



## KEC International Ltd

## Optimistic management commentary amid poor Q4

## Capital Goods

## Sharekhan code: KEC

Reco/View: Buy



CMP: Rs. 375

Price Target: Rs. 487



Upgrade



Maintain



Downgrade

## 3R MATRIX

	+	=	-
Right Sector (RS)	✓	✗	✗
Right Quality (RQ)	✓	✗	✗
Right Valuation (RV)	✓	✗	✗

+ Positive = Neutral - Negative

## What has changed in 3R MATRIX

	Old		New
RS	✓	↔	✓
RQ	✓	↔	✓
RV	✓	↔	✓

## ESG Disclosure Score

## ESG RISK RATING

Updated Jan 08, 2022

36.87

## High Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

## Company details

Market cap:	Rs. 9,656 cr
52-week high/low:	Rs. 550/368
NSE volume: (No of shares)	2.97 lakh
BSE code:	532714
NSE code:	KEC
Free float: (No of shares)	12.4 cr

## Shareholding (%)

Promoters	51.8
FII	12.2
DII	26.4
Others	9.6

## Price chart



## Price performance

(%)	1m	3m	6m	12m
Absolute	-3.6	-28.5	-19.4	-4.5
Relative to Sensex	4.5	-23.4	-12.1	-19.9

Sharekhan Research, Bloomberg

## Summary

- For Q4FY2022, KEC International Limited (KEC) reported poor set of numbers across all fronts. The quarter was impacted by legacy orders in Brazil, suspension of work in Afghanistan and a steep increase in commodity prices.
- The management expects FY2023 to be better in terms of execution and margins as it renegotiates certain fixed price contracts in T&D segment, commodity prices cool off and impact of SAE Brazil's legacy order subsidies. Further, higher contribution from non T&D orders in revenues would help OPM to normalise from H2FY2023.
- Year-to-date (YTD) order inflows grew by 45% y-o-y to Rs. 17,203 crore and strong order book of Rs 27,716 crore including L1.
- We have trimmed our estimates but retain a Buy on KEC with a revised PT of Rs. 487 given strong likelihood of margins bottoming out, strong order backlog, healthy order pipeline and diversified business model.

For Q4FY22, KEC's consolidated revenues came in at Rs 4,275cr vs Rs 4,361 crore in Q4FY21 (down 2% YoY). It was below our estimates of Rs 5,184 crore. Revenue growth was impacted by poor performance of T&D business due to suspension of projects in Afghanistan and also postponement of execution of certain orders due to increase in commodity prices. Operating profit declined by 29% y-o-y to Rs 252 crore (vs estimate of Rs. 366 crore) due to a sharp increase in raw material cost. Operating margin declined by 224 bps y-o-y and came in at 5.9% vs 8.1% in Q4FY21 (versus our estimate of 7.1%). The drop in margins was caused by lower gross margins and higher employee cost due to low leverage owing to subdued revenues. Net profit declined by 42% y-o-y to Rs 112cr vs our estimates of Rs 192cr. Order inflow during the year is at Rs. 17,203 crore, a stellar growth of 45% against last year, while order book stood at is at Rs. 23,716 crore, a strong growth of 24% y-o-y; L1 of over Rs. 4,000 crore. The company expects execution to pick up for FY2023 with a scale-up in international T&D orders and non-T&D segments such as civil and oil & gas segments. Margins are also expected to improve on account of renegotiations in certain fixed price contracts and execution of orders with better margins.

## Key positives

- Non-T&D business share increase to 50% in FY22 (vs 42% in FY21). Railways, Civil and Cables revenues grew by 11%/34%/28% y-o-y during Q4FY22
- Order intake was up 45% y-o-y at Rs. 17,203 crore, order book (including L1) remains strong at Rs. 27,716 crore
- Margin trajectory to improve from H2FY23 on account of high margin orders and increase in contribution of non-T&D segment

## Key negatives

- T&D revenues declined by 16% y-o-y to Rs. 1,940 crore due to suspension of projects in Afghanistan and delayed execution of certain orders due to increase in commodity prices
- Operating profit margin at 5.9% has been the lowest ever quarterly margin in the last 7 years.
- Operating profit and net profit declined sharply by 29% y-o-y and ~42% y-o-y respectively during the quarter.

## Management Commentary

- The management expects FY23 performance to improve on account of higher execution, better margins and increase in contribution from Non T&D segments such as cables, civil, railways and oil & gas.
- It expects good traction in international markets particularly Saudi Arabia, UAE and the US.
- Cash burn in SAE Brazil has been to the tune of ~Rs 400 crore so far, around Rs 1,000 crore of revenues have been impacted due to suspension of work in Afghanistan and execution postponement in certain orders.

