## Q3FY10 Result Update

January 29, 2010

BHEL, the largest engineering and manufacturing enterprise in India, reported its Q3FY10 result that were in line with street expectations with respect to bottomline numbers but slightly below expectations in case of topline growth. BHEL's topline (net sales) grew by 17.9% y-o-y to Rs. 7,100 cr, operating margins expanded by 290 bps y-o-y to 21.6% while net profit registered growth of 35.7% y-o-y to Rs. 1,072.6 cr.

### Key Highlights of the Results

| (Rs. in cr) | Q3FY10 | Q3FY09 | % Chg y-o-y | Q2FY10 | % Chg q-o-q | 9MFY10 | 9MFY09 | % Chg y-o-y |
|---|---|---|---|---|---|---|---|---|
| Net Sales | 7100.3 | 6022.3 | 17.9% | 6625.2 | 7.2% | 19321.2 | 15694.1 | 23.1% |
| Other Operating Income | 128.9 | 126.6 | 1.8% | 102.3 | 26.0% | 307.0 | 314.4 | -2.4% |
| Other Income | 193.3 | 179.7 | 7.6% | 195.5 | -1.1% | 615.9 | 590.8 | 4.2% |
| **Total Income** | **7422.5** | **6328.6** | **17.3%** | **6923.0** | **7.2%** | **20244.1** | **16599.3** | **22.0%** |
| Total Expenditure | 5667.5 | 5001.6 | 13.3% | 5495.7 | 3.1% | 16242.7 | 13589.0 | 19.5% |
| EBIDTA | 1755.0 | 1327.0 | 32.3% | 1427.3 | 23.0% | 4001.4 | 3010.3 | 32.9% |
| Depreciation | 103.8 | 86.5 | 20.0% | 93.4 | 11.1% | 293.3 | 233.4 | 25.7% |
| EBIT | 1651.2 | 1240.5 | 33.1% | 1333.9 | 23.8% | 3708.1 | 2776.9 | 33.5% |
| Interest | 6.9 | 17.9 | -61.5% | 4.5 | 53.3% | 15.7 | 22.6 | -30.5% |
| PBT | 1644.3 | 1222.6 | 34.5% | 1329.4 | 23.7% | 3692.4 | 2754.3 | 34.1% |
| Tax (incl DT) | 571.7 | 432.0 | 32.3% | 471.5 | 21.3% | 1291.3 | 963.6 | 34.0% |
| **Reported PAT** | **1072.6** | **790.6** | **35.7%** | **857.9** | **25.0%** | **2401.1** | **1790.7** | **34.1%** |
| EPS on Reported PAT | 21.9 | 16.2 | 35.7% | 17.5 | 25.0% | 49.1 | 36.6 | 34.1% |
| Equity | 489.5 | 489.5 | | 489.5 | | 489.5 | 489.5 | |
| Face Value | 10.0 | 10.0 | | 10.0 | | 10.0 | 10.0 | |
| OPM (%) | 21.6% | 18.7% | | 18.3% | | 17.2% | 15.1% | |
| NPM (%) | 14.5% | 12.5% | | 12.4% | | 11.9% | 10.8% | |
| **Cost as a % of sales** | | | | | | | | |
| Input Cost | 55.5% | 58.2% | | 57.3% | | 58.4% | 58.7% | |
| Staff Cost | 17.3% | 15.3% | | 16.1% | | 17.6% | 17.2% | |
| Other expenses | 7.0% | 9.6% | | 9.6% | | 8.0% | 10.6% | |

**(Source:** Company, HDFC Sec)

- BHEL's Q3FY10 result were in line with street expectations with respect to bottomline numbers but slightly below expectations in case of topline growth. BHEL reported sales of Rs. 7,100 cr, up 17.9% y-o-y and 7.2% q-o-q. On a y-o-y basis the growth in sales is below the company's target growth rate for the year of about 20-25%. In 9MFY10, BHEL has reported topline growth of 23.1% to Rs. 19,321.2 cr. The topline growth is mainly driven by growth in the power division (18.5% and 23.3% increase y-o-y in Q3FY10 and 9MFY10 respectively) as shown in the segmental performance given below.

