

July 9, 2010

BUY

Price Rs 441	Target Price Rs 464
Sensex	17,652

Price Performance

(%)	1M	3M	6M	12M
Absolute	11	16	11	31
Rel. to Sensex	4	18	11	2

Source: Bloomberg

Stock Details

Sector	Engineering & Cap Goods
Reuters	BLUS.BO
Bloomberg	BLSTR@IN
Equity Capital (Rs mn)	180
Face Value(Rs)	2
No of shares o/s (mn)	90
52 Week H/L	446/304
Market Cap (Rs bn/USD mn)	40/854
Daily Avg Volume (No of sh)	84399
Daily Avg Turnover (US\$m)	0.7

Shareholding Pattern (%)

	M'10	D'09	S'09
Promoters	40.1	40.1	40.1
FII/NRI	9.0	7.7	8.2
Institutions	7.6	7.5	7.2
Private Corp	8.7	9.3	9.0
Public	34.6	35.4	35.5

Source: Capitaline

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- **Industry progression to MEP inevitable – DS Gupta acquisition to further strengthen BLSR's MEP capabilities**
- **Developing non-commercials as new growth drivers - Commercial sector contribution to fall from 80% to 60%**
- **Uptick in margins over next 3-5 years – drives by structural change in industry, scale benefits and sourcing benefits**
- **With ROE of 46%, valuations are attractive at 17.7X FY11E and 14.9X FY12E earnings. Retain BUY rating**

We had arranged a fund manager's meeting with the management of Blue Star (BLSR). Following are the key highlights of the meeting:

Outlook for Electro-Mechanical Projects & Packaged Air-conditioners (EMP&PAC) has improved

- **Demand outlook** – Management indicated strong pick up in demand across all sectors barring commercial real estate.
 - Demand from **IT and retail** segments has picked up. It is expected to further strengthen by end FY11E.
 - **Hotels and hospitals** to continue to provide good growth opportunity for the next few years.
 - In the infrastructure sector, construction of **metro rails** will be a key growth-driver. Orders from metro projects in Bangalore, Chennai and Kolkata worth Rs12-13 bn are expected to be finalized over the next 6-9 months. Given its past experience with DMRC, BLSR expects to secure a significant share of the above projects.
 - Demand from **airports** is expected to be lackluster, post the recent finalization of the Mumbai Airport – the last of the major airports.
 - Infrastructure (airport and metro), power (electrification and T&D) and industrials will emerge as the new growth drivers over the next 5 years (Note – power electricals and industrials are currently clubbed by BLSR under the PEIS division). This diversification will enable BLSR to reduce dependency on the cyclical commercial sector. Currently, BLSR's order intake from the above sectors stood at Rs3.0 bn in FY10E. This is expected to double to Rs6.0 bn in FY11E – split as infrastructure (airports, metro) - Rs3.0-3.5 bn, industrials – Rs1.5 bn and power – Rs1.0 bn.
 - With the planned focus on non-commercial sectors, the management expects exposure to the traditional commercial sector (IT/ITES offices and retail) to come down from the current 80% to about 60% over the next 5 years.

Financial Snapshot

Rs Mn

YE-Mar	Net Sales	EBITDA (Core)	(%)	APAT	AEPS (Rs)	AEPS % chg	RoE (%)	P/E	EV/ EBITDA	P/BV
FY09	25,026	2,823	11.3	1,829	20.3	29.5	58.2	21.7	15.4	10.8
FY10	25,250	2,935	11.6	1,999	22.2	9.3	46.6	19.8	14.5	8.1
FY11E	29,826	3,368	11.3	2,249	25.0	12.5	40.2	17.6	12.3	6.3
FY12E	35,410	3,966	11.2	2,662	29.6	18.4	37.6	14.9	10.1	5.0

- **Industry progression inevitable** – The air-conditioning industry's progression from providing standalone mechanical / HVAC (Heating Ventilation and Air-conditioning) services to providing composite MEP (Mechanical Electrical and Plumbing) services is inevitable (as highlighted by us in our report "Just chill..." dated Apr'10). BLSR has made significant headway in this direction and has metamorphosed into a composite MEP player offering mechanical, electrical and plumbing services under a single roof:
 - BLSR acquired skill sets in electricals through the acquisition of Naseer Electricals in Jan '08
 - It is in the final stages of acquiring DS Gupta Constructions Pvt. Ltd., thereby acquiring skill sets in plumbing.
- **Competition** – The management expects the industry to undergo further consolidation over the next few years with about 4-5 players garnering a 75-80% share (against the current 50-60%) – in line with developed markets. This is likely to have a positive impact on the industry margins, especially of the top 4-5 market players.

