

Declining orders are a concern

Lower medium-term visibility drives rating downgrade

February 8, 2012

Rating Down from Neutral	Reduce
Target price Reduced from 500	INR 440
Closing price February 7, 2012	INR 487
Potential downside	-9.7%

Action: Medium-term concerns, valuation drives stock downgrade

Thermax's Q3FY12 order inflow fell ~40% y-y, thus driving a 19% y-y decline in its orderbook. Continued deferral of order inflow in the power utility sector and the industrial customers has raised concerns on Thermax's medium-term revenue visibility. Weak results and dismal management commentary concur with our view of risks to medium-term revenue growth and margins. Despite being strongly managed, we believe it would be difficult for the company to escape from cyclical pressures.

- The Projects business faces medium-term concerns due to the industrial slowdown and rising competition, despite slowing demand.
- Slower order inflow and rising competition in the utility space are likely to lead to slower sales growth over FY12-13F, though longer-term order flow will be driven by demand pick-up from process industries.
- While we had first highlighted slowdown concerns in our Anchor report *Assessing earnings risk*, the order inflow and margin outlook has worsened further since then, thus driving our earnings cut by 5-15%.

Catalysts: Macro factors to drive stock performance

Continued delay in policy reforms, industrial capex, poor order inflows and sustained high levels of commodity prices are key negative catalysts.

Valuation: Trading at ~18x FY13F EPS; downgrade to REDUCE

At ~18x FY13F EPS, Thermax is now trading at the upper end of peer group evaluation and its own historical trading band. We continue to value the stock at 14x Sep-13F EPS which is in line with 12-year mean multiple for TMX. With ~10% downside, we downgrade TMX to REDUCE.

31 Mar	FY11	FY12F		FY13F		FY14F	
Currency (INR)	Actual	Old	New	Old	New	Old	New
Revenue (mn)	53,371	59,818	55,773	59,246	48,632	70,019	56,572
Reported net profit (mn)	3,817	4,127	3,931	3,912	3,346	4,671	4,143
Normalised net profit (mn)	3,817	4,127	3,931	3,912	3,346	4,671	4,143
Normalised EPS	32.03	34.64	32.99	32.83	28.08	39.20	34.77
Norm. EPS growth (%)	47.3	8.1	3.0	-5.2	-14.9	19.4	23.8
Norm. P/E (x)	15.7	N/A	15.2	N/A	17.9	N/A	14.4
EV/EBITDA (x)	9.4	8.0	9.2	8.2	10.9	6.6	8.4
Price/book (x)	4.5	N/A	3.8	N/A	3.3	N/A	2.8
Dividend yield (%)	2.1	N/A	1.9	N/A	1.6	N/A	2.0
ROE (%)	31.9	28.2	27.0	22.4	19.5	22.8	21.0
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash	net cash	net cash

Source: Company data, Nomura estimates

Key company data: See page 2 for company data and detailed price/index chart.

Anchor themes

We believe India's industrial sector offers significant opportunity over the coming years. We see potential opportunities in niche segments.

Nomura vs consensus

We are more cautious than consensus on near-term earnings strength (FY13F EPS 20% below consensus) given our expectation of an industrial slowdown.

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See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Key data on Thermax

Income statement (INRmn)

Year-end 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
Revenue	33,703	53,371	55,773	48,632	56,572
Cost of goods sold	-20,713	-36,787	-37,976	-32,214	-38,060
Gross profit	12,990	16,584	17,797	16,418	18,512
SG&A	-6,186	-6,788	-7,671	-6,904	-7,456
Employee share expense	-3,300	-4,597	-4,965	-5,263	-5,684
Operating profit	3,505	5,199	5,161	4,251	5,372
EBITDA	3,947	5,740	5,789	4,962	6,165
Depreciation	-442	-541	-628	-711	-793
Amortisation					
EBIT	3,505	5,199	5,161	4,251	5,372
Net interest expense	-20	-41	-40	-40	-40
Associates & JCEs					
Other income	519	579	660	710	760
Earnings before tax	4,004	5,737	5,781	4,921	6,092
Income tax	-1,416	-1,967	-1,850	-1,575	-1,949
Net profit after tax	2,588	3,770	3,931	3,346	4,143
Minority interests	4	47	0	0	0
Other items					
Preferred dividends					
Normalised NPAT	2,592	3,817	3,931	3,346	4,143
Extraordinary items	-1,149	0	0	0	0
Reported NPAT	1,443	3,817	3,931	3,346	4,143
Dividends	-695	-1,246	-1,146	-976	-1,208
Transfer to reserves	748	2,570	2,785	2,371	2,935

