

VKS Projects Ltd

One-time assessment

CRISIL IPO Grade 1/5 (Poor)

May 09, 2012

Grading summary

CRISIL has assigned a CRISIL IPO grade of '1/5' (pronounced "one on five") to the proposed IPO of VKS Projects Ltd (VKS). This grade indicates that the fundamentals of the IPO are poor relative to the 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.

Weak revenue visibility is the major factor which has constrained the IPO grade assigned to VKS. As of June 2011, VKS' order book of Rs 967 mn translated into 1.6x FY11 sales; this provides revenue visibility for the next 12-15 months only. Though the company has a fairly good execution track record in handling mechanical, piping and heavy equipment erections for various process industries, of late it has been accepting orders for civil construction or earthworks – recently it accepted two such orders worth ~Rs 950 mn. These are not complex jobs and are positioned lower in the value chain; moreover, these orders could also be margin dilutive. Hence, undertaking such jobs indicates that the company is not focusing on its core competency. The grade is further constrained by the company's inability to win large contracts from marquee clients. Although the company has in the past bagged orders from clients such as Reliance, Thermax, Deepak Fertilizer, Rashtriya Chemicals & Fertilizers (RCF), and IG Petro, we believe its inability to get repeat orders of large magnitude from these clients is a matter of concern.

The grade also considers the high concentration risk faced by VKS as orders from two new clients comprise 97% of the order book. Any delay or hiccups in these orders or companies could have an adverse impact on revenues going forward. Moreover, working capital is also high with working capital days in the range of 90-100. Owing to higher working capital requirements, debt increased to Rs 132 mn in FY11 from Rs 52 mn in FY10. Besides, the business is highly dependent on promoter Dr V Sukumaran and there is a need to strengthen the second line of management.

The only positive for VKS is its strong execution track record. So far, the company has completed ~40 projects, without any major hiccups, in nine different states across India. Over a period of time, VKS has built up capabilities and obtained necessary pre-qualifications, which have led to an increase in average ticket size to ~Rs 400-500 mn from ~Rs 20-30 mn.

VKS' revenue increased from Rs 33 mn in FY07 to Rs 597 mn in FY11 following its order intake increasing at 102% CAGR. EBITDA margins contracted by 125 bps y-o-y in FY11 to 11.4% due to higher employee cost. Reported net profit has increased to Rs 27 mn in FY11 from Rs 1 mn in FY07 owing to robust revenue growth. VKS' net worth for FY11 was Rs 128 mn compared to Rs 32 mn FY10.



About the company

VKS Projects Ltd (VKS) is a Mumbai-based engineering, procurement and construction (EPC) company undertaking mechanical and infrastructural construction contracts for fabrication and erection of high pressure piping, and heavy equipment erection. The company is an expert in fabricating and erecting reaction vessels, vacuum tray driers, storage tanks and heat exchangers for industries such as refinery, petrochemicals, dyestuff, pharma and bulk drugs, metallurgy, power and textiles. VKS also undertakes civil and land development contracts.

The company's client portfolio includes Reliance, Thermax, Deepak Fertilizer, RCF and IG Petro. During FY07-09, the company undertook projects with an average ticket size of Rs 20-30 mn. Post FY09, it started taking relatively higher-value projects. Recently, it received an order worth Rs 450 mn from PACL India Ltd and another worth Rs 490 mn from Lanco Infratech for civil work at the Anuppur Thermal Power Plant in Madhya Pradesh.

