Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

Company Update

KEC International Ltd

Balance sheet improvement holds the key

Capital Goods	Sharekhan code: KEC

Reco/View: Buy	↔	CMP: **Rs. 448**	Price Target: **Rs. 515**	↔

↑ 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 July 08, 2022				36.87
High Risk				
NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

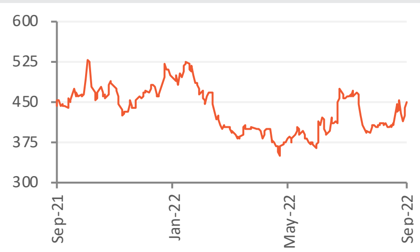
Company details

Market cap:	Rs. 11,536 cr
52-week high/low:	Rs. 550 / 346
NSE volume: (No of shares)	5.1 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	11.4	20.3	12.5	1.4
Relative to Sensex	10.8	6.3	10.5	1.1

Sharekhan Research, Bloomberg

Summary

- Recent interaction with KEC International Limited (KEC) reaffirms that the company's efforts to improve working capital cycle, bring down debt, and close the Brazil legacy orders are well on track.
- The company expects ~15% annual revenue growth in FY2023/FY2024 and expects margin to revert to 10% by FY2024.
- Year-to-date (YTD) order intake has surpassed Rs. 7,000 crore. The company aims Rs. 20,000 crore (+15% y-o-y) order inflows in FY2023E.
- We retain Buy on KEC with an unchanged PT of Rs. 515, considering its diversified revenue stream, healthy order backlog, promising order prospects, and upside risk to margin.

KEC International Limited (KEC) is on the cusp of improvement in its working capital cycle and leveraged position, driven by completion of legacy orders in Brazil, margin improvement, and strong order prospects. The company's strong order book of ~Rs. 32,000 crore (including L1) enables the company in being selective in picking up orders. Further, reducing competitive intensity in most of the business segments and strong order prospects of Rs. 1,11,000 crore bode well for the future growth in order inflows. In addition, successful diversification into other high-growth potential segments such civil, railways, and oil and gas has helped to scale up its business substantially. The company targets ~15% revenue growth for the next two years and expects margin to revert to 10% in FY2024E.

- **SAE Brazil's pain to subside from Q4FY2023:** In the recent RPG Group conference, KEC's management reaffirmed that SAE Brazil, subsidiary of SAE Towers, would come out of the woods soon. KEC 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. KEC is executing the last EPC order in Brazil and it should be completed towards the end of the quarter. The company would not be bidding for EPC projects in Brazil at least in the near future. Moreover, KEC will not undertake any EPC project where engineering is done by a third party. The company expects positive margin coming from Brazil from Q4FY2023.
- **Working capital cycle to improve, margin to revert to 10% in FY24:** KEC expects working capital days to come down from 150 days currently to 120-130/100 days by FY2023/FY2024E. The improvement will be led by a decline in commodity prices reducing the inventory cost and changes in tax structure in civil and railways, which would free up working capital to the extent of Rs 300 crore-Rs 400 crore. KEC also expects claims worth Rs. 250 crore to be released from projects in Afghanistan by Q4FY2023. Further, execution of new orders with better pricing, improvement in SAE Brazil's performance, 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 margin improvement. For FY2024E, management is confident of reverting to erstwhile double-digit margin of 10%.
- **Robust and diversified order book/order pipeline to lead future growth:** The company's order book remains strong at Rs. 31,720 crore (including L1). The company has also scaled its order book significantly in the civil segment, which is likely to be the largest growth driver. The company has increased its capabilities in the civil segment and the employee count has risen from 100 to 1,100 employees in the past few years. As per the company, competitive intensity has come down in the past two years in all the business segments. Hence, reducing competition and a strong order pipeline of Rs. 1,11,000 crore would lead to strong growth in inflows. Given the strong order prospects, KEC intends to have an order book worth Rs. 40,000 crore by the end of FY2025, almost double the FY2022 order book of Rs. 23,716 crore. Based on recent order wins, KEC's order intake in FY2023 has surpassed Rs. 7,000 crore. The company is looking at an order intake of Rs. 20,000 crore in FY2023E (Rs. 17,200 crore in FY2022).

