



## Blue Star

STOCK INFO.	BLOOMBERG
BSE Sensex: 19,243	BLSTR IN
	REUTERS CODE
S&P CNX: 5,702	BLUS.BO

26 October 2007

Buy

Previous Recommendation: Buy

Rs379

Equity Shares (m)	89.9
52-Week Range	398/142
1, 6, 12 Rel. Perf. (%)	5/36/107
M. Cap. (Rs b)	34.1
M. Cap. (US\$ b)	0.9

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	YoY (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
03/07A	16,013	712	7.9	45.6	47.9	16.0	36.9	36.1	2.2	29.9
03/08E	22,418	1,481	16.5	108.0	23.0	11.4	58.0	58.0	1.6	15.1
03/09E	29,143	2,089	23.2	41.1	16.3	8.1	58.0	66.4	1.2	10.5

- 2QFY08 sales up 46% YoY, PAT up 150% YoY:** Blue Star has reported yet another excellent quarter, significantly beating our expectations. Sales at Rs5.5b (expected Rs5.3b) are up 46% YoY. EBITDA margin is a big positive surprise, up 350bp YoY to 12.5%. EBITDA has more than doubled to Rs684m (expected Rs471m). With financial leverage also kicking in, PAT is up 150% YoY at Rs460m (expected Rs280m).
- Several drivers of sales and margins:** Apart from the mega trends – IT/Telecom, Retail/Entertainment, Cold chain and SEZs – there are several new demand drivers: Airports, Hotels, Hospitals, Power, etc. Margins are expanding due to (1) high-demand environment, allowing the company to pick only profitable orders, (2) economies of scale, (3) value engineering, (4) strengthening rupee and (5) cushion of service income.
- Significant EPS upgrade – 30% in FY08, 34% in FY09:** Even after a strong 47% income growth in 1H, Blue Star's order book is up 31% YoY at Rs10.3b. Further, the company is confident of sustaining double-digit margins in FY08 (1H margin at 10.5% against our estimate of 8.6%), and 100bp increase in margins every year. Considering this, we have revised our FY08 margin to 10.4% (8.4% earlier) and FY09 margin to 11.4% (8.9% earlier). This results in a 30% upgrade in our FY08E EPS to Rs16.5 and a 33% upgrade in our FY09E EPS to Rs23.2. FY07-09 EPS CAGR is a robust 71%.
- Target P/E re-rated from 20x to 25x; buy for 53% upside:** We believe Blue Star will continue to enjoy rich valuation given high earnings growth, RoE of over 45%, and dividend payout of 40%. We have re-rated the stock from a P/E of 20x to 25x. At 25x FY09E EPS, our target price is Rs581, a 53% upside from current levels. **Buy.**

### QUARTERLY PERFORMANCE (RS M)

Y/E MARCH	FY07				FY08				FY07	FY08E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
<b>Operating Income</b>	<b>3,123</b>	<b>3,759</b>	<b>3,701</b>	<b>5,429</b>	<b>4,623</b>	<b>5,478</b>	<b>5,044</b>	<b>7,274</b>	<b>16,013</b>	<b>22,418</b>
Change (%)	35.8	33.0	40.4	36.4	48.0	45.7	36.3	34.0	36.3	40.0
Total Expenses	2,965	3,431	3,463	4,985	4,243	4,794	4,581	6,463	14,844	20,082
<b>EBITDA</b>	<b>158</b>	<b>328</b>	<b>238</b>	<b>445</b>	<b>379</b>	<b>684</b>	<b>463</b>	<b>810</b>	<b>1,169</b>	<b>2,336</b>
Change (%)	36.1	67.5	52.2	11.7	139.4	108.4	94.5	82.2	34.9	99.8
EBITDA Margin (%)	5.1	8.7	6.4	8.2	8.2	12.5	9.2	11.1	7.3	10.4
Depreciation	43	46	58	62	50	52	65	95	209	262
Interest	20	24	22	30	22	16	31	37	95	106
Other Income	5	8	4	44	1	8	4	47	61	60
<b>PBT</b>	<b>100</b>	<b>266</b>	<b>163</b>	<b>397</b>	<b>308</b>	<b>624</b>	<b>371</b>	<b>726</b>	<b>926</b>	<b>2,028</b>
Tax	27	82	48	57	85	164	100	203	214	548
Tax/PBT (%)	27.1	30.9	29.2	14.4	27.5	26.3	27.0	28.0	23.1	27.0
Reported PAT	73	184	115	340	223	460	271	523	712	1,481
<b>Adjusted PAT</b>	<b>73</b>	<b>184</b>	<b>115</b>	<b>340</b>	<b>223</b>	<b>460</b>	<b>271</b>	<b>523</b>	<b>712</b>	<b>1,481</b>
Change (%)	44.6	58.8	66.4	34.0	205.8	149.8	135.3	53.8	45.6	108.0
PAT Margin (%)	2.3	4.9	3.1	6.3	4.8	8.4	5.4	7.2	4.4	6.6

