Q2FY12 Result Update

November 17, 2011

BHEL, the largest engineering and manufacturing enterprise in India in the power equipment sector reported its Q2FY12 results beating street estimates on back of better execution, accounting policy changes and strong performance in the Industry segment. Net Sales for quarter grew 23.7% y-o-y and 44.5% to Rs 10,298.6 cr. Operating margins have come down to 18.6% in Q2FY12 from 19.2% in Q2FY11 but up from 15.3% reported in Q1FY12. Pursuant to change in accounting policy in leave encashment, profits have been positively impacted by Rs 166 cr. Consequently PAT stood at Rs 1,412 cr, up 23.6% y-o-y and 73.1%. Order inflows have grown to 14.3 bn, up 6% y-o-y while order backlog as on September 2011 stood at Rs 1,610 bn.

Key Highlights of the Results

Particulars (Rs cr)	**Q2FY12**	**Q2FY11**	**% chg**	Q1FY12	**% chg**	**H1FY12**	**H1FY11**	**% chg**
Net Sales	**10298.6**	**8328.4**	**23.7%**	**7125.7**	**44.5%**	**17424.3**	**14808.1**	**17.7%**
Other Operating Income	246.9	162.2	52.2%	145.8	69.4%	392.7	283.6	38.5%
Total Operating Income	10545.5	8490.6	24.2%	7271.5	45.0%	17817.0	15091.7	18.1%
Total Expenditure	8586.3	6858.2	25.2%	6158.2	39.4%	14744.6	12494.3	18.0%
EBIDTA	**1959.2**	**1632.4**	**20.0%**	**1113.2**	**76.0%**	**3072.4**	**2597.4**	**18.3%**
Other Income	219.9	162	35.7%	248.7	-11.6%	468.5	325.5	43.9%
Depreciation	188.8	134.1	40.8%	170.9	10.5%	359.7	261	37.8%
EBIT	1990.3	1660.3	19.9%	1191.0	67.1%	3181.2	2661.9	19.5%
Interest	9.7	5.9	64.4%	8.8	10.2%	18.4	9.8	87.8%
PBT	1980.6	1654.4	19.7%	1182.2	67.5%	3162.8	2652.1	19.3%
Tax (incl DT)	568.6	515.9	10.2%	366.7	55.1%	935.2	846	10.5%
Adjusted PAT	1412.0	1138.5	24.0%	815.5	73.1%	2227.6	1806.1	23.3%
Prior period tax	0	-3.8	NA	0.0	NA	0	-3.8	NA
Reported PAT	**1412.0**	**1142.3**	**23.6%**	815.5	**73.1%**	**2227.6**	**1809.9**	**23.1%**
EPS on Reported PAT	5.8	4.7	23.6%	3.3	73.1%	9.1	7.4	23.1%
Equity	489.5	489.5		489.5		489.5	489.5	
Face Value	2	2		2.0		2	2	
OPM (%)	18.6%	19.2%		15.3%		17.2%	17.2%	
NPM (%)	13.4%	13.5%		11.2%		12.5%	12.0%	

(**Source:** Company, HDFC Sec)

- BHEL reported Net Sales of Rs 10,298.6 cr, up 23.7 y-o-y and 44.5% q-o-q. Growth in sales picked up mainly on account of better execution on few high rating sets in the Industry segment and impact of slippages from Q1FY12. Other Operating income was higher by 52.2% y-o-y and 69.4% q-o-q to Rs 246.9 cr.

- Operating margins have expanded sequentially to 18.6% from 15.3% in Q1FY12, up 330 bps q-o-q. The favourable impact on margins came through also because of accounting change in the leave encashment policy of the company whereby company has accounted the leave encashment expenditure with 30 days a month as base for computation of encashment of leave against the earlier formula of computation of leave encashment based on 26 days a month. Consequently staff costs a percentage cost of sales have come down to 13.1% in Q2FY12 from 18.3% in Q1FY12 even as input cost and other expenses have risen to 59.4% (58.2% in Q1FY12) and 10.9% (9.9% in Q1FY12) respectively. Operating margins over corresponding quarter last year have fallen 60 bps from 19.2% because of higher other expenses which rose from 10.9% as percentage cost to sales from 7.6%.

Cost as a % of sales	**Q2FY12**	**Q2FY11**	**Q1FY12**	**H1FY12**	**H1FY11**
Input Cost	59.4%	59.6%	58.2%	58.9%	59.2%
Staff Cost	13.1%	15.2%	18.3%	15.2%	17.6%
Other expenses	10.9%	7.6%	9.9%	10.5%	7.6%

(**Source:** Company, HDFC Sec)

BHEL has made higher provision on liquidated damages and provisions on contractual obligations of Rs 200-250 cr during the quarter.

