CRISIL IER IndependentEquityResearch

ISMT Ltd

Initiating coverage

Enhancing investment decisions

Explanation of CRISIL Fundamental and Valuation (CFV) matrix

The CFV Matrix (CRISIL Fundamental and Valuation Matrix) addresses the two important analysis of an investment making process – Analysis of Fundamentals (addressed through Fundamental Grade) and Analysis of Returns (Valuation Grade) The fundamental grade is assigned on a five-point scale from grade 5 (indicating Excellent fundamentals) to grade 1 (Poor fundamentals) The valuation grade is assigned on a five-point scale from grade 5 (indicating strong upside from the current market price (CMP)) to grade 1 (strong downside from the CMP).

CRISIL Fundamental Grade	Assessment	CRISIL Valuation Grade	Assessment
5/5	Excellent fundamentals	5/5	Strong upside (>25% from CMP)
4/5	Superior fundamentals	4/5	Upside (10-25% from CMP)
3/5	Good fundamentals	3/5	Align (+-10% from CMP)
2/5	Moderate fundamentals	2/5	Downside (negative 10-25% from CMP)
1/5	Poor fundamentals	1/5	Strong downside (<-25% from CMP)

About CRISIL Limited

CRISIL is a global analytical company providing ratings, research, and risk and policy advisory services. We are India's leading ratings agency.We are also the foremost provider of high-end research to the world's largest banks and leading corporations.

About CRISIL Research

CRISIL Research is India's largest independent and integrated research house.We provide insights, opinions, and analysis on the Indian economy, industries, capital markets and companies. We are India's most credible provider of economy and industry research. Our industry research covers 70 sectors and is known for its rich insights and perspectives. Our analysis is supported by inputs from our network of more than 4,500 primary sources, including industry experts, industry associations, and trade channels. We play a key role in India's fixed income markets.We are India's largest provider of valuations of fixed income securities, serving the mutual fund, insurance, and banking industries. We are the sole provider of debt and hybrid indices to India's mutual fund and life insurance industries.We pioneered independent equity research in India, and are today India's largest independent equity research house. Our defining trait is the ability to convert information and data into expert judgements and forecasts with complete objectivity. We leverage our deep understanding of the macroeconomy and our extensive sector coverage to provide unique insights on micromacro and cross-sectoral linkages. We deliver our research through an innovative web-based research platform. Our talent pool comprises economists, sector experts, company analysts, and information management specialists.

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Last updated: 31 March, 2011

Analyst Disclosure

Each member of the team involved in the preparation of the grading report, hereby affirms that there exists no conflict of interest that can bias the grading recommendation of the company.

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ISMT Ltd

Pushing for seamless growth

Fundamental Grade	**3/5 (Good fundamentals)**
Valuation Grade	**5/5 (CMP has strong upside)**
Industry	**Metals & Mining**

March 23, 2012

Fair Value	**Rs 40**
CMP	**Rs 26**

ISMT is one of the leading producers of seamless tubes in India and the only domestic player to be backward integrated. Though the company faces demand slowdown in the medium term, both locally and globally, as well as higher competition, the recent commissioning of the premium quality finishing (PQF) mill and the upcoming power plant are expected to improve its profitability. We initiate coverage on ISMT with a fundamental grade of **3/5**, indicating that its fundamentals are **good** relative to other listed securities in India.

Diversification provides better industry positioning

ISMT produces tubes of varying outer diameters (ODs) up to 273 mm which enables it to cater to the varied industries, securing a diversified revenue portfolio. The diversified industry mix helps it to negotiate the vagaries of end-user industries better than its peers. However, ODs above 273 mm not produced by the company have better margins though the end-user market is mainly Oil and Gas. ISMT's current capacity utilisation is low at ~40% due to significant expansion by the company in FY11 and also overcapacity in the industry. We expect utilisation to improve to 47% in FY14 supported by growth in underlying industries.

Captive power plant + process improvement ⇒ margin expansion

The commissioning of its captive power plant (CPP) coupled with the improved capacity utilisation of the PQF mill will result in margin expansion from an expected 14.1% (down from 16.3% in FY11 due to demand slowdown and increased competition) in FY12 to 15.3% in FY14. The newly added PQF mill will also expand its addressable market and enable cost savings for the company due to higher efficiency leading to improvement in margins.

Susceptible to industrial cyclicalities and Chinese dumping

ISMT is exposed to cyclicality of the end-user industries. Also, raw material being a significant part of the cost structure, any upward price movement is bound to result in margin erosion for the company. Aggressive imports of seamless tubes from China have lowered profitability for domestic manufacturers. Countries like the US and Europe has already levied anti- dumping duty on Chinese imports; a similar move in India will benefit the industry.

Expect three-year revenue CAGR of 12.3% and margins of ~15%

We expect revenues to grow at a CAGR of 12.3% to Rs 24.7 bn in FY14 driven by 9.3% volume CAGR. We believe that-despite challenges in the industry-CPP commissioning and process improvement will result in margin expansion (though it would be lower compared to its past performance) over next two years. Adjusted PAT is estimated grow at 12% over the same period.

Valuations: Current market price has strong upside

CRISIL Research has assigned price to earnings (P/E) of 5x on FY14E EPS of Rs 8.1 to arrive at a fair value of Rs 40 per share.

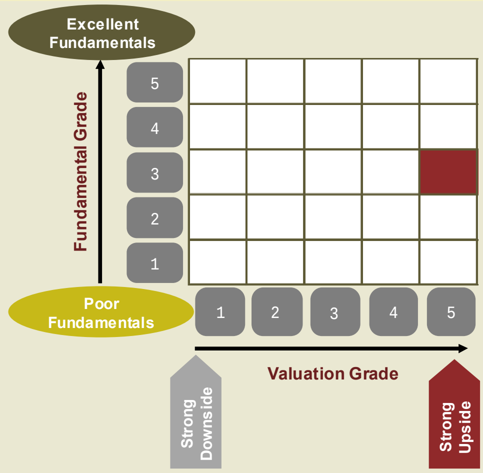
KEY FORECAST

(Rs mn)	FY10	FY11	FY12E	FY13E	FY14E
Operating income	12,691	17,449	20,816	23,026	24,699
EBITDA	1,873	2,838	2,942	3,424	3,768
Adj Net income	485	845	699	884	1,187
Adj EPS-Rs	3.3	5.8	4.8	6.0	8.1
EPS growth (%)	15.2	74.2	(17.2)	26.4	34.3
Dividend Yield (%)	1.5	5.2	4.8	5.4	5.8
RoCE (%)	7.4	11.0	10.5	11.9	13.4
RoE (%)	9.1	14.6	11.7	13.8	16.0
PE (x)	19.7	4.2	5.4	4.3	3.2
P/BV (x)	1.7	0.6	0.6	0.6	0.5
EV/EBITDA (x)	10.9	5.4	5.6	4.7	3.9

NM: Not meaningful; CMP: Current market price

Source: Company, CRISIL Research estimates

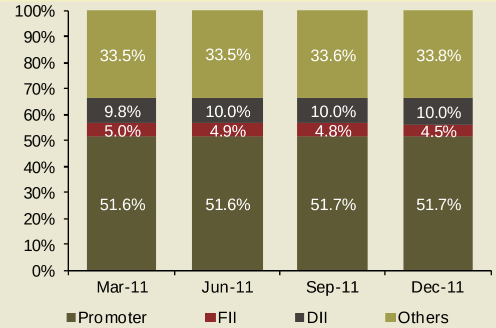
CFV MATRIX



KEY STOCK STATISTICS

NIFTY/SENSEX	5228/17196
NSE/BSE ticker	ISMTLTD/ISMT
Face value (Rs per share)	5
Shares outstanding (mn)	146.5
Market cap (Rs mn)/(US$ mn)	3,809/78
Enterprise value (Rs mn)/(US$ mn)	16,574/331
52-week range (Rs)/(H/L)	61/22
Beta	1.19
Free float (%)	48%
Avg daily volumes (30-days)	135,285
Avg daily value (30-days) (Rs mn)	4.07

SHAREHOLDING PATTERN



PERFORMANCE VIS-À-VIS MARKET

	Returns			
	1-m	3-m	6-m	12-m
ISMT	-18%	10%	-24%	-45%
NIFTY	-5%	10%	6%	-3%

ANALYTICAL CONTACT

Chetan Majithia (Head) chetanmajithia@crisil.com
Vishal Rampuria vrampuria@crisil.com
Prateek S Chauhan pchauhan@crisil.com

Client servicing desk

+91 22 3342 3561 clientservicing@crisil.com

Table 1: ISMT's - Business environment

Parameter	Core business segment	
	Seamless pipes	Steel billets
Revenue CAGR (FY09-11)	9.6%	32.3%
Revenue CAGR (FY11-14)	13.3%	9.9%
Revenue contribution (FY11)	69%	31%
Product application	• Oil and gas exploration and production • Boilers, heat exchangers • Automobiles	• Cast billets - consumed in-house • Bearing billets and alloy billets - merchant sales
Geographic presence	India, the US, Europe	India
Market position	• Second largest seamless tubes manufacturer in India • Diversified revenue portfolio	Small player
End market	• Oil and gas exploration companies • Oil and gas and water supply distribution infrastructure companies • Engineering products companies like BHEL, Thermax • Auto component manufacturers • Heavy engineering • Construction equipment and mining	NA
Key competitors	• **Domestic:** Maharashtra Seamless Ltd, Jindal Saw • **Foreign:** Tenaris SA, Vallourec and TMK	NA
Demand driver	• Surge in domestic E&P activities from ONGC, RIL, Essar Oil, IOCL, Gail and others • Surge in global E&P activities primarily in the US and MENA • Domestic demand for boilers and heat exchangers from growing demand for power plants • Growing demand for auto components	• Growing demand for bearings
Margin drivers	• Change in raw material prices (scrap, pig iron and DRI) • Change in currency • Change in price realisations	• Metallurgical properties of the billets manufactured

Source: Company, CRISIL Research

Grading Rationale

A leading seamless tube player in India

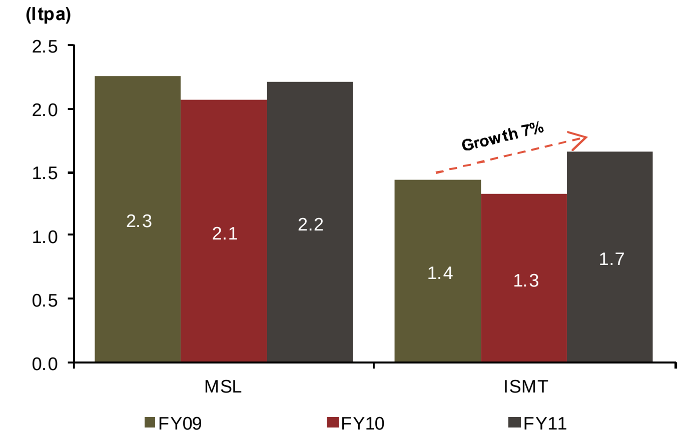
ISMT is a leading producer of precision seamless tubes in India, behind Maharashtra Seamless, with an installed capacity of 4.65 lakh tonnes per annum (ltpa). The company produces tubes which are below 10.75'' (273 mm) diameter and, therefore, have varied usage. The company also has a separate division whereby it produces value-added precision products from seamless tubes like cold rolled rings for bearings, components, couplings, constant velocity cages, etc. ISMT has a well-diversified revenue portfolio with an exposure to different segments which insulates it from vagaries of any particular sector (Refer Figure 2).

