

Kennametal Inc. (KMT)

\$29.69 (As of 02/07/20)

Price Target (6-12 Months): **\$25.00**

Long Term: 6-12 Months

Zacks Recommendation: Underperform

(Since: 02/06/20)

Prior Recommendation: Neutral

Short Term: 1-3 Months

Zacks Rank: (1-5)

4-Sell

Zacks Style Scores:

VGM:C

Value: B

Growth: C

Momentum: F

Summary

In the past three months, Kennametal's shares have underperformed the industry. In second-quarter fiscal 2020, the company's earnings and sales lagged estimates by 10.5% and 3.7%, respectively. Sales declined 14% year over year on weakness in all three segments, forex woes and adverse impact of business days. The company believes that challenging end-market conditions, issues related to 737 MAX and higher tax rates will affect its financials in the second half of fiscal 2020. It expects adjusted earnings per share of \$1.20-\$1.50, down from \$1.70-\$2.10 mentioned earlier. Organic sales are predicted to decline 9-12% versus fall of 5-9% stated earlier. Restructuring charges will likely be \$55-\$65 million. Forex woes might be dragging too. In the past seven days, its earnings estimates for fiscal 2020 and 2021 have been lowered.

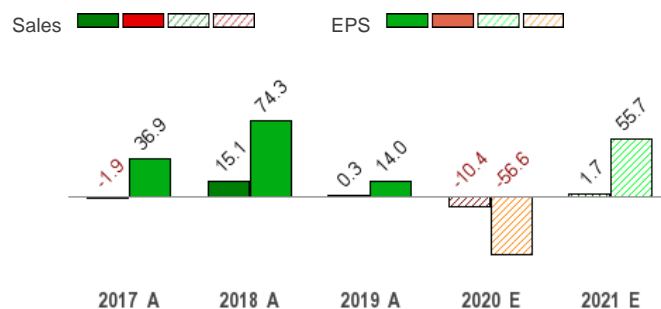
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$42.03 - \$27.49
20 Day Average Volume (sh)	910,802
Market Cap	\$2.5 B
YTD Price Change	-19.5%
Beta	2.32
Dividend / Div Yld	\$0.80 / 2.7%
Industry	Manufacturing - Tools & Related Products
Zacks Industry Rank	Top 42% (106 out of 254)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	-10.5%
Last Sales Surprise	-3.7%
EPS F1 Est- 4 week change	-25.8%
Expected Report Date	NA
Earnings ESP	0.0%
P/E TTM	15.2
P/E F1	22.7
PEG F1	2.7
P/S TTM	1.1

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	507 E	514 E	547 E	571 E	2,163 E
2020	518 A	505 A	539 E	560 E	2,127 E
2019	587 A	587 A	597 A	604 A	2,375 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$0.39 E	\$0.41 E	\$0.56 E	\$0.72 E	\$2.04 E
2020	\$0.17 A	\$0.17 A	\$0.38 E	\$0.58 E	\$1.31 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 02/07/2020. The reports text is as of 02/10/2020.

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** (55.3% of revenues generated in second-quarter fiscal 2020): The segment provides products and services in the industrial end markets such as general engineering, aerospace & defense, transportation, and energy.

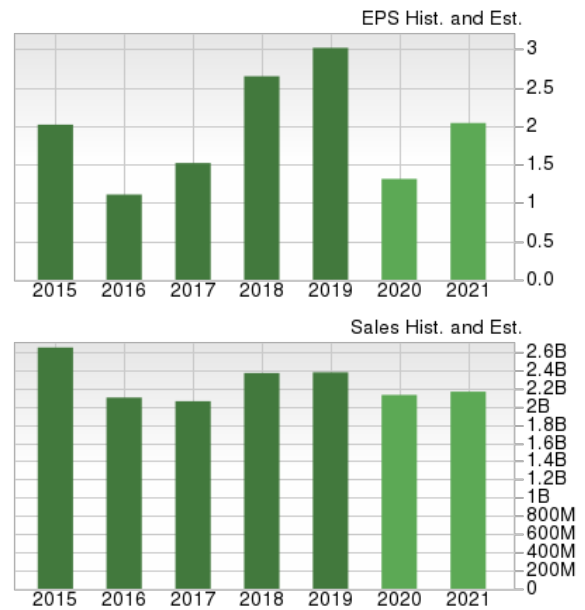
The segment offerings — sold under Kennametal Brand — are, in turn, used for the production of automobiles, ships, aero engines, trucks, airframe and other equipment.

