June 22, 2021 | REINITIATION REPORT | VOL-7, NO-8

Kirloskar Pneumatic Co. Limited

BUY

CMP: Rs.387 | **TARGET PRICE: Rs.475** | **TIME : 12 months**

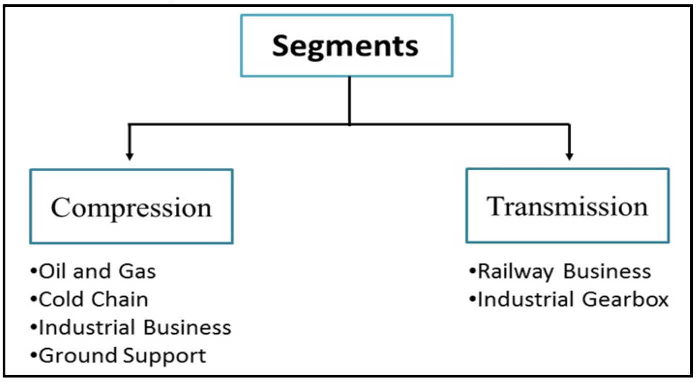
REINITIATION REPORT:

We had initiated coverage on Kirloskar Pneumatic Co. Limited (KPCL) on 19th November 2019 (Vol-5 No-08) at Rs134 with a target price of Rs192, revised to Rs275 and further upgraded to Rs375. Considering the recent developments, strong industry tailwinds, healthy financials of the company, robust order book and strong management vision, the positive outlook for the company is further encouraged and we thereby re-initiate a fresh BUY call on the stock at CMP of Rs387.

About the Company:

Kirloskar Pneumatic Company Limited (KPCL) was founded in 1958 by Shantanurao Laxmanrao Kirloskar, is headquartered in Pune. KPCL is a well diversified product company which serves some of the major and critical sectors (which help drive the economy of a country) like oil & gas, steel, cement, food & beverages, railways, defence, marine etc. To cater to such critical requirement of the industry; KPCL has successfully developed various sophisticated, high-tech and high-end products. While catering to some of the clients in the international market, the company is continuously upgrading and maintains highest standard of quality. The company has its state-of-the-art manufacturing facilities at Hadapsar, Saswad and Nasik. The company is IMS (Integrated Management System - ISO 9001, ISO 14001 and OHSAS 18001) certified. KPCL has an in-house capability to engineer, design, manufacture, construct, commission and service products and systems. The company is powered with highly qualified and trained service personnel who cater to clients across India while also driven by a strong sales and service networks.

Exhibit 01: Segments Catered



Source: KPCL Financial Analyst Meet August 20, 2018 PPT

KPCL manufactures and sells air, gas, air conditioning & refrigeration compressors systems in India and to some extent in some international frontiers. The company has a plethora of products for refrigeration and gas compression systems for refineries and petrochemical plants; CNG systems for city gas distribution (CGD) companies; industrial refrigeration compressors and packaging solutions for cold storage, dairy, pharmaceutical units and process plants; air compressors and packages for the industrial markets and engineering; transmission products like traction gears, customized gearboxes; specialized products for Indian Railways, wind power projects, and other industrial markets; power transmission equipment and reverse reduction gears for marine gear engines, etc. The company essentially works in two major business domains i.e. compression product segment and transmission product segment. The compression business can be further bifurcated into oil & gas, cold chain, industrial biz and ground support business while the transmission product segment can be subdivided into railway business and those catering to industrial gearbox. KPCL is a leading market player in some of the areas of its business and with the help of a dedicated team which caters to the sales & services for exports, KPCL is trying to explore exports opportunities in the Middle East, South East Asia, China, Southern and western parts of Africa etc.

