CRISIL RESEARCH

Independent Equity Research

Enhancing investment decisions

In-depth analysis of the fundamentals and valuation

Hydro S&S Industries Ltd.

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- White Labelled Research
- Valuation on companies for use of Institutional Investors, Asset Managers, Corporates

Other Services by the Research group include

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- Customised Research on Market sizing, Demand modelling and Entry strategies
- Customised research content for Information Memorandum and Offer documents

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)

Fundamental Grade

CRISIL's Fundamental Grade represents an overall assessment of the fundamentals of the company graded in relation to other listed equity securities in India. The grade facilitates easy comparison of fundamentals between companies, irrespective of the size or the industry they operate in. The grading factors in the following:

- Business Prospects: Business prospects factors in Industry prospects and company's future financial performance
- Management Evaluation: Factors such as track record of the management, strategy are taken into consideration
- Corporate Governance: Assessment of adequacy of corporate governance structure and disclosure norms

The grade is assigned on a five-point scale from grade 5 (indicating Excellent fundamentals) to grade 1 (Poor fundamentals)

CRISIL Fundamental Grade	Assessment
5/5	Excellent fundamentals
4/5	Superior fundamentals
3/5	Good fundamentals
2/5	Moderate fundamentals
1/5	Poor fundamentals

Valuation Grade

CRISIL's Valuation Grade represents an assessment of the potential value in the company stock for an equity investor over a 12 month period. The 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 Valuation Grade	Assessment
5/5	Strong upside (>25% from CMP)
4/5	Upside (10-25% from CMP)
3/5	Align (+-10% from CMP)
2/5	Downside (negative 10-25% from CMP)
1/5	Strong downside (<-25% from CMP)

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.

Additional Disclosure

This report has been sponsored by NSE - Investor Protection Fund Trust (NSEIPFT).

Disclaimer:

List of companies under coverage

Sl. No.	Report Date	Company Name	Sector	CMP	M. Cap (Rs. Mn)	Initiating Coverage		3QFY10 Update	
						Fundamental value	Fundamental grade	Fundamental value	Fundamental grade
1	02-Feb-10	Aarti Industries	Chemicals	49	3,757	56	3/5	56	3/5
2	31-Jan-10	ABG Shipyard	Shipping	315	10,286	242	3/5	259	3/5
3	01-Feb-10	Apollo hospitals	Hospitals	712	44,102	642	4/5	724	4/5
4	04-May-10	Beardsell Limited	Packaging/Expanded Polystyrene	64	245	54	3/5	-	-
5	06-Apr-10	Dhanuka Agritech Ltd	Pesticides	271	2,483	283	3/5	-	-
6	29-Jan-10	DLF	Real Estate	335	568,495	356	3/5	356	3/5
7	27-Jan-10	Dolphin Offshore	Oil & Gas	385	6,060	315	3/5	417	3/5
8	05-Feb-10	EID Parry	Sugar	348	30,050	394	4/5	395	4/5
9	01-Feb-10	Everest Kanto	Manufacturing	131	13,252	270	4/5	135	4/5
10	11-May-10	GKB Ophthalmics Ltd	Ophthalmic Lens	48	199	52	2/5	-	-
11	23-Feb-10	Havells India Ltd	Capital Goods	533	32,070	614	4/5	-	-
12	29-Jan-10	Hero Honda	Automobiles	1,889	377,240	1,747	5/5	1937#	5/5#
13	02-Mar-10	Hindusthan National Glass & Industries Ltd.	Packaging/Glass	240	21,049	314	4/5	-	-
14	13-May-10	Hydro S&S Industries Ltd.	Petrochemicals | Plastic Compounds	71.5	465	32.5	3/5	-	-
15	11-Feb-10	Indiabulls Securities	Financial Services	31	7,932	60	4/5	48	4/5
16	05-Feb-10	JBF Industries	Textiles	111	6,882	119	3/5	129	3/5
17	05-Feb-10	JM Financial	Financial Services	39	30,550	57	4/5	57	4/5
18	21-Jan-10	KKCL	Fashion and apparels	265	3,292	336	3/5	-	-
19	01-Feb-10	KRBL	Agriculture/Rice	194	4,716	340	3/5	340	3/5
20	11-May-10	KSE Limited	Animal Feed	210	673	200	3/5	-	-
21	31-Jan-10	NTPC	Power	214	1,764,537	228	5/5	231	5/5
22	29-Jan-10	Pantaloon Retail (India)	Retail	406	77,282	*	4/5	*	4/5
23	04-Feb-10	Phoenix Mills	Real Estate	203	29,404	160	2/5	183	2/5
24	22-Apr-10	Polaris Software	Information Technology	186	18,407	247	4/5	-	-
25	19-Apr-10	Sangam (India) Ltd	Textiles	33	1,380	46	3/5	46	5/5
26	03-Feb-10	UTV Software	Media and Entertainment	498	17,066	548	3/5	538	3/5
27	07-May-10	Zylog System	Information Technology	456	7,494	530	3/5	-	-

CMP - Current Market Price (as on date of respective report)

M Cap - Market Capitalisation (as on date of respective report)

*NA - Not Applicable (Company has requested for a fundamental grading only)

Includes Q4FY10 result update

Independent Research Report – Hydro S&S Industries Ltd.

Revving up the growth engine

Industry: Petrochemicals | Plastic Compounds
Date: May 13, 2010

Chennai-based Hydro S&S manufactures high quality, reinforced polypropylene (PP) compounds, thermoplastic elastomers and fibre reinforced composites. It has emerged as a leading supplier of PP compounds to the automobile manufacturing industry.

Flourishing automobile industry to drive demand for PP compounds

We expect demand for PP compounds to grow by 13-14% over the next two years on the back of strong growth in the automobile industry. PP compounds are being used as substitutes for steel, iron and aluminium in auto production as they hold better tensile properties and facilitate weight reduction.

Strong domain expertise and R&D focus positions Hydro S&S for growth

Hydro S&S was established as a joint venture between WS Group and UK-based Hydro Polymers. By capitalising on the technology received from Hydro Polymers and its own R&D focus; Hydro S&S has developed PP compounds for various applications in automobile manufacturing inline with stringent norms of original equipment manufacturers (OEMs). Hydro S&S is the exclusive supplier of plastic compounds solution for component requirements in Tata Nano.

Capacity expansion with a focus on geographic and client diversification

Hydro S&S' operations are largely concentrated in southern India, primarily catering to Hyundai Motors. The newly commissioned manufacturing facility at Pune with a capacity of 7,000 metric tonnes per annum (mtpa) has expanded the company's total capacity to 25,000 mtpa. Hydro S&S plans to use the Pune facility to cater to the requirements of auto manufacturers in western and northern India, and to expand its client base. We expect Hydro S&S to be successful in its plans thanks to its strong domain expertise and good relations with OEMs.

