April 18, 2022

Deepak Industries Limited: Ratings reaffirmed; outlook on long-term rating revised to Positive

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Fund-based – Term Loans	26.07	22.45	[ICRA]AA- Reaffirmed; Outlook revised to Positive from Stable
Fund-based – Working Capital Facilities*	80.00	78.00	[ICRA]AA- Reaffirmed; Outlook revised to Positive from Stable
Non-fund based – Bank Guarantee/ Letter of Credit	26.00	19.00	[ICRA]A1+; Reaffirmed
Non-fund based – Forward Cover	0.75	0.75	[ICRA]A1+; Reaffirmed
Standby line of credit	2.00	2.00	[ICRA]A1+; Reaffirmed
Unallocated Limit	-	12.62	[ICRA]AA- / [ICRA]A1+ Reaffirmed; Outlook revised to Positive from Stable
Total	**134.82**	**134.82**	

**Instrument details are provided in Annexure-1; *Can be availed as cash credit/WCDL*

Rationale

The revision in the outlook on the long-term rating to Positive from Stable considers Deepak Industries Limited's (DIL) robust performance in 9M FY2022, as reflected by around 64% growth in its operating income on a YoY basis, supported by a pick-up in demand in both automobile and industrial gear segments, leading to a substantial improvement in profits, cash accrual and interest coverage. The Positive outlook on the long-term rating reflects ICRA's opinion that DIL's credit profile is likely be strengthened by its growing scale of operations, healthy business returns and limited needs for additional borrowings due to sizeable cash accruals. The ratings continue to factor in the company's healthy ROCE, a conservative capital structure, strong debt protection metrics and a strong liquidity position, given a large free cash and bank balance. The ratings also draw comfort from DIL's established position in the automotive and industrial gears market with long relationships with leading commercial vehicle (CV) and tractor OEMs[1] and the company's ability to pass on most of its cost increases, albeit with a lag, to its customers in the automotive gear segment. The contracts in the industrial gear segment are firm price in nature, however, the segment's share in DIL's overall revenue remains low (around 11.5% in 9M FY2022). Moreover, the company's adequate raw material inventory at present along with a short time lag between order receipt and purchase is likely to shield DIL's profit margins to an extent from a sharp rise in steel prices in the recent past. The company's foray into the value-added gear segments, which command higher realisations and an increasing trend in capacity utilisation are likely to support DIL's profitability, going forward. In Q1 FY2022, DIL acquired Lotus Auto Engineering Limited (Lotus Auto), an automobile component manufacturing entity through liquidation process under the Insolvency and Bankruptcy Code (IBC), 2016 on a going concern basis. The same is likely to provide operational synergies at the Group level through augmentation of the overall capacity and scopes for enhancement of product lines and backward integration.

[1] *Original Equipment Manufacturer*

The long-term rating is, however, constrained by the company's exposure to the cyclicality associated with the CV and tractor industries and its high client concentration risks. However, incremental revenues from reputed CV OEMs added to its clientele in the recent years are expected to reduce the client concentration risk to an extent. Besides, a balanced mix of revenues from the CV and tractor segments mitigates DIL's sectoral concentration risk. The performance of DIL's industrial gear segment remained muted historically, with stagnant revenues and depressed profitability. Nevertheless, the segment's revenue and profits at an absolute level are likely to improve in the current fiscal, led by an improvement in demand from the user industries.

Key rating drivers and their description

Credit strengths

Robust performance in 9M FY2022; higher revenues from value-added products and operational synergy with a newly acquired entity likely to improve overall performance – DIL's operating income in 9M FY2022 grew by around 64% on a YoY basis to Rs. 453.4 crore, driven by improved demand from the CV, tractor and industrial gear segments. In 9M FY2022, the company's operating margin remained healthy at 22.3% (21.2% in FY2021) and the interest coverage improved to 21.9 times from 12.2 times in FY2021. In the full year of FY2022, a robust topline growth is expected, which is likely to result in a significant improvement in profits, cash accrual and debt coverage metrics compared to FY2021. A significant increase in the sales of relatively value-added products like ground gears is likely to support the company's operating margin. DIL's acquisition of Lotus Auto is likely to provide operational synergies at the Group level through augmentation of the overall capacity and scopes for enhancement of product lines and backward integration. DIL's investment of Rs. 38 crore (including Rs. 33.64-crore optionally convertible debentures and Rs. 4.36-crore equity) for the acquisition was funded through internal accruals.

Established presence in industrial and automotive gears markets; long relationships with leading CVs and tractor OEMs provide competitive edge – DIL, incorporated in 1954, has an established presence in the domestic industrial and automotive gears markets with a long association with leading CVs and tractor OEMs. The company's product offerings include automotive transmission gears and shafts, couplings, gear boxes and engine gears, catering primarily to the LCV, the MCV and the tractor segments. The company, being the single/main supplier of various gears and shafts to some of these OEMs, has significant competitive advantage.

