Everest Kanto Cylinders - BUY

AR analysis

EKCL IN	Rs158	Auto	14 July 2009	Company Update

Performance under high pressure

We continue to view EKC as a structural story with short-term challenges owing to the situation in Iran and domestic gas supply disruptions. The company remains confident of robust growth in 2HFY10 on the back of improved gas availability. The second half of FY09 was a weak period for EKC's standalone operations, leading to increased inventory at the end of the year. We expect the inventory situation to improve once demand starts picking up in 3QFY10. The product mix continues to improve, with the low-margin industrial business now forming only 10% of the total revenues.

MD&A highlights the big opportunity in the domestic business: Natural gas currently forms only 8% of India's total energy mix, as against the global average of 24%. Gas supply is expected to increase from 119.98mmscmd currently to 197.09mmscmd in FY11. Demand for CNG is expected to treble at 7% of total gas demand in the next five years. CNG is currently available at only 1% of India 35,000 retail fuel outlets. With the government's plans to launch city gas distribution in over 200 cities, demand for CNG vehicles is likely to surge, which in turn would lead to demand for cylinders.

Healthy operating cash flows despite worsening of inventory situation: The Company's inventory situation worsened in FY09. The company ended the year with almost 10 months of inventory, including finished-goods inventory of 30 days and WIP inventory of 64 days—an indication of the weak demand in 4QFY09. Raw-material inventory also increased by 10 days, as weak demand for CNG cylinders in 4Q precluded inventory reduction. In spite of an incremental investment of Rs2,039m into inventory funding, the company registered positive operating cashflow of Rs1,201m.

Lower-margin industrial business now forms only 10% of overall revenues: The share of the low-margin industrial cylinders business in EKC's revenues has dropped to 10% after the CPI acquisition. Jumbo cylinders form only 0.3% of EKC's volume sales, but their high realisations mean they account for 18% of overall revenues. UAE operations now contribute ~60% of the company's profit. Given the tax incentives at that plant, EKC's tax rate has dropped from 19% in FY08 to 10% in FY09.

Financial summary

Y/e 31 Mar	FY07A	FY08A	FY09A	FY10ii	FY11ii
Revenues (Rs m)	4,250	5,287	8,566	10,420	13,856
EBITDA Margins (%)	26.9	28.9	31.1	30.1	30.1
Pre-Exceptional PAT (Rs m)	717	1,078	1,630	1,711	2,395
Reported PAT (Rs m)	717	1,030	1,441	1,711	2,395
EPS (Rs)	7.3	10.2	14.3	16.4	23.0
Growth (%)	93.5	38.5	40.0	15.4	40.0
PER (x)	**21.5**	**15.5**	**11.1**	**9.6**	**6.9**
ROE (%)	23.7	21.5	23.3	22.0	24.1
Debt/Equity (x)	0.2	0.5	1.0	0.8	0.7
EV/EBITDA (x)	13.6	11.5	8.1	6.0	4.1
Price/Book (x)	**5.1**	**3.3**	**2.6**	**2.1**	**1.7**

Price as at close of business on 13 July 2009

12-mth Target price (Rs) 250 (58%)

Market cap (US$ m)	**326**
52Wk High/Low (Rs)	327/84
Diluted o/s shares (m)	101
Daily volume (US$ m)	3.5
Dividend yield FY09ii (%)	0.5
Free float (%)	40.3

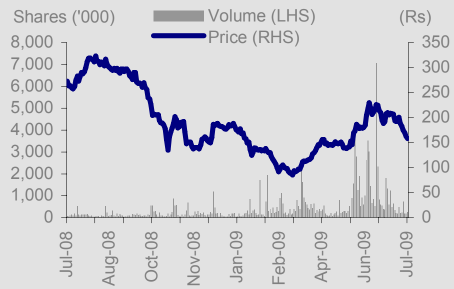
Shareholding pattern (%)

Promoters	59.8
FIIs	13.9
Domestic MFs/Insurance cos	3.7
Others	22.7

Price performance (%)

	1M	3M	1Y
Everest Kanto	-29.7	9.3	-41.4
Rel. to Sensex	-17.6	-12.9	-40.9
Nitin Fire Protection Industries	-15.2	11.5	-24.0

Stock movement



Jatin Chawla
jatin.chawla@iiflcap.com
(91 22) 4646 4654

Inventory situation worsens… EKC's inventory situation worsened significantly in the standalone operations. Inventory in India operations shot up from eight months in FY08 to 11 months in FY09. The wide variety of cylinder sizes requires the company to maintain three-four months of inventory, but inventory levels as high as 11 months are worrying. Management said the company has completely stopped purchasing raw material except for industrial cylinders, and the inventory situation should start improving from 3QFY10 onwards. At a consolidated level too, inventory rose from nine months to 10 months, largely on account of the standalone operations.