Industry affected by competition - limits growth and bargaining power

The PP compound industry is highly fragmented with very low entry barriers (low capex and low technology) resulting in intense competition, which limits the bargaining power with OEMs. Also, the prices of key raw materials are linked to volatile crude prices, which limit the company's pricing flexibility. This has restricted Hydro S&S' operating margins to 5-8%.

Revenues to grow at a three-year CAGR of 16%, RoE to expand

We expect revenues to grow at a three-year CAGR of 16% to Rs 1,849 mn in FY12, primarily supported by strong growth in the PP compounds business. EBITDA margins are expected to improve to 6.1% by FY12 from 3.4% in FY09 and net margins are expected to improve to 1.4% in FY12. ROE is expected to improve to 9.9% in FY12.

We assign Hydro S&S 3/5 on fundamentals and 1/5 on valuations

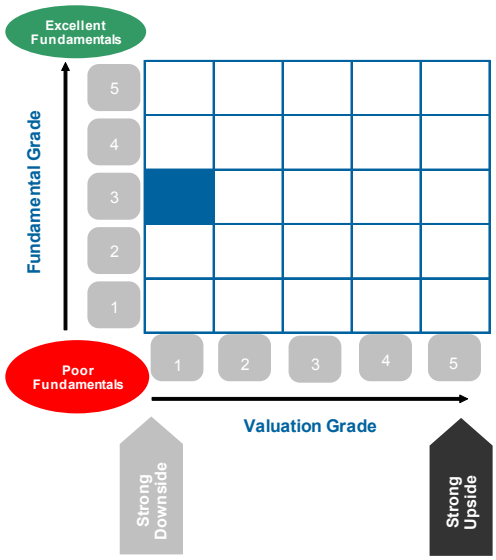
We assign Hydro S&S a fundamental grade of **3/5**, indicating that its fundamentals are **'good'** relative to other listed securities. Hydro S&S' leading position in the PP compounds industry, growth potential, strong domain expertise and diversification plans positively influence our grading. However, the intense competition coupled with low entry barriers, reliance on volatile crude-based raw materials and low bargaining power with OEMs temper our fundamental grading. A valuation grade of **1/5** indicates that the current market price of the stock has **'strong downside'** from the current levels. We have arrived at a one-year fair value of Rs 32.5 per share.

Key forecast (consolidated financials)

(Rs mn)	FY08	FY09	FY10E	FY11E	FY12E
Operating income	1,168	1,184	1,093	1,431	1,849
EBITDA	126	40	63	80	112
Adj Net income	54	(18)	(0.1)	6	25
EPS-Rs	8.2	(2.8)	(0.0)	1.0	3.9
EPS growth (%)	82.6	NM	NM	NM	291.4
PE (x)	7.3	NM	NM	72.4	18.5
P/BV (x)	1.5	0.9	1.9	1.9	1.8
RoCE(%)	22.5	3.4	6.1	8.6	12.9
RoE(%)	22.0	NM	NM	2.6	9.9
EV/EBITDA (x)	5.1	13.4	11.6	10.0	7.6

Source: CRISIL Forecast

CFV matrix



- Fundamental grade of '3/5 indicates good fundamentals
- Valuation grade of '1/5' indicates strong dow nside

Key stock statistics

NSE Ticker	HYDROS&S
Fair value (Rs per share)	32.5
Current market price (as on 12 May, 2010)	71.5
Shares outstanding (Mn)	6.5
Market cap (Rs Mn)	465
Face Value (Rs per share)	10
Enterprise value (Rs Mn)	805
52-week range (Rs) (H/L)	75.5 /30.5
P/E on EPS estimate (FY11E)	72.4
Beta	1.5
Free float (%)	33.47
Average daily volumes	60,165

Share price movement

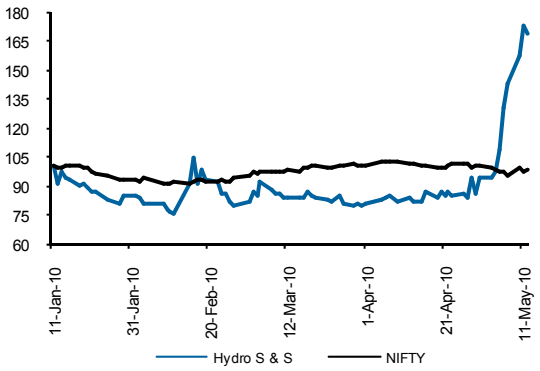


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Table 1: Business Environment

Parameter	Plastic Compounds	FRP Pultruded Profiles	Trading activities
Revenue contribution (FY09)	95%	1.9%	3.1%
Revenue contribution (FY12)	95.8%	1.3%	2.9%
Product / service offering	Reinforced polypropylene compounds - primarily for end use in automobile applications	FRP pultruded profiles for applications in High Tension electrical segment and automobile industry	Colour master batches
Geographic presence	Pan India	Pan India	Pan India
Market position	One of the leading organised manufacturers of reinforced PP compounds in India for application in the automobile industry	Leading manufacturer of pultruded profiles	Small player
End market	Mainly used for plastics in automobile, electric and household appliance industries	Applications in High Tension electrical segment and automobile industry	Diversified
Key clients	Hyundai Motors India Ltd. Tata Auto Components Ltd. General Motors Tractor & Farm Equipments Ltd.	BHEL Areva T & D Hyundai Motors India Ltd. Tata Auto Components Ltd. General Motors Tractor & Farm Equipments Ltd	Many
Key competitors	Machino Polymers Ltd., Tipco Industries Ltd., Zylog Plastalloys and many small regional players	Machino Polymers Ltd., Tipco Industries Ltd., Zylog Plastalloys and many small regional players	Many
Sales growth (FY06-FY09 – 3-year CAGR)	11.1%	34.7%	94.4%
Sales Forecast (FY09-FY12 – 3-year CAGR) –	16.7%	2.3%	17.6%
Demand drivers	Strong growth in automobile industry estimated at a CAGR of 12.3% over FY11 to FY14. Increasing use of PP compounds as substitutes in automobile manufacturing	Strong growth in electrical and automobile industry	Diverse applications
Margin drivers	Fragmented industry coupled with low entry barriers leading to intense competition impacting pricing powers	Fragmented industry leading to low margins	Intense competition resulting in low margins
	Dependent on crude oil prices	Dependent on crude oil prices	
	Low bargaining power with OEMs (original equipment manufacturers)	Low bargaining power with OEMs	

