Indbank Merchant Banking Services Ltd (A Subsidiary of Indian Bank)

Bharat Heavy Electricals Ltd.

EQUITY REPORT

April 25, 2014

BSE Code:	500103	NSE Code:	BHEL	Reuters Code:	BHEL.BO	Bloomberg Code:	BHEL:IN

Bharat Heavy Electricals Ltd (BHEL), the Indian state-owned engineering and manufacturing enterprise was incorporated on November 13, 1964 under the Indian Companies Act, 1956. The company is engaged in design, engineering, manufacturing, construction, testing, commissioning and servicing of a wide range of products and services for the core sectors of the economy including power, transmission, industry, transportation, renewable energy, oil & gas and defence. It operates in two segments: Power and Industry. The cumulative overseas installed capacity of BHEL manufactured power plants exceeds 9,000 MW across 21 countries including Malaysia, Oman, Iraq, the UAE, Bhutan, Egypt and New Zealand.

Investor's Rationale

Competitive advantage against international peer - Notwithstanding the difficult business environment, BHEL has retained its market leadership position during FY'14 with 72% market share in power sector. BHEL records the highest ever commissioning / svnchronization of 13,452 MW in 2013-14 on the back of the company's improved focus on project execution. BHEL is in a better shape to give cutthroat competition to its international peers as the lifecycle cost of BHEL-made equipment is lower due to better PLF (plant load factor), lower downtime and the cost advantage of China-made equipment is gradually declining. Also, recently Government has mandated that Power utility companies should procure power equipments from domestic players. We expect all these factors will boost company's sales and order book in the coming quarters.

Order book expected to rise further - With CCI's (Competition Commission of India) efforts to fast track projects, some of the BHEL projects could see some pick-up. There are ~17GW of power projects at the tendering stage. Execution has picked-up from clients like Bajaj Hindustan & Monnet Ispat. We expect healthy order-flow from central and state utilities, while order flow from private sector is expected to remain sluggish going ahead. The company ended the year FY'14 with an order book of Rs.1,015.38 bn.

Power generation capex likely to pick-up - The Indian power sector has witnessed a series of attempts by the government to address the various contentious issues surrounding SEB (state electricity board) finances, fuel availability, tariff review, etc. During the year, the government allowed power utility companies to hike electricity prices. And also CIL (coal India Ltd.) has signed a number of FSA (fuel supply agreement) to provide continues fuel to power utilities. All these efforts are likely to increase capex in the power sector and are expected to boost order flow. This could be a tipping point, particularly for the equipment manufacturer like BHEL.

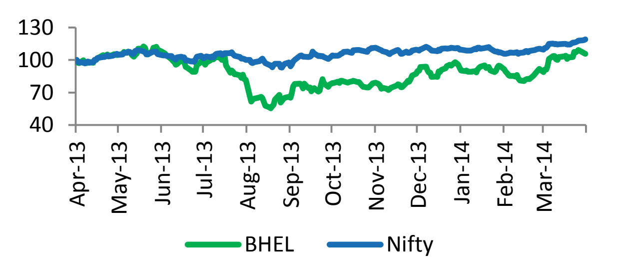
Market Data

Rating	**BUY**
CMP (₹)	191.2
Target (₹)	**228**
Potential Upside	~19.0%
Duration	Long Term
Face Value (₹)	2.0
52 week H/L (₹)	207.9/100.1
Adj. all time High (₹)	586
Decline from 52WH (%)	8.0
Rise from 52WL (%)	91.0
Beta	1.8
Mkt. Cap (₹bn)	467.9
Enterprise Value (₹bn)	410.4

Fiscal Year Ended

Y/E	FY13A	FY14E	FY15E	FY16E
Revenue (₹bn)	484.3	383.1	414.0	446.8
EBITDA (₹bn)	93.9	42.1	45.5	49.1
Net Profit (₹bn)	66.2	34.0	35.1	36.7
Adj EPS (₹)	27.0	13.9	14.3	15.0
P/E (x)	7.1	13.8	13.3	12.7
P/BV (x)	1.5	1.4	1.4	1.3
EV/EBITDA (x)	4.3	9.7	8.9	8.1
ROCE (%)	22.6	11.4	11.3	11.3
ROE (%)	21.7	10.5	10.2	10.1

