around 2012.

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2.3 STATE FARMS CORPORATION OF INDIA LTD. (SFCIL)

INTRODUCTION

SFCIL was established in 1969 when the administrative control of the then existing mechanised farms like the one at Suratgarh, set up in 1956 with cooperation from Soviet government, and Jetsar in Rajasthan were transferred to it. Initially, farms were set up for production of foodgrains. Subsequently, these farms started producing labelled seeds. In 1974, when the concept of National Seeds project came into being, these farms started producing certified seeds. Production of foundation seeds started in 1978 and that of breeder seeds in 1982. At present, the company is managing seven farms in different states of the country. The main objectives of the company are:

- set up and run agriculture farms for production of seeds (food grains, fibre crops, plantation crops, oilseeds, vegetables and fruits);
- study of these crops in different parts of the country;
- set up poultry, sheep, pig and other cattle breeding farms either as independent units or as part of agricultural operations;
- to function as seedsmen, nurserymen and to buy and sell and trade in any goods associated with the activities of the company.

During FY 2002, production was organised mainly in seven farms, namely Suratgarh, Sardragarh, Jetsar, Hissar, Bahraich, Raichur and Aralam. The management of the company has decided to wind up the loss making farms at Chengam, Rae Bareli, Kokilabari and Barpeta. The location of the various farms is shoswn in the table below:

Table 1 - Location of Farms

	Location	Title of land	Area (hectare)
Suratgarh	Rajasthan	Purchased	6296
Sardargarh	Rajasthan	Purchased	4548
Jetsar	Rajasthan	Purchased	5394
Hissar	Haryana	Leased	2710

...Contd.

	Location	Title of land	Area (hectare)
Bahraich	UP	Leased	3828
Raichur	Karnataka	Purchased	2960
Aralam	Kerala	Purchased	3060
Raebareli	UP	Leased	191
Chengam	Tamil Nadu	Leased	3904
Kokilabari	Assam	Leased	1986
Barpeta	Assam	Leased	100

Source: Credit Analysis & Research Ltd. (CARE)

The leased lands have been obtained from state governments (SGs) while the titles of the purchased lands are in the name of the President of India.

The authorised capital and paid-up share capital of SFCIL as on March 31 2002, were Rs.250 Mn and Rs.241.897 Mn respectively, the shares being fully held by GoI. SFCIL is a private limited company, having 3024 employees on its roll, as on 31.3.2002. The company is under the administrative control of the Department of Agriculture & Cooperation (DAC), Ministry of Agriculture (MoA) and has its registered office in New Delhi and two regional offices in Lucknow and Hyderabad.

INDUSTRY REVIEW

Agriculture in India

Indian agriculture has seen a gradual transformation since independence. From food shortages and imports in 1960s, the country has moved towards self-sufficiency and export. Agriculture and allied activities accounted for about 25% of the GDP of the country in FY 2001-02.Though the share of agriculture in GDP has declined from 31% in FY 1993-94 to 25% in FY 2001-02, the growth in GDP continues to have a strong correlation with the performance of the agricultural sector.

Agriculture provides employment to around 65% of the total workforce. The share of agricultural products in the total export earnings (US $ 5,871.1 Mn – 13.4% for FY 2001-02) is also substantial. Exports of agricultural products

stood at US $ 3,489 Mn for the period April-October 2002, accounting for 11.9% of total exports for the period.

Out of 107 Mn farming families in India, about 83 Mn belong to small and marginal categories.

Food grains and oilseeds

The production of foodgrains, area under foodgrains cultivation and the yield per hectare for the period 1980-81 to 2002-2003 are given in the table below:

Table 2 - Foodgrains

						CARG (%)	
Year	**2002-03**	**2001-02!**	**2000-01**	**1990-91**	**1980-81**	**1981-91**	**1991-01**
Production (Mn. tonnes)	184.1	211.17	195.92	176.39	129.59	3.49	1.17
Area (Mn. hectres)	N/A	122.55	119.78	127.84	126.67	0.10	-0.72
Yield (Kg per hectare)	N/A	1723	1636	1380	1023	3.38	1.91

! Advance estimates as on 05.04.2002

Source: DAC, MoA / CARE

The production and yield per hectare have shown a declining growth rate in the period 1991-01 over the period 1981-91. There has also been a decrease in area under cultivation of foodgrains over the period under consideration. Though India is one of the largest producers of foodgrains, the yield per hectare compares poorly with that of major agriculture producers in the world. The inadequate spread of new technological practices including use of High Yielding Varieties (HYV) of seeds, the small size of farms and inadequate irrigation facilities are some of the reasons for relatively lower yield in comparison with international standards.

The production of oilseeds, area under oilseeds cultivation and the yield per hectare between the period 1980-81 to 2002-2003 are shown in table no. 3

Table 3 - Oilseeds

						CARG (%)	
Year	**2002-03#**	**2001-02!**	**2000-01**	**1990-91**	**1980-81**	**1981-91**	**1991-01**
Production (Mn tonnes)	15.57	21.16*	18.40	18.61	9.37	7.92	-0.13
Area (Mn hectares)	21.01	23.32	23.25	24.15	17.60	3.58	-0.88
Yield (Kg per hectare)	741	907	791	771	532	4.21	0.77

! Advance estimates as on 05.04.2002

*Fourth Advance estimates as on 27.06.2002 estimate production at 20.73 Mn tones.

#Estimate according to monthly review of Indian Economy, CMIE April-2003.

Since figures for FY'02 and FY'03 are estimates, computation of CARG has been restricted to the period 2000-01.

Source: DAC, MoA / CARE

All the parameters have shown a negative or declining trend in the period 1991-01 compared to the period 1981-91.The domestic production of oilseed is lower than the demand. The current demand for edible oils is around 11 Mn tonnes annually as against a domestic supply of around 7 Mn tonnes. Out of total agriculture imports for the period April-October 2003, valued at $1500 Mn, edible oil import alone accounted for 63% ($940 Mn) of the total. Production of oilseeds has not increased over the years due to factors like lack of genetic advancement in technology in evolving high productivity seeds, compulsion of raising oilseeds on unirrigated land (80% of area) and low productivity per hectare as compared to that of food grains.

Horticultural Crops

The production and area under cultivation of horticultural crops for the period 1999-00 to 2001-2002 are shown in the table no. 4.

