ICICI Securities Ltd

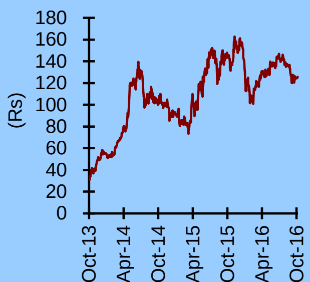
Equity Research

October 18, 2016

BSE Sensex: 28051

Capital Goods

KEC International (BUY)



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INDIA

T&D Equipment

Well placed to grow, States business to be the kicker

Reason for report: Sector Update

We met the managements of tower manufacturing/transmission line EPC players – (including KEC International & Skipper - Unrated) and we re-iterate our positive view on the sector. With a healthy order-book, strong execution impetus & favorable commodity price regime, we are convinced of strong topline growth & margin profile for the companies. All the companies highlighted the growing importance of states in their businesses as PGCIL ordering is likely to plateau (though recent ordering has been healthy), which also underpins the criticality of the success of the UDAY scheme for our investment argument to hold true. We recommend KECI as the top picks in the midcaps capital goods space given attractive valuations and strong growth in the offing.

- **KEC Int'l (KECI) -** Management highlighted strong business potential for the medium term given improved availability of power and the political pressures to improve the power situation. Consequently, states have become active customers and the business for larger EPC contractors should see healthy growth as order sizes are on the rise. Company is also seeing decent flows from private TBCB players which earlier experimented with smaller players and faced delays. On the profitability front, management highlighted that interest costs are on their way down due to shifting to lower cost borrowings and improvement in working capital.

- **Feedback from other players –** Companies highlighted healthy growth prospects for the industry as well as the companies across the sectors. However, from a longer term perspective players believes that sustainable growth can only be visible if generation capacities see improvement and SEB losses narrow. Few states are active in giving out tenders and opportunities; North East, J&K also provide for a healthy ordering base. According to the managements, bid prices are moving towards rational levels which are being reflected in the profitability.

- **Skipper – Growing franchise:** We are impressed by Skipper's strong order book (1.8x FY16 revenues), margin profile & growth. We believe the company has the necessary capabilities to increase effective market share in a competitive environment with focus only on tower manufacturing. Skipper is possibly one of the lowest cost producers and after its expansion it would become the largest tower manufacturing company in India. With the strategy of tying up with multiple players for a single bid, Skipper stands a strong chance to increase market share for the tower supply segment though it also links its fortunes to the execution of the EPC player. With lower than peer working capital requirements and low cost expansion model across segments, Skipper enjoys healthy RoEs (which are higher than its peers). While the company has ventured into the turnkey segment, it plans to be very selective and would only go ahead if it is profitable enough.

Valuation

Company	Mcap (Rs bn)	Reco	TP (Rs)	RoE (%)			P/E (x)			EPS % CAGR
				FY16	FY17E	FY18E	FY16	FY17E	FY18E	(FY16-18)
KECI	32	BUY	170	12.7	14.8	15.8	16.7	12.5	10.2	27.7
Skipper	16	Unrated	NA	24.9	24.1*	24.7*	16.7	14.6*	11.3*	21.5

Source: Company data, I-sec research

* Bloomberg Consensus Estimates

KEC Int'l – Key takeaways from management interaction

- Management stressed the growing importance of states in the domestic business and highlighted that they are a strong area of growth for KECI. Earlier, lack of power availability was a common resort for states to not improve T&D infrastructure which is changing fast as power availability sees improvement across the length and breadth of the country.
- While EPC contractors have choice not to work in certain states, states have limitations in case fast execution is needed. KECI and other larger players have experience of most of the states and tailor-make the bids accordingly to factor in payment/execution delays.
- State segment orders are more profitable on an absolute basis as they include insulator and conductor bought outs and their installation while PGCIL orders are generally erection and civil in nature. Increasingly, there is a trend in states to order out high ticket size projects.
- Orders from TBCB players are also on the rise as some of them had a bad experience with small contractors.
- Overseas business is seeing modest growth – While Middle East is sluggish, South East Asia and SAARC countries are seeing decent growth. SAE currently has a two year order book and is seeing improvement in profitability as well as order prospects.
- Railways business has a strong order position with a strong bid pipeline of bigger ticket projects. Margins in the segment are inching towards T&D margins as PQs for bigger projects are being made.
- In the solar EPC segment, not many big ticket orders are visible though situation can change rapidly. Willingness of SEBs is critical for segmental growth.
- KECI is likely to see improvement in interest costs due to shift to low cost borrowings (commercial paper) and improvement in working capital situation.

