Update
SECTOR: ENGINEERING

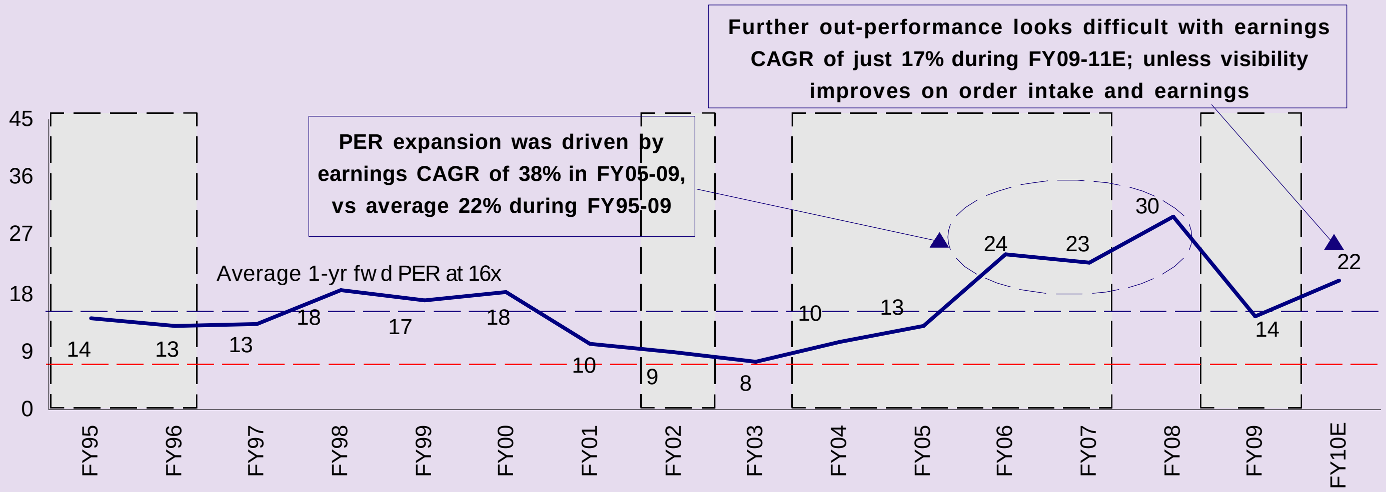
Indian Engineering

BSE Sensex: 14,658 | S&P CNX: 4,349 | 2 July 2009

Sector outperformance of 32% since March 2009; valuations running ahead of earnings

Our Engineering and Capital Goods universe, comprising ABB, BHEL, Crompton Greaves, L&T and Siemens, has delivered 81% returns since March 2009, v/s 49% by BSE Sensex. The recent outperformance had been driven by expectations of positive impact on business environment with continuity of government. Post the recent outperformance, 1-year forward sector P/E now stands at 22x FY11 and is in-line with 21x, average during FY05-09. The period between FY05-09 was one of the best periods in terms of power and industrial capex, resulting in earnings CAGR of 38%. During FY09-11, we expect earnings CAGR of 17%, and thus the current P/E of 22x leaves limited room for further outperformance, until visibility improves further on order intake and thus earnings.

SECTOR PER (1 YR FORWARD) AT 20X FY10E AND EXPECTED EARNINGS CAGR AT 17% IN FY09-11



Note: Shaded area indicates earnings growth in excess of 20% YoY *Source: Bloomberg/MOSL*

Valuation multiples converge in uncertain earnings outlook period: Our analysis indicates convergence of valuation multiples for Engineering and Capital Goods sector during periods when earnings outlook is uncertain. For instance, in FY02 and FY03, P/E multiples (1-year forward) had converged at 7.5-9.0x. These periods coincided with beginning of the revival of the industrial cycle, and sector reported earnings growth of 57% YoY in FY02 and 15% YoY in FY03 vs negative earnings growth of 17% CAGR during FY98-01. Similarly, we notice that currently, the sector P/Es have largely converged, again given the uncertain earnings outlook.

