# Bharat Heavy Electricals BHEL.NS BHEL IN

ELECTRICAL EQUIPMENT

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Order cancellation: Isn't that priced in?

# Adjusted 3QFY12 results in line but no order is sentimentally negative; Buy on correction

January 30, 2012

| | |
|---|---|
| **Rating** Remains | **Buy** |
| **Target price** Reduced from 332 | INR 315 |
| **Closing price** January 27, 2012 | INR 274 |
| **Potential upside** | +15% |

### Action: No new orders and some cancellation of previous orders could impact stock near-term; Buy on such a decline

BHEL's 3QFY12 results were in line with expectations after adjusting for INR2.28bn of additional provisions created during the quarter and reflected under the "other" expense line-item. Most other cost items and revenue growth, too, were slightly better than expected, though no new orders during the quarter and an order cancellation of INR58bn are potential dampeners for the stock price in the near term. We, however, note that:

- Our assumptions already classify ~INR230bn of the existing order book as slow moving and/or at the risk of cancellation/deferment, and our interactions with investors suggest a similar assumption by the bulk of the Street, as well. As such, the official statement of order cancellation of INR58bn is not new information but merely a confirmation of Street fears.
- While no new order is a negative surprise, this is mainly due to continued postponement of some larger orders by customers. For example, whether the NTPC bulk tender is finalised in FY12 or FY13 hardly makes any difference to BHEL valuation, as per our estimates.

### Catalysts: Orders, results, macro and policy action

Softening commodity prices and policy reforms are key upside triggers.

### Valuation: At 9.6x FY13F EPS, stock prices in adverse sector fortune

At 9.6x FY13F EPS, we estimate the stock is now pricing in a negative terminal growth rate and/or substantial reduction in sustainable ROE (down to low-teens vs. ~30% in FY12F). While we do not rule out near-term numbers to mirror such a trend, extrapolating such assumptions until perpetuity is unjustified, in our view. We reiterate our Buy rating.

| 31 Mar | FY11 | FY12F | | FY13F | | FY14F | |
|---|---|---|---|---|---|---|---|
| Currency (INR) | Actual | Old | New | Old | New | Old | New |
| **Revenue (mn)** | 399,212 | 466,580 | 465,340 | 547,217 | 526,332 | 608,999 | 556,801 |
| **Reported net profit (mn)** | 60,112 | 65,194 | 66,161 | 70,591 | 69,044 | 75,396 | 69,148 |
| **Normalised net profit (mn)** | 53,568 | 65,194 | 66,161 | 70,591 | 69,044 | 75,396 | 69,148 |
| **Normalised EPS** | 21.89 | 26.64 | 27.03 | 28.84 | 28.21 | 30.80 | 28.25 |
| **Norm. EPS growth (%)** | 24.5 | 21.7 | 23.5 | 8.3 | 4.4 | 6.8 | 0.2 |
| **Norm. P/E (x)** | 12.3 | N/A | 10.0 | N/A | 9.6 | N/A | 9.6 |
| **EV/EBITDA (x)** | 7.1 | 6.2 | 5.9 | 5.4 | 5.5 | 5.0 | 5.2 |
| **Price/book (x)** | 3.3 | N/A | 2.7 | N/A | 2.2 | N/A | 1.9 |
| **Dividend yield (%)** | 2.7 | N/A | 3.1 | N/A | 3.2 | N/A | 3.2 |
| **ROE (%)** | 33.3 | 29.1 | 29.5 | 26.1 | 25.5 | 23.5 | 21.7 |
| **Net debt/equity (%)** | net cash | 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 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 1-3%, as we expect some execution delays.

