RESULT UPDATE

Ruchir Khare
ruchir.khare@kotak.com
+91 22 6218 6431

MAHARASHTRA SEAMLESS LTD (MSL)

PRICE: RS.447 RECOMMENDATION: BUY
TARGET PRICE: RS.560 FY19E PE: 11.5X

MSL Q2FY18 PAT declined 12.5% YY despite significant growth in revenue due to execution of low margin legacy orders. EBITDA margin contracted YY due to 1/ booking of low margin legacy orders and 2/ high base of Q2FY17.

We consider that this is a quarterly aberration and maintain our FY19 earnings estimate. We believe that MSL valuations can get rerated on back of strong growth in company's estimated consolidated profits through FY17-19E driven by 1) recovery in demand for seamless pipes in the domestic/international market and 2) imposition of anti-dumping duty on Chinese imports would lead to demand shifting towards domestic industry and 3) limited competition from domestic players who are struggling with their highly leveraged balance sheets.

We value MSL stock at 9x EV/EBITDA FY19E earnings and maintain BUY with an unchaged target price of Rs 560 per share.

Summary table

(Rs mn)	FY17	FY18E	FY19E
Sales	14,342	20,056	25,590
Growth (%)	41	40	28
EBITDA	2,249	2,808	4,453
EBITDA margin (%)	15.7	14.0	17.4
PBT	1961	2408	3993
Net profit	1,156	1,565	2,595
EPS (Rs)	17.3	23.4	38.7
Growth (%)	(575.8)	35.4	65.8
CEPS (Rs)	27.8	34.6	50.5
BV (Rs/share)	409.9	429.9	465.0
DPS (Rs)	2.5	2.8	3.0
ROE (%)	4.3	5.6	8.7
ROCE (%)	2.1	3.3	5.8
Net cash (debt)	(2,478)	(2,690)	(2,335)
NW Capital (Days)	210.6	189.6	174.2
EV/Sales (x)	2.2	1.6	1.2
EV/EBITDA (x)	14.1	11.3	7.1
P/E (x)	25.9	19.1	11.5
P/Cash Earnings (x)	16.1	12.9	8.8
P/BV (x)	1.1	1.0	1.0

Source: Company, Kotak Securities – Private Client Research

Consolidated Result

(Rs mn)	Q2FY18	Q2FY17	YoY %	Q1FY18	QoQ
Income from Operations	**4839.7**	**3048.7**	**58.7**	**4502.9**	**7.5**
Decrease/ (Increase) in stock	(200.0)	11.2	(1885.7)	-267.2	(25.1)
Material consumed	3496.6	1874.5	86.5	3192.7	
Purchase of traded goods	0.0	0.0		4.4	(100.0)
Employee expenses	161.1	118.7	35.7	153.9	4.7
Other expenses	781.7	450.0	73.7	811.2	(3.6)
Total expenditure	4239.4	2454.4	72.7	3895.0	8.8
EBITDA	**600.3**	**594.3**	**1.0**	**607.9**	**(1.3)**
Other income	150.7	193.0	(21.9)	175.6	(14.2)
Depreciation	186.3	174.5	6.8	179.9	
EBIT	**564.7**	**612.8**		**603.6**	
Finance cost	22.2	12.5	77.6	20.6	7.8
PBT	**542.5**	**600.3**	**(9.6)**	**583.0**	**(6.9)**
Exceptional items	0.0	0.0		0.0	
Reported PBT	542.5	600.3	(9.6)	583.0	(6.9)
Total tax	202.8	212.0	(4.3)	210.6	(3.7)
PAT	**339.7**	**388.3**	**(12.5)**	**372.4**	**(8.8)**
Adjusted PAT	339.7	388.3	(12.5)	372.4	(8.8)
EPS Adjusted	**5.1**	**5.8**	**(12.5)**	**5.6**	**(8.8)**
EBITDA (%)	12.4	19.5		13.5	
Tax Rate (%)	37.4	35.3		36.1	
RM/Sales	68.1	61.9		65.1	

Source: Company, Kotak Securities – Private Client Research

Result Highlights

MSL revenue stood at Rs 4.8 Bn in Q2FY18 (+58.7% YY, numbers not comparable strictly due to change in indirect taxes from excise to GST) driven mainly by seamless pipes and ERW pipes division.

