Kennametal Inc. (KMT)

$35.11 (As of 01/07/20)

Price Target (6-12 Months): **$37.00**

Long Term: 6-12 Months	**Zacks Recommendation:** (Since: 01/06/20) Prior Recommendation: Underperform	**Neutral**
Short Term: 1-3 Months	**Zacks Rank:** (1-5)	**3-Hold**
	Zacks Style Scores:	VGM:C
	Value: C | Growth: D | Momentum: A	

Summary

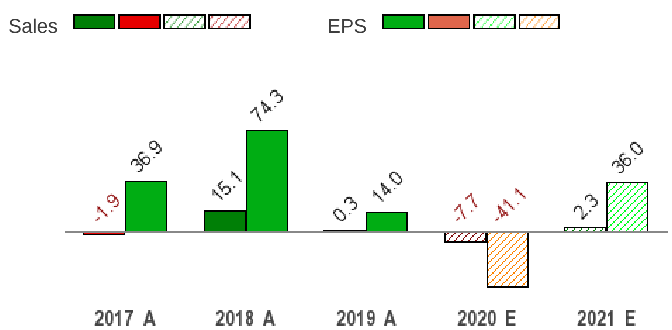
In the past three months, Kennametal's shares have outperformed the industry. The company is gaining from a diversified customer base and its three initiatives — including growth, modernization and simplification. Also, its policy of rewarding shareholders with dividends bodes well. However, the company believes that challenging end-market conditions (especially in transportation, general engineering and energy markets) and restructuring charges (predicted to be $55-$65 million) will affect financials in fiscal 2020. It expects adjusted earnings per share of $1.70-$2.10 for the year, down from $2.80-$3.20 mentioned earlier. The company anticipates organic sales decline of 5-9% versus the previously mentioned 2% decline to 2% growth. Also, it believes that high raw material costs will impact its performance in the fiscal second quarter.

Price, Consensus & Surprise

Data Overview

52 Week High-Low	$42.03 - $27.49
20 Day Average Volume (sh)	608,977
Market Cap	$2.9 B
YTD Price Change	-4.8%
Beta	2.32
Dividend / Div Yld	$0.80 / 2.3%
Industry	Manufacturing - Tools & Related Products
Zacks Industry Rank	Top 26% (66 out of 254)
Last EPS Surprise	0.0%
Last Sales Surprise	0.0%
EPS F1 Est- 4 week change	0.0%
Expected Report Date	02/03/2020
Earnings ESP	0.0%
P/E TTM	14.1
P/E F1	19.7
PEG F1	2.4
P/S TTM	1.3

Sales and EPS Growth Rates (Y/Y %)



Sales Estimates (millions of $)

	Q1	Q2	Q3	Q4	Annual*
2021	527 E	537 E	577 E	606 E	2,243 E
2020	518 A	524 E	561 E	588 E	2,192 E
2019	587 A	587 A	597 A	604 A	2,375 A

EPS Estimates

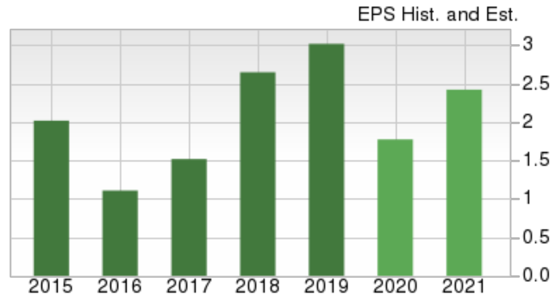
	Q1	Q2	Q3	Q4	Annual*
2021	$0.42 E	$0.41 E	$0.70 E	$0.89 E	$2.42 E
2020	$0.17 A	$0.20 E	$0.60 E	$0.81 E	$1.78 E
2019	$0.70 A	$0.71 A	$0.77 A	$0.84 A	$3.02 A

*Quarterly figures may not add up to annual.