Valuation and ratio analysis

FD normalised P/E (x)	23.1	15.7	15.2	17.9	14.4
FD normalised P/E at price target (x)	20.2	13.7	13.3	15.7	12.7
Reported P/E (x)	41.4	15.7	15.2	17.9	14.4
Dividend yield (%)	1.2	2.1	1.9	1.6	2.0
Price/cashflow (x)	9.0	25.8	15.4	31.8	13.6
Price/book (x)	5.5	4.5	3.8	3.3	2.8
EV/EBITDA (x)	13.5	9.4	9.2	10.9	8.4
EV/EBIT (x)	15.2	10.3	10.4	12.7	9.6
Gross margin (%)	38.5	31.1	31.9	33.8	32.7
EBITDA margin (%)	11.7	10.8	10.4	10.2	10.9
EBIT margin (%)	10.4	9.7	9.3	8.7	9.5
Net margin (%)	4.3	7.2	7.0	6.9	7.3
Effective tax rate (%)	35.4	34.3	32.0	32.0	32.0
Dividend payout (%)	48.1	32.7	29.2	29.2	29.2
Capex to sales (%)	2.5	6.1	2.7	3.1	2.7
Capex to depreciation (x)	1.9	6.0	2.4	2.1	1.9
ROE (%)	13.9	31.9	27.0	19.5	21.0
ROA (pretax %)	14.8	17.2	14.9	12.2	15.6

Growth (%)

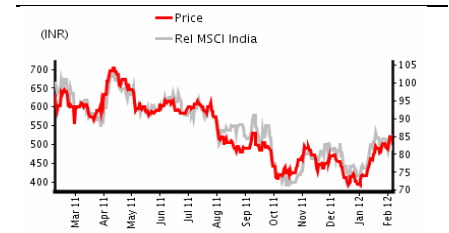
Revenue	-2.6	58.4	4.5	-12.8	16.3
EBITDA	-6.4	45.4	0.9	-14.3	24.2
EBIT	-9.4	48.3	-0.7	-17.6	26.4
Normalised EPS	-9.9	47.3	3.0	-14.9	23.8
Normalised FDEPS	-9.9	47.3	3.0	-14.9	23.8

Per share

Reported EPS (INR)	12.11	32.03	32.99	28.08	34.77
Norm EPS (INR)	21.75	32.03	32.99	28.08	34.77
Fully diluted norm EPS (INR)	21.75	32.03	32.99	28.08	34.77
Book value per share (INR)	90.48	110.35	133.72	153.62	178.25
DPS (INR)	5.83	10.46	9.62	8.19	10.14

Source: Company data, Nomura estimates

Relative performance chart (one year)



Source: ThomsonReuters, Nomura research

(%)	1M	3M	12M
Absolute (INR)	20.6	2.5	-23.6
Absolute (USD)	29.6	2.7	-29.0
Relative to index	7.6	1.6	-21.3
Market cap (USDmn)	1,218.6		
Estimated free float (%)	33.9		
52-week range (INR)	720/380.6		
3-mth avg daily turnover (USDmn)	1.03		
Major shareholders (%)			
RDA Holding & Trading	54.0		
Aga Arnawaz Rohitz	8.2		

Source: Thomson Reuters, Nomura research

Notes

We expect a revenue decline over FY12-FY14F

Cashflow (INRmn)

Year-end 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
EBITDA	3,947	5,740	5,789	4,962	6,165
Change in working capital	4,687	-2,118	-718	-2,229	218
Other operating cashflow	-2,002	-1,301	-1,180	-854	-1,989
Cashflow from operations	6,632	2,320	3,891	1,878	4,394
Capital expenditure	-838	-3,265	-1,500	-1,500	-1,500
Free cashflow	5,794	-945	2,391	378	2,894
Reduction in investments	-2,260	1,289	-875	0	0
Net acquisitions					
Reduction in other LT assets	-90	7	0	0	0
Addition in other LT liabilities	74	147	0	0	0
Adjustments	46	-330	-50	-50	125
Cashflow after investing acts	3,564	168	1,466	328	3,019
Cash dividends	-695	-1,246	-1,146	-976	-1,208
Equity issue	0	0	0	0	0
Debt issue	39	1,400	-1,399	0	0
Convertible debt issue					
Others	98	473	0	0	635
Cashflow from financial acts	-558	626	-2,545	-976	-573
Net cashflow	3,006	794	-1,080	-648	2,447
Beginning cash	3,696	6,702	7,496	6,417	5,769
Ending cash	6,702	7,496	6,417	5,769	8,216
Ending net debt	-6,623	-6,017	-6,337	-5,689	-8,136

