Emkay Research

Hindustan Construction Company

Result Update

On a firmer footing

22 January 2008

BUY

Price	Target Price
Rs 171	**Rs260**
Sensex	**17,605**

Price Performance

(%)	1M	3M	6M	12M
Absolute	(13)	(0)	32	11
Rel. to Sensex	(5)	(1)	18	(10)

Stock Details

Sector	Construction
Reuters	HCNS.BO
Bloomberg	HCC@IN
Equity Capital (Rs mn)	256
Face Value	Rs1
52 Week H/L	279/83
Market Cap	43.7
Daily Avg Volume (No of shares)	3565607
Daily Avg Turnover (US$)	19.4

Shareholding Pattern (%)

(31st Dec.'06)	
Promoters	47.0
FII	14.4
Institutions	17.4
Private Corp.	10.1
Public	11.1

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HCC reported its Q3FY08 numbers which were in line with our expectations. The revenues for the quarter grew 39.8% y-o-y to Rs7.5 billion, while the EBITDA grew at 45.8% y-o-y owing to a marginal improvement in margins of 60 bps to 12.9% for the quarter. However, the interest cost more than doubled resulting in a slower growth of 13.9% y-o-y at the PAT level to Rs250 million.

The company's operational performance has seen a marked improvement during the current fiscal after a rather subdued FY07. Given the strong and a growing order book., we expect the company to post strong growth in revenues at a CAGR of 31% over the period of FY07-FY10E. This growth is expected to be backed by an improving mix in revenue with hydro power segment contributing a higher proportion, thereby resulting in an improved operating margin and net margin. We expect the PAT to grow at a CAGR of 51% over the period of FY07-10E. The company's real estate plans have also taken off well with Lavasa township project starting to generate revenues albeit in a small fashion.

We believe that the company is on a strong growth trajectory and with more clarity emerging in the real estate business; the company looks to set to unlock value for the shareholders. We value the company on a SoTP based valuation of Rs260 / share assigning a value of Rs148 / share to the core construction business (15xFY10E), Rs109 / share to the real estate business and Rs3/ share for the BOT projects. We maintain our 'BUY' recommendation.

BWSL Project – Back on track

The Bandra Worli Sealink project is now back on track and is expected to be completed by the end of December, 2008. The Maharashtra cabinet sub-committee on infrastructure recently approved a claim to the extent of Rs1.57 billion by HCC on account of change in design of the bridge structure. This has been done to speed up the development and avoid any further delays. A formal approval of the claim from MSRDC is expected soon. However, the company's claims on account of time and cost overrun will go into arbitration. The company has already booked all the losses expected from the project and no more loss is expected to be there on account of this project. We view this as a positive development as this will not only ease pressure on the cash flow but will also lead to an improvement in operating margins as was earlier envisaged.

Improving mix of order book

The order book as at the end of the third quarter stood at Rs90.5 billion, which is 3.2 TTM revenues. Apart from this there are orders worth over 30 billion for which the company has been declared L1 bidder. The company expects to close the fiscal with a strong order backlog of Rs120 billion. The share of power segment in the order book has gone up substantially from 14% at the end of FY05 to 44% currently. This is expected to go up further as the company is awaiting award of LOI in couple of large hydro power projects. This would help in improving the operating margins going forward as the hydro power segment command higher margins.

Vikhroli IT Park development – Value at Rs26/ share

The development of the Vikhroli IT park of 1.9 mn sqft is going on in full swing. The company expects to complete the development by the end of 2008 and to be ready for occupation by end FY09. Thus, the cash flow will start from the beginning of FY10 from this project which is expected to be to the tune of over Rs1 billion per annum through lease rentals. We value the project on the basis of capitalisation of lease rentals at Rs7.1 billion or Rs26/ share

Lavasa – Evolving as a new Educational hub

Oxford university likely to set shop

Lavasa corporation is in an advanced stages of discussion with Oxford university to set up shop in its upcoming township at Lavasa. The company had earlier sold some land to Pune based renowned educational group Symbiosis. The company has also tied up with GDST international school and the school is likely to come up in FY09. This apart, the company is also in advanced stages of discussio with various educational outfits viz. Institute of international business relations of Germany, Chirst college of Bangalore and several other leading instittions in the area of education.

We believe that given the locational advantage in terms of proximity to the Pune city and a picturesque location and the tie-ups already in place, Lavasa has a potential to emerge as a world class educational center.

Successful soft launch provides comfort

The company has successfully launched the first phase at Lavasa and achieved a sales of Rs3.2 billion. An advance of Rs750 million is already received against the sale. During the soft launch, the company sold appartments and villas of various sizes ranging from Rs1-10 million. The company intends to do a controlled development and of the entire project and has launched a miniscule portion in the first phase. Going forward, the company intends to generate a revenue of at least Rs10 billion every year.

