

SUZLON ENERGY

INR 1,205

*Confusion continues*

ACCUMULATE

* Results below expectations

Suzlon Energy (Suzlon) came up with the second consecutive quarter of surprises. Its reported revenues and net profits were below our expectations. Standalone revenues grew 27% Y-o-Y to INR 11 bn in Q3FY07 and net profit grew by 8.8% to INR 1.7 bn. EBITDA registered a growth of 10% Y-o-Y at INR 2.0 bn, but higher other expenses on account of increased overheads on manufacturing facility in the US and China saw margin decline by 290bps Y-o-Y. On a consolidated level, revenues stood at INR 19.1 bn and net profits at INR 1.7 bn. Despite lower tax rate, net margin declined by 590bps.

* Implied 4QFY07 numbers very high to achieve guidance

The outlook for global wind market remains robust (discussed further in the section) and provides sustainability of growth for Suzlon in the coming years. However, predictability of earnings has been difficult. This is demonstrated in the earnings for the last two quarters, wherein volume growth has been sluggish, despite a strong order book. Q2FY07 saw margin pressure on account of 4% special duty on imports, change in product mix, and increased overheads due to international operations. This quarter, the pressure continued due to insufficient volume ramp up at manufacturing facilities in the US and China, leading to unapportioned overheads. It baffles us that the company could not supply for international orders from its under utilised domestic facilities. The performance of the last two quarters has now put the onus on the company to achieve very high numbers in the fourth quarter to meet their unchanged guidance for FY07E.

* Revising estimates downwards

We have revised our EPS estimates downwards for FY07E, FY08E, and FY09E by 8.8%, 6.9% and 6.2%, respectively. We now expect an EPS CAGR of 37% during FY06-09E as against our earlier estimate of 40% CAGR. The stock trades at a PE of 21.6x and 18.7x on our revised FY08E and FY09E estimates of INR 57.5 and INR 68.1, respectively. We are changing our recommendation from 'TRADING SELL' to 'ACCUMULATE', as we see an upside of only ~12-15% from current levels. Even this upside could be back-ended till the confusion on quarterly performances abates. We would advise investors to buy at 7-10% lower levels.

Financials

Year to March	Q2FY07	Q2FY07	% change	Q1FY07	% change	FY07E	FY08E
Sales (INR mn)	19,139	20,870	(8.3)	8,806	117.3	61,887	96,413
EBITDA (INR mn)	2,546	3,600	(29)	1,500	70	13,414	21,967
Net profit (INR mn)	1,744	2,354	(26)	1,349	29	10,377	16,018
EPS (INR)						36.8	57.5
P/E (x)						33.4	21.6
EV/ EBITDA						25.8	15.7
ROE (%)						33.2	38.3

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Harish Sharma
+91-22-2286 4307
harish.sharma@edelcap.com

Krishnakant Thakur
+91-22-2286 4318
krishnakant.thakur@edelcap.com

Reuters : SUZL.BO
Bloomberg : SUEL IN

Market Data

52-week range (INR) : 1,510 / 760
Share in issue (mn) : 287.5
M cap (INR bn/USD mn) : 346.4 / 7,833.6
Avg. Daily Vol. BSE/NSE ('000) : 939.4

Share Holding Pattern (%)

Promoters : 69.7
MFs, Fls & Banks : 1.2
Fls : 21.4
Others : 7.7

Result Highlights

- ◆ Consolidated net revenues at INR 19.1 bn grew by 117% Y-o-Y, while net profit at INR 1.7 bn grew by 29.2% Y-o-Y. Due to seasonality of the business, Q-o-Q comparison does not provide the right picture.
- ◆ Suzlon's MW sales grew 58% Y-o-Y in this quarter at 339 MW. Domestic volumes at 190 MW remained almost flattish, while international volumes stood at 149 MW as against 13 MW in Q3FY06.
- ◆ For 9MFY07, Suzlon registered volume growth of 60% at 923 MW. Domestic volume contributed 62% to the total volumes.
- ◆ Realisations for domestic and export volumes stood at INR 43.2 mn/MW and INR 43.0 mn/MW respectively.
- ◆ EBITDA grew by 70% Y-o-Y to INR 2.5 bn, whereas EBITDA margin declined by 370bps to 13.3% as:
 - There was a 220bps increase in other expense that moved from 16.1% in Q3FY06 to 18.4% in Q3FY07. This high is due to higher freight cost and increased overheads of manufacturing facility in the US and China.
 - Employee cost (as a percent of sales) also moved from 4.1% in Q3FY06 to 9.4% in Q3FY07, as volumes did not come through.
- ◆ Interest cost saw a sharp increase of 469% Y-o-Y on account of additional interest burden due to Hansen's acquisition.
- ◆ Net profit grew by 29.2% Y-o-Y to INR 1.74 bn, while net margins stood at 9.0%.

