

### INITIATING COVERAGE

#### Share Data

Market Cap	Rs. 753 bn
Price	Rs. 1538.25
BSE Sensex	14650.51
Reuters	BHEL.BO
Bloomberg	BHEL IN
Avg. Volume (52 Week)	0.23 mn
52-Week High/Low	Rs. 1538/880
Shares Outstanding	489.52 mn

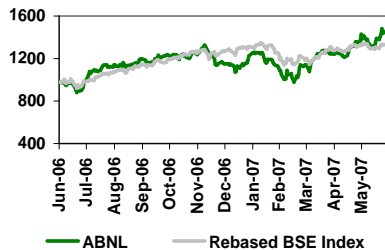
#### Valuation Ratios

Year to 31 March	2008E	2009E
EPS (Rs.)	61.5	79.7
+/- (%)	24.7%	29.6%
PER (x)	25.0x	19.3x
EV/ Sales (x)	3.3x	2.6x
EV/ EBITDA (x)	17.2x	13.2x

#### Shareholding Pattern (%)

Promoters	68
FII's	20
Institutions	8
Public & Others	4

#### Relative Performance



### Bharat Heavy Electricals Limited

Hold

#### BHEL – A star performer

Bharat Heavy Electricals Ltd. (BHEL) is India's largest PSU engineering company providing services to the core sectors of the Indian economy viz. Power Generation & Transmission, Industry and Defence. The company operates through 14 manufacturing units, 8 service centers, and 4 power sector regions, besides project sites spread across India and abroad.

Given the strong order backlog of Rs. 550 bn, expanding international business, improving margins and increased emphasis on capacity expansion, we believe that there is strong growth momentum for BHEL. However, given the recent appreciation in the stock price of almost 11% in the last two weeks, we initiate coverage of BHEL with a Hold rating with guidance to accumulate below Rs. 1,450.

#### Key Figures

Year to March	FY05	FY06	FY07	FY08E	FY09E	CAGR (%)
(Figures in Rs mn, except per share data) (FY07-09E)						
Net Sales	94,911	132,282	172,375	215,701	276,398	26.6%
EBITDA	14,157	23,413	32,909	41,630	54,174	28.3%
<b>Net Profit</b>	9,646	16,779	24,147	30,120	39,034	27.1%
<b>Margins(%)</b>						
EBITDA	14.9%	17.7%	19.1%	19.3%	19.6%	
NPM	10.2%	12.7%	14.0%	14.0%	14.1%	
<b>Per Share Data (Rs.)</b>						
EPS	19.7	34.3	49.3	61.5	79.7	27.1%
PER (x)	78.1x	44.9x	31.2x	25.0x	19.3x	
CEPS	24.2	39.3	54.9	68.5	88.2	
P/CEPS (x)	63.6x	39.1x	28.0x	22.5x	17.4x	

- We expect the revenues of BHEL to grow at a FY07-09E CAGR of 26.6% driven by strong order backlog. EBITDA margins are expected to improve marginally, which in turn would lead to increase in EPS which is estimated to reach Rs. 61.5 for FY08E.
- BHEL's stock has witnessed a sharp increase recently; still it trades at a significant discount to its peers such as Siemens, ABB and ALSTOM. Currently the stock trades at a forward PE of 25x FY08E and 19.3x FY09E. We initiate coverage of BHEL with a 12-month price target of Rs 1,661 which is 27x FY08E.

## Rationale

### *Enhancing capacity*

BHEL has plans to enhance its manufacturing facility in the next 3 years from 6,000 MW to 15,000 MW per annum with a total investment of around Rs.32 bn. Currently, BHEL is in the process of enhancing its manufacturing capacity to 10,000 MW per annum at a cost of Rs.12 bn by the end of 2007. The enhanced capacity would result in better delivery schedules and greater bargaining power.

*BHEL to invest Rs. 32 bn to enhance capacity by 250% in next three years*

### *Strong order backlog*

BHEL ended FY07 with an order book position of Rs. 550 bn, a whopping 46.3% increase as compared to FY06. The strong order backlog of around 3x FY07 revenues gives a clear visibility on the revenue generation for the next few years. In addition, the target of 68 GW of new capacity addition under the XIth five-year plan ending 2012 has also opened doors for a strong order pipeline coming for BHEL till FY10-11.