Table 4 -Horticultural Crops

(Area: Mn hectares: Production: Mn tonnes)

Crop/Year	2001-2002		2000-01		1999-2000	
	Area	Production	Area	Production	Area	Production
Fruits	3.95	46.80	3.89	45.37	3.80	45.50
Vegetables	6.89	96.54	6.25	93.92	5.99	90.83
Others^	5.70	4.61	5.53	4.51	N.A	6.03
Total	**16.54**	**147.95**	**15.67**	**143.80**		**142.36**

^ others include flowers, spices, cashew nut, arecanut, coconut and other horticultural crops.

N.A: Not Available.

Source: Economic Survey 2002-03 / CARE

As is evident from above, production as well as the area under cultivation of horticultural crops have grown over the period under consideration. India has emerged as the largest producer of coconut, arecanut, cashewnut, ginger, turmeric, black pepper and the second largest producer of fruits and vegetables.The major impediments facing Indian agriculture sector are the near stagnant growth in sowing area and yield per hectare during the last decade, increasing demographic pressures on land, low investment in rural infrastructure, low processing of agricultural products and inadequate credit flow to the sector.

Institutional Framework

The role of some of the key organisations attending to various functions in the agriculture sector is given below:

Table 5 - Organisational Framework

Function	Organisation
Policy & overall co-ordination	Ministry of Agriculture, GoI
Policy formulation, planning & coordination of agriculture development	Department of Agriculture & Co-operation (DAC), State Departments of Agriculture (SDAs),etc.
Management of supply of inputs and services to the agriculture sector	DAC, SDAs, Department of Fertilizers etc.

...Contd.

Function	Organisation
Management of output prices of agriculture commodities.	Commission for Agricultural Costs and Prices (CACP), DAC Implementation agencies: FCI, CCI, JCI, NAFED, Tobacco Board, SDAs , etc.
Marketing and distribution of agriculture products	State Agricultural Produce Marketing Boards, NAFED, National Cooperative Marketing Federation Ltd., Tribal Cooperative Marketing Development Federation Ltd., State Trading Corporation, State level bodies, etc.
Financing	National Bank for Agriculture and Rural Development, Commercial Banks, Regional Rural Banks, Cooperatives, etc.
Research & Development	Indian Council of Agricultural Research, Department of Agricultural Research and Education, State Agriculture Universities, SDAs
Personnel training	Extension division of DAC, ICAR, SDAs, State level bodies, etc
Export of Agriculture Products	Agricultural & Processed Foods Export Development Authority, Indian Silk Export Promotion Council, State level bodies, etc.

Source: CARE

As is evident from above, a number of Government institutions are active in the entire value chain of the Indian agriculture sector with large interdependencies.

Regulatory Framework

The farmers, who produce several crops including foodgrains, must get quality seeds to ensure high level of production. In recent years, several improved, high

yielding and hybrid seeds have been developed. As the impact of the kind of seed used will be known only after harvesting i.e. after the farmer has invested substantial time and money, it is important that quality seeds are made available to the farmers. To avoid malpractices and ensure availability of quality seeds to farmers, it became essential to regulate the quality of seed sold to farmers. The **Seeds Act, 1966 (Seeds Act)** which came into force throughout the country on October 2, 1969, provided for the formation of various regulatory bodies to carry out the provisions of the Act. The important regulatory bodies and their respective functions are shown in the table below:

Table 6 - Important Regulatory Bodies

Regulatory Bodies	Role
Central Seed Committee (CSC)	To give suggestions to the Central Government (CG) regarding seed production, certification, notification of new varieties and matters related to the administration of the Act.
Central Seed Certification Board (CSCB)	To formulate the guidelines and procedures with regard to seed certification in the country and to maintain the uniformity for seed certification standards.
Seed Certification Agency	To carry out Certification work of various seeds notified under Seeds Act 1966, National Seeds Corporation Ltd. started functioning as Seed Certification Agency initially. Subsequently, 22 states have established their own State Seed Certification Agencies (SSCAs).
Central Seed Testing Laboratory (CSTL)	To initiate seed testing programmes designed to promote uniformity in test results between all seed laboratories in India, collect data continuously on the quality of seeds found in the market and make the data available to the CSC and to coordinate investigations to the methods of germination, etc. to standardize the testing procedure. Since there is no independent Central Seed Testing Laboratory as on date, a laboratory of the Indian Agricultural Research Institute has been designated as such since 1969.
State Seed Testing Laboratories	

Source: CARE

The Act, *inter alia*, provides for:

- notification of kinds/varieties to be brought under the purview of the Seeds Act;
- the procedure of sale of seed; and
- etablishment of seed law enforcement machinery.

Further, CG is empowered to make rules under the Act and give directions to SGs, if necessary, to carry out the purpose of the Act. However, the responsibility of enforcement of various provisions of the Act is vested with the state governments.

In exercise of the powers conferred by Section 3 of Essential Commodities Act, 1955, the **Seed Control Order, 1983** came into force throughout the country on December 30, 1983. The Order made licensing compulsory for any person (Dealer) engaged in selling, exporting or importing of seeds in India.

The **Protection of Plant Varieties and Farmer's Rights Act, 2001** deals with Plant Variety Protection (PVP) which became mandatory for India due to the agreement on Trade Related Intellectual Property Rights (TRIPS).

The National Seeds Policy, 2002 has been tabled in the Parliament. The main objective of the policy is the creation of an appropriate climate for the seed industry to utilize available and prospective opportunities, safeguarding the interests of Indian farmers and the conservation of agro-biodiversity.

Seed Industry

Seeds form the fundamental and crucial input for sustained growth in farm production, often stimulating the use of new methods, machinery and yield-enhancing agro-inputs. Seeds of appropriate characteristics are required to meet the demand of diverse agro-climatic conditions and intensive cropping systems. Sustained increase in agriculture production and productivity is dependent to a large extent on the development of new and improved varieties of crops and an efficient system for timely supply of quality seeds to farmers.

The main characteristics of the seed industry are:

- seeds are living organisms and must remain alive in order to produce good plants. Environmental factors like moisture and temperature have profound effect on the physiological quality of the seed;

- production and marketing are seasonal;

- seed production is always beset with risks, as production and consumption are influenced by nature;

- demand estimation is difficult;

- production process follows a definite pattern and needs continuous surveillance;

- statutory controls and quality standards are important;

- proper storage facilities complying with the humidity and temperature requirements for a particular variety of seed are essential;

- high volume low value nature of some seed crops like cereals makes long distance transport unattractive; and

- basic input for agriculture and hence having sensitivities.

