



C MAHENDRA EXPORTS LIMITED

Issue Details

C. Mahendra Exports Limited proposes to come out with an Initial Public Offer (IPO) of 15 million shares of face value Rs. 10 each, through the book building route. Of the total issue, at least 50% would be reserved for Qualified Institutional Buyers (QIBs), not less than 15% for non-institutional investors, and 35% for retail investors. Post-IPO, the shares will be listed on Bombay Stock Exchange and the National Stock Exchange.

Proposed Use of IPO Proceeds

The IPO proceeds are proposed to be used primarily for:

- Setting up of a diamond processing unit at Gujarat Hira Bourse, SEZ, Ichchhapore, Surat
- Setting up of a jewellery manufacturing unit at Mumbai
- Setting up retail outlets
- Brand development expenses
- Investment in subsidiary C. Mahendra BVBA (CMBVBA)
- General corporate purposes

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IPO Grading

ICRA has assigned an IPO Grade 2, indicating below average fundamentals, to the proposed initial public offering (IPO) of C. Mahendra Exports Limited (CMEL). ICRA assigns IPO gradings on a scale of IPO Grade 5 to IPO Grade 1, with Grade 5 indicating strong fundamentals and Grade 1 indicating poor fundamentals.

An ICRA IPO Grade is a symbolic representation of ICRA's current assessment of the fundamentals of the issuer concerned. The fundamental factors assessed include, *inter alia*, business and competitive position, financial position and prospects, management quality, corporate governance, and history of compliance and litigation.

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Strengths

- Long experience in the cut and polished diamond business
- Established association with the world's largest diamond mining company, De Beers, ensures steady and assured supply of rough diamonds
- Revenue growth to be driven by the recovery in both volumes and realisations in the export business, as well as diversification into the retail jewellery business through its subsidiary "Ciemme Jewels"
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Concerns

- The CPD business is characterized by high competitive pressures, inherently low value addition and correspondingly modest margins
- While the operating environment has improved, the outlook on margins is still uncertain given the rise in rough prices and the fact that its ability to establish itself in the retail business remains to be seen
- Challenges involved in scaling up the retail businesses, where the company's track record is limited; competition from both established chains as well as strong local players
- Exposure to forex risks as reflected in forex loss in FY 2010 could lead to variability in earnings. High working capital intensity in the CPD because of elongated debtors
- Shareholders returns to be affected by the Overall low / modest operating and net profit margins and high working capital intensity
- Adverse capital structure with high gearing of 4.82x as of FY 2009-10 on standalone basis on account of high working capital borrowings.

Grading Rationale

The assigned grading favourably factor in the company's experience in the CPD business, its long-standing relationship with the major diamond mining company, De Beers, as DTC¹ Sightholder since 1991 and expected improvement in operating income and margins because of the gradually improving operating environment as well as its diversification into retail through its subsidiary. The grading is however, constrained by the low margins inherent in the CPD business, the high variability in profits seen in the last few years, execution risks involved in scaling up the retail business where its track record is limited, and the inherently high working capital intensity in both the businesses which would constrain the company's ability to generate free cash flows. The grading also factors, CMEL's highly leveraged capital structure, resulting from high working capital intensity which limits its financial flexibility.

CMEL has established itself as one of the leading exporters of CPDs from India. CMEL caters to the export as well as domestic markets, with exports accounting for the bulk of its CPD revenues (78% during 2009-10). With an estimated annual turnover of 1.09 million carats in 2009-10, CMEL's product range is dominated by low-value diamonds, with 61% of its sales in 2009-10 contributed by the under-US\$600 price range. The share of higher-value diamonds (above US\$600) has, however, been increasing over the last three years (from around 34% in 2008-09 to 39% in Q1 2010-11), which should have a beneficial impact on the company's margins, going forward.

The diamond industry is very fragmented, with low value addition and is characterized by high competition. Players typically have low margins and the working capital intensity is high arising from the long conversion cycle involved as well as delays in realization of export proceeds, which is more pronounced during demand slowdown in the key export markets. However, CMEL gradual diversification into larger size diamond, where competition is relatively lower, and its long presence in this business and established relationship with both customers as well as suppliers of rough diamonds are a source of comfort.

