

Hindustan Construction

STOCK INFO.	BLOOMBERG
BSE Sensex: 10,213	HCC IN
	REUTERS CODE
S&P CNX: 3,017	HCNS.BO

5 June 2006

Buy

Previous Recommendation: Buy

Rs125

Equity Shares (m)	274.3
52-Week Range	196/52
1,6,12 Rel. Perf. (%)	-12/-5/75
M.Cap. (Rs b)	34.2
M.Cap. (US\$ b)	0.7

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
3/06A	19,870	844	3.3	14.7	37.9	3.6	13.6	11.4	1.8	19.1
3/07E	29,580	2,008	7.3	122.4	17.0	2.3	16.8	10.3	1.1	11.3
3/08E	40,000	2,643	9.6	31.6	13.0	2.0	16.3	13.2	0.9	9.1

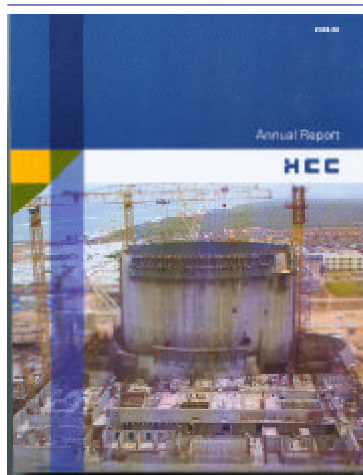
Annual report, FY06: key takeaways

Management outlines definite positive trend: Management has outlined a definite positive trend, both in terms of infrastructure spending in the economy and also HCC's positioning to capitalize the same. The Chairman's letter to shareholders states, "We have sizeable orders; we have the capital to finance growth; we have the managerial bandwidth; and we are hungry for scale. Thus I see better times ahead".

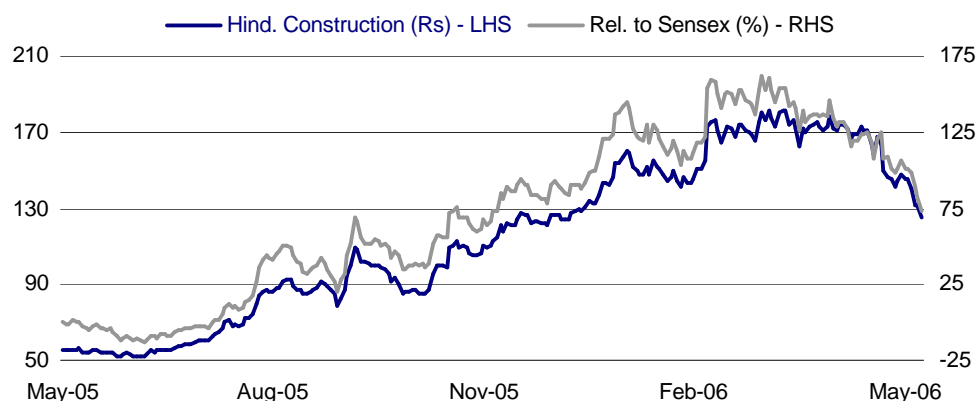
Robust order pipeline: HCC's order book in March 2006 stood at Rs96.7b v/s Rs53.8b in March 2005 (up 80% YoY). As at end March 2006, HCC has submitted price bids for projects at over Rs22.8b, while price bids worth Rs122.5b are expected to be submitted in the near future. The company also submitted prequalification bids for 11 projects of Rs65.7b, and expects to submit prequalification bids for five new projects valued at Rs55b in the near future. During FY06, the company forayed into gas pipelines and EPC hydropower projects.

Increased focus on real estate: Realty development is emerging as a key business vertical for HCC, and the company is seeking opportunities in township development. In Lavasa Corp, HCC's stake has increased to 60.5% (v/s 50%).

Recommend Buy: We expect HCC to report net profit of Rs2b (up 138%) in FY07, and Rs2.6b (up 32% YoY) in FY08. At CMP of Rs125, the stock quotes at reported PER of 17x FY07E and 13x FY08E. Adjusting for value of real estate, subsidiaries and investments, it quotes at PER of 9.1x FY07 and 6.9x FY08E. Maintain **Buy**, with SOTP-based price target of Rs193/share.



STOCK PERFORMANCE (1 YEAR)



Key highlights from the Chairman's letter

The Chairman's letter to shareholders outlined a definite positive trend, both in terms of infrastructure spending in the economy and also HCC's positioning to capitalize on the same. It states, "We have sizeable orders; we have the capital to finance growth; we have the managerial bandwidth; and we are hungry for scale. Thus I see better times ahead".

