ANCHOR REPORT

India capital goods

NOMURA
EQUITY RESEARCH

Assessing earnings risk

Looking beyond the clouds: Assessing the sector amid global/domestic uncertainty

The investment cycle is slowing owing to structural and cyclical stress: policy logjams, interest rates, commodity prices. Things could get worse before they improve, and we have cut numbers.

Looking beyond the near-term pain, we pick companies that have strong business models and the most attractive risk-reward positioning. CRG, VOLT and TMX are the top BUYs in our coverage. Critically, these companies share a history of experienced management. BHEL (NEUTRAL) remains at risk, despite now fair valuation. We keep our REDUCE call on ABB India.

Key analysis in this anchor report includes:

- Study of India's capex cycle since the 1990s.
- DuPont analysis-based forensics for individual companies.
- What is consensus pricing in?
- What do valuations imply?

October 12, 2011

Research analysts

India Capital Goods

Amar Kedia - NFASL
amar.kedia@nomura.com
+91 22 4037 4182

Indrajit Yadav - NSFSPL
indrajit.yadav@nomura.com
+91 22 4037 4992

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ELECTRICAL EQUIPMENT

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Investment cycle slowing due to mix of structural and cyclical woes

India's investment cycle has suddenly and substantially slowed on the back of several macro headwinds such as policy logjams, and rising interest rates and commodity prices. While the policy logjams on infrastructure-related capex and even on some large-ticket industrial projects are structural issues that need to be addressed by the Government, interest rates and commodity prices are worries that emerge as part of economic cycles.

India's infrastructure need and opportunity is undeniable, but things could get worse before getting better

Our economists expect inflation to come down to 6.8% by March 2012, and hence the RBI taking a pause in the rate hikes cycle. Coupled with the fact that India is chronically underinvested in infrastructure, we maintain our long-term positive outlook on the sector. However, a nervous global market implies a worsening of the situation before it turns for the better. Further, internal issues such as the slow pace of reforms and fuel shortages will also continue to hurt sector growth over the medium term, in our view.

Firms that could emerge stronger from impending shocks

As we maintain a negative view on the possibility of a near-term fix to the internal structural problems, we would avoid stocks such as BHEL, where we see greater risk of a continued slowdown. While we expect the rest of our stocks to likely escape the current turmoil in the investment cycle from the policy logjams, at least partially, the impact from a worsening global macro environment is difficult to predict. We thus assess potential earnings risk for these stocks, and highlight those with significant risk already priced in and/or those better placed to withstand the cyclical shocks. We provide read-across by looking at similar historical data at Bharat Electronics, BEML, AIA Engineering, Carborundum and Blue Star (all not rated).

Our picks: CRG, VOLT and TMX

Based on an analysis of the above fundamentals, we believe CRG and VOLT (both still BUY) and TMX (upgraded to BUY) have already priced in significant earnings risk despite their compelling businesses. We see continued near-term downside for ABB (still REDUCE), BHEL (NEUTRAL from Reduce) and KKC (still NEUTRAL) from current levels, though we think KKC would bounce back from any correction from current levels.

Fig. 1: Stocks for action

Company	Bloomberg Ticker	Nomura Rating	Stock Price	Target Price	Upside/ Downside (%)
Crompton Greaves	CRG IN	BUY	149	240	61%
Thermax	TMX IN	BUY↑	418	500↓	20%
Voltas	VOLT IN	BUY	105	150↓	43%
ABB India	ABB IN	REDUCE	666	525↓	-21%

Prices as of 7th October. Source: Nomura Estimates

Rating: *See report end for details of Nomura's rating system.*

Anchor themes

The investment cycle in India has been disappointing, on various external and internal issues. While we remain constructive from a long-term perspective, worsening macro conditions could drive further risks before things get better. In this context, we identify companies that are best placed to handle the situation.

Nomura vs consensus

We have an out-of-consensus Buy call on CRG with a TP that is 25% higher than mean.

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Amar Kedia - NFASL
amar.kedia@nomura.com
+91 22 4037 4182

Indrajit Yadav - NSFSPL
indrajit.yadav@nomura.com
+91 22 4037 4992

Contents

Executive Summary

India is currently witnessing a mix of structural and cyclical pressures in the capex cycle

We note that FY04 to FY08 witnessed an unparalleled capex boom in India fuelled by easing policies, fund availability and a continued demand/supply mismatch, among others. On the back of this, we estimated India's infrastructure investment opportunity over FY11-15F to be about US$600bn in our Anchor report titled, *Different stroke*s, dated 12 August, 2010.

However, sentiments have been dented in general over the past 12 months. While a slowdown in the investment cycle is not an aberration per se for any economy, factors driving the slowdown are important to analyse. For the India infrastructure sector, we see a mix of structural and cyclical factors plaguing near- to medium-term visibility -- first, the aftermath of Lehman bankruptcy that continues to haunt the world macro environment, and then the deteriorating pace of policy initiatives in the infrastructure sector by the existing policy makers.

Structural constraints – mostly related to policy issues
We highlighted structural concerns facing the sector in our note *Structural bottlenecks ahead*, dated 22 April, 2011. These primarily relate to the availability of resources such as land, fuel and funding. Additionally, there could be constraints in the form of unfavourable Government policies such as environmental clearances and uncertainty over the tax regime, among others. Falling competitiveness of the industry could be another driver of a capex slowdown for the respective sector. A slowdown induced by such reasons is a greater reason of concern for us than the typical macro cycle-induced slowdown.

We also quote excerpts from our recent report on the infrastructure sector titled, *Valuation factors in deterioration in fundamentals*, dated 29 September, 2011.

Hurdles in environmental clearances and land acquisitions have slowed investments in infrastructure, impacting most sectors. For instance, lack of coal availability due to environmental issues and transportation infrastructure bottlenecks, and state electricity board (SEB) losses have taken the sheen out of the power generation segment. Industrial capex has been muted since FY09, and analyst estimates suggest no material pick up in the near term.

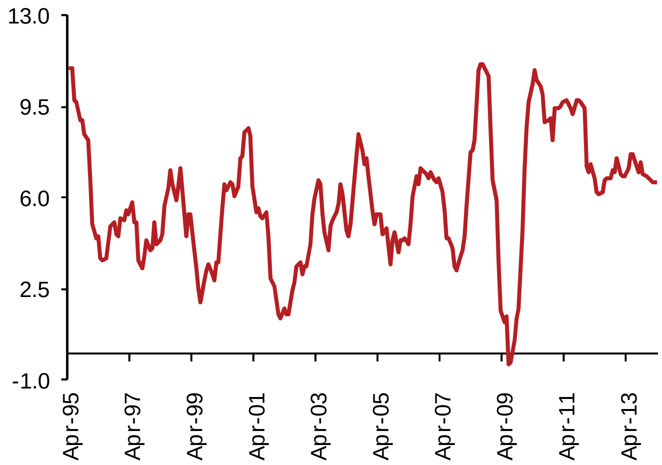
Cyclical pressures – primarily a function of overcapacity, high commodity prices and rising interest rates
Apart from the policy logjam, the macroeconomic environment, too, hasn't been supportive of the capex cycle. India's current inflation rate at 10% is close to the peak witnessed over the past 15+ years. To counter inflation and inflationary expectations, the Indian central bank (RBI) has responded with repeated monetary tightening over the past several quarters. Specifically, the RBI has taken 12 repo rate hikes, and the current rate, at 8.25%, is 75bps lower than what prevailed just before the post-Lehman crisis period.

Similarly, commodity prices are significantly above trend currently (though still below 2008 levels) and pose a significant threat to margins for several capital goods companies.

Our view of a typical business cycle is as follows –

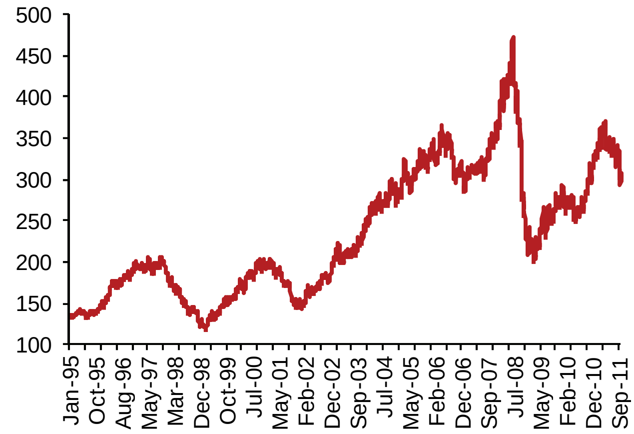
The cyclical upswing in demand is typically followed by a capacity build-up by suppliers in anticipation of continued demand pull. However, most often such capacity addition comes with a lag and by then demand has typically already slowed down. At times, existing suppliers benefit from low existing capacity in the system and thus make extraordinary profits – such instances excite more vendors and lead to overcapacity. Some of the notable examples of such behaviour are in the Transmission & Distribution equipment segment as well as in the boiler and turbine segment currently. However, we believe that this overcapacity is only a temporary phenomenon, in most cases, as a revival of demand in general leads to an automatic match-up with capacity. The time frame within which such demand-supply balance is achieved is arguable, nevertheless, and visibility of improvement could be a key determinant of timing the entry into a particular sector.

Fig. 2: WPI inflation peaking out



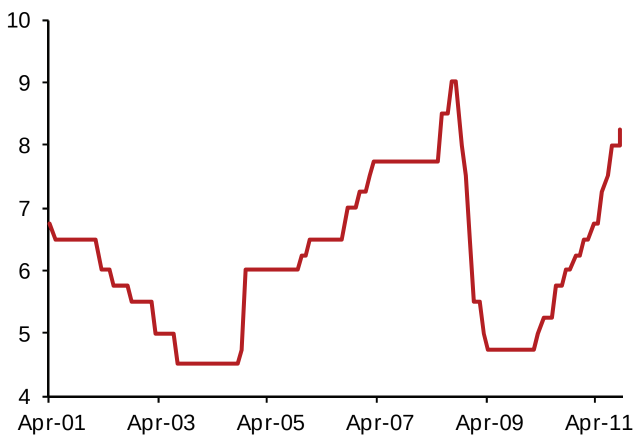
Source: CEIC, Nomura Global Economics

Fig. 3: Commodity price Index (CRY Index)



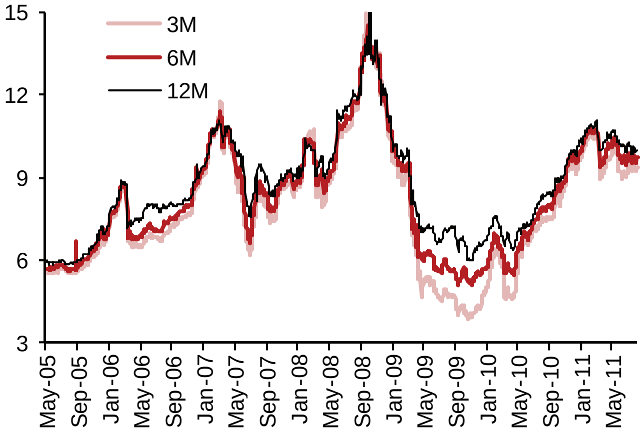
Source: Bloomberg

Fig. 4: Repo rate (%)



Source: RBI

Fig. 5: Short-term interest rate (%)



Source: Bloomberg

India's infrastructure opportunity is unquestionable, but what if we revert to the pre-capex boom period?

Going forward, our economics team expects inflation to come down to 6.8% by March 2012, primarily driven by the base effect. Accordingly, the team doesn't expect any further tightening by the RBI. A global slowdown will also inevitably lead to a softening of commodity prices from these levels and should be positive for companies in our sector.

At the same time, we reiterate our thesis on India's large infrastructure investment opportunity, though timelines might shift a bit depending on the severity of the slowdown and the continued impasse in domestic policy making.

To us, a cyclical slowdown is a normal course of correction so as to protect the economy from overheating and is often driven by a hawkish Central Bank policy stance – it is in this sense that it is cyclical.

However, the extent to which the global scenario could worsen is difficult to predict. The impact from such a scenario could be worse than our base case estimates and outlook for the sector. It could also mean continued deferral on capex by companies in general, and this could materially impact the financial performance of several companies in the sector.

Accordingly, we assess earnings risk for companies we cover in the capital goods sector to try to determine those best placed to withstand the current slowdown.

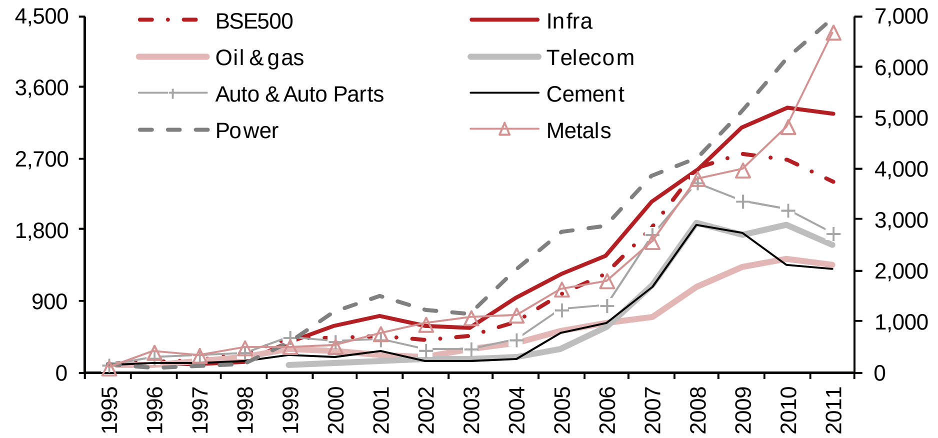
Focusing on the complete investment cycle from late '90s

We believe that any analysis of the impact of cyclicality on the Indian capital goods sector is meaningless unless one takes into account the full cycle of data from previous lows, which was in the late 1990s. We note that the Street (including ourselves) often compares companies' historical financials and valuation ratios for a period of the past 5-6 years with the current dataset. However, given that India's investment story started in FY04-05, we believe such a comparison would provide a positively biased view, at best. It is thus necessary, in our view, that we take into account data points from the previous cyclical lows to see what happens if capex – which took off in FY04-05 – all of a sudden stands still for the near term.

Even a comparison with the post-Lehman crisis period is unfair, in our view, since that was a period that only impacted credit availability and was not necessarily a cyclical pause in the investment cycle.

Fig. 6: Investment cycle took off in a big way only around FY04

Corporate Capex Index (indexed to 1995; metals on RHS)



Source: Ace Equity, Nomura research

While we do not attempt to predict what stage of the cycle these companies are currently in and how long the adversities could continue, we do attempt to analyse the impact from such adversities, if any. We also attempt to see which stocks are best positioned to withstand the pressure from internal and external shocks, as highlighted earlier.

In this context, we have also segregated companies that we believe could be suffering from internal structural issues such as a policy logjam. We would recommend avoiding stocks that are plagued by such structural issues even if their valuations appear attractive.

Our preferred picks: CRG, TMX and VOLT

Our methodology for the purpose of this analysis evolves from the DuPont analysis framework. We start with comparing the historical ROE/ROCE for a particular company and then try and find out reasons why the ROE/ROCE has expanded or collapsed over the time period for that particular company.

Fig. 7: Typical DuPont equation

$$ROE = \frac{\text{Net profit}}{\text{Equity}} = \frac{\text{Net profit}}{\text{Pretax profit}} \times \frac{\text{Pretax profit}}{\text{EBIT}} \times \frac{\text{EBIT}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Equity}}$$

Source: Nomura research

As depicted in the equation above, ROE is primarily a function of operating margin, tax burden, asset turnover and financial leverage. Of these, we do not focus on tax burden, since for companies in our coverage tax rates have not been a big driver of ROE and further it is not of a predictable nature. We also exclude the impact of financial leverage from our consideration, since most of the companies in the capital goods space have had very little financial leverage.

a) Our key focus thus is on <u>profit margin</u>, and

b) <u>Asset turnover</u> trends for these companies, over the analyzed timeframe.

c) We further break-up asset turnover analysis into <u>working capital management</u>

d) and <u>sales trends</u>, to find out whether the asset turnover ratios benefit merely from sales growth or is there a genuine effort by the management to keep working capital in check.

Based on the above framework, we analyse how well are the companies placed to sustain risks from an impending slowdown be it internal or external factors induced. Below table summarizes key trend observed by us for each of the companies over the available financial history of 12 years.

Fig. 8: Identifying companies that have efficiently managed their balance sheet across the cycle

Shaded area highlights companies that have excelled as per the respective criteria

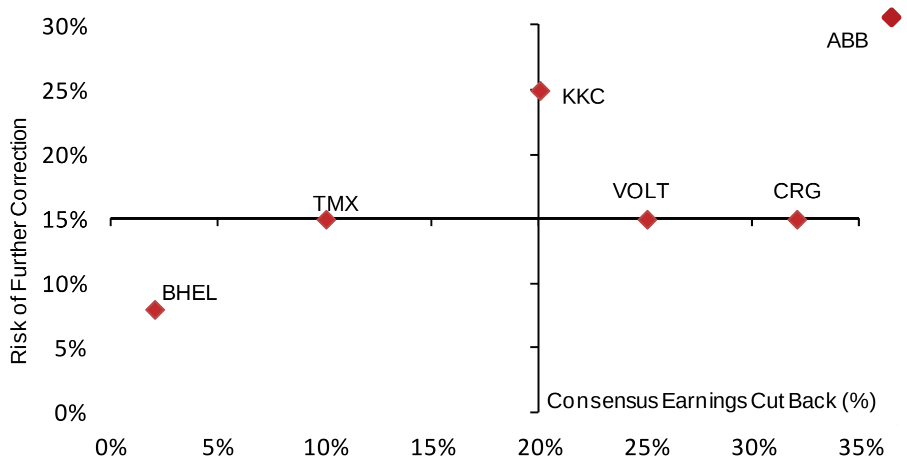
	ABB	AIAE	BEML	BHE	BHEL	BLSTR	CRG	CU	KKC	TMX	VOLT
ROE	↓	↓	↓	↓	↑	↓	↑	↔	↑	↑	↑
ROCE	↓	↓	↓	↓	↑	↓	↑	↔	↑	↑	↑
Asset Turnover	↓	↓	↓	↓	↓	↓	↑	↔	↑	↑	↔
Asset Turnover Ex-Cash	↓	↓	↓	↓	↔	↓	↑	↔	↑	↑	↔
Working Capital Cycle	↑	↔	↑	↑	↓	↑	↓	↓	↓	↓	↓

Source: Nomura research

Our next step entailed a comparison of what the consensus estimates are building in for the stocks we cover now versus what they were building in at the peak of the cycle. We then compared this with the earnings risk that we see for these companies based on the business strength gauged from the above analysis. The below chart summarizes our findings of earnings risk that is already anticipated by consensus vs. what it could be over and above this.

Fig. 9: While consensus estimates are down sharply, we see further risk for most companies

%



Shaded area highlights companies that are preferred based on the above criteria; axis divided on the basis of observed median for the analysed companies

Source: Bloomberg, Nomura estimates

Cognizant of the current expectations of earnings risk and business strength (or structural constraints that it is facing as the case may be), we try to interpret how much of this risk is already priced into the stocks and thus identify opportunities.

Based on our analysis, we find a few stocks that exhibit traits that we were looking for to qualify them as investible ideas based on:

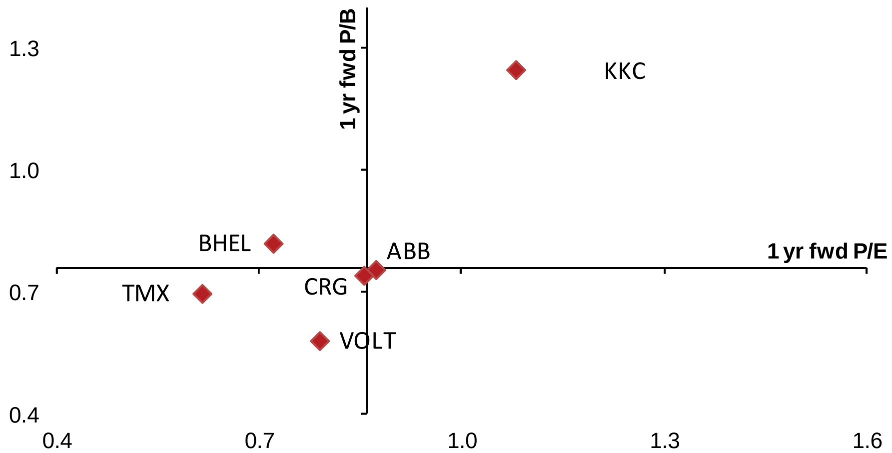
- valuations already factoring in significant near-term earnings risk;
- relatively low earnings risk here onwards; and
- balance sheet strength and/or superior earnings quality.

We have also segregated stocks that, in our view, are subject to structural slowdown risks as discussed earlier – notably BHEL.

The figures below summarize our findings based on these parameters.

Fig. 10: Stocks trading below 12-year mean levels are few

1 year forward multiple over 12 year mean multiple (x)



Shaded area highlights companies that are trading below 12 year mean levels across both the parameters; axis divided on the basis of observed median for the analysed companies

Source: Bloomberg, Nomura research

Fig. 11: Identifying companies that are largely pricing in earnings risk

Dark shades highlight most preferred companies, while light shades are preferred upon correction

	ABB	BHEL	CRG	KKC	TMX	VOLT
Relative valuation			√		√	√
Risk to earnings			√			√
Balance sheet strength/ Earnings quality		√	√	√	√	√
Concerns: Structural (S) / Cyclical (C)	C	S	C	C	C	C
Our preference	x	x	√	-	√	√

Source: Nomura research

Accordingly, we highlight CRG, TMX and VOLT as stocks that are currently pricing in significant earnings risk while being strong businesses at the same time, and these would be our preferred investment ideas.

Apart from these, we single out KKC for exhibiting excellent efforts in containing the impact of business cyclicality by way of efficient working capital management and thus sustainably high ROE/ROCE. We would highlight KKC as a stock that may be prone to near-term downside due to expensive valuation or earnings risk not yet factored in by the Street, but would keep it in the radar in case of correction.

On the other hand, we see continued downside risks for BHEL and ABB on account of multiple factors such as structural concerns and/or expensive valuation/earnings risk/relatively inefficient balance sheet management.

Sector valuation summary

Fig. 12: India Capital Goods sector valuation comps

		P/E (x)			P/BV (x)			EPS CAGR		ROE (%)		
	Price	FY11	FY12F	FY13F	FY11	FY12F	FY13F	FY09-11	FY11-13F	FY11	FY12F	FY13F
BHEL	325	14.9	12.2	11.3	3.9	3.2	2.7	12%	15%	33.3	29.1	26.1
ABB India	666	101.6	45.7	30.9	5.9	5.3	4.6	-49%	81%	2.6	12.1	15.9
Cummins India	406	19.5	17.3	15.8	6.2	5.4	4.7	18%	11%	35.1	35.5	31.7
Crompton Greaves	149	10.7	12.7	9.6	3.0	2.5	2.1	29%	5%	32.1	21.8	23.9
Thermax	418	13.1	12.1	12.7	3.8	3.1	2.6	15%	1%	31.9	28.2	22.4
Larsen & Toubro@	1,393	15.9	13.2	11.0	2.4	2.2	1.9	15%	20%	19.7	19.6	19.8
Voltas	105	10.9	12.9	10.8	2.5	2.1	1.8	12%	1%	29.2	21.7	18.4
Covered companies' average		**14.2**	**13.4**	**11.9**	**3.7**	**3.1**	**2.6**	**17%**	**9%**	**30.2**	**26.0**	**23.7**
Siemens India*	837	33.1	28.4	23.9	7.7	6.4	5.2	14%	18%	25.7	25.4	24.6
Areva T&D India*	219	30.2	23.5	18.1	5.2	4.5	3.4	-12%	29%	18.0	19.9	21.1
AIA Engineering*	311	16.1	14.8	12.6	2.8	2.4	2.1	2%	13%	18.6	17.4	17.7
BEML Ltd*	468	8.7	9.1	6.8	0.9	0.9	0.8	-9%	13%	11.8	9.7	12.4
Bharat Electronics*	1,519	15.2	12.9	11.5	2.4	2.1	1.8	3%	15%	16.8	17.1	16.9
Carborundum Universal*	148	8.1	7.6	6.4	1.9	1.5	1.3	28%	12%	22.4	21.2	21.4
Blue Star*	222	12.4	12.6	9.8	3.9	3.4	2.9	-5%	13%	27.0	25.0	29.1
Sector Average		**16.1**	**14.6**	**12.3**	**3.6**	**3.0**	**2.6**	**9%**	**13%**	**24.7**	**22.4**	**22.0**
SENSEX								17%	13%			

Pricing as of October 7, 2011

* Bloomberg consensus estimates for non rated companies (see below exhibit for ratings).

ABB India and Areva T&D India FY11/12/13 correspond with CY10/11/12 estimates, while Siemens India FY11/12/13 is average of Sep-10/11/12/13 and Sep-11/12/13/14 estimates respectively.

Averages for P/E, EPS CAGR and ROE do not include ABB India given highly volatile trend.

@ L&T P/E, ROE and EPS adjusted for subsidiary valuation and earnings

Source: Bloomberg, Nomura estimates

Fig. 13: India Capital Goods sector performance and rating comparison

	Nomura Rating	# of Recommendations			Stock price performance over			
		Buy	Sell	Hold	1m	3m	6m	12m
BHEL	NEUTRAL	21	4	15	(8.4)	(18.2)	(26.0)	(37.6)
ABB India	REDUCE	0	34	2	(22.8)	(22.6)	(17.4)	(28.8)
Cummins India	NEUTRAL	12	7	3	(7.4)	(15.9)	(18.1)	(22.4)
Crompton Greaves	BUY	19	14	11	(2.0)	(43.1)	(48.2)	(55.3)
Thermax	BUY	14	6	15	(3.6)	(34.4)	(40.4)	(42.1)
Larsen & Toubro	BUY	34	3	3	(18.6)	(25.2)	(16.6)	(31.6)
Voltas	BUY	19	3	5	(16.0)	(37.1)	(42.5)	(56.6)
Siemens India	Not Rated	3	9	6	(4.0)	(6.3)	(6.5)	2.0
Areva T&D India	Not Rated	4	6	3	(4.0)	(14.7)	(19.1)	(31.8)
AIA Engineering	Not Rated	4	2	3	(9.9)	(16.2)	(13.2)	(25.2)
BEML Ltd	Not Rated	4	0	0	(0.2)	(23.2)	(38.3)	(59.4)
Bharat Electronics	Not Rated	8	0	1	(5.0)	(8.9)	(16.9)	(19.0)
Carborundum Universal	Not Rated	4	1	2	(1.4)	(2.5)	21.8	26.9
Blue Star	Not Rated	3	3	6	(12.1)	(28.3)	(41.5)	(55.4)
Sector Average					**(8.2)**	**(21.2)**	**(23.1)**	**(31.2)**
NIFTY					(5.1)	(14.7)	(17.0)	(20.1)
SENSEX					(5.4)	(5.6)	(17.1)	(20.1)

Note: pricing as of October 7, 2011

Source: Bloomberg, Nomura estimates

Fig. 14: Earnings estimates: Nomura vs consensus (Rs mn)

	FY12F			FY13F			FY14F		
	Nomura	Consensus	Difference	Nomura	Consensus	Difference	Nomura	Consensus	Difference
BHEL	65,194	66,637	-2%	70,591	74,496	-5%	75,396	73,345	3%
ABB India	3,112	3,260	-5%	4,604	4,884	-6%	5,854	6,184	-5%
Cummins India	6,918	6,848	1%	7,113	7,342	-3%	8,725	8,369	4%
Crompton Greaves	7,830	7,230	8%	10,302	9,230	12%	12,578	10,603	19%
Thermax	4,127	4,220	-2%	3,912	4,788	-18%	4,671	5,314	-12%
Larsen & Toubro@	44,344	43,392	2%	52,893	50,986	4%	62,041	60,070	3%
Voltas	2,696	3,384	-20%	3,222	3,887	-17%	3,964	4,486	-12%

Source: Bloomberg, Nomura estimates

Scenario analysis: What if the US and Europe slip back into recession?

As the markets have been signaling that risks to our baseline forecasts are on the downside, our global economics team have considered a bear case economic scenario, most obviously triggered by a market meltdown, but the fragile state of the advanced economies leaves them vulnerable to unforeseen shocks or policy errors. For details, see *Global Weekly Economic Monitor*, 12 August 2011, and *Global market turbulence: Implications for Asia*, 9 August 2011.

The bear case scenario assumes:

- The US and Euro area slip back into recession, with US GDP averaging -1% saar in 2H11 and Euro GDP averaging -3% before recovering to around 2% growth in 2012.
- The CRB commodity price index falls 15% between now and year-end, but starts rising back again through 2012 reaching current levels by end-2012.

If there is a market meltdown and recessions in the US and euro area, we have no doubt that initially many economies in the region would be hit hard again in an echo of the global financial crisis, as non-linear effects start to kick in, notably financial decelerator effects, multiplier effects of weakening exports on domestic capex and jobs, and capital flight. However, less disturbing this time around are the two factors that there is less leverage in the financial system (less room for capital flight) and less chance of Asian trade finance drying up, as the world's central banks have most likely learnt the need to provide ample USD liquidity through FX swap arrangements.

In this scenario, we find Hong Kong, Singapore, Malaysia and Taiwan to be among the most vulnerable. But, as in 2009, we would expect that, over time, powerful tailwinds would develop, allowing Asia to bounce back before other regions. These tailwinds include a likely further decline in commodity prices and the ample room Asia has to ease monetary and fiscal policies – more so than any other region. In our bear case scenario, we would expect the Fed to resort to further quantitative easing, which once again would likely precipitate strong net capital inflows into Asia, attracted by stronger growth, superior fundamentals and higher interest rates relative to other regions.

What if things get even worse than we can foresee? Although our global economics team does not see such a situation as plausible at the moment, they have run an extreme-case scenario analysis to provide some perspective. This extreme scenario assumes:

- US GDP averaging about -4% saar in 2H11 and Euro GDP averaging -6.5% before recovering to around 1% growth in 2012.
- CRB commodity price index falls 40% between now and year-end, and stays at the lower level through 2012.

The table below summarises both the official bear case and the hypothetical extreme case scenarios.

Fig. 15: Real GDP growth forecasts: baseline and downside scenarios

	2011F			2012F		
	Base case	**Bear case**	**Extreme case**	**Base case**	**Bear case**	**Extreme case**
Australia	2.2	1.5	0.9	4.6	3.5	3.3
China	9.5	9.0	8.5	8.6	8.8	6.0
Hong Kong	5.4	4.4	3.4	4.5	4.0	1.2
India	7.7	7.0	6.5	7.9	7.6	7.0
Indonesia	6.5	6.0	4.8	7.0	6.8	4.0
Malaysia	4.7	4.0	1.0	5.1	4.8	-0.4
New Zealand	2.2	1.8	1.4	3.5	3.5	3.3
Philippines	5.1	4.7	3.3	5.7	5.3	2.4
Singapore	5.6	4.3	1.5	5.3	5.1	-1.8
South Korea	3.5	2.5	1.5	5.0	5.0	2.5
Taiwan	4.5	3.6	2.4	5.0	4.9	0.9
Thailand	4.1	3.5	0.6	4.7	4.5	-0.5
Vietnam	6.4	6.0	4.5	6.9	6.5	4.2
Asia ex Japan, Aus, NZ	7.9	7.2	6.4	7.6	7.6	5.1

Source: CEIC and Nomura Global Economics. Units: % y-o-y

The global bear case does not look bad for much of Asia and in fact is marginally better than the base case for China in 2012 because we would expect a V-shape rebound for the region thanks to the likely decline in commodity prices and the ample room Asia has to ease monetary and fiscal policies. We would also expect the Fed to resort to further quantitative easing, which once again would likely precipitate strong net capital inflows into Asia. In the extreme case, however, even these strengths will be tested.

Bharat Heavy Electricals BHEL.NS BHEL IN

ELECTRICAL EQUIPMENT

NOMURA
EQUITY RESEARCH

No relief in sight, but reaching fair valuation

Medium-term concerns remain, and stock price factors in lack of potential orders

October 12, 2011

Rating Up from Reduce	**Neutral**
Target price Reduced from 346	INR 332
Closing price October 7, 2011	INR 325
Potential upside	+2.2%

Action: Upgrade to NEUTRAL rating

While we remain extremely concerned about near-term order inflow for the sector and also foresee continued execution delays for BHEL, we believe that, at current levels, the stock is now extrapolating these concerns beyond the visible horizon. We believe that there is an equal probability of improvement in the sector's fortunes (most notably related to policy reforms on SEB health and land & fuel availability) post this visible horizon and that, as such, downside from current levels is limited.