- Operating margins for the quarter stood at 21.6%, a 290 bps expansion y-o-y and 330 bps increase q-o-q. On a y-o-y basis, the margins increased largely on account of lower input costs, which are at 55.5% as a percentage to sales, compared to 58.2% in the corresponding quarter last year. Even on a q-o-q basis, raw material costs are down from 57.3% as a percentage to sales in Q2FY10. Even as metal prices have declined sharply, BHEL was not able to take advantage of the fall in raw material prices in the early part of FY10. This benefit has only started to accrue partly since Q2FY10 and largely in Q3FY10. This is because BHEL stocks inventory for 9-10 months. Hence, the low cost raw material that was procured from September 2008 onwards was yet to enter the production cycle. The benefit of the same is visible this quarter and can be expected to continue for the next 2 quarters as well. The management has guided for a 200 bps improvement in raw material costs y-o-y for FY10. In 9MFY10, raw material cost as a % of sales is at 58.4% vs 58.7% in 9MFY09. This can be expected to fall sharply in Q4, bringing down the overall level for FY10.

- Next, staff cost increased to Rs. 1,226.9 cr, up 33.3% y-o-y due to wage increases and provisions made for the 6$^{th}$ pay commission. For FY10 (E), BHEL is looking at about 15% employee cost as a percentage to sales. In 9MFY10, it is at 17.6% of net sales and 16.8% of total income. On a q-o-q basis, employee costs are higher by about 14.8%. The management has indicated that most of the provisioning has been done on account of 6$^{th}$ pay commission wage arrears (Rs. 1,113 cr has been provided for in 9MFY10 and the full year provision is supposed to be at Rs. 1,484 cr) and staff cost increases in the last quarter of FY10 will primarily pertain to employee addition and pay hikes. The management expects total staff cost for FY10 (E) to be about Rs. 4,500 cr. In 9MFY10, the staff costs amount to Rs. 3,409.6 cr.

- Other expenditure (which comprises provisioning on account of contractual obligations, liquidation damages and doubtful debts) was down 13.4% y-o-y and down 21.2% q-o-q to Rs. 499 cr.

- Interest costs were down 61.5% y-o-y at Rs. 6.9 cr, but up 53.3% q-o-q. Depreciation was up 20% y-o-y and up 11.1% q-o-q at Rs. 103.8 cr in line with the capex carried out by the company. Increase in EBIDTA margins led to a bottomline growth of 35.7% y-o-y and 25% q-o-q to Rs. 1,072.6 cr. EPS for the quarter stood at Rs. 21.9.

- In 9MFY10, BHEL has reported a topline of Rs. 19,321.2 cr, up 23.1% y-o-y, EBIDTA margins of 17.2% (increase of 210 bps y-o-y) and a PAT of Rs. 2,401.1 cr up 34.1% y-o-y. EPS for the 9 months is at Rs. 49.1. Based on BHEL's target topline of Rs. 32,000 cr, it has achieved about 60% of its target. This is in line with the nature of its business, as BHEL reports about 40% of full year net sales in Q4. Hence, we believe, BHEL is on track to achieve its growth target.

- Order inflows during Q3FY10 stood at about Rs. 16,000 cr, up about 3.1% y-o-y and 100% q-o-q. The management indicated that there was a delay in closing certain orders in the 9MFY10 due to the completion of some formalities. As a result order inflow is down 18.3% y-o-y at Rs. 36,425 cr in 9MFY10. The total outstanding order book is Rs. 1,34,000 cr as of 9MFY10. Of this, 84% is from the power segment, 11% from the industrial segment and the balance from the international segment. Private sector played a major role with 12GW from the 15GW booked in the 9-month period, which could be the key towards better execution going forward.

- Some of the orders won by BHEL during the quarter have been listed below. New orders for Dec-09 include two projects, earlier awarded to Chinese manufacturers, which have been reawarded to BHEL.

| Client | Location | Capacity (MW) | Order size (Rs cr) |
|---|---|---|---|
| Jindal Power Limited | Chhattisgarh | 2400 (4*600) | 5040 |
| Power Engineers Contracting Company, UK | Nasiryah power project in Iraq | 42 | 91 |
| Prayagraj Power Generation Company Limited (PPGCL) | Uttar Pradesh | 1980 (3*660) | 5600 |
| Adhunik Power and Natural Resources Limited | Jharkhand | 270 | 640 |

(**Source:** Company website)

