Kirloskar Oil Engines

Performance Highlights

Y/E March (₹ cr)	2QFY16	2QFY15	% chg. (yoy)	1QFY15	% chg. (qoq)
Net Sales	590	628	(6.0)	582	1.5
EBITDA	48	64	(24.3)	53	(8.1)
EBITDA margin (%)	8.2	10.2	(198)	9.0	(86)
PAT	36	35	1.1	36	(0.5)

Source: Company, Angel Research (Standalone)

For 2QFY2016, Kirloskar Oil Engines (KOEL) reported a disappointing set of numbers. Its top-line for the quarter declined by 6.0% yoy to ₹590cr. The raw material cost declined by 286bp yoy to 62.3% of sales while employee expense increased by 79bp yoy to 8.5% of sales, and other expenses increased by 405bp yoy to 21.0% of sales. This resulted in the EBITDA margin contracting by 198bp yoy to 8.2%. Other income increased by 61.1% yoy to ₹20cr and consequently, the net profit remained flat at ₹36cr.

Outlook to remain subdued in the near term: In the near term, we expect the company to witness some pressure on account of overall slowdown in the Genset industry. In addition, the absence of large engines orders has been impacting the top-line and profitability. KOEL has expanded its capacity in the past and is positioned to successfully cater to improvement in demand once the operating environment changes in the longer run. KOEL also has taken measures to increase its focus on exports which should aid growth.

Cash rich position: KOEL is a debt free company with cash and cash equivalents of approximately ₹835cr. With ample capacity in place, there is no major capex expected in the near future. Consequently depreciation expense is also expected to remain low which will add to the bottom-line. We expect KOEL's cash and cash equivalents to be at ~₹982cr in FY2017E which is approximately 26% of the current market cap.

Outlook and Valuation: We expect KOEL's revenue to recover post FY2016, ie to ₹2,826cr in FY2017E. With recovery in the top-line, we expect the EBITDA margin to recover to 10.4% in FY2017E. Consequently the profit is expected to grow to ₹193cr in FY2017E. We have scaled down our numbers for FY2016E and have accounted for improvement in the top-line for FY2017E. At the current market price, the stock trades at 19.7x its FY2017E earnings (vs its 3-year median of 21.7x). **At the current juncture, we have a Neutral rating on the stock as the infrastructure scenario in the country is expected to remain dampened in the near term.**

Key financials

Y/E March (₹ cr)	FY2013	FY2014	FY2015	FY2016E	FY2017E
Net Sales	2,357	2,319	2,507	2,471	2,826
% chg	1.3	(1.6)	8.1	(1.4)	14.3
Adj. Net Profit	212	178	143	132	193
% chg	35.2	(15.9)	(19.8)	(7.8)	46.1
OPM (%)	13.8	13.1	9.9	8.8	10.4
EPS (₹)	14.7	12.3	9.9	9.1	13.3
P/E (x)	17.9	21.2	26.5	28.7	19.7
P/BV (x)	3.3	3.0	2.8	2.7	2.5
RoE (%)	19.4	14.7	11.0	9.7	13.4
RoCE (%)	19.4	16.4	10.9	8.0	12.4
EV/Sales (x)	1.4	1.4	1.2	1.2	1.0
EV/EBITDA (x)	10.3	10.3	11.6	13.4	9.5

Source: Company, Angel Research, Note: CMP as of November 13, 2015

NEUTRAL

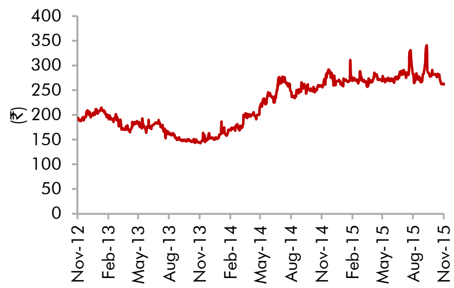
CMP	₹262
Target Price	-
Investment Period	-

Stock Info	
Sector	Capital Goods
Market Cap (₹ cr)	3,796
Net debt (₹ cr)	(876)
Beta	0.6
52 Week High / Low	261/ 141
Avg. Daily Volume	26,711
Face Value (₹)	2
BSE Sensex	25,760
Nifty	7,807
Reuters Code	KIRO.BO
Bloomberg Code	KOEL IN

