Initiating Coverage

Kennametal India Ltd.

December 31, 2021

RETAILRESEARCH

HDFC securities
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20 YEARS

Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
Industrial Products	Rs. 1780	Buy at Rs 1760-1800 band & add more on dips to Rs. 1602	Rs.1960	Rs.2109	2 quarters

HDFC Scrip Code	KENNAMET
BSE Code	505890
NSE Code	KENNAMET
Bloomberg	KNM IN
CMP Dec 30, 2021	1780
Equity Capital (Rs cr)	22
Face Value (Rs)	10
Equity Share O/S (cr)	2.2
Market Cap (Rs cr)	3916
Book Value (Rs)	266
Avg. 52 Wk Volumes	86,754
52 Week High	1892.55
52 Week Low	836.95

Share holding Pattern % (SEP, 2021)	
Promoters	75.00
Institutions	13.52
Non Institutions	11.48
Total	100.0

* Refer at the end for explanation on Risk Ratings

Fundamental Research Analyst
Chintan Patel
chintan.patel@hdfcsec.com

Our Take:

Kennametal India Limited, with a strong global parentage, operates in carbide tools and special purpose machines manufacturing for automotive, defense, railways, infrastructure, aerospace and green engineering segments. Nearly half its revenue comes from the automotive segment. Rising opportunities in the field of electric vehicles and aerospace, along with the recovery/growth in the auto sector will help drive business of the company. The company operates in a highly competitive market and the presence of its dual brands can help it bid for business separately. This makes it more agile and competitive. Innovation is a key driver of the company's business and innovative products can help company be different from its peers and provide it with a competitive advantage. We believe that the company will grow faster going forward, led by the growth in automotive, aerospace and other engineering products segments, efficient capital allocation, strong parent company and healthy balance sheet.

Valuation & Recommendation:

We expect revenue/EBITDA/PAT to grow at CAGR of 15.3%/19%/24% over FY21-FY24E, on account of expectation of growth in Auto, opportunity in aerospace and e-mobility, infrastructure, dual brands strategy and strong parentage. Kennametal is currently trading at an attractive valuation of 30xDec23E EPS. With improved return ratios, a top market position vis-à-vis peers, and innovative products, Kennametal deserves a premium valuation. We feel investors can buy the stock at the CMP of 1780 and add on declines to around Rs. 1,602 (27.0xDec23E EPS), for a base target price of Rs. 1960, which implies 33.0x Dec23 EPS. Our Bull case target price of Rs. 2109 (35.5xDec23E EPS), attributes an upside of 18.5%.

Financial Summary

Rs in Cr	Q1FY22	Q1FY21	YoY (%)	Q4FY21	QoQ (%)	FY21	FY22E	FY23E	FY24E
Net Revenues	237.5	197.1	20.5	211.9	12.1	854	1007	1169	1309
EBITDA	192.3	170.7	12.7	174.6	10.1	131	163	195	221
Depreciation	9.2	9.6	-4.2	9.4	-2.1	38	39	41	43
Other Income	1.8	1.4	28.6	1.3	38.5	7	8	9	10
Tax	9.8	4.5	117.8	7.4	32.4	25	34	42	48
APAT	28.3	13.93	103.2	21.6	31.0	73	98	121	140
EPS (Rs)	12.88	6.01		9.84		33.4	44.5	55.2	63.6
P/E (x)						53.4	40.0	32.2	28.0
EV / EBITDA (x)						29.0	23.0	18.7	16.3
RoE (%)						12.5	15.7	18.0	19.2

Recent Triggers

Q1FY22 Review

Topline grew by 20.5% YoY and 12.1% QoQ to Rs 237.5 cr in Q1FY22. EBITDA stood at Rs 47 cr, up 69.1% YoY, 21.8% QoQ. EBITDA margin of 19% in Q1FY22 was on account of strong topline, helping it deliver strong margins in the first quarter. In an inflationary economy, with cost headwinds, the company continues to strive for performance by protecting gross margins and operating margins. Profit after tax doubled on a YoY basis to Rs 28.3 cr, up 31% sequentially.

Key Triggers Going Forward

Surge of growth in automotive indicates a positive sign

Automotive segment is a key sector for the company, as >50% of its revenue is attributable to transportation –two wheelers, Farm Equipment, Railways, Heavy Vehicles, Four-wheelers etc.

