

Company Results Review

29 January 2007 | 9 pages

Suzlon Energy Ltd (SUZL.BO)

Sell: Margin Contraction Mutes Strong Sales Growth

- Profits up 29% YoY** — 3QFY07 PAT at Rs1.74bn was up a sedate 29% despite 117% sales growth on account of a 373bps margin contraction. Sales were driven by a 49% YoY growth in volumes and 11% YoY increase in WTG realizations.
- Margins contract 361bps** — PAT growth was muted on account of lower WTG EBITDA margins of 13.9% (down 361bps YoY) caused by (1) Sales volumes not absorbing the cost of capacity expansion (staff and overheads) (2) Higher freight costs on account of a significant increases in export MW at 149MW in 3QFY07 vis-à-vis 24MW in 3QFY06. Hansen EBITDA margins contracted 238bps QoQ.
- FY07E management guidance** — Management has guided for MW Sales of 1500-1600MW (CIR Estimates 1600MW), EBITDA margins of 20-22% (CIR estimates 19.5%) and Hansen EBITDA margins of 14% (CIR estimates of 15%).
- Order backlog remains strong** — WTG business ended 3QFY07 with an order backlog (OB) of Rs77.1bn (1643MW) comprising (1) Domestic OB of Rs15.4bn (372MW) and (2) Export OB of Rs61.7bn (1271MW). Key large order wins in the quarter included (1) 88.2MW - TrustPower (2) 40MW - from BP (3) 25MW - Tata Power (4) 55MW - Vijay Anand Roadlines and (5) 40MW – HPCL.
- Maintain Sell/Medium Risk** — YoY margin contraction should continue in 4QFY07E and in FY08E as (1) exports increase (particularly to the US) and (2) capacity expansion leads to staff costs and overheads not getting absorbed proportionately. Maintain Sell/Medium Risk.

Sell/Medium Risk	3M
Price (29 Jan 07)	Rs1,204.75
Target price	Rs1,137.00
Expected share price return	-5.6%
Expected dividend yield	0.5%
Expected total return	-5.1%
Market Cap	Rs346,685M
	US\$7,849M

Price Performance (RIC: SUZL.BO, BB: SUEL IN)



Figure 1. Suzlon Statistical Abstract

Year to	SUEL EPS	EPS Growth	SUEL P/E (x)	SUEL ROE (%)	Div. Yield (%)	SUEL + H EPS (x)	EPS Growth (%)	SUEL + H P/E (x)	Suel + H EV/E (X)
31-Mar	(Rs)	(%)	(x)	(%)	(%)	(x)	(%)	(x)	(X)
2005A	42.04	-12.8%	28.7	22.8	63.9%	0.3%	42.04	-12.8%	28.7
2006A	26.22	-37.6%	46.0	38.5	43.1%	0.4%	30.75	-26.9%	39.2
2007E	32.48	23.9%	37.1	28.0	30.3%	0.5%	37.25	21.1%	32.3
2008E	51.18	57.6%	23.5	18.6	36.2%	0.6%	56.87	52.7%	21.2
2009E	74.66	45.9%	16.1	13.4	38.1%	0.7%	80.88	42.2%	14.9

Source: Citigroup Investment Research Note: SUEL + H is Suzlon + Hansen Consolidated.

