

13 November 2018

KNR Construction

Revenue growth contained; future bright, though; retaining a Buy

Rating: **Buy**

Target Price: ₹269

Share Price: ₹190

Its constrained OB being executed finally showed up in this quarter. KNR's revenue growth was muted and earnings slid. This does not raise any grave concerns as growth would return once its hybrid annuity portfolio is "appointed" (four expected shortly). We see inspiring growth in FY20 to make good the expected subdued revenue growth in FY19. It's heartening to see a further shortening of the cash-conversion cycle; at 25 days it is indeed among the best and clearly exemplifies a sound business strategy at work. A well-set balance sheet, proven execution capabilities and de-risking efforts for its hybrid annuity portfolio support our preference for KNR. We retain our Buy rating on the stock.

Excl. HAM, OB weak; urgently need appointed dates for HAM. There was order accretion of ~₹2.7bn in Q2. But, like Q1, it was no new order but change in scope of work in existing orders. With this, the 30th Sep'18 OB excl. HAM was ~₹18bn (0.9x book-to-bill). Incl. HAM, the revenue potential is ~₹58bn (2.9x book-to-bill).

Shorter working capital takes net debt down. Though gross debt, at ~₹2.4bn, is largely the same, the shorter cash-conversion cycle (at 25 days now, from 30 at Q1-end and 40 at Q4FY18-end) is the sole reason for net debt declining to ~₹0.7bn. The 30th Sep'18 gross debt of ~₹2.4bn includes ~₹2.1bn of promoter exposure.

HAM monetisation – negotiations underway. The talks are at advanced stages. Management highlights that due diligence is largely done. Negotiation and legal work is underway; thus, it hopes to make an announcement soon on the transaction. It is trying to match closure of this transaction with financial closure.

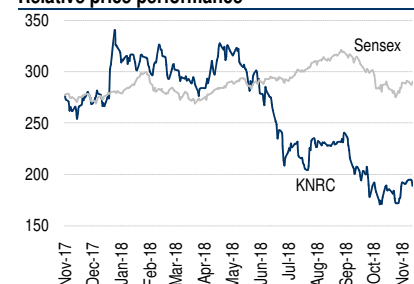
Valuation. As estimates have been adjusted for the higher H1 FY19 margins and as we build some delay in the appointed date for one hybrid annuity project, FY19e earnings are up ~1% but for FY20 down ~5%. At the CMP, the stock trades at (excl. BOT) 5.1x FY20e EV/EBITDA. **Risk.** Slower-than-expected project execution.

Key data	KNRC IN / KNRL.BO
52-week high / low	₹349 / 163
Sensex / Nifty	35,144 / 10,583
3-m average volume	\$0.5m
Market cap	₹26.7bn / \$368m
Shares outstanding	141m

Shareholding pattern (%)	Sep'18	Jun'18	Mar'18
Promoters	55.4	55.4	55.4
- of which, Pledged	-	-	-
Free float	44.6	44.6	44.6
- Foreign institutions	3.4	3.3	3.8
- Domestic institutions	29.5	28.9	29.4
- Public	11.8	12.5	11.4

Estimates revision (%)	FY19e	FY20e
Sales	-5.8	-3.6
EBITDA	2.5	-1.3
EPS	0.6	-5.3

Relative price performance



Source: Bloomberg

Key financials (YE Mar)	FY16	FY17	FY18	FY19e	FY20e
Sales (₹ m)	9,025	15,411	19,317	19,423	27,177
Net profit (₹ m)	1,611	1,681	2,721	1,813	2,254
EPS (₹)	11.5	12.0	19.3	12.9	16.0
Growth (%)	120.6	4.4	61.8	-33.4	24.3
PE (x)	8.9	15.1	14.7	14.7	11.8
EV / EBITDA (x)	10.0	11.4	10.7	7.8	6.5
PBV (x)	1.9	2.8	3.4	2.0	1.7
RoE (%)	24.9	13.3	24.4	20.6	15.7
RoCE (%)	19.4	21.6	26.1	17.8	21.2
Net debt / equity (x)	0.1	0.1	0.1	0.1	0.1

Source: Company, Anand Rathi Research

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Quick Glance – Financials and Valuations

