

## **Thermax Ltd**

**CMP: Rs 80.30**

**Price Target Of Rs. 125 (12 months)**

- Order backlog of Rs 251 crore including Rs 90 crore order from Shree Cement for captive power plant. The order is to be executed by December-02.
- The completion schedule of Shree Cement order will result in no profit booking in FY'02. Almost the entire profit will be booked in Q2'03 & Q3'03.
- Better management of financial portfolio will result in no additional provision in Q4'02. For the period ended December-01, provision of Rs 5 crore has been made-PBT & Extra-ordinary items for the period is Rs 5.69 crore. In FY'01, provision for decline in value of investments (Rs 12.48 crore) was more than the income from financial assets. **Non-provision for decline in value of investments will boost EPS by Rs 2.15.**
- Retired 250 employees through VRS. The employee cost is expected to come down from 13.7% of sales in FY'01 to 12.3% in FY'02 and 10.5% in FY'03.
- The focus on cost reduction has started paying off. Material cost is lower by 2 percentage points (on 9 months basis). The focus is on bulk sourcing and restricting number of vendors per product to not more than 3.
- The stock is trading at 5.3 X FY'03 EPS. As of now, except for Shree Cement order, the order backlog shows no improvement. However, considering the cost reduction based turnaround, we rate the stock **Market Outperformer** with price target of Rs 120.

### **Investment Argument & Valuation**

Thermax is a strong turnaround story driven by cost reduction and one large order, which will be completed in FY'03. Net of Shree Cement order (Rs 90 crore), the order book is flat. We have not used the cash per share theory to value the stock, as it does not make sense in our opinion. The investment portfolio accounted for almost 40 % of the Balance Sheet size in FY'01 & contributed negatively to the P&L Account. If cash is not deployed effectively, no point in getting excited about cash rich nature of the company.

As of now, net of Shree Cement order, the order backlog is flat. We have not factored in any improvement in order inflow and thereby order backlog. However, the visibility is very clear till FY'03 based on order completion schedule.

Despite the cost reduction measures, due to no visibility in order book beyond FY'03, we believe that stock will enjoy low discounting. Considering that profit booking on Shree Cement order will get reflected in Q2'03 & Q3'03 and because of the low base, we believe that stock should not quote at P/E of more than 8.



Even then the stock is undervalued and offers upside potential of almost 50 % in one year. We rate the stock Outperformer.

### ***Shree Cement order is the key***

It is the first order received by the co-gen division of Thermax in almost 3 years. The captive power plant will be the first in India to use pet coke as fuel and will generate power at a cost-30 percent cheaper than the grid cost. The order is due for completion in 16 months from zero date-in December 2002. The completion schedule will result in almost the entire order booking in Q2'03 & Q3'03.

### ***Q4'02 will provide the first trigger***

Thermax does not publish Q4 results separately but in the first three quarters of FY'01, no provision for decline in value of investments was made. In FY'01, Thermax made a provision of Rs 12.48 crore. In FY'02, provision of Rs 5 crore has already been made and there is little possibility of any additional provision. It will result in lower provisioning and thereby higher PAT (on y-o-y basis) by Rs 7.48 crore and provision for decline in value of investment does not result in any tax benefit.

### ***Cash Per share theory does not make sense***

We do not subscribe the theory of using market value of the investment portfolio of Thermax as valuation tool. Rather than cash on hand, what matters more is the utilization of cash. Because of the provision made for decline in value of investment, the actual return on financial assets was negative. Secondly, major portion of the investment portfolio is in Income funds and the dividend declared by income funds is taxable effective from FY'03, thus the effective return will be lower. Third, Thermax has limited use for the funds deployed in financial assets except to declare higher dividend so as to maintain the post tax return for its shareholders. Even in that case, dividend yield is not attractive and in our opinion stocks are not bought purely for dividend yield.

### ***Balance sheet is clean ...***

Thermax is one of the few companies to provide for decline in value of investments (Rs 5 crore in FY'02, Rs 12.48 crore in FY'01 and Rs 8.31 crore in FY'00) though it is not tax deductible and AS-13 offers option not to provide for the same. Bad debt w/off in FY'01 (till then forming part of Notes to Accounts) had resulted in higher loss by Rs 2.18 crore.

### ***... and virtually debt free***

The debt: equity ratio is low at 0.12:1 and the cost of debt is less than 10%. Considering the cash generated and with virtually no capex, we do not believe that the status will change. Debt consists primarily of working capital loan and commercial paper and considering the interest rate scenario; the cost of funds will only come down.



***VRS will result in tax cover and lower employee cost***

Post VRS given in Q3'02 (according to management, there are no plans for any more VRS), we expect the employee cost to come down from 13.7% of sales in FY'01 to 10.5% in FY'03. The VRS is written off over a period of 3 years (against 5 years as required under Income Tax Act) resulting in deferred tax credit for the company.

***Energy Business continues to remain concern***

Energy division of Thermax accounts for 21.7% of capital employed as against 19.3% employed by Environment division. Rest cannot be attributed to either of the division as Investment alone accounts for 40% of total capital employed.

