SHANTHI GEARS LIMITED

Analyst Contacts

Subrata Ray
subrata@icraindia.com
+91-22-30470027

Srinivasan V
vsrinivasan@icraindia.com
+91-44-45964306

Relationship Contact

Jayanta Chatterjee
jayantac@icraindia.com
+91-9845022459

Ratings

ICRA has assigned long-term rating of [ICRA]AA- (pronounced ICRA double A minus) to the Rs.30.00 crore[1] fund based facility of Shanthi Gears Limited ("SGL" / "the Company")[2]. ICRA has long-term rating of [ICRA]AA- (pronounced ICRA double A minus) outstanding on the USD 2.00 million term loan facilities, the Rs.30.00 crore fund based facilities and the Rs.5.00 crore non-fund based facilities of SGL. ICRA also has short-term rating of [ICRA]A1+ (pronounced ICRA A one plus) outstanding on the Rs.2.00 crore fund based (sub-limit) facilities and the Rs.15.00 crore non-fund based facilities of SGL. The outlook on the long-term rating is stable. Though the term loan facilities of the Company are denominated in foreign currency, ICRA's rating for the same is on the national scale as distinct from an international rating scale.

Key Financial Indicators

	31-Mar-09	31-Mar-10	31-Mar-11
Operating Income (OI)	252.5	121.4	160.4
Growth in OI	3.4%	-51.9%	32.1%
OPBDITA	108.3	48.5	67.3
OPBDITA / OI	42.9%	40.0%	42.0%
Adjusted Profit After Tax (APAT)	44.4	15.9	29.0
APAT / OI	17.6%	13.1%	18.1%
Return on Capital Employed [viz., PBIT / Average (Total Debt + TNW + DTL – CWIP)]	28.6%	10.4%	18.3%
Total Debt	89.3	25.6	9.8
Tangible Net Worth (TNW)	202.3	210.8	229.2
Total Debt / TNW (times)	0.4	0.1	0.0
Total Debt / OPBDITA (times)	0.8	0.5	0.1
Net Cash Accruals / Total Debt	65.8%	137.3%	475.0%
OPBDITA / Interest and finance charges (times)	8.9	11.3	52.7
Debtor (days)	47	42	54
Creditor (days)	33	50	40
Inventory (days)	167	255	187
Net Working Capital / OI	28.3%	42.5%	34.1%

Note: Amount in Rs. Crore; OPBDITA: Operating Profit before Depreciation, Interest, Tax and Amortisation; PBIT: Profit before Interest and Tax; DTL: Deferred Tax Liability; CWIP: Capital Work-in-Progress; Source: Annual reports

Website:
www.icra.in

[1] *100 lakh = 1 crore = 10 million*
[2] *For complete rating scale and definitions, please refer ICRA's website (www.icra.in) or other ICRA Rating Publications*

Credit Strengths

- Comfortable financial profile characterised by healthy margins / liquidity and conservative capital structure;
- Promoter's experience and established presence of SGL in the industry for over four decades;
- Strong and diversified customer base mitigate business concentration.

Credit Challenges

- Closely associated to the domestic economic cycle; slowdown in industrial expansion expected to adversely impact revenue growth and profitability in the near-to-medium term;
- Moderate scale of operations in an industry characterized by growing competition expected to moderate margins;
- High inventory levels accentuate vulnerability of earnings to sharp decline in steel prices.

Rationale

The ratings reflect the comfortable financial profile of SGL as characterised by healthy margins, strong cash flows and conservative capital structure. Closely knit to the domestic economic cycle, slowdown in industrial expansion is expected to adversely impact revenue growth and profitability. However, the established presence of SGL in the industry for over four decades and its diversified client base / customer segments (which mitigate business concentration) are expected to insulate the impact to an extent. SGL's scale of operations is modest in an industry which is characterized by growing competition. The ratings also consider SGL's high inventory levels, which accentuates the vulnerability of its earnings to any sharp decline in steel prices.

Company Profile

Commencing business as a gear manufacturer for the textile industry in 1969, SGL diversified into the manufacture of standard (off-the-shelf) and customised (non-standard) gears over the years. SGL caters to various industries including steel, compressors, power, earthmoving equipment, cement and textiles. SGL's product portfolio encompasses a range of customised gear boxes, loose gears, worm gear boxes and helical gear boxes. The Company has manufacturing facilities (including a foundry) located in and around Coimbatore, Tamil Nadu.

