Varahi Ltd

CRISIL IPO Grade 3/5 (Average)

February 21, 2012

Grading summary

CRISIL has assigned a CRISIL IPO grade of '3/5' (pronounced "three on five") to the proposed IPO of Varahi Ltd (Varahi). This grade indicates that the fundamentals of the IPO are average 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.

The assigned grade takes into account Varahi's established position in the Indian packaging industry, which is on a sustained growth trajectory thanks to the growth in end-user industries – mainly FMCG and pharmaceuticals. CRISIL Research expects this industry to grow at 13-16% CAGR over FY11-14. The grade factors in the company's focus on innovation and product development, ensuring cost savings for its clients. The grade also reflects the company's long-standing relationship with its clients such as Dabur, Perfetti Van Melle and Bajaj Corp, which has translated into repeat orders and provides revenue visibility. Promoter's sound technological knowledge has encouraged product innovations, which has helped in creating a strong brand image. Further, the proximity of Varahi's manufacturing units to key clients' operations ensures timely delivery of its products and lowers logistic costs.

However, the grade is constrained by the highly competitive nature of the packaging industry due to the presence of a large number of unorganised players and low entry barriers. Hence players have limited bargaining power. However, continuous product innovation helps in strengthening client relationships and may provide better margins. In addition, Varahi's high client concentration (two large clients accounted for ~80% of FY11 revenues) remains a key risk. Further, successful completion of the proposed capacity expansion remains a key monitorable. On the corporate governance front, independent directors have significant experience in the plastics industry but their management oversight needs to be further strengthened. Also, related party transactions remain a key monitorable.

The company's income grew at a two-year CAGR of 21.9% to Rs 1,086 mn in FY11. The adjusted net profit was Rs 108 mn in FY11 as against Rs 77 mn in FY09. It recorded EPS of Rs 5.4 for FY11. Its net worth as of March 2011 was Rs 547 mn. The company's RoNW was 23.4% in FY09, which declined to 21.7% in FY11.

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About the company

Varahi Ltd was incorporated as Varahi Plastics Private Ltd in December 1993. It was rechristened Varahi Private Ltd in September 2006. It was converted into a public limited company in May 2011 and the name was again changed to Varahi Ltd. It manufactures plastic products such as PET / HDPE / PP bottles, PET jars, PET pre-forms, PET containers, caps and closures.

The company has expanded its capacity significantly in the past one decade via organic and inorganic routes; the number of manufacturing units is up from one to five. Most of the plants are in proximity to the clients' manufacturing units, which helps in reducing the clients' inventory and also the logistics cost. Few of the firm's plants enjoy fiscal benefits, such as income tax and excise duty exemptions.

Issue details

Type of issue	Fresh issue
Fresh Issue	Rs 1,100 mn (approximate)
Face value	Rs 10
Objects of the fresh issue	- Setting up a manufacturing unit in Indore, Madhya Pradesh and to meet its working capital requirements - Setting up a manufacturing unit in Manesar, Haryana and to meet its working capital requirements - Part repayment of existing term loans
Price Band	Not available at the time of grading
Offer for sale	Not available at the time of grading
Lead Managers	Saffron Capital Advisors Private Ltd
Legal Advisors to the Issue	M/s. Crawford Bayley & Co.
Registrar to the issue	Bigshare Services Private Ltd

Source: DRHP

Detailed Grading Rationale

A. Business Prospects

- ### *An established player in plastic packaging industry with innovation as its forte*

  Varahi's thrust on research and development, and use of modern equipment and technologies have ensured consistent product innovation over the past few years, which has reportedly helped its clients lower costs. Innovation and technology improvement have also reduced dependence on manual labour and led to quick turnaround, clean finishing, lower wastage and consistency in quality. For instance, Varahi has been designing containers with lower weight without compromising on their strength, which lowers the cost of raw materials. At the same time, Varahi has benefited from higher operational efficiencies as the overhead cost is directly proportional to the weight of the product. Varahi has the intellectual property rights (IPRs) for all its in-house designed products. Industry sources classify Varahi as one of the preferred vendors for its clients.

  In an industry, which is on a sustained growth trajectory: Varahi is a niche player in the polymer-based packaging space of the unorganised and diversified Indian packaging industry. CRISIL Research expects the Indian packaging industry to grow at 13-16% CAGR over FY11-14, driven by growth in end-user industries – mainly FMCG and pharmaceuticals. Demand for polymer packaging, which is on a sustained growth trajectory, is expected to grow at a higher rate due to the trend to replace metals with plastics.