ISMT is the second largest producer of seamless tubes in India.

Only company in the domestic sphere to be backward integrated

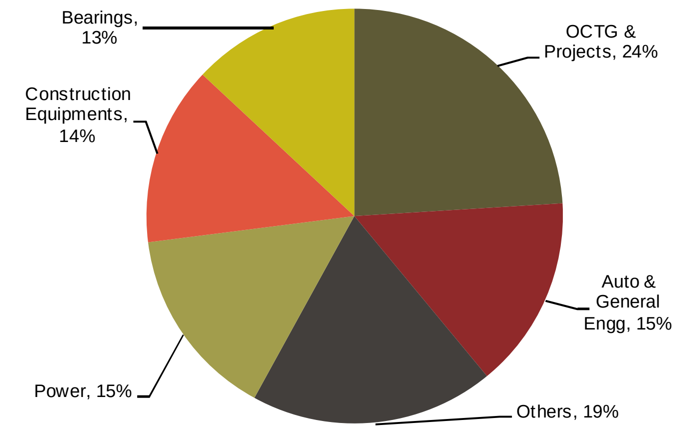
Competitors like Maharashtra Seamless focus on higher dimension tubes, which are mainly used in oil and gas exploration. Though Jindal Saw has a sizeable exposure to seamless tubes, it is primarily focussed on large diameter longitudinal submerged arc welded (LSAW) and ductile iron (DI) pipes.

Figure 1: Sales volume growth



Source: Company, Prowess, CRISIL Research

Figure 2: ISMT's revenue portfolio



Source: Company data, CRISIL Research

To benefit from growth in underlying industries

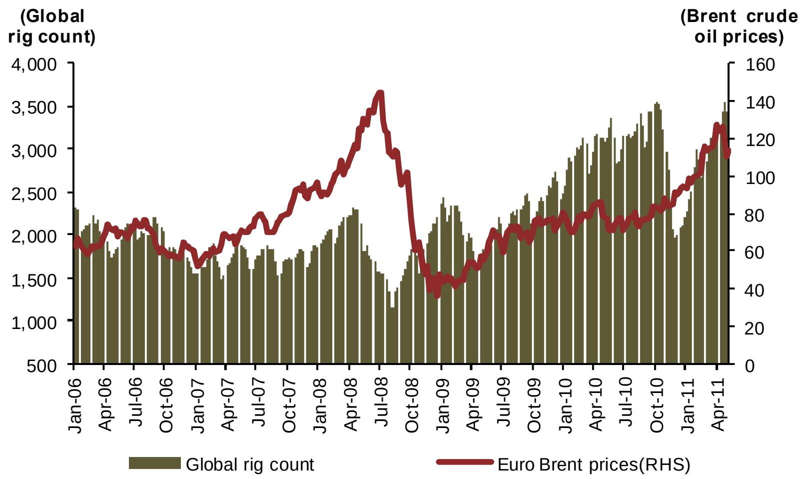
Demand for seamless tubes to be driven by:

1. Ramp-up in global E&P activity

CRISIL Research believes that the medium-term outlook of global demand for seamless pipes is significantly positive on the back of increased demand for crude oil. Oil exploration and production (E&P) activity has a positive correlation with crude oil prices. We believe the firm oil price in conjunction with depleting resources and growing demand would require oil majors to go for incremental exploration activities.

CRISIL Research expects crude oil demand to clock 92.6 mn barrels per day (mbpd) in 2015 vs. 87.4 mbpd in 2010 at a CAGR of 1.2%. Demand growth will primarily be driven by emerging economies such as China and India in the Asia Pacific, Saudi Arabia in the Middle East and Brazil. However, with OD's above 10.75'' finding major applications in E&P activity and ISMT being in the sub 10.75'' diameter, the benefits accrued from the same will be limited.

Figure 3: Oil E&P activity correlated with crude oil prices



Source: Baker Hugers and Hatch, CRISIL Research

Oil E&P activity is directly related to crude oil prices due to commercial viability of the business

The domestic story is similar

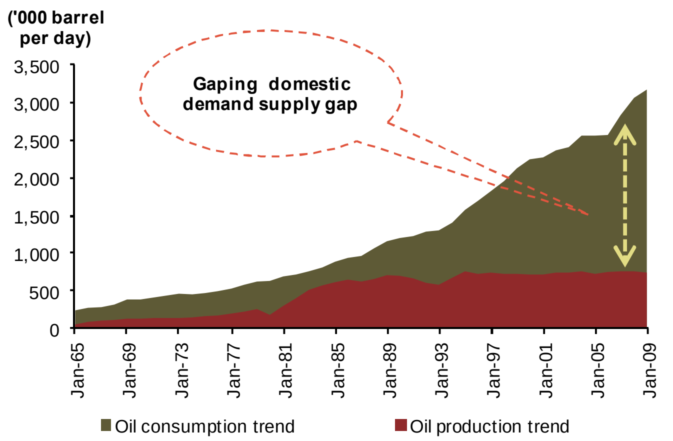
The domestic market for seamless tubes is estimated to be around 6.5 ltpa. With the recent thrust on domestic E&P activities, demand for seamless pipes is estimated to grow at 5% to 8% per annum.

India's oil consumption expected to grow 3% y-o-y till 2015

India is a significant consumer of oil, primarily driven by country's energy needs attributable to its high-growth economy and increasing population. According to the IEA, coal/peat and natural gas account for ~40% and 5% of India's energy needs, respectively, while oil accounts for nearly 24% of the total energy requirement. According to BP Statistical Review data, India currently imports ~76% of its oil requirement and its consumption is expected to reach 3,941 tbpd by 2015.

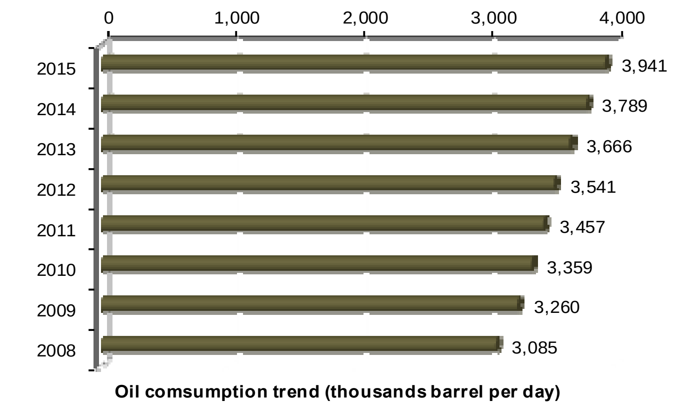
Increased domestic consumption of oil and natural gas to drive demand for seamless tubes

Figure 4: Significant demand-supply gap in oil



Source: BP Statistical Review, CRISIL Research

Figure 5: India's growing oil consumption



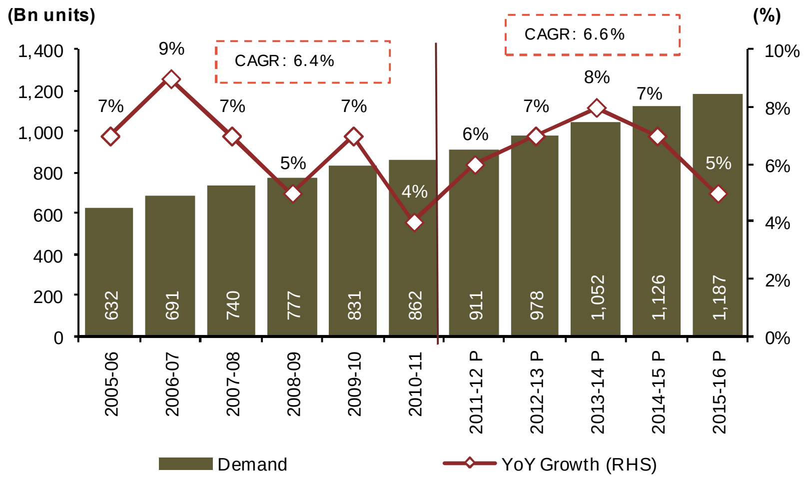
Source: BP Statistical Review, CRISIL Research

2. Huge capacity additions in power sector

CRISIL Research expects capacity additions of 87 GW in the domestic power sector over FY11-16, with coal-based capacities accounting for about 80%. With 90 tonnes of boiler tubes required for setting up 1 MW of power plant, 7.8 MT (mn tonnes) of seamless tubes will be required over FY11-16. Also, replacement demand coupled with increasing usage of premium tubes (premium tubes comply with stringent environmental norms and are instrumental in increasing the efficiency of power plants on the back of certain chemical properties, viz., corrosion resistance) will entail a huge demand for seamless tubes and will provide ISMT a lucrative revenue potential.

87 GW of domestic power capacity addition over FY11-16 to result in demand for 7.8 MT of seamless tubes

Figure 6: Power demand snapshot



Source: CEA, CRISIL Research

3. Strong growth in auto component industry

CRISIL Research expects the auto component industry to grow by 14-16% over FY11-16. Strong demand growth coupled with ISMT's thrust on value-added products for the industry viz., stabiliser bars, piston pins, steering linkages, clutch parts, airbag canisters, etc. augurs well. Also, competitive delivery timelines will ensure a better positioning in the segment.

