Company In-Depth

26 April 2007 | 10 pages

Everest Kanto Cylinder (EKCL.BO)

Buy: Announces Large Export Order; Target Price Raised to Rs1,300

Rating change ☐
Target price change ☑
Estimate change ☑

- What's new — EKC announced an export order win worth Rs2.2bn for supply of CNG cylinders to Iran and Pakistan, which will largely be executed out of the company's Dubai plants. The size of the order reinforces our view on the increasing tightness in the gas cylinder market, especially for CNG applications, and EKC's continued dominance in the domestic and global markets.
- China expansion on schedule — The company has commenced construction work in China, has placed orders for machinery, and remains on course to commence production with an initial capacity of 200K cylinders by 3QFY08. The Dubai expansion has had a few delays, however, and is likely to commence production in the current quarter.
- Raising earnings 19-23% — Based on the announced order win and our discussions with management, we believe there exists upside to our previous estimates on utilizations at the various operating facilities. We have accordingly revised our FY08E-09E earnings by 19-23% on these changes.
- Raising target price to Rs1,300 — Based on our revised earnings estimates, we raise our target price to Rs1300 and maintain our target P/E multiple of 20x. We also roll forward earnings by three months; we expect FY09E to capture the contribution from China and full utilization from Dubai. Strong earnings visibility (EPS CAGR of 45% for FY07-09E) and a leveraged play on the alternate energy/CNG theme are key reasons supporting our Buy/Medium Risk (1M) rating on the stock.

Buy/Medium Risk	1M
Price (25 Apr 07)	Rs1,012.60
Target price	Rs1,300.00
from Rs990.00	
Expected share price return	28.4%
Expected dividend yield	0.6%
Expected total return	**29.0%**
Market Cap	Rs19,768M
	US$486M

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

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

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	143	11.90	234.8	85.1	29.1	40.9	0.2
2006A	324	18.39	54.6	55.1	11.8	33.7	0.3
2007E	650	33.29	81.0	30.4	6.7	29.3	0.7
2008E	1,003	51.37	54.3	19.7	5.4	30.5	1.3
2009E	1,358	69.54	35.4	14.6	4.3	32.8	1.7

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	85.1	55.1	30.4	19.7	14.6
EV/EBITDA adjusted (x)	70.2	34.3	18.3	12.5	9.8
P/BV (x)	29.1	11.8	6.7	5.4	4.3
Dividend yield (%)	0.2	0.3	0.7	1.3	1.7
Per Share Data (Rs)					
EPS adjusted	11.90	18.39	33.29	51.37	69.54
EPS reported	11.90	18.39	33.29	51.37	69.54
BVPS	34.75	85.63	150.14	186.87	236.59
DPS	2.50	3.50	6.66	12.84	17.38
Profit & Loss (RsM)					
Net sales	1,324	2,355	4,087	6,305	8,276
Operating expenses	-1,114	-1,865	-3,147	-4,904	-6,431
EBIT	**210**	**490**	**940**	**1,401**	**1,846**
Net interest expense	-27	-37	-64	-107	-183
Non-operating/exceptionals	36	22	26	43	78
Pre-tax profit	**219**	**476**	**903**	**1,337**	**1,740**
Tax	-76	-141	-253	-334	-383
Extraord./Min.Int./Pref.div.	0	-11	0	0	0
Reported net income	**143**	**324**	**650**	**1,003**	**1,358**
Adjusted earnings	143	324	650	1,003	1,358
Adjusted EBITDA	288	588	1,108	1,653	2,127
Growth Rates (%)					
Sales	79.4	77.9	73.5	54.3	31.3
EBIT adjusted	nm	133.9	91.7	49.1	31.7
EBITDA adjusted	225.4	104.2	88.4	49.2	28.7
EPS adjusted	234.8	54.6	81.0	54.3	35.4
Cash Flow (RsM)					
Operating cash flow	**-6**	**300**	**234**	**673**	**1,100**
Depreciation/amortization	78	98	168	252	281
Net working capital	-227	-122	-584	-581	-539
Investing cash flow	**-65**	**-591**	**-1,277**	**-558**	**-433**
Capital expenditure	-65	-591	-1,277	-558	-433
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**156**	**667**	**1,251**	**341**	**260**
Borrowings	138	-93	481	628	648
Dividends paid	-17	-70	-148	-286	-387
Change in cash	**85**	**376**	**209**	**457**	**926**
Balance Sheet (RsM)					
Total assets	**1,237**	**2,514**	**4,720**	**6,562**	**8,572**
Cash & cash equivalent	36	290	480	937	1,863
Accounts receivable	168	234	443	691	907
Net fixed assets	439	939	2,048	2,354	2,506
Total liabilities	**820**	**1,004**	**1,789**	**2,914**	**3,953**
Accounts payable	182	266	499	777	1,020
Total Debt	488	395	876	1,504	2,152
Shareholders' funds	**417**	**1,509**	**2,931**	**3,648**	**4,619**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	21.7	25.0	27.1	26.2	25.7
ROE adjusted	40.9	33.7	29.3	30.5	32.8
ROIC adjusted	16.2	24.8	25.4	25.7	28.6
Net debt to equity	108.3	7.0	13.5	15.6	6.3
Total debt to capital	53.9	20.7	23.0	29.2	31.8

