Company Focus

6 March 2008 | 12 pages

Suzlon Energy (SUZL.BO)

Downgrade to Sell: Treading on Thin Ice

Change in opinion ☑
Rating change ☑
Target price change ☑
Estimate change ☑

- **Cost of growth** — We underestimated the cost that Suzlon would have to pay in executing its strategy to become the top 3 WTG manufacturers in each market it operates and the pressures that it would put on management bandwidth in managing so many moving parts of a complex supply chain.
- **Problems galore** — (1) Supply delays, (2) tower shortages, (3) key component shortages, (4) negative forex movements, and (5) nacelle custom duty changes in the US. The latest in this chain of problems is product liabilities. We think it would be too simplistic to assume that there is a quick fix to these problems and that other problems would not occur in the future.
- **Earnings cut 17-20% over FY08-11E** — We cut earnings to factor in (1) retrofit program delaying shipment schedules in 4QFY08E and 1HFY09, (2) lower incremental order wins and execution, (3) provisions of Rs1.19bn in FY08E, (4) higher incremental provisions for warranties & guarantees, and (4) lowering of our structural WTG EBITDA margin expectations to 14% from 15% earlier.
- **Target price cut to Rs241** — We cut our target multiple to 20x Dec09 (from 26x Dec09 earlier) at a 24% discount to that of BHEL. FY08E-11E EPS CAGR of 44% is deceptively robust as it is coming off the low base of FY08E. Post our earnings cut, RoEs come down to 14-20%, well below that of ABB and BHEL, and Suzlon's cash flow from operations will be negative at least till FY10E.
- **Downgrade to Sell** — We downgrade Suzlon to Sell (3M) from Buy (1L) given limited upside to our target price.

Sell/Medium Risk	3M
from Buy/Low Risk	
Price (05 Mar 08)	Rs237.65
Target price	Rs241.00
from Rs396.00	
Expected share price return	1.4%
Expected dividend yield	0.5%
Expected total return	**1.9%**
Market Cap	Rs355,746M
	US$8,845M

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

Figure 1. Statistical Abstract

Year to 31-Mar	Net Profit (Rsmn)	FD EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	3,654	8.41	-13%	28.4	13.1	63.9%	0.3%
2006A	7,562	5.26	-37%	45.3	12.6	43.1%	0.4%
2007A	8,648	6.00	14%	39.8	9.8	27.8%	0.4%
2008E	8,944	5.76	-4%	41.4	4.0	14.5%	0.5%
2009E	14,338	9.23	60%	25.8	3.5	15.2%	0.5%
2010E	20,199	13.00	41%	18.3	3.0	18.4%	0.5%
2011E	26,546	17.09	31%	14.0	2.5	20.2%	0.5%