- **WIDIA** (8.8%): 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** (35.9%): 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 Sell:

- ▼ In the past three months, Kennametal's shares have declined 13.2% compared with the industry's growth of 1.1%. Lowered projections (as detailed below) seems to have created bearish sentiments for the stock. In the past seven days, the Zacks Consensus Estimate for earnings has been lowered by 30.9% to 38 cents per share for the third quarter and by 22.5% to \$1.31 for fiscal 2020. This makes us cautious about the stock.
- ▼ In the second quarter of fiscal 2020, Kennametal's earnings and sales lagged estimates by 10.5% and 3.7%, respectively. On a year-over-year basis, the bottom line declined 76.1% due to weak sales and margin results. For fiscal 2020, it expects challenging end-markets, higher tax rates and issues with 737 MAX to impact the results for the second half. Organic sales are projected to decline 9-12% for the year, while adjusted earnings per share are expected to be \$1.20-\$1.50. The two projections compare unfavorably with the previously mentioned sales decline of 5-9% and earnings per share of \$1.70-\$2.10. Also, effective tax rate is expected to be 25-28%, higher than 22-24% expected previously.
- ▼ Weakness in gross and operating profits can be dragging for Kennametal. In second-quarter fiscal 2020, the company recorded a 33.5% year-over-year decline in gross profit, while gross margin was down 770 basis points (bps). Also, adjusted operating income dipped 69.8% year over year on a decline in organic sales, negative impacts of simplification/modernization actions, high costs 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 \$51 million or 39 cents per share in the fiscal second 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 have neutral impacts in the year, with unfavorable impact in the first half, offset by favorable impacts expected in the second half.
- ▼ Kennametal'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 1% on revenues and 1 cent per share on earnings in second-quarter fiscal 2020. Fluctuations in foreign exchange rates may continue to affect the company's top and bottom lines in the quarters ahead.

Challenging end-market conditions, higher tax rates and issues with 737 MAX will likely impact Kennametal in fiscal 2020. Also, forex woes and restructuring charges might be dragging.

Risks

- Kennametal's three initiatives — including growth, modernization and simplification — have been proving advantageous. The growth initiative is helping boost the company's sales through improvement in commercial execution. The simplification initiative is improving operational efficiency and reducing costs. The modernization initiative is in progress now and is contributing to strong operating leverage. Compared with the year-ago quarter, these initiatives boosted the company's bottom line by 10 cents per share in the second quarter. Also, it anticipates the second phase of simplification/modernization to yield annualized savings of \$35-\$40 million by the end of fiscal 2020 and \$25-\$30 million by fiscal 2021.
 - 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 company's 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 improve 9-11% and 3-5%, respectively. In addition, the company remains committed to rewarding its shareholders through dividend payments. In the first half of fiscal 2020, it distributed dividends totaling \$33.1 million to its shareholders. Also, the company's diversified customer base in various end markets enables it to avoid customer concentration risks. Prime end-markets 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.
-

Last Earnings Report

Kennametal Misses Earnings Estimates in Q2, Cuts Guidance

Kennametal reported weaker-than-expected results for second-quarter fiscal 2020 (ended Dec 31, 2019) with both earnings and sales lagging estimates by 10.5% and 3.7%, respectively.

This machinery company's adjusted earnings in the reported quarter were 17 cents, below the Zacks Consensus Estimate of 19 cents. Also, the bottom line plunged 76.1% from the year-ago figure of 71 cents on weak sales and margin results.