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New Order Win

EKC has announced that it has won export orders worth Rs2.2bn (35% of FY08E sales; total exports in FY06 were Rs1.1bn) for the supply of CNG cylinders to Iran and Pakistan. While the exact details are currently not available, our discussions with management indicate that the order wins are likely for larger, high value-added cylinders (73-97 litres capacity) with better realizations. The order will primarily be executed at the company's existing and new Dubai capacities over the next 1-1½ years. The order win improves earnings visibility for the company and will improve utilizations as well as average realizations from the Dubai facilities. The order also reinforces our view of EKC being well-placed to benefit from the tightness in the market, aided in part by a well-timed and aggressive expansion strategy. We have accordingly increased our assumptions for Dubai realizations by 11-13% from FY08-09E and revised our capacity utilization assumptions as detailed in the section below.

Capacity Utilizations Set to Improve Further

Based on the new order win and discussions with management that indicate a sharp ramp up in Dubai utilization in the current quarter, and backed by the sustained tightness in the high pressure gas cylinder market, we revisit our capacity utilization assumptions for the various facilities of EKC. We describe in detail the revisions and the rationale for the same below.

- Dubai – EKC's new Dubai plant has been facing delays in its commissioning and is slated to commence production towards the end of the current quarter. Because we believe our earlier assumption of full year average utilization for the Dubai plants is conservative at 75%, we leave it unchanged. However, we have increased our utilization assumption in FY09E to 100% (from 80% earlier), given that the current plant is already running at 110%+ utilization levels and the new plant should attain full utilization levels in c.6-8 months. With significant visibility for Dubai production following the new order win, we believe achieving levels of 100%+ utilization in FY09E is a realistic expectation.

- Gandhidham – The Gandhidham plant is currently running at c.30-35% utilization levels and could ramp up to an average of 75-80% by FY08E, which is in line with our earlier assumptions. However, given (1) the demand for CNG cylinders is only likely to increase, (2) the expected uptick in demand from the CNG segment in FY09E, and (3) the reliance on the Gandhidham facility to cater for the bulk of domestic CNG sales of EKC, we now expect the company to attain average utilization levels of 90% for this plant by FY09E. The company's track record in running the Aurangabad and Tarapur plants at full capacity lends us comfort on the company's technical prowess and ability to reproduce similar efficiency levels at its Gandhidham facility.

- Aurangabad and Tarapur – Management has indicated that both these plants are currently being operated at c.100% utilization levels. We expect this to sustain over our forecast horizon. In addition, de-bottlenecking plans, especially at the Tarapur facility, could further enhance production, though we do not factor in any upside from this.

- China – Production from the greenfield China plant is slated to commence in 3QFY08. We maintain our assumption of production at 15% of the capacity of 200K cylinders in FY08E, which is conservative vis-à-vis management's guidance. We would await further clarity on the progress of the China expansion before making any meaningful change to this assumption.

Figure 1 illustrates our new utilization/production assumptions by plant.

Figure 1. EKC – Capacity Utilization and Production Assumptions by Plant

(no. of cylinders)	FY06	FY07E	FY08E	FY09E
Aurangabad				
CNG production	-	-	-	-
% of total	*0.0%*	*0.0%*	*0.0%*	*0.0%*
Industrial production	96,076	104,500	115,500	115,500
% of total	*100.0%*	*100.0%*	*100.0%*	*100.0%*
Total production	96,076	104,500	115,500	115,500
Capacity	110,000	110,000	110,000	110,000
Capacity utilization	87.3%	95.0%	105.0%	105.0%
Tarapur				
CNG production	77,826	86,400	96,000	96,000
% of total	*52.4%*	*60.0%*	*60.0%*	*60.0%*
Industrial production	70,690	57,600	64,000	64,000
% of total	*47.6%*	*40.0%*	*40.0%*	*40.0%*
Total production	148,516	144,000	160,000	160,000
Capacity	160,000	160,000	160,000	160,000
Capacity utilization	92.8%	90.0%	100.0%	100.0%
Dubai				
CNG production	105,939	117,600	147,000	196,000
% of total	*100.0%*	*100.0%*	*100.0%*	*100.0%*
Industrial production	-	-	-	-
% of total	*0.0%*	*0.0%*	*0.0%*	*0.0%*
Total production	105,939	117,600	147,000	196,000
Capacity	96,000	196,000	196,000	196,000
Capacity utilization	110.4%	60.0%	75.0%	100.0%
Gandhidham				
CNG production	170	71,400	153,000	183,600
% of total	*1.6%*	*60.0%*	*60.0%*	*60.0%*
Industrial production	10,340	47,600	102,000	122,400
% of total	*98.4%*	*40.0%*	*40.0%*	*40.0%*
Total production	10,510	119,000	255,000	306,000
Capacity	340,000	340,000	340,000	340,000
Capacity utilization	3.1%	35.0%	75.0%	90.0%
China				
CNG production			30,000	130,000
% of total			*100.0%*	*65.0%*
Industrial production			-	70,000
% of total			*0.0%*	*35.0%*
Total production			30,000	200,000
Capacity			200,000	400,000
Capacity utilization			15.0%	50.0%
TOTAL				
CNG production	183,935	275,400	426,000	605,600
% of total	*50.9%*	*56.8%*	*60.2%*	*62.0%*
Industrial production	177,106	209,700	281,500	371,900
% of total	*49.1%*	*43.2%*	*39.8%*	*38.0%*
Total production	361,041	485,100	707,500	977,500
Capacity	706,000	806,000	1,006,000	1,206,000
Capacity utilization	51.1%	60.2%	70.3%	81.1%

