GLOBAL IDEAS

18 March 2013

WWW.ANCHORCAPITAL.CO.ZA
WWW.INVESTORCAMPUS.COM

Alstom — Powering ahead EUR34.64

Investment thesis

- For 9M12/13 Alstom, a global leader in transport infrastructure, power generation and electrical grid solutions, generated 53% of its sales outside Western Europe and the US in high-growth markets. Although the European debt crisis has not impacted the company as severely as some of its rivals (Germany's Siemens), its diversification into emerging markets (EM) has nevertheless served it well.
- In 2003 the company was on the verge of bankruptcy due to a combination of factors (which we elaborate on later in this note), which saw the share price plummet 90%.
- Although the business is cyclical, Alstom should benefit from the global move towards alternative power sources. According to the *2012 World Energy Outlook*, half of all new power capacity is based on renewable sources of energy, with a steady increase in hydropower and the rapid expansion of wind and solar power, which has cemented the position of renewables as an indispensable part of the global energy mix. The publication expects that, by 2035, renewables will account for almost one-third of total electricity output – Alstom could certainly make inroads here.
- At a 12M forward estimated P/E of around 9.9x and 2.6% dividend yield the share looks attractive (the share trades at a 12M trailing P/E of 13.2x). Alstom's results over the past two years have also shown a consistent increase in orders, while the group recorded its first positive free cash flow number in three years in its 1H13 results. By close of FY2011/12 the company had orders worth nearly EUR50bn.
- Overall the company seems to be in the midst of a sustainable upcycle which we think could see the share rerate over the next few years.
- On the decidedly negative side of the equation, continuing reports of bribery and corruption (both proven and unproven) against the group and its subsidiaries in different geographies during the past decade or more is of great concern. The company's CEO, Patrick Cron defended the company and moved to allay fears by saying that Alstom uses agents and consultants to support its business in certain geographies and he believed the company was "too soft in its control" of these agents/consultants. Cron has given his personal commitment that he will ensure Alstom is an ethical company.

Alstom's metrics are as follows:

Spot (EUR)	34.64
Mkt Cap EURmn	10,670.42
12M trailing P/E	13.17
12M fwd P/E	9.9
10-year average P/E	15.9
10-year average DY	2.81
FYE	31-Mar
P/Book ratio	2.35
12M trailing DY	2.31
12M fwd DY	2.62

Source: Bloomberg, Anchor Capital

Global Ideas is a newsletter published four times a week (Monday, Wednesday-Friday) and available only to clients of Investor Campus and Anchor Capital. Once a week we also feature an in-depth analysis of a company on our focus list. The key objective of this newsletter is to provide ideas for investment in the global investment universe.

We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watchlist, which is continually reviewed and updated.

Contacts

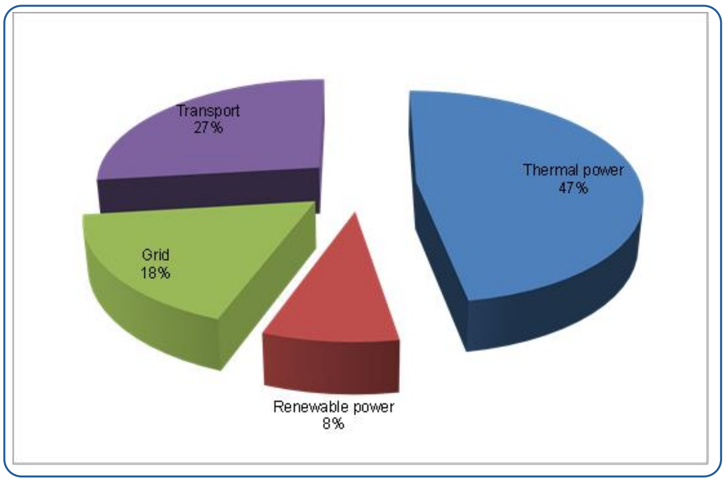
Anchor Capital reception	**011 591 0677**	**Trading Desk**	**012 665 3461**
Investment/ Sales	mnyoung@anchorcapital.co.za	General Enquiries	info@anchorcapital.co.za
Brokerage/ Trading	fswart@anchorcapital.co.za	Newsletter Enquiries	newsletters@anchorcapital.co.za

