

Modern Tube Industries Ltd

CRISIL IPO Grade 1 / 5 (Poor)

August 18, 2011

Grading summary

CRISIL has assigned a CRISIL IPO grade of '1/5' (pronounced "one on five") to the proposed IPO of Modern Tube Industries Ltd (Modern Tube). This grade indicates that the fundamentals of the IPO are poor relative to 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 offer price for the issue may be higher or lower than the level justified by its 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. To arrive at the overall grade, amongst various other parameters, CRISIL has considered the company's business prospects, its financial performance, management capabilities and corporate governance practices.

The assigned grade exhibits Modern Tube's weak position in the seamless and welded tubes and pipes segment vis-à-vis established competitors. Despite scaling up its manufacturing assets, Modern Tube continues to operate largely as a trader (~70% of revenues in FY10), due to which margins are low. Further, its debtor days are around 100, which is more than double the industry average of 30 to 45 days. Its asset utilisation rate is on the lower side as the company is in an expansion mode. The grade also reflects the promoter's limited experience in manufacturing though he is highly experienced in the trading of stainless steel products. Further, Modern Tube portrays below average corporate governance. Independent directors' engagement level in the business needs improvement.

However, the grade has taken into account Modern Tube's growth prospects, as it is scaling up assets to supplement existing capacities. The same will enable the company to manufacture critical application products that enjoy high margins and will help in increasing capacity utilisation rates.

Modern Tube trades in and manufactures stainless steel seamless and welded tubes. It has an installed capacity of 7,200 metric tonnes per annum. Its customer base includes engineering and equipment manufacturing companies that cater to cement, fertiliser and pharma industries. Trading sales contribute the most to revenues, while manufacturing comprises only 30% of revenues.

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About the company

Vadodara-based Modern Tube trades and manufactures stainless steel seamless and welded tubes, u-tubes and pipes. Its manufacturing facility - spread across 6 acres - is located near the GIDC Port (Gujarat). Although currently it has a capacity of 7,200 metric tonnes per annum (MTPA), up from its initial capacity of 180 MTPA in 2006, it continues to be largely a trading company. In FY10, Modern Tube derived ~70% of its total sales through trading goods (average of past four years - 80% of net revenues), while the balance was contributed by the manufacturing business. It imports sheets as an input material for seamless pipes and sources steel coils locally (mainly from Jindal group's JSW Steel) for making welded tubes. Its established client base includes diverse industries such as auto, chemical equipment, furniture, railway coaches, sugar and power plants. Modern Tube exports (1.1% of total revenues - average of past four years) to over 10 countries.

Mr Mahendra Bhansali started Modern Tube after gaining over 10 years of trading experience in stainless steel products. The trading business was being run under a proprietary concern - Modern Tube Industries Ltd - floated in 1996, which was converted into a limited company in 2006.

Issue details

Shares offered to public	Not available at the time of grading
As per cent of post issue equity	Not available
Object of the issue	<ul style="list-style-type: none"> Expanding manufacturing facility to 14,400 MTPA from 7,200 MTPA Working capital requirement and general corporate purposes
Amount proposed to be raised	Rs 650 mn
Price band	Not available at the time of grading
Lead managers	Aryaman Financial Services Ltd

Source: DRHP, CRISIL Research

Detailed Grading Rationale

A. Business Prospects

- Modern Tube faces strong competition*

Modern Tube is a small player with a manufacturing capacity of 7,200 mtpa as of FY10, which exposes it to strong competition from large and established peers like Zenith, Ratnamani Metals and Prakash Steelage. These peers have been operating for over a decade and have established relationships with end-users. Owing to their scale of operations, they are better placed to bag big-ticket orders and enjoy economies of scale.

Table 1: Peer comparison: Capacity

Capacity (MTPA)	FY07	FY08	FY09	FY10
Modern Tube Industries	200	1,200	7,200	7,200
Prakash Steelage Ltd	4,000	12,200	15,600	15,600
Zenith	120,000	120,000	120,000	210,000
Ratnamani Metals and Tubes*	300,000	300,000	350,000	350,000

* Capacity and utilisation details for carbon steel pipes; hence not strictly comparable.

