



# Modern Tube Industries Ltd

One-time assessment

**CRISIL IPO Grade 1/5 (Poor)**

March 15, 2012

## Grading summary

CRISIL has reaffirmed 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 grade exhibits Modern Tube's weak position in the intensely competitive stainless steel welded and seamless tubes and pipes segment. Despite scaling up its manufacturing assets, Modern Tube continues to operate largely as a trader (trading sales contributed 63% to revenues in H1FY12). The receivable days has deteriorated to 159 days as on H1FY12 from 78 days in FY09, significantly higher than industry average of 65 to 80 days, thereby putting stress on the company's financials. The promoter has limited experience in manufacturing though he is highly experienced in the trading of stainless steel products. Lack of technical expertise has resulted in low capacity utilisation at 34% in FY11. The management's ability to scale up manufacturing operations in a segment where there is intense competition from established domestic manufacturers and cheap imports from China is a key monitorable. Further, quick churning of key management personnel within six to 18 months of joining is an area of concern. Also, Modern Tube portrays below average corporate governance with three out of four independent directors attending only 50-60% of the board and other committee meetings in FY11.

The grade has, however, taken into account Modern Tube's growth prospects, as it is scaling up asset utilisation in the current year through the manufacturing of tubes for critical applications. It has successfully added clients in the past year for the sale of these tubes. Also, the company is making efforts to move from a promoter driven firm to a professional set-up – for which it has hired a few experienced people from the industry.

Revenues have grown at a CAGR of 95% during FY07 to FY11 on account of capacity expansion and higher trading sales. EBITDA margin doubled to 12.7% in FY11 owing to higher trading margins. PAT increased at a CAGR of 114% during FY07-11. The company reported revenues of Rs 1,104 mn and net profit of Rs 22 mn in H1FY12; net worth was Rs 235 mn as on H1FY12.

## 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 8,700 metric tonnes per annum (MTPA), up from its initial capacity of 180 MTPA in 2006, it continues to be largely a trading company. In H1FY12, Modern Tube derived 63% of its total sales through trading of tubes/sheets/coils (average of past four years - 75% 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 (2% of total revenues - average of past three 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 – M/s. Modern tube Industries - floated in 1996, the entire operations of which were gradually shifted to Modern Tube Industries Ltd incorporated in 2006.

## Issue details

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

\* Capacity has already been expanded upto ~8700 MTPA

Source: RHP, CRISIL Research

## Detailed Grading Rationale

### A. Business Prospects

#### ▪ *Modern Tube faces strong competition in the manufacturing segment*

Modern Tube is a small player with a manufacturing capacity of ~8,700 mtpa as of H1FY12, which exposes it to strong competition from large and established peers like Remi Metals, Ratnamani Metals and Prakash Steelage. These peer companies have been operating for over a decade and have well-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. The company also faces competition from cheap Chinese imports of tubes in the absence of any anti-dumping duty.

**Table 1: Modern Tube is a small player compared to peers**

Capacity* (MTPA)	FY07	FY08	FY09	FY10	FY11
Modern Tube Industries	200	1,200	7,200	7,200	7,200
Prakash Steelage Ltd	4,000	12,200	15,600	15,600	17,600
Ratnamani Metals and Tubes	18,900	18,900	21,900	21,900	21,900
Remi Metals	70,000	70,000	70,000	70,000	70,000

Source: Prowess, Company

**Table 2: Competition intense with players sitting on low utilisation rates**

Utilisation*	FY07	FY08	FY09	FY10	FY11
Modern Tube Industries	47.2%	16.0%	11.2%	34.2%	33.8%
Prakash Steelage Ltd	121.5%	35.3%	43.6%	68.6%	65.1%
Ratnamani Metals and Tubes	39.3%	61.4%	55.6%	46.5%	55.2%
Remi Metals	10.6%	9.3%	7.8%	8.2%	17.6%

\* Capacity and utilisation rates are for the steel tubes product category

Source: Prowess, Company

#### ▪ *Trading dominates revenues, but company's focus on manufacturing sales is increasing*

The manufacturing facility of Modern Tube can produce multiple products that find applications across industries (auto, oil and gas, pharma, sugar and railway coaches). Though the proportion of trading sales has declined (to 63% in H1FY12 from 67% in FY10) as the utilisation rates of its installed capacity have improved, trading sales continue to comprise the major chunk of revenues. Manufacturing tubes, used in critical application in the oil and gas, nuclear and power sectors, boosted sales in the manufacturing segment. The management indicated that utilisation levels remained low as they were unable to manufacture these tubes owing to lack of requisite machinery. However, they have tried to address the same by adding machinery and additional processes in the current year to produce these tubes. The management has indicated that they have obtained the necessary third party verification certificates but we believe the ability to bag large scale orders and execute them remains a key monitorable. Though, margins are relatively better in this segment, we believe that the company's profitability will remain under pressure as it has to under-cut to penetrate the market and establish a client base.