**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.

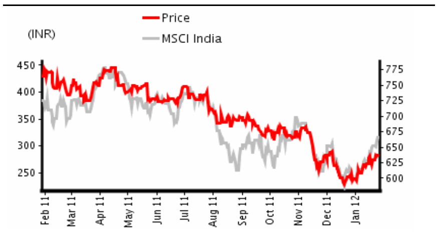
# Key data on Bharat Heavy Electricals

## Income statement (INRmn)

| Year-end 31 Mar | FY10 | FY11 | FY12F | FY13F | FY14F |
|---|---|---|---|---|---|
| **Revenue** | **337,897** | **399,212** | **465,340** | **526,332** | **556,801** |
| Cost of goods sold | -208,431 | -242,767 | -286,746 | -333,763 | -358,384 |
| **Gross profit** | **129,466** | **156,444** | **178,594** | **192,569** | **198,417** |
| SG&A | -6,311 | -25,696 | -27,090 | -29,986 | -33,454 |
| Employee share expense | -65,395 | -56,375 | -60,142 | -64,869 | -68,148 |
| **Operating profit** | **57,760** | **74,373** | **91,361** | **97,713** | **96,815** |
| | | | | | |
| **EBITDA** | **62,340** | **80,283** | **98,828** | **105,362** | **104,795** |
| Depreciation | -4,580 | -5,909 | -7,466 | -7,649 | -7,980 |
| Amortisation | | | | | |
| EBIT | 57,760 | 74,373 | 91,361 | 97,713 | 96,815 |
| Net interest expense | -335 | -547 | -547 | -547 | -547 |
| Associates & JCEs | | | | | |
| Other income | 8,412 | 6,418 | 8,676 | 6,659 | 7,715 |
| **Earnings before tax** | **65,837** | **80,244** | **99,491** | **103,825** | **103,983** |
| Income tax | -22,800 | -26,676 | -33,329 | -34,781 | -34,834 |
| **Net profit after tax** | **43,037** | **53,568** | **66,161** | **69,044** | **69,148** |
| Minority interests | | | | | |
| Other items | | | | | |
| Preferred dividends | | | | | |
| **Normalised NPAT** | **43,037** | **53,568** | **66,161** | **69,044** | **69,148** |
| Extraordinary items | 73 | 6,544 | 0 | 0 | 0 |
| **Reported NPAT** | **43,110** | **60,112** | **66,161** | **69,044** | **69,148** |
| Dividends | -13,321 | -17,747 | -20,513 | -21,407 | -21,439 |
| **Transfer to reserves** | **29,789** | **42,365** | **45,648** | **47,637** | **47,709** |
| | | | | | |
| **Valuation and ratio analysis** | | | | | |
| FD normalised P/E (x) | 15.4 | 12.3 | 10.0 | 9.6 | 9.6 |
| FD normalised P/E at price target (x) | 18.9 | 15.2 | 12.3 | 11.8 | 11.8 |
| Reported P/E (x) | 15.3 | 11.0 | 10.0 | 9.6 | 9.6 |
| Dividend yield (%) | 2.0 | 2.7 | 3.1 | 3.2 | 3.2 |
| Price/cashflow (x) | 28.2 | 15.1 | 34.0 | 29.0 | 10.0 |
| Price/book (x) | 4.2 | 3.3 | 2.7 | 2.2 | 1.9 |
| EV/EBITDA (x) | 9.1 | 7.1 | 5.9 | 5.5 | 5.2 |
| EV/EBIT (x) | 9.8 | 7.6 | 6.3 | 6.0 | 5.6 |
| Gross margin (%) | 38.3 | 39.2 | 38.4 | 36.6 | 35.6 |
| EBITDA margin (%) | 18.4 | 20.1 | 21.2 | 20.0 | 18.8 |
| EBIT margin (%) | 17.1 | 18.6 | 19.6 | 18.6 | 17.4 |
| Net margin (%) | 12.8 | 15.1 | 14.2 | 13.1 | 12.4 |
| Effective tax rate (%) | 34.6 | 33.2 | 33.5 | 33.5 | 33.5 |
| Dividend payout (%) | 30.9 | 29.5 | 31.0 | 31.0 | 31.0 |
| Capex to sales (%) | 5.3 | 4.5 | 2.6 | 1.9 | 1.3 |
| Capex to depreciation (x) | 3.9 | 3.0 | 1.6 | 1.3 | 0.9 |
| ROE (%) | 29.9 | 33.3 | 29.5 | 25.5 | 21.7 |
| ROA (pretax %) | 17.4 | 17.6 | 17.8 | 17.0 | 16.1 |
| | | | | | |
| **Growth (%)** | | | | | |
| Revenue | 25.7 | 18.1 | 16.6 | 13.1 | 5.8 |
| EBITDA | 42.0 | 28.8 | 23.1 | 6.6 | -0.5 |
| EBIT | 42.4 | 28.8 | 22.8 | 7.0 | -0.9 |
| Normalised EPS | 37.7 | 24.5 | 23.5 | 4.4 | 0.2 |
| Normalised FDEPS | 37.7 | 24.5 | 23.5 | 4.4 | 0.2 |
| | | | | | |
| **Per share** | | | | | |
| Reported EPS (INR) | 17.61 | 24.56 | 27.03 | 28.21 | 28.25 |
| Norm EPS (INR) | 17.58 | 21.89 | 27.03 | 28.21 | 28.25 |
| Fully diluted norm EPS (INR) | 17.58 | 21.89 | 27.03 | 28.21 | 28.25 |
| Book value per share (INR) | 65.03 | 82.34 | 100.99 | 120.45 | 139.95 |
| DPS (INR) | 5.44 | 7.25 | 8.38 | 8.75 | 8.76 |

