



Hindustan Construction

STOCK INFO.	BLOOMBERG
BSE Sensex: 12,724	HCC IN
	REUTERS CODE
S&P CNX: 3,678	HCNS.BO

19 October 2006

Buy

Previous Recommendation: Buy

Rs123

Equity Shares (m)	274.3
52-Week Range	196/56
1,6,12 Rel. Perf. (%)	12/-36/-24
M.Cap. (Rs b)	33.7
M.Cap. (US\$ b)	0.7

YEAR	NET SALES	PAT	EPS *	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
3/06A	19,870	844	3.3	14.7	37.4	3.5	13.6	11.4	1.8	20.0
3/07E	27,162	1,466	5.3	62.3	23.0	2.3	12.5	8.9	1.3	13.7
3/08E	36,500	2,007	7.3	36.9	16.8	2.1	13.2	11.7	1.1	10.8

* Fully diluted

- Revenue growth, EBITDA margins surprise positively:** During 2QFY07, HCC reported revenues of Rs4.2b (up 39.1% YoY), EBITDA of Rs395m (up 53.3% YoY), and net profit of Rs42m (up 45.3% YoY). EBITDA margins improved 87bp to 9.4% during 2QFY07, better than our expectations of 6.9%. Interest cost was higher at Rs158m (v/s estimates of Rs20m) and net profit stood at Rs42m (lower than estimate Rs89m).
- Robust order backlog, increased share of power sector:** During 2QFY07, the order booking was Rs10.4b while order backlog stood at Rs98b, up from Rs79b during September 2005. The company has also emerged as L1 in projects of Rs10b. Power sector (hydro and nuclear) now accounts for 47% of the order book v/s 38% at March 2006 and 21% at September 2005. EBITDA margins in power segment stand at 15%+, compared with ~8-12% for roads, irrigation, etc.
- Considerable progress on real estate front:** (a) To commence construction of IT park (2m sq.ft.) at Vikhroli, Mumbai by end-Nov 2006; (b) contracted 450 acres (on the outskirts of Mumbai and Navi Mumbai) for township development and targeted total acreage of 1,000 acres by June 2007; and (c) undertaking slum rehabilitation for 25 acres, entailing development of 2m sq.ft. It has tied up another 2,500 acres at Lavasa, (total 12,500 acres now).
- Revising earnings estimates, Maintain Buy:** We downgrade earnings estimates for FY07 to Rs1.5b (down 5%) and for FY08 to Rs2.0b (down 3%), to factor in higher-than-expected interest cost. We upgrade our price target to Rs132/sh (from Rs126/sh) to factor in higher investments in real estate projects. At CMP of Rs123/sh, HCC trades at PER of 23x FY07E and 16.8x FY08E. Adjusted for the value of real estate (Rs44/sh), the stock trades at 15x FY07 and 11x FY08.

QUARTERLY PERFORMANCE

									(Rs Million)	
	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Sales	4,610	3,022	4,557	7,681	5,743	4,203	6,004	11,219	19,870	27,162
Change (%)	30.9	12.8	28.4	50.4	24.6	39.1	31.8	46.1	34.0	36.7
EBITDA	409	258	486	675	461	395	571	1,244	1,829	2,662
Change (%)	-4.2	10.7	20.5	40.9	12.8	53.3	17.5	84.2	17.3	45.6
As of % Sales	8.9	8.5	10.7	8.8	8.0	9.4	9.5	11.1	9.2	9.3
Depreciation	118	129	130	147	161	186	188	189	524	725
Interest	83	120	126	85	74	158	85	98	414	415
Other Income	35	29	9	8	62	10	10	52	61	134
Extra-ordinary income	0	400	1	12	0	0	0	0	431	0
PBT	243	437	239	463	288	61	308	1,008	1,383	1,656
Tax	16	81	12	25	36	19	31	104	135	190
Effective Tax Rate (%)	6.7	18.5	5.2	5.4	12.6	31.5	10.1	10.3	9.7	11.5
Reported PAT	227	357	227	438	251	42	277	904	1,248	1,466
Adj PAT	227	29	226	426	251	42	277	904	817	1,466
Change (%)	71.5	131.3	106.3	5.9	10.9	45.3	22.3	112.2	21.4	79.3

E: M0St Estimates

2QFY07: Revenue growth and EBITDA margins surprise positively

During 2QFY07 HCC reported revenues of Rs4.2b (up 39.1% YoY), EBITDA of Rs395m (up 53.3% YoY), and net profit of Rs42m (up 45.3% YoY). EBITDA margins improved 87bp to 9.4%, better than our expectations of 6.9%. While revenues have also been better than our estimates (Rs3.8b), interest cost was higher at Rs158m (v/s estimates of Rs20m) and net profit stood at Rs42m (lower than our estimate of Rs89m). This quarter has traditionally been a weak quarter for HCC, given slowdown in construction activity due to monsoons.

