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

Thermax Ltd.

EQUITY REPORT

January 24, 2014

BSE Code:	500411	NSE Code:	THERMAX	Reuters Code:	THMX.NS	Bloomberg Code:	TMX:IN

Thermax Ltd, founded in 1980, is engaged in providing engineering solutions to the energy and environment sectors. The company operates primarily in two segments, namely, Energy and Environment. Energy segment includes boilers and heaters, absorption chillers/heat pumps, and power plants. Environment segment includes air pollution control equipments/ systems, water and waste recycle plants, ion exchange resins and performance chemicals. The company is having presence in 75 countries across Asia Pacific, Africa, the Middle East, Europe, the United States and South America.

Investor's Rationale

- Thermax witnessed a weak performance in Q2FY'14 with 13% YoY de-growth in revenue and order intake at just ₹7.7 bn due to the slow pace of execution of large projects. Poor operating conditions and tight liquidity have naturally increased the stress on the company's balance sheet. But as soon as the order execution starts picking up, the company start reporting higher earning visibility. Despite the constrained environment, we remain positive and provide relatively high valuations as compared to its peers owing to its stable networking Capital and improved cash.

- Thermax's ability to bag base orders of ~₹7-8 bn per quarter, increasing market share and strong management pedigree gives us confidence that it will be able to tide the slowdown and participate in the up-turn of the cycle meaningfully and will continue to surprise positively in terms of order flow. We believe Thermax will continue to benefit from the continued power shortage and strong product portfolio.

- Though, challenges persist for Thermax given the weak capex environment. In the absence of big ticket orders, growth is likely to be subdued for the company. But at the same time strict government regulations, increased environmental concerns and currency depreciation is also leading to increased traction in the export market (currently at 19% of revenues). With increasing service export, Fortified positioning in HRSG and Initial forays into LATAM, Africa, Europe & Middle East, we expect overseas revenue contribution increase to 40% by FY'16E.

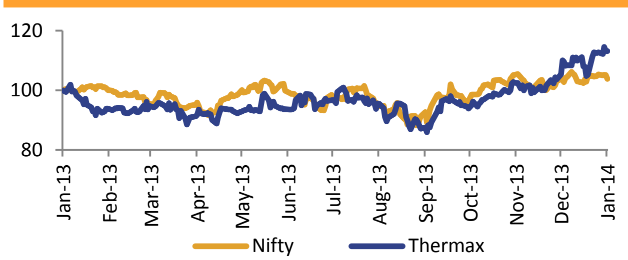
- The company's subsidiary, Thermax Babcock & Wilcox (TBW), has started the process of commissioning the manufacturing facility for manufacturing of utility boilers with an annual capacity of 3 GW at Shirwal (Maharashtra). The factory has provision for expansion to 5GW; and the initial project cost stands at ₹8 bn with debt-equity ratio (DER) of 50:50. Post the commencement of the manufacturing facility and focus towards capacity expansion are likely to be growth triggers for the company, going ahead.

Market Data	
Rating	**BUY**
CMP (₹)	644.8
Target (₹)	**720**
Potential Upside	~11.7%
Duration	Medium Term
Face Value (₹)	2.0
52 week H/L (₹)	719.8/530.0
Adj. all time High (₹)	910.0
Decline from 52WH (%)	10.4
Rise from 52WL (%)	21.7
Beta	0.4
Mkt. Cap (₹bn)	76.8
Enterprise Value (₹bn)	77.4

Fiscal Year Ended

Y/E	FY12A	FY13A	FY14E	FY15E
Revenue (₹bn)	60.9	54.9	59.7	65.7
EBITDA (₹bn)	5.9	4.9	5.4	6.2
Net Profit (₹bn)	4.0	3.2	3.5	4.0
Adj EPS (₹)	33.9	26.9	29.5	33.4
P/E (x)	19.0	24.0	21.8	19.3
P/BV (x)	4.7	4.1	3.7	3.3
EV/EBITDA (x)	11.9	15.8	14.4	12.2
ROCE (%)	31.8	20.3	19.5	19.6
ROE (%)	24.8	17.1	16.8	17.2

One year Price Chart



Shareholding Pattern	Sep'13	Jun'13	Diff.
Promoters	62.0	62.0	-
FII	15.3	14.3	1.0
DII	8.3	8.8	(0.5)
Others	14.4	14.9	(0.5)

Thermax: India's leading energy and environment engineering company

The company's presence spans 75 countries across Asia Pacific, Africa and the Middle East, CIS countries, Europe, USA and South America.