Catalysts: Orders, results, macro and policy action

We view continued earnings and/or order misses compared to Street estimates and defaults by developers or state utilities as negative triggers, while softening commodity prices and policy reforms are upside catalysts.

Our view ties up with historical study: strongly positioned for upturn but sector woes plague visibility in the medium term

FY11 margin levels are at the peak of the cycle and suggest downside risks, especially with the incoming competition and slowing growth. This is largely built into our estimates now.

Valuation: Trading at 11x FY13F EPS; close to pre-FY05 boom

Valuation is below BHEL's mid-cycle trading range, but is still higher than pre-utility capex boom levels. We do not rule out BHEL reverting to pre-FY05 multiples, but the possibility of improvement in order activity in 12-18m suggests that such a severe correction would be brief. Tweaking estimates for further execution delays and minor relief in raw-material cost.

31 Mar	FY11	FY12F		FY13F		FY14F	
Currency (INR)	Actual	Old	New	Old	New	Old	New
Revenue (mn)	397,227	463,449	466,580	553,147	547,217		608,999
Reported net profit (mn)	60,114	64,423	65,194	70,320	70,591		75,396
Normalised net profit (mn)	53,552	64,423	65,194	70,320	70,591		75,396
Normalised EPS	21.88	26.32	26.64	28.73	28.84		30.80
Norm. EPS growth (%)	24.4	20.3	21.7	9.2	8.3		6.8
Norm. P/E (x)	14.9	N/A	12.2	N/A	11.3	N/A	10.6
EV/EBITDA (x)	8.7	6.9	7.2	6.2	6.4		5.9
Price/book (x)	3.9	N/A	3.2	N/A	2.7	N/A	2.3
Dividend yield (%)	2.2	N/A	2.5	N/A	2.8	N/A	2.9
ROE (%)	33.3	28.8	29.1	26.0	26.1		23.5
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash		net cash

Source: Nomura estimates, BHEL stock split in 5:1 ratio effective 3 October, 2011.

Key company data: *See page 2 for company data and detailed price/index chart.*

Anchor themes

Even as demand for power is unlikely to slow, we expect actual power capacity to be constrained by limitations on land & fuel availability and environmental clearances.

Nomura vs consensus

Our FY12-13F EPS is lower than consensus by 2-5%, as we expect order deferrals to impact execution. We are also concerned about margins due to rising competition.

Research analysts

India Capital Goods

Amar Kedia - NFASL
amar.kedia@nomura.com
+91 22 4037 4182

Indrajit Yadav - NSFSPL
indrajit.yadav@nomura.com
+91 22 4037 4992

Key data on Bharat Heavy Electricals

Income statement (INRmn)

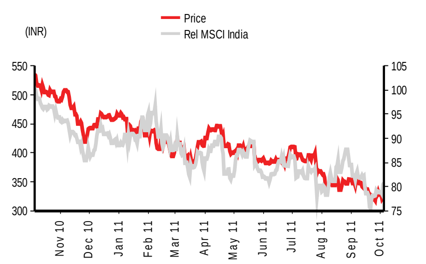
Year-end 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
Revenue	**337,894**	**397,227**	**466,580**	**547,217**	**608,999**
Cost of goods sold	-208,431	-243,567	-289,304	-349,091	-393,888
Gross profit	**129,463**	**153,661**	**177,276**	**198,126**	**215,110**
SG&A	-7,214	-22,791	-26,884	-31,331	-34,879
Employee share expense	-64,492	-56,512	-60,128	-67,080	-73,600
Operating profit	**57,757**	**74,358**	**90,264**	**99,715**	**106,632**
EBITDA	**62,337**	**80,267**	**97,552**	**107,407**	**114,654**
Depreciation	-4,580	-5,909	-7,288	-7,692	-8,022
Amortisation					
EBIT	57,757	74,358	90,264	99,715	106,632
Net interest expense	-335	-547	-547	-547	-547
Associates & JCEs					
Other income	8,412	6,418	8,319	7,788	8,152
Earnings before tax	**65,834**	**80,228**	**98,036**	**106,955**	**114,236**
Income tax	-22,800	-26,676	-32,842	-36,365	-38,840
Net profit after tax	**43,034**	**53,552**	**65,194**	**70,591**	**75,396**
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	**43,034**	**53,552**	**65,194**	**70,591**	**75,396**
Extraordinary items	73	6,562	0	0	0
Reported NPAT	**43,106**	**60,114**	**65,194**	**70,591**	**75,396**
Dividends	-13,321	-17,841	-20,213	-21,887	-23,377
Transfer to reserves	**29,786**	**42,273**	**44,980**	**48,704**	**52,019**
Valuation and ratio analysis					
FD normalised P/E (x)	18.5	14.9	12.2	11.3	10.6
FD normalised P/E at price target (x)	18.9	15.2	12.5	11.5	10.8
Reported P/E (x)	18.5	13.2	12.2	11.3	10.6
Dividend yield (%)	1.7	2.2	2.5	2.8	2.9
Price/cashflow (x)	34.3	18.1	28.9	16.8	20.2
Price/book (x)	5.0	3.9	3.2	2.7	2.3
EV/EBITDA (x)	11.2	8.7	7.2	6.4	5.9
EV/EBIT (x)	12.1	9.4	7.8	6.9	6.4
Gross margin (%)	38.3	38.7	38.0	36.2	35.3
EBITDA margin (%)	18.4	20.2	20.9	19.6	18.8
EBIT margin (%)	17.1	18.7	19.3	18.2	17.5
Net margin (%)	12.8	15.1	14.0	12.9	12.4
Effective tax rate (%)	34.6	33.3	33.5	34.0	34.0
Dividend payout (%)	30.9	29.7	31.0	31.0	31.0
Capex to sales (%)	5.3	4.6	2.6	1.8	1.1
Capex to depreciation (x)	3.9	3.1	1.6	1.3	0.9
ROE (%)	29.9	33.3	29.1	26.1	23.5
ROA (pretax %)	17.4	17.6	17.8	17.8	17.5
Growth (%)					
Revenue	25.7	17.6	17.5	17.3	11.3
EBITDA	42.0	28.8	21.5	10.1	6.7
EBIT	42.4	28.7	21.4	10.5	6.9
Normalised EPS	37.6	24.4	21.7	8.3	6.8
Normalised FDEPS	37.6	24.4	21.7	8.3	6.8
Per share					
Reported EPS (INR)	17.61	24.56	26.64	28.84	30.80
Norm EPS (INR)	17.58	21.88	26.64	28.84	30.80
Fully diluted norm EPS (INR)	17.58	21.88	26.64	28.84	30.80
Book value per share (INR)	65.03	82.34	100.72	120.62	141.87
DPS (INR)	5.44	7.29	8.26	8.94	9.55

Source: Nomura estimates

Notes

Revenue growth rate has already slowed to sub 18% from high twenties as base effect catches up and on execution delays.

Relative performance chart (one year)



Source: Thomson Reuters, Nomura research

(%)	1M	3M	12M
Absolute (INR)	-8.4	-19.7	-40.8
Absolute (USD)	-14.7	-27.7	-46.4
Relative to index	-3.7	-3.7	-16.5
Market cap (USDmn)	15,548.6		
Estimated free float (%)	22.3		
52-week range (INR)	539/309.5		
3-mth avg daily turnover (USDmn)	33.67		
Major shareholders (%)			
President of India	67.7		
LIC	4.4		

Source: Thomson Reuters, Nomura research

Cashflow (INRmn)

Year-end 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
EBITDA	62,337	80,267	97,552	107,407	114,654
Change in working capital	-24,495	-22,182	-49,598	-30,822	-44,012
Other operating cashflow	-14,651	-14,244	-20,414	-29,124	-31,236
Cashflow from operations	**23,191**	**43,841**	**27,541**	**47,460**	**39,406**
Capital expenditure	-17,756	-18,091	-12,000	-10,000	-7,000
Free cashflow	**5,436**	**25,750**	**15,541**	**37,460**	**32,406**
Reduction in investments	-275	-3,593	0	0	0
Net acquisitions					
Reduction in other LT assets	0	0	0	0	0
Addition in other LT liabilities	3,131	-6,363	0	0	0
Adjustments		92			
Cashflow after investing acts	**8,291**	**15,886**	**15,541**	**37,460**	**32,406**
Cash dividends	-13,321	-17,841	-20,213	-21,887	-23,377
Equity issue					
Debt issue	-216	356	0	0	0
Convertible debt issue					
Others					
Cashflow from financial acts	**-13,537**	**-17,485**	**-20,213**	**-21,887**	**-23,377**
Net cashflow	**-5,246**	**-1,599**	**-4,672**	**15,574**	**9,029**
Beginning cash	103,147	97,901	96,302	91,629	107,202
Ending cash	97,901	96,302	91,629	107,202	116,231
Ending net debt	-96,623	-94,668	-89,995	-105,569	-114,598

Source: Nomura estimates

Notes

Net addition to cash is under pressure as rising working capital is straining operating cash flow.

Balance sheet (INRmn)

As at 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
Cash & equivalents	97,901	96,302	91,629	107,202	116,231
Marketable securities	0	0	0	0	0
Accounts receivable	206,888	273,546	310,799	328,062	365,100
Inventories	92,355	109,630	128,193	150,348	167,322
Other current assets	32,205	35,469	42,654	38,850	42,644
Total current assets	**429,348**	**514,947**	**573,274**	**624,462**	**691,297**
LT investments	798	4,392	4,392	4,392	4,392
Fixed assets	39,450	51,631	56,343	58,651	57,629
Goodwill	0	0	0	0	0
Other intangible assets	0	0	0	0	0
Other LT assets	0	0	0	0	0
Total assets	**469,596**	**570,971**	**634,009**	**687,505**	**753,318**
Short-term debt					
Accounts payable	75,798	96,000	113,690	115,623	130,787
Other current liabilities	248,619	293,434	289,145	292,003	290,634
Total current liabilities	**324,417**	**389,434**	**402,836**	**407,627**	**421,421**
Long-term debt	1,278	1,634	1,634	1,634	1,634
Convertible debt					
Other LT liabilities	-15,272	-21,636	-16,979	-16,979	-16,979
Total liabilities	**310,422**	**369,432**	**387,490**	**392,282**	**406,076**
Minority interest					
Preferred stock	0	0	0	0	0
Common stock	4,895	4,895	4,895	4,895	4,895
Retained earnings	154,278	196,643	241,624	290,328	342,347
Proposed dividends					
Other equity and reserves					
Total shareholders' equity	**159,174**	**201,538**	**246,519**	**295,223**	**347,242**
Total equity & liabilities	**469,596**	**570,970**	**634,009**	**687,505**	**753,318**
Liquidity (x)					
Current ratio	1.32	1.32	1.42	1.53	1.64
Interest cover	172.4	135.9	164.9	182.2	194.8
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	198.0	220.7	229.2	213.1	207.7
Days inventory	149.5	151.3	150.4	145.6	147.2
Days payable	117.6	128.7	132.6	119.9	114.2
Cash cycle	229.9	243.3	247.0	238.8	240.7

Source: Nomura estimates

Notes

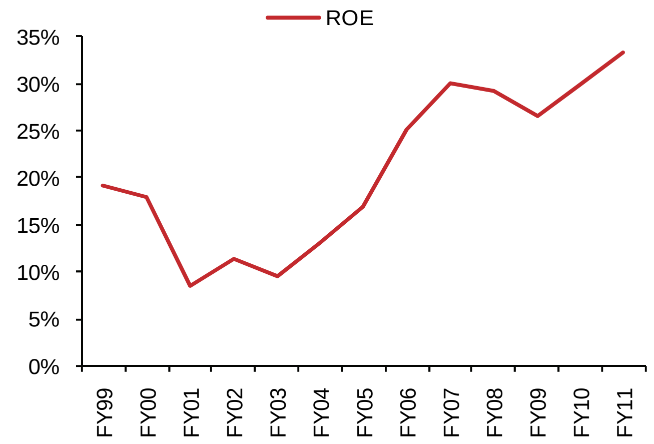
Rising working capital pressure to hurt return ratios as cash cycle elongates.

How well is BHEL positioned for a turn in the cycle?

Balance sheet and return efficiency

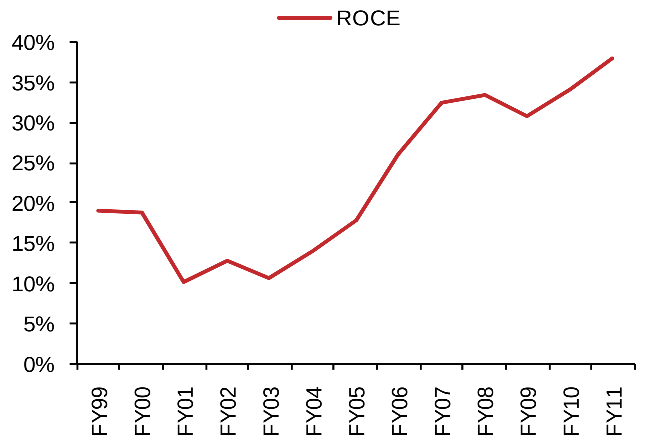
Consistency of return ratios
BHEL's return ratios have risen significantly over the past eight years mainly due to rising EBITDA margins, steady growth and a falling working-capital cycle. However, as we discuss later, all of these factors are at substantial risk of reversal over the medium term, in our view.

Fig. 16: BHEL: ROE has consistently been rising …



Source: Company, Nomura research

Fig. 17: … and so has ROCE

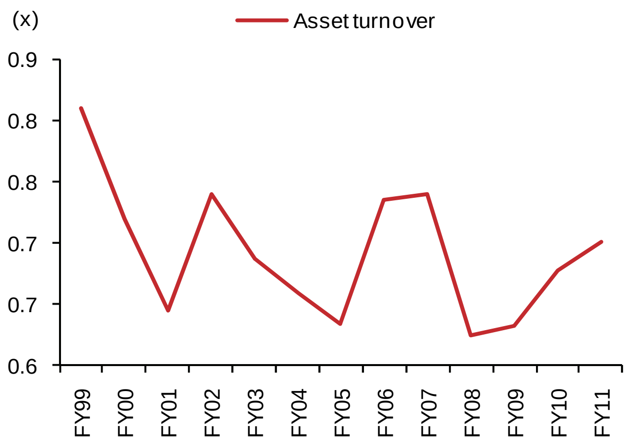


Source: Company, Nomura research

Management of working capital and asset turnover
Asset turnover ex cash has come back to late 1990s levels despite a falling working-capital cycle. Asset turnover, including cash, is already worse and is gradually declining. This is primarily due to unproductive use of cash in the balance sheet, in our view. We think that without a supportive working-capital cycle the asset turnover trend for the company would have been worse.

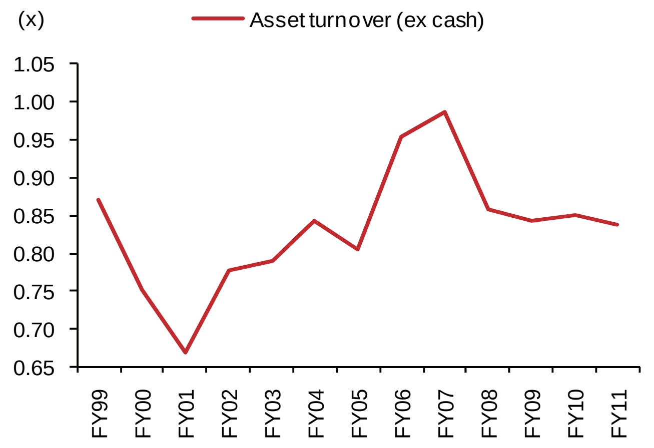
Even the fall in the working-capital cycle appears to be due mainly to rising customer advances and is only partly alleviated by a fall in the inventory cycle. We see no clear trends from the receivable cycle.

Fig. 18: Asset turnover has declined over the period despite a falling working-capital cycle…



Source: Company, Nomura research

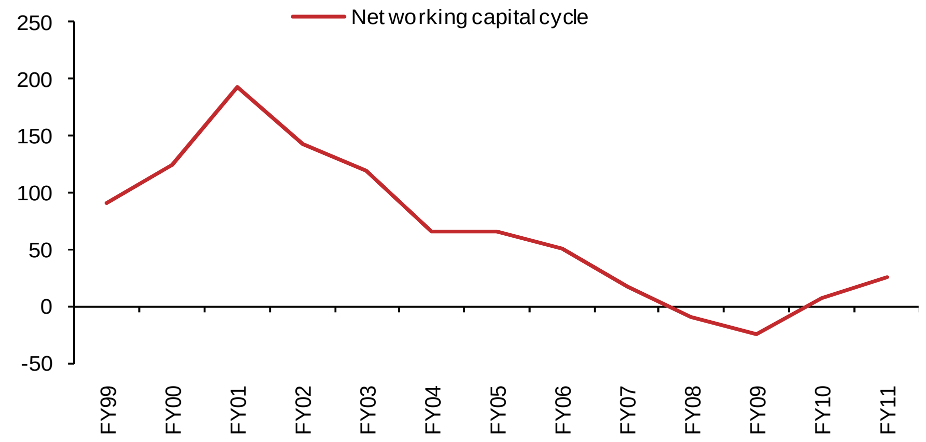
Fig. 19: …though asset turnover ex cash has been better, even that is now under threat



Source: Company, Nomura research

Fig. 20: Fall in working-capital cycle driven mainly by rising customer advances; also aided by better inventory

Days of revenue



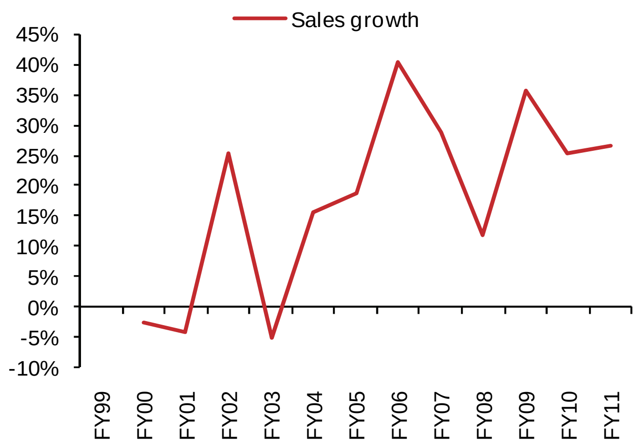
Source: Company, Nomura research

Trajectory of growth

BHEL's sales growth has ranged from 20-30% since FY05 when the utility capex boom started. At the same time, margins started to improve, possibly due to operating leverage benefits. The dip in FY09 margins was mainly due to provisioning for staff cost hikes.

However, our fundamental concerns about slowing growth for BHEL and margin pressure, both emanating from rising competition and slowing utility capex, could imply a reversal of the trend that we have been seeing since FY05.

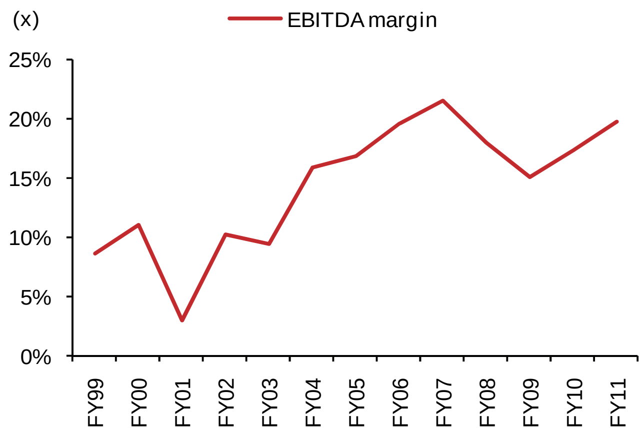
Fig. 21: Strong sales growth aided in strong return ratios



Source: Company, Nomura research

Fig. 22: Rise in EBITDA margins is the key driver of improvement in return ratios

% of revenues



Source: Company, Nomura research

Risks from adverse turn in the cycle

Sales and margin trends suggest that the business is close to peak-cycle levels – in this case it co-relates with the utility capex cycle. Fundamentally, we believe that BHEL's existing order book should allow it to benefit for another 2 years or so.

Risks to sales

We see an imminent risk of a sales slowdown for BHEL on account of slowing orders, rising competition, and execution delays.

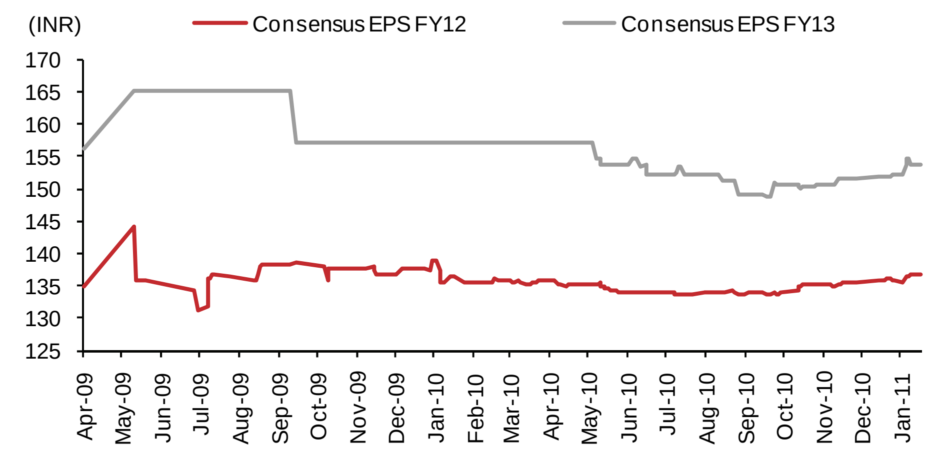
Risk to margins

Margin risk is clearly visible as, prior to the utility capex boom, BHEL margins were <15% compared to current levels of 20%. A slowdown in sales would also lead to reversal of benefits due to operating leverage, in our view.

What are consensus estimates building in?

Consensus EPS estimates for BHEL have been flat over the past 12 months and have yet to factor in any risk of execution delays, in our view. Nevertheless, upside risks are also possible for BHEL from any slowdown in commodity prices, as a significant share of its projects are on a fixed-price basis.

Fig. 23: Consensus estimates have yet to factor in execution risks



Source: Bloomberg

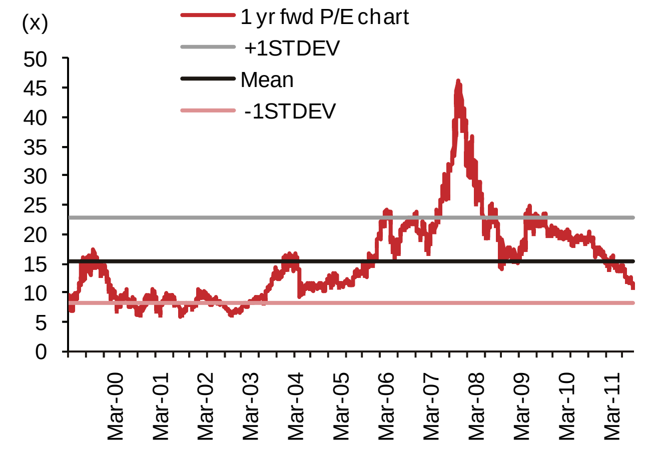
What is the valuation factoring in?

BHEL is currently trading below its 12-year mean on P/E and slightly below its 12-year P/BV mean. However, we note that it is still trading above its trading range during the pre-utility capex boom period, i.e., prior to FY05.

BHEL's re-rating since FY05 has been due mainly to the utility capex pick-up story and BHEL's monopoly status, which helped it increase margins and ROEs. In the current context, all of these favourable arguments are diminishing for BHEL and hence, we do not expect any re-rating at this time.

Fig. 24: Stock trading below 12-yr P/E mean, but in line with mean multiples pre-utility capex boom (-1 STDEV)

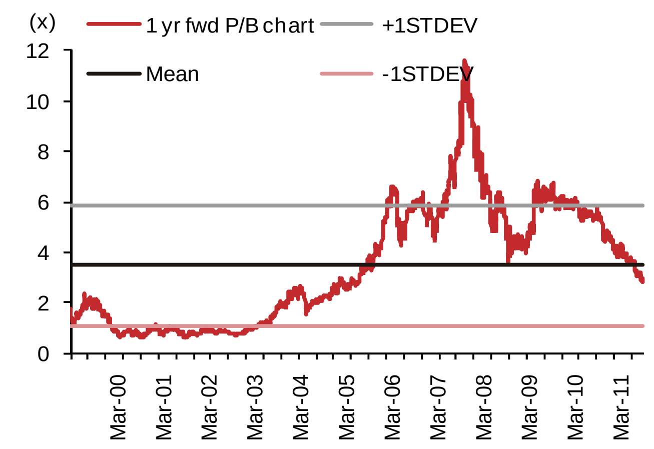
BHEL 1 year forward P/E chart



Source: Company, Bloomberg, Nomura estimates

Fig. 25: On P/BV, stock is still close to 12-yr mean and well above pre-utility capex boom multiples

BHEL 1 year forward P/B chart



Source: Company, Bloomberg, Nomura estimates

Impression: Strongly positioned on balance sheet, though downside risks on margins and working-capital cycle

Our evaluation is based on –

- FY11 margin levels being at the peak of the cycle and suggest downside risks, especially with the upcoming competition and slowing growth;
- Slower order flow will lead to slower sales growth. This will also be impacted by rising competition and execution delays, in our view;

- While valuation is below the mid-cycle trading range, it is still much higher than pre-utility capex boom period trading range. We would expect BHEL stock to revert to the multiples at which it used to trade pre FY05, and that would imply continued downside from current levels.

Tweaking estimates and TP; upgrade to NEUTRAL

As we build in further execution delays and minor near-term relief from softening commodity prices, our FY12 and FY13 estimates rise 2-3%. However, we build in further cuts in medium-term margin estimates, i.e., beyond FY13, to factor in rising competition. Together with the impact of these changes and rolling over to Sep-12, we arrive at our new TP of INR332.

Valuation methodology

We continue to value BHEL using a discounted cashflow (DCF) methodology, assuming a cost of equity of 12% and a terminal growth rate of 4% (explicit forecast period until FY17F, second-stage growth forecast until FY20). We believe that using 4% terminal growth is justified since rising competition and demand saturation will put a check on high growth rates. Our 4% terminal growth assumption is also in line with the estimated ~4% revenue CAGR over FY15-17F.

Risks

What could trigger upside in the stock?

- A higher-than-expected share of private orders under the 12th and 13th Five-year Plans;
- Delays or cancellation in capacity by new domestic equipment manufacturers;
- Substantial decline in key commodity prices such as steel and copper, as almost half of the order book is on fixed price contract, in our view.

What could trigger downside in the stock?

- Worsening of fuel availability for new and/or already ordered projects could lead to delays in new and existing orders.
- Rising competition could drive pricing even lower than our current estimates, thus pressurising margins.

Crompton Greaves CROM.NS CRG IN .

INDUSTRIALS

NOMURA
EQUITY RESEARCH

Fundamentals do not change due to adverse cycle

Opportunity remains lucrative, though worsening global macro causes near-term pains

October 12, 2011

Rating Remains	**Buy**
Target price Remains	INR 240
Closing price October 7, 2011	INR 149
Potential upside	+61.1%

Impression: Significant macro risk already priced in; Buy

In a sector with growing competitive intensity, we believe players with low cost structures will benefit. CRG's 34% market share of PGCIL's transformer orders over FY09-11, along with double-digit margins over the same period, testify to its low-cost advantage, in our view. Even though the business outlook has deteriorated, we believe this reflects a cyclical trough and is not company-specific. And although the timing of recovery in the India and international markets is uncertain, we think the structural opportunity is attractive. Our evaluation:

- FY11 margin levels are close to the peak of the cycle and suggest downside risks, but we believe these are largely built into consensus estimates.
- Sales are cyclical but have also been impacted by a slow pick-up in domestic power orders. Risk from global slowdown is a key overhang.
- In contrast, consensus estimates have adjusted sharply since peak levels, and mostly have changed to reflect post-1QFY12 results.

Valuation: At 9.6x FY13F EPS, stock factors in significant EPS risk

While the stock is already trading below its 10-year mean multiples now, we note that CRG has undergone significant transformation over the past 5-6 years (following acquisitions as well as rising market share and margins in domestic markets). We also highlight that since this transformation, CRG is now trading at some of the lowest multiples since FY05 even on significantly reduced earnings estimates. We maintain our estimates and TP, implying 61% upside potential from current levels. Buy.

31 Mar	FY11	FY12F		FY13F		FY14F	
Currency (INR)	Actual	Old	New	Old	New	Old	New
Revenue (mn)	100,051	110,459	110,459	125,990	125,990	147,523	147,523
Reported net profit (mn)	9,268	7,830	7,830	10,302	10,302	12,578	12,578
Normalised net profit (mn)	9,268	7,830	7,830	10,302	10,302	12,578	12,578
Normalised EPS	14.45	12.21	12.21	16.06	16.06	19.61	19.61
Norm. EPS growth (%)	12.4	-15.5	-15.5	31.6	31.6	22.1	22.1
Norm. P/E (x)	10.7	N/A	12.7	N/A	9.6	N/A	7.9
EV/EBITDA (x)	7.5	9.0	9.0	7.0	7.0	5.5	5.5
Price/book (x)	3.0	N/A	2.5	N/A	2.1	N/A	1.7
Dividend yield (%)	1.7	N/A	1.6	N/A	2.1	N/A	2.5
ROE (%)	32.1	21.8	21.8	23.9	23.9	24.0	24.0
Net debt/equity (%)	5.2	3.3	3.3	net cash	net cash	net cash	net cash

Source: Nomura estimates

Key company data: *See page 2 for company data and detailed price/index chart.*

Anchor themes

Decades of under-investment, followed by a march towards building sufficient power for the nation create significant opportunities, though structural constraints and rising competition suggest the need to be selective.

Nomura vs consensus

Our FY13F EPS is 17% higher than consensus as we build in a tax shelter from increased R&D spend, which we believe consensus has yet to factor in.

