Prabhudas Lilladher

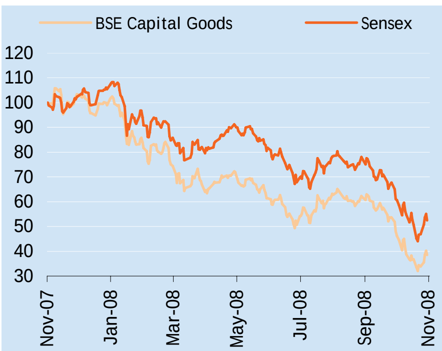
Capital Goods

Topline grows, Margins Plunge

Q2FY09 Result Review

November 7, 2008

BSE Capital Goods Performance v/s Sensex



Source: Bloomberg

- **Revenue growth above expectation:** Our universe of companies in the capital goods sector recorded earnings growth of 30% (excluding Suzlon), which is ahead of our expectation. Currency depreciation would have played its part in this, but overall the execution in the sector was as expected.

- **EBITDA margins decline:** EBITDA margin has come down by 283bps YoY. Main reason for this has been increased raw material cost and to a certain extent foreign exchange loss. Raw material cost increase was due to execution of fixed cost contracts with higher input costs. Although commodity prices have corrected in the recent past, going ahead only companies which are either executing fixed cost contracts (which were taken when commodity prices were peaking) or have control over pricing will be able to benefit from this decrease in commodity prices. Companies which have liabilities in foreign exchange have been hit during the quarter due to the depreciating rupee.

- **Interest cost on an uptrend:** Both interest cost and debt levels, especially for working capital funding has increased in this quarter. Interest expenses for the sector have grown by 44% YoY. On an average, interest cost for most companies has increased in the range of 100-200bps YoY. Interest cost ranges from 10% to 17%. Although RBI has taken steps to infuse liquidity into the system, it is to be seen how and when this would be beneficial to the capital goods companies.

- **Order book growth continues:** Order book for the sector grew by 45% YoY and 8.3% QoQ. Although YoY order book has grown at a healthy pace, Order inflows have only increased by 5% YoY. The order book growth is clearly trending downwards. Keeping in mind the liquidity crunch, slow down in the industrial capex and elections in the next six months, we expect the pace of order inflow to reduce, especially from the industrial side.

- **Outlook:** Several issues like increased raw material cost, increased interest cost and slow down in industrial capex have affected the capital goods industry in the recent past. Although commodity prices have corrected recently, going ahead only companies which are, either executing fixed cost contracts (which were taken when commodity prices were peaking) or have control over pricing, will be able to benefit from this decrease in commodity prices. Amongst our universe of companies, we remain positive on companies which are dependent on infrastructure spend, especially on power. We expect companies with lower funding requirements and positive cash flows to trade at a premium.

Absolute Stock Performance

(%)	1M	6M	12M
Sensex	**(14.5)**	**(42.3)**	**(48.1)**
Capital Goods	**(16.4)**	**(44.1)**	**(61.4)**
ABB*	(29.2)	(53.9)	(68.8)
ACE	(29.1)	(72.9)	(72.1)
Areva T&D*	(26.8)	(43.3)	(67.2)
BHEL	(7.3)	(22.2)	(50.8)
Crompton Greaves	(16.7)	(33.3)	(58.8)
Elecon Eng.	(37.9)	(69.2)	(81.3)
EMCO	(33.1)	(76.5)	(84.4)
Hind. Dorr Oliver	(31.9)	(62.5)	(69.8)
Jyoti Structures	(27.6)	(60.8)	(77.6)
KEC International	(62.5)	(80.1)	(83.9)
KEI Industries	(13.5)	(73.9)	(76.4)
Suzlon Energy	(44.7)	(75.6)	(81.8)
Voltamp Transf.	(29.5)	(70.7)	(77.9)
Voltas	0.4	(59.0)	(62.2)

(Prices as on November 6, 2008)