Standalone steel pipes & tubes (seamless pipes & ERW pipes) sales stood at Rs 4.7 Bn (+43.9% YY; flat QQ). Our positive outlook on this division is predicated upon the potential increase in capex by major oil companies in India. We note that New Exploration Licensing policy (NELP) and Hydrocarbon Exploration Policy (HELP), has emphasized on maximizing the domestic exploration of oil and gas to attain self-sufficiency by 2022. We believe that this augers well for company's business as it would entail huge capital expenditure of over Rs 2.3 trillion through FY17-20 by major Hydrocarbon companies, thereby generating good demand for company's products. Seamless pipes constitutes to nearly 8-11% of overall capex incurred by upstream/downstream companies.

Further, we believe that MSL would benefit disproportionately over FY18-20 on back of 1/ imposition of anti-dumping duty on Chinese imports restricting major competition and 2/ limited competition from domestic players who are struggling with their highly leveraged balance sheets. We believe that this has positioned MSL in near monopoly situation for next few years.

EBIT margins in Steel pipes & tubes division contracted sharply YY to 7.7% in Q2FY18 vis-à-vis 11.3% in Q2FY17 due to execution of low margin legacy orders. We note that MSL business suffered severely between FY12-16 due to dumping of cheap products by Chinese players into Indian markets. Execution of these orders will have dampening effect on company's margins. Since most of the orders are short cycle in nature, we assume that these orders would not last into FY19. We therefore consider Q2FY18 margins as quarterly aberration and maintain our FY19 revenue/operating margin estimate.

Segment reporting (Consolidated)

	Q2FY18	Q2FY17	YoY (%)	Q1FY18	QoQ (%)
Segment Revenues (Rs mn)					
Steel pipes & tubes	4769.6	3313.6	43.9	4765.2	0.1
Power-Electricity	70.1	60.8	15.3	50	40.2
Segment EBIT (Rs mn)					
Steel pipes & tubes	368.4	373.8	(1.4)	400.8	(8.1)
Power-Electricity	45.7	45.9	(0.4)	27.3	67.4
EBIT (%)					
Steel pipes & tubes	7.7	11.3		8.4	
Power-Electricity	65.2	75.5		54.6	

Source: Company, Kotak Securities – Private Client Research

Power division reported 44% YY revenue growth at Rs 70.1 mn (+15.3% YY) and EBIT at Rs 45.7 mn. MSL owns 7 MW wind power capacity in Satara, Maharashtra (commissioned with total cost of c.Rs 360 mn in 2001). Further, the company has also set up a 5MW solar Power Plant in Pokaran, District Jaisalmer Rajasthan. The project was allotted to the company under Jawaharlal Nehru National Solar Mission (JNNSM) of the Govt. of India (in total MSL commissioned 20 MW solar power plant in Rajasthan

Increase in oil prices could boost value of oil rigs

Oil prices have risen c.40% in last three months. MSL has invested in six oil rigs (out of which 3 are currently deployed). We believe that with increasing trend in crude price, MSL would likely find demand for its remaining three oil rigs. This could also lead to the increase in net asset value of these oil rigs (Note, we do not account for the value of these assets in our valuation model).

High growth in revenue/PAT to flow into FY18/FY19; recovery in operating margins likely to aid to free cash flow generation

We project 33.5% CAGR between FY17-19 in consolidated revenues from Rs.14.3 Bn in FY16 to Rs 25.5 Bn in FY19E. We note that Seamless pipes sales volume has gained traction in the last few quarters. Within the revenue stream, we expect seamless pipes divisions to report growth at 32.3% CAGR between FY17-19 from Rs 10.9 Bn in FY14 to Rs 19.1 Bn in FY19E. We expect ERW division to grow at 19% CAGR in the same period from Rs 2.9 Bn in FY17 to Rs 40.7 Bn in FY19E.

We expect EBITDA margins to expand in FY19E on back of improved pricing (aided by limited competition) and operating leverage. In our projections, we build EBITDA margin at 17.4% in FY19E (lower FY18 EBITDA margin to 14%, set in line with 1HFY18 reported financials). We project ROE to improve to 8.7% in FY19 from 4.3% in FY17. Note that ROE appears to be depressed due to higher level of investments (c.35% of total assets currently) held by the company. Adjusted for this, ROE would stand at 9.6%/16.1% in FY17/FY19.