- ### *Enjoys strong relationship with top clients…*

  Having been around for more than 15 years, Varahi has established itself as one of the leading players with a portfolio of heavyweight clients. The company has long-standing relationship with its top clients such as Dabur India Ltd, Perfetti Van Melle and Bajaj Corp Ltd to name a few. It works closely with them to understand their needs and modify products/solutions to suit their needs – a well-established recipe for retaining customers for over a decade. It has also been able to capitalise on the buoyancy in demand from end-user industries over the recent years.

- ### *… which partially mitigates client concentration risk*

  Varahi's top two clients contributed ~80% to FY11 revenues, exposing the company to high client concentration risk as the loss of a single customer will result in significant loss of revenue and sub-optimal capacity utilisation. Also, dependence on few customers may weaken the company's bargaining power. The company has to give a two-month credit to its customers, while there is no credit available from its major raw material suppliers.

  However, the risk is partially mitigated because the clients are big FMCG companies whose focus area is not packaging and the general industry set-up is to procure these materials from vendors. Also, a decade-old relationship with top clients – maintained due to product innovation, quality of products and timely delivery –is unlikely to turn sour or end. Another factor is mutual dependency - a chunk of the clients' requirement of bottles, jars and caps is met by Varahi. The company has added many prominent clients in the past one decade in order to diversify its customer profile.

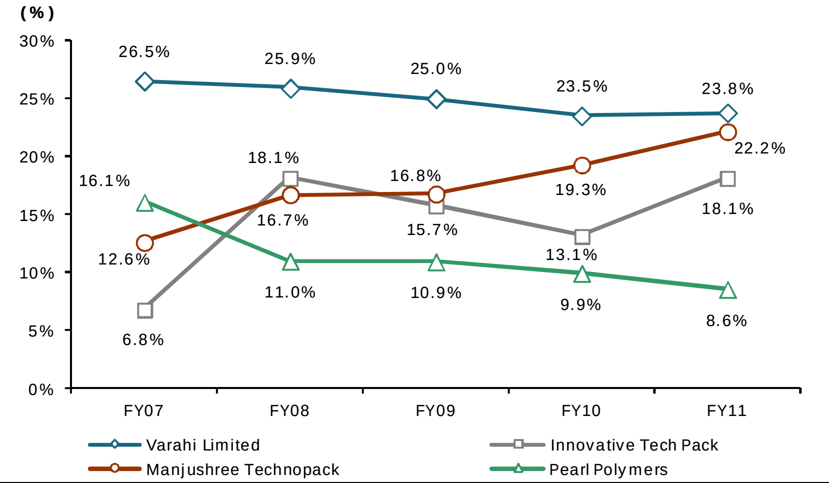
- *Multiple locations lower logistic costs*

  Varahi has five manufacturing units in the country: two in Baddi (Himachal Pradesh) and one each in Panatnagar (Uttarakhand), Delhi and Noida. All of them are located in proximity to its key clients' operations. The proposed new plant in Indore will also be near its key client's manufacturing facility. This ensures timely delivery of the products to the company and lowers logistic costs.

- *Innovation, location and operating efficiencies help keep margins above peers'…*

  The company has maintained healthy EBITDA margins of above 23% in the past few years through March 2011, which is consistently higher compared to the peers'. Varahi and its peers have few common customers and cater predominantly to the same end-user industries. Varahi's focus on innovation and operating efficiencies has resulted in superior performance.

EBITDA margin comparison of peers



Source: DRHP, CRISIL

- *… but low entry barriers intensify competition*

  Competition in the domestic packaging industry is severe due to the presence of a large number of players on account of low entry barriers, low capital requirement and limited product differentiation. Hence, structurally buyers have strong bargaining power and players in the packaging industry have limited pricing. However, large volumes with quality norms specified by major customers, such as large FMCG and pharmaceutical companies, require a supplier with sufficient capital and advance technology. Further, larger players tend to be more cost competitive due to economies of scale. Increasing competition in the industry calls for continuous development and innovation.

- *Successful capacity expansion in the past but future expansion a key monitorable*

  Varahi has expanded capacity significantly in the past; it has increased its gross block from Rs 348 mn as on March 31, 2007 to Rs 1,012 mn as on June 30, 2011. In the past one decade, the company has added manufacturing facilities in Baddi, Pantnagar and Noida, which now together contribute significantly to the company's revenues. The new capacities use the latest technology with high automation and are located closer to its large customers. It has procured machinery from leading suppliers of the machinery for PET bottles, viz. SACMI, Italy and ASB international Pvt. Ltd. It has been able to maintain its EBITDA margins above 23% over the period.