Source: Prowess, Company, CRISIL Research

- Scaled up asset base with limited manufacturing experience...*

The manufacturing facility of Modern Tube can produce multiple products that find applications across industries (auto, oil and gas, pharma, sugar and railway coaches). Although it has scaled up its capacity (from 180 MTPA in 2006 to 7,200 MTPA by the end of FY09), the limited experience in manufacturing has led to production of low-end/general category products. However, the company plans to get into a higher margin business by setting up supplementary capacities that will enable it manufacture critical products.

- ... resulting in relatively low utilisation*

Modern Tube was unable to utilise the plant at an optimal level as it did not have the requisite machinery – thus failing to convert the increasing inquiries for manufacturing of critical application products, especially from the oil and gas sector. To supplement its existing capacity - which will enable it to service a rise in demand - as well as enhance asset base, Modern Tube now plans to nearly double its capacity which will be funded through IPO proceeds. It is focusing on manufacturing of critical application products that enjoy higher EBITDA margins. The company has also received third party certifications and accreditations approving its products and plant (e.g. RIL, ESSAR, etc.). With new capacity coming in place, the company will be in a position to service large clients.

Table 2: Installed capacity

In metric tonnes	FY08	FY09	FY10
Seamless tubes and pipes	200	800	800
Utilisation	19.0%	20.1%	99.0%
Big pipe plant	-	1,200	1,200
Utilisation	0.0%	8.3%	29.8%
Other welded tubes and pipes	1,000	5,200	5,200
Utilisation	15.4%	10.5%	25.3%

Source: DRHP, CRISIL Research

Even when compared with peers, its overall utilisation of assets is the lowest. Industry-wide asset utilisation in the seamless tubes and pipes segment reached the optimum level in FY10 with a rise in demand following the economic revival and the restoration of capex plans by end-user segments, especially in the oil and gas sector. But, Modern Tube reported low utilisation levels of ~34% in FY10.

Table 3: Peer comparison: Utilisation

Utilisation	FY07	FY08	FY09	FY10
Modern Tube Industries	47.2%	16.0%	11.2%	34.2%
Prakash Steelage Ltd	121.5%	35.2%	43.6%	68.6%
Zenith	59.1%	73.0%	56.8%	55.2%
Ratnamani Metals and Tubes*	20.5%	20.6%	22.7%	32.2%

* Capacity and utilisation details for carbon steel pipes; hence not strictly comparable.

Source: Prowess, Company, CRISIL Research

- *Continues to be a trading company; delays in receivables leading to liquidity problems*

Despite scaling up its asset base, Modern Tube derives ~ 70% of net revenues (average of past four years - 80% of revenues) through the trading business. Trading business margins are low. Added to this, Modern Tube’s debtor days are around 100, which is on the higher side for a trading business (industry average is 30 to 45 days). There was a delay in payment from debtors along with increase in sales, which led to liquidity problems and the company delaying the tax payments.

- *Weak internal controls and systems limit control over operation*

Modern Tube’s internal systems and processes are inadequate for the company’s current size and its planned expansions. In addition, the company officials were unable to analyse historical performance. To increase efficiency and grow as a manufacturer, Modern Tube will have to implement adequate systems and processes that will enable it to monitor performance and take accurate measures accordingly. However, the management has realised the loopholes and is taking steps to improve systems and processes.

B. Financial Performance

- Growth in manufacturing sales remains a monitorable*

Revenues have grown at a CAGR of 139.5% during FY07 to FY10 on account of capacity expansion and trading sales (average of past four years - 80% of revenues). With increasing mix of trading sales, margins contracted over the past three years. However, in 1QFY11, absence of low-margin trading revenues resulted in margin expansion, as indicated by the management. The change in revenue mix remains to be seen, especially after taking into account the high dependence on trading revenues till FY10.

Table 4: Financial performance

Particulars	FY07	FY08	FY09	FY10	1QFY11
Revenues (Rs mn)	78	589	583	1,069	296
Traded products (% of revenues)	90.4%	91.4%	75.2%	67.2%	-
EBITDA	14	43	47	59	26
EBITDA margin	17.5%	7.3%	8.0%	5.5%	8.7%
Reported PAT	3	14	3	21	9
Adj PAT*	3	14	3	1	9
Adj PAT margin	3.4%	2.4%	0.5%	0.1%	2.9%
Adj EPS	0.2	1.1	0.2	0.1	4.5
RoE	26.3%	45.4%	5.8%	1.3%	5.7%
Balance sheet ratios					
Inventory days	137	62	88	49	123
Creditors days	337	122	77	51	459
Debtor days	263	102	78	108	609
Current ratio (x)	1.4	1.5	2.3	3.3	1.8
Debt-equity (x)	2.5	4.4	4.1	2.2	1.8