In FY21, increase in prices of vehicles owing to BS-6 migration, restricted finance availability, coupled with the pandemic led to Retail sales de-growth of 34%, passenger vehicles sales fall of 12% and commercial vehicles sales drop of 51% YoY. However, Tractor sales grew ~24% on account of good monsoons, loan waivers and Minimum Support Prices (MSPs). The auto component industry fared significantly better, with a decline of only 3% in the year ended in March 2021. In the coming years, volume growth will be driven by PLI schemes, Vehicle scrappage policy and electric vehicles. In the near future, normalisation in auto sector and growth in volumes will help company perform better.

Opportunity in electric vehicles (EVs) and aerospace

The company, with its hybrid engine, will definitely play a part in the electric vehicles segment. . Like in China, growth is likely to come from the two-wheeler segment. Passenger and commercial vehicles penetration will come later. The way mix between IC and EV segments plays out in the future will pave the way for growth. Its dependence on passenger and heavy commercial vehicles could impact volumes if EV momentum picks pace. The management seems confident to compensate that with newer opportunities from the EV space.

Kennametal offers the best performing aerospace tools for machining CFRP, titanium, aluminum, hard alloys and more. The latest knowledge on aerospace tooling and solutions for successful production in the aerospace industry differentiates it from the competition. The company recently launched hi-tech FBX series of drills useful in flat bottom drilling in aerospace manufacturing.

Potential in Infrastructure space and expected boom in Capex

Kennametal is focussing on increasing its presence in the infrastructure space and reduce dependence on more cyclical automobile/industrial applications. Globally, >40% of revenues comes from its products in infrastructure domain. In India, however the infrastructure segment is small, due to lower use of advanced infrastructure construction technology in India.

India has lacked an investment cycle for the past ten years since peaking in FY2011, post recovery from the GFC. This is characterised by the absence of large-scale capex in sectors like power and metals. India's long awaited capex cycle is now showing initial signs of revival. The national infrastuture pipeline has outlay a capex of Rs 11,760 bn over FY20-25 towards the power sector, which would indirectly support companies like Kennametal.

Dual brands and innovative products

Its dual brands - Kennametal and WIDIA, makes it agile and more competitive in the market place. With the dual brands, it can bid for projects separately. Kennametal brand competes in full solution segment, whereas Widia in performance segment. WIDIA is the focus brand for the company. WIDIA was an old brand in India and had a leadership position with a strong brand recall. The company is planning to increase sales support and distribution for WIDIA and increase its reach. There is a focus on channel partner for development and the availability of products. WIDIA products are completely manufactured in India with some imported components. The company recently launched FIX-8 program for high productive turning application, digital boring system, Multi-Tip PCBN Wiper Program, and New Ceramic Grade for cast Iron, Hard Materials and Super Alloys under the Kennametal Brand and Varimill Xtreme, AluFlash 2&3 Flute, WGC Steel, Roughing Universal and Aluminum machining and TDMX for SS under WIDIA brand. Innovative products are the key drivers for the company. The Machining Solutions Group with its expanding footprint in China and South East Asia, sees greater potential from a broader customer base. The growing trade tensions also make India an attractive destination for safe investments for both sales in India and for exports from India. The MSG team remote commissioned a large Special Purpose Machines in the UK, China and France, using an advanced remote technology from Bengaluru.

With a state-of-the-art facility in Bengaluru, Kennametal is also well positioned to capitalize the localization drive and 'Atmanirbhar Bharat' initiative of the government for supply to public sector and government undertakings. With most of the supply chain for India's operations being locally sourced, there is likely to be very less impacton sourcing.

Kennametal continues to invest in stocking more SKUs of fast-moving imported products ('First Choice' from Kennametal, 'All Star' from WIDIA). The "one" metal cutting brand strategy obviates duplication of work, resources and costs, and helps Kennametal to remain efficient while being a strong player to deliver on its commitment to customers. With wider choice of cutting tools from different brands suitable for different applications, Kennametal is well poised to participate in all the three segments of the market viz., value, performance and full solution.

