

August 30, 2022

ISGEC Hitachi Zosen Limited: Ratings assigned and upgraded; withdrawn simultaneously

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Fund-based	130	115	[ICRA]A- (Stable) assigned; simultaneously withdrawn [ICRA] AA (CE) (Negative)
Fund-based	10	15	[ICRA]A- (Stable) assigned; simultaneously withdrawn [ICRA] AA- (CE) (Negative)
Non-fund based	315	220	[ICRA]A- (Stable) assigned; simultaneously withdrawn [ICRA] AA (CE) (Negative)
Non-fund based	25	25	[ICRA]A- (Stable) assigned; simultaneously withdrawn [ICRA] AA (CE) (Negative)
Non-fund based	20	25	[ICRA]A- (Stable) assigned; simultaneously withdrawn [ICRA] AA- (CE) (Negative)
Fund-based/Non-fund based	-	135	[ICRA]A- (Stable)/A2+; assigned
Term loans	20	20	[ICRA]A- (Stable); upgraded from [ICRA]BBB+ (stable)
Unallocated limits	50	15	[ICRA]A- (Stable); upgraded from [ICRA]BBB+ (stable)
Total	570	570	

*Instrument details are provided in Annexure-1

Rationale

ICRA has withdrawn its ratings of [ICRA]AA(CE) (Negative) and [ICRA]AA-(CE) (Negative) for the bank facilities of ISGEC Hitachi Zosen Limited (IHZL) and simultaneously assigned a fresh rating of [ICRA]A- (Stable) for these facilities. ICRA has also upgraded the ratings assigned to the bank facilities that did not have explicit credit enhancement to [ICRA] A-(Stable) from [ICRA]BBB+(Stable). Additionally, short-term rating of [ICRA]A2+ has been assigned to the Rs. 135-crore fund-based/non-fund based bank facilities.

The rating action follows the Guidance Note and the FAQ document issued by the Reserve Bank of India (RBI) to the credit rating agencies on April 22, 2022, and July 26, 2022, respectively, guiding that the benefit of a corporate guarantee that does not meet the evaluation mechanism/criteria defined by the RBI is not to be considered while assigning credit enhanced (CE) ratings¹. It also guided that the benefit of a letter of comfort (LoC) is not to be considered while assigning credit enhanced (CE) ratings.

Among the other considerations, the [ICRA]AA(CE) and [ICRA]AA-(CE) ratings drew comfort from the corporate guarantee and letter of credit, respectively, provided by IHEL's parent to the lenders of the rated bank facilities. For assigning the ratings, ICRA had assessed the attributes of the CG and LoC issued by ISGEC Heavy Engineering Ltd. (IHEL), holding a 51% stake, in favour of the rated facility. While the guarantee was legally enforceable, irrevocable, unconditional, covered the entire amount and tenor of the rated facility, and met all the attributes of a strong guarantee, it did not specify the timeline for invocation and payment mechanism. Taking cognisance of the above, ICRA had assigned a rating of [ICRA]AA(CE) to the CG-backed and

¹ The RBI has permitted the existing (CE) ratings to continue until the residual tenor of the loan. However, for the (CE) ratings outstanding on working capital facilities that are renewed periodically (like cash credit facilities that fall due for renewal at an annual frequency), the residual tenor of these facilities is to be considered as the time remaining until the next due date of renewal.

[ICRA]AA-(CE) to the LoC-backed facilities against the unsupported rating of [ICRA]BBB+ [*and in relation to the guarantor's rating of [ICRA]AA*]. The Negative outlook reflected ICRA's outlook on the rating of the guarantor, IHEL, that has been subsequently revised to Stable.

To align itself with the above regulatory guidance, ICRA would no longer be considering the benefit of a guarantee that lacks an invocation and payment mechanism or the benefit of an LoC in its credit assessments, even as such a support represents a relatively strong expression of commitment on the part of the support provider for the supported facilities in comparison to the support that is only implicit in nature. Accordingly, ICRA has assigned the rating of [ICRA]A- (Stable) to the above bank facilities of IHZL, while withdrawing the [ICRA]AA(CE) (Negative) and [ICRA]AA-(CE) (Negative) ratings.

ICRA notes that IHZL and its parent IHEL {rated [ICRA]AA (Stable)} have close business linkages and IHZL is of strategic importance to its parent. Therefore, ICRA expects IHEL to be willing to extend timely financial support to IHZL, as and when needed. There also exists a consistent track record of IHEL having extended timely financial support to IHZL in the past. IHZL's ratings factor in the above strengths arising from a parent with a relatively strong credit profile, even as the benefit of the CG and LoC extended by the parent has been ignored.