Thermax Ltd, headquartered in Pune, provides sustainable solutions in Energy and Environment by the way of standard products in the 6 areas of business, such as Boilers and Heaters, Absorption Cooling, Water and Waste Solutions, Chemicals for Energy and Environment applications, Power and Cogeneration systems and Air Pollution and Purification. The company operates globally through 19 International offices, 12 Sales & Service offices and 11 manufacturing facilities - 7 of which are in India and 4 overseas. The company's presence spans 75 countries across Asia Pacific, Africa and the Middle East, CIS countries, Europe, USA and South America. The group consists of 5 domestic wholly owned subsidiaries, 13 overseas wholly owned subsidiaries and 2 joint ventures. Tuning into the needs of the day, all its solutions are innovative, energy-efficient, environment-friendly and easy to operate. From its experience of over four decades in the energy sector, the company offers a range of boilers and thermal oil heaters, energy chillers and customized products like exhaust gas boilers. Thermax absorption chillers have found a niche in green energy systems in Europe and Australia.

Thermax also helps industries reduce energy costs by shifting to abundantly available, alternate energy such as biomass. Thermax provides industries with clean technologies that recover pollutants; thereby reducing their hazardous impact on the environment.

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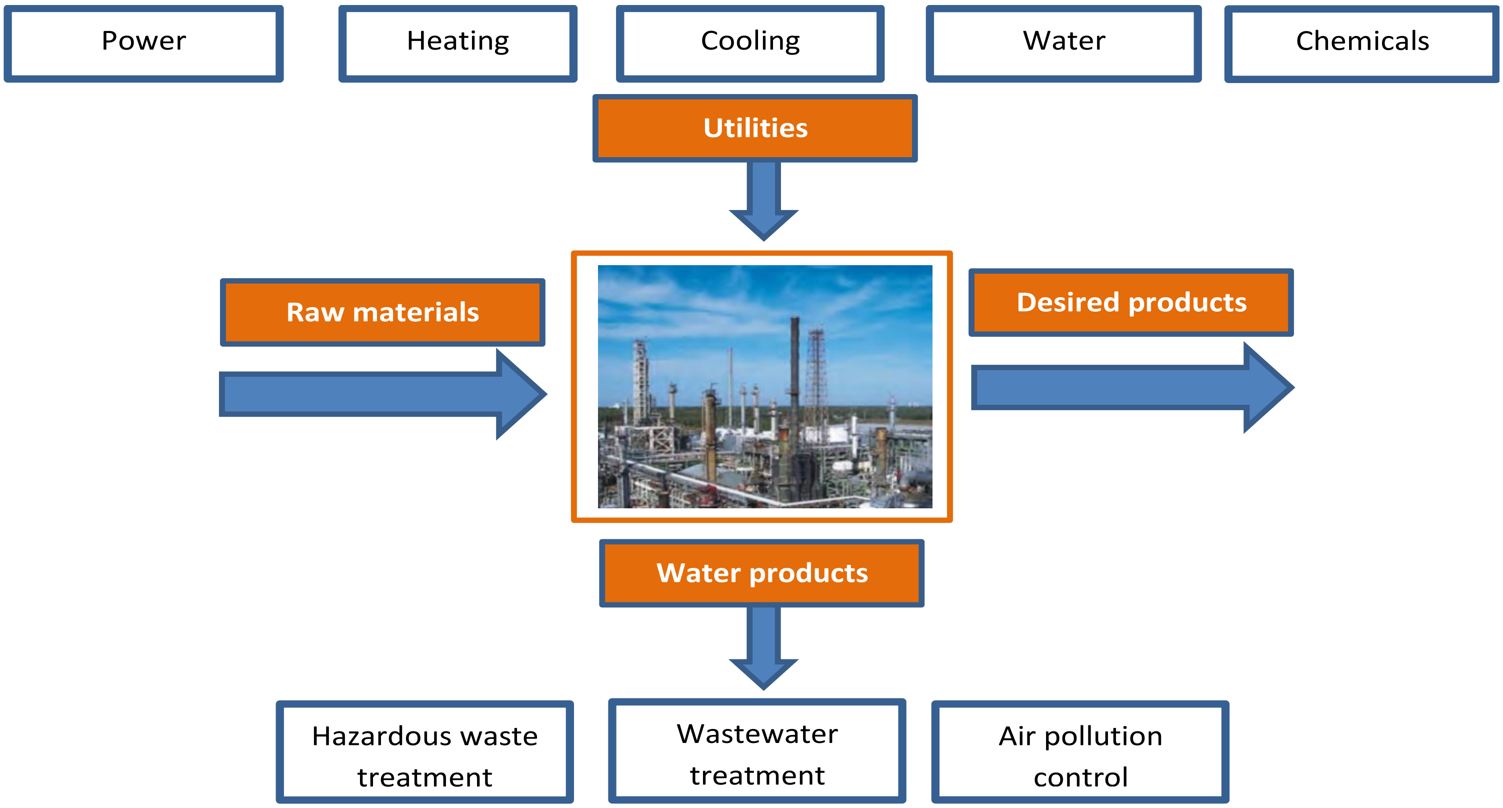
Thermax's energy-environment offerings



