kotak Institutional Equities

BGR Energy Systems (BGRL)

Industrials

ADD

MARCH 17, 2010

UPDATE.

Coverage view: Attractive

Price (Rs): 513

Target price (Rs): 500

BSE-30: 17,383

Khaperkheda site visit reassuring—execution on track so far. A site visit reflected good execution capabilities with a large proportion of the project value captured in-house. The management seemed confident of the near-term performance of the company. BGR has reported strong progress in terms of execution, order booking and stronger-than-expected balance sheet and working capital positions. We retain our ADD rating and TP of Rs500 based on execution track record, near-term visibility and sectoral opportunities.

Company data and valuation summary

BGR Energy Systems

Stock data			
52-week range (Rs) (high,low)			593-117
Market Cap. (Rs bn)			36.9
Shareholding pattern (%)			
Promoters			81.3
FIIs			1.6
MFs			6.6
Price performance (%)	**1M**	**3M**	**12M**
Absolute	0.1	3.5	328.0
Rel. to BSE-30	(5.4)	0.5	118.2

Forecasts/Valuations	2010	2011E	2012E
EPS (Rs)	23.6	30.2	37.7
EPS growth (%)	47.4	27.8	25.0
P/E (X)	21.7	17.0	13.6
Sales (Rs bn)	26.1	34.8	43.7
Net profits (Rs bn)	1.7	2.2	2.7
EBITDA (Rs bn)	3.1	4.1	5.1
EV/EBITDA (X)	12.2	9.5	7.7
ROE (%)	26.9	27.6	27.7
Div. Yield (%)	0.8	1.0	1.3

Site visit – key takeaways: Capturing a large proportion of value in-house

The key takeaways from our site visit to the Khaperkheda power plant include (1) about Rs8.5 bn of revenue booked versus a total contract value of Rs9.98 bn, (2) most of project value captured in-house, apart from mechanical and electrical supplies, (3) advance procurement and supply of commodity requirements for the site mitigates commodity risks, (4) BOP and BTG vendors have several interfaces and delays by any of them would delay others and (5) state utilities are ill prepared to take up project execution; BoP likely to remain the preferred route. BHEL site management cites improvement in delivery of critical items with higher outsourcing and advanced procurement; however, state utilities and subcontractors still affect execution.

Management seems confident on near-term performance; several opportunities in the offing

The management seems positive on the near-term earnings of the company and has also reported progress (erection of boiler drum at Mettur) in the EPC orders. BGR has also been managing the working capital levels well as reported at end of 9MFY10. Several large orders (Suratgarh EPC: 2X660 MW, Chhabra EPC: 2X660 MW, Koradi: 3X660 MW) to the tune of about Rs204 bn are likely to be finalized in the next few months including some private sector orders.

Competition scaling up—but still remain behind on scale, scope and learning curve

The competition has been scaling up in the recent past with several vendors taking up BoP contracts. However, we believe that these companies are still behind BGR Energy in terms of scale and scope of capabilities. Companies such as Sunil Hitech, McNally Bharat and Techpro Systems have scaled up their businesses but still very few companies have the capability to execute a complete BoP package individually, particularly for large unit sizes of 500 MW and above.

Retain ADD based on good execution, better balance sheet quality, sectoral opportunities

We retain our target price of Rs500 based on 17X Mar'11E earnings and retain ADD based on (1) strong execution with a pick-up in large EPC orders, (2) high near-term visibility, (3) strong balance sheet, and (4) sectoral opportunities. Key risks: (1) large investment requirement in equipment venture, (2) competition impacting margins, (3) concentrated customer base.

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Site visit takeaways: Capturing large proportion of value apart from supplies

BGR Energy is capturing most of the value of the project in-house—only employing labor subcontractors and taking mechanical and electrical supplies. Most of the design, engineering and civil execution is being captured in-house. BGR Energy has employed about 80 engineers for execution and would be employing about 1,400 contract laborers through sub-contractors at any point of time. Of all the BoP components, only Ash handling had been outsourced (awarded to Tecpro Ashtech), however, sub items like a long distance pipeline for transporting ash to ash dyke, pumps for that purpose were not subcontracted. In coal handling as well, all the civil execution was handled in-house, while wagon tipplers, crushers and a stacker reclaimer were ordered from Elecon Engg. BGR handles all the tall structures (chimney, cooling tower) and civil works (such as various buildings, BTG foundation) in-house through the help of labor contractors.