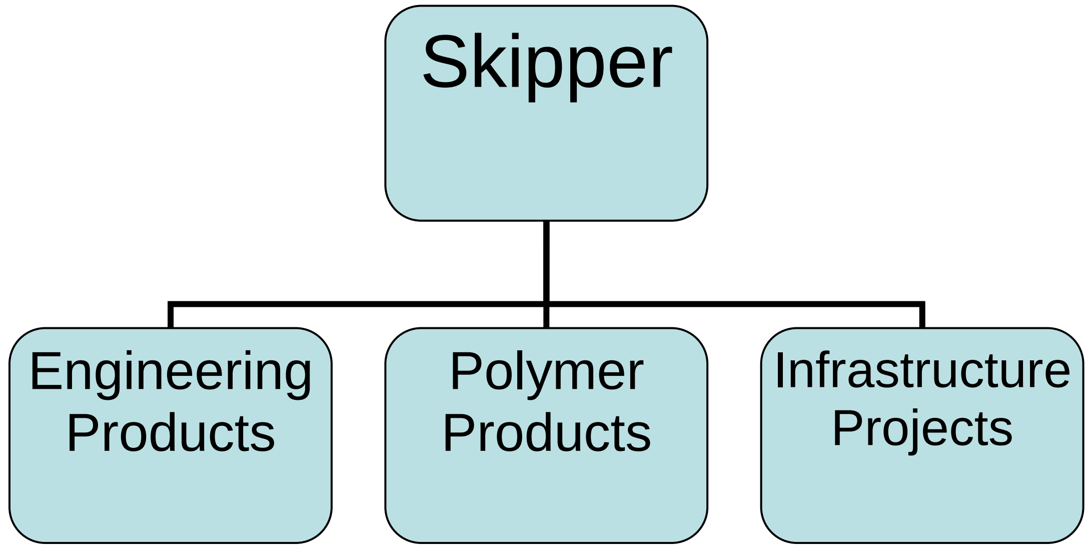
Feedback from other players

- Business from any state typically has a three - four year life cycle – wherein PQ norms are relaxed for the entry of smaller players, and they opt for smaller contractors, which inevitably leads to delays and henceforth PQs are strengthened to improve execution and delivery.
- At any given point of time, four to five states have a significant amount of orders and the company continues to bid and win even in highly competitive states (albeit selectively) to have PQ credentials.
- Competition has eased out significantly and price bids are seeing much more rational competition, unlike earlier wherein many players were quoting at lower prices to gain market share/increase utilisation.
- While pockets of growth opportunities exist (North Eastern States, J&K, etc), for a sustainable growth for the industry, generation capacity addition needs to exist. The way things are currently, there could be cliff in capacity addition which may impact medium term growth.
- In the other infrastructure segments, both railways and pipeline segment are seeing strong improvement. In the pipelines segment, given strong economics for asset owners and poor financial condition of some engineering peers, it should lead improvement in profitability. Balance of FY17 should see strong ordering in the above segments.
- Construction projects businesses are seeing steady margin improvement and lowering of interest costs and players are going international, in those countries wherein parent has a good on the ground presence.
- Companies have been extremely conservative in its provision accounting –while actual expenses are on the lower side.

Skipper – Well placed to capture growth

Established in 1981, Skipper Ltd. has evolved into one of the world's leading manufacturers for Transmission & Distribution Structures (Towers & Poles) in its Engineering Products segment, a leading and respected brand in the Plastic Water Pipes sector as well as trusted partner for executing critical Infrastructure EPC projects.

Chart 1: Business Verticals & key product/service offerings



Engineering Products
- Power transmission towers
- Power distribution poles (swaged, high mast, octagonal)
- Transmission line monopoles
- Mild Steel and High Tensile Angles
- Fasteners
- Tower Accessories
- Galvanised and Black ERW Pipes

Polymer Products
- UPVC Pipes
- CPVC Pipes
- SWR Pipes
- Fittings

Infrastructure Projects
- Transmission Line
- EPC Underground Utility
- Laying by HDD (Horizontal Directional Drilling)
- Water EPC

Source: Company data, I-sec research

Table 1: Key financial metrics segment wise (FY16)

Particulars	Engineering Products	Polymer Products	Infrastructure Projects
Manufacturing capacity	200,000 MTPA	41,000 MTPA	-
Revenue (Rs mn)	13,260	1,525	277
% of total revenues	88.0	10.1	1.8
EBIT (Rs mn)	1,937	165	43
EBIT Margin (%)	14.6	10.8	15.5
3 year CAGR Revenues (%)	16.6	46.9	22.6
Capital Employed (Rs mn)	6,796	1,177	317
RoCE (EBIT/CE) %	28.5	14.0	13.5

Source: Company data, I-sec research

Integrated operations leading to superior margin profile

Skipper is the only tower manufacturer with fully backward-integrated manufacturing facilities. The company has three state-of-the-art manufacturing facilities in Uluberia & Junglepore, near Kolkata in West Bengal with a total manufacturing capacity of 200,000MTPA. The company has a unique advantage of producing 100% of prime raw material- Mild Steel & High Tensile Angles (upto 200X200X25) in-house. It has 35 Angle and Plate CNC lines, 7 in-house galvanizing plants & nut bolt capacity of 600MT per month.

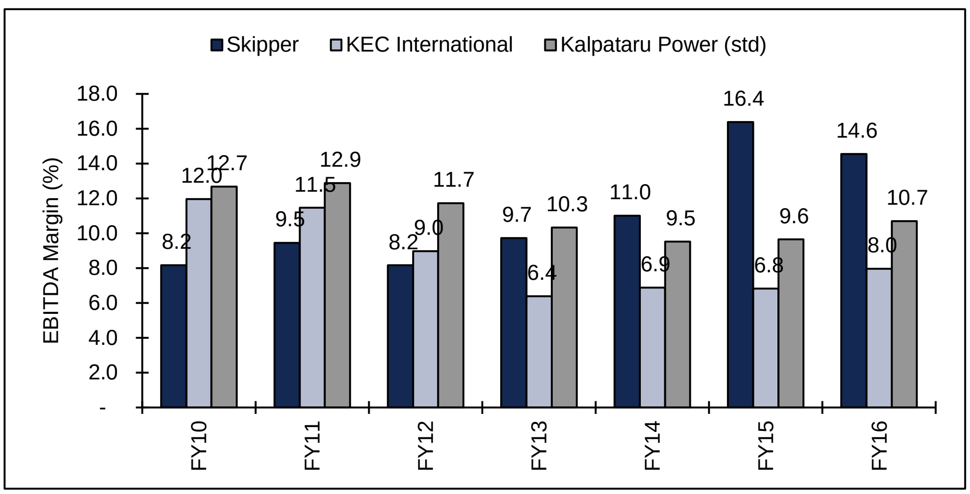
Table 2: Engineering Products manufacturing facilities

