Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

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 30.99

Updated Oct 08, 2022

High Risk

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

Source: Morningstar

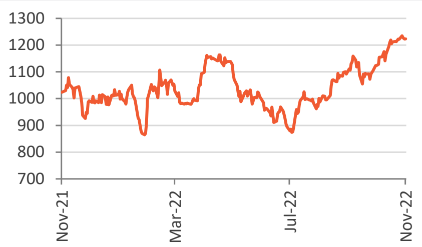
Company details

Market cap:	Rs. 11,686 cr
52-week high/low:	Rs. 1,274/836
NSE volume: (No of shares)	1.1 lakh
BSE code:	500067
NSE code:	BLUESTARCO
Free float: (No of shares)	5.9 cr

Shareholding (%)

Promoters	38.8
FII	11.8
DII	23.1
Others	26.4

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	8.8	25.9	7.3	21.1
Relative to Sensex	1.7	21.6	0.5	19.3

Sharekhan Research, Bloomberg

Blue Star Ltd

Project business leads show, outlook remains bright

Capital Goods	Sharekhan code: BLUESTARCO
Reco/View: Buy ↔	CMP: Rs. 1,223 · Price Target: Rs. 1,410 ↑

↑ Upgrade ↔ Maintain ↓ Downgrade

Summary

- Blue Star Limited's (Blue Star) Q2FY2023 performance was driven by strong growth in EMPS, while UCP segment delivered resilient performance despite lean quarter. OPM was below our expectations despite gross margin improvement. Net profit grew in-line with our estimates.
- The company expects order intake momentum in the EMPS segment to continue and expects 6-6.5% margin in FY2023. RAC industry would grow by 20-25% during FY2023 and Blue Star would grow faster than the industry.
- Blue Star has strong growth levers in all its business segments as the capex cycle is on upswing and consumer sentiments are also improving. We envisage ~21%/~34% revenue/PAT CAGR of FY2022-2025E.
- We maintain a Buy rating on Blue Star with a revised PT of Rs. 1,410, given robust H1FY2023 and strong long-term growth potential in both UCP and EMPS segments.

Q2FY2023 consolidated revenues were broadly in line with our estimates. While sales exceeded our expectations, net profit came in-line with estimates due to miss on OPM estimates. Revenues came in at Rs 1,576 crore (up 27% y-o-y). Operating profit grew by 21% y-o-y to Rs 86 crore in-line with our estimates. Gross margin improved to 23.3% (up 20 bps y-o-y and 217 bps q-o-q). Higher other cost resulted in operating margin declining by 27 bps y-o-y to 5.4%. Net profit grew by 36% y-o-y to ~Rs 43 crore. The EMPS segment led Q2 performance by registering a revenue growth of 33% y-o-y and contributing 61% to total sales. Unitary products, which include room ACs, recorded a growth of 15.4% in a seasonally lean quarter, contributing 33% to total sales. Profitability in EMPS segment was good with PBIT margin at 6.3% (6.4% in Q2FY2022), while unitary products reported EBIT margin of 6.2% (vs 5.1% in Q2FY2022).

Key positives

- Robust revenue growth of ~33% in EMPS verticals and EBIT margin were firm at 6.3%
- UCP reported resilient growth of 15% in revenue as RAC sales grew by 17%, while EBIT margin improved to 6.2% vs 5.1% in Q2FY22.
- Management outlook remains upbeat as it expects strong order inflows in the EMPS segment.
- The RAC and commercial refrigeration business is also expected to well given low level of penetration and growing investments in food processing and the organized retail sectors respectively.

Key negatives

- OPM declined by ~30 bps y-o-y mainly due to higher other expenses (up 49% y-o-y).
- Net debt increased to Rs. 393 crore (debt equity ratio of 0.37) compared to Rs 44 crore in Q2FY22 mainly due to build up of inventory (it maintains 75 days of inventory) to mitigate supply chain disruptions.