Revision in estimates – We have maintained our estimates for FY2023/FY2024E.

Our Call

Maintain Buy with an unchanged PT of Rs. 515: Despite strong order book, KEC's performance in the past few quarters has been adversely affected by legacy orders in its Brazil subsidiary and sharp uptick in commodity prices. However, closure of legacy projects by Q3FY2023, decline in commodity prices, and execution of high-margin orders would help the company improve its operating performance and balance sheet in the medium term. The company's strong order book and high order inflow visibility provide comfort. KEC trades at a P/E of ~13x its FY2024E EPS, which provides substantial room for upside, given its healthy order backlog and order pipeline, margin revival and healthy profitability from FY2024E. Hence, we reiterate our Buy rating on the stock with an unchanged 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	16,280	18,469
OPM (%)	8.7	6.6	7.0	9.4
Adjusted PAT	553	376	446	875
% YoY growth	(2.3)	(32.0)	18.8	96.0
Adjusted EPS (Rs.)	21.5	14.6	17.4	34.0
P/E (x)	20.8	30.7	25.8	13.2
P/B (x)	3.4	3.2	2.9	2.4
EV/EBITDA (x)	11.5	15.6	12.9	8.1
RoNW (%)	18.0	10.8	11.8	20.1
RoCE (%)	20.2	13.0	14.6	21.6

Source: Company; Sharekhan estimates

SAE Brazil's pain to subside from Q4FY2023

In the recent RPG group conference, where KEC's management was present, the discussion largely centred around its subsidiaries – SAE Towers and SAE Brazil. SAE Brazil reported loss of Rs. 70 crore/Rs. 100 crore at EBITDA/PBT level, respectively, in Q1FY2023. High interest rate of 17-18% impacted profits at the 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 it 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. KEC is executing the last EPC order in Brazil and it should be completed towards the end of the quarter, post which SAE will only have tower orders and orders from Mexico. The company would not be bidding for EPC projects in Brazil at least in the near future. Moreover, it will not undertake any EPC project where engineering is done by a third party. The company expects positive margin from Brazil from Q4FY23. Most of the contractors have lost money in Brazil in the past two years as steel prices have skyrocketed and the entire cost could not be passed on to clients. The subsidiary's tower and supplies business (more than Rs 1,000 crore orders) is profitable and Mexico region is also doing well as there is lot of scope for growth since many transmission projects are coming up in the US.

