Bharat Heavy Electricals BHEL.NS BHEL IN

ELECTRICAL EQUIPMENT

NOMURA EQUITY RESEARCH

Coalgate, fake orders and then some more

New concerns on medium-term execution as questions arise on order book credibility

September 12, 2012

Rating Remains	**Neutral**
Target price Reduced from 210	INR 199
Closing price September 10, 2012	INR 198
Potential upside	+0.5%

Action: Execution outlook worsens, while stock seems fairly valued

Recent news flow regarding several private sector power producers being implicated in the 'coalgate' scandal, some of which are BHEL's existing customers, has negative implications for BHEL's execution outlook. We estimate that ~28% of BHEL's existing order book is at risk now (compared to ~19% earlier) and this drives our earnings cuts over the next few years. Simultaneously, several other private power developers have allegedly placed fake orders with power equipment companies in order to boost their chances of securing coal mines in India. Such issues question the credibility of the >115GW equipment orders placed in the system and raise the possibility that post clean-up of some of these orders (through cancellation/forfeiture), new order activity could revive sooner than earlier expected, albeit likely to be in 2-3 years, in our view. In the medium term, we believe the outlook remains highly uncertain as the clean-up of existing orders will bring accompanying pain for the incumbents.

Catalysts: Orders, results and sector concerns

Execution and order inflow/cancellation clarity are key stock catalysts.

Valuation: Cut FY13F-14F earnings estimates 1-8% and TP to INR199

We continue to value BHEL based on a DCF methodology (Ke 13.5% and terminal growth of 4%). Our TP of INR199/share factors in deteriorating margins (down to 12-14% levels post FY14 and <8% post FY17) and <6GW p.a. coal-based order inflow over the medium term. Given ~0.5% potential upside from current levels, we maintain our NEUTRAL rating.

31 Mar	FY12		FY13F		FY14F		FY15F
Currency (INR)	Actual	Old	New	Old	New	Old	New
Revenue (mn)	485,299	502,044	501,683	513,026	486,737		471,989
Reported net profit (mn)	70,400	64,708	64,214	61,524	56,710		47,207
Normalised net profit (mn)	70,592	64,708	64,214	61,524	56,710		47,207
FD normalised EPS	28.84	26.44	26.24	25.14	23.17		19.29
FD norm. EPS growth (%)	31.8	-8.0	-9.0	-4.9	-11.7		-16.8
FD normalised P/E (x)	6.9	N/A	7.5	N/A	8.5	N/A	10.3
EV/EBITDA (x)	4.0	N/A	4.0	N/A	4.2	N/A	4.2
Price/book (x)	1.9	N/A	1.6	N/A	1.4	N/A	1.3
Dividend yield (%)	3.8	N/A	3.8	N/A	3.4	N/A	2.8
ROE (%)	30.9	23.4	23.2	19.3	17.8		13.3
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash		net cash

Source: Company data, Nomura estimates

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

Anchor themes

Even as consumer demand for power is unlikely to slow, we expect actual power capacity to be constrained by limitations on land & fuel availability and environmental clearances. Meanwhile new concerns on execution emerge as order book credibility for the sector is in question now.

Nomura vs consensus

We are broadly in-line with consensus on FY13-14F estimates.

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

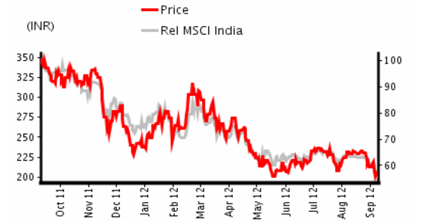
Key data on Bharat Heavy Electricals

Income statement (INRmn)

