

# Kirloskar Oil Engines

**Rs 273**

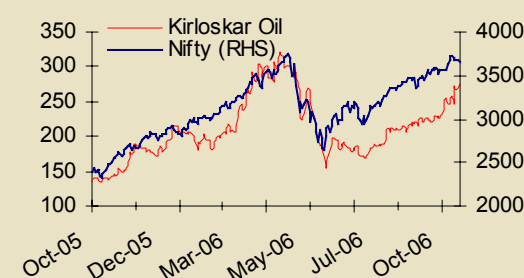
26th Oct 2006

**Revising estimates upwards**
**Buy**

SCRIP DETAILS	
Market Cap (Rs crores)	2,650.8
P/E (x)-FY07(E)	15.3
Market Cap/Sales (x) FY07(E)	1.3
Market Cap/EBITDA (x) FY07(E)	10.5
EV/EBIDTA (x) FY07(E)	8.6
Equity Capital (Rs crores)	19.4
Face Value (Rs)	2.0
52 Week High/Low (Rs)	330/ 130
Website: <a href="http://www.kirloskar.com">www.kirloskar.com</a>	
NSE Code	KIRLOSOIL
Sensex	12698
Nifty	3678

(As on 30th June 2006)	
Promoters	61.02%
Mutual Funds/ Banks/ FIs	18.95%
Foreign	3.66%
Others	0.15%
Public	16.22%

### COMPARATIVE PRICE MOVEMENT



**Kirloskar Oil Engines Ltd (KOEL)** declared its results for the second quarter, much above our expectations;

KOEL has recorded a 45.3% growth in total operating income, from Rs 338.1 crores to Rs 491.2 crores, driven by a 58.4% growth in engine sales, from Rs 258.1 crores to Rs 408.8 crores, medium engines growing 62% YoY and small engines up 77% YoY. The net sales of the auto components segment grew 24.1%, from Rs 26.9 crores to Rs 33.4 crores, which was driven by the capacity addition getting operational. Operating profit has increased 81.2%, from Rs 31.8 crores to Rs 57.5 crores. PAT adjusted for extraordinary items increased 196.2%, from Rs 21.9 crores to Rs 64.8 crores; PAT margins improved, from 6.5% to 13.2%.

**For H1FY07**, total operational income has increased 39.4%, from Rs 665.7 crores to Rs 927.7 crores, driven by a 70.2% YoY-growth in small engines, 58% growth in medium engines, and 25.1% growth in large engines, The auto components segment registered a growth of 17.4%, while exports have increased 13.5%, from Rs 61 crores to Rs 70 crores. Operating profit has increased 64.8%, from Rs 61.1 crores to Rs 100.7 crores and margins have improved 170 bps, from 9.2% to 10.9%, driven by a better product-mix and operational efficiency. Adjusted PAT has increased 141.3%, from Rs 36.6 crores to Rs 88.3 crores; margins improved 400 bps, from 5.5% to 9.5%.

### Engines Segment driving growth

In H1FY07, sales from the engines segment grew 49%, from Rs 506.4 crores to Rs 754.7 crores, while margins improved from 8.6% to 10.3%, leading to a 78%-growth in PBIT, from Rs 43.8 crore to Rs 77.9 crores. Capital employed by the segment increased 24.9%, from 151.6 crores to Rs 189.4 crores and ROCE improved from 57.7% to 82.2%.

For H1FY07, the share of **small engines** in total sales increased to 17.9%, from 15.3% in H1FY06. The sales grew 70.2%, from Rs 102.7 crores to Rs 174.8 crores. The growing demand for Gensets, especially due to the increased growth from the telecom sector and the diesel agricultural market, has stabilised, which fares well for KOEL

The **medium engines** segment recorded a growth of 58% in net sales, from Rs 362.3 crores in H1FY06 to Rs 572.3 crores in H1FY07, increasing its contribution to total sales, from 53.9% to 58.5%. It is also working towards indigenising the 494HP-803HP engines by FY08; currently, the Company sources the engines from Daewoo, Korea.

The **large engines** segment grew 25.1%, from Rs 35.5 crores to Rs 44.4 crores, though its contribution to total sales dipped from 5.3% in H1FY06 to 4.5% in H1FY07. The marine engines order book in this segment is strong and KOEL is negotiating for more such orders, and is likely to see increased contribution from this segment, in the coming years.

