

Virgo Engineers Limited

CRISIL IPO Grade 4/5 (Above average)

September 30, 2010

Grading summary

CRISIL has assigned a CRISIL IPO grade of '4/5' (pronounced "four on five") to the proposed IPO of Virgo Engineers Ltd (VEL). This grade indicates that the fundamentals of the IPO are above average relative to the other listed equity securities in India. However, this grade is not an opinion on whether the issue price is appropriate in relation to the issue fundamentals. The grade is not a recommendation to buy, sell or hold the graded instrument, its future market price or suitability for a particular investor.

The assigned grade reflects VEL's strong position in the ball valve manufacturing business. It also reflects favourable business prospects arising from the strong demand scenario expected on account of increase in investments in oil and gas industry over the next three-five years. Since the company is on the approved manufacturer's list (AML) of six of the top ten global oil and gas players, it is well poised to benefit from the large investments planned in this sector. The grade is supported by the high level of customer loyalty enjoyed by VEL; its repeat business accounts for over 90% of revenues. Going forward, growth is expected to be driven by geographic and product diversification.

The grade also takes into account the promoters' business acumen. They have successfully captured opportunities and translated them into strong growth for the company.

However, the grade is constrained by the competitive nature of the valve industry. Though VEL has established a client base that comprises leading oil and gas players, its global market share is less than 2% and it faces stiff competition from other global players.

VEL's revenues have grown at a healthy CAGR of nearly 29.8% between FY07 and FY10 to Rs 6.7 bn. It posted PAT of Rs 855 mn in FY10. EBITDA and PAT margins during the same period were 21.1% and 12.6% respectively. EPS was Rs 20.3 (adjusted for 1:1 bonus issue) while RoE was 27%.

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About the company

Virgo Engineers Ltd (VEL) is one of the leading manufacturers of manual and automated ball valves globally. These are flow control valves used to regulate the volume or pressure of a fluid (liquid or gas) and are largely used in the oil and gas, infrastructure and certain process industries. VEL has manufacturing units in India, Pune and Coimbatore (ball valves, triple offset valves, gate valves, and check valves), the USA (severe service application valves) and Europe (large size ball valves and steam products). In FY10, the oil and gas sector accounted for 95.43% of revenues, while the infrastructure sector contributed 2.45% and process industries 2.12%.

From a predominantly domestic player, VEL has gradually spread across the USA, Europe, Far East and Middle East. The USA and Europe account for nearly 40% of the company's sales. India accounts for around 25-30%, while Middle East and Far East account for the balance.

The company has expanded its product portfolio by acquiring RIFOX, a steam products manufacturing company, and launched a new improved product line - triple offset valves. The latest products will help the company serve industries other than oil and gas and infrastructure, such as power, mining and paper. The company is also looking at the inorganic route (acquisitions) for expansion.

VEL's business direction and vision is governed by its promoter, Mr Mahesh Desai, who is supported by his brother Mr Jagdish Desai. They are backed by an experienced second line of management.

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Issue details

No. of shares being offered	13.4 mn; 10.7 mn is fresh issue and 2.7 mn is offer for sale
As per cent of post issue equity	25.4%
Amount proposed to be raised	Rs 3,407 mn (approximately)
Objects of the issue	Fund capital expenditure at existing manufacturing facilities and subsidiaries
	Capital expenditure for information technology infrastructure
	Repayment of a portion of the debt
Price band	Not available at the time of grading
Lead managers	IDFC Capital Ltd and Edelweiss Capital Ltd

Detailed Grading Rationale

A. Business Prospects

- ***Favourable relationship with key clients***

VEL's order book is Rs 4.3 bn as of June 2010; repeat customers contribute a little over 90% of this. The company is on the AML of six of the top ten global oil and gas players. VEL is on the AML of Exxon Mobil, Shell, Chevron and Petrobras (Brazil) to name a few. Its Indian customers include Reliance, GSPL and Cairn India. Typically, it takes four-five years for a company to receive approval from oil and gas players. The AML list of major oil and gas companies is very restrictive in nature with not more than six to 15 approved suppliers on it. Being an approved manufacturer does not necessarily result in confirmed sales but it does improve the chances of receiving future business either from the oil and gas company directly or through the engineering companies implementing projects for the oil and gas companies. Thus, the status of an approved supplier reflects good execution capabilities and quality standards adhered to by VEL.

