

BLUE STAR

More pain before gain

India Equity Research | Engineering and Capital Goods



We met the Blue Star (BSL) management to get an update on business environment. The overhang of tough macros continues to plague the company as its order intake is likely to plunge a sharp ~25% during the current fiscal. Air conditioner margins continue to bear the brunt of high competitive intensity and increased input costs. We believe there is more pain in store before gain, and expect turnaround to yield results in FY15.

Order intake may decline 25% in FY13E; cost cutting focus to stay

The company expects the sluggish market to exert pressure on new orders. It expects order intake to decline ~25% in FY13E, in turn lowering the order backlog at end FY13. Execution is getting deferred due to client-specific issues. In case of significant delays, BSL is renegotiating with clients to protect margins. The company is likely to speed up its cost cutting drive, as it plans to reduce ~10% of workforce and cut fixed overheads besides trimming total capital employed in the business by ~INR2bn during FY13.

AC demand facing the heat; competitive intensity to remain high

BSL indicated that demand for air conditioners (AC) is under pressure. Interestingly, it stated that demand from smaller cities / town in recent months has shrunk faster. The AC industry continues to face margin pressure due to: (i) currency depreciation (INR/USD), and (ii) high competitive intensity (especially from Japanese players in residential AC). The company is not able to pass on high input cost to consumers. In commercial AC business, BSL is facing delays/deferrals in spending from clients.

Outlook and valuations: Challenging; Not Rated

With BSL facing challenges across business segments, we believe revival is likely to be a time consuming affair with positive results expected only FY15 onwards. The stock is trading at 17.0x and 11.8x consensus earnings for FY13E and FY14E, respectively. We do not have a recommendation on the stock as it is currently not under our coverage.

Financials

Year to March	FY09	FY10	FY11	FY12
Revenues (INR mn)	25,026	25,250	28,589	27,003
Rev. growth (%)	12.7	0.9	13.2	(5.5)
EBITDA (INR mn)	2,596	2,747	2,486	(111)
Net profit (INR mn)	1,803	1,975	1,546	(891)
Share outstanding (mn)	90	90	90	90
EPS (INR)	20.1	22.0	17.2	(9.9)
EPS growth (%)	3.5	9.6	(21.8)	NM
P/E (x)	8.6	7.9	10.1	NM
EV/EBITDA (x)	6.0	5.8	7.3	NM
ROAE (%)	57.2	46.0	29.0	(17.0)

EDELWEISS RATINGS

Absolute Rating NOT RATED

MARKET DATA (R: BLUS.BO, B: BLSTR IN)

CMP	: INR 173
Target Price	: NA
52-week range (INR)	: 263 / 150
Share in issue (mn)	: 89.9
M cap (INR bn/USD mn)	: 16/ 280
Avg. Daily Vol.BSE/NSE('000)	: 326.3

SHARE HOLDING PATTERN (%)

	Current	Q4FY12	Q3FY12
Promoters %	40.1	40.1	40.1
MF's, FI's &	14.0	14.0	13.3
FII's	7.1	6.4	6.6
others	38.8	39.5	40.0
* Promoters pledged shares (% of share in issue)	:	NIL	

RELATIVE PERFORMANCE (%)

	Sensex	Stock	Stock over Sensex
1 month	0.5	(10.2)	(10.6)
3 months	5.8	6.5	0.7
12 months	3.0	(32.6)	(35.7)

Rahul Gajare

+91 22 4063 5561
rahul.gajare@edelcap.com

Amit Mahawar

+91 22 4040 7451
amit.mahawar@edelcap.com

Swarnim Maheshwari

+91 22 4040 7418
swarnim.maheshwari@edelcap.com

September 10, 2012

Intake likely to decline 25% in FY13; focus on cutting cost remains

In the domestic market, tough macros continue to exert pressure on new orders which are hard to come by. BSL indicated that it has seen several deferments in new orders. Management now expects order intake to decline ~25% during the fiscal (against flat estimate earlier), thus leading to lower backlog at FY13 end. While BSL's order momentum from power (NTPC and BHEL only) and IT sector has been strong, orders from hospitals have moderated (along with delays). There have been no enquiries from private sector power players for a while. It has decided to go slow on hotel orders as they involve maximum delays and cost over runs affecting margin. It is looking forward to new orders from Railways (mainly Metro), but expects the same towards FY13 end or early FY14.