Robust order backlog, power sector gains share

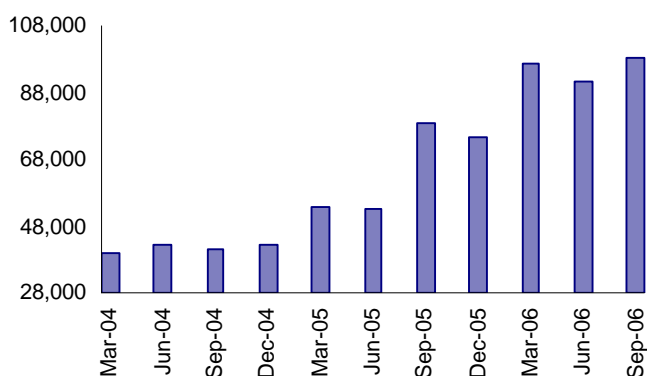
Order book during September 2006 stood at Rs98.2b, up from Rs79b during September 2005. The power sector (hydro and nuclear) now accounts for 47% of the order book v/s 38% as of March 2006 and 21% as at September 2005. EBITDA margins for the power segment stand at 15%+, compared with ~8%-12% for roads, irrigation etc. The company has emerged as L1 in projects of Rs10b. Order intake during 2QFY07 stood at Rs10.4b.

ORDER BOOK COMPOSITION (%)

	SEP-06	MAR-06	SEP-05
Power (Hydro and Nuclear)	47	38	12
Transportation	38	43	44
Water Supply/Irrigation	11	15	35
Others	4	4	9

Source: Company

TREND IN QUARTERLY ORDER BACKLOG (RS M)



Source: Company

Interest cost has been higher than estimates

Interest cost (net of interest income) increased to Rs158m during 2QFY07, from Rs74m in 1QFY07, as cash on book declined to Rs3.5b as at September 2006, from Rs10b as at March 2006. The key fund utilization has been: equipment Rs2b, working capital Rs2b, new projects (towards mobilization) Rs2b and real estate Rs500m. HCC has not taken mobilization advances from customers (current eligibility ~Rs7b), which carry interest rates of 10.5%-11.0%. During 2HFY07 we believe that cash flow should improve as projects which are under mobilization phase currently, would enter the construction phase. This would result in receipts from customers against invoices raised.

FUND UTILIZATION (RS B)

	1HFY07
Equipments	2.0
Working Capital	2.0
New Projects (Towards Mobilization)	2.0
Real Estate	0.5

Source: Company

Bandra-Worli Sealink project: continues to be drag on margins

During 2QFY07, HCC incurred losses of Rs150m on the project, compared with Rs100m-120m during 1QFY07. This has led to EBITDA margin being impacted up to 270bp during 1HFY07. This is because while expenses were accounted for in totality, revenues are booked based on the original cost of the project. Management indicated that they expect the 'engineers certificate' and notification on the revised project cost (Rs6.3b, v/s original Rs4.3b) during FY07, or early FY08. Until date, the company has booked cumulative revenues of Rs2.0b on this project, and incurred a cost of Rs3.6b, thus incurring cumulative underrecovery of Rs1.7b (loss in the P/L account). Management also seemed hopeful of recovering a part of this amount going forward. They reiterated that the project is scheduled to be completed by March/April 2008.

BANDRA-WORLI SEALINK: REVISED COST (RS M)

Original Project Cost	4,300
Escalations, Based on Index	1,000
Variations to Original Work Scope	900
Revised Project Cost	6,300

Source: Company/ Motilal Oswal Securities

Since FY03, HCC has reported cumulative revenues of Rs52b, and the cumulative losses booked on Bandra-Worli Sealink project is Rs1.7b. This entails an EBITDA margin impact of 290bp over the past four years from this project. An early notification on the revised project cost will enable the company to curtail losses going forward, and also recover a part of the cumulative underrecoveries of Rs1.5b.

BOT projects

HCC has emerged as L1 in the annuity road project for the stretch of 30km, costing Rs2.7b, in Andhra Pradesh. The concession period is 20 years (includes construction period of two years). The semi-annual annuity receipt is Rs238.5m, and expected ROE is 15%. HCC has also submitted bids for two more road projects on BOT basis. Apart from annuity projects in the road sector, HCC is also bidding for BOT projects in power, and has targeted US\$50m as investments in this sector. The company is already looking at hydropower projects in Uttar Pradesh, Uttaranchal etc.