What it does:

Alstom SA serves the power generation and rail transport market by offering a broad range of solutions for the rail industry, from tramways to high-speed trains. The company also provides integrated power plants and associated services and equipment for a wide variety of energy sources, and renders technology solutions to eliminate pollutants and reduce emissions. Alstom is present in around 100 countries with 92,600 employees globally. It is one of the world's top-three companies in power transmission, while in the rail sector one out of every three tramways and one out of every four metros, globally, are built by the group. The company listed on the Paris stock exchange on 22 June 1998.

The group's products are divided into four segments:
- Thermal Power.
- Transport.
- Grid.
- Renewable Power.

Sales by segment 9M12/13



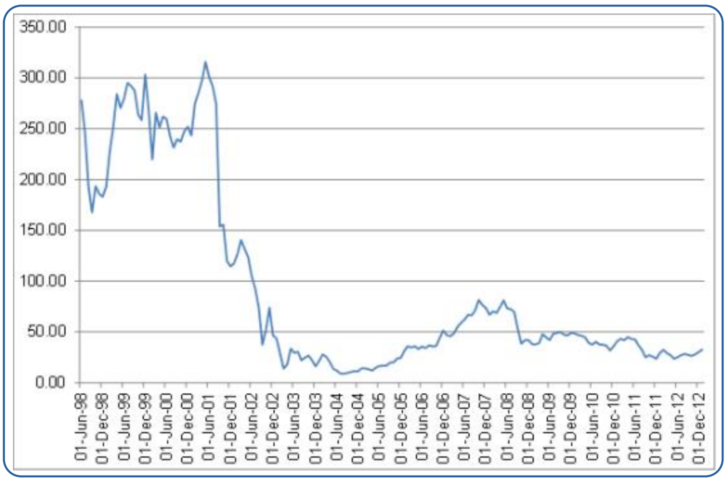
Source: Company data, Anchor Capital

Alstom's share price took a huge hit between May 2001 and March 2003, plummeting over 90% as the company fought off bankruptcy. The reasons for the financial position Alstom found itself in were:
- Alstom had ventured into an agreement with ABB to share its electricity generation activities, and although the agreement was strategically sound Alstom inherited sales contracts dealing with a new generation of gas turbines which had design flaws. This resulted in the company incurring costs of EUR4bn-EUR5bn.
- Inadequate operational performance – Management conceded that because Alstom had grown extremely quickly (doubling its size in three years), the companies it had purchased were integrated without any attempt to achieve industrial optimisation. This resulted in the increase in size being accompanied by a decrease in activity and a deficiency in the monitoring systems.
- The market collapse in 2002 and 2003 was accompanied by a feeling of distrust from Alstom's clients regarding the company's situation. The repercussion of this was that clients placed orders with rivals while at the same time, the company's bankers became nervous about investing in the company and stopped granting guarantees to Alstom clients, leading to a drop in orders. This resulted in a fall in cash advances and relations with suppliers becoming difficult.
- The companies which had contributed to Alstom's external growth had been bought with existing debts, notably Alcatel. This resulted in Alstom's debt increasing twenty-fold. Alstom works with finance from clients and suppliers, but if clients believe the company is financially fragile they do not place orders, and, thus, debt increases.
- The collapse of Renaissance Cruises - a major customer of Alstom.

In 2003/2004, Alstom's order book shrank to one year of sales, significantly below the usual backlog of two to three years, while the company's debt reached EUR5bn and the losses wiped out the group's capital. In order to save the company Alstom cuts its workforce, divested from certain assets, shut down factories and in 2004 at the behest of shareholders the French government temporarily took a minority interest in the company.