E: MOST Estimates

## 2QFY08 sales up 46% YoY, PAT up 150% YoY

Blue Star has reported yet another excellent quarter, significantly beating our expectations. Sales at Rs5.5b (expected Rs5.3b) are up 46% YoY. EBITDA margin is a big positive surprise, up 350bps YoY to 12.5%. EBITDA has more than doubled to Rs684m (expected Rs471m). With financial leverage also kicking in, PAT is up 150% YoY at Rs460m (expected Rs280m).

**Segment analysis:** Sales growth was robust across all 3 segments. Profit growth was strong in:

- ✦ **Central AC**, due to: (1) high-demand environment, allowing the company to pick only profitable orders, (2) value-engineering and judicious price hikes, (3) cushion of service income;
- ✦ **Cooling products**, due to full impact of room AC plant in Himachal Pradesh, which enjoys excise and income tax benefits.

Other positive factors driving margins are economies of scale and strengthening rupee.

### SEGMENT ANALYSIS (RS M)

	2QFY07	2QFY08	YOY (%)	FY07	YOY (%)
<b>Segment Income</b>	<b>3,759</b>	<b>5,478</b>	<b>45.7</b>	<b>16,013</b>	<b>36.3</b>
Central AC	2,747	4,011	46.0	11,243	36.9
Cooling Products	697	1,034	48.4	3,728	37.5
Prof. Electronics	142	315	122.0	1,042	29.7
<b>Segment EBIT</b>	<b>372</b>	<b>759</b>	<b>104.2</b>	<b>1,486</b>	<b>37.9</b>
Central AC	266	571	114.6	1,039	29.8
Cooling Products	27	107	300.7	247	87.4
Prof. Electronics	79	81	2.8	200	30.8
Unallocable Exps (net)	81	120	47.2	464	41.2
<b>Total EBIT</b>	<b>291</b>	<b>640</b>	<b>120.2</b>	<b>1,021</b>	<b>37.9</b>
<b>Seg. EBIT Margin (%)</b>	<b>10</b>	<b>14</b>	<b>4.0</b>	<b>9</b>	<b>0.1</b>
Central AC	10	14	4.5	9	-0.5
Cooling Products	4	10	6.5	7	1.8
Prof. Electronics	56	26	-29.9	19	0.2
<b>Total EBIT Margin (%)</b>	<b>7.7</b>	<b>11.7</b>	<b>3.9</b>	<b>6.4</b>	<b>0.0</b>

Source: Company/Motilal Oswal Securities

## Several drivers of sales and margins

Apart from the mega trends – IT/Telecom, Retail/Entertainment, Cold chain and SEZs – there are several new demand drivers: Airports, Hotels, Hospitals, Power, etc. During the quarter, Blue Star booked several orders across various verticals.

### MAJOR ORDERS DURING 2QFY08

VERTICAL	CUSTOMER	LOCATION
IT	Cognizant Technologies	Coimbatore
	HCL Technologies	Gurgaon
Telecom	Aircel	Chennai
Retail	Pantaloon Retail	Bangalore
Airports	—	Ahmedabad, Thiruvananthapuram
Cold chain	Haryana State Agri Marketing Board	Gurgaon
Others	RBI	Guwahati
	DuPont	Secunderabad
	Moser Baer	Noida

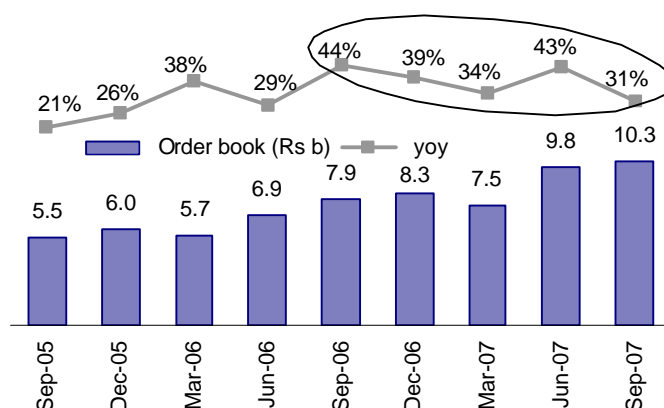
Source: Company / Motilal Oswal Securities

Margins are expanding due to all the factors which were in play in 2Q – high demand environment, value engineering, economies of scale, rising service income, etc. Besides, in the Central AC segment, Blue Star is increasingly relying on the sub-contracting/distribution model for packaged Acs, further boosting scale and margins.

