

Blue Star

| | |
|-----------------------------|--------------------------------|
| BSE SENSEX 9,756 | BLOOMBERG BLSTR IN |
| S&P CNX 2,860 | REUTERS CODE BLUS.BO |

7 June 2006

Buy

Rs535

| | |
|--------------------------|-----------|
| Equity Shares (m) | 18.0 |
| 52-Week Range | 799 / 295 |
| 1,6,12 Rel. Perf. (%) | -7, 3, 30 |
| M.Cap. (Rs b) | 9.6 |
| Avg. daily volume ('000) | 7.9 |

| YEAR END | NET SALES (RS M) | PAT (RS M) | EPS (RS) | EPS YoY (%) | P/E (X) | P/BV (X) | ROE (%) | ROCE (%) | EV/ SALES | EV/ EBITDA |
|----------|------------------|------------|----------|-------------|---------|----------|---------|----------|-----------|------------|
| 3/06E | 11,746 | 489 | 27.2 | 39.4 | 19.7 | 5.6 | 30.5 | 33.1 | 0.9 | 12.4 |
| 3/07E | 15,034 | 642 | 35.7 | 31.2 | 15.0 | 4.7 | 33.9 | 35.3 | 0.7 | 9.6 |
| 3/08E | 19,244 | 835 | 46.4 | 30.1 | 11.5 | 3.9 | 36.7 | 38.7 | 0.6 | 7.6 |
| 3/09E | 24,632 | 1,077 | 59.9 | 29.0 | 8.9 | 3.1 | 38.8 | 41.0 | 0.5 | 6.1 |

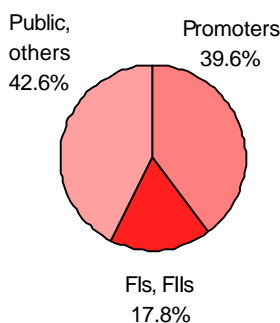


Investment Ideas for Private Clients

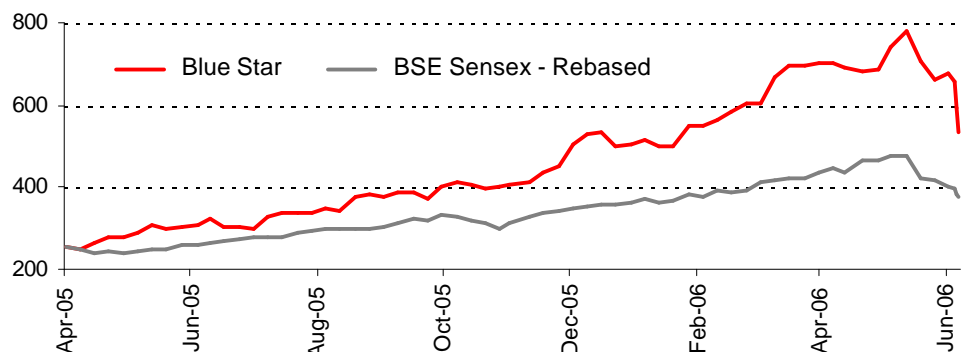
Blue Star is a market leader in central air-conditioning systems, and an excellent play on the 4 mega trends of IT/ITeS, retail & entertainment, SEZs and cold chain infrastructure. We expect Blue Star to sustain topline growth of 28% and EPS CAGR of 30% over the next 3 years. We recommend **BUY**.

- **Beneficiary of 4 mega trends:** We see Blue Star as a major beneficiary of 4 mega trends: IT/ITeS, retail & entertainment (malls, multiplexes), SEZs and cold chain infrastructure. Each trend should drive demand for Blue Star's air-conditioning and refrigeration products.
- **Strong clientele, high repeat business:** We expect high repeat business for Blue Star from its national accounts i.e. clients who will source all their air-conditioning requirements only through Blue Star. These include DLF, Shoppers' Stop, Infosys, HCL, ICICI Bank and Café Coffee Day. Many of them have lined up expansions which will require air-conditioning.
- **EPS CAGR of 30% through FY09:** Blue Star's order book as on March 2006 is 38% higher YoY. This coupled with the robust demand situation led us to factor in aggressive topline growth of 28% through FY09. With small expansion in margins and tax savings from the new plant in Himachal, our net profit and EPS CAGR works out to an attractive 30%.
- **Valuation in line with peers, BUY:** Blue Star is currently trading at a PE of 19.7x FY06. We consider this reasonable relative to its earnings growth and in line with peers. **Our 1-year target price is Rs710** (i.e. Rs142 after the proposed 5:1 stock split). We expect a 33% annualised return from the stock over the next 3 years. **BUY**.

SHAREHOLDING PATTERN (%)



BLUE STAR VS SENSEX - LAST 1 YEAR



Investment Argument

We initiate coverage of Blue Star with a BUY. We expect annualised return of 33% through FY09, including healthy dividends in the interim. Our 1-year target price is Rs710 (i.e. Rs142 on Rs2 paid-up after the proposed 5:1 stock split).

Over the last 5 years, Blue Star has consistently outperformed the market.

| Time-frame | 6m | 1 year | 2 years | 3 years | 5 years |
|------------------|----|--------|---------|---------|---------|
| Sensex change | 1% | 44% | 100% | 195% | 179% |
| Blue Star change | 4% | 74% | 246% | 404% | 1088% |
| Relative | 3% | 30% | 146% | 208% | 908% |

Going forward, our earnings model for Blue Star suggests a 30% EPS CAGR over the next 3 years. So, we don't expect any significant derating in stock valuation. Adding healthy dividends, we expect annualised return of 33% per annum.

We discuss key positives which could make this happen.

