

June 12, 2008

Elecon Engineering Ltd

Result
Update

Target Price Revised @ Rs128

ACCUMULATE

Price	Target Price
Rs110	Rs128
Sensex	15,185

Price Performance

(%)	1M	3M	6M	12M
Absolute	(26)	(48)	(66)	(29)
Rel. to Sensex	(18)	(44)	(54)	(34)

Source: Capitaline

Stock Details

Sector	Material Handling
Reuters	ELCN.BO
Bloomberg	ELCN@IN
Equity Capital (Rs mn)	186
Face Value(Rs)	2
No of shares o/s (mn)	93
52 Week H/L	343/101
Market Cap (Rs bn/USD bn)	10/233
Daily Avg Volume (No of sh)	242359
Daily Avg Turnover (US\$mn)	0.9

Shareholding Pattern (%)

	M'08	D'07	S'07
Promoters	42.2	42.2	42.2
FII/NRI	9.1	9.4	8.8
Institutions	19.5	20.0	17.6
Private Corp	5.9	4.0	4.5
Public	23.4	24.5	26.9

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Q4FY2008 results are below expectations- (1) revenue below estimates at Rs3.3 bn and 16% yoy growth and (2) net profit below estimates at Rs230 mn and 30% yoy growth. For FY2008, Elecon Engineering (EEL) reported net profit growth at 26% yoy to Rs672 mn and earnings of Rs7.2/Share, below estimates. Led by slippages in new business, we have revised our revenue estimates by 15.1%(Rs11.5 bn) and 23.2%(Rs14.0 bn) for FY2009E and FY2010E respectively. Consequently, the net profit estimates are revised by 22.1%(Rs840 mn) and 31.6%(Rs992 mn) for FY2009E and FY2010E respectively.

EEL has undergone steep de-rating in valuations from 25X 1-Year Forward PER to 10X 1-Year Forward PER. The current de-rating in valuations is fully factoring key concerns (1) Execution risk in new business initiatives and (2) High dependence on new business initiatives. We continue to maintain positive outlook on core business of MHE and TE- amidst enabling business environment and strong order backlog. But, we adopt cautious approach and ascribe lower valuation, value EEL at 12X FY2010E earnings. We believe that- managing growth in individual businesses and especially in new business segment will remain a key concern. We would review company's performance in coming quarters to upgrade our investment rating. Currently, we maintain 'ACCUMULATE' rating with a revised price target of Rs128.

Lower than expected revenue growth – due to slippages in revenues of windmill business

The revenue performance for Q4FY08 was below our expectations. Revenue growth was subdued at 16% yoy to Rs3.3 bn. The below expected performance was primarily due to slippages on expected revenues in new business i.e. the windmill business. The management had guided for additional revenues to the tune of Rs1.0 bn during the quarter from the windmill business, which did not materialize. The revenues were further impacted as Material Handling Equipment (MHE) Division registered muted growth at 5.8% yoy to Rs2.0 bn primarily due to slower order booking. Whereas, the Transmission Equipment (TE) Division continued its growth momentum and grew by 29.2% yoy to Rs1.4 bn.

EBITDA growth muted at 13% - below our expectations

Led by below expected revenue growth, EBITDA for the quarter grew by 13% yoy to Rs441 mn, below our estimates. EBITDA margins declined by 40 bps yoy from 13.8% in Q4FY07 to 13.4% in Q4FY08, below our estimates. Decline in margins is attributed to marginal dip in operating performance of the TE division. The margins in TE division dipped from 21% in Q4FY07 to 19% in Q4FY08. Also muted EBITDA growth is triggered by (1) slippages in revenues of new business and (2) muted growth in MHE division.

Key Financials: Rs mn

YE- Mar	Net Sales	EBITDA (Core) (%)	APAT (%)	AEPS (Rs)	EV/ EBITDA	Div Yld	P/BV	RoCE (%)	P/E	
FY07	7231	1215	16.8	549	5.7	11.5	5.5	1.3	26.1	19.6
FY08P	8264	1305	15.8	672	7.2	9.2	4.4	1.8	24.1	15.6
FY09E	11535	1814	15.7	841	9.1	7.6	3.4	1.8	24.8	12.3
FY10E	13963	2173	15.6	992	10.7	6.6	2.7	1.8	23.0	10.4

Note – FY2007 figures have been adjusted to reflect 2:1 bonus issue

Net profit growth at 30%, below our expectations

Net profit for the quarter increased 30% yoy to Rs230 mn. The growth in net profit was below our estimates primarily due to below expected revenue growth and drop in operating margins. Further, the 30% net profit growth was loaded with 173% yoy growth in other income to Rs22 mn. Earnings for the quarter stood at Rs2.5/Share adjusting for 2:1 bonus issue.