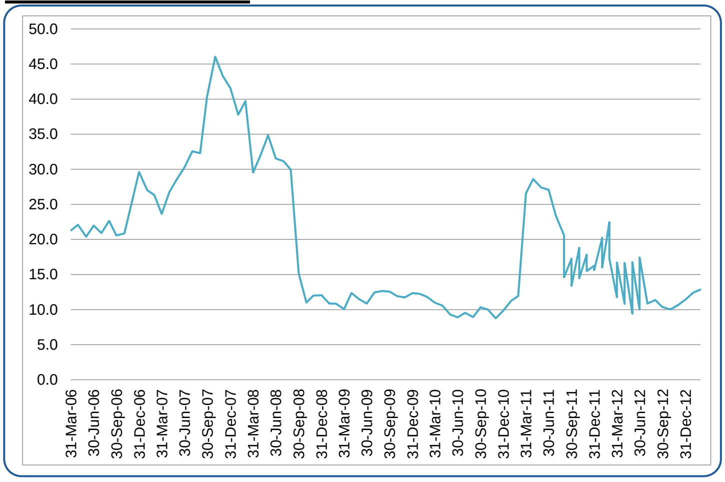
Since December 2012 the share price has been improving slowly from its trading range of levels (for the most part) below EUR30.00 from September 2011 to November 2012, helped by cost-cutting initiatives and increased orders and sales especially in developing countries. YTD the Alstom share price is up c. 15.0% and we believe it still has significant room to move higher, especially considering that it is coming from such a low base.

Alstom share price performance (EUR)



Source: Bloomberg, Anchor Capital

Alstom historic P/E



Source: Bloomberg, Anchor Capital

Alstom forecasts

Alstom				
March y/e	2012	2013F	2014F	2015F
EPS (EUR)	2.50	3.20	3.50	3.50
% growth		28%	9%	0%
DPS (EUR)	0.80	0.90	1.00	1.00
P/E	13.9x	10.8x	9.9x	9.9x
DY		2.6%	2.9%	2.9%
Share price (EUR)	34.64			
12M Fwd P/E	9.9x			

Source: Bloomberg estimates, Anchor Capital

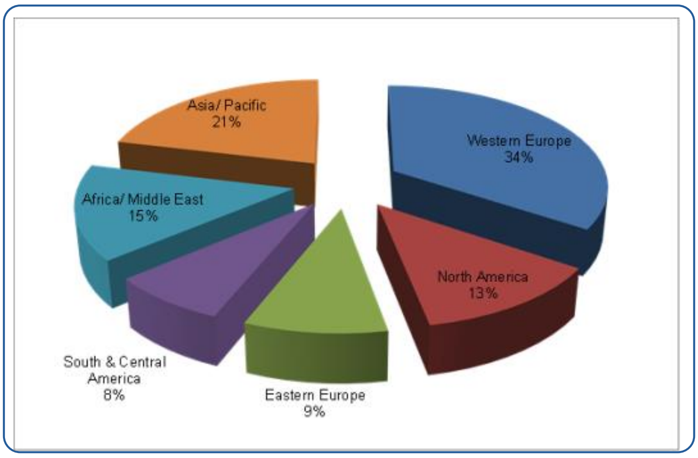
Results 3Q12/13

For 3Q 2012/13 (from 1 October to 31 December 2012), Alstom reported a sustained level of orders at EUR5.1bn, up 3% YoY. Transport continued to deliver an extremely solid performance with orders at EUR1.7bn (up 12% YoY). Thermal Power received orders of EUR1.6bn (down 13% YoY), while orders in Renewable Power reached EUR0.6bn (+99.4%, YoY), significantly up compared with the two previous quarters. Grid registered a relatively sound EUR1.1bn in orders (-6% YoY). The group`s sales continued its recovery, up 1% YoY.

For 9M12/13 Alstom`s order intake was EUR17.2bn, up 14% compared with 9M11/12. Order growth continued to be supported by EM, which represented 48% of total orders for the period, as well as by a robust demand in Transport (up 50% YoY). The company`s total sales reached EUR14.7bn, up 3%, compared with 9M11/12.

In October 2012, Alstom launched a EUR350mn share capital increase through an accelerated book building exercise and a new bond issuance of EUR350mn, with these two financing transactions contributing to maintaining the sound financial structure of the Group. Alstom management also maintained its positive free cash flow guidance saying that it should be positive for FY13-FY15, with the group's operating margin likely to gradually improve to c. 8% of sales in FY13-FY15 from 7.1% in FY12. The company's backlog stood at EUR52bn as on 31 December 2012, representing 30 months of sales.