Expected pick-up in order execution provides higher earning visibility

The company's net profit declined 12.5% in Q2FY'14, however, the decline was stemmed by growth in exports and service income.

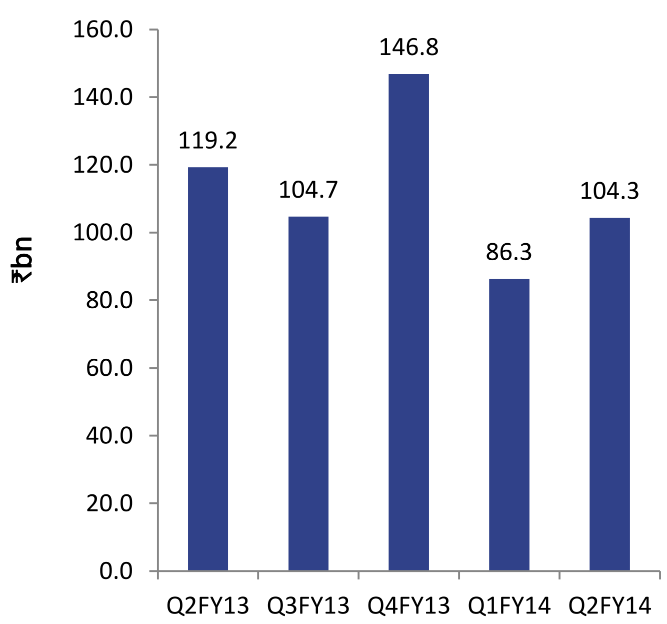
Thermax expects a pick-up in execution in H2FY'14, which will help Thermax to end FY'14E on a flattish note before commencing its journey of growth in FY'15E.

Energy and environment major, Thermax Ltd has posted a net profit of ₹10.43 bn for the quarter ended September 2013, representing a decline of 12.5% YoY. The decline was limited by a growth in exports and service income by 35% and 18% YoY, during the quarter. However, negative operating leverage played the spoilsport for EBITDA margins, which came in 123 bps YoY lower at 8.9%, due to the intensified competition, rising input costs and rising share of low yielding EPC orders. During the quarter Thermax has made one time tax provision of ₹2.90 bn towards a survey under section 133A of the Income Tax Act. Thus, lower other income and one-offs in terms of write-back of tax credit for some disallowed expenses led 67% YoY decline in reported PAT declining 67% YoY at ₹3.0 bn. However, the management expects a pick-up in execution H2FY'14, which will help Thermax to end FY'14E on a flattish note before commencing its journey of growth in FY'15E.