Strong growth in the auto component industry to aid demand for seamless tubes

Table 2: Size and growth of auto component industry

	FY12E		FY13E	
	Size (Rs bn)	Growth	Size (Rs bn)	Growth
Domestic consumption				
OEM	1,334	18%	1,516	14%
Replacement	557	10%	624	12%
Total	1,891	15%	2,140	26%
Domestic production				
OEM	1,334	18%	1,516	14%
Replacement	283	8%	299	6%
Exports	221	23%	276	25%
Total	1,838	17%	2,091	14%

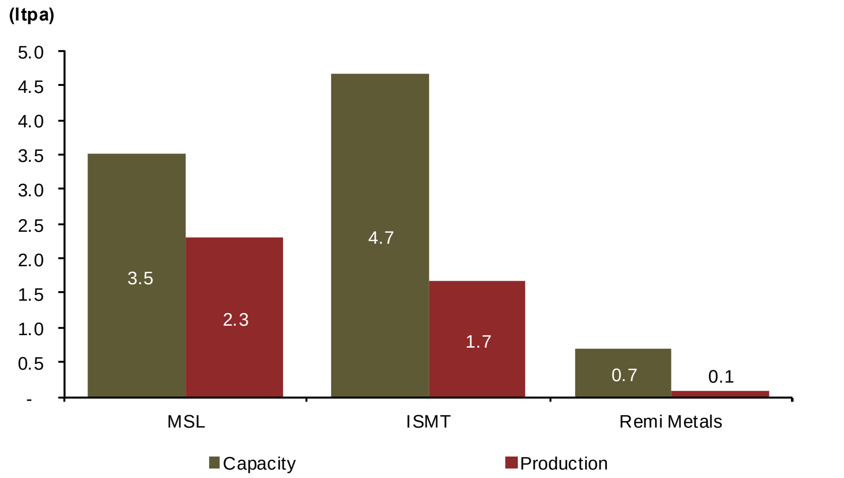
Source: CRISIL Research

Capacity utilisaton is low; expected to expand

ISMT tripled its capacity from 1.6 ltpa to 4.65 ltpa in FY11 by commissioning a new premium quality finishing (PQF) mill to cater to the domestic and global demand in the value-added lower diameter thin walled tubes market. This expansion resulted in a lower utilisation level of 36% during the same period. The 3.1-ltpa PQF mill, which was commissioned at its Baramati plant at a capex of Rs 3.8 bn, started commercial production in H1FY11 (the company achieved 30% utilisation of its Baramati facility during 9MFY12). The company expects gradual ramp-up in utilisation of the enhanced manufacturing capacity. Though the company faces medium term demand slowdown, both locally and globally, we believe exports are expected to boost utilisation levels in the longer run as production is shifted to developing countries like India.

Increased capacity utilisation to result in volume growth

Figure 7: Seamless pipes domestic capacity and production



*- Jindal Saw's seamless production isn't available

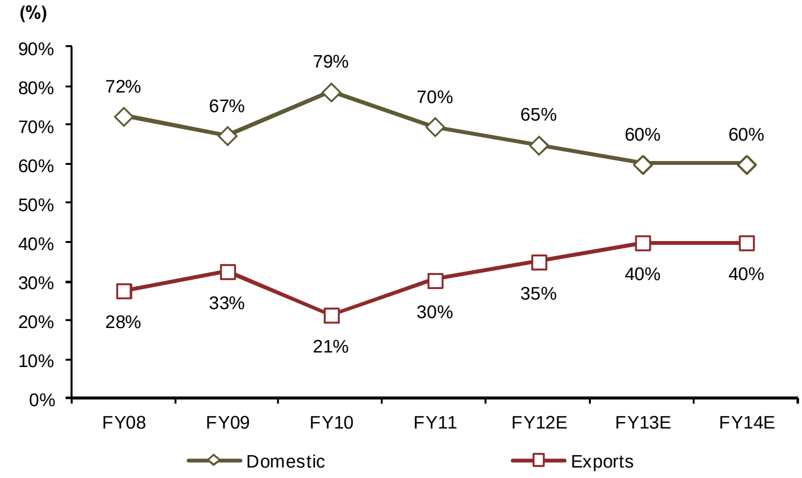
Source: Company, CRISIL Research

Exports to grow faster

ISMT has steadily increased its presence in the export market. A close look at the volume numbers illustrates the same. ISMT's export volume has grown from 38,704 tonnes in FY08 to 44,171 tonnes in FY11 at a CAGR of 5%. With production and end user market shifting to developing countries, companies like ISMT are expected to benefit. We expect the company to aggressively add more customers to improve its volume growth. Given the anti-dumping duty on Chinese products in the US and Europe, ISMT's products have become price competitive in the foreign market which will further bolster its export volumes. Also, with the company's expanding portfolio of value-added products, competitive delivery timelines and addition of new customers, we expect exports to clock 76,527 tonnes in FY14. Overall, the share of exports is expected to increase from 30% in FY11 to 40% in FY14.

Adding more customers is key to increasing export

Figure 8: Geographical break-down of tube volume

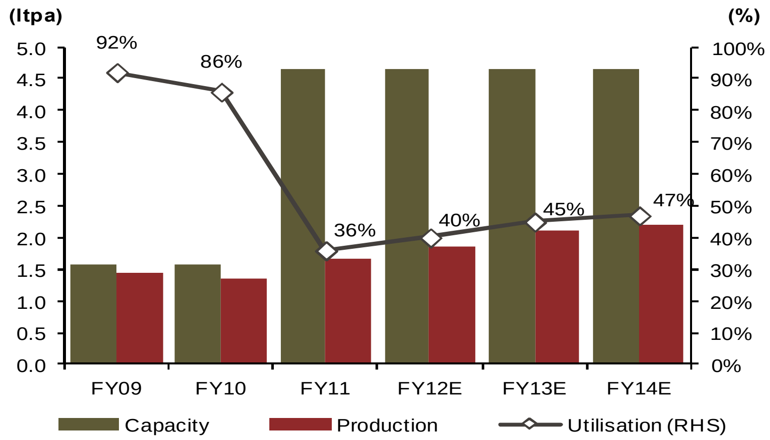


Source: Company, CRISIL Research

Anti-dumping duty on Chinese products in the USA and Europe provides potential for export volume expansion

The company has produced 0.8 ltpa of seamless tubes in H1FY12 and we expect production to reach 1.86 ltpa (H2 expected to fare better than H1) in FY12, 2.09 ltpa in FY13 and 2.19 ltpa in FY14, at a utilisation rate of 40%, 45% and 47%, respectively. This will result in sales volume growing at a CAGR of 9.3% from FY11 to FY14.

Figure 9: Volume growth to play out



Source: Company, CRISIL Research

Power plant, process improvement to boost margins

We believe that the commissioning of the captive power plant (CPP) coupled with optimisation of its various processes will result in margin expansion from an expected 14.1% in FY12 to 15.3% in FY14.

CPP to reduce power cost

Benefit of CPP to accrue from FY13

ISMT is in the process of commissioning its CPP of 40 MW capacity in Chandrapur, Maharashtra in FY13 at an estimated cost of Rs 2.1 bn. Grid synchronisation for the same has already happened in January 2012. The power plant is expected to produce ~175 MU and

245 MU of power operating at 50% and 70% PLF in FY13 and FY14 respectively. In FY11, the average price for procuring grid power was Rs 5.85 per unit. With the rates having appreciated by 11% in H1FY12, we believe after the commissioning of the plant in Q1FY13, the average power generation cost is expected to be close to Rs 5 per unit in FY13 (having factored in coal procurement at Rs 4,000-4,500 per tonne and total coal requirement of 0.2-0.3 mn tonnes). We believe this will translate into cost savings of Rs 385 mn and Rs 516 mn for FY13 and FY14 respectively. Though ISMT has already applied for coal linkage, given the shortage of linkage coal for major power utilities, we believe the company has to resort to e-auction and imported coal to meet its requirement.

Table 3: CPP commissioning to result in power savings

	FY11	FY12E	FY13E	FY14E
Total units consumed (MU)	285	315	341	360
Rate per unit - external (A) (Rs)	5.9	6.5	6.7	6.8
Total cost (Rs mn)	1,667	2,050	2,284	2,456
Power plant capacity (MW)			40	40
PLF			50%	70%
MU generated (B)			175	245
Cost/unit (C)			4.5	4.7
Savings = (A-C)*B (Rs mn)			385	516

Source: Company, CRISIL Research

New PQF mill to optimise manufacturing process

The company currently operates two mills - Assel and PQF. The former is used to manufacture tubes in the OD (outer diameter) range of 168-273 mm while the latter is employed for OD lower than 168 mm. The PQF mill, which was commissioned by the company in FY11, will enable it to cater to the niche market while resulting in cost savings. Also, this expansion has been awarded the “Mega Project” status by the state government making ISMT eligible for fiscal benefits (involves sales tax and electricity duty exemption for production from the new PQF mill) of up to Rs 2 bn over a period of seven years from the date of commencement of production. The new mill will help thus:

PQF mill to increase the size of addressable market available to the company, in addition to potential cost savings

- Expand the addressable market with the capability to produce small diameter thin-walled tubes with OD of 38 mm and wall thickness of 3.2 mm.
- Lower costs resulting from elimination of upstream and downstream processes and improved economies of scale to result in cost savings of ~Rs 2,000/ tonne.
- Cast billets of standard diameter can be used as inputs in the mill instead of rolled billets of varying diameters, resulting in elimination of process of rolling billets, which will result in cost savings to the tune of Rs 1,500/tonne.
- Ability to produce longer length tubes and less redundant deformation, to result in lower wastages.

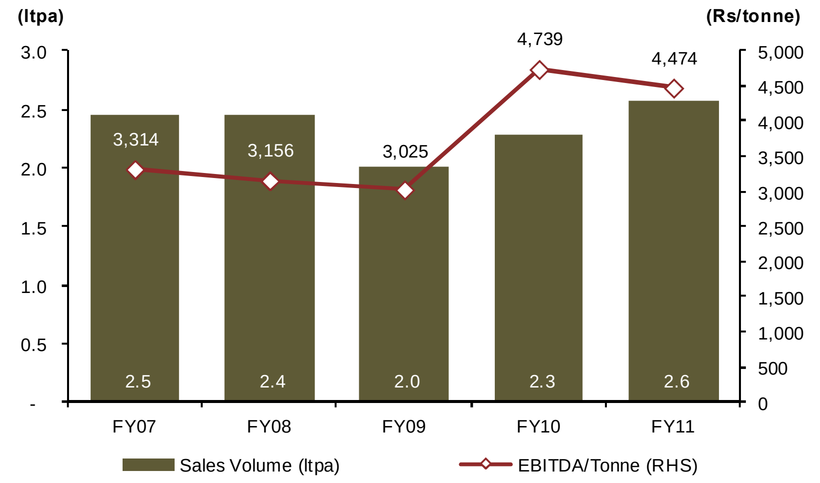
As a result, we estimate potential average cost saving of Rs 3,500-3,700 per tonne on tube processing on the back of improved capacity utilization, the benefit of which is expected to be partially passed on to its customers.