Shareholding Pattern (%)	
Promoters	72.7
MF / Banks / Indian FIs	6.6
FII / NRIs / OCBs	10.4
Indian Public / Others	10.3

Abs.(%)	3m	1yr	3yr
Sensex	(7.6)	(8.6)	40.7
KOEL	(0.8)	1.7	39.4

3 Year price chart



Source: Company, Angel Research

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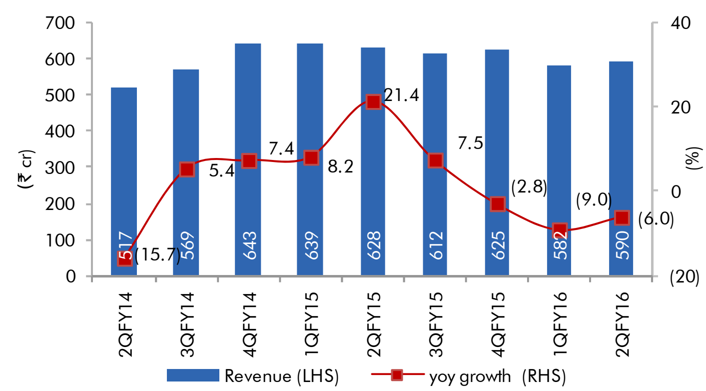
Exhibit 1: 2QFY2016 performance highlights

Y/E March (₹ cr)	2QFY16	2QFY15	% chg. (yoy)	1QFY15	% chg. (qoq)	1HFY2016	1HFY2015	% chg
Net Sales	**590**	**628**	*(6.0)*	**582**	*1.5*	**1,171**	**1,267**	*(7.5)*
Net raw material	368	409	*(10.2)*	373	*(1.5)*	741	825	*(10.2)*
(% of Sales)	*62.3*	*65.2*	*(286)*	*64.2*	*(186)*	*63.2*	*65.1*	*(2.9)*
Employee Cost	50	48	*3.6*	48	*5.5*	98	94	*3.8*
(% of Sales)	*8.5*	*7.7*	*79*	*8.2*	*32*	*8.3*	*7.4*	*12.2*
Other Expenses	124	106	*16.4*	108	*14.5*	232	208	*11.3*
(% of Sales)	*21.0*	*16.9*	*405*	*18.6*	*239*	*19.8*	*16.5*	*20.4*
Total Expenditure	**542**	**564**	*(4.0)*	**529**	*2.4*	**1,071**	**1,128**	*(5.1)*
Operating Profit	**48**	**64**	*(24.3)*	**53**	*(8.1)*	**101**	**139**	*(27.6)*
OPM (%)	*8.2*	*10.2*	*(198)*	*9.0*	*(86)*	*8.6*	*11.0*	*(238)*
Interest	0	0	*(86.7)*	0	*(33.3)*	0	0	*(79.2)*
Depreciation	27	26	*3.9*	26	*2.4*	53	50	*5.4*
Other Income	20	12	*61.1*	19	*2.2*	39	26	*49.4*
PBT	**41**	**50**	*(17.9)*	**46**	*(9.8)*	**87**	**115**	*(24.5)*
(% of Sales)	*7.0*	*8.0*		*7.8*		*7.4*	*9.1*	
Tax	5	15	*(63.5)*	10	*(44.4)*	15	32	*(53.1)*
(% of PBT)	*13.1*	*29.4*		*21.2*		*17.4*	*28.0*	
Reported PAT	**36**	**35**	*1.1*	**36**	*(0.5)*	**72**	**83**	*(13.3)*
Extraordinary Expense/(Inc.)	-	-		-		-	-	
Adjusted PAT	**36**	**35**	*1.1*	**36**	*(0.5)*	**72**	**83**	*(13.3)*
PATM	*6.1*	*5.6*		*6.2*		*6.1*	*6.5*	

