Prabhudas Lilladher

Capital Goods

EBITDA margin catapults, margin outlook cautious

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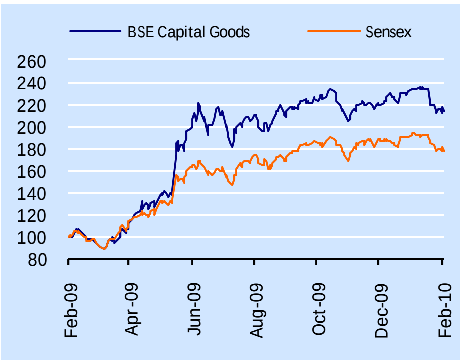
Q3FY10 Result Review

Sensex v/s Auto Index



Source: Bloomberg

- **Trend in order inflow and order book improves:** During Q3FY10 order inflow for the coverage universe increased by 11% YoY (Siemens and Thermax witnessing the maximum growth) which is a marked improvement after three quarters of decline. We expect the momentum to further pick up in the domestic market in Q4FY10, especially in the T&D space from Power Grid Corporation of India (PGCIL). Order book increased by 16.3% YoY and 6.3% QoQ.

- **Revenue growth below estimate:** For the sector, we expected a revenue growth of 21% (excluding Suzlon) YoY on the back of a low base in Q3FY09. However, revenue growth for the segment was considerably lower at 15% due to lower commodity prices, which led to lower recognition of revenue of PVC-based orders and de-growth in order inflow during Q3FY09-Q2FY10 which has already resulted in lower than expected growth for 9MFY10. This lower inflow is likely to have a further negative impact over the next 1-2 quarters as well.

- **EBITDA margin catapults but outlook is cautious:** Our coverage universe reported EBITDA margin improvement of 333bps YoY to 17% for the quarter, and is the highest EBITDA margin for the past 12-16 quarters. Utilization of lower cost commodity and benefits of excise duty cut are the main contributors to these increased margins. Going forward, we are cautious on the EBITDA margin on the back of relatively higher commodity prices and chances of an excise rollback. We expect these high margins to peak out in the next 1-2 quarters.

- **Bharat Heavy Electricals (BHEL), BGR Energy (BGR), Crompton Greaves (CG) and Suzlon are our top picks:** We remain positive on BHEL and BGR, as both these companies have very strong order books and would be the key beneficiaries of increased activities in the power generation space. While BGR would still have to prove its execution capabilities for large projects, the stock is fairly attractive even on conservative earnings estimates. In case of CG, we like the fact that the company has a considerable advantage in the 765kv range domestically and we expect a much better performance from its International divisions in FY11. As for Suzlon, given the debt refinancing programme and early signs of international order inflow improving, we believe that the worst is behind them.

Comparative Valuation

Name	Rating	CMP (Rs)	EPS (Rs)			PE (x)			RoE (%)		
			FY10E	FY11E	FY12E	FY10E	FY11E	FY12E	FY10E	FY11E	FY12E
ABB*	Reduce	793	18.2	22.9	27.7	43.5	34.6	28.6	16.9	18.1	18.7
Action Construction	Acc	39	2.7	4.3	5.6	14.5	9.1	6.9	14.5	19.8	21.9
Areva T&D*	Reduce	274	9.1	11.8	14.1	30.1	23.2	19.4	26.9	28.2	27.3
BHEL	Acc	2,380	89.8	110.0	133.6	26.5	21.6	17.8	30.3	30.0	29.5
BGR Energy	Acc	480	25.3	34.5	42.1	18.9	13.9	11.4	28.9	31.2	31.2
Crompton Greaves	Acc	419	20.7	23.8	27.8	20.3	17.6	15.1	30.6	27.1	24.9
EMCO	Acc	95	8.0	9.2	10.9	11.8	10.3	8.7	10.4	9.9	10.5
Hind. Dorr	Acc	171	16.7	20.6	24.1	10.3	8.3	7.1	31.7	31.8	29.2
Jyoti Structures	BUY	166	11.6	14.7	17.9	14.3	11.3	9.3	20.7	21.8	21.7
Kalpataru Power	Acc	1,131	62.2	85.0	111.8	18.2	13.3	10.1	19.4	22.4	24.5
KEC International	Acc	588	38.4	46.9	56.6	15.3	12.5	10.4	30.0	29.2	28.2
Siemens#	Reduce	643	16.4	19.8	22.7	39.1	32.4	28.3	26.6	22.4	22.5
Suzlon	Acc	73	(4.3)	5.8	8.4	(17.1)	12.6	8.8	(8.0)	11.8	15.1
Thermax	NR	638	21.4	26.8	32.4	29.8	23.8	19.7	23.8	25.5	26.1
Voltas	Acc	160	9.7	10.4	11.9	16.5	15.4	13.5	35.8	30.4	28.2

