VRL Logistics Limited

CRISIL IPO Grade 3/5 (Average)

March 09, 2011

Grading summary

CRISIL has assigned a CRISIL IPO grade of '3/5' (pronounced "three on five") to the proposed IPO of VRL Logistics Limited (VRL). This grade indicates that the fundamentals of the IPO are average 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 grade is not a recommendation to buy, sell or hold the graded instrument, its future market price or suitability for a particular investor.

The assigned grade reflects the robust outlook for the logistics sector - CRISIL Research expects the industry to grow at 11% CAGR to Rs 4.6 tn in 2013-14 - and VRL's position as one of the leading players in the domestic freight transportation business. A strong network of 859 self-owned and franchise branches, 44 transhipment hubs and a fleet of 2,573 trucks enable VRL to offer logistics solutions to a diversified base of customers across India and focus on the high-margin less than truck load (LTL) business. The company primarily caters to small and mid-sized companies, which reduces business concentration risk. During the six-month period ended September 30, 2010, no single customer contributed more than 2% of revenues and the 10 largest customers accounted for only 5.08% of revenues. VRL has also established a strong presence in passenger transportation services in Karnataka, Maharashtra and Goa, and plans to enter other high-growth metropolitan and Tier 2 cities in western, central and northern India. The grade also takes into account a strong second line of management.

The grade is moderated by VRL's historically aggressive debt-funded expansion program which resulted in high gearing and strained its financials. We have taken into account the inherent cyclicality of the transportation industry, where VRL operates an asset-heavy business model; this makes it difficult for VRL to adjust its capacity to reduced freight availability in case of an economic downturn. There exists further scope to improve the management information system (MIS) - the company at present does not capture details of total tonnage handled and aggregate kilometers run by all its vehicles. We believe these details are important to analyse the logistics business.

VRL's revenues increased at 14.1% CAGR between FY08 and FY10 to Rs 7.1 bn, on the back of huge expansion in fleet size and stable contribution from the wind power business. EBITDA margins declined from 19.8% in FY08 to 16.7% in FY09 as the company did not pass on the incremental cost to the customers following the economic downturn. However, EBITDA margin rebounded in FY10 to 19.4% due to economic revival, which supported freight availability and freight rates. The increased operating cash flow helped the company reduce its borrowings resulting in lower interest cost. VRL's profit increased at a CAGR of 96% between FY08 and FY10 to Rs 288.7 mn.

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About the company

VRL is one of the leading provider of transportation and logistics service for goods and passenger transportation services in India. The promoter, Mr Vijay Sankeshwar, set up the transportation business in 1976 with one truck. Vijayanand Roadlines Private Ltd was incorporated in 1983. It was rechristened VRL Logistics Ltd in 2006. Today it is the largest private sector owner of commercial vehicles with a fleet of 2,573 trucks and 256 buses.

VRL operates goods transportation services across 534 cities in 20 states and six union territories in India, supported by a strong network of 436 self-owned branches and 423 exclusive franchise offices. It has established 44 transshipment hubs which facilitate the hub and spoke model, and offer flexibility to transport a broad range of goods and services to multiple destinations.

VRL launched passenger transportation services in 1996. It currently offers these services in 93 cities of Karnataka, Maharashtra and Goa, along 188 routes.

In 2006, VRL ventured into the wind energy business and has an installed capacity of 42.5 MW at Kappatgudda in Gadag district in North Karnataka. The power generated is sold to Hubli Electricity Supply Company Ltd (HESCOM) under six power purchase agreements (PPAs). The wind energy business is not VRL's core area of operations and is used as a tax management tool.

