

July 12, 2013

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Incorporated in 1945, KEC International Ltd (KEC) having market cap of ~₹12.5 bn and net worth of ~₹11.5 bn at the end of FY'13 is a global infrastructure Engineering, Procurement and Construction (EPC) major. The power transmission veteran has its footprint in 48 countries across the globe providing EPC projects and tower supply facilities. It operates in the verticals of Power Transmission, Power Systems, Cables, Railways, Telecom and Water. The Company's order book remains robust at ₹94.7 bn in FY'13.

Investor's Rationale

KEC reported a subdued 3.9% YoY growth in its consolidated top-line at ₹21.0 bn. However, it witnessed a loss of ₹0.14 bn on margin pressure driven by the huge expenses made on recently started verticals (water & railways). Also, the hefty interest cost (partly due to capitalization of Vadodara facility) has further pressurized the bottom line. It also booked a forex loss of ₹0.12 bn in the quarter. Going ahead, the company believes that the expenses on new verticals is an investment that will provide huge potential to grow as the operation accelerated for a reason that currently the firm is bagging ~25-30% of orders from these 2 ventures.

The company started its order book with ₹78 bn in 2012 and is currently sitting on a pile of ₹94.7 bn order book, up by 10.5% YoY. With a very robust order book, we expect that the company will register a decent revenue growth for FY'14 over FY'13 led by the equal distribution of projects between India and foreign countries. Besides, the firm is also anticipating a decent sales growth of ~15% in FY'14 and margins to improve, albeit slowly. The management has however shifted its priorities from aggressive order accretion towards margin expansion.

KEC witnessed a slower growth of 4.1% in EBITDA margins in Q4FY'13 on high expense in new businesses viz; water & railways coupled with lower margin bids & competitive pricing in FY'13. We expect that the company in near term is however not going to see any significant rise in margins but could realize a growth of ~7.5% by FY'15 on expectation of new orders (having booked at higher margins) that are likely to be executed by Q2FY'14.

Currently, the company is loaded with a net debt of ₹12 bn which the firm believes to slash on a regular basis considering the capital it can generate in the coming years considering its very robust order book in line.

Key risk

Depreciating rupee: The persistent depreciating rupee against US dollar is denting the profit margins of power companies via raising fuel costs or by making the economics of running the plant on imported coal unviable and KEC being the major player is no exception to save itself from the heat.

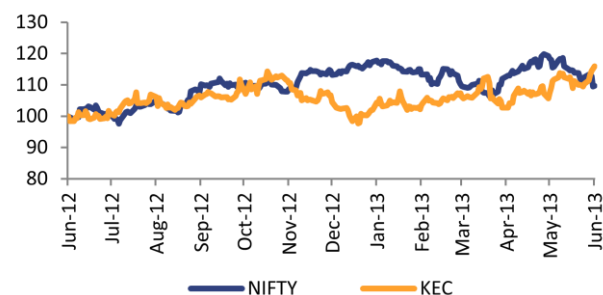
Market Data

Rating	BUY
CMP (₹)	34
Target (₹)	41
Potential Upside	~36.8%
Duration	Long Term
Face Value (₹)	2
52 week H/L (₹)	80.7 / 26.9
Adj. all time High (₹)	(91)
Decline from 52WH (%)	57.4
Rise from 52WL (%)	27.7
Beta	0.3
Mkt. Cap (₹ bn)	8.8
Enterprise Value	21.8

Fiscal Year Ended

Y/E	FY12A	FY13A	FY14E	FY15E
Revenue (₹bn)	58.1	69.7	81.0	90.8
EBITDA (₹bn)	4.7	3.8	5.2	6.5
Net Profit (₹bn)	2.0	0.6	1.5	2.2
Adj EPS (₹)	8.1	2.5	6.1	8.9
P/E (x)	4.2	13.6	5.6	3.9
P/BV (x)	0.8	0.8	0.7	0.6
EV/EBITDA (x)	3.8	5.7	4.6	3.8
ROCE (%)	17.6	11.7	14.5	16.6
ROE (%)	18.9	5.7	12.5	15.7

One year Price Chart



Shareholding Pattern	Jun'13	Mar'13	Diff.
Promoters	44.5	44.5	0
FII	2.5	2.2	0.3
DII	34.5	36.4	(1.9)
Others	18.4	16.8	1.6

EPC major, KEC is the part of ₹150 bn RPG Group. It has diversified its business in 6 segments with state-of-art 8 manufacturing facilities. Also, it is the only company in the world to have 4 tower testing stations.

