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Suzlon Energy **Annual Report Analysis** September 18, 2008

Edelrank
1

EdelRank: Annual report ranking for best accounting and disclosure practices (on a scale of 1-10 from best to worst. Refer Annexure-A for details

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Market Data

52-week range (INR):	460 / 174
Share in issue (mn):	1,496.9
M cap (INR bn/USD mn):	324 / 7,434.9
Avg. Daily vol. BSE ('000):	6,631.3

Share Holding Pattern (%)

Promoters	:	65.9
MFs, FIs & Banks	:	3.6
FIIs	:	21.7
Others	:	8.7

Profitability analysis and financial highlights

- Suzlon Energy's (Suzlon) ROAE (adjusted) before exceptional items was at 20.2%, despite return on net operating assets (RNOA) before exceptional items being at 14.2% (ROE analyser analyses the difference).
- Declining RNOA, from 36% in FY06 to 14% in FY08, has led to ROAE dipping from 42% in FY06 to 20% in FY08.
- Cost of goods sold (as a percentage of sales) increased from 60% of sales in FY07 to 65% in FY08, due to change in geographical mix in which it operates, undertaking of wind turbine generator (WTG) erection, installation and commissioning of project activities, and changes in product mix.
- Unhedged foreign currency exposure (net liabilities) as at March 31, 2008, was INR 7.2 bn. The company has recognised foreign exchange gain of INR 258 mn in FY08 (loss of INR 333 mn in FY07) out of which INR 195 mn is unrealised gain. With INR depreciating ~13% against USD since March 2008, future profits will be impacted.
- During the year, Suzlon reported exceptional expenses of INR 1.5 bn (net of tax). It includes a provision of INR 1.2 bn made to resolve the blade crack issue in some of its S88 turbines in the US and Portugal.

Accounting highlights

- Impact of compliance with more logical global accounting practices will result in reduction of consolidated PAT and basic EPS (before exceptional items) by ~6% each and RONW by 1%.
- Redemption premium on zero coupon convertible bonds (ZCCB) has not been charged to P & L or reserves but disclosed as a contingent liability

Funding growth through debt, equity, quasi equity, and options

- Loan book increased ~92% to INR 99.3 bn in FY08 (INR 51.6 bn in FY07). However, average borrowing cost dipped from 9.8% to 7.9%, mainly on account of issuance of ZCCB of USD 500 mn (due in 2012), redeemable at a premium of ~45% (effective yield ~7.7% in USD terms). The bonds are convertible at a conversion price of INR 360-371 per share of INR 2.
- Suzlon has raised USD 552 mn through equity issue at an issue price of INR 383 per share of INR 2, issued to QIBs.
- It raised EUR 440 mn in its 100% subsidiary, Hansen Transmissions International, Belgium (Hansen), through an IPO. Post IPO, holding of Suzlon in Hansen has reduced to 71.3%.
- Suzlon had significant potential future commitments to purchase REpower Systems (REpower) shares from Martifer and Areva groups, pursuant to option arrangements. Contingent liabilities, at INR 48.2 bn (INR 47.2 bn towards guarantees given in connection with acquisition of shares of REpower and INR 1.0 bn towards premium on redemption of ZCCBs), are ~59% of the reported net worth.
- Areva and Martifer, subsequently, exercised the put option. The transaction with Areva was completed in June 2008, whereas the transaction with Martifer is expected to be completed in December 2008, for which Suzlon may have to raise fresh debt.

Profitability analysis (ROE analyser; refer to Annexure B for details)

ROE analyser analyses profitability on the scale of operating efficiency and capital allocation efficiency (detailed concept explained in Annexure B). We have analysed the profitability of Suzlon for FY08 and the results and key findings are given below:

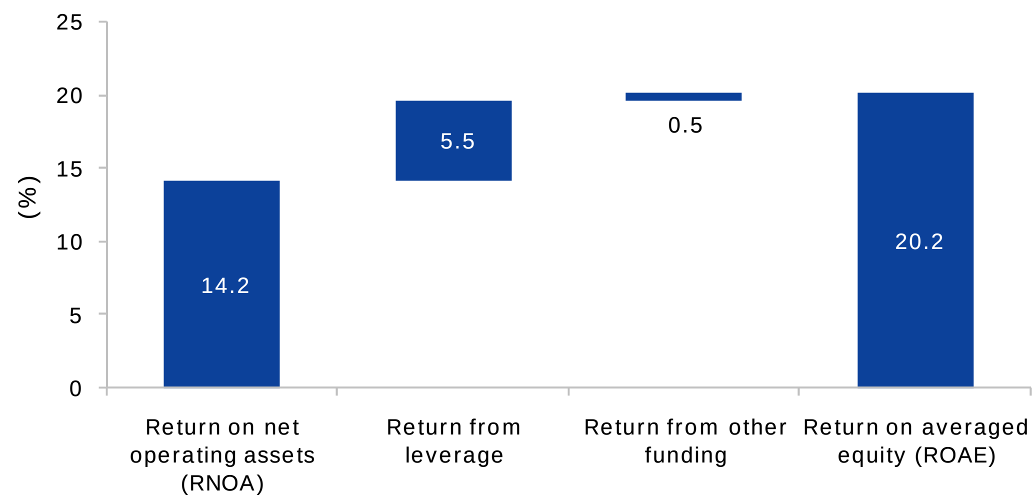
ROE analyser*

		FY06		FY07		FY08
A. Return on net operating assets (RNOA) (OPATO x NOPAT margin) (%)		**35.8**		**19.2**		**14.2**
OPATO (Operating assets turnover) (x)	1.7		1.5		1.3	
NOPAT (Net operating profit afer tax) margin (%)	20.5		13.2		11.2	
B. Return from leverage (FLEV x spread) (%)		**6.4**		**8.6**		**5.5**
FLEV (Financial leverage) (x)	0.2		0.8		0.8	
NBC (Net borrowing cost) (%)	7.6		8.1		7.0	
Net financial spread (RNOA -NBC) (%)	28.2		11.1		7.2	
C. Return from other fundings (%)		**0.1**		**0.0**		**0.5**
ROAE derived (A+B+C) (%)		**42.3**		**27.8**		**20.2**