Key takeaways from the Chairman's letter are:

- ✍ The need to rapidly build physical infrastructure has finally occupied the center stage of policy making and implementation, both in New Delhi and in state capitals.
- ✍ I feel more confident than before, that your company will enjoy an ever increasing order book in the years ahead.
- ✍ We will continue our efforts to improve efficiencies in asset utilization to arrest this (operating margins) decline (FY06 9.5% v/s FY05 10.8%), if not improve it. Meanwhile, the recent trend in bids opened does indicate that there could be a reversal and margins may start to improve. But it would be foolhardy for any one in the pure construction business to expect margins to go up significantly.
- ✍ The strategy is therefore to attain much higher levels of scale, which is precisely what your company aims to achieve. The incremental US\$200m (Rs8.8b) of low cost international capital raised in March 2006, will be utilized to increase the scale of your company's business.

Robust order backlog (up 80% YoY)

HCC's order book in March 2006 stood at Rs96.7b, v/s Rs53.8b in March 2005 (up 80% YoY). As at end-March 2006, HCC has submitted price bids for projects over Rs22.8b, while price bids worth Rs122.5b are expected to be submitted in the near future. The company has also submitted prequalification bids for 11 projects worth over Rs65.7b, and expects to submit pre-qualification bids for five new projects worth Rs55b in the near future. The Annual Report states that the company is confident of securing a sizable share of these new projects.

Key observations

- ✍ **Higher average order size:** During FY06, order intake stood at Rs58b, comprising 14 projects, resulting in an average order size of Rs4b. Excluding the Sawalkote Hydro Power project (Rs19.4b), average order size stands at Rs2.9b. This indicates continued focus towards high-value projects.
- ✍ **Changing composition towards high margin segments:** During FY06, the share of hydroelectric projects in total order intake stood at ~60% (Rs34b), and of road projects at ~30% (Rs18b). Thus composition of order book has improved. Recent project awards have been from power segment where margins are better, when compared with roads and irrigation segments. As at March 2006, share of the power sector in order backlog has increased to 38% (v/s 12% in June 2005), and of the water supply/irrigation segment has declined to 15% (v/s 35% in June 2005).

ORDER BOOK COMPOSITION (%)

	JUNE 2005	DEC. 2005	MAR.2006
Power	12	21	38
Transportation	44	51	43
Water Supply & Irrigation	35	22	15
Others	9	6	4

Source: Company

- ✍ **Foray in gas pipeline business:** HCC bagged its first gas pipeline project executed in joint venture with Nova Joint Stock Co., Russia, of Rs550m on EPC basis from Gujarat State Petronet Ltd.
- ✍ **Foray in Hydropower EPC contracts:** The company has received intimation of approval by the government of Jammu and Kashmir for execution of the 1200MW Sawalkote Hydro Power project on EPC basis. The project is to be executed in a joint venture with SPAS, Norway and Ozaltin, Turkey. The total project size for consortium is Rs43.2b, and HCC's share is Rs19.4b.
- ✍ **Adjacent road packages (Rs9.2b):** Of the seven road projects awarded during FY06, HCC bagged four successive packages (159km, Rs9.2b) in the Lucknow Muzzafarpur section in Uttar Pradesh. This aggregation enables savings in mobilization, equipment and labor costs, resulting in better margins than otherwise possible.

LIST OF NEW PROJECTS SECURED IN FY06 (RS M)

Lucknow Muzaffarpur National Highway, Package 1	1,981
Lucknow Muzaffarpur National Highway, Package 2	2,123
Lucknow Muzaffarpur National Highway, Package 3	2,500
Lucknow Muzaffarpur National Highway, Package 4	2,552
Mughal Road, J&K	2,144
National Highway Project, Rajasthan	3,760
National Highway Project, Assam	3,172
Pir-Panjal Tunnel, Railway Line project, J&K	2,184
Pir-Panjal Tunnel, Railway Line project, J&K	1,730
Uri-II Hydroelectric Project, J&K	5,750
Chamera Hydroelectric Project, Himachal Pradesh	5,049
Teesta Low Dam Hydroelectric, West Bengal	3,959
Sawalkote Hydroelectric Project, J&K	19,406
Kalol Mehsana Gas Pipeline Project, Gujarat	550

Source: Company

Increased focus on Real Estate as a business segment

Realty development is emerging as a key business vertical for HCC, and the company is seeking opportunities in township development through Hincon Realty Ltd., its 100% subsidiary. HCC plans to foray into construction of large integrated townships targeting middle and upper-middle class income households.