Research analysts

India Capital Goods

Amar Kedia - NFASL
amar.kedia@nomura.com
+91 22 4037 4182

Indrajit Yadav - NSFSPL
indrajit.yadav@nomura.com
+91 22 4037 4992

See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

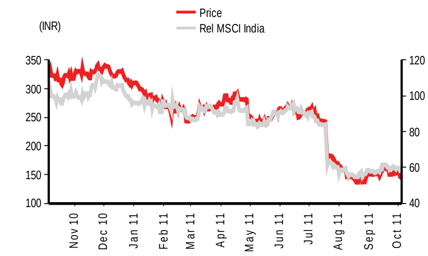
Key data on Crompton Greaves

Income statement (INRmn)

Year-end 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
Revenue	**91,409**	**100,051**	**110,459**	**125,990**	**147,523**
Cost of goods sold	-59,517	-66,916	-77,553	-87,561	-102,844
Gross profit	**31,892**	**33,135**	**32,906**	**38,430**	**44,679**
SG&A	-9,542	-9,822	-11,001	-12,321	-13,799
Employee share expense	-11,131	-11,811	-13,229	-14,816	-17,039
Operating profit	**11,219**	**11,502**	**8,677**	**11,293**	**13,841**
EBITDA	**12,770**	**13,438**	**11,118**	**13,810**	**16,664**
Depreciation	-1,551	-1,936	-2,441	-2,517	-2,823
Amortisation					
EBIT	11,219	11,502	8,677	11,293	13,841
Net interest expense	-428	-352	-376	-376	-376
Associates & JCEs	32	80	80	80	80
Other income	1,100	1,142	1,155	1,258	1,419
Earnings before tax	**11,922**	**12,372**	**9,536**	**12,255**	**14,964**
Income tax	-3,650	-3,100	-1,702	-1,948	-2,381
Net profit after tax	**8,272**	**9,272**	**7,834**	**10,307**	**12,583**
Minority interests	-26	-4	-4	-4	-5
Other items					
Preferred dividends					
Normalised NPAT	**8,247**	**9,268**	**7,830**	**10,302**	**12,578**
Extraordinary items					
Reported NPAT	**8,247**	**9,268**	**7,830**	**10,302**	**12,578**
Dividends	-947	-1,645	-1,551	-2,045	-2,501
Transfer to reserves	**7,299**	**7,623**	**6,279**	**8,257**	**10,077**
Valuation and ratio analysis					
FD normalised P/E (x)	12.1	10.7	12.7	9.6	7.9
FD normalised P/E at price target (x)	18.7	16.6	19.7	14.9	12.2
Reported P/E (x)	12.1	10.7	12.7	9.6	7.9
Dividend yield (%)	1.0	1.7	1.6	2.1	2.5
Price/cashflow (x)	10.5	18.4	10.6	9.7	8.0
Price/book (x)	4.0	3.0	2.5	2.1	1.7
EV/EBITDA (x)	7.6	7.5	9.0	7.0	5.5
EV/EBIT (x)	8.7	8.7	11.5	8.6	6.6
Gross margin (%)	34.9	33.1	29.8	30.5	30.3
EBITDA margin (%)	14.0	13.4	10.1	11.0	11.3
EBIT margin (%)	12.3	11.5	7.9	9.0	9.4
Net margin (%)	9.0	9.3	7.1	8.2	8.5
Effective tax rate (%)	30.6	25.1	17.8	15.9	15.9
Dividend payout (%)	11.5	17.7	19.8	19.9	19.9
Capex to sales (%)	1.7	7.6	7.7	4.8	4.1
Capex to depreciation (x)	1.0	3.9	3.5	2.4	2.1
ROE (%)	38.0	32.1	21.8	23.9	24.0
ROA (pretax %)	21.4	18.9	11.8	13.4	14.5
Growth (%)					
Revenue	4.6	9.5	10.4	14.1	17.1
EBITDA	28.3	5.2	-17.3	24.2	20.7
EBIT	28.4	2.5	-24.6	30.1	22.6
Normalised EPS	47.3	12.4	-15.5	31.6	22.1
Normalised FDEPS	47.3	12.4	-15.5	31.6	22.1
Per share					
Reported EPS (INR)	12.85	14.45	12.21	16.06	19.61
Norm EPS (INR)	12.85	14.45	12.21	16.06	19.61
Fully diluted norm EPS (INR)	12.85	14.45	12.21	16.06	19.61
Book value per share (INR)	39.04	51.05	60.83	73.70	89.41
DPS (INR)	1.48	2.56	2.42	3.19	3.90

Source: Nomura estimates

Relative performance chart (one year)



Source: ThomsonReuters, Nomura research

(%)	1M	3M	12M
Absolute (INR)	13.1	-40.0	-51.4
Absolute (USD)	6.4	-44.9	-55.5
Relative to index	7.7	-29.4	-32.1
Market cap (USDmn)	2,025.6		
Estimated free float (%)	54.9		
52-week range (INR)	349/132.75		
3-mth avg daily turnover (USDmn)	18.88		
Major shareholders (%)			
Avantha Holdings	39.1		
Solaris Holding	25.4		

Source: Thomson Reuters, Nomura research

Notes

Effective tax rate declining over FY12-14F

Cashflow (INRmn)

Year-end 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
EBITDA	12,770	13,438	11,118	13,810	16,664
Change in working capital	-125	-4,459	269	-1,346	-1,537
Other operating cashflow	-3,207	-3,588	-2,002	-2,248	-2,683
Cashflow from operations	**9,437**	**5,391**	**9,384**	**10,216**	**12,445**
Capital expenditure	-1,526	-7,593	-8,550	-6,000	-6,000
Free cashflow	**7,911**	**-2,202**	**834**	**4,216**	**6,445**
Reduction in investments	-3,864	-1,211	0	0	0
Net acquisitions					
Reduction in other LT assets					
Addition in other LT liabilities					
Adjustments	1,100	1,142	1,155	1,258	1,419
Cashflow after investing acts	**5,148**	**-2,271**	**1,989**	**5,474**	**7,864**
Cash dividends	-947	-1,645	-1,551	-2,045	-2,501
Equity issue	-2,173	-306	0	0	0
Debt issue	0	0	0	0	0
Convertible debt issue					
Others	-996	518	0	0	0
Cashflow from financial acts	**-4,116**	**-1,433**	**-1,551**	**-2,045**	**-2,501**
Net cashflow	**1,032**	**-3,704**	**439**	**3,428**	**5,364**
Beginning cash	5,656	6,688	2,984	3,423	6,851
Ending cash	6,688	2,984	3,423	6,851	12,215
Ending net debt	-1,679	1,719	1,280	-2,148	-7,512

Source: Nomura estimates

Notes

Sufficient free cashflow to fund current quantum of capex and acquisitions

Balance sheet (INRmn)

As at 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
Cash & equivalents	6,688	2,984	3,423	6,851	12,215
Marketable securities					
Accounts receivable	21,463	25,427	27,842	31,756	37,184
Inventories	10,194	11,893	13,747	15,565	18,306
Other current assets	2,674	5,192	5,716	6,520	7,634
Total current assets	**41,018**	**45,496**	**50,728**	**60,692**	**75,338**
LT investments	5,536	6,747	6,747	6,747	6,747
Fixed assets	13,760	19,417	25,526	29,009	32,186
Goodwill					
Other intangible assets					
Other LT assets	0	0	0	0	0
Total assets	**60,314**	**71,660**	**83,001**	**96,448**	**114,271**
Short-term debt					
Accounts payable	26,567	29,595	34,209	38,732	45,554
Other current liabilities	3,603	4,298	4,745	5,412	6,337
Total current liabilities	**30,170**	**33,892**	**38,954**	**44,144**	**51,891**
Long-term debt	5,010	4,703	4,703	4,703	4,703
Convertible debt					
Other LT liabilities	49	160	160	160	160
Total liabilities	**35,229**	**38,756**	**43,817**	**49,008**	**56,754**
Minority interest	43	157	157	157	157
Preferred stock	0	0	0	0	0
Common stock	1,283	1,283	1,283	1,283	1,283
Retained earnings	23,760	31,464	37,743	46,000	56,077
Proposed dividends					
Other equity and reserves					
Total shareholders' equity	**25,043**	**32,747**	**39,026**	**47,283**	**57,360**
Total equity & liabilities	**60,314**	**71,660**	**83,001**	**96,448**	**114,271**
Liquidity (x)					
Current ratio	1.36	1.34	1.30	1.37	1.45
Interest cover	26.2	32.7	23.1	30.0	36.8
Leverage					
Net debt/EBITDA (x)	net cash	0.13	0.12	net cash	net cash
Net debt/equity (%)	net cash	5.2	3.3	net cash	net cash
Activity (days)					
Days receivable	83.9	85.5	88.3	86.3	85.3
Days inventory	64.8	60.2	60.5	61.1	60.1
Days payable	161.3	153.2	150.6	152.0	149.6
Cash cycle	-12.5	-7.4	-1.8	-4.6	-4.2

Source: Nomura estimates

Notes

Working capital cycle is lengthening and needs to be tracked, although it is not a major concern as yet

How well is Crompton Greaves positioned for a turn in the cycle?

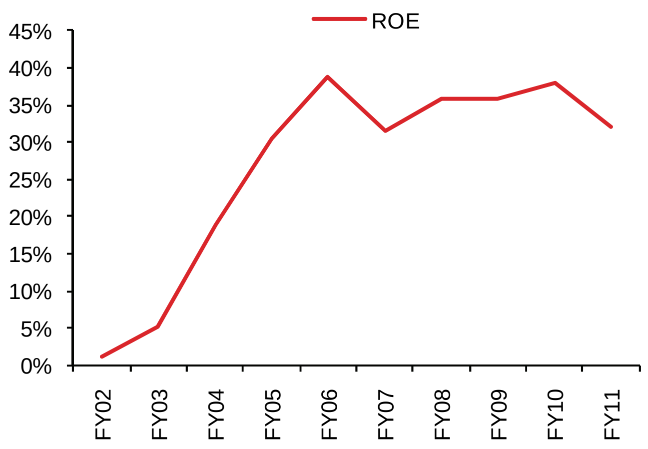
We have used consolidated numbers to chart the historical financials for Crompton Greaves (CRG), as subsidiaries form a substantial part of the business and valuation for the company. Since the major impact of the company's international acquisitions started to be felt only from FY06, we have, at times, restricted our reference period to that timeline for relevance purposes.

Balance sheet and return efficiency

Consistency of return ratios

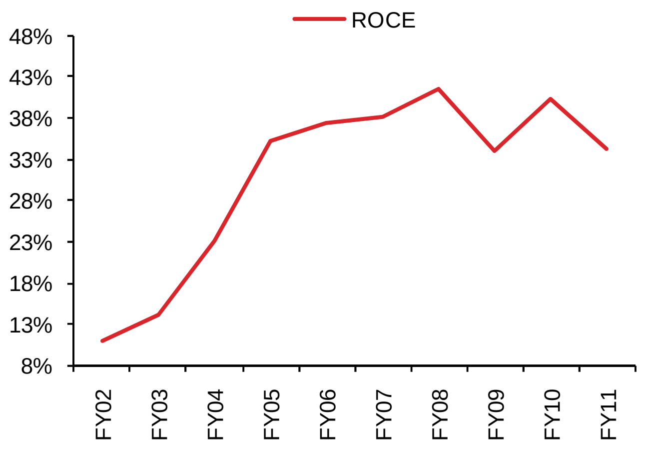
Return ratios for CRG have been healthy at above 30% since its acquisition of international businesses, starting from FY06. We do notice some volatility around a change in cycles, which we believe is largely led by sales slowdown and some working capital pressure.

Fig. 26: Return ratios have been stable since FY06 …



Source: Company, Nomura research

Fig. 27: …with some volatility around business cycles

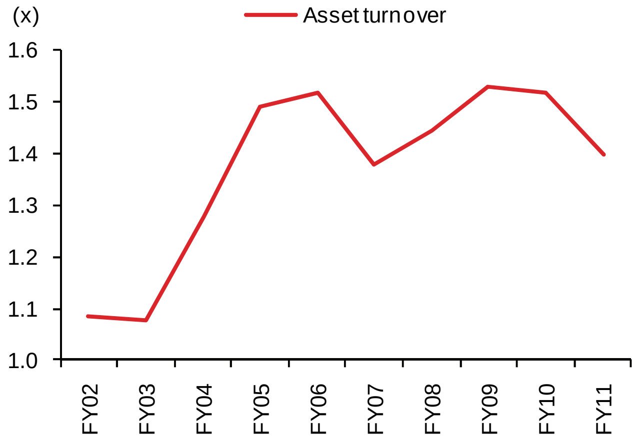


Source: Company, Nomura research

Management of working capital and asset turnover

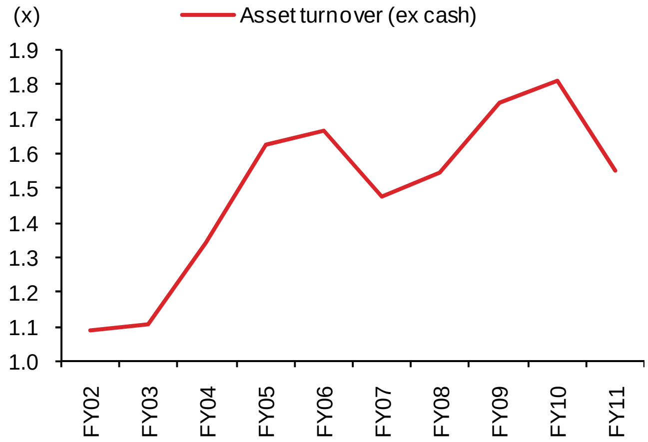
We believe the company has maintained tight control over its working capital cycle, which is evident in the charts below. The increase in the WC cycle in FY11 is mainly due to adverse business cycles, in our view. Despite slower sales, asset turnover has remained steady, mainly due to tight control over capital employed in both fixed assets and working capital, on our reading.

Fig. 28: Asset t/o depicting pressure from slower sales…



Source: Company, Nomura research

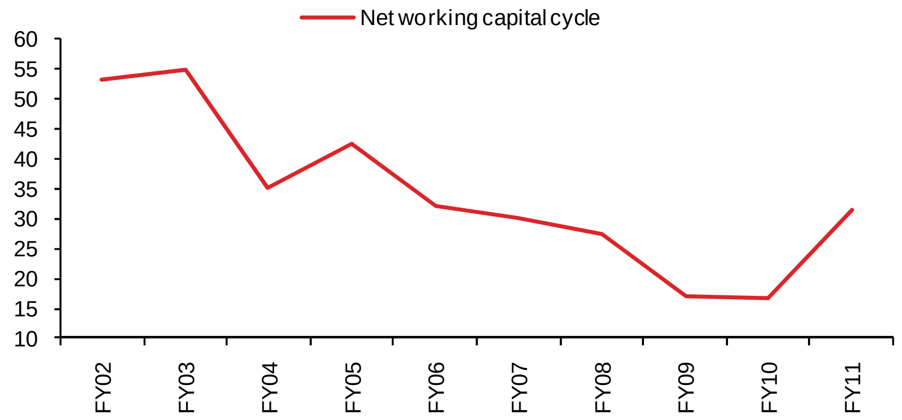
Fig. 29: …and recent uptick in WC cycle; cyclical nature



Source: Company, Nomura research

Fig. 30: Sharp improvement in WC cycle, barring past 12m, led by a decline in receivables and inventory days

Days of revenue

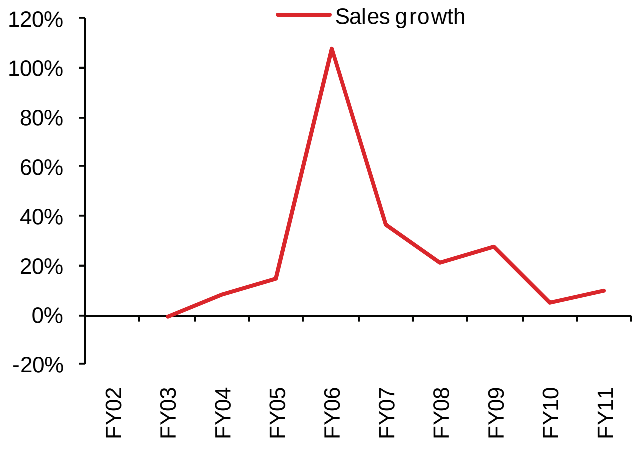


Source: Company, Nomura research

Trajectory of growth

The company's sales trend has been disappointing over the past few years, although margins have been rising. We largely attribute this to tight control over costs and the benefit from operating leverage. However, given concerns over sales growth in the near term owing to a slowing global economy, we believe margins could suffer (as evident in the 1QFY12 results) in the near term.

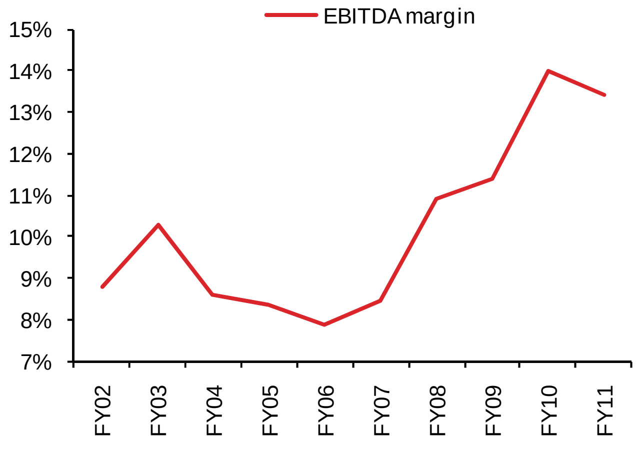
Fig. 31: Sales have been under pressure and is a key risk



Source: Company, Nomura research

Fig. 32: Margins close to all-time peak; we see downside risks

% of revenues



Source: Company, Nomura research

Risks from an adverse turn in the cycle

While sales already indicate a bottom-cycle trend, margins are close to peak cycle.

Risk to sales

Post the Lehman crisis, overall sales had nearly approached zero growth, but refrained from entering negative territory. This, in our view, was led mainly by a slowdown in international markets. We continue to see similar risks to sales owing to ongoing concerns about global economies, especially in the the US and Europe.

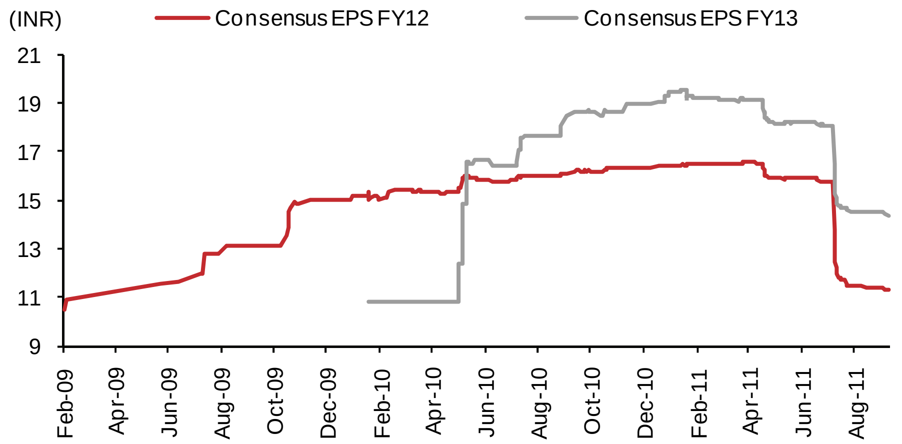
Risk to margins

FY11 margin levels are at close to the top-end of the margin range (9-14%), and we see downside risks from these levels. Average historical margins for the company (since FY06) have been at around 11.5%, though post the Lehman crisis, margins were still rising. Depending on the extent of slowdown in global economies, we could see 300-400bp margin risk for the company. Our FY12F estimates factor in 330bps.

What are consensus estimates building in?

Mean consensus EPS estimates have corrected 30-35% for CRG since peaking, with recent estimates falling even lower. We believe current consensus estimates already build in risks to margins for the company, though there is still some risk to sales from a severe global slowdown.

Fig. 33: Consensus earnings estimates already down 30-35% since peak



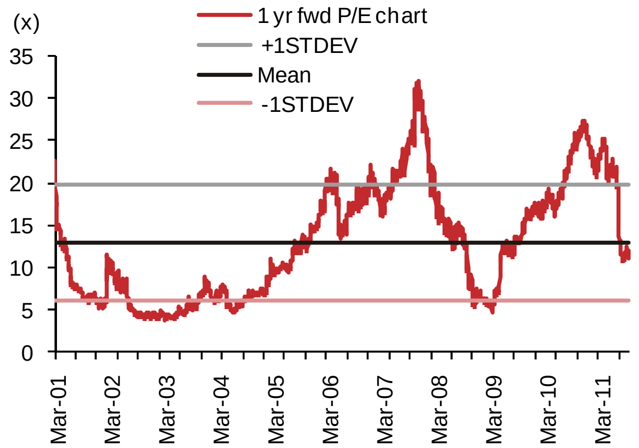
Source: Bloomberg

What are valuations factoring in?

- CRG has largely traded at 15-25x earnings since FY06 (post acquisitions) except during the post-Lehman bankruptcy period.
- Even on a longer timeframe of 10 years, we note that the stock is now trading below the mean trading levels both on a P/E and P/BV basis.
- While a severe recession in Europe and the US could lead to further interim de-rating of the stock, we believe it is now pricing in visible medium-term risks to margins and sales growth.

Fig. 34: Stock is trading below 10-year mean trading multiples…

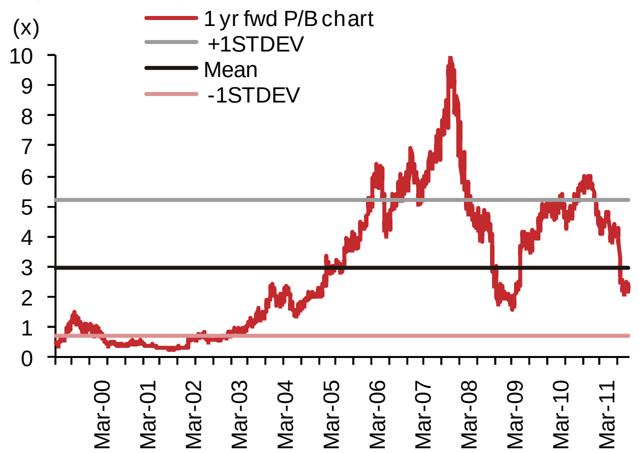
Crompton Greaves 1-year fwd P/E chart



Source: Company, Bloomberg, Nomura estimates

Fig. 35: …and even lower on average levels since FY06

Crompton Greaves 1-year fwd P/BV chart



Source: Company, Bloomberg, Nomura estimates

Impression: Significant macro risk already priced-in, though extreme case could see further interim risks

CRG stock has corrected by more than 55% over the past 12 months and has underperformed the broader markets by 22%. At current levels, we believe the stock is attractively valued and significant earnings risk is already priced in. However, we do not rule out further correction in the interim were global macro conditions take a sharper dip. On a longer-term horizon, we believe CRG presents an attractive risk-reward opportunity. Our evaluation is based on:

- Despite FY11 margin levels being close to the peak of the cycle and have downside risks, we believe these are largely built into consensus estimates.
- Sales growth is cyclical but has also been impacted by a slow pick-up in domestic power orders. Risk from a severe global slowdown will be a key overhang.
- In contrast, consensus estimates have adjusted sharply since peak levels, and mostly have changed to reflect post-1QFY12 results.
- The stock is now trading below 10-year mean multiples, but since the company has transformed significantly over the past 5-6 years (on the back of international acquisitions as well as rising market share and margins in domestic markets), we would place more emphasis on a mean trading range comparison with the likes of MNC peers such as ABB, SIEM and Areva T&D, which are trading above 16x 1 year forward EPS.
- Since these acquisitions, the stock is now trading significantly below mean levels and on lowered earnings estimates nonetheless.

Valuation methodology

We continue to value the core business at 15x Mar-13F EPS of INR16.06 to arrive at our TP of INR240. Our multiple of 15x is at a slight discount to the mid-cycle multiple of 16x for the stock, which we believe is justified, given that we believe business conditions are reflective of cyclical pains at this point.

Investment risks

1) Further slowdown in power sector investments; 2) rising competition in domestic and international T&D; 3) worsening of the European crisis, and; 4) a substantial rise in commodity prices could hit margins.

Cummins India CUMM.NS KKC IN .

ELECTRICAL EQUIPMENT

NOMURA
EQUITY RESEARCH

For the long term

Near-term concerns on a worsening macro, but wait for opportunity

October 12, 2011

Rating Remains	**Neutral**
Target price Remains	INR 430
Closing price October 7, 2011	INR 406
Potential upside	+5.9%

Impression: Near-term risks from global slowdown, but impressive fundamentals imply share price strength upon correction

Despite more than a 30% correction since its past 12-month peak, we do not rule out near-term downside risks for Cummins India, in case of a severe global recession. Our evaluation is based on:

- FY11 margin levels are at the peak of the cycle and could be prone to downside risks, but this could be partially offset by lower RM costs.
- Sales growth is cyclical and tends to be highly volatile around turns.
- In comparison, consensus estimates have corrected only modestly.
- Current valuations do not appear appealing, compared with the historical mean on both a P/E and P/BV basis. However, we would review our estimates upon a market correction.

Cutting estimates on near-term slowdown risks; maintain Neutral

We are cutting our FY12-14F estimates by 10-15% to account for slower sales growth (mainly exports) on account of an anticipated global slowdown. We also lower our margin estimates modestly on account of falling utilisation levels, albeit slightly offset by a fall in raw material costs.

Despite the near-term risk on earnings growth, we continue to see Cummins India as a fundamentally strong company which has managed its balance sheet and return ratios well in past cycles.

Our valuation methodology remains unchanged (except for rolling over to Sep-13F EPS from Mar-13F earlier) as we value the stock at 15x Sep-13F EPS of INR28.6 to arrive at our TP of INR430, which is in line with the stock's mid-cycle trading range.

31 Mar	FY11		FY12F		FY13F		FY14F
Currency (INR)	Actual	Old	New	Old	New	Old	New
Revenue (mn)	39,105	45,278	44,897	54,400	50,467	62,898	61,500
Reported net profit (mn)	5,910	7,026	6,918	7,958	7,113	9,115	8,725
Normalised net profit (mn)	5,789	6,615	6,507	7,958	7,113	9,115	8,725
Normalised EPS	20.88	23.86	23.47	28.71	25.66	32.88	31.47
Norm. EPS growth (%)	32.4	14.3	12.4	20.3	9.3	14.5	22.7
Norm. P/E (x)	19.5	N/A	17.3	N/A	15.8	N/A	12.9
EV/EBITDA (x)	16.2	13.4	13.7	11.1	12.5	9.5	10.0
Price/book (x)	6.2	N/A	5.4	N/A	4.7	N/A	4.1
Dividend yield (%)	3.1	N/A	3.6	N/A	3.7	N/A	4.5
ROE (%)	35.1	36.0	35.5	35.1	31.7	34.8	33.9
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash	net cash	net cash

Source: Nomura estimates

Key company data: *See page 2 for company data and detailed price/index chart.*

Anchor themes

We believe India's industrial sector offers the unfolding of a substantial opportunity over the coming years. We see potential opportunities in niche segments.

Nomura vs consensus

We are in line with consensus on FY13F earnings but our TP is 10% lower on greater caution towards the exports outlook for the company.

Research analysts

India Capital Goods

Amar Kedia - NFASL
amar.kedia@nomura.com
+91 22 4037 4182

Indrajit Yadav - NSFSPL
indrajit.yadav@nomura.com
+91 22 4037 4992

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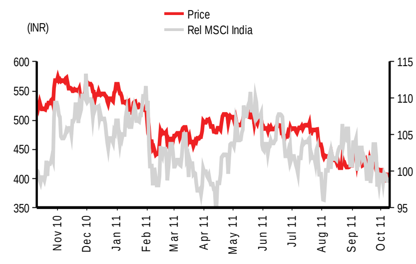
Key data on Cummins India

Income statement (INRmn)

Year-end 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
Revenue	**28,125**	**39,105**	**44,897**	**50,467**	**61,500**
Cost of goods sold	-18,383	-26,170	-29,977	-33,780	-41,166
Gross profit	**9,741**	**12,935**	**14,920**	**16,687**	**20,334**
SG&A	-2,877	-4,120	-4,753	-5,091	-6,204
Employee share expense	-1,953	-2,546	-3,056	-3,667	-4,217
Operating profit	**4,912**	**6,268**	**7,111**	**7,929**	**9,914**
EBITDA	**5,273**	**6,635**	**7,547**	**8,520**	**10,634**
Depreciation	-361	-366	-436	-590	-720
Amortisation					
EBIT	4,912	6,268	7,111	7,929	9,914
Net interest expense	-21	-19	-19	-19	-19
Associates & JCEs	419	262	513	410	404
Other income	799	1,512	1,369	1,491	1,735
Earnings before tax	**6,109**	**8,024**	**8,974**	**9,811**	**12,034**
Income tax	-1,736	-2,235	-2,468	-2,698	-3,309
Net profit after tax	**4,373**	**5,789**	**6,507**	**7,113**	**8,725**
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	**4,373**	**5,789**	**6,507**	**7,113**	**8,725**
Extraordinary items	65	121	412	0	0
Reported NPAT	**4,439**	**5,910**	**6,918**	**7,113**	**8,725**
Dividends	-2,775	-3,457	-4,026	-4,140	-5,078
Transfer to reserves	**1,663**	**2,453**	**2,892**	**2,973**	**3,647**
Valuation and ratio analysis					
FD normalised P/E (x)	25.8	19.5	17.3	15.8	12.9
FD normalised P/E at price target (x)	27.3	20.6	18.3	16.8	13.7
Reported P/E (x)	25.4	19.1	16.3	15.8	12.9
Dividend yield (%)	2.5	3.1	3.6	3.7	4.5
Price/cashflow (x)	16.0	21.6	12.0	17.8	13.7
Price/book (x)	7.2	6.2	5.4	4.7	4.1
EV/EBITDA (x)	19.7	16.2	13.7	12.5	10.0
EV/EBIT (x)	21.0	17.1	14.4	13.4	10.7
Gross margin (%)	34.6	33.1	33.2	33.1	33.1
EBITDA margin (%)	18.7	17.0	16.8	16.9	17.3
EBIT margin (%)	17.5	16.0	15.8	15.7	16.1
Net margin (%)	15.8	15.1	15.4	14.1	14.2
Effective tax rate (%)	28.4	27.9	27.5	27.5	27.5
Dividend payout (%)	62.5	58.5	58.2	58.2	58.2
Capex to sales (%)	2.2	3.7	7.8	6.9	3.3
Capex to depreciation (x)	1.7	3.9	8.0	5.9	2.8
ROE (%)	30.0	35.1	35.5	31.7	33.9
ROA (pretax %)	24.0	25.8	25.9	24.4	26.0
Growth (%)					
Revenue	-14.1	39.0	14.8	12.4	21.9
EBITDA	10.5	25.8	13.8	12.9	24.8
EBIT	13.8	27.6	13.5	11.5	25.0
Normalised EPS	4.8	32.4	12.4	9.3	22.7
Normalised FDEPS	4.8	32.4	12.4	9.3	22.7
Per share					
Reported EPS (INR)	16.01	21.32	24.96	25.66	31.47
Norm EPS (INR)	15.78	20.88	23.47	25.66	31.47
Fully diluted norm EPS (INR)	15.78	20.88	23.47	25.66	31.47
Book value per share (INR)	56.31	65.16	75.59	86.32	99.47
DPS (INR)	10.01	12.47	14.53	14.93	18.32

Source: Nomura estimates

Relative performance chart (one year)



Source: ThomsonReuters, Nomura research

(%)	1M	3M	12M
Absolute (INR)	-7.4	-16.5	-22.1
Absolute (USD)	-12.3	-24.7	-29.6
Relative to index	-4.2	-2.6	-0.3
Market cap (USDmn)	2,291.3		
Estimated free float (%)	49.0		
52-week range (INR)	578.57/395		
3-mth avg daily turnover (USDmn)	3.01		
Major shareholders (%)			
Cummins Inc	51.0		
LIC	8.2		

Source: Thomson Reuters, Nomura research

Notes

Slowing revenue growth to mirror macro concerns in the domestic and international markets

Cashflow (INRmn)

Year-end 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
EBITDA	5,273	6,635	7,547	8,520	10,634
Change in working capital	2,238	-1,054	1,995	-1,392	-1,198
Other operating cashflow	-473	-358	-193	-816	-1,189
Cashflow from operations	**7,037**	**5,222**	**9,349**	**6,312**	**8,247**
Capital expenditure	-607	-1,440	-3,500	-3,500	-2,000
Free cashflow	**6,430**	**3,782**	**5,849**	**2,812**	**6,247**
Reduction in investments	-3,337	75	-158	0	0
Net acquisitions					
Reduction in other LT assets	61	-18	0	0	0
Addition in other LT liabilities	0	0	0	0	0
Adjustments	0	11	0	0	0
Cashflow after investing acts	**3,154**	**3,850**	**5,692**	**2,812**	**6,247**
Cash dividends	-2,775	-3,457	-4,026	-4,140	-5,078
Equity issue	0	0	0	0	0
Debt issue	-143	96	-183	0	0
Convertible debt issue					
Others					
Cashflow from financial acts	**-2,918**	**-3,361**	**-4,209**	**-4,140**	**-5,078**
Net cashflow	**236**	**489**	**1,483**	**-1,328**	**1,169**
Beginning cash	323	559	1,037	2,520	1,192
Ending cash	559	1,049	2,520	1,192	2,361
Ending net debt	-473	-855	-2,520	-1,192	-2,361

Source: Nomura estimates

Notes

Despite adversities, cash flow generation remains strong

Balance sheet (INRmn)

As at 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
Cash & equivalents	559	1,037	2,520	1,192	2,361
Marketable securities	7,056	6,981	7,139	7,139	7,139
Accounts receivable	5,229	7,182	7,380	8,987	10,952
Inventories	4,097	5,190	5,442	6,114	7,451
Other current assets	2,788	3,396	3,420	3,832	4,648
Total current assets	**19,728**	**23,785**	**25,900**	**27,263**	**32,550**
LT investments	274	274	274	274	274
Fixed assets	3,337	4,411	7,475	10,385	11,665
Goodwill					
Other intangible assets					
Other LT assets	170	187	187	187	187
Total assets	**23,508**	**28,657**	**33,836**	**38,109**	**44,676**
Short-term debt	86	183	0	0	0
Accounts payable	5,178	7,109	7,165	8,098	9,710
Other current liabilities	2,634	3,302	5,717	6,083	7,391
Total current liabilities	**7,898**	**10,594**	**12,882**	**14,181**	**17,101**
Long-term debt					
Convertible debt					
Other LT liabilities	0	0	0	0	0
Total liabilities	**7,898**	**10,594**	**12,882**	**14,181**	**17,101**
Minority interest					
Preferred stock	0	0	0	0	0
Common stock	554	554	554	554	554
Retained earnings	15,056	17,508	20,400	23,373	27,020
Proposed dividends					
Other equity and reserves					
Total shareholders' equity	**15,610**	**18,063**	**20,954**	**23,928**	**27,574**
Total equity & liabilities	**23,508**	**28,657**	**33,836**	**38,109**	**44,676**
Liquidity (x)					
Current ratio	2.50	2.25	2.01	1.92	1.90
Interest cover	239.5	330.2	374.6	417.7	522.3
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	78.2	57.9	59.4	59.2	59.2
Days inventory	87.1	64.8	64.9	62.4	60.1
Days payable	110.7	85.7	87.1	82.5	78.9
Cash cycle	54.6	37.0	37.1	39.2	40.4

Source: Nomura estimates

Notes

Clean and strong balance sheet, though limited visibility on any inorganic growth intent

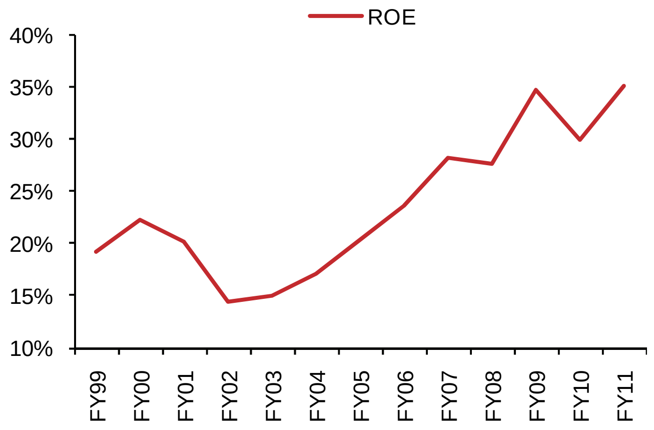
How well is Cummins India positioned for a turn in the cycle?

