Company Focus

2 September 2008 | 9 pages

Suzlon Energy (SUZL.BO)

Sell: Early Purchase of Martifer's Stake & Domination Agreement

- **To hike stake in REpower to 88.76% by Dec15, 2008 —** Suzlon has signed an agreement with Martifer for the acquisition of its stake (22.48%) in REpower for €270mn by Dec 15, 2008, which is earlier than our expectation of 1QFY09.

- **Seeking a domination agreement** — German laws provide protection to minority shareholders if the majority shareholder does not have a domination agreement in place. This effectively means that the REpower management cannot act in anyway that could be detrimental to the minority shareholders of REpower. More specifically it prevents Suzlon from accessing REPower's technology. Suzlon has been having problems with its S88-2.1MW with 85 cracked blades on last count and has also announced a retrofit programme for 1,251 blades for which the company has provided Rs1.22bn in FY08.

- **Could be a positive** — Suzlon's earlier-than-expected purchase of Martifer's stake in REpower and efforts to have a domination agreement in place (Management estimates this could take 6-9 months) are steps in the right direction as this could provide Suzlon access to REpower's technology and address question marks about its own turbines over the medium term. However, it remains to be seen how fast and how profitably REPower's technology could be used to enhance Suzlon's existing product palette.

- **But what is the hurry?** — In our view, Suzlon's hurry to get the domination agreement in place could suggest that the company might be facing problems in winning incremental orders especially in USA and Europe with its existing products.

Sell/Medium Risk	**3M**
Price (02 Sep 08)	Rs222.50
Target price	Rs216.00
Expected share price return	-2.9%
Expected dividend yield	0.5%
Expected total return	**-2.4%**
Market Cap	Rs333,361M
	US$7,546M

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

Figure 1. Suzlon – Statistical Abstract

Year to 31-Mar	Net Profit (Rsmn)	FD EPS (Rs)	EPS growth (%)	P/E (x)	EV/EBITDA (x)	ROE (%)	Yield (%)
2005A	3,654	8.41	-13%	26.5	21.1	63.9%	0.4%
2006A	7,562	5.26	-37%	42.3	35.5	43.1%	0.4%
2007A	8,648	6.00	14%	37.1	27.5	27.8%	0.4%
2008E	11,815	7.61	27%	29.2	18.8	20.3%	0.4%
2009E	15,068	9.71	28%	22.9	14.6	17.2%	0.5%
2010E	21,274	13.71	41%	16.2	11.1	20.5%	0.5%
2011E	29,861	19.24	40%	11.6	8.7	23.4%	0.5%

Source: Citi Investment Research estimates

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See Appendix A-1 for Analyst Certification and important disclosures.

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Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	37.1	29.2	22.9	16.2	11.6
EV/EBITDA adjusted (x)	27.4	18.8	13.3	10.7	8.7
P/BV (x)	9.1	4.1	3.5	2.9	2.4
Dividend yield (%)	0.4	0.4	0.5	0.5	0.5
Per Share Data (Rs)					
EPS adjusted	6.00	7.61	9.71	13.71	19.24
EPS reported	6.00	6.64	9.71	13.71	19.24
BVPS	24.40	54.12	62.90	75.82	94.48
DPS	1.00	1.00	1.10	1.10	1.10
Profit & Loss (RsM)					
Net sales	79,857	136,794	189,468	241,830	293,616
Operating expenses	-68,617	-120,435	-166,008	-210,293	-252,623
EBIT	**11,240**	**16,359**	**23,459**	**31,537**	**40,993**
Net interest expense	-2,523	-5,320	-8,275	-9,857	-11,074
Non-operating/exceptionals	965	1,689	3,494	4,724	6,881
Pre-tax profit	**9,683**	**12,728**	**18,679**	**26,404**	**36,800**
Tax	-1,035	-1,999	-2,712	-3,705	-4,976
Extraord./Min.Int./Pref.div.	0	-428	-896	-1,426	-1,962
Reported net income	**8,648**	**10,301**	**15,070**	**21,274**	**29,861**
Adjusted earnings	8,648	11,815	15,070	21,274	29,861
Adjusted EBITDA	12,958	19,253	28,293	38,492	48,705
Growth Rates (%)					
Sales	107.9	71.3	38.5	27.6	21.4
EBIT adjusted	36.0	45.5	43.4	34.4	30.0
EBITDA adjusted	44.3	48.6	47.0	36.0	26.5
EPS adjusted	14.0	26.9	27.6	41.2	40.4
Cash Flow (RsM)					
Operating cash flow	**-331**	**11,090**	**-10,823**	**-723**	**8,386**
Depreciation/amortization	1,718	2,894	4,834	6,954	7,713
Net working capital	-11,691	-2,146	-33,162	-28,951	-29,188
Investing cash flow	**-18,457**	**-54,025**	**-37,784**	**-14,878**	**-4,812**
Capital expenditure	-18,377	-22,763	-37,784	-14,878	-4,812
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**46,303**	**93,430**	**20,879**	**39,644**	**-7,640**
Borrowings	47,113	47,726	21,909	40,145	-7,675
Dividends paid	-1,640	-1,751	-1,927	-1,927	-1,927
Change in cash	**27,515**	**50,495**	**-27,728**	**24,043**	**-4,066**
Balance Sheet (RsM)					
Total assets	**125,413**	**263,901**	**326,931**	**411,690**	**458,389**
Cash & cash equivalent	15,383	69,602	41,874	65,918	61,852
Accounts receivable	25,704	46,906	66,949	88,768	110,950
Net fixed assets	23,085	42,954	75,903	83,826	80,926
Total liabilities	**90,136**	**172,619**	**221,609**	**285,595**	**302,397**
Accounts payable	0	0	0	0	0
Total Debt	51,620	99,346	121,255	161,399	153,724
Shareholders' funds	**35,277**	**91,282**	**105,322**	**126,095**	**155,992**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	16.2	14.1	14.9	15.9	16.6
ROE adjusted	27.8	20.3	17.2	20.5	23.4
ROIC adjusted	19.2	16.5	15.7	15.0	16.4
Net debt to equity	102.7	32.6	75.4	75.7	58.9
Total debt to capital	59.4	52.1	53.5	56.1	49.6

