

Industrials
Electrical Equipment
 Equity – India

Neutral (V)

Target price (INR)	318.00
Share price (INR)	282.40
Forecast dividend yield (%)	2.4
Potential return (%)	15

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 (%)	-13.8	-20.2	-34.4
Relative ^A (%)	-4.1	-18.1	-20.5

Index^A BOMBAY SE IDX

RIC	BHEL.BO
Bloomberg	BHEL IN
Market cap (USDm)	13,307
Market cap (INRm)	691,202
Enterprise value (INRm)	574539
Free float (%)	32

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

2 December 2011

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BHEL (BHEL IN)

Upgrade to Neutral (V): Negatives in the price

- ▶ **Stock at its lowest PE multiple since 2003 after 19% correction over last three months (33% in last one year) vs flat sensx**
- ▶ **Growth in order inflow for FY12 is a challenge, acceleration in 2H could boost investor sentiment, long-term growth uncertain**
- ▶ **Upgrade to Neutral (V) from UW(V), maintain estimates and INR318 target**

Stock trading at its lowest multiple post steep correction and we see limited

downside: We have maintained that BHEL will see flat/negative EPS growth in FY13-14 due to declining order inflow and margins. The market has factored in weak growth prospects which have led to a stock correction of 33% over the last year, and 19% over the last three months versus Sensex up 2%. Consensus too has now downgraded its EPS forecasts by 5-10% for FY13-14 in last 3-6 months (refer exhibit 7). Our EPS forecasts are still 8-9% below consensus (refer exhibit 8). The stock is now trading at PE of c10x, its lowest multiple since 2003 (refer exhibit 2), fully pricing in the negatives we believe. We see limited downside from the current levels.

Growth in order inflow for FY12 is a challenge, but should pick up in 2H, although the long-term outlook remains uncertain: Post a decline in 1H (at INR168bn, -31% yoy - refer exhibit 4), we do expect better orders in 2H (at INR375bn, up 4% yoy), but it would be a challenge for BHEL to grow or even reach FY11 levels based on the visible pipeline of orders (refer exhibit 5). However, an improvement in order inflow during H2 should be sentiment positive. The long-term outlook for order inflow remains uncertain given the fuel pressure and competition from both domestic and international peers.

What could turn things around? While the company can manage its sales and earnings from its existing order book of INR1.6trillion (3.4x FY12e revenue - refer exhibit 6) for the next 2-3 years, the growth beyond FY14 is dependant on new order inflows over the next 2-3 years. Things may look up after a few years if fuel (read coal) pressure eases or alternative fuel like nuclear picks up. Additionally if BHEL is able to explore other business segments like railways or transmission in a big way in next few years, this could be another upside.

Upgrade to Neutral (V) from Underweight (V), maintain estimates and target price of INR318: We use EVA to value BHEL, assuming a WACC of 11%, target sales growth of 6%, operating return of 17% and target asset return of 1.75x, which yields our target price of INR318 (refer exhibit 9), implying a potential return of 15% from the current price. Our target implies a PE of 11.6x on FY13e EPS versus the current FY12PE of 10.3x. **Upside risk:** higher-than-expected margins from a faster-than-expected shift to supercritical technology. **Downside risk:** lower than-expected order inflow intake impacting earnings.

Financials & valuation

Financial statements

Year to	03/2011a	03/2012e	03/2013e	03/2014e
Profit & loss summary (INRm)				
Revenue	422,466	479,585	508,058	514,263
EBITDA	85,857	98,555	98,204	95,235
Depreciation & amortisation	-5,441	-6,701	-7,887	-8,838
Operating profit/EBIT	80,415	91,854	90,317	86,397
Net interest	9,659	9,381	10,696	12,539
PBT	90,871	101,235	101,013	98,937
HSBC PBT	90,871	101,235	101,013	98,937
Taxation	-30,759	-33,914	-33,839	-33,144
Net profit	60,112	67,322	67,174	65,793
HSBC net profit	59,315	67,322	67,174	65,793

Cash flow summary (INRm)

