AXIS DIRECT

BHARAT HEAVY ELECTRICALS

ENGINEERING

6 JUN 2017 Quarterly Update

BUY

Target Price: Rs 200

Adjusted earnings beat; BUY

BHEL's Q4FY17 revenue at Rs 97 bn was down 3% YoY and missed our/consensus expectations of Rs 105 bn. EBITDA at Rs 6.5 bn was impacted by one-time provisions for gratuity and leave salary liabilities. Adjusted EBITDA at Rs 10.4 bn was significantly above our expectation of Rs 5.9 bn. This was driven by 900 bps improvement in gross margin at 45% (back to FY15 levels). Adjusted PBT at Rs 6.5 bn was impacted by lower other income and higher interest charges.

Q4 order inflow at Rs 163 bn was up 4% YoY and order backlog at Rs 1,005 bn was down 9%. However, **executable order backlog improved to Rs 660 bn (vsRs 590 bn in FY16)**. Moreover, Yadadri project is expected to get environmental clearance in Q1, which would increase executable order backlog further to Rs 840 bn.

CMP	: Rs 153
Potential Upside	: 30%

MARKET DATA

No. of Shares	: 2,448mn
Free Float	: 37%
Market Cap	: Rs375bn
52-week High / Low	: Rs183 / Rs114
Avg. Daily vol. (6mth)	: 6.5 mn shares
Bloomberg Code	: BHEL IB Equity
Promoters Holding	: 63%
FII / DII	: 16% / 16%

Order pipeline remains strong: In the power segment, BHEL is L1 in ~2.64 GW of orders. Further, BHEL is participating in tenders worth ~5.4 GW. Given the **strong order pipeline and thrust on scrapping, management expects overall power market order inflow at 10-12 GW p.a.** In the industry segment, the medium term growth will be driven by T&D products, railways, solar and defense sectors.

Macro developments: Management highlighted four key macro developments that would significantly drive earnings. (1) Scrapping of old plants by NTPC and state utilities would expand size of BTG market to 12-15 GW pa from 8 GW currently; (2) Recent order of CEA of doing away with JDU^ would drive expansion of BHEL's margin;(3) Recent cabinet approval for 10 nuclear power plants (2 expected to be awarded in FY18) for 700 MW each and (4) Expected ordering for FGD in 22 GW of NTPC's power plants

CutFY18 estimates;roll forwardTP; maintainBUY: We cut our FY18 EPS toRs5.2 (vsRs8.4 earlier) to factor in FY17 results and slower recovery in margin.Our revisedTP ofRs200 (vs210 earlier) is based on 20x FY19E.

Financial summary (Standalone)

Y/E March	FY16	FY17	FY18E	FY19E
Sales (Rs mn)	249,408	275,876	305,690	351,516
EBITDA (Rs mn)	(16,678)	11,009	19,713	34,236
Adj PAT (Rs mn)	(12,639)	4,959	12,679	24,042
Con. EPS* (Rs.)	-	-	3.6	6.3
EPS (Rs.)	(5.2)	2.0	5.2	9.8
Change YOY (%)	(188.4)	(139.2)	155.7	89.6
P/E (x)	(29.7)	75.7	29.6	15.6
RoE (%)	(4.1)	1.6	3.9	7.2
EV/E (x)	(16.5)	24.6	10.1	4.6
DPS (Rs)	2.0	3.0	3.0	3.0

Source: *Consensus broker estimates, Company, Axis Capital

JDU^ - Joint Deed of Undertaking

Key drivers

(Rsbn)	FY17	FY18E	FY19E
Order inflow	235	427	538
Backlog	1,005	1,130	1,297
Margin	3.9%	6.3%	9.5%

