



VMS INDUSTRIES LIMITED

Issue Details

VMS Industries Limited (VMS) proposes to come out with an Initial Public Offer (IPO) of (#) equity shares of face value Rs. 10 each, aggregating to Rs. 25.75 crore. The issue is being made through a 100% book building process wherein up to 50% of the issue shall be allocated on proportionate basis to Qualified Institutional Buyers ('QIBs'), out of which 5% shall be available for allocation on a proportionate basis to mutual funds only and the remaining QIB portion shall be available for allocation on proportionate basis to all QIBs, including mutual funds, subject to valid bids being received from them at or above the issue price. Under-subscription, if any, in the mutual funds portion will be met by a spill over from the QIB portion and be allotted proportionately to the QIB bidders. Further, not less than 15% of the issue shall be available for allocation on a proportionate basis to non-institutional bidders and not less than 35% of the issue shall be available for allocation on a proportionate basis to retail individual bidders, subject to valid bids being received from them at or above the issue price.

Proposed Use of IPO Proceeds

The IPO proceeds of Rs. 25.75 crore and the company's internal accrual of Rs. 0.18 crore are proposed to be used in the manner as stated in *Table 1*.

Table 1: VMS' utilisation of IPO Proceeds and company's internal accrual

Particulars	Rs. crore
Purchase of machineries	5.58
Setting up of corporate office at Ahmedabad	1.10
Long-term working capital requirement	17.40
Issue expenses	1.85
Total	25.93

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IPO Grading

ICRA has assigned an IPO Grade 1 to the proposed IPO of VMS, indicating poor fundamentals. ICRA assigns IPO grading on a scale of IPO Grade 5 through IPO Grade 1, with IPO Grade 5 indicating strong fundamentals and IPO 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, timeliness, 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 are provided on an "as is" basis, without representations and warranties of any nature.

Strengths

- ↑ Relatively larger ship breaking plot leased to the company at Sosiya-Alang in Gujarat, and established infrastructure for beaching and cutting ships. However, further capital expenditure towards purchase of equipment is required to scale up the operations
- ↑ Significant growth in the company's revenue in FY10 primarily led by commencement of ship breaking activities in 2009
- ↑ Healthy profit margins of the company witnessed in FY10 supported by ship recycling and offshore business activities; VMS registered an Operating margin (OPBDITA/OI) of 15.30% and Return of net worth (RONW) of 14.37% in FY10

Concerns

- ↓ Moderate scale of operations and limited experience of the company in ship-recycling business, having actively forayed in this segment in 2009
- ↓ Business exposed to volatility in demand in metal sector and cyclical nature of the ship recycling industry
- ↓ Despite relatively higher entry barriers, the industry is characterized by moderate profit margins due to fierce competition, low value addition and long working capital cycles
- ↓ Exposure to foreign exchange rate risks could lead to variability in earnings

Grading Rationale

ICRA has assigned an IPO Grade 1 indicating poor fundamentals to the proposed initial public offering (IPO) of VMS Industries Limited (VMS). 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. The grading positively factors in the availability of relatively larger ship breaking plot, successful commissioning of ship recycling operations in May 2009 and healthy operating margin during FY10. The grading also takes into account the capable management team and the aggressive plans of the company in ship recycling business to achieve high rate of growth in near to medium term. However; the IPO grade is constrained by VMS' limited track record in ship recycling business, modest scale of operations and price risks inherent in the business given the substantial lead time between purchase of ship and sale of scrap. The company also remains exposed to various environmental and regulatory risks due to the nature of business. The grading is also constrained by high competitive intensity and low value additive nature of operations. Moreover, the profit margins of company remain vulnerable to cyclicity in the ship recycling industry, volatility in metal sector and VMS's exposure to foreign currency exchange rate risk.

VMS is a relatively new player in ship-recycling industry having commenced its operations in May 2009. Till FY08; VMS' revenue largely comprised of fee income from 'Management services and consultancy'. Prior to venturing into ship recycling activity, VMS was providing consulting and information technology services to Bhavnagar Municipal Corporation and also had share in the profit of a partnership firm 'M/s Eternal Automobiles' - a dealer of two wheelers for 'Honda Motor Cycle and Scooter India Pvt. Ltd'(HMC). VMS holds 25% stake in Eternal Automobiles with 75% stake being held by Mrs. Sangeeta Jain who is also one of the promoters of VMS. The company owns tug and speed boat that are leased out to third parties. In FY09, company recorded a total turnover of Rs. 1.41 crore of which 93.0% was due to the leasing activity; 3.5% was in the form of Management services & consultancy and 1.6% was from share in the profit from partnership firm. In FY10 with the commencement of ship breaking activities, the company's scale of operations increased significantly and it discontinued its Management services and consultancy business. During FY10, the company's Operating Income (OI)¹ stood at Rs. 28.66 crore of which 89.8% was from ship-breaking division; 9.9% from leasing activity of the offshore division and 0.1% though profit from share in partnership firm. Till July 2010, the company had purchased 6 ships with a total tonnage of 36,702 MT and had recycled 3 ships with a total tonnage of 20,150 MT. In July 2010, remaining 3 ships were in the process of dismantling, cutting and scrapping.