Source: Company data, Nomura estimates

### Relative performance chart (one year)




Source: ThomsonReuters, Nomura research

| (%) | 1M | 3M | 12M |
|---|---|---|---|
| Absolute (INR) | -14.8 | -22.2 | -35.6 |
| Absolute (USD) | -19.2 | -31.3 | -43.5 |
| Relative to index | -5.1 | -21.9 | -16.1 |
| Market cap (USDmn) | 12,652.6 | | |
| Estimated free float (%) | 22.3 | | |
| 52-week range (INR) | 475.8/246 | | |
| 3-mth avg daily turnover (USDmn) | 23.61 | | |
| Major shareholders (%) | | | |
| President of India | 67.7 | | |
| LIC | 4.8 | | |

Source: Thomson Reuters, Nomura research

**Notes**

Slowing profit growth but returns are still attractive

## Cashflow (INRmn)

| Year-end 31 Mar | FY10 | FY11 | FY12F | FY13F | FY14F |
|---|---|---|---|---|---|
| EBITDA | 62,340 | 80,283 | 98,828 | 105,362 | 104,795 |
| Change in working capital | -24,290 | -22,387 | -58,937 | -53,896 | -10,939 |
| Other operating cashflow | -14,651 | -14,262 | -20,475 | -28,670 | -27,666 |
| **Cashflow from operations** | **23,400** | **43,634** | **19,416** | **22,796** | **66,190** |
| Capital expenditure | -17,961 | -17,886 | -12,000 | -10,000 | -7,000 |
| **Free cashflow** | **5,439** | **25,748** | **7,416** | **12,796** | **59,190** |
| 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 | 4,932 | 4,939 |
| Adjustments | -3 | | | | |
| **Cashflow after investing acts** | **8,291** | **15,792** | **7,416** | **17,728** | **64,129** |
| Cash dividends | -13,321 | -17,747 | -20,513 | -21,407 | -21,439 |
| Equity issue | | | | | |
| Debt issue | -216 | 356 | 0 | 0 | 0 |
| Convertible debt issue | | | | | |
| Others | | | | | |
| **Cashflow from financial acts** | **-13,537** | **-17,391** | **-20,513** | **-21,407** | **-21,439** |
| **Net cashflow** | **-5,246** | **-1,599** | **-13,097** | **-3,679** | **42,689** |
| Beginning cash | 103,147 | 97,901 | 96,302 | 83,205 | 79,525 |
| Ending cash | 97,901 | 96,301 | 83,205 | 79,525 | 122,215 |
| Ending net debt | -96,623 | -94,668 | -81,571 | -77,892 | -120,581 |

Source: Company data, Nomura estimates

**Notes**

Cash flow from operations remains strong, though will be impacted in FY12F and FY13F due to sudden changes in working capital

## Balance sheet (INRmn)

| As at 31 Mar | FY10 | FY11 | FY12F | FY13F | FY14F |
|---|---|---|---|---|---|
| Cash & equivalents | 97,901 | 96,302 | 83,205 | 79,525 | 122,215 |
| Marketable securities | 0 | 0 | 0 | 0 | 0 |
| Accounts receivable | 206,888 | 273,546 | 322,111 | 350,317 | 348,361 |
| Inventories | 92,355 | 109,630 | 127,790 | 144,540 | 152,907 |
| Other current assets | 32,000 | 35,469 | 40,697 | 40,917 | 40,580 |
| **Total current assets** | **429,143** | **514,947** | **573,803** | **615,299** | **664,063** |
| LT investments | 798 | 4,392 | 4,392 | 4,392 | 4,392 |
| Fixed assets | 39,655 | 51,631 | 56,165 | 58,516 | 57,537 |
| 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** | **570,970** | **634,360** | **678,207** | **725,991** |
| Short-term debt | | | | | |
| Accounts payable | 75,798 | 96,019 | 113,296 | 123,942 | 124,076 |
| Other current liabilities | 248,619 | 293,415 | 289,154 | 269,787 | 264,789 |
| **Total current liabilities** | **324,417** | **389,434** | **402,450** | **393,729** | **388,864** |
| Long-term debt | 1,278 | 1,634 | 1,634 | 1,634 | 1,634 |
| Convertible debt | | | | | |
| Other LT liabilities | -15,272 | -21,636 | -16,910 | -11,978 | -7,039 |
| **Total liabilities** | **310,422** | **369,432** | **387,174** | **383,384** | **383,459** |
| 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 | 242,291 | 289,928 | 337,637 |
| Proposed dividends | | | | | |
| Other equity and reserves | | | | | |
| **Total shareholders' equity** | **159,174** | **201,538** | **247,186** | **294,823** | **342,532** |
| **Total equity & liabilities** | **469,596** | **570,970** | **634,360** | **678,207** | **725,991** |
| | | | | | |
| **Liquidity (x)** | | | | | |
| Current ratio | 1.32 | 1.32 | 1.43 | 1.56 | 1.71 |
| Interest cover | 172.4 | 135.9 | 166.9 | 178.5 | 176.9 |
| | | | | | |
| **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 | 198.0 | 219.6 | 234.2 | 233.2 | 229.0 |
| Days inventory | 149.5 | 151.8 | 151.5 | 148.9 | 151.5 |
| Days payable | 117.6 | 129.2 | 133.6 | 129.7 | 126.3 |
| Cash cycle | 229.9 | 242.3 | 252.2 | 252.3 | 254.2 |

