Sharekhan by BNP PARIBAS

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Stock Update | Result Update

KEC International Ltd

Subdued Q2, profitability to improve from H2FY2023

Capital Goods	Sharekhan code: KEC
Reco/View: Buy ↔	CMP: **Rs. 436**
	Price Target: **Rs. 500** ↓

↑ Upgrade ↔ Maintain ↓ Downgrade

Summary

- For Q2FY2023, KEC International Limited's (KEC's) profitability lagged estimates, while sales were in-line led by 20% y-o-y growth in non-T&D businesses. Losses at SAE Brazil and higher interest cost eroded its profitability.
- The management expects H2FY2023 to be better as SAE Brazil orders are nearing completion and high-margin orders would reflect in revenues. Further, working capital cycle/debt are expected to reduce due to the closure of long gestation and low-margin orders.
- The company increased revenue guidance to 20% y-o-y growth (versus 15% earlier) for FY2023 based on strong year-to-date (YTD) order intake of Rs. 10,465 crore and order book of Rs. 27,569 crore.
- We retain a Buy on KEC with a revised PT of Rs. 500 backed by improving margin trajectory from H2FY2023, high revenue visibility and a diversified business model.

Q2FY2023 performance was in line on the sales front. However, profitability lagged expectations due to provision of Rs. 76 crore towards impairment of subsidiary in SAE Brazil and higher interest cost. Consolidated revenues came in at Rs. 4,064 crore (up 13.3% y-o-y). Sales growth was driven by 20% y-o-y growth in non-T&D revenue, which includes railways, civil, oil and gas, infrastructure, and cables. Operating profit declined by 29.7% y-o-y to Rs. 178 crore (vs. estimate of Rs. 281 crore) due to sharp increase in erection and sub-contracting charges. Operating profit margin (OPM) declined by 270 bps y-o-y and came in at 4.4% (versus our estimate of 6.9%). Adjusted net profit was down by ~55% y-o-y to Rs. 55 crore (versus our estimates of Rs. 116 crore) due to a low operating profit and higher interest costs. YTD order inflow during the year is at Rs. 10,465 crore (up 25% y-o-y), while the order book is at Rs. 27,569 crore and L1 or over ~Rs. 6,500 crore. Standalone business too delivered subdued performance, with 11% y-o-y growth in sales to Rs. 3,736 crore, EBITDA margin stood at 6.2% (down 320 bps y-o-y), while PAT declined by 73% y-o-y to Rs. 36 crore. The company eyes a 20% y-o-y revenue growth in FY2023. 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 increased to 49% in Q2FY2023 (vs. 46% in Q2FY2022). Civil, Cables and Smart infra revenue grew by 65%/9.6%/47% y-o-y during Q2FY2023.
- Strong YTD order intake growth of 25% y-o-y and robust order book
- Margins to improve from H2FY2023 as high-margin orders get executed and legacy orders in Brazil are closed in Q3. Fresh order backlog excluding 5% of slow-moving orders have EBITDA margin of 8-10%.

Key negatives

- T&D revenues grew slower at 7.5% y-o-y to Rs. 2,091 crore.
- Operating profit margin has hit the lowest at 4.4% in the past 7-8 years.
- Adjusted net profit declined sharply by 55% y-o-y due to poor operating performance and higher interest cost due to elevated debt.

Management Commentary

- Management raised its revenue growth guidance to 20% y-o-y (from 15% y-o-y) for FY2023.
- KEC expects H2FY2023 would have improved margins and contribution from non-T&D segments would continue to increase.
- The interest rate for working capital debt (excluding SAE debt) currently is 7% which is an increase of 200 bps from last year's levels.
- KEC expects debt to reduce by Rs. 600-700 crore in the next couple of quarters.

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. 500: 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. 34,000 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 would help to scale up its business and profitability. The company eyes ~20% revenue growth for FY23 and expects margin to revert to 8-10% in FY2024E. KEC is trading at a P/E of ~16x its FY2024E EPS, which provides substantial room for upside, given its healthy order backlog and order pipeline and possibility of margin revival. Hence, we maintain a Buy rating on the stock with a revised PT of Rs. 500.