Quarter Ending **12/2019**

Report Date	Feb 03, 2020
Sales Surprise	-3.69%
EPS Surprise	-10.53%
Quarterly EPS	0.17
Annual EPS (TTM)	1.95

Revenue Details

Kennametal generated revenues of \$505.1 million, declining 14% year over year. While organic sales fell 12% in the quarter, forex woes had an impact of 1% and business days left a negative impact of 1%.

The company's performance suffered from weakness in India, the United States and Germany. Also, concerns related to the supply chain of 737 MAX were a spoiler.

Kennametal's top line lagged the Zacks Consensus Estimate of \$524.4 million.

On a geographical basis, the company generated revenues of \$245.2 million from America operations, decreasing 17% year over year. Sales in Europe, the Middle East and Africa (EMEA) were down 13.8% to \$150.4 million while the same from the Asia Pacific dropped 6.6% to \$109.4 million.

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

Industrial revenues of \$279.2 million were down 12% year over year. The results were adversely impacted by an 11% decline in organic revenues and a 1% impact from forex woes.

WIDIA revenues were \$44.3 million, down 9.4% year over year. The results were negatively impacted by an organic sales decline of 8% and the business days' impact of 1%.

Infrastructure revenues totaled \$181.5 million, declining 18% year over year. The results were affected by 1% from forex woes, 1% from business days, 14% decline in organic sales and 2% from divestiture headwinds.

During the quarter, the company divested specialty alloys business, receiving cash proceeds of \$24 million. Margin accretion is expected from the transaction.

Margin Profile

Kennametal's cost of goods sold in the reported quarter dipped 4% year over year to \$373.1 million. It represented 73.9% of revenues compared with 66.2% in the year-ago quarter. Gross profit deteriorated 33.5% year over year to \$132 million wherein margin contracted 770 basis points (bps) to 26.1%. Operating expenses summed \$107.5 million in the quarter under review, decreasing 6.2% year over year. As a percentage of revenues, operating expenses were 21.3% compared with 19.5% a year ago.

Adjusted operating income in the reported quarter slumped 69.8% year over year to \$24.5 million. Notably, this downside is caused by a decline in organic sales, the negative 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 partly offset by the benefits of simplification/modernization actions. Adjusted operating margin slipped 900 bps to 4.8%.

Adjusted effective tax rate was 29.6% compared with 21.3% in the prior year.

Balance Sheet and Cash Flow

Exiting the fiscal second quarter, Kennametal had cash and cash equivalents of \$105.2 million, decreasing 7.3% from \$113.5 million at the end of the last reported quarter. Long-term debt and capital leases inched up 0.1% sequentially to approximately \$593.2 million.

In the first half of fiscal 2020, the company generated net cash of \$87.1 million from operating activities, surging 41.6% from the year-ago period. Capital invested in purchasing property, plant and equipment came in at \$147.5 million, above \$88.1 million in the year-earlier period. Free cash outflow was \$59.6 million compared with \$24.1 million in the first half of fiscal 2019.

Restructuring Actions

In July 2019, the company announced that it is undertaking certain measures as part of its simplification/modernization initiatives, which are likely to help it streamline the business structure, improve efficiency and boost shareholder value. These restructuring moves are likely to be completed within the next two years and aid the company to progress toward achieving the fiscal 2021 (ending June 2021) targets.

The suggested restructuring actions will likely yield annualized savings of \$35-\$40 million in fiscal 2020 (ending June 2020). Pre-tax charges associated with these efforts will be \$55-\$65 million.

The company predicts that facility closures scheduled for fiscal 2021 will lead to annualized savings worth \$25-\$30 million. Pre-tax charges in the year will be \$55-\$65 million.

Outlook

For fiscal 2020, Kennametal anticipates to gain from simplification/modernization activities. However, end-market challenges, issues related with the 737 MAX and higher tax rates will adversely impact results in the second half. Therefore, the company lowered its projections for the full year.

It predicts an organic sales decline of 9-12% for fiscal 2020, indicating a decline from the previous projection of 5-9% fall. It expects adjusted earnings per share of \$1.20-\$1.50, suggesting a decrease from the earlier forecast of \$1.70-\$2.10.

