Company Focus

15 April 2008 | 11 pages

Everest Kanto Cylinder (EKCL.BO)

Target price change

Buy: Best Play on City Gas; US Acquisition Provides Upside

- **Highest leverage to impending city gas 'wave'** — The recent notification of regulations governing city gas distribution (CGD) has set the stage for explosive growth in this segment over the next few years. As opposed to some of the existing CGD companies, CNG enablers like EKC – despite being indirect beneficiaries – are most levered to increasing number of cities coming under the CGD net, which would facilitate rapid conversions of vehicles to CNG.

- **US acquisition a positive...** — EKC announced that it has received regulatory approvals for the acquisition of US-based CP Industries (CPI), a world leader in manufacture of very large, seamless cylinders. We view this as a significant positive, given the complementary product portfolio (large cylinders vs. EKC's relatively smaller ones), strong reputation esp. in the US (US govt. is a customer), and strong operating profitability (CY07A EBITDA margin of 24%).

- **...should add 6% to earnings** — On our estimates, CPI could potentially add 6% to EKC's PAT over FY09-10E. EKC has also finalized the structure of the US$65m deal, which would be part-funded through debt (US$45m tied up).

- **Adjusting target** — We are adjusting our TP to Rs404 (Rs437 earlier) as we reduce our target P/E multiple to 19x Sep-09E earnings (22x earlier), to reflect a reduction in our target multiples for capital goods peers, but retain our FY08-10E earnings estimates. Our target P/E is well supported by an EPS CAGR of 47% over FY08-11E and healthy return ratios. Our price target also includes Rs23 value accretion from CPI, based on 19x Sep-09E earnings. We await detailed financials of CPI before explicitly building the same into our forecasts.

Buy/Medium Risk	1M
Price (15 Apr 08)	Rs287.00
Target price	Rs404.00
from Rs437.00	
Expected share price return	40.8%
Expected dividend yield	0.6%
Expected total return	**41.4%**
Market Cap	Rs29,032M
	US$728M

Price Performance (RIC: EKCL.BO, BB: EKCL IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	324	3.68	54.6	78.0	16.8	33.7	0.2
2007A	718	7.35	99.9	39.0	9.3	31.7	0.3
2008E	1,115	10.54	43.4	27.2	6.0	28.4	0.6
2009E	1,748	16.53	56.8	17.4	4.6	31.5	0.9
2010E	2,492	23.56	42.5	12.2	3.5	34.4	1.5

Source: Powered by dataCentral

Saurabh Handa[1]
+91-22-6631-9858
saurabh.handa@citi.com

Rahul Singh[1]
+91-22-6631-9863
rahul.r.singh@citi.com

Garima Mishra[1]
garima.mishra@citi.com

See Appendix A-1 for Analyst Certification and important disclosures.

