

India Capital Goods Sector

Theme: order book analysis - a look beyond the numbers

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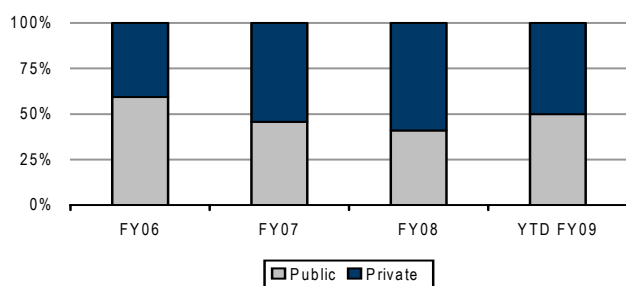
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- A slowing macro, liquidity squeeze, high borrowing cost and receding equity wealth in combination can potentially slow order inflows and extend execution cycles. Hence, quality of order book will take precedence over the order backlog and inflow momentum when dictating the stock prices, in our view.
- With the corporate sector is undergoing a phase of capex rationalisation (more expected) and scaling down of prior investment plans, higher gearing to the private sector corporate capex for L&T (50% of YTD inflows) versus a 25% gearing for BHEL suggests a more defensive order book for the latter.
- While there were no unusual trends in size and duration of the order books for L&T and BHEL, order skew towards real estate and metals for L&T (53% of YTD orders) that are witnessing capex purge are areas of potential concern, in our view. NHA project disbursements could help diversify the order mix, though.
- In terms of geographic gearing lighter mix of international projects YTD (6% of mix versus 26% in FY08) highlight some slowdown in the global order activity. Management attributes this to falling commodity prices and the subsequent re-evaluation of the projects.

Order inflow- looking beyond the numbers

We studied three aspects of an order book for testing its resilience: 1) where the orders originate from (private/government) to test the risk of delay/cancellation, 2) sectoral /geographic gearing (some sectors like real estate and metals are slowing down) and 3) the trends in order book duration and size (to understand lead time and execution cycles).

Figure 1: Over 50% of the order book is geared to the private sector



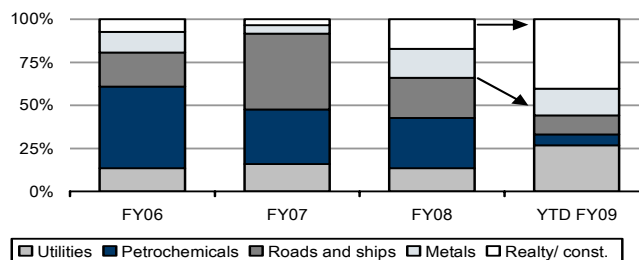
Source: Company data, Credit Suisse estimates.

Corporate/government mix: While comparing L&T with BHEL, we note that L&T's high gearing to the private sector (Figure 1) compared with a 25% gearing for BHEL suggests higher order book risk profile for L&T. While its higher gearing towards the government sector offers lower risk compared with L&T, we note that the risk for BHEL (if any) stems from a possible elongation of execution cycles. A slower execution rate implies that the rate of revenue growth would be lower than what the order book growth might suggest.

Sectoral gearing: An order inflow analysis for the past few years for L&T suggests that in recent times bookings have been skewed towards the realty/construction and metal sectors. About 53% of order

inflows announced YTD have been from these sectors compared with only 34% in FY08 (some large ticket orders are highlighted in Fig. 3).

Figure 2: Order inflow trend based on the client sector



Source: Company data

A slower capex activity in both these sectors suggests that future order activity could be muted, in our view. The sectoral gearing could get more comfortable, though, if NHA road project disbursements (60 projects with a value of Rs700 bn) are on track (by March 2009) and L&T manages to obtain a portion of these construction contracts.

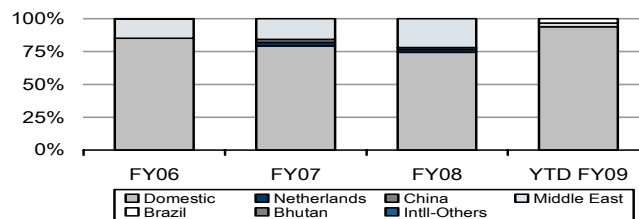
Figure 3: L&T: some large orders from the real estate and metals sectors (Rs mn)

	YTD FY09
Tata Steel	15,780
NESCO, Godrej Properties, PBEL Property Dev, etc	35,000
Bombay Dyeing	20,000
Bhushan Steel Limited	4,500
SAIL	8,600
Construction of IT and office space (TCS, etc)	14,500
Total	98380
% of YTD order inflows	34%

Source: Company data

Geographic gearing: The order book inflows for L&T suggest a slower activity in international orders (6% of mix versus 26% last year). Management suggested that falling commodity prices have led to reassessment of cost of projects leading to a delay in the order activity.

Figure 4: International order activity has been slower this year



Source: Company data, Credit Suisse estimates.

Valuation metrics

Company	Ticker	CS rating	Price		P/E (x)	
			Local	Target	FY09	FY10
Larsen & Toubro	LT IN	O	691	1,115	16.2	13.8
BHEL	BHEL IN	O	1,269	1,630	20.1	14.2

Note: O = OUTPERFORM, N = NEUTRAL, U = UNDERPERFORM

Source: Company data, Credit Suisse estimates

Companies Mentioned (Price as of 03 Dec 08)

Larsen & Toubro (LART.BO, Rs690.95, OUTPERFORM [V], TP Rs1115.16)
 Bharat Heavy Electricals (BHEL.BO, Rs1268.85, OUTPERFORM, TP Rs1629.82)
 Tata Steel Ltd (TISC.BO, Rs148.90, OUTPERFORM [V], TP Rs320.00)
 Steel Authority of India Ltd (SAIL.BO, Rs63.70, OUTPERFORM [V], TP Rs125.00)
 Tata Consultancy Services (TCS.BO, Rs536.00, OUTPERFORM, TP Rs725.00, MARKET WEIGHT)
 Bombay Dyeing (BDYN.BO, Rs141.80, NOT RATED)

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