Issue details

Shares offered to public	Not available at the time of grading
As per cent of post issue equity	Not available at the time of grading
Object of the issue	<ul style="list-style-type: none">• Long-term working capital requirement• Procurement of construction equipment and key machineries• Setting up engineering design studio/office and training centers in Chennai, Cochin, Delhi, Hyderabad and Ahmedabad• General corporate purposes
Amount proposed to be raised	~ Rs 550 mn
Price band	Not available at the time of grading
Lead managers	Aryaman Financial Services Ltd

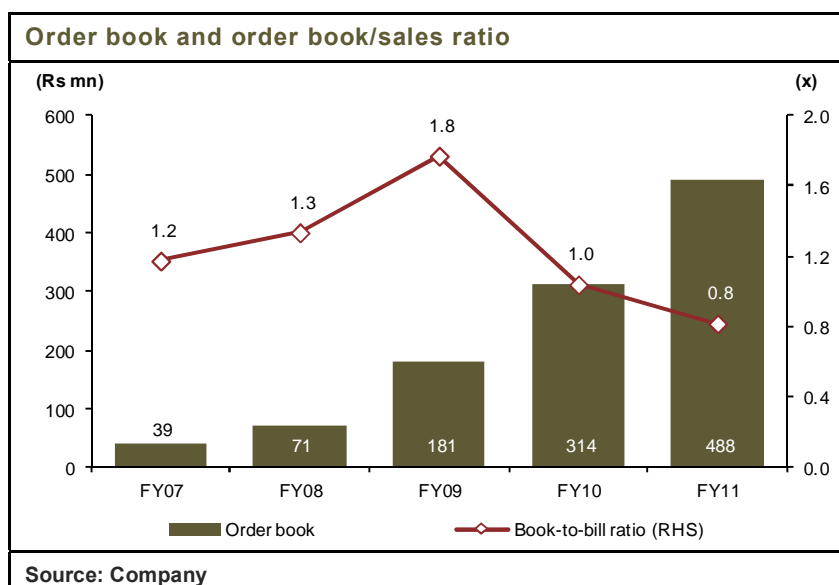
Source: DRHP

Detailed Grading Rationale

A. Business Prospects

▪ **Low order book constraints revenue visibility**

As of June 2011, VKS' order book backlog stood at Rs 967 mn which translates into 1.6x FY11 revenue and provides visibility for only 12-15 months. This is lower compared to other EPC players whose book-to-bill ratio is ~3x. Further, given the current unfavourable business climate faced by the EPC industry and the slowdown in the investment cycle, we are concerned that a low revenue visibility could have an adverse impact on growth going forward.



▪ **Shifting away from core competency; large portion of order book related to civil constructions**

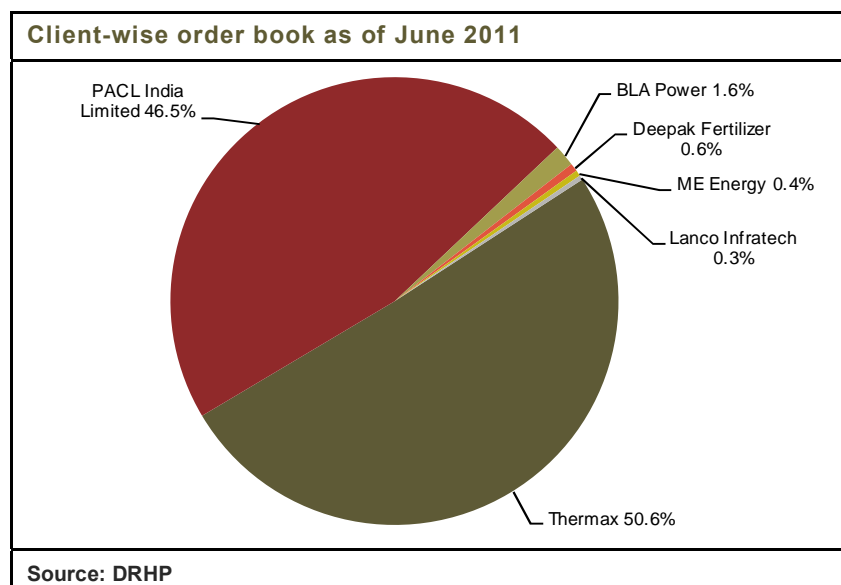
VKS is an EPC player focusing mainly on the industrial infrastructure space such as oil & gas, power, fertiliser, auto, chemical and petrochemical plants. The company's core competency lies in undertaking mechanical and infrastructural construction contracts for fabrication and erection of high pressure piping, and heavy equipment erection. However, it has started taking orders for civil construction or earthworks which are not complex jobs and are lower in the value chain. Recently, it has accepted two such orders worth ~Rs 950 mn. Apart from highlighting the company's lack of focus on its core competency, these orders could also be margin dilutive.