Figure 1: Standalone inventory increased by three months during the year

Standalone (days)	FY05	FY06	FY07	FY08	FY09
Cash conversion cycle	95.3	60.2	115.7	184.8	161.4
Inventory days	136.4	87.4	106.1	243.2	337.9
Debtor days	46.3	42.6	39.3	63.4	48.5
Creditor days	87.4	69.7	29.7	121.9	225.0

Source: Company, IIFL Research

Figure 2: Inventory valuation methodology

H. Inventory Valuation:

a. Raw Materials and Components, Work in Progress, Finished Goods, Goods for Trade and Stores, Spares, etc. are valued at Cost or Net Realisable value whichever is lower.

b. Goods in transit are valued at cost to date.

c. 'Cost' comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventory to their present location and condition. Cost formulae used are either 'First In First Out' or 'Average Cost' as applicable

d. Inter-unit transfers are valued either at works / factory costs of the transferor unit.

Source: IIFL Research

Figure 3: Consolidated inventory too increased by a month

Consolidated (days)	FY05	FY06	FY07	FY08	FY09ii
Cash conversion cycle	118.8	63.5	141.9	243.7	228.0
Inventory days	140.9	87.4	134.5	276.2	302.0
Debtor days	41.9	39.4	51.9	57.6	40.4
Creditor days	64.1	63.3	44.5	90.1	114.4

Source: Company, IIFL Research

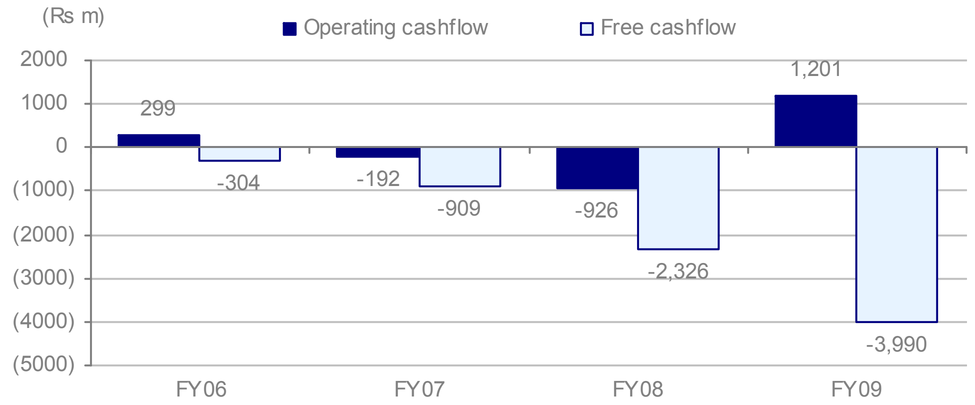
…however, the company generated positive operating cashflow: Despite the worsening inventory situation, the working capital situation improved, largely on account of the company delaying payments to its suppliers. Thus, investments in working capital reduced from Rs2,170m to Rs883m. As a result, cashflow from operations was positive at Rs1,183m.

Figure 4: Cashflow statement

Rs m	FY07	FY08	FY09	FY10ii	FY11ii
Cash flow from operation					
Net profit before tax	953	1,272	1,597	2,061	2,885
Less:Other income	(31)	(80)	(89)	(85)	(80)
Add: Depreciation	178	215	693	860	1,023
Add: Interest expense	36	45	71	272	302
Less: increase in NWC	(1,078)	(2,170)	(883)	2,028	(767)
Less: Direct taxes	(245)	(243)	(206)	(350)	(491)
Total Operating cash flow	**(187)**	**(961)**	**1,183**	**4,785**	**2,872**
Cash flow from investing					
Other income	31	80	89	85	80
Less: Capex	(718)	(1,400)	(5,191)	(1,117)	(600)
Less: Increase in investments	(1)	12	99	0	0
Total Investment cash flow	**(688)**	**(1,309)**	**(5,003)**	**(1,032)**	**(520)**
Cash flow from financing					
Increase in debt	307	1,684	3,834	206	360
Less: Interest expense	(36)	(45)	(71)	(272)	(302)
Less: Dividend and dividend tax	(114)	(142)	(142)	(146)	(243)
Add: Other items	(88)	29	(52)	0	0
Total Financing cash flow	**69**	**1,526**	**3,570**	**(212)**	**(185)**
Net change in cash	**(805)**	**(743)**	**(251)**	**3,541**	**2,167**