SGL was promoted by a first generation entrepreneur, Mr. P Subramanian, who is currently the Chairman and Managing Director. As on September 30, 2011, the promoters held 44.1 per cent stake in the Company. SGL is listed on the National Stock Exchange and the Bombay Stock Exchange.

Business Risk Profile

Shift in focus towards manufacture of lower-margin products, to enhance revenue base, expected to moderate margins

Over the last two fiscals, SGL's management was focusing on manufacture of high-margin products (which are predominantly the customised products) which led to significant scale-down in revenues. However, SGL has revised its focus to enhance the revenue base over the next 2-3 years through manufacture of even low-margin products. The customised products generally entail higher operating margin owing to the level of complexity involved in its manufacture while the standard products would typically net relatively lower margin on account of competition. In view of the shift in focus, the share of revenues from standard products is expected to increase going forward and contribute to the overall growth in revenues while the operating margins are expected to moderate.

Table 1: Contribution to revenues by product segments

Fiscal	2008-09		2009-10		2010-11	
No. of months	12		12		12	
	Amount	Share	Amount	Share	Amount	Share
Non-standard (customised)	170.2	67.6%	89.0	73.4%	105.6	65.9%
Standard	81.5	32.4%	32.3	26.6%	54.8	34.1%
Total	*251.7*	*100.0%*	*121.4*	*100.0%*	*160.4*	*100.0%*

Source: Company; Note: Amount in Rs.crore

Moderate scale of operations in an industry characterized by growing competition expected to moderate margins; however, established presence of SGL expected to insulate the impact to an extent

SGL's scale of operations is modest in the industrial gears market, which is characterised by growing competition from both the organised and unorganised players. While the unorganised players largely focus on the standard products segment and the replacement markets, SGL primarily competes with the organised players since it largely focuses on the customised product segment and caters to large corporates.

There is growing competition in the industrial gears segment, especially from the larger players and in the standard products segment. International players are expected to foray into this segment on account of closure of units in the West (owing to high labour costs and pollution-related issues). These players are, however, largely expected to cater to the export markets, besides the standard gears segment of the domestic market. While such competition is expected to moderate the margins, SGL's established presence in the industrial gears market for over four decades and its focus on the customised products segment is expected to insulate the impact to an extent.

Foray into manufacture of compressors likely from H2, 2012-13; modest operating margins from the proposed business likely to moderate overall margins

The management intends to forward integrate into manufacture of compressors (in which industrial gears would form a major component). While the Company has the necessary infrastructure to manufacture these products, its facilities are also fully integrated (i.e., it has casting unit, forging unit, fabrication unit and heat-treatment plant which are required for the proposed business). Since gears and gear-boxes are manufactured in-house, the management intends to outsource manufacture of the remaining components to units located in and around Coimbatore (which is an industrial hub). Such outsourcing entails relatively lower investment in plant and machinery. While the forward integration is expected to diversify SGL's business to an extent, it would also result in the Company competing with some of its existing customers which may have an adverse impact on the entity's business growth in the medium term.

The market for compressors is dominated by larger players. SGL targets to capture a small share of the market in the initial stages through penetrative pricing strategy. Consequently, although manufacture of compressors requires high technical expertise, the business is expected to deliver modest operating margins. Therefore, over the medium term, the overall margins may moderate to an extent. The management anticipates commencement of the business by the second half of fiscal 2012-13. Timely commencement of the proposed business would contribute to revenue growth and profitability.

Customer segments remain well-diversified; however, the operations closely related to the domestic economic cycle

Table2: Contribution to revenues by customer segments

Fiscal	2008-09		2009-10		2010-11	
No. of months	12		12		12	
	Amount	Share	Amount	Share	Amount	Share
General Engineering	85.6	33.9%	38.9	32.1%	49.6	30.9%
Textiles (including machinery)	12.4	4.9%	11.2	9.3%	16.0	9.9%
Steel	29.3	11.6%	11.6	9.5%	15.5	9.7%
Windmills	9.4	3.7%	7.2	5.9%	9.9	6.2%
Conveyor / material handling	13.4	5.3%	2.5	2.1%	6.8	4.2%
Earthmoving	13.5	5.4%	4.5	3.7%	5.7	3.6%
Compressors	13.4	5.3%	10.8	8.9%	~1.0	0.6%
Others[1]	75.5	29.9%	34.7	28.6%	55.9	34.9%
Total	*252.5*	*100.0%*	*121.4*	*100.0%*	*160.4*	*100.0%*

