Initiating Coverage
Sector: Capital Goods
BSE Sensex: 15,922

PINC RESEARCH

BHEL

BUY
CMP Rs2,332
TP Rs2,700

Initiating Coverage

Structural risks won't play out in the medium term

We expect BHEL to have a 49% market share in the XII Five Year Plan orders (54% in XI Five Year Plan). With around 100 GW of capacities expected to be ordered for the XII Five Year Plan, we expect a 17% growth in order inflows for BHEL.

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BHEL would be able to weather competition

- BHEL's competency in subcritical space is well established. Around 47% and 71% of state and central sector orders were won through ICB in FY09.
- JVs with State Gencos and Bulk Orders provide visibility with 9000 MW under super critical technology already in the pipeline. This would help faster absorption of super critical technology and make it cost competitive.
- Plans for setting up domestic manufacturing capacities by various players (except L&T) are still at a nascent stage.
- Protectionist policies, stringent bidding criteria (requirement of domestic manufacturing facilities) and uncertainty from IPR issues would limit competition from the Chinese players.

VALUATIONS

The key drivers of BHEL's valuations are: **1) Execution Rate** (Revenue growth) **2) Order flows 3) Return Ratios**

BHEL's revenue growth is expected to remain strong given its capacity additions, and robust order inflows.

BHEL currently trades at 21x our FY11 EPS estimates, a premium of ~48% to the Sensex valuations (65% average over past 2 years). BHEL remains one of the few companies in the capital goods space with a good visibility for a strong topline and bottomline growth and robust return ratios. Hence, we believe that there is further scope for an expansion in BHEL's valuation premiums. We rate the stock a 'BUY' with a target price of Rs 2,700 (24x FY11 EPS).

STOCK DATA

Market cap	Rs1140bn
Book Value per share	282.4
Shares O/S (F.V. Rs10)	489.5
Free Float	32.3%
Avg Trade Value (6 months)	Rs2.7bn
52 week High/Low	2405/984
Bloomberg Code	BHEL@IN
Reuters Code	BHEL.BO

PERFORMANCE (%)

	1M	3M	12M
Absolute	3.0	12.1	38.5
Relative	0.4	0.2	25.5

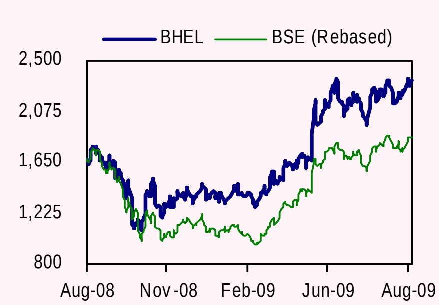
KEY FINANCIALS

(Rs mn)	FY08	FY09	FY10E	FY11E	FY12E
Net Sales	195,439	262,342	330,689	441,812	541,188
YoY Gr.(%)	11.9	34.2	26.1	33.6	22.5
Op. Profit	35,201	38,014	56,060	74,293	89,994
Op. Marg.(%)	18.0	14.5	17.0	16.8	16.6
Adj. Net Profit	28,593	31,381	42,374	54,104	64,155
YoY Gr.(%)	18.4	9.7	35.0	27.7	18.6

KEYRATIO

	FY08	FY09	FY10E	FY11E	FY12E
Dil. EPS (Rs)	58.4	64.1	86.6	110.5	131.1
ROCE *(%)*	30.0	24.9	28.9	29.8	28.5
RoE (%)	26.5	22.7	23.6	23.2	21.7
PER (x)	39.9	36.3	26.9	21.1	17.8
EV/ Net Sales (x)	4.9	3.8	3.0	2.2	1.8
EV /EBDITA (x)	30.0	27.8	18.9	14.2	11.7