Issue details

Shares offered to public	23,566,667
As per cent of post issue equity	25%
Object of the issue	• Funding the purchase of vehicles for the passenger and goods transportation business • Funding the prepayment of certain loans availed by the company • General corporate purposes
Amount proposed to be raised	Not available at the time of grading
Price band	Not available at the time of grading
Lead managers	SBI Capital Market Ltd

Source: DRHP

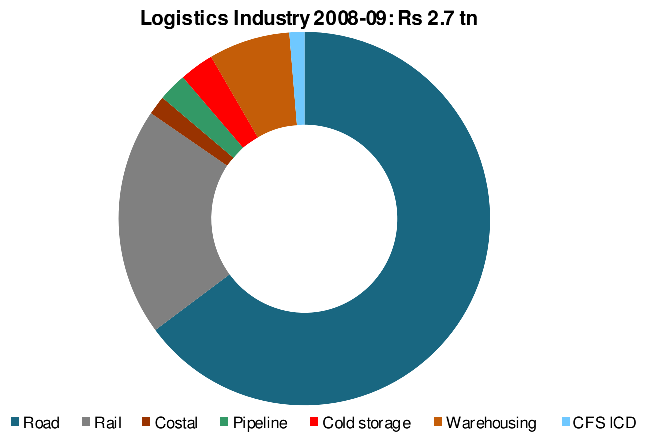
Detailed Grading Rationale

A. Business Prospects

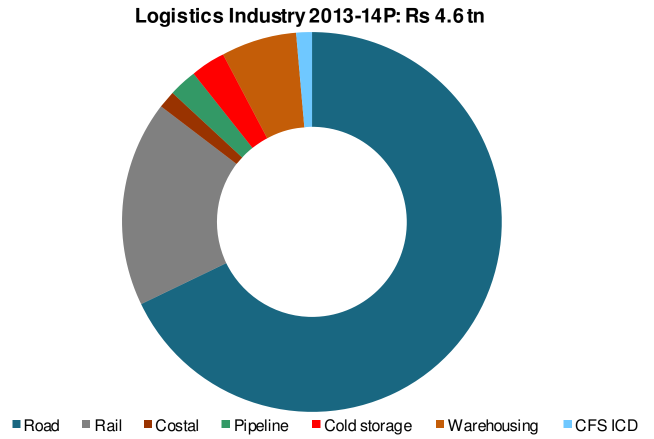
- ### *Transportation and logistics sector register robust growth*

CRISIL Research expects the logistics industry to grow at 11% CAGR to Rs 4.6 tn in 2013-14 from Rs 2.7 tn in 2008-09. It is expected to benefit from: ***a)*** strong economic growth, ***b)*** growth in logistics spending as firms compete to reach target consumers across geographies and ***c)*** favorable government policies.

Logistics industry to grow at 11% CAGR to Rs 4.6 tn in 2013-14



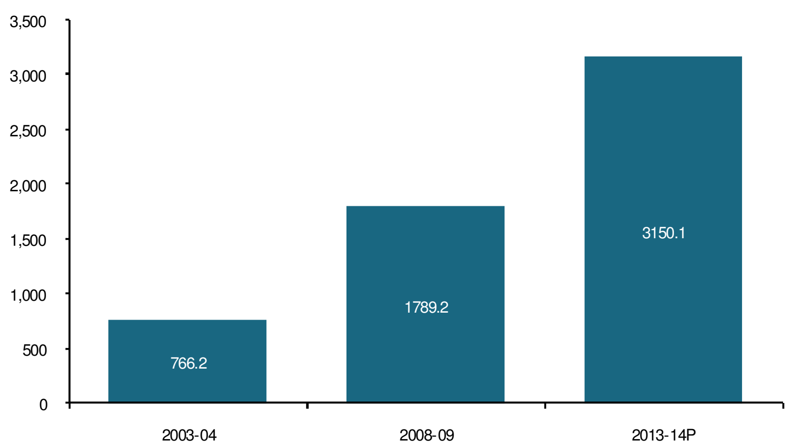
Source: CRISIL Research



Source: CRISIL Research

The share of road transport in freight movement has steadily increased from 14% in 1950-51 to around 61% today. The road segment is expected to register strong growth supported by improved infrastructure and growth in non-bulk freight movement on account of increased demand. CRISIL Research expects the road transportation industry to grow at a CAGR of 12% to Rs 3.2 tn in FY14.