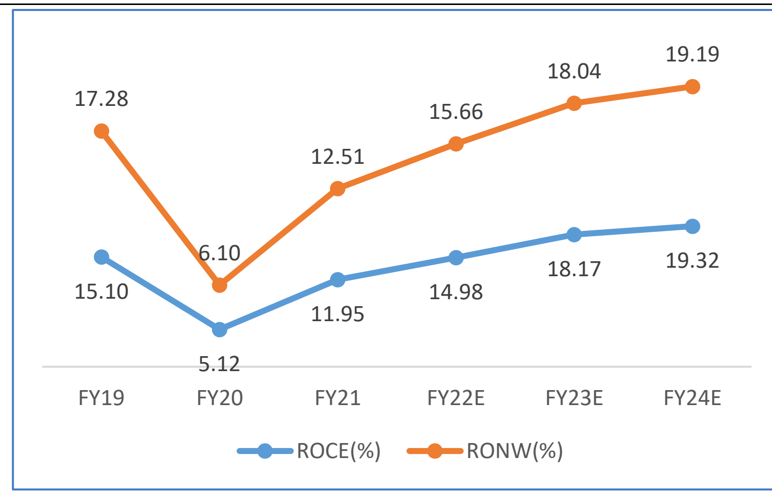
Strong Parental Support

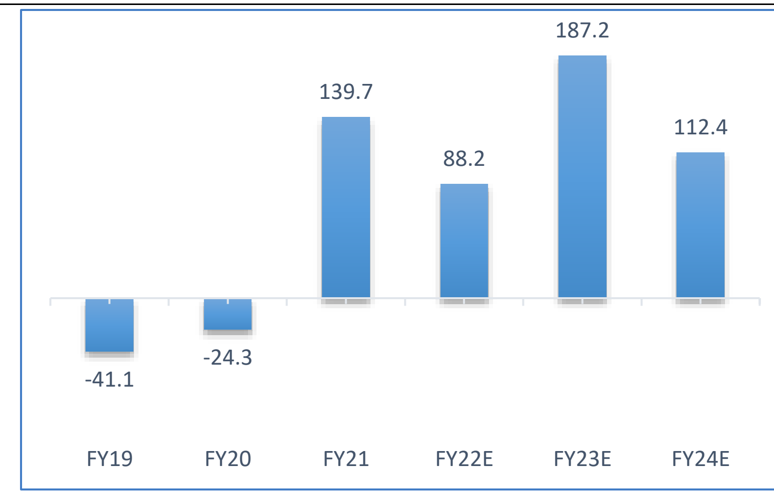
The company receives technological and managerial support from Kennametal Inc (KIL), the world's second-largest manufacturer of carbide tools. KIL has benefitted from synergies with Kennametal Inc's manufacturing and marketing efficiency, international presence, R&D capabilities, and support in the sourcing of raw materials, such as tungsten, tantalum, and cobalt. Besides, KIL has been gradually expanding its customer base and providing clients with access to high-precision tools sourced from other Kennametal Inc. units. Last year, the company launched a lot of innovative products from the parent’s stable in India.

Strong Financials

The company posted a strong revenue growth of 21% at Rs 853.7cr in the year ended in June-2021, on account of recovery from the end-user industries like automotive. It reported EBITDA at Rs 130.8 cr in FY21, up 52.4%. EBITDA margin stood at 15.3%, improved by 502 bps. The company posted more than double PAT of Rs 73.3 cr in FY21, as compared to the previous year. The company reported EPS is Rs 33.35. The free cash flow of the company has turned positive to ~Rs 140 cr in FY21, from a negative FCF of Rs 41 cr in FY19. It is a debt free company, with cash and cash equivalent at Rs 113 cr, a sign of healthy balance sheet of the company.

