

Company In-Depth

11 January 2007 | 10 pages

Suzlon Energy Ltd (SUZL.BO)

As Good As It Gets, Downgrade to Sell

 Rating change
 Target price change
 Estimate change

- Too good to last too long** — We earlier expressed concern that Suzlon stock was building too much expectation into its price. Our recent interaction with Suzlon management indicates that the 1HFY07 margin contraction is not a blip but a trend. The 350bps margin contraction that we expected over a three-year period will now happen in one year.
- Margin bounce back unlikely** — It is unlikely that Suzlon can bounce back to its earlier high 24% EBITDA margin levels after margins collapse 388bps in FY07E. The recent high realization orders wins is more of a component shortage effect than a strong pricing environment effect. As Suzlon exports more to the US, margins would come under pressure, impacting profitability.
- Earnings revised downwards** — We are cutting our Suzlon + Hansen consolidated earnings estimates by 22%, 17% and 13% for FY07E, FY08E and FY09E respectively. We now expect an EPS CAGR of 38% over FY06-09E (45% earlier).
- Downgrade to Sell** — Our new Rs1,137 target price (down from Rs1,516) is the result of an earnings downgrade and a P/E multiple reduction to 20x (22.2x earlier). Our 20x multiple is at a 20-25% premium to global peers and a discount to BHEL's 23x FY08E multiple. BHEL's order backlog provides visibility for two years whereas Suzlon backlog provides visibility only for nine months.
- Risks on the upside** — 1) Better-than-expected order wins; 2) better-than-expected MW sales in international and domestic markets; 3) higher sales realizations; and 4) faster-than-expected backward integration benefits.

Sell/Medium Risk	3M
<i>from Hold/Medium Risk</i>	
Price (10 Jan 07)	Rs1,198.80
Target price	Rs1,137.00
<i>from Rs1,516.00</i>	
Expected share price return	-5.2%
Expected dividend yield	0.5%
Expected total return	-4.7%
Market Cap	Rs344,972M
	US\$7,761M

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



See page 6 for Analyst Certification and important disclosures.

Figure 1. Suzlon – Statistical Abstract

Year to	SUEL EPS	EPS Growth	SUEL P/E	SUEL EV/E	ROE	Div. Yield	SUEL + H EPS	EPS Growth	SUEL + H P/E	Suel + H EV/E
31-Mar	(Rs)	(%)	(x)	(%)	(%)	(%)	(x)	(%)	(x)	(X)
2005A	42.04	-12.8%	28.5	22.7	63.9%	0.3%	42.04	-12.8%	28.5	22.7
2006A	26.22	-37.6%	45.7	38.2	43.1%	0.4%	30.75	-26.9%	39.0	29.9
2007E	32.48	23.9%	36.9	27.8	30.3%	0.5%	37.25	21.1%	32.2	22.9
2008E	51.18	57.6%	23.4	18.5	36.2%	0.6%	56.87	52.7%	21.1	16.1
2009E	74.66	45.9%	16.0	13.3	38.1%	0.7%	80.88	42.2%	14.8	11.9

Note: SUZL + H is Suzlon Consolidated + Hansen Transmission

Source: Citigroup Investment Research estimates

Venkatesh Balasubramaniam¹

+91-22-6631-9864
 venkatesh.balasubramaniam@citigroup.com

Deepal Delivala¹

+91-22-6631-9857
 deepal.delivala@citigroup.com

Pankaj Sharma¹

pankaj4.sharma@citigroup.com

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¹Citigroup Global Market India Private Limited

Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	28.5	45.7	36.9	23.4	16.1
EV/EBITDA adjusted (x)	74.4	38.8	27.6	18.4	13.5
P/BV (x)	13.2	12.7	10.0	7.3	5.2
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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Earnings Revised Downwards

We met the management of Suzlon recently to get an update on the business. We are cutting our consolidated Suzlon + Hansen earnings estimates by 22%, 17% and 13% in FY07E, FY08E and FY09E respectively as a result of:

- **Marginal cut in MW sales: FY07E = 1600MW (1715MW), FY08E = 2491MW (2595MW) and FY09E = 3500MW (3600MW).**
- **The 350bps margin compression that we expected over a three-year period would now happen in one year because:**
 1. Increased realization of recent order wins is more of component shortage driven event rather than a strong pricing environment scenario.
 2. As the company ramps up on capacity in China and USA all the costs might not get absorbed in one go until full capacity is utilized.
 3. Exports as a percentage of sales is set to increase to 38% in FY07E, 58% in FY08E and 69% in FY09E, implying pressure on margins.
 4. As facilities outside India ramp up we expect the staff costs to increase to 4% of sales compared to 3% of sales in FY06.
 5. Bulk of the export sales is to US (PTC extended till CY08). Suzlon has only 600MW of rotor blade capacity in US and hence a significant portion of US sales will be exported from India, implying higher freight costs.