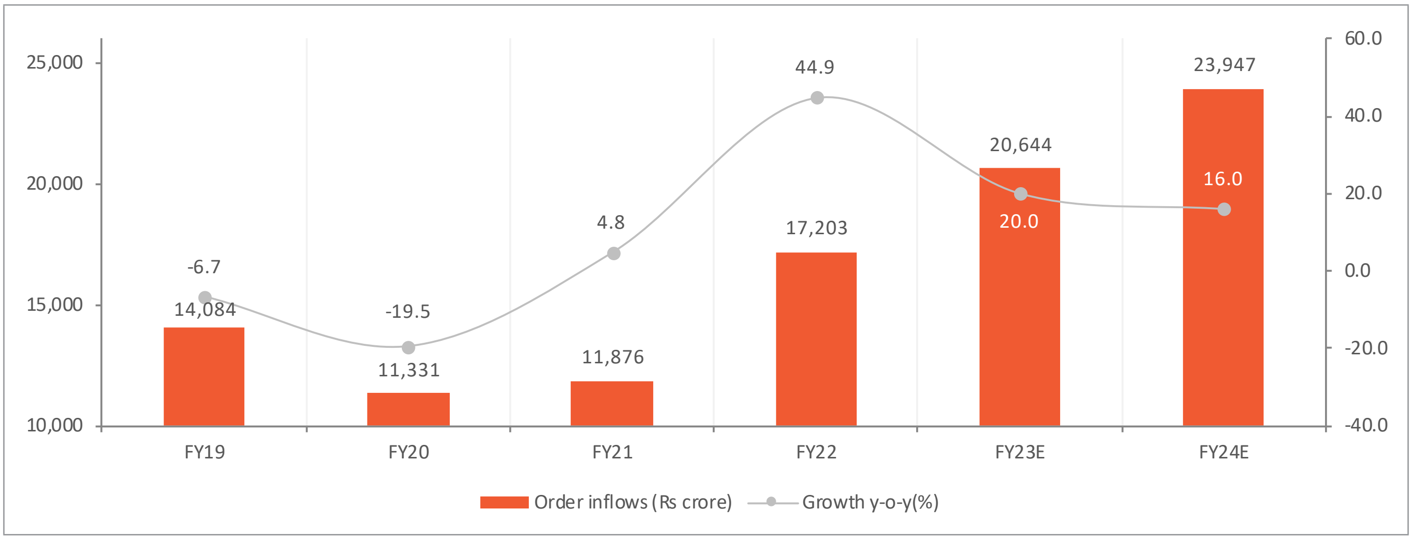
Working capital cycle to improve, margin to revert to 10% in FY2024

KEC expects working capital days to come down from 150 days to 120-130/100 days by FY2023/FY2024E. The improvement will be led by a decline in commodity prices reducing the inventory cost and changes in tax structure in civil and railways, which would free up working capital to the extent of Rs 300-Rs 400 crore. 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 Q3FY2023/Q4FY2023. KEC also expects claims worth Rs. 250 crore to be released from projects in Afghanistan by Q4FY2023. 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 margin improvement. For FY2024E, management is confident of reverting to erstwhile double-digit margin of 10%.

