

Media/India
IPO Grading report

DQ Entertainment (International) Limited

Fitch IPO Grade 3(ind)

Fitch has assigned a grade of '3 (ind)' out of a maximum of '5 (ind)' to the proposed initial public offer of DQ Entertainment (International) Limited. The grade indicates the average fundamentals of the issue relative to other listed equity securities in India.

IPO Details

DQ Entertainment (International) Limited proposes an IPO of 16,048,011 equity shares of INR 10 each. This includes a reservation of up to 991,282 equity shares of INR 10 each for eligible employees. The issue would constitute 20.24% of the post issue paid-up capital of the company

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Amendment:

This report updates the report published on 1st February 2010. The number of shares of the issue has been updated for the Pre IPO allotment. The issue size has been revised from 19,820,782 equity shares to 16,048,011.

Shareholding pattern

	Pre issue		Post issue	
	No. of shares	(%)	No. of shares	(%)
Promoters				
DQ Entertainment (Mauritius) Limited	59,462,218*	94.03	59,462,218	75.00
Total holding of promoter	59,462,218	94.03	59,462,218	75.00
Promoter group (other than promoters)	Nil	Nil	Nil	Nil
Total holding of directors (other than promoters)	Nil	Nil	Nil	Nil
Others, if any***	Nil	Nil	Nil	Nil
IDFC Investment Advisors Limited	2,936,427	4.64	2,936,427	3.70
Rajesh Sachdeva	251,402	0.40	251,402	0.32
Ajay Sharma	125,824	0.20	125,824	0.16
Amit Jasani	146,968	0.23	146,968	0.19
Nikhil Vohra	146,821	0.23	146,821	0.19
Pradip Darshan	36,705	0.06	36,705	0.05
Christo Equities Inc.	128,624	0.20	128,624	0.16
Total Holding of Others	3,772,771	5.97	3,772,771	4.76
Eligible employees (pursuant to the employee reservation portion)	Nil	Nil	991,282**	1.25
Public (pursuant to the net issue)	Nil	Nil	15,726,630	19.84
Total	63,234,989	100.00	79,283,000	100.00

Source: Company, Fitch

* Includes 246 Equity Shares held by nominees of DQ Entertainment (Mauritius) Limited. The said 246 Equity Shares include 41 Equity Share held by Tapaas Chakravarti as nominee of DQ Entertainment (Mauritius) Limited.

** Assuming that the Employee Reservation Portion is fully subscribed by the Eligible Employees pursuant to the Issue.

*** The Company has completed a Pre-IPO Placement of 3,772,771 Equity Shares to certain selected investors for cash at a price of Rs. 68.11 per Equity Share.

Grading Rationale

- The grading assigned to DQ Entertainment (International) Limited (DQ) factors in its strong business growth over the past two years. The company has moved from a pure outsourcing service model to one where it does most of its projects on a co-production model along with large animation studios, as well as developing their own Intellectual property (IP) content. In turn, co-production has helped the company secure large projects, as reflected in its robust order book of INR4.7bn as at January 2010, in addition to proportionate rights in respective IPs. Also, DQ's ownership in IP content of animation projects has given it the opportunity to access additional revenue streams such as audio visual distribution, merchandising and publishing rights in the IPs.
- Fitch expects the company's future growth to be largely dependent on the continued roll-out of DQ's IP content. The company has a limited track record of realising revenues from licensing and distribution, although the management expects this to increase significantly in future with the substantial ongoing investments in IP. To mitigate the risk of cash flow mismatch during the execution phase, DQ endeavours to tie up a majority of its project funding prior to commencement, through pre-sales to broadcasters or through co-production arrangements.
- DQ ensures that it receives the service revenues for all co-production projects. Also, prior to executing projects, it endeavours that at least some broadcasters are on board. Should its IP business become successful, this would lead to stable

and recurring cash flows from its various alternate licensing and distribution revenue streams.

- The '3(ind)' grading factors in DQ's inherent cost advantage given low domestic manpower costs; manpower contributes between 45%-55% of total costs depending upon the nature of animation. The grading also takes into account the expansion in the company's EBITDAR margin to 38.6% in FY09 (FY08: 26.6%), due to a combination of manpower cost reduction and more revenue from high-end 3D animation. This has been augmented by in-house training provided to its employees.

Company Background

Tapaas Chakravarti had earlier promoted DQ Entertainment Limited which was engaged in the development of animation production services. DQ Entertainment Limited was amalgamated with DQ with effect from May 1, 2007, pursuant to which DQ Entertainment Limited's business was transferred to DQ. DQ is a wholly-owned subsidiary of DQ Mauritius, which in turn is wholly owned by DQ Entertainment plc - an Isle of Man entity. DQ Entertainment Plc was listed in the AIM market in December 2007, to raise funds for various animation production activities.

Management

The company's founder, Tapaas Chakravarti is the CMD and CEO, and is supported by a professional management team. The company currently has 5 members on its board of directors, of which 3 members are independent.

