Company Focus

25 June 2008 | 12 pages

GMR Infrastructure (GMRI.BO)

Buy: InterGen Deal – Good Assets but Seems Expensive

- **Transaction details** — GMR announced acquisition of 50% stake in InterGen N.V. from AIG Highstar Capital II, L.P. and its affiliates for US$1.1bn. InterGen has 12 power plants with a total capacity of ~6,251 net equity MW located in the UK, the Netherlands, Mexico, the Philippines and Australia. It has another 4600MW under development.
- **Acquisition financing** — The entire $1.1bn has been tied up as a 2-year bridge loan facility from a consortium of banks. The company indicated that the cost of funds was very competitive. The loan would be taken in an SPV (formed for the acquisition) backed by a corporate guarantee from GMR Infrastructure. We expect GMR to infuse some equity, albeit a small amount, at a later stage.
- **The positives** — 1) Good quality operational assets using high-end technology, having fuel linkages and offtake agreements. 2) Strong InterGen management team. 3) Leveraging on InterGen's capabilities to bid for large-sized power projects in India (i.e., UMPP, etc.) and abroad.
- **Key concerns** — 1) High price – implied P/BV of 4x for plants with ROEs of 19%-20% seems on the higher side. 2) High gearing – InterGen has ~$4.3bn debt and a debt-equity ratio of ~8. Majority of the debt is rated below investment grade by the rating agencies (Ba3/BB-). 3) Strained cash flows due to high debt servicing requirements. 4) Profitability – almost 30% of EBITDA comes from a single merchant power plant in UK – a big risk in our view.
- **Maintain estimates, Buy (1M) rating** — We will revert with more details once InterGen financials are available.

Buy/Medium Risk	**1M**
Price (25 Jun 08)	Rs99.15
Target price	Rs187.00
Expected share price return	88.6%
Expected dividend yield	0.0%
Expected total return	**88.6%**
Market Cap	Rs184,300M
	US$4,322M

Price Performance (RIC: GMRI.BO, BB: GMRI IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	na	na	na	na	na	na	na
2007A	1,744	0.96	na	103.5	9.1	na	0.0
2008E	2,110	1.16	20.9	85.6	2.8	5.0	0.0
2009E	4,168	2.29	97.6	43.3	2.3	5.8	0.0
2010E	7,053	3.87	69.2	25.6	2.0	8.4	0.0

Source: Powered by dataCentral

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

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	na	103.5	85.6	43.3	25.6
EV/EBITDA adjusted (x)	na	na	26.3	12.7	9.0
P/BV (x)	na	9.1	2.8	2.3	2.0
Dividend yield (%)	na	0.0	0.0	0.0	0.0
Per Share Data (Rs)					
EPS adjusted	na	0.96	1.16	2.29	3.87
EPS reported	na	0.96	1.16	2.29	3.87
BVPS	na	10.94	35.11	43.53	49.00
DPS	na	0.00	0.00	0.00	0.00
Profit & Loss (RsM)					
Net sales	na	17,151	20,916	30,843	42,858
Operating expenses	na	-12,876	-16,072	-20,991	-25,718
EBIT	**na**	**4,275**	**4,844**	**9,853**	**17,140**
Net interest expense	na	-1,441	-1,408	-3,216	-4,558
Non-operating/exceptionals	na	0	0	560	841
Pre-tax profit	**na**	**2,833**	**3,436**	**7,196**	**13,424**
Tax	na	-415	-659	-1,349	-2,717
Extraord./Min.Int./Pref.div.	na	-673	-668	-1,679	-3,654
Reported net income	**na**	**1,744**	**2,110**	**4,168**	**7,053**
Adjusted earnings	na	1,744	2,110	4,168	7,053
Adjusted EBITDA	na	5,620	7,144	14,235	23,455
Growth Rates (%)					
Sales	na	na	22.0	47.5	39.0
EBIT adjusted	na	na	13.3	103.4	74.0
EBITDA adjusted	na	na	27.1	99.3	64.8
EPS adjusted	na	na	20.9	97.6	69.2
Cash Flow (RsM)					
Operating cash flow	**na**	**5,044**	**3,816**	**8,094**	**12,328**
Depreciation/amortization	na	1,346	2,299	4,382	6,315
Net working capital	na	1,811	-449	-457	-1,039
Investing cash flow	**na**	**-19,647**	**1,075**	**-73,029**	**-71,863**
Capital expenditure	na	-19,579	-15,527	-72,567	-71,873
Acquisitions/disposals	na	0	16,602	0	0
Financing cash flow	**na**	**20,846**	**62,606**	**97,596**	**46,105**
Borrowings	na	7,354	19,359	59,754	10,648
Dividends paid	na	-23	0	0	0
Change in cash	**na**	**6,243**	**67,496**	**32,661**	**-13,430**
Balance Sheet (RsM)					
Total assets	**na**	**63,685**	**127,806**	**229,674**	**282,634**
Cash & cash equivalent	na	13,000	80,497	113,158	99,728
Accounts receivable	na	0	0	0	0
Net fixed assets	na	48,059	44,527	112,712	178,270
Total liabilities	**na**	**38,501**	**57,267**	**138,194**	**177,519**
Accounts payable	na	0	0	0	0
Total Debt	na	37,057	56,416	116,170	126,819
Shareholders' funds	**na**	**25,184**	**70,540**	**91,480**	**105,115**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	na	32.8	34.2	46.2	54.7
ROE adjusted	na	na	5.0	5.8	8.4
ROIC adjusted	na	na	9.3	10.9	9.9
Net debt to equity	na	95.5	-34.1	3.3	25.8
Total debt to capital	na	59.5	44.4	55.9	54.7

