

Sustaining Growth; Improving Visibility

2QFY07 Result: Sales +33%; PAT +38%; Order book +42%YoY

BHEL's 2QFY07 demonstrated sustained growth with sales at Rs33.4bn (+33%YoY) in line with MLe (Rs33.7bn) & Recurring PAT at Rs3.6bn (+38%YoY) v/s MLe of Rs3.76bn on one-time provisions for labor costs. More importantly, the rise in the order book by 42%YoY & 16%QoQ to Rs457bn reinforces our view of the robust outlook ahead. We reiterate our Buy recommendation.

Strong business momentum in Power & Industrial division

BHEL's both divisions, Power & Industry, witnessed strong business momentum with top-line growing at 28.8% & 34.8%YoY respectively. This robust performance contributed to 33%YoY overall sales growth. While power business margins expanded 131bps to 21.3%, margins in Industry business fell 268bps to 12.2%.

Order Intake Driven By State Govt. Utilities

The order backlog of Rs457bn (+42%YoY) reinforces our stand on BHEL being the core beneficiary of the continued momentum in the power capex. Key order wins in 2Q were mainly from state utilities of Uttar Pradesh (~Rs24.4bn), Karnataka (~Rs21bn) and Rajasthan (Rs8.4bn). This also reinforces our view of state capex being one of the key drivers of BHEL's new orders.

One-time Labor Costs Impact EBITDA & PAT

BHEL reported PAT was 4% below MLe mainly on one-time provisions which led to rise in staff costs by 21%YoY and lesser decline in staff cost to sales of 170bps v/s MLe 350bps. These provisions were pertaining to leave encashment extension from 240 days to 480 days (encourage higher working hours to meet targets) and rise in interest rate on actuarial valuations of provisions. Ex-one time labor costs, recurring PAT was marginally ahead of MLe.

Key growth triggers intact

We see the following triggers for the stock to outperform the market:

- Improving pipeline of orders** led by likely setting-up of a) sub-critical plants at NTPC/State Utilities, b) ultra large coal-based projects (9x4GW) led by the Ministry of Power / NTPC and increased activity to place bulk orders on BHEL of two of these sets to accelerate super critical technology absorption,
- 29% earnings CAGR** over FY06-08E led by 21% YoY sales growth, stable-to-declining material prices and operating leverage driving up margins.

Maintain Buy with PO of Rs2760

We reiterate Buy on BHEL with PO of Rs2760. Our PO based on FY08E PER of 25x – in-line with peak PE in the last cycle (94-97) & PEG of 1x. Risk: Chinese competition, project execution and cap on FII holding.

>> Employed by a non-US affiliate of MLPF&S and is not registered/qualified as a research analyst under the NYSE/NASD rules.

Merrill Lynch does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision.

Refer to important disclosures on page 4 to 5. Analyst Certification on page 2. Price Objective Basis/Risk on page 2.

Equity | India | Engineering & Construction
30 October 2006



Merrill Lynch

Bharat Parekh >> +91 22 6632 8656

Research Analyst
DSP Merrill Lynch (India)
bharat_parekh@ml.com

Amish Shah >> +91 22 6632 8672

Research Analyst
DSP Merrill Lynch (India)

Stock Data

Price	Rs2,475
Price Objective	Rs2,760
Date Established	3-Apr-2006
Investment Opinion	C-1-7
Volatility Risk	HIGH
ML Symbol / Exchange	BHRVF / BSE
Bloomberg / Reuters	BHEL IN / BHEL.BO