Backward integration into steel provides additional revenue stream

ISMT's steel plant in Jejuri manufactures steel billets for both in-house consumption and market sale. Consequent to the expansion at its tubes facility, the company augmented its steel capacity by 1 ltpa to 3.5 ltpa in FY11. The cast billets manufactured at the plant are consumed in-house while bearing and alloy steel billets are sold in the market owing to higher realisation. The company was producing billets in smaller lots and as per the requirement of its customers. This facilitates a better positioning in the bearing and auto components segment. With the standard billet size to be used in the PQF mill, the company intends to source common grade billets for its tube manufacturing unit from the open market and instead focus on the production of higher realisation yielding bearing and alloy steel billets and continue catering to its steel market.

Increased production of bearing and alloy steel billets in the offing

Figure 10: Steel sales volumes and EBITDA/tonne



Source: Company, CRISIL Research

Shifting of Structo's cold drawn facilities to India will help reduce cost

ISMT had acquired Sweden-based Structo Hydraulics AB in FY07 for Rs 300 mn, a leading tubes and engineering products manufacturer for the hydraulic cylinder industry. This acquisition gave the company access to the European markets - Structo's clientele included Caterpillar, Volvo, etc. - in conjunction with high-end technology. However, the global financial meltdown in FY09 adversely impacted Structo's business and it started reporting losses. The company is shifting cold drawn facilities of Structo to India as many end customers have shifted operation to Asia Pacific region. This measure will enable the company to rationalise its cost; labour-intensive cold drawn process will now be done at ISMT. It has recently transported one of the cold-rolled benches from Structo's plant in Storfors, Sweden to India and intends to transport the remaining in the near future. However, Structo, which is currently at a breakeven level, will not contribute significantly to ISMT's profitability, over our analysis horizon (FY12-14).

Structo's acquisition provided ISMT readymade access to European markets

Exports provide natural hedge to its forex exposure

Export revenues in US dollar and Euro provide a natural hedge to the overseas raw material sourcing for the company as well as debt installment and interest on foreign loans. Exports accounted for ~30% of the tube sales volumes and Rs 3.28 bn in FY11. Going forward, we believe that with increased penetration of Indian players on the back of anti-dumping duty on Chinese equipment, the company's export sale volumes will clock 35% and 40% of the total tube sales volume in FY12 and FY13, respectively.

Table 4: Foreign currency exposure

$ mn	FY11	FY12E	FY13E	FY14E
Net foreign currency inflow	10	12	15	17
Principal+Interest Outgo	20	20	20	20

Source: Company, CRISIL Research

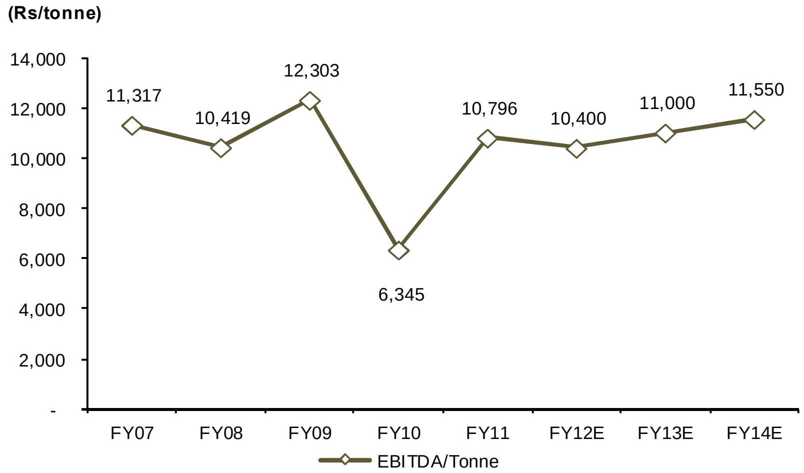
The company's exports provide a natural hedge for its raw material sourcing. However, depreciation of the Indian rupee will result in ISMT reporting mark-to-market losses of ~Rs 498 mn in FY12 (assumption is based on 1USD= Rs 48) on the back of its unhedged exposure to foreign currency loan.

Raw material price volatilities + Chinese competition ⇒ margin pressure to continue

The company uses scrap (50%), pig iron (20%), DRI (Direct Reduced Iron) (20%) and others (10%) as raw materials for its steel plant in Jejuri. It sources pig iron and DRI from Sesa Goa and Welspun Ltd, while it imports scrap. Since raw material is a significant part of the cost structure (~53% of sales in FY11), any upward price movement is bound to result in margin erosion.

The anti-dumping duty in the US and Europe has resulted in aggressive dumping of seamless tubes by Chinese players in India. This has resulted in increased competition and has impacted profitability. However, ISMT's move to add CPP and process improvement through the PQF mill will help it increase its overall margins.

Figure 11: EBITDA per tonne for tubes segment



Source: Company, CRISIL Research

EBITDA/tonne dropped significantly in FY10 on account of loss reported at EBITDA level by Structo

Capacity expansion by MSL to result in increased competition in the near term

Maharashtra Seamless Ltd (MSL) is ISMT's major competitor in the seamless tubes space. However, MSL primarily caters to the higher OD of more than 10 inches, which finds applications in the E&P activity. MSL is adding 2 ltpa capacity to its existing capacity of 3.5 ltpa which is expected to be operational by Q2FY13. The 2 ltpa plant was acquired on an asset purchase basis from Romania at a total cost (including set-up costs) of Rs 3 bn. With its new capacity, MSL will be able to manufacture seamless pipes up to 7 inches, which finds application in the shale gas exploration and production. Given the production facility to manufacture tubes up to 7 inches, we believe MSL will enter into ISMT's domain resulting in increased competition in the domestic market.

ISMT vs. MSL

Particulars	ISMT	MSL
Capacity	Seamless tubes: 4.65 ltpa	Seamless tubes: 3.5 ltpa; ERW pipes (6"- 20" OD): 2 ltpa
Capacity expansion plans	None	2 ltpa
Seamless End markets	Diversified portfolio with an exposure to segments like oil exploration and drilling (24%), boiler in power generation units (15%), construction equipment (14%), bearing and alloy steel (13%) and auto and general engineering (15%)	Primary focus on OCTG segment (~60%)
Clientele	**Hydrocarbon and process industry:** IOCL, BPCL, HPCL, EIL, RPL, MRPL, BRPL, CPCL Power: BHEL, BGR Energy Systems, Thermax **Bearings:** FAG Bearings, NRB Bearings **Auto:** TATA Motors, Komatsu, Rani Madras, Force Motors **Construction equipment and mining:** Wipro Ltd, Sandvick Asia, BEML	**Oil and gas:** ONGC, OIL, GAIL, RIL, Indraprastha Gas, Cairn Energy, Mahanagar Gas Ltd, British Gas (India) **Hydrocarbon and process Industry:** IOCL, HPCL, BPCL, EIL, RPL, MRPL, BRPL, CPCL **Automotive industry:** Bajaj Auto, LML, Mahindra & Mahindra, Telco, Scooter India

Source: Company, CRISIL Research

Peer comparison: ISMT enjoys better realisations but lower margins

MSL is the largest manufacturer of seamless tubes followed by ISMT. MSL primarily caters to the higher OD of more than 10 inches, which enjoys higher margins, though the end-user market is mainly oil and gas. On the other hand, ISMT's focus on value-added products enables it to garner higher realisations than its competitors. The company's EBITDA margin is lower than that of MSL due to the latter's presence in higher diameter tubes and better operational efficiency. Higher interest cost on account of capital expenditure funded through substantial debt has resulted in subdued PAT margins for ISMT. On account of revaluation of its assets in FY10, the asset turnover and return ratios of MSL dropped from 7.5x in FY09 to 2.5x in FY10. Return ratios are lower due to competition pressure and lower utilisation levels.

Table 5: Peer comparison: Seamless tubes and pipes

	MSL					ISMT				
Rs mn	FY07	FY08	FY09	FY10	FY11	FY07	FY08	FY09	FY10	FY11
Capacity (seamless tubes- ltpa)	3.5	3.5	3.5	3.5	3.5	1.6	1.6	1.6	1.6	4.7
CU	65%	70%	64%	58%	65%	102%	103%	92%	86%	36%
Revenues	13,994	15,104	20,776	16,146	17,153	10,658	13,682	14,522	12,691	17,449
Sales Realisation	52,081	49,849	50,023	72,641	57,636	67,124	76,704	67,309	74,668	67,124

	MSL					ISMT				
Cost (as a % of sales)	FY07	FY08	FY09	FY10	FY11	FY07	FY08	FY09	FY10	FY11
Raw material cost	64%	67%	69%	62%	64%	53%	54%	53%	52%	52%
Employee cost	1.2%	1.5%	1.2%	1.7%	1.8%	4.8%	8.2%	8.9%	9.2%	7.1%
Power and fuel cost	6.6%	7.2%	6.3%	6.8%	8.4%	12.9%	13.1%	12.3%	17.3%	16.5%

	MSL					ISMT				
Key ratios	FY07	FY08	FY09	FY10	FY11	FY07	FY08	FY09	FY10	FY11
EBITDA Margin (%)	25.1	21.1	17.9	26.2	22.4	23.1	16.9	16.7	14.8	16.3
EBITDA/Tonne (Rs/tonne)	13,295	12,229	14,882	16,450	17,971	11,317	10,419	12,303	6,345	10,796
Debt-equity Ratio (x)	0.12	0.09	0.06	0.04	0.03	2.2	1.8	2.4	2.1	2.1
Adj PAT margin (%)	16.7	12.9	12.5	17.6	16.6	9.0	7.4	2.9	3.8	4.8
Asset turnover ratio (x)	5.1	5.5	7.5	2.5	1.7	1.3	1.7	1.9	1.7	1.8
RoE (%)	35.0	19.3	21.6	15.8	11.8	22.9	22.2	8.1	9.1	14.6

Source: Company, Prowess, CRISIL Research

ISMT's net working capital days appear to be on the lower side owing to its highest creditor days; the company converts its import obligation to buyer's credit.