Source: Company data, Nomura estimates

Notes

We believe net addition to cash is under pressure as rising working capital is straining operating cash flow.

Balance sheet (INRmn)

As at 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
Cash & equivalents	6,702	7,496	6,417	5,769	8,216
Marketable securities	0	0	0	0	0
Accounts receivable	7,984	10,672	11,286	9,154	9,143
Inventories	2,563	3,657	3,786	3,193	3,778
Other current assets	7,057	8,143	8,309	7,816	8,357
Total current assets	24,306	29,968	29,797	25,932	29,493
LT investments	3,703	2,415	3,290	3,290	3,290
Fixed assets	5,484	8,208	9,079	9,868	10,575
Goodwill					
Other intangible assets					
Other LT assets	297	289	289	289	289
Total assets	33,790	40,880	42,455	39,380	43,647
Short-term debt	80	1,479	80	80	80
Accounts payable	20,581	22,193	22,511	17,262	18,378
Other current liabilities	1,813	2,951	2,823	2,626	2,842
Total current liabilities	22,474	26,623	25,414	19,968	21,300
Long-term debt					
Convertible debt					
Other LT liabilities	441	588	588	588	588
Total liabilities	22,914	27,211	26,001	20,555	21,888
Minority interest	94	520	520	520	520
Preferred stock	0	0	0	0	0
Common stock	238	238	238	238	238
Retained earnings	10,543	12,911	15,696	18,066	21,001
Proposed dividends					
Other equity and reserves					
Total shareholders' equity	10,782	13,149	15,934	18,305	21,239
Total equity & liabilities	33,790	40,880	42,455	39,380	43,647

Notes

In our view, rising working capital pressure is likely to hurt return ratios as the cash cycle elongates.

Liquidity (x)

Current ratio	1.08	1.13	1.17	1.30	1.38
Interest cover	172.7	126.8	129.0	106.3	134.3

Leverage

Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash

Activity (days)

Days receivable	74.2	63.8	72.0	76.7	59.0
Days inventory	47.3	30.9	35.9	39.5	33.4
Days payable	287.7	212.2	215.4	225.3	170.9
Cash cycle	-166.2	-117.5	-107.5	-109.1	-78.4

Source: Company data, Nomura estimates

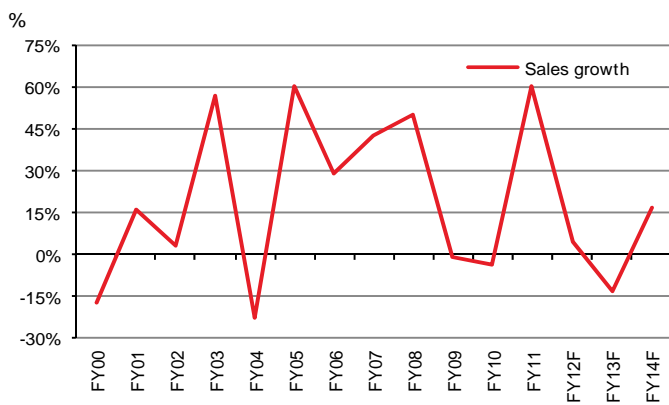
Concerns on revenue visibility, order inflows drive the rating downgrade

As noted in our October 12, 2011 Anchor report, *Assessing earnings risk*, our concerns on sales growth for Thermax are now playing out. In our view, the surge in Thermax's sales following a high share of utility orders looks unsustainable over the long term, while slowing industrial capex could add further pressure to the shares.

As Fig 1 suggests, TMX's sales growth is highly volatile during changing macro-economic conditions. We do not rule out a similar slowdown from current levels in case of a severe slowdown in the company's domestic industrial capex.