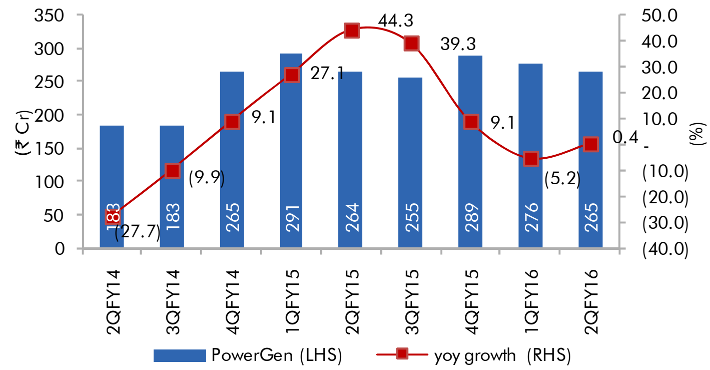
Source: Company, Angel Research

Exhibit 2: Top-line remains subdued



Source: Company, Angel Research

Exhibit 3: PowerGen Segment growth



Source: Company, Angel Research

Top-line growth remains subdued

For 2QFY2016, the top-line declined by 6.0% yoy to ₹590cr. The decline was on account of a muted performance across all segments and due to absence of large engine orders in FY2016 (last portion of the order completed in FY2015). As per the Management, the domestic power gen segment saw a decline of 4% in 1HFY2016E. Exports performed well, growing by 27% on a yoy basis.

Exhibit 4: Segmental Performance

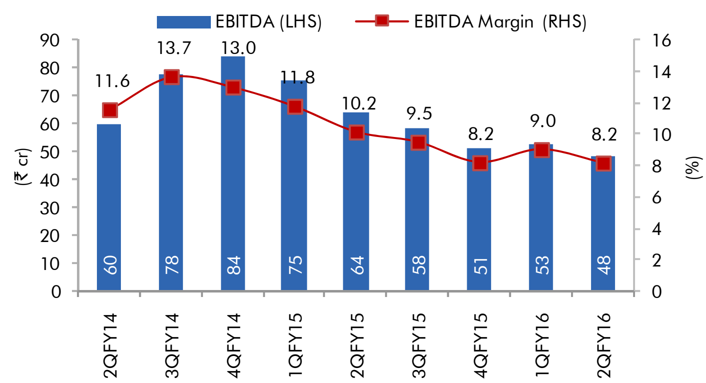
(₹ Cr)	2QFY16	2QFY15	% chg. (yoy)	1HFY16	1HFY15	% chg. (yoy)
PowerGen	265	264	0.5	541	555	(2.4)
Agricultural	107	113	(5.8)	206	205	0.4
Industrial	99	94	5.0	190	193	(1.6)
Customer Support	83	85	(2.4)	172	177	(2.7)
Large Engines	31	67	(54.3)	52	122	(57.4)
Total	**584**	**623**		**1,162**	**1,252**	

Source: Company, Angel Research

EBITDA Margin contracts on account of higher other expenses

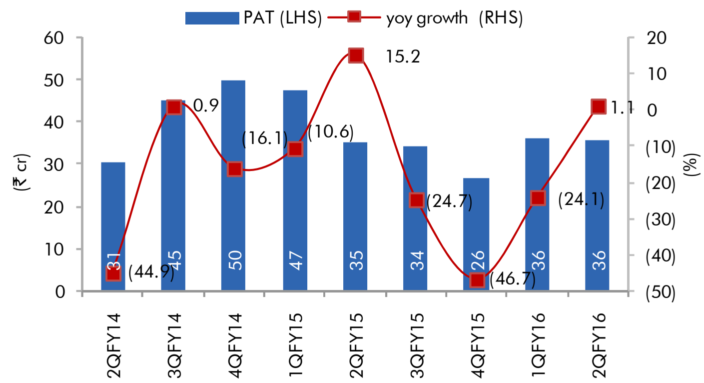
The raw material cost declined by 286bp yoy to 62.3% of sales while employee expense increased by 79bp yoy to 8.5% of sales, and other expenses increased by 405bp yoy to 21.0% of sales. This resulted in the EBITDA margin contracting by 198bp yoy to 8.2%. As per the Management, the other expense was higher as there was a one-off expense related to payment of consultancy fees and shifting of manufacturing from Pune plant to Kagal plant. The fixed portion of the fees (~₹7-₹8cr) was paid up front. Additionally, the CSR expense which was incurred in the last quarter of the previous year has been spread out evenly in the current year. As on 1HFY2016, the expense was ₹3cr against ₹10-₹20 lakhs in the same period last year. Aided by higher other income which grew by 61.1% yoy to ₹20cr, the net profit grew marginally by 1.1% yoy to ₹36cr.

