KEC International – ADD

23 June 2011

IIFL Institutional Equities

Strong visibility, robust returns

KEC is witnessing robust order inflow traction with wins worth Rs10.44bn (13% of order book) in June 2011. The Rs78bn order book provides ample visibility for the next seven quarters. Improving traction in non-transmission sectors (which currently account for 26% of KEC's order book, vs 12% in FY08) and better geographical diversification increases comfort on execution. Higher margins for SAE Towers would offset margin pressures from new businesses. But intense competition in domestic markets coupled with high commodity prices could pose downside risk to margins. At 8.8x FY12ii EPS, we find the stock attractively valued, given strong RoEs and little balance-sheet stress.

Inflow momentum adds to visibility from large order book: KEC International's order book grew 42% in FY11, driven by robust traction in existing businesses (order book up 26% YoY) and acquisition of SAE Towers. The order inflow momentum continues to be strong in 1QFY12, with announced order wins worth Rs10.44bn (13% of order book) in June 2011. The end-FY11 order book of Rs78bn translates into book-to-bill ratio of 2x—a four-year high.

Better geographical and sector diversification lends comfort: Post acquisition, SAE's order book has increased from Rs5.8bn to Rs8.9bn, helped by inflows totalling Rs6.7bn. The Americas now constitute 21% of KEC's order book, and robust growth in the region has compensated for the slowdown in Central Asia and Africa. KEC's entry into new businesses—power BoP, railways and water—is also gaining traction and non-transmission projects now form 26.2% of its order book, vs 12% in FY08. Railway business order book has increased from Rs1.36bn in FY10 to Rs3.9bn in FY11.

Competition remains a worry: Competition for the orders in the domestic business remains intense, with international players joining the smaller domestic entrants. KEC did indicate the competitive intensity would remain high, but maintained that EBITDA margins would remain stable at ~10%. But intense competition combined with high raw-material costs and entry into new sectors could pose downside risks to margins.

Company update

CMP	Rs79
12-mth TP (Rs)	*101 (27%)*
Market cap (US$ m)	455
Bloomberg	KECI IN
Sector	Construction

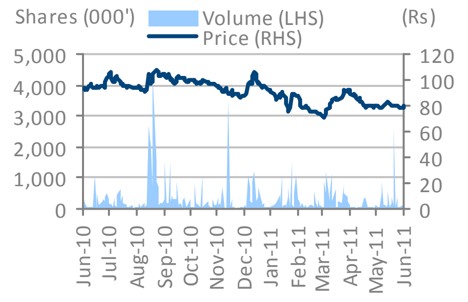
Shareholding pattern (%)

Promoters	41.7
FIIs	4.4
Domestic MFs	38.8
Others	15.2
52Wk High/Low (Rs)	123/70
Shares o/s (m)	257
Daily volume (US$ m)	1
Dividend yield FY12ii (%)	1.4
Free float (%)	58.0

Price performance (%)

	1M	3M	1Y
KEC International	-1.2	10.4	-14.6
Rel. to	**2.9**	**12.0**	**-12.9**
Jyoti Structures	11.7	8.2	-45.0
Kalpat. Power	6.2	11.7	-38.9
Gammon India	-11.3	-12.2	-54.7

Stock performance



Financial summary (Rs m)

Y/e 31 Mar	FY10A	FY11A	FY12ii	FY13ii	FY14ii
Revenues (Rs m)	39,072	44,742	53,556	59,982	67,180
EBITDA Margins (%)	10.4	10.3	10.1	10.0	9.9
Pre-Exceptional PAT (Rs m)	1,897	2,056	2,310	2,589	2,965
Reported PAT (Rs m)	1,897	2,056	2,310	2,589	2,965
EPS (Rs)	7.4	8.0	9.0	10.1	11.5
Growth (%)	55.8	8.4	12.3	12.1	14.5
PER (x)	**10.8**	**9.9**	**8.8**	**7.9**	**6.9**
ROE (%)	28.2	23.7	22.3	21.1	20.5
Debt/Equity (x)	1.0	1.5	1.3	1.0	0.8
EV/EBITDA (x)	**6.8**	**7.1**	**6.3**	**5.5**	**4.8**
Price/Book (x)	2.6	2.2	1.8	1.5	1.3