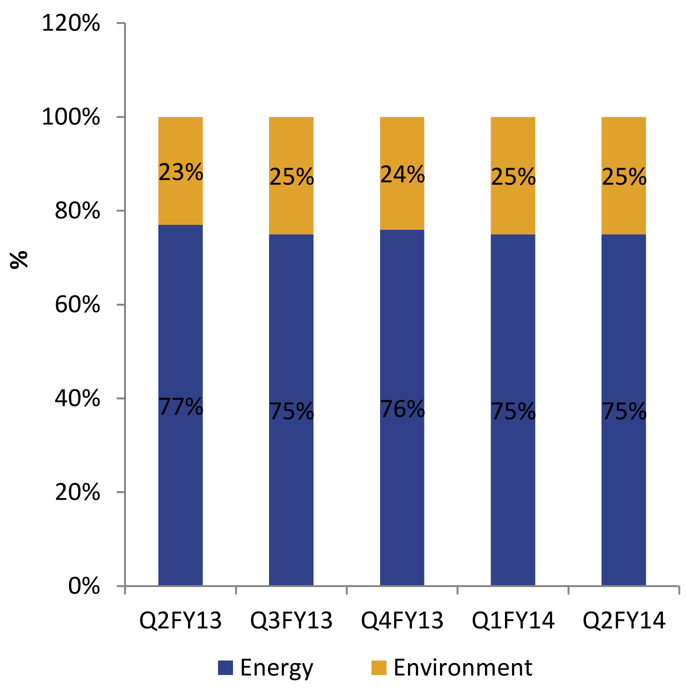
We expect revenues and PAT to grow 9.9% and 13.2%, respectively, over FY'14-15E, while margins are expected to range between 9.0% and 9.4% over the same period.

Service revenues (comprised of chemicals and resins, O&M, Retrofit, Energy audit, etc) are up 18% YoY. Exports contributed 26% of standalone revenues and 35% of TMX global consolidated revenues. The energy segment reported revenues at ₹7.9 bn, down 16% YoY mainly due to reduction in billing for large boilers/ EPC projects, constrained the pace of execution by the clients given the increased macro volatility. EBIT margins declined 90bps YoY to 9.0% on account of lower revenue led negative operating leverage and Forex MTM losses. While Environment segment revenues declined just 2.4% YoY to ₹2.7 bn and EBIT margin fell by 110 bps YoY to 8.6%, impacted by continued pricing pressure and also MTM on forex transactions.

Revenue performance during Q2FY'14



Energy segment continued its dominance



Given the weak order inflow in Q2FY'14 and muted execution, we expect revenues to record 8.7% and 10% YoY growth for FY'14E and FY'15E, respectively.

In the current environment, management expects to receive orders from sectors like Sugar, Food Processing, Breweries and Pharma.

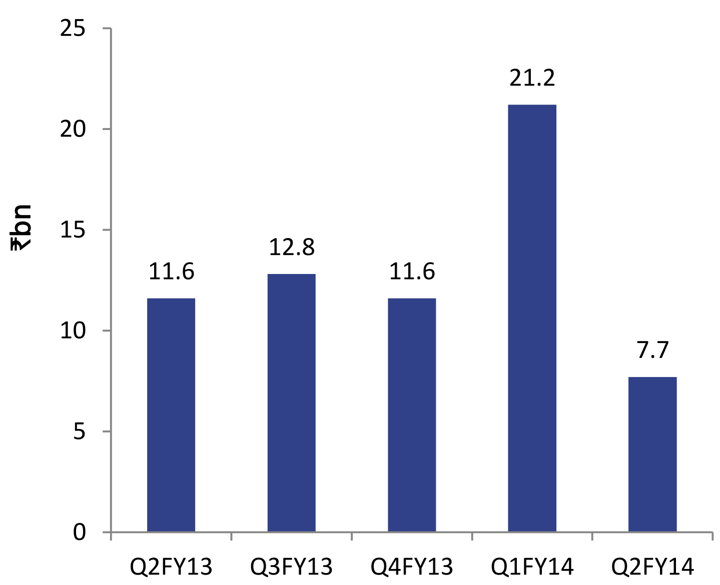
At the end of H1FY'14, Thermax has an order backlog of ₹53.08 bn against ₹44.12 bn in September 2012. However, generally the market for capital goods continues to be sluggish and the management does expect to beat last year's sales. During the quarter, order intake for energy division was ₹5.87 bn (₹7.70 bn for the group) and for the Environment division it was ₹1.81 bn (₹2.01 bn for the group).

