

# Capital Goods

## A USD 12bn order pipeline should revive T&D capex

INDIA | CAPITAL GOODS | SECTOR UPDATE

19 February 2019

### Expect domestic T&D order activity to revive in the medium term...

The Empowered Committee on Transmission has recently approved Rs 115bn projects to connect renewable energy power plants. This is in addition to Rs 65bn of projects already under competitive bidding (Rs 53bn inter-state and Rs 12bn intra-state), and a further Rs 55bn of projects for which award timelines are not yet fixed. This makes the total pipeline Rs 235bn over the next two years. Majority of these projects will be competitively bid out and only Rs 27bn are to be nominated to PGCIL. However, PGCIL is likely to be a major beneficiary even under the competitive bidding route. The Empowered Committee expects many of these projects to be awarded and commissioned by the end of CY20. While we expect the order-award process to be faster than usual, meeting the commissioning timeline is a tough ask in our view.

### ... after a two year slowdown

In the past two years (FY17-18) PGCIL's orders and those from tariff-based competitively bid (TBCB) projects had declined sharply due to the pipeline of projects shrinking and a lack of interest by private sector and financial institutions.

### Visibility on international orders has also improved

Based on our analysis of the capex plans of the Power Grid Company of Bangladesh (PGCB), we have identified projects worth Rs 380bn (US\$ 5.4bn) that would come up for bidding over the next two years. We arrive at this opportunity after excluding US\$ 2.3bn projects that are funded by the Chinese and Korean agencies, as companies from these countries would be natural beneficiaries of orders for these projects. In addition, Brazil has awarded the US\$ 3.4bn of transmission projects in its recently concluded auction process in December 2018. These opportunities are over and above existing activity from North Africa, the Middle East, and SAARC.

### All this should help T&D players' order books to grow in the medium term

In all, we expect US\$ 12.2bn of new order opportunities for T&D equipment companies over the next two years, fueling order inflows for FY20-21 and addressing investors' concerns on declining order flows in the sector.

### Positive for KEC, L&T, SIEM, ABB, GE T&D, KPP, and Techno Electric...

Companies that are best levered to benefit from the spurt in T&D orders are KEC (upgrade to Buy), L&T (Buy), Kalpataru Power (NR), and Techno Electric (NR) from substations and transmission-line projects. Siemens (Sell), ABB (Sell), GE T&D (Sell) would not only benefit from opportunities in sub-stations, but also from an HVDC project in Bangladesh.

### ...but competitive intensity is likely to remain high

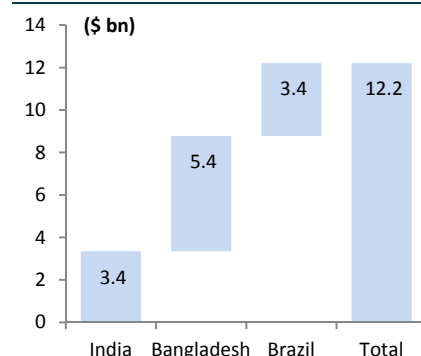
As the pace of domestic orders is likely to pick up after a gap of two years, we believe competition in these orders will be aggressive. Since most projects are funded by multilateral agencies in Bangladesh, they are open to global competition – for instance, two projects that are likely to be awarded by the end of February have 15 bidders each. In Brazil, local players are given a higher preference at the time of bidding.

### In the long term, we still expect a bulk of domestic capex to be state-driven

This uptick in ordering from the central sector is temporary; the structural trend – of PGCIL's capex gradually declining – still holds for the long term. With the national grid almost complete, the focus has shifted to building intra-state grids.

Company	CMP	Rating	PE (x)	
			FY20E	FY21E
ABB IN	1,229	Neutral	40.9	35.4
BDL IN	241	Neutral	9.9	10.4
BHE IN	75	Neutral	11.2	10.5
BHEL IN	61	Neutral	13.1	9.3
COCHIN IN	336	Buy	11.2	9.8
KKC IN	663	Neutral	21.5	19.3
ENGR IN	107	Neutral	16.1	14.5
GETD IN	285	Sell	27.6	31.6
KECI IN	239	Buy	10.3	8.7
LT IN	1,245	Buy	18.5	16.6
SIEM IN	944	Sell	30.5	27.4
TMX IN	967	Neutral	30.3	25.6
VATW IN	267	Buy	8.2	6.4
VOLT IN	522	Neutral	27.1	24.4