RELATIVE PERFORMANCE



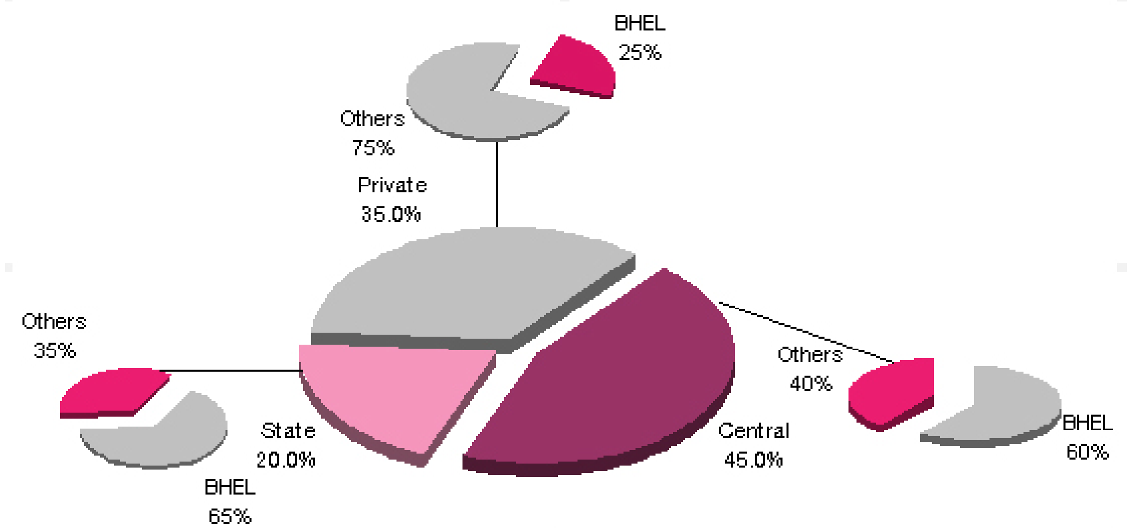
Order inflows to remain robust

We expect a 17% rise in order inflow from the XII Plan period on the back of a 49% market share

We expect BHEL to bag 48,750 MW of orders during the XII Five Year Plan, a 17% growth

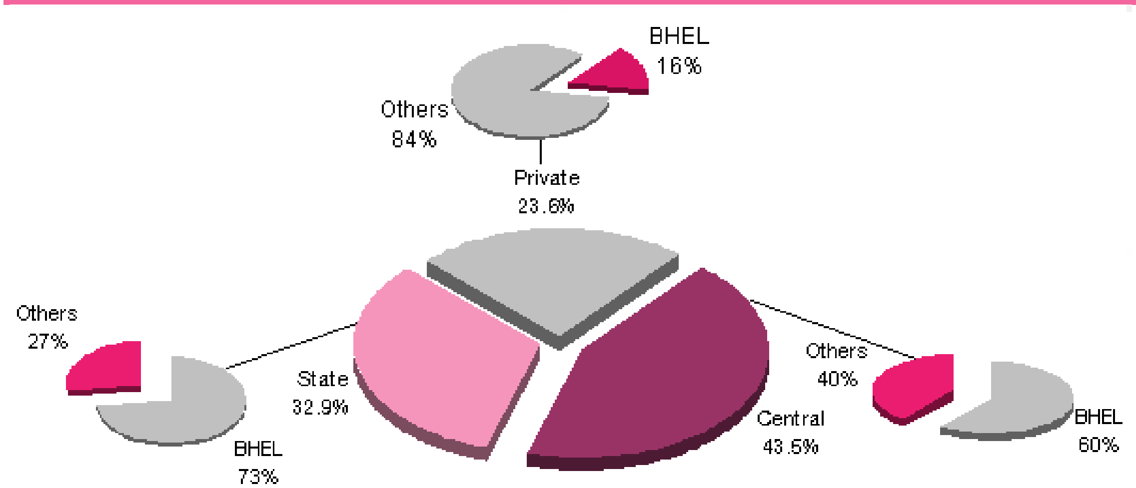
We expect BHEL's market share at ~49% for the XII Plan, in comparison to a 54% market share during the XI plan. Though the market share is expected to be marginally lower, around 1,00,000 MW of capacities are projected to be ordered (against 78,000 MW) in the XII Five Year Plan which would lead to growth in order flows for BHEL. Accordingly, we expect BHEL to bag 48,750 MW of orders during the XII Five Year Plan as compared to 41,700 MW during the XI Five Year Plan. This translates to a 17% increase in order inflows.

Exhibit 1 - Our estimates of BHEL's market share in the XII Plan



Source: PINC Research, Company

Exhibit 2 - BHEL's market share in the XI Five Year Plan



Source: PINC Research, Company

- **Central Sector order share:** BHEL had a 60% market share in Central Sector orders during the XI Five Year Plan. A large portion of the orders for the central sector units (NTPC and DVC) is planned to be tendered as bulk orders, where BHEL would have an option to undertake 50% of these bulk orders. Besides, in the XI plan, some of the orders (3960 MW) were placed with Russian vendors, which are currently under dispute. Hence, these vendors might not find place in the XII Five Year Plan orders. Hence, we expect BHEL to maintain its 60% market share for the central sector orders in the XIIth Five Year Plan.