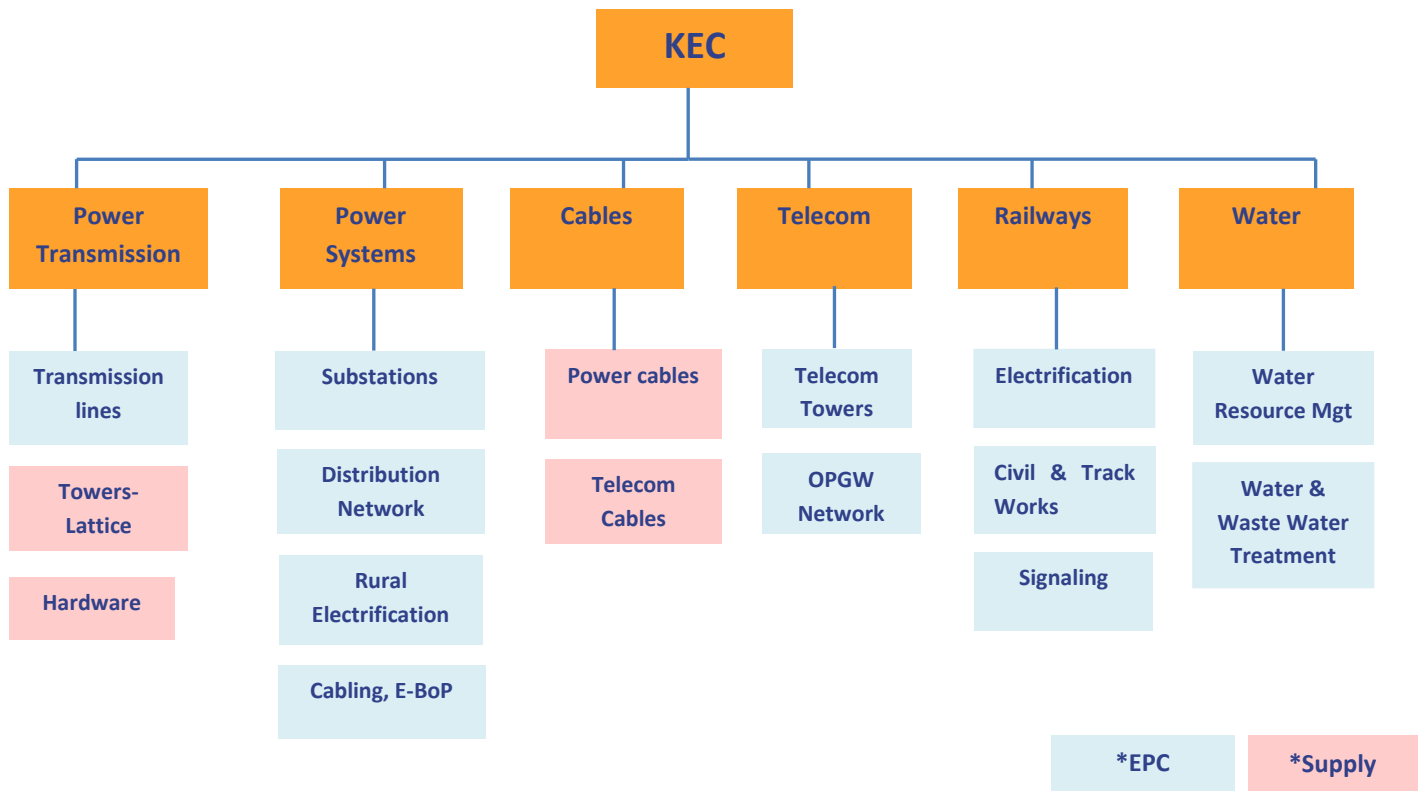
KEC's acquisition of SAE Towers for \$95 mn has helped the company to grow its presence in North America and Latin America.

