

Rating Rationale

December 10, 2019 | Mumbai

Vardhman Special Steels Limited

Rating outlook revised to 'Negative'; ratings reaffirmed

Rating Action

Total Bank Loan Facilities Rated	Rs.546.52 Crore
Long Term Rating	CRISIL AA/Negative (Outlook revised from 'Stable' and rating reaffirmed)
Short Term Rating	CRISIL A1+ (Reaffirmed)

Rs.150 Crore Commercial Paper	CRISIL A1+ (Reaffirmed)
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1 crore = 10 million

Refer to annexure for Details of Instruments & Bank Facilities

Detailed Rationale

CRISIL has revised its rating outlook on the long-term bank facilities of Vardhman Special Steels Limited (VSSL) to '**Negative**' from 'Stable' while reaffirming the rating at '**CRISIL AA**'; the short-term rating has been reaffirmed at 'CRISIL A1+'.

The revision in outlook reflects the weak performance during first half of fiscal 2020 owing to adverse market conditions in the automobile industry as well as a planned plant shutdown in first half of fiscal 2020. VSSL reported 20% year-on year decline in revenues and moderation of 190 bps in operating margin to 4% during first half of fiscal 2020. The company mainly caters to steel requirement by automotive sector which contributes over 80% of overall revenue of the company. The moderation in operating margin was due to negative operating leverage owing to lower capacity utilization as well as large inventory loss post fall in steel prices. The company had built a large inventory (almost twice of normal inventory levels) in March 2019 in the anticipation of planned shutdown in first half of fiscal 2020. The inventory has reduced significantly as on 30th September 2019.

For remaining of fiscal 2020, operating performance is expected to remain moderate, owing to expected muted automobile demand in near term. As a result, cash accruals are expected to moderate to around Rs. 20 crore during current fiscal from around Rs. 45 crore in fiscal 2019. Debt protection metrics also has moderated owing to lower operating profitability, for instance interest coverage is expected at around 1.5-1.7 times in 2020 as against around 3.2 times in 2019.

In August 2019, VSSL entered into a technical assistance agreement with Aichi Steel Corporation, Japan (ASC, a Toyota Group Associate) which also acquired 11.46% in VSSL through fresh equity issuance for Rs 50 crore. The tie up is intended to reduce operational costs, improve the product quality and improve process efficiencies through technical know-how of Aichi. Also VSSL will benefit from access to the clientele of ASC. The equity infusion of Rs 50 crore has also improved the financial risk profile of the company.

The ratings of VSSL continue to reflect strong support from Vardhman Group, whose flagship company, Vardhman Textiles Ltd (VTXL; rated 'CRISIL AA+/FAAA/Stable/CRISIL A1+') is the largest shareholder in VSSL. The ratings also factor in a moderate business risk profile, supported by considerable backward integration. These rating strengths are partially offset by susceptibility to cyclical in end-user industries and an average financial risk profile.

Analytical Approach

CRISIL has applied its parent notch-up framework to factor in the extent of support from Vardhman Group (whose flagship company, VTXL is the largest shareholder in the VSSL) as the company will enjoy strong support from the group owing to its 59% shareholding in VSSL.

Key Rating Drivers & Detailed Description

Strengths:

* Strong support from Vardhman Group

VSSL, prior to its demerger from VTXL (flagship company of Vardhman Group), was the steel division of the latter. Operations continue to be largely controlled by the management of group even after the demerger. That's because of 58.97% of the equity shares are owned by group including VTXL, its promoters, and other promoter-holding/investment companies. Post the acquisition, ASC also holds 11.46% in the company. VSSL receives support from the group, uses the Vardhman group logo, and has common banking and treasury operations with VTXL. Any major change in the shareholding will be key rating sensitivity factor.

* Moderate business risk profile

Market position is supported by a strong customer base, including automotive original equipment manufacturers and other established players in the engineering segment. In-house manufacturing of ingots and billets, along with ability to pass on price increases, resulted in moderate operating efficiency. The management's focus on the steel business, high capacity utilisation, and considerable backward integration (around 90%) should drive improvement in the business risk profile over the medium term.