Management Commentary

- In the EMPS business, the overall pace of execution remained healthy. The company witnessed a strong uptick in enquiries, and order finalizations in the data center segment, metro railways and the factories segment. The inflow of tenders in the infrastructure sector continued to remain encouraging.
- Despite being a seasonally lean quarter w.r.t. demand, the RAC business registered decent growth. The commercial refrigeration business also witnessed growing demand across all segments with consumption levels normalizing. The demand for supermarket refrigeration products from the retail segment continued to be encouraging and demand from the hospitality sector revived.
- The professional electronics and industrial systems saw growing demand for the non-destructive testing business as well as data security solutions for the BFSI sector.
- The company grew in line with the market and maintained a market share of 13.25%.
- For FY2023, the RAC industry is expected to grow at 20-25% and Blue Star would grow more than the industry. The company would update about its plans for RAC exports in the next six months.

Revision in estimates – We have introduced FY2025 estimates and slightly tweaked our estimates for FY2023-FY2024.

Our Call

Valuation – Maintain Buy with a revised PT of Rs. 1,410: Blue Star is expected to outperform the industry as well as its peers driven 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 a strong order book and continued traction in order inflows in both domestic and international markets. We expect revenue/PAT to clock a CAGR of ~21%/34% over FY2022-2025E. At CMP, the stock trades at ~33x September FY2024E EPS. We maintain our Buy rating on the stock with a revised PT of Rs. 1,410.

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	FY22	FY23E	FY24E	FY25E
Net Sales	6,046	7,497	8,967	10,637
OPM (%)	5.7	6.1	6.6	6.9
Adjusted PAT	168	216	302	408
Y-o-Y growth (%)	66.9	28.4	40.0	35.0
Adj. EPS	17.4	22.4	31.3	42.3
P/E	69.6	54.2	38.7	28.7
P/B	11.5	10.3	8.8	7.2
EV/EBITDA	32.4	26.0	19.2	14.9
ROCE (%)	20.9	22.5	26.0	30.5
RONW (%)	17.7	20.0	24.5	27.7

Source: Company; Sharekhan estimates

Good performance by all business segments

Q2FY2023 consolidated revenues were broadly in line with our estimates. While sales exceeded our expectations, net profit came in-line with estimates due to miss on OPM estimates. Revenues came in at Rs 1,576 crore (up 27% y-o-y). Operating profit grew by 21% y-o-y to Rs 86 crore in-line with our estimates. Gross margin improved to 23.3% (up 20 bps y-o-y and 217 bps q-o-q). Higher other cost resulted in operating margin declining by 27 bps y-o-y to 5.4%. Net profit grew by 36% y-o-y to ~Rs 43 crore. The EMPS segment led Q2 performance by registering a revenue growth of 33% y-o-y and contributing 61% to total sales. Unitary products, which include room ACs, recorded a growth of 15.4% in a seasonally lean quarter, contributing 33% to total sales. Profitability in EMPS segment was good with PBIT margin at 6.3% (6.4% in Q2FY2022), while unitary products reported EBIT margin of 6.2% (vs 5.1% in Q2FY2022).

Multiple levers for growth across business segments

In the EMPS segment, order inflows continue to be good in Q3FY2023 as well and the execution has scaled up considerably. The company is witnessing a strong uptick in enquiries, and order finalisations in the data center, metro railways and the factories. In UCP, company is continuously expanding its footprints and promoting new range of affordable premium ACs particularly in the hindi speaking belts (north region). The company's product portfolio is compliant with new BEE rating norms and its maintained its market share of 13.25%. The demand for supermarket refrigeration products from the retail segment continued to be encouraging, demand from the hospitality sector also revived during the quarter. The company gained strong traction in tier 3/4/5 cities, which contributed 65% to total segment revenues. It maintained its market leadership in conventional and ducted ACs. The company expects commercial refrigeration segment to grow at a CAGR of ~20% over the next few years. In Professional electronics and industrial systems, the sales growth of 49.9% to Rs 92 crore was driven by robust demand for medical diagnostic equipments with increasing awareness and investments in the healthcare sector. The demand for the non-destructive testing and data security solutions for the BFSI sector also continued to be encouraging. The company received major orders from Arcelor Mittal, Jindal Saw, Tata Steel, HDFC and ICICI Bank during the quarter. Hence, the outlook is robust across segments and therefore we build in ~21% revenue CAGR.