SNAPSHOT

52 week H / L	Mcap (Rs mn)
422/ 98	24871
Face value: 2	
BSE Code	NSE CODE
505283	NA

Annual Performance

(Rs mn)	FY19	FY20	FY21	FY22E
Sales (Net)	7,102	8,211	8,233	9,228
EBITDA	877	872	1,130	1,292
EBITDA (%)	12.4	10.6	13.7	14.0
Other Income	145	185	101	107
Interest	1	12	17	21
Depreciation	219	326	376	382
PBT	802	719	839	996
PAT	553	535	638	747
Equity	128	128	129	129
EPS (INR)	9	8	10	12

Quarterly Performance

Parameters (Rs mn)	Jun-20	Sept-20	Dec-20	Mar-21
Sales (Net)	777	1,475	1,803	4,151
EBITDA	(35)	156	260	722
EBITDA (%)	(4.49)	10.60	14.42	17.39
Other Income	50	27	30	22
Interest	1	4	3	9
Depreciation	95	95	94	93
PAT	(57)	59	132	503
Equity (Rs mn)	128	128	128	129

Ratio Analysis

Parameters (Rs mn)	FY19	FY20	FY21	FY22E
EV/EBITDA (x)	28.0	28.5	21.9	19.2
EV/Net Sales (x)	3.5	3.0	3.0	2.7
M Cap/Sales (x)	3.5	3.0	3.0	2.7
M Cap/EBITDA (x)	28.4	28.5	22.0	19.3
Debt/Equity (x)	0.1	0.2	0.2	0.2
ROCE (%)	16.6	14.6	15.1	16.8
Price/Book Value (x)	5.0	5.0	4.2	4.7
P/E (x) TTM	15.9	53.2	39.0	33.3

Shareholding Pattern as on 31 March 2021

Parameters	No of Shares	%
Promoters	34,588,510	53.82
Institutions	13,558,723	21.10
Public	16,120,057	25.08
TOTAL	**64,267,290**	**100.00**

Source: Annual Report

Note: All the data is calculated as per Market Price on 21 June,2021

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INVESTMENT RATIONALE:

(A) Year That Went By: If one looks at the revenue split, then the segment of air compressors contributes nearly 15-18%; refrigeration compressors contribute 30-35%; gas compressors contribute 45-50%; while the transmission business is nearly 4-5%. According to KPCL, the estimates of air compressor market is approximately above Rs30bn in India, and this is a market which continuously grows on a global level also. The refrigeration compression segment business, had a moderate sales during the last year; there was a decline in ammonia compressor to the cold chains and ice plants as no new plants were built during the year; however, the refractory systems, petrochemical complex and hydrocarbon etc. saw an uptick in the second half for the company. Domestic refrigeration market is roughly around Rs12bn and the Management sees this market to continuously grow. The processed gas system is the larger part of the business where the company had seen record sales of CNG packages to the CGD companies; KPCL expects the business to grow further due to the 9th and 10th round of CGD, while the industry expects another 8000CNG stations to come up in next 8-10 years in an anticipation to cover about 70% of the Indian population, while bringing in a business of approximately Rs60bn to the industry.