The company expects effective tax rate of 25-28%, higher than 22-24% expected previously for the current fiscal year.

Capital expenditure is expected to be \$240-\$260 million for fiscal 2020, largely supporting the simplification/modernization initiatives. The company estimates free operating cash flow at a break-even. The past guided range was \$20-\$50 million.

Recent News

Dividend

On **Feb 3, 2020**, Kennametal announced that its board of directors approved the payment of a quarterly cash dividend of 20 cents per share to its shareholders of record as of Feb 11, 2020. The dividend will be paid out on Feb 25.

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.

Valuation

Kennametal shares are down 19.5% and 19.2% in the year-to-date and over the trailing 12-month periods respectively. Stocks in the Zacks sub-industry and the Zacks Industrial Products sector are down 4% and 0.7% in the year-to-date period, respectively. Over the past year, the Zacks sub-industry and the sector are up 17.1% and 10.5% respectively.

The S&P 500 index has moved up 3.3% year to date and 21.8% in the past year.

The stock is currently trading at 16.87x forward 12-month earnings per share, which compares to 17.81x for the Zacks sub-industry, 18.17x for the Zacks sector and 19.12x 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 16.17x. Our Underperform recommendation indicates that the stock will perform worse than the market. Our \$25 price target reflects 14.34x forward 12-month earnings per share.

The table below shows summary valuation data for KMT.

Valuation Multiples - KMT					
		Stock	Sub-Industry	Sector	S&P 500
P/E F12M	Current	16.87	17.81	18.17	19.12
	5-Year High	24.74	20.19	19.89	19.34
	5-Year Low	9.13	13.13	12.6	15.18
	5-Year Median	16.17	16.35	16.62	17.47
EV/EBITDA F12M	Current	8.67	8.99	17.81	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	8.56	8.87	14.03	10.79
EV/Sales F12M	Current	1.41	1.49	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	1.41	1.44	2.28	2.79

As of 02/07/2020

Industry Analysis Zacks Industry Rank: Top 42% (106 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 (SDV KY)	Neutral
Stanley Black & Decker, Inc. (SWK)	Neutral
Allegheny Technologies Incorporated (ATI)	Underperform

