Flashnote

HSBC Global Research

Industrials
Energy Equipment
Equity – India

Welspun Corp Ltd

Neutral

Target price (INR)	**165.00**
Share price (INR)	**153.25**
Forecast dividend yield (%)	**1.4**
Potential return (%)	**10.8**

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

Performance	**1M**	**3M**	**12M**
Absolute (%)	27.4	92.4	-16.5
Relative^ (%)	16.6	72.2	-16.9

Index^	BOMBAY SE IDX
RIC	WGSR.BO
Bloomberg	WLCO IN
Market cap (USDm)	710
Market cap (INRm)	34,907
Enterprise value (INRm)	62,176
Free float (%)	58

21 February 2012

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Downgrading to N: Tough environment at home and abroad

- **Tough demand environment will continue to hurt earnings growth and low investor confidence will prevent stock re-rating**
- **However, global expansion to provide some solace**
- **We downgrade to Neutral from OW and cut our TP to INR165 from INR265**

Recent earnings report and post-earnings conference call point to tough environment. The company reported lower-than-expected sales volume and we believe it is likely to miss its full year guidance on sales volume as well. The global slowdown has adversely impacted capital expenditure decisions for large projects. Line pipe manufacturers like Welspun have been hurt by policy paralysis across the globe from policymakers and private corporates, which has led to delays in pipeline projects. While political leaders have been trying to avoid tough decisions pending elections, private companies have been waiting for financing conditions to improve and commodity prices to settle down. These tough economic conditions have also led to nationalistic fervour, resulting in projects being awarded to companies with domestic presence. Consequently, pipe manufacturing companies are facing pressures in their non-domicile markets.

Welspun diversification strategy has negatively impacted investor sentiment. Welspun has been an aggressive player with a global reputation, adding capacity in anticipation of demand, and forging newer global relationships. However, over the last year, the adverse business environment and its aggressive approach has hurt its credibility badly. Its acquisitions of Leighton Infrastructure and the MSK projects have had nothing to show so far. Similarly, its backward integration plan through the acquisition of Maxsteel is now looking like a bad business decision as a result of falling domestic gas production.

Welspun's global expansion is its only saviour. Welspun is adding capacity in US and Saudi Arabia. Both of these countries are likely to give preference to companies that have domestic presence. Consequently, we expect these new plants to ensure both margins and order flow. This is likely to provide some support for the stock.

Valuation and risk. We are no longer bullish on the demand environment and the company's diversification strategy is yet to show results. Hence, we cut our earnings estimates by 45-60%. We also roll forward our valuation to FY14e EPS (previously FY13e) but continue to value the business at 7x, leading to valuation of INR165 (earlier INR265). We now rate the stock as Neutral downgraded from Overweight. Our biggest concern on the stock remains demand growth and lack of investor confidence on corporate governance.

Financials & valuation

Financial statements

Year to	03/2011a	03/2012e	03/2013e	03/2014e
Profit & loss summary (INRm)				
Revenue	80,236	78,928	95,350	100,707
EBITDA	14,838	11,541	13,556	15,426
Depreciation & amortisation	-2,440	-3,555	-4,375	-4,746
Operating profit/EBIT	12,399	7,986	9,181	10,681
Net interest	-1,471	-2,489	-2,638	-2,251
PBT	11,112	4,377	7,799	10,023
HSBC PBT	11,112	4,377	7,799	0
Taxation	-2,871	-1,751	-2,652	-3,408
Net profit	8,341	2,824	5,218	6,700
HSBC net profit	8,341	2,824	5,218	6,700
Cash flow summary (INRm)				
Cash flow from operations	6,747	8,294	12,041	18,159
Capex	-11,089	-21,224	-4,996	-3,000
Cash flow from investment	-22,574	-21,224	-4,996	-3,000
Dividends	-476	-557	-557	-557
Change in net debt	22,080	11,146	-3,511	-19,892
FCF equity	-4,116	-14,461	3,151	11,315
Balance sheet summary (INRm)				
Intangible fixed assets	0	0	0	0
Tangible fixed assets	51,560	69,568	70,528	69,122
Current assets	44,439	58,659	64,548	73,466
Cash & others	7,532	11,683	15,194	27,206
Total assets	110,363	142,431	149,281	156,792
Operating liabilities	30,218	39,750	42,009	43,461
Gross debt	38,060	53,356	53,356	45,476
Net debt	30,528	41,674	38,163	18,271
Shareholders funds	34,695	42,133	46,795	60,819
Invested capital	58,249	76,794	77,874	71,921

