

Shirdi Industries Limited

CRISIL IPO Grade 2/5 (Below Average)

November 26, 2010

Grading summary

CRISIL has assigned a CRISIL IPO grade of '2/5' (pronounced "two on five") to the proposed IPO of Shirdi Industries Ltd (Shirdi). This grade indicates that the fundamentals of the IPO are below 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 IPO grade assigned to Shirdi reflects the company's strong position in the manufacturing and marketing of medium density fibre (MDF) and particle boards in India. It is one of the first companies in India to trade in and import MDF boards before setting up a manufacturing plant in Pantnagar, Uttarakhand, giving it an early-mover advantage. This is the largest plant in India at a single location manufacturing a wide variety of wood-based products. Also, the company's new manufacturing facility in Coimbatore is operational now and manufactures designer doors, panel doors and lamination of particle and MDF boards. Additionally, the upcoming facility in Gummidipoondi near Chennai, is expected to increase the current installed capacity of MDF boards from 3.9 mn sq metres to 6.2 mn sq metres.

The grade is constrained by poor corporate governance practices and weak second line of management, which is inadequately informed about the key aspects of business operations. We also believe that the independent directors' oversight on the business is low. According to the auditors, the company's integral audit system needs to be enlarged to match the size and nature of the business. Further, over the past two years, the company has been consistently making delayed payments on bank dues and statutory dues like provident fund, investor education and protection fund, employee state insurance and government taxes. While the company has started making payments on time since July 2010, it continues to remain a key monitorable.

The company's consolidated revenues amounted to Rs 1.8 bn during the first nine months of FY10. EBITDA margin was 28.1% while net margin was 8.9%. Historically, the company has had high leverage resulting in lower PAT margins. Total consolidated debt as on December 31, 2009 was Rs 2.1 bn in comparison to the total net worth of Rs 964 mn. The company's high working capital requirement and expansion plans prompted liquidity problems in FY09 and FY10.

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About the company

Shirdi Industries, part of the ASIS Group, was originally incorporated as Shirdi International Engineers Private Ltd in December 1993. It was later renamed Shirdi Industries Private Ltd and finally Shirdi Industries Ltd in June 1997. The company started off as an advisor in foreign trade and investment. In 1997, it expanded into custom clearing and forwarding services. Since FY07, the company is primarily engaged in the manufacturing of MDF, particle boards, pre-laminated MDF and particle boards, laminates, flooring, door skins, panel doors, modular furniture and other allied products. It also trades in transferable export /import incentives by offering forward sell options to exporters and purchase options to importers on a deferred payment basis.

It began importing and trading in MDF, particle boards and other products required for interior furnishing in 1996. In 2003, the company commenced production of designer doors, door skins and furniture components located in Mahape, Navi Mumbai. In December 2006, the company ceased its Navi Mumbai operations. It commenced manufacturing operations at the Pantnagar unit, Uttarakhand in February 2007. The manufacturing unit is well equipped with advance PLC controls, telescopic belts, wind forming stations and automatic glue forming stations, which ensure consistent quality. At this plant the company uses rice husks as a raw material for boilers, reducing emission, which makes the company eligible for the Clean Development Mechanism (CDM) and Voluntary Carbon Standards (VCS) credits. The company is entitled for VCS credit for a period of 30 years and CDM credit for 10 years starting from February 2007. Currently, it is expected to generate 82,000 units p.a. but since the registration for both these entitlements is pending, no income has been accounted against these credits till date.

Shirdi is promoted by Mr Rakesh Agarwal, Mr Sarvesh Agarwal, Mr Mukesh Bansal and Mr Hariram Agarwal along with corporate promoter Asis Industries Private Limited (AIPL).

Issue details

Shares offered to public	6,500,000
As per cent of post issue equity	27.3%
Object of the issue	<ul style="list-style-type: none"> To fund the setting up of manufacturing plant at Gummidipoondi near Chennai To fund the capital expenditure for civil work and purchase of additional equipment for the Pantnagar unit in Uttarakhand General corporate purposes (not mentioned)
Amount proposed to be raised	Rs 1,138 mn (approximate) plus funds for general corporate purposes
Price band	Not available at the time of grading
Lead managers	Collins Stewart Inga and Yes Bank Limited

Detailed Grading Rationale

A. Business Prospects

- MDF and particle boards – huge potential in India**

The wood-based panel industry is dominated by particle boards (40%), plywood (29%) and MDF (21%). Globally, there is a shift in production pattern of wood panels, whereby plywood is being replaced by MDF and particle boards. This is because MDF and particle boards are more environment friendly and cost efficient compared to plywood. Shirdi primarily manufactures MDF and PB panels. The Indian market is still dominated by plywood (up from 22% to 35% during 1998-2008) due to consumer perception that plywood is more durable and reliable. Currently, MDF and particle boards are mainly used in the commercial segment in India and are mostly imported. However, in the long run due to increasing awareness, environment-friendly nature and cost effectiveness, we expect a shift in preference for MDF and PB in the residential segment. Also, there is a change in consumption pattern towards modular furniture in urban and semi-urban areas, further increasing the demand for MDF and PB panels.

