

KEC International

27 March 2015

Reuters: KECL.BO; Bloomberg: KECI IN

On Course Towards Recovery In Operating Margin

We had a meeting with the management of KEC International (KEC) recently to get the latest business update. The management is optimistic on revival in order inflows and a recovery in operating margin by 200bps in FY16E driven by better margin T&D (Transmission and Distribution) orders, stabilisation of SAE Towers & cable business and completion of legacy projects in railway & water segments. Following are the key takeaways:

Domestic T&D orders expected to revive: While KEC reported weak order inflows for the past six months because of sluggish order placement activity in domestic market, it expects a healthy recovery in order inflow momentum from 4QFY15. It expects the order inflow run-rate to jump back to the normalised rate of Rs18bn-Rs20bn per quarter compared to Rs11bn/Rs14bn of order inflows reported in 2QFY15/3QFY15, respectively. Order placement traction from Power Grid Corporation of India (PGCIL) has improved, while KEC's market share in it is also on the rise. The annual addressable opportunity size for KEC from PGCIL orders stands at Rs70bn-Rs80bn in case of transmission lines and Rs50bn-Rs60bn in case of sub-stations. In 9MFY15, KEC's market share in PGCIL tenders stood at 9%, which it aims to scale up significantly going forward. Healthy order placement activity is also seen from state electricity boards (SEBs) of Karnataka, Tamil Nadu, West Bengal, Andhra Pradesh and Rajasthan. In its total order book of Rs87.6bn as of 3QFY15-end, PGCIL accounted for an 18%-19% share while SEBs had a 16%-17% share.

International orders to remain steady: KEC expects its international order inflows to remain steady. Order inflow from the MENA region has not slowed down, despite the recent decline in crude oil prices. In the MENA region (21% of current order book), KEC is exposed to primarily three countries – Saudi Arabia, Abu Dhabi and Oman. With the continuous thrust on investment in public infrastructure projects in these three countries, a robust growth in order inflows is expected. T&D capex in other key geographies like the SAARC region excluding India (driven by Nepal, Bhutan and Bangladesh) and Africa (driven by Kenya, Uganda and Mozambique), accounting for 11% of the order book each, is also progressing at a steady pace.

Revenue and margin outlook for T&D segment: Driven by a healthy current order book of Rs87.6bn (1.1x FY14 revenue), L1 status in orders worth Rs30bn, healthy capex outlay by PGCIL and SEBs, stable international order inflows as well as new opportunities arising from tariff-based competitive bidding projects worth Rs530bn, KEC is hopeful of a 10%-15% YoY growth in revenue in FY16E in the T&D segment. While pending receivables from international markets could lead to a minor provision for forex fluctuations (primarily from South Africa and Brazil) in 4QFY15 (overall 80% of its exposure is in US dollar terms and the rest in various local currencies). However, KEC is winning new T&D orders at an EBITDA margin of 9% in both transmission and sub-station segments and, therefore, it has retained FY16E operating margin guidance of 8% for the consolidated entity.

Y/E March (Rsmn)	FY13	FY14	FY15E	FY16E	FY17E
Net revenue	69,795	79,018	82,880	92,741	101,814
EBITDA	3,814	4,933	4,641	6,677	8,247
Adjusted PAT	652	849	395	1,644	2,658
Adjusted EPS (Rs)	2.5	3.3	1.5	6.4	10.3
EPS growth (%)	(69.0)	30.3	(53.5)	316.3	61.6
EBITDA margin (%)	5.5	6.2	5.6	7.2	8.1
PER (x)	29.2	22.4	48.2	11.6	7.2
P/BV (x)	1.7	1.6	1.4	1.3	1.1
EV/EBITDA (x)	9.0	7.9	8.1	5.6	4.4
Dividend yield (%)	0.7	0.8	1.4	1.8	2.2
RoCE (%)	12.3	13.5	11.0	16.2	20.1
RoE (%)	5.8	5.7	13.8	11.8	16.9