* excluding extraordinary income ; Note: All ratios are computed on Adj PAT

Source: DRHP, CRISIL Research

- Ex-extraordinary income earnings down*

Modern Tube's reported PAT increased at a CAGR of 101% to Rs 21 mn in FY10 from Rs 2.6 mn in FY07. However, excluding extraordinary income (adjustment for variation in stock valuation as directed by IT department resulted in additional income of Rs 20 mn) adjusted PAT recorded a negative CAGR of 21% on account of low EBITDA margins in the trading business and an increase in depreciation and interest cost due to capacity enhancement. Lower profitability, higher capital base and inability to improve asset turnover has affected returns to equity shareholders. RoE has come down to 1.3% in FY10 from 26.3% in FY07.

Table 5: Peer comparison

Capacity (MTPA)	Peer financials				Utilisation	FY07	FY08	FY09	FY10
	FY07	FY08	FY09	FY10					
Modern Tube Industries	200	1,200	7,200	7,200	Modern Tube Industries	47.2%	16.0%	11.2%	34.2%
Prakash Steelage Ltd	4,000	12,200	15,600	15,600	Prakash Steelage Ltd	121.5%	35.2%	43.6%	68.6%
Zenith	120,000	120,000	120,000	210,000	Zenith	59.1%	73.0%	56.8%	55.2%
Ratnamani Metals and Tubes*	300,000	300,000	350,000	350,000	Ratnamani Metals and Tubes*	20.5%	20.6%	22.7%	32.2%
* Capacity and utilisation details for carbon steel pipes									
EBITDA margin	FY07	FY08	FY09	FY10	RoCE	FY07	FY08	FY09	FY10
Modern Tube Industries	17.5%	7.3%	8.0%	5.5%	Modern Tube Industries	38.1%	27.4%	15.3%	13.1%
Prakash Steelage Ltd	4.4%	8.1%	8.3%	9.7%	Prakash Steelage Ltd	20.7%	29.7%	23.5%	37.0%
Zenith	10.1%	10.3%	8.1%	9.3%	Zenith	15.2%	18.0%	16.5%	18.7%
Ratnamani Metals and Tubes	22.5%	21.4%	16.1%	20.6%	Ratnamani Metals and Tubes	42.51%	55.7%	37.0%	28.6%

Source: Prowess, Company, CRISIL Research

C. Management Capabilities and Corporate Governance

- *Limited management capability*

Modern Tube has been largely a promoter-driven company, depending on promoter and managing director Mr. Mahendra Bhanshali. He has a decade of experience in the trading of stainless steel seamless and welded tubes and pipes but limited understanding of the manufacturing business.

- *Trading sales has stretched working capital requirements*

Modern Tube was set up to focus on the manufacturing business. However, despite enhancing capacities, growth has been driven by the trading business and the same has created liquidity issues for the company. Its debtors days moved to around 100, which is more than double the industry average as it faced delays in collections.

- *From a proprietary set-up to a professional set-up*

Modern Tube operates as a proprietary concern. The promoter has a fair understanding of demand for products and pricing of the same but is constrained by limited manufacturing experience. From marketing to micro-level operations – booking of orders and their pricing, and placing orders for raw material and their purchase cost - the promoter is involved at every level. Efforts are on to have a professional set-up - the company has hired a few experienced people (three to four people across business functions) from the industry. Mr Himanshu Sharma, earlier employed with Zenith Ltd (a competitor of Modern Tube) has been roped in for his technical understanding of the business; Mr Girish Kulkarni, earlier employed with Apollo Tyres and ABB, has over 30 years of experience in accounts and finance division.

- *Second line of management to focus on systems and processes*

Having joined recently, most of the key managerial personnel have limited understanding of the company's business. Further, weak systems and processes limit their ability to analyse the historical performance. With professionals joining the business, we expect the company to increasingly focus on developing the internal systems and processes, which will help it to improve performance.

- *Independent director's ability to exercise management oversight is weak*

Modern Tube's recently-formed board consists of six members, of whom four are independent directors. This meets the regulatory requirements. However, only one of the independent directors is closely involved in business activities and plays a major role in guiding the promoter in taking business and financial decisions. Other independent directors' engagement level in the business needs to increase.