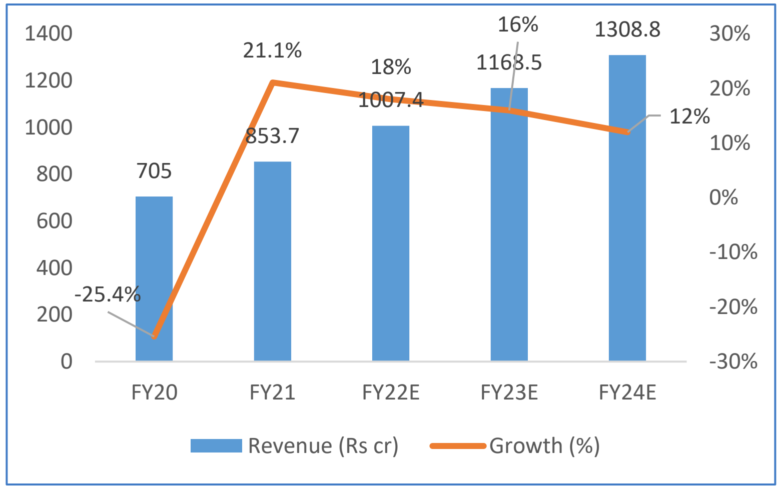
Improved Return Ration and Positive FCF

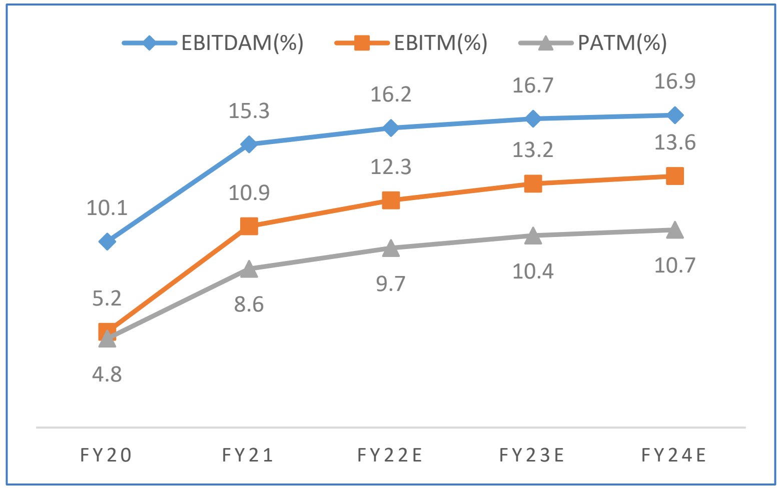




(Source: Company Filings, HDFC Research)

Revenue and margin profile





(Source: Company Filings, HDFC Research)

What could go wrong?

- With over 70% of the raw materials like Tungsten Carbide, Cobalt, not available in India and other components (including traded goods) are imported, the operating margins remain susceptible to movement in forex rates.

- Customers are mainly from capital-intensive industries, such as automobile, energy, steel and aerospace, where demand is cyclical and dependent on the economy. The company's operating performance is, therefore, expected to remain sensitive to the global and Indian economic growth and the capex at end-user industries.

- The Government's efforts at bringing about FAME (Faster Adoption & Manufacturing of Hybrid and Electric Vehicles) is another potential area of concern, as this would impact the conventional automotive segment and by extension, the demand for the company's products as well in the short run.
  However M&HCV forms a large portion of Auto exposure and here the EV transitions risks could be back ended.

- Margins on Traded goods (~32% of sales) have a cap due to transfer pricing mechanisms and tends to pull down the overall margins.

- The intensity of competition is expected to continue with almost all global players making India a manufacturing location for production of tools.

- Global chip shortage, inflation and trade tensions between countries affecting supply chain are some other concerns faced by the company.

About the company

Kennametal India Ltd was incorporated in 1938. It is a 75% subsidiary of Kennametal Inc. It manufactures carbide tools and special-purpose machines for automotive, defense, railways, infrastructure and general engineering segments. Kennametal Inc, USA, a leading global company in developing and manufacturing sophisticated hard material cutting and wear protection solutions having applications across varied range of industries. 98 patents were granted to Kennametal parent in FY21 with cumulative patents being 1721. 11 new product families were launched in FY21.

The manufacturing unit is in Bengaluru. Product offering includes standard and customized technologies for the metalworking, such as sophisticated metal cutting tools, tooling systems and services. Its products also include advanced, high-performance materials, such as cemented tungsten carbide products, super alloys, coatings and investment castings. The end-users of the company's products are manufacturers, metalworking suppliers, machinery operators and processors engaged in a diverse array of industries. It also caters to customer operations battling extreme conditions associated with wear fatigue, corrosion and high temperatures.
Kennametal India has 1500+ customers and 200+ channel partners.

Business segments

Hard metal products (Revenue contribution 86.4%, EBIT contribution 93.9%): Hard metal products segment deals in metal and metal cutting tools. The sales of this segment comprise of manufactured and traded goods.

The hard metal segment is dedicated to delivering world-class metalworking solutions and services through our two trusted brands viz., Kennametal and WIDIA. Through these brands Kennametal offers a complete portfolio of precision-engineered products and custom solution services. With an array of milling, turning, hole making, threading, and tooling systems products, backed by a skilled network of authorized distributor partners and spares support, it is positioned to service the customers end-to-end. Kennametal is a market leader in wear solutions, engineered components and earth cutting and construction tools that deliver productivity, reliability, and extended life to a wide range of industries with the ability to deliver high performance in a challenging environment. The years of expertise and innovation in matching advanced material solutions and technologies to various applications, helps customers solve wear problems, avoid costly downtime, prevent catastrophic failures and aids them in achieving significant savings.

