Company Flash

19 October 2006 | 6 pages

Hindustan Construction (HCNS.BO)

Positive Margin Surprise, But Profits Disappoint

- Profits disappoint — HCC's Recurring PAT at Rs41mn (up 629% YoY) was below CIR estimates of Rs90mn (up 1513% YoY) on account of higher than expected interest cost and tax rate. Reported PAT was down 88% YoY on account of exceptional items net of tax of Rs351mn in 2QFY06.

- Positive margin surprise — After 9 successive quarters of YoY margin contraction HCC's margins expanded 85bps in 2QFY07. We believe one has to observe margins closely for the next two quarters to see if this is sustainable, as margins improving are contingent on HCC not booking losses on the Bandra Worli Sea Link project.

- Strong order backlog, but... — HCC has a strong order backlog of 35 projects of Rs98bn projects (hydel – 47%, transportation 38%, water supply/irrigation -11% and others – 4%). But 18 of the 35 projects are in the initial mobilization phase and 4 projects are running late because of loss of planned work.

- Bandra Worli still booking losses – HCC is continuing work on the Bandra Worli Sea Link project despite MSRDC not accepting the price variations till date. In the event that the price variations are not allowed HCC could go for arbitration. According to the management, a positive ruling in its favor could provide an upside of Rs4-5bn and in our view have a positive effect on EBITDA margins.

- Real estate update — HCC now plans to develop 13,000 acres of land into 113mn sqft where the scope of the Lavasa project has been increased to 12,500 acres and 100mn sqft. It is too early to impute significant upside from the real estate venture as this is a long gestation project with implementation and commercial risks.

Sell/Low Risk	**3L**
Price (19 Oct 06)	Rs123.00
Target price	Rs105.00
Expected share price return	-14.6%
Expected dividend yield	0.7%
Expected total return	**-14.0%**
Market Cap	Rs31,519M
	US$696M

Figure 1. HCC Statistical Abstract

Year to 31-Dec	Net Profit (Rs mills)	EPS (Rs)	EPS Growth (%)	P/E (x)	Adj. P/E (x)	EV / EBITDA (x)	Adj EV/EBITDA (x)	P / Book (x)	ROE (%)	DPS (Rs)	Div. Yield (%)
FY05A	661	2.88	66.8%	42.7	38.7	20.3	18.6	8.0	25.6%	0.60	0.5%
FY06A	858	3.13	8.6%	39.3	35.6	18.8	17.2	3.5	13.8%	0.70	0.6%
FY07E	886	3.23	3.2%	38.1	34.5	18.6	17.0	3.3	9.6%	0.80	0.7%
FY08E	1,513	5.52	70.8%	22.3	20.2	14.2	13.1	2.9	14.9%	0.90	0.7%
FY09E	2,081	7.59	37.5%	16.2	14.7	10.9	10.1	2.5	17.8%	1.00	0.8%

Source: Citigroup Investment Research estimates

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Figure 2. HCC 2QFY07 Results

Year End Mar31 (Rsmn)	2Q06	2Q07	% YoY	2Q07E	% YoY	Remarks
Order Book Position	78,950	98,190	*24.4%*	95,000	*20.3%*	Strong order backlog
Net Sales	**3117**	**4257**	***37%***	**4354**	***-100%***	
Less: JV	(96)	(54)		(60)		
Income	**3022**	**4202**	***39%***	**4300**	***42%***	In line with estimates
Material + Construction %	**76.8%**	**75.4%**		**81.5%**		Raw material costs surprises on the upside
Material	(1143)	(1392)	*22%*	(1484)	*30%*	
as % of net sales	37.8%	33.1%		34.5%		
Staff Cost	(324)	(422)	*30%*	(344)	*6%*	Indication of a tight labour condition
as % of net sales	10.7%	10.0%		8.0%		
Construction	(1177)	(1779)	*51%*	(2021)	*72%*	
as % of net sales	39.0%	42.3%		47.0%		
Others	(121)	(216)	*79%*	(129)	*7%*	
as % of net sales	4.0%	5.1%		3%		
Total Expenditure	**(2764)**	**(3808)**	***38%***	**(3978)**	***44%***	Margins surprise on the upside improving 85bps
EBITDA	**258**	**394**	***53%***	**323**	***25%***	
EBITDA Margin	**8.5%**	**9.4%**	**85**	**7.5%**		
Depreciation	(129)	(186)	*44%*	(161)	*25%*	
EBIT	**128**	**208**	***62%***	**161**	***25%***	
EBIT Margin	**4.2%**	**4.9%**	**70**	**3.7%**		
Interest	(120)	(158)	*32%*	(74)	*-38%*	Higher than expected interest cost
Other Income	0	10	*2115%*	10	*2183%*	
Company' share of Profit/(Loss) in JVs	(3)	0		0	*-100%*	
PBT	**6**	**60**	***899%***	**97**	***1515%***	
PBT Margin	**0.2%**	**1.4%**		**2.3%**		
Current Tax	2	(7)				
Deferred Tax	4	(5)				
FBT	(6)	(7)				
Total Tax	**(0)**	**(19)**	***4562%***	**(7)**	***1546%***	According to management tax rate would be lower in 3Q FY07 and 4QFY07
Tax Rate	**6.9%**	**32.1%**		**7.0%**		
Recurring PAT	**6**	**41**	***629%***	**90**	***1513%***	Profits below our estimates
Recurring PAT Margin	**0.2%**	**1.0%**		**2.1%**		
Exceptional	32	1		0		
Capital Gains on Transfer of DR	400	0		0		
Tax Adjustment	(80)	0		0		
Reported PAT	**357**	**42**	***-88%***	**90**	***-75%***	

Source: Company Reports

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

Analyst Certification Appendix A-1

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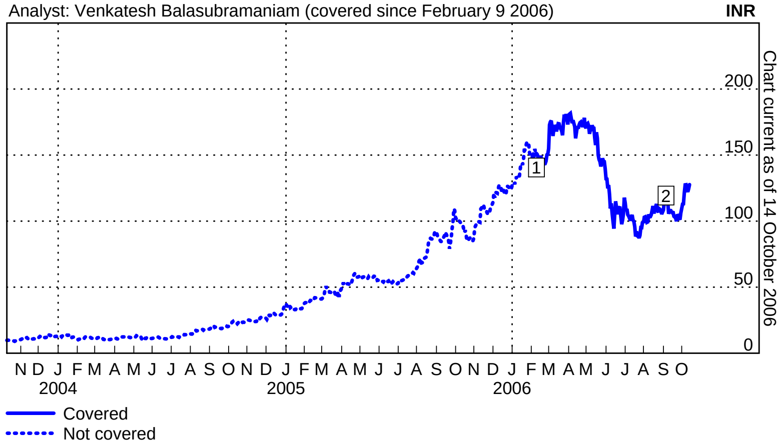
Hindustan Construction Co Ltd (HCNS.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Venkatesh Balasubramaniam (covered since February 9 2006)



#	Date	Rating	Target Price	Closing Price
1:	9 Feb 06	3L	130.00	NA
2:	6 Sep 06	3L	*105.00	117.60

*Indicates change.

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