Capital Goods & Engineering

Poised for a big leap

Amit Mahawar

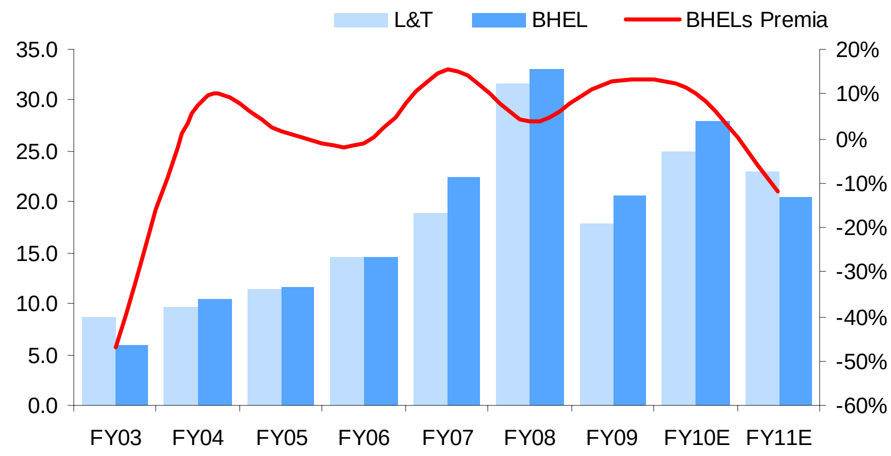
August 2009

Contents

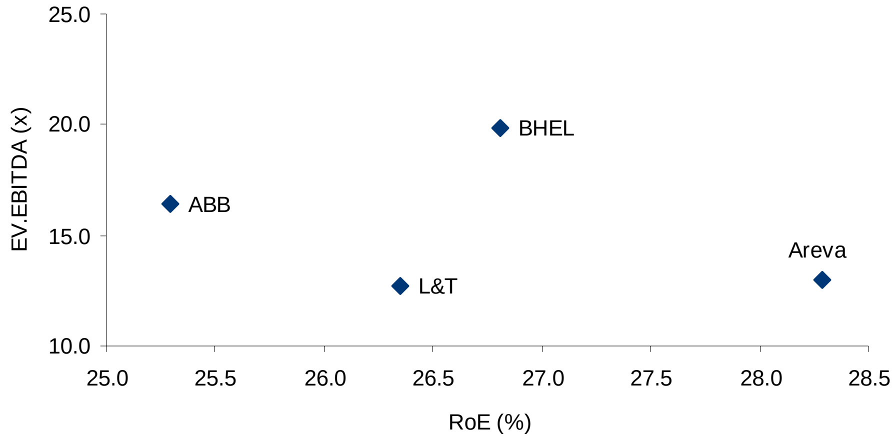
We initiate coverage on L&T & BHEL

- We initiate coverage on two key large cap stocks in the Indian engineering and capital goods space (69% weightage in the capital goods index).
- We prefer L&T as a top pick in the sector, given its diversified dominance in the overall infrastructure space and increased focus in key areas, like power and defense.
- **L&T—We initiate coverage with a Buy rating:** We have a bullish outlook on L&T, given its positioning in the Indian engineering and construction space, newer initiatives by the company and an improved outlook for infrastructure spending. We see the dynamics for L&T changing positively over the next 2 years, with significant development expected to take place over the coming years, which will help the company to generate additional profitable revenue streams, which would further optimise the existing diversified business model. We set a price target of Rs 1869 (+23%) for L&T on a SOTP basis.
- **BHEL—We initiate coverage with a Buy rating:** The dominant player in the power generation equipment space in India, BHEL is set to see a decent 25%+ CAGR in earnings over FY09-11E. However, we see no major upside in the valuations in the near to medium term, with business inflows expected to stay muted in FY10E, adequate discounting of earnings. We assign a 25% premia to average PE of FY05-09 to BHEL, ascribing a price target of Rs 2580 (+10%).

Average and expected P/E

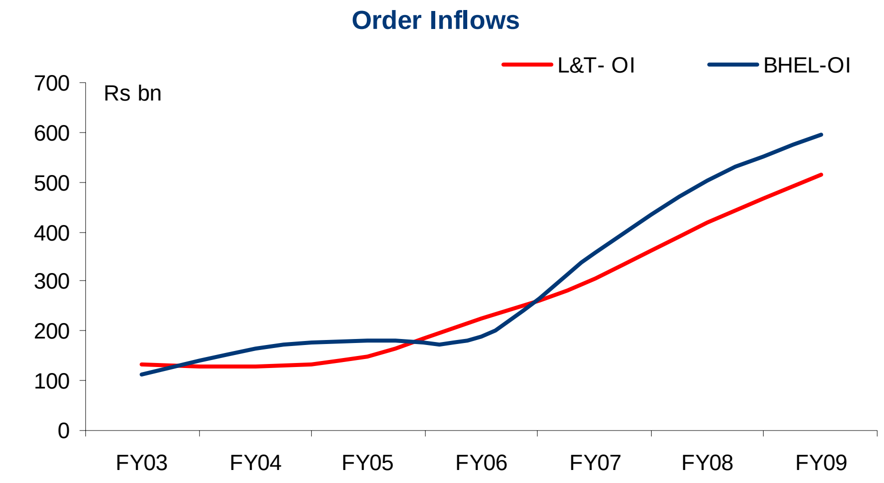


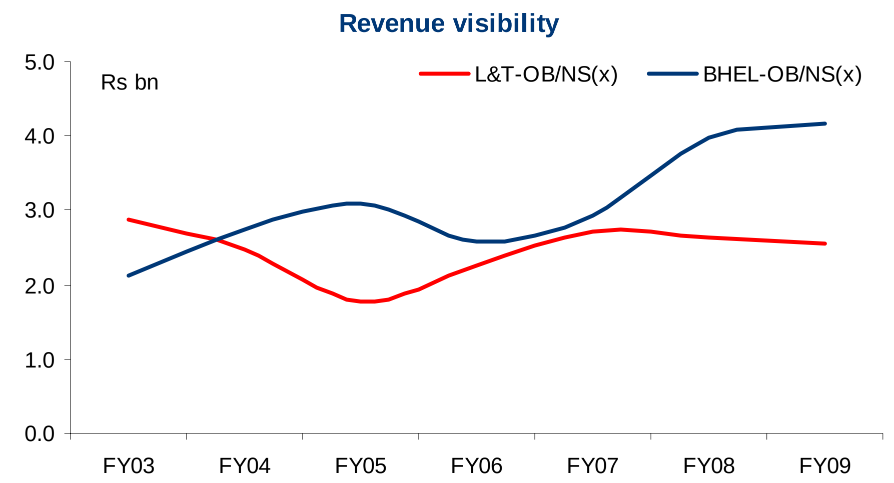
Peer Valuation

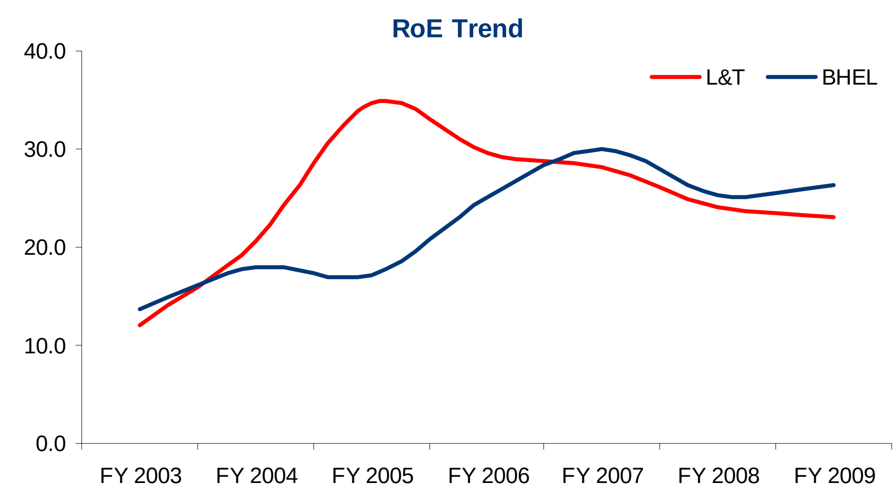


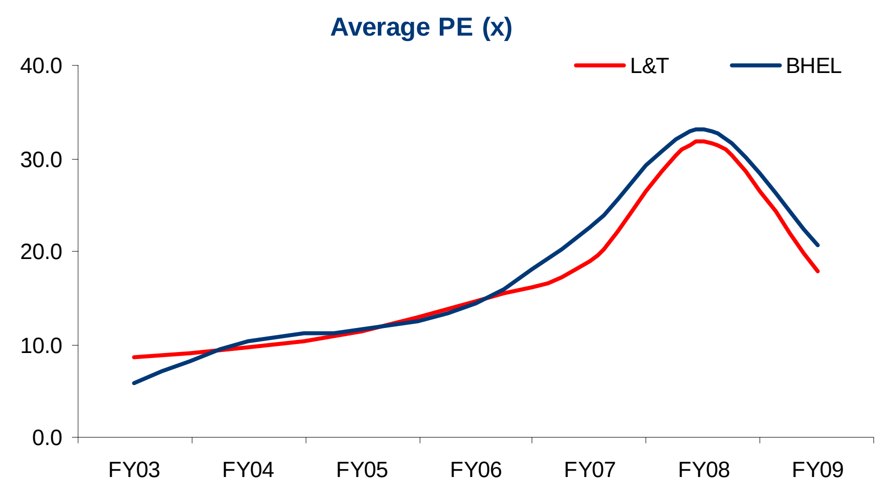
Source: MF Global India Research

L&T vs. BHEL— Key Parameters





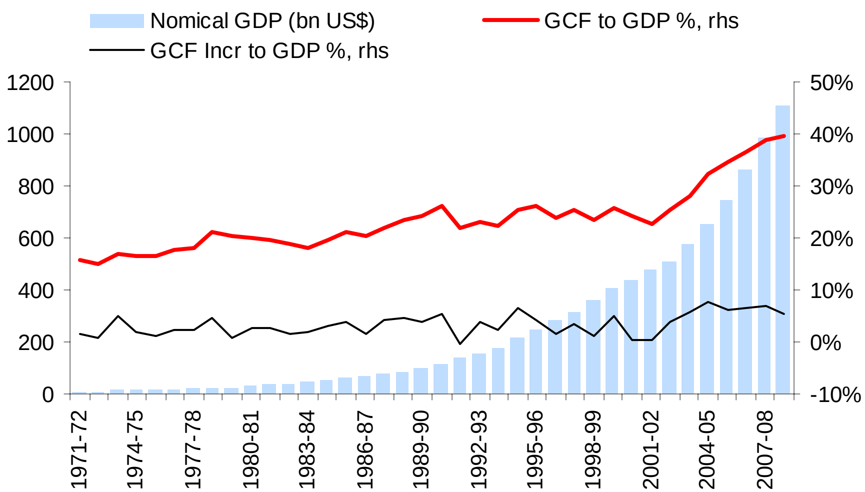


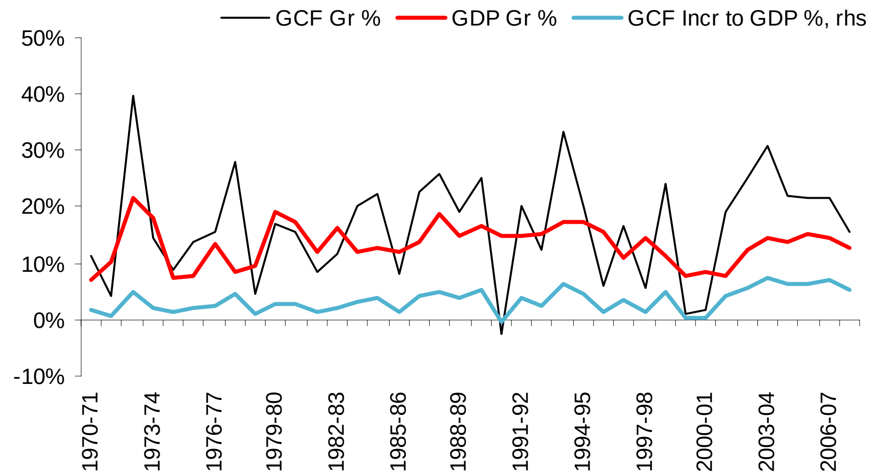


Source: Company, MF Global India Research

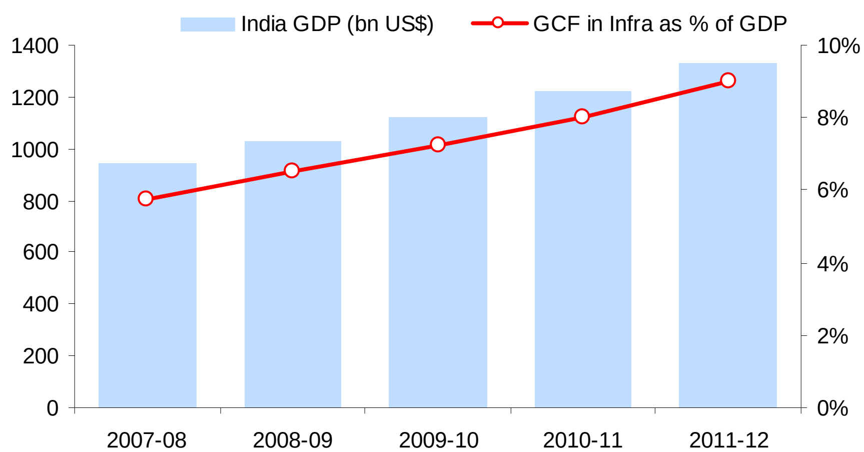
ECONOMY & INDUSTRY OUTLOOK

GCF & GDP trends





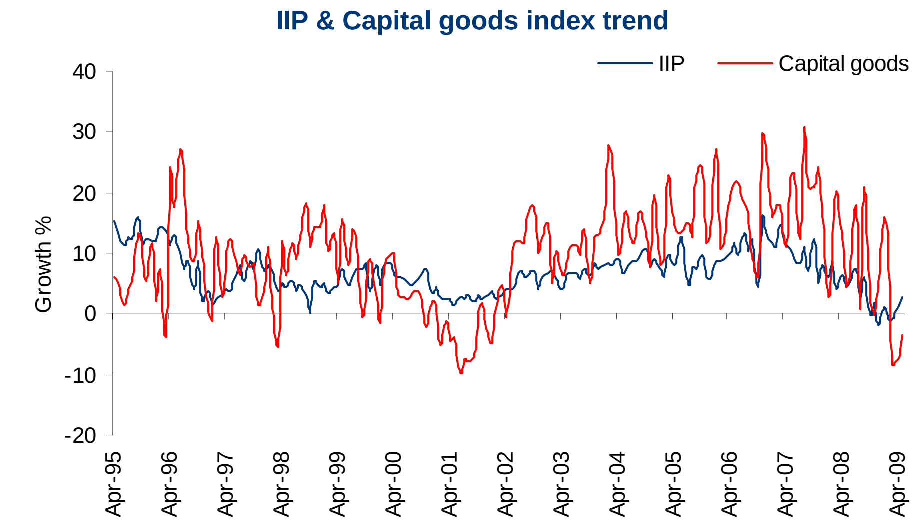
11th Plan GDP and GCF (planned)

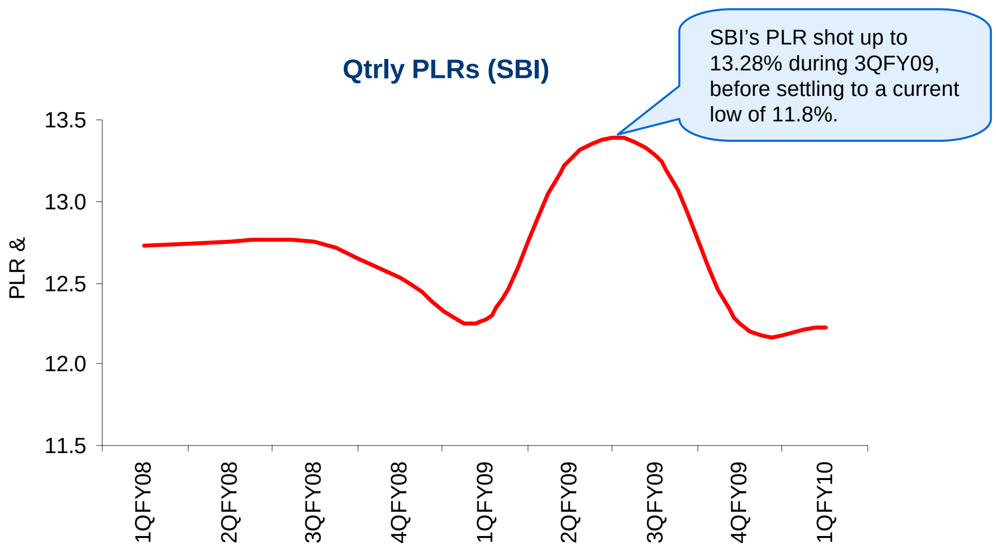


- Infrastructure spending to get a boost as India tries to attain 9% GDP levels. In order to attain a healthy GDP growth rate of 9.0%+ (real terms), the government planned an increase in investments in core infrastructure, during the 11th Five-Year Plan period (FY07-12E), assigning an increase in infrastructure investments from 5.0% of the GDP to almost 9.0%+ by FY12E. However, the global financial crisis and liquidity crunch led to a slower GDP growth for India during FY09 to around 6.7%.
- The overall slowdown led to a slowdown in infrastructure spending in FY09, due to which GCF increase to GDP ratio came down from 6.9% in FY08 to around 5.3% in FY09.

