

BHARAT HEAVY ELECTRICALS (BHEL)

INR 2,506

*Powering ahead***BUY**

Bharat Heavy Electricals' (BHEL's) Q3FY07 revenues were in-line with our estimates, whereas profitability was ahead. Nearly 58% Y-o-Y earnings growth and second highest EBITDA/PAT margins (in the last 14 quarters) were highlights of this strong quarter. Revenues were at INR 43 bn, up 30% Y-o-Y and Q-o-Q. On the back of an excellent operational quarter, net earnings stood at INR 6.7 bn.

Despite BHEL missing out on the first two ultra mega power projects (UMPPs), we believe that the company remains the biggest beneficiary with ~60,000 MW of planned capacity additions over the next five years. With large size project accruing (1,000 MW order from Damodhar Valley Corporation), strong order intake momentum, improving visibility, and company seeking inorganic growth, there could be positive surprises to our estimates.

* **Steaming quarter**

Revenue grew 30% Y-o-Y and Q-o-Q to INR 43 bn for Q3FY07, driven by strong performance of the power and industrial segments that grew 29% and 33% respectively. We maintain our revenue growth estimate of 34% for FY07E to INR 180 bn.

EBITDA stood at INR 9.2 bn, up by 54% Y-o-Y. BHEL reported second highest EBITDA margin (in the last 16 quarters), up 329bps Y-o-Y, to 21.4% for the quarter. BHEL posted net profit of INR 6.7 bn, 58% Y-o-Y growth, translating into EPS of INR 27.3 for Q3FY07.

* **An opportunity lost; Much more to be gained**

Post announcement of two UMPP (Sasan and Mundhra) awards, there were concerns on BHEL losing out on a huge opportunity. However, we believe that with seven more UMPPs in the pipeline and large amount of inter-regional transmission and upgradation capex on anvil, business opportunities for BHEL are strong over the next 3-4 years. The order backlog of INR 467 bn, up 38% Y-o-Y, represents ~2.6x FY07E revenues. With aggressive global venture and continuing repeat orders, we expect the company's strong order intake to continue.

* **Powering beyond 2008; Premium valuations to sustain**

We remain positive on BHEL, based on its tie ups with Alstom and Siemens for transfer of supercritical technology. Further, the Ministry of Heavy Industries has moved a cabinet note in favour of BHEL to reserve some large power projects, bolstering our outlook. BHEL also plans to increase its capacity to 15,000 MW from 10,000 MW, as per the requirements of the Indian power sector. It has also earmarked ~INR 100 bn for inorganic growth through acquisitions across globe. At CMP of INR 2,506, the stock trades at P/E of 26x and 21x FY07E and FY08E revised earnings, respectively. Strong return ratios and augmented visibility on performance provide us comfort us on premium valuations. We reiterate our '**BUY**' recommendation.

Financials

Year to March	Q3FY07	Q3FY06	% change	Q2FY07	% change	FY07E	FY08E
Revenues (INR mn)	43,397	33,267	30.4	33,412	29.9	180,256	219,323
EBITDA (INR mn)	9,292	6,029	54.1	4,563	103.6	32,875	40,042
Net profit (INR mn)	6,677	4,232	57.8	3,600	85.5	23,593	28,636
EPS (INR)	27.3	17.3	57.8	14.7	85.5	96.4	117.0
PE (x)						26.0	21.4

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Reuters : BHEL.BO
Bloomberg : BHEL IN

Market Data

52-week range (INR) : 2,668 / 1,531
Share in issue (INR mn) : 244.8
M cap (INR bn/USD mn) : 613.3/13,869.7
Avg. Daily Vol. BSE/NSE ('000) : 524.1

Share Holding Pattern (%)

Promoters : 67.7
MFs, Fls & Banks : 7.3
Fls : 21.9
Others : 3.0

* Segmental performance

BHEL's topline growth was driven by strong performance of its power and industry segments. Power segment, which contributes more than 70% to the company's topline, registered a healthy Y-o-Y growth of 29% in Q3FY07 to INR 35 bn. Revenues for its industry segment grew by 33% Y-o-Y to INR 12.7bn in Q2FY07.

