



## BHEL

STOCK INFO.	BLOOMBERG
BSE Sensex: 13,024	BHEL IN
	REUTERS CODE
S&P CNX: 3,769	BHEL.BO

30 October 2006

Buy

Rs2,440

Previous Recommendation: Buy

Equity Shares (m)	244.8
52-Week Range	2,498/1080
1,6,12 Rel. Perf. (%)	-3/-7/53
M.Cap. (Rs b)	597.1
M.Cap. (US\$ b)	13.3

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
03/06A	136,873	16,769	68.5	73.7	35.6	8.2	25.2	39.6	4.2	21.7
03/07E	177,217	22,872	93.4	36.4	26.1	6.5	27.8	42.8	3.1	15.5
03/08E	212,028	28,880	118.0	26.3	20.7	5.2	28.0	41.9	2.6	12.2

**2QFY07 performance impacted by one-offs:** During 2QFY07, BHEL reported net revenues of Rs33.4b (up 33% YoY), EBITDA of Rs4.6b (up 24% YoY) and net profit of Rs3.6b (up 38% YoY). The reported numbers have been impacted by higher gratuity provisions of Rs450m (based on actuarial valuations) and higher performance incentive of Rs160m.

**Industrial division witnesses margin pressure from higher commodity prices:** Power division reported strong 2QFY07 performance, with revenues at Rs27.1b, up 29% YoY and EBIT of Rs5.8b, up 37% YoY. EBIT margins improved to 21.3% in 2QFY07, from 20.0% in 2QFY06. Industrial division witnessed margin pressure during 2QFY07, and reported revenues at Rs10.4b were up 35% YoY and EBIT of Rs1.3b, up 11% YoY. EBIT margins of the industrial division declined to 12.2% in 2QFY07, down from 14.9% in 2QFY06, being led by higher commodity prices, particularly copper and CRGO.

**Order backlog at Rs457b (up 42% YoY):** BHEL's order backlog as at September 2006 stood at Rs457b (up 42% YoY) comprising: power systems Rs346b, industry division, Rs77b and exports Rs34b. Order intake during 2QFY07 stood at Rs98b, which has been quite encouraging.

**Valuation and view:** Given the robust order book of Rs457b, BHEL has strong revenue growth visibility going forward. We expect revenue CAGR of 25% and net profit CAGR of 31% over FY06-08E. The stock trades at a P/E of 26.1x FY07E, 20.7x FY08E and 17.3x FY09E. Maintain **Buy**.

### QUARTERLY PERFORMANCE

Y/E MARCH	(Rs Million)									
	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
<b>Sales</b>	19,365	25,103	33,267	55,157	26,564	33,412	45,696	68,029	132,892	173,701
Change (%)	65.4	45.2	45.5	23.5	37.2	33.1	37.4	23.3	40.0	30.7
<b>EBITDA</b>	1,715	3,689	6,029	11,949	3,182	4,563	8,728	15,172	23,382	31,645
Change (%)	332.0	66.0	70.8	37.0	85.5	23.7	44.8	27.0	65.4	35.3
As a % Sales	8.9	14.7	18.1	21.7	12.0	13.7	19.1	22.3	17.6	18.2
Depreciation	576	624	620	640	639	667	689	730	2,459	2,724
Interest	123	133	136	195	131	136	189	302	587	757
Other Income	931	1,057	1,187	2,133	1,201	1,699	1,300	2,823	5,308	7,023
<b>PBT</b>	1,947	3,989	6,460	13,247	3,613	5,460	9,150	16,964	25,644	35,187
Tax	668	1,388	2,229	4,567	1,246	1,860	3,385	5,824	8,852	12,316
Effective Tax Rate (%)	34.3	34.8	34.5	34.5	34.5	34.1	37.0	34.3	34.5	35.0
<b>Reported PAT</b>	1,279	2,602	4,232	8,680	2,367	3,600	5,764	11,140	16,792	22,872
Change (%)	444.3	64.4	78.3	48.5	85.1	38.4	36.2	28.3	76.1	36.2
<b>Adj. PAT</b>	1,279	2,602	4,232	8,680	2,367	3,600	5,764	11,140	16,792	22,872
Change (%)	266.8	64.4	78.3	48.5	85.1	38.4	36.2	28.3	74.1	36.2

E: MOST Estimates; Other Income includes Operational Other Income

## 2QFY07 performance impacted by one offs

During 2QFY07, BHEL reported net revenues of Rs33.4b (up 33% YoY), EBITDA of Rs4.6b (up 24% YoY) and net profit of Rs3.6b (up 38% YoY). The reported numbers were lower than our expectations: revenue Rs35.2b, EBITDA Rs6b and net profit Rs4b.