Source: Planning Commission, MF Global India Research Estimates

Economic indicators suggest some relief



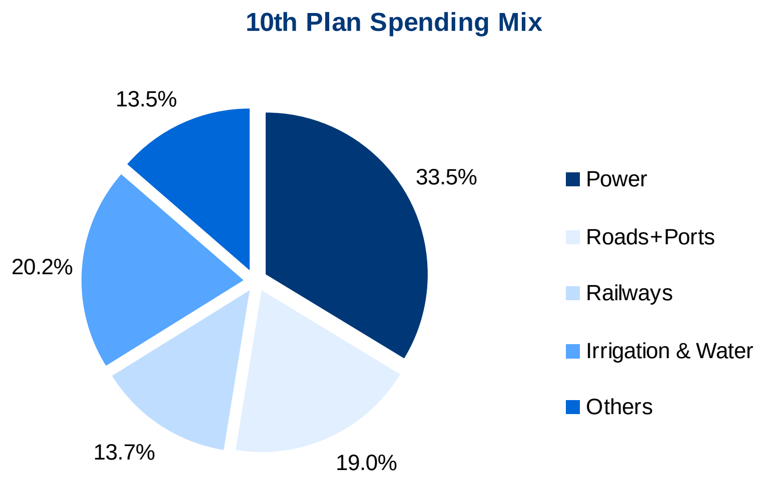


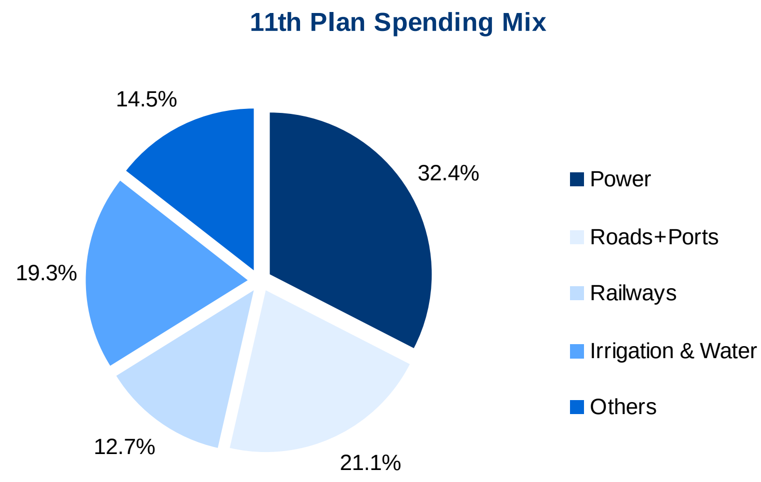
- **IIP & CG indexes show some recovery:** Both the IIP & CG indexes showed a sharp decline during 3QFY09, hit by a severe liquidity crunch that had an adverse impact on overall industrial demand.

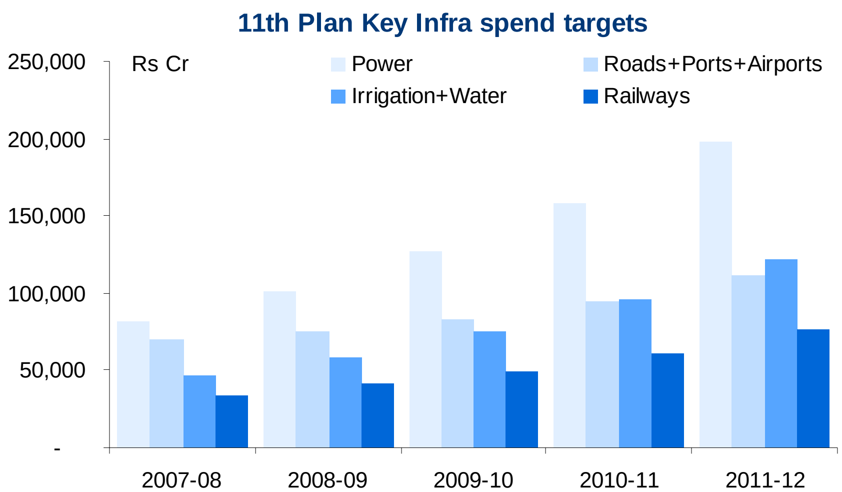
- **Companies faced tight liquidity during the second and third quarter of FY09:** Led by increasing PLRs by the banks, companies faced a situation of tight liquidity, due to non-availability of cheap funds. This resulted in an overall slowdown in the general spending levels of companies and individuals. With interest rates sort of stabilising, we do not see raising of debt as a key issue for sound companies in the engineering and capital goods space.

Source: RBI, MF Global India Research

11th Five-Year Plan-wise spending mix







- Power and roads account for ~50%+ of the total government infrastructure spending. Around 52% and 53% of the 10th and 11th Five-Year Plan spending, respectively, was planned for core infrastructure, like power and roads, which is still dominated by the public sector. However, we see the scenario changing from hereon and expect an increased participation by private sector players, especially in the 12th Five-Year Plan period.

Source: Planning Commission, MF Global India Research

11th Five-Year Plan-wise spending mix (contd…)

- Five-year Plans in India are mainly about government spending in the overall infrastructure space. Going by the 10th and 11th Five-Year Plan documents of the Planning Commission of India, you will notice that in the 10th Plan (FY02-07), the total government spending share was around 80%+, which in the 11th Plan is still substantially skewed at 70%+.

- This clearly indicates that the core infrastructure development and capex in India is all about government and government spending and we are yet to see some major capex by the private sector players in the core infrastructure space.

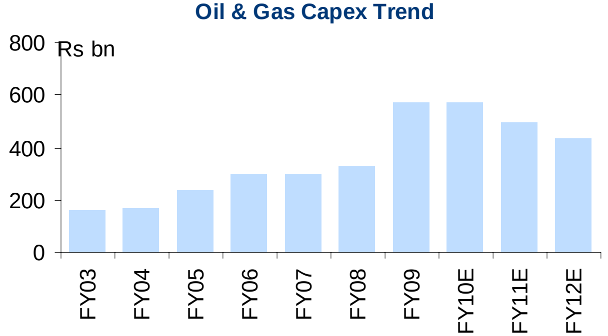
Share of Public sector capex in the 10th & 11th Five year plan

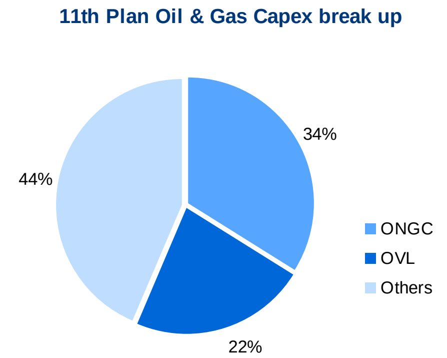
Rs billion	Actual 10th Plan	Planned 11th Plan
Power	2,919	6,665
Public spending %	*69%*	*72%*
Roads & Ports	1,657	4,331
Public spending %	*88%*	*58%*
Irrigation	1,763	3,970
Public spending %	*99%*	*99%*
Railways	1,197	2,618
Public spending %	*100%*	*81%*
Others	1,181	2,977
Public spending %	*50%*	*34%*
TOTAL	**8,716**	**20,562**
Public spending %	*80%*	*70%*

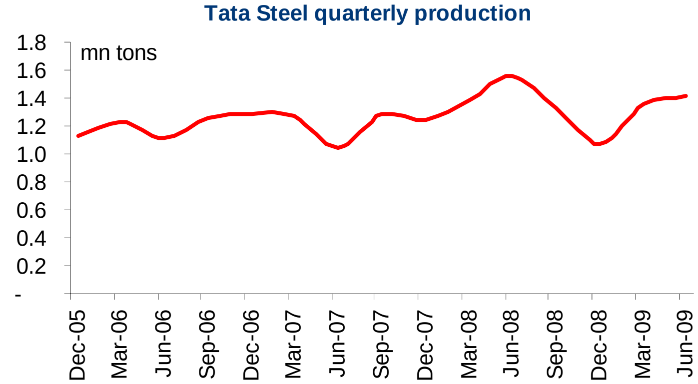
Source: Planning Commission, MF Global India Research,

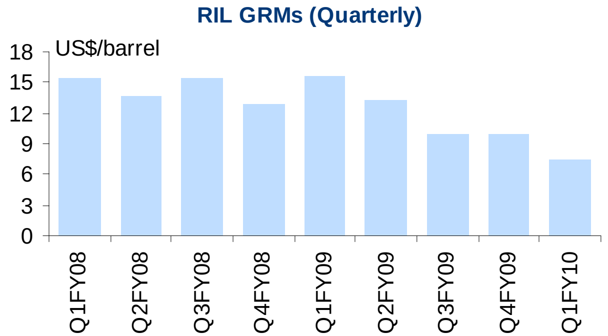
Oil & gas throw up decent opportunities, metals & mining yet to pick up

- **Oil & Gas**
  - Majority of the capex in the Oil & Gas space is covered by the downstream players (mainly ONGC). ONGC, including OVL, covers around 56%+ of the domestic capex. Pending FY09 orders to come in FY10E—ONGC had announced Rs 196bn+ of capex in FY09, of which it could incur around Rs 126bn+ only (Dec '08). We expect the remaining set of orders to be awarded in the near future, which would augur well for L&T, given its dominant market share in the ONGC's business.
  - Domestic Oil & Gas capex outlook promising—With imports still around 70%+ of the total Indian oil needs, the outlook for oil & gas capex appears promising. ONGC alone, had a planned capex of around Rs 800bn+ during the 11th Plan, of which it had incurred only Rs 303bn. Total pending order awards for FY10E (including FY09 slippages) for ONGC would be around Rs 279bn+.
- **Metals & Mining**
  - While most of the industry players believe that steel prices have bottomed out for now and demand in India has picked up, there is still time before we could hear major announcements (both greenfield and brownfield) from this space.







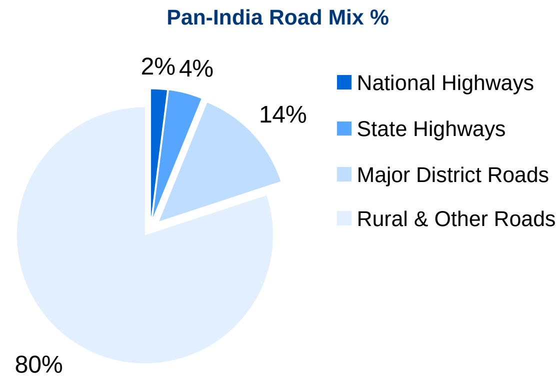


Source: Industry, MF Global India Research

MF Global

Huge PPP opportunity in Roads

	State	Length Km	TPC Rs Cr
Projects Awarded			
Pimpalgaon-Nasik-Gonde	Maharashtra	60	940
MP/Maharastra Border-Dhule	Maharasthra	97	835
Pune-Sholapur(Pkg-1)	Maharasthra	110	1110
Gujarat/MH Border-Surat-Hazira	Gujarat	133	1509
Cuddapah-Mydukur-Kurnool	Andhra Pradesh	188	1585
Vadakkancherry-Thrissur Section of NH-47	Kerala	30	617
Elevated Road from Chennai Port to maduravoyal	Tamil Nadu	19	1345
Kishangarh-Beawar	Rajasthan	94	795
Hyderabad-Vijayawada	Andhra Pradesh	181	1740
Armur-Adloor-Yellareddy Section of NH-7	Andhra Pradesh	60	491
Total Projects Awarded		**972**	**10967**
Pending for Award			
Hazaribagh-Ranchi	Jharkhand	71	625
Kannur-Kuttipuram(Pkg-1)	Kerala	83	1366
Kannur-Kuttipuram(Pkg-2)	Kerala	82	1312
Amristar-Pathankot	Punjab	102	705
Ghaziabad-Aligarh	UP	126	1141
Goa/KNT Border-Panji	Goa	65	471
Jaipur-Tonk-Deoli	Rajasthan	149	1184
Pune-Sholapur(Pkg-2)	Maharashtra	110	835
Talegaon-Amaravati	Maharashtra	67	567
Total Projects Pending for Award		**854**	**8206**



- India has huge scope in road development, with almost 80%+ of the current road infrastructure pertaining to rural roads. The country has long-term potential for development of National Highways & Expressways.
- While awards have been slow in the NHAI road projects, mainly due to weak private sector participation, NHAI is positive about increased private sector participation in the upcoming projects. The Model Concession agreement (MCA) has been changed to lure private bidders now.
- NHAI has more than 15000kms of road projects which are yet to be awarded under the NHDP programme. The total in CY09 is only 972kms worth of PPP-based awards and awards for 854kms of projects are expected in the next 2-3 months..

Source: NHAI, MF Global India Research

POWER SECTOR OUTLOOK

Power Generation Equipment Capacities Planned

Power generation equipment manufacturing capacities planned in India

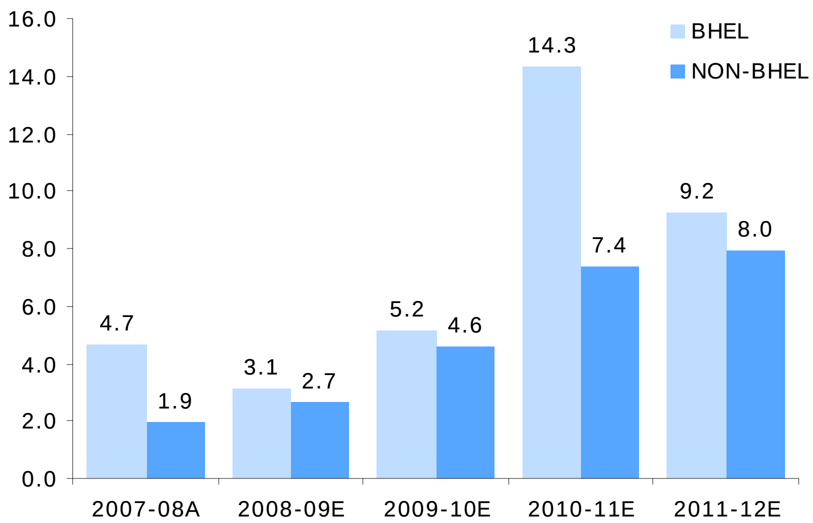
	2010	2011		Investment (Rs bn)	Remarks
BHEL	15,000	20,000	BTG	42	Upto 15,000 Mw entirely thermal
L&T- MHI	4,000	4000	Boilers & Turbines	15	51% stake by L&T
JSW-Toshiba	3,000	3,000	Turbine Generators	20	75% Toshiba,
Alstom Bharat Forge	NA	5,000	Turbine Generators	NA	51% Alstom,

- **BHEL:** Is currently undergoing a massive capex programme to increase its installed capacity by 5000Mw (50%) by January, 2010. This would entirely be done to increase thermal capacity, as the company had already added around 2500Mw in the hydro segment earlier.
- **L&T:** L&T might be looking at ~3000Mw of BTG orders per annum by FY11E. As we understand, the 4000Mw boiler plant at Hazira is expected to be commissioned by January '10 and the turbine manufacturing plant by June, 2010. While L&T has already started bagging orders, we expect this JV to attain a substantial order book by FY11E. As far as the impact on PAT is concerned, since the first few sets are to be imported, we expect L&T's bottom line to be positively impacted only after FY12E.
- **ALSTOM-Bharat Forge:** Alstom, SA, a global leader in the power generation equipment space (with 25% market share in core equipment) has announced a JV with Bharat Forge Ltd., to set up a 5000Mw turbine generator JV. The JV will start functioning with effect from 2010-11, with Alstom having the majority 51% stake.
- **JSW-Toshiba:** JSW has announced a 3,000Mw turbine generator JV with Toshiba (Japan), which is expected to be operational by Dec, '09. The company is currently in search of a technical partner for its boiler JV.

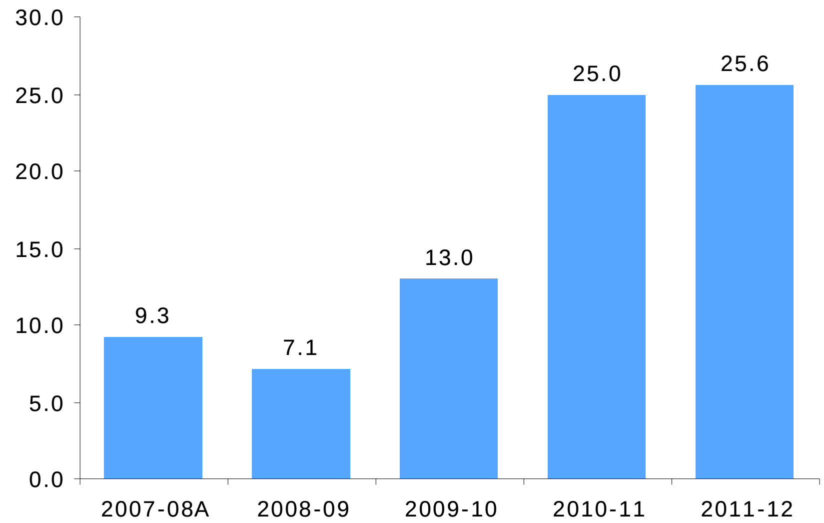
Source: Company, MF Global India Research

Power Generation Equipment Outlook

11th Plan likely capacity addition – Thermal (Gw)



11th plan year-wise plan (Gw)



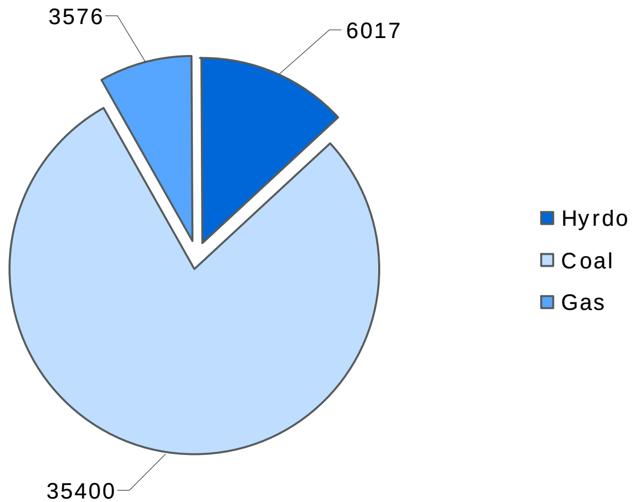
- **Just 11% progress was achieved in the first year in thermal sets:** India added just 6.6Gw of new thermal capacities during FY07-08, of which 4.7Gw (70%+), was done by BHEL. Total 11th Plan addition was at 9.3Gw during 2007-08. Also, in FY09, total capacity addition of just about 6Gw took place, of which just around 3Gw was contributed by BHEL.

- **More than 39Gw of new thermal capacities scheduled during 2011 and 2012:** Around 64%+ of the total 11th Five-Year Plan thermal addition has been targeted during the last two years. Of this, more than 23.5Gw would come from BHEL (~60%+). Slippages from one year to the other would essentially mean an additional burden on the already planned annual capacity addition (mentioned above).

