



M AND B SWITCHGEARS LIMITED

Issue Details

M and B Switchgears Limited (MBSL) proposes to come out with an Initial Public Offer (IPO) of 50 lakh shares through the book building route. Subsequent to reservation for the eligible shareholders, at least 50% of the Net Issue shall be reserved for Qualified Institutional Buyers (QIBs), not less than 15% of the Net Issue shall be reserved for non-institutional bidders and not less than 35% of the Net Issue shall be reserved for retail investors. Post-IPO, the shares will be listed on the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE).

Proposed Use of IPO Proceeds

The IPO proceeds are proposed to be used for –

- Setting up a 4 MWp solar photovoltaic power plant at Rajgharh, Madhya Pradesh
- General corporate purpose

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IPO Grading

ICRA has assigned a IPO Grade 2 to the proposed IPO of M and B Switchgears Limited (MBSL), indicating below average fundamentals. 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 standing track record of promoters in the transformer manufacturing business
- Significant growth prospects in the transformer industry because of anticipated increase in power capacity in India and initiatives to reduce Transmission & Distribution (T&D) losses
- Good location of the solar power project being implemented by MBSL with solar irradiation of 5.8-5.5 Kwh /sqm/day Implementation of the solar power project. Choice of proven crystalline silicon technology reduces technological risks
- Reputed and experienced EPC contractor (Tata BP Solar India Limited) appointed for execution of Phase I of the solar power project resulting in lower technological and implementation risks
- Lower year on year variation in solar power projects (as compared to wind or hydro power) expected to result in lesser variance in cash flows

Concerns

- Small scale of operations of the company in the transformer business resulting in lower bargaining power vis a vis larger customers and moderate economies of scale.
- Highly competitive and fragmented nature of the transformer industry with significant competition from small and medium sized players
- High working capital intensity of operations arising out of high debtor days resulting in negative fund flow from operations over the last two years
- Early stage of implementation for solar power project resulting in higher execution risks; however engagement of reputed EPC contractor for Phase I of the project acts as a risk mitigant.
- High cost of power generation make solar power projects highly unviable in the absence of subsidised feed in tariffs or other financial incentives like revenues through sale of Renewable Energy Certificates (RECs). MSBL to derive significant portion of revenues from sale of RECs; however, nascent stage of REC trading in India gives rise to regulatory and market risks
- High off-take risks, as MBSL yet to tie up for sale of power with customers. However, risk is partially mitigated by the power shortage in the state of Madhya Pradesh and low capacity for the project (6MW).
- High funding risks as financial closure for Phase I is yet to be achieved; further funding of Phase II of the project is highly dependent on the successful funding raising through IPO
- Large quantum of equity funding for the solar project resulting in expectations of modest equity returns from the project

Grading Rationale

The IPO Grade assigned by ICRA reflects the long standing track record of the promoters in the transformer manufacturing business; good demand prospects for transformer business given the anticipated additions to power capacity in India and initiatives to reduce Transmission & Distribution (T&D) losses; good location of the solar power project under implementation, moderate approval and technological risks for the project and the appointment of reputed EPC contractor for Phase I of the project. The grading is however constrained by the small scale of operations resulting in lower bargaining power vis a vis customers who are bigger players, highly competitive nature of transformer industry which leads to pressure on operating margins. The grading also takes into consideration the early stage of project implementation of the solar power project, high funding risks as the financial closure for Phase I of the project is yet to be achieved and large part of the funding requirement for Phase II is dependent on IPO proceeds, high regulatory and market risks as MBSL proposes to generate significant revenues from trading of RECs which is at present at nascent stage in India. Moreover, as the company is yet to place orders for Phase II of the project, there is risk of escalation in project cost. The Grading also takes into account the high off-take risks as the company is yet to tie up for sale of power with customers, however, this risk is partially mitigated by the power shortage in the state of Madhya Pradesh and small capacity for the project (6MW). Further, the overall returns from the project are expected to be low given the large quantum of equity funding for the project.

