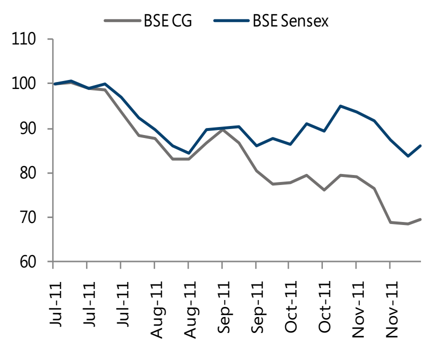
Capital Goods Q2FY12 Review

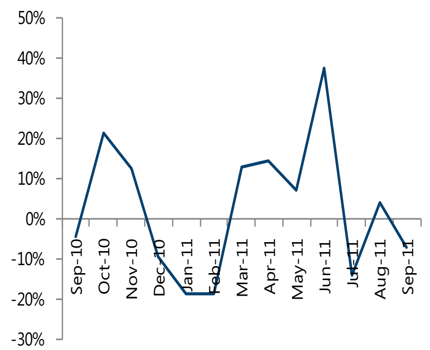
Still time for silver lining

Our coverage universe of capital goods delivered subdued performance with a 4% y-o-y revenue growth. Margins for the coverage universe have dipped by 370 bps due to lower realizations and high costs. Profitability for our coverage universe was down by 41% y-o-y due to higher interest cost burden and elongated working capital cycle for companies in the quarter. Order intake declined by 8% y-o-y to approximately ₹ 43.2bln. Declining order book for the sector has led to revision in estimates; thereby indicating negative outlook for next 2-3 quarters.

CG Index vs Sensex



Cap Goods growth in IIP (y-o-y)



Mixed performance on execution front this quarter

Coverage universe's revenue grew by just 4% y-o-y owing to negative surprises by Voltas and BGR Energy. Within our coverage universe, AIA registered highest revenue growth of 33% y-o-y to ₹ 3.4bln, mainly driven by highest ever volume growth in its mining segment. Elecon also witnessed strong revenue growth of 20% y-o-y and Jyoti Structures' revenue grew by 16.5% y-o-y. Amongst large caps BHEL, L&T, Thermax and ABB delivered good numbers with revenue growth in the range of 19-21% y-o-y.

EBITDA declines 26% y-o-y; margins dip by 370bps

EBITDA for the coverage universe de grew by 26% y-o-y; EBITDA margin declined 370bps to 9.2%. Cost overruns due to high commodity prices and lower realizations due to competition continued to dent margins of all companies. Voltas' EBIDTA margin declind drastically by 760 bps y-o-y and reached to 2.4% due to substantial cost overruns on two Qatar projects. Crompton Greaves margins also fell by 550 bps y-o-y to 8.4% due to higher input cost and lower realization. However, Elecon's margins improved by 40 bps y-o-y to 14.7%. BGR energy had high margin BOP orders during the quarter which helped the company report highest ever margin of 14.3%.

Declining profits and elongated working capital cycle- a key concern

PAT for our coverage universe declined 41% y-o-y to ₹ 2.71bln. BGR's interest cost rose 118% y-o-y due to increase in debt by ₹ 5bln to ₹ 23bln. Jyoti Structures interest cost rose by 50% y-o-y due to increase in LC charges and working capital loan; which lowered its profitability by 11% y-o-y to ₹ 221mln. Deteriorating working capital cycle due to higher debtor days and decline in orders and customer advances has necessitated borrowings for the companies to fund regular working capital requirements; which in turn has impacted profitability.

Order inflow declines 8% y-o-y in Q2FY12

Order inflow for the coverage universe declined 8% to approximately ₹ 43.2bln. Barring few BTG orders to BHEL and opening of NTPC super critical bulk tenders for BTG, no big announcements were made in the quarter. Only relief came from PGCIL which declared orders worth ₹ 35.6bln as compared to ₹ 18.8bln in Q2FY11.