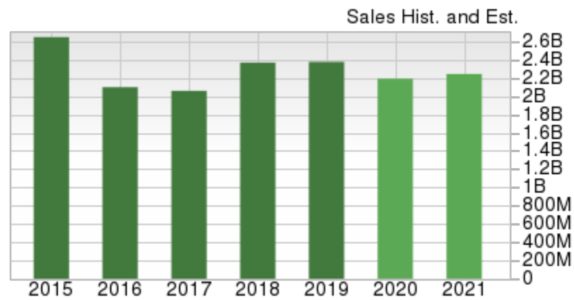
The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 01/07/2020. The reports text is as of 01/08/2020.

Overview

Based in Latrobe, PA, Kennametal Inc. is a manufacturer, marketer and distributor of high-speed metal cutting tools, tooling systems and wear-resistant parts. It has operations in various countries, including the Americas, the Asia Pacific, and Europe, Middle East and Africa. Exiting fiscal 2019 (ended June 2019), it had approximately 10,400 employees.



Its products are marketed through a number of channels to the end users, comprising manufacturers of machine tools, transportation vehicles and various components, airframe, aerospace components, machinery (light and heavy), components (energy-related), and others. Also, the company's products are used by manufacturers and suppliers in the oil and gas exploration, road construction, and other industries.



Kennametal reports results under three segments — including Industrial, WIDIA and Infrastructure. A brief discussion of the segments is provided below.

- **Industrial** (54% of revenues generated in first-quarter fiscal 2020): The segment provides products and services in the industrial end markets such as general engineering, aerospace & defense, transportation, and energy.

  The segment offerings — sold under Kennametal Brand — are, in turn, used for the production of automobiles, ships, aero engines, trucks, airframe and other equipment.

- **WIDIA** (8.5%): The segment provides metal cutting solutions (both customized and standard) in the energy, general engineering, aerospace and transportation end markets.

  The main product brands under the segment are WIDIA Hanita, WIDIA and WIDIA GTD.

- **Infrastructure** (37.5%): The segment serves end users in the energy, general engineering and earthworks markets. These players, in turn, support mining, oil and gas, petrochemical, process, aerospace, packaging, and other industries.

  The main product brand offered under the segment is Kennametal.

Reasons To Buy:

Kennametal is well-positioned to gain from a diversified customer base and strategic initiatives. Also, it remains committed toward rewarding its shareholders handsomely.

- In the past three months, Kennametal's shares have gained 24.4% compared with the industry's growth of 21.4%. The company's three initiatives — including growth, modernization and simplification — have been proving advantageous. The growth initiative is helping to boost the company's sales through improvement in commercial execution. The simplification initiative helped in improving operational efficiency and reducing costs. The modernization initiative is in progress now and is contributing to strong operating leverage. As a matter of fact, in first-quarter fiscal 2020, these initiatives boosted the company's bottom line by 7 cents per share. Also, it anticipates the second phase of simplification/modernization to yield annualized savings of $35-$40 million by fiscal 2020 end.

- Kennametal has set some long-term targets. By fiscal 2021, the company anticipates witnessing adjusted sales of $2,500-$2,600 million. The adjusted gross margin is estimated to be 41%, while adjusted operating expenses are predicted to be 20% of sales. As a percentage of sales, adjusted EBITDA of $600-$675 million will likely represent 24-26%. The adjusted operating margin will likely be 19-21%. On a segmental basis, the Industrial segment's sales are anticipated to grow 2-4% (CAGR) between fiscal 2019 and 2021, while that for the WIDIA and Infrastructure segments are projected to grow 9-11% and 3-5%, respectively.

- Kennametal remains committed to rewarding its shareholders through share repurchase and dividend payments. In fiscal 2019, it distributed dividends totaling $65.7 million to its shareholders, wherein approximately $16.6 million was distributed in the first quarter of fiscal 2020. Also, the company's diversified customer base in various end markets enables it to avoid customer concentration risks. Prime end-market served include aerospace, automotive, and machine tool and farm machinery industries as well as manufacturers and suppliers in the highway construction, coal mining, quarrying, and oil and gas exploration industries.

