

Company Focus

31 January 2008 | 9 pages

Thermax (THMX.BO)

 Target price change
 Estimate change

Buy: Keeping the Faith

- Reducing target price to Rs748 from Rs764, maintain Buy/Low risk** – We are reducing our target price on the back of a) reduction in earnings estimates of 9%-15% over FY09E-10E, b) rolling forward our multiple to 21x Dec09E from 23x Sept09E. While near-term concerns remain, the stock, down 27% from its peak, prices in most of the bad news and risk reward remains favorable.
- Growth to moderate in FY09E, but pick up in FY10E** – Thermax reported order backlog of Rs29bn, down 11% YoY. We thus expect Thermax revenue growth to moderate to 21% in FY09E (vs 32% expected earlier). However, management's confidence and our own comfort on long-term fundamentals lead us to believe that the order inflows should pick up soon.
- Slowdown in captive power plant orders, but industrial boilers demand intact**— Demand for captive power plants slowed due to higher interest rates and lower differential between grid and captive power prices despite higher coal prices. An imminent hike in electricity tariffs should lead to more orders. The company also mentioned that it is in the final negotiation stage for 3 new orders.
- Adding new legs of growth** – We expect growth to pick up in FY10E given 1) increase in order inflows in FY09E, 2) contribution from new plants at Baroda and China, 3) growth due to new tie-ups with Blacke-Durr & Georgia Pacific.
- Maintain Buy** – We like Thermax despite near-term concerns as 1) it's a niche player in captive power and environment technologies, 2) offers one of the highest ROE's of 36% (off an unlevered balance sheet) in our sector.

Buy/Low Risk	1L
Price (30 Jan 08)	Rs652.50
Target price	Rs748.00
	<i>from Rs764.00</i>
Expected share price return	14.6%
Expected dividend yield	0.9%
Expected total return	15.6%
Market Cap	Rs77,749M
	US\$1,978M

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



Figure 1. Thermax Statistical Abstract

Year	Net Profit (Rs mn)	FD EPS (Rs)	EPS Growth (%)	P/E (x)	P / Book (x)	ROE (%)	ROCE (%)	DPS (Rs)	Div. Yield (%)
FY06A	1,016	8.53	55.3%	76.5	16.9	22.2%	20.2%	3.4	0.5%
FY07A	1,992	16.72	96.1%	39.0	13.2	38.0%	32.9%	6.0	0.9%
FY08E	2,971	24.93	49.1%	26.2	9.7	42.6%	38.2%	6.0	0.9%
FY09E	3,359	28.19	13.1%	23.1	7.3	36.0%	32.3%	6.0	0.9%
FY10E	4,539	38.10	35.1%	17.1	5.4	36.5%	33.3%	6.0	0.9%

Source: Company, Citi Investment Research estimates

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	76.5	39.0	26.2	23.1	17.1
EV/EBITDA adjusted (x)	42.1	25.2	16.7	14.2	10.2
P/BV (x)	16.9	13.2	9.7	7.3	5.4
Dividend yield (%)	0.5	0.9	0.9	0.9	0.9
Per Share Data (Rs)					
EPS adjusted	8.53	16.72	24.93	28.19	38.10
EPS reported	8.53	16.26	24.93	28.19	38.10
BVPS	38.53	49.50	67.57	88.89	120.12
DPS	3.40	6.00	6.00	6.00	6.00
Profit & Loss (RsM)					
Net sales	16,261	23,266	35,927	43,503	56,553
Operating expenses	-14,653	-20,573	-31,843	-38,896	-50,232
EBIT	1,608	2,694	4,084	4,607	6,321
Net interest expense	-16	-15	-15	-15	-15
Non-operating/exceptionals	137	360	432	497	571
Pre-tax profit	1,728	3,038	4,500	5,088	6,877
Tax	-703	-1,046	-1,530	-1,730	-2,337
Extraord./Min.Int./Pref.div.	-9	-55	0	0	0
Reported net income	1,016	1,937	2,971	3,359	4,539
Adjusted earnings	1,016	1,992	2,971	3,359	4,539
Adjusted EBITDA	1,768	2,889	4,309	5,003	6,775
Growth Rates (%)					
Sales	28.1	43.1	54.4	21.1	30.0
EBIT adjusted	73.1	67.6	51.6	12.8	37.2
EBITDA adjusted	68.7	63.4	49.1	16.1	35.4
EPS adjusted	55.3	96.1	49.1	13.1	35.1
Cash Flow (RsM)					
Operating cash flow	2,299	3,421	3,728	4,660	3,142
Depreciation/amortization	160	195	225	396	454
Net working capital	1,090	1,313	533	905	-1,852
Investing cash flow	-1,047	-2,317	-2,800	-1,750	-200
Capital expenditure	-261	-545	-2,800	-1,750	-200
Acquisitions/disposals	-785	-1,772	0	0	0
Financing cash flow	-985	-679	-817	-819	-819
Borrowings	3	-48	0	0	0
Dividends paid	-540	-825	-819	-819	-819
Change in cash	267	425	111	2,092	2,123
Balance Sheet (RsM)					
Total assets	11,315	17,766	24,333	30,588	36,571
Cash & cash equivalent	547	972	1,083	3,175	5,298
Accounts receivable	2,412	4,000	6,367	8,230	10,699
Net fixed assets	1,439	1,789	4,365	5,719	5,465
Total liabilities	6,724	11,868	16,282	19,996	22,259
Accounts payable	1,654	3,117	5,041	6,092	7,920
Total Debt	70	22	22	22	22
Shareholders' funds	4,591	5,898	8,052	10,592	14,313
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	10.9	12.4	12.0	11.5	12.0
ROE adjusted	22.2	38.0	42.6	36.0	36.5
ROIC adjusted	50.1	176.9	145.9	80.5	81.7
Net debt to equity	-10.4	-16.1	-13.2	-29.8	-36.9
Total debt to capital	1.5	0.4	0.3	0.2	0.2

