

Alstom

What a shame, it could have been so good. Move to a Neutral rating from Not Rated and cut TP to €27 (€33)

Following a period of restriction, we are moving to a Neutral rating and a Dec-14 price target of €27 from Not Rated (Neutral rating and Dec-14 price target of €33 prior to restriction). Alstom's share price has declined ~10% following the revised bid from GE. We see the stock fully valued and disagree with the post deal Sell Side consensus target price of €31. We believe the stock will trade on P/E and dividend yield rather than SOP given the complexity and uncertain JV value realization.

- **We like the Transport story:** We saw the first GE offer as favorable for Alstom, allowing it a clean start with a strong balance sheet, a positive outlook for growth, and moderate margin improvements in Transport resulting in the only larger cap European play on rail infrastructure spending.
- **The revised bid reduces the upfront cash and introduces complexity:** We now expect an excess cash distribution of €6 per share compared to up to €18 before. The €2.5bn floor provided by the put to GE provides a longer term upside option but we believe an exit in the medium term is unlikely given that the JV structure was added to address French national interests. It is unclear what the dividend payments to the parent will be. The 20% government voting right may reduce the strategic flexibility of the group, as shown already with the government requirement to amend the GE offer.
- **What is it worth?** We estimate a pro forma FY2016 EPS of €2.1 per share assuming a €2bn cash distribution to reduce shares outstanding by 22%. At our Dec 2014 €27 target price, the stock would trade on 13x pro forma FY2016E EPS or a 2.6% dividend yield, which compares to the Capital Goods Sector on 15x and 3% on CY2015, respectively. In our SOP valuation, we value Transport at 9.5x FY2016E EV/EBIT and value the GE JVs at €2.1bn based on earnings vs the €2.5bn minimum put value. We apply a 20% discount on the operating assets for the complexity of the structure and relatively low level of net earnings / high implied P/E on a pre discount SOP approach and low cash conversion at group level.

Neutral

Previous: Not Rated

ALSO.PA, ALO FP

Price: €26.63

Price Target: €27.00

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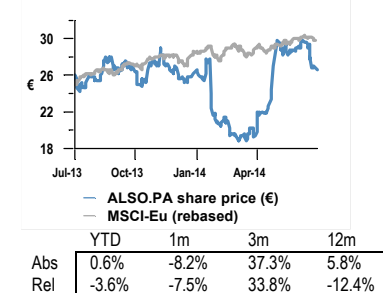
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Price Performance



Alstom (ALSO.PA;ALO FP)

FYE Mar	2013A	2014A	2015E (Prev)	2015E (Curr)
Adj. EPS FY (€)	2.75	2.07	2.05	2.05
Adjusted P/E FY	9.7	12.9	13.0	13.0
Revenue FY (€ mn)	20,269	20,269	20,110	20,110
EBIT FY (€ mn)	1,187	1,008	1,155	1,155
EBIT Margin FY	5.9%	5.0%	5.7%	5.7%
Earning Before tax FY (€ mn)	964	700	855	855
Net Att. Income FY (€ mn)	802	556	704	704
Headline EPS FY (€)	2.66	1.80	2.28	2.28

Source: Company data, Bloomberg, J.P. Morgan estimates.

Company Data

Price (€)	26.63
Date Of Price	30 Jun 14
Price Target (€)	27.00
Price Target End	31-Dec-14
Date	
52-week Range (€)	30.95-18.69
Market Cap (€ bn)	8.22
Shares O/S (mn)	309

See page 15 for analyst certification and important disclosures, including non-US analyst disclosures.

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Review of the announced transaction

Transaction summary (revised GE bid)