As in most developing countries, the Government has played a dominant role in the development of the seed industry. Seeds are often regarded as a strategic input to agriculture and, therefore, the Government has evolved an institutional mechanism to ensure supply of adequate quantity of quality seeds at reasonable prices to farmers.

The policy and regulatory framework that has evolved over a period of time has influenced not only the seed sector positively, but has also been instrumental in the growth achieved in agriculture production. The Indian seed sector has made impressive progress over the last three decades, contributing to the area under High Yielding Variety (HYV) having almost doubled during the period 1980-81 to 1998-99. The table no. 7 shows the area under HYV for major foodgrains for the period 1980-81 to 1998-99:

Table 7 - Area under HYV

(Mn Hectares)

	Year					CARG (%)	
Foodgrains	**1998-99!**	**1997-98!**	**1996-97***	**1990-91**	**1980-81**	**1991-99**	**1981-91**
Wheat	24.0	23.0	23.7	21.0	16.1	1.9	3.0
Rice	33.0	32.2	33.4	27.4	18.2	2.7	4.6
Jowar	9.3	9.0	8.3	7.1	3.5	3.9	8.2
Bajra	7.2	7.0	6.1	5.7	3.6	3.4	5.2
Maize	3.6	3.6	3.8	2.6	1.6	4.8	5.5
Total/Avg.	**77.1**	**74.8**	**75.3**	**63.8**	**43.0**	**2.7**	**4.5**

** Provisional ! Target*

Source: Statistical Outline of India, 2002-03, Tata Services Limited - CARE

Stages in Seed multiplication

Seed industry in India is involved in the production of seeds of good quality as also in achieving diversity in varietal distribution. The Indian seed programme adheres to the three generation system of seed multiplication, namely, breeder, foundation and certified seeds. The basic seed is evolved by research organisations, ICAR, State Agriculture Universities (SAUs), and SDAs. The process of seed development takes three to four years. Breeder seeds are produced from Nucleus seed in the first year. In the second year, Foundation seed is produced from Breeder seed and then Certified/Quality seed is produced from Foundation seed in the third year. The seed produced may be used by farmers in the third year itself or in the fourth year.

All varieties notified under section 5 of the Seeds Act 1966, have to be certified by SSCAs as per the certification standards set by the CSCB or truthfully labeled as per the norms of the Seeds Act 1966. Seed certification is voluntary. However, it is mandatory on the part of all seed producers to represent all information as prescribed under the Seeds Act 1966.

The table no. 8 shows the various stages of Certified Seed production and the agencies involved at each stage:

Table 8 - Stages of Seed Multiplication

Stage	Description (Genetic Purity %)	Agencies Involved	Regulatory Bodies
Nucleus Seed	Nucleus seed is the seed produced by the Breeder to develop a particular variety and is directly used for multiplication as breeder seed. (100%)	Research Organisations, ICAR, State Agriculture Universities, and State Departments of Agriculture, Private Companies.	CG in consultation with CSC notifies the variety to be certified.
Breeder Seed	Breeder seed is the seed material directly controlled by the originating or the sponsoring Breeder or Institution for the initial and recurring production of foundation seed. (100%)	Research Organisations, ICAR, State Agriculture Universities, State Departments of Agriculture, NSCL, SFCIL, State Seed Corporations, Private Companies.	Certification standards are set by CSCB. Central Seed Testing Laboratory (ICAR), SSCAs, State Seed Testing Laboratories (SSTLs).
Foundation Seed	Foundation seed is the progeny of breeder seed. (100%)	NSCL, SFCIL, State Seed Corporations. Private Companies. (Individual farmers can also produce Foundation seed on registered farms.)	Central Seed Testing Laboratory (ICAR), SSCAs, SSTLs.
Certified Seed	Certified seed is the progeny of foundation seed. (97%)	NSCL, SFCIL, State Seed Corporations, Private Companies. (Individual farmers can also produce Certified seed on registered farms.)	Central Seed Testing Laboratory (ICAR), SSCAs, SSTLs.

Source: CARE

In the matter of distribution of good quality seeds, Indian seed industry has recorded impressive growth, as shown in the table below:

Table 9 - Distribution of Certified/Quality seeds

(Mn quintals)

					CARG (%)	
Crops/Year	**2001-02***	**2000-01!**	**1990-91**	**1983-84**	**1983-91**	**1991-01**
Cereals	6.231	5.979	3.470	2.570	4.38	6.23
Pulses	0.648	0.384	0.341	0.210	7.17	1.33
Oilseeds	1.950	1.185	0.859	0.650	4.06	3.64

...Contd.

						CARG (%)	
Crops/Year		**2001-02***	**2000-01!**	**1990-91**	**1983-84**	**1983-91**	**1991-01**
Fibres	0.480	0.291	0.216	0.190	1.85	3.37	
Vegetables	1.667	0.705	0.824	0.880	-0.93	-1.72	
Total /Avg.	**10.976**	**8.544**	**5.710**	**4.500**	**3.46**	**4.58**	

*! Anticipated * Target*

Source: DAC, MoA / CARE

Though the distribution of certified/quality seed has almost doubled for the period under consideration, the growth rates for the period 1991-01, except for cereals and fibres have declined compared to the period of 1983-91. This is perhaps a reflection of the fact that there has not been any significant improvement in seeds technology in the vital segments of the farm economy such as pulses, oilseeds, fruits and vegetables.

Current Scenario

The commercial world seed market is assessed at around US $30 Billion. The U.S. seed industry, with total sales of nearly $6 Billion per year, is the largest seed industry in the world. Organised seed industry in India with a turnover of around US $620 Mn, ranks among the top ten countries in the world. The domestic consumption is around US $600 Mn and seeds worth about US $20 Mn are exported (Source: International Seed Federation). However, some estimates put the domestic market size at around $900 Mn.

Indian seed sector involves the participation of private as well as public sectors. The seed industry in India broadly comprises two national level corporations (NSCL & SFCIL), 13 SSCs, ICAR, SAUs, Co-operative sector, around 200 private seed companies and the unorganised sector involving thousands of seed producers, seed traders, dealers and merchant agents. For quality control and certification, there are 22 SSCAs and 101 SSTLs. The leading companies in the private sector are MAHYCO, Monsanto India, Nath Seeds, Proagro Seed Co. Ltd., Ankur Seeds Ltd., Raasi Seeds, Advanta India Ltd., PHI Seeds Ltd., etc,.

