ECON F-355 BUSINESS ANALYSIS AND VALUATION COURSE ASSIGNMENT

PART-2 : QUALITATIVE ANALYSIS

COMPANY ALLOTTED: KNR CONSTRUCTIONS

SUBMITTED BY:

AKHAND PRATAP SINGH	2020A2PS1753P
AMAN GOYAL	2020A2PS0245P
DEEPANSHU GUPTA	2020B4PS1276P
GAURANG KRISHNA	2020A2PS1489P

COURSE IC:
DR. RAJAN PANDEY

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Key accounting estimates and judgements

1. **Revenue Recognition**
    - Company follows a **percentage completion method** in which they realize the revenue periodically over a long term project.

    - The 2 key factors that are considered in estimating the future costs are **estimates of labor costs and productivity efficiencies.**

    - There are also provisions for estimating the losses on uncompleted contracts which are recorded during the period of the contract.

2. **Property, Plant and Equipment**
    - The company estimates the **useful lives** of their property, plan and equipment at the end of each reporting period.

    - The company usually follows the **straight line depreciation method** to depreciate its fixed assets which is a common method in the infra and construction industry.

3. **Fair Value Measurement Of Financial Instruments**
    - The fair value is estimated using various valuation techniques in which the **Discounted Cash Flow model** is one such technique.

4. **Leases**
    - The company does a separate accounting of each lease component separately.

    - The **lease liability** is measured by taking the present value of the **lease payments** that are not paid during the commencement date of lease.

- If the implicit rate of lease cannot be readily determined, then the company uses the **borrowing rate** as the discounting factor.

5. Impairment Of Financial Assets

- The company utilizes **Expected Credit Loss Model** for recognition and measurement of various impairment losses.

- Those assets that are measured at **amortized cost** and **trade receivables** are usually considered for calculating impairment loss.

6. Provision Of Employee Benefits

- Apart from wages, salaries and compensation, the company also provides various **post-employment benefits** like **fund scheme, pensions.**

- The contributions made by the employee in their **Pension Account** is recognised during the service period of the employees.

- All the schemes of the company related to funds and pensions are managed by Life Insurance Corporation Of India**(L.I.C)**

7. Intangible Assets

- The company amortizes all its intangible assets over their useful life

- The company recognizes **Computer Software** as its intangible assets which has a useful life of 3 Years.

Any Significant change in Accounting policy

- As seen from the financial statements of the last 5 years there has been no significant changes in the assumption in financial statements and Accounting policy.
- KNR Constructions explains its key accounting policies and assumptions as per **Indian Accounting Standards** (Ind AS), in its financial statements.

Auditor Report Analysis

- Auditor's report clearly states that the company has sold **49%** of its shares in their subsidiaries to M/S Cube Highways and Infrastructure III Pte. Limited.
- The other important thing to note is that Auditors have specifically mentioned that the correctness and appropriateness of Financial records mentioned by the company are not verified.
- Also from the auditor's report, it is clearly stated that this auditor's report is not effective in assuring the future viability of the company which is a **point of worry** as many people while analyzing and studying the report are in a view to depend a lot on Auditor's company in evaluation company's performance which is not a reality.
- Company was not audited on their compliance with fiscal laws like direct and indirect laws as it was meant to be a part of Statutory financial audit.

Financial Highlights and Stock Price Performance

1st Quarter

DATE	PRICE	HIGH	LOW	VOLUME	CHG%
APR 04,2022	292.30	297.00	291.60	191.35K	-0.14%
APR 01 ,2022	292.70	294.00	285.00	289.12K	3.01%
MAR 31,2022 (release date)	284.15	285.00	278.50	287.79K	2.69%
MAR,30,2022	276.70	280.00	270.05	1.33M	1.69%
MAR,29,2022	272.10	274.75	268.30	443.37K	0.09%

Stock Price Performance on, before and after the release of 1st Quarterly Result:

- The stock prices went up by **2.69%** when the quarterly results were declared and volume was also quite decent.

- The stock shows one of the best price movements of this year with stock price rising to as **high as Rs 297.** Bullish sentiments were greatly associated with the stock in and around the quarterly result date.

2nd Quarter

DATE	PRICE	HIGH	LOW	VOLUME	CHG%
JULY 04,2022	230.05	237.75	228.7	121.45K	-2.38%
JULY 01,2022	235.65	236.15	228.75	58.5K	1.12%
JUN 30,2022 (release date)	233.05	234.80	228.20	129.06K	0.91%
JUN,29,2022	230.95	235.50	225.40	168.27K	-1.79%
JUN,28,2022	235.15	236.50	228.10	220.42K	0.75%

Stock Price Performance on, before, and after the release of 2nd Quarterly Result:

- Before the quarterly result, the stock price showed an impressive uptrend and prices were continuously moving up, so when the quarterly result came out the **volume drastically decreased** owing to the **contrary opinion rules** of the traders.

