9th July, 2010 Initiating Coverage

Everest Kanto Cylinder (EKC)

CMP : Rs. 134.00

TARGET: Rs. 210.00

Recommendation BUY

EKC: a brief history

Everest Kanto Cylinders Ltd was incorporated in the year 1978. In the same year, the company in collaboration with Kanto Koatsu Yoki Manufacturing Company, Japan set up a manufacturing unit at Aurangabad. In the year 1981, they started commercial production in their Aurangabad plant. In the year 1985, they expanded their manufacturing capacity with in-house technology by setting up a new facility at Tarapur to manufacture the widest range of High Pressure Gas Cylinder. Since then company has grown substantially not only in India but across the globe. It became a public limited company in 2005.

It is the largest player among the domestic space in the field of industrial, jumbo and CNG cylinders. After capacity expansion, it is slated to become one of the largest cylinder manufacturer globally. It has manufacturing facilities in India, UAE, USA and China catering to global demand in different segments of cylinders.

Investment arguments

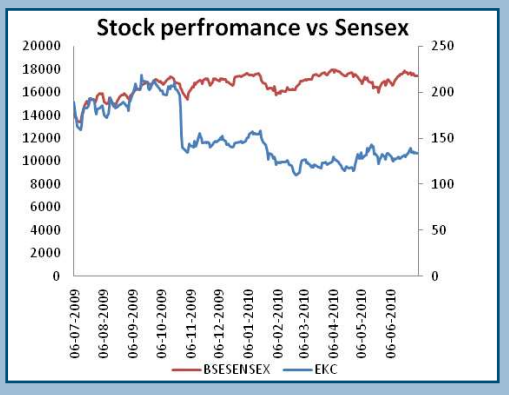
- ✓ The company is the market leader in India as far as CNG and industrial cylinders are concerned. The next company in terms of capacity, Nitin Fire Protection is mainly a trading company engaged in these types of cylinders. EKC is likely to have 1.5 million cylinders capacity soon which is far ahead of other small players like Maruti Komatsu or Nitin Fire Protection.The company has been supplying CNG cylinders to most of the OEM like Maruti, Suzuki, Toyota, Ashok Leyland etc and in retrofitting market, its share is about 60%.

- ✓ In recent times, the company was having some sort of trouble due to high cost inventory that it acquired in the height of commodity boom. In Q4FY10, the high cost inventory has been completely written off and selling prices of its cylinders are once again showing increasing trend. Hence EBITDA margins are likely to witness around 20% in coming quarters which is far higher than the abnormal negative EBITDA margins in Q4FY10 and around 12.55% during Q3FY10 on consolidated basis.

- ✓ Due to firming of crude oil prices and collapse of LNG prices, CNG mode of transportation is becoming favorable apart from being more environments friendly. In India too, recent hike in petrol and diesel

COMPANY DETAILS	
BSE code	532684
NSE code	EKC
Face value(Rs)	2.00
Market cap(Rs.Cr)	1347
Free float(%)	18.28
52 week high/low(Rs)	221.80/107.80
Av. Daily volume	20,000

SHARE HOLDING PATTERN As on 31/3/10	
Promoters	59.82
Mutual funds & UTI	2.20
FIIs	19.61
Body corporate	2.48
Public	15.89
Total	100



ANALYST

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prices has made the case stronger for switching to CNG mode of transportaion.Moreover increased natural gas availability has enabled city gas distribution companies in Delhi , Mumbai and parts of Gujarat to open more CNG stations.Pune has very recently joined the exclusive list of new city on CNG map. Moreover Ministry of Petroleum and Natural Gas and Petroleum and Natural Gas Regulatory Board has identified 100 more Indian cities that are likely to be brought under city gas distribution network in coming days. All these are positive news for Everest Kanto Cylinders.

- ✓ Recently EKC has received its first order from within China for jumbo cylinders. Though the Chinese plant was set up almost two years ago, the company was unable to receive any order to sell either jumbo or CNG cylinders within China. Hence recent 120 jumbo cylinders orders and another 400 in the pipeline is a new breakthrough for the company in China which is likely to emerge as a very big market for CNG use.

- ✓ Few quarters ago, the capacity utilization of Dubai plant was hardly 55% due to lack of adequate demand in Middle East. But for last few months, this particular plant is operating at more than 105% capacity utilization levels. The big trigger has been phenomenal growth of CNG cylinders from Iran which is trying very hard to shift from its dependence on imported petro products to abundantly available CNG at home.