Current valuations partly factor in industrial recovery; ABB, Siemens and L&T more leveraged

- ABB, Siemens are highly leveraged to private capex. Thus, the valuation will expand in the event of industrial capex recovery. Currently, both companies already quote at 30% premium to sector average.
- BHEL's recent sector underperformance of 33% since March 2009 is driven by moderate earnings upgrades expectations as compared to peers, post continuity of government.
- L&T trades at premium of 10% to sector average and we believe that any further premium expansion is contingent on industrial capex rebound and success of new ventures like ship building, power equipment, nuclear, railways.

Valuation and view: We remain **Neutral** on the sector since it trades at one year forward P/E of 22x, in line with average during best period of earnings CAGR for the sector (FY05-FY09).

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Limited room for further outperformance; valuations running ahead of earnings

Our Engineering and Capital Goods universe, comprising ABB, BHEL, Crompton Greaves, L&T and Siemens has delivered 81% returns since March 2009, v/s 49% by BSE Sensex and 42% by NSE Nifty. The recent out-performance had been driven by comfortable valuations (at 14x FY10 in March 2009) and expectations of positive impact on business environment with continuity of government.

Post the recent out-performance, 1-year forward sector P/E now stands at 22x FY11 and is in-line with 21x, average during FY05-09. The period between FY05-09 was one of the best periods in terms of power and industrial capex, resulting in earnings CAGR of 38%. During FY09-11, we expect earnings CAGR of 17%, and thus the current P/E of 22x leaves limited room for further outperformance, until visibility improves further on order intake and thus earnings.

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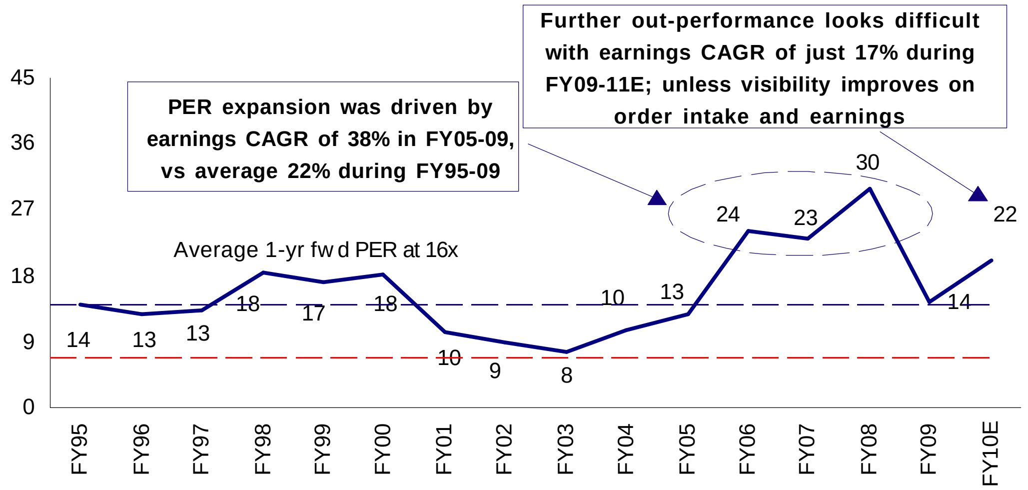

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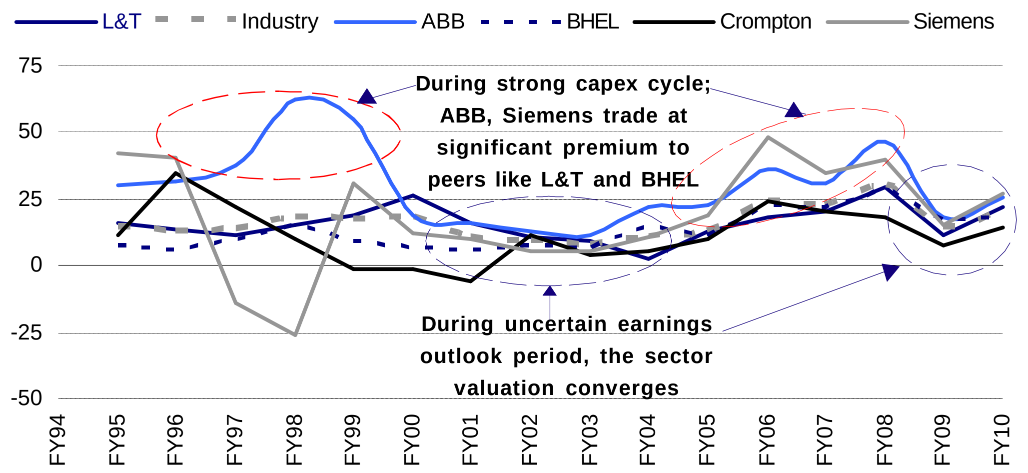
Valuation multiples converge in uncertain earnings outlook period; ABB, Siemens highly leveraged to industrial capex