Expect robust FY08 performance, while FY07 could be subdued

We expect FY07 performance to be subdued as:

- ⌘ 18 of total 35 projects (~ 55%-60% of order book in value terms) as at September 2006 are in the mobilization stage, resulting in no revenue bookings on these projects, and
- ⌘ Higher share of revenue bookings in FY07 accruing from transportation and irrigation segments, which entail comparatively lower margins compared with hydro projects.

During FY08, we expect both revenues and EBITDA margins to positively surprise us: on the back of:

- ⌘ Strong revenue growth, as 18 of total 35 projects (~55%-60% of order book in value terms) which are in the mobilization stage, would reach the revenue recognition stage over the next 6-9 months
- ⌘ EBITDA margin improvement will be driven by: (1) higher contribution from the high-margin power segment, which accounted for 20% of revenues in FY06, while the share in current order book stands at

47% (up from 12% in September 2005); (2) projects reaching the margin recognition threshold (AS7 - 10%); and (3) reduced losses (as % of revenues) from Bandra-Worli Sealink project.

Considerable progress on real estate front

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. Management has indicated its aim to be amongst the Top 10 real estate developers in the country.

- ⌘ **Update on Lavasa:** HCC has tied up for additional 2,500 acres increasing the total area under development to 12,500 acres. It has already spent Rs4.5b on the project until date, of which HCC's equity contribution (60% stake) is Rs700m. Total cost to FY09 is estimated to be Rs10b; a significant part of this would be financed through debt. Post this investment, the project is expected to achieve self sustenance in terms of financing structure, resulting in limited equity contribution. Also, HCC plans to induct investors at three levels: specialty segments (e.g. hospitality etc.), infrastructure (e.g. power, water, sewage etc.) and a strategic investor in Lavasa Corp., which would reduce the funding requirement on HCC's books.
- ⌘ **Development of Vikhroli land (IT park):** HCC is likely to commence construction of the IT park (2m sq.ft.) at its Vikhroli land, Mumbai by end-November 2006. The estimated project cost is estimated at Rs5b which would be financed through debt and bank guarantees. The management indicated that expected rentals from the property are estimated at Rs1b p.a.
- ⌘ **Other land banks:** HCC intends to focus on large integrated townships (100-500 acres) targeting middle and upper middle income group households, and has identified the outskirts of metros such as Thane, Pune, Nashik and Mumbai, in the western region, as potential development locations. Management expects to have a land bank of 1,000 acres by June 2007. The acquisition is to be financed through equity infusion of Rs1.5b-2b in Hincon Realty, and the balance would be raised through debt. As at September06, the company had

already contracted for 450 acres (on the outskirts of Mumbai and Navi Mumbai) for township development. The company is also working on slum rehabilitation projects over 25 acres, entailing development of 2m sq.ft.

HCC has achieved considerable progress on the real estate front both on Lavasa and its other real estate forays. This we believe would contribute significantly to its growth in future.

Downgrading earnings to factor in higher interest cost, maintain Buy

We are downgrading our earnings estimates for FY07 (by 5%) and for FY08 (by 3%), to factor in the higher-than-expected net interest expenditure. Thus, we now expect HCC to report net profit of Rs1.5b in FY07, Rs2b in FY08 and Rs2.4b in FY09. The management has indicated that they expect notification of the revised Bandra-Worli Sealink project cost by end-FY07, and if so, which we also believe is possible, there would be upgrades. We upgrade our price target to Rs132/sh, from Rs126/sh to factor in the higher investments in real estate projects. At CMP of Rs123/sh, HCC trades at PER of 23x FY07E and 16.8x FY08E. Adjusted for the value of real estate (Rs44/sh), the stock trades at 15x FY07 and 11x FY08.

L&T: SUM OF PARTS VALUE

	BUSINESS SEGMENT	METHOD	VALUATION (X)	VALUE (RS M)	VALUE (RS/SH)	RATIONALE
HCC Standalone	Construction	FY08E PER (x)	12	24,086	88	Premium to industry average
Hincon Realty (100% subsidiary)						
Lavasa Project	Township	Land Value (Rs m/acre)	3.5	6,349	23	Out of 8,000 acres of land, 3,000 acres will be developed. Recent transactions by Lavasa was at Rs2-4.5m/acre (land sale)
Hincon Realty	Real Estate	NPV of expected rentals		3,000	11	Based on NPV of expected rentals from office space
Investments (at book value)				2,703	10	At Book Value
Total				36,139	132	

Source: Company/ Motilal Oswal Securities

Hindustan Construction: an investment profile

Established in 1926 by the Walchand Hirachand group, HCC is one of the oldest and largest construction companies in India with pre-qualification skills and proven execution capabilities across sectors like power, roads, bridges, ports, water irrigation and supply, urban infrastructure and pipelines. HCC specializes in the construction of technologically complex and long-gestation period projects. The company has successfully and gradually transformed from a civil engineering contractor to an integrated EPC executor.

