

# Bharat Heavy Electricals (BHEL)

Voltage stabilizer

- **We upgrade BHEL to OW post the sharp underperformance:** BHEL has underperformed the falling Sensex by 12% over the last 3 months and 21% since its all-time high (Dec-07). We believe the stock has been beaten down hard enough, and valuations at 20.4x FY2010 earnings offer bounce-back potential.

- **Good-old buy-themes pertinent in uncertain markets:** A) strong order book assures revenue visibility (4.1 years), insulates BHEL from demand uncertainties, B) domestic infrastructure growth story; relatively immune to global slowdown fears, C) strong RoE, cash balances, cash flows and earnings growth.

- **Medium-term catalysts strong:** Potential order flows of 15GW (Rs450 bn) over the next 6-12 months, including supercritical orders.

- **Dec q – capital goods sector has disappointed; BHEL no exception, but could be forgiven:** Order flows have been exceptionally strong and the weak numbers were a reflection of wage hikes and provisions rather than structural issues.

- **Dec-08 DCF-based PT of Rs2,850 (unchanged):** Stock price discounts long-term risks of margin contraction, market share loss and execution issues, in our view.

## BHEL IN, BHEL.BO

	FY06	FY07	FY08E	FY09E		
Sales	133,740	172,806	211,322	259,826	52-week range (Rs)	978-2870
Net profit	16,416	23,605	29,968	38,576	Market cap (Rs B)	1011.0
EPS (Rs)	33.5	48.2	61.2	78.8	Market cap (US\$ B)	25.5
DPS (Rs)	12.5	18.0	22.9	29.4	Shrs outstanding (MM)	489.5
Net sales growth (%)	40.4	29.2	22.3	23.0	Free float (%)	100%
Net profit growth (%)	70.2	43.8	27.0	28.7	Avg daily value (Rs MM)	1848
EPS growth (%)	70.2	43.8	27.0	28.7	Avg daily value (US\$ MM)	46.2
P/E (x)	61.6	42.8	33.7	26.2	Avg daily volume(mn)	1.3
EV/EBITDA (x)	25.2	19.8	14.6	10.7		

Source: JPMorgan estimates, Company data.

**Upgrade  
Overweight**

Previous Rating: Neutral

**Rs2,065.35**

01 February 2008

Price Target: Rs2,850.00

**India**

**Engineering**

**Shilpa Krishnan<sup>AC</sup>**

(91-22) 6639-3010

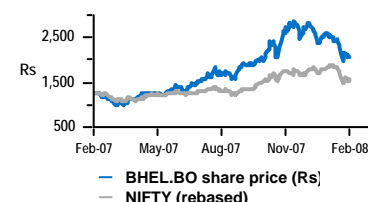
shilpa.x.krishnan@jpmorgan.com

**Rohit Tandon**

(91-22) 6639-3011

rohit.k.tandon@jpmorgan.com

**Price Performance**



	YTD	-1M	-3M	-12M
Absolute	-20.1%	-20.1%	-22.4%	65.4%
Relative	-6.6%	-6.6%	-13.0%	38.3%

Source: RIMES, Reuters.

## Stock has been punished enough

### Stock has underperformed, valuations appear more attractive

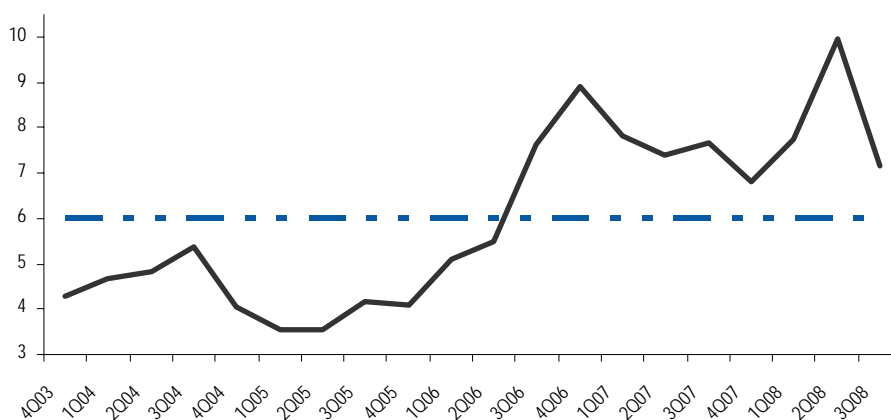
BHEL has corrected 39% since its all-time high, underperforming the Sensex by 21% since Dec-07 and 12% since Oct-07.

