Godrej Properties – REDUCE

GPL IN	Rs497	Real Estate	31 March 2010	Initiating coverage

Marketing czar

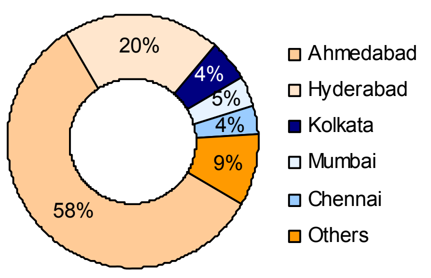
We like Godrej Properties's (GDPL) business model, as joint-development contracts keep upfront capital commitment low, and the company has a established a strong record in identifying attractive land parcels. Furthermore, the Godrej group's brand franchise and a pan-India construction contract with L&T ensure strong demand for its projects. On the other hand, the model's weaknesses are: 1) dependence on joint development partners for all regulatory approvals; 2) continuing negative operating cash flows that increase the likelihood of further equity dilution; and 3) put options offered to private equity investors in some SPVs. GDPL plans to increase its footprint in Mumbai, NCR and Bangalore, and to scale up execution c.10x in the medium term. Trading at 12% premium to our NAV of Rs440/share, the stock is richly valued, in our view. We initiate coverage with REDUCE.

Joint development de-risks business model: GDPL's JD approach has enabled it to tie up significantly more land than it could have in the traditional 'land banking' model. This means the company can walk away from uneconomic projects, without any major financial impact. It has a pan-India construction contract with L&T that affords it attractive pricing and increased credibility on execution.

Key concerns—reliance on JD partners for regulatory approvals, significant cash burn: GDPL is dependent on JD partners for regulatory approvals. Also, it has registered negative operating cash flows of c.Rs8bn over FY07-1HFY10 despite generating surplus from its premium 'Planet Godrej' project in Central Mumbai. The management's aggressive growth plans require further cash infusion in the medium term.

We initiate with REDUCE: Though the Godrej Group owns large tracts of land in the central suburb of Vikhroli, development timelines remain uncertain. Our 1-year forward NAV of Rs440/share indicates 11% downside from current levels. We initiate with REDUCE.

Split of GDPL's interest in saleable area



Financial Summary

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Revenues (Rs m)	2,274	2,053	1,372	5,404	10,607
EBITDA Margins (%)	52.7	34.3	26.3	37.2	45.8
Reported PAT (Rs m)	750	757	749	1,335	3,302
EPS (Rs)	12.4	12.5	10.7	19.1	47.3
Growth (%)	-72.2	0.9	-14.4	78.2	147.3
PER (x)	40.0	39.7	46.3	26.0	10.5
ROE (%)	31.1	25.3	9.1	14.3	26.5
Debt/Equity (x)	1.1	2.2	0.6	0.9	0.8
EV/EBITDA (x)	27.2	51.6	107.5	20.5	8.7
Price/Book (x)	12.5	10.0	4.2	3.7	2.8

Price as at close of business on 30 March 2010

Source: Company, IIFL Research

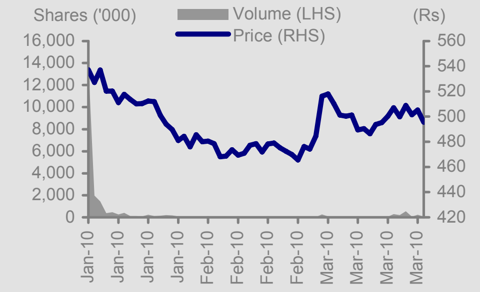
12-mth TP	***(Rs) 440 (-11%)***
Market cap (US$ m)	**772**
52Wk High/Low (Rs)	587/444
Diluted o/s shares (m)	70
Daily volume (US$ m)	2
Free float (%)	16.2

Shareholding pattern (%)

Promoter	83.8
FII	4.8
Domestic MF/Insurance	6.7
Others	4.6

Price performance (%)

	1M	3M	1Y
Godrej Properties	4.9	-	-
Rel. to Sensex	-2.2	-	-
DLF	3.5	-15.5	86.6
Unitech	1.1	-12.0	116.8
HDIL	-4.2	-20.7	269.3