Beneficiary of 4 mega trends

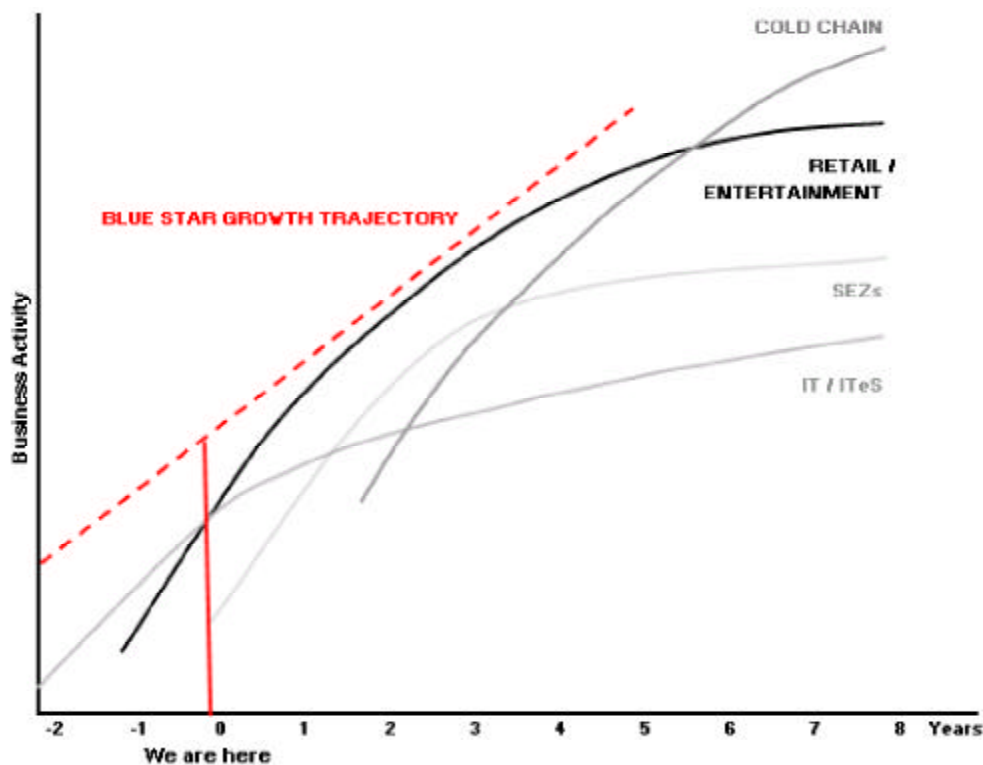
We see 4 mega trends as an integral part of the ongoing Indian economic growth story -

- **IT / ITeS** – growing @ 28-30% per annum
- **Retail & Entertainment** – malls, multiplexes, fast food chains, coffee shop chains, etc
- **SEZs i.e. Special Economic Zones** – offering tax shield for export-oriented businesses
- **Cold chain infrastructure** – to mitigate food product losses estimated at Rs.200b every year.

We expect these mega trends to fully pan out over the next 8 years as depicted below. (For details see Annexure 1, page 11.)

We see Blue Star as a major beneficiary of these trends, each of which should drive demand for its products.

FOUR MEGA TRENDS - THEMATIC REPRESENTATION



- **IT / ITeS** - growing @ 28-30% per annum
- **Retail & Entertainment** - malls, multiplexes, fast food chains, coffee shop chains, etc
- **SEZs** - offering tax shield for export-oriented businesses
- **Cold chain infrastructure** - to mitigate food product losses estimated at Rs.200b every year.

Source: Motilal Oswal Securities

Blue Star is a market leader in central air-conditioning. It also has a wide range of refrigeration products such as freezers, cold storages, water-coolers, etc. (for details see Annexure 2, page 13.)

| BLUE STAR - FY06 REVENUE BREAKDOWN | | | Rs b |
|------------------------------------|---------------|-------------|-------|
| Segment | Indian market | Blue Star | |
| | | Revenue | Share |
| Central air-conditioning | 28.0 | 8.2 | 29% |
| Cooling products | | | |
| Window & split ACs | 28.0 | 1.1 | 4% |
| Refrigeration products | 4.0 | 1.0 | 25% |
| Exports | | 0.6 | |
| Total HVAC & R | 60.0 | 11.0 | |
| Prof. electronics - Trading | | 0.8 | |
| TOTAL REVENUE | | 11.8 | |

Source: Company Presentation

Strong clientele, high repeat business

We have analysed Blue Star's major orders executed in the last 7 quarters -

| | |
|--------------------------|------------|
| Total orders | 42 |
| No. of cities | 17 |
| Unique customers | 30 |
| No. of repeat orders | 12 |
| % of total orders | 29% |

We expect higher share of repeat orders going forward. Blue Star has several national accounts i.e. clients who will source only from Blue Star all their air-conditioning requirements anywhere in the country. These include

ANNOUNCED PLANS OF BLUE STAR'S MAJOR CLIENTS

| DLF | Shoppers' Stop (K Raheja group) | Others |
|---|---|--|
| <p>Commercial -</p> <ul style="list-style-type: none"> IT parks in Noida, Chandigarh, Kolkata, Hyderabad, Bangalore, Pune, Chennai. <p>Retail & Entertainment -</p> <ul style="list-style-type: none"> 17m sq ft of ongoing retail projects 100 malls with ~500 cinema screens in over 60 cities, in the next 4-5 years <p>Hotels -</p> <ul style="list-style-type: none"> Total investment of Rs36-40b over the next 7-10 years Super luxury hotels in 5-6 cities 100 business and 4-star hotels <p>SEZ -</p> <ul style="list-style-type: none"> 4 projects in the North; others in pipeline. | <p>Shoppers' Stop stores -</p> <ul style="list-style-type: none"> 4 stores in FY07; 13 stores in FY08 <p>Hyper City (Retail) -</p> <ul style="list-style-type: none"> Hyper malls in Navi Mumbai, South Mumbai, Hyderabad, Pune and Delhi, on the lines of Inorbit <p>Hotels -</p> <ul style="list-style-type: none"> Renaissance Hotel, Mumbai - Phase II (300 Rooms) 5-star hotel at Mindspace, Malad 5-star hotel at Vashi, Navi Mumbai 5-star hotel at Hyderabad <p>IT parks -</p> <ul style="list-style-type: none"> 4.5m sq ft at Hyderabad <p>Others -</p> <ul style="list-style-type: none"> Expansion of Crossword bookstores | <p>Infosys -</p> <ul style="list-style-type: none"> 550 acre development in Hyderabad 50 acres in Thiruvananthapuram SEZ 31 hectare IT SEZ at Mysore <p>HCL -</p> <ul style="list-style-type: none"> 46-acre campus in Noida 26-acre campus in Bangalore 50-acre campus in Chennai <p>Satyam -</p> <ul style="list-style-type: none"> 50 acres allotted in Visakhapatnam 2.77 acre facility in Kolkata <p>Café Coffee Day -</p> <ul style="list-style-type: none"> 20 coffee lounges (a Lounge can be around 15-20,000 sq ft compared to 8,000 sq ft for a normal espresso bar) |

