

18 May 2020

Blue Star

Focused on long-term value creation; maintaining a Buy

Rating: **Buy**

Target Price: ₹626

Share Price: ₹475

Despite challenging times, Blue Star remains focused on shareholder value-creation courtesy its approach, which concentrated on increasing localisation of components and rationalising SKUs. This can aid in volume leverage leading to better profitability in UCP segment. The increase in localisation is in anticipation of a hike in customs duties for room-ACs and components. Its execution pace in projects, where it has robust ₹29.5bn order book would be driven by liquidity with clients as 20 project sites (of 150) have become operational.

In the present circumstances, where the country is being divided into multiple zones, an all-India policy is not possible. Hence, sales are being monitored, zone-wise. Competition can turn keener in Jun'20 as channel partners would focus on reducing inventory to free capital employed for summer products.

The focus continues on cost rationalisation in trying times, while adequate steps are taken to strengthen the balance sheet. Further updates pertaining to the issue of debentures, which can be used to refinance debt needs to be keenly watched.

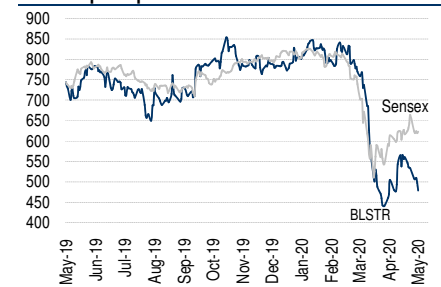
Valuations and Outlook: We have not revised our estimates after the analyst meet and maintain a Buy, with a TP of ₹626 (25x FY22e EPS of ₹25). For FY20-22, we model revenue/PAT registering 12%/28% CAGRs, with limited working-capital required. This could result in the RoCE expanding from 20% in FY20 to 24% in FY22. At the CMP of ₹467, the stock trades at 24x/19x FY21e/FY22e EPS of ₹19.4/₹25.

Risks: Unseasonal rainfall and an extended winter, slowdown in pace of order inflows and in project execution.

Key data	BLSTR IN / BLUS.BO
52-week high/low	₹888 / 409
Sensex/Nifty	30029 / 8823
3-m average volume	\$0.8m
Market cap	₹45bn / \$594.1m
Shares outstanding	96m

Shareholding pattern (%)	Sep'19	Dec'19	Mar'20
Promoters	38.8	38.8	38.8
- of which, Pledged	-	-	-
Free Float	61.2	61.2	61.2
- Foreign Institutions	11.0	10.9	7.5
- Domestic Institutions	20.4	19.5	23.2
- Public	29.9	30.8	30.5

Relative price performance



Source: Bloomberg

Key financials (YE Mar)	FY18	FY19	FY20	FY21e	FY22e
Sales (₹ m)	46,481	52,348	53,602	61,268	67,539
Net profit (₹ m)	1,387	1,873	1,474	1,864	2,403
EPS (₹)	14.4	19.5	15.4	19.4	25.0
PE (x)	46.9	23.9	30.4	24.1	18.7
EV / EBITDA (x)	25.6	13.6	16.4	13.5	10.6
PBV (x)	8.2	5.1	5.7	4.3	3.7
RoE (%)	19.0	22.8	17.3	18.9	21.3
RoCE (%)	20.8	24.9	19.5	21.9	23.6
Dividend yield (%)	1.5	2.1	2.1	1.5	1.7
Net debt/equity (x)	0.5	0.4	0.6	0.4	0.3

Source: Company, Anand Rathi Research

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Quick Glance – Financials and Valuations

Fig 1 – Income statement (₹m)