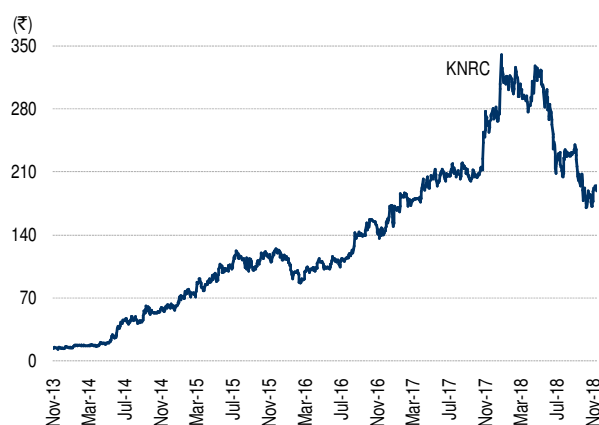
Fig 1 – Income statement (₹ m) - standalone

Year-end: Mar	FY16	FY17	FY18	FY19e	FY20e
Order inflows	30,305	18,379	4,723	60,000	30,000
Order backlog	34,635	37,689	23,266	63,943	66,866
Net revenues	9,025	15,411	19,317	19,423	27,177
Growth (%)	3.0	70.7	25.3	0.6	39.9
Direct costs	6,787	12,248	14,297	14,608	21,391
SG&A	710	867	1,158	1,242	1,426
EBITDA	1,529	2,296	3,861	3,572	4,360
EBITDA margins (%)	16.9	14.9	20.0	18.4	16.0
Depreciation	423	639	1,341	1,527	1,497
Other income	317	303	393	314	340
Interest expenses	132	219	231	329	385
PBT	1,291	1,741	2,682	2,030	2,817
Effective tax rate (%)	-24.7	3.4	-1.5	10.7	20.0
+ Associates / (Minorities)	-	-	-	-	-
Net income	1,611	1,573	2,721	1,813	2,254
Adjusted income	1,611	1,681	2,721	1,813	2,254
WANS	141	141	141	141	141
FDEPS (₹ / sh)	11.5	12.0	19.4	12.9	16.0

Fig 3 – Cash-flow statement (₹ m) - standalone

Year-end: Mar	FY16	FY17	FY18	FY19e	FY20e
PBT + Net interest expense	1,106	1,657	2,520	2,045	2,862
+ Non-cash items	423	639	1,341	1,527	1,497
Oper. prof. before WC	1,529	2,296	3,861	3,572	4,360
- Incr. / (decr.) in WC	1,376	315	2,182	-521	1,266
Others incl. taxes	-273	121	194	305	873
Operating cash-flow	426	1,860	1,486	3,788	2,221
- Capex (tang. + intang.)	621	1,408	2,040	1,200	1,400
Free cash-flow	-195	452	-555	2,589	821
Acquisitions	-	-	-	-	-
- Div. (incl. buyback & taxes)	68	-	85	84	84
+ Equity raised	-	-	-	-	-
+ Debt raised	157	-169	171	-23	-67
- Fin investments	119	239	-278	1,910	1,236
-Net interest expense + Misc.	-229	-41	-382	-72	-264
Net cash-flow	4	86	192	643	-302

Source: Company, Anand Rathi Research

Fig 5 – Price movement


Source: Bloomberg

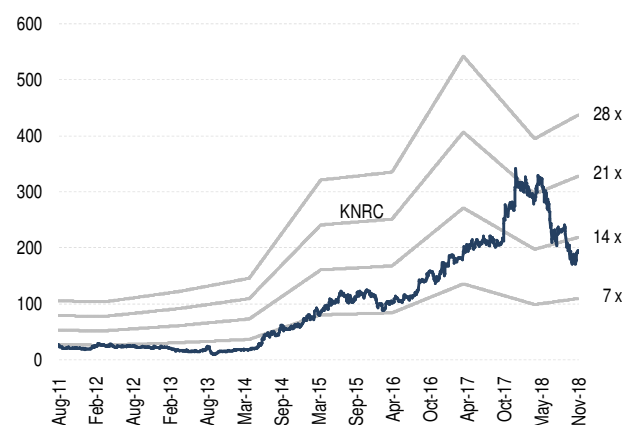
Fig 2 – Balance sheet (₹ m) - standalone