Step One: GE acquires Alstom Energy

- **Overall price unchanged, but less cash:** GE's offer to acquire the Power and Grid businesses of Alstom remains unchanged at an equity value of €12,350mn.
- **Fixed price – GE takes the risks:** The scope of the deal includes Alstom's corporate costs and shared services. The offer is a fixed price without closing adjustments or reps and warranties, hence alike a public takeover of a listed company and not an asset disposal. The estimated €600mn cash proceeds of the Heat Exchanger disposal to Triton (announced on April 1, 2014, yet to complete) will accrue to GE. As in the original offer, GE takes on all the potential risks on the business until closure with no adjustments to the price. This includes potential negative operating cash flow or decline in earnings due to weaker business activity due to uncertainty introduced by the deal.
- **EV adjustments:** According to Alstom, the enterprise value is €11.4bn as €1.9bn of cash (prepayments), €1.2bn of pensions and €250mn of other non-operating assets go with the business. GE sees an enterprise value of €9.9bn with €2.5bn of cash (includes expected cash proceeds of HX disposal) and other non-operating assets coming with the business (ignoring the pension liability).
- **We estimate around 12.3x EV/EBIT:** Based on our estimates for FY2016 (March year/end) and using Alstom's definition of the EV, GE is paying ~12.3x EV/EBIT. We expect FY2015 operating earnings to decline given the announced HX disposal and guidance for lower margins and then stabilize in FY2016.
- **French government on board assuming it can buy a stake in Alstom:** The Alstom Board has unanimously recommended the offer, based on the recommendation of the independent directors appointed by the Board. The French State has confirmed that subject to execution of definitive agreements for the various alliances between GE, Alstom and the State and the State entering into an agreement to purchase shares in Alstom, it will grant the required foreign investment authorization.
- **Long period until completion, anti trust approval required:** The deal is expected to complete in H1 2015 and requires Alstom shareholder approval, works council consultation and merger control and other regulatory clearances. In gas turbines, as we have written in our [May 2014 Power Gen & Transmission industry review](#), we estimate a 10-year average market share (annual market shares can be distorted by large orders) for GE of 40% and for Alstom of 7% (trend falling towards 3-4% in recent years) in the market for turbines >75MW (utility use, Alstom does not have a material exposure to industrial turbines). Siemens is a Nr 2 with 29% share, followed by MHI with 11% (higher in recent years).
- **Use of cash at Alstom:** Once completed, Alstom will use the proceeds to pay down debt, fund the growth of the Transport division and distribute excess cash to shareholders. Alstom has €5.3bn of gross debt and €0.4bn of financial leases on its balance sheet at 31/03/2014. It has not said whether it will buy back the debt or hold it to maturity. The market value of Alstom's listed debt is currently

~€350mn higher than its nominal value, representing the high interest rates and now much reduced credit risk. Alstom said that it desires a strong balance sheet for the new company. It is unclear how Alstom will treat Alstom Energy in the FY2015 financials from an accounting basis. We would assume the businesses will move to discontinued operations with the JV stakes later remerging as equity accounting.

Step Two: Alstom acquires stakes in JVs

- **Alstom buys back stakes:** Once the deal is closed, GE and Alstom will form the following JVs: Grid, Renewables and Global Nuclear & French Steam. Alstom will have 50% ownership/governance in all three JVs. Alstom will pay €2.5bn (€2.6bn according to GE) for these stakes assuming a debt free/cash free basis. GE stated in its release that Alstom will pay a higher multiple to buy back into these businesses than the 8x EV/EBITDA GE calculates (on its definition of the EV ex pensions and other differences to our methodology) it paid for Alstom Energy. Alstom said that the higher multiple reflects the optionality of the put given to Alstom (see discussion below).
- **Grid JV:** Alstom will buy a 50% stake and account for 50% of the earnings (equity method) of the former Alstom Grid business while GE will contribute GE Digital Energy to the JV. We estimate GE Digital Energy to have €1.1bn of sales with a 7% operating margin. GE Digital Energy is a mid sized player in the High and Medium Voltage market (transformers, switch gear, capacitors, circuit breakers etc). It also has an offering in smart meters, substation automation and grid management. It provides AC grid project services and substation EPC. We would expect to see some cost synergies in North America, where the majority of GE's activities are. It is unclear how the partnership of GE with China XD fits into this transaction. In May 2012, GE announced a JV with China XD for the Chinese market (GE owns 41% in JV) and acquired a 15% stake in China XD (listed in Shanghai) for \$535mn. We have assumed that GE retains the stake. Neither company has commented on this.
- **Renewables JV:** Alstom buys a 50% share of its former Renewables business excluding on-shore wind. This includes Hydro Power and the offshore wind start up (no sales, development costs). GE keeps 100% of the onshore wind business (about €400-500mn of sales, mid single digit margins on our estimates). GE is not present in Hydro (it had sold the business to Andritz in 2007). We do not expect any material cost synergies. The scope of the JV had about €1.3bn revenues in 2014, according to Alstom.
- **Nuclear & French Steam JV:** Alstom and GE will have shared governance in a 50/50 alliance in global nuclear and French steam. In addition, the French State will hold a preferred share giving it a veto and other governance rights over issues relating to security and nuclear plant technology in France. Based on company comments, we estimate sales of €1.4bn. Profitability has not been disclosed. Based on the price paid for the JVs and the comment by GE on the multiple paid by Alstom, we only see mid single digit margins in this business (on an implied basis) which would be surprisingly low given that we expect a high share of services of this business. The business includes the large steam turbine (Arabelle) used in nuclear power plants and steam related (OE and service) activities in France. Most of the large steam turbines used in France are in nuclear power plants.

