Company Focus

SMALL & MID CAP

30 January 2009 | 14 pages

Thermax (THMX.BO)

Outlook Remains Challenging. Cutting TP to Rs211

Rating change ☑
Target price change ☑
Estimate change ☑
Results ☑

- **Better than expected results - Standalone PAT up 9% YoY –** Revenues declined by 6%YoY, led by a decline of 9%YoY in the energy segment. Environment segment grew by 14%YoY. Margins (adjusted for forex loss) have improved by 137bps, driven by cost cutting initiatives. Order book of Rs41bn is up 40%YoY; however, the pace of order book growth has moderated.
- **Pushback in investments to hurt order inflows –** Management suggested there is "substantial resistance" from clients to finalize orders, especially large sized projects. Some clients have cancelled/slowed execution. According to Thermax, cement and metals sector capex is expected to slow down while the power sector will continue to invest, albeit at a lower level than before.
- **But there are some positives –** 1) While risks to order inflows remain, we believe increased power sector exposure should help provide some support to growth. 2) Mgmt has been ahead of the curve and seems geared to handle the downturn; ~293bps margin improvement for 9MFY09 is commendable, esp. since it was in the back-drop of rising input costs & no pass through clauses. 3) The company has no debt and one of the highest RoEs in the sector.
- **Cutting ests by 23%-31% for FY10-11E, TP to Rs211. Maintain Buy** – We cut our rev assumptions to factor in moderating growth trajectory. We cut our TP to Rs211 (from Rs480) based on 8x FY10E (15x Dec09E earlier). We value Thermax at 50% discount to BHEL given its lower visibility and earnings growth. Historically Thermax has traded on par with BHEL, but in recent past, has been trading at widening discount. We raise our risk rating to Medium from Low reflecting the difficult environment for private sector capex.

Buy/Medium Risk	**1M**
from Buy/Low Risk	
Price (29 Jan 09)	Rs159.30
Target price	Rs211.00
from Rs480.00	
Expected share price return	32.5%
Expected dividend yield	5.0%
Expected total return	**37.5%**
Market Cap	Rs18,982M
	US$390M

Price Performance (RIC: THMX.BO, BB: TMX IN)

Figure 1. Thermax Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31-Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2007A	1,992	16.72	96.1%	9.5	3.2	38.0%	3.8%
2008A	2,886	24.22	44.9%	6.6	2.5	42.9%	3.8%
2009E	3,068	25.75	6.3%	6.2	2.1	37.2%	5.0%
2010E	3,139	26.35	2.3%	6.0	1.7	31.5%	5.0%
2011E	3,469	29.11	10.5%	5.5	1.5	28.8%	6.3%

Source: Company reports, Citi Investment Research

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See Appendix A-1 for Analyst Certification and important disclosures.

