India Equity Research | Engineering and Capital Goods

Company Update

SUZLON ENERGY

INR 94

Edelweiss
Ideas create, values protect

Valuations factor in more than concerns

BUY

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Extension of production tax credit, a big boost to wind energy industry

The US House of Representatives finally passed the long-awaited and much-debated extension of production tax credits (PTC) and investment tax credits (ITC), as part of the Economic Stabilisation Act of 2008, this week. The tax credit package will extend PTC for a year and ITC for eight years. US is the fastest growing wind energy market and extension of these benefits will bring about renewed focus on wind energy development in the country. Suzlon with majority of its order book from US is expected to be a major beneficiary.

REpower provides strong visibility till 2011

REpower is expected to be a major beneficiary of the EU setting the target of growing the share of renewable energies to 20% until 2010. A major contribution of this is expected to come from wind energy. As per the management, REpower's order book already contains binding orders worth more than EUR 1.6 bn as well as almost EUR 5 bn from frame contracts. Most of these orders are expected to come from offshore wind where REpower has a strong foothold. Management has guided for sales of EUR 1.1 bn in FY09 and EUR 1.65 bn in FY10, with EBIT margins at 5.5-6.5% and 8.0-8.5%, respectively.

Slower order intake and rights issue: Overhang on the stock

Suzlon Energy's (Suzlon) total order book was at 3,040 MW at Q1FY09 end against 2,882 MW in the same period previous year, registering a growth of only 5.4% Y-o-Y. The company's international order book has increased 7.9% Y-o-Y, which is a growth driver for the company. Current order book provides for execution of ~1,500 MW each in FY09 and FY10, which is far below our FY09E and FY10E and provides downside risks to our numbers. However, with extension of PTC (49% of order book from US) and Suzlon's focus on the European market, orders are expected to flow in some time.

Outlook and valuations: Very attractive amidst concerns; maintain 'BUY'

Even amidst concerns of slower order book accretion and equity dilution overhang, we believe that recent stock price correction provides a good opportunity for investors to enter the stock. Valuations at 9.4x FY09E and 5.4x FY10E are the lowest that the stock has tested since listing. Even with downward risk on FY10 numbers, Repower's contribution to Suzlon's EPS is expected to be INR 2-2.25 in FY10E, consolidation of which is expected in FY10. We reiterate our **'BUY'** recommendation.

Financials

Year to March	FY07	FY08	FY09E	FY10E
Revenue (INR mn)	79,857	136,794	173,949	255,243
Rev growth (%)	*124.1*	*71.3*	*27.2*	*46.7*
EBITDA (INR mn)	13,216	19,245	25,010	40,339
Net profit (INR mn)	8,673	10,461	15,380	26,741
Shares outstanding (mn)	1,439	1,497	1,555	1,555
Diluted EPS (INR)	6.0	7.6	9.9	17.2
EPS growth (%)	*78.8*	*26.5*	*29.7*	*73.9*
Diluted P/E (x)	15.4	12.6	9.4	5.4
EV/EBITDA (x)	12.9	7.9	6.3	4.1
ROAE (%)	27.8	19.7	14.0	17.9

Reuters	:	SUZL.BO
Bloomberg	:	SUEL IN

Market Data

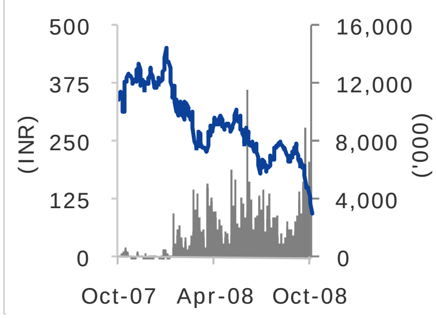
52-week range (INR)	:	460 / 92
Share in issue (mn)	:	1,496.9
M cap (INR bn/USD mn)	:	140.3 / 2,920
Avg. Daily Vol. BSE/NSE ('000)	:	7,531.2

Share Holding Pattern (%)

Promoters	:	65.9
MFs, FIs & Banks	:	3.6
FIIs	:	21.7
Others	:	8.8

Relative Performance (%)