The company continues to serve the key sectors for growth where, **compression business** is nearly 95% of the turnover wherein ~40-45% of business comes from gas compression systems business. As far as the segment of industrial applications of air compressors is concerned, KPCL serves various players in the industry related to LPG, industrial air movement in steel plant etc.; in addition to this, every industry somewhere down the line requires a gas compression system; and as far as refrigeration business is concerned, end customers generally tend to be from the oil and gas industry related to petrochemical complexes, hydrocarbon industry etc. The total market share of company in the air compression industry is significantly lower than the other competitors whereas in the other two segments of refrigeration and gas compression, the market share enjoyed by KPCL is reasonably higher. For the air compression and refrigeration compression business the company caters to a range of (-10) degree to (-60) degree. **Gas compression business** is an additional opportunity due to growing CNG stations and the major advantage enjoyed by KPCL is they manufacture the entire set which gives a better cost position while delivering better quality product with high performance and efficiency. Market share of KPCL in this domain is 50% as compared to the competition. Management has mentioned there is enough headroom for growth in all the 3 segments where the gas compression business and industry are growing enormously with the newly announced bidding for the 9th and 10th round of CGD bidding scheme. The guidance of the government too is quite clear that the economy is gradually moving towards a clean energy and more or less a gas-based energy distribution economy. For the gas compressor business, there are only two major players who are able to cater to requirements with very large packages and API compliant i.e. American Petroleum Institute compliant where KPCL is one of the two players in this domain. In terms of the business involving **CNG packages** (which fits in the station at the fuel filling sites for vehicles), which too is a larger business, KPCL is one of the top two players and has at least 50% market share. The advantage for KPCL here is the entire CNG packages is indigenously manufactured by them. The company is looking at larger opportunities coming from MENA i.e. Middle-East and North African countries and advance discussions with many players in this geography. **The ammonia compressors** business has a quick turnaround for the company; KPCL serves clients in the cold chain industry in India as well as the South East Asia and African countries. The company's share for the **air compressors** is much lower as compared to most of its competitors. The company has been constantly putting in efforts to develop their own ancillary products like screws, impellers, the entire design, the gear box for the centrifugal compressors as well as all the other parts used in compressors. These in-house and inbuilt parts will help the company customize the final product as well as enable to manufacture client specific products designs. This clearly will help KPCL nibble some more market share and at the same time address the requirements for import substitutes. Management is looking at gradually increasing the scale and size of the company as the market dynamics continue to change; KPCL intends to capture the benefits from the value chain advantages going forward to become an integrated value chain player.

Transmission Segment: In FY21 this segment reported a sale of Rs313.1mn as compared to Rs478.0mn last year. The railway orders were completely muted during FY21 and the business continued to lose money. While in the meantime, the company developed high speed gear boxes, which are anticipated not only to be the backbone for the centrifugal compressors business but the team also extended the same to make high speed gear boxes for 50MW power station which is also a growth area for KPCL. This change in strategy is anticipated to pull the segment out of the losses.

Exhibit 02: Road Railer

Source: newindianexpress.com/cities/chennai/2018/sep/26/southern-railway-launches-indias-first-roadrailer-train-1877217.html

INVESTMENT RATIONALE (contd.)

(A) Year That Went By: (contd.)

Road Railer: The business of roadrailers is currently very small for KPCL and the same does not exist with any other company in the country. Wabash National Corporation (USA) had initiated this business which runs on road as well as rail. This concept developed quickly in the US and spread to other parts of the world wherever long distances were supposed to be covered for haulage goods. KPCL thought about this pioneering concept, learnt the same from Wabash and invested in the business. KPCL has already done the spade work of sending their team to Wabash to learn, getting the approvals from Railways to run the wagons on the rail, getting permissions from state transport for running the railers on the road in different states, building the product at the plant in Nasik and developing platforms to connect the railers to be put on the road. By 2016, the team was ready and started running the roadrailers between Chennai and Delhi and back (and this is the only zone where KPCL is allowed to run the railers). Nearly 1250 road railers have run between Chennai and Delhi. There have been no issues reported so far and KPCL intends to scale this part of the business up since the approvals are in place, technology has been demonstrated, customers have been convinced with its efficacy and cost effectiveness. This business can be scaled up with proper logistic partner, in terms of volume as well as routes. This exclusive KPCL product can bring long term benefit to the logistic sector and the country as a whole. If the same is scaled up, there can be immense value chain advantage for the logistic players. The long-term focus which KPCL has chosen is to only manufacture these roadrailers rather than running this as a separate business. Once, this business picks up, the transmission segment can stop making losses.