Board of directors

Name	Age	Designation
Tapaas Chakravarti	53	Chairman and Chief Executive Officer
Rashmi Chakravarti	46	Executive and Non-Independent Director
Kunchithapadam Balasubramanian	66	Non-executive and Independent Director
Theresa Plummer-Andrews	65	Non-executive and Independent Director
Girish Kulkarni	43	Non-executive and Independent Director

Source: Company Data

Business Overview

DQ Entertainment (International) Limited is an animation services and production company focused on both the Indian and international markets. The company carries out production, co-production and global distribution of TV series, direct-to-home videos and feature films. It is also creates game art for online, mobile and next-generation consoles. It has an asset base of over 350 hours of animation content from which it earns revenues through licensing and distribution activities.

Animation Services & Co-Production

A sizeable portion of the company's revenues continues to come from pure outsourcing services, with the remaining coming from service revenues relating to DQ's co-production projects. In outsourcing business, DQ faces competition from animation services companies based out of countries like Korea, Taiwan and Philippines. This is likely to put pressure on margins going forward as these regions have comparable cost structures

The company's strategy of acquiring IP rights has helped reduce customer attrition, and increase the volume of higher-end outsourcing work, leading to better margins for DQ. The company is planning to meet most of its manpower requirement by using in-house trained staff, which should reduce average manpower cost per head, although overall manpower costs will increase in anticipation of the higher revenues

going forward. The company also plans to increase efficiency of its project management, which in turn is expected to increase resource utilisation levels. This could support margins, going forward.

Licensing & distribution

Within its co-production agreements for IP projects, in addition to service revenues, DQ also has a share in future license revenues, in the same proportion as its equity participation.

As of FY09 the company has distribution rights aggregating INR470.5m. The company now has a library of 350 hours of international animated programs. These represent the projects in which the company has a stake in the distribution revenues as well. The company is also investing in its own IP-development, and management expects this to become a major stream of revenues going forward.

Manpower

The company had 2,788 employees as on August 31, 2009. DQ has also set up its own training facilities in Hyderabad and Kolkata, to ensure availability of quality manpower at low cost. These have a capacity of training 270 people per annum. In FY09 the manpower cost is 46% which has declined from 54% in FY08 primarily on account of enhanced productivity of associates due to in-house training, coupled with manpower rationalization.

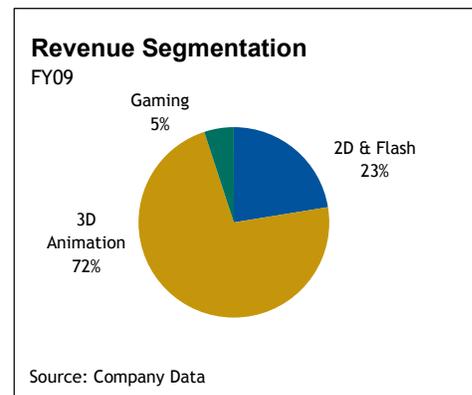
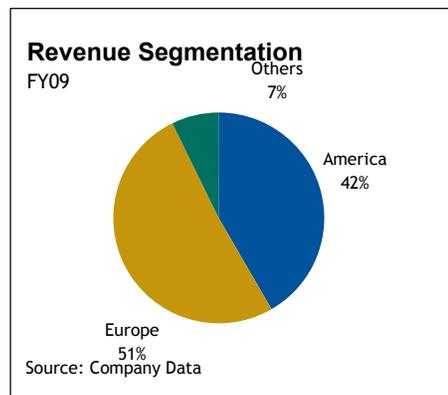
The production capabilities include 10 production facilities in India (8 in Hyderabad and 1 each in Mumbai and Kolkata). Also the company has third-party sales representatives in Paris, Tokyo and Los Angeles

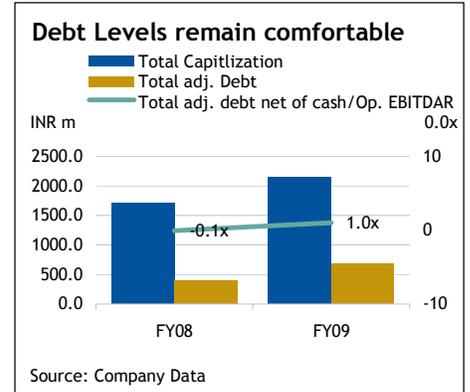
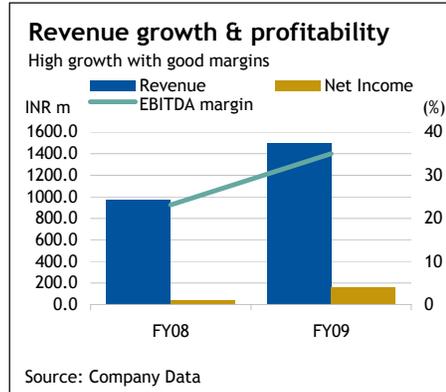
Financial Overview

Growth & Profitability

The company has shown a high growth rate in revenues over FY08-FY09. This has been accompanied by an expansion in EBITDAR margin to 38.6% in FY09, from 26.6% in FY08. Most of the revenues (91%) of the company in FY09 were from television production. Licensing and distribution activities contributed a meagre 5% of revenues, whilst full motion video and game development contributed 4%.