☞ **Lavasa – HCC's stake increased to 60%:** Post recent rights issue of Rs320m by Lavasa Corp, Hincon Realty's stake has increased to 60.47%, as the private developers did not participate in the rights issue.

LAVASA: REVISED SHAREHOLDING PATTERN (%)

	ORIGINAL	MAR-06
HCC and Associates	50.0	60.5
BILT and Associates	12.5	15.6
Venkateshwara Hatcheries	12.5	12.5
Private Developers	25.0	11.9

Source: Company

Lavasa Corporation is developing a 10,000 acre integrated township in Warasgaon, situated between the cities of Pune and Mumbai. Currently, the infrastructure works, including access roads, internal roads, promenades, bridges, weirs, hotel, town hall, buildings, bungalows and utilities are in progress. In our recent meeting, the management stated that Phase 1 of residential bookings (110 plots of 0.75-0.25 acres) have been sold out in 3 months at ~Rs4.0-4.5m/acre. Further, given the surge in real estate prices in Pune

over the past 6-9 months, the management is much more confident on the success of Lavasa, which is a 40 minute drive from Hinjewadi (IT Park in Pune).

☞ **Land at Vikhroli:** HCC has also transferred development rights for 9 acres of land at Vikhroli (West), Mumbai to Hincon Realty and booked capital gains of Rs400m in FY06. The company is exploring various development options like construction of an IT park, shopping mall, etc.

☞ **Integrated townships:** HCC intends to focus on large integrated townships (100-500 acres) targeting middle and upper middle income group households, and has identified outskirts of cities such as Thane, Pune, Nashik and Mumbai in the Western region as potential development locations.

Financial performance and ratio analysis

During FY06, HCC reported revenues of Rs19.9b (up 33.6% YoY), EBITDA of Rs1.8b (up 17.3% YoY) and pre-exceptional net profit of Rs844m (up 28.3% YoY). The reported net profit is adjusted for profit on sale of investments of Rs58m, writeback of excess tax provision of Rs53m and transfer of development rights to Hincon Realty of Rs400m (post-tax Rs328m).

COST ANALYSIS (RS M)

Y/E MARCH	FY03	FY04	FY05	FY06
Sales (Net of Excise)	6,772	10,579	14,873	19,870
Construction Expenses	4,604	7,871	11,814	16,011
<i>% of Net Sales</i>	<i>68.0</i>	<i>74.4</i>	<i>79.4</i>	<i>80.6</i>
Office and Site Est. Exp.	374	507	546	716
<i>% of Net Sales</i>	<i>5.5</i>	<i>4.8</i>	<i>3.7</i>	<i>3.6</i>
Employee Expenses	610	768	954	1,314
<i>% of Net Sales</i>	<i>9.0</i>	<i>7.3</i>	<i>6.4</i>	<i>6.6</i>
EBITDA	1,183	1,433	1,559	1,829
EBITDA Margin (%)	17.5	13.5	10.5	9.2

Source: Company/Motilal Oswal Securities

☞ **Construction expenses** as percentage of revenues increased to 80.6% in FY06 v/s 79.4% in FY05, largely a result of the shift in revenue composition towards irrigation and road projects, which entail significantly higher material consumption.

- ✎ **Staff cost** as a percentage of revenues was largely stagnant at 3.6% in FY06 v/s 3.7% in FY05. Number of employees has increased 70% in FY06, and thus going forward we expect increased quantum.
- ✎ **EBITDA margins** declined to 9.2% in FY06, v/s 10.5% in FY05 and also 17.5% in FY03, largely a result of the change in composition of revenue mix towards water and irrigation projects. We notice that a large percentage of the incremental new orders are from the power segment, which entail comparatively better margins. Further, during FY07, we expect several large projects to cross the threshold limit for margin recognition, as HCC accounts for margins post 10% completion (Percentage Completion Method). Thus, we believe that EBITDA margins for HCC have bottomed in FY06, and should improve from FY07.

