

Sudar Garments Ltd

CRISIL IPO Grade 1/5 (Poor)

January 21, 2011

Grading summary

CRISIL has assigned a CRISIL IPO grade of '1/5' (pronounced "one on five") to the proposed IPO of Sudar Garments Ltd (Sudar). 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 is constrained by Sudar's weak corporate governance practices. One of the independent directors is closely involved in business activities and is known to influence the promoter's business and financial decisions. Other independent directors do not have sufficient understanding of their role and lack the ability to exercise management oversight. We believe this will limit the independent directors' ability to act in the best interest of minority shareholders. Also, the company does not have a strong second line of management to match the growing business. While the company has taken steps to strengthen its team, the efficacy of the same will be seen only over the medium term. The grade is further impacted by a weak business risk profile due to the company's limited experience in retail business, the absence of long-term contracts and high dependence on few buyers for a bulk of its revenues.

However, the grade does factor in the growth prospects of Sudar's domestic apparel business, which includes contract manufacturing for several domestic apparel brands and selling its own brands through distributors and multi-brand outlets. The domestic apparel market is buoyant and CRISIL Research expects it to grow at a CAGR of 9% from Rs 1,400 bn in FY11 to Rs 2,100 bn by FY16. The grade also takes into account the company's long-standing relationship with key buyers in the export market.

Sudar's revenues have grown at a healthy CAGR of nearly 150% between FY08 and FY10 to Rs 528 mn. It posted PAT of Rs 43 mn in FY10. EBITDA and PAT margins during the same period were 17.1% and 8.1% respectively. RoE has been improved to ~32% in FY10 from ~7.5% in FY08.

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About the company

Mr Murugan Muthiah Thevar, the promoter of the company, has been associated with the apparel manufacturing business since 1992. He started working as a cutting master with Gokaldas Exports Ltd and later on moved out to commence his own garments manufacturing business. He started contract manufacturing for exporters through a proprietary concern named 'Sudar Garments'. On January 28, 2002, it was incorporated as a private company under the name of Sudar Garments Pvt. Ltd, under the Companies Act, 1956. On March 17, 2010 it was re-converted into a public company as Sudar Garments Ltd.

Until FY07, the company had a small manufacturing set up with 150 sewing machines. In FY08, the company expanded its capacity to 500,000 garments by installing an additional 150 sewing machines along with a few specialised supporting machines and also introduced an assembly line approach for producing garments. This greatly enhanced the company's capacity to take on large orders. Subsequently, the company increased its capacity further to 800,000 garments by installing 180 sewing machines in FY09 and to 2 mn garments by installing 116 sewing machines in FY10.

Sudar functions as an integrated apparel manufacturer with facilities for cutting, body stitching, washing, ironing and finishing at its own manufacturing setup at Khalapur Taluka, Raigad District, Maharashtra. Also, the company has an established distribution network and selling agents in South India for its existing brand 'Glory to Glory'. The company is planning to launch two more brands - 'St. Paul' and 'Majesty' - in the domestic market.

Issue details

Shares offered to public	9.088 mn
As % of post issue equity	49%
Object of the issue	<ul style="list-style-type: none"> • Expansion of the existing apparel manufacturing unit • Meeting working capital requirement • Setting up retail outlets and brand building • Meeting general corporate expenses • Meeting the issue expenses
Amount proposed to be raised	Rs 600-650 mn
Price band	Not available at the time of grading
Lead managers	Ashika Capital Limited

Details of project cost

Sr. no	Expenditure items	Total estimated cost (Rs mn)
1	Expansion of the existing apparel manufacturing unit	262.9
2	Meeting Working Capital Requirement	250.0
3	Setting up Retail Outlets and Brand Building	59.0
4	Meeting General Corporate Expenses	NM
5	Meeting the Issue Expenses	NM
	Total	600-650

Note: NM - not mentioned in DRHP

Source: Company, DRHP

Detailed Grading Rationale

A. Management Capabilities and Corporate Governance

- *Technically sound promoter and long-term client relationships...*

Mr Murugan Muthiah Thevar, the promoter and managing director, has around two decades of experience in garment manufacturing. He has been associated with the apparel manufacturing business since 1992. He started manufacturing garments on a contract basis for exporters. Over a period of time, Sudar has also started manufacturing garments for domestic retailers and selling its own brand through distributors. Due to the promoter's long experience in the industry, the company has been able to retain customers and maintain relationships by providing them with timely, qualitative and cost competitive solutions for their requirements.