In India, 80% of the seed used for cultivation is farm-saved seed. Seed replacement rate for the major crops like rice and wheat is below 10 per cent as against the desired rate of about 20%. The organised seed sector supplies

around 10 million quintals of certified/quality seeds of major field crop groups namely, cereals, pulses, oilseeds, fibres and fodders. Although there is no reliable data available on quantity of seeds supplied by the unorganised sector, there is no doubt that the unorganised sector plays a major role in the seed sector. Hence, it is difficult to estimate the exact market size, both in terms of quantity and value.

The private sector accounts for around 70% of the market in terms of the organised turnover whereas the public sector has a greater share in terms of volume sales. SFCIL and NSCL together have a market share of around 6% in cereals, around 11% in pulses and around 5% in total certified/quality seed in volume terms for the year FY 2001-02. Public sector agencies concentrate more on HYV and hybrid varieties of food crops and cereals, which are of 'high volume low margin' nature. Organised private sector participation in this segment of the seed sector is almost negligible on account of the typically low margin on these products. Public sector agencies have direct access to breeder seeds developed by ICAR and SAUs. Due to the long gestation period involved in developing new seed varieties and in absence of system for varietals registration, till recently, private organizations generally did not invest in research. Further, the rampant piracy of varieties and breeding lines that is reportedly prevalent in the country also acts as a major hindrance. Now, a number of private seed companies have their own seed research programmes.

However, the investment of private seed companies is limited to work on hybrids (for certain crops), since hybrids provide an in-built mechanism for protecting them from piracy. Companies with foreign/technical collaboration and subsidiaries of MNCs operating in India outsource germplasm from their collaborators/MNCs. Companies also get into Licensing arrangements with MNCs for outsourcing germplasm. Private companies tend to concentrate on developing hybrid varieties for oilseeds, maize, cotton and vegetable crops, which are typically 'low volume high margin' products. Factors responsible for the immense interest shown by private companies in development and sale of such specific hybrid seeds include the higher margins on these products as also that such hybrid seeds can be used only once, which assures a market for the next sowing season. Private companies have a dominant share of the vegetable seed market. Of late, there has been a gradual shift towards branded hybrid varieties of fruit and vegetable seeds, which give better prices and higher yield in relatively shorter span of their cropping activities.

Trade

Imports are mostly confined to vegetable, flower and fruit seeds for which no import restrictions exist. Total imports during FY 2000-01 were valued at $13.9 Mn, compared with $13.6 Mn in FY 1999-00.

India also exports seeds (mostly vegetable seed), which are mainly custom grown by foreign seed companies for export to third country markets. Varied agro-climatic conditions and cheap labour make India a favoured country for custom growing of seeds. Exports during FY 2000-01 were valued at $20 Mn, compared with $18.4 Mn in FY 1999-2000.

Biotechnology

Biotechnology can be used to develop new seeds/ crops, which are tolerant to disease, pests, abiotic stresses and also improve productivity and nutritional quality of food. Till date, with the exception of Monsanto's Bt cotton, no Genetically Modified (GMO) varieties of crops have been "officially" released by Genetic Engineering Approval Committee, the regulatory body which determines use of GMOs at the commercial level. In FY 02, the area under transgenic crop has risen by 6% globally to 58.7 Mn hectares. The country's stake in agriculture biotechnology is expected to increase. Work is underway with transgenics of rice, brassica, moongbean, pigeonpea, cotton, potato, tomato, and some vegetables like cabbage, cauliflower etc. According to a Vision Paper prepared by the Department of Biotechnology, transgenics of these crops would complete field assessment and some of them would be ready for large scale production by 2005.

Outlook

As mentioned earlier, Indian seed industry has made enormous progress over the last three decades with the Government playing a dominant role. In the last decade or so, participation of private sector in the seed sector has increased. Private players are expected to increase their presence with launch of new hybrid varieties of seeds. The industry is expected to undergo a consolidation phase with small players either exiting the market or being acquired by larger players. The Protection of Plant Varieties and Farmers Rights Act, 2001 and National Seeds Policy 2002 are major positives for the Indian seed sector. India has certain inherent advantages that can make her a dominant player in the

world seeds market. In addition to the advantages of relatively cheap agricultural labour, second largest area of farmland and the largest area of irrigated land, a wide variety of agro-climatic conditions is also available in the country. India, with all these favourable factors, is well placed to serve both domestic and international markets.

OPERATIONS OF SFCIL

SFCIL, together with the other public sector seed company NSCL, was envisioned to give direction to the seed industry in India with the production and distribution of certified seeds of various crops. SFCIL assumes the farming risk while the other sizeable players resort to contract farming for production of seeds.

Product Profile

SFCIL's product profile consists of different types of seed and planting material, as shown below:

Table 10 – Main crops under seed production

Cereals	Paddy, Wheat, Maize,Barley etc
Pulses	Moong, Urd, Arhar ,Cowpea, Gram
Oilseeds	Mustard, Toria, Soyabean
Fibre crop	Cotton, Jute
Vegetables	Carrot, Raddish, Palak etc
Plantation crop	Coconut, Rubber ,Cocoa
Horticulture	Mango,Guava,etc
Social forestry	Teak ,Neem etc

Source: CARE

Apart from seed production, the company is also engaged in various agriculture related activities like horticulture, cash crop production, social forestry and energy plantation, cultivation of ornamental and medicinal plants, sheep and goat rearing etc. Some of the Kharif crops produced are paddy, bajra, maize, moong, sugarcane etc. Production of Rabi crops like wheat, barley, gram etc. is also undertaken on the farms.

The production of Kharif and Rabi crops over six years is shown below:

Table 11 -Production for the period FY 1996-97 to FY 2001-02

(quintals)

	2001-02	2000-01	1999-2000	1998-99	1997-98	1996-97
Kharif	272202	279965	382608	325455	372212	320226
Rabi	169108	152740	190220	189600	179191	200525
Total	**441310**	**432705**	**572828**	**515055**	**551403**	**520751**

Source: CARE

It may be noted that the production of both Rabi and Kharif crops over the years has been erratic owing to dependence on rainfall, as only limited irrigation facilities are available in many of the farms. However, there appears to be a declining trend in production of such crops.

SFCIL, in line with national priorities, has been focussing on production of cereals like paddy and wheat etc. in which the profit margin is low. As indicated earlier, private players usually focus on low volume products like oilseeds and pulses where the profit margin is high.

