Shriram EPC

PRICE - RS. 223
TARGET - RS. 416
OUTPERFORM

Diversified EPC contractor set to soar on macro tailwinds

Shriram EPC Ltd (SEPC), with multiple growth levers in the form of integrated wind energy solutions, turnkey contracting in renewable energy space, biomass-based power generation and contracting services for core industries, is a well differentiated EPC contracting company.

Further, we believe that the company has timed its mega watt class (1.5MW) wind turbine initiative perfectly, given that global turbine supply is geared to meet only ~95% of demand, placing turbine suppliers in a sweet spot that is expected to last 2-3 years. This new product line, secured through a strategic alliance with Leitwind, will employ gearless and permanent magnet technologies, both having the effect of increasing installation and operational efficiencies. This, we think, will enable SEPC position itself as a niche player in the wind energy solutions business.

With a strong orderbook, profitable project execution track record, well-devised strategy for wind energy and a buoyant industrial investment scenario, we believe SEPC is ideally positioned to grow rapidly over the next 2-3 years.

Strong Investment rationale

- Proxy play to the ongoing capex in renewable energy (biomass & wind), core industries (metals, power & cement) and government spend on urban renewal (municipal services);
- Multiple business verticals, reflected in the Dec'07 orderbook of Rs. 22.8bn comprising renewable energy (34%), process & metallurgy (57%) and urban renewal (9%), thereby diversifying vertical risk;
- Strategic alliances with leading global players – Leitwind for wind turbines, Hamon group for cooling towers & air pollution control;
- Vision to capture leadership position in biomass-based power generation through Orient Green Power (~51% stake), the company that will operate power generation assets in India, based on non-conventional energy sources;
- Business at an inflexion point, with RoEs set to improve >3.6x over FY07-10E, to ~31%, primarily as a result of the company's initiatives in wind energy and biomass-based power generation; and
- Strong promoter group (Chennai based Shriram group) and experienced, professional management team that has been together for >10 years.

Valuation – Asymmetric bet on the upside

Given the start-up nature of the 1.5MW class wind-turbine venture, we have attached conservative probabilities to the roll-out and success of the venture. Still, we expect SEPC's earnings to grow at a CAGR of >120% over FY07-10E, given the opportunities to tap the ongoing capex in renewable energy, core industrial sectors and urban renewal. Given that the SEPC stock trades at a P/E multiple of 6.4x FY10E earnings, with further earnings upsides possible, we consider the stock to be an asymmetric bet on the upside. We arrive at our one year target price based on a P/E multiple of 12.0x on FY10E consolidated EPS of Rs. 34.7. Accordingly, we expect the stock to trade at a price of Rs. 416 per share. **We initiate coverage with an OUTPERFORM rating with 87% upside from current levels.**

Financial Summary

Year	Revenues (Rs. mn)	EBITDA (Rs. mn)	PAT (Rs. mn)	EPS (Rs.)	P/E (x)	EV/EBITDA (x)
FY07	2,957	223	141	6.9	32.1	41.5
FY08E	5,333	486	295	6.6	33.7	19.0
FY09E	16,709	1,963	756	16.9	13.2	4.7
FY10E	29,257	4,695	1,547	34.7	6.4	2.0

Initiating Coverage

Dated	24th March 2008
BSE SENSEX	14995
NIFTY	4574
O/S Shares (nos mn)	42.9mn (Fully diluted 44.6mn)
Market Cap	Rs. 9,557mn (Fully diluted Rs. 9,947mn)
52 week Hi-Lo	Rs. 194 – Rs. 377
Average Daily Volume (nos)	1,611,802
Free Float (%)	11.66
BSE Code	532945
NSE Code	SHRIRAMEPC
Bloomberg code	SEPC IN
Reuters code	SHRI.BO

Shareholding Pattern (%) post public issue

Promoters	43.06
Institutions	45.28
Public	11.66

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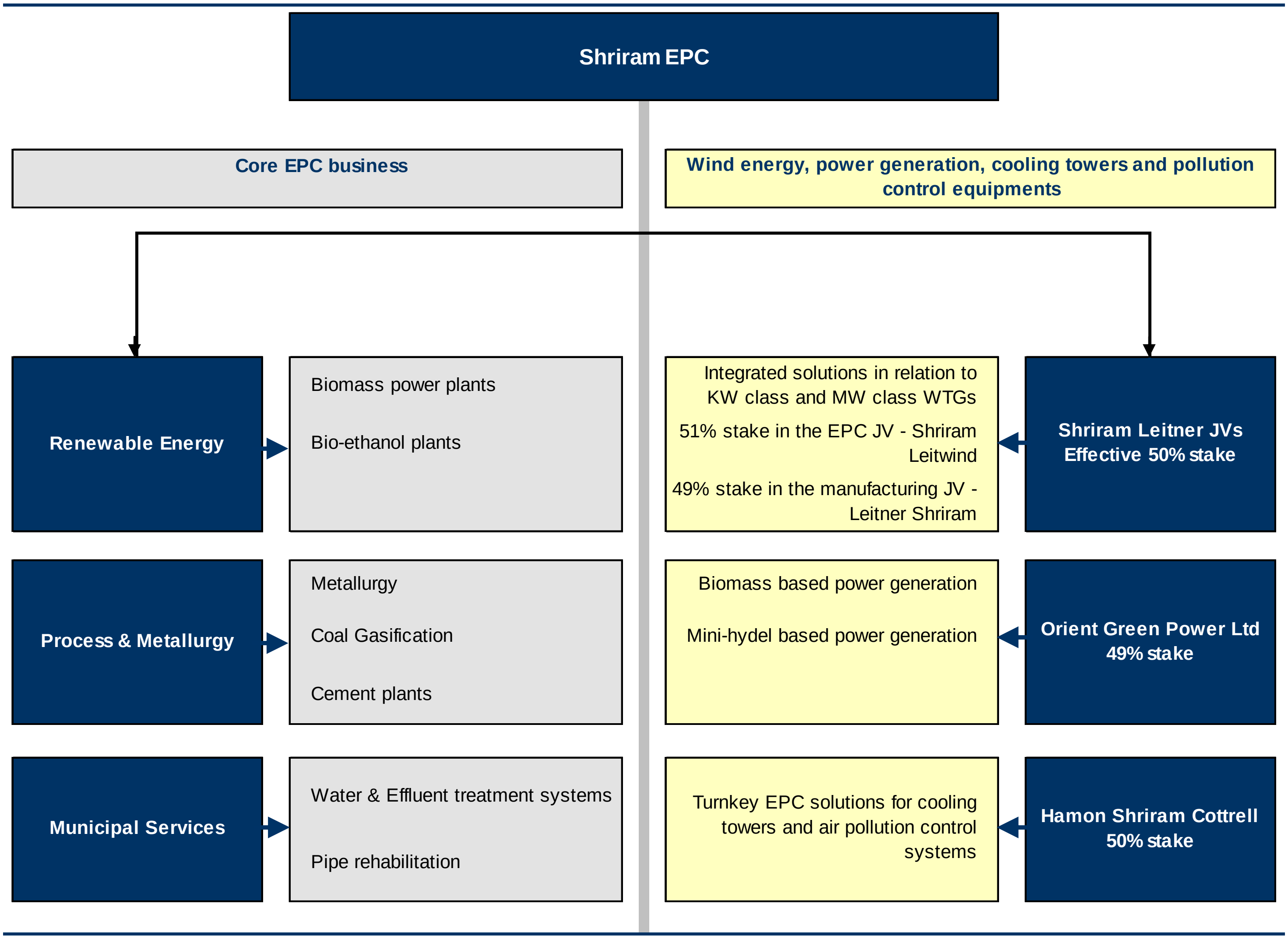
BUSINESS STRUCTURE



