

Capital Goods

Capital goods stocks expected to outperform

Capital goods stocks, in line with broad market, have corrected in the past few days. One of the key reasons for decline is lower-than-expected growth in industrial production (represented by IIP).

We believe that the momentum in the infrastructure investment continues to be uninterrupted, thereby mitigating any significant risk of slowdown in the industrial activity. Accelerating Infrastructure spends, rising capex by corporates and improving business environment will ensure healthy volume growth for capital goods companies.

We maintain **Positive** Outlook on the sector.

Earnings drivers remain intact, providing support to valuations

- Strong order-books across companies, providing earnings visibility.
- More predictability for metal prices, ensuring stable margin environment.
- Key risks continue to be: Sharp rise in interest rates, government's fiscal health.

Top Picks: Focus on power capex

We believe India's Power Capex Programme provides impressive earnings visibility to power equipment manufactures. These companies will be able to post superior earnings growth, improve RoCE and RoE and generate healthy cash-flows over the next few years.

Top Buys

Company	Year End.	Price	M-Cap	2 Yr. EPS	RoCE	RoE	PE	FY08
		Rs.	US\$ mn	CAGR (%)	FY07E	FY07E		(x)
BHEL	March	2,426	13,240	29.4	39.9	27.0	21.1	
Crompton Greaves	March	264	1,540	26.8	32.0	32.3	18.6	
Siemens	September	1,110	4,169	50.8	62.1	42.6	21.0	
Cummins	March	260	1,147	31.6	38.1	27.3	16.1	
Kalpataru Power	March	917	542	50.3	37.1	34.2	13.3	

Dhirendra Tiwari

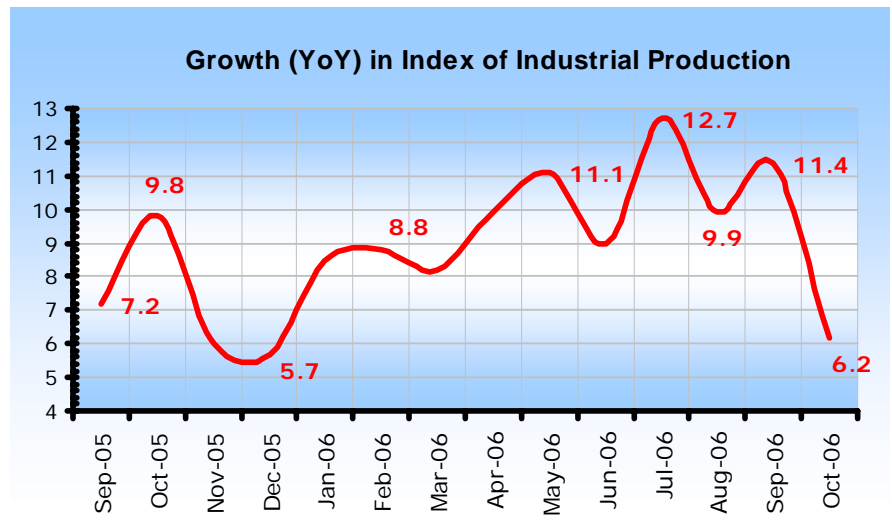
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IIP Numbers: Possibly a blip

Sectoral Growth-% YoY

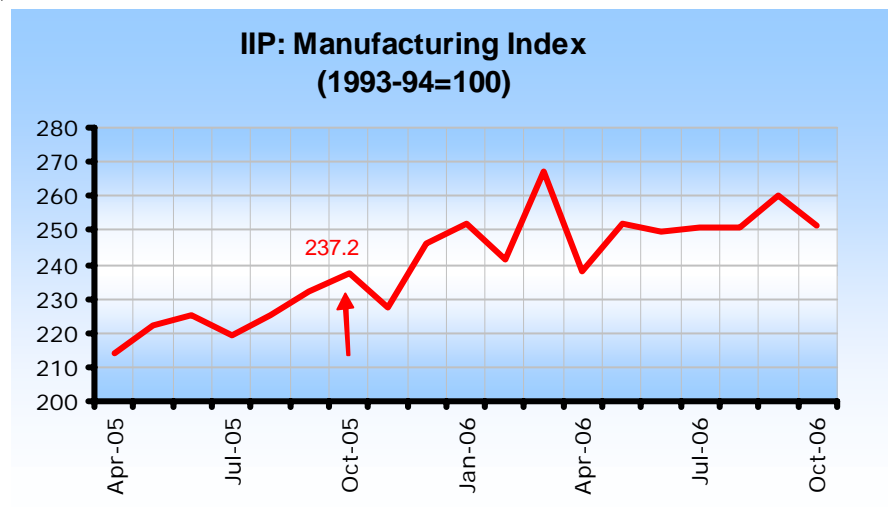
- **Manufacturing: 6.0%**
- **Electricity: 9.7%**
- **Mining: 4.0%**



Slower manufacturing growth in Oct'06

Key Reason for Lower Growth

- Lower growth in Consumer Durables and Non Durables
- High Base Effect



Auto and cement industries suggest pick up in Nov.