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Will buy Martifer's stake earlier than expected

- Yesterday, Suzlon announced that it has signed an agreement with Martifer for the acquisition of Martifer's total stake of about 22.48% in REpower Systems AG of Germany for a total consideration of €270mn.

Figure 2. REpower – Shareholding Structure

	Stake	Shares (€)	Price	€ mn - Remarks
Suzlon	7.8%	0.70	150.0	105 - Shares bought in the open market and rights issue subscribed
Suzlon	25.88%	2.33	150.0	349 - Shares tendered in the open offer
Suzlon (Areva)	29.88%	2.69	173.4	466 - Share bought from Areva for an estimated Euro 173.4/share
Suzlon	2.74%	0.25	na	na - Bought from the open market
Suzlon (Martifer)	22.48%	2.02	133.5	270 - Will be completed by December 15, 2008
Free Float	11.24%	1.01		
		8.99		

Source: Citi Investment Research, Suzlon, REpower and Bloomberg

- This agreement is slated to be completed by December 15, 2008 and will consolidate Suzlon's total holding in REpower to ~ 88.76%. It was earlier anticipated that this transaction would be consummated in 1QFY09.

Seeks domination and P&L transfer agreement with REpower

- Suzlon has also informed the BSE that the company has announced its intention to seek a domination and profit and loss transfer agreement between its German subsidiary SE Drive Technik GmbH and REpower Systems AG, Germany, the process for which would be completed in due course in terms of German Law.

What is a domination and profit and loss transfer agreement?

- A domination agreement is an agreement in which one company submits itself legally to the direction of another. In consequence, Suzlon would be authorized to issue binding directives and thus control REpower management.

- A profit and loss transfer agreement is an agreement in which a company transfers its entire profits to another company; in consequence, Suzlon would be entitled to receive the entire profits of REpower. At the same time, Suzlon would be liable for potential losses made by REpower.

Why hike the stake in a hurry and seek such an agreement?

- German laws provide protection to minority shareholders if the majority does not have a domination agreement in place. This effectively means that REpower management cannot act in any way that could be detrimental to the minority shareholders of REpower. More specifically it prevents Suzlon from accessing REPower's technology.

- Suzlon has been having problems with its S88-2.1MW with 85 cracked blades on last count and has also announced a retrofit programme for 1,251 blades for which the company has provided Rs1.22bn in FY08.

Domination agreement could be a positive but ...

- Suzlon's earlier-than-expected purchase of Martifer's stake in REpower and efforts to have a domination agreement in place (Management estimates this could take 6-9 months) are steps in the right direction as this could provide Suzlon access to REpower's technology and address question marks about its own turbines over the medium term.

- However, it remains to be seen how fast and how profitably REPower's technology could be used to enhance Suzlon's existing product palette. This could also lead to additional borrowings or dilution in FY09E for Suzlon.

- In our view, Suzlon's hurry to get the domination agreement in place could suggest that the company might be facing problems in winning incremental orders especially in USA and Europe with its existing products.

