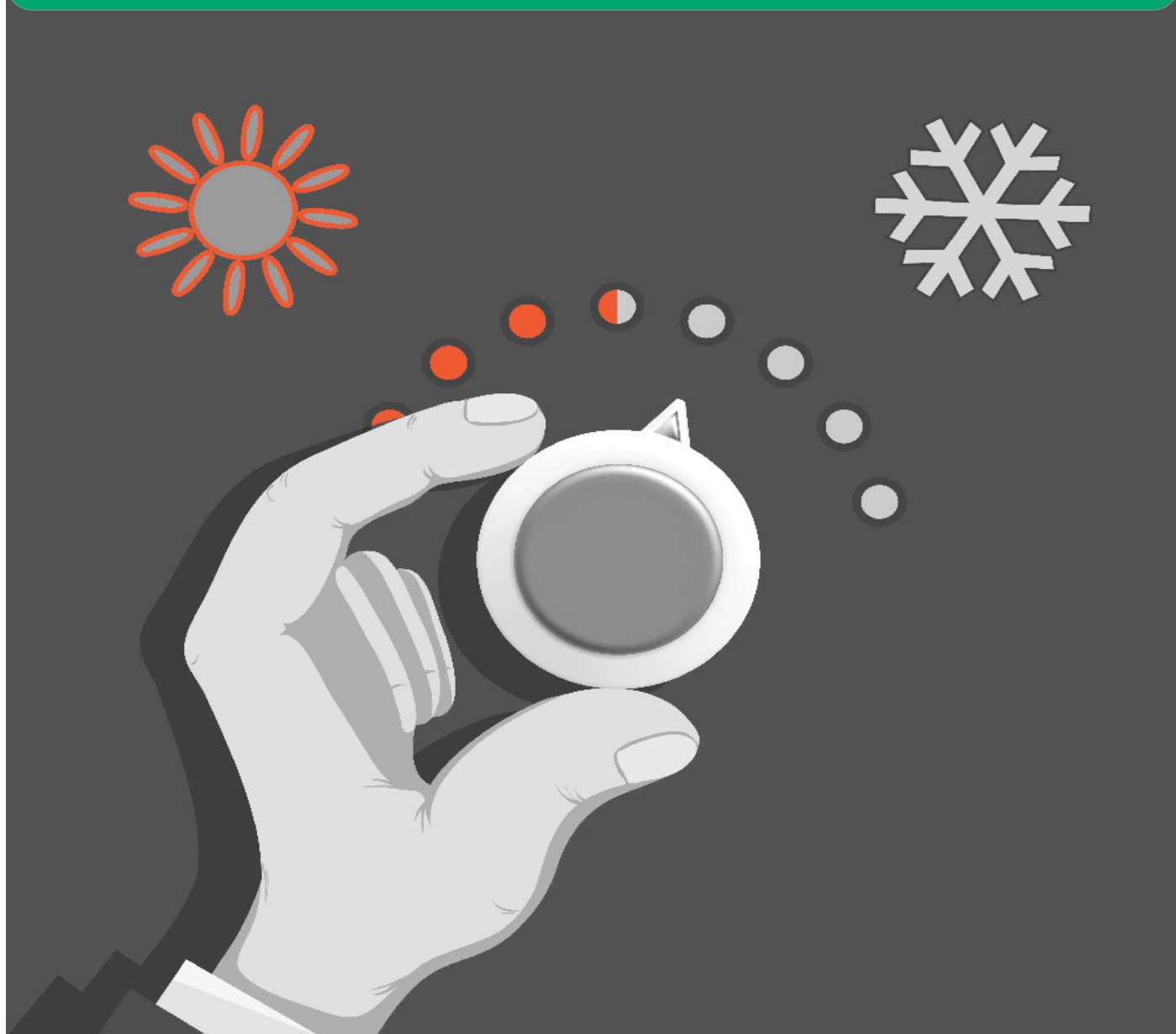


# Stock Idea

Sector: Capital Goods

April 05, 2021

## Blue Star Limited



**Well-conditioned for long-term growth**

**Sharekhan**

by BNP PARIBAS



Powered by Sharekhan's 3R Research Philosophy



## 3R MATRIX

	+	=	-
Right Sector (RS)	✓	✗	✗
Right Quality (RQ)	✓	✗	✗
Right Valuation (RV)	✓	✗	✗

+ Positive = Neutral - Negative

## Reco/View

Reco:	Buy
CMP:	Rs. 922
Price Target:	Rs. 1200

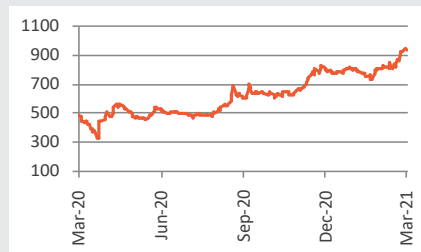
## Company details

Market cap:	Rs. 8,882 cr
52-week high/low:	Rs. 973/435
NSE volume: (No of shares)	15.9 lakh
BSE code:	500067
NSE code:	BLUESTARCO
Free float: (No of shares)	5.9 cr

## Shareholding (%)

Promoters	38.8
FII	10.4
DII	22.5
Others	28.4

## Price chart



## Price performance

(%)	1m	3m	6m	12m
Absolute	7	14	44	108
Relative to Sensex	7	14	15	31

Sharekhan Research, Bloomberg

## Blue Star Limited

## Well-conditioned for long-term growth

Capital Goods

Sharekhan code: BLUESTARCO

Initiating Coverage

## Summary

- We initiate coverage on Blue Star (Blue Star) with a PT of Rs. 1,200, given its high net earnings growth trajectory for FY2021E-FY2023E and favourable relative valuation.
- Expectation of strong summers, focus on technology, in-house manufacturing, introduction of new products and a recovery in project segment will be near-term growth drivers.
- Company would focus on growing higher than industry growth rates, improving profitability through scale and backward integration, deepening distribution reach and pursuing profitable adjacencies.
- Revenue and earnings to clock a 27% and 71% CAGR, respectively for FY2021-2023E driven by core UCP segment along with improvement in OPM while return ratios are expected to improve.

Blue Star (Blue Star) has been one of the most recognised player in the RAC and refrigeration products. It continues to gain foothold in core business categories and is also consolidating in its global presence. With superior product performance, high focus on technology and a premium brand image, Blue Star is one of the preferred choices for aspirational consumers. Blue Star's market share has consistently increased from 7.5% in FY14 to 12.5% in FY20 despite a rising number of players in the air-conditioning (AC) industry. In order to gain market share, Blue Star is constantly expanding its distribution network and looking to add new dealers in metros and Tier-3, -4 and -5 cities. It is also establishing its brand in e-Commerce channels. To further leverage its brand strength and distribution network, Blue Star has entered into product categories such as water purifiers, air coolers and air purifiers. These segments will help make further in-roads into the residential segment and the engineering element in these products will help Blue Star to differentiate its products. Blue Star is well-entrenched in both the retail and institutional levels in its distribution network. Going ahead, the company sees a smart recovery in demand month-on-month over Q4FY21 with soaring temperatures and expectation of a hotter summer ahead. The company has aligned its long-term focus on reducing import dependency and remains sanguine of government's push to develop a local ecosystem for component manufacturing for the AC industry. India's e-Commerce opportunity is worth \$35 billion and should double in the next four years. Blue Star aims to raise its air-conditioner (AC) sales through e-commerce from less than 5% to over 20% by FY24. The company's net debt has reduced to Rs. 160 crore in FY20 compared to 240 crore in FY19 due to effective working capital management despite COVID-19 and generated a free cash flow (FCF) of Rs. 370 crore in FY20. With rising return ratios, healthy cash flow, lean working capital cycle and a comfortable leverage position, Blue Star is placed favourably as compared to listed brands in terms of its valuation vis-à-vis RoE and EPS growth prospects. Hence, we initiate coverage on Blue Star Ltd with a price target of Rs. 1,200.

**Making rapid strides:** With a superior product performance, high technology focus and a premium brand image, Blue Star is a preferred choice of aspirational consumers. Over the past five years, Blue Star's market share has consistently increased from 7.5% in FY14 to 12.5% in FY20, despite a rising number of players in the AC industry including multi-national brands with deep pockets. Blue Star aims to outpace industry growth led by its distribution network expansion, rising market share, favourable product mix (it has a higher market share in fast-growing inverter AC) and expansion in the northern region. The company's strategic plan for FY21-24 focuses on 1) growing faster than the market, 2) improving profitability through scale and backward integration, 3) deepening distribution penetration incl. e-commerce, 4) pursuing profitable adjacent product opportunities.

## Our Call

**Valuation – Initiate Coverage with a TP of Rs 1200:** Blue Star has made consistent, rapid progress and outperformed the industry as well as its peers driven by strengthening distribution network, rising market share and improving product mix (higher proportion of inverter ACs). Over the next five years, Blue Star's management has ambitious growth plan of increasing revenues at a 20% CAGR and profitability by 25% CAGR. With rising return ratios, healthy cash flow, lean working capital cycle and a comfortable leverage position, Blue Star is placed favourably compared to listed brands in terms of its valuation vis-à-vis RoE and EPS growth prospects. The company is currently trading at a P/E of 32x FY23E EPS and we have assigned a PE of 42x which is at a discount to its competitors like Voltas and Havells as the company has been gaining market share consistently in the residential market and expected to continue further. We initiate coverage on Blue Star Ltd with a PT of Rs. 1,200.

## Key risk

Slowdown in the domestic macro-environment and higher loss funding in roads can negatively affect business outlook and earnings growth.

## Valuation (Consolidated)

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenue	5,235	5,360	4,181	5,853	6,798
OPM (%)	6.6%	5.3%	5.8%	6.6%	6.9%
Adjusted PAT	187	147	93	206	274
% YoY growth	39.2%	-21.4%	-36.6%	120.7%	33.0%
Adjusted EPS (Rs.)	19.5	15.3	9.7	21.4	28.5
P/E (x)	47.0	59.8	94.3	42.7	32.1
P/B (x)	10.1	11.3	10.8	9.9	8.9
EV/EBITDA (x)	25.3	28.8	34.6	22.3	18.1
RoNW (%)	22.0%	17.8%	11.7%	24.2%	29.3%
RoCE (%)	24.4%	19.5%	14.2%	23.4%	28.4%

Source: Company, Sharekhan estimates

## Executive Summary

### 3R Research Positioning Summary

#### ■ Right Sector:

Low per capita consumption, improving demographics, soaring temperatures, lower penetration of air-conditioners and greater spends on home improvement will drive demand for RACs.

#### ■ Right Quality:

Management continuity, constant innovation and cash conservation form pillars of new strategic plan.

#### ■ Right Valuation:

Company's strong net earnings growth trajectory coupled with favourable relative valuations should aid a re-rating.

### Valuation and return potential

- ♦ Revenue/ earnings would clock 27.1%/ 71% CAGR over FY2021-23E driven by its core cooling products segment along with improvement in operating margins.
- ♦ Stock trades at 42.7x/32.1x its FY2022E/ FY2023 earnings and we have assigned a PE of 42x which is at a discount to its competitors.

### Catalysts

#### Long-term triggers

- ♦ Demographics provide suitable conditions for growth in air conditioners
- ♦ Low penetration levels to drive demand
- ♦ Product innovation and energy efficiency driving RAC sales in India

#### Medium Term Triggers

- ♦ Market potential in Healthcare, Food Preservation and Home Delivery sectors has enhanced with the virus providing opportunities in commercial refrigeration.
- ♦ Well prepared for demand led by the onset of summer with improved and enhanced product offering in the RAC and commercial refrigeration segments.
- ♦ Rising distribution reach indicating a deeper presence across various markets.

#### Key Risks:

- ♦ Slowdown in the domestic macro-environment.
- ♦ Competition from international and domestic players due to widespread market operations
- ♦ Disruption in supply caused due to geo-political reasons, imposition of non-tariff barriers or COVID-19.

### Earnings and Balance sheet highlights

- ♦ **Earnings growth:** Expect strong growth in net earnings with a 71% CAGR over FY2021-FY2023E.
- ♦ **Balance sheet:** Healthy balance sheet with lean working capital cycle and a comfortable leverage position place Blue Star favourably compared to listed brands
- ♦ **Cash Flows:** Cash flows remain healthy and it has generated FCF of Rs 370 crore in FY20
- ♦ **Return ratios:** Expect RoE and RoCE to remain healthy at 29.3% and 28.4%, respectively.

