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Updates

Siemens: Trading premium unjustified considering inconsistent operating performance and dependence on large orders

News Roundup

Corporate

- Reliance Power Ltd, whose shares got listed last week below its offer price after a mega IPO, said on Sunday that it plans to issue bonus shares to all shareholders, except the promoters. The surprise move is said to be in response to the general feeling among retail investors who felt betrayed as the shares continue to trade below its offer price. (BL)
- Internet major Yahoo!, currently resisting a hostile takeover bid by software giant Microsoft, will incur about Rs 100 crore in severance payouts and other expenses related to its planned job cuts across the world, which includes about 40 people in India. (FE)
- Tata Advanced Systems, a wholly-owned subsidiary of Tata Industries, and Israel Aerospace Industries Ltd, have signed a Memorandum of Understanding to set up a joint venture company. (BL)
- State Bank of India's subsidiary, SBI Capital Markets, plans to set up a \$100 million venture capital fund to invest in knowledge-based sectors in the country. (BS)

Economic and political

- The department of industrial policy and promotion is working on ways to monitor investments of overseas private equity funds in India. This follows a suggestion from capital market regulator Sebi on the need to check unhealthy practices like asset stripping which erode value of companies. (ET)
- The income tax department has suggested a differential system for levying dividend distribution tax on companies in its list of pre-Budget suggestions to the Central Board of Direct Taxes. (BS)

Source: ET = Economic Times, BS = Business Standard, FE = Financial Express, BL = Business Line.

EQUITY MARKETS

India	Change, %			
	15-Feb	1-day	1-mo	3-mo
Sensex	18,115	2.0	(4.7)	(8.0)
Nifty	5,303	1.9	(7.1)	(10.2)
Global/Regional indices				
Dow Jones	12,348	(0.2)	2.1	(6.3)
Nasdaq Composite	2,322	(0.5)	(0.8)	(12.0)
FTSE	5,788	(1.6)	(1.9)	(8.0)
Nikkei	13,797	1.3	(0.5)	(9.0)
Hang Seng	24,367	0.9	(3.3)	(11.8)
KOSPI	1,711	1.0	(1.4)	(11.2)
Value traded - India				
		Moving avg, Rs bn		
	15-Feb	1-mo	3-mo	
Cash (NSE+BSE)	204.3	220.0	130.5	
Derivatives (NSE)	426.8	655.7	659	
Deri. open interest	742.6	1,308	1,010	

Forex/money market

	Change, basis points			
	15-Feb	1-day	1-mo	3-mo
Rs/US\$	39.7	0	37	33
6mo fwd prem, %	0.7	(25)	71	24
10yr govt bond, %	7.5	1	(6)	(40)

Net investment (US\$m)

	13-Feb	MTD	CYTD
FIs	87	1,249	(4,271)
MFs	2	(69)	1,923

Top movers -3mo basis

Best performers	Change, %			
	15-Feb	1-day	1-mo	3-mo
Apollo Tyres	46	(1.9)	(12.6)	25.2
Thomas Cook	70	5.0	(22.0)	21.2
Punjab Tractors	244	(0.7)	(15.3)	22.1
Asian Paints	1,158	0.3	11.4	15.6
BPCL	469	0.8	8.0	7.9
Worst performers				
MRF	4,607	3.1	(24.8)	(36.3)
Moser Baer	178	3.1	(29.9)	(35.1)
Balaji Telefilms	215	(1.2)	(28.4)	(34.2)
Tvs Motor	40	1.3	(34.3)	(37.0)
Arvind Mills	50	4.5	(29.3)	(29.4)

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Industrials**SIEM.BO, Rs1564**

Rating	REDUCE
Sector coverage view	Attractive
Target Price (Rs)	1,700
52W High -Low (Rs)	2250 - 968
Market Cap (Rs bn)	263.7

Financials

September y/e	2006	2007	2008E
Sales (Rs bn)	60.6	94.2	119.6
Net Profit (Rs bn)	3.8	5.3	7.5
EPS (Rs)	22.7	31.3	44.3
EPS <i>gth</i>	31.3	38.0	41.2
P/E (x)	68.9	49.9	35.3
EV/EBITDA (x)	38.9	27.9	18.9
Div yield (%)	0.2	0.3	0.3