**Table 3: Though contribution of trading sales has declined, it remains high**

Revenue break-up	FY08	FY09	FY10	FY11	H1FY12
Total Sales (Rs mn)	592	591	1074	1131	1104
Manufacturing	9%	25%	33%	35%	37%
Trading	91%	75%	67%	65%	63%

Source: RHP, CRISIL Research



## ▪ *Receivables at alarming levels, can deteriorate net worth if written off*

Though the company's revenues have increased at a fast pace over the past five years, receivables days have also increased from 102 days in FY08 to 159 as on H1FY12. With the present slowdown in the macro environment, the company may find it difficult to recover its receivables. Any potential default of debtors can deteriorate its net worth.

**Table 4: Break-up of debtors of Modern Tube**

Rs mn	FY08	FY09	FY10	FY11	H1FY12
Debtors( above 6 months)	6.4	25.6	38.1	40.5	99.2
% of total	4%	2%	12%	8%	10%
Less than 6 months	157.5	99.2	278.1	439.0	862.7
<b>Total Debtors</b>	<b>163.9</b>	<b>1248.2</b>	<b>316.2</b>	<b>479.6</b>	<b>962.0</b>
<b>Debtor Days</b>	<b>102</b>	<b>78</b>	<b>108</b>	<b>156</b>	<b>159</b>

Source: RHP, CRISIL Research

**Table 5: Debtor days nearly 2-3x peers**

Debtor Days	FY08	FY09	FY10	FY11	H1FY12
Modern Tube Industries	102	78	108	156	159
Prakash Steelage Ltd	85	93	74	84	84
Ratnamani Metals and Tubes	36	42	58	69	60
Remi Metals	63	68	62	56	80

Source: Prowess

## ▪ *Increase in utilisation rate to be slow*

The company was to double the capacity expansion to 14,400 MTPA by October 2011 but has only managed to reach 8,700 MTPA till H1FY12; the remaining is expected to be completed by May 2012. The company proposes to purchase plant & machinery and other fixed assets worth Rs 364 mn from the IPO proceeds; it has placed orders worth Rs 295 mn so far, implying that it is yet to place orders for 19% of the plant and machinery equipment required for the proposed capacity expansion.

Even though its present capacity remains unutilised, the company believes this is the right time to further expand capacity as it foresees bulk orders from large customers undertaking projects in the next one year. The management believes with the expanded capacity on stream and the necessary quality certifications in place, it will be in a position to capitalise on the expected bulk orders. However, given the relatively smaller size of the firm and intense competition from other established players in the segment, we believe that it will be difficult for the company to bag large orders and improvement in utilisation rates will be slow.

## ▪ *Internal controls and systems require strengthening*

The company, over the past one year, has improved its internal processes and MIS. However, they 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 strengthen its systems and processes to enable it to monitor performance effectively on an on-going basis.

## B. Financial Performance

### ■ *Growth in manufacturing sales remains a monitorable*

Revenues have grown at a CAGR of 95% during FY07 to FY11 on account of capacity expansion and trading sales (average of past four years - 75% of revenues). Capacity utilisation in the seamless tubes and pipes segment stood at 85%, while the big pipe plant and the welded tubes and pipes plant operated at 34% and 26%, respectively, in FY11. Management intends to scale down their trading sales in future. Accordingly, their ability to ramp up manufacturing sales and execute bulk orders for critical application tubes are key monitorables.

**Table 6: Financial performance**

Particulars	FY07	FY08	FY09	FY10	FY11	H1FY12
Revenues (Rs mn)	78	592	591	1,074	1,131	1,104
Traded products (% of revenues)	90	91	74	67	65	63
EBITDA (Rs mn)	14	43	47	59	144	89
EBITDA margin (%)	17.5	7.3	8.0	5.5	12.7	8.0
Reported PAT (Rs mn)	3	14	3	21	56	22
Adj PAT* (Rs mn)	3	14	3	1	56	22
Adj PAT margin (%)	3.4	2.4	0.5	0.1	4.9	2.0
Adj EPS (Rs)	23.8	8.9	1.4	0.4	4.5	1.8
RoE (%)	26.3	45.4	5.8	1.3	30.8	20.0
<b>Balance sheet ratios</b>						
Inventory days	137	62	88	49	84	35
Creditors days	337	122	77	51	170	268
Debtor days	263	102	78	108	156	159
Current ratio (x)	1.4	1.5	2.3	3.2	1.7	1.6
Debt-equity (x)	2.5	4.4	4.1	2.2	2.0	2.8

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

Source: RHP, CRISIL Research

### ■ *Healthy PAT growth owing to improvement in operating profitability*

With increasing mix of trading sales, margins contracted over FY08-FY10. However, in FY11, operating profitability improved with higher margins in trading sales. EBITDA margin had doubled to 12.7% in FY11; however, it has dropped to 8.0% in H1FY12 owing to increase in input cost and overall slowdown in demand. Modern Tube's PAT has grown at a CAGR of 114% from FY07 to FY11 in line with the improvement in operating profitability. RoE has increased to 30.8% in FY11 from 1.3% in FY10.