The stock is now valued at 26.5x FY2009 earnings and 20.4x FY2010 earnings. We believe these valuations are attractive. Our earnings estimates for BHEL are below-consensus, factoring in potential execution issues, margin disappointments and wage cost pressures.

### The ratio of P/E to visibility has dipped sharply, suggests bounce-back potential

The P/E to visibility chart is a good yardstick of BHEL's stock performance in relation to its order-related news flows, in our view. Visibility is the order backlog divided by trailing twelve months' revenues, and is an indicator of the number of years of assured revenues that the current order backlog provides. P/E, on the other hand, is a measure of earnings growth and sustainability expectations. Thus, P/E and visibility should move in tandem, everything else remaining equal. Over the past quarter, there is a sharp contraction in P/E multiple vs visibility, suggesting the stock could potentially bounce-back.

Figure 1: One yr fwd P/E to visibility chart (x)



Source: Company data, Datastream

## Strong medium term catalysts ahead

### Order-related news flows have been strong over the past quarter

BHEL has recorded strong order flows of Rs100 bn in Dec-q, as shown in Table 1. Orders included a slew of orders from NTPC - Mauda, TNEB-JV, Bongaigaon and Nabinagar. Damodar Valley Corp-Tata Power's JV project, Maithon, has also placed its order on BHEL. Recently, the company has reported further orders from Reliance

Industries for gas turbines and TNEB's North Chennai project. Both these order wins are significant – the RIL project is BHEL's maiden order for the 345MW advanced class Frame-9FA gas turbines. The TNEB order is BHEL's first in the 600X1MW configuration (sub-critical).

Table 1: BHEL - Order flow in 3q 2008

	Plant Name	Capacity	Contract value (Rs bn)
1	TNEB - North Chennai	600X1MW	24.8
2	RIL - GT	345X1MW	8.7
3	NTPC - Nabinagar JV	500X2MW	25.0
4	NTPC - TNEB JV (Ennore)	500X2MW	18.8
5	NTPC - Bongaigaon	250X3MW	18.8
6	NTPC - Mauda	250X3MW	25.0
7	DVC Maithon	525X2MW	21.1

Source: Company reports.

### Potential ordering of 15GW over the next 6-12 months

We see potential order flows of 11GW in the sub-critical space (implying an EPC value of Rs352 bn) and 4.2GW in the super-critical space (EPC value: Rs136 bn).

For NTPC's supercritical projects at Barh and North Karanpura (660X2MW each) BHEL is the sole bidder. NTPC management stated in its earnings call on Feb 1, 2008 that it would decide upon these bids in March 2008. The potential wins could pave the way for more projects in this keenly contested but fast-growing segment.

BHEL has already announced a JV with TNEB for 2X800MW supercritical project, and may contemplate one with UP Genco as well.

Table 2: Potential order wins over next 6 months to a year

Project	Utility	Configuration	Capacity	Likely EPC value (Rs bn)	Likely BTG value (Rs bn)
Bokaro A TPS	DVC	500X1	500	16.0	11.0
Barsingar Ext	NLC	125X2	250	8.0	5.5
Tuticorin JV	NLC	500X2	1,000	32.0	22.0
Kalisindh TPS	RRVUNL	500X1	1,000	32.0	22.0
Anpara-D	UPRVUNL	500X1	1,000	32.0	22.0
Obra REP	UPRVUNL	500X1	1,000	32.0	22.0
Tripura Gas ILFS JV	ONGC	250X3	750	24.0	16.5
Koradi Rep	Mahagenco	500X1	500	16.0	11.0
Koradi Ext	Mahagenco	500X2	1,000	32.0	22.0
Chandrapur	Mahagenco	500X1	500	16.0	11.0
Malwa	MPGENCO	500X2	1,000	32.0	22.0
Satpura Ext	MPGENCO	500X1	500	16.0	11.0
Kakatiya Ext	APGENCO	500X1	500	16.0	11.0
Mettur Ext	TNEB	500X1	500	16.0	11.0
Sagardighi Ext	WBPDCCL	500X1	1,000	32.0	22.0
Korba West Ext	CSEB	300X2	600	19.2	13.2
<b>Total sub-critical</b>			<b>11,000</b>	<b>352.0</b>	<b>242.0</b>
Krishnapatnam	APGENCO	800X2	1,600	51.2	35.2
Barh II	NTPC	660X2	1,320	42.2	29.0
North K Pura	NTPC	660X2	1,320	42.2	29.0
<b>Total super-critical</b>			<b>4,240</b>	<b>135.7</b>	<b>93.3</b>
<b>Total ordering over the next 6-12 months</b>			<b>15,240</b>	<b>487.7</b>	<b>335.3</b>

