Macquarie Research
Equities

INDIA

Hindustan Construction

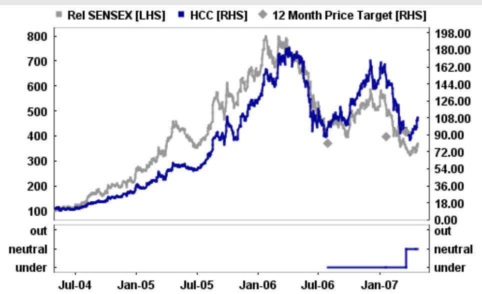
30 April 2007

HCC IN		Neutral
Stock price as of 27 Apr 07	Rs	98.45
12-month target	Rs	93.00
Upside/downside	%	-5.5
Valuation	Rs	93.00
- Sum of Parts		
GICS sector		capital goods
Market cap	Rs m	25,228
30-day avg turnover	Rs m	59.1
Market cap	US$m	620
Number shares on issue	m	256.2

Investment fundamentals

Year end 31 Mar		2006A	2007E	2008E	2009E
Total revenue	m	19,870	24,747	32,171	40,214
EBITDA	m	1,827	2,328	3,056	4,021
EBITDA growth	%	17.2	27.4	31.3	31.6
EBIT	m	1,303	1,565	2,166	3,041
EBIT Growth	%	17.8	20.1	38.4	40.4
Recurring profit	m	975	1,163	1,506	2,221
Reported profit	m	848	306	994	1,466
Adjusted profit	m	840	756	994	1,466
EPS rep	Rs	3.59	1.20	3.88	5.72
EPS rep growth	%	0.7	-66.7	224.4	47.5
EPS adj	Rs	3.46	2.95	3.88	5.72
EPS adj growth	%	11.0	-14.8	31.4	47.5
PE adj	x	28.4	33.4	25.4	17.2
ROA	%	5.9	5.1	6.5	8.2
ROE	%	14.1	8.9	11.1	14.7
EV/EBITDA	x	18.2	14.0	10.9	8.3
Net debt/equity	%	36.2	123.4	106.5	108.3
Price/book	x	3.0	3.0	2.7	2.4

HCC IN rel SENSEX performance, & rec history



Source: Datastream, Macquarie Research, April 2007 (all figures in INR unless noted)

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Weakness persists

Event

- HCC's 4Q FY3/07 results were even weaker than our below-consensus estimates. Delays in major projects have resulted in anaemic revenue growth and the withdrawal of tax benefits has resulted in a YoY profit decline. With the core construction business outlook remaining weak and still-insufficient clarity on real estate forays, we expect HCC to underperform its peers.

Impact

- **Delays in major projects impacts revenue growth.** We have been highlighting the weak order book profile for some time. We were concerned about the significant contribution of early-stage hydropower projects in difficult geographies like Jammu & Kashmir. The concentration of road projects in Assam and Uttar Pradesh added to our concerns. The risk of delays in these projects has now manifested. Sluggish implementation of these projects would continue to be a drag on revenue growth.
- **Large investments are impacting profit growth.** The company has invested ~Rs7bn during FY07 in the construction business for capital expenditure and working capital requirements. This has resulted in interest and depreciation costs increasing by 130bp YoY as a proportion of revenues during FY07. Pressure on this front is unlikely to abate with the company guiding for capex of Rs2bn during FY08.
- **Order inflows are sluggish.** Since the fresh order intake during FY07 comprised only 86% of revenues booked during the year, the order book declined by 5%. We do not expect a sharp acceleration in order bookings over the next couple of years. The outlook for the two main sectors – hydropower and roads – remains sedate. Six hydropower projects won during FY06-07 have stretched resources and the company's inexperience in bidding for BOT road projects means accretion to road orders would be modest at best.

Earnings revision

- No change.

Price catalyst

- 12-month price target: Rs93.00 based on a Sum of Parts methodology.
- Catalyst: Moderate revenue growth and continuing margin pressure as evidenced from quarterly numbers

Action and recommendation

- The weakness is the core construction business is evident. We are cautious on the real estate foray as well. Lack of demand visibility in the Lavasa project and change of plans for the Vikhroli project mean that any gains for the real estate business are some way away. Consequently, we expect the company to continue underperforming its peers. Neutral rating maintained.

Delays in major projects impacts revenue growth

We have been highlighting the weak order book profile for some time. We were concerned about the significant contribution of early-stage hydropower projects in difficult geographies like Jammu & Kashmir. The concentration of road projects in Assam and Uttar Pradesh added to our concerns. The risk of delays in these projects has now manifested.

