Sanghavi Forging and Engineering Ltd. (SFEL) - IPO Note: "AVOID" 3rd May, 2011

Issue date	4th May, 2011- 9th, May, 2011
Issue size	Rs. 369mn
FV	Rs.10
Price Band	Rs. 80-85 per share
Fresh issue	4.34 mn equity shares
Issue structure	50% - QIBs 35% - Retail 15% - Non Institutional Bidders
Equity shares prior to issue	8.35 mn
Equity shares post issue	12.69mn
Post issue market capitalization	Rs. 1.08 bn at upper price band
Promoters	Mr. Babulal Sanghavi Mr. Jayanti Sanghavi, Mr. Naresh Sanghavi
Book Running Lead Managers	Arihant Capital Markets Ltd.
IPO Grading	Grade 3/5 by CARE
Registrar to the issue	Bigshare Services Pvt. Ltd.

Gujarat based SFEL is engaged in manufacturing and exporting of forging products for the non-automotive sector. It has an installed capacity of 3,600 MTPA for manufacturing of forged flanges and precision machined components (with single piece forging up to 4 MT) in the area of open and closed die forgings catering to various user industries like Oil and Gas, Power, Ship Building and Aerospace. The key factor in its forging business is the vendor/consultant approval, given the critical end use of the product. The company, in the last few years, has been successful in obtaining various such approvals in both the domestic and international markets. The company has diversified client base with top 10 clients accounting for 38% of revenues in FY10 and has good client relationship worldwide resulting in repeat business from its clients. The company has made Pre-IPO placement of 0.69mn equity shares of Rs. 10/- each fully paid up at premium of Rs.70/- aggregating to Rs.55.9mn to Dango & Dienenthal Maschinenbau GMBH KG, Germany.

At the upper band of the issue price, SFEL is valued at 27x its 9MFY11 annualized earnings of Rs. 3.1/share (post issue).However, we believe the company faces concerns like a) modest scale of operations, b) high working capital intensity, c) project risk marked by project size of around six times of its networth as on December 31, 2010 and more than four times of its existing capacity, d) exposure to raw material price fluctuation risk and foreign exchange fluctuation risk, e) expensive valuations as compared to peers in the non automotive forging space, f)post issue market capitalization of Rs.1.08bn as compared to issue size of Rs.369mn, inspite of higher PE multiple.

With due consideration to the above factors, we believe that premium valuations are not justified and recommend investors to "AVOID" the issue.

Financial summary (Consolidated)

Y/e 31 Mar (Rs. mn)	FY09	FY10	9MFY11
Total income	295.2	288.9	293.2
Total expenses	241.3	230.7	232
EBITDA	53.9	58.2	61.1
PBT	35	39.3	44.9
Reported PAT	22.6	24.7	29.5
Equity Capital	39.3	47.8	79.9
Networth	87.6	120.3	173.6
Total Borrowings	113.3	103.6	152.6

Source: RHP, Ajcon Research

Shareholding Pattern (%)	Pre Issue
Promoters	86.28
Public	13.72
Total	100

Peer Analysis

Segment	CMP (Rs.)	FV (Rs.)	Book value (Rs.)	P/BV(x)	EPS (TTM)	PE(x)	RONW (%)
SFEL Ltd.	80-85	10	42.7#	1.99	3.1	27	20.9
Ramkrishna Forging	116	10	77.6	1.49	11.16	10	9.8
Pradeep Metals Ltd.	20.3	10	13.8	1.47	2.89	7	-
MM Forgings Ltd.	128	10	77.1	1.66	25.8	5	10.5

*Source: RHP, Ajcon Research, *9MFY11 annualized, #post issue Book Value*

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COMPANY BACKGROUND AND BUSINESS MODEL

SFEL was promoted by Mr. Babulal Sanghavi in 1989 and started commercial production in 1991. The company has made a conscious decision to focus on non-automotive sector as its major business strategy. SFEL is manufacturing products for non-automotive sectors. The major opportunities for non-automotive forgings are in the following Industries:

a) Oil and Gas
b) Power, Thermal, Hydro and Nuclear
c) Ship Building
d) Aerospace & Defence