Location	Total capacity (MTPA)
Uluberia	95000
Unit 1	69,000
BCTL	36,000
Total	**200,000**

Source: Company data, I-sec research

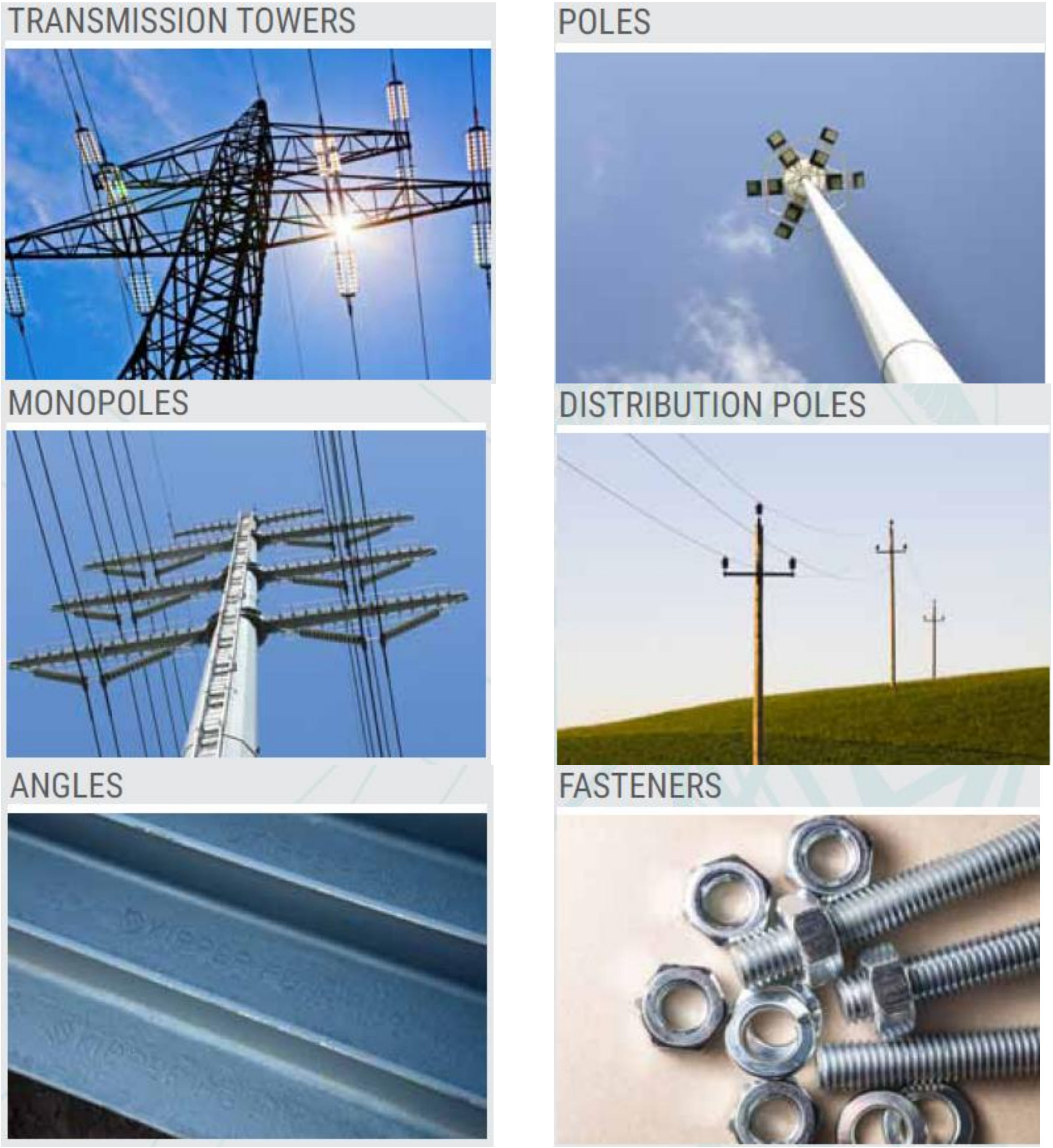
While KEC International & Kalpataru Power have their manufacturing facilities in different locations (KEC- Nagpur, Jabalpur, Jaipur; Kalpataru- Gandhinagar, Raipur), Skipper has its entire manufacturing capacity located in Kolkata, which results in cost savings owing to economies of scale. Further, being located close to all the major steel plants in the Eastern India, the company enjoys lower in-ward freight costs as compared to its peers leading to superior margins.