Shareholding, September 2007

	% of Pattern Portfolio	Over/(under) weight
Promoters	55.2	-
FIs	8.3	0.2 (0.4)
MFs	8.4	1.4 0.8
UTI	-	- (0.6)
LIC	7.8	1.2 0.6

Siemens: Trading premium unjustified considering inconsistent operating performance and dependence on large orders

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- **Annual report highlights: Clear shift of revenue mix to project execution—higher proportion of bought out items, also explain lower margins**
- **Siemens continue to maintain large currency hedging forward contracts, gains/losses are adjusted in other costs resulting in volatile operating margins**
- **1Q results highlighted sedate growth in power segment—margins expanded across segments**
- **Siemens (adjusted for its IT business valuation) trades at a premium to all other industrial/capital goods stocks, including ABB**
- **Maintain our target price of Rs1,700 and REDUCE rating on the stock**

Siemens' annual report highlights (1) clear shift to projects with project execution, (2) significant net sell position amounting to Rs6 bn in US Dollar and Rs16.5 bn in Qatari Riyal through forward contracts, (3) commissioning of 12,000 MVA transformer factory at Kalwa, and (4) adjustment of exchange gains/losses in other costs that adds volatility to the reported operating margins.

Annual report highlights: Clear shift of revenue mix to project execution—higher proportion of bought out items, also explain lower margins

Siemens' annual report highlights clear shift to project execution with project execution accounting for 50% (Rs39 bn out of a turnover of Rs77.3 bn) of its turnover in the y/e September 2007 versus 30% in y/e ended September 2006. Purchases towards project execution account for 49% of sales in the y/e September 2007 versus 31% in the y/e September 2006. We believe projects are being executed with high proportion of bought out components reflecting in lower margins that Siemens has reported in the y/e September 2007 (particularly in the power segment where execution of Qatar orders contributed to strong revenue growth).

Siemens continues to maintain large currency hedging forward contracts related to exports business

Siemens' annual report highlights that it maintains significant net sell position through forward contracts in US Dollar and Qatari Riyal to hedge its likely exports revenues in these two currencies. Net sell position amounts to Rs6 bn in US Dollar and Rs16.5 bn in Qatari Riyal. Siemens is also running a net buy position through forward contracts in Euros, probably to hedge its imports, amounting to Rs13.5 bn. Large forward contract positions corroborate our understanding that Siemens hedges away all its foreign currency exposures each transaction-wise, a fact clearly stated in its annual report.

Significant exchange gains/losses are adjusted in other costs adding volatility to the reported operating margins in the core business

Siemens has reported a foreign exchange gain of Rs1.1 bn in the y/e September 2007, very significant compared to a reported PAT of about Rs6 bn. Siemens adjusts its foreign exchange gains/losses in other costs, thus adding significant volatility to reported EBITDA margins generated from core business. Adjusted for exchange gains/losses Siemens standalone operating margins have declined to 8.2% in the y/e September 2007 versus from 8.5% in y/e September 2006 and 10.7% in the y/e September 2005.

Commissions its first power transformer factory with a capex of US\$50 mn, may have revenue potential of about Rs6 bn

Siemens has commissioned its first power transformer factory at Kalwa, Maharashtra with an installed capacity of 15,000 MVA. Based on production and sales figures reported for transformers by ABB and Areva we highlight that this factory may have revenue potential of about Rs6 bn when fully utilized. Assuming an EBITDA margin of 10%, this facility may have payback period of about four years at an EBITDA level. We highlight that Siemens' reported installed capacity (15,000 MVA) of power transformers with this facility is higher than last reported capacity by both Areva (9,000 MVA) and ABB (12,000 MVA).

1Q results highlighted sedate growth in power segment—margins expanded across segments

The power segment that led the growth in year ended September 2007 with 117% growth reported a sedate growth of 9.5%. We believe growth in power segment has been sedate because of declining order book (Rs93.7 bn versus Rs110 bn last year). Growth in execution is led by transport segment with 2.5X execution on a yoy basis, while both automation and drives and industrial solution and services have reported about 40% growth. The transport segment has picked up, probably led by strong execution of about Rs9.3 bn order that Siemens received from Mumbai Rail Vikas Corporation to provide Mumbai's suburban railway system with an advanced rail traction system.

