December 23, 2021

Kirloskar Ferrous Industries Limited: Ratings reaffirmed; outlook revised from Stable to Negative; rated limits enhanced

Summary of rating action

Instrument^	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Commercial Paper	100.00	650.00	[ICRA]A1+; assigned/reaffirmed
Fund-based - Term Loan	254.59	223.26	[ICRA]AA reaffirmed; Outlook revised from Stable to Negative
Fund-based – Proposed Term Loan	-	150.00	[ICRA]AA (Negative) assigned
Fund-based - Working Capital Facilities	455.00	316.33	[ICRA]AA/[ICRA]A1+ reaffirmed; Outlook revised from Stable to Negative
Non-fund Based - Working Capital Facilities	690.00	860.00	[ICRA]AA/[ICRA]A1+ reaffirmed; Outlook revised from Stable to Negative
Proposed issue of Non-Convertible Debentures (NCD)	-	250.00	[ICRA]AA (Negative) assigned
Total	**1,499.59**	**2,449.59**	

^Instrument details are provided in Annexure-1

Rationale

The revision in the outlook on the long-term rating of Kirloskar Ferrous Industries Limited (KFIL) reflects the expected increase in leverage levels and moderation in debt protection metrics of the company following the proposed debt-funded acquisition of Indian Seamless Metal Tubes Limited[1] (ISMT) and KFIL's exposure to associated business integration risks. While arriving at the ratings, ICRA has considered the consolidated financial risk profile of KFIL and ISMT. KFIL has entered into a Share Subscription Agreement dated November 25, 2021 to acquire 51.25% stake in ISMT through preferential allotment of equity shares[2] for an aggregate consideration of Rs. 476.6 crore. Additionally, KFIL would be extending unsecured loan of Rs. 194 crore in ISMT. The total consideration of Rs. 670 crore for the acquisition would be funded largely by issue of debt securities. This is expected to increase KFIL's consolidated debt to about Rs. 1,150 crore as on March 31, 2022 vis-à-vis Rs. 291.8 crore as on March 31, 2021. KFIL's ability to successfully integrate ISMT's operations with itself and achieve the desired operating parameters would be crucial for the profitable ramp-up of ISMT's operations, and hence would remain a key monitorable. ICRA also notes that KFIL has commenced an open offer for acquiring up to 25.05% of the emerging voting capital of ISMT. In case the same materialises, it would involve additional cash outflow of up to Rs. 240 crore. The proposed acquisition coincides with a large ongoing major capital expenditure (capex) programme of around Rs. 700 crore, proposed to be funded largely via internal accruals over FY2022 and FY2023. Both are likely to keep KFIL's free cash flows under check.

Nonetheless, the ratings favourably factor in the established position of KFIL in the foundry-grade pig iron and ferrous castings business. The company is a part of the reputed Pune-based Kirloskar Group, which has a proven management track record.

[1] *ISMT is a Sick Industrial Company under the Section 3(1)(O) of the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) since 2016*

[2] *Subject to approval from shareholders of both the companies and the statutory and regulatory clearances*

The ratings also derive comfort from the backward integration achieved through coke and captive power generation, which in turn generates significant cost savings (annual savings of around Rs. 80 to 100 crore in power cost and coke cost). ICRA also notes that the cost structure would improve further once the captive iron ore mines become operational. ICRA believes that over the medium term, KFIL is likely to derive operational synergy benefits from the proposed acquisition of ISMT, given its diverse product portfolio with a high share of value-added products as well as a broader customer base.

These strengths are partially offset by the susceptibility of the company's operating margins to fluctuating raw material prices, given the commoditised nature of the pig iron business. The ratings are constrained by the casting division's exposure to the demand cyclicality in the key end-user segments (both commercial vehicle and tractor segments) that had impacted its past operating performance, along with a relatively higher customer concentration risk. However, this risk is mitigated to some extent by KFIL's established relationships with large original equipment manufacturers (OEMs) and healthy share of their business. ICRA notes the company's exposure to foreign currency movement, considering its sizeable imports of coking coal. However, the company adopts conservative hedging policies to minimise the impact of forex risk.

Key rating drivers and their description

Credit strengths

Status as one of the leading pig iron players in the domestic market – KFIL is one of the leading manufacturers of foundry-grade pig iron and ferrous castings in the domestic market. As per the company's management, KFIL has a healthy market share of 40-42% in the foundry grade pig iron and 19% in the castings segment (source - company presentation). The company is a part of the reputed Pune-based Kirloskar Group, which has presence across diversified business segments and a proven management track record. The company has a competitive cost structure for pig iron manufacturing because of its sinter plant, coke oven plant, captive power plant and hot blast stoves.

