BHEL July 5th, 2008

CMP: Rs 1500 **"Accumulate"**

BSE Code	500103
NSE Code	BHEL

Key Data

Sensex	13454
52 week H/L (Rs)	2925/1325
July Month H/L (Rs)	1512/1340
Market Cap (Rs Cr)	73442.69
Avg. daily vol. (6m)	518297
Face Value (Rs)	10

Source: Capitaline

Shareholding Pattern (%)

Promoters	67.72
Institution	8.60
Foreign holding	18.07
Non-Promoter Corp. Holding	3.58
Public & Others	2.03

Source: Capitaline

One-Year Performance: (Rel. to Sensex)

Source: Capitaline

BUSINESS & BACKGROUND

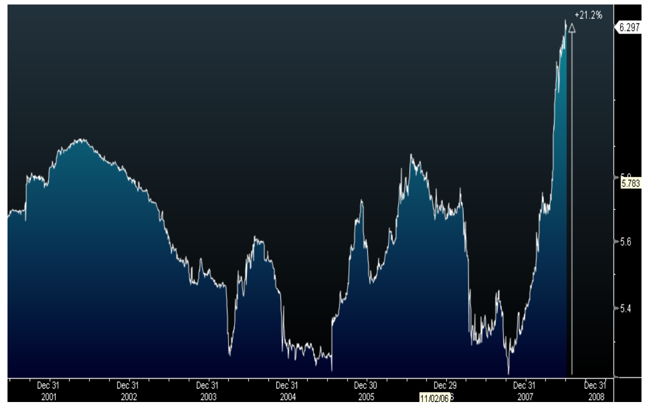
BHEL is engaged in manufacturing and distributing electrical, electronic and mechanical & nuclear power equipment. It manufactures over 180 products under 30 major product groups and caters to core sectors of the Indian economy viz., power generation and transmission, industry, transportation, telecommunication, renewable energy.

Sector:-

The capital goods sector is expected to see a good YoY growth, led by huge order inflow especially from Oil & gas sector, Power, metals etc. We expect the sector to witness pressure on margins and in profits due to rise in commodity prices, crude oil, forex exposure etc. But we are positive on the sector on account of large orders on back of infrastructure development especially in power, metals, oil &gas and strong revenue visibility.

- ***IIP numbers:*** The index of Industrial production, which hit a low of 3.9% YoY% in Mar 08,was at 7% in April 2008. The capital goods index took a sharp cut, growing just by 2.1% YoY before it increased to 14.2% April, 2008. We believe this recent slow down could be one time event (an aberration) as order book for the most of the companies continue to witness strong growth momentum.
- ***Increasing Exports:-*** Companies like Suzlon, L&T, Punj Lloyd etc., are increasing thrust on international orders. These companies grab the opportunites in the countires like Middle East & European countries. We expect some more order inflow especially from Middle East and Other emerging countries on the back of massive infrastrcuture development.
- ***Growth Lies A head: -*** While the stocks in the capital goods and engineering space have fallen by more than 50%, we believe the story is not yet over. This sector will outperform on the back of huge investment in infrastructure **(500 USD billion for next 3-5 years)**, We expect this trend to continue in coming fiscal on the back of govt. spending in infrastructure along with massive private participation.
- ***Order book to remain Buoyant: -***Despite of low capital goods index number in Jan 2008, order book for most of the companies have shown significant growth, largely on the back of increased investment in manufacturing sector and govt. thrust on infrastructure (Oil & Gas, Power generation, T&D etc.) Companies like BHEL, Suzlon, L&T, Punj Lloyd etc. has witnessed strong growth. We expects order intake to continue to grow upwards on back of strong industrial capex (oil & gas, metals etc.), power generation, T&D etc.

Appreciation of Chinese currency: - Chinese currency (RMB) has increased by 15% V/s INR in last 6 months which has reduced the pricing power of Chinese players.



Source: Bloomberg

- ***Pressure on margins to continue :-*** Higher raw material costs are 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.

We continue to remain positive on the buiness momentum for the capital goods sector on back of huge invesmtent in infrastructure both by Private and Govt.Organisation. With the huge invesmtent & recent market correction, we belive that the current valuations are rich and factor the underlying growth for the these comapnies.

Investment Rationale

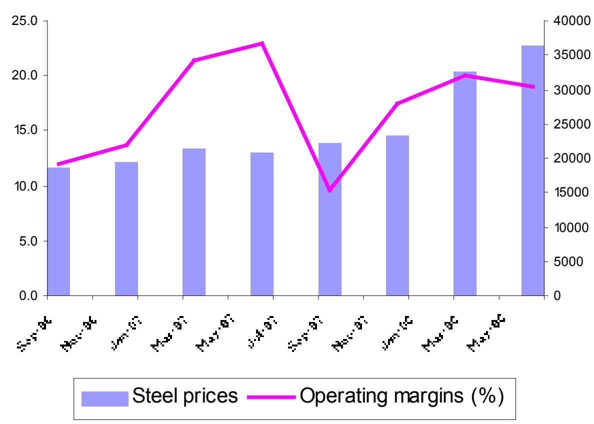
- Sustained growth has been witnessed in the Indian economy in the last few years and as per latest estimates, the economy is expected to grow at 8.7 per cent in 2007-08 and average at 9 per cent during the XI plan. The XI Plan envisages a capacity addition of 78,577 MW to the installed power generating base of the country. Riding on this growth, BHEL plans to be a Rs.45,000 Crore turnover company by 2011-12.