Auto sales (No.)

	Current Month Nov-06	Current Month Nov-05	y-o-y %	YTD FY07	YTD FY06	y-o-y %
Total Commercial Vehicles	40,317	28,010	43.9	284,628	210,215	35.4
Total Cars & Utility Vehicles	111,731	87,560	27.6	871,752	722,286	20.7
Total Two Wheelers	674,692	587,938	14.8	5,308,718	4,638,315	14.5
Three Wheelers	34,421	27,611	24.7	267,821	225,718	18.7
Total	861,161	731,119	17.8	6,732,919	5,796,534	16.2

Cement Dispatches

(MnT)	Nov-05	Nov-06	YoY (%)	YTD 06	YTD 07	YoY (%)
Cement Production	11.101	12.429	12.0	77.807	86.915	11.7
Cement Despatches	10.995	12.431	13.1	77.171	86.207	11.7

B&K View: Economy on track

	H1FY07	H1FY06	projection
Real GDP	9.1%	8.5%	7.5-8%
Agriculture	2.6%	3.7%	1-1.5%
Industry	10.0%	9.0%	8.1-8.6%
Services	10.7%	9.9%	9.5-10%
Inflation	5.30%	4.09%	5to5.5%
Fiscal Deficit	2.2%	2.4%	4-4.2%

Broad Industry fundamentals remain intact

- **Revenue visibility continues to be strong, backed by healthy order book and continuing momentum in order flow.**

Healthy Order Book

(Rs. mn)	Order book	FY06/CY05	Comments
Company		Sales (x)	
BHEL	457,000	3.4	Up 22% since March 2006.
ABB	35,646	1.2	Up 70% since December 2005. Largely Power T&D.
Areva T&D India	26,000	2.4	Power T&D.
Siemens	77,220	2.1	Up 102% since September 2005. On a standalone basis.
Crompton Greaves	18,537	0.7	Up 24% since March 2006. Largely Power Segment.
Kalpataru Power Transmission	22,000	2.6	Up 24% since March 2006. Including L1 Projects.
Larsen & Toubro	307,000	1.9	Up 31% since March 2006.
Thermax	29,730	1.8	Up 72% since March 2006.

Notes:

- 1) Order books are as of 30th September 2006.
- 2) Order book for Siemens, Crompton Greaves, L&T and Thermax are on standalone basis.
- 3) Siemens has an order book of nearly Rs. 12 bn, due to one large order from Qatar General Electricity & water corporation.

- **Investments in the infrastructure sector will boost long-term outlook. We see investment in the infrastructure sector to be at Rs. 12,000 bn (US\$ 275 bn) in various segments of infrastructure sector over the next five years.**

Infrastructure investments

Sector	Rs. bn	US\$ bn	Comments
Power	5,384	120	X and XI Plan
Roads	1,720	38	NHDP I - VII
Ports	560	12	FY06-FY14
Oil & gas	2,276	51	FY06-FY10
Telecom	1,125	25	FY06-FY10
Airports	150	3	FY06-FY12
Railways	1,300	29	FY06-FY12

Source: B&K estimates, industry, Plan reports

Our interaction with the industry suggests continuation of momentum in the infrastructure investments.

- **Revival in “manufacturing capex” continues. This is why:**
 - o **Demand:** Accelerated investment in the infrastructure sector, thereby boosting demand for key commodities, such as Cement, steel, non-ferrous.
 - o **Peaking capacity utilization:** Lack of green-field expansion in past seven years, coupled with strong demand, triggered fresh capex.
 - o **Healthy balance sheet:** Healthy cash flow generation driven by improving profitability has boosted business confidence, encouraging Corporates to initiate fresh capex.

