

India Ratings Downgrades Bharat Heavy Electricals to 'IND AA+'; Off RWN; Outlook Negative

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By Vivek Jain

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India Ratings and Research (Ind-Ra) has downgraded Bharat Heavy Electricals Limited's (BHEL) Long-Term Issuer Rating to 'IND AA+' from 'IND AAA'. Simultaneously, all ratings have been removed from Rating Watch Negative (RWN) and a Negative Outlook has been assigned to all Long-term ratings. A full list of rating actions is at the end of this commentary.

The removal of RWN follows the completion of the ongoing evaluation of BHEL's key business parameters.

KEY RATING DRIVERS

Revenue Declined: BHEL's revenue declined by 47% over FY13-FY16 because of low order intake over FY12-FY15 and the presence of slow-moving projects worth nearly INR500bn in its order book in FY16. According to provisional FY16 financials, revenue declined 15% yoy to INR251bn, as against Ind-Ra's expectation of revenue growth in FY16. The Negative Outlook reflects Ind-Ra's expectations of a further revenue decline over FY17, if issues related to the slow-moving order book are not resolved. BHEL has been looking at diversifying its revenue base into areas such as defence, water, transportation, transmission and industrial products, to lower its dependence on the power sector. During FY16, BHEL commissioned 15GW, up 26% yoy, which is likely to aid revenue generation and debtor reduction.

More Slow-Moving Projects in Order Book: BHEL's order book grew 9% yoy to INR1,107bn in FY16. However, nearly INR500bn (45%) of the order book (compared with INR250bn at FYE15) comprises slow-moving projects, thus putting pressure on revenue visibility. Slow-moving orders are generally characterised by the lack of environmental clearances and financing issues at the client side. Three slow-moving orders – Yadadri and Bhadradi projects by Telangana State Power Generation Corporation Limited and the Ennore SEZ project by Tamil Nadu Generation and Distribution Corporation Limited (TSGenco) – accounted for 27% of its FY16 order book. Management expects to resolve the issues related to the slow-moving orders soon so that they can contribute to the revenue from FY17.

Order Inflow Improved: BHEL's annual order inflow increased 42% yoy to INR437bn in FY16, compared with muted order inflows (worth INR220bn-INR320bn) over FY12-FY15. The FY16 orders were particularly aided by the INR179bn order for 5X800MW power plants in the Yadadri project by TSGenco. However, during FY16 the company also recorded order cancellations worth INR70bn; thus, the net order inflow stood at INR363bn. Ind-Ra expects BHEL's

order inflow to remain between INR350bn-INR400bn in FY17, aided by the 12GW worth of orders in which the company is favourably placed. BHEL also expects the government of India's initiatives of setting up ultra mega power projects in the 'plug and play' mode to improve the overall market for the company. Also, Central Electricity Authority has directed to take up the renovation and modernisation/replacement of 30GW-40GW of old state projects and retire 8GW capacity on account of inefficiency, which could provide additional opportunity to BHEL.

EBITDA Margins Turned Negative: BHEL's EBITDA margin fell to negative 7.8% in FY16 (FY15: 7.1%; FY14: 11.8%), given the 15% revenue decline and the high operating leverage in the business in the form of fixed employee expenses at nearly INR55bn. Although BHEL does not plan to recruit additional manpower over the medium term and reduced its staff strength over FY12-FY16, the wage revision impact is likely to be visible beginning 4QFY17, with the full effects visible in FY18. Debtor and inventory provisions amounting to INR10.7bn and INR1.2bn, respectively, also led to the decline in BHEL's EBITDA margins. Excluding the provisions, its EBITDA margins would have been negative 2.7% in FY16.

During FY16, BHEL's gross margin also declined 530bps yoy to 37% on account of its low-gross-margin supercritical projects, which had to be executed under a joint deed of undertaking. As most of its orders would be supercritical, BHEL's ability to win such contracts without the joint deed of undertaking clause would hold the key to improvement in its gross margins. Ind-Ra expects EBITDA margins to turn marginally positive in FY17 driven by a revenue increase and higher gross margins.

Comfortable Liquidity: BHEL's cash balances remained healthy during FY16 at INR101bn (FY15: INR98bn), which provides sufficient liquidity to tide it over its current situation. Additionally, the company has access to fund-based limits of INR50bn.

Debtors Days Remain High: BHEL's accounts receivable declined 5% yoy to INR356bn at FYE16 and 6% yoy to INR376bn at FYE15, despite a 15% and 23% yoy revenue decline during FY16 and FY15, respectively. Of the INR20bn decline in accounts receivable, INR11bn has been on account of the provisions undertaken by the company. Its debtor days increased to 507 in FY16 from 455 in FY15. BHEL has been actively following up with its customers for the release of payments and in some cases, has withheld supplies/services to projects under financial stress.

Government Ownership: The ratings factor in the support BHEL could receive from the government of India on account of the latter's ownership in the company (63.06% at FYE16) as well as BHEL's strategic importance in India's power sector value chain. Its operational linkages with the government are reflected in its ability to secure orders from central and state utilities.

RATING SENSITIVITIES

Negative: Any significant debt-led investment or acquisition and/or a significant decline in order inflow, leading to a further decline in the revenue, and/or non-improvement in the EBITDA margins and/or an increase in the working capital cycle could lead to a negative rating action.

Revision of Outlook: An improvement in the revenue and/or operating margins, along with an improvement in the working capital cycle, could result in the Outlook being revised to Stable.

COMPANY PROFILE

BHEL is engaged in the design, engineering, manufacture, construction and testing of a wide range of products and services for power plants, transmission systems, transportation works, renewable energy units, oil and gas facilities and defence services. The company operates 17 manufacturing facilities and two repair units with a total manufacturing

capacity of 20,000MW. BHEL reported EBITDA of negative INR20bn (INR21bn) and profit after tax of negative INR9bn (INR14bn).

BHEL's ratings:

- Long Term Issuer Rating: downgraded to 'IND AA+' / Negative from 'IND AAA'; off RWN
- INR550bn non-fund-based limits: downgraded to Long-term 'IND AA+' / Negative from 'IND AAA' and affirmed at Short-term 'IND A1+'; off RWN
- INR50bn fund-based limits: downgraded to Long-term 'IND AA+' / Negative from 'IND AAA' and affirmed at Short-term 'IND A1+'; Off RWN

SOLICITATION DISCLOSURES

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Rating Outstanding

(As on 01/Sep/2016)

Long Term Issuer Rating	IND AA+ / Negative	
Fund Based Working Capital Limit	IND A1+ / Rating Watch Off	INR 50000 m
Fund Based Working Capital Limit	IND AA+ / Negative	INR 50000 m
Non-Fund Based Working Capital Limit	IND AA+ / Negative	INR 550000 m
Non-Fund Based Working Capital Limit	IND A1+ / Rating Watch Off	INR 550000 m

Applicable Criteria

Corporate Rating Methodology

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