Industry Comparison Industry: Manufacturing - Tools & Related Products				Industry Peers		
	KMT Underperform	X Industry	S&P 500	CFX Neutral	IEX Neutral	SWK Neutral
VGM Score	C	-	-	C	C	B
Market Cap	2.46 B	3.82 B	24.00 B	4.28 B	13.03 B	24.79 B
# of Analysts	6	6.5	13	7	8	10
Dividend Yield	2.69%	1.69%	1.78%	0.00%	1.17%	1.69%
Value Score	B	-	-	C	D	B
Cash/Price	0.04	0.10	0.04	0.03	0.05	0.01
EV/EBITDA	6.53	7.87	14.07	22.04	20.21	14.79
PEG Ratio	2.69	2.11	2.04	2.15	2.95	2.07
Price/Book (P/B)	1.83	2.27	3.28	1.37	5.76	2.71
Price/Cash Flow (P/CF)	6.72	13.58	13.58	9.96	24.95	13.58
P/E (F1)	22.42	18.26	18.86	16.58	29.49	18.26
Price/Sales (P/S)	1.11	1.45	2.65	1.14	5.22	1.72
Earnings Yield	4.41%	5.48%	5.30%	6.02%	3.39%	5.48%
Debt/Equity	0.47	0.38	0.71	1.32	0.38	0.35
Cash Flow (\$/share)	4.42	3.14	6.89	3.65	6.87	12.01
Growth Score	C	-	-	C	A	B
Hist. EPS Growth (3-5 yrs)	14.99%	9.45%	10.80%	4.49%	13.39%	9.31%
Proj. EPS Growth (F1/F0)	-56.51%	6.53%	7.23%	10.75%	0.17%	6.31%
Curr. Cash Flow Growth	10.92%	10.92%	9.51%	-19.54%	4.80%	4.76%
Hist. Cash Flow Growth (3-5 yrs)	2.02%	6.13%	8.55%	4.18%	7.29%	6.13%
Current Ratio	2.53	2.71	1.20	2.32	3.52	1.01
Debt/Capital	31.85%	27.44%	42.90%	56.84%	27.28%	25.78%
Net Margin	5.89%	7.49%	11.76%	-12.40%	17.06%	6.62%
Return on Equity	11.97%	12.42%	16.98%	9.06%	20.68%	16.15%
Sales/Assets	0.85	0.84	0.54	0.41	0.68	0.68
Proj. Sales Growth (F1/F0)	-10.45%	0.00%	4.15%	1.82%	0.66%	3.42%
Momentum Score	F	-	-	B	C	F
Daily Price Chg	-3.23%	-1.85%	-0.64%	-2.65%	0.09%	-1.85%
1 Week Price Chg	-9.04%	-5.82%	-2.60%	-5.28%	-4.82%	-4.29%
4 Week Price Chg	-16.11%	-5.06%	0.72%	-3.22%	-1.46%	-1.34%
12 Week Price Chg	-11.74%	-1.68%	4.69%	8.92%	5.94%	4.45%
52 Week Price Chg	-19.12%	5.53%	16.01%	49.34%	24.30%	27.33%
20 Day Average Volume	910,802	27,539	1,961,054	957,571	376,841	1,221,419
(F1) EPS Est 1 week change	-25.70%	0.00%	0.00%	0.00%	0.00%	0.16%
(F1) EPS Est 4 week change	-25.84%	-0.45%	-0.00%	0.03%	-4.66%	-0.55%
(F1) EPS Est 12 week change	-25.84%	-1.16%	-0.16%	-2.38%	-4.69%	-1.16%
(Q1) EPS Est Mthly Chg	-29.36%	-9.78%	0.00%	0.00%	-10.79%	-19.23%

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	B
Growth Score	C
Momentum Score	F
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.

Disclosures

This report contains independent commentary to be used for informational purposes only. The analysts contributing to this report do not hold any shares of this stock. The analysts contributing to this report do not serve on the board of the company that issued this stock. The EPS and revenue forecasts are the Zacks Consensus estimates, unless indicated otherwise on the reports first page. Additionally, the analysts contributing to this report certify that the views expressed herein accurately reflect the analysts personal views as to the subject securities and issuers. ZIR certifies that no part of the analysts compensation was, is, or will be, directly or indirectly, related to the specific recommendation or views expressed by the analyst in the report.

Additional information on the securities mentioned in this report is available upon request. This report is based on data obtained from sources we believe to be reliable, but is not guaranteed as to accuracy and does not purport to be complete. Any opinions expressed herein are subject to change.

ZIR is not an investment advisor and the report should not be construed as advice designed to meet the particular investment needs of any investor. Prior to making any investment decision, you are advised to consult with your broker, investment advisor, or other appropriate tax or financial professional to determine the suitability of any investment. This report and others like it are published regularly and not in response to episodic market activity or events affecting the securities industry.

This report is not to be construed as an offer or the solicitation of an offer to buy or sell the securities herein mentioned. ZIR or its officers, employees or customers may have a position long or short in the securities mentioned and buy or sell the securities from time to time. ZIR is not a broker-dealer. ZIR may enter into arms-length agreements with broker-dealers to provide this research to their clients. Zacks and its staff are not involved in investment banking activities for the stock issuer covered in this report.

ZIR uses the following rating system for the securities it covers. **Outperform-** ZIR expects that the subject company will outperform the broader U.S. equities markets over the next six to twelve months. **Neutral-** ZIR expects that the company will perform in line with the broader U.S. equities markets over the next six to twelve months. **Underperform-** ZIR expects the company will underperform the broader U.S. equities markets over the next six to twelve months.

No part of this report can be reprinted, republished or transmitted electronically without the prior written authorization of ZIR.