Company Focus

15 July 2008 | 10 pages

DLF (DLF.BO)

Target price change ☑

Buy: Correction Overdone; Relatively Insulated Play

- **Top Pick** – We see DLF as a core holding and a relatively insulated play in these tough times. While the stock is down 24% over last 3 months on weak sentiments for property, the correction appears overdone as DLF scores on asset mix, business model and balance sheet. Reiterate Buy with lower target of Rs585 based on 10% discount (15% premium earlier) on NAV of Rs650 (cut 12%), factoring in higher discount rates, increased cap-rates and likely delays.
- **What differentiates DLF?** – 1) Focus on office/retail assets (~50m sq ft under construction ahead of peers) provides greater access to capital and relatively insulates it from supply risks, 2) De-leveraged balance sheet in this liquidity strained scenario, 3) Sizeable landbank substantially paid for, and 4) Growing lease asset portfolio (~8msq ft in FY08), driving higher lease income in FY09E.
- **What's new?** – 1) Mid-income housing the thrust, launched town houses in New Gurgaon at Rs2550/sqft, more on anvil in 2H; 2) DLF's buyback plans for 1.3% equity at price not exceeding Rs600/share, a near-term valuation support; 3) Good progress on hotels – ~300 keys to start in FY09; 4) Some push back in timelines for Dhankuni township due to socio-political factors.
- **Dependence to DLF Assets down, but critical to growth** – While sales to DAL are down to 37% in FY08 (54% in FY07), it still remains critical to DLF's growth. We see higher risks as success is contingent on capital flows – stressed today.
- **Key Risks** – 1) Demand/funding risks for comm. asset portfolio, 2) Sensitive to rising cap-rates; 3) Timely launches and execution, 4) Sustained profitability.

Buy/Medium Risk	**1M**
Price (14 Jul 08)	Rs455.80
Target price	Rs585.00
from Rs846.00	
Expected share price return	28.3%
Expected dividend yield	0.9%
Expected total return	**29.2%**
Market Cap	Rs777,063M
	US$18,164M

Price Performance (RIC: DLF.BO, BB: DLFU IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	1,917	12.34	100.2	36.9	7.5	22.6	0.0
2007A	19,337	12.75	3.3	35.7	26.5	108.8	0.0
2008E	78,558	46.08	261.4	9.9	4.1	72.1	0.9
2009E	94,461	55.41	20.2	8.2	3.0	41.5	0.9
2010E	115,433	67.71	22.2	6.7	2.1	37.0	0.9

Source: Powered by dataCentral

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

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	37.0	35.8	9.9	8.2	6.7
P/E reported (x)	37.0	35.8	9.9	8.2	6.7
P/BV (x)	7.5	26.6	4.1	3.0	2.2
Dividend yield (%)	0.0	0.0	0.9	0.9	0.9
Per Share Data (Rs)					
EPS adjusted	12.34	12.75	46.08	55.41	67.71
EPS reported	12.34	12.75	46.08	55.41	67.71
BVPS	61.16	17.18	112.52	154.35	212.06
NAVps ordinary	na	na	na	na	na
DPS	0.10	0.01	4.00	4.00	4.00
Profit & Loss (RsM)					
Net operating income (NOI)	**5,154**	**15,918**	**100,671**	**129,712**	**155,016**
G&A expenses	-397	-1,051	-3,153	-2,838	-3,406
Other Operating items	-361	-591	-732	-750	-1,060
EBIT including associates	**4,396**	**14,276**	**96,787**	**126,124**	**150,550**
Non-oper./net int./except.	-801	11,114	-328	-176	3,361
Pre-tax profit	**3,595**	**25,389**	**96,459**	**125,948**	**153,911**
Tax	-1,668	-6,042	-17,534	-31,487	-38,478
Extraord./Min. Int./Pref. Div.	-10	-11	-367	0	0
Reported net income	**1,917**	**19,337**	**78,558**	**94,461**	**115,433**
Adjusted earnings	1,917	19,337	78,558	94,461	115,433
Adjusted EBIT	4,396	14,288	96,733	126,124	150,550
Adjusted EBITDA	4,757	14,866	97,518	126,874	151,610
Growth Rates (%)					
NOI	142.1	208.8	532.4	28.8	19.5
EBIT adjusted	225.9	225.0	577.0	30.4	19.4
EPS adjusted	100.2	3.3	261.4	20.2	22.2
Cash Flow (RsM)					
Operating cash flow	**-15,375**	**-39,232**	**-27,296**	**59,141**	**52,582**
Depreciation/amortization	361	578	785	750	1,060
Net working capital	-8,589	-62,932	-105,596	-36,070	-55,816
Investing cash flow	**-15,075**	**-19,136**	**-65,826**	**-35,344**	**-32,357**
Capital expenditure	-7,175	-25,329	-59,172	-35,112	-32,102
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**31,976**	**60,573**	**108,338**	**-27,758**	**-31,897**
Borrowings	31,644	58,007	23,282	-14,119	-14,848
Dividends paid	-16	-18	-6,819	-13,639	-17,048
Change in cash	**1,526**	**2,205**	**15,216**	**-3,961**	**-11,672**
Balance Sheet (RsM)					
Total assets	**69,436**	**181,237**	**400,421**	**441,610**	**534,103**
Cash & cash equivalent	1,950	4,155	19,371	15,410	3,738
Net fixed assets	17,043	41,851	100,058	99,247	130,289
Total liabilities	**59,881**	**145,596**	**190,717**	**164,410**	**158,519**
Total Debt	41,320	99,327	122,609	95,109	80,260
Shareholders' funds	**9,555**	**35,641**	**209,704**	**277,199**	**375,584**
Profitability/Solvency Ratios					
EBIT margin adjusted (%)	38.1	54.2	68.0	64.1	61.6
ROE adjusted (%)	22.6	108.8	72.1	41.5	37.0
ROA adjusted (%)	4.0	15.4	27.0	22.4	23.7
Net debt to equity (%)	412.0	267.0	49.2	28.8	20.4
Interest coverage (x)	2.8	4.8	32.7	33.3	47.2