Robust and diversified order book and order pipeline to lead future growth

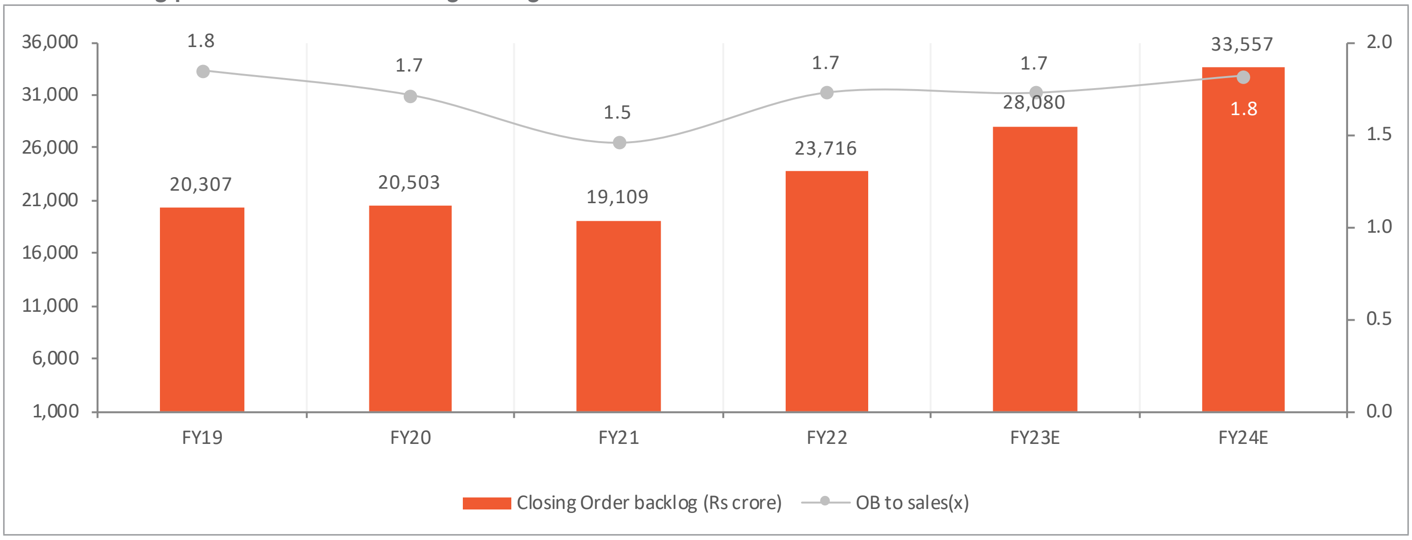
The company's order book remains strong at Rs. 31,720 crore (including L1). The company has also scaled its order book significantly in the civil segment, which is likely to be the largest growth driver with orders across industrial, residential, water pipelines, public spaces, and defence. The company has increased its capabilities in the civil segment and the employee count has risen from 100 to 1,100 employees in the past few years. As per the company, ccompetitive intensity has come down in the past two years with 7-8 bidders (vs. 12-15 bidders) in railway projects, 6-7 players in metro projects (vs. 10-12 players), and 3-4 players in civil projects (vs. 8-9 players). In domestic T&D projects, there are 4-5 players. Hence, reducing competition and a strong order pipeline of Rs. 1,11,000 crore would lead to robust growth in inflows. KEC intends to have an order book worth Rs. 40,000 crore by the end of FY2025, almost double the FY2022 order book of Rs. 23,716 crore. The company is looking at an order intake of Rs. 20,000 crore in FY2023E (Rs. 17,200 crore in FY22). Based on the recent order wins, KEC's order intake in FY2023 has surpassed Rs. 7,000 crore. Almost 40% of most recent order wins is from the railways. Since the company has a very robust order book, it would not undertake any projects that are margin dilutive.

Order inflow has been robust since FY2022



Source: Company, Sharekhan Research

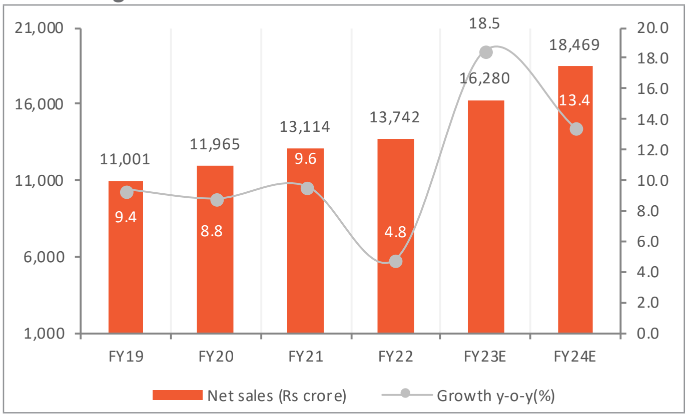
Order backlog provides revenue visibility of ~2 years