Year-end 31 Mar	FY11	FY12	FY13F	FY14F	FY15F
Revenue	**399,212**	**485,299**	**501,683**	**486,737**	**471,989**
Cost of goods sold	-242,767	-296,482	-312,807	-308,586	-309,932
Gross profit	**156,444**	**188,817**	**188,875**	**178,150**	**162,057**
SG&A	-25,696	-38,617	-41,029	-41,189	-40,956
Employee share expense	-56,375	-54,658	-57,931	-60,335	-62,840
Operating profit	**74,373**	**95,542**	**89,916**	**76,627**	**58,261**
EBITDA	**80,283**	**103,542**	**98,081**	**84,919**	**66,784**
Depreciation	-5,909	-8,000	-8,165	-8,292	-8,524
Amortisation					
EBIT	74,373	95,542	89,916	76,627	58,261
Net interest expense	-547	-513	-475	-450	-400
Associates & JCEs					
Other income	6,418	8,186	6,401	8,465	12,598
Earnings before tax	**80,244**	**103,215**	**95,841**	**84,642**	**70,459**
Income tax	-26,676	-32,623	-31,628	-27,932	-23,251
Net profit after tax	**53,568**	**70,592**	**64,214**	**56,710**	**47,207**
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	**53,568**	**70,592**	**64,214**	**56,710**	**47,207**
Extraordinary items	6,544	-193	0	0	0
Reported NPAT	**60,112**	**70,400**	**64,214**	**56,710**	**47,207**
Dividends	-17,747	-18,206	-18,654	-16,474	-13,714
Transfer to reserves	**42,365**	**52,194**	**45,560**	**40,236**	**33,494**
Valuation and ratio analysis					
Reported P/E (x)	8.1	6.9	7.5	8.5	10.3
Normalised P/E (x)	9.0	6.9	7.5	8.5	10.3
FD normalised P/E (x)	9.0	6.9	7.5	8.5	10.3
FD normalised P/E at price target (x)	9.1	6.9	7.6	8.6	10.3
Dividend yield (%)	3.7	3.8	3.8	3.4	2.8
Price/cashflow (x)	11.0	279.6	10.0	8.3	5.6
Price/book (x)	2.4	1.9	1.6	1.4	1.3
EV/EBITDA (x)	4.9	4.0	4.0	4.2	4.2
EV/EBIT (x)	5.2	4.4	4.4	4.6	4.9
Gross margin (%)	39.2	38.9	37.6	36.6	34.3
EBITDA margin (%)	20.1	21.3	19.6	17.4	14.1
EBIT margin (%)	18.6	19.7	17.9	15.7	12.3
Net margin (%)	15.1	14.5	12.8	11.7	10.0
Effective tax rate (%)	33.2	31.6	33.0	33.0	33.0
Dividend payout (%)	29.5	25.9	29.1	29.1	29.1
Capex to sales (%)	4.4	2.7	2.0	1.4	0.0
Capex to depreciation (x)	3.0	1.6	1.2	0.8	0.0
ROE (%)	33.3	30.9	23.2	17.8	13.3
ROA (pretax %)	17.6	18.0	15.1	12.9	10.4
Growth (%)					
Revenue	18.1	21.6	3.4	-3.0	-3.0
EBITDA	28.8	29.0	-5.3	-13.4	-21.4
EBIT	28.8	28.5	-5.9	-14.8	-24.0
Normalised EPS	24.5	31.8	-9.0	-11.7	-16.8
Normalised FDEPS	24.5	31.8	-9.0	-11.7	-16.8
Per share					
Reported EPS (INR)	24.56	28.76	26.24	23.17	19.29
Norm EPS (INR)	21.89	28.84	26.24	23.17	19.29
Fully diluted norm EPS (INR)	21.89	28.84	26.24	23.17	19.29
Book value per share (INR)	82.34	103.67	122.28	138.72	152.40
DPS (INR)	7.25	7.44	7.62	6.73	5.60

Source: Company data, Nomura estimates

Relative performance chart (one year)



Source: ThomsonReuters, Nomura research

(%)	1M	3M	12M
Absolute (INR)	-13.6	-10.5	-43.0
Absolute (USD)	-13.7	-10.4	-52.1
Relative to index	-14.3	-16.0	-47.6
Market cap (USDmn)	8,752.3		
Estimated free float (%)	22.3		
52-week range (INR)	357.28/197.35		
3-mth avg daily turnover (USDmn)	15.85		
Major shareholders (%)			
President of India	67.7		
LIC	4.8		

Source: Thomson Reuters, Nomura research

Notes

We expect margins to decline on increasing competition and higher raw material price

Cashflow (INRmn)