- *Auditors' qualification with respect to weak internal controls*

FY10 reports were audited by Janardan Tamboli & Co. (change in auditor in past one year) who found there has been improvement in the process of maintaining the company's books of accounts. Earlier auditors, Shah & Bhandari, had qualified in their annual audit reports for FY08 and FY09 that the company had weak internal control systems and incomplete register under 301 of the Companies Act, 1956 and had contravened Section 58A & 58AA of the Companies Act, 1956.

In 2009, the IT department commented that inventory was not disclosed at its fair value in the books of accounts. Accordingly, the survey team had directed Modern Tube to declare an addition of Rs 20 mn to its inventory on account of variation in stock valuation and report higher profitability. Modern Tube agreed to the addition of Rs 20 mn and reported higher other income in FY10 and accepted the tax liability on the same.

Annexure I

Business Profile

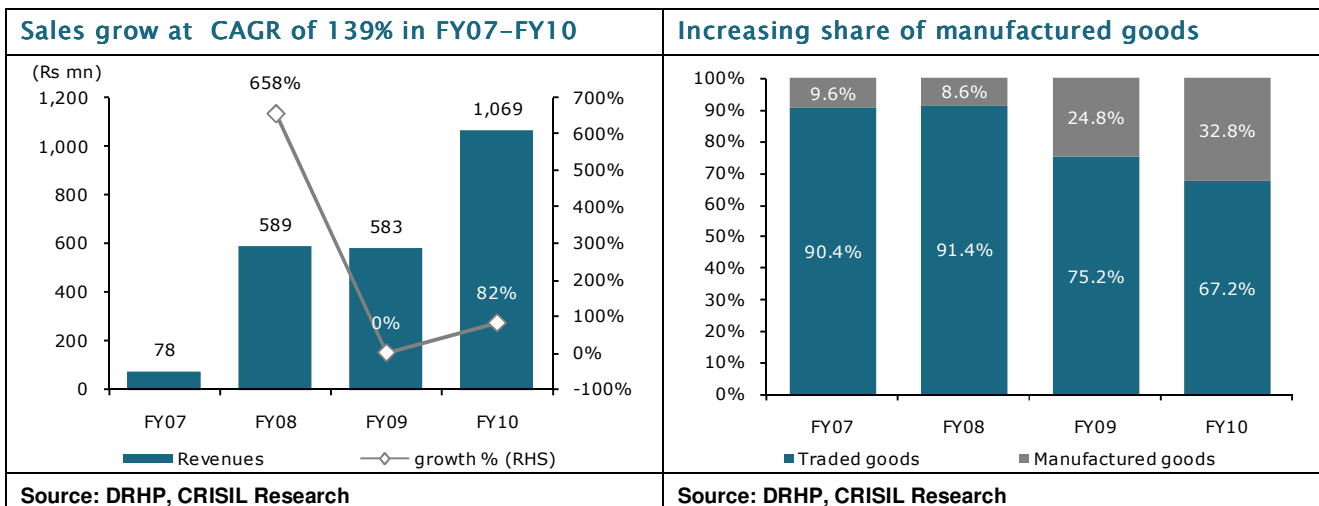
Modern Tube trades and manufactures stainless steel seamless and welded tubes, u-tubes and pipes. Its manufacturing facility - spread across 6 acres - is located near the GIDC Port (Gujarat). Although currently it has a capacity of 7,200 MTPA, up from its initial capacity of 180 MTPA in 2006, it continues to be a trading company. Modern Tube derives ~70% of its total sales through trading goods (average of past four years - 80% of net revenues). It exports (1.1% of total revenues - average of past four years) to over 10 countries (the US, the UK, Canada and South-east Asian countries). It imports sheets as an input material for seamless pipes and sources steel coils locally (from the Jindal group-mainly from JSW Steel) for making welded tubes. Mr Mahendra Bhansali started Modern Tube after gaining over 10 years of trading experience in stainless steel products. The trading business was being run under a proprietary concern - Modern Tube Industries Ltd - floated in 1996, which was converted into a limited company in 2006.