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Details of the Transaction

We attended the analyst meet organized by GMR where it discussed the InterGen acquisition. The company did not divulge too many financial details. Below are takeaways.

Acquisition of 50% stake in InterGen

GMR announced the acquisition of a 50% stake in InterGen from AIG Highstar Capital II, L.P. and affiliates.

InterGen is a global power generation firm with 12 power plants representing a total generation capacity of ~6,251 net equity MW. InterGen's plants are located in the UK, the Netherlands, Mexico, the Philippines and Australia. These facilities include 5,300 net equity MW in operation, 428 MW under construction and 523 MW under agreement.

GMR Infrastructure Limited will jointly own InterGen with the Ontario Teachers' Pension Plan (Teachers'). Teachers' has been a 50% owner of InterGen since 2005. The transaction remains subject to final agreements and regulatory approvals but is expected to close in the third quarter of 2008.

Acquisition price and financing

GMR will pay $1116mn to buy a 50% stake in InterGen from AIG Highstar and affiliates. The entire amount has been tied up as a 2-year bridge loan facility from a consortium of banks. The loan is denominated in US dollars, and the company indicated that the cost of funds was very competitive. An SPV would be formed, and the loan would be taken on the SPV's books backed by a corporate guarantee from GMR Infrastructure. While the amount has been tied up as credit lines, the debt equity structure is not finalized and will be known shortly.

Our sense is that the ultimate equity portion would be fairly small in relation to the total purchase price.

Why did AIG Highstar sell?

As per GMR management, the AIG Highstar fund was a fixed tenor fund and needed the funds for redemptions.

InterGen Assets Overview

Figure 1. InterGen Operational Capacities.

No	Name of Plant	Country	(MW)	Intergen Stake %	Attributable capacity	Fuel	COD	Fuel Sourcing	PPA
1	La Rosita	Mexico	1100	100%	1100	Gas	2003	126-mile cross-border natural gas pipeline that runs from Ehrenberg, Arizona to the plant site.	500 MW - 25 yr PPA with Mexico's Comisión Federal de Electricidad (CFE) under a 25-year build-own-operate PPA.
2	Bajio	Mexico	600	51%	306	Gas	2002		500 MW - 25 yr PPA with Mexico's Comisión Federal de Electricidad (CFE) under a 25-year build-own-operate PPA.
3	Spalding	UK	880	100%	880	Gas	2004		Tolling Agreement with British Gas
4	Rocksavage	UK	748	100%	748	Gas	1998		
5	Coryton	UK	777	100%	777	Gas	2002	two long-term gas supply contracts	Merchant Power
6	Rijnmond	Netherlands	820	100%	820	Gas	2004		supplies electricity to Netherlands & NW Europe.
7	Quezon Power	Philippines	460	46%	211	Coal	2000		25-year PPA with Manila Electric Company (Meralco)
8	Callide C	Australia	920	25%	230	Coal	2001	Coal from the adjacent Anglo Coal Callide Mine	
9	Millmerran	Australia	850	27%	228	Coal	2003	Commodore mine. Captive Coal Mine - $8-10 cost of extraction	sells all of its electricity into the National Electricity Market (NEM)
	Total		**7155**		**5300**				

Source: InterGen, GMR Infrastructure, Citi Investment Research

Figure 2. InterGen – Plants under construction/ being acquired

No	Name of Plant	Country	(MW)	Intergen Stake %	Attributable capacity	Fuel	COD
1	Acquisition of assets from Transalta	Mexico	523	100%	523	Gas	Mid 2008
2	Rijnmond - II	Netherlands	428	100%	428	Gas	mid 2010
					951		