Source: Company, Sharekhan Research

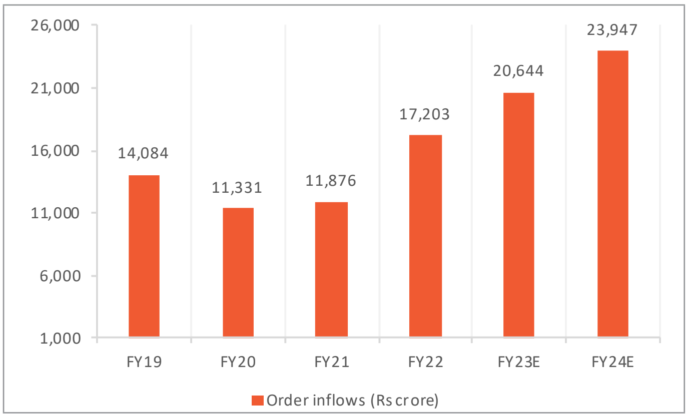
Financials in charts

Net sales growth trend



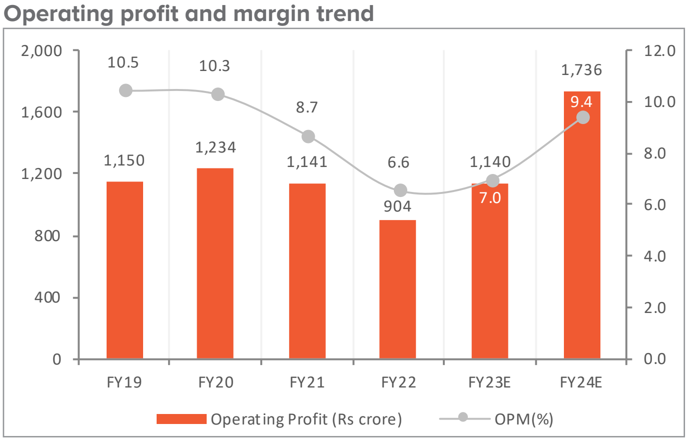
Source: Sharekhan Research

Order inflows ternd



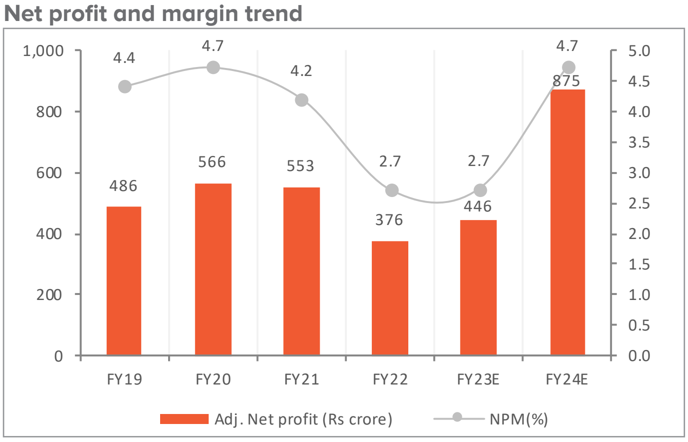
Source: Sharekhan Research

Operating profit and margin trend



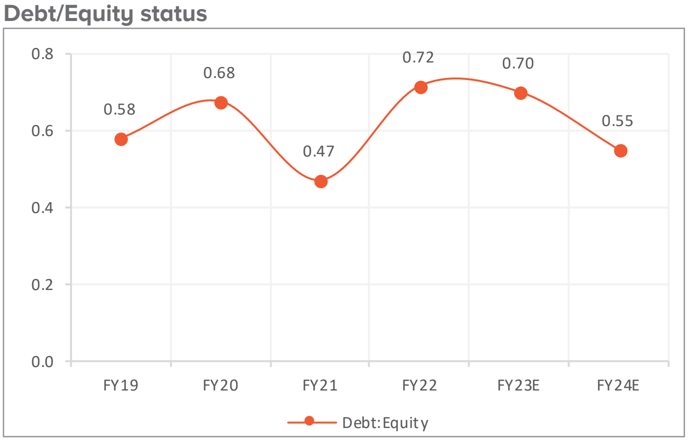
Source: Sharekhan Research

Net profit and margin trend



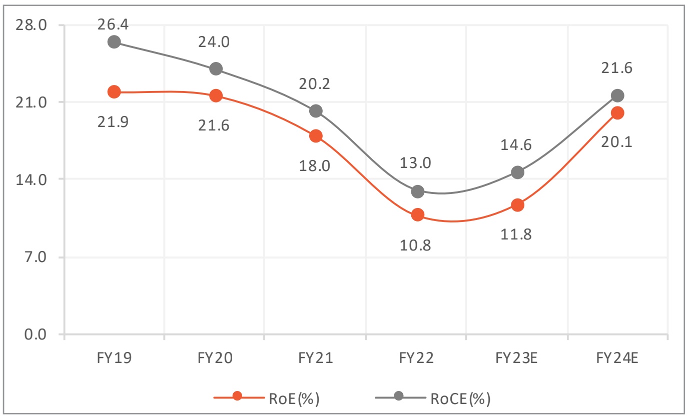
Source: Sharekhan Research

Debt/Equity status



Source: Sharekhan Research

Return ratios trend



Source: 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.