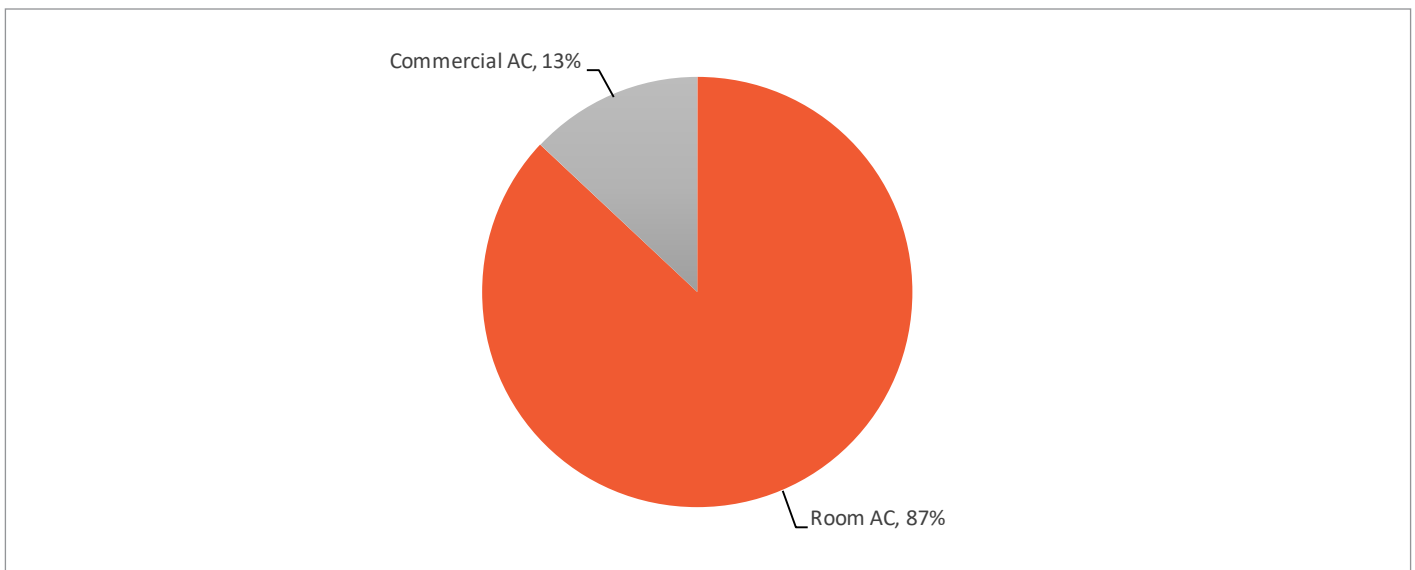
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### Why we like space – Healthy growth trajectory in RAC led by domestic structural levers

**AC segment has long-term structural growth triggers in terms of suitable demographics, rising per capita income, rising urbanization, low penetration levels, uninterrupted availability of power etc which would aid in maintaining healthy growth trajectory over the long term.**

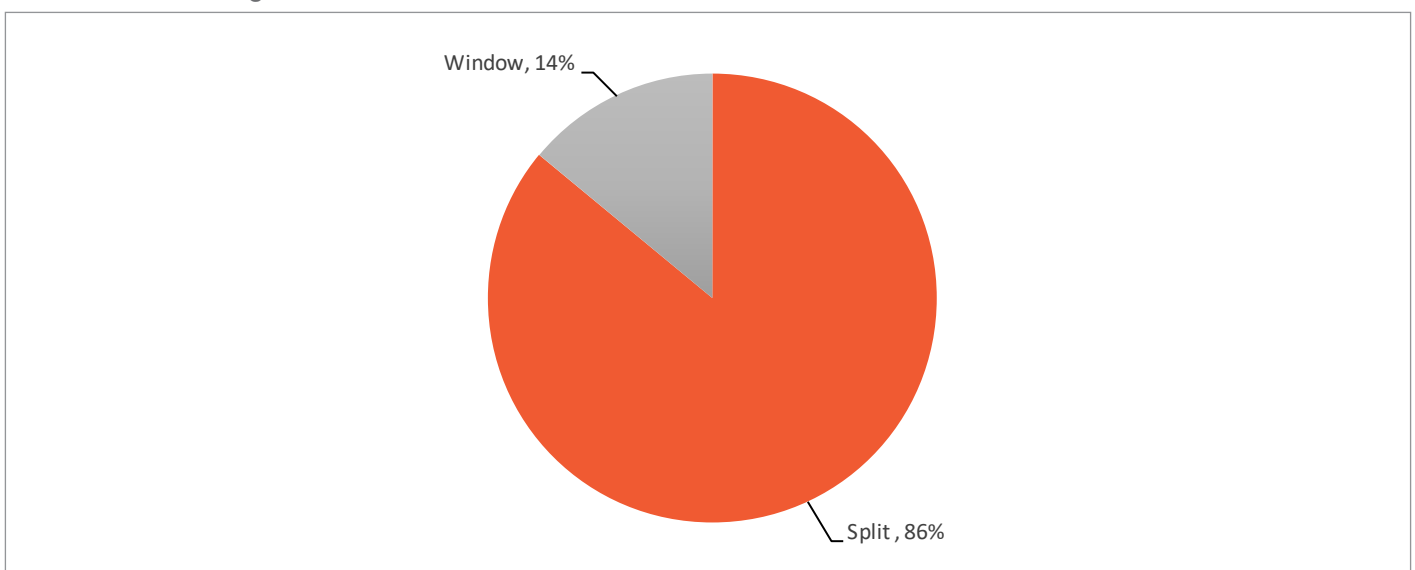
**Global: RAC Industry Overview:** Global demand for air conditioners is rising on improving penetration in emerging countries and focus on energy efficiency in developed/ developing economies. After a slight decrease in demand in 2018, the global air conditioners market grew at a modest rate of 3.4% from 2018 to 2019, registering a demand of 113.5 million units. China accounts for approximately 40% of the total market in 2019 followed by USA, Japan, India and Brazil.

#### Global Air Conditioning Overview



Source: Industry, Sharekhan

#### Global RAC Market Segments

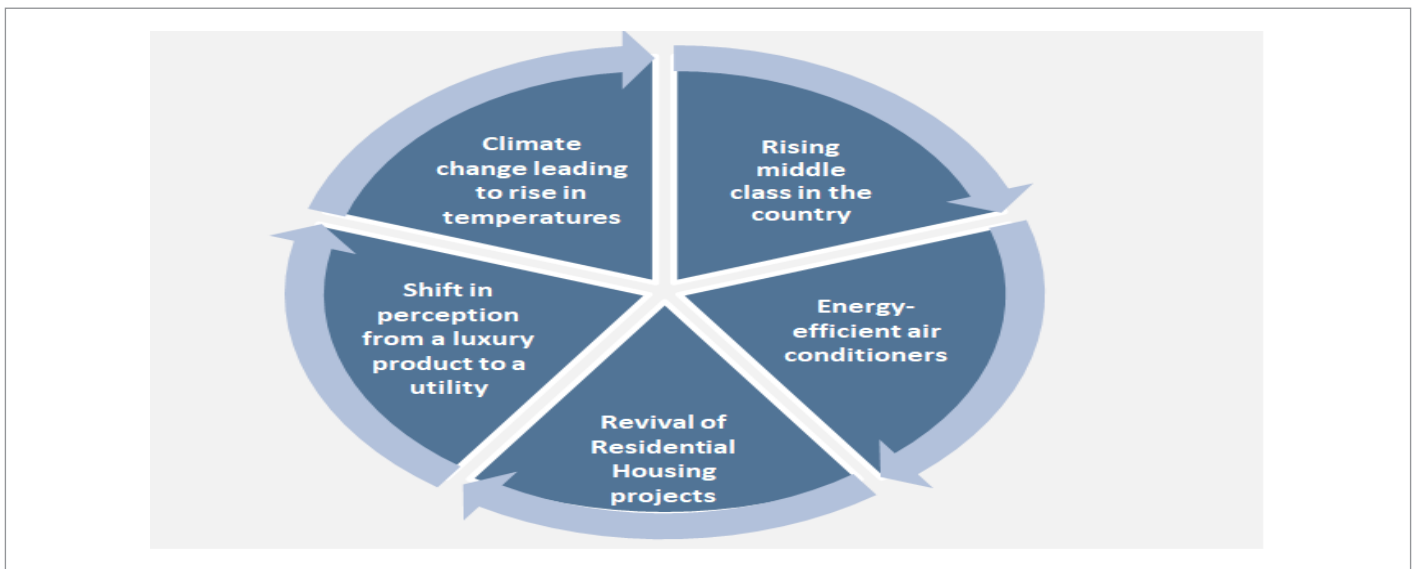


Source: Industry, Sharekhan

### Demographics provide suitable conditions for growth in air conditioners:

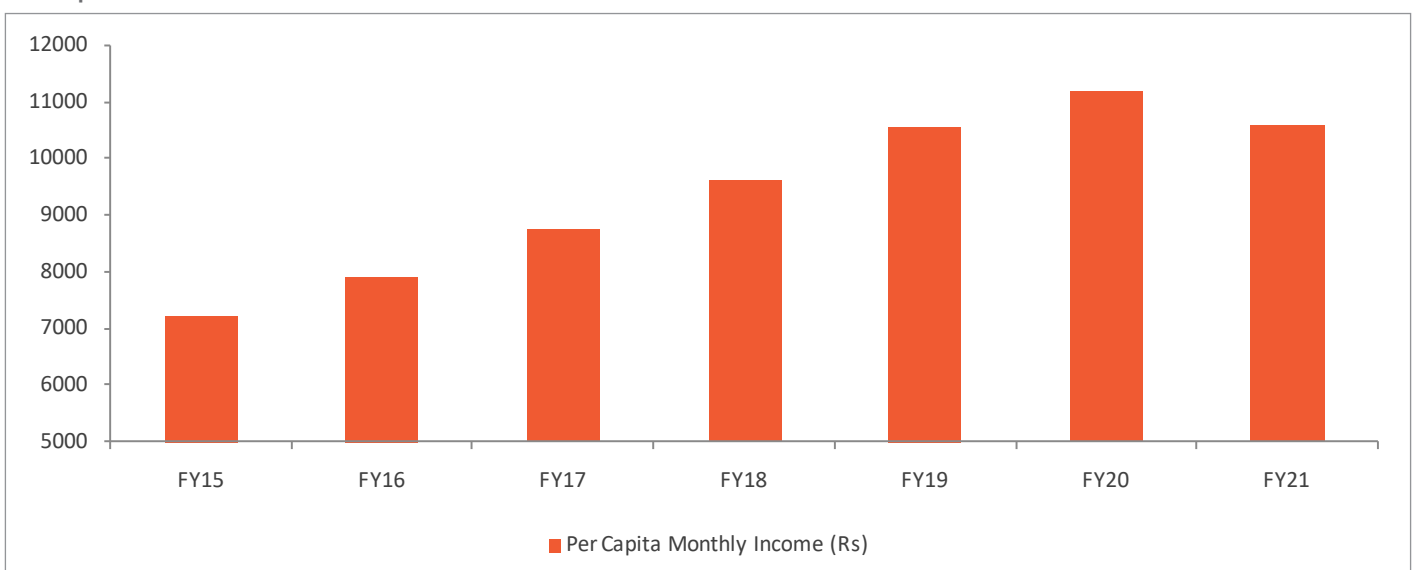
Indian demographics provide suitable conditions such as urbanisation, low penetration, increasing affordability (improving per capita income) and better availability of electricity; we believe that the domestic RAC market and home appliances market is poised to witness secular growth over the next five years. Low RAC penetration at 8% of the total households (China: 60%; Japan > 90%) despite a hotter climate, improving affordability and better availability of electricity provide growth visibility on the sector. India is currently at the same stage as China was in 1998-2000, post which RAC demand had witnessed secular growth. Additionally, climatic conditions in India are more severe, which leads to purchase of room ACs as a key decision when a person moves up a certain income threshold. The RAC industry is expected to record ~8-10% CAGR between FY20-FY25F despite COVID-19 impact.