- ✓ All these years, EKC has been importing its key raw material, steel seamless tubes from Tenaris of Italy. Though this relationship has been quite cordial for last 15 years, it leaves EKC exposed to vagaries of raw material prices which is almost 65-66% of net sales. Hence the company has tried to reduce its dependence on imported costly raw material from a single supplier by installing a plate mill and billet piercing plant in India. Both these new technologies are likely to reduce raw material cost to some extent besides increasing the bargaining power of the company. Both these new plants will be commissioned in H1FY11.

Investment concerns

- Delay in rollout of CNG in new cities in India.
- Raw material price fluctuation and consequent inability of EKC to pass on raw material price hike to consumers.
- Over exposure to Iran for CNG cylinders.

CNG is a much cheaper mode of transportation compared to petrol or diesel

Theoretically 1 kg of CNG is energy equivalent to about 1.46 liters of petrol and about 1.18 liters of diesel. Thus purely from energy efficiency point of view, CNG is preferable compared to petrol and diesel. Additionally, CNG is much cleaner fuel compared to petrol and diesel and radical transformation of Delhi, Ahmedabad etc in recent years due to large scale switchover to CNG has demonstrated this fact amply.

CNG cylinders can come in two ways for automobile owners. Either through OEM like Maruti or Ashok Leyland or through retrofitting route. In the OEM version, CNG or flexi fuel engines are costlier compared to petrol or diesel. But payback period may be hardly one year even in OEM version. On the other hand, retrofitting means fitting CNG engines on old cars at about Rs40,000 . Generally a nascent CNG market like India is more likely to see OEM demand compared to retrofitting as new CNG version models are launched. But a matured or advanced CNG market like Pakistan witnesses almost 90% CNG cylinder demand from retrofitting side.

We have tried to analyze the payback period in the case of CNG conversion versus petrol or diesel versions of engines taking into account petrol or diesel prices in Delhi.

	CNG (Delhi)			Petrol (Delhi)
	Cars at 20km per day	Cars at 50km per day	Public transport at 100km per day	
Fuel unit	kg	kg	kg	liter
Fuel cost per unit(Rs)	27.50	27.50	27.50	51.4
Mileage(km per unit)	14	14	12	12
Fuel cost per km(Rs)	1.96	1.96	2.29	4.28
Savings per km(Rs)	2.32	2.32	1.99	
Conversion kit cost(Rs)	40,000	40,000	40,000	
Break even(km)	17,241	17,241	20,100	
Payback period(years)	2.36	1	0.5	

Source: Eureka Research, Industry

It is obvious that whether cars travel at 20km per day or 50km per day or 100km per day, there is enough incentive for one to switch over from petrol to diesel. In the case of 20km per day category, pay back period is 2.36 years while it is hardly 1 year for 50km per day category. In the case of public transport vehicles plying about 100km per day, payback period is even shorter at about 0.5years.

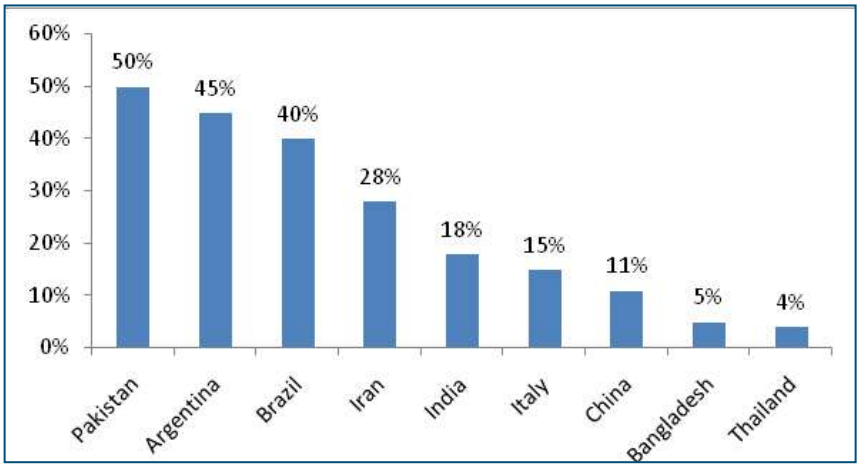
In the case of diesel, payback period is longer. Hence in countries like India where diesel prices at retail level are artificially kept low, it is unlikely that non public transporters will easily shift to CNG version. But in case diesel price is also partially or fully deregulated in future, CNG cars will be much more preferable compared to diesel ones.