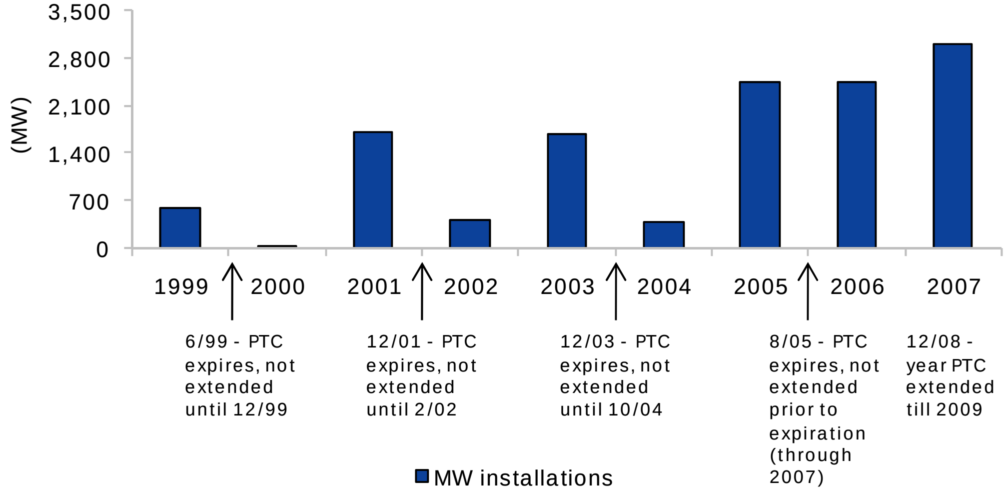
	Sensex	Stock	Stock over Sensex
1 month	(28.2)	(58.9)	(30.7)
3 months	(24.4)	(53.4)	(29.0)
12 months	(42.4)	(73.7)	(31.3)



Extension of production tax credit a big boost to wind energy industry

The US House of Representatives finally passed the long-awaited and much-debated extension of production tax credits (PTC) and investment tax credits (ITC), as part of the Economic Stabilisation Act of 2008, this week. The tax credit package will extend PTC for a year and ITC for eight years. Earlier, PTC was expected to expire by December 2008 and with the extension, we expect renewed focus on wind energy as one of the most important sources of energy going forward. Historically, PTC played a vital role in development of wind energy in the US as experienced by sharp drop in wind installations post expiry of PTC. The non-extension of PTC had led to installations in 2004 falling drastically to 389 MW from 1,687 MW in 2003. However, with the re-introduction in 2005, volumes had picked up. This act provides a tax credit of USD 2 cents/unit incentive to investors. US is the fastest growing wind energy market and with extension of this benefit, orders are likely to start flowing in.

Effect on PTC on US wind energy demand

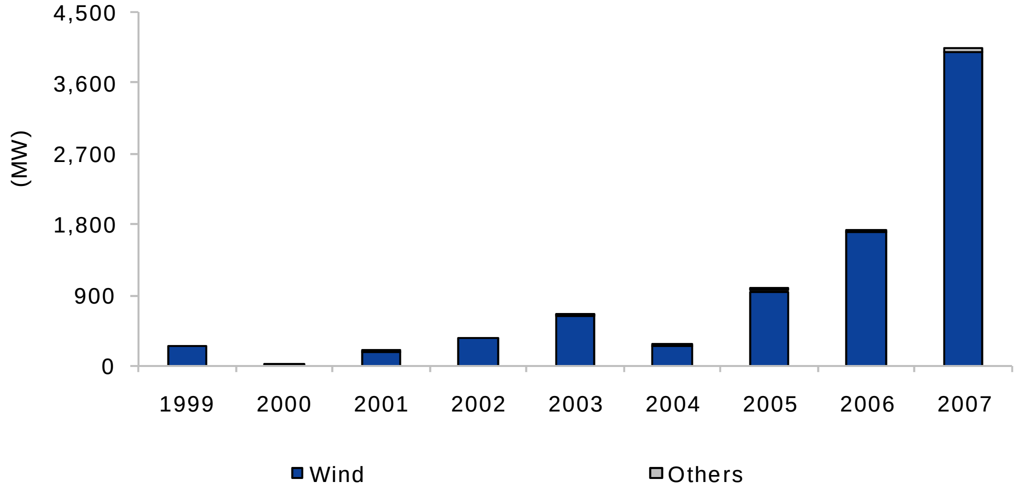


Source: American wind Energy association

Renewable Energy Portfolio Standard: A mandatory mechanism

US and other countries have set up the Renewable Energy Portfolio Standard (RPS), which ensures that a minimum amount of renewable energy from wind, solar, biomass etc., is included in the portfolio of electricity resources serving a state or country. It also stipulates that the share be increased over a period of time. Of the more than 8,900 MW of new non-hydro renewable energy capacity that has come on line in RPS states from 1998 through 2007, roughly 93% has come from wind power, with biomass (4%), solar (2%), and geothermal (1%) playing lesser roles.