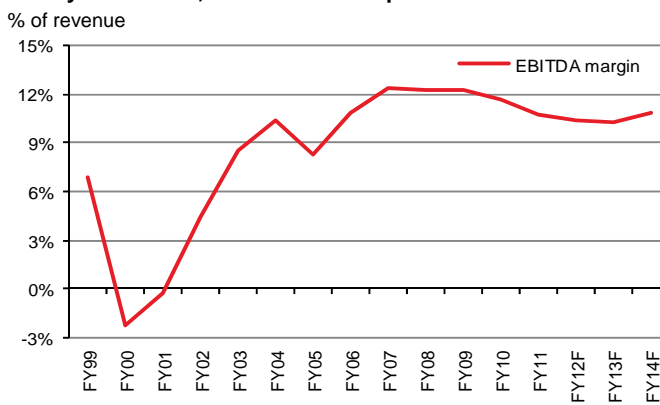
In our view, margins are now much better than in previous peaks or lows as a result of Thermax's sustained improvement in business performance. However, the drying up of orders and which accompanies revenue slowdown could pressure margins from current peak levels.

Fig. 1: Volatile sales growth, expected to be subdued in near term



Source: Company data, Nomura research

Fig. 2: Sharp rise in margins since FY02 and has been steady since then, within + / - 200 bps from 12%

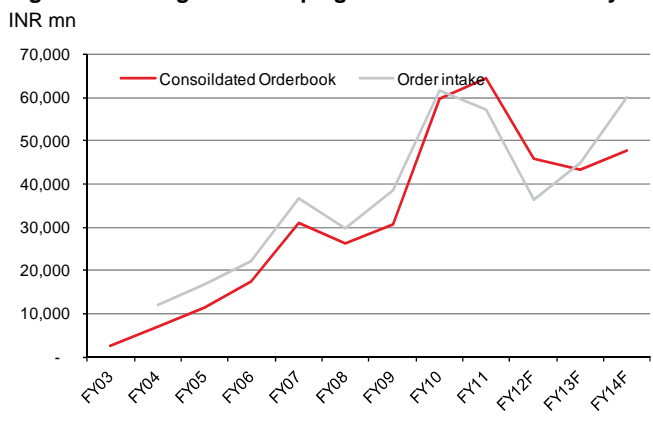


Source: Company data, Nomura research

Weak order inflow a key concern

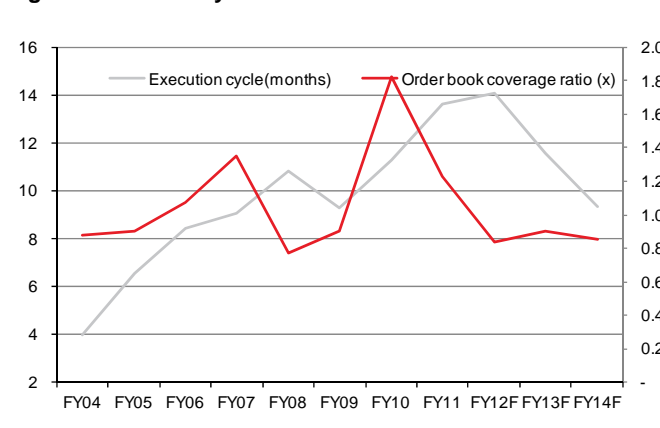
Thermax's consolidated order inflow for 9MFY12 declined by 17% against 9MFY11. While Thermax's short-cycle products business is likely to continue in the near term, we believe there are risks to its projects business, especially in the power sector. Further, Thermax has witnessed high volatility during cycle turns and we believe that this time will be no different. Policy logjams impacting decision-making on large industrial and power capex are only likely to worsen the scenario, in our view. Implied execution cycle is also expected to return to normal levels of 9-10 months once the utility orders are complete.

Fig. 3: Declining orders to plague medium-term visibility



Source: Company data, Nomura research

Fig. 4: Execution cycle to return to 9-10 months

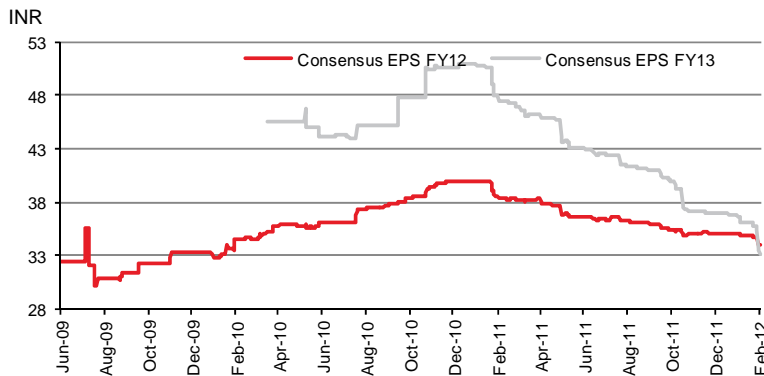


Source: Company data, Nomura research

What are consensus estimates building in?