Source: Ministry of Power

The recent win of RIL's gas turbine may open new doors for BHEL. RIL plans to set up more gas-based projects in the country, as shown in Table 2.

Finally, a potential resolution of the gas pricing issue could result in more gas-based projects. According to media reports, BHEL is the lowest bidder for advanced class

gas turbines for NTPC's Kawas and Gandhar gas projects (combined size 2.6GW & total order value of cRs78bn). However, these projects are stuck due to NTPC's gas pricing dispute with RIL. With recent gas discoveries, we believe that the gas segment could account for 20% of new orders, compared to less than 10% in the past. Currently, BHEL has a very miniscule market share in this segment; with most projects being supplied by Siemens (eg; Torrent), Alstom (eg; Lanco).

Table 3: Gas projects envisaged & bid out

Location	Size (MW)	Status	Client
Haryana SEZ	2,000	Environmental clearance obtained	Reliance Industries
Navi Mumbai SEZ	2,000	Land acquisition complete	Reliance Industries
Kawas	1,300	Bidding over, BHEL-GE the lowest bidder, but orders not awarded	NTPC
Gandhar	1,300		NTPC

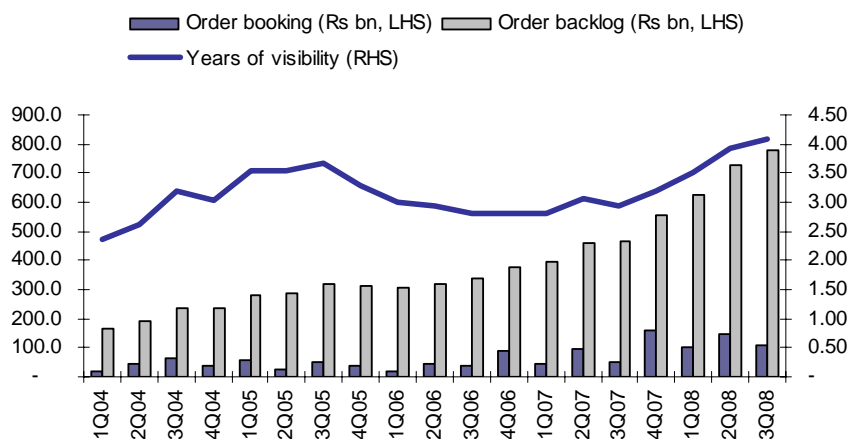
Source: Company data, Ministry of Power

## BHEL fits the themes we like to play in uncertain markets

### Insulated from domestic / global uncertainties

BHEL's strong order book of Rs780 bn assures revenue visibility of 4.1 years based on trailing twelve months' revenues. This would protect it from domestic / global uncertainties, in our view.