### Auto Components Business

In H1FY07, the auto components segment saw a 17.4% growth in revenues, from Rs 53 crores to Rs 62.2 crores. However, margins dropped from 10.7% to 9.2%, leading to a PBIT of Rs 5.7 crores. KOEL has made a strategic decision to reduce its business from after-sales services (involving spares parts) and focus on auto components supply to OEMs. Though currently, profitability in this segment is a little depressed, going ahead, with higher sales from OEMs and as volumes pick up, margins would improve.

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## Financials

In Rs crores	Q2FY07	Q2FY06	Chg (%)	H1FY07	H1FY06	Chg (%)	FY06	FY07(E)	Chg (%)
<b>Net Sales</b>	<b>476.3</b>	<b>327.9</b>	<b>45.3</b>	<b>903.3</b>	<b>645.5</b>	<b>39.9</b>	<b>1,395.3</b>	<b>1,910.0</b>	<b>36.9</b>
Other Operating Income	14.9	10.2	46.2	24.4	20.2	21.0	48.5	60.0	23.8
Total expenditure	433.7	306.4	41.6	827.1	604.6	36.8	1,285.0	1,717.0	33.6
<b>Operating Profit</b>	<b>57.5</b>	<b>31.8</b>	<b>81.2</b>	<b>100.7</b>	<b>61.1</b>	<b>64.8</b>	<b>158.8</b>	<b>253.0</b>	<b>59.3</b>
<i>OPM (%)</i>	<i>11.7</i>	<i>9.4</i>		<i>10.9</i>	<i>9.2</i>		<i>11.0</i>	<i>12.8</i>	
Other Income	29.49	7.34	301.8	31.62	9.27	241.1	16.08	40.00	148.8
Interest	2.91	2.17	34.1	6.58	4.21	56.3	9.74	13.00	33.5
Depreciation	7.44	6.56	13.4	14.88	13.43	10.8	27.98	32.00	14.4
<b>PBT before Extra-ord</b>	<b>76.7</b>	<b>30.4</b>	<b>152.6</b>	<b>110.9</b>	<b>52.7</b>	<b>110.3</b>	<b>137.1</b>	<b>248.0</b>	<b>80.8</b>
<i>PBT (%)</i>	<i>15.6</i>	<i>9.0</i>		<i>11.1%</i>	<i>7.9</i>		<i>9.5</i>	<i>12.6</i>	
Extraordinary Items		108.8			108.8		108.8		
PBT (reported)	76.7	139.2	-44.9	110.9	161.5	-31.4	246.0	248.0	0.8
PAT - reported	64.8	130.7	-50.4	88.3	145.4	-39.3	200.6	173.0	-13.8
<b>PAT (adj. For extraord)</b>	<b>64.8</b>	<b>21.9</b>	<b>196.2</b>	<b>88.3</b>	<b>36.6</b>	<b>141.3</b>	<b>91.8</b>	<b>173.0</b>	<b>88.5</b>
<i>PAT (%)</i>	<i>13.2</i>	<i>6.5</i>		<i>9.5</i>	<i>5.5</i>		<i>6.4</i>	<i>8.8</i>	
Equity Share capital	19.4	19.4		19.4	19.4		19.4	19.4	
EPS (Rs) reported	6.7	13.5	-50.4	9.1	15.0	-39.3	20.7	17.8	-13.8
<b>Adj. EPS (Rs)</b>	<b>6.7</b>	<b>2.3</b>	<b>196.2</b>	<b>9.1</b>	<b>3.8</b>	<b>141.3</b>	<b>9.5</b>	<b>17.8</b>	<b>88.3</b>