* Management guidance looks difficult to achieve

Management has guided for 1500-1600 MW sales for the current financial year. In 9MFY07, Suzlon has achieved sales of 924 MW. On the operating margins front too, the management has guided for 20-22% of margins for the full year. In 9MFY07, Suzlon has achieved operating margin of only ~16%. In our view, though fourth quarter is robust, given the cyclical nature in the business the guidance is too strong to be achieved.

* Global wind energy outlook improves

International Energy Agency (IEA), in its world energy outlook, has portrayed a very promising scenario for wind energy. It expects wind power to be the second largest renewable electricity source in 2030. The US market is also expected to grow significantly with extension of production tax credit from December 2007 to December 2008; the US market installed 3000 MW in 2006, taking its cumulative installed capacity to 11000 MW by the end of the year. China added 1000 MW of wind energy, taking its cumulative installation base to 2300 MW; it is expected to treble its capacity to 8000 MW by 2010, boosting the global wind energy market.

* Growth in order book continues

Suzlon continues to see order inflows from both the domestic and international markets. Currently, it has an order book of 1642 MW as against 1443 MW in the last quarter. Domestic orders comprise 23% and international orders 77% of its order book. It recently bagged orders from British Petroleum (40 MW), Hindustan Petroleum (25 MW), and Tata Power (50 MW), to be executed in the domestic market. It also secured a second major order in the Australian market (88 MW) from New Zealand-based Trust Power Ltd. These types of domestic orders from the corporate sector indicates the acceptance of wind energy as an alternative source of energy and provides strong outlook for the wind energy market, going forward.

Table 1: Order book break-up Q3FY07

	MW	Execution cycle
India	371	3-6 months
US	548	
China	210	
Australia	182	
Brazil	224	
Europe	105	
Total	1640	1-1.5 years

Source: Company, Edelweiss research

*** Improved pricing**

Management has guided that the orders from international market will see a 6-7% increase in prices during January 2007-December 2007. The company's domestic order book witnessed a realisation improvement of 3.7% Q-o-Q from INR 40 mn/MW in Q2FY07 to INR 41.5 mn/MW in Q3FY07. International orders also saw realisation improvement of 3.4% Q-o-Q.

*** Capacity expansion to cater to the strong demand**

Suzlon currently has a capacity of 1500 MW in India. It plans to ramp up its capacity to 2700 MW by establishing a 600 MW rotor blade capacity in the US and 600 MW integrated plant in China. These two capacities are expected to come on stream by March 2007. It is also expanding Hansen Transmission's capacity from the existing 3200 MW to 5800 MW by October 2008. Suzlon is expected to source 3500 MW of gear box capacity from Hansen, after its expansion.