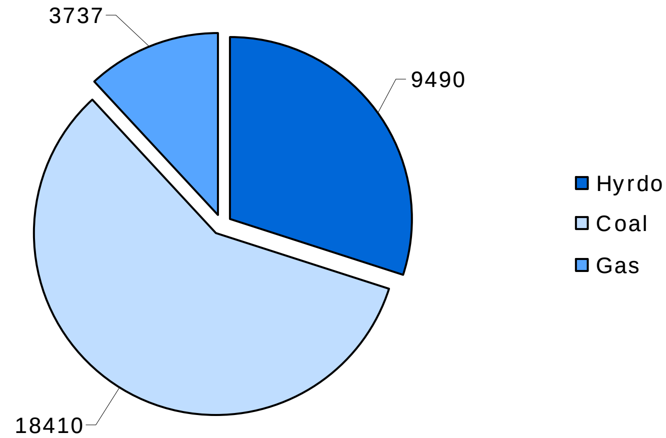
Source: CEA, MF Global India Research

BHEL dominates 11th Plan orders

BHEL's share in the 11th plan (mw)



Non-BHEL orders (mw)



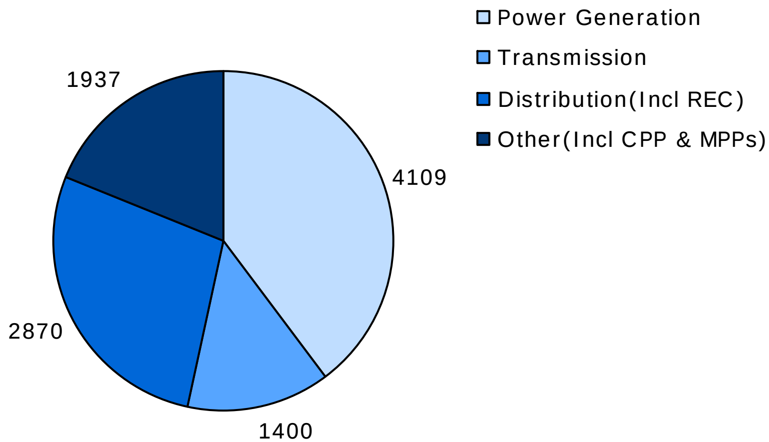
- 56% of the total 11th Plan orders (44.9Gw) and 66%+ of coal sets orders (35.4Gw) have been bagged by BHEL, thus maintaining its dominance in the domestic power generation equipment market.

- While we expect a gradual market share loss for BHEL, going forward, as more global companies enter the Indian power equipment market, we still believe that BHEL will be able to post a decent growth as the size of the absolute market pie would also increase substantially.

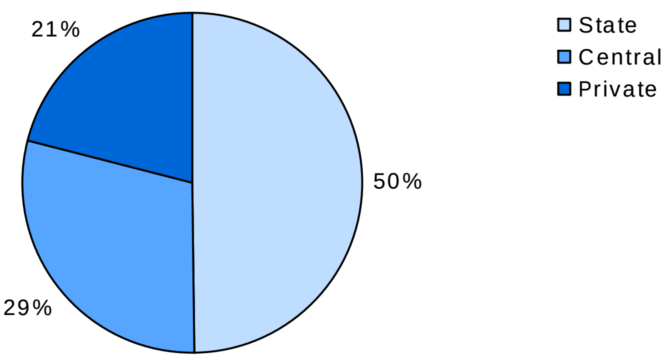
Source: CEA, MF Global India Research

Funding status for power projects

11th plan fund requirement (Rs bn)



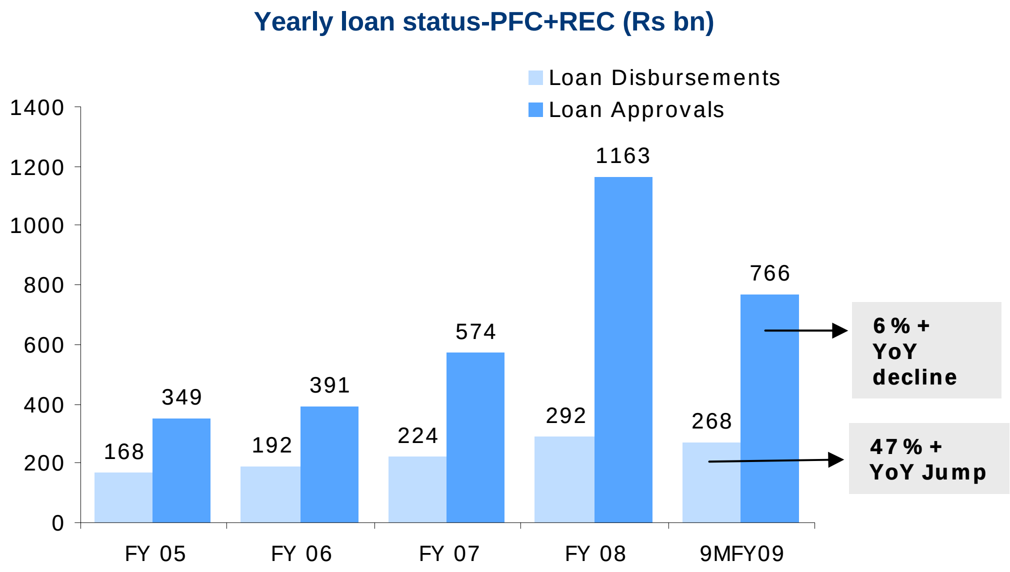
11th plan fund requirement

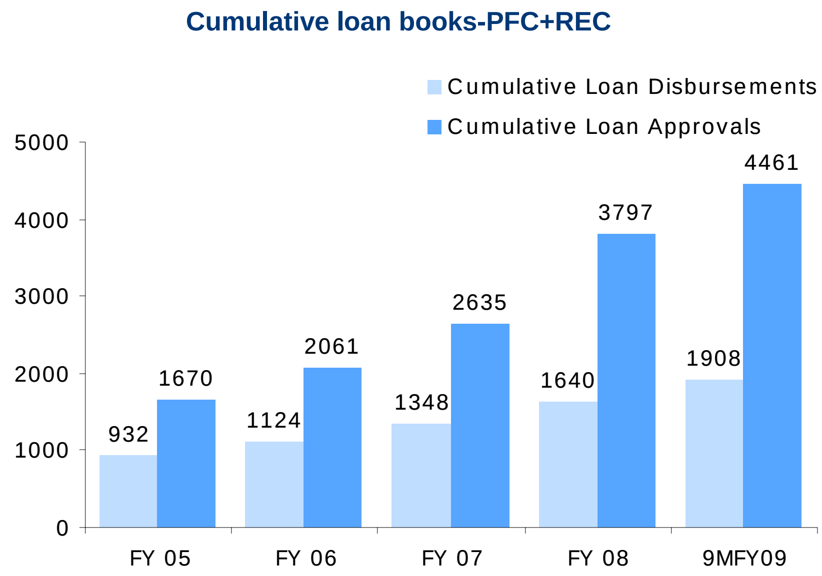


- Loan disbursements still appear to be healthy
  - The overall disbursements for the power sector still appear to be healthy. For 9MFY09, the collective disbursement for both PFC & REC taken together has grown by 47%+ yoy to Rs 268billion.
- New loan approvals see a marginal dip
  - After posting a sharp jump of 103%+ yoy during FY08, the overall loan approvals for both PFC & REC taken together, has seen a dip of around 6% yoy, during 9MFY09, which we feel was due to a very high growth posted in the previous year.

Source: Planning Commission, MF Global India Research

Funding status for power projects (contd.)





- While we do not rule out the possibility of a temporary slowdown in funding for the power sector, we are still convinced about the medium- to long-term healthy funding growth in the power sector and do not see any funding issues for the likes of NTPC, DVC, CSEB, etc. (which account for 40%+ of BHEL's current order book).

Source: PFC, REC, MF Global India Research

Companies Section

Larsen & Toubro – ***Improved Perception*** - Buy *(+23%)*

(CMP Rs 1519 / MCap US$ 18.7bn / Target Price Rs 1869)

BHEL – ***Execution in focus*** **-** Buy *(+10%)*

(CMP Rs 2343 / MCap US$ 24bn / Target Price Rs 2580)

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INITIATING COVERAGE

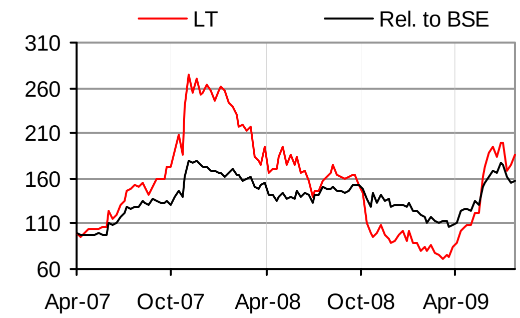
August 4, 2009

Larsen & Toubro (LT IN / LARTBO)

BUY

Improved Perception

CMP Rs 1519
Target Rs 1869 (+23%)



Company data	
O/S shares :	586mn
Market cap (Rs) :	891bn
Market cap (USD) :	18.7bn
52 - wk Hi/Lo (Rs) :	1800 / 557
Avg. daily vol. (3mth) :	3.8mn
Face Value (Rs) :	2

Share holding pattern, %	
FII / NRI :	16.2
FI / MF :	9.5
Non-Pro. Corp. Holdings :	4.3
Public & Others :	2.3

Y/E Mar, Rs bn	FY09	FY10E	FY11E
Net Sales	401.9	520.1	668.2
PAT	30.0	40.6	52.5
EBIDTA mrg, %	12.3	12.7	12.6
PAT mrg, %	7.5	7.8	7.9
ROE, %	23.0	25.3	26.3
EPS, Rs	50.9	68.8	89.1
PER, x	29.8	22.1	17.0

This note should be read for:
- *Investment rationale*
- *Company Overview & Valuations*

Executive summary

- Larsen & Toubro (L&T) is a proxy for the India infrastructure growth story. With its well-diversified dominance across sectors, L&T leaves open a huge medium to long-term value upside. While public sector capex has been the saving grace for Indian infrastructure companies, the next major value lever would come from overall industrial demand, which for a developing, domestic consumption-led economy like India cannot stay at current levels for long.

Key investment arguments

- **Execution to drive near-term earnings:** With the current order book of Rs 716.5bn (2x FY09 revenues), we expect L&T to post a PAT growth of 32% for FY10E and about 24% for FY11E, on a standalone basis. Major growth would come from the E&C segment (~85% of L&T's standalone revenues).
- **Captures the industrial recovery well:** While most industries have a cautious view, we believe that any major recovery in the industrial outlook, especially, metals, etc. would be hugely positive for L&T, as it would change our growth assumptions for the company. The current business is well supported by public sector capital expenditure and the market is looking forward to strong signals of industrial recovery and newer announcements in private sector capex.
- **L&T shifts gears through new ventures:** The MOUs signed by L&T with global players in the field of nuclear power, defense, electronics, etc. will have long-term potential positives for the company, while the power equipment venture with MHI will be positive in the medium term (the next two years).

Valuation

- We initiate coverage on L&T with a positive view, given its overall dominance in the domestic E&C space, improved business conditions in the last few months and a strong cushion from the public infrastructure spending. This, coupled with a long-term structural potential that India offers in the core infrastructure space, throws open huge business growth opportunities for a market leader like L&T. The company has been garnering repeat business from various large entities in both the public and private space, due to its impressive track record . We initiate coverage on L&T with a BUY rating and our SOTP-based price target of Rs 1869 (+23%).

Investment Overview

Sustainable competitive advantage	Diversified dominance across the core infrastructure space.
Financial structure	Standalone financial leverage at 0.5 and RoE at 25%.
Earnings visibility	Current OB at Rs 717bn (>2x sales) with a stable PAT margin outlook.
Valuation	Trading at a one-year forward PE of 25x (FY10E) and 20x (FY11E), standalone.
Future event triggers	Overall industrial recovery and increased spending announcements in the private and public sector.
Expected price momentum	We expect a price momentum of 23% over the next one year.

Valuation Summary

Y/E Mar, Rs mn	FY2007	FY2008	FY2009	FY2010E	FY2011E
Net Sales	203,360	291,985	401,869	520,053	668,180
Growth, %	23.9	43.6	37.6	29.4	28.5
EBIDTA	26,110	35,875	49,581	65,852	84,344
EBIDTA margins, %	12.8	12.3	12.3	12.7	12.6
Core EBIDTA	26,110	35,875	49,581	65,852	84,344
Net profit	17,792	23,254	30,003	40,575	52,523
Net profit margin, %	8.7	8.0	7.5	7.8	7.9
Net Profit (adjusted)	17,792	23,254	30,003	40,575	52,523
EPS, Rs	30.2	39.5	50.9	68.8	89.1
EPS Growth, %	42.6	30.7	29.0	35.2	29.4
PER, x	50.3	38.5	29.8	22.1	17.0
EV/EBIDTA, x	18.1	14.8	11.7	16.6	12.8
EV/Net Sales, x	2.3	1.8	1.4	2.1	1.6
Price/Book Value, x	11.9	7.6	6.2	5.1	4.0
ROIC, %	21.5	15.5	14.5	13.1	14.5
ROE, %	28.2	24.1	23.0	25.3	26.3
Dividend Yield, %	0.1	0.5	1.1	0.7	0.8

Source: Company, MF Global India Research Estimates

SWOT Analysis

SWOT

STRENGTH

- L&T is India's biggest E&C company, with diversified businesses across all major verticals.
- The company has a strong client reference base that helps it garner repeat business.
- L&T's business is well spread across public and private sector clients, which we see as an optimal business mix. While the public sector provides a strong cushion in the event of a slowdown, the private sector helps the company attain huge business growth in a recovery period.

WEAKNESS

- L&T has several verticals of business, some of which like oil & gas, metals, etc. have cyclical elements, thereby having a direct impact on L&T's business growth.

OPPORTUNIITES

- Huge scope for core infrastructure development throws open enormous opportunities for L&T.
- L&T looks forward to tap the huge potential in the India power generation equipment market, for which it had already tied up with MHI (JAPAN).
- L&T has taken several initiatives in the area of nuclear power, defense, electronics, etc. that would provide additional business visibility in the long term.

THREATS

- With improved outlook for infrastructure development, the number of players in competition with L&T in several verticals would only increase, which, in turn, could impact L&T's profitability growth.
- We see succession planning to be a key issue in the near term for L&T.

Sum-of-the-parts valuation for L&T

Sum-of-the-Parts (SOTP)

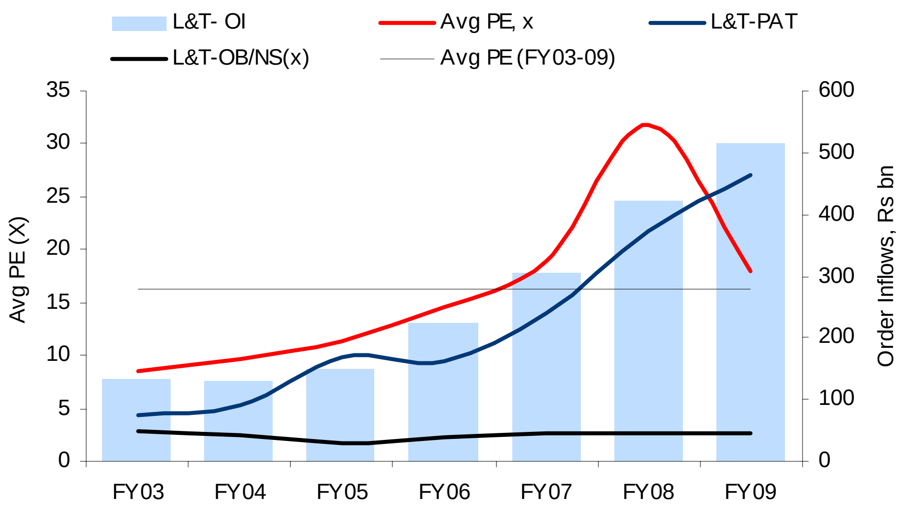
	Business	Valuation methodology	Multiple	L&T's stake	Value (Rs mn)	Per share (Rs)	Remark
L&T Parent	E&C, EBG, MIP	PE	23	100%	1017983	1727	20% premia on avg 1 Yr Fwd FY05-09 PE
L&T InfoTech	Teir-2 IT service vendor	PER	10	100%	24,598	42	35% discount over Infosys
L&T Finance	Equipment & Retail finance	P/BV	1	100%	9,233	16	1.0x Forward Book
L&T Infra Finance	Project financing	P/BV	1	100%	7,209	12	1.0x Forward Book
L&T IDPL	BOT projects holding co.	P/BV	1	78.4%	20,265	34	1.0x Forward Book
L&T UIL	Urban infrastructure	PE deal	NA	58.8%	1,788	3	20% discount to PE deal
L&T International subsidiaries							
L&T Oman		PER	10	65%	3,650	6	50% discount to L&T Standalone valuations
Key Associates							
Audco India		PER	10	50%	4,510	8	50% discount to L&T Standalone valuations
L&T Komatsu		PER	10	50%	7,566	13	50% discount to L&T Standalone valuations
L&T Case equipment		PER	10	50%	2,269	4	50% discount to L&T Standalone valuations
EWAC Alloys		PER	10	50%	1,515	3	50% discount to L&T Standalone valuations
Total					**990,154**	**1869**	

- **L&T valued at 20% premium to FY05-09 average PE:** Taking into account L&T's position in the Indian E&C space, there is a positive outlook for the core infrastructure development, going forward, and we factor in the near-term business potential that L&T offers, and assign a reasonable 15%+ premium to L&T on its last 4 years' average PE of 19.1x (1-year forward). The current business flow momentum shows encouraging signs with public spending having already provided a strong cushion to the current valuations.
- **L&T InfoTech:** Nimesh Mistry, MF Global India IT Analyst, expects tier II IT companies to remain under pricing pressure during FY10E and FY11E and expects these companies to post single-digit volume growth. Thus, we have modeled L&T Infotech for an 8% & 3% EPS decline during FY10E & FY11E, respectively.
- **Other key subsidiaries:** We have valued L&T Finance, L&T Infra Finance & L&T IDPL, at 1x book on FY11E basis. For L&T Oman, we have assigned a 50% discount to L&T's standalone valuations on FY11E basis. We have valued other associates, like Audco India, L&T Komatsu, LT Case & EWAC Alloys at 50% discount to L&T standalone P/E valuation on FY11E basis.

