BHEL - BUY

CMP Rs1,402, Target Rs1,610

Sector: Capital Goods	
Sensex:	8,955
CMP (Rs):	1,402
Target price (Rs):	1,610
Upside (%):	14.9
52 Week h/l (Rs):	2,366 / 984
Market cap (Rscr) :	68,609
6m Avg vol ('000Nos):	485
No of o/s shares (mn):	490
FV (Rs):	10
Bloomberg code:	BHEL IB
Reuters code:	BHEL.BO
BSE code:	500103
NSE code:	BHEL

Prices as on 26 Feb, 2009.

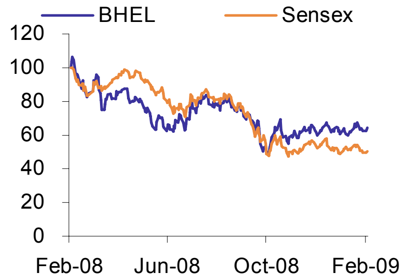
Shareholding pattern

December '08	(%)
Promoters	67.7
Institutions	25.5
Non promoter corp hold	4.3
Public & others	2.5

Performance rel. to sensex

(%)	1m	3m	1yr
BHEL	3.5	9.2	13.9
L&T	(8.0)	(18.0)	(16.1)
ABB	(20.7)	(16.5)	(20.1)
Siemens	15.4	1.5	(23.0)

Share price trend



Rs1.1trn order book provides strong visibility

Robust investments in the power sector coupled with BHEL's dominance in the power equipment space translated into a robust order book. BHEL's order book of Rs1.1trn, grew by 3.5x over the past five years, is 5.3x FY08 gross revenues provides strong revenue visibility. In order to avoid delays, it is doubling capacity to 20,000MW by FY12. Since majority of the orders are from the Government and NTPC, BHEL is insulated from lower payment risk and order cancellations. We believe BHEL's order book will continue to grow as fresh investments are announced in the power sector.

Lower commodity prices will positively impact margin

In order to overcome supply chain issues, BHEL stocks its key raw materials for a period of four-six months. For the 9M FY09 steel prices were higher by ~48% yoy, thus negatively impacting margins for the year. However with prices correcting by 51% over the past 7 months and BHEL consuming its high cost inventory in Q4 FY09, we expect its margins to improve in FY10. Also its staff cost will increase marginally as the full impact of sixth pay commission will be accounted for in FY09.

Beneficiary of robust investments in the power sector

BHEL being the largest power equipment supplier in the country is a direct beneficiary of the robust investments planned in the power sector. Apart from gaining orders for BTG, it will also benefit from EPC orders for generation, transmission and distribution. Robust investments in the overall infrastructure space will enable BHEL's earnings to witness 33% CAGR over FY09-11E.

Defensive bet, trades at 13x FY11E EPS, BUY

BHEL's earnings growth over the next two years will be aided by 1) strong and growing order book, 2) improved execution, 3) capacity addition, 4) improving margins due to lower raw material cost and 5) depreciating rupee. At 13x FY11E EPS, we believe the stock is attractively valued. We initiate coverage with BUY rating and a target price of Rs1,610/share, an upside of 15%.

Valuation summary

Y/e 31 Mar (Rs m)	FY08	FY09E	FY10E	FY11E
Revenues	197,269	249,417	331,528	397,574
yoy growth (%)	12.0	26.4	32.9	19.9
Operating profit	37,414	41,106	64,989	79,001
OPM (%)	19.0	16.5	19.6	19.9
Pre-exceptional PAT	28,529	29,462	43,649	52,561
Reported PAT	28,593	29,462	43,649	52,561
yoy growth (%)	18.4	3.0	48.2	20.4
EPS (Rs)	58.3	60.2	89.2	107.4
P/E (x)	24.1	23.3	15.8	13.1
Price/Book (x)	6.4	5.4	4.4	3.6
EV/EBITDA (x)	16.2	14.8	9.3	7.6
Debt/Equity (x)	0.0	0.0	0.0	0.0
RoE (%)	29.2	25.0	30.7	30.3
RoCE (%)	45.0	38.3	47.0	46.5