One year Price Chart



Shareholding Pattern	Mar'14	Dec'13	Diff.
Promoters	63.06	67.72	(4.66)
FII	16.14	15.63	0.51
DII	16.47	11.96	4.51
Others	4.33	4.69	(0.36)

BHEL - largest state-owned engineering and manufacturing enterprise

The cumulative overseas installed capacity of BHEL manufactured power plants exceeds 9,000 MW across 21 countries including Malaysia, Oman, Iraq, the UAE, Bhutan, Egypt and New Zealand.

BHEL is an integrated power plant equipment manufacturer and one of the largest engineering and manufacturing companies in India. The company is also one of the leading international companies in the power field. The company is engaged in the design, engineering, manufacture, construction, testing, commissioning and servicing of a wide range of products and services for the core sectors of the economy, viz. Power, Transmission, Industry, Transportation, Renewable Energy, Oil & Gas and Defence. BHEL offers over 180 products and provides systems and services to meet the needs of core sectors like: power, transmission, industry, transportation, oil & gas, non-conventional energy sources and telecommunication. They have a wide-spread network comprising 15 manufacturing divisions, 8 service centres, 4 power sector regional centres, 18 regional offices, besides a large number of project sites spread all over India and abroad.

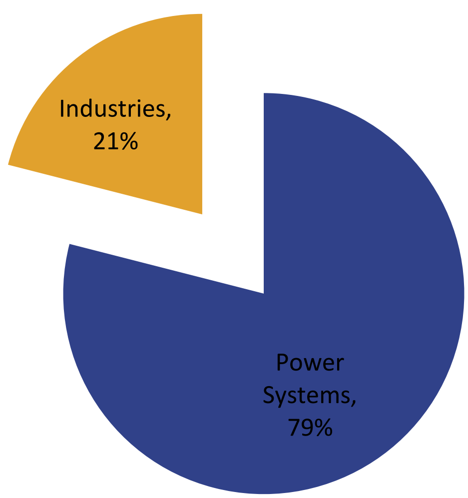
The company has a share of 57% in India's total installed generating capacity contributing 69% (approx.) to the total power generated from utility sets (excluding non-conventional capacity) as of March 31, 2013.Company has been exporting power and industry segment products and services for over 40 years. BHEL's global references are spread across over 75 countries. The cumulative overseas installed capacity of BHEL manufactured power plants exceeds 9,000 MW across 21 countries including Malaysia, Oman, Iraq, the UAE, Bhutan, Egypt and New Zealand. Moreover, Company's physical exports range from turnkey projects to after sales services.

Company's Segment

Power Systems: Power segment contributes around 79% of the total revenue. In this business segment, the company caters to different power projects categories, which include Thermal, Hydro, gas and Nuclear power plants. During FY13 All time high 9,298 MW utility capacities added during a year; 14% up from the previous year and 30 MW synchronized, awaiting clearance from utilities for capacity addition.

Industries: Industry segment contributes around 21% of the total revenue. BHEL is also a leading manufacturer of a variety of Industrial Systems & Products. Industry business of the company aims at meeting the growing demand for a number of industries, like metallurgical, mining, cement, paper, fertilizers, refineries & petro-chemicals etc. besides Captive / Industrial utilities.

Segment wise revenue (FY13)



The company highlighted that the demand scenario for captive power plants is bleak on account of lack of fuel availability and sluggish investment cycle.

