

## Company

23 July 2009 | 10 pages

# Thermax (THMX.BO)

## Challenging FY10E; Expensive Valuations; Downgrade to Sell

 Equity   
 Rating change   
 Target price change   
 Estimate change 

- Raising target, but downgrading to Sell** — We increase our target to Rs414 (from Rs211), based on a P/E of 16x Sept 10E (vs. 8x FY10E earlier) – a 27% discount to BHEL given lower visibility into revenues. Thermax, up ~134% YTD, is at a P/E of 19x FY10E, factoring in a broader economic revival. We believe FY10E could remain challenging and downgrade the stock from Buy to Sell.
- 1Q FY10 revenues down 25% yoy; PAT declines 27% yoy, worse than expected** — The revenue decline was due to lower order intake in 3Q FY09. Margin improvement, driven by cost-cutting initiatives, was a positive surprise and commendable given the revenue decline. Thermax's order book at Rs32bn is up 22% yoy and 11.4% qoq – positive as a slowdown in orders was an overhang on the stock.
- Management expects decline in FY10E revenues, pickup in 2H FY10E** — FY10 revenues are likely to decelerate due to lower order intake in FY09. Thermax expects FY10 order inflows to grow marginally on a recovering economy, especially in 2H FY10E. Food processing, agro-based industries, distilleries & cement sectors are picking up, while the metal sector remains subdued.
- Cutting EPS for FY10E by 16%** — We factor in lower revenues given order renegotiations/cancellations, and expect order inflows to pick up meaningfully only in 2H FY10E/1H FY11E, which would lower revenue booking in the current year given the short-cycle nature of orders of its product business.
- Early beneficiary of recovery, but order inflows have to grow meaningfully** — While there has been some pickup in order inflows, we believe it has to pick up strongly for the stock to re-rate from current levels. Also, while 1Q FY10E order book is up YoY, at end-2Q FY10E it could be flat/negative given the high-base effect (adjusted for cancelled orders).

<b>Sell/Medium Risk</b>	<b>3M</b>
<i>from Buy/Medium Risk</i>	
Price (22 Jul 09)	Rs429.40
Target price	Rs414.00
<i>from Rs211.00</i>	
Expected share price return	-3.6%
Expected dividend yield	1.2%
<b>Expected total return</b>	<b>-2.4%</b>
Market Cap	Rs51,166M
	US\$1,057M

### Price Performance (RIC: THMX.BO, BB: TMX IN)



Figure 1. Thermax Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31-Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2007A	1,992	16.72	96.1	25.7	8.7	38.0	1.4
2008A	2,787	23.39	39.9	18.4	6.8	41.4	1.4
2009A	3,554	29.82	27.5	14.4	5.2	40.7	1.2
2010E	2,651	22.25	-25.4	19.3	4.3	24.4	1.2
2011E	3,520	29.54	32.8	14.6	3.5	26.7	1.4

Source: Company and Citi Investment Research and Analysis estimates

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See Appendix A-1 for Analyst Certification and important disclosures.

