October 04, 2023

ISGEC Hitachi Zosen Limited: Ratings reaffirmed; rated amount enhanced

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Fund-based	115.00	130.00	[ICRA]A- (Stable); reaffirmed
Fund-based	15.00	-	-
Non-fund based	245.00	260.00	[ICRA]A- (Stable); reaffirmed
Non-fund based	25.00	-	-
Fund-based/Non-fund based	135.00	310.00	[ICRA]A- (Stable)/[ICRA]A2+; reaffirmed/ assigned
Term loans	20.00	5.00	[ICRA]A- (Stable); reaffirmed
Unallocated limits	15.00	-	-
Total	**570.00**	**705.00**	

**Instrument details are provided in Annexure-I*

Rationale

The reaffirmation of the ratings continues to draw comfort from the favourable credit profile of the company's shareholders — Isgec Heavy Engineering Limited (IHEL, rated [ICRA]AA/ Stable/ [ICRA]A1+) and Hitachi Zosen Corporation (HZC) — as well as their established position in the engineering capital goods space. Further, both the shareholders share their brand name with ISGEC Hitachi Zosen Limited (IHZL). In addition to the technological expertise of its stakeholders that has enabled the company to expand its product offerings, IHZL derives strengths from the continued marketing support from the joint venture partners. Additionally, IHZL benefits from the location of its fabrication unit at Dahej, Gujarat. The proximity of the unit to the port enables efficient logistical management, given the sizeable supplies to global customers.

ICRA notes the optical deterioration in the reported debt metrics in FY2023 due to the renewal of lease for its manufacturing plant with IHEL, which has led to a recognition of a lease liability of Rs. ~127 crore, and corresponding right-of-use asset. Hence, the total debt increased to Rs. 245.3 crore as on March 31, 2023 compared with Rs. 113.7 crores as on March 31, 2022, in line with expectations. However, excluding the impact of lease liabilities to IHEL, the capital structure has remained stable with total debt (excluding lease liabilities)/TNW of 0.82 times as on March 31, 2023 (0.77 times as on March 31, 2022). Similarly, the total debt (excluding lease liabilities)/OPBIDTA has also remained stable (2.06 times in FY2023 against 2.05 times in FY2022). Further, the lease agreement with IHEL was renewed at a lower annual lease rental of Rs. ~18 crore per annum against Rs. ~28 crore per annum earlier, which should result in lower cash outflow.

The ratings also consider the fact that the company follows a policy of hedging its foreign currency-denominated exposure, which mitigates the currency risks to a large extent. However, the ratings are constrained by the volatility of the company's revenues, given the lumpiness of order booking and the long order manufacturing cycle. The long tenor of project completion, coupled with the revenue recognition policy to book revenues based on dispatches, results in sizeable inventory build-up at times, especially for long duration orders, leading to high working capital intensity of operations. Moreover, given the company's presence in niche product segments, its order book remains concentrated towards a few industries, such as oil and gas (refining specifically) and fertilisers, and links IHZL's business prospects to the capacity investment plans of these sectors.

The ratings also remain constrained by competition from both domestic and international players. Moreover, the company's profit margins remain exposed to the fluctuations in the prices of key raw materials, as equipment supply contracts are typically fixed price in nature and IHZL has a long execution cycle. However, the company largely mitigates the raw material price risk by entering into fixed-price contracts with vendors that are back-to-back and within a short duration of the order award for a large proportion of its raw material. However, the company still remains exposed to sharp variations in energy and freight costs, evident from the decline in operating profit margins (OPM) in FY2023.

The Stable outlook factors in expectations of IHZL maintaining stable profitability and coverage metrics over the medium term in addition to getting benefits from its strong operational and financial linkages with the parent. Further, IHZL has been able to gradually improve its overall standalone operations keeping its dependence on JV partners for technology and financial support limited, for project design as well as execution.

