Q4FY2008 Capital Goods earnings preview

Slower execution, margin pressure may impact performance

- The entire capital goods segment has been in the eye of the storm in the recent times owing to fears of overstretched valuation, slowdown in order execution and increasing margin pressure due to rising input costs. Consequently, the sector has underperformed the broader market, with the BSE Capital Goods Index correcting by 29.1% in the last quarter as compared with a 22.9% correction in the Sensex.
- High raw material cost is likely to exert greater pressure on the margins of all the capital goods companies, as they would find it difficult to pass on the entire impact to customers. This combined with slower order execution has led to a sector de-rating. In line with this, we have downgraded the valuation multiples and consequently the price targets for some of the companies under our coverage.
- Though we acknowledge that there has been a slowdown of sorts in order execution lately, but we think the same is a medium-term phenomenon. We maintain our bullish outlook on the overall sector considering the high infrastructure spending and the continuous rise in the industrial capital expenditure. Consequently, we expect the order inflows to remain strong in the times to come. As it is, the bulk of the companies under our coverage are currently sitting on order books that are at record levels. This imparts strong visibility to their future earnings.
- Considering the buoyancy, we strongly believe that the existing valuations of the capital goods companies are extremely attractive. At the current levels, the sector seems to be oversold. Therefore we advise investors to use the current gloom as an opportunity to buy and build positions in fundamentally strong companies.
- We expect slower order execution and higher input cost to affect the Q4FY2008 performance. We expect our capital goods universe to report a top line growth of 20.5% and a bottom line growth of 5.7% for Q4FY2008.

Quarterly estimates Rs (cr)

Company	Net sales			Net profit		
	Q4FY2008E	Q4FY2007	% yoy chg	Q4FY2008E	Q4FY2007	% yoy chg
Bharat Bijlee	268.4	179.0	49.9	36.3	29.1	24.7
BHEL*	8,070.2	7,576.0	6.5	1,066.4	1,150.3	-7.3
Crompton Greaves	1,234.5	990.0	24.7	93.3	69.9	33.5
Genus Overseas	220.4	152.0	45.0	24.3	12.7	91.3
Indotech	72.0	56.7	27.0	11.1	10.3	7.8
International Combustion	25.6	24.1	6.2	3.0	2.8	7.1
KEI Industries	252.9	207.8	21.7	15.0	11.4	31.6
KSB Pumps	129.3	109.6	18.0	15.8	12.5	26.7
Larsen & Toubro	8,060.2	6,248.2	29.0	805.7	700.8	15.0
Punj Lloyd	2,444.1	1,703.6	43.5	104.3	89.1	17.1
Ratnamani Metals	213.5	152.5	40.0	24.1	17.5	37.7
Sanghvi Movers	67.2	52.1	29.0	18.8	15.1	24.5
Thermax	999.9	856.5	16.7	93.5	66.8	40.0
WS Industries	57.2	44.8	27.7	3.7	2.2	68.2
OUR UNIVERSE	**22,115.5**	**18,352.9**	**20.5**	**2,315.3**	**2,190.5**	**5.7**

*Sales on gross basis. Numbers as per provisional results for FY2008

Bharat Bijlee

Bharat Bijlee Ltd's (BBL) performance in Q3FY2008 was below expectations mainly due to the disruption of production on account of the expansion activities carried out by the company during the quarter. This led to a build-up of inventory during the period (Q3FY2008) which is expected to clear in Q4FY2008. We expect BBL to post a 49.9% growth in its revenues and a 24.8% rise in its profits.

We now value BBL based on 12x its FY2010E earnings per share (EPS), which gives us a fair value of Rs2,783. We value its marketable securities at a 30% discount to the current market price. Hence we set a new price target of Rs3,020 for BBL.

BHEL

Bharat Heavy Electricals Ltd (BHEL) has announced its FY2008 provisional numbers. The performance was below expectations mainly on account of execution delays and capacity constraints. The margins also took a hit when the company made provisions for an increase in the wages, in line with the Sixth Pay Commission's recommendations. While the company has been making a provision of Rs82 crore every quarter, the provision this quarter was higher at Rs120-125 crore and was made with a retrospective effect. In order to take into account the slower than expected execution and the high input cost we revise our earnings estimate for FY2009 and FY2010 downwards by 7.6% and 9% respectively to Rs77.5 and Rs103.5 per share. We also revise our price target for the stock to Rs2,381, valuing it at 23x FY2010 estimate. We believe the concerns on the execution front, due to which the stock has underperformed the market over the past week, have been over done. The stock is currently trading at attractive valuations and offers a buying opportunity.

	FY2009		FY2010	
	Now	Earlier	Now	Earlier
EPS (Rs)	77.5	83.9	103.5	113.8
Change	-7.6		-9.0	

Crompton Greaves

Crompton Greaves Ltd (CGL) expects a growth of 24.7% in its top line and an increase of 33.5% in its bottom line. The power systems business has been reporting a disappointing performance for two quarters (Q2FY2008 and Q3FY2008). However, we believe the sales would pick up in FY2009. CGL witnessed a marginal slowdown in its order booking during Q4FY2008 mainly on account of a slump in the US housing sector. Going forward, we believe the power system business would witness a pick-up in the order inflow as the impetus on the development of the transmission and distribution network in India remains strong. We now value CGL based on 20x its FY2010E estimate and set a new price target of Rs367.

Genus Power Infrastructure

Genus Power Infrastructure Ltd (GPIL) witnessed a slight dip in its sales in Q3FY2008. However, this was mainly on account of a delay in the execution of its projects, which are likely to get cleared in Q4FY2008. We expect GPIL to report a growth of 45% in its revenues and a surge of 91.3% in its profits for the fourth quarter. We continue to value GPIL at 12x its FY2009E EPS of Rs53.5 and maintain our price target of Rs643.