Almost 41% of the orders were won through ICBs in FY09

- **State Sector order share:** BHEL had a 73% market share in State Sector orders during the XI Five Year Plan. Most of the State Gencos (Generating Companies) are expected to place orders on the basis of international competitive bidding (ICB). BHEL has already proved its competence in the XI Five Year Plan, by winning 47% of the orders through ICBs in FY09. Besides, BHEL is also forming JVs with state governments to protect its turf. It has already formed three JVs with State Governments for setting up 4,900 MW of generating capacities in the XII plan, the equipment orders for which would be placed with BHEL. Hence, we expect BHEL's share from the State Sector orders to remain high at around 65%

- **Private Sector order share:** BHEL's share of orders from private sector fell sharply to 16% during the XI plan, as many private sector orders were placed with Chinese and Korean players. We expect that the overseas players and domestic private sector equipment manufacturers would continue to garner major share of the order flows from private sector utilities in the XII Five Year Plan. However, as BHEL's capacities become operational, faster execution cycle would draw more order from the private sector, which would lead to a marginal increase in BHEL's market share to 25% in the XII Five Year Plan projects.

BHEL's market share can be higher at 54% if it is able to draw more order from the private sector utilities

Faster execution cycle might draw more private sector utilities to issue orders to BHEL

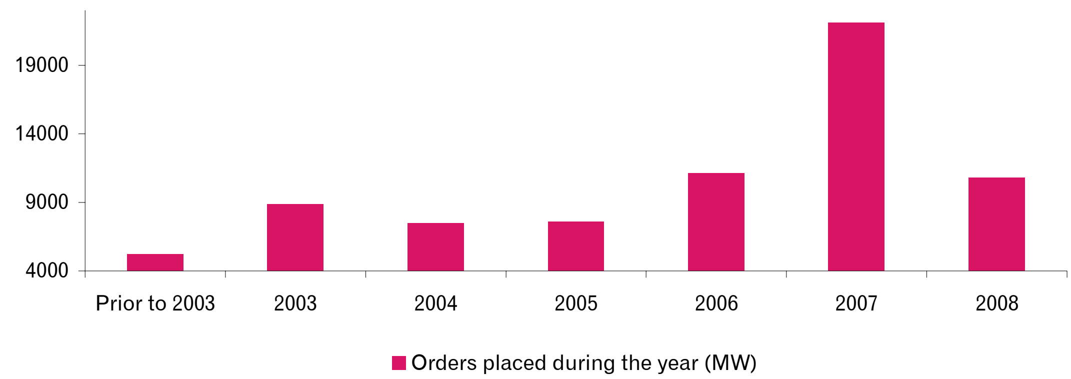
Long execution cycle on account of capacity constraints has been one of the key reasons which have deterred private sector utilities from issuing orders to BHEL. BHEL is increasing its capacities from 10,000 to 20,000 MW over the next two years. Besides, it is also expanding its vendor base and taking steps to reduce cycle time, rejection and rework rate which would lead to faster execution. This might draw more private sector utilities to issue orders to BHEL. Even if BHEL is able to increase its order share from private sector utilities to 35%, it would be able to maintain its overall market share in the power generation space at 54%. In Q1FY10, BHEL has already received huge orders to the extent of around Rs 120 bn from the private sector.

Going by the past trend, equipment ordering for the XII Five Year Plan projects should commence by H2FY10

Around 60% of the equipment orders were placed three years prior to commencement of the XI Five Year Plan

The order flows from the central and state sector had slowed down considerably in the last two quarters on account of elections in the country. We expect the ordering for the XII Five Year Plan projects to pick up pace from H2FY10 onwards. The bulk equipment orders for Central Sector utilities (NTPC and DVC) of around 7260 MW(11x660MW) is expected to be placed by the end of FY10. The Power Ministry has been pushing State Gencos to place equipment orders well in advance of the commencement of the Five Year Plan. As can be observed from chart below, around 60% of the equipment orders were placed three years prior to commencement of the XI Five Year Plan. Similarly, we expect the state and central sector orders to commence in H2FY10 and pick up pace in FY11.

Exhibit 3 - When were equipment orders placed for the XI plan?