Exhibit 5: EBITDA margin



Source: Company, Angel Research

Exhibit 6: Net profit trend



Source: Company, Angel Research

Conference Call Highlights

- Economic revival has been sluggish and has had a direct impact on the PowerGen and Industrial segment. The Agri business was impacted on account of shift in demand towards electrical pump sets as electrification has improved. Spare sales were lower on account of low usage of DG set and lesser industrial activities.
- The competitive scenario is intense in the sub-125kVA segment and everybody is scampering for a share of the pie. The domestic PowerGen segment industry saw a decline of 4% in volume terms. Few players in MHP and HHP have taken price cuts of ~4-5%. KOEL has refrained from cutting its prices.
- Market share increase in PowerGen by ~4-5% for a competitor is on account of pick up in 4G activity (Reliance Jio). Ex of telecom, KOEL maintained its market share. The Management expects telecom to be in a lull over the next few months but it should pick up when the Airtel order comes up. The company has not participated in a big way in 4G but is hopeful that some of the test orders translate in to larger orders.
- Exports' contribution has increased from 8% in 1HFY2015 to 10% in 1HFY2016. The company expects to maintain its previous growth rates.
- Tiller volumes are expected to pick up in the next year on account of subsidy application and link up with four major banks for retail financing. Subsidy approval from various state governments will be an important factor in the near term. The company has sold 600 power tillers in 1HFY2016. With timely subsidies, the Management is expecting sales of ~500 tillers per month for FY2017E.

Investment arguments

Near term performance subdued; to improve over the longer run

The generator set industry in general is facing headwinds on account of delay in pickup in economic recovery. In the past, the industrial and infrastructure segment witnessed persistent headwinds such as inflationary pressures, slow order inflows, high interest rates and policy paralysis, which has resulted in slower execution and dip in demand for gensets. The PowerGen segment accounts for ~45% of total revenues and is impacted by the above mentioned reasons. Although the recovery has been slower than expected, the expected improvement in the economic scenario would impact KOEL positively as it has the necessary capacity in place to cater to an improving scenario.

Debt free and cash rich company

KOEL is a debt free company with cash and cash equivalents of approximately ₹835cr. With ample capacity in place, there is no major capex expected in the near future. Consequently depreciation expense is also expected to remain low which will add to the bottom-line. We expect KOEL's cash and cash equivalents to be at ~₹982cr in FY2017E which is approximately 26% of the current market cap.

This is on the back of measures taken by the company to significantly reduce its debtor days from 45 in FY2013 to 17 in FY2015.

Increasing focus on exports – a long term growth driver

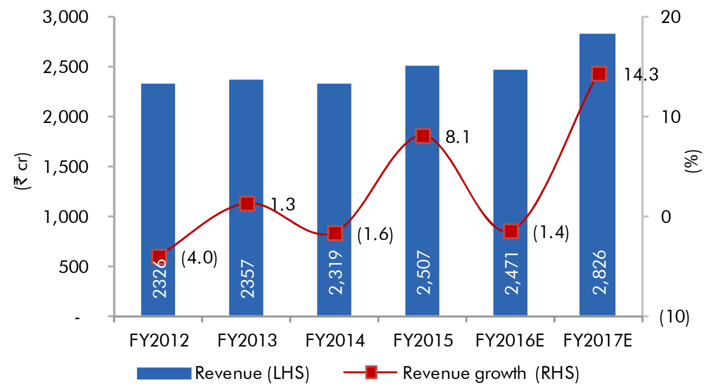
In order to balance out any slowdown in the domestic economy, the company is focusing on the export market. The company's major export markets are Middle East and Africa along with USA, Europe and South Asia/South East Asia. Middle East accounts for 47% of total exports and Africa accounts for 37%. The company is upping its focus on exports and plans to enter new markets while also increasing its market share in existing markets. The company expects Middle East and Africa to be larger contributors to the international business of the company and is taking steps to increase its presence in USA where it has less of a presence.