Revenue growth during 4Q FY3/07 was anaemic at 7.8% as adverse climatic conditions in Jammu & Kashmir and land acquisition issues in road projects impacted project implementation. Growth for the full year was sedate as well, with revenues increasing by only 18.7%. Sluggish implementation of these projects would continue to be a drag on revenue growth. Further land acquisition delays in road projects would put our FY08 revenue estimates at risk.

Fig 1 4Q FY3/07 results

(Rs m)	FY06	1Q FY07	2Q FY07	3Q FY07	4Q FY07	FY07
Sales	**19,870**	**5,735**	**4,202**	**5,361**	**8,277**	**23,576**
Share of JV sales	412	71	54	45	199	369
Expenditure	**18,042**	**5,282**	**3,808**	**4,779**	**7,555**	**21,424**
Raw Material Consumed	8,631	1,865	1,392	1,570	2,579	7,406
Employee Expenses	1,319	418	422	633	614	2,087
Construction Expenses	7,381	2,817	1,779	2,365	4,003	10,964
Other Expenses	713	181	216	211	359	966
EBITDA	**1,827**	**454**	**394**	**583**	**722**	**2,153**
Interest	414	74	158	175	212	620
Depreciation	524	162	186	206	244	797
Other Income	55	62	10	2	125	199
Profit/Loss on JVs	31	7	1	81	154	244
Profit before tax	975	287	61	285	546	1,179
Tax	135	36	19	65	266	386
Profit After Tax	**840**	**251**	**42**	**220**	**280**	**793**
EPS (Rs)	3.3	1.0	0.2	0.9	1.0	3.1
Yearly Growth (%)						
Revenues	33.6	24.4	39.1	17.7	7.8	18.7
EBITDA	17.2	11.0	52.9	19.9	7.0	17.8
PAT	22.3	14.8	-196.4	-3.0	-36.1	-5.6
Margins (%)						
EBITDA	9.2%	7.9%	9.4%	10.9%	8.7%	9.1%
PAT	4.2%	4.4%	1.0%	4.1%	3.4%	3.4%
Tax rate	13.8%	12.6%	31.5%	22.8%	48.7%	32.7%

Source: Company data, Macquarie Research, April 2007

Profits before tax have declined adjusting for one-off items

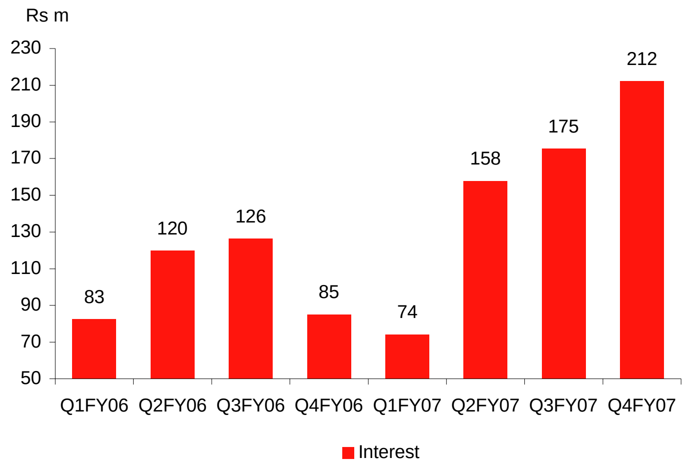
4Q FY3/07 profits-before-tax (PBT) increased by 17.9% YoY, helped by other income of Rs125.2m (from foreign exchange gains) and profits from joint ventures of Rs154.3m (claims received from completed projects). Both these items are non-recurring in nature. Adjusting for these items, PBT decreased by 42.5% YoY for the quarter. Adjusted PBT for FY07 decreased by 7.7%.

Other income was mainly on account of foreign exchange gains. The company had issued foreign currency convertible bonds (FCCBs) worth US$100m last year. Sharp appreciation in the rupee during 4Q FY3/07 resulted in a reduction in rupee liability, which the company booked as other income. In addition to the non-recurring nature, we find the accounting treatment aggressive as well. Though the FCCBs do not have yearly coupons, they carry a YTM of 4.25%. The company does not provide for interest costs according to accrual principles as the management maintains that the FCCBs would eventually convert. With the bonds currently deep out of money, we find booking of exchange gains aggressive especially when the company is not providing for contingent costs.