▪ **Unable to win large repeat orders from marquee clients**

Although the company has in the past bagged orders from prestigious clients such as Reliance, Themax, Deepak Fertilizer, RCF and IG Petro, it has not been able to get repeat orders of large magnitude from these clients. Inability to win orders of large ticket size from these clients is a concern.

▪ **High concentration risk**

VKS is exposed to high concentration risk as orders from two new clients comprise 97% of its order book. Any delay or hiccups in these orders or clients could have an adverse impact on revenues going forward.

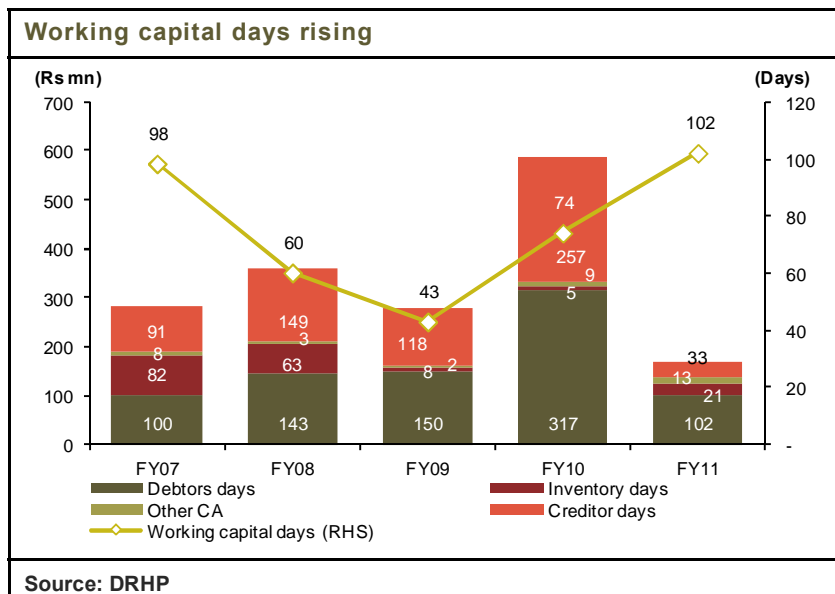


▪ **Absence of price escalation in some projects = risk of margin volatility**

VKS undertakes EPC works mainly for fabrication and erection of plants and machinery for various industrial infrastructure projects. For the projects where the client provides the raw materials, the risk of increase in prices is low; but where the raw materials are not provided by client, the contract value includes the cost of raw materials. Since some of the projects do not have a price escalation clause, fluctuations in prices of raw material in such projects could adversely impact its profitability.

▪ **Increasing working capital requirements**

VKS' working capital requirement has increased given the growing business and the increase in order ticket size. Its working capital days are in the range of 90-100 on account of higher inventory days. As of FY11, the company has inventory worth Rs 34 mn compared to Rs 5 mn in FY10. Owing to higher working capital requirements, debt increased to Rs 132 mn in FY11 from Rs 52 mn in FY10.



▪ **Good execution track record**

However, we note that VKS has a good execution record having executed 40 projects across various states like West Bengal, Karnataka, Punjab, Tamil Nadu, Uttar Pradesh and Uttarakhand; these projects were completed on time and without any major execution hurdles. Currently, it is executing projects in Madhya Pradesh, Maharashtra and Delhi. VKS has strong project management system and safety measures in place, and has been awarded ISO 9001:2008, ISO 14001:2004 and OHSAS 18001:2007 certification for the same.

