

13 October 2010

# Capital Goods

## 2H outlook will be key

Order inflow, revenue and margin remain the key items to watch in management's outlook. The September-end quarter saw slow tendering. We see 15% yoy PAT growth in our capital goods universe and 10% in our utilities universe. We like BHEL, BEL and Crompton in capital goods and NTPC in utilities.

### Key recommendations and forecasts

#### Sector performance

	(1M)	(3M)	(12M)
Absolute	902.5	1235.7	2141.2
Absolute (%)	6.0	8.4	15.5
Rel market (%)	-1.4	-3.8	-2.7

India Bse 30 Sensitive: 20203.34  
 BSE Capital Goods: 15997.29  
 Priced COB 12 October 2010  
 Source: Bloomberg

	Reuters	Year end	Recom	Price	Target price	EPS 1fcst	PE 1fcst
BHEL <sup>1</sup>	BHEL.BO	Mar 2011	Buy	Rs2543.55	Rs2981.00	118.11	21.5
Power Grid <sup>1</sup>	PGRD.BO	Mar 2010	Buy	Rs109.45	Rs120.00	4.92	22.2
Tata Power <sup>1</sup>	TTPW.BO	Mar 2011	Hold	Rs1415.40	Rs1346.00	31.61	44.8
Crompton <sup>1</sup>	CROM.BO	Mar 2011	Buy	Rs317.50	Rs364.00	14.13	22.5
Bharat Electronics <sup>1</sup>	BAJE.BO	Mar 2011	Buy	Rs1850.55	Rs2105.00	104.39	17.7
Larsen & Toubro <sup>1</sup>	LART.BO	Mar 2011	Hold	Rs1999.50	Rs1912.00	63.3	31.6
Siemens India <sup>1</sup>	SIEM.BO	Sep 2010	Sell	Rs814.80	Rs505.00	23.13	35.2
ABB <sup>1</sup>	ABB.BO	Dec 2010	Sell	Rs906.80	Rs472.00	10.41	87.1
Voltas <sup>1</sup>	VOLT.BO	Mar 2011	Sell	Rs240.25	Rs166.00	10.63	22.6
NTPC <sup>1</sup>	NTPC.BO	Mar 2011	Buy	Rs210.30	Rs244.00	11.59	18.1

1. Normalised EPS - Post-goodwill amortisation and pre-exceptional items  
 Source: Company data, RBS forecasts

### September quarter saw staid tendering; management outlook remains key

Project activity declined in the September-end quarter, with net additions to the number of outstanding projects down to 1,540 from 1,948 in the same period last year. We believe order inflows remained muted, given delays in order tendering, particularly at government players such as NTPC and Power Grid. We estimate 15% yoy PAT growth for the capital goods companies and 10% for the utilities in our coverage universe. As in past quarters, management comments regarding the outlook for order inflow, order book, revenue and margin will be key, as these would set the tone for 2HFY11 and full fiscal year (to March).

### Policy support remains in favour of local players

The six months to end-September saw continuation of policies that support local manufacturing. Power Grid floated a draft of a note that would make it mandatory for suppliers to have domestic manufacturing facilities within three years. This follows a Central Electricity Authority directive in the last financial year to state and central utilities to place orders with domestic vendors.

### Orders should see traction in 2HFY11F

We expect better traction in equipment orders in 2H, particularly by government players. By December 2010, we would expect NTPC to float a tender for a Rs180bn contract for the bulk supply of 800MW projects (following the bulk tender for 11x 660MW that is currently under consideration, which should be a positive for BHEL. Similarly, order flow from Power Grid should pick up once its follow-on equity offer closes in November 2010, benefiting transmission equipment suppliers, such as Crompton.

### We still like BHEL, BEL and Crompton in the capital goods sector; NTPC in utilities

We maintain our preference for BHEL, BEL and Crompton Greaves in the capital goods space. We are positive on L&T in the medium term, but prefer BHEL in the near term. We maintain our Sell ratings on the MNC T&D companies we follow. In utilities, we like NTPC. Important disclosures can be found in the Disclosures Appendix.