Year-end: Mar	FY18	FY19	FY20	FY21e	FY22e
Net revenues (₹ m)	46,481	52,348	53,602	61,268	67,539
Growth (%)	6.0	12.6	2.4	14.3	10.2
Direct costs	34,641	39,312	40,180	45,338	49,979
SG&A	9,181	9,572	10,593	12,552	13,429
EBITDA	2,659	3,465	2,829	3,377	4,131
EBITDA margins (%)	5.7	6.6	5.3	5.5	6.1
- Depreciation	638	749	880	910	982
Other income	170	247	447	475	480
Interest expenses	287	479	295	450	409
PBT	1,956	2,511	2,061	2,492	3,220
Effective tax rate (%)	25.3	16.7	31.7	26.0	26.0
+ Associates/(Minorities)	-22	-191	26	20	20
Net income	1,440	1,900	1,434	1,864	2,403
Adjusted income	1,387	1,873	1,474	1,864	2,403
WANS	96	96	96	96	96
FDEPS (₹/sh)	14.4	19.5	15.4	19.4	25.0
FDEPS growth	12.2	35.0	-21.3	26.5	28.9
Gross margins (%)	25.5	24.9	25.0	26.0	26.0

Fig 3 – Cash-flow statement (₹m)

Year-end: Mar	FY18	FY19	FY20	FY21e	FY22e
PBT	1,956	2,511	2,061	2,492	3,220
+ Non-cash items	638	749	880	910	982
Oper.prof. before WC	2,594	3,260	2,941	3,402	4,202
- Incr./(decr.) in WC	-2,138	-312	2,243	-2,147	160
Others incl. taxes	-376	-188	-805	-673	-908
Operating cash-flow	80	2,759	4,379	582	3,454
- Capex (tang.+intang.)	-915	-885	-1,572	-440	-880
Free cash-flow	-835	1,874	2,807	143	2,574
Acquisitions					
- Div. (incl.Buyback& taxes)	-960	-960	-960	-672	-768
+ Equity raised	1	1	-	-	-
+ Debt raised	1,538	-254	1,044	-399	-
- Fin investments	-23	-14	-22	-0	-
- Misc. (CFI + CFF)	122	-446	-939	1,277	91
Net cash-flow	(157)	201	1,930	348	1,897

Source: Company, AnandRathi Research

Fig 5 – Price movement


Source: Bloomberg

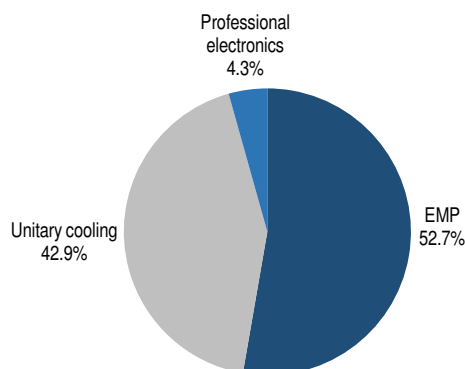
Fig 2 – Balance sheet (₹ m)

Year-end: Mar	FY18	FY19	FY20	FY21e	FY22e
Share capital	192	193	193	193	193
Net worth	7,927	8,731	7,824	10,437	12,072
Total debt	3,699	3,445	4,489	4,090	4,090
Minority interest	15	18	23	15	15
DTL/(Assets)	-	-	-	-	-
Capital employed	11,642	12,194	12,336	14,542	16,177
Net tangible assets	3,359	3,499	3,924	3,453	3,350
Net intangible assets	631	503	514	514	514
Goodwill	-	-	-	-	-
CWIP (tang. &intang.)	184	308	564	564	564
Investments (strategic)	132	146	169	169	169
Investments (financial)	-	-	-	-	-
Current assets (ex cash)	27,247	28,043	26,282	31,575	33,941
Cash	809	1,009	2,939	3,287	5,184
Current liabilities	20,720	21,315	22,056	25,019	27,545
Working capital	6,527	6,727	4,226	6,555	6,395
Capital deployed	11,642	12,193	12,335	14,542	16,177
Contingent liabilities	-	-	-	-	-