Even as we highlight the risk of a slowdown in sales growth and about a 100 bp risk to margins, we believe consensus estimates have yet to factor these in. So far we have seen a 15-35% correction in consensus EPS estimates since peak levels for both FY12 and FY13, but factoring in the above, we see 15-20% further downside.

Fig. 5: FY12/13F est. down 15-35% from peak so far



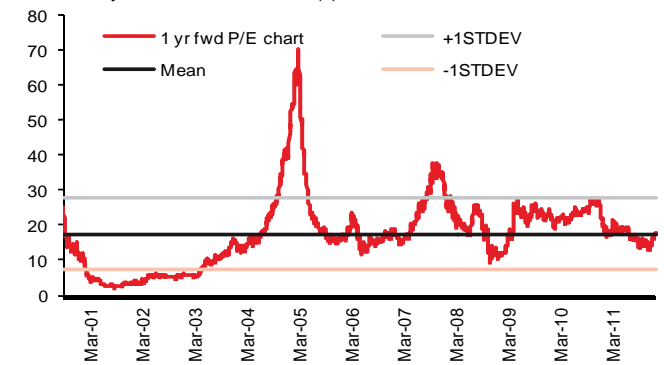
Source: Company data, Bloomberg

What is the valuation factoring in?

While consensus estimates have yet to correct, as mentioned above, we note that the stock is currently trading at its 12-year mean multiples. In our view, a correction in earnings would imply that the stock is still at around its mid-cycle trading range.

Fig. 6: Stock trading at 12-yr mean on P/E...

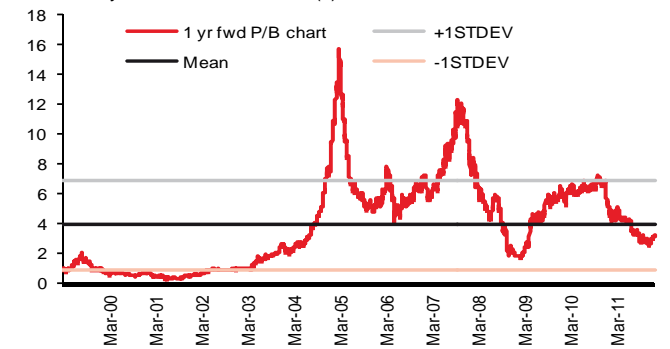
Thermax 1-year forward P/E chart (x)



Source: Company data, Bloomberg, Nomura estimates

Fig. 7: ...and marginally lower on P/B

Thermax 1-year forward P/B chart (x)



Source: Company data, Bloomberg, Nomura estimates

Q2FY12 results review

Above or below estimates

Thermax's Q3FY12 reported PAT came in below our and consensus estimates by 15% and 6%, respectively. In our view, lower-than-expected sales and decline in EBITDA margin were key disappointments in the results.

Fig. 8: Thermax's 3QFY12 results – Actual vs. estimates

INR Mn	Dec-11	Nomura Est	Consensus Est	Dec-10	Sep-11	Change y-y	Change q-q	Vs Nomura Est	Vs Consensus Est
Net Sales	12,693	13,547	13,608	12,412	13,035	2%	-3%	-6%	-7%
Operating EBITDA	1,354	1,709	1,486	1,464	1,405	-8%	-4%	-21%	-9%
EBITDA Margin	10.7%	12.6%	10.9%	11.8%	10.8%				
Reported PAT	955	1,127	1,019	1,002	1,017	-5%	-6%	-15%	-6%
Recurring EPS (Rs)	8.01	9.46	8.68	8.41	8.53	-5%	-6%	-15%	-8%