¹ **Note:** OI for all the past financial years does not account the interest income and revenue from sale of investments of the company; the same have been accounted in the company's Non operating income

The ship-recycling industry is fragmented, and is characterized by high competitive intensity, low value addition and earnings volatility due to its cyclical nature. The entry barrier in the industry is relatively high on account of limited supply of plots for ship breaking at Alang-Sosiya and various compliances/permissions necessary to carry out the recycling operations. Despite relatively higher entry barriers, the industry players have low margins due to fierce competition, low value addition and long working capital cycles. Also, the industry is vulnerable to the volatility of demand in the metal sector and cyclical nature of ship recycling business. The cyclical nature in ship breaking industry is due to international regulations and variability in cargo freight rates, which in turn are dependent on global economic activity. Nevertheless, the concern on the availability of vessels in the international market is partially mitigated by the regulation of International Maritime Organization (IMO) which required tanker owners to stop operating single-hull vessels by the end of 2010 owing to which the number of such vessels available for scrap might see an increase in short to medium term. However; the ship recycling industry is also exposed to the price risks arising from the volatility in demand in the metal sector due to large lead time between purchase of ship and sale of scrap.

VMS purchases ships from international Cash Buyers through agents. Post dismantling, the company sells the ship to steel item manufacturers and processors. In FY10, VMS purchased 3 ships with total tonnage of 20,150 MT at an average purchase cost of approximately Rs. 13,500/tonne. Subsequently, it purchased 3 more ships with a total tonnage of 16,552 MT between April and July 2010. During FY10, the top 10 customers of VMS accounted for over 25% of the turnover from ship recycling activities.

Driven by ship recycling activities; VMS' OI grew from Rs. 1.41 crore in FY09 to Rs. 28.66 crore in FY10. The operating margin (OPM) and net profit margin (NPM) of the company had been healthy at 15.30% and 9.10% in FY10 respectively backed by the upturn in demand of steel. The margins were also supported by high profitability in offshore business. The FY09 OPM & NPM of 74.34% and 51.29% respectively are not comparable to those of FY10 since the company was not involved in ship recycling activities till FY09. In FY10; Return on capital employed (ROCE) and Return on net worth (RONW) stood at 14.83% and 14.37% respectively. VMS avails Foreign Letters of Credit (FLCs) for the purchase of ships, however, till July 2010, the company did not follow any practice to hedge the foreign exchange risk which is a concern from grading perspective.

VMS' equity capital increased from Rs. 2.46 crore as on 31st March 2006 to Rs. 10.04 crore as on 31st March 2010. In FY07; promoters and associates invested Rs. 8.36 crore in the company by subscribing to nearly 16.73 lakh equity shares at a premium of Rs. 40 and face value of Rs. 10 per share. Further, the equity capital of VMS increased to Rs. 10.04 crore as on 31st March 2010 on account of 1:1 bonus issue to the shareholders. The increase in equity capital during FY10 is also attributed to the subsequent issue of nearly 3.55 lakh fresh equity shares representing 3.54% share of the company to new individual investors at a premium of Rs. 30 per share and the face value of Rs. 10 per share. Fresh issue was followed by 1:1 bonus issue in January 2010 to the investors which resulted in total dilution of 7.08% of promoter's stake in the company.

VMS's gearing increased to 0.79 times as on March 31st, 2010 from 0.41 times as on March 31st, 2009 on account of purchase of 3 ships through FLCs and Cash Credit (CC) in FY10. As of 31st March 2010; the company's debt comprised of FLC (60.2%); buyer's credit (29.8%); term loan (5.7%) and unsecured loans (4.0%).

Going forward, the company's ability to time the purchase and dismantle the ships; efficiently execute the cutting operations by way of employing additional equipments and hedging the foreign exchange risks would be critical to ensure its healthy performance.