Year-end 31 Mar	FY11	FY12	FY13F	FY14F	FY15F
EBITDA	80,283	103,542	98,081	84,919	66,784
Change in working capital	-22,059	-82,839	-24,078	-6,350	30,723
Other operating cashflow	-14,262	-18,969	-25,702	-19,917	-11,053
Cashflow from operations	**43,962**	**1,734**	**48,301**	**58,653**	**86,454**
Capital expenditure	-17,602	-13,097	-10,000	-7,000	
Free cashflow	**26,360**	**-11,364**	**38,301**	**51,653**	**86,454**
Reduction in investments	-3,593	-225	0	0	0
Net acquisitions					
Reduction in other LT assets	0	0	0	0	0
Addition in other LT liabilities	-6,363	6,173	5,743	5,072	4,222
Adjustments	0	-6,173	0	0	-7,000
Cashflow after investing acts	**16,404**	**-11,589**	**44,043**	**56,724**	**83,676**
Cash dividends	-17,747	-18,206	-18,654	-16,474	-13,714
Equity issue					
Debt issue	-256	213	0	0	0
Convertible debt issue					
Others					
Cashflow from financial acts	**-18,003**	**-17,993**	**-18,654**	**-16,474**	**-13,714**
Net cashflow	**-1,599**	**-29,582**	**25,389**	**40,250**	**69,962**
Beginning cash	97,901	96,302	66,720	92,109	132,359
Ending cash	96,302	66,720	92,109	132,359	202,321
Ending net debt	-95,280	-65,486	-90,875	-131,125	-201,087

Source: Company data, Nomura estimates

Notes

The worst of working capital pain is probably over now, in our view

Balance sheet (INRmn)

As at 31 Mar	FY11	FY12	FY13F	FY14F	FY15F
Cash & equivalents	96,302	66,720	92,109	132,359	202,321
Marketable securities	0	0	0	0	0
Accounts receivable	274,656	358,448	367,145	356,207	314,013
Inventories	108,521	134,445	138,722	134,589	125,605
Other current assets	35,751	31,624	34,111	33,095	30,946
Total current assets	**515,229**	**591,237**	**632,087**	**656,250**	**672,886**
LT investments	4,392	4,617	4,617	4,617	4,617
Fixed assets	51,347	56,444	58,279	56,986	55,463
Goodwill	0	0	0	0	0
Other intangible assets	0	0	0	0	0
Other LT assets	0	0	0	0	0
Total assets	**570,967**	**652,298**	**694,983**	**717,854**	**732,965**
Short-term debt					
Accounts payable	84,794	108,891	107,731	106,270	102,871
Other current liabilities	305,249	303,903	296,446	275,470	256,266
Total current liabilities	**390,043**	**412,794**	**404,177**	**381,740**	**359,136**
Long-term debt	1,021	1,234	1,234	1,234	1,234
Convertible debt					
Other LT liabilities	-21,636	-15,462	-9,720	-4,648	-426
Total liabilities	**369,429**	**398,566**	**395,691**	**378,326**	**359,944**
Minority interest					
Preferred stock	0	0	0	0	0
Common stock	4,895	4,895	4,895	4,895	4,895
Retained earnings	196,643	248,837	294,396	334,632	368,126
Proposed dividends					
Other equity and reserves					
Total shareholders' equity	**201,538**	**253,732**	**299,292**	**339,527**	**373,021**
Total equity & liabilities	**570,967**	**652,298**	**694,983**	**717,854**	**732,965**
Liquidity (x)					
Current ratio	1.32	1.43	1.56	1.72	1.87
Interest cover	135.9	186.3	189.3	170.3	145.7
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	220.1	238.7	264.0	271.2	259.1
Days inventory	151.0	150.0	159.4	161.6	153.2
Days payable	120.7	119.5	126.4	126.6	123.2
Cash cycle	250.4	269.2	296.9	306.3	289.2

Source: Company data, Nomura estimates

Notes

Under a normal scenario (i.e. no developer defaulting), we expect the balance sheet situation to improve from here

Medium-term concerns on order inflow and execution to weigh on the stock

'Coalgate' raises risk of order cancelation

As per media articles (*Cong minister, MP, kin in nationwide CBI coal raids, The Hindustan Times, dated September 4, 2012*), some of BHEL's private sector customers have been named by the Central Bureau of Investigation (CBI) in the alleged coal allocation scam, widely referred to as 'coalgate'. While the status of coal mines allotted to them remains uncertain, we highlight potential risk to BHEL's order book from projects that were ordered on the back of these mine allocations.

As per our estimates, 28% of BHEL's existing order backlog (as of June-12) is at risk of cancellation/deferment due to either non-availability of coal linkage or cancellations of existing coal mines/linkage due to the coal allocation scam. Of this, we have already factored in potential risk of cancellation/deferment for ~19% of the June-12 order book.

Hence, the additional orders share at risk due to the coal allocation scam, as per our estimates is ~9% of the existing order book.