KEC- A billion dollar EPC major

KEC, a \$1.3 bn enterprise with 55% plus business from international markets is country's biggest producer of electric power transmission towers and one of the largest Power Transmission Engineering, Procurement & Construction (EPC) companies in the world. Headquartered in Mumbai, India is the part of ₹150 bn RPG Group, and is having 8 manufacturing facilities across India, Brazil and Mexico with a combined manufacturing capacity of 251,000 metric tonnes per annum. With the manpower strength of ~50,000 employees it operates in 6 business segment namely power transmission (that contributes 75.2% of its order book), power system (12.4%), cable (1.1%), telecom (2.0%), railways (4.6%) and water (4.7%). Notably, it is the single company in the world to have 4 tower testing stations, capability to test towers upto 1,200 kV and also the first company in India to erect 765 kV line. Besides, it also provides telecom infrastructure services, satellite and GPRS surveys, and hotline stringing services. Apart from India (attribute 51.5% of order book) it provides tower supply projects and turnkey project facilities to 45 countries, outside India. It has operations in Algeria, Afghanistan, Egypt, Ethiopia, Ghana, Kazakhstan, Kenya, Mali, Mozambique, Namibia, Nigeria, Saudi Arabia, South Africa, Tajikistan, United Arab Emirates etc.

Also, one of the company's major milestones it has achieved was the acquisition of SAE Towers, US worth \$95 mn in 2010. The subsidiary, SAE Towers is the leading manufacturer of lattice transmission towers in America. The firm serving the markets of Mexico and Brazil has annual production capacity of 100,000 mt. Also, with the manpower of 1,000 employees it manufactures steel poles, sub-station structures and hardware.

Business Overview



KEC's evenly split approach to boost growth

KEC in its persistent expansion drive has judiciously framed its key strategies for growth which include the expansion in products, topographies and businesses. Focusing light on some of its executed projects and primarily the forthcoming plans.

Product expansion-

- KEC recently has finished the execution for EHV cables at Vadodara worth ₹1.8 bn in FY'13 which can produce 4,000 cable km annually. Notably, it has been designed for future capacity expansion and likely to add ~₹3.5 bn turnover for cables segment.
- Exploring opportunities in Solar (National Solar Mission (NSM) where it has planned to add 20,000 MW by FY'22) and Wind sector (Annual capacity addition in Wind – 2,500 MW/annum).
- Grid Parity is on card by 2017, move to slash price of purchasing power from electricity grid.
- Strategic plans to increase presence in poles segment in future.

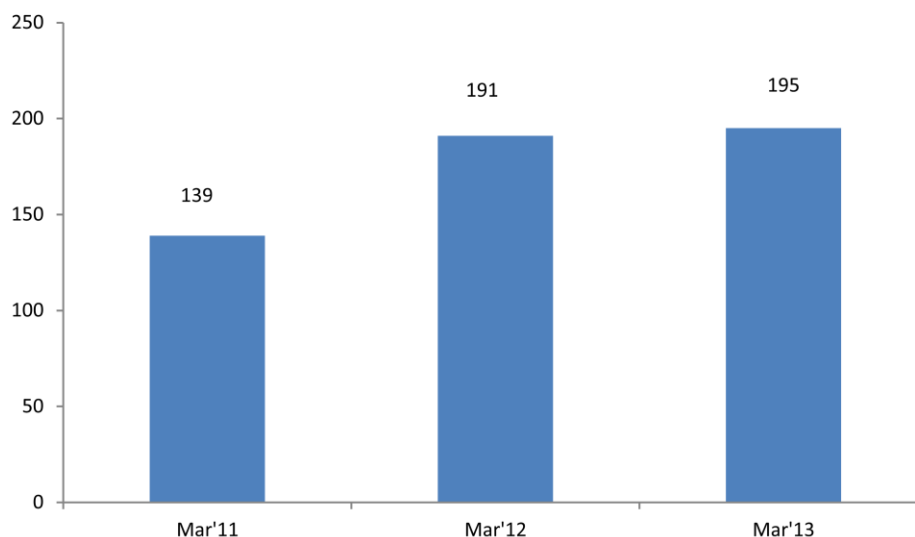
Geographical Expansion-

- Strengthen presence in SAARC & Brazil (Next 10 years plan – 61 GW generation and 42,553 kms transmission). Besides, Brazil is aggressively improving its transmission networks, SAE (43% market share in Brazil) is all set to tap the tremendous opportunities ahead.
- Executing 220 kV substation projects in Kazakhstan worth ₹9.4 bn and is further planning to set up transmission lines by the end of FY'14. Once these projects get operational will help KEC to slash its high operational and maintenance cost.
- SAE Towers is expanding its pole production capacity from 5,000 tonne to 12,000 tonne at its existing facility in Mexico at an investment of ₹0.3 bn to cater the increasing demand of poles in North American region.

