

PATEL ENGINEERING

INR 350

Branching out

REDUCE



Patel Engineering's (PEC's) Q4FY07 and FY07 results were ahead of our expectations. Revenues in Q4FY07 grew 32% Y-o-Y and 82% Q-o-Q to INR 4 bn. Operating profits (EBIT) grew 86% Y-o-Y and 10% Q-o-Q to INR 384 mn. Operating margins dipped sequentially to 9.7% from 16% in Q3FY07, but grew Y-o-Y from 6.9% in Q4FY06. Net earnings grew 60% Y-o-Y and 16% Q-o-Q to INR 340 mn. Net margins are at 8.6% in Q4FY07 vis-à-vis 7% in Q4FY06 and 13.4% in Q3FY07. The impact on taxation due to withdrawal of benefits u/s 80IA has not come in FY07, as the matter is still under arbitration. We expect this impact to come in FY08E, which is likely to result in higher tax provisioning.

Revenues in FY07 grew 37% Y-o-Y to INR 11 bn, with operating and net margins at 11.2% and 9.8% in FY07 vis-à-vis 10.2% and 9% in FY06, respectively. Consolidated revenues grew 31% Y-o-Y to INR 13 bn, with operating and net margins at 10.6% and 8.3% in FY07 vis-à-vis 9.2% and 7.2% in FY06, respectively. The full impact of the expected scale down in the US subsidiary operations has not come through in FY07. We believe this impact is likely to come in FY08E and expect the contribution to consolidated revenues to reduce to ~10% from the current level of ~17%.

PEC's order backlog at FY07 end stands at INR 50 bn, of which, hydro power projects constitute 55%, irrigation 25%, with the balance 20% coming from the transport segment. We believe PEC's focus on higher margin, higher value hydro power and irrigation projects is likely to continue going forward, thus sustaining its strong margins.

* Current valuation factors in growth potential

We have calibrated our revenue and profitability estimates in line with PEC's FY07 provisional numbers. Based on our consolidated EPS estimate of INR 18.4 and INR 22 (vis-à-vis our previous estimate of INR 17.5 and INR 21), the stock trades at a PE of 19x and 16x for FY08E and FY09E respectively. Our sum-of-the-parts (SOTP) valuation points to a business value of INR 19 bn. We reckon downside risk to current stock price levels and maintain our 'REDUCE' recommendation on the stock.

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Bloomberg : PEC IN

Market Data

52-week range (INR) : 635 / 222
Share in issue (mn) : 60.0
M cap (INR bn/USD mn) : 21.0 / 509.6
Avg. Daily Vol. BSE/NSE ('000) : 191.5

Share Holding Pattern (%)

Promoters : 54.1
MFs, FIs & Banks : 8.9
FIs : 10.5
Others : 26.5

Financials	(INR mn)						
Year to March	Q4FY07	Q4FY06	% change	Q3FY07	% change	FY07UA	FY08E
Revenues-net (INR mn)	3,962	3,014	31.5	2,184	81.5	11,036	13,587
EBITDA (INR mn)	456	270	69.2	419	8.8	1,512	1,915
Net profit (INR mn)	340	212	59.9	292	16.4	1,081	1,075
EPS (INR)	5.7	4.2	34.1	4.9	16.4	18.1	18.0
PE (x)						19.3	19.4
EV/EBITDA (x)						15.2	12.0
ROACE (%)						14.1	13.1

* Re-organising subsidiary operations

PEC is in the process of reorganising its subsidiary operations. It is scaling down its US subsidiary operations for better opportunities in the domestic market. PEC is shifting a large part of its micro tunneling operations carried out by its US subsidiary to India, while maintaining its focus on redevelopment opportunity in the US. We expect the full impact of the scale down in US operations to come in FY08E, which is likely to reduce the subsidiary's contribution to the consolidated revenues to ~10% from ~17% currently.

PEC is in the process of firming up its plans for development of its ~500 acre land bank and has set up a separate subsidiary for undertaking all real estate operations. We however do not expect any significant contribution from PEC's real estate ventures before FY09E and thus have not considered them in our consolidated estimates.