Source: Company; Note: Amounts in Rs.crore

The Company's customer segments remain diversified across a wide range of industries, including textiles, steel, windmill, conveyor / material handling, earthmoving and compressors. The general engineering segment remains the largest sales contributor. While the overall revenue base witnessed healthy growth, revenues from the compressor segment declined sharply during 2010-11; this is primarily attributed to the Company's proposed entry into the compressor segment which would essentially result in the Company competing with its customers in that segment.

[1] *Includes industries such as sugar, cement, machine tools, paper, rubber, mining, construction, chemicals and plastics*

SGL caters to both OEM as well as replacement markets, thereby insulating it from the cyclicality in the engineering industry to an extent. OEMs prefer associating with the organised gear manufacturers' for supplies due to factors like quality, rapid ability to scale up and timely delivery. However, the Company remains closely associated to the domestic economic cycle by catering to various industry segments. Therefore, slowdown in industrial expansion is expected to adversely impact revenue growth and profitability in the near-to-medium term. The Company foresees its entry into the compressor segment as a diversification measure to insulate the impact of economic slowdown.

The management foresees healthy orders from the power sector (including wind energy sector), since gear boxes account for about 10 per cent of the project costs in such plants. However, this segment entails orders in large volumes where competitive pricing is critical. SGL, which presently caters to the smaller-capacity windmill segment[3], is eyeing entry into the higher-capacity windmill segment. The management intends to cap the exposure to the wind energy sector at 10 per cent of revenues, to avoid concentration risks.

SGL's revenues from key clientele remain well-diversified, with top 10 customers contributing to only 28.3 per cent of revenues during the last fiscal. The Company caters to established players in some of the aforementioned business segments.

Table 3: Customer concentration

Fiscal	2008-09	2009-10	2010-11
No. of months	12	12	12
Contribution to sales from:			
▪ largest customer	3.8%	8.4%	6.8%
▪ top five customers	14.2%	21.4%	18.3%
▪ top ten customers	23.9%	30.3%	28.3%

Source: Company and ICRA estimates

Domestic market remains the growth driver

Sales to the domestic market continue to dominate SGL's revenues. Going forward too, ICRA expects SGL to continue to focus on the domestic market for growth, since it offers opportunities to expand in both the industrial gear as well as the compressor segments.

Table 4: Geographic concentration

Fiscal	2008-09		2009-10		2010-11	
No. of months	12		12		12	
	Amount	Share	Amount	Share	Amount	Share
Domestic sales	219.8	87.0%	112.2	92.4%	150.0	93.2%
Export sales	32.7	13.0%	9.2	7.6%	10.4	6.8%
Total	*252.5*	*100.0%*	*121.4*	*100.0%*	*160.4*	*100.0%*

Source: Company and ICRA estimates; Note: Amounts in Rs.crore

Financial Risk Profile

Revenues and profitability rebound; margins remain robust

SGL's operating income rebounded during 2010-11 on the back of sustained marketing efforts with a view to enhance its revenue base. Growth was witnessed across all business segments (barring the compressors segment). The operating margin continues to remain robust, with customised products continuing to garner major share of the revenues. The growth in revenues and operating margin led to better absorption of fixed costs and led to strong growth in the net margin and cash accruals. Also, interest costs reduced during 2010-11 due to repayment of long-term debt and minimal utilisation of working capital borrowings. The strong growth in operating profits during 2010-11 led to growth in profitability.

[3] *Of less than 250 KW capacity*

While the revenues continued to increase on the back of healthy orders, the operating margin declined during the half-year ended September 30, 2011. The fall in operating margins is primarily attributed to increases in raw material costs, employee costs (owing to induction of several top management personnel) and also to the variation in margins on customised products which dominates the product portfolio. Despite such decline, the margins remain robust.