Ratio, growth and per share analysis

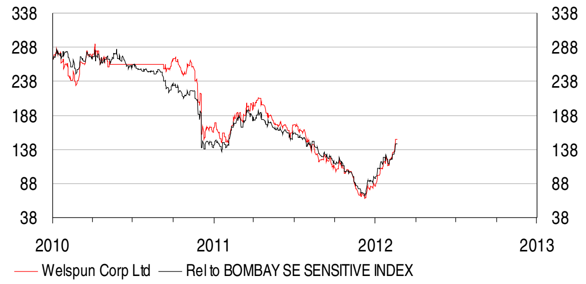
Year to	03/2011a	03/2012e	03/2013e	03/2014e
Y-o-y % change				
Revenue	9.2	-1.6	20.8	5.6
EBITDA	12.5	-22.2	17.5	13.8
Operating profit	11.4	-35.6	15.0	16.3
PBT	20.3	-60.6	78.2	28.5
HSBC EPS	31.9	-73.7	84.8	28.4
Ratios (%)				
Revenue/IC (x)	1.6	1.2	1.2	1.3
ROIC	18.6	7.1	7.8	9.4
ROE	26.2	7.4	11.7	12.5
ROA	9.3	3.3	4.7	5.3
EBITDA margin	18.5	14.6	14.2	15.3
Operating profit margin	15.5	10.1	9.6	10.6
EBITDA/net interest (x)	10.1	4.6	5.1	6.9
Net debt/equity	83.1	94.8	78.6	29.2
Net debt/EBITDA (x)	2.1	3.6	2.8	1.2
CF from operations/net debt	22.1	19.9	31.6	99.4
Per share data (INR)				
EPS reported (fully diluted)	37.47	9.85	18.20	23.37
HSBC EPS (fully diluted)	37.47	9.85	18.20	23.37
DPS	2.32	2.09	2.09	1.66
Book value	169.52	185.08	205.56	212.15

Valuation data

Year to	03/2011a	03/2012e	03/2013e	03/2014e
EV/sales	0.6	0.8	0.6	0.4
EV/EBITDA	3.4	5.4	4.3	2.5
EV/IC	0.9	0.8	0.8	0.5
PE*	4.1	15.6	8.4	6.6
P/Book value	0.9	0.8	0.7	0.7
FCF yield (%)	-20.1	-70.5	15.4	55.2
Dividend yield (%)	1.5	1.4	1.4	1.1

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

Price relative



Source: HSBC

Note: price at close of 20 Feb 2012

Investment view

The stock has underperformed the market by 19% over the last 12 months on the back of global slowdown, which has led to declining order books and investor concerns on corporate governance.

Tougher environment in global and domestic markets. We don't expect the demand environment to improve from current levels. We are witnessing the following trends in the pipes market:

- Large projects in US are not moving forward on environmental concerns and policy paralysis
- Companies are pushing orders back in search of cheaper raw material pricing and better financing
- Due to tight financial conditions, there is a dearth of replacement demand
- Order book cycles have become shorter as companies want to avoid commodity price volatility
- There is a growing emphasis on nationalism as governments try to pacify their citizens with employment prospects and income growth. This has led to domestic companies bagging a higher proportion of orders.
- Infrastructure activity in domestic market has also dried up as the Indian government tries to balance its budget and deficit

Welspun diversification strategy has negatively impacted investor sentiment. Welspun has been an aggressive player with a global reputation, adding capacity in anticipation of demand, and forging newer global relationships. However, over the last year, the adverse business environment and its aggressive approach have hurt its credibility badly. Its acquisitions of Leighton Infrastructure and the MSK projects have had nothing to show so far. The purchase of Leighton by the company, which was previously presumed to be bought by its parent has not gone over well with the investors. Similarly, its backward integration plan through the acquisition of Maxsteel now appears to be a bad business decision, courtesy of falling domestic gas production. Maxsteel was purchased from its parent and consequently any bad performance is now attributed to governance.