* Calibrating estimates for FY08E and FY09E

We calibrate our estimates for FY08E and FY09E in line with PEC's FY07 provisional numbers. We believe the growth momentum in core operations is intact and expect ~23% growth in revenues, going forward. We believe the impact of withdrawal of benefits u/s 80IA is likely to come in FY08E and have thus kept our tax rate assumptions unchanged. Though the scale down in US operations in FY07 has been slower than previously expected, we believe its contribution to consolidated revenues is likely to reduce further FY08E onwards.

Table 1: Calibrating estimates to factor in growth on augmented base (standalone)

	Pre revision		Post revision		Remarks
	FY08E	FY09E	FY08E	FY09E	
Revenues	13,042	15,954	13,587	16,626	Growth outlook remains intact with revenues likely to grow at ~25%. We expect revenue growth of 23% in FY08E and 22% in FY09E
EBITDA	1,864	2,312	1,915	2,383	} Realigning operating expenses to FY07 levels. Assume a ~50bps improvement in margins going forward over FY07 margin levels
<i>EBITDA margins</i>	<i>14.3</i>	<i>14.5</i>	<i>14.1</i>	<i>14.3</i>	
EBIT	1,474	1,823	1,581	1,965	} Realigning expenses to FY07 levels.
<i>EBIT margins</i>	<i>11.3</i>	<i>11.4</i>	<i>11.6</i>	<i>11.8</i>	
PAT	1,019	1,234	1,075	1,279	} We expect the impact of withdrawal of benefits under Sec 80IA to likely come in FY08E
<i>PAT margins</i>	<i>7.8</i>	<i>7.7</i>	<i>7.9</i>	<i>7.7</i>	
EPS	17.5	20.7	18.0	21.4	

Source: Edelweiss research

Table 2: Realigning estimates to factor in slower subsidiary ramp-down (Consolidated)

	Pre revision		Post revision		Remarks
	FY08E	FY09E	FY08E	FY09E	
Revenues	14,331	17,342	15,097	18,270	The full impact of the expected slowdown in US subsidiary operations is likely to come in FY08E onwards
EBITDA	2,036	2,519	2,115	2,628	Realigning expenses to FY07 levels. Higher margin projects in the US likely to lead to margins expansion
<i>EBITDA margins</i>	<i>14.2</i>	<i>14.5</i>	<i>14.0</i>	<i>14.4</i>	
EBIT	1,576	1,956	1,671	2,093	
<i>EBIT margins</i>	<i>11.0</i>	<i>11.3</i>	<i>11.1</i>	<i>11.5</i>	
PAT	1,045	1,261	1,100	1,315	We expect the impact of withdrawal of benefits under Sec 80IA to likely come in FY08E
<i>PAT margins</i>	<i>7.3</i>	<i>7.3</i>	<i>7.3</i>	<i>7.2</i>	
EPS	17.5	21.1	18.4	22.0	

Source: Edelweiss research

* Current valuation factors in growth potential

Despite the growth momentum in core operations remaining intact and a strong margin outlook, we believe current valuation captures all potential upsides from current as well as potential projects in the construction and real estate space. Based on our SOTP valuation of INR 19 bn, we reckon downside risk to current stock price levels and continue to maintain our 'REDUCE' recommendation on the stock.

Table 3: SOTP valuation

	(INR mn)
Construction business	10,903
Overseas business	1,510
Infrastructure project	738
Real estate	6,250
Total	19,401
Current EV	23,778
<i>Potential upside (%)</i>	<i>(18.4)</i>

Source: Edelweiss research

Table 4: Financials snapshot (Standalone)

(INR mn)