Fund raising to ease pressure on company's cash flow

HCC has so far invested over Rs2 billion in the Lavasa project. However, going forward the company is looking to raise fund at the project level. While it is not clear yet as to the likely mode of raising the funds, but it would not only ease pressure on the cash flows of the parent i.e. HCC, but would also provide an opportunity for value unlocking to the shareholders.

NAV based value at Rs75 / share

We value the HCC's stake in the Lavasa project at Rs20.7 billion or Rs75/ share on NPV based valuation. Given the size of the project and the fact that the project is still evolving, it is a little difficult to ascertain the exact dynamics of the project at this stage. Howeve, some of the key assumptions that we have taken for our valuation are:

- Development period of 15 years from FY08 to FY22
- Total development space of 150 mn sqft as envisaged by the company
- Realisation and development cost per sqft assumed at Rs2600 and Rs1000 respectively with no inflation in prices.
- Full tax rate of 30% and a discount rate of 15%
- Infrastructure development cost of Rs5 million per acre has been assumed for developing 8500 acres of land
- Company is yet to acquire ~3000 acres of land for which an average acquisition cost of Rs1 million per acre has been assumed

	Rs. Million
GNAV	40,563
Less: Payable for balance land to be acquired	3,000
Less: Debt	5,000
NAV	32,563
HCC's share	20,678
Value / share (Rs.)	75

BOT the way forward

The company currently has only two small BOT road projects in its portfolio. However, going forward the company intends to focus on this segment agrresively and is planning to take projects in various segments viz. large road projects, airports and hydro power projects. The company has currently bidded for some large BOT based road projects and is awaiting results on the same. The company also plans to form a Infrastructure holding subsidiary to focus on this business.

Financials

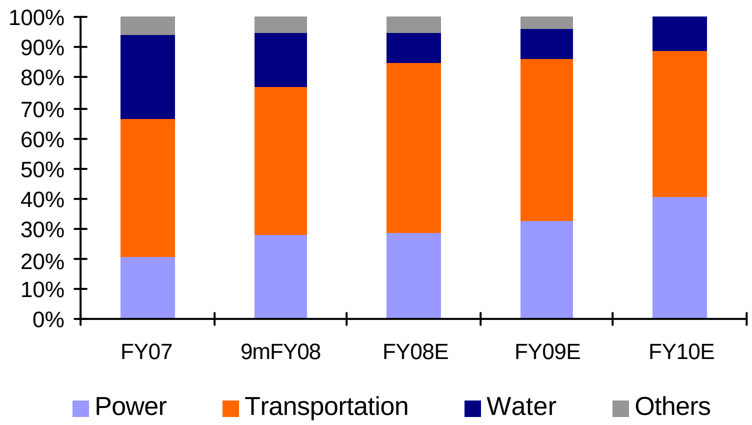
Growth in core business continues to be strong

We introduce our estimates for FY10. We expect the company to register a growth in revenues at a CAGR of 31% from Rs23.6 billion in FY07E to Rs52.6 billion. We expect the order intake to continue to remain robust going forward.

First signs of improvement in operating margins

The company has reported an improvement of 167 bps improvement in EBITDA margins in the first nine months of the current fiscal to 11.6% as compared to the corresponding period last year. This has been possible on account of higher contribution from hydropower segment to the revenue mix which was at 28% compared to 20% for fiscal FY07.

Revenue Mix



We expect an operating margin of 11% in the full year FY08E. However going forward we expect the margins to improve further to 12% in FY09E and to 12.5% in FY10E. This woeld be driven by two key catalysts viz. a) Increasing share of hydropower segment in the revenue mix from 20% in FY07 to 41% in FY10E; b) no more write offs on account of losses on Bandra worli sea link project.

High interest cost, a cause of concern

With increasing investments in the real estate subsidiary, the company has raised substantial amount of debt in the last couple of years. The debt equity ratio (considering FCCB to be a part of equity) has been increasing steadily from 0.6x to 1.0x currently. This has resulted in the interest cost increasing increasing almost three fold between FY06 and FY08E thereby dragging the net margin to 3.7% in FY08E. We believe that going forward, the real estate subsidiary will become self sustaining in terms of investment requirements which will ease pressure on cash flows of HCC, the parent company.