A portion of the IPO proceeds is proposed to be invested in CMEL's Belgium based subsidiary C.Mahendra BVBA, which acts as the main sourcing channel of roughs for the group after DTC. The company expects that this will enable it to source roughs at attractive prices through direct sourcing from mines as well as further diversify its supplier base in the import market. Since one of the proceeds of the

¹ *Diamond Trading Company Private Limited (DTC) is the London-based rough (uncut) diamond marketing arm of De Beers (South Africa), the largest diamond miner in the world.*

IPO is setting up a third diamond processing unit, sourcing of roughs at attractive prices remain critical for company's profitability.

As a diversification measure, CMEL through its wholly owned step down subsidiary "Ciemme Jewels Limited" ventured into manufacturing and marketing of studded jewellery since 2004. CMEL markets its studded jewellery products under the brand name of "Ciemme". The margins in this business are higher due to the higher value addition, brand salience and sale to the end customer. One of the objects of the IPO proceeds would be to set up a chain of retail stores across the country. However, stiff competition from both established chains as well as strong local players coupled with company's limited track record in the retail jewellery business entails significant challenges for CMEL in scaling up this business.

The company's revenues and margins have shown considerable volatility in the past. While the its revenues have shown a strong growth till FY2008; the growth slowed down in the last two years with severe demand recession in the key export markets, which affected both volumes as well as realisations. The margins and profitability indicators, too, which have been showing an increasing trend till FY 2008 has seen a decline. The volatility in margins is also compounded because of the industry's exposure to exchange rate fluctuations. Also, the businesses remain highly working capital intensive, which affects the company's ability to generate free cash flows and has also led to an adverse capital structure. Going forward, the company's ability to scale up successfully in the retail business coupled with ability to maintain reasonable growth and margins in its core CPD business, as well as ensure a control on the working capital intensity, would be critical.

Company Profile

Initially promoted as a partnership firm by Mr. Mahendra Shah, Mr. Champak Mehta and Mr. Pravin Shah in 1974, C. Mahendra Exports Limited (CMEL) was incorporated as a private limited company in January 2007 and converted into a public limited company in March 2007. CMEL is in the business of manufacturing CPDs (ranging from 0.01 carat to 1 carat). It exports diamonds primarily to Hong Kong, the United States (US), the United Arab Emirates (UAE), Belgium, and Israel. The company has two 100% EOU² manufacturing facilities at Surat (Gujarat). CMEL is the flagship entity of the CMEL group, which also has a diamond jewellery manufacturing and retailing division (under the brand name of *Ciemme*). The group's sales and distribution network is spread across major diamond centres of the world such as Hong Kong, Chicago (US), Houston (US), Los Angeles (US), New York (US), Dubai (UAE), Antwerp (Belgium) and Bangkok (Thailand).

Promoters and Management

CMEL was promoted as a partnership firm by Mr. Mahendra Shah, Mr. Champak Mehta and Mr. Pravin Shah in 1974, who have significant experience) in the gems and jewellery industry.. Its Board of Directors has six Directors, of whom three are Independent directors. Currently, the promoters and promoter group hold 100% of the paid-up capital of CMEL.

CMEL has two direct subsidiaries namely C Mahendra International Limited (CMIL) and CM BVBA and has 9 step subsidiaries most of them operational outside India. The Jewellery business is carried out through its subsidiary Ciemme Jewels Limited and owns 10 retail showrooms at present, primarily located in Mumbai. The subsidiaries aboard are involved in sourcing, trading and marketing of rough and CPDs.

Business & Competitive Position

Diamond processing dominates the overall business mix with a contribution of around 93% of the total sales in 2008-09

Over the years, diamond processing has been the main business of CMEL and the same contributed to around 93% of the total sales in 2009-10. CMEL has a wide product range comprising of CPD's in different sizes, colours and shapes. The product portfolio comprises various cuts including Stars, pointers, large specials, princess cuts, fancies etc.

Exports markets dominates to be major revenue driver for CMEL

More than 80% of CMEL's polished diamond sales in 2009-10 (78% in 2008-09) are derived from exports. CMEL's sales portfolio is spread across the major diamond consuming markets. The major markets to

² Export Oriented Unit

which it sells are Hong Kong (HK), UAE, US, Thailand, Belgium etc. Reflecting the slowdown in US markets, its sales to USA has decreased from 19% in 2006-07 to 7.7% in 2009-10.

