30 July 2009 | 9 pages

Everest Kanto Cylinder (EKCL.BO)

Equity ☑
Rating change ☑
Estimate change ☑

Downgrade to Sell: Weak 1Q, Near-term Outlook Not Supportive

- **Disappointing 1Q** — EKC's 1Q PAT of Rs166m was down 53% yoy and 40% qoq, well below our estimates. While we did expect modest qoq decline in profits, the magnitude of decline, especially in the Dubai subsidiary, was a surprise. With the near-term outlook not supportive of valuations, we downgrade to Sell.

- **Margins boosted by forex gains; lower RM inventory a silver lining** — Reported EBITDA margins of 28% were supported by forex gains of Rs95m. Excl. forex gains, EBITDA margin came in at 22%, largely flat on a sequential basis. The quarter was impacted by: (i) Dubai revenues down 54% qoq, driven by low demand from Iran, (ii) EBIT loss of Rs12m in USA (Rs13m in 4Q), driven by low margins (c17% vs. 32% in FY09) and amortisation of goodwill, and (iii) higher tax rate due to lower contribution from Dubai. Decline in RM inventory by cRs600m during 1Q is +ve, and further declines should support margins.

- **Reducing earnings 21-29%** — We are cutting our FY10-12E earnings by 21-29% on the poor growth outlook, esp. in Dubai, driving lower utilisations. Domestic volumes should pick up during the year with demand for jumbo cylinders (order received for cUS$5m), launch of CNG models by Maruti, and demand from Pune. However, we would wait for better visibility as well as demand in Iran to recover before advising investors to re-enter the stock.

- **Near-term outlook not supportive of valuations; downgrade to Sell** — Our TP remains at Rs175 despite our earnings cut as we increase our target multiple to 15x Sep-10E P/E (11x earlier), maintaining 10-20% discount to market. We downgrade to Sell (3M) from Buy (1M) as business fundamentals continue to remain weak. While India profitability should improve going forward, it may not be enough to fully offset the slowdown in Dubai and lack of pick up in China.

Sell/Medium Risk	3M
from Buy/Medium Risk	
Price (29 Jul 09)	Rs179.90
Target price	Rs175.00
Expected share price return	-2.7%
Expected dividend yield	0.7%
Expected total return	**-2.1%**
Market Cap	Rs18,198M
	US$377M

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 (%)
2008A	1,043	9.81	33.4	18.3	3.8	26.7	0.7
2009A	1,375	12.94	31.9	13.9	2.9	25.0	0.7
2010E	1,100	10.35	-20.0	17.4	2.5	16.5	0.6
2011E	1,401	13.17	27.3	13.7	2.2	18.0	0.8
2012E	1,885	17.73	34.6	10.1	1.8	20.4	1.0