Subdued performance in FY2008

EEL registered muted performance in FY2008 at revenue and net profit front. Revenues for FY2008 grew by 14% to Rs8.3 bn, below our estimates. The muted performance was attributed to slippage in revenues of new business i.e. Windmill Business to the tune of Rs1.0 bn. The MHE Division also witnessed muted growth at mealy 5% to Rs4.7 bn due to delays in mobilization of contracts and delayed order booking. Whereas, TE Division growth was healthy at 25% to Rs3.9 bn. Led by below expected revenue growth, EBITDA growth at 7% to Rs1.3 bn was below our expectations. EBITDA margins declined by 100 bps to 15.8% primarily due to higher contribution by high margin TE Division. Consequently, net profit grew by 26% to Rs664 mn, below our estimates. FY2008 earnings stood at Rs7.2/Share adjusting for 2:1 bonus issue.

Strong order book at Rs12.9 bn, 55% growth

EEL order book at Rs12.9 bn, in line with our expectations. The order book has grown at 55% from Rs8.3 bn to Rs12.9 bn. The current order book indicates robust visibility at 1.6X FY2008 revenues, best in last 5 years. MHE Division contributes 84% to order backlog at Rs10.8 bn and registered 76% yoy growth. The order book for TE division declined marginally by 6% yoy to Rs2 bn. In FY08, EEL bagged few high value orders like (1) SAIL, IISCO plant - Rs1.9 bn involving supply and erection of various equipments like stackers, reclaimers, tipplers, etc (2) Tecpro Systems – Rs0.6 bn coal handling plant, (3) Sical – Rs0.5 bn supply of wagon tippler, stackers, reclaimers and (4) BGR Energy – Rs0.3 bn coal handling equipment.

Revision in FY2009E and FY2010E earnings estimates- led by slippages in new business

EEL has slipped yet again on delivering its FY08 revenue guidance. The deviation is triggered by its new business i.e. Wind Mill and Wind Mill Gears. Management has guided for income of Rs1.0 bn from the Wind Mill business. Adjusting for slippages in new business, the revenue at Rs8.3 bn was in line with estimates. Further, EEL has revised its guidance on the new business front, owing to delays in (1) acquisition of required technology and (2) commissioning of designated facilities. The Wind Mill Gears facility is expected to commission in August 2008 against earlier target date of June 2008, slippage of 2-3 months. Accordingly, we have revised our revenue estimates for new business by 41.8% in FY2009E and FY2010E to Rs2.7 bn and Rs3.4 bn respectively. Consequently, revenue estimates for FY2009E and FY2010E are revised by 15.1% and 23.2% respectively. The revenue estimates for FY2009E and FY2010E are revised from Rs13.6 bn to Rs11.5 bn and Rs18.2 bn to Rs14.0 bn respectively. We expect the EBITDA margins to maintain at 15.6-15.8% levels in FY2008-10E period led by stronger growth in Gears business. We have also revised our net profit estimates by 22.1% and 31.6% to Rs0.8 bn and Rs1.0 bn for FY2009E and FY2010E respectively. The earnings are revised to Rs9.1 and Rs10.7 for FY2009E and FY2010E respectively.

In Rs mn	FY08		FY09E				FY10E		
	Estimates	Actual	Change (%)	Old Estimates	Revised Estimates	Change (%)	Old Estimates	Revised Estimates	Change (%)
Old Business	8,356	8,264	-1.1	10,835	9,935	-8.3	14,743	11,963	-18.9
MHE	4,684	4,396	-6.2	6,604	5,487	-16.9	9,708	6,851	-29.4
Gear	3,660	3,856	5.4	4,213	4,435	5.3	5,009	5,100	1.8
Other	12	12	0.0	17	12	-29.1	26	12	-51.8
New Business	1,000	0	-100.0	2,750	1,600	-41.8	3,438	2,000	-41.8
Wind Mill	1,000	0	-100.0	2,000	1,000	-50.0	2,500	1,250	-50.0
Wind Gears	0	0	-	750	600	-20.0	938	750	-20.0
Total	9,356	8,264	-11.7	13,585	11,535	-15.1	18,180	13,963	-23.2

In Rs mn	FY2008	FY2009E	FY2010E
Old Estimates	730	1,079	1,450
Actual/Revised	664	841	992
Change (%)	-9.0	-22.1	-31.6

Uncertainty looms at new business front- we are getting apprehensive

We view that, uncertainty and pessimism prevails at the new business front. Further, it is aggravated by postponement of deadlines and revenue guidance since last 4 quarters. EEL is consistently failing to deliver the revenue guidance and largely missing its guidance on new business. In absence of clear direction and roadmap- we are getting apprehensive on new business. We have revised our revenue estimates on new business by 41.8% in FY2009E and FY2010E to Rs2.7 bn and Rs3.4 bn respectively. But, despite this steep revision in revenue estimates- successful execution in coming years will be deciding factor and remain overhang on valuations and stock performance.