Source: Company annual report, Edelweiss research

** excluding the impact of exceptional items*

ROE Tree



Source: Company annual report, Edelweiss research

Declining trend in RNOA is on account of:

- Increase in material cost and operating expenses
- Revenue has not been able to keep pace with the increased investment in fixed assets, lowering operating asset turnover
- Increase in CWIP, excluding CWIP RNOA, for FY08 stood at 15.3 % (FY07—20.3%)

Cash flow analysis (refer Annexure B for details)

Reformulated cash flow (INR bn)

		FY08
Net cash from operating activities (1)		**(17.0)**
NOPAT (Net operating profit after tax) #	15.4	
Increase in net operating assets (NOA) #	(32.4)	
Net cash from financing activities (2)		**(4.7)**
Adjusted net financing expense #	(3.4)	
Decrease in net financial obligation #	(1.3)	
Net cash flow from share holders (3)		**21.7**

Note: # Adjusted for direct debit into reserves

Source: Company annual report, Edelweiss research

1. **Cash from operating activities:** Cash generated from operations less cash deployed into net operating assets (includes operating cash).
2. **Cash from financing activities:** Sum of net cash from debt financing and non-strategic investments (includes surplus cash).
3. **Cash from equity financing:** Represents premium received on QIP issue and others.

Shareholders' fund analysis

(INR bn)

Particulars		FY08
Opening shareholders' fund		34.2
Add:		**49.1**
Profit for the year	10.3	
Increase in equity share capital	0.1	
Share Premium on QIP issue	21.8	
Unrealised gain on dilution	12.0	
Movement in foreign currency translation reserve	4.8	
Less:		**2.3**
Proposed dividend incl. tax	1.8	
Share issue expenses	0.3	
Issue expenses on ZCCB	0.2	
Others	0.0	
Closing shareholders' fund		**81.0**

Source: Company annual report, Edelweiss research

Levering up balance sheet to fund inorganic growth

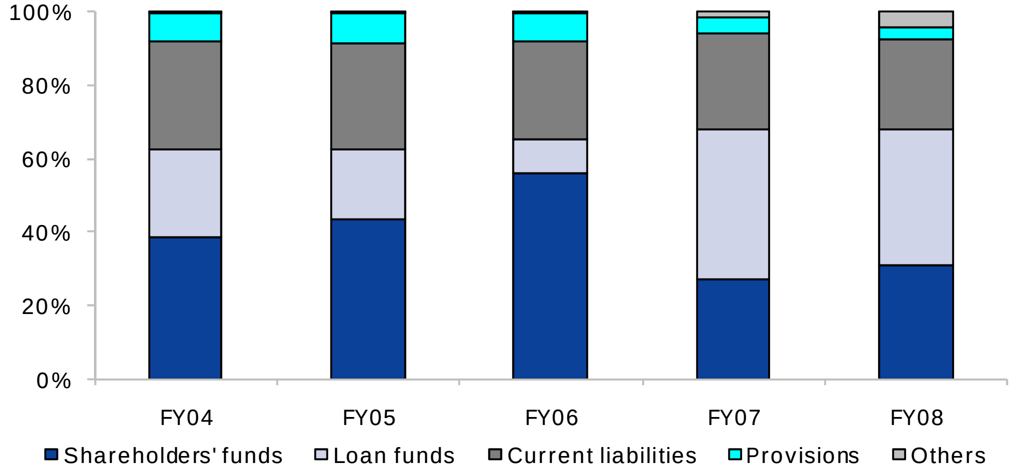
Balance sheet adequately leveraged. Future capex may require to be funded through mix of equity and debt

Proportion of inventories and debtors reduced on account of better controls, while investments rose on acquisition of stake in REpower

Cost of goods sold depicts rising trend over the years

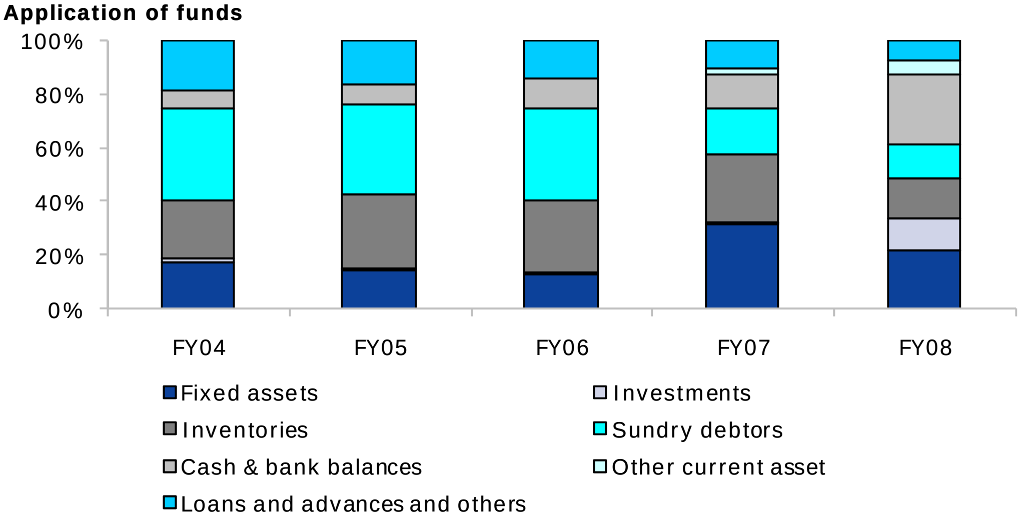
Balance sheet and income statement analysis