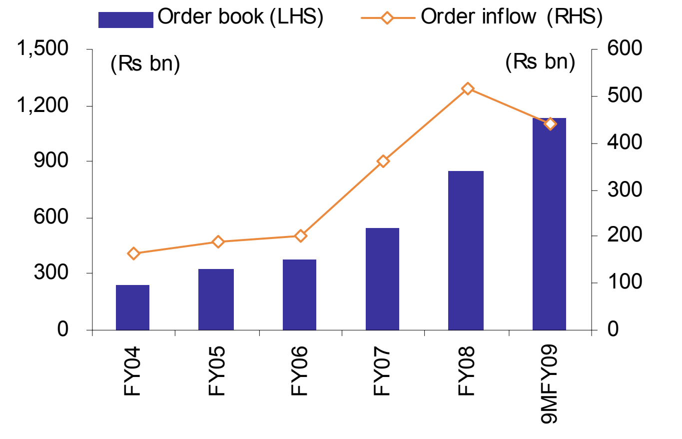
Source: Company, India Infoline Research

Rs1.1trn order book, 5.3x FY08 revenues provides strong visibility

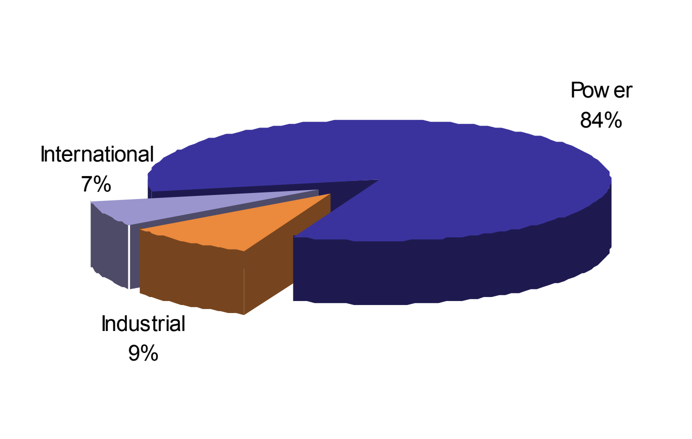
Since most of the orders are from the Government and NTPC, BHEL is insulated from payment and order cancellation risk

BHEL's Rs1.1trn order book, 5.3x FY08 gross revenues, will be executed over the next couple of years, thus providing strong earnings visibility. 84% of these orders are BTG followed by industrial at 9% and international at 7%. The power segment comprises of BTG orders of units up to 600MW. Since most of these orders are from the Government and NTPC, chances of cancellations and delayed payments are low, thus providing a stable growth outlook.

Order book has grown 3.5x over 5 years



Power accounts for 84% of the order book



Source: Company, India Infoline Research

Targets year end order book position of Rs1.2trn

BHEL targets a year end order book position of Rs1.2trn representing an order inflow of ~Rs500bn. The management has set a marginally lower target of Rs400bn order inflow (on a higher base) for FY10. This will be on account of slower tendering of fresh orders for the XIIth five year plan. Most of these new orders will be from state electricity boards and a bulk order of 11x660MW from the Government. Incase BHEL is L1 for this bulk order, it has been assured for 6 units, however the management is confident of receiving orders for atleast 5 units.

Some of the recent projects awarded to BHEL

Customer	Location	Type of entity	Value (Rs bn)
Jindal Power	Chattisgarh	Private	50
Pragati III CCPP	Bawana	Public	35
MPPGCL	Malwa	Public	31
MSPGCL	Chandrapura TPS	Public	26
APPDCL	Krishnapatnam	Public	25
ONGC Tripura Power	Pallatanam	Public	22
Chhattisgarh SEB	Marwa	Public	22
Mauda STPP	Nagpur	Public	21
TNEB	North Chennai	Public	21
Tishreen Thermal Power Plant	Syria	Private	20
DVC	Bokaro TPS	Public	18
NTPC	Barh	Public	14
APGENCO	Bhoopalpally	Public	13
GVK Power Limited	Goindwal Sahib	Private	11

