

MARCH 21, 2011

**UPDATE**

Coverage view: **Cautious**

Price (Rs): **256**

Target price (Rs): **380**

BSE-30: **17,879**

**Key takeaways from management meeting and channel checks.** Sobha remains one of our top picks in the sector with (1) stock trading at 33% discount to our target NAV, (2) current stock price implying minimal value apart from ongoing developments, (3) presence in residential vertical and Bangalore geography – probably the least risky segment in Indian real estate and (4) no significant land buying plan or outstanding that could impact cash flows. Retain BUY with March 2012 NAV-based TP of Rs380/share.

**Company data and valuation summary**

Sobha Developers

Stock data		Forecasts/Valuations			
		2010	2011E	2012E	
52-week range (Rs) (high,low)	404-185	EPS (Rs)	14.1	18.8	24.0
Market Cap. (Rs bn)	25.1	EPS growth (%)	(7.1)	33.4	27.9
<b>Shareholding pattern (%)</b>		P/E (X)	18.2	13.6	10.7
Promoters	60.5	Sales (Rs bn)	11.3	15.1	18.3
FIs	29.7	Net profits (Rs bn)	1.4	1.8	2.4
MFs	4.8	EBITDA (Rs bn)	2.6	3.2	4.1
<b>Price performance (%)</b>		EV/EBITDA (X)	14.8	11.1	8.5
Absolute	1M 3M 12M	ROE (%)	9.7	10.1	11.7
Rel. to BSE-30	3.1 (13.7) (8.8)	Div. Yield (%)	0.4	0.5	0.6

**Projects update – lots of preparation, no launches this quarter**

Our management meeting/channel checks indicate (1) no new launches by Sobha in 4QFY11E (we would have expected at least a partial launch of the 2.9 mn sq. ft Sobha Elysium project in Bangalore), (2) sales holding steady though with no new launches, we could see another quarter of a marginal dip qoq and (3) Gurgaon launch is near term with some visibility among NCR brokers and HUDA opening tenders for the Northern peripheral road which would improve connectivity for Sobha's project. We believe this project is key to Sobha's investment thesis as (1) 52% of its potential launch area over the next few quarters is at Gurgaon and likely it's a higher proportion of sales value, (2) provides proof-of-entry in a new market and (3) increasing signs of monetization of vast land bank (227 mn sq. ft).

**Bengaluru residential market continues to witness steady sales and pricing**

Absorption in the Bengaluru residential market (Sobha's primary market) remains stable with annual absorption of over 36 mn sq. ft (versus all-time high of approximate 50 mn sq. ft). Inventory is in line with trend (14 months) and prices have also remained stable post a 10% increase over 1HFY11 but still remain below peak prices. We expect Bengaluru demand to continue to stay robust given (1) positive outlook on IT services demand and hence hiring trend remaining robust and (2) no evidence of any significant speculative element built into either volumes or prices.

**Current stock price implies minimal value beyond ongoing projects and book value**

Our target price is Rs380/share based on March 2012 NAV assuming a WACC of 15%. Based on the current stock price, we find minimal value being ascribed to either (1) development more than current ongoing projects or (2) brand and Sobha operating as a going concern. 93% of Sobha's current EV is accounted by (1) PV of cash flows from current projects + (2) book value of land + (3) value of the contracting business. Even at our target price, Sobha's stock will be valuing incremental development of 3 m sq. ft which is only equal to its current run-rate.

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### No new launches in 4QFY11E but Gurgaon project launch is key event to watch

Based on our management meeting and channel checks, we believe Sobha has not launched any new project in 4QFY11E (to date) but (1) delivery/handling over has started for Ruby and Ruby Platinum (West Bangalore, total 0.8 mn sq. ft), (2) sales in existing projects have held up but no new launch implies we could see a qoq dip in volumes; however, overall Bangalore market remains healthy and (3) we find increased visibility of Sobha's first launch in Gurgaon happening near term with (a) opening of tenders for the Northern Peripheral road (Gurgaon) and (b) awareness of the project among brokers/agents. We would have expected the launch and partial opening of sales for the Sobha Elysium project (2.9 mn sq. ft) in Bangalore.

