

Company Focus

27 October 2008 | 12 pages

Bharat Heavy (BHEL.BO)

Time To Get Constructive On This One. Upgrade to Buy

Change in opinion ✓
Rating change ✓
Target price change ✓
Estimate change ✓

- **In times of stress** — The “India Infrastructure Super-Cycle” is showing signs of stress. The global credit crisis has reduced the quantum of credit available and increased the cost of the same. In our view, neither will infrastructure capex come to a standstill, nor can it continue at the same pace as in the last 2 years.
- **Go for the most robust order backlog.....** — BHEL is working on ~ 48GW (Rs1040bn – 3.9x FY09E sales) of orders with 85% of orders from the government (CPSUs/SEBS) and order inflow momentum continues to be strong. Compared to BHEL, L&T's backlog is more susceptible to cancellations in times of extreme stress (45%:55% government: private split). While one cannot completely write-off order slowdown/cancellation risks, India's power crisis, shortage of domestic equipment manufacturing capacity and political backing should provide enough ammunition to BHEL to neutralize the risks.
- **.....and Rs83bn of net cash** — Given net cash of Rs83bn and BHEL running a 12-14% PAT margin business with RoEs ~ 30%, the balance sheet has the ability to withstand systemic working capital stress.
- **Upgrade to Buy. Target price Rs1,373** — Stock correction of 30%+ in the last 1 month and reasonable P/E of 11.7x FY10E provides long-term investors an attractive entry point. Though 2QFY08 was an ordinary quarter with Recurring PAT up 10% YoY (15% below CIR estimates) we upgrade BHEL to Buy (1L) from Hold (2L). BHEL is our top pick in the capital goods space. We cut our target price to Rs1,373 (Rs2,025) on the back of a 1-10% earnings cut and target P/E multiple cut to 16x (23x) given the tougher operating environment.

Buy/Low Risk	1L
<i>from Hold/Low Risk</i>	
Price (24 Oct 08)	Rs1,091.75
Target price	Rs1,373.00
<i>from Rs2,025.00</i>	
Expected share price return	25.8%
Expected dividend yield	1.7%
Expected total return	27.4%
Market Cap	Rs534,433M
	US\$10,758M

Price Performance (RIC: BHEL.BO, BB: BHEL IN)



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2007A	24,544	50.14	46.5	21.8	6.1	30.5	1.1
2008A	26,876	54.90	9.5	19.9	5.0	27.5	1.4
2009E	31,203	63.74	16.1	17.1	4.2	26.4	1.7
2010E	45,613	93.18	46.2	11.7	3.3	31.4	1.9
2011E	54,775	111.90	20.1	9.8	2.6	30.0	2.2

Source: Powered by dataCentral

Venkatesh Balasubramaniam¹

+91-22-6631-9864
venkatesh.balasubramaniam@citi.com

Deepal Delivala¹

+91-22-6631-9857
deepal.delivala@citi.com

Atul Tiwari¹

+91-22-6631-9866
atul.tiwari@citi.com

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

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¹Citigroup Global Markets India Private Limited