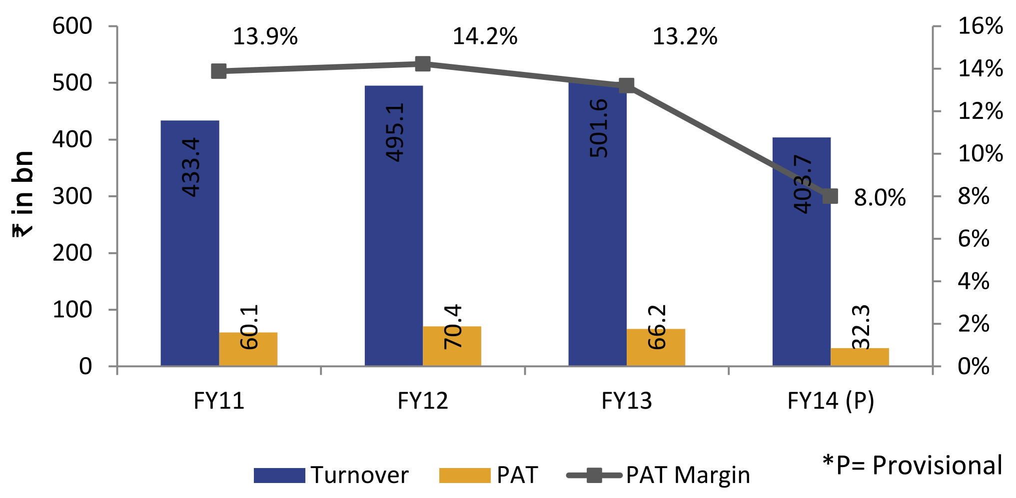
Lower demand and slower execution hampers revenue

BHEL witnessed a decline in the revenue by 13% YoY at ₹403.7 bn in FY14 mainly impacted by lower demand from the captive power plants and slower execution at the major power producers. The company has indicated that execution has been slower at the customer's end due to lack of clearances for its projects and tight liquidity market conditions.

In line with sharp fall in revenue coupled with higher fixed costs, the profit before tax of the company plunged sharply by around 50% YoY to ₹46.8bn in FY14 as against ₹94.3bn in FY13. As a result, PBT margin declined sharply by over 721 bps to 11.6% in FY14. Further, the company reported a provisional PAT of ₹32.2 bn, down by over 51% YoY, due to the high fixed cost, however PAT have been partially supported by higher other income mainly on account of gains on foreign exchange fluctuations on receivables. During FY14, profits have been impacted due to lower volumes, certain ongoing projects have got impacted as the Indian Power sector continues to be besieged with issues relating to fund constraints, land acquisition, clearances and coal linkages. Focus on cost optimization through increased localization of supercritical technologies and higher value additions. Going forward, we expect increased vendor base and design optimization efforts will likely to boost company's margins.

In Industry segment, while order outlook for captive power plants remain bleak but the management is quite optimistic on the transportation orders. This segment has been hit temporarily by the delays in the decision making of Indian Railways. Separately, management is also awaiting final approvals from Indian railways for setting up an Electric Multiple Unit (EMU) factory in Bhilwara. Also, management expects some revival during FY15 in both the segments. We expect execution of power projects and industry segment to remain constrained given the issues in terms of clearances and funding, particularly for IPPs (Independent power producer) and the slowdown in the investment cycle. Availability of coal remains a critical issue as existing capacities are running quite below their rated capacities.

BHEL performance trend



Increase in patents and copyrights to aid profitability

Increased R&D efforts have led to filing of nearly two patents/copyrights every working day. 434 patents/copyrights filed during 2013-14 were an increase of 13% over 2012-13. The company's R&D efforts are being directed towards developing new products using state-of-the-art technologies and processes, relevant to the needs of the country in terms of technology and features vis-à-vis global benchmarks.

More the patented and copyrighted products will likely create entry barriers for its peers to cater in that specific segment and will likely to increase company's profitability.

Expect power generation capex to pick up

Power generation capex is expected to pick up driven by structural trends. The Indian power sector has witnessed a series of attempts by the government to address the various contentious issues surrounding SEB finances, fuel availability, tariff review, etc. While the progress has been encouraging, there is still a lot that needs to be done.

Possible project awards of 20GW in next 12-15 months will be an important driver, given that industry capacity for super-critical boilers and turbines stand at ~21-24GW pa.

