Lanco Infratech

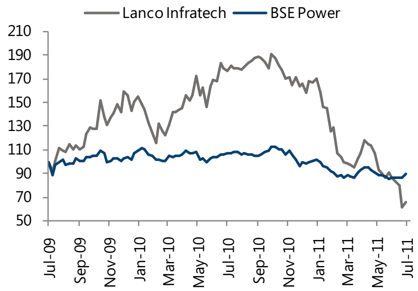
Visit Note

Not Rated

CMP	₹ 25
Target Price	-
Upside Potential	-

Price Performance

52 wk Hi/Lo	75/21
All time Hi/Lo	89/8
6 mnth Average Vol	9213500
Stock Beta	1.04



Valuation

	FY09	FY10	FY11
P/E (x)	18.5	12.0	12.8
P/BV (x)	2.6	1.8	1.3
RONW (%)	14.3	16.9	11.2
ROCE (%)	8.6	5.5	4.6

Peer Valuation (FY12P)

	Adani	JSWE
PE	11.6	8.2
P/B	2.7	1.6

Equity Data

Market Cap. (₹ bln)	60
Face value (₹)	1
No of shares o/s (mln)	2387

	Mar10	Mar11	%Δ
Promoters	67.95	67.98	0.04
DFI's	4.21	3.23	-23.2
FII's	19.11	18.84	-1.41
Public	8.73	9.95	13.9

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Strong project visibility; currently under pressure

We recently met the management of Lanco Infratech to discuss the business and current stock pressures. Investment Rationale: (1) Strong project visibility and financial closure progress, (2) equity funding support from EPC cash flows, (3) low-cost, high-passthrough fuel model.

Good project visibility and financial closure progress

By peer standards, Lanco scores favorably on its pre-construction milestone progress (including advanced financial closure); this implies high project visibility, we feel. The limited Harbin BTG order would support pipeline projects beyond the 9,300 MW currently announced.

Partial equity financing through in-house EPC margins

Lanco's in-house EPC work facilitates equity funding, while reducing upfront cash burn and execution times. Key risks include (1) increased execution delay sensitivity, (2) declining EPC margins, and (3) high intersegment elimination. Management does not plan to expand its road business (ROEs are low) and ultimately could exit its stagnant real estate vertical.

High equity dilution risk with gearing/interest cost concerns

Equity dilution is likely within two years, in our view. Balance sheet concerns include high consolidated gearing (3.6x FY11) and interest costs (113% growth FY11). These largely result from incremental capacity additions, as standalone debt:equity is well within acceptable limits.

Strong on fuel passthrough despite adverse recent news streams

Lanco sources primarily under domestic coal/gas linkages. This model allows favorable fuel economics (low imported coal) but exposes Lanco to domestic supply shortfalls. Passthrough on all non-merchant capacity but 660 MW protects margins from price fluctuations.

Lanco has recently faced adverse fuel-related developments: (1) Perdaman, (2) Griffin export license review and Bluewaters supply, (3) Premier Coal cancellation, (4) K III gas constraints, and (5) Indonesian coal price indexation.

Valuation

Lanco is cheap against peers: 7.3x P/E, 1.1x P/B, 6.4x EV/EBITDA (FY12 consensus). Not Rated.

Risks and concerns

Lanco fell 63% TTM from: (1) high gearing/equity dilution risk, (2) weak results (intersegment elimination), (3) execution delays, and (4) negative fuel news. Near-term pressures are likely.

Summary Financials

₹ in Mln	FY08	FY09	FY10	FY11
Net Sales	32413	60720	81076	77837
OPBDIT	6993	8874	15270	18905
Net Profit	3542	2804	4585	4461
EPS	1.68	1.33	2.05	1.92
Net Worth	18333	20976	33448	46231
Debt	31653	55970	83614	166517
Fixed Assets	38029	56306	70015	156407
Net Current Assets	10752	18011	34929	38213

Good project visibility and financial closure progress

Lanco enjoys high project visibility through advanced milestone progress for its pipeline under construction, especially on financial closure; however, recent execution delays have curtailed revenue growth. EPC milestone payments were pushed beyond Q4 FY11 from COD delays on Anpara 1-2 and Udupi 2. Project-specific issues include: (1) tariff uncertainty (A II: Haryana dispute, Udupi: capital cost awaiting CERC approval), (2) evacuation delays (Udupi 2: transmission line expected Sep-11), and (3) domestic fuel constraints (K III linkage untied).

The Harbin equipment order supports pipeline projects beyond the 9,300 MW currently announced with the aim of achieving 15,000 MW by FY15. The exact order pricing is unclear, but we suspect that previous reports of a low cost may be explained by the fact that this is a limited BTG order that excludes necessary ancillary equipment to be purchased subsequently.