**Table 7: Peer comparison**

Peer financials									
Revenue growth (y-o-y)	FY08	FY09	FY10	FY11	EBITDA margin	FY09	FY10	FY11	H1FY12
Prakash Steelage	42%	29%	46%	25%	Prakash Steelage	10.0%	9.9%	10.1%	9.4%
Ratnamani Metals	44%	15%	-9%	-3%	Ratnamani Metals	19.3%	19.2%	18.8%	17.2%
Remi Metals Gujarat Ltd	185%	-49%	17%	63%	Remi Metals Gujarat Ltd	-2.1%	-1.4%	0.3%	3.4%
Modern Tube	658%	0%	82%	5%	Modern Tube	8.0%	5.5%	12.7%	8.0%

Source: Prowess, Company



## ▪ ***Receivables on the rise, creditor days also increasing***

In order to aid revenue growth, the receivable days of the company have been on the rise in the past two years - from 78 days in FY09 to 159 days as on H1FY12. Also, the company has switched to letter of credit route of financing from cash payment mode, which has increased the creditor days from 77 in FY09 to 268 as on H1FY12. Higher creditor days have enabled the company to maintain its working capital days in spite of continuously rising receivables. However, we believe that the company needs to improve its collection systems in order to avoid potential losses that can result in significant deterioration of its net-worth.

## ▪ ***Contingent liability worth Rs 98.3 mn reported in FY11***

The company has reported a contingent liability of Rs 98.3 mn (177% of FY11 PAT and 46% of the FY11 net-worth) under the heading Gujarat Commercial VAT (Source: RHP). Though the management has mentioned that they have got the required legal opinion which states that this liability does not lie with Modern Tube, they were unable to adequately explain the nature of the liability.

## **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.

### ▪ ***Moving from a promoter driven firm to a professional set-up***

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. The promoter has a fair understanding of demand for products and pricing of the same but is constrained by limited manufacturing experience. 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. Gajendra Rathod, with a total experience of 20 years has been roped in as the Production Manager from Vikas Tubes Pvt. Ltd.

### ▪ ***Concerns on the attrition rate and salary levels***

Quick churning of key management personnel within six to 18 months of joining is an area of concern and may lead to instability in operations within the company. Further, we believe that the salary of senior executives in the company is low. For instance, the Executive Director, Mr Himanshu Sharma, draws a salary of ~Rs 4,00,000 per annum, lower than some of the junior executives working in the organisation (like Mr Patwa, CA, who is working as AGM-Accounts and Finance with a total experience of nine months). In this scenario, the company's ability to retain key personnel can be challenging.

**Table 8: Changes in key management personnel**

Name	Designation	Date of Joining	Date of Leaving	Months with the company
Mr Ramchandra Tambe	Manager – Accounts & Finance	03/03/2010	31/08/2010	6
Mr Sanjay Patel	Manager – Production	01/11/2009	30/06/2010	8
Mr Sunil Joshi	DGM – Quality	01/05/2009	31/05/2010	13
Mr C. K. Nair	Manager – Marketing	15/02/2008	31/03/2010	26
Mr John George	Manager – Works	01/12/2009	31/01/2010	2
Mr Himanshu Parmar	Manager – H.R.	16/06/2009	09/11/2010	17
Mr Parag Shah	Sr. Executive Planning	24/07/2009	25/11/2010	16
Mr Chirag Kansagra	Manager – Finance	01/11/2007	15/12/2010	38
Mr R K Patel	Sr. Manager – Production	23/09/2010	31/12/2010	3
Mr Girish Kulkarni	AGM- Accts & Fin	01/12/2010	21/05/2011	6
Mr Jatinder Saini	Sr Executive- Operations	02/02/2010	31/07/2011	18
Mr Monil Dobariya	Manager – Marketing	15/09/2009	21/03/2011	18
Mr Rajan George	Manager – International Business	02/08/2010	31/05/2011	10

Source: RHP

▪ ***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. Only one of the independent directors, Mr. Surendra Tamboli, has adequate knowledge on the business dynamics of the company and is able to exercise management oversight. Other independent directors' engagement level in the business needs to increase. Further, the attendance level of the independent directors in the board and other committee meetings is low, with three of four independent directors attending only 50-60% of the board and other committee meetings in FY11, indicating absence of independent oversight on the functioning of Modern Tube.

