

BHARAT HEAVY ELECTRICALS

ENGINEERING

17 AUG 2017

Quarterly Update

BUY

Target Price: Rs 200

Q1 a miss; underlying thesis intact

Q1FY18 revenue was down 2% YoY at Rs 55 bn missing our/consensus estimate of Rs 59/60 bn. On low capacity utilization and Q1 being a lean quarter, the revenue miss resulted in EBITDA loss of Rs 883 mn vs. our estimate of breakeven quarter. Gross margin at 40% was up 300 bps YoY and in line with estimates. Higher other income (aided by FX gain Rs 2.2 bn) resulted in PAT at Rs 0.8 bn (up 4% YoY).

Q1 order inflow at ~Rs 18 bn was down 50% YoY and order backlog at Rs 1,014 bn was down 6%. However, **executable order backlog improved to Rs 618 bn (vs. Rs 570 bn YoY)**. Yadadri project has got environmental clearance in Q1 and should become executable in Q2, which would increase executable order backlog further to ~Rs 800 bn. Increase in executable backlog would drive strong execution in FY19.

CMP : Rs 127
Potential Upside : 58%

MARKET DATA

No. of Shares : 2,448 mn
Free Float : 37%
Market Cap : Rs 309 bn
52-week High / Low : Rs 183 / Rs 116
Avg. Daily vol. (6mth) : 6.0 mn shares
Bloomberg Code : BHEL IB Equity
Promoters Holding : 63%
FII / DII : 16% / 17%

Order pipeline remains strong: In the power segment, BHEL is L1 in ~5 GW (vs. ~2.6 GW in Mar'17) of orders worth ~Rs 250 bn. Further, it is participating in tenders worth ~3 GW. Given the **strong order pipeline and thrust on scrapping old plants, the 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.

NTPC Patratu project (~Rs 120 bn) bidding not aggressive: Management explained that BHEL's bid price for this project was based on: 1) scope of the project; 2) land availability and condition of the site; 3) economies of scale as BHEL is currently executing similar order for 10 sets of 800 MW BTG units. We believe this order would be incrementally positive for earnings considering BHEL's large fixed overheads and low capacity utilization at <50%.

Maintain estimates; TP and BUY: We maintain FY18E/19E EPS at Rs 5.2/Rs 9.8. Our TP stands at Rs 200 (20x FY19E). We remain positive given the improvement in executable order backlog, strong order pipeline, thrust on scrapping of old plants and retrofit opportunity from emission norms.

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.)	-	-	5.3	7.5
EPS (Rs.)	(5.2)	2.0	5.2	9.8
Change YOY (%)	(188.4)	(139.2)	155.7	89.6
P/E (x)	(24.5)	62.4	24.4	12.9
RoE (%)	(4.1)	1.6	3.9	7.2
EV/E (x)	(12.6)	18.7	6.7	2.6
DPS (Rs)	2.0	3.0	3.0	3.0

Source: *Consensus broker estimates, Company, Axis Capital

Key drivers

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

Price performance

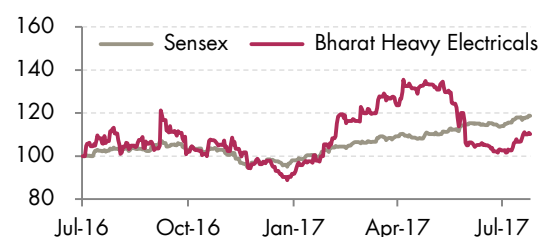
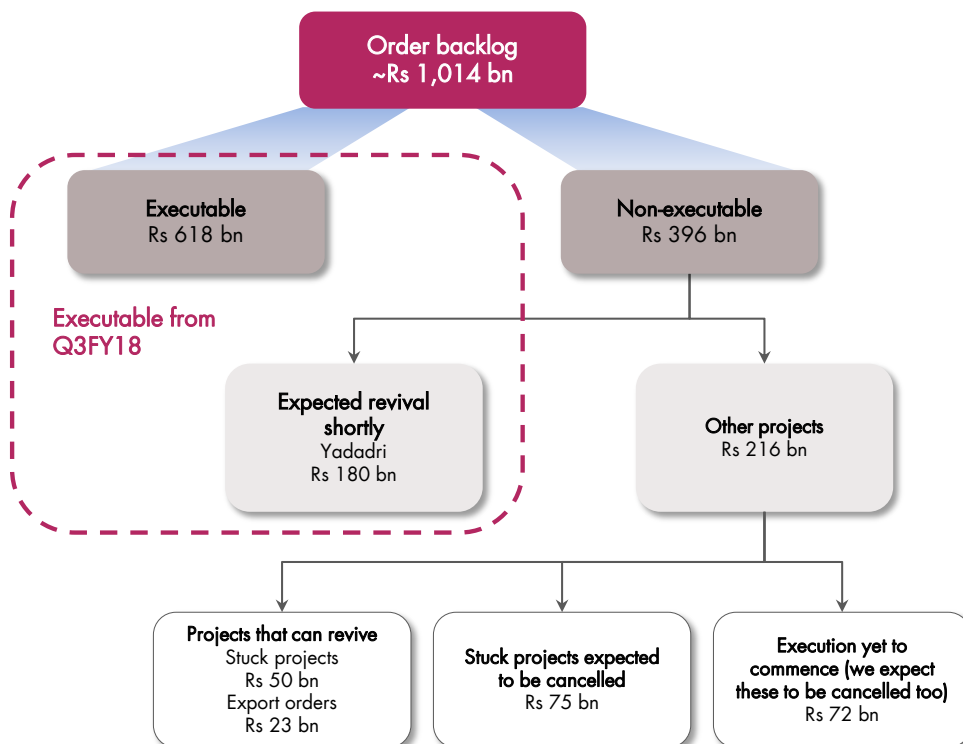