### A \$ 12bn opportunity to revive the T&D sector

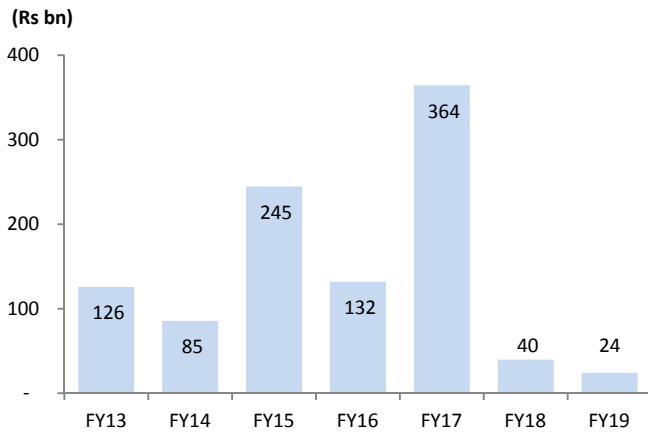


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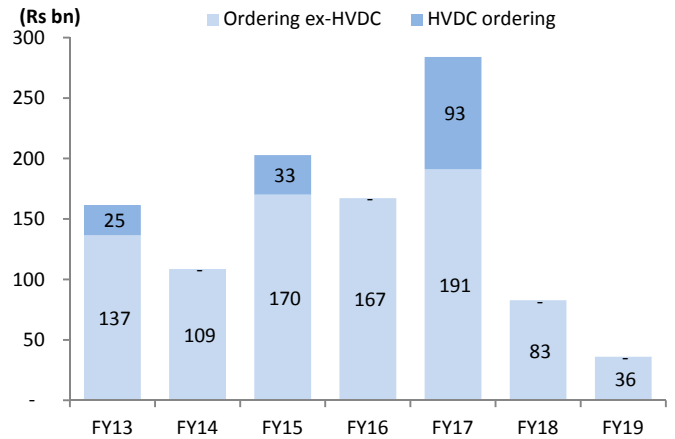
## Our thesis in charts

### PGCIL's investment approvals have significantly declined in FY18-19...

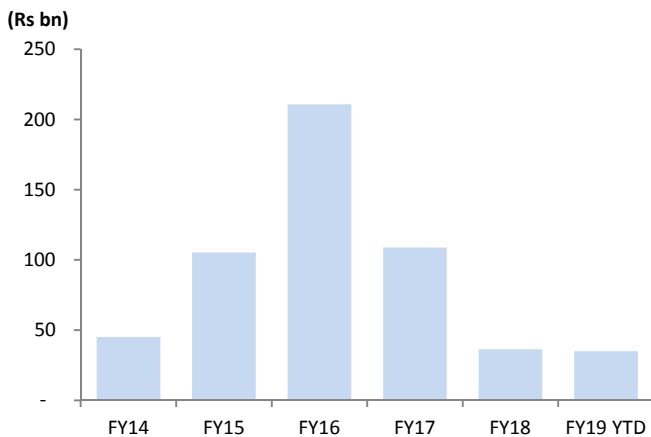


Source: PGCIL, PhillipCapital India Research

### ...which has had a telling effect on project awards by PGCIL

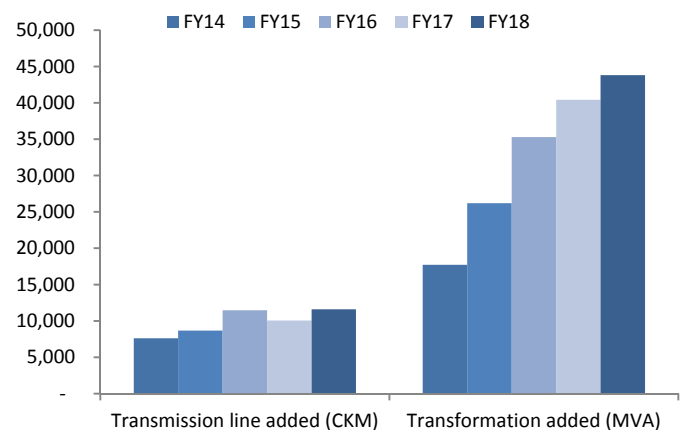


### Awards of TBCB have also sharply declined

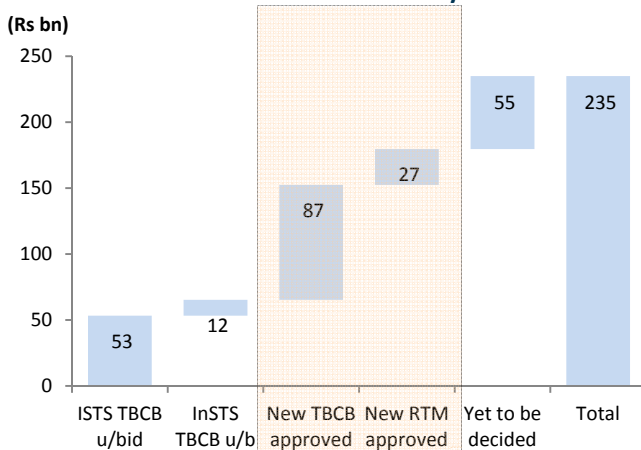


Source: CEA, PhillipCapital India Research

### Only, state transcos' capex has been growing

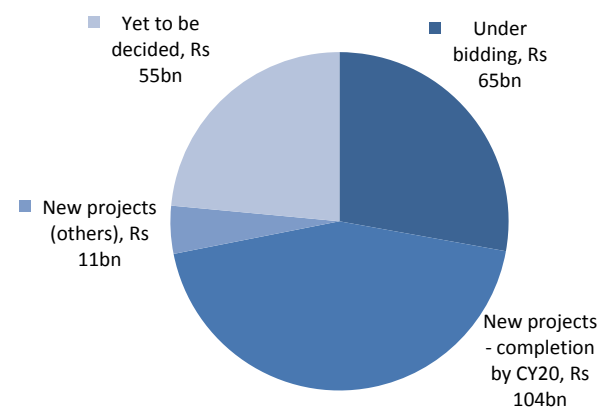


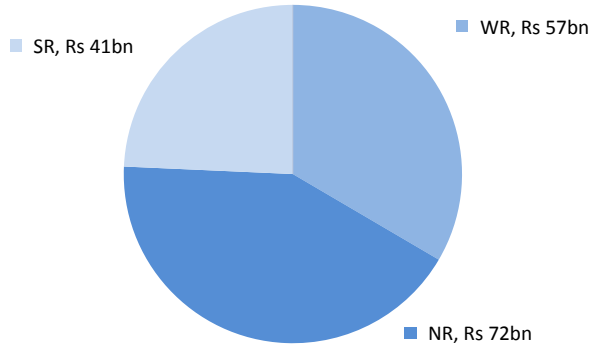
### We now see Rs 235bn of ordering opportunity in the domestic T&D market over the next two years...



