Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

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 36.87
Updated July 08, 2022

High Risk

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

Source: Morningstar

Company details

Market cap:	Rs. 11,433 cr
52-week high/low:	Rs. 550/346
NSE volume: (No of shares)	3.6 lakh
BSE code:	532714
NSE code:	KEC
Free float: (No of shares)	12.4 cr

Shareholding (%)

Promoters	51.8
FII	12.2
DII	26.5
Others	9.5

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	12.3	18.4	-28.5	6.8
Relative to Sensex	2.8	13.7	-23.4	-0.5

Sharekhan Research, Bloomberg

KEC International Ltd

Low profit mars performance, better times ahead

Capital Goods	Sharekhan code: KEC
Reco/View: Buy ↔	CMP: **Rs. 444** Price Target: **Rs. 515** ↑

↑ Upgrade ↔ Maintain ↓ Downgrade

Summary

- For Q1FY2023, KEC International Limited (KEC) lagged estimates on the profitability front, while sales were in-line led by non-T&D businesses. The quarter continued to be impacted by legacy orders in Brazil, higher interest cost, and steep increase in commodity prices.
- Management expects improvement from Q3FY2023 as losses in SAE Brazil lessens and commodity prices cool off . Further, working capital and debt level are expected to reduce due to closure of long gestation, low-margin orders.
- Year-to-date (YTD) order intake is at Rs. 3,472 crore, strong order book of Rs. 23,720 crore, and L1 of over Rs. 8,000 crore.
- We retain Buy on KEC with a revised PT of Rs. 515, given strong likelihood of margin improvement in H2FY2023, strong order backlog, healthy order pipeline, and diversified business model.

KEC's Q1FY2023 performance was in-line on the sales front. However, profitability was below expectations due to high commodity cost and loss in subsidiary – SAE Brazil. Consolidated revenue came in at Rs. 3,318 crore (up 31% y-o-y). Sales growth was driven by 46% y-o-y growth in non-T&D revenue, which includes railways, civil, oil and gas, infrastructure, and cables. Operating profit growth was restricted to 5% y-o-y to Rs. 168 crore (vs. estimate of Rs. 180 crore) due to a sharp increase in input cost and logistics cost. Operating profit margin (OPM) declined by 221bps y-o-y and came in at 5.1% (vs. our estimate of 5.7%). Net profit declined by 33% y-o-y to Rs. 31 crore (vs. our estimates of Rs. 42 crore) due to low operating profit and higher interest cost. YTD order inflow during the year is at Rs. 3,472 crore, while order book is at Rs. 23,720 crore, strong growth of 16% YoY, and L1 of over Rs. 8,000 crore. Standalone business performed better, with 22% y-o-y growth in sales to Rs. 2,849 crore, EBITDA margin stood at 8.2% (down 140 bps y-o-y), while PAT declined by 3% y-o-y to Rs. 100 crore. The company expects strong execution across its business segments going forward. Margins and profitability are likely to improve from H2FY2023, as legacy orders in Brazil and fixed-priced contracts get completed.

Key positives

- Non-T&D business share increases to 50% in Q1FY23 (vs. 45% in Q1FY2022). Railways, Civil, and Cables revenue grew by 19%/99%/26% y-o-y during Q1FY23.
- Order intake was at Rs. 3,472 crore – (domestic: international – 85:15), while order book (including L1) remains strong at Rs. 31,720 crore (domestic: international – 66:34).
- Margin to improve from H2FY2023 on account of execution of high-margin orders and closure of some low-margin orders in standalone and legacy orders in Brazil.

Key negatives

- T&D revenue grew at a slower pace of 6% y-o-y to Rs. 1,279 crore due to delayed execution of certain orders.
- Operating profit margin at 5.1% has been the lowest-ever quarterly margin in the past seven years.
- Net profit declined sharply by 33% y-o-y due to poor operating performance and higher interest cost due to elevated debt levels.