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	28.7	46.0	37.1	23.5	16.1
EV/EBITDA adjusted (x)	74.7	39.0	27.7	18.5	13.5
P/BV (x)	13.3	12.7	10.0	7.4	5.3
Dividend yield (%)	0.3	0.4	0.5	0.6	0.7
Per Share Data (Rs)					
EPS adjusted	42.04	26.22	32.48	51.18	74.66
EPS reported	42.03	26.22	32.48	51.18	74.66
BVPS	90.77	94.56	120.30	163.66	229.44
DPS	4.00	5.01	6.00	7.00	8.00
Profit & Loss (RsM)					
Net sales	19,425	38,410	65,999	106,650	151,274
Operating expenses	-15,227	-30,146	-54,288	-88,713	-125,491
EBIT	4,197	8,265	11,711	17,936	25,783
Net interest expense	-458	-648	-1,756	-2,215	-2,301
Non-operating/exceptionals	234	556	720	1,110	1,144
Pre-tax profit	3,973	8,173	10,676	16,831	24,626
Tax	-322	-568	-1,273	-2,034	-3,058
Extraord./Min.Int./Pref.div.	2	-43	-33	-33	-33
Reported net income	3,653	7,562	9,369	14,763	21,535
Adjusted earnings	3,654	7,562	9,369	14,763	21,535
Adjusted EBITDA	4,691	8,980	12,868	20,262	28,740
Growth Rates (%)					
Sales	126.5	97.7	71.8	61.6	41.8
EBIT adjusted	219.4	96.9	41.7	53.2	43.7
EBITDA adjusted	223.4	91.5	43.3	57.5	41.8
EPS adjusted	-12.8	-37.6	23.9	57.6	45.9
Cash Flow (RsM)					
Operating cash flow	-583	-3,288	-4,886	-3,348	-2,733
Depreciation/amortization	493	716	1,157	2,325	2,957
Net working capital	-4,662	-10,989	-15,412	-20,437	-27,225
Investing cash flow	-1,855	-4,061	-7,600	-12,000	-2,000
Capital expenditure	-1,920	-4,063	-7,600	-12,000	-2,000
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	3,301	11,320	32,781	-3,395	378
Borrowings	1,574	549	34,750	-1,100	3,000
Dividends paid	-396	-1,647	-1,967	-2,295	-2,622
Change in cash	864	3,970	20,296	-18,743	-4,355
Balance Sheet (RsM)					
Total assets	20,874	49,024	102,041	126,466	159,233
Cash & cash equivalent	1,545	5,515	25,811	7,068	2,713
Accounts receivable	6,929	16,473	28,027	43,829	60,095
Net fixed assets	3,079	6,425	12,868	22,543	21,586
Total liabilities	11,767	21,585	67,202	79,158	93,013
Accounts payable	5,206	7,253	13,837	22,315	31,555
Total Debt	3,958	4,507	39,257	38,157	41,157
Shareholders' funds	9,107	27,439	34,840	47,308	66,221
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	24.1	23.4	19.5	19.0	19.0
ROE adjusted	63.9	43.1	30.3	36.2	38.1
ROIC adjusted	40.5	36.1	25.3	23.2	23.1
Net debt to equity	26.5	-3.7	38.6	65.7	58.1
Total debt to capital	30.3	14.1	53.0	44.6	38.3

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Suzlon reported 3QFY07 results today and hosted a follow-on conference call.

Margin contraction mutes strong sales growth

- 3QFY07 PAT at Rs1.74bn was up a sedate 29% despite a 117% growth in sales on account of a 373bps margin contraction.
- Sales growth was driven by 339MW of WTG sales up 49% YoY and a 10.7% increase in overall WTG realizations.
- However, profit growth was muted on account of lower WTG EBITDA margins of 13.9% (down 361bps YoY). This in turn was driven by (1) MW sales volumes not absorbing the cost of capacity expansion (staff and overheads). (2) Higher freight costs on account of a significant increases in export MW at 149MW in 3QFY07 vis-à-vis 24MW in 3QFY06.
- Hansen EBITDA margins contracting to 10.8% (down 238bps QoQ) once again muted growth.