- **Put options:** Alstom said that these JV agreements include the usual shareholder agreements with standard governance and liquidity rights. Alstom has the right to sell these stakes or list its share (unclear whether GE approval is needed). It is protected to the downside at the purchase price and can participate on the upside (again no details provided on formula). It has also not been disclosed what the maturity of these options are or conditions to exercise them. We discuss below how we value the options. The key issue is that the JV structure was designed to address concerns of the French Government on its national interests and hence we do not believe Alstom will be allowed to exercise them, at least under the current administration (next elections April or May 2017). The French Government has the right to block disposals based on its amended decree from May 15 that requires approval for transactions with foreigners of stakes or companies active in Energy and Transport, among others.

Step three: Alstom acquires GE Signaling

- **Addition to Alstom Signaling but not strategically important:** Alstom pays GE €602mn for 100% of its Rail Signaling business, based on Alstom's press release. Based on GE's release, this business had sales of €365mn in 2013 and employs 1,200 employees. GE had indicated that this is a mid teens operating margin business. This would indicate an EV/EBIT multiple of ~11x, which looks low for signaling assets but then little is known about the performance of this asset. GE and Alstom would also sign multiple collaboration agreements including a service agreement for GE locomotives outside the US, R&D, sourcing and manufacturing and commercial support in the US.
- **GE Rail Signaling** is a business unit of the GE's Transportation activities providing on-board and wayside signaling systems and communication solutions for freight and passenger rail. Alstom said that GE signaling achieved 60% of sales in North America and 15% in Europe and Lat Am each in 2013. This business has therefore limited overlap with Alstom's signaling activity, which is focused on passengers and has a global focus. Hence we do not expect any material synergies or changes in the competitive landscape. We estimate Signaling sales of about €1bn at Alstom prior to the transaction.

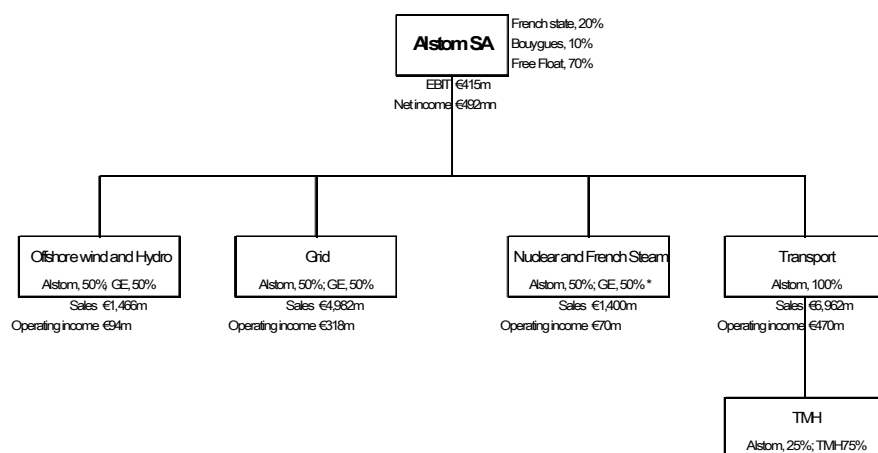
Step four: French government secures 20% of the votes and plans to acquire stake

- **French Government wants more control over Alstom:** The French Government plans to approve the transaction with GE assuming it can buy a 20% stake in Alstom.
- **Option to buy shares from Bouygues:** For a period of up to 20 months following the completion of the transaction (Step 1 to 3), the French government has a call option allowing it to acquire a maximum of 20% of the capital of Alstom, which is currently held by Bouygues, at the market price with a standard discount (not defined) on the condition that this price is higher or equal to a theoretical adjusted price of €35 per share. At the end of this period, for a period of eight trading days, a maximum of 15% of the capital of Alstom would be able to be acquired at the market price with a standard discount.
- **Government gets 20% voting right on completion:** Furthermore, following the completion of step 1 to 3 discussed above, Bouygues will be lending its shares which will allow the French Government to exercise 20% of the voting rights in Alstom and support the appointment of two members to Alstom's Board of Directors nominated by the French government.