In terms of EBIT margins, BHEL's power segment margins improved significantly to 24% for the current quarter, an improvement of 91bps Y-o-Y. However, the margins for the industry segment were softer by 193bps Y-o-Y at 12.3% for Q3FY07.

Table 1: Segmental performance

Year to March	Q3FY07	Q3FY06	Q2FY07
Segment revenue mix (%)			
Power	73.5	74.2	72.3
Industry	26.5	25.8	27.7
Segment EBIT margin (%)			
Power	23.9	23.0	21.3
Industry	12.3	14.2	12.2
Segment EBIT mix (%)			
Power	84.4	82.3	82.0
Industry	15.6	17.7	18.0
Order backlog (INR bn)	467	338	457
Order intake (INR bn)	57	52	101

Source: Edelweiss research

* Revising estimates upwards

Post a strong Q3FY07, we have revised our earnings estimates upwards for FY07 and FY08 to capture excellent operational performance, and upgraded our other income estimates by 130% to INR 6.3 and 139% to INR 7.5 bn in FY07E and FY08E, respectively.

Table 2: Revised estimates post Q3FY07 results

	Previous estimates		Revised estimates		Remarks
	FY07E	FY08E	FY07E	FY08E	
Revenues (INR mn)	180,256	213,637	180,256	219,323	FY07 revenue estimates maintained, FY08 revised marginally upwards to capture healthy order intake
EBITDA (INR mn)	32,723	39,040	32,875	40,042	EBIDTA margins maintained
EBITDA margin (%)	18.2	18.3	18.2	18.3	
Other Income	2,638	3,576	6,309	7,431	Post 9M FY07, we have revised our other income estimates upwards
PBT (INR mn)	31,866	38,711	35,746	43,389	Profitability improvement due to higher other income likely and better operating performance
PAT (INR mn)	21,031	25,549	23,593	28,636	
Net margin (%)	11.7	12.0	13.1	13.1	
EPS (INR)	85.9	104.4	96.4	117.0	

Source: Edelweiss research

Financials snapshot								(INR mn)
Year to March	Q3FY07	Q3FY06	% change	Q2FY07	% change	FY06	FY07E	FY08E
Revenues (net)	43,397	33,267	30.4	33,412	29.9	136,509	180,256	219,323
Raw material	24,609	18,942	29.9	18,567	32.5	80,779	100,957	122,471
Staff cost	5,105	4,527	12.8	5,660	(9.8)	18,785	24,944	30,413
Other operating expenses	4,390	3,769	16.5	4,621	(5.0)	11,087	21,480	26,396
Total expenditure	34,105	27,238	25.2	28,848	18.2	110,652	147,381	179,281
EBITDA	9,292	6,029	54.1	4,563	103.6	25,857	32,875	40,042
Depreciation	662	620	6.8	667	(0.7)	2,459	2,839	3,474
EBIT	8,630	5,409	59.5	3,897	121.5	23,398	30,036	36,569
Interest	120	136	(12.2)	136	(11.7)	587	599	611
Other income	1,855	1,187	56.2	1,699	9.2	2,797	6,309	7,431
Extraordinary items	-	-	N.A	-	N.A	(35)	-	-
PBT	10,365	6,461	60.4	5,460	89.8	25,643	35,746	43,389
Tax	3,688	2,229	65.5	1,860	98.3	8,852	12,154	14,752
Adjusted net profit	6,677	4,232	57.8	3,600	85.5	16,791	23,593	28,636
Reported net profit	6,677	4,232	57.8	3,600	85.5	16,756	23,593	28,636
Equity capital(FV:INR10)	2,448	2,448	-	2,448	-	2,448	2,448	2,448
# of shares (mn)	245	245	-	245	-	245	245	245
EPS (INR)	27.3	17.3	57.8	15	85.5	68	96	117
Market cap. (INR mn)							613,320	613,320
PE (x)							26	21
EV/EBITDA (x)							17	14
Market cap / Revenues (x)							3	3
as % of net revenues								
Raw material	56.7	56.9	(0.4)	55.6	2.0	59.2	56.0	55.8
Staff cost	11.8	13.6	(13.6)	16.9	(30.6)	13.8	13.8	13.9
Other operating expenses	10.1	11.3	(10.7)	13.8	(26.9)	8.1	11.9	12.0
EBITDA	21.4	18.1	18.1	13.7	56.8	18.9	18.2	18.3
Adjusted net profit	15.4	12.7	20.9	10.8	42.8	12.3	13.1	13.1
Tax rate	35.6	34.5	3.2	34.1	4.5	34.5	34.0	34.0