9M12/13 sales by destination



Source: Company data, Anchor Capital

Opportunities in EM:

After seeing a slowdown in orders in 2010 as the European economy stalled, Alstom refocused on EM, where energy demand was rapidly increasing. The company also branched out into new businesses including renewable energy such as offshore wind turbines. Below we list some of the contracts the company won in EM over the past 18 months or so:

- A contract worth c. EUR185mn for three units of 660 Mw supercritical coal turbine islands to the Nabinagar Power Generating Co.
- A EUR1bn deal with Brazilian wind-farm operator, Renova Energia to supply 1.2 Gw generators.
- $1.2bn to build a 450 Mw lignite-fired unit for Poland's state-owned power utility.
- A $5.8bn contract with the Passenger Rail Agency of South Africa (PRASA) to refurbish the country's passenger trains as part of a 20-year plan to overhaul the rail system.
- A EUR250mn contract to supply hydropower equipment to Ethiopia's Grand Renaissance dam.
- A c. EUR110mn contract from SA power utility, Eskom, to retrofit low pressure steam turbines.
- A c. EUR105mn contract with Brazilian railway operator, SuperVia, to supply 80 Metropolis metro cars, to be produced by Alstom's Lapa plant. SuperVia will provide the development site and Alstom will build the factory with each partner making an initial investment of EUR6mn in the new facility.

- A EUR40mn contract to supply two sets of gas turbine generators for a power plant in China.

- A c. EUR170mn contract to supply eight turbines and generators units for a hydro power plant in Colombia.

- A EUR170mn contract to supply eight turbines and generator units for Colombia's Ituango hydro power plant.

In the US, Alstom has invested a further $40mn in BrightSource Energy Inc, which is developing solar thermal power plants in the California desert, to reinforce its partnership with the solar power company, a leader in the concentrated solar thermal tower technology. Since its initial investment in 2010, Alstom has progressively increased its participation and now holds more than 20% of the company.

Growth drivers:

- **Strong growth in China:** Although growth has slowed (with the country recording seven consecutive quarters of reduced growth before increasing again in 4Q12), the country's economy is still expected to grow in the high single-digits. Thus it makes sense for Alstom to invest heavily in China. According to the State Grid Corporation of China, that country's energy consumption is expected to double by 2020, providing companies such as Alstom with significant opportunity for growth. Alstom's new Tianjin facility, due to be completed in May 2013, will be its largest hydroelectric facility globally, and will address local, regional and export markets, while Alstom Hydro is also scheduled to complete the construction of its global technology centre (also its largest in the world) in Tianjin by July. The centre will support its hydroelectric business growth in China and abroad and should see Alstom become a full value-chain entity in China, carrying out numerous hydroelectric activities, including R&D, sales and marketing, engineering and installation, maintenance and service. Over the past 10 years, the company has accumulated a 20% market share of the total installed capacity of large hydro equipment in China and there is still significant room for more gains in this area.

- **The rest of Asia.** For Alstom opportunities also abound in the rest of Asia, and it is expected that by 2020, Asia (including China) should account for 50% of the world's electricity consumption. Currently Asia Pacific accounts for 21% of Alstom sales but with significant growth forecast for this region in terms of global electricity consumption, Alstom could materially increase its sales exposure in the future.

- **EMs:** Alstom's refocus on EM has served it well with non-eurozone countries becoming increasingly important in the current challenging global economy and with EM accounting for 48% of total orders at the end of December 2012 (*see details above*).

- **Europe:** Despite ongoing austerity measures in much of Europe impacting its competitors such as Siemens, Alstom experienced a recovery in sales on the back of government contracts for commuter trains as operators placed orders to refurbish the ageing commuter fleets. This included a EUR440mn contract to supply 70 regional trains to Italy's state-owned railway operator and a EUR100mn order for 20 commuter trains from Zweckverband Großraum Braunschweig (ZGB), the German public transport authority.