Highlight possibility of one-offs in the transport segment as the cause of surprise margin decline in that segment

We are surprised by reported margins of -9.5% in the transport segment concomitant with 145% revenue growth in that segment which ideally should have led to operating leverage. We highlight that one-off provisions could have affected margins in the transport segment. We believe large contracts (such as MRVC contract) are being executed at much lower margins. MRVC order was won in May, 2005 while execution may have come in full swing only now.

Change our EPS estimates reflecting demerger, higher margins in power, automation and industrial services business and lower yoy growth in power due to high base

We have changed our standalone revenue projection to Rs94 bn and Rs117 bn for y/e September 2008E and 2009E, respectively, from Rs105 bn and Rs132 bn earlier. This reflects (1) demerger of building technologies segment, (2) lower growth expectations led by lower order book visibility (Unexecuted order value has declined to Rs94 bn at the end of 1Q results versus Rs110 reported at the end of 1Q results last year)—also reflecting in only 9.5% growth in the key power segment in 1Q results. Our standalone margin expectations are 10.6% (230 bps expansion over y/e September 2007) and 11.2% in the y/e September 2008E and 2009E. We have marginally revised our consolidated EPS estimates to Rs46.5 and Rs61.4 for the y/e September 2008E and 2009E from Rs44.3 and Rs58.8 earlier (Exhibits 1-4).

Maintain our target price of Rs1,700 and REDUCE rating on the stock

We maintain our target price of Rs1,700 on Siemens. We retain our REDUCE rating on the stock based on (1) likelihood that margin pressures would persist, (2) about 20% of consolidated earnings of Siemens come from the IT subsidiary SISL, which may be facing the pressure because of Rupee appreciation, (3) preponderance of very large orders in the order book that potentially yield lower margins and are less likely to be repeatable, and (4) lower order book visibility. Upside risk arise from better than expected margins as well as order inflow announcements.

Siemens (adjusted for its IT business valuation) trades at premium to all other industrial/capital goods stocks, including ABB

We highlight that Siemens trades at 39X and 28X its earnings for y/e September 2008E and 2009E adjusted for its IT business valuations (at 15X multiple). This valuation is comparable to ABB, which trades at valuation of 37X and 28X its earnings for the y/e December 2008E and 2009E, respectively (Exhibit 5). We highlight that ABB has several advantages over Siemens such as (1) focus on industrial automation and T&D while Siemens has several non core segments such as IT, transport, healthcare etc, (2) unlikely to be affected by parent-led mergers, demergers and acquisitions, (3) regular corporate communications, (4) no dependence on large bulk orders (in case of Siemens y/e September 2007 growth was essentially led by large order from Qatar), and (5) higher consistency of operating performance in terms of operating margins etc.

Exhibit 1: Margins have declined across segments in FY2007

Segmental revenues and margins of Siemens (Consolidated), September year-ends, FY2006-10E (Rs mn)

	2006	2007	2008E	2009E	2010E
Revenues					
Information technology services	9,604	11,246	14,007	16,748	19,958
Automation & Drives	12,210	16,555	22,350	27,937	33,525
Industrial Solution and Services	5,463	10,038	13,475	16,752	20,035
Power	19,782	43,008	50,535	63,168	75,802
Transport	2,483	3,467	6,415	7,698	9,237
Healthcare & other services	4,138	5,247	6,559	8,198	9,838
Building Technologies	756	1,020	1,275	1,530	1,836
Real Estate	421	496	545	600	660
EBIT Margins					
Information technology services	20.5	17.3	17.8	18.5	18.8
Automation & Drives	8.6	6.9	9.0	9.0	9.0
Industrial Solution and Services	10.9	10.2	12.0	12.0	12.1
Power	6.2	6.0	9.0	9.5	9.5
Transport	8.3	6.5	4.0	8.0	10.0
Healthcare & other services	2.4	2.2	3.5	5.0	5.0
Building Technologies	5.4	9.1	10.0	10.0	10.5
Real Estate	58.8	65.6	65.0	65.0	65.0
Segmental EBIT					
Information technology services	1,967	1,950	2,487	3,093	3,747
Automation & Drives	1,052	1,147	2,011	2,514	3,017
Industrial Solution and Services	598	1,026	1,620	2,017	2,415
Power	1,228	2,599	4,548	6,001	7,201
Transport	206	226	257	616	924
Healthcare & other services	100	113	230	410	492
Building Technologies	41	93	128	153	193
Real Estate	248	325	354	390	429