Management Commentary

- Management expects H2FY2023 performance to improve on account of better margins and increased contribution from non-T&D segments such as cables, civil, railways, and oil and gas.
- SAE Brazil reported loss of Rs. 70 crore/Rs. 100 crore at EBITDA/PBT level, respectively. High interest rate of 17-18% impacted profits at net level.
- KEC targets debt of Rs. 2,500 crore and 130-135 working capital days towards the end of FY2023.
- The total business opportunity in the coming years is pegged at Rs. 1,10,000 crore, of which domestic T&D, civil, and railways constitute Rs. 30,000 crore/Rs. 35,000 crore/Rs. 17,000 crore respectively.

Revision in estimates – We have fine-tuned our estimates for FY2023/FY2024, factoring in weak OPM and higher interest cost.

Our Call

Maintain Buy with a revised PT of Rs. 515: KEC has been affected by losses in legacy orders in its Brazil subsidiary, but the company is hopeful of an improved performance in H2FY2023. Moreover, healthy execution and high-margin orders coming in the next few quarters would lead to higher sales. Further, earnings are expected to improve as commodity prices cool off, interest cost stabilizes, and losses in Brazil subsidiary come down. The company's strong order book and high order inflow visibility also provides comfort. Despite the recent run-up in the stock price, KEC is trading at a P/E of ~13x its FY2024E EPS, which provides substantial room for upside, given its healthy order backlog and order pipeline, possibility of margin revival, and strong profitability in FY2024E. Hence, we maintain a Buy rating on the stock with a revised price target (PT) of Rs. 515.

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) Rs cr

Particulars	FY21	FY22	FY23E	FY24E
Revenue	13,114	13,742	16,635	18,938
OPM (%)	8.7	6.6	6.9	9.1
Adjusted PAT	553	376	453	876
% YoY growth	-2.3	-32.0	20.5	93.5
Adjusted EPS (Rs.)	21.5	14.6	17.6	34.1
P/E (x)	20.7	30.4	25.2	13.0
P/B (x)	3.4	3.2	2.9	2.4
EV/EBITDA (x)	11.4	15.5	12.8	8.2
RoNW (%)	18.0	10.8	11.9	20.1
RoCE (%)	20.2	13.0	14.8	21.6

Source: Company; Sharekhan estimates

SAE Brazil continues to impact performance

KEC's Q1FY2023 performance was in-line on the sales front, however its profitability was below expectations due to high commodity cost and loss in subsidiary – SAE Brazil. Consolidated revenue came in at Rs. 3,318 crore (up 31% y-o-y). Sales growth was driven by 46% y-o-y growth in non-T&D revenue, which includes railways, civil, oil and gas, infrastructure, and cables. Operating profit growth was restricted to 5% y-o-y to Rs. 168 crore (vs. estimate of Rs. 180 crore) due to a sharp increase in input cost and logistics cost. OPM declined by 221 bps y-o-y and came in at 5.1% (vs. our estimate of 5.7%). Net profit declined by 33% y-o-y to Rs. 31crore (vs. our estimates of Rs. 42 crore) due to low operating profit and higher interest cost. YTD order inflow during the year is at Rs. 3,472 crore, while order book is at Rs. 23,720 crore, strong growth of 16% y-o-y and L1 of over Rs. 8,000 crore. Standalone business performed better with 22% y-o-y growth in sales to Rs. 2,849 crore, EBITDA margin at 8.2% (down 140 bps y-o-y), and PAT down 3% y-o-y to Rs. 100 crore.

