

# 2Q in line, but cash flows disappoint, Maintain U/p

## In line results on stronger margin; Maintain U/p

Sobha reported 2Q earnings at Rs409mn, in line with our estimate even though revenue disappointed by 14% due to flat contribution from real estate. The expansion in EBIDTA margin by 300bps QoQ helped achieve profit expectation. The larger disappointment was due to increase in debt by Rs600mn due to investment in new launches and purchase of stake in one of its project. We maintain our Underperform rating with PO of Rs190 with 16% downside potential.

## Unlikely to achieve deleveraging guidance before FY13

Sobha maintained its debt reduction guidance at 0.5x for FY12 implying 25% reduction from current levels of Rs13.6bn, which we believe would be difficult to achieve in next two quarters. Sobha has another Rs600mn of outflow due to stake purchase in 3Q while 2Q sales run rate is unlikely to sustain. We expect Sobha to achieve 10% reduction in debt in 2HFY12 with debt / equity ratio improving to 0.6x. The cost of debt has increased by 100bps in 1H, though debt repayments are unlikely to be an issue in 2HFY12 with sufficient liquidity.

## Strong 2Q volume to trend down

Sobha has maintained its sales guidance of above Rs15bn for FY12 and sounded confident of achieving the same. We expect the strong sales volume of 0.93mn sq ft in 2Q is unlikely be repeated given lack of new launches in Bangalore in 2HFY12, and Sobha to miss the guidance by 5-7%. It is looking for 3-4 new launches in 2H, aggregating to ~1.7mn sq ft as against 3.5mn sq ft launch in 1H.

## Underperform on rising risks to Bangalore story

We expect the headwinds in Bangalore residential market to get chillier as global macro uncertainty increases while interest rates continue to remain high. We believe market expects high volumes and realization from Sobha for FY12 and is likely to be disappointed in 2HFY12 leading to downgrades.

### Estimates (Mar)

(Rs)	2010A	2011A	2012E	2013E	2014E
Net Income (Adjusted - mn)	1,341	1,813	1,716	1,812	2,263
EPS	13.68	18.49	17.50	18.48	23.08
EPS Change (YoY)	-7.5%	35.1%	-5.3%	5.6%	24.9%
Dividend / Share	2.50	3.00	3.50	4.62	5.77
Free Cash Flow / Share	3.16	20.93	2.61	25.29	9.80

### Valuation (Mar)

	2010A	2011A	2012E	2013E	2014E
P/E	16.57x	12.26x	12.95x	12.26x	9.82x
Dividend Yield	1.10%	1.32%	1.54%	2.04%	2.55%
EV / EBITDA*	13.89x	10.74x	10.76x	10.27x	8.38x
Free Cash Flow Yield*	1.40%	9.24%	1.15%	11.16%	4.32%

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 7.

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Refer to important disclosures on page 8 to 10. Analyst Certification on Page 5. Price Objective Basis/Risk on page 5. Link to Definitions on page 5. 1109925

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### Stock Data

Price	Rs226.65
Price Objective	Rs190.00
Date Established	6-Oct-2011
Investment Opinion	C-3-7
Volatility Risk	HIGH
52-Week Range	Rs184.95-Rs339.85
Mrkt Val / Shares Out (mn)	US\$443 / 98.1
Market Value (mn)	Rs22,226
Average Daily Volume	123,585
BofAML Ticker / Exchange	SBDRF / NSI
Bloomberg / Reuters	SOBHA IN / SOBH.BO
ROE (2012E)	9.0%
Net Dbt to Eqty (Mar-2011A)	64.4%
Est. 5-Yr EPS / DPS Growth	10.0% / 10.0%
Free Float	35.3%

### Key Changes

(Rs)	Previous	Current
2012E EPS	17.56	17.50
2013E EPS	18.67	18.48
2014E EPS	21.70	23.08
2012E EBITDA (m)	3,157.7	3,230.3
2013E EBITDA (m)	3,395.1	3,385.2
2014E EBITDA (m)	3,924.8	4,146.2

## iQprofile<sup>SM</sup> Sobha Developers

Key Income Statement Data (Mar)	2010A	2011A	2012E	2013E	2014E
<b>(Rs Millions)</b>					
Sales	11,299	14,739	13,564	15,200	17,091
Gross Profit	4,762	6,107	5,874	6,357	7,496
Sell General & Admin Expense	(2,299)	(2,946)	(2,713)	(3,040)	(3,770)
Operating Profit	2,179	2,958	2,958	3,073	3,794
Net Interest & Other Income	(521)	(444)	(435)	(408)	(417)
Associates	0	0	0	0	0
Pretax Income	1,658	2,514	2,524	2,665	3,378
Tax (expense) / Benefit	(275)	(669)	(808)	(853)	(1,115)
Net Income (Adjusted)	1,341	1,813	1,716	1,812	2,263
Average Fully Diluted Shares Outstanding	98	98	98	98	98