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	21.8	19.9	17.1	11.7	9.8
EV/EBITDA adjusted (x)	14.8	14.0	12.3	7.7	6.2
P/BV (x)	6.1	5.0	4.2	3.3	2.6
Dividend yield (%)	1.1	1.4	1.7	1.9	2.2
Per Share Data (Rs)					
EPS adjusted	50.14	54.90	63.74	93.18	111.90
EPS reported	49.33	58.41	63.74	93.18	111.90
BVPS	179.53	220.10	262.58	331.00	414.65
DPS	12.25	15.25	18.25	21.25	24.25
Profit & Loss (RsM)					
Net sales	170,180	191,311	248,019	309,719	379,034
Operating expenses	-140,017	-161,091	-214,658	-255,692	-312,550
EBIT	30,163	30,220	33,360	54,027	66,484
Net interest expense	-433	-354	-208	-208	-208
Non-operating/exceptionals	8,236	11,773	14,851	16,355	17,993
Pre-tax profit	37,966	41,638	48,004	70,174	84,270
Tax	-13,422	-14,762	-16,801	-24,561	-29,494
Extraord./Min.Int./Pref.div.	-397	1,717	0	0	0
Reported net income	24,147	28,593	31,203	45,613	54,775
Adjusted earnings	24,544	26,876	31,203	45,613	54,775
Adjusted EBITDA	32,893	33,192	36,589	57,856	70,980
Growth Rates (%)					
Sales	28.9	12.4	29.6	24.9	22.4
EBIT adjusted	45.5	0.2	10.4	62.0	23.1
EBITDA adjusted	41.9	0.9	10.2	58.1	22.7
EPS adjusted	46.5	9.5	16.1	46.2	20.1
Cash Flow (RsM)					
Operating cash flow	34,690	40,899	28,511	25,044	30,601
Depreciation/amortization	2,730	2,972	3,229	3,829	4,496
Net working capital	10,428	13,361	-4,241	-21,942	-25,721
Investing cash flow	-3,974	-6,452	-12,000	-14,000	-8,000
Capital expenditure	-3,974	-6,452	-12,000	-14,000	-8,000
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	-13,967	-8,675	-10,408	-12,119	-13,830
Borrowings	-4,689	59	0	0	0
Dividends paid	-6,925	-8,734	-10,408	-12,119	-13,830
Change in cash	16,749	25,771	6,103	-1,075	8,771
Balance Sheet (RsM)					
Total assets	232,977	306,902	372,202	434,356	508,087
Cash & cash equivalent	58,089	83,860	89,963	88,888	97,660
Accounts receivable	96,958	119,749	152,919	187,326	227,179
Net fixed assets	12,913	16,393	25,164	35,335	38,839
Total liabilities	145,094	199,102	243,607	272,265	305,049
Accounts payable	35,390	44,240	57,772	70,619	86,703
Total Debt	893	893	893	893	893
Shareholders' funds	87,883	107,742	128,537	162,031	202,977
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	19.3	17.3	14.8	18.7	18.7
ROE adjusted	30.5	27.5	26.4	31.4	30.0
ROIC adjusted	49.4	55.8	51.6	51.9	41.1
Net debt to equity	-65.1	-77.0	-69.3	-54.3	-47.7
Total debt to capital	1.0	0.8	0.7	0.5	0.4

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2791



Upgrade to Buy. New Target Price of Rs1,373

- The “India Infrastructure Super-Cycle” which started in early 2002 is showing signs of stress. The ongoing global credit crisis has reduced the quantum of credit available globally and increased the cost of the same. The sustenance of any capex cycle is dependent on plentiful availability of cheap credit. The Indian General Elections in FY10 could be another dampener as a new party coming into power typically takes a year to settle down and a year to restart projects. Further, ordering typically slows down in the run up to elections.
- However, BHEL is working on ~ 48,000MW (Rs1040bn) of orders and close to 85% of the orders are from central power sector utilities (CPSUs) and the SEBS. Just 15% of the orders are from the private sectors. This gives us confidence about the robustness of BHEL’s order backlog. Compared to BHEL, L&T’s order backlog is more susceptible to cancellations in times of extreme stress as L&T has a 45:55% split between the government and the private sector. Further, the power crisis in the country implies that any government coming to power at the Centre would be that much more proactive when it comes to the power sector, rather than any other infrastructure sub-sector.
- Most importantly BHEL’s balance sheet is very strong with net cash balance of Rs83bn at the end of FY08. Further, given that BHEL runs a 12-14% PAT margin business with RoEs ~ 30%, the balance sheet has the ability to withstand systemic working capital stress.
- BHEL has not out-performed the broader market over various time horizons as show in the table below, which we take as a sign of robustness of BHEL’s orders backlog. Further, as the stock has corrected 30%+ and now trades at reasonable valuations of 11.7x FY10E we upgrade BHEL to Buy/Low Risk (1L) from Hold/Low Risk (2L). BHEL would be our top pick in our rated electric equipment and engineering & construction universe.