- *... But independent director involved in key strategic and financial decisions...*

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. We believe this will limit his ability to act in the best interest of minority shareholders. Also, we believe the other independent directors have limited understanding of their roles and responsibilities. They are not adequately equipped to provide guidance and exercise oversight to ensure that the interests of minority shareholders are protected. In the past, the company has made unrelated financial investments which could have otherwise been invested in the operations of the company.

- *... And inexperienced and new management*

Most of the key managerial personnel have joined the company recently; also the board has been recently formed. Neither does the company have a strong second line of management nor a CFO. Also, most of the key management personnel are not adequately experienced to match the scale of growing operations.

However, the company is committed to take the necessary steps to strengthen its management. Sudar has recently appointed three managerial personnel, who are expected to join the company from February 2011. This could help the company to better manage the business.

B. Business Prospects

- *Rural and semi-urban markets to drive domestic demand growth; exports to recover gradually*

The Indian readymade garments (RMG) industry is highly fragmented with few organised and a large number of unorganised players. The high level of fragmentation in the domestic market leads to intense competition and thus exerts more pressure on margins for small unorganised players. Indian exporters too face severe price competition from low-cost countries such as China, Bangladesh and Vietnam. CRISIL Research estimates the domestic RMG industry is around Rs 1,400 bn (accounting for nearly 73% of total apparel demand) and Indian RMG exports are around Rs 490 bn in FY11.

In the past two years, with the slump in exports, growth in the Indian textiles industry was solely driven by the domestic market. Going forward, we expect the domestic market to continue to be the main driver for the textile industry. CRISIL Research expects the industry (exports and domestic together) to grow at a CAGR of 8% to reach Rs 2,700 bn by FY16 from an estimated Rs 1,890 bn in FY11.

The domestic apparel market is expected to grow at a CAGR of 9% from Rs 1,400 bn in FY11 to Rs 2,100 bn by FY16, against 6% recorded in the preceding five years. This will be primarily driven by higher consumer spending on clothing, increasing retail penetration in tier-II cities and rising preference towards readymade garments vis-à-vis stitched garments, especially in rural and semi-urban areas.

On the exports front, the US and EU together comprise around 80% of RMG exports from India. Exports to these destinations declined by 6% in FY10 following the economic downturn in 2008 and 2009.

In FY11, CRISIL Research expects exports to the US will recover but will remain subdued for EU. As a result, India's total RMG exports are estimated to remain flat at around \$10.5 bn in FY11 and to grow at a CAGR of 7% to \$15 bn by FY16, slower than growth in the domestic market.

- *Preference towards RMG to drive growth for shirts and trousers in domestic market*

In the domestic RMG market, 'shirts' is the largest category in terms of value, accounting for around 20% of overall apparel market in FY11. This is the most penetrated segment with a large number of manufacturers. This leads to a high level of fragmentation and, hence, intense competition. 'Trousers' is the third largest segment in RMG in terms of value, accounting for around 10% of the total apparel market. Comparatively, the competition in this segment is not as severe as that in the shirts segment.

CRISIL Research estimates the market for shirts in FY11 to be around Rs 230 bn, which is expected to grow at a CAGR of 8% to Rs 340 bn by FY16. The trousers market is estimated to be around Rs 123 bn in FY11 and to grow at a CAGR of around 10% to Rs 200 bn by FY16. CRISIL Research estimates the demand from the rural market, in value terms, will be around 40% for shirts and 50% for trousers. The rising preference towards RMG, especially in the rural market, is expected to drive the growth in demand for shirts and trousers.

- *Sudar focusing more on the domestic market to boost growth*

Sudar specialises in shirts, trousers and other apparels for men, women and kids. Sudar started manufacturing garments for exporters on contract basis. But due to intense competition and lower margins in

the export market, it started focusing more on the domestic market since FY07; the company also started selling its own brands through its distribution network spanning metros, mini metros and large cities in major parts of South India. The strategy to focus on domestic market began yielding positive results from FY09. In FY10, domestic sales accounted for around 60% of the turnover compared to mere 6% in FY06. The company's revenues have more than doubled each year in the past two years to reach Rs 528 mn in FY10 from Rs 84 mn in FY08.