Fig. 1: ~28% of existing order book at the risk of cancellation/slow moving

INR mn

	Order date	Order value	Likely execution till Sep-12	Balance order value
2x270MW **Goindwal** BTG order GVK	29-Aug-08	11,550	10,049	1,502
4x600MW Raigarh STPP Jindal Power Limited	26-Dec-08	50,400	27,090	23,310
1x600MW Korba West Power Co Raigarh Avantha Bhandar	14-May-09	14,750	10,657	4,093
2x600MW Derang Orissa Jindal India Thermal Power	7-Aug-09	26,000	15,730	10,270
2x525MW Malibrahmani, Angul Monnet Power	21-Aug-09	26,300	15,912	10,389
3x660MW super-critical Prayagraj JP Associates	24-Nov-09	56,000	27,300	28,700
270MW Jamshedpur TPP Adhunik Power	21-Dec-09	6,400	4,736	1,664
2x800MW Raichur Power EPC Karnataka State JV	19-Apr-10	63,000	6,458	56,543
2x600MW Baradarha, Chattisgarh, Dainik Bhaskar Power	19-Jul-10	26,650	7,662	18,988
4x270MW Latehar, Jharkhand, Abhijeet Infra	9-Aug-10	25,250	8,522	16,728
2x600MW Raigarh, Chattisgarh, Visa Power	21-Sep-10	26,650	5,863	20,787
1x800MW EPC Edlapur TPS KSEB and BHEL JV	30-Sep-11	36,010	3,601	32,409
1X700MW Bellary TPS Unit 3, Karnataka Power Corp (KPCL)	7-Oct-10	37,000	3,793	33,208
3x660MW Lalitpur TPP, Bajaj Hindusthan	FY11	55,672	974	54,698
5x270MW Nasik-II and 5x270MW Amravati-II Elena Power, In	FY11	57,643	5,908	51,735
1x600MW Avantha-II, Korba	FY11	12,903	226	12,677
Total		532,178	154,479	377,699
Orders already classified as slow (Nomura est.)		312,628	48,049	264,579
Additional order value at risk		**219,550**	**106,430**	**113,120**
Total orders at risk as % of overall o/b		40%		28%
Additional orders at risk as % of overall o/b		**17%**		**9%**

Source: Company, Nomura estimates

Pink highlighted rows are projects that were already classified as slow moving (Nomura estimates)

Potential fake orders by several power developers could lead to a mass clean-up in the next 2-3 years

As per another media article (*Firms may have falsified equipment orders to get coal blocks, Mint, September 7, 2012*), several equipment orders placed in the past (especially to Chinese firms) are potentially fake orders and were placed in order to favourably boost their chances of securing coal mine allocation. The media article suggests that some of these orders might be at risk of cancellation, as the promoters' original intention was never to set up a power project but to secure coal mines.

As per our estimates, over 35% (i.e. ~41GW) of the total power equipment orders placed for the 12th Five Year Plan period (i.e. ~116GW) have so far been placed to Chinese companies. A potential risk of cancellation of these orders, in addition to risk from cancellation/deferment of orders placed with BHEL as highlighted above, means that there is a serious issue of credibility in the current system-wide order book with all power equipment makers.

We believe the next 2-3 years could witness a significant clean-up of the system as several orders could be restructured, cancelled or deferred. While one can argue that advances would have been paid against potential fake orders too, we highlight that such advances would have been negligible given the magnitude of gains that these coal mines would have delivered to the promoters.

Extract from Article from Mint

Firms may have falsified equipment orders to get coal blocks, September 7, 2012

New Delhi: Several companies allotted captive coal blocks for their power projects claimed to have placed orders for power generation equipment with Chinese manufacturers to strengthen their candidature — only, these were not really orders.

An engineering, procurement and construction (EPC) contract works like this: the buyer identifies a supplier and awards it the contract, but this doesn't become an order till the former pays an advance and sets a delivery date.

"There were many who claimed that they had placed EPC orders with Chinese manufacturers such as Dongfang Electric Corp. and Harbin Power Equipment Co. Ltd to improve their chances. But they never placed any firm orders. That's a question that needs to be asked," said the chief executive officer of a private sector power firm who spoke on condition of anonymity.

This seems common knowledge in the power business, although Mint couldn't immediately identify companies that claimed to have placed orders for power equipment in a bid to strengthen their case. Mint also couldn't immediately reach Dongfang Electric and Harbin Power Equipment for comment.