Figure 2: Order backlog and visibility chart

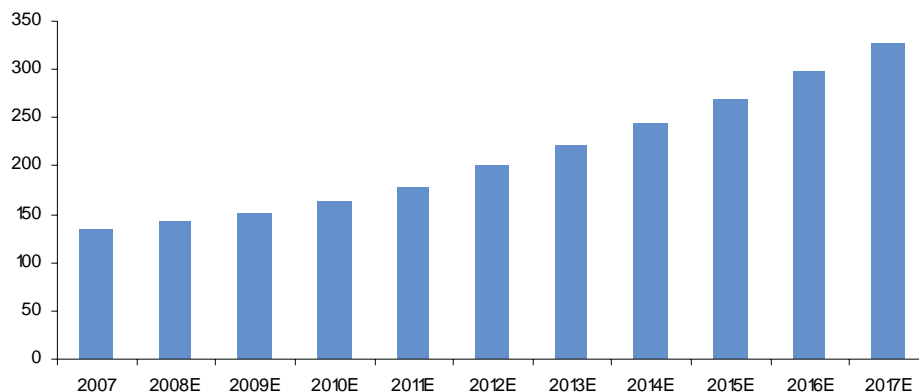


Source: Company data, JPMorgan estimates

### Domestic power capacity growth story

BHEL derives 95% of its revenues and 90% of its order backlog from India. Only a small portion of the revenues come from the Middle-East. Thus makes it relatively immune to fears of global slowdown and cutback in utilities' spending, in our view. India, a power-starved country, continues to allocate a large portion of its funds for new power capacities. Indian utilities have placed 60GW orders for the 11th plan, and BHEL has a 70% market share of 11th plan orders placed so far.

Figure 3: Power capacity addition growth in India



Source: Company data, JPMorgan estimates

### Strong RoE, cash balances, cash flows and earnings growth

BHEL's return on equity has consistently been healthy over the past few years, at 24-28%. The net cash on the y/e FY08E balance sheet accounts for 9% of the market cap. FCF has been strong over the last few years and we believe the company will continue to generate strong FCF despite its grand capex programme. BHEL's earnings growth is 24% through 2012, adjusted for margin pressures and execution issues.

Table 4: BHEL financial ratios

Ratios	FY 2006	FY 2007	FY 2008E	FY 2009E	FY 2010E
Cash/share (Rs)	64.9	84.4	160.4	189.4	247.6
Book Value / Share (Rs)	149.2	187.2	235.6	316.6	414.4
FCF/share	(21.7)	81.1	49.5	65.9	86.0
Total debt / Equity (%)	7.6	5.5	4.3	3.2	2.5
ROE (%)	24.6	28.7	29.0	28.5	28.0
ROCE (%)	36.3	42.2	42.4	42.1	41.6
ROE ex Cash	46.3	159.5	117.5	136.6	114.5
Fixed Assets Turnover (x)	12.4	12.4	12.1	12.5	14.3
Total Assets Turnover (x)	1.8	1.9	1.9	1.8	1.7

Source: JPMorgan estimates, Company data.

### Long-term concerns on market share, margins, execution capacity, priced in

We continue to have long term concerns on BHEL's market share. BHEL is facing stiff competition from Chinese equipment manufacturers, especially with private IPPs with large plans. However, potential supercritical project wins and wins in the GT segment, coupled with BHEL's capacity expansion project, will likely enable it to retain at least 45% market share.

On margins, we believe BHEL may have to offer better pricing to its customers to fill up its capacities going forward. This is also factored into our numbers.

Finally, potential execution hiccups could be another key risk. Although BHEL is ramping up its capacities, component and sub-component supply bottlenecks could result in lower than targeted capacity utilization.

However, we believe the current stock price discounts these risks already.

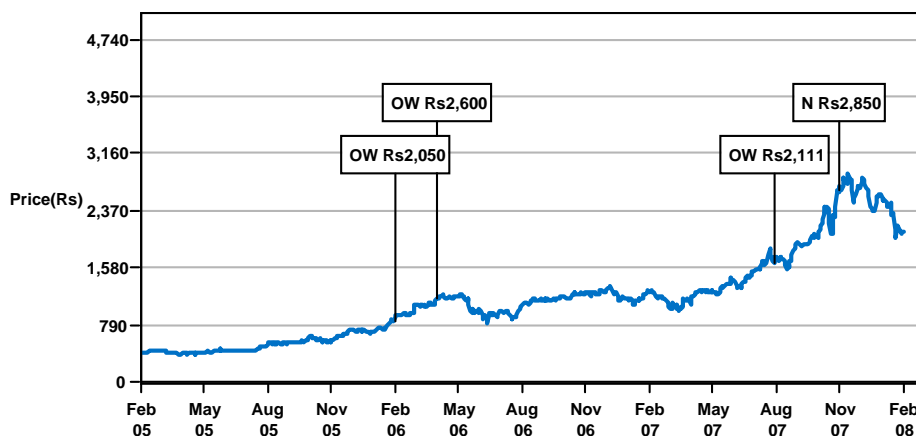
**Quarterly disappointment overhang: BHEL likely to pick up the threads faster**  
Dec-q has generally been a disappointing quarter for entire engineering / capital goods space, and BHEL was no exception. However, given that the weak numbers were a reflection of wage hikes and provisions rather than structural issues, we believe BHEL could pick up the threads fast enough.

