May 11, 2020

Happy Forgings Limited: Ratings reaffirmed; outlook revised to Stable from Positive

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Term Loans	72.00	62.38	[ICRA]A (Stable); Reaffirmed; outlook revised to Stable from Positive
Fund-based – Working Capital Facilities	140.00	147.00	[ICRA]A (Stable); Reaffirmed; outlook revised to Stable from Positive
Unallocated Limits	83.00	85.62	[ICRA]A (Stable)/[ICRA]A1; Reaffirmed; outlook on long term rating revised to Stable from Positive
Total	**295.00**	**295.00**	

**Instrument details are provided in Annexure-1*

Rationale

The revision in outlook follows the impact of the novel coronavirus (Covid-19) outbreak on the Indian auto component industry. The pandemic is expected to adversely impact automotive demand in the near-term and constrain an improvement in the credit profile for Happy Forgings Limited (HFL).

The automotive supply-chain disruption—primarily limited to China during January to February 2020—has snowballed into a demand shock, owing to the rapid spread of the pandemic and its adverse impact on the macro-economic environment. To contain the rapid proliferation of the disease, the Government of India (GoI) initially imposed a 21-day lockdown, which was subsequently extended till May 3, 2020. The GoI has now extended the lockdown for another 14 days, although with certain relaxations. The large-scale lockdown has disrupted production of automobile original equipment manufacturers (OEMs) and its supply chain from March 2020 onwards.

In ICRA's view, even after the lockdown restrictions are further eased, the demand environment is likely to remain subdued, since automobile purchase falls under discretionary spending. Accordingly, auto component companies, including HFL, are likely to witness lower earnings in the near-term because of restricted operations. Given the environment, the liquidity cushion between cash balances, available lines of credit and debt servicing requirements remains key. ICRA believes that HFL remains adequately positioned from a liquidity standpoint with sufficient cash and liquid investments (~Rs. 52 crore as on March 31, 2020) and undrawn credit facilities (buffer of ~Rs. 80-90 crore from drawing power). Against the aforementioned liquidity, the company has limited debt repayments of ~Rs. 3.4 crore in Q1 FY2021, in addition to supporting its fixed expenses. Led by a strong liquidity profile, it has not opted for moratorium on interest or debt repayments for the March–May 2020 period (under the Covid-19 – Regulatory Package announced by the Reserve Bank of India).

The ratings continue to favourably factor in HFL's strong financial risk profile as well as established relations and strong share of business with reputed tier-I automotive ancillaries and reputed OEMs. Aided by high proportion of sales from the relatively profitable machining segment as well as heavy forged components, the company was able to maintain strong operating profit margins (~25.6% in 9M FY2020), even during a contraction in volumes for the segment catered. While its liquidity remains more than adequate to tide over the current lockdown, the company's financial performance remains exposed to any prolonged weakness in demand in the segments catered, especially the commercial vehicles (CV) segment, wherein factors such as revised axle load norms, transition to stringent emission norms (Bharat Stage VI) and a weaker financing environment impacted offtake considerably in FY2020. A weak macro environment is expected to limit freight availability over the near term and weaken the financial profile of fleet operators, consequently impacting CV demand; any recovery in the latter half of the fiscal would hinge on a pickup in construction activity. The impact of the outbreak on consumer demand/sentiments over the coming quarters continues to remain uncertain and would need to be assessed.

The Stable outlook reflects ICRA's view that despite expectations of a relatively prolonged weakness in automotive demand, HFL is likely to maintain a comfortable credit profile and keep its dependence on external debt low, even as it continues with its substantial capital expenditure plans towards expanding capacity (may be postponed by a few months contingent upon the tenure of the lockdown). The company remains well positioned to benefit from a recovery in demand in the automotive segments catered over the medium term.

ICRA has previously taken note of the commercial dispute between HFL and the State Bank of India, related to the right to recompense the relief extended to the company during the debt restructuring undertaken in 2013. Even as the outflow of funds related to the demand is not likely to have material impact on HFL's credit profile, ICRA would continue to monitor the developments in this regard.

Key rating drivers and their description

Credit strengths

Established relationships and strong share of business with tier-I component manufacturers and OEMs – HFL is a Ludhiana-based manufacturer of forged and machined components that are mainly supplied to the CV and the tractors segments of the automotive industry. The promoters have over 35 years of experience in the forging industry. The company enjoys established relationships and a strong share of business with reputed tier-I automotive ancillaries such as Graziano Transmission India Private Limited, along with reputed OEMs such as Ashok Leyland Limited, VE Commercial Vehicles Limited, Escorts Limited, etc, which provide revenue visibility.