Table 6: Working capital days comparison

	Inventory days			Debtor days			Creditor days		
	FY09	FY10	FY11	FY09	FY10	FY11	FY09	FY10	FY11
ISMT Ltd	116	137	128	51	76	82	108	161	181
Maharashtra Seamless	101	164	174	45	49	47	96	54	88

Source: Company, Prowess, CRISIL Research

Key risks

Global slowdown = low demand, realisations

With the global economic slowdown exacerbating in future, ISMT's volumes and realisations will be adversely impacted. ISMT derives a sizeable portion of its revenues from exports (~20% of total sales) and any unfavourable demand scenario will lead to lower export revenues and, hence, a reduced topline.

Delay in ramping-up production, CPP commissioning

Delay in addition of new customers would lead to lower volume growth than projected. Also, a delay in commissioning and stabilisation of the power plant coupled with a delay in securing linkage coal will result in lower savings and, hence, lower margins.

Reduced export incentives = margin erosion

The new DEPB (Duty Entitlement Pass Book) scheme introduced by the Indian government during FY12 has lowered the incentives on export sales. Any further reduction/absence of such incentives coupled with slackening global demand will result in margin erosion for the company.

Anti-dumping duty on Chinese products in India

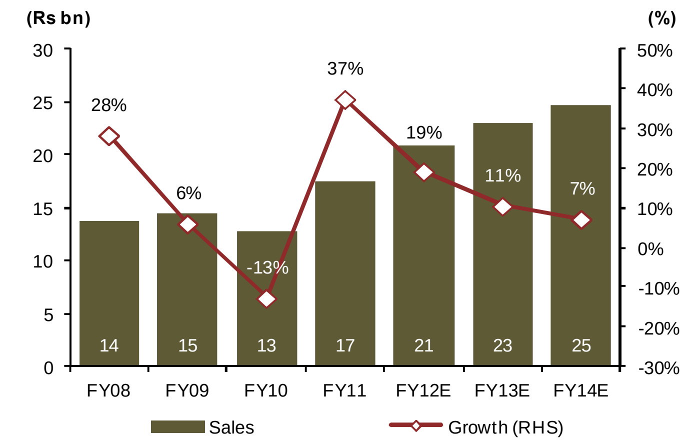
The levying of anti-dumping duty on Chinese products in India, which is absent, will provide a huge upside potential for the company to significantly improve its utilisation level. The company along with other industry participants has also applied for a safeguard duty which is under consideration by the government.

Financial Outlook

Revenue growth to be driven by volume growth

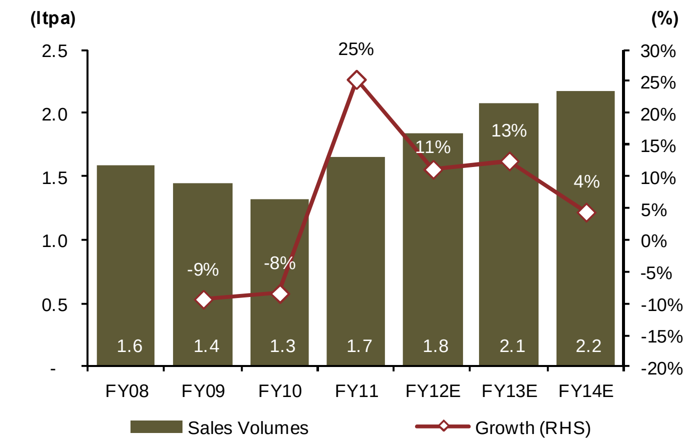
We expect revenues to grow to Rs 25 bn in FY14 at a three-year CAGR of 12.3%. We believe that the key growth driver will be sales volume growth of 9.3% in seamless tubes on the back of increased utilisation level of the enhanced capacity. We believe that company will be able to operate its plants at ~47% utilisation level by FY14.

Figure 12: Revenues to grow at a CAGR of 12.3%



Source: Company, CRISIL Research

Figure 13: Sales volume to grow at a CAGR of 9.3%

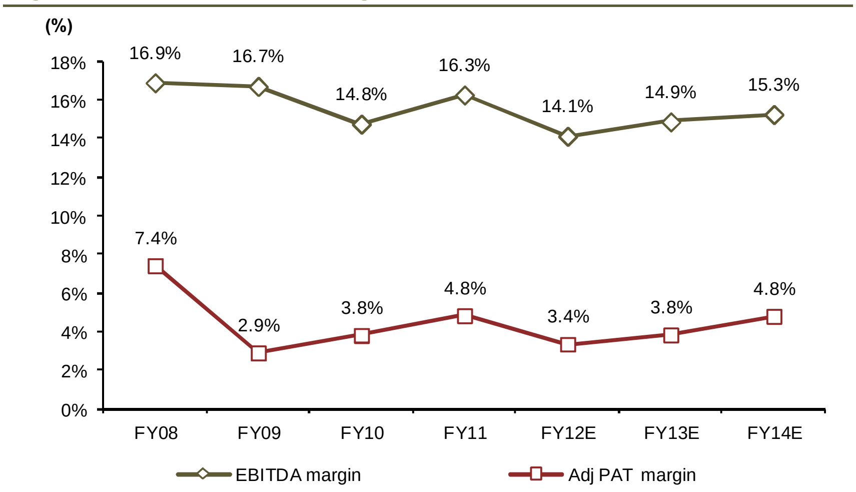


Source: Company, CRISIL Research

Operating margins to expand

ISMT enjoys stable operating margins on the back of stable cost structure and revenue diversification. Going forward, we believe that the installation of PQF mill and the commissioning of captive power plant will result in cost savings which will translate into margin expansion. However, increasing competition and medium term demand slowdown, both locally and globally, will limit overall margin expansion.

Figure 14: Overall EBITDA margins to improve



Source: Company, CRISIL Research

In FY10, recession impacted the automotive and OCTG segment adversely. This coupled with dumping by Chinese players resulted in sales de-growth

During FY10, reduced topline coupled with 19% hike in merchant power rates impacted EBITDA margins

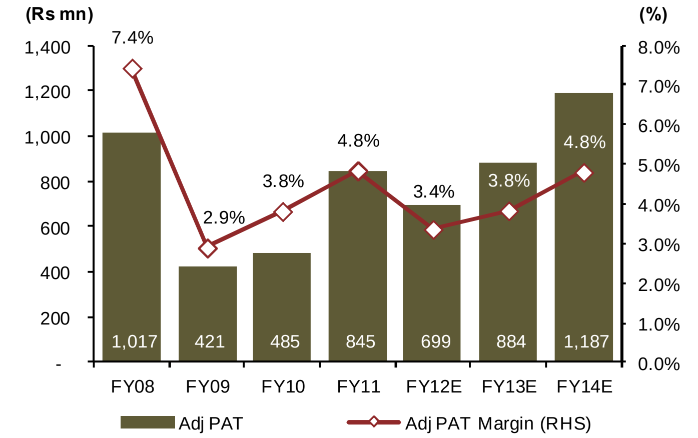
Adjusted PAT margin to decline in FY12, improve in FY13

ISMT's adjusted PAT is expected to grow from Rs ~845 mn in FY11 to Rs ~1,187 mn in FY14, primarily driven by strong top-line growth and better operating performance. However, adjusted PAT margin will decline from 4.8% in FY11 to 3.4% in FY12 before recovering to 3.8% in FY13 and 4.8% in FY14. Adjusted PAT margin decline in FY12 will be driven by lower utilization rate and higher interest cost and higher tax rate. However, in FY13 and FY14, better operating performance will translate into higher adjusted PAT margin.

With a substantial foreign currency loan, continued depreciation of the Indian rupee will result in forex loss of Rs 498 mn in FY12 (1US$=Rs 48), followed by gain of Rs 223 mn in FY13 (1US$=Rs 46.5). However, there wouldn't be any cash outgo. This mark to market losses will result in company reporting subdued PAT level in FY12.

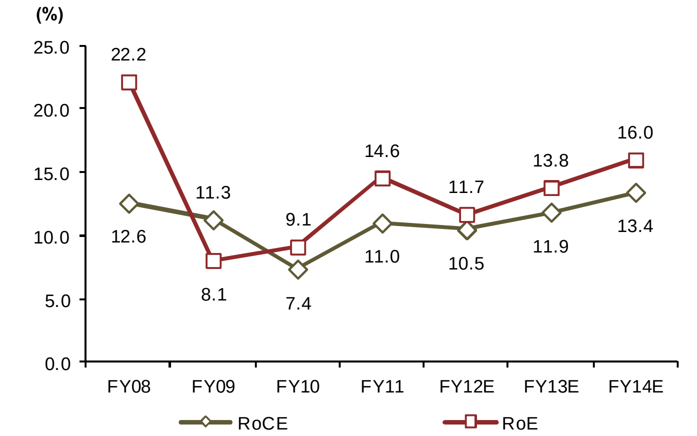
The EPS is expected to grow at 12% CAGR to Rs 8.1 in FY14 from Rs. 5.8 in FY11. Also, the company has redeemed FCCBs worth US$20mn on December 1, 2011 using an ECB loan.

Figure 15: PAT margin down in FY12, up in FY13



Source: Company, CRISIL Research

Figure 16: So also RoE and RoCE



Source: Company, CRISIL Research

Management Overview

CRISIL's fundamental grading methodology includes a broad assessment of management quality, apart from other key factors such as industry and business prospects, and financial performance.

ISMT has experienced top and second line of management

Based on our interactions with the management, we feel the company was transparent about its performance and acknowledged the shortfalls, if any.

Experienced management

ISMT has an experienced management headed by Mr Salil Taneja, CEO. He is the son of Mr B.R. Taneja - promoter of the company and non-executive director. Mr Salil Taneja is supported by Mr Rajiv Goel - CFO, Mr O.P. Kakkar - special advisor, Mr IAK Prakash - COO and Mr Nirmal Chandra - president (projects and product development). Based on our interactions with the management, we feel that the management is fairly experienced and has an in-depth understanding of the business.

Decentralised second line of management

Based on our interactions, we believe the company's second line is well experienced and independent of the promoter family. Some key managerial personnel have been associated with the company for more than a decade. The plant head of Baramati facility, Mr K.M. Bhapkar, has been associated with the company for the past two decades and has vast experience in the field. Also, the executive VPs of marketing, Mr N Kalyan and Mr S Mallya, have been with the company for over a decade. Mr N Kalyan looks after the marketing responsibilities in OCTG, boiler trade, logistics while Mr S Mallya is in charge of auto, mining and steel, bearing and general engineering.