Year to	03/2011a	03/2012e	03/2013e	03/2014e
Cash flow from operations	43,371	56,376	72,463	74,064
Capex	-17,623	-19,185	-12,701	-12,857
Cash flow from investment	-21,216	-19,235	-12,751	-12,907
Dividends	-17,746	-19,587	-19,544	-19,142
Change in net debt	1,955	-17,554	-40,167	-42,015
FCF equity	24,952	37,191	59,761	61,208

Balance sheet summary (INRm)

Year to	03/2011a	03/2012e	03/2013e	03/2014e
Intangible fixed assets	0	0	0	0
Tangible fixed assets	51,631	64,115	68,929	72,948
Current assets	514,947	589,056	657,252	705,375
Cash & others	96,302	113,855	154,023	196,038
Total assets	592,606	679,248	752,308	804,501
Operating liabilities	389,434	428,342	453,772	459,314
Gross debt	1,634	1,634	1,634	1,634
Net debt	-94,668	-112,222	-152,389	-194,404
Shareholders funds	201,538	249,273	296,902	343,553
Invested capital	80,843	110,974	118,386	122,971

Ratio, growth and per share analysis

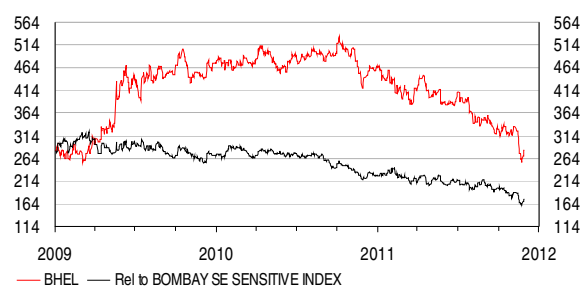
Year to	03/2011a	03/2012e	03/2013e	03/2014e
Y-o-y % change				
Revenue	26.7	13.5	5.9	1.2
EBITDA	45.0	14.8	-0.4	-3.0
Operating profit	47.2	14.2	-1.7	-4.3
PBT	37.1	11.4	-0.2	-2.1
HSBC EPS	39.1	13.5	-0.2	-2.1
Ratios (%)				
Revenue/IC (x)	6.6	5.0	4.4	4.3
ROIC	83.6	63.7	52.4	47.6
ROE	32.9	29.9	24.6	20.5
ROA	11.2	10.7	9.4	8.5
EBITDA margin	20.3	20.6	19.3	18.5
Operating profit margin	19.0	19.2	17.8	16.8
EBITDA/net interest (x)				
Net debt/equity	-47.0	-45.0	-51.3	-56.6
Net debt/EBITDA (x)	-1.1	-1.1	-1.6	-2.0
CF from operations/net debt				
Per share data (INR)				
EPS reported (fully diluted)	24.56	27.51	27.44	26.88
HSBC EPS (fully diluted)	24.23	27.51	27.44	26.88
DPS	6.23	6.88	6.86	6.72
Book value	82.34	101.84	121.30	140.36

Valuation data

Year to	03/2011a	03/2012e	03/2013e	03/2014e
EV/sales	1.4	1.2	1.1	1.0
EV/EBITDA	6.9	5.8	5.4	5.2
EV/IC	7.3	5.2	4.5	4.0
PE*	11.7	10.3	10.3	10.5
P/Book value	3.4	2.8	2.3	2.0
FCF yield (%)	3.6	5.4	8.7	8.9
Dividend yield (%)	2.2	2.4	2.4	2.4