Healthy order book and order pipeline bodes well for future growth

The company's order book (including L1) remains strong at Rs. 31,720 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 and 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 and tenders in the pipeline are over Rs. 1,11,000 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

- **Segment-wise revenue performance:** Revenue of the T&D business rose to ~Rs. 1,650 crore, led by strong growth of 17% y-o-y, driven by robust execution across India and overseas. Railways revenue posted growth of 19% y-o-y. Cables business has grown by 26% y-o-y and achieved rrevenue of ~Rs. 419 crore. Civil delivered impressive growth of ~2x, with revenue of ~Rs. 600 crore. Oil and gas reported revenue of ~Rs. 92 crore.
- **SAE Brazil – Performance to improve from Q3FY2023:** SAE Brazil reported loss of Rs. 70 crore/Rs. 100 crore at EBITDA/PBT level, respectively. High interest rate of 17-18% impacted profits at net level. The company stated that most of the legacy orders are nearing end in Brazil and losses should begin to decrease from Q2FY2023 and expects minimal loss in Q3FY2023. Further, the decline in commodity prices and interest cost (as the company supports its operations through internal accruals rather than resorting to debt) should help the performance at net level.
- **Margins to improve from H2FY2023:** KEC expects margins to remain at similar levels in Q2FY2023 due to execution of fixed price contracts, high interest cost, and losses from SAE Brazil. However, execution of new orders with better pricing, improvement in SAE Brazil's performance, decline in commodity prices, and stable interest cost (as debt declines due to working capital freeing up from Brazil and completion of certain T&D and railways projects) should lead to improvement in margins. For FY2024E, management is confident of reverting to erstwhile double-digit margin of 10%.
- **Strong order pipeline:** The government's focus on developing urban infrastructure and water pipeline bodes well for KEC's business. Further, private capex is picking up in various industries and realty sector. Further, sectors such as oil and gas also look promising. In T&D, the company recently secured new orders of over Rs. 1,200 crore for T&D and cabling projects across India, Middle East, and Americas,

including a prestigious order to build India's first 765kV Digital GIS Substation from PGCIL. In railways, there is a gradual pick up in tendering activities and the company is confident of securing a larger share of orders in the coming months. In civil, there is an all-time high order book + L1 of over Rs. 10,000 crore and it recently secured orders of over Rs. 1,200 crore across industrial, residential, hydrocarbon, defence, and data centre segments. Further, oil and gas and cables have huge opportunities going forward. The total opportunity in the coming years is pegged at Rs. 1,10,000 crore, of which domestic T&D, civil, and railways constitute Rs. 30,000 crore/Rs. 35,000 crore/Rs. 17,000 crore respectively.

- **Working capital and debt situation to improve in the coming quarters:** Net working capital stands at 148 days as of June 2022. Net debt stands at Rs. 3,418 crore, an increase of Rs. 885 crore. The company target to achieve debt levels of ~Rs. 2,500 crore in the next 2-3 quarters. Debt level is elevated due to support to its loss-making SAE Brazil subsidiary and few EPC orders in railways, where billing/payment is linked to achievement of a milestone. The company expects ~Rs. 300 crore of working capital/cash to be freed as the government has amended the inverted duty structure under GST, benefiting most of EPC players by reducing their tax liability. Further, large projects in T&D, railways, and other segments are in the last lag of execution. Therefore, the company expects its receivables to go down upon realisation of payments in Q3/Q4FY2023. Thus, the company targets debt of Rs. 2,500 c ore and 130-135 working capital days towards the end of FY2023.

Results (Consolidated) Rs cr

Particulars	Q1FY23	Q1FY22	YoY%	Q4FY22	QoQ%
Net Sales	**3,318**	**2,540**	**30.6**	**4,275**	**(22.4)**
Net raw material	1,314	1,054	24.7	1,860	(29.4)
Erection and subcontracting charges	1,149	808	42.2	1,528	(24.8)
Employee cost	341	302	12.8	318	7.1
Other Expenditure	346	216	59.9	317	9.1
Operating Profit	**168**	**160**	**5.3**	**252**	**(33.1)**
Other Income	8	2	364.9	3	134.5
Depreciation	39	38	3.0	42	(6.2)
Interest	100	65	54.1	95	4.8
PBT	37	59	(36.6)	118	(68.5)
Tax Expenses	6	12	(50.9)	6	5.9
Adj. PAT	31	46	(32.8)	112	(72.3)
EPS (Rs.)	1.2	1.8	(32.8)	4.4	(72.3)
Margin (%)			**BPS**		**BPS**
OPM	5.1	6.3	(122)	5.9	(81)
NPM	0.9	1.8	(88)	2.6	(169)
Tax rate	16.4	21.2	(478)	4.9	1,153

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 is 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.