Company Profile

VMS Industries Limited (VMS) was originally incorporated as 'Varun Management Services Private Limited' on December 2, 1991 at Bhavnagar with the Registrar of Companies, Gujarat, Dadar & Nagar Haveli. The entity became a public limited company in January, 2010 subsequent to which the name was changed to 'VMS Industries Limited'. In the initial years of operations (1992-96), the company was engaged in providing consulting and information technology services to Bhavnagar Municipal Corporation. Between 1994 and 1997; the company supplied oxygen gas to Bhavnagar based ship recycling entities after it acquired an operational oxygen plant in Sihor Gujarat Industrial Development Corporation at Bhavnagar. The plant was shutdown in 1997 when it became financially unviable due to the impact of slowdown in ship recycling industry. In May 2008, VMS entered into the offshore business activities & supporting services by purchasing tug and speed boat. In July 2010, while the tug was operated in the open market on hire basis; speed boat had been leased to Gujarat Maritime Board (GMB) till 5th March 2011. In May 2009; the company commenced its ship recycling operations on the allotted plot at Sosiya near Alang (Gujarat). The 5 year lease contract of the plot is effective from 17th March 2007 to 16th March 2012 and is subject to renewal thereafter. Till July 2010; the company had purchased 6 ships of which 3 have been completely dismantled. VMS also holds 25% stake in a partnership firm 'Eternal Automobiles' which is a dealer of two wheelers for 'Honda Motor Cycle and Scooter India Pvt. Ltd'.

Promoters and Management

VMS is promoted by Mr. Ajit Kumar Jain, his son Mr. Manoj Kumar Jain and other family members. Mr. Ajit Kumar Jain has around 50 years of experience in the field of activities related to ship breaking, dealing in automobile sales and transportation activities. He started the transportation business in 1958 by setting up a partnership firm. In 1966; the firm diversified into the manufacturing and trading of consumer items. In 1994, he set up a rolling mill in Bhavnagar. His son Mr. Manoj Kumar Jain is a Chartered Accountant and a partner in M/s Jain Seth & Co., Chartered Accounts. He has over 10 years of experience in various fields such as finance, taxation and consultancy services. He overlooks the overall operation of the company. The Board of Directors of VMS comprises 6 directors of which 3 are independent directors. Mr. Ajit Kumar Jain is the Managing Director of the company. Presently, the shareholding of the promoter group in VMS is 92.92%.

Corporate Governance

VMS has six directors out of which three are independent directors. This satisfies Clause 49 of Securities and Exchange Board of India (SEBI) for listed companies, which states that a company should have at least half of the board comprising of independent directors. VMS has complied with the corporate governance code in accordance with Clause 49 including constitution of the Shareholders and Investor Grievance Committee, Audit Committee and Compensation Committee.

Business and Competitive Position

Capacity utilization of the ship breaking plot and operational efficiency would be crucial factor to maintain healthy performance of the company going forward: Presently, the company's shipyard at Sosiya (Gujarat) has a capacity to handle ships of tonnage of 40,000 MT in a year. The company's ability to execute its operations efficiently by deploying skilled manpower and additional equipments at the ship recycling yard and to augment its capacity utilization would be the key to its growth. In offshore business; cash flows would depend on the number of days the tug and speed boat are leased in a year along with their respective leasing rate.

Focus of the company on ship recycling operations increases vulnerability to cyclical nature of the ship recycling industry and price risks arising from volatility in demand from metal sector: In FY10; nearly 90% of VMS' OI was contributed by ship-recycling activities while the remaining portion was contributed by offshore division and share in profit of partnership firm. Ship-recycling being the core business operation; VMS is exposed to cyclical nature in the ship recycling industry and price risks arising from the volatility in demand from the metal sector. This is because of large lead time between purchase of ship and sale of scrap. With the increase in the freight rates in recent past; shipping firms might delay scrapping of vessels which may affect the availability of ships in international market. Nevertheless; availability of single-hull vessels is likely to increase in near to medium term on the back of IMO regulation barring

operations of such vessels by the end of 2010. The prospects of the business of ship recycling are also exposed to the demand from the metal sector which largely determines the price of ship scrap. As a result; the timing of the purchase, dismantling of ships and sale of scrap is likely to affect the profitability of the company.

The company's offshore activities which involve leasing of tug/speed boat to third parties and the profit sharing in the business of dealership of two wheelers for HMC contributed to nearly 10% of the revenue of VMS in FY10. The long term nature of lease contract is likely to result in relatively stable cash flows from the offshore activities; however, the contribution as a percentage of the total revenue of the company is significantly low.

Exposure to foreign exchange rate risks: VMS expenditure towards purchase of ships is funded by FLCs denominated in foreign currency while the sale value of ship scrap is realized in domestic currency. Consequently; the profitability margins are also exposed to fluctuation in the foreign exchange rates during the lead time between purchase of ship and sale of scrap which can affect the effective purchase cost of ships.