Balance sheet and return efficiency

Consistency of return ratios

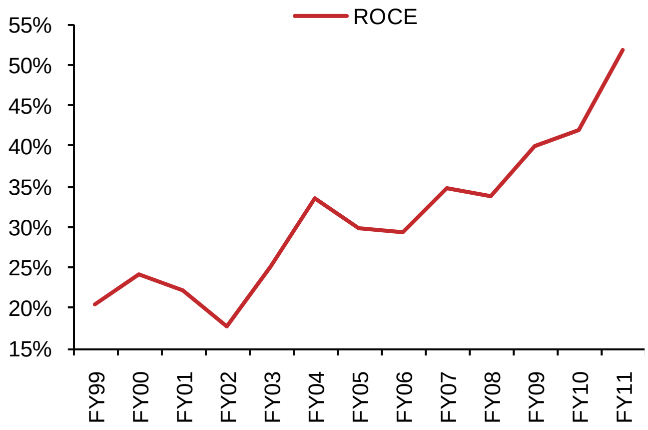
Despite interim cyclicality, Cummins India has been able to maintain a healthy and consistently rising ROE/ROCE trend.

Fig. 36: KKC: ROE has consistently been on a rising trend…



Source: Company, Nomura research

Fig. 37: … and so has its ROCE

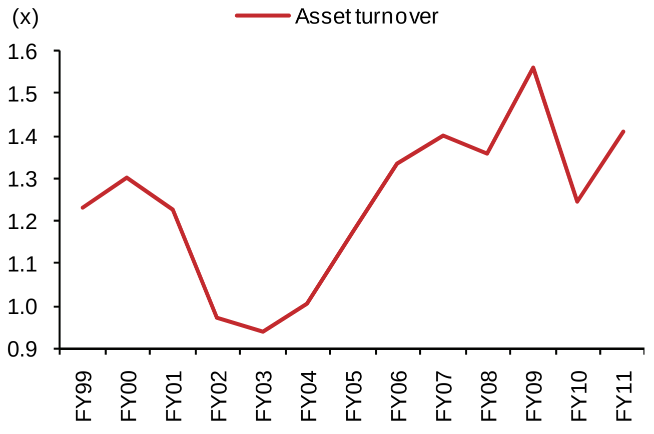


Source: Company, Nomura research

Management of working capital and asset turnover

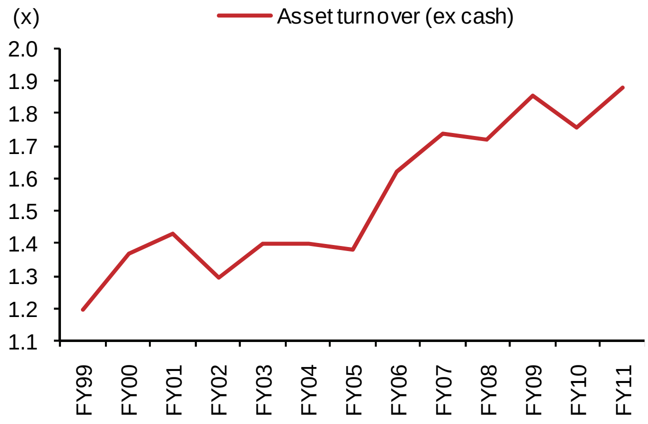
A steady trend of declining net working capital cycle and rising asset turnover implies strong management quality for the company over the past 12 years, in our view.

Fig. 38: Asset turnover too has been on a rise, though rising cash levels and slowing exports hit FY10 and FY11



Source: Company, Nomura research

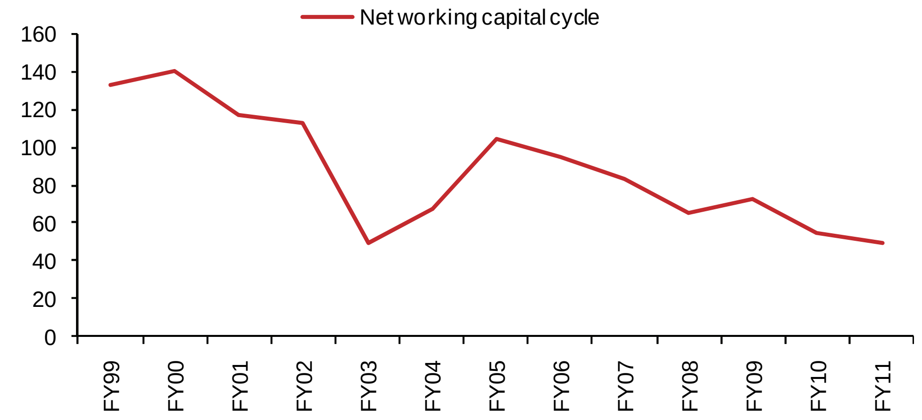
Fig. 39: Asset turnover ex cash confirms a secular uptrend in the business



Source: Company, Nomura research

Fig. 40: Management efforts, depicted in a tight rein over Net WC cycle (ex cash), partly explains rising ROCE

Days of revenue

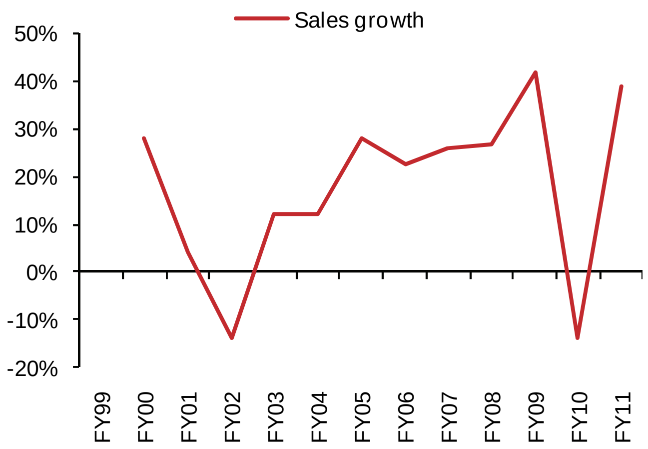


Source: Company, Nomura research

Trajectory of growth

Cummins' sales have been largely dependent on business cycles and depict great volatility around trend shift. Margins also depict similar business cyclicality, although we notice that the lows are now shallower.

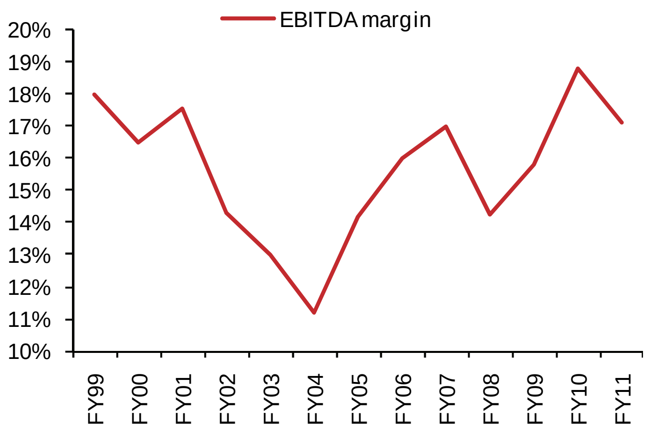
Fig. 41: Sales growth trend in line with business cycles; highly volatile around change in momentum



Source: Company, Nomura research

Fig. 42: Margins trend suggest cyclical business nature – strong sense of déjà vu in FY10-11; see downside risks

% of revenues



Source: Company, Nomura research

Risks from an adverse turn in the cycle

Sales and margin trends suggest that the business is close to peak cycle levels.

Risk to sales

Post the 2008-09 global financial crisis, overall sales declined by more than 10% in FY10, from very high growth rates until then. In an extreme global economic slowdown, we foresee that a similar (or even greater) decline is indeed possible for Cummins.

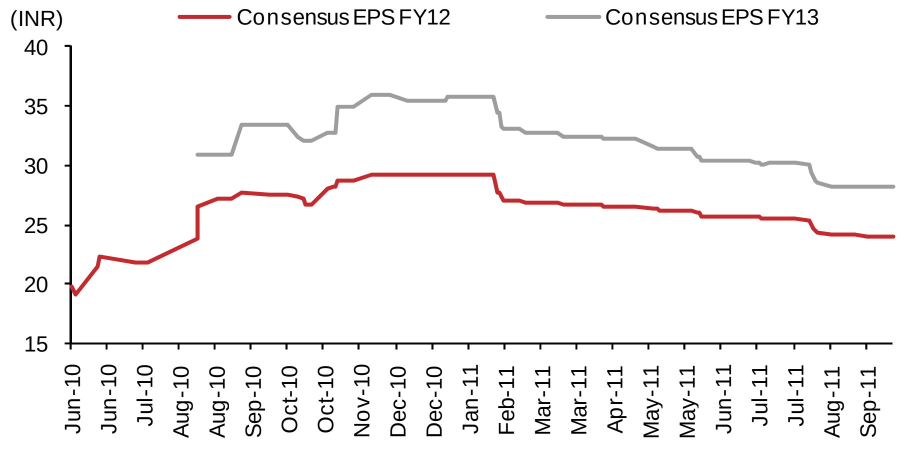
Risk to margins

FY11 margin levels are at the top-end of the margin range (11-19%) and we clearly notice downside risks from these levels. Average historical margins for the company have been around 14%, and incidentally the bottom during the 2008-09 global financial crisis period was also 14%. Therefore, the risk from the FY11 levels is around 300bps, on our estimates.

What are consensus estimates building in?

Consensus EPS estimates have corrected by ~20% for Cummins India since their peak. However, given the risk to sales and margins as highlighted above, we believe further downside risks are possible.

Fig. 43: Consensus estimates down 20% from peak; we see further downside risks

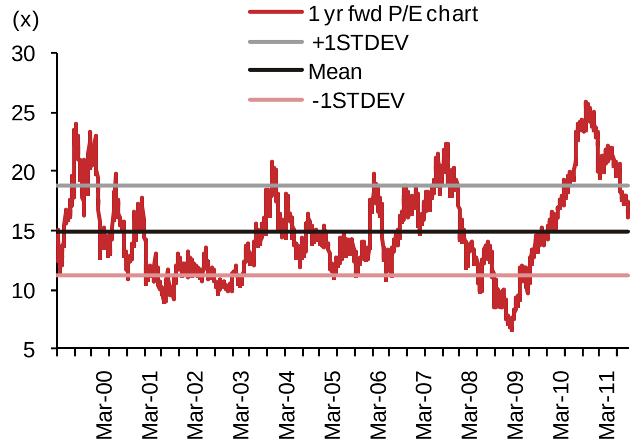


Source: Bloomberg

What is valuation factoring in?

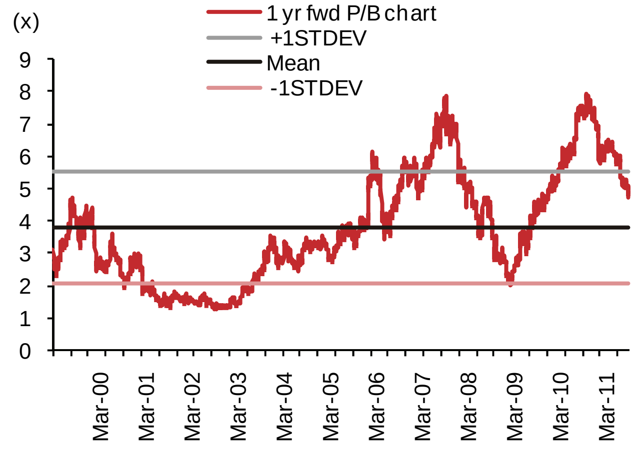
- Cummins India largely traded at 10-15x P/E during FY01 to FY07 when growth was much lower than the post-FY07 period and margins were also lower than the current mean.
- However, we rule out similar low multiples as the FY01-07 range for Cummins, because of continuous improvement in its balance sheet through tighter WC cycle management and asset efficiency.
- Cummins India's trailing 12-year mean P/E multiple is 15x, while the stock is currently trading at ~16x 1-year forward earnings which is close to the mean. On a P/BV basis, the stock is still +0.5 STDEV of mean levels.

Fig. 44: KKC trading close to 12-year mean P/E multiple…
KKC 1 year fwd P/E chart



Source: Company, Bloomberg, Nomura estimates

Fig. 45: …while slightly higher than mean P/B multiple
KKC 1 year fwd P/B chart



Source: Company, Bloomberg, Nomura estimates

Impression: Near-term risks from slowdown, but impressive fundamentals imply future strength

Although Cummins India stock has corrected by over 30% since its past 12-month peak, we do not rule out any near-term downside risks for Cummins India in case of a severe global recession. Our evaluation is based on:

- FY11 margin levels are at the peak of the cycle and could be prone to downside risks, though we note that falling commodity prices would compensate for margin loss due to lower utilisation.
- Sales growth is cyclical and tends to be highly volatile around a change in momentum.
- In comparison, consensus estimates have corrected only modestly.
- Current valuations do not appear appealing, compared with the historical mean on both a P/E and P/BV basis. However, we would review our estimates upon a market correction. We are positive on the company in the longer term.

Cutting estimates on near-term slowdown risks; remain Neutral on strong fundamentals

We are cutting our FY12-14F estimates by 10-15% to account for slower sales growth (mainly in exports) on account of an anticipated global slowdown. We are also lowering our margin estimates modestly on account of falling utilisation levels, though slightly offset by a fall in RM cost.

Despite near-term risks on earnings growth, we continue to see Cummins India as a fundamentally strong company which has managed its balance sheet and return ratios well in past cycles.

Our valuation methodology remains unchanged (except for rolling over to Sep-13F EPS from Mar-13F earlier) as we value the stock at 15x Sep-13F EPS of INR28.6 to arrive at our target price of INR430, which is in line with the stock's mid-cycle trading range.

Risks to our call

Downside risks: appreciation of the rupee, diesel prices pose a risk to demand for back-up power; competition from Chinese players.

Upside risks: raw material cost could pose negative or positive upsides depending on commodity price movements; export recovery could continue to surprise in the near term.

NOMURA
EQUITY RESEARCH

Strong leverage to adverse macro priced in now

Retain Buy on attractive long-term opportunity; concerns priced in

October 12, 2011

Rating Remains	**Buy**
Target price Reduced from 234	INR 150
Closing price October 7, 2011	INR 105
Potential upside	+42.9%

Action: Assuming coverage; attractive opportunity, although business is highly correlated to global macro conditions; Buy

Voltas has underperformed the SENSEX by 35% over the past 12 months on a slowdown in sales and margin concerns. We see limited further near-term downside risk from current levels even in a bear-case scenario, although the extreme case could drive further downside. Long term, however, we believe the stock is attractively valued and would use any correction to accumulate.

- FY11 margin levels are close to peak levels; we see a 100-150bp downside correction risk from here.
- Adverse macro conditions are likely to hurt near-term order inflows and sales growth; any pickup is contingent on global macro trends.
- Consensus estimates are largely building in margin risk, although some risk could emerge from a further sales slowdown.
- With consensus estimates also largely capturing earnings risk and valuations factoring in an even greater earnings decline, we believe current levels offer a good entry point from a long-term perspective.

Cutting estimates ~30% and TP to INR150 to factor in adverse macro

We cut our FY12-13F earnings on increased concerns over the company's near-term sales and margin outlook in the electro-mechanical and unitary cooling product segments, following a transfer of analyst coverage. Our revised TP of INR150 is based on 14x (previously: 16.3x) Sep-13F EPS of INR10.85, suggesting 43% implied upside. We assume coverage of the stock with a Buy rating.

31 Mar	FY11	FY12F		FY13F		FY14F	
Currency (INR)	Actual	Old	New	Old	New	Old	New
Revenue (mn)	51,914	59,253	51,643	70,792	56,027		63,540
Reported net profit (mn)	3,572	3,737	3,241	4,622	3,222		3,964
Normalised net profit (mn)	3,171	3,737	2,696	4,622	3,222		3,964
Normalised EPS	9.58	11.28	8.14	13.96	9.73		11.97
Norm. EPS growth (%)	-10.9	17.7	-15.1	23.7	19.5		23.0
Norm. P/E (x)	10.9	N/A	12.9	N/A	10.8	N/A	8.8
EV/EBITDA (x)	6.8	5.1	7.2	3.8	5.9		4.3
Price/book (x)	2.5	N/A	2.1	N/A	1.8	N/A	1.6
Dividend yield (%)	2.2	N/A	1.9	N/A	1.9	N/A	2.3
ROE (%)	29.2	24.6	21.7	24.9	18.4		19.5
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash		net cash

Source: Nomura estimates

Key company data: *See page 2 for company data and detailed price/index chart.*

Anchor themes

Investment cycle in India has been disappointing on various external and internal issues. While we remain constructive from a long-term perspective, worsening macro conditions could drive further risks before things improve. Voltas is a key beneficiary of infrastructure capex in India & Middle East.

Nomura vs consensus

Our FY12F EPS forecast is 20% lower than consensus on lower margin expectations in EMP segment.

Research analysts

India Capital Goods

Amar Kedia - NFASL
amar.kedia@nomura.com
+91 22 4037 4182

Lalit Kumar - NFASL
lalit.kumar@nomura.com
+91 22 4037 4511

Indrajit Yadav - NSFSPL
indrajit.yadav@nomura.com
+91 22 4037 4992

See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

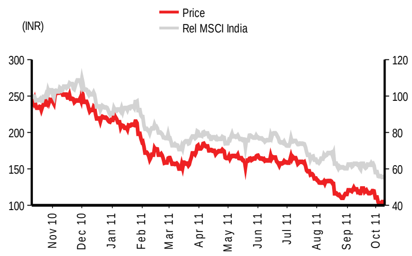
Key data on Voltas

Income statement (INRmn)

Year-end 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
Revenue	**48,236**	**51,914**	**51,643**	**56,027**	**63,540**
Cost of goods sold	-33,206	-37,018	-37,037	-40,182	-45,568
Gross profit	**15,030**	**14,896**	**14,606**	**15,845**	**17,972**
SG&A	-10,475	-10,552	-11,062	-11,800	-12,940
Employee share expense	0	0	0	0	0
Operating profit	**4,555**	**4,344**	**3,544**	**4,044**	**5,032**
EBITDA	**4,769**	**4,554**	**3,969**	**4,503**	**5,523**
Depreciation	-214	-210	-425	-458	-492
Amortisation	0	0	0	0	0
EBIT	4,555	4,344	3,544	4,044	5,032
Net interest expense	-98	-165	-347	-274	-154
Associates & JCEs	0	0	-1	0	0
Other income	612	664	803	1,091	1,091
Earnings before tax	**5,068**	**4,843**	**4,000**	**4,862**	**5,969**
Income tax	-1,472	-1,729	-1,273	-1,604	-1,970
Net profit after tax	**3,595**	**3,114**	**2,726**	**3,257**	**3,999**
Minority interests	-36	57	-31	-36	-36
Other items					
Preferred dividends					
Normalised NPAT	**3,560**	**3,171**	**2,696**	**3,222**	**3,964**
Extraordinary items	250	402	546	0	0
Reported NPAT	**3,810**	**3,572**	**3,241**	**3,222**	**3,964**
Dividends	-615	-768	-655	-651	-800
Transfer to reserves	**3,195**	**2,805**	**2,587**	**2,570**	**3,164**
Valuation and ratio analysis					
FD normalised P/E (x)	9.7	10.9	12.9	10.8	8.8
FD normalised P/E at price target (x)	13.9	15.6	18.4	15.4	12.5
Reported P/E (x)	9.1	9.7	10.7	10.8	8.8
Dividend yield (%)	1.8	2.2	1.9	1.9	2.3
Price/cashflow (x)	11.3	88.4	10.6	13.9	12.1
Price/book (x)	3.2	2.5	2.1	1.8	1.6
EV/EBITDA (x)	6.4	6.8	7.2	5.9	4.3
EV/EBIT (x)	6.7	7.2	8.0	6.5	4.8
Gross margin (%)	31.2	28.7	28.3	28.3	28.3
EBITDA margin (%)	9.9	8.8	7.7	8.0	8.7
EBIT margin (%)	9.4	8.4	6.9	7.2	7.9
Net margin (%)	7.9	6.9	6.3	5.8	6.2
Effective tax rate (%)	29.1	35.7	31.8	33.0	33.0
Dividend payout (%)	16.1	21.5	20.2	20.2	20.2
Capex to sales (%)	0.7	0.9	1.0	0.9	0.8
Capex to depreciation (x)	1.5	2.1	1.2	1.1	1.0
ROE (%)	40.6	29.2	21.7	18.4	19.5
ROA (pretax %)	16.0	13.2	9.7	10.8	12.3
Growth (%)					
Revenue	10.6	7.6	-0.5	8.5	13.4
EBITDA	49.5	-4.5	-12.8	13.4	22.7
EBIT	52.9	-4.6	-18.4	14.1	24.4
Normalised EPS	57.9	-10.9	-15.1	19.5	23.0
Normalised FDEPS	58.1	-10.9	-15.1	19.5	23.0
Per share					
Reported EPS (INR)	11.51	10.80	9.79	9.73	11.97
Norm EPS (INR)	10.75	9.58	8.14	9.73	11.97
Fully diluted norm EPS (INR)	10.75	9.58	8.14	9.73	11.97
Book value per share (INR)	32.78	41.17	48.93	56.69	66.23
DPS (INR)	1.86	2.32	1.98	1.97	2.41

Source: Nomura estimates

Relative performance chart (one year)



Source: ThomsonReuters, Nomura research

(%)	1M	3M	12M
Absolute (INR)	-14.3	-36.6	-56.2
Absolute (USD)	-18.9	-42.8	-60.4
Relative to index	-11.2	-22.6	-34.4
Market cap (USDmn)	705.0		
Estimated free float (%)	0.6		
52-week range (INR)	262.5/102		
3-mth avg daily turnover (USDmn)	3.49		
Major shareholders (%)			
Tata Group of Companies	27.7		
LIC, India	12.9		

Source: Thomson Reuters, Nomura research

Notes

Adverse macro situation drives near-term revenue slowdown

Cashflow (INRmn)

Year-end 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
EBITDA	4,769	4,554	3,969	4,503	5,523
Change in working capital	-526	-3,524	32	-404	-697
Other operating cashflow	-1,177	-638	-728	-1,604	-1,970
Cashflow from operations	**3,065**	**392**	**3,273**	**2,495**	**2,857**
Capital expenditure	-317	-446	-500	-500	-500
Free cashflow	**2,748**	**-54**	**2,773**	**1,995**	**2,357**
Reduction in investments	-775	-271	0	0	0
Net acquisitions	-236	-244	-31	-36	-36
Reduction in other LT assets	350	442	0	0	0
Addition in other LT liabilities	0	0	0	0	0
Adjustments	208	321	801	1,091	1,091
Cashflow after investing acts	**2,295**	**195**	**3,543**	**3,050**	**3,412**
Cash dividends	-615	-768	-655	-651	-800
Equity issue	0	0	0	0	0
Debt issue	-1,463	1,030	1,350	-900	-1,100
Convertible debt issue	0	0	0	0	0
Others	-99	-166	-347	-274	-154
Cashflow from financial acts	**-2,177**	**96**	**349**	**-1,825**	**-2,053**
Net cashflow	**119**	**291**	**3,892**	**1,225**	**1,359**
Beginning cash	4,571	4,689	4,980	8,872	10,097
Ending cash	4,689	4,980	8,872	10,097	11,456
Ending net debt	-4,337	-3,599	-6,142	-8,267	-10,726

Source: Nomura estimates

Notes

FCF generation remains good despite adverse macro

Balance sheet (INRmn)

As at 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
Cash & equivalents	4,689	4,980	8,872	10,097	11,456
Marketable securities	2,030	2,192	2,192	2,192	2,192
Accounts receivable	10,060	11,705	11,636	12,622	14,321
Inventories	11,441	16,185	16,099	17,467	19,821
Other current assets	2,078	2,440	2,440	2,440	2,440
Total current assets	**30,297**	**37,501**	**41,239**	**44,818**	**50,230**
LT investments	309	421	421	421	421
Fixed assets	2,262	2,458	2,533	2,575	2,583
Goodwill	764	916	916	916	916
Other intangible assets	0	0	0	0	0
Other LT assets	204	170	170	170	170
Total assets	**33,837**	**41,466**	**45,279**	**48,900**	**54,320**
Short-term debt	45	101	1,450	850	50
Accounts payable	11,142	13,383	13,312	14,444	16,390
Other current liabilities	8,706	9,692	9,640	10,460	11,869
Total current liabilities	**19,893**	**23,177**	**24,402**	**25,753**	**28,309**
Long-term debt	306	1,280	1,280	980	680
Convertible debt	0	0	0	0	0
Other LT liabilities	2,647	3,175	3,175	3,175	3,175
Total liabilities	**22,846**	**27,631**	**28,857**	**29,908**	**32,164**
Minority interest	139	218	218	218	218
Preferred stock	0	0	0	0	0
Common stock	331	331	331	331	331
Retained earnings	10,521	13,286	15,873	18,444	21,607
Proposed dividends	0	0	0	0	0
Other equity and reserves	0	0	0	0	
Total shareholders' equity	**10,852**	**13,617**	**16,204**	**18,774**	**21,938**
Total equity & liabilities	**33,837**	**41,466**	**45,279**	**48,900**	**54,320**
Liquidity (x)					
Current ratio	1.52	1.62	1.69	1.74	1.77
Interest cover	46.3	26.3	10.2	14.8	32.8
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	74.1	76.5	82.7	79.0	77.4
Days inventory	124.4	136.2	159.5	152.5	149.3
Days payable	126.0	120.9	131.9	126.1	123.5
Cash cycle	72.5	91.8	110.3	105.4	103.2

Source: Nomura estimates

Notes

Pressure on working capital is rising though we expect this to be well contained

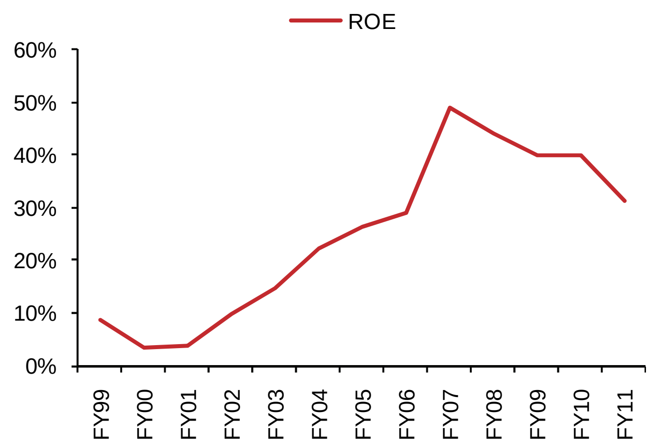
How well is Voltas positioned for a turn in the cycle?

Balance sheet and return efficiency

Consistency of return ratios

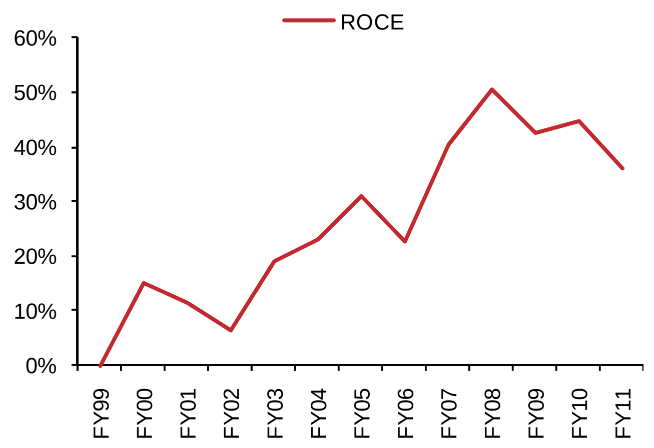
- Voltas' return ratios are significantly higher than the previous cycle (late 1990's) lows despite witnessing a falling trend since the FY07 peak. We note that this is in spite of an almost similar asset turnover ratio in FY99.
- The sharp improvement in return ratios is prima facie, attributed to tight working capital management and a sharp improvement in margins.
- Read across for Blue Star (a key competitor for Voltas in this segment): competitive cushion for Voltas might mean Blue Star has further downside risks on margins

Fig. 46: Return ratios peaked in FY07 but are still attractive…



Source: Company data, Nomura research

Fig. 47: … and much higher than the bottom

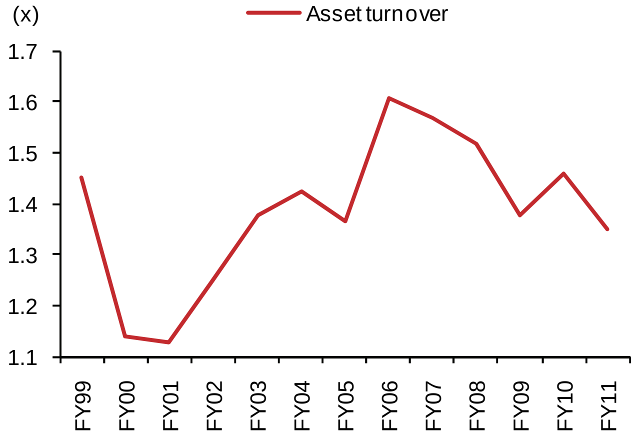


Source: Company data, Nomura research

Management of working capital and asset turnover

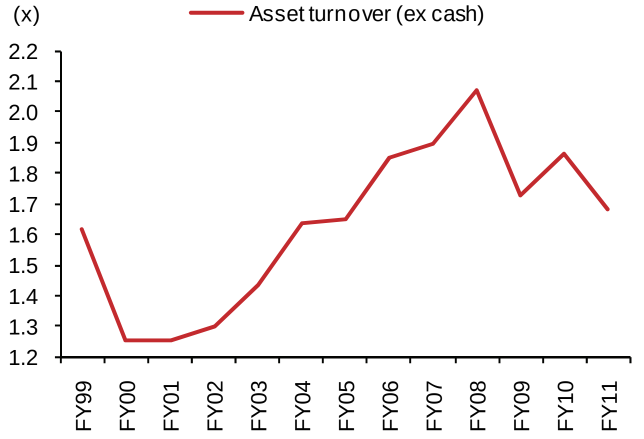
In our opinion, the company's reduced asset turnover since FY07 is primarily led by a cyclical slowdown in order inflows from the domestic and international markets since the FY07/08 peak. However, despite cyclical pressures, the working capital (WC) cycle has held up and improved significantly since the previous cycle. We notice there is a tight rein over receivables days although inventory days have expanded.