Source: Company, CRISIL Equities

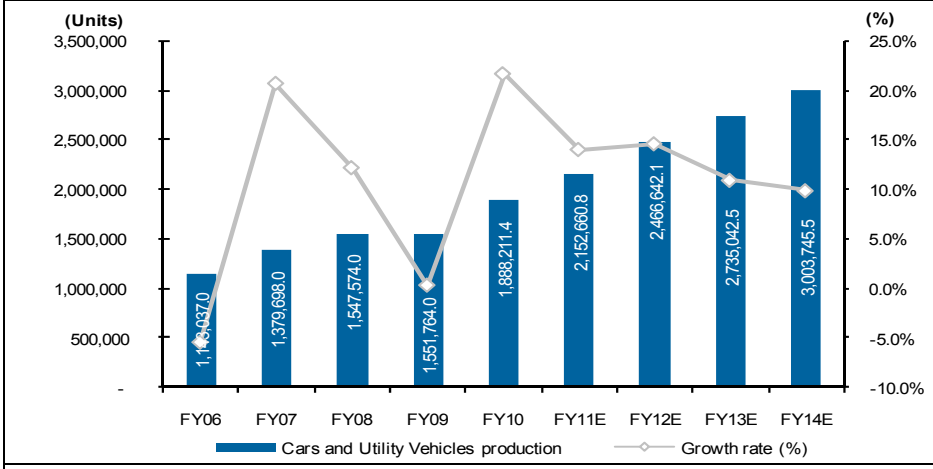
Grading Rationale

Strong growth in domestic auto industry to drive demand for PP compounds

Demand for PP compounds estimated to grow at 13-14% over the next two years

We expect demand for PP compounds from the automobile industry to grow at 13- 14% over the next two years. PP compounds are increasingly being used in automotive application for bumpers and in interiors such as dashboard and instrument consoles. Rising income levels and a rapidly growing middle class have augured well for the Indian automobile industry. We expect the production of domestic cars and utility vehicles to grow at a CAGR of 12.3% over FY10 to FY14. The strong growth in domestic automobile production and increasing use of plastic as a substitute for other materials will boost the demand for PP compounds.

Figure 1: Trends in car and utility vehicle production



Source: CRISIL Equities

India emerging as an auto manufacturing, sourcing base for global auto majors

Global auto majors are launching strategic models designed and developed for India, which will also be exported

India is emerging as an automobile manufacturing hub with global auto majors setting up operations here to capitalise on the strong domestic demand and its position as a low-cost manufacturing base. Global auto majors are launching strategic models designed and developed for India, which will also be exported globally. Ford Motor Co., Volkswagen AG, General Motors Co. and Nissan Motor Co. are expanding their product offerings in India and are setting up operations for global auto component sourcing. This will further increase the demand for PP compounds from automobile manufacturers.

Material substitution increasing demand for PP compounds

Substitution of traditional materials like steel, iron, aluminium and glass with polymer compounds

The global automobile industry has seen a change in material usage over the years driven by regulatory changes - stringent emission norms, higher mileage, safety requirements and improved performance. These changes have resulted in substitution of traditional materials like steel, iron, aluminium, and glass with polymer compounds which hold better tensile properties and are light-weight.

Table 2: Material substitution using polymer compounds in auto components

Auto Segments	Component	Original Material	New Material
Cars and 2-wheelers	Intake manifold	Cast Iron, Aluminium	Speciality plastic / Polymer
Cars and 2-wheelers	Oil pan	Cast Iron, Aluminium	Speciality plastic / Polymer
Cars	Bumper and facia	Steel	Plastic / Polymer structure
Cars	Instrument panel	Steel, Tin	Plastic / Polymer structure
Cars	Fuel tank	Steel	Plastic / Polymer structure
Cars	Head light	Glass	Plastic / Polymer structure

Source: CRISIL Research

The introduction of the Bharat Stage norms in India in various stages has also resulted in increasing use of plastic and polymer structures in automobile manufacturing, which has resulted in weight reduction and, hence, improvement in fuel efficiency. PP compounds are also being used in place of wood in cabin interiors for trucks. As of date, the application of PP compounds in passenger vehicles in India (approximately 30 to 40 kgs) is far less than in international markets (approximately 60 to 70 kgs). India's emergence as a manufacturing hub for small cars, which are exported, will further drive the usage of plastic in automobile production in line with international standards, which will lead to higher demand for PP compounds.

Strong domain expertise and R&D focus positions Hydro S&S for growth

Hydro S&S is a leading organised player in PP compounds used in the passenger car and utilities vehicles. Hydro S&S was set up as a joint venture between WS Industries and the UK-based Hydro Polymers Ltd., a subsidiary of Norsk Hydro S.A. By capitalising on the technology received from Hydro Polymers and its own R&D focus Hydro S&S has developed automotive compounds for various applications in line with the stringent norms of automotive OEMs. The company has a dedicated R&D team at its Padukottai facility, which focuses on developing compounds to meet enhanced performance specifications sought by OEMs for the launch of new models. This expertise has positioned Hydro S&S well to capitalise on opportunities emerging in the automobile manufacturing space. Hydro S&S is the largest supplier to Hyundai Motors and the second largest supplier to Tata Motors.

Table 3: Tier 1 customers and related OEMs

Tier 1 Customers	End clients (OEMs)
Pricol	Leader in Instrument clusters
TACO	Tier I supplier of Tata Motors, FIAT and General Motors India
Visteon	Tier I supplier of Hyundai India and Ford India
MATE	Tier I supplier of Ford India, Whirlpool India and Hyundai India
Hanil Auto	Tier I supplier of Hyundai India

Source: CRISIL Equities

Exclusive supplier of PP compounds for components in TATA Nano

Tata Nano project to result in demand of 6,000-7,000 mtpa of PP compounds in FY12

Hydro S&S was instrumental in providing plastic compounds solution for component requirements in TATA Nano, right from the development stage. The company has been awarded exclusive supplier status for supplying material for Tata Nano. Hydro S&S will cater the material requirement for the TATA Nano project from its Pune facility where it has set up a 7,000 mtpa plant and plans to further increase the plant capacity by 6,000 mtpa in FY11. Tata Motors is estimated to produce approximately 110,000 Nano in FY11 and 200,000 Nano's in FY12. This will result in a demand of approximately 6,000 – 7,000 mtpa of plastic compounds, by FY12 from the Nano project.