Source: Citi Investment Research estimates

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

[1]Citigroup Global Markets India Private Limited

Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	45.2	39.6	41.3	25.8	18.3
EV/EBITDA adjusted (x)	40.0	29.1	22.1	15.8	12.3
P/BV (x)	12.6	9.7	4.0	3.5	3.0
Dividend yield (%)	0.4	0.4	0.5	0.5	0.5
Per Share Data (Rs)					
EPS adjusted	5.26	6.00	5.76	9.23	13.00
EPS reported	5.26	6.00	5.76	9.23	13.00
BVPS	18.91	24.40	59.05	67.41	79.52
DPS	1.00	1.00	1.10	1.10	1.20
Profit & Loss (RsM)					
Net sales	38,410	79,857	131,674	183,349	246,683
Operating expenses	-30,146	-68,617	-116,609	-162,072	-216,855
EBIT	**8,265**	**11,240**	**15,065**	**21,277**	**29,828**
Net interest expense	-648	-2,523	-5,170	-5,976	-9,039
Non-operating/exceptionals	556	965	1,428	2,051	3,497
Pre-tax profit	**8,173**	**9,683**	**11,324**	**17,351**	**24,286**
Tax	-568	-1,035	-2,110	-2,596	-3,520
Extraord./Min.Int./Pref.div.	-43	0	-270	-417	-566
Reported net income	**7,562**	**8,648**	**8,944**	**14,338**	**20,199**
Adjusted earnings	7,562	8,648	8,944	14,338	20,199
Adjusted EBITDA	8,980	12,958	18,065	26,832	36,953
Growth Rates (%)					
Sales	97.7	107.9	64.9	39.2	34.5
EBIT adjusted	96.9	36.0	34.0	41.2	40.2
EBITDA adjusted	91.5	44.3	39.4	48.5	37.7
EPS adjusted	-37.4	14.0	-4.0	60.3	40.9
Cash Flow (RsM)					
Operating cash flow	**-3,288**	**-331**	**-18,514**	**-11,815**	**-12,870**
Depreciation/amortization	716	1,718	3,000	5,555	7,124
Net working capital	-10,989	-11,691	-32,180	-31,708	-40,194
Investing cash flow	**-4,061**	**-18,457**	**-28,561**	**-25,115**	**-9,534**
Capital expenditure	-4,063	-18,377	-28,561	-25,115	-9,534
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**11,320**	**46,303**	**77,998**	**39,652**	**38,044**
Borrowings	549	47,113	24,284	41,151	39,569
Dividends paid	-1,647	-1,640	-1,918	-1,917	-2,091
Change in cash	**3,970**	**27,515**	**30,923**	**2,722**	**15,640**
Balance Sheet (RsM)					
Total assets	**49,024**	**125,413**	**232,743**	**305,472**	**384,192**
Cash & cash equivalent	5,515	15,383	46,306	49,027	64,668
Accounts receivable	16,473	25,704	47,367	67,188	91,072
Net fixed assets	6,425	23,085	48,646	68,206	70,615
Total liabilities	**21,585**	**90,136**	**134,807**	**194,698**	**254,743**
Accounts payable	7,253	0	0	0	0
Total Debt	4,507	51,620	75,904	117,056	156,625
Shareholders' funds	**27,439**	**35,277**	**97,935**	**110,774**	**129,449**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	23.4	16.2	13.7	14.6	15.0
ROE adjusted	43.1	27.8	14.5	15.2	18.4
ROIC adjusted	36.1	19.2	12.1	11.4	12.4
Net debt to equity	-3.7	102.7	30.2	61.4	71.0
Total debt to capital	14.1	59.4	43.7	51.4	54.7

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Downgrade to Sell

We believe that Suzlon is a company with the right overall strategy in terms of its intention (1) to acquire and grow Hansen to meet Suzlon's demand for gearboxes and, at the same time, benefit from the strong demand for WTG gearboxes globally, (2) to acquire REPower to make a credible entry in Europe, the largest absolute market for WTGs over the near future, and (3) to backward integrate into components and sub components to take control of the supply chain to mitigate raw material pressures and component supply bottlenecks.

However, we underestimated the cost that Suzlon would have to pay in executing its strategy to become the top 3 WTG manufacturers in each market it operates and the pressures that it would put on management bandwidth in managing so many moving parts of a complex supply chain.

The international expansion drive has taken its toll in the form of (1) supply delays, (2) tower shortages in the international markets, (3) other key component shortages, (4) negative effects of foreign currency movements, and (5) negative effects of nacelle custom duty changes in the US. The latest in this chain of problems is product liabilities.

We think it would be too simplistic to assume that there is a quick fix to these problems and that other problems would not occur in the future. We see medium term issues on execution and earnings growth which could weigh down heavily on the stock performance. As a consequence, we downgrade Suzlon to Sell (3M) from Buy (1L).

Cut target price to Rs241

We cut our target price to Rs241 on the back of our downward revision of EPS estimates by 17 – 20% over FY08E – 11E. We have also cut our target multiple to 20x Dec09 (from 26x Dec09 earlier) at a 24% discount to that of BHEL. Our lower multiple reflects the increased risks and problems that the company faces. We think the FY08E – 11E EPS CAGR of 44% is deceptively robust as it is coming off the low base of FY08E. It is also pertinent to note that post our earnings cut, Suzlon's consolidated RoEs come to 14 – 20%, well below that of ABB and BHEL and, most importantly, Suzlon's cash flow from operations will be negative at least till FY10E.

