SSKI

INDIA RESEARCH

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BSE Sensex: 13966

Emco

Rs820

OUTPERFORMER

RESULT NOTE

Mkt Cap: Rs8.4bn; US$204m

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Result: Q4FY07

Comment: Below estimates led by higher interest costs; FY08 earnings downgraded by 3.8%

Last report: 18 January 2007 (Price Rs791; Recommendation: Outperformer)

Key valuation metric

Year to March (Rs m)	Sales	yoy chg (%)	Net Profit	EPS (Rs)	yoy chg (%)	PER (x)
2005	2359	53.6	98	16.1	138.8	50.8
2006	4,054	71.8	257	34.5	113.9	23.8
2007P	6,559	61.8	392	43.3	25.3	19.0
2008E	9,149	39.5	589	56.0	29.5	14.6
2009E	11,926	30.4	810	77.1	37.6	10.6

Emco reported its 4QFY07 results at a net profit of Rs131mn (+18% yoy), marginally below our estimates, primarily due to higher than estimated interest costs (funding of higher working capital). Revenues grew at a robust pace of 48% yoy to Rs2.5bn, while margins improved by 10bps during the quarter. The margin improvement was led by higher operating leverage and stable raw material prices during the quarter. The order backlog continued to remain extremely robust at Rs9.5bn (1.5x FY07 revenues) during the quarter led by 62% yoy growth in order booking. However, we have downgraded EMCO's FY08 and FY09 earnings by 3.8% and 2.8% respectively driven by the higher than estimated interest costs. Emco is currently trading at 14.6x FY08E and 10.6xFY09E earnings. Considering the strong order inflow and the ensuing visibility on revenues and strong earnings CAGR of 33% over FY07-09E as well as the value accretive acquisition of UEL (transmission company), we believe the valuations are extremely attractive. We reiterate Outperformer rating on the stock.

KEY HIGHLIGHTS

- Revenues grew by 48% yoy to Rs2.5bn driven by robust order backlog of Rs9.5bn as on 31st March 2007. The transformer revenues jumped by ~50%yoy during the quarter driven by strong execution of orders from APDRP & rural electrification program. Similarly, FY07 revenues grew at a strong pace of 62% yoy to Rs6.6bn.
- The order backlog has grown by 128% yoy to Rs9.5bn or 1.5x FY07 revenues. The transformer orders constitute 72% of the order backlog (10% export orders), while projects contributed 26% to the total order backlog and the balance 2% are meter orders.
- The order inflow during the quarter was Rs2bn (+62% yoy). The improvement in order flow during the quarter was driven by the APDRP and the rural electrification program.

Order backlog and booking trend

(Rs mn)	FY2005	1QFY06	2QFY06	3QFY06	4QFY06	FY2006	1QFY07	2QFY07	3QFY07	4QFY07	FY07
Order backlog	3,000	3,250	4,250	4,450	4,000	4,000	4,370	7,850	10,000	9,500	9,500
Order booking	2,799	873	1,761	1,171	1,248	5,054	1,476	4,785	3,782	2,017	12,059

Source: Company

- Operating margins improved by 10bps to 12.7% during the quarter and by 40bps during FY07 to 13.2% due to operating leverage from higher revenue growth as well as stable raw material prices.
- Interest cost jumped by 175% yoy to Rs88mn during the quarter and by 68% during FY07 due to the strong revenue growth and resultant higher working capital requirement. On the other hand, depreciation remained flat on a yoy at Rs15mn.
- Emco provided tax at the rate of 39% (inclusive of Fringe Benefit Tax) during the quarter against 34% in 4QFY06.
- As a result, net profit grew by 18% yoy to Rs131mn during the quarter and by 52% yoy to Rs392mn during FY07.
- We have treated the tax write back of earlier years of Rs14mn as extra-ordinary items. Consequently, reported profit of Rs145mn grew by 226% yoy during the quarter and by 113% to Rs406mn for FY07.

❑ Power plant – valued at Rs13/share

Emco is setting up a 135MW thermal power plant near Nagpur in Maharashtra through a 100% subsidiary (EMCO Energy) to generate steady cash flows as well as diversify its business. The power plant is likely to generate Rs2.5bn revenues and profit of Rs270m in the first full year of operations (FY10) at an assumed PLF of 80%. The project has equity IRR of 20.3%. We have valued the power plant at Rs13/share by discounting the equity cash flows at 18%. Overall, we believe the power plant will generate steady cashflows over a longer period of time complimenting the volatile cashflows of the core business.