Source: Company data, Kotak Institutional Equities estimates

Exhibit 2: Margin decline at SISL in the y/e September 2007, probably led by rupee appreciation

Key numbers of Siemens Information Services Ltd (SISL), September year-ends, 2006-2010E (Rs mn)

	2006	2007	2008E	2009E	2010E
SISL					
Revenues	8,737	10,236	12,795	15,354	18,425
<i>% growth</i>	35.6	17.2	25.0	20.0	20.0
EBIT	1,857	1,770	2,281	2,856	3,486
<i>EBIT margin</i>	21.2	17.3	17.8	18.6	18.9
PBT	1,687	1,600	2,111	2,687	3,316
<i>PBT margin</i>	19.3	15.6	16.5	17.5	18.0
Tax	(331)	(79)	(253)	(537)	(829)
<i>Tax rate</i>	19.6	4.9	12.0	20.0	25.0
PAT	1,356	1,521	1,858	2,150	2,487
<i>% growth</i>	8.4	12.2	22.1	15.7	15.7

Source: Company data, Kotak Institutional Equities.

Exhibit 3. Profit, Balance Sheet and Cash models of Siemens (standalone), September year-ends, FY2006-10E (Rs mn)

Profit model	2006	2007	2008E	2009E	2010E
Net revenues	45,360	77,660	93,975	117,025	140,326
Operating profit	4,004	7,415	9,987	13,137	15,824
Other income	1,457	1,038	1,002	1,473	2,077
EBIDTA	5,461	8,453	10,989	14,610	17,901
Interest	(1)	(2)	(2)	(2)	(2)
PBDT	5,460	8,451	10,987	14,607	17,899
Depreciation	(442)	(492)	(733)	(865)	(948)
PBT	5,018	7,959	10,254	13,742	16,951
Tax (incl deferred tax provision)	(1,454)	(2,777)	(3,476)	(4,659)	(5,746)
PAT (A)	3,564	5,182	6,778	9,084	11,205
EPS	21.1	30.7	40.2	53.9	66.5
OPM (%)	8.8	9.5	10.6	11.2	11.3
PAT margin (%)	7.9	6.7	7.2	7.8	8.0
Balance Sheet					
Share capital	337	337	337	337	337
Reserves & surplus	10,534	15,572	20,763	27,722	36,304
Total shareholders funds	10,871	15,909	21,101	28,059	36,641
Minority interest	0	0	0	0	0
Total debt	20	15	11	7	2
Total liabilities	10,891	15,924	21,112	28,065	36,644
Net block	2,621	4,637	5,905	6,539	7,092
Investments	4,163	5,570	6,838	7,472	8,025
Current assets	29,502	40,691	47,955	64,151	82,114
of which, cash	9,394	4,636	6,188	12,141	19,747
Less: Current liabilities	(27,690)	(35,287)	(38,630)	(48,507)	(58,444)
Net current assets	(7,583)	768	3,137	3,504	3,923
Total assets	10,891	15,924	21,112	28,066	36,644
BVPS (Rs)	322	472	626	832	1,087
RoE (%)	38.2	38.7	36.6	37.0	34.6
RoCE (%)	38.1	38.6	36.6	36.9	34.6
Cash flow statement					
Net profit before tax and extraordinary items	5,018	7,959	10,254	13,742	16,951
Add: Depreciation / amortisation / non-cash prov	442	492	733	865	948
Tax paid	(1,580)	(2,773)	(3,476)	(4,659)	(5,746)
Operating profit before working capital changes	3,880	5,677	7,511	9,949	12,152
Change in working capital / other adjustments	4,770	(8,351)	(2,369)	(366)	(420)
Net cashflow from operating activities	8,650	(2,674)	5,142	9,582	11,733
Fixed Assets	(2,267)	(1,900)	(2,000)	(1,500)	(1,500)
Investments	(1,337)	(36)	-	-	-
Cash (used) / realised in investing activities	(3,604)	(1,936)	(2,000)	(1,500)	(1,500)
Free cash flow	5,046	(4,610)	3,142	8,082	10,233
Borrowings	(6)	(5)	(4)	(4)	(4)
Dividend paid	(730)	(947)	(1,586)	(2,126)	(2,622)
Cash (used) /realised in financing activities	(541)	(932)	(1,590)	(2,130)	(2,626)
Cash generated /utilised	4,539	(4,758)	1,552	5,952	7,607

Source: Kotak Institutional Equities estimates.