  Varahi is now planning to almost double its gross block – it is contemplating a capex plan of over Rs 1,000 mn over the next three years from a mix of IPO proceeds and internal accruals – which is a key monitorable. It plans to set up a manufacturing unit in Indore, Madhya Pradesh to manufacture plastic packaging products, and a bottling unit in Manesar. The promoters are experienced in this business as a group company (Adhya Himalayan Waters) is already in the business of processing and filling packaged and natural mineral water. However, distribution and marketing of the product will be a challenge. Varahi has neither acquired land nor ordered any plant and machinery for the planned projects till date.

B. Financial Performance

The company's income grew at a two-year CAGR of 21.9% to Rs 1,086 mn in FY11; it posted revenues of Rs 337 mn in Q1FY12. EBITDA margin declined by 122 bps to 23.8% in FY11 from 25% in FY09, because of the impact of the inflation, which resulted in increase in power, labour and other administrative expenses. The adjusted net profit was Rs 108 mn in FY11 as against Rs 77 mn in FY09. In Q1FY12, the company reported Rs 33 mn profit. The company's RoNW was 23.4% in FY09, which declined to 21.7% in FY11.

Financial performance snapshot

Particulars	Unit	FY09	FY10	FY11	Q1FY12
Total Income	Rs mn	731	769	1086	337
EBITDA	Rs mn	183	181	258	83
EBITDA margins	%	25.0	23.5	23.8	24.6
Adjusted net profits	Rs mn	77	74	108	33
Net margins	%	10.6	9.6	9.9	9.8
RoCE	%	25.1	20.1	20.8	NA
RoNW	%	23.4	18.0	21.7	NA
Basic EPS	Rs	4.3	3.7	5.4	1.6
No. of equity shares (FV of Rs 10)	Mn	18.0	20.0	20.0	20.0
Net worth	Rs mn	371	444	547	579
net debt – equity	Times	0.7	0.8	1.1	1.1
Current ratio	Times	6.0	2.6	5.3	5.3

Note: Financials have been reclassified as per CRISIL standards

Source: DRHP

C. Management Capabilities and Corporate Governance

- *Technologically strong, experienced promoters and second line of management*

  The top management is headed by Mr Pramit Sanghavi, managing director, who, backed by sound technological knowledge, has spearheaded product innovations, which has helped in creating a strong brand image for Varahi. He handles project expansion, research and development, and business development functions. He is supported by his brother Mr Dewang Sanghavi, whole time director, who has over 20 years of experience in the plastic industry. He looks after purchase, administration and finance. Second line of management is strong and has good experience of the industry. Key management personnel - Mr. Antony Varghese (DGM – Finance & Operations) and Mr Pradeep Khare (Business Development Manager) have more than 20 years of experience, of which majority is in mineral water and packaging industry.

- *Board composition*

  Varahi's board consists of four directors of whom two are independent directors. The board is chaired by Mr Pramit Sanghavi, managing director, who has over 25 years of experience in the plastic processing Industry. The non-executive directors of the company are Mr Rajendra Kumar Chawla and Mr Navin Shah, who have more than 40 years of experience in the plastic industry.

- *Independent directors' management oversight can be strengthened further*

  Both the independent directors, Mr Rajendra Chawla and Mr Navin Shah, joined the board recently – on October 17, 2011 and July 29, 2011 respectively. Based on interactions with them, we believe that no board meeting has been held after their appointment. Both are involved in business operations. Although independent directors have experience in the plastics industry, we believe their management oversight can be further strengthened.

- *Promoter group transactions remain key monitorable*

  - Trademarks held in a partnership firm closely held by promoters:

    The company has the licence to use 70 intellectual properties (including the brand name 'Varahi' and its logo). All these IPRs are held by M/s. V-2 Corp, which is a partnership firm closely held by the promoters. As per the agreement provided to us, Varahi has been granted a worldwide exclusive licence to use the IPR on payment of licence fee of Rs 7,000 per intellectual property per year for the next three years without any increase in fee. Also, the exclusive agreement is for 10 years, and renewable after that.

  - Key manufacturing units on land taken on lease from promoter group:

    Many of the company's manufacturing units are constructed on land taken on lease from the promoter group. However, as per the agreement provided to us, the company has entered into five-year lease agreements at very nominal rentals (which are lower than market rates) with no escalation or termination clause.