Year to March	Q4FY07	Q4FY06	% change	Q3FY07	% change	FY06	FY07UA	FY08E
Total revenues	3,962	3,014	31.5	2,184	81.5	8,029	11,036	13,587
Direct & staff cost	3,205	2,550	25.7	1,580	102.9	6,516	8,621	10,944
Other expenditure	301	194	55.2	185	62.9	436	904	728
Total expenditure	3,506	2,744	27.8	1,765	98.7	6,952	9,524	11,672
EBITDA	456	270	69.2	419	8.8	1,077	1,512	1,915
Depreciation	72	63	13.5	70	2.1	256	273	334
EBIT	384	207	86.1	349	10.2	821	1,239	1,581
Interest	52	72	(28.7)	24	111.4	200	109	144
Other income	35	101	(65.6)	11	224.7	149	80	111
PBT	368	236	56.0	335	9.7	770	1,210	1,548
Tax	28	23	21.2	44	(35.1)	46	129	474
Reported net profit	340	212	59.9	292	16.4	724	1,081	1,075
Adjusted net profit	340	212	59.9	292	16.4	724	1,081	1,075
Equity capital(FV:INR1)	59.6	50.0	19.2	59.6	0.0	49.6	59.6	59.7
# of shares (mn)	59.6	50.0	19.2	59.6	0.0	49.6	59.6	59.7
EPS (INR)	5.7	4.2	34.1	4.9	16.4	14.6	18.1	18.0
PE (x)						24.0	19.3	19.4
EV/EBITDA (x)						21.3	15.2	12.0
as % of net revenues								
Total expenditure	88.5	91.1	(2.8)	80.8	9.5	86.6	86.3	85.9
EBITDA	11.5	8.9	28.7	19.2	(40.0)	13.4	13.7	14.1
Reported net profit	8.6	7.0	21.6	13.4	(35.8)	9.0	9.8	7.9
Tax rate	7.7	9.9	(22.3)	13.0	(40.9)	6.0	10.6	30.6

Source: Company, Edelweiss research

Company Description

PEC is a prominent player in the hydro and irrigation space. It has the resources and expertise to successfully commission complex projects in all segments of the infrastructure space, either as a developer or a contractor. Its project basket includes tunnels, dams, underground hydroelectric and irrigation projects, water conductor systems, nuclear and thermal power projects, bridges and marine works, highways and residential and commercial complexes. PEC has carved out a niche in underground works in the hydroelectric, transport and urban infrastructure space with its technical expertise in RCC works and micro tunneling.

Investment Theme

PEC is a significant player in the hydro and irrigation space with expertise to undertake projects across the entire infrastructure spectrum. Of the 60,000 MW of power generation capacity like to be added over the next five years, ~20,000 MW are likely to be added through the hydro power segment. The irrigation segment is also expected to see significant growth in order inflows at the state level. To give a perspective, Andhra Pradesh alone is likely to spend ~INR 250 bn on irrigation projects over the next five years. In addition to the strong growth at the macro level, PEC's recent entry in the power generation and real estate space is likely to enable it to sustain its growth momentum. Despite the overall growth momentum remaining intact we believe valuations have topped off. With real estate forming a large part of valuations we believe in the event of faith fledging out of real estate businesses we believe PEC is likely to get severely knocked down as greater importance gets attached to projects on ground rather than in the thinking pot.

Key Risks

We expect competition in the hydro and irrigation space to intensify with a large number of new players in the fray. We believe competitive pressures are likely to cap margin expansions going forward.

PEC's order backlog is spread over four years, leading to a lower order churning rate. We believe the longer gestation order profile of the core construction business is likely to keep cash positions under pressure. Added to this, PEC's recent venture in the owned infrastructure and real estate space is likely to demand upfront investments with returns being back ended. Though PEC currently does not face a cash crunch, we believe further expansions beyond the plans on the table may entail additional fund raising.

Financial Statements (Standalone)

Income statement					(INR mn)
Year to March	FY05	FY06	FY07UA	FY08E	FY09E
Income from operations	5,450	8,029	11,036	13,587	16,626
Direct costs	4,339	6,312	8,621	10,615	13,013
Employee costs	150	205	281	329	382
Other expenses	290	436	622	728	846
Total operating expenses	4,779	6,952	9,524	11,672	14,242
EBITDA	671	1,077	1,512	1,915	2,383
Depreciation and amortisation	210	256	273	334	419
EBIT	462	821	1,239	1,581	1,965
Interest expenses	64	200	109	144	194
Other income	41	149	80	111	72
Profit before tax	438	770	1,210	1,549	1,842
Provision for tax	48	46	129	474	564
Reported profit	390	724	1,081	1,075	1,279
Adjusted net profit	390	724	1,081	1,075	1,279
Shares outstanding	48.6	49.6	59.7	59.7	59.7
Dividend per share	1.0	1.4	1.3	1.4	1.5
Dividend payout (%)	12.5	9.3	7.2	7.8	7.0