### Indian RAC Market Drivers



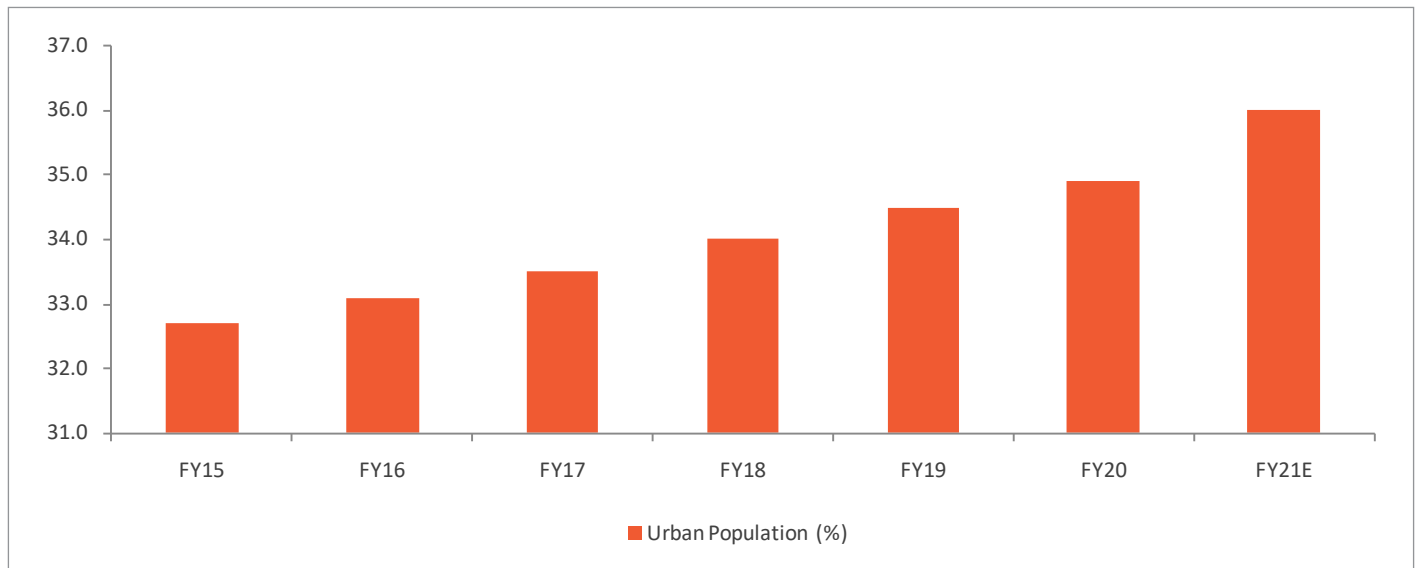
Source: Industry, Sharekhan

### Per Capita Income trend



Source: Mospi, Sharekhan Research

### Urban Population



Source: UN Urbanisation Prospects, Sharekhan Research

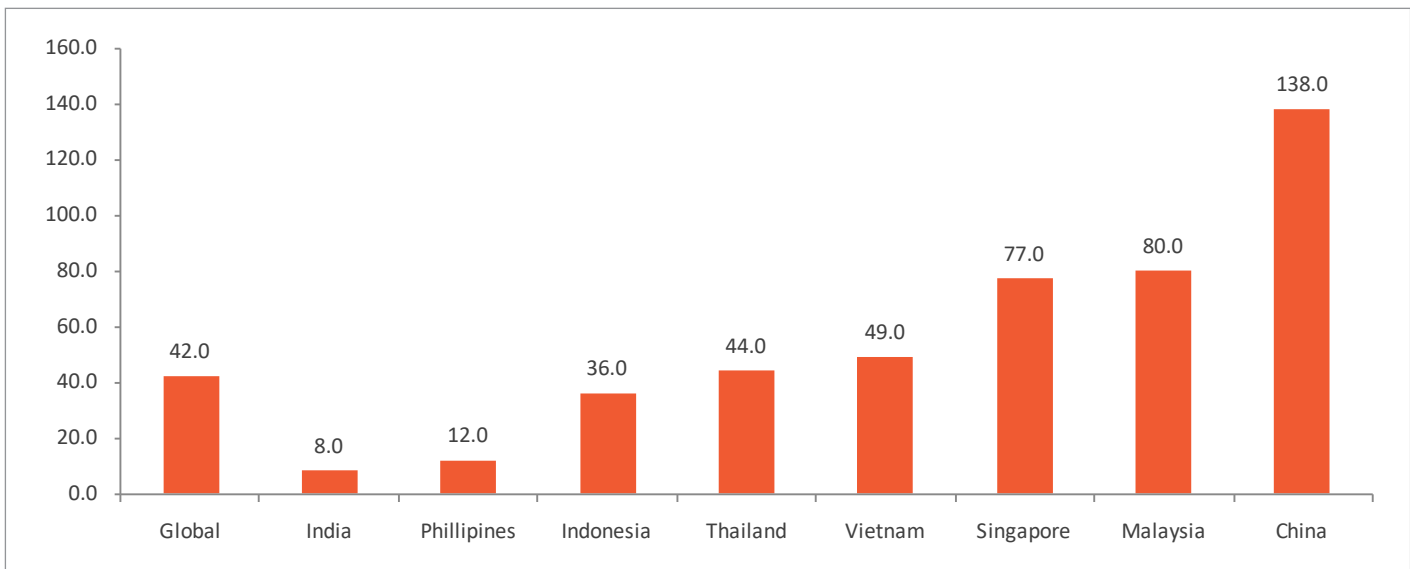
### Product innovation, rising online share and easy financing are other catalysts

Companies are currently focusing on adding new features to drive consumer excitement, premiumise and lower the replacement period. Some of these features are Internet connectivity, smart home devices with voice integration, adjustable inverter ACs, anti-dust/higher efficient fans, etc. This has mainly benefitted sales of larger organised players, helping them gain share. Also, the share of financing in consumer durables has increased sharply from ~23% in FY16 to ~31% in FY20 and is likely to remain a key driver of improving affordability and driving penetration. Similarly, the share of online purchases in India is still significantly low (~50% in mobile phones but much lower at ~5-10% in white goods) as compared to China (~80% in small appliances and ~50% in ACs). After the outbreak of COVID-19, we believe that preference towards e-Commerce purchases has increased significantly and the presence in the segment remains important to drive growth. Recovery post COVID-19 is likely to be the slowest. In comparison to other Asian countries, there is tremendous potential in the Indian market as the overall RAC penetration is relatively much lower. This underlines that Indian RAC market would be leading the path of global market growth in the next few years.

### Low penetration levels to drive demand

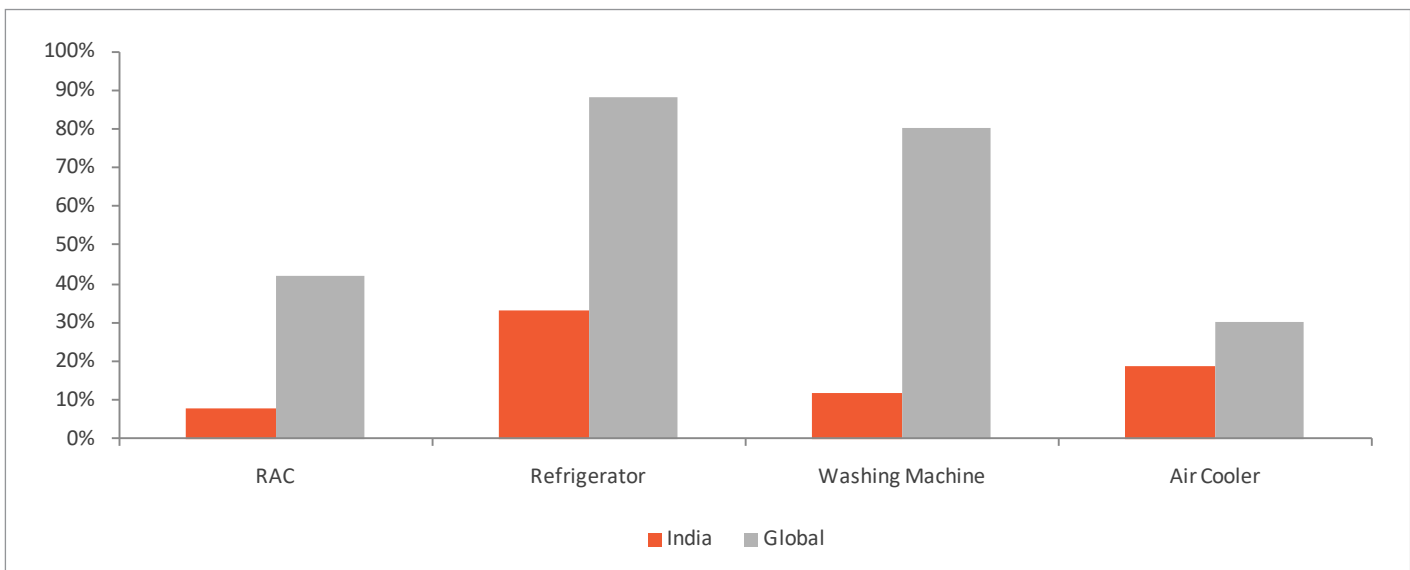
India's consumer durables market has been growing over the last few years but remains fragmented. Its growth is driven by the increase in disposable income, urbanisation and easy consumer financing. With an increase in efforts on product innovation and launch of new variants of products, the overall market is rising. The scope of penetration is supported by increase in organised retail market in future. The RAC penetration level in India (8%) lags as compared to the global level (42%) implying there is significant opportunity for growth. With rising temperatures in India the scope of demand will increase in the next few years. The overall Indian market remains at sub-par level when compared to the global average. With increase in rural market sales and product lining strategies, the market penetration is expected to improve in future.

#### RAC market penetration - Select Asian Countries and Global (%)



Source: Frost and Sullivan Analysis

#### Market Penetration of Consumer Durables -India v/s Global (%): FY20



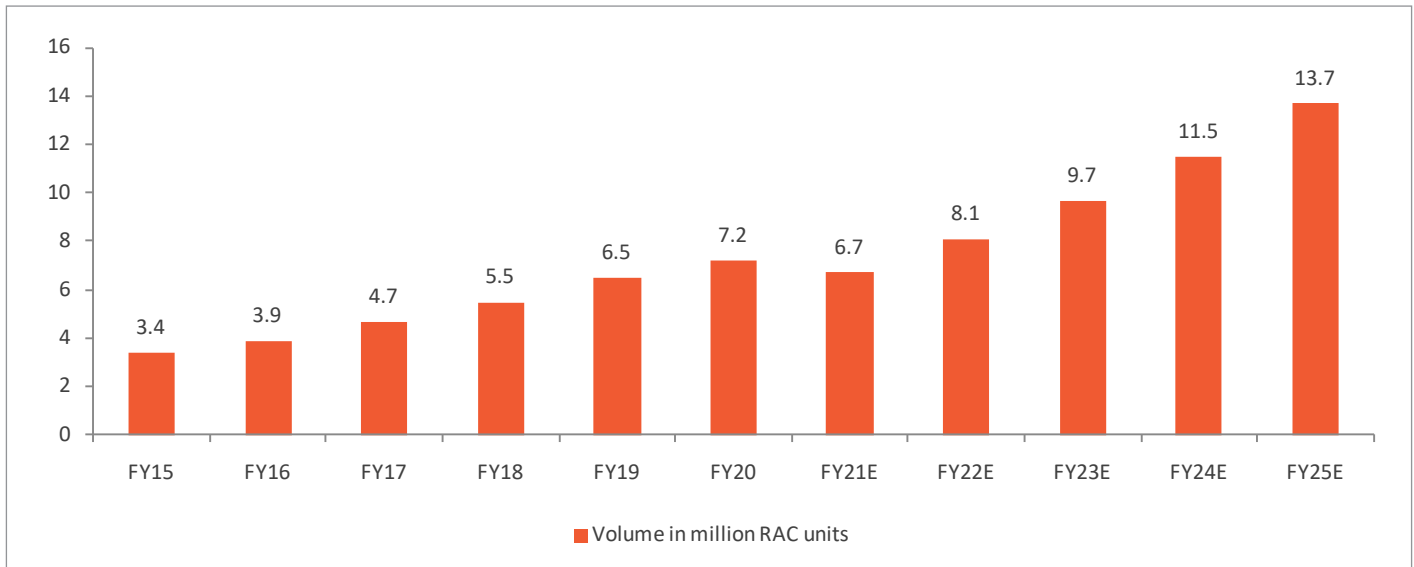
Source: Frost and Sullivan Analysis

#### Product innovation and energy efficiency driving RAC sales in India

Indian RAC sales volumes clocked a robust CAGR of 16.2% over FY2015 to FY2020. In the next five years, the market is expected to experience a CAGR of 13.7% reinforced by the increase in rural consumption, shorter replacement cycles, energy-efficient RACs and availability of multiple brands at various price points. However, the market is expected to have a slowdown for next one year due to the COVID-19 pandemic and revive again from FY2022. RAC volumes are expected to increase from 7.2 million units in FY2020 to reach 13.7 million units by FY2025. Future demand for RAC is expected to be driven by better features and energy efficiency as two key buying criteria in Indian market. The large domestic demand has seen major global RAC brands focusing on India as a manufacturing base with the government's focus and push on 'Make in India'. Further, the RAC market revenues are expected to grow at a CAGR of 15.9% from FY2020 to FY2025 to reach a market size of Rs. 386.4 billion in FY2025. It is to be noted that during the forecast period, average selling prices of RAC is expected to increase further. The price rise is attributed to rising raw material cost, impact of energy efficiency technology infusion among others.

