



SERVALAKSHMI PAPER LIMITED

Issue Details

Servalakshmi Paper Limited (SPL) is proposing an Initial Public Offer (IPO) consisting of a fresh issue aggregating to Rs. 60 crore. The issue is being made through a 100% book building process where up to 50% of the Issue to the public shall be allotted to eligible qualified institutional buyers (QIBs). 5% of the QIB portion shall be available for allocation on a proportionate basis to Mutual Funds only and the remainder of the QIB portion shall be available for allocation on a proportionate basis to all other eligible QIBs, including Mutual Funds, subject to valid bids being received at or above the Issue Price. Further, not less than 15% of the Issue to the public shall be available for allocation on a proportionate basis to Non-Institutional Bidders and not less than 35% of the Net Issue to the public shall be available for allocation on proportionate basis to Retail Individual Bidders, subject to valid bids being received at or above the Issue Price.

Proposed Use of IPO Proceeds

The company embarked on a project to set up an integrated paper mill, along with a captive power plant at a single location in two phases at a total investment of Rs. 340 crore. Phase I was completed with an investment of Rs. 280 crore and commercial production started from April 1, 2010. The company intends to meet the financial requirements of Phase II through the proposed IPO and would involve adding balancing equipment for improving productivity and producing value added products along with augmenting working capital needs.

| <i>Details</i> | <i>Cost (Rs Cr)</i> |
|---|---------------------|
| Project cost, including pre-operative expenses | 25.00 |
| Augmenting long term working capital requirements | 30.00 |
| Preliminary expenses, including IPO expenses | 5.00 |
| Total | 60.00 |

Analyst Contacts:

K. Ravichandran
ravichandran@icraindia.com
+91-44- 4596 4301

Sivabalan Sekhar
sivabalan.sekhar@icraindia.com
+91-44- 4596 4313

Mathew Kurian Eranat
mathew.eranat@icraindia.com
+91-44- 4596 4309

Relationship Contact:

Jayanta Chatterjee
jayantac@icraindia.com
+91-80- 4332 6401

Website:
www.icra.in

IPO Grading

ICRA has assigned an IPO Grade 2 indicating below average fundamentals to the proposed initial public offering of SPL. ICRA assigns IPO grading on a scale of IPO Grade 5 through 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.

Disclaimer: Notwithstanding anything to the contrary: An ICRA IPO grade is a statement of current opinion of ICRA and is not a statement of appropriateness of the graded security for any of the investors. Such grade is assigned with due care and caution on the basis of analysis of information and clarifications obtained from the issuer concerned and also other sources considered reliable by ICRA. However, ICRA makes no representation or warranty, express or implied as to the accuracy, authenticity, timelines, or completeness of such information. An ICRA IPO grade is not (a) a comment on the present or future price of the security concerned (b) a certificate of statutory compliance and/or (c) a credit rating. Further the ICRA IPO grade is not a recommendation of any kind including but not limited to recommendation to buy, sell, or deal in the securities of such issuer nor can it be considered as an authentication of any of the financial statements of the company and ICRA shall not be liable for any losses incurred by users from any use of the grade in any manner. It is advisable that the professional assistance be taken by any prospective investor in the securities of the company including in the fields of investment banking, tax or law while making such investment. All services and information provided by ICRA is provided on an "as is" basis, without representations and warranties of any nature.

Strengths

- Favorable demand prospects for paper consumption in various segments in the medium to long-term owing to factors such as governmental initiatives and current low per capita consumption in India
- Operational advantages to the company include plant location, configuration and access to captive power
- Part of the Servall Group which has for over four decades been in the paper manufacturing and paper equipment industry
- Minimum project execution risk with completion of Phase I and commencement of commercial production from April 2010

Concerns

- Although there is demand upside for paper consumption in the country, upcoming capacity additions in India are expected to outpace demand in the medium-term thereby leading to supply overhang and consequent pricing pressure
- Paper industry is prone to cyclical volatility leading to volatility of profit margins
- High competition on account of fragmented industry structure
- Volatility in profits due to forex rate fluctuations as the company is exposed to overseas sales and raw material imports
- Limited track record with production under stabilization phase in Printing & Writing Paper (PWP) with minimal PWP sales; however, this is partially mitigated with steady orders in Newsprint (NP) segment
- Weak financial risk profile with high gearing