Sources of funds



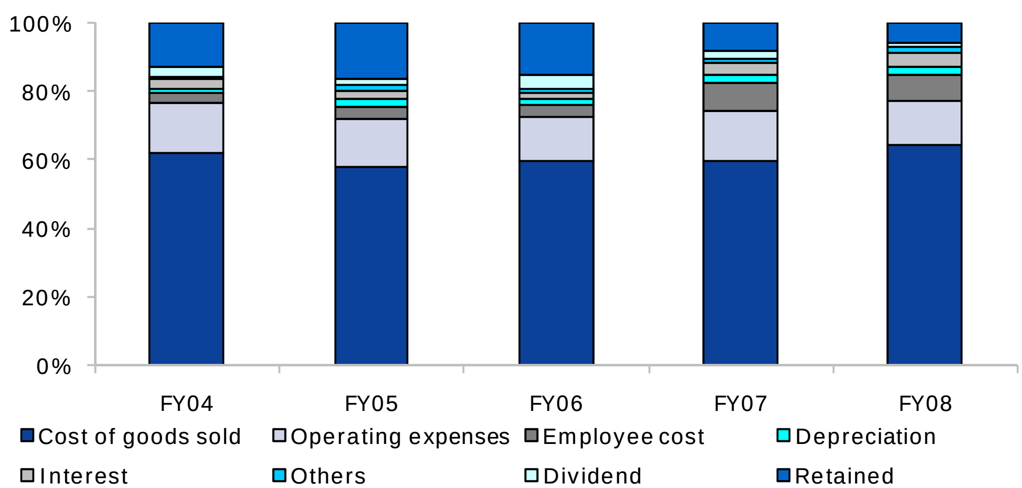
Source: Company annual report, Edelweiss research