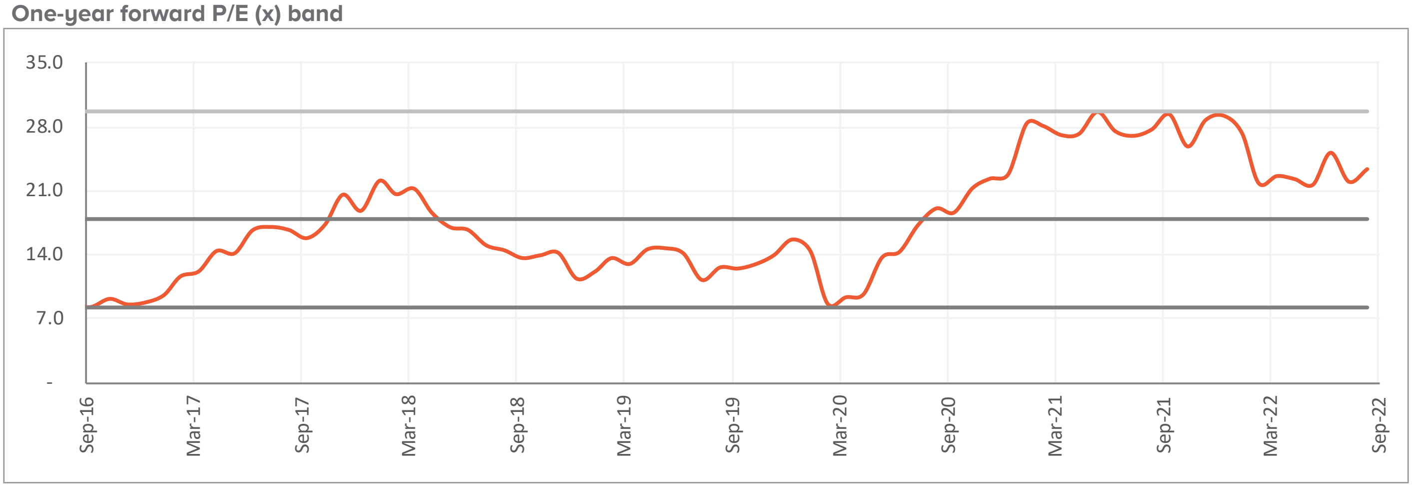
Company Outlook – Better prospects ahead

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. The green energy corridor is also a potential business opportunity for the company.

Valuation – Maintain Buy with an unchanged PT of Rs. 515

Despite strong order book, KEC's performance in the past few quarters has been adversely affected by legacy orders in its Brazil subsidiary and sharp uptick in commodity prices. However, closure of legacy projects by Q3FY2023, decline in commodity prices, and execution of high-margin orders would help the company improve its operating performance and balance sheet in the medium term. The company's strong order book and high order inflow visibility provide comfort. KEC trades at a P/E of ~13x its FY2024E EPS, which provides substantial room for upside, given its healthy order backlog and order pipeline, margin revival and healthy profitability from FY2024E. Hence, we reiterate our Buy rating on the stock with an unchanged 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 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 Limited	8.79
2	Kotak Flexicap Fund	3.19
3	Tata AIA Life Insurance Co. Limited	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 Limited	1.45
9	LIC Mutual Fund	1.31
10	Carniwal Investments Limited	1.16

Source: Bloomberg (old data)

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

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