Overall, the company has guided for FY13 revenue at FY12 levels and margins at ~4.5-5% even as it expects volatility on quarterly basis. Execution of contracts is getting deferred due to client-specific issues. In case of significant delays, BSL is renegotiating pricing with clients to protect its margins. The company has seen improvement in pricing in new orders (primarily design and build jobs). Barring the top 3-4 players, marginal / fringe players continue to put pressure on margins though. This fact was verified through our recent channel checks with other large MEP players.

Further, in order to work towards margin improvement over the medium term, BSL is expected to speed up its cost cutting drive. It plans to: (1) reduce ~10% of total workforce (mainly in projects' business); (2) reduce fixed overheads; and (3) bring down total capital employed in the business by ~INR2bn during FY13, thus reducing its interest outgo. Management also indicated it is fairly confident of reducing capital employed by INR1.0-1.5bn by FY13.

On the international front, the company is looking at only Qatar market as it looks to scale up its Middle East business. BSL has already completed INR1bn job in Qatar through a JV. Management, however, reiterated that its focus remains on India business. For its equipment business, BSL is looking at tapping the SAARC market.

AC demand facing the heat; competitive intensity to remain high

BSL indicated that demand for ACs is under pressure. Interestingly, demand has shrunk faster in smaller cities / town in recent months. The AC industry continues to face margin pressure on account of: (1) currency depreciation (INR/USD), given over ~50% of components are imported, largely from China; and (2) despite sharp rise in input costs, given high competitive intensity (especially from Japanese players in residential AC), the company is not able to pass on all the cost increases to consumers. In commercial AC business, the company faces delays / deferrals in spending from clients.

The company expects margin dip of 1% during FY13E even as it expect revenue growth of 8-10%. It is looking forward to pick up in volumes during the festive season. BSL will continue to expand its footprint in terms of dealer network. Further, to beat the input cost pressures the company is actively looking at investing in manufacturing facility in India. Case for local manufacturing is further strengthened by technical changes in energy efficiency norms every two years or so which are likely to affect the cost of imports.

Equipment business facing specter of slowdown in industrial capex

The tough macro environment has affected demand. Further, currency depreciation (INR/USD) has moved up the cost of imports northwards aggravating the demand pickup.

Read across for Voltas: Tough times to last longer than envisaged

With incremental orders hard to come, we expect the domestic MEP industry to see lower order intake. While incremental orders are certainly coming at better margins (mainly design and build jobs), fringe players continue to exert downward pressure on margins. In the AC business, high competitive intensity (mainly from Japanese players) is likely to keep pressure on margin intact. Overall, we expect Voltas' both segments to face the heat, with the international business (Dubai market has seen improved traction) being the silver lining. We maintain '**HOLD/ Sector Performer**' on Voltas with target price of INR120.

Company Description

Blue Star is India's largest central air conditioning company over 1,600 dealers and around 2,800 employees and 7 modern manufacturing facilities.

Blue Star primarily focuses on the corporate and commercial markets. These include institutional, industrial and government organisations as well as commercial establishments such as showrooms, restaurants, banks, hospitals, theatres, shopping malls and boutiques. The Company has started pursuing the residential segment with its wide range of sleek and contemporary Room ACs with special focus on smaller cities / towns.

Blue Star has business alliances with world renowned technology leaders such as Rheem Mfg Co, USA; Hitachi, Japan; Eaton - Williams, UK; Thales e-Security Ltd., UK; Jeol, Japan and many others, to offer superior products and solutions to customers

Key Risks

- Any major slowdown in capex spending in India and in economic activity with respect to infrastructure creation in India is likely to dry incremental order intakes for its EMP division.
- The profitability of its cooling product division is vulnerable to rise in input costs, increase in Chinese imports, excess capacity and increased competitive intensity.

Financial Statements

Income statement					(INR mn)
Year to March	FY08	FY09	FY10	FY11	FY12
Income from operations	22,216	25,026	25,250	28,589	27,003
Direct costs	16,909	18,743	18,821	20,432	20,858
Employee costs	1,544	1,823	1,849	2,061	2,069
Other expenses	1,532	1,865	1,833	3,610	4,186
Total operating expenses	19,985	22,430	22,503	26,103	27,113
EBITDA	2,230	2,596	2,747	2,486	(111)
Depreciation and amortisation	220	259	347	317	314
EBIT	2,011	2,337	2,400	2,169	(425)
Interest expenses	76	173	85	244	703
Other income	485	218	311	340	243
Profit before tax	2,420	2,382	2,627	2,265	(884)
Provision for tax	679	580	651	719	7
Core profit	1,741	1,803	1,975	1,546	(891)
Extraordinary items	0	0	140	4	0
Reported net profit	1,741	1,803	2,115	1,550	(891)
Adjusted net profit	1,741	1,803	1,975	1,546	(891)
EPS (INR) basic	19.4	20.1	22.0	17.2	9.9
Diluted equity shares (mn)	90	90	90	90	90
EPS (INR) fully diluted	19.4	20.1	22.0	17.2	(9.9)
CEPS (INR)	21.5	23.2	25.6	20.8	(6.4)
Dividend payout (%)	36.2	34.9	36.4	40.7	(10.1)