Weaknesses:*** Susceptibility to cyclicality in end-user industries**

The company is a small player in the alloy steel industry, with only about 3% of the total capacity in India. Its products are used in the automotive, tractor, bearings, engineering, and allied industries; it is dependent on companies in the automotive sector for over 80% of revenue. This dependence subjects the company to risks related to cyclicality in the automotive segment as witnessed during the recent years of economic slowdown. Further, vulnerability to fluctuations in input prices persists.

*** Average financial risk profile**

The interest coverage ratio is expected at 1.5-1.7 times in fiscal 2019 (3.1 time in 2019). The gearing while remains high, is expected to improve to 0.7 times as on March 31, 2020 as against 0.9 times as on March 31, 2019. Improvement in gearing is on account of equity infusion of Rs 50 crore by ASC in fiscal 2020. The operating margin gradually improved over the years to 6.1% in fiscal 2019 from 2.4% in fiscal 2015 due to improving process efficiencies and increasing capacity utilizations, however has remained lower 4% in first half of fiscal 2020 owing to lower capacity utilisation. As there are no major capex plans over medium term at present, the debt levels are expected to remain stable.

Liquidity Strong

VSSL's liquidity position is moderate; it had unutilised bank lines of Rs.50 crore at September 30, 2019 (bank limit utilisation has fluctuated between 75%-95% during January-September 2019) and is expected to generate cash accruals of ~Rs.25 crore in fiscal 2020, which should suffice to meet its term debt obligation of Rs. 12 crore for 2020. Accruals are expected to increase in fiscal 2021, which should enable the company service its debt obligations of Rs 19 crore in 2021. Presently the company has no major capex plan and focus is on increasing existing capacity utilization. Any major capex in future will be jointly done with ASC.

Outlook: Negative

CRISIL believes the operating performance will recover in line with the recovery in end user industry, while support from Vardhman Group should continue. The tie-up with ASC is also expected to support business and financial risk profile.

Rating Sensitivity factors**Upward factors:**

- * Substantial improvement in business performance, resulting in cash accruals increasing beyond Rs.50-60 crore
- * Steady improvement in credit metrics, especially interest coverage above 3 times

Downward factors:

- * Operating margin remaining below 5% on consistent basis affecting cash generation
- * Increase in gearing beyond 1-1.2 times and interest cover remaining below 2 times on sustained basis, due to continuing weak performance, higher capex or elongation of working capital cycle
- * Reduction in support from group, or downward rating action on, VTXL.

About the Company

The Vardhman group ventured into the steel business in 1972 by setting up Oswal Steels to manufacture special and alloy steels, with initial capacity of 0.5 lakh tpa. In 1986, the firm acquired a plant in Ludhiana, Punjab, and its capacity was increased to 1 lakh TPA. Oswal Steels became a division of VTXL in 1992. VTXL demerged its steel division as VSSL effective January 1, 2011. VSSL has capacity to manufacture 2.00 lakh TPA of steel billets and 2.0 lakh tpa of steel rolled products. Its manufacturing unit is equipped with a 30-tonne ultra-high-power electric arc furnace with an electro-magnetic stirrer, a vacuum degassing system, and a bloom caster.

During first six months ended 30th September 2019, VSSL posted revenue of Rs 453 crore and operating profit of Rs 18 crore as against Rs 565 crore and Rs. 33 crore respectively for similar period in corresponding year.

Key Financial Indicators

Particulars	Unit	2019	2018
Revenue	Rs crore	1121	859
Profit After Tax (PAT)	Rs crore	22	25
PAT Margin	%	2.0	2.9
Adjusted debt/adjusted networkth	Times	0.92	0.67
Interest coverage ratio	Times	2.95	3.17

Any other information: Not applicable

Note on complexity levels of the rated instrument:

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Annexure - Details of Instrument(s)

ISIN	Name of Instrument	Date of Allotment	Coupon Rate (%)	Maturity Date	Issue Size (Rs. Crore)	Rating Assigned with Outlook
NA	Commercial Paper	NA	NA	7-365 days	150	CRISIL A1+
NA	Cash Credit	NA	NA	NA	200	CRISIL AA/Negative
NA	Corporate Loan	NA	NA	Mar-26	59	CRISIL AA/Negative
NA	Corporate Loan	NA	NA	Dec-23	68.85	CRISIL AA/Negative
NA	Letter of credit &	NA	NA	NA	175	CRISIL A1+