Wind Energy installations through RPS



Source: US department of Energy

Assuming there is complete compliance, estimates suggest that over 60 GW of cumulative, new renewable energy capacity may be needed by 2025 to fully meet existing state RPS policies, including 4 GW already required by 2007, a cumulative 14 GW by 2010, and a cumulative 32 GW by 2015. The estimated 60 GW of new renewable capacity equates to an additional 4.7% of the total projected nationwide electricity generation in 2025, compared to a non hydro share of 2.4% in 2006.

New order inflow likely to slow till dust settles

The target set through RPS seems to be aggressive, more so given the current economic conditions. However, global warming is considered a renewed threat to global economy and widespread view supports increased investments in a cleaner technology. Upcoming UN talks in December are expected to be a stepping stone towards a treaty to curb emissions from fossil fuels beyond 2012 and underlying thought process to set the pace as, "***There is an economic crisis, a financial crisis, an energy crisis, and there is a climate crisis. The climate crisis is permanent. All the other crises today, tomorrow, hope will pass but the climate crisis is a permanent threat for the globe." EU Environment Commission.***

Suzlon's slower order accretion a worry; biggest downside risk to our numbers

Suzlon's total order book was at 3,039 MW in Q1FY09 against 2,882 MW in the same period previous year, registering a growth of only 5.4% Y-o-Y. International order book has increased 7.9% Y-o-Y, which is a growth driver for the company. Current order book provides execution of ~1,500 MW each in FY09 and FY10, which is far below our FY09 and FY10 estimates and provides downside risks to our numbers. However, with the extension of PTC (49% of order book from US) and Suzlon's focus on the European market, orders are expected to flow in some time.

Rights issue: An overhang on stock price

Suzlon's announcement of funding the Martifer stake for acquisition in REpower through rights issue of INR 18 bn has created a dilution overhang on the stock price. This was earlier expected to be funded through debt. However, it seems a prudent move for keeping leverage under control in a high interest and liquidity crunch scenario. On current prices, this is expected to dilute earnings by 12-14%. Even if the REpower acquisition is funded through debt, the debt/equity ratio is likely to be 1:1 with earnings destruction by ~4.1% in FY09E (for three months) and 9.3% in FY10E (full year). We expect the stock to be under short-term pressure, till the time the rights issue overhang is over.

Repower: Strong visibility till 2011

Repower is expected to be a major beneficiary of the EU setting the target of growing the share of renewable energies to 20% until 2010. A major contribution of this is expected to come from wind energy. As per the management, REpower's order book already contains binding orders worth more than EUR 1.6 bn as well as almost EUR 5 bn from frame contracts. Most of these orders are expected to come from offshore wind where REpower has a strong foothold. Management has guided for sales of EUR 1.1 bn in FY09 and EUR 1.65 bn in FY10, with EBIT margins at 5.5-6.5% and 8.0-8.5%, respectively.

Outlook and valuations: Attractive amidst concerns; maintain 'BUY'

Suzlon is currently grappling with issues like blade crack, high leverage (compared to other cap good companies), slower order book accretion, and equity dilution overhang. However, we believe that recent certification of its S88 model versions V2 and V3 will add credibility to its product portfolio. Current debt equity ratio at 0.8x is high and also not beyond uncomfortable levels. Slower order book accretion, however, poses the biggest risk to our FY09 and FY10 estimates. We believe that amidst all these concerns, valuations have become attractive at 9.4x FY09E and 5.4x FY10E. Even with downward risk on FY10 numbers, REpower is expected to be EPS accretive of INR 2-2.25 in FY10E, consolidation of which is expected in FY10 numbers. We maintain our **'BUY'** recommendation.