	CNG (Delhi)			Diesel (Delhi)
	Cars at 20km per day	Cars at 50km per day	Public transport at 100km per day	
Fuel unit	kg	kg	kg	liter
Fuel cost per unit(Rs)	27.50	27.50	27.50	40.1
Mileage(km per unit)	14	14	12	14
Fuel cost per km(Rs)	1.96	1.96	2.29	2.86
Savings per km(Rs)	0.90	0.90	0.57	
Conversion kit cost(Rs)	40,000	40,000	40,000	
Break even(km)	44,444	44,444	70,175	
Payback period(years)	6	2.44	1.92	

Source: Eureka Research, Industry

Source: Company

Natural gas(CNG) vehicle population as a % of total vehicle population in different countries



Source:IANGV

As the above graph shows neighboring country Pakistan is much ahead of India in terms of CNG car penetration. In fact two most populous countries in the world namely India and China has lots of distance to traverse in terms of CNG vehicle growth. Increased natural gas availability and rapidly rising income levels coupled with demographic dividend is likely to make these two countries big market for CNG cylinder manufacturing companies like EKC.

Automobile CNG cylinders manufactured by EKC

Jumbo cylinders manufactured by EKC

Key customers across different segments of cylinders

Though the focus of the company in recent years has been more towards CNG cylinders contributing about 60-61% of total cylinders sold, it also manufacturers industrial cylinders which contain various industrial gases and used in several industries like steel making. In India, the average realization of an industrial cylinder is about Rs 4000 per cylinder.

Industrial cylinders	CNG cascades	OEM s for CNG cylinders	Special cylinders
Praxair	Mahanagar Gas Ltd	Hyundai	Defense Department, India
BOC India Ltd	Indraprastha Gas Ltd	Toyota	USA Navy
Inox Air Products Ltd	Bhagyanagar Gas Ltd	Suzuki	
Advanced Silicon	Gujarat Adani	Tata Motors Ltd	
Air Products		Eicher Motors Ltd	
Air Liquide		Ashok Leyland Ltd	
		Swaraj Mazda	

Source:Company

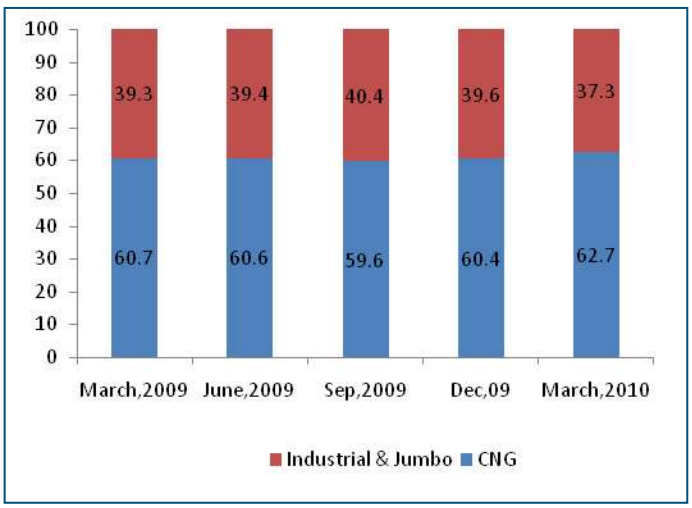
On the other hand, city gas distribution companies like Mahanagar Gas Ltd or Indraprastha Gas Ltd buy CNG cascades from EKC. These cascades hold large quantity of CNG at very high pressure. These CNG cascades are used at mother and daughter stations to store high pressure CNG gas. As per the management of Indraprastha Gas Ltd, one CNG cascade consists 40 cylinders and costing about Rs. 12 Lakh. It is expected that with city gas distribution networks likely to increase in coming days, CNG cascades volumes sold will go up significantly.

On the other hand, CNG cylinder price range from about Rs. 10,000 Rs. 11,000 per cylinder and they are supplied to either original equipment manufacturers (OEM) or retrofitters. In FY10, CNG cylinders volumes sold to OEM was 60% and 40% was towards retrofitters.

