MCNALLY BHARAT ENGINEERING

INR 181

Edelweiss
Ideas create, values protect

Continued strong performance

BUY

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Reuters	:	MCNL.BO
Bloomberg	:	MCNA IN

Market Data

52-week range (INR)	:	195 / 67
Share in issue (mn)	:	26.5
M cap (INR bn/USD mn)	:	4.8 / 108.0
Avg. Daily Vol. BSE ('000)	:	102.2

Share Holding Pattern (%)

Promoters	:	34.2
MFs, FIs & Banks	:	18.2
FIIs	:	9.6
Others	:	38.0

McNally Bharat Engineering's (McNally's) Q3FY07 results were in line with our expectations, after adjusting for loss on sale of assets. Sales increased by 35% Y-o-Y to INR 1.13 bn, while profits increased by 155% to INR 38 mn. However, adjusted for loss on sale of assets, profits increased at a higher 262% to INR 54 mn. As we have been maintaining for last few quarters, McNally's operating performance is rising with cleaning up of its low-priced orders. In fact, Q2FY07 was the last quarter of low-priced orders. Thus, this quarter the company recorded EBITDA margins (after adjustment) of 7.5% compared with 4.5% and 6.7% in FY06 and FY05 respectively.

McNally's order book, at the end of the quarter, was at INR 7.25 bn. Interestingly, the share of mineral processing (which has the highest margins among its various segments) has increased to 25% compared with 21% and 13% in the last two quarters. The company expects to add another INR 5-6 bn of orders during Q4FY07, more than half of which is likely to be from the mineral processing segment. Thus, we feel very confident of our high estimates for FY08E on the back of the order book increase as well as changing composition in the order book towards high margin segments. We continue to maintain our FY06-08E sales and profit CAGR estimates of 56% and 205% respectively. At INR 180.6, the stock trades at a PE of 23.4x and 11.5x on our EPS estimates of INR 7.7 and 15.7, respectively. We continue to maintain our 'BUY' recommendation.

Result Highlights

- Sales grew 35% to INR 1.13 bn.
- EBITDA increased by 123% to INR 84 mn, after adjusting for the loss on account of sale of fixed assets.
    - McNally had ventured into the highway construction business and subsequently moved away from one of the projects upon facing issues related to land acquisition. Meanwhile, the project cost went up and the local government refused to compensate the company accordingly. As a result, it has contested the order and decided to exit the business. It has already sold off the equipment for the same in the last two quarters and has booked a loss of INR 26 mn till date.
    - Adjusting for this, EBITDA margins have improved further to 7.5% compared with 4.5% last year.

Financials

Year to March	Q3FY07	Q3 FY06	*Y-o-Y %*	Q2FY07	*Q-o-Q %*	FY07E	FY08E
Net sales (INR mn)	1,126	832	*35.3*	1,122	*0.3*	5,589	8,070
EBITDA (INR mn)	84	38	*123.1*	75	*12.3*	401	824
PBT (INR mn)	61	17	*253.8*	53	*14.6*	287	699
Adjusted PAT (INR mn)	38	15	*155.3*	37	*3.5*	230	490
EBITDA margins %	7.5	4.5	*64.9*	6.7	*12.0*	0.1	0.1
Net profit margins %	3.4	1.8	*88.9*	3.3	*3.1*	0.0	0.1
Adj EPS (INR)	1.3	0.6		1.4		7.7	15.7
PE (x)	140.6	318.6		129.2		23.4	11.5

- PBT increased at a higher rate of 253% to INR 61 mn on account of lower interest and depreciation charges.
- PAT increased by 262% to INR 54 mn due to lower tax rate of 10.1% on account of previous losses. However, the company will pay marginal tax rate FY08E onwards. Adjusted profits (after taking into account the loss on sale of fixed assets) increased by 155% to INR 38 mn.