[1]Citigroup Global Markets India Private Limited

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	9.5	6.6	6.2	6.0	5.5
EV/EBITDA adjusted (x)	4.8	3.1	3.2	3.1	2.4
P/BV (x)	3.2	2.5	2.1	1.7	1.5
Dividend yield (%)	3.8	3.8	5.0	5.0	6.3
Per Share Data (Rs)					
EPS adjusted	16.72	24.22	25.75	26.35	29.11
EPS reported	16.26	24.40	19.94	26.35	29.11
BVPS	49.50	63.41	74.96	92.15	109.81
DPS	6.00	6.00	8.00	8.00	10.00
Profit & Loss (RsM)					
Net sales	23,266	34,815	33,783	36,459	39,925
Operating expenses	-20,573	-30,781	-29,464	-32,085	-35,112
EBIT	**2,694**	**4,035**	**4,318**	**4,374**	**4,812**
Net interest expense	-15	-17	-22	-22	-22
Non-operating/exceptionals	360	439	351	404	464
Pre-tax profit	**3,038**	**4,457**	**4,648**	**4,756**	**5,255**
Tax	-1,046	-1,571	-1,580	-1,616	-1,786
Extraord./Min.Int./Pref.div.	-55	21	-692	0	0
Reported net income	**1,937**	**2,907**	**2,376**	**3,139**	**3,469**
Adjusted earnings	1,992	2,886	3,068	3,139	3,469
Adjusted EBITDA	2,889	4,267	4,628	4,740	5,190
Growth Rates (%)					
Sales	43.1	49.6	-3.0	7.9	9.5
EBIT adjusted	67.6	49.8	7.0	1.3	10.0
EBITDA adjusted	63.4	47.7	8.5	2.4	9.5
EPS adjusted	96.1	44.9	6.3	2.3	10.5
Cash Flow (RsM)					
Operating cash flow	**3,421**	**2,667**	**487**	**3,584**	**3,470**
Depreciation/amortization	195	232	310	366	378
Net working capital	1,313	-538	-2,199	79	-376
Investing cash flow	**-2,317**	**-1,242**	**330**	**-200**	**-200**
Capital expenditure	-545	-1,382	-1,670	-200	-200
Acquisitions/disposals	-1,772	140	2,000	0	0
Financing cash flow	**-679**	**-1,271**	**-999**	**-1,091**	**-1,364**
Borrowings	-48	-22	0	0	0
Dividends paid	-825	-1,115	-1,091	-1,091	-1,364
Change in cash	**425**	**154**	**-182**	**2,292**	**1,906**
Balance Sheet (RsM)					
Total assets	**17,766**	**20,278**	**21,104**	**24,014**	**26,852**
Cash & cash equivalent	972	1,127	944	3,237	5,143
Accounts receivable	4,000	5,305	6,386	6,892	7,657
Net fixed assets	1,789	2,939	4,299	4,133	3,955
Total liabilities	**11,868**	**12,722**	**12,171**	**13,034**	**13,768**
Accounts payable	3,117	4,552	4,069	4,405	4,824
Total Debt	22	0	0	0	0
Shareholders' funds	**5,898**	**7,556**	**8,932**	**10,980**	**13,084**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	12.4	12.3	13.7	13.0	13.0
ROE adjusted	38.0	42.9	37.2	31.5	28.8
ROIC adjusted	176.9	148.6	59.2	45.4	48.7
Net debt to equity	-16.1	-14.9	-10.6	-29.5	-39.3
Total debt to capital	0.4	0.0	0.0	0.0	0.0

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Q309 results review

- **Standalone results –** Revenues for Thermax declined by 6%YoY, led by a decline of 9%YoY in energy segment revenues. Environment segment clocked a decent growth of 14%YoY. Margins (adjusted for forex loss) have improved by 137bps, driven by productivity improvement and cost cutting initiatives. Recurring PAT grew by 9%YoY. The company reported an order book of Rs41bn, up 40%YoY.

Figure 2. Thermax Standalone Results (RsM, percent)

	3QFY08	3QFY09E
Sales & Services (excluding Excise Duty)	**8,343**	**7,880**
Other Income from Operations	111	71
Total Income	**8,454**	**7,951**
% Growth YoY		**-6%**
EBITDA	**1,026**	**1,074**
EBITDA margin%	**12.1%**	**13.5%**
Change bps		**137**
Depreciation	(53)	(84)
Interest	(3)	(6)
Other Income	86	88
PBT	**1,056**	**1,072**
Tax	**(323)**	**(275)**
Effective Tax rate %	**31%**	**26%**
Recurring PAT	**734**	**797**
Recurring PAT margin %	**9%**	**10%**
Recurring PAT growth %		**9%**
Forex gain/ losses	17	(74)
Reported PAT	**750**	**723**

Source: Company reports, Citi Investment Research

Conference Call Takeaways

- Revenues in the quarter declined because of a conscious effort by the company to scale back execution for certain projects where it is sensing clients to be under funding constraint. This is to prevent working capital build-up at Thermax.