The third category of cylinders namely jumbo cylinders cost about US$12,000/cylinder in China and about US$17,000-20,000/cylinder in USA. These cylinders are used to store and transport large quantity of gas including industrial gases like beverage, food processing etc.

The cylinders supplied to defense establishments like navy and are very infrequent. Quantity wise also they are quite small.

Quarterly trend in production across different cylinder segments(%)



The adjacent graph depicts how CNG has been dominant portion in recent times. Entry barriers in CNG segment is much higher compared to industrial and jumbo cylinders. Moreover growth in CNG market has been much robust compared to industrial and jumbo segment.

EKC is one of the largest company globally in terms of cylinder manufacturing capacity

Company	Current capacity (cylinders)	Plant locations	Target markets
Everest Kanto Cylinders	1,500,000(likely in H1FY11)	Dubai, India, China, USA	India, U.A.E, Pakistan, Iran Bangladesh, Thailand, China
Beijing Tianhai Industry Company (BTIC)	1,500,000	China	Domestic (65%), Exports(35%)
Tainjin Tianhai High Pressure Vessel Company	1,200,000	China	Domestic(50%), exports(50%)
Faber Cylinders	900,000	Italy(4 plants)	> 50 countries world-wide including Pakistan, Italy
Rama Cylinders	300,000	India	Iran, Pakistan, Bangladesh Thailand,
Nitin Fire Protection Industries	250,000	Vizag SEZ	Russia mostly exports
Inflex - Argentoil S.A	240,000	Argentina (2 plants)	Argentina, US, Canada, UK, Italy, India, Pakistan, Australia, NewZealand, Indonesia, Bangladesh
Dynetek Cylinders	200,000	Canada, Germany	Europe(56%), Americas(35%)

As the above table shows, EKC is the largest cylinder manufacturer globally along Beijing Tianhai Industry Company (BTIC). The company has been aggressive in capacity expansion in India and abroad to take advantage of boost in CNG demand.

The demand in USA has been quite lackluster in recent times and hence company has not given any guidance of jumbo cylinders to be manufactured from USA subsidiary in coming Days.

The Company sold 687,000 cylinders in FY10. Out of this, industrial cylinder volumes=267,000; CNG in India=206,000; CNG in Dubai=157,000; jumbo cylinders in USA=1277 and 56,000 semi finished cylinders in China.

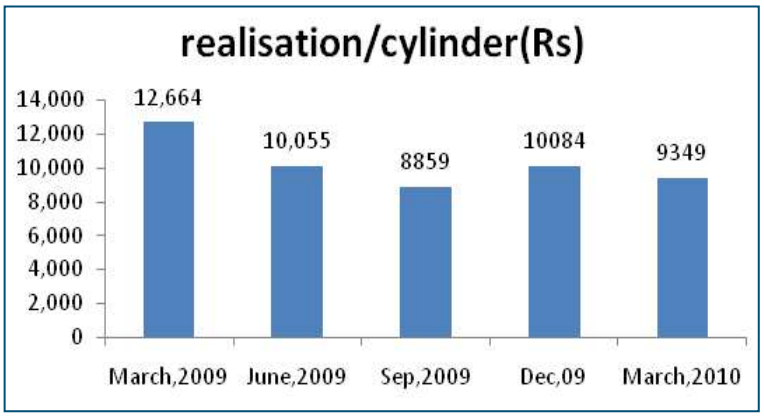
Plant wise capacity and production estimates

Plant	Capacity(nos)	Cylinder type	Capacity utilisation assumptions	
			FY11E	FY12E
Aurangabad	110,000	Industrial cylinder	95%	98%
Tarapur	160,000	Industrial & CNG	100%	100%
Dubai	196,000	CNG	105%	105%
Gandhidham(old)	340,000	Industrial & CNG	103%	105%
Gandhidham(new billet piercing)	200,000	Industrial	40%	60%
Gandhidham(new-jumbo)	5000	Jumbo	20%	30%
Kandla(SEZ)	300,000	CNG	15%	25%
China	200,000	CNG	5%	10%
China	5,000	Jumbo	25%	30%

The new billet piercing plant at Gandhidham to manufacture industrial cylinders is likely to commence anytime soon. Hence we have assumed around 40% capacity utilisation in FY11E and another 60% in FY12E.This billet piercing technology will reduce raw material cost to some extent as billet will replace much costly imported seamless tubes from Tenaris of Italy. The