Fiscal year end 31-Mar	2008	2009	2010E	2011E	2012E
<b>Valuation Ratios</b>					
P/E adjusted (x)	18.4	14.4	19.3	14.5	11.4
EV/EBITDA adjusted (x)	11.1	9.0	11.8	8.8	6.6
P/BV (x)	6.8	5.2	4.3	3.5	2.9
Dividend yield (%)	1.4	1.2	1.2	1.4	1.9
<b>Per Share Data (Rs)</b>					
EPS adjusted	23.39	29.82	22.25	29.54	37.73
EPS reported	24.40	24.25	22.25	29.54	37.73
BVPS	63.41	83.28	99.44	121.97	150.34
DPS	6.00	5.00	5.00	6.00	8.00
<b>Profit &amp; Loss (RsM)</b>					
Net sales	34,815	34,603	32,052	40,962	52,174
Operating expenses	-30,923	-29,791	-28,442	-36,079	-45,862
<b>EBIT</b>	<b>3,893</b>	<b>4,812</b>	<b>3,611</b>	<b>4,883</b>	<b>6,312</b>
Net interest expense	-17	-38	-38	-38	-38
Non-operating/exceptionals	439	404	445	489	538
<b>Pre-tax profit</b>	<b>4,315</b>	<b>5,178</b>	<b>4,017</b>	<b>5,334</b>	<b>6,811</b>
Tax	-1,528	-1,624	-1,366	-1,814	-2,316
Extraord./Min.Int./Pref.div.	121	-664	0	0	0
<b>Reported net income</b>	<b>2,907</b>	<b>2,889</b>	<b>2,651</b>	<b>3,520</b>	<b>4,495</b>
Adjusted earnings	2,787	3,554	2,651	3,520	4,495
Adjusted EBITDA	4,125	5,163	4,023	5,325	6,783
<b>Growth Rates (%)</b>					
Sales	49.6	-0.6	-7.4	27.8	27.4
EBIT adjusted	44.5	23.6	-25.0	35.2	29.3
EBITDA adjusted	42.8	25.2	-22.1	32.4	27.4
EPS adjusted	39.9	27.5	-25.4	32.8	27.7
<b>Cash Flow (RsM)</b>					
<b>Operating cash flow</b>	<b>2,667</b>	<b>1,393</b>	<b>477</b>	<b>3,562</b>	<b>3,441</b>
Depreciation/amortization	232	351	412	442	472
Net working capital	-538	-1,874	-2,586	-400	-1,526
<b>Investing cash flow</b>	<b>-1,788</b>	<b>2,204</b>	<b>-500</b>	<b>-500</b>	<b>-500</b>
Capital expenditure	-1,928	-1,954	-500	-500	-500
Acquisitions/disposals	140	4,158	0	0	0
<b>Financing cash flow</b>	<b>-1,271</b>	<b>-481</b>	<b>-766</b>	<b>-836</b>	<b>-1,115</b>
Borrowings	-22	41	-41	0	0
Dividends paid	-1,115	-697	-697	-836	-1,115
<b>Change in cash</b>	<b>-392</b>	<b>3,116</b>	<b>-789</b>	<b>2,226</b>	<b>1,826</b>
<b>Balance Sheet (RsM)</b>					
<b>Total assets</b>	<b>20,278</b>	<b>23,847</b>	<b>21,807</b>	<b>26,758</b>	<b>31,982</b>
Cash & cash equivalent	580	3,696	2,907	5,133	6,959
Accounts receivable	5,305	5,719	5,796	7,407	9,434
Net fixed assets	3,485	5,088	5,176	5,234	5,262
<b>Total liabilities</b>	<b>12,722</b>	<b>13,924</b>	<b>9,958</b>	<b>12,224</b>	<b>14,068</b>
Accounts payable	4,552	4,199	3,664	4,669	5,946
Total Debt	0	41	0	0	0
<b>Shareholders' funds</b>	<b>7,556</b>	<b>9,923</b>	<b>11,849</b>	<b>14,534</b>	<b>17,914</b>
<b>Profitability/Solvency Ratios (%)</b>					
EBITDA margin adjusted	11.8	14.9	12.6	13.0	13.0
ROE adjusted	41.4	40.7	24.4	26.7	27.7
ROIC adjusted	122.4	59.5	27.4	31.8	36.1
Net debt to equity	-7.7	-36.8	-24.5	-35.3	-38.8
Total debt to capital	0.0	0.4	0.0	0.0	0.0

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## 1Q FY10 standalone PAT down 27% yoy

- **1Q FY10 revenues down 25% yoy:** The decline was due to lower order intake in 3Q FY09. Revenues in the energy segment declined 23% yoy and the environment segment declined 30% yoy.
- **Margins improved despite sharp decline in revenues:** The EBITDA margin improved slightly in the quarter – commendable given the sharp fall in revenues – due to cost-cutting initiatives undertaken by the company.
- **Recurring PAT declined 27% yoy** on the back of lower revenues.
- **Order book up 22% yoy – a positive:** Thermax’s standalone order book is up 22% yoy and 11.4% qoq. This is a key positive as a slowdown in order inflows was a key overhang on the stock. The company registered order inflows of Rs10bn in 1Q FY10 vs. Rs5.8bn in 4Q FY09.

Figure 2. Thermax 1Q FY10 Results

	1Q FY09	1Q FY10	Comments
<b>Order backlog eoy</b>	<b>26,490</b>	<b>32,300</b>	
Order backlog Growth %		22%	
Sales & Services (excluding Excise Duty)	7,087	5,228	Lower revenues due to lower intake of orders in 3Q FY09
Other Income from Operations	83	148	
<b>Total Income</b>	<b>7,170</b>	<b>5,376</b>	
% Growth YoY		-25%	
<b>EBITDA</b>	<b>911</b>	<b>689</b>	<b>Margins improved due to cost-cutting measures</b>
<b>EBITDA margin%</b>	<b>12.71%</b>	<b>12.82%</b>	
Depreciation	(70)	(95)	
Interest	(3)	(5)	
Other Income	102	103	
<b>PBT</b>	<b>940</b>	<b>692</b>	
Tax	(303)	(227)	
Effective Tax rate %	32%	33%	
<b>Recurring PAT</b>	<b>637</b>	<b>465</b>	
Recurring PAT margin %	8.89%	8.65%	
Recurring PAT growth %		-27%	