Fig 4 – Ratio analysis

Year-end: Mar	FY18	FY19	FY20	FY21e	FY22e
P/E (x)	46.9	23.9	30.4	24.1	18.7
EV / EBITDA (x)	25.6	13.6	16.4	13.5	10.6
EV / Sales (x)	1.5	0.9	0.9	0.7	0.6
P/B (x)	8.2	5.1	5.7	4.3	3.7
RoE (%)	19.0	22.8	17.3	18.9	21.3
RoCE (%)	20.8	24.9	19.5	21.9	23.6
ROIC	17.0	22.4	15.9	21.1	24.1
DPS (₹ /sh)	10.0	10.0	10.0	7.0	8.0
Dividend yield (%)	1.5	2.1	2.1	1.5	1.7
Dividend payout (%) - incl. DDT	69.2	51.3	65.1	36.1	32.0
Net debt / equity (x)	0.5	0.4	0.6	0.4	0.3
Receivables (days)	75	78	57	66	66
Inventory (days)	80	61	59	64	61
Payables (days)	120	107	108	110	110
CFO: PAT %	5.8	147.3	297.1	31.2	143.8

Source: Company, AnandRathi Research

Fig 6 – Break-up of FY20 revenues


Source: Company

Key takeaways from the analyst meet

Execution pace driven by client liquidity and revised commissioning guidelines: At end-Q4 FY20 Blue Star's pending order-book was ₹29.5bn, up 21% y/y. Order inflows for the year were ₹31bn, up 5% y/y. Some of the large infrastructure orders in the designing phase would be air-conditioning systems for Chennai, Bangalore and Delhi airports. With the partial lifting of the lockdown, 20 sites are operational (of 150 projects). Blue Star will be reviewing each project in detail before re-starting them after the lockdown.

The pace of execution would be directly linked to client liquidity and revised timelines in which a client intends to commission a project. Considering the tight liquidity of customers in commercial real estate, Blue Star had made provision of ₹150m in Q4FY20 as a prudent accounting policy.

It expects projects in infrastructure to be least impacted as funding has already been tied up. Since, Blue Star's scope of work comes at the end of the project cycle (with around 90% of the project constructed), the probability of cancellation is limited. However, a change in the scope of work based on revision in utility of the project cannot be ruled out.

Maintains 12.5% market-share as UCP channel partners loaded with inventory, leading heightened competition in June 2020: At end-Q4FY20 Blue Star enjoyed a 12.5% market share in room ACs, up marginally. In UCPs, inventory with both OEMs and channel partners is for ~75 days. For Blue Star, that figure is 60 days (vs normal inventory of 45 days in summer). In the present context, where the country has been divided into zones, application of a common all-India policy is not possible. Hence, sales are being monitored zone-wise. Competition could increase in Jun'20 as channel partners would focus on reducing inventory to free capital employed in summer products.

Its marketing network comprises 6,000 retail outlets across India, of which 3,000 are operational. However, the pace of booking sales is expected to be tepid for the near to medium term as (a) retail outlets are gradually opening up but customer walk-ins are expected to be fewer and (b) e-commerce portals are not delivering non-essentials. For these reasons Blue Star expects industry wide declines of 10-25% in room-ACs for FY20. Inventory loading with channel partners increased because of primary sales growth in Jan and Feb'20 as in a normal summer. This compelled dealers to hold greater inventory for Mar'20 before the lockdown was announced.

Blue Star was planning a price hike of around 5% in room ACs as costs had risen because of the depreciating currency and greater logistics costs. That also compelled channel partners to stock inventory ahead of the peak summer season which is expected to be liquidated in coming quarters. Blue Star has started providing longer credit days (vs giving 21 days credit) to its channel partners in these challenging times.

It is confident of sales being booked via consumer-financing schemes and its share increasing from 40% in FY20 to ~55% in FY21. Despite securing mandatory permission to re-start its factories at Wada and Dadri, manufacturing operations have not commenced as the channel is loaded with inventory.

SKU rationalisation underway to improve localisation and enhance

profitability: Blue Star is in the process of rationalising its SKUs across room-ACs to lower dependence on imports as greater volumes of standard components could boost volumes and enhance profitability in UCPs. Further updates need to be keenly watched. Increase in localisation is in anticipation of an increase in customs duties on room-ACs and components, as the government intends to reduce import of room-ACs.

