

**Industrials**  
**Electrical Equipment**  
 Equity – India

## Underweight

Target price (INR)	510.00
Share price (INR)	677.30
Potential return (%)	-24.7

Note: Potential return equals the percentage difference between the current share price and the target price

Performance	1M	3M	12M
Absolute (%)	1.7	-17.6	-21.4
Relative <sup>A</sup> (%)	-6.0	-18.8	-6.0

Index<sup>A</sup> BOMBAY SE IDX

RIC ABB.BO  
 Bloomberg ABB IN

Market cap (USDm) 2,931  
 Market cap (INRm) 143,526

Enterprise value (INRm) 136211  
 Free float (%) 16

Note: (V) = volatile (please see disclosure appendix)

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This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it

# ABB India

UW: Margin recovery remains elusive

- ▶ **A 290bp miss in margins and higher interest cost and D&A drive yet another EPS miss of c62%**
- ▶ **We find little comfort from order growth and believe that margin recovery remains key to earnings growth**
- ▶ **Lower our FY11/12e EPS by c25%/11% (c42%/25% below cons); maintain UW with a lower target of INR510 (vs INR570)**

**Q3 results largely weak:** Although ABB reported an outperformance in sales growth (c29% y-o-y) and order inflow (up c23% y-o-y), we believe the results were weak overall. While strength in order intake can be attributed to lumpiness, in our opinion, the strength in sales growth is largely a result of a weak y-o-y comp. More important, in our view, is the continued weakness in margins, which fell c110bp q-o-q and came in c290-310bp below our and consensus expectations. In addition, depreciation remained high (up c110% y-o-y), interest cost came in higher than expected (up c200% y-o-y) and the tax rate also increased (c40% vs c34% in Q2), all of which drove an EPS miss of c62%/68% compared with HSBC/Cons estimates.

**Margin recovery remains elusive:** ABB has consistently missed earnings estimates over the past 7 quarters by more than 50%, largely on account of weaker profitability. Initially, it was projects business (PS & PA), then power products and now low voltage products – all surprising negatively because of low-margin orders. In such a scenario, we believe growth in order inflow holds little value as it may not necessarily translate into commensurate earnings growth. Hence, in our opinion, a sustainable margin recovery is key to earnings growth.

**Yet another double-digit downgrade:** Even though we were c20% below cons on FY11e EPS, we believe the weak Q3 numbers warrant another reduction in expectations. Hence, we have lowered our FY11/12e EPS by c25%/11%, putting us c42% below cons on FY11e EPS and c25% on FY12e EPS. The EPS cut is driven primarily by lower margin expectations (down c120bp) and higher D&A and net interest estimates.

**Stock remains at an unwarranted premium; maintain UW and cut target to INR510:** Driven largely by our FY12e earnings cut, we lower our target price to INR510 vs INR570 earlier. Our new target is derived from our preferred EVA valuation methodology and implies that, 12 months from now, the stock should be trading at a target 12M fwd PE of 23.6x. On our new estimates, the stock is currently trading at c39.2x FY12e PE. The stock remains significantly expensive vs its closest peers, Siemens and Areva & Crompton, which have delivered better results than ABB in FY11, despite operating under similar market conditions. Hence, we continue to find the premium on ABB unjustified and retain our UW rating on the stock.

## Financials & valuation

### Financial statements

Year to	12/2010a	12/2011e	12/2012e	12/2013e
<b>Profit &amp; loss summary (INRm)</b>				
Revenue	62,871	73,730	84,823	100,287
EBITDA	2,506	3,830	6,489	9,175
Depreciation & amortisation	-517	-886	-878	-862
Operating profit/EBIT	1,989	2,944	5,611	8,313
Net interest	-41	-63	-64	-12
PBT	1,002	2,881	5,548	8,301
HSBC PBT	1,948	2,881	5,548	8,301
Taxation	-370	-980	-1,886	-2,822
Net profit	632	1,902	3,662	5,478
HSBC net profit	1,229	1,902	3,662	5,478

### Cash flow summary (INRm)

Cash flow from operations	2,165	1,406	3,095	4,327
Capex	-1,042	-3,180	-1,530	-1,030
Cash flow from investment	-1,042	-3,180	-1,530	-1,030
Dividends	-495	-493	-545	-620
Change in net debt	-995	2,267	-1,020	-2,677
FCF equity	1,838	-1,774	1,565	3,297

