

Bharat Heavy Electricals

26 March 2013

Reuters: BHEL.BO; Bloomberg: BHEL IN

We had a meeting with the management of Bharat Heavy Electricals (BHEL) recently to gauge the current industry dynamics and get the latest business update. Lack of finalisation of new projects and delay in awarding L1 orders continues to hamper the growth prospects of BHEL. The award of Darlipalli and Gadarwara bulk tender orders is still awaited, 18 months after declaring L1 status, while RRVUNL, OPGC and NTPC Unchachar projects could be deferred to FY14. Consequently, we expect BHEL to report weak order intake in 4QFY13, a seasonally strong quarter, leading us to cut our order inflow assumption from Rs350bn to Rs220bn for FY13E. With fewer projects on the anvil, the competition remains intense and pricing irrational, as seen is BHEL's RRVUNL bid and Larsen & Toubro's Tanda bid. Factoring in lower order inflow assumption and higher pressure on margins, we have cut our FY14E revenue/earnings estimates by 6.8%/9.7%, respectively. We have retained our Sell rating on BHEL with a revised target price of Rs170 (from Rs215 earlier) as we reduced our PE multiple to 8x FY14E (from 9x earlier) due to subdued earnings visibility amid a weak capex cycle.

Delay in award of L1 orders/new projects hurts revenue traction: Even though BHEL has L1 status on projects worth Rs178bn (see Exhibit 1), we expect most of them to get deferred to FY14. The orders from BHEL's joint ventures with Maharashtra and Madhya Pradesh electricity boards are also unlikely to materialise soon as the projects do not have coal linkage. Most of the upcoming projects for bidding (see Exhibit 4) have already been delayed since the past one year and could get delayed further. Even if we assume that BHEL achieves 50% share in the upcoming orders, although at the cost of margins due to overcapacity in the BTG segment, they will not suffice due to the company's large scale of operations.

Intense pricing pressure to continue: The capex cycle for setting up new power projects remains weak due to structural issues impacting the power sector. As a result, for the fewer projects on anvil, the bidding remains fierce as seen in BHEL's bid for RRVUNL project (8%-10% lower than its original bid in January 2011) and L&T's bid for NTPC's Tanda project (lower than the bulk tender price). Consequently, we expect BHEL's operating margin to fall 240bps/170bps YoY in FY13E/FY14E to 16.9%/15.2%, respectively.

Outlook: BHEL is unlikely to sustain its revenue growth traction on such a high base, considering the subdued order placement activity and distorted demand-supply dynamics in the BTG (boiler, turbine and generator) segment. Also, margins would be under pressure due to severe price under-cutting to secure orders. Consequently, we expect BHEL to register decline in revenue/earnings CAGRs by 3.5%/14.5% over FY12-FY14E compared to 20.4%/28.2% CAGRs reported over FY10-FY12, respectively, thereby capping its valuation.

Y/E March (Rsmn)	FY10	FY11	FY12	FY13E	FY14E
Net sales	328,611	418,547	475,990	468,714	443,526
EBITDA	53,054	79,499	91,951	79,055	67,248
Net profit	42,961	60,534	70,873	62,099	51,847
EPS (Rs)	17.6	24.7	29.0	25.4	21.2
EPS growth (%)	37.4	40.4	17.1	(12.4)	(16.5)
EBITDA margin (%)	16.1	19.0	19.3	16.9	15.2
PER (x)	10.2	7.3	6.2	7.1	8.5
P/BV (x)	2.8	2.2	1.7	1.5	1.4
EV/EBITDA (x)	6.5	4.3	4.1	4.6	5.5
RoCE (%)	34.1	40.7	36.4	25.5	18.6
RoE (%)	29.8	33.6	31.1	22.7	16.9

Source: Company, Nirmal Bang Institutional Equities Research

SELL

Sector: Capital Goods

CMP: Rs180

Target Price: Rs170

Downside: 6%

Chirag Muchhala

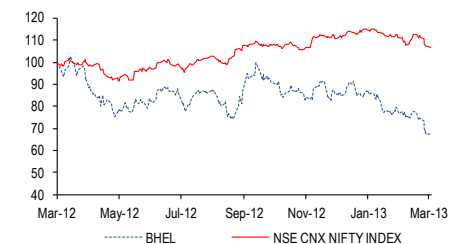
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Key Data