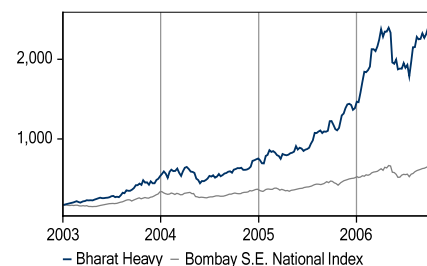


Table 1: BHEL's 2QFY07 Results Review

Year End Mar31 (Rsmn)	2Q06	2QFY07	% YoY
Order Backlog	322,000	457,000	41.9%
Gross Sales	27,878	36,654	31.5%
Excise Duty	2,774	3,243	16.9%
Net Sales	25,104	33,412	33.1%
Raw mtl	13,419	18,567	38.4%
% of net sales	53.5%	55.6%	
Staff cost	4,661	5,660	21.4%
% of net sales	18.6%	16.9%	
Other exp.	3,334	4,621	38.6%
% of net sales	13.3%	13.8%	
Total expenses	21,414	28,848	34.7%
EBITDA	3,690	4,563	23.7%
EBITDA margin %	14.7%	13.7%	
Interest	133	136	1.9%
Depreciation	624	667	6.8%
Other income	1,057	1,699	60.7%
PBT	3,990	5,460	36.8%
Tax	1,388	1,860	34.0%
Tax Rate	34.8%	34.1%	
Reported PAT	2,602	3,600	38.4%
Net Exceptionals (Income + Expense)	0	0	
Pre-exceptional Net	2,602	3,600	38.4%
Segmental Split	2Q06	2QFY07	% YoY
Sales			
Power	21,080	27,141	28.8%
Industry	7,713	10,399	34.8%
Total	28,793	37,540	30.4%
Intersegmental reevnue	916	886	-3.3%
Net Sales	27,877	36,654	31.5%
PBIT			
Power	4,221	5,789	37.1%
Industry	1,147	1,268	10.5%
Total	5,368	7,057	31.5%
Interest	133	135	1.5%
Unallocatable expenditure	1,245	1,462	17.4%
PBT	3,990	5,460	36.8%

Source: Company

Price Objective Basis & Risk

Our PO of Rs2760 is based on FY08E PER of 25x – in-line with peak PE in the last cycle (94-97) & PEG of 1x.

The risks are Chinese competition, project execution and cap on FII holding.

Analyst Certification

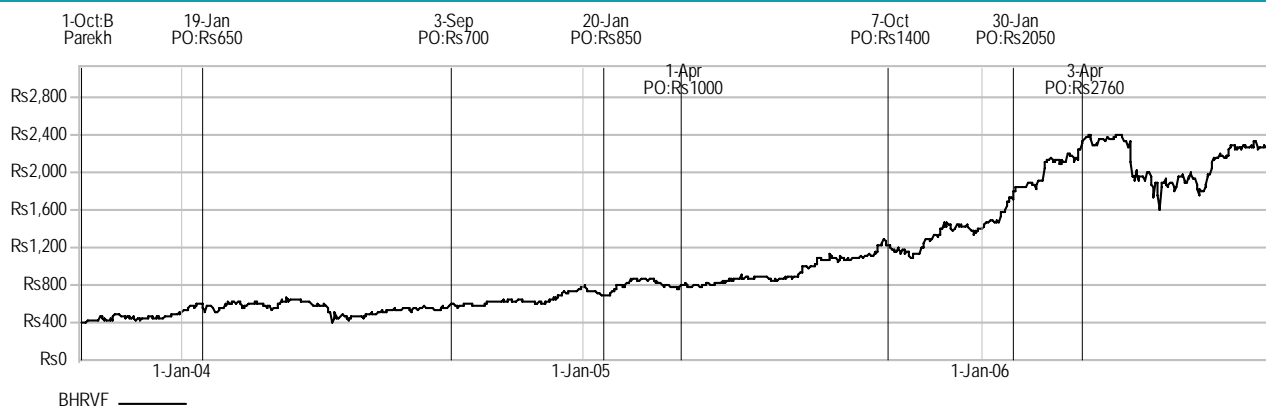
I, Bharat Parekh, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

Special Disclosures

In accordance with the SEBI (Foreign Institutional Investors) Regulations and with guidelines issued by the Securities and Exchange Board of India (SEBI), foreign investors (individuals as well as institutional) that wish to transact the common stock of Indian companies must have applied to, and have been approved by SEBI and the Reserve Bank of India (RBI). Each investor who transacts common stock of Indian companies will be required to certify approval as a foreign institutional investor or as a sub-account of a foreign institutional investor by SEBI and RBI. Certain other entities are also entitled to transact common stock of Indian companies under the Indian laws relating to investment by foreigners. Merrill Lynch reserves the right to refuse copy of research on common stock of Indian companies to a person not resident in India. American Depositary Receipts (ADR) representing such common stock are not subject to these Indian law restrictions and may be transacted by investors in accordance with the applicable laws of the relevant jurisdiction. Global Depository Receipts (GDR) and the Global Depository Shares of Indian companies, Indian limited liability corporations, have not been registered under the U.S. Securities Act of 1933, as amended, and may only be transacted by persons in the United States who are Qualified Institutional Buyers (QIBs) within the meaning of Rule 144A under the Securities Act. Accordingly, no copy of any research report on Indian companies' GDRs will be made available to persons who are not QIBs.