Source: Company and Citi Investment Research and Analysis

## Conference call takeaways

- **FY10 revenues to decelerate:** 1Q FY10 revenues declined due to lower order intake in 3Q FY09 and liquidity constraints at the client’s end, which led to slower execution. The company expects FY10 revenues to be lower than FY09 revenues due to lower order intake in FY09.
- **Positive growth in order inflows in FY10E:** Management suggested that the order inflows for FY10E would be higher than FY09 on the back of a recovering economy. Inflow growth could be in the range of 10-15% if markets improved.
- **Who is investing and who is not:** Management suggested that certain end-user segments have started serious inquiries – sectors like food processing, agro-based industries, distilleries and cement industries are seeing some

pickup. The company has got a USD\$29m order from a GCC country for a captive power plant for a cement company and a Rs1.03bn order from Madras Cements in India. The metals segment, especially ferrous metals, is still showing no signs of a pickup.

- **Margins to remain stable:** The company expects margins to remain largely stable at current levels. Thermax has undertaken cost-cutting initiatives in the form of "Project Ever-lean" which focuses on streamlining processes, eliminating waste and reducing costs.
- **Outlook:** Most of Thermax's clients in the private sector are expecting some pick-up in FY11. Thermax is expecting some uptick in order inflow from 3Q FY10E. Competition remains tough, and the company is focusing on cost-cutting initiatives.
- **On track for supercritical technology by FY12:** The company currently has capability for utility boiler units up to 300MW. It intends to improve this to 500MW in the near term and to 800MW (super-critical technology) by FY12.
- **Technical tie-ups**
  - **Thermax has tied up with GE Water USA.** GE's ultrafiltration and membrane bio-reactor technology will be used by Thermax for wastewater treatment projects. Thermax estimates that the need for advanced water treatment for India's industrial sectors is growing by 50% every year – driven by regulations regarding recycling of wastewater. Thermax will also distribute GE's reverse osmosis membranes to customers in India for water treatment projects.
  - **Thermax has tied up with Wehrle Umwelt GmbH, Germany, for industrial effluent treatment:** Thermax has signed a technology agreement for treatment of hard to treat industrial effluents. The technological tie-up will address pharmaceutical and bulk drug manufacturers; chemical industries; pulp and paper industries etc.
- **Progress on Essar and Brahmani orders** – Thermax has received advances from both Essar and Brahmani Steel for the renegotiated orders totaling ~Rs6.7bn. The company is waiting for Letters of Credit from the clients to start executing. Thermax has completed the raw material and component ordering for the Essar order.

### **Reducing our earnings estimate for FY10E by 16%**

- We are factoring in lower revenues on the back of the order renegotiations by Essar and Brahmani Steel. We also expect the order inflow momentum to pick up in a meaningful manner only in 2H FY10E / 1H FY11E given that corporate capex will take some time to recover, which would lower revenue booking in the current year.
- We are cutting our margin assumptions for FY10E given that not all of the margin expansion seen in FY09 is expected to sustain once execution of orders picks up in 2H FY10E.

Figure 3. Thermax Earnings Revision

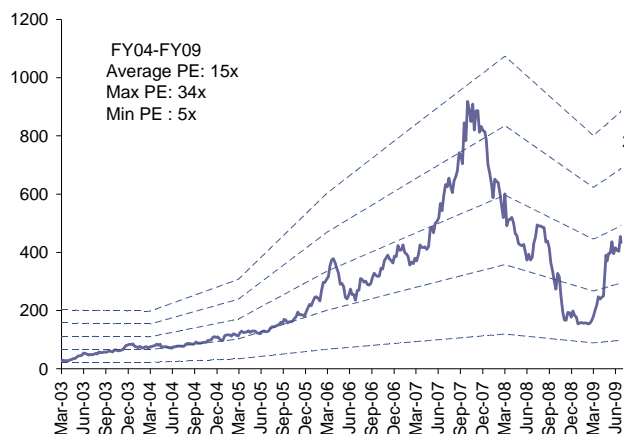
	FY10E	FY11E
<b>Sales</b>		
Old	36,459	39,925
New	32,052	40,962
% change	-12%	3%
<b>EBITDA</b>		
Old	13.00%	13.00%
New	12.55%	13.00%
% change	(45.00)	0.00
<b>PAT</b>		
Old	3,139	3,469
New	2,651	3,520
% change	-16%	1%