We now expect Suzlon + Hansen consolidated EPS CAGR of 38% over FY06-09E against 45% earlier.

Figure 2. Suzlon – Earnings Revision Table

Suzlon			Hansen			Suzlon + Hansen					
FY07E	FY08E	FY09E	FY07E	FY08E	FY09E	FY07E	FY08E	FY09E			
Sales			Sales			Sales					
Old	70,354	110,362	154,483	Old	18,700	21,450	24,750	Old	89,054	131,812	179,233
New	65,999	106,650	151,274	New	18,700	21,450	24,750	New	84,699	128,100	176,024
% Chg	-6.2%	-3.4%	-2.1%	% Chg	0.0%	0.0%	0.0%	% Chg	-4.9%	-2.8%	-1.8%
EBITDA			EBITDA			EBITDA					
Old	15,758	23,726	32,440	Old	3,254	3,861	4,554	Old	19,011	27,587	36,994
New	12,868	20,262	28,740	New	2,805	3,432	4,084	New	15,673	23,694	32,824
% Chg	-18.3%	-14.6%	-11.4%	% Chg	-13.8%	-11.1%	-10.3%	% Chg	-17.6%	-14.1%	-11.3%
EBITDA Margin %			EBITDA Margin %			EBITDA Margin %					
Old	22.4%	21.5%	21.0%	Old	17.4%	18.0%	18.4%	Old	21.3%	20.9%	20.6%
New	19.5%	19.0%	19.0%	New	15.0%	16.0%	16.5%	New	18.5%	18.5%	18.6%
% Chg	-290bps	-250bps	-200bps	% Chg	-240bps	-200bps	-190bps	% Chg	-284bps	-243bps	-199bps
PAT			PAT			PAT					
Old	12,298	17,743	24,629	Old	1,461	1,951	2,160	Old	13,759	19,694	26,789
New	9,369	14,763	21,535	New	1,375	1,640	1,795	New	10,744	16,403	23,330
% Chg	-23.8%	-16.8%	-12.6%	% Chg	-5.9%	-15.9%	-16.9%	% Chg	-21.9%	-16.7%	-12.9%
EPS			EPS			EPS					
Old	42.63	61.51	85.38	Old	5.06	6.76	7.49	Old	47.70	68.27	92.87
New	32.48	51.18	74.66	New	4.77	5.68	6.22	New	37.25	56.87	80.88
% Chg	-23.8%	-16.8%	-12.6%	% Chg	-5.9%	-15.9%	-16.9%	% Chg	-21.9%	-16.7%	-12.9%

Source: Citigroup Investment Research estimates

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

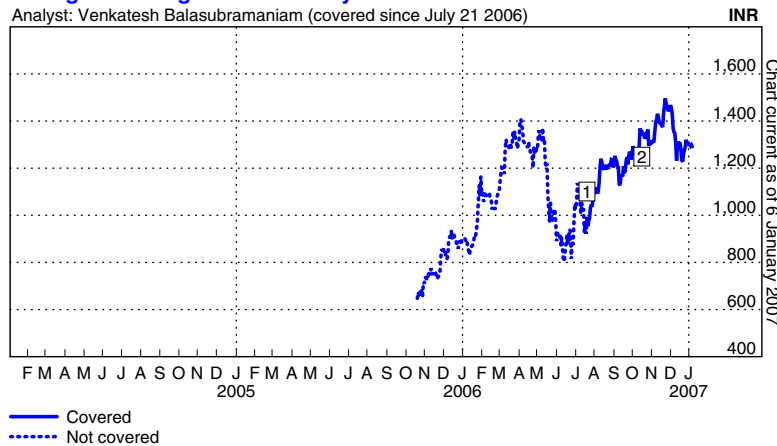
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IMPORTANT DISCLOSURES

Suzlon Energy Ltd (SUZL.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Venkatesh Balasubramaniam (covered since July 21 2006)



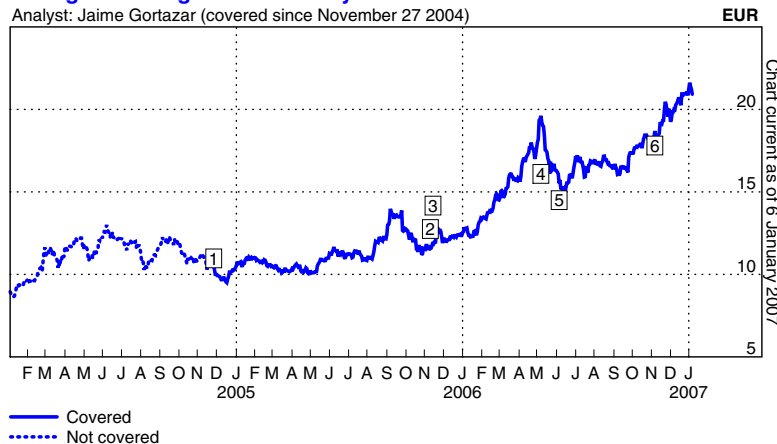
#	Date	Rating	Target Price	Closing Price
1:	20 Jul 06	1M	1,332.00	987.05
2:	17 Oct 06	*2M	*1,516.00	1,355.15

*Indicates change.

