

Servalakshmi Paper

Paper Dreams

Servalakshmi Paper (SPL), part of the Servall Group, was incorporated in November 2005. SPL manufactures printing and writing paper and newsprint. The company's plant is situated in Tamil Nadu and has total installed capacity of 90,000mn tonnes per annum, which makes it one of the largest single-location plants in India.

SPL is tapping the IPO market with an issue size of ₹60cr in the price band of ₹27–29/share, thus resulting in a public issue of 2.2cr and 2.1cr equity shares at the upper and lower price bands, respectively, of face value ₹10, resulting in a dilution of 49.7% and 47.9% stake.

SPL has embarked upon setting up an integrated paper mill with a capacity of 90,000mn tonnes per annum along with a 15MW captive power plant at a single location. The total investment is estimated to be ₹340cr and the entire project is to be completed in two phases. Phase-1 of the project has already been completed and the company's plant has commenced commercial operations from April 2010. Money raised through the IPO would be used for Phase-II, under which SPL plans to add balancing equipment for improving productivity and manufacturing value-added products. Funds would also be utilised for working capital needs.

The Indian paper industry is highly fragmented with nearly 700 manufacturing units spread across the country, with capacity ranging from 5 tonnes per day to over 1,000 tonnes per day. Total installed capacity is estimated to be at 9.18mn tonnes, with production of 8.60mn tonnes. The industry has grown at a 6% CAGR over the last few years and is estimated to grow at a 7.6% CAGR over the next 2–3 years, showing strong correlation with India's GDP growth. Nearly 600,000 tonnes of new capacity is estimated to have been added in 2008 and 2009. Industry estimates 500,000 tonnes of capacity addition over the next few years.

Outlook and valuations

Given that the best players in the industry have RoE of 14–16%, with cost of equity for the top Sensex companies in a similar range, we believe investors should approach investment in such a sector cautiously. SPL's plant has started its operations recently, thus the company will take some time to make profits. Further, given the nature of the industry, any sort of price correction in paper prices would lead to delay in profitability.

At the end of 6MFY2011, SPL had net worth of ₹40cr, while it plans to raise ₹60cr through 50% dilution, which would value the company at ₹120cr, i.e., P/B of 1.2x. Even at the lower price band of ₹27, SPL would trade at a P/B multiple of 1.20x (1.24x at upper band), while its peers, which are profit-making and have longer history of operations, are currently trading at an average P/B of 1.2x – thus placing the stock relatively expensive. **Hence, we recommend Avoid on the IPO.**

AVOID

Issue open: April 27, 2011

Issue close: April 29, 2011

Issue details

Face value: ₹10

Present eq. paid-up capital: ₹22.4cr

Offer Size: 2.1cr-2.2cr Shares*

Post eq. paid up capital*: ₹44.6cr-43.1cr

Issue size (amount): ₹60cr

Price band: ₹27-29

Promoters holding pre-issue: 100%

Promoters holding post-issue: 52-50%

*Note: *At lower and upper price bands, respectively*

Book building

QIBs At least 50%

Non-Institutional At least 15%

Retail At least 35%

Post issue shareholding pattern

Promoters Group 50.23%

MF/Banks/Indian

FIs/FII's/Public & Others 49.77%

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Company background

SPL is part of the Servall Group. Servall Group has a strong goodwill in the paper industry due to its long presence in the industry, spanning over four decades. The group is present across all industry verticals such as machinery manufacturing, paper manufacturing, project consultancy and turnkey project implementations. Servall Group manufactures a wide spectrum of papers such as printing and writing paper, newsprints, industrial paper and specialty papers. The group is proficient in handling turnkey projects, design, consultancy, erection and commissioning of paper machinery, machine rebuilding, unit equipment and spares. The group has built and supplied 35 paper machines of various capacities of up to 300 tonnes per day to paper mills in India. Servall Group has a client base of more than 300 paper mills in Asia, Europe, Africa and Gulf Countries.

SPL was incorporated in November 2005. The company manufactures printing and writing paper and newsprint. The company's plant is situated in Tamil Nadu and has total installed capacity of 90,000mn tonnes per annum, which makes it one of the largest single-location plants in India. The plant also ranks among the top 15 plants in the country. SPL's plant has a co-generation power plant with a capacity of 15MW for uninterrupted power and steam supply for the paper plant.