- **Order inflows and outlook –** Given the tight liquidity environment, Thermax is sensing "substantial resistance" from clients to finalize orders, especially large sized projects. If the current environment continues, it expects projects to be executed at a slower pace. There have been order cancellations, not too large, but some of these clients are now resuming discussions given that input costs have dropped.

- **Who is investing and who is not –** The top 4 client segments for Thermax for 9MFY09 have been Power, Metals, Refineries and Cement. The company expects significant slowdown in investments in the cement and metals sector. It expects power sector to continue to invest, albeit at a lower level than before. Pharmaceutical and food processing are also expected to continue investments; however, these would not be extensive in nature and the demand would be more for packaged /product boilers.

- Margins have expanded because of productivity improvement and cost cutting initiatives across the company. Thermax expects margins to be maintained at current levels.

Cutting Estimates by 23%-31% over FY10E-11E

We are cutting our estimates for FY10E -11E by 23%-31% on the back of a 28%-36% cut in revenues over the same period. Our margin assumptions have gone up a bit, given that the company should show a sharp improvement in margins on the back of cost-cutting initiatives. For FY09E, while our revenue assumptions have declined by 18%, it is compensated by an increase in margin assumptions by 270bps. We now expect Thermax to post earnings CAGR of 6% over FY09-11E.

Figure 3. Thermax estimate change (RsM, percent)

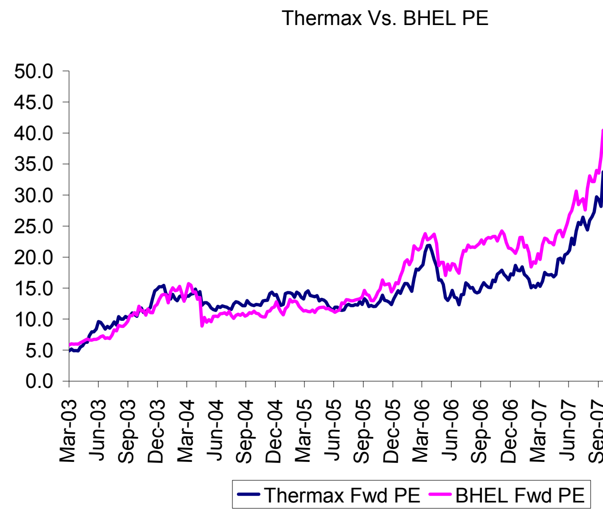
	FY09E	FY10E	FY11E
Sales			
Old	41,323	50,724	62,668
New	33,783	36,459	39,925
% change	-18%	-28%	-36%
EBITDA margins			
Old	11.00%	12.00%	12.00%
New	13.70%	13.00%	13.00%
bps change	270	100	100
PAT			
Old	3,067	4,062	5,057
New	3,068	3,139	3,469
% change	**0%**	**-23%**	**-31%**

Source: Citi Investment Research

Cutting target price to Rs211

We now value Thermax at Rs211 based on 8x FY10E vs. 15x Dec09E earlier. Historically, Thermax has traded almost on par with BHEL. However, in the recent past, it has started to trade at a widening discount, which is understandably so – in a downcycle, BHEL with higher visibility deserves to trade at a premium, in our view. We now value Thermax at a 50% discount to BHEL vs. a 25% discount earlier given its lower visibility and earnings growth.

Figure 4. Thermax vs BHEL PE



Source: Citi Investment Research

Why still a Buy

- **Outlook remains challenging, but power sector should provide some support to growth**- Exposure to private sector capex makes Thermax vulnerable to delays /cancellation of orders. Given the overall tight environment, companies have pulled back investment outlays and this will have an impact on the order inflows for the company. While the risks to order inflows remain, we believe that increased power sector/ utility boiler exposure would help provide some support to growth.