Year-end: Mar	FY16	FY17	FY18	FY19e	FY20e
Share capital	281	281	281	281	281
Net worth	7,377	8,955	11,578	13,307	15,476
Debt	1,167	1,441	2,204	2,408	2,389
Minority interest	-	-	-	-	-
DTL / (Assets)	-374	-815	-1,408	-1,635	-1,683
Capital employed	8,172	9,580	12,375	14,080	16,182
Net tangible assets	2,408	3,222	3,934	3,608	3,511
Net intangible assets	0	0	2	1	1
Goodwill	-	-	-	-	-
CWIP (tang. & intang.)	59	15	0	-	-
Investments (strategic)	432	271	396	2,306	3,542
Investments (financial)	3	403	-	-	-
Current assets (ex cash)	9,053	11,152	13,444	14,207	17,646
Cash	161	246	438	1,082	780
Current liabilities	3,946	5,729	5,839	7,124	9,296
Working capital	5,107	5,422	7,604	7,084	8,349
Capital deployed	8,172	9,580	12,375	14,080	16,182
Contingent liabilities	478	462	555	-	-

Fig 4 – Ratio analysis

Year-end: Mar	FY16	FY17	FY18	FY19e	FY20e
P/E (x)	8.9	15.1	14.7	14.7	11.8
EV / EBITDA (x)	10.0	11.4	10.8	7.8	6.5
EV / sales (x)	1.7	1.7	2.2	1.4	1.0
P/B (x)	1.9	2.8	3.4	2.0	1.7
RoE (%)	24.9	13.3	24.4	20.6	15.7
RoCE (%)	19.4	22.1	26.5	17.8	21.2
Sales / FA (x)	3.7	4.8	4.9	5.4	7.7
DPS (₹ / sh)	0.2	-	0.5	0.5	0.5
Dividend yield (%)	0.2	-	0.2	0.3	0.3
Dividend payout (%) - incl. DDT	2.1	-	3.1	4.7	3.7
Net debt / equity (x)	0.1	0.1	0.2	0.1	0.1
Receivables (days)	52.3	38.8	43.8	54.7	54.8
Inventory (days)	14.3	13.6	13.5	15.9	17.4
Payables (days)	45.3	33.8	41.3	28.2	29.8
CFO : PAT %	26.5	110.6	54.6	209.0	98.6

Source: Company, Anand Rathi Research

Fig 6 – PE band


Source: Company

Concall highlights

Income statement

- The effectively constrained order backlog being executed showed up in the financial performance. Consequently, revenue growth was restrained at ~6% y/y (to ~₹4.2bn). The positive from the Q2 revenue performance is the pace of OB conversion; at ~21% on the opening OB of ~₹19.8bn for Q2, this implies that the pace of execution is healthy.
- With the Q2 ~20% EBITDA margin, the company delivered positively surprising margins for a sixth straight quarter. The greater share of higher-margin work at irrigation projects and cost adjustments for a couple of nearing-completion road projects helped the core healthy operating margins. Management does not see the reported margin as sustainable and identifies a sustainable core margin at ~14-15%.
- Constrained growth in operating profitability (of ~1%) was further weighed down by higher finance costs (up 74% y/y) and depreciation (up ~67%). Consequently, earnings declined ~24% y/y to ~₹450m. Had it not been for higher other income (on the higher cash balance), earnings could have been even lower. Depreciation was higher on an accelerated charge for irrigation equipment (used in three shifts).