KEC from a decade has maintained its growth track record via emphasizing on its expansion strategy of focusing equally on product, geographical and business expansion.

The company in its geographical splash is working on establishing 220 kV substation projects in Kazakhstan worth ₹9.4 bn.

Sales from SAE tower, US (in \$ mn)



Business expansion-

- Presently executing Rural Electrification projects in India, Kenya, Ethiopia and Afghanistan.
- Targeting construction opportunities in US as US has proposed to spend over \$11 bn in upgrading its ailing transmission network.
- Increased tower manufacturing capacity in India to 274,000 mt in FY'13 from 174,000 mt in FY'12.

In a nutshell , KEC has kept all its key strategies in place in order to tap the future growth prospects in a multi billion EPC zone.

Major order wins across verticals:

Transmission business creating strong growth prospects

KEC is the largest Transmission EPC company globally driven by its continuous and major orders wins. It churns ~70% of its order from this particular segment. The firm covering not only the domestic market but has also bagged key orders in foreign countries which in turn are going to boost its revenues. We believe that the piled up order book will help the company to churn turnover of ₹81.1 bn by FY'14E. KEC's arm, SAE Towers has secured largest ever poles supply order worth ₹0.7 bn from Canada in FY'13. This move will help the company to attain its target of expanding its pole production capacity to 12,000 mt from 5,000 mt with a targeted investment of ~₹0.3 bn. Besides, KEC has again made its entry after 10 years in Indonesia and has grabbed an order from Indonesia's State Electricity Corporation for design, supply and erection of 150 kV transmission line between Bengkayang –Ngabang-Tayan with an order value of ₹1.3 bn.

Covering Gulf region, Saudi Electricity Company has awarded an order amounting to ₹2.0 bn for design, supply and erection of 380 kV transmission lines with interconnection of Al Salam, Madinah. We expect revenue visibility to remain intact in next 1-2 years.

It has also secured Supply and Erection of 400 kV transmission line from the Power Grid Corporation of India Limited (PGCIL). The order value is ~₹2.2 bn. We expect that all these orders once get accomplished will provide a big respite to the company on margin side and also help to slash the huge debt burden it is having in its books.

Cable Business

KEC has fully integrated state-of-the-art manufacturing facilities in different parts of India. Recent, set up of its cable facility in Vadodara is likely to add revenues of ~₹3.5 bn in cable segment. Besides, the firm's expect cable industry to post an annual growth rate of ~15% in following years providing growth opportunity to KEC. Recently, Cable business of KEC has grabbed an order amounted to ₹0.9 bn for supply of Power and Telecom Cables.

As per the data revealed by the Energy Information Administration showed that net power generation capacity is likely to grow by 22.7 trillion kwh by 2015 and notably demand for power cables is mainly driven by the power sector. Thus, pioneer KEC is all set to grab the future order to fulfill the expected demand growth.

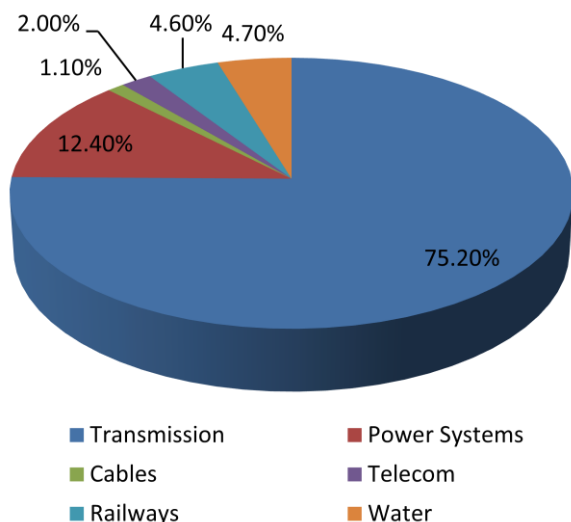
KEC's massive order book in FY'13 has ensured a decent earning visibility for next 18-24 months.

KEC International has bagged orders worth ₹9.1 bn in its transmission, cable business and power system business from domestic and international companies.