- Although the prices went up by **1.12%,** they soon went down which indicates strong bearish sentiments of the market.

3rd Quarter

DATE	PRICE	HIGH	LOW	VOLUME	CHG%
Oct 4, 2022	229.55	231.03	228.7	103.04K	0.5%
Oct 3, 2022	228.4	230.15	225.5	187.06K	-0.15%
Sep 30 2022 (release date)	228.75	230.00	222.95	132.76K	0.42%
Sep,29,2022	227.8	234.95	226.50	325.76K	-0.18%

Sep,28,2022	228.2	231.50	226.40	338.99K	-2.69%

Stock price performance on, before, and after the release of the 3rd Quarterly Result:

- The company’s stock price did not show a significant change in response to quarterly results announced by the company.On the day of results announcement, the company’s share price went up by 0.42% and it may be viewed as a profit making strategy for intraday traders .
- The week following the declaration of quarterly results showed the decline in the company's stock price which is a reflection of its decline in quarterly results as compared to previous quarters.

DUPONT ANALYSIS

The company's ROE has increased from **13% to 17%** during the FY 2021-2022 and we will make use of Dupont Analysis to explain this change. We are using both **3-way decomposition(traditional)** as well as **5 step Dupont Analysis.**

Here are the values of parameters**(in lakhs)** which are required to perform the analysis.

Parameter	FY-2022	FY-2021
Net Income	38,179.64	24,417.65
Sales	3,27,259.17	2,70,262.93
Total Assets	3,32,945.75	2,92,068.74
Equity	2,24,196.94	1,86,783.15
EBIT	57878.54	38113.31
PBT	57878.54	38113.31

3-Step Dupont Analysis

In this method, we break down the ROE into **Net Profit Margin(NPM), Asset Turnover and Financial Leverage(FL) ie** $ROE = NPM \times Asset\ Turnover \times FL$

Where,

$$NPM = \frac{\text{Net Income}}{\text{Sales}}$$

$$Asset\ T/O = \frac{\text{Sales}}{\text{Total Assets}}$$

$$FL = \frac{\text{Total Assets}}{\text{Total Equity}}$$

We calculated these factors for the year 2022 and 2021 so that we can explain the change in ROE easily.

Factors	FY-2022	FY-2021
NPM	**11.67%**	**9.03%**
Asset T/O	**0.983**	**0.925**
Financial Leverage	**1.49**	**1.56**
ROE	**17.09%**	**13.03%**

Explaining the ROE:

Key Points To Note:

- Increase in NPM from **9.03% to 11.67%**At the first glance, it is very much evident that the company's **operating efficiency(NPM)** has increased which has a **positive impact on the ROE** and also indicates that the company is now able to keep more profits for each rupee of sales it makes.

Moreover, the company has improved their **asset management** efficiency as the company's **asset turnover** has increased by **6.27%** which is **positively reflected in the ROE**. We can also interpret this increase by saying that the company is able to make more sales for each rupee of its assets.

We can also observe that the **financial leverage** of the company has decreased from **1.56 to 1.49** which has a **negative impact on ROE** but a clear indication that the company is reducing its debt.

5-Step Dupont Analysis

In this method we decompose our ROE into 5 factors by further breaking the net profit margin into **tax burden, interest burden and EBIT Margin.** The other two factors are the same as the 3-step Dupont i.e. financial leverage and asset turnover.

Where,

$$Tax\ Burden = \frac{\text{Net Income}}{\text{PBT}}$$

$$Interest\ Burden = \frac{\text{PBT}}{\text{EBIT}}$$

$$EBIT\ Margin = \frac{\text{EBIT}}{\text{Sales}}$$

ROE= Tax Burden x Interest Burden x EBIT Margin x Asset T/O x Financial Leverage

We calculated the ROE using 5-Step Dupont for the year 2022 and 2021

Parameters	FY-2022	FY-2021
Tax Burden	0.659	0.641
Interest Burden	1	1
EBIT Margin	17.69%	14.102%
Asset T/O	0.983	0.925
Financial Leverage	1.49	1.56
ROE	17.08%	13.04%

We would like to highlight the value of **Interest burden being 1** for both years as **EBIT=PBT,** because the company is **debt-free** and bears no interest expense.