Source: Company, Nirmal Bang Institutional Equities Research

BUY

Sector: Capital Goods

CMP: Rs74

Target Price: Rs124

Upside: 67%

Chirag Muchhala

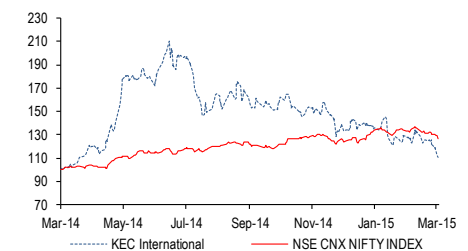
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Key Data

Current Shares O/S (mn)	257.1
Mkt Cap (Rsbn/US\$mn)	18.9/301.1
52 Wk H / L (Rs)	155/64
Daily Vol. (3M NSE Avg.)	732,554

One-Year Indexed Stock Performance



Price Performance (%)

	1 M	6 M	1 Yr
KEC International	(13.0)	(28.4)	10.5
Nifty Index	(3.9)	4.7	26.4

Source: Bloomberg

SAE Towers likely to stabilise

KEC's 100% subsidiary in the American continent, SAE Towers, is likely to stabilise in FY16 as against operating losses suffered in the current year. Its Brazil manufacturing plant (65,000mt capacity), which services only Brazil market, suffered inventory pile-up following slowdown in economic activity because of national elections in November 2014, leading to unabsorbed overheads and thereby affecting margins. However, economic activity has picked up pace and the current capacity utilisation has risen to 70%, leading to improved margin outlook for FY16. KEC's Brazil factory is already full of orders for the next 18 months. The second manufacturing plant of SAE Towers in Mexico (35,000mt capacity), which services Mexico, US and Canada markets, was impacted by predatory pricing by a new entrant, which took orders at 20% below the prevailing market price as an entry strategy. The situation in Mexico is slowly improving, but capacity utilisation still stands below 50% with the factory having orders for only the next three to four months. The management expects profitability of SAE Towers to be positive at the PBT level in FY16.

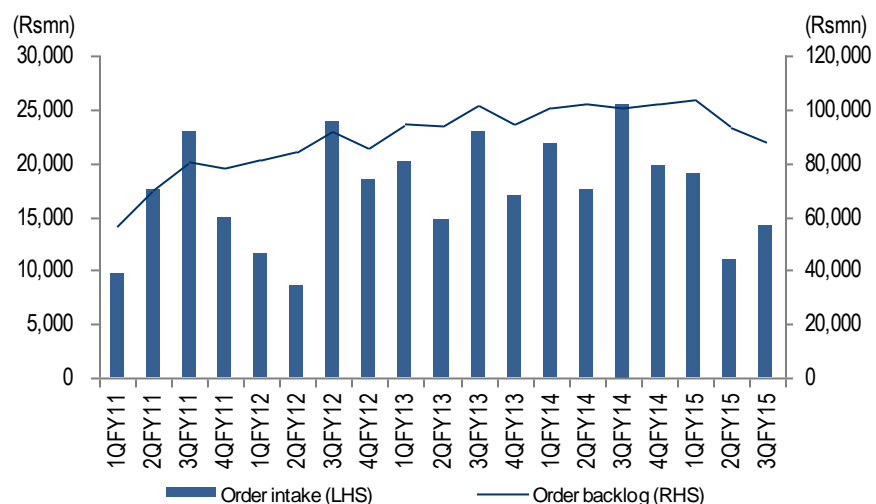
Cable, railway and water segments turning around