Source: Company Data, PL Research   * Y/e Dec   # Y/e Sept

Revenue below estimate but PAT in line

Performance of our capital goods universe for Q3FY10 was not in line with our expectation. For starters, the revenue growth was below our estimate. While EBITDA margin saw a considerable improvement during the quarter, the interest cost decrease too was ahead of estimate. This actually resulted in the actual PAT coming in line with expectation.

Our universe Q3FY10 performance **(Rs m)**

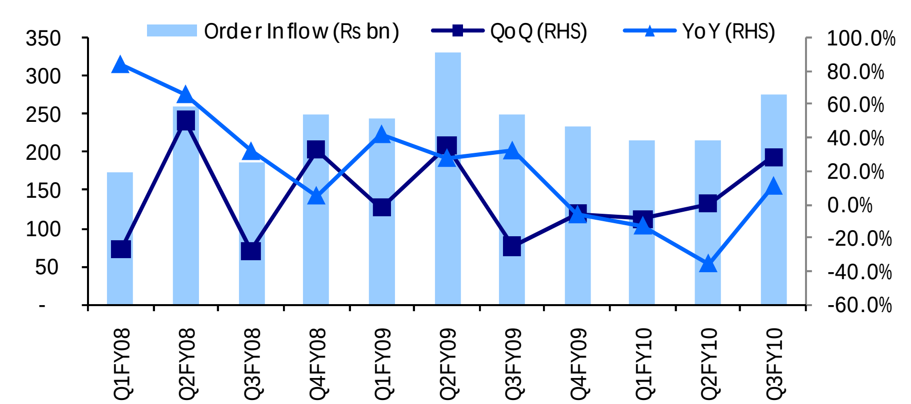
Y/e March	Q3FY10	Q3FY09	*YoY gr. (%)*	Q2FY10	*QoQ gr. (%)*
Net Sales	163,245	142,117	*14.9*	159,631	*2.3*
EBITDA	27,736	19,426	*42.8*	23,006	*20.6*
Margin (%)	*17.0*	*13.7*		*14.4*	
PAT (Excl. Ex Items)	17,912	12,426	*44.1*	15,109	*18.6*

Source: Company Data, PL Research

Trend in order inflow and order book improves: Order inflow during Q3FY10 has increased by 11% YoY (Siemens and Thermax witnessing the maximum YoY growth). This is a marked improvement after seeing three quarters of YoY de-growth. Even on a QoQ basis, order inflow seemed to have picked up pace considerably after growing by 28% during the current quarter as compared to -5%, -9% and 0.5% in the previous three quarters. Order inflow has come in from the power segment and a considerable quantum of order inflow was received from the Middle Eastern countries (Siemens and KEC) as well. We expect the momentum to pick up further in the domestic market in Q4FY10, especially in the transmission and distribution space as PGCIL has floated a large quantum of tenders which are expected to be awarded by the end of the fiscal.

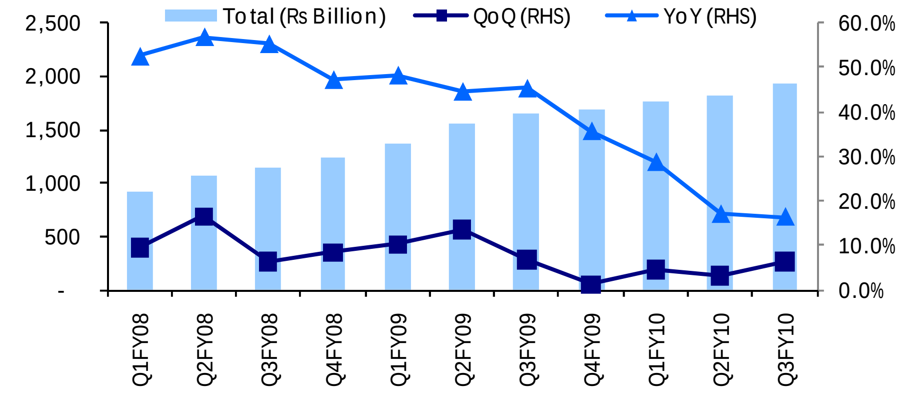
Order book for the coverage universe increased by 16.3% YoY and 6.3% QoQ.