[1]Citigroup Global Markets India Private Limited

Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	78.0	39.0	27.2	17.4	12.2
EV/EBITDA adjusted (x)	50.1	25.8	18.4	11.9	8.6
P/BV (x)	16.8	9.3	6.0	4.6	3.5
Dividend yield (%)	0.2	0.3	0.6	0.9	1.5
Per Share Data (Rs)					
EPS adjusted	3.68	7.35	10.54	16.53	23.56
EPS reported	3.68	7.35	10.54	16.53	23.56
BVPS	17.13	30.98	47.75	62.00	81.45
DPS	0.70	1.00	1.65	2.59	4.43
Profit & Loss (RsM)					
Net sales	2,355	3,851	5,793	9,088	12,664
Operating expenses	-1,865	-2,884	-4,395	-6,872	-9,509
EBIT	**490**	**967**	**1,398**	**2,216**	**3,156**
Net interest expense	-37	-53	-102	-164	-198
Non-operating/exceptionals	22	40	115	106	82
Pre-tax profit	**476**	**953**	**1,411**	**2,159**	**3,039**
Tax	-141	-236	-296	-410	-547
Extraord./Min.Int./Pref.div.	-11	0	0	0	0
Reported net income	**324**	**718**	**1,115**	**1,748**	**2,492**
Adjusted earnings	324	718	1,115	1,748	2,492
Adjusted EBITDA	588	1,145	1,646	2,630	3,686
Growth Rates (%)					
Sales	77.9	63.5	50.4	56.9	39.3
EBIT adjusted	133.9	97.2	44.6	58.5	42.4
EBITDA adjusted	104.2	94.7	43.8	59.8	40.2
EPS adjusted	54.6	99.9	43.4	56.8	42.5
Cash Flow (RsM)					
Operating cash flow	**300**	**-182**	**679**	**844**	**1,716**
Depreciation/amortization	98	178	248	414	530
Net working capital	-122	-1,078	-684	-1,318	-1,307
Investing cash flow	**-591**	**-717**	**-2,561**	**-1,412**	**-612**
Capital expenditure	-591	-717	-2,561	-1,412	-612
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**667**	**1,091**	**2,965**	**234**	**-530**
Borrowings	-93	307	2,255	531	-3
Dividends paid	-70	-114	-196	-307	-525
Change in cash	**376**	**192**	**1,083**	**-334**	**574**
Balance Sheet (RsM)					
Total assets	**2,514**	**4,718**	**8,878**	**11,414**	**14,075**
Cash & cash equivalent	290	471	1,554	1,220	1,794
Accounts receivable	234	575	878	1,377	1,919
Net fixed assets	939	1,478	3,792	4,790	4,871
Total liabilities	**1,004**	**1,704**	**4,047**	**5,142**	**5,836**
Accounts payable	266	379	578	907	1,264
Total Debt	395	702	2,957	3,488	3,485
Shareholders' funds	**1,509**	**3,024**	**4,830**	**6,272**	**8,239**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	25.0	29.7	28.4	28.9	29.1
ROE adjusted	33.7	31.7	28.4	31.5	34.4
ROIC adjusted	24.8	26.3	21.3	22.9	26.0
Net debt to equity	7.0	7.6	29.0	36.2	20.5
Total debt to capital	20.7	18.8	38.0	35.7	29.7

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Incorporating CPI acquisition

- We are incorporating value accretion from the acquisition of CPI into our estimates. In CY07, CPI reported revenues of US$40.6m and EBITDA of US$9.6m (24% EBITDA margin), driven by c2.6K cylinder sales at an average realization of ~US$16K/cyl.

- Cylinder sales are expected to increase once EKC takes over the plant, as CPI has been running its plant at well below full utilization (~65% utilization of full capacity of c4K cylinders), primarily due to lack of funds (from its parent, Reunion Industries) and consequently stretched working capital. EKC's experience, better access to capital, and strong relationships with raw material suppliers (esp. Tenaris) should help improve productivity – we forecast total cylinder sales of 3.5K by FY10E.

- Based on our estimates, in the first year of operation as a subsidiary of EKC i.e. FY09E (assuming 11 months contribution only, as the transaction will likely be consummated by end-Apr), we expect CPI to deliver sales of US$43m, EBITDA of US$10m (23.5% operating margin), and net income of US$2.7m. The corresponding figures in FY10E are US$55m, US$13m, and US$3.8m. Figure 1 below illustrates our estimates for CPI and our key assumptions behind the same.

Figure 1. CPI Estimates (US$m)