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Key Points

What differentiates DLF?

~50m sq ft currently under construction which is ahead of most peers – a good hedge, provides access to capital

- **Focus on commercial/retail (~42% of Gross NAV) assets** – Sizeable projects (~50m sqft) are in advanced stages of construction, ahead of most peers. This relatively insulates it from the planned supply from competitors, which we believe is likely to be more back-ended. This should also provide DLF's business model with a good hedge in the current environment, where residential business is going through sluggish demand. Further, this will provide the company with greater access to capital as we see private equity investors focusing on safety and near-term returns in current volatile times.

Net Debt/Equity of 0.49x and avg. cost of 11% a big advantage

- **De-leveraged balance sheet in this liquidity strained scenario** – We see DLF taking advantage of its strong balance sheet (net debt/equity of 0.49x with average cost of debt at 11% vs. peer costs at 13-15%) in case of any consolidation and distress selling from small developers facing liquidity crunch. Additionally, this would help in faster execution.

Leverage on paid landbank to launch mid-income housing at faster pace than peers

- **Sizeable landbank substantially paid for (excluding govt. dues)** – The company's 11,000acres (excluding large townships of Dhankuni, Bidadi still to be handed over by govt.) is substantially 90% paid for. We see this provide the company with a competitive advantage in current environment – 1) ability to launch mid-income housing across cities at affordable prices in timely manner, 2) facilitate faster execution – its success on initial launch of mid-income housing reflects this.

- **Large lease asset portfolio** – DLF's ~8msqft leased asset portfolio is likely to grow significantly in FY09E with more retail malls, IT Parks and office space being handed over for fit-outs. We see this driving healthy lease income going forward.

Lowering NAVs to factor higher risks

Reduce NAV by 12% to Rs650 (vs. Rs736 earlier) factoring 200bps increase in rates to 16% and potential execution delays

DLF's thrust on execution has largely differentiated it from most developers. It presently has ~62m sq ft under construction, higher than that for most peers. However, with the recent rate hikes (more in the offing) amidst fears of rising inflation, we see higher risks ahead as the operating environment for developers gets tougher, particularly in the residential segment (67% of DLF's landbank). Building for this and DLF's superior execution capabilities, we foresee a further 12-month delay in new launches/execution (building ~2-yr delay vs. guidance) of its development portfolio. Factoring 1) 200bps increase in discount rate to 16%; and 2) a higher cap rate of 10% (vs. 9% earlier) for commercial/IT Park, IT SEZs in Super Metros and Metros, and 11% (vs. 10% earlier) for other locations, we have lowered DLF's Mar'09E NAV by 12% to Rs650 (vs. Rs736 earlier).

What's new?