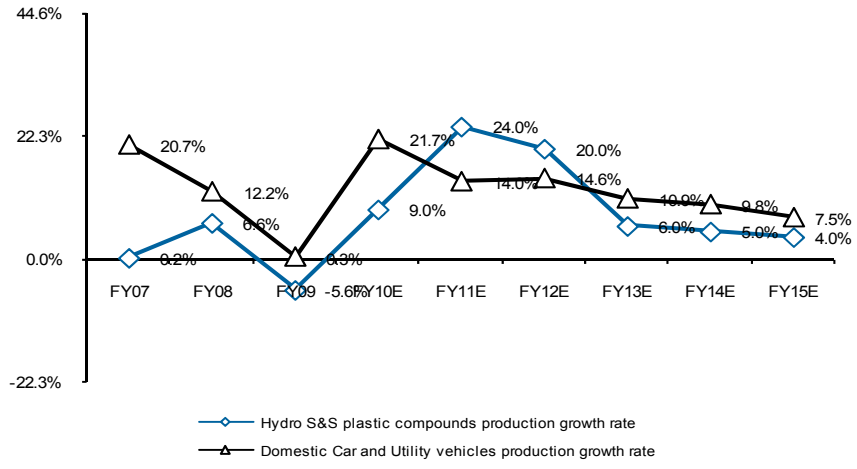
High competition limits Hydro S&S' ability to grow in line with the industry

PP is not a highly technology-intensive industry and requires very low capital expenditure

Despite being a leading player in PP compounds for end use in the automobile industry, Hydro S&S has not been able to grow in line with the industry due to increasing competition. Hydro S&S' production of PP compounds has not kept pace with the production of passenger and utility vehicles, despite an increase in the use of plastic compounds in automobile manufacturing. The PP compunds industry is not highly technology intensive and requires less capital for setting up a small plant (approximately Rs 9 mn for a 1,000 mt plant). Hydro S&S also has a high customer concentration with approximately 60% of the business coming from Hyundai Motors and 30% from Tata AutoComp Systems. The OEMs prefer to source material from more than one vendor to reduce business and other risks. As the OEMs have diversified their supply base by developing more vendors, this has limited Hydro S&S' growth and bargaining capacity. With the scale-up of demand for PP compounds for

Tata Nano, Hydro S&S is expected to register above–industry-level growth in FY11 and FY12.

Figure 2: Estimated production growth vis-à-vis the car and UV industry



Source: CRISIL Equities

Capacity expansion supports growth and diversification

Annual capacity to increase by 6,000 mtpa to 31,000 mtpa in FY11

Hydro S&S' business operations have been primarily concentrated in southern India, with as much as 60% catering to the requirement of Hyundai Motors. Transportation of PP compound over long distances can prove to be uneconomical since it is a bulky commodity. This has resulted in Hydro S&S largely being a regional player. In FY09, Hydro S&S commissioned a new manufacturing facility at Jejury (Pune) with a production capacity of 7,000 mtpa of plastic compounds, bringing the production capacity to 25,000 mtpa. Hydro S&S further plans to increase the plastic compounds manufacturing capacity at Pune by 6,000 mtpa at an estimated capex of Rs 35 mn. The Pune expansion will increase the total manufacturing capacity to 31,000 mtpa by FY11. The company plans to use the Pune facility to cater to the requirement of automobile manufacturers in western and northern India, thereby spreading out the client base. The Pune facility will also help Hydro S&S meet the demand from the Tata Nano plant coming up at Sanand in Gujarat and from other players setting up operations in the region. If Hydro S&S successfully bags contracts from new players setting up operations in western and northern India, its business profile will strengthen significantly and translate into meaningful diversification.

Low bargaining power with OEM suppliers limits margins

EBITDA margins have historically been in the range of 5% to 8%

Hydro S&S primarily supplies PP compounds to Tier 1 suppliers of OEMs. The OEMs aim to reduce the cost of materials to improve operational performance and typically dictate the prices at which they would procure from Tier 1 and Tier 2 suppliers. There also exist a large number of unorganized players in the industry, who typically operate on low margins. These factors limit Hydro S&S' bargaining power with OEM suppliers. At the same time, the prices of PP (the key raw material) remain volatile This has forced Hydro S&S to operate on low margins. Hydro S&S' EBITDA margins have been historically in the range of 5% to 8%.

Highly volatile raw material prices

PP prices linked to volatility in crude oil prices

Prices of PP, the key raw material used to produce plastic compounds, are highly volatile as they are linked to crude oil prices. The company enters into three- to six-month supply contracts with the OEMs, wherein the raw material cost is taken into account while pricing the products. Any sudden increase in PP prices as a result of volatility in international crude oil prices has an impact on the company's margins. Though Hydro S&S has indicated that it has been able to pass on the increase in cost to the customers, the pass-through is dependent on the demand-supply situation in the industry and has an impact on the company's margins.

Financial Outlook

Revenues to grow at three-year CAGR of 20.4% to Rs 2,064 mn in FY12

Revenues likely to register three-year CAGR of 16% in FY12

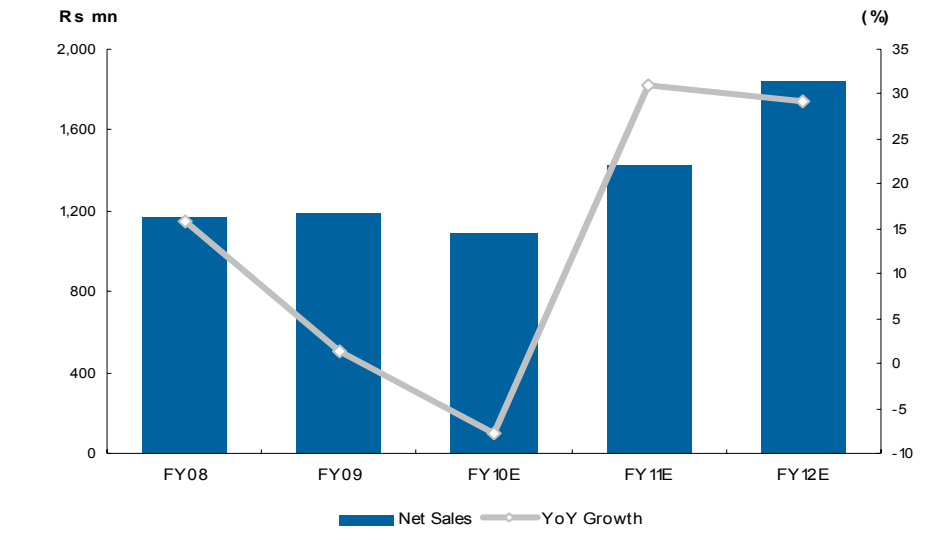
Hydro S&S' revenues declined 1% YoY to Rs 1,183.3 mn in FY09 mainly due to a decline in production volumes. The financial crisis and the economic slowdown impacted demand for automobiles leading to curtailment of production by key customers. With a revival in economic activity, demand for automobiles has gone up. The demand for PP compounds for the Tata Nano project will result in strong growth in PP compound sales – estimated at 3,300 mtpa in FY11 and 6,000 mtpa in FY12. We expect total revenues to grow at a three-year CAGR of 16% to Rs 1,848.7 mn in FY12, primarily supported by strong growth in PP compounds business. We expect gross revenues from the plastic compound segment to register a three-year CAGR of 16.7% to Rs 2,017.9 mn, while the FRP pultruded products are expected to register 2.3% growth to Rs 27.15 mn in the same period. The trading business is expected to grow at a CAGR of 17.6% to Rs 68 mn by FY12.