### One-offs in 2QFY07 numbers

- ✍ Gratuity provision of Rs450m based on actuarial valuations, which is applicable from FY07
- ✍ Performance incentive of Rs160m on revised terms

### Industrial division witnesses margin pressures from higher commodity prices

Power division reported strong 2QFY07 performance, with revenues at Rs27.1b, up 29% YoY and EBIT of Rs5.8b, up 37% YoY. EBIT margins improved to 21.3% in 2QFY07, from 20% in 2QFY06. Industrial division witnessed margin pressure during 2QFY07, and reported revenues at Rs10.4b, up 35% YoY and EBIT of Rs1.3b, up 11% YoY. EBIT margins of the industrial division declined to 12.2% in 2QFY07, down from 14.9% in 2QFY06. Industrial division now accounts for 28% of revenues and 18% of EBIT.

Management stated that the key reason for the margin decline was higher commodity prices, particularly copper and CRGO. Industrial business entails fixed-price contracts, and thus the sharp increase in commodity prices eroded margins. Going forward, we expect EBITDA margins to improve, given the moderation in terms of increase in copper prices.

The exports turnover for the 1HFY07 was up by 185% to Rs4,620m v/s Rs1,620 in 1HFY06. While the power segment is witnessing robust growth on the back of increasing investments, the industrial segment is benefiting from a revival in the Indian manufacturing industry and upturn in the capital investment cycle.

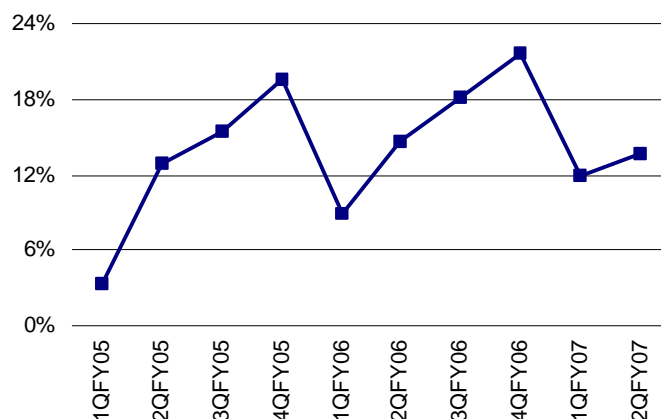
#### SEGMENT WISE ANALYSIS (RS M)

	1QFY06	2QFY06	3QFY06	4QFY06	1QFY07	2QFY07
<b>Revenue</b>						
Power	16,087	21,080	27,518	44,254	21,828	27,141
% Chg. YoY	76.5	62.8	55.0	22.9	35.7	28.8
Industrial	5,774	7,713	9,568	17,624	7,708	10,399
% Chg. YoY	35.3	14.3	15.5	18.0	33.5	34.8
Intersegment	718	916	940	1,172	661	886
<b>Total</b>	<b>21,143</b>	<b>27,877</b>	<b>36,146</b>	<b>60,706</b>	<b>28,875</b>	<b>36,654</b>
<b>EBIT</b>						
Power	2,163	4,221	6,325	10,984	4,089	5,789
Margin (%)	13.4	20.0	23.0	24.8	18.7	21.3
Industrial	440	1,147	1,360	3,516	362	1,268
Margin (%)	7.6	14.9	14.2	20.0	4.7	12.2

Source: Company

During 2QFY07, BHEL's EBITDA increased 24% YoY to Rs4.6b, while EBITDA margins declined by 104bp to 13.7%. The decline is largely due to higher raw material cost (as % of revenues), which increased to 55.6% during 2QFY07 (v/s 53.5% YoY) and Selling & General expenses which increased to 13.8% (v/s 13.3% YoY). Staff costs during the same period declined to 16.9% (v/s 18.6%) YoY.

#### TREND IN EBITDA MARGIN (%)



Source: Company

### Order backlog at Rs457b (up 42% YoY)

BHEL's order backlog as at September, 2006 stood at Rs457b (up 42% YoY) comprising: power systems Rs346b, industry division Rs77b and exports Rs34b. Order intake

during 2QFY07 stood at Rs98b (which has been quite encouraging). Order backlog from Power division is at Rs346b, up 18% QoQ while order backlog for Industry division was up 15% QoQ to Rs77b. The robust order backlog of Rs457b will translate into strong revenue CAGR going forward as average execution cycle for the power division is 24-36 months, while for the industrial division, it is 12-18 months.