Current Shares O/S (mn)	2,447.6
Mkt Cap (Rsbn/US\$bn)	439.2/8.1
52 Wk H / L (Rs)	275/178
Daily Vol. (3M NSE Avg.)	3,705,138

One Year Indexed Stock Performance



Price Performance (%)

	1 M	6 M	1 Yr
BHEL	(13.6)	(29.3)	(32.7)
Nifty Index	(3.8)	(0.7)	6.7

Source: Bloomberg

Exhibit 1: L1 projects of BHEL – Delay in awarding orders affecting revenue traction

Project	Developer	Unit size (MW)	Scope	Likely value (Rsbn)	Bids opened in	Status
Darlipalli	NTPC (Bulk tender 2)	2x800	Boiler	25.4	September 2011	Land acquisition pending
Gadarwara	NTPC (Bulk tender 2)	2x800	BTG	40.6	September 2011	Environment clearance pending
Suratgarh	RRVUNL	2x660	EPC	56.0	January 2013	Award of contract expected shortly
IB Valley	OPGC	2x660	BTG	34.0	November 2012	Likely to be awarded in 1HFY14
Unchachar	NTPC	1x500	EPC	22.0	N.A.	To be awarded on nomination basis, likely in 1HFY14

Source: Company, Industry, Nirmal Bang Institutional Equities Research

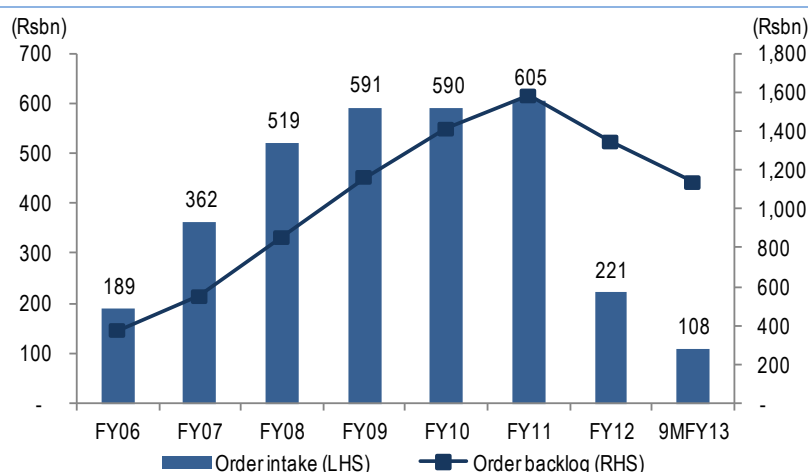
Exhibit 2: BHEL SEB JVs – Promising business strategy gone kaput

BHEL JV with	Project	Unit size (MW)	Likely value (Rsbn)	Status
Karnataka SEB	Yeramarus & Edlapur	3x800	99.0	Order received in FY11
Tamil Nadu SEB	Udangudi	2x800	63.0	Project scrapped by Tamil Nadu government due to the delay
Madhya Pradesh SEB	Khandwa	2x800	63.0	Yet to finalise a strategic partner, no coal linkage
Maharashtra SEB	Latur	2x660	52.0	Land acquisition pending, no coal/gas linkage

Source: Company, Industry, Nirmal Bang Institutional Equities Research

BHEL adopted a promising business strategy of setting up power plants in partnership with respective state electricity boards (SEBs) by picking up a minority stake. The strategy held promise as it guaranteed BHEL an EPC contract of that project, as it is a co-promoter, on negotiated price basis and not through competitive bidding, thereby ensuring better margins. However, several structural issues like land acquisition problems, environmental/forest clearances and non-availability of fuel have resulted in a delay in SEB JVs commencing their operations. It received orders from only one SEB JV till now (with Karnataka SEB), while Tamil Nadu SEB has already scrapped its JV due to the long delay. We expect the delay in two other JVs – with Madhya Pradesh SEB and Maharashtra SEB each – to continue as these projects do not have fuel linkage. BHEL was also in negotiations with the SEBs of Gujarat, Orissa, Andhra Pradesh, Punjab, Uttar Pradesh, West Bengal and Tripura to form similar JVs in order to set up power plants, but it seems unlikely in the near future due to dwindling cash balance of BHEL. Drying up of customer advances due to lack of new orders led to sharp decline in the cash balance of BHEL from Rs96bn in FY11 to Rs67bn/Rs35bn in FY12/9MFY13, respectively. As a result, we don't expect BHEL to block cash in long-gestation power generation projects via new SEB JVs.