One of the independent directors, Mr. Dilip Kumar Vyas, is also on the board of a company engaged in business similar to that of Modern Tube's; this indicates potential conflict of interest and raises doubts about Mr. Vyas' ability to properly exercise his duties and responsibilities as an independent director.

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

New auditors Janardan Tamboli & Co. who audited the FY10 reports 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

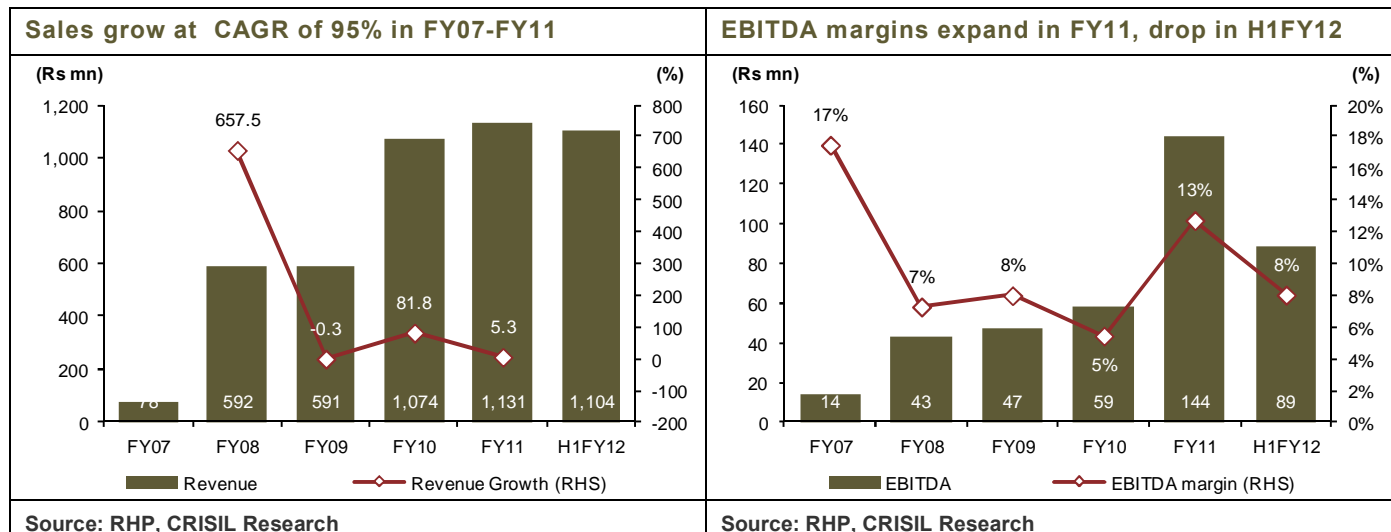
### Business Profile

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 8,700 MTPA, up from its initial capacity of 180 MTPA in 2006, it continues to be a trading company. Modern Tube derives ~63% of its total sales through trading goods (average of past four years - 75% of net revenues). Its established client base comprises a diverse set of industries including engineering and equipment manufacturing companies that cater to cement, fertiliser and pharma industries. It exports (2% of total revenues - average of past three 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 – M/s. Modern tube Industries - floated in 1996, the entire operations of which were gradually shifted to Modern Tube Industries Ltd incorporated in 2006.

**Table 9: Segment-wise capacity**

Installed capacity in metric tonnes	FY08	FY09	FY10	FY11
Seamless tubes and pipes	200	800	800	800
Big pipe plant	-	1,200	1,200	1200
Other welded tubes and pipes	1,000	5,200	5,200	5200
Total	1,200	7,200	7,200	7,200

Source: RHP, 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	40	Undergraduate	Since inception	Trading business - stainless steel pipes and tubes	Manas Capital Services Ltd
Mr. Himanshu Sharma	Whole-Time Director	55	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	37	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	56	M.Com (Management) from M.S University, 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	57	Masters in Commerce and L.L.B. (General – Contract Act, Civil & Criminal Act) from the M.S. University, Baroda. Following which he completed L.L.B. with specialization in Taxation & Corporate Laws from the M.S. University 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

Name	Designation	Age	Qualification	Date of Joining	Experience & previous employments	Directorships / partnership in other entities
Mr. Romeshkumar Shah	Independent Director	37	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

Source: RHP

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- First research house to release exchange-commissioned equity research reports in India
- Assigned the first IPO grade in India

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