Financial snapshot								(INR mn)
Year to March	Q3FY07	Q2FY07	% change	Q3FY06	% change	FY06	FY07E	FY08E
Net sales	19,139	20,870	(8.3)	8,806	117.3	38,410	61,887	96,413
Total expenditure	16,593	17,270	(3.9)	7,307	127.1	29,428	48,473	74,446
- Raw material	11,269	13,304	(15.3)	5,527	103.9	23,091	37,879	59,012
- Employee	1,803	1,684	7.1	360	400.3	1,216	2,986	3,583
- Other	3,520	2,282	54.3	1,420	148.0	5,121	7,607	11,851
EBIDTA	2,546	3,600	(29.3)	1,500	69.8	8,982	13,414	21,967
Other income	254	87	193.8	277	(8.3)	556	395	236
Depreciation	343	428	(20.0)	163	110.6	716	1,348	2,604
EBIT	2,458	3,258	(24.6)	1,614	52.3	8,822	12,461	19,599
Interest (Net)	638	547	16.6	112	469.1	648	801	1,499
PBT	1,820	2,711	(32.9)	1,502	21.2	8,175	11,660	18,100
Taxes	93	340	(72.8)	162	(42.8)	568	1,283	2,081
Adjusted PAT	1,744	2,354	(25.9)	1,349	29.2	7,596	10,377	16,018
Tax rate (%)	5.1	12.5		10.8		6.9	11.0	11.5
% of sales								
Raw material	58.9	63.7		62.8		60.1	61.2	61.2
Employee expense	9.4	8.1		4.1		3.2	4.8	3.7
Other expense	18.4	10.9		16.1		13.3	12.3	12.3
Operating profit	13.3	17.3		17.0		23.4	21.7	22.8
Net profit	9.0	11.2		14.9		19.8	16.8	16.6

Company Background

Suzlon, Asia's largest and the world's fifth largest wind turbine manufacturer in terms of market share provides end-to-end wind energy solutions such as wind resource mapping, identification and procurement of sites, execution of project work, erection and commissioning of WTGs, construction of power evacuation facilities, and providing operation and maintenance (O&M) services. This, along with its strong technological capabilities overseas and low cost vertically integrated manufacturing base in India gives it an edge over competitors.

Investment Theme

Suzlon's strong business model in terms of in-house technology and superior design capabilities has led to a consistent increase in its market share. A bulk of Suzlon's product requirements are manufactured at its Indian facilities, providing it a significant cost advantage. Its further capacity expansion in the US and China will help Suzlon to cater to strong global wind energy demand. It is also expanding capacity of Hansen transmission, which removes concerns of gear box supply.

Key Risks

Suzlon is likely to face increased competition from other global players such as Vestas, Gamesa, and Enercon. India, emerging as one of the fastest growing markets, is likely to have increased focus from players like Siemens and GE. However, we expect that Suzlon with its vertically integrated business model will be able to maintain its leading position in the Indian market. Further strong technical requirements serve as a barrier to new entrants.

Financial Statements

Income statement					(INR Mn)
Year to March	FY05	FY06	FY07E	FY08E	FY09E
Income from operations	19,425	38,410	61,887	96,413	119,994
Direct costs	12,904	26,482	43,443	67,679	84,232
Employee costs	618	1,216	2,986	3,583	4,121
Other expenses	1,211	1,730	2,044	3,184	3,662
Total operating expenses	14,732	29,428	48,473	74,446	92,015
EBITDA	4,692	8,982	13,414	21,967	27,980
Depreciation and amortisation	493	716	1,348	2,604	4,440
EBIT	4,199	8,266	12,066	19,363	23,540
Interest expenses	458	648	801	1,499	1,759
Other income	234	556	395	236	552
Profit before tax	3,975	8,175	11,660	18,100	22,333
Provision for tax	322	568	1,283	2,081	3,797
Extraordinary items	2	-	-	-	-
Reported profit	3,651	7,607	10,377	16,018	18,536
Adjusted net profit	3,651	7,607	10,377	16,018	18,536
Shares outstanding	288	288	288	288	288
Dividend per share	1.2	5.0	7.2	11.1	12.9
Dividend payout (%)	9.5	18.9	20.0	20.0	20.0

Common size metrics- as % of net revenues

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Operating expenses	75.8	76.6	78.3	77.2	76.7
Depreciation	2.5	1.9	2.2	2.7	3.7
Interest expenditure	2.4	1.7	1.3	1.6	1.5
EBITDA margins	24.2	23.4	21.7	22.8	23.3
Net profit margins	18.8	19.8	16.8	16.6	15.4

Growth metrics (%)

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Revenues	126.5	97.7	61.1	55.8	24.5
EBITDA	223.3	91.4	49.3	63.8	27.4
PBT	227.7	105.6	42.6	55.2	23.4
Net profit	151.9	108.3	36.4	54.4	15.7
EPS	151.9	108.3	36.4	54.4	(100.0)