- **Alternative energy sources:** According to the *2012 World Energy Outlook*, half of all new capacity is based on renewable sources of energy, with a steady increase in hydropower and rapid expansion of wind and solar power, which has cemented the position of renewables as an indispensable part of the global energy mix. The publication expects that, by 2035, renewables will account for almost one-third of total electricity output – Alstom could definitely make inroads here. There is also increased demand for gas-fired power generation with the share of natural gas in the global energy mix expected to increase sharply in the coming years (Europe is predicted to generate 20% of its electricity from renewable resources by 2020). Increased demand for gas-fired power generation will primarily replace coal and oil in certain markets, and also complement renewable energy sources. This is an area (GT26 flexible gas turbines and power plants provide a solution to meet the climate-change challenge, while at the same time providing grid stability) where Alstom has significant expertise and the group should therefore benefit from this demand increase. Renewable power currently only accounts for c. 8% of Alstom's sales and there is thus huge potential for this division to grow exponentially. Alstom also continues to build industrial capabilities in fast-growing EM countries and to strengthen its new technologies, with the company announcing a second manufacturing unit for its wind-power generation infrastructure business in Latin America.

- **Diversification:** Alstom's strategy of having a broad global presence (100 countries) is a definite positive in times of economic uncertainty.

- **Contracts from government-controlled companies.** Power-generation projects in the private sector have suffered over the past few years due to coal supply and pricing issues, as well as problems regarding land acquisition. It would appear that most of Alstom's contracts come from government, which is positive for the company.

Risks:

- **Cyclicality:** Alstom's business is cyclical and there is a continuing need for the company to streamline its operations through increased geographic diversity. To a large extent Alstom has succeeded in doing this over the past three years or more by diversifying its operations into the high-growth EMs. This is perhaps due to lessons learned a few years back when one of the reasons Alston share price plummeted was that demand for power plants had fallen significantly as electric utilities scaled back expansion plans. As demand wanes for coal-fired power plants in many markets outside China and India, Alston's expertise in renewable energy should serve it well in this regard.

- **Serious cases of bribery and corruption against the company:** There have been six proven cases of bribery and corruption against Alstom and its subsidiaries over the past decade or more. The company has reportedly also been investigated by the US, UK, and French authorities for paying bribes and kickbacks on contracts in Brazil, Italy, Venezuela, Singapore, Indonesia, Poland and Slovenia, while the Norwegian government pension fund has placed Alstom on a watchlist because of the number of corruption charges against the company. Press reports suggest Alstom is infamous for paying bribes to win contracts. As mentioned CEO Patrick Cron has moved to allay fears and defended the company saying that he believes Alstom was ..' too soft in controls" and giving his personal undertaking to ensure Alstom is an ethical company. Some of the cases against Alstom include:

  - ◊ 2005 - Mexico fined Alstom $27,000 for paying $653,000 into the accounts of two government officials to win two contracts (worth $2.8mn) at a parastatal. The Mexican authorities also disqualified Alstom from obtaining contracts from the federal government for two years thereafter.

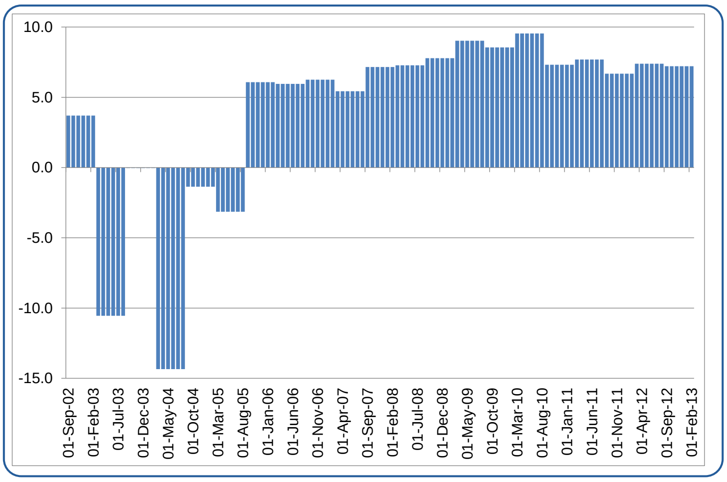
  - ◊ 2008 - French authorities investigate the company after reports in the Wall Street Journal (WSJ) that it had paid hundreds of million dollars in bribes to win contracts in Asia and South America between 1995 and 2003. Initially Alstom denied it was under investigation for bribery in reference to South American and Asian contracts. In one case, the WSJ alleged that Alstom paid $6.8mn in bribes to win a $45m contract to expand São Paulo's (Brazil) underground network.