- **Management seems geared to handle downturn –** Thermax management has been one of the first in the sector to recognize the slowdown and has taken appropriate steps to deal with it. The company has undertaken a lot of cost cutting and productivity improvement – evident in ~293bps margin improvement for 9MFY09. This improvement was in the back-drop of rising input costs and no pass through clauses. In the unwinding of the capex cycle, we believe the risk of negative surprises by the company is relatively lower than other companies in our capital goods/construction space. Management has curtailed capex and is in a cash conservation mode.

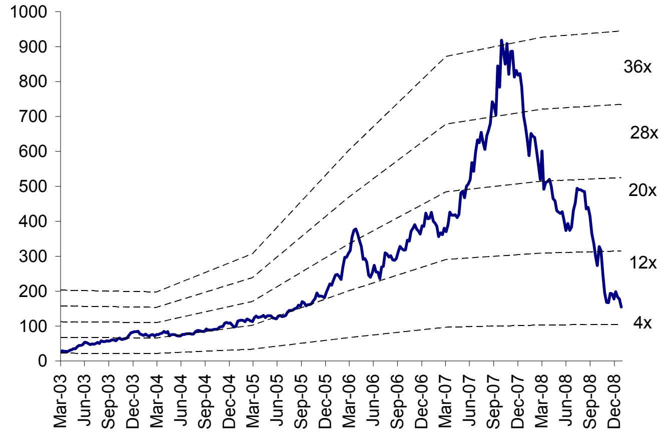
- Despite the cut in our earnings, the company continues to have one of the highest RoE's in the capital goods sector.

Figure 5. Capital Goods RoE's

	FY07	FY08	FY09E	FY10E	FY11E
BHEL (1L, BHEL.BO)	31%	27%	27%	32%	30%
Areva (3M, AREV.BO)	43%	47%	39%	34%	34%
ABB (3L, ABB.BO)	33%	35%	29%	28%	26%
L&T (2L, LART.BO)	27%	26%	23%	21%	20%
Thermax (1M, THMX.BO)	38%	43%	37%	32%	29%

Source: Citi Investment Research

Figure 6. Thermax PE chart



Source: Citi Investment Research

Figure 7. Thermax – Relative performance vs Sensex and BHEL

Source: Citi Investment Research

Thermax

Company description

Thermax specializes in energy and environment engineering solutions. It offers products and services in heating, cooling, waste heat recovery, captive power, water treatment and recycling, waste management and performance chemicals

Investment strategy

We have a Buy / Medium Risk (1M) rating on Thermax shares. Our rating is supported by our forecast FD EPS CAGR of 6% for FY09E-11E and ROEs of ~28-37%. Thermax has a 21% share in the overall boiler market in India, and is the leader in small and medium-sized boilers. BHEL, with a 69% market share, is the industry's only other scale player. With BHEL focusing on higher-capacity utility boilers, Thermax appears poised to capture a larger share of market in industrial boilers and smaller-capacity utility boilers. We think Thermax is in a sweet spot given 1) India's captive power capacity is set to grow by 63% in the next five years due to lack of quality supply and high industrial tariffs; and 2) higher environmental standards would increase demand for its products.

Valuation

Our target price for Thermax shares of Rs211 is based on a target P/E multiple of 8x Mar-10E, at a 50% discount to our 16x target multiple for BHEL. We believe Thermax should trade at a discount to BHEL given that BHEL is the market leader and is a direct beneficiary of all power capex in India, and the fact that Thermax has lower visibility of revenues as compared to BHEL.

Risks

We rate Thermax shares as Medium Risk. We have raised our risk rating to Medium from Low given Thermax's business model is dependent on capex of the private sector, which is currently facing higher interest rate environment and liquidity constraints. The key downside risks that could prevent the shares from reaching our target price include: lower than expected order inflows, rising interest rates, rupee appreciation, manpower shortages, increasing competition, decline in oil prices, low pricing flexibility, international operations and a pending lawsuit in US.