Large investments are impacting profit growth

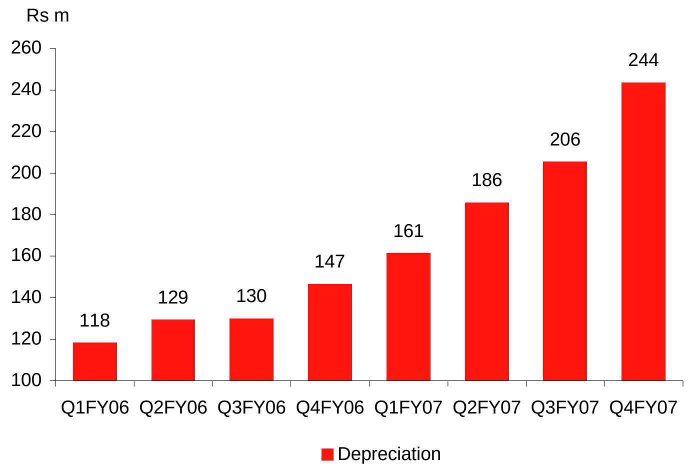
The company invested ~Rs7bn in the construction business in FY07 for meeting capital expenditure and working capital requirements. As a result, Rs9bn fresh capital raised last year is now substantially invested. The much higher than expected capital infusion in the construction business was necessitated by the six hydropower projects won during FY06-07. This has resulted in interest and depreciation costs increasing by 130bp YoY as proportion of revenues during FY07. Pressure on this front is unlikely to abate with the company guiding for capex of Rs2bn during FY08.

Fig 2 Interest cost is rising as cash balances decline



Source: Macquarie Research, April 2007

Fig 3 Increased capex results in higher depreciation



Source: Macquarie Research, April 2007

Tax rates have been adjusted as expected

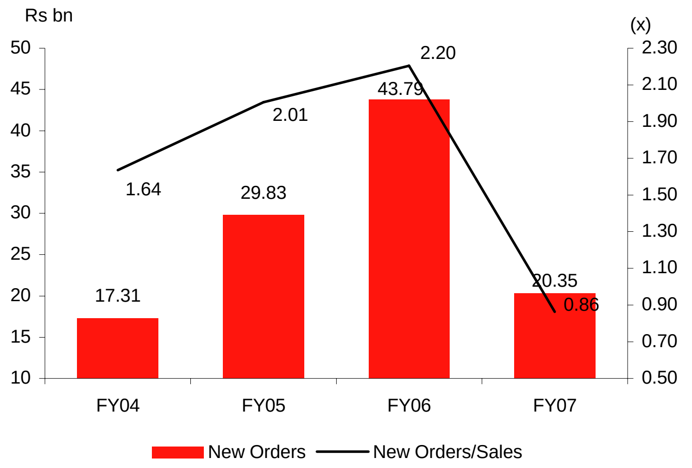
HCC was a late convert to the group of companies claiming tax benefit under Sec 80IA. However, once it was convinced of the applicability of these benefits for construction companies, it wrote back tax provisions for earlier years as well. As a result, the effective tax rate for FY05 and FY06 was 1.3% and 13.8% respectively. For FY07, the company has provided tax at the rate of 32.7%. As a result, net profits have declined by 5.6% YoY to Rs793m.

As the withdrawal is retrospective, the company has provided Rs425m for prior period taxes, against our estimate of Rs450m. Accounting for the prior period taxes, net profits for FY07 declined 43% YoY to Rs367.6m. However, the mitigating factor is that the prior period taxes would not result in an actual cash outflow as the company had already paid taxes as per the full rate and then claimed exemption under the section.

Order inflows are sluggish

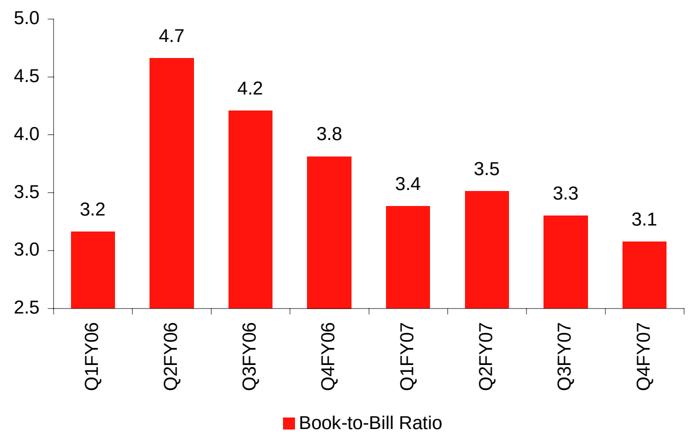
Since the fresh order intake during FY07 comprised only 86% of revenues booked during the year, the order book declined by 5%. We do not expect a sharp acceleration in order bookings over the next couple of years. The outlook for the two main sectors – hydropower and roads – remains sedate. Six hydropower projects won during FY06-07 have stretched resources and the company's inexperience in bidding for BOT road projects means accretion to road orders would be modest at best.