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

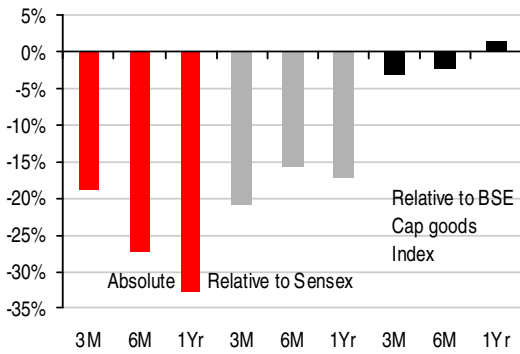
Price relative



Source: HSBC

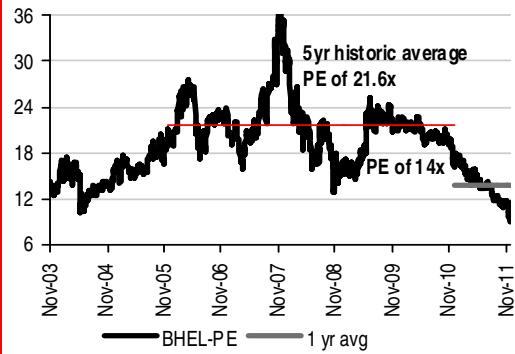
Note: price at close of 29 Nov 2011

Exhibit 1: BHEL has underperformed the sensex in last one year due to weak outlook



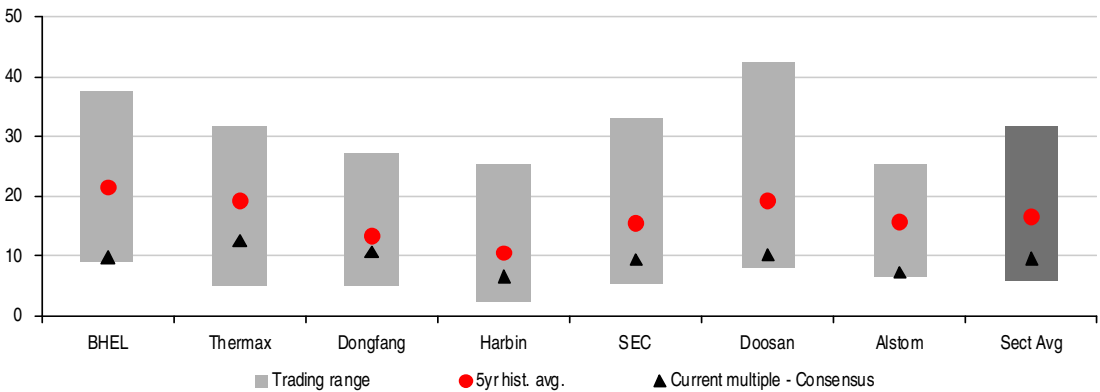
Source: Thomson Reuters Datsastream, Pricing as of close of 28 November 2011

Exhibit 2: Now trading at its lowest PE since 2003



Source: Thomson Reuters Datsastream, Pricing as of close of 28 November 2011

Exhibit 3: At the bottom end of its trading range, even compared to its peers



Source: Thomson Reuters Datsastream, Pricing as of close of 28 November 2011

Exhibit 4: Growth in order inflow in FY12 is a challenge, though improvement in 2H can boost investors sentiment, but growth in long term is uncertain

Order inflow (INRbn)	FY10	FY11	1HFY12	2HFY12e	FY12e	FY13e	FY14e
Power	431	464	90	298	388	407	356
y/y	-9%	8%	na	na	-16%	5%	-13%
Industry	159	141	78	78	155	171	188
y/y	27%	-11%	na	na	10%	10%	10%
Total	590	605	168	375	543	578	544
y/y	-1%	2%	-31%	4%	-10%	6%	-6%