Source: MF Global India Research

Valuation and price target

PE, PAT & Business visibility Trends



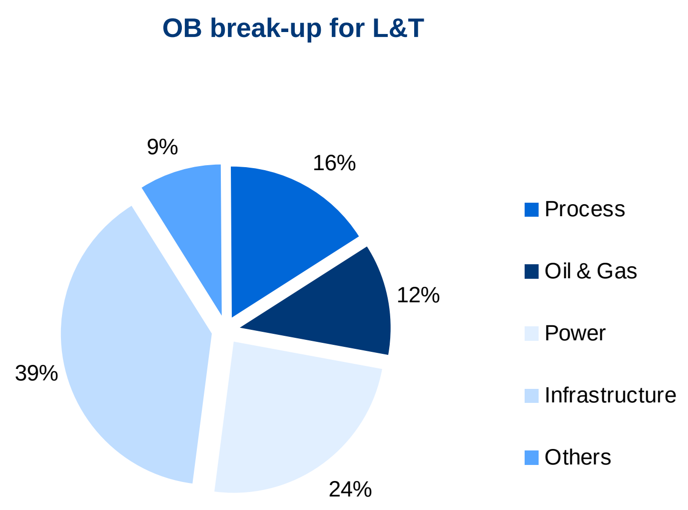
Return, %	L&T	SENSEX	BHEL
1 Month	-7	4	2
3 Month	71	39	40
6 Month	**123**	66	61
1 Year	10	7	36
YTD	82	55	60
5 Yr	674	202	772
10 Yr	1735	233	1650

- **Strong outperformance by L&T in the last 6 months:** After the Satyam overhang, L&T has seen a sharp recovery, clearly outperforming the BSE SENSEX. With a 6-month return of 123%+, L&T almost gave a double return over SENSEX return (BSE SENSEX gave a 61% return in the last 6 months).

- **We value L&T at a 20% premia to its average PE during FY05-09:** L&T commanded an average yearly high valuation during FY08 with a PE of 32x (1-Yr forward), essentially driven by a robust infrastructure spending outlook with a GDP growth of 9%+. We assign a 20%+ premium to L&T's average FY05-09 PE and see it as a more appropriate base to value the stock. While public spending would continue to provide a strong cushion to current valuations, we see a gradual recovery in the private sector industrial capex and we expect things to pan out positively over the next 3-5 quarters. Also, L&T's increasing focus in the defense and power segments (including nuclear) would augur well as a long-term strong valuation lever, leading to a substantial rerating of L&T.

Source: MF Global India Research

L&T has a well-diversified portfolio of infrastructure projects



- L&T executes infrastructure projects across all major verticals, like power, roads, hydrocarbons, process plants, metals and mining space, railways, etc. The company commands a huge client reference base across the public and private sectors.
- We expect the long-term business mix of L&T to see a substantial change over the next 3-5 years, with its entry into several other verticals like defense (both electronics and ship building) and power generation equipment. We particularly expect L&T to be a substantial player in the BTG market by 2012.

KEY BUSINESS VERTICALS

Infrastructure
- ✓ Roads & Bridges
- ✓ Ports & Harbours
- ✓ Airports
- ✓ Railways
- ✓ Buildings & Factories
- ✓ Urban Infra
- ✓ Water

Power
- ✓ Generation
- ✓ Equipments
- ✓ Electrification/Transmission & Distribution

Hydrocarbons
- ✓ Upstream
- ✓ Mid & Downstream
- ✓ Pipelines
- ✓ Valves

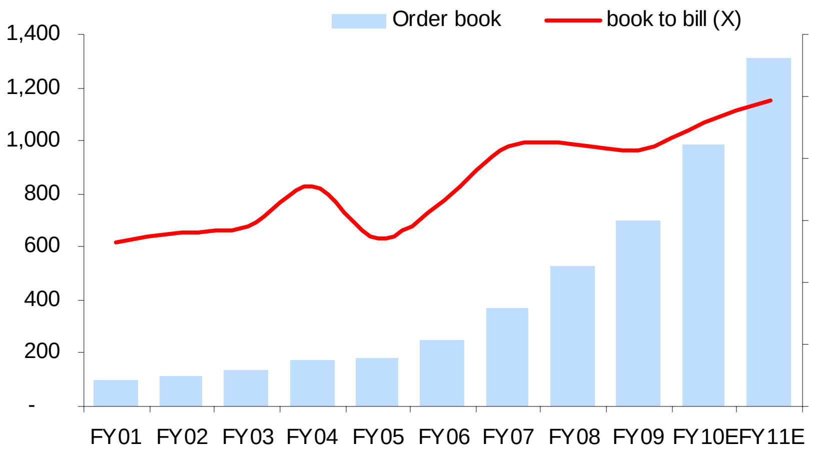
Process
- ✓ Minerals & Metals
- ✓ Bulk Material Handling
- ✓ Fertilisers

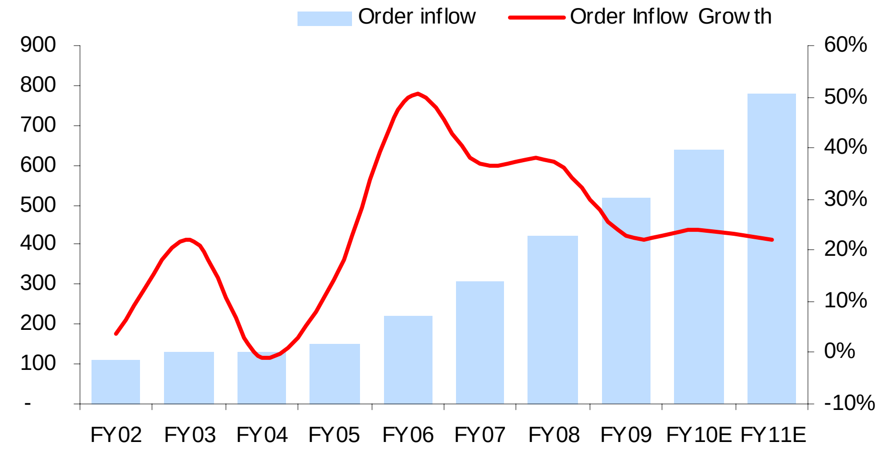
Others
- ✓ Shipbuilding
- ✓ Defense & Aerospace
- ✓ Construction & Mining Eqpt.
- ✓ Electrical & Electronic Products
- ✓ Technology Services

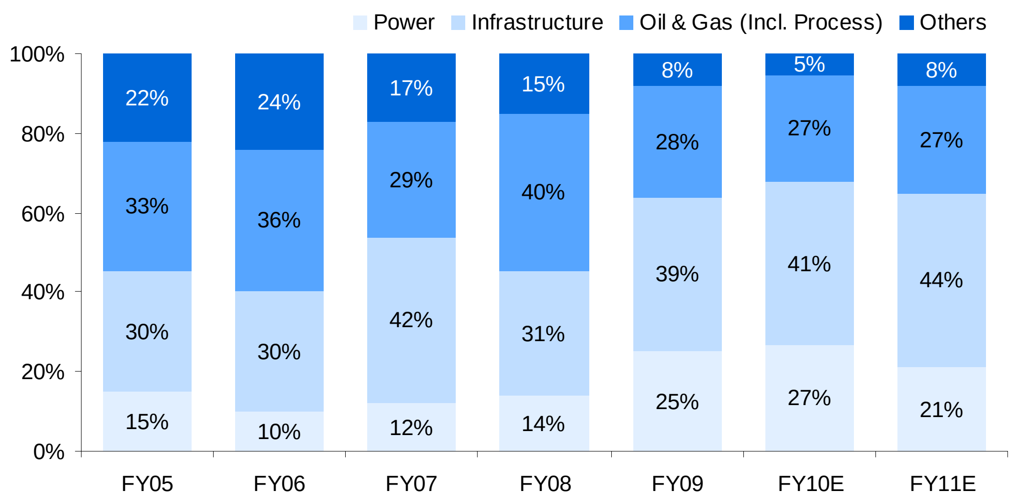
Source: Company, MF Global India Research

Order book and order inflow trend for L&T

Order book and inflow trend for LT







Source: Company, MF Global India Research Estimates

Order book and order inflow trend for L&T (Contd.)

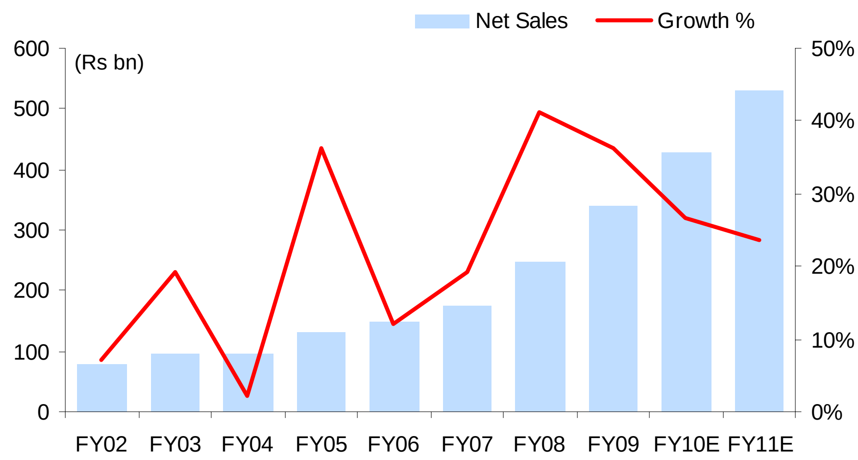
- FY01-09 order inflow CAGR at 22%+. Riding the wave of strong economic activity, L&T bagged decent business growth (particularly during FY06-08). This growth was driven by activities across sectors, which is reflected in a strong GDP growth during FY06-08 of ~9%.

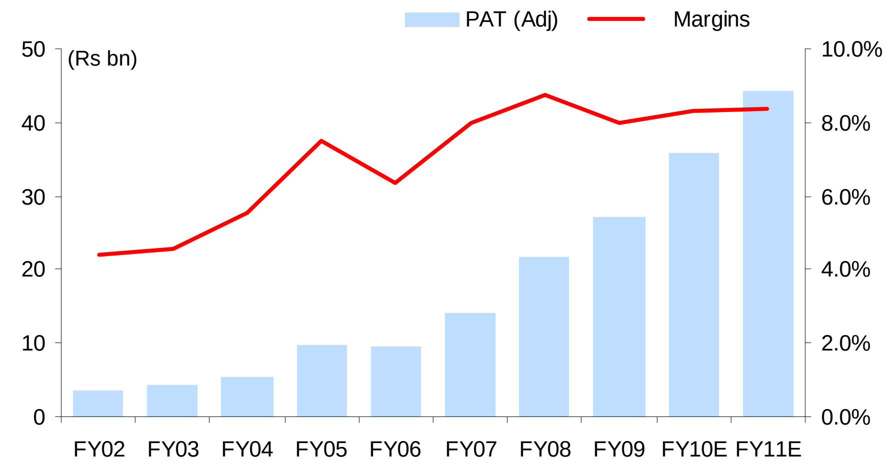
- We expect FY09-11E order inflow CAGR at 23%+. We have modeled L&T for a 23%+ order inflow CAGR over FY09-11E, led by a healthy growth in infrastructure, power, oil & gas sectors. We have taken into consideration L&T's market share during the 10th Plan and the overall market share during FY08 and FY09 in different sectors to arrive at our expected order share for L&T. We have not factored any growth from the metals and mining space for L&T while arriving at our process sector order inflows, which mainly comes from Oil and gas and other chemicals space.

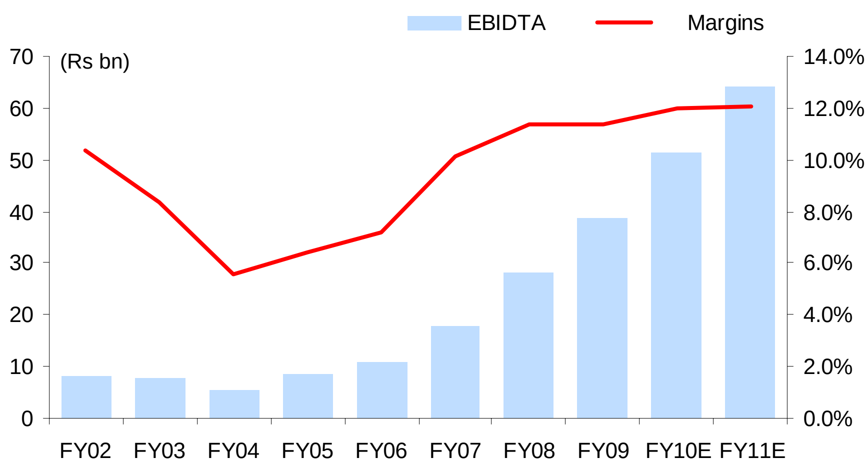
Order Inflow Gr %	FY06	FY07	FY08	FY09	FY10E	FY11E
Power	-	64%	60%	119%	32%	42%
Infrastructure	50%	92%	1%	54%	31%	25%
Oil & Gas (Incl. Process)	63%	10%	89%	-14%	18%	-2%
Others	63%	-3%	21%	-35%	-15%	20%
Order Inflow Growth	50%	37%	37%	23%	24%	22%

Source: Company, MF Global India Research Estimates

Healthy execution and inflows to drive core bottom line





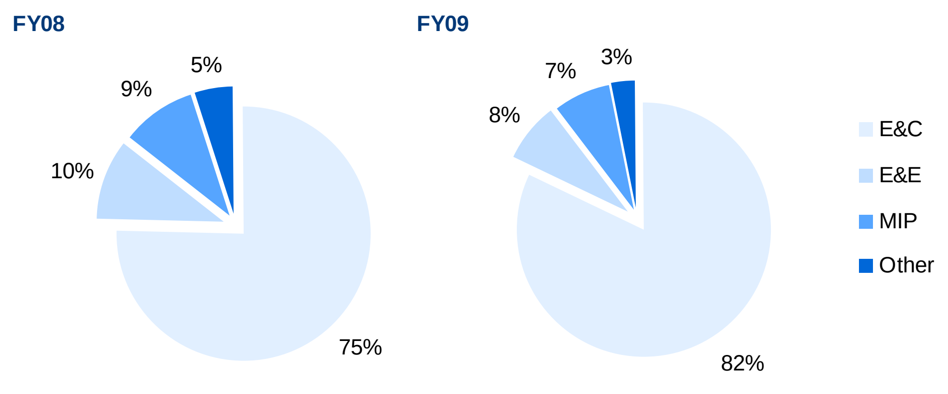


- **Strong 34%+ CAGR in profits over FY02-09:** L&T has shown a strong revenue growth of 23%+ over FY02-09 (CAGR), which was essentially driven by robust order inflows during the same period. PAT growth for the company was even higher at 34%+ (FY02-09, CAGR), due to a decent improvement in PAT margins, which doubled to 8%+ over FY02-09.
- **Execution to drive FY09-11E earnings growth:** We expect L&T to report a PAT CAGR of 28%+ over FY09-11E, mainly driven by a healthy project execution, current OB and order inflow growth during the same period.

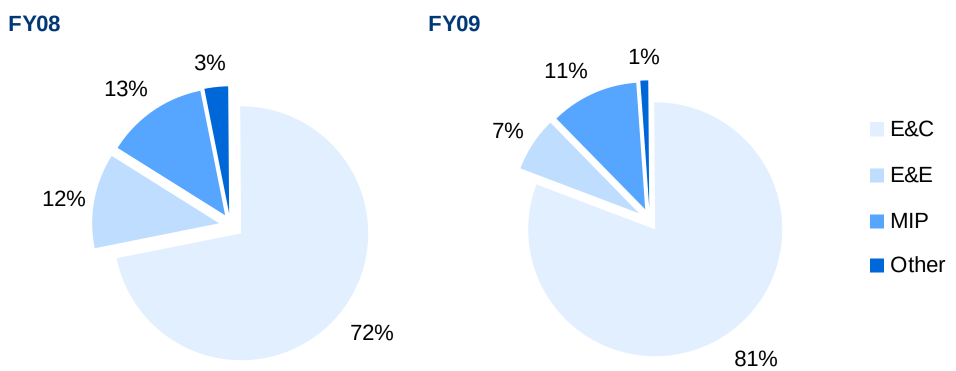
Source: Company, MF Global India Research Estimates

Segmental Performance

Revenue break-up



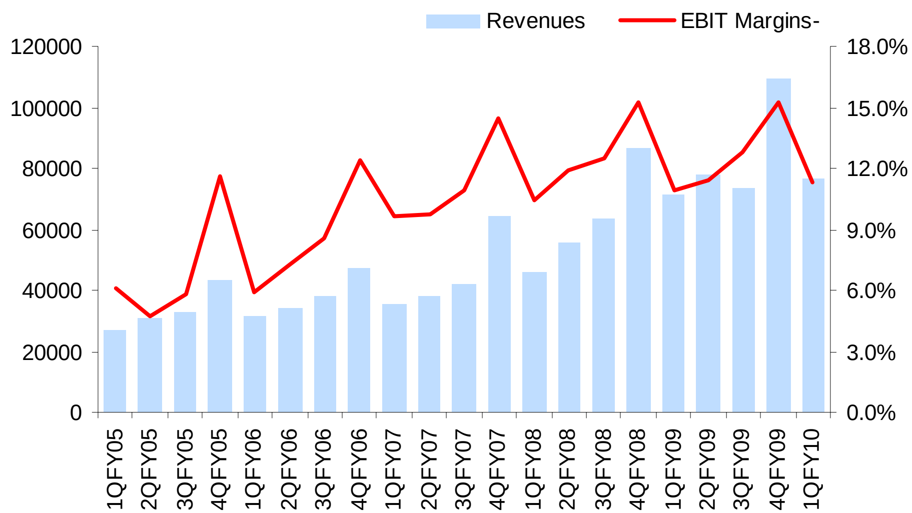
EBIT break up

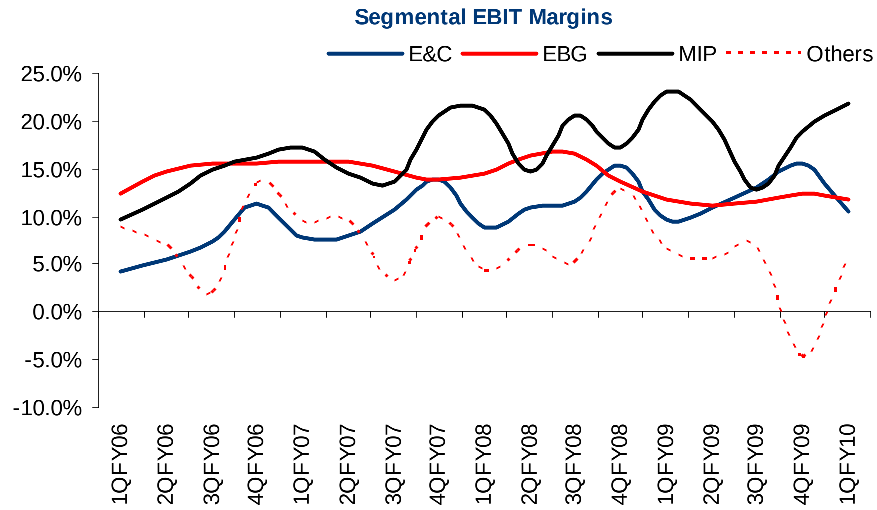


- **E&C division:** Core division for L&T, E&C division maintained its healthy growth rate with an execution (revenues) growth of 47%+ during FY09 contributing more than 82%+ of the total standalone sales for L&T. The E&C division's rising share (from 75% in FY08 to 82%+ in FY09) was mainly due to weak performance in the E&E & MIP divisions.
- **E&E division:** The division was under intense pressure during FY09, with a moderate revenue growth of 4%+ and a sharp 21%+ decline in EBIT, which was mainly due to lower utilisation levels and competition. We have assumed a growth rate of 15% for the E&E division for FY10.
- **MIP-Revenue growth during FY09:** Was moderate with a mere 2% yoy. EBIT grew higher by 8%+, which was mainly due to rupee depreciation, as L&T derived increasing MIP revenues from the exports market (exports in the MIP division were at 24%+ in FY09 against ~20% in FY08). We have assumed a flattish growth for this division in FY10E.
- **Others:** With the divestment of RMC business, this segment's share in total sales has come down to 3% in FY09.