Between June 2004 and 31 March 2011, the coal ministry allotted 195 coal blocks on a nomination basis to various firms for captive use. Of these, 114 blocks were awarded to companies developing power projects.

A Delhi-based power sector expert, who also didn't want to be identified, confirmed the modus operandi and said, "The suppliers don't have a problem to issue such a letter. The question is whether any money was paid. To be fair, it is extremely difficult to verify such orders. Things such as equipment or land made a company go up the ladder (in the coal block allotment process), although nobody knew the process of selection. One made the case and then it was a lottery."

A second power sector expert, who, too, spoke on condition of anonymity, confirmed that this was common practice.

While power utilities placed orders for overseas equipment largely because of the inability of local manufacturers to meet growing demand, India has already decided to impose an import duty on power generation equipment in a move that will benefit domestic firms.

Amol Kotwal, associate director (energy and power systems practice) for South Asia and the Middle East at Frost and Sullivan, said, "A lot of companies who have got coal blocks have benefited through this modus operandi. However, it is imperative that the concerned authorities need to look at the actual progress on the project on ground and take necessary actions if required."

The Central Bureau of Investigation (CBI) has registered five cases over alleged irregularities in allocation to and utilization of coal mines by private companies.

"The cases have been registered in connection with the allegations related to getting coal blocks allocated on the basis of misrepresentations and false claims in the

applications, presentations and connivance/lack of due diligence on part of public servants," CBI said in a release.

Chinese imports are relatively cheaper because equipment makers from that country benefit from low interest rates and an undervalued currency. Undervaluing the currency makes exports cheaper and increases demand of products.

Fig. 2: List of power projects that have ordered imported power equipment

Project	Developer	Capacity	Likely CoD	BTG/EPC Contractor	Likely Coal Supply	Status
Talwandi Sabo	Sterlite Energy	1980	2015	SEPCO	FSA	On track as per news BS news in Nov 2011
Malaxmi Ventures Navabharat Power Ph 1	Navabharat	1050	2014	Harbin	Captive Coal Mines	
Kamalganga Orissa Power Project	GMR	1400	2013	SEPCO	FSA	On track
KVK Neelanchal Ph 1	KVK Neelanchal	350	2014	Harbin	FSA	
KVK Neelanchal Ph 2	KVK Neelanchal	700	2015	Harbin	FSA	
Tiroda Ph I (2*660)	Adani Power	1320	2012	SCMEC China	FSA	On track
Tiroda Phii (1*660)	Adani Power	660	2014	SCMEC China		On track
Adani -Mundra Iv (3*660)	Adani Power	1980	2013	SEPCO		On track
Lanco Amarkantak U-3	Lanco Infratech	660	2014	Dong Fang	FSA	On track
Lanco Amarkantak U-4	Lanco Infratech	660	2014	Dong Fang	FSA	On track
Athena Chhattisgarh Power	Athena	1200	2014	Dong Fang		Main plant construction under full swing as per website
KSK Mahanadi - Wardha CHG Ph 1	KSK Energy Ventures	1800	2012	SEPCO	Captive Coal Mines	Main plant construction under full swing as per website
KSK Mahanadi - Wardha CHG Ph 2	KSK Energy Ventures	1800	2013	SEPCO	Captive Coal Mines	SEPCO has begun the shipment of material supplies
R K M POWER Ph 1 At Uchpinda	RKM	720	2015	Harbin	FSA	
R K M POWER Ph 2 At Uchpinda	RKM	360	2015	Harbin	FSA	
Dhariwal Infra-CESC-Now	CESC	600	2014	Shanghai Electric	FSA	
Bhaiyathan Power Project	India Bulls	1320		CNTIC	Captive Coal Mines	
270 Mw Barmer Project-Ii	JSW Energy	270	2016	Dong Fang		
Bhavanapadu Thermal Power Project, Ph 1	Athena	1320		Dong Fang	Mix	Shipment of BTG equipment already started to receive
Lanco Babandh U1 Ph 1	Lanco Infratech	660	2014	Dong Fang	FSA	On track
Lanco Babandh U2 Ph 1	Lanco Infratech	660	2015	Dong Fang	FSA	On track
Mahanadi Power Private Limited U1	Lanco Infratech	660	2015	Dong Fang	FSA	On track
Mahanadi Power Private Limited U2	Lanco Infratech	660	2015	Dong Fang	FSA	On track
Warora(EMCO) Ph 1	GMR	300	2013	Shanghai Electric	FSA	On track
Warora(EMCO) Ph 2	GMR	300	2013	Shanghai Electric	FSA	On track
Butibori	Reliance Power	300	2013	Shanghai Electric	FSA	The construction activities are going on full swing presently
Essar Power Salaya Ph 1	Essar Power	1200	2012	Harbin	Imported Coal	87% Complete as of Q2FY12
Essar Power Mahan	Essar Power	1200	2012	Harbin	Captive Coal Mines	77% Complete as of Q2FY12
540 Mw Wardha Warora Power Plant	KSK Energy Ventures	540	2012	SEPCO	FSA	On track
1x600 MW Of 2000 MW Tori Ph 1 U 1	Essar Power	600	2013	Harbin		
1x600 MW Of 2000 MW Tori Ph 1 U 2	Essar Power	600	2013	Harbin		
UMPP Sasan	Reliance Power	3960	2014	Shanghai Electric	Captive Coal Mines	Supply started by Shanghai Electric
UMPP Krishnapatnam	Reliance Power	4000		Shanghai Electric	Imported Coal	