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Key Financials

	Rating	Price (Rs)	EPS (Rs)		PE (x)		RoE (%)		Book to bill
			FY09	FY10	FY09	FY10	FY09	FY10	FY09
ABB*	Reduce	536	25.2	32.1	21.2	16.7	27.6	28.3	1.0
Action Construction Equip	Reduce	23	4.0	4.6	5.7	4.9	22.4	22.6	—
Areva T&D*	Accumulate	156	10.6	14.1	14.7	11.0	39.2	38.1	1.6
BHEL	Accumulate	1,282	68.9	96.2	18.6	13.3	25.4	28.0	4.0
Crompton Greaves	Accumulate	153	14.0	17.0	10.9	9.0	29.6	27.5	1.2
Elecon Engineering	Reduce	38	8.3	10.2	4.6	3.7	28.5	27.6	1.6
EMCO	Reduce	39	12.2	14.8	3.2	2.6	17.2	18.3	1.1
Hindustan Dorr Oliver	Accumulate	45	8.5	13.0	5.3	3.5	23.5	26.9	2.2
Jyoti Structures	BUY	56	10.8	14.5	5.2	3.8	21.0	22.5	1.9
KEC International	Accumulate	114	36.5	43.8	3.1	2.6	27.3	25.8	1.3
KEI Industries	Reduce	18	3.3	7.7	5.4	2.3	12.3	19.0	—
Suzlon Energy	Accumulate	20	8.8	11.5	2.3	1.7	14.6	16.1	0.8
Voltamp Transformers	Reduce	347	88.3	92.8	3.9	3.7	43.8	37.7	0.7
Voltas	BUY	73	7.6	9.7	9.6	7.5	37.2	35.4	2.4

Highlights

Revenue growth beats expectation

Our universe of companies in the capital goods sector recorded earnings growth of 30% (excluding Suzlon), which is ahead of our expectation. Currency depreciation would have played its part in this, but overall the execution in the sector was as expected.

EBITDA margins

EBITDA margins decreased by 283bps, which was much higher than expected. Additional raw material cost and foreign exchange loss are the two major factors which contributed to this phenomenon.

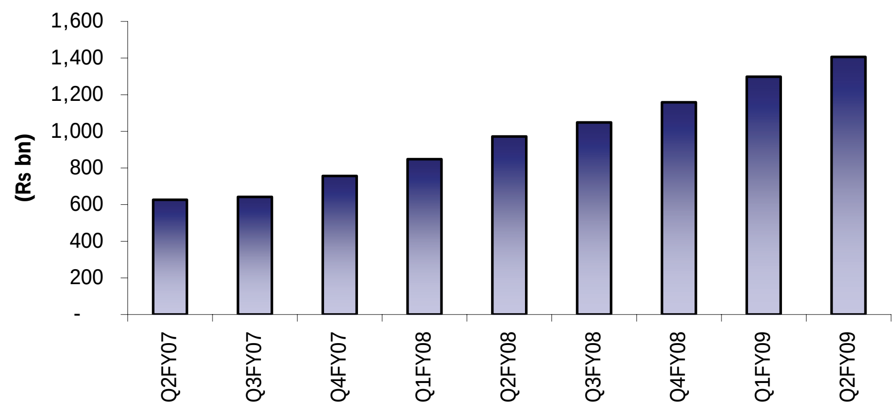
Q2FY09 Results **(Rs m)**

	Revenue			EBITDA Margin (%)			PAT		
	Actual	**Estimate**	*Variation (%)*	**Actual**	**Estimate**	*Variation (Bps)*	**Actual**	**Estimate**	*Variation(%)*
ABB*	15,562	17,682	*(12.0)*	11.0	12.3	*(125)*	1,048	1,469	*(28.7)*
ACE	1,451	1,173	*23.7*	9.0	9.0	*(3)*	88	98	*(9.8)*
Areva T&D*	5,865	6,140	*(4.5)*	16.3	17.8	*(155)*	504	644	*(21.8)*
BHEL	53,426	49,473	*8.0*	13.3	14.9	*(160)*	6,158	5,999	*2.6*
Crompton Greaves	10,896	10,808	*0.8*	13.5	11.0	*245*	925	809	*14.4*
Elecon Eng.	2,522	2,360	*6.9*	15.2	16.1	*(91)*	160	192	*(16.5)*
EMCO	2,306	2,300	*0.3*	13.3	13.3	*0*	113	120	*(5.4)*
Hind. Dorr Oliver	1,164	1,025	*13.6*	11.6	12.1	*(52)*	80	74	*7.3*
Jyoti Structures	4,212	4,350	*(3.2)*	12.0	11.8	*18*	201	215	*(6.6)*
KEC International	8,069	7,272	*11.0*	7.0	10.6	*(366)*	179	330	*(45.9)*
KEI Industries	2,607	2,489	*4.7*	7.1	10.0	*(285)*	46	83	*(44.3)*
Voltamp Transf.	1,700	1,882	*(9.7)*	22.3	18.6	*374*	273	236	*16.0*
Voltas	9,285	8,782	*5.7*	8.7	7.6	*113*	622	485	*28.3*
Total	**119,064**	**115,737**	*2.9*	**12.3**	**13.2**	*(92)*	**10,398**	**10,753**	*(3.3)*

