PIPAVAV SHIPYARD

AVOID

IPO Note

Not plain vanilla ship building

Pipavav Shipyard Ltd. (PSL) is a strong contender in the domestic ship building space with an integrated facility spanning ~500 acres located in southern coast of Gujarat. It has an order backlog of USD930mn consisting of 22 panamax carriers and 12 OSVs.

However Valuations seem expensive…

PSL is positioning itself as an integrated engineering player as compared to a plain vanilla ship yard. However, we believe that the initial 2-3 years will see revenues accruing from the vessel building initiative. Hence we have to compare it with the two listed players namely ABG Shipyard and Bharati Shipyard. In comparison, valuations seem stretched.

No past track record

PSL has started commercial operations in FY10 (April 2009). It has a potentially untested track record which may lead to downside risks in case of non execution of orders or any other operational inability.

Doubtful order book

The order backlog of USD930mn consists of doubtful orders of ~USD445mn with various unresolved issues. This poses a question on the future revenue visibility of the company.

VALUATIONS & RECOMMENDATION

We are using comparative valuation approach to value PSL as we do not have enough revenue visibility to undertake DCF valuation. Since PSL has just commenced operations, P/E would not be suitable to look at. We are using P/BV and market cap/order book, EV/Order book etc. to value PSL with its domestic peers. On a P/BV basis, PSL compares at 2.6x FY10 and 2.2x FY11 as compared to the domestic industry average of <1x. On EV/Order book basis its at 1.1x as compared to 0.3x of ABG Shipyard & on Mkt Cap/Order book it stands at 0.9x which is double of domestic peers. While we believe that PSL will be one of the largest yards in 3-5 years time frame, we lack the visibility at this juncture to draw comfort from the same. Hence, we recommend an 'AVOID' on the issue.

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ISSUE SNAPSHOT

No. of shares offered	84.9 mn (Rs. 10 each)
Proposed Price band	Rs55-60
Proposed Issue size	Rs4.7-5.1bn
Issue period	Sep 16th-Sep 18th'09
Mkt Cap	Rs36.7-40bn
Listing	BSE & NSE
Equity pre issue	580.3mn shares
Equity post issue	665.8mn Shares

PROMOTERS OF THE ISSUE

Promoter	:	Nikhil P Gandhi Bhavesh P Gandhi Atul Punj
Company	:	SKIL Infrastructure Ltd. Punj Lloyd Ltd

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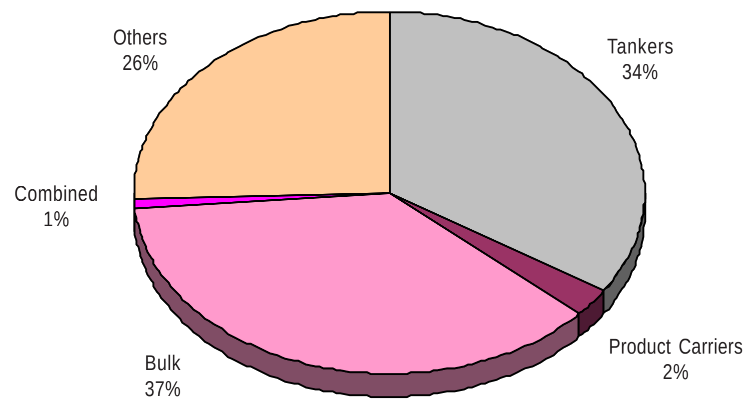
Industry Overview

Ship building industry is cyclical in nature and is into its fifth cycle. The cycle lasts longer than a shipping cycle at 15-18 years. While ship building started to be the main stay of Europe, post the 1960s the ship building scene shifted to Asia with the emergence of newer countries like Japan and South Korea. The 1973 oil crisis sounded the death knell for European yards and many of them shut down for being unviable. Japan emerged as the new giant then. Gradually S Korea & China picked up steam. As of today, Japan, S Korea and China together comprise of 90% of the ship building industry in tonnage terms. India accounts for less than 1% of the same. However, in terms of capacity India is a growing market.

Exhibit 1 - World fleet (dwt)

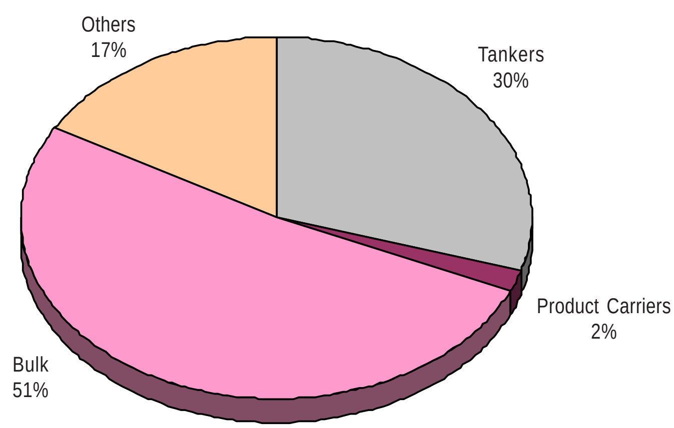


Source: Platou

The current world order backlog stands at ~600mn dwt...

The current world order backlog stands at ~600mn dwt of which a major chunk comprises of bulk fleet while offshore fleet in terms of dwt stands at a negligible level. Tankers and bulk carriers are primarily manufactured in South Korea and China while slightly high end tankers and product carriers are made in Japan. Offshore rigs are the mainstay of Singapore and HK while countries like India specialize in offshore and specialty vessels.