Source: Company data, Nomura estimates

**Notes**

Balance sheet facing pressure from deteriorating working capital

# 3QFY12 results were in-line with expectations adjusted for higher provisioning

## ABOVE OR BELOW EXPECTATIONS?

BHEL's 3QFY12 reported earnings results were 5-8% below Nomura and consensus estimates, mainly due to sharply higher other expenses reported by the company. However, adjusted for higher provisions relating to liquidated damages and contractual obligations, the results were in line with estimates.

## WHAT DOES THE RESULT MEAN?

- Revenue was in line with expectations, and most other cost items (including raw material costs and staff costs) were lower than expectations.
- Had it not been for higher other expenses (due to high provisions, as explained above), results would have been a positive surprise.
- Order inflows have surprised negatively though – according to management, there have no new orders in the power segment this quarter. a 9MFY12 order inflow is down ~60% y-y facing difficulties in all segments. Moreover, management disclosed order cancellation and/or reduction in scope of work for some orders totalling to ~INR 58bn and will be likely dampener for the stock in the near term, in our view.

## LIKELY STOCK REACTION:

The stock was down ~3% on the day its results were announced, and we expect it to remain weak in the near term. However, much of the bad news on the order inflow slowdown is in the price, in our view, and hence we recommend further accumulation in case of any weakness in the stock.

## KEY NUMBERS:

**Fig. 1: 3QFY12 results vs estimates**

INR mn

| INR Mn | Dec-11 | Nomura Est | Consensus Est | Dec-10 | Sep-11 | Change y-y | Change q-q |
|---|---|---|---|---|---|---|---|
| Net Sales | 107,431 | 108,385 | 105,666 | 90,233 | 105,455 | 19.10% | 1.90% |
| Operating EBITDA | 20,805 | 22,011 | 20,868 | 20,717 | 19,592 | 0.40% | 6.20% |
| EBITDA Margin | 19.4% | 20.3% | 19.7% | 23.0% | 18.6% | | |
| Reported PAT | 14,326 | 15,530 | 14,777 | 14,032 | 14,121 | 2.10% | 1.50% |
| Recurring EPS (Rs) | 5.85 | 6.34 | 6.17 | 5.73 | 5.77 | 2.10% | 1.50% |

Source: Company data, Bloomberg, Nomura estimates

**Fig. 2: BHEL 3QFY12: detailed results**

INR mn

| | Dec-10 | Sep-11 | Dec-11 |
|---|---|---|---|
| **Gross Sales** | **92,798** | **107,576** | **110,783** |
| Excise duty | 4,305 | 4,590 | 5,303 |
| **Net Sales** | **88,493** | **102,986** | **105,480** |
| Change YoY (%) | 25% | 24% | 19% |
| Other operating Income | 1,741 | 2,470 | 1,951 |
| **Total Revenue** | **90,233** | **105,455** | **107,431** |
| | | | |
| Expenditure | 25% | 22% | 22% |
| - consumption of raw materials | 50,857 | 65,658 | 64,882 |
| - staff cost | 13,487 | 13,491 | 13,377 |
| - other exp. | 7,932 | 11,192 | 13,113 |
| - inc./dec. in stock | (2,759) | (4,479) | (4,745) |
| Total expenses | 69,516 | 85,863 | 86,626 |
| | | | |
| **EBITDA** | **20,717** | **19,592** | **20,805** |
| Change YoY (%) | 33% | 20% | 0% |
| Margins (%) | 23.0 | 18.6 | 19.4 |
| Depreciation | 1,447 | 1,888 | 1,861 |
| Other Income | 1,529 | 2,199 | 1,960 |
| EBIT | 20,800 | 19,903 | 20,903 |
| EBIT% | 23% | 19% | 19% |
| Interest | 145 | 96 | 145 |
| PBT | 20,655 | 19,806 | 20,758 |
| | | | |
| Tax | 6,623 | 5,686 | 6,432 |
| Effective Tax rate % | 32% | 29% | 31% |
| **PAT** | **14,032** | **14,121** | **14,326** |
| Recurring PAT | 14,032 | 14,121 | 14,326 |
| Change YoY (%) | 31% | 24% | 2% |
| **Recurring EPS** | **5.73** | **5.77** | **5.85** |
| | | | |
| RM as % of sales | 54 | 59 | 57 |
| Staff cost as % of sales | 15 | 13 | 13 |
| Other Exp as % of sales | 9 | 11 | 12 |
| Total Exp as % of sales | 79 | 83 | 82 |
| **EBITDA %** | **23.0%** | **18.6%** | **19.4%** |
| PAT % to FY | 33% | 33% | 33% |
| Sales % to FY | 27% | 25% | 25% |
| **Order inflows (Rs bn)** | **126** | **143** | **(35)** |
| **Order Backlog (Rs bn)** | **1,580** | **1,610** | **1,465** |