Key Risks

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

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22	FY23E	FY24E
Revenue	13,114	13,742	16,413	18,422
OPM (%)	8.7	6.6	5.7	8.2
Adjusted PAT	553	376	279	711
% YoY growth	(2.3)	(32.0)	-25.8	155.1
Adjusted EPS (Rs.)	21.5	14.6	10.8	27.6
P/E (x)	20.3	29.8	40.2	15.8
P/B (x)	3.3	3.1	3.0	2.5
EV/EBITDA (x)	11.2	15.3	15.1	9.3
RoNW (%)	18.0	10.8	7.5	17.3
RoCE (%)	20.2	13.0	12.0	19.4

Source: Company; Sharekhan estimates

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 NEW

ESG RISK RATING 36.87

Updated Oct 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. 11,227 cr
52-week high/low:	Rs. 550/346
NSE volume: (No of shares)	5.2 lakh
BSE code:	532714
NSE code:	KEC
Free float: (No of shares)	12.4 cr

Shareholding (%)

Promoters	51.9
FII	11.6
DII	26.5
Others	10.0

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	1.6	2.7	16.5	-8.5
Relative to Sensex	-3.6	-2.1	4.9	-9.5

Sharekhan Research, Bloomberg

Profitability stays under pressure

KEC's Q2FY2023 performance was in-line on the sales front. However, profitability was below expectations due to provision of Rs. 76 crore towards impairment of subsidiary in SAE Brazil and higher interest cost. Consolidated revenue came in at Rs. 4,064 crore (up 13.3% y-o-y). Sales growth was driven by 20% y-o-y growth in non-T&D revenue, which includes railways, civil, oil and gas, infrastructure, and cables. Operating profit declined by 29.7% y-o-y to Rs. 178 crore (vs. estimate of Rs. 281 crore) due to sharp increase in erection and sub-contracting charges. Operating profit margin (OPM) declined by 270bps y-o-y and came in at 4.4% (vs. our estimate of 6.9%). Adjusted net profit was down by ~55% y-o-y to Rs. 55 crore (vs. our estimates of Rs. 116 crore) due to low operating profit and higher interest cost. Standalone business performed better, with 11% y-o-y growth in sales to Rs. 3,736 crore, EBITDA margin stood at 6.2% (down 320 bps y-o-y), while PAT declined by 73% y-o-y to Rs. 36 crore. The company aims 20% y-o-y revenue growth in FY23. Margins and profitability are likely to improve from H2FY2023, as legacy orders in Brazil and fixed-priced contracts get completed.

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

YTD order inflow during the year is at Rs. 10,465 crore (up 25% y-o-y), while order book is at Rs. 27,569 crore and L1 of over ~Rs. 6,500 crore. 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. 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). 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 highlights

T&D sales driven by international markets: T&D business had sales of Rs. 2,091 crore, growth of ~7% YoY driven by strong execution in international markets. The YTD order intake for T&D was Rs. 3,775 crore. The company secured five substantial orders in India including two prestigious orders for building digital GIS substations for PGCIL.

Strong T&D pipeline – The international T&D pipeline is very strong particularly in Abu Dhabi, Dubai, Oman and Saudi Arabia. Africa is also improving especially East Africa. In India, the tender pipeline is strong in states like Maharashtra, Karnataka and Rajasthan. The total bid pipeline is around Rs 25,000-30,000 crore.

Non T&D segment grew by ~20% y-o-y: Railways clocked revenues of Rs. 858 crore for the quarter (down 13% y-o-y) due to unusual and heavy rainfall in certain parts of India. Its order inflows doubled to ~Rs. 2,500 crore and it has a strong tender pipeline. It also expanded presence in the emerging area of TCAS (Train Collision Avoidance System) with 2 orders. Civil's sales grew by 65% y-o-y to Rs. 740 crore. The company secured YTD orders of Rs. 3,000 crore (+25% y-o-y) including substantial orders in water pipelines, public spaces, industrial and residential segments. Civil has a very strong order pipeline across residential and public projects. Oil & gas segment delivered very good performance post acquisition of KEC Spur Infrastructure last year and had sales of Rs. 81 crore and YTD order intake of Rs. 385 crore and has a strong order book including L1 of ~Rs. 900 crore, comprising government and private orders. Cables had revenues of Rs. 390 crore and grew by 9.6% y-o-y despite decline in copper prices. The company developed five new products this year and has successfully commercialized 3 of them.

OPM to improve going forward – The company expects that from Q1FY2024 onwards margin would be in higher single digit. Margin in non T&D segment is high as T&D are fixed price contracts. Therefore, increasing share of non-T&D would also aid margin improvement. The company believes that outstanding order book could make 8-10% OPM.

Debt levels would reduce by Rs. 600-700 crore – Debt level including acceptances have started declining and has reached Rs. 5,919 crore, a reduction of Rs. 156 crore q-o-q. The company expects it to further decline by Rs 600-700 crore. The Rs 90 crore increase in interest cost in H1FY23 vs H1FY22 is a result of rate hike of 200 bps and overall increase in working capital debt.

Average execution cycle is 18 months - Average execution cycle in T&D is 12-18 months, civil is 12 months, residential orders are between 12-24 months. Therefore, average order book is 18 months. Of the total order book, 5% of the order book is slow-moving.