Our analysis indicates convergence of valuation multiples for Engineering and Capital Goods sector during periods when earnings outlook is uncertain. For instance, in FY02 and FY03, P/E multiples (1-year forward) had converged at 7.5-9x. These periods coincided with the beginning of the new industrial cycle, and sector reported earnings growth of 57% YoY in FY02 and 15% YoY in FY03; vs negative earnings growth of 17% CAGR during FY98-01. Similarly, we notice that currently, the sector P/Es have largely converged, again given the uncertain earnings outlook.

Historical analysis indicates that as industrial activity improves in the economy, in the initial years, companies like ABB and Siemens trade at significant (50-70%) premium to peers. This is because these companies are more leveraged to industrial capex. Thus, we believe that a possible recovery in the industrial cycle during 2HCY10, will be positive for both ABB and Siemens, and could drive out-performance vs peers.

SECTOR PER CONVERGES IN UNCERTAIN EARNINGS OUTLOOK PERIOD – HAPPENED IN FY02/FY03 AND CURRENTLY

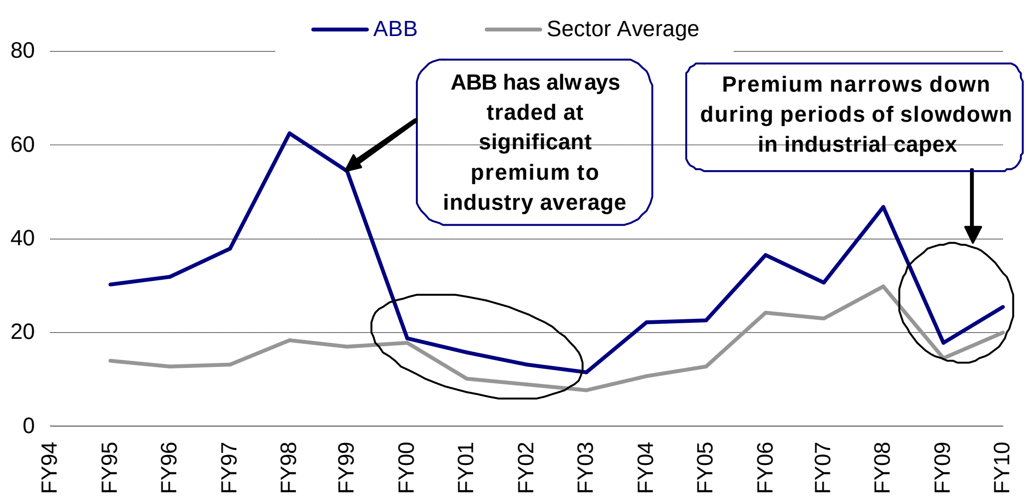


Source: Bloomberg/MOSL

ABB: Always trades at premium valuations to peers; premium could expand with revival of industrial capex

ABB has consistently traded at premium to peers due to (1) technology access through parent, (2) well-diversified business mix with capability to cater to industry, infrastructure and consumers, and (3) strong return ratios and balance sheet as compared to peers. Historically, the valuation premium has contracted and expanded depending upon strength of the industrial capex. We believe that valuation gap could expand between ABB and sector average in case of a possible recovery in the industrial cycle during 2HCY10.