**Revision in estimates** – We have lowered our estimates for FY2023/FY24 factoring in weak OPM for H1FY23 and execution challenges in the short term. Revision in estimates have resulted into reduction in our price target.

## Our Call

**Maintain Buy with a revised PT of Rs. 487:** KEC has been affected by losses in legacy orders in Brazil, but is likely to have minimal impact in Q1FY2023. Moreover, a pick-up in execution and high margin orders kicking in in FY23 would lead to satisfactory growth on sales and profitability fronts. The company's strong order book and high order inflow visibility would drive future growth. Currently, given the recent correction in the stock price, KEC is trading at a P/E of ~11x its FY2024E on revised earnings, which provides substantial room for upside given its healthy order backlog, strong order pipeline and improving margin and profit trajectory from H2FY23 onwards. Hence, we maintain a Buy rating on the stock with a revised PT of Rs. 487.

## Key Risks

Slowdown in tendering activities, especially in T&D and railways. Further, escalation in input cost and supply side constraints are key challenges.

## Valuation (Consolidated)

Particulars	FY21	FY22	FY23E	FY24E
Revenue	13,114	13,742	15,748	18,763
OPM (%)	8.7	6.6	7.2	9.2
Adjusted PAT	553	376	455	894
% YoY growth	-2.3	-32.0	21.2	96.3
Adjusted EPS (Rs.)	21.5	14.6	17.7	34.8
P/E (x)	17.4	25.7	21.2	10.8
P/B (x)	2.9	2.7	2.4	2.0
EV/EBITDA (x)	9.8	13.5	11.0	7.6
RoNW (%)	18.0	10.8	12.0	20.5
RoCE (%)	20.2	13.2	15.1	22.3

Source: Company; Sharekhan estimates

**Poor performance amid global headwinds and adverse commodity prices:** KEC's Q4FY22 consolidated revenues came in at Rs 4,275 crore versus Rs. 4,361 crore in Q4FY21 (down 2% YoY). It was sharply below our estimates of Rs 5,184cr. Revenues were impacted by poor performance of T&D which reported decline of 16% y-o-y to Rs. 1,940 crore. The decline was caused by suspension of projects in Afghanistan and also postponement of execution of certain orders due to increase in commodity prices. On the bright side, revenues of segments such as Railways, Civil and Cables grew by 11%/34%/28% y-o-y. Operating profit declined by 29% y-o-y to Rs 252 crore (vs estimate of Rs366cr) due to sharp increase in raw material costs. OPM declined by 224bps y-o-y and came in at 5.9% vs 8.1% in Q4FY21 (our estimate was 7.1%). The drop in margin was caused by lower gross margins and higher employee cost due to low leverage owing to subdued revenues. Net profit declined by 42% y-o-y to Rs 112 crore versus our estimates of Rs 192 crore.

**Order intake visibility strong; execution to improve in FY23:** The company's order inflow is up by 45% y-o-y at Rs. 17,203 crore, while order book (including L1) remains strong at Rs. 27,716 crore; providing revenue visibility for the next ~two years. The company has deepened its presence in technologically enabled areas in railways and has reinforced presence in industrial with orders in metals & mining, cement, FMCG and data centres. The company has also scaled its order book significantly in the civil segment which is likely to be the largest growth driver with orders across industrial, residential, water pipelines, public spaces and defence. Overall, tenders under evaluation & tenders in pipeline are over Rs. 125,000 crore. The company has already commenced execution of several new projects which have been secured based on current commodity/logistics costs, thereby promising high margins.

#### Key Conference call takeaways

- ♦ **Revenue decline:** Revenues of the T&D business were impacted due to suspension of projects in Afghanistan and also postponement of execution of certain orders due to increase in commodity prices. Both these factors have resulted in total impact of Rs 1,000 crore on revenues for the year. The company has a net exposure of Rs. 233 crore in Afghanistan as of March 2022.
- ♦ **Negotiations for fixed price contracts:** The company has been negotiating on cost escalation due to raw material price increases in 3-4 contracts in T&D segment. In case of favourable outcome, the margin could improve going forward.
- ♦ **Margins to improve from H2FY23:** KEC expects margins to remain at similar levels in the next two quarters as some contracts are fixed price contracts, which would have an impact of steep increase in material cost. However, as execution of new orders begin and if company successfully renegotiates terms on certain contracts, the margins are likely to improve from H2FY23. Further, off late commodity prices are cooling off and therefore there may not be further downside to margin. Also, consolidated margins are being impacted due to legacy orders of SAE, Brazil, however its impact in FY23 will be significantly lower.
- ♦ **Strong international order pipeline:** KEC is witnessing lot of enquiries from Saudi Arabia, UAE and Americas, while interest from Africa is muted.
- ♦ **Margin trajectory strong in Non T&D business:** While margins have been below 5% in the T&D business, the non-T&D business has better margins e.g. for Railways, the margins are at around ~10% and cables also has higher margins than T&D. Oil & Gas projects come with price variation and margins are not very weak in this segment currently.