- ***Promoters have capitalised on growth opportunities***

Initially the company used to trade in flow control products. As a part of backward integration, it started manufacturing ball valves. The promoters' decision to backward integrate operations and spread across geographies translated into significant growth in the past. Further, the strategy to establish presence in a relatively tough-to-penetrate USA valve market has provided VEL a competitive edge vis-à-vis other valve players who have been relatively unsuccessful so far. Till date, the management has been able to identify growth prospects and have accordingly scaled up operations. Going forward, the growth is expected to be driven by geographic and product diversification. The planned strategies are:

- ***Expanding product portfolio:*** Over 90% of the company's turnover comes from ball valves, leading to the risk of dependence on a single product. In addition, the company has increased focus on project-based sales, which are inherently more volatile. To diversify revenues, the company has recently increased its product offerings. In FY09, the company acquired a steam product manufacturing company called Rifox Hans Richter GmbH (RIFOX), Germany. Steam traps are automatic valves that find applications in various process industries such as chemicals, dairy, fertilisers, petrochemicals, pharmaceuticals and refineries. In FY10, the company launched a new technologically advanced product - triple offset valve.
- ***Geographic expansion:*** The company has set up manufacturing facilities and sales offices in the USA, Europe, Far East and Middle East. The company is now targeting emerging economies in Asia, especially China. VEL has recently set up sales office in Korea to tap the growing opportunities there. Asia is one of the top five consumers of ball valves and is expected to grow at a CAGR of 2% over the next three years. South and Central America, and Western Europe are expected to grow at a CAGR of 4% over the next three years. The move is primarily to de-risk geographical revenues and tap growth opportunities.

- ***Currency risk partially offset by natural hedge***

Out of VEL's total revenues, 70-75% is in foreign currency. In FY10, the USA contributed 31.5% to total revenues, Europe 15%, the Middle East 18.7% and Far East 9%. Out of the total foreign exchange exposure, 50% is naturally hedged due to costs incurred in foreign currency as the company has manufacturing facilities in the USA and Europe. The balance 50% of the foreign exchange exposure is still subject to the foreign exchange volatility and to hedge this risk, VEL enters into forex forward contracts.

- ***Cost competitiveness to benefit VEL, but competition to intensify in the long run***

The company has benefited by being a low-cost supplier to the global clients on account of lower overheads and efficient sourcing of castings from vendors. The company enjoyed about 20-25% EBITDA margins during the FY07-FY10 period due to a favourable global demand scenario and due to the cost arbitrage advantage enjoyed by it. Going forward, competition from low-cost Chinese products is expected to increase coupled with threat from new entrants including MNCs. This is likely to impact VEL's competitive position.

- ***Industry witnessed slowdown in 2009, but demand is reviving***

The oil and gas industry is the largest consumer of ball valves, accounting for 30% of the total demand. The valve industry has a lag effect of capex plans lined up by oil and gas industries. The economic slowdown has led to a deferral in the capex plans of the oil and gas industry and the same has impacted the valve industry. However, investments in the oil and gas industry have once again picked up pace. This is primarily because of stabilisation of oil prices and an improvement in the economy. Also, considering the dependence on fuel for industrial as well as consumer needs, investments in the oil and gas sector will be ongoing.