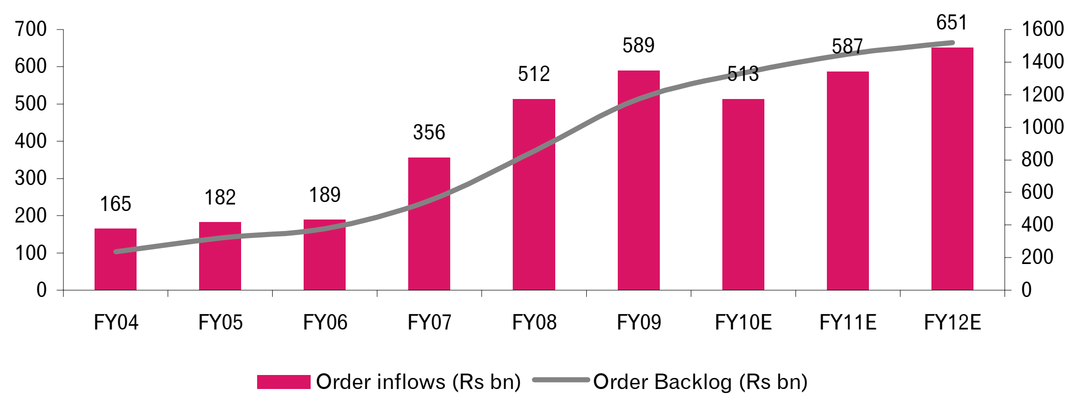


Source: PINC Research, CEA

Order flows would continue to remain robust, though order book growth would peak out

With BHEL's market share in XII Five Year Plan projects expected to remain strong, the order flows would continue to remain robust. However, with execution expected to pick up over the next two years, the order book is likely to remain flat in absolute terms.

Exhibit 4 - BHEL - Estimated Order Inflow and Order Backlog



Source: PINC Research, Company

BHEL is fully equipped for the intensifying competition

Competition from domestic players would be limited in the medium term

Only L&T-MHI venture has made considerable progress on setting up domestic manufacturing facilities

Given the huge opportunity in the domestic power generation equipment space, numbers of players are planning to commission manufacturing capacities. However, only L&T-MHI venture has made considerable progress on the same. The plans of the other players remain at a very nascent stage. Hence, we expect the other capacities to be operational only by FY12 and beyond and hence do not pose a threat to BHEL over the medium term.

L&T plans to commission its manufacturing facility by FY11. However, the scale up of the capacity to a target annual production of 4000 MW would take place only by the end of FY12.

Exhibit 5 - BTG manufacturing capacities announced

	Capability	MWs
L&T Mitubishi	500-1000 MW Boilers and Turbines	4000
JSW-Toshiba	500-1000 MW Turbines	3000
Alstom-Bharat Forge	600-800 MW supercritical Turbines	5000
R Infra - Shanghai Electric		10000
NTPC - Bhel		5000
GB Engg - Ansaldo Caldie	Boilers	2000
Skoda Power		na

Source: PINC Research

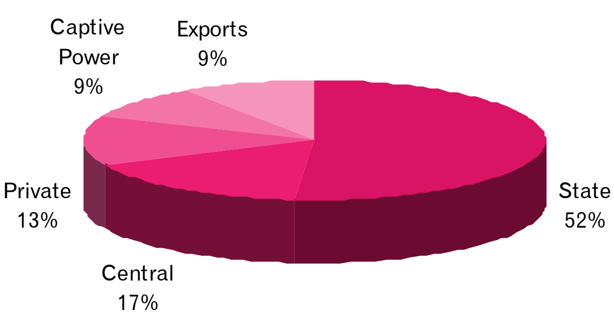
Would BHEL be impacted by equipment procurement by International Competitive Bidding (ICB)?

The Central Sector Gencos have already been placing orders on the basis of international competitive bidding since the XI Five Year Plan. Most of the State Gencos are also expected to place equipment orders through ICBs in the XII Five Year Plan (as the power offtake would also be based on ICB).

In FY09, around 71% of the central sector and 47% of the state sector orders were won against ICBs

Subcritical segment: BHEL has already proved its competency in the subcritical space. In FY09, around 71% of the central sector and 47% of the state sector orders were won against ICBs. In order to further increase its cost competitiveness as against the Chinese and Korean players, BHEL has introduced new units with configuration of 270 MW, 525 MW and 600 MW. This leads to lower cost per MW for the utilities, given the increased capacity and lower incremental manufacturing cost, which enables BHEL to retain its margins.