Product mix

It manufactures forged flanges, forgings and machined components for various industries like oil & gas, fertilizers, power, desalination & water treatment, ship building, defence, fabrication of process equipments, instrumentation etc. It is capable of manufacturing both standardized as well as customized products. The company has established market for its products overseas. It regularly exports to various international destinations to Europe, Middle East and Canada. The company's existing manufacturing plant consists of forging shop, die shop, heat treatment shop, conventional and CNC machining shop backed by related quality assurance equipments. Presently, it is using steam hammer technology for the open die forging and can produce single forged piece upto 4 MT.

SFEL manufactures these products from carbon steel, alloy steel and stainless steel conforming to international standards. The company operates from its existing plant based in Vadodara, Gujarat.

SFEL's products have been inspected and accepted by third party inspection agencies like Lloyds (LRIS), BVIS, SGS, TOYO, PDIL, DNV, ABS, TICB, UHDE India, DAE, NPCIL, etc. The quality of its products has been certified to be satisfactory in third party inspections.

PRODUCTS

Product category	End-Use Industries
Forged Flanges	Oil and Gas, Petrochemicals, Fertilizers and Process Plants
Closed Die Forgings	Valve manufacturers and OEMs
Open Die Forgings	OEM fabricators and power sector
Machined components	OEMs for instrumentation and valves

Source: RHP

OBJECTS OF THE ISSUE

Particulars	Estimated cost (Rs. in mn)
Setting up of new project	1,051.4
Margin money for working capital	82.5
Pre operative expenses including issue expenses	70
Total project cost	**1,204**
Means of financing	
Proceeds from pre-IPO placement	55.9
Present issue to public	369
Term loans and unsecured loans	726.4
Internal accruals	52.5

Source: RHP

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Key positives

- **Diversified product portfolio catering to various industries**
- **Approvals from clients/other industry bodies**
- **In-depth understanding of client requirements**
- **Capex to drive growth:** Its new project will have the capacity to manufacture products for various sectors which includes, Oil & Gas, Power sector (thermal, hydro and nuclear power, wind power), chemical & petro-chemical, heavy fabrication (OEMs), ship building, defence, general engineering and aerospace.
- **Diversified client base:** The company's clientele are from diversified user industries. It key clients include EIL, Toyo, Indian Oil Corporation Limited, Bharat Heavy Electricals Limited, Bharat Petroleum Corporation Limited, Hindustan Petroleum Corporation Limited, Shell Hazira and many more reputed clients. Top ten clients account for 38% of revenues.
- **Good international exposure: SFEL** exports has been to countries like Canada, UK, Germany, Italy France, Netherlands, Switzerland, Oman, Kuwait, Qatar, UAE, Egypt, Saudi Arabia, Argentina, Singapore, etc.

Key negatives

New project is at a very preliminary stage, Value of New Project > its current scale of operations

Presently, the implementation of its new project is at a very preliminary stage. SFEL has acquired leasehold rights on its plots situated at Waghodia Industrial Area, Taluka Waghodia, Dist Vadodara. However, the construction activity is yet to commence. Any delay in implementation of the same will increase the capital cost and also affect the realization of returns from the expansion. In addition, SFEL's project cost of Rs. 1.2 bn, is large in size compared to the present networth of the Company of Rs. 173.6 as on December, 2010. Since, the management and financial resources are till date allocated to a smaller scale of processing facilities, the New Project, poses some unforeseen risks and challenges to the financial and managerial capacity of the Company.

Higher working capital requirement

The company's working capital cycle increased to 153 days in FY10 as compared to 117 days in FY09. This was on account of higher average collection period of 104 days in FY10 as compared to 66 days in FY10. The main culprit being a large single order from M/S. Mazgaon Dock Ltd. (a Government of India undertaking in March 2010, for supply of parts and non realization of debtors from the same before the end of the year resulted in higher average collection period, which was realized in H1FY11.

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