Price performance

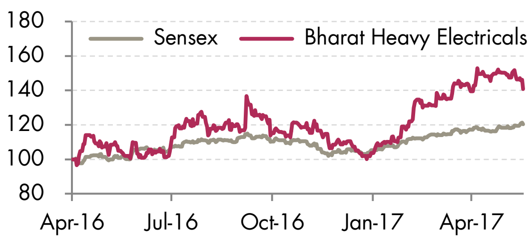
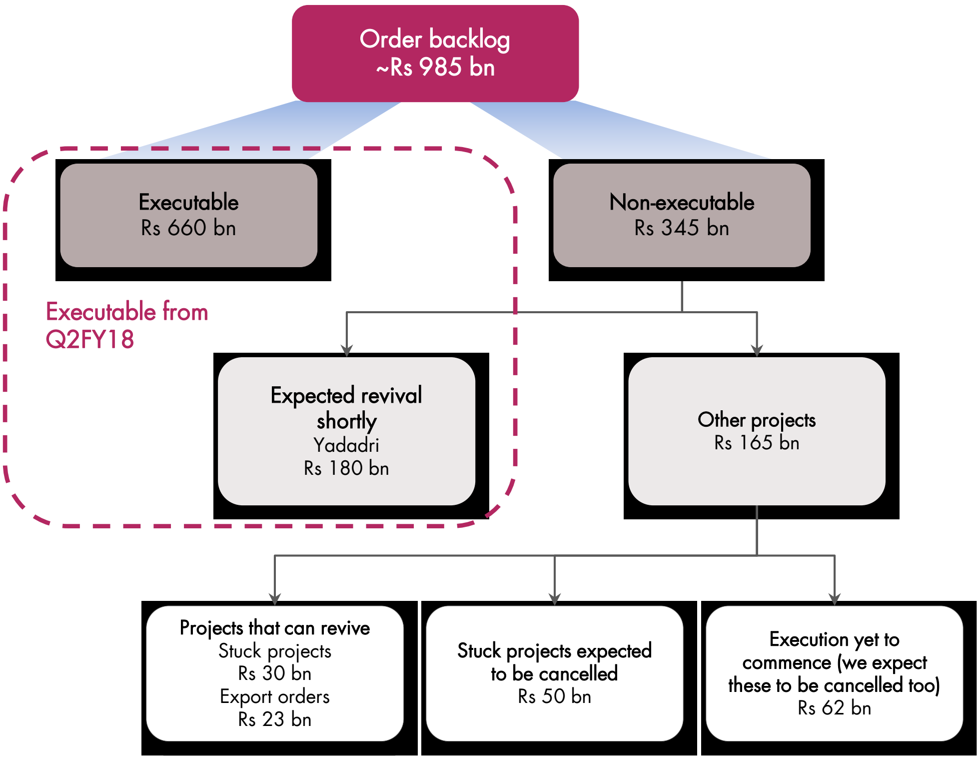


Exhibit 1: Results update

	Quarter ended					12 months ended		
(Rs. mn)	Mar-17	Mar-16	% Chg	Dec-16	% Chg	FY18E	FY17	% Chg
Net Sales/Income form op	**96,882**	**99,772**	**(2.9)**	**63,210**	**53.3**	**312,670**	**282,222**	**10.8**
EBIDTA	6,509	8,661	(24.9)	2,239	190.7	19,713	11,009	79.1
Other income	1,452	3,387	(57.1)	1,358	7.0	10,344	7,264	42.4
PBIDT	**7,961**	**12,049**	**(33.9)**	**3,596**	**121.4**	**30,057**	**18,273**	**64.5**
Depreciation	2,139	2,428	(11.9)	2,088	2.5	8,438	8,488	(0.6)
Interest	3,136	3,466	(9.5)	263	1,091.0	3,506	3,506	0.0
PBT	**2,686**	**6,154**	**(56.4)**	**1,246**	**115.6**	**18,113**	**6,278**	**188.5**
Tax	530	1,921	(72.4)	310	71.0	5,434	1,320	311.7
Reported PAT	**2,156**	**4,998**	**(56.9)**	**935**	**130.4**	**12,679**	**4,959**	**155.7**
No. of shares (mn)	2,448	2,448	-	2,448	-	2,448	2,448	-
EBIDTA margin (%)	6.7	8.7	(196.3)	3.5	-	6.3	3.9	61.6
PBIDT margin (%)	8.2	12.1	-	5.7	-	9.6	6.5	48.5
EPS (Rs)	**0.9**	**1.7**	**(49.1)**	**0.4**	**130.4**	**5.2**	**2.0**	**155.7**