- ♦ **Tax rate:** The tax rate was lower in Q4FY22 because of deferred tax assets and adjustment for losses primarily on account of its SAE, Brazil operations. The effective tax rate is @25% for the company.
- ♦ **Working capital & debt:** Net Working Capital stands at 137 days as on March 2022, an improvement of 4 days against December 2021 led by increasing credit period of key vendors and efforts on expediting commercial closure of projects. Net debt stands at Rs 2,613 crore, reduction of Rs. 300 crore, the debt levels have largely normalized and close to the company's target of ~Rs 2,500 crore.

Results (Consolidated)

Particulars	Q4FY22A	Q4FY21	YoY%	Q3FY22	QoQ%
<b>Net Sales</b>	<b>4,275</b>	<b>4,361</b>	<b>-2.0%</b>	<b>3,340</b>	<b>28.0%</b>
Net raw material	1,860	1,785	4.2%	1,339	38.9%
Erection and subcontracting charges	1,528	1,565	-2.3%	1,149	33.0%
Employee cost	318	298	6.7%	323	-1.5%
Other Expenditure	317	358	-11.4%	290	9.2%
<b>Operating Profit</b>	<b>252</b>	<b>355</b>	<b>-29.0%</b>	<b>239</b>	<b>5.3%</b>
Other Income	3	12	-72.5%	5	-32.7%
Depreciation	42	38	10.1%	39	6.7%
Interest	95	63	51.0%	82	15.7%
PBT	118	266	-55.7%	122	-3.7%
Tax Expenses	6	71	-91.9%	29	-80.0%
Reported PAT	112	194	-42.3%	94	19.7%
Exceptional items	-	-		-	
<b>Adj PAT</b>	<b>112</b>	<b>194</b>	<b>-42.3%</b>	<b>94</b>	<b>20%</b>
EPS (Rs.)	4.4	7.6	-42.3%	3.6	20%
OPM %	5.9	8.1	(224)	7.2	(127)
NPM %	2.6	4.5	(183)	2.8	(18)
Tax rate %	4.9	26.9	(2,198)	23.5	(1,859)

Source: Company, Sharekhan Research

## Outlook and Valuation

### ■ Sector View – Ample levers offer scope for growth

The government's increasing focus on infrastructure availability, affordable housing, thrust on rural electrification, 100% electrification of railway network by 2025, and increasing metro rail to 25 cities by 2025 are expected to propel growth for user industries. The government has envisaged Rs. 111 lakh crore of capital expenditure in the infrastructure sector during FY2020 to FY2025. Sectors such as energy (24%), roads (18%), urban (17%), and railways (12%) amount to ~71% of projected infrastructure investments. The government's continued thrust on infrastructure investment is expected to improve the demand environment across railways, metros, roads, healthcare, and real estates, providing ample opportunities for KEC across various segments it operates in. India's focus on becoming a \$5 trillion economy, building industries to drive manufacturing-led growth, and goals on sustainable energy will ensure significant investments in the power sector. India's power generation capacity is expected to reach 469 GW by 2022 and the development of high-voltage transmission grid will need to keep pace with generation capacity. Other factors that will drive growth in the T&D sector are the need for setting-up of inter-regional grid capacity to ensure seamless flow of power from one region to another, evacuation infrastructure for renewables, and cross-border interconnections with SAARC countries. With the setting up of the cross-country national grid, huge investments are being planned by states to improve connectivity, reliability, and affordability. An increase in large-size transmission line as well as substation tenders from state utilities can thus benefit companies such as KEC.