Road freight transport to grow at 12% CAGR over the next 5 years



Source: CRISIL Research

- ### *VRL – a leading player in the domestic freight transportation business*

  Over the years, VRL has established itself as one of the leading players in the domestic freight transportation business across 20 states and six union territories in India with a network of 436 self-owned branches and 423 franchise offices, which act as booking and delivery points. VRL operates a hub and spoke model to support its large scale of operations. VRL's 44 transshipment hubs at strategic locations across India act as the backbone of its logistics services - consignments (FMCG, pharma, cloth, food and other commodities) collected at different locations are consolidated at the hubs before being dispatched to the final destination. These hubs enable VRL to achieve higher freight density across wide geographies and facilitate optimum capacity utilisation. The strong network and fleet of 2,573 vehicles have helped the company offer reliable and timely logistics solutions to a diversified base of customers and emerge as a leading logistics player for transportation of FMCG, pharmaceutical products, food, cloth and general commodities. VRL was conferred the Frost & Sullivan 2009 - Voice of the Customer Award for Best Logistics Provider in the Indian Retail Sector and Voice of the Customer Award for Best Logistics Provider in the Indian FMCG Sector.

- ### *Differentiated consignee-driven model; focus on high-margin LTL business*

  VRL has adopted a differentiated consignee-driven business model with a focus on the high-margin LTL business. It primarily caters to the requirement of small and mid-sized customers who are not serviced by large players. VRL's widespread network of collection and delivery points enables it to service a larger number of customers across different geographies. This reduces its reliance on few large customers and thereby the business concentration risk. During the period ended September, 2010 no single customer contributed more than 2% of revenues and the 10 largest customers accounted for only 5.08%.

  The India-wide network of collection and delivery points and its strategically located transshipment hubs have enabled the company to focus on the attractive LTL business. The LTL service offers higher rates per load compared to the full truck load (FTL) service as it involves consolidation and transportation of freight from numerous customers to multiple destinations and, thus, generates higher net revenue per vehicle. Further, freight rates for the LTL service are based on the weight, volume and the distance compared with the FTL service which involves transportation of a single customer's freight to a single destination, with freight rates based on the distance. This has helped the company record better profitability compared with other large organised players who largely focus on the FTL business.

- ### *Increasing focus on the higher-margin express cargo services business*

  Within the LTL cargo business, VRL is focusing on expanding its presence in the high-margin express cargo services. At present, the company offers express cargo services to its clients across India. The business accounted for 10.8% of the goods transportation business revenues in FY10. The strategy to expand its express cargo service is positive since these services are priced at a premium compared with general LTL and FTL services.

- ### *In-house capabilities in body-building and vehicle maintenance, a key strength*

  VRL has developed strong indigenous capabilities and has achieved a high level of integration in its operations which support optimum capacity utilisation and increased profitability. It orders customised vehicles with higher horse power and has an in-house body-building facility where it builds lighter vehicles with longer bodies, which enable it to carry higher payload per vehicle and support increased profitability. VRL has established a large repair and maintenance facility and six satellite workshops in India to support its operations. VRL has an arrangement with Ashok Leyland who has set up a dedicated outlet for supply of spare parts at its facility at Varur in Hubli, Karnataka which ensures availability of genuine parts at lower rates and eliminates inventory cost.

- *Strengthening passenger transportation business: venturing into new regions*

  VRL is planning to expand its passenger transport services to high density metropolitan and Tier 2 cities in western, southern and central India, which are not adequately serviced by other private transporters. VRL plans to leverage its brand name and its network in the freight transport business to support its passenger transportation business. We believe this business offers significant opportunities given increasing urbanisation, and under-penetration of quality and reliable services across the country. Further, passenger transportation is a high-margin business on a cash basis and will strengthen the company's operational performance.

- *Wind power project accredited by UNFCC for carbon emission reductions trading*

  VRL's wind power project has received accreditation from UNFCC and received necessary approvals for the trade of carbon credits in 2010. It has entered into an agreement with ADB for the sale of ~318,800 CERs to be generated beetween March 2009 and December 2012. ADB has agreed to acquire 171,176 CERs at a price of US$15.83 per unit and the balance at a price of US$17.18. Accordingly, VRL has received an advance of Rs 123.8 mn towards 58,200 CERs to be delivered by July 1, 2010. The CER trading revenues will support increased profitability of the business in the near term.