Financials

Slow recovery in top-line

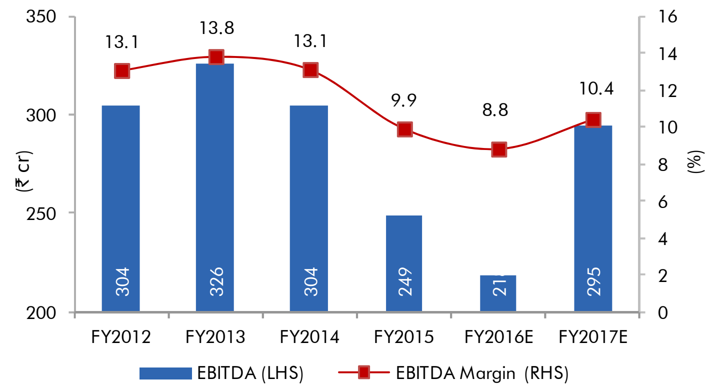
On account of overall slowdown in the PowerGen and Industrial segment along with absence of large engine orders, we expect the top-line to regress in FY2016E and recover in FY2017E to ₹2,826cr. The margins are expected to remain under pressure for the current year on account of lower sales and on account of some one-time expenses in the current year (Shifting to Kagal plant and Consultancy fees). We expect the EBITDA margin to improve on account of operating leverage and also due to higher-margin large engine orders coming in FY2017E.

Exhibit 7: Revenue growth to improve going forward



Source: Company, Angel Research

Exhibit 8: EBITDA margin to recover



Source: Company, Angel Research

The depreciation expense is expected to be flat as the company has undertaken capacity expansion in the past to position itself to best cater to the future uptick in demand. With no significant capex in sight, the flat depreciation is expected to add directly to the bottom-line. The cash position is expected to remain strong and as per our estimates, the cash and cash equivalents are expected to be at ₹982cr in FY2017E. On account of operating leverage, the PAT for FY2017E is expected to improve to ₹193cr.

Exhibit 9: Relative valuation (Trailing twelve months)

Company	Mcap (₹ cr)	Sales (₹ cr)	OPM (%)	PAT (₹ cr)	EPS (₹)	RoIC (%)	P/E (x)	P/BV (x)	EV/EBITDA (x)	EV/ Sales (x)
KOEL	**3,796**	**2,480**	**8.5**	**132**	**9.1**	**17.6**	**28.7**	**2.6**	**14.1**	**1.2**
Cummins India	27,886	28,491	2.7	781	28.2	23.2	35.7	8.5	35.3	1.0
Greaves Cotton	3,410	1,893	9.4	134	5.5	17.7	25.4	4.1	18.7	1.8

Source: Company, Angel Research

Outlook and valuation: We expect KOEL's revenue to recover post FY2016E to ₹2,826cr in FY2017E. With recovery in top-line, we expect the EBITDA margin to recover to 10.4% in FY2017E. Consequently the profit is expected to grow to ₹193cr in FY2017E. At the moment, the PowerGen and Industrial segments are facing pressure on account of slower-than-expected recovery in the macroeconomic environment. We have scaled down our numbers for FY2016E and have accounted for improvement in the top-line for FY2017E. At the current market price, the stock trades at 19.7x its FY2017E earnings (vs its 3-year median of 21.7x). **At the current juncture, we have a Neutral rating on the stock as the infrastructure scenario in the country remains dampened in the near term.**

Exhibit 10: One-year forward P/E band

Source: Company, Angel Research

Concerns

Continued slowdown in the economy: Any continued slowdown will adversely affect the company's performance.

Surplus electricity scenario: Contracting demand supply gap will be an adverse situation for the company to some extent.

Fluctuations in Steel price: Any substantial fluctuation in the steel price can lead to margin compression of the company.

Increasing imports from China: Low cost Chinese imports will continue to pose a threat to the company.

Company background

KOEL is the flagship company of the Kirloskar group, one of India's largest engineering conglomerates. It is one of the world's largest generating set manufacturers, specializing in manufacturing of both air-cooled and water-cooled engines (2.5HP to 740HP) and diesel generating sets across a wide range of power output from 5kVA to 3,000kVA. It has four manufacturing plants - at Kagal, Pune, Nashik and Rajkot. It has a sizable presence in international markets, with offices in Dubai, South Africa, and Kenya, and representatives in Indonesia and Nigeria. KOEL also has a strong distribution network throughout the Middle East and Africa. It caters to Power Generation, Agriculture and Industrial and machinery sectors.