Valuation and Recommendation

At current price of Rs.447, MSL stock is trading at 11.5x P/E and 7.1x EV/EBITDA on FY19E earnings.

We maintain BUY on Maharashtra Seamless Ltd with a price target of Rs.560

We value MSL stock at 9x EV/EBITDA FY19E earnings and arrive at a target price of Rs 560. In view of adequate upside to our target price we maintain 'BUY' rating on company's stock.

Valuation

EBITDA FY19	4452.6
EV/EBITDA (x)	9
Enterprise Value (E) mn	40073.8
Add: Investments, intercompany deposits, cash & FDs	3921.4
less Gross debt	6399.80
Target Market Cap	37595.45
Target Price (Rs)	**560**

Source: Kotak-PCG Research

Note: MSL has Rs 11.7 Bn worth of investments JVs/associate companies which are not contributing to cash flows as of now. We are not taking value of these investments into our valuation model. Monetization/deployment of these assets (mainly coal mines and6 oil rigs) could add to further upside to our target price.

Rating Scale

Definitions of ratings

BUY	–	We expect the stock to deliver more than 12% returns over the next 9 months
ACCUMULATE	–	We expect the stock to deliver 5% - 12% returns over the next 9 months
REDUCE	–	We expect the stock to deliver 0% - 5% returns over the next 9 months
SELL	–	We expect the stock to deliver negative returns over the next 9 months
NR	–	Not Rated. Kotak Securities is not assigning any rating or price target to the stock. The report has been prepared for information purposes only.
RS	–	Rating Suspended. Kotak Securities has suspended the investment rating and price target for this stock, either because there is not a Sufficient fundamental basis for determining, or there are legal, regulatory or policy constraints around publishing, an investment rating or target. The previous investment rating and price target, if any, are no longer in effect for this stock and should not be relied upon.
NA	–	Not Available or Not Applicable. The information is not available for display or is not applicable
NM	–	Not Meaningful. The information is not meaningful and is therefore excluded.
NOTE	–	Our target prices are with a 9-month perspective. Returns stated in the rating scale are our internal benchmark.

Fundamental Research Team

Sanjeev Zarbade
Capital Goods, Engineering
sanjeev.zarbade@kotak.com
+91 22 6218 6424

Ruchir Khare
Capital Goods, Engineering
ruchir.khare@kotak.com
+91 22 6218 6431

Amit Agarwal
Logistics, Paints, Transportation
agarwal.amit@kotak.com
+91 22 6218 6439

Nipun Gupta
Information Technology
nipun.gupta@kotak.com
+91 22 6218 6433

K. Kathirvelu
Production
k.kathirvelu@kotak.com
+91 22 6218 6427

Teena Virmani
Construction, Cement
teena.virmani@kotak.com
+91 22 6218 6432

Ritwik Rai
FMCG, Media
ritwik.rai@kotak.com
+91 22 6218 6426

Jatin Damania
Metals & Mining
jatin.damania@kotak.com
+91 22 6218 6440

Jayesh Kumar
Economy
kumar.jayesh@kotak.com
+91 22 6218 5373

Arun Agarwal
Auto & Auto Ancillary
arun.agarwal@kotak.com
+91 22 6218 6443

Sumit Pokharna
Oil and Gas
sumit.pokharna@kotak.com
+91 22 6218 6438

Pankaj Kumar
Midcap
pankajr.kumar@kotak.com
+91 22 6218 6434

Ashini Shah
Midcap
ashini.shah@kotak.com
+91 22 6218 5438

Technical Research Team

Shrikant Chouhan
shrikant.chouhan@kotak.com
91 22 6218 5408

Amol Athawale
amol.athawale@kotak.com
+91 20 6620 3350

Derivatives Research Team

Sahaj Agrawal
sahaj.agrawal@kotak.com
+91 79 6607 2231

Malay Gandhi
malay.gandhi@kotak.com
+91 22 6218 6420

Prashanth Lalu
prashanth.lalu@kotak.com
+91 22 6218 5497

Prasenjit Biswas, CMT
prasenjit.biswas@kotak.com
+91 33 6625 9810

Disclosure/Disclaimer