Fig. 48: Asset t/o trend similar to ROE/ROCE



Source: Company data, Nomura research

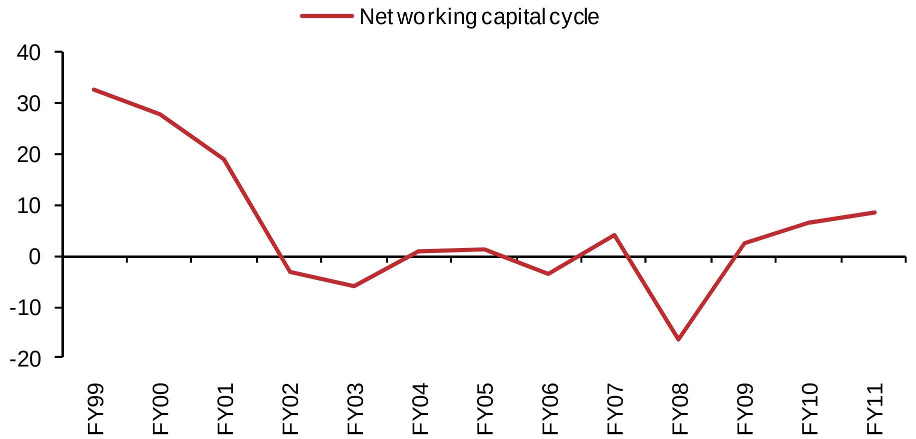
Fig. 49: Asset t/o ex cash is slightly better



Source: Company data, Nomura research

Fig. 50: WC cycle has compressed sharply, but has been inching up slightly since FY08 lows

Days of revenue

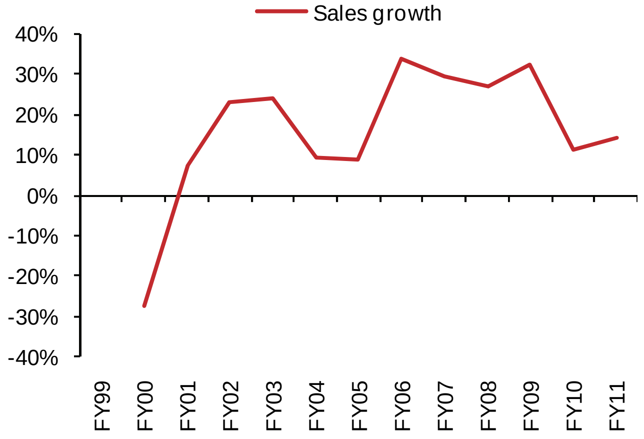


Source: Company data, Nomura research

Trajectory of growth

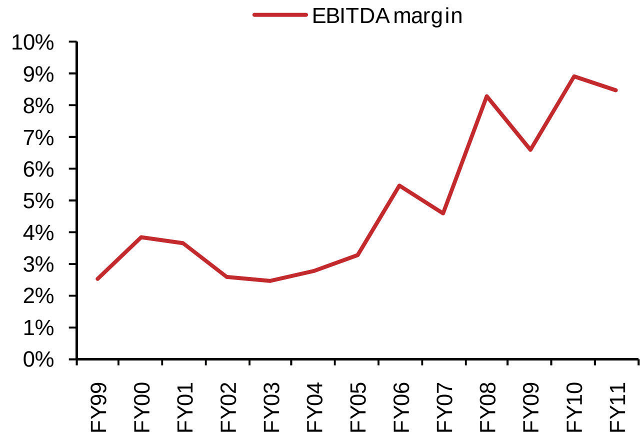
Voltas has consistently maintained a positive double-digit growth trend, even during cyclical lows. Although its sales trend has yet to recover meaningfully from previous lows and the lull in order inflow cycle currently suggests that a pick-up is still some time away, margins have been on a steady uptrend and surprisingly depict very little impact during cyclical lows.

Fig. 51: Sales have been on a secular growth path and, along with compressing WC cycle, explain the rise in asset t/o



Source: Company data, Nomura research

Fig. 52: Margins have been rising and cyclical sensitivity is typically +/- 100 bps; see downside from current levels
% of revenues



Source: Company data, Nomura research

Risks from an adverse turn in the cycle

The company's sales trend suggests that the business has yet to recover from previous cycle lows and its margins seem to be at risk.

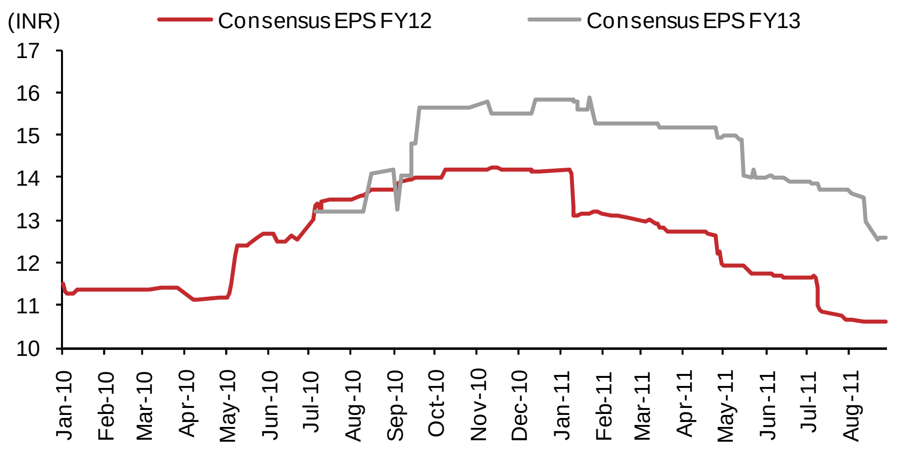
Risk to sales
A slowdown in the international business, along with a domestic lull in order inflows, could mean that the sales trend is likely to remain at current levels or even compress further. We would assign moderate risk of further downside to sales growth.

Risk to margins
Current margin levels are clearly close to peak levels although the risk to margins is typically +/- 100 bps. The previous peak was 8% in FY08, followed by the trough of 6.5% in FY09.

What is consensus estimates building in?

Consensus FY12-13F EPS estimates are down 20-25% from peak levels already. We believe this broadly captures the risk to margins although the risks to sales remain.

Fig. 53: Consensus est. are down 20-25% from peak levels for FY12-13F, thus largely building in earnings risk



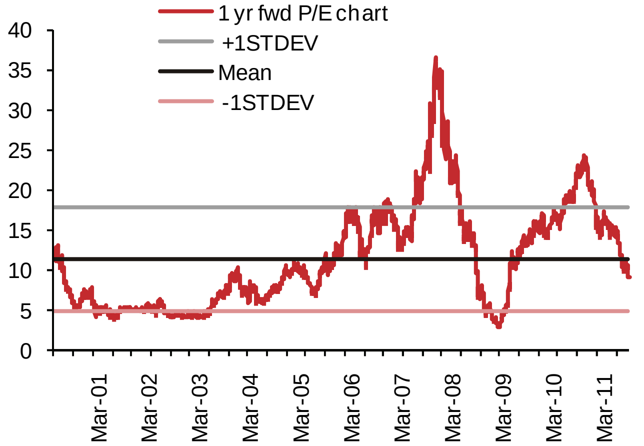
Source: Bloomberg

What is the valuation factoring in?

The stock is trading slightly below its mid-cycle P/E and appears even cheaper on P/BV based on its 12-year historical data. However, compared with the latest five-year historical range, the stock is significantly below its mid-cycle multiples.

Fig. 54: Stock trading below mid-cycle P/E multiples

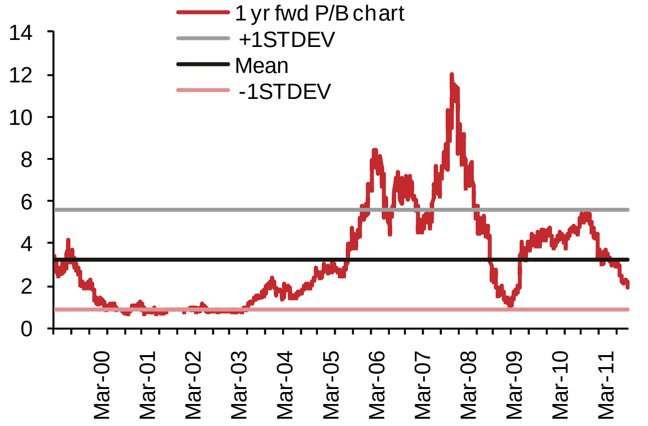
Voltas 1 year forward P/E chart (x)



Source: Company, Bloomberg, Nomura estimates

Fig. 55: …and 0.5 STDEV below mid-cycle P/B multiples

Voltas 1 year forward P/BV chart (x)



Source: Company, Bloomberg, Nomura estimates

Impression: Attractive opportunity, although the business is highly correlated to global macro conditions

Voltas has underperformed the international and domestic markets by 35% over the past 12 months on slowing sales growth and margin concerns. We see limited near-term downside risks from current levels in the bear-case scenario. Under the extreme case, however, the share price could see further downside in the interim. From a long-term perspective, nevertheless, we think the stock is attractive currently and any correction should be seen as an opportunity to accumulate the stock. Our evaluation is based on:

- FY11F margin levels are close to peak levels and we see risk of 100-150bps downside correction from these levels.
- Slowing order flows will likely lead to slower sales growth in both the domestic and international segments. However, we believe the sales trend already reflects market pressure and further downside should be limited.

- Consensus estimates are largely building in margin risks; we caution that further risk could emerge from sales continuing to slow from current levels.
- With earnings risk largely captured in the estimates, we believe current valuation is attractive from a long-term perspective. In our view, the stock could witness some downside upon further sales slowdown but that would be purely cyclical.

Cutting estimates ~30% and TP to INR150 to factor in adverse macro conditions

We cut our FY12-13F earnings by ~30% on increased concerns over its near-term sales and margins outlook in the electro-mechanical and unitary cooling product segments, due to adverse macro conditions. Our revised TP of INR150 is based on 14x (previously: 16.3x) Sep-13F EPS of INR10.85, suggesting 43% implied upside. We assume coverage of the stock with a Buy rating.

Risks that may impede the achievement of the target price

A delay in the pick-up of the domestic capex cycle would pose a key risk to our numbers and target price. Both the domestic Electro Mechanical Projects (EMP) (31% of revenue) and Engineering Products and Services (EPS) (9% of revenue) businesses are dependent on domestic capex spending and would likely be affected by any delay in capex.

Thermax THMX.NS TMX IN .

ELECTRICAL EQUIPMENT

NOMURA
EQUITY RESEARCH

Buy into the correction

Visible earnings risk priced in, but may fare worse in an extreme case

October 12, 2011

Rating Up from Neutral	**Buy**
Target price Reduced from 645	INR 500
Closing price October 7, 2011	INR 418
Potential upside	+19.6%

Impression: Strong fundamentals; upgrade to Buy

Given a 53% correction YTD, we think the stock now factors in the risks to business momentum. While we note that a severe global slowdown would drive further downside, we take this opportunity to upgrade the stock to Buy for the company's solid business fundamentals and strong track record during previous cycles. We base our evaluation on:

- FY11 margins have yet to recover from the previous cycle's low levels, while risk from current levels should be, at best, 200 bps, in our view.
- Slower order flow and rising competition in the utility space are likely to lead to slower sales growth over FY12-13F, we believe, though longer-term order flow should be driven by continued demand from process industries.
- While consensus estimates on the stock are down 10-20%, we think valuations already factor in the greater risk.

Strongly poised for cyclical revival...

Thermax remains among the biggest potential beneficiaries of demand for captive power plant and rising industrial capex, especially for process-flow industries such as metals, oil & gas and cement. Given a strong long-term opportunity and limited competition, we are positive on the fundamentals of the company and view the current downturn as a buying opportunity.

...but near-term slowdown drives 10-25% earnings cut

Over FY12-13F, we expect both sales growth and margins to take a hit, so our TP moves lower to INR500 as we now rebase it to 14x (from 16x) on Sep-13F EPS of INR36 (from Mar-13F EPS). Nevertheless, with potential upside of 20% to our new TP, we upgrade the stock to Buy.

31 Mar	FY11		FY12F		FY13F		FY14F
Currency (INR)	Actual	Old	New	Old	New	Old	New
Revenue (mn)	53,371	58,914	59,818	69,648	59,246		70,019
Reported net profit (mn)	3,817	3,932	4,127	4,780	3,912		4,671
Normalised net profit (mn)	3,817	3,932	4,127	4,780	3,912		4,671
Normalised EPS	32.03	33.00	34.64	40.11	32.83		39.20
Norm. EPS growth (%)	47.3	1.9	8.1	21.6	-5.2		19.4
Norm. P/E (x)	13.1	N/A	12.1	N/A	12.7	N/A	10.7
EV/EBITDA (x)	7.6	7.0	6.6	5.7	6.7		5.4
Price/book (x)	3.8	N/A	3.1	N/A	2.6	N/A	2.3
Dividend yield (%)	2.5	N/A	2.4	N/A	2.3	N/A	2.7
ROE (%)	31.9	26.4	28.2	26.6	22.4		22.8
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash		net cash

Source: Nomura estimates

Key company data: *See page 2 for company data and detailed price/index chart.*

Anchor themes

We believe India's industrial sector offers significant opportunity over the coming years. We see potential opportunities in niche segments.

Nomura vs consensus

We are more cautious than consensus on near-term earnings strength given our expectation of an industrial slowdown.

Research analysts

India Capital Goods

Amar Kedia - NFASL
amar.kedia@nomura.com
+91 22 4037 4182

Indrajit Yadav - NSFSPL
indrajit.yadav@nomura.com
+91 22 4037 4992

See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

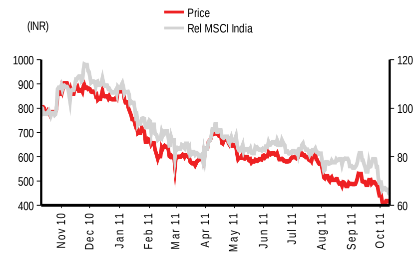
Key data on Thermax

Income statement (INRmn)

Year-end 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
Revenue	**33,703**	**53,371**	**59,818**	**59,246**	**70,019**
Cost of goods sold	-20,713	-36,787	-40,487	-39,281	-47,139
Gross profit	**12,990**	**16,584**	**19,331**	**19,965**	**22,880**
SG&A	-6,186	-6,788	-8,146	-8,553	-9,409
Employee share expense	-3,300	-4,597	-5,517	-6,068	-6,979
Operating profit	**3,505**	**5,199**	**5,669**	**5,343**	**6,493**
EBITDA	**3,947**	**5,740**	**6,352**	**6,116**	**7,355**
Depreciation	-442	-541	-683	-773	-863
Amortisation					
EBIT	3,505	5,199	5,669	5,343	6,493
Net interest expense	-20	-41	-50	-50	-50
Associates & JCEs					
Other income	519	579	635	635	635
Earnings before tax	**4,004**	**5,737**	**6,253**	**5,928**	**7,078**
Income tax	-1,416	-1,967	-2,126	-2,015	-2,406
Net profit after tax	**2,588**	**3,770**	**4,127**	**3,912**	**4,671**
Minority interests	4	47	0	0	0
Other items					
Preferred dividends					
Normalised NPAT	**2,592**	**3,817**	**4,127**	**3,912**	**4,671**
Extraordinary items	-1,149	0	0	0	0
Reported NPAT	**1,443**	**3,817**	**4,127**	**3,912**	**4,671**
Dividends	-695	-1,246	-1,203	-1,141	-1,362
Transfer to reserves	**748**	**2,570**	**2,924**	**2,772**	**3,310**
Valuation and ratio analysis					
FD normalised P/E (x)	19.2	13.1	12.1	12.7	10.7
FD normalised P/E at price target (x)	23.0	15.6	14.4	15.2	12.8
Reported P/E (x)	34.5	13.1	12.1	12.7	10.7
Dividend yield (%)	1.4	2.5	2.4	2.3	2.7
Price/cashflow (x)	7.5	21.7	8.7	16.0	13.7
Price/book (x)	4.6	3.8	3.1	2.6	2.3
EV/EBITDA (x)	11.0	7.6	6.6	6.7	5.4
EV/EBIT (x)	12.3	8.4	7.4	7.7	6.1
Gross margin (%)	38.5	31.1	32.3	33.7	32.7
EBITDA margin (%)	11.7	10.8	10.6	10.3	10.5
EBIT margin (%)	10.4	9.7	9.5	9.0	9.3
Net margin (%)	4.3	7.2	6.9	6.6	6.7
Effective tax rate (%)	35.4	34.3	34.0	34.0	34.0
Dividend payout (%)	48.1	32.7	29.2	29.2	29.2
Capex to sales (%)	2.5	6.1	2.5	2.5	2.1
Capex to depreciation (x)	1.9	6.0	2.2	1.9	1.7
ROE (%)	13.9	31.9	28.2	22.4	22.8
ROA (pretax %)	14.8	17.2	16.2	14.9	17.4
Growth (%)					
Revenue	-2.6	58.4	12.1	-1.0	18.2
EBITDA	-6.4	45.4	10.7	-3.7	20.3
EBIT	-9.4	48.3	9.0	-5.7	21.5
Normalised EPS	-9.9	47.3	8.1	-5.2	19.4
Normalised FDEPS	-9.9	47.3	8.1	-5.2	19.4
Per share					
Reported EPS (INR)	12.11	32.03	34.64	32.83	39.20
Norm EPS (INR)	21.75	32.03	34.64	32.83	39.20
Fully diluted norm EPS (INR)	21.75	32.03	34.64	32.83	39.20
Book value per share (INR)	90.48	110.35	134.89	158.15	185.93
DPS (INR)	5.83	10.46	10.10	9.57	11.43

Source: Nomura estimates

Relative performance chart (one year)



Source: ThomsonReuters, Nomura research

(%)	1M	3M	12M
Absolute (INR)	-21.1	-31.3	-48.0
Absolute (USD)	-25.3	-38.1	-53.0
Relative to index	-17.9	-17.4	-26.1
Market cap (USDmn)	1,014.0		
Estimated free float (%)	33.9		
52-week range (INR)	930/406		
3-mth avg daily turnover (USDmn)	2.12		
Major shareholders (%)			
RDA Holding & Trading	54.0		
Aga Arnawaz Rohitz	8.2		

Source: Thomson Reuters, Nomura research

Notes

Near-term earnings and sales trend reflective of cyclical woes.

Cashflow (INRmn)

Year-end 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
EBITDA	3,947	5,740	6,352	6,116	7,355
Change in working capital	4,687	-2,118	888	-1,562	-1,266
Other operating cashflow	-2,002	-1,326	-1,541	-1,430	-2,456
Cashflow from operations	**6,632**	**2,295**	**5,698**	**3,124**	**3,632**
Capital expenditure	-838	-3,265	-1,500	-1,500	-1,500
Free cashflow	**5,794**	**-970**	**4,198**	**1,624**	**2,132**
Reduction in investments	-2,260	1,289	-875	0	0
Net acquisitions					
Reduction in other LT assets	-90	7	0	0	0
Addition in other LT liabilities	74	147	0	0	0
Adjustments	46	-305	0	0	
Cashflow after investing acts	**3,564**	**168**	**3,323**	**1,624**	**2,132**
Cash dividends	-695	-1,246	-1,203	-1,141	-1,362
Equity issue	0	0	0	0	0
Debt issue	39	1,400	-1,399	0	0
Convertible debt issue					
Others	98	473	0	0	635
Cashflow from financial acts	**-558**	**626**	**-2,603**	**-1,141**	**-727**
Net cashflow	**3,006**	**794**	**720**	**483**	**1,406**
Beginning cash	3,696	6,702	7,496	8,217	8,699
Ending cash	6,702	7,496	8,217	8,700	10,105
Ending net debt	-6,623	-6,017	-8,137	-8,619	-10,025

Source: Nomura estimates

Notes

Cash-flow generation remains reasonable despite cyclical pressures.

Balance sheet (INRmn)

As at 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
Cash & equivalents	6,702	7,496	8,217	8,699	10,105
Marketable securities	0	0	0	0	0
Accounts receivable	7,984	10,672	11,309	9,591	11,354
Inventories	2,563	3,657	4,016	3,885	4,669
Other current assets	7,057	8,143	8,586	8,543	9,278
Total current assets	**24,306**	**29,968**	**32,127**	**30,718**	**35,405**
LT investments	3,703	2,415	3,290	3,290	3,290
Fixed assets	5,484	8,208	9,025	9,752	10,389
Goodwill					
Other intangible assets					
Other LT assets	297	289	289	289	289
Total assets	**33,790**	**40,880**	**44,730**	**44,049**	**49,373**
Short-term debt	80	1,479	80	80	80
Accounts payable	20,581	22,193	24,536	21,100	22,821
Other current liabilities	1,813	2,951	2,934	2,917	3,210
Total current liabilities	**22,474**	**26,623**	**27,550**	**24,097**	**26,111**
Long-term debt					
Convertible debt					
Other LT liabilities	441	588	588	588	588
Total liabilities	**22,914**	**27,211**	**28,138**	**24,685**	**26,699**
Minority interest	94	520	520	520	520
Preferred stock	0	0	0	0	0
Common stock	238	238	238	238	238
Retained earnings	10,543	12,911	15,835	18,606	21,916
Proposed dividends					
Other equity and reserves					
Total shareholders' equity	**10,782**	**13,149**	**16,073**	**18,845**	**22,154**
Total equity & liabilities	**33,790**	**40,880**	**44,730**	**44,049**	**49,373**
Liquidity (x)					
Current ratio	1.08	1.13	1.17	1.27	1.36
Interest cover	172.7	126.8	113.4	106.9	129.9
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	74.2	63.8	67.2	64.4	54.6
Days inventory	47.3	30.9	34.7	36.7	33.1
Days payable	287.7	212.2	211.2	212.0	170.0
Cash cycle	-166.2	-117.5	-109.3	-110.9	-82.3

Source: Nomura estimates

Notes

Unlevered balance sheet provides room for growth.

How well is Thermax positioned for a turn in the cycle?

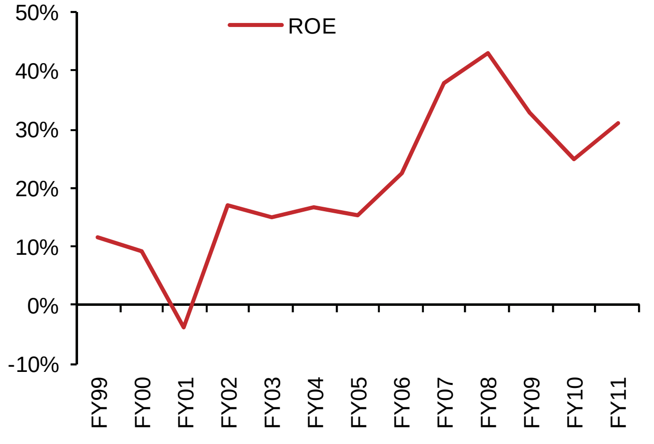
Balance sheet and return efficiency

Consistency of return ratios

We have seen significant improvement in return ratios for Thermax since the lows of the late 1990s. At the same time, the impact of cyclicality is clearly visible in the trend, though volatility is far lower than it was in the late 1990s. Even during the Lehman crisis, the low point was much higher than the late 1990s level. In absolute terms, even the current cyclical low ROE/ROCE in the 30-40% range is attractive, in our view.

Fig. 56: Return ratios have risen sharply since late 1990s crisis ...

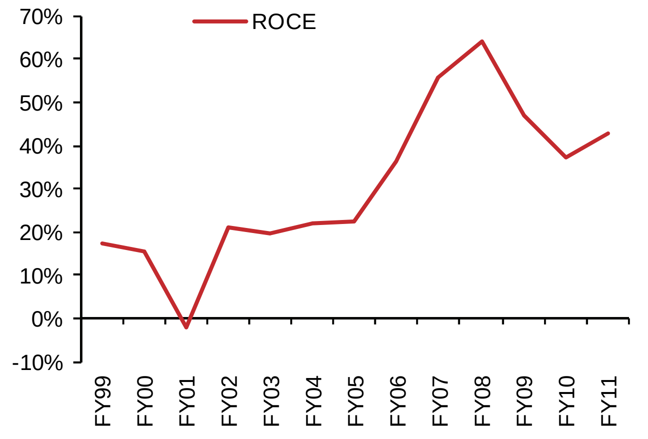
%



Source: Company, Nomura research

Fig. 57: ... and peaked in FY08; current levels also attractive

%



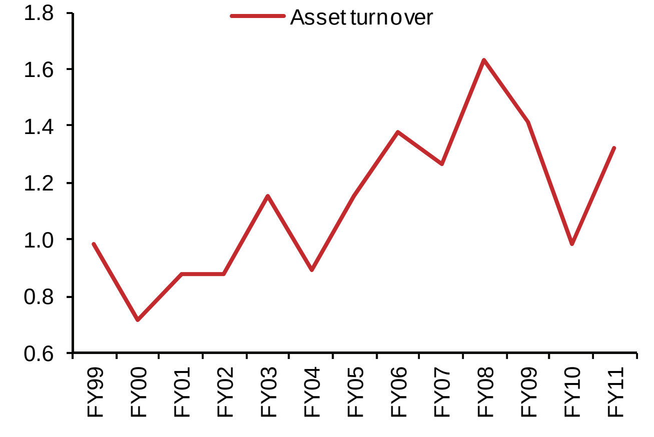
Source: Company, Nomura research

Managing working capital and asset turnover

While rising sales and, hence, asset turnover, has greatly helped Thermax report a strong improvement in return ratios, we also note a significant decline in its working-capital cycle since FY01. Over the past three years, its working-capital cycle has been flat despite pressure on receivable days.

Fig. 58: Asset turnover helps to explain the rise in return ratios

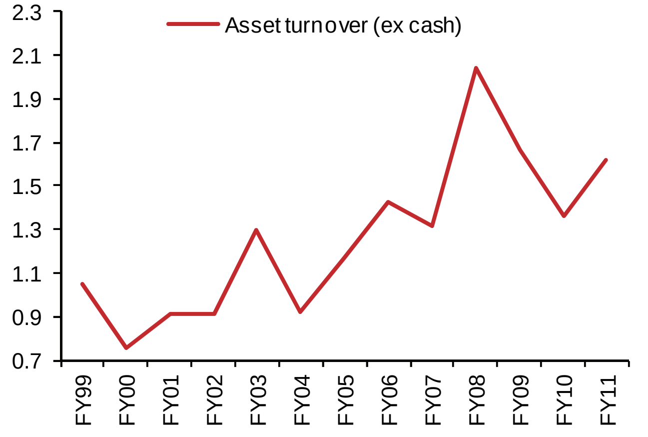
(x)



Source: Company, Nomura research

Fig. 59: Asset turnover ex cash is largely in sync, suggesting optimal cash management

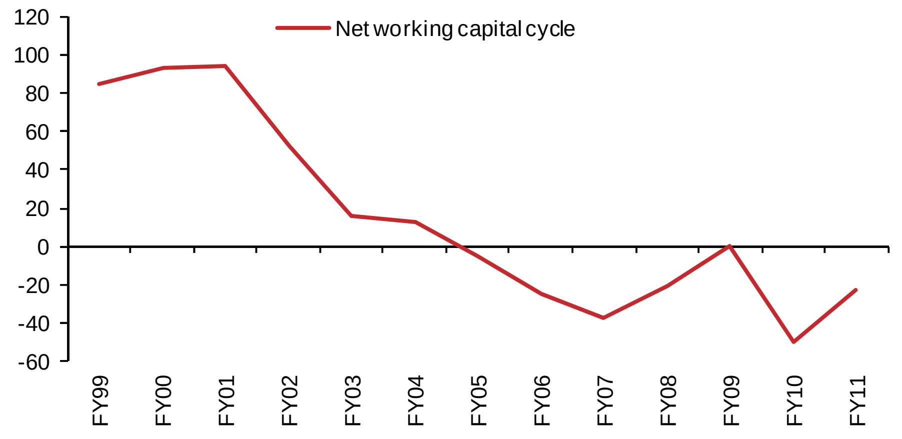
(x)



Source: Company, Nomura research

Fig. 60: Sharp compression in working-capital cycle over the past three years suggests purely sales-led fall in asset t/o

Days of revenue



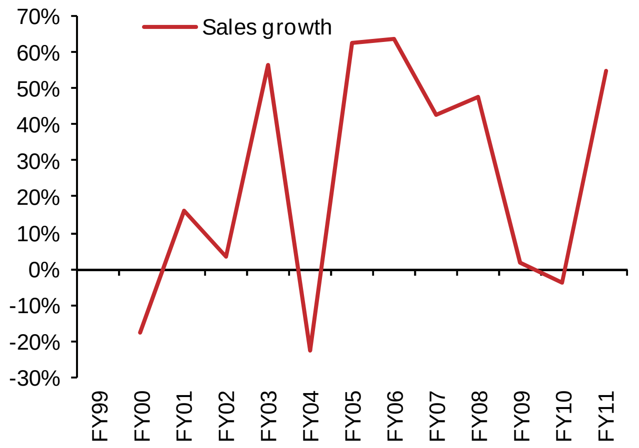
Source: Company, Nomura research

Trajectory of growth

Thermax's sales have been highly volatile around changes in cycles, but for the most part have grown 40% p.a. since FY03. Margins have also witnessed a sharp improvement since the FY02 bottom and have been moving within a narrow range of +/- 200 bps of 12% since FY04.

Fig. 61: Volatile sales growth trend, but largely above 40% pa

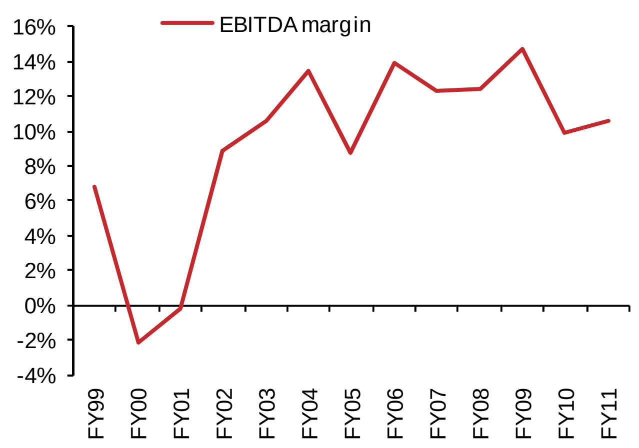
%



Source: Company, Nomura research

Fig. 62: Sharp rise in margins since FY02 and has been steady since then, within + / - 200 bps from 12%

% of revenues



Source: Company, Nomura research

Risks from a turn in cycle

The sales trend suggests that business is currently close to peak-cycle levels, though margins have not revived much since their FY10 bottom.

Risk to sales

There may be risk to sales growth for Thermax in the near term, as the recent surge in Thermax's sales following a high share of utility orders looks unsustainable over the long term. Slowing industrial capex could add further pressure. As the sales growth chart suggests, in the past growth has suddenly fallen from the high 40s into negative territory during adverse times. We do not rule out a similar slowdown from current levels in case of a severe slowdown in the domestic industrial capex.

Risk to margins

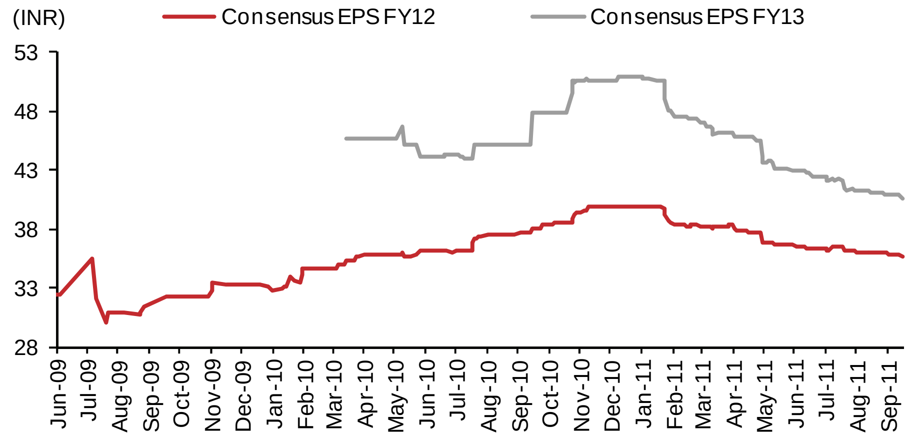
Margins are now much better than in previous peaks or lows as a result of sustained improvement in business performance. We are also confident because the lows during the Lehman crisis were much higher than the lows in the late 1990s. In our view, the next recession might not see margins collapsing below 8% levels, which is another 200 bps risk from current levels. In contrast, our estimates build in 50 bps of margin risk from current levels.

What are consensus estimates building in?

Even as we highlight the risk of a slowdown in sales growth and about a 200 bp risk to margins, we believe consensus estimates have yet to factor these in. So far we have seen 10-20% correction in consensus EPS estimates since peak levels for both FY12 and FY13, but factoring in the above, we see [10-15%] further downside in consensus estimates. As discussed next though, valuations have already corrected more than what consensus estimates suggest and in that sense we believe the markets are already building in the anticipated earnings risk.