#### Sobha has plans to launch 11.3 mn sq. ft over the next few quarters

Proposed launches in next few quarters, Sobha Developers (mn sq. ft)

S No.	Location	Project name	Type	Saleable area	Status
				(mn sq. ft)	
Existing locations					
1	Bangalore	Sobha Signature	Residential Apartments	0.2	Plan sanctioned
2	Bangalore	Ruby Ph - II	Residential Apartments	0.3	Plan sanctioned
3	Bangalore	Sobha Elysium	Mixed use residential	2.9	Final stage of approval
4	Bangalore	Kristal Property	Residential Apartments	0.2	Initiated plan approval process
5	Pune	Sobha Carnation - Ph 3	Residential Apartments	0.4	Final stage of approval
6	Coimbatore	Sobha Ruby	Residential Apartments	0.3	Submitted for plan approvals
7	Thrissur	Sobha City - Commercial	Commercial - Ph 2	0.2	Initiated plan approval process
New locations					
8	Chennai	Sobha Luxury apartments	Residential Apartments	0.2	Submitted for plan approvals
9	Chennai	Pudupakkam Property	Residential Apartments	0.7	Initiated plan approval process
10	Gurgaon, NCR	Township Development	Integrated Township	4.3	Final stage of approval
11	Gurgaon, NCR	Group Housing	Residential Apartments	1.5	Initiated plan approval process
12	Mysore	Belavatta Property	Plotted Development	0.2	Final stage of approval
Total				11.3	

Source: Company, Kotak Institutional Equities

### Gurgaon project details

Sobha's Gurgaon project is situated at Sector 109 at Babupur village, Gurgaon and is a 4.3 mn sq. ft villa project, 4 kms from Dwarka and potentially 0.5 km from the Indira Gandhi International Airport. As per press reports, HUDA (Haryana Urban Development Authority) has opened tenders for the 18-km long Northern Peripheral Road and IndiaBulls has emerged as the lowest cost bidder. If this process is finalized, it could lead to a launch of multiple projects in this region which are stuck (despite approvals) due to lack of connectivity. Sobha management believes that it has created enough visibility in the NCR market (a Google search indicates that the project is indeed mentioned in one of the broker websites (<http://www.newprojects.in/sobha/>) and with their strong brand and track record of villa development, sales should not be an issue. We think launching a villa project (and some early sales could be more like plot sales with construction outsourced to Sobha) is the best choice as (1) it's the safest purchase from a relatively less known developer, (2) helps manage launch, (3) could attract investor demand easily and (4) differentiate versus other group housing projects likely to be launched in that area.

We believe this project is a key to Sobha's investment thesis as (1) 52% of its potential launch area over the next few quarters is at Gurgaon and likely it's a higher proportion of sales value, (2) proof-of-entry in a new market and (3) signs of monetization of vast land bank (227 mn sq. ft).

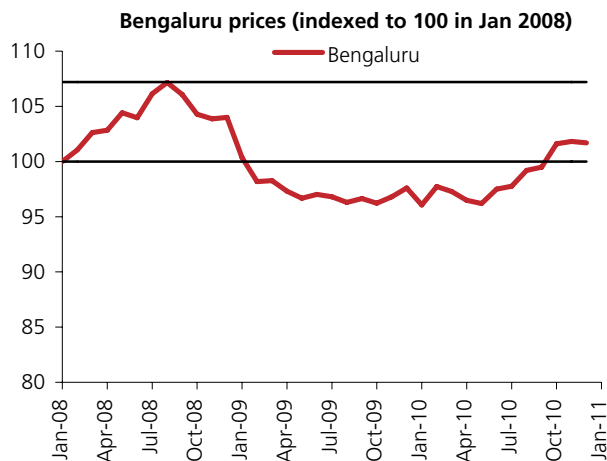
Location of Sobha's forthcoming project at Babupur Village in Gurgaon  
Map showing location of Sobha's new project