The upgrade in the ratings factors in the sharp increase in IHZL's order intake in FY2022, benefitting from a favourable investment cycle in its end-user industries, resulting in a healthy revenue visibility. Besides, the company demonstrated comfortable execution levels in FY2022. The company's healthy order book of Rs. 793 crore (as on June 30, 2022), supported by an order inflow of Rs. 531 crore in FY2022 and Rs. ~155 crore in Q1 FY2023, lends healthy revenue visibility over the near to medium term.

The ratings continue to draw comfort from the favourable credit profile of the company's shareholders — IHEL 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 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. The debt metrics had improved in FY2022 after deteriorating to some extent in FY2021, with gearing of 0.8 times (PY: 1.3 times) and total debt/OPBIDTA of 2.1 times (PY: 3.1 times). However, the debt metrics may moderate to some extent in FY2023, largely owing to recognition lease liability. 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 a sizeable inventory build-up, 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 partially mitigates the risk by entering into fixed-price contracts with vendors, especially being back-to-back and within a short duration of the order award, for a large proportion of its raw material.

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.

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, precision machinery, among others. 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 partners for a retainership fee. Notably, these JV partners also have significant involvement in operations, evident from the technical personnel stationed at the projects. Thus, the company benefits from 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 Rs. 793 crore as on June 30, 2022, lending healthy revenue visibility over the medium term. The order book includes delayed orders of Rs ~90 crore from a USA based client supplying to Russia. The same were ready to be dispatched on time in FY2022, but the Russia-Ukraine armed conflict and the resultant logistical challenges postponed the offtake by the client.

While the pace of order intake slowed in FY2020 and FY2021 on account of capacity constraints in one fiscal and pandemic-related delays in the latter, moderate recovery in the capex plans of some of the end-user industries in FY2022 aided significant increase in order flow (Rs. 531 crore in FY2022 against Rs 250 crore in FY2021).

Healthy capital structure and debt coverage metrics – IHZL has a healthy capital structure as it is well capitalised with an equity capital of Rs. 100 crore, resulting in a comfortable debt/TNW of 0.8 times as on March 31, 2022 (1.3 times as on March 31, 2021). The improvement in gearing has been brought about by reduction in lease liability, lower utilisation of working capital limits and term debt repayments. In FY2022, the company's debt coverage metrics also improved with total debt/OBPITDA of 2.1 times (3.1 times in FY2021) and interest coverage of 5.6 times (5.2 times in FY2021), despite a decline in operating profits and cash accrual generation following lower revenue booking. ICRA expects the borrowings level to remain elevated in the backdrop of a significantly high order book under execution. Further, the recognition of additional lease liability in FY2023 is expected to moderate the debt metrics, though they are expected to remain comfortable.

Credit challenges

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. IHZL's revenues declined slightly by 4.2% YoY to Rs. 324 crore in FY2022 as orders worth Rs ~90 crore (to be shipped to Russia) were postponed. IHZL's revenues are expected to grow sharply in FY2023 because of a strong order book and delivery of the pending Russian order during the fiscal. 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. In an operating environment of elevated raw material prices, the operating profitability may moderate to some extent.

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 refinery and petrochemicals. Hence, its order booking remains exposed to the capital expenditure cycle in these industries, adding to the lumpiness. As on June 30, 2022, around 73% of the company's orders were from the oil refinery sector, followed by 21% from the fertiliser segment and the balance 7% 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.

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 makes efforts to enter 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, which partly mitigates this risk.

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 (except projects awarded by its parent). The company had moderate unutilised fund-based limits with an average cushion in DP of around Rs. 106 crore in FY2022. While the working capital debt came down to Rs 100 crore as on March 31, 2022 (PY: Rs 144 crore), it increased to over Rs ~130 crore in Q1 FY2023 due to higher inventories and receivables.