Reasons To Sell:

- In the first quarter of fiscal 2020, Kennametal's earnings met estimates and declined 75.7% on a year-over-year basis on weak sales and margins. For fiscal 2020, it expects challenging end-market and regional conditions to impact its performance. The company predicts adjusted earnings per share of $1.70-$2.10, down from $2.80-$3.20 stated earlier. It expects free cash flow of $20-$50 million for the fiscal year, down from $75-$100 million mentioned earlier. Also, it expects an organic sales decline of 5-9% compared with previously mentioned fall of 2% to growth of 2%. The company believes that operating conditions in general engineering, transportation and energy end markets will be difficult.

Challenging end-market conditions, forex woes and restructuring charges will likely impact Kennametal in fiscal 2020. Raw material costs are expected to impact results in the second quarter.

- Weakness in gross and operating profits can be dragging for Kennametal. In first-quarter fiscal 2020, the company recorded a 34.2% year-over-year decline in gross profit, while gross margin was down 920 basis points (bps). Also, adjusted operating income dipped 71.1% year over year due to a decline in organic sales, the impact of simplification/modernization actions, high cost of raw materials and lower absorption of costs (including fixed and volume-related labor costs) in some facilities. Notably, charges related to simplification/modernization initiatives (pre-tax) were $8 million or 9 cents per share in the fiscal first quarter. For fiscal 2020, the company predicts incurring pre-tax charges of $55-$65 million from restructuring moves announced in July 2019. Also, it believes that high raw material costs will impact its performance in the second quarter, while the adverse impacts will be less in the second half of fiscal 2020.

- Kennametal's long-term debt balance at the end of first-quarter fiscal 2020 was approximately $593 million. Though this balance is relatively flat sequentially, fresh issuance in the quarters ahead is bound to increase it. We believe, if unchecked, high-debt levels can increase the company's financial obligations and prove detrimental to its profitability in the quarters ahead. Also, the company's business is exposed to risks related to foreign currency translation, given its strong presence in international markets. Though international diversity increases business scope, it also exposed the company to risks arising from unfavorable movements in foreign currencies and geopolitical issues. In this regard, foreign currency translation had an adverse impact of 2% on revenues and 1 cent per share on earnings in first-quarter fiscal 2020. Fluctuations in foreign exchange rates may continue to affect the company's top and bottom lines in the quarters ahead.

Last Earnings Report

Kennametal Q1 Earnings Meet Estimates, View Bleak

Quarter Ending	09/2019
Report Date	Nov 04, 2019
Sales Surprise	0.02%
EPS Surprise	0.00%
Quarterly EPS	0.17
Annual EPS (TTM)	2.49

Kennametal has reported in-line results for first-quarter fiscal 2020 (ended Sep 30, 2019). While earnings in the quarter met estimates, sales surpassed the same by 0.02%.

The machinery company's adjusted earnings in the reported quarter were 17 cents, meeting the Zacks Consensus Estimate. However, the company's earnings declined 75.7% from the year-ago figure of 70 cents on weak sales and margin results.

Revenue Details

In the quarter under review, Kennametal generated revenues of $518.1 million, declining 11.7% year over year. Organic sales declined 11% in the quarter while forex woes had an adverse impact of 2% and business days had a positive impact of 1%.

The company's organic performance suffered from weak end markets — including transportation, general engineering and energy — and soft market conditions regionally.

Kennametal's top line surpassed the Zacks Consensus Estimate of $518 million.

On a geographical basis, it generated revenues of $259.3 million from America operations, declining 10.3% year over year. Sales in Europe, Middle East and Africa (EMEA) were down 10.5% to $153.5 million, while that for the Asia Pacific declined 16.4% to $105.3 million.

The company reports revenue results under three segments — Industrial, WIDIA and Infrastructure. Its segmental performance for the fiscal first quarter is briefly discussed below:

Industrial revenues totaled $280 million, declining 12.9% year over year. The results were adversely impacted by an 11% decline in organic revenues and a 2% impact of forex woes.

WIDIA revenues were $44.1 million, down 9.5% year over year. The results were impacted adversely by forex woes of 1% and an organic sales decline of 10%, partially offset by a 2% impact from business days.