- Interest costs though still negligible for the company stood at Rs 9.7 cr against just Rs 5.9 cr in Q1FY11 on higher borrowings. Depreciation stood at Rs 188.8 cr, up 40.8% y-o-y and 10.5% q-o-q.

- The impact of accounting change in leave encashment policy buffed up PBT by Rs 166 cr which resulted in PBT growth of 67.5% q-o-q and 19.7% y-o-y to Rs 1,980.6 cr. If this is not taken into account, PBT growth would have been lower at 9.7% q-o-q and 53.5% y-o-y. Other income growth of 35.7% to Rs 219.9 cr also helped the company post better PBT growth y-o-y. Tax rate for Q2FY12 was lower at 28.7% compared to 31.2% in Q2FY11 and 31% in Q1FY12 due to R&D benefits which is entitled for tax benefits under Section 35(2AB). PAT grew 23.6% y-o-y and 73.1% q-o-q to Rs 1,412 cr.

- For the H1FY12, BHEL reported a 17.7% increase in net sales to Rs 17,424.3 cr. Other income was up 43.9% to Rs 468.5 cr. Operating margins have been maintained at 17.2%. Interest and Depreciation costs were up 87.8% and 37.8% respectively to Rs 18.4 cr and Rs 359.7 cr. PBT grew 19.3% to Rs 3,162.8 cr. Tax rate was lower at 29.6% compared to 31.9% which led to a better PAT growth of 23.1% to Rs 2,227.6 cr.

- BHEL's debt on books has increased significantly by Rs 1063.1 cr over last year to Rs 1480.1 cr as on September 2011. Net Core Working capital has gone up considerably (up 238% y-o-y) with increase in inventories and debtors and shortfall in advances.

Segmental Analysis

Particulars (Rs cr)	Q2FY12	Q2FY11	% chg	Q1FY12	% chg	H1FY12	H1FY11	% chg
Revenue								
Power	7797.3	7054.7	10.5%	5780.3	34.9%	13577.6	12428	9.3%
Industry	2960.3	1660.8	78.2%	1652.9	79.1%	4613.2	3048.7	51.3%
Total Revenue	10757.6	8715.5	23.4%	7433.2	44.7%	18190.8	15476.7	17.5%
EBIT								
Power	1315.9	1418.6	-7.2%	951.8	38.3%	2267.7	2489.2	-8.9%
Industry	800.4	336.8	137.6%	373.3	114.4%	1173.7	530	121.5%
Total EBIT	2116.3	1755.4	20.6%	1325.1	59.7%	3441.4	3019.2	14.0%
Revenue Mix								
Power	72.5	80.9		77.8		74.6	80.3	
Industry	27.5	19.1		22.2		25.4	19.7	
EBIT Margin (%)								
Power	16.9	20.1		16.5		16.7	20.0	
Industry	27.0	20.3		22.6		25.4	17.4	
Capital Employed								
Power	8272.2	3430.8		6627.2		8272.2	3430.8	
Industry	3996.2	1696.1		3565.3		3996.2	1696.1	
Unallocated net assets / liabilities	7702.4	9919.4		170641.5		7702.4	9919.4	
Total	19970.8	15046.3		180834.0		19970.8	15046.3	

(Source**:** Company, HDFC Securities)

Industry segment continue to outperform the Power segment in the second quarter as well in terms of revenue growth and profit growth. Share of Power segment to company's revenues has come down to 72.5% from 80.9% while that of Industry segment has gone up to 27.5% from 19.1% on a year on year basis. Revenues of the power segment grew 10.5% y-o-y and 34.9% q-o-q to Rs 7,797.3 crs while Industry segment revenues have gone up 78.2% y-o-y and 79.1% q-o-q to Rs 2,960.3 cr.

Out of the total order inflows of Rs 143 bn, the power sector has orders worth Rs 90.2 bn while industry sector orders stood at Rs 56 bn and balance others. Power sector included orders from (1) 2X660 MW – Singraini Coalfields valued at Rs 40.1 bn and (2) 2X660 MW – Dainik Bhaskar Group valued at Rs 37.8 bn.

EBIT of Power segment has come down 7.2% y-o-y and up 38.3% q-o-q to Rs 1,315.9 cr. Margins for the segment sequentially have come down from 20.1% to 16.9%. The Industry segment posted improvement in EBIT margins from 22.6% in Q1FY12 and 20.3% in Q2FY11 to 27% in Q2FY12. EBIT has grown 137.6% y-o-y and 114.4% y-o-y to Rs 800.4 cr in this segment. There has been a shift of Captive Power Plant customers to higher MW ratings which are getting reflected in the higher margins. The management however, expects the segment margins to be at stable normal levels for the full year.