Outlook

Negative factors affecting capital goods sector are not showing any signs to cool off in near term. Recent moderation in raw material prices and pause in interest rates may support profitability. However, major turnaround for the sector depends on pick up in investments which will drive order inflows and tame down the competition. Although, valuations for most of the companies are at all time low, the sector shall underperform the market due to stagnant order book and declining order inflows for few quarters. We continue to maintain our upward bias towards Elecon and AIA on account of attractive valuation and better growth prospects.

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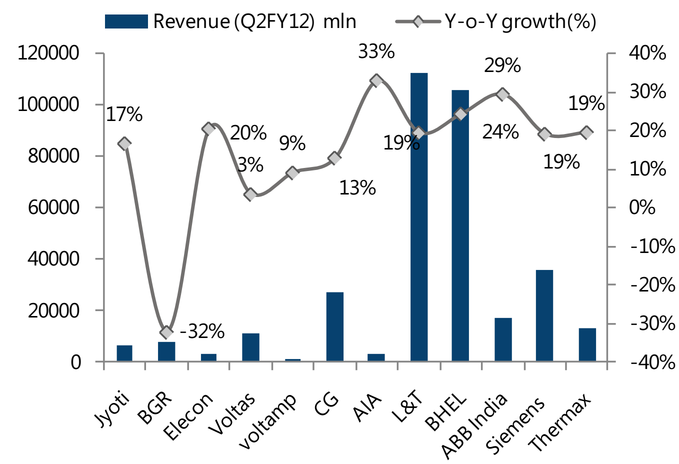
Mixed performance on revenue front

Our coverage universe reported revenue growth of just 4% y-o-y for Q2FY12. Within our coverage, AIA registered highest revenue growth of 33% y-o-y to ₹ 3.4bln, mainly driven by highest ever volume growth in its mining segment. Elecon also witnessed strong revenue growth of 20% y-o-y to ₹ 3.36bln, above our expectations (7% y-o-y); with substantial revenue jump in both its MHE and Transmission Gear segment. Moreover, Jyoti Structures revenue grew by 16.5% y-o-y on account of strong execution during the quarter. Voltas and Voltamp recorded moderate growth for the quarter at 3% y-o-y and 9% y-o-y respectively. However, BGR Energy's revenue declined by 32% y-o-y to ₹ 7.7bln due to depleting order book, extended monsoon on few project sites and delay in approval from consultants and engineers particularly for Marwa project. Excluding BGR Energy, coverage universe revenue grew by 12.6% y-o-y in Q2FY12 driven by strong execution by Elecon and AIA Engineering.

Among the large caps (not under coverage), ABB posted highest top line growth of 29% y-o-y, aided by better project execution in power segment. BHEL's revenue grew by 24% y-o-y with remarkable performance of its industry segment (up 59.4% y-o-y) which contributed 28% to the total sales. L&T, Thermax and Siemens too delivered decent revenue growth of 19% y-o-y.