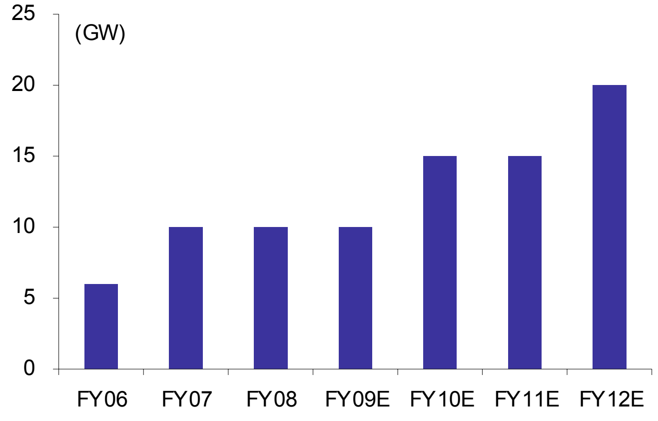
Source: Company, India Infoline Research

Doubling capacity to 20,000MW to overcome delays

Doubling capacity to 20GW by FY12

Generation capacity addition in the country has suffered in the past as BHEL was constrained for capacity. BHEL enhanced its capacity to 10,000MW in FY07 from 6,000MW in FY06. However, majority of this addition was for hydro generation sets (2.5GW) while the rest was due to the commencement of a third shift of operations. In order to overcome such delays in future, BHEL has charted out a 2-phase capacity expansion plan for its power division. In phase-I it will add 5,000MW which is expected to commission by Q3 FY10 and further add another 5,000MW by FY12, thus doubling its total installed capacity. This should enable BHEL to overcome delays going forward. However, as the addition will happen over a period of time, we have factored in some delays into our estimates.

Enhancing capacity to 20GW by FY12



Source: Company, India Infoline Research

In order to overcome supply chain issues, BHEL has entered into joint ventures with NTPC, Heavy Engineering Corp Ltd, Toshiba, NPCIL, TNEB, GE and Sheffield, UK.

Ventures entered into by BHEL

JV / MoU	Venture details
NTPC	Power equipments
Toshiba	Transmission equipments
Heavy Engineering Corp Ltd	Supply of castings and forgings
Sheffield, UK	Power equipments
NPCIL	Nuclear power equipments
TNEB	Super-critical thermal power plant
GE	Diesel locomotive

Source: Company, India Infoline Research

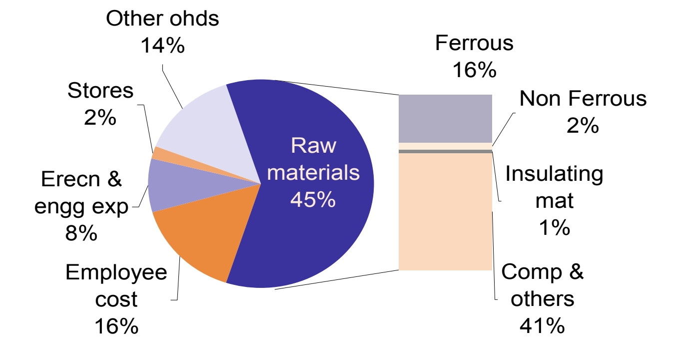
BHEL's operating margin to improve by 340bps to 20% by FY11E on account of lower steel prices and staff cost

Lower commodity prices to positively impact margins

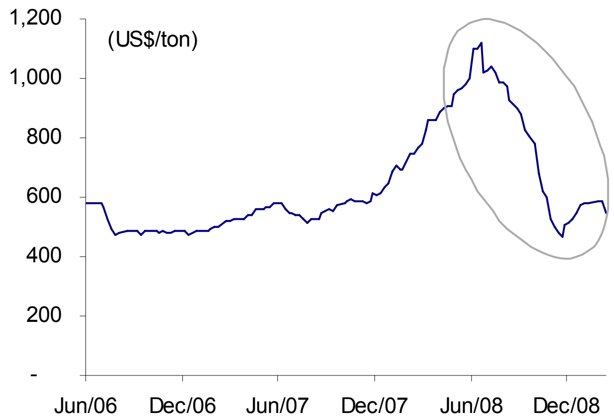
Raw materials form ~45% of the overall cost with steel accounting for ~16%. Price of steel has corrected by 51% over the past 7 months to US$550/ton from US$1,120/ton in July 08. BHEL follows a policy of maintaining inventory of 4 months for its indigenous materials and ~6 months for imported materials. As a result, it will be negatively impacted in Q4 FY09 when its entire high cost inventory will be consumed. However in FY10 when it utilizes lower cost raw materials, we expect its margins to improve. As per the management, BHEL has not yet re-negotiated contracts with its customers for lower prices, despite a de-escalation clause being in place (maximum de-escalation of up to 20%).