Key rating drivers and their description

Credit strengths

Established position of IHZL's shareholders in engineering capital goods – IHEL and HZC, the JV partners in IHZL, are reputed players in the engineering capital good space. IHEL has product offerings for capital goods, including boilers, presses, pressure vessels, among others and caters to clients across 90 countries. Japan-based HZC is a global player across various business verticals, including industrial plants, environmental systems, process equipment and precision machinery. Both the entities have a strong market position in their respective geographies with a long track record of execution and client relationship. Further, some of IHZL's facilities are backed by IHEL's corporate guarantee and LoC.

Operational synergies with JV partners – Given the niche segments IHZL operates in as well as the need for licences for critical process equipment like reactors, convertors, among others, its business generation is led by its JV. Notably, these JV partners also have significant involvement in the operations, evident from the technical personnel stationed at the projects. Thus, the company benefits from the operational synergies and client relationships of its shareholders. IHZL either receives direct orders facilitated by the JV partners or undertakes job work for their orders.

Healthy order book indicates adequate revenue visibility – IHZL's order book stood at Rs. 694 crore as on June 30, 2023 (Rs 793 crore as on June 30, 2022[1]), lending healthy revenue visibility over the medium term. The order bookings declined 14% YoY to Rs. 443 crore in FY2023 after a sharp jump in FY2022 (order intake of Rs. 516 crore in FY2022 vs Rs. 271 crore/Rs 225 crore in FY2021/FY2020). The order intake in FY2022 benefitted from the recovery in the capex plans in the refining and petrochemical industries which were possibly deferred in FY2021 on account of pandemic-related uncertainties. IHZL recorded healthy order inflows at Rs. 211 crore for Q1 FY2024 with the orders largely from the fertiliser and refinery segments. ICRA expects the order intake in FY2024 to remain robust around similar levels as FY2023.

Healthy capital structure and debt coverage metrics – IHZL's reported debt metrics deteriorated optically in FY2023, in line with earlier expectations, largely due to the renewal of lease for its manufacturing plant with IHEL in FY2023, which has led to the recognition of a lease liability of Rs ~127 crore (considered as debt), and corresponding right-of-use asset. However, excluding the impact of lease liabilities to IHEL, the capital structure has remained stable with the total debt (excluding lease liabilities)/TNW of 0.82 times as on March 31, 2023 (0.77 times as on March 31, 2022). Similarly, the total debt (excluding lease liabilities)/OPBIDTA has also remained stable (2.06 times in FY2023 against 2.05 times in FY2022). Further, the lease agreement with IHEL has been renewed at a lower annual lease rental of Rs. ~18 crore per annum against Rs. ~28 crore per annum earlier, which should result in lower cash outflow.

The working capital debt as on March 31, 2023 increased to Rs. 119.0 crore vs Rs. 100.5 crore as on March 31, 2022, while the term debt reduced to Rs. 7.5 crore as on March 31, 2023 with a scheduled repayment of Rs. 5 crore in FY2023. ICRA expects the borrowing level to remain elevated in the backdrop of a high order book under execution.

---

[1] As on June 30, 2022, there were some orders totalling Rs. ~90 crore, which were ready to be dispatched on time in FY2022, but the Russia-Ukraine conflict and the resultant logistical challenges postponed the offtake by the client. The same were delivered in FY2023, and the entire payment has been realised from the client.

Credit challenges

Exposure to input price risks – The profitability of the company remains exposed to the fluctuations in the prices of key raw materials, given that the equipment-supply contracts it enters into are typically fixed price in nature. However, as the manufacturing cycle is long, the company largely mitigates the raw material price risk by entering into fixed-price contracts for a large proportion of its bought-out raw material for which negotiations with vendors start during the pre-bid period. However, the company still remains exposed to sharp variations in energy and freight costs, evident from the decline in OPM in FY2023. IHZL's OPM declined sharply to 10.3% in FY2023 from 17.0% in FY2022 due to the impact of higher energy and freight costs, and to some extent higher raw material prices. The margins are expected to improve gradually with higher prices factored in the new orders being booked.