Source: Company data, Nomura research

## KEY TAKEAWAYS FROM THE MANAGEMENT CONCALL:

- The order environment remains challenging, with project finalisation continuously being postponed as developers continue to face uncertainties on fuel, land and environmental clearances and water availability.
- BHEL has faced cancellations in orders and/or reductions in scope of work for a few projects this quarter. The total order value for such projects was INR58.47bn and corresponded to roughly 1500MW of ordered projects. These orders included an order for 2x600 MW BTG sets and have been cancelled because the developers faced problems with fuel linkage and/or plans to re-order sets based on supercritical technology at a later date.

- In January, BHEL has received a LoA from Abhijeet Group for a 300MW BTG order in Vishakhapatnam for a total order value of INR 6.3 bn and another LoI from ONGC for 6 oil rigs worth a total of INR7.74bn.
- As far as status of other key orders is concerned company mentioned that the Rajasthan SEB order (where BHEL is L1 for 4x600 MW EPC) has secured environmental clearance and coal linkage and is under progress.
- The NTPC bulk tender is still under finalisation for the 800MW rating category, while the 660MW rating category order boiler order is yet to seek price bids (currently awaiting court decision on the suit filed by Gammon-Ansaldo combine)..
- Company mentioned that execution is on track for its JV projects with Karnataka SEB (we have included these projects as slow moving projects – see below).

## What level of order inflow is sustainable in the current environment?

While we remain concerned about the near-term order inflow for the sector, we believe that, at current levels, the stock is extrapolating these concerns beyond the visible horizon. In our assumptions, we have already built in significant slowdown in order inflows from the power sector for BHEL.

To put things into perspective, we highlight that negative sentiment around the power sector could hurt private developers' confidence in announcing new projects. However, we do not think orders from State and Central sectors would face similar issues. Further, BHEL has also been getting orders from international markets (primarily Africa and Middle East), which are expected to remain relatively stable despite weak global conditions.

We highlight that state/centre orders and exports have together formed at least INR250-300bn of annual order inflow for BHEL over the past few years. In contrast, our estimates for power sector inflows are around INR325bn p.a. over FY12-15F, which we think is reasonable.

In terms of the immediate pipeline, we see NTPC's bulk order (BHEL share ~6GW), BHEL's JV projects (3-4 GW), Coal India's Mahanadi coal field project (~1.6 GW) and Rajasthan SEB's two projects (1.2 – 2.4 GW), among others. The finalisation of these projects will help the company reach our order inflow assumptions for the power sector for FY12F and FY13F, which should extend revenue visibility until FY15F.

**Fig. 3: State/Central sector annual order flow has been around INR250-300bn for BHEL**
INR bn

| | FY08 | FY09 | FY10 | FY11 |
|---|---|---|---|---|
| State/Central sector | 225 | 292 | 28 | 254 |
| Exports | 22 | 28 | 9 | 20 |
| Total - State/Central + exports | 247 | 320 | 38 | 274 |
| Total individually disclosed orders | 287 | 453 | 329 | 515 |
| Total reported orders | 512 | 607 | 590 | 605 |

Source: Company, Nomura research

## How much of the current order book is at risk from fuel unavailability, and what does that mean for our estimates?

Upon our analysis of the status of coal linkages for power projects in BHEL's existing order book (as of December 2011), we identify six projects that could be without fuel linkage and could thus pose execution delays for BHEL. On BHEL's existing order book, these projects imply 15% share.

**Fig. 4: Projects without/doubtful coal linkages**

* Jindal Power has coal linkages for 1200MW, which is not considered in the analysis

| Project | Capacity (MW) | Order Value (INR mn) |
|---|---|---|
| 4x600 MW Raigarh STPP Jindal Power Ltd* | 1,200 | 25,200 |
| 2x800 MW Raichur Power EPC Karnataka State JV | 1,600 | 63,000 |
| 1x800 MW EPC Edlapur TPS KSEB and BHEL JV | 800 | 36,010 |
| 1x700 MW Bellary TPS Unit 3, karnataka Power Corp (KPCL) | 700 | 37,000 |
| 3x660 MW Lalitpur TPP, Bajaj Hindusthan | 1,980 | 55,672 |
| 1x600 MW Avantha-II, Korba | 600 | 12,903 |
| Total | 6,880 | 229,785 |

Source: Company, Nomura research

For the purpose of this analysis, we exclude projects that have LoA from Coal India, even though these projects, too, are at risk given LoAs are not firm fuel supply agreements. Incrementally, we believe bankers are turning cautious on lending to projects simply on the basis of LoA, since Coal India has not been meeting full requirement of these projects under the LoA (only excess coal after meeting firm FSAs are pro-rata distributed for projects under LoA).