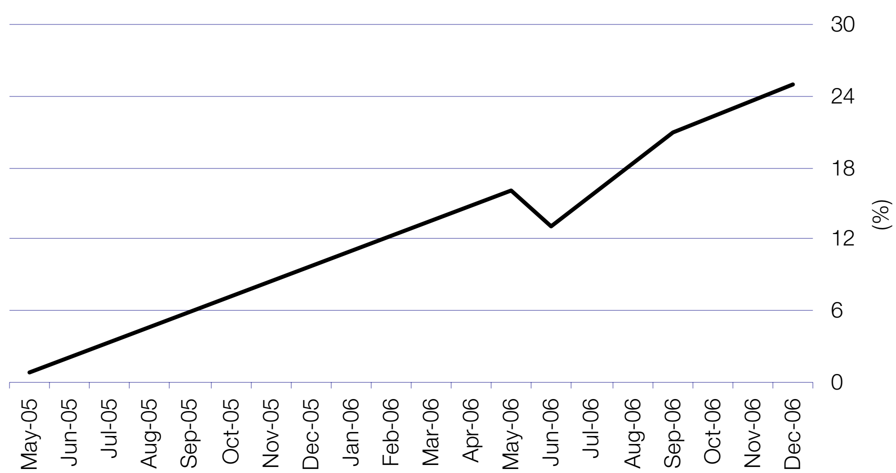
Improved order book

McNally had an order book of INR 7.25 bn during the quarter. This has not grown a lot in the last two quarters, as the highways order of ~INR 1.27 bn is no longer on its books. The company however expects to add INR 5-6 bn in its order book during the fourth quarter of this fiscal.

Interestingly, the last few quarters have seen a steady growth in McNally's orders from the mineral processing segment that has the highest margins among all the segments. Mineral processing order book, at the end of Q3FY07 was at INR 1.8 bn, a 60% increase over May 2006 levels. Consequently, its share of order book has increased to 25%, compared with almost no orders in May 2005. This is likely to lead to improved margins for the overall company.

During Q3FY07, it received two orders - from SEEPCO (INR 400 mn) in ash handling and Utkal Alumina (INR 930 mn) for ion mineral processing.

Chart 1: Increasing share of mineral processing



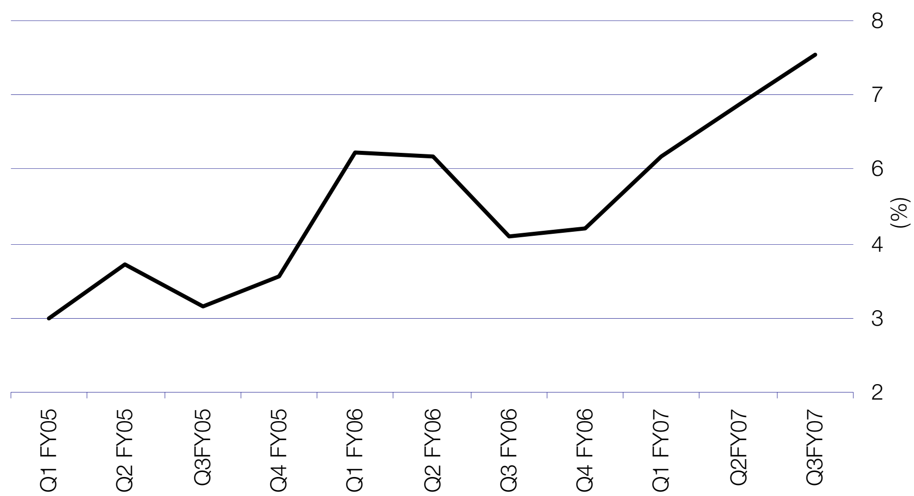
Source: Company, Edelweiss research

Rising EBITDA margins

McNally's EBITDA margins have been constantly increasing in the last few quarters because of the following:

- Higher sales growth
  - Sales for the nine months in FY07 have increased by 70% over the corresponding period last year.
- Declining share of low-priced orders
  - Earlier, in an effort to cover its fixed costs, McNally had resorted to low-priced orders. These have come to an end in H1FY07. Thus, the third quarter results reflect the improved order book composition.
- Higher share of high margin orders such as mineral processing

Chart 2: Rising EBITDA margins



Source: Company, Edelweiss research

Financial snapshot (INR mn)

Year to March	Q3FY07	Q3 FY06	*Y-o-Y %*	Q2FY07	*Q-o-Q %*	FY06	FY07E	FY08E
Net sales	1,126	832	*35.3*	1,122	*0.3*	3,312	5,589	8,070
Raw materials	858	675		894		2,687	4,590	6,547
Employee expenses	62	40		56		169	220	264
Other expenditure	123	80		97		303	378	435
Total expenditure	1,042	795	*31.1*	1,047	*(0.5)*	3,159	5,188	7,246
EBITDA	84	38	*123.1*	75	*12.3*	153	401	824
Other income	3	3	*0.0*	3	*18.5*	21	5	5
Depreciation	4	7	*(48.5)*	6	*(38.6)*	27	31	37
Interest	23	17	*36.7*	19	*22.2*	81	87	93
PBT	61	17	*253.8*	53	*14.6*	66	287	699
Provision for taxation - Current	6	2	*190.5*	6	*7.0*	13	57	210
PAT	54	15	*262.7*	47	*15.5*	53	230	490
Extra-ordinary Items	(16)	0		(10)	*59.4*	0	0	0
Adjusted PAT	38	15	*155.3*	37	*3.5*	53	230	490
Tax rate (%)	10	12	*(17.9)*	11	*(6.6)*	20	20	30
Equity capital (FV INR 10)	298	265		265		265	298	311
No. of shares (mn)	29.8	26.5		26.5		26.5	29.8	31.1
Adj EPS (INR)	1.3	0.6		1.4		2.0	7.7	15.7
PE (x)	140.6	318.6		129.2		91.0	23.4	11.5
Margins (%)								
R.M. (% of sales)	76.2	81.1	*(6.0)*	79.7	*(4.4)*	81.1	82.1	81.1
Emp Exp (% of sales)	5.5	4.8	*14.3*	5.0	*9.2*	5.1	3.9	3.3
Other Exp (% of sales)	10.9	9.6	*13.0*	8.7	*25.6*	9.1	6.8	5.4
OPM (%)	7.5	4.5	*64.9*	6.7	*12.0*	4.6	7.2	10.2
NPM (%)	3.4	1.8	*88.9*	3.3	*3.1*	1.6	4.1	6.1