Fig. 63: FY12/13F est. down just 10-20% from peak so far

INR



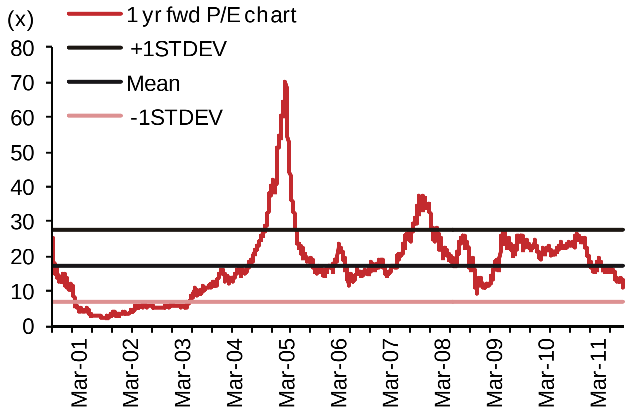
Source: Bloomberg

What is the valuation factoring in?

While consensus estimates have yet to correct, as mentioned above we note that the stock is already trading below its12-year mean multiples. A correction in earnings would imply that the stock is still at around its mid-cycle trading range.

Fig. 64: Stock trading below 12-yr mean on P/E…

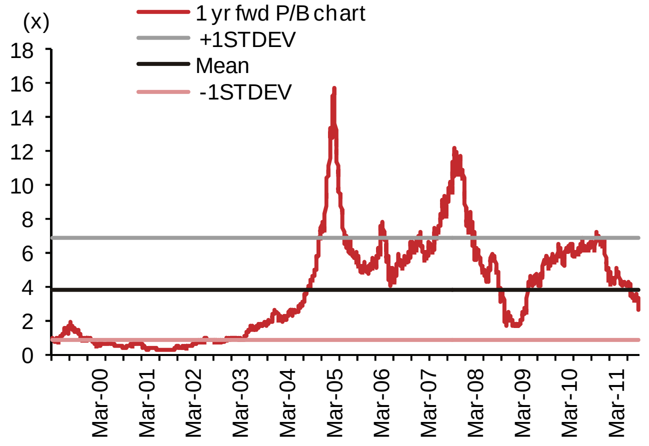
Thermax 1-year forward P/E chart (x)



Source: Company, Bloomberg, Nomura estimates

Fig. 65: …and on P/B as well

Thermax 1-year forward P/B chart (x)



Source: Company, Bloomberg, Nomura estimates

Strong fundamentals and correction offer an opportunity

With Thermax stock having underperformed overall markets 39% over the past 12 months, and the possibility that there may be further downside risks in the stock in the short term under a more extreme case scenario, on a long-term perspective, we think the stock offers value and that the correction offers an opportunity to accumulate. We base our evaluation on:

- FY11 margin levels have yet to recover from the previous cycle's low levels. Risk from current levels should be 200 bps at best, in our view.
- Slower order flow should lead to slower sales growth. Thermax's virtual exit from the utility space due to rising competition will also lead to a slowdown in sales, in our view. Longer-term, however, we remain convinced of TMX's ability to garner orders from a sustainable flow of industrial capex activity especially in the process flow domain such as oil & gas, metals, cements etc.
- Consensus estimates are down 10-20%, but we believe the valuation has already factored in the greater risk.
- Given Thermax's fair-value range and its robust business fundamentals, we recommend Buy and would use any further downside as an enhanced buying opportunity.

Cutting estimates on slowdown concerns; upgrade to Buy on attractive valuation

While Thermax's short-cycle products business is likely to continue in the near term, we believe there are risks to its projects business, especially in the power sector. Further, Thermax has witnessed high volatility during cycle turns and we believe that this time will be no different, though as discussed above, this is already built into the stock price now. Policy logjams impacting decision-making on large industrial and power capex are only likely to worsen the scenario, in our view.

Thus, we have factored in significantly slower growth for Thermax over FY12-13, which is accompanied by drop in margins too; our new assumptions drive our earnings cut of 10-25% over FY12-13F. We expect a revival in FY14.

Accordingly, we have cut our TP to INR500, now based on 14x Sep-13F EPS (from Mar-13 earlier) of INR36. Our assigned multiple of 14x is slightly lower than the 16x we assigned earlier (which is also the past 5-6 years' mean multiple). This is because we now align our valuation with the mean of the past 12 years, instead of just the past 6 years, as this is more relevant, in our view.

Despite our earnings and TP cuts, we believe the stock offers a potential upside of 19.6% to our new TP. Given Thermax's fundamentally strong business, which, in our view, is nicely poised to benefit from the cyclical upturn post the current slowdown we upgrade the stock to a Buy rating. Nevertheless, we caution that in the event of an extreme macro slowdown, the stock could see near term pressure.

Risks to our call

- Continued fuel shortages could stall demand for power projects.
- Thermax's move towards the utility boiler business could hit profitability substantially given high competition in that segment.
- Firming coal prices would reduce demand for captive power plants.

A severe global and domestic slowdown could lead to industrial capex deferral and that would be negative for Thermax.

ABB India ABB.NS ABB IN .

ELECTRICAL EQUIPMENT

NOMURA
EQUITY RESEARCH

Short circuit

Premium valuations continue despite worsening performance on buyback expectations

October 12, 2011

Rating Remains	**Reduce**
Target price Reduced from 585	INR 525
Closing price October 7, 2011	INR 666
Potential downside	-21.2%

Still expensive as near-term inflows remain elusive; Reduce

- ABB India appears suitably placed to tap into opportunities in India's T&D equipment sector, in our view, with access to high-end technology, presence across the value chain, and superior execution. Furthermore, the parent sees ABB India as an outsourcing hub and, we believe, it could increase outsourcing from the Indian unit, given its cost differentials compared with the parent's high-cost European base.
- While we remain positive on the long-term opportunity in the Indian T&D space, we see PGCIL's ordering activity picking up only in 2H FY12F, while SEB orders are still elusive. Rising SEB losses are also a concern, since they imply lower spending power with the distribution companies for new capex. Meanwhile, we foresee a slowdown in industrial capex as likely to hit the automation business in the near term; this business contributes ~40% of ABB's revenue and is highly dependent on the oil & gas and metal capex cycles.
- Price competition has affected the sector due to the influx of Chinese and Korean players and continued technology upgrading by select domestic vendors. On the positive side though, the company has largely accounted for losses from the rural electrification business and this should ease margin pressure, in our view.
- Valuation: We have cut our estimates by 15-20% to factor in poor macro conditions and reduced our TP to INR525. While earnings continue to disappoint, ABB has held on to steep valuations on expectations of further buybacks by the parent. Reaffirm Reduce on ~21% potential downside.

31 Dec	FY10	FY11F		FY12F		FY13F	
Currency (INR)	Actual	Old	New	Old	New	Old	New
Revenue (mn)	62,871	75,445	72,302	94,307	83,509		96,870
Reported net profit (mn)	632	3,623	3,112	5,778	4,604		5,854
Normalised net profit (mn)	1,399	3,623	3,112	5,778	4,604		5,854
Normalised EPS	6.60	17.10	14.69	27.27	21.73		27.63
Norm. EPS growth (%)	-60.4	159.0	122.5	59.5	47.9		27.1
Norm. P/E (x)	101.6	N/A	45.7	N/A	30.9	N/A	24.3
EV/EBITDA (x)	76.4	26.6	30.9	16.0	20.2		15.4
Price/book (x)	5.9	N/A	5.3	N/A	4.6	N/A	3.9
Dividend yield (%)	0.3	N/A	0.3	N/A	0.5	N/A	0.6
ROE (%)	2.6	14.0	12.1	19.3	15.9		17.5
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash		net cash

Source: Nomura estimates

Key company data: *See page 2 for company data and detailed price/index chart.*

Anchor themes

Decades of under-investment in T&D infrastructure and a sudden march towards a power-sufficient nation promise opportunities for equipment manufacturers.

Nomura vs consensus

We are in line with consensus on both earnings and valuation.

Research analysts

India Capital Goods

Amar Kedia - NFASL
amar.kedia@nomura.com
+91 22 4037 4182

Indrajit Yadav - NSFSPL
indrajit.yadav@nomura.com
+91 22 4037 4992

See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

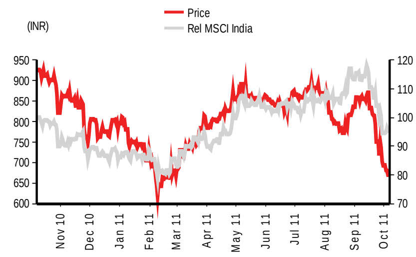
Key data on ABB India

Income statement (INRmn)

Year-end 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
Revenue	**62,372**	**62,871**	**72,302**	**83,509**	**96,870**
Cost of goods sold	-45,664	-48,538	-54,067	-61,196	-70,490
Gross profit	**16,708**	**14,334**	**18,235**	**22,313**	**26,380**
SG&A	-8,027	-8,165	-8,982	-10,329	-11,982
Employee share expense	-3,892	-4,901	-5,391	-6,011	-6,733
Operating profit	**4,789**	**1,267**	**3,862**	**5,973**	**7,666**
EBITDA	**5,274**	**1,784**	**4,425**	**6,625**	**8,409**
Depreciation	-485	-517	-564	-652	-744
Amortisation					
EBIT	4,789	1,267	3,862	5,973	7,666
Net interest expense	-256	-174	-200	-250	-250
Associates & JCEs					
Other income	726	855	984	1,253	1,453
Earnings before tax	**5,259**	**1,948**	**4,645**	**6,975**	**8,869**
Income tax	-1,728	-550	-1,533	-2,371	-3,014
Net profit after tax	**3,531**	**1,399**	**3,112**	**4,604**	**5,854**
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	**3,531**	**1,399**	**3,112**	**4,604**	**5,854**
Extraordinary items	0	-766	0	0	0
Reported NPAT	**3,531**	**632**	**3,112**	**4,604**	**5,854**
Dividends	-496	-496	-437	-646	-822
Transfer to reserves	**3,035**	**136**	**2,675**	**3,958**	**5,032**
Valuation and ratio analysis					
FD normalised P/E (x)	40.2	101.6	45.7	30.9	24.3
FD normalised P/E at price target (x)	31.5	79.5	35.7	24.2	19.0
Reported P/E (x)	40.2	224.7	45.7	30.9	24.3
Dividend yield (%)	0.3	0.3	0.3	0.5	0.6
Price/cashflow (x)	42.0	65.6	146.5	26.9	20.4
Price/book (x)	5.9	5.9	5.3	4.6	3.9
EV/EBITDA (x)	26.0	76.4	30.9	20.2	15.4
EV/EBIT (x)	28.6	107.5	35.4	22.5	16.9
Gross margin (%)	26.8	22.8	25.2	26.7	27.2
EBITDA margin (%)	8.5	2.8	6.1	7.9	8.7
EBIT margin (%)	7.7	2.0	5.3	7.2	7.9
Net margin (%)	5.7	1.0	4.3	5.5	6.0
Effective tax rate (%)	32.9	28.2	33.0	34.0	34.0
Dividend payout (%)	14.0	78.4	14.0	14.0	14.0
Capex to sales (%)	1.5	1.4	1.7	2.4	1.4
Capex to depreciation (x)	1.9	1.7	2.1	3.1	1.8
ROE (%)	15.5	2.6	12.1	15.9	17.5
ROA (pretax %)	9.5	2.5	7.0	9.7	11.3
Growth (%)					
Revenue	-8.8	0.8	15.0	15.5	16.0
EBITDA	-31.5	-66.2	148.1	49.7	26.9
EBIT	-34.7	-73.5	204.7	54.7	28.3
Normalised EPS	-35.0	-60.4	122.5	47.9	27.1
Normalised FDEPS	-35.0	-60.4	122.5	47.9	27.1
Per share					
Reported EPS (INR)	16.66	2.98	14.69	21.73	27.63
Norm EPS (INR)	16.66	6.60	14.69	21.73	27.63
Fully diluted norm EPS (INR)	16.66	6.60	14.69	21.73	27.63
Book value per share (INR)	114.38	114.38	127.64	146.32	170.07
DPS (INR)	2.34	2.34	2.06	3.05	3.88

Source: Nomura estimates

Relative performance chart (one year)



Source: ThomsonReuters, Nomura research

(%)	1M	3M	12M
Absolute (INR)	-20.9	-22.2	-27.4
Absolute (USD)	-26.2	-29.9	-34.5
Relative to index	-14.8	-6.0	-2.2
Market cap (USDmn)	2,879.6		
Estimated free float (%)	25.0		
52-week range (INR)	955/595		
3-mth avg daily turnover (USDmn)	1.89		
Major shareholders (%)			
ABB Asea Brown Boveri	69.1		
LIC	9.5		

Source: Thomson Reuters, Nomura research

Notes

We expect margins to recover but remain lower than normal levels

Cashflow (INRmn)

Year-end 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
EBITDA	5,274	1,784	4,425	6,625	8,409
Change in working capital	-631	1,017	-2,706	19	385
Other operating cashflow	-1,258	-635	-749	-1,368	-1,811
Cashflow from operations	**3,385**	**2,166**	**970**	**5,275**	**6,983**
Capital expenditure	-916	-860	-1,200	-2,000	-1,336
Free cashflow	**2,469**	**1,307**	**-230**	**3,275**	**5,647**
Reduction in investments	442	1	0	0	0
Net acquisitions					
Reduction in other LT assets	0	0	0	0	0
Addition in other LT liabilities	-39	-45	0	0	0
Adjustments	-656	-137	137	0	
Cashflow after investing acts	**2,216**	**1,126**	**-93**	**3,275**	**5,647**
Cash dividends	-496	-496	-437	-646	-822
Equity issue	0	0	0	0	0
Debt issue	0	0	0	0	0
Convertible debt issue					
Others	39				
Cashflow from financial acts	**-457**	**-496**	**-437**	**-646**	**-822**
Net cashflow	**1,759**	**630**	**-530**	**2,629**	**4,825**
Beginning cash	3,482	5,241	5,871	5,341	7,970
Ending cash	5,241	5,871	5,341	7,970	12,795
Ending net debt	-5,241	-5,871	-5,341	-7,970	-12,795

Source: Nomura estimates

Balance sheet (INRmn)

As at 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
Cash & equivalents	5,241	5,871	5,341	7,970	12,795
Marketable securities	0	0	0	0	0
Accounts receivable	28,577	29,260	33,675	36,606	39,810
Inventories	7,294	6,979	7,769	8,294	9,554
Other current assets	6,380	7,153	8,226	9,501	11,021
Total current assets	**47,493**	**49,262**	**55,010**	**62,371**	**73,179**
LT investments	169	168	168	168	168
Fixed assets	7,895	8,238	8,874	10,222	10,815
Goodwill					
Other intangible assets					
Other LT assets	0	0	0	0	0
Total assets	**55,556**	**57,668**	**64,052**	**72,761**	**84,162**
Short-term debt					
Accounts payable	29,869	31,630	35,242	39,879	45,941
Other current liabilities	1,450	1,846	1,808	1,921	2,228
Total current liabilities	**31,320**	**33,477**	**37,049**	**41,800**	**48,169**
Long-term debt	0	0	0	0	0
Convertible debt					
Other LT liabilities	-1	-46	-46	-46	-46
Total liabilities	**31,319**	**33,431**	**37,003**	**41,754**	**48,123**
Minority interest					
Preferred stock					
Common stock	424	424	424	424	424
Retained earnings	23,813	23,813	26,625	30,583	35,615
Proposed dividends					
Other equity and reserves					
Total shareholders' equity	**24,237**	**24,237**	**27,049**	**31,007**	**36,039**
Total equity & liabilities	**55,556**	**57,668**	**64,052**	**72,761**	**84,162**
Liquidity (x)					
Current ratio	1.52	1.47	1.48	1.49	1.52
Interest cover	18.7	7.3	19.3	23.9	30.7
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	170.7	167.9	158.9	154.0	144.0
Days inventory	54.8	53.7	49.8	48.0	46.2
Days payable	245.7	231.2	225.7	224.6	222.2
Cash cycle	-20.2	-9.7	-17.1	-22.6	-32.0

Source: Nomura estimates

Notes

Clean balance sheet with net cash

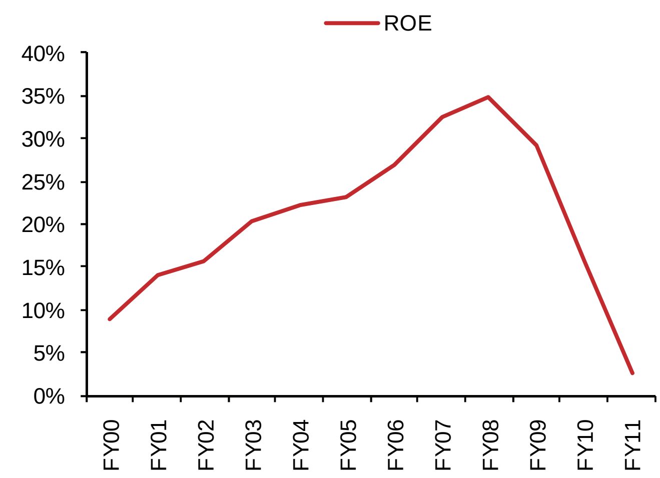
How well is ABB India best positioned for a turn in the cycle?

Balance sheet and return efficiency

Consistency of return ratios

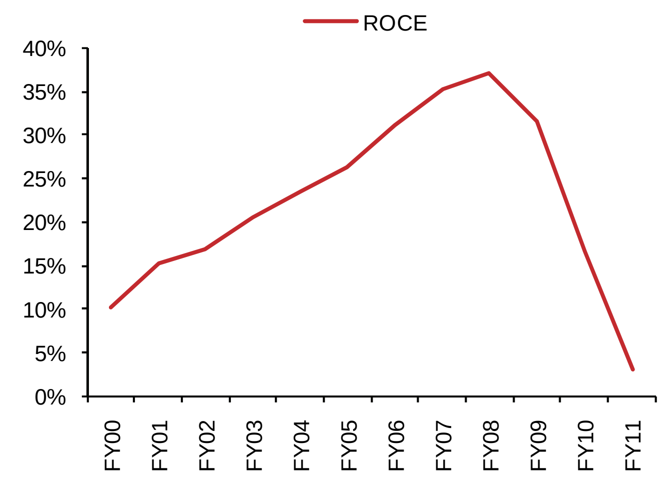
- ABB India has witnessed severe erosion in its return profile since FY08.
- In fact, returns since FY06 could arguably be lower than what is visible, given that growth in the rural electrification business then had pumped-up returns during that period.

Fig. 66: Sharp deterioration in return profile…



Source: Company, Nomura research

Fig. 67: …on a move into rural business

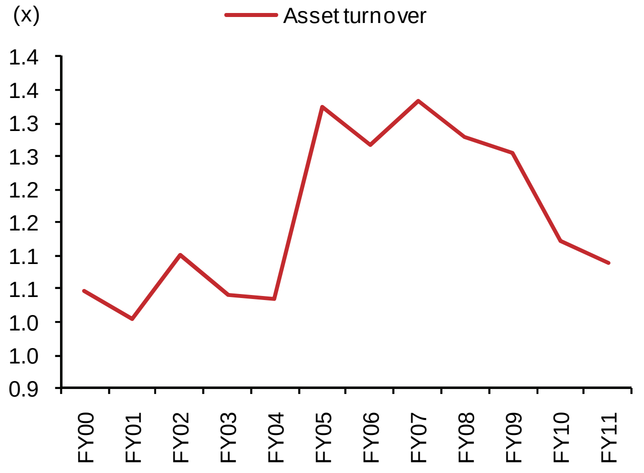


Source: Company, Nomura research

Management of working capital and asset turnover

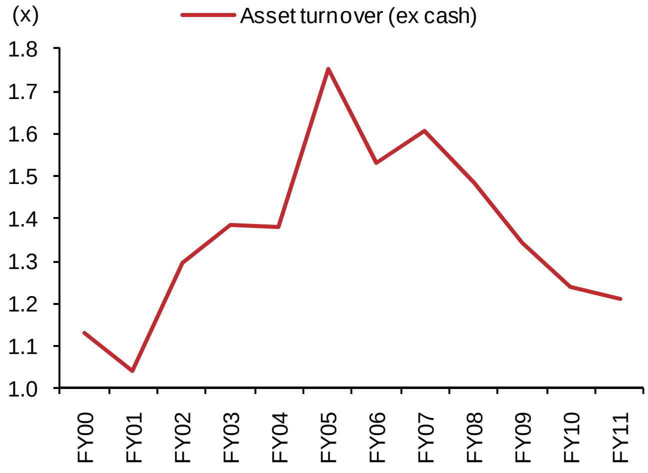
- Continues to suffer from the aftermath of the FY09 credit crisis-impinged slowdown, as order flows have yet to pick up for the company.
- Sales are thus still to pick up, as the products business is not ramping-up as yet.
- Furthermore, the company has also lost market share in key segments, thus impacting its growth profile.
- Meanwhile, working capital continues to rise and, together with slowing sales, is impacting asset turnover.

Fig. 68: Slow sales growth impacting asset t/o



Source: Company, Nomura research

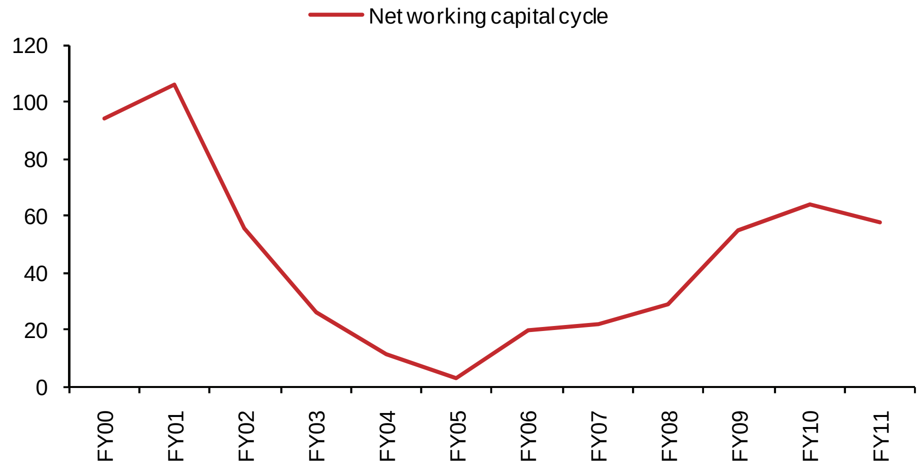
Fig. 69: …though cash management has been fine



Source: Company, Nomura research

Fig. 70: Working capital has been rising steadily since FY05

Days of revenue



Source: Company, Nomura research

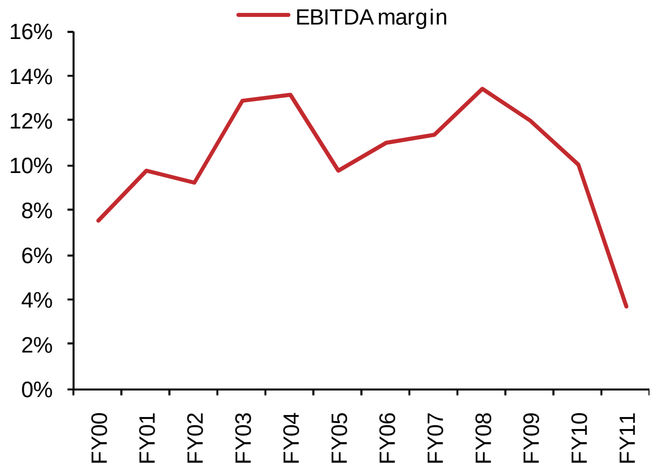
Trajectory of growth

- We gain very little confidence in ABB's ability to sharply ramp-up growth and margin profile from the trends, as depicted in the charts below.
- Continued competition in the T&D segment is likely to exert further pressure on recovery.

Fig. 71: Revenues are yet to recover from FY09 collapse

Source: Company, Nomura research

Fig. 72: While margins continue to deteriorate



Source: Company, Nomura research

Risks from an adverse turn in the cycle

Trends suggest that ABB has yet to recover from the aftermath of the previous cycle.

Risk to sales

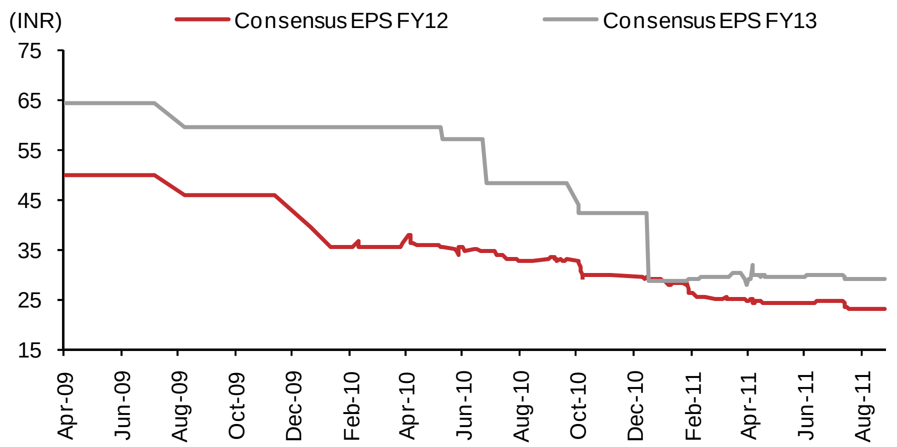
Given that the order book has expanded marginally over the past few quarters, we expect that sales should revive, albeit marginally. However, headwinds for a sharp revival appear very high.

Risk to margins

Margins are already at the bottom of the cycle and this is due mainly to the impact of the rural electrification business. While we expect margins to revive from these levels, the extent will depend on a revival in ABB's pricing power in key product segments.

What is consensus estimates building in?

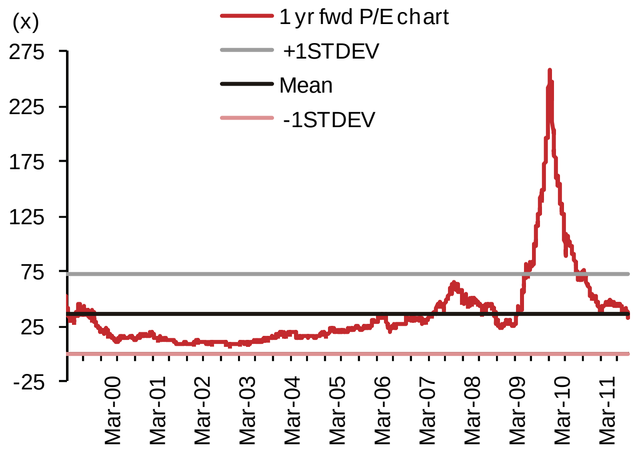
Fig. 73: Estimates down 50-60% but we see further risk as 1HCY11 has been worse than expected



Source: Bloomberg

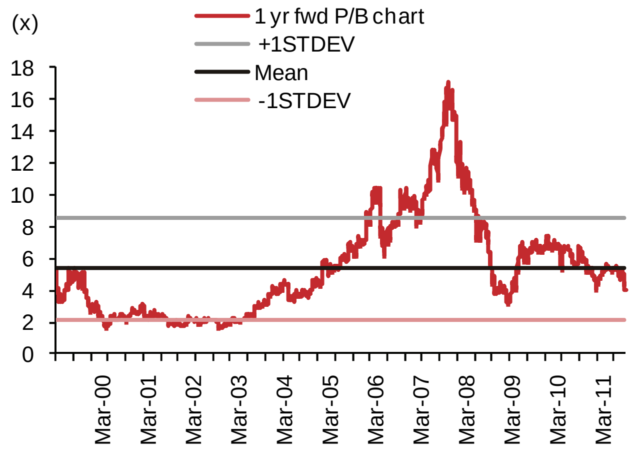
What is valuation factoring in?

Fig. 74: The stock continues to trade at premium valuations…



Source: Company, Bloomberg, Nomura estimates

Fig. 75: …despite a disastrous performance on buyback expectations



Source: Company, Bloomberg, Nomura estimates

Cutting estimates by 15-20%; TP reduced to INR525

We are building in more caution on account of a worsening global macro, as we cut our estimates by 15-20%. Our earnings revisions are driven by reducing hopes of strong pick up in execution and margins.

We value ABB India at 20x (unchanged) Sep 13F (from Mar-13F earlier) EPS of INR26.3, which is lower than the historical average but justified, in our view, given that the company is losing market share, leading to lower sustainable lower ROE from the earlier average levels (adjusted for the difference between expected and actual earnings). Our target multiple for ABB is still higher than that used for CRG because ABB continues to be more technology-driven and has higher potential of winning more technology-intensive orders vs CRG.

Investment risks

Upside risks include: 1) Sharper-than-expected recovery in the industrial and power products segment; and 2) a substantial decline in commodity prices, thus benefitting margins.

Bharat Electronics (BHE IN, Not Rated)

Company background

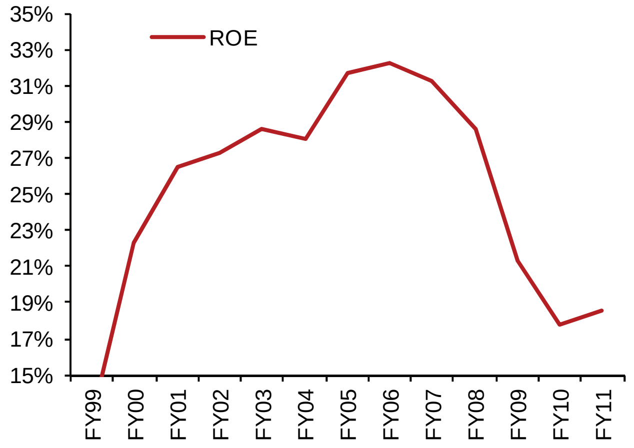
Bharat Electronics (BHE) caters primarily to the defence sector through its nine manufacturing units. The defence sector contributed 80% of its sales for FY11, with the remaining coming from the civilian sector. Research and Development is the core strength of BHE, which has collaborated with various leading research institutes, including DRDO. The analysis of the company's turnover for FY11 indicates that 57% was due to BHE-designed products, 21% due to products developed by DRDO and other indigenous agencies, and the remaining due to foreign technology. BHE expects the modernization drive of the country's security forces to provide a significant business opportunity for the company.

Balance sheet and return efficiency

Consistency of return ratios

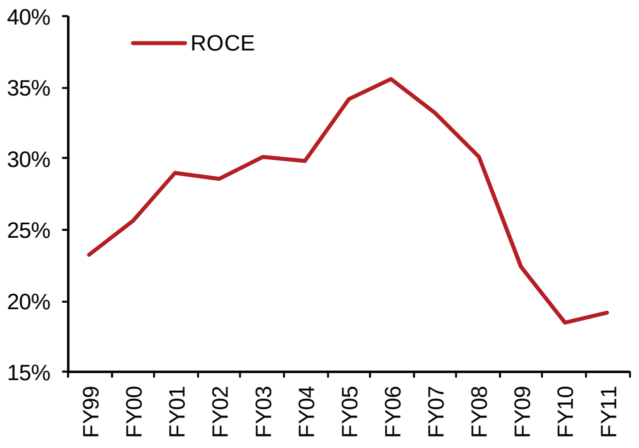
- Return ratios have come off their peaks in FY06 and are even lower than previous lows.
- All the parameters are close to the bottom, raising the key question of whether the problem is cyclical or structural. Incidentally, Bharat Electronics operates in the defence sector, which is not cyclical.

