14 October 2014

MOTILAL OSWAL

FulCrum CAPITAL GOODS INSIGHTS

T&D Spend Accelerating…

…led by High Technology Areas and Intra-State segments

- **During 1HFY15, PGCIL's ordering activity stood at INR85b (up 59% YoY) led by high technology areas (at 46% of project awards) and Transmission Towers (34%). Competitive intensity remains stable.**
- **Emerging areas like Green Energy Corridors, Intra State transmission projects, Substation automation to drive growth. Another important trend is that the share of UHV segment in Twelfth Plan (FY13-17E) is increasing to 30-32% from 5-7% earlier, and given that there are few players prequalified in this segment, the business economics should possibly improve.**
- **MNC players, particularly Alstom T&D (Not Rated) and ABB India (Neutral) are best positioned to capture the upsides from high-end products. CRG (Buy) has been expanding presence in the chain.**

PGCIL project awards improving, led by high technology areas

During 1HFY15, PGCIL's ordering activity has shown meaningful improvement from the lows in FY14, with ordering activity at INR85b (up 59% YoY). Key takeaways are: i) Bulk of the project awards (at 46%) are from high technology segments like HVDC, STATCOM, GIS, etc where the competition was largely restricted to MNC players. In the recent concall, Alstom T&D stated that the FY15 growth in PGCIL awards will be led by high technology areas; excluding them, the awards will be muted and similar to FY14 levels. ii) Transmission tower project awards stand at INR29b in 1HFY15 (vs INR43b in FY14). Competitive intensity remains stable with 6 bidders averaging in most bids, vs elevated levels of 12-14 bids in FY12.

Emerging new growth areas to support spending

While PGCIL ordering is likely to plateau at ~INR170-200b pa in the medium term, after bouncing back from lows of INR109b in FY14; we believe that there exist upside possibilities from i) **Green Energy Corridors** (investment plan INR425b, Process initiated for Technical and Financial Assistance) and expect initial renewable energy grid project awards in FY15, ii) **Intra-state transmission projects** (as strengthening of the sub-transmission network in the states is an important part of the chain, and the investments during the Eleventh Plan has been just ~45-50% of the requirements) and iii) **Substation automation** (particularly post the blackouts in July 2012) including concentrators / PMUs, FACTS, etc for grid stability. **Desert 2050 Plan** also entails renewable energy addition of 300GW, and transmission spend of INR4.5t, of which INR198b is targeted in the Thirteenth Plan (FY18-22). Another important driver, particularly for large players, is that the share of UHV segment in Twelfth Plan (FY13-17E) is increasing to 30-32% from 5-7% earlier, and given that there are few players prequalified in this segment, the business economics should possibly improve.

1QFY15 revenue growth in positive territory, Margins improving

Un-covered power product companies have reported 15% YoY revenue increase (ttm, as at end 1QFY15); margins have also improved from lows of ~1-1.1% ttm in 1HFY14 to 2.6% in 1QFY15. The margins had peaked at 17-18% in FY08/09 and thus the decline has been substantial, largely led by intense pricing pressure and negative operating leverage. Segmental analysis for the **coverage companies** indicates that ttm revenue growth stood at 12%, and ttm EBIT margins stabilizing at 6.9% (vs peak levels of 15% in FY08/09). With product prices bottoming out and competitive environment becoming more disciplined, margins should improve.

ABB, CRG, Alstom T&D best positioned

We believe that there are multiple levers at play, including increased share of high technology products and also the need to correct under-investments in intra-state transmission / distribution segment. MNC players, particularly **Alstom T&D** (Not Rated) and **ABB India** (Neutral) are best positioned to capture the upsides from high-end products, given the continuous focus on indigenization. **CRG** (Buy) has been expanding its presence in the chain, including 765kva Circuit Breakers, Substation Automation, GIS, etc and also has a market share of 18% in distribution segment in India.

Fulcrum aims to capture and analyze the emerging trends in different sub-segments of the Capital Goods sector. The discussion encompasses various products, companies, and segments that are likely to be impacted or touched by these emerging trends.