Regulatory aspects, an important factor to watch: Costing factors depend on regulations. Energy-rating norms were expected to be revised in Dec'19. This was postponed by a year and is unlikely to be implemented by Dec'20. Quality control and BIS certification of vendors was needed, which is not being implemented. Demand for room-ACs could depend on implementation of an e-waste policy. Updates need to be keenly watched.

Costs being rationalised / business terms being re-negotiated: Blue Star is rationalising its fixed costs and re-negotiating business terms with creditors, rolling over letters of credit and asking for aggressive discounts with suppliers. Also, capex plans are getting re-calibrated.

Concrete steps to strengthen balance sheet, maintain liquidity: Revenue booking of ₹4bn was delayed, resulting in PAT being ₹700m lower, on the implementation of the lockdown in Mar'20. Blue Star is taking steps to strengthen its balance sheet as it expects the scenario in projects and products to continue. In that respect, it has taken Board approval to raise up to ₹5bn via a private placement of non-convertible debentures. The intent would be to maintain robust liquidity amid these challenging times, and used to support channel partners in projects and products. Outstanding debt at end-Q4FY20 was ₹4.5bn (₹3.4bn a year ago). The increase in debt can be attributed to (a) more orders placed with vendors in Feb'20 anticipating supply-chain disruptions in Mar and Apr'20 in UCPs, (b) inventory getting stuck with channel partners.

The company's focus is on controlling working capital in its projects division and re-negotiating terms with suppliers. Updates regarding this need to be keenly watched. Blue Star had cleared dues of its small and medium-sized channel partners, who had been faced with liquidity issues in Mar'20.

Outlook & Valuations

We have not revised our estimates after the analyst meet. We maintain a Buy, with a TP of ₹626 (25x FY22e EPS of ₹25).

Despite short-term pressures, Blue Star is well-placed to navigate challenging times, supported by its robust business model which has bounced back every such time in the past decade. Its key strengths are (a) its all-India distribution network for room ACs, (b) expanding product range of commercial cooling products, (c) a well-accepted brand among domestic consumers, and expanding its water-purifier range.

Its robust project-division order-book offers assurance of revenue but the pace of execution would depend on liquidity with clients, an important monitorable. The prospects for its professional electronics division are closely linked to digitisation of the economy and capex for upgrading hospitals.

At the CMP of ₹467, the stock trades at 24x/19x FY21e/FY22e EPSs of ₹19.4/₹25. For FY20-22, we model revenue/PAT registering 12%/28% CAGRs with limited working capital required, which could result in the RoCE expanding from 20% in FY20 to 24% in FY22. The sharp improvement in the profit CAGR can be attributed to the 21% drop in FY20 PAT because of (a) higher tax rates and (b) delay in booking ₹700m PAT because of the lockdown across India.

Risks.