Ability to pass on raw material price hike to customers in the automobile gear segment, albeit with a lag – The risk arising out of fluctuations in raw material prices is mitigated to an extent by DIL's ability to pass on the price hikes to its customers in the automobile gear segment, although with some lag. The company has an adequate raw material (mainly steel) inventory of more than a quarter as it had anticipated a price rise and started increasing the inventory level from H2 FY2021. This will protect the company's margins from a sharp rise in steel prices in the recent past to a large extent, mainly for the industrial gear segment, wherein the contracts are of firm price nature.

Financial profile characterised by healthy ROCE, conservative capital structure and strong debt coverage metrics – DIL's healthy profits at an absolute level kept its return indicators heathy, as reflected by the ROCE and Core ROCE of 19.0% and 26.7% respectively, in FY2021. The company's moderate debt levels compared to its sizeable net worth resulted in a comfortable capital structure, as reflected by a gearing of 0.3-0.4 times over the last three fiscals. Healthy profits and a conservative capital structure led to strong debt coverage indicators of DIL, as reflected by an interest coverage of 12.2 times (21.9 times in 9M FY2022), total debt relative to OPBDITA of 1.0 times and net cash accruals relative to the total debt of 79% in FY2021. The company's overall leverage was negative on a net debt basis as on March 31, 2021, supported by a free cash and bank balance of around Rs.163 crore, which imparts a high degree of financial flexibility.

Credit challenges

Exposed to cyclicality associated with CV and tractor industries – With around 87% of the company's revenue generated from sales to the CV and tractor segments in FY2021, DIL is exposed to the cyclicality associated with the CV and the tractor industries, which keeps its profitability and cash flows volatile. CV sales volume has recovered significantly in FY2022, albeit on a lower base, and is likely to grow by 11-14% in FY2023 as per ICRA's estimates, led by an ebbing of the pandemic-related challenges, traction in infrastructure and construction activities along with last-mile and e-commerce transportation demand. After a significant volume growth in FY2021, tractor sales moderated to some extent in the recent months and the volume growth is likely to remain muted in the near term. Nonetheless, a balanced mix of revenues from the CV and tractor segments (almost equal revenues from the segments in FY2021) is likely to mitigate DIL's sectoral concentration risks to some extent.

Exposed to client concentration risk – DIL remains exposed to the high client concentration risk as the top two and top five customers accounted for nearly 50% and 72% of its total revenues in FY2021, respectively. This will keep DIL's business operations vulnerable to the performance of its key clientele. However, a reputed client base, coupled with DIL's long-term relationships with its clients, mitigates such risk to an extent. Besides, ICRA notes that the addition of reputed CV OEMs to its clientele in the recent years is likely to bring down the client concentration, going forward.

Weak performance of the industrial gear division historically – The company's industrial gear segment, which caters to the clients in the sectors like power, steel, cement, sugar, etc, accounted for 12.7% of DIL's overall sales in FY2021. The segment's revenue remained stagnant over the past few years and contracted by around 23% in FY2021 to around Rs. 54 crore due a decline in capex activities in the user industries amid the pandemic. The profitability of the industrial gear segment also remained muted, as reflected by consecutive losses at the PBIT level from FY2016 to FY2019 and modest profits in the subsequent two fiscals. However, in 9M FY2022, the revenue from the industrial gear segment improved by 38% compared to 9M FY2021, and the current orderbook stands at around 2 times the revenue in FY2021. Hence, the segment's overall performance is likely to improve in FY2022.

Liquidity position: Strong

DIL's liquidity is likely to remain **strong**. The company had a healthy unencumbered cash and bank balance of ~Rs. 130 crore as on September 30, 2021, even after acquisition of Lotus Auto which entailed an investment of Rs. 38 crore. At present, DIL's free cash and bank balance stands at around Rs. 170 crore. Its cash flow from operation declined in FY2021 due to an increase in inventory and receivables. Nevertheless, the cash flow from operations is likely to remain healthy, going forward. This along with limited debt servicing obligations (around Rs. 9 crore and Rs. 5 crore in FY2023 and FY2024, respectively), sizeable undrawn working capital limit (Rs. 18 crore on an average between December 2020 and November 2021) would support DIL's overall liquidity profile, going forward. ICRA expects the company to be able to comfortably meet its capex commitments in the near-to-medium term through internal accruals and yet be left with a sizeable surplus cash.

Rating sensitivities

Positive factors – ICRA may upgrade DIL's long-term rating if a consistent rise in its operating income along with maintenance of healthy profit margins lead to a material improvement in its credit profile. Core ROCE of more than 25% on a sustained basis may also trigger an upgrade of the long-term rating.

Negative factors – ICRA may downgrade DIL's ratings if there is a significant decline in the company's revenue or profit margins or any major debt-funded capital expenditure, which may lead to a significant weakening of its credit profile. A deterioration in total debt/OPBDITA above 1.5 times on a sustained basis may also be a trigger for ratings downgrade.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	Corporate Credit Rating Methodology Auto Components
Parent/Group Support	Not applicable
Consolidation/Standalone	The ratings are based on the standalone financial profile of the company.

