Flashnote

HSBC Global Research

Industrials
Electrical Equipment
Equity – India

Areva T&D (ATD IN)

Neutral

Target price (INR)	220.00
Share price (INR)	205.20
Forecast dividend yield (%)	1.0
Potential return (%)	8.2

Note: Potential return equals the percentage difference between the current share price and the target price, plus the forecast dividend yield

Performance	1M	3M	12M
Absolute (%)	-6.0	-0.2	-28.7
Relative^ (%)	3.5	-2.1	-15.6

Index^	BOMBAY SE SENSITIVE INDEX
RIC	AREV.BO
Bloomberg	ATD IN
Market cap (USDm)	944
Market cap (INRm)	49,064
Enterprise value (INRm)	50,466
Free float (%)	23

Note: (V) = volatile (please see disclosure appendix)

30 November 2011

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N: Management commentary turning positive

- **Increasing activity from Power customers, railways likely to improve; competition becoming healthy, prices stabilising**
- **Proposed demerger imminent; likely to bring in cross selling & cost synergies; impending asset sale may neutralise debt**
- **Valuation appears full; need visibility on margin improvement; maintain N and TP of INR220**

We recently met with Mr Abhishek Mani, Investor Relations head, at Areva T&D. Below, we highlight some of the key takeaways from the meeting.

Business outlook improving: After years of bearishness, Areva's tone on business outlook is now turning positive. The company noted that the order pipeline remains strong with increased activity from SEBs (through PPP model), Power Grid (new Chairman has strong focus on execution) and national utilities (c15% of total generation capex is T&D related). In addition, management noted that competition is finally returning to healthy levels and pricing seems to have stabilised. Other than the Power sector, demand for T&D equipment is also likely to improve from the Railways sector, with a lot of orders in the pipeline for Metro projects as well as dedicated freight corridors. Areva estimates the current railway T&D market to be around a mere INR5bn but believes it is likely to grow sharply over the next couple of years.

Proposed demerger imminent, likely to drive growth & margin improvement: The demerger of the Transmission and the Distribution divisions is likely to become effective over the next four to six weeks, after which, both these businesses will be separately listed on the exchange. Transmission is likely to benefit from Alstom's global sourcing initiative (cUSD2bn requirement per annum), which should drive both growth & margin improvements of c200-300bp. Distribution, on the other hand, will focus on cross selling and cost synergies with Schneider to improve margins from mid-single digit to low double digits. This may also entail restructuring the business. In addition to these synergies, the businesses are likely to benefit from the impending asset sale (as part of the restructuring at Areva T&D), which should draw proceeds of cINR5bn, making these companies largely debt neutral.

Valuation appears full, maintain Neutral with a positive bias: Given the difficult business environment, we would like to obtain more visibility on order pipeline and see some sustainable improvement in margins before we start factoring in a brighter outlook in our numbers. We keep our estimates unchanged and at c20.4x CY12e PE, as we find the valuation relatively rich. However, we think there remains upside potential to earnings as well as trading multiples if the company is able to deliver earnings improvement on the back of synergies and restructuring post demerger. Hence, we maintain our Neutral rating on the stock and target price of INR220. Our TP is derived from our preferred EVA valuation methodology and implies a 12-month forward target multiple of c17x on 24-month forward estimated EPS of INR12.9.

Financials & valuation

Financial statements

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Profit & loss summary (INRm)				
Revenue	40,200	43,168	49,330	58,149
EBITDA	4,407	4,358	5,227	6,545
Depreciation & amortisation	-936	-970	-971	-967
Operating profit/EBIT	3,471	3,388	4,255	5,578
Net interest	-655	-657	-644	-614
PBT	2,816	2,731	3,612	4,963
HSBC PBT	2,816	2,731	3,612	4,963
Taxation	-949	-915	-1,210	-1,663
Net profit	1,867	1,816	2,402	3,301
HSBC net profit	1,867	1,816	2,402	3,301
Cash flow summary (INRm)				
Cash flow from operations	427	4,644	2,680	3,275
Capex	-1,131	-980	-980	-880
Cash flow from investment	-1,131	-980	-980	-880
Dividends	-500	-502	-560	-615
Change in net debt	1,389	-3,162	-1,140	-1,780
FCF equity	-1,756	3,664	1,700	2,395
Balance sheet summary (INRm)				
Intangible fixed assets	0	0	0	0
Tangible fixed assets	8,939	8,949	8,958	8,871
Current assets	35,740	36,781	42,094	49,844
Cash & others	4,391	7,553	8,693	10,473
Total assets	44,682	45,732	51,054	58,718
Operating liabilities	24,636	24,372	27,851	32,830
Gross debt	8,957	8,957	8,957	8,957
Net debt	4,566	1,404	264	-1,516
Shareholders' funds	10,024	11,338	13,181	15,866
Invested capital	21,292	19,741	21,291	23,409