Bharat Heavy (BHEL.BO; Rs1,355.70; 1L)

Valuation

Our target price of Rs1,373 is based on a target P/E multiple of 16x, which is set at a ~13% discount to the historical average P/E multiple given the global credit crisis and the de-rating of most stocks globally. Our target multiple is well supported by EPS CAGR of 27% over FY08-FY11E with average RoEs at 29%. Our target multiple is set at 14% premium to ABB given BHEL's superior earnings growth expectations vis-à-vis ABB (18%) and in line L&T given more or less similar earnings growth expectations (23%).

Risks

We rate BHEL Low Risk in line with our quantitative risk-rating system, which tracks 260-day historical share price volatility. We believe BHEL deserves a Low Risk rating as its order book provides good earnings visibility over the medium term. Key downside risks to the stock achieving our target price are: 1) Delays in power-sector reforms could affect order flows and earnings; 2) Regulatory uncertainties could hurt valuations and the sentiment toward the stock; 3) Competitive pressures from global majors are a concern, particularly as technology upgrades are affected; and 4) In the short-term, progress on order flows would influence market sentiment.

Areva T & D India (AREV.BO; Rs178.95; 3M)

Valuation

Our target price of Rs167 is based on a target P/E multiple of 14x CY09E. Our target P/E multiple is in line with that of ABB. Though Areva T&D's expected EPS CAGR/ RoEs over CY08E -10E at 19%/ 36% are superior to that of ABB at 18%/ 27%, we do not accord a premium to Areva T&D given ABB's superior leverage and FCF profile. Our target P/E multiple is also set at a discount to the historical average P/E multiple given the global credit crisis and the subsequent de-rating of stocks.

As reference, our target multiple for ABB is derived using the historical average PEG of 0.8 and our expectations of 18% EPS CAGR to arrive at a target P/E multiple of 14x.

Risks

Our quantitative risk-rating system, which tracks 260-day historical share price volatility, assigns a High Risk rating to Areva T&D India. However, we believe a Medium Risk rating is more appropriate given that strong power and industrial capex in India provides Areva T&D India with significant visibility on order inflows and that the company is a top 3 player in India in the power and automation space. Areva T&D's peers BHEL and ABB are rated Low Risk. Our risk rating on the stock is based on a number of factors, namely industry-specific risks, financial risk and management risks. The upside risks that could cause shares to exceed our target price include the following: (a) better than expected order booking, (b) better than expected execution, and (c) better than expected margins. The key downside risks include the following: (a) increased competition, (b) slowdown in investments in generation, transmission and distribution, (c) slowdown in the industrial capex cycle, (d) substantial increase in input prices and (e) Employee retention.

ABB (India) (ABB.BO; Rs461.80; 3L)

Valuation

Our Rs448 target price for ABB is based on a target P/E multiple of 14x Dec 2009E. ABB's valuations are, in our view, largely pegged to the rate at which earnings grow. Our target P/E multiple is derived using the average PEG of 0.8 over the last 9 years and our expectations of 18% EPS CAGR over CY07-10E to arrive at a target P/E of 14x.

Risks

Our quantitative risk-rating system, which tracks 260-day historical share price volatility, assigns a Medium Risk rating to ABB India shares. However, we believe a Low Risk rating is more appropriate given that the strong power and industrial capex in India provides ABB with significant visibility on order inflows and ABB is India's market leader in the power and automation space. Our Low Risk rating is also in line with BHEL's. The key upside risks to our target price are: 1) better-than-expected order wins; 2) better-than-expected order execution; and 3) better-than-expected margins.

Larsen & Toubro (LART.BO; Rs660.30; 2L)

Valuation

We use a sum-of-the-parts (SOTP) methodology to value the L&T group, resulting in a target price of Rs697. Our target P/E multiple is set at 12x March 2010E, which is a 50% discount to its average P/E multiple over the last 4.5 years, warranted given the more challenging operating environment due to the global credit crisis. We also believe that the parent numbers do not capture the value inherent in the subsidiaries of L&T. We value L&T's subsidiaries at Rs107 with L&T Infotech at Rs21 (5x FY10E EPS, in-line with second-tier peers), L&T Finance at Rs18 (1.0x FY10E P/BV), and L&T IDPL at Rs33.