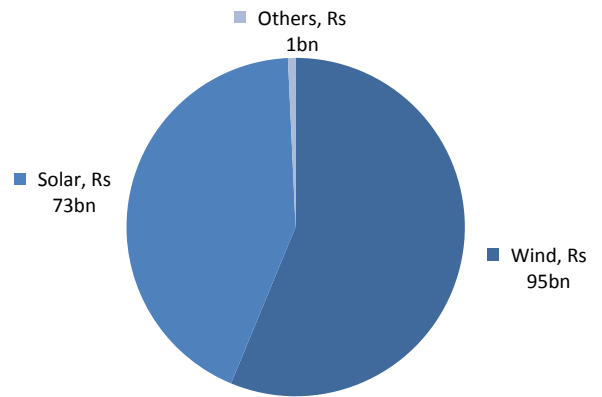
Source: CEA, PhillipCapital India Research

### ...of which, Rs 104bn of recently approved projects need to be completed by CY20

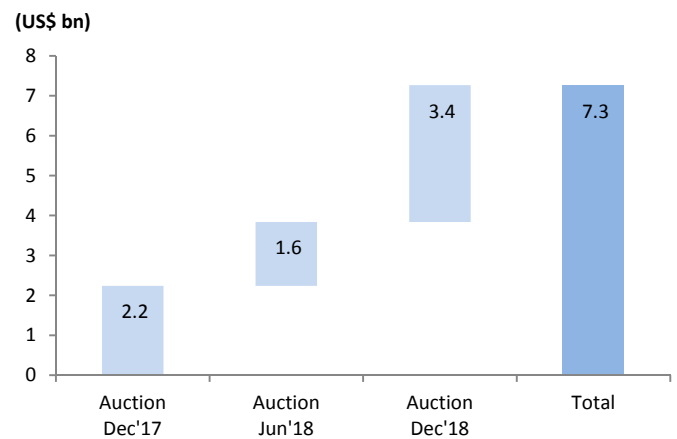


**Most projects are clustered in western and northern India, where execution is relatively easy**


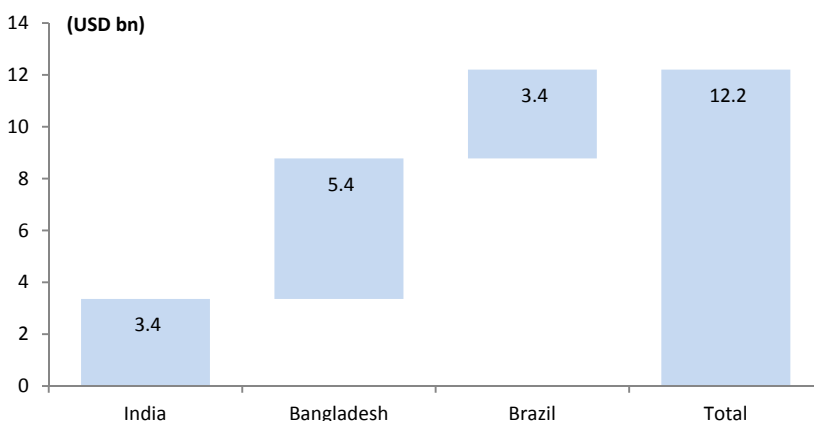
Source: CEA, PhillipCapital India Research

**Orders are largely split between projects dedicated for wind and solar power plants**

**Building the Bangladesh power grid offers a US\$ 5.4bn opportunity for Indian T&D players**

Funding agency	Total costs (Rs bn)
Funded by Indian LOC	151
WB, ADB, AIIB, KfW	194
GOB & PGCB	35
<b>Opportunity for Indian players</b>	<b>380</b>
China funding	135
EDCF, South Korea	23
<b>Total</b>	<b>538</b>

**Brazil auctioned US\$ 3.4bn of T&D BOOT assets in Dec 2018**


Source: PGCB, PhillipCapital India Research

**In all, a US\$ 12bn opportunity should revive the T&D sector**


Source: PhillipCapital India Research

# KEC International (KECI IN)

Perfectly placed to gain from a pickup in T&D orders

INDIA | CAPITAL GOODS | Company Update

19 February 2019

## KEC should be the biggest beneficiary of a pickup in T&D orders

The T&D sector (including SAE) accounts for 64%/60%/76% of KEC's order inflows/orderbook/revenues. We believe that within our coverage, KEC would be the biggest beneficiary of an uptick in T&D order activity over the next two years. The company has had a healthy 15% market share of PGCIL's orders, and should benefit from the Green Energy Corridor-related order activity. In the past two quarters alone, KEC has won Rs 25bn of orders (20% of its FY19 YTD order inflow) from Bangladesh, providing confidence that it will gain from ordering by Power Grid Company of Bangladesh Limited (PGCB). Also, through its subsidiary SAE, KEC has a local manufacturing presence in Brazil, giving it an advantage over other domestic peers in securing orders from the latest round of auctions there.