Partial equity financing through in-house EPC margins

Lanco performs EPC work in-house on its power plants and applies the resulting cash flows toward project equity requirements. Lanco's construction & EPC segment is included in the standalone entity; all other businesses are organized under SPVs. EPC margins fund up to 50% of a typical plant's SPV-level equity but meet the full equity burden on solar projects. Management expects the construction & EPC order backlog to cross $7.5 bln from the current $6.7 bln if certain projects materialize, and Lanco will continue to add third-party contracts beyond the existing Akaz (Iraq), Koradi, and Moser Baer projects.

The in-house EPC model enhances execution control and turnaround times, while reducing upfront capital costs through, for instance, lower outlays on OEM equipment, project design, and payment security mechanisms. However, Lanco is doubly sensitive to execution delays through their impact on both power and EPC sales, and segment margins appear unsustainable given their historical premium over industry averages. These risks materialized in Q4 FY11 when project COD delays caused EPC milestone payments to be pushed back and construction & EPC margins declined. Although management deferred inclusion of projects into subsidiaries until commissioning, consolidated Q4 FY11 sales were optically reduced as intersegment elimination rose from higher sales for subsidiaries against associates.

Lanco does not wish to expand its roads portfolio as it considers 18-20% ROEs in the segment to be low, and the company ultimately hopes to divest its stagnant real estate vertical. Management's strategy has been to target long road stretches (80+ km) as intense bidding competition has pushed equity returns below 10% for shorter lengths. Capital infusion into Lanco Hills has been pared back as a result of the weak Hyderabad real estate market, and the project has faced losses after customer price discounts.

High equity dilution risk with gearing/interest cost concerns

We consider equity dilution likely for Lanco Infratech. Gearing and interest costs rose sharply in FY11 (3.6x, 113% growth, respectively) as Lanco enjoyed a rapid capacity expansion from 1349 MW in FY10 to 3292 MW in FY11. The primary incremental addition came from Anpara 1 (600 MW) and Udupi 1-2 (1200 MW). Management would consider an IPO within two years to support capacity expansion plans but is not unduly worried about its current leverage as debt is largely ring-fenced at the SPV level. Although standalone gearing is moderate and a 12% cost of debt is not unreasonable, leverage has entered into a red flag zone (3.2+ for largecap companies) that we clearly associate with high dilution risk.

Strong on fuel passthrough despite adverse recent news streams

Lanco enjoys a low-cost, high-passthrough fuel model. The fuel mix is diversified and shifting in composition from gas to coal. A primary dependence on domestic coal linkages keeps per-unit coal expenses in check. Further, passthrough on all but 660 MW of the non-merchant capacity (albeit not at 100% cost escalation) insulates margins from fuel price volatility. Lanco's offtake arrangements would accommodate passthrough of imported or domestic e-auction coal, according to management, permitting discretion in fuel sourcing arrangements.

Despite a credible fuel strategy, Lanco has come under pressure from negative news flows on its Australian coal operations and domestic sourcing; Indonesian coal FOB indexation has a neutral impact.

- **Perdaman**

Perdaman filed an AUD3.5 bln lawsuit for breach of contract on its 25-year, ~3 Mtpa CSA from Griffin. Lanco asserts that the agreement is intact for future fuel supply to a urea plant whose financial closure and construction are pending. We consider the damage estimate aggressive, but clarity is limited.

- **Griffin export license, Bluewaters supply**

Griffin faces regulatory risks: (1) the export license may undergo review, (2) locals opposed coal price hikes, and (3) tensions arose when it appeared the asset would not supply Bluewaters (3 Mtpa, AUD40/ton, CPI-linked; Lanco says exploration problems prompted only temporary supply restrictions).

- **Premier Coal bid cancellation**

Lanco dropped its Premier Coal bid given solar power capex needs and adequate Griffin coal supplies. In our view, Lanco was not a frontrunner anyway and holding Premier and Griffin (adjacent blocks) posed competition concerns. Any future asset bids would focus on smaller, less costly greenfield resources.

- **Domestic supply constraints**

Gas supply is still untied on K III despite an FY12 scheduled COD.

- **Indonesian coal regulations**

Udupi sources Indonesian coal at a 5% discount to benchmark rates. According to management, the tariff allows full passthrough of increased fuel costs as Indonesian coal FOB rates are pegged to an index blend.