Source: Company data, Nomura estimates, Bloomberg

What the results mean

- Disappointment in sales was led by energy segment sales, which were flat y-y, while the environment segment grew marginally by ~3% y-y. Revenue from domestic operations was flat at INR9.29bn, while exports grew by 18% y-y to INR3.23bn.
- EBITDA margins have declined by 110 bps y-y to 10.7% against our expectation of an 80bps rise y-y mainly on account of increased staff cost and other expenditures. Profitability suffered by 100bps, due to a forex loss (~INR127mn).
- RM/sales has gone down in line with our expectations, however, the increase in other expenditure cancelled out the improvement.
- Overall, results were lower than expectations across the board by 7-8% on consensus estimates

Key takeaways from management's conference call post the 1QFY12 results

- Consolidated order book for Thermax declined ~19% y-y given weak order inflows (down 40% y-y). There has been no major order booked in this quarter, except for one order of INR700mn from a ferrous metallurgy company. EPC order book stands at INR15.75bn.
- Execution is on track for most of the projects and only ~10% of the order book is facing delays in execution, as per management.
- Net working capital increased to INR1.75bn mainly as cash advances going down by INR1bn. There has been no deterioration in inventory levels since H1FY12. Receivables, however, have gone up by INR500-600mn as collections are difficult in this quarter as well.
- New factory for the Thermax-Babcock & Wilcox JV is expected to be operational by Sep 2013, in line with management's expected timeline. Management mentions that it has not ramped up manpower owing to the slowdown in the power sector. The cash breakeven is also now expected to be later by roughly one year.
- Management mentions that a decline in sales is possible in coming quarters as well. Revenue growth is likely to be flat or even decline in FY13F, as per management.
- Management guides that oil and gas along with metals will be the segments contributing towards growth going forward. Management expects the cement sector to improve in the next two to three quarters.

Key Numbers

- Net sales were flat at INR12.7bn vs our and consensus estimates of INR13.5 bn.
- EBITDA margins have gone down by 110 bps y-y to 10.7% against our expectation of 80bps rise y-y.
- PAT at INR955mn is down 5% y-y and lower by 15% vs. Nomura estimates.

Fig. 9: Thermax's Q3FY12 results

INR Mn	Dec-11	Dec-10	Sep-11
Net Sales / Interest Earned / Operating Income	12,629.7	12,161.2	12,867.3
Other operating income	63.8	250.5	167.5
Expenditure	(11,339)	(10,948)	(11,630)
Operating Profit	1,354.4	1,464.2	1,404.8
Depreciation	(119.8)	(105.5)	(117.2)
Other Income	156.6	116.9	208.0
Profit Before Interest and Tax	1,391.2	1,475.5	1,495.6
Interest	(7.0)	(2.0)	(11.0)
Profit before Tax	1,384.2	1,473.4	1,484.5
Tax	(429.3)	(471.2)	(467.7)
Profit after Tax	955.0	1,002.2	1,016.9
Extraordinary Items			
Net Profit	955.0	1,002.2	1,016.9
EPS	8.01	8.41	8.53
EBITDA Margin	10.7%	11.8%	10.8%
Tax rate	31.0%	32.0%	31.5%
(Increase)/Decrease in Stock in Trade and Work in Progress	(47.6)	(10.2)	(5.7)
Consumption of Raw Materials	8076.3	8188.3	8838.2
Purchase of Traded Goods	660.3	468.1	298.3
Employees Cost	1042.0	974.7	985.5
Other Expenditure	1608.1	1326.7	1513.7
Total Expenditure	11339.1	10947.5	11630.0
Revenue growth y-y	2.3%	65.9%	19.4%
EBITDA growth y-y	(7.5%)	63.8%	9.3%
Adj. PAT growth y-y	(4.7%)	77.4%	13.6%
RM cost as % of revenues	68.5%	69.7%	70.0%
Employee cost as % of revenues	8.2%	7.9%	7.6%
Other Exp as % of revenues	12.7%	10.7%	11.6%
Total exp as % of revenues	89.3%	88.2%	89.2%

Source: Company data

Cutting estimates on slowdown concerns; Downgrade to Reduce

While Thermax's short-cycle products business is likely to continue in the near term, we believe there are risks to its projects business, especially in the power sector. We have factored in significantly slower growth for Thermax over FY12-13F, which is accompanied by a drop in margins as well; our new assumptions drive our earnings cut of 5-15% over FY12-13F.