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**Important Disclosures**

**Bharat Heavy Electricals (BHEL) (BHEL.BO) Price Chart**



Date	Rating	Share Price (Rs)	Price Target (Rs)
31-Jan-06	OW	850.50	2050.00
03-Apr-06	OW	1149.02	2600.00
31-Jul-07	OW	1644.00	2111.00
31-Oct-07	N	2654.55	2850.00

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.  
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IB clients*	50%	51%	38%
JPM SI Equity Research Coverage	41%	47%	12%
IB clients*	71%	64%	49%

\*Percentage of investment banking clients in each rating category.

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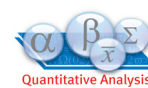
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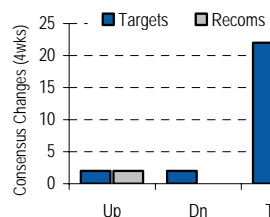
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All Data As Of 01-Feb-08

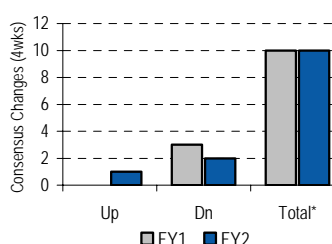
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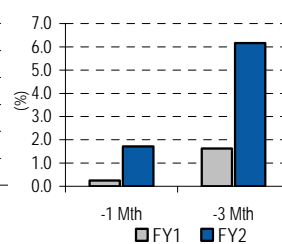
### Targets & Recommendations



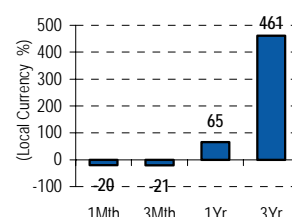
### EPS Revisions



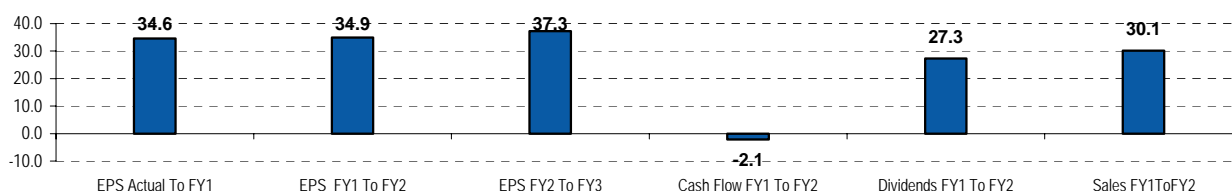
### EPS Momentum (%)



### Historical Total Return (%)



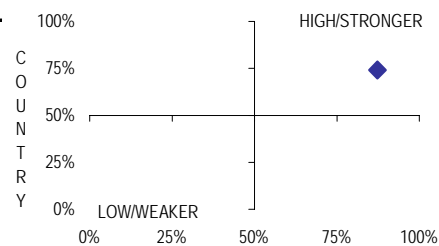
### Consensus Growth Outlook (%)



### Quant Return Drivers (A Score >50% indicates company ranks 'above average')

Score 0% (worst) to 100% (best)	vs Country Peers	vs (regional) IBES Industry Peers
Valuations: P/E Vs Market (12mth fwd EPS)	20%	13%
Valuations: P/E Vs Sector (12mth fwd EPS)	32%	27%
Valuations: EPS Growth (forecast)	68%	75%
Momentum: 12 Month Price Momentum	75%	80%
Momentum: 1 Month Price Reversion	51%	69%
Quality: Return On Equity (forecast)	75%	92%
Quality: Earnings Risk (Variation in Consensus)	87%	79%
Earnings&Sentiment: Earnings Momentum	78%	78%
Earnings&Sentiment: Change in Recoms	89%	96%
Earnings&Sentiment: Net Revisions Fy2 EPS	30%	31%

