Sharekhan by BNP PARIBAS

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Stock Update

Result Update

Blue Star Ltd

Robust Q1, Impressive growth trajectory

Capital Goods	Sharekhan code: BLUESTARCO		
Reco/View: Buy ↔	CMP: Rs. 991	Price Target: Rs. 1,250 ↔	

↑ Upgrade ↔ Maintain ↓ Downgrade

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)	✓		

+ Positive = Neutral – Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

ESG Disclosure Score NEW

ESG RISK RATING 30.66

Updated Jul 08, 2022

High Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

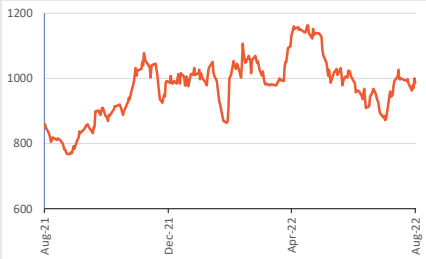
Company details

Market cap:	Rs. 9,543 cr
52-week high/low:	Rs. 1,225/758
NSE volume: (No of shares)	1.2 lakh
BSE code:	500067
NSE code:	BLUESTARCO
Free float: (No of shares)	5.9 cr

Shareholding (%)

Promoters	38.8
FII	12.3
DII	22.1
Others	26.9

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	11.5	-9.5	-6.2	15.1
Relative to Sensex	1.6	-14.3	-7.5	7.9

Sharekhan Research, Bloomberg

Summary

- We maintain a Buy rating on Blue Star Limited (Blue Star) with an unchanged PT of Rs. 1,250, given robust Q1 and multiple growth levers in UCP as well as EMPS segments.
- Blue Star reported an impressive performance with strong revenue growth across business verticals, OPM was also ahead of expectations despite gross margin pressures. Net profit grew 5x y-o-y owing to strong operational performance, higher other income and lower tax.
- Demand for Room air conditioners (RACs) peaked in March/April and started slowing down from May onwards. Blue Star's RAC volumes grew by 39% during January– June 2022 as compared to January – June 2019 (comparable pre-covid quarter), while the market grew by 30% during the same period.
- The management expects the margin to improve from H2FY23 given declining commodity prices. On a sustainable basis, the company expects RAC operating margin at ~9%.

Blue Star's Q1FY23 consolidated revenues were in-line with our estimates, while net profit exceeded our expectations helped by higher other income and lower tax rate. Revenues came in at Rs 1,970crore (up 87% y-o-y). Operating profit grew by 192% y-o-y to Rs 123 crore in line with our estimates. While gross margin dropped by 330 BPS y-o-y to 21.1% due to high raw material costs. Tight control of employees and other costs resulted in an operating margin at 6.3% (up 224 bps y-o-y). Apart from strong operating profit, higher other income and lower tax also helped in the net profit growing more than 5x to ~Rs 74crore. EMPS segment recorded revenue growth of 57% y-o-y contributing 40% to total sales, while Unitary products which include room ACs recorded growth of 122.5%, contributing 57% to total sales. Notably, the growth in the AC business was 24% higher as compared to Q1FY20 which was the normal quarter before the pandemic. Profitability in EMPS segment improved as it reported a PBIT margin of 5.7% (4% in Q1FY22), while Unitary products' EBIT margin jumped to 8.1% (vs 4.3% in Q1FY22).

Key positives

- Robust revenue growth of ~123%/57% in UCP/EMPS verticals led by the low base, strong growth in ACs and deep freezers and improved execution in projects.
- Management commentary remains buoyant for FY23 on sales and profitability fronts. Project business has a healthy and diversified order book.
- Net cash of ~Rs.81 crore as compared to net debt of ~Rs. 69crore as of June 2021. The company redeemed NCDs of Rs 175 crore in June 2022 given its strong cash position.