Important Disclosures

BHRVF Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of September 30, 2006 or such later date as indicated.

Investment Rating Distribution: Engineering & Construction Group (as of 30 Sep 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	14	66.67%	Buy	4	28.57%
Neutral	7	33.33%	Neutral	2	28.57%
Sell	0	0.00%	Sell	0	0.00%

Investment Rating Distribution: Global Group (as of 30 Sep 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1325	44.76%	Buy	434	32.75%
Neutral	1420	47.97%	Neutral	412	29.01%
Sell	215	7.26%	Sell	48	22.33%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months.

FUNDAMENTAL EQUITY OPINION KEY: Opinions include a Volatility Risk Rating, an Investment Rating and an Income Rating. **VOLATILITY RISK RATINGS**, indicators of potential price fluctuation, are: A - Low, B - Medium, and C - High. **INVESTMENT RATINGS**, indicators of expected total return (price appreciation plus yield) within the 12-month period from the date of the initial rating, are: 1 - Buy (10% or more for Low and Medium Volatility Risk Securities - 20% or more for High Volatility Risk securities); 2 - Neutral (0-10% for Low and Medium Volatility Risk securities - 0-20% for High Volatility Risk securities); 3 - Sell (negative return); and 6 - No Rating. **INCOME RATINGS**, indicators of potential cash dividends, are: 7 - same/higher (dividend considered to be secure); 8 - same/lower (dividend not considered to be secure); and 9 - pays no cash dividend.

MLPF&S or an affiliate expects to receive or intends to seek compensation for investment banking services from this company within the next three months: Bharat Heavy.

The country in which this company is organized has certain laws or regulations that limit or restrict ownership of the company's shares by nationals of other countries: Bharat Heavy.

The analyst(s) responsible for covering the securities in this report receive compensation based upon, among other factors, the overall profitability of Merrill Lynch, including profits derived from investment banking revenues.

Other Important Disclosures

UK readers: MLPF&S or an affiliate is a liquidity provider for the securities discussed in this report.

Information relating to Non-U.S. affiliates of Merrill Lynch, Pierce, Fenner & Smith Incorporated (MLPF&S):

MLPF&S distributes research reports of the following non-US affiliates in the US (short name: legal name): Merrill Lynch (France): Merrill Lynch Capital Markets (France) SAS; Merrill Lynch (Frankfurt): Merrill Lynch International Bank Ltd, Frankfurt Branch; Merrill Lynch (South Africa): Merrill Lynch South Africa (Pty) Ltd; Merrill Lynch (Milan): Merrill Lynch International Bank Limited; MLPF&S (UK): Merrill Lynch, Pierce, Fenner & Smith Limited; Merrill Lynch (Australia): Merrill Lynch Equities (Australia) Limited; Merrill Lynch (Hong Kong): Merrill Lynch (Asia Pacific) Limited; Merrill Lynch (Singapore): Merrill Lynch (Singapore) Pte Ltd; Merrill Lynch (Canada): Merrill Lynch Canada Inc; Merrill Lynch (Mexico): Merrill Lynch Mexico, SA de CV, Casa de Bolsa; Merrill Lynch (Argentina): Merrill Lynch Argentina SA; Merrill Lynch (Japan): Merrill Lynch Japan Securities Co, Ltd; Merrill Lynch (Seoul): Merrill Lynch International Incorporated (Seoul Branch); Merrill Lynch (Taiwan): Merrill Lynch Global (Taiwan) Limited; DSP Merrill Lynch (India): DSP Merrill Lynch Limited; PT Merrill Lynch (Indonesia): PT Merrill Lynch Indonesia; Merrill Lynch (KL) Sdn. Bhd.: Merrill Lynch (Malaysia); Merrill Lynch (Israel): Merrill Lynch Israel Limited; Merrill Lynch (Russia): Merrill Lynch CIS Limited, Moscow.