Cable segment (11% of 9MFY15 revenue) posted a healthy 63% YoY growth in revenue to Rs6.9bn in 9MFY15 driven by improved competitiveness and rationalised manufacturing costs after moving the manufacturing plant from Thane in Maharashtra to Vadodara in Gujarat. Further, KEC has also developed the technology for extra high voltage 220KV cables and expects to book revenue from the same next year, which will enjoy high margins because of limited competition. Overall, continuation of scale-up in cable revenue is expected (can achieve total turnover of Rs14bn at full capacity utilisation) with a mid-single digit operating margin in FY16E (the segment incurred losses because of over-capacity in the industry for the past several years). In the railway segment (1.3% of 9MFY15 revenue), KEC is focusing on mid-to-large sized projects worth around Rs1bn and expects to register operating margin of 8%-9%. In the water segment (1.6% of 9MFY15 revenue), KEC has stopped bidding for canals, dams and irrigation projects and wants to focus solely on waste water treatment projects. KEC expects to end FY15E with a legacy order book of Rs500mn, comprising railway and water projects, which it aims to execute by July 2015.

Outlook and valuation

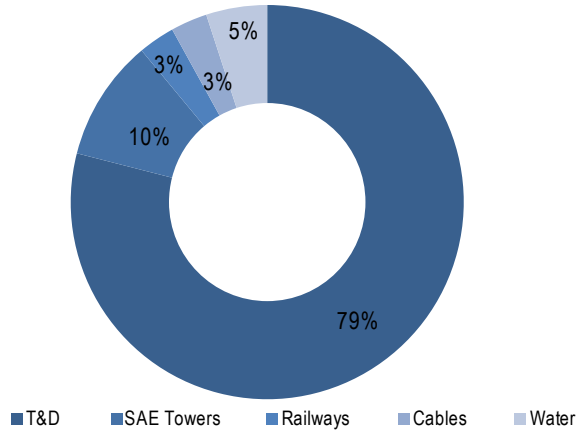
Driven by better margin T&D orders, stabilisation of SAE Towers & cable business and completion of legacy projects in railway & water segments, KEC is poised to register a healthy expansion in its operating margin profile. While the management retained its operating margin guidance of 8.0% for FY16, we have factored in lower margin recovery of 7.2%/8.1% for FY16E/FY17E, respectively. This is expected to result in a 190bps operating margin expansion over FY14-FY17E, leading to a 46% adjusted earnings CAGR versus a 26% CAGR decline reported over FY11-FY14. A healthy rise in return ratios (RoE expected to rise from 5.7% in FY14 to 16.9% in FY17E) and reasonable valuation along with a high scalability potential owing to a strong T&D capex outlay likely over the next three to five years in India led us to retain Buy rating on KEC. We have also retained our target price of Rs124 on the stock based on 12x FY17E earnings (median P/E of past seven years is 13.6x).

Exhibit 1: Order inflow and order book position



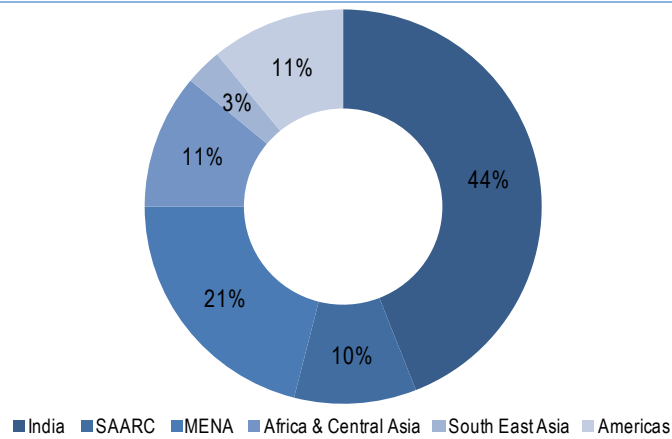
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 2: Segment-wise order book break-up



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 3: Geography-wise order book break-up