Key negatives

- Gross margins stayed under pressure and declined ~330 bps y-o-y due to an increase in commodity prices and freight cost
- Demand for RACs cooled down in May-June 2022 given weak consumer sentiments

Management Commentary

- Demand for ACs peaked in March/April and started slowing down from May onwards in RAC.
- Blue Star's RAC volumes grew by 39% between January– June 2022 as compared to January – June 2019 and the market has grown by 30% during the same period.
- Margins in the UCP segment are unlikely to improve in Q2FY23, however, there is a possibility of margin pick up from Q3FY23. Advertisement and promotional expenses for the industry are coming down and this is likely to lead to better operating leverage.
- The company grew in line with the market and maintained a market share of 13.25%.
- The long-term sustainable operating margin in AC business is expected to be around ~9% with peak season margin going up to 10%.
- There were a lot of first-time buyers in the RAC segment from tier 3/4/5 markets. Commercial refrigerators grew by 10-11% y-o-y with strong demand from ice cream, processed foods, and pharmaceutical segments.
- EMP and commercial AC systems should post remarkable growth in FY2023 led by healthy order inflow both from commercial real estate, data center, and infrastructure (metro railway, water distribution, and power distribution). Received major orders from Bangalore metro rail corporation of Rs 390 crore.

Revision in estimates – We have maintained our estimates for FY2023-FY2024.

Our Call

Valuation – Maintain Buy with an unchanged PT of Rs. 1,250: Blue Star is expected to outperform the industry as well as its peers drove by a strengthening distribution network, rising market share, and improving product mix. Besides, scale-up in commercial refrigeration products, backward integration, increase in in-house manufacturing would also aid growth. Similarly, the EMPS segment's growth prospects are brighter given the strong order book and continued traction in order inflows in both domestic and international markets. We expect revenue/PAT to clock a CAGR of ~20%/39% over FY22-24E. At CMP, the stock trades at ~29xFY24E EPS. We maintain our Buy rating on the stock with an unchanged PT of Rs. 1,250.

Key Risks

An increase in input costs could put pressure on margins. Intense competition across segments is a key concern.

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22	FY23E	FY24E
Net Sales	4,264	6,046	7,365	8,695
OPM (%)	5.6	5.7	6.2	6.6
Adjusted PAT	101	168	231	325
Y-o-Y growth (%)	(31.7)	66.9	37.6	40.7
Adj. EPS	10.5	17.4	24.0	33.8
P/E	94.1	56.4	41.0	29.1
P/B	10.7	9.3	8.2	6.9
EV/EBITDA	33.2	26.6	20.3	15.3
ROCE (%)	16.3	20.9	25.0	30.6
RONW (%)	12.1	17.7	21.3	25.7

Source: Company; Sharekhan estimates

Robust all-round performance: Blue Star's Q1FY23 consolidated revenues were in-line with our estimates, while net profit exceeded our expectations helped by higher other income and lower tax rate. Revenues came in at Rs 1,970crore (up 87% y-o-y). Operating profit grew by 192% y-o-y to Rs 123 crore in line with our estimates. While gross margin dropped by 330 BPS y-o-y to 21.1% due to high raw material cost. Tight control on employees and other cost resulted in operating margin at 6.3% (up 224 bps y-o-y). Apart from strong operating profit, higher other income and lower tax also helped in the net profit growing more than 5x to ~Rs 74crore. EMPS segment recorded revenue growth of 57% y-o-y contributing 40% to total sales, while Unitary products which includes room ACs recorded growth of 122.5%, contributing 57% to total sales. Notably, the growth in the AC business was 24% higher as compared to Q1FY20 which was the normal quarter before pandemic. Profitability in EMPS segment improved as it reported PBIT margin at 5.7% (4% in Q1FY22), while Unitary products' EBIT margin jumped to 8.1% (vs 4.3% in Q1FY22).

