Q3FY2009 Capital Goods earnings review

Execution risks loom large

Key points

- On an aggregate basis, the capital goods and engineering companies under our coverage reported a 28.2% growth in revenues for Q3FY2009. The revenue growth was marginally above our estimate. A strong top line growth was reported by the larger companies like Larsen and Toubro (L&T) and Punj Lloyd. The revenue growth of the mid-caps was broadly in line with our expectations.

- As expected, the operating performance of these companies remained under pressure due to a higher raw material cost. The softening prices of raw materials should help to improve their operating performance going forward. The profitability of the companies under our coverage was also dented by an increase in their interest cost, as companies across the board saw stretched working capital needs. As a result, the aggregate profits of the companies under our coverage grew by 8.8%, which was lower than our estimate.

Earnings highlights

BHEL

- In Q3FY2009 the sales of Bharat Heavy Electricals Ltd (BHEL) grew by 21.3% year on year (yoy) and the growth was lower than our estimate. The operating profit margin (OPM) of the company remained under strain because of its high raw material cost and wage provisions. The profit growth of 2.4% was lower than our estimate.

- The company continues to report strong order flows with a 39% year-on-year increase in order flows and the backlog rising to Rs113,500 crore during the third quarter.

- During the quarter the company's working capital cycle also turned positive after turning negative in March 2008, thanks mainly to inventory build-up and vendor financing.

- BHEL has enough orders on hand. However, timely execution of these orders would be the key driver of its revenues going forward. The softening prices of the key inputs should help it to improve its profitability.

Q3FY2009—result snapshot Rs (cr)

Company	Net sales			Net profit		
	Q3FY2009	Q3FY2008	% yoy chg	Q3FY2009	Q3FY2008	% yoy chg
Bharat Bijlee	140.4	111.9	25.5	13.3	12.3	8.1
BHEL	6022.3	4964.2	21.3	790.6	771.9	2.4
Crompton Greaves*	2150.4	1716.1	25.3	123.2	82.7	49.0
Genus power	120.5	105.5	14.2	10.6	10.0	6.8
Indotech Transformers	55.1	52.1	5.9	12.3	12.2	0.9
Larsen & Toubro	8594.0	6382.7	34.6	604.1	481.8	25.4
Patels Airtemp	13.4	10.4	29.1	1.8	1.4	29.4
Punj Lloyd	3143.4	2162.7	45.3	65.7	116.9	-43.8
Sanghvi Movers	88.8	64.4	37.8	23.9	17.8	34.8
Thermax	795.1	845.4	-6.0	79.3	73.5	8.0
WS Industries	49.1	56.4	-13.0	0.8	3.6	-77.5

*Consolidated

Crompton Greaves

- The company continues to show a stable performance, reporting a robust growth in the sales of its stand-alone and consolidated businesses in the third quarter. At the profit after tax (PAT) level, the Q3FY2009 performance was above our expectations led by marginally better sales and lower depreciation charge on account of a change in the accounting policy.
- The stand-alone order book of the company increased by 23% to Rs2,674 crore while its consolidated order book stood at Rs6,592 crore. The company has bid for Rs3,500 crore worth of orders.
- The power system division of the company has not shown any sign of slowdown yet; however, the demand for distribution transformers has dropped significantly in markets like the USA and Ireland. In India, the company is only witnessing a slower demand growth in the industrial segment, as is evident from the pressure on its margins during Q3FY2009.
- The current order book of the company provides visibility to its revenues for the next 12-15 months. Further, the ability of the company and its subsidiaries to capture global demand would result in a 25% compounded annual growth in its earnings growth, over FY2008-10E, in our view.