**2-7% potential risk to our revenue estimates from such projects in FY12F/13F**

We had first highlighted the risk to our and consensus estimates from such projects in our July 22, 2011 note titled, *Start of execution problems to gain momentum*. Since then, we have already incorporated a large portion of these risks into our revenue estimates for BHEL.

In our current assumptions, such projects contribute only 2-7% of FY12-13F estimates and hence do not pose substantial risk.

## Change in estimates and valuation methodology

We are tweaking our estimates to factor in lower order inflow in FY12F as well as further cutbacks in industry and exports segments orders into the future. Our new order inflow assumptions in the power segment now suggest no recovery in power sector fortunes even until FY15F, while industry and exports segment orders are mostly flat over FY10-17F. Thus, our EPS estimates are now down 2-8.5% over FY13 and FY14F, respectively.

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.

We have reduced our target price, however, mainly due to lower order inflow assumptions.

At 9.6x FY13F EPS, BHEL is arguably among the cheapest stock in the capital goods universe. Even as long-term concerns remain, we reiterate our Buy recommendation on attractive valuations.

## What does the current stock price imply?

While we share investor concerns on order inflow visibility over the medium term, we highlight that at current levels, the stock is building unrealistic expectations about long-term growth and margin profile for the stock.

For example, the implied EBITDA margins and ROE for BHEL, in the terminal year of our DCF valuation based on the current stock price, is just 13% each, which is substantially lower and appears highly unreasonable considering that the current adverse scenario in the power sector cannot continue until perpetuity.

Similarly, the implied terminal growth is -1% post FY17F on CMP which again is unrealistic, in our view.

**Fig. 5: Current market price (CMP) implies unrealistic assumptions**

A comparison of our base case DCF with CMP implied assumptions, and all other assumptions remaining equal

| | FY11 | FY12F | FY17F | |
|---|---|---|---|---|
| | | | Base case | Implied from CMP |
| EBITDA margins | 20% | 21% | 18% | 13% |
| ROE | 30% | 29% | 17% | 13% |
| Terminal growth | | | 4% | -1% |

Source: Nomura estimates

Further, we note the current market capitalisation of BHEL as close to the levels of FY06 and FY07. While the outlook has changed since then, we note that the annual order inflow outlook is still much higher than the actual order inflow reported in FY06 and FY07.

**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.

# What drives our Buy rating on BHEL?

## Incrementally positive newsflow in the power sector

**Tariff hike is now a reality at most SEBs**

While tariff hikes have been a contentious issue for most states, we now see evidence of progressive action being taken by state distribution companies over the past few months. Our banking analyst's interaction with Power Finance Corporation (POWF IN) also suggests that, incrementally, SEBs' condition has started to improve and stricter enforcement by banking agencies will likely yield further results.

Below we note some key takeaways from this meeting:

- The state power ministers' conference in July 2011 adopted 14 resolutions to improve SEBs' discipline. These include computerization of accounts, regular filing of tariff revision petitions, timely payment of subsidies by state governments, and bringing down AT&C losses to 15%, among others.
- Based on these resolutions, the finance and the power ministry are jointly expected to come up with a list of conditions necessary for further disbursal of short-term loans by SEB lenders.
- Since August 2011, all lenders have stopped short-term lending to weak SEBs, and some action on this front is expected soon.
- The outlook on state electricity boards is definitely looking brighter with the recent spate of tariff hikes and the appellate tribunal's judgement directing state electricity commissions to ensure the timely determination of tariffs.
- The Tamil Nadu Electricity Board (TNEB, the weakest SEB) had recently sought the regulator's approval to hike tariffs by 38%, and this will likely add INR110bn to its revenue next year, or around 50% of current revenue. This implies a cash-positive scenario conducive to regular debt servicing within two years.
- The Appellate Tribunal for Electricity in India has ruled that all state distribution companies in the country will have to file their tariff revision petitions by April 1 every year, and failure to do so within a month of the specified time would empower respective state power regulators to *suo motto* begin the exercise on behalf of the distribution companies ('Tribunal orders annual hike in power tariffs to avoid big shock

once in years', *The Economic Times*, November 22, 2011). Further, such a decision by the state regulator would be binding on the state discoms.