- **Will the Government buy shares in the market now? We don't think so.** The French Government could buy shares in the market at any time if it wants to. Given it will get 20% voting rights post closure and that the May 15 decree gives it power over Alstom's future anyway, we do not believe that it makes sense for the French Government to buy additional shares in the market before it becomes clear whether it can buy shares from Bouygues and at what price. The recent sale by the French Government of a stake in GdF-Suez for €1.8bn has raised speculation that this cash will be used now for a purchase of shares.

Figure 1: Overview of Alstom post transaction assuming all steps completed

FY2016 (March 31) pro forma financials, potential outcome



Source: Alstom, GE, J.P. Morgan estimates. * 50/50% governance but GE consolidates 80% of earnings.

New Alstom pro-forma valuation

Summary – target price of €27 per share

We reduce our target price from €33 to €27 following the revised bid from GE. The reduction vs our initial valuation is due mainly to the application of a discount to the asset value on the back of the introduced complexity, lower share of cash as part of compensation, the multiple Alstom pays to buy back into some of the divested businesses, the increased uncertainty on the final outcome, and increased influence of the French Government.

We disagree with the approach others take on valuing the puts at full value as a sale of the stakes to GE (or another party) appears unlikely to us in the coming years given that the French government introduced them into the deal structure to protect French interests. Our valuation also take into account potential costs at Alstom for the deal completion, potential bribery fines related to Transport, and costs to either retire the outstanding debt or payment of interest until maturity.

We have tried to piece together a picture on what the two companies have agreed but admit that there is still some uncertainty and financials of the JVs particularly have not been disclosed fully. The overall patchy disclosure and at times different messages from GE and Alstom on the same topic also indicates that not all details were agreed upon when the deal was amended over a very short time ahead of the deadline.

- Our target price of €27 per share is set for Dec 2014 and based on the calculation shown below in Table 4. We value Transport at 9.5x FY2016E EV/EBIT. We value the three JVs with GE at €2.1bn rather than the €2.5bn put value as we base the valuation on earnings given uncertainty on potential exit. The valuation is negatively impacted by the 20% earnings share of Alstom in the Nuclear and French Steam JV (vs 50% governance). We assume that Alstom distributes €6 per share or €2bn in excess cash, which we credit to the valuation in full.
- We apply a 20% discount to the valuation (on operations, not cash). This is because of the complexity of the company, ownership structure and limits to access to cash flow of JVs. Also, we believe that Alstom will trade more on a P/E and dividend yield going forward given uncertain path, at least for now, on the realization of the asset values in an SOP. Our target price implies a 13x FY2016E pro forma P/E (assuming debt is retired, higher if interest payments remain).
- Our valuation assumes that Alstom buys back its debt, which currently trades ~€350mn above nominal value. We believe the market is wrong in ignoring this as either the debt is bought back at a price above the nominal value or Alstom will have to pay high interest expense for years to come. This would only make sense if it were to do a large acquisition to put the money to work.
- We also include in our valuation €250mn as cash outflow for Alstom over the next 12 months for deal completion costs, potential bribery fines following the DoJ investigation (GE takes any related to Energy), and tax leakage which we estimate at <€150mn.
- We assume in our valuation that Alstom will need €1bn of cash to run the operations (would still not cover prepayments, potential working capital

fluctuations of Transport) and we give the company €750mn for potential acquisitions.

- The company has not indicated what dividend policy it will have or what if any dividends are paid by the JVs. We have made an early estimate, assuming 50% of earnings from the JVs are distributed as cash to Alstom/GE and that Alstom Transport achieves an 80% FCF conversion. Alstom would then distribute half of its free cash flow corresponding to 1/3 of earnings. At a 3% dividend yield (average Capital Goods sector), we would get to €24 per share. If we would require a 3.5% yield given the complexity, we estimate the stock would only be worth €21.

Table 1: Step 1: GE acquires Alstom Energy

€ million

		<u>Comment</u>
Equity value (offer)	12,350	Same as original offer, confirmed by both parties
Net cash in business	(1,900)	Same as original offer, all other assets assumed on debt free/cash free basis, based on Alstom (GE says Euro2.5bn)
pension liabilities	1,200	As original offer, share of pension liability taken by GE but GE does not include pension liabilities in EV calculation
other assets	(250)	As per original offer, includes tax assets, reported by Alstom
Enterprise value	11,400	Prior to expected HX proceeds of €600mn
Valuation of deal on FY 2016 (March)		
Operating profit Alstom Energy 2016E	1,156	Declining vs 2014 due to HX disposal, falling earnings in Thermal
Corporate costs	(137)	Go with GE as announced
Share of restructuring & other costs	(143)	75% of restructuring and other costs taken below operating profit by Alstom
EBIT	877	This still includes capitalized R&D benefit, so underlying multiple higher
EV/EBIT	12.2	EV reduced by expected net cash proceeds of HX disposal which accrue to GE

Source: Company reports and J.P. Morgan estimates.