Bhaskar Chakraborty
bhaskar@iiflcap.com
91 22 4646 4670

Avi Mehta
avi.mehta@iiflcap.com
91 22 4646 4650

Figure 1: Analysing GDPL’s business model

	Land acquisition, change of land use	Development plan preparation	Plan approvals	Construction	Sales and Marketing
Godrej Properties’ strategy	• JD partner owns land and gets change of land use • Godrej brand provides credibility	• Employ leading architects such as SOM • Contract with PG Patki Architects for projects pan-India	• Depend on JD partner for obtaining regulatory approvals	• Fixed-price contracts with L&T for all its projects • L&T is responsible for material sourcing	• Godrej brand = Strong recall pan-India • Use brokers as well as temporary sales executives for marketing
Industry practice	• Developers undertake change of land use on their own	• Similar to GDPL	• Developers have in-house expertise in obtaining plan approvals	• Industry peers have in-house sourcing teams • Construction is outsourced to local contractors	• Brand loyalty for players largely restricted to their local regions
Comment	• GDPL can take on more projects than in the ‘land banking’ model • JD partner takes large share of revenues/profits as ‘Change of land use’ is done by him	• In-line with industry standards	• Obtaining regulatory clearances represents a large portion of the value add and hence GDPL has to forego a larger share of its margins	• With fixed-price contracts in place, margins are more predictable and execution risk is mitigated • Volume commitment to L&T ensures better terms for GDPL	• Strong Godrej brand backing allows GDPL to achieve better sales • Construction by L&T adds to marketability of projects
Strength	◐	◕	◔	●	●

◔ Low strength ● High strength

Source: Company

Joint development model reduces upfront capital deployment
GDPL follows a joint development (JD) model whereby it ties up with the landowner by offering a small upfront payment and a share of revenues/ saleable area/ profits from the project. This allows the company to significantly reduce its upfront capital requirement and allows it to take up more projects than it could have taken up if it followed the 'land banking' model.

Proven track record in identifying attractive land parcels
GDPL has been successful in identifying and tying up attractive land parcels across the country through the JD model. The Godrej brand lends credibility in negotiating with JD partners, who often favour Godrej over competitors.

This is underscored by the success of GDPL's first project in Bangalore—Godrej Woodside—that is the first residential colony in the now-bustling North Bangalore market. Also, its recent success in Ahmedabad, where it sold 888 flats aggregating 1.8m sq ft in the first 10 days of launch underscores the strength of its brand outside Mumbai.

GDPL has also executed the JD model of development with considerable success, with only one of its c.20 JD projects going to arbitration since incorporation.

Superior construction quality through tie-up with L&T
GDPL has abandoned the model of working with multiple contractors and has instead entered into an MOU with Larsen & Toubro (L&T) for constructing all its projects across the country. GDPL reserves the right to appoint a different contractor for any of its projects.

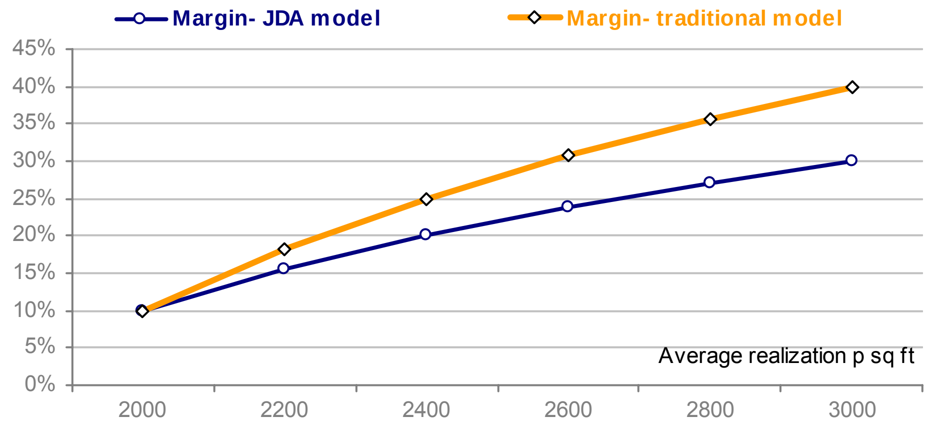
Significant volume commitment (c.82m sq ft developable area across India) ensures strong commitment from L&T in terms of resources as well as pricing. For example, for the Ahmedabad project, L&T has been contracted at a fixed price of Rs995p sq ft of saleable area. The pan-India commitment with L&T reduces execution risks and improves the brand image of GDPL.