Company Description

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 operation and maintenance (O&M) services. This, along with its strong technological capabilities overseas and low-cost vertically integrated manufacturing base in India, give 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 the company's product requirements are manufactured at its Indian facilities, providing it a significant cost advantage. Further, capacity expansion in the US and China will help the company cater to the strong global wind energy demand. It is also expanding capacity of Hansen Transmission, which obliterates 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 see increased focus from players like Siemens and GE. However, we believe 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	FY06	FY07	FY08	FY09E	FY10E
Income from operations	35,639	79,857	136,794	173,949	255,243
Direct costs	26,482	52,965	88,702	117,139	172,113
Employee costs	1,216	6,682	10,430	13,084	17,668
Other expenses	1,730	6,994	18,418	18,717	25,123
Total operating expenses	29,428	66,642	117,550	148,939	214,904
EBITDA	6,212	13,216	19,245	25,010	40,339
Depreciation and amortisation	716	1,718	2,894	3,710	5,028
EBIT	5,496	11,498	16,351	21,299	35,312
Interest expense	648	2,763	5,320	5,787	7,062
Other income	556	965	2,646	1,867	1,809
Profit before tax	5,404	9,699	13,676	17,379	30,059
Provision for tax	568	1,034	1,833	1,999	3,318
Core profit	4,836	8,665	11,843	15,380	26,741
Extraordinary items	-	-	(1,512)	-	-
Profit after tax	4,836	8,665	10,332	15,380	26,741
Minority interest	(10)	(8)	428	-	-
Share of associates			(558)		
Profit after minority interest	4,847	8,673	10,461	15,380	26,741
Equity shares outstanding (mn)	1,438	1,439	1,548	1,555	1,555
EPS (INR) basic	3.4	6.0	7.4	9.9	17.2
Diluted shares (mn)	1,438	1,439	1,497	1,555	1,555
EPS (INR) fully diluted	3.4	6.0	7.6	9.9	17.2
DPS	0.8	0.8	0.9	1.3	2.3
Dividend payout (%)	34.3	20.0	20.0	20.0	20.0

Common size metrics- as % of net revenues

Year to March	FY06	FY07	FY08	FY09E	FY10E
Operating expenses	82.6	83.5	85.9	85.6	84.2
Depreciation	2.0	2.2	2.1	2.1	2.0
Interest expenditure	1.8	3.5	3.9	3.3	2.8
EBITDA margins	17.4	16.5	14.1	14.4	15.8
Net profit margins	13.6	10.9	8.7	8.8	10.5

Growth metrics (%)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Revenues	83.5	124.1	71.3	27.2	46.7
EBITDA	32.4	112.8	45.6	30.0	61.3
Net profit	32.4	79.2	36.7	29.9	73.9
EPS	(59.9)	78.8	26.5	29.7	73.9

Balance sheet (INR mn)

As on 31st March	FY06	FY07	FY08	FY09E	FY10E
Equity capital	2,875	2,878	3,096	3,109	3,109
Preference share Capital	281	25	25	25	26
Reserves & surplus	24,217	31,226	77,917	135,856	157,249
Shareholders funds	27,373	35,136	81,038	138,990	160,384
Secured loans	3,899	19,844	70,664	80,664	85,664
Unsecured loans	608	31,776	28,682	28,682	28,682
Borrowings	4,507	51,620	99,346	109,346	114,346
Minority Interest	75	141	10,244	10,244	10,244
Net deferred tax	(818)	177	218	218	218
Sources of funds	**31,137**	**87,074**	**190,846**	**258,798**	**285,191**
Gross block	6,293	43,211	55,998	89,709	104,736
Depreciation	1,536	7,016	10,318	14,029	19,056
Net block	4,757	36,195	45,680	75,680	85,680
Capital work in progress	1,652	4,498	11,197	11,197	11,197
Total fixed assets	6,409	40,693	56,877	86,877	96,877
Investments	76	156	31,418	62,836	94,253
Inventories	13,310	31,363	40,848	61,954	83,916
Sundry debtors	16,473	25,704	32,013	57,189	69,930
Cash and equivalents	5,515	15,383	69,602	43,363	9,977
Loans and advances	6,407	12,076	18,250	27,375	31,481
Other current assets			14,894	14,894	14,894
Total current assets	41,705	84,526	175,606	204,774	210,197
Sundry creditors and others	12,977	33,340	64,830	84,279	101,135
Provisions	4,101	4,999	8,225	11,410	15,001
Total CL & provisions	17,078	38,339	73,055	95,689	116,136
Net current assets	24,627	46,187	102,552	109,085	94,061
Others	25	39	0	0	0
Uses of funds	**31,137**	**87,074**	**190,846**	**258,798**	**285,191**
Book value per share (BV) (INR)	19.0	24.4	52.3	89.4	103.2