Exhibit 1: Revenue growth in Q2FY12

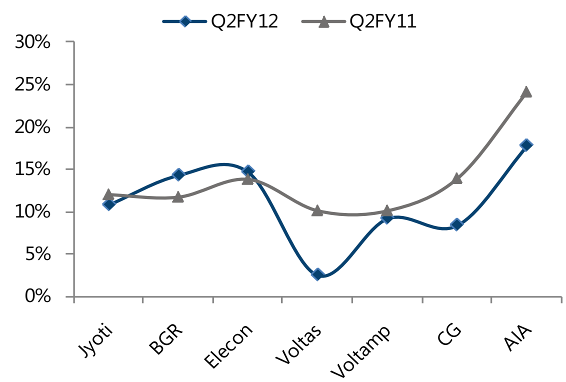


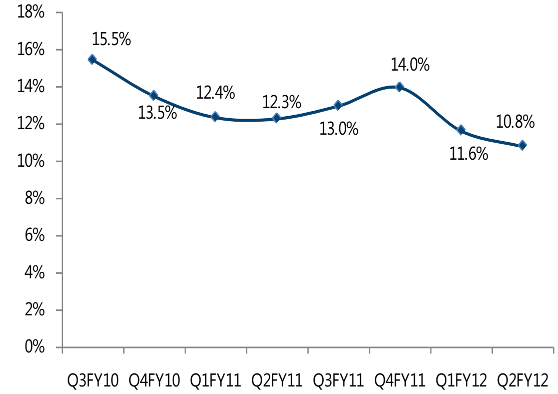
Source: Company, MSFL Research

Higher input cost and lower realization reduces EBIDTA margins

EBIDTA for our coverage unverse declined by 26% y-o-y which resulted in drop of 370 bps in margins for Q2FY12. Voltas' EBIDTA margin declind drastically by 760 bps y-o-y and reached to 2.4% due to substantial cost overruns on two Qatar projects. Crompton Greaves margins also fell by 550 bps y-o-y to 8.4% due to higher input cost and lower realization. However, the sharp margin decline was slightly compensated by improvement in Elecon's margin by 40 bps y-o-y to 14.7%. BGR Energy had high margin BOP orders during the quarter which helped the company report highest ever margins of 14.3%.

Exhibit 2: EBITDA margin for Q2FY12 and quarterly sector margin trend





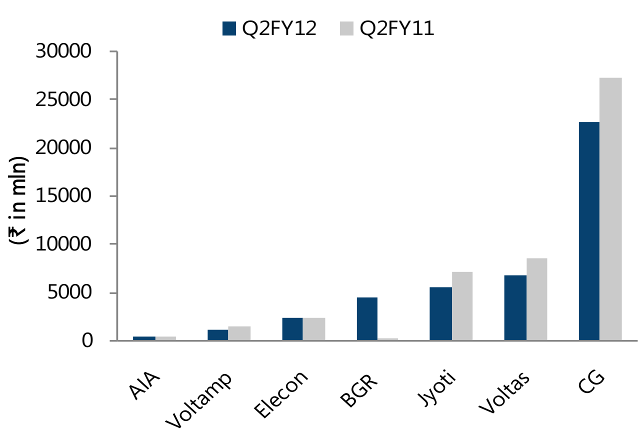
Source: Company, MSFL Research

Order intake weakens in the quarter

Order inflow for our coverage universe declined by 8% to approximately ₹ 43.2bln. The issues in macro environment like land acquisition, environment clearences as well as high funding cost causing delay in order finalizations still continue to hamper order inflow growth.

Amongst, large caps, L&T recorded degrowth of 21% y-o-y in order intake on back of continued delays and deferrals in order finalizations. ABB and BHEL surprised positively for order inflows during the quarter. BHEL reported 6% y-o-y growth driven by strong order inflow in industry segment (up 134% y-o-y) to ₹ 51 bln. ABB exceptionally secured large orders in core industries such as steel, pulp and power which led to 23% y-o-y growth in order inflows to ₹ 25bln.