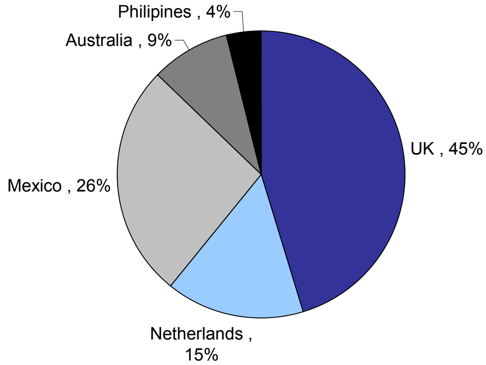
Source: Citi Investment Research

InterGen has 5300 MW in operation, 428 MW under construction and 523 MW under agreement. Also, InterGen has plans to develop another ~4600MW of capacities, including a 500MW wind farm in Mexico, 2250MW capacity expansion in UK and 460MW Quezon expansion in Philippines.

A brief analysis of the asset profile

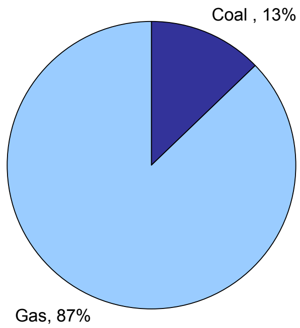
- **By Region:** 45% of InterGen's operational capacity is in the UK followed by Mexico at 26%, the Netherlands at 15%, Australia at 9% and the Philippines at 4%.
- **By Fuel:** 87% of the operational capacities are gas based while 13% are coal based.
- **Average life of current assets –** 5.5 years, with remaining life of 30 years as indicated by management.
- **Fixed vs. Variable revenues -** ~70% of the capacities are tied up under long-term PPAs or tolling agreements.

Figure 3. InterGen's Operational Capacities breakup by Region



Source: Citi Investment Research

Figure 4. InterGen's Operational Capacities breakup by Fuel



Source: Citi Investment Research

Management Control and Shareholding Structure

After the acquisition GMR infrastructure and Ontario Teachers' Pension Plan (OTPP) will hold a 50% stake each in InterGen. InterGen will be governed by a 2-tier board structure – a supervisory board and a management board. Both GMR and OTPP can nominate 5 persons each to the supervisory board for a total of 10 members. All major decisions will have to be approved by the supervisory board. In the management board, GMR and InterGen will each nominate 2 members who will participate in the decision making along with other members of the management.

Both GMR and OTPP have a "Right of first offer," i.e., if either investor decides to exit, it has to offer the stake first to the other investor.

Analysis

The Positives

- **Good quality operational assets** – Our discussions with management seem to indicate that the quality of InterGen's assets is quite good. InterGen's plants employ high-end technology like supercritical technology and advanced class gas turbines. The average age of the plants is 5.5 years. 70% of the plants are tied up under PPAs or long-term tolling agreements.

- **Strong management team** – InterGen has a strong management team, which has been running the company since its inception in 1995 with several members of the management being the founding members. InterGen has built and operated over 16,000MW of power plants to date.

- **Leveraging on InterGen's capabilities** – This acquisition provides GMR the scale (it becomes the largest private player in India with attributable currently operational capacity of ~3500MW). This will enable GMR to qualify to bid for large-sized power projects in India (i.e., UMPP etc.) and abroad.

Key Concerns

We do not have the detailed financials of InterGen as yet; below are some takeaways from the management meet.

Figure 5. InterGen Financials

Calender year 2007	USD mn	Comments
Revenues	1650	
EBITDA	613	30% of EBITDA comes from Coryton merchant plant in UK
Normalised PAT	105	Normalised for marked to market losses/ gains
Normalised ROE	19%	
Distribution to shareholders	144	This payment has been out of equity. Lenders agreement suggests that company can make payment to equity holders as long as Debt service coverage ratio >1.4
Distribution to shareholders in CY08 so far	55	Total $355 mn equity has been distributed to shareholders over last 3 years
Balance Sheet		
Equity	544	
Debt	4301	Press reports suggest that Intergen had refinaced $3.1bn at 9.125% yield (Ba3/BB- rating) in July 2007. Debt is till 2017 with backended principal payment
Debt Equity	8	
Acquisition Price for 50% stake	1116	
Implied Equity Value for 100% stake	2232	
Implied Price to Book	**4.1**	

Source: Citi Investment Research

- **High Price** Based on the above calculations it seems that GMR has valued the company on a 4x P/B multiple – expensive in light of the fact that normalized ROEs seem to be in the 19%-20% range.

- **High Gearing –** Intergen had roughly $4.3bn debt on its books as on Dec 31, 2007 and a debt-equity ratio of 8. Majority of the debt is rated below investment grade by the rating agencies (Ba3/BB-).