Order book growth continues

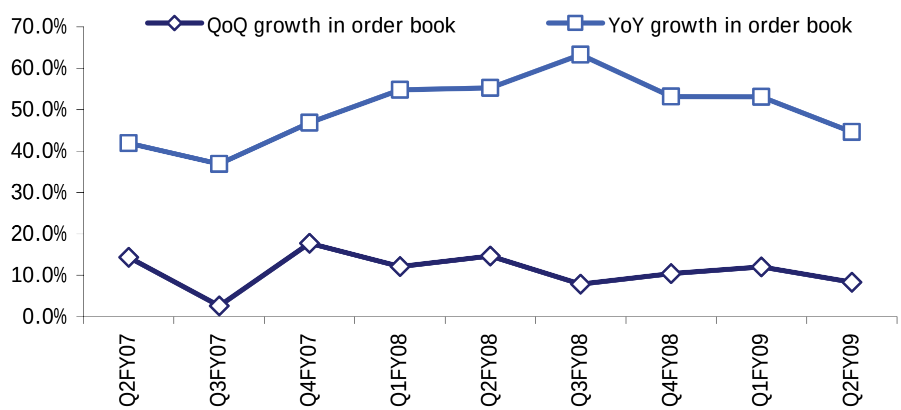
Order book for the sector grew by 45% YoY and 8.3% QoQ. Although YoY order book has grown at a healthy pace, Order inflows have only increased by 5% YoY. The order book growth is clearly trending downwards. Keeping in mind the liquidity crunch, slow down in the industrial capex and elections in the next six months, we expect the pace of order inflow to reduce, especially from the industrial side.

Sector order book



Source: Company Data, PL Research

Sector order book growth



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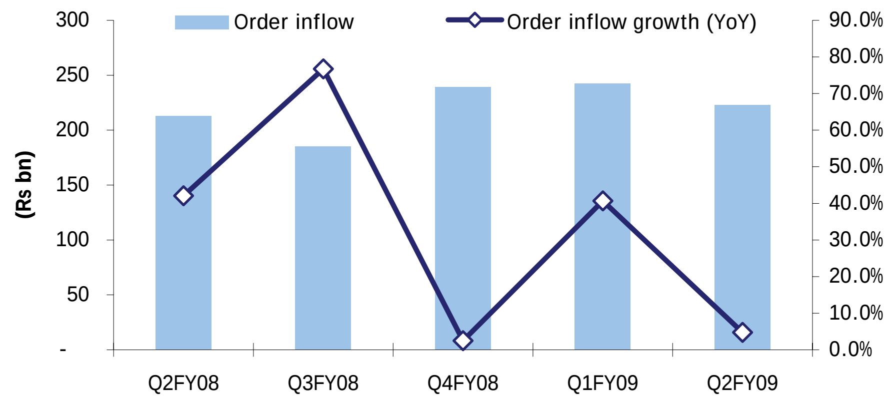
Sector order inflow