BALANCE SHEET ANALYSIS (RS M)

Y/E MARCH	FY03	FY04	FY05	FY06
Net Worth	1,395	1,639	3,530	8,898
Borrowings	3,766	4,195	4,257	12,978
Gearing (x)	2.7	2.6	1.2	1.5
Fixed Assets (Gross)	4,891	5,482	6,208	7,728
Work-In-Progress	356	86	478	1,074
Cash & Bank Balance	366	407	875	10,060
Inventory	4,367	5,213	5,833	10,987
Inventory (Days)	235	180	143	202
Creditors	1,603	2,388	4,039	5,910
Creditors (Days)	127	111	125	135

Source: Company/Motilal Oswal Securities

- ✎ **Increase in net worth:** HCC's net worth as at March 2006 stands at Rs8.9b, up from Rs3.5b in March 2005. This has increased the bidding capacity of the company significantly, and would now enable the company to bid for large projects independently. For instance, NHA cash contracts stipulate that: 'Average three years net worth of all the consortium partners put together should be at least 25% of the project cost'.
- ✎ **Increased gearing:** HCC has witnessed a significant increase in debt funds to Rs13b in FY06, up from Rs4.3b in FY05. This is due to Rs4.5b (v/s nil) FCCB issue in March 2006 and increase in short term borrowings of Rs3.5b. Advances from customers (interest bearing) have also increased to Rs1b in March 2006 v/s Rs641m

in March 2005. We believe that a part of the GDR and FCCB proceeds (combined Rs8.8b) would be used to repay debt, which would bring down gearing.

- ✎ **Significant increase in capex:** During FY06, HCC's capex stood at Rs2.1b, up 89% YoY, largely a result of equipment purchases. This is broadly in line with order book growth of 80% YoY to Rs96.7b in March 2006. During FY07, the Annual Report states that the capital commitment is Rs2.3b.
- ✎ **Increase in cash and bank balance:** Cash and bank balance has increased to Rs10b in FY06 v/s Rs875m in FY05. This increase is again a direct result of the Rs8.8b raised through international issue in March 2006.
- ✎ **Increase in inventory days:** Inventory days in FY06 increased to 202 v/s FY05 at 143 days. Inventory largely comprises: (a) stores and spares; (b) work in progress; and (c) site mobilization expense. We believe that the increase in inventory is largely a result of the higher site mobilization expense, given that HCC witnessed order intake of Rs29b in 2QFY06 (work on these projects should have commenced in 4QFY06). During FY07, we expect this number to decline.
- ✎ **Negative cash flow from operations:** During FY06, the cash from operations stood at negative Rs1.7b v/s positive Rs2.2b in FY05. This is largely a result of the increase in inventory to Rs11.0b in FY06, up from Rs5.8b in FY05. We expect inventory levels to decline in FY07, as the company starts revenue recognition from these projects, and thus expect positive cash flow from operations in FY07.

Recommend Buy

We expect HCC to report net profit of Rs2b for FY07 (up 138%) and Rs2.6b for FY08, respectively. Based on SOTP, we value the core business of HCC at Rs135/share (14x P/E), Lavasa project at Rs33/share and investments at Rs25/share (at book value) and arrive at a target price of Rs193/share. At CMP of Rs125, the stock quotes at reported PER of 17x FY07E and 13x FY08E. Adjusting for value of real estate, subsidiaries and investments, it quotes at PER of 9.1x FY07 and 6.9x FY08E. Maintain **Buy**, with SOTP-based price target of Rs193/share.

INCOME STATEMENT		(RS MILLION)				
Y/E MARCH	2004	2005	2006	2007E	2008E	
Net Sales	10,579	14,873	19,870	29,580	40,000	
Change (%)	56.2	40.6	33.6	48.9	35.2	
Construction Expenses	7,871	11,814	16,011	23,985	32,434	
Staff Cost	768	954	1,314	1,860	2,390	
Office and Site Estab. Exps	507	546	716	768	1,154	
EBITDA	1,433	1,559	1,829	2,967	4,022	
% of Net Sales	13.5	10.5	9.2	10.0	10.1	
Depreciation	438	453	524	656	759	
Interest	376	395	414	107	291	
Other Income	17	56	461	47	47	
Share of Turnover in JV	-32	-17	31	70	90	
PBT	605	750	1,383	2,322	3,109	
Tax	248	10	135	270	423	
Rate (%)	41.0	1.3	9.7	11.6	13.6	
Reported PAT	357	740	1,248	2,051	2,686	
EO Income (Net of Exp.)	0	82	404	43	43	
Adjusted PAT	357	658	844	2,008	2,643	
Change (%)	46.9	84.3	28.3	138.0	31.6	