The company has high dependence on the European and American geographies, which together have contributed over 90% to the revenues over FY08 and FY09. Around 72% of the work in FY09 was from 3-D animation, whilst low margin 2-D animation services accounted for the remaining 28%.





Leverage and interest cover

The company has had comfortable leverage levels and interest cover over FY08 and FY09. The total debt in FY09 was INR 364.7m. The net debt/EBITDAR over the last 2 years has been less than 1.0x (FY09: 1.0x) while interest cover remained comfortable at 5.8x in FY09.

Expansion plans - Substantial investment in co-productions

The company has investment plans of INR 1,714.7m over FY10 and FY11. Around 75% of the total funds requirement, excluding funds to be raised through the issue, has been arranged as follows:

Funding Arrangement

Particular	In INR Million
Aggregate funds required for the objects of the issue	1,714.3
Funding through the net proceeds of the issue	1086.7
Funds required excluding the net proceeds of the issue	628.0
75% of the funds required excluding the proceeds issue	471.0

Arrangements regarding 75% of the funds required excluding the proceeds of the Issue

Funded through existing equity/Internal Accruals	39.7
Funded through third party debt	
- Loan agreements	112.5
- Sanction letters	335.0
Total Debt	447.5
Grand Total	487.2

Source: DRHP

The major portion of this capex would be for co-production and own IP developments in various animation products as follows:

Spending plan (INRm)

Particulars	Amount to be	
	Estimated financed requirement from net of Funds* proceeds	Debt
Investment in co-production agreements, focusing on IP	1049.67	565.17
Development of office premises and production facilities: Development of infrastructure and additional facilities at the SEZ unit, Kokapet Village	519.16	392.13
Investment in subsidiary DQ Entertainment (Ireland) Limited	145.90	129.22

Source: DRHP

* Apart from net proceeds and debt, the remaining amount is to be funded by internal accruals

Annexure 1

Financial Summary

Income Statement	2009	2008*
Revenues	1,509.1	945.7
Revenue Growth	59.6	-
EBIT	255.0	124.4
Interest Expense Net of Interest Income	55.6	43.4
Net Income	161.5	70.1
Balance Sheet		
Cash and Equivalents	105.4	429.3
Total Assets	2,184.5	1,952.3
Total Debt	364.7	403.7
Off-Balance Sheet Debt	312.9	0.0
Total Adjusted Debt	677.6	403.7
Preferred Stock + Minority Interests	2.0	2.0
Common Equity	1,460.4	1,298.7
Total Adjusted Capitalisation	2,140.1	1,704.4
Cash Flow		
Operating EBITDAR ("Op. EBITDAR")	581.8	251.7
Cash Interest Paid, Net of Interest Received	31.0	36.8
Cash Tax Paid	0.0	0.0
Associate Dividends	0.0	0.0
Other Changes before Funds From Operations	2.0	-19.4
Funds from Operations	552.9	195.5
Working Capital	-501.6	-150.9
Cash Flow from Operations	51.3	44.6
Non-Operational Cash Flow	0.0	0.0
Capital Expenditure	262.9	502.7
Dividends Paid	0.0	0.0
Free Cash Flow	-211.7	-458.1
Receipts from Asset Disposals	2.3	0.0
Business Acquisitions	0.0	0.0
Business Divestments	0.0	0.0
Exceptional & Other Cash Flow Items	0.0	0.0
Net Cash In/Outflow	-209.4	-458.0
Equity Issuance/(Buyback)	0.0	675.3
FX movement	0.0	0.0
Other Items Affecting Cash Flow	-75.6	1.6
Net Cash Flow Available for Financing	-285.0	218.9
Closing Net Debt	259.3	-25.6
Profitability		
Op. EBITDAR/Revenues (%)	38.6	26.6
EBIT/Revenues (%)	16.9	13.2
FFO Return on Adjusted Capital (%)	30.5	14.0
Credit Ratios		
Funds From Operations/Gross Interest Expense (x)	10.9	5.5
FFO Fixed Charge Cover (x)	6.5	5.5
Op. EBITDAR/Net Fixed Charges (x)	5.8	5.8
Adjusted Leverage/FFO (x)	1.0	1.7
Total Adjusted Debt Net of Cash/Op. EBITDAR (x)	1.0	-0.1
Total Adjusted Debt/Total Adjusted Capitalisation (%)	31.7	23.7

Source: Fitch

* From April 13,2007 to March 31,2008

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