Well placed to tap growing business opportunities: The management is confident of strong growth momentum in FY23 with operating margin of the AC business expected to be ~9%. The company is confident of outpacing the expected industry growth of 20-25% in RAC by delivering 25-30% growth. Sri City Phase-1 is expected to commission in Q3FY2023, which would be able to serve all the southern states and save logistics cost and improve delivery time by 10-12 days. Further, EMPS and commercial AC systems should post remarkable growth in FY2023 led by healthy order inflow both from government and private sector. The company has been expanding its distribution reach into tier-3, 4 and 5 cities and consolidating market share. The mass premium product portfolio in RAC has seen encouraging response and expected to do well going forward. Further, other products such deep refrigerators and water coolers are expected to contribute meaningfully to the business in the medium-long term.

Blue star's Q1FY2023 Concall and Investor Update Highlights

- **Q1 performance:** Robust show is a result of strong performance across its business segments helped by long summer and healthy execution in the projects business. The RAC sales grew by 163% y-o-y . Its new range of affordable mass premium products have received an encouraging response. The company maintained its market share of 13.25% in RAC business.
- **Strong order book in EMPS segment:** The order Book stood at Rs. 2,777 crore (up 24% y-o-y). Order inflows from commercial building, factories, date centre and infrastructure have picked up and the company recorded more than 2x growth in order inflow at Rs 1,366 crore during Q1FY23. The company received major orders from the Bangalore metro rail corporation worth Rs 390 crore. In commercial air conditioning, the company has gained market share in all product categories such as conventional and inverter ducted AC systems as well as chillers. International business is also receiving strong traction in the GCC region in the backdrop of higher oil prices. The new markets – Nigeria, Nepal and Bangladesh have responded well to the launch of new products.
- **RAC volumes grew by 39% during Jan-June 2022 -** The RAC volumes for Blue Star grew by 39% between January– June 2022 as compared to January – June 2019 and the market has grown by 30% during the same period.
- **Expansion:** The Sri City commercial operations is expected to start in October- November 2022 which would house company's third RAC manufacturing unit along with PLI led manufacturing. Sri city would be able to serve all the southern states and save logistics cost and improve delivery time by 10-12 days.
- **Commercial refrigeration business:** The commercial refrigeration grew at a slower pace of 10-11% y-o-y as advance purchases took place in Q4FY23 itself. Blue star is a leader in the commercial refrigeration business. However, the market size is small and therefore its share in the total revenues is not substantial as yet. The demand for water coolers seem to be picking up in the recent times. Manufacturing of water coolers was shifted to Wada from Himachal Pradesh. Owing to the transition, the company could not meet the demand and lost revenues of Rs 10-15 crore.

- **Wada deep freezer facility:** Wada deep freezer facility is operational now where 300 ltr. capacity is being stepped up and manufacturing of 400 ltr/500 ltr is in full swing. Margin improvement in the business has been happening since May onwards and expected to improve significantly by Q3 as the company can now indigenously manufacture glass top deep freezers.
- **Changes in BEE rating:** The company has not increased the prices due to change in energy levels. Each level of energy efficiency change leads to 10% improvement in energy efficiency, while the cost rises by 7%.
- **Margin improvement in UCP:** The company expects 200 bps improvement in RAC margin in H2FY23. It also stated that on a sustainable basis, it can be 10% operating margin and 9% EBIT margin in peak season.
- **Net cash position:** Q1FY23 net cash stood at ~Rs.81 crore as compared to net debt of ~Rs. 69 crore as of June 2021. The company redeemed NCDs of Rs 175 cr in June 2022 given its strong cash position.

Results (Consolidated) **Rs cr**

Particulars	Q1FY23	Q1FY22	Y-o-Y(%)	Q4FY22	QoQ (%)
Revenue	**1,970**	**1,052**	**87.3**	**2,248**	**-12.3**
Operating Profit	**123**	**42**	**192.0**	**143**	**-13.7**
Other Income	11	8	31.4	6	67.6
Interest	11	11	-1.0	13	-17.9
Depreciation	22	20	9.9	23	-4.4
PBT	**101**	**19**	**420.1**	**113**	**-10.7**
Tax	26	7	304.0	38	-30.0
PAT	74	12.7	482.8	76	-1.8
Adj.EPS	7.7	1.3	482.8	7.9	-1.8
Margin (%)			**BPS**		**BPS**
OPM	**6.3**	**4.0**	**224.4**	**6.4**	**(10.2)**
NPM	3.8	1.2	255.7	3.4	40.5
Tax Rate	26.0	33.5	(747.9)	33.2	(720.1)