Poor order inflows from core industries dragged profitability

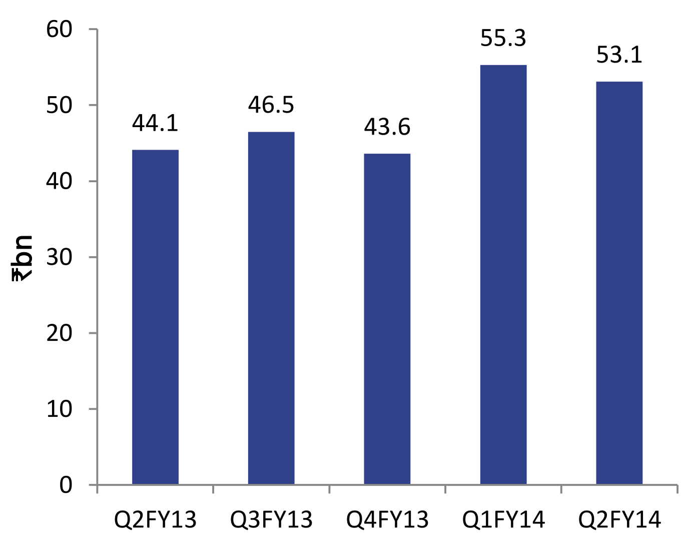
Order inflows during Q2FY'14 declined by 34%YoY at ₹7.7 bn, with the domestic intake at just ₹5.5 bn as the company failed to record a big ticket order during Q2FY'14. While, export orders at ₹2.1 bn have remained stable largely given muted intake in product businesses. The company's standard products, comprising of Heating (Package Boilers, etc), Cooling (Absorption Cooling and Chilling), Water Treatment plants (for commercial / residential units and small industries), Chemicals, etc., comprise ~35-40% of the revenues and contributed ~₹5-6 bn of order intake per quarter.

Large orders continue to remain elusive as the capex cycle continues to remain weak. In the current environment, management expects to receive orders from sectors like Sugar, Food Processing, Breweries and Pharma. Order flows from conventional sectors like Metals and Autos remain weak. Enquiries in the export market (primarily MENA region) have improved substantially. However, H1FY'14 saw order inflows of ₹28.2 bn, which is ~50% of our order inflow assumption of ₹58.0 bn for FY'14E. Going ahead, Thermax has to maintain a quarterly run rate in H2FY'14 that stands at ₹15.0-16.0 bn per quarter. Thermax' current backlog is at ₹53. 1 bn, out of which 82% comes from the power sector. Given the weak order inflow in Q2FY'14 and muted execution, we expect revenues to record 8.7% and 10% YoY growth for FY'14E and FY'15E, respectively.

Order intake during Q2FY'14



Order backlog during Q2FY'14



The management indicated that there has been no major order loss, and the lower bookings are a reflection of the resistance and postponement on the part of the customers to award projects. Key segments that contributed to domestic orders in Q2FY'14 includes: Food, Chemicals, Refinery, Sugar and Sponge Iron. Going forward, chemicals and resin business

Recently, the company received an order valued approximately ₹2.69 bn for the design, engineering, manufacture, supply, erection and commissioning of three HRSGs from a leading petrochemical company

should witness increased intake from sugar industry; food and food processing, brewery and pharma segments should contribute to intake in standard products; IT offices to support orders for water and waste water treatment plants; Textiles machinery is also witnessing capacity expansion.