During the XI<sup>th</sup> Plan, the government has set a capacity addition target of ~60,000MW. Hydro power is also witnessing increased traction. Also, with the increase in capex plans of the companies in petrochemical, steel and aluminium sector, large orders for captive power plants are expected. Another growing area for BHEL is the increasing demand for renovation and modernization of existing plants, which would increase significantly with life extension programs. Fresh inflows for export orders have also been healthy.

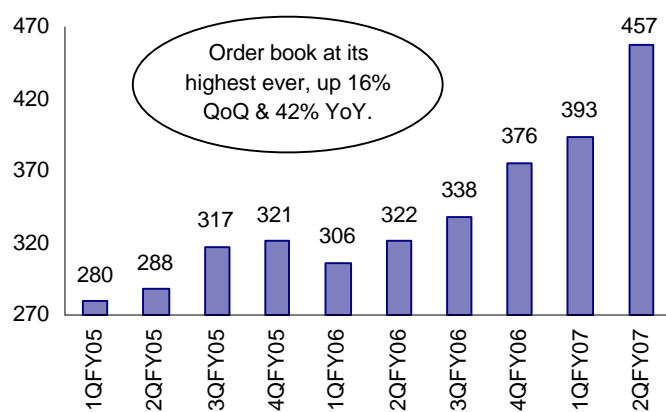
### Ramp up in capacity to meet higher demand

BHEL has firmed up its capex plans to invest Rs16b for the brownfield expansion of its existing annual capacity from 6,000MW to 10,000MW. The execution would be completed by early 2008. Management indicated that they have already spent 50% of the above capex, and the remaining amount would be invested by FY08. The company has also started taking various initiatives to develop vendor base and sub-contractor network with a view to outsourcing simple fabrication work and utilizing its own facilities for high value-added jobs.

### Valuation and view

Given the order book of Rs457b, BHEL has strong revenue growth visibility going forward. We expect revenue CAGR of 25% and net profit CAGR of 31% over FY06-FY08E. The stock trades at a P/E of 26.1x FY07E, 20.7x FY08E and 17.3x FY09E. Maintain **Buy**.

TREND IN ORDER BACKLOG (RS B)



Source: Company

## BHEL: an investment profile

### Company description

BHEL is India's dominant producer of power and industrial machinery and a leading EPC company, established in the late 1950s. The government's holding post divestment stands at 67.7%. The company has 14 manufacturing divisions, 8 service centers, 4 power sector regional centers besides project sites spread across all over India with annual installed capacity of 6,000MW. It has formed a tie-up with Alstom and an alliance with Siemens for the manufacture of super-critical 800MW boilers and turbines respectively.

### Key investment arguments

- Order backlog at end-2QFY07 stands at Rs457b, a book-to-bill ratio of 3.3x FY06.
- Huge investments in power sector in XIth plan (capacity addition of 60,000MW) will ensure higher order intake.
- Technology transfer agreement with Alstom for the super critical 800MW boilers has been signed.

### Key investment risks

- Though BHEL's order book is chock-a-block for the next three years, the key challenge is to meet the execution deadlines and improve cost efficiencies
- Effective management of the spiraling raw-material prices is a key to remain competitive and profitable.

#### COMPARATIVE VALUATIONS

		BHEL	L&T	CROMPTON
P/E (x)	FY07E	26.1	22.5	21.8
	FY08E	20.7	18.1	17.8
P/BV (x)	FY07E	6.5	6.4	9.7
	FY08E	5.2	5.6	7.6
EV/Sales (x)	FY07E	3.1	2.0	1.9
	FY08E	2.6	1.7	1.5
EV/EBITDA (x)	FY07E	15.5	21.4	18.3
	FY08E	12.2	17.2	14.3

#### SHAREHOLDING PATTERN (%)

	SEP.06	JUN.06	SEP.05
Promoters	60.4	60.4	60.4
Domestic Institutions	18.9	15.8	15.7
FII's/FDIs	9.8	13.1	12.8
Others	10.9	10.7	11.1

### Recent developments

- Tied-up with Alstom for technology transfer for super-critical 800MW boilers
- Has firmed up capex plans of Rs16b to increase annual capacity to 10,000MW from 6,000MW by early FY08.