This research report has been prepared and issued by MLPF&S and/or one or more of its non-U.S. affiliates. MLPF&S is the distributor of this research report in the U.S. and accepts full responsibility for research reports of its non-U.S. affiliates distributed in the U.S. Any U.S. person receiving this research report and wishing to effect any transaction in any security discussed in the report should do so through MLPF&S and not such foreign affiliates.

This research report has been approved for publication in the United Kingdom by Merrill Lynch, Pierce, Fenner & Smith Limited, which is authorized and regulated by the Financial Services Authority; has been considered and distributed in Japan by Merrill Lynch Japan Securities Co, Ltd, a registered securities dealer under the Securities and Exchange Law in Japan; is distributed in Hong Kong by Merrill Lynch (Asia Pacific) Limited, which is regulated by the Hong Kong SFC; is issued and distributed in Taiwan by Merrill Lynch Global (Taiwan) Ltd or Merrill Lynch, Pierce, Fenner & Smith Limited (Taiwan Branch); is issued and distributed in Malaysia by Merrill Lynch (KL) Sdn. Bhd., a licensed investment adviser regulated by the Malaysian Securities Commission; and is issued and distributed in Singapore by Merrill Lynch International Bank Limited (Merchant Bank) and Merrill Lynch (Singapore) Pte Ltd (Company Registration No.'s F 06872E and 198602883D respectively). Merrill Lynch International Bank Limited (Merchant Bank) and Merrill Lynch (Singapore) Pte Ltd. are regulated by the Monetary Authority of Singapore. Merrill Lynch Equities (Australia) Limited, (ABN 65 006 276 795), AFS License 235132, provides this report in Australia. No approval is required for publication or distribution of this report in Brazil.

Merrill Lynch (Frankfurt) is regulated by BaFin.

Copyright, User Agreement and other general information related to this report:

Copyright 2006 Merrill Lynch, Pierce, Fenner & Smith Incorporated. All rights reserved. This research report is prepared for the use of Merrill Lynch clients and may not be redistributed, retransmitted or disclosed, in whole or in part, or in any form or manner, without the express written consent of Merrill Lynch. Merrill Lynch research reports are distributed simultaneously to internal and client websites eligible to receive such research prior to any public dissemination by Merrill Lynch of the research report or information or opinion contained therein. Any unauthorized use or disclosure is prohibited. Receipt and review of this research report constitutes your agreement not to redistribute, retransmit, or disclose to others the contents, opinions, conclusion, or information contained in this report (including any investment recommendations, estimates or price targets) prior to Merrill Lynch's public disclosure of such information. The information herein (other than disclosure information relating to Merrill Lynch and its affiliates) was obtained from various sources and we do not guarantee its accuracy. Merrill Lynch makes no representations or warranties whatsoever as to the data and information provided in any third party referenced website and shall have no liability or responsibility arising out of or in connection with any such referenced website.

This research report provides general information only. Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other investment or any options, futures or derivatives related to such securities or investments. It is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek financial advice regarding the appropriateness of investing in any securities, other investment or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities or other investments, if any, may fluctuate and that price or value of such securities and investments may rise or fall. Accordingly, investors may receive back less than originally invested. Past performance is not necessarily a guide to future performance. Any information relating to the tax status of financial instruments discussed herein is not intended to provide tax advice or to be used by anyone to provide tax advice. Investors are urged to seek tax advice based on their particular circumstances from an independent tax professional.

Foreign currency rates of exchange may adversely affect the value, price or income of any security or related investment mentioned in this report. In addition, investors in securities such as ADRs, whose values are influenced by the currency of the underlying security, effectively assume currency risk.

Officers of MLPF&S or one or more of its affiliates (other than research analysts) may have a financial interest in securities of the issuer(s) or in related investments.

Merrill Lynch Research policies relating to conflicts of interest are described at <http://www.ml.com/media/43347.pdf>.

Fundamental equity reports are produced on a regular basis as necessary to keep the investment recommendation current.