Source: Powered by dataCentral

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

Fiscal year end 31-Mar	2008	2009	2010E	2011E	2012E
Valuation Ratios					
P/E adjusted (x)	18.3	13.9	17.4	13.7	10.1
EV/EBITDA adjusted (x)	12.7	8.9	11.0	8.3	6.7
P/BV (x)	3.8	2.9	2.5	2.2	1.8
Dividend yield (%)	0.7	0.7	0.6	0.8	1.0
Per Share Data (Rs)					
EPS adjusted	9.81	12.94	10.35	13.17	17.73
EPS reported	9.81	12.94	10.35	13.17	17.73
BVPS	47.41	61.25	70.86	83.08	99.54
DPS	1.20	1.20	1.09	1.38	1.86
Profit & Loss (RsM)					
Net sales	5,287	8,566	8,708	10,703	12,491
Operating expenses	-3,976	-6,786	-7,346	-8,897	-10,175
EBIT	**1,312**	**1,780**	**1,362**	**1,806**	**2,316**
Net interest expense	-71	-272	-168	-191	-151
Non-operating/exceptionals	80	89	100	32	53
Pre-tax profit	**1,320**	**1,597**	**1,294**	**1,648**	**2,218**
Tax	-243	-156	-194	-247	-333
Extraord./Min.Int./Pref.div.	-35	-66	0	0	0
Reported net income	**1,043**	**1,375**	**1,100**	**1,401**	**1,885**
Adjusted earnings	1,043	1,375	1,100	1,401	1,885
Adjusted EBITDA	1,527	2,473	2,149	2,732	3,299
Growth Rates (%)					
Sales	35.6	62.0	1.7	22.9	16.7
EBIT adjusted	36.0	35.7	-23.5	32.6	28.2
EBITDA adjusted	33.7	61.9	-13.1	27.2	20.8
EPS adjusted	33.4	31.9	-20.0	27.3	34.6
Cash Flow (RsM)					
Operating cash flow	**-713**	**986**	**2,633**	**1,432**	**2,107**
Depreciation/amortization	215	693	787	926	983
Net working capital	-1,971	-1,082	746	-895	-761
Investing cash flow	**-1,430**	**-5,224**	**-1,192**	**-660**	**-697**
Capital expenditure	-1,430	-5,224	-1,192	-660	-697
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**2,483**	**3,647**	**-1,508**	**-654**	**-1,008**
Borrowings	1,684	3,835	-1,379	-490	-787
Dividends paid	-142	-142	-129	-164	-221
Change in cash	**339**	**-591**	**-67**	**118**	**403**
Balance Sheet (RsM)					
Total assets	**8,309**	**14,465**	**13,838**	**15,086**	**16,464**
Cash & cash equivalent	647	393	323	438	838
Accounts receivable	908	980	804	1,024	1,216
Net fixed assets	2,853	7,308	7,713	7,448	7,161
Total liabilities	**3,513**	**8,275**	**6,678**	**6,693**	**6,408**
Accounts payable	929	1,850	1,517	1,933	2,293
Total Debt	2,386	6,221	4,841	4,351	3,564
Shareholders' funds	**4,796**	**6,196**	**7,168**	**8,405**	**10,069**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	28.9	28.9	24.7	25.5	26.4
ROE adjusted	26.7	25.0	16.5	18.0	20.4
ROIC adjusted	20.7	17.3	9.7	12.6	15.3
Net debt to equity	36.3	94.1	63.0	46.6	27.1
Total debt to capital	33.2	50.1	40.3	34.1	26.1

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Disappointing 1Q

Figure 1. EKC – Consolidated 1QFY10 Results (Rupees in Millions)

Year to 31-Mar	1QFY09	4QFY09	1QFY10	% yoy	% qoq	Comments
Net Sales	**1,892**	**1,961**	**1,535**	**-18.8%**	**-21.7%**	Negatively impacted by slowdown in Dubai operations (-54% qoq) and continued weakness in domestic demand (-11% qoq)
(Increase)/decrease in stock in trade	(12)	(403)	(30)	156.8%	-92.5%	
Raw material consumed	849	1,492	820	-3.4%	-45.0%	
Staff cost	139	145	175	26.5%	20.6%	
Other expenses	275	315	233	-15.5%	-26.1%	
Forex loss/(gain)	31	(32)	(95)	-411.8%	196.1%	
Total expenditure	1,281	1,517	1,102	-14.0%	-27.3%	
EBITDA	**610**	**444**	**433**	**-29.0%**	**-2.5%**	
EBITDA margin	*32.3%*	*22.6%*	*28.2%*			22% excl. the forex gain; impacted by higher industrial:CNG mix, pricing cuts in India, and low contribution from Dubai
Interest	100	54	37	-62.6%	-30.9%	Total debt o/s down from Rs6.2bn to Rs5.6bn during the quarter; interest costs also down with Libor
Depreciation	121	205	186	54.6%	-9.0%	
Other income	32	12	4	-86.3%	-63.6%	
Profit before tax	421	197	214	-49.3%	8.4%	
Tax	71	(81)	48	-33.3%	-158.9%	
Tax rate	*16.9%*	*-40.9%*	*22.2%*			Lower contribution from Dubai
Profit after tax	**350**	**278**	**166**	**-52.6%**	**-40.2%**	
Minority Interest			2			
Reported PAT			168			

Source: Company Reports, Citi Investment Research and Analysis

Reducing earnings 21-29%

Figure 2 below illustrates our earnings changes over FY10-12E

Figure 2. EKC – earnings revision

Year to	Net Profit (Rs Mils.)		Diluted EPS (Rs)			Dividend Per Share (Rs)	
31-Mar	Old	New	Old	New	% Chg	Old	New
2010E	1,401	1,100	13.18	10.35	-21.5%	1.4	1.1
2011E	1,964	1,401	18.47	13.17	-28.7%	1.9	1.4
2012E	2,573	1,885	24.20	17.73	-26.7%	2.5	1.9

Source: Citi Investment Research and Analysis estimates

The main driver of our earnings cut is lower production numbers across most of the company's plants due to slowdown in demand (see Figure 3). We have also pared our realisation assumptions, though the impact on margins is not very significant as RM costs also decline. We expect demand and volumes to pick up towards the end of the year, which justifies the 27-35% earnings growth we forecast over FY11-12E.