- PFC expects at least 5-10% increase in tariffs from all SEBs which haven't recently raised tariffs in response to the appellate tribunal's directive. The only exception would be Uttar Pradesh, which has declined to raise tariffs until after the state elections in CY12. However, Uttar Pradesh has been servicing its debts regularly, and even the Oct-11 payments have been on time.
- Under the modified conditionality that PFC is enforcing on all projects since Apr-11, PFC won't make disbursals until the power purchase agreement and fuel supply agreement are in place compared with the earlier condition of getting PPA done within 12 months and having the Letter of Assurance (LoA) for fuel linkage.
- The Shunglu committee report is expected to be ready by end Dec-11 and it would try to address transparency and timeliness issues with SEB accounting.

**Fig. 6: Tariff hikes by key states over past few months**

Only major states studied; we have not considered North-Eastern states, Goa & Puducherry and Mumbai

| State | Effective Date | Effective hike |
|---|---|---|
| Andhra Pradesh | Aug-10 | 4% |
| | Mar-11 | 19% |
| Bihar | Jan-11 | 2% |
| | May-11 | 19% |
| Chhattisgarh | Apr-11 | 14% |
| Delhi [Pvt. Discoms] | Aug-11 | 22% |
| Gujarat | Apr-10 | 1.5-3.5% |
| | Sep-11 | 4% |
| Haryana | Oct-10 | 17% |
| Himachal Pradesh | Jun-10 | 12% |
| | Jul-11 | 8-9% |
| Jammu & Kashmir | Apr-10 | 12% |
| | Oct-11 | 18% |
| Jharkhand | May-10 | 11% |
| | Aug-11 | 19% |
| Karnataka | Dec-10 | 6-7% |
| | Oct-11 | 6% |
| Kerala | Oct-02 | NA |
| Madhya Pradesh | Jun-10 | 11% |
| | May-11 | 6% |
| Maharashtra | Sep-10 | 3% |
| | Oct-11 | 4% |
| Orissa | Apr-11 | 20% |
| Punjab | Apr-10 | 8% |
| | May-11 | 9% |
| Rajasthan | Sep-11 | 22-23% |
| Tamil Nadu | Aug-10 | 11% |
| | Nov-11 | 38%* |
| Uttar Pradesh | Apr-10 | 14% |
| Uttarakhand | Apr-10 | 3% |
| West Bengal | Apr-10 | 10-11% |
| | Apr-11 | 9-10% |

Note: * Tamil Nadu has recently filed tariff petition for a 38% hike

Source: ERC tariff orders, SEB tariff petitions, Nomura research

**Environment clearance for projects picks up pace**

Land and environment clearances have delayed proposed infrastructure projects. However, here too we see incrementally positive news flow emerging for the sector as the government has been relaxing norms to accommodate industry proposals. For example, as per media articles, the environment ministry has now relaxed environment clearance norms for projects requiring forest land ('Environment Minister Jayanthi Natarajan relaxes environmental clearance norms for projects requiring forest land', The Economic Times, Sep 13, 2011).

Similarly, approvals on some of the long-pending projects have now been hastened. We note the environmental clearance for Lavasa hill city as a case in point ('Lavasa gets conditional environmental clearance', Live Mint, Nov 9, 2011).

While we have still a long way to go in terms of environmental approval reforms and are still far from what could be termed as a 100% industry-friendly model, we note that increasingly positive developments will, nevertheless, boost investor and developer confidence in the infrastructure sector in general.

**However, coal availability for new projects in the near term remains uncertain; partial relief for long-term from imports**

Even as we witness positive developments relating to other issues plaguing the power sector, coal availability remains a practical problem for which a near-term solution is yet to be determined.

In our April 12, 2011 report, *Structural bottlenecks ahead*, we had highlighted that domestic coal availability (from Coal India and subs and captive coal blocks) could increase from the current 365mn ton p.a. to 630mn tons p.a. by FY17 in a best-case scenario. This would imply enough coal availability for an incremental power capacity ~50-55GW p.a. by the end of FY17. In contrast, the actual power capacity addition envisaged during the same period is much more (>100 GW), suggesting that coal availability will remain a medium-term concern.

What could mitigate the problem partially, in our view, is imported coal from mines that Indian corporates have acquired over the past few years. Despite the potential of coal imports, what remains a key concern for the sector is whether the discoms would be in a position to pay up for the higher power cost owing to imported coal (which is more expensive compared with domestic coal). Continuing with our argument on positive traction on SEB reforms, we believe in the long-term discoms should be in a position to gradually accept more power based on imported coal as their own financial health improves. Below we list out some of the large coal mine acquisitions made by Indian corporates in recent times, which could likely add to India's coal supply.