MDF and particle board production in India is low vs. the global average (% of total wood panel production in 2008)					
Various types of panel	World	USA	Europe	China	India
Hardboard	3%	3%	5%	2%	6%
Insulating board	3%	5%	3%	0%	0%
MDF	21%	13%	17%	34%	9%
Particle board	40%	48%	64%	14%	19%
Plywood	29%	27%	9%	46%	34%
Veneer sheets	4%	4%	2%	4%	32%
MDF & PB	61%	61%	81%	48%	28%

Source: FAO

- Domestic production of MDF and particle boards to provide competitive advantage over imports**
 Almost 60-70% of the Indian demand for MDF and particle boards is met through imports from Europe, Sri Lanka and South East Asia because of limited domestic capacity. These imports have a high landed cost due to high cost of logistics and import duty. The CIF value for import of MDF is between US\$180 and US\$300 per CBM, and for particle boards it is US\$125-200 per CBM. Against this, marine freight, port handling and local transport in country of export costs between US\$50 and US\$70 per CBM resulting in ex-factory price of US\$75-130 per CBM for particle boards and US\$130-230 per CBM for MDF. Besides, imports are subject to customs duty and import handling charges involving port charges, shipping line charges, custom clearing agent's cost and transportation charges. Since locally produced products are based on import parity, indigenous manufacturers have a strong competitive advantage over imports.

- **Shirdi Industries – A leading player in MDF and particle boards**

Shirdi is a leading manufacturer of MDF and particle boards in India, both plain and pre-laminated. It is one of the first companies in India to trade in and import MDF boards. In FY07, it set up a manufacturing unit in Pantnagar, Uttarakhand. It is the largest plant in India at a single location that manufactures a wide variety of wood-based products.

- **New facilities to increase market reach:** The company has now implemented the other phase of expansion and capacity additions. The second facility in Coimbatore started manufacturing designer doors, panel doors and lamination of MDF and particle boards in 2009. The upcoming facility in Gummidipoondi near Chennai will manufacture MDF, HPL, printing and pre-lamination of imported boards, which will strengthen Shirdi's position in the South.
- **Well-established branch network:** Shirdi has a well-established network of 18 branches and offices across all the major states. The pan-India marketing and distribution set-up ensures efficient supply mechanism. Besides, Shirdi stands to gain from a strong brand name - ASIS.

- **Shirdi to face stiff competition from large established players**

MDF and PB panels are predominantly imported as most of the large wood panel manufactures in India are focused on plywood. However, given the initial success of Shirdi and good industry prospects, large established players like Greenply and Novopan now intend to expand capacities in the MDF and particle board segment, which may create stiff competition for Shirdi and impact its profitability in the medium term.

- **Rising wood prices may put pressure on margins**

The primary raw material used for the production of MDF and particle boards is wood. As per FAO, the demand for wood from the wood-based panel industry in India has increased at a CAGR of 5.5% in the past 10 years and is further expected to increase at a CAGR of 5% till 2020. Over the past one decade, wood prices have been consistently rising on the back of increasing demand from the wood and paper industries, and strict forest preservation rules of the Central government. Increasing wood prices may stress the company's margins as it does not have any long-term contracts for raw material supplies.

B. Financial Performance

Shirdi's revenues logged a healthy CAGR of 54% between FY05 (Rs 391 mn) and FY09 (Rs 2,205 mn), largely because of the manufacturing of MDF and particle boards in Pantnagar, Uttaranchal in FY07. EBITDA margins improved from negative 4% in FY05 to 22.7% in FY09 due to increased contribution from the high-margin manufacturing operations instead of the low-margin trading business. The significant improvement in EBITDA margins has not fully percolated to net margins on account of increase in depreciation and interest costs (gearing has increased from 0.6x in FY05 to 2.5x in FY09). PAT margins increased from negative 6.6% in FY05 to 7.2% in FY09.