About the company

Deepak Industries Limited (DIL), incorporated in 1954, is promoted by Mr. Pradip Kumar Daga. DIL began its operations in 1957, after acquiring a company named New Allenberry Works (NAW), with a factory on Hazra Road, Kolkata. DIL has three other units in Faridabad, Rudrapur and Baghola. The Faridabad unit was set up in 1971, the Rudrapur unit began operations in December 2007, while the Baghola plant commenced commercial operations in FY2018. DIL had another plant in Dharwad, Karnataka which commenced operation in January 2016, but has been closed as the unit's sales volume remained low. The company manufactures gears, shafts, gearboxes and couplings used in the automobile (tractors and CVs) and various other industries like power, steel, cement, sugar etc. DIL also has a 5-MW solar power plant in Agar, Shajapur, Madhya Pradesh, which sells power to the Group company Deepak Spinners Limited.

In June 2021, DIL acquired Lotus Auto Engineering Limited (Lotus Auto) through liquidation process under IBC, 2016 on a going concern basis. Lotus Auto, an erstwhile Amtek Group company, has its plant at Bhiwadi, Rajasthan and was a vendor for reputed automobile OEMs. It has facilities like casting, vertical machining, turning etc.

Key financial indicators (audited)

DIL (Standalone)	FY2020	FY2021	9M FY2022*
Operating Income (Rs. crore)	411.5	428.2	453.4
PAT (Rs. crore)	45.9	55.1	64.5
OPBDIT/OI (%)	19.5%	21.2%	22.3%
PAT/OI (%)	11.1%	12.9%	14.2%
Core ROCE (%)	22.3%	26.7%	-
Total Outside Liabilities/Tangible Net Worth (times)	0.5	0.6	-
Total Debt/OPBDIT (times)	1.0	1.0	-
Interest Coverage (times)	9.5	12.2	21.9

*PAT: Profit after Tax; OPBDIT: Operating Profit before Depreciation, Interest, Taxes and Amortisation; *Unaudited*

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 as of Oct 01, 2021 (Rs. crore)	Date & Rating in	Date & Rating in FY2022	Date & Rating in FY2021	Date & Rating in FY2020
					Apr 18, 2022	-	Feb 19, 2021	Nov 11, 2019
1	Term loan	Long Term	22.45	23.08	[ICRA]AA- (Positive)	-	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)
2	Fund-based Working Capital Facilities*	Long Term	78.00	-	[ICRA]AA- (Positive)	-	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)
3	Bank Guarantee/ Letter of Credit	Short Term	19.00	-	[ICRA]A1+	-	[ICRA]A1+	[ICRA]A1+
4	Forward Cover	Short Term	0.75	-	[ICRA]A1+	-	[ICRA]A1+	[ICRA]A1+
5	Standby line of credit	Short Term	2.00	-	[ICRA]A1+	-	[ICRA]A1+	[ICRA]A1+
6	Unallocated Limit	Long Term/ Short Term	12.62	-	[ICRA]AA- (Positive)/ [ICRA]A1+	-	-	-

**Can be availed as cash credit/ WCDL*

Complexity level of the rated instruments

Instrument	Complexity Indicator
Term loan	Simple
Fund-based Working Capital Facilities*	Simple
Bank Guarantee/ Letter of Credit	Very simple
Forward Cover	Simple
Standby line of credit	Simple
Unallocated Limit	Not applicable

**Can be availed as cash credit/ WCDL*

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 analyzing 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, is available on ICRA's website: www.icra.in

Annexure-1: Instrument details

ISIN No	Instrument Name	Date of Issuance	Coupon Rate	Maturity Date	Amount Rated (Rs. Crore)	Current Rating and Outlook
NA	Term Loan- 1	Feb-2016	-	Dec-2022	2.46	[ICRA]AA- (Positive)
NA	Term Loan- 2 (Corporate Loan)	May-2015	-	Sep-2023	7.00	[ICRA]AA- (Positive)
NA	Term Loan- 3 (Covid 19 Loan)	Apr-2020	-	Jun-2022	0.99	[ICRA]AA- (Positive)
NA	Term Loan- 4 (GECL 2.0 Loan)	Jun-2021	-	Mar-2025	12.00	[ICRA]AA- (Positive)
NA	Fund-based Working Capital Facilities*	-	-	-	78.00	[ICRA]AA- (Positive)
NA	Bank Guarantee/ Letter of Credit	-	-	-	19.00	[ICRA]A1+
NA	Forward Cover	-	-	-	0.75	[ICRA]A1+
NA	Standby line of credit	-	-	-	2.00	[ICRA]A1+
NA	Unallocated Limit	-	-	-	12.62	[ICRA]AA- (Positive)/ [ICRA]A1+

Source: *Company; *Can be availed as cash credit/ WCDL*

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

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

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About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

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