SFCIL is not a price setter but usually has to follow the prices set by the respective SSCs and NSCL. As mentioned earlier, the product profile of SFCIL is geared toward high volume low margin products. The average sale price and the cost per quintal of some of the crops for the FY 2001-02 are given in the table below:

Table 12 - Cost of production

(Rs. per quintal)

	Avg. price	Direct cost	Contribution	Other cost(#)	PBILDT
	a	b	c=a-b	d	e=c-d
Paddy	959	433	526	431	95
Wheat	976	507	469	544	-75
Moong	2704	2687	17	2384	-2367
Sugarcane	101	74	27	63	-36
Guar	1858	1602	256	1497	-1241

...Contd.

	Avg. price	Direct cost	Contribution	Other cost(#)	PBILDT
	a	b	c=a-b	d	e=c-d
Soyabean	1597	2904	-1307	2848	-4155
Barley	855	515	340	410	-70
Gram	3241	1498	1743	1256	487
Mustard	3216	826	2390	709	1681

(#) other costs include cost of gunny bags, preservatives, etc

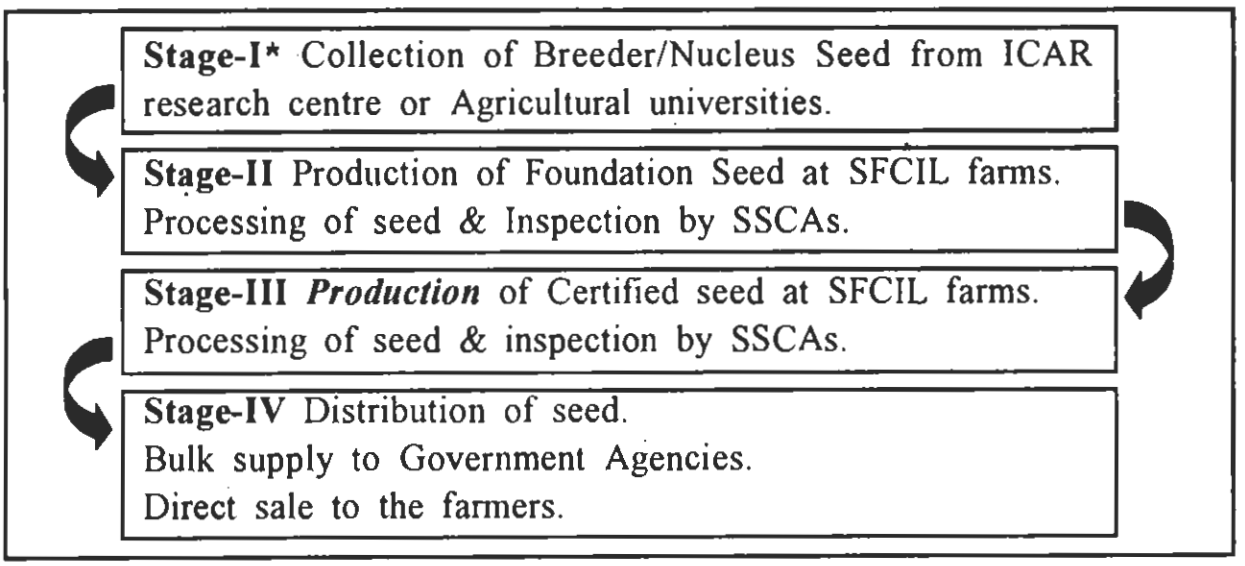
Source: CARE

As can be noted, the profit margin on most of the products is negative. The company is not able to meet the "other costs" in most of the cases. As a result, it is suffering from operating losses.

Seed Production

As mentioned above, the different type of seeds produced at SFCIL are test stock, breeder, foundation and certified seeds. The different stages of seed production are given in the table below:

Table 13 - Stages in seed production



**SFCIL also undertakes production of breeder seeds on behalf of ICAR*

Source: CARE

Sometimes SFCIL, on behalf of ICAR, undertakes the production of the test stock seed which is an intermediate stage between the nucleus and breeder seed.

A test stock seed is evaluated to identify the characteristics of the seed like the potential, moisture content etc.

The production of different types of seed by SFCIL during the six year period is given in the table below:

Table 14 - Production of different types of seeds

(quintals)

	2001-02	2000-01	1999-2000	1998-99	1997-98	1996-97
Breeder	1547	1635	3419	1306	1460	6393
Test stock	2525	414	1170	863	1313	1025
Foundation	27826	21211	24405	31881	45903	66095
Certified	134139	134252	186371	137626	119102	127965
	166037	**157512**	**215365**	**171676**	**167778**	**201478**

Source: CARE

The share of SFCIL in all categories of seeds is marginal when compared to total seed production in the country. The share in Breeder seed is around 7-9%, Foundation seed 5-7% and the Certified seed is around 2%.

Seed recovery

Seed recovery is the seed obtained from the produce. The seed recovery rate i.e. the conversion of produce into seed of SFCIL is low in comparison to the industry average of around 75-80%. The conversion rate of some of the crops for the period FY 1998-99 to FY 2001-02 is given below:

Table 15 - Seed recovery rate

(%)

	2001-02	2000-01	1999-2000	1998-99
Paddy	66	63	66	57
Moong	61	61	56	38
Guar	58	64	59	29
Soyabean	33	70	79	35

...Contd.

	2001-02	2000-01	1999-2000	1998-99
Wheat	74	75	74	74
Barley	72	76	74	70
Gram	73	68	70	70

Source: CARE

The low recovery rate impacts the financial performance of the company as the leftover seeds are sold as commercial grain at a lower rate than the seed price.

Land utilisation

At present, SFCIL is operating on seven of its farms. The operating parameters of these farms are given below:

Table 16 - Performance of Individual Farms

	Total Area	Cropped Area (hectare)	(% of cropped/ total)	Profit (RsMn)
Suratgarh	6296	5694	90	32.70
Sardargarh	4548	4024	88	17.40
Jetsar	5394	2735	51	-1.54
Hisar	2710	2291	85	-3.68
Bahraich	3828	3136	82	-20.94
Raichur	2960	1564	53	-14.09
Aralam	3060	2541	83	-27.30
Total	**28796**	**21985**	**76**	-17.40

Source: CARE

On an average, the cropped area of SFCIL is about 76% of the total area. This is partly due to inadequate irrigation facilities and also the fact that farms usually do not get the authorised discharge of water from the irrigation source. Only about one-third of the total area of SFCIL is under irrigation.