Key issues

- **Slowdown in investments if interest rates substantially go up.** This is true for infrastructure projects (viability will be questioned) as well as manufacturing capex (industry will find returns unattractive).
- **Will margins be sacrificed for volume growth?** It seemed in early phase of economic expansion (2003-2005). Growing business was the key issue, even though it meant no growth in margins. However, we believe that with most corporates adequately booked, there is focus on profitable growth.
- **Raw materials:** Escalating raw materials is the biggest threat to margins. We continue to believe that there will be pressure on gross margins despite softening of commodity prices in recent time.
- **Rising cost of skilled labour:** Engineering is skilled activity and access to good quality human resource is the key to competitive advantage. We believe that skilled manpower will become scarcer and expensive.
- **Project execution risk:** Capital goods/construction companies are full with large order book.

Top Buys

BHEL

- Ideal play on power investment in India.
- Doing a capex of Rs.16 bn to double capacity from nearly 5500 MW per year to 10000 MW per year. We believe this is a timely move and will help the company prepare for the XI Plan power projects.
- Growing at 30% (FY06-08E). The stock is trading at 21.1x FY08E.

Crompton Greaves

- Being the market leader in transformers and switchgears, the company stands to gain from ongoing investments in the T&D sector.
- Has successfully turn around Pauwel's and has recently acquired Ganz in order to strengthen its competitive positioning as a global player.
- Doing a capex of Rs. 1 bn in FY07 for increasing power & distribution transformer capacity.
- Growing at 27% (FY06-08E). The stock is trading at 18.6x FY08E.

Siemens

- Key beneficiary of substantial investment in power sector (especially in T&D) as well as in the infrastructure sector such as airports, mining, telecom and urban infrastructure.
- Outsourcing by parent, for software services and engineering products/ projects, will continue to be a key long-term growth driver for the company.
- Growing at 51% (FY06-08E). The stock is trading at 21x FY08E earnings.

Cummins

- One of the largest manufacturers of diesel engines in India.
- Cummins India is expected to post accelerated growth over next three years, led by improving demand conditions in domestic market and pick up in exports.
- Increasing outsourcing by Cummins Inc. will put Cummins India on a faster growth trajectory in years to come. Exports contribute 35% of the revenues.
- Growing at 32% (FY06-08E). The stock is trading at 16.1x FY08E earnings.

Kalpataru Power

- One of India's largest power transmission manufacturing and contracting companies.
- Key beneficiary of substantial capacity creation driven by aggressive investment plans of PGCIL for National Grid to be commissioned by 2012 along with continued growth momentum in SEB space with APDRP and Rural electrification programme.
- Growing at 66% (FY06-08E). The stock is trading at 13.3x FY08E earnings.