BALANCE SHEET		(RS MILLION)				
Y/E MARCH	2004	2005	2006	2007E	2008E	
Share Capital	200	229	256	274	274	
Reserves	1,439	3,300	8,642	14,789	17,006	
Net Worth	1,639	3,530	8,898	15,064	17,281	
Loans	4,195	4,257	12,978	7,461	9,000	
Deffered Tax Liability	748	725	677	677	677	
Capital Employed	6,583	8,511	22,554	23,202	26,958	
Gross Fixed Assets	5,482	6,208	7,728	9,502	11,002	
Less: Depreciation	1,874	2,305	2,807	3,463	4,222	
Net Fixed Assets	3,609	3,903	4,921	6,039	6,780	
Capital WIP	86	478	1,074	800	800	
Investments	486	1,899	1,265	4,745	8,245	
Curr. Assets	6,321	7,721	23,067	22,647	25,817	
Inventory	5,213	5,833	10,987	12,156	16,438	
Debtors	13	31	28	42	56	
Cash & Bank Balance	407	875	10,060	8,077	6,756	
Loans & Advances	684	982	1,991	2,371	2,565	
Other Current Assets	4	0	1	1	1	
Current Liab. & Prov.	3,918	5,489	7,773	11,030	14,684	
Creditors	2,388	4,039	5,910	8,871	11,996	
Other Liabilities	1,308	1,167	1,491	1,600	1,850	
Provisions	223	283	372	559	838	
Net Current Assets	2,403	2,232	15,294	11,617	11,133	
Application of Funds	6,583	8,511	22,554	23,202	26,958	

E: MOST Estimates

RATIOS						
Y/E MARCH	2004	2005	2006	2007E	2008E	
Basic (Rs)						
Adjusted EPS	1.8	2.9	3.3	7.3	9.6	
Growth (%)	46.9	61.0	14.7	122.4	31.6	
Cash EPS	4.0	4.8	5.3	9.7	12.4	
Book Value	8.2	15.4	34.7	54.9	63.0	
DPS	0.5	0.6	0.7	1.1	1.5	
Payout (incl. Div. Tax.)	31.7	21.2	16.4	16.8	17.5	
Valuation (x)						
P/E (standalone)		43.5	37.9	17.0	13.0	
Cash P/E		25.8	23.4	12.8	10.1	
EV/EBITDA		20.5	19.1	11.3	9.1	
EV/Sales		2.2	1.8	1.1	0.9	
Price/Book Value		8.1	3.6	2.3	2.0	
Dividend Yield (%)		0.5	0.6	0.9	1.2	
Profitability Ratios (%)						
RoE	23.5	25.5	13.6	16.8	16.3	
RoCE	16.4	15.4	11.4	10.3	13.2	
Turnover Ratios						
Debtors (Days)	0	1	1	1	1	
Inventory (Days)	180	143	202	150	150	
Creditors. (Days)	111	125	135	135	135	
Asset Turnover (x)	1.7	2.0	1.3	1.3	1.6	
Leverage Ratio						
Debt/Equity (x)	2.6	1.2	1.5	0.5	0.5	

CASH FLOW STATEMENT		(RS MILLION)				
Y/E MARCH	2004	2005	2006	2007E	2008E	
PBT before EOItems	605	750	1,383	2,322	3,109	
Add: Depreciation	438	453	524	656	759	
Interest	376	395	414	107	291	
Less: Direct Taxes Paid	248	10	135	270	423	
(Inc)/Dec in WC	-503	639	-3,877	1,694	-837	
CF from Operations	667	2,226	-1,691	4,508	2,899	
(Inc)/Dec in FA	-550	-1,139	-2,139	-1,500	-1,500	
(Pur)/Sale of Investments	-174	-1,413	634	-3,481	-3,500	
CF from Investments	-724	-2,552	-1,504	-4,981	-5,000	
(Inc)/Dec in Networth	157	1,284	4,278	4,458	0	
(Inc)/Dec in Debt	430	61	8,722	-5,518	1,539	
Less: Interest Paid	376	395	414	107	291	
Dividend Paid	113	157	205	344	469	
CF from Fin. Activity	98	794	12,381	-1,510	779	
Inc/Dec of Cash	41	468	9,186	-1,983	-1,321	
Add: Beginning Balance	366	407	875	10,060	8,077	
Closing Balance	407	875	10,060	8,077	6,756	



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Disclosure of Interest Statement	Hindustan Construction
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No

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