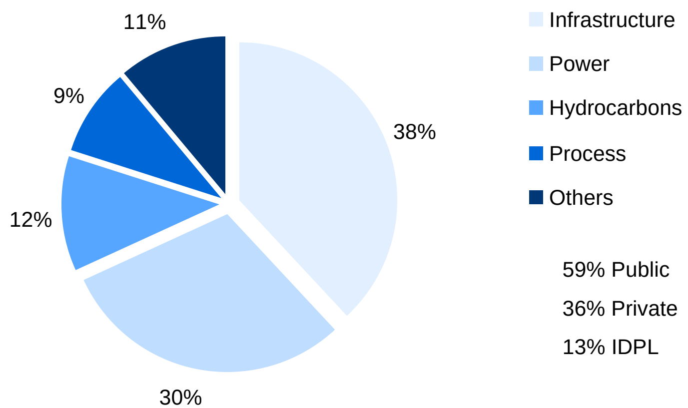
Source: L&T, MF Global India Research

Latest order book mix and quarterly profit trend





Order Inflow break-up (Jun '09)

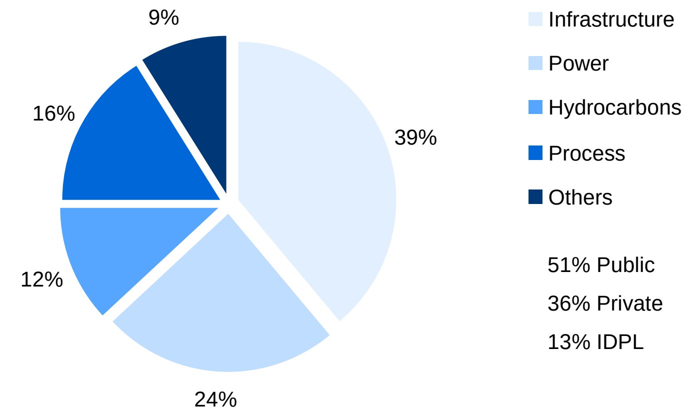


59% Public

36% Private

13% IDPL

Order Book break-up (Jun '09)



51% Public

36% Private

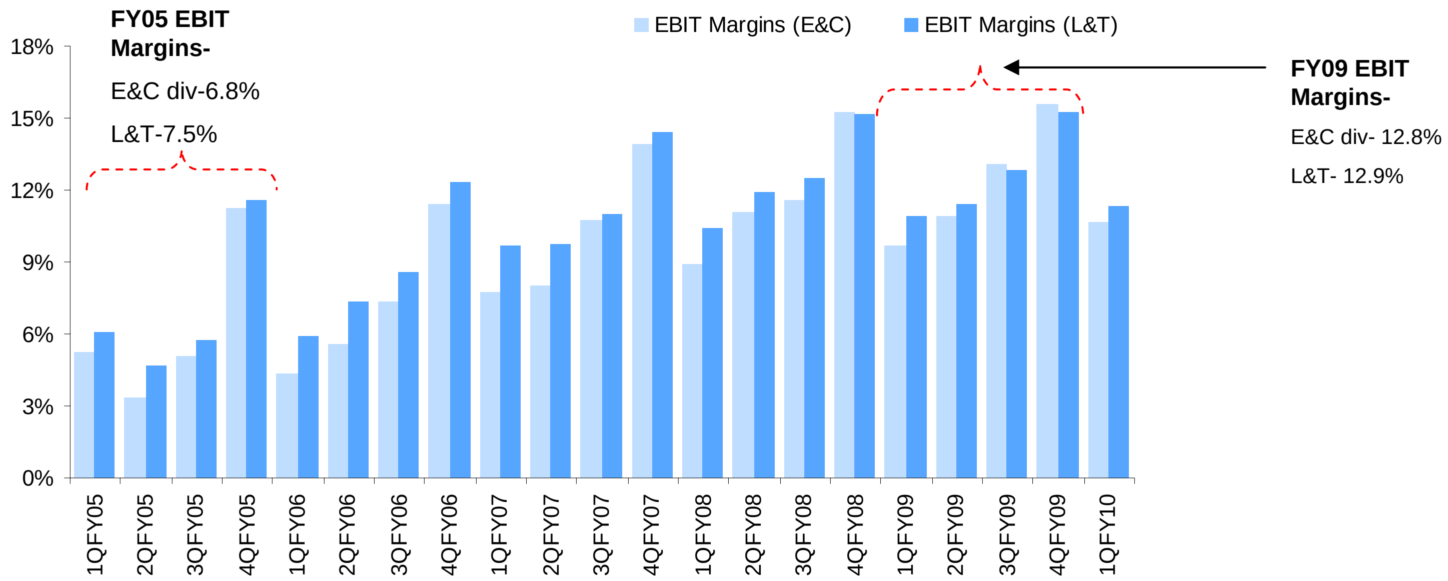
13% IDPL

Source: Company, MF Global India Research

Change in business mix to be margin-accretive for L&T

- **L&T has seen strong margin improvement in the last four years:** Led by a strong performance in E&C & MIP divisions (92% of L&T's EBIT), L&T has seen a healthy 540bps improvement in overall EBIT margins from 7.5% in FY05 to 12.9% levels in FY09. We are further positive about the margins for L&T, given its focus in areas, like power generation equipment and defense, which we strongly believe could augur well for the company.

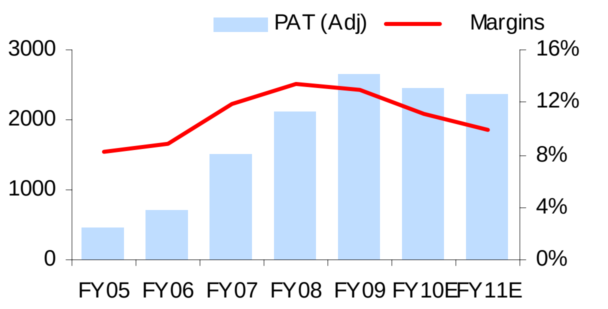
- We believe that L&T's overall business margins would further improve over the next 4-5 years, given a change in its revenue mix, which is expected to improve on the back of increased power revenues (mainly, BTG revenues), which despite competition, could lead to an overall improved EBIT margins for L&T from current levels.



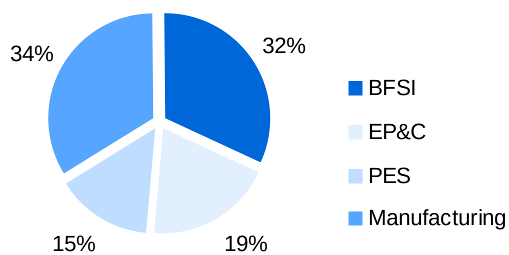
Source: Company, MF Global India Research

Key Subsidiaries

L&T Infotech

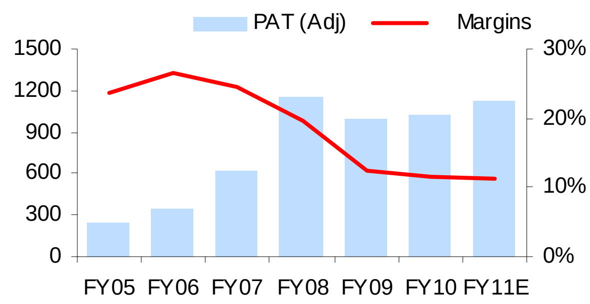


Business Mix- L&T Infotech



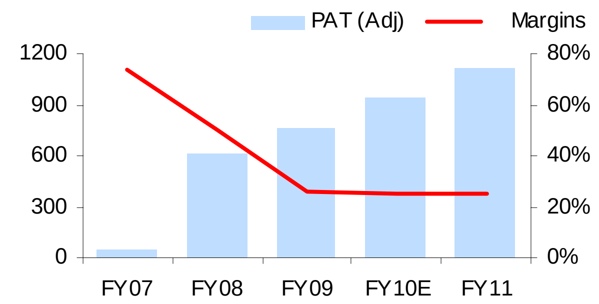
- A tier II IT services company, L&T Infotech, with more than 10,000 employees, provides both onsite and offsite services, with offices located in US, India, Canada, Denmark, France, UK, Japan, Germany, etc.
- L&T Infotech posted a decent 36% consolidated PAT jump during FY09, led by improved capacity utilisation levels and rupee depreciation (16%+, YoY).
- We have assumed a de-growth of about 8% in FY10E PAT for L&T Infotech on account of subdued volume growth and pressure on billing rates.

L&T Finance



- L&T Finance intends to tap money through the bond market over the next 15-18 months, to expand its operations to the insurance and AMC business.
- It caters to the small and medium enterprises in equipment finance, tractor and farm equipment financing, construction equipment and micro finance, etc.
- L&T Finance had a weak FY09 with PAT decline of 15%+, due to higher interest cost and lower volumes.
- We expect a moderate 3-10% growth in earnings for the next two years, taking a conservative approach.

L&T Infra Finance



- Started in FY07, it is engaged in vanilla term loans, subordinate debt, quasi equity and non-fund based support.
- L&T Infra Finance posted a sharp revenue jump of 140%+ during FY09, however, due to cost pressures, PAT was up only 40%+.
- We expect a decent 19-24% jump in FY10E and FY11 earnings for the company.

Source: Company, MF Global India Research

L&T to focus on scaleable long-term businesses

- L&T exited from the following businesses:
  - Sale of dairy and milk process equipment plant (FY06).
  - Sale of its 48% JV share in L&T-John Deere Pvt. Ltd. (FY06).
  - Sale of glass container business (FY06).
  - Sale of the tractors division (L&T-John Deere) (FY06).
  - Sale of RMC business (FY09).

- Other non-core businesses currently under L&T operations:
  - Petrol dispensing pumps and systems (under the E&E division).
  - Medical devices and equipments (under the E&E division).

- MOUs with global players in nuclear power and defense solutions:
  - Westinghouse Electricity Company (US).
  - Atomic Energy of Canada (Canada).
  - Atomstroyexport (Russia).
  - GE Hitachi Nuclear Energy (US).
  - JV with EADS for Defense Electronics.
  - Development of shipyard cum port for Defense vessels in Chennai.

L&T IDPL Portfolio

- **Roads & Bridges:** After exiting two projects, L&T has around 14 projects under its road and bridges portfolio now. Total investments made in these projects would be around Rs 115bn+ and total development proposed would be around 4824kms. The company further awaits bidding for several NHAI projects during FY10E.

- **Ports:** L&T has exited one of the projects and now has four port development projects under its ambit. The total capacity of these ports post development would be around 43mn TPA and the total outlay for L&T would be around Rs 37.7bn+.

- **Urban Infrastructure:** With a total expected development of around 44mn sq.ft., L&T's total outlay would be around Rs 123.7bn. L&T has several large projects in this segment. After exiting one of the projects, L&T now has around 22 projects in this segment.

- **Power, Airports, etc.:** L&T has three projects in this segment to be developed, with a total outlay of Rs 40.6bn+.

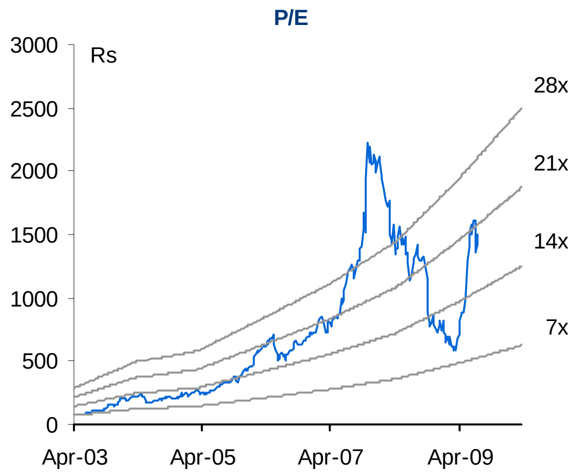
Current infrastructure development portfolio

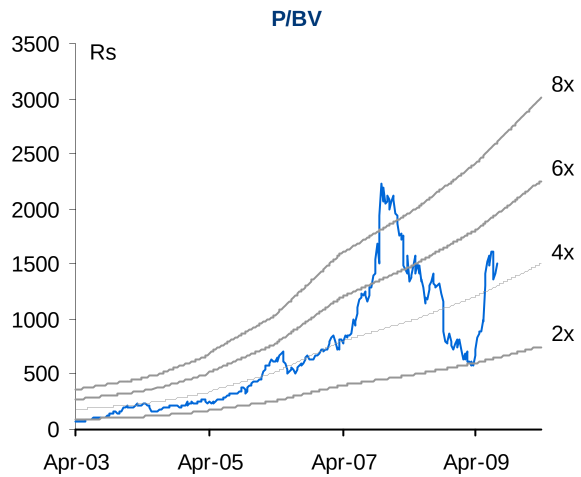
	Roads & Bridges	Ports	Urban Infra	A'port, Water supply etc
Operational	7	1	8	2
Under development	7	3	14	1
TOTAL	**14**	**4**	**22**	**3**

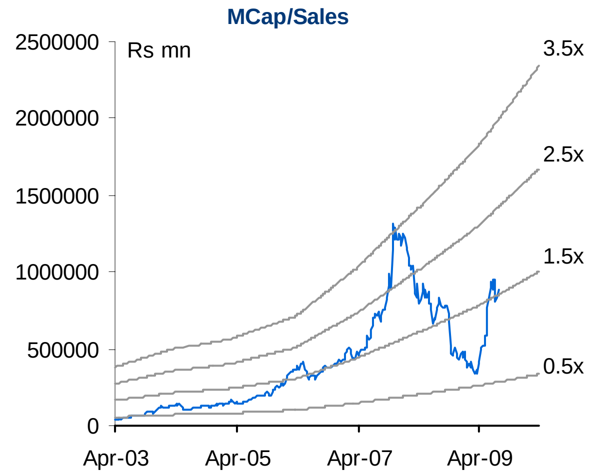
Source: Company, MF Global India Research

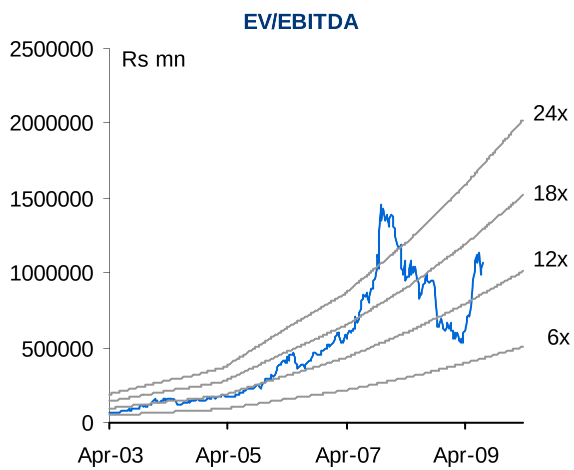
MF Global

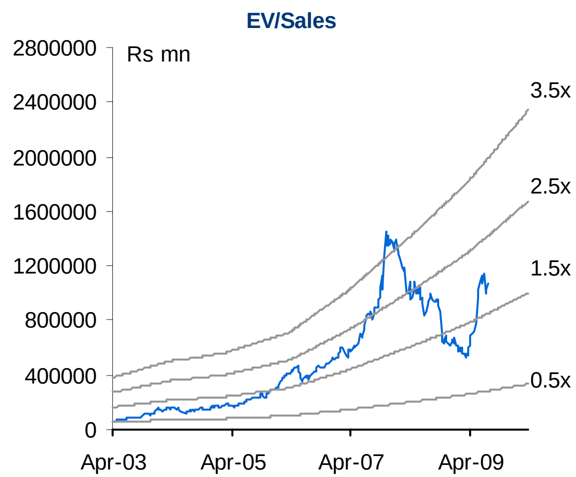
Absolute rolling valuation band charts









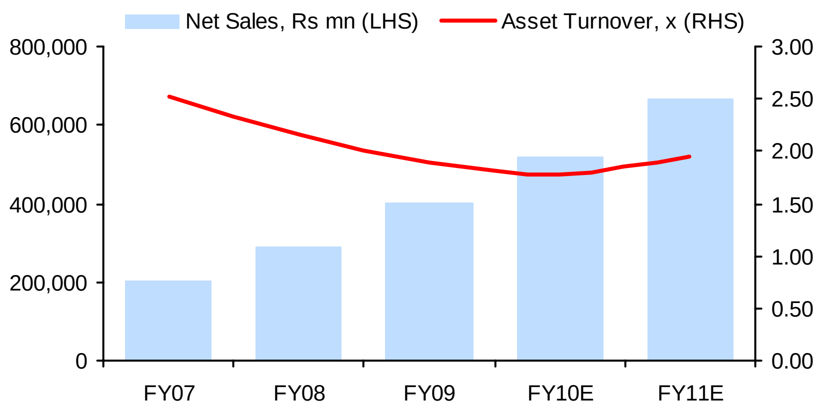


- While L&T has significantly outperformed both the BSE SENSEX & BSE Capital Goods index in the last six months, we expect the stock to maintain the outperformance, given the favourable dynamics in the E&C space in India.