In FY09, BHEL's staff cost is expected to rise by 65% yoy to Rs43bn as it accounted for the Sixth Pay Commission. This translated into higher staff cost at 17% of sales for FY09, a jump of 400bps. However, with no such adjustments in future, this is expected to normalize at 14% of sales by FY11E. This coupled with lower material cost will enable BHEL's margins to improve by 340bps to 19.9% by FY11E.

Raw material forms 45% of overall cost



Steel price has halved since July 08



Source: Company, India Infoline Research

Supercritical orders put BHEL in the big league

In the past BHEL has been unable to bag any supercritical orders. Of the three UMPP's that were awarded to Tata Power (Mundra) and Reliance Power (Sasan and Krishnapatnam), non have been awarded to BHEL. Tata Power awarded the main plant package to Toshiba-Doosan while Reliance Power awarded it to Shanghai Electric for its Sasan UMPP. Reliance Power is yet to award contracts for its Krishnapatnam UMPP.

However, BHEL has been successful in breaking the jinx as it bagged orders for 600MW and 800MW turbines from NTPC's Barh, APGENCO's Krishnapatnam and TNEB, thus putting it into the big league. We believe BHEL will continue to receive more such orders as the Chinese players cannot bid for the 565 super heat and 593 reheat supercritical machines. Moreover, BHEL is insulated by the rupee depreciation which gives it a ~25% cushion against imports.

Supercritical orders awarded to BHEL

Client	Location	Capacity	Order Value (Rs bn)
NTPC	Barh	2x660	14
APGENCO	Krishnapatnam	1x600	13
TNEB	Tuticorin	2x800	87

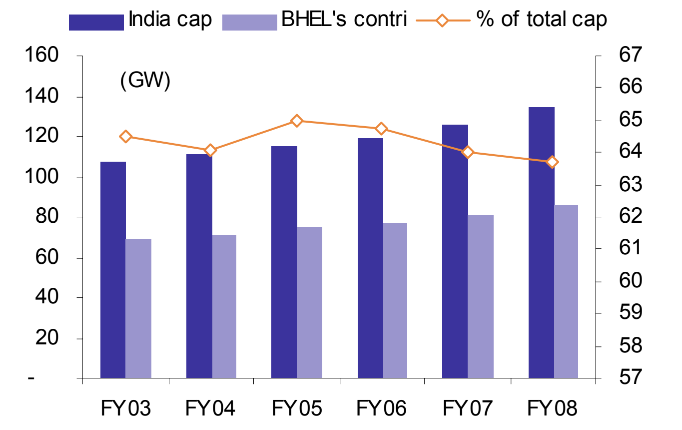
Source: Company, India Infoline Research

Huge opportunity in the power sector

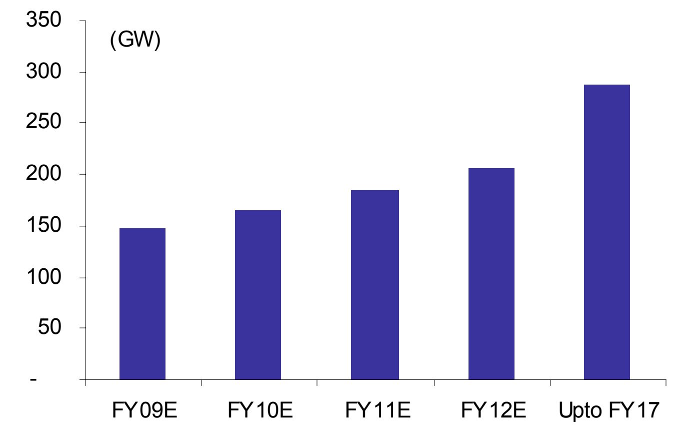
160GW opportunity over FY08-17E, BHEL being the largest player will be a direct beneficiary

India will continue to be a power deficit country for the next few years. Thus it makes it imperative for the country to add more capacity to suffice its ever growing demand. In order to meet the mission of "Power for all by 2012" the country plans to add ~160GW over the FY08-17. This translates into ~US$150bn opportunity for the power equipment players. BHEL being the largest player controlling 65% of the domestic market is a direct beneficiary of this opportunity. BHEL's equipments are form 64% of the country's generating assets. BHEL will also benefit from R&M orders of ageing plants across the country.