Common size metrics- as % of net revenues

Year to March	FY05	FY06	FY07UA	FY08E	FY09E
Operating expenses	87.7	86.6	86.3	85.9	85.7
Depreciation	3.8	3.2	2.5	2.5	2.5
Interest expenditure	1.2	2.5	1.0	1.1	1.2
EBITDA margins	12.3	13.4	13.7	14.1	14.3
Net profit margins	7.1	9.0	9.8	7.9	7.7

Growth metrics (%)

Year to March	FY05	FY06	FY07UA	FY08E	FY09E
Revenues	38.8	47.3	37.5	23.1	22.4
EBITDA	37.8	60.4	40.4	26.7	24.4
PBT	54.8	75.8	57.1	28.0	18.9
Adjusted Net profit*	70.4	85.8	49.3	(0.5)	18.9
Adjusted EPS*	70.4	82.1	24.1	(0.5)	18.9

Cash flow statement					(INR mn)
Year to March	FY05	FY06	FY07E	FY08E	FY09E
Net profit	390	724	1,081	1,075	1,279
Add: Depreciation	210	256	273	334	419
Add: E.O.Adjustments	-	(2)	2	-	-
Add: Deferred tax	13	22	-	-	-
Gross cash flow	613	1,001	1,355	1,409	1,697
Less: Dividends	49	77	89	96	103
Less: Changes in W. C.	394	2,342	2,954	1,686	1,919
Operating cash flow	170	(1,418)	(1,688)	(373)	(324)
Less: Change in investments	205	(114)	-	197	197
Less: Capex	381	104	500	800	1,000
Free cash flow	(416)	(1,408)	(2,188)	(1,370)	(1,521)

* adjusted for marginal tax rate

Balance sheet					(INR mn)
As on 31st March	FY05	FY06	FY07E	FY08E	FY09E
Equity capital	49	50	60	60	60
Reserves & surplus	1,245	1,897	6,692	7,671	8,846
Shareholders funds	1,294	1,947	6,751	7,730	8,906
Secured loans	2,928	3,871	4,002	4,672	5,418
Unsecured loans	129	484	488	531	564
Borrowings	3,057	4,355	4,490	5,203	5,982
Sources of funds	4,351	6,302	11,241	12,933	14,888
Gross block	2,532	2,590	3,136	3,936	4,936
Depreciation	856	863	1,135	1,469	1,888
Net block	1,676	1,727	2,000	2,467	3,048
Capital work in progress	-	46	-	-	-
Total fixed assets	1,676	1,773	2,000	2,467	3,048
Investments	282	168	168	365	561
Inventories	1,428	2,854	4,225	5,201	6,364
Sundry debtors	768	1,022	1,375	1,692	2,071
Cash and equivalents	917	520	2,279	1,622	880
Loans and advances	1,437	2,466	3,279	4,037	4,940
Total current assets	4,551	6,861	11,157	12,552	14,255
Sundry creditors and others	1,978	2,354	1,956	2,321	2,846
Provisions	36	25	6	7	8
Total CL & provisions	2,014	2,379	1,962	2,328	2,854
Net current assets	2,537	4,482	9,195	10,224	11,401
Net deferred tax	(144.1)	(121.8)	(121.8)	(121.8)	(121.8)
Others	-	0	1	-	-
Uses of funds	4,351	6,302	11,241	12,933	14,888
Book value per share (INR)	27	39	113	130	149