## Segmental Analysis

| (Rs. Cr) | Q3FY10 | Q3FY09 | % Chg y-o-y | Q2FY10 | % Chg q-o-q | 9MFY10 | 9MFY09 | % Chg y-o-y |
|---|---|---|---|---|---|---|---|---|
| **Revenue** | | | | | | | | |
| Power | 5708.7 | 4818.9 | 18.5% | 5428.3 | 5.2% | 15705.8 | 12736.5 | 23.3% |
| Industry | 1802.0 | 1752.2 | 2.8% | 1595.4 | 12.9% | 4729.9 | 4533.4 | 4.3% |
| Total Revenue | 7510.7 | 6571.1 | 14.3% | 7023.7 | 6.9% | 20435.7 | 17269.9 | 18.3% |
| **EBIT** | | | | | | | | |
| Power | 1308.6 | 712.5 | 83.7% | 1121.9 | 16.6% | 3258.7 | 2131.0 | 52.9% |
| Industry | 405.1 | 223.4 | 81.3% | 270.6 | 49.7% | 837.6 | 630.2 | 32.9% |
| Total EBIT | 1713.7 | 935.9 | 83.1% | 1392.5 | 23.1% | 4096.3 | 2761.2 | 48.4% |
| **Revenue Mix** | | | | | | | | |
| Power | 76.0 | 73.3 | | 77.3 | | 76.9 | 73.7 | |
| Industry | 24.0 | 26.7 | | 22.7 | | 23.1 | 26.3 | |
| **EBIT Margin (%)** | | | | | | | | |
| Power | 22.9 | 14.8 | | 20.7 | | 20.7 | 16.7 | |
| Industry | 22.5 | 12.7 | | 17.0 | | 17.7 | 13.9 | |

(**Source:** Company, HDFC Securities)

- The Power segment contributed 79% of the company's revenues in Q3FY10. In Q3FY10, revenues for the segment were up 18.5% y-o-y and 5.2% q-o-q. PBIT margins the have expanded to 22.9% in Q3FY10 from 14.8% in Q3FY09 and 20.7% in Q2FY10 primarily driven by lower raw material costs.

- The industry segment has seen muted growth of 2.8% y-o-y in line with the slowing demand offtake among the industrial clients. The industrial equipment division primarily caters to process industries, transportation (including leasing of locomotives to Indian Railways), transmission, defense and diesel generating sets (DG). However, on a q-o-q basis, revenue increased by 12.9% indicating that there are signs of revival in the industrial segment, which is also supported by the latest IIP numbers. PBIT margins have expanded by about 130 bps q-o-q but are down 270 bps y-o-y (indications that there is still some pricing pressure).

## Other Developments / Takeaways

- Order inflow in 9MFY10 is Rs. 36,425 cr, down 18.3% y-o-y. Despite lower order inflow, the management stands by its revised order inflow guidance of Rs. 55,000 cr. Earlier the management had guided for about Rs. 50,000 cr of order inflow in FY10. However, in Q1FY10 the management revised upwards its order inflow guidance to about Rs. 55,000 cr (due to signs of economic recovery) of which Rs. 40,000 cr is expected to be in the power segment and Rs. 15,000 cr in the industry segment. Further, the company has added that the Rs. 55,000 cr order inflow guidance for FY10 (E) does not include any supercritical bulk order from NTPC-DVC in the current year. The company expects to win the bulk order in the first quarter of FY11 (E).

- BHEL had augmented its manufacturing capacity for power plant equipment from 6,000 MW to 10,000 MW annually by December 2007. This manufacturing capacity was being further enhanced to 15,000 MW annually by the end of March 2009. The capacity has already come on stream and is in the process of stabilization. The company had earmarked a capex of Rs. 1,800 cr for FY10, most of which has been completed. For FY11, the capex target is about Rs. 1,900 cr. The second phase of capacity expansion of 5,000 MW is expected to be ready by December 2011, taking the entire capacity to 20,000 MW. The company expects to complete ordering machinery for the second phase of capex by end FY10. The funds for these are expected to come from internal accruals.

- During the quarter, BHEL commissioned its new Utra High Voltage Transformer Manufacturing Facility at Bhopal. As part of its manufacturing capacity expansion to 15,000 MW per annum and to equip itself for this anticipated surge in demand for transformers at nearly 1,20,000 MVA per year, BHEL has taken several steps to become self reliant. This new facility will enable BHEL to produce an additional 12,000 MVA of transformers per annum. With this, the total installed transformer manufacturing capacity at BHEL's Bhopal plant will go up to 30,000 MVA per annum while the total capacity of BHEL including its Jhansi plant will go up 45,000 MVA.

