

# PENNNAR'S NEW AVATAR

*After shedding excess baggage during the slowdown, the Hyderabad-based steel company is now banking on its value-added business for growth*

*Manish Bhandari*

**T**he eagle is the most majestic bird in the sky. Legend has it that all eagles molt — at least once — during their lifetime. When an eagle reaches the age of 30, its physical condition deteriorates. Its talons lose their flexibility and cannot properly grip the prey. Its beak becomes dull and bent. Its wing feathers become thick and heavy, sticking to its chest and impairing its flight. This makes survival difficult and causes a great deal of depression. The bird then retreats to a mountain-top, where over a five-month period it knocks off its beak by banging it against a rock. It plucks out its talons and feathers. Each stage produces re-growth of the removed body parts that 'renews' the eagle and allows it to live for another 30-40 years.

The story of Pennar Industries of Hyderabad shows quite a few similarities to the life cycle of the eagle. Pennar set up a cold-rolling steel strip (CRSS) and cold-rolled formed sections (CRFS) plant in 1988. Building on its initial success, it acquired Nagarjuna's steel

plant and financed it through debt, suffering during the industrial slowdown of 1998-2002. The sales of the company took a hit from ₹260 crore in FY99 to ₹72 crore in FY02, while profitability declined from ₹8.5 crore to a loss of ₹46 crore over the same period. Not

surprisingly, the downturn saw the stock collapse from its high of ₹80 in 1992 to around 40 paise in 2002. It used the brief upturn in 2004-2007 to focus on its core capabilities in steel manufacturing and exited its profile and aluminium units. Just like the eagle, Pennar shed additional weight and began the journey of transformation. The company had the vision to transform itself from a commodity player and move up the value chain by providing value-added engineering services and products. "We wanted to transition from being a manufacturer of commodity steel to a provider of engineered products and services as we believed that our business model could no longer

*"We wanted to change as we believed that our model could no longer serve to deliver our growth, profitability and liquidity targets*

— **ADITYA RAO**  
Vice-chairman and MD, Pennar Industries

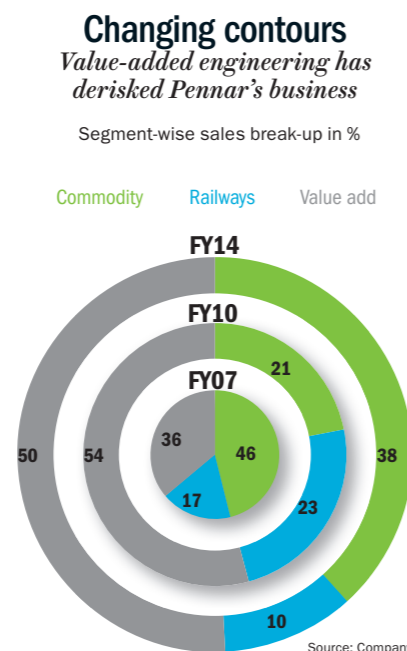
serve to deliver our growth, profitability and liquidity targets,” explains Aditya Rao, the chairman, Nrupender Rao’s, son who was recently appointed vice-chairman and managing director. The is now divided into four strategic business units: systems and projects, industrial components, precision tubes and steel products, and each has its own distinct markets, capital assets and distinct customers.

**TURNING POINT**

Ten years ago, Pennar was forced to change. It embraced continuous value-addition as a competitive advantage in a world with breakneck technological advancements. It reduced its dependence on steel products, with value-added applications increasing from 36% of sales in 2007 to 50% in 2014. (see: *Changing contours*) The core steel business has allowed it to enter new sectors such as precision tubes, railway coach profiles, road safety systems and pre-engineered buildings. The entry into value-add business was the brain child of Aditya, a phys-

**LAST YEAR, PRIVATE EQUITY FIRM ZEPHYR PEACOCK PICKED UP 25% STAKE IN PENNAR ENGINEERING BUILDING SYSTEMS FOR ₹50 CRORE**

ics and engineering management graduate from Cornell University. Aditya founded new businesses: Pennar Engineered Building Systems (PEBS) in 2010 and Pennar Enviro in 2013. PEBS has many firsts to its credit by building the first gold-rated green factory in India, by constructing the largest clear span building (99 m), and by setting up the largest warehouse in the country (10 million sq ft). In just four years since commencing operations, PEBS clocked revenues of ₹352 crore (FY14). In 2013, PEBS also raised ₹50 crore (25% stake) through a private equity firm, Zephyr Peacock.



While captive consumption of cold-rolled steel sheets today accounts for about 33% of production, going forward, these businesses will give way to engineering-oriented business units, focusing primarily on system integration and custom-designed products, thereby enhancing earn-

ing. electrostatic precipitators (extensively used for pollution control in the cement and thermal power industries) and seed processing plants. Special efforts were made to manufacture components for the automotive and white goods sectors. It also acquired the press metal profiles division of Tube Investments Group (TI) and created manufacturing facilities to develop precision tubes (CDW) components for automotive and general engineering applications, mounting structures for solar panels and hydraulics cylinders.

**SUNRISE SECTORS**

The company has made two strategic investments in sunrise industries. Pennar’s engineering credentials allow it to enter new markets faster than competition. Steel buildings are the fastest systems for industrial construction today and are popular all over the world in the form of pre-engineered buildings (PEB). These are custom-designed, expandable, durable and maintenance-free. These buildings are suitable for industrial as well as commercial applications such as warehouses, factories, aircraft hangars, logistic parks, etc. It is a ₹5,000-crore industry and is growing at more than 20% a year. Pennar’s PEBS engineering team size per crore of revenue is the highest in the industry. This has been instrumental in allowing the company (see: *The pull factor*) to grow at three times the market growth rate over the past three years.