Issue details

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Exhibit 1: Objects of the issue

Particulars	Amount (₹ cr)
Purchase of equipment for value-added products	25
Long-term working capital requirement	30
Preliminary and pre-operative expenses including expenses for the IPO	5
Total cost of Phase-II	60

Source: Company, Angel Research

Exhibit 2: Shareholding Pattern

Shareholding pattern	Pre-issue		Post issue	
	No of shares	%	No. of shares	%
Promoter and promoter group	22,424,000	100	22,424,000	50
Public	-	-	22,222,222	50
Total	22,424,000	100	44,646,222	100

Source: Company, Angel Research

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be completed in two phases. Phase-1 of the project has already been completed and the company's plant has commenced commercial operations from April 2010.

Money raised through the IPO would be used for Phase-II, under which SPL plans to add balancing equipment for improving productivity and manufacturing value-added products. Funds would also be utilised for working capital needs.

About the industry

The global paper industry is estimated to be worth USD\$500bn. Global consumption of paper and boards has grown from 169mn tonnes in 1981 to 253mn tonnes in 1993, 352mn tonnes in 2005 and 390mn tonnes currently. The global paper industry is estimated to have been growing at a rate of 2.5–2.8% per annum.

The paper industry is very capital-intensive and cyclical in nature. Currently, the industry is highly dominated by North American and European producers. It is estimated that North America consumes over 100mn tonnes of paper and boards, while Asia consumes about 140mn tonnes of paper. Europe's share stands at 102mn tonnes. China is one of the fastest growing consumers of paper, with growth of 9.3% in recent times, which is expected to slow down to 7.1% going ahead. India currently consumes 8.5mn tonnes per annum of paper and is one of the fastest growing markets, with a growth rate of 7.4% per annum.

The Indian paper industry is highly fragmented with nearly 700 manufacturing units spread across the country, with capacity ranging from 5 tonnes per day to over 1,000 tonnes per day. Total installed capacity is estimated to be at 9.18mn tonnes, with production of 8.60mn tonnes. The industry has grown at a 6% CAGR over the last few years and is estimated to grow at a 7.6% CAGR over the next 2–3 years, showing strong correlation with India's GDP growth. Nearly 600,000 tonnes of new capacity is estimated to have been added in 2008 and 2009. Industry estimates 500,000 tonnes of capacity addition over the next few years.

Key strengths

Strong expertise: Given Servall Group's strong know-how in the paper industry due to its long experience spanning across four decades, SPL has been able to set up its plant at a lower cost compared to competitors. The project in totality would be handled by promoter Group Company M/s. Servall Engineering Works (P) Ltd., an expert in paper machinery design, engineering and manufacturing. As per management and project consultant, total project cost as per industry norms was estimated at ~₹400cr, but, in actual, it came to ₹295cr, an approximate saving of ₹100cr. SPL plans to further expand its capacity by 100,000 tonnes per annum.

Strong execution ability: The successful completion and implementation of Phase-1 of the project, without any hiccups or any over-run of cost, shows management's strong execution capability.

Logistical advantages: SPL's paper mill is in close vicinity to Tuticorin Port (72km), with the National Highway NH7 just 5km away. This enables faster transportation of raw materials and finished products.

Risks and concerns

Promoter Group in a competing business: SPL's promoters have group concerns/entities that are also engaged in the manufacturing of paper.

Commodity nature of the business: The paper industry is highly commoditised and lacks pricing power.

Outlook and valuation

Low per capita consumption and low penetration of key products

India constitutes 16.5% of the world's total population; however, it consumes only 1.53% of the world's total paper production. Per capita paper consumption is estimated to stand at 8kgs, as against global average of 50kgs (Japan – 250kg; Korea – 165/kg; and China – 42kg). An increase of 1kg in consumption on a per capita basis will increase demand by 1mn tonnes. Coated paper forms only 10% of India's total consumption under the writing and printing paper category, as against 40–50% in developed countries.