Outlook and Valuation

The company's operational performance has seen a marked improvement during the current fiscal after a rather subdued FY07. Given the strong and a growing order book., we expect the company to post strong growth in revenues at a CAGR of 31% over the period of FY07-FY10E. This growth is expected to be backed by an improving mix in revenue with hydro power segment contributing a higher proportion, thereby resulting in an improved operating margin and net margin. We expect the PAT to grow at a CAGR of 51% over the period of FY07-10E. The company's real estate plans have also taken off well with Lavasa township project starting to generate revenues albeit in a small fashion. We believe that the company is on a strong growth trajectory and with more clarity emerging in the real estate business, the company looks to set to unlock value for the shareholders. We value the company on a SoTP based valuation of Rs260 / share assigning a value of Rs148 / share to the core construction business (15xFY10E), Rs109 / share to the real estate business and Rs3/ share for the BOT projects. We maintain our 'BUY' recommendation.

SoTP Valuation

Segment	Basis	Multiple (x)	Value (Rsmn)	Value per share (Rs)	Justification
Core business Value					
Construction business	FY09E, PE (x)	15.0	40644.9	148	Rolling forward to FY10E. Multiple in line with peers like Patel, NCC, SPML and IVRCL
Embeded Value					
Roads (toll based)	P/BV	3.0	82.4	0.3	IRR expected to touch 23% post commencement of projects. Premium juistified as CoE in range of 12-14%. Buyers could pay 3-5x for an expected IRR of 10-12%. However conservatively valued at 2.5x only
Roads (annuity based)	P/BV	1.5	825.0	3	Financial closure achieved. Project is on course and thus P/BV multiple at 1.5x in line with our valuation for annuity based BOT projects
Real Estate division					
Lavasa Project	NPV		20677.6	75	NAV based assuming a total execution period of 15 years
Vikroli IT park	NPV		7140.0	26	Construction already started. Assuming a rental of Rs50 p.m. per sqft and a capitalisation rate of 10%
SRS Residential Projects in Mumbai	NPV		2037.8	7	Two projects in Mumbai. Assuming development over next four years
Total Fair value			**71407.7**	**260**	

Quarterly Financials

Income Statement Y/E,Mar (Rs. mn)	Q3FY08	Q3FY07	Y-o-Y Gr.(%)	9m FY08	9m FY07	Y-o-Y Gr.(%)
Net Sales	7500	5361	40%	20293	15299	33%
Expenses	6532	4698	39%	17938	13779	30%
EBIDTA	**968**	**664**	**46%**	**2355**	**1520**	**55%**
EBIDTA %	*12.9*	*12.4*	50 bps	*11.6*	*9.9*	(100) bps
Other income	54	2	2894%	481	74	552%
Interest	408	175	133%	1072	407	163%
Depreciation	233	206	14%	687	553	24%
PBT	**380.9**	**284.7**	**34%**	**1076.2**	**633.1**	**70%**
Total Tax	130.4	64.8	101%	359.6	207.5	73%
Effective tax rate (%)	*34.2*	*22.8*		*33.4*	*32.8*	
Adjusted PAT	**250.5**	**219.9**	**14%**	**716.6**	**425.6**	**68%**
E/O items	0.0	0.0		0.0	0.0	
Reported PAT	**250.5**	**219.9**	**14%**	**716.6**	**425.6**	**68%**
Net Margin (%)	*3.3*	*4.1*		*3.5*	*2.8*	
FDEPS	0.9	0.8	14%	2.6	1.6	68%

Income Statement

Y/E, Mar (Rs. m)	FY07	FY08E	FY09E	FY10E
Net Sales	**23576**	**31404**	**41479**	**52633**
Growth (%)	*18.7*	*33.2*	*32.1*	*26.9*
Expenses	**21180**	**27950**	**36502**	**46054**
Growth (%)	*17.6*	*32.0*	*30.6*	*26.2*
Consumption of Materials	7406	11934	15762	19737
% of sales	*31.4*	*38.0*	*38.0*	*37.5*
Personnel exps	2087	2669	3318	4211
% of sales	*8.9*	*8.5*	*8.0*	*8.0*
Construction exps	10964	12091	15762	20001
% of sales	*46.5*	*38.5*	*38.0*	*38.0*
Admin exps	967	1256	1659	2105
% of sales	*4.1*	*4.0*	*4.0*	*4.0*
(Profit)/loss on JV's	-244	0	0	0
% of sales	*-1.0*	*0.0*	*0.0*	*0.0*
EBIDTA	**2396**	**3454**	**4977**	**6579**
Growth (%)	*28.9*	*44.2*	*44.1*	*32.2*
EBIDTA %	***10.2***	***11.0***	***12.0***	***12.5***
Other income	199	471	207	263
Net Interest exp	620	1264	1407	1677
Depreciation	797	911	1016	1121
PBT	**1179**	**1751**	**2762**	**4044**
Current tax	208	578	911	1335
Deferred tax	178	0	0	0
Total Tax	**386**	**578**	**911**	**1335**
Effective tax rate (%)	*32.8*	*33.0*	*33.0*	*33.0*
Adjusted PAT	**793**	**1173**	**1850**	**2710**
Growth (%)	*-4.4*	*48.0*	*57.7*	*46.4*
Net Margin (%)	*3.3*	*3.7*	*4.4*	*5.1*
E/O items	24	0	0	0
Reported PAT	**817**	**1173**	**1850**	**2710**