Table 5: Recent results

Half-year ended September 30,	2010	2011
Operating Income (OI)	70.2	84.0
Growth in OI		19.7%
OPBDITA	32.2	34.3
OPBDITA / OI	45.8%	40.8%
APAT	12.3	14.1
APAT / OI	17.6%	16.8%

Source: Press release and ICRA estimates; Note: Amounts in Rs.crore

Margins expected to moderate on shift in product portfolio and increasing competition; however, the overall credit profile expected to remain comfortable

The Company's current order book value is Rs.65 crore, to be executed over 3-4 months. While the revenue growth is expected to be healthy in the current fiscal, slowdown in industrial expansion is expected to adversely impact revenue growth and profitability in the near-to-medium term. Similarly, the margins are expected to moderate to an extent in the near term due to SGL's focus on low-margin standard products and higher employee costs (due to induction of several top management personnel). Margins in the medium term are also expected to moderate due to increasing competition and SGL's entry into manufacture of compressors at competitive price points. Despite this, SGL's credit profile is expected to remain comfortable on the back of strong cash accruals (from production of customised products and increased income from investments), adequate liquidity and minimal debt levels.

Strong capital structure and liquidity; modest capital expenditure plans

SGL's capital structure remains strong with minimal debt levels. The cash accruals during the last fiscal were utilised towards repayment of debt. Although the working capital intensity declined during 2010-11, the Company's working capital requirements increased marginally due to the enhanced scale of operations. The Company's liquidity position is strong, with healthy cash balances.

The capital expenditure incurred by SGL during 2010-11 and the current fiscal largely pertains to setting up of the facilities for manufacturing compressors. Therefore, timely commencement of the new business will contribute towards improvement in profitability. SGL estimates capital expenditure of Rs.5 crore towards setting up of R&D facilities during 2011-12 and Rs.5-10 crore towards setting up facilities for manufacture of compressors during 2012-13, apart from normal capital expenditure of about Rs.5 crore per annum. SGL also has plans to expand its capacities to manufacture larger gear boxes; however, such plans are not crystallised as on date.

Working capital characterised by high inventory levels

While the Company's inventory levels declined during March 2011, they increased during the current fiscal since the management decided to procure increased quantities of raw materials (steel) instead of holding cash. According to the management, higher raw material inventory levels in the backdrop of a portfolio dominated by customised products offer advantages of lower lead time for procurement of raw materials, timely delivery, optimisation of scrap and also better bargaining power with suppliers (due to procurement in bulk). These advantages, in turn, lead to better pricing and margins for the finished products. Therefore, the Company negotiates with suppliers and enjoys discount on bulk purchase, which contributes to the healthy operating margins.

While any sharp decline in steel prices may impact earnings considering the high inventory levels, the Company's balance sheet and cash accruals remain strong enough to absorb some write-offs in such cases without impacting coverage indicators significantly.

December 2011

Annexure:

Instrument	Amounts	Rating action
Fund based facilities	Enhanced from Rs.30.00 crore to Rs.60.00 crore	[ICRA]AA- (Stable) assigned

ICRA Limited

An Associate of Moody's Investors Service

CORPORATE OFFICE
Building No. 8, 2nd Floor, Tower A; DLF Cyber City, Phase II; Gurgaon 122 002
Tel: +91 124 4545300; Fax: +91 124 4545350
Email: info@icraindia.com, Website: www.icra.in

REGISTERED OFFICE
1105, Kailash Building, 11th Floor; 26 Kasturba Gandhi Marg; New Delhi 110001
Tel: +91 11 23357940-50; Fax: +91 11 23357014

Branches: **Mumbai**: Tel.: + (91 22) 24331046/53/62/74/86/87, Fax: + (91 22) 2433 1390 **Chennai**: Tel + (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294, Fax + (91 44) 2434 3663 **Kolkata**: Tel + (91 33) 2287 8839 /2287 6617/ 2283 1411/ 2280 0008, Fax + (91 33) 2287 0728 **Bangalore**: Tel + (91 80) 2559 7401/4049 Fax + (91 80) 559 4065 **Ahmedabad**: Tel + (91 79) 2658 4924/5049/2008, Fax + (91 79) 2658 4924 **Hyderabad**: Tel +(91 40) 2373 5061/7251, Fax + (91 40) 2373 5152 **Pune**: Tel + (91 20) 2552 0194/95/96, Fax + (91 20) 553 9231