Grading Rationale

The IPO grade assigned by ICRA reflects the favorable long-term demand prospects for the paper industry owing to various government initiatives (such as Sarva Shiksha Abhiyan), low per capita consumption of paper and the over all economic growth being witnessed in the country; the operational advantages with the company in the form of proximity to Tuticorin Port for imports and exports, backward integration with deinking plant and captive co-generation power plant and technology advantages such as POM technology; the promoters' established track record in the paper manufacturing and engineering industry spanning over four decades; and the minimum project execution risks on account of completion of Phase I and commencement of commercial production from April 2010. The grading also factors in the anticipated supply glut in the industry with ongoing capacity expansion programs of other incumbents in the medium-term leading to possible pricing pressures; the cyclical volatility inherent to the paper industry leading to fluctuating profit margins; and, the high fragmentation in the industry. The grading is also constrained by the vulnerability of profits to forex rate fluctuations as the company is exposed to exports (currently estimated at 20% of total sales) and imports (currently estimated at 70% of total purchases including imported fuel for co-generation power plant); the limited track record with production under stabilization phase for PWP; and the weak financial risk profile with high gearing (4.27 times as at end-March 2010).

Company Profile

Servalakshmi Paper Limited was incorporated as Sri Sai Shakthi Raam Papers Private Limited in November 2005. Its name was changed to Servalakshmi Paper Private Limited in January 2007 and later the company was converted into a public limited company in April 2010. SPL, part of the Servall Group of Companies (Servall Group), is engaged in the business of manufacturing PWP and NP at its plant in Kodaganallur village, Tirunelveli, Tamil Nadu spread over 340 acres. The company, which commenced commercial production from April 1, 2010, is being set up in two phases: phase one included setting-up a Greenfield paper manufacturing plant of 90,000 metric tons per annum (mtpa) capacity with a multi-fuel, cogeneration power plant of 15 mega watt (MW) capacity and 300 tons per day (tpd) deinking plant; phase two includes capex to improve productivity and enable manufacturing of value-added products, and augmenting of long term working capital requirements. The second phase is to be funded with the proceeds from the IPO and is expected to be completed by March 2011.

Promoters and Management

SPL is part of the Tamil Nadu-based Servall Group of Companies (Servall Group), which has been present in the paper industry for over four decades. Servall Group is involved in various segments of the paper industry such as paper machinery manufacturing, paper manufacturing like NP and PWP, project consultancy and turnkey project implementation.

The Servall Group has the following closely held paper mills, apart from SPL, which are engaged in the manufacturing of newsprint, printing and writing paper, and specialty paper.

- (i) Danalakshmi Paper Mills Private Limited (DPMPL)
- (ii) Servalakshmi Paper and Boards (P) Limited (SPBPL)
- (iii) Vijayalakshmi Paper Mills (VJPM)

The Group also handles turnkey projects, design, consultancy, erection and commissioning of paper machinery, machine rebuilding, unit equipment and spares for more than 300 paper mills in Asia, Europe, Africa and the Middle East through

- (i) Servall Engineering Works Private Limited (SEWL), which is engaged in the manufacturing of machineries and accessories for paper manufacturing units
- (ii) Techno Spin Private Limited (TSPL), which is engaged in the manufacturing of rolls and spares for paper industry

SPL is currently 100% held by the promoter and promoter group. The breakup of the pre-issue shareholding pattern is as follows.

| Shareholder | No of Shares | % of Shares |
|---|-------------------|---------------|
| Servalakshmi Paper and Boards Private Ltd | 8,237,246 | 36.7% |
| Danalakshmi Paper Mills Private Ltd | 5,346,056 | 23.8% |
| Servall Engineerings Works Private Ltd | 4,835,030 | 21.6% |
| Mrs R Jeevanlatha | 1,274,588 | 5.7% |
| Mr R Ramswamy | 1,097,000 | 4.9% |
| Mr Y Shivram Prasad | 600,000 | 2.7% |
| Mrs Nirupa Sriramulu | 540,000 | 2.4% |
| Mrs Shobana S Prasad | 440,000 | 2.0% |
| Techno Spin Private Ltd | 54,080 | 0.2% |
| Total | 22,424,000 | 100.0% |