Recently launched town houses in New Gurgaon – more on anvil in 2HFY09; timely execution will be crucial

- **Mid-income housing, the thrust** – Encouraged by this strong response, DLF is targeting to sell ~4,000 units/qtr and recently launched town houses in New Gurgaon at Rs2550/sqft. More mid-income launches are planned in Chandigarh, Indore, Bangalore, Chennai and Kochi over the next few quarters. In addition, it is also looking to launch some super luxury/luxury projects in Mumbai, Delhi and Goa. We see DLF differentiating itself by scaling-up in this segment; however with overall residential demand environment tough, appropriate pricing and timely execution will be crucial.

Plans to buyback up to 1.3% of equity at a price of up to Rs600/share

- **Buyback plans at Rs600/share, near-term valuation support** – The company's approved buyback plans for 1.3% of equity at a price not exceeding Rs600/share, up to a total consideration not exceeding Rs11bn. We see this as 1) near-term valuations support for the stock, and 2) highlighting a relatively better cash flow situation for the company, which is comforting in the current environment. However, although DLF has sufficient cash of Rs19.4bn (as on Mar'08) to fund the buyback, the buyback could drain some of the cash reserves, which could be used more effectively in times of distress in the current environment.

- **Good progress on hotel business** – 1) Signed management contract with Hilton for 7-new hotels; 2) targeting to have ~4,200 rooms under construction in FY09; 3) Plans underway to have ~300 keys operational in FY09; and 4) Work on International conventional centre, Dwarka has started.

Socio-political factors likely to push back timeline for Dhankuni and Bidadi projects

- **Push back in timeline for large township projects** – Socio-political factors have led to delays in govt. providing land for its Dhankuni township project (5% of Gross NAV) – this could result in some execution delays for this project. Additionally, we see a higher probability of approval/execution delays for its Bidadi project (4% of Gross NAV) given recent political changes. Factoring this, we have built in 12-m execution delay in our NAV assumptions.

Key risks in the current scenario

Key risks – 1) sluggish residential market, 2) asset sale strategy contingent on capital flows; and 3) potential supply risks

DLF has consistently delivered on performance over the past few quarters. However, given the tough environment, we see the following risks going forward.

- The company's asset sale strategy to DLF Assets remains contingent on capital flows. With volatile markets and moderating fund flows towards real estate, cash flows could get adversely impacted. Further, outstanding from DOT is high at Rs19bn as of Mar'08 and lack of sufficient capital with the asset holding company (DLF Assets) could affect future asset injections from DLF. We see this as an inherent risk to the company's overall growth.

- Potential supply risks across asset classes, particularly IT Parks/IT SEZs. While there is strong demand for IT space, in the event of the sector facing a slowdown, DLF could get adversely impacted due to its high leverage and scale in IT/ITSEZ space (~64m sq ft of landbank).

- Sluggish demand environment in residential market continues. Given DLF's aggressive pipeline of mid-income housing projects, a good response will be crucial for growth ahead and cash flows.

DLF

Company description

DLF is one of India's oldest real estate developers. Established in Delhi in 1946, it has continued to expand and diversify its real estate businesses, and is among the largest developers in India. It has historically built its businesses in Delhi and adjoining areas, know as the National Capital Region (NCR). DLF has diversified into other geographic locations over the past few years. These expansions are spread across India, with a focus on the Northern India belt, Kolkata, Mumbai, Chennai, and a number of other large and rapidly growing cities. DLF enjoys a strong brand franchise with a good track record in execution and delivery. This is the flagship company of the KP Singh family, with the founders holding an 88% stake. It is one of India's largest developers, with a diversified asset portfolio and an emerging pan-India presence.

Investment strategy

We rate DLF Buy/Medium Risk (1M), with a target price of Rs585. DLF's scale, large landbank across top-tier growth cities, execution record, de-leveraged balance sheet and disclosure standards differentiate it from its peers. Its diversified portfolio of ~751m sq ft is leveraged toward commercial/IT Parks/Retail mall assets, which should provide a good hedge in the near-term against the residential segment slowdown. The response to its recently launched mid-income housing has been encouraging. With DLF delivering on its promises, we see the recent correction as an enhanced opportunity to buy and believe the stock should be a core holding for exposure to the Indian real estate sector.