During FY12 and FY13, power BTG (boiler turbine generator) project awards stood at just ~10GW pa, including bulk tender, and compares with an annual run-rate of the 25-30GW pa during FY07-10 as lack of project clearances and availability of fuel supply hit power utilities sentiment and lead them to put capex on hold. However recent project clearances and FSA signed by CIL with a number of power Utilities Company boost the sentiment of power companies. Going ahead, the government is likely to award projects of ~20GW in next 12-15 months by PSUs (public sector unit) and is expected to boost order flow. This could be a Tipping point, particularly for the equipment manufacturer like BHEL. Also, an important driver has been the 'Case 2' Bidding Document (approved on Sept 2013) with bidding for 9.3GW has already been initiated.

The trend of increased project awards could possibly be supported by the interplay of structural factors:

i) Ensuring the financial viability of the Distribution business models i.e. SEBs.

ii) Improved demand planning by distribution companies.

iii) Coal mine allocations post gap of 5 years, etc.

Rise in ordering activities to aid BHEL

BHEL has an order book of `1,015 bn as on 31st March 2014. And BHEL's market share in Power Sector in the country was 72% during 2013-14.

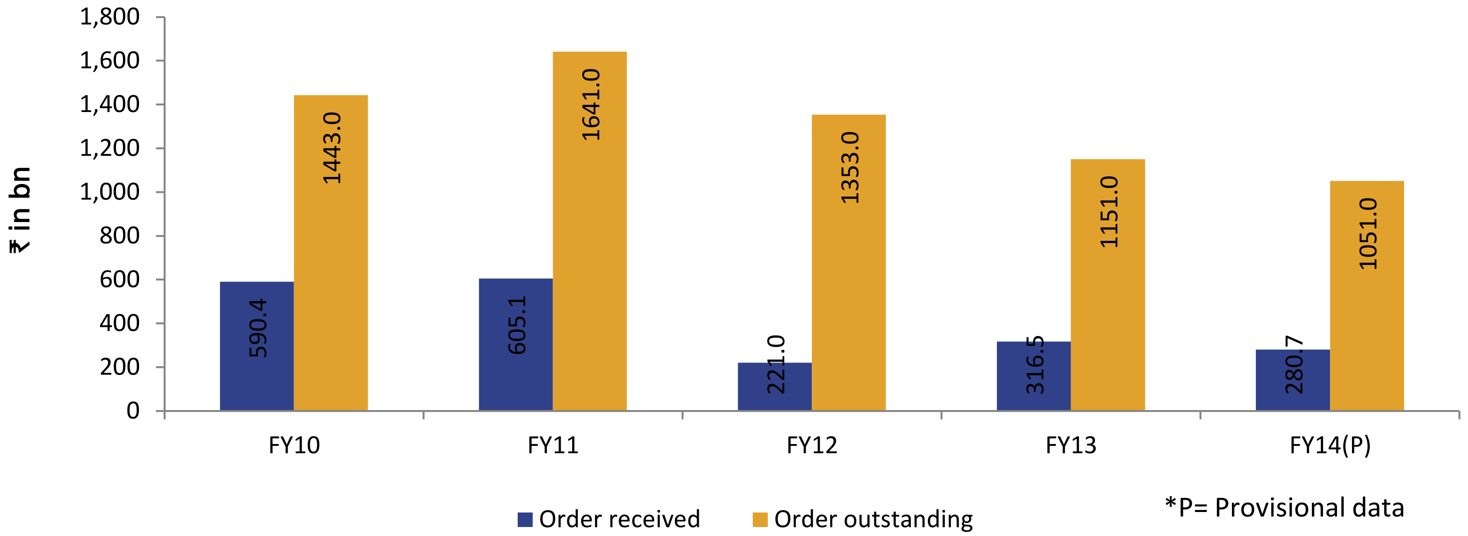
Both power & industrial market segments in which the company operates continued to witness fewer project deliveries by clients due to economic slowdown. BHEL's order intake declined by over 19% YoY in Q4FY14 to ₹168 bn as against ₹208 bn in Q4FY13. During FY14, company's total order intake stood at ₹285 bn and around 59% of the total order inflow comes only in Q4, which reflects that the efforts made the government to revive economy will shortly begin yielding actual results. However company's total order outstanding declined by 11% YoY to ₹1,015 bn in FY14 as against ₹1,151 bn.