Source: Google maps, Company, Kotak Institutional Equities estimates

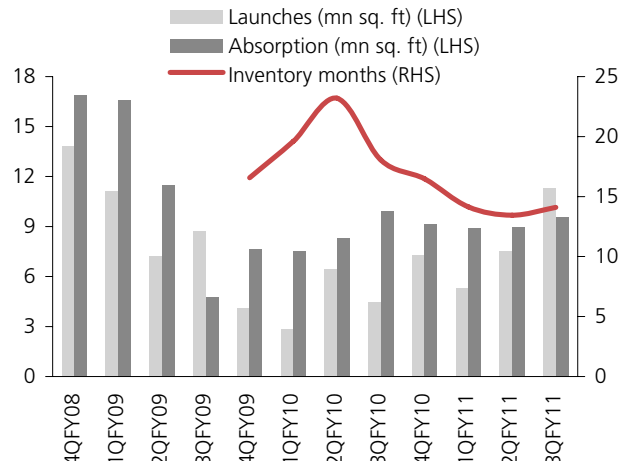
### Bangalore market remains steady for now

Bangalore residential prices still lower than previous peak  
Indexed residential prices, Bangalore, Jan 2008-Jan 2011



Source: Propequity, Kotak Institutional Equities

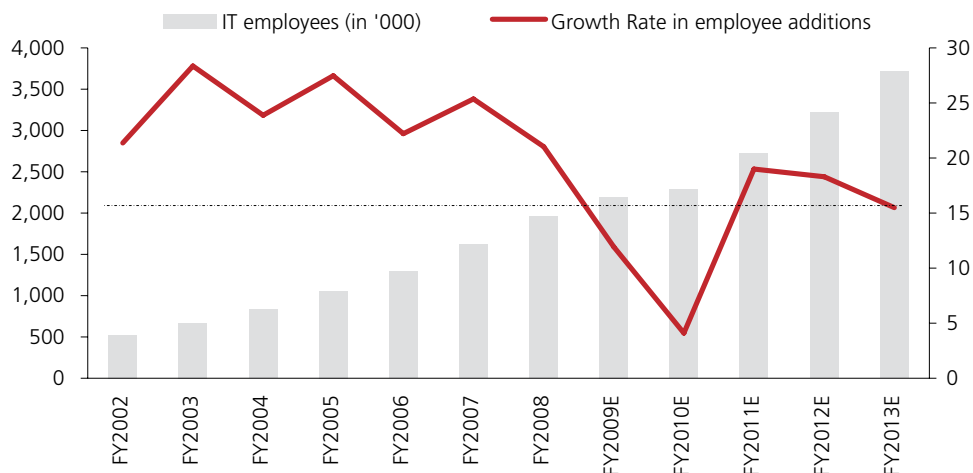
Absorption data reveals no slowdown  
Launches, Absorption, Inventory months, Bangalore, 4QFY08-3QFY11



Source: Propequity, Kotak Institutional Equities

### IT employees expected to grow 18% in FY2012E over FY2011E

IT employees and growth rate in employee additions, March fiscal year-ends



Source: NASSCOM, Kotak Institutional Equities estimates

### Current price implies minimal value for ongoing business

Based on the current stock price, we find minimal value being ascribed to either (1) development more than current ongoing projects or (2) brand and Sobha operating as a going concern. 93% of Sobha's current EV is accounted by (1) PV of cash flows from current projects + (2) book value of land + (3) value of the contracting business.

### Current market price is factoring 0.5 mn sq. ft of development in steady state

SOTP valuation of Sobha Developers (Rs mn)

	Value (Rs mn)	Comments
Current market price (Rs)	256	
Outstanding shares (mn)	98	
Total market cap (Rs mn)	25,104	
Debt (Rs mn)	12,453	Current debt (as of end-3QFY11)
<b>Enterprise value (Rs mn) [A]</b>	<b>37,557</b>	
<b>Valuation (Rs mn)</b>		
(1) Ongoing projects	9,109	Based on 3QFY11 data, assuming 16% cost of capital, inflow over three years starting one year later
(2) Contractual business	4,417	At 10x FY2012E earnings assuming 10% net margin
(3) Land valued at acquisition cost	21,572	Historical cost of 224 mn sq. ft of FSI less balance amount to be paid (Rs1.48 bn)
<b>Total value (Rs mn) [B]</b>	<b>35,097</b>	
<b>Residual value for ongoing development business [A-B]</b>	<b>2,460</b>	
<b>Value of executing 1 m sq. ft assuming third party land</b>		
Area (mn sq. ft)	1	
Average rate (Rs)	4,000	Assumed average selling price in Bengaluru
Revenue (Rs mn)	4,000	
EBIT @ 20% margin	800	Assumed developer EBIT margin @ 20% based on JDA
Profit after tax (Rs mn)	528	Assuming marginal rate of tax at 33.99%
<b>Present value (Rs mn)</b>	<b>5,041</b>	<b>Assuming 5% constant inflation and 16% cost of capital</b>