Exhibit 1: Results update

(Rs mn)	Quarter ended					12 months ended		
	Jun-17	Jun-16	% Chg	Mar-17	% Chg	FY18E	FY17	% Chg
Net Sales/Income form op	55,056	56,225	(2.1)	96,882	(43.2)	312,670	282,222	10.8
EBIDTA	(883)	230	(483.4)	6,509	(113.6)	19,713	11,009	79.1
Other income	4,622	2,493	85.4	1,452	218.2	10,344	7,264	42.4
PBITD	3,739	2,723	37.3	7,961	(53.0)	30,057	18,273	64.5
Depreciation	2,001	2,182	(8.3)	2,139	(6.4)	8,438	8,488	(0.6)
Interest	657	57	1,063.2	3,136	(79.0)	3,506	3,506	0.0
PBT	1,080	485	122.6	2,686	(59.8)	18,113	6,278	188.5
Tax	272	188	45.0	530	(48.7)	5,434	1,320	311.7
Adjusted PAT	808	298	171.5	2,156	(62.5)	12,679	4,959	155.7
Extra ordinary income/ (exp.)	-	480	-	-	-	-	-	-
Reported PAT	808	778	3.9	2,156	(62.5)	12,679	4,959	155.7
No. of shares (mn)	2,448	2,448	-	2,448	-	2,448	2,448	-
EBIDTA margin (%)	(1.6)	0.4	(201.3)	6.7	-	6.3	3.9	61.6
PBITD margin (%)	6.8	4.8	-	8.2	-	9.6	6.5	48.5
EPS (Rs.)	0.3	0.1	171.5	0.9	(62.5)	5.2	2.0	155.7

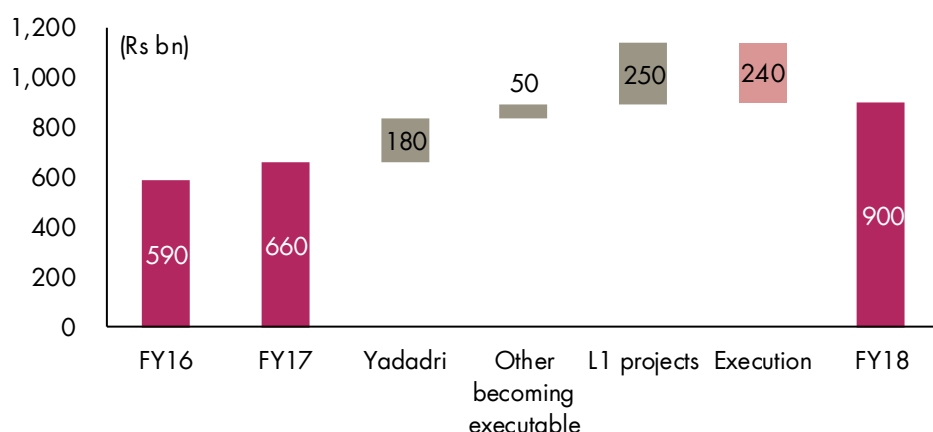
Source: Company, Axis Capital

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 Joint Deed of Undertaking 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.

Exhibit 2: Order backlog breakup


Source: Company, Axis Capital

Exhibit 3: Executable order backlog to improve



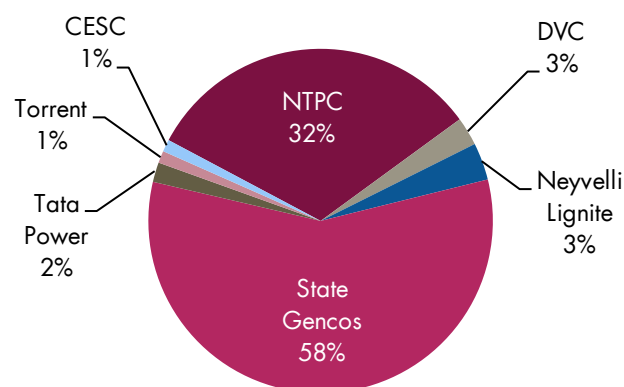
Source: Company, Axis Capital

Scrapping of old plants to improve 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:

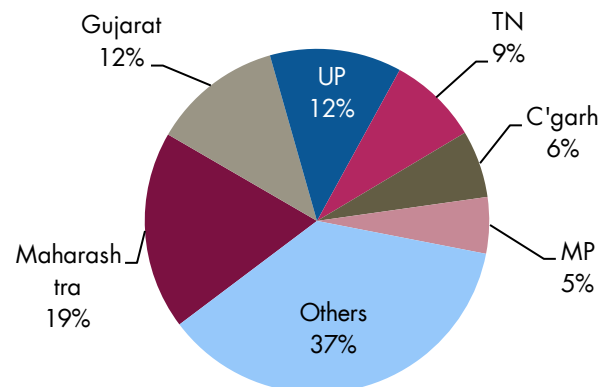
- ♦ NTPC constitutes about a third of the plants to be scrapped and the Ministry of Power recently issued a press release stating that NTPC would scrap 11 GW of its existing old plants and replace them with new on supercritical technology over next 5 years with an investment of ~Rs 500 bn (note: timeline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

Exhibit 4: 35 GW of old plants, bulk with NTPC and States



Source: Central Electricity Authority, Axis Capital

Exhibit 5: Among states, bulk with financially sound states



Source: Central Electricity Authority, Axis Capital

- ♦ **Financially sound State Electricity Boards (SEBs)** such as those of Maharashtra, Gujarat, Punjab and Chhattisgarh **constitute 43% of the State's project to be scrapped**

- ♦ **UP**, one with a financially weaker SEB, 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 those of Jharkhand, Rajasthan, etc. **are selling their old sites to 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:

- ♦ 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 6: 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 7: 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 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. BHEL has recently received order for Rs 7.5 bn and expect further orders worth ~Rs 15 bn in FY18.

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 implementation timeline 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-Babcock & 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 8: 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 (Rs mn/MW)	25	32	32	32
New eqpt mkt (Rs bn)	250	327	433	469
New eqpt market (USD bn)	4	5	6	7
Retrofit opportunity (Rs bn)*				
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 (Rs bn)		27	206	206
* assuming 5 years to comply rather than 2 yrs notified (Rs bn)				
Total market size (Rs bn)	250	355	639	674
Total market size (USD bn)	4	5	10	10

Source: Axis Capital

Profit & loss (Rs mn)

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
<i>Gross margin (%)</i>	<i>35.5</i>	<i>39.2</i>	<i>42.0</i>	<i>42.7</i>
Total operating expenses	(105,160)	(97,162)	(108,793)	(115,861)
EBITDA	(16,678)	11,009	19,713	34,236
<i>EBITDA margin (%)</i>	<i>(6.7)</i>	<i>4.0</i>	<i>6.4</i>	<i>9.7</i>
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)
<i>Tax rate (%)</i>	<i>30.8</i>	<i>21.0</i>	<i>30.0</i>	<i>30.0</i>
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
<i>Adj. PAT margin (%)</i>	<i>(5.1)</i>	<i>1.8</i>	<i>4.1</i>	<i>6.8</i>
Net non-recurring items	3,505	-	-	-
Reported net profit	(9,134)	4,959	12,679	24,042

Balance sheet (Rs mn)

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 (Rs mn)

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
<i>Chg in working capital</i>	<i>20,193</i>	<i>(24,497)</i>	<i>64,519</i>	<i>21,578</i>
Cash flow from operations	20,684	(7,544)	89,142	57,855
<i>Capital expenditure</i>	<i>(5,067)</i>	<i>(3,345)</i>	<i>(4,000)</i>	<i>(4,000)</i>
Cash flow from investing	(7,793)	(6,831)	(7,506)	(7,506)
<i>Equity raised/ (repaid)</i>	<i>-</i>	<i>-</i>	<i>-</i>	<i>-</i>
<i>Debt raised/ (repaid)</i>	<i>653</i>	<i>(367)</i>	<i>-</i>	<i>-</i>
<i>Dividend paid</i>	<i>(4,895)</i>	<i>(7,343)</i>	<i>(7,343)</i>	<i>(7,343)</i>
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)	(24.5)	62.4	24.4	12.9
EV/ EBITDA (x)	(12.6)	18.7	6.7	2.6
EV/ Net sales (x)	0.8	0.7	0.4	0.3
PB (x)	1.0	1.0	0.9	0.9
Dividend yield (%)	1.6	2.4	2.4	2.4
Free cash flow yield (%)	0.1	-	0.3	0.2

Source: Company, Axis Capital

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Research Team

Sr. No	Name	Designation	E-mail
1	Hiren Trivedi	Research Associate	hiren.trivedi@axissecurities.in
2	Kiran Gawle	Associate	kiran.gawle@axissecurities.in

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