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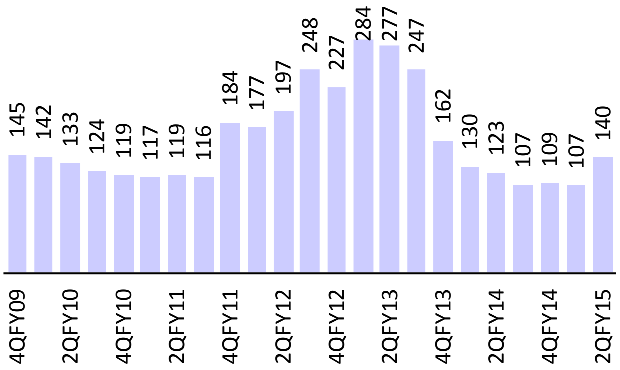
PGCIL project awards improving, led by high technology areas

During 1HFY15, PGCIL's ordering activity has shown meaningful improvement from the lows in FY14, with ordering activity at INR85b (up 59% YoY). While the acceleration has been encouraging, the ttm project awards at INR140b, is still down 50% from peak levels of INR284b (ttm, 1QFY13). Key takeaways are:

- **Order awards led by High technology areas:** Key project awards in 1HFY15 have been: i) Champa - Kurukshetra HVDC order of INR33b to Alstom Grid ii) STATCOM orders of INR4.9b to Siemens AG (first such project award). Thus, incrementally a large part of the ordering is skewed towards high technology projects including HVDC, STATCOMs, WAM, GIS, etc. In the recent concall, Alstom T&D stated that the growth in PGCIL awards in FY15 will be led by high technology areas; excluding them, the awards will be muted and similar to FY14 levels.
- **Transmission tower order awards at INR29b (vs INR43b in FY14), competitive intensity remains stable:** Transmission tower packages project awards stand at INR29b in 1HFY15 (vs INR43b in FY14), and are largely towards private IPPs like Lalitpur (1320MW), NCC Power (1320MW), IL&FS (1200MW), etc. Competitive intensity remains stable with 6 bidders averaging in most bids, vs elevated levels of 12-14 bids in FY12. Most of the companies have been guiding for stable margins in the segment.

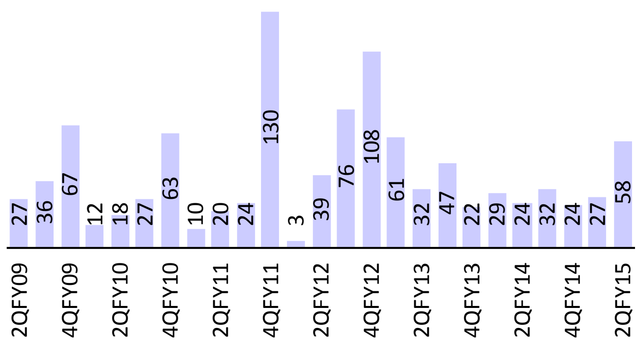
Order awards led by High technology areas

Project Awards (ttm, INR B) have improved from low levels



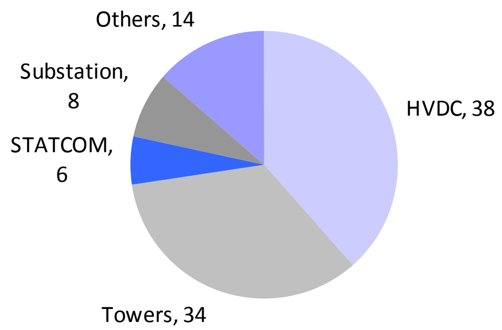
Source: Company, MOSL

1HFY15 awards are up 59% YoY (Quarterly Awards, INR B)