The segment wise results reveal that Environmental division is more profitable than energy division. EBIT margin of environmental division for the period ended December 2001 was 10.65% against 1.7 percent of Energy division. The margins have remained in the same range throughout 2001. It is clear that the energy division has been a burden on the company. No break-up of order backlog is available but our estimate that it continues to remain skewed in favour of energy division.

With no major orders except Shree Cement order in the pipeline for energy division, we believe that energy division will continue to remain a drag on the company.

**Thermax is not a valuation play, at least not till FY'03 considering the poor margins enjoyed by both the divisions. It is nowhere near managing RoCE equal to its cost of capital. It is a trading opportunity to capitalize on successive four excellent quarters.**

<b>P&amp;L Account</b>					
	<b>98-99</b>	<b>99-00</b>	<b>00-01</b>	<b>01-02(E)</b>	<b>02-03(E)</b>
<b>Sales</b>	4660.32	4059.17	4726.00	4405.06	5155.06
<b>Operating Cost</b>	4429.57	4337.02	4965.90	4210.49	4682.10
<b>Other Income</b>	415.80	921.36	318.60	302.00	302.00
<b>Operating Profit (Excluding O. Income)</b>	230.75	-277.85	-239.90	194.57	472.96
<b>EBIDTA</b>	646.55	643.51	78.70	496.57	774.96
<b>Interest</b>	46.76	33.36	37.00	37.20	37.20
<b>Gross Profit</b>	<b>599.79</b>	<b>610.15</b>	<b>41.70</b>	<b>459.37</b>	<b>737.76</b>
<b>Depreciation</b>	101.68	123.65	117.10	121.70	142.38
<b>Extra-Ordinary Income/(Expenses)</b>	0.00	-63.30	-29.30	-82.70	-82.70
<b>Profit before Tax</b>	498.11	423.20	-104.70	254.97	512.68
<b>Tax</b>	115.00	100.00	27.50	74.42	153.80
<b>Profit after Tax</b>	<b>383.11</b>	<b>323.20</b>	<b>-132.20</b>	<b>180.55</b>	<b>358.87</b>
<b>Equity Capital</b>	232.50	<b>232.50</b>	<b>232.50</b>	<b>232.50</b>	232.50
<b>EPS (Rs)</b>	<b>16.48</b>	<b>13.90</b>	<b>N.A.</b>	<b>7.77</b>	15.44
<b>Book Value</b>	145.65	152.87	150.74	153.18	163.12
<b>Dividend per Share</b>	<b>3.50</b>	<b>3.50</b>	<b>3.50</b>	<b>5.10</b>	<b>5.10</b>

<b>Balance Sheet</b>					
	<b>98-99</b>	<b>99-00</b>	<b>00-01</b>	<b>01-02(E)</b>	<b>02-03(E)</b>
Equity Capital	232.48	232.50	232.50	232.50	232.50
Free Reserves	3239.23	3471.92	3314.08	3375.98	3616.21
<b>Net Worth</b>	<b>3471.71</b>	<b>3704.42</b>	<b>3546.58</b>	<b>3608.48</b>	<b>3848.71</b>
<b>Debt</b>	<b>166.43</b>	<b>385.96</b>	<b>425.28</b>	<b>425.28</b>	<b>425.28</b>
<b>Total Capital Employed</b>	<b>3638.14</b>	<b>4090.38</b>	<b>3971.86</b>	<b>4033.76</b>	<b>4273.99</b>
Gross Block	1609.40	1670.26	1680.64	1780.64	1880.64
Less: Depreciation	531.42	621.97	711.70	833.40	975.78
Net Block	1077.98	1048.29	968.94	947.24	904.86
Capital WIP	43.76	42.57	20.22	20.22	20.22
Investments	1134.17	1606.44	1582.00	1730.15	1751.75
<b>Current Assets, Loans &amp; Advances</b>	<b>2449.03</b>	<b>2577.26</b>	<b>2542.14</b>	<b>2612.55</b>	<b>2728.56</b>



Debtors	1005.50	1084.50	1113.52	1157.84	1171.43
Stock in Trade	540.45	547.05	521.88	484.07	566.49
Cash & Bank Balance	204.65	255.76	191.86	255.76	275.76
Other Current Assets	91.10	71.27	96.07	96.07	96.07
Loans & Advances	607.33	618.68	618.81	618.81	618.81
<b>Current Liabilities &amp; Provision</b>	<b>1152.51</b>	<b>1334.34</b>	<b>1183.26</b>	<b>1323.50</b>	<b>1187.58</b>
Liabilities	1058.27	1228.08	1137.37	1184.58	1048.66
Provisions	94.24	106.26	45.89	138.92	138.92
<b>Net Current Assets</b>	<b>1296.52</b>	<b>1242.92</b>	<b>1358.88</b>	<b>1289.05</b>	<b>1540.98</b>
<b>Misc. Expenditure</b>	<b>85.72</b>	<b>150.15</b>	<b>41.82</b>	<b>47.11</b>	<b>56.18</b>
(To the extent not w/off)					
<b>Total Capital Employed</b>	<b>3638.14</b>	<b>4090.38</b>	<b>3971.86</b>	<b>4033.76</b>	<b>4273.99</b>

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