Source: Infraline, Company data, Nomura research

Post clean-up of the sector order backlog, order activity could revive sooner than earlier anticipated, but incumbents will likely bear the brunt in the interim

While the clean-up act will be painful for the incumbent power equipment makers, domestic or foreign alike, we see a positive outcome post this clean-up act – in our view, if a large chunk of the existing 115GW+ system wide order backlog of power equipment is cleaned up, then new order activity could revive sooner than our earlier expectations and vendors would get another opportunity to fill up their utilisation levels.

This, however, comes after the clean-up act ensues and in our view, could cause new orders to come with significantly lower margins than current orders. Furthermore, the clean-up act itself would lead to trouble for several equipment makers as it could affect some of their projects where work has already started.

In any case, the positives are at least 2-3 years away, in our view and largely built into our numbers.

Implementation of import duty, will only be a sentiment positive, in our view

For several months now, there has been speculation regarding the implementation of an import duty on imported power. Nevertheless, we believe that the proposed duty is still a non-issue. Our contention rests on the following three key arguments:

- Chinese competition is already fading on the back of a depreciating Rupee; also, fewer orders are anticipated from the private sector, while public-sector orders as well as expected Ultra Mega Power Projects (UMPP) orders have a mandatory domestic manufacturing clause.
- Surplus domestic manufacturing capacity is already a much bigger threat for BHEL compared to Chinese competition, and even without Chinese imports, we believe BHEL will face significant competition in winning new orders.
- As the following media article suggests, the proposed duty would be prospective in nature and will not affect most of the already-placed orders scheduled to commission over the 12th Five-Year Plan. The list of power plants with imported equipment is given below.

Article from The Hindu Business Line

New Delhi, Sept. 10: Seven Ultra Mega Power Projects and 106 mega power projects will not have to pay higher duty for importing equipment.

The Finance Ministry has notified a new duty structure that prescribes an effective duty of over 22 per cent, including education cess. However, this new duty will not be imposed on ultra mega power projects, mega power projects and expansion of existing mega projects which had received certificate of approval from the Power Ministry till July 19, 2012, the date on which the Cabinet took the decision.

Power Secretary P. Umashankar told Business Line: "There is a list of projects given mega status or provisionally declared as a mega project. These will not be affected. But any other project beyond this list will have to pay duty as per Government notification."

Exempted projects

The list of exempted projects includes 111 mega projects with permanent certificates and two with provisional ones. The provisional approval holders have been given three months to convert to permanent status, the official added. All these mega projects are expected to take care of capacity addition requirements up to the end of 12th Plan.

Earlier, power equipment for projects with capacity over 1,000 MW were exempt from basic Customs duty while those for projects with capacity of less than 1,000 MW attracted basic Customs duty of five per cent. This was done at a time when there was not enough capacity for ultra mega power projects (project with minimum capacity of 4,000 MW). Power producers such as NTPC and Tata Power say the imposition of the Customs duty will increase the project cost.

Capacity additions

A senior NTPC official told Business Line, "The equipment that we will buy for our future projects will be more expensive. There would be no change for the moment.''

At the same time Tata Power said: "The easy import of equipment for power projects has been a large contributor to the capacity addition in the 11th Plan, with almost 50 per cent of additional coal-based capacities depending on imported equipment.

Added Customs duties will curb the import of superior technology products that are already high priced, thus, hindering the advancement of the sector."