During Q4FY14, BHEL bagged a mega EPC order worth ₹79 bn for 3x660 MW Supercritical units from NTPC for North Karanpura project against stiff international competition. With this, the company's market share in Power Sector in the country was 72% during 2013-14, further strengthening its leadership position.

The plant load factor of all BHEL supplied sets in the country was 1.6% more than that of all India average. 35 BHEL supplied sets achieved a PLF of over 90% while 79 sets achieved a PLF of 80-90% during 2013-14. So, this clearly represents the Company's competitive advantage against its peers.

We expect a healthy order flow from central and state utilities, while order flow from the private sector would remain sluggish, going forward.

Order-book trend



*P= Provisional data

BHEL bags ₹30 bn mega contract for 2x800 MW supercritical boilers against stiff international competition

Bharat Heavy Electricals Limited (BHEL) recently won a prestigious order for the supply of 2x800 MW Steam Generators (Boilers) with supercritical parameters for an upcoming power project in Odisha. The contract has been placed by NTPC Ltd. and valued at nearly ₹30 bn.

With this order, BHEL has taken its tally of supercritical boilers of 660 MW, 700 MW and 800 MW ratings to 32 sets, cementing its leadership position in supercritical technology. The order also reinforces BHEL's position at the forefront of the Indian power equipment manufacturing industry.

BHEL's scope of work in the contract envisages design, engineering, manufacture, and supply, erection, testing and commissioning of the Steam Generators and associated auxiliaries. The key equipment for the contract will be manufactured at BHEL's Trichy, Ranipet, Bhopal, Hyderabad and Bangalore plants while the company's Power Sector-Southern Region will be responsible for civil works and erection / commissioning of the equipment.

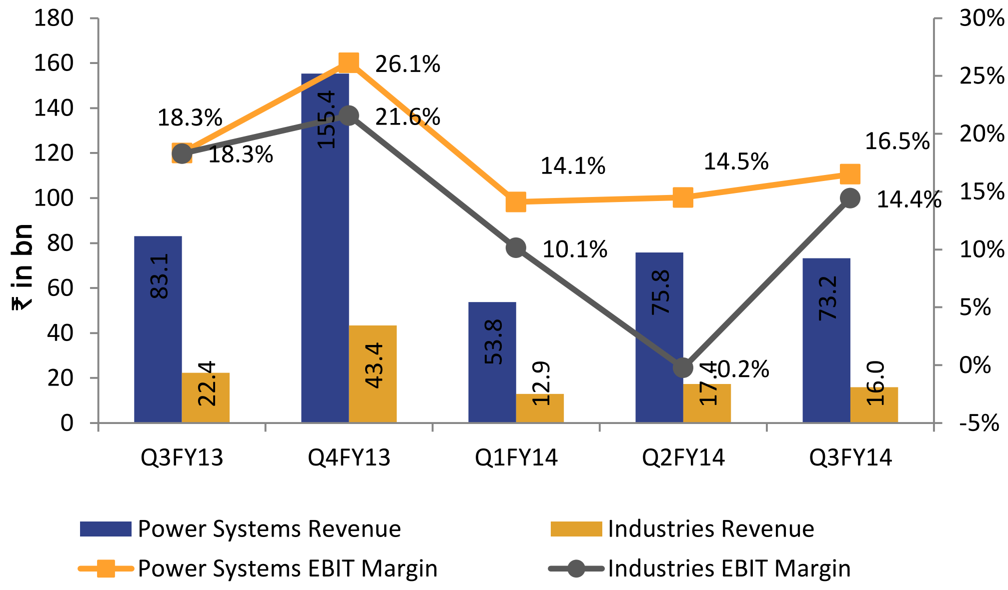
Lifecycle cost of BHEL made equipment is lower due to better PLF and lower downtime as compared to Chinese OEM products.

Imported products witness erosion of competitive intensity

Of the 90GW capacity under construction as per CEA, the share of Chinese and other imported equipments stand at 36.8% and 6.3% respectively. This is a large market pie being captured by importing products. However, BHEL has largely retained its preferred supplier position as Government has mandated that Power utility companies should procure power equipments from domestic players. Also, lifecycle cost of BHEL made equipment is lower due to better PLF and lower downtime. Also, the cost advantage of China made equipment is gradually declining.