### Balance sheet summary (INRm)

Intangible fixed assets	295	350	262	207
Tangible fixed assets	7,943	10,182	10,922	11,145
Current assets	49,262	53,227	61,180	73,522
Cash & others	9,413	7,146	8,166	10,843
Total assets	57,714	63,973	72,578	85,089
Operating liabilities	31,630	36,481	41,970	49,621
Gross debt	0	0	0	0
Net debt	-9,413	-7,146	-8,166	-10,843
Shareholders funds	24,237	25,646	28,762	33,621
Invested capital	28,795	34,725	39,017	44,259

### Ratio, growth and per share analysis

Year to	12/2010a	12/2011e	12/2012e	12/2013e
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#### Y-o-y % change

Revenue	0.8	17.3	15.0	18.2
EBITDA	-60.7	52.8	69.4	41.4
Operating profit	-66.3	48.0	90.6	48.1
PBT	-81.0	187.5	92.5	49.6
HSBC EPS	-68.6	54.7	92.5	49.6

#### Ratios (%)

Revenue/IC (x)	2.2	2.1	2.2	2.3
ROIC	5.2	6.4	10.3	13.3
ROE	5.1	7.4	12.7	16.3
ROA	1.3	3.1	5.4	6.9
EBITDA margin	4.0	5.2	7.7	9.1
Operating profit margin	3.2	4.0	6.6	8.3
EBITDA/net interest (x)	61.3	60.8	102.0	740.4
Net debt/equity	-38.8	-27.9	-28.4	-32.3
Net debt/EBITDA (x)	-3.8	-1.9	-1.3	-1.2
CF from operations/net debt				

#### Per share data (INR)

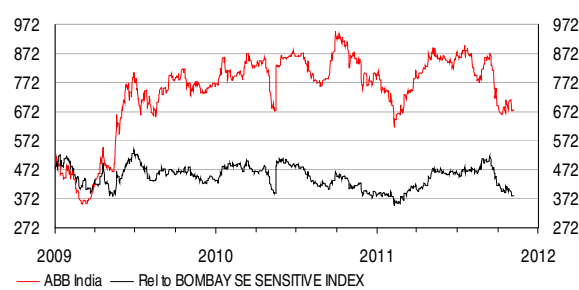
EPS reported (fully diluted)	2.98	8.97	17.28	25.85
HSBC EPS (fully diluted)	5.80	8.97	17.28	25.85
DPS	2.00	2.20	2.50	3.00
Book value	114.38	121.02	135.73	158.66

### Valuation data

Year to	12/2010a	12/2011e	12/2012e	12/2013e
EV/sales	2.1	1.8	1.6	1.3
EV/EBITDA	53.5	35.6	20.8	14.4
EV/IC	4.7	3.9	3.5	3.0
PE*	116.8	75.5	39.2	26.2
P/Book value	5.9	5.6	5.0	4.3
FCF yield (%)	1.3	-1.2	1.1	2.3
Dividend yield (%)	0.3	0.3	0.4	0.4

Note: \* = Based on HSBC EPS (fully diluted)

### Price relative



Source: HSBC

Note: price at close of 07 Nov 2011

## Key takeaways from the conference call

### Demand environment

- ▶ In the Power segment, there was a slowdown in generation related to fuel linkage, land acquisition, funding, etc. However, there was a lot of traction in T&D. A number of tenders are expected from both PGCIL and States
- ▶ Expect ongoing demand in the Infrastructure segment, driven by government initiatives, such as Metro Rail
- ▶ In the Industry segment, robust demand outlook in most markets except for Cement and Metals/Minerals sector, where capacity utilisation levels have dipped below 80%
- ▶ Strong growth coming from renewables, particularly the Solar sector. Weaker rupee is helping the textile industry and, after years of muted capex, investment in the petrochemical sector is also picking up
- ▶ Inflation and high interest rates likely to continue as the key headwinds for the sector

### Order inflow

- ▶ Pick-up in order intake was driven by several large order wins, most notably in the transmission and steel sectors. Project business contributed more than 60% of order intake in Q3
- ▶ Big ticket orders included a INR3.3bn order for a 765kV substation and a INR8.2bn order from a steel plant. Company has not yet booked the HVDC order as it remains in final stages of financial closure