Ratios

Year to March	FY05	FY06	FY07E	FY08E	FY09E
ROAE (%)	34.6	44.7	24.9	14.8	15.4
ROACE (%)	12.6	15.4	14.1	13.1	14.1
Current ratio	2.3	2.9	5.7	5.4	5.0
Debtors (days)	51	46	45	45	45
Fixed assets t/o (x)	2.2	3.1	3.5	3.5	3.4
Average working capital t/o (x)	2.7	2.3	1.6	1.4	1.5
Average capital turnover ratio (x)	1.5	1.5	1.3	1.1	1.2
Net debt/ equity	1.4	1.9	0.3	0.4	0.5
Gross debt/equity	2.4	2.2	0.7	0.7	0.7

Valuations parameters

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Basic EPS (INR)	8.0	14.6	18.1	18.0	21.4
Y-o-Y growth (%)	70.4	82.1	24.1	0.5	18.9
Basic CEPS (INR)	12.3	19.8	22.7	23.6	28.5
PE (x)	43.6	24.0	19.3	19.4	16.3
Price/BV(x)	13.1	8.9	3.1	2.7	2.3
EV/Sales (x)	4.2	2.9	2.1	1.7	1.4
EV/EBITDA (x)	34.1	21.3	15.2	12.0	9.6

Financial Statements (Consolidated)

Income statement					(INR mn)
Year to March	FY05	FY06	FY07UA	FY08E	FY09E
Income from operations	7,922	10,148	13,310	15,097	18,270
Direct costs	6,538	7,929	10,356	11,760	14,234
Employee costs	231	353	358	379	436
Other expenses	369	621	800	843	972
Total operating expenses	7,138	8,903	11,515	12,981	15,642
EBITDA	784	1,245	1,795	2,115	2,628
Depreciation and amortisation	266	311	378	445	535
EBIT	518	934	1,417	1,671	2,093
Interest expenses	96	261	193	222	272
Other income	67	135	70	152	98
Profit before tax	489	808	1,294	1,600	1,919
Provision for tax	68	66	145	501	604
PAT before minority interest	421	742	1,149	1,100	1,315
Less: Minority interest	-	9	41	-	-
Profit after tax	421	733	1,109	1,100	1,315
Shares outstanding	49	50	60	60	60
Dividend per share	1.0	1.4	1.3	1.4	1.5
Dividend payout (%)	11.5	9.1	6.7	7.6	6.8

Common size metrics- as % of net revenues

Year to March	FY05	FY06	FY07UA	FY08E	FY09E
Operating expenses	90.1	87.7	86.5	86.0	85.6
Depreciation	3.4	3.1	2.8	2.9	2.9
Interest expenditure	1.2	2.6	1.5	1.5	1.5
EBITDA margins	9.9	12.3	13.5	14.0	14.4
Net profit margins	5.3	7.2	8.3	7.3	7.2

Growth metrics (%)

Year to March	FY05	FY06	FY07UA	FY08E	FY09E
Revenues	1.9	28.1	31.2	13.4	21.0
EBITDA	23.3	58.8	44.2	17.8	24.2
PBT	37.1	65.1	60.2	23.7	19.9
Adjusted Net profit*	47.9	74.0	51.2	(0.8)	19.6
Adjusted EPS*	47.9	70.5	25.7	(0.8)	19.6

Cash flow statement

					(INR mn)
Year to March	FY05	FY06	FY07E	FY08E	FY09E
Net profit	421	742	1,149	1,100	1,315
Add: Depreciation	266	311	378	445	535
Add: E.O.Adjustments	2	(31)	2	-	-
Add: Deferred tax	33	32	10	13	19
Gross cash flow	722	1,054	1,539	1,557	1,869
Less: Dividends	49	77	89	96	103
Less: Changes in W. C.	616	2,164	2,815	1,628	1,961
Operating cash flow	57	(1,187)	(1,365)	(167)	(195)
Less: Change in investments	197	(39)	-	-	-
Less: Capex	311	411	550	2,490	2,690
Free cash flow	(451)	(1,560)	(1,915)	(2,657)	(2,885)