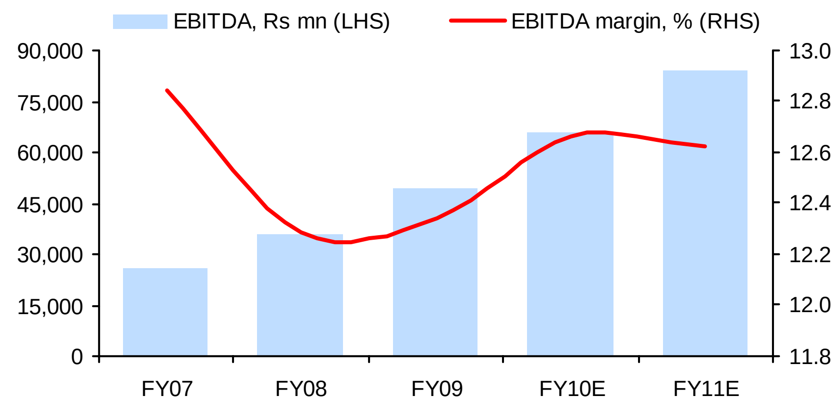
Source: MF Global India Research

MF Global

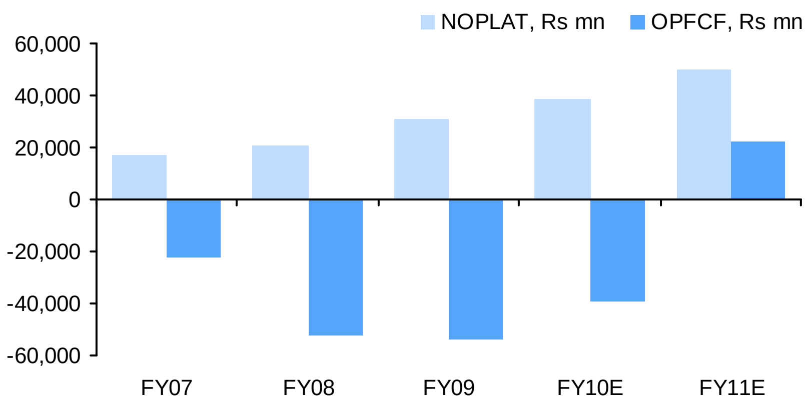
Financial Performance



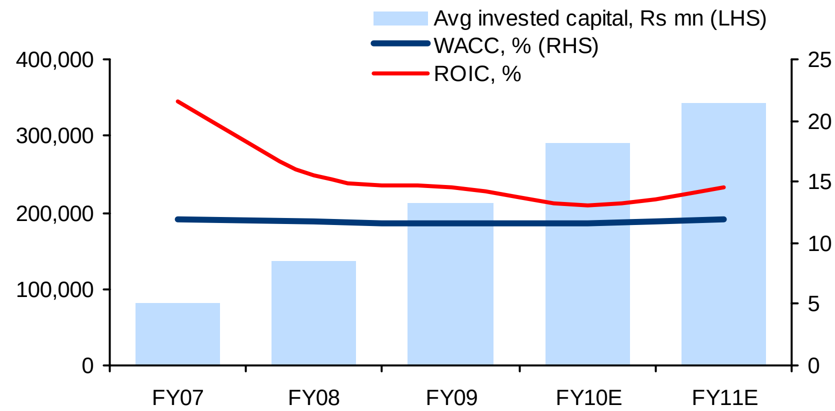
- Significant increase assumed in invested capital leads to a lower assets turn during FY10E.



- We have a positive outlook for L&T's overall business margins.



- Assumed a favourable scenario in cash flows in FY11E.



- RoIC slated to improve in FY11E on better EBIT growth..

Source: Company, MF Global India Research Estimates

Financials

Income Statement

Y/E Mar, Rs mn	FY07	FY08	FY09	FY10E	FY11E
Net sales	**203,360**	**291,985**	**401,869**	**520,053**	**668,180**
Growth, %	*24*	*44*	*38*	*29*	*28*
Other income	1,768	1,519	2,929	3,075	2,921
Total income	205,129	293,504	404,798	523,128	671,102
Operating expenses	-179,019	-257,629	-355,217	-457,277	-586,757
EBITDA (Core)	**26,110**	**35,875**	**49,581**	**65,852**	**84,344**
Growth, %	*65.1*	*37.4*	*38.2*	*32.8*	*28.1*
Margin, %	*12.8*	*12.3*	*12.3*	*12.7*	*12.6*
Depreciation	-3,427	-5,004	-7,279	-9,878	-11,238
EBIT	**22,683**	**30,872**	**42,302**	**55,974**	**73,107**
Growth, %	*69.4*	*36.1*	*37.0*	*32.3*	*30.6*
Margin, %	*11.2*	*10.6*	*10.5*	*10.8*	*10.9*
Interest paid	-1,584	-2,031	-4,620	-6,066	-5,994
Other Non-Operating Income	4,328	5,325	5,754	8,346	8,819
Non-recurring Items	4,610	0	7,891	0	0
Pre-tax profit	**30,890**	**35,408**	**51,836**	**59,938**	**77,674**
Tax provided	-7,327	-11,471	-14,257	-19,117	-24,918
Net Profit	**22,401**	**23,254**	**37,893**	**40,575**	**52,523**
MF Net profit	**17,792**	**23,254**	**30,003**	**40,575**	**52,523**
Growth, %	*42.6*	*30.7*	*29.0*	*35.2*	*29.4*
Unadj. shares (m)	279	288	585	589	589
Wtd avg shares (m)	589	589	589	589	589

Balance Sheet

Y/E Mar, Rs mn	FY07	FY08	FY09	FY10E	FY11E
Cash & bank	17,180	15,608	16,419	7,807	12,603
Debtors	61,104	82,344	127,942	173,053	203,815
Inventory	36,780	50,190	60,714	96,942	105,308
Loans & advances	51,727	108,356	155,756	201,895	250,137
Other current assets	343	386	386	386	386
Total current assets	167,133	256,883	361,217	480,083	572,250
Investments	24,783	55,523	46,567	44,884	52,845
Gross fixed assets	61,143	78,737	128,874	144,874	161,374
Less: Depreciation	-21,299	-24,034	-31,841	-41,719	-52,957
Net fixed assets	54,400	85,235	97,034	103,156	108,418
Total assets	**247,989**	**399,694**	**506,871**	**630,176**	**735,566**
Current liabilities	105,418	156,012	188,688	246,173	313,269
Total current liabilities	105,418	156,012	188,688	246,173	313,269
Non-current liabilities	67,069	126,430	174,406	206,935	200,687
Total liabilities	172,487	282,442	363,094	453,108	513,956
Paid-up capital	567	585	1,171	1,171	1,171
Reserves & surplus	68,649	107,726	133,980	167,025	211,335
Shareholders' equity	75,502	117,252	143,777	177,068	221,610
Total equity & liabilities	**247,989**	**399,694**	**506,871**	**630,176**	**735,566**

Source: Company, MF Global India Research Estimates

Financials

Cash Flow

Y/E Mar, Rs mn	FY07	FY08	FY09	FY10E	FY11E
Pre-tax profit	30,890	35,408	51,836	59,938	77,674
Depreciation	3,427	5,004	7,279	9,878	11,238
Chg in working capital	-12,461	-40,729	-70,847	-69,993	-20,275
Total tax paid	-7,521	-11,328	-13,513	-19,117	-24,918
Other operating activities	8,908	-747	3,182	1,451	719
CF from operating activities	**23,244**	**-12,392**	**-22,063**	**-17,843**	**44,437**
Capital expenditure	-28,092	-35,838	-19,078	-16,000	-16,500
Chg in investments	-8,026	-30,740	8,955	1,684	-7,961
Other investing activities	9,654	-796	1,163	994	1,270
CF from investing activities	**-25,625**	**-66,153**	**-8,450**	**-11,638**	**-21,449**
Free cash flow	-2,381	-78,545	-30,514	-29,481	22,988
Equity raised/(repaid)	361	-96	586	0	0
Debt raised/(repaid)	29,335	58,838	47,232	32,529	-6,248
Dividend (incl. tax)	-1,100	-5,148	-11,640	-7,530	-8,213
Other financing activities	-21,425	21,293	-4,854	-4,130	-3,732
CF from financing activities	**11,401**	**76,973**	**31,324**	**20,869**	**-18,193**
Net chg in cash	9,020	-1,572	811	-8,612	4,795

Per-share data

Y/E Mar, Rs mn	FY07	FY08	FY09	FY10E	FY11E
MF EPS (INR)	30.2	39.5	50.9	68.8	89.1
Growth, %	*42.6*	*30.7*	*29.0*	*35.2*	*29.4*
Book NAV/share (INR)	128.1	198.9	243.9	300.4	376.0
FDEPS (INR)	30.2	39.5	50.9	68.8	89.1
CEPS (INR)	28.2	47.9	49.9	85.6	108.2
CFPS (INR)	15.5	(30.9)	(53.5)	(49.8)	56.3
DPS (INR)	1.0	7.4	16.9	10.9	11.9

Ratios

Y/E Mar	FY07	FY08	FY09	FY10E	FY11E
Return on assets (%)	12.2	8.0	9.3	8.2	8.6
Return on equity (%)	28.2	24.1	23.0	25.3	26.3
Return on Invested capital (%)	21.5	15.5	14.5	13.1	14.5
RoIC/Cost of capital (x)	1.8	1.3	1.2	1.1	1.2
RoIC - Cost of capital (%)	9.6	3.8	2.9	1.5	2.7
Return on capital employed (%)	21.8	13.4	15.0	13.3	14.6
Cost of capital (%)	11.9	11.7	11.6	11.6	11.9
RoCE - Cost of capital (%)	9.9	1.7	3.4	1.7	2.7
Total debt/Equity (%)	85.2	105.0	118.5	114.6	88.7
Net debt/Equity (%)	62.4	91.7	107.1	110.2	83.1
Asset turnover (x)	2.5	2.2	1.9	1.8	2.0
Sales/Total assets (x)	1.0	0.9	0.9	0.9	1.0
Sales/Net FA (x)	4.8	4.2	4.4	5.2	6.3
Working capital/Sales (x)	0.2	0.3	0.4	0.4	0.4
Receivable days	109.7	102.9	116.2	121.5	111.3
Inventory days	66.0	62.7	55.1	68.0	57.5
Payable days	93.8	98.0	90.0	85.0	90.0
Current ratio (x)	1.6	1.6	1.9	2.0	1.8
Quick ratio (x)	1.2	1.3	1.6	1.6	1.5
Interest cover (x)	14.3	15.2	9.2	9.2	12.2
Dividend cover (x)	31.4	5.3	3.0	6.3	7.5
PER (x)	50.3	38.5	29.8	22.1	17.0
PEG (x) - y-o-y growth	1.2	1.3	1.0	0.6	0.6
Price/Book (x)	11.9	7.6	6.2	5.1	4.0
Yield (%)	0.1	0.5	1.1	0.7	0.8
EV/Net sales (x)	2.3	1.8	1.4	2.1	1.6
EV/EBITDA (x)	18.1	14.8	11.7	16.6	12.8
EV/EBIT (x)	20.8	17.2	13.7	19.5	14.8
EV/NOPLAT (x)	25.1	21.8	16.4	23.3	18.2
EV/CE	3.3	2.2	1.8	2.8	2.6
EV/IC (x)	5.9	3.9	2.7	3.7	3.2

Source: Company, MF Global India Research Estimates

INITIATING COVERAGE

August 4, 2009

BHEL (BHEL IN / BHEL.BO)

Buy

Execution in focus

CMP Rs 2343

Target Rs 2580 (+10%)

This note should be read for:
- *Investment rationale*
- *Company overview and valuations.*

Executive summary

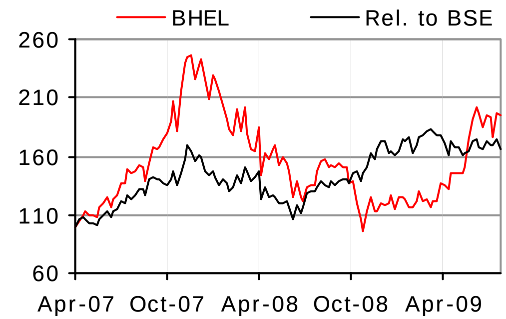
- BHEL is a major supplier of power generation equipment (mainly BTG) in the domestic market with a 54%+ market share in the 11th Plan orders). The company has got a strong execution track record with a strong clientele (>80%+ of the current business comes from government-owned companies like NTPC, DVC, etc. We see a long-term sustainable market for BHEL, with the belief that a developing economy like India would continue to see long-term power generation capacity addition, though the element of strong competition from global giants is inevitable.

Key investment arguments

- **OB to drive earnings:** BHEL, with its current outstanding OB of Rs 1241bn+ (>4xFY09 revenues), is set to see an EPS CAGR of 25%+ over FY09-11E. Order flows for FY10E will stay muted as 11th Five-Year Plan ordering process is over and thus, BHEL's focus will shift to execution now.
- **Capacity increase to aid long-term growth:** BHEL is expanding its installed capacity by 50%+ with effect from Dec '09, which would be crucial for its long-term business growth. The company is on schedule at most of its expansion locations.
- **Strong balance sheet:** BHEL has a strong balance sheet capable of supporting any large inorganic expansion plan that the company may have. The healthy net worth also supports operations in the overall macro-economic crisis.

Valuation

- While we are positive about BHEL's business prospects in the long run, despite increasing competition, we believe that the stock would continue to lead the Indian power generation equipment market for a long time. Also, we see the Indian power equipment market attaining a substantial size over the next 3-5 years, implying a decent growth for BHEL. We initiate coverage on BHEL with a Buy rating, assigning a 25% premia to average PE for FY05-09 to FY11E earnings, implying a price target of Rs 2580 (+10% upside).



Company data	
O/S shares :	490mn
Market cap (Rs) :	1147bn
Market cap (USD) :	24bn
52 - wk Hi/Lo (Rs) :	2405 / 984
Avg. daily vol. (3mth) :	1.3mn
Face Value (Rs) :	10

Share holding pattern, %	
Promoters :	67.7
FII / NRI :	16.2
FI / MF :	9.2
Non Pro. Corp. Holdings :	3.9
Public & Others :	2.1

Y/E Mar, Rs bn	FY09	FY10E	FY11E
Net Sales	262.3	362.2	445.1
PAT	31.4	41.2	49.3
EBIDTA mrg, %	16.9	16.8	16.7
PAT mrg, %	12.0	11.4	11.1
ROE, %	26.3	28.0	26.8
EPS, Rs	64.1	84.2	100.8
PER, x	36.5	27.8	23.3

Investment Overview

Sustainable competitive advantage	60%+ market share in the domestic market, strong client reference base.
Financial structure	Unleveraged balance sheet, RoEs healthy at 26.6%.
Earnings visibility	Current OB at Rs 1241bn+ (>4x FY09E revenues).
Valuation	Trading at a one-year forward PE of 23x and a price to book of 5.6x.
Future event triggers	Better-than-expected execution, order inflows and further expansion announcements (both organic & inorganic).
Expected price momentum	We expect a price momentum of 10%+ over the next one year.

Valuation Summary

Y/E Mar, Rs mn	FY2007	FY2008	FY2009	FY2010E	FY2011E
Net Sales	172,375	193,046	262,342	362,218	445,087
Growth, %	28.9	12.0	35.9	38.1	22.9
EBIDTA	35,767	37,031	44,259	60,817	74,485
EBIDTA margins, %	20.7	19.2	16.9	16.8	16.7
Core EBIDTA	35,767	37,031	44,259	60,817	74,485
Net profit	24,142	24,813	31,382	41,202	49,324
Net profit margin, %	14.0	12.9	12.0	11.4	11.1
Net Profit (adjusted)	24,142	24,813	31,382	41,202	49,324
EPS, Rs	98.6	50.7	64.1	84.2	100.8
EPS Growth, %	44.1	(48.6)	26.5	31.3	19.7
PER, x	23.8	46.2	36.5	27.8	23.3
EV/EBIDTA, x	14.4	13.2	10.7	17.9	14.2
EV/Net Sales, x	3.0	2.5	1.8	3.0	2.4
Price/Book Value, x	6.5	10.6	8.8	7.0	5.6
ROIC, %	46.4	46.3	48.3	33.8	28.3
ROE, %	30.0	25.4	26.3	28.0	26.8
Dividend Yield, %	1.0	0.7	0.7	0.7	0.7

Source: Company, MF Global India Research Estimates

SWOT Analysis

STRENGTH

- Commands huge client confidence, 56% share of orders in the 11th Five-year Plan in BTG.
- Derives majority (>80 %+) business from govt. companies.
- Strong revenue visibility with a current book to bill of 4x+.
- Strong balance sheet with Rs 80bn+ of cash.

WEAKNESS

- Dependence on BoP suppliers and shortage of critical components pose a key threat to execution.
- Slow capacity addition in the power generation equipment space.

SWOT

OPPORTUNIITES

- Super-critical orders in the 12th Five-Year Plan (>50% of the total 12th Plan capacities), throws open huge business potential.
- BHEL has got great chances to go for inorganic expansions/diversifications on a global scale at this time.
- While currently in the nascent stage, JVs with NTPC/NPCIL etc. could throw open doors for incremental profits.

THREATS

- Domestic market share set to come down with increasing competition from global players.
- Intense competition for BHEL will have a negative impact on the capital return ratios, in times to come.
- Flattish outlook for the order inflows, coupled with a 30%+ revenue growth, indicates some pressure for the working capital.

Strategic and technical tie-ups for BHEL

- BHPV (as a 100% subsidiary)
  - BHEL is currently in talks to acquire a 100% stake in BHPV, and plans to invest around Rs 275crore as capex and around Rs 34crore as equity infusion. The Central Government has decided to waive loans and interest up to Rs 415crore and settle outstanding liabilities of around Rs 264crore for BHPV.
  - BHEL expects to derive a revenue of Rs 10bn from BHPV in industrial boilers in the next five years.

- BHEL-NTPC (50:50 JV)
  - A new company, NTPC BHEL Power Projects Pvt. Ltd., has been incorporated on 28 April '08, to carry out EPC work in the power sector.