Financial Summary

Profit & Loss

Particulars (₹ in mln)	2007	2008	2009	2010	2011
Sales	**16058**	**32413**	**60720**	**81076**	**77837**
Total Expenditure	11860	25419	51846	65805	58933
EBITDA	**4198**	**6993**	**8874**	**15270**	**18905**
EBITDA Margin (%)	26.1	21.6	14.6	18.8	24.3
Depreciation	656	776	1073	3479	3537
EBIT	3542	6218	7800	11792	15367
Interest Cost	829	920	2185	3554	7555
Other Income	416	953	562	1839	2582
Extraordinary Items	0	0	0	0	0
PBT	**3130**	**6250**	**6178**	**10077**	**10395**
Tax	472	1405	1690	3643	3850
PAT (Before MI)	**2658**	**4846**	**4487**	**6434**	**6545**
Minority Interest	788	1229	1041	915	1703
PAT (After MI)	**1880**	**3542**	**2804**	**4585**	**4461**
PAT Margin (%)	11.7	10.9	4.6	5.7	5.7
EPS	0.99	1.64	1.31	2.02	1.90
Sales Growth (%)	992	102	87	34	(4)
EBITDA Growth (%)	2410	67	27	72	24
PAT Growth (%)	1002	88	(21)	64	(3)

Balance Sheet

Particulars (₹ in mln)	2007	2008	2009	2010	2011
Sources of Funds					
Share Capital	2198	2198	2198	2385	2387
Reserves & Surplus	12907	16135	18570	30316	43844
ESOP Outstanding	0	0	207	746	0
Net Worth	**15105**	**18333**	**20976**	**33448**	**46231**
Total Loans	**17099**	**31653**	**55970**	**83614**	**166517**
Deferred Tax Liability	93	173	175	1003	5368
Minority Interest	3763	5588	7033	7108	8453
TOTAL	**36059**	**55747**	**84154**	**125173**	**226570**
Application of Funds					
Net Fixed Assets	24390	38029	56306	70015	156407
Investments	6029	6966	9837	20229	31949
Goodwill	0	0	0	0	0
Current Assets	17064	37790	49342	70039	102989
Current Liabilities	11424	27038	31331	35110	64776
Net Current Assets	**5640**	**10752**	**18011**	**34929**	**38213**
TOTAL	**36059**	**55747**	**84151**	**125173**	**226570**

Cash Flows

Particulars (₹ in mln)	2007	2008	2009	2010
Internal Accruals	2739	5583	5265	8336
(Inc)/Dec in Net Current Assets	(5207)	(13253)	(1800)	(4056)
Other Adjustments	2468	7670	(3464)	(4280)
Cash Flow from Operations	**3805**	**5450**	**2383**	**1557**
Dividend/Dividend Tax	0	0	0	0
Inc/(Dec) in Debt	15701	14554	24317	27644
Inc/(Dec) in Equity	1890	0	0	187
Other Adjustments	(17591)	(14554)	(24317)	(27831)
Cash Flow from Financing	**29936**	**13188**	**17119**	**26959**
Fixed Asset Formation	(29649)	(14420)	(19357)	(16960)
(Inc)/Dec in Investments	(5014)	(936)	(2871)	(10392)
Other Adjustments	34664	15356	22229	27352
Cash Flow from Investments	**(32033)**	**(15260)**	**(17447)**	**(28410)**
Net Change in Cash	**1707**	**3379**	**2054**	**106**

Ratios

Particulars (₹ in mln)	2007	2008	2009	2010	2011
P/E	24.9	14.6	18.5	12.0	12.8
P/BV	3.6	2.9	2.6	1.8	1.3
EV/EBIDTA	4.2	4.2	5.8	8.7	11.2
EV/Sales	1.1	0.9	0.8	1.6	2.7
Dividend Yield (%)	-	-	-	-	-
EPS	0.99	1.68	1.33	2.05	1.92
DPS	0.0	0.0	0.0	0.0	0.0
Book Value	7	8	10	14	19
ROE	23.4	21.2	14.3	16.9	11.2
ROCE	0.5	9.6	8.6	5.5	4.6
Solvency Ratio (x)					
Debt/Equity	1.1	1.7	2.7	2.5	3.6
Debt/EBIDTA	4.1	4.5	6.3	5.5	8.8
Turnover Ratio (x)					
Asset Turnover	0.8	0.7	0.9	0.8	0.4
Fixed Asset Turnover	1.3	1.0	1.3	1.3	0.7
Current Ratio	1.5	1.4	1.6	2.0	1.6
Inventory (days)	32	33	15	14	-
Debtors (days)	61	82	72	100	100
Creditors (days)	349	383	217	189	390

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Analyst declaration

We, **Sam Watcha** & **Sitaraman Iyer**, hereby certify that the views expressed in this report are purely our views taken in an unbiased manner out of information available to the public and believing it to be reliable. No part of our compensation is or was or in future will be linked to specific view/s or recommendation(s) expressed by us in this research report. All the views expressed herewith are our personal views on all the aspects covered in this report.

MSFL Investment Rating

The ratings below have been prescribed on a potential returns basis with a timeline of up to 12 months. At times, the same may fall out of the price range due to market price movements and/or volatility in the short term. The same shall be reviewed from time to time by MSFL. The addressee(s) decision to buy or sell a security should be based upon his/her personal investment objectives and should be made only after evaluating the stocks' expected performance and associated risks.

Key ratings:

Rating	Expected Return
Buy	> 15%
Accumulate	5 to 15%
Hold	-5 to 5%
Sell	< -5%
Not Rated	-

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