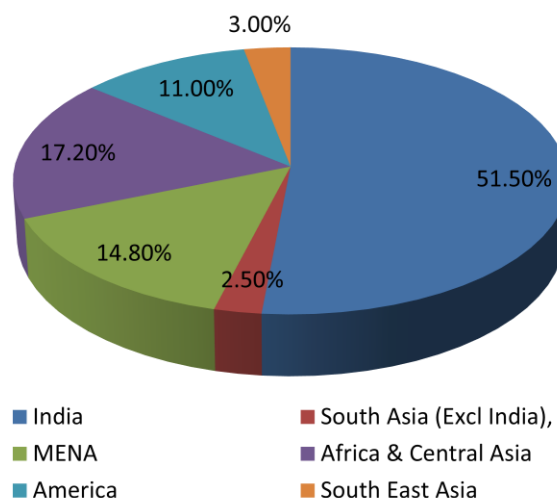
With over ₹180 bn size of cable market in India, KEC expects this industry to have annual growth rate of 15% in coming years.

Robust and Diversified Order Book – ₹94.7 bn (\$ 1.7 bn) as on FY'13

Business wise



Region wise



The PGCIL has awarded an order worth ₹2.9 crore for supply and erection of 400 kV transmission line in Chhattisgarh.

Power Systems Business

The company's second largest business vertical, Power system business contributes 12.04% of its total order book. Making its entry in 765 kV GIS substation space, it has received an order from PGCIL to establish 800 kV Gas Insulated Substation (GIS) in Chhattisgarh during FY'13 worth ₹2.9 bn. The firm's decision to diversify its focus from transmission to power system will give an advantage to cater end-to-end solutions from power evacuation to distribution to consumers.

Under this vertical KEC has executed various EPC projects such as Rural Electrification to over 500,000 BPL families via covering 11,000 villages. Also the firm is establishing a Electrical-Balance of Plant (E-BoP) project in India in order to improve the performance and reliability of power delivery systems which we expect help the firm to gain more market share, going ahead.

T&D Industry Outlook

From past 50 years, India has been able to make barely half of the desired level of investment in the power transmission and distribution (T&D) sector. On industrial front, T&D industry is likely to witness a strong demand domestically led by the expected rise in new power generation capacities targeted to generate (88,537 GW in its 12th plan), addition of transmission lines (107,440 CKM in its 12th plan) and setting substation with targeted output of (270,000 MVA by 2017) creating a huge opportunity for players in the T&D space and hence the growth prospects to KEC, given its strong presence in the domestic T&D market.

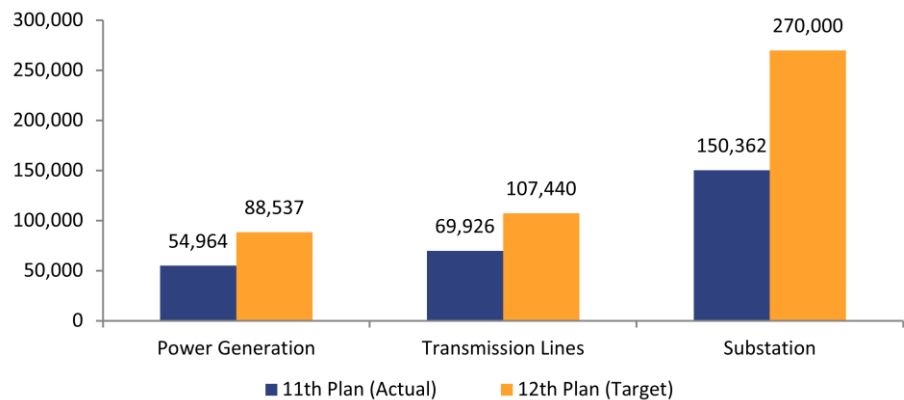
On industrial front, T&D industry is likely to witness a strong demand worldwide led by the rise in new power generation capacities.

The development of T&D industry is however under pressure due to the unavailability of adequate funds, high import duty, policy paralysis etc.

The industry is reeling under various issues such as lower investment, high service-tax, Central Sales Tax (CST), scarcity of raw materials leading to higher imports etc. To ease the problems it is important for the government as well as the allied authorities to take effective measures to boost the sector's growth. Some measures are stated as under:

- Government budget need to provide an impetus to boost growth in T&D sector.
- Service-tax exemption to all power projects that will cut generation and distribution price, as T&D firms are not allowed to credits on tax paid on procurements.
- Formation of a provision in the CST Act to grant exemption to sub-contractors for supplying goods to SEZ unit.