#### Researched by

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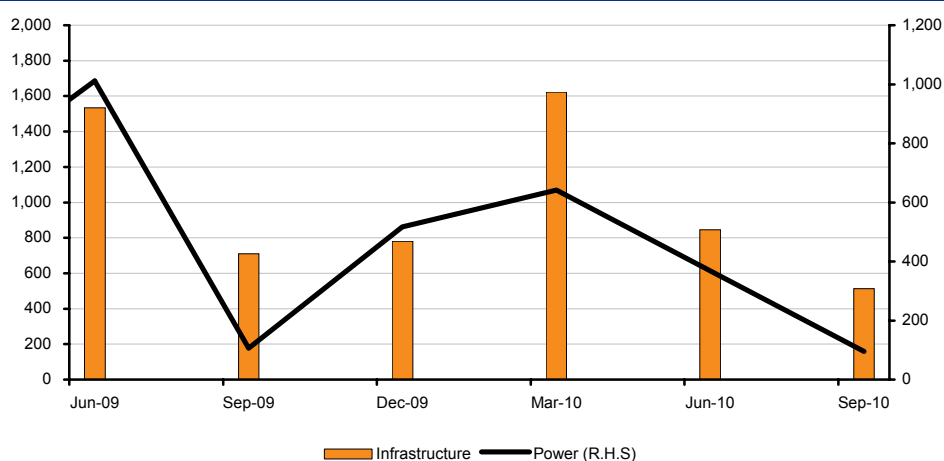
## 2HFY11 outlook remains key

The September-end quarter saw dull tendering activity. We expect PAT growth of 15% for our capital goods universe and 10% for our utilities stocks. We continue to like BHEL, BEL and Crompton in capital goods, while NTPC is our pick among utilities.

### September-end quarter saw a slowdown in tendering

Project activity weakened during the quarter (2QFY11; 4QFY10 for Siemens and 3QFY10 for ABB) on a yoy basis, with net additions to the number of outstanding projects (planning and under-execution) declining to 1,540 from 1,948 in the same quarter last year. There was a slowdown in tendering for both electricity and distribution projects. In the electricity sector, net additions to the number of outstanding projects declined to 30 (from 96 in the same quarter last year), with additions in terms of value at Rs498bn (down 53% yoy). In the distribution segment, the addition to the number of outstanding projects was 43 (vs 104 last year), but the value addition increased to Rs18bn (ie, up 7% yoy).

**Chart 1 : The net addition (in Rsbn) to under-execution projects declined in Sep quarter**



Source: *Projects Today*

We believe order inflows remained muted during the quarter, as there have been delays in order tendering, particularly at government players such as NTPC and Power Grid. As per *Projects Today*, there was a decline of 10% yoy in electricity sector orders during April-August 2010. However, we expect a pick-up in order inflow in the latter half of the current fiscal year.

### We expect 15% yoy earnings growth for capital goods, 10% utilities

We expect our capital goods coverage universe to see 16% yoy growth in revenues, led by potentially strong growth at BHEL. We forecast similar PAT growth (15% yoy) for our universe of stocks, but expect margins to remain flat. BHEL is expected to register around 25% sales and profit growth, and L&T relatively muted sales growth of 10%, but potential margin expansion should result in profit growth of about 16%. We expect Crompton to post moderate 7% yoy revenue growth, but slightly higher growth in profit. For Siemens, we forecast 26% yoy growth in earnings, and for ABB, earnings contraction of 49% yoy. Voltas is likely to register earnings contraction of 1.4% yoy. Our utilities universe should see moderate 10% yoy growth in earnings.

We present below our key expectations from the September 2010 quarter results, by company.

#### ABB

We expect cost overruns in power projects, resulting in a sharp decline in margins on a yoy basis. Order inflow, especially in power segment, might remain muted on the low level of tendering during the quarter.

June 2010 order book – Rs85.3bn.

**Key items to watch**

- Management comments on continuation of cost overruns in projects.
- Profitability of the power systems business.
- Comments on pricing pressure in the products business.

**BHEL**

1H is generally subdued for the company, as revenue is back ended. However, we expect strong yoy growth in profit and revenue in 2QFY11, although margins should be flat.

June 2010 order book – Rs1,480bn.

**Key items to watch**

- Order inflow for the quarter (current guidance of Rs590bn-600bn for FY11; 1QFY11 inflow was Rs108bn).
- Any indication of further progress in the bulk order expected from NTPC.