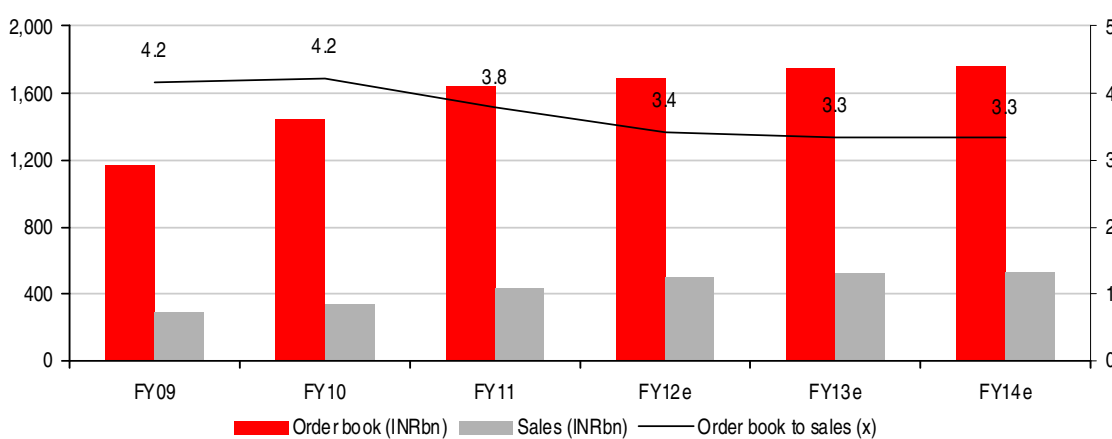
Source: Company data, HSBC estimates

Exhibit 5: Potential pipeline of orders in the power segment over the next one year

Project	Unit size	MW	INRbn	Likely in
NTPC Bulk order II - Boilers only	4x800	3,200	51	2HFY12
JV/MOU with Tamil Nadu Electricity Board	2x800	1,600	51	2HFY12/FY13
JV/MOU with Madhya Pradesh Power Generation Co Ltd	2x800	1,600	51	2HFY12/FY13
JV/MOU with Maharashtra Genco	2x660	1,320	42	2HFY12/FY13
JV/MOU with Gujarat State Electricity Board	4x800	3,200	102	2HFY12/FY13
RRVUNL Rajasthan two orders	4x660	2,640	79	2HFY12
Total		13,560	377	

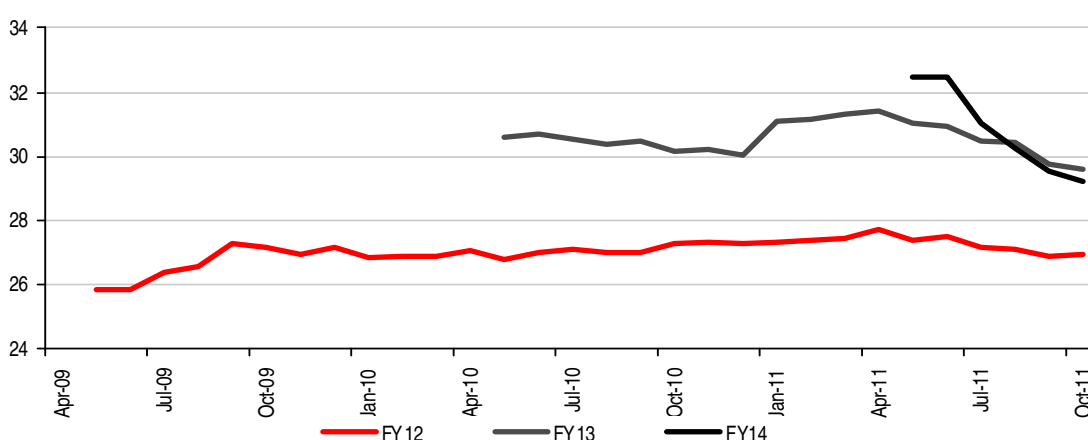
Source: HSBC estimates

Exhibit 6: Existing order book of INR1.6 trillion (3.4x FY12e revenue) to support sales and earnings over next 2-3 years



Source: Company data, HSBC estimates

Exhibit 7: Consensus has also downgraded BHEL's EPS forecasts by 5-10% for FY13-14 in last 3-6 months



Source: Factset

Exhibit 8: HSBC's EPS forecast for FY13-14 are still below consensus by 8-9%, likely to move towards our numbers

INRm	HSBC			Consensus			% change		
	FY12e	FY13e	FY14e	FY12e	FY13e	FY14e	FY12e	FY13e	FY14e
Sales	479,585	508,058	514,263	483,697	541,198	562,119	-1%	-6%	-9%
% growth	14%	6%	1%	14%	12%	4%			
EBITDA	98,555	98,204	95,235	94,457	104,392	102,083	4%	-6%	-7%
Margin %	20.6%	19.3%	18.5%	19.5%	19.3%	18.2%			
Net Profit	67,322	67,174	65,793	66,388	73,019	72,038	1%	-8%	-9%
EPS (INR)	28	27	27	27	30	29	1%	-8%	-9%
% growth	13%	0%	-2%	12%	10%	-1%			

Source: HSBC estimates, Bloomberg for consensus as on 28 November 2011

Upgrade to Neutral (V) rating and maintain TP of INR318

We use an Economic Value Added approach to value BHEL, assuming a WACC of 11% (using a cost of debt of 9.0%, cost of equity of 11.5% and beta of 0.9). We assume target sales growth of 6%, operating return of 17% and target asset return of 1.75x, which yields a target price of INR318, implying a potential return of 15.0% (including dividend yield). Our target implies a PE of 11.6x on FY13e EPS versus the current FY12e PE of 10.3x. See exhibit 9 for our BHEL valuation summary.