Outlook for Unitary Cooling Products (UCP) remains strong

- **Room air-conditioners (RAC)** – Overall, the RAC market will grow at a robust pace led by demand from residential sector. However, BLSR will continue to maintain focus on commercial sales for growth, in line with its policy of retail (residential) sales being a non-focus area for growth. Hence, BLSR will grow at a robust pace, but lower than overall RAC market growth rate.
- **Commercial Refrigeration** – The management has guided for strong growth in the commercial refrigeration over the next 5 years on the back of buoyancy from retail, exports and food processing sectors / industries. The segment is expected to grow at 13-14% CAGR over the next 5 years (Vs ~10% CAGR in the past).

Outlook for Professional Electronics & Industrial Systems (PEIS) – eyeing diversification

- Under this segment, BLSR procures and supplies equipments like medical systems & equipments, testing machines (both destructive and non-destructive), data communication equipment, industrial pumps and valves, etc. With pick-up in capex environment, management expects strong growth potential in the next 5 years.
- Further, BLSR is metamorphosing from a pure equipment supplier to solutions / systems provider and is taking projects on EPC basis. Concurrently, BLSR is bidding for projects ranging from Rs0.1 to 1.0 bn in the industrials (steel, oil & gas) and power (electricals and sub-stations).

Eyeing expansion in operating margins – the buck does not stop here

The management has indicated robust outlook for operating margins ahead - expects uptick in operating margins over the next 5 years. Already BLSR has improved its margins by 560 bps from 6.1% in FY05 to 11.8% in FY10.

- **EMP&PAC** – Management expects improvement in operating margins on the back of (1) industry-wide consolidation enabling top players executing large projects and earning high margins (2) domestic market to graduate along lines of other developed markets – where operating margins average around 15-16% (Vs 10-12% for BLSR) (3) relatively low competition in the large projects space, i.e. +Rs1 bn order size market.
- **UCP** – Improvement in operating margins would be driven by scale in business. The domestic market will witness sustained volume growth, being an extremely under-penetrated market. Hence there is scope for improvement in operating margins led by expansion in volumes, sourcing benefits, etc.

Acquisition of DS Gupta Constructions to enhance plumbing capabilities

BLSR is in the final stages of acquiring DS Gupta Constructions Pvt. Ltd. (DSG) (deal is expected to be closed by mid-July) – amongst the largest independent plumbing and fire fighting contracting company in India. DSG earned revenues of Rs1.3 bn in FY10 and has an order backlog of Rs2.75 bn. The acquisition will plug the gap for BLSR in the composite MEP services.

Eyeing inorganic growth in water, power and oil & gas

BLSR is eyeing diversification into power (largely electrical), water and water treatment systems and oil & gas (mechanical services) sectors over the next 5 years – to reduce dependency on the commercial segment. However, BLSR is extremely focused on maintaining its ROCE, despite plans to venture into new business areas.

Balance Sheet – 317% increase in ‘Other Current Assets’ temporary

In FY10, BLSR's other current assets increased by 317% from Rs0.9 bn to Rs3.6 bn (despite no traction in revenues). This is largely attributed to implementation of SAP systems on receivables management and invoicing w.e.f. Apr'09. The implementation of the SAP systems resulted in higher lead time for invoicing and also increased the time gap between revenue booking (based on percentage completion method) and invoicing (as based on the modalities of the contract). However, since Jan'10, the management has reverted to the earlier system of customer invoicing and expects the above anomaly to be addressed over the ensuing quarter. As on Mar'10, Rs2 bn was related to debtors arising from delayed invoicing and Rs1.5 bn linked to non-invoiced / unbilled revenues.

We reiterate our BUY recommendation

We reiterate that BLSR, with its dominant share in the domestic market, is well poised to capitalize on the ensuing Rs529 bn opportunity in the domestic MEP industry. Further, BLSR is likely to be a primary beneficiary of the domestic air-conditioning industry's progression from HVAC to integrated MEP play. BLSR has strong order book at Rs17.3 bn (0.7X FY10E revenues) and has witnessed sustained momentum in order inflows (including non-HVAC) – lending comfort to our FY11E earning estimates. Given ROE of 46%, at CMP, BLSR is trading at attractive valuations of 17.4X FY11E and 14.6X FY12E earnings of Rs24.9 and Rs29.6 per share respectively. We retain our BUY rating with a price target of Rs464