The blade cracking problem

On March 3, 2008, Suzlon announced that it will make a provision of Rs1bn (US$25mn) in 4QFY08 for its retrofit program which will involve structural strengthening of cracking S88 2.1MW turbine blades totaling to 1,251 blades (930 installed and 320 in transit) of 417 WTGs over a 6 month period. This is on the back of Rs190mn of provisioning for 34 defective blades in 3QFY08.

Our take on the problem

- Such problems are not uncommon in the industry: (1) Vestas have had occasional blade issues (nothing significant though) and bigger issues with gearboxes, (2) Clipper Wind had issues with their blades and they are going to reinforce 260 rotors, of which 150 are in the field.

- In the case of Clipper Wind, it had to pay additional penalties for delays. We believe that one cannot rule out more liabilities than the Rs1.19bn of provisions that Suzlon is making on account of delays and generation loss.
- Since 320 of the 1,251 blades that Suzlon is retrofitting are those that are in transit, we believe that shipments will be affected over 4QFY08 and 1QFY09.
- Vestas and Gamesa make provisions of 4 – 5% of sales vis-à-vis 2 – 2.5% for Suzlon and this take us back to the question "Is Suzlon providing enough for product related liabilities?"
- Though we have not heard of any order cancellations yet, one cannot rule out that possibility.

In light of the above issues, we have revised downwards our EPS estimates by 17 – 20% over FY08E – 11E as explained below.

Figure 2. Suzlon + Hansen + REPower Consolidated Earnings Revision

Year End Mar31 (Rsmn)	FY08E	FY09E	FY10E	FY11E	- Remarks
Suzlon MW Sold					
Old	2,395	3,600	4,800	5,500	- Adjusting FY08E and FY09E MW sales to factor in delay in shipments
New	2,295	3,300	4,500	5,200	- Adjusting FY10E and FY11E MW sales for potential lower order wins
% Chg	-4.2%	-8.3%	-6.3%	-5.5%	
Suzlon Sales					
Old	114,390	173,660	234,835	276,026	
New	109,863	159,860	220,066	261,290	
% Chg	-4.0%	-7.9%	-6.3%	-5.3%	
Hansen Sales					
Old	23,708	31,319	40,949	54,456	- No changes here
New	23,708	31,319	40,949	54,456	
% Chg	0.0%	0.0%	0.0%	0.0%	
Suzlon Margins %					
Old	15.0%	15.2%	15.3%	15.4%	- FY08E margins cut on account of provisioning
New	13.6%	14.0%	14.1%	14.2%	- FY09E-FY11E margins cut on lower leverage on lower MW sales/provisions
% Chg	(136)	(125)	(122)	(120)	
Hansen Margins %					
Old	13.0%	14.5%	14.6%	15.2%	- No changes here
New	13.0%	14.5%	14.6%	15.2%	
% Chg	0	0	0	nm	
Consolidated Recurring PAT					
Old	11,115	17,897	24,841	32,152	
New	8,944	14,338	20,199	26,546	
% Chg	-19.5%	-19.9%	-18.7%	-17.4%	
FD EPS Estimates					
Old	7.15	11.52	15.99	20.69	- FD EPS cut is 17 - 20%
New	5.76	9.23	13.00	17.09	
% Chg	-19.5%	-19.9%	-18.7%	-17.4%	

Source: Citi Investment Research estimates

Takeaways from conference call to address those problems

- The first set of defects was discovered in a few blades in the second half of Dec2007. On Jan 29th, 2008, during the quarterly call Suzlon declared that it is making a provision of Rs190mn for replacing 34 blades and repairing 68 blades.

- In Feb 2008, Suzlon discovered more cracks in other blades taking the toll to 45 blades (including the previous 34 blades) to be replaced.

- On Mar 3rd, 2008, Suzlon announced that it will make a provision of Rs1bn (US$25mn) in 4QFY08 for its retrofit program which will involve structural strengthening of its cracking S88 2.1MW turbine blades totaling to 1,251 blades (930 installed and 320 in transit) of 417 WTGs over 6 months. In addition, this cost also includes the replacement of the additional 11 blades. Out of these 1251 blades, 942 are in US and the rest are in Brazil and Europe.