Profit and loss statement

Y/E March (₹ cr)	FY2013	FY2014	FY2015	FY2016E	FY2017E
Total operating income	**2,357**	**2,319**	**2,507**	**2,471**	**2,826**
% chg	*1.3*	*(1.6)*	*8.1*	*(1.4)*	*14.3*
Net Raw Materials	1446	1444	1626	1567	1779
% chg	*4.0*	*(0.2)*	*12.6*	*(3.6)*	*13.5*
Power and Fuel	23	21	21	20	20
% chg	*(17.7)*	*(9.0)*	*0.6*	*(1.4)*	*(2.8)*
Personnel	173	163	188	202	222
% chg	*(1.1)*	*(6.3)*	*15.9*	*7.0*	*10.0*
Other	390	388	424	464	510
% chg	*(9.1)*	*(0.3)*	*9.1*	*9.5*	*10.0*
Total Expenditure	2,032	2,015	2,259	2,253	2,531
EBITDA	**326**	**304**	**249**	**218**	**295**
% chg	*7.1*	*(6.6)*	*(18.3)*	*(12.3)*	*35.1*
(% of Net Sales)	*13.8*	*13.1*	*9.9*	*8.8*	*10.4*
Depreciation& Amortisation	93	98	102	105	111
EBIT	**233**	**206**	**147**	**113**	**184**
% chg	*9.6*	*(11.7)*	*(28.8)*	*(23.2)*	*62.9*
(% of Net Sales)	*9.9*	*8.9*	*5.9*	*4.6*	*6.5*
Interest & other Charges	**2**	**0**	**0**	**0**	**0**
Other Income	40	38	59	71	85
(% of Net Sales)	*1.7*	*1.6*	*2.4*	*2.9*	*3.0*
Recurring PBT	**231**	**206**	**147**	**112**	**183**
% chg	*17.5*	*(11.1)*	*(28.8)*	*(23.2)*	*63.0*
PBT (reported)	**271**	**243**	**205**	**183**	**268**
Tax	72	65	62	51	75
(% of PBT)	*26.6*	*26.7*	*30.3*	*28.0*	*28.0*
PAT (reported)	**199**	**178**	**143**	**132**	**193**
Extraordinary Expense/(Inc.)	*13.4*	*0.0*	*0.0*	*0.0*	*0.0*
ADJ. PAT	**212**	**178**	**143**	**132**	**193**
% chg	*35.2*	*(15.9)*	*(19.8)*	*(7.8)*	*46.1*
(% of Net Sales)	*9.0*	*7.7*	*5.7*	*5.3*	*6.8*
Basic EPS (₹)	**14.7**	**12.3**	**9.9**	**9.1**	**13.3**
Fully Diluted EPS (₹)	**14.7**	**12.3**	**9.9**	**9.1**	**13.3**
% chg	*35.2*	*(15.9)*	*(19.8)*	*(7.8)*	*46.1*

Balance sheet

Y/E Mar. (₹ cr)	FY2013	FY2014	FY2015	FY2016E	FY2017E
SOURCES OF FUNDS					
Equity Share Capital	29	29	29	29	29
Reserves& Surplus	1,125	1,238	1,313	1,357	1,463
Shareholders' Funds	1,154	1,267	1,341	1,386	1,492
Total Loans	-	-	-	-	-
Other Long Term Liabilities	30	13	17	17	17
Long Term Provisions	22	25	24	24	24
Deferred Tax (Net)	34	30	29	29	29
Total liabilities	1,240	1,335	1,412	1,457	1,562
APPLICATION OF FUNDS					
Gross Block	1,133	1,179	1,249	1,338	1,440
Less: Acc. Depreciation	542	636	736	841	952
Net Block	591	543	514	497	488
Capital Work-in-Progress	27	42	21	22	14
Goodwill	-	-	-	-	-
Investments	418	608	876	824	824
Long Term Loans and adv.	66	96	108	108	108
Other Non-current asset	26	29	32	32	32
Current Assets	615	534	381	485	672
Cash	25	52	25	52	159
Loans & Advances	93	102	100	104	119
Inventory	189	167	172	176	224
Debtors	289	177	53	122	139
Other current assets	21	35	31	31	31
Current liabilities	504	516	521	512	576
Net Current Assets	112	18	(140)	(27)	96
Misc. Exp. not written off	-	-	-	-	-
Total Assets	1,240	1,335	1,412	1,457	1,562