Application of funds



Source: Company annual report, Edelweiss research

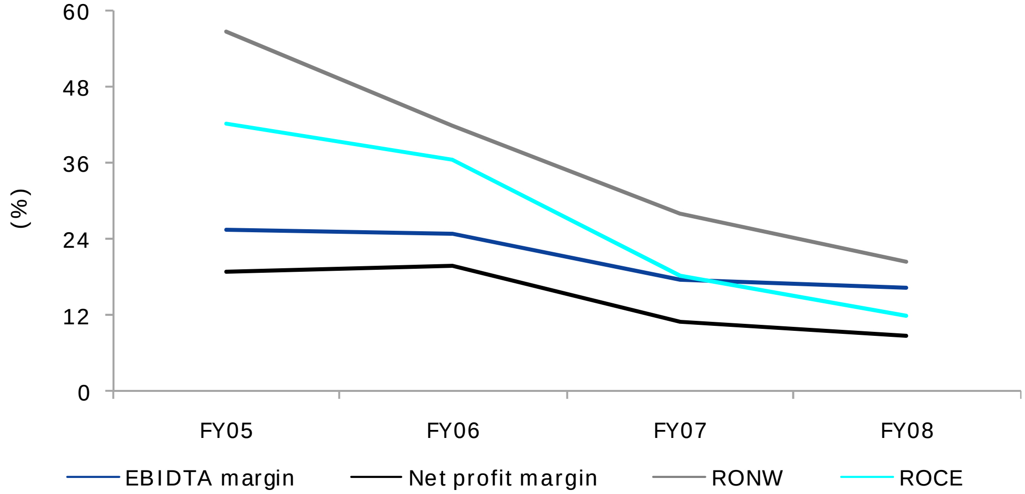
Utilisation of income



Source: Company annual report, Edelweiss research

Decreasing trend in operating margins led to dip in return ratios

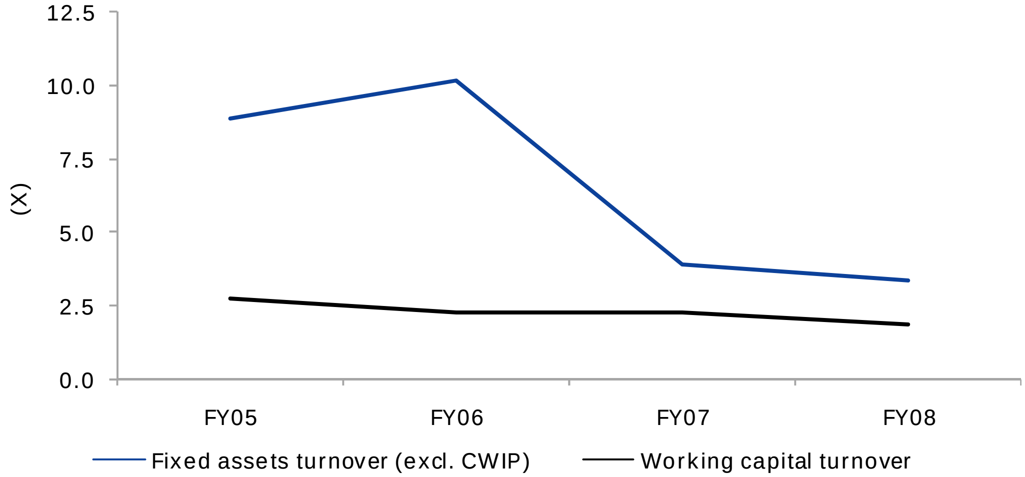
Profitability ratios



Source: Company annual report, Edelweiss research

Declining fixed asset turnover led to decrease in operating margins and ROCE

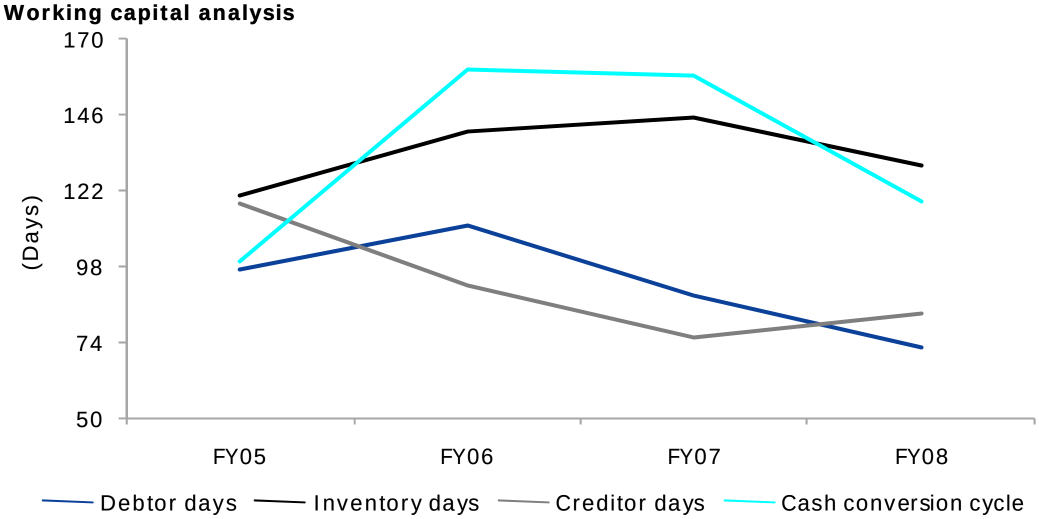
Turnover ratios



Source: Company annual report, Edelweiss research

Suzlon has set up manufacturing facilities in the US, China, and Europe to be close to its customers; thus, helping it improve its cash conversion cycle

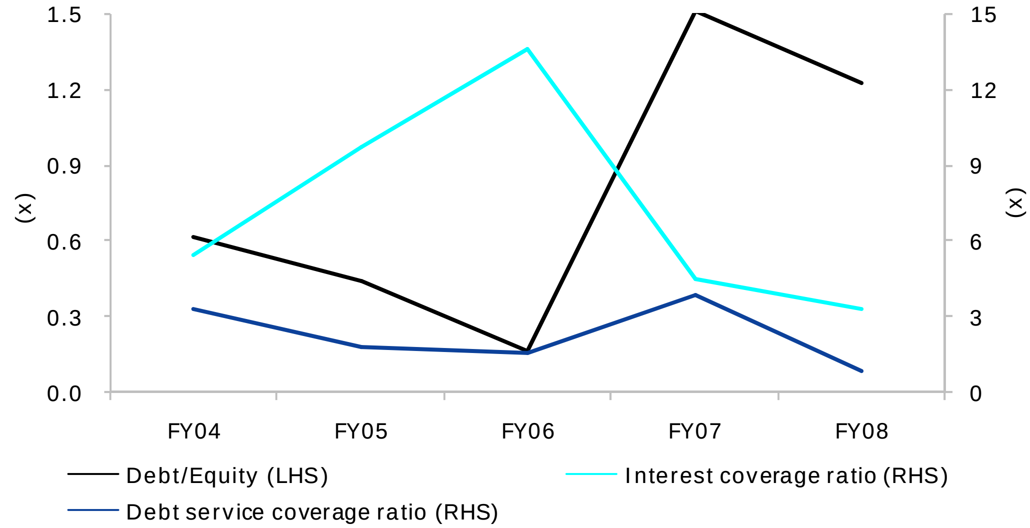
Working capital analysis



Source: Company annual report, Edelweiss research

Increased borrowings to fund acquisition of Hansen in FY07 raised debt equity and led to a dip in interest coverage and DSCR