Recently, the company received an order valued approximately ₹2.69 bn for the design, engineering, manufacture, supply, erection and commissioning of three HRSGs (heat recovery steam generators) from a leading petrochemical company for its proposed captive power plant as a part of its expansion program. Each HRSG generates 275 ton per hour (TPH) high pressure steam and 30 TPH low pressure steam for the customer's captive power and process requirements.

Overseas business to support growth in the near term

With a 27% overseas contribution in total consolidated revenues in FY'13, the company has a strong presence in the overseas market. Further, we believe that Thermax's technology tie ups and strong growth in the company's wholly subsidiary Danstoker and Rifox, particularly in biomass, heat pumps, etc provide further opportunities to access overseas markets. Successful execution track record of EPC projects also expands the possibilities for more such contracts. With increasing service export, Fortified positioning in HRSG and Initial forays into LATAM, Africa, Europe & Middle East, we expect overseas revenue contribution increase to 40% by FY'16E.

During Q2FY'14, the performance of subsidiaries improved substantially, with profit improving to ₹51 mn in Q2FY'14 from ₹27 mn in Q1FY'14.

During Q2FY'14, the performance of subsidiaries improved substantially, with profit improving to ₹51 mn in Q2FY'14 from ₹27 mn in Q1FY'14. The management attributed the improvement to strong performance by Danstoker and improvement in China subsidiary. Favorable currency, better product mix and few high margin orders helped Danstroker report strong numbers. Thermax's China subsidiary is expected to achieve cash break-even by year end. It also expects losses in TMX instrumentation to reduce over the course of the year.

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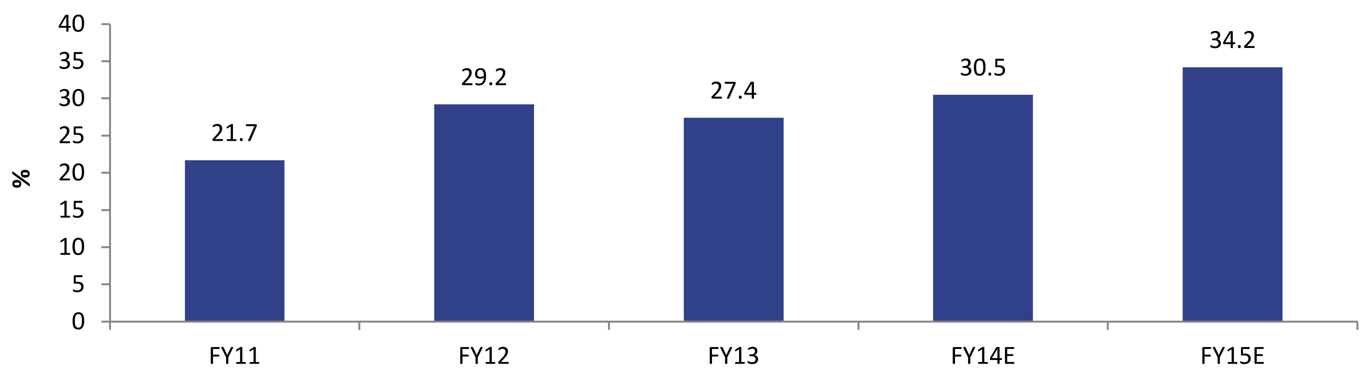
Thermax B&W JV has reported loss of ₹90 mn in Q2FY'14. The factory is ready to start commercial operations and Thermax is scouting for orders to fill the factory. The company is planning to execute part of Reliance order in BTG JV to ensure faster execution and start utilization of factory/resources.

Overseas Revenues (% of consolidated revenues)