The customer profile consists of jewellery manufactures, and sales are mainly routed through its subsidiaries. CMEL's export customers are a mix of its own group companies (subsidiaries) and others. In 2009-10, almost 17% of its total CPD exports (32% in 2008-09) were routed through its group companies. These group companies mainly comprise of its polished diamond marketing and distribution arms present across USA, Hong Kong and Belgium. The company's customer base is concentrated to some extent with around 65% sales in FY 2009-10 arising from top ten customers. Also a part of its total CPD exports were routed through its group companies. These group companies are mainly its polished diamond marketing/distribution subsidiaries³ present across Hong Kong, the US and Belgium. With the growing demand for diamonds in India and recessionary environments in the global market CMEL Group has increased its presence in the domestic market (both in polished diamonds and jewellery manufacturing). CMEL's polished diamond sales in the Indian market increased from a share of 11% in 2006-07 to 17% in 2009-10.

Relatively wide product portfolio; Gradual diversification into higher value segment

Table 1: Product Portfolio

CMEL Export CPD US\$ Price Range	% Value		
	2008-09	2009-10	Q1FY11
Below 200	16%	22%	12%
200 to 350	29%	23%	24%
350 to 600	22%	17%	26%
600 to 1000	12%	10%	12%
Above 1000	22%	29%	27%

CMEL is engaged in cutting and polishing of diamonds of various sizes of both low and high values, ranging from 0.01 to 1 carat. As per industry trends, going forward, a significant share of growth is expected to come from the higher value segment. In line with the shifting trends, CMEL has

Source: Company

increased its share of higher value carats over the past few years. In 2009-10, export of CPDs in the US\$ price range of above 1000 had risen to 29% of total exports from 22% in 2008-09, with gradual increase in the above US\$ 350-1000 segment also. This increased share in larger sizes has resulted in higher p/c realisation for CMEL, and should have favourable impact on profitability.

Sightholder status with DTC and access to other primary source suppliers facilitate a steady supply of quality rough diamonds:

Maintaining an uninterrupted supply of rough diamonds is of critical importance to the Indian CPD industry. The industry obtains its supplies primarily from De Beers, Rio Tinto, Alrosa⁴ and the Antwerp diamond market in Belgium. CMEL enjoys a Sightholder status with DTC since 1991. The sightholder status is due for review/renewal after the completion of the current three-year contract period in March 2011. The company procures 25%-35% of its rough diamonds from DTC; around 15%-25% through its subsidiary - C. Mahendra BVBA in Antwerp (Belgium); and the rest from secondary source suppliers in the domestic and international markets.

De Beers currently sells rough diamonds to an exclusive group of Sightholders⁵ (who are traders or cutters located in diamond cutting centres around the world. All Sightholders are evaluated on various parameters (like technical ability, distribution & marketing, vertical integration, business strategy and financial transparency) and go through a rigorous selection/review process, including BPP⁶ compliance. As a DTC Sightholder, CMEL benefits from steady supplies of quality rough diamonds from DTC at competitive prices, continued advertising & marketing support, and access to DTC's consumer research knowledge base.

³ C. Mahendra BVBA (Antwerp), C. Mahendra Exports (HK) Ltd. (Hong Kong), Ciemme (LA), Inc. (Los Angeles) and C. Mahendra (USA) Inc. (USA) through its subsidiary C. Mahendra (NY) LLC (New York, USA)

⁴ After De Beers and Rio Tinto, Alrosa is the world's third largest diamond mining company by diamond production. The state-owned Alrosa operates the mines situated in the Western Yakutia in Russia. It sells part of its output through DTC, besides selling directly to the market.

⁵ Source: www.dtc-sightholderdirectory.com

⁶ The Best Practice Principles (BPP) Assurance Programme has been developed by DTC to provide evidence to pipeline partners, consumers and other stakeholders that the exploration, extraction, sorting, cutting, polishing, manufacture and sale of diamonds by DTC Sightholders, are undertaken in a professional, ethical, environment-friendly and accountable manner.

Revenues are vulnerable to currency fluctuations; slowdown in the export markets might affect the growth prospects

Since CMEL is primarily into exports, its revenues are denominated in foreign currency (US \$). For FY08, FY09 and FY10 the company's income/ (loss) arising out of exchange difference was Rs. (31.6⁷) crore, Rs. 10.1 crore and Rs. (37.3) crore. Thus, the firm is exposed to the fluctuations in currency markets. The company hedges its foreign currency exposure by entering into forward contracts as well as currency swap to a certain extent of its exposures.