- Similar business operations under promoter group owned firms:

  M/s. Adhya Himalayan Water is engaged in the business of processing and filling packaged and natural mineral water, and it manufactures all kinds of plastic goods. M/s. Mahodar Beverages manufactures plastic bottles and caps. Both these businesses are similar to Varahi's, which could lead to potential conflict of interest. However, both the companies have entered into non-compete agreement with Varahi. Also, both are very small in terms of revenue (Adhya and Mahodar's revenues were Rs 76.8 mn and Rs 25.4 mn, respectively, in FY11) and capacity as compared to Varahi. As per the management, Adhya also plans to restrict its pre-form and bottle sales over the medium term and focus on selling only packaged mineral water.

Annexure I

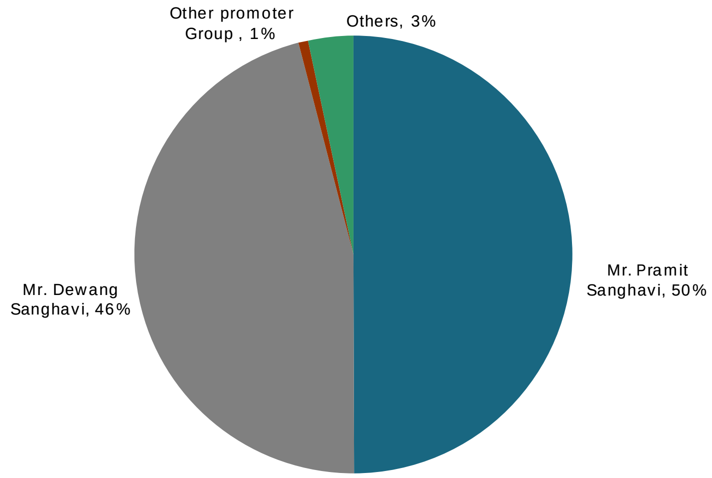
Business Profile

Varahi manufactures plastic packaging products. Having started as a manufacturer of only plastic caps and closures in Delhi, it diversified into manufacturing of PET pre-forms, PET / HDPE / PP bottles, PET jars and containers made from rigid plastic. It caters largely to FMCG, chemicals and pharmaceutical industries. It has the licence to use a total of 70 intellectual properties – 58 designs, two copyrights, one patent and nine trademarks; all brands are the property of the promoter-owned partnership firm.

The company has expanded its capacity significantly in the past one decade via organic and inorganic routes; the number of manufacturing units is up from one to five. The company's plants are located in Delhi, Noida, Pantnagar (Uttarakhand) and two in Baddi (Himachal Pradesh). Most of the plants are in proximity to the clients' manufacturing units, which helps in reducing the clients' inventory and also the logistics cost. Few of the firm's plants enjoy fiscal benefits, such as income tax and excise duty exemptions.

Varahi has also been appointed by IOCL (Indian Oil Corporation Ltd) as a consignment stockist on a non-exclusive basis for products such as LLDPE, HDPE, PP, etc. for the area covered under the state of Uttarakhand. The business is in initial stages currently.

Share holding pattern – Pre-issue



Source: DRHP

Annexure II: Profile of the Directors

Name	Age	Designation	Yrs of Experience	Date of joining	Qualification	Other directorship
Mr. Pramit Sanghavi	51	Chairman and Managing Director	25+	17-Dec-93	Indian School Certificate Examination of the University of Cambridge Local Examinations Syndicate	Private Ltd Companies: Satakshi Polymers Private Ltd, V-Two Plastics Private Ltd, Yoshaka Edutech Private Ltd; Partnership firms: M/s. Adhya Himalayan Waters, M/s. V-2 Corp; Sole proprietorships – M/s. Mahodar Beverages, M/s. Lambodar Industries
Mr. Dewang Sanghavi	49	Whole time Director	20+	17-Dec-93	Master of Science (Operational Research) from University of Delhi	Private Ltd Companies: Satakshi Polymers Private Ltd, V-Two Plastics Private Ltd; Partnership firms: M/s. Adhya Himalayan Waters, M/s. V-2 Corp; Sole proprietorships – M/s. Hans Plastics
Mr. Navin Shah	69	Independent Director	45+	29-Jul-11	-	Public Ltd Companies: Insecticides (India) Ltd; Sole proprietorships – M/s. Kamal Polymers
Mr. Rajendra Kumar Chawla	75	Independent Director	50+	17-Oct-11	Graduate from Punjab University	NA

Source: DRHP