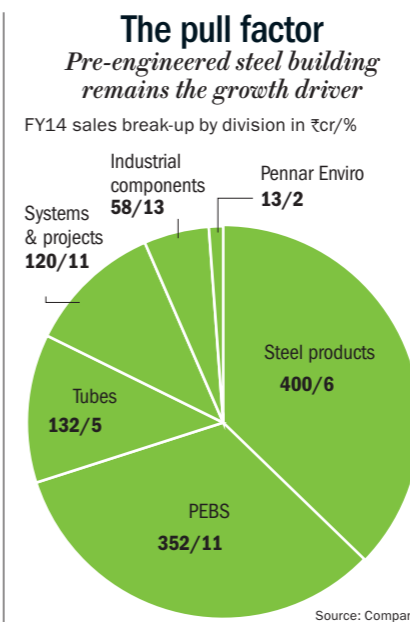
Pennar Enviro (PEL), another manufacturing unit, makes and markets fuel additives and water treatment chemicals. It has diversified by providing cohesive solutions in the design and construction of clear water and wastewater treatment plants. The water-treatment business of Pennar has grown at over 200% the last fiscal, when the overall water-treatment indus-

try has had negative growth. But given the market size of ₹20,000 crore, there is enough headroom for growth.

As industrial activities increase in India, the services, engineering, design and products of Pennar will be in huge demand. Amtech Auto, Larsen & Toubro, My Home Construction, Ranbaxy and AGI Glaspac are some of its clients. Since the company has entered this business last year, it is still small compared with players such as Thermax and Va Tech Wabag in terms of topline and products services offered. Pennar is positioning the enviro division as a proxy play on the PEB business, since it targets clients of the PEBS division, offering related solutions. For example, a prefab factory setup would require a wastewater management system for its other industrial activities.

**THE ROAD AHEAD**

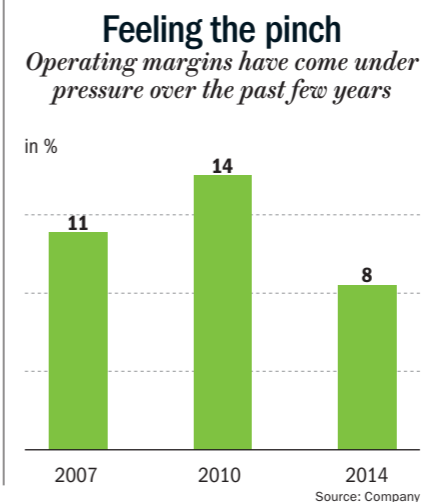
In FY14, the company had clocked sales of ₹1,117 crore and hopes to triple turnover in the coming years. “On a consolidated basis we hope to triple turnover over the next three to four years. This will be accomplished by expanding market share in our project businesses and investing around ₹50 crore per year into all of our business units to fund capacity and capability expansion,” says Aditya. The upturn in industrial activity is likely to expand return on capital employed (ROCE) and shareholder value significantly. The consolidated entity, Pennar Industries, has low levels of debt. The debt to equity ratio of the company is 0.4x, which is primarily working capital short-term debt. “Strategic use of debt to gain market share is a very possible option that will allow the company to outgrow our competitors. Increasing capacity, entry into new geographies, expansion of product and service profile are po-



tential avenues to deploy capital,” mentions Aditya.

The slowdown in the infrastructure, automotive and railways sectors, however, has had a severe impact on operations at Pennar, resulting in higher operating costs, increase in working capital costs, longer operating cycles and delays in order-book execution. The company’s profits have fallen from ₹76 crore in FY11 to ₹31 crore in FY14, while sales declined 3.6% to ₹1074 crore led by a squeeze in margins. (see: *Feeling the pinch*)

As the economy recovers with the promise of new deals from the new government, Pennar is strongly po-



sitioned to reap the benefit. Most of its business units are working at a 60-70% utilisation level, indicating high level of operating leverage available in the business as sales increase manifold over the next few years. Procurement efficiencies, economies of scale, lower logistics costs from the vicinity of manufacturing locations to customers and pan-India marketing presence will help it be price-competitive and launch new products. “Pennar’s engineering credentials will allow us to rapidly enter and evaluate new markets faster than our competitors. For example, PEBS’ engineering team size per crore of revenue is the highest in the industry. This has allowed the company to grow at three times the market growth rate of close to 30% a year, over the past three years,” points out Aditya.

Pennar has a strong product portfolio and its product profile touches the vision laid down by the new government in the areas of infrastructure development, industrial infrastructure by PEBS, railways and solar profiles. As the eagle spreads its wings after molt and resumes flight, Pennar is ready to take off. In a down cycle, the company has achieved ROCE of 15-20% levels and we expect a minimum 20% ROCE during the upturn. Though the commodity business is vulnerable, the company is moving towards value-added segments, which after attaining a certain scale will reduce the effect of commodity blues on the company. Though in the current rally, the stock has doubled to ₹40 levels, we believe there is enough headroom for the stock to grow. At current prices, the stock is trading at a PE of five times FY15/FY16 earnings. Investors looking for a long haul can hop on to the gravy train. ☺

THE AUTHOR IS THE MANAGING PARTNER AND CEO, VALLUM ADVISORS. HE OR HIS CLIENTS HAVE INVESTMENTS IN PENNAR INDUSTRIES