



Q3FY2010 Capital Goods & Engineering earnings review

Sales growth disappoints, execution is the key to future

The Q3FY2010 results of the capital goods & engineering companies under Sharekhan Universe saw a pattern quite similar to Q2FY2010 results, where the revenue growth remained muted and the improved operating profit margin (OPM) played savior. The sluggish top line growth has led us downgrade the earnings estimates (particularly the FY2010 estimates) for quite a few companies in this sector post their Q3FY2010 results. However, given the quantum of investment expected to flow in infrastructure space, the future of the capital goods sector continues to hold promise. We feel, those companies who scale up their capacities along with matching expertise in project execution would emerge as the outperformers going ahead. Our top picks for the sector are Bharat Heavy Electricals Ltd (BHEL), Crompton Greaves and EMCO.

- ◆ **Top line continues to be sluggish**—The capital goods & engineering companies under our coverage continue to see a muted growth in sales mainly on account of slower execution of projects/order backlog, lower volume growth and lower commodity prices. Some of the companies like Punj Llyod and Crompton Greaves derive substantial portion of their business from global markets which are yet to recover from the economic crisis. BHEL continues to be the outperformer among the capital goods companies under our coverage with a 17.9% year-on-year (y-o-y) growth in the top line that led the cumulative top line of the capital goods companies under our coverage grow by 1.8% on a y-o-y basis. However, excluding BHEL, the cumulative top line declined by 4.7% year on year (yoy) mainly due to dismal performance by Larsen & Toubro, Punj Llyod and Thermax and less than expected growth posted by companies like BHEL and Crompton Greaves.

Net sales					Rs (cr)	
Company	Q3FY10	Q3FY09	% yoy	Q2FY10	% qoq	
BHEL	7100.3	6022.3	17.9	6625.2	7.2	
Crompton (consolidated)	2246.4	2149.8	4.5	2189.0	2.6	
EMCO	208.1	207.9	0.1	201.4	3.3	
Larsen & Toubro	8071.4	8594.0	-6.1	7866.2	2.6	
Punj Llyod	2904.0	3120.0	-6.9	2876.4	1.0	
Thermax (stand-alone)	726.3	788.0	-7.8	668.0	8.7	
Total sales	21256.5	20881.9	1.8	20426.1	4.1	

- ◆ **Improved operating performance plays saviour:** A favourable commodity cycle and operating efficiencies led to improved operating performance by most of the companies that matched our overall profitability expectation for the sector. This led the operating profit to increase by a strong 29.7% on a y-o-y basis on a muted sales growth. The cumulative OPM of the capital goods companies under our coverage improved to 15.1% in Q3FY2010 from 11.9% in Q3FY2009.

Operating profit and OPM

Company	Operating profit (Rs cr)			OPM (%)	
	Q3FY10	Q3FY09	% yoy	Q3FY10	Q3FY09
BHEL	1434.8	1020.7	40.6	20.2	16.9
Crompton (consolidated)	320.0	226.2	41.4	14.2	10.5
EMCO	26.6	27.7	-4.0	12.8	13.3
Larsen & Toubro	956.1	896.0	6.7	11.8	10.4
Punj Llyod	389.3	212.3	83.4	13.4	6.8
Thermax (stand-alone)	89.4	96.8	-7.6	12.3	12.3
Total EBITDA	3216.1	2479.7	29.7	15.1	11.9

- ♦ **Lower interest cost further boosts PAT:** A lower interest cost in the quarter further boosted the y-o-y growth in the net profit of the companies under our coverage to 49.1%. Companies like Crompton Greaves and EMCO saw the interest cost for the quarter decline on company-specific reasons like repayment of debt. However, Punj Lloyd continued to see its financial cost rise in the quarter on account of working capital requirements.

Net profit		Rs (cr)		
Company	Q3FY10	Q3FY09	% yoy	% qoq
BHEL	1072.6	790.6	35.7	25.0
Crompton (consolidated)	199.6	123.2	62.0	3.2
EMCO	10.0	8.2	22.5	-15.3
Larsen & Toubro	696.3	604.1	15.3	37.2
Punj Lloyd	9.6	-226.6	-104.2	-81.3
Thermax (standalone)	56.5	72.3	-21.8	4.4
Total	2044.7	1371.8	49.1	18.8

- ♦ **Order intake picking up:** Most of the companies saw the growth momentum in order booking continuing during the quarter led by robust demand in power sector. The order book of our capital goods universe grew by 21.1% yoy and a muted 5.8% quarter on quarter (qoq) during the quarter. Driven by the revival in the private capital expenditure demand and the continued momentum in the power sector, we expect the order intake to be healthy in future also.