Blue Star's Q2FY2023 Conference call and Investor Update Highlights

- **Strong order book in EMPS segment:** Order book grew by 30% y-o-y to a record Rs 4,162 crore during the quarter as compared to Rs 3,186 crore in Q2FY2022. Order booking for H1FY2023 has grown by 89% y-o-y to Rs 2,564 crore. The company booked its first order for railway electrification and also won its largest order for data center segment. While the company witnessed a strong uptick in enquiries, and order finalisations in the data center, metro railways and the factories; inflow in the Infrastructure sector also remained strong. The company gained strong traction in tier 3-4-5 cities which contributed 65% to total segment revenues. It maintained its market leadership in conventional and ducted ACs. In International business too, the company is continuously expanding its offerings and witnessing strong demand for refrigeration from fast food chains. The company targets 6-6.5% margin in FY2023E, post which the margins could improve as the revenues scale up further and commodity prices benefit starts reflecting in numbers. The company said that it does command minor premium (vs peers) in some of the orders.

- **Industry wise break-up in EMPS:** The order book is equally divided amongst infrastructure, factories and data centre orders.

- **RAC sales grew by 17% in Q2FY23** - The RAC sales for Blue Star grew by 17% y-o-y despite being a seasonally lower demand quarter. The commercial refrigeration business also witnessed a growth in demand across all segments with consumption levels back to normal. The company is continuously expanding its footprints and promoting new range of affordable premium ACs particularly in the hindi speaking belts (north region) where its presence is low. The company's product portfolio is compliant with new BEE rating norms and it maintained its market share of 13.25%. The RAC industry is expected to grow at a rate of 20-25% in FY2023E. While the demand for supermarket refrigeration products from the retail segment continued to be encouraging, demand from the hospitality sector also revived. The company gained strong traction in tier 3/4/5 cities which contributed 65% to total segment revenues. It maintained its market leadership in conventional and ducted ACs. The company expects commercial refrigeration segment to grow at a CAGR of ~20% over the next few years.

- **Pricing** – The company has been able to contain the margin erosion due to high commodity prices through price revisions keeping in mind the demand-supply scenario. Going forward too, the company would be reviewing its prices. It believes that once there is stability in China and exchange rate become normal, prices would also stabilize. The company aims to grow its market share to 13.75-15%.

- **Exports of RACs** – The company is contemplating its strategy on RAC exports and would update on the same in the next two quarters.
- **Professional electronics and industrial systems too has bright prospects** – The sales growth of 49.9% to Rs 92 crore was driven by robust demand for medical diagnostic equipments with increasing awareness and investments in the healthcare sector. The demand for the non-destructive testing and data security solutions for the BFSI sector also continued to be encouraging. The company received orders from companies like Arcelor Mittal, Jindal Saw, Tata Steel, HDFC Bank and ICICI bank.
- **Business outlook:** The outlook remains robust as the company has grown faster than the market through efficient capacity utilisation and expanding its domestic and international footprints. Order inflow in the projects segment would continue to be buoyant. The investment cycle has pricked up and the company is seeing increasing number of investments into water, metro railways and power distribution. Low level of AC penetration and strong demand for commercial refrigeration would continue to drive UCP business growth.
- **Expanding market share in RACs:** Its market share is not uniform across the country. For instance, in hindi speaking belt of India the company is not doing that well. It has repositioned its products and distribution expansion is almost halfway through post which the company expects market share to rise in these belts.
- **Net debt has gone up due to high inventory build-up:** Net Borrowing rose to Rs 392.6 crore (debt equity ratio of 0.37) compared to Rs 44.34 crores as on September 30, 2021 owing to build up of inventory (the company now maintains 75 days of inventory as supply chain issues still persist) to mitigate supply chain disruptions and capital investments for the manufacturing capacity expansion projects. The company expects that from current levels, debt could rise by Rs 100-150 crore going forward.

Results (Consolidated) **Rs cr**

Particulars	Q2FY23	Q2FY22	y-o-y(%)	Q1FY23	QoQ (%)
Net Sales	**1,576**	**1,240**	**27.1**	**1,970**	**-20.0**
Operating profit	**86**	**71**	**21.1**	**123**	**-30.6**
Other Income	8.6	8.1	5.3	10.5	-18.6
Interest	12	11	8.1	11	13.8
Depreciation	24	20	19.8	22	11.0
PBT	**58**	**47**	**22.0**	**101**	**-43.1**
Tax	15	16	-6.9	26	-43.5
Reported PAT	43	31	36.0	74	-42.6
Adjusted PAT	**43**	**31**	**36.0**	**74**	**-42.6**
Adj. EPS (Rs.)	**4.4**	**3.3**	**36.0**	**7.7**	**-42.6**
Margin (%)			**BPS**		**BPS**
OPM	5.4	5.7	(27.3)	6.3	(82.8)
NPM	2.7	2.5	17.6	3.8	(106.3)
Tax rate	25.9	33.9	(801.0)	26.0	(17.8)

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 grow strongly. Blue Star, being a leading player, with a 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.