Sector-wise order inflows for BHEL in FY09



Source: PINC Research, Company

BHEL has won substantial orders through ICBs in FY09

	Negotiated Orders (%)	Orders won through ICBs (%)
State Sector	53%	47%
Central Sector	29%	71%
Private Sector	98%	2%
Captive Power	67%	33%
Exports	83%	17%

Source: PINC Research, Company

Super Critical segment: Though super critical equipment is a new segment for BHEL, we believe that BHEL would be able to grab significant market share in this segment on account of the following reasons:

- **Pipeline of 9000 MW of supercritical orders through JVs and Bulk orders:** A large portion of the orders for super critical equipments for central sector players is planned to be tendered as bulk orders, where BHEL would have an option to execute 50% of the same. Besides, BHEL has entered into JVs with State Gencos for putting up capacities based on supercritical technology, where the equipments would be supplied by BHEL. Considering these order flows, BHEL already has a pipeline of around 9000 MW in the super critical equipment space. Further, BHEL is also negotiating with other State Genco for creating JVs.

Exhibit 6 - BHEL - JVs with State Gencos

JV with	Capacity planned	BHEL's stake
Maharashtra State Generating Co. Ltd.	1320	26%
Karnataka Power Corp.	1980	n.a.
Tamil Nadu Electricity Board	1600	26%
Total	4900	

Source: PINC Research, Company

- **Protectionist policies, stringent bidding requirements might keep Chinese players at bay:** Stringent qualification criteria have been proposed to bid for the bulk orders from the central sector utilities. These include requirement of a manufacturing facility or a roadmap for the same. This might deter some of the Chinese and Korean players from bidding for these contracts. We believe there is a possibility of such condition being built into other State and Central sector tenders as well.

The uncertainty regarding IPR issues may deter many private sector utilities from placing orders with Chinese players

- **IPR issues might limit order flow for Chinese players:** The Chinese equipment manufacturers have acquired technology for super critical equipments through various U.S., European and Japanese players. The technology transfer agreements with these players restrict the players to bid for projects in other countries. Though Chinese players have been bidding for super critical equipment based projects in India, the uncertainty regarding these IPR issues may deter many private sector utilities from placing orders with these players.

Though we remain confident that BHEL would be able to scale up market share in the super critical segment, the margins from these orders might be lower initially on account of higher import content and royalty payments.

Exhibit 7 - Recent Milestones

10-Jul-06	First order secured for boiler designed to suit firing of imported coal
12-Oct-06	First order for Petcoke-fired CFBC boilers
19-Jul-07	Only supplier in the world of porcelain Disc Insulators for +800 kV UHDVC application
29-Aug-08	Order for the new rating units of 270 MW
23-Oct-08	First order for 660 MW Steam Turbine Generators with supercritical parameters

Source: PINC Research, Company

Faster execution would drive growth, though margins would remain under pressure

Capacity additions, expansion of vendor base would result in faster execution

BHEL is taking steps to reduce cycle time, rejection and rework rate, which would lead to faster execution

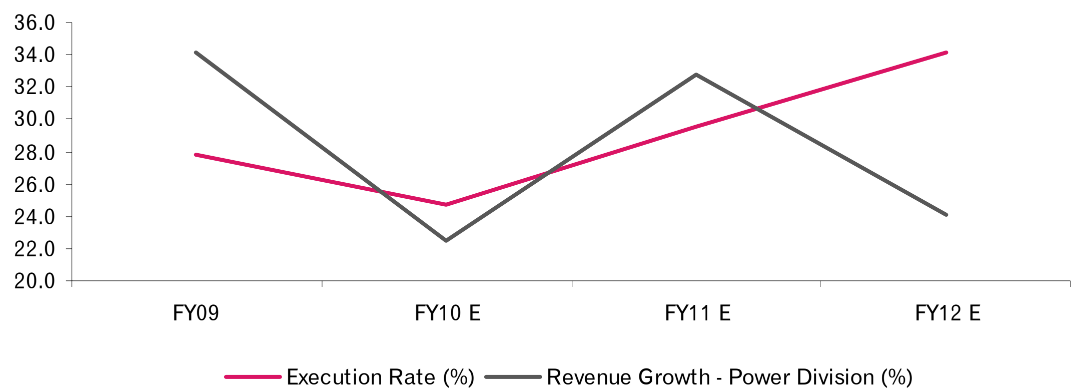
BHEL is currently implementing an expansion plan to increase its annual capacity from 10,000 MW to 15,000 MW by Dec 2009 and further to 20,000 MW by Dec 2010.

This envisages, creation of manufacturing facility for supercritical equipments apart from increase in shop floor area, material handling, storage and shipping facilities. BHEL would also raise its capability to build higher rating boilers of 800 MW and 1000 MW. As part of the expansion, BHEL commissioned a new stamping unit in Jagdishpur, U.P. and is further putting up a forging facility at the same location. This would enhance BHELs production capacity for manufacturing Thermal Boilers to 4,81,000 MT from the current capacity of 1,08,000 MT,

BHEL is also expanding its vendor base across the country. It has tied up with UK based Sheffield Forgemasters for high quality forgings.