Source: Company, Kotak Institutional Equities estimates, Bloomberg

**Sobha has Rs12.2 bn cash flow available from ongoing and completed projects**

Cash flow from ongoing and completed projects, as of Dec 31, 2010 (Rs mn)

Description	Unit	Ongoing projects	Completed projects
Total super built-up area	mn sq. ft	8.64	6.53
Less: Non saleable area (office space, club house & JD share)	mn sq. ft	(1.15)	-0.16
Sobha's share of saleable area	mn sq. ft	7.49	6.37
Total area sold till 31 December 2010	mn sq. ft	4.42	6.17
Unsold area	mn sq. ft	3.07	0.2
Construction cost to be spent	Rs mn	12,429	312
Receivables outstanding + balance to be billed and collected on sold units	Rs mn	8,667	570
Sales value of unsold stock	Rs mn	14,953	718
<b>Cash flow available</b>	<b>Rs mn</b>	<b>11,191</b>	<b>976</b>
<b>Total cash flow available</b>	<b>Rs mn</b>	<b>12,167</b>	

Source: Company, Kotak Institutional Equities

**We have a target price of Rs380/share**

NAV-based valuation, Sobha Developers, March fiscal year-ends (Rs bn)

	March '12 based NAV			
	Growth rate in selling prices			
	0%	3%	5%	10%
<b>Gross valuation (Rs bn)</b>	<b>17.0</b>	<b>31.0</b>	<b>41.8</b>	<b>75.2</b>
Residential projects	22.3	28.5	32.9	45.2
Commercial projects	(2.8)	1.7	5.4	17.8
Retail projects	(2.6)	0.8	3.5	12.2
Less: Land cost to be paid	(1.5)	(1.5)	(1.5)	(1.5)
Less: Net debt	(10.1)	(10.1)	(10.1)	(10.1)
Add: Land sales / value	2.0	2.0	2.0	2.0
Add: Contractual business	5.0	5.0	5.0	5.0
<b>NAV</b>	<b>12.4</b>	<b>26.4</b>	<b>37.2</b>	<b>70.6</b>
Total no. of shares (mn)				<b>98</b>
<b>NAV/share</b>				<b>379</b>
<b>Target price @0% discount to NAV</b>				<b>379</b>