Table 4: Key assumptions in major segments

Particulars	FY08	FY09	FY10E	FY11E	FY12E
Plastic Compounds					
Volumes (MT)	13,538	12,778	13,940	17,277	20,733
Realisation per MT	95,360	99,417	85,500	90,342	97,324
Gross Sales (Rs Mn)	1,291	1,270	1,192	1,561	2,018
YoY growth	14.7%	-1.6%	-6.2%	31.0%	29.3%
FRP Pultruded					
Volumes (MT)	55,261	110,797	114,000	118,800	119,400
Realisation per MT	328	229	206	217	227
Gross Sales (Rs Mn)	18.1	25.4	23.5	25.7	27.2
YoY growth	102.3%	40.0%	-7.4%	9.4%	5.5%
Trading goods					
Gross Sales (Rs Mn)	41.9	42.1	36.5	47.6	61.4
YoY growth	75.5%	0.4%	-13.4%	30.5%	28.9%

Source: CRISIL Equities Estimate

Figure 3: Sales and YoY growth

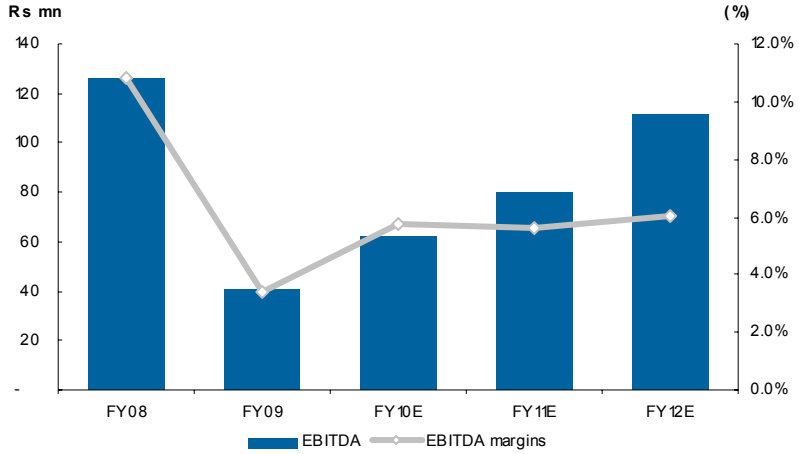


Source: CRISIL Equities Estimate

EBITDA margins expected to be 5.5-6% in the near term

The company's operating margins declined sharply by 740 bps YoY to 3.3% in FY09 due to volatility in raw material prices and the company's inability to pass on the increase in raw material prices to the OEMs. The decline in production volumes resulted in increased per unit operating cost, further squeezing margins. The pickup in auto sales in FY10 has eased pricing pressures. We expect operating margins at 5.7% in FY10 and 5.6% in FY11 and improve to 6.1% in FY12.

Figure 4: EBITDA and EBITDA margins

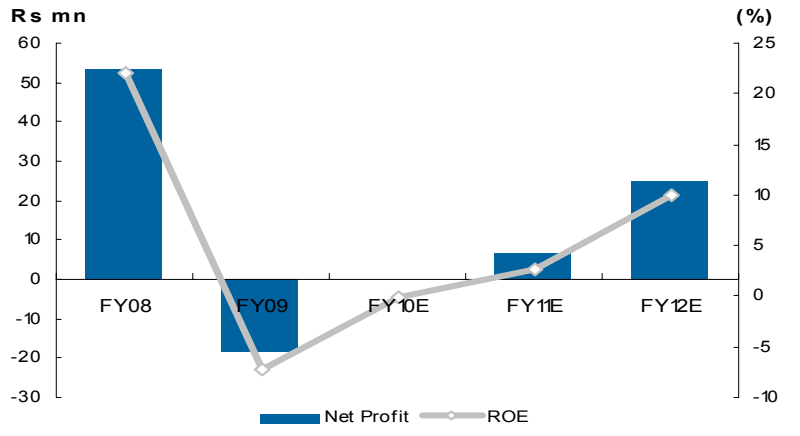


Source: CRISIL Equities Estimate

Capex of Rs 35 mn is expected to be financed through debt

We have assumed a capex of Rs 35 mn in FY11, which is expected to be financed through debt. Hydro S&S will require to raise debt also on account of increased working capital requirement considering the sharp growth in sales. As a result, interest expenses will likely rise from Rs 48 mn in FY09 to Rs 53 mn in FY12. Depreciation expenses are likely to go up from Rs 20.6 mn in FY09 to Rs 28.6 mn in FY12. In line with our operating margin assumption, net profit margin is likely to improve to 0.4% in FY11 and 1.4% in FY12. RoE is expected to be 2.6% in FY11, and 9.9% in FY12.

Figure 5: Net profit margin and RoE



Source: CRISIL Equities Estimate

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.

Strong management with good experience and domain expertise

Hydro S&S has a strong and experienced management headed by Mr V Srinivasan, who has more than four decades of experience in electrical transmission and distribution, and the engineering plastics business. Mr Murali Venkatraman, the vice chairman of the company, has been associated with Hydro S&S since inception, and plays a key role in strategic decisions and management of the company. Mr Narayan was the managing director of Hydro S&S till July 2009. He continues to be the ordinary director of the company. Mr Narayan has played a key role in shaping the business by driving the company's capacity expansion plan, R&D initiatives and implementing several business processes. The promoters hold non-executive positions on the board and provide active guidance to the management.

To strengthen the management, Mr N.K. Ramaswamy was appointed as the CEO on May 4, 2009. Mr Ramaswamy brings along over twenty years' experience in the plastic industry. He has been associated with companies such as GE Plastic.

Ability to develop new compounds catering to user requirement

Proactive and experienced management at the helm of operations

Hydro S&S was set up as a joint venture between WS Industries and the UK-based Hydro Polymers Ltd., a subsidiary of Norsk Hydro S.A. Sighting opportunities for plastic applications in the automotive industry, the company was quick to develop compounds for automotive requirement compared to its earlier focus on furniture applications. The technology transfer from Hydro Polymers, and the management's expertise and focus on research and development has helped in developing compounds to meet enhanced performance specifications sought by OEMs.

Geographic diversification to protect against increasing competition

The management is actively seeking to geographically diversify its operations and cater to the automobile manufacturers operating in northern and western India. The company has set up a manufacturing facility near Pune in western India. This expansion will help the company cater to the requirement of new clients and reduce the risk of client concentration.

Second line of management

We believe the company has a strong second line of management. The senior management team has varied work experience, ranging from 20 to over 40 years in their respective fields; most of them have been with the company since its inception. The company has also hired senior professionals to strengthen the management.

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 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 the company's corporate governance.