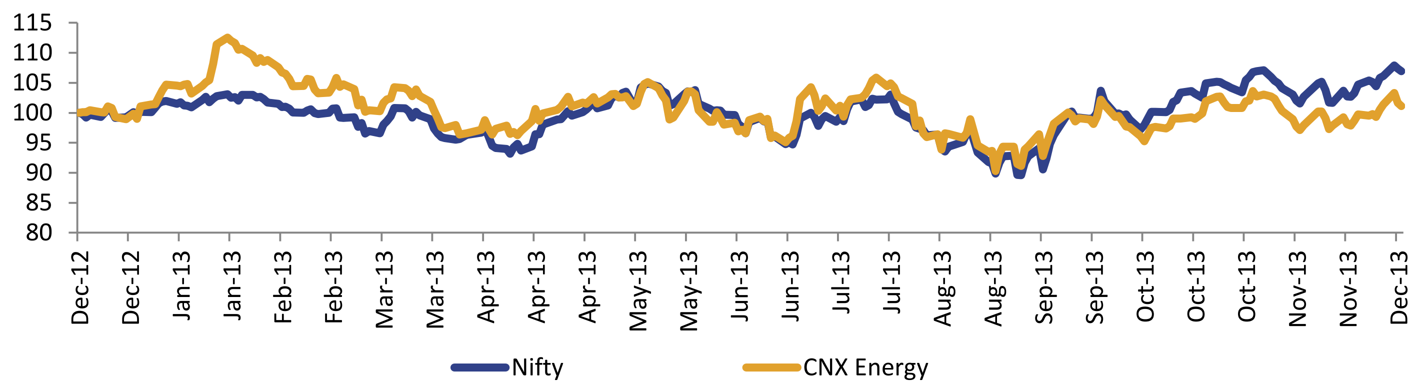
The company's "days sales outstanding" position at the end of the first six months of fiscal 2014 expanded by 20 days to 118 days, indicating tighter liquidity conditions in the sector.

Expect Thermax to withstand its growth trajectory

The capital goods sector was adversely affected for the second consecutive year. Investments have continued to be low especially in infrastructure sectors like power due to policy challenges affecting important milestones such as environmental clearances, fuel linkages and land acquisition, among others. Factors like sectoral banking limit exhaustion and tariff revisions have further added to the complexities resulting in a large number of big projects being delayed.

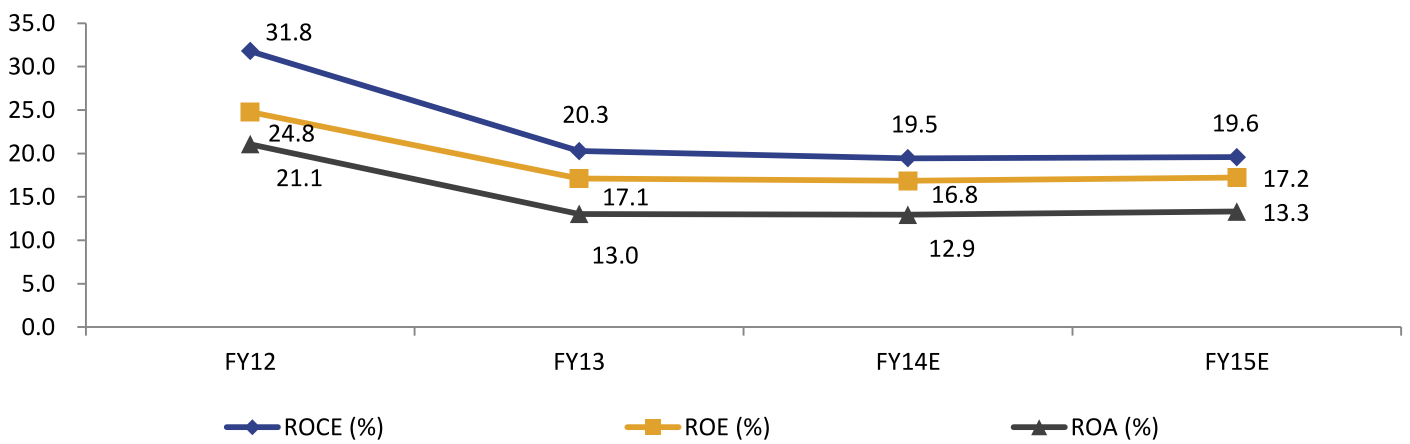
Thermax's performance over the past few quarters has been a reflection of the investment drought in the economy. Order inflows have declined and the order book has contracted. The upshot has been lower revenue on account of the slow pace of execution of large projects, partly linked to delays from clients. Poor operating conditions and tight liquidity have naturally increased the stress on the company's balance sheet.