The profit making state farms (in FY 2002) are located in Suratgarh and Sardargarh in Rajasthan. The farm at Aralam in Kerala is exclusively meant for the plantation crops like Cashewnut, Rubber, Black pepper etc.

Marketing Network

The main channels for disposal of various types of seeds produced are:

- State Departments of Agriculture (SDA);
- State Seed Corporations(SSCs);
- Authorised Seed Dealers;
- Sale counters;
- Minikit programme; and
- Mobile vans and kissan melas.

The sale of the seeds of SFCIL is skewed in favour of SDAs and SSCs with almost 60% of the total sales. The share of centrally sponsored programme like Minikit programme, where the money is collected from GoI, contributes almost 20% of the sale. The sale to the SDAs and SSCs is generally on credit basis. The marketing network of the company is not adequate and concentration risk is pretty high. To avoid over dependence on the State Governments, the company is trying to strengthen its dealer network where sale is on cash basis.

FINANCIAL PERFORMANCE

A summary of the operating performance of SFCIL is given in the following table :

Table 17 -Operating performance

(Rs.Mn.)

For the Year ended	31/03/02	31/03/01	CARG(#)
Net Sales & transfers	423	408	1%
Subsidies received	42	23	21%
Increase/(decrease) in stock	65	-14	—
Other Operational income	26	26	5%
Total Income	**557**	**443**	**5%**
Cost of production	505	556	3%
Gross Profit	67	-106	—

...Contd.

For the Year ended	31/03/02	31/03/01	CARG(#)
Profit After Tax	**-45**	**-203**	—
Dividend	0	0	—
Net Cash Accruals	-35	-248	—

(#) CARG – Growth per annum from FY 1996-97 to FY 2001-02

Source: CARE

The net sales of the company have been erratic over the years and it has only reported a marginal increase of 1% over the period 1997-02. The subsidies which SFCIL receives on account of Technology Mission on Oilseeds and Pulses (TMOP) have increased by 21%.The company has been making losses over the period mainly due to increase in the cost of production. The major component of the cost of production has been the employee expenses.

The precarious financial condition of SFCIL would be evident from the last five years' Balance Sheet and Profit & Loss account, as shown in the tables below:

Table 18 – Balance Sheet

(Rs. *Mn*)

As at	31/03/02	31/03/01	31/03/00	31/03/99	31/03/98
Fixed Assets					
Gross Block	742	718	689	674	654
less : Depreciation	266	246	240	225	207
Net Block	476	472	449	449	446
add : Capital WIP	2	3	7	6	7
Total Fixed Assets	**478**	**475**	**456**	**456**	**454**
Investments	2	2	2	2	2
Current assets					
Inventories	531	467	480	448	465
i. R M, stores & spares	26	27	26	29	35
ii. WIP	409	324	329	312	297
iii. Finished Goods	96	116	125	107	133
Sundry Debtors	188	147	97	92	93
Loans & advances	24	28	42	32	34

...Contd.

As at	31/03/02	31/03/01	31/03/00	31/03/99	31/03/98
Cash & Bank balances	260	86	20	11	7
Total Current Assets	**1004**	**728**	**638**	**583**	**599**
Current Liabilities					
Sundry Creditors	561	564	467	393	317
Other current liab./ provisions	173	177	95	82	36
Total Current Liabilities	**735**	**741**	**562**	**475**	**354**
Net Working Capital	269	-13	76	108	245
Total Assets	**749**	**463**	**534**	**566**	**701**
Term Liabilities					
Term loans from FIs/ Banks	221	196	194	184	169
Unsecured loans from GoI	521	228	78	34	24
Unsecured loans	163	126	109	99	98
Total Term Liabilities	**906**	**550**	**382**	**317**	**291**
Share Holders Funds	**-157**	**-87**	**153**	**249**	**409**
Represented by					
Equity Share Capital	242	242	242	242	242
Capital Reserves	362	353	357	358	359
Other reserves	-768	-712	-444	-306	-189
Unutilised Grant for VRS/VSS	9	32	0	0	0
less :Misc.Expenses not w/o	2	3	2	45	3
Tangible Networth	**-157**	**-87**	**153**	**249**	**409**
Total Liabilities	**749**	**463**	**534**	**566**	**701**

Source: CARE

Table 19 – Profit & Loss Account

(Rs.Mn)

For the Year ended	31/03/02	31/03/01	31/03/00	31/03/99	31/03/98
Net Sales & transfers	423	408	422	382	376
Subsidies received	42	23	12	14	20
Increase/(decrease) in stock	65	-14	35	-11	27

...Contd.

For the Year ended	31/03/02	31/03/01	31/03/00	31/03/99	31/03/98
Other Operational income	26	26	19	29	21
Total Income	**557**	**443**	**489**	**414**	**444**
Expenses					
RM, stores & other cons (net)	112	104	105	105	125
Salaries & Wages	336	398	349	304	284
Electricity & Water charges	8	10	10	8	7
Operating expenses	15	17	23	22	26
Admn, Selling & Dist. OH	29	29	27	29	29
Write off	4	9	4	8	4
Total Cost of Production	**505**	**566**	**518**	**477**	**476**
Add :Expenditure Capitalised	16	17	15	18	17
Gross Profit PBILDT	67	-106	-14	-45	-15
less : Depreciation	21	19	17	17	19
PBILT	46	-125	-31	-63	-33
less : Interest	92	79	63	55	42
Sub-total	-46	-204	-93	-117	-76
add : Other Income (non operational)	3	3	2	2	0
less : Deferred Exp written off	0	0	0	0	0
Profit Before Tax	**-43**	**-201**	**-91**	**-116**	**-76**
Tax	2	2	1	2	2
Profit After Tax	**-45**	**-203**	**-93**	**-118**	**-77**
Prior year adjustment	-11	-64	-46	0	-6
Adjusted PAT	**-56**	**-267**	**-138**	**-117**	**-84**
Gross Cash Accruals	-35	-248	-122	-100	-65
Net Cash Accruals	-35	-248	-122	-100	-65

Source: CARE

Cash Flows for the period FY 1996-97 to FY 2001-02 are given in the table below:

Table 20 - Past Cash Flows

(Rs Mn)

Year	31/03/02	31/03/01	31/03/00	31/03/99	31/03/98
Cash From Operations	-52	-27	-20	97	15
Purchase of Fixed Assets & CWIP	-22	-25	-16	-19	-26
Miscellaneous Expenditure	0	-1	43	-42	1
Cash Flow From Financing activities					
Changes in Loan	356	168	65	25	47
Change in capital reserves	9	-4	-1	-1	-1
Additional grant for VRS	-23	32			
Interest	-92	-79	-63	-55	-42
Net Cash flow From Financing activities	249	119	1	-31	3
Surplus	175	66	8	5	-6
Closing cash balance	260	86	20	11	7

Source: CARE

The operating cash flow has been negative for the last three years. The company has been borrowing to meet the operating expenses. The loan withdrawal for FY 2001-02 is given below:

Table 21 - Loan funds

(Rs.Mn.)