  - ◊ 2012 - The Switzerland office of the attorney-general fined Alstom CHF36.4mn after a two-year investigation revealed two Alstom entities failed to prevent bribery of officials in Latvia, Tunisia and Malaysia. The European Anti-Fraud Office (OLAF) opened an official investigation regarding corruption in the awarding of the contract for the construction of Unit 6 of Slovenia's Sostanj lignite power plant.

  - ◊ Two of the company's subsidiaries were blacklisted by the World Bank for making what it called an "improper payment" to a senior government official involved in a Zambian hydropower plant contract funded by the Bank in 2002. Alstom was fined $9.5mn in February.

- **Margins:** Although steady and holding up well, Alstom's profit margins (at around 7.2% currently) have lagged the double-digit margins of its main competitors Siemens and General Electric (GE). However, in November, Alstom said it was aiming for annual sales growth of more than 5%, and expected a progressive improvement in its profit margin to c. 8% for FY2013/14.

<u>Alstom historic operating margin (September 2002 to date)</u>



Source: Bloomberg, Anchor Capital

<u>Conclusion:</u>

The company is holding up well in terms of its profit margins (7%) and earnings, despite headwinds in its Thermal Power division (with fewer large projects in this division) while the European crisis has had less of an impact on Alstom than some of its competitors (Siemens). Alstom has also said that due to its current dynamic commercial activity, it expects the 4Q12/13 order intake to be strong with a continuing recovery in sales. In 3Q12/13 the company's book-to-bill ratio (*used in the semiconductor equipment industry this ratio indicates the orders received to units shipped and billed for a specified period, in general a month or a quarter. A ratio of above 1 implies more orders were received than filled=strong demand, while a ratio below 1=weaker demand*) was over 1 for the 9th quarter in a row. Alstom has a substantial order backlog of over two years of sales and has, over the past few months, had a solid order intake not only from EM but, considering the financial crisis faced by many European countries, it has done well in terms of business coming from Europe.

Order growth continued to be supported by EM, which represented 48% of the total orders at the end of December 2012, as well as by robust demand in its Transport division. Currently it would seem to us that the company's long-term business prospects seem sound, especially in the Renewable Power division, which in 3Q12/13 registered twice the level of orders of the previous year. In 3Q12/13 Renewable Power made up 8% of sales by segment so there is substantial room for growth. The company's financial risk profile is also characterised by good liquidity, albeit tempered by higher debt.

Overall we are positive for Alstom and believe the share is due for a rerating, although the bribery and corruption cases and allegations are worrying, we are hopeful that statements made by its CEO are not just window dressing. It would seem, on the surface at least, that these allegations haven't tarnished its ability to obtain orders from customers.

We believe the company's presence in strong EM growth markets, its expertise in a growing alternative energy arena, management maintaining its positive (and improving) free cash flow guidance for FY13-FY15, company expectations that the operating margin will gradually improve to c. 8% in FY13/14, forecast annual sales growth of more than 5% this year and in FY14-FY15 as well as the fact that the company had orders worth c. EUR50bn by FY11/12 provide it with strong upside potential. Although the environment remains challenging, the fact that the credit crisis in Europe has not impacted it as much as its competitors should see the company perform even better in the region when problems there eventually subside. Long-term we think Alstom is a good share to have in your portfolio, with the recovery in its order intake being driven by numerous successes in EM, where we expect demand to continue to grow, while activity in the developed economies should remain sluggish in the medium-term.

Marco de Matos

The business of money: Global asset management and stockbroking

The business of knowledge: Financial education, information and valuation services