How is India Inc Doing?*

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Growth in India's non-financial corporate sector shrank in 2015-16, after three consecutive years of "steep moderation" according to the Reserve Bank of India (RBI). In its annual study of the Performance of the Corporate Business Sector, the RBI attributes this downturn to "lacklustre demand", echoing the sentiments of many businessmen who have been unwilling to strongly articulate this perception in the face of the hype on growth fed by schemes like "Make in India" and "Start-up India". But, actual trends in the economy do not seem to provide much ground for satisfaction, let alone celebration.

One factor that tends to discount this more realistic view of Indian economic performance are the trends reflected in the GDP estimates. According to those estimates, in a world of slow growth, India stands out as a lead performer. That assessment has, however, been contested. GDP estimates, now computed with a new methodology adopted for the revised series with 2011-12 as base, have been the target of widespread scepticism both within and outside government. But, for those ignoring such scepticism and backing the GDP numbers, the message on growth has been encouraging. To start with, despite some recent signs of flagging growth, India is the fastest growing country in the world, when growth is measured using those numbers. Second, dynamism in services is still driving India's economy, in what structurally is proving to be an unusual development trajectory, with premature (relative to per capita GDP) diversification into services. Third, and perhaps most importantly, there are signs that after a long period, growth is turning away from being solely services-focused, with signs of a revival of manufacturing. Manufacturing GDP growth, which fell from 6 per cent in 2012-13, to 5.5-5.6 per cent during the next two years, is estimated to have risen to a creditable 9.3 per cent in 2015-16.

Two issues still bothered those unconvinced by the story of dynamism. First, was some concern about the composition of services growth, which accounted for two-thirds of the increment in GDP over a long period. Any attempt to breakdown services GDP into that contributed by the modern services sectors (offering either marketed or non-marketed and publicly provided services) and the more backward services that are more primitively organised and characterised by extremely low productivity, shows that the former can at best account for 50 per cent of the output of services.That makes a large part of the services sector a sink for the unemployed unable to find livelihoods in the commodity producing sectors, rather than a site for institutions exploiting the benefits of India's skilled but relatively cheap labour.

The second issue was that one other available indicator of industrial growth, namely the Index of Industrial Production, not only did not support the claims of high manufacturing growth, but seemed to point to a significant deceleration of growth in recent months. Combined with news from those with ears to the ground that demand was slack and capacity utilisation low in India, this was a dampener on claims that India was finally coming into its own in the global manufacturing arena. The response of the 'celebratory brigade' has been that the company accounts data from the Ministry of Corporate Affairs used in the new series on national income is more inclusive of all manufacturing related activities than the Index of Industrial

Production, making the value added figures from the National Accounts Statistics a more reliable indicator of industrial performance. On those grounds the depressing news reflected in the IIP figures that have been routinely put out has been ignored.

The RBI study on corporate sector performance may, therefore, be a much needed corrective. It corroborates the view that services growth, especially that of IT services has been reasonable even if falling, but points to a significant deceleration of manufacturing sales in 2014-15 and a contraction in 2015-16. However, the study points to some unusual trends that may partly explain the discrepancy between sales growth and GDP growth. Essentially, the evidence presented seems to suggest that the decline in the global prices of commodities, which reduced raw material and fuel costs for companies, was a major influence on corporate performance. The fall partly explains the decline in the value of sales. But since the value of production fell by only by 2.4 per cent, whereas cost or expenditures incurred by these firms fell by 4.4 per cent, there has been an increase in both profits and gross value added (or the excess of the value of production relative to the expenditure on raw materials). As a result, there has been a sharp divergence between the change in the value of sales (-1.6 per cent) and the change in gross value added (9.7 per cent in 2015-16). It could be argued that, since GDP measures value added, this should also result in a divergence between the changes in value of sales and production and the changes in GDP.

Associated with these trends is an increase in the profits earned by the companies sampled. Net profits rose by 9.3 per cent in 2015-16 (as compared with a fall of 0.7 per cent in the previous year), and profitability as measured by the operating and net profit margins improved. (The profitability ratios and growth figures relate to a slightly different sample of companies in the two years 2014-15 and 2015-16, with 2,925 firms covered in the first and 2,932 in the second, respectively).

The one striking conclusion that emerges from these figures is that the reason manufacturing GDP figures may seem inflated relative to trends in sales and value of production is that prices of final products do not move downwards in tandem with costs. In fact, given the widespread perception of slack demand in many industries, even the contraction in sales value is possibly the result of a combination of a reduction in sales volume and a downward adjustment of prices to transfer a part of the benefits of cost reduction to the buyer. This unwillingness of firms to pass on the full ‘benefits’ of a cost reduction possibly also increases the contraction of sales as a result of any adverse, exogenous influences on the level of demand. The scenario seems to be one where the manufacturing sector, when considered as a whole, is settling for higher profits even at the expense of lower sales volumes.

It should be expected that not all firms would be in a position to not just protect but also raise profits by not transmitting the fall in costs to the buyer. This seems to come through in the RBI data as well. While the larger firms in the sample record significant profit increases when sales contracted, medium sized companies showed lower increases in operating margins and a fall in net profits, and small companies recorded much larger decline in sales and significant and substantial declines in operating and net profit margins respectively.

However, the aggregate data conceals substantial differences in trends in sales and profits across industries. Two industries that were hit harder than the others seem to be the Cement and Iron and Steel industries. In Cement while sales contracted there was no sign of an improvement in profits and profit margins as a result of cost decline. In the case of Iron and Steel, contraction in output volumes and prices led to a sales decline of 10.2 per cent, and the operating profit margin also fell to a seven-year low level of 11.0 per cent.

On the other hand, the industry that was affected most by the global commodity price decline was Petroleum and Petroleum Products, which epitomised the pattern where cost declines resulted in contraction of sales value but shored up profits, since expenditure fell more than the value of production did.

These features of corporate performance reflected in the 2015-16 data point to certain tentative conclusions. The first is that a combination of depressed commodity prices and oligopolistic pricing seems to explain the divergence between the figure on nominal sales and value of production growth in the registered manufacturing sector, on the one hand, and the growth of gross value added in and GDP contributed by that sector. Second, the ability to shore up profits in times when sales values are contracting seems to restricted to larger firms in the sector, so that associated with the sales and GDP growth divergence is an increased differential in performance between the large and small firms in the corporate sector. Third, there are some industries that are doing particularly badly because of global and domestic demand trends, the impact of which on aggregate corporate performance is concealed by trends in sectors such as petroleum and services. In sum, arriving at judgements on manufacturing dynamism based only on the GDP figures may not warranted.

These trends have to be seen in light of the fact that the commodity price decline seems to have bottomed out and prices are ruling higher than their previous lows and are likely to increase. This would make it difficult for even the big firms to garner larger profit margins despite lower sales. What needs to be seen is whether that would close the gap between the figures on growth as indicated by the financial accounts of firms and the GDP numbers.

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