Gamesa (GAM.MC)

Ratings and Target Price History - Fundamental Research

Analyst: Jaime Gortazar (covered since November 27 2004)

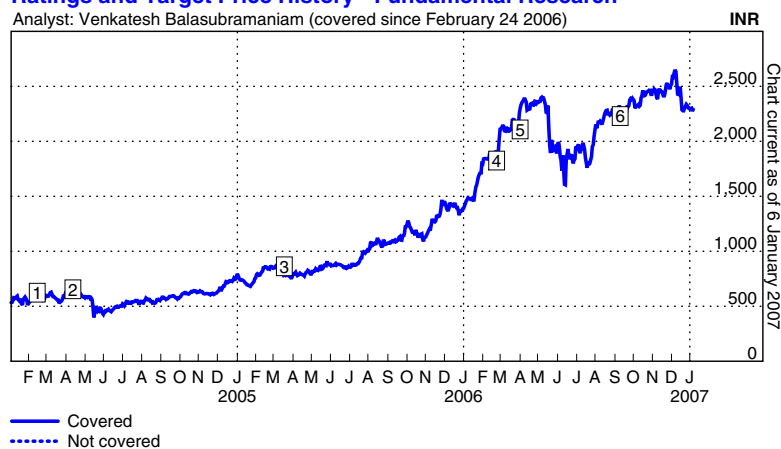


#	Date	Rating	Target Price	Closing Price
1:	26 Nov 04	*2M	*11.30	10.49
2:	10 Nov 05	2M	*13.50	11.56
3:	15 Nov 05	*1M	13.50	11.95
4:	8 May 06	*2M	*20.00	19.61
5:	6 Jun 06	*1M	20.00	15.52
6:	7 Nov 06	*2M	20.00	18.69

*Indicates change.

Bharat Heavy Electricals (BHEL.BO)
Ratings and Target Price History - Fundamental Research

Analyst: Venkatesh Balasubramaniam (covered since February 24 2006)



#	Date	Rating	Target Price	Closing Price
1:	16 Feb 04	1L	*710.00	613.85
2:	13 Apr 04	1L	*750.00	649.35
3:	18 Mar 05	1L	*945.00	789.90
4:	23 Feb 06	1L	*2,256.00	1,893.85
5:	3 Apr 06	1L	*2,643.00	2,298.05
6:	10 Sep 06	1L	*2,764.00	2,254.60

*Indicates change.

Hansen Natural Corp (HANS)
Ratings and Target Price History - Fundamental Research

Analyst: Gregory Badishkian (covered since November 3 2005)



#	Date	Rating	Target Price	Closing Price
1:	2 Nov 05	1S	18.00	14.53
2:	10 Nov 05	1S	*22.00	16.85
3:	12 Jan 06	1S	*32.50	23.04
4:	9 Mar 06	1S	*37.50	24.56
5:	9 May 06	1S	*51.25	44.06
6:	2 Aug 06	*2S	*51.00	46.07
7:	8 Aug 06	2S	*35.00	29.46
8:	9 Nov 06	2S	*30.00	24.88

*Indicates change.

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Data current as of 31 December 2006

	Buy	Hold	Sell
Citigroup Investment Research Global Fundamental Coverage (3106)	43%	41%	15%
<i>% of companies in each rating category that are investment banking clients</i>	45%	41%	34%
India -- Asia Pacific (118)	58%	14%	28%
<i>% of companies in each rating category that are investment banking clients</i>	48%	50%	39%
Multi-industry -- Europe (1)	0%	100%	0%
<i>% of companies in each rating category that are investment banking clients</i>	0%	100%	0%
Natural Products -- North America (2)	0%	100%	0%
<i>% of companies in each rating category that are investment banking clients</i>	0%	0%	0%

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For securities in emerging markets (Asia Pacific, Emerging Europe/Middle East/Africa, and Latin America), investment ratings are: Buy (1) (expected total return of 15% or more for Low-Risk stocks, 20% or more for Medium-Risk stocks, 30% or more for High-Risk stocks, and 40% or more for Speculative stocks); Hold (2) (5%-15% for Low-Risk stocks, 10%-20% for Medium-Risk stocks, 15%-30% for High-Risk stocks, and 20%-40% for Speculative stocks); and Sell (3) (5% or less for Low-Risk stocks, 10% or less for Medium-Risk stocks, 15% or less for High-Risk stocks, and 20% or less for Speculative stocks).

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