Chart 2: Superior margin profile compared to peers



Source: Company data, I-sec research

Chart 3: End-to-end manufacturing capability



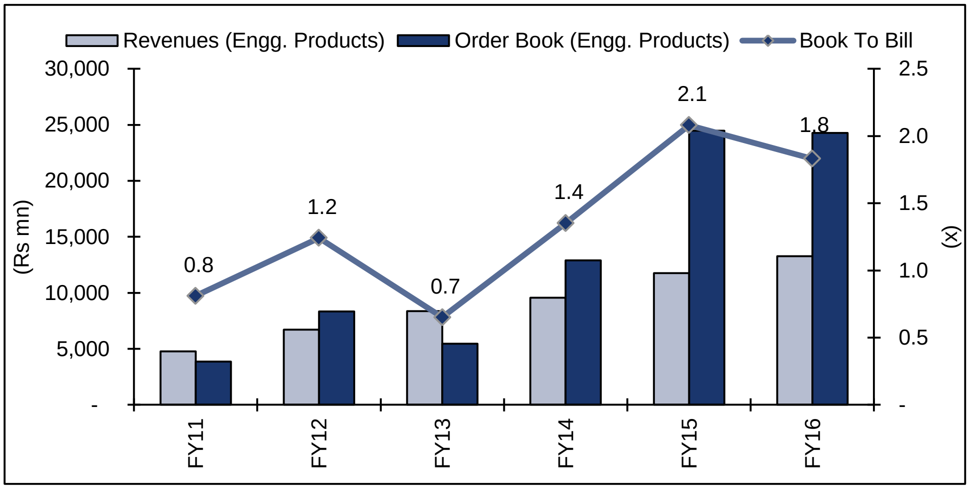
Source: Company data, I-sec research

Further, significant scale (large scale single unit location), benefits of logistics cost (proximity to port) to and RM procurement (proximity to steel producers), allows Skipper to cost efficiently manufacture angles and towers. The combination of all these probably makes Skipper one of the lowest cost large scale manufacturer of transmission towers in the world.

Strong Order Book; growth prospects healthy

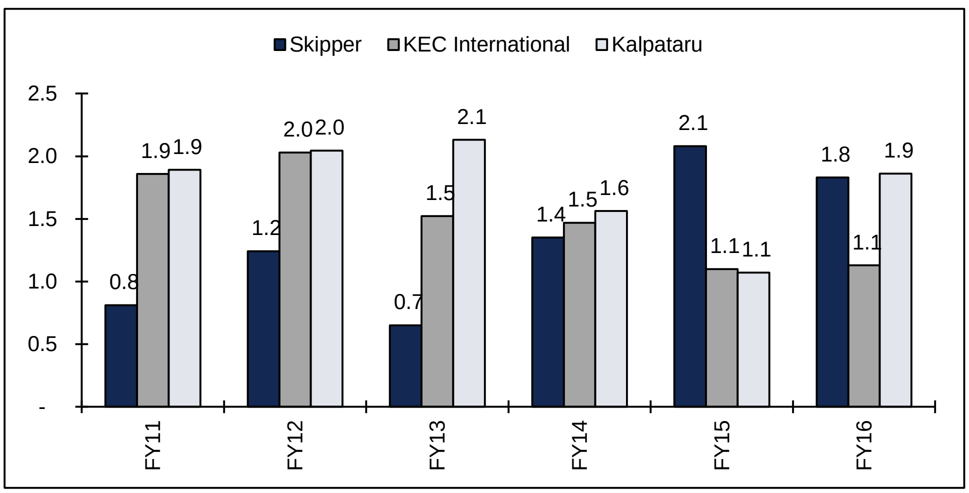
Skipper, being the tower manufacturer and supplier, is able to participate in more number of tenders via different EPC players that include EMC, Tata Projects, L&T, Isolux, NCC, Abengoa. As a result, the company has been able to amass healthy order book in the recent years which stood at Rs24.3bn (1.8x FY16 revenues vs 1.3x industry average) as on March 31, 2016.

Chart 4: Order-book growth has been healthy post FY13



Source: Company data, I-sec research

Chart 5: Book-to-bill ratio trend



Source: Company data, I-sec research

While theoretically one can opine that being a tower only supplier may restrict the market potential for Skipper as most domestic tenders are on an EPC basis, being a supplier only works in favour of Skipper as it has the option to tie up with multiple bidders for the same tender vs. integrated EPC players who can only bid under one name. This gives it a chance of higher utilisation of capacities, though largely being a tower supplier only Skipper does not enjoy the enlarged topline as compared to integrated EPC players. However, it also prevents the company from being exposed to the vagaries of project execution and with more than three/fourths of cost under control of the company it does not lead to margin volatility on a project to project basis.

Expansion in North-East- a unique proposition

With key TBCB projects of Rs12-15bn coming up as well as orders from Rs100bn worth of projects under execution by PGCIL expected in the north east region, the company is gearing up its manufacturing capacity to specifically cater to north-eastern markets. It is setting up a green-field tower manufacturing facility in Guwahati with a manufacturing capacity of 30,000MTPA (capex Rs400mn) which is expected to be commissioned by FY17 end. Not only, this new facility will enjoy excise duty and income tax exemptions but also being close to the demand centres there will be savings related to outward freight costs. Also, the competition is expected to be less for the projects in the region which makes Skipper well placed to lap up major chunk of tower supply orders at healthy margins.

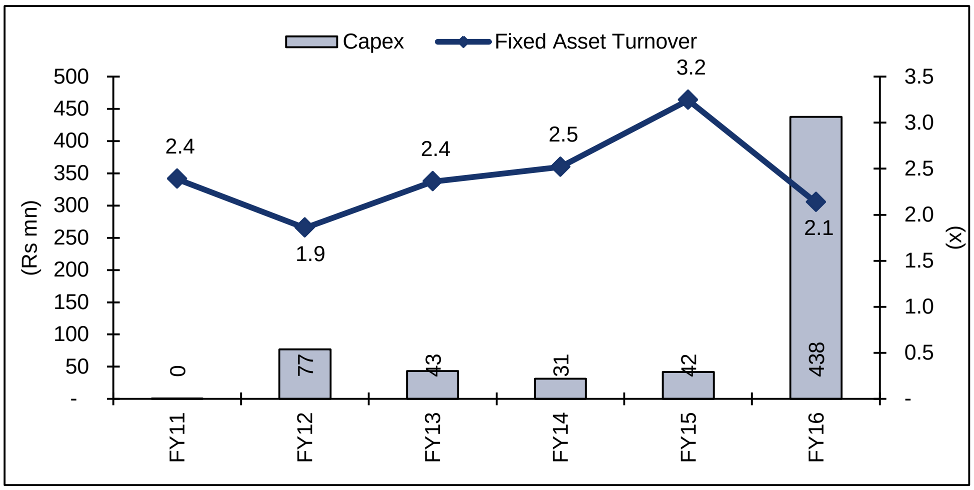
Chart 6: Manufacturing facilities

Source: Company data, I-sec research

Low capex model in the PVC products segment allows for quick expansion with low capital commitment

