May 25, 2021 Revised

ISGEC Heavy Engineering Limited: Ratings reaffirmed; outlook revised to Negative

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Long-term Fund-based Working Capital	400.00	600.00	[ICRA]AA reaffirmed; Outlook revised to Negative from Stable
Short-term – Non-fund based Working Capital	2726.27	2755.17	[ICRA]A1+ reaffirmed
Fund-based / Non-fund based Working Capital	974.83	1044.83	[ICRA]AA / [ICRA]A1+ reaffirmed; long-term outlook revised to Negative from Stable
Long-term – Non-fund based Working Capital	98.90	0.00	-
Long-term/Short-term unallocated limits	200.00	0.00	-
Total	**4400.00**	**4400.00**	

**Instrument details are provided in Annexure-1*

Rationale

ICRA has considered the consolidated financials of ISGEC Heavy Engineering Limited (IHEL) while assigning the credit ratings.

The revision in outlook to Negative follows the expected increase in indebtedness of IHEL due to the proposed debt-funded capex in CBPI Philippines assets[1] (with delay in monetisation) and the Rs. 200-crore term loan availed by IHEL (standalone for working capital purpose), and the increase in the working capital requirements, as reflected by an increase in working capital intensity from 5% in FY2017 to 18% in FY2020, owing to the shift in the order profile towards Government clients, where IHEL does not avail interest-bearing mobilisation advances. These factors are likely to result in a moderation of the debt coverage metrics in the near term.

The ratings are constrained by the nascent completion stage of IHEL's current order book; however, the execution risks are mitigated to an extent by the company's long track record and experienced management team. Further, the second wave of covid-19 infections and the localised lockdowns could disrupt the construction activity and delay project execution in the near term. Additionally, the rating continues to factor in the exposure of the fresh order intake to the cyclical nature of the end-user industries and the profit margins are vulnerable to the competitive intensity in the domestic and international markets. Also, IHEL (standalone) has extended corporate guarantees for working capital limits of its joint venture entities (Rs.665 crore as on Mar 2020) and the weaker-than-expected performance of the subsidiaries can entail funding requirements.

The ratings favourably factor in the established position of IHEL as an engineering, procurement and construction (EPC) company and a fabricator for equipment/machinery in the capital goods sector, aided by its long-term technical tie-ups/alliances with several recognised global heavy engineering companies as well as its in-house design and manufacturing capability. This apart, the ratings factor in the healthy order book of Rs. 6192 crore as on Dec 2020 (standalone level) which lends revenue visibility over the medium term and the order book is well diversified across industry segments, customers and geographies; covering a wide range of product segments. With various cost optimisation measures undertaken in 9M FY2021, the operating margins witnessed an increase to 8.8% from 5.6% in 9M FY2021. IHEL's exposure to price risks remains moderate

[1] IHEL was under arbitration with Cavite Biofuels Producers Inc or CBPI, Philippines for whom the former was executing a sugar project on EPC basis. As a part of settlement arrived at in October 2019, IHEL acquired 100% equity stake in the entities owning entire assets of the said project.

as it enters into back-to-back arrangements with vendors for most of its material and the fact that many of its new orders have in-built price escalation for key inputs. However, the significant increase in the steel prices is likely to exert pressure on operating margins in the near term for orders which are fixed price in nature. Further, the policy of fully hedging its forex exposures also mitigates the currency fluctuation risks to a large extent. The company has sufficient cushion of an average of around Rs. 1300 crore in the non-fund based limits to address its fresh order requirements over the near to medium term. Further, the absence of cash margin requirements supports the company's financial flexibility.

Key rating drivers and their description

Credit strengths

Established position as a leading EPC player and manufacturer for capital goods: The company enjoys a strong market position in the capital goods segment, which contributes to most of its revenues and profits. Apart from in-house capabilities, IHEL has several technology joint ventures (JVs) and strategic technology partnerships with international majors. These, along with IHEL's long track record in the industry and its ability to absorb and indigenise technology, bolsters its market position. In 9M FY2021, 61% of IHEL's gross revenues was derived from the EPC business, 25% from manufacturing with balance from its sugar operations. With captive manufacturing and fabrication facilities across key product segments likes presses, boilers, process equipment, IHEL enjoys the benefits of synergies with its EPC segment, which is characterised by sound designing and execution capabilities.

Healthy and diversified order book: IHEL continues to have a healthy order book (Rs. 6192 crore as on Dec 2020 at standalone level) which lends healthy revenue visibility over the medium term. Further, the order book is well diversified across industry segments, customers and geographies; covering a wide range of product segments. While cyclicality in a single industry would impact IHEL's order and revenue booking, it is not highly exposed to one sector. Moreover, the order book is spread across more than 100 individual orders, resulting in modest order concentration. The top five and top ten orders account for 29% and 46% respectively of the pending order book (as of Dec 2020).