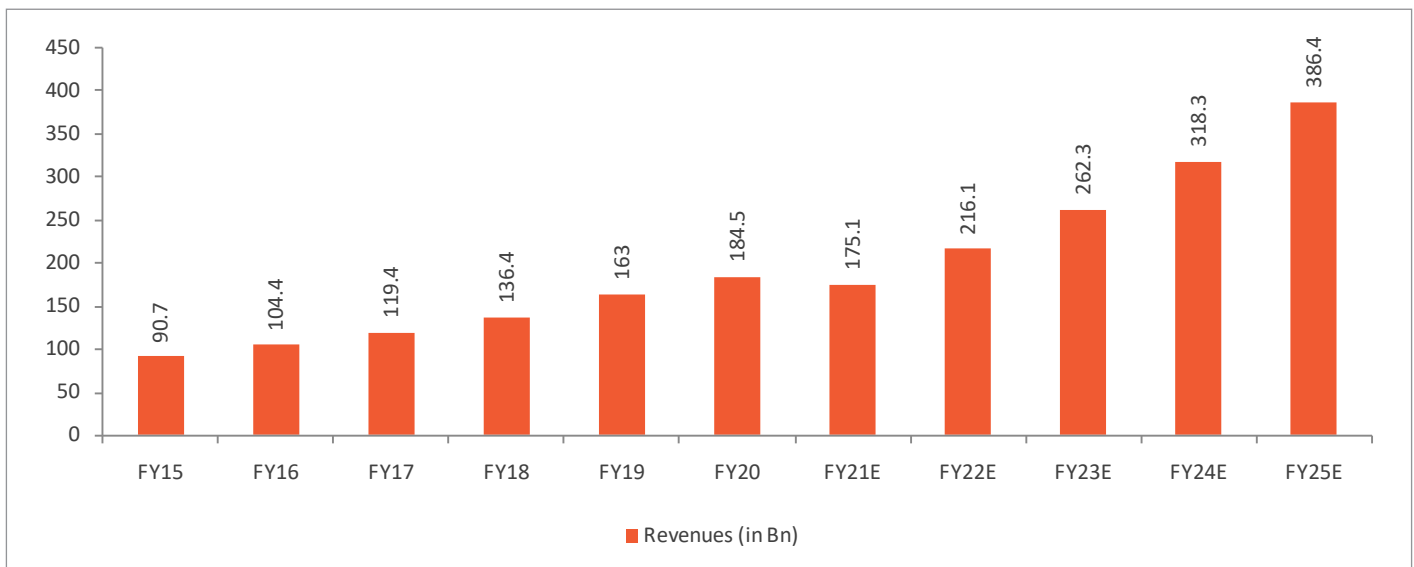


### Market Size and Forecast of RAC



Source: Frost and Sullivan Analysis

### Energy-efficient RACs to cut power consumption costs



Source: Frost and Sullivan Analysis

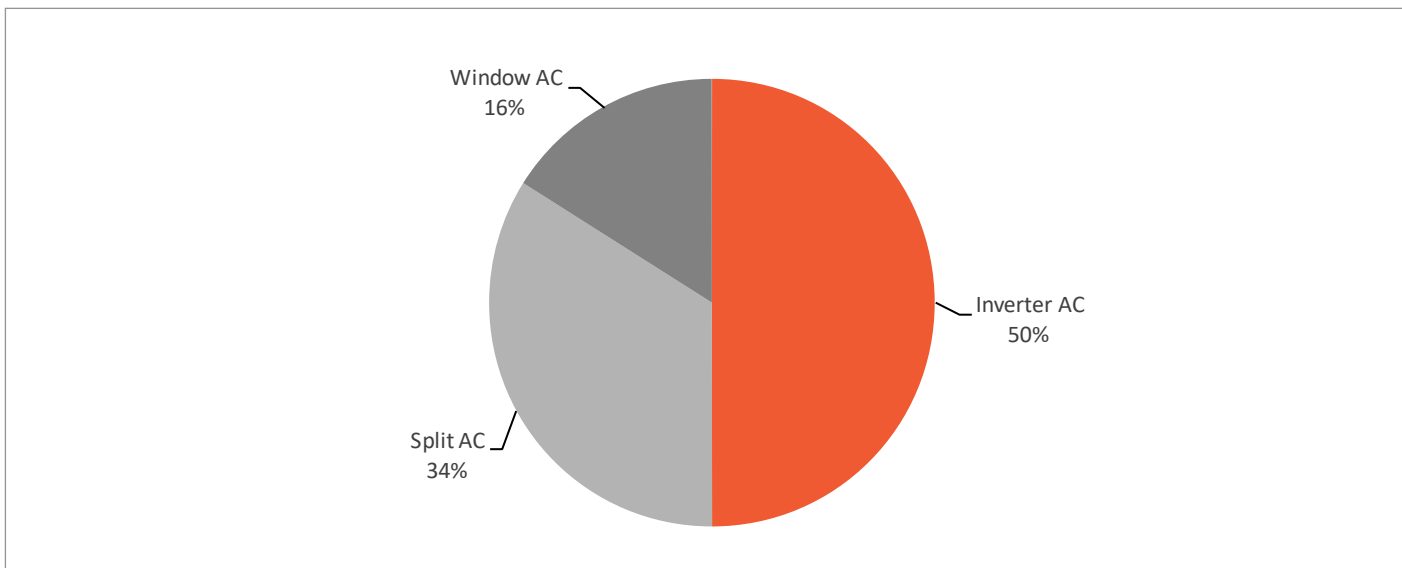
The transformation in the RAC market commenced with the introduction of star ratings by the Bureau of Energy Efficiency (BEE) in 2007 to promote energy efficiency. The star rating was made mandatory from 2007 and was upgraded in 2012 and 2014. The enforcement of first energy efficiency ratio was introduced in 2015. Voluntary labelling of inverter RACs, which are considered more efficient in comparison to conventional RACs, started from 2016. From 2018, all RACs that are sold in India, including inverter RACs are classified under mandatory appliances for star rating program. Further, the inverter technology would boost RAC sales growth, wherein Inverter technology is designed in such a way that it can save 30-50% of electricity (units consumed) over a regular air conditioner. Inverter RACs work differently than regular AC and use an inverter to control the compressor speed. With this technology, speed and power of the compressor is adjusted appropriately and it draws low energy to keep the temperature stable. So, it automatically adjusts its capacity based on the requirement of the room resulting in lower energy consumption. In recent years, all the RAC brands have adopted the inverter technology with varying degrees of composition in their product portfolio and Inverter ACs has seen an impressive growth from 20% in RAC market in FY2017 to 50% in FY2020.

#### Power consumed (watts)

Star Rating	0.75 Ton	1 Ton	1.5 Ton	2 Ton
1 Star Non Inverter	627	843	1246	1680
2 Star Non Inverter	596	800	1184	1626
3 Star Inverter	542	747	1104	1448
4 Star Inverter	464	645	945	1293
5 Star Inverter	450	554	840	1113

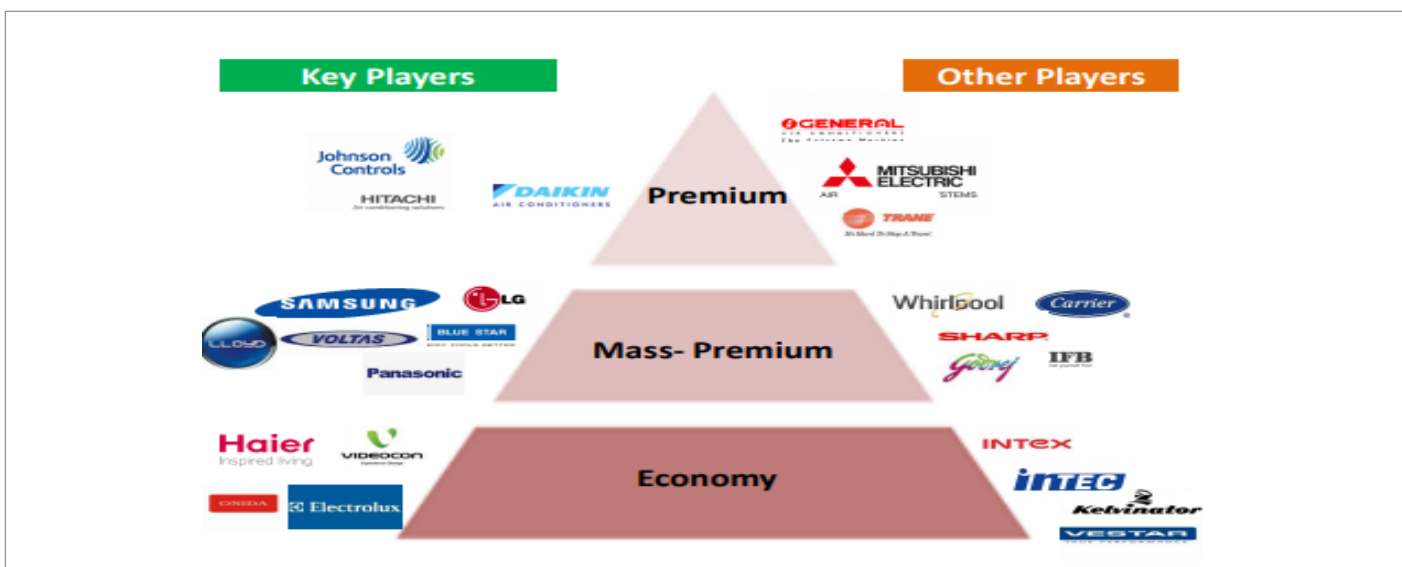
Source: Bureau of Energy Efficiency (BEE)

#### Market Segmentation by Type of RAC



Source: Industry, Sharekhan

#### Air conditioner market in India

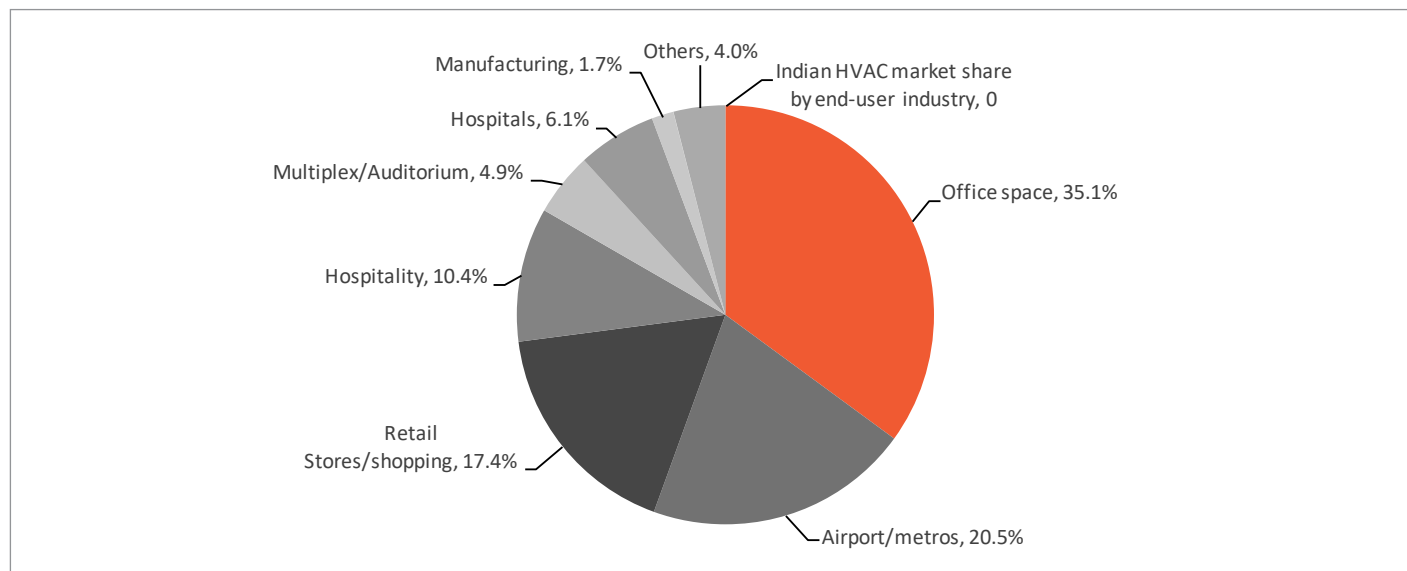


Source: Industry, Sharekhan

## Indian HVAC

The Indian heating, ventilation, and air conditioning (HVAC) market has been witnessing a considerable growth due to rise in commercial offices and buildings, industries, hospitals, data centres, server rooms, and universities. Further, rising infrastructure spending in the country is also driving the HVAC market's growth. Several infrastructure projects such as airports and metro railway expansion projects are coming up across the country, leading to strong growth in the segment.