Machining solutions (Revenue contribution 13.6%, EBIT contribution 6.1%): The machining solutions segment manufactures and sells customised capital intensive machines. Group specializes in providing end-to-end solutions i.e. from design to manufacture and after-sales service.

Machining Solutions Group (MSG): The Machining Solutions Group - MSG manufactures special purpose machines, tool and cutter grinding machines as well as fixture and tooling solutions through the "WIDMA' brand. With an expanding customer base, MSG has set high standards in the industry by engineering the most complex components with high precision, be it microtools or large structural parts for railways and aerospace.

Exports constituted 29.6% of sales in FYJun21. Germany, US and China are the three big markets for Hard metal products.

Financials – Consolidated

Income Statement — June ending year

Particular (Rs cr)	FY20	FY21	FY22E	FY23E	FY24E
Revenue (Rs cr)	705	854	1007	1169	1309
CoGS	382	456	537	624	699
Gross Profit	323	398	470	545	610
Employee Expenses	119	127	142	158	173
Other Expenses	133	140	165	192	216
EBITDA	71	131	163	195	221
Depreciation & Amortisation	34	38	39	41	43
EBIT	37	93	124	154	178
Finance Cost	1.9	0.3	0.3	0.3	0.3
Other Income	13	7	8	9	10
Profit before excep. Items tax	47	100	132	163	188
Excep. Items	-5	-1	0	0	0
PBT	42	99	132	163	188
Tax Expenses	8	25	34	42	48
PAT	34	73	98	121	140

Balance sheet — June ending year

Particular (Rs cr)	FY20	FY21	FY22E	FY23E	FY24E
Gross block	342	356	394	440	491
Accumulate Depreciation	95	131	170	211	255
PPE	246	225	224	229	236
Capital work in progress	32	52	44	33	21
Intangible Assets	1	1	1	1	1
Non-current tax assets	52	43	43	43	43
Other current assets	13	3	3	3	3
Total non-current assets	345	323	314	309	305
Inventories	206	205	220	166	195
Trade Receivables	91	113	127	95	115
Cash & Bank Balances	45	129	158	272	300
ST other financial assets	2	4	4	4	4
Other current assets	12	3	3	3	3
Total current assets	355	454	512	540	617
Total assets	700	777	826	849	921
LT Borrowings	0	0	0	0	0
LT Provision	6	3	3	3	3
Deferred Tax Liability	1	0	0	0	0
Total noncurrent liabilities	6	4	4	4	4
ST Borrowings	13	0	0	0	0
Trade Payables	60	103	112	86	102
ST other financial liabilities	15	35	35	35	35
Provision	21	19	20	20	20
Other current liabilities	29	32	32	32	32
Total current liabilities	138	188	198	172	188
Share capital	22	22	22	22	22
Other Equity	534	564	603	651	707
Total Equity	556	586	625	673	729
Total Equity & Liabilities	700	777	826	849	921

Cash flow

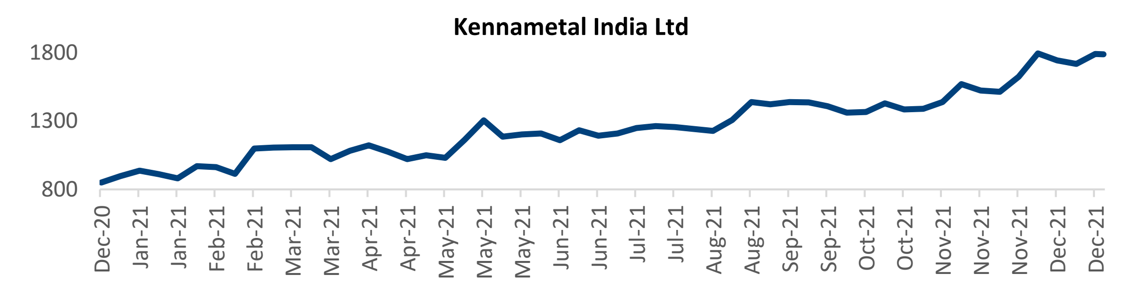
Particulars (Rs cr)	FY20	FY21	FY22E	FY23E	FY24E
PBT	47	100	132	163	188
Depreciation	34	38	39	41	43
Finance cost	-2	0	0	0	0
Total Adjustments	32	41	40	41	43
Op. before wc changes	79	140	171	204	232
Chg in trade receivables	77	-14	-14	32	-20
Chg in Inventories	3	1	-15	53	-28
Chg in payables	0	0	10	-26	17
Other	-108	59	0	0	0
Cashflow from operating activities	34	166	118	222	152
Capex	-58	-26	-30	-35	-39
Interest received	4	0	0	0	0
Dividend received	0	1	0	0	0
Others	0	0	0	0	0
Cashflow from investing activities	-54	-25	-30	-35	-39
Proceed from ST Borrowings	3	0	0	0	0
Proceed from LT Borrowings	0	0	0	0	0
Repay of the LT Borrowings	0	-13	0	0	0
Repay of ST Borrowings	0	0	0	0	0
Dividend Paid	0	-44	-59	-73	-84
Interest paid	-2	0	0	0	0
Cashflow from financing activities	1	-57	-59	-73	-84