Infrastructure revenues totaled $194 million, declining 10.8% year over year. The results were adversely impacted by 1% from forex woes and an 11% decline in organic sales, partially offset by 1% positive impact from business days.

Margins

Kennametal's cost of goods sold in the reported quarter grew 0.9% year over year to $379.1 million. It represented 73.2% of revenues versus 64% in the year-ago quarter. Gross profit moved down 34.2% year over year to $139 million, wherein margin declined 920 basis points (bps) to 26.8%. Operating expenses totaled $114.2 million in the quarter under review, decreasing 7.4% year over year. As a percentage of revenues, it was 22% versus 21% in the year-ago quarter.

Adjusted operating income in the reported quarter declined 71.1% year over year to $24.3 million. Notably, fall in adjusted operating income resulted from a decline in organic sales, the impacts of simplification/modernization actions, high cost of raw materials and lower absorption of costs (including fixed and volume-related labor costs) in some facilities. However, the adverse impacts were to some extent offset by the benefits of simplification/modernization actions. Adjusted operating margin dipped 970 bps to 4.7%.

Adjusted effective tax rate was 22.5%, down from 23.6% in the year-ago quarter.

Balance Sheet and Cash Flow

Exiting the fiscal first quarter, Kennametal had cash and cash equivalents of $113.5 million, decreasing 37.6% from $182 million at the end of the last reported quarter. Long-term debt and capital leases inched up 0.1% sequentially to approximately $592.9 million.

In the fiscal first quarter, the company generated net cash of $27.5 million from operating activities, surging 199.4% from the year-ago quarter. Capital invested for purchasing property, plant and equipment totaled $72.5 million, above $43.3 million in the year-ago quarter. Free cash inflow was $44.5 million, up from $33.2 million in the year-ago quarter.

Restructuring Actions

In July 2019, the company announced that it is taking certain measures as part of its simplification/modernization initiatives, which are likely to help it simplify the business structure, improve efficiency and boost shareholder value.

In October 2019, it ceased to produce at Lichtenau, Germany-based facility. It expects to divest the specialty alloys business (part of Infrastructure segment) in second-quarter fiscal 2020.

These restructuring moves are likely to be completed in the next two years and help the company to progress toward fiscal 2021 (ending June 2021) targets. The suggested restricting actions are part of its previously announced simplification/modernization drive for fiscal 2020, which will likely yield annualized savings of $35-$40 million and incur pre-tax charges of $55-$65 million by fiscal 2020 end.

The company predicts that facility closures scheduled for fiscal 2021 will result in annualized savings of $25-$30 million. Notably, pre-tax charges will likely be $60-$75 million, combining fiscal 2020 and fiscal 2021 actions.

Outlook

For fiscal 2020, Kennametal anticipates gaining from simplification/modernization initiatives, meant for simplifying the business structure, improving efficiency and boosting shareholder value. However, end-market conditions will likely be challenging in the year, especially in transportation, general engineering and energy end markets. Also, regionally conditions will likely be difficult.

For fiscal 2020, the company predicts an organic sales decline of 5-9% as compared with previously mentioned fall of 2% to growth of 2%. It expects adjusted earnings per share of $1.70-$2.10, down from $2.80-$3.20 stated earlier.

The company expects effective tax rate of 22-24% for the fiscal year.

It expects capital expenditure of $240-$260 million for fiscal 2020, largely supporting the simplification/modernization initiatives. The company estimates free cash flow of $20-$50 million for the fiscal year, down from $75-$100 million mentioned earlier.

Recent News

Update on Restructuring Plans

On **Jan 7, 2020**, Kennametal has provided updates on its restructuring actions, announced in July 2019. These moves are part of the company's simplification/modernization initiatives, meant for simplifying the business structure, improving efficiency and boosting shareholder value.

As noted, the company ceased operations at its manufacturing facilities based in Irwin, PA and Lichtenau, Germany, by merging their operations with its lower-cost facilities. Also, the company progressed toward shutting its Neunkirchen-based distribution center. Talks with representatives of employees have been completed and distribution operations have been outsourced to a logistics specialist (third-party).