## Blue Star orders remain in high-growth orbit

Even after a strong 47% income growth in 1H, Blue Star's unexecuted order book as on 30 September 2007 is up 31% YoY at Rs10.3b. Our analysis of Blue Star's order book trend suggests that the company has moved into a high-growth orbit.

### BLUE STAR – ORDER BOOK TREND



Source: Company / Motilal Oswal Securities

Blue Star also plans to increase its business opportunity by building competencies to take up complete electro-

mechanical projects. (Such projects are at least 2x the size of the central AC, with similar margins).

**Capex to match demand growth:** Blue Star is constructing its fifth plant at Wada, Phase 1 of which is expected to cost Rs350m. Further, it also plans to strengthen its IT infrastructure. It has upped its capex guidance for FY08 from Rs600m to Rs600-800m.

Overall, we are convinced that the revenue outlook for Blue Star is very positive.

### **Significant EPS upgrade - 30% in FY08E, 34% in FY09**

Hitherto, Blue Star has been guiding for a double-digit margin by FY09. However, after its 1HFY08 performance, the company seems confident of sustaining double-digit margins in 2HFY08, and also improving margins by 100 bps every year for at least a couple of years thereafter.

Considering this, we have revised our FY08 margin to 10.4% (8.4% earlier) and FY09 margin to 11.4% (8.9% earlier). This results in a 30% upgrade in our FY08E EPS to Rs16.5 and a 33% upgrade in our FY09E EPS to Rs23.2. FY07-09 EPS CAGR is a robust 71%.

### **Valuation and view**

- ✍ At CMP of Rs379, the stock trades at a P/E of 23x FY08E and 16x FY09E.
- ✍ We believe the stock will continue to enjoy premium valuation considering the robust EPS CAGR of 71%, RoE and RoCE greater than 53%, and high payout ratio of 40%.
- ✍ We have re-rated Blue Star's target P/E from 20x to 25x, considering its high quality growth coupled with high visibility.
- ✍ We have valued Blue Star at 25x FY09E EPS to arrive at a 12-18 month target of Rs581, a healthy 53% upside from current levels.
- ✍ We maintain **Buy**.

## Blue Star: an investment profile

### Company description

Blue Star is India's leading Central Air-conditioning company with a market share of over 30%. Besides, it also makes a wide range of window and split ACs, and refrigeration products such as deep freezers, cold storages, water dispensers, visi-coolers, etc.

### Key investment arguments

- Blue Star's products and services should see high demand from four mega trends: (1) IT/ITeS growth (2) Boom in retail and entertainment (3) SEZs, and (4) Expected large scale investment in cold chain.
- Blue Star has several national accounts (i.e. large all-India customers) with visible expansion plans. These include names like Infosys, Wipro, Bharti Airtel, DLF, Vishal Retail, Aditya Birla Retail, etc.
- The company has attained critical mass of cash flows to support its own growth and also manage healthy dividend payout of over 40% of profits.

### Key investment risks

- Slowdown in IT/ITeS, led by US recession and stronger rupee.
- Sharp increases in input prices such as copper and steel, affecting margins.

#### COMPARATIVE VALUATIONS

		BLUE STAR	VOLTAS
P/E (x)	FY08E	16.3	35.0
	FY09E	12.1	26.7
P/BV (x)	FY08E	8.1	12.1
	FY09E	5.7	8.9
EV/Sales (x)	FY08E	1.2	1.9
	FY09E	0.9	1.5
EV/EBITDA (x)	FY08E	10.5	27.1
	FY09E	7.9	19.6

#### SHAREHOLDING PATTERN (%)

	SEP-07	JUN-07	SEP-06
Promoter	40.2	40.2	40.1
Domestic Inst	9.3	8.1	15.0
Foreign	8.1	8.6	2.6
Others	42.4	43.1	42.3

### Recent development

- Blue Star announced the setting up of its fifth plant at Wada near Thane in Maharashtra. Spread over 35 acres, this plant is expected to meet most of Blue Star's future requirements. The company will be investing Rs350m in Phase 1, expected to go on stream by March 2008.