- Suzlon ended 1QFY09 with an export order backlog of 2772MW up a poor 8% YoY and domestic order backlog of 267MW down 15% YoY. Against the backdrop of PTC not getting extended in the US and Suzlon's S88 turbines facing product liabilities, we are concerned about Suzlon's ability to meet our FY09E MW assumption of 3100MW and FY10E MW assumption of 4000MW of sales.

Suzlon Energy

Company description

Suzlon Energy is the world's fifth-largest wind turbine generator (WTG) company, and the largest WTG manufacturer in Asia. Suzlon is a fully integrated wind power company that provides customers with consultancy, design, manufacturing, operations, and maintenance services. It 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, which should increase its capacity from the current 1500MW to 4700MW by FY09E. SUEL's product range includes turbines of 350kW, 600kW, 950kW, 1000kW, 1250kW, 1500kW, 2000kW, and 2100kW capacity.

Investment strategy

We rate Suzlon Sell/Medium Risk. We believe Suzlon has a good strategy: (1) acquire and grow Hansen to meet Suzlon's demand for gearboxes and at the same time benefiting from the strong demand for WTG gearboxes globally; (2) acquire REPower to make a credible entry in Europe, the largest absolute market for WTGs over the near future; and (3) backward integrate into components and sub-components to take control of the supply chain and mitigate raw material and component supply bottleneck risks. However, the international expansion drive has taken its toll on the company: (1) supply delays; (2) tower shortages in the international markets; (3) key component shortages; (4) negative effects of foreign currency movements and nacelle custom duty changes in the US. The latest in this chain of problems is product liabilities. Further, medium-term issues such as: (1) commodity price increases; (2) delays in Suzlon's WTG capacity ramp-up; (3) the possibility of PTC not being extended; and (4) further provisions for blade damage problems may weigh heavily on the stock's performance.

Valuation

Our target price of Rs216 is based on 17x Dec 09E EPS, the low end of Suzlon's 05-08 P/E range of 17-47x given concerns about Suzlon's S88 WTG. The recent EME order cancellations and availability issues have taken the stock to its trough valuation of 17x one-year forward earnings. We do not expect a significant re-rating until the company comes clean on its S88 turbine blade damages issue and establishes that it has a credible product to service its end-markets without product liabilities.

Risks

We rate Suzlon Medium Risk based on a number of industry-specific, financial and management risks. Key upside risks include better-than-expected MW sales in the international and domestic markets, better-than-expected realizations, and Suzlon significantly improving its international sales operating margins. Further, if PTC is extended, the stock could move up sharply on positive sentiment. If any of these risk factors has a greater impact than we expect, Suzlon's share price could exceed our target price.

Appendix A-1

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Suzlon Energy (SUZL.BO)

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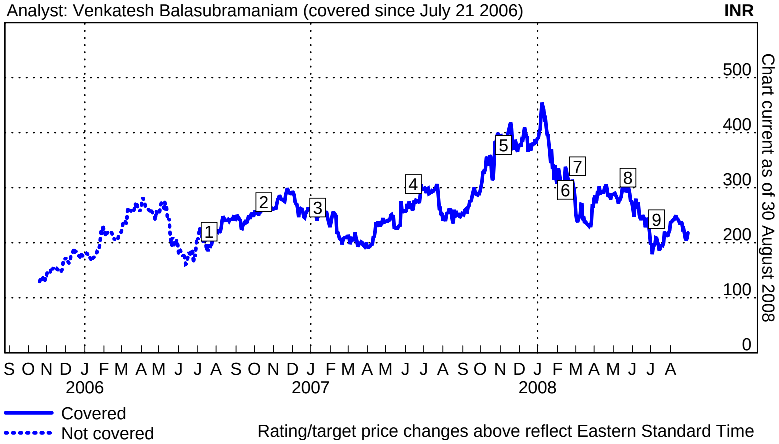
Analyst: Venkatesh Balasubramaniam (covered since July 21 2006)



#	Date	Rating	Target Price	Closing Price
1:	20 Jul 06	1M	266.40	197.41
2:	17 Oct 06	*2M	*303.20	271.03
3:	11 Jan 07	*3M	*227.40	248.13
4:	14 Jun 07	*1M	*340.00	262.14
5:	7 Nov 07	*1L	*445.40	378.96
6:	14 Feb 08	1L	*396.00	338.15
7:	5 Mar 08	*3M	*241.00	237.65
8:	26 May 08	3M	*303.00	305.00
9:	10 Jul 08	3M	*216.00	208.35

*Indicates change.

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