Indotech Transformers

For Q4FY2008, we expect Indotech Transformers Ltd (ITTL) to report a 27% rise in its revenues and an 8.4% increase in its profits on the back of a reduced operating profit margin (OPM) on a y-o-y basis. ITTL reported a spectacular OPM for the first nine months of FY2008. However, we expect the OPM to taper down during FY2009. The order inflow has been weak for the company in the recent past. Going forward Indian transformer manufacturing space is going to witness capacity addition. Subsequently we have factored in lower realisations for FY2009. The rising copper prices would result in a higher input cost and suppress the margin. Hence, we revise our FY2009 earnings estimate for ITTL by 10.5% to Rs49.6 per share. We also revise our price target for ITTL to Rs645.

International Combustion

International Combustion Ltd (ICL) is expected to report a 6.3% growth in its revenues and a 7.5% rise in its profits. We believe the gear box division of the company would deliver a better performance in FY2009. We maintain our price target of Rs519 for ICL.

KEI Industries

KEI Industries (KEI) is the largest listed player in the cable manufacturing space. The company recently ventured into high tension cable business, where it is trying to establish a foothold. The company should report a growth of 21.7% in its revenues and a 31.6% increase in its profits for Q4FY2008. We continue to value KEI based on 12x its one-year forward earnings and maintain our Buy recommendation with a price target of Rs125.

KSB Pumps

KSB Pumps is expected to benefit from the increasing expenditure in the power and refining sectors. The company's margin bounced back in the last quarter and we expect the trend to continue in Q1CY2008. For Q1FY2008 we expect the company to report a top line growth of 18% and a bottom line growth of 26.7%. We maintain our Buy recommendation with a price target of Rs451.

Larsen & Toubro

Larsen & Toubro (L&T), the largest engineering and construction company of India, reported strong numbers throughout FY2008. Its order backlog stood at Rs49,600 crore in December 2007 and the order inflows continued to be strong in the fourth quarter as well. However, the company's international subsidiary, L&T FZE, incurred a foreign exchange loss of Rs150-200 crore due to commodity hedging during the quarter. These losses shall be reflected in L&T's consolidated numbers for Q4FY2008. For the same quarter, we expect the company to report a top line growth of 29% on a high base of last year and a bottom line growth of 13.3%.

We value the core business of L&T at 25x FY2010E earnings or at Rs3,038 per share, and its subsidiaries at Rs1,006 per share. We maintain our Buy recommendation on the company with a revised price target of Rs4,044.

Punj Lloyd

For Punj Lloyd Ltd (PLL) we expect a revenue growth of 43.5% on account of the faster execution of its projects during the quarter. We expect a growth of 17.1% in the company's profits for Q4FY2008. During the quarter the company reported order inflows of Rs19,197.1 crore. We still believe PLL is the only player with capabilities to challenge L&T, which is the biggest engineering and construction player in the country. We continue to value PLL on sum-of-the-parts (SOTP) basis, valuing the core business at 22x fully diluted EPS of FY2010E and the investments at Rs46 per share. Our revised price target for PLL is Rs556. We continue to recommend a Buy on the stock.

Sanghvi Movers

Sanghvi Movers Ltd (SML), the largest crane hiring service provider in India, is expected to continue its growth stint. It is expected to report a 29% growth in its revenues and a 24.5% increase in its profits for Q4FY2008. The company is expected to have added 22 cranes in Q4FY2008. We have set a price target of Rs298 for SML, valuing it at 12x FY2010E earnings. We maintain our Buy recommendation on the stock.

Thermax

We expect Thermax to report a top line growth of 16.7% and a bottom line growth of 40% for the fourth quarter. Its OPM is expected to show a slight improvement. However, we do expect a marginal slowdown in its order inflows. The higher raw material prices (particularly steel prices) are also likely to exert pressures on its margins. Considering all this, we downgrade our earnings estimate for FY2008 by 6.3% and that for FY2009 by 7.4%. Going forward, we expect Thermax to benefit from its entry into the subcritical utility boilers segment. We maintain our Buy recommendation on the stock with a revised price target of Rs633 based on 16x its FY2010E earnings.

WS Industries

WS Industries (WSI) displayed a strong performance during the first nine months of FY2008 and we expect the company to report a 27.7% growth in its revenues for Q4FY2008. On the back of a better OPM we expect its fourth quarter profits to grow by 67%. We believe the order flow for WSI would remain strong owing to the increased demand for insulators. The company would also add a greenfield capacity by mid CY2008. We value WSI on SOTP basis, valuing its core business at 9x FY2009 earnings and its real estate venture at Rs29.1 per share. We thus get a fair value of Rs108 for WSI.

Valuations-Sharekhan Capital Goods Universe

Company	CMP (Rs)	FY2009E EPS	FY2009E P/E	Price target
Bharat Bijlee	2169	194.3	11.2	3020
BHEL	1776	77.5	22.9	2381
Crompton Greaves	261	14.4	18.1	367
Genus Overseas	442	53.5	8.3	643
Indotech	522	49.6	10.5	645
International Combustion	372	58.0	6.4	519
KEI Industries	63	10.4	6.1	125
KSB Pumps	326	32.2	10.1	451
Larsen & Toubro	2648	125.7	21.1	4044
Punj Lloyd	309	17.4	17.7	556
Sanghvi Movers	205	18.9	10.9	298
Thermax	471	32.9	14.3	633
WS Industries	80	8.7	9.1	108

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