### Key Cash Flow Statement Data

Net Income	1,341	1,813	1,716	1,812	2,263
Depreciation & Amortization	323	278	272	312	352
Change in Working Capital	(1,179)	294	(763)	924	(1,085)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(47)	(90)	(69)	(69)	(69)
Cash Flow from Operations	438	2,294	1,156	2,980	1,461
Capital Expenditure	(128)	(242)	(900)	(500)	(500)
(Acquisition) / Disposal of Investments	0	(10)	0	0	0
Other Cash Inflow / (Outflow)	39	75	69	69	69
Cash Flow from Investing	(90)	(177)	(831)	(431)	(431)
Shares Issue / (Repurchase)	252	0	0	0	0
Cost of Dividends Paid	(287)	(343)	(400)	(528)	(661)
Cash Flow from Financing	241	(2,665)	(400)	(2,028)	(1,661)
Free Cash Flow	310	2,053	256	2,480	961
Net Debt	13,915	12,130	12,206	10,186	9,817
Change in Net Debt	(5,172)	(1,774)	76	(2,020)	(369)

### Key Balance Sheet Data

Property, Plant & Equipment	2,061	2,041	2,669	2,857	3,005
Other Non-Current Assets	27	37	37	37	37
Trade Receivables	4,430	4,252	4,088	3,540	3,512
Cash & Equivalents	826	288	213	733	102
Other Current Assets	31,204	32,267	32,332	32,741	34,504
Total Assets	38,547	38,885	39,339	39,908	41,160
Long-Term Debt	14,740	12,418	12,418	10,918	9,918
Other Non-Current Liabilities	0	0	0	0	0
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	6,529	7,709	6,847	7,632	8,281
Total Liabilities	21,270	20,127	19,265	18,550	18,199
Total Equity	17,329	18,832	20,148	21,432	23,034
Total Equity & Liabilities	38,599	38,959	39,413	39,982	41,233

### iQmethod<sup>SM</sup> - Bus Performance\*

Return On Capital Employed	5.8%	6.9%	6.3%	6.5%	7.8%
Return On Equity	9.6%	10.2%	9.0%	8.9%	10.3%
Operating Margin	19.3%	20.1%	21.8%	20.2%	22.2%
EBITDA Margin	22.1%	22.0%	23.8%	22.3%	24.3%

### iQmethod<sup>SM</sup> - Quality of Earnings\*

Cash Realization Ratio	0.3x	1.3x	0.7x	1.6x	0.6x
Asset Replacement Ratio	0.4x	0.9x	3.3x	1.6x	1.4x
Tax Rate (Reported)	16.6%	26.6%	32.0%	32.0%	33.0%
Net Debt-to-Equity Ratio	80.3%	64.4%	60.6%	47.5%	42.6%
Interest Cover	4.2x	6.7x	6.8x	7.5x	9.1x

### Key Metrics

\* For full definitions of iQmethod<sup>SM</sup> measures, see page 7.

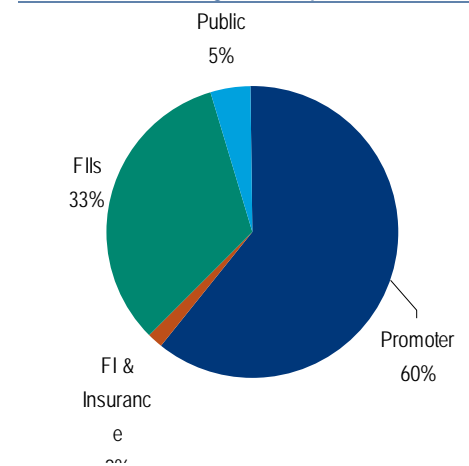
### Company Description

Sobha is a Bangalore based real estate developer primarily focused on mid to high end residential development. It has a contractual division also which has been credited with development of various campuses for Infosys. It has land bank spread across 10 cities primarily in South India.

### Investment Thesis

We expect headwinds in the Bangalore residential market to get chillier as global macro uncertainty increases, while interest rates continue to remain high. We believe the market's expectations are very high on SOBha's volume and realization for FY12 and are likely to be disappointed in 2HFY12, leading to downgrades. Hence, our Underperform rating.