BHEL contributes 64% of the overall installed capacity



India's expected installed capacity over XIth and XIIth five year plans



Source: Company, India Infoline Research

In addition, BHEL will also benefit as competition from Chinese and Korean players remains low. It recently outbid its international counterparts under the international competitive bidding to win an order for 2 sets of 600MW in Madhya Pradesh. This should enable BHEL to grow its order book going forward and reap benefits of higher investment in the sector. We expect BHEL to continue to maintain its 64% market share going forward.

23-Feb-2009

BHEL once again outbids Chinese companies in international competitive bidding; Bags Rs31,500mn mega contract for installing 2 sets of 600 MW each in Madhya Pradesh

Once again outbidding Chinese equipment suppliers under International Competitive Bidding (ICB), BHEL has won an order for the main plant package at the upcoming Malwa Thermal Power Project (TPP) in Madhya Pradesh, involving two new-rating units of 600 MW each.

Valued at Rs31,500mn, the order for the greenfield power project has been placed on BHEL by Madhya Pradesh Power Generating Company Limited (MPPGCL).

Significantly, in Madhya Pradesh, this is the first order secured by BHEL for the new-rating units of 600 MW and is a testimony to the customer's confidence in the company's technological excellence and capability in executing projects of this magnitude. This project will significantly augment the existing generating capacity in the state of Madhya Pradesh.

BHEL's scope of work in the contract includes design, engineering, manufacture, supply, erection and commissioning of Steam Turbines, Generators, Boilers and associated Auxiliaries, including Transformers, Busducts and state-of-the-art Controls and Instrumentation, in addition to civil works for the main power block.

While the first set is scheduled to go on stream in a tight schedule of 39 months, the second set will be commissioned in 43 months from the zero date of contract.

BHEL has fully established state-of-the-art technology for the manufacture of thermal sets up to 1,000 MW rating suited to Indian conditions using Indian as well as imported coal. The company has also introduced new rating thermal sets of 270 MW, 525 MW and 600 MW to meet customer demand and orders for 85 numbers of 500-600 MW rating sets have been won by the company, so far.

BHEL is building Capacity and Capability to contribute fully for meeting the power forecast for the 11th Plan and beyond. For this, the company has enhanced its manufacturing capacity to 10,000 MW per annum which is being further enhanced to 15,000 MW per annum by December 2009 and to 20,000 MW by December 2011. Manpower is also being ramped up in a commensurate and timely manner. Besides, the company has taken steps like shift in operational focus from Product to Project and implementation of effective Project Management Systems.

Source: BHEL Press Release

33% earnings CAGR over FY09-11E beating the economic downturn, initiate coverage with BUY

BHEL's strong order book of Rs1.1trn provides earnings visibility for the next couple of years. Its order book coverage ratio has improved considerably to over 5x from 2.6x in FY06. Huge investments planned in the sector coupled with BHEL's dominance should enable it to grow its order book over the next couple of years. In order to overcome delays, it is in the process of doubling capacity to 20,000MW by FY12. We expect BHEL to improve its execution as this additional capacity comes on stream and its JV's take form. As a result it should be able to generate ~Rs47bn of free cash flow over FY09-11E, thus funding its capex through internal accruals. BHEL has net cash of Rs161/share (11% of CMP) which we expect will grow to ~Rs178/share by FY11. Robust growth outlook on the back of a strong and growing order book should enable BHEL to witness 33% earnings CAGR over FY09-11E, beating the economic slowdown. We initiate coverage with BUY rating and a target price of Rs1,610/share, an upside of 15%.

BHEL currently trades below its average PE of 22x

Source: Bloomberg, India Infoline Research

Financials

Income statement

Y/e 31 Mar (Rs m)	FY08	FY09E	FY10E	FY11E
Revenue	197,269	249,417	331,528	397,574
Op profit	**37,414**	**41,106**	**64,989**	**79,001**
Depreciation	(2,972)	(3,342)	(4,075)	(4,964)
Interest exp	(354)	(286)	(262)	(238)
Other income	10,034	7,847	6,500	7,064
PBT	**44,122**	**45,327**	**67,152**	**80,863**
Taxes	(15,593)	(15,864)	(23,503)	(28,302)
Adj profit	**28,529**	**29,462**	**43,649**	**52,561**
Ex items	65	-	-	-
Net profit	**28,593**	**29,462**	**43,649**	**52,561**