DLF, Shoppers' Stop, Infosys, HCL, Satyam, Microsoft, ICICI Bank and Café Coffee Day. Most of these customers have huge expansion plans lined up, all of which will require air-conditioning and refrigeration.

Many more growth drivers

New room AC plant at Himachal: In May 2005, Blue Star commissioned Phase 1 of its room AC plant at Kala Amb in Himachal Pradesh. This plant enjoys excise duty and income tax exemptions, and puts Blue Star on a level-playing field with competitors who already have these benefits.

In FY06, production from this plant was 30,000 units. Blue Star expects to complete Phase 2 by August 2006, taking the total capacity to 150,000 window and split AC units on a single shift basis. Fiscal benefits coupled with automation and vertical integration should significantly improve Blue Star's competitive position in this segment.

New product launches: Blue Star introduces new products at regular intervals in all its divisions, catering to specific requirements of industries/clients. Recent product launches include -

- Variable Refrigerant Flow AC systems (4QFY06)
- Hiper Plus Packaged ACs (4QFY05)
- Mega Split ACs for restaurants and showrooms (2QFY05)
- Deep freezers (1QFY05)
- Screw-, process- and tandem scroll chillers (FY04).

All these products have huge potential moving forward. In some cases, they lower Blue Star's dependence on imports, easing pressure on margins.

Exports: Given the booming domestic market, Blue Star did not fully focus on the international market till recently. Going forward, this is a potential upside to our estimates.

| Rs m | FY03 | FY04 | FY05 | FY06E |
|----------------------|-------------|--------------|--------------|--------------|
| Product exports | 91.4 | 313.7 | 471.3 | 631.1 |
| YoY | 42% | 243% | 50% | 34% |
| Project exports | 0.0 | 64.7 | 140.6 | 250.0 |
| YoY | -100% | - | 117% | 42% |
| TOTAL EXPORTS | 91.4 | 378.4 | 611.9 | 881.1 |
| YoY | 42% | 314% | 62% | 44% |

E: MOSSt Estimates

Source: Company Annual Reports

Value-added service business: Blue Star maintains over 600,000 tons of installed air-conditioning and refrigeration equipment. Here too, it keeps up its innovations -

- Migration to customer-centric solutions - energy management, air quality management, product upgrades and enhancements, etc
- New services such as duct cleaning
- Improvement of spares availability by setting up regional parts centers
- Toll-free helpline and extended hours of service operation including 24x7 option to customers.

Though service revenues are not separately available, we believe they are healthy and contribute significantly to the bottomline.

Healthy financials, aggressive projections

Shareholder value consciousness: Blue Star's financial track record convinces us of the top management's shareholder value consciousness. Our indicators are -

- The company taking up only those orders with reasonable margin and payment terms, such that there is no adverse impact on return on capital
- Last 5-year EPS CAGR of 20%, RoCE up from 22.4% to 33.1% and RoE up from 24.8% to 30.5%
- Demerger of Blue Share Infotech in FY02 and share buyback in FY03

- Average dividend payout of 48% for the last 5 years
- The recently announced 5:1 stock split to Rs2 paid up per share. (The company claims this will improve liquidity and enable institutional investment into the company.)

Aggressive 28% topline growth estimate: For Blue Star projections, all the relevant growth numbers are 25%+.

| KEY NUMBERS | Rs b | YoY |
|----------------------------------|------|-----|
| FY06 Sales | 11.7 | 28% |
| Central AC | 8.2 | 26% |
| Cooling products | 2.7 | 29% |
| Industrial products | 0.8 | 36% |
| Product exports | 0.6 | 34% |
| Room ACs (volumes) | - | 50% |
| Refrigeration products (volumes) | - | 40% |
| Order inflow (9m FY06) | 9.5 | 35% |
| Order book (March 06) | 5.6 | 38% |
| Central AC | 4.7 | 33% |
| Cooling products | 0.4 | 83% |
| Industrial products | 0.5 | 63% |

We have married these numbers with higher expected demand from the 4 mega trends to factor in an aggressive 28% topline growth for the next 3 years. We have assumed very small margin expansion due to operating efficiency and economies of scale at the new plant in Himachal.

We have also assumed tax saving from the new plant. Accordingly, our net profit and EPS CAGR through FY09 works out to an attractive 30%.

Valuation in line with peers

At CMP of Rs535, Blue Star is currently trading at a PE of 19.7x FY06. This looks attractive relative to expected EPS CAGR of 30%. Blue Star's valuation is also in line with that of peer company Voltas.