Year ended	31/03/02	31/03/01
Loans from Banks	221	196
Unsecured loans from GoI	521	228
Unsecured loans	163	126

Source: CARE

SFCIL is availing cash credit facility from commercial banks (Syndicate Bank and State Bank of Saurashtra) against hypothecation of finished and standing crops. The rate of interest charged by Syndicate Bank is 16% p.a. while that

of State Bank of Saurashtra is 13.5%. The company has been defaulting on interest payment due to cash losses. In FY 2001-02, the company returned term loan Rs. 43.1 mn taken from State Bank of Bikaner & Jaipur after receipt of loan from GoI.

Past Ratio analysis

Financial ratios for the past five years is shown below:

Table 22 - Past Financial ratios

For the year ended	31/03/02	31/03/01	31/03/00	31/03/99	31/03/98
Incr. In income from operations (%)	26	-9	18	-7	3
Average Collec. Period (days)	145	109	81	88	83
Average Inventory (days)	361	305	327	349	345
Average Creditors (days)	1832	1812	1497	1235	811
PBILDT/Total Income (%)	12	-24	-3	-11	-3
Operating Profit/Total Income (%)	8	-28	-6	-15	-8
Return On Investment (ROI) (%)	8	-25	-6	-10	-5
Return on Networth (RONW) (%)	-37	-613	-46	-36	-17

Source: CARE

SFCIL has been reporting operating losses for the past five years under review and the networth of the company has become negative. The average inventory days is almost a year. The receivable of the company has deteriorated over the period under review as the company has been selling on credit to the various State Government agencies. Almost 60% of the sales is made through this channel.

Statutory Liabilities

The statutory liabilities payable as on March 17, 2003 are shown in table no. 23 :

Table 23 - Statutory Liabilities

(Rs.Mn)

EPF	260
Gratuity	40
Total	**300**

Source: CARE

The company is not regular in statutory payments to Employees Provident Fund (EPF).

Contingent Liabilities

Contingent liabilities as on March 31, 2002 which have not been provided for by the company include the following:

- Lease payment for Central State Farm, Lodhowal & Hissar (Rs.75 Mn),
- Non-settlement of lease terms on CSF, Bahraich & Raebareli (Rs.39 Mn),
- Interest on EPF (Rs.51 Mn),
- Grant received under National Seed Project-III utilised for other purposes (Rs.63 Mn),
- Claim not acknowledged as debt (Rs 3.13 Mn).

Inter-Firm Comparison

As mentioned earlier, domestic seed industry comprises NSCL, SFCIL, 13 SSCs, around 200 organised seed companies and the unorganised sector. The table below shows a comparison of the performance of the various entities in the Indian seed industry on various parameters:

Table 24 - Comparison- Indian seed industry

Parameters	NSCL and SFCIL	SSCs*	Private companies
Objective/ Focus	SFCIL: To demonstrate the efficacy of large scale mechanised farming and produce seeds. NSCL: Production of breeder, foundation, certified and labeled seeds of a wide range and vegetable crops.	Production and supply of certified seed and within the state marketing of certified seed.	Focus is on commercial viability of operations.

...Contd.

Parameters	NSCL and SFCIL	SSCs*	Private companies
Production	SFCIL: Production at owned or leased farms from State Govts. Conversion rate in SFCIL is lower compared to the industry norm. NSCL: Contract farming, marginal Production at one leased farm (Operations of farm to be closed down in this FY).	Mostly contract farming. Players prefer to avoid the risk involved in farming.	Mostly contract farming. Players prefer to avoid the risk involved in farming.
Product profile	SFCIL: Concentration in 'High volume low value'products like wheat, paddy & pulses. Marginal presence in oilseeds & vegetables. Marginal production of hybrid variety seeds. NSCL: Diversified product profile. Share of 'high volume low value' is high around 70 percent. Marginal production of hybrid variety seeds.	Diversified product profile. Presence in Hybrid variety seeds. Product profile catering to local demand in respective states.	Product profile tilted in favour of 'low volume high value' crops. Dominant presence and focus on hybrid varieties of oilseeds, maize, cotton & vegetable crops. Majority of the companies operate with a regional focus.
Presence/ Marketing & Distrbn. network	Pan India presence. SFCIL: Heavy dependence on SDAs, SSCs (around 60%) and centrally sponsored programme (around 20%) for distribution of seeds. NSCL: Well developed nationwide marketing and distribution network.11 regional offices and 84 area offices. Sale through State Governments around 40%.	Respective state. Distributors & dealers.	Majority of the companies operate with a regional focus. However, bigger companies like MAHYCO have a considerable presence across majority of the states. Distributors & dealers.
Target market	All farmers, including marginal farmers	All farmers, including marginal farmers.	Farmers producing 'cash crop' like cotton, vegetables, fruits, oilseeds, etc.
R & D	Access to breeder, foundation seeds from ICAR, SAUs. No Research and Development efforts on their own.	Access to breeder, foundation seeds from ICAR, SAUs. No R&D effort on their own.	R&D effort concentrated to develop new hybrid varieties. In other cases, licensing arrangements worked out with MNCs to get access to parent seed.

...Contd.

Parameters	NSCL and SFCIL	SSCs*	Private companies
Employee cost as a % of sales.	SFCIL : 60 NSCL : 30	11.18	6.48^
PAT margin (%)	Both SFCIL and NSCL are making losses. However, in case of NSCL, the company has incurred losses for the last two years after satisfactory performance for the previous years.	1.55	8.40^
Sales Turnover (Rs.Mn)	SFCIL : 423 NSCL : 659	615	552#

**Analysis is done on the basis of latest available data on 5 SSCs i.e Andhra Pradesh State Seed Devp. Corp. Ltd., Gujarat State Seed. Corp. Ltd., Maharashtra State Seed. Corp. Ltd., Karnataka State Seed Corp. Ltd., and Haryana Seed Devp. Corp. Ltd.*

^ Analysis is done on the basis of latest available data of 9 private companies of the Indian seed industry. # Based on turnover from seeds business only, in case of diversified Agrochemical firms

Source: CARE.