BUSINESS OVERVIEW

Background

Shriram EPC Ltd (SEPC) was promoted by the Chennai-based Shriram group in June 2000, to render engineering, procurement and construction services. Further, pursuant to a High court of Madras order dated July 22, 2005, Shriram Engineering Construction Company Pvt. Ltd, another group company originally incorporated in 1982, which was focused on civil construction works, merged into SEPC effective April 1, 2004.

SEPC listed on the Indian bourses during Feb'08 after a successful IPO during Jan'08.

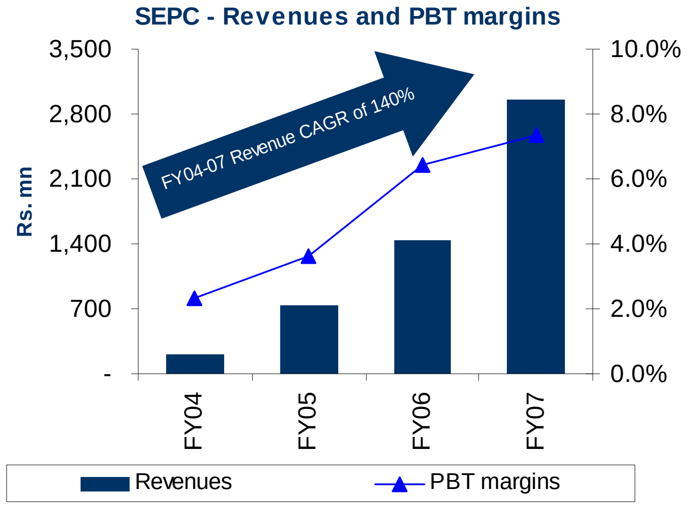
Core EPC business of SEPC

SEPC has established itself as a dominant EPC player in three broad verticals – Renewable energy, process & metallurgy and urban renewal. The core services of the company in these verticals include detailed design & engineering, materials procurement and overall project management.

- Renewable energy projects (~17% of FY07 revenues) consist primarily of biomass-based power generation, co-generation and bio-ethanol plants.
- In process and metallurgy (~40% of FY07 revenues), SEPC is focused on providing turnkey solutions for iron & steel, cement, aluminum, copper and thermal power plants. The company's orderbook comprises services relating to blast furnace auxiliaries, rolling mills, aluminum refining plants, copper smelting plants, coal gasification plants and coke oven batteries.
- Municipal service projects (~7% of FY07 revenues) of SEPC consist of design & implementation of turnkey environmental projects, which include water distribution, effluent / sewage treatment and pipe rehabilitation.

WTG – Integrated solutions

In relation to wind turbine generators (WTGs), SEPC focuses on providing integrated solutions, which include identification of suitable windfarm sites, technical planning, infrastructure development, installation & commissioning of WTGs, connection to grid and after-sale operations & maintenance. The vertical contributed ~37% to FY07 revenues and consisted of services in relation 250KW machines.



Source: SEPC Red Herring Prospectus, Spark Research

In FY09E, SEPC will launch megawatt class (1.5MW) WTGs, through the strategic partnership with Leitwind, a Dutch company engaged in manufacture of WTGs in Europe. The manufacturing facility, located at Gummidipoondi (near Chennai), will commence operations with an initial capacity of 140 machines per annum during Sep'08.

Stake in Orient Green Power

SEPC holds ~49% stake in Orient Green Power Ltd (OGPL), the company which will be engaged in biomass-based and hydel-based power generation. Stake is to be raised to ~51%.

OGPL currently has majority stakes in operating power generation assets totaling to ~25MW. The company proposes to grow its power assets to ~150MW by FY10E, for which the company has identified suitable acquisition opportunities. OGPL plans to list in the AIM exchange, a move that can unlock significant value for SEPC shareholders.

Majority stake in Hamon Shriram Cottrell

SEPC holds a majority stake in Hamon Shriram Cottrell, the company established in partnership with Hamon, to provide turnkey EPC solutions for cooling towers and air pollution control systems.

INVESTMENT RATIONALE

1 – Direct play on renewable energy theme, with strengths in wind and biomass

SEPC, we believe, is a direct play on the ~ US$ 90bn global investments into wind energy and the ~ US$ 1bn domestic investments into biomass power, which we expect will materialise over 2008-10. SEPC plans to ride the renewable energy theme by adopting the following broad strategies :-

Integrated solutions in relation to wind turbines

- Provide WTG related integrated solutions, including identification of windfarm sites, infrastructure development, installation, commissioning, grid connection and after-sale operations & maintenance.
- In this vertical, SEPC will focus on the 1.5MW WTGs that are to be manufactured in partnership with Leitwind. SEPC seeks to derive maximum value from the global tight supply situation. SEPC will target the Indian and European markets to sell its megawatt class WTGs whereas the existing 250KW product line will be gradually phased out over FY09-10E.

EPC contracts in relation to renewable energy plants

- Focus on opportunities arising out of biomass power plants that are to be setup in India. With a yawning gulf between India's current biomass-based power generation capacity (~1.1GW) and the potential (~16GW), SEPC intends to leverage its six year experience in biomass EPC contracting to establish itself as a leading domestic player in the vertical.
- Target opportunities for providing turnkey services in relation to wheat / corn based bio-ethanol plants and seek to establish a global footprint through such services.