Accordingly, we have cut our TP to INR440, now based on 14x Sep-13F EPS of INR31.4. Our valuation method remains unchanged at 14x 1 year forward earnings which is the mean multiple of the past 12 years. The stock offers a potential downside of 10% on our new TP.

Risks to our investment view

- Significant decline in commodity prices could benefit margins for Thermax.
- Stronger-than-expected pick up in industrial and/or power capex cycle could be an upside risk.

Appendix A-1

Analyst Certification

We, Amar Kedia and Indrajit Yadav, hereby certify (1) that the views expressed in this Research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Research report and (3) no part of our compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

Issuer Specific Regulatory Disclosures

Mentioned companies

Issuer name	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Thermax	TMX IN	INR 487	07-Feb-2012	Reduce	Not rated	123

Disclosures required in the U.S.

123 Market Maker - NSI

Nomura Securities International Inc. makes a market in securities of the company.

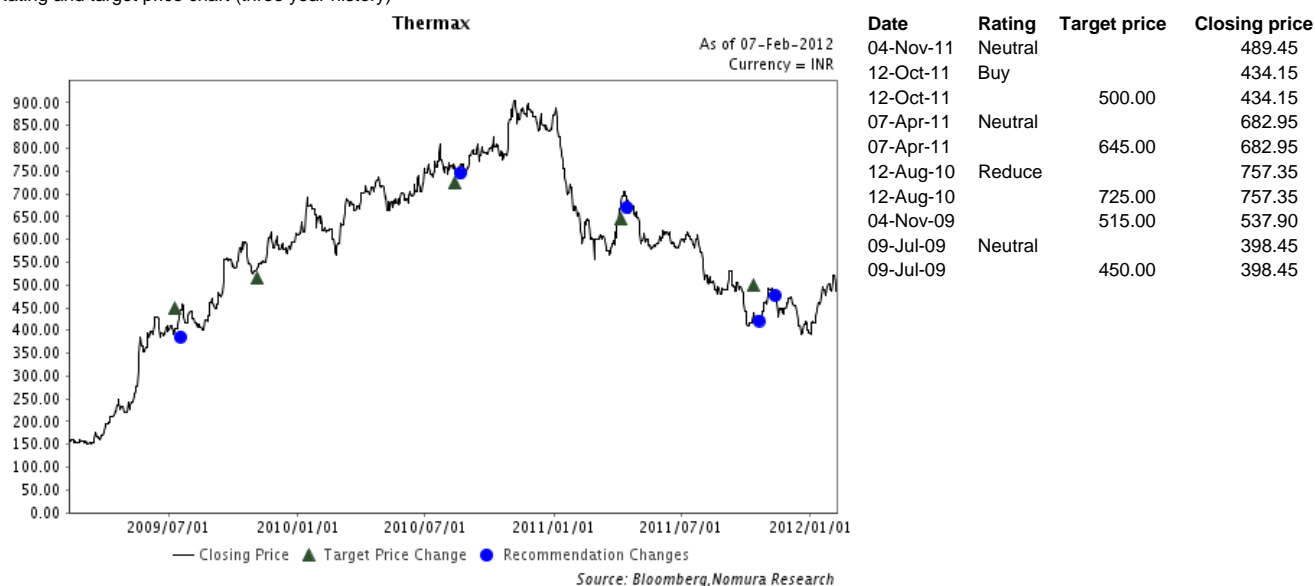
Previous Rating

Issuer name	Previous Rating	Date of change
Thermax	Neutral	09-Feb-2012

Thermax (TMX IN)

INR 487 (07-Feb-2012) Reduce (Sector rating: Not rated)

Rating and target price chart (three year history)



For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology Our TP of INR440 is based on 14x Sep-13F EPS of INR31.4, which is slightly lower than its mid-cycle range. We justify this multiple as the company enters a slower growth phase in the near term.

Risks that may impede the achievement of the target price •Significant decline in commodity prices could benefit margins for Thermax. •Stronger than expected pick up in industrial and/or power capex cycle could be an upside risk.

Important Disclosures

Online availability of research and conflict-of-interest disclosures

Nomura research is available on www.nomuranow.com, Bloomberg, Capital IQ, Factset, MarkitHub, Reuters and ThomsonOne.

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STOCKS

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SECTORS

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Explanation of Nomura's equity research rating system in Japan and Asia ex-Japan

STOCKS

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