Order Inflow & Order Book

Particulars (in billion)	Q2FY12	Q2FY11	% chg	Q1FY12	% chg	H1FY12	H1FY11	% Chg	FY11	FY10	% Chg
Order backlog	1610	1540	4.5%	1596	0.9%	1610	1540	-1.7%	1624	1443	12.5%
Order inflow	143	135	6%	25	478.7%	168	242	-89.4%	605	610	-0.8%

(Source: Company, HDFC Securities)

With the sharp fall in order intake witnessed in Q1FY12 to 25 bn, Q2FY12 order booking gave some respite to the company. Orders inflows stood at Rs 143 bn, 6% up y-o-y. However, for the half year FY12, order inflows were only Rs 168 bn compared to Rs 242 bn in H1FY11.

Order backlog as of September 2011, stood at Rs 1,610 bn compared to Rs 1,540 bn last year. The current order backlog is 3.6x trailing twelve months revenues of Rs 44,195 cr.

BHEL commissioned 3,025 MW for H1FY12 of which Q2FY12 commissioning stands at 1775 MW. The company has a target commissioning of 12,000 MW for FY12E. While the management had indicated in Q1FY12 that they would report TNEB JV by Q3 and Q4 of FY12, it has indicated this quarter that it is yet to get coal linkage for this JV. This raises concern on full year revenues for FY12.

Under the NTPC projects BHEL is likely to get orders of Rs 6,520 cr, provided it matches the L1 quotations for the supply of supercritical BTG for the 7,200MW (9x 800MW) power projects. Under highly aggressive bidding for these projects, Doosan and BGR Systems emerged as the lowest bidders and are likely to get five units of order in the respective categories.

Other Developments / Takeaways

Capex on additional capacity of 20 GW - Management has given capex guidance of ~Rs 1200 cr in FY12. The company is raising manufacturing capacity to 20 GW by March 2012. It is looking at synchronising ~12 GW during FY12E.

Guidance - The management was unable to give order inflow guidance due to the silent period before the FPO.

FPO & Stock Split – Under 5% disinvestment of equity capital out of Government's shareholding, BHEL has filed the DRHP. The company has undergone a stock split from Rs 10 to Rs 2 on 4th October 2011.

Concerns

- Delays in power-sector reforms could affect order flows and earnings.
- Regulatory uncertainties.
- Decline in order inflows is a cause of concern for BHEL.
- Execution delays in orders.
- Super-critical equipment has lower margins due to the high import component requirement, which could put pressure on BHEL's margins going ahead. However, BHEL is an integrated manufacturer and the management expects the import component requirement to reduce going ahead as BHEL gains scale of operations and hence the impact on margins to be mitigated.
- Competition pressures from global majors: In the domestic market, BHEL is facing stiff competition from international players, particularly from Chinese power plant equipment (PPE) manufacturers, who have twin advantages of economies of scale and global reach. This threat may be mitigated if the proposal of heavy industry ministry to levy 14% import duty on power equipment is implemented.
- Margin contraction due to higher commodity prices.
- Currency appreciation may lead to preference for imported equipment.

Conclusion

BHEL is the largest engineering and manufacturing enterprise in India in the energy-related/infrastructure sector accounting for around 65% of India's installed power capacity. It caters to the core sectors of the Indian Economy, viz. Power, Transmission, Industry, Transportation, Renewable Energy, Oil & Gas and Defence.

Improved visibility and thrust on power reforms by the government could result in an addition of ~55-62 GW of generation capacity in India over the Eleventh Plan, entailing an investment of ~INR 4.2 trillion. Of the above capacity addition, ~65% plus is estimated to be from thermal-based power plants. This is a positive for BHEL as its forte lies in setting up coal-based power plants. BHEL has also demonstrated its skill in hydro power projects. Further, to cater to the country's ambitious future power-capacity addition programme, BHEL is also planning to increase its capacity to 20 GW by March 2012 from the existing 15 GW.

For H1FY12, BHEL posted 17.7% growth in Net Sales to Rs 17,424.3 and 23.1% growth in PAT to Rs 2,227.6 cr over H1FY11. Operating margins were steady at 17.2%. Order backlog at the end of Q2FY12 stands at Rs.1610 bn which is 3.6x latest trailing four quarters providing one of the best revenue visibility in Engineering space.

Backlog addition has slowed as new orders have got postponed on tough macro and bureaucratic hurdles. Concerns remain over revenue growth beyond FY13 owing to limited order pipeline and intensifying domestic competition, which are likely to put pressure on margin going forward. However, the company expects to maintain margins on the back of cost savings and technology innovation. Indigenization should grow on supercritical sets, which will help sustain margins. FIIs stake which has been falling over last 4-5 quarters (from 17.07% in June 30, 2009 qtr to 12.90% in March 2011 qtr) had risen marginally to 13.07% in June 2011 but again fallen to 12.87% in September 2011.