Ratio, growth and per share analysis

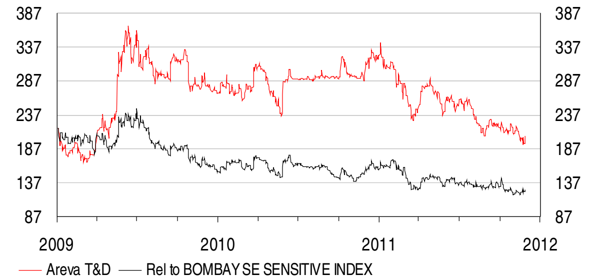
Year to	12/2010a	12/2011e	12/2012e	12/2013e
Y-o-y % change				
Revenue	12.7	7.4	14.3	17.9
EBITDA	5.3	-1.1	19.9	25.2
Operating profit	-2.8	-2.4	25.6	31.1
PBT	-3.9	-3.0	32.2	37.4
HSBC EPS	-4.8	-2.7	32.2	37.4
Ratios (%)				
Revenue/IC (x)	1.9	2.2	2.3	2.5
ROIC	11.6	12.4	14.3	17.0
ROE	18.6	16.0	18.2	20.8
ROA	5.6	4.0	5.0	6.0
EBITDA margin	11.0	10.1	10.6	11.3
Operating profit margin	8.6	7.8	8.6	9.6
EBITDA/net interest (x)	6.7	6.6	8.1	10.7
Net debt/equity	45.6	12.4	2.0	-9.6
Net debt/EBITDA (x)	1.0	0.3	0.1	-0.2
CF from operations/net debt	9.3	330.7	1014.7	
Per share data (INR)				
EPS reported (fully diluted)	7.81	7.60	10.05	13.80
HSBC EPS (fully diluted)	7.81	7.60	10.05	13.80
DPS	1.80	2.00	2.20	2.40
Book value	41.92	47.42	55.12	66.36

Valuation data

Year to	12/2010a	12/2011e	12/2012e	12/2013e
EV/sales	1.3	1.2	1.0	0.8
EV/EBITDA	12.2	11.6	9.4	7.3
EV/IC	2.5	2.6	2.3	2.0
PE*	26.3	27.0	20.4	14.9
P/Book value	4.9	4.3	3.7	3.1
FCF yield (%)	-3.6	7.5	3.5	4.9
Dividend yield (%)	0.9	1.0	1.1	1.2

Note: * = Based on HSBC EPS (fully diluted)

Price relative



Source: HSBC

Note: price at close of 28 Nov 2011

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Management commentary turning increasingly positive

Demand outlook

- **SEBs:** Activity has increased significantly in all states where elections are nearing. New projects are not being financed directly by the States but are coming up on BOT basis, thus eliminating constraints related to State financing.
- **Power Grid:** New management is extremely focused on execution, evidence for which is the reduction in the tender-to-order award lead time to c4-6 weeks from c6-9 months earlier. Power Grid is likely to place orders worth around INR220-230bn in FY12 compared with around INR183bn in FY11.
- **National utilities:** Stable growth is expected here. The opportunity is c.INR8m per MW and the scope of work includes switchyards, substations related to evacuation to the grid and e-BOP work.
- **Railways:** Management expects metro-related orders to pick up sharply. In addition, with changes in the Railway Ministry, orders related to dedicated freight corridors are expected to pick up sharply. The scope of work involves distribution transformers, traction transformers and tapping stations.
- **Exports:** The group currently derives c13-14% of revenues from exports. It would like to increase this to c25% in the medium term but is not too keen to grow in the MENA region as competition is intense. The margin profile could improve only with increased exposure to Europe once that market improves.