### HVAC Market segmentation



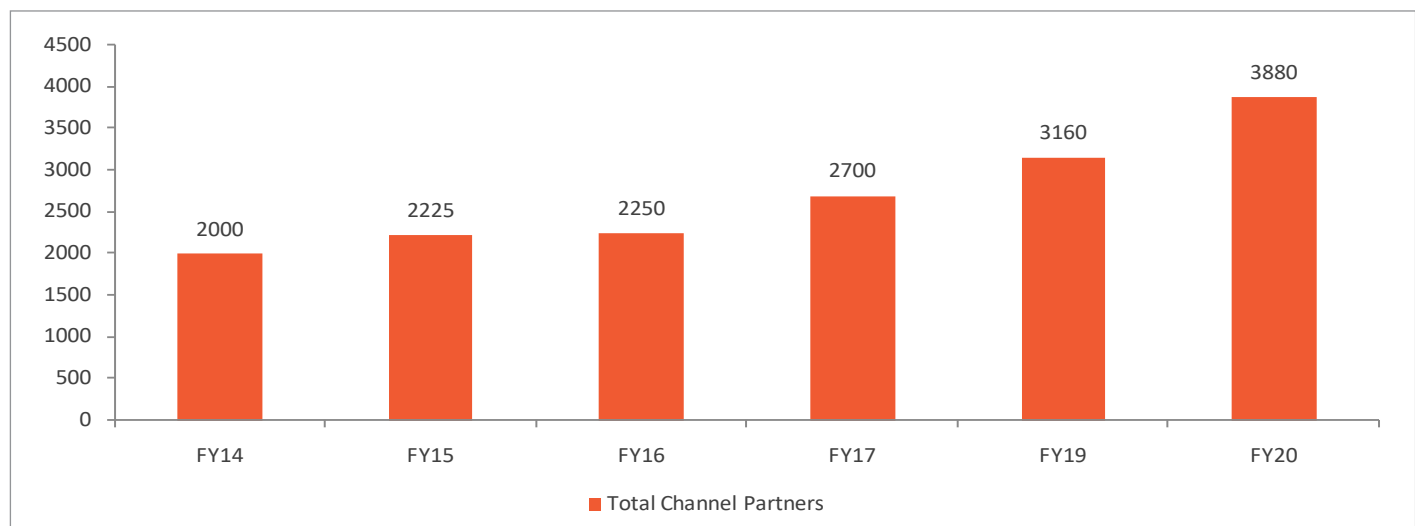
Source: Industry, Sharekhan

## Why we like Blue star – Right growth initiatives to drive broad-based growth with constant market share gains

### Consistently gaining market share and rising distribution reach in an underpenetrated market

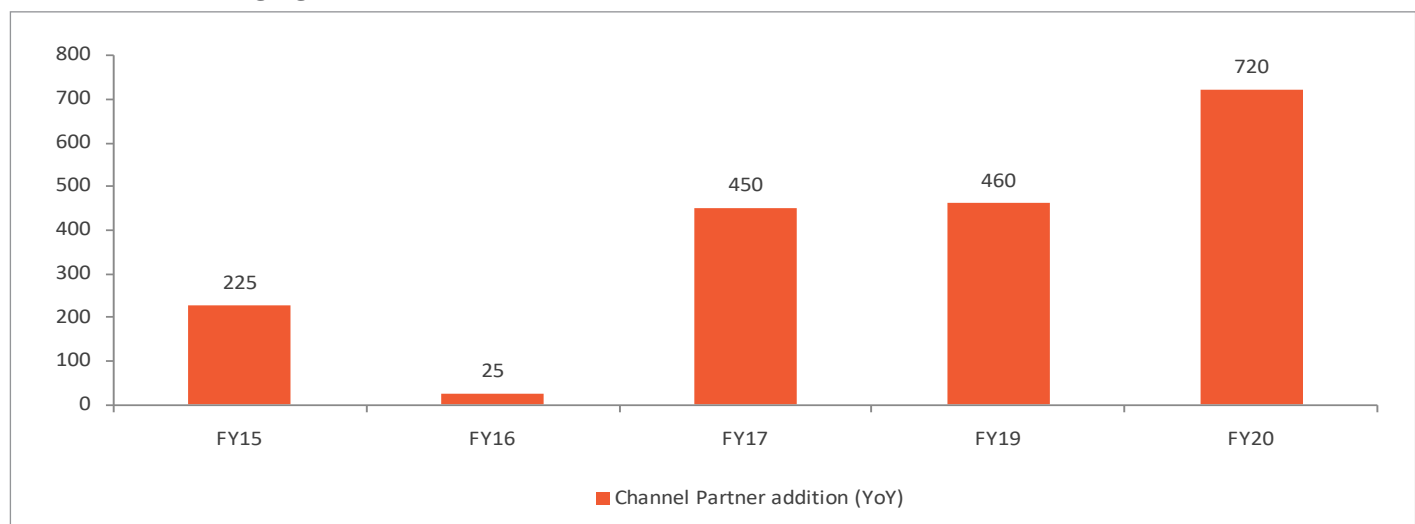
Blue Star has been one of the most recognised manufacturers of ACs and refrigeration products. With its superior product performance, high technology focus and a premium brand image it is one of the preferred choices for aspirational consumers. Blue Star market share has consistently increased from 7.5% in FY14 to 12.3% in FY20, despite a rising number of players in the RAC industry. Further, the company aims to expand its market share further by capturing an additional pie of the market in northern India, where it enjoys a 9% market share. In order to expand its market share Blue Star has added ~720 channel partners in FY20, one of its highest additions since FY15. Total channel partners stood at ~3,880 at end-FY20 (v/s ~2,000 in FY14). This indicates the company's deeper presence across various markets. Blue Star has expanded its retail distribution reach for room air conditioners (RAC) and added ~508 retailers and distributors across India, thereby increasing its presence in Tier 2/3 markets by 10% y-o-y. Further, it plans to expand its market share in northern region which is the largest market for RACs in India and it has taken multiple initiatives in the north like (a) venturing into the window AC market, (b) price rationalisation to be more competitive and (c) increasing ad spends. Given that room AC penetration (at 8%) continues to lag other consumer durables (Refrigerators: 33%, Washing Machines: 14%), we expect this segment to deliver consistent growth over the next decade with increasing affordability, power availability, ease of financing, nuclearisation of families and lifestyle changes.

#### Total channel partners have steadily risen..



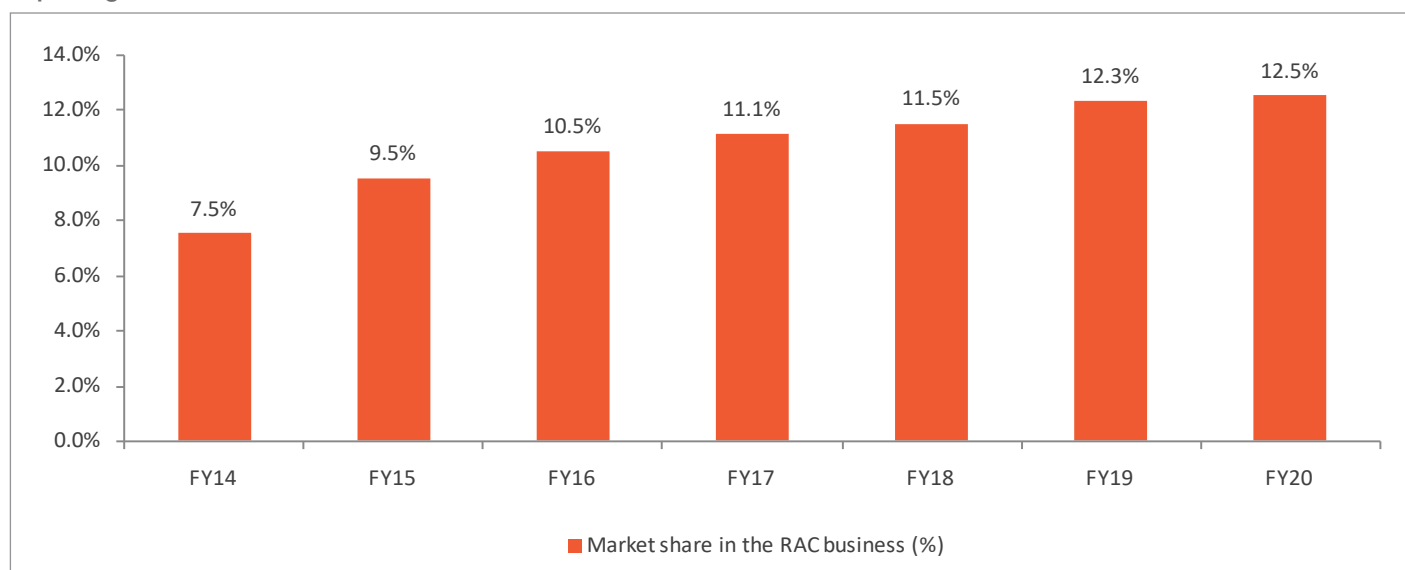
Source: Company, Sharekhan

#### ... with FY20 witnessing highest addition



Source: Company, Sharekhan

### Improving market share in RAC business



Source: Company, Sharekhan

### Expanding product range; scale and indigenization to improve profitability

Blue Star has a strong brand strength and distribution network and to further leverage these Blue Star has entered into new product categories including water purifiers, air coolers and air purifiers. These segments will help make further in-roads into the residential segment and the engineering element in these products will help Blue Star to differentiate its products. Currently these products contributed 2-3% of the total revenues in UCP segment and expected to contribute in higher single digits by FY23E. Blue Star spent Rs140 crore- Rs150 crore capex at Wada (Maharashtra) plant for brownfield expansion (to make water coolers and deep freezers) while it is also building a greenfield manufacturing plant at Sri City in Andhra Pradesh, having 600,000 units, setup in three phases of 200,000 units each (the plant will be commissioned by FY23E with capex of Rs. 250 crore) and will service South and West India markets from this facility. According to Blue Star, the consumer durable brands are likely to opt for a higher share of India-based manufacturing rather than relying on imports.

### Bright prospects in commercial refrigeration products

Commercial refrigeration adoption in India is only at a sub-5% level, which translates into huge opportunities for Blue Star, which has the widest range of refrigeration products in the industry. The Commercial Refrigeration market witnessed a surge in demand driven by aggressive expansion plans from fast growing segments such as food, dairy, restaurants, e-tailers and cloud kitchens. Supermarket refrigeration also provided ample growth opportunities in addition to pharmaceutical and healthcare industries. Blue Star is the market leader in the commercial refrigeration category with a share of 32%. The key products in this category include deep freezer, bottle cooler, visi-cooler/freezer, storage water cooler/dispenser, bottled water dispenser, ice cuber/flaker and cold room. Blue Star is well entrenched at both retail and institutional level in terms of its distribution network. In terms of its revenue mix, retail sales and OEM accounts for 50:50 share. Deep freezers and modular cold rooms (MCRs) are witnessing robust growth owing to expansion of e-tailers and portals such as Big Basket, Swiggy and Zomato along with aggressive expansion from Quick Service Restaurants (QSR) such as Jubilant FoodWorks, Hardcastle, etc. In addition, dairy, ice-cream and food processing segments are also witnessing high growth. Further, Blue Star recently forayed into adjacent complementary categories such as kitchen refrigeration, medical refrigeration and retail refrigeration. The outlook for these categories is promising, considering the expansion plan of end-user industries such as food processing and cold chain logistics providers, pharmaceutical manufacturers and hospitals as well as large and medium format modern retail stores.

## Company products



Source: Company, Sharekhan

## Water purifier category offers immense potential

Blue Star forayed into the water purifier category in FY18. This category is witnessing strong growth of 20% as water quality is deteriorating while consumers are becoming more health-conscious with a rise in disposable income. With a low penetration level of 6%, this category holds tremendous growth potential as it is a basic need of every household. Over the next 10 years, the penetration level is likely to increase to 20-25% and the size of this industry is expected to be equivalent to that of the AC industry. The water purifier category also provides avenue for regular service income, which is another positive. The company widened their offerings in water purifiers including a few models with a unique Immuno Boost technology, which deliver alkaline and antioxidant water.

The market size of residential water purifier market is estimated to be Rs. 4,200 crore with around 2.6 million units being sold every year in variants such as RO, UV, RO+UV. In terms of value, because of their higher price points, electric water purifiers account for around 80% of the market, while the balance comprises gravity-based water purifiers. The market is dominated by three players - Eureka Forbes, Kent RO and Livpure.

## Water purifier products

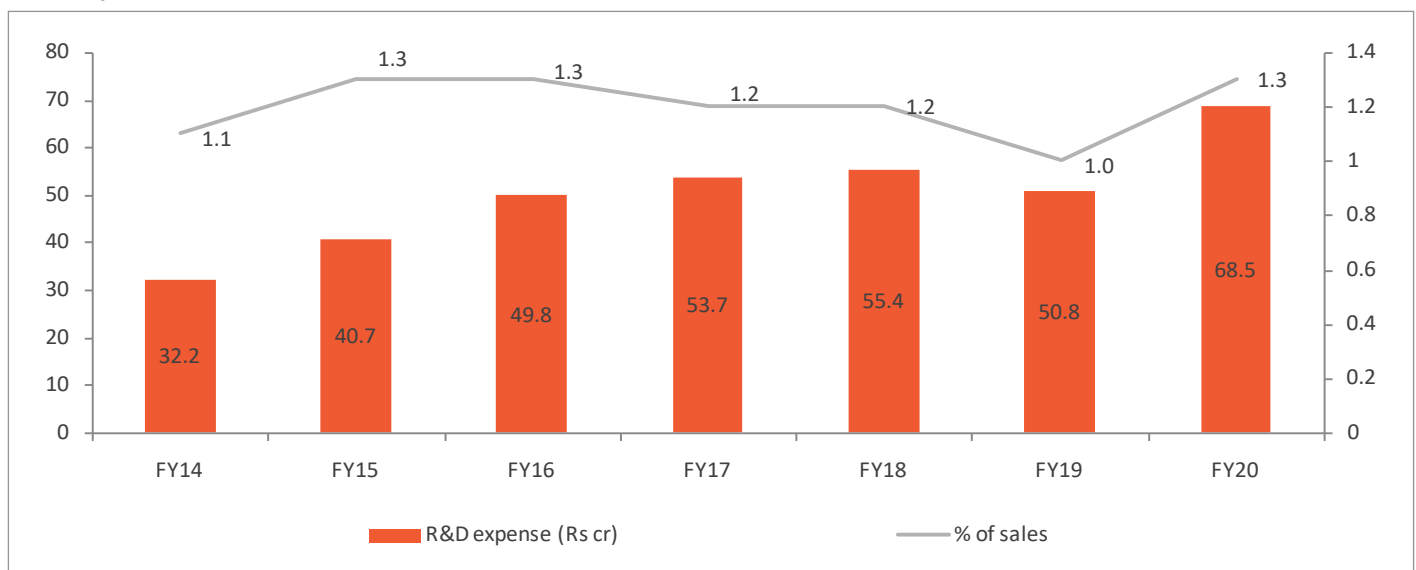


Source: Company, Sharekhan

## R&D focus improvement augurs well for longer-run sustainability

Blue Star is known for launching break-through products based on cutting-edge technology which offers innovative features and enhances a consumer's experience. It has high level of product development and testing skills and believes in consistent investment in R&D to enhance technical capabilities including electronics for digital and smart products. Some of the highly innovative and distinct features developed by Blue Star includes decimal cooling capabilities which offers precise temperature setting in the multiple of 0.1 degree Celsius, sound-proof acoustic jacket for the compressor for extra-quiet performance, dual rotor technology for faster cooling and a built-in voltage stabiliser designed to operate smoothly from 160 V to 270 V without the aid of an external voltage stabiliser. In FY20, Blue Star continued to enhance its R&D activities with 35% y-o-y increase in spends to Rs 68 crore. R&D spends now form 1.3% of sales, up from 1% in FY19. Blue Star has already developed a 3-star inverter split AC complying to the 2021 BEE energy-efficiency norms, with an ISEER Star Rating of 3.90. Blue Star has forayed into the 'Premium-Yet- Affordable' segment by rolling out range of ACs with integrated air-purifiers and smart Wi-Fi enabled 5-Star ACs. The company also launched a new range of air coolers and RO/RO+UV range of water purifiers in the entry/mid-level segment for e-Commerce platforms. A complete range of 3/5-star RACs with specific focus on the cost-competitive inverter model series was launched in FY20.