Chart 1: Shareholding as on Sep 11



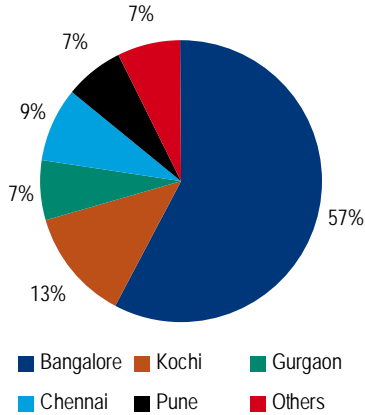
Source: BSE

### Stock Data

Price to Book Value

1.1x

**Chart 2: NAV – Bangalore remains key**



Source: BofA Merrill Lynch Global Research

## Maintain Underperform; PO of Rs190

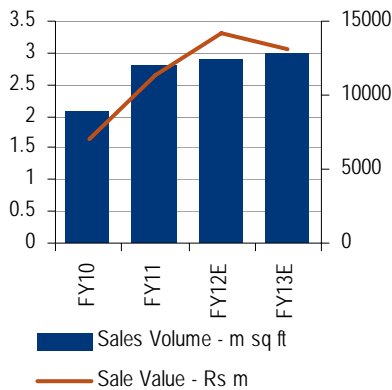
We maintain our Underperform rating on Sobha Developers with PO of Rs190 – offering 16% downside potential from the current levels – based on 20% discount to our NAV. We expect the headwinds in Bangalore residential market to get chillier as global macro uncertainty increases while interest rates continue to remain high. We believe market expects high volumes and realization from Sobha for FY12 and is likely to be disappointed in 2HFY12 leading to downgrades.

**Table 1: Sobha Developers - NAV summary**

	Value (Rs m)	Value per share (Rs)	% of NAV (pre debt)
Residential projects	16,811	171	44.9%
Commercial projects			
Value of land bank	16,116	164	43.0%
Construction business	2,670	27	7.1%
Manufacturing business	1,874	19	5.0%
<b>Gross NAV</b>	<b>37,471</b>	<b>382</b>	
<i>Less</i>			
- Net debt	12,966	132	
- Outstanding land payments	1,281	13	
<b>Net NAV</b>	<b>23,224</b>	<b>237</b>	
<b>Assuming 20% discount to NAV</b>	<b>18,579</b>	<b>190</b>	
<b>Price Objective</b>		<b>190</b>	

Source: BofA Merrill Lynch Global Research

**Chart 3: Sales estimate for FY12/13**

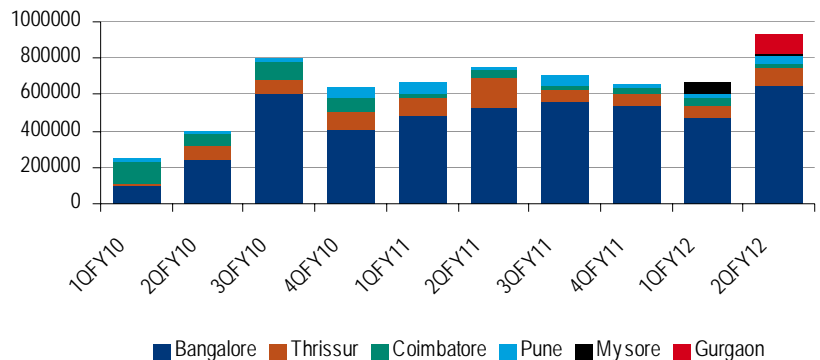


Source: BofA Merrill Lynch Global Research

## Volume peaked in 2Q

Sobha saw a robust 2Q volume on back of slew of launches in 1H, both in Bangalore and other locations including Gurgaon. But we expect the pace to slow down back to 0.6-0.7mn sq ft a quarter as new launches slow down. Sobha has plans to launch another ~1.7mn sq ft (mostly outside Bangalore - Chennai/Coimbatore) in 2H against 3.5mn sq ft launched for sale in 1H. We believe increasing competition in Bangalore market, while high prices in Gurgaon should lead to slowdown in volume for Sobha.

**Chart 4: Sales volume spike due to bunching up of new launches (sq ft)**



Source: BofA Merrill Lynch Global Research

## Debt reduction to be lower than guidance

Sobha reported an increase in debt by another Rs600mn post Rs1bn increase in 1Q taking total net debt to Rs13.6bn. The debt increased in 2Q due to dividend payout, investment in fixed assets for launch of projects in new locations and buyback of PE stake in its project for Rs600mn. We believe it will be difficult for Sobha to reduce debt by Rs3bn in remaining two quarters given it has outflow obligation of another Rs600mn stake purchase in 3Q. We expect Sobha to reduce debt by 10% in 2HFY12 as the benefit of recent strong sales will start flowing in.