▪ **Net worth is expected to increase post IPO and enhance financial pre-qualifications**

The company has spent the past few years in building its capabilities and obtaining the necessary pre-qualifications, which has led to strong traction in new order flows. The average ticket size for orders has increased from ~ Rs 20-30 mn to ~Rs 400 - 500 mn. The company recently received orders worth Rs 490 mn from Lanco Infra and Rs 450 mn from PACL Ltd. We believe following the IPO the increase in its net worth will strengthen its financial qualifications and help it to bid for large projects; this will place the company on a strong growth trajectory.

B. Financial Performance

VKS' revenue increased from Rs 33 mn in FY07 to Rs 597 mn in FY11 due to strong inflows of orders. EBITDA margins contracted by 125 bps in FY11 to 11.4% due to higher employee cost. Net profit increased to Rs 27 mn in FY11 from Rs 1 mn in FY07 owing to robust revenue growth. The company's net worth for FY11 was Rs 128 mn compared to Rs 32 mn FY10.

Financial performance snapshot

	(Rs mn)				
Particulars	FY07	FY08	FY09	FY10	FY11
Total operating income	33	53	102	302	597
EBITDA margin (%)	8.3	6.1	0.8	12.6	11.4
Adjusted Net profit / (loss)	1	1	(3)	20	27
Adjusted Net Margin (%)	2.4	1.7	(3.2)	6.6	4.5
ROCE (%)	36.8	16.9	2.0	74.3	33.6
ROE (%)	44.3	21.9	(58.4)	105.4	33.5
Adjusted EPS (Rs)	3.2	3.6	(12.9)	7.3	3.3
No. of Equity Shares (mn)*	0.3	0.3	0.3	2.8	8.0
Net Worth	4	5	6	32	128
Debt-Equity Ratio	2.5	3.3	1.8	1.6	1.0

Note: The financial numbers in this document have been re-classified as per CRISIL standard and hence may not match with the DRHP numbers

* Adjusted for issue of bonus shares in the ratio of 4:1 in FY11

Source: DRHP, CRISIL Research

C. Management Capabilities and Corporate Governance

- ***Promoter has over two decades of experience in the EPC business***

Founder and managing director Dr V K Sukumaran holds a bachelor's degree in mechanical engineering and has more than two decades of experience in the EPC business. He has good understanding of the various technical aspects of the business. He has been instrumental in shaping the company's growth and taking it to the current stage. Based on our interaction with the management, we believe that the management is constantly exploring new business opportunities and has identified opportunities in the power transmission segment.

- ***Dependence on promoter is high; second line needs to be strengthened***

VKS has been largely a promoter-driven company and the dependence on promoter Dr V K Sukumaran is very high. Mr M Parameswaran (CEO) joined the company in May 2011 and does not have any experience in the construction and engineering business. Prior to joining VKS, he was with UTI Technology. We believe that the company at this stage is highly dependent on Dr Sukumaran and there is a need to rope in more professionals with relevant experience and qualifications to strengthen the second line of management. Though the management has appointed a few key people recently with relevant professional and educational qualifications and is taking steps in this direction, we believe that this is not adequate and there is a need to strengthen it further as the company moves towards the next level of growth.

- ***Concerns on remuneration and responsibility***

Dr Saritha Sukumaran, director, is not actively involved in the business. She lacks technical experience and her involvement is limited to matters related to recruitment and administration. We believe the remuneration of Rs 15,00,000, given to her is not justifiable given her responsibilities and contribution to the business. Moreover, salary paid to senior executives in the company is low; for instance, chief executive officer, Mr Parmeshwaran, despite his experience and qualifications, draws a salary of Rs 12,00,000 per annum. In this scenario, the company's ability to retain key personnel can be challenging.

- ***Independent directors are well qualified but lack experience***

Although the independent directors are well qualified and have been with the company for more than a year, they do not have an understanding of either the commercial or the marketing aspects of the business. We believe that their involvement is not high since they lack adequate industry experience.

- ***Ability to exercise management oversight is limited***

Based on our interaction with the company, we believe that independent directors' involvement with the business is low and, hence, their ability to exercise management oversight may not be adequate.