## R & D expense trend



Source: Company, Sharekhan



Room air conditioners undergoing endurance testing



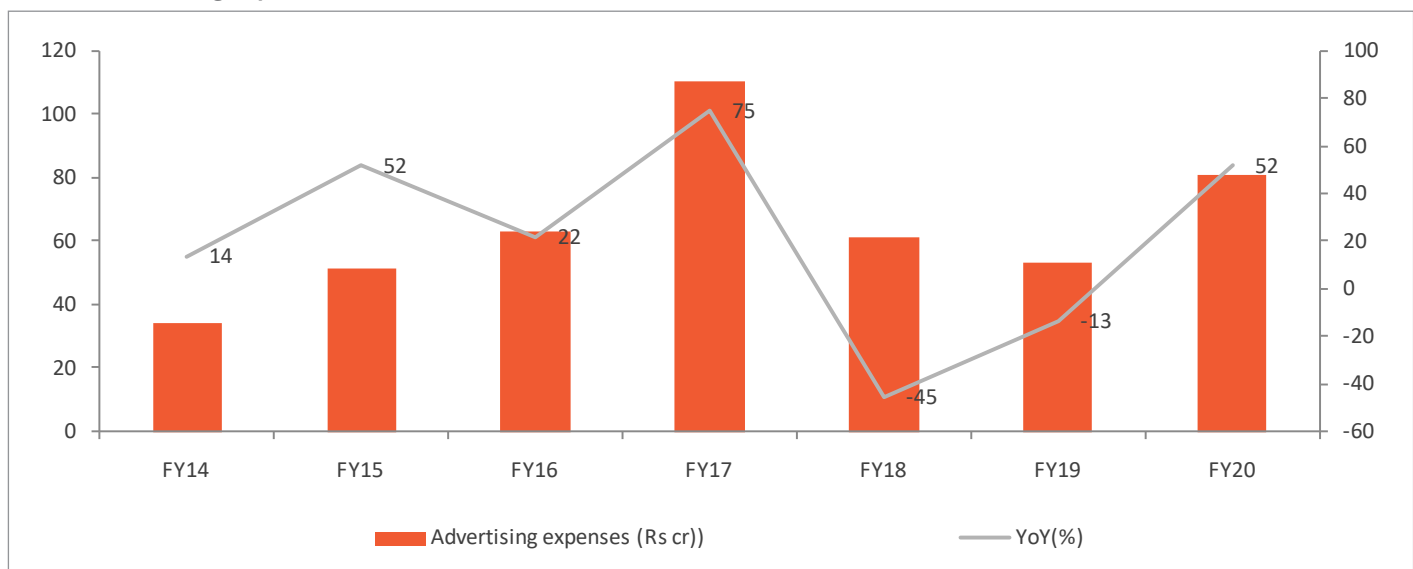
The salt spray test chamber, where components such as nuts and bolts, sheet metal and electronic PCBs are tested

Source: Company, Sharekhan

### Sustaining brand salience through advertising and communication

Consumers in the RAC segment are brand-conscious, preferring specialist air-conditioning players. This has worked to the advantage of Blue Star as it enjoys the reputation of being a premium and aspirational brand, and its rich pedigree and high quality product array has been in conjunction with this image. The company aims to strengthen the Blue Star brand with a value proposition of “Built On Trust.” It aims to increase advertisement spending from 2.7% of product revenues to 3% to grow its image as a premium player. It also plans to increase digital media presence so as to resonate with young customers. The advertising efforts have been successful in building a premium brand image for Blue Star.

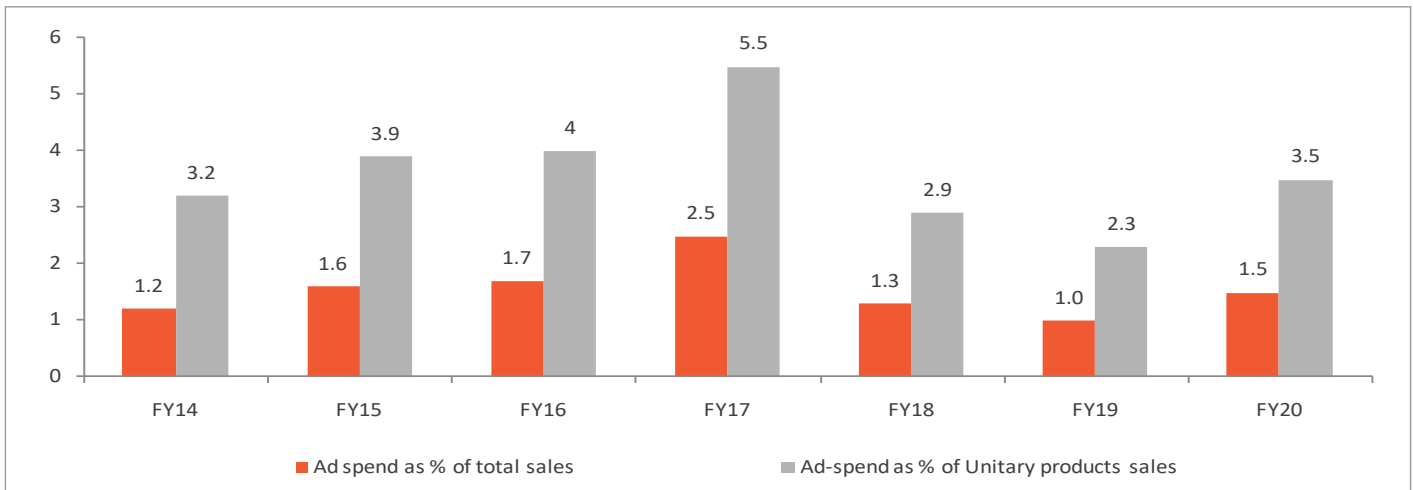
#### Trend of advertising expenses



Source: Company, Sharekhan



#### Ad-spends as % of total/unitary products sales



Source: Company, Sharekhan

#### A three-point growth strategy

Blue Star has a strategic plan for FY21-24, with three objectives- to grow faster than the market, improve profits by scale and backward integration, deepen distribution through conventional and E-com channels. This ties in with what they have been consistently saying- increase manufacturing component and deepen distribution. This strategy focuses on backward integration, liquidity maintenance, and network expansion. The company is set to shift its operating model from a physical to hybrid 'phygital' model for post COVID-19 scenario. The current contribution from e-commerce to total sales is 5%; Blue Star aims to increase this contribution to 20% of sales by FY24E.

#### Enhancing manufacturing capabilities

The government has given a clear directional guidance towards reducing import dependency from not just China but also from other countries in general under the Atmanirbhar Bharat umbrella. While the government has already been taking steps towards the same, the latest geopolitical developments has furthered the initiative and brought some sense of urgency. A number of tariff and non-tariff barriers have already been erected which includes Quality Control Order and a hike in import duty on compressors and Indoor Units, which came about in 2018. To reduce dependence on imports from China, Blue Star has invested to expand its range of plastic-molding tools and hard-formed tools. This would enable backward integration for the company. Also, Blue Star has made significant upgrades to its Wada facility (it has added heater-less vaporizer machine and a Fanuc robot), which has led to cost savings and an improvement in productivity.



The room air conditioners manufacturing facility at Himachal Pradesh

Source: Company, Sharekhan

## Consolidating global presence

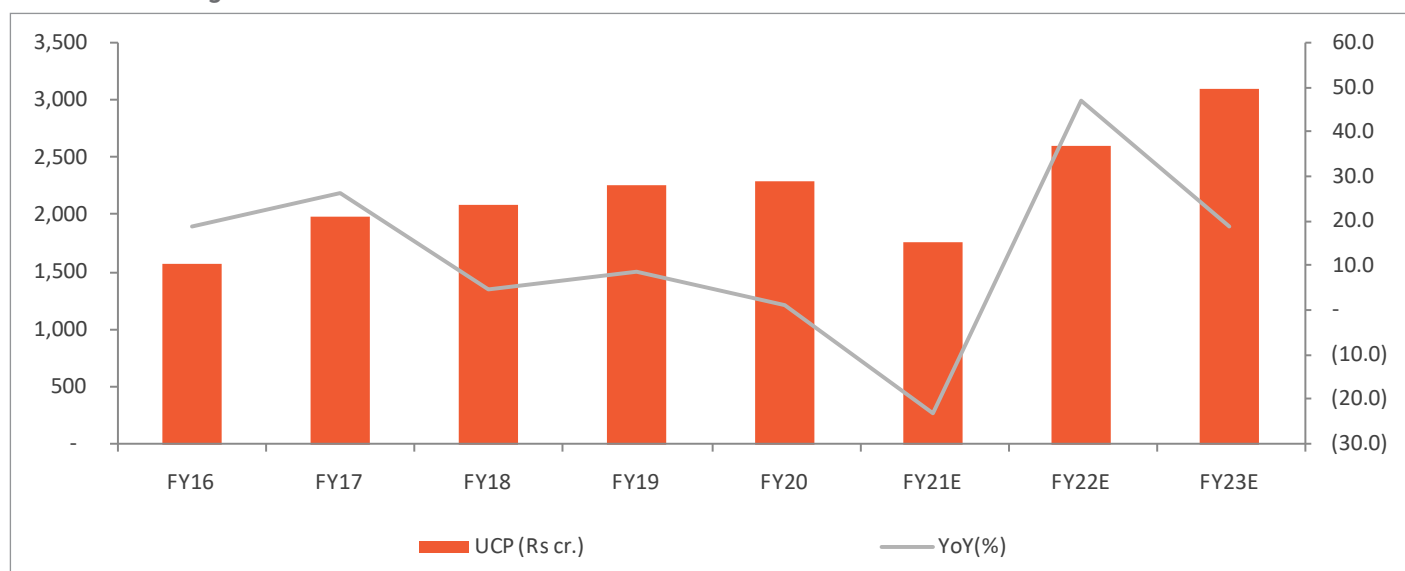
Blue Star's products are exported to 18 countries across the Middle East, Africa, SAARC and ASEAN regions. Revenues from abroad doubled to Rs. 520 crore in FY20 (v/s Rs. 260 crore in FY15). Also, share of revenue from abroad now constitutes ~10% of the company's total revenue (versus 8.4% in FY14). Due to temperatures in the Middle East going up to 60°C, Blue Star with its range of cooling solutions has a plethora of opportunities in the region. Hence, the company has expanded its operations by starting a new office and inaugurating its first state-of-the-art flagship showroom in Dubai.

**Financials: Healthy earnings growth and return ratios provides comfort:** Earnings growth expected to remain healthy, led by 27.5% and 71% CAGR in revenue and net income, respectively, over FY2021-FY2023E, driven by rising penetration of ACs from a low base and Blue Star's strengthening distribution network, rising market share and improving revenue mix (higher proportion of inverter ACs). Besides, scale-up in commercial refrigeration products and water purifier will also aid growth. Management stated that it has a clear focus to retain and grow margins in the UCP segment. Further, efficient working capital management and earnings growth will lead to higher free cash flows. Net borrowings declined by Rs. 213 crore to Rs. 131 crore as of Q3FY21-end versus Rs. 340 crore as of Q2FY21. Net debt is largely flat y-o-y despite EBITDA and PAT declining by 44% and 76% in 9MFY21. Going ahead, Blue Star expects to maintain a tight control over working capital through disciplined billing and cash collection. RoCE and RoE to remain healthy at 28.4% and 29.3%, respectively.

## UCP segment to see healthy growth

UCP segment has grown at a 10% CAGR over FY16-FY20 driven by healthy growth in RAC and commercial refrigeration business. We expect RAC business to grow well ahead driven by a healthy demand outlook, robust product portfolio, distribution network expansion and a strong after-sales service network. We believe growth triggers are in place for all main categories — RAC, commercial refrigerators and water purifiers. We therefore expect the Unitary segment to grow at a 32% CAGR during FY21-FY23E.

### UCP revenue and growth trend

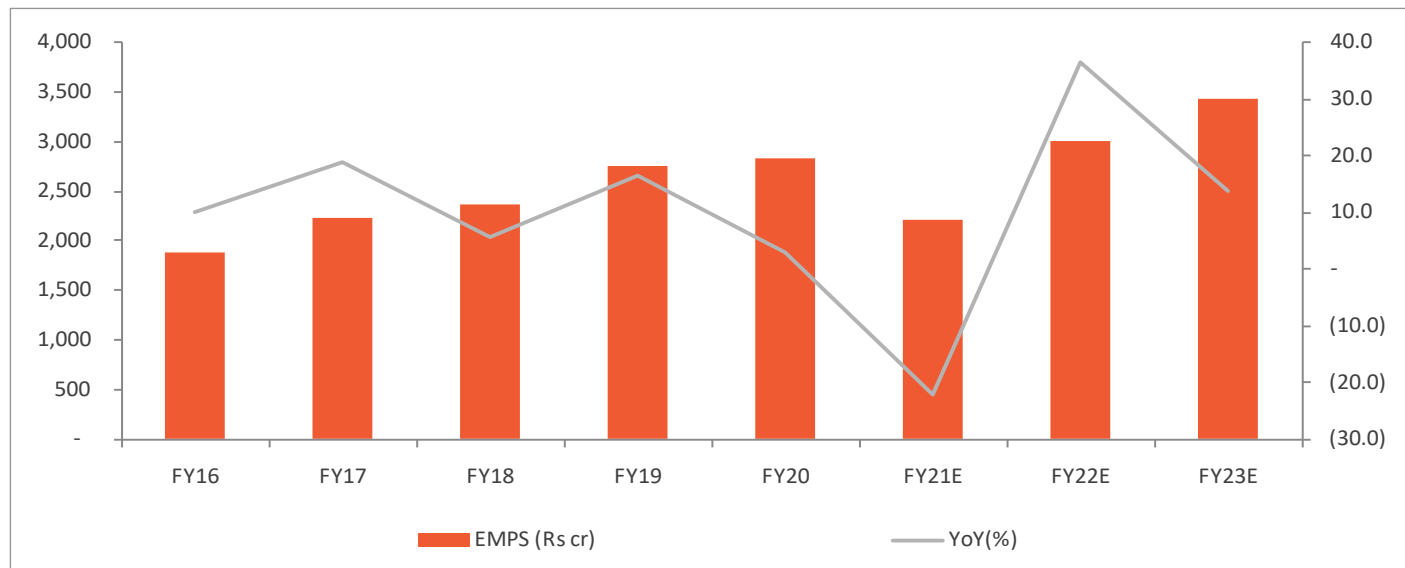


Source: Company, Sharekhan

**Extended electro-mechanical projects and packaged air conditioning systems capabilities through acquisitions:** This segment grew by 11% y-o-y in FY20 driven by buildings and factories, infrastructure, and industrial segments. The growth outlook remains healthy for this segment and Blue Star has bagged a significant order from the Mumbai Metro Rail Corporation. L&T has also awarded the company with prestigious orders for major airports at New Delhi, Bengaluru and Chennai. Carried-forward order book of the Electro-Mechanical Projects business remains healthy at Rs 3200 crore after Q3FY21. Commercial air-conditioning segment during FY20 grew faster than the market and improved its market share across product categories, aided by new product launches and increased operational reach in tier 3/5 cities. Newly launched products

such as the next-generation inverter ducted, water-cooled VRF, air-cooled VFD screw chiller and configured oil-free chiller gained good traction and market acceptance provides healthy outlook. We therefore expect the EMP segment to grow at a 24.7% CAGR during FY21-FY23E.