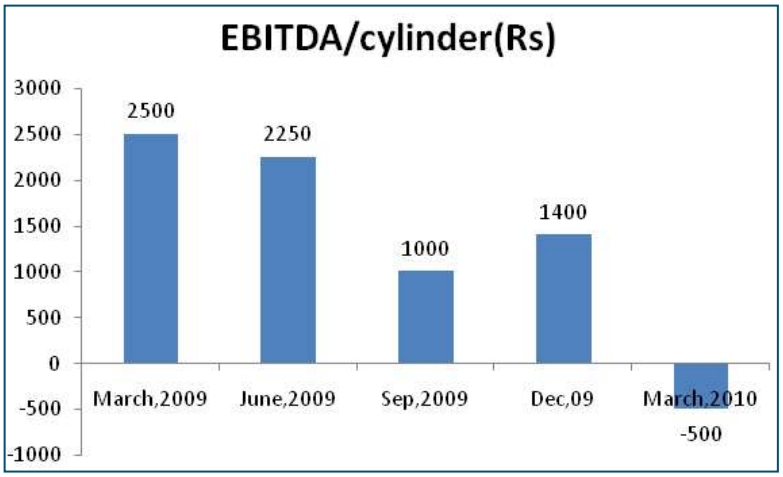
new jumbo plant at Gandhidham has been much delayed as the company acquired its USA subsidiary with the same product profile. This plant is also likely to be commissioned very soon. As per management guidance, we have assumed 20% and 30% capacity utilization in FY11E and FY12E respectively. Kandala SEZ CNG plant is likely to cater to robust demand from Pakistan, Iran, Middle East and Bangladesh. This will be in addition to exports from its Dubai plant.

Recent quarterly trends on cylinder realisation and profitability on consolidated basis



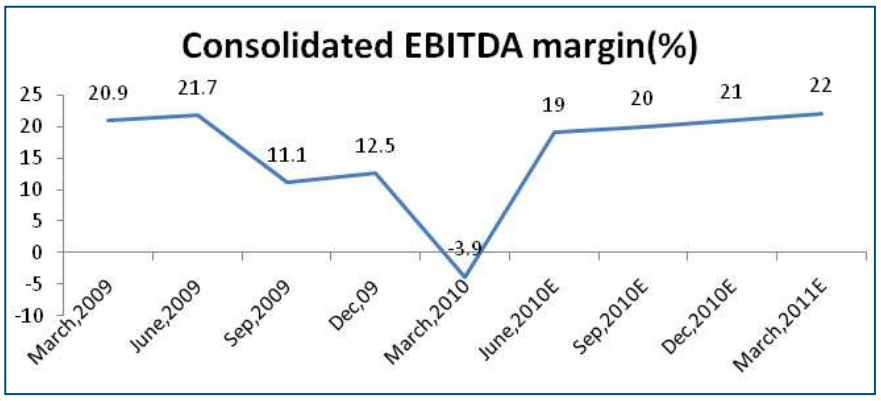
The above graph shows average realisation per cylinder sold in last five quarters. The main raw material seamless tubes are an imported product and its price shot up significantly in FY09. Along with this the company was forced to increase its average realisation in order to mitigate raw material pressure. But once the raw material prices started to correct towards H2FY09, the company was found holding significant high cost inventory. As the raw material prices started to correct, average realisation per cylinder also dropped. Apart from raw material price trends, average realisation per cylinder is also determined by type of cylinder manufactured and sold. For example, industrial cylinders cost much less compared to CNG and jumbo cylinders. Hence if more of industrial cylinders are manufactured and sold in a particular quarter, average realisation may drop. Secondly there is a difference in realisation in CNG cylinders sold to OEMs and retrofitters. Again retrofitter's prices may be low compared to OEM CNG cylinders. Jumbo cylinders are the costliest and absolute numbers sold are quite low compared to industrial or CNG cylinders. Hence all these factors may affect average realization per cylinder.

As per management guidance, cylinder volumes sold will go up in Q1FY11 and Q2FY11. But more Industrial cylinders will be sold on sequential terms and CNG volume is likely to remain same. Hence again unless EKC is able to renegotiate cylinder prices upwards with OEMs in next two quarters, realisation per cylinder may not improve significantly in coming two quarters.But as jumbo cylinders and CNG cylinders volume pick up from Q3FY11, average realisation per cylinder sold will increase.