Cash flow statement

Y/E Mar. (₹ cr)	FY2013	FY2014	FY2015	FY2016E	FY2017E
Profit before tax	271	243	205	183	268
Depreciation	93	98	102	105	111
Change in Working Capital	(81)	122	131	(86)	(17)
Direct taxes paid	(72)	(65)	(64)	(51)	(75)
Others	6	(60)	(35)	(71)	(85)
Cash Flow from Operations	**216**	**338**	**339**	**81**	**202**
(Inc.)/Dec. in Fixed Assets	(97)	(61)	(49)	(90)	(94)
(Inc.)/Dec. in Investments	110	(190)	(269)	53	-
(Incr)/Decr In LT loans & adv.	(9)	(33)	(16)	-	-
Others	28	59	52	71	85
Cash Flow from Investing	**31**	**(224)**	**(282)**	**33**	**(9)**
Issue of Equity	(0)	-	-	-	-
Inc./(Dec.) in loans	(87)	-	4	-	-
Dividend Paid (Incl. Tax)	(85)	(85)	(87)	(87)	(87)
Others	(78)	(1)	(1)	-	-
Cash Flow from Financing	**(250)**	**(86)**	**(84)**	**(87)**	**(87)**
Inc./(Dec.) in Cash	(3)	28	(27)	27	106
Opening Cash balances	**27**	**25**	**52**	**25**	**52**
Closing Cash balances	**25**	**52**	**25**	**52**	**159**

Key ratios

Y/E Mar.	FY2013	FY2014	FY2015	FY2016E	FY2017E
Valuation Ratio (x)					
P/E (on FDEPS)	17.9	21.2	26.5	28.7	19.7
P/CEPS	12.4	13.7	15.5	16.0	12.5
P/BV	3.3	3.0	2.8	2.7	2.5
EV/Net sales	1.4	1.4	1.2	1.2	1.0
EV/EBITDA	10.3	10.3	11.6	13.4	9.5
EV / Total Assets	2.8	2.4	2.1	2.0	1.8
Per Share Data (₹)					
EPS (Basic)	14.7	12.3	9.9	9.1	13.3
EPS (fully diluted)	14.7	12.3	9.9	9.1	13.3
Cash EPS	21.1	19.1	16.9	16.4	21.0
DPS	5.0	5.0	5.0	5.0	5.0
Book Value	79.8	87.6	92.8	95.9	103.2
DuPont Analysis					
EBIT margin	9.9	8.9	5.9	4.6	6.5
Tax retention ratio	0.7	0.7	0.7	0.7	0.7
Asset turnover (x)	3.5	3.5	4.7	5.0	5.3
ROIC (Post-tax)	25.1	22.5	19.2	16.4	24.8
Cost of Debt (Post Tax)	3.2	-	-	-	-
Leverage (x)	(0.4)	(0.5)	(0.7)	(0.6)	(0.7)
Operating ROE	16.7	-	-	-	-
Returns (%)					
ROCE (Pre-tax)	19.4	16.4	10.9	8.0	12.4
Angel ROIC (Pre-tax)	34.2	30.8	27.6	22.8	34.4
ROE	19.4	14.7	11.0	9.7	13.4
Turnover ratios (x)					
Asset TO (Gross Block)	2	2	2	2	2
Inventory / Net sales (days)	25	28	25	26	26
Receivables (days)	45	37	17	18	18
Payables (days)	93	92	84	83	83
WC cycle (ex-cash) (days)	7	4	(15)	(18)	(9)
Solvency ratios (x)					
Net debt to equity	(0.4)	(0.5)	(0.7)	(0.6)	(0.7)
Net debt to EBITDA	(1.4)	(2.2)	(3.6)	(4.0)	(3.3)
Int. Coverage (EBIT/ Int.)	124.7	686.5	733.5	563.4	917.6

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DISCLAIMER

Disclosure of Interest Statement	**Kirloskar Oil Engines**
1. Analyst ownership of the stock	No
2. Angel and its Group companies ownership of the stock	No
3. Angel and its Group companies' Directors ownership of the stock	No
4. Broking relationship with company covered	No

Note: We have not considered any Exposure below ₹ 1 lakh for Angel, its Group companies and Directors

Ratings (Based on expected returns over 12 months investment period):	*Buy (> 15%)*	*Accumulate (5% to 15%)* *Reduce (-5% to -15%)*	*Neutral (-5 to 5%)* *Sell (< -15)*