Aspects	Wind	Biomass
SEPC services	Design, manufacture & installation of WTGs	Turnkey construction services
Rated capacities	1.5 MW turbines & 250KW turbines	7.5-15 MW plants
Partnerships	Leitwind	None
Key Clients	Theolia, Fairdeal, Dodanavar	Laxmi Energy, ETA Power
Dec'07 orderbook	Rs. 1.8bn	Rs. 2.1bn
Project locations	TN, Karnataka, Maharashtra	Punjab, TN, Chattisgarh, Maharashtra
Target opportunity	Rs. 49.0bn	Rs. 29.0bn

Global wind energy theme and SEPC's positioning

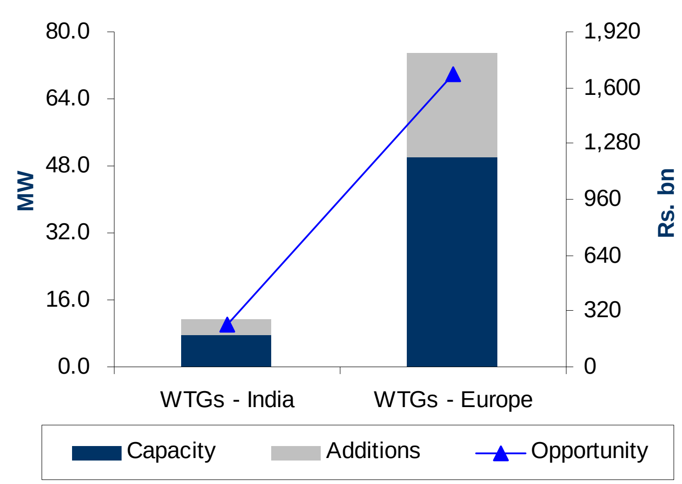
Acute short supply – Globally, WTG supply has lagged demand, over the last 3-5 years. Aggressive expansion plans of the European countries and the Asian majors, China and India, have bolstered demand further. According to Global Wind Energy council, global WTG installations are expected to grow at a CAGR of 18% over 2007-10, from ~91GW to ~150GW, implying annual installations of ~20GW. Increased cost competitiveness of wind-based power generation (Rs. 4 per unit), greater environmental awareness and incentives (production tax credits & accelerated depreciation) are chief reasons for the demand surge.

Based on industry sources, we estimate global WTG supply capacity at ~19GW, implying that <95% of demand can only be met, representing a short supply situation. As a result, we believe turbine suppliers are in a sweet spot with capacity absorption virtually assured over the next 2-3 years.

SEPC is an established turbine supplier seeking toehold into megawatt class machines – SEPC commenced supply of 250KW WTGs in Sep'06 and has supplied more than 210 turbines since. In 2007, SEPC tied up with the Dutch company Leitwind, a technology partner, in order to manufacture and supply 1.5MW gearless WTGs, capable of operating at variable speeds and variable pitch. The turbines will employ permanent magnet technology, which implies lesser moving parts and in turn, permits quick installation and hassle free operation post installation. Effective FY09, the WTG business of SEPC (including the 250KW turbines) will operate under the Leitwind brand.

The 1.5MW turbine manufacturing facility at Gummidipoondi, being set up at a total cost of Rs. ~2.0bn, will have an annual capacity of 250 machines by FY10.

Europe & India - Rs. 1.9tn wind energy opportunity



Source: Spark Estimates

SEPC's 1.5MW wind turbine generators are technologically superior and are to be competetively priced

Technology	Variable pitch Fixed speed Geared	Variable pitch Variable speed Geared	Variable pitch Variable speed Gearless	Variable pitch Variable speed Gearless Permanent magnet
Players	Suzlon	Gamesa, Vestas, GE Wind	Enercon	Shriram Leitwind
Pricing	~ Rs. 65mn per MW	~ Rs. 68mn per MW	~ Rs. 64mn per MW	~ Rs. 66mn per MW

Target opportunity for SEPC

- SEPC will aggressively market its 1.5MW turbines and focus on opportunities in India. Further, the company has identified Europe as a thrust area, given Europe's transparent operating environment and the company's intention to mine the France-based windfarm major Theolia, an existing SEPC client.
- Europe and India are expected to add 24.7GW and 3.6GW of wind-based power generation capacity respectively, over the next three years. On this basis, we expect the revenue opportunity from turbine supply, in Europe and India, at Rs. 1,680bn and Rs. 245bn respectively.
- The European and Indian wind turbine markets together, we believe, present SEPC revenue opportunities of ~Rs. 49bn over the next three years. SEPC will target a market share of ~8% on wind turbine installations in India and a market share of ~2% on the European turbine installations.

Particulars	Europe	India
Installed WTGs (GW)	50.3	7.3
Additions over 2008-10 (GW)	24.7	3.6
Total opportunity for turbine suppliers (Rs. bn)	1,680	245
Target opportunity for SEPC (Rs. bn)	29	20
Target market share (%)	1.7%	8.0%

Our projections

We believe there will be strong demand for SEPC's megawatt class turbines for several reasons such as

- superior technology (permanent magnets & gearless turbines);
- competitive pricing (Rs. 66mn per MW); and
- the prevailing tight supply situation.

However, we believe SEPC faces significant technology risks, given that the company currently has operating data from only one WTG in Tamil Nadu. Even by Sep'08, when the Gummidipoondi plant is scheduled to commence operations, SEPC will have operating data from only one other WTG, at Karnataka. The lack of operating data could work against the company and lead to execution slippages.

Thus, we assign a 60% capacity utilisation to the megawatt class turbine capacity and arrive at our projections. Accordingly, we project turbine business revenues and net profits over FY09-10E, cumulatively, at Rs. 16.8bn and Rs. 1.3bn respectively.

Particulars	FY09E	FY10E
1.5MW units – average annual capacity	60	168
Conversion probability	60%	60%
Estimated units sold	36	101
Revenues from 1.5MW units	Rs. 3.6bn	Rs. 11.1bn
Revenues from 250KW units	Rs. 1.4bn	Rs. 0.9bn
Total revenues	Rs. 4.9bn	Rs. 12.0bn
EBITDA	Rs. 0.7bn	Rs. 1.9bn
Profits after taxes	Rs. 0.2bn	Rs. 1.0bn

Domestic biomass theme and SEPC's niche

Strong growth ahead

Investments into biomass power projects in India have progressed steadily, with commissioned capacities increasing from ~300MW (54 projects) to ~1,103MW (~100 projects), over Mar'05-Dec'07 (Source: MNES).

According to the Ministry, biomass power capacity additions in India, over 2008-12, are expected to be >2,000MW. We list below the key factors that will operate in favour of biomass power capacity additions in India.

- Financial support in the form of interest rate subsidies from the Ministry of non-conventional energy sources.
- Availability of financing for such projects from IREDA and financial institutions.
- State support through rates through long term PPAs, wheeling & banking facilities and prompt payment mechanisms.
- Single window clearance facilities at the state nodal departments.
- Eligibility for carbon credits.