Source: Company, Axis Capital

Exhibit 2: Order backlog breakup



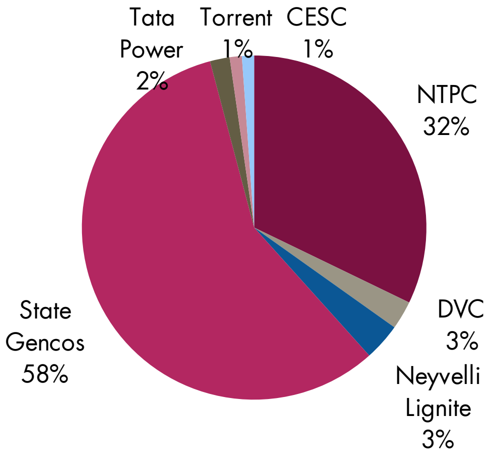
Source: Company, Axis Capital

Scrapping of old plants to drive improvement in power market

CEA's recent draft national electricity plan projected no further requirement of thermal capacities over 2017-22. Management clarified that CEA has not considered replacement of old and inefficient 35 GW of capacities with new super critical ones. BHEL and other stakeholders have submitted their comments and final report is awaited. According to the management, replacement of scraped projects itself would lead to expansion of BTG market to 12-15 GW pa from ~8 GW pa currently. Refer page 12 of our report 'BTG market 3X in 3 years' dated June 2016. Key developments on the scrapping of old plants and their replacement are as follows:

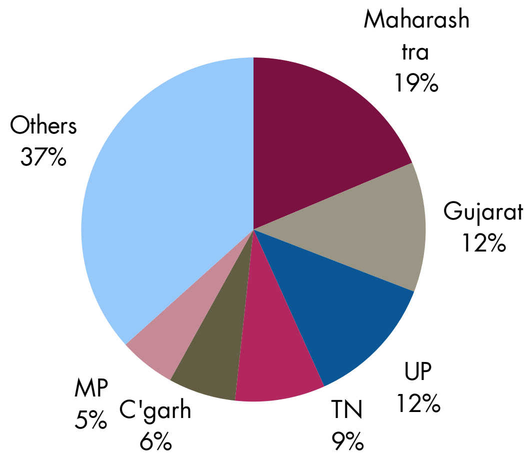
- NTPC constitutes about 1/3 rd of the plants to be scrapped and Ministry of Power recently issued a press release stating that NTPC would scrap 11 GW of its existing old plants and replace them with new on supercritical technology over next 5 years with an investment of ~Rs 500 bn(note: timeline defined)http://pib.nic.in/newsite/PrintRelease.aspx?relid=155395

Exhibit 3: 35 GW of old plants, bulk with NTPC and States



Source: Central Electricity Authority, Axis Capital

Exhibit 4: Among states, bulk with financially sound states



Source: Central Electricity Authority, Axis Capital

- **Financially sound State Electricity Boards (SEBs)** such as Maharashtra, Gujarat, Punjab and Chhattisgarh **constitute 43% of the State's project** to be scrapped
- **UP,** one of the financially weaker SEBs has already **awarded new projects at 3 out of the 4 locations**. UP State has awarded projects at its Obra, Panki and Harduaganj sites, wherein old plants of 938 MW would be replaced with new plants totaling 2,640 MW
- Other states also joining the bandwagon
  - AP awarded a 800MW project to BHEL at Dr. N.TATA plant for replacing the old 420 MW
  - Maharashtra declared BHEL as L1 for 660 MW Bhusaval plant for replacing old 420 MW
- **Financially weaker SEBs** such as Jharkhand, Rajasthan, etc. **are selling their old sites for cash-rich NTPC for it to expand at that location**
  - Jharkhand state sold its old inefficient plant of 700 MW at Patratu site to NTPC to replace it with new plant
  - Rajasthan SEB has also sold its Chhabra power plant to NTPC which has an existing capacity of 1,000 MW and an under-construction capacity of 1,320 MW