Given the robust growth expected in the domestic market, we expect the contribution of domestic revenues to rise in the medium term.

- ***Rising contribution of domestic revenues to keep receivables high for Sudar***

To grow and compete with other manufacturers in the domestic market, the company has been offering higher credit days to its customers. The average debtors' days for a garment manufacturer in the domestic market are around 90 days, while the same for Sudar were around 140 days in FY10. Going forward as well, with the rise in domestic revenues, the company's receivables are expected to remain high in the short to medium term.

- ***Intense competition and rising raw material prices exert pressure on margins***

The garment industry is the least capital-intensive and also the most fragmented part of the textile value chain. The high level of fragmentation is also a result of the erstwhile government policies which reserved garment manufacturing for the small-scale sector until 2003-04, which resulted in a large number of units with small capacities. High level of fragmentation and low product differentiation has resulted in intense competition for manufacturers, thus, impacting their margins.

Also, raw material prices have been rising over the past one year, exerting more pressure on margins. Manufacturers have been unable to pass on the hike due to extreme competition in domestic as well as export markets. Raw material costs account for around 60% of sales for garment manufacturers. Cotton (S-6 variety) prices are estimated to have surged by around 50% y-o-y in FY11. Consequently, cotton yarn (40s count) prices are estimated to have shot up by around 37% y-o-y and fabric prices have surged by around 15-20% y-o-y during the same time. The sharp run-up in cotton prices has led to higher demand for polyester and blended yarns/fabrics, resulting in increase in their prices as well.

CRISIL Research expects cotton and polyester prices to remain firm over the next two years, thus exerting pressure on margins for manufacturers. We expect Sudar's margins too will be under pressure over the medium term.

- ***Dependence on contract labour a risk for continual availability of manpower***

Garmenting is a labour intensive business, accounting for around 8-10% of sales for garment manufacturers, and even higher for retailers. Availability and cost of labour have been major concerns for the domestic manufacturers. Garmenting units across the country have been facing challenges in terms of acquiring and retaining labour especially skilled labour. In this context, Sudar's high dependence (around 95% of work force) on contract labour will be a key risk for continual availability of manpower. Also, labour costs have shot up by around 20% in the past one year. Labour costs are expected to continue to rise and put pressure on margins.

- ***Heavy dependence on few buyers***

Due to the promoter's involvement with garment manufacturing over the past two decades, the company has a strong customer base in the domestic market. Our discussions with the major clients revealed that the company has a good track record for quality products and timely delivery. It has been able to retain customers and maintain relationships by providing them timely and cost competitive solutions for their requirements.

However, the company has been highly dependent on its top three to four clients for around 90% of its revenues. The company is aware of this concentration risk and has started diversifying its client base by entering into export of uniforms, along with its traditional exports through merchant exporters. In addition, the company has started supplying garments to large domestic brands on a contract basis. Also, it has plans to set up its own retail stores to sell its brands. We believe these efforts will help the company in diversifying its revenue stream and reducing the concentration risk in the medium term.

- ***Lack of long-term export contract limits visibility on export revenues***

In FY10, the company started manufacturing uniforms for exporters to cater to the non-conventional and the relatively high margin segments. In FY10, the company bagged an order to supply uniforms to Dubai Port, through a merchant exporter. The rise in revenues seen last year was mainly due to the export order. However, the company does not have any long-term contract which limits the visibility of its export revenues. Also, the company has predominantly dealt through merchant exporters, making its revenues vulnerable to the downturns of economic conditions of export destinations.

- ***Retail foray to exert pressure on financials***

Sudar intends to enter the retail market and plans to have a total of 25 retail outlets in major cities of South India. The company proposes to open 10 retail outlets on leased premises in Chennai and the rest on franchisee basis in other parts of South India. The company would sell only its own brands through its retail outlets. The brands are yet to be registered, and are likely to face tough competition in a market that is flooded with other well established national and regional brands.