### Valuation and view

- Valuation is rich at a P/E of 23x FY08E and 16x FY09E.
- We believe the stock will continue to enjoy premium valuation given high 72% EPS CAGR through FY09E, RoE and RoCE of over 45% and dividend payout of 40%.

### Sector view

- The HVAC&R (heating, ventilating, air-conditioning and refrigeration equipment) sector is in a high-growth phase.
- Growth in central AC is led by demand from IT and retail sectors, while growth in room ACs is led by higher income levels and lifestyle aspirations.
- Investments in SEZs, cold chain, airports, hotels and hospitals are expected to keep the growth momentum strong over the next five years at least.

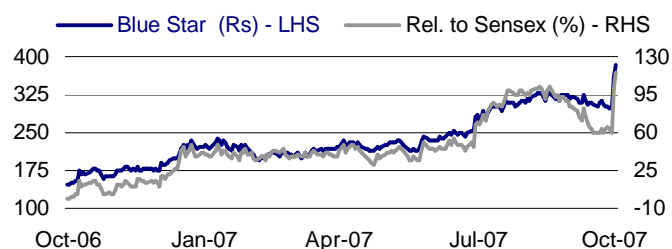
#### EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY08	16.5	12.1	36.4
FY09	23.2	17.2	34.9

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
379	581	53.2	Buy

#### STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2006	2007	2008E	2009E	2010E
<b>Net Sales</b>	<b>11,745</b>	<b>16,013</b>	<b>22,418</b>	<b>29,143</b>	<b>36,429</b>
Change (%)	27.6	36.3	40.0	30.0	25.0
Raw Materials	9,079	12,427	17,180	22,334	27,917
% of Net Sales	77.3	77.6	76.6	76.6	76.6
Staff Cost	883	1,229	1,521	1,884	2,335
% of Net Sales	7.5	7.7	6.8	6.5	6.4
Admin. & Other Exp.	917	1,188	1,381	1,601	1,844
% of Net Sales	7.8	7.4	6.2	5.5	5.1
<b>EBITDA</b>	<b>866</b>	<b>1,169</b>	<b>2,336</b>	<b>3,325</b>	<b>4,333</b>
Change (%)	49.9	34.9	99.8	42.3	30.3
Depreciation	159	209	262	313	358
Interest	57	95	106	97	41
Other Income	41	61	60	70	100
Non Recurring Income	0	0	0	0	0
<b>PBT</b>	<b>691</b>	<b>926</b>	<b>2,028</b>	<b>2,984</b>	<b>4,033</b>
Tax (incl FBT and def. tax)	202	214	548	895	1,210
Tax/PBT (%)	29.2	23.1	27.0	30.0	30.0
<b>Reported PAT</b>	<b>489</b>	<b>712</b>	<b>1,481</b>	<b>2,089</b>	<b>2,823</b>
<b>Adjusted PAT</b>	<b>489</b>	<b>712</b>	<b>1,481</b>	<b>2,089</b>	<b>2,823</b>
Change (%)	39.4	45.6	108.0	41.1	35.1

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2006	2007	2008E	2009E	2010E
<b>Net Worth</b>	<b>1,727</b>	<b>2,130</b>	<b>2,979</b>	<b>4,226</b>	<b>5,997</b>
Share Capital	180	180	180	180	180
Reserves	1,547	1,950	2,799	4,046	5,817
<b>Total Debt</b>	<b>759</b>	<b>890</b>	<b>1,226</b>	<b>715</b>	<b>105</b>
Net Deferred Tax	91	65	65	65	65
<b>Capital Employed</b>	<b>2,576</b>	<b>3,085</b>	<b>4,270</b>	<b>5,006</b>	<b>6,168</b>
Gross Fixed Assets	1,977	2,308	2,982	3,282	3,882
Capex	377	244	700	300	600
Less: Acc. Depreciation	1,010	1,167	1,430	1,743	2,101
<b>Net Fixed Assets</b>	<b>968</b>	<b>1,141</b>	<b>1,553</b>	<b>1,539</b>	<b>1,781</b>
Capital WIP	111	24	50	50	50
Investments	52	53	53	53	53
<b>Curr. Assets</b>	<b>4,967</b>	<b>6,495</b>	<b>8,869</b>	<b>11,464</b>	<b>14,356</b>
Inventory	1,648	2,086	2,710	3,467	4,369
Debtors	2,388	3,507	4,910	6,382	7,978
Cash & Bank	24	46	50	55	60
Loans, Adv. & Others	906	856	1,199	1,559	1,949
<b>Curr. Liabilities</b>	<b>3,553</b>	<b>4,650</b>	<b>6,267</b>	<b>8,100</b>	<b>10,072</b>
Creditors	1,531	1,896	2,565	3,298	4,100
Other Liabilities	1,742	2,600	3,602	4,682	5,852
Provisions	280	154	100	120	120
<b>Net Curr. Assets</b>	<b>1,413</b>	<b>1,845</b>	<b>2,602</b>	<b>3,364</b>	<b>4,284</b>
Misc. Expenses	33	22	12	0	0
<b>Total Assets</b>	<b>2,576</b>	<b>3,085</b>	<b>4,270</b>	<b>5,006</b>	<b>6,168</b>