Biomass presents SEPC a Rs. 29bn target opportunity

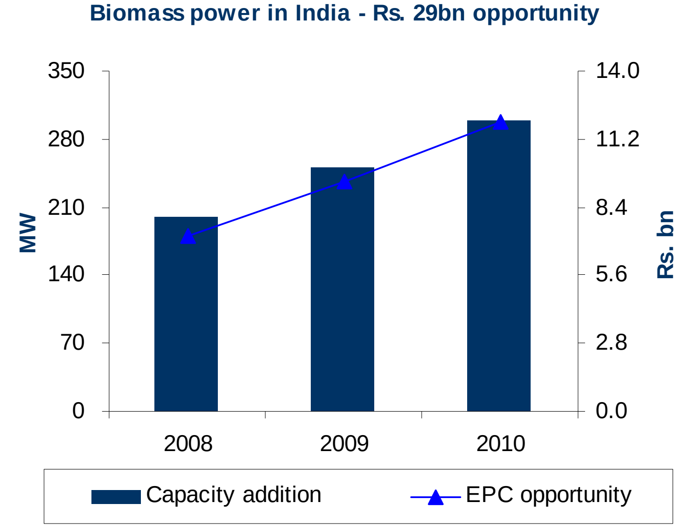
Based on the mentioned factors, we expect the capacity to grow at a CAGR of 19% over 2008-2010, to ~1,853MW, implying an average capacity creation of ~250MW each year. We expect the said capacity augmentation to present an EPC opportunity of ~Rs. 29bn.

SEPC is an established player in biomass power

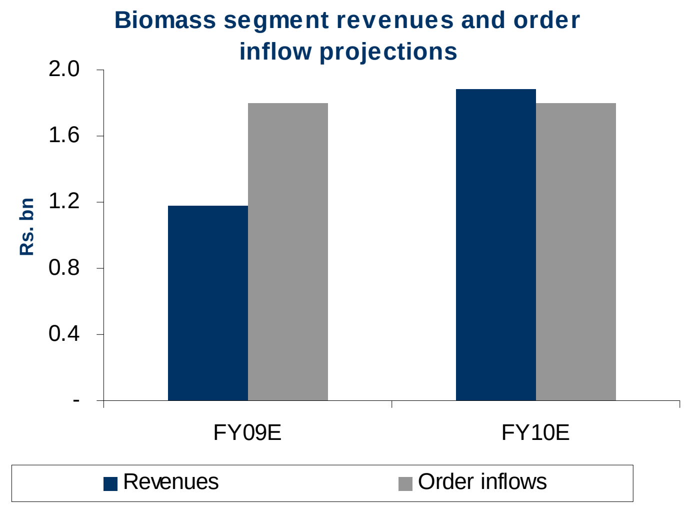
- SEPC has established itself as a strong player in biomass power plants, with the segment generating >Rs. 1.6bn revenues since commencement.
- The Dec'07 orderbook of SEPC, in the biomass segment, stands at a healthy Rs. 2.1bn. The orderbook is expected to be executed over the next two years and contains an equal proportion of lumpsum contracts and cost-plus contracts.
- As a strategy, SEPC plans to increasingly focus on lumpsum turnkey contracts, with a view to earn superior margins (~9%) as against the margins (~7%) in cost-plus contracts.
- We expect SEPC to target a 20% market share of the Rs. 29bn EPC opportunity, virtue of its established position in the biomass segment.

Our projections

- We project healthy order inflows of ~Rs. 3.6bn over FY09-10E, of which we think a significant portion (>50%) to be from OGPL.
- We expect revenues from the segment to grow at a CAGR of 55% over FY07-10E, from Rs. 0.5bn to Rs. 1.9bn.
- We assume operating profit margins at ~8-9%.



Source: Spark Estimates



Source: Spark Estimates

Strong drivers for global investments in wind energy

- Globally, the fastest growing renewable energy source. Potential for wind energy is >45GW in India alone.
- Lower lead time of ~12 months for creation of generation capacities, when compared with traditional energy sources.
- Rapid improvements in technology steadily lowering the initial investment requirement.
- Low running costs compensate for the relatively high initial investment.
- Fiscal support in the form of production tax credits and accelerated depreciation.
- Healthy equity IRRs in the 14-16% range.

Operational aspects of a 1.5MW WTG installation in India	
Capital cost	Rs. 100mn
Debt-equity	60:40
Capacity factors	25-33%
Tariffs per kWhr	Rs. 3.3 – 4.0
Annual fixed costs	Rs. 0.7mn
Unit operating costs	Rs. 0.2 – 0.4
Unit generation cost (incl. debt service and depreciation)	Rs. 1.8 – 3.2
Equity IRRs	14 – 16%

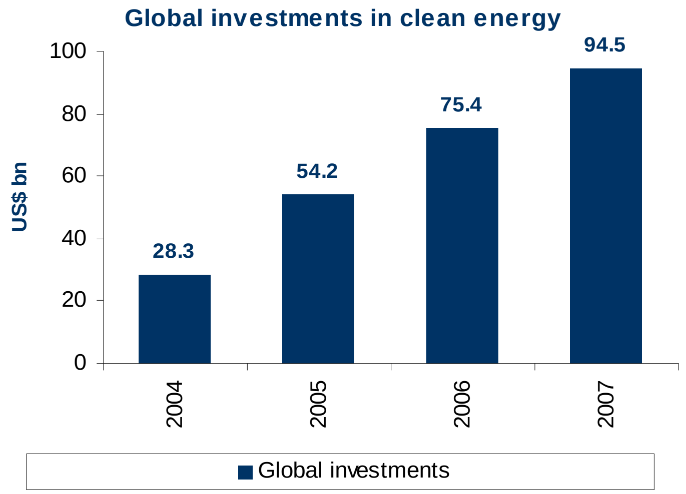
Rationale for biomass-based power generation in India

- Proven power generation source with >1GW of installed capacities in India. Biomass-based power generation potential of India estimated at >16GW.
- Reasonable gestation period of ~15 – 20 months.
- Limited execution risks as the technology is identical to that used in traditional coal based thermal power plants.
- Availability of feed stock is virtually secured, as biomass power generation is a licensed activity.
- Fiscal initiatives such as accelerated depreciation and duty exemptions.
- Impressive equity IRRs in the 16-20% range.