**BEL**

We expect sales for the quarter to grow, but profit to decline yoy as margins contract.

June 2010 order book – Rs125bn.

**Key items to watch**

- Margin movement (historically, 2Q has seen a sharp qoq jump).

**Crompton Greaves**

We expect the consumer products business and the industrial segment to drive revenue growth. The power segment should remain flat at best, as adverse forex movements likely result in a contraction in overseas revenues. We expect margins to be flat yoy.

June 2010 order book – Rs68bn.

**Key items to watch**

- Outlook for the international power business in FY11 (management is currently guiding for 5% top-line growth on a constant-currency basis). The average €/Rs exchange rate declined about 20% yoy during the September-end quarter.
- Order inflow in the domestic power segment.

**L&T**

We expect single-digit revenue growth for the quarter, but potential margin expansion should lead to higher profit growth. We expect order inflow to remain strong, as the company has already announced order inflow of about Rs147bn for the quarter.

June 2010 order book – Rs1078.2bn.

**Key items to watch**

- Order inflow and management comments on inflows (FY11 order inflow guidance of Rs870bn with 20% of orders from the power sector).
- Timelines in terms of subsidiary divestments.

**Siemens**

We anticipate that performance in the energy segment will improve, with overall strong growth in sales and profit on a yoy basis. However, margins will likely be flat.

June 2010 order book – Rs135.5bn.

**Key items to watch**

- Energy segment performance, which despite revenue growth in 3QFY10 saw a sharp yoy decline in the PBIT margin.

**Voltas**

We expect yoy revenue growth across segments, led by engineering. However, margins are likely to decline, resulting in an earnings decline, despite revenue growth.

June 2010 order book – Rs50bn.

**Key items to watch**

- Margin movement; order inflow and outlook on the Middle East business.

**NTPC**

We expect steady yoy growth in revenue and profit, given that additional capacity – one unit at Dadri (of 490MW capacity) – became operational during the quarter.

**Key items to watch**

- Management comments on supercritical equipment orders.

**Tata Power**

We expect sales to decline with flat profit growth, on a yoy basis.

**Key items to watch**

- Progress of projects under construction, particularly Maithon (where the first unit of 550MW capacity is due to be commissioned in FY11).

**Power Grid**

We expect sales and profit to rise yoy.

**Key items to watch**

- Indications on awarding of T&D equipment orders.
- Capitalisation of assets in 1H, and capex spend for FY11 and FY12.

**Table 1 : September 2010 quarter forecasts for our capital goods and utilities coverage universe**

Rsm	Sep-10			Sep-09			yoy		
Company	Net sales	PBDIT	PAT	Net sales	PBDIT	PAT	Net sales	PBDIT	PAT
ABB	15,571	732	425	14,689	1,375	831	6.0%	-46.8%	-48.8%
BHEL	82,756	15,670	10,788	67,275	12,318	8,579	23.0%	27.2%	25.8%
BEL	14,338	3,079	2,335	12,991	3,201	2,374	10.4%	-3.8%	-1.6%
Crompton	23,382	3,257	2,107	21,890	3,067	1,932	6.8%	6.2%	9.1%
L&T	86,887	10,019	6,395	79,188	8,372	5,530	9.7%	19.7%	15.6%
Siemens	34,754	3,461	1,929	25,180	2,452	1,530	38.0%	41.2%	26.0%
Voltas	12,121	1,174	904	10,996	1,259	917	10.2%	-6.2%	-1.4%
NTPC	125,320	40,545	23,519	112,526	36,836	21,520	11.4%	10.1%	9.3%
Tata Power	16,237	3,962	1,825	17,211	4,168	1,811	-5.7%	-4.9%	0.8%
PGCIL	19,596	16,059	5,486	17,486	14,723	4,661	12.1%	9.1%	17.7%

Source: Company data, RBS forecasts

**We still like BHEL, BEL and Crompton in cap goods, NTPC in utilities**

We like BHEL because of its higher revenue visibility on a strong order backlog, while we prefer Crompton over its MNC peers in the T&D space, as CRG's product-focused business holds it in good stead for margins. In our utilities universe, we have Buy ratings on NTPC and PWGR, while we have a Hold rating on Tata Power.