- Suzlon does not believe there are quality issues as this is the largest sized turbine it currently sells. This has happened because this product is relatively new.

- The cracks have occurred in these blades at a particular place near the root. The company has reached the conclusion that the faults occurred because (1) the blades were not stiff enough at that point, and (2) very specific wind turbulence conditions.

- The company assesses that it will not have to change the design, manufacturing, quality testing or installation process in a major way to rectify the defect in future production lots.

- The short term solution to fix current lot of blades is to retrofit with extra fibre glass. The company has rolled out 20 sets of blades which will be used to replace temporarily the blades being retrofitted.

- The provision of Rs1bn includes (1) replacement of damaged blades, (2) strengthening of other blades, (3) interest costs for the 20 sets of blades, (4) logistic costs, and (5) manpower costs.

- Retrofitting of blades will take approximately 1-2 days for each blade (implying that generation loss to customers will not be much) and will be carried out at wind farm sites. Company has already established and rehearsed the process for doing the same.

- The long term solution is that it will have to strengthen the particular area in each blade with extra fibre glass material which will cost less than 1% of the cost of blade.

- The company does not expect (1) any further provisions at this point in this regard, (2) its warranty cost to go up, (3) any slow down in orders due to this from customers, 4) any order cancellations from customers due to quality issues, and 5) slowdown in shipments.

- Suzlon usually gives warranties/guarantees for 1 - 2 years on its machines Customers can buy warranty/guarantee for 4 - 5 years if they want it. The amount of warranties provided for is not relevant as a % of sales and are dependent on a number of other parameters. Suzlon believes that warranty provisions it makes are sufficient.

- Suzlon uses fibre glass material to manufacture blades, while many other players use composites/carbon fibre. Suzlon believes that the current material being used is optimal from both the design and economic perspective and does not intend to change it. However, the company keeps on exploring the possibility for improvements.

- Each blade that Suzlon manufactures is tested for 3-4 months which includes laboratory testing, simulation testing, endurance testing and testing post installation which the company believes is sufficient and inline with industry standards. Testing time for new machine are greater than 1 year and the machines are designed for standard life of 20 years
- The contracted orders of the company have cancellation clauses but there are penalties for cancelling contracts.

Suzlon Energy

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 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 to Sell/Medium Risk.

We believe that Suzlon is a company with the right overall strategy in terms of its intention (1) to acquire and grow Hansen to meet Suzlon's demand for gearboxes and at the same time benefit from the strong demand for WTG gearboxes globally, (2) to acquire REPower to make a credible entry in Europe, the largest absolute market for WTGs over the near future, and (3) to backward integrate into components and sub components to take control of the supply chain to mitigate raw material pressures and component supply bottlenecks.

However, we underestimated the cost that Suzlon would have to pay in executing its strategy to become the top 3 WTG manufacturers in each market it operates and the pressures that it would put on management bandwidth in managing so many moving parts of a complex supply chain.

The international expansion drive has taken its toll in the form of (1) supply delays, (2) tower shortages in the international markets, (3) other key component shortages, (4) negative effects of foreign currency movements, and

(5) negative effects of nacelle custom duty changes in the US. The latest in this chain of problems is product liabilities.

We think it would be too simplistic to assume that there is a quick fix to these problems and that other problems would not occur in the future.

Valuation

Our target multiple of 20x Dec09 is at a 24% discount to that of BHEL, which we believe is justified because BHEL is free cash flow positive and has a larger order backlog which provides sales coverage for the next three years. The FY08E – 11E EPS CAGR of 44% for Suzlon looks robust but is coming off the low base of FY08E. It is also pertinent to note that post our earnings cut, Suzlon's consolidated RoEs come to 14 – 20%, well below that of ABB and BHEL, and most importantly Suzlon's cash flow from operations will be negative at least till FY10E.

Risks

We rate Suzlon shares Medium Risk based on a number of factors, namely: industry-specific risks, financial risk and management risks. We have revised our risk rating from Low Risk to Medium Risk to reflect the increased risks and problems the company faces.

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.

If any of these risk factors has a greater impact than we expect, Suzlon's share price could exceed our target price.