### Valuation and view

- Given the immense potential of building generating capacity in the power sector in India, we expect the order book of BHEL to be robust going forward.
- As the company rapidly executes its orders, effectively manages its cost, and benefits from its operating leverage, we expect the earnings to grow at a CAGR of 31% over FY06-08E basis.
- The stock trades at a P/E of 26.1x FY07E, 20.7x FY08E and 17.3x FY09E. Maintain **Buy**.

### Sector view

- Investments in manufacturing industries are likely to continue their momentum as they are operating at their peak utilization rates.
- The government is finalizing capex plans for increased investments in the country's T&D segment.
- Import duty cuts may enhance scope of competition for the domestic companies.

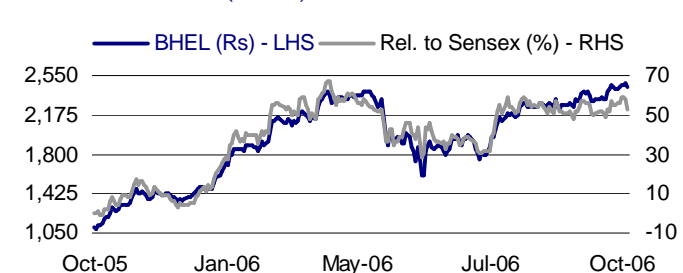
#### EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	93.4	95.0	-1.6
FY08	118.0	115.1	2.5