Earnings summary

Sector/Company	Basic information				Financials				Valuation					
	Price 13-Dec-06	Mkt Cap	Year end	Reco	Net sales (Rs. mn)	Net Profit (Rs. mn)	Adj. EPS (Rs.)	PER (x)	EV/Sales (x)	EV/EBITDA (x)				
	(Rs.)	(US\$ m)			FY07E FY08E	FY07E FY08E	FY07E FY08E	FY07E FY08E	FY07E FY08E	FY07E FY08E				
ABB India	3,575	151,494	3,380	Dec	41,827	57,601	82.8	118.1	43.2	30.3	3.4	2.4	28.5	19.4
ALA Engineering	1,266	22,511	502	Mar	4,950	7,300	43.3	64.2	29.3	19.7	4.6	3.1	19.8	13.5
Alla-Laval India	822	14,934	333	Dec	6,642	7,971	47.7	58.9	17.2	14.0	2.2	1.8	11.5	9.2
Areva T&D India	944	37,661	840	Dec	13,283	19,413	24.6	37.1	38.4	25.5	2.8	1.9	23.8	15.7
Astra Microwave Products	153	8,156	182	Mar	1,000	1,411	282	429	28.9	19.1	7.9	5.5	17.7	11.9
Bajaj Electricals	379	3,277	73	Mar	10,075	11,350	396	504	8.3	6.5	0.5	0.4	5.8	4.7
Bharat Earth Movers	933	34,278	765	Mar	23,247	27,461	2,230	2,933	15.4	11.7	1.3	1.1	11.0	8.5
Bharat Electronics	1,241	99,280	2,215	Mar	42,082	48,749	6,915	8,114	14.4	12.2	1.8	1.4	7.8	5.8
Bharat Heavy Electricals	2,426	593,714	13,247	Mar	162,923	199,533	22,124	28,231	26.8	21.1	3.4	2.7	16.4	12.5
Bharati Shipyard	300	6,743	150	Mar	3,781	6,052	885	1,158	10.8	8.3	2.9	1.9	7.4	5.8
Blue Star	175	15,725	351	Mar	14,839	18,516	623	847	25.2	18.6	1.1	0.9	16.0	12.4
Carborundum Universal	163	15,259	340	Mar	5,691	6,880	771	974	19.8	15.7	2.8	2.2	13.1	10.1
Crompton Greaves	264	69,045	1,541	Mar	49,580	56,897	2,847	3,729	24.3	18.5	1.4	1.2	16.5	13.4
Cummins India	260	51,460	1,148	Mar	21,493	26,225	2,546	3,191	20.2	16.1	2.4	2.0	14.2	11.2
Eimco Elecon India Ltd	335	1,934	43	Mar	1,140	1,235	103	122	18.7	15.9	1.9	1.8	9.6	8.6
Emco	687	6,393	143	Mar	6,173	8,042	368	523	19.0	13.4	1.4	1.1	10.7	8.3
Elecon Engineering Co	397	12,164	271	Mar	7,085	9,159	539	769	22.8	16.0	2.0	1.5	12.7	9.1
Finolex Cables Ltd	465	14,234	318	Mar	10,878	14,548	1,010	1,478	14.1	9.6	1.5	1.1	11.2	7.9
Grindwell Norton	119	6,588	147	Dec	3,618	4,097	413	449	16.0	14.7	1.8	1.5	10.6	9.3
Havell's India	326	17,506	391	Mar	13,733	17,873	868	1,151	20.2	15.2	1.3	1.0	13.5	10.4
Hind Rectifiers	896	1,349	30	Mar	954	1,192	135	184	9.9	7.3	1.5	1.2	6.8	5.4
Honeywell Automation India	1,690	14,943	333	Dec	6,310	8,236	550	728	27.1	20.5	2.4	1.8	18.3	13.5
Jyoti Structures	124	9,546	213	Dec	10,333	14,466	488	783	19.6	12.2	1.1	0.8	10.1	7.2
KEI Industries	430	4,341	97	Dec	4,632	5,987	358	422	14.2	12.0	1.2	1.0	8.7	7.5
KSB Pumps	596	10,378	232	Dec	4,199	4,945	531	635	19.5	16.3	2.3	1.9	11.7	9.2
Kirloskar Brothers	418	44,215	986	Mar	17,252	21,067	3,321	2,501	23.7	17.7	2.4	1.9	19.5	13.9
Kirloskar Oil Engines	269	26,082	582	Mar	17,092	20,027	1,166	1,507	22.4	17.3	1.6	1.3	14.2	11.1
Kalpataru Power Trans	917	24,310	542	Mar	15,487	21,136	1,369	1,831	17.8	13.3	1.5	1.1	9.4	7.2
Larsen & Toubro	1,421	398,285	8,886	Mar	202,179	247,250	13,328	15,968	14.6	12.2	1.6	1.3	15.4	12.3
Mather & Platt Pumps	161	1,829	41	Mar	1,275	1,760	110	177	13.6	8.4	1.2	0.8	8.2	5.1
McNally Bharat	137	3,631	81	Mar	5,488	6,958	174	299	23.9	13.9	1.0	0.8	14.8	9.7
Revathi Equipment	603	1,936	43	Mar	1,204	1,676	217	290	8.9	6.7	1.8	1.2	6.2	3.9
Siemens India	1,110	187,082	4,174	Sep	83,872	121,425	6,417	8,932	29.1	21.0	2.0	1.3	17.6	11.7
Shanthi Gears	65	5,271	118	Mar	2,068	2,543	387	518	14.4	11.1	2.8	2.2	7.5	5.6
Suzlon Energy Ltd	1,302	374,620	8,358	Mar	67,975	89,600	15,142	18,866	24.7	19.8	5.3	4.0	20.3	16.0
Thermax	373	44,463	992	Mar	21,210	27,761	1,718	2,282	25.9	19.5	2.1	1.6	16.9	12.6
TRF Ltd	391	2,150	48	Mar	3,230	4,603	166	277	13.0	7.8	0.8	0.5	8.4	5.1
Voltamp Transformers	626	6,334	141	Mar	3,861	5,406	385	556	16.4	11.4	1.6	1.1	10.8	7.3
Voltas	101	33,452	746	Mar	22,726	28,324	1,313	1,858	25.5	18.0	1.5	1.2	19.5	14.0

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