Cash flow statement

Cash flow statement					(INR Mn)
Year to March	FY05	FY06	FY07E	FY08E	FY09E
Net profit	3,651	7,607	10,377	16,018	18,536
Add: Depreciation	493	716	1,348	2,604	4,440
Add: Misc expenses written off	(2)	(4)	4	-	-
Add: Deferred tax	(167)	(568)	-	-	-
Gross cash flow	3,975	7,750	11,729	18,622	22,976
Less: Dividends	411	1,657	2,075	3,204	3,707
Less: Changes in W. C.	4,478	10,989	9,098	12,111	8,333
Operating cash flow	(914)	(4,896)	556	3,307	10,935
Less: Change in investments	(65)	(2)	2	-	-
Less: Capex	1,850	4,046	6,853	11,000	4,440
Free cash flow	(2,699)	(8,940)	(6,298)	(7,693)	6,496

Balance sheet					(INR Mn)
As on 31st March	FY05	FY06	FY07E	FY08E	FY09E
Equity capital	869	2,875	2,875	2,875	2,875
Reserves & surplus	7,024	24,217	32,519	45,333	60,162
Shareholders funds	7,893	27,092	35,394	48,209	63,037
Minority Interest	65	75	75	75	75
Secured loans	3,567	3,899	6,899	14,899	10,899
Unsecured loans	1,544	889	635	635	635
Borrowings	5,111	4,788	7,534	15,534	11,534
Sources of funds	13,069	31,954	43,003	63,817	74,646
Gross block	3,597	6,293	12,876	23,876	28,315
Depreciation	808	1,536	2,614	5,218	9,657
Net block	2,789	4,757	10,261	18,658	18,658
Capital work in progress	289	1,652	1,652	1,652	1,652
Total fixed assets	3,079	6,409	11,913	20,309	20,309
Investments	78	76	78	78	78
Inventories	5,756	13,310	21,446	30,769	38,294
Sundry debtors	6,929	16,473	26,542	41,350	51,463
Cash and equivalents	1,545	5,515	1,979	2,287	4,782
Loans and advances	3,247	6,407	8,009	8,810	10,131
Other current assets					
Total current assets	17,477	41,705	57,976	83,215	104,671
Sundry creditors and others	5,980	12,977	20,453	31,346	39,755
Provisions	1,829	4,101	7,334	9,261	11,480
Total CL & provisions	7,809	17,078	27,787	40,607	51,235
Net current assets	9,668	24,627	30,189	42,608	53,436
Net Deferred tax	241	818	818	818	818
Others	4	9	5	5	5
Uses of funds	13,069	31,938	43,003	63,817	74,646
Book value per share (BV)	27	94	123	168	219

Ratios

Year to March	FY05	FY06	FY07E	FY08E	FY09E
ROE (%)	62.8	43.5	33.2	38.3	33.3
ROCE (%)	45.8	39.2	33.2	36.7	34.8
Current ratio	2.2	2.4	2.1	2.0	2.0
Debtors (Days)	130	157	157	157	157
Fixed assets t/o (x)	8.1	8.1	6.8	6.0	5.9
Debt/Equity	0.6	0.2	0.2	0.3	0.2

Valuations parameters

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Cons EPS (INR)	12.7	26.5	36.8	57.5	68.1
Y-o-Y growth (%)	151.9	108.3	36.4	54.4	(100.0)
CEPS (INR)	47.7	28.9	40.8	64.8	79.9
PE (x)	94.9	45.5	32.8	21.0	0.0
Price/BV(x)	43.9	12.8	9.8	7.2	0.0
EV/Sales (x)	18.0	9.0	5.6	3.6	0.0
EV/EBITDA (x)	74.6	38.5	25.8	15.7	0.0

Edelweiss Securities

14th Floor, Express Towers,
Nariman Point, Mumbai – 400 021
Board: (91-22) 2286 4400
Email: research@edelcap.com



Naresh Kothari – 2286 4246

Head, Institutional Equities

Vikas Khemani – 2286 4206

Head, Institutional Equities

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Yogesh Radke - 2286 4328	Alternative & Quantitative	Ravi Pilani - 4009 4533
		Dipesh Shah - 2286 4434

Email addresses: firstname.lastname@edelcap.come.g. naresh.kothari@edelcap.com*unless otherwise specified***RATING INTERPRETATION**

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period

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