Order book		Rs (cr)			
Company	Q3FY10	Q3FY09	% yoy	Q2FY10	% qoq
BHEL	134000	113500	18.1	125,800	6.5
Crompton (Consolidated)	6078	6,592	-7.8	6,400	-5.0
EMCO	1500	1,300	15.4	1,600	-6.3
Larsen & Toubro	91104	68,801	32.4	81,623	11.6
Punj Lloyd	23431	21,908	7.0	26,808	-12.6
Thermax	5612	4,100	36.9	5,059	10.9
Total	261,725	216,201	21.1	247,290	5.8

Outlook

- ♦ Most of the companies under our coverage showed a robust order intake during the quarter and there were substantial bids in the pipeline on the back of increased investment in power, hydrocarbon and road projects. Still the execution of the order book needs to be picked up as seen in the decline in the revenue of some of the leading players. Further, concerns on the Chinese and Korean competition in the power equipment is also fading with the recent modification in the norms related to the proportion required to manufacture and test capital goods domestically, which goes in favour of domestic players.
- ♦ **Our top picks in the sector are BHEL, Crompton Greaves and Emco.** We have revised our price target for Punj Lloyd, Thermax, Larsen & Toubro and Crompton Greaves. We have also upgraded our recommendation on Thermax from Reduce to Hold and on BHEL from Hold to Buy.

Earnings revision

Company	Rating	Earnings revision	Reasons for revising estimates
BHEL	Buy	None	-
Crompton (consolidated)	Hold	Upwards	Good operating performance (including subsidiaries)
EMCO	Buy	Downwards (marginally)	M9FY2010 performance
Larsen & Toubro	Hold	Downwards	Disappointing fall in Q3FY2010 revenue
Punj Lloyd	Hold	Downwards	Simon Carves woes continue, various litigations faced by Punj Lloyd and slow order booking in its various projects
Thermax (stand-alone)	Hold	Downwards (for FY2010)	Top line decline during M9FY2010

Outlook and valuations

Company	Growth outlook	The quarter gone by....	Key monitorables ahead...
BHEL	Additional 5,000MW capacity coming on-stream from March 2010 will expedite order execution	Best performer in the capital goods segment with good operating performance	Order intake, pick up in execution of order backlog along with margins (amid growing competition from Chinese, Korean and domestic players)
Crompton Greaves	Revival in the US and European markets, particularly for distribution transformers, demand in domestic power T&D and industrial sector	Top line disappoints, OPM improved due to global sourcing, better engineering and design	Order intake particularly in 765kV space, sustainability of margins
EMCO	Entry into 765Kv segment, new ventures like coal mining	Top line disappoints, interest cost reduction led to growth in profits	Commencement of coal mining venture, order intake and margins
Larsen & Toubro	Reduced the top line growth guidance from 15% to 10% in FY2010.	Top line growth disappoints on slow execution of orders in the E&C division	Pick-up in order execution along with sustainability of margins at M9FY2010 level
Punj Lloyd	Hydrocarbon and power sectors to boost order intake, better performance of subsidiaries	Good performance on a stand-alone basis, disappointment on continued cost overrun in Simon Carves, high interest cost	Order intake, Simon Carves cost overruns, various on-going litigations, pick-up in Libyan order execution and margins
Thermax	Entry into super critical boilers, robust order intake in the M9FY2010	Decline in energy segment disappoints	Order intake especially in energy segment, order execution and margins in energy segment

Valuation table

Company	CMP (Rs)	Reco	EPS (Rs)			P/E (x)		
			FY2009	FY2010	FY2011	FY2009	FY2010	FY2011
BHEL	2295	Buy	64.1	90.5	116.8	35.8	25.4	19.6
Crompton (consolidated)	418	Hold	15.3	22.1	24.8	27.2	18.9	16.8
EMCO	84	Buy	9.9	10.5	12.6	8.5	8.0	6.7
Larsen & Toubro	1437	Hold	48.6	62.9	78.6	29.6	22.8	18.3
Punj Lloyd	171	Hold	-	10.3	14.2	-	16.7	12.1
Thermax	620	Hold	24.1	22.7	29.7	25.7	27.3	20.9

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

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