Order inflow picks up



Source: Company Data, PL Research

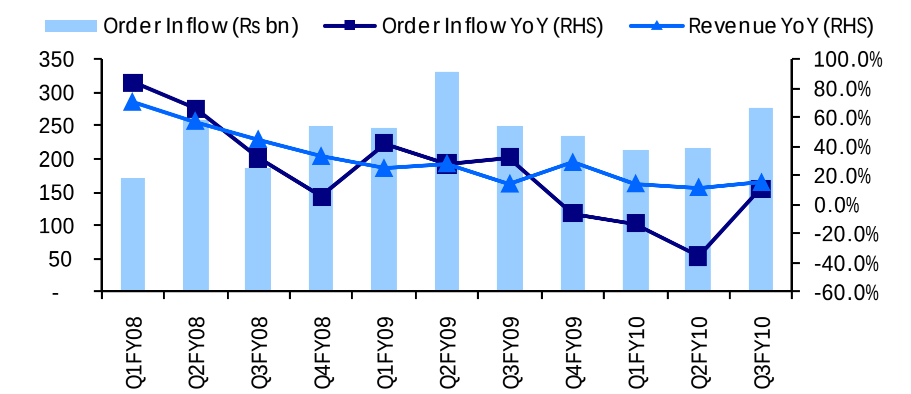
Order book growth maintained



Source: Company Data, PL Research

Revenue growth below estimate: For the capital goods sector, we were expecting a revenue growth of 21% YoY (excluding Suzlon) on the back of a low base in Q3FY09. However, the revenue growth for the segment was considerably lower at 15%. Factors which contributed to this lower-than-expected growth were lower commodity prices, which led to lower recognition of revenue of PVC-based orders and considerable de-growth in order inflow between Q3FY09 and Q2FY10 which has already resulted in lower than expected growth for 9MFY10. This lower order inflow could have a further negative impact over the next 1-2 quarters as well. Apart from this, companies like CG, Suzlon have also stated that there was some deferment of delivery schedules from the customer's end as well.

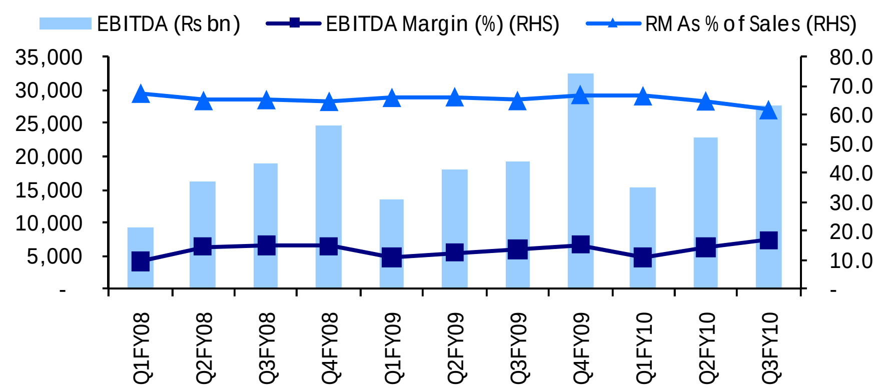
Revenue growth below estimate



Source: Company Data, PL Research

EBITDA margin catapults but outlook is cautious: Our coverage universe reported EBITDA margin improvement of 333bps YoY to 17% for the quarter, which actually is the highest EBITDA margin for the past 12-16 quarters. Utilization of lower cost commodity and benefits of excise duty cut are the main contributors to these increased margins. Going forward, we are cautious on the EBITDA margin on the back of relatively higher commodity prices and chances of an excise rollback. We expect these high margins to peak out in the next 1-2 quarters. Apart from that, a slow order inflow between Q3FY09 and Q2FY10, coupled with increased competition, will create margin pressures while executing these projects for players who had won these orders under stiff competition.