Limited price escalation risk and forex fluctuation risks: In its EPC business, a large proportion (70-80%) of the equipment is bought out and IHEL typically enters into back to back contracts with the equipment suppliers and remains exposed to input price risks for the balance 20-30% equipment which is manufactured in-house. However, over the last 1-2 years, the company's order book composition has witnessed a shift towards Government/public sector clients (48% of current order book), most of which offer contracts with price variation clauses which augur well for longer tenor contracts. However, the significant increase in the steel prices is likely to exert pressure on operating margins in the near term for orders which are fixed price in nature. This apart, the company also follows a full hedging policy to cover its forex risk. The margins in the sugar business, however, remain vulnerable to change in Government policy and agro-climatic conditions.

Credit challenges

Large proportion of current order book at a nascent stage of execution; however, company's execution track record gives comfort: IHEL is exposed to execution risks, including delay in client-related approvals and site availability as is common in the EPC space. Further, the second wave of Covid-19 infections and the localised lockdowns could disrupt the construction activity and impact execution in the near term. As on Dec 2020, the company had 34% of pending orders under 20% execution of the project order value and at a nascent stage of progress. Notwithstanding the initial stages of completion, IHEL's long execution track record provides comfort.

Delay in monetisation of CBPI assets has resulted in company undertaking debt-funded capex at CBPI plant, which is likely to result in increased debt levels and moderation in debt coverage metrics; Weaker-than-expected performance of subsidiaries/ JVs can entail funding requirements: A delay in monetisation of CBPI assets has resulted in the company undertaking debt-funded capex at the CBPI plant and IHEL (standalone) availed Rs. 200 crore of the term debt for its working capital purpose, which would result in increased debt levels and moderation in debt coverage metrics in the near term. IHEL has extended corporate guarantees for working capital limits of its joint venture entities (Rs.665 crore as on Mar 2020). A weaker-than-expected performance of the subsidiaries can entail funding requirements.

Growing working capital requirements with changing order mix: IHEL's working capital requirements steadily rose over FY2017-2020, led by high revenue growth in the EPC segment and its changing order profile. While a large order book entails high retention money build-up, many incremental orders do not offer interest-free customer advances, as was common in the past. This, along with varying payment cycles, results in higher working capital intensity (NWC/OI of 18% in FY2020, up from 5% in FY2017). IHEL utilised its existing cash and liquid investments and debt to fund these increased requirements. The company has sufficient cushion of an average of around Rs. 1300 crore in the non-fund based limits to address its requirements over the medium term. Further, the absence of cash margin requirements supports the company's financial flexibility.

Intense competition from domestic and international players: The order booking is exposed to the cyclical nature of the end-user industries and the profit margins are vulnerable to the competitive intensity in the domestic and international markets.

Liquidity position: Adequate

The liquidity position is expected to remain adequate, as reflected by the unencumbered cash of Rs. 92 crore, undrawn term loans of Rs. 113 crore and unutilised fund-based working capital limits of Rs. 514 crore as on March 2021. Further, the debt repayments of around Rs. 81 crore are likely to be met from the cash flow from operations. The capex towards the CBPI project is expected to be funded by debt, which is likely to be sanctioned shortly.

Rating sensitivities

Positive factors – Timely commencement and adequate ramp-up in the operations of CBPI resulting in sufficient cash generation for debt servicing or monetisation of CBPI assets resulting in an improvement of consolidated credit metrics would be critical for revision in the outlook to Stable. In addition, a significant increase in the order book execution while improving the operating profits and cash generation, resulting in strengthening of the liquidity and debt coverage metrics on a sustained basis, could also see a revision of outlook to Stable.

Negative factors – Any delays in project execution / ramp-up of operations for CBPI impacting the cash flow generation resulting in support or material delay in monetisation of CBPI assets would be a Negative trigger. Considerable decline in revenue due to lower order book execution, or reduction in profit margins and cash flow generation resulting in weakening of liquidity and debt coverage metrics on a sustained basis could also lead to a rating downgrade.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	Corporate Credit Rating Methodology
Parent/Group Support	Not Applicable
Consolidation/Standalone	For arriving at the ratings, ICRA has considered the consolidated financials of IHEL. List of companies given in Annexure-2.

About the company

IHEL was established in 1946 by the Puri family and has a track record of more than 75 years in the capital goods industry. It has presence in more than 90 countries and has executed orders in countries in the South East Asia, the US, Africa and the Middle East, apart from India. Apart from the EPC of industrial boilers, sugar machinery, power plants, material handling projects, air pollution equipment etc, it also has fabrication and casting facilities across five manufacturing facilities in India, two of which are in Haryana and one each in Gujarat, Uttar Pradesh and New Delhi. The EPC business comprised 76% of the IHEL's revenues in 9M FY2021.