Segment Revenue	Q2FY07	Q2FY06	Chg (%)	H1FY07	H1FY06	Chg (%)
Engines	408.8	258.1	58.4	754.7	506.4	49.0
<i>% of Total</i>	<i>81.1</i>	<i>74.1</i>		<i>79.2</i>	<i>73.8</i>	
Auto Component	33.4	26.9	24.1	62.2	53.0	17.4
<i>% of Total</i>	<i>6.6</i>	<i>7.7</i>		<i>6.5</i>	<i>7.7</i>	
Others	62.1	63.5	-2.2	135.7	127.1	6.8
<i>% of Total</i>	<i>12.3</i>	<i>18.2</i>		<i>14.2</i>	<i>18.5</i>	
<b>Total</b>	<b>504.3</b>	<b>348.5</b>		<b>952.7</b>	<b>686.5</b>	
<b>Less Inter segment</b>	<b>13.1</b>	<b>10.4</b>	<b>25.5</b>	<b>24.9</b>	<b>20.8</b>	<b>19.7</b>
<b>Net Sales</b>	<b>491.2</b>	<b>338.1</b>	<b>45.3</b>	<b>927.7</b>	<b>665.7</b>	<b>39.4</b>
<b>PBIT</b>						
Engines	42.0	22.7	84.9	77.9	43.8	78.0
<i>Segment Margin (%)</i>	<i>10.3</i>	<i>8.8</i>		<i>10.3</i>	<i>8.6</i>	
Auto Component	4.1	3.1	34.1	5.7	5.7	1.4
<i>Segment Margin (%)</i>	<i>12.2</i>	<i>11.3</i>		<i>9.2</i>	<i>10.7</i>	
Others	6.6	1.6	316.4	7.6	1.9	301.1
<i>Segment Margin (%)</i>	<i>10.7</i>	<i>2.5</i>		<i>5.6</i>	<i>1.5</i>	
<b>Total</b>	<b>52.7</b>	<b>27.4</b>	<b>92.7</b>	<b>91.2</b>	<b>51.3</b>	<b>77.8</b>
Capital Employed						
Engines	189.4	151.6	24.9	189.4	151.6	24.9
<i>ROCE (%)</i>	<i>88.7</i>	<i>59.9</i>		<i>82.2</i>	<i>57.7</i>	
Auto Component	78.9	48.7	62.1	78.9	48.7	62.1
<i>ROCE (%)</i>	<i>20.7</i>	<i>25.1</i>		<i>14.5</i>	<i>23.2</i>	
<b>Total</b>	<b>878.2</b>	<b>773.7</b>	<b>13.5</b>	<b>878.2</b>	<b>773.7</b>	<b>13.5</b>
<i>ROCE (%)</i>	<i>24.0</i>	<i>14.1</i>		<i>20.8</i>	<i>13.3</i>	

### Second quarter results beat expectations

KOEL has recorded a 45.3% growth in **total operating income**, from Rs 338.1 crores to Rs 491.2 crores, driven by a 58.4% growth in engine sales, from Rs 258.1 crores to Rs 408.8 crores, medium engines growing 62% YoY and small engines up 77% YoY. The net sales of the auto components segment grew 24.1%, from Rs 26.9 crores to Rs 33.4 crores, which was driven by the capacity addition getting operational.

**Operating profit** has increased 81.2%, from Rs 31.8 crores to Rs 57.5 crores. Operating profit margins have improved 230 bps, from 9.4% to 11.7%; although raw material cost as a percentage of net sales increased 80 bps, it was more than offset by the 170 bps-improvement in other expenses as a percentage of net sales, from 13.4% to 11.7%, and a 150 bps-improvement in staff cost as a percentage of net sales, from 6.6% to 5.1%.

Interest cost increased 34.1%, from Rs 2.2 crores to Rs 2.9 crores, while depreciation increased 13.4%, from Rs 6.6 crores to Rs 7.4 crores. Other income increased 301.8%, from Rs 7.3 crores to Rs 29.5 crores, leading to a 152.6% growth in PBT before extraordinary items, at Rs 76.7 crores, from Rs 30.4 crores. **PAT** adjusted for extraordinary items increased 196.2%, from Rs 21.9 crores to Rs 64.8 crores; PAT margins improved, from 6.5% to 13.2%.