Exhibit 3: Weakening order inflow

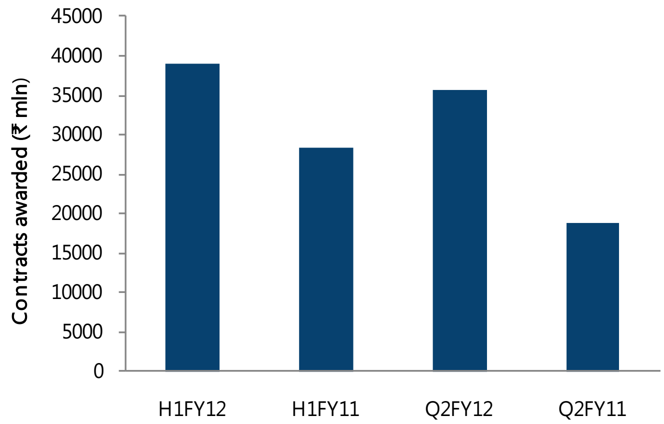


Source: MSFL Research

PGCIL ordering activity picking up momentum gradually

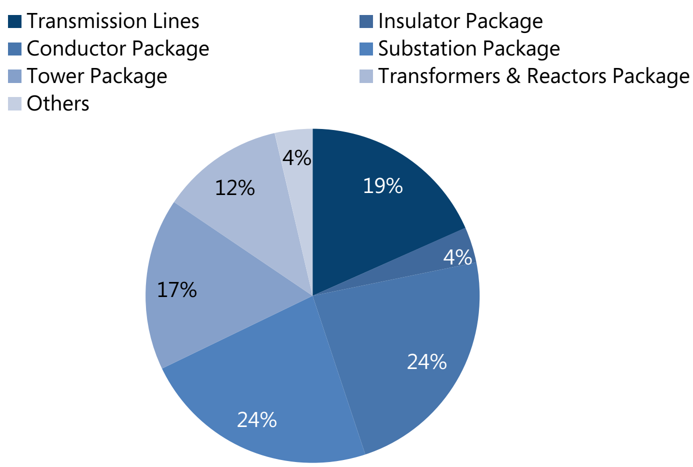
During Q2FY12, order-awarding activity from PGCIL has picked up sharply with 89. 5% y-o-y growth to ₹ 35.6bln as compared to ₹ 18.8bln in Q2FY11. On half yearly basis, PGCIL awarded total contracts worth ₹ 38.9bln for H1FY12, up by 37% y-o-y. Jyoti Structures received major orders from PGCIL during the quarter taking PGCIL's share in total order inflows to 35% from 22% in Q1FY12. Crompton Greaves also bagged few significant orders from PGCIL for 765 Kv substation. Moreover, in October alone, PGCIL awarded orders worth ₹ 39.5bln; taking the YTD capex to approximately ₹ 80bln. Thus, we are optimistic that PGCIL will meet its targeted capex of ₹ 150-160bln for FY12 and expect that it shall provide some solace to the declining order book of T&D companies.

Exhibit 4: PGCIL order awards gradually picking up



Source: PGCIL Website, MSFL Research

Exhibit 5: YTD break up of orders segment wise

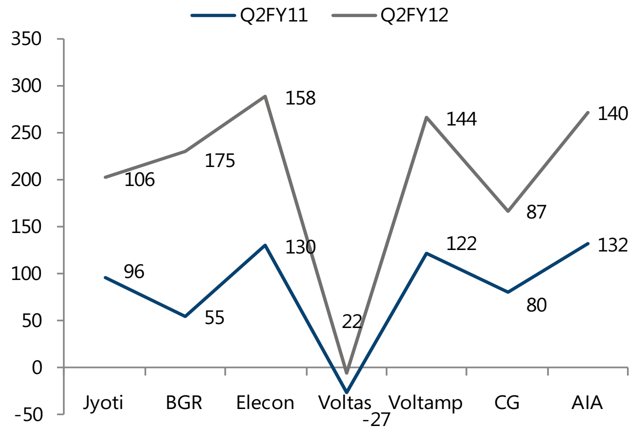


Source: PGCIL website, MSFL Research

Deteriorating working capital cycle leads to rising interest cost

Capital goods sector's profitability has been hit badly due to increase in interest cost during the quarter. PAT for our coverage universe was down by 41% y-o-y to ₹ 2.71bln. BGR's interest cost rose 118% y-o-y due to increase in debt by ₹ 5bln to ₹ 23bln. Consequently its PAT declined by 34% y-o-y to ₹ 514mln. Jyoti structures interest cost rose by 50% y-o-y due to increase in LC charges and working capital loan, which lowered its profitability by 11% y-o-y to ₹ 221mln. Voltas interest cost rose by 90% to ₹ 71mln in Q2FY12. The interest cost for CG increased by 108% y-o-y to ₹ 102mln due to increased borrowings for funding few recent acquisitions. Hence its PAT was down by 45% y-o-y to ₹ 1.18bln. Deteriorating working capital cycle due to higher debtor days and decline in orders and customer advances necessitates borrowings to fund regular working capital requirements. High borrowing cost particularly in high interest rate cycle has taken a toll on profitability of the companies.