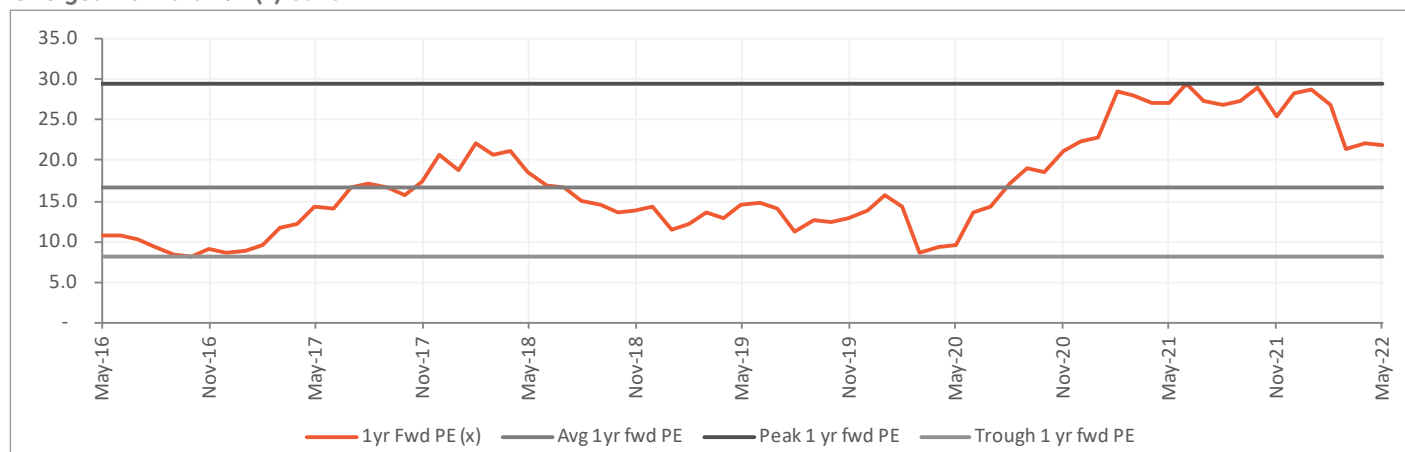
### ■ Company Outlook – Better prospects ahead

Ordering activity is gradually gaining momentum with tendering visibility remaining healthy in railways, international T&D, and civil. Management sees Rs. 1,25,000 crore project pipeline across businesses. International T&D pipeline is very strong in the Middle East, the Americas, Bangladesh and far east regions. The company expects execution to pick up going ahead for FY2023 with scale-up in execution in the international T&D orders, civil and oil & Gas while domestic T&D is expected to remain flattish. Sluggishness in domestic T&D project awards is well compensated through opportunities arising in international T&D (across the MENA region, Bangladesh, the Far East and North and West Africa), with a good chunk of tenders being floated. Tenders in the green energy corridor have been floated, wherein opportunity remains bright for the company.

### ■ Valuation – Maintain Buy with a revised PT of Rs. 487

KEC has been affected by losses in legacy orders in Brazil, but is likely to have minimal impact in Q1FY2023. Moreover, a pick-up in execution and high margin orders kicking in in FY23 would lead to satisfactory growth on sales and profitability fronts. The company's strong order book and high order inflow visibility would drive future growth. Currently, given the recent correction in the stock price, KEC is trading at a P/E of ~11x its FY2024E on revised earnings, which provides substantial room for upside given its healthy order backlog, strong order pipeline and improving margin and profit trajectory from H2FY23 onwards. Hence, we maintain a Buy rating on the stock with a revised PT of Rs. 487.

#### One-year forward P/E (x) band



Source: Sharekhan Research

## About company

KEC is a global power transmission infrastructure EPC major. The company is present in the power T&D, cables, railways, renewable (solar energy), smart infra, and civil construction businesses. Globally, the company has powered infrastructure development in more than 61 countries. KEC is a leader in power transmission EPC projects and has more than seven decades of experience. Over the years, the company has grown through the organic as well as the inorganic route.

## Investment theme

T&D spend in India is expected to be around Rs. 2,300 billion over FY2018-FY2023E, up 28% over FY2012-FY2017. A large part of this spend is likely to come from state electricity boards. Additionally, ordering for the Green Energy Corridor is likely to provide ample opportunities in the domestic market. Moreover, expansion in the regional transmission network in Africa, SAARC, and CIS countries is likely to supplement domestic demand and present a large business opportunity. KEC has significantly scaled up the non-T&D segments (railways and civil segments) and margins in these segments have improved significantly. The opportunity size remains high in the non-T&D segment to provide enough opportunity to ramp up its total order outstanding for the business. KEC's order book remains strong, providing strong revenue visibility; and order inflow visibility remains healthy in international T&D, railways and civil segments.

## Key Risks

- ♦ Slower-than-expected execution of projects in domestic and international markets due to various reasons is expected to affect performance.
- ♦ Slowdown in tendering activities, especially in T&D, railways, and overseas orders.

## Additional Data

### Key management personnel

Mr. Harsh Vardhan Goenka	Non-Executive - Non Independent Director-Chairperson
Mr. Vimal Kejriwal	Executive Director
Rajeev Aggarwal	Chief Financial Officer
Mr. Ajit Tekchand Vaswani	Non-Executive - Independent Director

Source: Company Website

### Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Swallow Associates Ltd.	26.36
2	Summit Securities Ltd.	10.93
3	HDFC AMC	8.79
4	Instant Holdings Ltd.	8.64
5	Kotak Mahindra AMC/India	3.19
6	FIL Ltd.	2.91
7	FIL Ltd./Bermuda	2.78
8	Fidelity Investments	2.65
9	Goenka Harsh Vardhan	1.96
10	STEL Holdings Ltd.	1.95

Source: Bloomberg

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## Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and deteriorating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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by BNP PARIBAS

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