Godrej brand recall sets up pan-India sales platform
GDPL's strategy to foray into real estate development across the country is anchored around the Godrej brand. Godrej is a well known brand across the country. The credibility associated with the brand helps GDPL in achieving strong sales in its projects. Construction outsourced to L&T adds further credibility to GDPL's offering. All this has helped GDPL achieve considerable success outside its home base, Mumbai. GDPL pays a royalty of 0.5% of its gross turnover to Godrej Industries for using the Godrej brand.

JD partner's share of economic interest is large, as it plays a critical role beyond land aggregation
GDPL does not have in-house expertise in working with the regulatory system to acquire necessary approvals for launching its projects. Instead, it depends on its JD partners for regulatory approvals like 'Change of Land Use' and sanctioning project plans. Since these approvals represent a significant share of the value addition, GDPL has to forego a large share of the developer margins to its JD partners. Indeed, GDPL has c.60% economic interest on the total developable area indicating that the JD partners have attractive shares across its projects.

Variable land cost in JD model limits margin upside
Compared to the traditional land banking model where the land cost for a developer is a fixed amount, in the JD model the developer's land cost increases with higher realisations/profits on the project. This is as a result of the fixed percentage of revenues/profits that the developer has to share with the land owner. Hence, GDPL's margins are expected to be lower than in the traditional land-ownership model in an increasing price environment.

Figure 2: Margin upside limited in an increasing realization scenario



Source: IIFL Research

Aggressive growth plans going forward

GDPL has an aggressive growth strategy and intends to: (1) add projects in Mumbai and Bangalore; and (2) enter the NCR market. In Mumbai, it intends to pursue the redevelopment opportunity. GDPL intends to focus on the residential vertical.

The company expects to fund the capital required for tying up new projects primarily through debt funding. It expects the net D/E ratio to increase from the current 0.6x (post IPO) to ~1.5x over the next two years. GDPL's policy of structuring its JD projects as development agreements allows it to raise debt to fund its capital requirements.

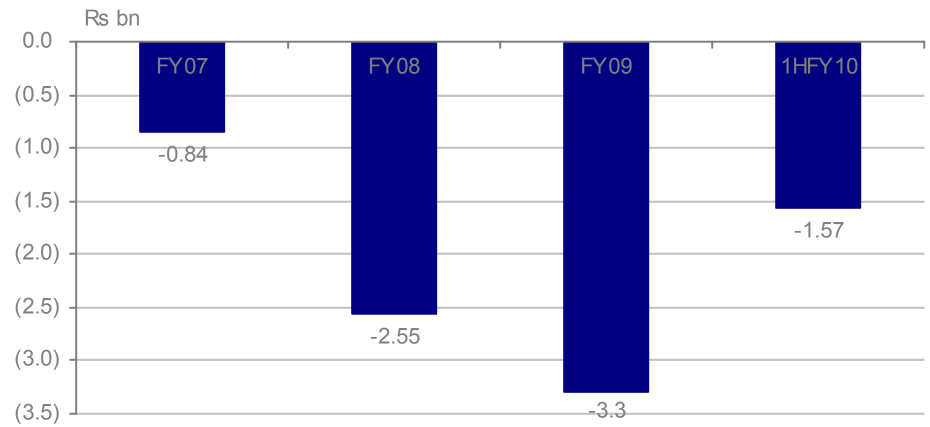
Negative operating cash flows for next 2-3 years

GDPL added significantly to its development pipeline over FY07-09. As a result, the company reported negative cash flows from operations over this period. This is in spite of generating significant cash surplus from the Planet Godrej project at Mahalaxmi in Central Mumbai.

With its plans of acquiring new projects in Mumbai, NCR and Bangalore, GDPL expects operating cash flows to remain negative for the next 2-3 years. This could necessitate further equity dilution, in our view, as servicing 1.5x leverage could be onerous in the face of another cyclical slowdown in real-estate demand.

Prior to its IPO, GDPL preferred selling stakes in project-owning SPVs to various private equity investors to fund its growth. For example, it sold 49% stake in Godrej Developers Private Ltd to Red Fort India Real Estate, 49% each in Godrej Realty Private Ltd and Godrej Waterside Private Ltd to HDFC Ventures and 49% in its Prakriti project (Kolkata) to Milestone Real Estate. The company could look at such opportunities in the future.