Company Description

BHEL is the largest engineering and manufacturing enterprise in India in the energy-related/infrastructure sector. It manufactures over 180 products under 30 major product groups and caters to core sectors of the Indian economy viz. power generation and transmission, industry, transportation, telecommunication, and renewable energy. BHEL has a wide network comprising 14 manufacturing divisions, 4 power sector regional centres, over 100 project sites, 8 service centres, and 18 regional offices across the country. This enables the company to promptly serve its customers and provide them with suitable products, systems, and services. It has acquired and adopted some of the best technologies from leading companies in the world and alongside is developing its own R&D centres.

Investment Thesis

Given the improved visibility on the power sector reforms and government's thrust on them, we believe that ~59,659 MW of generation capacity is likely to be added in India over the next six years, entailing investment of ~INR 2.4 tn. Of the above capacity addition, over ~65% is estimated to be from thermal based power plants, which is a positive for BHEL, as setting up coal-based power plants is the company forte. BHEL has also demonstrated its skills in hydro power projects. Further, to cater to country's ambitious future power capacity addition programme, BHEL is also planning to increase its capacity to 15,000 MW from its current capacity of 10,000 MW.

Key Risks

The domestic power sector has not kept pace with the growth in demand for power in the past, resulting in energy shortages. Any slowdown in power reforms can impact BHEL, as it has a 65% market share in country's total installed capacity.

In the domestic market, BHEL is facing stiff international competition, particularly from China.

Any unprecedented rise in the prices of energy and input materials such as steel, copper, and aluminum is likely to affect the company's margins adversely. Therefore, improvement in productivity continues to be a focal point for BHEL.

Financial Statements

Income statement					(INR mn)
Year to March	FY05	FY06	FY07E	FY08E	FY09E
Income from operations	99,472	136,509	180,256	219,323	262,467
Direct costs	55,728	80,779	100,957	122,471	146,325
Employee costs	16,504	18,785	24,944	30,413	36,453
Other expenses	10,577	11,087	21,480	26,396	31,589
Total operating expenses	82,809	110,652	147,381	179,281	214,367
EBITDA	16,663	25,857	32,875	40,042	48,100
Dep. and amortisation	2,189	2,459	2,839	3,474	4,327
EBIT	14,474	23,398	30,036	36,569	43,774
Interest expenses	814	587	599	611	599
Other income	2,357	2,797	6,309	7,431	9,080
Profit before tax	16,017	25,608	35,746	43,389	52,255
Provision for tax	6,282	8,852	12,154	14,752	17,766
Extraordinary items	200	(35)	-	-	1
Reported profit	9,534	16,791	23,593	28,636	34,488
Adjusted net profit	9,734	16,756	23,593	28,636	34,489
Shares outstanding	245	245	245	245	245
Dividend per share	9.1	14.5	14.5	18.5	22.5
Dividend payout %	22.9	21.2	15.0	15.8	16.0

Common size metrics- as % of net revenues

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Operating expenses	83.2	81.1	81.8	81.7	81.7
Depreciation	2.2	1.8	1.6	1.6	1.6
Interest expenditure	0.8	0.4	0.3	0.3	0.2
EBITDA margins	16.8	18.9	18.2	18.3	18.3
Net profit margins (adjusted)	9.8	12.3	13.1	13.1	13.1

Growth metrics (%)

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Revenues	19.4	37.2	32.0	21.7	19.7
EBITDA	26.7	55.2	27.1	21.8	20.1
PBT	27.4	59.9	39.6	21.4	20.4
Net profit	44.9	76.1	40.5	21.4	20.4
EPS	44.9	76.1	40.5	21.4	20.4