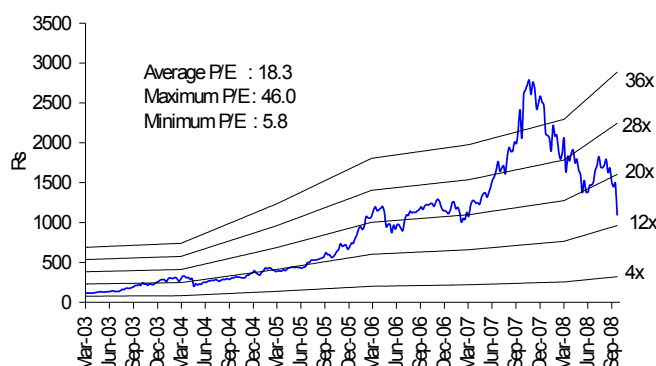
Figure 1. BHEL vs. BSE Sensex Price Performance

Relative Performance	1 Month	2 Month	3 Month	6 Month	1 Yr	2 Yr	3 Yr	5 Yr
BHEL	-34%	-36%	-37%	-41%	-46%	-11%	94%	411%
Sensex	-36%	-40%	-41%	-48%	-48%	-31%	10%	83%
Relative Performance	2%	3%	4%	7%	3%	20%	84%	329%

Source: Bloomberg, Citi Investment Research

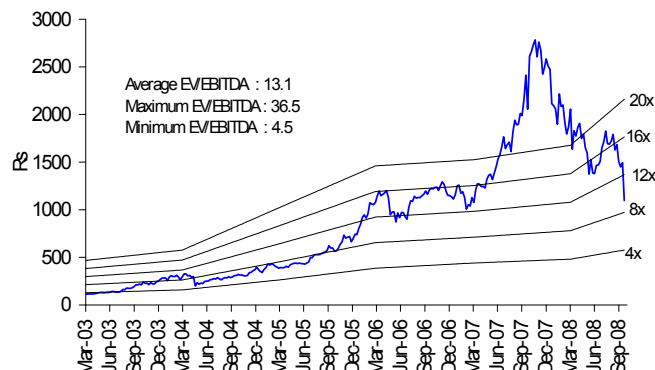
- We cut our target price to Rs1,373 (from Rs2,025 earlier) to factor in: (1) earnings cut of 1-10% over FY09E-FY12E; and (2) cut in our target P/E multiple of 16x Dec09 (from 23x Dec09 earlier). Our target multiple of 16x is set at a ~13% discount to the historical average multiple (vis-à-vis the ~15% premium earlier) given the global credit crisis and the de-rating of most stocks globally. Our target multiple is well supported by EPS CAGR of 27% over FY08–FY11E with average RoEs at the 29% levels. Further, our target multiple is set at 14% premium to ABB given BHEL’s superior earnings growth expectations vis-à-vis ABB (18%) and in line L&T given more or less similar earnings growth expectations (23%).

Figure 2. BHEL – 1-Year Forward Rolling P/E Bands



Source: DataCentral, Citi Investment Research estimates

Figure 3. BHEL – 1-Year Forward Rolling EV/EBITDA Bands



Source: DataCentral, Citi Investment Research estimates

Silver lining in a not so great quarter

- BHEL's 2QFY09 Recurring PAT at Rs6.2bn up 11% YoY was 15% below CIR estimates of Rs7.3bn on the back of 423bps margin contraction on higher-than-expected raw material costs. BHEL's raw material costs are impacted with a lag of 6–9 months when commodity prices move up significantly.
- We had underestimated the quantum of the impact and also had expected the impact to come through in 3QFY08 rather than 2QFY08. According to management one should see this impact in 3QFY08 also and 4QFY08 would be the quarter when these costs will start to come off.
- The silver lining in the results is that: (1) order inflows and order backlog remain robust; (2) staff costs and other expenses are very much under control; and (3) if raw material costs have had such a sharp impact they are also bound to come off sharply in the near future as global commodity prices have taken severe beating in the last few months.