Figure 3: Operating cash flows expected to continue negative trend



Source: Company, IIFL Research

Some of the current PE transactions have put options on GDPL

Some of the PE deals that the company has entered into at SPV level have IRR guarantees and financial exit clauses for the funds within specific timelines. GDPL has to provide exit to the fund/s if such exit is not possible through other means, and also has to make good any IRR shortfall of the funds' investment. These could, under extreme circumstances, cause liquidity risk for GDPL's balance sheet.

Expensive valuation, initiate with REDUCE

We build in 10x scale-up in execution and monetisation of 36m sq ft of saleable interest (implying c.60m sq ft of gross development) by GDPL over FY09-19ii. We have factored in average realisation of c.Rs4,400p sq ft for its portfolio (note that Ahmedabad project, which accounts for 58% of its saleable interest, is selling at Rs2,300p sq ft). Using a discount rate of 14%, our 1-year forward NAV for GDPL is Rs 440/share. We initiate coverage on the stock with a REDUCE rating.

Company snapshot

Background

- Godrej Properties is a part of Godrej Group of companies and recently raised Rs4.68bn in December 2009 through its IPO.
- The company is engaged in residential and commercial developments and has a net saleable interest of over 47.4m sq ft. It enters into MOUs with Godrej group companies for undertaking development on land belonging to the group. It has done MOUs for 220 acres spread across Mumbai (Vikhroli), Hyderabad, Bangalore and Mohali.
- The company follows a 'joint development' (JD) model, wherein it obtains development rights from landowners. About 90% of its declared land bank involves JD arrangements. While this model reduces upfront capital commitments, JDs face the risk of the landowner terminating contracts on receiving a better offer. Any changes in development plans also require the consent of JD partners, thereby reducing flexibility of the business model.
- Godrej Properties has to pay a royalty of 0.5% of its gross turnover to Godrej Industries for using the Godrej trademark.

Split of GDPL's interest in saleable area

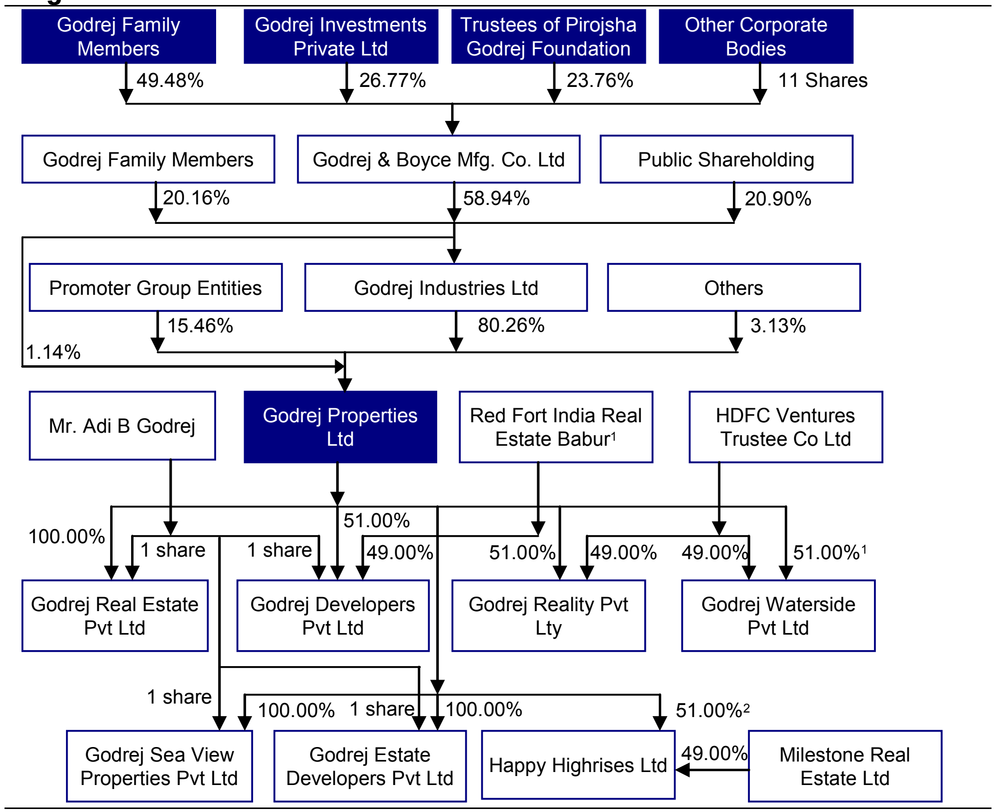
City	Saleable area (m sq ft)
Ahmedabad	27.3
Hyderabad	9.6
Kolkata	2.6
Mumbai	1.8
Chennai	1.7
Kochi	1.6
Pune	1.3
Bangalore	0.8
Mangalore	0.4
Chandigarh	0.2
Total	**47.4**

