

Company Flash

29 April 2007 | 7 pages

Hindustan Construction (HCNS.BO)

Sell: Another Disappointing Quarter - Q407 PAT Declined by 12%

- Recurring PAT declined by 12% YoY** — HCC's Q407 net profit at Rs367mn (down 12% YoY) was 26% below our estimates mainly on account of slower than expected execution of order backlog, flat margins, mobilization of resources in certain early stage projects on which revenues have not been recognized and higher than expected depreciation and interest costs.
- Lower than expected revenue growth** - HCC Q407 revenues grew by 8% YoY, 21% below our estimates due to delays in order execution caused by unseasonal rains, heavy snowfall and non completion of land acquisition by the client in certain projects.
- Order backlog declined by 4% YoY** — HCC's order backlog of Rs93bn declined by 4% YoY mainly due to high base effect; delay in awarding of Letter of Intent on Rs20bn on orders on which HCC is the lowest bidder and the removal of Rs1.5bn order from the backlog due to delays in the project from the client side.
- Lavasa update** — HCC intends to start the marketing of a part of Lavasa project (phase I) from October 2007 onwards. A further investment of Rs3bn is to be made in Lavasa in the near future, out of which HCC intends to invest Rs1bn.
- Continuing losses at Bandra Worli Sea Link project** — The company continues to book losses on the Bandra Worli Sea Link project. It has booked a total of Rs2.3bn of losses on the project of which Rs700mn were booked in 2007. The company expects to book further losses and expects the arbitration to happen after 2-3 years.

Sell/Low Risk	3L
Price (27 Apr 07)	Rs98.45
Target price	Rs105.00
Expected share price return	6.7%
Expected dividend yield	0.8%
Expected total return	7.5%
Market Cap	Rs25,228M US\$620M

Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2005A	661	2.88	66.8	34.2	6.4	25.6	0.6
2006A	858	3.13	8.6	31.5	2.8	13.8	0.7
2007E	886	3.23	3.2	30.5	2.6	9.6	0.8
2008E	1,513	5.52	70.8	17.8	2.3	14.9	0.9
2009E	2,081	7.59	37.6	13.0	2.0	17.8	1.0

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

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Figure 1. HCC Q407 Income Statement (Rs Mn)

Year End Mar31 (Rsmn)	4Q06	4Q07	% YoY	4Q07E Comments
Order Book Position	96,720	93,120	-3.7%	
Net Sales	7751	8476	9%	10500
Less: JV	(70)	(199)		-50
Income	7681	8277	8%	10450 21 % below our estimates due to slower execution of order backlog
Material Costs	(3529)	(2579)	-27%	(3344)
as % of net sales	45.9%	31.2%		32.0%
Staff Cost	(379)	(614)	62%	(700) Higher staff costs have hurt margins
as % of net sales	4.9%	7.4%		6.7%
Construction Costs	(2869)	(4003)	40%	(4755) Higher than expected construction costs on account of mobilization of resources in some early stage projects
as % of net sales	37.3%	48.4%		45.5%
Others	(229)	(359)	57%	(449)
as % of net sales	3.0%	4.3%		4.3%
Total Expenditure	(7006)	(7555)	8%	(9248)
EBITDA	675	722	7%	1202
EBITDA Margin	8.8%	8.7%	(6)	11.5% 277 bps below our estimates
Depreciation	(147)	(244)	66%	(220) Higher than expected
EBIT	528	479	-9%	982
EBIT Margin	6.9%	5.8%	(109)	9.4%
Interest	(85)	(212)	149%	(170) Higher than expected
Other Income	8	125	1457%	8 Exchange rate gain on FCCBs
Company's share of P&L in JVs	12	154		
PBT	463	546	18%	820
PBT Margin	6.0%	6.6%		7.8%
Total Tax	(46)	(179)	286%	(321)
Tax Rate	10.0%	32.7%		39.2%
Recurring PAT	417	367	-12%	499 26% below our estimates
Recurring PAT Margin	5.4%	4.4%		4.8%
Tax of previous years	21	(425)		Reversal of Section 80 IA benefits
Provision for tax of previous years written back		425		Provision for taxes written back (Section 80IA)
Reported PAT	438	367	-16%	499

Source: Citigroup Investment Research

Hindustan Construction

Company description

HCC is an 80-year-old construction company where the major shareholders own a 47% stake. It has cash contracting skills across power (thermal, hydel, nuclear), roads, bridges, dams, barrages, industrial, buildings, water supply, sanitation, ports, harbors and other marine works.

Investment thesis

We rate HCC Sell/ Low Risk (3L), with a target price of Rs105 (Rs130 earlier) as we feel the margin contraction bugbear looms large on account of (a)

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commodity price increase (b) staff cost increase to retain employees (c) increasing competition across subsectors (d) increased subcontracting as the company grows bigger. We also believe that the sales growth CAGR would slow down on account of the long gestation hydel projects won in FY06.

We are also wary of the value the markets are imputing for the Lavasa real estate investments at such an early stage. Upside in the long term notwithstanding, we believe these investments can justify higher valuations only on successful completion and sale of a certain percentage of the property.

Valuation

We look at HCC as two distinct parts: the cash contract business and real estate investments.

Core Cash Contracting Business: Against a P/E of 23x FY08E for L&T, we use a P/E of 17x FY08E FD EPS to value the core cash contracting business of HCC because HCC is smaller on scale and order book. The value/share of the cash contracting business works out to Rs94/share (Rs121/share earlier). Our P/E 17x FY08E multiple is supported by forecasted earnings CAGR of 34% over FY06-09E.

Lavasa Project: We use Rs1mn/acre market value of raw land to calculate the Enterprise Value and knock off the debt of Rs5bn to get the equity value of the project. HCC equity stake of 60% and a 20% holding discount gives a value of Rs9/share for the Lavasa Project.

Vikhroli (West) Land: We use Rs2000/sqft to value the 9 acres of land that HCC owns in Vikhroli (West). A 20% holding company discount provides us a value of Rs3/share

Based on sum-of-the-parts we set a target price of Rs105/share for HCC.

Alternatively on adjusting for the real estate investment, HCC would trade on an EV/EBITDA of 11.3x FY08E at our target price of Rs105, in line with other second tier construction peers.

Risks

We rate HCC Low Risk, which differs from the Medium Risk rating assigned by our quantitative risk-rating system because HCC has a beta of less than 1 and HCC's order backlog of greater than Rs90bn implies sales coverage of 4.8x FY06 sales and provides good earnings visibility in the medium term.

The key risk factors on the downside are as follows:

- (1) The construction business is subject to project risks;
- (2) The judiciary not allowing Section 80I (A) benefits to non-BOT projects;
- (3) Equity dilution as the company raises capital to expand and fund BOT projects; and
- (4) The construction business is sensitive to economic variables - growth, interest rates and the investment cycle.

The key upside risks include:

- (1) Private equity investors taking a stake in Lavasa project at value higher than what we have imputed
- (2) Completion and sale of phase I of Lavasa Corporation before schedule
- (3) Markets imputing a higher valuation for the real estate investment on the sale of smaller tracts of land
- (4) A faster than expected order execution
- (5) Stronger than expected order inflow.

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If any of these risk factors has a greater impact than we expect, HCC's share price will have difficulty attaining our target price.

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Appendix A-1

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Analyst: Venkatesh Balasubramaniam (covered since February 9 2006)



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