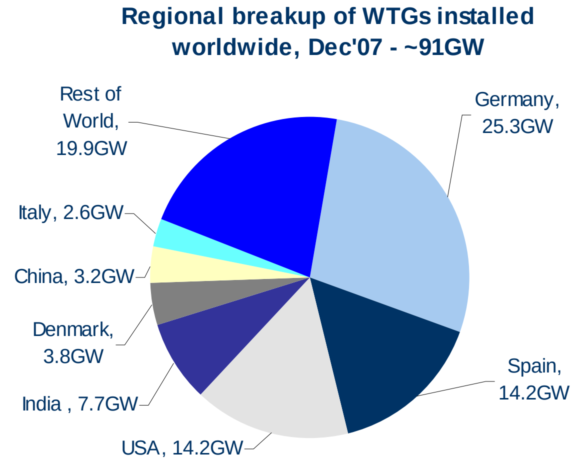
Operational aspects of a 7.5MW biomass plant in India	
Capital cost	Rs. 398mn
Debt-equity	70:30
Plant load factors	70-85%
Tariffs per kWhr	Rs. 3.3 – 4.0
Annual fixed costs	Rs. 9.0mn
Unit operating costs	Rs. 1.2 – 1.4
Unit generation cost (incl. debt service and depreciation)	Rs. 2.5 – 2.8
Equity IRRs	16 - 20%

Aspects	Wind Energy Theme - Global	Biomass Power Theme - India
Background	Established renewable energy source with global installed capacity of ~91GW, growing at >20% each year	Proven power generation source based on organic wastes. 1.1GW of biomass-based plants are installed in India.
Typical unit size	250KW to 3MW machines, with each windfarm having atleast 20-30 units	7.5 - 15MW units with upto 2 units within a single plant
Capital cost per MW	▪ Rs. 60 - 68mn with an expected life of >20 years ▪ Capital costs are expected to decline 15-20% with improvements in technology	▪ Rs. 50 - 55mn with an expected life of >25 years ▪ Capital costs not expected to vary significantly as biomass power plants use conventional thermal power technology
Gestation period	12 - 15 months	15 - 20 months
Locations	Onshore and offshore sites with high incedence of winds. Eastern & Western Ghats in India are examples of onshore sites.	Andhra Pradesh (301MW installed), Karnataka (254MW) and Tamil Nadu (216MW) are dominant states, representing ~70% of India's biomass-based power generation plants.
Favourable legislations	▪ Production tax credit, at 1.5cents per kwhr, allowed by the Government of United States ▪ Wind Power Production incentives (WPPI) provided for by the Government of Canada ▪ European utilities set targets of drawing a minimum percentage of power from alternative energy sources ▪ In India, benefits take the form of accelerated tax depreciation, concessional customs, excise & sales tax exemptions and tax holidays	▪ Licensing based on earmarking specific catchment areas for designated projects ▪ Sale of power to the State utilites at preferential tariffs, with escalation provisions ▪ Accelerated depreciation (80% based on the WDV method) and 10 year tax holiday ▪ Concessional cutoms rates and exemptions from excise & sales tax
Key risks	▪ Withdrawl of the fiscal initiatives ▪ Discovery of equally scalable alternate source of renewable energy	▪ Rollback of the fiscal initiatives ▪ Indiscriminate licensing

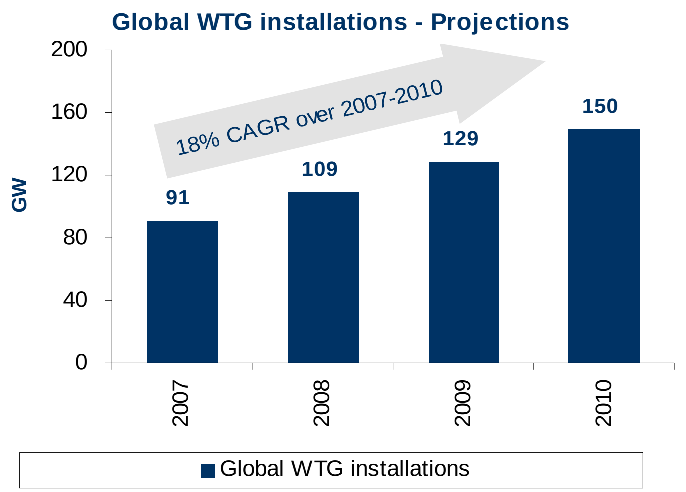
RENEWABLES AND WIND ENERGY - FOCUS CHARTS



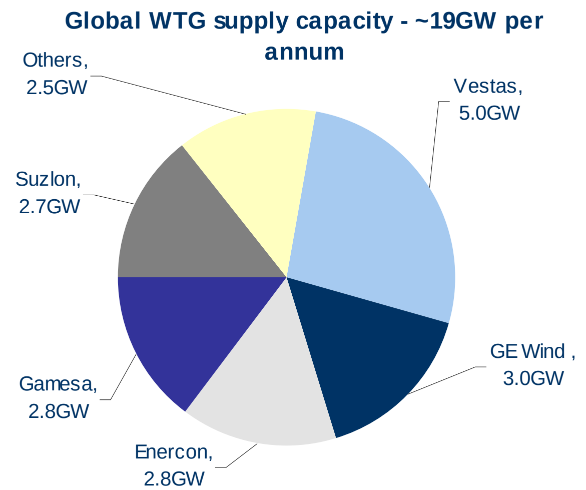
Source: New Energy Finance, Spark Research



Source: Global Wind Energy Council, Spark Estimates



Source: Global Wind Energy Council, Spark Research

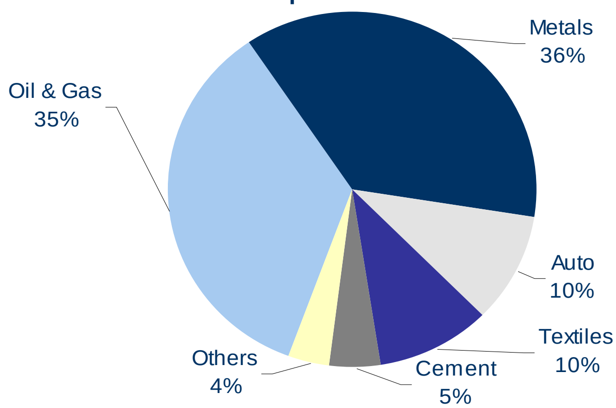


Source: Global Wind Energy Council, Spark Estimates

2 – Key beneficiary of the strong investments expected to flow into core industries in India

SEPC's 'process & metallurgy' segment derives its demand from capacity creation in core industries such as metals, cement and power. SEPC, we believe, will be a major beneficiary of the >3 fold increase in core industrial investments, expected over the five year period commencing 2007. Core industrial investments are expected to swell from Rs. 2.3tn over 2002-06 to Rs. 7.0tn over 2007-11. Steel and cement industries, thrust areas for the 'process & metallurgy' segment, are expected to be major drivers for such investments and are expected to contribute >40% of the sectoral investments.