Source: Company, IIFL Research. Priced as on 21 June 2011

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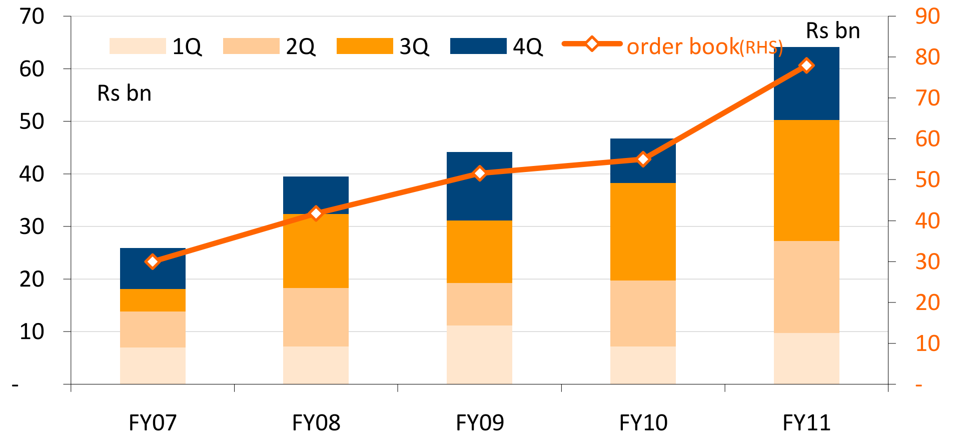
Strong order inflow momentum and diversified order book provide ample growth visibility

- Order inflows during FY11 stood at ~Rs62bn—up 33% YoY and higher than the Rs39.5bn-Rs46.8bn range seen in the previous three years. End-FY11 order book of Rs78bn provides ample visibility for the next seven quarters.

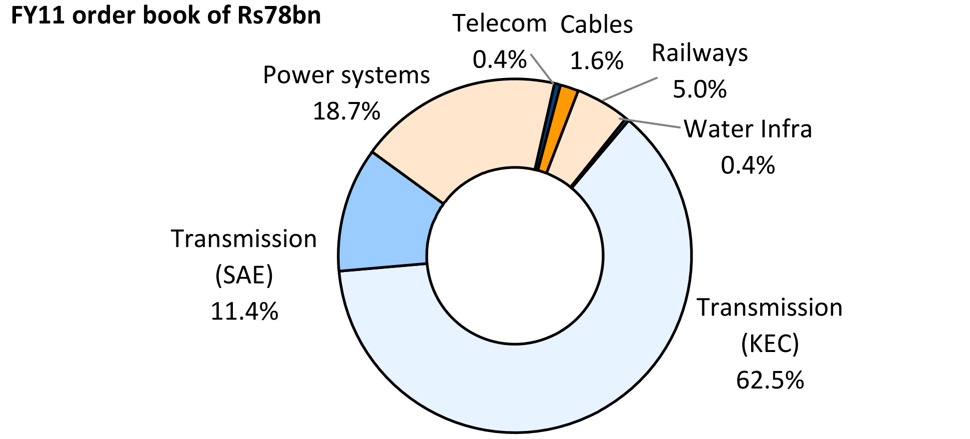
Figure 1: Strong order inflow in 2HFY11 aided by SAE acquisition