Evidence of mitigating commodity risks with early supply of commodity requirements to site

BGR supplies most of the reinforcement and structural steel required at the time of start of project and that helps mitigate the commodity-price-related risks in the fixed price contracts. For instance, in this specific project, almost 17,000 T of reinforcement steel was supplied in 2007 itself against a total project requirement of about 20,000 T. The client makes payment as per the progress of delivery on site and that helps control inventory costs for BGR Energy. Even 60-70% of the total structured steel requirement for the projects was acquired in the first few months after award of the project.

BOP and BTG vendors have several interfaces and delay by one of them would delay the other

We noted several points of interface between the scope of the BoP and BTG vendors. Some key interfaces that we noted were (1) coal input into coal mills/bunkers (in scope of BTG vendors) from conveyor from coal handling plant (in scope of BoP vendor), (2) Cooling water and make-up water to be provided by BoP vendor but it has to be to be picked up by a BTG vendor for pumping into the boiler, (3) civil foundations for turbine and boiler are provided by BoP vendor while installation is in scope of BTG vendor, (4) chimney is in scope of BoP vendor but ESP from which the flue gases come is in the scope of BTG vendor, (5) start-up power in scope of BTG vendor.

State utilities ill prepared to take up the project execution; BoP likely to remain the preferred route

Our interaction seemed to suggest that state utilities are ill prepared to managing the projects themselves as a large number of experienced employees have left these organizations over the past few years. Thus state utilities would have to continue to depend on BoP vendors (given reluctance of entities like BHEL to take up EPC contracts) for help in managing project execution. State utilities do not seem to push the execution, effectively leading to delays in projects. For instance (1) procedural clearances for design drawings are protracted given the involvement of various agencies, (2) state utilities rely on physical exchange and very sparingly use emails. In contrast, private sector utilities seem to push the execution of projects more aggressively led by ownership interest and ambition.

Most employees of BGR Energy had long experience in the state utilities

We noticed that most employees of BGR Energy had joined in the past 3-4 years and had worked in state electricity boards for long periods of time (15-25 years). Manpower constraints were cited as the biggest execution constraint. Employees seemed to be spoilt for choice as various companies among utilities, equipment vendors and BoP vendors are simultaneously trying to build capabilities in this space. However, the exodus from state utilities is making them even weaker so their dependence on consultants, BoP/EPC vendors is increasing.

Project background

Project was awarded to BGR Energy in June-July 2007 and was scheduled to be completed in March 2010. However, the project is now likely to be completed only in September 2010 or later. Coordination between various agencies related to clearances on drawings, inter-linkage between various entities such as civil and mechanical contractors have led to delay in project execution. A couple of critical items like turbine casings etc. have also not been received.

Other site-specific issues have been that this plant is being executed on a relatively smaller amount of land i.e. about 55 hectares of land versus about 90-100 hectares of land typically required for 500 MW units. This site also used to have a 30 MW configuration power plant which has been demolished to make way for a larger power plant.

BHEL management cited improvement in delivery however state utilities, subcontractors still affect execution

BHEL site management cited lots of improvement in its own functioning such as (a) higher amount of outsourcing versus earlier with more vendors being developed even for relatively more critical items, (b) sequential delivery of items from manufacturing sites, advance procurement action for items such as castings and forgings have eased the constraints. However, BHEL management seemed to believe client ownership and the ability to push project execution by supporting contractors is very low in SEBs. Some SEBS have embarked on capacity addition after a hiatus. Thus lull in capacity addition in SEBs in between (1999-2004/5) as well as loss of skilled man power to private sector has affected abilities to manage projects. Similarly, sub-contractors are overbooked and thus they also delay deliveries as they juggle limited resources across various projects. For instance, same Suni Hitech is a contractor for several projects of BHEL in Maharashtra itself. BHEL was employing Sunil Hitech for some parts of erection and commissioning related activities for BTG package.

BGR Energy has reported relatively good progress in the two EPC projects

BGR Energy has reported relatively good progress in the two large EPC projects under execution viz. 2X600 MW Kalisindh and 1X600 MW Mettur thermal power plants. The company recently reported successful lifting and erection of the boiler drum at the Mettur power plant in 107 working days. The boiler structural erection works had commenced on September 29, 2009. The management seems optimistic about the near-term earnings of the company led by a pick-up in the execution of the EPC orders. The company has also reported stronger-than-expected balance sheet and working capital levels at the end of 9MFY10 versus end-FY2009 levels. BGR had a net cash of about Rs500 mn at the end of 9MFY10 versus a net debt of about Rs940 mn at end of FY2009.