Entity Profile

M and B Switchgears Limited (MBSL) is engaged in the business of manufacturing distribution transformers, power transformers, furnace transformers and special purpose transformers. The company is also planning to diversify its operations into solar power segment and is in the process of setting up a 2MWp grid connected PV solar power project in Madhya Pradesh. Further, the company is planning to set up an additional 4MWp grid connected PV solar power project (for which the company is proposing to come out with an IPO). The company began with a capacity to manufacture 550 transformers per annum and has gradually increased its capacity to 5,109 transformers per annum. Existing annual production capacity is 9, 00,000 KVA per annum on single shift basis.

Promoters and Management

MBSL was promoted by Mr. Shyam Sunder Mundra in 1976 as a proprietorship concern. Subsequently it was converted into a private limited company in 1999 and a public limited company in November 2010. The company has been engaged in the manufacturing of transformers since the last 30 years and primarily caters to the requirements of state electricity boards and government controlled utilities.

Currently, the promoters (i.e Mr. Shyam Sunder Mundra and his family) and their associates have a 100% stake in MBSL. Post the IPO of the company, the shareholding of the promoter group would decline to 70.69%.

Table 1: Shareholding Pattern of MBSL

Category	Pre-Issue	Post-Issue
Promoters & Promoter Group	94.26%	70.69%
Others	5.74%	4.31%
Public	-	25.0%
Total	100%	100%

Source: DRHP

Corporate Governance

MBSL's Board of Directors comprises 6 Directors and includes three independent directors. These Directors are from diverse fields like finance, business, and engineering industry. The Board of Directors of the Company has a combination of executive and non-executive Directors. The company has constituted four committees to comply with corporate governance requirements which include Audit committee, Shareholders'/Investors' Grievance Committee and the Remuneration Committee of which three are chaired by Non Executive Directors.

Business and competitive position

Transformer Business

Significant track record of operations in the transformer business

MSBL has been engaged in the business of manufacturing of transformers since the last 30 years and primarily caters to the requirements of state electricity boards and government controlled utilities. Moreover, over the years, MBSL has increased its presence in high KVA transformers segment and specialised transformers (like furnace duty transformers, dry type transformers, fire proof transformers, potential transformers) has improved its competitive position in the industry.

Share of revenues from non-activities like trading and sale of scrap has declined over the years

Besides being present in the transformer manufacturing business, MBSL is also engaged in trading of iron and steel and sale of scrap. However over the years, the revenue contribution from this non-core business i.e. trading of iron and steel and sale of scrap has witnessed a declining trend which has also resulted in the company reporting higher operating margins over the last three years

Table: Revenue contribution from different segments

Segment	FY 2006	FY 2007	FY 2008	FY 2009	FY2010	7M FY 011
Sale of Transformers	47.32%	72.14%	65.47%	94.91%	88.10%	86.24%
Trading & sale of scrap	52.68%	27.86%	34.53%	5.09%	11.90%	13.76%
Total	100%	100%	100%	100%	100%	100%
Operating Margins	3.62%	3.27%	3.84%	4.76%	8.87%	6.81%

High client concentration risk, though company is taking steps to increase sales to private customer to reduce concentration on sales to State Utilities

MBSL mainly supplies transformers to State Electricity Boards and other Public Sector. In the past, a large part of the revenues of the company have been contributed by Madhya Pradesh Vidyut Vitaran Company (MPVVCL) and Tamil Nadu Electricity Board (TNEB). As top 3 customers of the company account for more than 70% of the its sales, the customer concentration risk is high. Revenue from SEB's constitute around 70% of company's operating income. The payment cycle from SEBs is typically long on account of long drawn process for approval of bills and weak financial profiles of the entities, which has resulted in high debtor days for the company. However, the company is now taking steps to increase sales to private customers, which is expected to diversify its customer profile over the medium term.