### JPMorgan Composite Q-Score



### COMPOSITE Q-SCORE\*\* (0% To 100%)

Company	74%	87%
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### Regional IBES Industry Peers (Closest by Size, Consensus. ADV = Average daily value traded in US\$m over the last 3 mths)

Code	Name	Country	USD MCAP	ADV	PE FY1	Q-Score**
9501-JP	Tokyo Electric Power Co. Inc.	Japan	35,021	119.06	-33.7	0%
601991-CN	Datang International Power Generation Co. Ltd.	China	26,222	32.35	51.0	67%
500103-IN	<b>Bharat Heavy Electricals Ltd.</b>	<b>India</b>	<b>25,661</b>	<b>9.96</b>	<b>31.1</b>	<b>87%</b>
015760-KR	Korea Electric Power Corp.	South Korea	24,872	90.68	11.5	9%
9503-JP	Kansai Electric Power Co. Inc.	Japan	23,168	55.12	28.1	22%
9502-JP	Chubu Electric Power Co. Inc.	Japan	19,699	53.07	23.4	2%
2-HK	CLP Holdings Ltd.	Hong Kong	19,059	40.19	13.6	42%
3-HK	Hong Kong & China Gas Co. Ltd.	Hong Kong	16,555	37.27	18.1	75%
9531-JP	Tokyo Gas Co. Ltd.	Japan	12,391	60.28	24.3	8%
5347-MY	Tenaga Nasional Bhd	Malaysia	12,251	20.22	11.4	12%
6-HK	HongKong Electric Holdings Ltd.	Hong Kong	12,168	18.51	13.5	76%

### Country Peers (Closest by Size, Consensus. ADV = average daily value traded in US\$m over the last 3 mths)

Code	Name	Industry	USD MCAP	ADV	PE FY1	Q-Score**
532868-IN	DLF Ltd.	Real Estate Development	35,181	21.01	21.0	86%
500112-IN	State Bank of India	Regional Banks	34,682	24.73	18.3	22%
532712-IN	Reliance Communications Ltd.	Major Telecommunications	31,536	39.27	25.7	38%
532174-IN	ICICI Bank Ltd.	Regional Banks	28,973	20.45	29.8	33%
500510-IN	Larsen & Toubro Ltd.	Trucks/Construction/Farm Machinery	26,526	26.28	42.0	77%
500103-IN	<b>Bharat Heavy Electricals Ltd.</b>	<b>Electrical Products</b>	<b>25,661</b>	<b>9.96</b>	<b>31.1</b>	<b>74%</b>
500113-IN	Steel Authority of India Ltd.	Steel	22,469	13.87	11.7	90%
500209-IN	Infosys Technologies Ltd.	Information Technology Services	21,830	13.30	18.6	25%
532540-IN	Tata Consultancy Services Ltd.	Information Technology Services	21,753	6.47	16.8	44%
500010-IN	Housing Development Finance Corp. Ltd.	Finance/Rental/Leasing	19,610	14.29	37.5	44%
500875-IN	ITC Ltd.	Tobacco	18,651	6.93	23.2	44%

Source: Factset, Thomson and JPMorgan Quantitative Research. For an explanation of the Q-Snapshot, please visit <http://jpmorgan.hk.acrobat.com/qsnapshot/>  
Q-Snapshots are a product of JPMorgan's Global Quantitative Analysis team and provide quantitative metrics summarized in an overall company 'Q-Score.'

Q-Snapshots are based on consensus data and should not be considered as having a direct relationship with the JPMorgan analysts' recommendation.

\* Total number of target prices, recommendations or EPS forecasts that make up consensus. \*\* The Composite Q-Score is calculated by weighting and combining the 10 Quant return drivers shown. The higher the Q-Score the higher the one month expected return. On a 14 Year back-test the stocks with the highest Q-Scores have been shown (on average) to significantly outperform those stocks with the lowest Q-Scores in this universe.