Company description

McNally is a Williamson Magor group company. It was set up in 1961 as a turnkey project execution provider. It is one of the leading companies in bulk material handling, process plants, mineral beneficiation, and port handling equipment. It has diversified into mobile bulk handling equipment, ash handling, water treatment, and road construction.

Investment thesis

With 50, 000 MW of capacity addition expected over FY07-12, we expect a total capital expenditure of Rs.112.5 bn on the material handling equipment front over a period of six years. McNally, being one of the bulk material handling equipment players, is expected to benefit from the same.

In the mineral beneficiation segment, we expect McNally to benefit from the huge investments announced by the corporates in the metal sector; mineral beneficiation comprises 5% of the total project costs. With expected investment of at least INR1330-1700 bn in the metal sector over the next 5-7 years, the opportunity size works out to INR 68 bn.

In the port handling equipment, we expect the National Maritime Development Programme implemented by the Government of India (GoI) to fuel growth.

Risk and concerns

McNally recently exited from one of the highways contracts. It has currently filed an order against the local government for compensation. Any adverse ruling may have a one-time impact on its numbers, though management is sure of actually receiving some compensation from the local government.

Given that project cycle is typically 18-24 months, any mis-pricing of contracts or related slippages has the potential of giving negative surprises in the future.

Financial Statements

Income statement (INR mn)

Year to March	FY04	FY05	FY06	FY07E	FY08E
Income from operations	1,935	2,879	3,312	5,589	8,070
Direct costs	1,621	2,313	2,687	4,590	6,547
Employee costs	136	167	169	220	264
Other expenses	171	290	303	378	435
Total operating expenses	1,929	2,771	3,159	5,188	7,246
EBITDA	6	108	153	401	824
Depreciation and amortisation	12	23	27	31	37
EBIT	(6)	85	126	370	787
Interest expenses	55	58	81	87	93
Other income	77	7	21	5	5
Profit before tax	16	35	66	287	699
Provision for tax	1	8	13	57	210
Reported profit	15	26	53	230	490
Adjusted net profit	15	26	53	230	490
Shares outstanding	26	26	26	30	31
Dividend per share	-	0.2	0.5	1.5	3.1
Dividend payout (%)	-	18.7	25.2	20.0	20.0

Common size metrics- as % of net revenues

Year to March	FY04	FY05	FY06	FY07E	FY08E
Operating expenses	99.7	96.2	95.4	92.8	89.8
Depreciation	0.6	0.8	0.8	0.6	0.5
Interest expenditure	2.8	2.0	2.4	1.6	1.2
EBITDA margins	0.3	3.8	4.6	7.2	10.2
Net profit margins	0.8	0.9	1.6	4.1	6.1

Growth metrics (%)

Year to March	FY04	FY05	FY06	FY07E	FY08E
Revenues	64.0	48.8	15.0	68.7	44.4
EBITDA	(84.2)	1684.9	41.7	161.4	105.7
PBT	216.9	116.9	91.2	335.4	143.4
Net profit	48.1	74.9	100.1	337.6	113.0
EPS	48.1	74.9	100.1	337.6	113.0

Cash flow statement (INR mn)

Year to March	FY04	FY05	FY06	FY07E	FY08E
Net profit	15	26	53	230	490
Add: Depreciation	12	23	27	31	37
Add: Deferred tax	(0)	6	(1)	-	-
Gross cash flow	27	55	79	261	526
Less: Dividends	-	5	13	46	98
Less: Changes in W. C.	3	96	518	594	678
Operating cash flow	24	(46)	(452)	(380)	(249)
Less: Change in investments	(0)	1	20	-	-
Less: Capex	23	38	123	80	200
Free cash flow	1	(85)	(594)	(460)	(449)