Cash Flow

Y/E, Mar (Rs. m)	FY07	FY08E	FY09E	FY10E
Pre-tax profit	1179	1751	2762	4044
Depreciation	797	911	1016	1121
Interest Provided	610	1264	1407	1677
Interest Paid	-739	-1264	-1407	-1677
Others	-151	0	0	0
Chg in working cap	-7662	-1270	-3294	-4599
Tax paid	-388	-578	-911	-1335
Operating cash Inflow	**-6354**	**814**	**-428**	**-769**
Capital expenditure	-3784	-2000	-1500	-1500
Free Cash Flow	**-10139**	**-1186**	**-1928**	**-2269**
Investments	-1023	-2000	-1000	-1000
Equity Capital Raised	0	0	0	0
Loans Taken / (Repaid)	3370	3000	3000	3000
Lease liabilities	-16	0	0	0
Dividend (incl tax)	-179	-225	-240	-289
Others	10	0	0	0
Net chg in cash	**-7976**	**-410**	**-167**	**-557**
Opening cash position	10060	2084	1673	1506
Closing cash position	**2084**	**1673**	**1506**	**948**

Balance Sheet

Y/E, Mar (Rs. m)	FY07	FY08E	FY09E	FY10E
Equity share capital	256	256	274	274
Reserves & surplus	8784	9718	15637	18025
Networth	**9041**	**9974**	**15911**	**18300**
Deferred tax liability	**855**	**855**	**855**	**855**
Secured Loans	4825	7825	10825	13825
Unsecured Loans	6311	6311	6311	6311
Loan Funds	**11136**	**14136**	**17136**	**20136**
Total Liabilities	**21032**	**24965**	**33902**	**39291**
Gross Block	11012	13012	14512	16012
Less: Depreciation	3550	4461	5477	6598
Net block	**7462**	**8551**	**9035**	**9414**
Capital WIP	1513	1513	1513	1513
Investment	**2286**	**4286**	**5286**	**6286**
Current Assets	**25082**	**25807**	**32246**	**39954**
Inventories	17708	18928	23865	30282
Sundry debtors	5	43	57	72
Cash & bank balance	2084	1673	1506	948
Loans & advances	5174	5162	6818	8652
Other assets	111	0	0	0
Current liabilities	**10936**	**10817**	**14178**	**17877**
Current liabilities	10459	10325	13637	17304
Provisions	477	492	541	573
Net current assets	**14146**	**14990**	**18068**	**22077**
Miscllaneous exp	**0**	**0**	**0**	**0**
Total Assets	**25407**	**29340**	**33902**	**39291**

Key ratios

Y/E, Mar (Rs. m)	FY07	FY08E	FY09E	FY10E
Per Share Data (Rs)				
EPS	3.1	4.6	6.7	9.9
Cash EPS	5.6	8.1	10.4	14.0
EBITDA / Share	9.3	13.5	18.1	24.0
Book Value	35.3	38.9	58.0	66.7
Valuations (x)				
PER	68.9	46.5	31.6	21.6
Adjusted PER #	32.6	22.0	14.9	10.2
Price / CEPS	38.0	26.2	20.4	15.3
Price / BV	6.0	5.5	3.7	3.2
EV / Sales	2.9	2.3	1.8	1.5
EV / EBITDA	28.4	20.7	14.9	11.8
Adjusted EV / EBITDA #	15.5	11.8	8.7	7.1
EV/EBIT	42.5	28.1	18.7	14.2
Adjusted EV / EBIT #	23.3	16.0	10.9	8.6
Returns (%)				
RoCE	6.8	9.3	12.5	14.9
RoNW	8.8	12.3	14.3	15.8
RoIC	15.3	15.6	19.7	22.2
Effeceincy ratio (x)				
Asset Turnover	1.0	1.1	1.3	1.4
Asset Turnover	1.1	1.4	1.6	1.7
Fixed Asset Turnover	2.5	2.6	3.0	3.4
Gearing Ratio (x)				
Net debt/ Equity	0.5	0.6	0.5	0.5
Total Debt/Equity	1.7	1.9	1.1	1.1

Price / EV adjusted for value assigned to businesses other than core construction business

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