Cash flow statement

Cash flow statement					(INR mn)
Year to March	FY05	FY06	FY07E	FY08E	FY09E
Net profit	9,534	16,791	23,593	28,636	34,488
Add: Depreciation	2,189	2,459	2,839	3,474	4,327
Add: E.O.adjustments	179	-	-	-	(1)
Add: Deferred tax	(198)	(1,554)	-	-	-
Gross cash flow	11,704	17,696	26,432	32,110	38,813
Less: Dividends	2,225	4,047	4,002	5,105	6,209
Less: Changes in W. C.	2,910	1,576	5,529	6,090	4,352
Operating cash flow	6,570	12,074	16,902	20,915	28,252
Less: Change in invt.	(200)	(7)	7	-	-
Less: Capex	1,557	2,732	5,179	10,000	16,001
Free cash flow	5,213	9,348	11,716	10,915	12,251

Balance sheet					(INR mn)
As on 31st March	FY05	FY06	FY07E	FY08E	FY09E
Equity capital	2,448	2,448	2,448	2,448	2,448
Reserves & surplus	57,821	70,566	90,157	113,688	141,966
Shareholders funds	60,269	73,013	92,604	116,135	144,414
Secured loans	5,000	5,000	5,000	5,000	5,000
Unsecured loans	370	583	583	583	583
Borrowings	5,370	5,583	5,583	5,583	5,583
Sources of funds	65,639	78,596	98,187	121,718	149,997
Gross block	36,289	38,221	45,375	55,375	71,375
Accumulated depreciation	26,193	28,528	31,367	34,841	39,167
Net block	10,096	9,693	14,008	20,534	32,208
Capital work in progress	1,300	1,976	0	0	1
Total fixed assets	11,396	11,668	14,008	20,534	32,209
Investments	89.5	82.9	89.5	89.5	89.5
Inventories	29,161	37,444	51,962	66,353	79,406
Sundry debtors	59,721	71,681	93,957	116,606	142,335
Cash and equivalents	31,779	41,340	53,056	63,971	76,222
Loans and advances	27,523	12,844	16,112	21,564	28,387
Other current assets					
Total current assets	148,184	163,308	215,086	268,494	326,350
Sundry creditors and others	71,204	88,077	106,659	122,777	139,618
Provisions	28,009	15,123	31,074	51,360	75,771
Total CL & provisions	99,214	103,200	137,734	174,137	215,389
Net current assets	48,971	60,108	77,353	94,357	110,960
Add / (Less) : Deferred tax asset/ lia	5,183	6,737	6,737	6,737	6,737
Others	0	0	0	0	1
Uses of funds	65,639	78,596	98,187	121,718	149,997
Book value per share (BV)	246	298	378	474	590

Ratios

Year to March	FY05	FY06	FY07E	FY08E	FY09E
ROAE (%)	17.2	25.1	28.5	27.4	26.5
ROACE (%)	23.3	32.4	34.0	33.3	32.2
Current ratio	1.5	1.6	1.6	1.5	1.5
Debtors (days)	219	192	190	194	198
Fixed assets t/o (x)	7.3	9.5	10.5	8.7	6.7
Average working capital t/o (x)	2.2	2.5	2.6	2.6	2.6
Gross debt/Equity	0.1	0.1	0.1	0.0	0.0

Valuations parameters

Year to March	FY05	FY06	FY07E	FY08E	FY09E
EPS (INR)	39.0	68.6	96.4	117.0	140.9
<i>Y-o-Y growth (%)</i>	<i>44.9</i>	<i>76.1</i>	<i>40.5</i>	<i>21.4</i>	<i>20.4</i>
CEPS (INR)	48.7	78.5	108.0	131.2	158.6
PE (x)	64.3	36.5	26.0	21.4	17.8
Price/BV(x)	10.2	8.4	6.6	5.3	4.2
EV/Sales (x)	5.7	4.1	3.1	2.6	2.2
EV/EBITDA (x)	34.0	21.9	17.2	14.1	11.8

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RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period

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