Source: Company, Kotak Institutional Equities estimates

**Revenue model of Sobha Developers**  
March fiscal year-ends, 2008 – 2013E (Rs mn)

	2008	2009	2010	2011E	2012E	2013E
<b>Apartments</b>						
Apartment volumes (mn sq. ft)	2.7	1.5	2.0	2.9	4.0	5.6
Revenues	8,387	4,890	6,252	9,314	12,621	17,438
Rate/sq. ft	3,164	3,244	3,141	3,211	3,131	3,105
<b>Commercial</b>						
Commercial volumes (mn sq. ft)	-	-	-	-	0.1	0.4
Revenues	-	-	-	-	186	1,215
Rate/sq. ft	-	-	-	-	2,924	3,380
<b>Contractual sales</b>						
Contractual volumes (mn sq. ft)	5.6	3.0	3.2	3.3	3.5	3.6
Revenues	5,353.9	3,665.0	3,481.8	3,795.1	4,174.6	4,592.1
Rate/sq. ft	950	1,222	1,105	1,147	1,202	1,259
<b>Plot sales</b>						
Plot sale volumes (mn sq. ft)	-	-	-	-	2.4	3.6
Revenues	-	-	-	-	1,298.4	1,943.0
Rate/sq. ft	-	-	-	-	543	539
<b>Retail rental revenues</b>						
Total retail stock	-	-	-	-	-	0.1
Total retail lease rentals	-	-	-	-	-	143
Rate/sq. ft	-	-	-	-	-	99
<b>Revenues from real estate</b>	<b>8,387</b>	<b>4,890</b>	<b>6,252</b>	<b>9,314</b>	<b>14,106</b>	<b>20,739</b>
<b>Contractual revenues</b>	<b>5,354</b>	<b>3,665</b>	<b>3,482</b>	<b>3,795</b>	<b>4,175</b>	<b>4,592</b>
Others	53	148	30	-	-	-
Land sale+A/c policy change	-	1,121	1,800	1,800	-	-
<b>Revenues</b>	<b>13,794</b>	<b>9,824</b>	<b>11,563</b>	<b>14,909</b>	<b>18,281</b>	<b>25,331</b>
% growth	21	(29)	18	29	23	39
<b>Revenues from residential projects</b>						
Revenues from residential projects	-	-	6,252	9,314	12,621	17,438
Revenues from under construction projects	-	-	5,675	6,936	4,913	3,422
<b>% of total residential revenues</b>	<b>-</b>	<b>-</b>	<b>90.8</b>	<b>74.5</b>	<b>38.9</b>	<b>19.6</b>

Source: Company, Kotak Institutional Equities estimates

## Profit model of Sobha Developers

March fiscal year-ends, 2008-2013E (Rs mn)

	2008	2009	2010	2011E	2012E	2013E
<b>Total revenues</b>	<b>14,311</b>	<b>9,740</b>	<b>11,299</b>	<b>15,109</b>	<b>18,281</b>	<b>25,331</b>
Land and construction cost	(7,642)	(4,398)	(6,364)	(9,276)	(11,102)	(15,559)
Employee costs	(1,025)	(1,009)	(768)	(940)	(1,128)	(1,184)
SG&A costs	(1,941)	(1,546)	(1,530)	(1,662)	(1,919)	(3,040)
<b>EBITDA</b>	<b>3,703</b>	<b>2,788</b>	<b>2,636</b>	<b>3,231</b>	<b>4,131</b>	<b>5,548</b>
Other income	53	148	39	125	75	100
Interest	(615)	(1,074)	(693)	(451)	(439)	(706)
Depreciation	(350)	(360)	(323)	(282)	(315)	(360)
<b>Pretax profits</b>	<b>2,791</b>	<b>1,501</b>	<b>1,658</b>	<b>2,623</b>	<b>3,451</b>	<b>4,581</b>
Extraordinary items	—	—	—	—	—	—
Current tax	(510)	(422)	(296)	(709)	(1083)	(1436)
Deferred tax	33	20	21	16	9	7
<b>Net income</b>	<b>2,315</b>	<b>1,099</b>	<b>1,383</b>	<b>1,930</b>	<b>2,377</b>	<b>3,152</b>
<b>Adjusted net income</b>	<b>2,315</b>	<b>1,099</b>	<b>1,383</b>	<b>1,930</b>	<b>2,377</b>	<b>3,152</b>
<b>EPS (Rs)</b>						
Primary	31.7	15.1	14.1	19.7	24.2	32.1
Fully diluted	31.7	15.1	14.1	19.7	24.2	32.1
<b>Shares outstanding (mn)</b>						
Year end	73	73	98	98	98	98
Primary	73	73	98	98	98	98
Fully diluted	73	73	98	98	98	98
<b>Cash flow per share (Rs)</b>						
Primary	27.7	35.0	24.9	10.4	16.1	27.5
Fully diluted	27.7	35.0	24.9	10.4	16.1	27.5
<b>Growth (%)</b>						
Net income (adjusted)	43	(53)	26	40	23	33
EPS (adjusted)	29	(53)	(6)	40	23	33
DCF/share	(1)	26	(29)	(58)	55	71
Cash tax rate (%)	18	28	18	27	31	31