Downgrade to Sell

Our TP of Rs175 remains unchanged despite our earnings cut as we increase our target multiple to 15x (11x earlier), maintaining it at a 10-20% discount to the market multiple. We believe the weak near-term outlook does not support higher valuation multiples, while the robust long-term outlook for CNG conversions does not warrant a higher discount. We would look for more appealing valuations or signs of improvement in demand outlook before recommending investors buy the stock.

Figure 3. EKC – Changes to plant-wise capacity utilization and production assumptions

Year to 31-Mar	old			new		
(no. of cylinders)	**FY10E**	**FY11E**	**FY12E**	**FY10E**	**FY11E**	**FY12E**
Aurangabad						
CNG production	-	-	-	-	-	-
Industrial production	110,000	110,000	110,000	110,000	110,000	110,000
Total production	110,000	110,000	110,000	110,000	110,000	110,000
Capacity	110,000	110,000	110,000	110,000	110,000	110,000
Capacity utilization	*100.00%*	*100.00%*	*100.00%*	*100.00%*	*100.00%*	*100.00%*
Tarapur						
CNG production	96,000	96,000	96,000	96,000	96,000	96,000
Industrial production	64,000	64,000	64,000	64,000	64,000	64,000
Total production	160,000	160,000	160,000	160,000	160,000	160,000
Capacity	160,000	160,000	160,000	160,000	160,000	160,000
Capacity utilization	*100.00%*	*100.00%*	*100.0%*	*100.00%*	*100.00%*	*100.00%*
Dubai						
CNG production	205,800	205,800	205,800	166,600	166,600	176,400
Industrial production	-	-	-	-	-	-
Total production	205,800	205,800	205,800	166,600	166,600	176,400
Capacity	196,000	196,000	196,000	196,000	196,000	196,000
Capacity utilization	*105.00%*	*105.00%*	*105.0%*	*85.00%*	*85.00%*	*90.00%*
Gandhidham (original - CNG/industrial)						
CNG production	163,200	204,000	244,800	163,200	204,000	244,800
Industrial production	40,800	51,000	27,200	40,800	51,000	27,200
Total production	204,000	255,000	272,000	204,000	255,000	272,000
Capacity	340,000	340,000	340,000	340,000	340,000	340,000
Capacity utilization	*60.00%*	*75.00%*	*80.0%*	*60.00%*	*75.00%*	*80.00%*
Gandhidham (new - billet piercing)						
Total production (only industrial)	10,000	60,000	120,000	10,000	40,000	100,000
Capacity	200,000	200,000	200,000	200,000	200,000	200,000
Capacity utilization	*5.00%*	*30.00%*	*60.0%*	*5.00%*	*20.00%*	*50.00%*
Gandhidham (new - jumbo)						
Total production (only jumbo)	250	400	500	350	500	500
Capacity	5,000	5,000	5,000	5000	5000	5000
Capacity utilization	*5.00%*	*8.00%*	10.0%	*7.00%*	*10.00%*	*10.00%*
Gandhidham/Kandla (new - SEZ)						
Total production (only CNG)	-	90,000	120,000	-	75,000	105,000
Capacity	300,000	300,000	300,000	300,000	300,000	300,000
Capacity utilization	*0.00%*	*30.00%*	*40.0%*	*0.00%*	*25.00%*	*35.00%*
China						
CNG production	18,000	40,000	40,000	18,000	30,000	40,000
Industrial production	12,000	40,000	40,000	12,000	30,000	40,000
Total production	30,000	80,000	80,000	30,000	60,000	80,000
Capacity	200,000	200,000	200,000	200,000	200,000	200,000
Capacity utilization	*15.00%*	*40.00%*	40.0%	*15.00%*	*30.00%*	*40.00%*
China (jumbo)						
Total production (only jumbo)	-	-	-	-	-	-
Capacity	5,000	5,000	5,000	5,000	5,000	5,000
Capacity utilization	*0.00%*	*0.00%*	*0.0%*	*0.00%*	*0.00%*	*0.00%*
TOTAL						
CNG production	483,000	635,800	706,600	443,800	571,600	662,200
Industrial production	236,800	325,000	361,200	236,800	295,000	341,200
Jumbo production	250	400	500	350	500	500
Total production	**720,050**	**961,200**	**1,068,300**	**680,950**	**867,100**	**1,003,900**
% change				*-5.43%*	*-9.79%*	*-6.03%*
Capacity	**1,516,000**	**1,516,000**	**1,516,000**	**1,516,000**	**1,516,000**	**1,516,000**
Capacity utilization	***47.50%***	***63.40%***	***70.5%***	***44.92%***	***57.20%***	***66.22%***