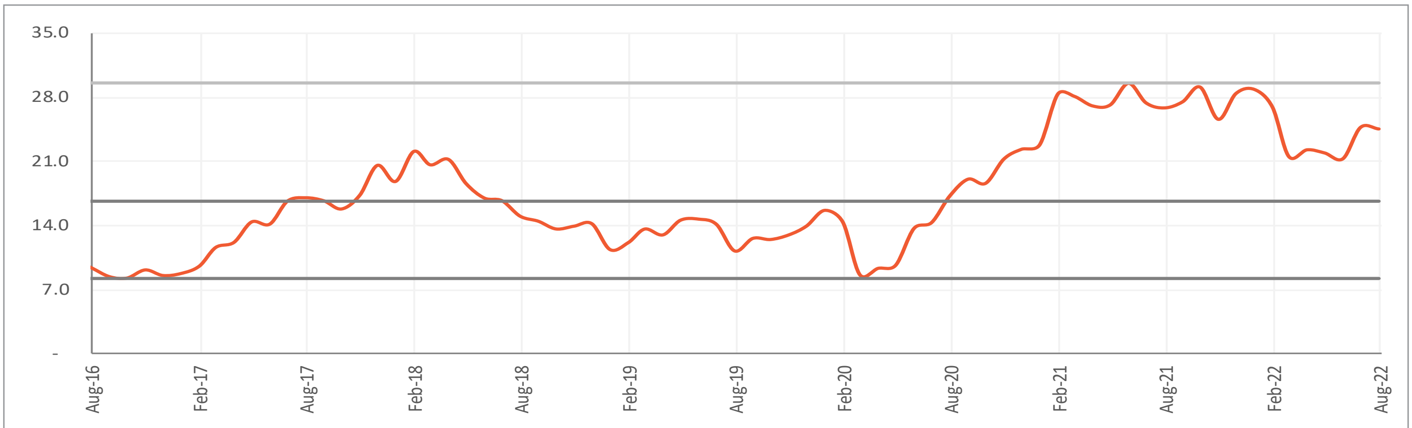
■ Company Outlook – Better prospects ahead

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 international T&D orders, civil, and oil and gas, while domestic T&D is expected to remain flat. 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. 515

KEC has been affected by losses in legacy orders in its Brazil subsidiary, but the company is hopeful of an improved performance in H2FY2023. Moreover, healthy execution and high-margin orders coming in the next few quarters would lead to higher sales. Further, earnings are expected to improve as commodity prices cool off, interest cost stabilizes, and losses in Brazil subsidiary come down. The company's strong order book and high order inflow visibility also provides comfort. Despite the recent run-up in the stock price, KEC is trading at a P/E of ~13x its FY2024E EPS, which provides substantial room for upside, given its healthy order backlog and order pipeline, possibility of margin revival, and strong profitability in FY2024E. Hence, we maintain a Buy rating on the stock with a revised PT of Rs. 515.

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	HDFC Trustee Company Ltd	8.79
2	Kotak Flexicap Fund	3.19
3	Tata AIA Life Insurance Co Ltd	2.01
4	DSP Flexicap Fund	1.98
5	UTI - Value Opportunities Fund	1.92
6	IDFC Sterling Value Fund	1.85
7	Fidelity Funds - India Focus Fund	1.54
8	L&T Mutual Fund Trustee Ltd	1.45
9	LIC Mutual Fund	1.31
10	Carniwal Investments Limited	1.16

Source: Bloomberg

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 detoriating 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

Sharekhan

by BNP PARIBAS

Know more about our products and services

For Private Circulation only

Disclaimer: This document has been prepared by Sharekhan Ltd. (SHAREKHAN) and is intended for use only by the person or entity to which it is addressed to. This Document may contain confidential and/or privileged material and is not for any type of circulation and any review, retransmission, or any other use is strictly prohibited. This Document is subject to changes without prior notice. This document does not constitute an offer to sell or solicitation for the purchase or sale of any financial instrument or as an official confirmation of any transaction. Though disseminated to all customers who are due to receive the same, not all customers may receive this report at the same time. SHAREKHAN will not treat recipients as customers by virtue of their receiving this report.