Key Financials

Income Statement

Y/E, Mar (Rs. mn)	FY09	FY10	FY11E	FY12E
Net Sales	25,026	25,250	29,826	35,410
Growth (%)	12.7	0.9	18.1	18.7
Expenditure	22,203	22,315	26,458	31,444
Materials Consumed	18,743	18,821	22,470	26,855
Employee Cost	1,828	1,855	2,191	2,601
Manufacturing Exp	101	103	138	163
Other Exp	1,531	1,536	1,659	1,825
EBITDA	2,823	2,935	3,368	3,966
Growth (%)	19.6	3.9	14.8	17.8
EBITDA margin (%)	11.3	11.6	11.3	11.2
Depreciation	259	347	408	459
EBIT	2,565	2,588	2,960	3,507
EBIT margin (%)	10.2	10.2	9.9	9.9
Other Income	16	147	68	68
Interest expenses	173	85	47	47
PBT	2,409	2,650	2,981	3,529
Tax	579	651	733	867
Effective tax rate (%)	45.7	36.6	36.6	36.6
Adjusted PAT	1,829	1,999	2,249	2,662
Growth (%)	29.5	9.3	12.5	18.4
Net Margin (%)	7.3	7.9	7.5	7.5
(Profit)/loss from JVs/Ass/MI	0	0	0	0
Adj. PAT After JVs/Ass/MI	1,829	1,999	2,249	2,662
E/O items	(26)	139	-	-
Reported PAT	1,803	2,138	2,249	2,662
Growth (%)	3.6	18.6	5.2	18.4

Cash Flow

Y/E, Mar (Rs. mn)	FY09	FY10	FY11E	FY12E
PBT (Ex-Other income)	2,382	2,766	2,981	3,529
Depreciation	259	347	408	459
Interest Provided	173	85	47	47
Other Non-Cash items	143	35	0	0
Chg in working cap	-379	-1,278	1,045	-538
Tax paid	-631	-732	-733	-867
Operating Cashflow	1,947	1,223	3,748	2,629
Capital expenditure	-851	-239	-500	-500
Free Cash Flow	1,096	983	3,248	2,129
Other income	-7	-3	0	0
Investments	-32	62	0	0
Investing Cashflow	-38	59	0	0
Equity Capital Raised	0	0	0	0
Loans Taken / (Repaid)	-93	-184	0	0
Interest Paid	-172	-85	-47	-47
Dividend paid (incl tax)	-737	-737	-887	-1,067
Income from investments	0	0	0	0
Others	0	0	0	0
Financing Cashflow	-1,001	-1,005	-933	-1,113
Net chg in cash	57	38	2,315	1,015
Opening cash position	27	92	132	2,447
Closing cash position	83	130	2,447	3,462

Balance Sheet

Y/E, Mar (Rs. mn)	FY09	FY10	FY11E	FY12E
Equity share capital	180	180	180	180
Reserves & surplus	3,491	4,737	6,099	7,694
Net worth	3,671	4,917	6,279	7,874
Secured Loans	0	0	0	0
Unsecured Loans	273	89	89	89
Loan Funds	0	0	0	0
Net deferred tax liability	273	89	89	89
Total Liabilities	6	(15)	(15)	(15)
	3,950	4,991	6,353	7,948
Gross Block				
Less: Depreciation	3,325	3,519	4,019	4,519
Net block	1,449	1,542	1,950	2,409
Capital work in progress	1,876	1,977	2,069	2,110
Investment	248	16	16	16
Current Assets	44	42	42	42
Inventories	10,379	13,928	15,445	18,894
Sundry debtors	2,081	2,580	2,753	3,268
Cash & bank balance	6,086	6,282	7,305	8,673
Loans & advances	92	132	2,447	3,462
Other current assets	1,255	1,324	1,524	1,809
Current lia & Prov	865	3,609	1,417	1,682
Current liabilities	8,602	10,971	11,218	13,113
Provisions	7,521	9,811	10,058	11,953
Net current assets	1,081	1,160	1,160	1,160
Misc. exp	1,777	2,957	4,227	5,780
Total Assets	6.0	-	-	-

Key ratios

Y/E, Mar	FY09	FY10	FY11E	FY12E
Profitability (%)				
EBITDA Margin	11.3	11.6	11.3	11.2
Net Margin	7.3	7.9	7.5	7.5
ROCE	73.4	57.9	52.2	49.0
ROE	58.2	46.6	40.2	37.6
RoIC	61.5	46.7	51.6	63.9
Per Share Data (Rs)				
EPS	20.3	22.2	25.0	29.6
CEPS	23.4	26.0	29.5	34.7
BVPS	40.8	54.7	69.8	87.5
DPS	7.0	8.0	8.5	10.5
Valuations (x)				
PER	21.7	19.8	17.6	14.9
P/CEPS	18.8	17.0	14.9	12.7
P/BV	10.8	8.1	6.3	5.0
EV / Sales	1.6	1.6	1.3	1.0
EV / EBITDA	15.4	14.5	12.3	10.1
Dividend Yield (%)	1.6	1.8	1.9	2.4
Gearing Ratio (x)				
Net Debt/ Equity	0.0	(0.0)	(0.4)	(0.4)
Net Debt/EBIDTA	0.1	(0.0)	(0.7)	(0.9)
Working Cap Cycle (days)	23.3	34.2	44.0	51.6

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