In 9MFY10, the company posted Rs 1,759 mn revenues with EBITDA margin of 28.1% and net margin of 8.9%. The higher EBITDA margin was mainly due to a fall in the raw material expenses as percentage of sales; down from 36.7% in FY09 to 24.4% in 9MFY10. During this period, the manufacturing operations contributed 75% to overall revenues, while the trading business contributed the rest. The finance charges during the nine-month period were Rs 185 mn compared to Rs 199 mn for FY09. The net worth of the company as on December 31, 2009 was Rs 964 mn and the corresponding debt was Rs 2.1 bn.

Financial performance snapshot

		9MFY10 Actual 9 months	FY09 Actual 12 months	FY08 Actual 12 months	FY07 Actual 12 months
Revenues from manufactured products	Rs mn	1306	1720	1217	24
Revenues from trading business	Rs mn	454	485	924	798
Total operating income	Rs mn	1769	2225	2148	854
EBITDA margins	%	28.1	22.7	20.9	12.2
Net profits	Rs mn	158	160	167	57
Net margins	%	8.9	7.2	7.8	6.7
RoCE	%	NA	14.2	18	8.9
RONW	%	NA	22	28.1	13.3
Basic EPS	Rs	9.1	9.0	9.7	2.9
Diluted EPS	Rs	9.1	9.0	9.5	2.9
No. of equity shares	Mn	17.3	17.8	17.3	19.4
Net worth	Rs mn	964	806	646	544
Book value (FV Rs 10)	Rs	55.7	45.3	37.3	28.0
Debt-equity ratio	Times	2.2	2.5	2.6	1.7

* Note1: Numbers have been re-classified as per CRISIL standards; RoCE and RONW are annual figures

Source: DRHP

- *Higher debt level puts significant pressure on cash flows*

The company started manufacturing in FY07. It faced a liquidity problem in FY09 and FY10 due to the economic downturn, and high level of inventory and debtors maintained by it. Due to high raw material inventory averaging over four months in FY09 and nine months ending FY10, and extending higher credit period to its customers, the reliance on bank limits for bridging the working capital gap has increased. At the same time, the company has invested ~Rs 2.0 bn in expanding its manufacturing capacities in Uttarakhand and Coimbatore between FY06 and FY09. All this has led to a significant jump in the debt level from Rs 98 mn in FY05 to Rs 2,028 mn in FY09. This has significantly stressed the cash flows due to which the company has been consistently making delayed payments of its term loans since FY09 and payment of various statutory dues. We believe that due to the inherent nature of the industry

there will be consistent pressure of servicing the working capital requirement. The situation is likely to improve with the inflow of initial public offer proceeds.

Working capital intensive business

	FY06	FY07	FY08	FY09	9MFY10
Debt-equity ratio	1.2	1.7	2.6	2.5	2.2
Receivable days	28	168	103	91	201
Inventory days	34	61	70	124	215
Payable days	218	287	59	91	191
Working capital cycle (days)	-156	-58	114	124	226

Source: DRHP, CRISIL Equities

C. Management Capabilities and Corporate Governance

Managing director instrumental in setting up the largest PB/MDF manufacturing facility in India

Mr Rakesh Agarwal, managing director, has been instrumental in implementing the project for manufacturing plain and pre-laminated MDF and particle boards, decorative laminates and other miscellaneous items in Pantnagar, Uttaranchal, and Coimbatore. Under his leadership, Shirdi became one of the first few companies to trade in and import MDF- and particle board-based panels in India and later became a full-fledged manufacturing unit. The Pantnagar plant is currently the largest manufacturing unit of MDF and particle boards in India at a single location. Also, under his leadership, the company has set up pan-India sales and marketing network.

Weak second line of management

Shirdi has built its second line of management over the past three years. Most of the key management personnel were appointed in FY07 with the onset of the manufacturing operations. The company's second line seems to be inadequately informed about the key aspects of business operations. In addition, there seems to be significant dependence on Mr Rakesh Agarwal for overall business direction and continuity. We believe that the second line of management needs to be strengthened in order to match the future scale of operations.

Conflict of interest among Shirdi's current operations and other promoter group entities

Some of the other promoter group entities - Asis Industries Private Limited, Asis Global Limited and Asis Overseas Limited - may undertake businesses similar to Shirdi's current operations. Since no non-compete agreement has been signed between Shirdi and the aforesaid group entities, chances of a potential conflict of interest in the future do exist.