Explaining the ROE

Key Points To Note:

- Increase in **Tax Burden** by **2.9%**
- **EBIT Margin** has increased from **14.1% to 17.69%**
- As the company is **debt free,** Interest burden is **unity**

The company has shown an impressive increase of **3.59%** in the **EBIT Margin** and around **2.9% increase** in **tax burden.** Each of these increases has a positive effect on the ROE and hence increase in the value of ROE was inevitable.

We are also able to reconcile the values of ROE which is around **17%** for 2022 and around **13%** for 2021 using both 3-way and 5-way Dupont analysis.

Chairman's Message

There is no direct message as such from the Chairman of the company so here we are analyzing the MD's message and drawing out the main points from it.

Some of the key points as discussed in the MD’s message are as follows:

- The Company has maintained its ‘zero debt’ level, owing to timely execution of projects and asset-light policy. The Board of Directors of the company are again and again mentioning their debt free quality as their main strength.

- The MD's next most important point is about the tremendous growth of the Indian Road and Construction sector since the last 2 years where he states that **”In the month of March 2022, the pace of awarding projects witnessed a robust pick, after being subdued for nearly 9-10 months”.**

- The Company is looking very forward to a great sense of growth as a part of the Infrastructure sector. MD clearly states that infrastructure development in India has been a key driver for the Indian economy. India is expected to become the third-largest construction market by 2025.

- The last important point we could extract from the MD’s message was showing the positive of a company's fundamentals to their shareholders for the last fiscal year whereas there was no special mention of any types of negative impacts on the company's fundamentals.

Management Discussion and Analysis

SWOT ANALYSIS	Explanation	Factor
Strengths	• The company has an impressive order book of worth **Rs 90,008 Mn** in which majority of the projects is related to **road constructions** which the company is known for	**Company specific Factor**
	• The company holds several large projects for the Year 2022-23 such	**Macroeconomic Factor**

	as construction of National Infrastructure Pipeline , Delhi Mumbai Expressway, Chennai-Bengaluru Expressway which is a big plus in the company's future growth.	
	• The company has worked exceptionally well in **managing their assets** as within a span of 3 years they were able to pay all of their debt. (Although being **debt-free** is not always desirable which we will discuss in the **Threats**)	**Company specific Factor**
	• The company has Significant experience and a strong track record in **timely and successful execution of projects**. Along with it the company has Qualified and experienced employees led by a proven management team.	**Company specific Factor**

Weakness:

SWOT ANALYSIS	Explanation	Factor
Weakness	• The company is unable to cope up with the **latest technology** which is required in the modern construction which results in delaying projects and it also makes them vulnerable against their competitors who use these technologies.	**Company specific factor**

	• The company is overdependent on Government plans and policies to support the construction industry and is less focused on company specific issues and plans to promote their company further. The company is in the misconception of considering construction sector growth as their growth.	**Macroeconomic Factor**
	• Company has very little global presence as compared to global players. Also the company's online presence is very lesser when compared to big players.	**Company specific factor**
	• Since the last pandemic the construction industry has suffered from **lack of labor facilities** and thus have been struggling to fill their **growing demand** for services and if they want to get a huge labor force they would have to incur very high costs.	**Industry specific factor**

Threats:

SWOT ANALYSIS	**Explanation**	**Factor**
Threats	• The biggest threat as reported by us for the company is their **inability to understand the difference between their personal success and the industry's success** as a whole.	**Company specific factor**
	• Company considers their being	**Company specific**

	debt free as a big positive and wants to go on with the same trend, but as per our analysis this could be a big threat for the company since the construction industry is a **capital intensive sector** and working **completely on your risk** can be a major drawback.	**factor**
	• **Higher level of competition** from domestic and global players may help KNR Constructions by implementing them to do certain innovations , **fast adoption of technology** ,efficient performance but certainly to a greater extent is a threat for the company if the company is not able to cope up with the emerging competition.	**Industry specific factor**
	• **Economic Recession** Company run its business operations within the country's economy, and **company don't have any control over their country's economy**. If the economy of the country is in recession and investment in the business is getting lower.	**Macroeconomic factor**

Opportunities:

SWOT ANALYSIS	Explanation	Factor
Opportunities	• KNR construction has recently got **certain mega BOT-HAM projects** such as Valanchery	**Company specific factor**

	Bypass to Kaprikkad project(HAM) and Ramanattukara to Valanchery bypass project(HAM) which could be a great opportunity for the company to **extend their business with BOT-HAM**.	
	• The **Government plans to incur higher expenditure** towards road construction. In the Union Budget 2022-23 – the Central Government has made the highest ever outlay of ` 1.99 Lakh Crores . Also the budget focuses extensively on key growth engines – **PM Gati Shakti plan** for building crucial infrastructure like roads, ports, railways, logistics, etc.	**Macroeconomic Factor**
	• India's **construction industry** is witnessing a very **high growth** since the last 5 years which if implemented correctly can be a big boom for KNR Constructions.	**Industry Specific Factor**

ii) What in your opinion is the most important aspect of MD&A for the company for its future?