**Table 2 : Recommendations and valuations comparison**

	CMP	TP	Rating	PE		P/BV		EV/EBITDA		EPS (Rs)		BVPS (Rs)	
				FY11F	FY12F	FY11F	FY12F	FY11F	FY12F	FY11F	FY12F	FY11F	FY12F
Capital Goods													
ABB*	906.80	472.00	Sell	87.1	52.1	7.4	6.6	63.0	36.9	10.4	17.4	122.4	137.5
BHEL	2,543.55	2,981.00	Buy	21.5	18.4	6.0	4.7	14.0	12.0	118.1	138.1	424.9	537.3
BEL	1,850.55	2,105.00	Buy	17.7	14.6	3.0	2.6	11.6	9.4	104.4	127.1	621.6	717.0
Crompton	317.50	364.00	Buy	22.5	18.7	6.3	4.9	14.9	12.6	14.1	16.9	50.4	64.3
L&T	1,999.50	1,912.00	Hold	31.6	23.6	5.7	4.8	21.7	16.3	63.3	84.6	350.8	417.1
Siemens**	814.80	505.00	Sell	35.2	30.8	8.2	6.8	15.7	18.6	23.1	26.5	99.8	120.4
Voltas	240.25	166.00	Sell	22.6	19.8	5.8	4.7	16.3	14.2	10.6	12.1	41.4	50.7
Utilities													
NTPC	210.30	244.00	Buy	17.7	15.6	2.5	2.3	13.2	10.9	11.9	13.5	83.7	93.0
Tata Power	1,415.40	1,346.00	Hold	44.8	37.2	3.2	3.0	21.2	18.6	31.6	38.0	443.7	469.1
PGCIL	109.45	120.00	Buy	20.0	17.5	2.6	2.4	10.2	8.6	5.5	6.2	42.1	46.5

Priced at COB 12 October 2010. \* ABB year-end is Dec., so FY11F refers to CY10F data and FY12F to CY11F; \*\* Siemens year-end is Sep., so FY11F is FY10F and FY12F is FY11F.  
Source: Bloomberg, RBS forecasts

## Annexure

**Table 3 : Key developments during the quarter**

Key developments	Description
Tata Power sells stake in Bumi mines to private equity player	Tata Power entered into a deal with private equity player Olympus Capital to sell 15% of its stake in the special purpose vehicles (SPVs) that own 30% of KPC and Arutmin. The 15% stake is valued at US\$300m, implying a total equity value of US\$2bn for Tata Power's stake in the coal mines.
Power Grid to invite bids to lease out telecom towers	Power Grid said it plans to invite bids for leasing out telecom towers in the next 3-4 months to telecom companies. This is part of the company's effort to diversify the existing business. The company sees Rs3.5bn-4bn revenue potential from the telecom business in the next 4-5 years.
L&T Infra gets infrastructure finance company status	L&T Infra received the status of an infrastructure finance company from the Reserve Bank of India (RBI). This should help it to mobilise funds at lower rates and offer more flexibility in its lending to infrastructure projects.
NTPC plans to float a Rs180bn tender for 800MW supercritical projects	NTPC announced that by December 2010 it will float a tender for a Rs180bn contract for the bulk supply of 800MW projects. The main plant package (boiler and turbine) cost for these projects is estimated by the company at Rs180bn; expenditure of another Rs220bn is expected on civil construction and the balance of plant (BoP) package related works. However, we note that the tender might get delayed until the existing tender for 11x 660MW projects is awarded.
NTPC to invite Rs110bn bids for ancillary equipment	NTPC said it will invite international competitive bids by the end of this year to buy ancillary equipment worth Rs110bn for five power projects
Power Grid invites fresh bids for Rs70bn project	Power Grid invited fresh bids from shortlisted bidders BHEL-ABB and Siemens for Rs70bn high voltage direct current (HVDC) sub-stations. We note that BHEL-ABB consortium was earlier notified as the lowest bidder for the project.
L&T Finance Holdings Files DRHP for a Rs15bn IPO	L&T Finance Holdings Ltd filed a DRHP with SEBI to raise Rs15bn through a public offering. The company said the IPO proceeds would be utilised to increase the capital base of L&T Finance and L&T Infra to meet capital requirements.

Source: Company data, media reports

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