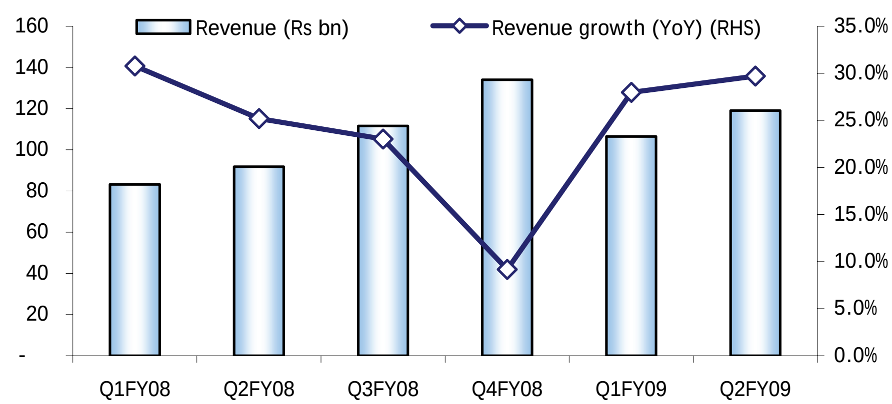


Source: Company Data, PL Research

Revenue grows at a healthy pace

Revenue growth during the quarter was above our expectation at 30% growth YoY. This was backed by good execution and in certain cases helped by the currency movements. Although most of these companies have healthy order books and even if execution is done at a brisk pace, new order inflow could be a concern especially from the industrial segment. This could result in this growth rate coming down.

Sector Revenue

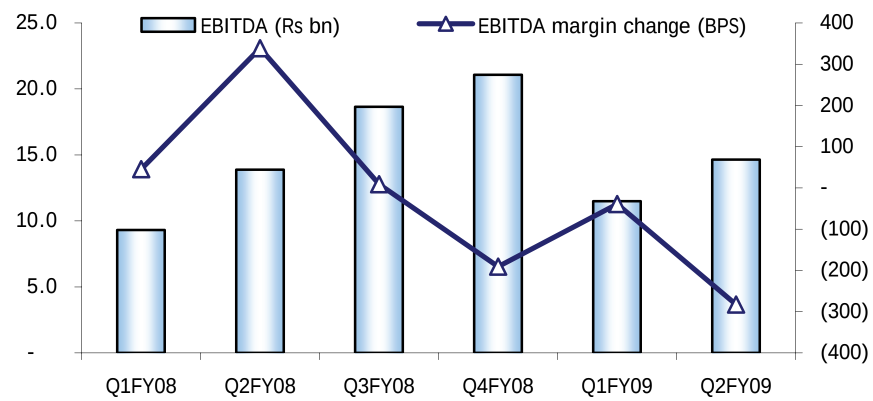


Source: Company Data, PL Research

EBITDA margin dips

EBITDA margin has come down by 283bps YoY. Main reason for this has been increased raw material cost and to a certain extent foreign exchange loss. Raw material cost increase was due to execution of fixed cost contracts with higher input costs. Although commodity prices have corrected in the recent past, going ahead only companies which are either executing fixed cost contracts (which were taken when commodity prices were peaking) or have control over pricing will be able to benefit from this decrease in commodity prices. Companies which have liabilities in foreign exchange have been hit during the quarter due to the depreciating rupee.

Sector EBITDA



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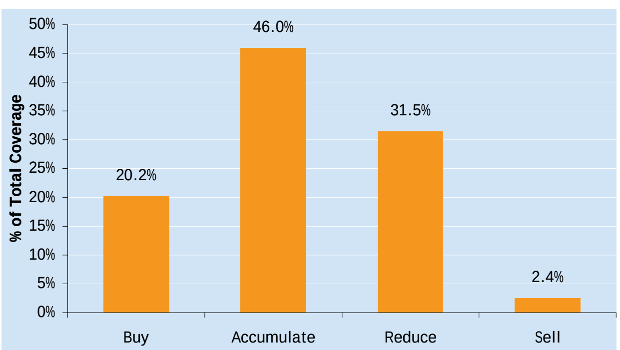
Rating Distribution of Research Coverage



PL's Recommendation Nomenclature

BUY	:	Over 15% Outperformance to Sensex over 12-months	**Accumulate**	:	Outperformance to Sensex over 12-months
Reduce	:	Underperformance to Sensex over 12-months	**Sell**	:	Over 15% underperformance to Sensex over 12-months
Trading Buy	:	Over 10% absolute upside in 1-month	**Trading Sell**	:	Over 10% absolute decline in 1-month
Not Rated (NR)	:	No specific call on the stock	**Under Review (UR)**	:	Rating likely to change shortly