Corporate Governance

CRISIL's fundamental grading methodology includes a broad assessment of corporate governance and management quality, apart from other key factors such as industry and business prospects, and financial performance. In this context, CRISIL Research analyses the shareholding structure, board composition, typical board processes, disclosure standards and related-party transactions. Any qualifications by regulators or auditors also serve as useful inputs while assessing a company's corporate governance.

Overall, corporate governance at ISMT meets the minimum levels supported by reasonably good board practices and involvement of an independent board.

Corporate governance practices at ISMT conform to regulatory requirement

Board composition

ISMT's board consists of 10 members, of whom four are independent directors, which is in line with the requirements under Clause 49 of SEBI's listing guidelines. The board is chaired by Mr S.C. Gupta who is a non-executive, independent director. Mr S.C. Gupta has worked as CMD of Punjab National Bank and Indian Overseas Bank. The other independent directors:

- Mr K.K. Rai has held senior positions at Vijaya Bank and has also served as executive director of Allahabad Bank.
- Mr Vinod Sethi has worked as managing director of Morgan Stanley Investment Management, Inc, New York and currently runs his own investment firm.
- Mr V Gourishankar is an IDBI nominee on the board.

Board's processes

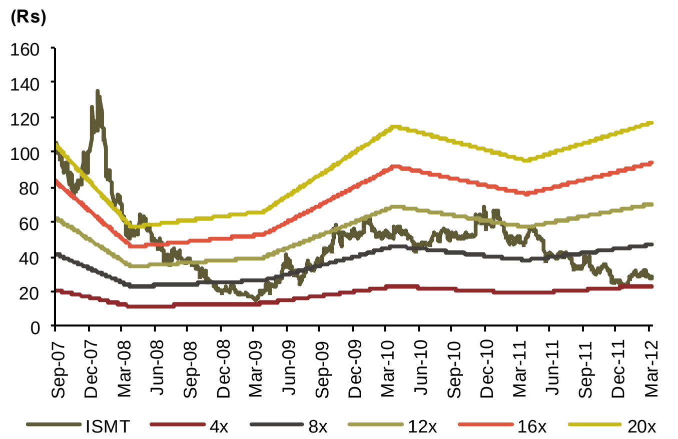
The company's quality of disclosure can be considered good judged by the level of information and details furnished in the annual report, websites and other publicly available data. The company has all necessary committees in place to support corporate governance practices. The audit committee is chaired by an independent director, Mr Vinod Sethi. The committee meets at timely and regular intervals. The remuneration committee is chaired by Mr K.K. Rai, another independent director.

Valuation Grade: 5/5

The tubes sector, especially seamless tubes, is heavily dependent on capital expenditure of oil and gas, power, auto components and other end-user industries. As a result, sales volume, capacity utilisation and price realisation for tube companies is volatile in nature. Additionally, due to dependence on steel / steel-based products, which are its key raw material, any fluctuations in the same results in volatility in margins of tube manufacturers. Thus, we believe that P/E (price to earnings multiple) is the best method to value a tube company like ISMT. Due to large over-capacities, especially in case of submerged arc welded (SAW) pipes, Indian pipe manufacturing companies have been trading at a low PER. Since April 2009, large Indian pipe manufacturers (excluding APL Apollo tubes) have traded at a median one-year forward PER of between 4.6x and 9.7x. Though ISMT has traded at a higher multiple in the past (median of last five years is 10x), we believe given the local overcapacity, competition and demand slowdown in the medium term both locally and globally, and its ability to add new customers will limit a significant ramp-up of its enhanced capacity. This will, in turn, limit profitability expansion.

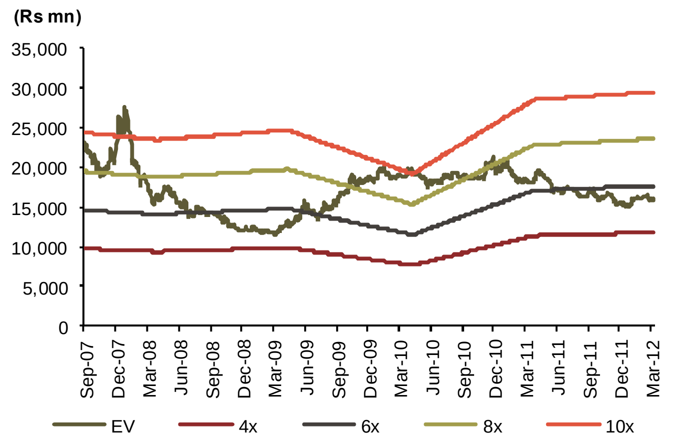
We assign P/E of 5x to ISMT's FY14 EPS of Rs 8.1. We initiate coverage on ISMT with a one-year fair value of Rs 40. Based on the current market price of Rs 26, we assign a valuation grade of '5/5' indicating that the market price has strong upside from current levels. At our fair value, the implied EV/EBITDA for ISMT is 4.5x on FY14 earnings estimate.

One-year forward P/E band



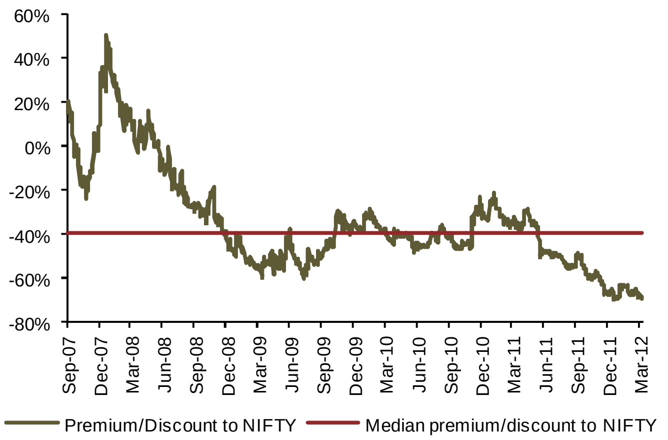
Source: NSE, CRISIL Research

One-year forward EV/EBITDA band



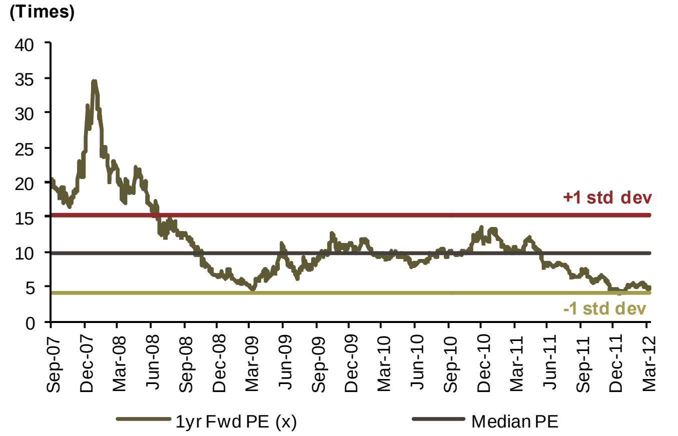
Source: NSE, CRISIL Research

P/E – premium / discount to NIFTY



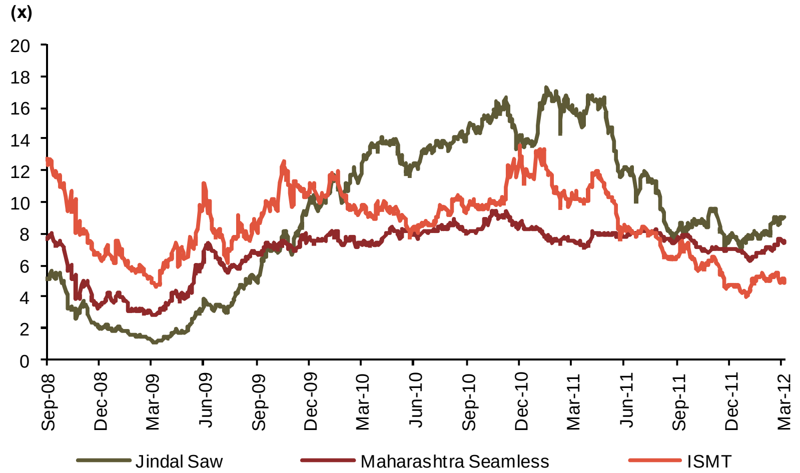
Source: NSE, CRISIL Research

P/E movement



Source: NSE, CRISIL Research

One-year forward PER trend for Indian seamless manufacturers



Source: NSE, CRISIL Research

Peer comparison

	M.cap	EBITDA Margin			PAT Margin			RoE (%)			P/E (x)		
Companies	(Rs mn)	FY11	FY12E	FY13E	FY11	FY12E	FY13E	FY11	FY12E	FY13E	FY11	FY12E	FY13E
ISMT Ltd	**3,809**	**16.3**	**14.1**	**14.9**	**4.8**	**3.4**	**3.8**	**14.6**	**11.7**	**13.8**	**4.2**	**5.4**	**4.3**
Jindal Saw	47,414	18.7	13.6	14.9	9.7	6.1	7.3	na	8.3	11.8	12.8	14.1	9.3
Maharastra seamless	26,521	25.4	20.0	20.1	19.4	14.7	14.6	14.2	12.6	13.0	6.7	8.5	7.7
Global Peers													
Vallourec	5,971*	17.7	16.8	20.3	7.6	6.5	9.0	8.6	7.6	10.8	15.2	15.9	10.1
Tenaris	23,398**	24.6	26.2	27.1	13.4	14.8	15.6	13.1	14.0	14.1	16.4	13.6	12.3