Worldwide ball valve market (US\$ mn)

Particulars	2005	2006	2007	2008	2009	2010	2011	2012
Total	9,159	9,554	9,961	10,389	10,465	10,708	11,087	11,507
Growth		4.3%	4.3%	4.3%	0.7%	2.3%	3.5%	3.8%

Source: DRHP

- ***VEL's capex plans will help feed the rising demand as well as provide tax benefits***

One of VEL's manufacturing facilities is a 100% export oriented unit (EOU) that primarily undertakes large project jobs for ball valves (manual and automated). On account of the EOU status, the company enjoys tax benefits, which are due to expire in 2011. However, the company has planned to utilise the IPO proceeds to set up a manufacturing facility in a special economic zone in Chennai, which would enjoy tax benefits. The company expects the Chennai plant to commence operations at the beginning of CY11. Any delay with respect to the commencement of Chennai operations would result in company paying higher taxes.

- ***Sound corporate governance structure***

VEL's directors have shown the ability and willingness to exercise management oversight. The independent directors also bring in professional expertise from their respective fields, which helps the company in the decision-making process. The board of directors is involved in the functioning of the company and all critical business decisions are discussed and debated by the board.

B. Financial Performance

The company's revenues grew at a CAGR of 29.8% between FY07 and FY10. However, revenues declined by 2% year-on-year in FY10. VEL's revenue growth is linked to the growth of end-user industries such as oil and gas. However, there is a lag effect. The economic slowdown witnessed in 2009 led to a slowdown in the capex plans of the oil and gas industry and the same affected VEL's performance in FY10.

Historically VEL's EBITDA margins have hovered in the range of 23% to 25% during FY07-FY09. However, in FY10, VEL's EBITDA margins declined by 180 bps to 21.1% due to lower growth in revenues and the acquisition of RIFOX. Formation of EVS Inc. (a subsidiary in the USA) and recruitment of additional employees in overseas locations also exerted pressure on margins. Economies of scale and restructuring of RIFOX will likely enable the company to improve margins going ahead.

Net margins also declined in FY10 in line with EBITDA margins. However, historically the company has maintained net margins in the range of 15% to 18%. Similarly, lower profitability impacted RoE, which declined from 38.1% to 26.8%. Revival in oil and gas capex cycle is expected to benefit valve manufacturers such as VEL, who enjoy AML status.

The company had issued bonus shares in the ratio of 1:1 during 1QFY11. With that the equity shares of the company stand at 42 mn.

Financial performance snapshot

Particulars	Unit	FY07	FY08	FY09	FY10
Operating income	Rs mn	3,079	5,141	6,879	6,733
Operating margins	%	24.9	25.0	22.9	21.1
Net profits	Rs mn	505	906	1,009	855
Net margins	%	16.3	17.5	14.6	12.6
ROCE	%	61.9	51.9	38.1	26.8
RONW	%	67.4	63.0	43.5	27.3
Diluted EPS#	Rs	24.0	21.5	23.9	20.3
No. of equity shares#	mn	21.1	42.2	42.2	42.2
Net worth	Rs mn	1,066	1,811	2,830	3,438
Book value (FV Rs 10)#	Rs	50.6	43.0	67.1	81.5
Debt-equity ratio	x	0.4	0.6	0.5	0.3

* Note1: Numbers have been re-classified as per CRISIL standards

Adjusted for bonus shares issued in the ratio of 1:1 pre-IPO (May 2010).

Source: DRHP

C. Management Capabilities and Corporate Governance

Mr Mahesh Desai and Mr V. Balasubramanian (Mani), the promoters, have been instrumental in setting up and growing the business of Virgo Engineers Ltd. Mr Jagdish Desai, Mr Mahesh Desai's brother, has also significantly contributed towards the growth of the company by expanding business across geographies. The business model chosen by the company to set up a stock and sell unit, especially in the USA, instead of approaching distributors has given it an edge over competitors. It enabled the company create a strong foothold in the USA. Mr V. Balasubramanian has retired but he continues to be a board member and actively takes interest in business. VEL is a professionally-managed firm supported by a strong and experienced second line of management.

The company's board consists of 12 members, of whom six are independent directors. The independent directors bring in professional expertise from their respective fields, which helps the company in the decision-making process. The directors of the company have shown ability and willingness to exercise management oversight in the past. The board of directors is involved in the functioning of the company and all critical business decisions are discussed and debated by the board.