These restructuring moves are likely to start yielding benefits in the form of lower structural costs from the second half of fiscal 2020 (ending June 2020). The suggested restricting actions are part of the company's previously announced simplification/modernization drive for fiscal 2020, which will likely yield annualized savings of $35-$40 million and incur pre-tax charges of $55-$65 million by fiscal 2020 end.

Additionally, Kennametal predicts that facility closures scheduled for fiscal 2021 (ending June 2021) will result in annualized savings of $25-$30 million. Meanwhile, it now predicts to incur pre-tax charges of $55-65 million versus $60-75 million estimated earlier.

In relation to its previous plan of closing Essen, Germany-based manufacturing facility, Kennametal instead decided to lower activities at this facility. The agreement reached with employee representatives aims at achieving lower operating costs and workforce. Moreover, the company is working on other facility closure plans.

Dividend

On **Nov 26, 2019**, Kennametal paid out a quarterly cash dividend of 20 cents per share to shareholders of record as of Nov 12, 2019.

Valuation

Kennametal's shares have decreased 1.1% over the trailing 12 months. Stocks in the Zacks sub-industry and the Zacks Industrial Products sector have moved up 22.5% and 17.8% over the past year.

The S&P 500 index has moved up 24.3% in the past year.

The stock is currently trading at 16.59x forward 12-month earnings per share, which compares to 18.18x for the Zacks sub-industry, 18.04x for the Zacks sector and 18.74x for the S&P 500 index.

Over the past five years, the stock has traded as high as 24.74x and as low as 9.13x, with a 5-year median of 16.06x. Our Neutral recommendation indicates that the stock will perform in line with the market. Our price target of $37 reflects 17.42x forward 12-month earnings.

The table below shows summary valuation data for KMT.

Valuation Multiples - KMT

		Stock	Sub-Industry	Sector	S&P 500
P/E F12M	Current	16.59	18.18	18.04	18.74
	5-Year High	24.74	20.19	19.9	19.34
	5-Year Low	9.13	13.13	12.59	15.17
	5-Year Median	16.06	16.29	16.54	17.44
EV/EBITDA F12M	Current	9.49	9.46	17.8	12.66
	5-Year High	11.79	11.02	18.2	12.66
	5-Year Low	5.8	7.15	10.68	9.08
	5-Year Median	8.53	8.86	13.99	10.78
EV/Sales F12M	Current	1.6	1.6	3.14	3.26
	5-Year High	2.06	1.96	3.14	3.37
	5-Year Low	0.9	1.18	1.76	2.3
	5-Year Median	1.39	1.43	2.28	2.78

As of 01/07/2020

Industry Analysis **Zacks Industry Rank:** Top 26% (66 out of 254)

Top Peers

SPX FLOW, Inc. **(FLOW)**	Outperform
Colfax Corporation **(CFX)**	Neutral
IDEX Corporation **(IEX)**	Neutral
Ingersoll-Rand PLC (Ireland) **(IR)**	Neutral
MSC Industrial Direct Company, Inc. **(MSM)**	Neutral
Sandvik AB **(SDVKY)**	Neutral
Stanley Black & Decker, Inc. **(SWK)**	Neutral
Allegheny Technologies Incorporated **(ATI)**	Underperform