(B) What Next? The company has already chalked out a number of initiatives to make the businesses profitable as well as sustainable. Some of these include

Product Development: The **air compression business** has been successful in manufacturing screw compressors which are first of its kind, designed and manufactured in India and are already in the market and the feedback from the customers related to the performance is quite good. The company has built its own intellectual property with its own know-how and anticipates this to be a long-term differentiator for the growth of this business. In addition to this, the company has worked on another product development related to the **centrifugal compressors** which are high volume compressors, created and manufactured by KPCL's own inbuilt designs, internally built gear boxes and know-how etc. As far as the **reciprocating compressors** business is concerned the company was able to deliver 24 large compressors for oxygen plant manufacturers in India. In terms of the centrifugal compressor and high-speed gear boxes the company can make upto 50MW high speed gear box for power station where there is only one player in India in this domain.

R&D Spend: The company has been off late focusing on screws compressors where their market share is low. The company has the best in class investments done in the hardware as well as the software to develop these screw compressors designs. In addition to this, the know-how of the development of screws of specific designs and applications, size, performance etc., for best in class precision is available with KPCL. Many players in the developed countries are looking at products which provide higher efficiency while consuming lesser of energy etc. and give higher productivity, better performance etc. KPCL has been able to deliver some superior performance products which means better output. In terms of centrifugal compressors, the same is a very small but a rapidly growing market. KPCL has an integrated value chain and makes its own casting, impellers, gear box, have full assembly and setup for services as well as support while aiming to develop best precision products and services. The process and R&D to develop newer products is a continuous process and some new products with better efficiencies are anticipated to be launched going forward.

Aftersales Market: The segment related to reciprocating and ammonia compressor require constant aftersales services. KPCL has a field distribution within the company and also propelled by some sales partners. In terms of the after-sales business, KPCL is reasonably next to best for the after sales market and service support systems. The company is powered by some of the finest employees, finest service team and many customers buy products from KPCL due to aftersales backup which is an important add-on to boost the sales, hence advantages to winning orders and market share

Price Hikes: KPCL already has the orders in hand and thus the planning for procurement becomes easier. The inflationary cost of steel and copper will remain a challenge for all the industry players including KPCL, however in order to maintain the margins, the company will be looking at better efficiencies, better conversion and internal process improvement. In the longer term the inflationary costs will be a pass through to the customers via price hikes. The company aims at maintaining the margins via improved working and price increases whenever necessary.

Capex: In FY21 the Management was slightly conservative and incurred a capex only to the tune of Rs70mn and the previous year (FY20) had spent nearly Rs1000mn, consequently had the capacity to execute all the orders. In the current year, the company is looking at incurring a capex plan of ~Rs500mn which aims at building capacity as well as capabilities for future growth.

The vision of the Management is to make use of the integrated systems created by the company for manufacturing high precision and good quality goods with focus on margin improvement in the business in the competitive landscape and try to reduce the losses in the transmission segment.

Please Turn Over

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Financials: For most of FY21, the company faced a lot of issues related to broken supply chain, inflation costs, increased steel and copper prices, the pressure on margins were seen due to change in the product mix; however, recovery was seen in the second half to end of year on a very strong note. The major product line i.e. the compression business related to air compression, refrigeration and gas compression did well; however, the transmission systems did not fare that well with drop in sales with very few orders from the railways and some of the orders were cancelled. Q4FY21 was a strong quarter for the company; the company had started the quarter with an order backlog of ~Rs10bn and could ramp up the execution aided by the very strong supply-chain performance and the vendors. In FY21, exports were only at Rs240mn which translates into just 3% of the sales, however, seeing strong enquiry flow as well as active discussions on several projects indicate FY22 exports could be better. KPCL has learnt to do business of the same magnitude with lower expenditures, and the company believes the same is sustainable. Apart from some volumes which will go up, the expenditure is anticipated to remain in the same range as percentage of sales. In FY21, the company has availed a bank loan to the tune of Rs400mn from bankers and the Debt- Equity stands at 0.07. Company has cash and cash equivalents to the tune of Rs2110mn and net cash of Rs1710mn to fund the long-term growth projects. Net working capital cycle appears to be stretched for FY21, however, the company is trying to work out especially on the project businesses. KPCL had significant receivables more by Rs1190mn in FY21 as compared to FY20; but this is moderated by reduction in inventory of Rs520mn; free cash flow from operations stood at Rs375mn which is 58% of the PAT which shows significant improvement in the quality of earnings. The company is not looking at any capex requirement for the year; most of the capex which is to the tune of Rs500mn will be as a balancing capex, debottleneck etc. for Pgas projects. In the current scenario, some issues related to the second wave were seen in the state of Maharashtra due to lock down, however, the company has a strong order book backlog of Rs9000mn which will help the company report good numbers in FY22. It is quite obvious that the margins will continue to inch higher post transmission losses are taken care of. Knowing that there is immense cyclicality in the business and generally the second half of the year are generally good in terms of margins. The company has come back to the dividend distribution list while declaring a dividend of Rs3.5 per share for the face value of Rs2 per share.