ABB'S VALUATION PREMIUM TO PEERS HAS NARROWED, GIVEN SLOWDOWN IN INDUSTRIAL CAPEX (PER, X)

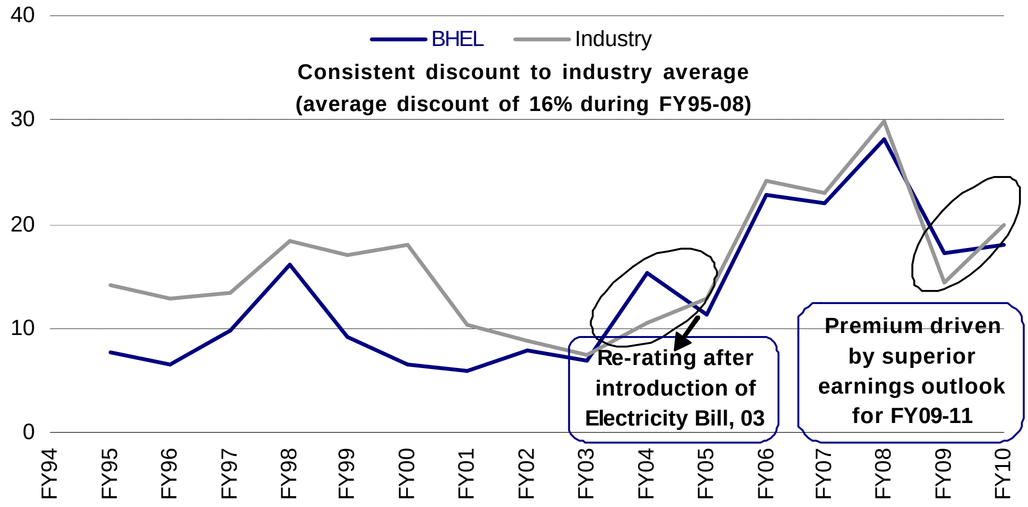


Source: Bloomberg/MOSL

BHEL: Recent underperformance driven by possible earnings upgrades for peers

BHEL's recent sector underperformance of 33% since March 2009 is driven by moderate earnings upgrades expectations as compared to peers, post continuity of government. Historically, BHEL has always traded at average discount of ~16% to sector P/E. The stock quoted at premium to sector average in (1) FY03-FY05 driven by passage of Electricity Act, Tripartite agreement, etc which had led to serious reforms in power sector, and (2) FY08-FY09 driven by the robust earnings outlook of 20-25% CAGR and book to bill ratio of 4x+, vs deterioration in earnings outlook for peers.

BHEL'S PREMIUM VALUATIONS DURING FY08/FY09 WAS DRIVEN BY SUPERIOR EARNINGS OUTLOOK VS PEERS

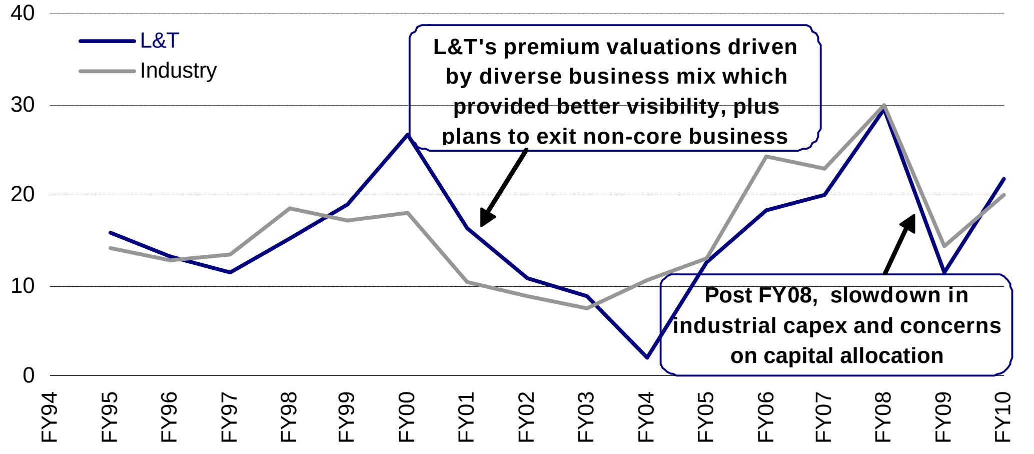


Source: Bloomberg/MOSL

L&T: Uncertainty on industrial capex/ capital allocation led to increased valuation discount against industry in FY08-FY09

For majority of the period during FY03-FY09, L&T has traded at discounted valuations to sector average. During FY09, the uncertainly on industrial capex (L&T derives ~45-50% of profits from industrial activities) and concerns on capital allocation (investments / advances in subsidiaries, associates, etc at Rs54b in FY09 vs 12b in FY07) have led to widening of discount vs sector average to 20%. Currently, the stock trades at premium of 10% to sector average and we believe that any further premium expansion is contingent on industrial capex rebound and success of new ventures like ship building, power equipment, nuclear, railways, power generation, etc.