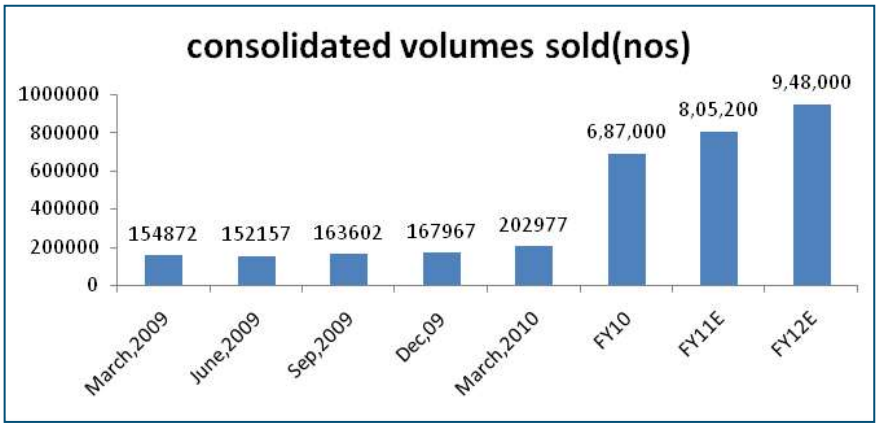
The EBITDA/cylinder dipped significantly in recent quarters due to high cost inventory and reduction in capacity utilisation in Dubai and USA plants. Moreover China plant was unable to show any significant ramp up in finished product due to inability to receive clearances to sell within China both in industrial and CNG cylinder category. All these problems are now resolved and the EBITDA/cylinder is likely to revert towards Rs2400-2500 in coming quarters.

Coming to EBITDA margin at consolidated level, high cost inventory mostly contributed to dip in EBITDA margin in recent times.Due to one time and final mark down of high cost inventory to net realisable value by Rs18 Cr in Q4FY10, the consolidated EBITDA margin was negative in Q4FY10 quarter. But EBITDA margins are set to improve drastically from Q1FY11 onwards mainly for three reasons. First, high cost and high margin jumbo cylinders sales are likely to pick up. Second, low cost billet piercing and steel plates plant will enable the company to source key raw material to a significant extent. Thirdly, demand is picking up for CNG and CNG cascades in India and abroad due to wide price differential between crude and natural gas prices and better availability of natural gas in key markets. As the capacity utilisation picks up, EBITDA margins are likely to revert to at least average FY08 numbers.



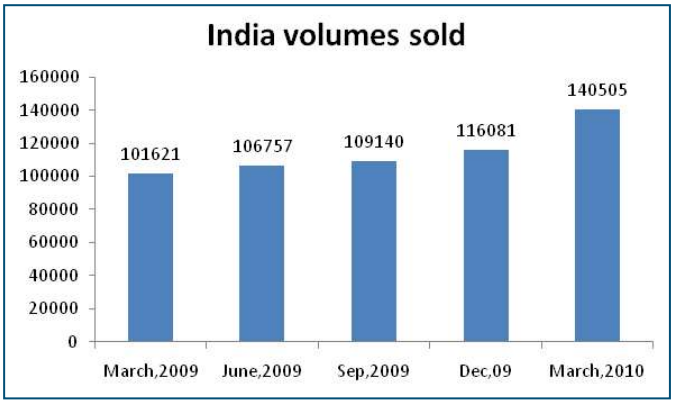
Source: Company, Eureka Research

The following graph shows that though average realization and EBITDA per cylinder dipped along with consolidated EBITDA margin in last few quarters, volume growth has been on an upward trend. This means that demand is very much on revival path across all categories of cylinders (except USA).