SPL is managed by a team of professionals with vast experience in the industry and the promoters are also actively involved in the daily operations of the company. The team includes Mr. R Ramswamy, Chairman and Managing Director, Mr. K Padmanabha Reddy, Chief Executive Officer (Marketing), Mr. Raghu Reganti, CEO (Works), Mr. S P Guptha, Senior General Manager (Commercial); and Mr. M. Ganesan, Senior General Manager (Finance and Accounts).

Mr. Ramswamy is the founder of the Servall Group and has over four decades of experience in the paper industry. Mr. Reddy heads the marketing function of the paper division and has 32 years of experience in the industry with companies such as Tamil Nadu Newsprint and Papers Ltd. and, Hindustan Paper Corporation. Mr Reganti has 33 years of experience and has previously worked in A P Rayons Ltd, a unit of Ballarpur Industries Ltd and Khanna Paper Mills Ltd. Mr Guptha and Mr Ganesan have over 30 years of experience in their respective fields and have been associated closely with the Servall Group.

Corporate Governance

The Board of Directors of the company has seven directors of whom one is an executive director and three are non-independent, non-executive directors and three are independent directors. As per the provisions of the Listing Agreement to be entered into with the Stock Exchange(s), the company has complied with the corporate governance code in Clause 49 to the extent applicable. The board functions largely through the following committees: Audit Committee, Remuneration Committee and Shareholders'/Investor Relations Committee. All the members of the committees are non-executive directors.

Business and Competitive Position

Demand prospects are favourable in the paper industry; however, ongoing capacity additions by other incumbents may lead to supply overhang in the medium-term

The Indian paper industry had an estimated capacity of 8.4 million tonnes per annum (mtpa) in 2008-09. With a consumption of approximately 8.7 million tonnes in 2008-09, the per capita consumption of paper was around 9 kg, as against the world average of 58kg. The low per capita consumption, combined with the increasing literacy levels, government investment in education, changing urban lifestyles and overall economic growth offer favourable growth opportunities for the paper industry.

However, the capacity additions currently anticipated in the industry, over 2008-2013, is in the range of 2.3 mtpa; of which PWP alone is estimated to be over 60%. Therefore, in the long-term, while there is scope for favorable demand upside, the capacity additions in PWP may outpace the demand leading to supply glut in the domestic markets causing pricing pressures

Domestic PWP prices have seen steadily rebounded recently; however, ongoing capacity additions may lead to softening of prices. High reliance on imported newsprint due to inverted duty structure and poor quality of domestic newsprint; domestic newsprint prices move in tandem with international prices.

Prices of paper in all segments increased during the period 2006-08, but following the reversal in global economic cycle in the second half of 2008, international prices saw significant correction. However, domestic PWP prices did not fall to the extent of domestic newsprint and industrial paper and board prices. The domestic PWP segment remains shielded to some extent because majority of writing paper used in India is of lower quality with limited scope for import substitution, as also the resilience of demand for PWP from a wide variety of end users and applications. Going forward, the unfavourable demand supply situation may create downward pressure on the PWP prices. However, the recent upswing in international PWP prices provides opportunities for domestic manufacturers to increase export volumes and moderate domestic supply; as a result, domestic PWP prices are currently witnessing firming-up of prices. Besides, the increasing trend in outsourcing of printing from EU to India is expected to strengthen demand for domestic PWP paper.

Duty on imported newsprint is currently zero, whereas the basic duty on raw material imports like waste paper and wood pulp continue to remain at 5%. The adverse impact of the duty structure on domestic manufacturing has been represented to the Government of India by Indian Newsprint Manufacturers association (INMA) and is under consideration. The inverted duty rate structure along with the poor quality of domestic newsprint has led to high reliance on imported newsprint by Indian media houses. Consequently, domestic newsprint prices move in tandem with international prices, albeit at a discount due to its inferior quality. Thus, domestic newsprint manufacturers are exposed to volatility in prices arising from global price movements.