BLUE STAR RELATIVE VALUATIONS

| Metric | Blue Star | * Voltas |
|-------------------------------|------------|------------|
| CMP (Rs) - 7 June 2006 | 535 | 778 |
| FY06 | | |
| RoE (%) | 30.5 | 29.2 |
| EPS (Rs) | 27.2 | 21.3 |
| Book value (Rs) | 96.0 | 73.0 |
| PE (x) | 19.7 | 36.5 |
| Price / Book (x) | 5.6 | 10.7 |
| FY07E | | |
| RoE (%) | 33.9 | 46.3 |
| EPS (Rs) | 35.7 | 40.0 |
| Book value (Rs) | 114.7 | 100.1 |
| PE (x) | 15.0 | 19.5 |
| Price / Book (x) | 4.7 | 7.8 |
| FY08E | | |
| RoE (%) | 36.7 | 45.7 |
| EPS (Rs) | 46.4 | 55.2 |
| Book value (Rs) | 138.5 | 141.1 |
| PE (x) | 11.5 | 14.1 |
| Price / Book (x) | 3.9 | 5.5 |

* - Voltas numbers based on consensus estimates

Recommendation: BUY

We expect Blue Star's earnings growth rate to be higher than the market over the next 3 years at least. So, we expect no major derating of the stock's current valuation.

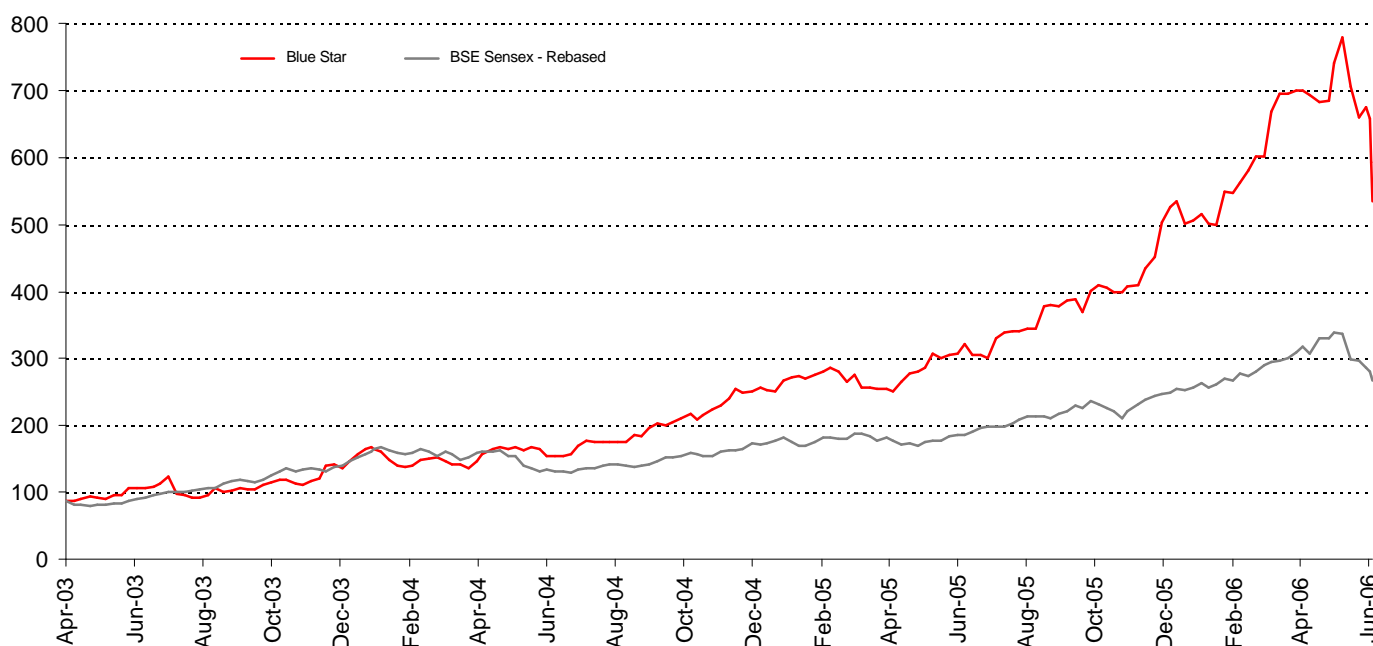
Beyond FY09, Blue Star's earnings growth may be lower at 23-25%. Our target PE for FY09 is 20x giving a target price of Rs1,200 (Rs240 post split). Considering healthy dividends in the interim, IRR on the stock works out to 33%.

CASH FLOW (RS)

| Year 0 Stock price | Year 1 Dividend | Year 2 Dividend | Year 3 Target price | IRR |
|-----------------------|--------------------|--------------------|------------------------|-----|
| -535 | 15 | 20 | 1,200 | 33% |

At a PE of 20x FY07E, our 1-year target price is **Rs710** (Rs142 post split), an upside of 33% from current levels. We recommend **BUY**.

BLUE STAR vs SENSEX - LAST 3 YEARS



Where the story could go cold

High competition: In central air-conditioning, Blue Star's major competitors in India are Voltas, ETA Group Dubai and Carrier. Many new players (e.g. Daikin of Japan) are making a foray into this business. In room ACs, there is stiff competition from many leading players including LG, Samsung, Voltas, Carrier, and also the assembled ACs segment.

Mitigant: We expect Blue Star to withstand competition given -

- its 60-year presence in this business offering turnkey solutions
- introduction of new products at regular intervals
- its national accounts i.e. clients who are likely to source all their air-conditioning requirements anywhere in the country through Blue Star alone

Wafer-thin margins: Blue Star operates at wafer-thin margins of 5-7%. We have factored in small expansion moving forward due to economies of scale. However, higher prices of inputs such as steel and copper could adversely affect margins as raw materials constitute a very high 78% of sales.

Mitigant: The company claims to have built in contingency reserve / escalation clauses in most of its projects. Further, it hopes to keep raw material consumption in check through value engineering.

People factor: Recruiting and retaining skilled engineers is critical for Blue Star to participate in the high-growth business opportunity. Further, after raw materials, people cost is the highest expense head at 7.5% of sales. While we have factored in 26-28% growth in people costs, anything higher will lower our margins and profit estimates.

Mitigant: Blue Star claims to be a preferred employer in the industry. It is also a stakeholder-focused, cost conscious company. So, as in the past, we expect it to effectively manage the people issue.