Fig 4 Order intake has lagged revenues in FY07…



Source: Macquarie Research, April 2007

Fig 5 …as a result, order coverage ratio has declined



*Excluding the Rs19.4bn Sawalkote project under dispute

Source: Macquarie Research, April 2007

We are not enthused by plans for real estate foray

Large pre-launch investment of Rs9bn has been planned for the Lavasa project. Without core economic activity to attract people from existing urban centres to the new township, developing the required network effect remains an uphill task. Increased upfront investment has pushed the break-even point even further.

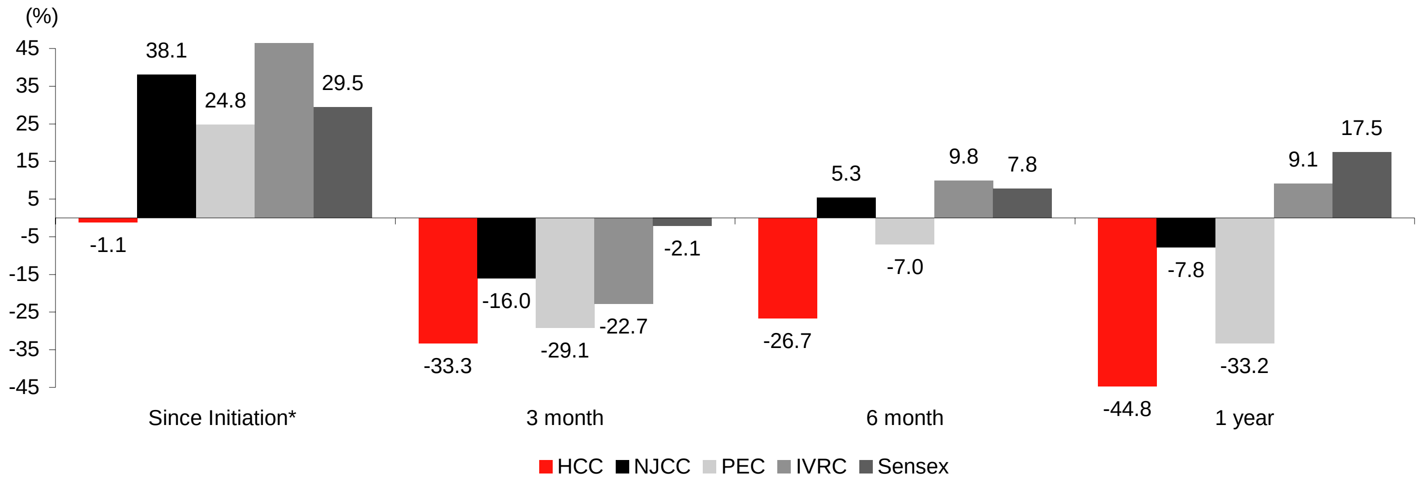
In addition to the large 12,500-acre Lavasa project, the company has indicated that it has significant expansion plans for the real estate business and is in the process of aggregating around 1,500 acres of land in Mumbai and other cities in the state of Maharashtra. The company got a late start in creating an exploitable land bank, and the success of its real estate plans depends on the price paid for the contracted land after a significant run-up in prices. Management has given no details on the acquisition price. We will wait for more details on the land bank before ascribing a value to it.

Change in plans for the Vikhroli (West) IT park project in Mumbai underlines the challenges the company faces in the real estate business. The company had earlier planned to develop 1.7m sq ft of office space for IT companies over 9 acres land in Vikhroli. However, demand from the sector has been weak given that IT parks are no longer attractive for IT companies given the withdrawal of tax benefits for IT parks. Consequently, the company now plans to develop a general corporate park instead. The change in plans would delay the launch of the project. Revenues would be further deferred given that a general corporate park would take longer to fill than an IT park.

Expect HCC to underperform its peers

The weakness is the core construction business is evident. We are cautious on the real estate foray as well. Lack of demand visibility in the Lavasa project and the change of plans for the Vikhroli project mean that any gains for the real estate business are some way away. Consequently, we expect the company to continue underperforming its peers.