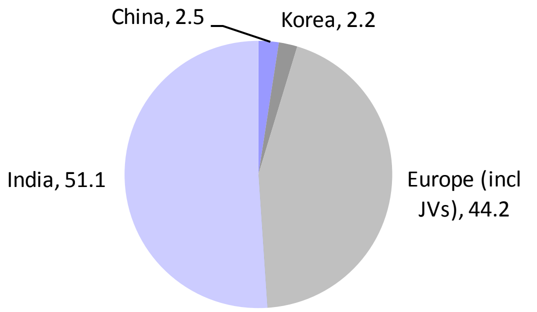
Source: Company, MOSL

1HFY15 Project Awards (ttm, INR B) led by HVDC, Towers and STATCOM orders



Source: Company, MOSL

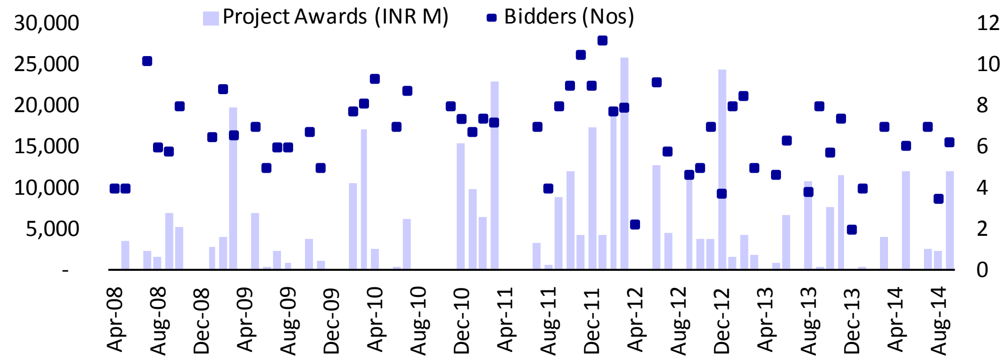
1HFY15 awards largely bagged by European players (for HVDC, STATCOM, etc)



Source: Company, MOSL

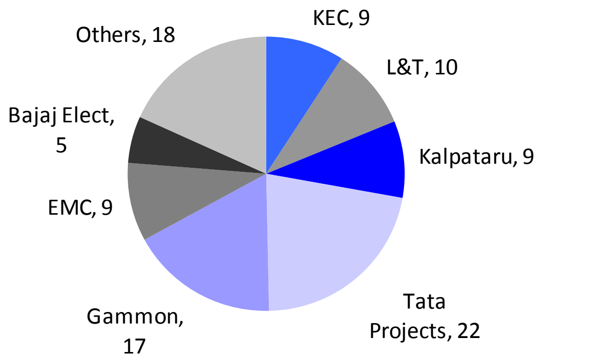
Transmission tower order awards improve, competitive intensity stable

Transmission tower: competitive intensity remains stable with 6 bidders averaging in most bids, v/s elevated levels of 12-14 bids in FY12



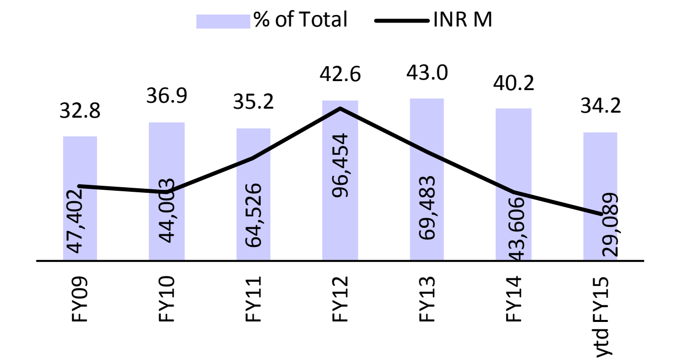
Source: MOSL, Company

1HFY15 Project wins largely by front-line players (% of total)