Tax rate: In FY06, Blue Star commissioned its room AC plant in Himachal Pradesh. The plant enjoys 100% exemption from income tax for the first 5 years. Also, FY07 is the last year of lower tax rate for its plant in Dadra. Accordingly, we have factored in lower-than-peak tax rates through FY09. However, we do not have access to profits by plant, and actual tax rates could be higher.

Mitigant: Our earnings model for Blue Star is not very sensitive to tax rates. If we assume peak tax rate for FY09, our EPS CAGR drops from 30% to 28%.

Financials and Projections

| INCOME STATEMENT | | (Rs million) | | | | |
|-------------------------------|--------------|--------------|---------------|---------------|---------------|---------------|
| Y/E MARCH | 2004 | 2005 | 2006E | 2007E | 2008E | 2009E |
| Net Sales | 6,975 | 9,208 | 11,746 | 15,034 | 19,244 | 24,632 |
| change (%) | 19.8 | 32.0 | 27.6 | 28.0 | 28.0 | 28.0 |
| Stock adjustment | 108 | 259 | 472 | 604 | 773 | 989 |
| Net Sales (stock adj.) | 7,083 | 9,467 | 12,217 | 15,638 | 20,017 | 25,622 |
| Raw Materials | 5,380 | 7,430 | 9,551 | 12,225 | 15,648 | 20,029 |
| % of net sales | 76.0 | 78.5 | 78.2 | 78.2 | 78.2 | 78.2 |
| Staff Cost | 596 | 724 | 913 | 1,168 | 1,495 | 1,914 |
| % of net sales | 8.4 | 7.6 | 7.5 | 7.5 | 7.5 | 7.5 |
| Admin. & Other Exp. | 709 | 736 | 917 | 1,159 | 1,463 | 1,847 |
| % of net sales | 10.0 | 7.8 | 7.5 | 7.4 | 7.3 | 7.2 |
| EBITDA | 398 | 578 | 837 | 1,087 | 1,411 | 1,832 |
| change (%) | 18.7 | 45.4 | 44.7 | 29.9 | 29.8 | 29.8 |
| Depreciation | 100 | 123 | 159 | 188 | 215 | 241 |
| EBIT | 298 | 455 | 677 | 899 | 1,196 | 1,590 |
| Interest | 18 | 32 | 57 | 84 | 103 | 137 |
| Other Income | 80 | 47 | 41 | 52 | 67 | 85 |
| Non Recurring Income | 106 | 55 | 0 | 0 | 0 | 0 |
| PBT | 465 | 524 | 661 | 867 | 1,160 | 1,538 |
| Tax (incl FBT and def. tax) | 140 | 132 | 172 | 225 | 325 | 462 |
| Tax/PBT (%) | 30.1 | 25.3 | 26.0 | 26.0 | 28.0 | 30.0 |
| PAT | 326 | 392 | 489 | 642 | 835 | 1,077 |
| Share of associates | | | | | | |
| Minority interest | | | | | | |
| Consolidated PAT | | | | | | |
| Adjusted PAT | 251 | 351 | 489 | 642 | 835 | 1,077 |
| change (%) | -5.8 | 39.7 | 39.4 | 31.2 | 30.1 | 29.0 |
| EBITDA margin | 5.6 | 6.1 | 6.8 | 6.9 | 7.0 | 7.1 |
| Adjusted PAT margin | 3.5 | 3.7 | 4.0 | 4.1 | 4.2 | 4.2 |

E: MOSSt Estimates

Financials and Projections (contd...)

BALANCE SHEET (Rs million)

| Y/E MARCH | 2004 | 2005 | 2006E | 2007E | 2008E | 2009E |
|--------------------------|--------------|--------------|--------------|--------------|--------------|---|
| Net Worth | 1,298 | 1,484 | 1,727 | 2,063 | 2,491 | 3,059 |
| Share Capital | 180 | 180 | 180 | 180 | 180 | 180 |
| Reserves | 1,118 | 1,304 | 1,547 | 1,884 | 2,311 | 2,879 |
| Total debt | 134 | 373 | 759 | 833 | 1,133 | 1,482 |
| | | | | | | <i>Higher working capital requirement</i> |
| Capital Employed | 1,432 | 1,857 | 2,486 | 2,896 | 3,624 | 4,540 |
| Gross Fixed Assets | 1,353 | 1,639 | 1,977 | 2,288 | 2,588 | 2,888 |
| Capex | 151 | 290 | 377 | 300 | 300 | 300 |
| Less: Acc. Depreciation | 772 | 873 | 1,010 | 1,197 | 1,412 | 1,654 |
| Net Fixed Assets | 581 | 766 | 968 | 1,091 | 1,176 | 1,235 |
| Capital WIP | 69 | 73 | 111 | 100 | 100 | 100 |
| Investments | 55 | 52 | 52 | 52 | 52 | 52 |
| Curr. Assets | 2,768 | 3,861 | 4,817 | 6,063 | 7,943 | 10,348 |
| Inventory | 855 | 1,190 | 1,498 | 2,102 | 2,875 | 3,865 |
| Debtors | 1,359 | 1,958 | 2,388 | 2,883 | 3,691 | 4,724 |
| Cash & Bank | 24 | 25 | 24 | 25 | 30 | 35 |
| Loans, Adv. & Others | 530 | 689 | 906 | 1,052 | 1,347 | 1,724 |
| Curr. Liabilities | 1,996 | 2,856 | 3,404 | 4,340 | 5,566 | 7,104 |
| Creditors | 762 | 932 | 1,193 | 1,525 | 1,950 | 2,494 |
| Other Liabilities | 1,038 | 1,705 | 1,930 | 2,469 | 3,158 | 4,041 |
| Provisions | 195 | 219 | 280 | 345 | 457 | 569 |
| Net Curr. Assets | 772 | 1,005 | 1,413 | 1,723 | 2,377 | 3,244 |
| Misc. Expenses | 43 | 44 | 33 | 21 | 9 | 0 |
| Net Deferred Tax | -87 | -83 | -91 | -91 | -91 | -91 |
| Total Assets | 1,432 | 1,857 | 2,486 | 2,896 | 3,624 | 4,540 |

E: MOSSt Estimates

Financials and Projections (contd...)