### Cost optimisation/pressures

- ▶ Strong focus on operational excellence – continuous efforts to rationalise supply chain, procurement, production, etc, has resulted in a decline of c3% y-o-y in material cost to sales
- ▶ Employee strength unlikely to go up from here. Instead, ABB is focusing on hiring experts. Employee expense is likely to remain c9% of sales
- ▶ Backlog related to rural electrification is cINR310m. ABB expects to deliver all of it by the first half of FY12
- ▶ Pricing pressure in the T&D market remains, driven by continued competition from Chinese, Korean and domestic players. However, ABB said it believed pricing was unlikely to deteriorate further
- ▶ Expenses in Q3 include one-time stamp duties related expense of INR240m

### Margins

- ▶ Low Voltage margins suffered in Q3 because of some low-margin orders and a negative impact from a start-up business that is part of that division
- ▶ Prices for Power products have come down sharply. ABB is trying to optimise cost to recover margins here
- ▶ Discrete Automation & Motion (DAM) margins remain healthy and are sustainable
- ▶ ABB said it should be able to deliver high single digit margins when the environment returns to normal. Not willing to commit to a timeline for this recovery

## Q3 FY11 results summary

### ABB Standalone - Dec YE (INRm)

	Q3FY10	Q4FY10	Q1FY11	Q2FY11	Q3FY11a	Q3FY11e	BB Cons Q3FY11e	Act vs HSBC	Act vs Cons
Net Sales	13,340	20,506	17,813	16,930	17,263	15,876	15,982	8.7%	8.0%
EBITDA	345	327	1,016	855	666	1,080	1,113	-38.3%	-40.1%
Profit before tax	208	156	877	589	371	878	902	-57.8%	-58.9%
Net Income	115	68	595	387	222	588	685	-62.3%	-67.7%
EPS (INR)	0.5	0.3	2.8	1.8	1.0	2.8	3.3	-62.3%	-68.3%
<b>Margins &amp; trends</b>									
Sales growth	-8%	9%	22%	17%	29%	19%	20%	10.4%	9.6%
EBITDA mgn	2.6%	1.6%	5.7%	5.0%	3.9%	6.8%	7.0%	(294)	(310)
PBT mgn	1.6%	0.8%	4.9%	3.5%	2.1%	5.5%	5.6%	(338)	(350)
NI mgn	0.9%	0.3%	3.3%	2.3%	1.3%	3.7%	4.3%	(242)	(300)

Source: Company data, HSBC

## Segment results

### Segment sales (INRm)

	Q110	Q210	Q310	Q410	Q111	Q211	Q311
Power Systems	3,825	4,173	3,919	6,350	5,723	5,077	5,462
Power Products	4,318	4,441	3,992	5,404	4,400	4,688	4,975
Process Automation	2,866	2,259	2,180	4,582	3,298	2,938	2,781
Discrete Automation and Motion	3,960	3,649	3,445	4,875	4,174	4,211	4,344
Low Voltage Products	973	1,034	1,039	1,440	1,297	1,275	1,391
Unallocated/Intersegment	(1,190)	(925)	(1,086)	(1,930)	(932)	(1,063)	(1,517)
<b>Total</b>	<b>14,752</b>	<b>14,631</b>	<b>13,490</b>	<b>20,720</b>	<b>17,960</b>	<b>17,125</b>	<b>17,435</b>

Source: Company data, HSBC

### Segment sales growth

	Q110	Q210	Q310	Q410	Q111	Q211	Q311
Power Systems	-14.5%	-10.1%	2.8%	48.9%	49.6%	21.7%	39.4%
Power Products	1.4%	-11.5%	-15.7%	-8.8%	1.9%	5.6%	24.6%
Process Automation	14.0%	-27.8%	-16.1%	-2.2%	15.1%	30.1%	27.5%
Discrete Automation and Motion	28.4%	14.7%	-0.4%	12.2%	5.4%	15.4%	26.1%
Low Voltage Products	25.6%	25.7%	4.4%	16.8%	33.3%	23.3%	33.8%
<b>Total</b>	<b>4.9%</b>	<b>-3.4%</b>	<b>-8.2%</b>	<b>9.0%</b>	<b>21.7%</b>	<b>17.0%</b>	<b>29.2%</b>