The information contained herein is obtained from publicly available data or other sources believed to be reliable and SHAREKHAN has not independently verified the accuracy and completeness of the said data and hence it should not be relied upon as such. While we would endeavour to update the information herein on reasonable basis, SHAREKHAN, its subsidiaries and associated companies, their directors and employees ("SHAREKHAN and affiliates") are under no obligation to update or keep the information current. Also, there may be regulatory, compliance, or other reasons that may prevent SHAREKHAN and affiliates from doing so. This document is prepared for assistance only and is not intended to be and must not alone be taken as the basis for an investment decision. Recipients of this report should also be aware that past performance is not necessarily a guide to future performance and value of investments can go down as well. The user assumes the entire risk of any use made of this information. Each recipient of this document should make such investigations as it deems necessary to arrive at an independent evaluation of an investment in the securities of companies referred to in this document (including the merits and risks involved), and should consult its own advisors to determine the merits and risks of such an investment. The investment discussed or views expressed may not be suitable for all investors. We do not undertake to advise you as to any change of our views. Affiliates of Sharekhan may have issued other reports that are inconsistent with and reach different conclusions from the information presented in this report.

This report is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject SHAREKHAN and affiliates to any registration or licensing requirement within such jurisdiction. The securities described herein may or may not be eligible for sale in all jurisdictions or to certain category of investors. Persons in whose possession this document may come are required to inform themselves of and to observe such restriction.

The analyst certifies that the analyst has not dealt or traded directly or indirectly in securities of the company and that all of the views expressed in this document accurately reflect his or her personal views about the subject company or companies and its or their securities and do not necessarily reflect those of SHAREKHAN. The analyst further certifies that neither he or its associates or his relatives has any direct or indirect financial interest nor have actual or beneficial ownership of 1% or more in the securities of the company at the end of the month immediately preceding the date of publication of the research report nor have any material conflict of interest nor has served as officer, director or employee or engaged in market making activity of the company. Further, the analyst has also not been a part of the team which has managed or co-managed the public offerings of the company and no part of the analyst's compensation was, is or will be, directly or indirectly related to specific recommendations or views expressed in this document. Sharekhan Limited or its associates or analysts have not received any compensation for investment banking, merchant banking, brokerage services or any compensation or other benefits from the subject company or from third party in the past twelve months in connection with the research report.

Either SHAREKHAN or its affiliates or its directors or employees / representatives / clients or their relatives may have position(s), make market, act as principal or engage in transactions of purchase or sell of securities, from time to time or may be materially interested in any of the securities or related securities referred to in this report and they may have used the information set forth herein before publication. SHAREKHAN may from time to time solicit from, or perform investment banking, or other services for, any company mentioned herein. Without limiting any of the foregoing, in no event shall SHAREKHAN, any of its affiliates or any third party involved in, or related to, computing or compiling the information have any liability for any damages of any kind.

Compliance Officer: Ms. Priya Sonavane; Tel: 022-61150000; email id: compliance@sharekhan.com;

For any queries or grievances kindly email igc@sharekhan.com or contact: myaccount@sharekhan.com

Registered Office: Sharekhan Limited, The Ruby, 18th Floor, 29 Senapati Bapat Marg, Dadar (West), Mumbai – 400 028, Maharashtra, INDIA, Tel: 022 - 67502000/ Fax: 022 - 24327343. Sharekhan Ltd.: SEBI Regn. Nos.: BSE / NSE / MSEI (CASH / F&O / CD) / MCX - Commodity: INZ000171337; DP: NSDL/CDSL-IN-DP-365-2018; PMS: INP000005786; Mutual Fund: ARN 20669; Research Analyst: INH000006183.