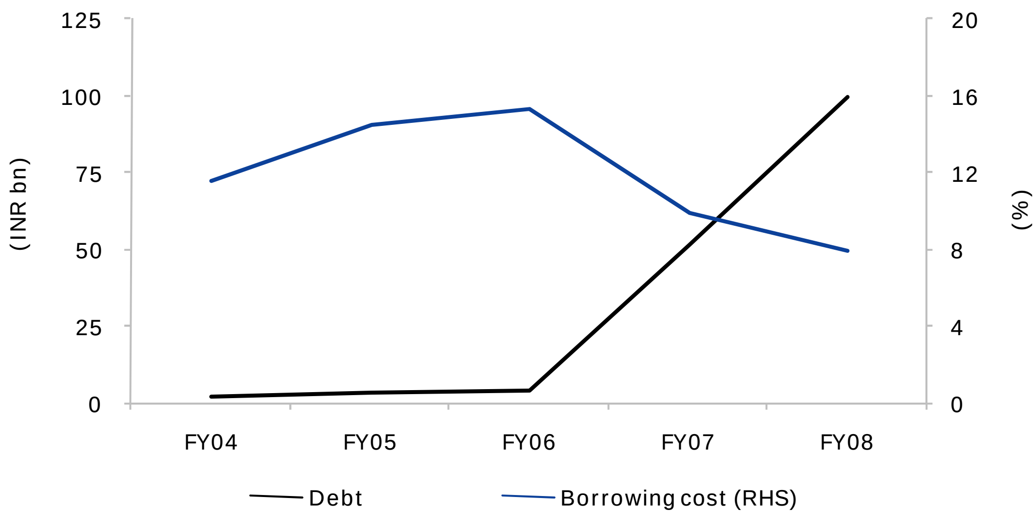
Leverage analysis



Source: Company annual report, Edelweiss research

Loan book increased sharply. However, borrowing cost dipped due to low-cost borrowings on account of ZCCB

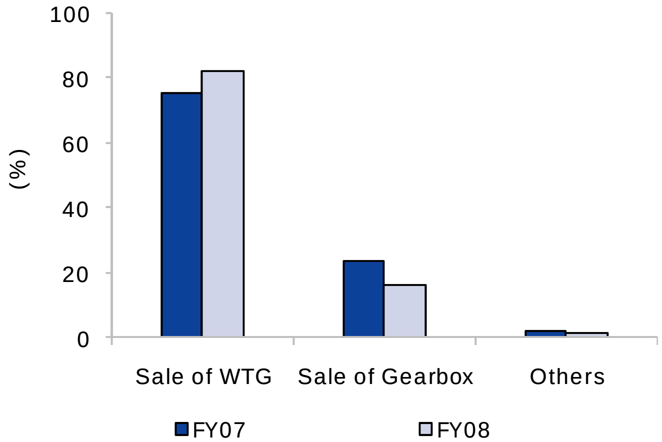
Borrowing analysis



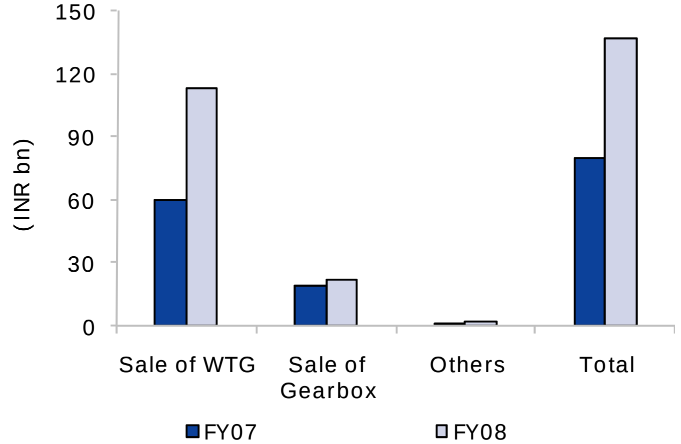
Source: Company annual report, Edelweiss research

Segmental performance –

Segment revenue share

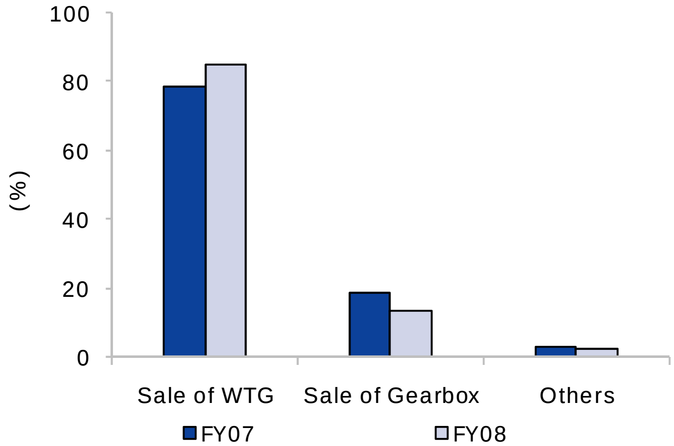


Segment revenue growth

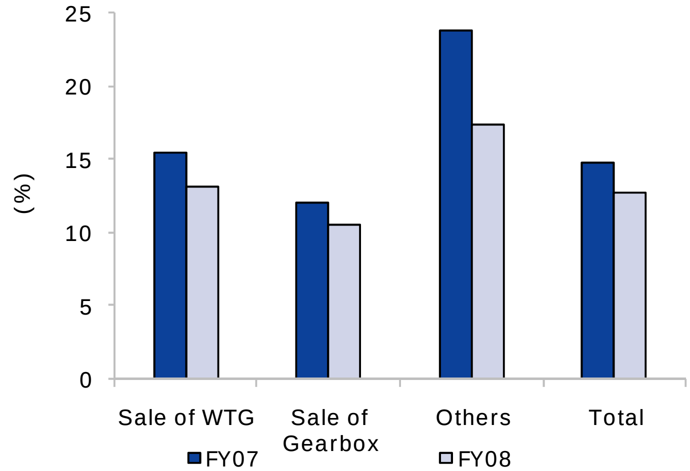


Sale of WTG was the major revenue contributor, with the highest revenue growth over the previous year