Breakup of India's Rs. 7.0tn core industrial investments expected over FY07-11



Source: CRISIL Research

'Process & metallurgy' segment highlights

- Actively commenced in 2004, the segment generated revenues of Rs. 1.2bn during FY07 and possessed an orderbook of Rs. 13.0bn as at Dec'07.
- Key clients include Steel Authority of India, Sree Jayajothi cement, OPG Energy and Jindal Steel & Power.
- SEPC accesses superior technology and execution skill-sets through partnerships with leading international players such as Danielli of Italy and SSIT of China.
- Lump sum turnkey contracts (46% of the segment's Dec'07 orderbook) are undertaken where the company has successfully executed similar projects. This gives the company the opportunity to control costs and enhance margins. Cost-plus contracts are usually taken up to venture into new areas and gain expertise. As a result, the segmental operating margins are in the healthy range of 13-15%.
- We project healthy order inflows of ~Rs. 4.5bn over FY09-10E. We expect revenues from the segment to grow at a CAGR of 87% over FY07-10E, from Rs. 1.2bn to Rs. 7.7bn.

3 – Strong proxy to spend on water and waste management systems

In the municipal services vertical, SEPC has a presence of more than a decade and has created a strong foundation to effectively exploit the following opportunities.

a) Derived demand from core industrial investments

- Investments into core industries bring along with them requirements for setting up water treatment plants, effluent treatment plants, waste water systems and such other facilities. The resultant spend could originate either from the corporates or from the Government.
- With BHEL, Karnataka Urban Water Infrastructure Development Finance Corporation, Tamil Nadu Water Supply and Drainage Board and Gujarat Water Supply & Sewerage Board as key clients and an orderbook of Rs. 1.0bn, the sub-vertical has witnessed a quantum scale-up in recent years and is expected to contribute steadily.

b) Government investments into sewage systems

- India's urban water infrastructure has been and continues to be put under tremendous pressure as a result of an increasing urbanization trend. Fittingly, greater public spend is being directed towards improving the sewage systems in urban areas.
- Within this space, SEPC provides advanced pipe rehabilitation solutions in relation to the renovation, replacement & repair of waterways, drainage pipes, industrial process & gas applications and sewer pipe networks & systems.
- SEPC offers the widest range of latest trenchless technologies available in the marketplace, through the use of the Rib loc™ lining technology and licensed use of the MSWL, CIPP lining, GRP Lining and pipebursting technologies. These technologies allow rehabilitation of underground sewer and water pipes without the need to excavate.
- In this sub-vertical, the company has already completed a project involving desilting and rehabilitation of sewer lines in Delhi. The sub-vertical has a Rs. 1.0bn orderbook and the management expects significant traction with projects worth >Rs. 16.0bn lined up for award at the four metros. Being one of three major players in the space, SEPC expects to target a 33% market share on such opportunities.

Segment highlights

- We expect order inflows to be robust, at ~Rs. 4.3bn over FY09-10E, with pipe-rehabilitation works contributing ~75%.
- We expect revenues from the segment to grow from Rs. 0.2bn in FY07 to Rs. 2.5bn in FY10E.

4 – Strategic foray into power generation through non-conventional energy sources

SEPC's stake in OGPL represents a strategic foray into power generation, with a vision to add a business that is insulated from the vicissitudes of the construction investment cycle and generates steady cashflows.

OGPL will invest in and develop power generation assets based on biomass and other renewable energy technologies across India, through its operating subsidiaries.

Significant positives for OGPL

- OGPL plans to capture leadership position (>10% market share) in biomass based power generation by aggressively pursuing organic and inorganic opportunities to develop a portfolio of generation assets. Overall, the company will look to control a significant ~200MW of power generation assets by FY11E.
- With an initial equity investment of Rs. 0.8bn, we believe OGPL has the necessary financial strength to carry out a major portion of such expansion. SEPC's domain expertise in operating & maintaining biomass-based power plants provide adequate comfort as regards the operating capabilities.
- Biomass-based power generation is a licensed activity with several beneficial terms such as virtual monopoly over the feedstock catchment area, committed offtake, accelerated depreciation, preferential tariffs, prompt payment mechanisms, 80IA exemption and entitlement to trading of carbon emission rights. With key issues pertaining to power generation addressed and with non-conventional energy sources being incentivised, we consider SEPC's foray into the business to be timely.
- The generation assets have attractive fundamentals, with stable cashflow patterns, strong profitability (net margins at ~20%) and healthy equity IRRs in the 16-20% range.

Particulars	FY09E	FY10E
Operational capacities (MW)	60	150
Average stake of OGPL	70%	70%
PLF assumptions	62%	72%
Average tariff (Rs. / unit)	3.25	3.33
Revenues (Rs. mn)	1,059	3,152
EBITDA%	54.8%	54.7%
Net profit %	16.6%	19.4%
Profits pertaining to SEPC's 51% stake in OGPL (Rs. mn)	63	219

5 – Established partnerships with leading global players

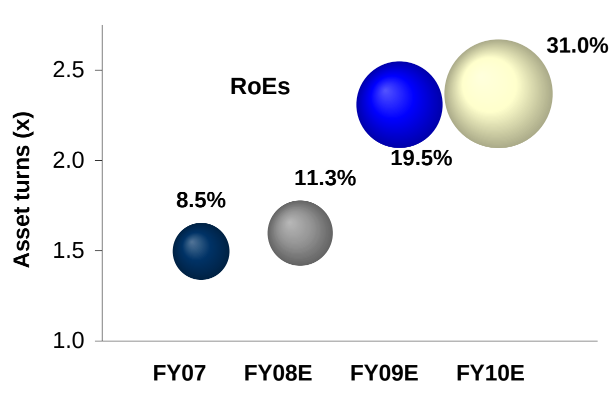
We like SEPC's strategy of partnering with leading global players in the various business verticals, which allows the company to gain better access to advanced technologies and resources, enabling the company to compete better. SEPC has the following strategic / project-specific alliances.

- Strategic alliance with Leitwind, a Netherlands company that has certain proprietary technology used in WTGs. Leitwind is a leader in ropeway systems and has developed permanent magnet-based drive technology, which is the key component used in WTGs..
- In relation to the municipal services business, the company has entered into license agreements with CPT group, Perco and Angerlehner for the use of advanced pipe bursting and lining technologies.
- Strategic alliance with the Hamon group for providing advanced cooling tower solutions.
- SEPC works with other leading global players such as Danielli (Italy), Waterbury (Canada), SSIT (China) and Envirotherm (Germany) for its projects in the process & metallurgy vertical.