Source: Company Reports and Citigroup Investment Research estimates

Raising Earnings Estimates 19-23%

On the new order win announced, the consequent improvement in Dubai realizations, and our new assumptions for capacity utilizations at the other facilities as detailed earlier, we revising our earnings estimates for FY08-09E by 19-23%. We have pared our domestic realization assumptions because we assume that announcements of capacity additions by new players could result in increasing competition – albeit marginally in our view – as the demand scenario remains robust. Further, we maintain our rupee assumptions even though the current trend in faster appreciation of the rupee vis-à-vis the dollar is beneficial for EKC, given its key raw material is denominated in dollars (we estimate ~12% upside to EPS for every 5% appreciation in the rupee). This should also provide a cushion against possible margin contraction, driven by increasing price competition.

Figure 2. EKC – Earnings Revisions

Year to	Net Profit (Rs Mils.)		Diluted EPS (Rs)			DPS (Rs)	
31-Mar	Old	New	Old	New	% Chg	Old	New
2007E	645	650	33.03	33.29	0.8%	6.6	6.7
2008E	840	1,003	43.02	51.37	19.4%	10.8	12.8
2009E	1,104	1,358	56.54	69.54	23.0%	14.1	17.4

Source: Citigroup Investment Research estimates

Increased City Gas Penetration – Visibility Improves

Since our last update in January, significant developments on the expected increase in gas usage in India have lent further credence to the thesis of India being at the threshold of witnessing strong growth in the usage of CNG, which would be directly beneficial to EKC. Some recent developments are highlighted below:

- GAIL has signed an MoU with Reliance Industries for the transportation of the latter's KG basin gas and has also announced plans to lay 5,000 kms of pipelines across the country; significant of these are the Jagdishpur-Haldia and the Dabhol-Bangalore pipelines. These pipelines would transport gas to hitherto non-existent demand pockets. GAIL has also signed an MoU for a JV for city gas distribution projects in West Bengal.

- GSPC has signed a gas transportation agreement for the transmission of 3.5-11mmscmd of its KG basin gas from Kakinada to Bharuch through Reliance's pipeline.

- According to media reports, Reliance Industries has plans to set up city gas distribution projects across various states such as West Bengal, Tamil Nadu, Karnataka, etc. for the marketing of its KG basin gas.

- British Gas has also announced plans to foray into city gas distribution in the southern states, either through its subsidiary Gujarat Gas or by setting up new subsidiaries.

- Bajaj Auto has announced that it would shortly be launching CNG two-wheelers. This bodes well for EKC, which we believe will be the likely supplier of a large proportion of the cylinder requirements for the vehicles, given its association with the project from the pilot stage.

4Q Preview

We expect the company's 4QFY07 net income to come in at Rs192m, relatively flat sequentially, driven by slightly better utilizations and lower tax rate that would mitigate the impact of the one-off trading gains in the previous quarter. For full year FY07, we expect the company to report net income of Rs650m.