Phase I of the paper mill project completed marginally behind schedule; Phase II of project, to be completed by March 2011, will increase productivity and enable production of value added paper.

The paper production plant is being set up by SPL in two phases. Phase I, which involved setting up of the pulping machine, deinking plant, power plant, head-box assembly and calendaring was completed marginally behind schedule (from the earlier proposed completion by January 2010 to April 2010). The delay was on account of floods that damaged the piping system for bringing in water to the plant. The cost of Phase I was Rs 280 crore, out of which Rs 224 crore was funded through debt and the rest through equity. Commercial production of paper started on April 01, 2010.

Phase II of the project, being set up at a cost of Rs 60 crore will involve the purchase and installation of equipment for value added product manufacturing, and augmenting long term working capital requirements. The cost of capital expenditure under this phase is Rs 25.00 crore, including Rs 4.32 crore of civil work. Post Phase II, the capacity of SPL would increase to 108,000 mtpa.

Locational advantage includes proximity to Tuticorn Port and tax incentives

The factory located at Tirunelveli sources water from Thamirabarani River, which is a perennial water body. The company has received necessary permissions from relevant authorities for drawing water from the river though concerns regarding water tapping from Thamirabarani had been raised in the past. The site, which is spread over an area of 340 acres, currently has an ETP to process effluent water and the same is released within the premises of the site for development of greenery and irrigation of sugar cane. Further, the management has started cultivating sugar cane in a portion of the site using the ETP water to demonstrate that the water is safe for agriculture. The plant is located 72 kms from the Tuticorin Port thereby providing proximity for imports and exports. Since the company depends on imported raw materials for its production (70% of the total raw material

requirement), net costs towards the logistics would be lower than factories located in the hinterland. Since the company would have export sales, proximity to Tuticorin Port is beneficial and since export sales would be quoted in net landed-cost basis. SPL will be able to extract better margins through exports than any competitor that is located inland.

The company, with a capex of Rs. 340 crore against the eligibility criterion of Rs. 250 crore, is entitled for Value Added Tax (VAT) refunds from the Government of Tamil Nadu through its industrial policy for promotion of investments in Southern backward districts such as Tirunelveli. Besides, the company also enjoys excise duty rate of 0% for the first 3,500 tons of paper production. The plant occupies an area of around 60 acres, out of a contiguous area of 340 acres owned by the company. This is located only 18 km from the Tirunelveli town. The available land can be used by the company for future expansions or can be held as land bank with expected price appreciation.

High dependence on imported wastepaper exposes SPL to volatility in international prices and rupee-dollar exchange rate movements

The major raw material for SPL is imported wastepaper (estimated over 70% of total wastepaper consumed) which is then converted to pulp by the deinking plant. SPL would also consume virgin wood pulp (estimated around 10% of total pulp requirement) depending upon the quality of the end product and customer requirements. The major sources of imported newspaper are the USA, the European Union, Australia and the Middle East. Despite the incidence of 5% basic import duty on wastepaper, due to the poor recovery of waste paper in India and lower quality of wastepaper from domestic sources, the reliance on imported waste paper is high. Since SPL imports waste paper in significant quantity, it is exposed to the cyclicalities in international waste paper prices, which in turn have a high correlation to the international pulp prices. The company, however, has a natural hedge on exchange rate fluctuations to a limited extent since it plans to export up to 25-30% of its production to countries such as Sri Lanka and Singapore. Nonetheless, SPL has hedged its position through currency forwards on a case-to-case basis.

SPL is self-sufficient in power requirements with multi-fuel cogeneration power plant; exposed to volatility in P&F costs as it is predominantly dependent on imported coal for fuel

SPL is backward integrated with captive, multi-fuel power plant at Tirunelveli of 15 MW providing stable power and steam for paper production. The estimated power requirement at full plant capacity is 12 MW and the excess capacity will enable the company to absorb the power requirements of any future expansions. Till such expansion, SPL is selling the additional power to Tamil Nadu Electricity Board (TNEB). The primary fuel used by SPL in its boiler is imported coal. The quantity of coal required at full capacity is around 300 tpd. Although proximity to Tuticorin Port provides savings in the form of lower land freight costs, the company remains exposed to volatility in international coal and freight charges. Nonetheless, the company uses multi-fuel feedstock such as bio-waste and lignite for its boiler thereby reducing its exposure to imported coal.