6 – At an inflexion point - capital efficiencies are set to improve sharply

- SEPC is at an inflexion point in its growth path, with strong growth expected in its EPC business and the renewable energy business expected to boost profitability significantly.
- We expect the RoE, based on consolidated profits, to improve sharply from 8.5% in FY07 to ~31% in FY10E, representing a >3.6x improvement in capital efficiencies over the period.

SEPC is at an inflexion point with capital efficiencies set to improve significantly



Source: Spark research

KEY RISKS

Technology and acceptance risks relating to the megawatt class turbines

- The technology and acceptance risks surrounding the megawatt class WTG of SEPC, we think, are the most significant downside risks to our estimates.
- The 1.5MW turbines use modern technologies that are virtually untested, which can serve as a severe deterrent to the potential clients. A lack of operating data or inconclusive operating data could seriously hamper the prospects of that business. Further, we note that SEPC has not started marketing the 1.5MW WTG and thus we cannot be certain about the demand for the product.
- However, we take comfort from the facts that the 1.5MW WTGs use the superior permanent magnet technology and are to be competitively priced. The prevailing short supply of turbines provides us added comfort that SEPC will be able to successfully market its new product.

Commodity price risks

- SEPC provides turnkey solutions in the EPC contracting business. A majority of the company's contracts are on a lumpsum turnkey basis, implying that the company is exposed to risks of raw material price fluctuations. Any unfavourable shifts in raw material prices could lead to margin erosion and pose a downside to our estimates.

Rollback of fiscal incentives in renewable energy

Rollback of the fiscal incentives, such as accelerated depreciation and the 10 year tax holiday, can result in a slowdown of investments into renewable energy and can have an adverse impact on the prospects of SEPC.

Execution risks

Government clearances, project delays and extended monsoon season could cause time and cost over-runs and also delay project execution and defer revenue accrual. The problem is aggravated by the scarcity of skilled human capital. Also, contingent liabilities on projects could be substantial.

Competition

India's construction sector in general and SEPC's low-ticket size EPC market in particular, are severely fragmented. There is intense competition for the low ticket-size projects and the sector is getting increasingly commoditised. Thus, most projects are awarded to lowest bidders, resulting in price-competition. Such increased competition could compress the margins of SEPC, representing a downside to our estimates.

Management of inorganic growth

OGPL plans to grow inorganically by acquiring operating biomass-based power generation assets. Given the stretched valuations of power generation assets, there is a distinct possibility that the company could overpay for such assets.

VALUATION DISCUSSION

Base case

- We believe that relative valuation methodologies based on earnings multiples are ideal for valuing companies such as SEPC. We note that SEPC's peers, operating in a variety of similar contracting businesses, currently trade between 11 - 24x FY09E earnings.
- SEPC currently trades at 13.2x FY09E earnings and 6.4x FY10E earnings. We believe that the company, virtue of its strong expected earnings growth and improvements in capital efficiencies, will continue to trade at similar multiples a year from now.
- We expect SEPC to grow strongly, with earnings CAGR of ~122% over FY07-10E, given its comprehensive game plan to exploit opportunities in the renewable energy space and the strong growth prospects of the process & metallurgy and municipal service verticals. We expect SEPC to trade at a P/E multiple of 12.0x on FY10E consolidated EPS of Rs. 34.7, a year from now. Accordingly, we expect the SEPC stock to trade at a price of Rs. 416 per share.
- We initiate coverage on SEPC with an **OUTPERFORM** rating based on a **Mar'09 price target of Rs. 416**. We note that from current levels, there exists an 87% upside to our price target.

Blue sky scenario

Our base case estimates are drawn up on the basis of the following two significant assumptions, for the sake of conservatism.

- Capacity utilisation at the megawatt class WTG manufacturing facility taken at 60%, despite the prevailing tight supply situation. We have done so because we consider the technology risk surrounding the megawatt machines to be significant.
- Revenues from trading of carbon emission rights not considered in arriving at the earnings estimates of OGPL, given that there could be restrictions imposed on such trading.

However, taking into consideration the there is a realistic chance that the megawatt class technology is well received and that OGPL earns revenue from the trading of CERs, we also consider it pertinent to present a blue sky scenario for SEPC, assuming such possibilities materialise.

Based on our blue sky scenario, we expect SEPC's FY07-10E earnings CAGR of ~137%. Applying our target multiple of 12.0x on our blue sky estimates, we arrive at a valuation of Rs. 503 for the SEPC stock, representing an upside of 125% from current levels. **Thus, we consider SEPC to be a compelling as well as an asymmetric bet on the upside.**

SEPC's earnings estimates for base case and blue sky scenarios

Particulars	Stake	Base case FY09E	Base case FY10E	Blue sky FY09E	Blue sky FY10E
Stand alone net profits		561	808	561	808
Leitner Shriram & Shriram Leitner	50%	103	483	154	685
		60% WTG capacity utilisation		80% WTG capacity utilisation	
Orient Green Power	51%	63	219	104	338
		No revenues from CERs		CERs traded at US$ 12.5	
Hamon Shriram Cottrell	50%	11	12	11	12
Ennore Coke	32%	18	26	18	26
Consolidated net profit		**756**	**1,547**	**849**	**1,869**
Consolidated EPS (Rs.)		**16.9**	**34.7**	**19.0**	**41.9**

Note: All numbers in Rs. mn unless otherwise stated

SEPC - PEER VALUATION MATRIX													
Company	Price 19-Mar-08 Rs.	M.Cap Rs. mn	E.V Rs. mn	Revenues Rs. mn		EBITDA Rs. mn		Net profits Rs. mn		P/E (x)		RoE %	
				FY08E	FY09E	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E
Larsen & Tuobro	2,841	829,546	861,822	256,112	342,053	33,090	47,877	22,793	31,207	36.4	26.6	28.7	29.9
IVRCL	357	47,620	51,027	34,657	47,967	3,708	5,093	1,911	2,630	24.9	18.1	13.3	15.8
NCC	221	50,528	63,552	38,227	49,584	4,266	5,989	2,023	2,714	25.0	18.6	16.8	16.6
Gammon	388	33,647	35,550	25,923	33,556	2,309	3,037	1,158	1,610	29.1	20.9	10.5	12.6
Maytas Infra	581	34,180	38,852	11,519	20,855	1,714	2,852	980	1,622	34.9	21.1	17.8	20.3
HCC	113	28,880	44,348	31,559	39,526	3,462	4,569	1,036	1,513	27.9	19.1	10.5	12.5
Simplex Infra.	562	27,708	33,509	26,761	37,790	2,808	4,276	936	1,673	29.6	16.6	19.0	18.7
Patel Engineering	574	34,217	39,177	16,392	21,612	2,226	2,931	1,216	1,529	28.1	22.4	16.3	17.4
McNally Bharat	160	4,587	4,587	7,068	9,357	525	964	259	431	17.7	10.6	19.3	19.8
Praj Industries	111	20,330	18,824	9,104	13,988	1,482	2,058	1,199	1,756	17.0	11.6	57.1	44.6
Alstom Projects	494	33,113	30,088	16,600	21,515	1,758	2,424	1,464	1,949	22.6	17.0	38.7	39.2
Thermax	531	63,284	60,622	33,956	44,115	4,346	5,837	2,954	3,940	21.4	16.1	42.0	42.6
ABB	1,106	234,264	221,192	83,443	110,012	10,922	14,673	7,288	9,951	32.1	23.5	38.1	38.4
BHEL	1,852	906,518	851,213	218,051	289,467	48,761	67,726	32,829	46,304	27.6	19.6	33.7	37.3
Suzlon	235	352,378	392,081	132,711	195,937	19,761	30,384	11,375	18,398	31.0	19.2	22.0	24.2

