

Q4FY2008 results –earnings downgrade

27 May 2008

BUY

Price	Target Price
Rs1656	Rs2330
Sensex	16,349

Price Performance

(%)	1M	3M	6M	12M
Absolute	(11)	(20)	(36)	23
Rel. to Sensex	(7)	(15)	(25)	8

Source: Capitaline

Stock Details

Sector	Engineering
Reuters	BHEL.BO
Bloomberg	BHEL@IN
Equity Capital (Rs mn)	4895
Face Value (Rs)	10
No of shares o/s (mn)	490
52 Week H/L	2,925/1,301
Market Cap (Rs bn/USD mn)	811/18,991
Daily Avg Vol. (No of shares)	1721392
Daily Avg Turnover (US\$m)	74.1

Shareholding Pattern (%)

	M'08	D'07	S'07
Promoters	67.7	67.7	67.7
FII/NRI	18.2	19.7	20.0
Institutions	8.6	7.7	7.7
Private Corp	3.4	3.0	2.9
Public	2.1	1.9	1.8

Source: Capitaline

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BHEL declared its Q4FY2008 results with net sales of Rs72 bn and net profit at Rs11.1 bn. However the same is below our expectation. The net sales growth of barely 4.1% clearly shows execution problems with the company. Severe shortage of engineers and other skilled workers, coupled with shortage of contractors and BOP equipment has hampered BHEL execution pace and led to delay in execution of its orders. Q4FY2008 EBIDTA at Rs13.63 bn declined by 14.1% yoy, on account of 29% yoy increase in staff cost and 45.4% yoy increase in other expenditure. The Q4FY2008 staff cost however includes provision for wage hike on account of 6th pay commission recommendations. The net profit at Rs11.1 bn declined by 3.4% yoy. The order book position is at Rs 85.5 bn which was ahead of expectations. To factor in slower pace of execution, higher raw material prices and higher employee cost, we are downgrading our earnings estimate by 20%. Our EPS estimates now stand at Rs75.2 for FY2009 and Rs103.7 for FY2010. In order to factor in a lower earnings growth we are downgrading our price target to Rs2330, which is based on 22.5X its FY2010 earnings. At CMP of Rs1655, BHEL is trading at 16X its FY2010 earnings and 10.4X its FY2010 EBIDTA, which is near the lower range of its trading band. We believe that BHEL is taking steps in right direction to address issue of supercritical order, increasing pace of execution and expanding capacity. Faster execution of delayed order shall also improve near-term earnings growth. **Maintain BUY.**

Result Highlights

- BHEL declared its Q4FY2008 results with net sales of Rs72 bn and net profit at Rs11.1 bn. However the same is below our expectation.
- The net sales growth of barely 4.1% clearly shows execution problems with the company. Severe shortage of engineers and other skilled workers, coupled with shortage of contractors and BOP equipment has hampered BHEL execution pace and led to delay in execution of its orders.
- Q4FY2008 EBIDTA at Rs13.63 bn declined by 14.1% yoy, on account of 29% yoy increase in staff cost and 45.4% yoy increase in other expenditure. The Q4FY2008 staff cost however includes provision for wage hike on account of 6th pay commission recommendations.
- Actual Staff cost for FY2008 was Rs26 bn, while provisions were made to the tune of Rs6.2 bn. till 9MFY2008, BHEL had provided for approximately Rs2.5 bn which was based on estimation of an increase of 25% in wage costs. However after the recommendation of 6th pay commission new estimates of were close to 45% increase in salaries. Thus the provisioning for Q4FY2008 includes 45% of wage cost in 4QFY08 and shortfall of 20% in provisions till 9MFY08. This meant that close to Rs2.95 bn provisions were made in Q4FY2008.
- Excluding the provisions for staff cost, EBIDTA for the quarter improved by 4% and EBIDTA margins stayed flat on a yoy basis.
- PBT for the quarter declined by 5.1%, lower than EBIDTA decline primarily because of higher other income on account of surplus cash plus some interest received on tax refunds. The net profit at Rs11.1 bn declined by 3.4% yoy.
- The order book position is at Rs 85.5 bn which was ahead of expectations. The order book comprises Rs710 bn from the power segment, Rs88 bn from the industrial segment and Rs57 bn from international orders. Order backlog as on date is Rs914 bn, implying that strong order inflows for BHEL continue.