Huge prospects in T&D and Substation industry (Values in MVA)



Logjams to KEC's growth and company's strive towards mitigating the risks

• Rise in input cost

The Company's business hovers around the usage of key commodities like steel, zinc, copper, aluminum etc and the adverse rupee movements is expected to continue to pressure raw material costs and the related segments. However, in a bid to save itself from higher material cost, the company relies on keeping its commodity hedged to optimum levels and also focus on using domestic products and reducing imports.

• 2. Subdued infrastructural development

Sluggish infrastructural development coupled with lesser capex will exert brake on overall development and thus could lower order intake.

- KEC having operations in over 40 countries will not be pressurized much with the downturn in investment activities in one region or country. Further, it has set exposures to under-developed and emerging economies where investment in infrastructure is a key priority.

• 3. Heavy import duty

For manufacturing transformers, a critical raw material is needed known as Cold Rolled Grain Oriented (CRGO) steel which is not at all domestically available so have to import fully. The heavy import duty on such type of raw materials is putting pressure on company's expenses and hence increase in the prices.

- To produce such steel currently only 5 global steel makers have the technology. Now India considering CRGO vital need has planned to invest ~₹5 bn. KEC too believes that there is an urgent need to invest more in its testing facilities.

The company that booked ~70% of its order from T&D business is equally impacted by the issues related to the T&D industry. The increasing raw material cost, heavy import duty on critical commodities are some of the bottlenecks, KEC is pressurized with.

Balance Sheet (Consolidated)

Y/E (₹mn)	FY12A	FY13A	FY14E	FY15E
Share Capital	514	514	514	514
Reserve and surplus	10,564	10,958	12,014	14,047
Net Worth	11,078	11,472	12,529	14,561
Loan funds	11,139	14,560	17,472	19,219
Long term provisions	972	885	806	733
Current Liabilities	31,707	34,709	38,656	42,646
Deferred tax liability (net)	666	804	804	804
Other long term liabilities	100	100	100	100
Total Equity & Liabilities	55,662	62,530	70,366	78,063
Fixed Assets	12,428	13,539	15,163	16,679
Deferred tax assets (net)	153	183	183	183
Loans & Advances	5,101	6,618	7,280	7,644
Current Assets	37,253	41,274	46,639	52,236
Other Non-current Assets	727	917	1,100	1,320
Total Assets	55,662	62,530	70,366	78,063

Key Ratios (Consolidated)

Y/E	FY12A	FY13A	FY14E	FY15E
EBITDA Margin (%)	8.1	5.5	6.4	7.2
EBIT Margin (%)	7.3	4.7	5.7	6.5
NPM (%)	3.6	0.9	1.9	2.5
ROCE (%)	17.6	11.7	14.5	16.6
ROE (%)	18.9	5.7	12.5	15.7
Adj EPS (₹)	8.1	2.5	6.1	8.9
P/E (x)	4.2	13.6	5.6	3.9
BVPS (₹)	43.1	44.6	48.7	56.6
P/BVPS (x)	0.8	0.8	0.7	0.6
EV/Operating Income (x)	0.3	0.3	0.3	0.3
EV/EBITDA (x)	3.8	5.7	4.6	3.8
EV/EBIT (x)	4.2	6.7	5.3	4.3

Profit & Loss Account (Consolidated)

Y/E (₹mn)	FY12A	FY13A	FY14E	FY15E
Total Operating Income	58,147	69,794	81,098	90,803
Operating Expenses	53,434	65,980	75,878	84,224
EBITDA	4,713	3,814	5,220	6,579
Other Income	616.3	160.5	176.6	194.2
Depreciation	479	560	628	703
Exceptional Items	9.8	1.4	0.0	0.0
EBIT	4,841	3,413	4,769	6,070
Interest	1,597	1,944	2,235	2,492
PBT	3,243	1,468	2,533	3,577
Tax	1,150	818	963	1,288
Net Profit	2,093	650	1,570	2,289

Valuation and view

We believe that the loss in current quarter and pressurized margin will be overdone with incremental cash generation from its various projects and other significant plans.

Considering the robust order backlog supported with uninterrupted cash flow, the revenue visibility for KEC is still intact over ensuring years. In the longer run, capex in transmission space & EHV cables, which attract a premium in the current power sector, will be a major focus for KEC that will help to enhance its bottom line as well as the topline in next couple of years.

At a current market price (CMP) of ₹ 34.3, the stock trades at 5.6x FY14E and of 3.9x FY15E, earnings. We recommend 'BUY' with a target price of ₹41, which implies potential upside of ~20% to the CMP from 1 year perscpeive.



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