	Dec-07A	Mar-09E[1]	Mar-10E	Comments
No. of cylinders sold	2,600	2,750	3,500	Capacity utilization to improve post-acquisition from ~65% currently to ~85% by FY11E
Avg. realization (US$/cyl.)	15,615	15,700	15,700	Assuming relatively flat average realizations
Sales	**40.6**	**43.2**	**55.0**	
EBITDA	**9.6**	**10.1**	**12.9**	
Margin	*23.6%*	*23.5%*	*23.5%*	Assuming margins to stay in line with CY07 levels
Interest		2.7	3.0	US$45m loan tied up for the acquisition. Additional US$5m capex assumed in FY10E.
Interest rate		*6.0%*	*6.0%*	Low cost of debt (already tied in)
Depreciation		3.0	3.5	Assuming 10% avg. depreciation on fixed assets of US$30m (though total B/S size is US$65m, US$35m of this comprises goodwill, working capital, intangibles, etc.)
Depreciation rate		*10.0%*	*10.0%*	
PBT		4.4	6.4	
PAT (US$m)		**2.7**	**3.8**	Assuming 40% effective tax rate
PAT (Rs m)		**107**	**154**	INR/US$ = 40
FDEPS (Rs)[2]		***1.0***	***1.5***	
Earnings accretion/dilution		***6.1%***	***6.2%***	Lower accretion to earnings than to EBITDA because of high tax rate assumed
EBITDA/gross block		**33.8%**	**36.9%**	Healthy return on the acquisition (calculated on gross block of US$30m)

Source: Company Reports and CIR estimates. [1]11 months only. [2]Assuming no dilution on account of the acquisition.

Deal Structure

- CPI would be acquired by CP Industries Holdings, Inc., a 100% subsidiary of EKC Hungary Ltd, which in turn is a 100% subsidiary of the EKC's Dubai subsidiary. The prime driver behind this structure is certain tax advantages (on goodwill, royalty payments, etc.) that the company hopes to benefit from.

- A loan of US$45m has already been tied up with a consortium of banks (ABN Amro, Standard Chartered, Citibank) with first charge on the company's assets at Tarapur, Aurangabad, and Gandhidham. The balance ~US$20m will be funded through internal accruals.

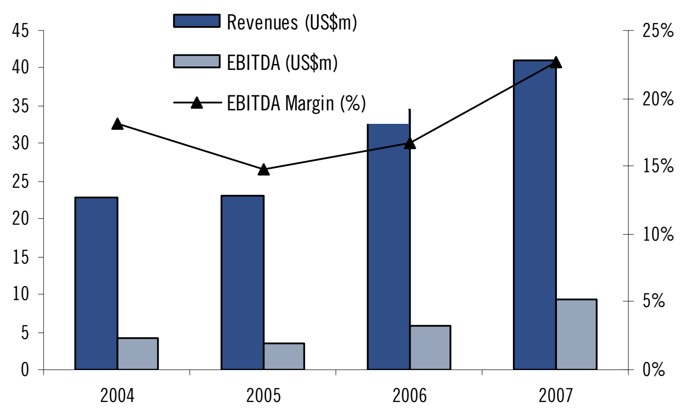
CPI background

- CPI is a major global manufacturer of large, seamless, high-pressure cylinders (~2K litre capacity) for storage and transportation of pressurized gases. The company has manufacturing facilities located in Pittsburgh and a representative office in Beijing. It can manufacture cylinders compliant with the US and Chinese govt. standards, ISO, ASME, and other standards.

- The cylinders find applications in various industries such as transport (64% of sales), offshore (19%), storage (8%), defence, and others. The company has a presence both in the US as well as in international markets (exports contribute ~20% of sales). Key customers include international companies (e.g. Praxair, Air Liquide, BOC, Chesterfield), US-based companies, the US govt., etc.

- CPI reported revenues of US$41m in CY2007 (up 19% yoy) with an EBITDA of ~US$10mn. Operating margins have gone up from 15% to 24% over the past 4 years driven by better sales mix and price increases (see Figure 2). Of total global CY07E cylinder sales of US$93m in the segment, CPI has ~43% market share (source: Company Reports).

Figure 2. CPI – Financial Performance



Source: Company Reports

New price target of Rs404

- Our new target price of Rs404 comprises:
  - Rs381 value from core, existing business of EKC (valued at 19x Sep09E earnings)
  - Rs23 value accretion from CPI (valued at 19x Sep-09E earnings)

- We have reduced our target PE multiple for EKC from 22x earlier to 19x to factor in a reduction in our target multiples for capital good peers. EKC's target multiple still remains at a discount to peers' multiples which are in the

20-28x range (see Figure 3). Despite better earnings growth profile, we value EKC at a discount to its peers to factor in the difference in the nature of businesses and also the higher order book visibility of the capital goods companies.