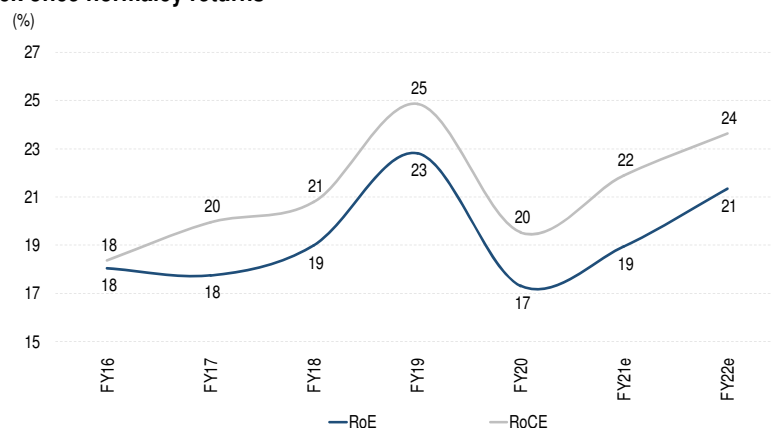
unseasonal rainfall,

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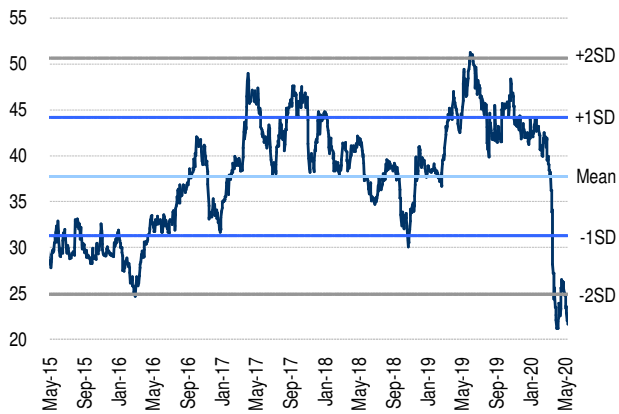
huge increases in labour costs, eating into the project division’s margins.

Fig 7 – Blue Star has a proven track record of RoCE expansion and can bounce back once normalcy returns



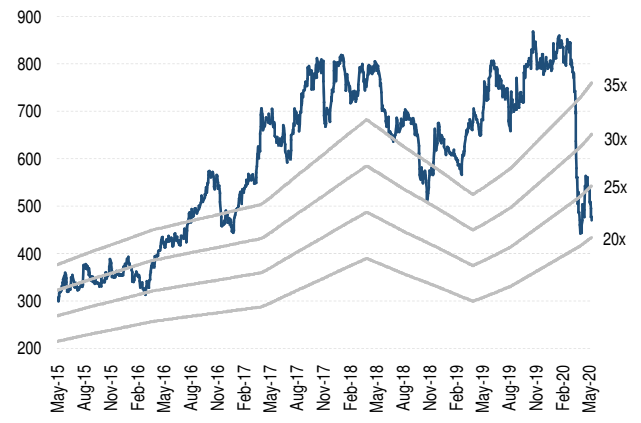
Source: Company, Anand Rathi Research

Fig 8 – Standard deviation



Source: Company

Fig 9 – PE band



Source: Company

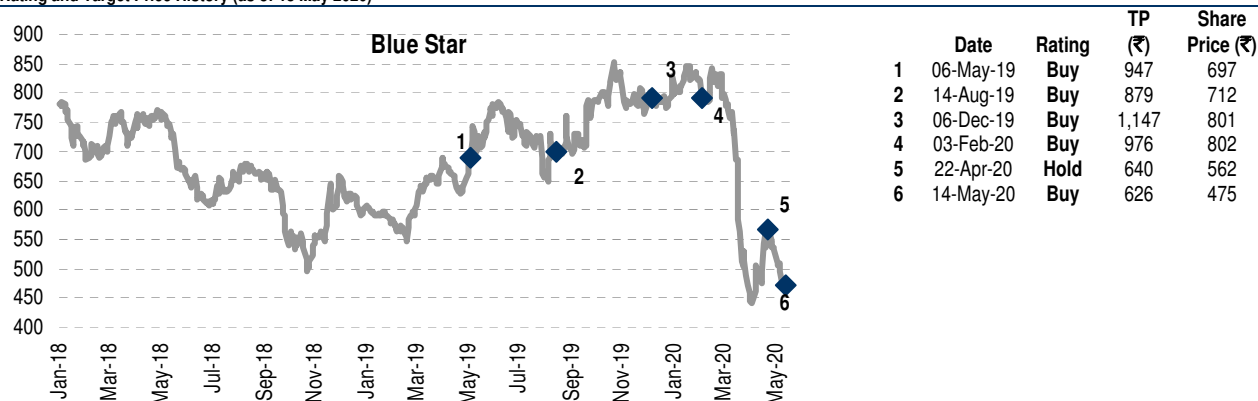
Appendix

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