Fig 7 – Financial highlights

YE: Mar (₹ m)	Q2 FY18	Q2 FY19	% Y/Y	Q2 FY18	% Q/Q	H1 FY18	H1 FY19	% Y/Y
Sales	3,933	4,163	5.8	5,564	-25.2	8,741	9,726	11.3
EBITDA	825	831	0.8	1,099	-100.0	1,670	1,930	15.6
<i>EBITDA margins (%)</i>	<i>21.0</i>	<i>20.0</i>	<i>-100bps</i>	<i>19.7</i>	<i>23bps</i>	<i>19.1</i>	<i>19.8</i>	<i>74bps</i>
Interest	43	74	74.4	72	3.2	95	146	54.7
Depreciation	235	393	66.9	360	9.1	479	753	57.1
Other income	27	88	227.5	178	-50.4	149	266	77.8
PBT	574	453	-21.1	844	-46.4	1,246	1,297	4.1
Tax	-17	3	-115.8	104	-97.5	-20	107	-622.8
PAT	591	450	-23.8	740	-39.2	1,267	1,190	-6.0

Source: Company

Guidance and growth prospects

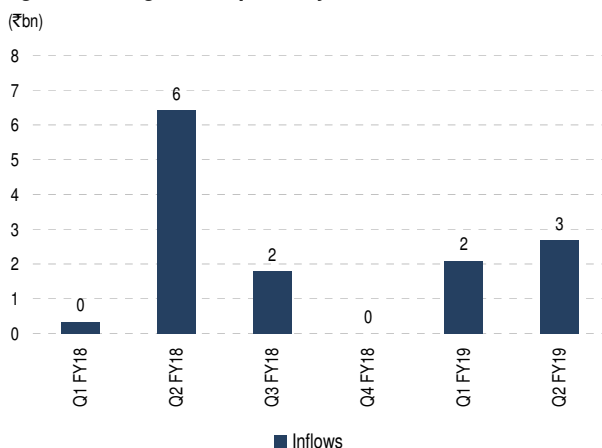
- Management guided to FY19 revenues of ~₹18bn-19bn, but with potential. In the guided-to revenues, it expects the four NHAI hybrid annuity projects to contribute ~₹2bn-2.5bn.
- With work expected to commence by end-FY19 on the entire HAM portfolio and as efforts would continue toward addressing issues with some of the slow-moving orders, management sees ₹23bn+ revenues as possible in FY20 (lowered from ₹25bn+ guided to earlier). Any new orders could help to a better than guided to revenue in FY20.
- Management envisages a 14-15% EBITDA margin as sustainable. It highlights that the recent higher-than-guided-to margin is a result of execution of higher-margin jobs at irrigation projects (gradually inching into jobs with slightly lower margins) and cost adjustments for a couple of nearing-completion projects.
- The FY19 tax-rate guidance of 8-10% is due to deferred tax benefits for capex.

- On capex, it has already incurred capex of ~₹0.85bn from the total guided-to figure of ~₹1.3bn. For FY20, it expects a similar figure.
- On equity infusion, in accordance with the terms of the sanctioned financial closure, it would have to infuse ~₹2bn of the equity required in FY19 (provided appointed dates for the four NHAI projects come through).
- Management alludes to the fact that awarding has been sluggish year-to-date, as the NHAI awaits closure of the recently-awarded projects. But hopes it would pick up shortly. It highlights that its appetite is tilted toward EPC projects though it could look at HAM projects. It is targeting inflows of ~₹20bn-25bn in the next 3-4 months.
- It also looks to gradually diversify into urban infrastructure, flyovers, elevated metro-rail and the railways segment to broad-base, de-risk and diversify its opportunity landscape. It is also looking at mining orders as an alternative for its equipment bank for irrigation projects.