Overall, corporate governance at Hydro S&S represents good practices supported by reasonably good and fairly independent board. The board members hold strong industry experience and play a vital role in the company's management. We feel the company's corporate governance practices meet the minimum required levels.

Board composition

Board comprises eight members, of which two are executive and three independent directors

Hydro S&S' board comprises eight members, of which three are independent, which is in line with the stipulated SEBI listing guidelines. The company's directors hold strong industry experience and most of the directors have been associated with the company for a long time. Given the background of directors, we believe the board is fairly diversified. Mr Narayan Sethuraman and Mr S.K. Subramanyan are the executive directors. Mr Balasubramanyan (independent director) has over 20 years of industry experience and has been advising companies on matters relating to accountancy, financial and taxation. Mr V Thirupathi, (independent director) has over 20 years of experience in the banking and finance industry, and was the managing director of ICICI Credit Corporation Ltd. Mr Babulal Verma, independent director, has been associated with Hydro S&S for several years.

Board's processes

Various committee are in place as stipulated by the listing agreement

The company's quality of disclosure can be considered good, judged by the level of information and detail furnished in annual reports, website and other publicly available data. . The company has various committees in place to support corporate governance practices.Further, we assess that the audit committee is chaired by an independent director- Mr V. Thirupathi and it meets at timely and regular intervals.

Valuation Grade: 1/5

We have valued Hydro S&S' business using the discounted free cash flow to firm method (DCF). Based on this method, our one-year fair value for the stock is Rs 32.5 per share. We initiate our coverage on Hydro S&S with a valuation grade of 1/5. This grade indicates that the current market price of the company (Rs 71.5) has 'strong downside' from the current levels.

We expect Hydro S&S to earn an EPS of Rs 1 and Rs 3.9 in FY11 and FY12 respectively.

Following are the key factors in our valuation:

- We have considered discounted free cash flows from FY11 to FY15.
- We have assumed a target debt-equity ratio of 0.6.
- We have considered cost of equity at 17%.

Financial performance, including its cash flows, is highly vulnerable to growth in the automobile industry, volatility in crude oil prices and ability to pass on the increase in cost to OEMs

Given the highly competitive nature of the industry, the company's financial performance, including its cash flows, is highly vulnerable to growth in the automobile industry, volatility in crude oil prices and ability to pass on the increase in cost to OEMs. Although we remain cautious in our assumptions, we feel any positive change may significantly impact our valuation.

We have assumed a terminal growth rate of 3%, equity risk premium of 6% and a risk-free rate of return of 7%.

Table 5: Sensitivity to WACC and terminal growth rate

	Terminal growth rate				
	1.0%	2.0%	3.0%	4.0%	5.0%
9.8%	37	47	59	76	99
10.8%	27	35	44	56	72
11.8%	20	25	**32.5**	41	53
12.8%	13	18	23	30	39
13.8%	8	12	16	22	28

Source: CRISIL Equities Estimate

Company Overview

Hydro S&S was established in 1987 as a joint venture between the promoters of WS Industries and the UK-based Hydro Polymers Ltd (wholly-owned subsidiary of Norsk Hydro SA) to manufacture reinforced polypropylene (PP) compounds. In 2002, Hydro Polymers sold its holding to WS Group and exited the joint venture. WS Group, established in 1961, is a South India-based leading industrial group with interests in electrical transmission, distribution, engineering plastics and telecom projects.

Hydro S&S originally started as a manufacturer of PP compounds for the furniture and appliance segments, and diversified in the manufacturing of PP compounds for the automotive industry. Sales to the automotive industry accounted for about 96% of Hydro S&S' FY09 revenues.

Hydro S&S has three manufacturing plants located at Pondicherry, Pudukottai in Tamil Nadu and Pune for the manufacturing of PP compounds with an installed capacity of 25,000 mtpa. Through these production facilities the company supplies PP and other materials to automobile manufacturers across southern, northern and western India. The company has an R&D facility in Pudukottai where it develops customer-specific new products and compounds. Hydro S&S is also involved in providing consultancy and product development assistance to OEMs. The company was involved in the development of special quality plastic compound for the development of Tata Nano. The company has been awarded preferred supplier status for supplying material for Tata Nano.

Table 6: History of Hydro S&S

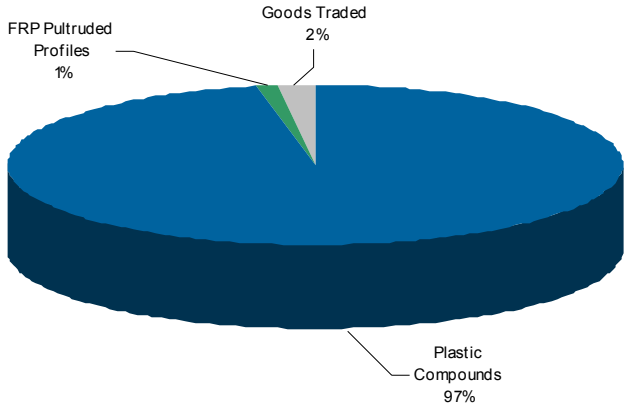
1987	Foundation of Hydro S&S as a joint venture between WS Industries and Hydro Polymers Ltd., a UK-based wholly-owned subsidiary of Norsk Hydro ASA
2001	Hydro S&S listed on the Bombay Stock Exchange
2002	Hydro Polymers exited the joint venture by selling its 51% holdings in Hydro S&S to the promoters of WS Industries
2006	Hydro S&S restructured its product portfolio completely – it exited from the low-margin furniture compounds business to focus on high-margin PP compounds targeted at automobile applications
2007	Selected as the preferred supplier of reinforced thermoplastic compounds for Tata Nano
2009	Commissioned a new manufacturing facility with an initial capacity of 6,000 mtpa at Jejury near Pune, increasing the total manufacturing capacity to 25,000 mtpa

Source: Company

Business Overview

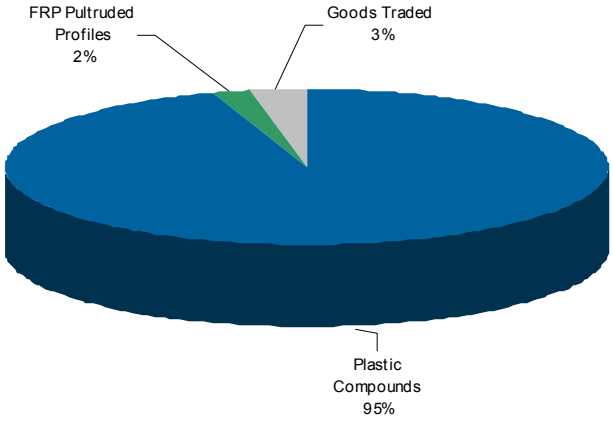
Hydro S&S is a leading manufacturer of high quality, reinforced PP compounds, thermoplastic elastomers and fibre reinforced composites. It primarily caters to the automotive industry. The company is the primary supplier to Tier 1 suppliers of automobile manufacturers. Hydro S&S operates under three lines of business: 1) plastic compounds, 2) FRP pultruded profiles and 3) trading activities.