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector View – Bright growth prospects given under penetration of high value consumer electronics

The air-conditioner segment has long-term structural growth triggers in terms of suitable demographics, rising per capita income, rising urbanisation, low penetration levels, various financing options and uninterrupted availability of power etc., which would help companies maintain a healthy growth trajectory in the long term. RAC penetration level in India is at ~14-16% which is way behind as compared to the global average of 42%. This implies there is a significant growth opportunity for AC industry. The industry grew at a healthy pace of ~14%/16% in value and volume terms, respectively over FY15-20. However, last two summer seasons have been adversely impacted due to the COVID-led lockdown. Hence, given the lower base and pent-up demand of the last two years, AC industry is expected to grow at 20-25% in the next two years. Moreover, long-term growth triggers being intact for the industry, we expect a CAGR of ~20% over FY21-25E. Further, commercial refrigeration adoption in India is only at a sub-5% level. However, given rapid urbanisation, growth in pharmaceuticals and food & beverage industries, opening of shops, malls and offices post pandemic, pick up in construction activities, the industry is expected to post strong growth. Blue Star being a leading player with wide reach and range of products in both ACs and commercial refrigeration will be one of the key beneficiaries. Further, the company is well poised to leverage its experience in electro-mechanical projects (EMPs) and commercial air-conditioning products which are expected to witness healthy growth because of increase in public and private capex in sectors such as infrastructure, metro rail, power, retail and healthcare.

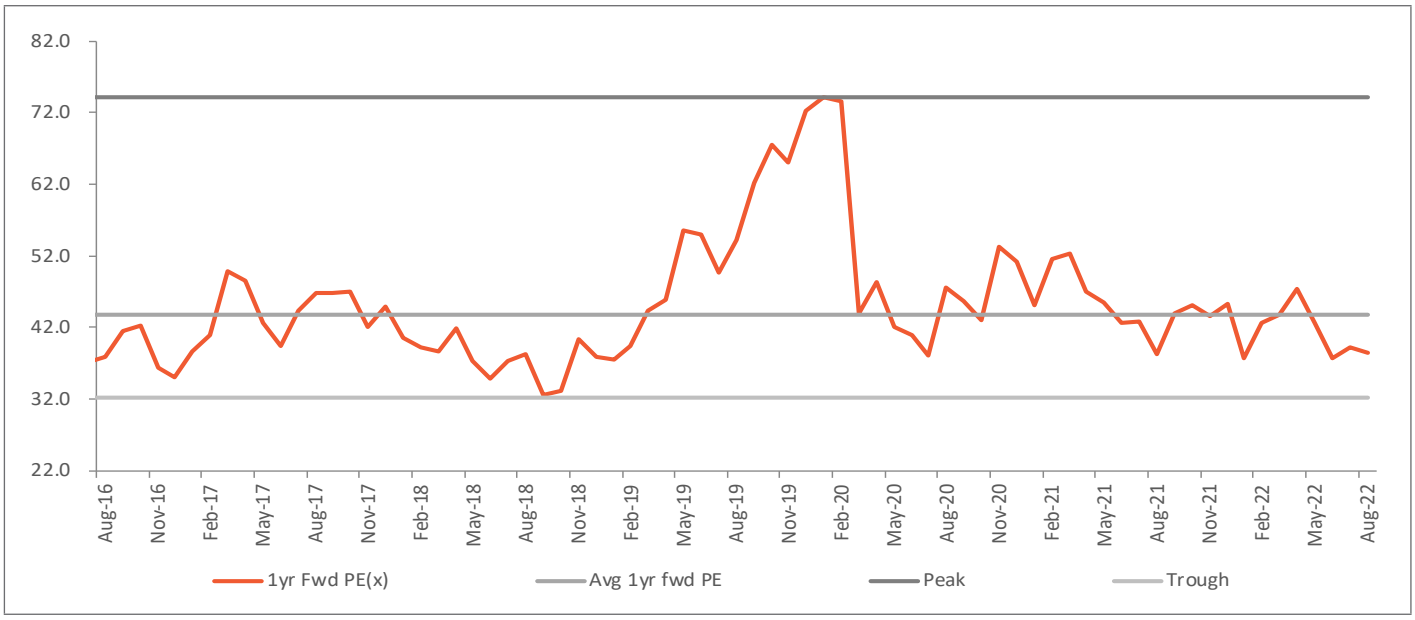
■ Company outlook – Long-term growth opportunities intact