Backward integration achieved through coke and captive power generation; cost structure to improve further once the captive iron ore mines become operational – The 2,00,000-MTPA coke oven plant was commissioned in FY2020 and the 20-MW captive power plant was commissioned in FY2021. The coke oven plant reduced its dependence on external coke purchase by 50% of its total requirement. Besides, captive power generated from the waste heat coming out of the coke oven plant and benefit from coke oven resulted in cost savings of around Rs. 80 to Rs.100 crore in FY2021. The company is in the process of setting up an additional 2,00,000-MTPA coke oven plant along with a 20-MW power plant at Koppal, which will make it self-sufficient in coke and power requirement. It has recently commissioned a sinter plant at Hiriyur, which will reduce its dependence on high-cost lump ore. The company has two iron ore mines, which were bagged in the year 2018 at a competitive premium of 36.7% and 55.5%, respectively. Once the mines become operational, this will reduce the landed cost of iron ore by at least 40%, leading to a further improvement in KFIL's cost structure. ICRA expects cost savings from these projects to support the operating profitability in the medium-to-long term.

Healthy operating performance – KFIL reported healthy capacity utilisation levels in both pig iron and foundry divisions, supported by improved domestic demand. While pig iron capacity utilisation increased to 102% in H1 FY2022 from 83% in FY2021, the foundry capacity utilisation rose to 79% in H1 FY2022 from 63% in FY2021. Healthy demand and a rise in prices boosted the operating income, which stood at Rs. 1,781 crore in H1 FY2022 against annual operating income of Rs. 2,038 crore in FY2021. The operating profit margin also remained steady at 22.3% in H1 FY2022 against 22.6% in FY2021. Going forward, while the standalone operating profit margins are likely to be moderate, the same would remain healthy at an absolute level supported by commissioning of cost optimisation capex. Nonetheless, ICRA expects the consolidated operating margin in FY2023 to remain significantly lower than the standalone operating profit margin of KFIL in FY2022 as ISMT's pipe business would fetch lower margins compared to KFIL's pig iron/foundry business.

Established relationships with OEMs – KFIL mainly caters to large casting requirements (more than 50 kg) of tractor, commercial vehicle (CV) and utility vehicle (UV) and diesel engine segment, and has a market share of 19% as per the company's presentation. It has a reputed customer base and a long experience of dealing with OEMs, resulting in repeat orders.

Credit challenges

Proposed debt funded acquisition of ISMT Limited to weaken the capital structure and debt protection metrics – KFIL has entered into a Share Subscription Agreement to acquire 51.25% stake in ISMT through preferential allotment of equity shares. Additionally, KFIL would be extending unsecured loan of Rs. 194 crore in ISMT. As on March 31, 2021, ISMT had a consolidated debt (including accrued interest) of Rs. 3,531.6 crore. Post the acquisition, this would be settled at Rs. 670 crore and the balance amount will be written back. Also, while the existing promoters of ISMT would have a 23.7% stake in the company along with board representation, KFIL will assume full management control. Besides, ICRA understands that the current pledged shareholding of ISMT's existing promoters (out of 7,12,15,114 equity shares held by Promoters and Promoters Group, 6,89,00,000 equity shares are pledged with the lenders as on September 2021) would also be released once the transaction is completed. The total consideration of Rs. 670 crore would be funded largely by issue of debt securities. Consequently, the consolidated debt-to-operating profit is likely to exceed 1.5 times as on March 31, 2022 against KFIL's standalone debt-to-operating profit of 0.6 times as on March 31, 2021. While the same is likely to improve in FY2023 with increased operating profits generated by ISMT, it would remain lower than ICRA's earlier estimates. Nonetheless, it would remain consistent with the rating category. ICRA also notes that the ability of KFIL to successfully integrate ISMT's operations with itself and achieve the desired operating parameters (in terms of power and other cost savings) would be crucial for the profitable ramp-up in operations of ISMT, and hence would remain a key monitorable.

Exposure to volatility in raw material prices – Raw materials account for the major part of the operational cost for pig iron players, including KFIL, and are thus important determinants of profitability. As the pig iron business is cyclical in nature, it is exposed to margin risks arising from the temporary mismatches in the prices of raw materials and pig iron, causing volatility in profitability and cash flows. Nonetheless, backward integration through coke and iron ore would mitigate the risk to some extent. ICRA also notes that given the sizeable coking coal imports, KFIL's profitability remains exposed to foreign currency movements. The company, however, adopts conservative hedging policies to minimise the impact of forex volatility.

Casting division performance is exposed to inherent cyclicality in key end-user segments and client concentration risk – KFIL's casting division derives more than 90% of its sales from CV and tractor segments both of which are exposed to the inherent demand cyclicality. Any sustained demand weakness from its key end-user segments, as witnessed in the past, would adversely impact its revenues and earnings profiles.