RATIOS

| Y/E MARCH | 2004 | 2005 | 2006E | 2007E | 2008E | 2009E | |
|---------------------------------|------|------|-------|-------|-------|-------|--|
| Basic (Rs) | | | | | | | |
| EPS | 14.0 | 19.5 | 27.2 | 35.7 | 46.4 | 59.9 | 33% CAGR FY06-09 |
| Cash EPS | 19.5 | 26.4 | 36.0 | 46.1 | 58.4 | 73.3 | |
| Book Value | 72.2 | 82.5 | 96.0 | 114.7 | 138.5 | 170.0 | |
| Dividend per share | 9.0 | 10.0 | 12.0 | 15.0 | 20.0 | 25.0 | Healthy dividend payouts |
| Payout incl. Div. Tax. (%) | 71.0 | 56.5 | 50.0 | 47.6 | 48.8 | 47.3 | |
| Valuation - at Rs535 (x) | | | | | | | |
| P/E | | | 19.7 | 15.0 | 11.5 | 8.9 | Reasonable valuation |
| Cash P/E | | | 14.8 | 11.6 | 9.2 | 7.3 | |
| Price/Book Value | | | 5.6 | 4.7 | 3.9 | 3.1 | |
| EV/Sales | | | 0.9 | 0.7 | 0.6 | 0.5 | |
| EV/EBITDA | | | 12.4 | 9.6 | 7.6 | 6.1 | |
| Dividend Yield (%) | | | 2.2 | 2.8 | 3.7 | 4.7 | |
| Profitability (%) | | | | | | | |
| RoE | 26.5 | 28.1 | 30.5 | 33.9 | 36.7 | 38.8 | Reflects shareholder value consciousness |
| RoCE | 27.9 | 30.5 | 33.1 | 35.3 | 38.7 | 41.0 | |
| Turnover Ratios | | | | | | | |
| Debtors (days of sales) | 71 | 78 | 74 | 70 | 70 | 70 | |
| Inventory (days of sales) | 45 | 47 | 47 | 51 | 55 | 57 | |
| Creditors (days of total exp.) | 42 | 38 | 38 | 38 | 38 | 38 | |
| Asset Turnover (x) | 4.9 | 5.1 | 4.9 | 5.4 | 5.5 | 5.6 | |
| Leverage Ratio | | | | | | | |
| Debt/Equity (x) | 0.1 | 0.3 | 0.4 | 0.4 | 0.5 | 0.5 | |

E: MOSSt Estimates

Financials and Projections (contd...)

| CASH FLOW STATEMENT | | (Rs million) | | | | |
|-----------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Y/E MARCH | 2004 | 2005 | 2006E | 2007E | 2008E | 2009E |
| PBT before EO items | 359 | 469 | 661 | 867 | 1,160 | 1,538 |
| Add: Depn & amortisation | 122 | 122 | 171 | 200 | 226 | 251 |
| Interest paid | 18 | 32 | 57 | 84 | 103 | 137 |
| Less: Direct Taxes Paid | (140) | (132) | (172) | (225) | (325) | (462) |
| (Incr)/Decr in WC | (98) | (233) | (409) | (309) | (649) | (862) |
| CF from Operations | 261 | 258 | 308 | 616 | 516 | 602 |
| Extraordinary Items | 106 | 55 | 0 | 0 | 0 | 0 |
| CF including EO items | 368 | 313 | 308 | 616 | 516 | 602 |
| (Incr)/Decr in FA | (151) | (290) | (377) | (300) | (300) | (300) |
| (Pur)/Sale of Investments | (13) | 3 | 0 | 0 | 0 | 0 |
| CF from Investing activity | (164) | (287) | (377) | (300) | (300) | (300) |
| Issue/(Reduction) of Capital | 0 | 0 | 0 | 0 | 0 | 0 |
| Incr/(Decr) in Debt | 13 | 239 | 386 | 74 | 300 | 349 |
| Interest Paid | (18) | (32) | (57) | (84) | (103) | (137) |
| Dividend Paid (incl. div. tax) | (183) | (205) | (244) | (305) | (407) | (509) |
| Others | (21) | (27) | (17) | 0 | (0) | 0 |
| CF from Financing activity | (209) | (25) | 68 | (315) | (211) | (297) |
| Incr/(Decr) of Cash | (5) | 1 | (1) | 1 | 5 | 5 |
| Add: Opening Balance | 29 | 24 | 25 | 24 | 25 | 30 |
| Closing Balance | 24 | 25 | 24 | 25 | 30 | 35 |

E: MOSSt Estimates

ANNEXURE 1:

The 4 mega trends

We see 4 mega trends as an integral part of the ongoing Indian economic growth story -

- **IT / ITeS** – growing @ 28-30% per annum
- **Retail & Entertainment** – malls, multiplexes, fast food chains, coffee shop chains, etc
- **SEZs i.e. Special Economic Zones** – offering tax shield for export-oriented businesses
- **Cold chain infrastructure** – to mitigate food product losses estimated at Rs.200b every year.

We expect these mega trends to fully pan out over the next 8 years as depicted below.