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Keeping the faith

Thermax reported strong growth in Q308 – PAT up 51% YoY. However, the company reported an order backlog of Rs29bn, down ~11% YoY. This, coupled with management expectations of FY09E being a more modest year in terms of growth, have led to a meaningful cut in our estimates for FY09E. **However, we are inclined to believe that this is more a temporary slowdown, and growth should pick up in FY10E.**

We have reduced our estimates by 9%-15% over FY09E-10E and our target price to Rs748 (from Rs764 earlier). Our new target price is based on PE of 21x Dec09E against 23x Sept09E earlier.

We believe that the stock, down ~ 27% from its peak, prices in most of the bad news and the risk reward remains favorable.

Growth to moderate in FY09E...

Thermax order backlog at end of 9MFY08 was Rs29bn, down 11% YoY. This has led to concerns on the revenue growth outlook for FY09E given that Thermax has mostly short cycle orders which get executed within 12-18 months. We have cut our revenue estimates for FY09E and now expect growth of 21% YoY vs 32% earlier.

Captive power plants seem to be the key pressure point – The slowdown in order inflows seem to be due to high interest rates and stable electricity prices despite rising coal prices. The company expects orders to get confirmed as the electricity rates get hiked under new tariff orders and the differential between the grid and captive power prices widen.

Negotiations on for 3 plant orders – Thermax is in final negotiations for 3 orders and is confident of announcing order wins soon. **The company mentioned that even if it wins an order in March 2008, it would be able to bill at least 65% of that in FY09, which somewhat allays our concerns of the impact of the slowdown in the order intake so far.**

... to bounceback in FY10E

We expect FY10E to be a better year in terms of growth as:

- **Foray in higher MW Power Plants** – Thermax had signed technology agreement with Babcock and Wilcox for 135MW unit capacity boilers. The technology absorption is complete and the company is currently in discussion with developers for small-sized IPP plants. We do not expect the company to foray into utility range boilers for at least another year.
- **Industrial bBoilers demand intact** – The demand for industrial boilers remained strong, and the company expects it to grow by 10%-15% in the next year. These boilers are used in over 20 industries. Thermax has ~27% - 30% market share and plans to increase market share by 5% to ~35%.

- The new facilities at Baroda and China would complete one full year of commercial operations. Thermax hasn't booked too many orders for these facilities currently given that these plants would need to stabilize production. We expect these facilities to start contributing meaningfully to the top-line in FY10E.
- New initiatives like technology tie-ups with the Blacke Durr and Georgia-Pacific Chemicals should start contributing to revenues.

Margins expected to be 11.5%-12% range in FY09-10E

We expect Thermax margins to be 11.5% in FY09E and 12% in FY10E (versus our previous estimates of 12.5% for FY09E and FY10E). Margins in FY09E should be lower than 12% in FY08E as:

- revenue growth would moderate; and
- fixed overheads of the new plants at Baroda and China should start getting booked with revenue growth kicking in only in FY10E.

Other takeaways

Impact of Rupee Appreciation – Rupee appreciation is hurting exports, and if rupee falls below Rs37, Thermax would lose its competitiveness in the export market.

Purolite case – The company stated that the process was on track and are confident that the results would be in its favour. The case is scheduled for hearing in July.

Reducing estimates by 9%-15% over FY09E-10E, target price to Rs748.

We are reducing our earnings estimates for FY09-10E on the back of lower revenue growth and reduction in margins.