Exhibit 3: Annual order book position – a sharp decline



Source: Company, Nirmal Bang Institutional Equities Research

The order intake in 9MFY13 remained weak at Rs108bn, 36% down YoY despite a low base of FY12, leading to contraction in the order backlog at Rs1,137bn, down 22% YoY and 7% QoQ. Over the past six quarters, BHEL has witnessed a sharp decline in its order book from Rs1,610bn in 2QFY12 to Rs1,137bn in 3QFY13 resulting in the order book to TTM sales ratio declining by 3.5x to 2.2x over the same period. The announced order intake in 4QFY13 till date amounts to only Rs36.0bn (Rs28.5bn towards boilers of 3x660MW Nabinagar project and Rs7.5bn towards 4x170MW Bhutan hydro-power project) as the award of many projects, especially those on which BHEL has L1 status, is yet to take place. Consequently, we have cut our order inflow assumption for FY13E from Rs350bn to Rs220bn.

Exhibit 4: Upcoming projects for bidding in FY14

Project	State	Developer	Unit size (MW)	Scope
Bhusawal	Maharashtra	Maharashtra SEB	1x660	EPC
Nashik	Maharashtra	Maharashtra SEB	1x660	BTG
Khandwa	Madhya Pradesh	Madhya Pradesh SEB	2x660	EPC
Khargaon	Madhya Pradesh	NTPC	2x660	EPC
Ennore	Tamil Nadu	Tamil Nadu SEB	1x660	EPC
Wanakbori	Gujarat	Gujarat SEB	1x800	EPC
Ghatampur	Uttar Pradesh	Neyveli Lignite	2x660	EPC
Surajpur	Chhatisgarh	IFFCO	2x660	BTG

Source: Industry, Nirmal Bang Institutional Equities Research

Exhibit 5: Status on perceived slow moving orders in the order book

Project	Unit size (MW)	Developer	Value (Rsbn)	Status
Raigarh	2x660	Visa Power	26.7	Non-moving project, BHEL has stopped supply
Nashik & Amravati	10x270	Indiabulls phase 1	57.8	Execution of eight units on schedule while two units at Nashik are slow moving
Nashik & Amravati	10x270	Indiabulls phase 2	57.8	Slow-moving project, BHEL has held back supply due to non-receipt of payment
Vizag	1x300	Abhijeet Project	6.3	Not much work done as project has funding problems
Jamshedpur	2x270	Adhunik Power	1.3	Execution on track, commercial operations have started at unit 1 while at unit 2 they are expected to start shortly

Source: Media articles, Industry, Nirmal Bang Institutional Equities Research

Exhibit 6: Change in our FY14 earnings estimates

(Rsmn)	Old	New	Variation (%)
Revenue	475,835	443,526	(6.8)
EBITDA	74,557	67,248	(9.8)
PAT	57,391	51,847	(9.7)

Source: Nirmal Bang Institutional Equities Research

Rating track

Date	Rating	Market price (Rs)	Target price (Rs)
27 January 2012	Buy	281	327
30 January 2012	Buy	274	327
4 April 2012	Hold	264	286
13 April 2012	Hold	257	286
24 May 2012	Hold	209	221
27 July 2012	Hold	212	221
20 September 2012	Hold	216	221
4 October 2012	Sell	249	221
30 October 2012	Sell	227	221
7 January 2013	Sell	242	221
4 February 2013	Sell	225	215

Disclaimer

Stock Ratings Absolute Returns

BUY > 15%

HOLD 0-15%

SELL < 0%

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