Results Table

Rs millions	Q408	Q407	Var (%)	FY2008	FY2007	Var (%)
Gross Sales	79599	75760	5.1%	214976	188385.2	14.1%
Excise Duty	7579	6563	15.5%	21321	16010	33.2%
Net Sales	72020	69197	4.1%	193655	172375.2	12.3%
Total Expenditure	58387	53324.8	9.5%	120321.5	139658.9	-13.8%
Raw Material Consumed	41943	35911		114895	98740	
as % of sales	58.2%	51.9%		59.3%	57.3%	
Stock Adjustment	-3931	2385		-8273	-1812	
as % of sales	-5.5%	3.4%		-4.3%	-1.1%	
Employee Expenses	11661	9036.9		31459	24511	
as % of sales	16.2%	13.1%		16.2%	14.2%	
Other Expenses	8714	5991.8		21906	18027	
as % of sales	12.1%	8.7%		11.3%	10.5%	
Operating profit	13633	15872.2	-14.1%	33668	32909.2	2.3%
Other Income	4244	2860	48.4%	13962	7615	83.3%
PBIDT	17877	18732.2	-4.6%	47630	40524.2	17.5%
Interest	42	46.8	-10.3%	354	433	-18.2%
Depreciation	827	762	8.5%	2972	2730	8.9%
PBT	17008	17923.4	-5.1%	44304	37361.2	18.6%
Tax	5897	6419	-8.1%	15711	13214	18.9%
Profit After Tax	11111	11504.4	-3.4%	28593	24147.2	18.4%
EPS (Rs/share)	22.7	23.5		58.4	49.3	
Margins						
OPM (%)	18.9%	22.9%		17.4%	19.1%	
PBIDTM(%)	24.8%	27.1%		24.6%	23.5%	
PBT(%)	23.6%	25.9%		22.9%	21.7%	
PATM(%)	15.4%	16.6%		14.8%	14.0%	
Tax Rate	34.7%	35.8%		35.5%	35.4%	

Segmental Results

Revenue	Q408	Q407	Var (%)	FY2008	FY2007	Var (%)
Power	56740	54220	4.6%	159188	138575	14.9%
Industry	24133	22917	5.3%	60106	53763	11.8%
EBIT						
Power	17741	17479	1.5%	39310	35813	9.8%
Industry	6304	5577	13.0%	10863	8772	23.8%
EBIT (%)						
Power	31.3%	32.2%		24.7%	25.8%	
Industry	26.1%	24.3%		18.1%	16.3%	

Order Book details

Rs billion	Q408	Q407	Var (%)	FY2008	FY2007	Var (%)
Order at the beginning of the Quarter	780	467	67%	550	375	47%
Order inflow	155	159	-3%	520	363	43%
Revenue booked	80	76	5%	215	188	14%
Order backlog at the end of the Q	855	550	55%	855	550	55%

Concall highlights

Prices of steel which is the key raw material for BHEL, has witnessed a very sharp increase in the recent times. And since a large part (approximately 40%) of BHEL's order book is comprised of fixed price contracts, its EBIDTA margins are likely to be impacted by increase in steel and other commodity prices. In the Concall Management indicated that critical raw material inputs are purchased as soon as BHEL is awarded the project or declared as the lowest bidder. Hence, we believe that BHEL EBIDTA margins to some extent would be protected against the sharp increase in commodity price. Management also guided for a stable margins scenario as operating leverage on account of volume growth is expected to mitigate increased raw material and other operating expenditure.

Management also highlighted that BHEL has the capabilities to cater to supercritical requirements as differences from the sub-critical segment are more on the materials front than on technology. Margins in the supercritical segment would expand gradually as the company imbibes the technology and makes progress on higher indigenization. However management also highlighted that some clients insist on some key components being imported.

On the issue of shortage of workers the company said that it has added 4000 employees in FY2008. Further is said that it plans to add another 18,000 - 20,000 employees to its current work force by next 3-4 years.

BHEL has planed a capex of Rs50 bn to expand its capacity from 7000 MW to 15000 MW by Dec-March 2009. The company currently has capacity of 11000 of capacity with three shifts in operation. Acquisition of BHPV is also likely to contribute incremental capacity of about 5% in FY2009E. BHPV is likely to be a source for boilers and pressure parts.

Downgrading earnings

To factor in slower pace of execution, higher raw material prices and higher employee cost, we are downgrading our earnings estimate by 20%. Our EPS estimates now stand at Rs75.2 for FY2009 and Rs103.7 for FY2010. In order to factor in a lower earnings growth we are downgrading our price target to Rs2330, which is based on 22.5X its FY2010 earnings.

Revised Estimates (Rs million)	FY2009E	FY2010E
Revenue	253486	332060
Change	-15%	-16%
Net Profit	36801	50737
Change	-20%	-20%
EPS (Rs/share)	75.2	103.7
Change	-20%	-20%

Valuation and view

At CMP of Rs1655, BHEL is trading at 16X its FY2010 earnings and 10.4X its FY2010 EBIDTA, which is near the lower range of its trading band. We believe that BHEL is taking steps in right direction to address issue of supercritical order, increasing pace of execution and expanding capacity. Key positive triggers are negotiated orders for 800MW supercritical units from NTPC, visibility on execution of projects in JVs like that with TNEB for supercritical projects and award of 800X2 MW supercritical units from Krishnapatnam project. Faster execution of delayed order shall also improve near-term earnings growth. Maintain BUY.

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