* adjusted for marginal tax rate

Balance sheet					(INR mn)
As on 31st March	FY05	FY06	FY07E	FY08E	FY09E
Equity capital	49	50	60	60	60
Reserves & surplus	1,282	1,957	6,820	7,823	9,035
Minority interest	315	254	254	386	517
Shareholders funds	1,331	2,007	6,879	7,883	9,095
Secured loans	3,833	5,069	5,051	7,032	9,090
Unsecured loans	130	484	488	531	564
Borrowings	3,963	5,553	5,538	7,563	9,654
Sources of funds	5,609	7,814	12,672	15,832	19,266
Gross block	3,209	3,574	4,170	5,020	6,070
Depreciation	1,169	1,190	1,568	2,012	2,547
Net block	2,040	2,384	2,602	3,007	3,523
Capital work in progress	-	46	-	1,640	3,280
Total fixed assets	2,040	2,430	2,602	4,647	6,803
Investments	322	284	284	284	284
Inventories	1,794	3,031	4,536	5,429	6,612
Sundry debtors	1,350	1,714	2,122	2,209	2,634
Cash and equivalents	1,075	722	2,604	2,103	1,440
Loans and advances	1,598	2,569	3,427	4,135	5,047
Total current assets	5,816	8,035	12,689	13,876	15,733
Sundry creditors and others	2,368	2,788	2,764	2,823	3,381
Provisions	36	25	6	7	8
Total CL & provisions	2,405	2,813	2,770	2,830	3,389
Net current assets	3,411	5,222	9,919	11,046	12,344
Net deferred tax	(164.8)	(153.2)	(163.7)	(176.4)	(195.3)
Others	1	32	31	31	31
Uses of funds	5,609	7,814	12,672	15,832	19,266
Book value per share (INR)	27	40	115	132	152

Ratios

Year to March	FY05	FY06	FY07E	FY08E	FY09E
ROAE (%)	36.0	43.9	25.0	14.9	15.5
ROACE (%)	10.7	13.9	13.8	11.7	11.9
Current ratio	2.4	2.9	4.6	4.9	4.6
Debtors (days)	62	62	58	53	53
Fixed assets t/o (x)	2.5	2.8	3.2	3.0	3.0
Average working capital t/o (x)	2.8	2.4	1.8	1.4	1.6
Average capital t/o ratio (x)	1.6	1.5	1.3	1.1	1.0
Net debt/Equity	1.9	2.3	0.4	0.7	0.9
Debt/Equity	3.0	2.8	0.8	1.0	1.1

Valuations parameters

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Basic EPS (INR)	8.7	14.8	18.6	18.4	22.0
Y-o-Y growth (%)	47.9	70.5	25.7	(0.8)	19.6
Basic CEPS (INR)	14.1	21.1	24.9	25.9	31.0
PE (x)	40.4	23.7	18.8	19.0	15.9
Price/BV(x)	12.8	8.6	3.0	2.6	2.3
EV/Sales (x)	3.0	2.3	1.8	1.6	1.3
EV/EBITDA (x)	30.3	19.1	13.2	11.2	9.0

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Ashutosh Goel	- 2286 4287	Automobiles, Auto Components	Shabnam Kapur	- 2286 4394
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Harish Sharma	- 2286 4307	Infrastructure, Auto Components, Mid Caps	Swati Khemani	- 2286 4266
Priyanko Panja	- 2286 4300	Infrastructure, Engineering, Telecom	Neha Shahra	- 2286 4276
Hitesh Zaveri	- 2286 4424	Information Technology	Priya Ramchandran	- 2286 4389
Parul Inamdar	- 2286 4355	Information Technology	Anubhav Kanodia	- 2286 4361
Priyank Singhal	- 2286 4302	Media, Retail	Tushar Mahajan	- 2286 4439
Prakash Kapadia	- 4097 9843	Mid Caps	Harsh Biyani	- 2286 4419
Niraj Mansingka	- 2286 4304	Oil & Gas, Petrochemicals	Nirmal Ajmera	- 2286 4258
Nimish Mehta	- 2286 4295	Pharmaceuticals, Agrochemicals	Ankit Doshi	- 2286 4671
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Yogesh Radke	- 2286 4328	Alternative & Quantitative		

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RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period

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