Product stabilization to be completed by year end

Although the company started commercial production in April 2010, minor slippage in synchronization led to low capacity utilization in the first half of 2010-11. Average capacity utilization for the first six months was only 32% and crossed 70% from Q3FY2011 (that is, when capacity for FY 2011 is considered as 75,000 MTPA as per lead-bankers financial appraisal). The product mix for the same period has been 25% PWP and 75% newsprint as against the company's planned production of 70% PWP for the year. As newsprint prices are lower than PWP prices, this will result in lower average sales realization for 2010-11. Once stabilization for PWP production is completed, the company expects to commence production of PWP at planned capacity.

SPL to focus on higher margin PWP products albeit at the lower price bands within that segment; 'FSC' certification to aid exports to EU / USA

The company intends to manufacture and market newsprint and PWP under its "Lakshmi" brand. The company's plant has the flexibility to produce NP and PWP of varying grades. The planned product mix in the first year is 70:30 for PWP and NP. The 70% PWP segment would offer around 45% through whole sale and 55% through retail. The retail segment further broken in to 20% copier, 10% maplitho, 15% note book and the remaining 10% for computer stationery. The long term product mix planned by the company is 80% PWP and 20% NP with focus on copier and maplitho paper. The company does not have a concrete product mix policy as of now as it is under stabilization phase. Because SPL's PWP is manufactured primarily from wastepaper, the company pitches its products just below grades of players such as Ballarpur Industries Limited, JK Paper Limited and Tamil Nadu Newsprint and Papers Limited. It is estimated that around 40% of the copier market is constituted by consumers such as photocopier shops and the company intends to target such price-sensitive consumers. The company has also obtained Forest Stewardship Council (FSC) certification which is expected to fetch higher realizations given the ability of SPL to manufacture using recycled paper.

SPL is currently negotiating with publishers and media houses for long term tie-ups

SPL is also under negotiations with potential customers like Navneet Publishers, Repro India Ltd, Ajanta Publishers, Thomson Press, and FFI International for long term agreements for PWP off-take. For NP sales, the major domestic customers so far are The Times of India, Deccan Herald, The Hindu, Kerala Kaumudi and Rashtra Deepika. NP is typically sold on order basis without any long term agreements.

SPL plans to export nearly 25-30% of its production as part of its long term marketing strategy. Because SPL's paper is manufactured from wastepaper, it is eco-friendly and has been recommended for the Forest Stewardship Council (FSC) certificate.

Financial Position

The company started commercial operations in April 2010

| Particulars | | Q1FY11 | FY 10 | FY 09 | FY 08 |
|----------------------------|----------|---------|----------|----------|---------|
| Operating Income (OI) | Rs Cr | 14.8 | - | - | - |
| Growth in OI | % | - | - | - | - |
| OPBDIT | Rs Cr | 1.5 | -0.0 | -0.1 | -0.1 |
| Profit After Tax (PAT) | Rs Cr | -10.5 | -0.1 | -0.1 | -0.0 |
| Net Cash Accrual | Rs Cr | -5.0 | -0.0 | -0.0 | -0.0 |
| Total Debt | Rs Cr | 247.4 | 230.5 | 123.8 | 17.8 |
| Tangible Net Worth | Rs Cr | 45.6 | 53.9 | 42.4 | 23.4 |
| Total Assets | Rs Cr | 320.9 | 302.1 | 174.4 | 41.5 |
| OPBDIT/OI | % | 10.0% | - | - | - |
| PAT/OI | % | -70.9% | - | - | - |
| Return on Capital Employed | % | -9.7% | -0.3% | -0.3% | -0.2% |
| Return on Net Worth | % | -85.1% | -0.2% | -0.3% | -0.2% |
| Total Gearing | Times | 5.43 | 4.27 | 2.92 | 0.76 |
| OPBDIT/Interest | Times | 0.22 | -7.79 | -49.19 | - |
| Net Working Capital/OI | % | 53.0% | - | - | - |
| Debtors days | Days | 33 | - | - | - |
| Creditors days | Days | 132 | - | - | - |
| Inventory days | Days | 235 | - | - | - |
| Capex outflow | Rs Cr | (21.18) | (107.85) | (108.42) | (15.44) |
| Free cash flow | Rs Cr | (19.31) | (122.53) | (125.42) | (22.17) |
| Earnings Per Share | Rs/share | | -0.04 | -0.11 | -0.08 |