As is evident from above, in case of SFCIL, the employee cost is substantially higher than that for the other players. Further, the product profile of SFCIL is geared towards 'high volume low value' products. In essence, a combination of both the factors has affected financial performance of SFCIL.

SWOT ANALYSIS

Strengths

- Fully owned by GoI and, being a public sector company, enjoys strong liaison with research institutions both at the Centre and State levels. It has access to breeder seeds from ICAR and State Agricultural Universities.

- It is an agency for implementation of centrally sponsored schemes like Mini kit programme.

- It also maintains a seed bank.
- SFCIL has 28,796 hectare of land at seven farms for experimentation and demonstration of new technology and varieties of seed.
- It is the only institution where test stock seed is produced on behalf of ICAR.
- An established name for production of certified seeds.
- It has a set of skilled and experienced workforce to educate the farmers about the techniques of optimal utilisation of potential of seeds.
- It produces different varieties of seeds and, therefore, can meet part of the unsatisfied need of the deficit states.

Weaknesses

- SFCIL assumes the farming risk because it undertakes the seed production at its own farms, both leased and purchased. The production on own farms is not economical. (Most seed companies rely on contract farming for seed productions.)
- It is an ageing organisation and is characterised by heavy concentration of employees in the lower categories. There is shortage of qualified managerial manpower at almost all the farms.
- Part of the area in various farms is not utilised and cultivated because of inadequate irrigation facilities.
- High employee cost affects the operating efficiency of the company.
- Company is making losses for the past five years and, as a result, it is not able to generate internal resources for investment in improvement of the infrastructure at farms.
- There is no continuity at the top and Board of Directors is not broad based.

- The distribution network of the company is also skewed in favour of the state owned agencies where there is a lag in payment.

- The market share of SFCIL is quite low in comparison to the total production of different categories of seeds in the country.

Opportunities

- Indian economy is agriculture based and seed is one of the basic and critical inputs in the whole agricultural process.

- There is demand for quality certified seeds which generally have better potential.

- Opportunity exists in strengthening its distribution network and increasing the number of dealers. Then the financial position of the company may improve.

- Company may give some part of its land on contract for production.

Threats

- National Seed policy 2002 would allow the private players access to breeder seeds. Therefore, there may be greater competition from private players.

- MNCs may enter the market with the opening of the seed sector and, as a result, the company may face greater competition.

- Some of the private players have international collaborations and, therefore, have access to latest technology.

- The private players may take the market share of SFCIL, as their financial position is stronger.

DISINVESTMENT CONSIDERATIONS

As mentioned earlier, the company has been making losses for the past five years. The main issues affecting SFCIL's performance are reiterated below:

- Unviable business model: SFCIL assumes the farming risk on itself and produces seeds at its own farms. Most of SFCIL's competitors rely on contract farming for production of seeds. Even NSCL relies on contract growers for seed production and has closed three of its farms. In case of SFCIL, the seeds not adhering to the accepted quality standards are sold as commercial grains which fetch lower price as compared to the seeds.

- Excess manpower: The total manpower of SFCIL as on March 20, 2002 was around 3000 employees, as shown below:

Table 25 - Employee Strength

Category	No of employees
A	49
B	59
C	587
D	918
Daily Paid Workers (DPWs)	748
Awardee plantation Workers	634
Total	2995

Source: CARE

The distribution of manpower is skewed with most of the employees concentrated at the bottom level, including about 750 daily paid workers who were regularised in 1985.

- One important operational issue concerning the company is the sub-optimal utilisation of land at its disposal due to inadequate irrigational facilities.

- The product profile of SFCIL is skewed towards "high volume low margin" products like the foodgrains.

- The distribution network of the company is largely dependent on state government entities with almost 60% of the sales routed through them. Since the financial health of most of these entities is not very good, the sales are on credit basis and consequently, there is a considerable lag in receiving payment

- The company has been making losses for the past five years and the entire net worth has been wiped out. SFCIL would have been referred to Board for Industrial and Financial Reconstruction, if it were a manufacturing company.

The options before the Government, therefore, are the following:

Option I: Disinvestment of its entire holding;

Option II: Merger with NSCL; and

Option III: Closure of the company.

Option I: Disinvestment of GoI's holding

Given its unviable business model, large labour force and precarious financial position, it is unlikely to be attractive to any investor. Further, the only asset it has is land and land ceiling laws may come in the way of private parties holding such huge tracts of agricultural land.

Option II: Merger with NSCL

SFCL and NSCL are two central public sector undertakings operating in the seed industry, with considerable overlapping of functions. However, the business model followed by SFCIL is the one that has been tried and discarded by NSCL. The staff composition of SFCIL is also not suited for NSCL's business model. Further, NSCL's financial position is also not healthy as to be able to absorb the liabilities of SFCIL. In view of the above, it will not be desirable to merge the two companies.

Option III: Closure of the company

As mentioned earlier, SFCIL was established to develop farms in various states to produce different types of seed of cereals, fibre crops, pulses, oilseeds etc.. Today, due to various schemes/ programmes organised by various state entities and others, farmers are aware of the benefit of technology. The ability of farmer to deploy appropriate technology is constrained by his resources as well as availability at the right time. The main objective for which the company was set up, therefore, no longer seems to be relevant. In seeds production, the sector being fully competitive, the role of SFCIL is at best marginal.

Further, there is considerable overlapping of functions performed by SFCIL and NSCL. NSCL's business model seems to be more in line with the industry practices. In view of this, it is difficult to justify the continued functioning of SFCIL with Government support. In view of the presence of NSCL and state level Seed Corporations, there may not be any impact on availability of seeds to farmers, even if SFCIL is closed/wound up.

RECOMMENDATIONS

Although closure/winding up of SFCIL appears to be the economically viable option, the Commission recommends that an attempt should be made to sell the entire equity of Government of India in SFCIL to a strategic buyer, together with rationalisation of manpower and financial restructuring, the details of which may be finalised in consultation with the prospective buyers. If the attempt does not succeed, closure/ winding up of SFCIL has to be pursued.

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