Table 2: Step 2: Alstom acquires stakes in GE Alstom Energy

€ million

		Comment
Alstom cash contribution	2,550	GE says 2,600, Alstom 2,500
GE asset contribution	1,001	GE Digital Energy
- Sales	1,100	Provided by Alstom
- Operating profit	77	Not available, JPM estimate
- Operating margin	7.0%	
EBIT multiple	13.0	Implied, GE said that multiple is higher than what it has paid but GE calculates multiple differently.
JVs	—	
Offshore wind and Hydro		Offshore wind does not have sales yet
- Sales	1,466	FY2016 JPM E
- Operating profit	94	FY2016 JPM E
- Margin	6.4%	FY2016 JPM E
Multiple	9.5	Higher growth than rest but low margin, so slightly higher multiple
Value	898	(JPM value)
Grid		
- Sales	4,982	FY2016 JPM E
- Operating profit	318	FY2016 JPM E
- Margin	6.4%	FY2016 JPM E
Multiple	9.5	Difficult business with execution risk on backlog, giving it a slightly higher multiple than before due to GE businesses added with higher margins
Value	3,018	(JPM value)
Nuclear and French Steam		50%/50% governance but GE expected to consolidate 80% of earnings
- Sales	1,400	JPMorgan estimate
- Operating profit	70	
- Margin	5%	Implied by transaction multiple and based on GE comments, JPMorgan estimates.
Multiple	9.0	Low multiple given government control
Value	630	(JPM value)
Total value of JVs	4,545	
Alstom share of ownership	2,273	Alstom is paying €2.5-2.6bn for these business which we value at €2.3bn

Source: Company reports and J.P. Morgan estimates.

Table 3: Step 3: Alstom acquires GE Signaling

€ million

Enterprise value	602	Disclosed by GE
- Sales	365	Disclosed by Alstom
- Operating profit	55	
- Margin	15%	GE indicates mid teens, JPM estimate
Multiple	11.0	Implied

Source: Company reports and J.P. Morgan estimates.

Table 4: Overview of Alstom pro forma

€ mn, year end March 2016 pro forma

Asset	Sales	Profit	Margin	Multiple	Value	Comment
Alstom Transport incl. GE Signaling	6,962	470	6.8%	9.5	4,469	See below
Corporate costs	NM	(25)	NM	9.5	(238)	Listing, treasury etc currently provided by group
Ongoing restructuring costs	NM	(30)	NM	9.5	(285)	50bp of sales, normal for industrial business
Enterprise	6,962	415	6.0%	9.5	3,946	
Debt at 4% rate		0			0	Alstom said all debt repaid over time
Cash at 0.5% rate		9			1,750	Needed for flexibility to run €7bn business plus M&A plans
Pension at 4% rate		(13)			(325)	Remaining pensions
Profit before tax		411			5,371	
Tax at 30%		(123)				Assumption, no guidance, uncertain impact of deal on tax structures
Joint Venture income assuming 30% tax rate	NM	204	NM	12.7	2,584	P/E multiples
- Grid (50%)	NM	111	NM	13.6	1,509	Implied by EV/EBIT multiple
- Renewables (50%)	NM	33	NM	13.6	449	Implied by EV/EBIT multiple
- Nuclear (20%)	NM	10	NM	12.9	126	Implied by EV/EBIT multiple
- Transmash Holding (25%)	NM	50	NM	10.0	500	Low multiple given lack of financial detail
Net income / equity value		492		16.2	7,955	
Number of shares post buyback		240				
EPS 2016E pro forma, value per share		2.1			33	
Discount for JV structure/cash access	10.0%				(795)	Limited access to cash in part of group
Discount for 20% government control	10.0%				(795)	Reduced freedom
Equity value after discount				13.0	6,397	
Excess cash to be distributed to Alstom shareholders						
GE offer for Alstom Energy					12,350	As announced
Cash going with Alstom Energy to GE					(1,900)	As announced
Cash payment of Alstom to GE for JVs					(2,550)	As announced
Cash payment to GE for GE Signaling					(602)	As announced
Repayment of Alstom net debt					(3,019)	as per March 31, 2014
Costs to retire bonds (current market value, materializes either through buy out or interest over time)					(348)	as per June 30, 2014 market prices
Tax leakage, deal costs and remaining bribery fine					(250)	JPM estimate based on comments from companies
Cash to fund Transport operations					(1,000)	Minimum net cash needed
Cash reserve for future M&A					(750)	Assumption
Excess cash					1,931	€6 per share
Number of shares bought back at current price					69	
Total Alstom equity value per share					8,328	
					27.0	

Source: Company reports and J.P. Morgan estimates.