E: MOST Estimates

RATIOS					
Y/E MARCH	2006	2007	2008E	2009E	2010E
<b>Basic (Rs)</b>					
<b>EPS</b>	<b>5.4</b>	<b>7.9</b>	<b>16.5</b>	<b>23.2</b>	<b>31.4</b>
Cash EPS	7.2	10.2	19.4	26.7	35.4
Book Value	19.2	23.7	33.1	47.0	66.7
Dividend per share	2.4	3.0	6.0	8.0	10.0
Payout incl. Div. Tax. (%)	49.9	42.8	42.6	40.3	37.3
<b>Valuation (x)</b>					
P/E		47.9	23.0	16.3	12.1
Cash P/E		37.0	19.6	14.2	10.7
Price/Book Value		16.0	11.4	8.1	5.7
EV/Sales		2.2	1.6	1.2	0.9
EV/EBITDA		29.9	15.1	10.5	7.9
Dividend Yield (%)		0.8	1.6	2.1	2.6
<b>Profitability (%)</b>					
RoE	30.5	36.9	58.0	58.0	55.2
RoCE	33.1	36.1	58.0	66.4	72.9
<b>Turnover Ratios</b>					
Debtors (days of sales)	74	80	80	80	80
Inventory (days of sales)	51	48	44	43	44
Creditors (days of total exp.)	51	47	47	47	47
Asset Turnover (x)	4.6	5.2	5.3	5.8	5.9
<b>Leverage Ratio</b>					
Debt/Equity (x)	0.4	0.4	0.4	0.2	0.0

CASH FLOW STATEMENT					
(Rs Million)					
Y/E MARCH	2006	2007	2008E	2009E	2010E
PBT excl. EO Items	691	926	2,028	2,984	4,033
Add: Depn & Amortization	171	219	272	326	358
Interest Paid	57	95	106	97	41
Less: Direct Taxes Paid	-202	-214	-548	-895	-1,210
(Incr)/Decr in WC	-409	-409	-753	-757	-915
<b>CF from Operations</b>	<b>308</b>	<b>617</b>	<b>1,106</b>	<b>1,755</b>	<b>2,308</b>
Extraordinary Items	0	0	0	0	0
<b>CF including EO Items</b>	<b>308</b>	<b>617</b>	<b>1,106</b>	<b>1,755</b>	<b>2,308</b>
(Incr)/Decr in FA	-399	-295	-700	-300	-600
(Pur)/Sale of Investments	0	-1	0	0	0
<b>CF from Inv. Activity</b>	<b>-399</b>	<b>-296</b>	<b>-700</b>	<b>-300</b>	<b>-600</b>
Incr/(Decr) in Net worth	-2	0	0	0	0
Incr/(Decr) in Debt	394	106	335	-511	-609
Interest Paid	-57	-95	-106	-97	-41
Dividend Paid (incl. div. tax)	-244	-309	-631	-842	-1,052
<b>CF from Fin. Activity</b>	<b>90</b>	<b>-298</b>	<b>-402</b>	<b>-1,450</b>	<b>-1,703</b>
<b>Incr/(Decr) of Cash</b>	<b>-1</b>	<b>22</b>	<b>4</b>	<b>5</b>	<b>5</b>
Add: Opening Balance	25	24	46	50	55
<b>Closing Balance</b>	<b>24</b>	<b>46</b>	<b>50</b>	<b>55</b>	<b>60</b>

E: MOST Estimates



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**Blue Star**

- |   |    |
|---|----|
| 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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