Balance sheet

Y/e 31 Mar (Rs m)	FY08	FY09E	FY10E	FY11E
Equity capital	4,895	4,895	4,895	4,895
Reserves	102,847	123,347	151,676	185,789
Net worth	**107,742**	**128,242**	**156,571**	**190,684**
Debt	952	952	952	952
Total liabilities	**108,694**	**129,194**	**157,523**	**191,636**
Fixed assets	16,393	22,632	30,637	36,754
Investments	83	83	83	83
Def tax asset	13,379	13,379	13,379	13,379
Net wrkg cap	**(5,021)**	**14,676**	**32,239**	**53,183**
Inventories	57,364	72,860	97,259	116,885
Sundry debtors	119,749	152,096	203,031	244,000
Other cur assets	16,074	20,416	27,254	32,753
Sundry creditors	(165,765)	(189,488)	(240,298)	(274,347)
Other cur liab	(32,444)	(41,208)	(55,008)	(66,108)
Cash	83,860	78,424	81,185	88,237
Total assets	**108,694**	**129,194**	**157,523**	**191,636**

Cash flow statement

Y/e 31 Mar (Rs m)	FY08	FY09E	FY10E	FY11E
PBT	44,122	45,327	67,152	80,863
Depreciation	2,972	3,342	4,075	4,964
Tax paid	(15,593)	(15,864)	(23,503)	(28,302)
Working capital Δ	13,361	(19,698)	(17,562)	(20,945)
Op cash flow	44,862	13,106	30,161	36,580
Cap expenditure	(6,452)	(9,580)	(12,080)	(11,080)
Free cash flow	**38,410**	**3,526**	**18,081**	**25,500**
Equity raised	(0)	-	-	-
Investments	-	-	-	-
Debt financing/disposal	59	-	-	-
Dividends paid	(8,734)	(8,962)	(15,320)	(18,448)
Other items	(3,963)	-	-	-
Net Δ in cash	**25,771**	**(5,436)**	**2,761**	**7,052**

Key ratios

Y/e 31 Mar	FY08	FY09E	FY10E	FY11E
Growth matrix (%)				
Revenue growth	12.0	26.4	32.9	19.9
Op profit growth	3.8	9.9	58.1	21.6
EBIT growth	17.7	2.6	47.8	20.3
Net profit growth	17.5	3.3	48.2	20.4
Profitability ratios (%)				
OPM	19.0	16.5	19.6	19.9
EBIT margin	22.5	18.3	20.3	20.4
Net profit margin	14.5	11.8	13.2	13.2
RoCE	45.0	38.3	47.0	46.5
RoNW	29.2	25.0	30.7	30.3
RoA	10.6	8.8	10.7	10.7
Per share ratios				
EPS	58.3	60.2	89.2	107.4
DPS	15.3	15.6	26.7	32.2
Cash EPS	64.4	67.0	97.5	117.5
BVPS	220.1	262.0	319.8	389.5
Payout (%)				
Dividend payout	30.6	30.4	35.1	35.1
Tax payout	35.3	35.0	35.0	35.0
Liquidity ratios				
Debtor days	222	223	224	224
Inventory days	106	107	107	107
Creditor days	307	277	265	252
Leverage ratios				
Interest coverage	125.6	159.7	257.6	340.8
Net debt / equity	(0.8)	(0.6)	(0.5)	(0.5)
Net debt / op. profit	(2.2)	(1.9)	(1.2)	(1.1)
Component ratios (%)				
Raw material	48.3	48.8	48.5	48.9
Erection & engg exp	7.2	7.2	7.3	7.3
Staff cost	13.2	17.3	14.3	13.1
Other op exp	12.3	10.2	10.4	10.8

Du-Pont Analysis

Y/e 31 Mar (Rs m)	FY08	FY09E	FY10E	FY11E
Tax burden (x)	0.65	0.65	0.65	0.65
Int burden (x)	0.99	0.99	1.00	1.00
EBIT margin (x)	0.23	0.18	0.20	0.20
Asset turnover (x)	0.73	0.75	0.82	0.81
Fin leverage (x)	2.76	2.83	2.85	2.84
RoE (%)	**29.2**	**25.0**	**30.7**	**30.3**

Recommendation parameters for fundamental reports:

Buy – Absolute return of over +10%

Market Performer – Absolute return between -10% to +10%

Sell – Absolute return below -10%

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