Client concentration risk in casting division – The company faces client concentration risk in the casting division. The top three customers accounted for more than half of KFIL's castings revenue. However, KFIL has a healthy share of business with its key customers. Over the last few years, it has added new customers to its portfolio, which mitigates the customer concentration risk to some extent.

Liquidity position: Adequate

KFIL's liquidity is **adequate**, with unutilised fund-based limits of more than Rs. 100 crore as on October 31, 2021 (with commensurate drawing power) and healthy accruals of around Rs. 500 crore expected during the year. The company has repayment obligation of Rs. 78 crore and major capex plans of Rs. 400 crore in FY2022, the company has already incurred ~Rs. 200 crore in H1 FY2022. While the proposed acquisition of ISMT would be funded largely by debt, the balance capex would be funded by term loans of Rs. 100 crore and internal accruals. The company has repayment obligations of Rs. 225 crore and capex of Rs. 300 crore in FY2023. The capex in FY2023 would be funded by term loans of Rs. 100 crore (if necessary) and the balance through internal accruals. ICRA expects the total consolidated accruals of KFIL to remain higher than the total repayment and capex (equity contribution) obligations of Rs. 425 crore in FY2023.

Rating sensitivities

Positive factors – Given the Negative outlook, a rating upgrade in the near term is unlikely. However, the outlook could be a revised to Stable if seamless integration and profitable and successful ramp-up of ISMT result in a healthy return on capital employed.

Negative factors – Pressure on the ratings could arise if KFIL is unable to profitably ramp up the operations of ISMT in a timely manner or in case the consolidated debt-to-operating profit ratio remains above 1.5 times on a sustained basis.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	Corporate Credit Rating Methodology Rating Methodology for Entities in the Ferrous Metals Industry
Parent/Group Support	Not Applicable
Consolidation/Standalone	For arriving at the ratings, ICRA has considered the consolidated financials of KFIL and ISMT.

About the company

KFIL, incorporated in 1991, is a part of the Pune-based Kirloskar Group. KFIL manufactures pig iron and ferrous castings such as cylinder blocks, cylinder heads, transmission parts and different types of housings required by automobile, tractor and diesel engine industries. KFIL's plants in Koppal (Karnataka), Solapur (Maharashtra) and Hiriyur (Karnataka) have a combined casting capacity of 150,000 metric tonnes per annum (MTPA) and a combined pig iron capacity of 541,400 MTPA.

Key financial indicators

KFIL financials	FY2020 (Audited)	FY2021 (Audited)
Operating Income (Rs. crore)	1,849.7	2,038.1
PAT (Rs. crore)	112.4	302.1
OPBDIT/OI (%)	11.7%	22.6%
PAT/OI (%)	6.1%	14.8%
Total Outside Liabilities/Tangible Net Worth (times)	1.2	0.9
Total Debt/OPBDIT (times)	1.4	0.6
Interest Coverage (times)	12.5	18.3

Source: Company; PAT: Profit after Tax; OPBDIT: Operating Profit before Depreciation, Interest, Taxes and Amortisation

Status of non-cooperation with previous CRA – Not Applicable

Any other information: None

Rating history for past three years

	Instrument				Current Rating (FY2022)		Chronology of Rating History for the past 3 years						
		Type	Amount Rated	Amount Outstanding*	Date & Rating in		Date & Rating in FY2021			Date & Rating in FY2020		Date & Rating in FY2019	
					Dec 23, 2021	Sep 13, 2021	Mar 1, 2021	Oct 5, 2020	May 11, 2020	Dec13,2019	Sep 9,2019	Nov 13,2018	Oct 4,2018
1	Commercial Paper	ST	100.0	-	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+
	Commercial Paper	ST	550.0	-	[ICRA]A1+	-	-	-	-	-	-	-	-
2	Term Loan	LT	223.26	223.26	[ICRA]AA (Negative)	[ICRA]AA (Stable)	[ICRA]AA- (Positive)	[ICRA]AA-(Stable)	[ICRA]AA-(Stable)	[ICRA]AA- (Stable)	[ICRA]AA-(Stable)	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)
3	Proposed Term Loan	LT	150.00	-	[ICRA]AA (Negative)	-	-	-	-	-	-	-	-
4	Cash Credit/WCDL	LT/ST	316.33	-	[ICRA]AA (negative) / [ICRA]A1+	[ICRA]AA (Stable)/ [ICRA]A1+	[ICRA]AA- (Positive) / [ICRA]A1+	[ICRA]AA- (Stable)/ [ICRA]A1+	[ICRA]AA- (Stable)/ [ICRA]A1+	[ICRA]AA- (Stable)/ [ICRA]A1+	[ICRA]AA- (Stable)/ [ICRA]A1+	[ICRA]AA- (Stable)/ [ICRA]A1+	[ICRA]AA- (Stable)/ [ICRA]A1+
5	Letter of Credit and Bank Guarantee	LT/ST	860.0	-	[ICRA]AA (Negative) / [ICRA]A1+	[ICRA]AA (Stable)/ [ICRA]A1+	[ICRA]AA- (Positive) / [ICRA]A1+	[ICRA]AA- (Stable)/ [ICRA]A1+	[ICRA]AA- (Stable)/ [ICRA]A1+	[ICRA]AA- (Stable)/ [ICRA]A1+	[ICRA]AA- (Stable)/ [ICRA]A1+	[ICRA]AA- (Stable)/ [ICRA]A1+	[ICRA]AA- (Stable)/ [ICRA]A1+
6	Proposed NCD	LT	250.00	-	[ICRA]AA (Negative)	-	-	-	-	-	-	-	-