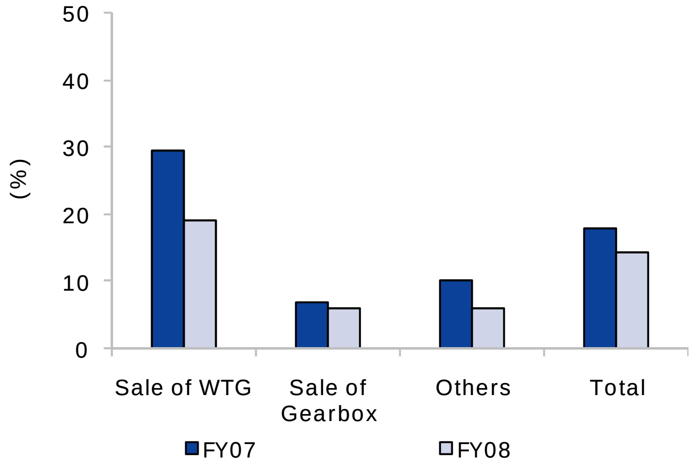
Segment operating income share



Segment EBIT margin



Segment ROA

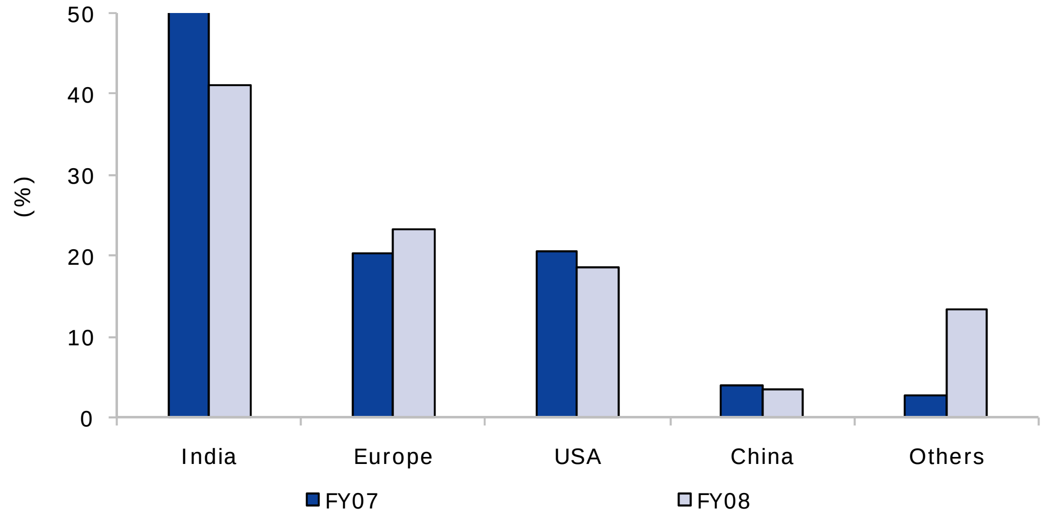


Source: Company annual report, Edelweiss research

Sale of WTG contributed the highest operating income and had the highest ROA, but relatively low EBIT margin

India contributed more than half of Suzlon's total revenue

Geographical segment revenue share



Source: Company annual report, Edelweiss research

Accounting policy analysis

ICAI has issued a concept paper on convergence of accounting standards with IFRS and has indicated full adoption of IFRS from the financial year commencing April 1, 2011.

We have calculated the impact on reported financials of the company in light of more logical globally accepted practices (refer Annexure C for details).

Impact of adoption of more reasonable accounting

Sl. No.	Particulars of the issue	Reason	Impact on PAT	Impact on net worth	Impact on basic EPS
1	Employee Stock option accounted using intrinsic value instead of fair value method	IFRS/ US GAAP more logical	(34)	(34)	(0.0)
2	Provision for long term nature are not discounted to there present value	IFRS more logical	Note 1	Note 2	Note 1
3	Issue Expenses and redemption premium on convertible bonds not debited to income statement	IFRS/AS 30/31 more logical	(729)	633	(0.5)
	Total	**(A)**	**(763)**	**599**	**(0.5)**
	Reported Cosolidated PAT*, Net worth and Basic EPS*	(B)	11,813	81,013	8.1
	Revised Consolidated PAT*, Net worth and Basic EPS*		11,050	81,612	7.6
	% Impact	(A)/(B)	(6)	1	(6.5)

Source: Company annual report, Edelweiss research

Note: INR mn except for calculation of EPS

** Consolidated PAT and basic EPS excludes impact of exceptional items of INR 1,511.7 mn*

Note1 – In our opinion, Suzlon's PAT/basic EPS is likely to increase; however, due to unavailability of adequate information, the impact is not quantifiable.

Note 2 – In our opinion, Suzlon's net worth is likely to increase; however, due to unavailability of adequate information, the impact in not quantifiable.

Key extracts from MD&A

Exceptional growth in balance sheet size:

- Net worth of the company has increased ~136.7% during the year from INR 34.2 bn as at beginning FY08 to INR 81.0 bn as at end-FY08. The major contributors to the increase are as follows:
  - The company raised INR 21.8 bn through a follow-on offer of equity to selected QIBs at an issue price of INR 1,917 per equity share of INR 10 (since adjusted to INR 383.40 per equity share of INR 2).

- The effective 100% holding in Hansen, a subsidiary, was diluted during the year to 71.3% due to allotment of fresh equity shares to institutional investors. This dilution led to a gain of INR 12.0 bn, which has been credited to reserves in the consolidated financial statements.