Buoyant demand prospects for transformer business

As part of its mission to provide electricity to the entire country by 2012, the Government has set a target of adding over 60,000 circuit kilometres of new transmission lines. The Government is also carrying out expansion of the five regional systems as well as the interregional grid to boost transmission capacity from 17,000 MW to 37,000 MW. The network expansion is expected to continue beyond 2012 commensurate with generation capacity and demand growth projections. Growth of power generation capacity and, transmission and distribution network is expected to boost demand for power and distribution transformers in India. Replacement of transformers installed during the Sixth Plan (1980-85) and Seventh Plan (1985-89) periods is also expected to add to demand. While generation capacity is being augmented, smart-grid technologies are increasingly being deployed to reduce transmission and distribution losses. Going ahead, greater use of 765 kV extra high voltage (EHV) transmission highways and High Voltage Direct Current (HVDC) links are expected to open up new opportunities for the industry.

Small scale of operations of the company resulting in lower bargaining power vis a vis customers and business certainty is dependent upon its ability to successfully bid for tenders: -

The Indian transformer industry is quite competitive. The transformers industry is highly fragmented with large number of players from organised and unorganized segments. Further, players in the unorganized segment catering to the smaller rating distribution transformers have over time moved up the value chain and have started manufacturing higher rating transformers, this has further increased the level of competition in the industry. Besides competing with smaller unorganized players, companies like MBSL also face competition from larger players with long track record of operations in the industry (like EMCO, Bharat Bijlee, Crompton Greaves, Transformers and Rectifiers India Limited (TRIL), Kirloskar Electric, Voltamp Transformers and Indian subsidiaries of multinational companies such as ABB, Siemens, and Areva T&D) and Chinese manufacturers. MBSL's small scale of operations results in limited bargaining power with customers, moreover, as the company's main customers comprise of state electricity boards where the procurement is driven by tender, thus the company's future growth will be dependent on its ability to secure orders.

Solar Power Business**Good location of projects coupled with use of proven PV technology moderates technology related risks**

The project site (for Phase I and Phase II) is located in Village Gagorni, District Rajghar, Madhya Pradesh. The project site falls under a solar irradiation zone of 5.8-5.5 Kwh/sqm/day, which results in it being a relatively high irradiation zone.

MBSL will be implementing the project using the Crystalline Silicon PV technology for the entire 6 MW of solar power project, which is an established and proven technology for implementation of solar power projects. Use of PV technology coupled with good location of the project reduces the technological risks. Moreover, solar power projects witness less annual variation as compared to wind and hydro power, causing lesser variance in cash flows.

Moderate approval risk as all necessary approvals required for commencement of construction in place

The company has fully acquired the 18.52 hectares of land required for implementation of Phase I and Phase II of the project. All the necessary statutory approvals required for commencement of construction of the project has been obtained by the company, reducing the approval risk for the project to a large extent.

Other approvals required for evacuation of power, registration for receipt of REC have been applied for by the company (for Phase I) and will be required at a later stage when the projects will be nearing completion.

Execution risks exist due to early stage of project implementation, however, engagement of experienced and reputed equipment suppliers and contractors acts as mitigant

MBSL has appointed Tata BP Solar India Limited (Tata BP Solar) as the turnkey solution provider for Phase I of the project. Tata BP Solar would be responsible for providing equipment, setting up of the plant, commercial production, and evacuation of electricity and as EPC contractor. Tata BP is an experienced player with more than --- years experience in the solar power industry. Though the project is still in initial stages of implementation and the promoters have limited experience in implementation of solar power projects, however, appointment of Tata BP Solar as the EPC contractor provides comfort and acts as a key risk mitigant.

High off-take risks due to lack of arrangement for sale of power; nascent stage of REC trading adds to risk

MBSL plans to generate revenues through two main revenue streams from the solar power project - sale of power to private parties and sale of RECs generated. While sale of power is expected to have limited contribution in the overall revenues from the solar power business, a large part of the revenues would be contributed by sale of RECs.