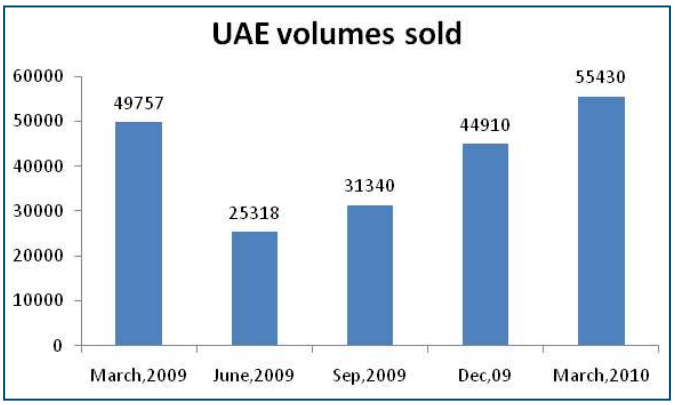


Source: Company, Eureka Research

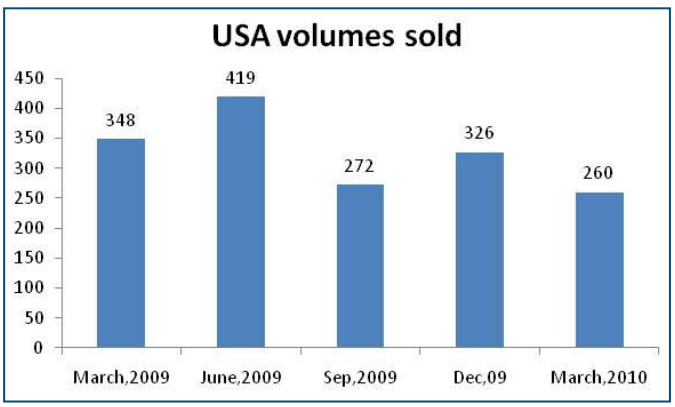
Demand from within India has been much robust in recent times. The reason being automobiles sales growth with CNG version has been quite robust along with demand from retrofitting markets like Delhi and Gujarat. For example, NCR Delhi has been witnessing around 3500 vehicle conversion to CNG per month and Bharuch another 2000-3000 per month. Moreover new areas in Gujarat and Pune have been brought under CNG network.



Dubai plant was operating at around 55% capacity utilisation till few quarters ago. CNG cylinders demand from that region collapsed in H2FY09 and gradually they picked up in H2FY10.Now robust demand from Iran and Pakistan has kept capacity utilization at more than 100% in Dubai plants. Capacity utilization is likely to sustain above 100% in these plants in coming quarters also.



USA plant saw huge dip in capacity utilization due to lack of fresh demand. The only conciliatory point in USA plant is that fixed costs are quite low in that plant. Against annual jumbo cylinder production capacity of 5000, capacity utilization is unlikely to go above 20% in coming quarters.



Debt Position : Quite Comfortable

As on 31st March,2010, the total debt on the books of EKC was Rs. 501cr which has come down further in recent months. Average rate of interest is around 3.5%.As per management guidance, considering present LIBOR rate, total interest outgo for FY11e is Rs13Cr. FCCB is the major debt(US$35 million. FCCB is zero coupon and conversion price is Rs270, due in Sept, 2012.There is debt in the USA subsidiary to the extent of US$34 million. This debt is 3 month LIBOR plus 2.75%.Dubai subsidiary has US$2 million debt for term period at LIBOR plus 0.9%.Chinese subsidiary has debt of US$4.5million with interest cost of around 6% per annum. This is the debt with the highest interest rate. In India , there is short term debt of ECB of US$10 million with interest rate of 5.7%, to be repaid in next 2.5 years. There is another short term loan of about Rs70 Cr with the Indian part with interest rate of LIBOR plus 2%. All LIBOR rates are 3 months duration. There is no rupee loan in India.The total interest payment in FY11 is likely to be less than Rs13Cr

Preferential issue of 6.5 mn equity shares at Rs.135 per equity share

- The shareholders of EKC have approved a preferential issue of 6.0 mn equity shares to two funds of Reliance Capital Asset Management Ltd. out of this 4.0 mn shares are for Reliance Growth Fund and 2.0 mn shares are for Reliance Regular Savings Fund - Equity Option.
- Earlier the Board had also approved preferential issue of equity shares aggregating to 0.51 mn equity shares to the existing private equity investors of the company if they choose to exercise their anti dilution rights.
- The equity shares would be issued at Rs. 135 (FV of Rs.2 and premium of Rs. 133).
- Thus EKC would raise Rs. 879 mn.
- Due to 6.5mn fresh equity issuance , the equity capital of the company would be Rs. 215.3 mn.

Use of funds

The proceeds of the issue would be used for capital expenditure, working capital and repayment of debt. Rs.300 mn would be used to fund the capex of setting up of 3 lakh CNG cylinders per annum plant at Kandla SEZ through steel plate technology.Rs.250 mn would be used for the increased working capital requirements and balance Rs.329 mn would be used to retire high cost Indian debt.