*Amount in Rs. crore; *As on March 31, 2021; LT – Long Term; ST – Short Term*

Complexity level of the rated instrument

Instrument	Complexity Indicator
Commercial Paper	Very Simple
Term Loan	Very Simple
Proposed Term Loan	Very Simple
Cash Credit/WCDL	Simple
Letter of Credit and Bank Guarantee	Simple
Proposed NCD	Very Simple

The Complexity Indicator refers to the ease with which the returns associated with the rated instrument could be estimated. It does not indicate the risk related to the timely payments on the instrument, which is rather indicated by the instrument's credit rating. It also does not indicate the complexity associated with analyzing an entity's financial, business, industry risks or complexity related to the structural, transactional, or legal aspects. Details on the complexity levels of the instruments, is available on ICRA's website: www.icra.in

Annexure-1: Instrument details

ISIN No/Banker Name	Instrument Name	Date of Issuance	Coupon Rate	Maturity Date	Amount Rated (Rs. Crore)	Current Rating and Outlook
NA	Commercial Paper*	NA	NA	-	650.00	[ICRA]A1+
HSBC Limited	Term Loan 1	Apr-2019	5.90%	Apr-2024	39.64	[ICRA]AA (Negative)
Kotak Mahindra Bank Limited	Term Loan 2	Nov-2019	5.40%	Aug-2024	19.41	[ICRA]AA (Negative)
	Term Loan 3	Oct-2020	5.40%	Oct-2023	38.33	[ICRA]AA (Negative)
	Term Loan 4	Mar-2020	5.40%	Aug-2024	25.88	[ICRA]AA (Negative)
	Term Loan 5	July-2021	5.30%	Jun-2025	100.00	[ICRA]AA (Negative)
	Term Loan 6	Proposed	-	-	150.00	[ICRA]AA (Negative)
Bank of Maharashtra	Fund based Bank Facilities	NA	NA	NA	45.00	[ICRA]AA (Negative)/ [ICRA]A1+
Axis Bank Limited		NA	NA	NA	10.00	
Canara Bank		NA	NA	NA	5.00	
HSBC Limited		NA	NA	NA	35.00	
ICICI Bank Limited		NA	NA	NA	80.00	
DBS Bank Limited		NA	NA	NA	50.00	
Kotak Mahindra Bank Limited		NA	NA	NA	25.00	
BNP Paribas		NA	NA	NA	60.00	
NA	Proposed Fund based Bank Facilities	NA	NA	NA	6.33	
Axis Bank Limited	Non-fund based Bank Facilities	NA	NA	NA	165.00	[ICRA]AA (Negative)/ [ICRA]A1+
HSBC Limited		NA	NA	NA	100.00	
ICICI Bank Limited		NA	NA	NA	90.00	
HDFC Limited		NA	NA	NA	5.00	
Citi Bank		NA	NA	NA	140.00	
Kotak Mahindra Bank Limited		NA	NA	NA	175.00	
DBS Bank Limited		NA	NA	NA	45.00	
IDBI Bank		NA	NA	NA	75.00	
NA	Proposed Non-fund based Bank Facilities	NA	NA	NA	65.00	
NA	NCD*	NA	NA	NA	250.00	[ICRA]AA (Negative)

Source: *Company; *Proposed*

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

ANALYST CONTACTS

Jayanta Roy
+91 33 2287 6617
jayanta@icraindia.com

Priyesh Ruparelia
+91 22 6169 3328
priyesh.ruparelia@icraindia.com

Sakshi Suneja
+91 22 6114 3438
sakshi.suneja@icraindia.com

Anshuman Bharati
+91 22 6169 3351
anshuman.bharati@icraindia.com

RELATIONSHIP CONTACT

L Shivakumar
+91 22 6114 3406
shivakumar@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:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

For more information, visit www.icra.in

ICRA Limited

Registered Office

B-710, Statesman House, 148, Barakhamba Road, New Delhi-110001
Tel: +91 11 23357940-45

Branches