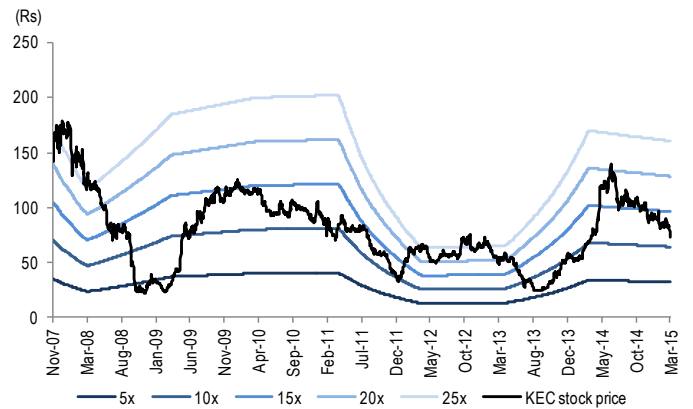


Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 4: P/E charts



Source: BSE, Nirmal Bang Institutional Equities Research



Source: BSE, Nirmal Bang Institutional Equities Research

Financial statements (consolidated)
Exhibit 5: Income statement

Y/E March (Rsmn)	FY13	FY14	FY15E	FY16E	FY17E
Net sales	69,795	79,018	82,880	92,741	101,814
% growth	20.0	13.2	4.9	11.9	9.8
Raw material costs	53,301	59,594	62,989	69,463	75,750
Staff costs	4,829	5,661	5,967	6,677	7,229
Other overheads	7,852	8,831	9,283	9,923	10,589
Total expenditure	65,981	74,086	78,238	86,064	93,567
EBITDA	3,814	4,933	4,641	6,677	8,247
% growth	(19.1)	29.3	(5.9)	43.9	23.5
EBITDA margin (%)	5.5	6.2	5.6	7.2	8.1
Other income	160	138	41	46	51
Interest costs	1,944	2,633	3,153	3,056	2,906
Depreciation	561	705	892	1,015	1,104
Profit before tax	1,470	1,733	637	2,652	4,288
Tax	818	883	242	1,008	1,629
Adjusted net profit	652	849	395	1,644	2,658
Extra-ordinary items	(1)	(182)	1,347	-	-
Reported net profit	650	668	1,741	1,644	2,658
Adjusted PAT margin (%)	0.9	1.1	0.5	1.8	2.6
Adjusted EPS (Rs)	2.5	3.3	1.5	6.4	10.3
% growth	(69.0)	30.3	(53.5)	316.3	61.6

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 7: Balance sheet

Y/E March (Rsmn)	FY13	FY14	FY15E	FY16E	FY17E
Share capital	514	514	514	514	514
Reserves	10,958	11,402	12,842	14,096	16,273
Net worth	11,472	11,916	13,357	14,610	16,787
Short-term loans	9,612	15,247	14,747	14,247	13,447
Long-term loans	7,078	6,026	6,026	5,726	5,326
Total loans	16,690	21,273	20,773	19,973	18,773
Deferred tax liability (net)	621	514	514	514	514
Total Liabilities	28,783	33,702	34,643	35,097	36,074
Gross block	13,296	14,026	14,755	15,555	16,455
Depreciation	3,514	4,283	5,176	6,191	7,295
Net block	9,782	9,742	9,580	9,364	9,160
Capital work-in-progress	301	180	200	200	200
Goodwill	3,424	3,778	3,778	3,778	3,778
Inventories	3,960	5,052	5,223	5,336	5,858
Debtors	28,870	38,078	39,283	42,941	46,026
Cash	1,556	1,440	2,156	1,785	1,431
Loans and advances	6,618	7,106	7,493	7,623	8,089
Other current assets	7,836	8,520	8,785	9,274	9,774
Total current assets	48,840	60,197	62,940	66,958	71,178
Creditors	24,671	32,131	33,306	36,159	38,601
Other current liabilities & provisions	8,893	8,064	8,548	9,045	9,641
Total current liabilities	33,564	40,194	41,854	45,204	48,243
Net current assets	15,276	20,003	21,086	21,754	22,936
Total assets	28,783	33,702	34,643	35,097	36,074