Source: Company data, HSBC

### Segment EBIT (INRm)

	Q110	Q210	Q310	Q410	Q111	Q211	Q311
Power Systems	(485)	(212)	(28)	(381)	17	(35)	23
Power Products	359	284	(28)	204	214	220	164
Process Automation	303	208	(41)	346	217	150	64
Discrete Automation and Motion	106	461	484	271	509	320	459
Low Voltage Products	(7)	(3)	40	(12)	104	125	29
Unallocated	(155)	(140)	(175)	(224)	(144)	(125)	(298)
<b>Total</b>	<b>121</b>	<b>598</b>	<b>253</b>	<b>204</b>	<b>917</b>	<b>656</b>	<b>442</b>

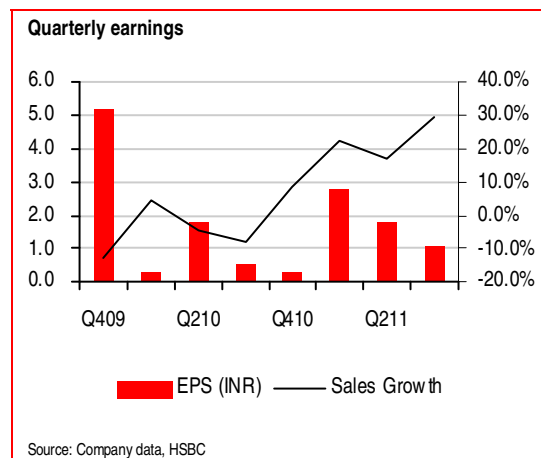
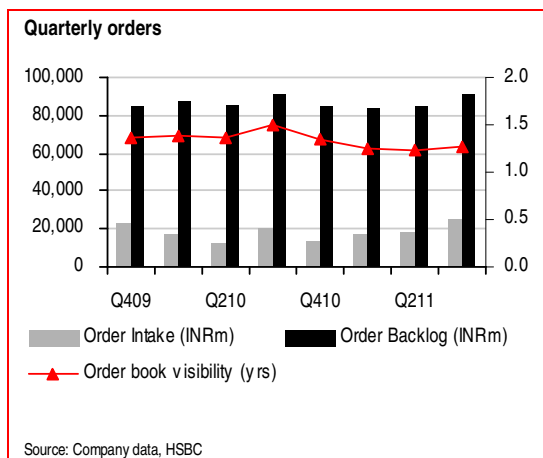
Source: Company data, HSBC

### Segment EBIT margin

	Q110	Q210	Q310	Q410	Q111	Q211	Q311
Power Systems	-12.7%	-5.1%	-0.7%	-6.0%	0.3%	-0.7%	0.4%
Power Products	8.3%	6.4%	-0.7%	3.8%	4.9%	4.7%	3.3%
Process Automation	10.6%	9.2%	-1.9%	7.6%	6.6%	5.1%	2.3%
Automation Products	2.7%	12.6%	14.0%	5.6%	12.2%	7.6%	10.6%
Low Voltage Products	-0.8%	-0.3%	3.9%	-0.8%	8.0%	9.8%	2.1%
Total	0.8%	4.1%	1.9%	1.0%	5.1%	3.8%	2.5%

Source: Company data, HSBC

## Order flow and earnings



## Valuation and risks

Driven by our earnings cut, we lower our target price to INR510 vs INR570 earlier. Our new target price is derived from our preferred EVA valuation methodology, assuming target sales growth of c9%, through-cycle operating return margin of c9.0% and a WACC of 11.7% (assumptions: risk-free rate of 7.5%; equity risk premium of 5.5%; sector beta of 0.90 and a company beta of 1). Our target price implies that, 12 months from now, the stock should be trading at a 12-month forward PE of 23.6x on 24-month forward EPS of INR21.6.

Under HSBC's research model, for stocks without a volatility indicator, the Neutral rating band is 5ppt above and below the hurdle rate for India stocks of 11%. This translates into a Neutral rating band of 6% to 16% above the current share price. Our new 12-month target price of INR510 implies a potential negative return of 25%, which is below the Neutral rating band; hence, we maintain our UW rating. Potential return equals the percentage difference between the current share price and the target price.