- Our target PE is also well supported by an earnings CAGR of 50% over FY08-10E (further 41% growth in FY11E) and healthy capital return ratios, both meaningfully higher than peers (see Figure 3). In addition, EKC is highly levered to and a direct play on city gas distribution, which is on the threshold of explosive growth in India over the next few years.

Figure 3. EKC's peer group target multiples

	RIC Code	Price 11-Apr-08	M-cap US$m	Rating	Target Price	Target PE[1] (x)	Target PE[1] Basis	EPS CAGR FY08-10E	Target P/BV[2]	ROE FY09E
Suzlon Energy	SUZL.BO	290	10,903	3M	241	20.0	Dec-09E	50.3%	3.6	15.2%
Punj Lloyd	PUJL.BO	331	2,520	1L	493	23.0	Dec-09E	47.4%	4.9	18.4%
BHEL	BHEL.BO	1,830	22,471	2L	1,832	20.0	Mar-10E	28.4%	6.7	29.5%
L&T	LART.BO	2,774	20,342	1L	4,141	28.0	Dec-09E	36.3%	10.1	28.1%
Thermax	THMX.BO	511	1,528	1L	748	21.0	Dec-09E	23.6%	8.4	36.0%
Average						**22.4**		**37.2%**	**6.8**	**25.4%**
Everest Kanto	EKCL.BO	284	720	1M	404	19.0	Sep-09E	49.5%	6.5	31.5%

Source: Citi Investment Research estimates. [1]Target PE on core earnings. [2]Target FY09E P/BV.

Highest leverage to impending city gas 'wave'

- EKC is, in our view, most highly levered to increasing city gas distribution (CGD) in India, which is imminent now given the huge increase in domestic gas supplies over the next few years and the notification of regulations.

- The Petroleum and Natural Gas Regulatory Board (PNGRB) recently notified regulations for city gas distribution (refer our note titled, '*City Gas – Transparency, More Scrutiny, but Platform for Growth*', dated 3 April 2008)[1]. Amongst other things, the regulations provide detailed guidelines for bidding for city gas projects in new geographies. Their notification is an important milestone for the market and significant newsflow in this regard can be expected over the next 6-12 months.

- The regulations would largely be neutral for incumbents such as IGL and Ggas unless these companies manage to successfully bid for new geographies. EKC, on the other hand, despite being in a seemingly unrelated space, would directly reap the benefits of this structural shift, as more cities coming under the CGD net would spur conversions of vehicles from liquid fuels to the more environment-friendly and economic CNG.

- GAIL has identified 230 cities for introduction of city gas distribution in a phased manner over the next few years. This will be up dramatically from the 8-10 cities in India that currently have CGD networks.

- Further, despite competition for EKC having increased over the last couple of years, the market will likely witness an unprecedented boom and production of cylinders should be easily absorbed, esp. for EKC, the market leader.

[1] The detail report may be accessed at: https://www.citigroupgeo.com/pdf/SAP15081.pdf

Everest Kanto Cylinder

Company description

Everest Kanto Cylinder (EKC) is the largest domestic manufacturer of high pressure gas cylinders used for the storage of industrial gases and CNG. While the first manufacturing facility (at Aurangabad) was set up in collaboration with Kanto Koatsu Yoki of Japan in 1978, subsequent facilities have been built using in-house technology. The company currently has four manufacturing plants -- in Aurangabad, Tarapur, Gandhidham, and Dubai -- that have a total production capacity of 806,000 cylinders per year. An aggressive expansion plan, including a greenfield plant in China, expansion of the Gandhidham facility, and a new plant in an SEZ, would increase EKC's capacity to 2.3m cylinders over the next 4-5 years.