Source: Citi Investment Research and Analysis estimates

### Increasing TP to Rs414; downgrade to Sell/Medium Risk

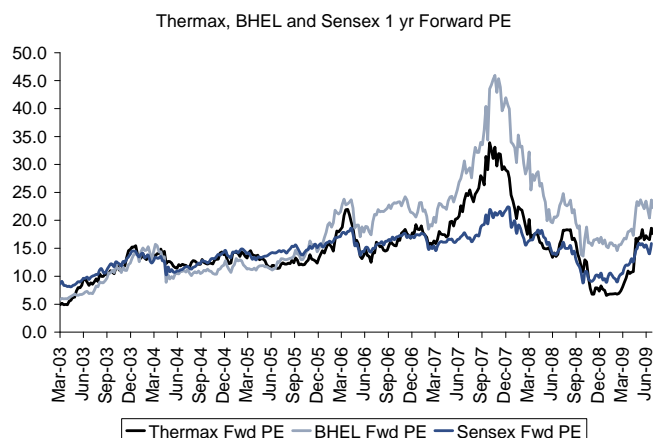
- We increase our target price of Thermax to Rs414, based on a P/E of 16x Sept 10E – a 27% discount to BHEL. Thermax has traded at an average P/E of ~15x over the last 6 years and at an average discount of 13% to BHEL P/E over the last 6 years. We believe that this discount will widen, given lower visibility of revenues.
- Thermax has risen ~134% YTD and is currently trading at a PE of 19x FY10E, factoring in much of the good news regarding expectations of a broader economic revival.
- We believe FY10E could remain challenging and the stock could trade sideways if the order inflows do not pickup significantly. Consequently, we downgrade the stock to Sell/Medium Risk from Buy/Medium risk.

Figure 4. Thermax PE chart



Source: Citi Investment Research and Analysis

Figure 5. Thermax, BHEL and Sensex PE



Source: Citi Investment Research and Analysis

## Thermax

### Company description

Thermax specializes in energy and environment engineering solutions. It offers products and services in heating, cooling, waste heat recovery, captive power, water treatment and recycling, waste management and performance chemicals.

### Investment strategy

We have a Sell/Medium Risk rating on Thermax. Thermax has run up sharply this year, factoring in expectations of a broader economic revival. While there has been some pickup in order inflow, we believe it has to pick up strongly for the stock to re-rate. FY10E is likely to remain challenging.

### Valuation

Our target price for Thermax of Rs414 is based on a P/E of 16x Sept 10E, in line with the stock's 6-year average range of 15-16x. For reference, during the same period Thermax has traded at an average P/E discount of 13% to sector leader BHEL. We believe that this discount will widen due to lower visibility into revenues for Thermax.

### Risks

We rate Thermax shares as Medium Risk. We believe this is appropriate given that Thermax's business model is dependent on capex of the private sector, which has not picked up materially. The key upside risks to our target price include higher than expected order inflow, a pick-up in private-sector capex and faster execution.

# Appendix A-1

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#### Fundamental Research

Analyst: Deepal Delivala

Covered since May 23 2007

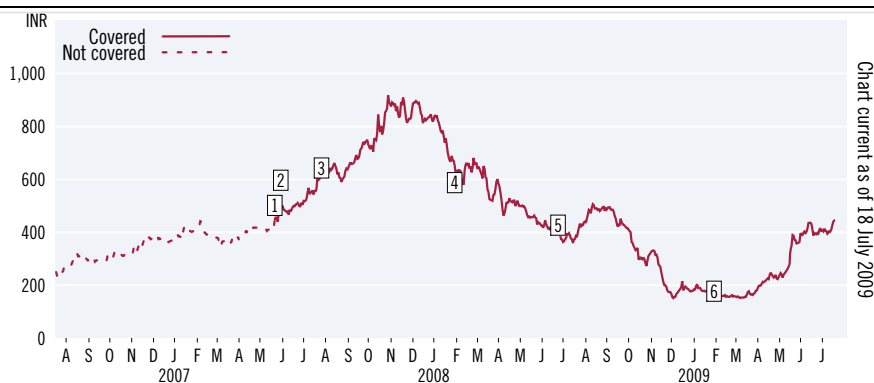


Chart current as of 18 July 2009

Date	Rating	Target Price	Closing Price
1 22-May-07	*1L	*562.00	448.50
2 30-May-07	1L	*604.00	488.85

Date	Rating	Target Price	Closing Price
3 26-Jul-07	1L	*764.00	637.30
4 30-Jan-08	1L	*748.00	652.50

Date	Rating	Target Price	Closing Price
5 24-Jun-08	1L	*480.00	393.80
6 29-Jan-09	*1M	*211.00	159.30

\* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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