These steps would enable BHEL to reduce cycle time, rejection and rework rate, and lead to faster execution.

Exhibit 8 - BHEL - Revenue growth and Execution Rate (%)



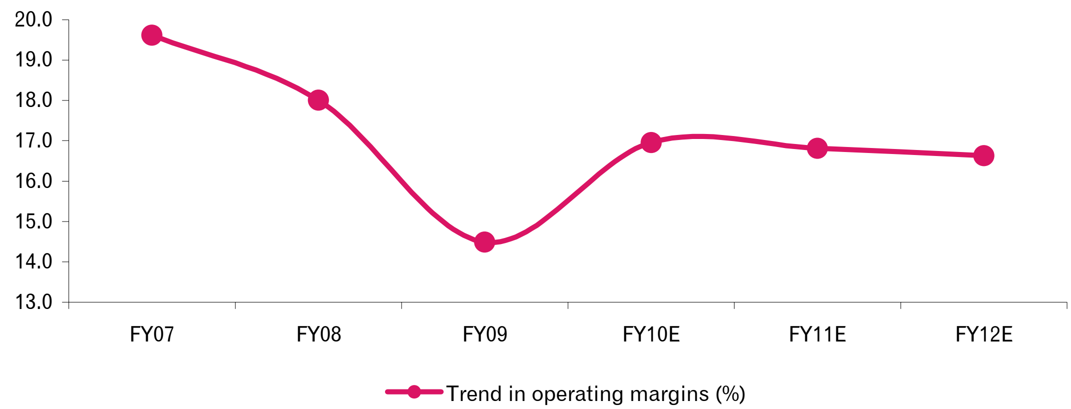
Source: PINC Research, Company

Lower margins on supercritical projects would not affect margins significantly in the medium term

Lower margins in super critical orders to affect overall margins in the medium term as execution and revenue bookings would take place only beyond FY12

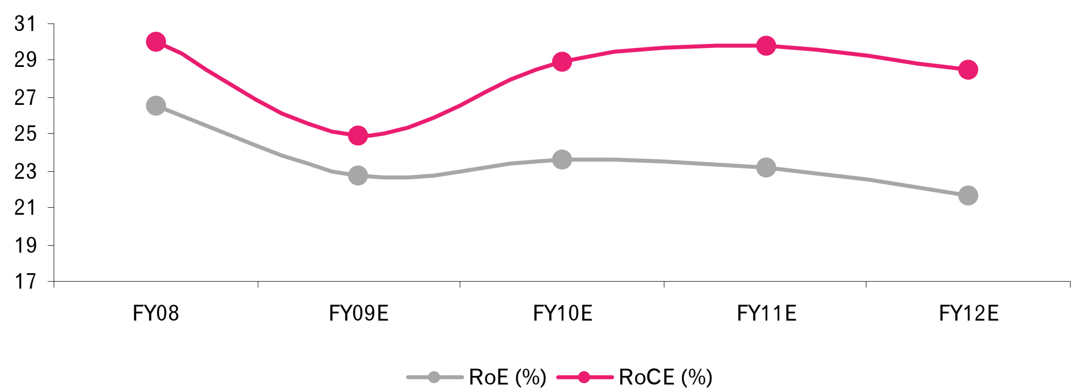
We expect BHEL's margins on the initial set of supercritical equipments to be lower on account of higher import content and royalty payments. However, we do not expect these projects to affect BHEL's overall margins as the execution and the revenue bookings from these projects would take place only beyond FY11-FY12. Nonetheless, we think that the operating margins in the medium term would be under pressure given the intensifying competition especially for the private sector orders. Hence, we do not expect operating margins to expand back to the 18-20% band witnessed prior to FY08.