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 6: Cash flow

Y/E March (Rsmn)	FY13	FY14	FY15E	FY16E	FY17E
EBIT	3,253	4,227	3,749	5,662	7,143
(Inc./dec.) in working capital	(4,206)	(4,843)	(367)	(1,040)	(1,536)
Cash flow from operations	(953)	(615)	3,382	4,622	5,607
Other income	160	138	41	46	51
Depreciation	561	705	892	1,015	1,104
Interest paid (-)	(1,944)	(2,633)	(3,153)	(3,056)	(2,906)
Tax paid (-)	(710)	(991)	(242)	(1,008)	(1,629)
Dividends paid (-)	(152)	(180)	(301)	(391)	(481)
Net cash from operations	(3,037)	(3,576)	620	1,229	1,746
Capital expenditure (-)	(1,639)	(545)	(750)	(800)	(900)
Net cash after capex	(4,677)	(4,121)	(130)	429	846
Inc./(dec.) in short-term borrowing	4,739	5,635	(500)	(500)	(800)
Inc./(dec.) in long-term borrowing	(430)	(1,052)	-	(300)	(400)
Inc./(dec.) in total borrowings	4,309	4,583	(500)	(800)	(1,200)
Cash from financial activities	4,309	4,583	(500)	(800)	(1,200)
Others	(105)	(579)	1,347	-	-
Opening cash	2,029	1,556	1,440	2,156	1,785
Closing cash	1,556	1,440	2,156	1,785	1,431
Change in cash	(473)	(116)	716	(371)	(354)

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 8: Key ratios

Y/E March	FY13	FY14	FY15E	FY16E	FY17E
Per share (Rs)					
EPS	2.5	3.3	1.5	6.4	10.3
Book value	44.6	46.3	52.0	56.8	65.3
Valuation (x)					
P/E	29.2	22.4	48.2	11.6	7.2
P/BV	1.7	1.6	1.4	1.3	1.1
EV/EBITDA	9.0	7.9	8.1	5.6	4.4
EV/sales	0.5	0.5	0.5	0.4	0.4
Return ratios (%)					
RoCE	12.3	13.5	11.0	16.2	20.1
RoE	5.8	5.7	13.8	11.8	16.9
RoIC	13.2	14.2	11.6	17.2	21.0
Profitability ratios (%)					
EBITDA margin	5.5	6.2	5.6	7.2	8.1
EBIT margin	4.7	5.3	4.5	6.1	7.0
PAT margin	0.9	1.1	0.5	1.8	2.6
Turnover ratios					
Total asset turnover ratio (x)	2.6	2.5	2.4	2.7	2.9
Debtor days	151	176	173	169	165
Inventory days	21	23	23	21	21
Creditors days	169	197	193	190	186
Solvency ratios (x)					
Debt-equity	1.5	1.8	1.6	1.4	1.1
Interest coverage	1.7	1.6	1.2	1.9	2.5

Source: Company, Nirmal Bang Institutional Equities Research

Rating track

Date	Rating	Market price (Rs)	Target price (Rs)
29 November 2012	Buy	62	79
2 January 2013	Buy	67	79
7 January 2013	Buy	68	79
31 January 2013	Buy	61	79
2 April 2013	Buy	57	79
9 April 2013	Buy	55	79
9 May 2013	Buy	49	68
22 May 2013	Buy	47	68
9 July 2013	Buy	32	68
6 August 2013	Buy	25	41
7 October 2013	Buy	29	41
29 October 2013	Buy	34	41
13 February 2014	Buy	54	65
5 May 2014	Hold	77	85
1 August 2014	Accumulate	120	126
9 October 2014	Buy	106	126
3 November 2014	Buy	102	130
9 January 2015	Buy	93	130
6 February 2015	Buy	86	124

Disclaimer

Stock Ratings Absolute Returns

BUY > 15%

ACCUMULATE -5% to 15%

SELL < -5%

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