Consolidated income statement(Rs.Cr)

Rs.Cr	FY09	FY10	FY11E	FY12E
Net sales	856.32	649.43	840	1170
Other income	8.91	60.34	30	40
Total income	865.23	709.77	870	1210
Operating expenses	604.71	590.78	663.6	912.6
EBITDA	260.52	118.99	176.4	257.4
EBITDA%	30.42	18.33	21	22
Depreciation & amortisation	69.28	56.88	62	78
Interest	31.54	14.39	13	12
PBT	159.7	47.72	101.4	167.4
Tax	22.18	6.30	12.12	21.71
PAT	137.52	41.43	89.28	145.69

Consolidated balance sheet (Rs.Cr)

	FY09	FY10	FY11E	FY12E
Share Capital	20.23	20.23	21.53	21.53
Total Shareholders Funds	619.62	620.92	780	920
Total Debt	622.06	501.55	410	385
Total Liabilities	**1241.68**	**1122.72**	**1190**	**1305**
Gross Block	696.36	714.43	950	1110
Less: Accumulated Depreciation	163.92	169.79	180	210
Net Block	**532.44**	**544.64**	**770**	**900**
Capital Work in Progress	198.33	162.12	130	60
Investments	2.32	4.49	5	5
Inventories	488.49	339.09	220	300
Sundry Debtors	98.05	92.84	110	150
Cash and equivalents	39.23	59.94	71	50
Loans and Advances	87.67	74.60	60	40
Total Current Assets	**713.44**	**566.47**	**461**	**540**
Sundry creditors	139.78	104.49	140	160
Provisions	20.23	20.46	20	20
Others	45.43	19.17	10	10
Total Current Liabilities&provisions	**205.44**	**144.12**	**170**	**190**
Net Current Assets	508	422.35	291	350
Net Deferred Tax	0.59	(10.88)	(6)	(10)
Total Assets	1241.68	1122.72	1190	1305

Key financial ratios

	FY09	FY10	FY11E	FY12E
Growth(%)				
Net sales	62	(24)	29.34	39.28
EBITDA	59.76	(54)	48.24	46
PAT	31.88	(70)	115.50	63.18
Profitability(%)				
EBITDA margin	30.42	18.33	21	22
PAT margin	16	6.38	10.62	12.45
ROCE	10.13	8.00	6.8	14
ROE	9.45	9.74	11	19
Per share data(Rs)				
EPS	13.59	4.09	8.29	13.53
CEPS	20.44	9.72	14.05	20.78
BVPS	61.25	61.39	72.46	85.46
Valuation(x)				
P/E	-	-	16.16	9.9
P/CEPS			9.54	6.45
PEG	-	-	0.16	0.04
P/BV	-	-	1.84	1.57
EV/EBITDA	-	-	3.55	2.42
EV/net sales	-	-	0.75	0.53
Dividend yield(%)	1.00	0.99	1.00	1.00
Turnover days				
Debtor days	41.8	52.2	47.8	46.8
Creditor days	59.58	58.72	60.83	50
Gearing ratio(%)				
Debt to equity	1.00	0.80	0.53	0.42
Current ratio	3.47	3.93	2.71	2.84
Interest coverage ratio	8.25	8.27	13.57	21.45

Recommendation

The company faced troubles in FY10 due to falling CNG demand, high cost inventory and idle capacity in many of its plants. These issues are mostly behind the company and now the company is likely to report strong topline and bottomline growth. New orders in jumbo and CNG cylinder category are likely to be received in coming days. The macro scenario governing the sector is witnessing rapid progress in terms of CNG network being widened into several new cities and robust demand for CNG as a compelling alternative for petrol or diesel.

Based on FY11E and FY12E earnings, the stock is trading at PEx of 16.16 and 9.9 respectively. This is lower than the historic 12month forward PEx where the stock enjoyed PEx of around 19 times . Thus based on historic 12 month forward PEx, the stock looks attractive.

Again, based on P/BV multiple, the stock is trading at just 1.84 times and 1.57 times on FY11E and FY12 numbers. This is lower than historic 12 month forward P/BV multiple of around 2.

We believe that the current stock price discounted almost all known negatives including abnormal Q4FY10 earnings where one time inventory write off had wiped out its profits.

Taking into account all these factors, we recommend "BUY" with a target price of Rs210.

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