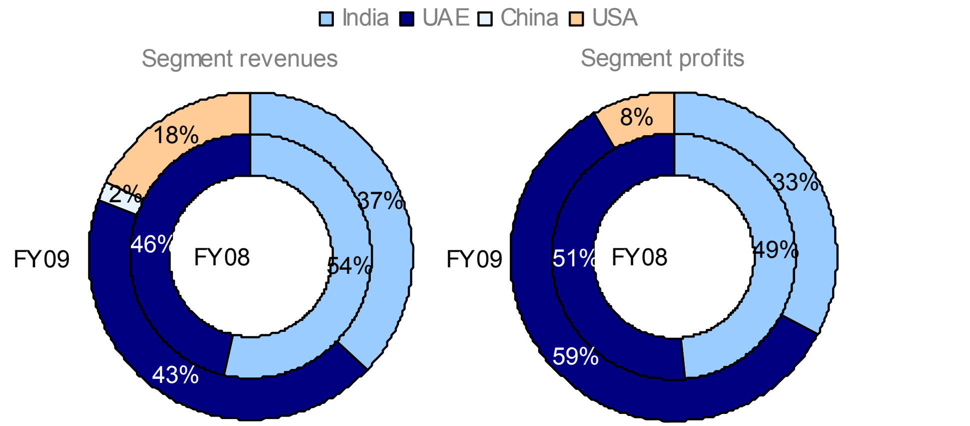
Source: Company, IIFL Research

Figure 5: Positive operating cashflow in spite of the increase in inventory is a surprise



Source: Company, IIFL Research

Figure 7: UAE operations account for ~60% of consolidated FY09 profits



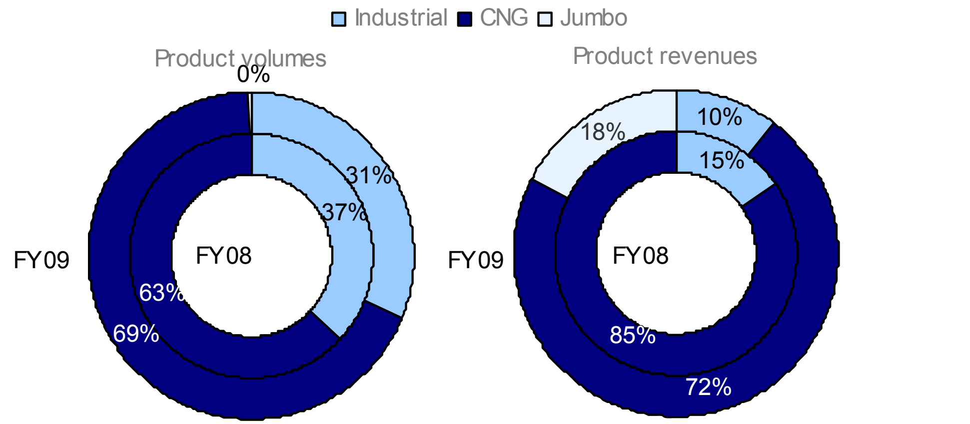
Source: Company, IIFL Research

Figure 6: ROEs maintained as financial leverage increased during the year

	FY05	FY06	FY07	FY08	FY09
Tax burden (x)	0.65	0.70	0.75	0.81	0.90
Interest burden (x)	0.54	0.67	0.70	0.71	0.52
EBIT Margin (x)	0.31	0.30	0.32	0.34	0.36
Asset Turnover (x)	1.42	1.65	1.51	0.97	0.87
Financial Leverage (x)	2.10	1.45	1.24	1.39	1.78
Return on Equity	**32.0%**	**34.0%**	**31.6%**	**26.2%**	**26.1%**

Source: Company, IIFL Research

Figure 8: With the acquisition of CPI Inc (jumbo cylinders), low-margin industrial cylinders now contribute only 10% of consolidated revenues



Source: Company, IIFL Research

Tax rate halves to 10%: EKC's tax rate dropped from 20% in FY08 to 10% in FY09, thanks mainly to the increase in the zero-tax UAE plant's contribution to consolidated profit from ~50% in FY08 to ~60% in FY09. The contribution of the Indian plant, where the company pays full tax,declined from 49% to 33%. The company's tax rate at the US plant is ~25%, as the company uses its Hungarian arm (which is tax-free) to book some royalty amounts.