- During the conference call, the management stated that BHEL's sub-critical 600MW boiler gives energy efficiency equivalent to that of a super-critical 660MW set. However, it indicated that it would like the Ministry of Power to look at specifications that are energy efficient. In this regard, the company has submitted a petition to Central Electricity Authority (CEA)/Ministry of Power to stress boiler efficiency and not to be bogged down by super-critical/sub-critical differentiation of sets.

- The management expects 20-25% growth as far as the sales are concerned and more than 30% growth as far as profits are concerned for FY10. The management is confident of meeting its MoU target of gross sales of Rs. 32,000 cr. The company is looking to manufacture 10,000 – 11,000MW in FY10.

- An interim dividend of Rs. 11 per share has been declared by the company on January 21,.2010.

## Concerns

- Delays in power-sector reforms could affect order flows and earnings.
- Regulatory uncertainties.
- Decline in order inflows is a cause of concern for BHEL.
- Execution delays in orders.
- Super-critical equipment has lower margins due to the high import component requirement, which could put pressure on BHEL's margins going ahead. However, BHEL is an integrated manufacturer and the management expects the import component requirement to reduce going ahead as BHEL gains scale of operations and hence the impact on margins to be mitigated.
- Competition pressures from global majors: In the domestic market, BHEL is facing stiff competition from international players, particularly from Chinese power plant equipment (PPE) manufacturers, who have twin advantages of economies of scale and global reach. However, expectation of licensing restrictions on Chinese players in supercritical boilers could bring some relief to BHEL.

## Conclusion

BHEL is India's largest electrical equipment supplier–accounting for around 65% of India's installed power capacity. While BHEL's order book provides comfort for the next 4 years, order execution is a key challenge area for the company. Though the company has managed execution reasonably well in 9MFY10, the bulk of order execution takes place in the last quarter. The company also faces diverse set of challenges emanating from the increasing competition in the sector. However, part of these concerns are mitigated with majority of the capacity expansion (10,000 MW to 15,000 MW) being on schedule.

Bulk tendering for supercritical power equipment catalyzes competition for BHEL. The government appears keen on more players in power equipment manufacturing. A substantial ramp up in exports may also be limited by technology alliances, which may limit export opportunity to relatively smaller countries. However, BHEL is actively looking to enter into a JV / acquire a foreign company focused on technology.

BHEL is well placed in the industry due to its strong balance sheet, cash flows and order backlog. The company's order backlog at Rs. 1,34,000 cr is 5.1x its FY09 revenue. The private sector has also showed increased confidence in BHEL's execution capabilities and equipment quality. Execution is expected to pick up momentum with capacities stabilizing by March 09. Further, BHEL is also expected to benefit from lower commodity prices in the quarters to come. At the current market price, the stock trades at 22x our FY11 (E) EPS of Rs. 106.9. Historically, BHEL has traded between 10-30x one year forward earnings, with an average of 23x. Currently, BHEL is trading at about a 30% premium to the Sensex. Though we continue to like BHEL, at the current valuations the stock appears to be fairly valued. BHEL works in the public-sector-dominated power sector and was a strong defensive against crisis of confidence in private enterprise and tough financing environment. Also, according to reports, the government is considering selling 10% stake in BHEL and a final decision is yet to be taken.

The positives of intermediate term visibility of revenues and PSU divestment related positive sentiments could be partly offset by concerns on long term visibility of revenues due to emerging competition and pressure on margins due to commodity price rise expectation. Further lackluster results from another large player in the Engineering space could result in default buying in BHEL.

In our Q2FY10 Result Update, we had stated, 'We expect BHEL to trade in the Rs. 2,150 – 2,550 band. Investors can look at accumulating the stock at the Rs. 2,200 levels". Thereafter, BHEL made a low of Rs. 2,105 on 4 November, 2009 and a high of Rs. 2,454 on 6 January, 2010. It is currently quoting at Rs. 2,344. Fresh investors can enter the stock in the Rs. 1,970 – 2,100 band for a price target of Rs. 2,458 (23 x FY11(E) EPS).

## Quick Estimates

| (Rs cr) | FY09 | FY10 (E) | FY11 (E) |
|---|---|---|---|
| Sales | 26234 | 31481 | 38092 |
| EBIDTA (excluding other income) | 3801 | 5824 | 7276 |
| EBIDTA (%) | 14.5 | 18.5 | 19.1 |
| Reported PAT | 3138 | 4288 | 5233 |
| EPS | 64.1 | 87.6 | 106.9 |

(**Source:** Company, HDFC Securities)

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