The most important aspect of MD&A as per our analysis is:

1. The company is looking forward for various mega projects in the next 10 years under Government of India such as Ramanattukara to Valanchery bypass project, Valanchery Bypass to Kaprikkad project ,Bangalore-Mangalore Project and Cheyyur-Panayur Road which comprises a total order of over 90,000 million. This leads us to a point that the company seems to be over dependent on the Government for their future projects which could backfire at some point of time.

2. The company is well aware of all the threats for their construction sector but is unable to come up with any types of mitigation techniques to overcome their threats. The company talks about the competition advancement in their sector due to increased technology, greater level of opportunities provided by the government but has not been able to come up with proper measures to tackle the competition and take the first mover advantage.

iii) Is your finding of this year's MD&A relatable to its past stock price performance?

1. As the company clearly stated in its strengths its order book of over 90,000 million for the next year and a similar order book from the last 5 years which is eventually visible in its stock price movement since the last 3 years. The company's stock price has witnessed a growth of 70.84% in the last 5 years .

2. The company is unable to manage their competition and is struggling to gain a competitive advantage due to use of obsolete technology , lack of labor facilities and high fixed cost which is their drawback as compared to its peers. Since the last 5 years average share price growth of the company's peers is 99.57% whereas the company's share price growth over the past 5 years remains 60.84% which is significantly low as compared to its peers.

3. The company stock's price has risen to the same rise as shown by the construction and infrastructure industry which can be seen as a positive in today's scenario but showing a constant level of growth equal to the industry will not help in the long run over the next 10-15 years.

iv) Does MD&A help you analyze the financial performance of the company reported?

Yes, MD&A was really helpful for the evaluation of financial performance of the company for the reported year 2021-22. The company's MD&A clearly stated the company's overall performance for the year highlighting their major positives.

Financial Ratio Analysis

Financial Ratios	KNR Construction	Rail Vikas Nigam LTD.	PNC Infratech Ltd	Mahindra Lifespace Developers LTD.	NCC Ltd.	Industry
Liquidity Ratios						
➢ Current Ratio	2.18	3.48	2.09	1.68	1.35	1.48
➢ Quick Ratio	1.99	3.46	1.59	0.43	1.22	1.35
➢ Dividend Payout Ratio %	1.84	32.26	2.21	20	25.28	13.59
Solvency Ratios						
➢ Financial Leverage	2	2.67	2.79	1.57	2.51	2.45
➢ Market cap. to Debt cap.	8.09	1.52	2.43	10.34	0.40	4.11
➢ Interest coverage ratio	4.21	3.98	3.21	5.44	2.22	4.57

Leverage Ratios						
➢ Debt to Equity Ratio	0.76	0.91	1.39	0.18	0.34	1.24
➢ Assets Turnover Ratio	0.78	1.14	0.71	0.14	0.8	0.3527
➢ Debt to Profit	5.21	5.38	9.54	2.07	4.05	5.82
Activity Ratios						
➢ Days payable	94.93		58.79		447.12	190.46
➢ Inventory Turnover ratio	6.4	0.1	7.71	0	3.03	2.87
➢ ROA %	7.54	6.94	5.51	2.69	2.42	4.701
Market Ratios						
➢ Price/BV(per share)	2.97	2.15	1.85	3.18	0.97	2.59
➢ Basic EPS	14.01	6.48	27.4	14.85	9.4	12.57
➢ Price/Earnings	20.73	11.2	10.48	53.61	13.21	24.76

Is the stock worth purchasing?

- **Current ratio** of KNRC is **2.18** which is higher than its peers and Industry average. Also its quick ratio is higher than its peers and Industry average, which is a good sign for the company and shows that the company has **lesser liabilities** than its peers.
- **Dividend payout ratio** of KNR Constructions is **significantly lower** than its peers and Industry average, which is not a good sign for investing in the company
- Company has **minimal debt** and has a better **interest coverage ratio** than some of its peers. Which is a good sign for the company as investors look for higher Interest coverage ratio while investing in a company.
- **Debt to equity ratio** of KNR construction is **0.78** which is fairly good than its peers and industry average. This shows that the company has cleared its

previous debt and is **capable of lending more money** for its expansion programs.