Order backlog

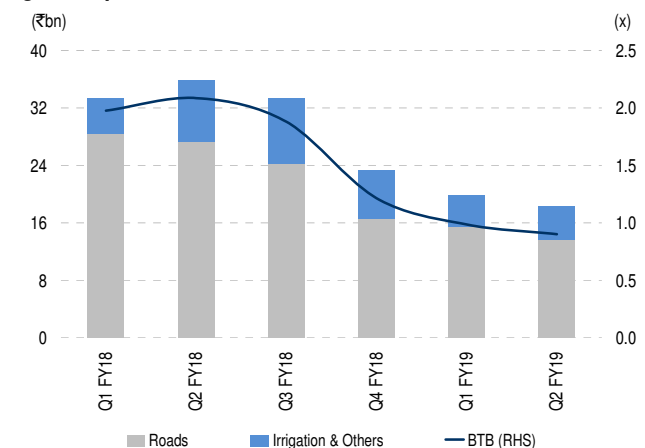
- The company ended Q2 FY19 with an order backlog of ~₹18.3bn. It picked up no orders during the quarter but the change in scope of work across number of projects contributed ~₹2.7bn. The Q2-end OB implies a book-to-bill of ~0.9x on TTM sales. The OB excludes hybrid annuity projects, which, accounted for, boosts the order backlog to ~₹58.1bn, which implies a book-to-bill of 2.9x TTM sales.
 - The company has in hand five hybrid annuity projects, requiring ~₹17.7bn debt and ~₹4.4bn equity infusion.
 - It has received sanction letters from the banks for the four NHAI projects. The documents have been submitted to the NHAI for appointed dates. For the fifth (the KSHIP project), it has received a Letter of Award (LOA) and expects to sign the concession agreement by this month end.
 - The four NHAI hybrid annuity projects have an EPC value of ~₹31.6bn in the total EPC value of ~₹39.8bn (incl. KSHIP).
 - With the financial closure already sanctioned for the four NHAI projects, these four would be first off the block. There is still some time for the KSHIP project to get going as signing of concession agreement and financial closure are awaited.

Fig 8 – Change of scope - only inflows for Q1 and Q2



Source: Company, Anand Rathi Research

Fig 9 – Sep'18-end OB: ~₹18bn; Incl. HAM OB: ~₹58bn



Source: Company

BOT toll projects

- There appears to have been, during the quarter, a further infusion of ~₹152m in the Telengana annuity project. With this, the company, along with its partner, has cumulatively infused ~₹0.6bn equity. We believe the funds have been extended to meet major maintenance expenses.
- The two BOT toll projects are doing well. The average daily collection at the Muzaffarpur-Barauni project during the quarter was ~₹1.6m; on the second project, Walayar-Vadakanchery in Kerala, it was ~₹1.5m.
- Walayar-Vadakanchery is still not yielding its full potential as one of the adjacent stretches is incomplete. Once this is completed, management expects collections to improve by another ~₹0.2m a day. After the additional fund infusion in the recent past by the company, the SPV is able to meet obligations on its own.

Hybrid annuity projects

- The company recently secured five hybrid annuity projects, for a combined project cost of ~₹56bn and an EPC value of ~₹40bn.
 - Of these five, concession agreements have already been signed for the four from the NHAI, and the LOA has already been received for the Karnataka State Highway Authority project.
 - During the quarter, it received a sanction letter for the fourth NHAI project, thus, closing all the NHAI projects well within time.
 - The company has closed these projects at a cost of ~9.5%. Including syndication fees (considering amortisation over the project lifecycle), finance cost works out to ~9.6%. When bidding for the projects, management had considered more than this. It has closed two projects with HDFC and two with Axis.
 - With financial closure in place, management expects appointed dates for the Trichy-to-Kallagam and Chittoor-to-Mallavaram projects by Dec'18. For Meensurutti-to-Chidambaram, it expects the appointed date to come through by Jan'19. Ramsanpalle-to-Mangloor could take a little longer as there is some utility shifting issue (pipeline shifting) which needs to be settled. Management hopes that the appointed dates for the four NHAI projects would be obtained and construction commence by FY19-end.
 - For the KSHIP hybrid annuity project, the recently-elected Karnataka government has already given the go-ahead to the signing of the concession agreement. Management is expected to submit its comments to the authority concerned within a week and the concession agreement to be signed within a month.

Fig 10 – FC sanctioned for four hybrid annuities

(₹ bn)	State	Client	Lanes	Length (km)	Concession period (yrs)	Estimated		Estimated		EPC value	Status
						BPC	equity	Grant	debt		
Trichy to Kallagam	Tamil Nadu	NHAI	Four	39	17	10.2	1.0	4.3	3.8	7.2	FC sanctioned
Meensurutti to Chidambaram	Tamil Nadu	NHAI	Two	32	17	4.8	0.5	2.0	1.8	3.4	FC sanctioned
Chittoor to Mallavaram	Andhra Pradesh	NHAI	Six	61	17.5	17.3	1.4	7.4	5.7	12.3	FC sanctioned
Ramsanpalle to Mangloor	Telangana	NHAI	Four	47	17	12.3	1.0	5.2	4.2	8.7	FC sanctioned
Magadi to Somwarpath	Karnataka	KSHIP	Two	166	9	11.4	0.5	7.5	2.1	8.1	LOA received
Total				344		56.1	4.4	26.5	17.7	39.8	