(Source: Company, HDFC sec Research)

Financial Ratio

Particulars	FY20	FY21	FY22E	FY23E	FY24E
EPS (Rs)	15.4	33.4	44.5	55.2	63.6
DPS (Rs)	0.0	20.0	26.7	33.1	38.2
P/E	115.4	53.4	40.0	32.2	28.0
Book Value (Rs)	252.6	266.2	284.0	306.1	331.6
P/B	7.0	6.7	6.3	5.8	5.4
EV/EBITDA	54.8	29.0	23.0	18.7	16.3
Debt to Equity(x)	0.0	0.0	0.0	0.0	0.0
Current Ratio(x)	2.6	2.4	2.6	3.1	3.3
ROCE(%)	5.1	12.0	15.0	18.2	19.3
RONW(%)	6.1	12.5	15.7	18.0	19.2
EBITDAM(%)	10.1	15.3	16.2	16.7	16.9
EBITM(%)	5.2	10.9	12.3	13.2	13.6
PATM(%)	4.8	8.6	9.7	10.4	10.7
Interest Cover(x)	37.3	436.0	544.0	650.5	737.3
Asset Turnover(x)	1.0	1.1	1.2	1.4	1.4
Inventory Turnover(x)	1.9	2.2	2.3	2.3	2.3
Debtors Turnover(x)	7.8	7.5	7.4	7.4	7.4
Fixed Asset Turnover (x)	2.9	3.8	4.5	5.1	5.5
Inventory Days	197	164	161	159	156
Receivable days	47	48	49	49	49
Payable days	58	82	82	82	82

One Year Price Chart



HDFC Sec Retail Research Rating description

Green Rating stocks

This rating is given to stocks that represent large and established business having track record of decades and good reputation in the industry. They are industry leaders or have significant market share. They have multiple streams of cash flows and/or strong balance sheet to withstand downturn in economic cycle. These stocks offer moderate returns and at the same time are unlikely to suffer severe drawdown in their stock prices. These stocks can be kept as a part of long term portfolio holding, if so desired. This stocks offer low risk and lower reward and are suitable for beginners. They offer stability to the portfolio.

Yellow Rating stocks

This rating is given to stocks that have strong balance sheet and are from relatively stable industries which are likely to remain relevant for long time and unlikely to be affected much by economic or technological disruptions. These stocks have emerged stronger over time but are yet to reach the level of green rating stocks. They offer medium risk, medium return opportunities. Some of these have the potential to attain green rating over time.

Red Rating stocks

This rating is given to emerging companies which are riskier than their established peers. Their share price tends to be volatile though they offer high growth potential. They are susceptible to severe downturn in their industry or in overall economy. Management of these companies need to prove their mettle in handling cyclicality of their business. If they are successful in navigating challenges, the market rewards their shareholders with handsome gains; otherwise their stock prices can take a severe beating. Overall these stocks offer high risk high return opportunities.

HDFC securities Limited, I Think Techno Campus, Building - B, "Alpha", Office Floor 8, Near Kanjurmarg Station, Opp. Crompton Greaves, Kanjurmarg (East), Mumbai 400 042 Phone: (022) 3075 3400 Fax: (022) 2496 5066

Compliance Officer: Binkle R. Oza Email: complianceofficer@hdfcsec.com Phone: (022) 3045 3600

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