We expect the retail business to become fully operational and start contributing to the company's turnover in the next two years. Sudar would need to invest significantly to launch and ensure the growth of retail business. The company plans to investment Rs 24 mn for setting up the retail outlets and Rs 35 mn for brand building, which according to us, may not be commensurate for a retail foray and brand building exercise. We believe that until the retail operations are fully stabilised, higher selling and marketing expenses will exert pressure on the company's financials.

C. Financial Performance

Sudar's revenues grew at a two-year CAGR of nearly 150% to Rs 528 mn in FY10. EBITDA margins improved to 17.1% in FY10 from 14.2% in FY08; PAT margins increased to 7.9% in FY10 from 2.3% in FY08. Improvement in PAT margin increased RoE to 31.8% in FY10 from 7.7% in FY08. RoCE too improved to 22.1% in FY10 from 10.1% in FY08.

Financial performance snapshot

Particulars	Unit	FY08	FY09	FY10
Operating income	Rs mn	87	207	528
EBITDA	Rs mn	12	29	90
EBITDA margins	%	14.2	14.1	17.1
Net profits	Rs mn	2	6	42
Net margins	%	2.3	2.9	7.9
ROCE	%	10.1	12.8	22.1
ROE	%	7.7	10.4	31.8
Basic EPS	Rs	2	7	4
No. of equity shares (FV of Rs 10)	mn	1	1	9
Net worth	Rs mn	46	68	193
Book value	Rs	51	76	20
Current ratio	Times	7.3	7.3	2.8

Source: Company, CRISIL Equities

Sudar's revenues are estimated to grow mainly driven by healthy demand from domestic sales and support from exports, especially from the uniforms export segment. In FY10, the company bagged an order to supply uniforms to Dubai Port, resulting in a sharp rise in export revenues. On the domestic side, the company managed to record a healthy growth due to higher penetration of its own brands sold through distributors, which yielded better margins compared to contract manufacturing.

- **Domestic sales to drive revenue growth**

CRISIL Equities expects Sudar's revenues to grow moderately, over the next five years, mainly driven by rising demand in the domestic market. The company's revenues from the domestic segment are expected to grow at a faster pace compared to exports. Growth in the domestic market can be attributed to higher penetration of its own brands. We expect the retail business of the company to stabilise over the next two years. The company will also continue with its contract manufacturing for other domestic retailers. Export revenues are expected to grow slower than domestic revenues over the next five years. However, revenues from the export of uniforms are expected to increase significantly over the next two years mainly due to the order to supply uniforms to Dubai Port.

- **EBITDA margins to drop**

EBITDA margins are expected to drop in the short term due to rising raw material costs and intense price competition in domestic and export markets. Also, the company's foray into retail market is also expected to sharply push up its other manufacturing costs including labour, other overheads and selling-advertising expenses.

Annexure I

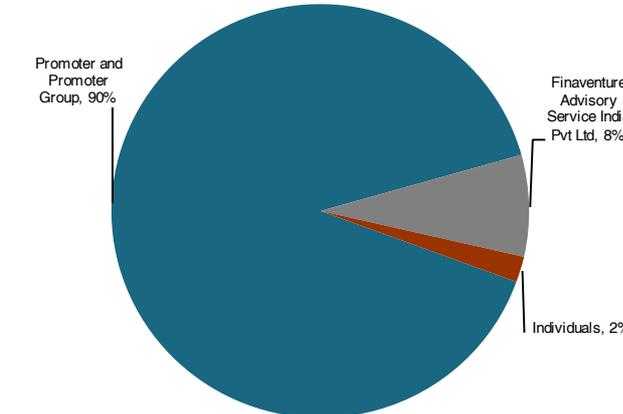
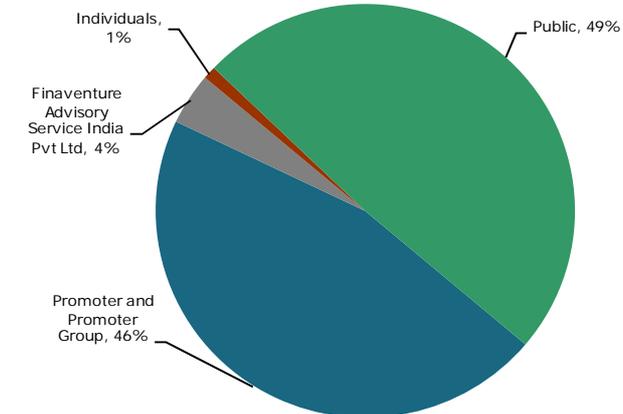
Business Profile

Sudar is an integrated apparel manufacturer with the capability of designing and manufacturing including cutting, body stitching, washing, ironing and finishing. It specialises in shirts, trousers and a wide range of other apparels for men, women and kids, catering to domestic as well as export markets.