IHEL has a 100% subsidiary – SSML – which is a 10,000-tcd sugar mill located in Yamunanagar, Haryana. IHEL also floated a 51:49 JV with Hitachi Zosen Ltd, Japan in March 2012. The JV, known as ISGEC Hitachi Zosen Ltd, manufactures pressure vessels and heat exchangers for the exports market at Dahej, Gujarat and caters to the petrochemical, oil refining and fertiliser industries. IHEL has entered into a 51:49 JV, both with Titan Metal Fabricators of the US (ISGEC Titan Metal Fabricators) for production and sale of engineering equipment and with the Redecam Group of Italy (ISGEC Redecam Enviro Solutions Pvt Ltd) for executing orders in the air pollution control segment. In FY2019, IHEL acquired a 100% stake in Eagle Press, a company domiciled in Canada and manufacturing mechanical presses, through its Canadian subsidiary. In October 2019, as part of a settlement, IHEL through its 100% subsidiary acquired the entities owning assets related to CBPI, Philippines for a nominal amount.

Key financial indicators (audited)

IHEL Consolidated	FY2019	FY2020
Operating Income (Rs. crore)	5041	5840
PAT (Rs. crore)	144	151
OPBDIT/OI (%)	5.7%	5.2%
PAT/OI (%)	2.9%	2.6%
Total Outside Liabilities/Tangible Net Worth (times)	2.2	2.1
Total Debt/OPBDIT (times)	1.1	3.3
Interest Coverage (times)	6.4	5.0

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 (Rs. crore)	Amount Outstanding as of Mar 2021 (Rs. crore)	Date & Rating in	Date & Rating in FY2021	Date & Rating in FY2020	Date & Rating in FY2019
					May 25, 2021	-	Feb 19, 2020	Nov 12, 2018
1	Long-term Fund-based Working Capital	Long-term	600.00	--	[ICRA]AA (Negative)	-	[ICRA]AA (Stable)	[ICRA]AA (Stable)
2	Short-term – Non fund based Working Capital	Short term	2755.17	--	[ICRA]A1+	-	[ICRA]A1+	[ICRA]A1+
3	Fund based / Non fund based Working Capital	Long term/ Short term	1044.83	--	[ICRA]AA (Negative)/ [ICRA]A1+	-	[ICRA]AA (Stable)/ [ICRA]A1+	[ICRA]AA (Stable)/ [ICRA]A1+
4	Long-term – Non fund based Working Capital	Long term	0.00	--	-	-	[ICRA]AA (Stable)	[ICRA]AA (Stable)
5	Long-term unallocated limits	Long term/ Short term	0.00	--	-	-	[ICRA]AA (Stable)/ [ICRA]A1+	[ICRA]AA (Stable)/ [ICRA]A1+

Complexity level of the rated instruments

Instrument	Complexity Indicator
Long-term Fund-based Working Capital	Simple
Short-term – Non fund based Working Capital	Very Simple
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-1: Instrument details

ISIN No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. Crore)	Current Rating and Outlook
NA	Long-term Fund-based Working Capital	NA	NA	NA	600.00	[ICRA]AA (Negative)
NA	Short-term – Non fund based Working Capital	NA	NA	NA	2755.17	[ICRA]A1+
NA	Fund based / Non fund based Working Capital	NA	NA	NA	1044.83	[ICRA]AA (Negative)/ [ICRA]A1+

Source: *Company*

Annexure-2: List of entities considered for consolidated analysis

Company Name	IHEL Ownership	Consolidation Approach
ISGEC Heavy Engineering Limited	100.00%	Full Consolidation
ISGEC Covema Ltd.	100.00%	Full Consolidation
ISGEC Exports Ltd.	100.00%	Full Consolidation
Saraswati Sugar Mills Ltd.	100.00%	Full Consolidation
ISGEC Engineering & Projects Ltd.	100.00%	Full Consolidation
Free Look Software Private Ltd.	100.00%	Full Consolidation
ISGEC Hitachi Zosen Ltd.	51.00%	Full Consolidation
ISGEC SFW Boilers Private Ltd.	51.00%	Full Consolidation
ISGEC Titan Metal Fabricators Private Ltd.	51.00%	Full Consolidation
ISGEC Redecam Enviro Solutions Private Ltd.	51.00%	Full Consolidation
Eagle Press & Equipment Co. Limited*	100.00%	Full Consolidation
ISGEC Investments Pte Ltd.*	100.00%	Full Consolidation

**Including their subsidiaries; ISGEC Investment Pte Ltd owns CBPI assets*

Source: *IHEL*

Corrigendum

Document dated May 25, 2021 has been corrected with revisions as detailed below:

- Rephrased the analytical approach on page number 1.
- Revision in the Key Financial Indicators section for FY2019 on page number 4.

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