Proposed means of improvement in coal supply could, in fact, halt near-term order inflows

Complying with the directive from Prime Minister's Office, Coal India (CIL) has initiated the process of signing fuel supply agreements (FSAs) with power plants having long-term power purchase agreements (PPAs) and expected to be commissioned by March 31, 2015. However, we note that the order could increase uncertainties on new order inflows for BHEL. How will the scenario change?

- Earlier, power developers signed Letters of Assurance (LOAs) with CIL and hoped to get at least some coal on a priority basis to start the power plant. However, based on the new development, the projects will be evaluated to confirm whether the LOA will be converted into FSA. We expect the Central Electricity Authority of India (CEA) to notify the list of projects shortly. We note that there will be certain projects which will not feature in this list. We expect these projects to face pressure from lenders on account of increased fuel uncertainty and may be delayed/cancelled.
- Even though bulk of the XII Five-Year Plan orders are already finalised, projects not in the notified list and yet to order equipment will have to wait for the results of the coal block auctions for fuel security. Decision making for equipment orders, thus, could be delayed further, in our view.

Changes in our estimates

We are cutting our earnings estimates by 1-8% over FY13-14F as we build in execution concerns emerging from potential disruptions on the back of 'coalgate' as highlighted above. Lower utilisation will have its impact on margins as well and coupled with margin pressure from competition, our EPS estimates also move down.

Fig. 3: Changes in our estimates

	Old		New		Change	
INR Mn	FY13F	FY14F	FY13F	FY14F	FY13F	FY14F
Revenues	502,044	513,026	501,683	486,737	0%	-5%
EBITDA	101,118	96,870	98,081	84,919	-3%	-12%
EBITDA margin	20.1%	18.9%	19.6%	17.4%	-3%	-8%
PAT	64,708	61,524	64,214	56,710	-1%	-8%
EPS (INR)	26.4	25.1	26.2	23.2	-1%	-8%

Source: Nomura estimates

Nomura vs consensus

Fig. 4: Nomura vs Consensus estimates

INR Bn

	FY13F			FY14F		
	Nomura	Consensus	Difference	Nomura	Consensus	Difference
Revenue	502	487	3%	487	467	4%
EBITDA	98	92	7%	85	82	3%
EBITDA Margin	19.6%	18.9%	3%	17.4%	17.6%	-1%
PAT	64	64	1%	57	57	0%
EPS (INR)	26.2	26.0	1%	23.2	23.3	0%

Source: Bloomberg, Nomura Estimates

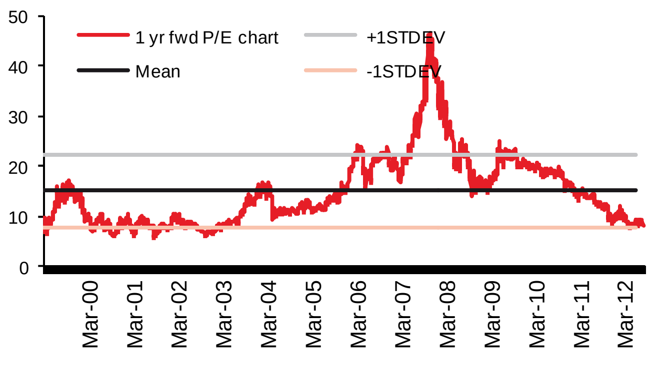
Valuation methodology

We continue to value BHEL using a discounted cash flow (DCF) methodology, assuming a cost of equity of 13.5% and a terminal growth rate of 4% (explicit forecast period until FY20F). We believe that using 4% terminal growth is justified since rising competition and demand saturation could put a check on high growth rates. Given ~0.5% potential upside to our DCF-based TP of INR199, we maintain our NEUTRAL rating on the stock.

We estimate EBITDA margin compression from current levels of 21.3% in FY12 to 13.3% in FY17F. We also see further margin risk post FY17F (and estimate it to turn to single digits) as orders received until FY13F will be completed by FY17F and lull in new orders in the medium term will likely weigh on utilisation levels post FY17F.