The promoter, Mr Thevar, commenced manufacturing of readymade garments on contract basis for exporters, through a proprietary concern named 'Sudar Garments' in 1992. Over a period of time, due to the expansion in customer base, the increase in demand for readymade garments, and to gain advantage of having all the outsourced activity under one umbrella, the company restructured its business and on January 28 2002, Sudar Garments Private Limited was incorporated under the Companies Act, 1956.

Until FY07, the company had a small manufacturing set up, having 150 sewing machines producing 350,000 garments per year. Since then the company has continuously expanded its capacity. As of March 2010, the company has around 600 sewing machines producing 2 mn garments per year at its own manufacturing setup in Khalapur Taluka, Raigad District, Maharashtra. The unit caters to requirements of retailers, wholesalers and exporters, as well as manufactures products under its brand 'Glory to Glory'. The company is also planning to launch two more brands - 'St. Paul' and 'Majesty' - and sell through its established distribution network and selling agents in South India.

Shareholding pattern

Pre-issue shareholding pattern	Post-issue shareholding pattern
	
<p>Source: DRHP</p>	<p>Source: DRHP</p>

Annexure II: Profile of the directors and key management personnel

Board of Directors

Name	Designation	Age	Date of Joining	Qualification	Exp (yrs)	Previous Employment	Directorship/ partnership in other entities
Mr. Murugan Muthiah Thevar	Chairman & Managing Director	43	January 25, 2002	Matriculation	18	None	None
Mr. Gopi Chellapan Nair	Whole Time Director	53	May 15, 2010	Bachelor of Arts	20	Reliable Exports, Ambreen Exports, Associated Indian Exports, Hill Dale Co Ltd, Globus Stores Pvt Ltd	None
Mr. Deepak Shenoy	Independent & Non-Executive Director	26	January 20, 2010	Bachelor of Commerce	3	Solaris Corporate Services Pvt Ltd	Aritra Investments & Trading Pvt Ltd
Mr. Shridhar Shetty	Independent & Non-Executive Director	64	July 8, 2010	MA LLB (Gen), DFM (Mumbai Univ), CAIIB PGD in Export Import Management	20	Vijaya Bank	AB & Co Corporate Services Ltd, Global Fairdeal Ltd
Mr. Venketraman Gopal Nadar	Independent & Non-Executive Director	35	16, 2010	Bachelor of Commerce	15	None	Shriya Chemicals Pvt Ltd

Source: Company, DRHP

Key Management Personnel

Name	Designation	Age	Date of Joining	Qualification	Exp (yrs)	Functions Performed
Mr. M. S. Anand	VP Finance	58	Jul-10	LLB, PGDM in PersonnelMgmt. & industrial Relation, MA in English language and Literature	35	Finance
Mr. Rajendra Pillai	GM- Human Resource and Administration	NA	Jun-10	B.Com, M.S.W (Industrial Relation & Personal Management), Diploma in Business Management	17	Production
Mr. Albert S Pilai	Manager finishing and dispatch department	32	Oct-09	B. Com	12	Dispatch and finishing products
Mr. Prafulla Chandra Hegde	Head Washing Department	53	Jul-95	H.S.C.	15	Washing process of finished denims and other such fabrics
Ms. E Reena Nadar	Manager Accounts	26	Feb-03	S.S.C	12	Annual budget and accounts
Mr. Y Edwin Joseph	Manager Corporate Planning	29	Jul-09	ITA	3	Corporate planning
Mr. Tirumalai Perumal	General Manager Merchandising	40	May-08	B. Com	7	Merchandising
Ms. Sapna Karmokar	CS and compliance officer	26	Jul-10	B.Com, CS & LLB	7	Secretarial and Compliance

Note: NA - Not available in DRHP

Source: Company, DRHP

Disclaimer

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