Common size metrics- as % of net revenues

Year to March	FY08	FY09	FY10	FY11	FY12
Direct cost	76.1	74.9	74.5	71.5	77.2
Employee expenses	7.0	7.3	7.3	7.2	7.7
S G & A expenses	6.9	7.5	7.3	12.6	15.5
Operating expenses	90.0	89.6	89.1	91.3	100.4
Depreciation and amortization	1.0	1.0	1.4	1.1	1.2
Interest expenditure	0.3	0.7	0.3	0.9	2.6
EBITDA margins	10.0	10.4	10.9	8.7	(0.4)
EBIT margins	9.1	9.3	9.5	7.6	(1.6)
Net profit margins	7.8	7.2	7.8	5.4	(3.3)

Growth metrics (%)

Year to March	FY08	FY09	FY10	FY11	FY12
Revenues	39.3	12.7	0.9	13.2	(5.5)
EBITDA	102.4	16.4	5.8	(9.5)	NM
PBT	161.3	(1.6)	10.3	(13.8)	NM
Net profit	144.5	3.5	9.6	(21.8)	NM
EPS	144.5	3.5	9.6	(21.8)	NM

Balance sheet					
(INR mn)					
As on 31st March	FY08	FY09	FY10	FY11	FY12
Equity capital	180	180	180	180	180
Reserves & surplus	2,456	3,491	4,737	5,555	4,559
Shareholders funds	2,635	3,671	4,917	5,735	4,739
Secured loans	363	273	601	2,046	1,152
Unsecured loans	2	0	59	2,138	2,280
Borrowings	365	273	660	4,184	3,432
Defered tax liability	36	6	(15)	(7)	0
Sources of funds	3,036	3,950	5,562	9,912	8,171
Gross block	2,726	3,325	3,519	3,741	4,271
Depreciation	1,348	1,449	1,542	1,810	2,088
Net block	1,377	1,876	1,977	1,931	2,183
Capital work in progress	181	248	26	285	190
Total fixed assets	1,558	2,124	2,003	2,215	2,374
Investments	46	44	42	1,018	1,214
Inventories	2,735	2,081	2,580	4,006	4,372
Sundry debtors	4,837	6,086	6,282	7,786	7,653
Cash and equivalents	27	92	204	465	508
Loans and advances	2,588	1,255	1,314	1,362	975
other current assets		871	3,608	4,725	3,411
Total current assets	10,187	10,385	13,989	18,344	16,919
Sundry creditors and others	6,347	7,521	9,312	10,643	11,803
Provisions	2,409	1,081	1,160	1,023	533
Total CL & provisions	8,755	8,602	10,472	11,666	12,335
Net current assets	1,432	1,782	3,516	6,678	4,583
Uses of funds	3,036	3,950	5,562	9,912	8,171
Adjusted BV per share (INR)	29	41	55	64	53

Free cash flow					
(INR mn)					
Year to March	FY08	FY09	FY10	FY11	FY12
Net profit	1,741	1,803	2,115	1,550	(891)
Depreciation	220	259	347	317	314
Deferred tax	(29)	24	(21)	8	0
Others	(202)	189	(9)	207	745
Gross cash flow	1,730	2,274	2,433	2,082	168
Less: Changes in WC	391	379	1,522	2,833	(2,436)
Operating cash flow	1,338	1,896	911	(752)	2,604
Less: Capex	1,125	851	239	502	523
Free cash flow	214	1,045	672	(1,254)	2,081

Cash flow metrics					
Year to March	FY08	FY09	FY10	FY11	FY12
Operating cash flow	1,338	1,896	911	(752)	2,604
Financing cash flow	(605)	(998)	(689)	2,445	(1,876)
Investing cash flow	(752)	(841)	(112)	(1,430)	(682)
Net cash flow	(19)	57	110	263	46
Capex	(1,125)	(851)	(239)	(502)	(523)
Dividends paid	(80)	(736)	(736)	(839)	(729)