Key investment arguments

- ✍ Possesses pre-qualifications and proven execution capabilities across sectors; will benefit from large ticket sized orders in hydro and nuclear sectors
- ✍ Has the youngest fleet of specialized equipments, skilled manpower, in-house fabrication facility and EPC execution capabilities
- ✍ Lavasa project could be value accretive, and 10% increase in FSI can enhance shareholder returns by 100%.

Key investment risks

- ✍ Focus on key large projects increases the project specific risks
- ✍ Retention of experienced manpower is a challenge

COMPARATIVE VALUATIONS

		HIND.CON.	NCC	GAMMON
P/E (x)	FY07E	23.0	19.6	28.2
	FY08E	16.8	12.6	18.7
P/BV (x)	FY07E	2.3	1.7	3.3
	FY08E	2.1	1.4	2.8
RoE (%)	FY07E	12.5	18.2	11.5
	FY08E	13.2	24.0	15.2

SHAREHOLDING PATTERN (%)

	SEP.06	JUN.06	SEP.05
Promoter	47.0	46.9	52.4
Domestic Inst	20.5	12.1	12.1
Foreign	12.2	21.9	14.8
Others	20.3	19.1	20.7

Recent developments

- ✍ Significant ramp on Real Estate front, Tied up additional 2,500 acre at Lavasa, Commencement of work on IT Park at Vikhroli by November and working on other Slum Rehabilitation projects.
- ✍ Along with consortium partners, HCC is developing the 1200MW Sawalakote hydel power plant in Jammu and Kashmir.

Valuations and view

- ✍ At CMP of Rs123/sh, HCC trades at PER of 23x FY07E and 16.8x FY08E. Adjusted for the value of real estate (Rs44/sh), the stock trades at 15x FY07 and 11x FY08.

Sector view

- ✍ Increased government commitment towards infrastructure projects has led to several large projects taking off the ground
- ✍ We notice a trend of margin expansion, driven by changing composition of order book and higher margins at bidding stage

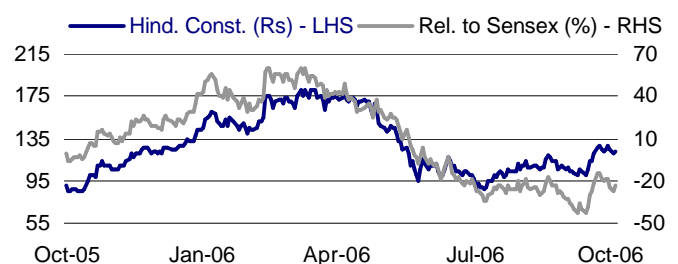
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	5.3	4.6	15.3
FY08	7.3	6.9	5.7

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
123	132	7.3	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT (Rs Million)

Y/E MARCH	2005	2006	2007E	2008E	2009E
Net Sales	14,873	19,870	27,162	36,500	48,700
Change (%)	40.6	33.6	36.7	34.4	33.4
Construction Expenses	11,814	16,011	22,024	29,596	39,879
Staff Cost	954	1,314	1,708	2,180	2,766
Office and Site Establishment E	546	716	768	1,154	1,304
EBITDA	1,559	1,829	2,662	3,569	4,752
% of Net Sales	10.5	9.2	9.8	9.8	9.8
Depreciation	453	524	725	828	1,008
Interest	395	414	415	576	899
Other Income	56	461	64	64	64
Share of turnover in JV	-17	31	70	90	90
PBT	750	1,383	1,656	2,319	2,999
Tax	10	135	190	312	582
Rate (%)	1.3	9.7	11.5	13.5	19.4
Reported PAT	740	1,248	1,466	2,007	2,417
Extra-ordinary Income (net of ex)	82	404	0	0	0
Adjusted PAT	658	844	1,466	2,007	2,417
Change (%)	84.3	28.3	73.7	36.9	20.4

BALANCE SHEET (Rs Million)