Fig. 5: Currently trading at -1STDEV 12-yr P/E mean

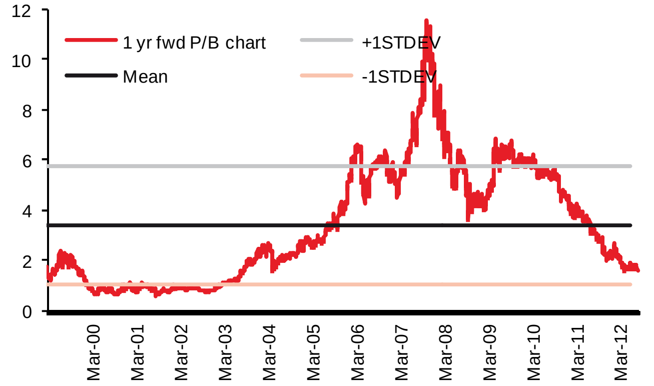
BHEL 1-year forward P/E



Source: Company, Bloomberg, Nomura estimates

Fig. 6: … and at -1STDEV 12-yr P/BV mean

BHEL 1-year forward P/B



Source: Company, Bloomberg, Nomura estimates

Investment risks

Upside risks

- Commodity price decline can be a key upside risk as ~50% of the order book is on fixed price contracts.
- Significant developments in new coal sourcing, whether domestically or through imports could drive the new power capex, thus benefitting BHEL.

Downside risks

- 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, putting pressure on margins.

Appendix A-1

Analyst Certification

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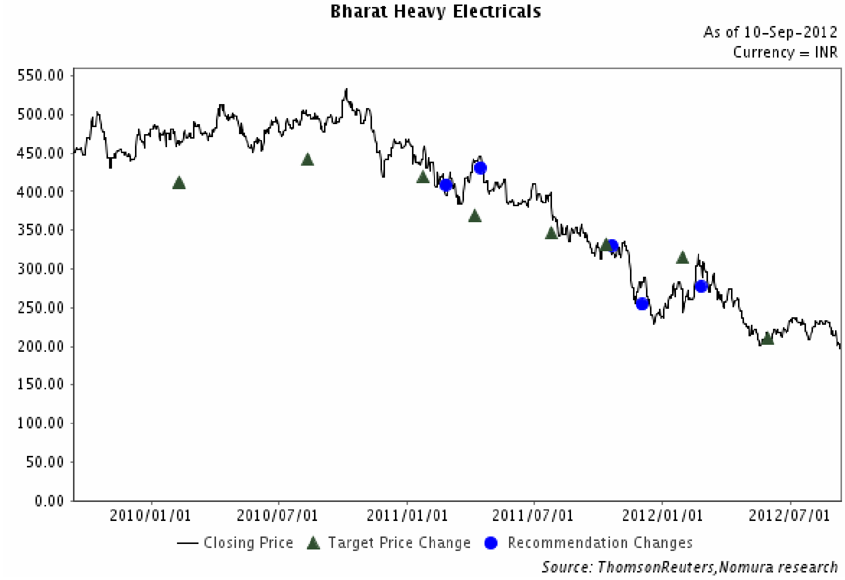
Issuer name	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Bharat Heavy Electricals	BHEL IN	INR 198	10-Sep-2012	Neutral	Not rated	

Previous Rating

Issuer name	Previous Rating	Date of change
Bharat Heavy Electricals	Buy	16-Feb-2012

Bharat Heavy Electricals (BHEL IN) **INR 198 (10-Sep-2012)** Neutral (Sector rating: Not rated)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
30-May-12		210.00	211.00
16-Feb-12	Neutral		284.55
30-Jan-12		315.00	244.15
24-Nov-11	Buy		261.75
12-Oct-11	Neutral		338.00
12-Oct-11		332.00	338.00
26-Jul-11		346.00	380.73
07-Apr-11	Reduce		439.03
07-Apr-11		370.00	439.03
17-Feb-11	Neutral		416.41
24-Jan-11		419.00	453.71
12-Aug-10		442.00	498.59
09-Feb-10		413.00	466.43

For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology Our target price is INR199. We value BHEL using a discounted cashflow (DCF) methodology, assuming a cost of equity of 13.5% and a terminal growth rate of 4% (explicit forecast period until FY20F). We believe 4% terminal growth is justified since rising competition and demand saturation will put a check on high growth rates.

Risks that may impede the achievement of the target price Upside risks: 1)Commodity price decline can be a key upside risk as ~50% of the order book is on fixed price contract. 2)Significant development in new coal sourcing whether domestically or through imorts could drive new power capex thus benefitting BHEL. Downside risks: 1)Worsening of fuel availability for new and/or already ordered projects could lead to delays in new and existing orders. 2)Rising competition could drive pricing even lower than our current estimates, putting pressure on margins.

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Explanation of Nomura's equity research rating system in Japan and Asia ex-Japan

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