## BHEL Financial statements

Profit and Loss statement					Cash flow statement				
Rs in millions, year-end Mar	FY06	FY07	FY08E	FY09E	Rs in millions, year-end Mar	FY06	FY07	FY08E	FY09E
Revenues	145,255	187,020	228,703	281,196	EBIT	32,022	45,391	56,248	71,653
% change Y/Y	41%	29%	22%	23%	Depreciation & amortisation	2,459	2,489	3,174	3,875
Gross Margin (%)	18%	21%	21%	23%	Change in working capital	(29,828)	13,490	(9,506)	(12,042)
EBITDA	25,552	39,096	49,046	64,457	Taxes	(8,852)	(12,900)	(15,438)	(19,873)
% change Y/Y	84%	53%	25%	31%	Others	(2,999)	(2,549)	(2,677)	(2,811)
EBITDA Margin (%)	18%	21%	21%	23%	Cash flow from operations	(7,198)	45,920	31,801	40,804
EBIT inc OI	32,022	45,391	56,248	71,653	Capex	(2,824)	(5,754)	(7,000)	(8,000)
% change Y/Y	50%	42%	24%	27%	Disposal/ (purchase)	0	0	0	0
EBIT Margin (%)	22%	24%	25%	25%	Net Interest	(587)	(470)	(550)	(550)
Net Interest	587	470	550	550	Free cash flow	(10,609)	39,696	24,251	32,254
Earnings before tax	25,608	36,505	45,406	58,449	Investments	7	0	0	0
% change Y/Y	62%	43%	24%	29%	Other	5,336	645	(2,286)	(2,286)
Tax	8,852	12,900	15,438	19,873	Dividends paid	(4,047)	(4,956)	(6,292)	(8,100)
as % of EBT	35%	35%	34%	34%	Total	-9349	35385	15672	21868
Net Income (pre exceptionals)	16,756	23,605	29,968	38,576	Beginning cash	36,992	27,643	63,027	78,700
% change Y/Y	75%	41%	27%	29%	Ending cash	27,643	63,027	78,700	100,567
Shares Outstanding	489.52	489.52	489.52	489.52	DPS	8.3	10.1	12.9	16.5
EPS (pre exceptionals)	34.2	48.2	61.2	78.8					
% change Y/Y	75%	41%	27%	29%					
Balance sheet					Ratio Analysis				
Rs in millions, year-end Mar	FY06	FY07	FY08E	FY09E	%, year-end Mar	FY06	FY07	FY08E	FY09E
Cash and cash equivalents	41,340	78,528	92,706	121,182	EBITDA margin	18%	21%	21%	23%
Accounts receivable	71,681	102,477	125,317	154,080	Net profit margin	8%	5%	6%	6%
Inventories	37,444	49,669	61,268	75,195	SG&A/sales	40%	39%	39%	38%
Others	845	10	10	10	Sales per share growth	41%	29%	22%	23%
Current assets	163,308	240,684	289,300	360,467	Sales growth	41%	29%	22%	23%
Investments	83	83	83	83	Net profit growth	75%	41%	27%	29%
Net fixed assets	11,668	15,034	18,960	22,556	EPS growth	75%	41%	27%	29%
Others	0	0	0	0	Interest coverage (x)	NA	NA	NA	NA
Total assets	175,059	255,801	308,344	383,105	Net debt to total capital	-20%	-29%	-28%	-30%
Liabilities					Net debt to equity	-49%	-80%	-76%	-75%
Payables	2,841	38,501	46,760	56,412	Sales/assets	0.8	0.7	0.7	0.7
Others	100,359	126,365	145,973	170,456	Assets/equity	2.4	2.8	2.7	2.5
Total current liabilities	103,200	164,866	192,733	226,867	ROE	20%	24%	26%	29%
Total debt	5,582	5,010	5,010	5,010	ROCE	20%	23%	29%	33%
Other liabilities	70,173	53,162	68,578	98,554					
Total liabilities	178,956	223,037	266,321	330,431					
Shareholders' equity	73,014	91,663	115,338	154,965					

Source: Company reports and JPMorgan estimates.