Limited oversight by independent directors and inadequate internal control system

Though the independent directors are experienced in their respective industries (not in the wood-based panel industry), based on their involvement in the company decisions we believe that their ability to exercise management oversight is low. The company has been consistently making delayed payments of undisputed statutory dues like provident fund, investor education and protection fund, employee state insurance and government taxes. The company has consistently defaulted in repayment of dues to banks throughout FY09 and 9MFY10. Further, according to the auditor, the company's integral audit system needs to be enlarged to match the size and nature of the business.

Thus, we believe that the overall corporate governance of Shirdi Industries is weak and needs significant improvement.

Annexure I Business Profile

The company started off as an advisor in foreign trade and investment. In 1997, the company expanded into custom clearing and forwarding. Since FY07, the company is primarily engaged in the manufacturing of an array of wood-based panel products such as MDF, particle boards, pre-laminated MDF and particle boards, laminates, flooring, door skins, panel doors, modular furniture and other allied products. It also trades in transferable export /import incentives by offering forward sell options to exporters and purchase options to importers on a deferred payment basis.

Manufacturing process of Shirdi Industries

Raw Materials	Intermediate Final Products	Intermediates	Final Products	
Wood	Particle Board	Impregnated Paper	Pre laminated Particle Board	HPL
Paper				Furniture & Components
Chemicals	MDF (medium density fibre)	Resin	Prelamintaed MDF	Prelaminated Flooring
Resin				Door & Door Skins

Source: DRHP

Existing capacities at Uttarakhand and Coimbatore manufacturing facilities

	Licensed capacity			Installed capacity			Actual production		
	Plain & pre-laminated boards	Decorative laminates	Furniture	Plain & pre-laminated boards	Decorative laminates	Furniture	Plain & pre-laminated boards	Decorative laminates	Furniture
	Sq metres	Sq metres	Sq metres	Sq metres	Sq metres	Sq metres	Sq metres	Sq metres	Sq metres
9MFY10	50,881,000	18,800,000	-	14,253,198	10,800,000	11,711,494	4,020,063	2,560,203	-
FY09	38,690,000	13,700,000	-	13,058,405	3,600,000	5,285,120	5,583,752	2,641,709	-
FY08	13,690,000	10,600,000	-	13,058,405	3,600,000	-	6,085,994	1,560,968	-
FY07	13,690,000	5,500,000	-	13,058,405	3,600,000	-	139,502	8,629	-
FY06	-	-	96,000	-	-	-	-	-	-
FY05	-	-	96,000	-	-	-	-	-	-

Source: DRHP

With the aim of scaling up its production facilities and widening its reach across the country, Shirdi started its second manufacturing facilities in Coimbatore in 2009. It is now establishing another facility in Gummidipoondi near Chennai, Tamil Nadu for the production of particle boards of thickness 8mm to 25mm, MDF boards of thickness 2.3mm to 8mm and other allied products. Also, the company is proposing to establish a manufacturing facility in Bhiwandi, Thane, Maharashtra, for manufacturing edge solutions for wood-based furniture products. The company has executed agreements for exclusive distributorship rights in India for PVC wrapped profiles which are used for producing edge solutions in modular furniture, with M/s. AGT Furniture Components, Turkey, and with M/s. PROBOS – PLASTICOS SA, Portugal for the distribution of PVC edge bends, used to cover the edges of boards used for manufacturing furniture.

Shirdi's plant in Pantnagar, Uttarakhand enjoys significant tax benefits like exemption of entry tax, central sales tax of 1%, ten-year exemption from central excise duty since FY07 and 100% exemption from income tax for the first five years since FY07 and thereafter 30% for the next five years, which enables the company to market its products at competitive rates.

Management and Board Profile

Shirdi is promoted by Mr Rakesh Agarwal, Mr Sarvesh Agarwal, Mr Mukesh Bansal and Mr Hariram Agarwal along with corporate promoter Asis Industries Private Limited (AIPL). Incorporated in 2000 as Asis InfoTech Private Limited, AIPL is in the business of system study, analysis, design, development and implementation of software systems; it posted of Rs 17 mn revenues in FY09. It is promoted by Mr Rakesh Agarwal and Mr Mukesh Bansal.

Mr Rakesh Agarwal is the managing director. He started as a lecturer at REC, Kurukshetra and later worked with the Ministry of Power and Directorate General of Technical Development (DGTD), a department under Ministry of Industry, GoI. In 1993 he promoted the ASIS Group, which now has interests in interior furnishing industry, logistics operations and software systems.

Mr Mukesh Bansal is a non-executive director. He started as a partner in a custom house, which was later acquired by the ASIS Group. He now leads the logistics operations of the group and advises on export/import and investment matters.