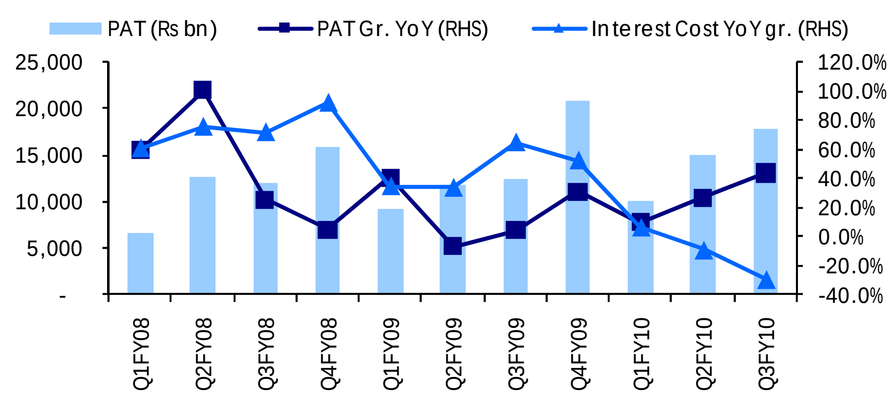
EBITDA margin increase



Source: Company Data, PL Research

PAT improves on the back of increased EBITDA and decreased interest cost: Most companies in the sector have witnessed a considerable decrease in their interest cost, as interest cost as a percentage of sales fell to 0.6% YoY from 1.0% (highest for the past 12 quarters atleast) for our coverage universe. The main contributor to this was lower interest rate, coupled with lower reliance on debt due to improved working capital conditions.

PAT increases due to higher EBITDA margin and lower interest cost



Source: Company Data, PL Research

Other key highlights

Competition has intensified in the transmission sector: Commentary from all the three transmission EPC players (Jyoti Structures, KEC International & Kalpataru Power) was indicating an increased competitive intensity, especially for PGCIL orders. A few fringe players have under cut and won a few contracts but the sustenance of this competition will only be gauged once these fringe players can successfully complete these contracts.

Excise duty rollback could reduce margin: Excise duty cuts which were made during November 2008-January 2009 seem to have definitely helped to improve margins for most products, as we believe that the benefit of this cut were not passed on to the end client. With expectation of excise duty rollback, the same products could face margin pressure unless the companies are in a position to increase prices to that effect.

BHEL, BGR, CG and Suzlon are our top picks: We remain positive on BHEL and BGR as both these companies have very strong order books and would be key beneficiaries of the increased activities in the power generation space. While BGR would still have to prove its execution capabilities for large projects, the stock is fairly attractive even on conservative earnings estimates. In case of CG, we like the fact that this company has a considerable advantage in the 765kv range domestically and we expect a much better performance from its international divisions in FY11. As for Suzlon, we believe that the risk reward ratio is favorable for the company and given the current debt refinancing programme and early signs of international order inflow improving, we believe that the worst is behind them.

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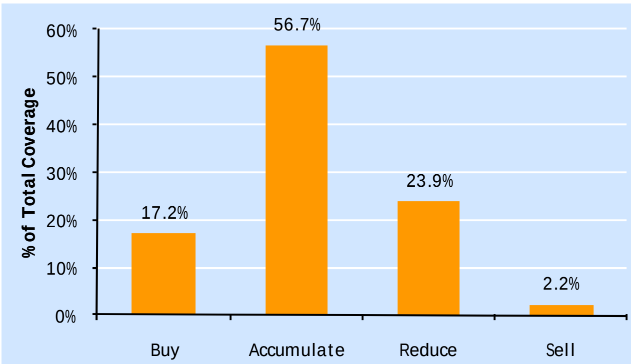
Rating Distribution of Research Coverage



PL's Recommendation Nomenclature

BUY	:	Over 15% Outperformance to Sensex over 12-months	**Accumulate**	:	Outperformance to Sensex over 12-months
Reduce	:	Underperformance to Sensex over 12-months	**Sell**	:	Over 15% underperformance to Sensex over 12-months
Trading Buy	:	Over 10% absolute upside in 1-month	**Trading Sell**	:	Over 10% absolute decline in 1-month
Not Rated (NR)	:	No specific call on the stock	**Under Review (UR)**	:	Rating likely to change shortly