*Strong order book position of Rs. 550 bn at March 07 end*

### *Expanding global presence*

During FY07, BHEL witnessed significant steps towards globalization with receipt of orders for power equipment for over 900 MW of power projects and 5,600 MVA of transformer capacity, the highest ever in the transmission sector overseas.

*Highest ever international orders*

Further, the company is positioning itself as a regular EPC Contractor in international markets besides pursuing the M&A route to avail inorganic growth opportunities to enlarge the company's operations and reach in the export markets.

### *Up-gradation and Introduction of new technologies*

BHEL has signed a 15-year technology transfer agreement with ALSTOM for 800MW super-critical technology boilers and has formed an alliance with Siemens for 800MW supercritical turbines. Introduction of higher rating hydro turbine generator sets and advanced class Gas Turbines has also been planned to cater to upcoming market requirements.

*Technology agreements to counter supercritical threat*

### Key Risks

#### *Derailment in power reforms*

During X<sup>th</sup> five-year plan, India could add only about 22,000 MW of generation capacity as against a target of 41,000 MW which shows that domestic power sector has not kept pace with the growth in demand for power in the past. Any such derailment of power reforms in the XI<sup>th</sup> plan would be a risk to our rating.

#### *Competition*

The threat from Chinese manufacturers is evident post the Hisar project deal which was clinched by Reliance-Shanghai consortium; any further lost deals to international competitors in this segment, would be a cause for concern.

There could be a further dent in the market share given that 16% capacity in 11<sup>th</sup> plan and 30% capacity in 12<sup>th</sup> plan would be of supercritical nature. Although BHEL has no prior expertise in supercritical technology, it has tied up with ALSTOM and Siemens to counter this threat.

#### *Prices of raw materials*

Any unprecedented rise in prices of primary raw materials such as steel, copper, and aluminium could significantly impact margins.

### Outlook

The enhanced manufacturing capacity, together with the state-of-the-art technology to produce higher rating super-critical thermal sets and a skilled workforce strengthens BHEL's position in the domestic market.

With the signing of a 15-year technology transfer agreement with Alstom for 800MW super-critical technology boilers and entering into an alliance with Siemens for 800MW supercritical turbines the company appears comfortably placed. In addition, the company has unveiled a Strategic Plan 2012 that will enable it to achieve a turnover of US\$10 bn by 2011-12 i.e. two and a half times its present turnover of US\$4 bn.

The upswing in the power sector is expected to push profits in the near term, however, FY09E onwards, we are anticipating a drop in margins due to

*Chinese EMs a cause for concern in addition to supercritical technology*

*BHEL poised to ride infrastructure boom*

Chinese competition and limited technological exposure (especially in supercritical technology) in the Indian market.

The stock currently trades at a forward PE of 25x FY08E and 19.3x FY09E. We initiate coverage of BHEL with a 12-month price target of Rs 1,661 which is 27x FY08E with a guidance to accumulate below Rs. 1,450.

### Company Background

Bharat Heavy Electricals Ltd. is one of the leading international companies in the field of power equipment manufacture. BHEL's range of services extends from project feasibility studies to after-sales-services. The company has 14 manufacturing units, 4 power sector regions, 8 service centers and 18 regional offices, besides project sites spread all over India and abroad.

BHEL has a well recognised track record of performance, making profits continuously since 1971-72 and paying dividends since 1976-77. BHEL manufactures over 180 products under 30 major product groups and caters to core sectors of the Indian economy viz., Power Generation and Transmission, Industry, Transportation, Renewable Energy, Defence, etc.

The quality and reliability of BHEL has already attained ISO 9000 certification for quality management and all the manufacturing units /divisions have been upgraded to the latest ISO 9001-2000 version. BHEL has also secured ISO 14001 certification for environmental management systems & OHSAS -18001 certification for occupational health and safety management systems for all its major units/divisions.

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