Volatility in revenues and operating profitability, along with long working capital cycle – The company's revenues have been volatile in the last five years because of lumpy order bookings, longer order execution timelines of 15–18 months and project completion-based revenue recognition. The long lead time for raw material procurement and significant fabrication process time elongated the execution tenor (typical for capital goods manufacturers). The longer execution cycle and the project completion method of revenue recognition result in revenue volatility and also have a bearing on the annual profitability. However, the IHZL management has guided the adoption of the percentage of completion method (POCM) of accounting for the orders that have commenced execution post Mar 31, 2023, which will lead to relatively low revenue variability, going forward. While the company has a healthy order book for FY2024 as well, the pace of order book generation with the recovery in demand in the end-user industries will be important.
IHZL's operating income (OI) increased significantly by 83.9% YoY to Rs. 596.4 crore in FY2023, driven partly by a strong opening order book, leading to healthy execution, but largely due to the delivery of pending orders of Rs. ~90 crore in FY2023, which were ready since Q4 FY2022, and had been recognised as part of the finished goods inventories as on March 31, 2022. Hence, revenue recognition on dispatch pertaining to those orders shifted from FY2022 to FY2023. Given the revenue recognition method, the company's working capital intensity is high during the order execution period with significant work-in-process inventory. It, however, receives interest-free customer advances across most orders, enabling it to part fund these requirements. The ability to receive the same on a sustained basis and the impact of any changes on the funding position will be a rating sensitivity.

Exposure to demand cyclicality in end-user industries and competitive pressures – IHZL manufacturers niche products for specific industries, namely fertilisers, oil refineries and petrochemicals. Hence, its order booking remains exposed to the capital expenditure cycle in these industries, adding to the lumpiness. As on June 30, 2023, around 37% of the company's orders were from the oil refinery sector, followed by 56% from the fertiliser segment and the balance 6% from the chemical segment. It also remains exposed to competition from established players. However, this is partly mitigated by the strong market position and the established relations of its JV partners, leading to business generation.

Liquidity position: Adequate

Despite the long working capital cycle, IHZL has a satisfactory working capital management policy, where the project execution begins only after the receipt of customer advances. The company had moderate unutilised fund-based limits with an average cushion in sanctioned limits of around Rs. ~94 crore in the 15 months over FY2023-Q1FY2024. Cushion in drawing power is estimated to be at a similar level in FY2024 or higher. The utilisation of limits has remained in the range of Rs. ~100-160 crore during the above period, with the average utilisation being Rs. ~126 crore.

The company's working capital borrowings are expected to remain at the current level in FY2024 as well with a similar expected pace of order execution. Over the past one year, fund-based WC limits have been enhanced by Rs. ~90 crore to Rs. 220 crore, with IHZL enjoying sufficient cushion in DP. Additionally, there are non-fund based limits as well which are partially convertible into fund based limits basis DP availability. The presence of promoters with a strong credit profile indicates financial flexibility.

Further, with limited term loan repayment commitments and only routine capex to be incurred over the medium term, the liquidity remains adequate.

Rating sensitivities

Positive factors – ICRA could upgrade the above long-term rating if the company demonstrates a considerable and sustained improvement in scale, led by a healthy order book build-up and execution with the improvement in profitability. Further, the rating could be upgraded if the credit profile of IHZL's parent, IHEL, strengthens.

Negative factors – Pressure on the ratings could arise in there is a considerable decline in revenues due to lower order book execution, or reduction in profits and cash flow generation. Other constraining factors include weakening of the liquidity profile led by a sustained deterioration of the working capital cycle, or deterioration in the credit profile of IHZL's parent IHEL, or weakening of linkages with the parent.