## We raise earnings estimates by 2%/6% for FY20/21

On improving visibility of orders in the T&D segment, we have raised our estimates for KEC's FY20/21 order inflow by 4%/5%, which has led to our earnings estimates increasing 2%/6%. We now expect KEC's earnings to grow at a more respectable 14% CAGR over FY18-21 with 22% ROE. However, it should be noted that orders, particularly for domestic projects, would be back-ended due to upcoming general elections.

## Upgrade to BUY with a revised target of Rs 315

After [our downgrade in May 2018](#), KEC's stock price has declined 36% and underperformed the BSE CapGoods Index by 22%. It now trades at 10x FY20 PE, which is below its long-term average one-year-forward PE of 13x. Based on limited downside to valuations from current levels and backed by increased order inflow visibility, we upgrade our rating to BUY (from Neutral) and raise our target to Rs 315 (from Rs 275), implying 30% upside. We have raised our target multiple to 13x June 2020 earnings (12x earlier) to reflect our optimism on one of the two re-rating catalysts for KEC, i.e. order inflows, the other being working capital.

## Exposure to private-sector TBCB projects is a concern

In the past three years, KEC has won c.Rs 17bn of orders (cumulatively) from private-sector BOOT projects. The unexecuted portion of these orders is Rs 6-7bn and the billed receivables are c.Rs 3.5bn, based on KEC's commentary in its recent post-results interactions. Liquidity issues faced by two of its clients could lead to a risk of prolonged receivables.

## The second leg of a re-rating will be on noticeable reduction in NWC intensity

Our estimates currently bake in a modest improvement in KEC's net working capital (NWC) intensity – from 37% in FY19 to 33% in FY21. However, historically, its NWC-to-sales ratio has averaged c.25%, even up to FY17-18. The current elevated working capital levels are mainly due to increased vendor funding and higher-than-average receivables. If the management is able to reduce working capital faster than our estimates, KEC's stock price could see another round of re-rating – in such a scenario, KEC's stock could trade at 16x one-year forward PE and would have a blue-sky target of Rs 400 – implying 65% upside.

Estimates change (Rs bn)	Previous Est.		Revised Est.		% Revision	
	FY20E	FY21E	FY20E	FY21E	FY20E	FY21E
Order inflows	153.04	175.28	158.96	183.46	3.9%	4.7%
Order backlog	223.34	255.92	227.26	264.03	1.8%	3.2%
Revenue	127.39	140.41	128.33	144.39	0.7%	2.8%
EBITDA	13.37	14.76	13.52	15.41	1.1%	4.4%
EBITDA margin (%)	10.5%	10.5%	10.5%	10.7%	4 bps	16 bps
Recurring PAT	5.89	6.69	5.98	7.09	1.6%	5.9%
Recurring EPS (Rs)	22.9	26.0	23.3	27.6	1.6%	5.9%
BVPS (Rs)	114.5	136.4	114.7	138.1	0.2%	1.3%
RoE (%)	21.8%	20.8%	22.2%	21.8%	34 bps	104 bps

## BUY (Upgrade)

CMP RS 239

TARGET RS 315 (+32%)

### COMPANY DATA

O/S SHARES (MN) :	257
MARKET CAP (RSBN) :	64
MARKET CAP (USDBN) :	0.9
52 - WK HI/LO (RS) :	443 / 233
LIQUIDITY 3M (USDMN) :	1.3
PAR VALUE (RS) :	2

### SHARE HOLDING PATTERN, %

	Dec 18	Sep 18	Jun 18
PROMOTERS :	51.3	51.2	51.0
FII / NRI :	7.9	9.8	11.7
FI / MF :	23.7	21.0	19.2
NON PRO :	2.6	3.0	3.6
PUBLIC & OTHERS :	14.6	15.1	14.5

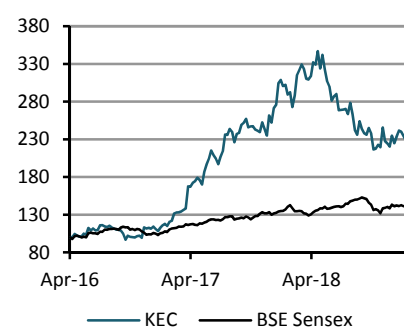
### KEY FINANCIALS

Rs bn	FY18	FY19E	FY20E
Net Sales	100.58	111.86	128.33
EBIDTA	10.24	11.80	13.52
Net Profit	4.73	5.10	5.98
EPS, Rs	18.4	19.8	23.3
PER, x	13.0	12.0	10.3
EV/EBIDTA, x	7.5	7.6	6.5
P/BV, x	3.1	2.5	2.1
ROE, %	26.4	22.9	22.2
Total debt/Equity (%)	88.4	131.4	110.6

### PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	-12.3	-12.1	-31.2
REL TO BSE	-12.7	-15.8	-36.5

### PRICE VS. SENSEX



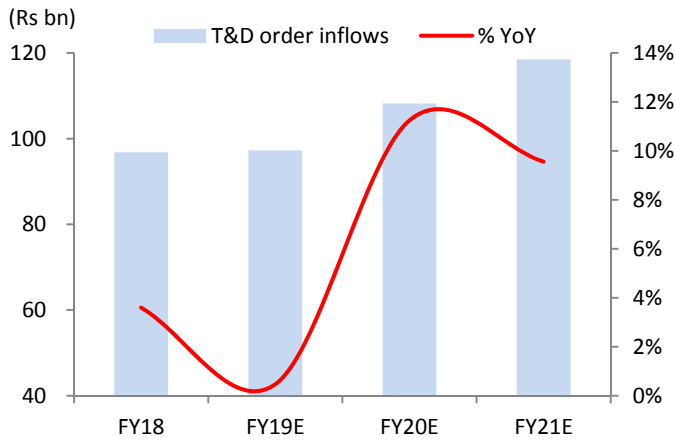
Source: Phillip Capital India Research

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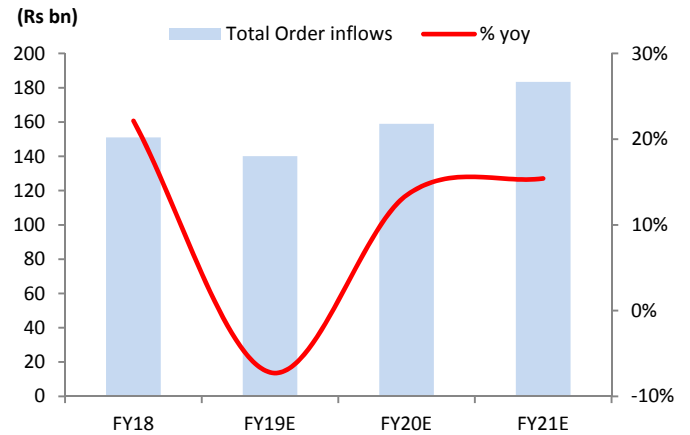
## Our view in charts