Free cash flow

Year to March	FY06	FY07	FY08E	FY09E	FY10E
Net Profit	4,847	8,673	10,461	15,380	26,741
Add: Depreciation	716	1,718	2,894	3,710	5,028
Add: Deferred tax	(568)	(126)	(23)	0	0
Add: Others	(13)	(96)	(29,898)	(31,418)	(31,418)
Gross cash flow	4,981	10,169	(16,566)	(12,328)	351
Less:Changes in working capital	10,989	11,691	(12,748)	32,773	18,361
Opertaing cash flow	(6,008)	(1,523)	(3,819)	(45,101)	(18,011)
Less: Capex	4,046	36,003	19,077	33,710	15,028
Free cash flow	**(10,054)**	**(37,525)**	**(22,896)**	**(78,811)**	**(33,038)**

Cash flow metrics

Year to March	FY06	FY07	FY08	FY09E	FY10E
Operating cash flow	(6,008.2)	(1,522.9)	(3,818.6)	(45,100.5)	(18,010.6)
Financing cash flow	12,837.7	45,222.4	67,635.3	52,674.1	(347.2)
Investing cash flow	(4,045.9)	(36,002.5)	(19,077.2)	(33,710.4)	(15,027.6)
Net cash flow	2,783.5	7,697.0	44,739.5	(26,136.9)	(33,385.4)
Capex	(4,045.9)	(36,002.5)	(19,077.2)	(33,710.4)	(15,027.6)
Dividend paid	(1,656.5)	(1,729.5)	(2,062.7)	(3,075.9)	(5,348.2)
Share issuance/(Buyback)	14,817.8	119.0	21,947.5	45,750.0	0.0

Ratios

Year to March	FY06	FY07	FY08	FY09E	FY10E
ROAE (%)	26.6	27.8	19.7	14.0	17.9
ROACE (%)	25.1	19.5	13.3	12.0	18.3
Inventory (days)	131	154	149	160	155
Debtors (days)	120	96	77	94	91
Debt/Equity (x)	0.2	1.5	1.2	0.8	0.7
Interest cover (x)	8.5	4.2	3.1	3.7	5.0
Payable (days)	131	160	202	232	197
Cash conversion cycle	121	91	24	21	49
Current ratio	2.4	2.2	2.4	2.1	1.8
Debt/EBITDA	0.7	3.9	5.2	4.4	2.8
Adjusted debt/Equity	0.2	1.7	1.3	0.8	0.7

Operating ratios

Year to March	FY06	FY07	FY08	FY09E	FY10E
Total asset turnover (x)	1.6	1.4	1.0	0.8	0.9
Fixed assets turnover (x)	9.4	3.9	3.3	2.9	3.2
Equity turnover(x)	2.0	2.6	2.4	1.6	1.7

Du pont analysis

Year to March	FY06	FY07	FY08	FY09E	FY10E
NP margin (%)	13.6	10.9	8.3	8.8	10.5
Total assets turnover	1.6	1.4	1.0	0.8	0.9
Leverage multiplier	1.2	1.9	2.4	2.0	1.8
ROAE (%)	26.6	27.8	19.7	14.0	17.9

Valuation parameters

Year to March	FY06	FY07	FY08	FY09E	FY10E
Diluted EPS (INR)	*3.4*	*6.0*	*7.6*	*9.9*	*17.2*
Y-o-Y growth (%)	*(59.9)*	*78.8*	*26.5*	*29.7*	*73.9*
CEPS (INR)	3.5	7.1	9.2	12.3	20.4
P/E (x)	27.6	15.4	12.2	9.4	5.4
Price/BV(x)	4.9	3.8	1.8	1.0	0.9
EV/Sales (x)	3.7	2.1	1.1	0.9	0.6
EV/EBITDA (x)	21.4	12.9	7.9	6.3	4.1
Dividend yield (%)	0.8	0.9	0.9	1.4	2.4

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Coverage group(s) of stocks by primary analyst(s): *Engineering and capital goods:*

Thermax, Techno Electric, Voltamp transformers, Transformer and Rectifier, Emco, Kalpataru Power Transmission, KEC International, Jyoti Structures, ABB, BHEL, Voltas, L & T, Siemens, Crompton Greaves, Suzlon Energy and Cummins India.

Suzlon Energy

Recent Research

Date	Company	Title	Price (INR)	Recos
08-Sep-08	**India-US Nuclear Deal**	A step in the right direction; *Sector Update*		
01-Sep-08	**Engineering & Capital Goods**	Roadblocks on the highway; *Visit Note*		
25-Aug-08	**Transformers**	Testing times ahead; *Visit Note*		
01-Aug-08	**Voltamp Transformers**	Voltage amplified; *Result Update*	765	Buy

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	94	59	14	8	187

* 10 stocks under review / 1 rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	75	65	47

Rating Interpretation

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