Figure 4. BHEL – 2QFY09 Results Review

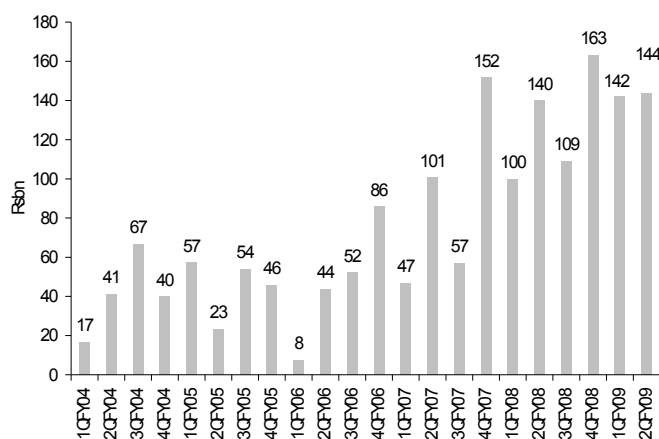
Year End Mar31 (Rsmn)	2Q08	2Q09	YoY	2Q09E	YoY - Remarks
Order Inflow (Rsbn)	140	142	1.5%	-	
Order Backlog (Rsbn)	726	1,040	43.3%	1,000	37.7% - Strong OB at 3.9x FY09E Sales
Gross Sales	44,393	57,983	30.6%	56,601	27.5% - Strong execution
Excise Duty	4,739	4,557		5,094	- Effective excise duty comes off when sales grows fast
Excise as % of Gross Sales	10.7%	7.9%		9.0%	
Net Sales	39,654	53,426	34.7%	51,507	29.9% - Effect of commodity price increase coming through now
(Inc)/ Dec in stock-in-trade	(3,798)	(4,400)			- Effect of commodity price increase coming through now
Raw material	25,435	36,212		27,814	- We underestimated the effect. Will affect 3QFY08E earnings
% of net sales	54.6%	59.5%		54.0%	- Raw material costs will ease in 4QFY08
Staff cost	6,296	8,898		8,978	- In line with expectations
% of net sales	15.9%	16.7%		17.4%	
Other exp.	4,769	5,609		5,800	- In line with expectations
% of net sales	12.0%	10.5%		11.3%	
EBITDA	6,952	7,107	2.2%	8,916	28.2%
EBITDA margin %	17.5%	13.3%		17.3%	- Margins contract 423bps
Interest	19	22		26	
Depreciation	694	744		750	
EBIT	6,258	6,364	1.7%	8,166	30.5%
Other income	2,334	3072		3,000	
PBT	8,592	9,436		11,166	
Tax	3,009	3,256		3,908	
Tax Rate	35.0%	34.5%		35.0%	
Recurring PAT	5,583	6,180	10.7%	7,258	30.0% - PAT 15% below expectations
Exceptional Other Income	2,675	-			
Exceptional Interest Cost	(174)	-			
Tax Adjustment	(878)	0			
Prior Period Income Tax	(310)	0			
Reported PAT	6,896	6,180	-10.4%	7,258	5.2%

Source: Company, Citi Investment Research estimates

Inflows robust and pipeline looks stronger than ever

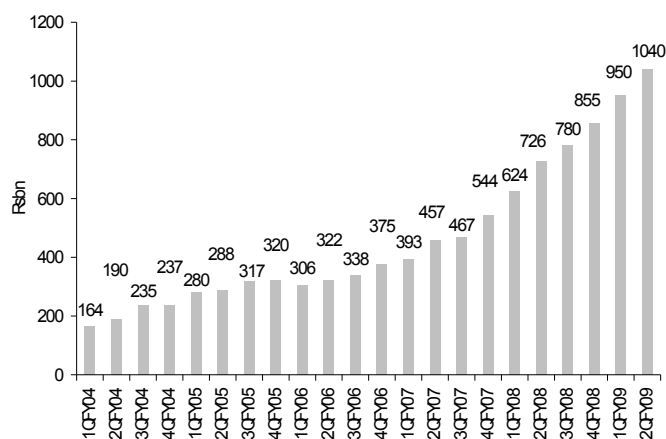
- BHEL's strong order booking continues with Rs144bn of orders in 2QFY09. The company has won Rs286bn of orders for 1H FY09 and is well on course to meet or beat the full-year guidance of Rs500bn of orders. The order backlog of Rs1040bn at 3.9x FY09E sales is the strongest among Indian capital goods companies.