Annexure I Business Profile

VEL is one of the leading manufacturers of manual and automated ball valves globally. VEL was incorporated as Virgo Engineers Private Limited in June 1987 and was changed to a public limited company in February 1995. Till 1989, the company traded in flow control products. In 1990, the company set up its first manufacturing facility for design and manufacture of automation systems in Pune, India. It also started distributing actuators and accessories for Mecair, Italy. Thereafter, it backward integrated and started manufacturing ball, butterfly, gate and check valves in Pune, India. In late 2006, VEL set up a manufacturing plant at Pogliono, Italy to manufacture large diameter ball valves for global distribution. These are flow control valves used to regulate the volume or pressure of a fluid largely catering to the oil and gas, infrastructure and certain process industries. VEL has manufacturing units in India, Pune and Coimbatore (ball valves, triple offset valves, gate valves, and check valves), the USA (severe service application valves) and Europe (large size ball valves and steam products).

The company has diversified its revenues by acquiring steam products manufacturing company RIFOX in FY09. It launched a new improved product called triple offset valve under the Tritork brand name in FY10. The company plans to expand its manufacturing capacity and its subsidiary operations to cater to the rising demand of ball valves and triple offset valves.

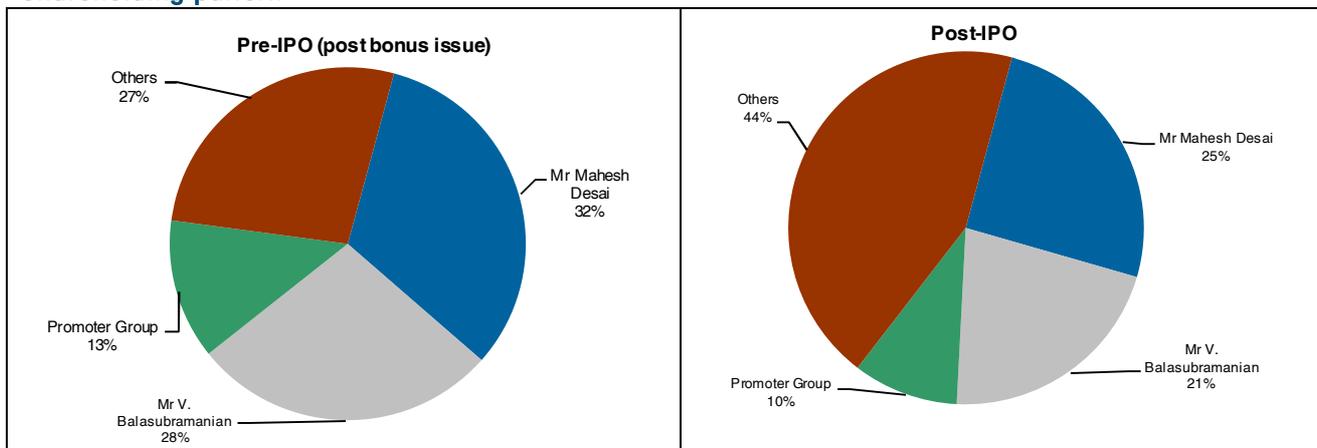
VEL has re-aligned its corporate structure in the past two years taking into account the growth opportunities across products and regions. The company has divested stake in unviable units, acquired new business, formed another subsidiary in the USA – EVS Valves – and transferred Vintrol business to its wholly-owned subsidiary – Virgo Valves & Controls Ltd (VVCL). The company has proposed to amalgamate a subsidiary company, Vintrol India Ltd, with VVCL. The re-alignment aims to create a simpler and transparent structure (in terms of intercompany transfers).

Management and Board Profile

VEL’s business direction is governed by its promoter, Mr Mahesh Desai, who is supported by his brother Mr Jagdish Desai and other senior personnel. In addition, the company has a highly experienced second line.

The company appointed two additional board members – Mr Paresh Rajda, whole time executive director, and Mr Dheerendra Joshi, independent director at the beginning of CY10. VEL’s board now comprises 12 directors, of whom six are independent directors. The board comprises professional and reputed directors from varied industry backgrounds. The board has the ability to exercise management oversight.