Indian CPD industry witnesses revival in volume growth since November2009, though sustainability of the same in the near future is yet to be seen; long term prospects are expected to be bright

Table: 2 India's CPD exports for the periods ending

Particulars	FY09	FY10 [^]	% change	Q1FY10	Q1FY11 [^]	% change
<u>CPD</u>						
Amount (Rs. crore)	66,225	82,932	25.2%	15,617	27,150	73.8%
Amount (USD Million)	14,605	17,542	20.1%	3,208	5,947	85.4%
Quantity (Crore carats)	4.6	5.8	27.4%	1.3	1.4	7.9%
Value per carat (Rs.)	14,474	14,230	-1.7%	11,942	19,235	61.1%
Value per carat (USD)	319	301	-5.7%	245	421	71.7%
Exchange Rate* in Rs. for 1 US\$	45.5	51.2	12.6%	45.5	51.2	12.6%

Source: GJEPC, *Exchange rates assumed by GJEPC based on RBI average rates , [^]Provisional numbers

The Indian CPD exports have witnessed a robust growth of around 25.2% (20.1% in dollar terms) vis-à-vis the previous year with the polished diamond exports touching Rs. 82,932 crore (~US\$ 17,542 million) in FY10 as compared to approximately Rs. 66,225 crore (~US\$ 14,605 million) in the previous year. This growth has come in the backdrop of steep downward pressure on sales witnessed by the industry since the onset of global credit crisis in late 2008. The revival in growth started to find some pace since Nov 2009 Further; the Indian CPD exports have continued to post a robust performance in the first quarter of the current fiscal as reflected by a strong growth of around 73.8% (85.4% in dollar terms) vis-à-vis the previous year. The growth has been majorly contributed by the emerging markets in Asia (mainly China) and Middle East (mainly Dubai) and partially from some revival of demand in the US market.

In ICRA's view while the credit outlook for the Indian CPD industry is stabilizing, the extent to which the current demand recovery sustains remains a question mark; the profit outlook is also somewhat uncertain, given the increase in the costs of roughs and the likely rise in wage costs. Thus, a strong net worth and a conservative capital structure that enable an entity to absorb volatility in demand and in price realisations would continue to be critically important factors from a credit perspective. Other factors that would also be important from the point of view of credit worthiness include: (a) efficient working capital management , especially the ability to realise export proceeds in a timely manner (b) ability to procure roughs from direct sources (that is, mining companies) as against from the open market, since contracts with mining companies usually ensure steady availability of raw materials at competitive rates; (c) extent of geographically diversified customer base; (d) ability to handle foreign exchange volatility; and (e) extent of forward integration into jewellery, which usually provides better margins vis-à-vis manufacturing of CPDs.

Proposal to set up new diamond processing unit as well as jewellery manufacturing unit to expand business would enable the company to capitalize on the recovery of the gems and jewellery sector

The company intends to invest Rs. 36.0 Cr from the IPO proceeds to set up another diamond cutting and polishing unit with latest technologies at Gujarat Hira Bourse SEZ, Ichchhapore, Surat in order to meet the increasing demand for CPD as well as to supply CPD to our new jewellery manufacturing unit to be set up in Mumbai for captive consumption. Further, this will also entail tax benefit to our Company. The factory would have facilities for sawing, bruting, polishing, assortments of diamonds, strong rooms and

⁷ 100 lakh=1 Crore= 10 million

maintenance rooms for equipments of administrative offices. The installed capacity of the unit is expected to be in the range of 80,000- 100,000 carat per annum.

In addition to it the company also intends to invest Rs. 23.6 Cr for setting up a jewellery manufacturing facility in Mumbai within the SEEPZ zone and will be dedicated for exports. This will enable CMEL to widen the product portfolio in the growing diamond studded jewellery market.

Vertical integration into jewellery retailing; higher profitability venture, however challenge to create strong market position for new brand 'Ciemme'

CMEL has one jewellery manufacturing subsidiary –Ciemme Jewels Ltd. (CJL) (Mumbai) Ciemme Jewels Ltd. at present has 10 retail outlets (5 in Mumbai and 1 in Surat, Ahmedabad, Mangalore and Rourkela), marketing its jewellery ranging under the brand name 'Ciemme'.

The Company intends to open 15 new exclusive retail outlets by year 2013. The Company intends to earmark Rs. 30 Cr out of the Net Proceeds for opening of the aforesaid 15 exclusive retail outlets. The average area of retail store will be around 400 to 500 Sq.Ft. the company intends to open the exclusive retail outlets across the country covering East, West, North and South zones and the execution will be spread over next three fiscals.