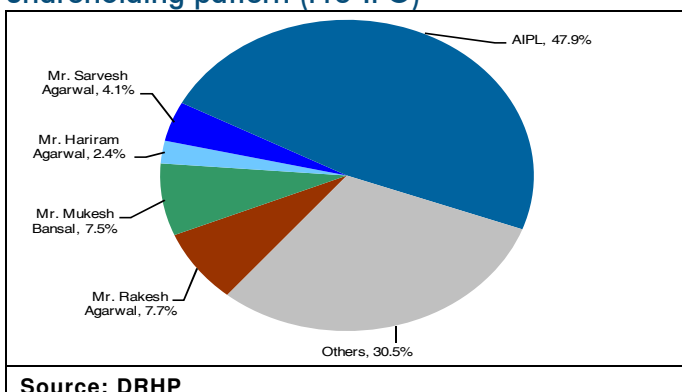
Mr Hariram Agarwal is a non executive director. He has served in various departments in the Government of Uttar Pradesh.

Mr Sarvesh Agarwal is a whole time director. He initiated the importing of MDF/PB. He is responsible for marketing, brand promotion, sales and distribution and other operational activities.

The second line of management includes Mr Hiren Oza (VP – accounts), Mr A. Pattanayak (VP - marketing), Mr S. N. Gupta (VP – corporate affairs), Mr Vianney D’Gama (GM – plant and administration), Mrs Ujwala Joshi (brand manager) and Mr Manoj Singh (head of information technology).

The company’s board comprises 11 directors, of whom four are independent - well experienced and qualified in their respective fields. Mr Jasbir Singh Bhullar was appointed on September 30, 2004 and has more than two decades of experience in the business of manufacturing and trading of textile goods. Mr Sujay Nitin Kantawala was appointed on December 16, 2005 and has more than a decade of experience as a lawyer. He is also the audit committee chairman. Mr Anand Kumar Jain was appointed on November 1, 2006 and has more than three decades of experience in the manufacturing and marketing of LPG valves and regulators, optical fiber, FRP rods and copper wires and cables. Mr Mahabir P Agarwal was appointed on March 15, 2010 and has more than two decades of experience in real estate development and construction, and more than a decade of experience in the bulk drug industry.

Shareholding pattern (Pre-IPO)



Source: DRHP

Annexure II: Profile of the Directors

Name	Designation	Age	Qualification	Other directorships
Mr Rakesh Kr Agarwal	Managing Director	46	B.E. (mechanical engineering), Gorakhpur	Labh Capital Services Private Limited Asis Logistics Limited Asis Global Limited Repute Properties Private Limited Asis Industries Private Limited
Mr Sarvesh Agarwal	Executive Director	33	Commerce graduate	Asis Overseas (C& F) Private Limited Asis Global Limited Asis Logistics Limited Rachana Finance and Investment Private Limited Asis Industries Private Limited
Mr Hariram Agarwal	Non Executive Director	72		Dytel Finance and Investment Private Limited Asis Industries Private Limited
Mr Mukesh Bansal	Non Executive Director	48	Commerce graduate	Labh Capital Services Private Limited Asis Overseas (C& F) Limited Manhar Properties Private Limited Asis Industries Private Limited Asis Logistics Limited
Mr Bankuru Venkateswara Rao	Executive Director	50	Masters in Science (applied organic chemistry)	NIL
Mr Piyush Goyal	Chairman, Non Executive Director	45	Bachelors in Law, Mumbai	Flashnet Info Solutions (India) Limited Intercon Advisors Private Limited S V Shah Construction Services Private Limited Flash Agro farms Private Limited Sajal Finance and Investments Private Limited
Mr Anand Kumar Jain	Independent Director	65	B.Sc., Lucknow B.E., Roorkee	Transvalves India Private Limited Arihant LPG Private Limited Gaurav Fincap Private Limited
Mr Ravish Chand Jain	Non Executive Director	55	B.Sc., Meerut	Arihant Technomac Limited U.P. Telelinks Limited Trans Valves (INDIA) Private Limited Arihant LPG Private Limited Arihant Optics Limited
Mr Sujay Kantawala	Independent Director	44	B.A., Mumbai	Flawless Diamonds Limited
Mr Jasbir Singh Bhullar	Independent Director	57		Anil Cloth Mills Private Limited
Mr Mahabir Prasad Agarwal	Independent Director	56	B.Com	Ambience Properties Limited Kaveri Projects Limited Ambience Resorts and Motels Private Limited Vasundhara Constructions Private Limited Shubham Telecom Private Limited A R Pharmacare Private Limited Universal Realtors Private Limited

Disclaimer

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