**T&D order inflows to pick up over FY20-21 after muted growth in FY18-19...**

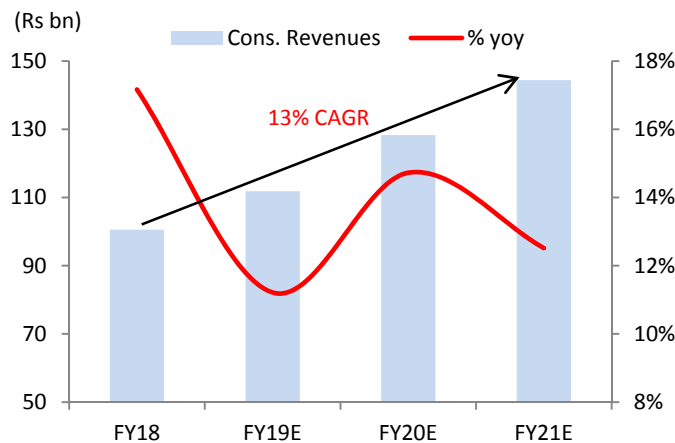


Source: Company, PhillipCapital India Research

**...which will lead to healthy double-digit growth in overall new orders**

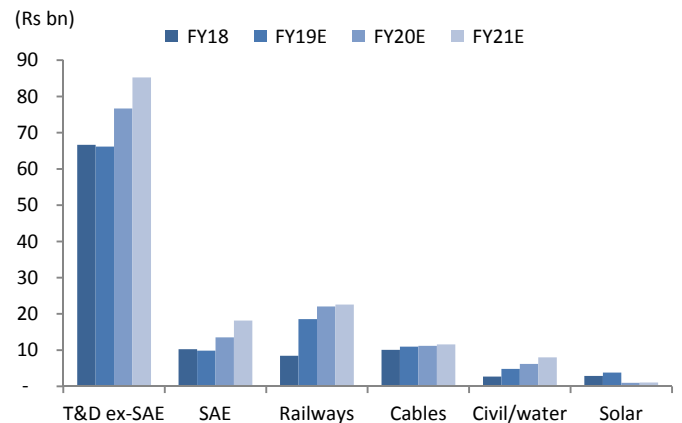


**Consolidated revenues to see 13% CAGR over FY18-21**

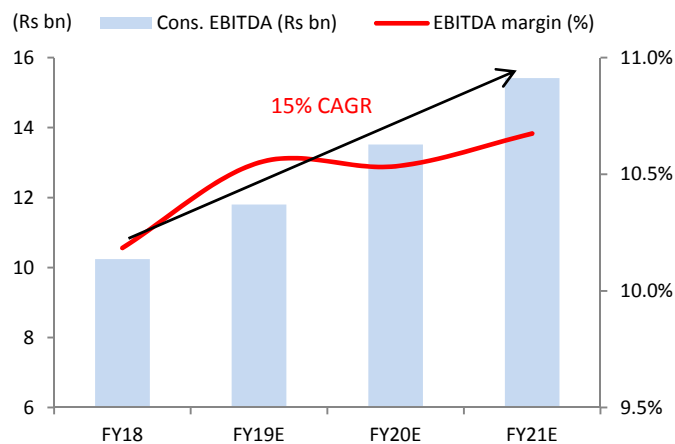


Source: Company, PhillipCapital India Research

**Revenue by segments**

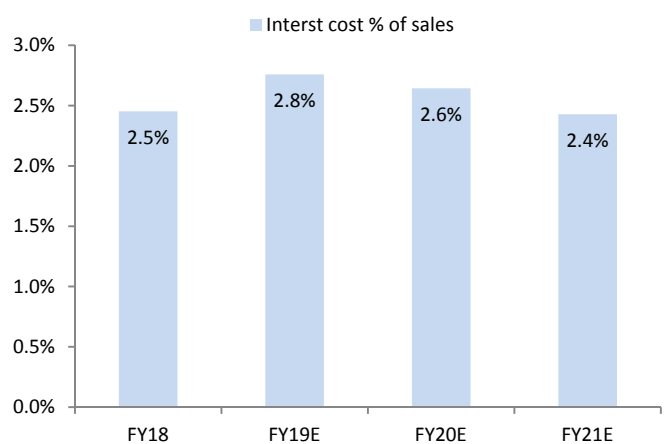


**15% CAGR in EBITDA**



Source: Company, PhillipCapital India Research

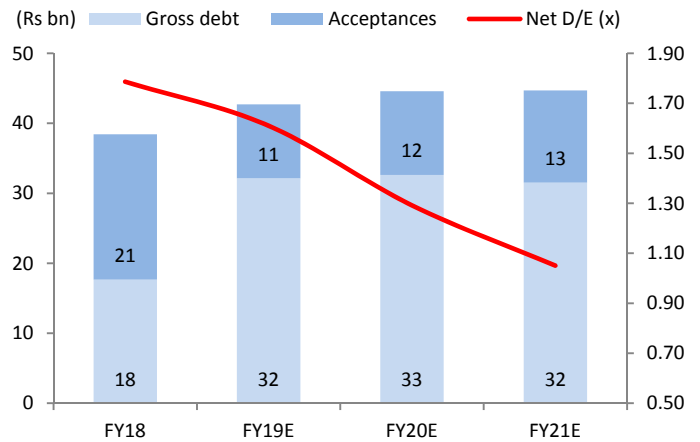
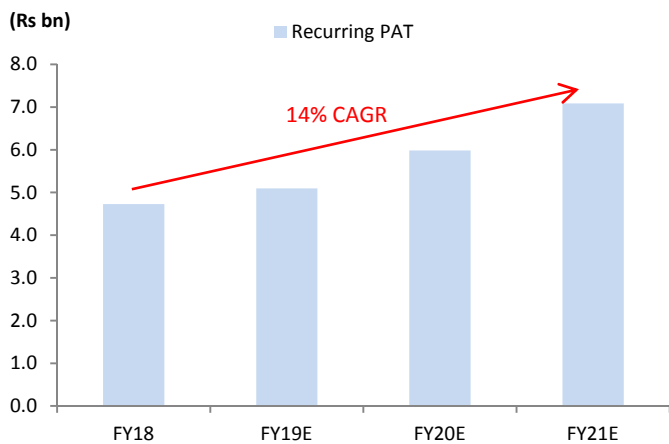
**Interest expenses as a % of sales**



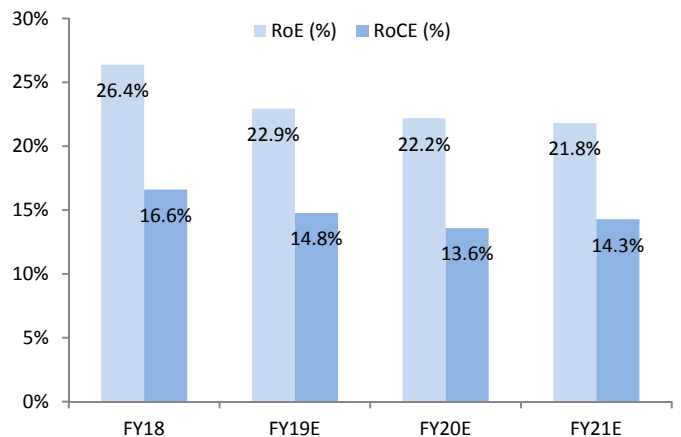
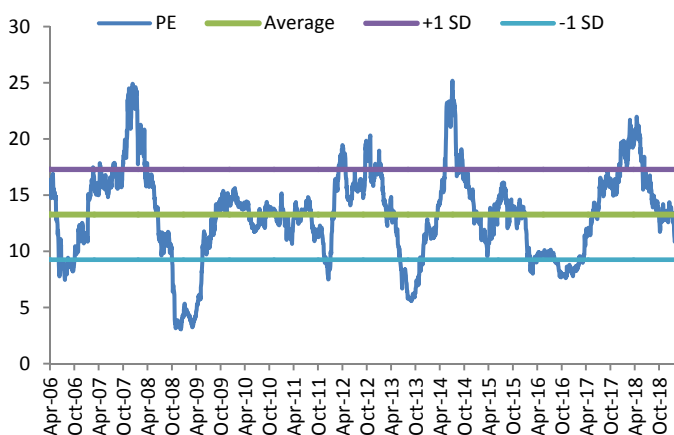
**Net working capital intensity is likely to reduce albeit gradually...**

Days	FY18	FY19E	FY20E	FY21E
Inventory	23	23	22	22
Trade receivable	257	262	249	245
Other assets	48	39	39	40
<b>Gross working capital days</b>	<b>328</b>	<b>323</b>	<b>309</b>	<b>306</b>
- Acceptances	75	35	34	33
- Other creditors	94	89	89	89
<b>Trade payables</b>	<b>169</b>	<b>124</b>	<b>123</b>	<b>122</b>
Customer advances	44	35	33	35
Due to customers	15	16	15	15
Other liabilities	13	13	13	13
<b>Current liability days</b>	<b>241</b>	<b>187</b>	<b>185</b>	<b>185</b>
<b>Net working capital days</b>	<b>87</b>	<b>137</b>	<b>125</b>	<b>121</b>
<b>NWC - % of Sales</b>	<b>24%</b>	<b>37%</b>	<b>34%</b>	<b>33%</b>
<b>NWC days (ex- acceptances)</b>	<b>162</b>	<b>171</b>	<b>159</b>	<b>154</b>
<b>NWC % of Sales</b>	<b>45%</b>	<b>47%</b>	<b>43%</b>	<b>42%</b>