Figure 2. Suzlon Consolidated Results

Year End Mar31 (Rsmn)	Q106	Q107	% Chg	Q206	Q207	% Chg	H106	H107	% Chg	Q306	Q307	% Chg	Q406
Income from operations	3,111	10,689	244%	11,230	20,870	86%	14,341	31,559	120%	8,806	19,139	117%	15,263
(Inc)/ Dec in stock in trade	2,660	6,514	145%	(1,452)	578	-140%	1,208	7,092	487%	727	46	-94%	40
Consumption of raw material as a % of sales	(4,422)	(12,196)	176%	(5,732)	(13,882)	142%	(10,154)	(26,078)	157%	(6,254)	(11,316)	81%	(8,846)
	56.7%	53.2%		64.0%	63.7%		62.4%	60.2%		62.8%	58.9%		57.7%
Staff Cost as a % of sales	(199)	(1,171)	490%	(239)	(1,684)	604%	(438)	(2,855)	552%	(360)	(1,803)	400%	(418)
	6.4%	11.0%		2.1%	8.1%		3.1%	9.0%		4.1%	9.4%		2.7%
Other expenditure as a % of sales	(489)	(1,978)	305%	(1,282)	(2,282)	78%	(1,771)	(4,260)	141%	(1,420)	(3,520)	148%	(2,073)
	15.7%	18.5%		11.4%	10.9%		12.3%	13.5%		16.1%	18.4%		13.6%
Total Expenditure	(2,450)	(8,831)	261%	(8,705)	(17,270)	98%	(11,154)	(26,101)	134%	(7,307)	(16,593)	127%	(11,297)
EBITDA	661	1,858	181%	2,525	3,600	43%	3,187	5,458	71%	1,500	2,546	70%	3,966
EBITDA margin %	21.3%	17.4%		22.5%	17.3%		22.2%	17.3%		17.0%	13.3%		26.0%
Depreciation	(132)	(347)	162%	(143)	(428)	199%	(276)	(776)	181%	(163)	(343)	111%	(277)
EBIT	529	1,511	186%	2,382	3,172	33%	2,911	4,683	61%	1,337	2,204	65%	3,689
Interest Charges	(114)	(366)	220%	(148)	(547)	269%	(263)	(913)	248%	(112)	(638)	469%	(133)
Other Income	60	161	167%	69	87	26%	129	248	91%	277	254	-8%	338
PBT	475	1,306	175%	2,302	2,711	18%	2,777	4,017	45%	1,502	1,820	21%	3,894
Tax	(29)	(346)	1099%	(236)	(340)	44%	(265)	(686)	159%	(162)	(93)	-43%	(141)
Effective Tax Rate	6.1%	26.5%		10.3%	12.5%		9.5%	17.1%		10.8%	5.1%		3.6%
PAT pre minority interest	446	960	115%	2,066	2,371	15%	2,512	3,331	33%	1,340	1,727	29%	3,753
Minority Interest	8	(7)		11	(17)		18	(25)		9	17		(37)
PAT post minority interest	454	953	110%	2,077	2,354	13%	2,530	3,306	31%	1,349	1,744	29%	3,715

Source: Suzlon and Citigroup Investment Research

Figure 3. Suzlon Consolidated 3QFY07 Segmental Results

Year End Mar 31 (Rsmn)	Q106	Q206	% Chg	Q206	Q207	% Chg	H106	H107	% Chg	Q306	Q307	% Chg	Q406
Total Revenue													
Gear Box	0	3,152	<i>nm</i>	0	4,368	<i>nm</i>	0	7,520	<i>nm</i>	0	4,533	<i>nm</i>	0
WTG	3,085	7,518	<i>144%</i>	11,024	16,087	<i>46%</i>	14,110	23,604	<i>67%</i>	8,732	14,432	<i>65%</i>	15,076
Others	27	23	<i>-15%</i>	207	418	<i>102%</i>	234	441	<i>88%</i>	78	174	<i>124%</i>	188
Total	3,112	10,693	<i>244%</i>	11,231	20,872	<i>86%</i>	14,344	31,565	<i>120%</i>	8,809	19,139	<i>117%</i>	15,264
EBITDA													
	bps			bps			bps			bps			
Gear Box	0	521		0	472		0	993		0	491		0
Margins%	<i>nm</i>	16.5%	<i>nm</i>	<i>nm</i>	10.8%	<i>nm</i>	<i>nm</i>	13.2%	<i>nm</i>	<i>nm</i>	10.8%		<i>nm</i>
WTG	620	1,414		2,593	2,962		3,213	4,375		1,531	2,010		3,887
Margins%	20.1%	18.8%	-128	23.5%	18.4%	-511	22.8%	18.5%	(423)	17.5%	13.9%	-361	25.8%
Others	(4)	(38)		47	111		43	73		2	33		387
Margins%	-15.6%	-165.5%		22.8%	26.5%		18.4%	0.2%		3.0%	0.2%		206.5%
Total	615	1,896		2,640	3,545		3,256	5,441		1,534	2,534		4,275
EBIT													
Gear Box	0	385		0	281		0	666		0	373		0
Margins%	<i>nm</i>	12.2%	<i>nm</i>	<i>nm</i>	6.4%	<i>nm</i>	<i>nm</i>	8.9%	<i>nm</i>	<i>nm</i>	8.2%		<i>nm</i>
WTG	504	1,221		2,469	2,743		2,973	3,964		1,386.6	1,791		3,628
Margins%	16.3%	16.2%	-8	22.4%	17.1%	-535	21.1%	16.8%	-428	15.9%	12.4%	-347	24.1%
Others	(21)	(56)		28	92		7	36		-15.7	28		369
Margins%	-76.3%	-245.9%		13.3%	22.1%		2.9%	8.2%		-20.2%	16.1%		196.7%
Total	483	1,549		2,497	3,116		2,980	4,666		1,371	2,192		3,997
Interest	(114)	(366)		(148)	(547)		(263)	(913)		(112)	(638)		(133)
Other unallocables (net)	106	123		(46)	142		60	265		243	266		30
PBT	475	1,306		2,302	2,711		2,777	4,017		1,502	1,820	<i>21%</i>	3,894