Key balance sheet number at end of 9MFY10 versus end-FY2009 levels (Rs mn)

	9MFY10	FY2009
Liabilities		
Equity	6,500	5,633
Debt	8,500	7,090
Assets		
Fixed assets	1,250	1,031
Cash	9,000	6,152
Current assets	**22,000**	**19,539**
Debtors	14,000	12,789
Loans and advances	8,000	6,432
Current liabilities	**18,750**	**13,229**
Sundry creditors	10,000	12,551
Provision & advances	8,750	677
Net working capital	**3,250**	**6,310**
Net debt/ (cash)	**(500)**	**938**

Source: Company, Kotak Institutional Equities

Competition increasing—but still behind in scale, scope and learning curve

The competition for BGR has been scaling up in the recent past with several vendors capable of taking up complete BoP contracts versus individual packages. Some players such as Techpro Systems Ltd., which were primarily restricted to coal and ash handling have started bidding for complete BoP packages through the consortium route. Several players such as McNally Bharat Engineering, Sunil HiTech Engineers, Punj Lloyd etc. have recently won large BoP contracts to the tune of about Rs4.5-9 bn. For instance, Techpro Systems Ltd, in consortium with Viatech and Gammon, has won a BoP order for 1X500 MW Korba west power plant worth Rs9.9 bn. McNally Bharat Engg recent won a Rs4.4 bn order for coal, lime and gypsum handling systems for 3X250 MW Bongaigaon power project. We highlight that the order size has significantly increased versus the earlier average of about Rs500-600 mn (for McNally Bharat).

However, we believe that these companies are still behind BGR Energy in terms of scale and scope of capabilities. For instance, McNally Bharat is yet to win a complete BoP order and has only won individual packages in the past. Very few companies have the capability to execute a complete BoP package.

Vendors have scaled up their capability set
List of several large orders won by BoP vendors in the recent past

Vendor	Date	Client	Project	Size (Rs mn)
Sunil Hi Tech Eng. Ltd	Jan-10	MAHAGENCO	BoP contract for Unit No. 8 of 1 x 250 MW Parli TPP	4,878
Techpro Systems Ltd		Chhattisgarh State Power Gen Co. Ltd	BoP contract for 1X500 MW Korba West TPP	9,930
Punj Lloyd	Jan-10	Ind-Bharat Energy Ltd	BoP contract for 2X350 MW Orissa based TPP	9,470
McNally Bharat Engg Co. Ltd	Mar-10	Steel Authority of India Ltd	Infrastructure related works at Rourkela steel plant	2,454
	Jan-10	NTPC	Coal, Lime and Gypsum Handling Plant for 3X250 MW Bongaigaon TPP	4,380
	Nov-09	Steel Authority of India Ltd	Coal Handling Plant at Rourkela Steel Plant	3,065
BGR Energy	Aug-09	Chhattisgarh State Power Gen Co. Ltd	Balance of Plant work for 2X500 MW Marwa TPP	16,330
	Jul-09	MAHAGENCO	BOP works for the main plant package of the 2X500 MW Chandrapur	16,318

Source: Company, BSE, News flows

Several tenders likely to be decided over next few quarters

Several state electricity boards are likely to award tenders for full EPC as well as BoP projects in the next few quarters. Orders to the tune of about Rs204 bn are likely to be awarded in the immediate future. These include Rajasthan state electricity boards Chhabra (2X660 MW) and Suratgarh (2X660 MW) EPC orders and MAHAGENCO's Koradi (3X660 MW) BoP order.

Orders to the tune of about Rs190 bn likely to be placed in the near future
Details of EPC/BoP orders likely to be placed in the near future

Project	State	Agency	Capacity (MW)	Type of order	Size (Rs bn)
Chhabra	Rajasthan	RRVUNL	2X660	EPC basis	66
Suratgarh	Rajasthan	RRVUNL	2X660	EPC basis	66
Koradi	Maharashtra	MAHGENCO	3X660	BoP order	40
Sagardighi	West Bengal	WBPDCL	2X500	BoP order	20
Haldia	West Bengal	CESC	2X300	BoP order	12
Total					**204**

Source: CEA, Industry, News flows, Kotak Institutional Equities

Opportunity space seems reasonably large

The Central Electricity Authority of India estimates an additional 76 GW of thermal capacity in the XIIth five year plan (FY2013-17). This is likely to be led by the supercritical space which is expected to contribute to about 57% of the total additional capacity. The CEA expects a tentative requirement of about 500 BoP packages in the XIIth plan for the upcoming capacities. Note that even if number of the BoP packages may be lower in the XIIth versus the XIth plan, their capacities are likely to be higher due to higher average unit size.