Figure 5. BHEL – QoQ Order Booking



Source: Company, Citi Investment Research

Figure 6. BHEL – QoQ Order Backlog



Source: Company, Citi Investment Research

Figure 7. BHEL Order Wins in 2QFY09

Client/Location	Rsbn - Capacity
MSPGCL	26.9 - 2X500 MW, BTG
APPDCL	25 - 2X800MW, SG
Tripura	22 - 726MW, CCPP
GVK	11.6 - 2X270 MW
RRVUNL	9.9 - 2X250 MW
SJVNL	6.4 - 6X68.67 MW
SAIL	3.4 - 3 Turbo Blowers
IER	3 - 4XFr 6B, GTG
ICF	2.9 - 13 Electric Sets
PT MP	1.6 - 3X18 MW, BTG
Rwanda	1.4 - 2X14MW, Hydro
Not disclosed	29.4
Total	143.5

Source: Company, Citi Investment Research

- The order inflow pipeline looks as solid as ever with BHEL already having won the Barh 2X660 TG package of Rs14.7bn, a 1 X 600MW order for ~Rs15bn in 3QFY09. Further BHEL is the sole bidder for 5 X 500MW of NTPC orders for Rs62.5bn. We are confident that BHEL will achieve its full-year guidance of order inflows of Rs500bn.
- Further the negotiated sets from Government are expected to be recognized next year and the company believes that XIth plan ordering could pick up in FY10E irrespective of the General Elections.
- BHEL is working on ~48,000MW of orders and close to 85% of the orders are from CPSUs and SEBS. Just 15% of the orders are from the private sector. This gives us confidence about the robustness of BHEL's order backlog. Compared to BHEL, L&T's order backlog is more susceptible to cancellations in times of extreme stress as L&T has a 45%:55% split between the government and the private sector. Last, but not least, the power crisis in the country implies that any government coming to power at the Centre would be that much more proactive when it comes to the power sector, rather than any other infrastructure sub-sector.

Earnings revision

We reduce our earnings estimates by 10% in FY09E and by 0.5-1% over FY10E-12E to factor in the following

- BHEL has hiked its sales guidance for FY09E from 25% to 25-30% based on the superior execution in 1H FY09 and expected execution over the next 2 quarters. Further, the company expects to post a sales CAGR of 25% over the next few years. The capacity constraints faced in FY08 have been resolved with capacity moving to 10,000MW from 6,000MW in Dec07 and with the advance procurement of critical components like castings and forgings. Further, capacity increase to 15,000MW by Dec09 and 20,000MW by Dec11 are running according to schedule. As a consequence we have hiked our sales estimates by 1% over FY09-12.

- BHEL's raw material costs are impacted with a lag of 6–9 months when commodity prices move up significantly. We had underestimated the quantum of the impact and also had expected the impact to come through in 3QFY08 rather than 2QFY08. According to management one should see this impact in 3QFY08 also and 4QFY08 would be the quarter when these costs will start to come off. As consequence we have hiked our raw material cost estimates for FY09E
- However, if raw material costs have had such a sharp impact they are also bound to come off sharply in the near future as global commodity prices have taken severe beating in the last few months. As a consequence our raw material cost estimates as a percentage of sales remain largely unchanged over FY10E-12E.
- According to BHEL the estimated wage bill for FY09E is likely to Rs42bn (vs. our earlier estimates of Rs40bn) in FY09E and Rs45bn in FY10E (vs. our earlier estimates of Rs44bn). As a consequence we have adjusted our staff cost estimates marginally.

We now expect BHEL to post an EPS CAGR of 27% over FY08–FY11E with average RoEs at 29%.

Figure 8. BHEL Earnings Revision Table

Year End Mar31	FY09E	FY10E	FY11E	FY12E
Order Inflow (Rsbn)				
Old	500	416	496	531
New	500	416	496	531
Chg	0.0%	0.0%	0.0%	0.0%
Net Sales (Rsmn)				
Old	244,836	306,158	375,044	450,052
New	248,019	309,719	379,034	454,841
Chg	1.3%	1.2%	1.1%	1.1%
EBITDA Margins %				
Old	17.0%	18.7%	19.0%	18.9%
New	14.8%	18.7%	18.7%	18.7%
Chg	(223)	(7)	(24)	(16)
PAT (Rsmn)				
Old	34,584	45,933	55,843	66,098
New	31,203	45,613	54,775	64,893
Chg	-9.8%	-0.7%	-1.9%	-1.8%
EPS (Rs)				
Old	70.65	93.83	114.08	135.03
New	63.74	93.18	111.90	132.56
Chg	-9.8%	-0.7%	-1.9%	-1.8%

Source: Citi Investment Research estimates

Bharat Heavy

Company description

BHEL is the largest engineering company in India, manufacturing equipment for the power and industrial segments. It is the largest manufacturer of power plant equipment in India. The industrial equipment division primarily caters to process industries, transportation (including leasing of locomotives to Indian Railways), transmission, defense and diesel generating sets (DG).