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
2,440	2,596	6.4	Buy

#### STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT						RATIOS					
(Rs Million)											
Y/E MARCH	2005	2006	2007E	2008E	2009E	Y/E MARCH	2005	2006	2007E	2008E	2009E
<b>Total Income</b>	<b>99,663</b>	<b>136,873</b>	<b>177,217</b>	<b>212,028</b>	<b>243,311</b>	<b>Basic (Rs)</b>					
Change	18.8	40.4	29.9	19.5	14.7	<b>EPS</b>	<b>39.4</b>	<b>68.5</b>	<b>93.4</b>	<b>118.0</b>	<b>140.8</b>
Staff Cost	16,504	18,785	21,603	27,004	29,704	Change (%)	17.5	73.7	36.4	26.3	19.4
Mfg. Expenses	47,784	69,424	90,633	108,930	125,341	Cash EPS	48.4	78.6	104.6	130.4	154.3
Selling Expenses	18,393	22,806	29,819	32,128	36,241	Book Value	246.2	298.3	374.2	470.1	584.6
<b>EBITDA</b>	<b>16,982</b>	<b>25,858</b>	<b>35,162</b>	<b>43,965</b>	<b>52,025</b>	DPS	8.0	14.5	16.0	20.0	24.0
Change	26%	52%	36%	25%	18%	Payout (incl. Div. Tax.)	23.0	23.3	18.8	18.6	18.7
% of Net Sales	17.0	18.9	19.8	20.7	21.4	<b>Valuation (x)</b>					
Depreciation	2,189	2,459	2,724	3,033	3,300	P/E		35.6	26.1	20.7	17.3
Interest	814	587	757	725	725	Cash P/E		31.1	23.3	18.7	15.8
Other Income	2,037	2,797	3,506	4,224	5,030	EV/EBITDA		21.7	15.5	12.2	9.9
Extra-ordinary Items (net)	-200	35	0	0	0	EV/Sales		4.2	3.1	2.6	2.2
<b>PBT</b>	<b>15,817</b>	<b>25,644</b>	<b>35,187</b>	<b>44,431</b>	<b>53,030</b>	Price/Book Value		8.2	6.5	5.2	4.2
Tax	6,282	8,852	12,316	15,551	18,561	Dividend Yield (%)		0.6	0.7	0.8	1.0
Rate (%)	39.7	34.5	35.0	35.0	35.0	<b>Return Ratio</b>					
Reported PAT	9,534	16,792	22,872	28,880	34,470	RoE		17.1	25.2	27.8	28.0
<b>Adjusted PAT</b>	<b>9,655</b>	<b>16,769</b>	<b>22,872</b>	<b>28,880</b>	<b>34,470</b>	RoCE		29.6	39.6	42.8	41.9
Change	17.5	73.7	36.4	26.3	19.4	<b>Turnover Ratios</b>					
<b>BALANCE SHEET</b>	<b>(Rs Million)</b>					<b>Debtors (Days)</b>	248	228	226	224	222
Y/E MARCH	2005	2006	2007E	2008E	2009E	Inventory (Days)	121	119	110	110	110
Share Capital	2,448	2,448	2,448	2,448	2,448	Creditors. (Days)	87	89	81	78	76
Reserves	57,821	70,566	89,130	112,625	140,633	Asset Turnover (x)	9.1	13.6	13.4	13.4	14.8
<b>Net Worth</b>	<b>60,269</b>	<b>73,014</b>	<b>91,578</b>	<b>115,073</b>	<b>143,081</b>	<b>Leverage Ratio</b>					
Loans	5,370	5,582	5,150	5,150	5,150	Debt/Equity (x)	0.1	0.1	0.1	0.0	0.0
Differed Tax Liability	-5,183	-6,737	-600	-600	-600	<b>CASH FLOW STATEMENT</b>	<b>(Rs Million)</b>				
<b>Capital Employed</b>	<b>60,456</b>	<b>71,859</b>	<b>96,128</b>	<b>119,623</b>	<b>147,631</b>	Y/E MARCH	2005	2006	2007E	2008E	2009E
Gross Fixed Assets	36,289	38,221	43,529	48,919	52,834	<b>PBT before EO Items</b>	<b>16,017</b>	<b>25,608</b>	<b>35,187</b>	<b>44,431</b>	<b>53,030</b>
Less: Depreciation	25,847	28,398	30,552	33,485	36,785	Add: Depreciation	2,189	2,459	2,724	3,033	3,300
<b>Net Fixed Assets</b>	<b>10,442</b>	<b>9,823</b>	<b>12,977</b>	<b>15,433</b>	<b>16,048</b>	Interest	814	587	757	725	725
Capital WIP	953	1,846	1,592	900	900	Less: Direct taxes paid	6,282	8,852	12,316	15,551	18,561
Investments	90	83	150	150	150	(Inc)/Dec in WC	-2,910	-1,576	-6,844	-11,395	-7,975
<b>Curr. Assets</b>	<b>133,430</b>	<b>158,063</b>	<b>215,082</b>	<b>262,280</b>	<b>313,278</b>	<b>CF from operations</b>	<b>9,827</b>	<b>18,228</b>	<b>19,510</b>	<b>21,243</b>	<b>30,520</b>
Inventory	29,161	37,444	46,327	57,451	67,142	EO Income	-200	35	0	0	0
Debtors	59,721	71,681	95,267	116,960	135,324	<b>CF from Operations in</b>	<b>9,627</b>	<b>18,263</b>	<b>19,510</b>	<b>21,243</b>	<b>30,520</b>
Cash & Bank Balance	31,779	41,340	55,797	66,133	85,551	(Inc)/dec in FA	-1,557	-2,732	-5,625	-4,798	-3,915
Loans & Advances	12,297	11,999	16,846	20,891	24,415	<b>CF from investments</b>	<b>-1,357</b>	<b>-2,726</b>	<b>-5,692</b>	<b>-4,798</b>	<b>-3,915</b>
Other Current Assets	472	845	845	845	845	(Inc)/Dec in Networth	-19	-1,697	6,137	0	0
<b>Current Liab. &amp; Prov.</b>	<b>84,459</b>	<b>97,955</b>	<b>133,673</b>	<b>159,140</b>	<b>182,745</b>	(Inc)/Dec in Debt	-30	213	-432	0	0
Creditors	20,997	28,041	33,948	40,566	46,518	Less: Interest Paid	814	587	757	725	725
Other Liabilities	50,208	54,792	79,212	94,654	108,542	Dividend Paid	2,225	3,904	4,308	5,385	6,462
Provisions	13,254	15,123	20,513	23,921	27,684	<b>CF from Fin. Activity</b>	<b>-3,088</b>	<b>-5,976</b>	<b>640</b>	<b>-6,110</b>	<b>-7,187</b>
<b>Net Current Assets</b>	<b>48,971</b>	<b>60,108</b>	<b>81,409</b>	<b>103,140</b>	<b>130,533</b>	<b>Inc/Dec of Cash</b>	<b>5,182</b>	<b>9,561</b>	<b>14,458</b>	<b>10,336</b>	<b>19,418</b>
Misc. Expenses	0	0	0	0	0	Add: Beginning Balance	26,596	31,779	41,340	55,797	66,133
<b>Application of Funds</b>	<b>60,456</b>	<b>71,859</b>	<b>96,128</b>	<b>119,623</b>	<b>147,631</b>	<b>Closing Balance</b>	<b>31,779</b>	<b>41,340</b>	<b>55,797</b>	<b>66,133</b>	<b>85,551</b>

E: MOST Estimates

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**BHEL**

1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No

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