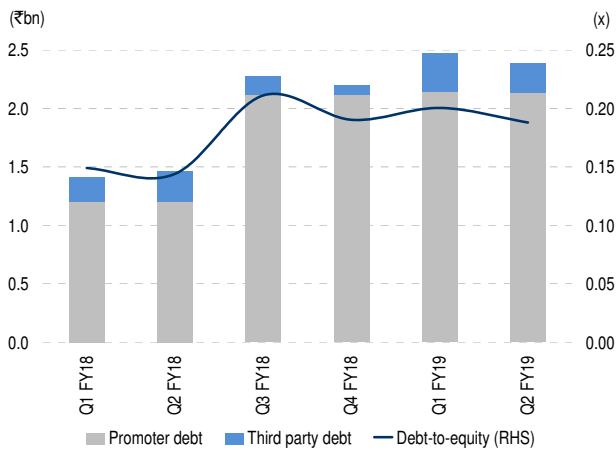
Source: Company

- On land acquisition, 60-65% land has already been acquired for the Trichy-to-Kallagam and Chittor-to-Mallavaram projects. For Meensurutti-to-Chidambaram, the figure is ~60%. For the fourth, Ramsanpalle-to-Mangloor, there is an issue with pipeline shifting and, thus, land acquisition is at ~40-45%. With regard to reserved forest land for the fourth project, a requisition has already been submitted for clearance. Management hopes to seek the appointed date only if 80% land is in place.
- Site mobilisation has already started and the company has already spent ~₹0.8bn overall, including site establishment expenses and hiring of manpower.
- Management is already in discussion with a developer-cum-infrastructure fund to ensure that capital intensity involved with HAM is reduced and the projects have a ready buyer in place once they are completed. Due diligence for the four NHAI projects is largely complete. (KSHIP is outside this deal as its equity requirement is negligible; 75% to come from the Authority.) At present, final discussions and legal documentation are underway. Management is trying to match the closure of this deal with the financial closure.

Balance Sheet

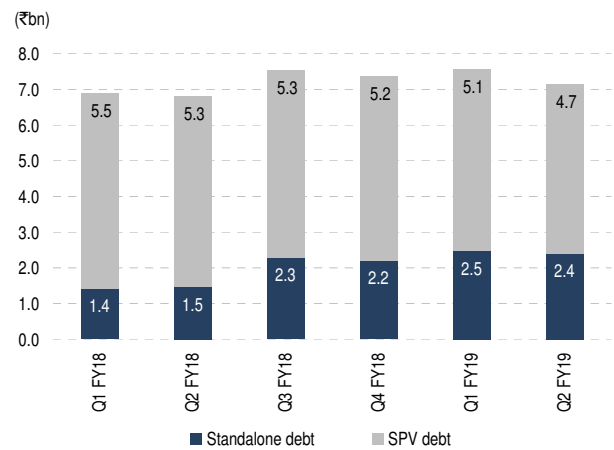
- On 30th Sep'18, gross debt was down marginally, at ~₹2.4bn. Of this, the promoter's exposure was ~₹2.1bn, with third-party debt a meagre ~₹0.3bn. With a ~₹1.7bn cash balance, the company has net debt of ~₹0.7bn on net worth of ~₹12.7bn.

Fig 11 – Gross debt down slightly; meagre third-party debt



Source: Company

Fig 12 – BOT toll SPV debt down ~₹0.4bn q/q, ~₹0.6bn y/y



Source: Company

- Debt at the two BOT toll SPVs eligible for consolidation was ~₹4.7bn, down ~₹0.4bn q/q, ~₹0.6bn y/y. Gross debt for the two annuity SPVs (in which the company has a 40% stake each, and not consolidated) declined ~₹0.08bn q/q, ~₹0.4bn y/y, to ~₹6.7bn.
- Consolidated debt at end-Q2 was ~₹7.1bn, standalone and BOT toll combined.
- The company continues to boast of its best-in-class cash-conversion cycle, which was further down five days q/q, to 25, largely due to lower receivable days (down to 20, from 28 a quarter back).