Source: Citi Investment Research and Analysis

Everest Kanto Cylinder

Company description

Everest Kanto Cylinder (EKC) is the largest domestic manufacturer of high pressure gas cylinders used for storage of industrial gases and CNG. While the first manufacturing facility (at Aurangabad) was set with Kanto Koatsu Yoki of Japan in 1978, subsequent facilities were built using in-house technology. It now has four manufacturing plants - Aurangabad, Tarapur, Gandhidham, and Dubai - with 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 1.5m cylinders over the next two years.

Investment strategy

We rate the EKC stock Sell/Medium Risk (3M). We believe it is uniquely positioned to capture significant growth potential for high pressure gas cylinders in India, driven largely by rising CNG penetration domestically and abroad. While the long-term outlook remains robust, near-term pressures are impacting the company adversely. Weakening demand from domestic OEMs has impacted India operations, while international operations have been impacted by slowdown in Iran and no pick up in China. While we expect demand to pick up towards the end of the year and are confident of the long-term potential for CNG, we would await signs of a sustained recovery and believe near-term outlook could cloud sentiment on the stock. In addition, increasing competition in the domestic market could cap pricing power and margins.

Valuation

Our 12-month Rs175 target price is based on 15x Sep-10E consolidated earnings, including the contribution from India, Dubai, US-based CPI, and the China plant. Our target multiple remains at 10-20% discount to market multiples, as the near-term outlook is not supportive of higher valuations. Given our positive long-term view on the industry and EKC's better growth trajectory than the broader market (EPS CAGR of 31% over FY10-12E), we do not believe a larger discount is warranted.

Risks

We give a Medium Risk rating to EKC as opposed to the High Risk rating suggested by our quantitative risk rating system given EKC's unique positioning in a market with a robust long-term growth potential. Key upside risks to our target price: 1) Faster than expected recovery in Iran or China; 2) Sharp uptick in CNG conversions in India; 3) Sharp drop in raw material inventory and procurement cost which could boost margins; 4) Return of pricing power as demand picks up; 5) Sharp rupee appreciation.

Appendix A-1

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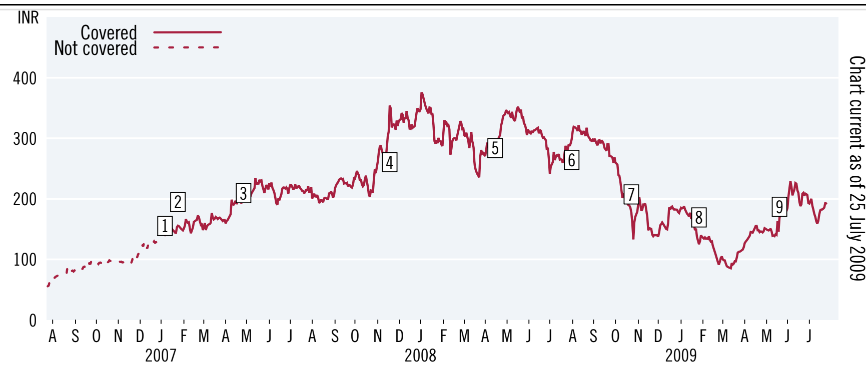
Everest Kanto Cylinder (EKCL.BO)

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	18-Nov-07	1M	*437.00	311.50
5	15-Apr-08	1M	*404.00	288.70
6	31-Jul-08	1M	*365.00	298.50
7	23-Oct-08	1M	*280.00	177.35
8	27-Jan-09	1M	*181.00	125.05
9	20-May-09	1M	*175.00	169.05

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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