As per ICRA estimates sale of power on merchant basis along with REC is expected to result in adequate returns, but at the same time, returns would be highly exposed to market and regulatory risks. While the RECs will be traded on the power exchanges for market-based price discovery with ceiling and floor levels as set by the CERC, the overall risk profile for solar projects adopting the REC framework remains high, given the uncertainties over the pricing of RECs and the absence of a strong enforcement and penalty mechanism for ensuring RPOs by SERCs as of now.

Project cost appears to be reasonable; however company exposed to funding risks

The project cost for Phase I and Phase II is estimated to be around Rs. 17.48 crore/MW, which is comparable to the projects implemented in India so far. Though the EPC contract for Phase I has been finalized with Tata BP Solar, the company is yet to finalise EPC/ equipment orders for Phase II, which may expose the project cost (for Phase II) to escalation risks. The funding risk for the company remain high, as the company is yet to achieve financial closure for Phase I of the project. MBSL proposes to fund Phase I of the project through term loans of Rs. 22.50 crore and equity / promoter contribution of Rs. 11.00 crore. Though the promoters have already brought in Rs. 7.46 crore till date, the company is yet to tie up with banks for the term loans, exposing the project to funding risk. The company plans to fund the entire project cost of Rs. 72.0 crore for Phase II through the proceeds of the proposed IPO. Thus, the funding plan for Phase II would be contingent on successful funding raising through the IPO.

Table 8: Total project Cost and means of finance

Cost of Projects	Phase I	Phase II	Means of Finance	Phase I	Phase II
	Rs. Crore	Rs. Crore		Rs. Crore	Rs. Crore
Land	Break up not available	0.36	Debt	22.50	-
Site Development and Civil works		3.00	Equity (promoter funding)	11.00	-
Survey of land, technical survey, including installation and commission charges and project management and training fee		5.40	IPO Proceeds		71.36
Plant & Machinery		62.20			
Evacuation Infrastructure		0.40			
Total Cost		33.50	71.36	Total Funding	33.50

Source: DRHP, Company

Financial position

Significant improvement in operating margins in FY 2010 on the back of lower revenue share from trading business and focus on high value add products

MBSL has reported a healthy CAGR of 27% in revenues in the last five years albeit on a low base. The operating income of the company has increased from Rs. 14.8 crore in FY 2005-06 to 38.2 crore in FY 2009-10. The operating margins of the company have increased from around 3.5% in FY 2006 to FY 2008 to 4.76% in FY 2009 and further to 8.87% in FY 2010. The increase in operating margins has been on account of two factors – reducing share of trading sales in total revenues and increased focus of the company on sale of specialised transformers like furnace transformers, mining and dry type transformers where the company enjoys higher margins. However, with an increase in the scale of operations and increase in working capital borrowings, the interest expense has also increased, which has resulted in less than commensurate growth in PAT despite healthy growth in operating profits.

Going forward, income from solar power will constitute majority of the company's revenues the transformers business however may show a moderate rate of growth.

Table 6: Revenues and Profitability

(Rs. Crore)	2007-08	2008-09	2009-10	FY11-(7M)
Net Sales	18.40	24.80	38.23	24.83
Operating Income	18.76	25.15	38.77	24.83
OPBDIT	0.72	1.20	3.44	1.69
Interest & Finance Charges	0.56	0.64	2.06	1.13
PAT	0.29	0.42	0.93	0.60
NCA	0.37	0.53	1.22	0.79
EPS*	37.79	53.87	120.17	
OPBDIT/OI	3.84%	4.76%	8.87%	6.81%
PAT/OI	1.54%	1.67%	2.40%	2.41%
RoCE	11.32%	10.04%	15.47%	12.24%
RoNW	4.73%	6.37%	10.30%	7.47%

Note: OPBDIT – Operating Profit before Depreciation, Interest and Tax, PAT – Profit After Tax, ROCE – Return on Capital Employed, RONW – Return on Net Worth, EPS – Earnings per share

Source: Company, DRHP

*The face value of shares during FY 2007-08, 2008-09 & 2009-10 was Rs.100.