Industry Comparison Industry: Manufacturing - Tools & Related Products

Industry Peers

	KMT Neutral	X Industry	S&P 500	CFX Neutral	IEX Neutral	SWK Neutral
VGM Score	C	-	-	D	C	D
Market Cap	2.91 B	4.37 B	23.82 B	4.43 B	12.99 B	25.11 B
# of Analysts	5	6	13	7	6	10
Dividend Yield	2.28%	1.67%	1.8%	0.00%	1.17%	1.67%
Value Score	C	-	-	C	D	D
Cash/Price	0.04	0.08	0.04	0.03	0.04	0.01
EV/EBITDA	7.49	8.53	13.92	22.43	20.44	16.31
PEG Ratio	2.35	2.23	2.00	2.23	2.84	2.14
Price/Book (P/B)	2.17	3.34	3.32	1.41	6.01	3.34
Price/Cash Flow (P/CF)	7.95	14.32	13.58	10.30	26.28	14.32
P/E (F1)	19.60	19.08	18.86	17.14	28.43	18.40
Price/Sales (P/S)	1.26	1.58	2.63	1.18	5.19	1.75
Earnings Yield	5.07%	5.25%	5.30%	5.84%	3.52%	5.44%
Debt/Equity	0.47	0.45	0.72	1.32	0.39	0.52
Cash Flow ($/share)	4.42	3.14	6.94	3.65	6.50	11.53
Growth Score	D	-	-	C	C	D
Hist. EPS Growth (3-5 yrs)	14.99%	9.55%	10.56%	4.49%	12.58%	9.55%
Proj. EPS Growth (F1/F0)	-41.19%	7.02%	7.49%	11.19%	3.24%	7.02%
Curr. Cash Flow Growth	10.92%	10.92%	14.83%	-19.54%	18.92%	9.16%
Hist. Cash Flow Growth (3-5 yrs)	2.02%	7.27%	9.00%	4.18%	8.19%	7.27%
Current Ratio	2.54	2.71	1.23	2.32	3.21	0.98
Debt/Capital	31.78%	30.87%	42.92%	56.84%	28.18%	32.10%
Net Margin	8.31%	7.48%	11.08%	-12.40%	17.05%	4.80%
Return on Equity	15.40%	14.13%	17.16%	9.06%	21.28%	17.10%
Sales/Assets	0.89	0.84	0.55	0.41	0.70	0.69
Proj. Sales Growth (F1/F0)	-7.71%	0.00%	4.15%	1.82%	1.58%	3.39%
Momentum Score	A	-	-	D	B	B
Daily Price Chg	-2.53%	-0.80%	-0.22%	1.46%	-1.23%	-0.80%
1 Week Price Chg	-1.70%	-0.77%	-0.30%	1.76%	0.08%	0.74%
4 Week Price Chg	-2.23%	4.36%	2.11%	9.74%	4.71%	5.04%
12 Week Price Chg	18.58%	14.99%	5.70%	29.79%	7.75%	11.06%
52 Week Price Chg	0.34%	20.08%	22.84%	80.88%	26.62%	28.98%
20 Day Average Volume	608,977	28,724	1,570,747	1,131,187	335,487	954,153
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
(F1) EPS Est 4 week change	0.00%	0.00%	0.00%	-2.11%	0.65%	0.00%
(F1) EPS Est 12 week change	-37.91%	-5.10%	-0.53%	-0.96%	-1.62%	-3.87%
(Q1) EPS Est Mthly Chg	0.00%	-0.34%	0.00%	-3.90%	0.23%	0.00%

Zacks Stock Rating System

We offer two rating systems that take into account investors' holding horizons: Zacks Rank and Zacks Recommendation. Each provides valuable insights into the future profitability of the stock and can be used separately or in combination with each other depending on your investment style.

Zacks Recommendation

The Zacks Recommendation aims to predict performance over the next 6 to 12 months. The foundation for the quantitatively determined Zacks Recommendation is trends in the company's estimate revisions and earnings outlook. The Zacks Recommendation is broken down into 3 Levels; Outperform, Neutral and Underperform. Unlike many Wall Street firms, we have an excellent balance between the number of Outperform and Neutral recommendations. Our team of 70 analysts are fully versed in the benefits of earnings estimate revisions and how that is harnessed through the Zacks quantitative rating system. But we have given our analysts the ability to override the Zacks Recommendation for the 1200 stocks that they follow. The reason for the analyst over-rides is that there are often factors such as valuation, industry conditions and management effectiveness that a trained investment professional can spot better than a quantitative model.

Zacks Rank

The Zacks Rank is our short-term rating system that is most effective over the one- to three-month holding horizon. The underlying driver for the quantitatively-determined Zacks Rank is the same as the Zacks Recommendation, and reflects trends in earnings estimate revisions.

Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	C
Growth Score	D
Momentum Score	A
VGM Score	C

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

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