Exhibit 4. Profit, Balance Sheet and Cash models of Siemens (Consolidated), September year-ends, FY2006-10E (Rs mn)

Profit model	2006	2007	2008E	2009E	2010E
Net revenues	60,586	94,175	108,934	134,819	161,476
Operating profit	6,417	9,837	12,587	15,974	19,030
Other income	669	761	732	1,134	1,659
EBIDTA	7,086	10,598	13,319	17,108	20,690
Interest	(43)	(45)	(11)	(11)	(11)
PBDT	7,043	10,553	13,308	17,097	20,679
Depreciation	(1,260)	(1,403)	(1,718)	(1,773)	(1,817)
PRETAX PROFITS	5,783	9,149	11,590	15,324	18,862
Tax (incl deferred tax provision)	(1,955)	(3,007)	(3,743)	(4,975)	(6,129)
PAT (A)	3,828	6,142	7,847	10,349	12,733
EPS	22.7	36.4	46.5	61.4	75.5
OPM (%)	10.6	10.4	11.6	11.8	11.8
PAT margin (%)	6.3	6.5	7.2	7.7	7.9
Balance Sheet					
Share capital	337	337	337	337	337
Reserves & surplus	12,056	17,964	24,136	32,868	43,618
Total shareholders funds	12,393	18,301	24,474	33,205	43,955
Minority interest	40	80	80	80	80
Total debt	40	317	317	313	309
Total liabilities	12,473	18,698	24,870	33,598	44,344
Net block	4,934	7,546	8,576	9,015	9,544
Investments	6,677	8,649	9,679	10,117	10,646
Current assets	36,777	47,511	55,535	74,542	95,689
of which, cash	11,618	8,570	12,798	21,377	31,952
Less: Current liabilities	(33,748)	(40,180)	(43,062)	(53,780)	(64,710)
Net current assets	(8,588)	(1,239)	(325)	(615)	(973)
Total assets	12,473	18,698	24,870	33,598	44,344
BVPS (Rs)	368	543	726	985	1,304
RoE (%)	35.5	39.9	36.7	35.9	33.0
RoCE (%)	33.5	39.1	36.0	35.4	32.7
Cash flow statement					
Net profit before tax and extraordinary items	5,783	9,149	11,590	15,324	18,862
Add: Depreciation / amortisation / non-cash prov	1,260	1,403	1,718	1,773	1,817
Tax paid	(2,156)	(3,298)	(3,743)	(4,975)	(6,129)
Operating profit before working capital changes	4,887	7,254	9,564	12,122	14,550
Change in working capital / other adjustments	6,036	(7,350)	(914)	290	357
Net cashflow from operating activities	10,923	(95)	8,651	12,412	14,908
Fixed Assets	(3,194)	(3,375)	(2,748)	(2,212)	(2,346)
Investments	(1,291)	195	-	-	-
Cash (used) / realised in investing activities	(4,485)	(3,180)	(2,748)	(2,212)	(2,346)
Free cash flow	6,439	(3,276)	5,903	10,201	12,562
Borrowings	(921)	277	-	(4)	(4)
Dividend paid	(895)	(1,016)	(1,674)	(1,617)	(1,983)
Cash (used) /realised in financing activities	(1,710)	(715)	(1,674)	(1,622)	(1,987)
Cash generated /utilised	4,876	(3,193)	4,228	8,579	10,575
Net cash at end of year	11,621	8,425	12,798	21,377	31,952

Source: Kotak Institutional Equities estimates.