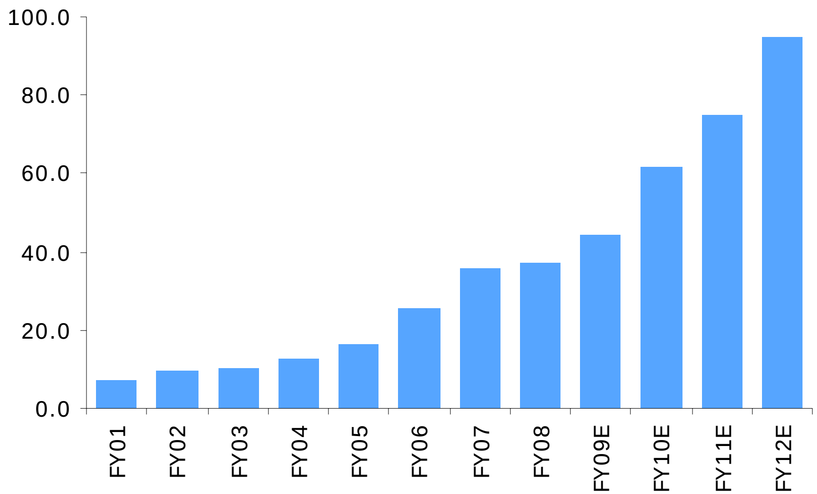
- BHEL-NPCIL MoU
  - BHEL and NPCIL have entered into a MoU to form a JV to carry out EPC activity in nuclear plants (conventional islands only), both in India and abroad.

- BHEL-TNEB JV
  - BHEL and TNEB have signed a MoU during FY08, to build, own and operate a 1600Mw (800 Mwx2), power plant at Udangudi.

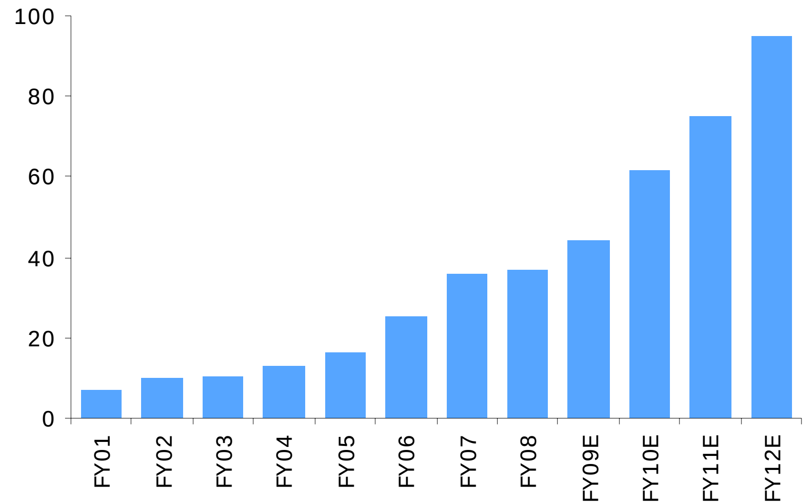
- Old tie-ups
  - BGGTS-This technical agreement gives BHEL access to the complete range of GE Gas turbines (except the new H class). BHEL is currently undergoing a massive expansion at its Hyderabad plant, which will start manufacturing the complete range of 9FA GT series. The JV has completed 10 years, and the agreement could be extended by a further period of 10 years.
  - PPIL-This JV with Siemens is under mutual liquidation as it has completed 10 years and will soon cease to exist.

Execution to drive near-term profit growth

EBIDTA (Rs bn)



PAT (Rs bn)

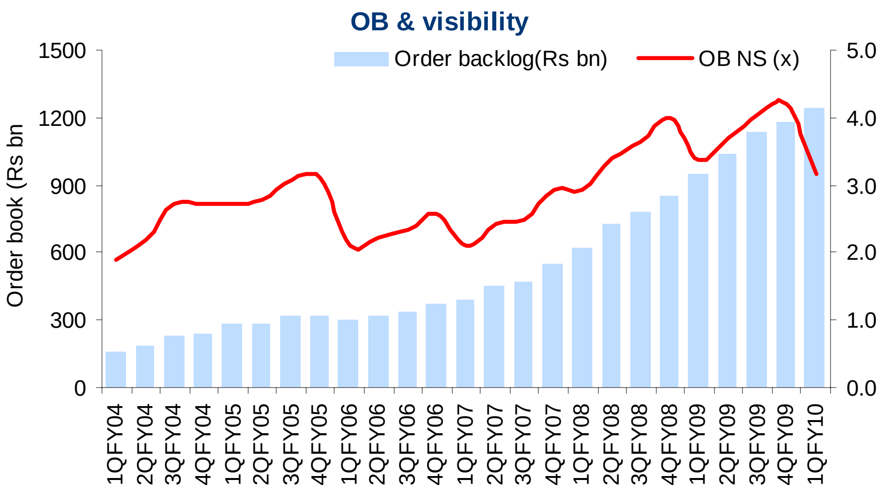


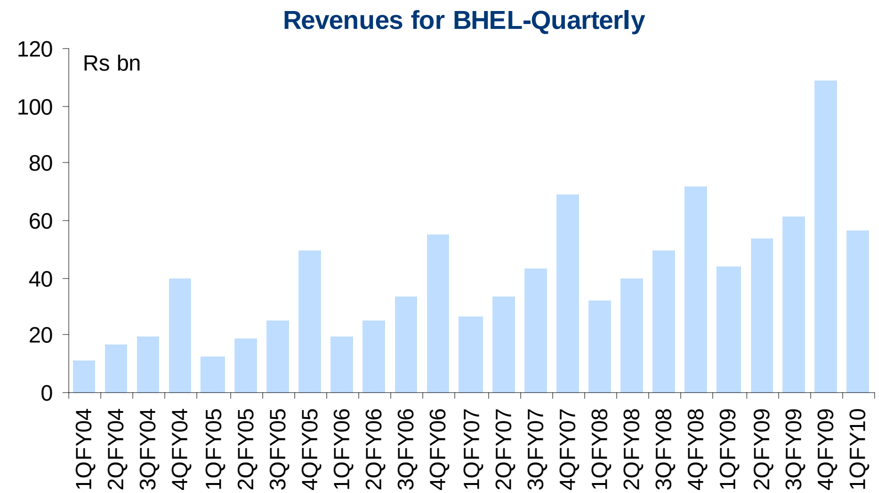
- **Strong earnings growth reported in FY01-09:** BHEL reported a healthy 21% EPS CAGR over FY01-09, led by healthy business inflows during the same period. Also, strong improvement in OPMs from 12% levels to 16%+ currently, contributed to a healthy EPS growth.

- **FY09-11E PAT CAGR expected at 25%:** We expect BHEL to post an earnings growth of 25%+ over FY09-11E (CAGR), mainly on the back of a healthy execution. Currently, the company has sufficient revenue visibility, which would help the company to report a decent PAT growth during FY09-11E.

Source: Company, MF Global India Research Estimates

Execution to remain critical for current valuation support



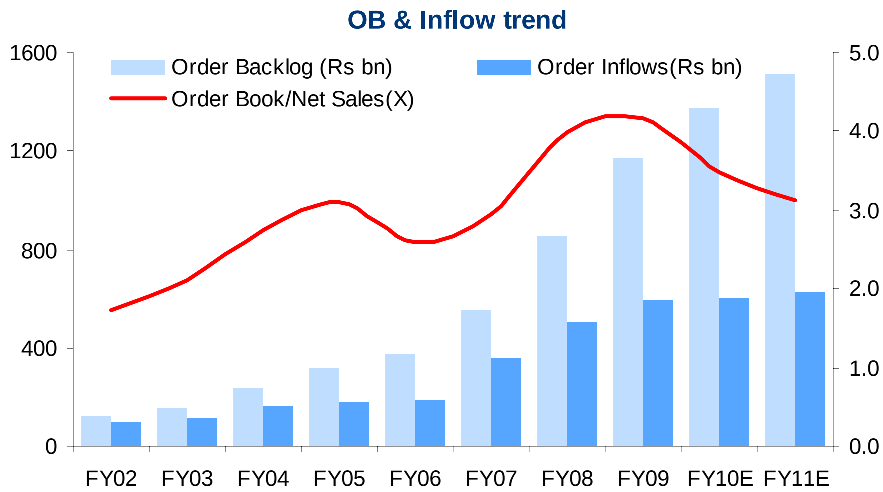


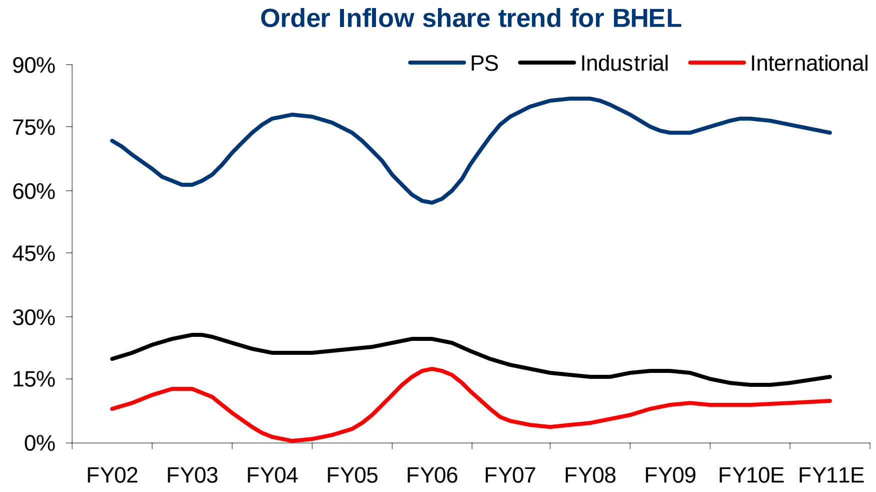
- **Execution to remain critical for valuations:** BHEL has a strong revenue visibility up to FY12E covered in the current OB. The biggest concern on the street is the execution part, especially with the expanded capacities. Execution to stay on the active radar of BHEL as stated by the management. The company expects to start operations at its expanded capacities (50% increase in installed capacity across plants to 15,000Mw) in a phased manner, and as indicated by the management, the expansion milestones are on track.

- **Revenue visibility to stay muted from FY09 levels:** While BHEL reported an impressive order inflow growth of 19%+ during FY09, much ahead of the street's and our expectations, the revenue visibility (OB/NS) will witness a decline in FY10E as BHEL attains a healthy revenue growth of 30%+, coupled with muted order inflows growth, during the same period.

Source: Company, MF Global India Research Estimates

Industrial order flows under pressure





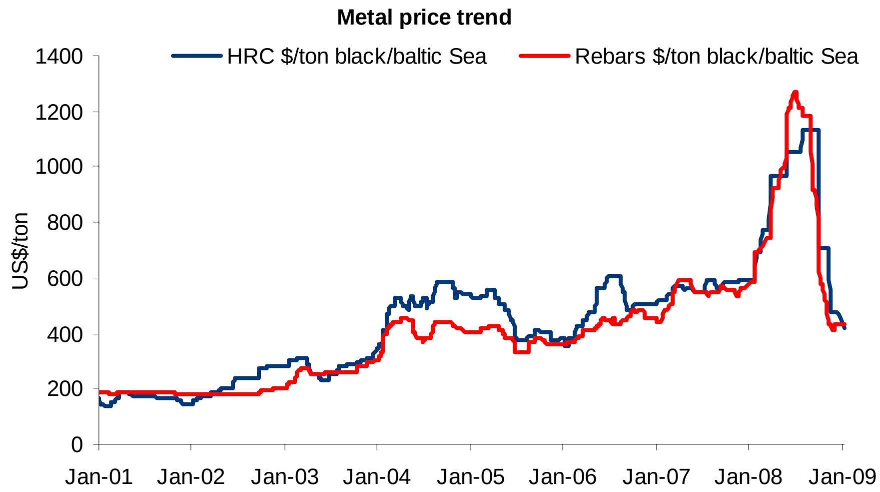
- **Industrial order flows to remain under pressure during FY10E:** This division grew by 27%+ in order inflow terms for BHEL over FY02-09 CAGR, on the back of a strong commercial activity and ordering for the captive power plants. However, we expect a decline of ~20%+ in FY10E inflows for BHEL in this division.

- **Muted growth in power sector order inflows:** BHEL's power segment has posted a strong 36%+ CAGR (FY02-09) in order inflows, mainly on the back of strong 11th Plan orders. With the 11th Plan ordering now largely concluded, we expect muted growth for BHEL during FY10E.

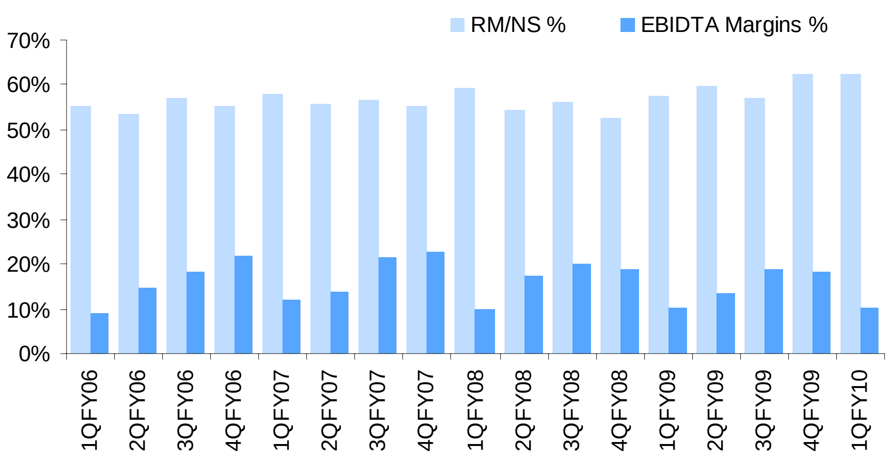
Source: Company, MF Global India Research Estimates

Benefit from decline in input costs yet to come

CIS HRC (Black Sea/Baltic Sea) ($/ton)



RM/NS & OPM trend- Quarterly

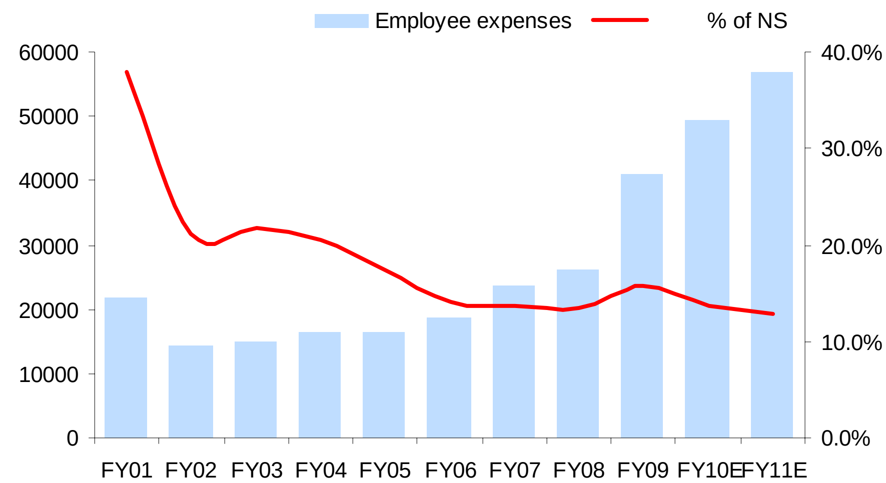


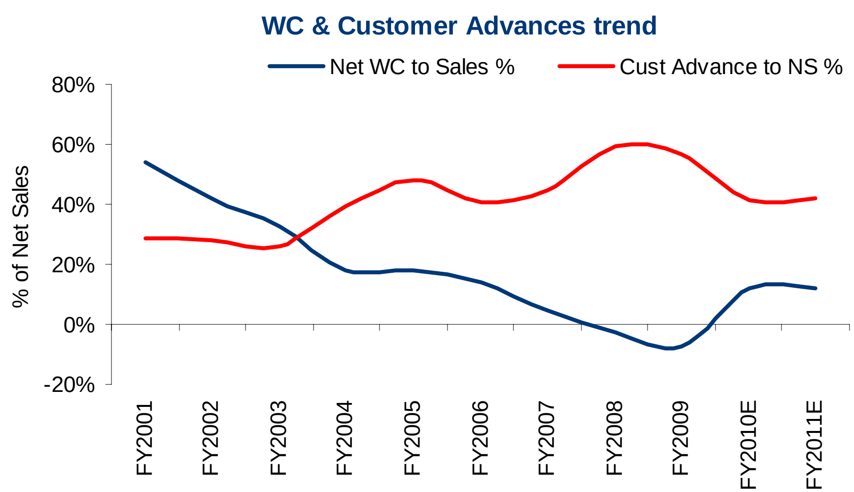
- **Average steel prices during CY08 were down by 25-30%:** There was a steep correction in average steel prices during CY08, wherein steel prices crashed by around 30%+. This is going to largely benefit companies with fixed price contracts, with the time of benefit depending on the execution timeline. We expect BHEL to report a substantial input cost decline in FY10E, mainly on the fixed price component of business, which is around 50%.

- **Management expects a 200bps reduction in RM/NS during FY10E:** BHEL's management expects FY10E numbers to be positively impacted by the decline in input costs. The company is still to report this substantial decline in input cost, which is a critical assumption we have built into our FY10E numbers.

Source: Company, Bloomberg, MF Global India Research Estimates

BHEL's employee cost and working capital





- **Salary cost assumptions:** We have assumed a 20% (10% headcount rise and 10% wage rate hike) and 15% (5% headcount rise and 10% wage rate hike) rise in salary cost for BHEL during FY10E and FY11E, respectively. Even after this, we see employee cost to sales ratio contributing positively to BHEL's OPM, mainly due to the higher execution that the company will witness during FY10E and FY11E.

- **BHEL's working capital to remain under pressure:** A higher execution growth for BHEL, coupled with a flattish outlook for fresh order inflows during FY10E, indicates a working capital pressure as customer advances to sales ratio would decline from 50% levels to less than 40% during FY10E.

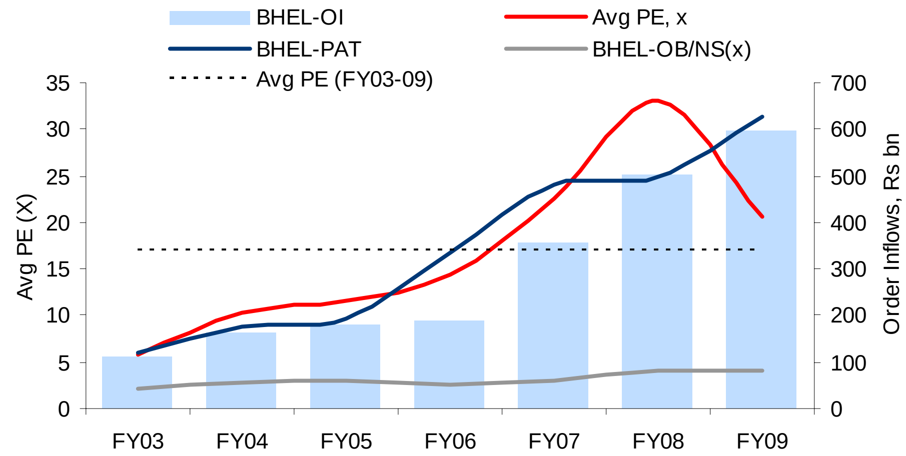
Source: Company, MF Global India Research Estimates

Valuations and price target

- **Valuation and price target:** We initiate coverage on BHEL with a Buy rating and our price target of Rs 2580 (+10%), assigning a 25% premium over average PE multiple during FY05-09. While we model BHEL for an EPS CAGR of 25%+ over FY09-11E, we believe that the current valuations adequately discount the strong earnings growth over the next 2-3 years for BHEL, leaving a limited upside of 10% over the next one year.