Capital intensive nature of the business requires for continual funding from external sources to fund working capital requirements: VMS would require managing the funding of its inventory (purchase of ships); debtors and other operational costs. This is likely to result in high net working capital (NWC) requirement and hence the ability of the company to grow would depend critically on its capability to tie up external funds or promoter's capability to infuse equity.

Financial Position

Growth, Profitability and Earnings

Robust growth in the VMS' OI in FY10 owing to its venture into ship breaking activities in May 2009 coupled with healthy operating and net profit margin

Table 2: Profitability indicators

(Rs. crore)	FY07	FY08	FY09	FY10
Operating Income	0.05	0.11	1.41	28.66
Growth (Y-o-Y) (%)	85.08%	102.40%	1223.07%	1929.11%
OPBDITA	0.04	0.05	1.05	4.39
PAT	0.02	0.03	0.72	2.61
OPBDITA/OI	69.19%	46.26%	74.34%	15.30%
PAT/OI	29.95%	31.32%	51.29%	9.10%
ROCE	0.24%	0.38%	4.44%	14.83%
RONW	0.14%	0.22%	4.67%	14.37%

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

Source: Draft Red Herring Prospectus (DRHP)

The historical return indicators of the company as represented by ROCE and RONW are not comparable with that of FY10 since the company started the recycling activity in May 2009. Till FY09; VMS' OI was insignificant and was contributed by 'Management services and consultancy' division; offshore business activities & supporting services and profit sharing in partnership firm. VMS' revenue increased significantly in FY10 on account of commencement of ship breaking activities. In FY10; VMS was able to operate at healthy operating and net margins. The company's return indicators as represented by ROCE and RONW were healthy and stood at 14.83% and 14.37% respectively in FY10.

Financial Leverage

Increase in the company's gearing on account of fresh external funding required for the purchase of ships during FY10

Table 3: Capital Structure & Debt Coverage Indicators

As of the end of	FY07	FY08	FY09	FY10
Equity Capital	4.13	4.13	4.13	10.04
Net Worth	15.10	15.15	15.90	20.39
Total Debt	0.00	0.25	6.50	16.16
Gearing	0.00	0.02	0.41	0.79

Source: DRHP

The historical gearing is not comparable with that of latest gearing as of 31st March 2010 provided in the table above since the company availed new credit lines in the form of Foreign Letter of Credit (FLCs) in order to purchase ships for scrap in FY10. As of 31st March 2010; the company's gearing stood at 0.79 times and its debt comprised of FLC (60.2%); buyer's credit (29.8%); term loan (5.7%) and unsecured loans (4.0%). While the buyer's credit and the term loans were availed by the company to partly fund the purchase of tug and speed boat in FY09; FLCs were availed at the time of purchase of 3 ships in FY10. The ability of VMS to do business critically depends on its borrowing capability since it requires a separate line of credit in the form of FLCs apart from cash credit for the purchase of each ship. Typically, the time period of FLCs is in the range of 180-270 days. During the period from April 10 to July 10; VMS availed 3 more credit lines of FLCs totaling an amount of nearly Rs. 31.6 crore. Going forward, the borrowing capability of the company would largely depend on its ability to increase its net-worth by ensuring healthy profit margins; fulfill financial obligations in a timely manner and the comfort factor of the lenders with the company.

The equity capital of VMS increased in FY10 on account of fresh equity shares issued to new investors coupled with issue of bonus shares to the shareholders by way of capitalization of Rs. 5.01 crore of share premium account. In FY10, the individual investors infused a capital of Rs. 1.42 crore in the form of equity.

Contingent Liabilities

Following table shows the contingent liability of the company as of 31st March 2009 and 31st March 2010:

Table 4: Contingent Liabilities

Particulars	As of 31 st March 2009	As of 31 st March 2010
Bank guarantee	0.64	0.64
Corporate guarantee to banks for bank limits granted to partnership firm where company is partner	0.92	1.65
Total	1.56	2.29

Source: DRHP

Negative fund flow from operations: In FY10, VMS had a negative fund flow from operations (FFO) on account of high net working capital requirements resulting from the increase in inventory due to purchase of ships and increase in trade & other receivables. Stretched FFO of the company is likely to continue in the short to medium term owing to the requirement of maintaining high level of inventory due to the nature of business.

Compliance and Litigation History

There are no outstanding litigations, suits or criminal or civil prosecutions, proceedings or tax liability against the company, its directors, promoters and promoter group that would have an adverse effect on VMS's business as of the date of the Draft Red Herring Prospectus (DRHP). There are no defaults, non-payments or overdue amounts with respect to statutory dues, institutional or bank dues or amounts due to holders of debentures, bonds and fixed deposits and arrears of preference shares. No disciplinary action has been taken by SEBI or any stock exchanges against the company or its directors or its promoter group companies.

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