Exhibit 5. Implied valuation of Siemens adjusted for its IT business
Valuation is higher compared to even ABB

Sum-of-the-Parts (SOTP) valuation of Siemens based on y/e Sep 2009E (Rs mn)

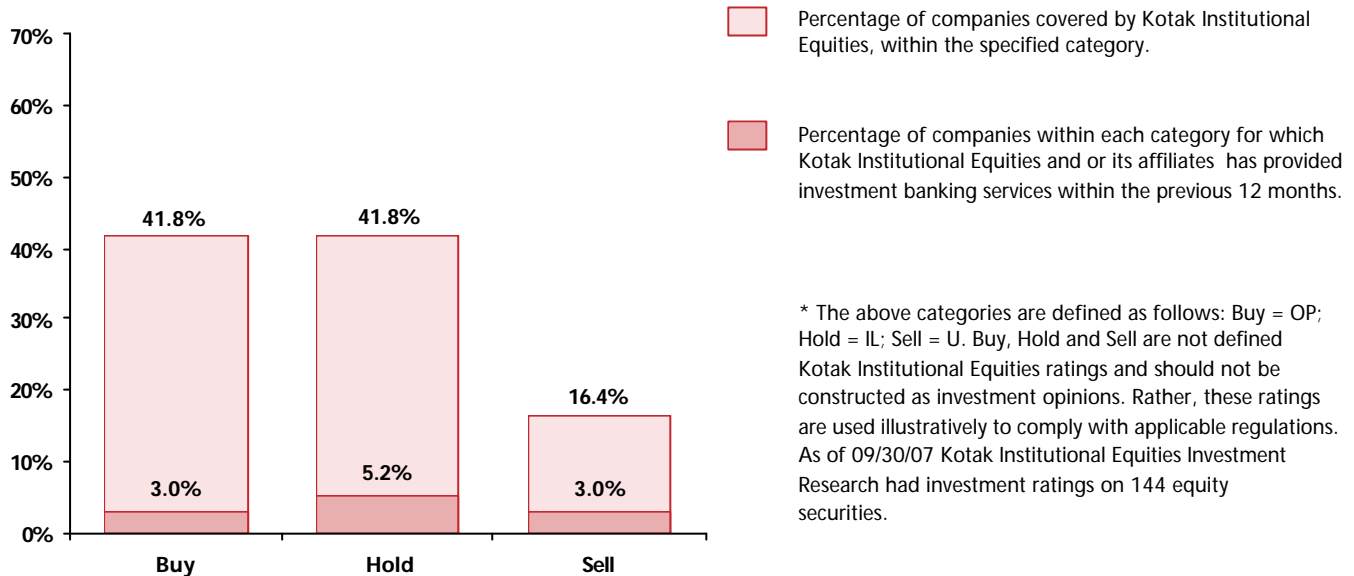
	2008E (Rs mn)	2009E (Rs mn)
Consolidated PAT of Siemens	7,847	10,349
Consolidated PAT of Siemens excluding SISL dividend	7,384	9,814
Earnings of SISL	1,858	2,150
P/E multiple (X)	15	15
Valuation of SISL	27,868	32,243
Market cap of Siemens	262,985	262,985
Market cap of Siemens excluding SISL	235,117	230,742
P/E multiple of Siemens (consolidated)	32	24
Implied P/E multiple of Siemens excluding SISL	39.3	28.1

Source: Kotak Institutional Equities estimates.

"Each of the analysts named below hereby certifies that, with respect to each subject company and its securities for which the analyst is responsible in this report, (1) all of the views expressed in this report accurately reflect his or her personal views about the subject companies and securities, and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report: Lokesh Garg."

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Source: Kotak Institutional Equities.

As of September 30, 2007

Ratings and other definitions/identifiers

New rating system

Definitions of ratings

BUY. We expect this stock to outperform the BSE Sensex by 10% over the next 12 months.

ADD. We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

REDUCE: We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

SELL: We expect this stock to underperform the BSE Sensex by more than 10% over the next 12 months.

Old rating system

Definitions of ratings

OP = Outperform. We expect this stock to outperform the BSE Sensex over the next 12 months.

IL = In-Line. We expect this stock to perform in line with the BSE Sensex over the next 12 months.

U = Underperform. We expect this stock to underperform the BSE Sensex over the next 12 months.

Our target price are also on 12-month horizon basis.

Other definitions

Coverage view. The coverage view represents each analyst's overall fundamental outlook on the Sector. The coverage view will consist of one of the following designations: Attractive (A), Neutral (N), Cautious (C).

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NA = Not Available or Not Applicable. The information is not available for display or is not applicable.

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