Key enablers accelerating the pace of scrapping of old plants are

- Lower execution risk as land for main plant, rail link, water pipeline, transmission, etc. is in place
- Current situation wherein India has surplus availability of both power and coal
- Amendments to the coal linkage and tariff policies that allows states to retain its coal linkage and PPAs upon commencement of new expansion

Exhibit 5: Results of CEA study on old inefficient plants

(GW)	Old plants	To be retired	Further review	R & M/ Life extension	Proposed replacement
State	20.0	4.5	4.6	10.9	8.2
Center	12.8	1.6	-	11.2	2.0
Private	1.5	-	-	1.5	-
Total	34.3	6.1	4.6	23.6	10.2

Source: Central Electricity Authority, Axis Capital

Exhibit 6: Power plants identified for scrapping in CEA study

State	Plant	To be retired (MW)	Proposed replacement (MW)
Haryana	Panipat TPS	440	800
U.P.	Harduaganj	290	660
U.P.	Panki	210	660
U.P.	Obra	438	2x660
M.P.	Amarkantak	280	660
M.P.	Satpura	313	660
Maharashtra	Nasik	250	660
Maharashtra	Bhusawal Unit 2	63	660
Maharashtra	Paras Unit 2	63	660
Gujarat	Ukai	240	660
Telangana	Kothagudem&Ramagundem	783	800
Tamilnadu	Ennore	450	660
West Bengal	DPL	280	660
Central			
West Bengal	DVC Durgapur	350	660
Jharkhand	DVC Chandrapura	780	2x660
Total		5,228	10,180

Source: Central Electricity Authority, Axis Capital

Early signs of compliance with new emission norms and retrofitting orders to follow in FY18

The management highlighted that it is currently getting orders from its customers of under execution projects to change the layout design of boilers and expects to get additional orders for air pollution equipment to comply with emission norms. The management believes that it would get the orders on a nomination basis under change in scope clause of its contracts.

We expect potential order value could be ~Rs 100 bn (15 GW @ Rs 6.5 mn/MW). According to the management, existing coal-based projects would require capex of ~ Rs 8 mn/MW, and some of large developers such as NTPC has requested for extension of timelines due to lack to proven technology of equipment to reduce NOx levels of high ash Indian coal. Note: in our report 'BTG market 3X in 3 years', we have assumed implementationtimeline of 8 years as against the mandated two years.

Few developments on retrofitting existing plants with FGDs and SCRs to comply with new emission norms are as follows:

- **NTPC issued pilot trial orders** to install Selective Catalytic Convertors (SCR) at its existing plants. Trial orders placed to GE Power India, Thermax-Babcok& Wilcox, L&T-Mitsubishi, and BHEL.
- **NTPC has invited tenders to install Flue Gas Desulphurization (FGD)** for some of its 'under construction' plants. Note that FGDs would constitute approx. 2/3rd of the USD 12 bn retrofitting capex.
- **While we had not anticipated private players to join, Reliance Power has invited tenders to install FGDs** at its 5.8 GW of 'existing plants'.

Exhibit 7: Market opportunity with new emission norms

	FY13-16	FY17	FY18	FY19
New equipment opportunity (GW)				
Re-bid - CY15 orders		7		
Pipeline for FY17-19		4	6	4
Re-powering scrapped plants		0	8	11
Total GW	**10**	**10**	**14**	**15**
Avg realization (Rsmn/MW)	25	32	32	32
New eqptmkt (Rsbn)	**250**	**327**	**433**	**469**
New eqpt market (USD bn)	**4**	**5**	**6**	**7**
Retrofit opportunity (Rsbn)*				
FGD - existing plants		-	80	80
SCR - existing plants		-	11	11
FGD - under construction plants		19	79	79
SCR - under construction plants		8	35	35
Retro-fit market (Rsbn)		**27**	**206**	**206**
* assuming 5 years to comply rather than 2 yrs notified (Rsbn)				
Total market size (Rsbn)	**250**	**355**	**639**	**674**
Total market size (USD bn)	**4**	**5**	**10**	**10**