❑ Acquisition and merger with Urja Engineers Ltd (UEL) complementary to project division

Emco in a consortium with its promoters and other shareholders had acquired 100% stake in Urja Engineers Ltd (UEL) through a SPV IEIPL at a cost of Rs1.2bn (Emco had invested Rs280mn). However, to have direct control of UEL as well as straighten out the structure, Emco has decided to merge IEIPL and UEL with itself. As a result of the merger, Emco will issue 1.22mn fresh equity shares to the shareholders of IEIPL (16 shares of Emco for 21 shares of IEIPL). Consequently, the total consideration for the acquisition of UEL works out to Rs1.2bn..

UEL has a tower manufacturing capacity of both transmission towers as well as telecom towers. Emco's project division (15% of revenues) buys transmission towers for execution of their projects (~10% of project division cost). As a result of the acquisition, the project division would have backward integration for 55-60% of their costs (45-50% transformers and 10% transmission towers), thereby improving the division's margins. Moreover, the UEL acquisition gives Emco the qualification norms to enter and bid for transmission projects.

Based on current business prospects and orders in hand, UEL had turnover of Rs800mn and a PAT of Rs100mn in FY07. Moreover, the business is likely to witness a growth of 45-50% growth over the next two years. Consequently, the acquisition has been done at a valuation of 12x FY07 earnings, which we believe is quite attractive considering the synergies with the project division and entry into transmission line business.

❑ Downgrade earnings by 3.8% - Reiterate Outperformer

We are downgrading our FY08 and FY09 earnings estimates by 3.8% and 2.8% to Rs56/share and Rs77/share respectively to reflect the higher debt and interest costs. We believe Emco's strong order backlog of Rs9.5bn coupled with stable margins would drive earnings at 33% CAGR over FY07-09E. The stock currently trades at 14.6x on FY08E and 10.6x FY09E earnings and at 7.4x FY08 EV/EBITDA. Considering the high revenue visibility (order backlog and booking), strong earnings momentum and a strong balance sheet, we believe valuations are extremely attractive. We maintain Outperformer rating on the stock with a price target of Rs1022/share.

Quarterly results

(Rs m)	1Q06	2Q06	3Q06	4Q06	FY2006	1Q07	2Q07	3Q07	4Q07	FY2007P
Net sales	**623**	**761**	**971**	**1,698**	**4,054**	**1,106**	**1,305**	**1,632**	**2,517**	**6,559**
Total expenses	542	663	845	1,484	3,534	957	1,128	1,410	2,198	5,693
EBITDA	**81**	**98**	**126**	**215**	**520**	**148**	**177**	**222**	**319**	**866**
OPM (%)	*13.0*	*12.9*	*13.0*	*12.6*	*12.8*	*13.4*	*13.5*	*13.6*	*12.7*	*13.2*
Other Income	-	-	-	-	-	-	-	-	1	1
Interest	27	24	34	32	118	26	40	44	88	198
Depreciation	13	14	14	15	57	15	14	15	15	60
PBT	**40**	**61**	**78**	**167**	**346**	**107**	**123**	**162**	**217**	**609**
Current Tax	4	9	17	58	88	33	36	56	79	204
Deferred tax	1	1	1	(2)	1	(1)		7	7	13
Tax Rate *(%)*	*13*	*17*	*22*	*34*	*26*	*30*	*29*	*39*	*39*	*36*
PAT	**35**	**51**	**61**	**111**	**257**	**75**	**87**	**99**	**131**	**392**
Extraordinary items	-	-	-	67	67	-	-	-	14	14
Reported PAT	35	51	61	45	191	75	87	99	145	406
% chg yoy										
Sales	37	36	67	122	72	78	71	68	48	62
PBT	238	123	117	268	187	166	103	108	30	76
PAT	272	103	98	256	168	114	71	64	18	52
Shares outstanding (m)	6.1	7.1	7.6	7.9	7.9	7.9	7.9	10.2	10.2	10.2
EPS (Rs)	5.8	7.2	8.0	5.6	32.5	9.5	11.0	9.7	14.2	38.4
PER (x)	35.6	28.6	25.7	36.4	25.2	21.6	18.7	21.1	14.4	21.4

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Disclaimer

Explanation of Ratings:

1. Outperformer: More than 10% to Index
2. Neutral: Within 0-10% to Index
3. Underperformer: Less than 10% to Index

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