Note: Estimates refer to consolidated numbers

Details of intended utilisation of IPO proceeds		
Expenditure items	Total estimated investments Rs. mn	Amount to be utilised out of net proceeds Rs. mn
Investments in Shriram Leitwind and Leitner Shriram	403.2	128.3
Investments in OGPL	400.0	400.0
Purchase of plant & equipments for pipe rehabilitation projects	76.7	76.7
General corporate purposes	895.0	895.0
Total		**1500.0**

FINANCIAL SUMMARY

SEPC Consolidated financial statements

Profit & Loss (Rs. mn)

	FY07	FY08E	FY09E	FY10E
Revenues	2,957	5,333	16,709	29,257
Operating Costs	2,734	4,847	14,745	24,563
EBITDA	223	486	1,963	4,695
Other Income	49	46	41	3
Depreciation	14	20	277	604
EBIT	258	512	1,727	4,094
Interest	41	103	442	849
PBT	217	409	1,285	3,245
Net Profit	131	286	943	2,387
Net profit after minority	141	286	727	1,510
Net profit incl. Associates	141	295	756	1,547

Balance Sheet (Rs. mn)

	FY07	FY08E	FY09E	FY10E
Paid up Capital	382	446	446	446
Reserves & Surplus	1,324	3,060	3,787	5,297
Minority interest	-	-	1,294	2,643
Total debt	200	1,228	4,154	9,044
Deferred Tax	9	28	28	28
Total Networth & Liabilities	**1,914**	**4,762**	**9,709**	**17,459**
Gross Fixed assets	219	419	4,899	11,046
Accumulated Depreciation	(43)	(62)	(339)	(943)
Net fixed assets	176	357	4,560	10,103
CWIP	0	1	1	1
Investments	172	957	149	149
Total Long term assets	348	1,315	4,710	10,254
Current assets				
Inventory	275	533	1,074	1,409
Debtors	1,356	2,240	5,153	8,646
Cash	269	1,527	860	296
Loans & Advances	653	1,067	2,147	2,818
Current liabilities	988	1,920	4,236	5,964
Net current assets	1,566	3,447	4,999	7,205
Total Assets	**1,914**	**4,762**	**9,709**	**17,459**

Cash Flows (Rs. mn)

	FY07	FY08E	FY09E	FY10E
Cash flows from Operations	(295)	(298)	(1,215)	(657)
Cash flows from Investing	(220)	(986)	(3,672)	(6,147)
Cash flows from Financing	(273)	2,542	4,220	6,240
Cash Generated	(787)	1,258	(667)	(564)
Opening Cash	1,056	269	1,527	860
Closing Cash	269	1,527	860	296

Growth ratios (%)

	FY07	FY08E	FY09E	FY10E
Sales	104.6%	80.3%	213.3%	75.1%
EBITDA	69.9%	118.1%	303.9%	139.1%
EBIT	95.8%	98.8%	237.1%	137.0%
PBT	132.2%	88.9%	214.1%	152.5%
Net Profit	111.3%	103.7%	153.7%	107.7%

Margin ratios (%)

	FY07	FY08E	FY09E	FY10E
EBITDA	7.5%	9.1%	11.8%	16.0%
EBIT	8.7%	9.6%	10.3%	14.0%
PBT	7.3%	7.7%	7.7%	11.1%
Net Profit	4.8%	5.4%	4.4%	5.2%

Performance ratios

	FY07	FY08E	FY09E	FY10E
RoA (%)	10.7%	11.6%	12.0%	11.6%
RoE (%)	8.5%	11.3%	19.5%	31.0%
RoCE (%)	7.9%	10.7%	17.5%	22.2%
Sales / Total Assets (x)	1.5	1.6	2.3	2.4
Fixed Assets Turnover (x)	22.2	20.0	6.8	4.0
Working capital Turnover (x)	1.7	2.1	4.0	4.8

Financial stability ratios

	FY07	FY08E	FY09E	FY10E
Total Debt to Equity (x)	0.1	0.4	0.8	1.1
Net Debt to Equity (x)	-0.3	0.0	0.4	0.7
Current ratio (x)	2.6	2.8	2.2	2.2
Working capital days	190.7	232.7	107.7	88.7
Inventory & Debtor days	198.6	187.2	134.2	123.7
Creditor days	130.0	142.6	103.4	87.4
Interest cover (x)	6.3	5.0	3.9	4.8
Debt to EBITDA (x)	0.9	2.5	2.1	1.9

Valuation metrics

	FY07	FY08E	FY09E	FY10E
Shares outstanding (mn)	20.2	42.9	42.9	42.9
Market Cap (Rs.mn)		9,557		
Fully Diluted Shares (mn)	20.2	44.6	44.6	44.6
Fully Diluted M.Cap (Rs.mn)		9,947		
Fully Diluted EPS (Rs.)	6.9	6.6	16.9	34.7
P/E (x)	32.1	33.7	13.2	6.4
Price to Sales (x)	3.2	1.8	0.6	0.3
EV (Rs.mn)		9,258		
EV to Sales (x)	3.1	1.7	0.6	0.3
EV/ EBITDA (x)	41.5	19.0	4.7	2.0
BV/ share (Rs.)	84.3	78.6	94.9	128.7
Price to BV (x)	2.6	2.8	2.3	1.7

Rating interpretation

OUTPERFORM	Greater than 15% upside from current price
NEUTRAL	Upside or downside from the current price is within 15%
UNDERPERFORM	Greater than 15% downside from the current price

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