Source: Company, MOSL

Transmission tower awards at ~35-40% of PGCIL awards

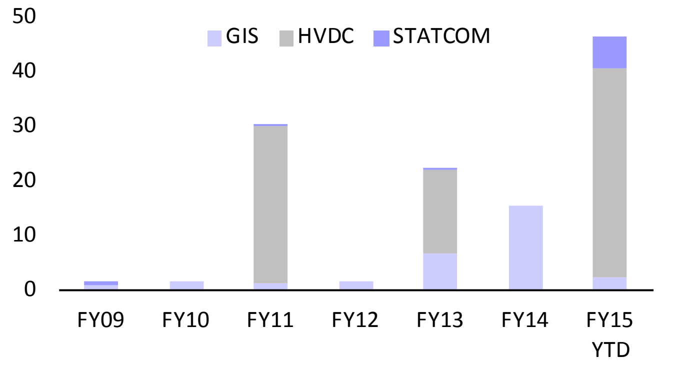


Source: Company, MOSL

Incremental awards led by High technology areas; competition restricted

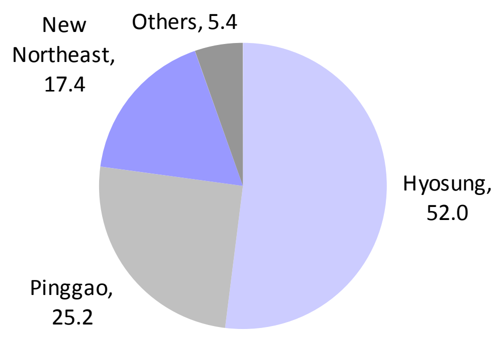
- In **HVDC**, expect Raigarh – Poglur (Tamilnadu, +/-600kv, 4GW) project to be possibly awarded in FY15. In addition, there are few more projects that are expected in next 2-3 years, which includes the 2.5GW West – North Connection and Sri Lanka - India connection. Since FY11, PGCIL has awarded three HVDC projects, aggregating INR111b, with two projects being won by Alstom T&D and one by ABB-BHEL. We understand that the localization levels in both the projects are likely at ~35-45%, given the pre-qualification norms; and the quantum is expected to improve. Bidders for the last project were: ABB, Alstom T&D and BHEL.
- In **STATCOM**, Siemens AG won the first such order for three sub-stations by PGCIL at INR4.9b. ABB in a recent concall had stated that the PGCIL plans to award 12 such projects, with each at ~USD100m; and thus the opportunity pie is significant. PGCIL had rejected the bids of Hyosung, Toshiba, China EPRI Science & Technology and Rongxin Power; and thus the bidders were ABB, Siemens and Alstom T&D.
- **GIS** is also witnessing increased traction, with project awards of INR27b in FY13/14; and another INR1.9b in 1HFY15. Of this, bulk of the orders has been bagged by Korean and Chinese players: with Hyosung (Korea) at INR15b, Pinggao (Korea) INR7b and North East Electric Group (China) INR5b. Alstom T&D has localized GIS manufacturing in India, with the Chennai factory commissioned in FY10. Also, ABB has recently commissioned the GIS factory in November 2013, and supplied the first 420kva GIS in 1QFY15. The company is still not pre-qualified by PGCIL for bidding, with three instances of bids rejected over the last one year.

High Technology Products contribute 46% of 1HFY15 awards (% of total project awards)



Source: Company, MOSL

Market share in GIS project awards wef FY13; dominated by Chinese and Koreans (%)



Source: Company, MOSL

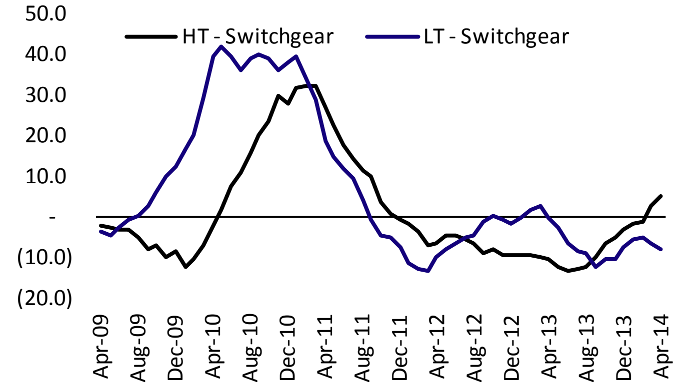
T&D spend to accelerate: SEBs / grid efficiency provide avenues

Emerging new growth areas to support T&D spending

While PGCIL ordering is likely to plateau at ~INR170-200b pa in the medium term, after bouncing back from lows of INR109b in FY14; we believe that there exist upside possibilities from i) Green Energy Corridors (investment plan INR425b, Process initiated for Technical and Financial Assistance) and expect few renewable energy grid project awards in FY15, ii) Intra-state transmission projects (as strengthening of the sub-transmission network in the states is an important part of the chain, and the investments during the Eleventh Plan has been just ~45-50% of the requirements) and iii) Substation automation (particularly post the blackouts in July 2012) including concentrators / PMUs, FACTS, etc for grid stability. Desert 2050 Plan also entails renewable energy capacity addition of 300GW, and transmission spending of INR4.5t, of which INR198b is targeted in the Thirteenth Plan (FY18-22).