Fig. 76: Sharp reversal in return ratios…



Source: Company, Nomura research

Fig. 77: …now lower than previous lows

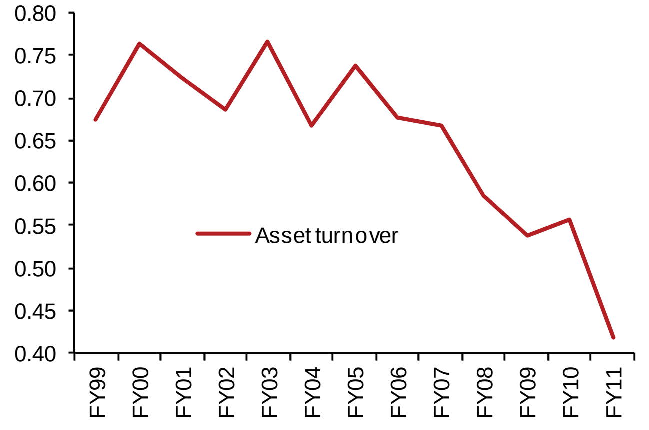


Source: Company, Nomura research

Management of working capital and asset turnover

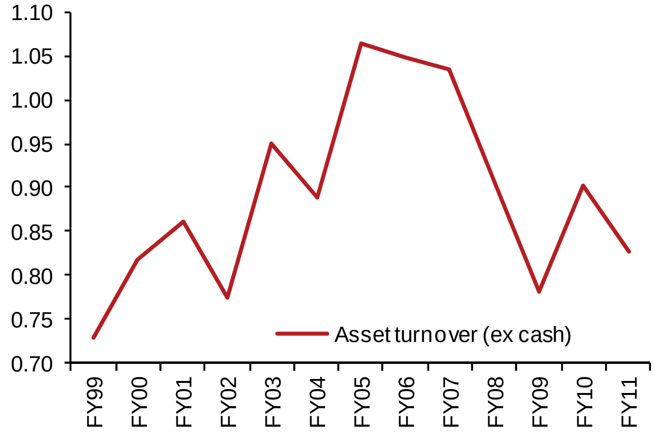
- The asset turnover has been falling consistently, primarily due to poor sales. Asset turnover excluding cash is close to FY00 lows, while overall asset turnover is worse, implying poor cash management by the company.
- Working capital cycle has improved after worsening from the lows of FY04. We notice that receivable and inventory cycle has deteriorated after an improvement in the interim.

Fig. 78: Asset turnover has fallen sharply since FY05
(x)



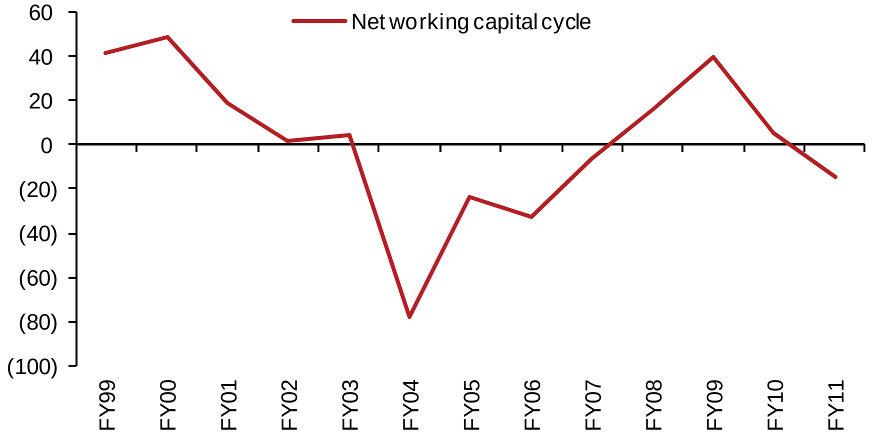
Source: Company, Nomura research

Fig. 79: Asset turnover ex cash is also close to late '90s low
(x)



Source: Company, Nomura research

Fig. 80: WC cycle is slightly better after worsening from their FY04/05lows
Days of revenue

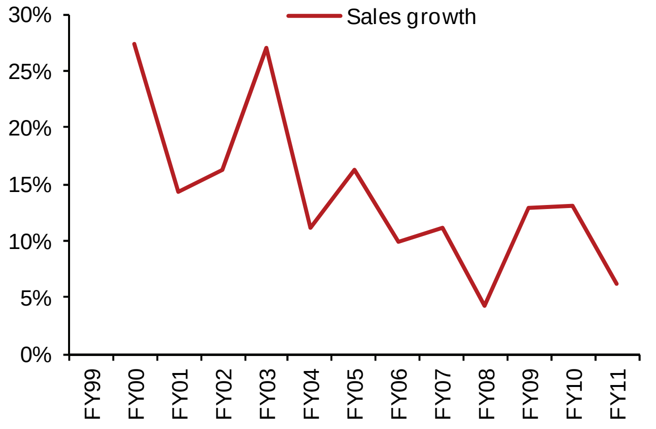


Source: Company, Nomura research

Trajectory of growth

Sales growth is on a constant decline, while margins are returning to lows of FY99 after peaking in the FY06-FY09 period.

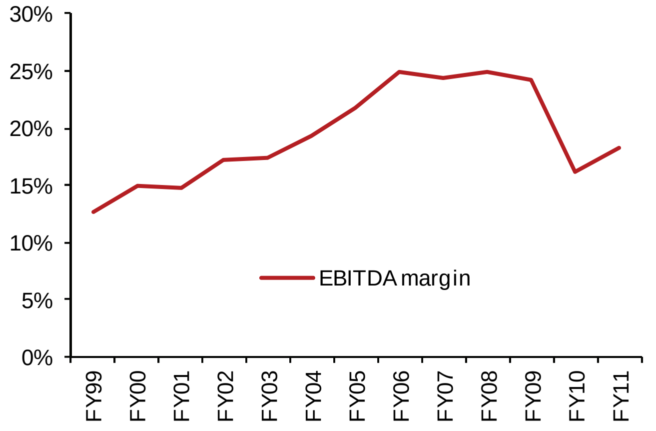
Fig. 81: Falling sales growth is the key culprit



Source: Company, Nomura research

Fig. 82: Margins only slightly better since late '90s and down from FY05-09 peak, possibly due to operating leverage

% of revenues



Source: Company, Nomura research

Risks from an adverse turn in the cycle

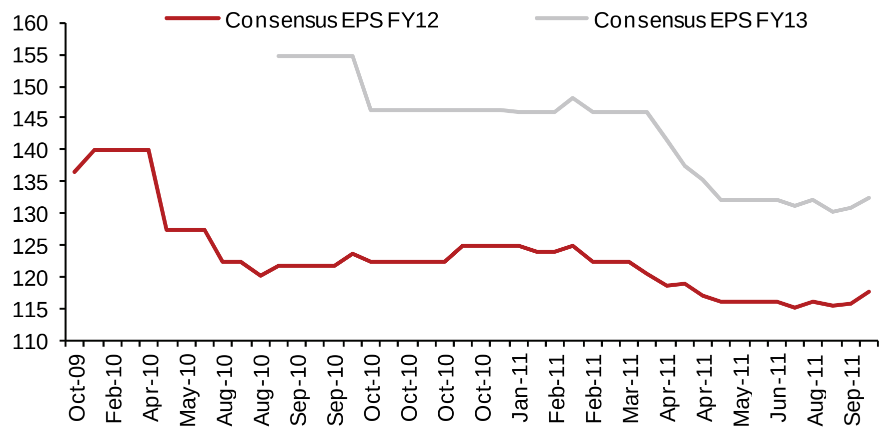
Bharat Electronics operates primarily in the defence sector, which is not cyclical. However, defence orders are typically lumpy, and as such can impact the sales trend and profitability of a company temporarily. Current trends suggest that Bharat Electronics has been suffering from poor sales growth, which is also impacting margins, and slow order decisions in the defence segment could be a reason for this.

Consensus estimates

- Consensus EPS estimates are down 15-16% for Bharat Electronics from its peak levels.

Fig. 83: Consensus estimate down 15-16%

INR



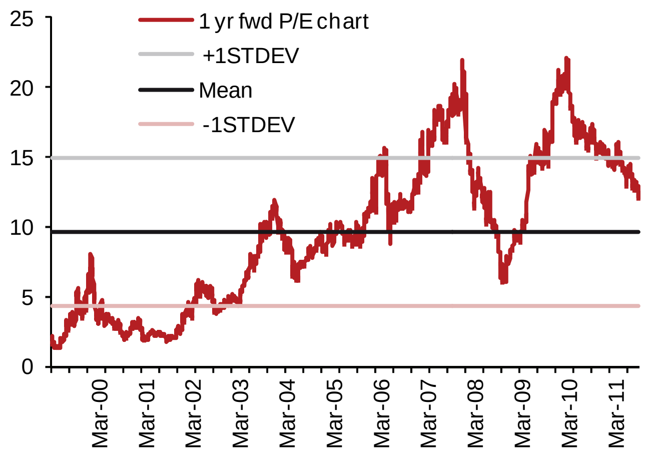
Source: Bloomberg

Consensus valuation

On consensus numbers, the stock is trading at average P/BV and slightly above on P/E on 12-year history.

Fig. 84: Stock still trading above 12 yr mean P/E range…

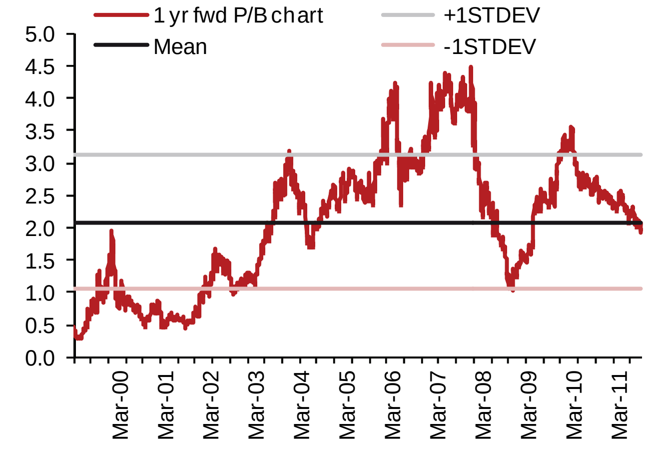
Bharat Electronics 1 year forward P/E chart (x)



Source: Company, Bloomberg

Fig. 85: … and close to mean P/BV levels

Bharat Electronics 1 year forward P/BV chart (x)



Source: Company, Bloomberg

Summary

Bharat Electronics stock has outperformed the SENSEX by 4% over the past 12 months.

- Most of the parameters are at their lows, even though Bharat Electronics commands a superior position in the defence sector, necessitating an analysis of structural issues in addition to cyclical problems.
- Sales growth has been consistently on decline over the past 12 years.
- Margins have come off from their FY06-FY09 peak period and are close to their FY09 lows.
- Consensus estimates are down 15-16% from their peak, though valuation is still well above mean multiples.

BEML (BEML IN, Not rated)

Company background

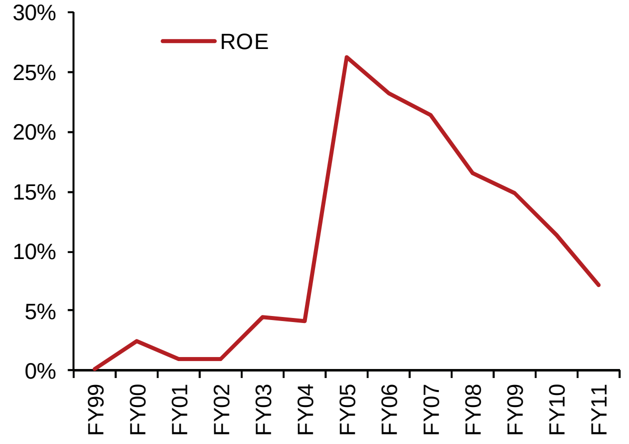
BEML Limited operates in India's core sectors such as Defence, Rail, Power, Mining and Infrastructure equipment supply. As part of its globalization strategy, the company has expanded its global reach by opening a local company at Indonesia and Brazil recently in addition to its Malaysia and China offices. The company operates under three major business verticals – Mining & Construction, Defence and Rail & Metro. The Rail & Metro segment accounted for 37% of revenue in FY11, while Earth Moving and Defence accounted for 41% and 20%, respectively. The company has drawn up VISION – 2013 with an ambitious growth rate of 12% CAGR for crossing INR 50 bn turnover by FY14 and achieving the INR 100 bn mark by FY17.

Balance sheet and return efficiency

Consistency of return ratios

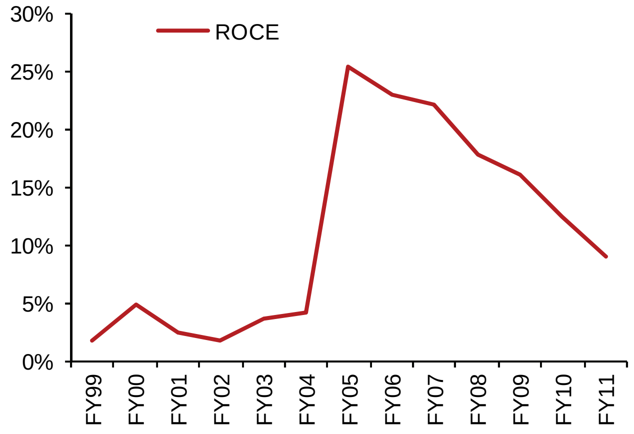
- Return ratios are back to single digits after experiencing a spike during FY05-FY09.
- A sharp improvement was seen in FY05 across the board but it has been followed by secular downfall since then.

Fig. 86: Sharp change in FY05 followed by consistent declining trend in the return ratios…



Source: Company, Nomura research

Fig. 87: … suggests a temporary business change impact in FY05, which is now fading



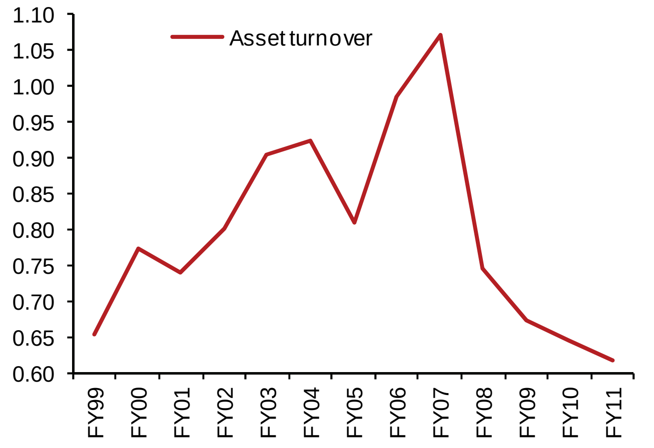
Source: Company, Nomura research

Management of working capital and asset turnover

- Asset turnover has been volatile over the years, reflecting the sector cyclical trends; however, it is now even worse than the previous lows.
- The working capital cycle peaked in FY04 but has deteriorated sharply since then, except in FY11

Fig. 88: Asset turnover broadly mirrors sector cycle…

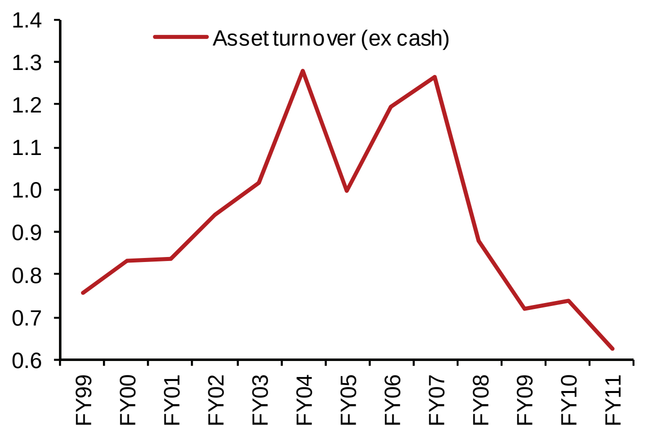
(x)



Source: Company, Nomura research

Fig. 89: …but bit more volatile and now worse than late '90s

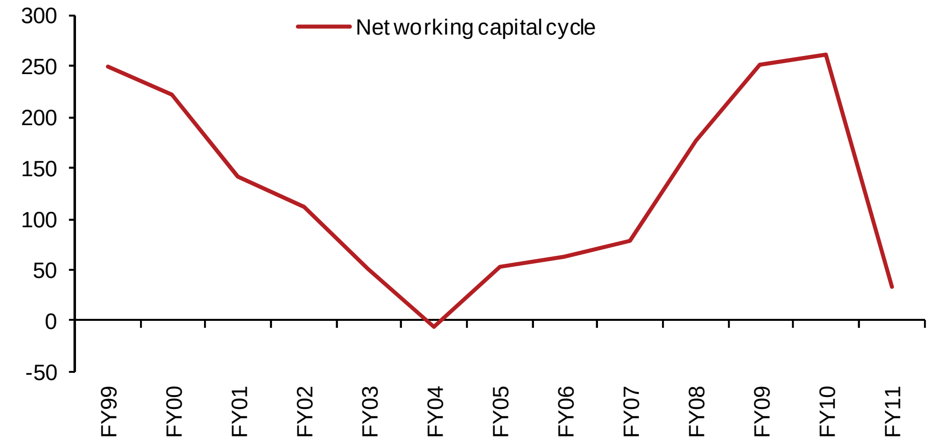
(x)



Source: Company, Nomura research

Fig. 90: WC cycle improved sharply until FY04 and has been worsening since then except for a sudden plunge in FY11

Days of revenue

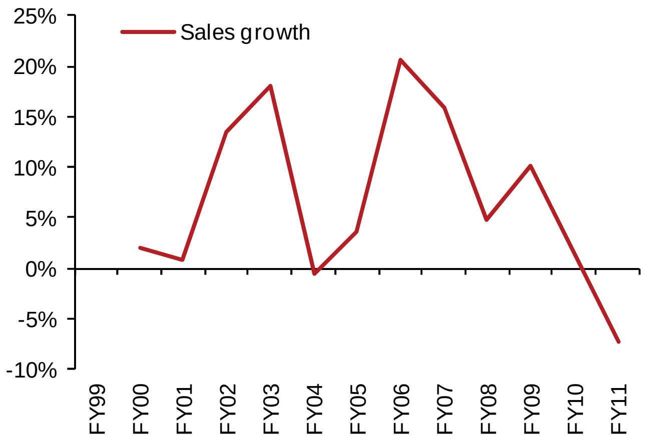


Source: Company, Nomura research

Trajectory of growth

- Sales growth has been slowing gradually for the company and is into negative territory now. Sales CAGR over FY99-11 is a mere 6.6%, making it the lowest growth profile across the companies in this analysis.
- The profitability of BEML has worsened with EBITDA declining at a 14% CAGR since FY05 and margins reaching all time lows.

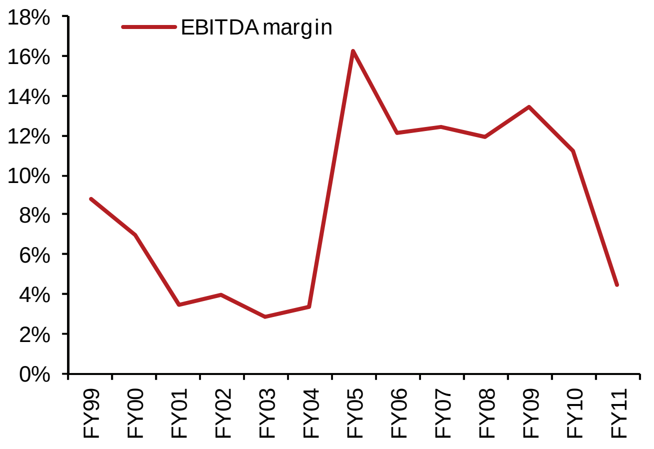
Fig. 91: Sales growth has only occasionally been above 15%



Source: Company, Nomura research

Fig. 92: Margin movement explains ROE/ROCE pattern since FY04; EBITDA CAGR since FY05 is -14%

% of revenues



Source: Company, Nomura research

Risks from an adverse turn in the cycle

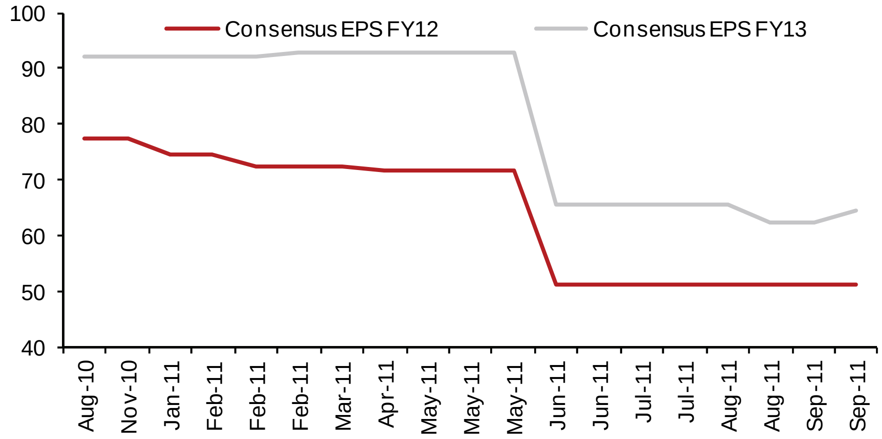
Poor sales and margins trend are approaching levels last seen in previous cycle lows.

Consensus estimates

• Consensus EPS estimates for BEML are down 30-35% from peak levels.

Fig. 93: Consensus est. cut 30-35% from peak

INR



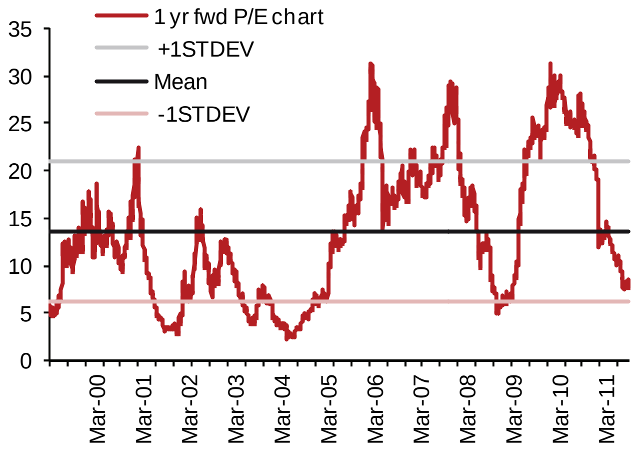
Source: Bloomberg

Consensus valuation

While the stock has fallen significantly from peak levels, we note that it is currently trading at -1 standard deviation of 12-year mean trading levels. However, the current valuation is in line with the mean multiple levels the stock used to trade at between FY99-FY05.

Fig. 94: Stock trading close to -1 Std. deviation of mean…

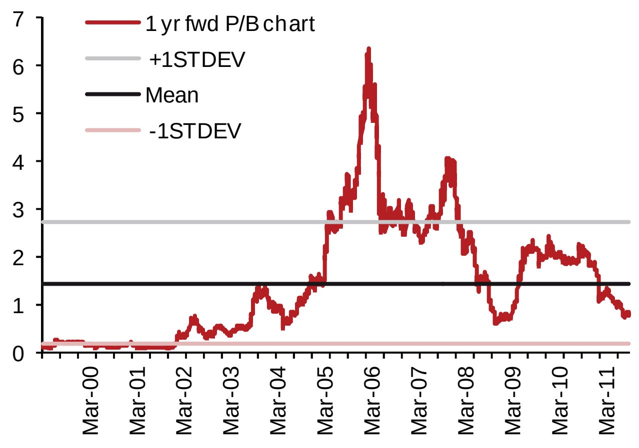
BEML 1 year forward P/E chart (x)



Source: Company, Bloomberg

Fig. 95: … on both P/E and P/BV, but is there value?

BEML 1 year forward P/BV chart (x)



Source: Company, Bloomberg

Summary

BEML stock underperformed the SENSEX by 36% over past 12 months.

- Return and turnover ratios are at the bottom seen during the previous cycle; the working capital cycle has been worsening though we notice one-off improvement in FY11.
- Sales growth has been steadily falling since FY05 and turned negative in FY11.
- EBITDA has been declining at a 14% CAGR since FY05, with margins approaching previous cycle lows.
- Consensus estimates are building in around 30-35% downside from current level.
- Valuation is close to -1 standard deviation of 12-year mean P/E but in line with mean historical FY99-05 trading multiples.

AIA Engineering (AIAE IN, Not rated)

Company background

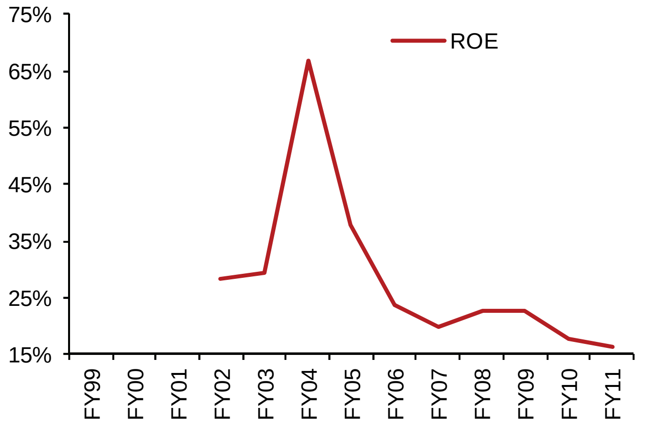
AIA Engineering (AIAE) focuses on the design, development and manufacturing of castings used in various industries including cement, mining and power. AIAE is the second-largest Hi-Chrome casting producer in the world. AIAE provides sales and services in more than 75 countries through its wholly owned subsidiary Vega Industries. AIAE has also collaborated with Southwestern Corp, UK, for process improvements.

Balance sheet and return efficiency

Consistency of return ratios

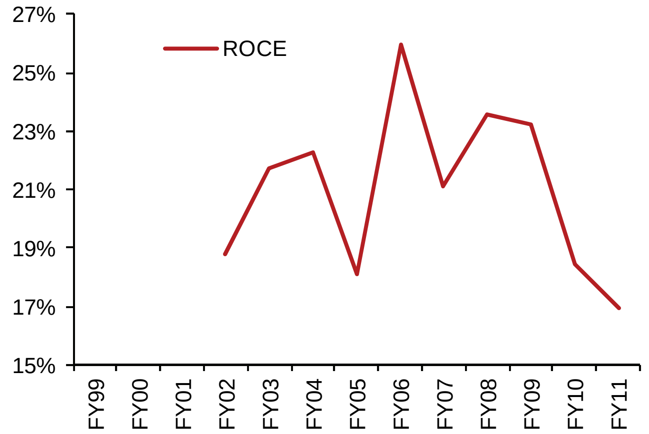
- AIA Engineering (AIAE IN) returns are seen to be in line with business cycles. AIAE has provided return on equity above 20% except in the past two years.

Fig. 96: Return ratios have declined since FY09 levels…



Source: Company, Nomura research

Fig. 97: …though they are in line with business cyclicality



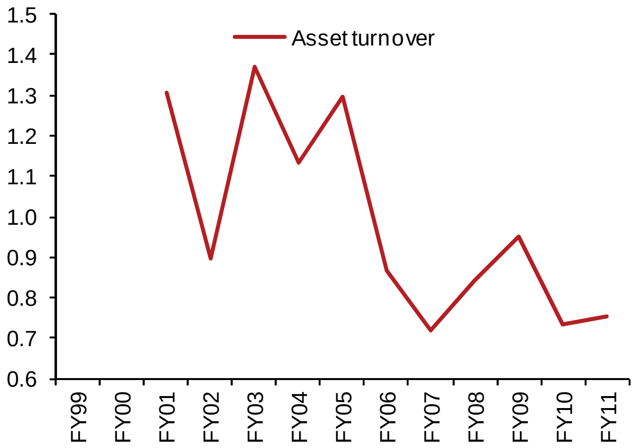
Source: Company, Nomura research

Management of working capital and asset turnover

- Total as well as ex-cash asset turnover are at the bottom and seem to be dictated by business cycles
- Working capital cycle also follows similar trend over FY03-FY08 and improved since FY09. Receivable days have improved continuously except in last two years while inventory days have been cyclical.

Fig. 98: Asset turnover has deteriorated consistently…

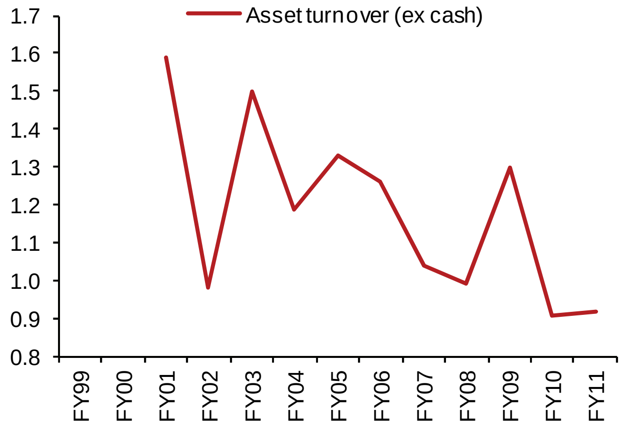
(x)



Source: Company, Nomura research

Fig. 99: …ex cash too

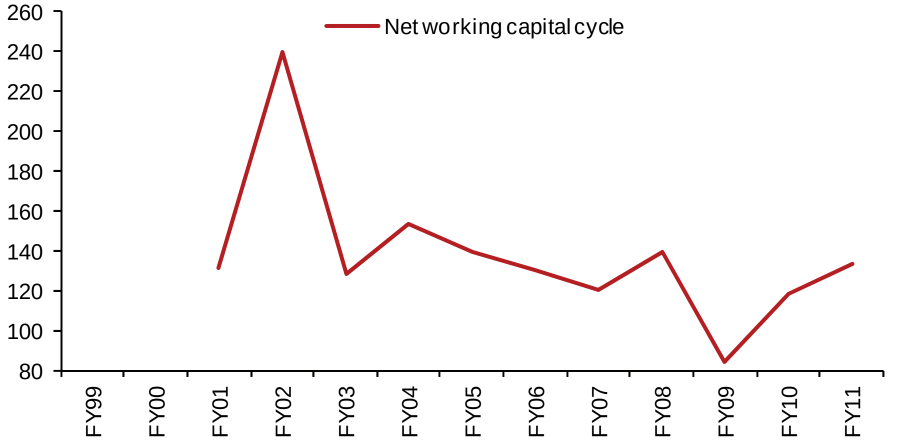
(x)



Source: Company, Nomura research

Fig. 100: WC cycle largely flat except for FY02 and FY09

Days of revenue



Source: Company, Nomura research

Trajectory of growth

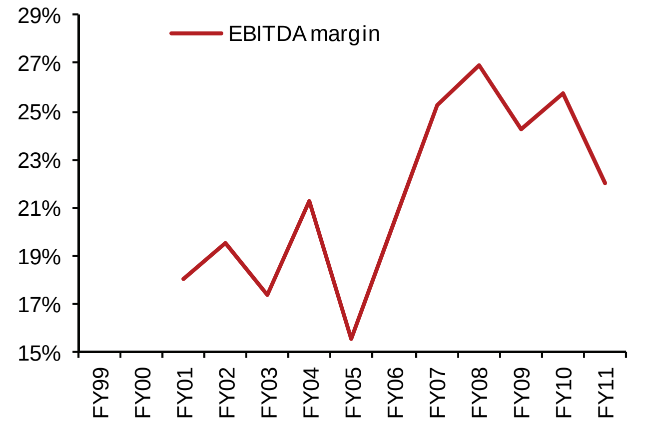
- Sales grew at 23.7% CAGR while EBITDA has been at a 26.2% CAGR over the past 10 years. However, sales growth shows high cyclicality over the years.

Fig. 101: Sales growth volatile amidst cyclicality

Source: Company, Nomura research

Fig. 102: Margins seem cyclical though trending higher

% of revenues



Source: Company, Nomura research

Risks from an adverse turn in the cycle

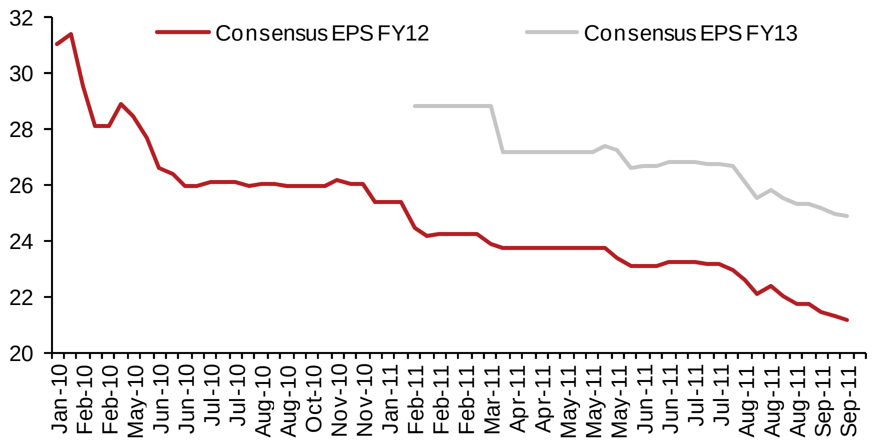
As of FY11 levels, sales trends are still recuperating from the post-Lehman slowdown, though margins were still falling. Trends suggest that overall the company is yet to recover from previous cycle lows.

Consensus estimates

- Consensus estimates are down 15-35% from their peak, with the bulk of the cut in near-term estimates.