Exhibit 9 - BHEL - EBITDA margins



Source: PINC Research, Company

Exhibit 10 - BHEL - Return ratios would continue to be robust



Source: PINC Research, Company

VALUATIONS

The key drivers of BHEL's valuations are:

1. **Execution Rate** (Revenue growth)
2. **Order flows**
3. **Return Ratios**

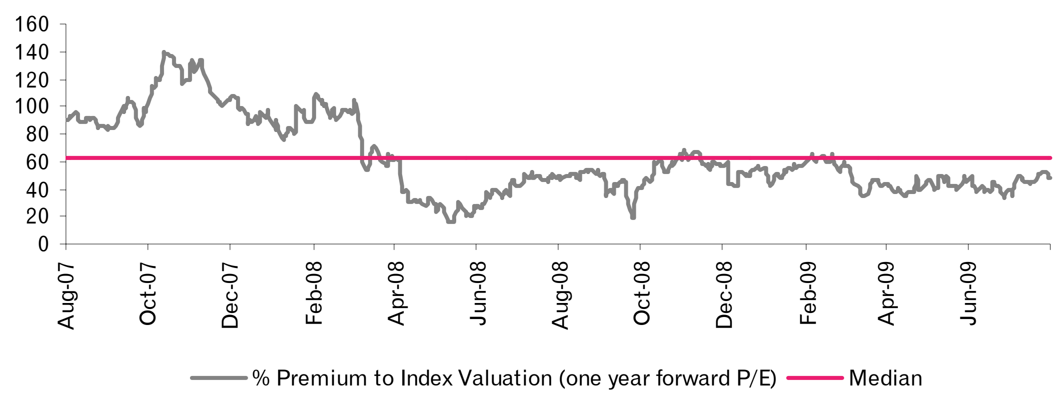
BHEL remains one of the few companies in the capital goods space with a good visibility for a strong topline and bottomline growth and robust return ratios.

We expect revenue growth to remain robust at a CAGR of 27% over next three years given the higher execution rate driven by new capacities. BHEL has proved its competency by winning large orders on ICBs. Besides, it has taken the right steps in the form of capacity additions, enlarging vendor base and entering into JVs with State Gencos, which will help retain a large part of the market share. With BHEL expected to have a strong 49% share in XII Five Year Plan capacities, the order flow momentum would continue through FY12.

In the last two years, BHEL valuations (one year forward P/E) have been at a premium of 65% on an average as compared to the Sensex. At the peak, the premium was 140% of the Index valuations.

BHEL currently trades at 21x our FY11 EPS estimates, a premium of ~45% to the Sensex valuations. BHEL remains one of the few companies in the capital goods space with an improved visibility for a strong topline and bottomline growth and robust return ratios. Hence, we believe that there is a further scope for an expansion in BHEL's valuation premiums. We rate the stock a 'BUY' with a target price of Rs 2,700 (24x FY11 EPS).

Exhibit 11 - BHEL valuation discount/premium to Sensex



Source: PINC Research, Company

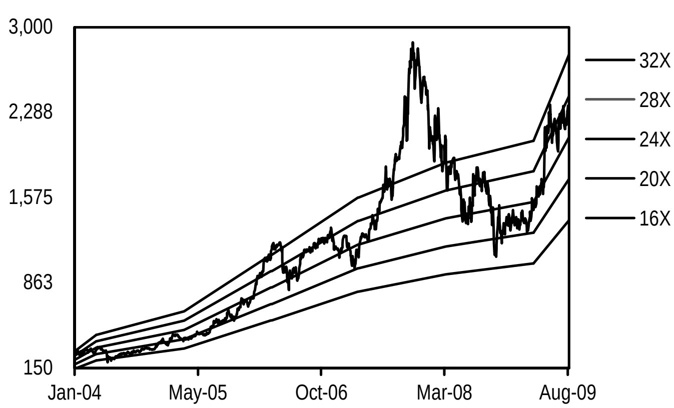
INCOME STATEMENT	2008	2009	2010E	2011E	2012E
Revenues	195,439	262,342	330,689	441,812	541,188
Growth (%)	*11.9*	*34.2*	*26.1*	*33.6*	*22.5*
Operating Profit	35,201	38,014	56,060	74,293	89,994
Other Income	12,055	14,124	13,418	14,088	14,793
EBIDTA	47,256	52,138	69,478	88,381	104,787
Growth (%)	*47.1*	*10.3*	*33.3*	*27.2*	*18.6*
Depr. & Amortization	2,589	3,343	3,831	4,580	5,453
EBIT	44,667	48,795	65,647	83,801	99,334
Interest Charges (Net)	354	308	289	289	277
PBT (Before E/o items)	44,313	48,488	65,357	83,512	99,057
Tax provision	15,711	17,106	22,983	29,408	34,902
E/o Income / (Loss)	(9)	0	0	0	0
Net Profits	28,593	31,381	42,374	54,104	64,155
Adjusted Net Profits	28,593	31,381	42,374	54,104	64,155
Growth (%)	*18.4*	*9.7*	*35.0*	*27.7*	*18.6*
Basic EPS (Rs)	58.4	64.1	86.6	110.5	131.1
Diluted EPS (Rs)	58.4	64.1	86.6	110.5	131.1
Growth (%)	*18.4*	*9.7*	*35.0*	*27.7*	*18.6*