The company's working capital borrowings are expected to remain at the current elevated level or even increase moderately during FY2023 with the increased pace of order execution. Recently, one of its existing bankers has enhanced the limits, giving IHZL sufficient cushion in drawing power as well as sanctioned limits to meet its working capital requirements. 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 – Negative pressure on the above ratings of IHZL could arise in the following scenarios: (a) considerable decline in revenues due to lower order book execution, or reduction in profits and cash flow generation, (b) weakening of liquidity profile led by sustained deterioration of working capital cycle, (c) deterioration in 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 Policy on Withdrawal of Credit Ratings
Parent/Group Support	Parent/Group Company: ISGEC Heavy Engineering Ltd and Hitachi Zosen Corporation 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 the IHZL's lenders for its facilities.
Consolidation/Standalone	Standalone

About the company

IHZL, incorporated in March 2012, is a 51:49 JV between IHEL, India, and HZC, 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	FY2021	FY2022
Operating income (Rs. crore)	338.5	324.4
PAT (Rs. crore)	7.5	4.1
OPBDIT/OI (%)	17.8%	17.0%
PAT/OI (%)	2.2%	1.3%
Total outside liabilities/Tangible net worth (times)	2.6	2.7
Total debt/OPBDIT (times)	3.1	2.1
Interest coverage (times)	5.2	5.6

Source: Company, ICRA Research

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 (FY2023)				Chronology of rating history for the past 3 years			
	Type	Amount rated (Rs. crore)	Amount outstanding* (Rs. crore)	Date & rating on	Date & rating in FY2022	Date & rating in FY2021	Date & rating in FY2020	
				Aug 30, 2022	Jun 15, 2021	-	Mar 17, 2020	Apr 11, 2019
1 Fund-based	Long Term	115	-	[ICRA]A-(Stable)	[ICRA]AA(CE) (Negative)	-	[ICRA]AA(CE) (Stable)	[ICRA]AA(SO) (Stable)
2 Fund-based	Long Term	15	-	[ICRA]A-(Stable)	[ICRA]AA-(CE) (Negative)	-	[ICRA]AA-(CE) (Stable)	[ICRA]AA-(S) (Stable)
3 Non-fund based	Long Term	220	-	[ICRA]A-(Stable)	[ICRA]AA(CE) (Negative)	-	[ICRA]AA(CE) (Stable)	[ICRA]AA(SO) (Stable)
4 Non-fund based	Long Term	25	-	[ICRA]A-(Stable)	[ICRA]AA(CE) (Negative)	-	[ICRA]AA(CE) (Stable)	[ICRA]AA(SO) (Stable)
5 Non-fund based	Long Term	25	-	[ICRA]A-(Stable)	[ICRA]AA-(CE) (Negative)	-	[ICRA]AA-(CE) (Stable)	[ICRA]AA-(S) (Stable)
6 Term loans	Long Term	20	12.5	[ICRA]A-(Stable)	[ICRA]BBB+ (Stable)	-	[ICRA]BBB+ (Stable)	
7 Unallocated limits	Long Term	15	-	[ICRA]A-(Stable)	[ICRA]BBB+ (Stable)	-	[ICRA]BBB+ (Stable)	[ICRA]BBB+ (Stable)
8 Fund-/Non-fund based limits	Long Term/Short Term	135	-	[ICRA]A-(Stable)/A2+	-	-	-	-

*As on March 31, 2022

Complexity level of the rated instrument

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
Unallocated	NA

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: 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	Fund-based	NA	NA	NA	115	[ICRA]A- (Stable)
NA	Fund-based	NA	NA	NA	15	[ICRA]A- (Stable)
NA	Non-fund based	NA	NA	NA	220	[ICRA]A- (Stable)
NA	Non-fund based	NA	NA	NA	25	[ICRA]A- (Stable)
NA	Non-fund based	NA	NA	NA	25	[ICRA]A- (Stable)
NA	Fund-based/ Non-fund based	NA	NA	NA	135	[ICRA]A- (Stable)/A2+
NA	Term loans	Jul 2019	8.20%-9.35%	FY2025	20	[ICRA]A- (Stable)
NA	Unallocated limits	NA	NA	NA	15	[ICRA]A- (Stable)

Source: Company

[Please click here to view details of lender-wise facilities rated by ICRA](#)

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

ANALYST CONTACTS

Sabyasachi Majumdar

+91-124-4545304

sabyasachi@icraindia.com

Girishkumar Kadam

+91 22 6114 3441

girishkumar@icraindia.com

Anupama Arora

+91-124-4545303

anupama@icraindia.com

Rohan Rustagi

+91-124-4545383

rohan.rustagi1@icraindia.com

Suksham Arora

+91-124-4545300

suksham.arora@icraindia.com

RELATIONSHIP CONTACT

Jayanta Chatterjee

+91 80 4332 6401

jyantac@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

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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



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