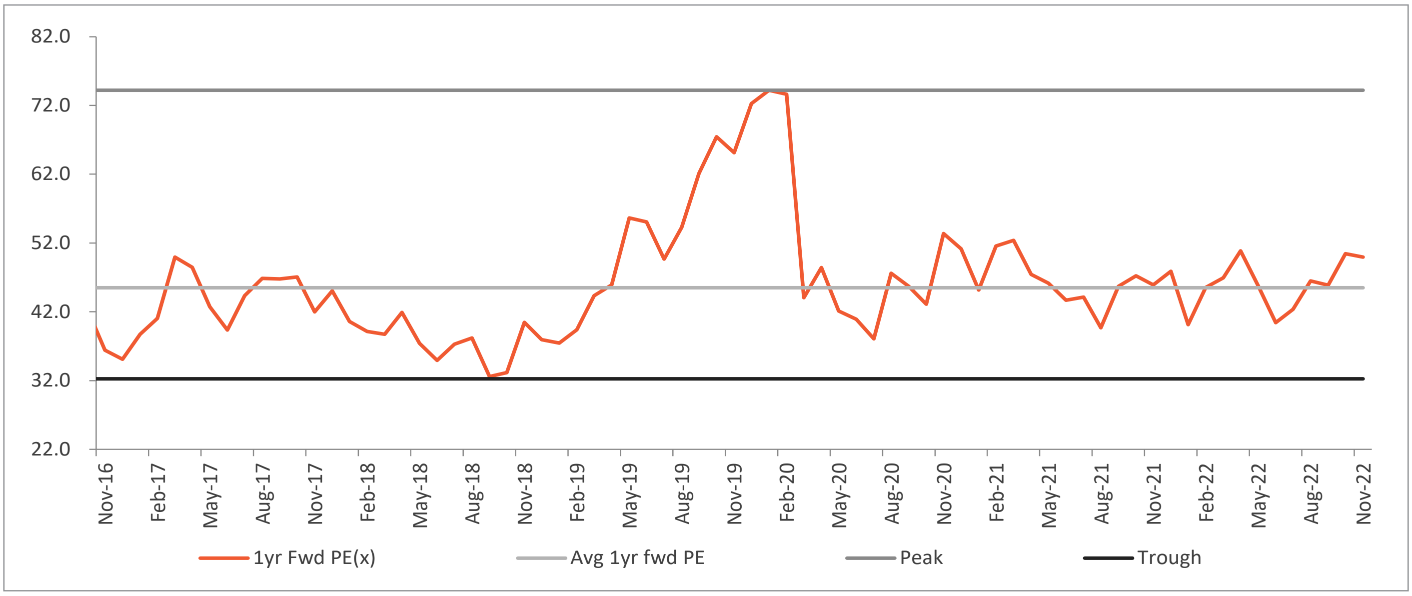
■ Company outlook - Long-term growth opportunities intact

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. Digitisation 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 a revised PT of Rs. 1,410

Blue Star is expected to outperform the industry as well as its peers driven 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 a strong order book and continued traction in order inflows in both domestic and international markets. We expect revenue/PAT to clock a CAGR of ~21%/34% over FY2022-2025E. At CMP, the stock trades at ~33x September FY2024E EPS. We maintain our Buy rating on the stock with a revised PT of Rs. 1,410.

One-year forward P/E (x) band



Source: Sharekhan Research

About 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 fulfils 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: Bloomberg

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	SBI Funds Management Pvt. Ltd.	7.82
2	Kotak Mahindra AMC	4.98
3	Axis Asset Management	3.57
4	T Rowe Price Group Inc.	2.42
5	Vanguard Group Inc.	2.00
6	ICICI Prudential AMC	1.95
7	Franklin Templeton India	1.53
8	Caisse de Depot et Placement	1.15
9	Caisse de Depot ET PLACEME	1.06
10	Mitsubishi UFJ Financial Group	0.99

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

Sharekhan

by BNP PARIBAS

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