Table 5: Dividend valuation – use of 3.5% required yield given Capital Goods is at 3%

€ mn, year end March 2016 pro forma

Assumed cash tax rate	30%
Assumed dividend pay out of JVs	50%
Assumed cash conversion of Transport	80%
Assumed dividend payout ratio as % of FCF	50%
Dividend	166
Implied payout ratio of earnings	34%
Assumed dividend yield	3.5%
Implied value of equity including cash distribution	6,678
per share	21.6

Source: Company reports and J.P. Morgan estimates.

Table 6: Alstom debt outstanding

€ million

Bond	Nominal value	maturity date	nominal rate	effective rate	Price	Amount outstanding	Current Market value
Sep-14	722	23/09/2014	4.00%	3.89%	100.80	743	749
Mar-15	60	09/03/2015	4.25%	4.47%	100.91	59	61
Oct-15	500	05/10/2015	2.88%	2.98%	102.90	500	515
Mar-16	500	02/03/2016	3.87%	4.05%	105.27	200	526
Feb-17	750	01/02/2017	4.13%	4.25%	108.10	750	811
Oct-17	350	11/10/2017	2.25%	2.44%	103.99	350	364
Oct-18	500	05/10/2018	3.63%	3.71%	109.82	500	549
Jul-19	500	08/07/2019	3.00%	3.18%	107.61	500	538
Mar-20	750	18/03/2020	4.50%	4.58%	115.70	750	868
Total bonds	4,632						4,980
Other borrowings	554						
earn out	40						
Derivatives	13						
Accrued interest	55						
Total borrowings	5,294						
ST borrowing	1267						
LT borrowing	4009						
Finance lease	96						
LT rental obligations	349						
Total financial debt	5,721						

Source: Company data, Bloomberg as of 30/6/2014

Risk / reward – where could we be wrong?

There are a number of uncertainties where we would expect more information of the companies over time and increased disclosure. Hence our analysis shown above probably has more than the usual margin of error and just represent a pro forma view of new Alstom.

Potential upside drivers

- **Synergies:** We have not assumed any cost or revenue synergies in the FY2016 forecasts or the valuation of the JVs. GE said that the originally specified cost synergies of \$1.2bn by year 5 in its original proposal, which appear to at least partly include planned cost actions of Alstom prior to the deal. GE said with the revised bid that the economics of the deal for GE shareholders in terms of value creation remains unchanged, indicating the synergies mostly accrue in the businesses that GE takes over to 100%. We could see some benefits on cost and synergies in Nuclear and French Steam and some cost and revenue synergies in Grid longer term.
- **Nuclear and French Steam agreement:** There is a lack of clarity on the structure of this JV. As we understand it, Alstom and GE each own 50% with the French Government owning a Golden Share as discussed above. However, according to Alstom, GE will consolidate 80% of the earnings. We don't understand how the consolidation can be different from the ownership. In our model we have used 20% contribution to Alstom earnings from the JV. Also, the margin of the JV seems very low in the mid single digits for what we believe to be a business with high service share and hence, may currently be depressed and have recovery potential.
- **Put options:** Should Alstom be allowed to sell the puts, either at cost or participating in the upside of the business, this could add to our valuation. We value the JVs at €2.1bn vs the €2.5-2.6bn Alstom pays. The difference is about €1.5 per share.

- **Improved business performance:** Over the past few years, customers may have had question marks on Alstom's long term strengths given its weaker balance sheet when compared to those of some of its competitors. Now with a strong balance sheet and a strong partner in the JVs, Alstom may gain market share.