Slowdown in the Indian energy sector



However, the company's "days sales outstanding" position (the average number of days taken to collect revenue after a sale has been made) at the end of the first six months of fiscal 2014 expanded by 20 days to 118 days, indicating tighter liquidity conditions in the sector. But that impact has been offset to an extent by an expansion in payables, or bills to be paid by Thermax, which has helped contain the effect on working capital.

Key Ratios



Balance Sheet (Consolidated)

Y/E (₹mn)	FY12A	FY13A	FY14E	FY15E
Share Capital	**238.3**	**238.3**	**238.3**	**238.3**
Reserve and surplus	16,055.3	18,448.5	20,652.0	22,876.0
Net Worth	**16,293.6**	**18,686.8**	**20,890.3**	**23,114.3**
Minority Interest	1,116.4	1,102.7	1,213.0	1,334.3
Loans	876.0	3,832.2	4,138.8	4,552.7
Deferred tax liability	377.7	383.0	383.0	383.0
Other long term liabilities	484.8	541.2	541.2	541.2
Long term provision	1.8	13.0	13.0	13.0
Total Liabilities	**19,150.3**	**24,558.9**	**27,179.2**	**29,938.4**
Fixed assets	10,906.6	13,901.4	15,569.6	17,437.9
Investment	0.3	0.3	0.3	0.3
Loans & Advances	627.6	380.8	399.8	419.8
Other assets	1,131.3	2,500.5	2,500.5	2,500.5
Net current assets	6,484.5	7,775.9	8,709.0	9,579.9
Total Assets	**19,150.3**	**24,558.9**	**27,179.2**	**29,938.5**

Key Ratios (Consolidated)

Y/E	FY12A	FY13A	FY14E	FY15E
EBITDA Margin (%)	9.7	8.9	9.0	9.4
EBIT Margin (%)	10.0	9.1	8.9	8.9
NPM (%)	6.4	5.5	5.6	5.8
ROCE (%)	31.8	20.3	19.5	19.6
ROE (%)	24.8	17.1	16.8	17.2
Adj EPS (₹)	33.9	26.9	29.5	33.4
P/E (x)	19.0	24.0	21.8	19.3
BVPS (₹)	136.7	156.8	175.3	194.0
P/BVPS (x)	4.7	4.1	3.7	3.3
EV/Operating Income (x)	1.2	1.4	1.3	1.2
EV/EBITDA (x)	11.9	15.8	14.4	12.2

Profit & Loss Account (Consolidated)

Y/E (₹mn)	FY12A	FY13A	FY14E	FY15E
Operating Income	60,912.1	54,917.0	59,694.8	65,664.3
Operating Expenses	54,992.7	50,015.4	54,322.2	59,491.8
EBITDA	5,919.4	4,901.6	5,372.5	6,172.4
Depreciation	662.5	770.7	1,001.9	1,302.5
Other Income	829.5	848.5	916.4	989.7
EBIT	6,086.4	4,979.4	5,287.0	5,859.6
Interest	121.7	165.4	198.5	238.2
PBT	5,964.7	4,814.0	5,088.5	5,621.5
Tax	2,043.3	1,773.4	1,730.1	1,798.9
Monority Interest	(113.8)	(160.7)	(160.7)	(160.7)
PAT	4,035.2	3,201.3	3,519.1	3,983.3

Valuation and view

We believe Thermax will continue to benefit from the continued power shortage and strong product portfolio and increasing traction in export markets. Near term constraint in domestic business will remains a major concern for the company. However large order finalizations including JSPL 1,320MW, Fertilizer projects, Hydrocarbon, capex, Cement capacity expansion, etc. are likely to be growth triggers for the company, going ahead. We maintained a positive view on Thermax, given the strong cash flows and business cycle management with low working capital needs.

At a current market price (CMP) of ₹644.8, the stock trades at a P/E of 21.8 FY14E and 19.3x FY15E. We recommend 'BUY' with a target price of ₹720, which implies potential upside of ~11.7% to the CMP from long term (1 year) perspective.

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