Fig 6 HCC has underperformed both its peers and the broader market



*Since July 31, 2006

Source: Macquarie Research, April 2007

Hindustan Construction Company (HCC IN, Neutral, Target price: Rs93.00)

Quarterly Results		3Q/07A	4Q/07E	1Q/08E	2Q/08E
Revenue	**m**	**5,361**	**9,448**	**7,456**	**5,463**
Gross Profit	**m**	**793**	**1,096**	**895**	**710**
Cost of Goods Sold	m	4,568	8,352	6,561	4,753
EBITDA	**m**	**583**	**898**	**708**	**519**
Depreciation	m	206	210	215	220
Amortisation of Goodwill	m	0	0	0	0
Other Amortisation	m	0	0	0	0
EBIT	**m**	**377**	**688**	**493**	**299**
Net Interest Income	m	-175	-176	-170	-180
Associates	m	81	8	10	10
Exceptionals	m	0	0	0	0
Forex Gains / Losses	m	0	0	0	0
Other Pre-Tax Income	m	2	10	10	10
Pre-Tax Profit	**m**	**285**	**530**	**343**	**139**
Tax Expense	m	-65	-286	-117	-47
Net Profit	**m**	**220**	**244**	**227**	**92**
Minority Interests	m	0	0	0	0
Reported Earnings	**m**	**220**	**-206**	**227**	**92**
Adjusted Earnings	**m**	**220**	**244**	**227**	**92**
EPS (rep)		0.86	-0.81	0.88	0.36
EPS (adj)		0.86	0.95	0.88	0.36
EPS Growth yoy (adj)	%	-13.2	-44.4	-9.8	120.0
EBITDA Margin	%	10.9	9.5	9.5	9.5
EBIT Margin	%	7.0	7.3	6.6	5.5
Earnings Split	%	29.1	32.2	22.8	9.2
Revenue Growth	%	17.7	23.0	30.0	30.0
EBIT Growth	%	6.0	30.1	68.8	43.7

Profit & Loss		2006A	2007E	2008E	2009E
Revenue	**m**	**19,870**	**24,747**	**32,171**	**40,214**
Gross Profit	**m**	**2,540**	**3,134**	**3,799**	**4,808**
Cost of Goods Sold	m	17,330	21,613	28,372	35,406
EBITDA	**m**	**1,827**	**2,328**	**3,056**	**4,021**
Depreciation	m	524	763	890	980
Amortisation of Goodwill	m	0	0	0	0
Other Amortisation	m	0	0	0	0
EBIT	**m**	**1,303**	**1,565**	**2,166**	**3,041**
Net Interest Income	m	-414	-583	-740	-900
Associates	m	31	98	40	40
Exceptionals	m	0	0	0	0
Forex Gains / Losses	m	0	0	0	0
Other Pre-Tax Income	m	55	84	40	40
Pre-Tax Profit	**m**	**975**	**1,163**	**1,506**	**2,221**
Tax Expense	m	-135	-406	-512	-755
Net Profit	**m**	**840**	**756**	**994**	**1,466**
Minority Interests	m	0	0	0	0
Reported Earnings	**m**	**848**	**306**	**994**	**1,466**
Adjusted Earnings	**m**	**840**	**756**	**994**	**1,466**
EPS (rep)		3.59	1.20	3.88	5.72
EPS (adj)		3.46	2.95	3.88	5.72
EPS Growth (adj)	%	11.0	-14.8	31.4	47.5
PE (rep)	x	29.3	87.9	27.1	18.4
PE (adj)	x	30.3	35.6	27.1	18.4
Total DPS		0.00	0.00	0.00	0.00
Total Div Yield	%	0.0	0.0	0.0	0.0
Weighted Average Shares	m	236	256	256	256
Period End Shares	m	256	256	256	256

Profit and Loss Ratios		2006A	2007E	2008E	2009E
Revenue Growth	%	33.6	24.5	30.0	25.0
EBITDA Growth	%	17.2	27.4	31.3	31.6
EBIT Growth	%	17.8	20.1	38.4	40.4
Gross Profit Margin	%	12.8	12.7	11.8	12.0
EBITDA Margin	%	9.2	9.4	9.5	10.0
EBIT Margin	%	6.6	6.3	6.7	7.6
Net Profit Margin	%	4.2	3.1	3.1	3.6
Payout Ratio	%	0.0	0.0	0.0	0.0
EV/EBITDA	x	19.2	14.7	11.5	8.8
EV/EBIT	x	26.7	21.4	16.1	11.6
Balance Sheet Ratios					
ROE	%	14.1	8.9	11.1	14.7
ROA	%	5.9	5.1	6.5	8.2
ROIC	%	16.4	8.9	7.5	10.4
Net Debt/Equity	%	36.2	123.4	106.5	108.3
Interest Cover	x	3.1	2.7	2.9	3.4
Price/Book	x	3.2	3.2	2.9	2.5
Book Value per Share		32.8	33.3	36.5	41.4