Source: Suzlon and Citigroup Investment Research

What is management guidance and what does that mean?

- **WTG Sales MW:** Management has guided for 1500 – 1600MW of sales in FY07E (CIR estimates 1600MW), implying sales of 577 – 677MW in 4QFY07 vis-à-vis sales of 390MW in 4QFY06.
- **WTG EBITDA margins:** Management has guided for EBITDA margins of 20-22% in FY07E (CIR estimates 19.5%). The WTG business has achieved margins of 16.8% in 9mFY07. However, if one sees Figure 3 we observe in EBITDA margins improved from 17.5% in 3QFY06 to 25.8% in 4QFY06 a 825bps improvement. A similar improvement in margins on a QoQ basis in 4QFY07 cannot be entirely ruled out as close to ~ 40% of full-year turnover is usually booked in 4Q. An improvement of similar magnitude could take full-year EBITDA margins ~ 20%, which is where our current estimate is.
- **Hansen EBITDA margins:** Management had guided for EBITDA margins of 14% in FY07E (CIR estimates of 15%). Hansen has achieved EBITDA margins of 12.3% in 9mFY07.

Order booking continues to be strong

- The WTG business has ended 3QFY07 with an order backlog of Rs77.1bn (1643MW) comprising (1) Domestic order backlog of Rs15.4bn (372MW) implying realizations of 41.5mn/MW. (2) Export order backlog of Rs61.7bn implying realizations of 48.6mn/MW.

- Key large order wins in the quarter included (1) 88.2MW (US\$132mn) from TrustPower) implying realizations of Rs66mn/MW (2) 40MW from British Petroleum (3) 25MW from Tata Power (4) 55MW from Vijay Anand Roadlines and (5) 40MW from HPCL

Enhanced capacity expansion plans

- Suzlon expects to spend ~ Rs33bn on capacity expansion over the next couple of years with investments of ~Rs15bn in the WTG business and ~Rs18bn in the gearbox business.
- We have already factored in ~Rs14bn of WTG capex and ~Rs10bn of gearbox capex in our numbers.
- The incremental capex of Rs9.8bn on setting up a 3500MW gearbox facility in Coimbatore would be done at an incremental D: E of 2:1.

Suzlon Energy Ltd

Company description

Suzlon Energy Limited is the world's fifth-largest wind turbine generator (WTG) company, and the largest WTG manufacturer in India and Asia. Suzlon is a fully integrated wind power company that provides customers with consultancy, design, manufacturing, operations, and maintenance services. Suzlon has a subsidiary in Germany for technology development, an R&D facility in the Netherlands for rotor blade molding and tooling, and wind turbine and rotor blade manufacturing facilities in India. The company is implementing a capacity expansion program to set up an integrated manufacturing facility in China, a rotor blade manufacturing facility in the US and a forging and foundry plant in India that should increase its capacity from the current 1600MW to 4700MW by FY09E. SUEL's product range includes turbines of 350kW, 600kW, 950kW, 1000kW, 1250kW, 1500kW, 2000kW, and 2100kW capacity.