CASH FLOW STATEMENT	2008	2009E	2010E	2011E	2012E
Net Profits	28,593	31,381	42,374	54,104	64,155
Depreciation	2,589	3,343	3,831	4,580	5,453
Inc from inv & int. (profit)	(12,046)	(14,124)	(13,418)	(14,088)	(14,793)
	-	-	-	-	-
	-	-	-	-	-
(Inc)/Dec in working cap	5,078	(18,808)	(8,151)	(21,740)	(26,351)
Other operating activities	(4,028)	(862)	(1,162)	(1,484)	(1,760)
Cash from operations	28,242	2,654	25,798	24,339	30,225
Net capital expenditure	(6,639)	(4,620)	(12,000)	(15,800)	(14,000)
Net Investments	0	(93,320)	(24,009)	(18,766)	(26,344)
Interest & dividend recd	12,046	14,124	13,418	14,088	14,793
Cash from inv. activities	5,407	(83,816)	(22,591)	(20,478)	(25,551)
Equity raised/(repaid)	(7,861)	0	0	0	0
Debt raised/(repaid)	59	(2)	0	0	(250)
Dividend (incl. tax)	(873)	(873)	(873)	(873)	(873)
Other financing activities	0	0	0	0	0
Cash from fin activities	(8,675)	(875)	(873)	(873)	(1,123)
Inc/(Dec.) in cash	24,973	(82,037)	2,333	2,988	3,551

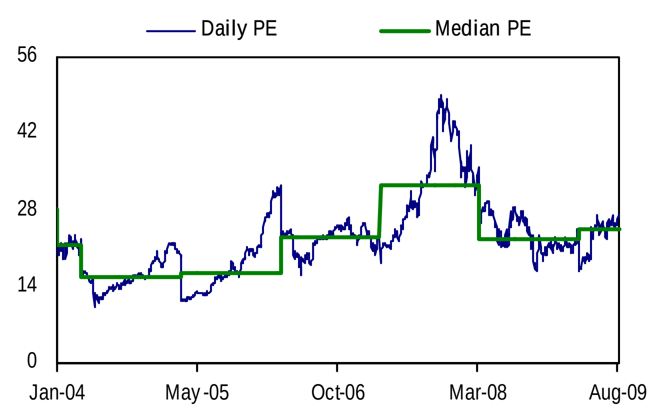
BALANCE SHEET	2008	2009E	2010E	2011E	2012E
Equity Share Capital	4,895	4,895	4,895	4,895	4,895
Reserves & Surplus	102,847	133,355	174,855	228,086	291,368
Shareholders' Funds	107,742	138,250	179,750	232,981	296,263
Minorities Interest	-	-	-	-	-
Total Debt	952	950	950	950	700
Deferred Tax liability	(13,379)	(14,241)	(15,403)	(16,887)	(18,647)
Capital Employed	95,315	124,959	165,298	217,045	278,316
Fixed Assets	16,393	17,670	25,838	37,058	45,605
Cash & cash eq.	83,860	93,420	117,439	136,225	162,598
Net current assets	78,839	107,206	139,377	179,903	232,628
Investments	83	83	83	83	83
Total Assets	95,315	124,959	165,298	217,045	278,316

KEY RATIOS	2008	2009E	2010E	2011E	2012E
OPM (%)	18.0	14.5	17.0	16.8	16.6
Net Margin (%)	14.6	12.0	12.8	12.2	11.9
Dividend Yield (%)	0.1	0.1	0.1	0.1	0.1
Net Debt/Equity (x)	(0.8)	(0.7)	(0.6)	(0.6)	(0.5)
Net working capital (days)	(9.2)	18.9	23.9	35.6	46.6
ROACE (%)	30.0	24.9	28.9	29.8	28.5
ROANW (%)	26.5	22.7	23.6	23.2	21.7
EV/Sales (x)	4.9	3.8	3.0	2.2	1.8
EV/EBIDTA (x)	30.0	27.8	18.9	14.2	11.7
PER (x)	39.9	36.3	26.9	21.1	17.8
PCE (x)	36.6	32.8	24.7	19.4	16.4
Price/Book (x)	10.6	8.2	6.3	4.9	3.8

P/E Band



EV/EBIDTA



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