- Investments increased to INR 31.4 bn in FY08 as against INR 0.2 bn in FY07 due to investments in REpower.

- Cash and bank balances stand at INR 69.6 bn in FY08 as compared to INR 15.4 bn in FY07. The increase was mainly due to increase in term deposits with banks, placed from QIP, Hansen IPO proceeds, and loans taken for investment in REpower shares.

Revenue increased at CAGR of 100% over the past five years; however, profit margin declined

- Suzlon recorded consolidated sales of 2,311 MW in FY08 as against 1,456 MW in FY07, registering a growth of 58.7%. In rupee terms, sales increased to INR 136.8 bn in FY08 compared to INR 79.9 bn in FY07, registering a growth of 71.3% with a CAGR of 100% over the past five years.

- PAT before exceptional items amounted to INR 11.7 bn and INR 8.6 bn for FY08 and FY07, representing 8.5% and 10.8% of total sales, respectively. Net profit amounted to INR 10.2 bn and INR 8.6 bn for FY08 and FY07, representing 7.4% and 10.8% of total sales, respectively.

Expansion continues through organic and inorganic routes

- The company, through its subsidiaries, purchased ~33.8% stake in REpower, the third-largest manufacturer of WTGs, for a consideration of ~EUR 453 mn and simultaneously has voting pooling agreements with Areva and Martifer (subject to certain minority protection and other rights), who, in aggregate, hold ~53.2% stake in REpower as at June 6, 2007.

- Suzlon, through its continuous backward integration process, is not only ensuring control over critical components, but also gaining competitive edge over its competitors. Suzlon has an integrated manufacturing base with most key components such as rotor blades, generators, gearboxes, control panel, and towers manufactured in-house. It also manufactures other components such as nose cones and nacelle covers and is establishing facilities to manufacture forging and foundry components used in WTGs and their components. After the successful acquisition of Hansen in FY07 and REpower in the current year, the company will evolve as a complete end-to-end service provider in the wind energy space, having design and manufacturing control over all critical components.

- Suzlon incurred an amount of INR 21.3 bn towards capital expenditure during the year. Expenditure was incurred mainly for expansion of its manufacturing capacity through construction of integrated manufacturing facilities in India and China.

- Work to establish 3,000 MW in new capacity is in an advanced state, with production scheduled to begin in July FY09 and reach full utilisation levels by Q4FY09E—more than doubling its manufacturing capacity from 2,700 MW to 5,700 MW.

- The company maintained its position as the fifth-largest wind turbine manufacturer with world market share increasing to 10.5% in CY07 from 7.7% in CY06. Along with REpower, Suzlon achieved a market share of 13.9% in CY07. The company also maintained its market leadership in India for the tenth consecutive year, with ~58% of the market share.

- Suzlon's acquisition of Hansen and a stake in REpower may negatively impact its financial condition and results of operations. The acquisitions will result in Suzlon recognising a significant amount of debt and goodwill in its books. Suzlon has increased its outstanding long-term debt in order to finance the offer for the outstanding equity share capital of REpower. In addition, it has potential future commitments to purchase REpower shares from Martifer and Areva, pursuant to option arrangements.

- Production clocked a growth of over 36% compared to the past year, increasing from 1,680 MW in FY07 to 2,331 MW in FY08.

ANNEXURES

Annexure A: EdelRank

EdelRank is a framework that ranks companies objectively for compliance with accounting standards and disclosure requirements. The ranking is based on percentage scoring achieved by the company for adhering to accounting standard and disclosure norms, out of a predefined score card.

EdelRank scorecard

AS No.	Accounting standards	% Score obtained
AS-1	Disclosure of Accounting Principles	100.0
AS-2	Valuation of Inventories	100.0
AS-3	Cash Flow Statement	100.0
AS-6	Depreciation Accounting	100.0
AS-7	Construction Contracts	100.0
AS-9	Revenue Recognition	100.0
AS-10	Accounting for Fixed Assets	100.0
AS-11	The Effects Of Changes In Foreign Exchange Rates	100.0
AS-13	Accounting for Investments	100.0
AS-15	Employee Benefits	100.0
AS-17	Segment Reporting	100.0
AS-18	Related Party Disclosures	100.0
AS-19	Leases	100.0
AS-20	Earnings Per Share	100.0
AS-21	Consolidated Financial Statements (1)	85.7
AS-22	Accounting for taxes on income	100.0
AS-23	Accounting for investment in Associate in Consolidation Financial Statement	100.0
AS-26	Intangible Assets	100.0
AS-27	Financial Reporting of Interest in Joint Ventures	100.0
AS-29	Provisions, Contingent Liabilities and Contingent Assets	100.0
	Total	**99.4**

Source: Company annual report, Edelweiss research

1. The company expressed its inability to analyse the accounting policies of REpower for consistency with consolidated accounting policies.

Annexure B: ROE and cash flow analyser

ROE analyser analyses profitability on the scale of operating efficiency and capital allocation efficiency. While operating efficiency is a measure of how efficiently the company is making use of operating assets, capital efficiency is the measure of balance sheet efficiency.

The above analysis involves:

1. Dissection of profitability along two major drivers:

   a. Return from operating activities (RNOA)

   b. Return from financing activities (leveraging effect on ROE)

   ROE = Return from operating activities (RNOA) + Return from leverage

Or

ROE = Operating margin x Operating assets turnover + Leverage spread x Leverage multiplier

Where:

- RNOA = NOPAT/Average operating assets
- Operating margin = NOPAT/Operating revenue
- Operating assets turnover = Operating revenue/Average operating assets
- Leverage spread = RNOA – Net borrowing cost
- Leverage multiplier = Average net financial obligation/Average common shareholders' equity

2. Reformulation of balance sheet; we have regrouped assets and liabilities into operating and financing categories (against traditional current and non current categorization).
3. Reformulation of income statement; we have regrouped income and expenses into operating and financing activities.