Annexure I

Business Profile

VKS is a Mumbai-based EPC player. It undertakes mechanical and infrastructural construction contracts for fabrication and erection of high pressure piping, fabrication and IBR piping, and heavy equipment erection. The company also has expertise in fabrication and erection of reaction vessels, vacuum tray driers, storage tanks and heat exchangers for industries such as refinery, petrochemicals, dyestuff, pharma and bulk drugs, metallurgy, power and textiles. VKS also undertakes civil and land development contracts.

The company's client portfolio includes Reliance, Thermax, Deepak Fertilizer, RCF and IG Petro. During FY07-09, the company undertook projects with an average ticket size of Rs 20-30 mn. Post FY09, it started taking relatively higher-value projects. Recently, it received an order worth Rs 450 mn from PACL India Ltd and another worth Rs 490 mn from Lanco Infratech for civil work at the Anuppur Thermal Power Plant in Madhya Pradesh.

The company is now eyeing power transmission and has set up a dedicated team to capture business opportunities in this segment.

Annexure II: Profile of the Directors

Name	Designation	Age (years)	Qualification	Yrs of Experience	Directorships / partnership in other entities
Dr V. K. Sukumaran	Managing Director (Promoter Director)	45	B.Tech (Mech), M.Phil, PhD (Green Construction)	20+	<u>Other directorships:</u> NIL
Dr Saritha Sukumaran	Whole-time Director (Promoter Director)	40	Bachelor in Ayurveda, Medicine and Surgery (BAMS)	7	<u>Other directorships:</u> NIL
Mr Jaywant Bolaikar	Independent Director	38	MBA (Finance)	17+	<u>Other directorships:</u> NIL
Mr Roy Daniel	Independent Director	41	B.Sc	10	<u>Other directorships:</u> NIL
Ms Lakshmi Wasekar	Independent Director	31	B.Pharm., PGDBM (Mktg)	7+	<u>Other directorships:</u> NIL

Source: DRHP

Our Capabilities

Making Markets Function Better

Economy and Industry Research

- Largest team of economy and industry research analysts in India
- Coverage on 70 industries and 139 sub-sectors; provide growth forecasts, profitability analysis, emerging trends, expected investments, industry structure and regulatory frameworks
- 90 per cent of India's commercial banks use our industry research for credit decisions
- Special coverage on key growth sectors including real estate, infrastructure, logistics, and financial services
- Inputs to India's leading corporates in market sizing, demand forecasting, and project feasibility
- Published the first India-focused report on Ultra High Net-worth Individuals
- All opinions and forecasts reviewed by a highly qualified panel with over 200 years of cumulative experience
- Largest independent equity research house in India, focusing on small and mid-cap companies; coverage exceeds 100 companies
- Released company reports on all 1,401 companies listed and traded on the National Stock Exchange; a global first for any stock exchange
- First research house to release exchange-commissioned equity research reports in India

Funds and Fixed Income Research

- Largest and most comprehensive database on India's debt market, covering more than 14,000 securities
- Largest provider of fixed income valuations in India
- Value more than Rs.33 trillion (USD 650 billion) of Indian debt securities, comprising 85 per cent of outstanding securities
- Sole provider of fixed income and hybrid indices to mutual funds and insurance companies; we maintain 12 standard indices and over 80 customised indices
- Ranking of Indian mutual fund schemes covering 73 per cent of assets under management and Rs.5 trillion (USD100 billion) by value
- Retained by India's Employees' Provident Fund Organisation, the world's largest retirement scheme
- covering over 50 million individuals, for selecting fund managers and monitoring their performance

Equity and Company Research

- Largest independent equity research house in India, focusing on small and mid-cap companies; coverage exceeds 100 companies
- Released company reports on all 1,401 companies listed and traded on the National Stock Exchange; a global first for any stock exchange
- First research house to release exchange-commissioned equity research reports in India
- Assigned the first IPO grade in India

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