IT / ITeS mega trend

We expect the IT and IT-enabled Services sector to generate construction demand of over ~100m sq ft through FY10. All of this will require air-conditioning

| IT / ITeS | FY06 | FY07 | FY10 |
|-------------------------------|------|-----------|------------|
| Total industry size (\$ b) | 22.5 | 29.6 | 60 |
| Growth over FY06 | | 28% | 103% |
| Estimated people base (m) | 1.3 | | |
| Minimum additional people (m) | | 0.4 | 1.3 |
| Sq ft per person | | 80 | 80 |
| Additional sq ft (m) | | 29 | 107 |

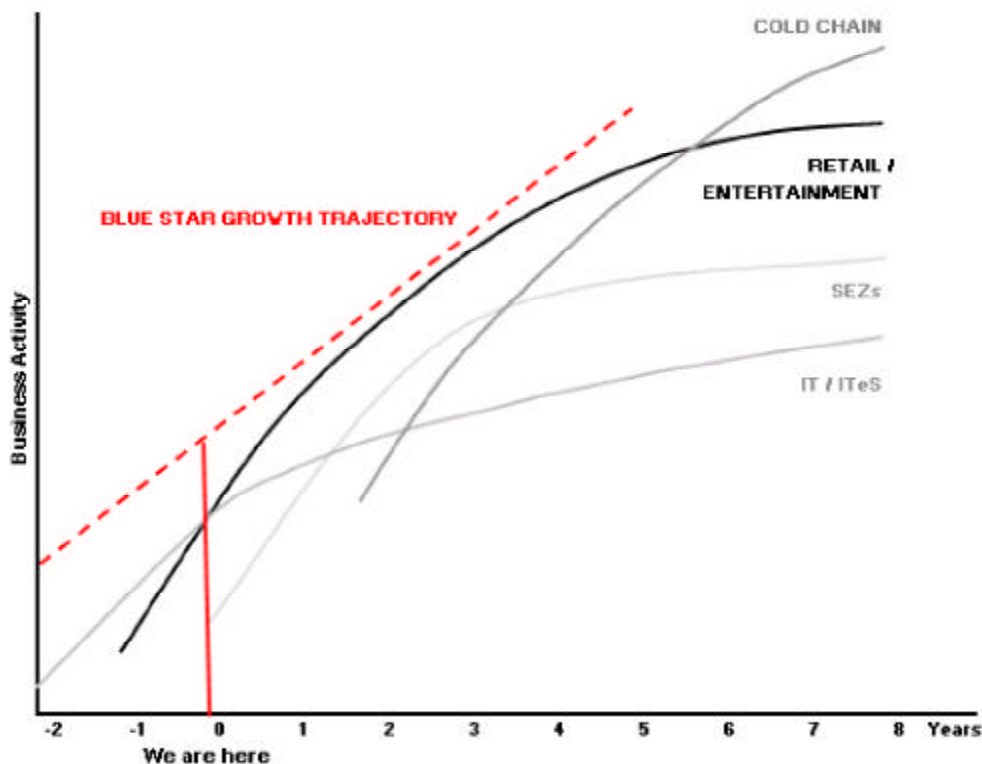
Source: Nasscom / MOST Estimates

Retail & entertainment mega trend

According to a joint study by IMAGES Retail and KSA Technopak, India's retail sector in 2006-07 will be characterized by the following -

- 50 million sq ft of quality space under development
- 7 major cities accounting for 41 million sq ft development
- 300 malls (40 in 2005), shopping centres and multiplexes under construction
- Opening of 35 hypermarkets, 325 large department stores, 1,500 supermarkets and over 10,000 new outlets

FOUR MEGA TRENDS - THEMATIC REPRESENTATION



- **IT / ITeS** - growing @ 28-30% per annum
- **Retail & Entertainment** - malls, multiplexes, fast food chains, coffee shop chains, etc
- **SEZs** - offering tax shield for export-oriented businesses
- **Cold chain infrastructure** - to mitigate food product losses estimated at Rs.200b every year.

Source: Motilal Oswal Securities

All this represents huge business opportunity for air-conditioning. Further, the retail sector is not opened up for FDI. If and when that happens, the likes of Walmart and Tesco are likely to line up entry into India, further boosting AC demand.

SEZ mega trend

On 1 April 2000, India's Export-Import Policy provided for setting up of SEZs (special economic zones) for an internationally competitive and hassle free environment for exports. Units set up in SEZs enjoy various tax benefits as do SEZ developers.

Over 150 SEZ proposals are pending clearance by the Indian government. Each SEZ is a minimum of 10 hectares or ~1m sq ft. All SEZs will have the following structures requiring air-conditioning -

- Premium residential township
- Health-care facilities
- Exclusive club house
- Modern shopping malls
- Banks & ATMs
- Food courts

Cold chain mega trend

Cold chain is a logistic system that provides a series of facilities for maintaining ideal storage conditions for perishables from the point of origin to the point of

COLD CHAIN LOGISTICS INFRASTRUCTURE

Farm level -

- Harvest methods (collecting, grading, sorting)
- Pre-cooling facilities
- Cold storages
- Controlled atmosphere storages
- High humidity storages
- Bulk milk carriers

Transport -

- Refrigerated carriers

Retail level -

- Cold storages
- Deep freezers
- Visi coolers
- Milk coolers
- Beer coolers

Consumer level -

- Water coolers
- Bottled water dispensers

consumption in the food supply chain. The chain starts at the farm level (e.g. harvest methods, pre-cooling) and covers up to the retail or consumer level, as the case may be.

In India, a strong cold chain infrastructure will help mitigate food product losses estimated at Rs200b per annum. The potential cold chain market size is placed at Rs100b over the next 4-5 years.

We expect Blue Star to be a major beneficiary of these mega trends.

ANNEXURE 2:

Blue Star background

Blue Star is market leader in central air-conditioning. It also has a wide range of refrigeration products such as freezers, cold storages, water-coolers, etc

| BLUE STAR - FY06 REVENUE BREAKDOWN | | | |
|---|----------------------|--------------------------|--------------|
| Segment | Indian market | Rs b | |
| | | Blue Star Revenue | Share |
| Central air-conditioning | 28.0 | 8.2 | 29% |
| Cooling products | | | |
| Window & split ACs | 28.0 | 1.1 | 4% |
| Refrigeration products | 4.0 | 1.0 | 25% |
| Exports | | 0.6 | |
| Total HVAC & R | 60.0 | 11.0 | |
| Prof. electronics - Trading | | 0.8 | |
| TOTAL REVENUE | | 11.8 | |

Source: Company Presentation

We see Blue Star as a major beneficiary of the 4 mega trends, each of which should drive demand for its products.