Figure 9: Management commentary on demand drivers for CNG cylinders

Natural Gas Scenario in India:

- Natural gas currently accounts for around 8% of total energy mix in India as against the global average of 24%. However, with increased availability and rapid development in transmission & distribution infrastructure, the share of natural gas in the energy mix is expected to increase in the coming years.
- Natural Gas infrastructure would span 8,000 Kms with product pipeline of 10,000 Kms.*
- 30 cities have Compressed Gas Distribution (CGD) network.*
- Projected Gas Supply expected to increase from current 119.98 MMSCMD to a level of about 197.09 MMSGMD in 2010-11.*

** Source: PNGRB*

Improved gas infrastructure to accelerate CNG demand:

Although the demand for CNG along with piped gas in households in India is forecast to more than treble at 7% of total gas demand in the next five years, CNG is offered at only about 1% of India's 35,000 retail outlets. With the availability of CNG in India set to double in the next two years, plans have been chalked out in order to launch city gas distribution projects in over 200 cities in a phased manner. With natural gas becoming easily available and CNG infrastructure improving, we believe the demand for CNG vehicles will also rise. This, in turn, will boost demand for CNG cylinders.

Source: Company, IIFL Research

Financial summary

Income statement summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09A	FY10ii	FY11ii
Revenue	4,250	5,287	8,566	10,420	13,856
EBITDA	1,145	1,527	2,661	3,138	4,165
EBIT	**967**	**1,312**	**1,969**	**2,278**	**3,143**
Interest income	8	0	0	0	0
Interest expense	53	71	272	302	338
Exceptional items	0	-49	-189	0	0
Others items	31	80	89	85	80
Profit before tax	**953**	**1,272**	**1,597**	**2,061**	**2,885**
Tax expense	236	243	156	350	491
Net profit	**717**	**1,030**	**1,441**	**1,711**	**2,395**

Cashflow summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09A	FY10ii	FY11ii
Profit before tax	953	1,272	1,597	2,061	2,885
Depreciation & Amortization	178	215	693	860	1,023
Tax paid	-245	-243	-206	-350	-491
Working capital Δ	-949	-1,484	-1,190	2,276	-513
Other operating items	-129	-686	308	-248	-254
Operating Cash-flow	-192	-926	1,201	4,598	2,650
Capital expenditure	-718	-1,400	-5,191	-1,117	-600
Free cash flow	**-909**	**-2,326**	**-3,990**	**3,482**	**2,050**
Equity raised	919	887	0	0	0
Investments	-1	12	99	0	0
Debt financing/disposal	307	1,684	3,834	206	360
Dividends paid	-114	-142	-142	-146	-243
Other items	-88	29	-52	0	0
Net change in Cash & cash equivalents	**114**	**144**	**-251**	**3,541**	**2,167**

Source: Company data, IIFL Research

With the bulk of the capex already done and inventory correction underway, the company will likely turn free-cash-flow-positive in FY10

We expect inventory levels to correct from seven months in FY09 to four months in FY10

Balance sheet summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09A	FY10ii	FY11ii
Cash & cash equivalents	471	644	393	3,934	6,101
Sundry debtors	575	908	981	1,475	1,959
Trade Inventories	1,144	2,846	4,885	2,336	2,663
Other current assets	917	1,815	876	1,066	1,418
Fixed assets	**1,478**	**2,657**	**6,084**	**6,506**	**6,247**
Intangible assets	0	0	1,224	1,060	896
Other assets	143	122	32	-44	-44
Total assets	**4,727**	**8,991**	**14,474**	**16,333**	**19,239**
Short-term debt	68	295	888	799	959
Sundry creditors	378	929	1,850	2,072	2,369
Other current liabilities	623	836	205	146	244
Long-term debt/Convertibles	534	1,972	5,206	5,419	5,619
Other long-term liabilities	101	164	129	129	129
Networth	**3,024**	**4,796**	**6,196**	**7,767**	**9,918**
Total liabilities & equity	**4,727**	**8,991**	**14,474**	**16,333**	**19,239**

Ratio analysis

Y/e 31 Mar	FY07A	FY08A	FY09A	FY10ii	FY11ii
Sales growth (%)	80.5	24.4	62.0	21.7	33.0
Core EBITDA growth (%)	94.7	33.4	74.3	17.9	32.7
Core EBIT growth (%)	97.2	35.7	50.0	15.7	37.9
Core EBITDA margin (%)	26.9	28.9	31.1	30.1	30.1
Core EBIT margin (%)	22.7	24.8	23.0	21.9	22.7
Net profit margin (%)	16.9	20.4	19.0	16.4	17.3
Dividend payout ratio (%)	35.3	35.6	42.1	33.8	0.0
Tax rate (%)	24.7	19.1	9.8	17.0	17.0
Net Debt/Equity (%)	4.3	33.8	92.0	29.4	4.8
Return on Equity (%)	23.7	21.5	23.3	22.0	24.1
Return on Assets (%)	15.2	12.0	11.3	10.5	12.4

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%.