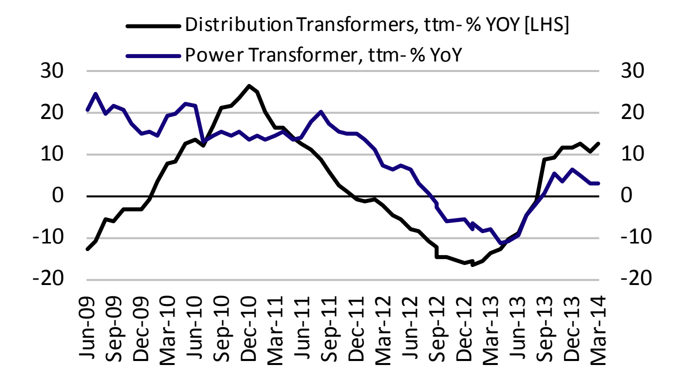
We understand that few of these project awards should possibly accelerate. Several of these projects will necessitate the need for technology up-gradation by Indian companies, while MNC players would benefit on the back of technological edge. In 4QFY14, PGCIL awarded orders for supply of ~1,300 PMUs to Alstom (INR3.6b) and recently awarded STATCOMs for three substations to Siemens (INR4.9b). Another important demand driver, particularly for large players, is that the share of ultra-high voltage segment in the Twelfth Plan is increasing to 30-32% from 5-7% earlier, and given that there are few players prequalified in this segment, the business economics should possibly improve.

HT Switchgears have witnessed traction, led by PGCIL spending (ttm, % YoY)



Source: Company, MOSL

Distribution Transformers growth rates higher than Power Transformers (ttm, % YoY)



Source: Company, MOSL

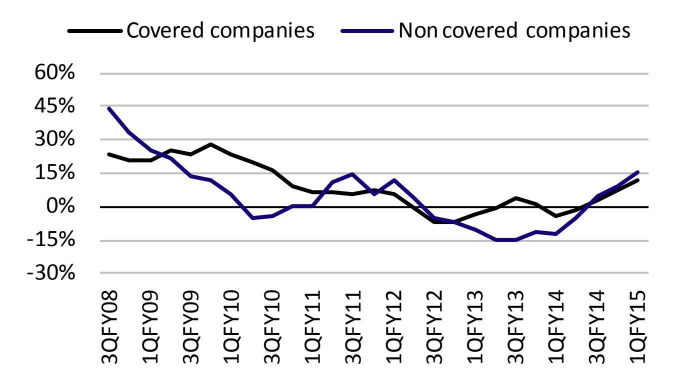
1QFY15 revenue growth in positive territory, Margins improving

- **Un-covered power product companies** have reported a meaningful 15% YoY revenue increase (ttm, as at end 1QFY15) and the growth rates have been building up; ttm margins have also improved from lows of ~1-1.1% in 1HFY14 to 2.6% in 1QFY15. The margins for the un-covered companies had peaked at 17-18% in FY08/09 and thus the decline has been substantial, largely led by intense pricing pressure and negative operating leverage.
- **Segmental analysis for the coverage companies** indicates that ttm revenue growth stood at 12%, and is up meaningfully. Revenue growth is also being

supported by exports, particularly for the coverage companies. In the case of covered companies, the ttm EBIT margins have halved from peak levels of 14.8% in FY08/09 to 6.9% in 1QFY15. This has largely been a function of increased competitive intensity resulting in a fall of 25-30% in transformer prices and poor fixed cost absorption. With prices showing signs of bottoming out and competitive environment becoming more disciplined, the margins are showing signs of stabilization, although at significantly lower levels in comparison to historic peaks.