The company commissioned three new PVC manufacturing plants in Ahmedabad, Guwahati & Sikandrabad in FY16 & another plant in Hyderabad in Q1FY17, more than tripling its manufacturing capacity to 41,000 MTPA vs 12,500 MTPA a year ago. Further, it intends to take it up to 100,000MTPA by 2019. The company adopts a leasing model for land and sheds while owing only the plant & equipment. This capex model allows the company to quickly expand into new geographies (plant commissioning timeline reduced to 8-9 months vs 24 months) at low capital costs (Rs.10,000/tonne vs Rs20,000/tonne) as well as enables it to quickly exit any market if need be.

Chart 7: Asset turns rising steadily



Source: Company data, I-sec research

PVC segment currently is focussed on the agricultural segment (75%) and plumbing forms the balance (25%). Company intends to inch the same up to 40% as newer capacities come in stream. Further, with geographical expansion, company is expanding from its stronghold (Eastern region) to south as well and plans to expand the product basket as well. The business offers healthy growth potential for Skipper given its low base and low cost expansion (Rs600mn for another 60,000 te spread over 4 years). Company believe the turnover of the segment can become 4-5x from FY16 levels with double digit margins and healthy ROCEs.

Table 3: PVC segment financials

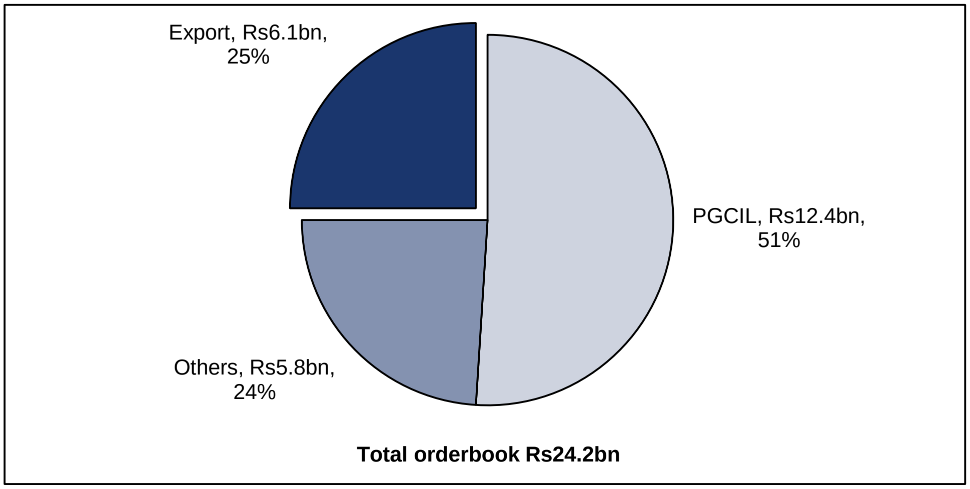
	FY11	FY12	FY13	FY14	FY15	FY16
Revenue	199	298	481	591	897	1,525
Growth	385%	50%	61%	23%	52%	70%
EBIT	30	66	187	60	103	165
Margin %	15.2	22.1	38.9	10.1	11.5	10.8
Capital Employed	116	318	437	334	459	1,177
ROCE %	26	21	43	18	22	14

Source: Company data, I-sec research

Exports- a key area of growth

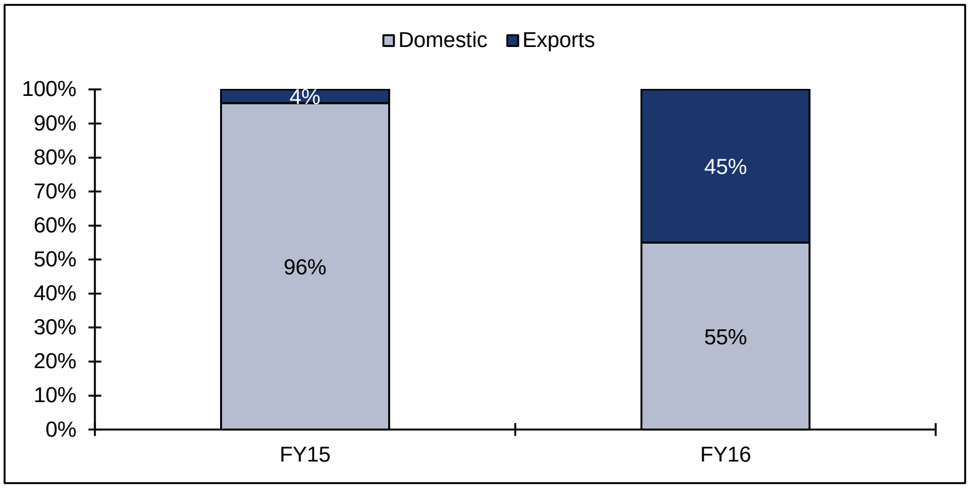
The company has grown its export order book from 4-5% of the total order book few years ago to 25% currently (Rs6bn). Skipper is currently present in 10 countries and is actively looking to expand its presence in international markets with a target of reaching 50 countries in coming years. While it is already exporting to Latin America, the company has bid for large projects in Southeast Asia & African markets and expects to secure significant business from these countries.