- *Cyclical nature of business*

  The transportation industry is cyclical in nature and susceptible to trends in economic activity. VRL operates an asset-heavy business model and this makes it difficult for it to pass on the incremental cost to the customers in case of an economic downturn. The economic downturn during FY09 affected the company's profitability.

- *High debt to equity ratio*

  VRL has a very high debt to equity ratio on account of its historically aggressive debt-funded expansion program. As of March 31, 2010, the company had a gearing of 3.5x with a debt of Rs 3.7 bn and net worth of Rs 1 bn. CRISIL Equities expects the gearing to decline post the IPO as the company plans to use ~Rs 1.1 bn from the IPO proceeds towards pre-payment of some of the loans to bring down the leverage to comfortable levels.

- *MIS can be improved*

  VRL operates a hub and spoke model and largely focuses on the LTL business, which involves transportation of goods to and from multiple customers and multiple geographies. At present the company does not maintain MIS on total tonnage handled and aggregate kilometers run by all its vehicles. We believe these details are important to analyse the logistics business.

B. Financial Performance

VRL's revenues increased at 14.1% CAGR between FY08 and FY10 to Rs 7.1 bn with the goods and passenger transport businesses benefiting from the fleet expansion and strong economic activities. Stable contribution from the wind power business also boosted revenues.

Fleet Expansion Goods Transportation	FY05	FY06	FY07	FY08	FY09	FY10	Sept,10
Truck Fleet	1,071	1,451	1,632	2,184	2,495	2,485	2,520
Net additions	380	181	552	311	10	35	53
Total Feet	1,451	1,632	2,184	2,495	2,505	2,520	2,573
Passenger Transportation	**FY05**	**FY06**	**FY07**	**FY08**	**FY09**	**FY10**	**Sept,10**
Busses	188.0	227.0	245.0	247.0	217.0	196.0	211.0
Net additions	39.0	18.0	2.0	(30.0)	(21.0)	15.0	45.0
Total Fleet	227	245	247	217	196	211	256

Source: Company

EBITDA margins declined from 19.8% in FY08 to 16.7% in FY09, as the economic downturn restricted the company's ability to pass on the complete increase in fuel and other cost which impacted margins. However, the EBITDA margin rebounded in FY10 to 19.4% due to the revival in economic activity, which increased both freight availability and freight rates. With the increased operating cash flow, the company reduced its borrowings, which lowered interest cost. In line with the increased revenues, improved margins and lower interest cost, VRL's profit increased at a CAGR of 96% between FY08 and FY10 to Rs 288.7 mn.

Financial performance snapshot

		FY08 Actual 12 months	FY09 Actual 12 months	FY10 Actual 12 months	1HFY11 Actual 6 months
Operating income	Rs mn	5,453	6,484	7,105	4,330
EBITDA	Rs mn	1,081	1,085	1,380	961
EBITDA margins	%	19.8%	16.7%	19.4%	22.2%
Net profits	Rs mn	75.4	32	289.7	316.0
RONW	%	7.7%	3.1%	27.2%	27.2%
Basic EPS	Rs	1.1	0.2	4.4	4.3
Diluted EPS	Rs	1.1	0.2	4.4	4.3
No. of equity shares	mn	70.7	70.7	70.7	70.7
Net worth	Rs mn	1,025	1,038	1,092	1,160
Book value per share	Rs	14.5	14.7	15.4	15.9
Net debt – equity	x	4	3.8	3.3	3.1

Source: DRHP,

*Note: Numbers have been reclassified as per CRISIL standards

C. Management Capabilities and Corporate Governance

- ### *Experienced top management*

  VRL's management is highly experienced in the logistics and transportation sector. The promoter Mr. Vijay Sankeshwar started the freight transportation business in 1976 and has played an active role in establishing VRL as a leading pan-India player in the domestic transportation business. Managing director Mr. Anand Sankeshwar has over 19 years experience in the transportation business and looks after VRL's strategic and marketing activities.

- ### *Strong second line of management*

  VRL has a strong and experienced second line of management in place, with most of them associated with the company since long. Other functional heads have good domain expertise and are well aware of the business opportunities, their strengths and weaknesses. We believe that the second line of management is capable and has been given the adequate autonomy to take decisions independently.