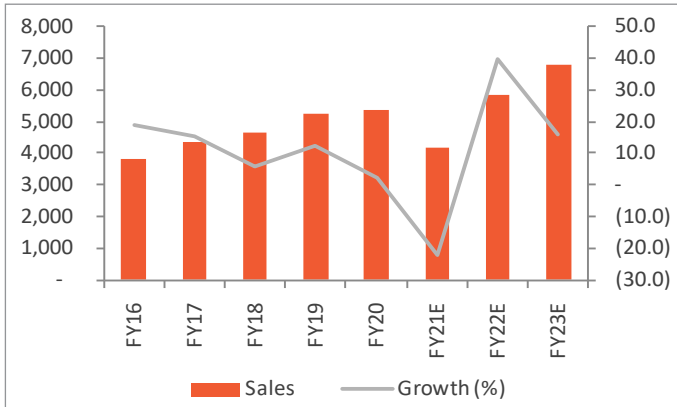
#### EMP revenue and growth trend



Source: Company, Sharekhan

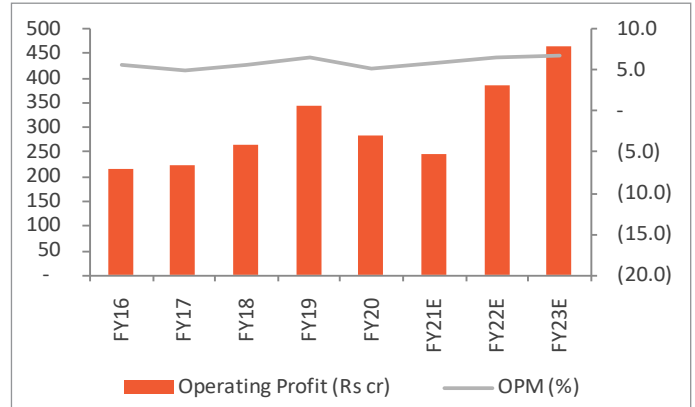
## Financials in charts

### Revenue Trend



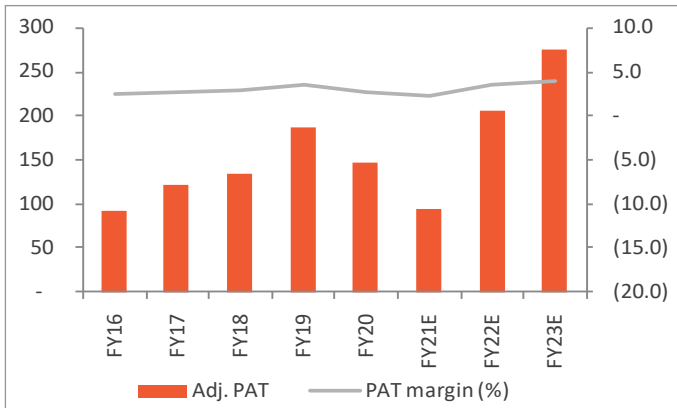
Source: Company, Sharekhan Research

### EBITDA Trend



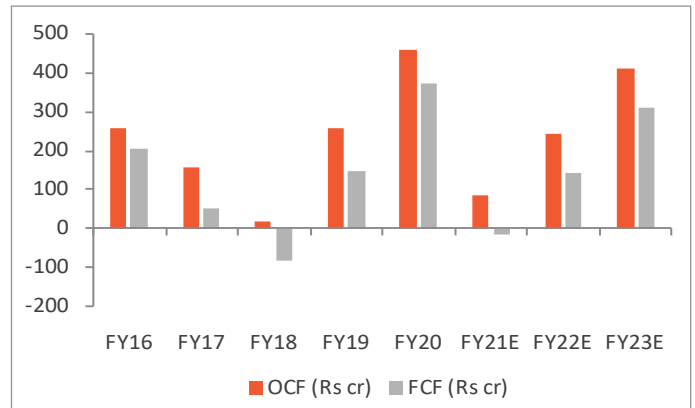
Source: Company, Sharekhan Research

### Net Profit Trend



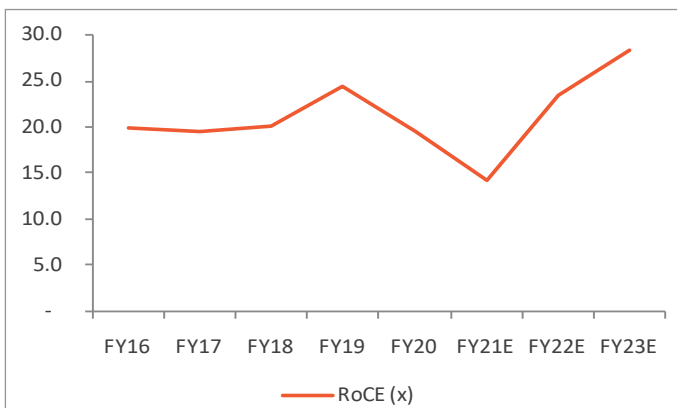
Source: Company, Sharekhan Research

### OCF/FCF Trend



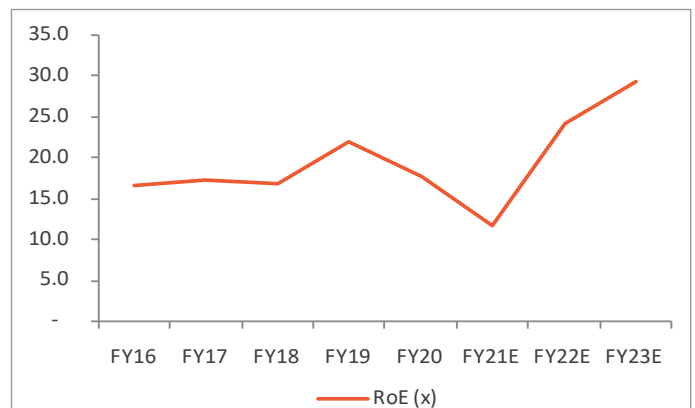
Source: Company, Sharekhan Research

### ROCE Trend



Source: Company, Sharekhan Research

### ROE Trend



Source: Company, Sharekhan Research

## Valuations - Growth sustainability to remain in spite of competition

Blue Star's implied P/E comes at 42x its FY2023E EPS which is at a discount to its competitor Voltas and Havells and has the further scope to grow given its increasing market share, scope for penetration in newer markets like north along with healthy balance sheet and return ratios.

### ■ Sector View – Strong headroom for growth given underpenetration

The AC segment has long term structural growth triggers in terms of suitable demographics, rising per capita income, rising urbanisation, low penetration levels, uninterrupted availability of power etc which would aid in maintaining healthy growth trajectory over the long term. RAC penetration level in India (8%) lags when compared to the global level (42%) implying there is significant opportunity for growth. Commercial refrigeration adoption in India is only at a sub-5% level, which translates into huge opportunities for Blue Star, which has the widest range of refrigeration products in the industry. The low penetration levels in ACs and commercial refrigeration provide immense potential for growth to the industry led by structural growth drivers.

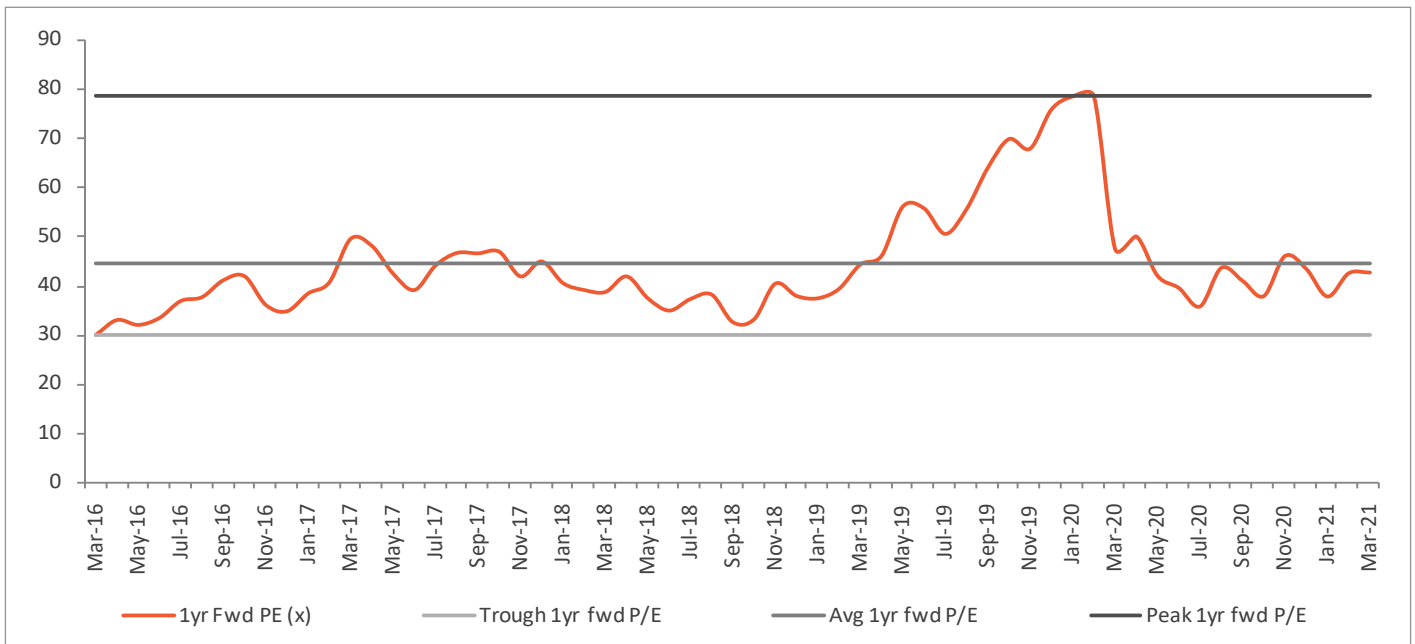
### ■ Company Outlook - Long-term growth opportunities remain intact for RACs and new opportunities in institutional refrigeration

Blue Star has a strong brand strength and distribution network and to further leverage these. Blue Star is well entrenched at both retail and institutional level in terms of its distribution network and it continues to prioritize project execution based on cash flow. The Room Air conditioners and Commercial Refrigeration businesses are expected to gain traction gradually. Due to rising temperatures and expectation of strong summers provide strong prospects for the coming quarter. Healthcare, pharma and processed foods segments will continue to offer good opportunities for the Commercial Refrigeration business in the new normal. Increased awareness on building immunity will offer good prospects for the Water Purifiers business. Digitisation and Healthcare initiatives offer good prospects for professional electronics and industrial systems and the outlook on these categories is promising, considering the expansion plan of end-user industries such as food processing and cold-chain logistics providers, pharmaceutical manufacturers and hospitals as well as large and medium-format modern retail stores. Company Strategic plan for FY21-24 was approved in March 2020 with focus on 1) growing faster than the market, 2) improving profitability through scale and backward integration, 3) deepening distribution penetration incl. e-commerce, 4) pursuing profitable adjacencies and company is well-set to achieve its growth objectives.