Tentative coal/lignite based thermal capacity addition during XIIth plan and requirement of BoPs during Xth, XIth and XIIth plans

Category	Unit size (MW)	No. of units	No. of projects	Capacity (MW)
Supercritical	660-800	64	27	43,640
Subcritical	500-600	34	18	18,300
Medium size	250-350	46	23	14,148
Smaller size	125	4	2	500
Total		**148**	**70**	**76,588**

BoP	No. of BOPs used during 10th Plan (21,180 MW)	No. of BoPs reqd during 11th Plan (61,723 MW)	Tentative reqt of BoPs in 12th Plan (76,588 MW)
Coal Handling Plant (CHP)	23	68	70
Ash Handling Plant (AHP)	23	69	70
Demineralized (DM) water Plant	32	69	70
Cooling Tower	41	79 [145]	70 [148]
Chimney	36	79 [117]	77 [148]
Fuel Oil (FO) System	22	71	70
Water Treatment Plant	36	76	70

Note: Due to higher unit size, number of BOPs may be less but their capacity may be higher

Source: CEA

Assuming a cost of about Rs50 mn per MW for setting up a thermal power plant and BoP works attributing to about 40% of the total cost, the additional 76 GW of thermal capacity in the XIIth plan offers a BoP opportunity of about Rs1.5 tn. This implies an annual opportunity space of about Rs306 bn from balance of plant works for the upcoming power capacity. However, we highlight that this would cover complete BoP works including electrical works (switchgear, switchyard, insulation etc.), which may not be within the scope of BGR Energy in some cases.

Estimation of size of per annum BoP opportunity in XIIth plan

Estimated capacity addition (MW)	99,900
Thermal capacity (MW)	76,588
Cost per MW (Rs mn/MW)	50
Total capex for thermal capacity (Rs bn)	3,829
BoP portion as a % of total cost (%)	40.0
Value of total BoP opportunity in XIIth plan (Rs bn)	**1,532**
Value of total BoP opportunity per year (Rs bn)	**306**

Source: CEA, Kotak Institutional Equities estimates

Retain ADD with unchanged target price of Rs500/share

We have retained our target price of Rs500/share based on 17X March 2011E P/E multiple. We have marginally revised our earnings estimates to Rs23.6 and Rs30.2 from Rs21 and Rs29.7 for FY2010E and FY2011E respectively based on slightly higher execution assumption in FY2010E versus earlier.

Revised estimates of BGR Energy, March fiscal year-ends ,2010-12E (Rs mn)

	New estimates			Old estimates			% change		
	FY2010E	FY2011E	FY2012E	FY2010E	FY2011E	FY2012E	FY2010E	FY2011E	FY2012E
Revenues	26,070	34,788	43,744	24,470	34,788	44,344	6.5	0.0	(1.4)
EBITDA	3,082	4,104	5,141	2,906	4,104	5,252	6.1	0.0	(2.1)
EBITDA margin (%)	11.8	11.8	11.8	11.9	11.8	11.8			
PBT	2,563	3,276	4,095	2,282	3,218	4,131	12.3	1.8	(0.9)
PAT	1,701	2,174	2,718	1,514	2,136	2,742	12.3	1.8	(0.9)
EPS (Rs)	23.6	30.2	37.7	21.0	29.7	38.1	12.3	1.8	(0.9)
yoy growth (%)									
Revenues	35.0	33.4	25.7	26.7	42.2	27.5			
EBITDA	47.5	33.2	25.3	39.1	41.2	28.0			
PBT	46.3	27.8	25.0	30.3	41.0	28.4			
PAT	47.4	27.8	25.0	31.2	41.0	28.4			
EPS	47.4	27.8	25.0	31.2	41.0	28.4			

Source: Kotak Institutional Equities estimates

We retain ADD based on (1) likely pick-up of execution of large EPC orders which would further boost revenues, (2) high near-term visibility based on large order backlog, (3) stronger-than-expected balance sheet and working capital, (4) strong sectoral opportunities and (5) subjectively positive commentary from management on near-term growth as well as order booking.

We do not value the equipment foray as JV agreements are yet to be finalized. After that too, we would not be in a hurry given that concerns would persist about the likely market positioning with several vendors jostling for space by then and a potential dilution for raising resources for the same.

Key risks to the company include (1) large investment requirement in equipment venture without commensurate returns, (2) rising competition which could adversely impact margins and (3) relatively concentrated customer base—has primarily focused on state government contracts so far—needs to demonstrate orders from the privates sector. Other risks include (1) relative inexperience in EPC projects, (2) concentration on few large orders, and (3) higher working capital requirements of large EPC orders.