Investment strategy

We rate BHEL Buy/ Low Risk (1L) with a 12-month target price of Rs1,373. India's long-term capacity addition requirements remain intact and are only increasing, with peak deficits widening to 16.6% at end-FY08. With its market leadership, we see BHEL as the best play on power generation capacity additions in India. High inflation and interest rates, along with the upcoming general election in India, have spoilt the environment for capital-goods companies such as BHEL. But with an order backlog of ~Rs1,040bn and sales coverage of 3-4 years, the company should easily weather any slowdown in order flow, on our analysis. Domestic competition is heating up with the entry of L&T-MHI, R-Infra - SEPCO, Toshiba-JSW, Gammon-Sadelmi- Franco Tosi and Thermax, but the threat of Chinese equipment suppliers has weakened at the margin with the price differential narrowing to 5% now.

Valuation

Our target price of Rs1,373 is based on a target P/E multiple of 16x, which is set at a ~13% discount to the historical average P/E multiple given the global credit crisis and the de-rating of most stocks globally. Our target multiple is well supported by EPS CAGR of 27% over FY08–FY11E with average RoEs at 29%. Our target multiple is set at 14% premium to ABB given BHEL's superior earnings growth expectations vis-à-vis ABB (18%) and in line L&T given more or less similar earnings growth expectations (23%).

Risks

We rate BHEL Low Risk in line with our quantitative risk-rating system, which tracks 260-day historical share price volatility. We believe BHEL deserves a Low Risk rating as its order book provides good earnings visibility over the medium term. Key downside risks to the stock achieving our target price are: 1) Delays in power-sector reforms could affect order flows and earnings; 2) Regulatory uncertainties could hurt valuations and the sentiment toward the stock; 3) Competitive pressures from global majors are a concern, particularly as technology upgrades are affected; and 4) In the short-term, progress on order flows would influence market sentiment.

Appendix A-1

Analyst Certification

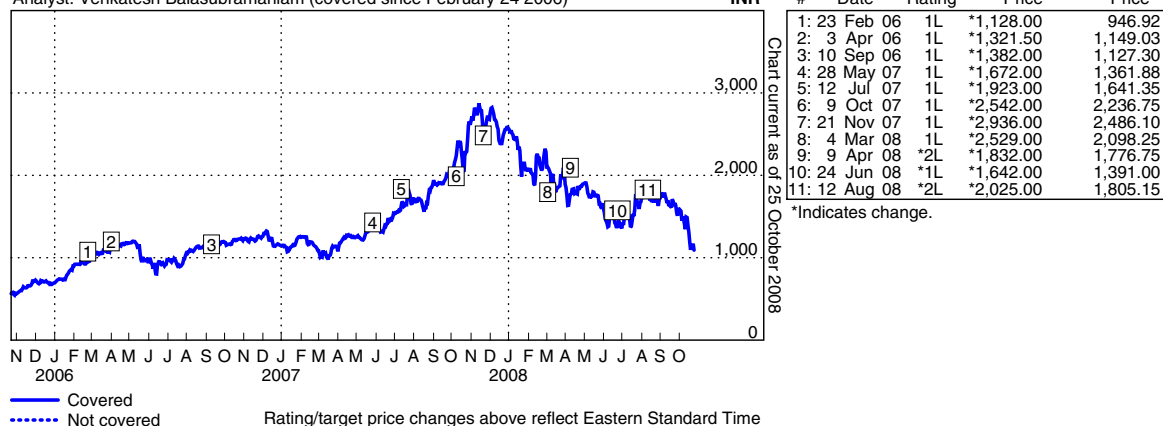
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Bharat Heavy (BHEL.BO)

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Analyst: Venkatesh Balasubramaniam (covered since February 24 2006)



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