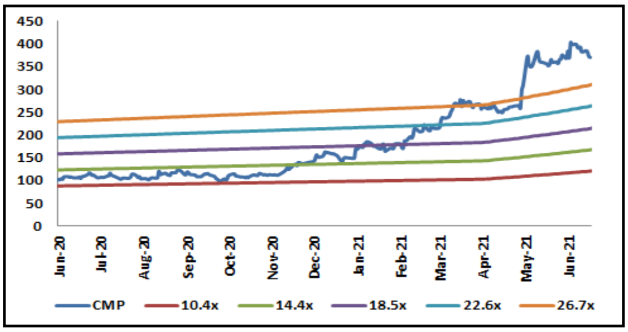
Risks and Concerns: The business in which KPCL is involved is largely dependent on the government policies and investments. A large number of customers of KPCL are from the engineering and other capital-intensive industries where the demand is more or less cyclical which in turn is dependent on the economic performance and condition of the country. Demand from many of the customers of KPCL is ultimately dependent on the capex cycle of the end user. Many a times, the working capital cycle becomes too stretched for KPCL. The operating margins are impacted by volatile input prices as the gestation period of projects in the segment for compressor systems can be time consuming ranging from 3-18 months. Moreover, there is stiff competition from many domestic and major international players in the segment for compressors and some of these players have access to strong technological support and managerial background from their parent companies.

Outlook and Valuations: KPCL continues to serve a variety of sectors like oil, gas, steel, cement, food & beverage, railways, defence, marine etc. which are directly or indirectly related to the capital-intensive industries (with cyclical demand), industrial growth of the country, capex cycle of the capital goods sector and or GDP. The product range offered by the company which are currently seeing ample tailwinds include air compressors, air conditioning and refrigeration systems, process gas systems, vapour absorption systems and industrial gear boxes etc. which are linked to the economic growth of the country. The company has an established market position in the compressor segment; in addition to this, the company has a healthy order book with an increased demand from end-user industries. The financial risk profile too remains strong which is supported by healthy liquidity for the virtually debt free company. KPCL is in position to manufacture some of the best-in-class products while providing superior solutions for the Make in India campaign. India is gradually moving towards a gas-based energy distribution economy and the market for CGD is growing at a fast pace. Moreover, it is projected the country's demand for CNG station is nearly 8000-9000 over the next 8-10 years. Servicing or after sales market is also another value addition for the company. Management intends to focus more on transmission business; streamlining the same can help an uptick in the margins in times to come. The vision of the Management is to make use of the integrated systems created by the company for manufacturing high precision and good quality goods with focus on margin improvement for the business in the competitive landscape and try to reduce the losses in the transmission segment. With the anticipated growth in sight, Management is indicating at a long-term vison of Rs20000mn over the next 3-4 years. The stock has already breached our third revised target price of Rs375 and looking at positivity in the industries which KPCL caters to, we reinitiate a buy with a revised target price to Rs475.

Exhibit 03: Price vs. Nifty

Source: Ace Equity

Exhibit 04: One Year Forward P/E



Source: Ace Equity

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