Going forward, we believe the competitive intensity of Chinese players has been largely eroded given imposition of 21% import duty in 2012 leading to differential of ~14% for domestic players. Further intense competition given commissioning of ~21- 24GW of supercritical BTG (Boiler turbine generator) manufacturing capacities in India has led to a 15% price correction in boilers and 20% in turbines is expected to erode the pricing differential. Lower downtime and better PLF of domestically manufactured power equipment.

Segment wise quarterly performance trend



Key risks hindering growth

- The key problems hindering the growth of the power sector are land, fuel, environment, and forest clearances. Even the government is finding it very difficult to get the required land for allotting to power projects.
- High interest cost.
- Threat from Chinese players.
- Slower than expected economic recovery.

Balance Sheet (Standalone)

Y/E (₹bn)	FY13A	FY14E	FY15E	FY16E
Share Capital	4.9	4.9	4.9	4.9
Reserve and surplus	248.7	299.6	319.0	338.2
Net Worth	**304.5**	**323.9**	**343.1**	**363.9**
Loans	14.2	11.4	11.4	11.4
Other long term liabilities	57.9	57.1	57.1	57.1
Long-term provisions	89.4	83.6	87.6	92.3
Current Liability	235.4	212.1	233.8	259.3
Total Liabilities	**701.4**	**688.1**	**733.0**	**784.0**
Fixed assets	56.3	53.5	56.1	61.7
Investments	0.0	2.0	2.0	2.0
Current Assets	509.6	508.5	550.9	596.2
Deferred tax asset	106.5	88.8	88.8	88.8
other asset	4.3	4.2	4.2	4.2
Total Assets	**701.3**	**688.1**	**733.0**	**784.0**

Profit & Loss Account (Standalone)

Y/E (₹bn)	FY13A	FY14E	FY15E	FY16E
Net Sales	**484.3**	**383.1**	**414.0**	**446.8**
Expenses	390.3	340.9	368.4	397.7
EBITDA	**93.9**	**42.1**	**45.5**	**49.1**
Depreciation	9.5	9.4	11.2	12.3
EBIT	**95.6**	**50.4**	**52.0**	**54.5**
Interest	1.3	1.2	1.2	1.2
Profit Before Tax	**94.3**	**49.2**	**50.8**	**53.2**
Tax	28.2	15.3	15.8	16.5
PAT	**66.2**	**34.0**	**35.1**	**36.7**

Key Ratios (Standalone)

Y/E	FY13A	FY14E	FY15E	FY16E
EBITDA Margin (%)	19.4	11.0	11.0	11.0
EBIT Margin (%)	19.7	13.2	12.6	12.2
NPM (%)	13.7	8.9	8.5	8.2
ROCE (%)	22.6	11.4	11.3	11.3
ROE (%)	21.7	10.5	10.2	10.1
EPS (₹)	27.0	13.9	14.3	15.0
P/E (x)	6.5	12.8	12.4	11.8
BVPS (₹)	304.5	323.9	343.1	363.9
P/BVPS (x)	1.4	1.3	1.3	1.2
EV/Operating Income (x)	3.5	6.3	5.8	5.4
EV/EBITDA (x)	3.9	8.9	8.1	7.4

Valuation and view

In the past two years, market for power generation equipment has been dogged by fuel supply issues, poor financials of SEBs and substantial industry overcapacity. However, various initiatives have already been taken by the government like allocation of 14 Coal blocks to PSUs, signing of FSAs (fuel supply agreement) by Coal India, bail-out package for state discoms and coal price 'pass-through' to address these issues. We also note that order intake during Q4FY14 has picked up sharply and we expect that execution rate to pick up further in the coming quarters and thereby profitability of the company likely to improve.

At a current CMP of ₹191.2, BHEL is currently trading at EV/EBITDA of ~3.9xFY13. Considering the company's strong fundamentals, we expect company to report an EBITDA of ₹49.1bn in FY16E and we assigned a forward EV/EBITDA multiple of ~10x FY16E, which provides a potential upside of ~19% for the coming 12 months.

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