Investment thesis

We rate Suzlon Sell/Medium Risk (3M). Despite being the fifth-largest wind turbine generator manufacturer in an industry where demand is greater than supply, higher EBITDA margins and RoE vis-à-vis peers were always under risk. We had expressed concerns about the Suzlon stock building in too much expectation into its price. Our worst fears are coming true now. Our recent interactions with the Suzlon management indicate that the 1HFY07 margin contraction is not a blip but more of a trend. The 350bps margins contraction that we expected over a three-year period would now happen in 1 year. It is unlikely that Suzlon can bounce back to high EBITDA margins of ~24% and we expect it to deliver EBITDA margins below 19.5% till FY09E. The recent high realization orders wins is more a component shortage impact rather than a strong pricing environment scenario. Further, as Suzlon exports more (particularly to the US) margins would slip into the 15-16.5% range.

Valuation

Our target price of Rs1,137 is based on a 20x P/E. Suzlon's two closest comparables are Gamesa from an international WTG perspective and BHEL from

a domestic perspective. Gamesa trades at an FY08E P/E multiple of 16.2x with an EPS CAGR of 21% for FY06-09E and ROE in the 20-25% range. We believe that Suzlon + Hansen consolidated with an EPS CAGR of 38% for FY06-09E and ROE in the 30-38% range, deserves to trade at a 20-25% premium to Gamesa's multiple, which gives us an FY08E P/E multiple of 20x lower than that of BHEL's target price multiple of 23.0x for FY08E, which we think is reasonable. This is because BHEL's current order backlog of Rs457bn provides visibility for the next two years whereas Suzlon OB of Rs66bn provides visibility only for the next nine months.

Risk

We rate Suzlon shares Medium Risk. The rating differs from our Speculative Risk rating suggested by our quantitative risk-rating system, which tracks 260-day historical share price volatility. We believe the quantitative risk-rating system produces a Speculative Risk rating because of the recent correction in the Indian stock markets rather than any major change in fundamentals. Our Medium Risk rating is in line with that for Gamesa. Our risk rating on the stock is based on a number of factors, namely: industry-specific risks, financial risk and management risks.

The key upside risks include better-than-expected MW sales in the international and domestic markets, better-than-expected realizations, and Suzlon maintaining its international sales operating margins at the same levels as that of domestic sales.

If any of these risk factors has a greater impact than we expect, Suzlon's share price could exceed our target price.

Analyst Certification Appendix A-1

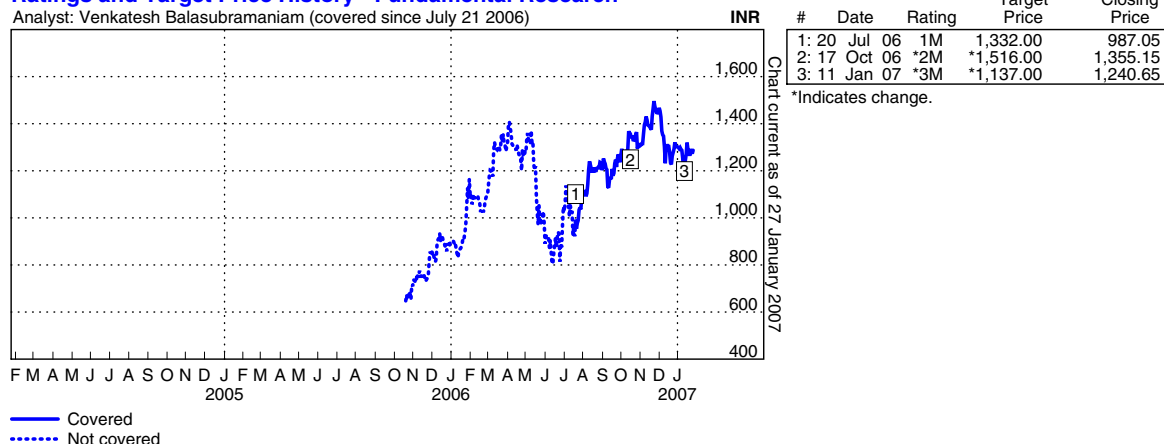
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Suzlon Energy Ltd (SUZL.BO)

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Analyst: Venkatesh Balasubramaniam (covered since July 21 2006)



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