Increased debt to fund growth in operations has resulted in increased gearing

The net worth of the company has witnessed a substantial increase in FY 2010 on account of Rs. 3.25 crore equity infusion by the promoters and healthy profits. The total debt of the company has also increased significantly over the last few years. The total debt of the company increased from Rs. 1.95 crore as on March 31, 2008 to Rs. 4.85 crore as on March 31, 2009 and further to Rs. 14.43 crore as on March 31, 2010. The increase in debt has been on account of increase in both working capital borrowings as well as long term debt. While the increase in working capital borrowings has been largely to support the increased funding requirements owing to increase in scale of operations, long term loans have been used to fund the capacity expansion of the company.

With an increase in debt levels, the gearing of the company has increased from 0.31 times as on March 31, 2008 to 1.46 times as on March 31, 2009. Though the total debt of the company increased further in FY 2010, the gearing of the company witnessed a moderate decline on account of equity infusion by the promoters in FY 2010. The company is also planning to take an additional loan of Rs 22.5 cores to fund the phase one of solar power project Other debt coverage indicators like interest coverage and NCA / Debt have remained moderate over the past few years. Nevertheless, the proceeds from the IPO coupled with accretion to reserves on account of profits from solar business are expected to result in a decline in the gearing going forward.

Table 7: Capital Structure

<i>(Rs. Crore)</i>	2007-08	2008-09	2009-10	FY 11-(7M)
Equity Capital	0.76	0.76	0.86	10.29
Net Worth	6.26	6.94	11.12	11.65
Total Debt	1.95	10.10	14.43	14.86
<i>Long Term Debt</i>	<i>0.21</i>	<i>4.85</i>	<i>5.73</i>	<i>7.76</i>
<i>Short term debt</i>	<i>1.74</i>	<i>5.26</i>	<i>8.70</i>	<i>7.10</i>
Gross Block	1.40	7.81	9.18	9.26
Gearing	0.31	1.46	1.30	1.28
Long Term Debt / Tangible Net Worth	0.02	0.70	0.51	0.66
Total outside liabilities / Tangible Net Worth	0.89	2.36	1.87	1.94
OPBDIT/Interest	1.28	1.86	1.67	1.50
DSCR	1.55	1.56	1.59	1.2
DSCR (excluding STD /prepayments)	1.55	1.56	1.59	1.2
Total Debt / OPBDITA	2.71	8.43	4.19	5.13
NCA / Total debt	19%	5%	8%	9%

Source: DRHP, Company

Contingent Liabilities**Table 9: Contingent Liabilities**

Particulars	Outstanding as on October 31, 2010
Outstanding Bank Guarantee	2.07
Corporate Guarantee on behalf of - Ambika Conductors Private Limited	1.00
Income Tax Demand	0.79
Total	3.87

Source: DRHP

Compliance and Litigation History**Accounting quality****Significant Accounting Policies**

The accounts of the company are in compliance with the accounting standards and the provisions of the Companies Act. The significant accounting policies adopted by the company are give below –

- **Fixed Assets depreciation and Capital Expenditure**
 - a. Fixed assets are carried at cost of acquisition less accumulated depreciation
 - b. Depreciation on fixed assets is being provided on straight line basis as the rates prescribed in schedule XIV of the Companies Act, 1956. Depreciation on assets added/disposed off during the year has been provided on a pro rata basis with reference to the month of addition/disposal
- **Inventories** are values at cost or net realizable value whichever is lower, except work in progress is valued at cost

Litigation

- **Key Litigations against MBSL:** There are two proceedings outstanding against the company (pertaining to payment of gratuity and income tax) The litigation against the company one for income tax claim amount to Rs 1.09 crores
- **Key Litigations against Directors of MBSL:** There is no litigation against the Directors of the company

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