Analytical approach

Analytical Approach	Comments
Applicable rating methodologies	Corporate Credit Rating Methodology Rating Approach–Implicit Support from Parent or Group
Parent/Group support	Parent/Group Company: ISGEC Heavy Engineering Ltd The rating assigned to IHZL factors in the high likelihood of its parent, IHEL [rated [ICRA]AA (Stable)], extending financial support to it because of the close business linkages between them. ICRA also expects IHEL to be willing to extend financial support to IHZL out of its need to protect its reputation from the consequences of a group entity's distress. There also exists a consistent track record of IHEL having extended corporate guarantees to IHZL's lenders for its facilities
Consolidation/Standalone	Standalone

About the company

IHZL, incorporated in March 2012, is a 51:49 JV between IHEL of India and HZC of Japan. The JV is involved in the manufacturing of specialised and critical process equipment for the oil refining, fertiliser and petrochemical industries. IHZL benefits from the technological capability and customer base of its shareholding entities, IHEL and HZC, which are also responsible for the bidding/marketing function of the company. Collaboration with HZC has given it access to licensed technology to build the critical process equipment. The JV has a fabrication facility based in Dahej, Gujarat.

Key financial indicators (audited)

IHZL Standalone	FY2022	FY2023
Operating income	324.4	596.4
PAT	4.1	8.3
OPBDIT/OI	17.0%	10.3%
PAT/OI	1.3%	1.4%
Total outside liabilities/Tangible net worth (times)	2.7	3.0
Total debt/OPBDIT (times)	2.1	4.0
Interest coverage (times)	5.6	2.8

PAT: Profit after tax; OPBDIT: Operating profit before depreciation, interest, taxes and amortisation; Amount in Rs crore

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

Instrument		Current rating (FY2024)				Chronology of rating history for the past 3 years		
		Type	Amount rated (Rs. crore)	Amount outstanding as on Oct 04, 2023 (Rs. crore)	Date & rating in FY2024	Date & rating in FY2023	Date & rating in FY2022	Date & rating in FY2021
					Oct 04, 2023	Aug 30, 2022	Jun 15, 2021	-
1	Fund-based	Long Term	130.00	-	[ICRA]A- (Stable)	[ICRA]A- (Stable)	[ICRA]AA(CE) (Negative)	-
2	Fund-based	Long Term	-	-	-	[ICRA]A- (Stable)	[ICRA]AA-(CE) (Negative)	-
3	Non-fund based	Long Term	260.00	-	[ICRA]A- (Stable)	[ICRA]A- (Stable)	[ICRA]AA(CE) (Negative)	-
4	Non-fund based	Long Term	-	-	-	[ICRA]A- (Stable)	[ICRA]AA-(CE) (Negative)	-
5	Term loans	Long Term	5.00	5.00	[ICRA]A- (Stable)	[ICRA]A- (Stable)	[ICRA]BBB+ (Stable)	-
6	Unallocated limits	Long Term	-	-	-	[ICRA]A- (Stable)	[ICRA]BBB+ (Stable)	-
7	Fund-/Non-fund based limits	Long Term/ Short Term	310.00	-	[ICRA]A- (Stable)/ [ICRA]A2+	[ICRA]A- (Stable)/ [ICRA]A2+	-	-

Complexity level of the rated instruments

Instrument	Complexity Indicator
Long term fund-based – Term loan	Simple
Long term – Fund-based working capital	Simple
Long term – Non-fund based working capital	Very Simple
Long term/Short term – Fund-based/Non-fund based working capital	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 analysing 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 are available on ICRA's website: Click Here

Annexure I: Instrument details

ISIN	Instrument Name	Date of Issuance	Coupon Rate	Maturity	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	Fund-based	NA	NA	NA	130.00	[ICRA]A- (Stable)
NA	Non-fund based	NA	NA	NA	260.00	[ICRA]A- (Stable)
NA	Fund-based/ Non-fund based	NA	NA	NA	310.00	[ICRA]A- (Stable)/ [ICRA]A2+
NA	Term loans	Jul 2019	8.20%-9.35%	FY2025	5.00	[ICRA]A- (Stable)

Source: Company

Please click here to view details of lender-wise facilities rated by ICRA

Annexure II: List of entities considered for consolidated analysis – Not Applicable

ANALYST CONTACTS

Sabyasachi Majumdar
+91-124 4545 304
sabyasachi@icraindia.com

Anupama Arora
+91 124 4545 303
anupama@icraindia.com

Rohan Rustagi
+91-124 4545 383
rohan.rustagi1@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