Under our research model, for stocks with a volatility indicator, the Neutral band is 10ppts above and below the hurdle rate for Indian stocks of 11%. Our target price of INR318 implies a potential return of 15.0% (including the dividend yield), which is in the Neutral band; therefore, we upgrade to Neutral (V) rating from Underweight (V) 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

Upside risks: Higher-than-expected margins from a faster-than-expected shift to supercritical technology.

Downside risks: Lower than-expected order inflow intake resulting in lower-than-expected execution and revenue and consequently earnings.

Exhibit 9: BHEL valuation summary

Key assumptions

Target sales growth	6.0%
Target OR margin	17.0%
Target asset turn	1.8
Tax rate	31%
WACC	11.0%
CAP	7.5

Value of current op (INRm)

Trend Sales	501,538
Trend CE	305,897
CE growth	3.4%
RoIC	29.8%
Trend OR	91,004
Value of current op	565,549

Value of future inv (INRm)

Incremental return	5,116
Incremental cost	1,156
EVA	2,348
Value of future inv	143,914

Total fair value, FY13e (INRm)

EV	709,462
EV – 12M fwd	787,669
Net debt	(152,389)
Customer advances	165,875
Minorities	0
Investments/Associates	(4,492)
Implied market cap	778,675
12M fwd target price (INR)	318

Source: HSBC estimates

Exhibit 10: BHEL target price sensitivity to target sales and margin assumptions

		Target sales growth %				
		4%	5%	6%	7%	8%
Target operating return %	15%	259	268	276	285	294
	16%	277	287	297	307	317
	17%	296	307	318	329	340
	18%	315	327	339	351	363
	19%	334	347	360	373	385

Source: HSBC estimates

Disclosure appendix

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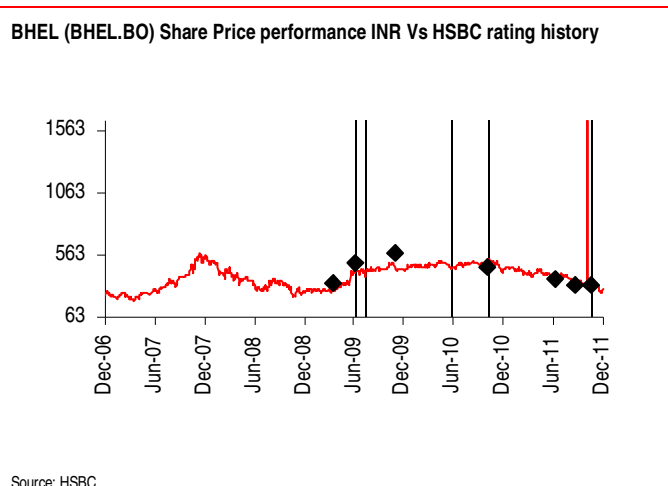
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Neutral (Hold)	35%	(22% of these provided with Investment Banking Services)
Underweight (Sell)	11%	(13% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities



Recommendation & price target history

From	To	Date
Overweight (V)	Neutral (V)	03 June 2009
Neutral (V)	Overweight (V)	14 July 2009
Overweight (V)	Overweight	26 May 2010
Overweight	Underweight	04 October 2010
Underweight	Underweight (V)	19 October 2011
Target Price	Value	Date
Price 1	334.00	19 March 2009
Price 2	490.00	03 June 2009
Price 3	570.00	26 October 2009
Price 4	460.00	04 October 2010
Price 5	370.00	09 June 2011
Price 6	318.00	23 August 2011
Price 7	318.00	19 October 2011

Source: HSBC

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