Larsen & Toubro

- Larsen and Toubro delivered a strong performance during the quarter on the back of the excellent performance of its engineering & construction (E&C) division. However, the slowdown in its operations was evident from the performance of its other divisions, which showed a slower top line growth and lower margins.
- The order book growth was again sustained as the order inflows grew by 12% to Rs14,620 crore, taking its overall order book to Rs68,801 crore. The year-on-year order inflow growth appeared to be lower on account of the large Rs5,500-crore Mumbai airport project bagged in the same period of the previous year.
- Though the order inflow has been very impressive so far, it will certainly be a challenge to sustain such a growth in the current scenario. The growth has already tapered off in the electrical and electronics, and machinery industrial parts divisions whereas there are chances that the future orders even in the E&C division might be taken at lower margins in order to sustain growth.
- Based on our sum of parts value, we arrive at a fair value of Rs970 per share (Rs715 for the standalone business, valuing it at 14x FY2010E earnings and valuing its subsidiaries at Rs255 per share). On the Satyam Computer Services (Satyam)' acquisition issue, we believe that the management has access to far more information, which combined with its excellent track record and professionally managed nature lead us to believe that it will take the best decision on the matter, which would be in line with the interest of the company's shareholders. However, we believe that this issue is likely to hover around as a hangover on the stock, since we have no idea about the actual magnitude of liabilities of Satyam until the restated financials are published. Hence, we maintain our very cautious stance and therefore maintain our Hold on the stock.

Punj Lloyd

- Punj Lloyd's Q3 performance was marred by its dismal operating performance. Its OPM (adjusting for the one-offs) fell to 6.8% from 10.1% in Q3FY2008.
- The company's order book stood at Rs21,908 crore. However, four of its orders cumulatively valued at Rs3,855 crore are facing delays due to client-specific issues.
- We believe the order inflows for Punj Lloyd could taper off significantly given the company's high dependence on oil related capital expenditure and its exposure to the Middle East (26% of the current backlog). Further deferment of orders would delay revenue booking. However, the management has highlighted the visibility of its revenues (to the tune of Rs11,500 crore) in FY2010.
- Ideally taking the average of PE (multiple of 9-10x) and trough PB valuations, the stock should provides returns of 25-30% (Rs110-115) over next 12-18 months. However, despite the attractive valuations the deterioration in business environment, high debt level and the overhang of the arbitration case for SABIC order (Punj Lloyd has GBP28.5 million riding on the SABIC case) the stock would continue to languish in the near-term. Long-term investor could continue to hold on to the stock.

Thermax

- The revenues of the energy division of Thermax lagged on account of slower order inflow in the previous quarter due to which the revenues declined by 6% yoy in the third quarter. The adjusted profit grew by 8% yoy in the third quarter.

- The company's order book of Rs4,103 crore declined by 9% yoy. The management indicated that despite a healthy order book execution of orders will slow down in FY2010 due to tight liquidity.
- Going forward, revenue from the energy division is likely to pick up, as orders bagged in the previous quarters are likely to get executed in the coming quarters. However, with the corporate capital expenditure getting pruned, there are also chances that orders might get deferred or cancelled. Consequently, we see a slowdown in the order intake in FY2010, which would affect the company's performance going forward. However, Thermax' agreement to manufacture utility boilers of up to 800MW rating could provide a positive surprise.

Outlook

During the quarter the larger companies continued to see decent order flows. BHEL particularly continued to witness a strong growth (+39% yoy) in its order inflows. Going forward, the order inflows for the companies in the capital goods sector will remain under pressure against the backdrop of a slowing demand and a cut in the capital expenditure of corporates. Further, though currently their order book remains robust, these companies face the challenge of executing these orders on schedule due to the strain on their working capital cycle and the ongoing liquidity crunch. This could, in turn, affect the revenue growth of these companies in future. Some respite would come from the falling raw material prices, which might reduce the pressure on their margins from the next quarter onwards. Our top picks in the sector are BHEL and Crompton Greaves amongst the large players while Sanghvi Movers is our preferred buy in the mid-cap space.

The author doesn't hold any investment in any of the companies mentioned in the article.