Operating income was nil till FY 2010 since commercial production commenced from April 2010. The company generated revenues of Rs. 14.8 crore during the first quarter of FY 2011 with operating margin of 10%, net margin of -70.9%. The negative margin was primarily on account of lower capacity utilization, high interest expense (Rs. 6.6 crore) and depreciation (Rs. 5.5 crore) during the quarter.

SPL had a high gearing of 4.27 times as of end-March, 2010. The total debt includes Rs 214.55 crore of long term debt for the purpose of funding Phase I of its paper mill project. The remaining short term debt is around Rs 15.89 crore. The gearing is expected to decrease in 2010-11 following infusion of equity through the IPO to 2.4 times as at end-March 2011. However, due to the losses in Q1FY2011, the net worth reduced and consequently gearing increased to 5.46 times as at end-June, 2010. The working capital indicators are also high as the company has stocked high levels of raw material. The repayment of term loans commence from October 2011 in quarterly installments at Rs 8 crore per quarter for 7 years.

Prospects

Going forward, earnings growth will be contingent on successful stabilization of operations of Phase I and timely commissioning and stabilization of Phase II project. Further, this is expected to be moderate in the medium-term, with main challenges being the moderately weak price outlook on account of supply glut and its ability to successfully market various grades of PWP and NP with its FSC certification.

Litigation History

There are no outstanding litigations/suits or civil/criminal prosecution, proceeding or tax liabilities against the company. However, some of its promoter/group companies are part of certain legal and other proceedings.



ICRA Limited

An Associate of Moody's Investors Service

CORPORATE OFFICE

Building No. 8, 2nd Floor, Tower A; DLF Cyber City, Phase II; Gurgaon 122 002

Tel: +91 124 4545300; Fax: +91 124 4545350

Website: www.icra.in

REGISTERED OFFICE

1105, Kailash Building, 11th Floor; 26 Kasturba Gandhi Marg; New Delhi 110001

Tel: +91 11 23357940-50; Fax: +91 11 23357014

Branches: **Mumbai:** Tel.: + (91 22) 3047 0000, Fax: + (91 22) 2433 1390 **Chennai:** Tel + (91 44) 4596 4300, Fax + (91 44) 2434 3663 **Kolkata:** Tel + (91 33) 2287 8839 /2287 6617/ 2283 1411/ 2280 0008, Fax + (91 33) 2287 0728 **Bangalore:** Tel + (91 80) 2559 7401/4049 Fax + (91 80) 559 4065 **Ahmedabad:** Tel + (91 79) 2658 4924/5049/2008, Fax + (91 79) 2658 4924 **Hyderabad:** Tel +(91 40) 2373 5061/7251, Fax + (91 40) 2373 5152 **Pune:** Tel + (91 20) 2552 0194/95/96, Fax + (91 20) 553 9231

© Copyright, 2011 ICRA Limited. All Rights Reserved.

Contents may be used freely with due acknowledgement to ICRA.

ICRA ratings should not be treated as recommendation to buy, sell or hold the rated debt instruments. ICRA ratings are subject to a process of surveillance, which may lead to revision in ratings. Please visit our website (www.icra.in/www.icraratings.com) or contact any ICRA office for the latest information on ICRA ratings outstanding. All information contained herein has been obtained by ICRA from sources believed by it to be accurate and reliable. Although reasonable care has been taken to ensure that the information herein is true, such information is provided 'as is' without any warranty of any kind, and ICRA in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness or completeness of any such information. All information contained herein must be construed solely as statements of opinion, and ICRA shall not be liable for any losses incurred by users from any use of this publication or its contents.