In Q1FY12, BHEL had guided for 10% order inflow growth at Rs 667 bn for FY12 which seems highly improbable with order inflows of only Rs 168 bn in the first half of the FY12. The second half of FY12 needs order inflows of almost 500 bn to meet this target which is at risk due to project deferments, coal linkages and financial closures in an era of high interest rates and would be difficult to meet. If the current order book condition does not improve in FY12, then company's earnings in FY14-FY15 are likely to be under pressure.

In Q2FY12, accounting policy for leave encashment was changed to a base of 30-day month compared with 26-day month earlier. This resulted in lower actuarial liability in employee costs boosting profits by Rs 166 cr. This is a continuation in trend of accounting policy changes boosting profits and is the second such accounting change in past 3 quarters. The management could not give any comment on the way this change will affect the margins going ahead (in compliance to the silent period before FPO)

We are revising downward our FY12 estimates and introducing FY13 estimates. Given the performance in first six months in FY12 and the dull outlook expected in the second half we expect subdued sales and profits in FY12E. The current order backlog is 3.6x trailing twelve months revenues of Rs 44,195 cr which offers some respite for FY12. However, if the stagnation in new order intake witnessed in the first half of FY12 continues the performance of BHEL is likely to be affected in FY13 and beyond. The imposition of import duty on mega and ultra mega power projects are a strong positive, though its impact will largely be visible once the 13th Plan ordering starts. Power sector is undergoing a lot of churn and uncertainty lately in environmental clearances and coal availability which have bought stagnation in capacity additions. RRVUNL's Chabra & Suratgarh - 2X660 MW plants getting coal linkage & NTPC planning to go ahead with its 11X660 MW & 9X880 MW packages are few positives trickling in into the sector but largely the view remains skewed downwards. In FY13, further pressure on margins can be expected under the present competitive scenario.

Stretched working capital (rising inventory & debtor days and falling advances) and possibility of downward revision in guidance of order inflow could be negative triggers going forward.

The stock is currently trading at 12.8x FY12E. Historically, BHEL has traded between 15-30x one-year forward earnings, with an average of 23x. Though BHEL is trading below its historical average P/E, we feel the stock has undergone a de-rating in the recent past due to issue in coal availability/linkages, drop in merchant power tariffs, poor condition of SEBs, legal tangles in some tenders, delay in order inflow and competition concerns. The positives of intermediate term visibility of revenues and expanded capacity could be partly offset by concerns on long term visibility of revenues due to emerging competition, pressure on margins and overhang of supply of stock due to possible equity dilution. Execution risks have increased due to higher exposure to private capex compared to earlier days where it was exposed to the public sector only. The proposed FPO for which BHEL has filed the DRHP will also be an overhang for the stock

In our Q2FY12 Result Update dated July 29 2011 we had stated, "We expect BHEL to trade in Rs.345 to Rs. 387 price band (12.5x-14x FY12 (E) EPS) (adjusted for stock split) for the next quarter." Thereafter, the stock touched a low of Rs. 286 on (post Q2FY12 result) and a high of Rs. 372 on 1st August 2011.

We expect BHEL to trade in the range of Rs 260 – Rs 338 (10x-13x FY13E EPS) for the next quarter.

Financials

Particulars (Rs cr)	FY09	FY10	FY11 (A)	FY12 (OE)	FY12 (RE)	FY13(E)
Net Sales (incl Op Income)	26859	33573	42496	50310	47045	53631
EBIDTA	4426	6258	9605	10062	8703	9761
OPM (%)	16.5%	18.6%	22.6%	20.00%	18.5%	18.2%
Reported PAT	3138	4311	5930	6769	5797	6382
EPS	12.8	17.6	24.2	27.7	23.7	26.1
P/E	24.2	17.6	12.8	11.21	13.1	11.9
PAT (%)	11.7%	12.8%	14.0%	13.5%	12.3%	11.9%

(OE: Original Estimates, RE: Revised Estimates, Source: Company, HDFC Sec)

Analyst: Siji A. Philip (siji.philip@hdfcsec.com)

RETAIL RESEARCH Tel: (022) 3075 3400 Fax: (022) 2496 5066 Corporate Office
HDFC Securities Limited, I Think Techno Campus, Building - B, "Alpha", Office Floor 8, Near Kanjurmarg Station, Opp. Crompton Greaves, Kanjurmarg (East), Mumbai 400 042 Phone: (022) 3075 3400 Fax: (022) 2496 5066 Website: www.hdfcsec.com
Email: hdfcsecretailresearch@hdfcsec.com