### Risks

We highlight the key upside risks to rating:

- ▶ Significant pick-up in execution
- ▶ Better-than-expected improvement in margins
- ▶ Resurgence of large orders

## Changes to FY11-13 earnings estimates

### ABB Ltd - Dec YE (INRm)

	CY09	CY10	New forecasts			Old forecasts			Change		
			CY11e	CY12e	CY13e	CY11e	CY12e	CY13e	CY11e	CY12e	CY13e
Order Backlog	84,787	84,362	89,853	101,314	119,377	87,341	96,030	111,745	2.9%	5.5%	6.8%
Net Sales	62,372	62,871	73,730	84,823	100,287	69,338	79,010	91,604	6.3%	7.4%	9.5%
Clean EBITDA	6,382	2,506	3,830	6,489	9,175	4,440	6,877	8,817	-13.7%	-5.6%	4.1%
Reported EBITDA	5,832	1,560	3,830	6,489	9,175	4,440	6,877	8,817	-13.7%	-5.6%	4.1%
Clean EBIT	5,897	1,989	2,944	5,611	8,313	3,789	6,177	8,101	-22.3%	-9.2%	2.6%
Reported EBIT	5,347	1,043	2,944	5,611	8,313	3,789	6,177	8,101	-22.3%	-9.2%	2.6%
Other Income	0	0	0	0	0	0	0	0			
Net Financials	(73)	(41)	(63)	(64)	(12)	22	34	99			
Profit before tax	5,274	1,002	2,881	5,548	8,301	3,811	6,211	8,200	-24.4%	-10.7%	1.2%
Income tax	(1,728)	(370)	(980)	(1,886)	(2,822)	(1,296)	(2,112)	(2,788)			
Extraordinary items	0	0	0	0	0	0	0	0			
Minorities	0	0	0	0	0	0	0	0			
Clean Net Income	3,916	1,229	1,902	3,662	5,478	2,515	4,099	5,412	-24.4%	-10.7%	1.2%
Reported Net Income	3,546	632	1,902	3,662	5,478	2,515	4,099	5,412	-24.4%	-10.7%	1.2%
Clean EPS	18.5	5.8	9.0	17.3	25.9	11.9	19.3	25.5	-24.4%	-10.7%	1.2%
Reported EPS	16.7	3.0	9.0	17.3	25.9	11.9	19.3	25.5	-24.4%	-10.7%	1.2%
DPS	2.0	2.0	2.2	2.5	3.0	2.2	2.5	3.0	0.0%	0.0%	0.0%
<b>Margins &amp; trends</b>											
Sales visibility (yrs)	1.4	1.3	1.2	1.2	1.2	1.3	1.2	1.2	-3.3%	-1.7%	-2.4%
Sales growth	16%	1%	17%	15%	18%	10%	14%	16%	7.0%	1.1%	2.3%
Clean EBITDA mgn	10.2%	4.0%	5.2%	7.7%	9.1%	6.4%	8.7%	9.6%	-1.2%	-1.1%	-0.5%
Reported EBITDA mgn	9.4%	2.5%	5.2%	7.7%	9.1%	6.4%	8.7%	9.6%	-1.2%	-1.1%	-0.5%
Clean EBIT mgn	9.5%	3.2%	4.0%	6.6%	8.3%	5.5%	7.8%	8.8%	-1.5%	-1.2%	-0.6%
Reported EBIT mgn	8.6%	1.7%	4.0%	6.6%	8.3%	5.5%	7.8%	8.8%	-1.5%	-1.2%	-0.6%
PBT mgn	8.5%	1.6%	3.9%	6.5%	8.3%	5.5%	7.9%	9.0%	-1.6%	-1.3%	-0.7%
Clean NI mgn	6.3%	2.0%	2.6%	4.3%	5.5%	3.6%	5.2%	5.9%	-1.0%	-0.9%	-0.4%
Reported NI mgn	5.7%	1.0%	2.6%	4.3%	5.5%	3.6%	5.2%	5.9%	-1.0%	-0.9%	-0.4%

Source: Company data, HSBC estimates

# Disclosure appendix

## Analyst Certification

The following analyst(s), economist(s), and/or strategist(s) who is(are) primarily responsible for this report, certifies(y) that the opinion(s) on the subject security(ies) or issuer(s) and/or any other views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Rahul Garg.