Source: Company, PhillipCapital India Research

**... leading to controlled debt levels**

**14% earnings CAGR over FY18-21**


Source: Company, PhillipCapital India Research

**RoEs to remain above 20%**

**Trading below long-term average one-year forward earnings...**


Source: Company, PhillipCapital India Research

**...as growth slowed in FY19. We believe this will pick up ahead**

	FY15-18	FY19E	FY19-21E
Order inflows	22%	-7%	14%
Order book	22%	15%	15%
Sales	6%	11%	14%
EBITDA	21%	15%	14%
Recurring PAT	57%	8%	18%
RoE (%)	9.7-26.4%	22.9%	22.9- 21.8%

## Financials

### Income Statement

Y/E Mar, Rs mn	FY18	FY19e	FY20e	FY21e
<b>Net sales</b>	<b>1,00,580</b>	<b>1,11,858</b>	<b>1,28,328</b>	<b>1,44,390</b>
Growth, %	17	11	15	13
Total income	1,00,580	1,11,858	1,28,328	1,44,390
Raw material expenses	-72,716	-82,414	-95,026	-1,06,964
Employee expenses	-7,984	-8,339	-9,442	-10,643
Other Operating expenses	-9,638	-9,304	-10,342	-11,371
<b>EBITDA (Core)</b>	<b>10,243</b>	<b>11,801</b>	<b>13,518</b>	<b>15,413</b>
Growth, %	19.7	15.2	14.6	14.0
Margin, %	10.2	10.5	10.5	10.7
Depreciation	-1,097	-1,210	-1,280	-1,408
<b>EBIT</b>	<b>9,146</b>	<b>10,591</b>	<b>12,238</b>	<b>14,004</b>
Growth, %	26.0	15.8	15.6	14.4
Margin, %	9.1	9.5	9.5	9.7
Interest paid	-2,466	-3,086	-3,391	-3,506
Other Non-Operating Income	396	315	337	392
<b>Pre-tax profit</b>	<b>6,954</b>	<b>8,024</b>	<b>9,184</b>	<b>10,890</b>
Tax provided	-2,350	-2,723	-3,199	-3,805
<b>Profit after tax</b>	<b>4,604</b>	<b>5,301</b>	<b>5,985</b>	<b>7,085</b>
<b>Net Profit</b>	<b>4,604</b>	<b>5,301</b>	<b>5,985</b>	<b>7,085</b>
Growth, %	41.3	7.8	17.4	18.4
<b>Net Profit (adjusted)</b>	<b>4,726</b>	<b>5,097</b>	<b>5,985</b>	<b>7,085</b>
Wtd avg shares (m)	257	257	257	257

### Balance Sheet

Y/E Mar, Rs mn	FY18	FY19e	FY20e	FY21e
Cash & bank	2,344	3,343	6,476	7,411
Debtors	70,851	80,194	87,552	96,844
Inventory	6,274	6,934	7,581	8,679
Loans & advances	13,360	11,957	13,680	15,662
Total current assets	92,829	1,02,428	1,15,289	1,28,596
Gross fixed assets	17,932	19,669	21,419	22,769
Less: Depreciation	-6,810	-8,020	-9,301	-10,709
Add: Capital WIP	781	709	709	709
Net fixed assets	11,903	12,358	12,828	12,769
<b>Total assets</b>	<b>1,05,390</b>	<b>1,15,051</b>	<b>1,28,382</b>	<b>1,41,631</b>
Current liabilities	64,473	54,988	62,408	70,366
Provisions	2,007	2,210	2,580	2,963
Total current liabilities	66,480	57,198	64,988	73,329
Non-current liabilities	18,936	33,402	33,896	32,800
Total liabilities	85,415	90,600	98,884	1,06,129
Paid-up capital	514	514	514	514
Reserves & surplus	19,460	23,937	28,984	34,988
Shareholders' equity	19,975	24,451	29,498	35,502
<b>Total equity &amp; liabilities</b>	<b>1,05,390</b>	<b>1,15,051</b>	<b>1,28,382</b>	<b>1,41,631</b>