Exhibit 2 - Global Order book (dwt)



Source: Platou

Domestic ship building scenario

There are ~28 ship yards in India of which only 5 command global orders and the rest are either small or cater mainly to government segment. Indian yards have carved a niche for themselves in the offshore and specialized vessel space as these vessels require customization, which is not on offer from the mass scale projects in Korea and China.

Company Background

PSL was originally promoted as Pipavav Ship Dismantling & Engineering Ltd in 1997 by SKIL, which has experience in port and other such related infrastructure. PSL's original objective was to assist in ship dismantling. Later on it changed its objective to ship building and repair.

Business Model

PSL has positioned its facility in Pipavav as a one stop shop for vessel building, repair, offshore structure construction and manufacture of other engineering items like boilers, stackers etc.

The company will focus primarily on the oil & gas sector with building of offshore vessels and structures. Its next focus area is catering to the defence sector by building naval vessels. Retrofit, stackers, boilers etc. seem to be next in line and plain vanilla vessels in the end.

Facilities

Upto 400k dwt vessels can be dry docked at PSL and 144k tpa of steel can be fabricated at the fabrication & block assembling facility...

The company has started commercial production from April 09. The shipyard, once fully completed shall comprise of one dry dock, one wet dock, fabrication & block assembling facility, dedicated offshore yard, repair facilities and facility for naval shipments and 2 Goliath cranes.

PSL should complete its dedicated offshore yard by March 2010 and the remaining facilities by October 2009. Upto 400k dwt vessels can be dry docked at PSL and 144k tpa of steel can be fabricated at the fabrication & block assembling facility.

Order book details

The order book of PSL comprises of 34 vessels which include 22 panamax bulk carriers and 12 offshore supply vessels valued at USD930mn. Details of the same are as enumerated below:

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a. 4 Panamax bulk carriers of 74.5k dwt for *Golden Ocean* and 6 Panamax bulk carriers of 74.5k dwt for AVGI with a combined value of USD374mn. These are scheduled for delivery between April 2010 and May 2012.

b. 2 Panamax bulk carriers of 74.5k dwt for *Golden Ocean* being negotiated to bring it under option. This option, if it comes into effect, shall expire by Dec 2010 and if not exercised, would entail an option cost of USD7mn. If exercised, vessels to be delivered for a realization of USD71mn.

c. USD231mn worth of orders from AVGI comprising of 6 panamax bulkers are under a refusal clause which can be exercised by the said customer in case it cannot arrange financing for the vessels.

d. 4 Panamax bulkers ordered by *Setaf* under arbitration for cancellation. These orders are worth USD144mn.

e. USD112mn worth of OSV orders from ONGC for which post submission of technical bids, order will be allocated.

We view the order book with a bit of caution as most of these orders are dated and no orders have been booked after that initial period of late 2006. Further more, many vessels are under arbitration for price revision or cancellation. However, a silver lining does exist as PSL has submitted a tender for seven naval vessels each worth ~Rs10bn. Naval orders are more reliable and have lesser risk of cancellations.

Valuations

PSL has no previous earning track record and we have projected earnings based on existing order backlog. We have incorporated some element of ship repair revenues as well which command higher margins. We have avoided using the DCF methodology due to lack of revenue visibility and have made a comparative valuation between PSL and two listed domestic entities i.e. ABG Shipyard and Bharati Shipyard. We have also made a global comparison for sanity check with Keppel Corp, Kawasaki Heavy and Samsung Heavy industries and have found out that they trade in the range of 0.9-1x P/BV.

Exhibit 3 - Comparative Valuations

	Pipavav Shipyard*		ABG Shipyard		Bharati Shipyard	
Rs Mn	FY10	FY11	FY10	FY11	FY10	FY11
Revenues	7,619	13,890	20,157	23,718	11,125	12,500
Net Profits	1,909	3,235	2,149	2,532	1,314	1,588
EPS	2.9	4.9	39.2	46.1	47.6	57.5
P/E (x)	20.9	12.3	6.4	6.4	4.3	4.3
P/BV (x)	2.6	2.2	1.0	1.0	0.7	0.7
EV/Order Book (x)	1.1	1.0	0.3	0.3	1.8	1.8
Order Book/Sales (x)	5.9	3.2	5.5	4.6	3.1	2.8
Mkt Cap/Order book (x)	0.9	0.9	0.1	0.1	0.4	0.4

Source: PINC Research **Calculations at upper band of Rs60*

As can be clearly seen from the above table, PSL is expensive in terms of P/E and P/BV with its listed and global peers. It is also expensive in terms of EV/order book, which denotes that for its size, the order backlog should be much more robust. The mkt cap/ order book ratio is also higher than its peers which means that for it to get listed at Rs60, the potential order book should be 100% secure, which seems unlikely at this juncture.

Recommendation

While we believe that PSL will grow to be an integrated marine engineering player, for the current time frame of 2-3 years, it will depend largely on vessel building revenues. Hence we see fit to compare it with comparable players in the listed and global space. We believe that the stock is expensive in relative terms. In terms of order book size, it is half the size of ABG Shipyard and slightly higher than Bharati Shipyard. We recommend an 'AVOID' on the issue on the back of lack of revenue visibility due to order book cancellations and no track record as well as expensive valuations which leave little on the table for investors.

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