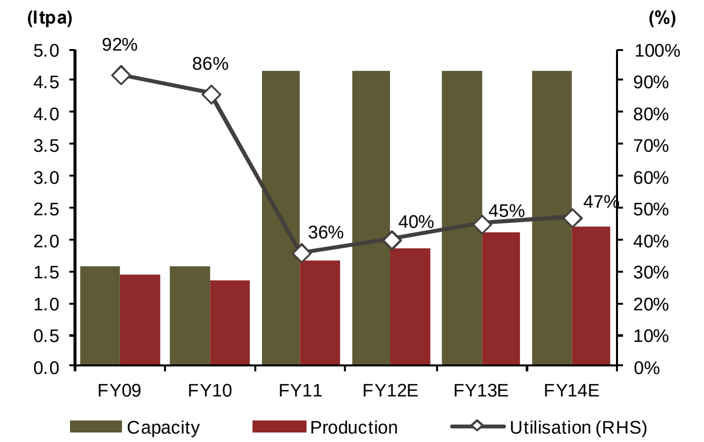
*- in Euro, **- in USD

Source: CRISIL Research, Industry sources

Company Overview

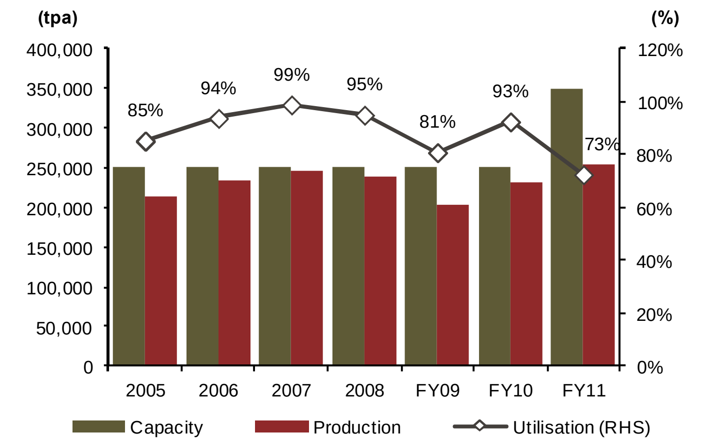
ISMT is the second largest integrated manufacturer with the largest manufacturing capacity of seamless tubes in India. It manufactures and supplies a wide range of seamless tubes (38 mm to 279 mm OD). It also produces more than 330 grades of alloy bearing and carbon steel. ISMT's products are certified by the American Petroleum Institute (API). ISMT is promoted by Baldev Raj Taneja, the promoter of Taneja Aerospace.

Figure 17: Seamless tubes capacity and production



Source: Company, CRISIL Research

Figure 18: Steel capacity and production



Source: Company, CRISIL Research

Milestones

1980	The Indian Seamless Metal Tubes Ltd started operations. Commissioned first seamless tubes capacity of 15,000 tpa
1990	Added second mill and increased capacity 50,000 tpa
1995	Started Indian Seamless Steels and Alloys Ltd (ISSAL) to produce alloy steel, the raw material used for seamless tubes
2000	Acquired Kalyani Seamless tubes Ltd, with a capacity of 90,000 tpa
2005	The Indian Seamless Metal Tubes Ltd and Indian Seamless Steels and Alloys Ltd merged to form ISMT Ltd
2007	ISMT acquired Structo Hydraulics AB, based in Sweden
2010	Commissioned new PQF mill
2010	Steel capacity increased to 350,000 tpa

Annexure: Financials

Income statement

(Rs mn)	FY10	FY11	FY12E	FY13E	FY14E
Operating income	**12,691**	**17,449**	**20,816**	**23,026**	**24,699**
EBITDA	**1,873**	**2,838**	**2,942**	**3,424**	**3,768**
EBITDA margin	**14.8%**	**16.3%**	**14.1%**	**14.9%**	**15.3%**
Depreciation	615	864	947	1,094	1,121
EBIT	**1,258**	**1,974**	**1,995**	**2,330**	**2,647**
Interest	741	980	1,128	1,164	1,059
Operating PBT	**517**	**994**	**867**	**1,167**	**1,588**
Other income	45	59	66	61	61
Exceptional inc/(exp)	-	(63)	(498)	223	223
PBT	**562**	**989**	**434**	**1,450**	**1,872**
Tax provision	77	208	233	344	462
Minority interest	-	-	-	-	-
PAT (Reported)	**485**	**781**	**201**	**1,107**	**1,410**
Less: Exceptionals	-	(63)	(498)	223	223
Adjusted PAT	**485**	**845**	**699**	**884**	**1,187**

Ratios

	FY10	FY11	FY12E	FY13E	FY14E
Growth					
Operating income (%)	(12.6)	37.5	19.3	10.6	7.3
EBITDA (%)	(22.8)	51.5	3.6	16.4	10.0
Adj PAT (%)	15.2	74.2	(17.2)	26.4	34.3
Adj EPS (%)	15.2	74.2	(17.2)	26.4	34.3
Profitability					
EBITDA margin (%)	14.8	16.3	14.1	14.9	15.3
Adj PAT Margin (%)	3.8	4.8	3.4	3.8	4.8
RoE (%)	9.1	14.6	11.7	13.8	16.0
RoCE (%)	7.4	11.0	10.5	11.9	13.4
RoIC (%)	7.7	10.9	10.3	11.1	12.1
Valuations					
Price-earnings (x)	19.7	4.2	5.4	4.3	3.2
Price-book (x)	1.7	0.6	0.6	0.6	0.5
EV/EBITDA (x)	10.9	5.4	5.6	4.7	3.9
EV/Sales (x)	1.6	0.9	0.8	0.7	0.6
Dividend payout ratio (%)	30.2	23.4	91.1	18.5	15.6
Dividend yield (%)	1.5	5.2	4.8	5.4	5.8
B/S ratios					
Inventory days	137	128	104	111	112
Creditors days	161	181	158	154	154
Debtor days	76	82	79	80	80
Working capital days	115	84	79	86	92
Gross asset turnover (x)	1.1	1.2	1.1	1.1	1.2
Net asset turnover (x)	1.7	1.8	1.6	1.7	1.9
Sales/operating assets (x)	1.0	1.3	1.5	1.7	1.9
Current ratio (x)	1.9	1.6	1.7	1.8	1.7
Debt-equity (x)	2.1	2.1	2.2	1.9	1.4
Net debt/equity (x)	1.9	2.0	2.1	1.8	1.4
Interest coverage	1.7	2.0	1.8	2.0	2.5

Per share

	FY10	FY11	FY12E	FY13E	FY14E
Adj EPS (Rs)	3.3	5.8	4.8	6.0	8.1
CEPS	7.5	11.7	11.2	13.5	15.8
Book value	38.4	40.8	40.8	46.7	54.6
Dividend (Rs)	1.0	1.2	1.3	1.4	1.5
Actual o/s shares (mn)	146.5	146.5	146.5	146.5	146.5

Balance Sheet

(Rs mn)	FY10	FY11	FY12E	FY13E	FY14E
Liabilities					
Equity share capital	733	733	733	733	733
Reserves	4,892	5,251	5,239	6,107	7,262
Minorities	-	-	-	-	-
Net worth	**5,624**	**5,983**	**5,971**	**6,840**	**7,994**
Convertible debt	-	-	-	-	-
Other debt	11,557	12,628	13,428	13,028	11,528
Total debt	**11,557**	**12,628**	**13,428**	**13,028**	**11,528**
Deferred tax liability (net)	356	684	684	684	684
Total liabilities	**17,538**	**19,295**	**20,083**	**20,551**	**20,206**
Assets					
Net fixed assets	7,555	11,539	13,892	13,297	12,676
Capital WIP	5,114	2,480	280	190	110
Total fixed assets	**12,668**	**14,018**	**14,171**	**13,487**	**12,786**
Investments	-	-	-	-	-
Current assets					
Inventory	3,898	4,860	4,848	5,678	6,090
Sundry debtors	2,813	4,098	4,719	5,220	5,599
Loans and advances	2,280	2,789	3,539	3,914	4,199
Cash & bank balance	637	715	664	666	537
Marketable securities	-	-	-	-	-
Total current assets	**9,628**	**12,461**	**13,769**	**15,477**	**16,424**
Total current liabilities	**5,101**	**7,570**	**8,242**	**8,799**	**9,390**
Net current assets	**4,528**	**4,891**	**5,526**	**6,679**	**7,034**
Intangibles/Misc. expenditure	**342**	**386**	**386**	**386**	**386**
Total assets	**17,538**	**19,295**	**20,083**	**20,551**	**20,206**

Cash flow

(Rs mn)	FY10	FY11	FY12E	FY13E	FY14E
Pre-tax profit	562	1,052	932	1,228	1,649
Total tax paid	126	120	(233)	(344)	(462)
Depreciation	615	864	947	1,094	1,121
Working capital changes	240	(286)	(686)	(1,150)	(484)
Net cash from operations	**1,543**	**1,751**	**960**	**828**	**1,824**
Cash from investments					
Capital expenditure	(1,333)	(2,258)	(1,100)	(410)	(420)
Investments and others	0	-	-	-	-
Net cash from investments	**(1,333)**	**(2,258)**	**(1,100)**	**(410)**	**(420)**
Cash from financing					
Equity raised/(repaid)	-	-	-	-	-
Debt raised/(repaid)	(368)	1,071	800	(400)	(1,500)
Dividend (incl. tax)	(171)	(213)	(213)	(238)	(255)
Others (incl extraordinaries)	313	(273)	(498)	223	223
Net cash from financing	**(226)**	**585**	**89**	**(415)**	**(1,532)**
Change in cash position	(16)	78	(51)	2	(129)
Closing cash	637	715	664	666	537

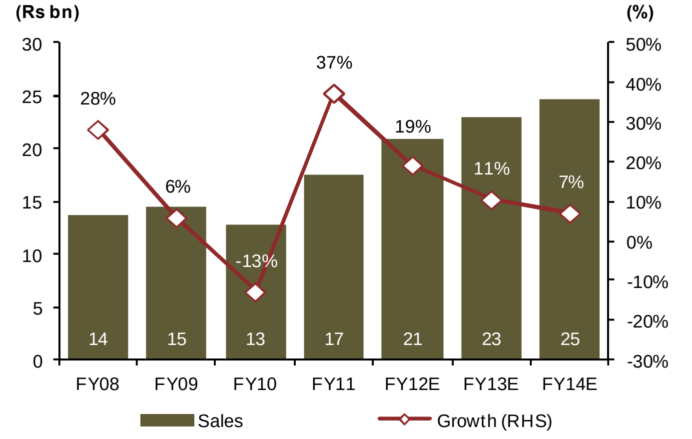
Quarterly financials (Standalone)

(Rs mn)	Q3FY11	Q4FY11	Q1FY12	Q2FY12	Q3FY12
Net Sales	**3,886**	**4,929**	**4,716**	**5,122**	**4,645**
Change (q-o-q)	-4%	27%	-4%	9%	-9%
EBITDA	**668**	**632**	**694**	**693**	**536**
Change (q-o-q)	-10%	-5%	10%	0%	-23%
EBITDA margin	**17%**	**13%**	**15%**	**14%**	**12%**
PAT	146	170	186	105	18
Adj PAT	**142**	**201**	**207**	**229**	**87**
Change (q-o-q)	-16%	41%	3%	11%	-62%
Adj PAT margin	**3.7%**	**4.1%**	**4.4%**	**4.5%**	**1.9%**
Adj EPS	**1.0**	**1.4**	**1.4**	**1.6**	**0.6**