- BHEL's nuclear sets account for 80% of the country's installed nuclear generating capacity and the largest nuclear set manufactured by BHEL so far is of 540 MW rating. The company is now gearing up for manufacture of higher rating Nuclear turbines & generators and is in discussions with Nuclear Power Corporation for a possible Joint Venture to take up EPC activities for the nuclear power plant business.

- BHEL has established its footprints in 70 countries of the world and further stimulation in the growth of BHEL's international business will be achieved through consolidation in existing markets, widening the export base through expansion of its existing basket of products and services, and by entering new markets, with the EPC business being the key driver of its exponential growth plans.

- Given the thrust on the power sector by the government, According to XI year plan, we expect capacity addition to be at 70,000 MW out of which 70% addition will be by thermal based power plants. Bhel being the leader in setting up coal based power plants will benefit from the planned capacity addition going forward. Bhel is planning a capacity addition from 10,000 MW to 15,000 MW by December 2009. Bhel also has specialization in Hydro power projects.

- About 40-50% of the company's contracts are PVC contract where they can put price variation claims on customer and for most of the other contract the company has agreements with suppliers of materials or maintains a good inventory. The company has effectively reduced employee cost/ Sales ratio from ~20% to ~14% over a period of 4 years. We believe this to improve going forward. Looking at the rising price of steel the company will not be able to pass all the rise through PVC but higher efficiencies from employee cost will help margins increase by 210 basis points over a period of two years.



Key Risks

- Any delay in executing order can have an adverse impact on the earnings of the company
- Any slow down in power sector in the form of new capacity addition can have an adverse impact on the performance of the company.

BHEL is facing intense competition in the industry particularly Chinese competition due to their size and economies of scale.

VALUATION

BHEL is the largest engineering and manufacturing enterprise in India in the energy related/ infrastructure sector. It manufactures over 180 products under 30 major product groups and caters to core sectors of the Indian economy viz., power generation and transmission, industry, transportation, telecommunication, renewable energy. AT CMP of Rs1500, the stock is trading at 21 x its FY09E EPS of Rs72. Chinese currency appreciating against Indian Rupee by 21% in last six months is positive for overall Indian capital good sector as competitive pricing edge which Chinese companies where enjoying will take a hit. BHEL secured highest orders worth Rs.50,265 cr during the year, from domestic and overseas markets. Currently order book stands at Rs. 91,417 Cr – which is 3.7 times its sales. We recommend investors to ***accumulate*** the stock at current levels.

(Rs crores)	Order book	Net Sales	Orderbook/sales	Price	EPS	P/E
BHEL	91417	19365	4.7	1500	58.41	25.7
Larsen & Tubro	52680	24854	2.1	2380	72.21	33.0

Financials

Particulars	FY06	FY07	FY08	FY09E	FY10E
Revenue (net sales)	13,228.3	17,237.5	19,365.5	24,981.4	31,226.8
Growth (%)		30%	12%	29%	25%
Total Expenses	10,889.3	13,946.6	15,998.7	20,110.1	25,137.6
Operating Profit	2,339.0	3,290.9	3,366.8	4,871.4	6,089.2
Other Income	530.7	761.5	1,396.2	1,100.0	1,240.0
Interest	58.8	43.3	35.4	25.4	25.4
Depreciation	245.9	273.0	297.0	499.6	624.5
PBT	2,565.1	3,736.1	4,430.6	5,446.4	6,679.3
Tax	885.2	1,321.4	1,571.1	1,906.2	2,337.8
PAT	1,679.9	2,414.7	2,859.6	3,540.2	4,341.6
Extraordinary item					
Adjusted PAT	1,679.9	2,414.7	2,859.6	3,540.2	4,341.6
Growth (%)		44%	18%	24%	23%
Equity	244.76	244.76	490	490	490
EPS	68.63	98.66	58.36	72.25	88.60
Margin(%)					
OPM	17.7	19.1	17.4	19.5	19.5
NPM	12.7	14.0	14.8	14.2	13.9

RATING INTERPRETATION
Buy Expected to appreciate more than 20% over a 12-month period
Accumulate Expected to appreciate up to 20% over a 12-month period
Hold Expected to remain in a narrow range
Avoid Expected to depreciate up to 10% over a 12-month period
Exit Expected to depreciate more than 10% over a 12-month period