- ### *Experienced independent directors*

  The company has highly qualified independent/non-executive directors with more than three decades of experience in their respective fields like industry, finance, law and management.

- ### *Expanded into unrelated business in the past, but management is now focused on logistics for VRL*

  In the past, the promoters had invested in the media business which led to tight cash flow position and consequently the company delayed payments to its bankers. Post the divestment of the media business, the company, in order to get tax incentives, also ventured into the Wind Power business using borrowed funds, resulting in high gearing.

  However, management is now keen to focus only on the transportation business and will not venture into unrelated diversifications. The management plans to enter the media business in the future but that will be through a separate company which will have no relation with VRL's operations.

Annexure I

Business Profile

VRL Logistics Limited (VRL) is mainly engaged in the business of transportation and logistics service for goods and transportation of passengers by road. Its pan-India goods transportation business offers solutions such as less than truck load ("LTL"), full truck load ("FTL") and express cargo services. The company offers passenger transportation services in Karnataka, Maharashtra and Goa. The company also operates courier services, wind power generation, and an air charter business.

Business segments

Goods transportation business (82.6% of FY10 revenues): VRL's pan-India goods transportation and distribution business operates across 20 states and six union territories and covers 534 cities. Its network includes 436 owned branches and 423 exclusive franchisee offices. The company has established 44 transshipment hubs operating on the hub-and-spoke model, with flexibility to transport a wide range of goods with delivery options to multiple destinations.

Passenger transportation business (13.2% of FY10 revenues): VRL operates passenger transport services in Karnataka, Maharashtra and Goa, covering 188 routes and 93 cities. The company operates a fleet of 256-owned vehicles with support from 56 owned branches and 515 franchisees.

Wind Power generation (4% of FY10 revenues): VRL operates 34 wind turbine generators with a power generation capacity of 42.5 MW at Kappatgudda in Gadag district in north Karnataka. The power generated is sold to Hubli Electricity Supply Company Ltd (HESCOM) under six power purchase agreements (PPAs). The wind power project is registered with the United Nations Framework Convention on Climate Change (UNFCCC) and has received all the necessary approval for trading carbon credits.

Air charter (0.2% of revenues): VRL also offers air charter services to individuals and corporate clients. The aircraft is used by corporate houses, high net worth individuals and the government of Karnataka. Management said that more than 50% of the usage is for internal purposes for VRL's senior management.

Annexure II: Profile of the Directors

Name	Designation	Age	Qualification	Date of appointment	Years of experience	Previous employment	Directorships / partnership in other entities
Mr. Vijay Sankeshwar	Executive Director, Chairman and Managing Director	60	Bachelor's degree in Commerce from Karnataka University, Dharwad.	March 31, 1983	35		VRL Securities Ltd, VRL Media Ltd, VRL Cements Ltd
Mr. Anand Sankeshwar	Executive Director, Managing Director	35	Bachelor's degree in Commerce from Karnataka University, Dharwad.	January 4, 1993	19		VRL Securities Ltd, VRL Media Ltd, VRL Cements Ltd
Mr. Sudhir Ghate	Independent Director	52	B.Com and Chartered Accountant	June 15, 2005	28	Ganesh & Sudhir Chartered Accountants	Trichur Heart Hospital Ltd, Avon Organics Ltd, Magnum Intergrafiks Pvt. Ltd, Mangalore Infotech Solutions Pvt. Ltd
Mr. C. Karunakara Shetty	Non- Executive Independent Director	57	Master's degree in Commerce and C.A. IIB)	June 15, 2005	33	Vijaya Bank	Bhagavathi Chits Pvt. Ltd, Bhagavathi Stocks and Shares
Mr. J. S. Korlahalli	Non-Executive Independent Director	70	Bachelor's degree in Commerce	June 16, 2010	38	Education professional	NIL
Mr. Prabhakar Kore	Non- Executive Independent Director	63	Master's degree in Commerce	June 16, 2010	45	Industrialist	Rajkumar Forge Ltd, Pune Shiva Shakti Sugars Ltd

Source: DRHP