Investment strategy

We rate the stock as Buy/Medium Risk with a target price of Rs404. We believe EKC is uniquely positioned to capture the significant growth potential of the market for high pressure gas cylinders, driven largely by increasing CNG penetration both domestically and abroad. Increased production from new and existing plants amidst the current tightness in the cylinder market would see the company delivering an EPS CAGR of 47% for FY08-11, on our estimates. While the CNG segment in India is still at a relatively nascent stage, cost economics, improving refueling infrastructure, visibility of gas supplies, and clarity on regulations should mean an accelerating trajectory for city gas distribution and consequently CNG penetration, thereby boosting demand for CNG cylinders. Coupled with the robust global outlook for natural gas-powered vehicles and a sanguine IP-linked growth outlook for industrial cylinders, we expect EKC's production to increase ~3x over FY07-10E. In addition, the recently concluded acquisition of US-based CPI Industries is positive as it gives EKC access to a global clientele in a niche segment of the market.

Valuation

Our 12-month target price for EKC of Rs404 comprises: (1) Rs381 value for the existing business of EKC based on 19x Sep09E earnings, representing a discount to fair-value multiples of 20-28x for its manufacturing / engineering peers in India and (2) Rs23 value accretion from the CPI acquisition based on 19x Sep-09E earnings. We prefer comparing EKC with capital goods companies that manufacture industrial goods that have a similar growth profile. However, given the difference in the nature of the business and the higher order book visibility of these companies, we believe EKC should trade at a discount to its peers. EKC is also a leveraged play on the alternative energy/CNG theme and one of the most leveraged plays to the expanding city gas distribution market in India. Our target P/E is well supported by an EPS CAGR of 47% for FY08-11E and healthy capital return ratios.

Risks

We assign a Medium Risk rating to EKC, rather than the High Risk rating as per our quantitative risk-rating system, given the strong visibility of growth on increasing CNG penetration. Key downside risks to our target price: 1) Exposure to a single supplier – EKC's reliance on Tenaris for most of its raw materials makes it vulnerable to the latter's pricing power. 2) China – a hitherto unexplored market, with the risk that EKC's entry there could incur teething troubles. 3) Competition – low physical barriers to entry have led to some players entering the market in the recent past, which might adversely impact EKC's pricing power. 4) Project risk – EKC is implementing significant expansion plans that are subject to time and cost over-runs. 5) CPI – integration and execution risks related to the CPI acquisition. 6) Crude prices – significantly lower crude prices could adversely impact CNG's strong economics and consequently slow CNG penetration.

Appendix A-1

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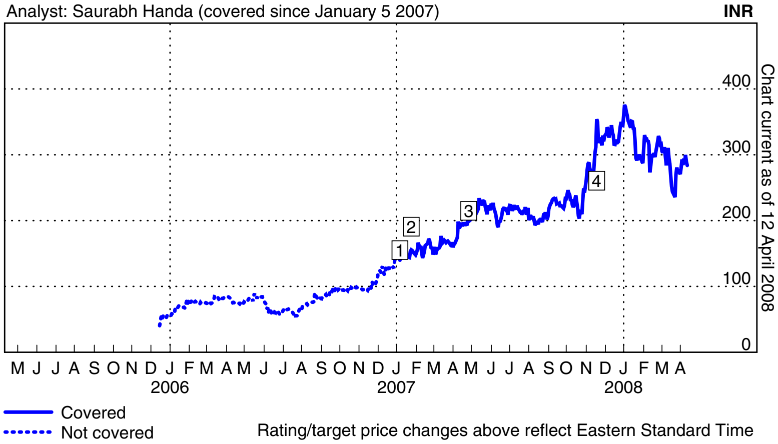
Everest Kanto Cylinder (EKCL.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Saurabh Handa (covered since January 5 2007)



#	Date	Rating	Target Price	Closing Price
1:	5 Jan 07	1M	190.00	139.78
2:	24 Jan 07	1M	*198.00	155.64
3:	26 Apr 07	1M	*260.00	204.05
4:	19 Nov 07	1M	*437.00	354.10

*Indicates change.

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