Bharat Heavy (BHEL.BO - Rs2,081.40; 1L)

Valuation

With Rs660bn of order wins in the last 19 months, advance class gas turbine wins and three supercritical order wins and more wins in the pipeline BHEL has more less answered most of the questions on competition and technology. Most importantly the supercritical orders wins imply that BHEL's growth is not a flash in the pan and it is in an envious position of bagging a significant number of the orders in the XIIth plan also. India's power capex will be stronger for longer and BHEL's fortunes would not be any different. As a consequence we value BHEL using a target P/E multiple to 26x December 2009E earnings, which is at a 7% discount to that of ABB. We believe ABB deserves to trade at a premium to BHEL given superior forecast earnings growth over the next three years.

Risks

We rate BHEL shares Low Risk. The rating differs from the Medium Risk rating suggested by our quantitative risk rating system, which tracks 260-day historical share price volatility. We believe BHEL's current order book of Rs780bn represents nearly three years' sales and provides very good earnings visibility over the medium term.

Key risk factors include:

Delay in power-sector reforms could affect order flows and earnings. The sector could also be subject to regulatory uncertainties, which could affect sentiment and valuations on the stock. Competitive pressures from global majors are also a concern; particularly as technology upgrades are affected. We believe it is imperative that BHEL demonstrate the ability to upgrade technology at reasonable costs for valuation ratings to sustain at current levels over the medium term. Over the short-term, investor progress on order flows does influence sentiment and delays herein could dampen sentiment.

If any of these risk factors has a greater impact than we anticipate, BHEL's share price will likely have difficulty attaining our target price.

ABB (India) (ABB.BO - Rs1,115.65; 2L)

Valuation

Our Rs1,260 target price for ABB is based on 28x CY09E EPS, in line with our target multiple for close comparable BHEL. ABB has traded at an average premium of ~50%+ to BHEL for the past three years, a premium that actually narrowed in CY03-06, compared with CY99-CY03, as BHEL re-rated significantly. ABB has also traded at an average premium of 85%+ to the BSE Sensex over the past three years. Our target multiple is supported by an EPS CAGR of 36% over CY07-10E with RoE of 32-36%.

Risks

Our quantitative risk-rating system, which tracks 260-day historical share price volatility, assigns a Medium Risk rating to ABB India. However, we believe a Low Risk rating is more appropriate given that strong power and industrial capex in India provides ABB with significant visibility on order inflows and ABB is India's market leader in the power and automation space. Our Low Risk rating is also in line with that of BHEL. The key upside risks to our target price include: 1) Better than expected order wins; and 2) Better than expected order execution. The key downside risks to our target price include: 1) Increased competition; 2) Slowdown in investments in generation, transmission and distribution; 3) Slowdown in the industrial capex cycle; 4) Substantial increase in input prices; and 5) Employee retention.

Appendix A-1

Analyst Certification

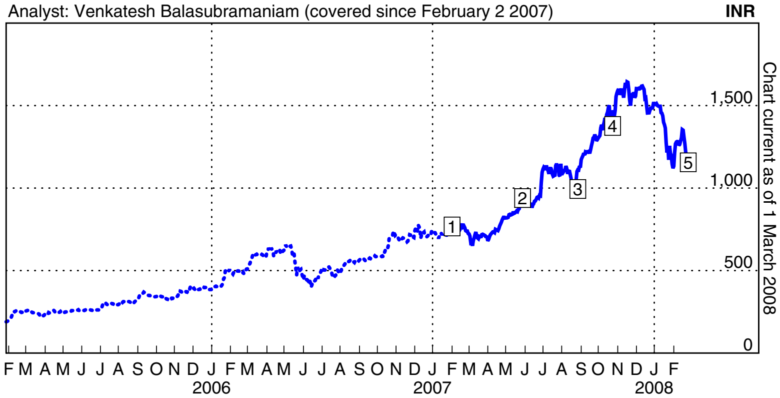
Each research analyst(s) principally responsible for the preparation and content of all or any identified portion of this research report hereby certifies that, with respect to each issuer or security or any identified portion of the report with respect to an issuer or security that the research analyst covers in this research report, all of the views expressed in this research report accurately reflect their personal views about those issuer(s) or securities. Each research analyst(s) also certify that no part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this research report.