Competition

- **Chinese/Korean:** Foreign players are moving away from entry-level pricing strategy. In recent reactor tenders (a product with highest competition), the Chinese are now L3/L4. Many foreign players have been absent from bidding lately as new pre-qualification (PQ) requires them to set up a manufacturing plant in India within 18 months of getting an order, or there is a severe penalty clause.
- **Domestic:** The intense competition reflected in recent order data is not indicative of current trading as these orders pertain to old tenders (some as old as 9-12 months). Domestic competition, particularly from smaller players, has reduced as Power Grid has now become increasingly focused on execution and is likely to impose late deliverable (LD) charges in case of delays (which could be up to c20-25% of the project cost). In addition, the smaller EPC players that have won 765kV substation orders are finding it difficult to source the circuit breakers (the most critical component of a substation) at their expected prices.
- **Pricing:** Product pricing seems to have stabilised and all MNCs are now unlikely to reduce prices further. Have seen stable pricing in tenders lately but there is always the risk of an exceptional bidder.

Likely impact of the proposed demerger

- **Timeline:** The proposed Transmission and the Distribution demerger is likely to take effect before January 2011. Post demerger, both will be separately listed as subsidiaries of Alstom and Schneider, respectively. Areva T&D shareholders will get one share each in these entities for every share held.
- **Transmission business (c70% group sales):** Transmission is likely to benefit from Alstom's global sourcing requirement for transmission equipment, which is estimated at cUSD2bn pa. This should not only provide a strong growth impetus but should help in further improving margins by c200-300bp. In a normal business environment, this business is capable of delivering EBIT margins of c12-13%.

- **Distribution business (c30% group sales):** Distribution is likely to undergo restructuring after the demerger to improve its profitability. In addition, the business is likely to benefit from the cross-selling opportunities Schneider can provide. Management expects EBIT margins to improve from c4-5% currently to c9-10% in the medium term.
- **Asset sale:** As part of the restructuring that Areva T&D has carried out over the past couple of years, the company currently has several assets for sale, which will commence once the demerger takes effect. Areva T&D expects to generate around INR5-6bn from these asset sales, which is likely to make the company debt neutral. Approximately c70% of these proceeds will go to the transmission business and c30% will go to the distribution business.
- **Management changes:** After the demerger, Mr Rathin Basu will continue to head Transmission, while Mr Graham Johnson (currently India sales head at Areva T&D) will head Distribution.

Valuation and key risks

Given the difficult business environment, we would like to obtain more visibility on order pipeline and see some sustainable improvement in margins before we start factoring in a brighter outlook in our numbers. As this stage, we keep our estimates unchanged and at c20.4x CY12e PE, we find the valuation as relatively rich. However, there remains upside potential to earnings as well as trading multiples if the company is able to deliver earnings improvement on the back of synergies and restructuring post demerger. Hence, we maintain our Neutral stance and target price of INR220. Our target price is derived from our preferred EVA valuation methodology, assuming target sales growth of c9%, through-cycle operating return margin of c9.0% and WACC of c12.1%.

Our target price implies that 12 months from now, the stock should be trading at a 12-month forward PE of c17x on 24-month forward EPS of INR12.9. Under HSBC's research model, for stocks without a volatility indicator, the Neutral rating band is 5ppt above and below the hurdle rate for India stocks of c11%. This translates into a Neutral rating band of 6% to 16% above the current share price. Our 12-month target price of INR220 suggests a potential return of 8.2% (including dividends), which is within the Neutral rating band; hence, we reiterate our Neutral rating on the stock. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

Risks

We highlight the key risks related to our investment case on ATD below:

Upside risks

- Significant pick-up in execution and order inflow
- Better-than-expected improvement in margins
- Bullish guidance on synergies post the proposed demerger

Downside risks

- Delay/cancellation of domestic transmission projects
- Excessive pricing pressure

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Disclosure appendix

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Underweight (Sell)	11%	(14% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities

Areva T&D (AREV.BO) Share Price performance INR Vs HSBC rating history

Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Neutral	25 January 2011
Neutral	Overweight	29 June 2011
Overweight	Neutral	11 October 2011
Target Price	**Value**	**Date**
Price 1	340.00	25 January 2011
Price 2	310.00	29 June 2011
Price 3	270.00	12 August 2011
Price 4	235.00	11 October 2011
Price 5	220.00	17 November 2011

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
AREVA T&D	AREV.BO	205.20	28-Nov-2011	2, 5, 7

Source: HSBC

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