Potential downside risks

- **Prepayments:** Our valuation on an EV basis does not subtract from net cash prepayments that Alstom Transport holds which we estimate could be €1.5bn. Investors with a conservative approach may want to treat the associated cash as an operating asset.
- **Dividend payments:** Alstom does not have dividend rights from the JVs and hence there is an uncertain cash stream up to the holding company which could impact the dividend payout of Alstom, also given that Transport has shown cash conversion below 100% in recent periods.
- **Transmash Holding:** We value Alstom's 25% stake in the Russian transport equipment company at 10x P/E which gives us an estimated market value of €500mn, which is above book value/what Alstom paid.
- **JV structures:** There is uncertainty about potential liabilities in the JVs (pensions, prepayments etc).
- **Lower cash distribution:** Alstom may decide to distribute less than our estimate of €2bn to shareholders and keep more money for M&A. This could dilute earnings near term and introduce uncertainty on what Alstom acquires.

Valuation of Transport

We summarize Alstom Transport financials in the table below. The top-line has grown just less than 2% during 2004-2014. However, we forecast mid to high single digit growth in the coming years due to an all-time high backlog and large South African order (worth €4bn, booked in Q2'FY14). It should not be overlooked that the capital employed has risen since the financial crisis which have greatly reduced ROCE as profitability has not grown. This is due to the change in the business mix and required investments to build supply chains and production in new markets.

We value the business at 9.5x FY2016E EV/EBIT. This is a small discount to the long term sector average of 10-10.5x due to the materially lower margin and higher project risks associated with the business, partially offset by the good growth outlook beyond FY2016.

Table 7: Alstom Transport - summary financials

€ mn, FY ends Dec'13

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015E	2016E
Backlog	14,676	14,321	14,489	14,141	15,239	17,283	19,506	19,243	19,516	20,659	22,965	23,165	27,456	27,656
Orders	6,412	4,709	5,490	5,184	5,388	7,467	8,114	5,484	5,709	6,311	7,109	6,402	10,457	6,797
Sales	5,072	4,862	5,134	5,128	5,288	5,509	5,685	5,749	5,604	5,168	5,458	5,876	6,166	6,597
Book to bill	1.26	0.97	1.07	1.01	1.02	1.36	1.43	0.95	1.02	1.22	1.30	1.09	1.70	1.03
Operating profit	-118	144	218	324	350	397	408	414	398	264	297	330	364	416
Margin	-2.3%	3.0%	4.2%	6.3%	6.6%	7.2%	7.2%	7.2%	7.1%	5.1%	5.4%	5.6%	5.9%	6.3%
Capital employed	805	360	125	125	-40	-84	-331	-78	445	1,403	1,924	1,881	NA	NA

Source: Company reports and J.P. Morgan estimates.

Investment Thesis, Valuation and Risks

Alstom (Neutral; Price Target: €27.00)

Investment Thesis

We assume in our assessment that the GE transaction completes in H1 2015 as discussed in this report. We believe that Alstom's Transport business has a strong outlook but that the investment story is diluted by the complexity of the ownership structure, influence of the French government (as could be seen when more shareholder friendly deal with GE got amended) and uncertainty on cash distribution and longer term cash flow / dividend for Alstom shareholders. Hence we rate the stock Neutral.

Valuation

We set our Dec-14 target price at €27, reflecting the pro forma valuation discussed in this note which includes a number of adjustments given the complex nature of the structure agreed with GE. The target price is based on 9.5x FY 2016E EV/EBIT for the Transport business and our valuation of the Energy JVs and EV adjustments. The implied P/E multiple is 13x FY2016. The multiple for Transport reflects a discount to the sector long-term average of 10.5x. This is because of the low margin and, hence, higher earnings volatility (most 5% margin businesses in the sector trade below 10x EV/EBIT normally). The discount also reflects the higher execution risks inherent in the train business (Alstom good track record, peers less so) and that the stake in TMH in Russia.

Risks to Rating and Price Target

Potential upside drivers

- **Synergies:** We have not assumed any cost or revenue synergies in the FY2016 forecasts or the valuation of the JVs. We could see some benefits on cost and synergies in Nuclear and French Steam and some cost and revenue synergies in Grid longer term.
- **Nuclear and French Steam agreement:** There is a lack of clarity on the structure of this JV. As we understand it, Alstom and GE each own 50% with the French Government owning a Golden Share as discussed above. However, according to Alstom, GE will consolidate 80% of the earnings. We don't understand how the consolidation can be different from the ownership. In our model we have used 20% contribution to Alstom earnings from the JV.
- **Put options:** Should Alstom be allowed to sell the puts, either at cost or participating in the upside of the business, this could add to our valuation. We value the JVs at €2.1bn vs the €2.5-2.6bn Alstom pays. The difference is about €1.5 per share.
- **Improved business performance:** Over the past few years, customers may have had question marks on Alstom's long term strengths given its weaker balance sheet when compared to some of its competitors. Now with a strong balance sheet and a strong partner in the JVs, Alstom may gain market share.