L&T CURRENTLY TRADES AT 10% PREMIUM TO SECTOR PER; SUSTAINABILITY CONTINGENT ON INDUSTRIAL CAPEX REVIVAL

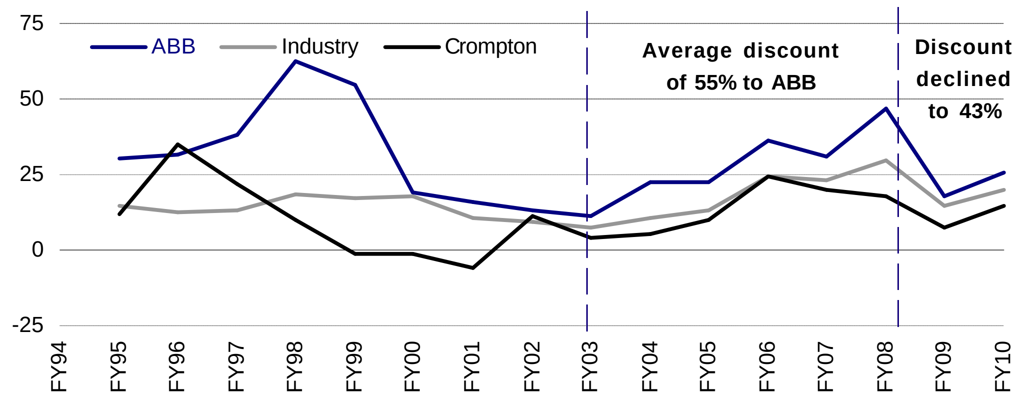


Source: Bloomberg/MOSL

Crompton Greaves: recent widening of valuation gap vs ABB partly captures in possibility of revival in industrial capex

Since FY03, Crompton has been trading at an average P/E discount of 55% to ABB. Given that Crompton has lower exposure to industrial capex as compared to ABB and also derives ~50%+ of consolidated profits from overseas markets (vs ~8-10% for ABB), the valuation gap shrank during periods of weak industrial capex in India. In a scenario of robust growth in Indian power sector and pick up in industrial capex, the valuation discount between ABB and Crompton will widen. During FY09, the gap had shrunk significantly but has again increased to 43% during 1QFY10; implying possibility of industrial revival.

CROMPTON: CURRENTLY TRADES AT A DISCOUNT OF 43% TO ABB, VS AVERAGE OF 55% POST FY03



Source: Bloomberg/MOSL

Valuation and view

We remain **Neutral** on the sector since it trades at one year forward P/E of 22x, in line with average during best period of earnings CAGR for the sector (FY05-FY09).

COMPARATIVE VALUATION

	RATING	CMP	TARGET PRICE			EPS (RS)			PER (X)		P/BV (X)		ROE (%)	
		RS/SH	RS	PER (X)	RETN.(%)	FY10	FY11	%YOY	FY10	FY11	FY10	FY11	FY10	FY11
ABB	Neutral	787	695	25	(12)	23.8	27.8	16.7	33.1	28.3	6.5	5.4	21.5	20.8
L&T	Neutral	1,588	1,231	18	(22)	58.5	65.0	11.1	27.1	24.4	6.5	5.6	21.3	20.2
BHEL	Neutral	2,225	2,033	18	(9)	87.8	112.9	28.7	25.4	19.7	6.9	5.6	30.0	31.2
Crompton	Neutral	293	285	15	(3)	16.9	19.0	12.5	17.3	15.4	6.9	5.6	31.2	28.1
Siemens	Neutral	487	346	20	(29)	18.5	17.5	-5.4	26.4	27.9	5.2	4.5	22.9	16.7

Source: MOSL

N O T E S

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Disclosure of Interest Statement

The MOSt group and its Directors own shares in the following companies covered in this report: Nil

MOSt has no broking relationships with the companies covered in this report.

MOSt is engaged in providing investment-banking services in the following companies covered in this report: Nil