Figure 2. Thermax revised estimates

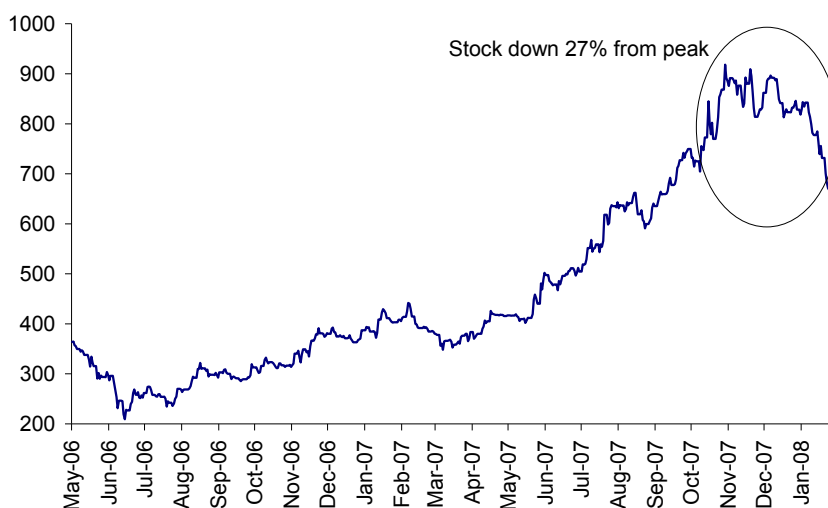
		FY08E	FY09E	FY10E
Sales	Old	34,860	46,123	57,279
	New	35,927	43,503	56,553
	Change	3.1%	-5.7%	-1.3%
EBITDA Margins	Old	12.0%	12.5%	12.5%
	New	12.0%	11.5%	12.0%
	Change bps	(2)	(98)	(53)
EPS	Old	24.34	33.22	41.66
	New	24.93	28.19	38.10
	Change	2%	-15%	-9%

Source: Citi Investment Research estimates

Reducing target price to Rs748 from Rs764, maintain Buy/Low risk

We are reducing our target price to Rs748 from Rs764 on the back of a) reduction in earnings estimates of 9%-15% over FY09E-10E and b) rolling forward our multiple to 21x Dec09E from 23x Sept09E (at a discount to BHEL , the market leader). The stock has corrected 27% from its peak and risk reward remains favorable, in our view.

Figure 3. Thermax stock price



Source: Citi Investment Research

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 Buy/Low Risk (1L) rating on Thermax. Our rating is supported by our forecast FD EPS CAGR of 24% for FY08E-10E and ROE's of ~36%. Thermax has a 21% share in the overall boiler market in India and is the leader in small and medium-sized boilers. BHEL, with a 69% market share, is the industry's only other scale player. With BHEL focusing on higher capacity utility boilers, Thermax is poised to capture a larger share of market in industrial boilers and smaller capacity utility boilers. We think Thermax is in a sweet spot given: 1)

India's captive power capacity is set to grow by 63% in the next five years due to lack of quality supply and high industrial tariffs; 2) Industrial capex is expected to grow 181% in FY06-10E driven by strong demand and peak capacity utilizations; and 3) Higher environmental standards.

Valuation

Our target price for Thermax of Rs748 is set at Dec09E P/E of 21x, at a discount to our target multiple for BHEL. We believe Thermax should trade at a discount to BHEL given that BHEL is the market leader and is a direct beneficiary of all power capex in India. Thermax has traded at an average discount of 35% to ABB given that ABB has had superior earnings growth and access to its parent's technology. Thermax has traded at a premium to the Sensex over the past 4 years, a premium that has been increasing due to superior earnings growth.

Risks

We rate Thermax as Low Risk. The rating differs from the Medium Risk rating assigned by our quantitative risk-rating system, which tracks 260-day historical share price volatility. We believe that our risk rating reflects earnings visibility of more than a year out for Thermax and its growing importance as a key player in the electrical equipment sector in India. The key downside risks to our target price include: rising interest rates, rupee appreciation, manpower shortages, increasing competition, decline in oil prices, low pricing flexibility, international operations and a pending lawsuit in US.

Appendix A-1

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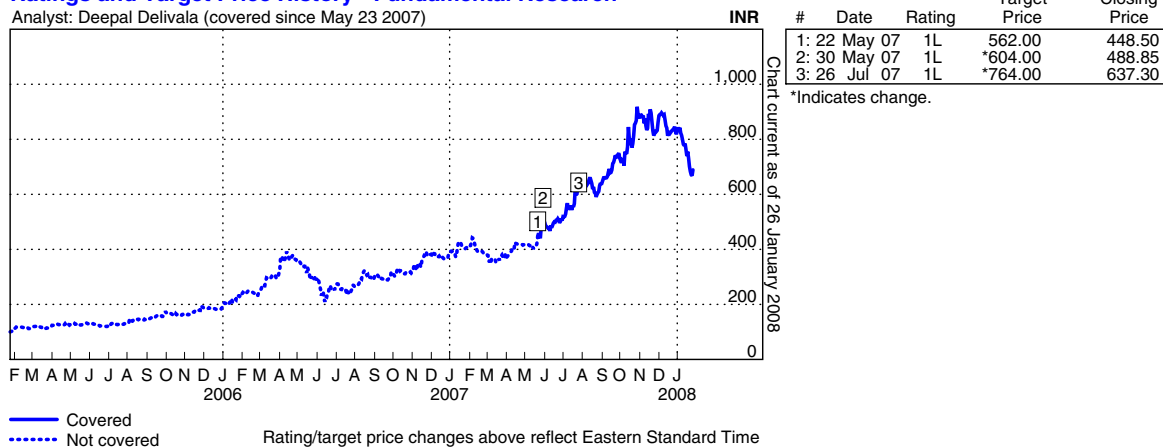
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Ratings and Target Price History - Fundamental Research

Analyst: Deepal Delivala (covered since May 23 2007)



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