Working capital cycle would improve going forward – Net working capital (NWC) stands at 148 days which is expected to come down to 120-130/100 days by FY2023/FY2024E. The company expects inventory levels to normalize in H2FY23. Further, the company is likely to receive Rs. 150-200 crore from Afghanistan in Q4. Changes in tax structure in civil and railways, would free up working capital to the extent of Rs. 300 crore. The company has already received Rs 40-50 crore and expects Rs. 200-250 crore to be released by March end. Further, large projects in T&D, railways, and other segments are in the last leg of execution. Therefore, the company expects its receivables to go down upon realization of payments. All these factors would lead to reduction in working capital cycle.

Results (Consolidated) Rs cr

Particulars	Q2FY23E	Q2FY22	YoY %	Q1FY23	QoQ %
Net Sales	**4,064**	**3,587**	**13.3**	**3,318**	**22.5**
Net raw materials	1,661	1,697	-2.1	1,314	26.4
Erection and subcontracting charges	1,520	1,023	48.5	1,149	32.3
Employee cost	354	316	12.2	341	4.1
Other Expenditure	350	298	17.5	346	1.3
Operating Profit	**178**	**253**	**-29.7**	**168**	**5.7**
Other Income	16	3	390.6	8	103.0
Depreciation	40	39	3.4	39	1.5
Interest	128	73	74.2	100	27.7
PBT	27	144	-81.6	37	-28.4
Tax Expenses	(29)	20	NM	6	NM
Exceptional items	-	44		-	
Reported PAT	**55**	**80**	**-31.2**	**31**	**78.1**
Adj. PAT	**55**	**124**	**-55.4**	**31**	**78.1**
EPS (Rs.)	**2.1**	**4.8**	**-55.4**	**1.2**	**78.1**
OPM %	4.4	7.1	(267)	5.1	(70)
NPM %	1.4	3.5	(210)	0.9	42

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.

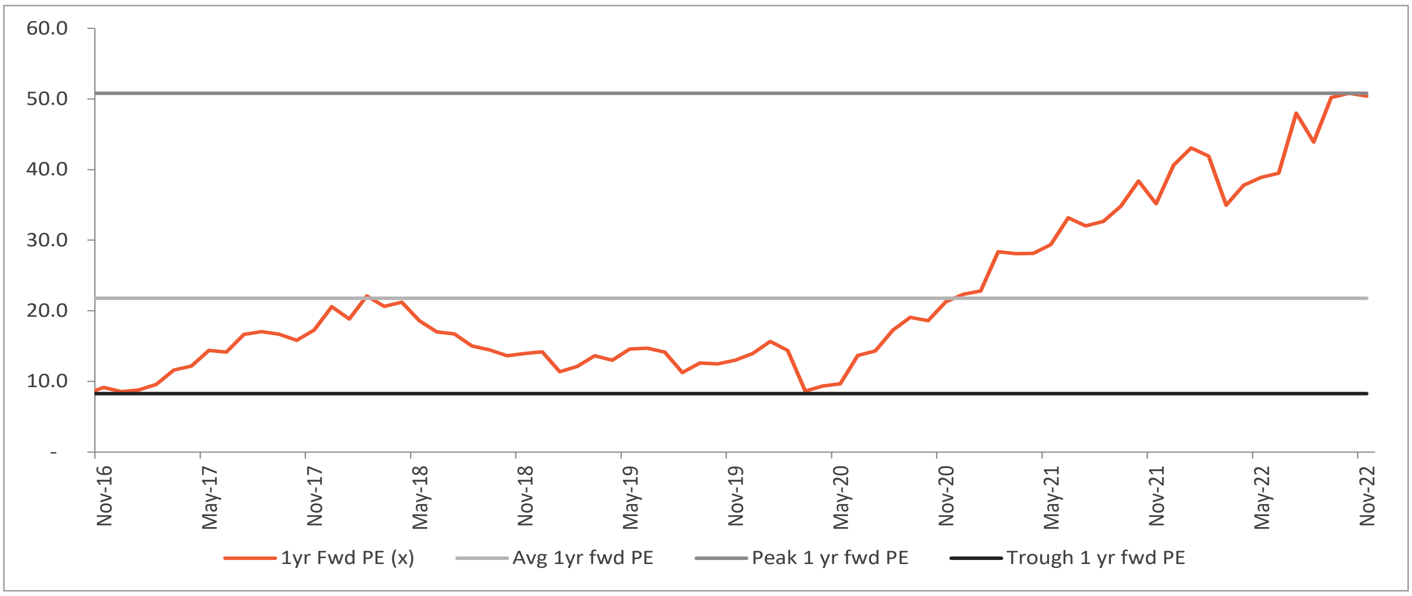
Company outlook - Better prospects ahead

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

Valuation - Maintain Buy with a revised PT of Rs. 500

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 a revised PT of Rs. 500.

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

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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