Shareholding pattern



Source: DRHP

Annexure II: Profile of the Directors

Name of Directors	Designation, Occupation	Age (years)	Qualification	Key positions held
Mr Mahesh Desai	Non Executive Chairman, Business	53	Mechanical engineering degree and a diploma in systems management from Bombay University. He also completed advanced management programme from Wharton School, Philadelphia, United States of America.	Co-founder of the company. Previously served as sales manager in Larsen & Toubro Ltd. (L&T) and a piping design engineer with Tata Consulting for three years.
Mr V. Balasubramanian	Non Executive Director, Business	64	A mechanical engineer. He also holds a diploma in management from Bombay University	Now a mentor and non-executive director of the company. A co-founder of the company, but retired recently. Before setting up the company he served as regional sales manager with L& T.
Mr Jagdish Desai	Non Executive Director, Business	51	He is an electrical engineer. He also completed postgraduate diploma in computer management from JBIMS and a course in executive education in business management from University of Michigan, USA.	Non-executive director of the company. Previously employed with Crompton Greaves handling sales of electrical equipments and as a regional manager in International Data Management.
Mr Paresh Rajda	Whole-time Executive Director, Service	53	A mechanical engineer from M.S. University, Baroda.	Executive director and heads the corporate finance, human resource and information technology functions. Earlier handled different position in different departments. Previously shouldered various positions in the company (head automation division to corporate finance). Previously worked as sales manager at Fisher-Xomox (I) Ltd.
Mr Rajaram Ajgaonkar	Non Executive Director, Professional	52	Commerce graduate and a degree in Law from Government Law College, Mumbai. He is also a qualified chartered accountant	Non-executive director. He is a practicing chartered accountant and also advising the company on accounting and tax matters since 1989.
Mr Kishore Kulkarni	Non Executive Independent Director, Consultant	55	A mechanical engineer, IIT and M.B.A. from JBIMS	Independent director of the company. Previously was employed with Voltas and ICICI Ltd. He then started his own advisory business and is associated with the company since 1995.
Ms. Hetal Gandhi	Nominee Director for Tano	44	A certified member of Institute of Chartered Accountants of India	Director nominated by Tano Mauritius India FVCI. A co-founder and the Managing Director of Tano India Advisors (P) Ltd, who are advisors to Tano Mauritius India FVCI. Earlier worked as consultant. Also as Chief Executive Officer of ILFS.
Prof. N. Venkiteswaram	Non Executive Independent Director, Professor	60	Graduated in economics and holds CA degree.	Independent director of the company. Professor at IIM and a member of Central Direct Tax advisory Committee.
Dr. Dhananjay Kelkar	Non Executive Independent Director, Professional	49	Holds master degree in Surgery.	Independent director of the company. Founder and Managing Trustee of non-profit trust Jnana Prabodhini Medical Trust. Founder of Deenanath Mangeshkar Hospital. Trustee of Adishakti school for adivasi.

Mr Abhay Nalawde	Non Executive Independent Director, Business	61	Physics graduate and holds Masters degree in business Administration (Marketing), from Pune University	Independent director of the company. MD of EcoAxis Systems Private Limited, a joint venture with A.T.E. Enterprises. Previously served as a CEO of Thermax Ltd.
Mr Manu Parpia	Non Executive Independent Director, Business	60	Chemical engineer and a Masters in Business Administration from the Harvard Business School	Independent director of the company. Previously he was associated with Godrej and also served as a CEO of Geometric Ltd.
Mr Dheerendra Joshi	Non Executive Independent Director, Professional	55	Holds masters degree in Technology from IIT, Madras and a qualified cost accountant (ICWA)	Independent director of the company. He was the MD of Aker Power gas Private Ltd. Has experience of 33 years in marketing, project management, etc. He was associated with Ceat Tyres, Modi Rubber Ltd, Tata Consulting Engineers, etc.

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