Y/E MARCH	2005	2006	2007E	2008E	2009E
Share Capital	229	256	274	274	274
Reserves	3,300	8,642	14,204	15,742	17,377
Net Worth	3,530	8,898	14,478	16,016	17,651
Loans	4,257	12,978	7,338	8,822	10,954
Deferred Tax Liability	725	677	677	677	677
Capital Employed	8,511	22,554	22,493	25,516	29,282
Gross Fixed Assets	6,208	7,728	10,502	12,002	14,002
Less: Depreciation	2,305	2,807	3,532	4,360	5,368
Net Fixed Assets	3,903	4,921	6,970	7,642	8,634
Capital WIP	478	1,074	800	800	800
Investments	1,899	1,265	4,745	8,245	10,245
Curr. Assets	7,721	23,067	20,282	22,463	27,233
Inventory	5,833	10,987	13,395	16,000	21,348
Debtors	31	28	38	52	69
Cash & Bank Balance	875	10,060	4,671	4,070	2,692
Loans & Advances	982	1,991	2,177	2,341	3,123
Other Current Assets	0	1	1	1	1
Current Liab. & Prov.	5,489	7,773	10,305	13,635	17,629
Creditors	4,039	5,910	8,146	10,947	14,750
Other Liabilities	1,167	1,491	1,600	1,850	2,000
Provisions	283	372	559	838	880
Net Current Assets	2,232	15,294	9,978	8,828	9,603
Application of Funds	8,511	22,554	22,493	25,516	29,282

E: MOST Estimates

RATIOS

Y/E MARCH	2005	2006	2007E	2008E	2009E
Basic (Rs)					
Adjusted EPS	2.9	3.3	5.3	7.3	8.8
Growth (%)	61.0	14.7	62.3	36.9	20.4
Cash EPS	4.8	5.3	8.0	10.3	12.5
Book Value	15.4	34.7	52.8	58.4	64.4
DPS	0.6	0.7	1.1	1.5	2.5
Payout (incl. Div. Tax.)	212	16.4	23.5	23.4	32.3
Valuation (x)					
P/E (standalone)	42.9	37.4	23.0	16.8	14.0
Cash P/E	25.4	23.0	15.4	11.9	9.8
EV/EBITDA	23.8	20.0	13.7	10.8	8.8
EV/Sales	2.5	1.8	1.3	1.1	0.9
Price/Book Value	8.0	3.5	2.3	2.1	1.9
Dividend Yield (%)	0.5	0.6	0.9	1.2	2.0
Profitability Ratios (%)					
RoE	25.5	13.6	12.5	13.2	14.4
RoCE	15.4	11.4	8.9	11.7	13.9
Turnover Ratios					
Debtors (Days)	1	1	1	1	1
Inventory (Days)	143	202	180	160	160
Creditors (Days)	125	135	135	135	135
Asset Turnover (x)	2.0	1.3	1.2	1.5	1.8
Leverage Ratio					
Debt/Equity (x)	1.2	1.5	0.5	0.6	0.6

CASH FLOW STATEMENT (Rs Million)

Y/E MARCH	2005	2006	2007E	2008E	2009E
PBT before Extraordinary Items	750	1,383	1,656	2,319	2,999
Add : Depreciation	453	524	725	828	1,008
Interest	395	414	415	576	899
Less : Direct Taxes Paid	10	135	190	312	582
(Inc)/Dec in WC	639	-3,877	-73	548	-2,153
CF from Operations	2,226	-1,691	2,533	3,959	2,172
(Inc)/Dec in FA	-1,139	-2,139	-2,500	-1,500	-2,000
(Pur)/Sale of Investments	-1,413	634	-3,481	-3,500	-2,000
CF from Investments	-2,552	-1,504	-5,981	-5,000	-4,000
(Inc)/Dec in Networth	1,284	4,278	4,458	0	0
(Inc)/Dec in Debt	61	8,722	-5,641	1,484	2,132
Less : Interest Paid	395	414	415	576	899
Dividend Paid	157	205	344	469	782
CF from Fin. Activity	794	12,381	-1,942	440	451
Inc/Dec of Cash	468	9,186	-5,389	-601	-1,378
Add: Beginning Balance	407	875	10,060	4,671	4,070
Closing Balance	875	10,060	4,671	4,070	2,692

E: MOST Estimates

N O T E S

For more copies or other information, contact

Institutional: Navin Agarwal. **Retail:** Manish Shah, Mihir Kothari

Phone: (91-22) 39825500 Fax: (91-22) 22885038. E-mail: inquire@motilaloswal.com

Motilal Oswal Securities Ltd, 3rd Floor, Hoechst House, Nariman Point, Mumbai 400 021

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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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