Chart 8: Exports constitute 25% of the order book (FY16)



Source: Company data, I-sec research

Chart 9: Exports constituted 45% of total sales in FY16

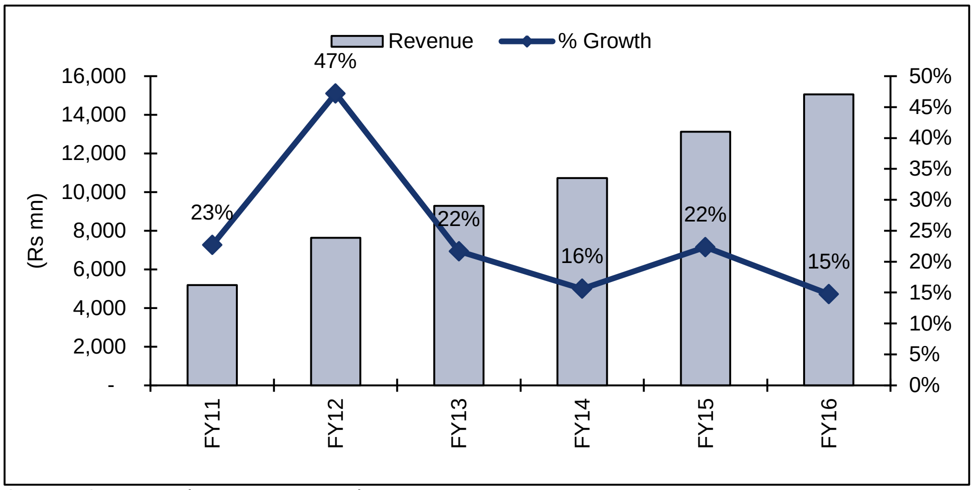


Source: Company data, I-sec research

Financials – Strong growth witnessed

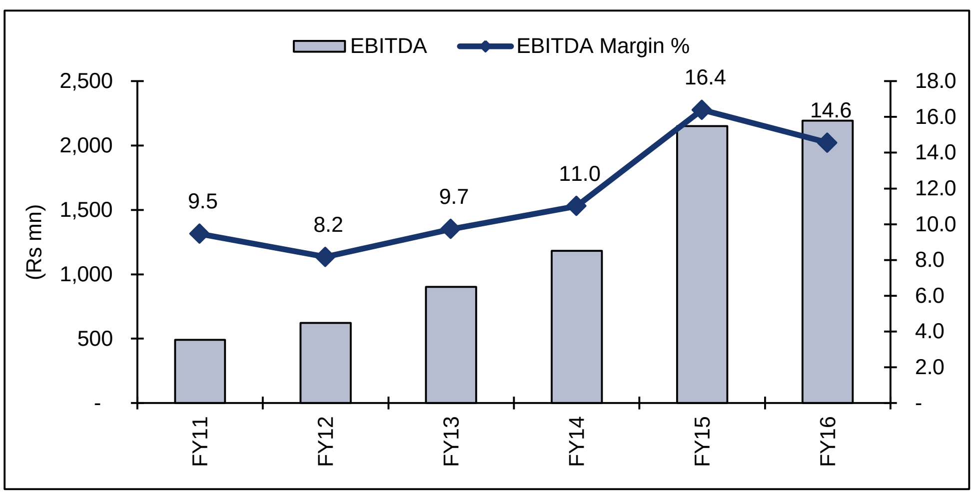
Skipper has registered topline CAGR of 23% in the last five years on the back of focussed execution in the engineering products segments and the company has reached capacity utilisation of over 90% in FY16. Coupled with margin expansion of almost 2x (from 8.2% to ~15%) and discipline in working capital consumption (down from 120 days to 90 days), company has grown its PAT by almost 10x in the last four years. Consequently, the company has improved its RoE profile from ~6% to 25% levels and kept leverage under check (D/E –of 1x). While cash flow generation has been intermittent given capex and working capital needs, management expects healthy free cash flow generation on the back of i) Low cost capex for expansion, and ii) Strong control over working capital by collaborating with efficient EPC players only.