Valuation

Our target price of Rs585 is based on a 10% discount (vs. 15% premium earlier) to our revised Mar09E NAV of Rs650 (vs. Rs736 earlier). The move to discount to NAV vs. premium earlier is largely recognizing increased risks post recent rate hikes and negative sentiment on property stocks as risk appetite tapers off further amidst volatile markets. We have also lowered our NAV by 12%, factoring in 200bps increase in discount rate to 16%, higher cap-rates of 10-11% for its commercial asset portfolio, and execution delay of 12 months on its development portfolio as the operating environment for developers gets tougher.

Our NAV includes Rs563 for the development portfolio and Rs87 for other asset holdings and new JV businesses (Rs61/share for the existing 9m sq ft of leased assets and 7.2m sq ft of plots and Rs26/share for DLF's share in construction and hotel JVs). The lower discount vs. peers (25-45%) is attributed to: 1) Leverage towards both office/IT Parks and retail assets provide access to capital in a liquidity-strained market; 2) a relatively de-leveraged balance sheet; 3) a strong execution track record; and 4) the company is a benchmark for disclosure standards.

Figure 1. DLF NAV Summary (Rs million)

Gross NAV Residential	878,577
Gross NAV Non-Residential	654,346
Total Gross NAV	**1,532,923**
Less: Amt outstanding for land	66,460
Less: Tax @ 25%	366,616
Less: Debt outstanding	122,609
Less: Customer Advances	26,000
Add: Cash	8,371
Net NAV	**959,609**
9m of existing owned/leased assets	60,000
7.2m sq ft in Plots	45,000
74% stake in Hotel JV - 51 hotel sites	32,879
50% stake in Construction JV	10,800
Total Value	**1,108,288**
No. of Shares Outstanding (m)	1,705
NAV Per Share (Rs)	**650**

Source: Citi Investment Research

We believe an NAV-based valuation methodology is most appropriate for developers, as it factors in the varied development projects and the spread-out time frame. Our March 2009E NAV is based on: 1) the current market prices; 2) development volume of 677m sq ft; 3) a cap rate of 10% for commercial/IT Park, IT SEZs in Super Metros and Metros, and 11% for other locations; 4) development portfolio is executed over a 11-13-year period; 5) average cost of capital of 16%; and 6) a tax rate of 25%.

Risks

We rate DLF Medium Risk, as opposed to the Speculative Risk rating assigned by our quantitative risk-rating system to stocks that have less than one year's trading history. The key reasons for assigning a Medium Risk rating include: 1) the company's robust business model; 2) pan-India land bank with initiatives to de-risk the business model through new business JVs; and 3) relatively healthy cash flows, at a time when most developers are facing funding constraints. The main risks to our investment thesis and target price include: 1) The company's asset sale strategy remains contingent on capital flows; 2) Response to DLF's new mid-income project launches expected in FY09 is crucial for growth ahead and cash flows; 3) Slowdown in the IT/ITES industry could lead to a decline in demand for commercial real estate; and 4) Slowdown in capital inflows or measures to regulate FDI in the real estate sector.

Appendix A-1

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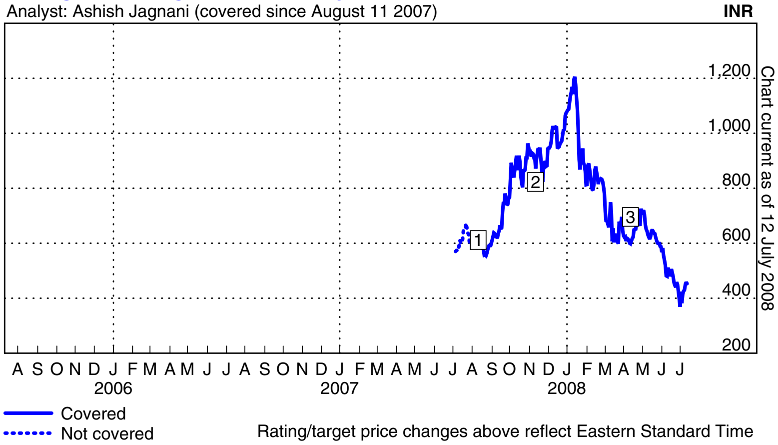
IMPORTANT DISCLOSURES

DLF (DLF.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Ashish Jagnani (covered since August 11 2007)



#	Date	Rating	Target Price	Closing Price
1:	10 Aug 07	1M	725.00	584.45
2:	12 Nov 07	1M	*1,046.00	871.20
3:	11 Apr 08	1M	*846.00	598.00

*Indicates change.

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