Source: Company, Kotak Institutional Equities estimates

**Balance model of Sobha Developers**  
March fiscal year-ends, 2008-2013E (Rs mn)

	2008	2009	2010	2011E	2012E	2013E
<b>Equity</b>						
Share capital	729	729	981	981	981	981
Reserves/surplus	9,380	10,394	16,348	18,054	20,229	23,358
<b>Total Equity</b>	<b>10,109</b>	<b>11,123</b>	<b>17,329</b>	<b>19,035</b>	<b>21,209</b>	<b>24,339</b>
Deferred tax liability/(asset)	(11)	(31)	(52)	(68)	(77)	(84)
<b>Liabilities</b>						
Secured Loans	14,381	18,783	14,466	12,084	11,084	9,834
Unsecured Loans	3,450	538	275	-	-	-
<b>Total Borrowings</b>	<b>17,831</b>	<b>19,322</b>	<b>14,740</b>	<b>12,084</b>	<b>11,084</b>	<b>9,834</b>
Current Liabilities	5,746	6,117	6,529	7,790	8,767	10,225
<b>Total Capital</b>	<b>33,675</b>	<b>36,531</b>	<b>38,547</b>	<b>38,841</b>	<b>40,983</b>	<b>44,314</b>
<b>Assets</b>						
Cash	287	214	826	1,354	1,010	320
Current assets	31,218	34,042	35,634	35,401	36,922	39,735
Gross block	2,711	2,930	2,942	3,222	3,726	4,331
Less: Accumulated depreciation	842	1,198	1,513	1,795	2,110	2,471
Net fixed assets	1,870	1,732	1,429	1,427	1,616	1,860
Capital work-in-progress	272	516	632	632	1,408	2,371
<b>Total fixed assets</b>	<b>2,142</b>	<b>2,248</b>	<b>2,061</b>	<b>2,059</b>	<b>3,024</b>	<b>4,232</b>
Intangible assets	—	—	—	—	—	—
Investments	27	28	27	27	27	27
Misc. expenses	—	—	—	—	—	—
<b>Total assets</b>	<b>33,675</b>	<b>36,531</b>	<b>38,547</b>	<b>38,841</b>	<b>40,983</b>	<b>44,314</b>
<b>Key ratios (%)</b>						
Debt/equity	176.6	174.2	85.3	63.7	52.4	40.5
Debt/capitalization	63.8	63.5	46.0	38.9	34.4	28.8
Net debt/equity	173.7	172.3	80.5	56.6	47.7	39.2
Net debt/capitalization	63.5	63.3	44.6	36.1	32.3	28.2
<b>RoAE</b>	<b>25.3</b>	<b>10.4</b>	<b>9.8</b>	<b>10.7</b>	<b>11.9</b>	<b>13.9</b>
<b>RoACE</b>	<b>13.3</b>	<b>6.3</b>	<b>6.2</b>	<b>7.1</b>	<b>8.4</b>	<b>10.9</b>

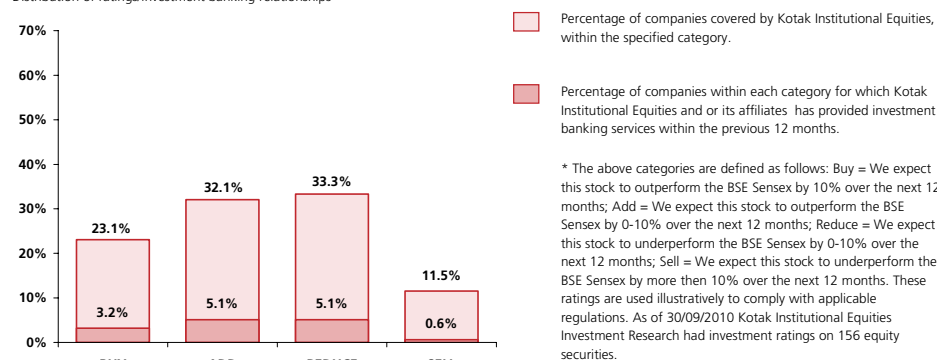
Source: Company, Kotak Institutional Equities estimates



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Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of September 30, 2010

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

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

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