Valuation

As estimates have been adjusted for the higher margins in H1 FY19 and as we build some delay in the appointed date for one hybrid annuity project, FY19e earnings are up ~1%, but for FY20 down ~5%. As a result of the shrunken FY20 earnings and as we reduce the EV/EBITDA multiple for the EPC vertical (from 8x to 7x; on the altered market-wide perception and funding scenario), we lower our target price to ₹269 (from ₹298 earlier).

Our sum-of-parts-based target is derived using a relative valuation multiple for the construction business (based on 7x FY20e EV/EBITDA; ~₹210 a share) and the BOT assets at the invested value (~₹59 a share). We have assumed ~₹3.3bn of equity infusion for the five new hybrid annuity projects by FY20.

Fig 13 – Change in estimates

(₹ m)	Old estimates		New estimates		Change (%)	
	FY19e	FY20e	FY19e	FY20e	FY19e	FY20e
Revenue	20,623	28,197	19,423	27,177	-5.8	-3.6
EBITDA	3,484	4,418	3,572	4,360	2.5	-1.3
EPS (₹)	12.8	16.9	12.9	16.0	0.6	-5.3

Source: Anand Rathi Research

At the ruling price, (excl. the BOT investments) the stock trades at 5.1x FY20e EV/EBITDA, against the assigned 7x FY20e. On a PER basis, the stock is trading at 11x FY20e tax-adjusted EPS of ₹13.3, against the target-price-implied 15x FY20e.

Fig 14 – EV / EBITDA band



Source: Company, Bloomberg, Anand Rathi Research

Risk

- Any slower-than-estimated pace of execution.
- Any significant deterioration in working capital.

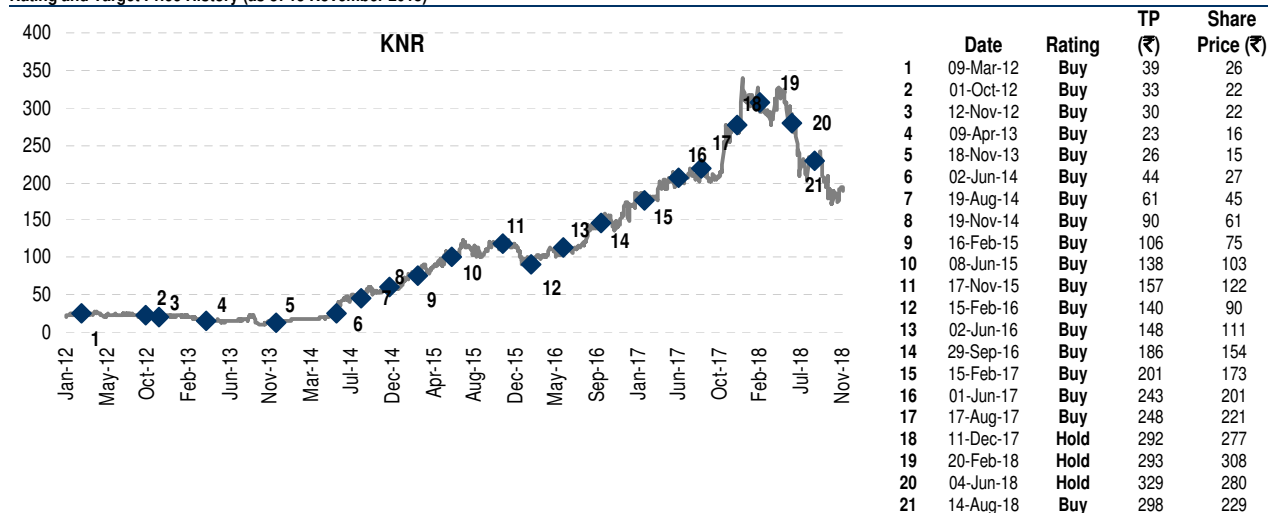
Appendix

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Rating and Target Price History (as of 13 November 2018)



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	Buy	Hold	Sell
Large Caps (>US\$1bn)	>15%	5-15%	<5%
Mid/Small Caps (<US\$1bn)	>25%	5-25%	<5%

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