Welspun's global expansion is its only saviour. Welspun is adding capacity in US and Saudi Arabia. Both these countries are likely to give preference to companies that have domestic presence. We expect these new plants to ensure both margins and order flow. This is likely to provide some support for the stock.

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Forecasts

Key Forecast changes and assumptions

		FY12e	FY13e	FY14e
Sales volume ('000 tonne)	**New**	**830,284**	**952,000**	**1,117,500**
	Old	1,078,750	1,240,000	1,370,000
	Change	-23%	-23%	-18%
Revenue (INRm)	**New**	**78,928**	**95,350**	**100,707**
	Old	83,473	95,617	104,581
	Change	-5%	0%	-4%
EBITDA per tonne (INR)	**New**	**12,284**	**12,368**	**11,858**
	Old	10,592	11,865	11,854
	Change	16%	4%	0%
EBITDA (INRm)	**New**	**11,541**	**13,556**	**15,426**
	Old	13,830	18,034	19,824
	Change	-17%	-25%	-22%
Net Profit (INRm)	**New**	**2,824**	**5,218**	**6,700**
	Old	6,303	8,609	9,801
	Change	-55%	-39%	-32%
EPS - diluted (INR)	**New**	**9.9**	**18.2**	**23.4**
	Old	27.6	37.7	42.9
	Change	-64%	-52%	-46%

Source: HSBC estimates

We reduce our sales volume estimates to account for tough market conditions. We largely keep our margin assumptions unchanged as its new plants in global markets should ensure good margins.

Valuation

Given the cyclical nature of order inflows, we value the company using a PE methodology. In the past five years, Welspun stock has traded at a one-year forward PE of between 5x and 35x, depending on how "hot" the capex cycle was. We value the company on 7x PE to account for 13.2% WACC, 3% growth, and 11% ROE using the Gordon growth model. We, however, roll forward our valuation to FY14e EPS (previously FY13e) to value the company at INR165.

Under our research model, for stocks without a volatility indicator, the Neutral band is 5ppt above and below our hurdle rate for Indian stocks of 11%, or 6-16% around the current share price. Our INR165 target price implies a potential return, including dividend yield, of 10.8%, which is within the Neutral band; thus, we rate our stock Neutral, downgrading it from Overweight

Risks and sensitivities

The biggest risk to our rating is the improvement in demand environment. .Post the US elections in September 2012, some of the large pipeline projects can get permission to commence construction. These can lead to large orders for pipe manufacturers and can boost the stock price.

The biggest concern for investors, in our opinion, is corporate governance. The final order from Securities and Exchange Board of India (SEBI) on corporate governance issue is still due. Any adverse decision can negatively impact the stock

Sensitivities: Our earning estimates and target price are sensitive to volume growth and margins trends. We calculate that a 10% increase in total pipe volumes would increase net profit by 15%. 10% increase in blended pipes EBITDA/tonne would increase net profit by 15%.

Disclosure appendix

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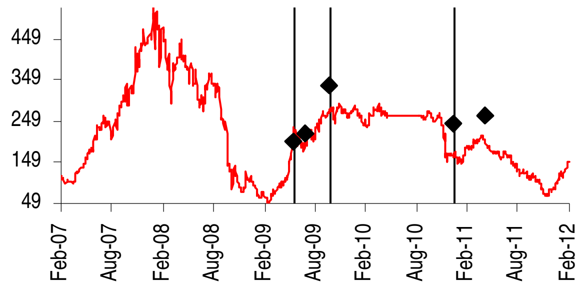
Underweight (Sell)	13%	(14% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities

Welspun Corp Ltd (WGSR.BO) Share Price performance INR Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Overweight (V)	Neutral (V)	01 June 2009
Neutral (V)	Overweight (V)	13 October 2009
Overweight (V)	Overweight	03 January 2011
Target Price	**Value**	**Date**
Price 1	200.00	01 June 2009
Price 2	220.00	17 July 2009
Price 3	335.00	13 October 2009
Price 4	245.00	03 January 2011
Price 5	265.00	28 April 2011

Source: HSBC

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