Capex plan of Rs1.8 bn in FY2009-10E period- spill over of FY2008

EEL incurred capex of Rs0.8 bn in FY2008 against proposed capex of Rs1.3 bn. Thus, there is spill over capex of Rs0.5 bn in FY2009E. The above capex was largely incurred on augmenting the MHE and Gear Box facilities. Company plans to spend Rs1.8 bn in FY2009E- largely on Wind Mill Gear Box (Rs1.0 bn), Wind Mills (Rs0.2 bn) and Maintenance Capex (Rs0.5 bn). Consequently, we have revised our estimates for FY2009E and FY2010E- to factor the changes in capex plan.

Key concerns mentioned in 'Initiating Report' take center stage

We view that, our key concerns mentioned in the 'Initiating Report' has taken center stage. The excerpts of the report are as under-

- *Execution risk in new business initiatives* - EEL is venturing into erection of wind mills and manufacturing of wind mill gearboxes to accelerate growth momentum. We believe that, new business initiatives are always exposed to execution risks.
- *High dependence on new business initiatives* - The dependence on new business initiatives in future earnings is very high. We believe that any adverse events will impact our earnings estimates.

Consequently, we have revised our net profit estimates by 22.1% and 31.6% to Rs0.8 bn and Rs1.0 bn for FY2009E and FY2010E respectively. The earnings are revised to Rs9.1 and Rs10.7 for FY2009E and FY2010E respectively.

Valuations

EEL has undergone steep de-rating in valuations from 25X 1-Year Forward PER to 10X 1-Year Forward PER. This is led by (1) muted growth in MHE business, despite strong order backlog and (2) slippages in the new business. The management has failed to deliver the revenue guidance for last 4 quarters. We view rising uncertainty and pessimism on new business as overhang on valuations and stock performance.

However, the current de-rating in valuations is fully factoring key concerns (1) Execution risk in new business initiatives and (2) High dependence on new business initiatives. The current valuations are in line with Mid Cap Engineering- trading at 10X-12X FY2009E earnings. We continue to maintain positive outlook on core business of MHE and TE- amidst enabling business environment and strong order backlog. But, we adopt cautious approach and ascribe lower valuation, value EEL at 12X FY2010E earnings. We believe that- managing growth in individual businesses and especially in new business segment will remain a key concern. We would review company's performance in coming quarters to upgrade our investment rating. Currently, we maintain 'ACCUMULATE' rating with a revised price target of Rs128.

Key Quarterly Financials (Rs mn) (Year End- March)

Y/E,Mar (Rs. mn)	Q4FY08	Q4FY07	% YoY	Q3FY08	% QoQ	FY2008	FY2007	Gr (%)
Net Sales	3,285	2,830	16%	1,852	77%	8,264	7,231	14%
Expenses	2,844	2,440	17%	1,504	89%	9,721	6,959	40%
Raw Materials	2,295	1,984	16%	1,176	95%	5,520	4,742	16%
% Of Sales	70%	70%	-	63%	-	67%	66%	-
Other expenditure	467	375	25%	232	99%	675	632	7%
% Of Sales	14%	13%	-	13%	-	8%	9%	-
Employee Cost	81	82	-1%	96	-15%	343	272	26%
% Of Sales	2%	3%	-	5%	-	4%	4%	-
Ebidta	441	389	13%	349	26%	1,305	1,215	7%
Ebidta%	13.4%	13.8%	-	19%	-	16%	17%	-
Other Income	22	8	173%	19	-27%	90	44	104%
Interest	85	58	48%	88	-3%	274	194	42%
Depreciation	36	34	7%	36	0%	142	122	16%
PBT	341	306	11%	243	37%	979	823	19%
Tax	111	130	-14%	77	44%	315	295	7%
PAT (Before EO Item)	230	176	30%	166	34%	664	528	26%
Net Margin%	7%	6%	-	9%	-	8%	7%	-
E/O Item	-	9	-100%	-	-	8	22	-63%
Reported PAT	230	186	24%	166	34%	672	549	22%
Earnings	2.5	5.8	-57%	1.8	34%	7.2	5.7	26%

Note – Q4FY2007 EPS has been adjusted to reflect 2:1 bonus issue made in Q3FY2008

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