Blue Star has a strong brand strength and distribution network and is well entrenched at both retail and institutional level in terms of its distribution network. The company is also becoming self-sufficient by commencing new manufacturing facilities in both RACs as well as commercial refrigeration which would lead to reduce its dependency on imports and cost saving led by backward integration. RAC and commercial refrigeration businesses are expected to gain traction gradually. 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. Digitization and healthcare initiatives offer good prospects for professional electronics and industrial systems. Moreover, the growth outlook for these categories is promising, considering 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.

■ Valuation – Maintain Buy with an unchanged PT of Rs. 1,250

Blue Star is expected to outperform the industry as well as its peers drove by a strengthening distribution network, rising market share, and improving product mix. Besides, scale-up in commercial refrigeration products, backward integration, increase in in-house manufacturing would also aid growth. Similarly, the EMPS segment's growth prospects are brighter given the strong order book and continued traction in order inflows in both domestic and international markets. We expect revenue/PAT to clock a CAGR of ~20%/39% over FY22-24E. At CMP, the stock trades at ~29xFY24E EPS. We maintain our Buy rating on the stock with an unchanged PT of Rs. 1,250.

One-year forward P/E (x) band



Source: Company, Sharekhan Research

About the company

Blue Star is India's leading air conditioning and commercial refrigeration company, with an annual revenue of over Rs. 5,000 crore, network of 32 offices, five modern manufacturing facilities, and 3,880 channel partners. The company has over7,500 stores for room ACs, packaged air conditioners, chillers, cold rooms as well as refrigeration products and systems. 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 has three business segments – Electro-Mechanical Projects (EMP) & commercial air conditioning systems, Unitary cooling products (UCP) and Electronics and Industrial Systems (EIS) which contribute 53%/43%/4% to FY22 revenues respectively. 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 and cold water purifier as well as air purifiers and air coolers.

Investment theme

Structural growth visibility in the Indian white goods segment remains high due to favourable demographics (urbanisation, per capita GDP, and low AC ownership similar to China's levels in 1998-2000). We believe Blue Star remains one of the key beneficiaries of rising AC penetration in India, led by its improving market share, impressive product profile, and strong service network. The company is well poised to grow driven by its strategy of –1. growing faster than the market 2. improving profits by scale and backward integration 3. deepening distribution through conventional and e-commerce channels.

Key Risks

- Sharp rise in key raw-material prices pose a key challenge
- Intense competition

Additional Data

Key management personnel

Mr. Ashok M. Advani	Chairman and MD
Mr. Suneel M. Advani	Vice Chairman
Mr. Vir S. Advani	MD
Mr. B Thiagarajan	Jt. MD
Mr. Nikhil Sohoni	CFO

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	SBI Fund Management Pvt. Ltd.	5.7
2	Kotak Mahindra AMC	5.0
3	Axis Asset Management	3.1
4	ICICI Pru AMC	2.2
5	T Rowe Price Group Inc.	2.1
6	Vanguard Group Inc.	2.0
7	Franklin Templeton India	1.8
8	HDFC AMC	1.4
9	Caisse de Depot et Placement	1.2
10	Mitsubishi UFJ Financial Group	1.0

Source: Bloomberg

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 detoriating 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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