## Important disclosures

### Stock ratings and basis for financial analysis

HSBC believes that investors utilise various disciplines and investment horizons when making investment decisions, which depend largely on individual circumstances such as the investor's existing holdings, risk tolerance and other considerations. Given these differences, HSBC has two principal aims in its equity research: 1) to identify long-term investment opportunities based on particular themes or ideas that may affect the future earnings or cash flows of companies on a 12 month time horizon; and 2) from time to time to identify short-term investment opportunities that are derived from fundamental, quantitative, technical or event-driven techniques on a 0-3 month time horizon and which may differ from our long-term investment rating. HSBC has assigned ratings for its long-term investment opportunities as described below.

This report addresses only the long-term investment opportunities of the companies referred to in the report. As and when HSBC publishes a short-term trading idea the stocks to which these relate are identified on the website at [www.hsbcnet.com/research](http://www.hsbcnet.com/research). Details of these short-term investment opportunities can be found under the Reports section of this website.

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## Rating definitions for long-term investment opportunities

### Stock ratings

HSBC assigns ratings to its stocks in this sector on the following basis:

For each stock we set a required rate of return calculated from the cost of equity for that stock's domestic or, as appropriate, regional market established by our strategy team. The price target for a stock represents the value the analyst expects the stock to reach over our performance horizon. The performance horizon is 12 months. For a stock to be classified as Overweight, the potential return, which equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated, must exceed the required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile\*). For a stock to be classified as Underweight, the stock must be expected to underperform its required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile\*). Stocks between these bands are classified as Neutral.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

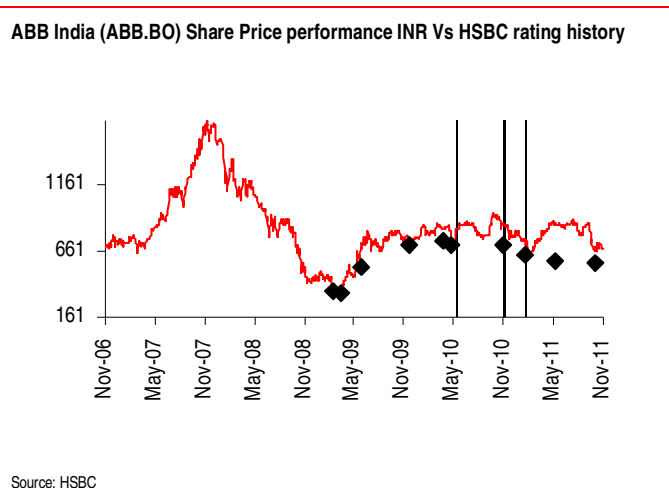
\*A stock will be classified as volatile if its historical volatility has exceeded 40%, if the stock has been listed for less than 12 months (unless it is in an industry or sector where volatility is low) or if the analyst expects significant volatility. However, stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

## Rating distribution for long-term investment opportunities

As of 08 November 2011, the distribution of all ratings published is as follows:

<b>Overweight (Buy)</b>	54%	(26% of these provided with Investment Banking Services)
<b>Neutral (Hold)</b>	35%	(22% of these provided with Investment Banking Services)
<b>Underweight (Sell)</b>	11%	(13% of these provided with Investment Banking Services)

## Share price and rating changes for long-term investment opportunities



### Recommendation & price target history

From	To	Date
Underweight (V)	Restricted	17 May 2010
Restricted	Underweight (V)	04 November 2010
Underweight (V)	Underweight	25 January 2011
Target Price	Value	Date
Price 1	350.00	23 February 2009
Price 2	335.00	19 March 2009
Price 3	542.00	03 June 2009
Price 4	712.00	26 November 2009
Price 5	736.00	30 March 2010
Price 6	710.00	03 May 2010
Price 7	Restricted	17 May 2010
Price 8	Restricted	28 July 2010
Price 9	710.00	04 November 2010
Price 10	630.00	25 January 2011
Price 11	590.00	15 May 2011
Price 12	570.00	11 October 2011

Source: HSBC



## HSBC & Analyst disclosures

### Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
ABB INDIA	ABB.BO	677.30	08-Nov-2011	4, 11

Source: HSBC

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