**Fig. 7: International coal mine acquisitions by Indian companies**

| Year | Coal Mine | Acquirer | Reserves (MT) | Stake |
|---|---|---|---|---|
| Jul-07 | Kaltim Prima Coal and PT Arutmin | Tata Power | 6125 | 30% |
| Mar-08 | Bunyu island, Indonesia | Adani Enterprises | 150 | 100% |
| Feb-09 | Barasentosa Lestari, Indonesia | GMR | 110 | 100% |
| Jun-09 | Boikarabelo, SA | CESC | 636 | 5% |
| Mar-10 | Aries, Indonesia | Essar | 64 | 100% |
| Mar-10 | Mozambique | Essar | 35 | 100% |
| Jun-10 | South Sumatra | Reliance Power | 2000 | 100% |
| Aug-10 | Galilee basin | Adani | 7800 | 100% |
| Dec-10 | Griffin Coal Mines | Lanco | 1100 | 100% |
| Aug-11 | Golden Energy Mines Tbk, Indonesia | GMR Energy | 860 | 30% |
| Aug-11 | Alpha Coal, Kevin's Corner | GVK Power & Infra | 7000 | 100% |

Source: Nomura research

**Chinese competition is expected to ease though domestic competition remains a long-term threat**

While we have been concerned about rising competition in the sector, we note that competition from China and Korea will likely ease. This is mainly on account of: 1) the proposed import duty on imported power equipment, and 2) ~20% depreciation of INR vs. CNY that will make Chinese imports expensive and hence uncompetitive.

While stability of the currency exchange rates cannot be forecast, we believe at this moment Chinese imports are ~25% more expensive compared to their earlier prices. Based on our channel checks, the historical difference between BHEL and Chinese imports has been around 10-15% and as such in the current situation, it is unlikely that Chinese equipment will find buyers in the Indian market.

However, we remain concerned that competition from domestic operators could pose a long-term threat to BHEL's market share. In our view, the only possible solution to domestic competition will be a genuine uptick in demand for equipment that could fill up capacity for all operators concerned.

# Appendix A-1

## Analyst Certification

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**Mentioned companies**

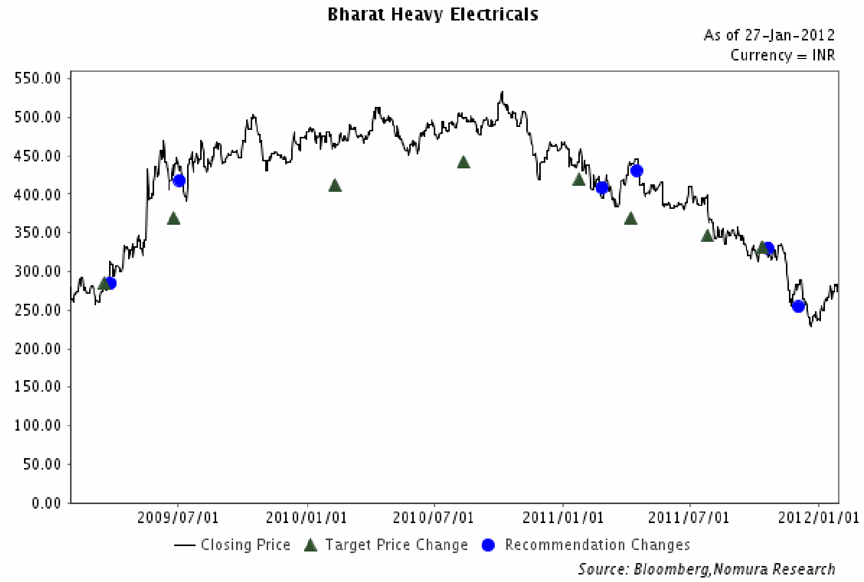
| Issuer name | Ticker | Price | Price date | Stock rating | Sector rating | Disclosures |
|---|---|---|---|---|---|---|
| Bharat Heavy Electricals | BHEL IN | INR 274 | 27-1-2012 | Buy | Not rated | |

**Previous Rating**

| Issuer name | Previous Rating | Date of change |
|---|---|---|
| Bharat Heavy Electricals | Neutral | 24-11-2011 |

**Bharat Heavy Electricals (BHEL IN)** **INR 274 (27-1-2012)** Buy (Sector rating: Not rated)

Rating and target price chart (three year history)




| Date | Rating | Target price | Closing price |
|---|---|---|---|
| 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 |
| 25-Jun-09 | Reduce | | 425.92 |
| 25-Jun-09 | | 370.00 | 425.92 |
| 18-Mar-09 | Neutral | | 291.85 |
| 18-Mar-09 | | 284.40 | 291.85 |

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

**Valuation Methodology** Our target price is INR315. We 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 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 that may impede the achievement of the target price** 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.

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