Risks

We rate L&T shares Low Risk, in line with our quantitative risk-rating system, and because L&T's order backlog of c.Rs630bn represents two years' sales and provides earnings visibility. Downside risks to our target price include: 1) attracting and retaining talent; 2) the E&C and electrical equipment businesses are sensitive to economic variables; 3) competitive pressures; and 4) L&T needs to keep abreast of technology trends to sustain valuations and earnings. Upside risks to our target price include: 1) better-than-expected order booking; 2) a better-than-expected execution rate; and 3) higher-than-expected EBITDA margins.

Appendix A-1

Analyst Certification

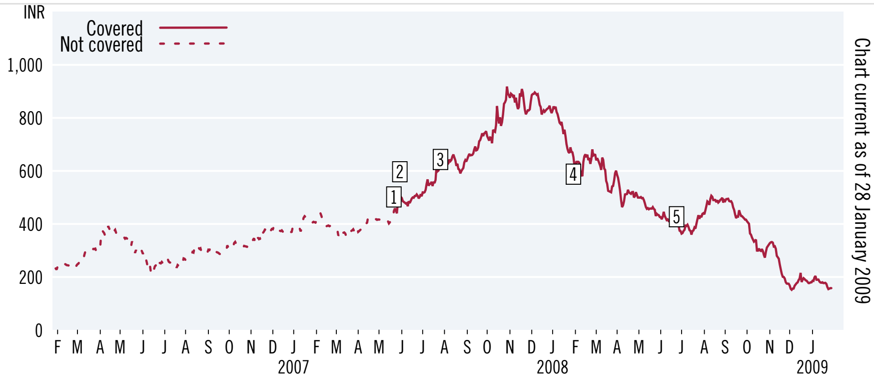
Each research analyst(s) principally responsible for the preparation and content of all or any identified portion of this research report hereby certifies that, with respect to each issuer or security or any identified portion of the report with respect to an issuer or security that the research analyst covers in this research report, all of the views expressed in this research report accurately reflect their personal views about those issuer(s) or securities. Each research analyst(s) also certify that no part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this research report.

IMPORTANT DISCLOSURES

Thermax (THMX.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Deepal Delivala
Covered since May 23 2007



Date	Rating	Target Price	Closing Price
1 22-May-07	*1L	*562.00	448.50
2 30-May-07	1L	*604.00	488.85
3 26-Jul-07	1L	*764.00	637.30
4 30-Jan-08	1L	*748.00	652.50
5 24-Jun-08	1L	*480.00	393.80

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

ABB (India) (ABB.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Venkatesh Balasubramaniam
Covered since February 2 2007

Date	Rating	Target Price	Closing Price
1 1-Feb-07	*1L	*880.00	760.55
2 29-May-07	1L	*1,103.20	914.98
3 28-Aug-07	1L	*1,266.00	1,110.95
4 24-Oct-07	*2L	*1,595.00	1,453.80
5 26-Feb-08	2L	*1,260.00	1,197.75
6 29-Apr-08	*3L	*1,027.00	1,135.35
7 17-Jun-08	3L	*1,003.00	962.95
8 25-Jul-08	3L	*834.00	833.60
9 27-Oct-08	3L	*448.00	500.40