Profitability & liquidity ratios

Year to March	FY08	FY09	FY10	FY11	FY12
ROAE (%) (on adjusted profits)	73.1	57.2	46.0	29.0	(17.0)
ROACE (%)	66.8	67.8	50.9	30.1	(5.4)
Debtors days	69	80	89	90	104
Inventory days	50	47	45	59	73
Fixed assets t/o (x)	17.6	15.4	13.1	14.6	13.1
Debt/equity (x)	0.1	0.1	0.1	0.7	0.7
Interest coverage (x)	26.6	13.6	28.4	8.9	(0.6)
Payable days	115	135	163	178	196
Cash conversion cycle	4	(8)	(29)	(30)	(19)
Current ratio	1.2	1.2	1.3	1.6	1.4

Operating ratios (x)

Year to March	FY08	FY09	FY10	FY11	FY12
Total asset turnover	7.3	7.2	5.3	3.7	3.0
Fixed asset turnover	17.6	15.4	13.1	14.6	13.1
Equity turnover	9.3	7.9	5.9	5.4	5.2

Valuations parameters

Year to March	FY08	FY09	FY10	FY11	FY12
Diluted EPS (INR)	19.4	20.1	22.0	17.2	(9.9)
Y-o-Y growth (%)	144.5	3.5	9.6	(21.8)	NM
CEPS	21.5	23.2	25.6	20.8	(6.4)
Diluted P/E (x)	8.9	8.6	7.9	10.1	NM
Price/BV (x)	5.9	4.2	3.2	2.7	3.3
EV/Sales (x)	0.7	0.6	0.6	0.6	0.6
EV/EBITDA (X)	7.1	6.0	5.8	7.3	NM
Dividend yield (%)	4.0	4.0	4.6	4.0	0.6

Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
ABB India	REDUCE	SU	L	AIA Engineering	HOLD	SU	M
Bajaj Electricals	BUY	SO	M	BGR Energy Systems	HOLD	SP	M
Bharat Heavy Electricals	HOLD	SP	L	Crompton Greaves	BUY	SO	M
Cummins India	HOLD	SP	L	Havell's India	BUY	SO	M
Jyoti Structures	HOLD	SP	M	Kalpataru Power Transmission	HOLD	SP	M
KEC International	HOLD	SP	M	Larsen & Toubro	BUY	SO	M
Siemens	BUY	SO	L	Techno Electric & Engineering	BUY	SO	M
Thermax	HOLD	SP	L	Voltamp Transformers	REDUCE	SU	M
Voltas	HOLD	SP	L				

ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

Edelweiss
Ideas create, values protect

Edelweiss Securities Limited, Edelweiss House, off C.S.T. Road, Kalina, Mumbai – 400 098.

Board: (91-22) 4009 4400, Email: research@edelcap.com

Vikas Khemani	Head Institutional Equities	vikas.khemani@edelcap.com	+91 22 2286 4206
Nischal Maheshwari	Co-Head Institutional Equities & Head Research	nischal.maheshwari@edelcap.com	+91 22 4063 5476
Nirav Sheth	Head Sales	nirav.sheth@edelcap.com	+91 22 4040 7499

Coverage group(s) of stocks by primary analyst(s): Engineering and Capital Goods

ABB India, AIA Engineering, BGR Energy Systems, Bharat Heavy Electricals, Bajaj Electricals, Crompton Greaves, Havell's India, Jyoti Structures, KEC International, Cummins India, Kalpataru Power Transmission, Larsen & Toubro, Siemens, Techno Electric & Engineering, Thermax, Voltamp Transformers, Voltas

Recent Research

Date	Company	Title	Price (INR)	Recos
04-Sep-12	KEC International	Changing course; time to BUY; <i>Visit Note</i>	55	Buy
24-Aug-12	Bharat Electronics	Sustaining ace defence play tag ; <i>Visit Note</i>	1,258	Buy
21-Aug-12	Engineering & Capital Goods	Expectations Galore; <i>Monthly Update</i>		

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	104	60	18	183
* 1 stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	114	58	11	

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

DISCLAIMER

General Disclaimer:

This document has been prepared by Edelweiss Securities Limited (Edelweiss). Edelweiss, its holding company and associate companies are a full service, integrated investment banking, portfolio management and brokerage group. Our research analysts and sales persons provide important input into our investment banking activities. This document does not constitute an offer or solicitation for the purchase or sale of any financial instrument or as an official confirmation of any transaction. The information contained herein is from publicly available data or other sources believed to be reliable, but we do not represent that it is accurate or complete and it should not be relied on as such. Edelweiss or any of its affiliates/ group companies shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. This document is provided for assistance only and is not intended to be and must not alone be taken as the basis for an investment decision. The user assumes the entire risk of any use made of this information. Each recipient of this document should make such investigation as it deems necessary to arrive at an independent evaluation of an investment in the securities of companies referred to in this document (including the merits and risks involved), and should consult his own advisors to determine the merits and risks of such investment. The investment discussed or views expressed may not be suitable for all investors. We and our affiliates, group companies, officers, directors, and employees may: (a) from time to time, have long or short positions in, and buy or sell the securities thereof, of company (ies) mentioned herein or (b) be engaged in any other transaction involving such securities and earn brokerage or other compensation or act as advisor or lender/borrower to such company (ies) or have other potential conflict of interest with respect to any recommendation and related information and opinions. This information is strictly confidential and is being furnished to you solely for your information. This information should not be reproduced or redistributed or passed on directly or indirectly in any form to any other person or published, copied, in whole or in part, for any purpose. This report is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject Edelweiss and affiliates/ group companies to any registration or licensing requirements within such jurisdiction. The distribution of this document in certain jurisdictions may be restricted by law, and persons in whose possession this document comes, should inform themselves about and observe, any such restrictions. The information given in this document is as of the date of this report and there can be no assurance that future results or events will be consistent with this information. This information is subject to change without any prior notice. Edelweiss reserves the right to make modifications and alterations to this statement as may be required from time to time. However, Edelweiss is under no obligation to update or keep the information current. Nevertheless, Edelweiss is committed to providing independent and transparent recommendation to its client and would be happy to provide any information in response to specific client queries. Neither Edelweiss nor any of its affiliates, group companies, directors, employees, agents or representatives shall be liable for any damages whether direct, indirect, special or consequential including lost revenue or lost profits that may arise from or in connection with the use of the information. Past performance is not necessarily a guide to future performance. The disclosures of interest statements incorporated in this document are provided solely to enhance the transparency and should not be treated as endorsement of the views expressed in the report. Edelweiss Securities Limited generally prohibits its analysts, persons reporting to analysts and their dependents from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover. The information provided in these documents remains, unless otherwise stated, the copyright of Edelweiss. All layout, design, original artwork, concepts and other Intellectual Properties, remains the property and copyright Edelweiss and may not be used in any form or for any purpose whatsoever by any party without the express written permission of the copyright holders. Edelweiss might be engaged or may seek to do business with companies covered in its research. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should take informed decision and use this document for assistance only and must not alone be taken as the basis for their investment decision.

Analyst Certification:

The analyst for this report certifies that all of the views expressed in this report accurately reflect his or her personal views about the subject company or companies and its or their securities, and no part of his or her compensation was, is or will be, directly or indirectly related to specific recommendations or views expressed in this report.

Analyst holding in the stock: No.

Additional Disclaimer for U.S. Persons

This research report is a product of Edelweiss Securities Limited, which is the employer of the research analyst(s) who has prepared the research report. The research analyst(s) preparing the research report is/are resident outside the United States (U.S.) and are not associated persons of any U.S. regulated broker-dealer and therefore the analyst(s) is/are not subject to supervision by a U.S. broker-dealer, and is/are not required to satisfy the regulatory licensing requirements of FINRA or required to otherwise comply with U.S. rules or regulations regarding, among other things, communications with a subject company, public appearances and trading securities held by a research analyst account.

This report is intended for distribution by Edelweiss Securities Limited only to "Major Institutional Investors" as defined by Rule 15a-6(b)(4) of the U.S. Securities and Exchange Act, 1934 (the Exchange Act) and interpretations thereof by U.S. Securities and Exchange Commission (SEC) in reliance on Rule 15a 6(a)(2). If the recipient of this report is not a Major Institutional Investor as specified above, then it should not act upon this report and return the same to the sender. Further, this report may not be copied, duplicated and/or transmitted onward to any U.S. person, which is not the Major Institutional Investor.

In reliance on the exemption from registration provided by Rule 15a-6 of the Exchange Act and interpretations thereof by the SEC in order to conduct certain business with Major Institutional Investors, Edelweiss Securities Limited has entered into an agreement with a U.S. registered broker-dealer, Marco Polo Securities Inc. ("Marco Polo").

Transactions in securities discussed in this research report should be effected through Marco Polo or another U.S. registered broker dealer.

Copyright 2009 Edelweiss Research (Edelweiss Securities Ltd). All rights reserved

Access the entire repository of Edelweiss Research on www.edelresearch.com