Figure 6: Segmental contribution to the top line (FY07)



Source: Company, CRISIL Equities Estimate

Figure 7: Segmental contribution to the top line (FY09)



Source: Company, CRISIL Equities Estimate

Hydro S&S earns 95% of its revenues from the plastic compounds segment

Plastic compounds

Hydro S&S manufactures a wide range of PP compounds by the judicious selection of alloys, blends of preferred-base polymers with hybrid reinforcements and uses advanced reaction process techniques. PP compounds are manufactured with finely tuned properties tailored for specific end-use applications. The elastomer modification of minerals and glass reinforced polypropylene results in a new sub-group of materials with their characteristic stiffness/impact profiles which find extensive applications in power tool housing, automotive bumpers and fascias. These compounds have extensive applications in automobile, domestic appliance and furniture industries.

Hydro S&S also manufactures a wide range of thermoplastic elastomers under the HYPRENE brand name. These products are manufactured under a strategic alliance with ExxonMobil Chemicals Asia Pacific Pte. Ltd, the worldwide leader in engineered TPEs. ExxonMobil's subsidiary Advanced Elastomer Systems (AES) provides the base material and technical support to Hydro S&S for the manufacture of TPEs in India. The company earns approximately 95% of the total revenues as of FY09 from this segment.

FRP pultruded profiles

The use of plastics as a substitute for wood and metal is increasing due to its excellent chemical, electrical and mechanical properties. In pultrusion, continuous glass rovings are impregnated with thermoset resins and continuously pulled through a heated die where the shape of the profile is achieved. The products hold high tensile strength which is about four times greater than that of steel or aluminium and is 30% to 45% lighter in weight. The products also meet a wide range of strength, colour and finish requirements. The FRP pultruded profiles are increasingly being used in High Tension electrical segment and automobile industry. This segment accounted for 2% of FY09 revenues.

Trading business

Hydro S&S is an authorised dealer of TOSAF for a whole range of masterbatches. The company works in conjunction with TOSAF to distribute and service masterbatches. Hydro S&S derives approximately 3% of its revenues for FY09, from trading activities.

Raw material requirements

85% of the PP requirement is met from domestic sources

Polypropylene is the basic raw material used to manufacture PP compounds which constitutes approximately 90% of the total raw material cost. The company sources 85% of its PP requirement from domestic manufacturers Reliance Industries Ltd. and Haldia Petrochemicals. The remaining 15% is imported from Singapore.

FINANCIAL STATEMENTS

Income Statement

(Rs Mn)	FY08	FY09	FY10E	FY11E	FY12E
Net sales	1,165	1,183	1,087	1,425	1,843
Operating Income	**1,168**	**1,184**	**1,093**	**1,431**	**1,849**
EBITDA	**126**	**40**	**63**	**80**	**112**
Depreciation	16	21	26	28	29
Interest	33	48	48	48	53
Other Income	2	3	7	6	7
PBT	**81**	**(26)**	**(5)**	**10**	**38**
PAT	**54**	**(18)**	**(0.1)**	**6**	**25**
No. of shares	6.5	6.5	6.5	6.5	6.5
Earnings per share (EPS)	8.2	(2.8)	(0.0)	1.0	3.9

Balance Sheet

(Rs Mn)	FY08	FY09	FY10E	FY11E	FY12E
Equity (Face Value)	65	65	65	65	65
Reserves	200	182	182	180	198
Debt	282	360	340	370	420
Current Liabilities and Provisions	169	101	119	155	200
Deferred Tax Liability/(Asset)	43	35	35	35	35
Capital Employed	**761**	**743**	**740**	**806**	**918**
Net Fixed Assets	195	319	293	299	276
Capital WIP	39	9	9	9	9
Investments	15	23	23	23	23
Loans and advances	33	38	26	34	44
Inventory	210	159	150	196	253
Receivables	259	183	180	235	304
Cash & Bank Balance	9	12	59	8	8
Applications of Funds	**761**	**743**	**740**	**806**	**918**

Cash Flow

(Rs Mn)	FY08	FY09	FY10E	FY11E	FY12E
Pre-tax profit	81	(26)	(5)	10	38
Total tax paid	(23)	(1)	4	(3)	(12)
Depreciation	16	21	26	28	29
Change in working capital	(66)	54	41	(73)	(91)
Cash flow from operating activities	**7**	**48**	**67**	**(38)**	**(38)**
Capital expenditure	(63)	(115)	(0)	(35)	(5)
Investments and others	(0)	(8)	-	-	-
Cash flow from investing activities	**(64)**	**(123)**	**(0)**	**(35)**	**(5)**
Equity raised/(repaid)	0	(0)	(0)	0	0
Debt raised/(repaid)	66	77	(20)	30	50
Dividend (incl. tax)	(9)	-	-	(8)	(8)
Others (incl extra ordinaries)	-	-	-	-	-
Cash flow from financing activities	**56**	**77**	**(20)**	**22**	**42**
Change in cash position	**(0)**	**2**	**47**	**(51)**	**(0)**
Opening Cash	9	9	12	59	8
Closing Cash	9	12	59	8	8