Potential downside risks

- **Prepayments:** Our valuation on an EV basis does not subtract from net cash prepayments that Alstom Transport holds which we estimate could be €1.5bn.

Investors with a conservative approach may would want to treat the associated cash as an operating asset.

- **Dividend payments:** Alstom does not have dividend rights from the JVs and hence there is an uncertain cash stream up to the holding company which could impact the dividend payout of Alstom, also given that Transport has shown cash conversion below 100% in recent periods.
- **Transmash Holding:** We value Alstom's 25% stake in the Russian transport equipment company at 10x P/E which gives us an estimated market value of €500mn, which is above book value/what Alstom paid.
- **JV structures:** There is uncertainty about potential liabilities in the JVs (pensions, prepayments etc)
- **Lower cash distribution:** Alstom may decide to distribute less than our estimate of €2bn to shareholders and keep more money for M&A. This could dilute earnings near term and introduce uncertainty on what Alstom acquires.

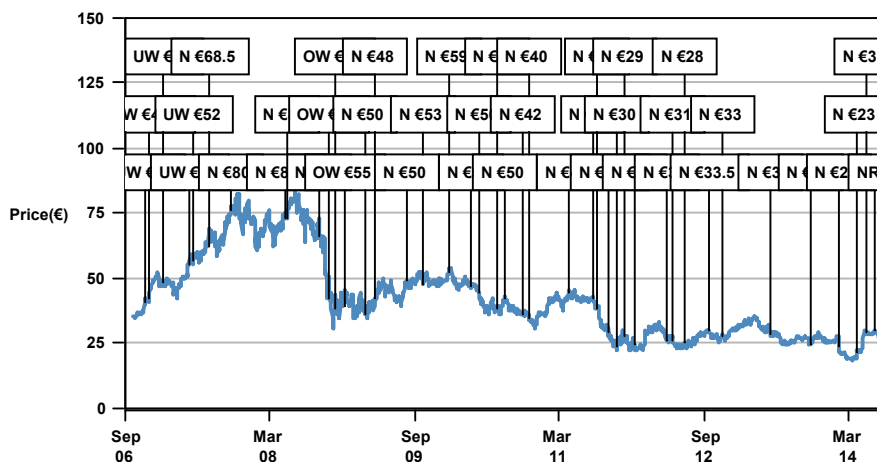
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Alstom (ALSO.PA, ALO FP) Price Chart



Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Nov 13, 2006.

Date	Rating	Share Price (€)	Price Target (€)
13-Nov-06	UW	41.08	37.00
27-Nov-06	UW	41.95	41.50
19-Jan-07	UW	48.20	44.00
01-May-07	UW	55.00	50.00
14-May-07	UW	56.58	52.00
12-Jul-07	N	62.52	68.50
08-Oct-07	N	76.38	80.00
29-Apr-08	N	72.88	83.50
08-May-08	N	72.98	88.00
04-Sep-08	N	66.37	85.00
08-Oct-08	OW	42.34	65.00
06-Nov-08	OW	38.12	60.00
08-Dec-08	OW	39.04	55.00
24-Feb-09	N	36.50	50.00
06-Apr-09	N	42.41	48.00
04-Aug-09	N	49.54	50.00
05-Oct-09	N	47.68	53.00
07-Jan-10	N	52.13	59.00
31-Mar-10	N	46.74	54.00
04-May-10	N	44.28	50.00
08-Jul-10	N	38.62	47.00
06-Aug-10	N	42.13	50.00
12-Oct-10	N	36.48	42.00

05-Nov-10	N	34.38	40.00
08-Apr-11	N	44.28	43.00
04-Jul-11	N	42.35	47.00
20-Jul-11	N	38.45	46.00
07-Sep-11	N	29.00	36.50
04-Oct-11	N	23.82	30.00
03-Nov-11	N	27.50	29.00
09-Dec-11	N	24.56	30.00
12-Apr-12	N	26.02	32.00
04-May-12	N	26.28	31.00
22-Jun-12	N	25.26	28.00
21-Sep-12	N	29.85	33.50
07-Nov-12	N	27.98	33.00
07-May-13	N	28.40	31.00
07-Oct-13	N	24.93	30.00
21-Jan-14	N	23.93	25.00
04-Apr-14	N	21.64	23.00
05-May-14	N	29.36	33.00
11-Jun-14	NR	29.64	--

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