Table 6: Segment-wise capacity

Installed capacity in metric tonnes	FY08	FY09	FY10
Seamless tubes and pipes	200	800	800
Big pipe plant	-	1,200	1,200
Other welded tubes and pipes	1,000	5,200	5,200
Total	1,200	7,200	7,200

Source: DRHP, CRISIL Research

Despite scaling up the capacity, Modern Tube continues to be a trading company as it derives ~70% of sales through trading goods (average of past four years - 80% of net revenues) as trading is the promoter's core strength.



Its established client base comprises a diverse set of industries (see Table 7), including engineering and equipment manufacturing companies that cater to cement, fertiliser and pharma industries.

Table 7: Industry-wise revenue break-down

Industry	FY07	FY08	FY09	FY10
Automobiles	14%	16%	13%	15%
Chemical Equipment	11%	12%	11%	10%
Dairy & Food Industries	3%	2%	7%	4%
Furniture	11%	10%	10%	10%
Heat Exchanger & Condensers	14%	14%	4%	15%
Oil & Gas Industries	11%	11%	10%	10%
Paper & Pulp Industries	4%	4%	3%	3%
Pharmaceuticals	3%	4%	8%	4%
Power Plants	5%	6%	10%	6%
Railway Coaches	9%	8%	10%	8%
Sugar Industries	15%	13%	14%	15%

Source: DRHP, CRISIL Research

Annexure II: Profile of the Directors

Name	Designation	Age	Qualification	Date of Joining	Experience & previous employments	Directorships / partnership in other entities
Mr. Mahendra Bhansali	Managing Director	39	Undergraduate	Since inception	Trading business - stainless steel pipes and tubes	Manas Capital Services Ltd
Mr. Himanshu Sharma	Whole-Time Director	54	Bachelor's degree in metallurgical engineering	Mar-09	Worked with Firth India Steel Co. Ltd as production planning engineer for two years. Has worked for over 30 years in various senior posts in Greaves Cotton Co. Ltd, Abhishek Steel Pvt. Ltd, Gaurav Tubes Pvt. Ltd, Zenith Birla (India) Ltd, etc.	Manas Capital Services Ltd
Mr. Ramesh Kumar Doshi	Independent Director	36	N.A.	Apr-10	Began his career as a commission agent dealing in various spare-parts and other utility equipment business. Later, started a proprietary business - dealing in refrigeration spare-parts - in 1995.	No
Mr. Dilip Kumar Vyas	Independent Director	55	M.Com (Management) from M.S Uni., Baroda He is also an alumnus of IIM, Ahmedabad	Sep-10	Ex-Group Captain, Indian Air Force. As commissioned officer has worked in various capacities; was a member of Indian Peace Keeping Force in Sri Lanka. Completed advanced financial accounting operations course and served two tenures as Command Financial Advisor and Controller. Was the India Head for Crediterity Info Services, Bangalore, where he looked into the overall daily functioning as well as charting a course for the company's expansion, profitability and growth. He is currently working with ABB in a senior post.	Rajputana Stainless Ltd
Mr. Surendra Tamboli	Independent Director	56	Masters in Commerce and L.L.B. (General – Contract Act, Civil & Criminal Act) from the M.S. University of Baroda. Following which he completed L.L.B. with specialization in Taxation & Corporate Laws from the M.S. University of Baroda and is a fellow member of the ICSI, New Delhi	Sep-10	Has worked as an Independent Company Secretary and in senior position in the legal department of companies like Diamond Power Infrastructure Ltd, Ambalal Sarabhai Enterprises Ltd, Jhagadia Copper Ltd, etc and is well versed with company affairs including rights issue, public issue and private placement of equity shares / warrants. He is also an ex-executive member of the Baroda Management Association as well as a visiting faculty at WLC College, Baroda. He is currently a practicing company secretary.	No

Mr. Romeshkumar Shah	Independent Director	36	Bachelor's degree in Electrical Engineering	Sep-10	Was a real estate and infrastructure space consultant wherein he dealt in SEZ properties in Dahej and Bharuch districts of Gujarat. In 2010, incorporated his own company - Omkar Procon Pvt. Ltd; runs an authorised service centre and provides liasioning and consultancy services for well known business groups including Areva Group, and companies like Tebma Shipyards Ltd and Emco Ltd. Also has interests in the gems & jewellery industry through a partnership concern - Riddhi Siddhi Jewellers.	Omkar Procon Pvt. Ltd
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Source: Company, DRHP

Disclaimer

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