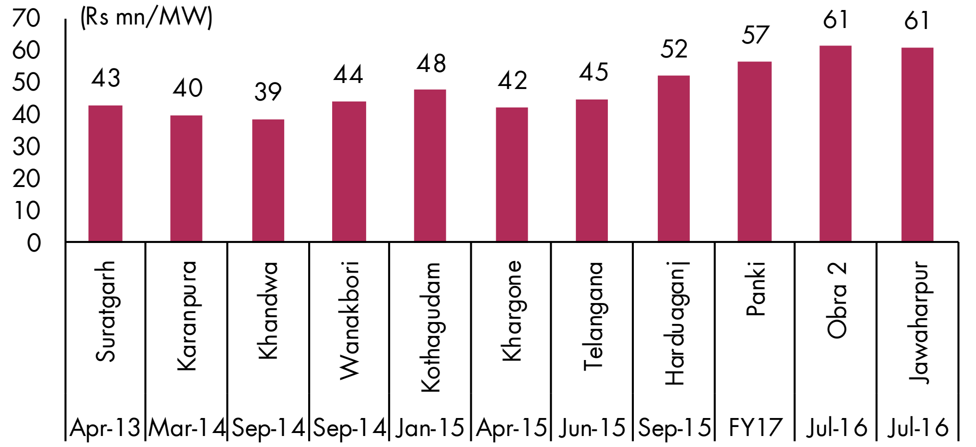
Source: Axis Capital

BTG pricing increased by ~15% over last 12 months

On a like-for-like basis, Boiler, Turbine & Generator (BTG) pricing has increased by ~15% over the last 12 months due to return of rational biding. EPC pricing has increased to ~Rs 61 mn/MW in the latest project won by Doosan. Adjusting for taxation of ~12% and increased cost of Rs 8 mn/MW due to extra equipment to comply with new emission norms, like-for-like pricing is Rs 46 mn/MW vs. Sep'14 low of Rs 39 mn/MW.

We expect this level of pricing to sustain as some of key competitors' capacities have been filled by exports. As an example, ~1/3rd of L&T's boilers capacity and ~1/2 of Thermax' boilers capacities have been filled by export orders from their foreign partners. Thermax' foreign partner B&W has shut its USA factory and would now shift its USD 700 mn of business (ex of China & India) from Thermax' Indian facility.

Exhibit 8: Pricing environment for EPC projects is improving



Source: Axis Capital

Financial summary (Standalone)

Profit &loss (Rsmn)

Y/E March	FY16	FY17	FY18E	FY19E
Net sales	249,408	275,876	305,690	351,516
Other operating income	7,828	6,346	6,980	7,678
Total operating income	**257,235**	**282,222**	**312,670**	**359,194**
Cost of goods sold	(168,754)	(174,052)	(184,164)	(209,097)
Gross profit	88,482	108,170	128,506	150,097
Gross margin (%)	*35.5*	*39.2*	*42.0*	*42.7*
Total operating expenses	(105,160)	(97,162)	(108,793)	(115,861)
EBITDA	**(16,678)**	**11,009**	**19,713**	**34,236**
EBITDA margin (%)	*(6.7)*	*4.0*	*6.4*	*9.7*
Depreciation	(9,356)	(8,488)	(8,438)	(8,729)
EBIT	**(26,034)**	**2,520**	**11,275**	**25,507**
Net interest	(268)	(3,506)	(3,506)	(3,506)
Other income	8,031	7,264	10,344	12,344
Profit before tax	**(18,272)**	**6,278**	**18,113**	**34,346**
Total taxation	5,633	(1,320)	(5,434)	(10,304)
Tax rate (%)	*30.8*	*21.0*	*30.0*	*30.0*
Profit after tax	(12,639)	4,959	12,679	24,042
Minorities	-	-	-	-
Profit/ Loss associate co(s)	-	-	-	-
Adjusted net profit	(12,639)	4,959	12,679	24,042
Adj. PAT margin (%)	*(5.1)*	*1.8*	*4.1*	*6.8*
Net non-recurring items	3,505	-	-	-
Reported net profit	(9,134)	4,959	12,679	24,042

Balance sheet (Rsmn)