Cashflow Analysis		2006A	2007E	2008E	2009E
EBITDA	**m**	**1,827**	**2,328**	**3,056**	**4,021**
Tax Paid	m	-135	-406	-512	-755
Chgs in Working Cap	m	-3,918	-5,272	883	-1,825
Net Interest Paid	m	-414	-583	-740	-900
Other	m	0	0	0	0
Operating Cashflow	**m**	**-2,640**	**-3,933**	**2,687**	**541**
Acquisitions	m	1,090	-1,000	0	0
Capex	m	-2,269	-2,099	-1,985	-1,985
Asset Sales	m	0	0	0	0
Other	m	45	-271	80	80
Investing Cashflow	**m**	**-1,135**	**-3,369**	**-1,905**	**-1,905**
Dividend (Ordinary)	m	-205	-203	-203	-203
Equity Raised	m	4,325	0	0	0
Debt Movements	m	8,853	0	0	0
Other	m	0	0	0	0
Financing Cashflow	**m**	**12,973**	**-203**	**-203**	**-203**
Net Chg in Cash/Debt	**m**	**9,199**	**-7,505**	**579**	**-1,567**

Balance Sheet		2006A	2007E	2008E	2009E
Cash	m	10,111	2,621	3,214	1,661
Receivables	m	71	69	89	111
Inventories	m	11,120	16,440	17,810	22,263
Investments	m	720	1,720	1,720	1,720
Fixed Assets	m	6,247	7,582	8,677	9,682
Intangibles	m	0	0	0	0
Other Assets	m	1,918	3,085	3,564	3,898
Total Assets	**m**	**30,187**	**31,516**	**35,075**	**39,335**
Payables	m	7,547	8,905	11,577	14,471
Short Term Debt	m	0	0	0	0
Long Term Debt	m	13,163	13,163	13,163	13,163
Provisions	m	380	234	316	405
Other Liabilities	m	676	674	674	674
Total Liabilities	**m**	**21,766**	**22,976**	**25,729**	**28,712**
Shareholders' Funds	m	8,417	8,536	9,342	10,620
Minority Interests	m	5	4	4	4
Other	m	0	0	0	0
Total S/H Equity	**m**	**8,422**	**8,540**	**9,346**	**10,623**
Total Liab & S/H Funds	**m**	**30,187**	**31,516**	**35,075**	**39,335**

All figures in INR unless noted.
Source: Macquarie Research, April 2007

Important disclosures:

Recommendation definitions

Macquarie Australia/New Zealand
Outperform – return >5% in excess of benchmark return (>2.5% in excess for listed property trusts)
Neutral – return within 5% of benchmark return (within 2.5% for listed property trusts)
Underperform – return >5% below benchmark return (>2.5% below for listed property trusts)

Macquarie Asia
Outperform – expected return >+10%
Neutral – expected return from -10% to +10%
Underperform – expected return <-10%

Macquarie First South Securities (South Africa)
Outperform – expected return >+5%
Neutral – expected return from -5% to +5%
Underperform – expected return <-5%

Recommendations – 12 months

Note: Quant recommendations may differ from Fundamental Analyst recommendations

Recommendation proportions

	AU/NZ	Asia	RSA
Outperform	44.37%	58.37%	42.60%
Neutral	44.01%	21.30%	46.80%
Underperform	11.62%	20.33%	10.60%

For quarter ending 31 March 2007

Volatility index definition*

This is calculated from the volatility of historic price movements.

Very high–highest risk – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30–40% in a year.

Low–medium – stock should be expected to move up or down at least 25–30% in a year.

Low – stock should be expected to move up or down at least 15–25% in a year.
* Applicable to Australian/NZ stocks only

Financial definitions

All "Adjusted" data items have had the following adjustments made:
Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense
Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

EPS = adjusted net profit / efpowa*
ROA = adjusted ebit / average total assets
ROA Banks/Insurance = adjusted net profit /average total assets
ROE = adjusted net profit / average shareholders funds
Gross cashflow = adjusted net profit + depreciation
*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

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