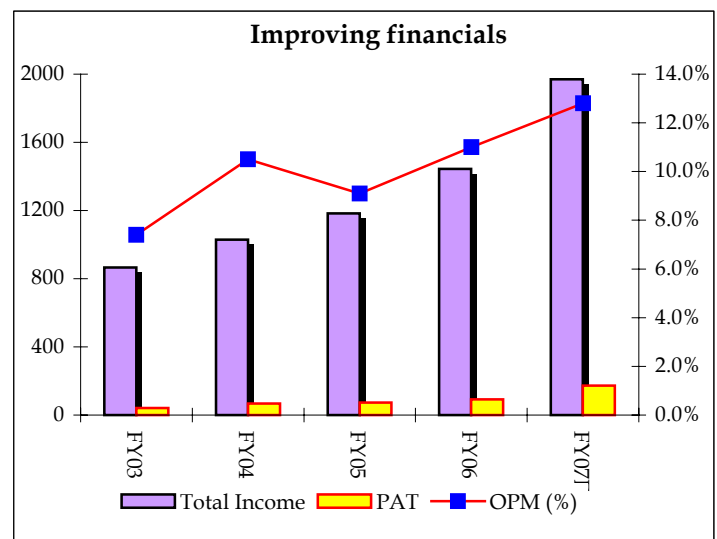
**For H1FY07**, total operational income has increased 39.4%, from Rs 665.7 crores to Rs 927.7 crores, driven by a 70.2% YoY-growth in small engines, from Rs 102.7 crores to Rs 174.8 crores, 58% growth in medium engines, from Rs 362.3 crores to Rs 572.3 crores, and 25.1% growth in large engines, from Rs 35.5 crores to Rs 44.4 crores. The auto components segment registered a growth of 17.4%, while exports have increased 13.5%, from Rs 61 crores to Rs 70 crores.

**Operating profit** has increased 64.8%, from Rs 61.1 crores to Rs 100.7 crores and margins have improved 170 bps, from 9.2% to 10.9%, driven by a better product-mix and operational efficiency. Raw materials cost as a percentage of net sales increased 90 bps, from 70.7% to 71.6%; however, other expenses as a percentage of net sales improved 120 bps, from 13.3% to 12.1%, and staff cost as a percentage of net sales improved 150 bps, from 6.9% to 5.4%.

Though interest cost increased 56.3%, from Rs 4.2 crores to Rs 6.6 crores, the 241.1% increase in other income, from Rs 9.3 crores to Rs 31.6 crores, helped. Depreciation increased 10.8%, from Rs 13.4 crores to Rs 14.9 crores. PBT before extraordinary items increased 110.3%, from Rs 52.7 crores to Rs 110.9 crores. In H1FY06, there was extraordinary income of Rs 97.5 crores, on account of profit on sale of shares of Cummins and Rs 11.34 crores being arrears of dividend. **Adjusted PAT** has increased 141.3%, from Rs 36.6 crores to Rs 88.3 crores; margins improved 400 bps, from 5.5% to 9.5%.

KOEL declared its Q2 results much above our expectations; and accordingly, we have upgraded our earnings estimates. For FY07(E), we expect KOEL to post total operating income of Rs 1,970, up 36.4%, from Rs 1,443.8 crores in FY06, operating profit of Rs 253 crores, up 59.3%, from Rs 158.8 crores, in FY06 and PAT of Rs 173 crores, up 88.5%, from Rs 91.8 crores. Thus, we revise our earlier FY07(E) EPS estimate, from Rs 14 to Rs 17.8.

The Company has increased its **focus on exports** and is targeting its export earnings at 50% of total revenue in the next 4 to 5 years, as against 10% now. We expect the Company to achieve exports of Rs 210 crores in FY07(E), compared to 132 crores in FY06. The Company is planning to set up an export-oriented unit to manufacture engine valves, with a capital outlay of Rs 60 crores. It also plans to set up a greenfield engines plant at Kolhapur, in Maharashtra, with a capital outlay of Rs 400 crores.



## Valuation and Conclusion

All the key sectors that KOEL supplies to, i.e. farm equipment, tractors, power generation, construction and industrial machinery, are growing, while going forward the strong demand from manufacturing sector and the automobile sector-boom would keep the growth momentum intact. The engines segment would be the key revenue driver for the Company; while small and medium engines continue to drive growth, large engines would also contribute, in the years to come, and also help improve profitability. The Company has been giving increased thrust to cost efficiency and we expect it to see better margins, going ahead.

For FY07, we expect the Company to post a growth of 36.4% in operating income, to Rs 1,970 crores and a 180 bps-improvement in operating margins, resulting in a 59.3%-rise in operating profits, to Rs 253 crores. PAT is expected to be Rs 173 crores, compared to Rs 91.8 crores (adjusted), a growth of 88.5%, resulting in an EPS of Rs 17.8.

At the CMP of Rs 273, the stock is trading at a P/E of 15.3x its FY07(E) EPS of Rs 17.8 and at EV/ EBITDA of 8.6x. Also, the Company has cash and cash equivalent of nearly Rs 57 a share. The stock offers tremendous value at the current levels; we maintain our Buy, with a medium to long-term perspective.

**WAY2WEALTH** Research

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