- **Valuation rationale:** While BHEL's average valuations over the last 12 years stands at just over 13x on a forward earnings basis, we believe that it is appropriate to value BHEL keeping the last 3-4 years as base, as there has been a sea change in both BHEL's absolute business size and the overall market dynamics in the power equipment space.

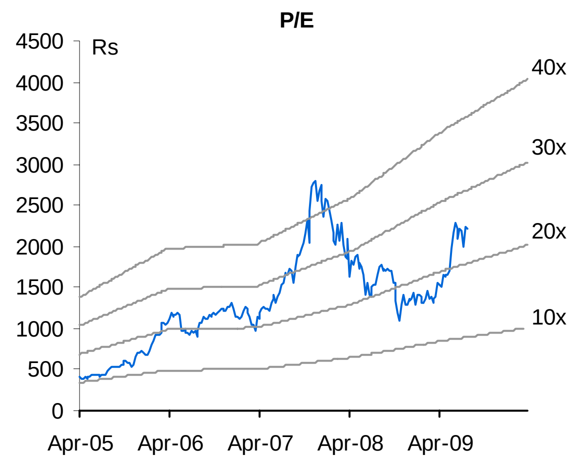
PE, PAT & Business visibility Trends

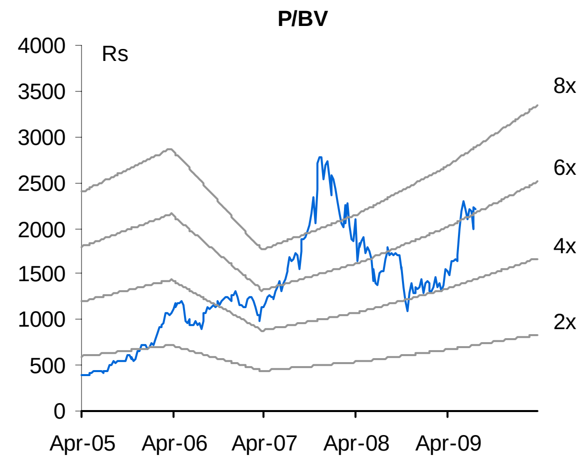


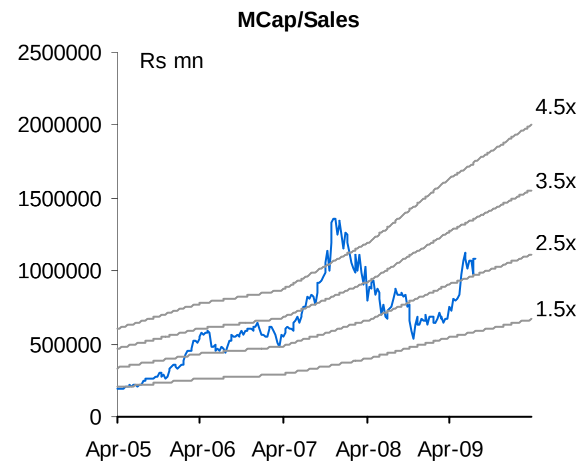
- **Triggers for re-rating**
  - **Change in our execution perception:** Better-than-expected execution for BHEL would be an important operating parameter warranting higher valuations for BHEL.
  - **Better-than-expected business flows:** We have assumed a muted order inflow growth for BHEL during FY10E as the 11th Plan ordering has come to an end already, any positive surprise in this regard (especially from the private sector and Middle East market) could trigger an upward valuation support.
  - **Successful absorption of super-critical technology:** BHEL is currently under a technology transfer agreement with Alstom (France) and would be looking to fully indigenise the technology over the next 3-5 years. We see this absorption as a critical and crucial achievement for BHEL as it would increase the comfort level for a lot of BHEL's clients.

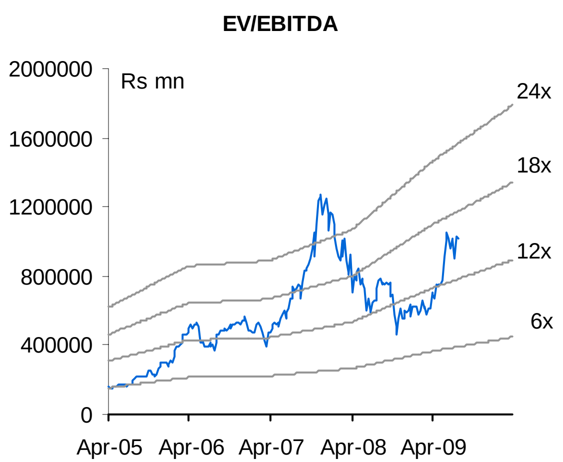
Source: Company, MF Global India Research Estimates

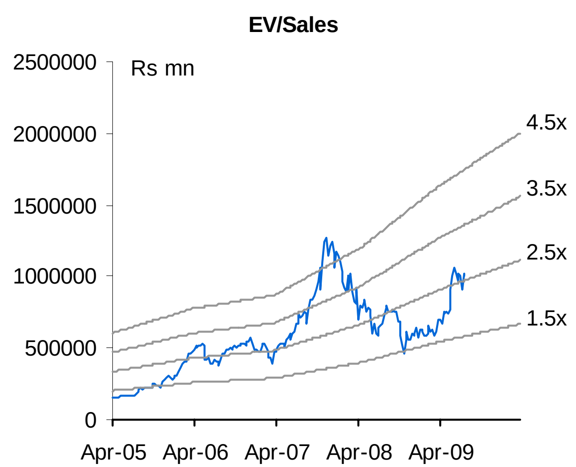
Absolute rolling Valuation band charts







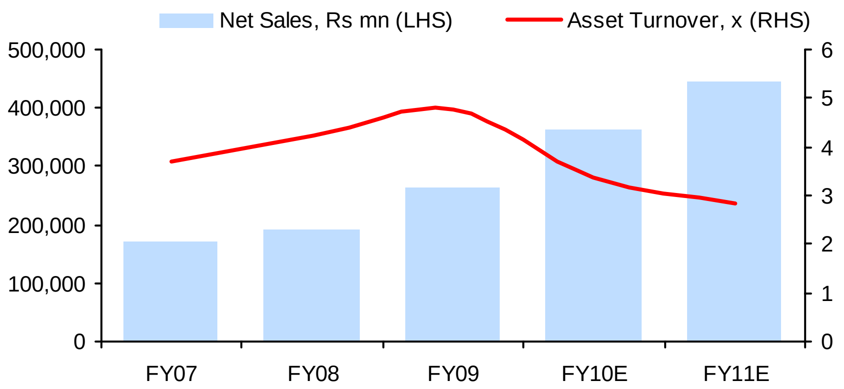




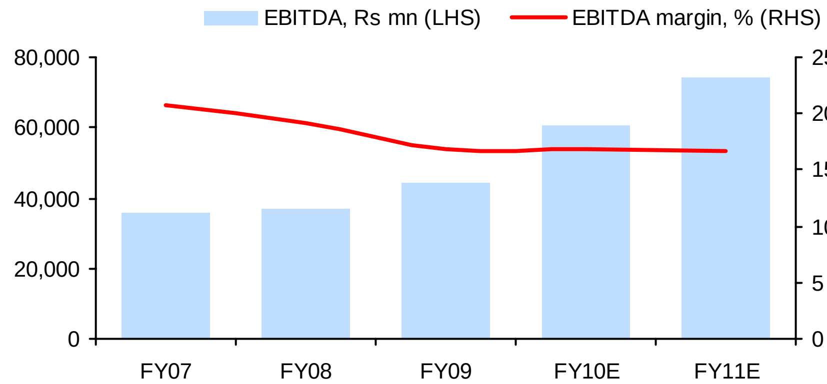
- The macro slowdown helped BHEL to outperform the capital goods index, as it is considered a safe haven, given its strong market share in the government-led power generation market. We feel that BHEL is rightly priced at this point in time.

Source: MF Global India Research

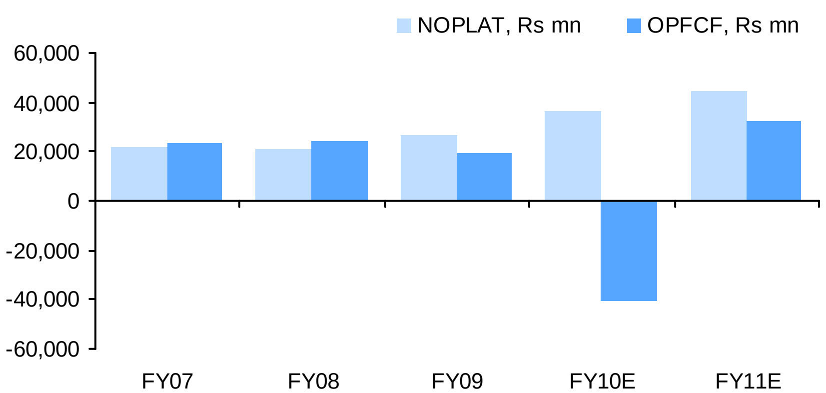
Financial Performance



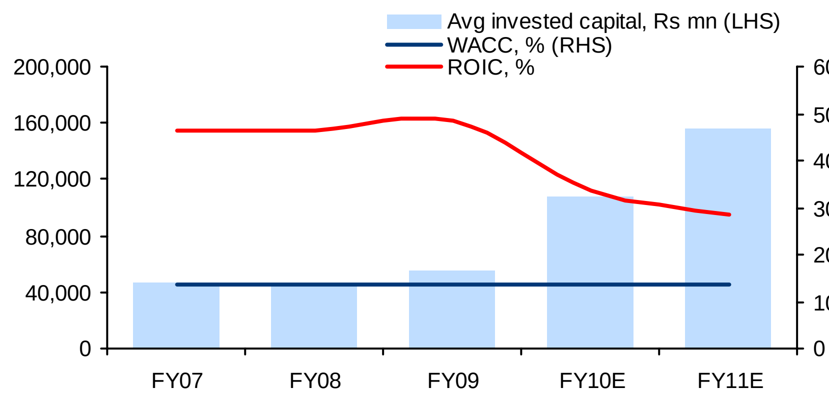
- Significant increase assumed in invested capital leads to a lower assets turn during FY10E.



- Input cost and salary cost to boost FY10E margins.



- Declining customer advances and extending payment cycle for debtors to put pressure on working capital during FY10E.



- Sharp rise in FY10E invested capital leads to a decline in RoIC.

Source: Company, MF Global India Research Estimates

Financials

Income Statement

Y/E Mar, Rs mn	FY07	FY08	FY09	FY10E	FY11E
Net sales	**172,375**	**193,046**	**262,342**	**362,218**	**445,087**
Growth, %	*29*	*12*	*36*	*38*	*23*
Other income	3,768	4,223	6,244	8,743	10,743
Total income	176,143	197,269	268,586	370,961	455,830
Operating expenses	-140,376	-160,238	-224,328	-310,144	-381,344
EBITDA	**35,767**	**37,031**	**44,259**	**60,817**	**74,485**
Growth, %	*39.8*	*3.5*	*19.5*	*37.4*	*22.5*
Margin, %	*20.7*	*19.2*	*16.9*	*16.8*	*16.7*
Core EBIDTA	35,767.4	37,031.2	44,258.5	60,816.7	74,485.5
Depreciation	-2,446	-2,589	-3,343	-5,104	-6,355
EBIT	**33,321**	**34,442**	**40,916**	**55,713**	**68,130**
Growth, %	*41.8*	*3.4*	*18.8*	*36.2*	*22.3*
Margin, %	*19.3*	*17.8*	*15.6*	*15.4*	*15.3*
Interest paid	-433	-354	-307	-362	-445
Pre-tax profit	**37,361**	**40,514**	**48,489**	**63,388**	**75,883**
Tax provided	-13,214	-15,711	-17,106	-22,186	-26,559
Net Profit	**24,147**	**24,803**	**31,382**	**41,202**	**49,324**
MF Net profit	**24,142**	**24,813**	**31,382**	**41,202**	**49,324**
Growth, %	*44.1*	*2.8*	*26.5*	*31.3*	*19.7*
EOI: Gains/(Losses)	0	3,441	0	0	0
Unadj. shares (m)	245	490	490	490	490
Wtd avg shares (m)	245	490	490	490	490

Balance Sheet

Y/E Mar, Rs mn	FY07	FY08	FY09	FY10E	FY11E
Cash & bank	58,089	83,860	98,956	57,372	89,135
Debtors	96,128	119,749	155,780	218,867	273,498
Inventory	42,177	57,364	77,624	107,177	124,380
Loans & advances	11,409	11,863	16,042	22,486	27,722
Other current assets	1,997	4,211	4,211	4,211	4,211
Total current assets	209,800	277,047	352,613	410,113	518,946
Investments	83	83	83	83	83
Gross fixed assets	41,351	44,435	76,072	92,797	97,774
Less: Depreciation	-31,463	-34,622	-37,965	-43,069	-49,424
Net fixed assets	12,913	16,393	38,107	49,728	48,350
Total assets	**232,147**	**306,902**	**404,183**	**473,303**	**580,758**
Current liabilities	117,329	165,765	225,951	253,957	314,105
Provisions	26,042	32,444	46,555	54,864	61,246
Total current liabilities	143,371	198,208	272,505	308,822	375,351
Non-current liabilities	893	952	952	952	952
Total liabilities	144,264	199,160	273,457	309,773	376,303
Paid-up capital	2,448	4,895	4,895	4,895	4,895
Reserves & surplus	85,435	102,847	125,831	158,635	199,560
Shareholders' equity	87,883	107,742	130,726	163,530	204,456
Total equity & liabilities	**232,147**	**306,902**	**404,183**	**473,303**	**580,758**

Source: Company, MF Global India Research Estimates

Financials

Cash Flow

Y/E Mar, Rs mn	FY07	FY08	FY09	FY10E	FY11E
Pre-tax profit	37,361	40,514	48,489	63,388	75,883
Depreciation	2,446	2,589	3,343	5,104	6,355
Chg in working capital	8,047	16,213	15,392	-62,767	-10,541
Total tax paid	-16,325	-22,733	-15,092	-22,186	-26,559
CF from operating activities	**31,529**	**36,582**	**52,131**	**-16,461**	**45,138**
Capital expenditure	-3,690	-6,069	-25,057	-16,725	-4,978
CF from investing activities	**-3,690**	**-6,069**	**-25,057**	**-16,725**	**-4,978**
Free cash flow	27,838	30,513	27,074	-33,186	40,161
Equity raised/(repaid)	0	2,448	0	0	0
Debt raised/(repaid)	-4,689	59	0	0	0
Dividend (incl. tax)	-4,047	-8,591	-11,978	-8,398	-8,398
Other financing activities	-2,353	1,342	0	0	0
CF from financing activities	**-11,089**	**-4,742**	**-11,978**	**-8,398**	**-8,398**
Net chg in cash	16,750	25,771	15,096	-41,584	31,763

Per-share data

Y/E Mar, Rs mn	FY07	FY08	FY09	FY10E	FY11E
MF Global EPS (INR)	98.6	50.7	64.1	84.2	100.8
Growth, %	*44.1*	*(48.6)*	*26.5*	*31.3*	*19.7*
Book NAV/share (INR)	359.1	220.1	267.0	334.1	417.7
FDEPS (INR)	98.6	50.7	64.1	84.2	100.8
CEPS (INR)	108.6	56.0	70.9	94.6	113.7
CFPS (INR)	128.8	74.7	106.5	(33.6)	92.2
DPS (INR)	24.5	15.3	15.3	15.3	15.3

Ratios

Y/E Mar	FY07	FY08	FY09	FY10E	FY11E
Return on assets (%)	11.9	9.3	8.9	9.5	9.4
Return on equity (%)	30.0	25.4	26.3	28.0	26.8
Return on Invested capital (%)	46.4	46.3	48.3	33.8	28.3
RoIC/Cost of capital (x)	3.4	3.4	3.6	2.5	2.1
RoIC - Cost of capital (%)	32.9	32.8	34.8	20.3	14.9
Return on capital employed (%)	24.3	20.1	19.9	20.9	20.5
Cost of capital (%)	13.5	13.5	13.5	13.5	13.5
RoCE - Cost of capital (%)	10.9	6.7	6.5	7.4	7.0
Total debt/Equity (%)	1.0	0.9	0.7	0.6	0.5
Net debt/Equity (%)	(65.1)	(77.0)	(75.0)	(34.5)	(43.1)
Asset turnover (x)	3.7	4.2	4.8	3.4	2.8
Sales/Total assets (x)	0.8	0.7	0.7	0.8	0.8
Sales/Net FA (x)	14.0	13.2	9.6	8.2	9.1
Working capital/Sales (x)	0.2	0.1	0.1	0.3	0.3
Receivable days	203.5	226.4	216.7	220.5	224.3
Inventory days	89.3	108.5	108.0	108.0	102.0
Payable days	89.9	100.8	105.9	102.2	102.2
Current ratio (x)	1.7	1.7	1.6	1.6	1.7
Quick ratio (x)	1.4	1.3	1.2	1.2	1.3
Interest cover (x)	n/a	n/a	n/a	n/a	n/a
Dividend cover (x)	4.0	3.3	4.2	5.5	6.6
PER (x)	23.8	46.2	36.5	27.8	23.3
PEG (x) - y-o-y growth	0.5	(1.0)	1.4	0.9	1.2
Price/Book (x)	6.5	10.6	8.77	7.01	5.6
Yield (%)	1.0	0.7	0.7	0.7	0.7
EV/Net sales (x)	3.0	2.5	1.8	3.0	2.4
EV/EBITDA (x)	14.4	13.2	10.7	17.9	14.2
EV/EBIT (x)	15.5	14.2	11.6	19.6	15.5
EV/NOPLAT (x)	22.9	23.0	17.5	28.2	22.1
EV/CE	4.7	3.5	2.7	5.0	4.0
EV/IC (x)	11.1	10.8	8.7	10.2	6.8

Source: Company, MF Global India Research Estimates

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