Source: Company, PhillipCapital India Research Estimates

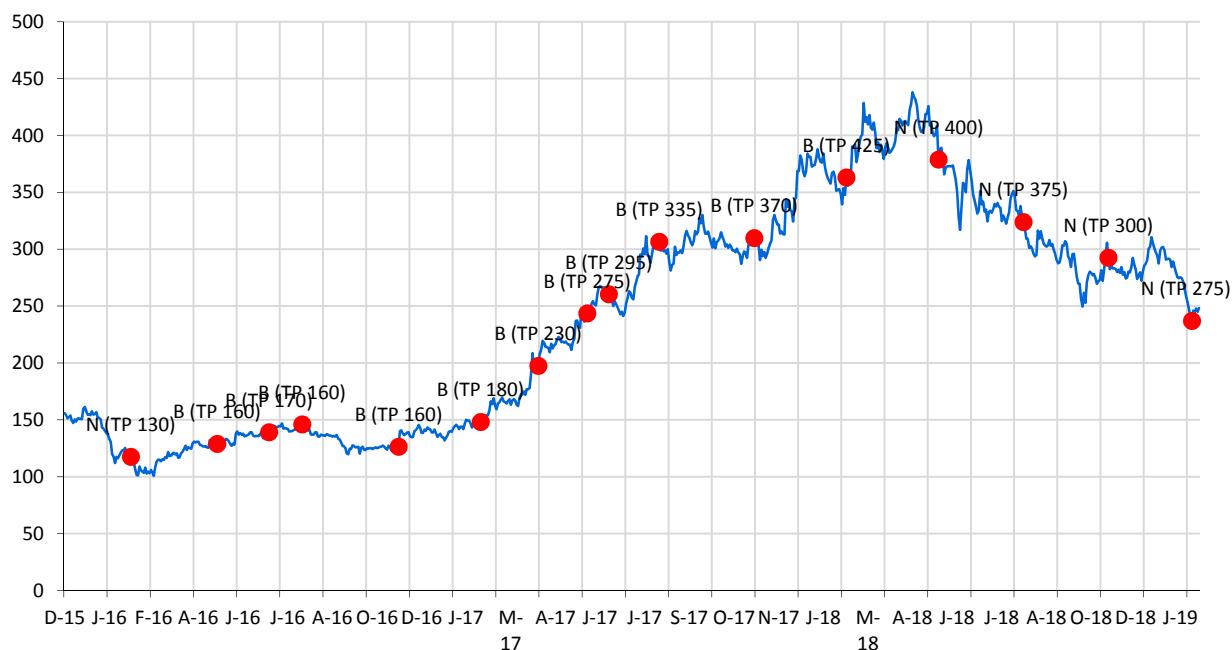
### Cash Flow

Y/E Mar, Rs mn	FY18	FY19e	FY20e	FY21e
Pre-tax profit	6,954	8,024	9,184	10,890
Depreciation	1,097	1,210	1,280	1,408
Chg in working capital	-900	-17,883	-1,937	-4,032
Total tax paid	-2,583	-2,723	-3,199	-3,805
<b>Cash flow from operating activities</b>	<b>6,596</b>	<b>-8,760</b>	<b>8,382</b>	<b>7,576</b>
Capital expenditure	-1,462	-1,665	-1,750	-1,350
<b>Cash flow from investing activities</b>	<b>-45</b>	<b>-880</b>	<b>-1,494</b>	<b>-1,040</b>
Free cash flow	6,552	-9,640	6,888	6,536
Equity raised/(repaid)	0	0	0	0
Debt raised/(repaid)	-3,394	14,467	493	-1,096
Dividend (incl. tax)	-491	-567	-662	-756
Other financing activities	-2,496	-3,261	-3,586	-3,749
<b>Cash flow from financing activities</b>	<b>-6,382</b>	<b>10,639</b>	<b>-3,755</b>	<b>-5,601</b>
<b>Net chg in cash</b>	<b>170</b>	<b>999</b>	<b>3,133</b>	<b>935</b>

### Valuation Ratios

	FY18	FY19e	FY20e	FY21e
<b>Per Share data</b>				
EPS (INR)	18.4	19.8	23.3	27.6
Growth, %	41.3	7.8	17.4	18.4
Book NAV/share (INR)	77.7	95.1	114.7	138.1
FDEPS (INR)	18.4	19.8	23.3	27.6
CEPS (INR)	23.1	23.7	28.3	33.0
CFPS (INR)	16.2	(45.5)	19.4	15.8
DPS (INR)	2.4	2.8	3.2	3.7
<b>Return ratios</b>				
Return on assets (%)	6.4	6.5	6.6	6.8
Return on equity (%)	26.4	22.9	22.2	21.8
Return on capital employed (%)	16.6	14.8	13.6	14.3
<b>Turnover ratios</b>				
Asset turnover (x)	2.7	2.4	2.2	2.4
Sales/Total assets (x)	1.0	1.0	1.1	1.1
Sales/Net FA (x)	8.6	9.2	10.2	11.3
Working capital/Sales (x)	0.3	0.4	0.4	0.4
Working capital days	94.4	143.9	132.0	128.5
<b>Liquidity ratios</b>				
Current ratio (x)	1.4	1.9	1.8	1.8
Quick ratio (x)	1.3	1.7	1.7	1.7
Interest cover (x)	3.7	3.4	3.6	4.0
Dividend cover (x)	7.7	7.2	7.2	7.5
Total debt/Equity (%)	88.4	131.4	110.6	88.8
Net debt/Equity (%)	76.7	117.7	88.6	67.9
<b>Valuation</b>				
PER (x)	13.0	12.0	10.3	8.7
Price/Book (x)	3.1	2.5	2.1	1.7
Yield (%)	1.0	1.2	1.4	1.5
EV/Net sales (x)	0.8	0.8	0.7	0.6
EV/EBITDA (x)	7.5	7.6	6.5	5.5
EV/EBIT (x)	8.4	8.5	7.2	6.1

## Stock Price, Price Target and Rating History



## Rating Methodology

We rate stock on absolute return basis. Our target price for the stocks has an investment horizon of one year.

Rating	Criteria	Definition
BUY	$\geq +15\%$	Target price is equal to or more than 15% of current market price
NEUTRAL	$-15\% > \text{to} < +15\%$	Target price is less than +15% but more than -15%
SELL	$\leq -15\%$	Target price is less than or equal to -15%.

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