Y/E March	FY16	FY17	FY18E	FY19E
Paid-up capital	4,895	4,895	4,895	4,895
Reserves & surplus	294,290	318,049	322,137	337,588
Net worth	299,185	322,944	327,032	342,483
Borrowing	1,263	896	896	896
Other non-current liabilities	-	-	-	-
Total liabilities	**300,448**	**323,840**	**327,928**	**343,379**
Gross fixed assets	132,980	137,795	143,478	147,478
Less: Depreciation	(93,348)	(101,836)	(110,274)	(119,003)
Net fixed assets	39,632	35,959	33,204	28,475
Add: Capital WIP	3,154	1,683	-	-
Total fixed assets	42,786	37,642	33,204	28,475
Total Investment	6,634	6,614	6,614	6,614
Inventory	96,374	73,724	83,751	96,306
Debtors	356,031	318,633	309,416	304,767
Cash & bank	100,860	104,918	177,963	219,720
Loans & advances	31,648	30,324	33,500	38,522
Current liabilities	335,105	288,462	318,195	352,952
Net current assets	251,029	279,584	288,109	308,289
Other non-current assets	-	-	-	-
Total assets	**300,448**	**323,840**	**327,928**	**343,379**

Source: Company, Axis Capital

Cash flow (Rsmn)

Y/E March	FY16	FY17	FY18E	FY19E
Profit before tax	(18,272)	6,278	18,113	34,346
Depreciation & Amortisation	9,356	8,488	8,438	8,729
Chg in working capital	*20,193*	*(24,497)*	*64,519*	*21,578*
Cash flow from operations	**20,684**	**(7,544)**	**89,142**	**57,855**
Capital expenditure	*(5,067)*	*(3,345)*	*(4,000)*	*(4,000)*
Cash flow from investing	**(7,793)**	**(6,831)**	**(7,506)**	**(7,506)**
Equity raised/ (repaid)	-	-	-	-
Debt raised/ (repaid)	*653*	*(367)*	-	-
Dividend paid	*(4,895)*	*(7,343)*	*(7,343)*	*(7,343)*
Cash flow from financing	**(5,074)**	**(8,958)**	**(8,591)**	**(8,591)**
Net chg in cash	7,816	(23,333)	73,045	41,758

Key ratios

Y/E March	FY16	FY17	FY18E	FY19E
OPERATIONAL				
FDEPS (Rs)	(5.2)	2.0	5.2	9.8
CEPS (Rs)	0.1	5.5	8.6	13.4
DPS (Rs)	2.0	3.0	3.0	3.0
Dividend payout ratio (%)	(53.6)	148.1	57.9	30.5
GROWTH				
Net sales (%)	(14.9)	10.6	10.8	15.0
EBITDA (%)	(167.5)	(166.0)	79.1	73.7
Adj net profit (%)	(188.4)	(139.2)	155.7	89.6
FDEPS (%)	(188.4)	(139.2)	155.7	89.6
PERFORMANCE				
RoE (%)	(4.1)	1.6	3.9	7.2
RoCE (%)	(5.8)	3.1	6.6	11.3
EFFICIENCY				
Asset turnover (x)	1.2	1.3	1.7	2.6
Sales/ total assets (x)	0.4	0.4	0.5	0.5
Working capital/ sales (x)	0.6	0.6	0.5	0.3
Receivable days	521.0	421.6	369.4	316.5
Inventory days	128.4	99.2	104.3	108.2
Payable days	294.1	224.3	244.7	259.7
FINANCIAL STABILITY				
Total debt/ equity (x)	-	-	-	-
Net debt/ equity (x)	(0.3)	(0.3)	(0.5)	(0.7)
Current ratio (x)	1.7	2.0	1.9	1.9
Interest cover (x)	(97.1)	0.7	3.2	7.3
VALUATION				
PE (x)	(29.7)	75.7	29.6	15.6
EV/ EBITDA (x)	(16.5)	24.6	10.1	4.6
EV/ Net sales (x)	1.1	1.0	0.6	0.4
PB (x)	1.3	1.2	1.1	1.1
Dividend yield (%)	1.3	2.0	2.0	2.0
Free cash flow yield (%)	-	-	0.2	0.1

Source: Company, Axis Capital

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