Emkay Research

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 EBIDTA 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 measly 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 expcted 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. Conseuquently, 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 EBIDTA 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, uncertaininty 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 uncertaininty 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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