Currently, SPL is making losses as the plant has recently started its operations. As the plant stabilises and its operations and utilisation start ramping up, profitability should follow. However, we are not bullish on the sector and the company due to the following reasons:

- 1) **Commodity nature of the business:** This leads to lack of pricing power.
- 2) **Growth by capex only:** The business requires continuous capex for growth, due to absence of pricing power; price-led growth is limited and short-lived.
- 3) **Perennially low RoE business:** We have analysed the paper sector and companies across the sector. As per our understanding of the sector, the best players in the sector have RoE of 14–16%.
- 4) **Industry running below capacity:** Total installed capacity is estimated to be at 9.18mn tonnes with production of 8.60mn tonnes, indicating that the industry is running below capacity. Hence, capacity ramp-up for SPL would be difficult, given such a scenario.

Given that the best players in the industry have RoE of 14–16%, with cost of equity for the top Sensex companies in a similar range, we believe investors should approach investment in such a sector cautiously. SPL's plant has started its operations recently, thus the company will take some time to make profits. Further, given the nature of the industry, any sort of price correction in paper prices would lead to delay in profitability.

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Exhibit 3: Peer comparison

Company	TTM P/B
BILT	1.5
TNPL	1.2
West Coast	1.1
J K	0.9
Average	1.2

Source: Company, Bloomberg

Profit & loss statement

Y/E March (₹ cr)	FY07	FY08	FY09	FY10	6MFY11
Gross sales	-	-	-	-	39
Less: Excise duty	-	-	-	-	-
Net Sales	-	-	-	-	39
Other operating income	-	-	-	-	-
Total operating income	-	-	-	-	39
% chg	-	-	-	-	-
Total Expenditure	-	0	0	0	37
Net Raw Materials	-	-	-	-	15
Other Mfg costs	-	-	-	-	18
Personnel	-	-	-	-	3
Other	-	0	0	0	1
EBITDA	-	(0)	(0)	(0)	2
% chg	-	-	-	-	-
(% of Net Sales)	-	-	-	-	4.4
Depreciation & Amortisation	-	0	0	0	4
EBIT	-	(0)	(0)	(0)	(3)
% chg	-	-	-	-	-
(% of Net Sales)	-	-	-	-	(7.1)
Interest & other Charges	-	-	0	0	13
Other Income	-	0	0	0	1
(% of PBT)	-	(221.1)	(168.4)	(22.5)	(4.1)
Recurring PBT	-	(0)	(0)	(0)	(15)
% chg	-	-	-	-	-
Extraordinary Expense/(Inc.)	-	-	-	-	-
PBT (reported)	-	(0)	(0)	(0)	(15)
Tax	-	0	0	0	-
(% of PBT)	-	(34.1)	(25.8)	(14.3)	-
PAT (reported)	-	(0)	(0)	(0)	(15)
Add: Share of earnings of associate	-	-	-	-	-
Less: Minority interest (MI)	0	0	-	-	-
Prior period items	-	-	-	-	-
PAT after MI (reported)	(0)	(0)	(0)	(0)	(15)
ADJ. PAT	(0)	(0)	(0)	(0)	(15)
% chg	-	-	-	-	-
(% of Net Sales)	-	-	-	-	-
Basic EPS (₹)	-	-	-	-	-
Fully Diluted EPS (₹)	-	-	-	-	-
% chg	-	-	-	-	-

Balance sheet

Y/E March (₹ cr)	FY07	FY08	FY09	FY10	6MFY11
SOURCES OF FUNDS					
Equity Share Capital	2	4	8	21	22
Preference Capital	7	2	3	1	-
Reserves & Surplus	8	17	32	32	18
Shareholders' Funds	17	23	42	54	40
Minority Interest	-	-	-	-	-
Total Loans	0	18	124	231	262
Deferred Tax Liability	-	-	-	-	-
Total Liabilities	17	41	166	284	302
APPLICATION OF FUNDS					
Gross Block	2	3	3	4	265
Less: Acc. Depreciation	-	0	0	0	5
Net Block	2	3	3	4	261
Capital Work-in-Progress	-	24	129	216	-
Goodwill / Intangibles	-	-	-	-	-
Investments	-	-	-	-	-
Current Assets					
Cash	5	7	7	3	2
Loans & Advances	10	7	24	19	22
Other	0	(0)	-	21	53
Current liabilities	0	0	8	18	41
Net Current Assets	15	13	22	24	36
Others	-	-	-	-	-
Total Assets	17	41	166	284	302

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