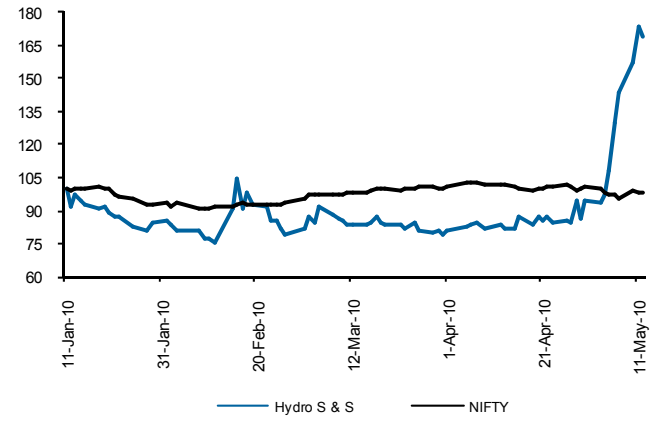
Ratios

	FY08	FY09	FY10E	FY11E	FY12E
Growth ratios					
Sales growth (%)	15.9	1.4	(7.7)	30.9	29.2
EBITDA growth (%)	74.9	(68.2)	55.7	28.0	39.9
EPS growth (%)	82.6	(134.3)	(99.6)	(8,711.1)	291.4
Profitability Ratios					
EBITDA Margin (%)	10.8	3.4	5.7	5.6	6.1
PAT Margin (%)	4.6	(1.5)	(0.0)	0.4	1.4
Return on Capital Employed (RoCE) (%)	22.5	3.4	6.1	8.6	12.9
Return on equity (RoE) (%)	22.0	(7.2)	(0.0)	2.6	9.9
Dividend and Earnings					
Dividend per share (Rs)	1.4	0.0	0.0	1.0	1.0
Dividend payout ratio (%)	17.1	0.0	0.0	101.3	25.9
Dividend yield (%)	2.3	-	-	1.4	1.4
Earnings Per Share (Rs)	8.2	-2.8	0.0	1.0	3.9
Efficiency ratios					
Asset Turnover (Sales/GFA)	3.6x	2.9x	2.3x	2.9x	3.6x
Asset Turnover (Sales/NFA)	6.2x	4.6x	3.6x	4.8x	6.4x
Sales/Working Capital	3.9x	3.9x	4.2x	5.2x	5.2x
Financial stability					
Net Debt-equity	1.0	1.3	1.0	1.4	1.5
Interest Coverage	3.4	0.4	0.8	1.1	1.6
Current Ratio	3.1	4.1	3.7	3.2	3.2
Valuation Multiples					
Price-earnings	7.3x	NM	NM	72.4x	18.5x
Price-book	1.5x	0.9x	1.9x	1.9x	1.8x
EV/EBITDA	5.1x	13.4x	11.6x	10.0x	7.6x

Source: CRISIL Estimates

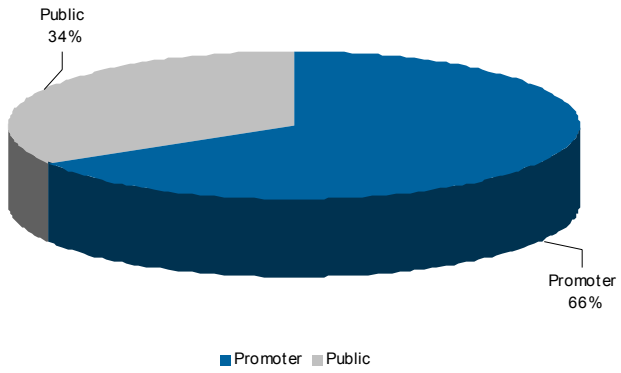
Focus Charts

Stock movement vs. market



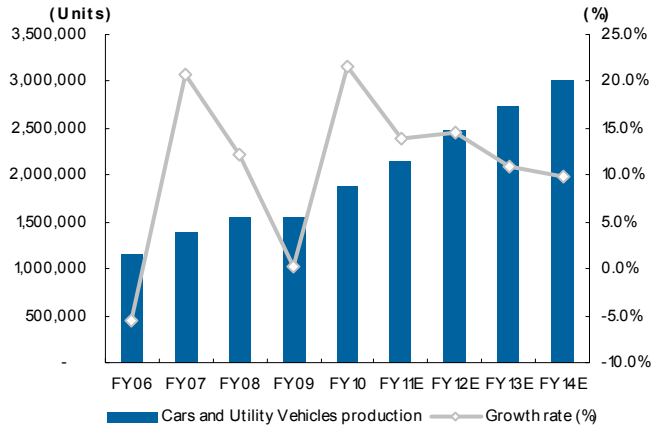
Source: NSE

Shareholding as of March 2009



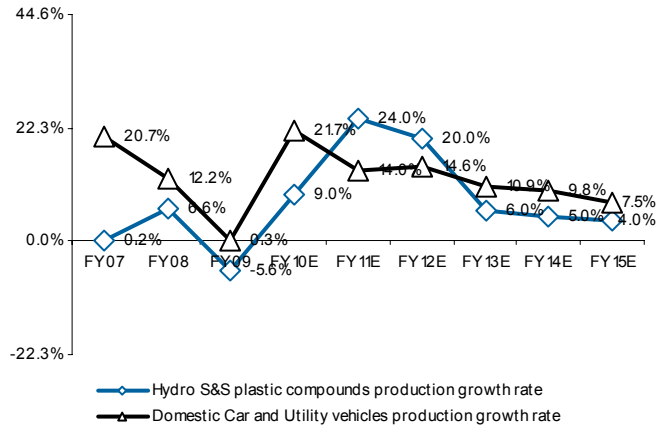
Source: NSE

Production of cars and utility vehicles



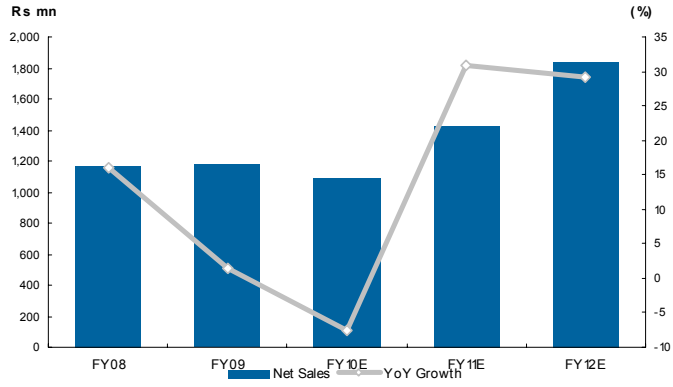
Source: CRISIL Research

Estimated production growth vis-à-vis the car and UV industry



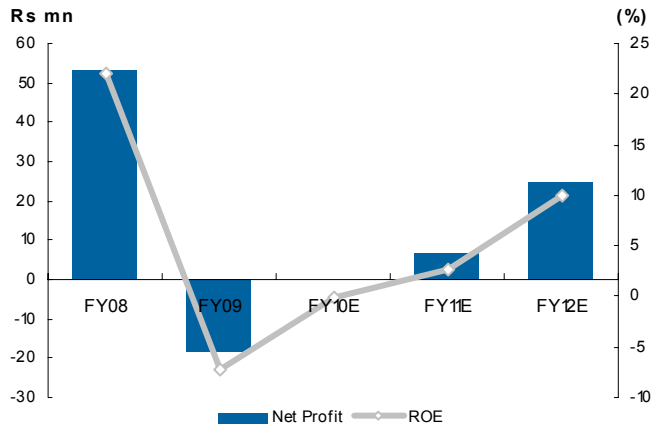
Source: CRISIL Equities Estimate

Sales and sales growth



Source: CRISIL Equities Estimate

Net profit margin and RoE



Source: CRISIL Equities Estimate

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CRISIL is India's leading Ratings, Research, Risk and Policy Advisory Company

About CRISIL Research

CRISIL Research is India's largest independent, integrated research house. We leverage our unique, integrated research platform and capabilities spanning the entire economy-industry-company spectrum to deliver superior perspectives and insights to over 600 domestic and global clients, through a range of subscription products and customised solutions.

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