Source: CRISIL Research

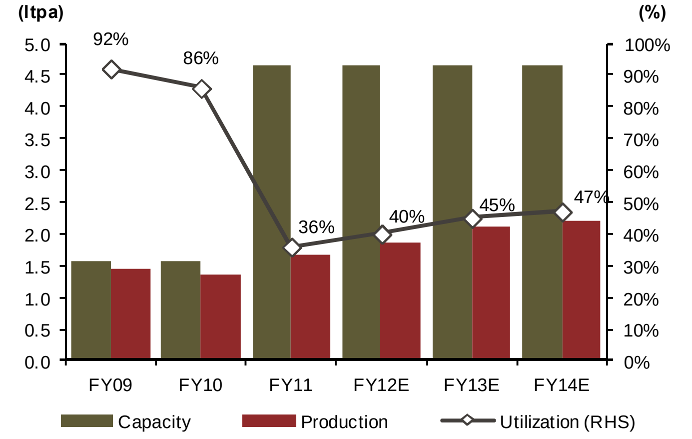
Focus Charts

Revenue and growth trend



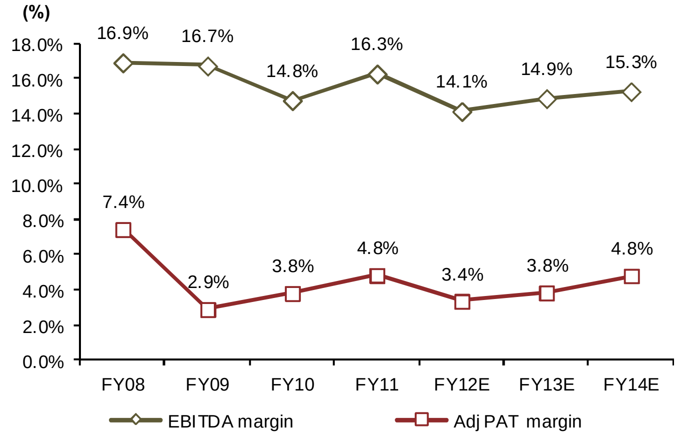
Source: Company, CRISIL Research

Production and utilisation trend



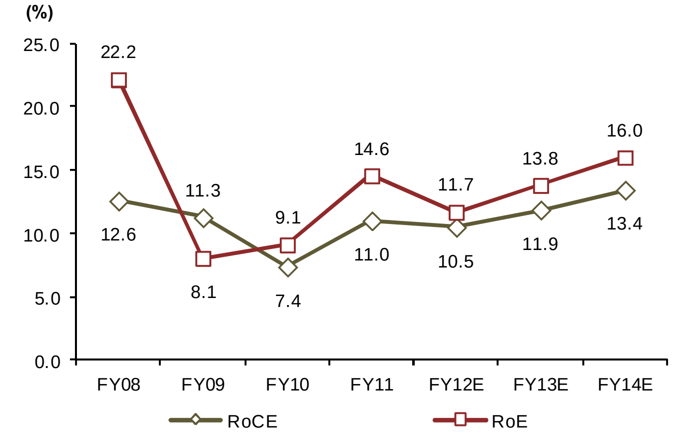
Source: Company, CRISIL Research

EBITDA and adjusted PAT margin trend



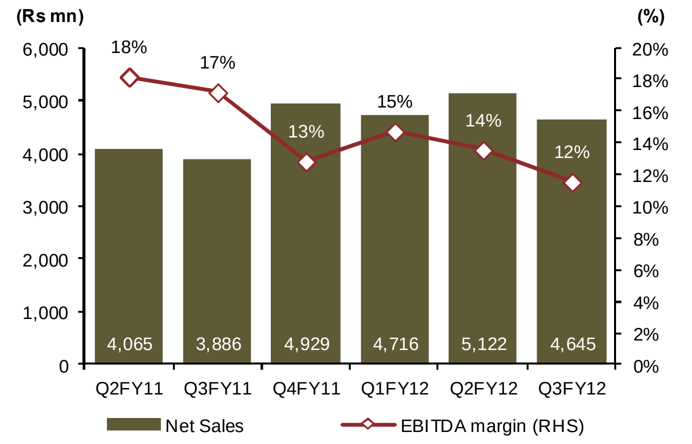
Source: Company, CRISIL Research

RoE and RoCE trend



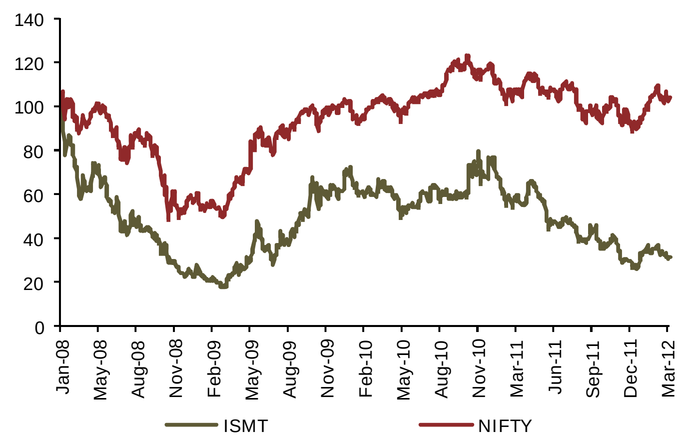
Source: Company, CRISIL Research

Quarterly sales and EBITDA margin trend



Source: Company, CRISIL Research

Share price movement



-Indexed to 100

Source: Company, CRISIL Research

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CRISIL Research Team

Senior Director

Mukesh Agarwal		+91 22 3342 3035	magarwal@crisil.com

Analytical Contacts

Tarun Bhatia	Director, Capital Markets	+91 22 3342 3226	tbhatia@crisil.com
Prasad Koparkar	Head, Industry & Customised Research	+91 22 3342 3137	pkoparkar@crisil.com
Chetan Majithia	Head, Equities	+91 22 3342 4148	chetanmajithia@crisil.com
Jiju Vidyadharan	Head, Funds & Fixed Income Research	+91 22 3342 8091	jvidyadharan@crisil.com
Ajay D'Souza	Head, Industry Research	+91 22 3342 3567	adsouza@crisil.com
Ajay Srinivasan	Head, Industry Research	+91 22 3342 3530	ajsrinivasan@crisil.com
Sridhar C	Head, Industry Research	+91 22 3342 3546	sridharc@crisil.com
Manoj Mohta	Head, Customised Research	+91 22 3342 3554	mmohta@crisil.com
Sudhir Nair	Head, Customised Research	+91 22 3342 3526	snair@crisil.com

Business Development

Vinaya Dongre	Head, Industry & Customised Research	+91 22 33428025	vdongre@crisil.com
Ashish Sethi	Head, Capital Markets	+91 22 33428023	asethi@crisil.com

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- Coverage on 70 industries and 139 sub-sectors; provide growth forecasts, profitability analysis, emerging trends, expected investments, industry structure and regulatory frameworks
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- Special coverage on key growth sectors including real estate, infrastructure, logistics, and financial services
- Inputs to India's leading corporates in market sizing, demand forecasting, and project feasibility
- Published the first India-focused report on Ultra High Net-worth Individuals
- All opinions and forecasts reviewed by a highly qualified panel with over 200 years of cumulative experience
- Largest independent equity research house in India, focusing on small and mid-cap companies; coverage exceeds 100 companies
- Released company reports on all 1,401 companies listed and traded on the National Stock Exchange; a global first for any stock exchange
- First research house to release exchange-commissioned equity research reports in India
- Assigned the first IPO grade in India

Funds and Fixed Income Research

- Largest and most comprehensive database on India's debt market, covering more than 14,000 securities
- Largest provider of fixed income valuations in India
- Value more than Rs.33 trillion (USD 650 billion) of Indian debt securities, comprising 85 per cent of outstanding securities
- Sole provider of fixed income and hybrid indices to mutual funds and insurance companies; we maintain 12 standard indices and over 80 customised indices
- Ranking of Indian mutual fund schemes covering 73 per cent of assets under management and Rs.5 trillion (USD100 billion) by value
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- covering over 50 million individuals, for selecting fund managers and monitoring their performance

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- Largest independent equity research house in India, focusing on small and mid-cap companies; coverage exceeds 100 companies
- Released company reports on all 1,401 companies listed and traded on the National Stock Exchange; a global first for any stock exchange
- First research house to release exchange-commissioned equity research reports in India
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Our Office

Ahmedabad
706, Venus Atlantis
Nr. Reliance Petrol Pump
Prahladnagar, Ahmedabad, India
Phone: +91 79 4024 4500
Fax: +91 79 2755 9863

Bengaluru
W-101, Sunrise Chambers,
22, Ulsoor Road,
Bengaluru - 560 042, India
Phone:+91 80 2558 0899
+91 80 2559 4802
Fax: +91 80 2559 4801

Chennai
Thapar House,
43/44, Montieth Road, Egmore,
Chennai - 600 008, India
Phone:+91 44 2854 6205/06
+91 44 2854 6093
Fax: +91 44 2854 7531

Hyderabad
3rd Floor, Uma Chambers
Plot No. 9&10, Nagarjuna Hills,
(Near Punjagutta Cross Road)
Hyderabad - 500 482, India
Phone: +91 40 2335 8103/05
Fax: +91 40 2335 7507

Kolkata
Horizon, Block 'B', 4th Floor
57 Chowringhee Road
Kolkata - 700 071, India
Phone: +91 33 2289 1949/50
Fax: +91 33 2283 0597

New Delhi
The Mira, G-1,
1st Floor, Plot No. 1 & 2
Ishwar Nagar, Mathura Road,
New Delhi - 110 065, India
Phone: +91 11 4250 5100
+91 11 2693 0117/121
Fax: +91 11 2684 2212

Pune
1187/17, Ghole Road,
Shivaji Nagar,
Pune - 411 005, India
Phone: +91 20 2553 9064/67
Fax: +91 20 4018 1930

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CRISIL Limited
CRISIL House, Central Avenue, Hiranandani Business Park,
Powai, Mumbai – 400076. India
Phone: +91 22 3342 3000 | Fax: +91 22 3342 8088
www.crisil.com

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