- **Strained cash flow situation –** Our discussions suggested that InterGen would have ~$300mn per year as interest outgo and had an EBITDA of

$613mn in 2007. The current operating cash flow seems to be barely able to meet the interest + principal payment (assuming a 10-year equal payment period – though the management said that the principal payments are backended).

- **Profitability of the plants** – GMR indicated that almost 30% of the EBITDA comes from a single merchant power plant in UK. A decline in spot rates would lower the overall profitability of the company. Moreover, it raises concerns regarding the profitability of the other 8 plants contributing 70% of the EBITDA.

GMR Infrastructure

Company description

The GMR Group is one of the leading infrastructure developers in India with interests in airports, roads, and power plants. The Government of India has been steadily opening up the infrastructure sector to private participation over the last decade or so. An early mover in the infrastructure space, it has captured attractive project opportunities. A prime example is the Hyderabad International Airport, which was among the first to be handed out to the private sector for development. GMR won this project on attractive terms i.e. only 4% revenue share to Government versus the Delhi airport project which has ~46%. According to Plan Documents, the government is aiming for infrastructure investments of US$494bn in the 11th Plan (FY07-FY12), representing 130% growth over that under the 10th Plan (FY02-FY07).

Investment strategy

We rate GMR shares as Buy / Medium Risk (1M) with an NPV-based target price of Rs187. GMR is a leading infrastructure developer in India - its portfolio includes three airports (Hyderabad, Delhi and Sabiha Gokcen International Airport in Turkey), 11 power plants, and six roads. We estimate airports and related real estate comprise 47% of GMR's value, other real estate 19%, power plants 18%, and roads 5%. GMR also has ~$1bn cash on books. We expect GMR's earnings to grow at 51% CAGR over FY08E-11E on the back of a 37% growth in revenues. In India, GMR has plans to bid for road, hydropower and power transmission projects. GMR is looking to emerge as an infrastructure developer across geographies. A GMR-led consortium is undertaking the upgradation of Sabiha Gokcen airport in Turkey.

Valuation

We have valued each individual project separately based on its equity cash flows discounted using the cost of equity and have arrived at a sum-of-the-parts target price of Rs187. Given the nature of the concession agreement and cashflows of the airports and associated real estate, comparison with global airports on valuation multiples may be misleading, and hence we prefer a DCF approach to value the same. Airports and related real estate comprise 47% of GMR's value, other real estate 19%, power plants 18%, and roads 5%. GMR also has ~$1bn cash on books.

Risks

We rate GMR shares Medium Risk. The rating differs from the High Risk rating suggested by our quantitative risk rating system, which tracks 260-day historical share price volatility. This is primarily because GMR has an existing asset base which has strong, recurring and stable cashflows. It also has assets under various stages of development which would contribute to revenues and profits once they come onstream which provides with good visibility. Key risks that could prevent the shares from reaching our target price include: 1) Airport financing structure issues, 2) competition from rival greenfield airport plans, or from other project developers, 3) UDF pricing risks, 4) regulatory risks, 5) traffic growth risks, 6) Softening of real estate prices 7) delay in achieving financial closure, 8) Rising interest rates, 9) project execution risks.

Appendix A-1

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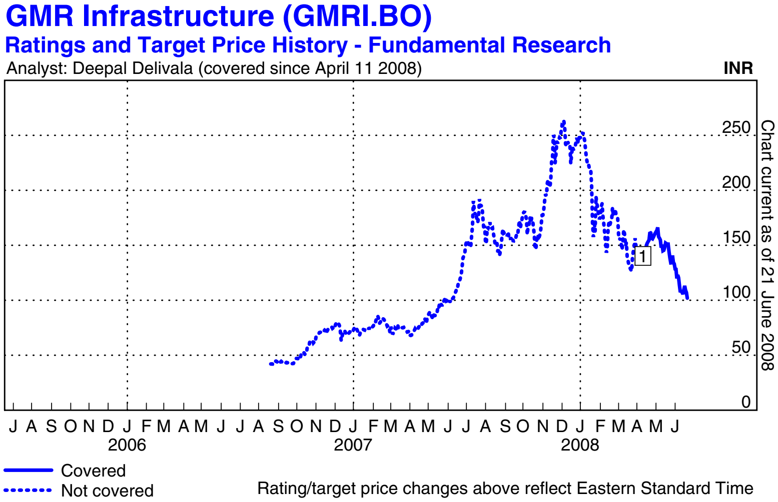

#	Date	Rating	Target Price	Closing Price
1:	10 Apr 08	1M	187.00	140.75

*Indicates change.

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