Chart 10: Revenue CAGR of 24% over FY11-16



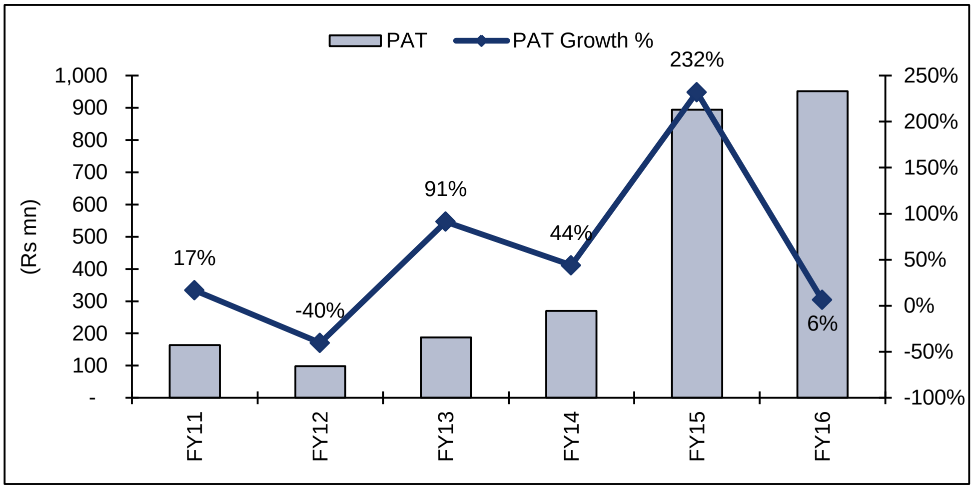
Source: Company data, I-sec research

Chart 11: EBITDA and EBITDA margin



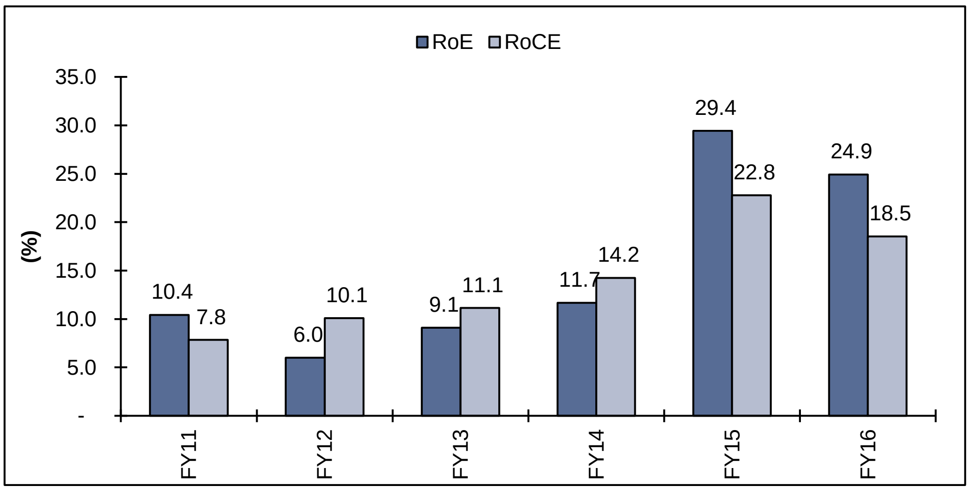
Source: Company data, I-sec research

Chart 12: PAT & PAT growth



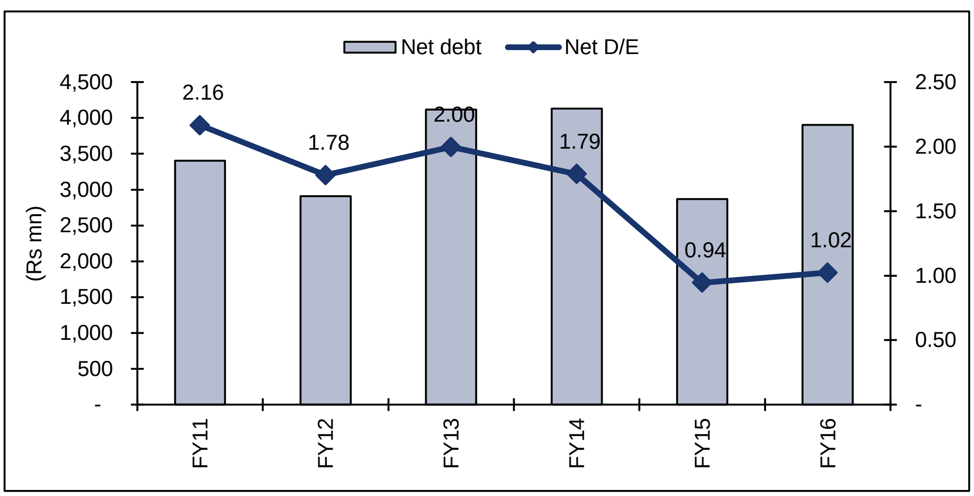
Source: Company data, I-sec research

Chart 13: Return profile – Strong performance



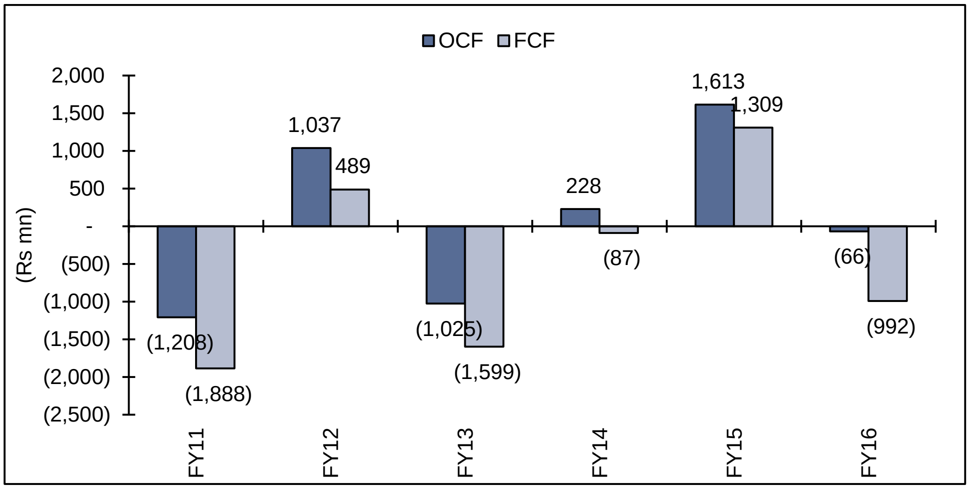
Source: Company data, I-sec research

Chart 14: Leverage on the decline



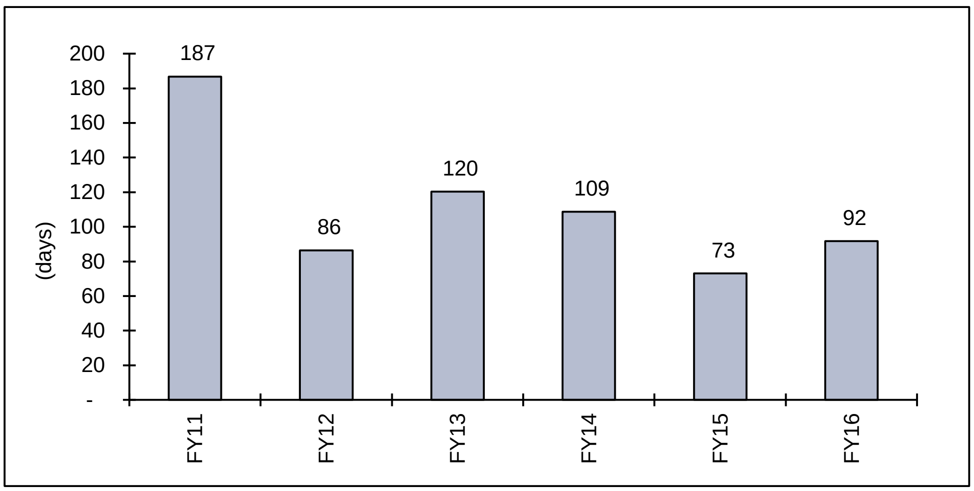
Source: Company data, I-sec research

Chart 15: Cash flow generation to improve post capex



Source: Company data, I-sec research

Chart 16: Net working capital days

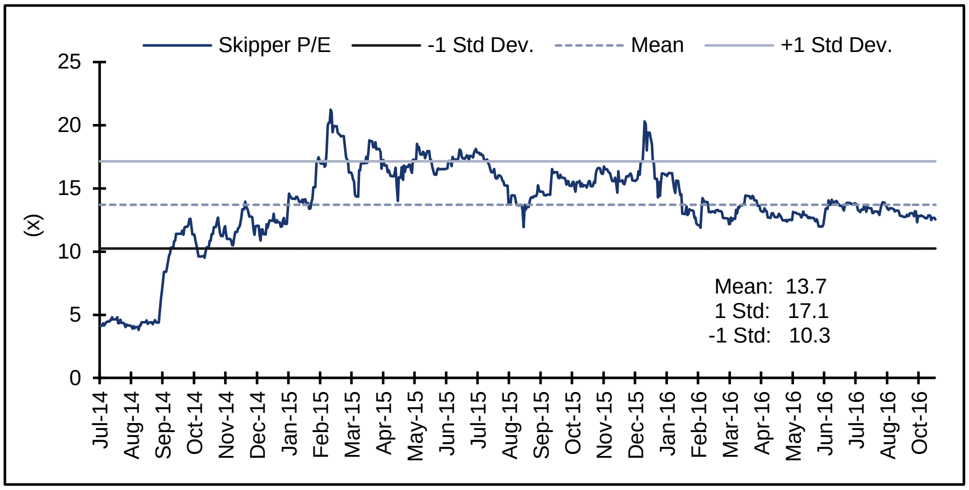


Source: Company data, I-sec research