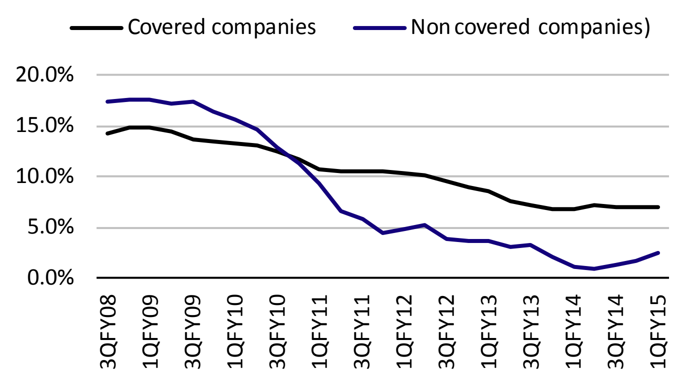
Management commentary has been positive; and the industry should bounce back to a much more normative growth level. Also, transformer prices have stabilized, albeit at lower levels. Competitive intensity is showing signs of moderation given the poor execution track record of new entrants / stringent evaluation by PGCIL including a 2-stage bidding process / decline in participation by Koreans given requirement of domestic manufacturing.

Power products revenues improve, for both coverage and other companies



Source: Company, MOSL

Margins have also shown signs of improvement, albeit at lower levels and are a function of operating leverage



Source: Company, MOSL

Capital Goods: Valuation summary

		M-Cap	CMP	EPS (INR)			P/E			EV/EBITDA			RoE (%)		
Company	**Rating**	**USD**	**INR**	**FY15E**	**FY16E**	**FY17E**	**FY15E**	**FY16E**	**FY17E**	**FY15E**	**FY16E**	**FY17E**	**FY15E**	**FY16E**	**FY17E**
ABB#	Neutral	4.0	1,146	13.0	19.4	30.3	82.3	55.1	35.4	36.7	27.7	19.8	10.0	14.0	19.7
BHEL	Buy	9.0	221	10.2	14.6	19.5	21.4	15.0	11.2	11.2	7.1	4.6	7.3	9.8	12.1
Crompton	Buy	2.2	204	6.4	11.8	16.8	31.9	17.3	12.2	15.9	10.9	7.9	10.5	17.2	20.8
Cummins	Buy	3.1	673	23.3	29.3	37.1	29.6	23.5	18.5	24.0	19.4	16.0	23.6	27.0	30.6
L&T	Buy	22.6	1,460	46.2	64.7	85.4	31.3	22.3	16.9	19.3	15.9	13.0	13.7	14.9	16.0
Siemens##	Sell	4.8	810	8.3	13.8	18.5	99.5	59.4	44.3	44.8	29.5	23.1	7.1	11.3	14.2
Thermax	Buy	1.7	850	20.8	33.1	50.2	41.7	26.2	17.3	24.9	16.4	11.0	11.8	17.2	22.7
Havells	Neutral	2.8	266	9.4	11.7	14.7	28.5	23.0	18.2	17.0	13.8	11.0	29.1	29.7	30.6
Voltas	Buy	1.3	227	9.7	12.8	16.1	24.6	18.5	14.8	20.4	16.4	11.0	12.4	18.1	19.6
Bharat Electronics	Buy	2.7	2,009	120.5	143.6	167.9	16.6	13.9	11.9	11.7	8.9	7.1	12.4	13.3	13.9
KEC International	NR	0.4	103	6.0	9.5	12.3	17.4	10.9	8.5	6.7	5.3	4.4	10.5	14.8	16.7
Alstom T&D*	NR	1.5	333	7.9	11.2	13.7	42.2	29.7	24.3	21.0	16.3	14.0	14.9	18.4	19.3
VA Tech Wabag	Buy	0.7	1,640	51.1	71.1	86.1	32.6	23.4	19.4	15.1	10.5	8.7	14.2	17.1	17.8

Year end December; ## Year end September, Sep 16=FY17, * Bloomberg Estimates

Source: Company, MOSL

NOTES

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