Bank Guarantee						
NA	Term Loan	NA	NA	Mar-26	13.6	CRISIL AA/Negative
NA	Proposed Term Loan	NA	NA	NA	30.07	CRISIL AA/Negative

Annexure - Rating History for last 3 Years

Instrument	Current			2019 (History)		2018		2017		2016		Start of 2016	
	Type	Outstanding Amount	Rating	Date	Rating	Date	Rating	Date	Rating	Date	Rating	Rating	
Commercial Paper	ST	150.00	CRISIL A1+			28-12-18	CRISIL A1+		--		--	--	
						26-06-18	CRISIL A1+						
						16-02-18	CRISIL A1+						
Short Term Debt (Including Commercial Paper)	ST							29-06-17	CRISIL A1+	27-07-16	CRISIL A1+	CRISIL A1+	
								09-03-17	CRISIL A1+				
Fund-based Bank Facilities	LT/ST	371.52	CRISIL AA/Negative			28-12-18	CRISIL AA/Stable	29-06-17	CRISIL AA-/Positive	27-07-16	CRISIL AA-/Stable	CRISIL AA-/Stable	
						26-06-18	CRISIL AA/Stable	09-03-17	CRISIL AA-/Stable				
						16-02-18	CRISIL AA-/Positive						
Non Fund-based Bank Facilities	LT/ST	175.00	CRISIL A1+			28-12-18	CRISIL A1+	29-06-17	CRISIL A1+	27-07-16	CRISIL A1+	CRISIL A1+	
						26-06-18	CRISIL A1+	09-03-17	CRISIL A1+				
						16-02-18	CRISIL A1+						

All amounts are in Rs.Cr.

Annexure - Details of various bank facilities

Current facilities			Previous facilities		
Facility	Amount (Rs.Crore)	Rating	Facility	Amount (Rs.Crore)	Rating
Cash Credit	200	CRISIL AA/Negative	Cash Credit	200	CRISIL AA/Stable
Corporate Loan	127.85	CRISIL AA/Negative	Corporate Loan	140	CRISIL AA/Stable
Letter of credit & Bank Guarantee	175	CRISIL A1+	Letter of credit & Bank Guarantee	175	CRISIL A1+
Proposed Term Loan	30.07	CRISIL AA/Negative	Proposed Working Capital Facility	15.52	CRISIL AA/Stable
Term Loan	13.6	CRISIL AA/Negative	Term Loan	16	CRISIL AA/Stable
Total	546.52	--	Total	546.52	--

Links to related criteria

[CRISILs Approach to Financial Ratios](#)[CRISILs Bank Loan Ratings - process, scale and default recognition](#)[Rating criteria for manufacturing and service sector companies](#)[Rating Criteria for Steel Industry](#)[CRISILs Criteria for rating short term debt](#)[Criteria for Notching up Stand Alone Ratings of Companies based on Parent Support](#)

For further information contact:

Media Relations	Analytical Contacts	Customer Service Helpdesk
Saman Khan Media Relations CRISIL Limited D: +91 22 3342 3895 B: +91 22 3342 3000 saman.khan@crisil.com	Anuj Sethi Senior Director - CRISIL Ratings CRISIL Limited B: +91 44 6656 3100 anuj.sethi@crisil.com	Timings: 10.00 am to 7.00 pm Toll free Number: 1800 267 1301 For a copy of Rationales / Rating Reports: CRISILratingdesk@crisil.com
Naireen Ahmed Media Relations	Gautam Shahi Director - CRISIL Ratings CRISIL Limited	For Analytical queries: ratingsinvestordesk@crisil.com

CRISIL Limited
D: +91 22 3342 1818
B: +91 22 3342 3000
naireen.ahmed@crsil.com

B:+91 124 672 2000
gautam.shahi@crsil.com

Omkar Bibikar
Rating Analyst - CRISIL Ratings
CRISIL Limited
D:+91 22 3342 3007
Omkar.Bibikar@crsil.com

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