Source: Company, IIFL Research

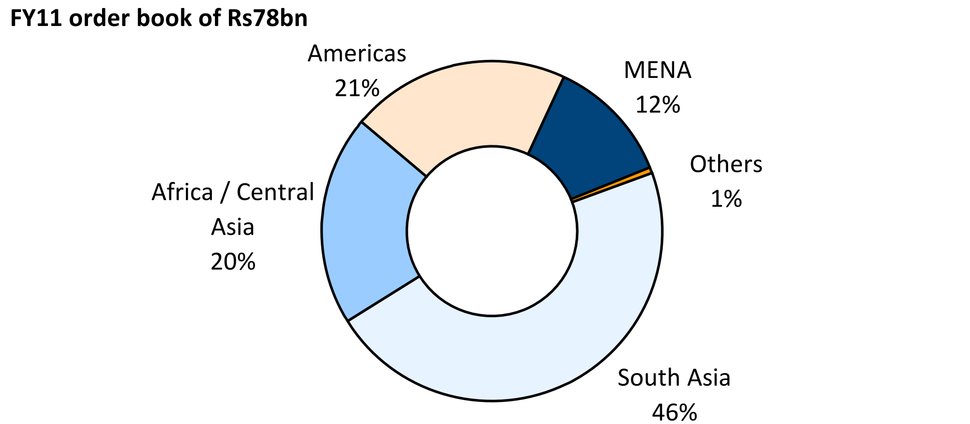
- While the traditional transmission business was strong, contribution from new sectors also increased substantially. Non-transmission segment orders now constitute 26% of the order book vs 12% three years ago.
- The company entered the power BoP and water businesses in FY11 and saw a pick-up in the railways and cables businesses during the year. In the sub-station segment, KEC entered the 400kV segment in India (two orders from PGCIL) and also the 500kV, 1150kV sub-station segments internationally (one project in Kazakhstan).
- KEC widened its geographical presence through the acquisition of SAE Towers in Sep-2010. This, coupled with a Rs7.35bn order from Canada, took the Americas' contribution to KEC's consolidated order book to 21% in FY11 from nil in the previous year. This also helped the company offset the slowdown in inflows from Africa and Central Asia. International geographies (45 countries) continue to contribute more than 50% of the order book.

Figure 2: Increasing traction in new sectors



Source: Company, IIFL Research

Figure 3: Diversified geographical presence lends comfort



Source: Company, IIFL Research

Expanding capabilities and reach

- KEC currently has domestic tower manufacturing capacity of 151,000 tonnes per annum. Post the acquisition of SAE Towers with manufacturing capacity of 100,000tpa (Mexico and Brazil), KEC is now the world's second-largest tower manufacturer.
- Post acquisition of RPG Cables in March 2010, KEC's cable manufacturing capacity stood at 25,780km of power cables and 10,000km of telecom cables per annum.
- The company is setting up a new greenfield capacity (3,000 cable-km per annum) in Vadodara (Gujarat) for manufacturing extra-high-voltage power cables. Total investment for this capacity would be Rs1.5bn. The capacity would be commissioned by 1QFY13.
- KEC was an early entrant in the railway electrification business. The company expanded its capabilities to serve other parts, including civil works and signalling (through acquisition of Jay Railway Signaling). KEC's railway sector order book increased from Rs1.36bn in FY10 to Rs3.9bn in FY11.

RoEs lower than cyclical highs but still strong

- KEC International's RoE declined from 24.1% in FY10 to 21.7% in FY11, primarily because of lower asset turns and higher interest outgo on financing for SAE Towers.
- Profitability remained stable in FY11 as SAE Towers' higher margin was offset by lower margins in the new businesses—railways, cables and telecom.
- Lower capacity utilisation levels for SAE Towers (~60%) would have adversely affected asset turns. However, post the strong order inflow witnessed for SAE Towers, overall utilisation levels should trend up, going forward.
- Longer operating cycle also hit RoE. Net working capital cycle increased from 78 days in FY10 to 93 days in FY11, driven primarily by the higher receivable days. This was offset to an extent by the increase in liability days from 161 in FY10 to 182 in FY11 (as strong order inflows led to an increase in customer advances).
- As per the management, receivables cycle lengthened as dispatches increased in March 2011, for which payments are yet to be received. Operating cycle should shorten over the next few quarters as the proportion of revenue from distribution comes down.

Figure 4: Dupont analysis

	FY07A	FY08A	FY09A	FY10A	FY11A
EBITDA margin	12.3%	12.6%	8.8%	10.4%	10.3%
PBT/EBITDA	0.63	0.74	0.59	0.72	0.68
PAT/PBT	0.65	0.66	0.65	0.65	0.65
Asset Turn	1.21	1.15	1.11	1.15	0.95
Asset/Equity	6.19	4.95	5.55	4.32	4.98
RoE	**38.5%**	**34.8%**	**20.9%**	**24.1%**	**21.7%**

Source: Company, IIFL Research, *RoE calculated on year-end equity

Figure 5: Working capital cycle lengthened in FY11

Days	FY09A	FY10A	FY11A	FY12ii	FY13ii
Inventory	24	23	27	27	27
Debtor	199	183	214	210	205
Loans and advances	32	37	39	39	39
Liabilities	196	161	182	182	182
Provisions	5	5	5	5	5
Net working capital	**54**	**78**	**93**	**90**	**85**