Exhibit 6: Working capital cycle increased for all companies under coverage



Source: MSFL Research

Outlook & Valuation

The aforementioned negatives are likely to impact the sector for another two to three quarters. However, recent moderation in raw material prices and pause or cut in interest rates is expected to support profitability. Major concern boils down to slow down in investments and industrial capex which hampers order inflows and intensify competition. Valuations for companies are at all time low, though further pressure is seemingly obvious considering stagnant order book and declining order inflows for medium term. We are positive on AIA and Elecon on account of attractive valuation and better growth prospects.

Exhibit 7: Quarterly performance summary

Fig in mln	Q2FY12	Q2FY11	% y-o-y
Jyoti Structures			
Total Income	6321	5423	16.6%
EBIDTA	680	631	7.8%
EBIDTA Margin	10.8%	11.6%	
PAT	221	248	-10.9%
EPS	2.7	3.0	
BGR Energy			
Total Income	7715.1	11356.1	-32.1%
EBIDTA	1102	1323	-16.7%
EBIDTA Margin	14.3%	11.7%	
PAT	514	778	-34%
EPS	7.0	8.4	
Elecon Engg			
Total Income	3368	2798	20.4%
EBIDTA	496	400	24.0%
EBIDTA Margin	14.7%	14.3%	
PAT	156	142	9.9%
EPS	1.7	1.5	
Voltas			
Total Income	11019	10651	3.5%
EBIDTA	273	1075	-74.6%
EBIDTA Margin	2.5%	10.1%	
PAT	169	746	-54.5%
EPS	0.5	2.3	

Voltamp			
Total Income	1355	1243	9.0%
EBIDTA	125	125	0.0%
EBIDTA Margin	9.2%	10.1%	
PAT	94	93	1.1%
EPS	9.3	9.2	1.1%
Crompton Greaves			
Total Income	27055	23979	12.8%
EBIDTA	2260	3332	-32.2%
EBIDTA Margin	8.4%	13.9%	
PAT	1167	2136	-44.6%
EPS	1.8	3.3	
AIA Engineering			
Total Income	3433	2585	32.8%
EBIDTA	612	624	-1.9%
EBIDTA Margin	17.8%	24.1%	
PAT	385	452	-14.8%
EPS	4.1	4.8	

Source: Companies, MSFL Research

Exhibit 8: Valuation

	CMP	MCap	Tgt	P/E		P/BV		ROE (%)		ROCE (%)	
				FY12E	FY13E	FY12E	FY13E	FY12E	FY13E	FY12E	FY13E
Jyoti Struct	50	4.1	97	3.6	3.1	0.6	0.5	17.4	17.5	15.5	15.1
BGR Energy	271	19.5	232	7.0	8.8	1.7	1.5	26.4	17.9	12.0	9.3
Elecon Engg	61	5.7	91	7.4	5.8	1.3	1.1	18.1	19.9	11.2	12.3
Voltas	92	30.5	90.5	13.7	10.2	1.9	1.7	15.1	17.6	9.5	11.7
Voltamp	508	5.1	477	9.8	8.1	1.2	1.1	13.3	14.5	10.0	10.9
Crompton G	132	84.8	136	15.1	11.5	2.3	1.9	15.9	18.1	12.3	14.3
AIA Engg	297	28.0	341	15.3	12.5	2.3	2.0	16.3	17.3	14.1	15.1

Source: MSFL Research

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Accumulate	5 to 15%
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Not Rated	-

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