IMPORTANT DISCLOSURES

ABB (India) (ABB.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Venkatesh Balasubramaniam (covered since February 2 2007)



#	Date	Rating	Target Price	Closing Price
1:	1 Feb 07	1L	880.00	760.55
2:	29 May 07	1L	*1,103.20	914.98
3:	28 Aug 07	1L	*1,266.00	1,110.95
4:	24 Oct 07	*2L	*1,595.00	1,453.80
5:	26 Feb 08	2L	*1,260.00	1,197.75

*Indicates change.

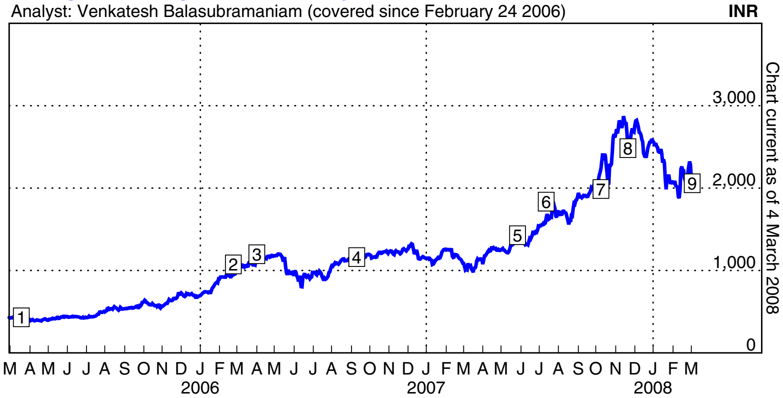
Covered
Not covered

Rating/target price changes above reflect Eastern Standard Time

Bharat Heavy (BHEL.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Venkatesh Balasubramaniam (covered since February 24 2006)



#	Date	Rating	Target Price	Closing Price
1:	18 Mar 05	1L	*472.50	394.95
2:	23 Feb 06	1L	*1,128.00	946.92
3:	3 Apr 06	1L	*1,321.50	1,149.03
4:	10 Sep 06	1L	*1,382.00	1,127.30
5:	28 May 07	1L	*1,672.00	1,361.88
6:	12 Jul 07	1L	*1,923.00	1,641.35
7:	9 Oct 07	1L	*2,542.00	2,236.75
8:	21 Nov 07	1L	*2,936.00	2,486.10
9:	4 Mar 08	1L	*2,529.00	2,098.25

*Indicates change.

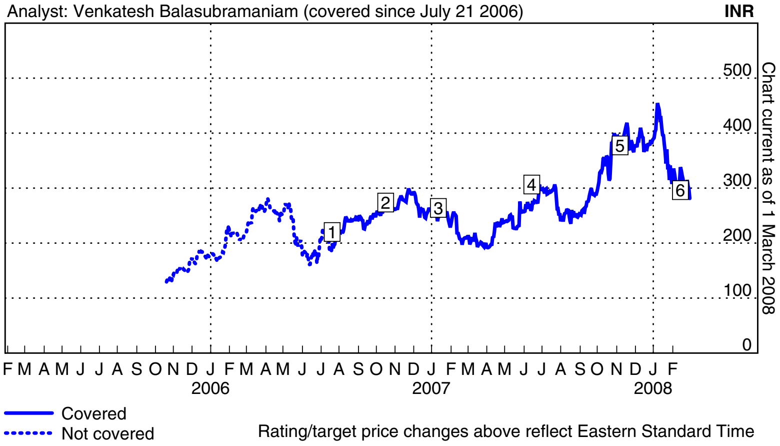
Covered
Not covered

Rating/target price changes above reflect Eastern Standard Time

Suzlon Energy (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	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

*Indicates change.

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Citi Investment Research Ratings Distribution

Data current as of 31 December 2007	**Buy**	**Hold**	**Sell**
Citi Investment Research Global Fundamental Coverage (3421)	50%	37%	12%
% of companies in each rating category that are investment banking clients	52%	53%	40%

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