Figure 3. EKC – 4Q Preview (Rupees in Millions)

Year to 31 Mar	1QFY07	2QFY07	3QFY07	4QFY07E
Net Sales	**796**	**1,001**	**1,118**	**1,078**
Total expenditure	576	737	800	787
EBITDA	**220**	**264**	**318**	**291**
EBITDA margin	*27.6%*	*26.4%*	*28.5%*	*27.0%*
Interest	8	18	12	12
Depreciation	42	44	48	48
Other income	6	6	12	12
Profit before tax	176	208	270	243
Tax	62	72	66	51
Tax rate	*35.0%*	*34.5%*	*24.5%*	*21.0%*
Profit after tax	**115**	**136**	**204**	**192**

Source: Company Reports and Citigroup Investment Research estimates

Everest Kanto Cylinder

Company description

Everest Kanto Cylinder Limited (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, the subsequent facilities have been built using in-house technology. The company currently has four manufacturing plants located in Aurangabad, Tarapur, Gandhidham, and Dubai with a total capacity to produce 706,000 cylinders per annum. An aggressive expansion plan including doubling of the Dubai capacity as well as a greenfield plant in China would see EKC's production capacity increase to 1.8m cylinders over the next 4-5 years.

Investment thesis

We rate the stock as Buy/Medium Risk (1M) with a target price of Rs1300. 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 deliver EPS CAGR of 45% for FY07-09 on our estimates. EKC offers a unique opportunity for investors to participate in the back-end-enabling chain to service the rapidly expanding CNG market in India and overseas. While the CNG segment in India is still at a nascent stage of development vis-à-vis some other countries, cost economics, rising awareness, improving refueling infrastructure and visibility of gas supplies should see CNG penetration on an accelerating trajectory in India, thereby boosting demand for CNG cylinders. Coupled with the robust global outlook for natural gas-powered vehicles (population forecasted to increase to 50m by 2020, a CAGR of 17%) and a sanguine IP-linked growth outlook for industrial cylinders, we expect EKC's production to increase 2x over our forecast horizon.

Valuation

Our 12-month target price for EKC of Rs1300 is based on a target P/E multiple of 20x. We also roll forward earnings by three months, in line with target multiples of its manufacturing / engineering peers. We based our target on 12-month forward earnings (to Dec-08E) because we believe it better captures the contribution from China and full utilization of the Dubai facilities. In the absence of any direct listed comparables, either locally or globally, we prefer comparing EKC with capital goods companies that manufacture industrial goods that have a similar growth profile. EKC is also a leveraged play on the alternate energy/CNG theme with growth driven by cost economics and environmental concerns. Our target P/E is well supported by an EPS CAGR of 45% for FY07-09E. Although EKC is relatively small, we believe its valuations will closely track those of its peers given its exposure to the rapidly developing CNG market, for which there are only a few other plays available.

Risks

We assign a Medium Risk rating to EKC, rather than the High Risk rating as per our quantitative risk-rating system, as we think it is more appropriate given the secular nature of the business that the company operates in and the strong visibility of growth on increasing CNG penetration. The risk factor is further mitigated by the firm's low leverage and strong return parameters. Key downside risks to our target price: 1) Exposure to a single supplier – EKC's reliance on Tenaris for most of its raw material makes it vulnerable to the latter's pricing power; any unanticipated pricing action on the part of Tenaris could be a negative for EKC. However, EKC has in the past passed on cost increases to its customers. 2) China – is a hitherto unexplored market and EKC's entry there could incur teething troubles. 3) Competition – while the cylinder market in India has been relatively less exposed to competition, the low physical barriers to entry might lead to new players flooding the market, which might have an adverse impact on EKC's pricing power and hamper its ability to pass on cost increases to customers. 4) Crude prices – significantly lower crude prices could adversely impact CNG's strong economics and consequently slow CNG penetration. If any of these risk factors has a greater impact than we anticipate, the stock might have difficulty reaching our target price.

Appendix A-1

Analyst Certification

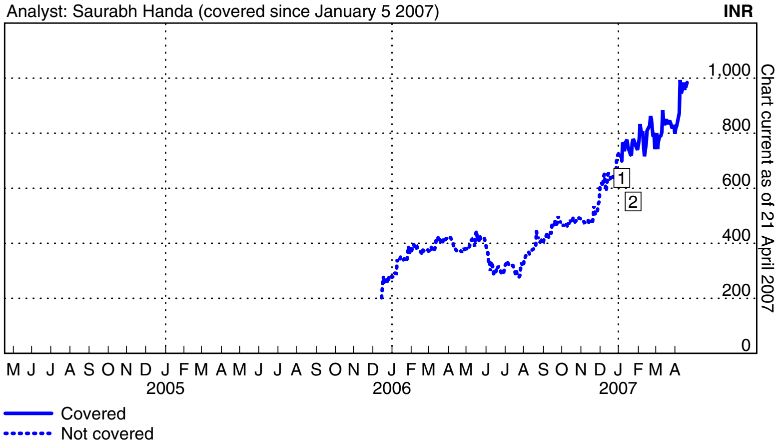
We, Saurabh Handa, Pradeep Mirchandani, CFA and Rahul Singh, research analysts and the authors of this report, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

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	950.00	698.90
2:	24 Jan 07	1M	*990.00	778.20

*Indicates change.

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% of companies in each rating category that are investment banking clients	42%	50%	42%

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