Consolidated financials of BGR Energy, March fiscal year-ends, 2005-12E (Rs mn)

	2005	2007	2008	2009	2010E	2011E	2012E
Income statement							
Operating income	**2,993**	**7,900**	**15,177**	**19,314**	**26,070**	**34,788**	**43,744**
Total operating expenses	(2,704)	(7,018)	(13,623)	(17,225)	(22,988)	(30,684)	(38,603)
EBITDA	**289**	**882**	**1,553**	**2,089**	**3,082**	**4,104**	**5,141**
Other income	(1)	3	52	317	320	323	329
Interest expense	(61)	(180)	(254)	(579)	(689)	(936)	(1,100)
Depreciation	(32)	(89)	(55)	(75)	(149)	(214)	(276)
Pre-tax profit	**190**	**613**	**1,296**	**1,752**	**2,563**	**3,276**	**4,095**
Tax	(54)	(213)	(411)	(596)	(863)	(1,103)	(1,378)
Net profits	**135**	**400**	**885**	**1,156**	**1,700**	**2,173**	**2,717**
EPS (Rs)	**12.6**	**4.0**	**12.1**	**16.0**	**23.6**	**30.2**	**37.7**
Balance sheet							
Shareholders funds	**431**	**825**	**4,732**	**5,633**	**6,995**	**8,735**	**10,910**
Equity share capital	108	108	720	720	720	720	720
Reserves and surplus	323	717	4,012	4,913	6,275	8,015	10,190
Loan funds	**889**	**2,464**	**5,027**	**7,090**	**8,244**	**10,218**	**11,218**
Secured	831	2,405	4,992	6,360	7,526	9,500	10,500
Unsecured	58	59	35	730	718	718	718
Total sources of funds	**1,323**	**3,304**	**10,141**	**13,498**	**16,035**	**19,779**	**22,990**
Net fixed assets	**336**	**414**	**538**	**1,031**	**1,678**	**2,314**	**2,938**
Investments	1	3	1,514	5	5	5	5
Net current assets (excl. cash)	**801**	**1,958**	**5,019**	**6,310**	**6,888**	**9,194**	**11,524**
Cash	185	929	3,070	6,152	7,464	8,265	8,522
Total application of funds	**1,323**	**3,304**	**10,141**	**13,498**	**16,035**	**19,779**	**22,990**
Free cash flow							
Net profit before tax and extraordinary items	190	613	1,296	1,752	2,563	3,276	4,095
Add: Depreciation / amortisation / non-cash prov	30	132	2,645	75	149	214	276
Tax paid	(54)	(213)	(148)	(205)	(841)	(1,072)	(1,340)
Operating profit before Wcap. changes	**165**	**531**	**3,793**	**1,622**	**1,872**	**2,418**	**3,030**
Change in working capital / other adjustments	(392)	(1,157)	(3,060)	(1,292)	(578)	(2,306)	(2,330)
Net cashflow from operating activites	**(226)**	**(626)**	**732**	**330**	**1,294**	**111**	**700**
Fixed Assets	(121)	(167)	(179)	(568)	(796)	(850)	(900)
Investments	—	(2)	(1,511)	1,509	(0)	—	—
Cash (used) / realised in investing activities	**(121)**	**(169)**	**(1,691)**	**941**	**(796)**	**(850)**	**(900)**
Free cash flow	**(347)**	**(795)**	**(958)**	**1,271**	**498**	**(739)**	**(200)**
Ratios							
EBITDA margin (%)	9.7	11.2	10.2	10.8	11.8	11.8	11.8
Net debt/equity	1.6	1.9	0.4	0.2	0.1	0.2	0.2
RoAE (%)	35.9	42.4	21.2	22.3	26.9	27.6	27.7
RoACE (%)	16.2	14.9	10.5	13.0	14.6	15.6	16.1

Source: Company, Kotak Institutional Equities estimates

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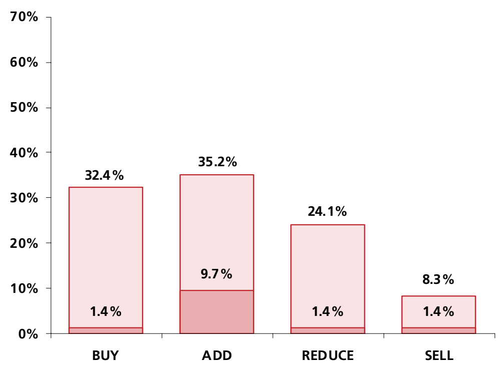

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Source: Kotak Institutional Equities

As of December 31, 2009

Ratings and other definitions/identifiers

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ADD. We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

REDUCE. We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

SELL. We expect this stock to underperform the BSE Sensex by more than 10% over the next 12 months.

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