Valuation

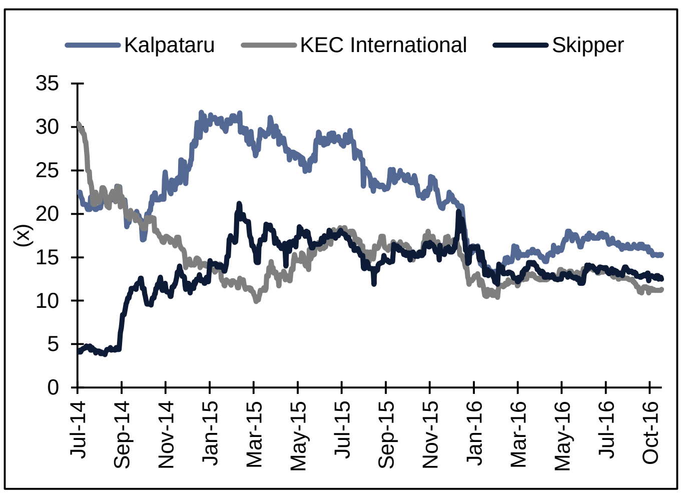
The stock is trading at 16.8x FY16 earnings and 15x/11x FY17E/FY18E consensus earnings. The stock has a short trading history; it has traded at multiples of 12x-20x (1 year forward) in the last two years. Considering the strong growth profile of the industry, healthy order book of Skipper, industry leading margins and better than peers' RoE profile, Skipper should command better than peer multiples.

Chart 17: 1 year forward P/E trend



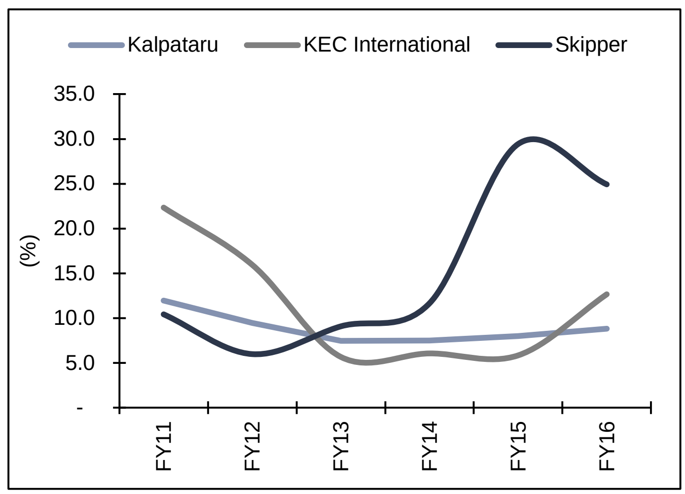
Source: Company data, I-sec research

Chart 18: Comparative P/E trend



Source: Company data, I-sec research

Chart 19: Comparative RoE trend



Source: Company data, I-sec research

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