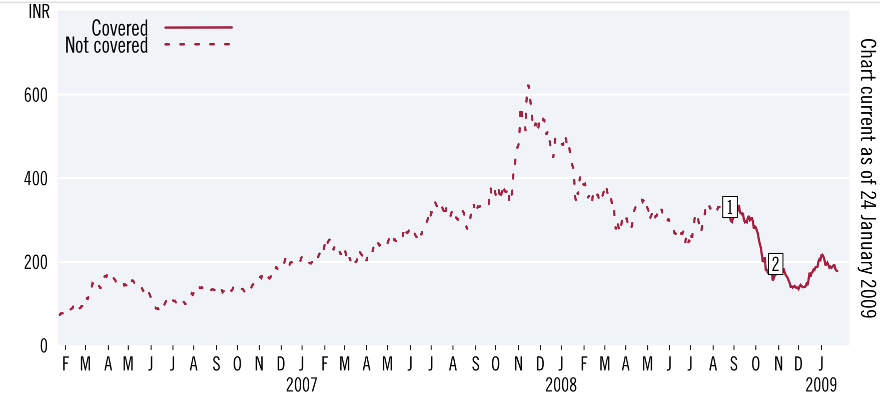
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Areva T & D India (AREV.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Venkatesh Balasubramaniam
Covered since August 26 2008



	Date	Rating	Target Price	Closing Price
1	26-Aug-08	*2M	*361.80	305.91
2	29-Oct-08	*3M	*167.00	169.70

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Bharat Heavy (BHEL.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Venkatesh Balasubramaniam
Covered since February 24 2006

	Date	Rating	Target Price	Closing Price
1	24-Feb-06	1L	*1,128.00	953.25
2	3-Apr-06	1L	*1,321.50	1,149.02
3	11-Sep-06	1L	*1,382.00	1,127.30
4	28-May-07	1L	*1,672.00	1,361.88
5	12-Jul-07	1L	*1,923.00	1,641.35
6	9-Oct-07	1L	*2,542.00	2,236.75
7	21-Nov-07	1L	*2,936.00	2,486.10
8	4-Mar-08	1L	*2,529.00	2,098.25
9	9-Apr-08	*2L	*1,832.00	1,776.75
10	24-Jun-08	*1L	*1,642.00	1,391.00
11	12-Aug-08	*2L	*2,025.00	1,805.15
12	27-Oct-08	*1L	*1,373.00	1,080.25

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Larsen & Toubro (LART.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Venkatesh Balasubramaniam
Covered since March 1 2006

	Date	Rating	Target Price	Closing Price
1	25-Apr-06	1L	*789.75	672.85
2	26-Feb-07	*2L	*866.50	796.20
3	5-Jun-07	*1L	*1,180.00	972.52
4	18-Jul-07	1L	*1,382.50	1,164.78
5	1-Nov-07	*3L	*2,005.00	2,213.30
6	22-Jan-08	*1L	*2,280.50	1,827.70
7	2-Apr-08	1L	*2,070.50	1,432.73
8	26-Jun-08	1L	*1,585.00	1,179.42
9	24-Sep-08	1L	*1,480.50	1,275.63
10	24-Oct-08	1L	*953.00	779.40
11	8-Dec-08	*2L	*787.00	740.20
12	27-Jan-09	2L	*697.00	638.20

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Citigroup Global Markets Inc. or its affiliates beneficially owns 1% or more of any class of common equity securities of Bharat Heavy, Larsen & Toubro. This position reflects information available as of the prior business day.

Within the past 12 months, Citigroup Global Markets Inc. or its affiliates has acted as manager or co-manager of an offering of securities of Areva T & D India, Bharat Heavy.

Citigroup Global Markets Inc. or its affiliates has received compensation for investment banking services provided within the past 12 months from ABB (India), Areva T & D India, Bharat Heavy, Larsen & Toubro.

Citigroup Global Markets Inc. or its affiliates expects to receive or intends to seek, within the next three months, compensation for investment banking services from Areva T & D India.

Citigroup Global Markets Inc. or an affiliate received compensation for products and services other than investment banking services from Thermax, ABB (India), Areva T & D India, Bharat Heavy, Larsen & Toubro in the past 12 months.

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following as investment banking client(s): ABB (India), Areva T & D India, Bharat Heavy, Larsen & Toubro.

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