Business segments

Blue Star has a presence in 3 segments (FY06 sales mix in brackets):

- Central air-conditioning (70%)
- Cooling & refrigeration products (23%)
- Professional electronics (7%)

Central air-conditioning: This mainly involves design, manufacturing, installation and maintenance of large central AC plants. The division also manufactures and sells packaged and ducted split ACs for smaller spaces e.g. showrooms and restaurants.

Blue Star also maintains over 600,000 tons of AC equipment. Apart from traditional maintenance, it offers value-added services such as Energy / Water / Air Quality management and other customer-centric solutions.

Cooling & refrigeration products: Blue Star has a wide range of window and split room ACs. However, unlike other popular brands - LG, Samsung, Carrier,

etc - Blue Star's prime focus even here is on the corporate and commercial segment. This division also manufactures the complete range of commercial refrigeration equipment such as cold storages, deep freezers, water coolers and bottle coolers.

Professional electronics: This division has 6 SBUs -

- Medical Electronics
- Material Testing Equipment & Systems
- Data Communication Products & Systems
- Test & Measuring Instruments
- Analytical Instruments
- Industrial Products & Systems

Blue Star represents in India several leading professional equipment manufacturers such as Hitachi Japan, Thales e-security UK, Panametrics US and JEOL Japan. Blue Star distributes various hi-tech products for segments such as healthcare, petrochemicals, banking, R&D, quality control, etc. The main form of income is via commission on sales.

Manufacturing facilities

Three of Blue Star's manufacturing facilities are ISO 9001 certified. The company's plants are also integrated via an ERP system.

| Plant | Major Products |
|---------------|---|
| Thane | Chillers and sub-assemblies for central ACs |
| Bharuch | Water coolers, deep freezers, cold room |
| Dadra | Packaged and ducted ACs, window and split ACs |
| Kala Amb (HP) | Window and split ACs |

Other points

- Founded in 1943; one of 50 Indian companies listed on BSE which are more than 60 years old
- 2,000 employees, 23 offices, 570 dealers
- Unbroken dividend record; FY06 dividend Rs12 per share (45% payout).

Segment Analysis

(Rs million)

| Y/E March | 2002 | 2003 | 2004 | 2005 | 2006 |
|-------------------------------|--------------|--------------|--------------|--------------|---------------|
| Sales | 5,080 | 5,869 | 6,975 | 9,208 | 11,746 |
| yoy | | 16% | 19% | 32% | 28% |
| Central AC Systems | 3,183 | 3,667 | 4,787 | 6,515 | 8,213 |
| yoy | | 15% | 31% | 36% | 26% |
| Cooling Products | 1,476 | 1,762 | 1,683 | 2,098 | 2,712 |
| yoy | | 19% | -4% | 25% | 29% |
| Prof. Elec. & Incl. Eqpmt. | 405 | 438 | 501 | 593 | 804 |
| yoy | | 8% | 14% | 18% | 36% |
| Residual | 16 | 2 | 3 | 2 | 17 |
| yoy | | -90% | 121% | -47% | 844% |
| Segment EBIT | 409 | 518 | 550 | 747 | 1,077 |
| EBIT margin | 8.0% | 8.8% | 7.9% | 8.1% | 9.2% |
| Central AC Systems | 320 | 366 | 463 | 603 | 800 |
| EBIT margin | 10.0% | 10.0% | 9.7% | 9.3% | 9.7% |
| Cooling Products | 33 | 63 | -26 | 43 | 132 |
| EBIT margin | 2.2% | 3.6% | -1.5% | 2.1% | 4.9% |
| Prof. Elec. & Incl. Eqpmt. | 74 | 100 | 112 | 120 | 153 |
| EBIT margin | 18.3% | 22.9% | 22.3% | 20.3% | 19.0% |
| Residual | -17 | -11 | 1 | -20 | -8 |
| Other Unallocable Exp. (net) | 80 | 94 | 66 | 190 | 329 |
| % to sales | 1.6% | 1.6% | 0.9% | 2.1% | 2.8% |
| Less : Interest | 56 | 22 | 18 | 32 | 57 |
| % to sales | 1.1% | 0.4% | 0.3% | 0.3% | 0.5% |
| Net Profit Before Tax | 273 | 402 | 466 | 525 | 691 |
| % to sales | 5.4% | 6.8% | 6.7% | 5.7% | 5.9% |
| yoy | 7% | 47% | 16% | 13% | 32% |
| Cap. Emp. in Segment | 926 | 1,070 | 1,413 | 1,748 | 2,384 |
| Central AC Systems | 437 | 524 | 759 | 1,011 | 1,311 |
| Cooling Products | 364 | 410 | 502 | 555 | 869 |
| Prof. Elec. & Incl. Eqpmt. | 78 | 90 | 122 | 155 | 205 |
| Residual | 47 | 46 | 30 | 26 | 0 |
| Unallocated Assets/Liabs. | 378 | 454 | 106 | 109 | 102 |
| Total Capital Employed | 1,305 | 1,524 | 1,519 | 1,857 | 2,486 |
| EBIT / CE | | | | | |
| Segment | 44.1% | 48.5% | 39.0% | 42.7% | 45.2% |
| Central AC Systems | 73.1% | 69.8% | 61.0% | 59.6% | 61.0% |
| Cooling Products | 9.0% | 15.5% | -5.1% | 7.8% | 15.2% |
| Prof. Elec. & Incl. Eqpmt. | 94.4% | 111.3% | 91.7% | 77.5% | 74.7% |
| Overall | 25.2% | 27.8% | 31.9% | 30.0% | 30.1% |



NOTES



For more copies or other information, please contact
Institutional: Navin Agarwal. **Retail:** Relationship Manager (RM) or MOS_t Franchisee
 Phone: (91-22) 39825500 / 56575200 Fax: (91-22) 22816161. E-mail: inquire@motilaloswal.com

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