Fig. 103: Consensus estimates down 15-35% from peak

INR



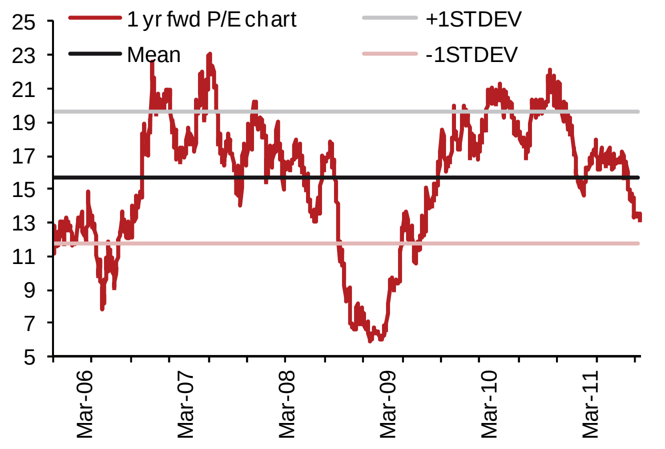
Source: Bloomberg

Consensus valuation

The stock is now trading lower than the average valuation it got over the last 12 years, while valuations are still almost twice that of the post-Lehman lows.

Fig. 104: Stock trading between mean and -1 Std deviation P/E

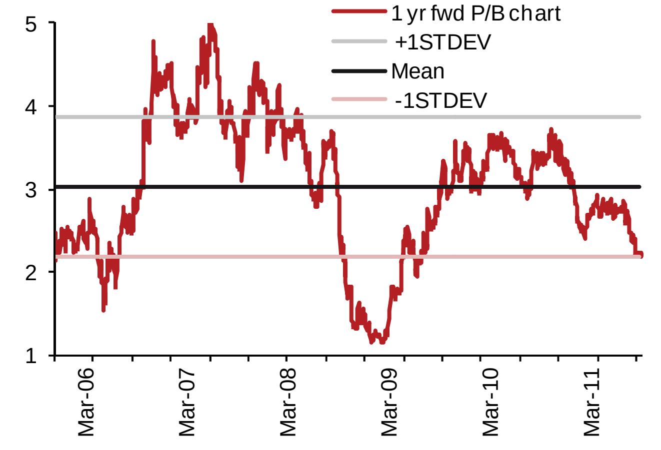
AIA Engineering 1 year forward P/E chart (x)



Source: Company, Bloomberg

Fig. 105: …and close to -1 Std. deviation on P/BV

AIA Engineering 1 year forward P/B chart (x)



Source: Company, Bloomberg

Summary

AIAE stock performance has been at par with the SENSEX over the past 12 months.

- Almost all data points show high cyclicality in business. Return and turnover ratios are at the bottom while margins showing downturn since FY08.
- Consensus estimates are building in around 15-35% downside from their peak.

Carborundum Universal (CU IN, Not rated)

Company background

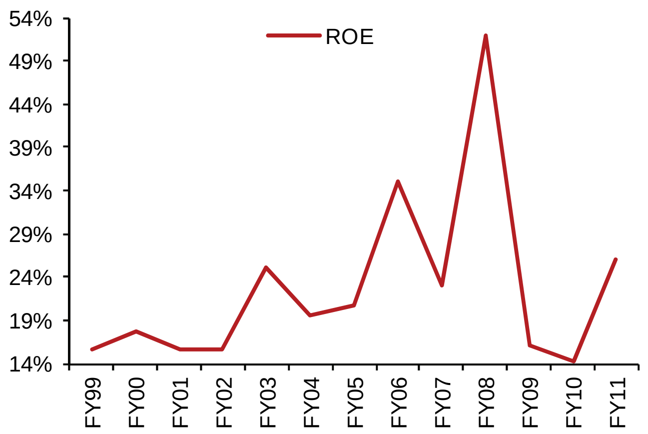
Carborundum Universal (CU) manufactures and supplies abrasives, ceramics and electro minerals from its 25 factories spread over seven countries. CU was incorporated in 1954 as a joint venture between Carborundum Company, USA, Universal Grinding Wheel Company, UK and Murugappa Group, India. The Murugappa Group is one of India's leading conglomerates, with sales over USD 3.14bn. CU has shown consistent growth over the past ten years on account of its successful acquisitions as part of the backward integration.

Balance sheet and return efficiency

Consistency of return ratios

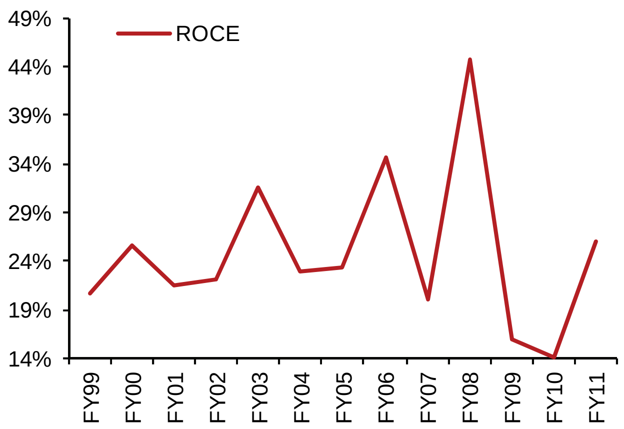
- Despite business cyclicality being evident, the company has maintained return ratios of 15-20% throughout, in line with peer averages.
- ROE and ROCE are now back to normal levels after bottoming out in FY10.

Fig. 106: Return ratios in line with peers maintained throughout…



Source: Company, Nomura research

Fig. 107: …though lower than previous cycle



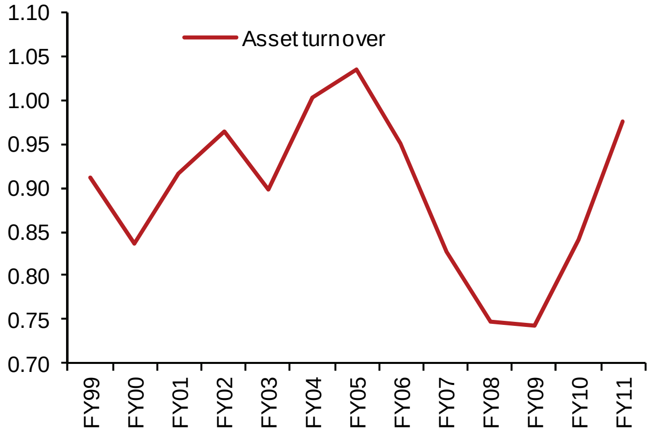
Source: Company, Nomura research

Management of working capital and asset turnover

- Asset turnover ratio shows similar pattern as return ratios with the exception of FY08, when return ratios hit a high but asset turn was at a low.
- The asset turnover dip in FY08-FY09 was due to the cyclical impact on sales and working capital, as per our reading.
- Working capital cycle has improved despite cyclical pressures. Receivables have contributed to improvement, while inventory has remained an issue.

Fig. 108: Asset turnover show signs of cyclicality

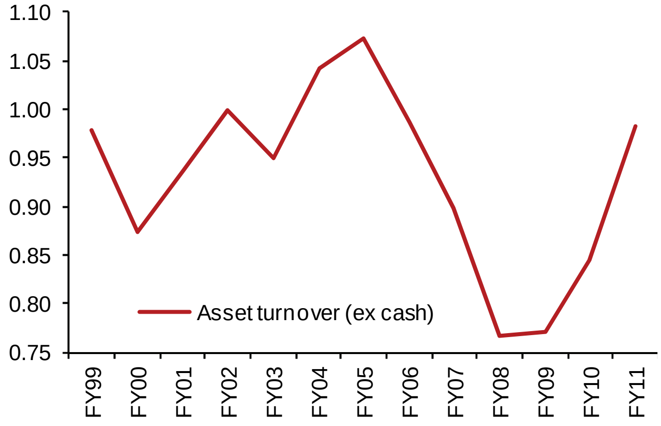
(x)



Source: Company, Nomura research

Fig. 109: no major difference in asset turnover ex cash

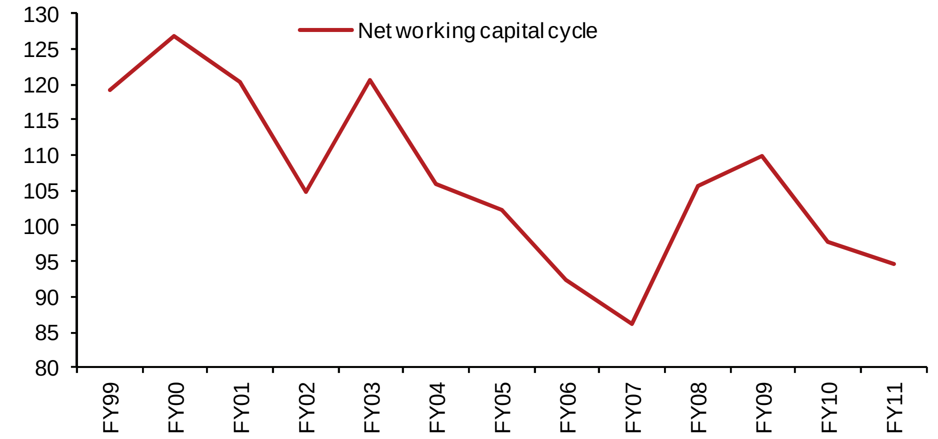
(x)



Source: Company, Nomura research

Fig. 110: Net WC cycle has shrunk sharply despite cyclicality

Days of revenue

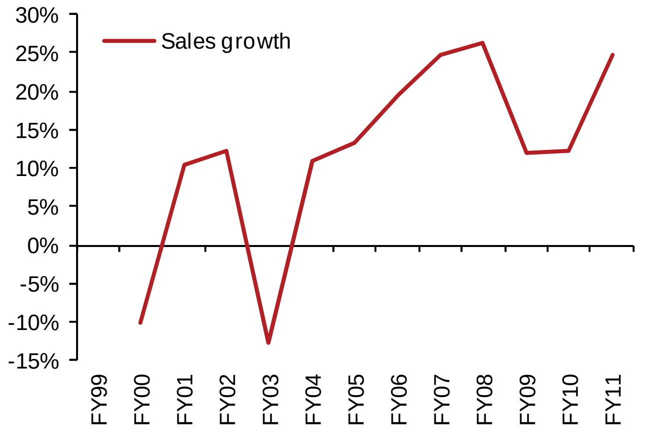


Source: Company, Nomura research

Trajectory of growth

- Carborundum Universal has managed sales growth at ~13.8% CAGR over the past 10 years, and the trend has been of a consistent double-digit growth rate.
- Margins are also seen in the range of 17-19%, providing ~13.2% CAGR in EBITDA over the past ten years. We note that margins bottomed at 17% post Lehman crisis.

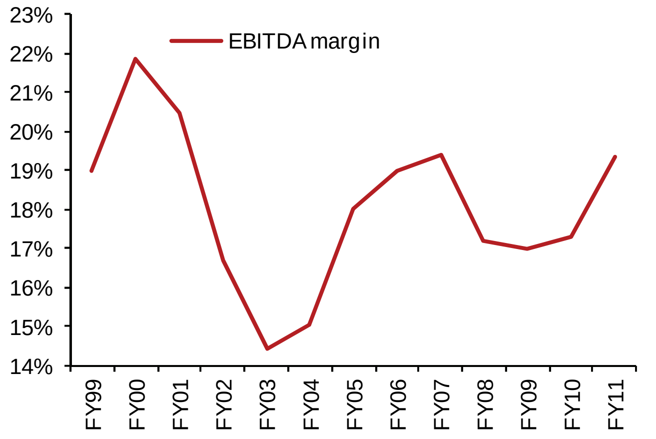
Fig. 111: Sales growth has consistently been in double digits



Source: Company, Nomura research

Fig. 112: Cyclical margins; +/- 100 bps of 18% since FY05

% of revenues



Source: Company, Nomura research

Risks from an adverse turn in the cycle

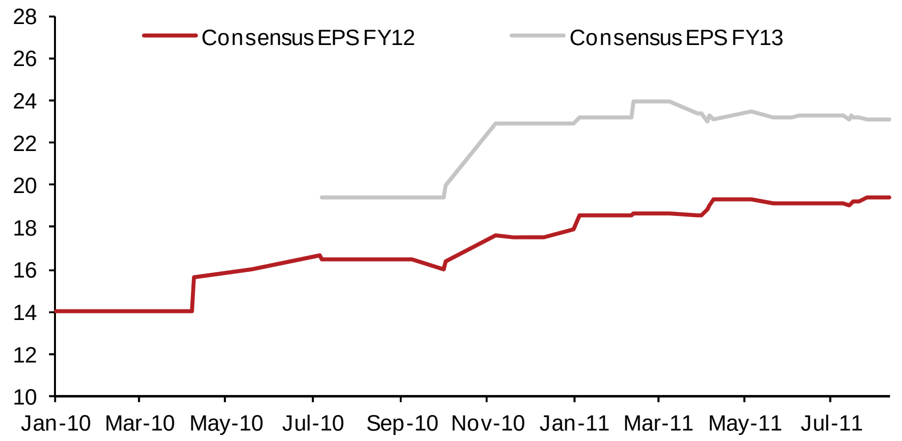
Both sales and margins trends suggest a revival of the company's business cycle from the post-Lehman lows witnessed in FY09.

Consensus estimates

• Consensus EPS estimates have consistently been rising over the past 18 months or so.

Fig. 113: Consensus estimates

INR

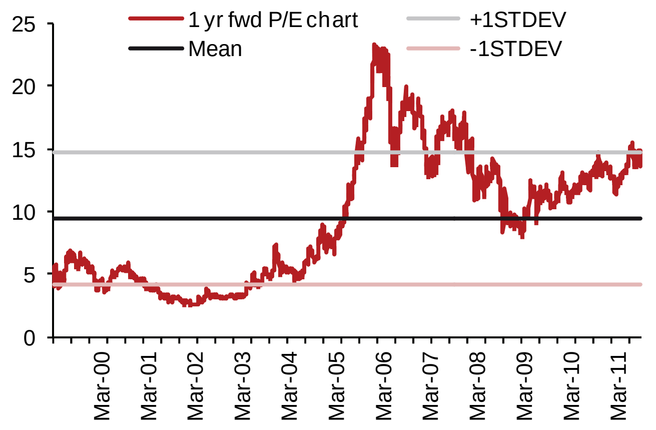


Source: Bloomberg

Consensus valuation

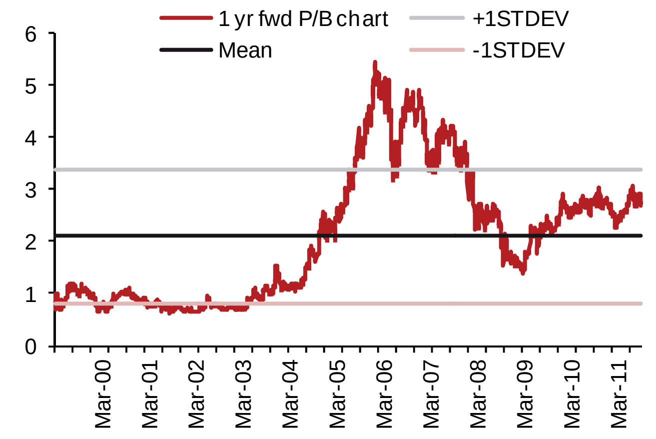
The stock is trading well above its mean P/E and P/BV multiple.

Fig. 114: Stock trading at +1 Std deviation of P/E mean…
Carborundum Universal 1 year forward P/E chart (x)



Source: Company, Bloomberg

Fig. 115: …and close to the same on P/BV
Carborundum Universal 1 year forward P/BV chart (x)



Source: Company, Bloomberg

Summary

Carborundum Universal stock outperformed overall markets by 51% over the past 12 months.

- Carborundum Universal has managed to provide consistent returns in the range of 15-20%.
- Sales growth witnessed a dip in FY-08-FY09 due to cyclical pressure; however, both sales and working capital returned to average in FY11.
- The company has maintained a healthy EBITDA margin of +/-100bps of 18% since 2005.
- Consensus estimates have increased consistently.

Blue Star (BLSTR IN, Not rated)

Company background

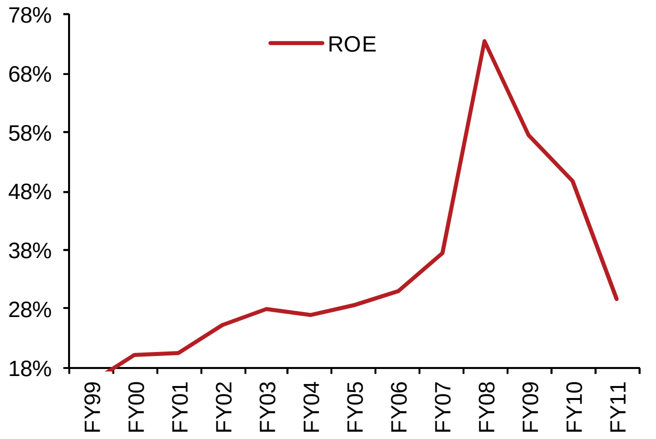
Blue Star is India's largest central air-conditioning company, with an annual turnover of ~INR 29 bn, a network of 29 offices, 6 manufacturing facilities and over 1,200 dealers. Blue Star primarily focuses on the corporate and commercial markets. The company has recently started pursuing the residential segment with its wide range of room air conditioners. Blue Star has business alliances with world renowned technology leaders such as Rheem Mfg Co, USA; Hitachi, Japan; Eaton-Williams, UK; Thales e-Security Ltd., UK; and Jeol, Japan to offer superior products and solutions to customers.

Balance sheet and return efficiency

Consistency of return ratios

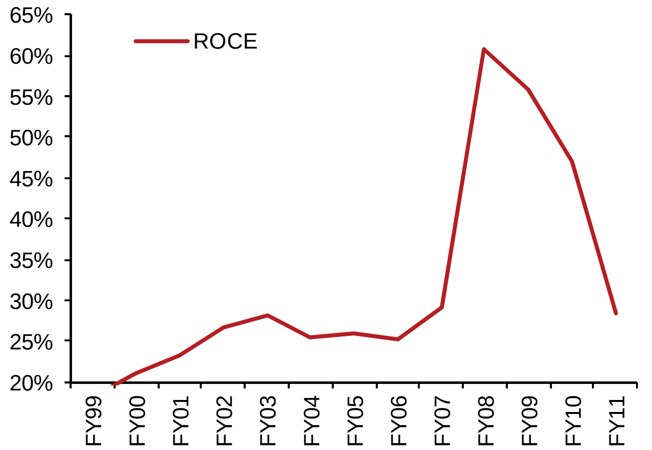
- Despite a sharp fall-off since FY08, Blue Star's ROE/ROCE profile is still better than peer average at 25%+ levels.

Fig. 116: Above peer average return ratios…



Source: Company, Nomura research

Fig. 117: … despite fall from peak in FY08

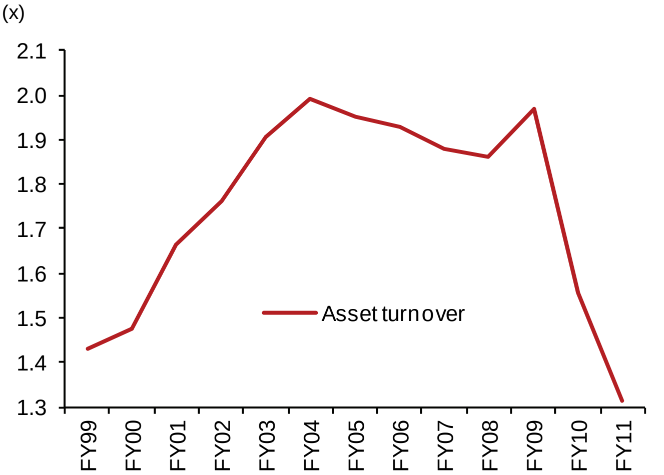


Source: Company, Nomura research

Management of working capital and asset turnover

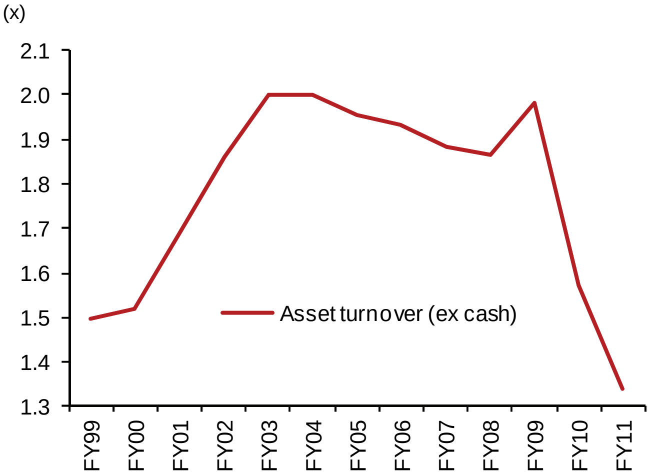
- Asset turnover for the company peaked in FY08 thus explaining ROE peaking the same year. However, since then slowing sales growth has led to significant fall off in the asset turnover, even as WC cycle continues to elongate.
- Working capital cycle has been worsening except for brief improvement in FY07-FY08. Receivables in particular have been key contributor to the deterioration.

Fig. 118: Asset turnover peaked in FY09 (same as ROE/ROCE)…



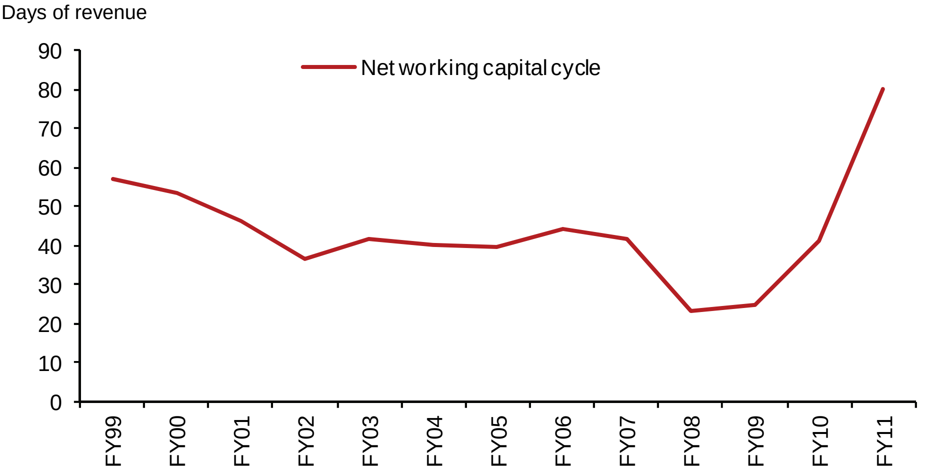
Source: Company, Nomura research

Fig. 119: …and is now lower than previous lows



Source: Company, Nomura research

Fig. 120: WC cycle has risen sharply and worse than Voltas

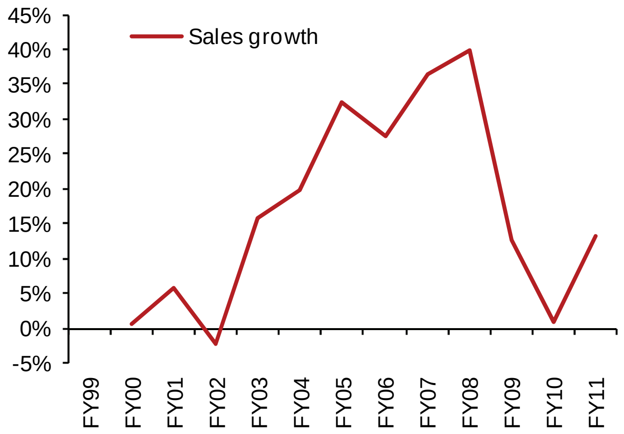


Source: Company, Nomura research

Trajectory of growth

- Sales growth shows a pattern similar to asset turnover and suggests high correlation to cycle.
- Trend has been similar to Voltas directionally though volatility is much higher, in our view.
- EBITDA margin had improved continuously until FY10 and is now similar to FY99 levels.

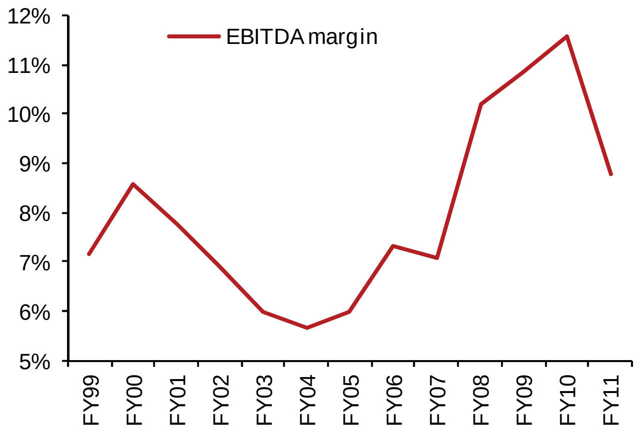
Fig. 121: Sales pattern highly correlated to business cycle



Source: Company, Nomura research

Fig. 122: Delayed cyclicality in margins; better than Voltas

% of revenue



Source: Company, Nomura research

Risks from an adverse turn in the cycle

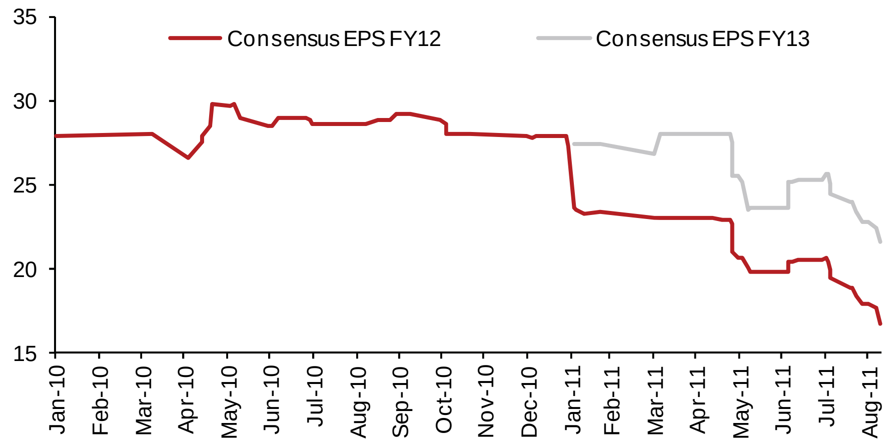
Sales trends are just now reviving (more of a base effect) from the post-Lehman collapse, while we notice a delayed impact on EBITDA margins.

Consensus estimates

- Consensus EPS estimates for Blue Star are down 35-40% from peak levels compared to a 20-25% cutback in Voltas estimates.

Fig. 123: Consensus est. down sharply since peak

INR



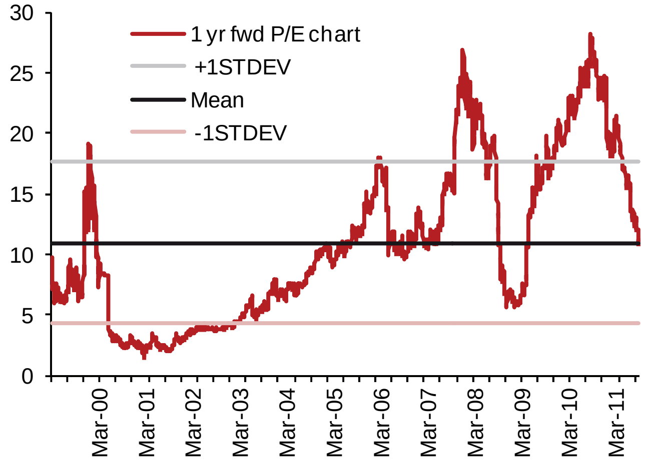
Source: Bloomberg

Consensus valuation

The stock is trading almost at the 12 year average P/E and P/BV multiples.

Fig. 124: Significant de-rating already…

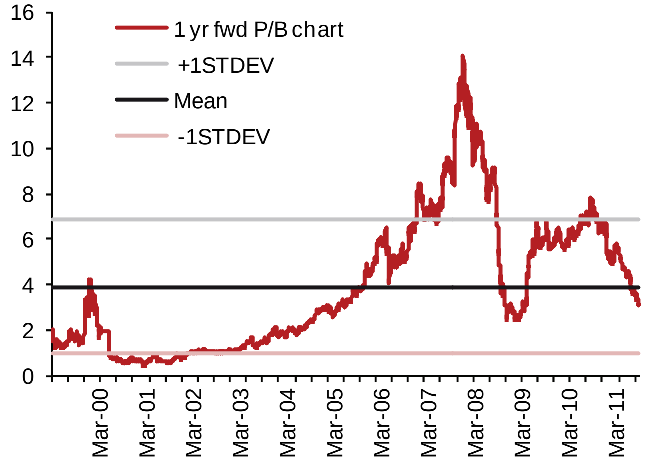
Blue Star 1 year forward P/E chart (x)



Source: Company, Bloomberg

Fig. 125: …but valuations still reflective of mid-cycle

Blue Star 1 year forward P/BV chart (x)



Source: Company, Bloomberg

Summary

Blue Star stock underperformed overall markets 31% over the past 12 months.

- Asset turnover, return ratios and working capital cycle are close to the bottom
- Blue Star shows similar trends as that of Voltas but the volatility is high. Blue Star also enjoys higher margins compared to Voltas.
- We also notice sharp contrast in the way WC cycle has been managed by Blue Star as against a very tight rein displayed by Voltas. Tight control over the WC cycle has allowed Voltas to keep a check on its asset turnover as well as return ratios.
- Consensus estimates are sharply down by around 35-40% since peak.
- Blue Star's 12-year mean P/E multiple at ~12x is in line with Voltas, while on P/BV it is 4x vs. 3.5x for Voltas. Currently, Voltas is trading below the 12-year mean multiples, as discussed above.

Appendix A-1

Analyst Certification

We, Amar Kedia and Indrajit Yadav, hereby certify (1) that the views expressed in this Research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Research report and (3) no part of our compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

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Mentioned companies

Issuer name	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
ABB India	ABB IN	INR 664	10-Oct-2011	Reduce	Not rated	
Bharat Heavy Electricals	BHEL IN	INR 332	10-Oct-2011	Neutral	Not rated	
Crompton Greaves	CRG IN	INR 152	10-Oct-2011	Buy	Not rated	
Cummins India	KKC IN	INR 410	10-Oct-2011	Neutral	Not rated	
Thermax	TMX IN	INR 417	10-Oct-2011	Buy	Not rated	
Voltas	VOLT IN	INR 101	10-Oct-2011	Buy	Not rated	

Previous Rating

Issuer name	Previous Rating	Date of change
ABB India	Neutral	30-Sep-2010
Bharat Heavy Electricals	Reduce	11-Oct-2011
Crompton Greaves	Not Rated	09-Feb-2010
Cummins India	Buy	12-Aug-2010
Thermax	Neutral	11-Oct-2011
Voltas	Not Rated	20-Sep-2010

Rating and target price changes

	Ticker	Old stock rating	New stock rating	Old target price	New target price
ABB India	ABB IN	Reduce	Reduce	INR 585	INR 525
Bharat Heavy Electricals	BHEL IN	Reduce	Neutral	INR 346	INR 332
Thermax	TMX IN	Neutral	Buy	INR 645	INR 500
Voltas	VOLT IN	Buy	Buy	INR 234	INR 150

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Explanation of Nomura's equity research rating system for Asian companies under coverage ex Japan published from 30 October 2008 and in Japan from 6 January 2009

STOCKS

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STOCKS

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Nomura Asian Equity Research Group

Hong Kong	Nomura International (Hong Kong) Limited 30/F Two International Finance Centre, 8 Finance Street, Central, Hong Kong Tel: +852 2536 1111 Fax: +852 2536 1820
Singapore	Nomura Singapore Limited 10 Marina Boulevard Marina Bay Financial Centre Tower 2, #36-01, Singapore 018983, Singapore Tel: +65 6433 6288 Fax: +65 6433 6169
Taipei	Nomura International (Hong Kong) Limited, Taipei Branch 17th Floor, Walsin Lihwa Xinyi Building, No.1, Songzhi Road, Taipei 11047, Taiwan, R.O.C. Tel: +886 2 2176 9999 Fax: +886 2 2176 9900
Seoul	Nomura Financial Investment (Korea) Co., Ltd. 17th floor, Seoul Finance Center, 84 Taepyeongno 1-ga, Jung-gu, Seoul 100-768, Korea Tel: +82 2 3783 2000 Fax: +82 2 3783 2500
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