- KNR Constructions has a very good **inventory turnover ratio** of **6.4** which is fairly good than its peers and industry average, also the company's days payable are very high (94.93 days), which signifies that the company is not able to pay its suppliers timely.
- KNR Constructions has an **ROA of 7.54%** which is fairly good than its peers and Industry average. It shows that the company is using its assets wisely to make profits.
- Company has an **EPS** of **14.01** which is not very good in terms of overall market but it's higher than its industry average.
- KNR Constructions has an **Price to Earnings** ratio of **20.73** which is fairly **good in terms of investing** and is higher than some of its peers. This signifies its worthwhile investment in KNR Constructions as it has a good P/E ratio.

Conclusion

S.No	Parameters	Explanation	Ratings (1 to 5)
(a)	Does the company provide adequate disclosures to assess the firm's business strategy and its economic consequences?	**YES** **(References: Page 70,71 and 72 of the annual report)**	4
(b)	Do footnotes and notes to financial accounts explain the key accounting policies and assumptions?	**YES** Company explains its key accounting policies and assumptions as per **Indian Accounting Standards** (Ind AS), in its financial statements. The Company follows the percentage completion method in which the revenues and expenses of long-term contracts are recognized as a percentage of the work completed during the period.	5

		The Company reviews the estimated useful lives of **property plants and equipment** at the end of each reporting period. Also the company estimated the fair value of financial instruments using discounting cash flow models. The Company uses actuarial assumptions to determine the **obligations for employee benefits** at each reporting period. **(References: Page 111 and 112 of the annual report)**	
(c)	Does the firm adequately explain its current performance?	**YES** The company has provided all the necessary information with which one can easily assess the company's performance. The company's order book for 2022 was very strong as they were able to take orders worth 90,008 mn which was quite impressive. Moreover the company's annual report contains parameters like **gross profit margin, Growth in ROE and ROA, Leverages** which gives enough information to assess the company's performance. **(References: Page 15 and 153 of the annual report)**	**5**
(d)	If the firm is on multiple business segments, what is the quality of segment disclosure? Are you satisfied with the extent of coverage given to subsidiary segments?	**NO** The company is focused on a single segment and therefore provides no disclosure discussing segment wise breakup of company's profits.	**3**

(e)	Does the firm discuss any particular bad news/event about the company that may be related to its poor performance or damaging to its prospects (transparency)?	**NO** The company is just simply focused on discussing their positives, then these positives can be in the form of numbers, Macroeconomic growth or the sector growth as a whole. Company is very optimistic in getting a whole lot of projects from the Government as a part of PM Gati Shakti plan.	**1**
(f)	Maximum % age of net income comes from sources of revenue other than sales.	**NO** For the year ended 31 March, 2022. Company's revenue from operations was 3,27,259.17 lakh and had another income of 4,168.27 lakh. Which clearly shows that the% age of net income from operations/sales is much higher than that of other sources of revenue. **(References:Profit and loss statement, Page 99 of the annual report)**	**5**
(g)	There is a significant similarity between net income and cash flows from operating activities.	**NO** While calculating Net income, the accountant has concentrated more on **general expenses** like COGS,salaries expense, finance expense, construction expenses which are primary expenses for construction companies like Knr. But while preparing the cash flow statement(indirect method) from operating activities, the company has concentrated more on sales, accounts receivable, some debts and interest incomes. Their main adjustments are related to **bad debts,allowance for doubtful accounts and other gains and losses on other securities such as mutual funds.** **(References: Page 101 and 103 of the annual report)**	**3**

(h)	The company clearly and elaborately explains its future plans, expected cash flows?	**NO** There is no mention of expected cash flows and its future plans in the annual reports and its prospects.	**2**
(i)	The company is likely to grow in excess of 10% per annum for the next 3-4 years.	**YES** Company is grown in excess of 10% in the last 5 years and its last year growth is 20.03%. Hence its expected to grow in excess of 10% for next 3-4 years. **(References: Page 32 of the annual report)**	**5**
(j)	There is earnings manipulation charge against the company in the media in the recent years.	**NO** **(References: KNR Constructions)**	**5**

As per above parameters we conclude that the company has a rating of **3.8** out of 5, which is a fairly good rating. Also the company is in its growth phase and delivering good returns for 5 years, but looking at the construction industry it seems that the company is lagging from its peers in some aspects, like a lower **dividend payout ratio** of **1.84%** as compared to other construction companies.

As per our analysis on the basis of our estimated future stock price,ratio analysis and market sentiments associated with the stock during rh, the company is expected to grow in excess of 10% for the next 3-4 years. Therefore, it's feasible to invest in KNR Constructions for a long duration.