Cash flow analyser

Unlike traditional cash flow, reformulated cash flow clearly distinguishes cash generation/usage into three broad buckets:

1. **Cash from operating activities:** Cash generated from operations less cash deployed into net operating assets.
2. **Cash from financing activities:** Sum of net cash from debt financing & financial assets.
3. **Cash from equity financing**: Sum of 1 and 2 represents net cash flow from/to shareholders (represents dividend/share buyback/share issuances).

Annexure C: Accounting policy analysis

ICAI has issued a concept paper on convergence of accounting standards with IFRS and has indicated full adoption of IFRS from the financial year commencing April 1, 2011. IASB and FASB are finalising a joint conceptual framework to make accounting more logical by adopting better practices from either IFRS or US GAAP.

We have recomputed the financials by:

(a) Applying more reasonable accounting treatment to the transaction where no authoritative accounting standard is issued for that transaction.

(b) Applying the logical accounting standard, in case a transaction is accounted by the company under any legal and regulatory requirement and not as per existing accounting standards.

(c) Applying accounting principles prescribed by IFRS/US GAAP, where the accounting principles significantly differ from that of Indian Accounting Standards and the treatment prescribed by IFRS/US GAAP is more logical. However, please note that these do not represent conversion of the financial statements in compliance with IFRS.

Stock option granted to employees

- **Existing provision**

  According to the guidance note issued by ICAI on 'Accounting for share based payments' the enterprise has an option to account for employee stock compensation based on either the 'fair value' method or the 'intrinsic value' method. Intrinsic value is the amount by which the quoted market price of the underlying share or its value determined by an independent valuer exceeds the exercised price of option.

- **Logical treatment as per IFRS/US GAAP**

  Both IFRS and US GAAP prescribe the 'fair value' method of expense recognition for share-based payment to employees. An enterprise that grants stock options to its employees is required to measure their fair value using an option pricing model and recognise that cost over the vesting period of the option. The 'fair value' method will result in recognition of higher stock compensation expense.

Measurement of provisions of long term nature

- **Existing provision:** AS-29 (Provisions, contingent liabilities and contingent assets) requires that the amount of a provision should not be discounted to its present value.

- **Logical treatment as per IFRS/US GAAP:** The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation

  IFRS requires that in measuring a provision, an entity should discount the provisions where the effect of the time value of money is material using a pre-tax discount rate (or rates) that reflect(s) current market assessments of the time value of money and those risks specific to the liability that have not been reflected in the best estimate of the expenditure. Where discounting is used, the increase in the provision due to the passage of time is recognised as an interest expense.

Issue expenses and redemption premium on FCCB and split accounting

- **Existing provision:** The transaction cost, directly attributable to the issue of bonds/notes, is charged to the security premium account (i.e., net worth) as defined in Section 78 of the Companies Act, 1956.

  Premium payable on the redemption of bonds is treated differently by companies:

  a. Some companies charge it proportionately over the maturity period of the bond to the securities premium account in absence of any specific guidelines and accounting standard.

  b. Few companies charge redemption premium fully in the securities premium account in the year of issue.

  c. Most companies give no treatment for redemption premium.

  d. Very few companies charge redemption premium over the maturity period of the bond to P&L account.

- **Logical treatment as per IFRS/AS-30/31:** IFRS and the new AS-30/31 require the issuer to show the liability component and equity component separately on the balance sheet (split-accounting). The liability component is measured on the basis of the present value of future cash flows, discounted at the market interest rate for similar instruments, but without the conversion option. The difference between proceeds of bonds issue and the fair value of liability is assigned to the equity component.

  Redemption premium will be calculated on the liability portion and treated as an expense to be amortised over the life of the FCCB on YTM basis. Transaction costs (e.g., issue expenses) are allocated to the liability and equity components in proportion to the allocation of total proceeds of bonds; the portion allocated to liability component will be amortised over the life of the FCCB on YTM basis.

Note

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Recent research

Date	Title
12-Sep-08	**Reliance Communications** – Annual Report Analysis
11-Sep-08	**Larsen & Toubro** – Annual Report Analysis
09-Sep-08	**ABB –** Annual Report Analysis
05-Sep-08	**Tata Steel –** Annual Report Analysis
02-Sep-08	**Mahindra & Mahindra** – Annual Report Analysis
29-Aug-08	**ITC** – Annual Report Analysis
27-Aug-08	**Orbit Corporation** – Annual Report Analysis
22-Aug-08	**Bharti Airtel** – Annual Report Analysis
13-Aug-08	**TCS -** Annual Report Analysis
06-Aug-08	**Tata Motors-** Annual Report Analysis
04-Aug-08	**Hindustan Unilever –** Annual Report Analysis
23-Jul-08	**Infosys Technologies** – Annual Report Analysis
21-Jul-08	**Reliance Industries** – Annual Report Analysis
09-Jul-08	**GSK Pharma** – Annual Report Analysis
08-Jul-08	**Ranbaxy** – Annual Report Analysis
05-May-08	**FCCB** – Real debt; optional equity
18-Mar-08	**Forex Derivatives** – Weapons of Mass destruction