Balance sheet (INR mn)

As on 31st March	FY04	FY05	FY06	FY07E	FY08E
Equity capital	198	198	265	298	311
Reserves & surplus	165	163	524	1,155	1,723
Shareholders funds	363	361	789	1,453	2,034
Secured loans	366	605	795	795	845
Unsecured loans	51	10	0	0	0
Borrowings	417	614	795	795	845
Sources of funds	780	975	1,584	2,249	2,880
Gross block	628	692	838	918	1,118
Depreciation	223	266	311	342	378
Net block	405	426	527	577	740
Capital work in progress	13	8	2	2	2
Total fixed assets	419	434	529	578	742
Investments	12	12	32	32	32
Inventories	114	135	118	262	378
Sundry debtors	955	1,319	1,896	2,297	3,316
Cash and equivalents	89	179	154	175	15
Loans and advances	408	398	574	718	897
Total current assets	1,566	2,031	2,742	3,451	4,606
Sundry creditors and others	1,181	1,454	1,684	1,727	2,236
Provisions	29	36	24	75	203
Total CL & provisions	1,210	1,490	1,708	1,802	2,439
Net current assets	356	541	1,034	1,650	2,167
Net deferred tax	(6)	(12)	(11)	(11)	(11)
Uses of funds	780	975	1,584	2,249	2,930
Book value per share (INR)	14	14	30	49	65

Ratios

Year to March	FY04	FY05	FY06	FY07E	FY08E
ROE (%)	4.1	7.3	9.1	20.5	28.1
ROCE (%)	9.4	10.5	11.4	19.6	30.6
Current ratio	1.3	1.4	1.6	1.9	1.9
Debtors (days)	180	167	209	150	150
Fixed assets t/o (x)	4.7	6.8	6.9	10.1	12.2
Debt/Equity	1.1	1.7	1.0	0.5	0.4

Valuations parameters

Year to March	FY04	FY05	FY06	FY07E	FY08E
EPS (INR)	0.5	0.8	1.7	7.7	15.7
Y-o-Y growth (%)	*48.1*	*74.9*	*100.1*	*337.6*	*113.0*
CEPS (INR)	1.4	2.5	3.0	8.7	16.9
PE (x)	374.7	214.3	107.1	23.4	11.5
Price/BV(x)	13.2	13.2	6.1	3.7	2.8
EV/Sales (x)	2.6	1.8	1.6	1.1	0.8
EV/EBITDA (x)	842.6	48.2	35.4	15.0	7.8

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Vikas Khemani – 2286 4206	Head, Institutional Equities

INDIA RESEARCH			SECTOR
Shriram Iyer	-	2286 4256	Head – Research
Gautam Roy	-	2286 4305	Airlines, Textile
Ashutosh Goel	-	2286 4287	Automobiles, Auto Components
Vishal Goyal, CFA	-	2286 4370	Banking & Finance
Revathi Myneni	-	2286 4413	Cement
Sumeet Budhraja	-	2286 4430	FMCG
Harish Sharma	-	2286 4307	Infrastructure, Auto Components, Mid Caps
Priyanko Panja	-	2286 4300	Infrastructure, Engineering, Telecom
Hitesh Zaveri	-	2286 4424	Information Technology
Parul Inamdar	-	2286 4355	Information Technology
Priyank Singhal	-	2286 4302	Media, Retail
Prakash Kapadia	-	2286 4432	Mid Caps
Niraj Mansingka	-	2286 4304	Oil & Gas, Petrochemicals
Nimish Mehta	-	2286 4295	Pharmaceuticals, Agrochemicals
Manika Premsingh	-	4019 4847	Economist
Sunil Jain	-	2286 4308	Alternative & Quantitative
Yogesh Radke	-	2286 4328	Alternative & Quantitative

INSTITUTIONAL SALES		
Nischal Maheshwari	-	2286 4205
Rajesh Makharia	-	2286 4202
Shabnam Kapur	-	2286 4394
Amish Choksi	-	2286 4201
Balakumar V	-	(044) 4263 8283
Monil Bhala	-	2286 4363
Ashish Agrawal	-	2286 4301
Nikhil Garg	-	2286 4282
Swati Khemani	-	2286 4266
Neha Shahra	-	2286 4276
Priya Ramchandran	-	2286 4389
Anubhav Kanodia	-	2286 4361
Tushar Mahajan	-	2286 4439
Harsh Biyani	-	2286 4419
Nirmal Ajmera	-	2286 4258
Ankit Doshi	-	2286 4671
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RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period