Key challenges in retail business

In ICRA's opinion, the key challenges that the company would need to contend with in this business would include competition from established players like Gitanjali Gems and Tanishq on the one hand, and a large number of local players with strong brand equity and loyal customer base on the other. Given the highly working capital intensive nature of the operations, ensuring quick asset turnover would be critical for maintaining growth and profitability. Since the CM group have limited operational history in diamond jewellery business; the ability to rapidly scale up the diamond jewellery business would be critical for revenue growth as well as profitability of the group.

Financial Position

Profitability and Earnings

Table 3: Financial Highlights

(Rs. Crore)	2006-07	2007-08	2008-09	2009-10
	Standalone			
Revenue	1141.72	1366.64	1413.27	1564.87
Growth (Y-o-Y)	25%	20%	3%	11%
OPBDITA	101.52	146.82	98.27	145.40
PAT	44.77	38.53	19.89	21.15
OPM	8.89%	10.74%	6.95%	9.29%
NPM	3.92%	2.82%	1.41%	1.35%
RONW	23.47%	24.79%	11.17%	8.30%
ROCE	11.48%	10.75%	8.68%	8.10%

Y-o-Y: Year-on-Year, OI: Operating Income; OPBDITA: Operating Profit before Depreciation, Interest, Taxes and Amortization; PAT: Profit After Tax; RONW: Return on Net Worth; ROCE: Return on Capital Employed Source: Company Annual report

The company on a standalone basis reported a healthy 14% CARG growth for the last five year fiscal. The growth was driven primarily by rise in CPD business along with movement towards bigger size diamonds which yield better price realizations. However the growth rate dropped FY 2009 onwards due to recession in key markets.

The operating margins witnessed a decline in FY09 on account of slowdown in demand in key consuming markets; however it has recovered marginally driven by increase in both volume and price of polished diamonds. The margins at consolidated level were better on account of jewelery business where value addition is higher. The NPM has been at modest levels due to high borrowing costs due to working capital requirements.

The return indicators have shown a decline because of falling margins as well higher borrowings because of the working capital intensity of the business.

Financial Leverage

Table 4: Capital Structure

(Rs. Crore)	2006-07	2007-08	2008-09	2009-10
	Standalone			
Net Worth	142.83	168.15	188.05	209.20
Total Debt	773.57	886.88	1038.66	1008.92
Gearing	5.42	5.27	5.52	4.82

Source: Company Annual report

CMEL's gearing as on March 31, 2010 stood at a high 4.82x times. The company's adverse capital structure is attributed to its modest accretion to reserve and high working capital borrowings. The company's debt requirements are primarily working capital based.

Working Capital

Table 5: Working Capital Indicators

(Rs. Crore)	2006-07	2007-08	2008-09	2009-10
	Standalone			
Debtor (days)	184	183	220	224
Creditor (Days)	140	119	103	102
Inventory (Days)	67	53	40	74
NWC/OI	69%	67%	77%	69%

Source: Company Annual report

The receivables position has been historically stretched and has worsened during last two fiscals during the recession on account of delay in realization of export bills. The CPD business has a high working capital requirement as the raw material (the cost of rough diamond can be up to 85% of the product cost) and work-in-progress inventory tend to be high because of the production process. Also the company is not able to earn any credit period on rough purchases from DTC with the payment generally required to be made in advance. This increases CMEL's working capital requirement further.

Contingent Liabilities

Table 6: Contingent Liabilities

Rs. crore	FY09	FY10
Corporate Guarantee for a subsidiary company	25.5	22.5
Pending Contracts	1.5	4.2
Bonds executed in favour of President of India for exports and seized goods	5.0	4.0
Disputed penalty under customs act	1.1	1.1
Disputed Service tax liability	0.02	0.02
Disputed Income tax liability		0.04
Total	33.12	31.86

Source: Company Annual report

Corporate governance

Currently's board has six directors, of which the Chairman of the Board is an executive director. In compliance with the requirements of clause 49 of the listing agreement, the company has three executive directors and three independent Directors. This satisfies clause 49 requirements, which states that a company with executive chairman should have at least half of the board comprising of independent directors.

In terms of the clause 49 of the listing agreement, the company has also constituted the following committees:

(a) Audit Committee;

- (b) Shareholders/ Investor Grievance Committee; and
- (c) Remuneration Committee.
- (d) IPO Committee

Compliance and Litigation History

C MEL is involved in some legal proceedings (over disputes relating to income tax, statutory non compliance under different sections of IT-Act ,civil proceeding with respect to insurance claim) and some service tax and custom cases that are at various stages of adjudication by city courts, high courts and various tribunals. The overall amount involved is not very significant.

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