Strong operating profitability and return indicators – Aided by a ramp up in capacity utilisation of the press lines and machining facilities, HFL's operating margin improved significantly to 27.7% in FY2019 from 17.5% in FY2014, with supplies for heavier components post the commercialisation of 8,000-MT press line aiding its profitability. Improving operating margins, coupled with healthy asset sweating has aided the company in reporting enhanced return metrics, with RoCE improving to 34.2% in FY2019 from 10.9% in FY2014. Despite moderation in demand in FY2020, and consequent decline in capacity utilisation leading to deterioration in profitability margin, it is expected to have remained at healthy levels, benefitting from an increasing proportion of higher value-added products. HFL recorded an operating margin of ~25.6% in 9M FY2020 (provisional financials). A lower capacity utilisation, coupled with investments towards setting up new press lines (8,000 MT and 14,000 MT), are likely to lead to a moderation in RoCE, over the next two years. The extent of moderation would remain contingent on the tenure of the ongoing lockdown and the overall impact of the same on demand in the segments catered.

Healthy financial risk profile, aided by infusion of funds by private equity player – MOPE Investment Advisors Private Limited invested Rs. 200.0 crore as equity in HFL in FY2019, acquiring a stake of 11.76% in the process. Aided by healthy accretion to reserves and prepayment of long-term debt post infusion of funds from the PE player, the company's capital structure witnessed a considerable improvement in FY2019, with the gearing reducing to 0.3 times as on March 31, 2019 from 1.6 times as on March 31, 2018. The total debt on the company's books declined to ~Rs. 156.1 crore as on March 31, 2019 from Rs. 300.5 crore as on March 31, 2018. As per provisional financials, the same further declined to ~Rs. 112.6 crore as on February 29, 2020. Its operating profitability metrics, coupled with reduced debt levels, resulted in robust debt coverage indicators, with a Total Debt/OPBDITA of 0.8 times, interest coverage of 9.1 times and NCA/Total Debt of 86% in FY2019. Despite witnessing a moderation in demand in FY2020 and the impact of the same on the company's profitability, the debt coverage indicators are expected to remain healthy.

Credit challenges

Agri-machinery and CV segments vulnerable to cyclicality; weak demand outlook due to poor macro environment and Covid-19 pandemic impact – HFL is primarily a supplier of forged and machined components to the CVs and the tractor segments of the automotive industry. Together, these two sectors constitute ~75% of its total revenues. Both these industries are inherently cyclical in nature, with the demand for CVs being impacted by industrial, agricultural production and freight dynamics, while tractor demand remains closely linked to monsoon performance and agricultural income. Despite the management's focus on expanding its customer and product portfolio (across other segments), the company's dependence on these segments is expected to remain high over the medium term. A recovery in demand in the key segments catered is not likely over the short term due to the ongoing lockdown and the uncertainty regarding the tenure of the same. However, HFL's established relationships and strong share of business with various customers provides comfort.

Moderate customer concentration risk – The revenue contribution from the top 10 clients remains at ~75-80%, resulting in moderate concentration risk. The risk is mitigated to an extent by its strong relationships with the clients and the share of business enjoyed by HFL. Additionally, over the years, the company has strived to de-risk its business considerably by adding new customers and enhancing the products supplied (contents/vehicle) to the existing customers, thereby trying to make HFL more entrenched in the supplier network.

Substantial capacity expansion plans and foray into relatively new product categories – The company is, at present, in the midst of a capacity expansion programme, wherein the forging and machining capacities would increase to levels of ~1,00,000 TPA and 50,000 TPA, respectively, by FY2022. The capex would be completed in two phases. In the first phase, a new 8,000-MT press line is being installed (along with machining facilities), while a 14,000-MT press line would be installed (along with machining facilities) in the second phase, which would help to cater to relatively new product categories. While a predominant share of its capex is likely to be funded through the internal accruals and the funds received from private equity infusion, timely completion of the same and HFL's ability to achieve healthy capacity utilisation levels for the enhanced capacity would remain a key rating sensitivity.

Liquidity position: Adequate

The liquidity position remains **adequate**, supported by sizeable cash balances (~Rs. 52 crore as of March 2020) and low utilisation of working capital facilities (buffer of ~Rs. 80-90 crore). With ongoing lockdowns across geographies to contain the Covid-19 pandemic expected to impact short-term cash flows, HFL continues to have sufficient liquidity to meet its fixed overheads and debt repayments (~Rs. 15 crore in FY2021). It may revise/defer its ongoing capex programme to an extent (~Rs. 230-240 crore over FY2021-FY2022) for enhancing the forging and machining capabilities, contingent upon the demand prospects in the industry.

Rating sensitivities

Positive triggers – An upgrade could be triggered if there is a sustainable recovery in volumes in the segments catered, which favourably impacts HFL's accruals and helps the company maintain healthy credit metrics in the context of its substantial capex plans. Further, material revenue diversification by ways of a sustained scale up in supplies to the export market, which helps to offset the weakness in domestic OEM supplies, would be favourably considered for rating upgrade.