### ■ Valuation - Initiate Coverage with a TP of Rs 1200

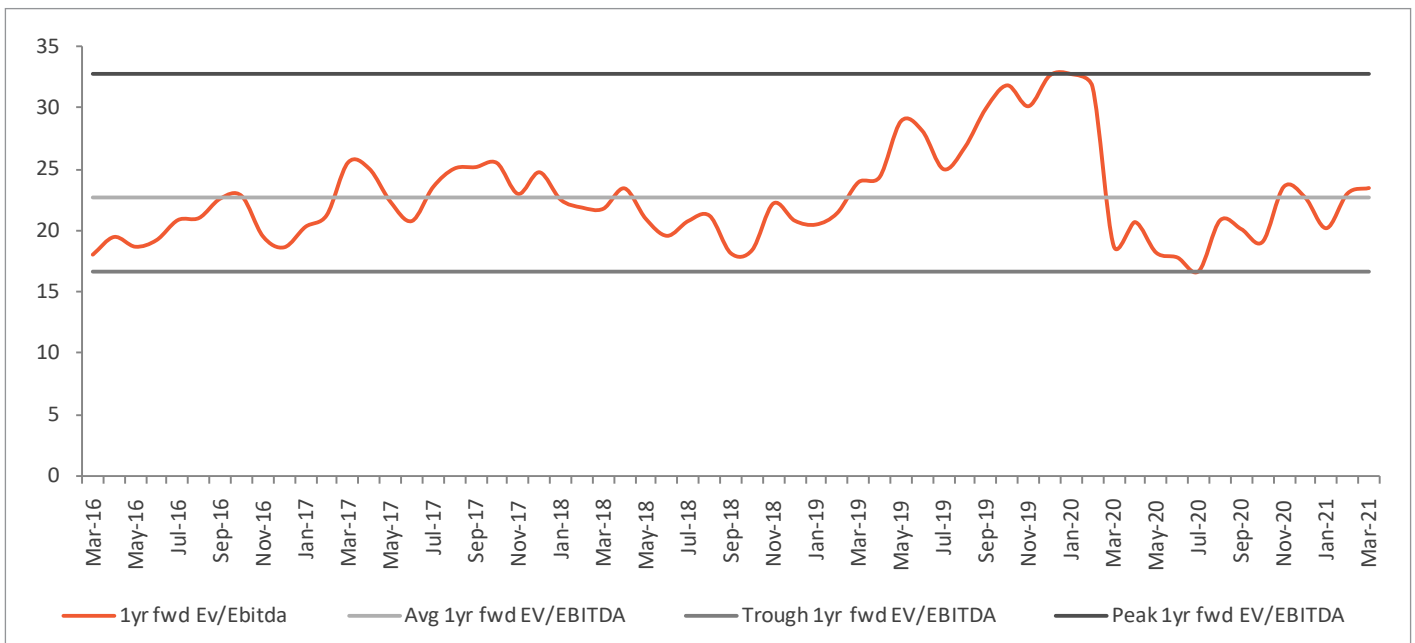
Blue Star has made consistent, rapid progress and outperformed the industry as well as its peers driven by strengthening distribution network, rising market share and improving product mix (higher proportion of inverter ACs). Besides, a scale-up in commercial refrigeration products and water purifier will also aid growth. Similarly, the EMPS segment's growth prospects are brighter led by a strong pipeline of infrastructure, building and industrial projects as well as the Blue Star's healthy order book and plan to tap large-value contracts. Over the next five years, Blue Star's management has ambitious growth plan of increasing revenues at a 20% CAGR and profitability by 25% CAGR. With rising return ratios, healthy cash flow, lean working capital cycle and a comfortable leverage position, Blue Star is placed favourably compared to listed brands in terms of its valuation vis-a-vis RoE and EPS growth prospects. Focus toward technology, in-house manufacturing and introduction of new products along with recovery in the project segment will be near-term growth drivers for Blue Star. The company is currently trading at a P/E of 32x FY23E EPS and we have assigned a PE of 42x which is at a discount to its competitors like Voltas and Havells as the company has been gaining market share consistently in the residential market and expected to continue with further penetration into different geographies including Tier 3-4-5 cities. We initiate coverage on Blue Star Ltd with a PT of Rs. 1,200.

### One-year forward P/E (x) band



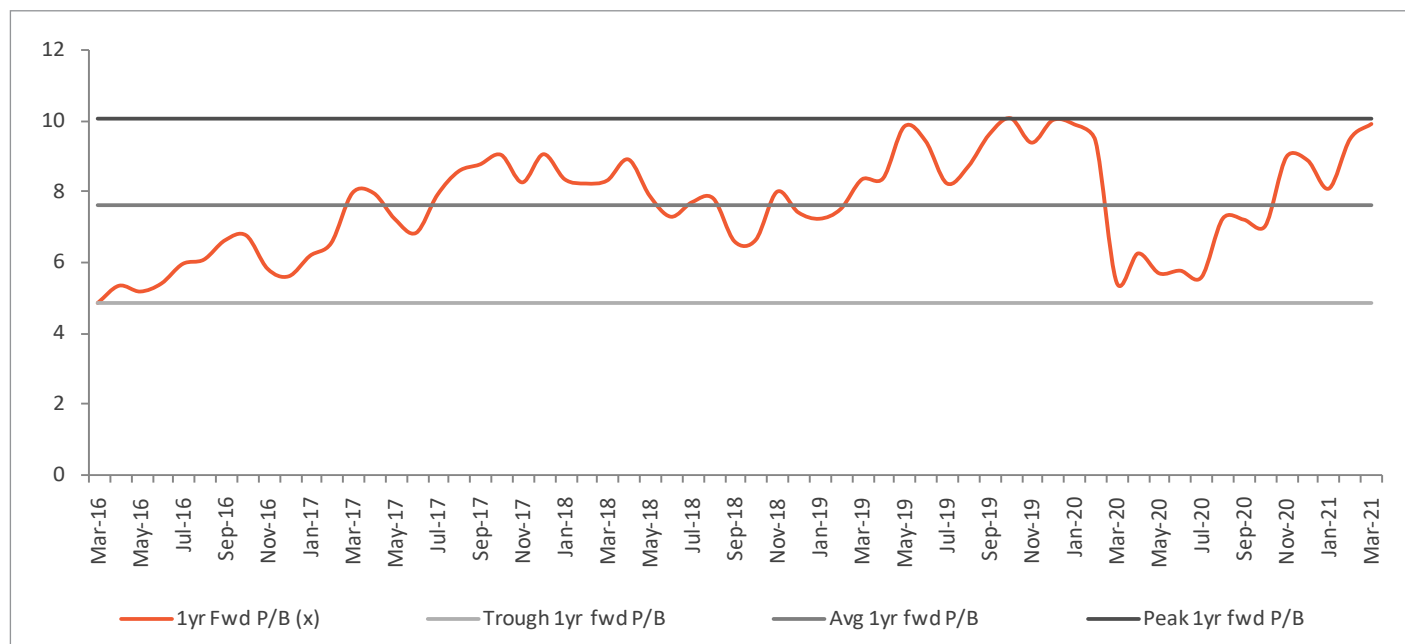
Source: Sharekhan Research

### One-year forward EV/EBITDA band



Source: Sharekhan Research

### One-year forward P/B band



Source: Sharekhan Research

### Peer Comparison

Particulars	P/E (x)			EV/EBITDA (x)			RoCE (%)		
	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E
Blue Star	94.3	42.7	32.1	34.6	22.3	18.1	14.2	23.4	28.4
Voltas*	63.0	46.4	40.4	62.9	39.3	32.6	16.2	17	22.2
Havells*	62.5	51.7	42.5	45.9	39.3	32.5	29.9	32	34.5
Johnson Hitachi*	97.2	25.4	17.6	50.3	27.5	21.2	6.5	18.1	22.6

Source: Sharekhan Research \*Bloomberg estimates

## Financials

### Statement of Profit and Loss (Consolidated)

	Rs cr				
Particulars	FY2019	FY2020	FY2021E	FY2022E	FY2023E
Total Revenue	5235	5360	4181	5853	6798
Raw Material Cost	3931	4018	2990	4250	4934
Employee Cost	421	485	550	627	718
Other Expenses	536	575	397	591	680
Total Operating Cost	4888	5077	3937	5468	6332
Operating Profit	347	283	245	386	466
Other Income	25	45	33	41	48
Interest & Other Financial Cost	48	29	60	47	33
Depreciation	75	88	93	104	115
Profit Before Tax	248	210	125	275	366
Tax Expense	42	65	31	69	92
Adjusted PAT before MI	206	145	93	206	274
Transfer to Minority Interest	19.1	-2.6	0	0	0
Adjusted PAT	187	147	93	206	274
Exceptional Items	-2.68	4.03	0	0	0
Reported PAT	190	143	93	206	274

Source: Company, Sharekhan estimates

### Balance Sheet (Consolidated)

	Rs cr				
Particulars	FY2019	FY2020	FY2021E	FY2022E	FY2023E
<b>Source of funds</b>					
Equity Capital	19.3	19.3	19.3	19.3	19.3
Reserves & Surplus	854	763	799	868	966
Net Worth	873	782	818	887	985
Non-controlling Interest	2	2	2	2	2
Deferred Tax Liabilities (Net)	-82	-82	-82	-82	-93
Total Borrowings	344.5	448.9	548.9	490.9	442.9
Non-Current liabilities	0	0	0	0	0
Capital Employed	1138	1152	1287	1299	1337
<b>Application of funds</b>					
Net Block	400	444	413	375	329
Capital WIP	41	67	67	67	67
Goodwill	0	0	0	0	0
Investment	32	107	182	257	332
<b>Current Assets</b>					
Inventories	869	870	647	899	1041
Sundry Debtors	1112	838	802	1042	1118
Cash and Bank Balance	101	294	293	273	389
Loans & Advances	31	34	38	39	40
Other Current Assets	674	794	619	867	1007
Less: Current Liab. & Provisions	498	546	426	596	693
Trade Payables	1535	1582	1203	1684	1956
Other Current Liabilities	546	426	596	693	442
Provisions	99	78	49	68	79
Net Current Assets	656	623	722	772	867
Net Assets	1138	1152	1287	1299	1337

Source: Company, Sharekhan estimates



### Cash Flow Statement (Consolidated)

Rs cr

Particulars	FY2019	FY2020	FY2021E	FY2022E	FY2023E
Cash flow from operating activities	258	457	87	241	410
Cash flow from investing activities	-58	-98	-101	-87	-129
Cash flow from financing activities	-181	-167	13	-174	-164
Net change in cash and cash equivalents	20	193	-1	-20	116
Opening cash balance	81	101	294	293	273
Closing cash balance	101	294	293	273	389
Free Cash Flows (FCFF)	150	371	-13	141	310
Free Cash Flows to Equity (FCFE)	83	464	42	48	237

Source: Company, Sharekhan estimates

### Key Ratios

Particulars	FY2019	FY2020	FY2021E	FY2022E	FY2023E
<b>Margins (%)</b>					
GPM (%)	24.9	25.0	28.5	27.4	27.4
OPM (%)	6.6	5.3	5.8	6.6	6.9
NPM (%)	3.6	2.7	2.2	3.5	4.0
Tax rate	17	32	25	25	25
As a percentage of revenue (%)					
Raw Material Cost (%)	75	75	72	73	73
Employee Cost (%)	8	9	13	11	11
Other Expenses (%)	10	11	10	10	10
<b>Financial ratios</b>					
Debt / Equity (x)	0.4	0.5	0.6	0.6	0.5
Inventory days	59	59	60	60	60
Debtor days	78	66	70	65	60
Payable days	107	106	105	105	105
Working capital cycle	30	19	25	20	15
Adjusted EPS (Rs.)	19.5	15.3	9.7	21.4	28.5
Cash EPS (Rs.)	27.2	24.4	19.4	32.3	40.4
Dividend Per Share (Rs.)	10.0	10.0	7.5	10.0	10.0
Dividend Payout Ratio (%)	51%	67%	77%	47%	35%
Book Value Per Share (Rs.)	91	82	86	93	103
RoNW (%)	22.0	17.8	11.7	24.2	29.3
RoCE (%)	24.4	19.5	14.2	23.4	28.4
<b>Valuation ratios</b>					
CMP (Rs.)	922	922	922	922	922
P/E (x)	47.0	59.8	94.3	42.7	32.1
Mcap (Rs. crore)	8811	8811	8811	8811	8811
Market cap / Sales (x)	1.7	1.6	2.1	1.5	1.3
Enterprise Value (Rs. crore)	9399	9415	9616	9520	9308
EV / Sales (x)	1.8	1.8	2.3	1.6	1.4
EV / EBIDTA (x)	25.3	28.8	34.6	22.3	18.1
Price / Book value (BV)	10.1	11.3	10.8	9.9	8.9
Dividend yield (%)	1.1	1.1	0.8	1.1	1.1
<b>Growth ratios (%)</b>					
Revenue	13	2	-22	40	16
Operating profit	30	-18	-14	58	21
Profit before tax	28	-18	-39	121	33
Adjusted PAT	40	-21	-37	121	33
EPS	39	-21	-37	121	33

Source: Company, Sharekhan estimates

## About company

Blue Star is India's leading air conditioning and commercial refrigeration company, with an annual revenue of over Rs 5360 crores a network of 32 offices, 5 modern manufacturing facilities and 3880 channel partners. The Company has 6000 stores for room ACs, packaged air conditioners, chillers, cold rooms as well as refrigeration products and systems, along with 1060 service associates reaching out to customers in over 900 towns. Blue Star's integrated business model of a manufacturer, contractor and after-sales service provider enables it to offer an end-to-end solution to its customers, which has proved to be a significant differentiator in the marketplace. The Company fulfills the cooling requirements of a large number of corporate, commercial as well as residential customers. Blue Star has also forayed into the residential water purifiers business with a stylish and differentiated range including India's first RO+UV Hot & Cold water purifier; as well as the air purifiers and air coolers businesses.

## Investment theme

Structural growth visibility in the India white goods segment remains high due to favorable demographics (urbanization, per capita GDP and AC ownership similar to China's levels in 1998-2000). Expectation of a high growth potential in ACs (8-10% CAGR in FY20-25F, despite COVID-19 impact) as penetration for white goods like room air conditioner remained quite low at 5%. We believe Blue Star remain one of the key beneficiaries of rising AC penetration in India led by its improving market share, product profile and strong service network. With company's new FY21-24 strategy in place with three objectives- grow faster than market, improve profits by scale and backward integration, deepen distribution through conventional and E-com channels provides healthy visibility and outlook.

## Key Risks

- ◆ Fluctuations in raw material prices pose a key challenge
- ◆ Sharp depreciation in Indian Rupee vis-à-vis Chinese Yuan
- ◆ Intense Competition

## Additional Data

### Key management personnel

Mr. Ashok M Advani	Chairman & MD
Mr. Suneel M Advani	Vice Chairman
Mr. Vir S Advani	M.D
Mr. B Thiagarajan	Jt. M. D
Mr. Neeraj Basur	CFO

Source: Bloomberg

### Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Ashok Mohn Family Trust	12.41
2	SMA Family Private	8.02
3	SBI Fund Management Pvt Ltd	5.75
4	HDFC AMC	4.30
5	ICICI Pru AMC	2.97
6	Advani Nargis Suneel	2.95
7	Advani Suneel Mohan	2.92
8	Kotak Mahindra AMC	2.92
9	Advani Ashok Mohan	2.70
10	T Rowe Price Group Inc	2.45

Source: Bloomberg

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## Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and deteriorating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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