Source: Company

Management

Name	Designation	Remarks / management description
Adi Godrej	Chairman	
Pirojsha Godrej	Executive Director	Bachelor degree from Wharton; MBA Columbia University
Milind Korde	Managing Director	18 years in real estate, including Tata Housing
Lalita Gupte	Independent Director	Chairperson of ICICI Venture Funds Management
Pranay Vakil	Independent Director	Chairman of Knight Frank in India
Keki Dadiseth	Independent Director	Erstwhile board member of Unilever, Member of board for Indian Hotels, Britannia, Nicholas Piramal, ICICI Pru Life
Pritam Singh	Independent Director	Board member for Delhi Stock Exchange, Hero Honda, Dish TV, local board of RBI

Organisation structure



Financial summary

Income statement summary (Rs m)

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Revenue	2,274	2,053	1,372	5,404	10,607
EBITDA	1,199	704	360	2,008	4,854
EBIT	**1,190**	**693**	**336**	**1,985**	**4,830**
Interest expense	-38	-53	-23	-66	-88
Other income	1	450	720	4	3
Profit before tax	**1,153**	**1,089**	**1,033**	**1,922**	**4,745**
Taxes	-404	-323	-279	-583	-1,438
Minorities and other	2	-9	-5	-5	-5
Net profit	**750**	**757**	**749**	**1,335**	**3,302**

Cashflow summary (Rs m)

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Profit before tax	1,153	1,089	1,033	1,922	4,745
Depr. & amortization	9	11	24	24	24
Tax paid	-411	-429	-279	-583	-1,438
Working capital Δ	-3,342	-3,993	-3,193	-3,592	-4,364
Other operating items	38	25	23	66	88
Operating cashflow	-2,553	-3,297	-2,391	-2,163	-945
Capital expenditure	-338	-54	0	0	0
Free cash flow	**-2,891**	**-3,351**	**-2,391**	**-2,163**	**-945**
Equity raised	1,505	0	4,687	0	0
Investments	0	23	0	0	0
Debt financing/disposal	1,347	3,832	-1,500	3,000	1,500
Dividends paid	0	-288	0	-199	-199
Other items	-36	-34	-23	-66	-88
Net change in cash	**-75**	**182**	**772**	**573**	**267**

Source: Company data, IIFL Research

Balance sheet summary (Rs m)

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Cash & equivalents	86	269	1,041	1,613	1,881
Sundry debtors	4,057	5,757	5,214	6,485	7,637
Inventories - trade	2,848	4,759	5,179	7,600	11,013
Other current assets	2,854	3,962	5,745	6,895	7,929
Fixed assets	**372**	**392**	**368**	**344**	**320**
Total assets	**10,217**	**15,139**	**17,547**	**22,937**	**28,780**
Sundry creditors	4,664	5,377	3,845	5,093	6,329
Other current liabs	411	198	397	397	397
Long-term debt/CBs	2,731	6,563	5,063	8,063	9,563
Tax liability/ (asset)	-4	-5	-5	-5	-5
Minorities/other equity	7	17	22	27	32
Net worth	**2,409**	**2,989**	**8,225**	**9,361**	**12,464**
Total liabs & equity	**10,217**	**15,139**	**17,547**	**22,937**	**28,780**

Ratio Analysis

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Revenue growth (%)	65.7	-9.7	-33.2	293.9	96.3
Op Ebitda growth (%)	138.2	-41.3	-48.8	457.4	141.7
Op Ebitda margin (%)	52.7	34.3	26.3	37.2	45.8
Op Ebit margin (%)	52.3	33.7	24.5	36.7	45.5
Net profit margin (%)	33.0	36.9	54.6	24.7	31.1
Dividend payout (%)	38.4	23.3	26.6	14.9	6.0
Tax rate (%)	35.1	29.7	27.0	30.3	30.3
Net debt/equity (%)	109.8	210.6	48.9	68.9	61.7
Return on equity (%)	31.1	25.3	9.1	14.3	26.5
ROCE (%)	22.2	6.6	2.2	9.0	17.1
Return on assets (%)	10.5	3.8	1.5	6.8	13.0

Source: Company data, IIFL Research

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.