Negative triggers – A rating downgrade could be triggered if weakness in demand in segment catered, on account of the Covid-19 pandemic is more prolonged than currently expected, consequently impacting the company's debt coverage indicators. Specific credit metrics that could result in a downgrade would include Debt/OPBDITA greater than 2.0 times on a sustained basis.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	Corporate Credit Rating Methodology Rating Methodology for Auto Component Manufacturers
Parent/Group Support	Not Applicable
Consolidation/Standalone	Standalone

About the company

HFL was incorporated in 1979 by Mr. Paritosh Kumar Garg as a private limited company, which was converted into a public limited company later in 1988. The company manufactures forged and machined transmission and engine components that are supplied mainly to the automotive sector. Its product range includes automotive crankshafts, steering knuckles, transmission gears, pinions, shafts, and forged/machined components for the Indian Railways. It has a total forging capacity of 60,000 MT (hammer and press forging combined) and a machining capacity of 34,500 MT. Its day-to-day operations are overseen by Mr. Ashish Garg (Managing Director), son of Mr. Paritosh Kumar Garg. MOPE Investment Advisors Private Limited, private equity player, invested Rs. 200.0 crore as equity in HFL in FY2019, acquiring a stake of 11.76% in the process.

Key financial indicators

	FY2018	FY2019
Operating Income (Rs. crore)	550.5	750.3
PAT (Rs. crore)	58.3	95.4
OPBDIT/OI (%)	24.9%	27.7%
RoCE (%)	29.8%	34.2%
Total Outside Liabilities/Tangible Net Worth (times)	2.1	0.5
Total Debt/OPBDIT (times)	2.2	0.8
Interest Coverage (times)	6.3	9.1
DSCR	3.7	5.1

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years

	Instrument	Type	Current Rating (FY2021)				Chronology of Rating History for the Past 3 Years				
			Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	Date & Rating	Date & Rating in FY2020	Date & Rating in FY2019		Date & Rating in FY2018		
					11-May-2020	30-Oct-2019	28-Feb-2019	14-Aug-2018	07-Nov-2017	31-May-2017
1	Term Loans	Long Term	62.38	62.38	[ICRA]A (Stable)	[ICRA]A (Positive)	[ICRA]A (Positive)	[ICRA]A (Stable)	[ICRA]A- (Stable)	[ICRA]BBB + (Positive)
2	Fund-based – Working Capital Facilities	Long Term	147.00	-	[ICRA]A (Stable)	[ICRA]A (Positive)	[ICRA]A (Positive)	[ICRA]A (Stable)	[ICRA]A- (Stable)	[ICRA]BBB + (Positive)
3	Non-fund Based – Working Capital Facilities	Short Term	0.0	-	-	-	[ICRA]A1	[ICRA]A1	[ICRA]A2+	[ICRA]A2
4	Unallocated Limits	Long/ Short Term	85.62	-	[ICRA]A (Stable)/ [ICRA]A1	[ICRA]A (Positive)/ [ICRA]A1	[ICRA]A (Positive) / [ICRA]A1	-	[ICRA]A- (Stable)/ [ICRA]A2+	[ICRA]BBB + (Positive)/ [ICRA]A2

Complexity level of the rated instrument

ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website www.icra.in

Annexure-1: Instrument details

ISIN No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	Term Loan 1	Sep-13	-	Mar-22	3.83	[ICRA]A (Stable)
NA	Term Loan 2	Nov-17	-	Mar-26	16.95	[ICRA]A (Stable)
NA	Term Loan 3	Nov-17	-	Mar-26	18.80	[ICRA]A (Stable)
NA	Term Loan 4	Feb-18	-	Jan-23	22.80	[ICRA]A (Stable)
NA	Fund Based Limits	NA	NA	NA	147.00	[ICRA]A (Stable)
NA	Unallocated Limits	NA	NA	NA	85.62	[ICRA]A (Stable)/[ICRA]A1

Source: Happy Forgings Limited

Annexure-2: List of entities considered for consolidated analysis - Not applicable

ANALYST CONTACTS

Subrata Ray
+91 22 6114 3408
subrata@icraindia.com

Shamsher Dewan
+91 1244545328
shamsherd@icraindia.com

Rohan Kanwar Gupta
+91 1244545808
rohan.kanwar@icraindia.com

RELATIONSHIP CONTACT

Jayanta Chatterjee
+91 80 4332 6401
jayantac@icraindia.com

MEDIA AND PUBLIC RELATIONS CONTACT

Ms. Naznin Prodhani
Tel: +91 124 4545 860
communications@icraindia.com

Helpline for business queries:

+91-9354738909 (open Monday to Friday, from 9:30 am to 6 pm)

info@icraindia.com

About ICRA Limited:

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For more information, visit www.icra.in

ICRA Limited

Corporate Office
Building No. 8, 2nd Floor, Tower A; DLF Cyber City, Phase II; Gurgaon 122 002
Tel: +91 124 4545300
Email: info@icraindia.com
Website: www.icra.in

Registered Office
1105, Kailash Building, 11th Floor; 26 Kasturba Gandhi Marg; New Delhi 110001
Tel: +91 11 23357940-50

Branches

Mumbai + (91 22) 24331046/53/62/74/86/87
Chennai + (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294,
Kolkata + (91 33) 2287 8839 /2287 6617/ 2283 1411/ 2280 0008,
Bangalore + (91 80) 2559 7401/4049
Ahmedabad+ (91 79) 2658 4924/5049/2008
Hyderabad + (91 40) 2373 5061/7251
Pune + (91 20) 2556 0194/ 6606 9999