Source: Company, IIFL Research

Assumptions

Y/e 31 Mar	FY10A	FY11A	FY12ii	FY13ii	FY14ii
Order inflow (Rs m)	46,750	64,151	65,000	70,000	75,000
Execution rate (%)	75.7	81.3	68.7	72.8	78.0
Gross margins (%)	23.6	27.7	27.6	27.6	27.5
Net working capital days	77	93	90	85	83

Source: Company data, IIFL Research

Financial summary

Income statement summary (Rs m)

Y/e 31 Mar	FY10A	FY11A	FY12ii	FY13ii	FY14ii
Revenue	**39,072**	**44,742**	**53,556**	**59,982**	**67,180**
EBITDA	4,059	4,625	5,431	5,998	6,651
EBIT	3,788	4,216	4,895	5,344	5,936
Interest expense	-865	-1,075	-1,352	-1,370	-1,385
Others items	10	26	10	10	10
Profit before tax	2,934	3,167	3,553	3,983	4,561
Tax expense	-1,037	-1,111	-1,244	-1,394	-1,597
Net Profit	**1,897**	**2,056**	**2,310**	**2,589**	**2,965**

Cash flow summary (Rs m)

Y/e 31 Mar	FY10A	FY11A	FY12ii	FY13ii	FY14ii
Operating profit	2,924	3,141	3,543	3,973	4,551
Depreciation & Amortization	270	408	535	655	715
Tax paid	-1,037	-1,111	-1,244	-1,394	-1,597
Working capital change	-2,588	-3,149	-1,735	-760	-1,305
Other operating items	163	36	0	0	0
Operating Cash-flow	-268	-674	1,100	2,473	2,364
Capital expenditure	-1,907	-2,005	-1,750	-1,000	-1,000
Free cash flow	**-2,175**	**-2,679**	**-650**	**1,473**	**1,364**
Debt financing/disposal	349	6,454	0	-1,000	-1,000
Dividends paid	-361	-357	-401	-450	-515
Other items	1,474	-2,503	10	10	10
Net change in Cash & cash equivalents	**-2,013**	**916**	**-1,041**	**33**	**-141**

Source: Company data, IIFL Research

Balance sheet summary (Rs m)

Y/e 31 Mar	FY10A	FY11A	FY12ii	FY13ii	FY14ii
Cash & cash equivalents	698	1,614	572	606	465
Sundry debtors	19,624	26,177	30,813	33,689	37,363
Trade Inventories	2,498	3,359	4,020	4,503	5,043
Other current assets	3,956	4,723	5,654	6,332	7,092
Fixed assets	**7,200**	**8,409**	**9,503**	**9,729**	**9,894**
Other assets	0	2,812	2,812	2,812	2,812
Total assets	**33,975**	**47,094**	**53,375**	**57,671**	**62,670**
Sundry creditors	17,214	22,248	26,631	29,827	33,406
Other current liabilities	562	561	671	752	842
Long-term debt/Convertibles	7,867	14,322	14,322	13,322	12,322
Other long-term liabilities	461	497	497	497	497
Networth	**7,871**	**9,466**	**11,254**	**13,273**	**15,603**
Total liabilities & equity	**33,975**	**47,094**	**53,375**	**57,671**	**62,670**

Ratio analysis

Y/e 31 Mar	FY10A	FY11A	FY12ii	FY13ii	FY14ii
Sales growth (%)	14.0	14.5	19.7	12.0	12.0
Core EBITDA growth (%)	34.7	13.9	17.4	10.5	10.9
Core EBIT growth (%)	36.1	11.3	16.1	9.2	11.1
Core EBITDA margin (%)	10.4	10.3	10.1	10.0	9.9
Core EBIT margin (%)	9.7	9.4	9.1	8.9	8.8
Net profit margin (%)	4.9	4.6	4.3	4.3	4.4
Dividend payout ratio (%)	16.3	15.0	15.0	15.0	15.0
Tax rate (%)	35.3	35.1	35.0	35.0	35.0
Net Debt/Equity (%)	91.1	134.3	122.2	95.8	76.0
Return on Equity (%)	28.2	23.7	22.3	21.1	20.5
Return on Assets (%)	5.8	5.1	4.6	4.7	4.9

Source: Company data, IIFL Research

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.

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