But Sobha remains comfortable on liquidity given available sanctioned limits from banks and just Rs2.5bn of debt required to be repaid in 2H. The cost of debt for Sobha also has increased in line with other developers by 100bps to 14% in 2Q.

Table 2: Earnings Snapshot for 1QFY11

	2QFY11	1QFY11	2QFY12	Change	
	Rs mn	Rs mn	Rs mn	YoY	QoQ
Sales and other receipts	4,308	3,179	3,294	-24%	4%
Construction cost	2,584	1,819	1,711	-34%	-6%
Gross margin	1,724	1,360	1,583	-8%	16%
<i>Gross margin (%)</i>	<i>40%</i>	<i>43%</i>	<i>48%</i>		
Staff costs	273	306	316	16%	3%
Other expenses	480	431	512	7%	19%
EBITDA	971	623	755	-22%	21%
<i>EBITDA margin (%)</i>	<i>23%</i>	<i>20%</i>	<i>23%</i>		
Depreciation	69	74	91	32%	23%
EBIT	902	549	664	-26%	21%
Interest expense	109	101	104	-5%	3%
Other income	5	5	32	540%	540%
EBT	798	453	592	-26%	31%
Tax	209	144	183	-12%	27%
<i>Tax (%)</i>	<i>26%</i>	<i>32%</i>	<i>31%</i>		
PAT	589	309	409	-31%	32%
<i>PAT Margin</i>	<i>14%</i>	<i>10%</i>	<i>12%</i>		

Source: BofA Merrill Lynch Global Research

## Price objective basis & risk Sobha Developers (SBDRF)

Our preferred valuation methodology is NAV, calculated by discounting the cash flows from each of the real estate projects. Our price objective of Rs190 is, therefore, based on our NAV of Rs237. We expect Sobha to trade at a discount of 20% to its NAV due to low NAV visibility and headwinds in its core market. Key assumptions underlying our NAV are a WACC of 15.1%, capitalization rate of 11% and inflation of 5% from FY13 on both selling prices and construction costs. On a P/E basis, at our PO of Rs190, the stock would trade at 11x FY12E earnings. Upside risks are higher-than-expected volume and a reduction in debt. Downside risks are a larger than expected price correction, global recession leading to a severe compression in demand.

## Link to Definitions

### Financials

Click [here](#) for definitions of commonly used terms.

## Analyst Certification

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14 November 2011

**India - General Coverage Cluster**

Investment rating	Company	BofA Merrill Lynch ticker	Bloomberg symbol	Analyst
<b>BUY</b>				
	Aditya Birla Nu	ADYAF	ABNL IN	Reena Verma Bhasin, CFA
	Anant Raj Industries Ltd	XNRJF	ARCP IN	Gagan Agarwal
	Brigade Enterprises	XBDGF	BRGD IN	Gagan Agarwal
	DLF Limited	XVDUF	DLFU IN	Abhishek Kiran Gupta
	Exide Indus Ltd	XEDRF	EXID IN	Sanjaya Satapathy
	Havells	HVLIF	HAVL IN	Sanjaya Satapathy
	Indiabulls Real Estate Ltd	IBELF	IBREL IN	Abhishek Kiran Gupta
	Motherson Sumi	XMSUF	MSS IN	Sanjaya Satapathy
	Oberoi Realty Ltd	XRXOF	OBER IN	Abhishek Kiran Gupta
	Opto Circuits	OPOCF	OPTC IN	Sanjaya Satapathy
	SINTEX INDUSTRIES LTD	SIXDF	SINT IN	Prasad Deshmukh
<b>NEUTRAL</b>				
	Chambal Fertilisers & Chemicals	CHBZF	CHMB IN	Prasad Deshmukh
	Coromandel International Ltd	CMDFF	CRIN IN	Prasad Deshmukh
	Grasim	GRSJF	GRASIM IN	Reena Verma Bhasin, CFA
	Grasim -G	GRSJY	GRAS LX	Reena Verma Bhasin, CFA
	Jain Irrigation Systems Ltd	JNIDF	JI IN	Prasad Deshmukh
	Shree Cements	SREEF	SRCM IN	Reena Verma Bhasin, CFA
	Unitech Ltd	UTKIF	UT IN	Abhishek Kiran Gupta
<b>UNDERPERFORM</b>				
	Ambuja Cements	AMBUF	ACEM IN	Reena Verma Bhasin, CFA
	Assoc. Cement	ADCLF	ACC IN	Reena Verma Bhasin, CFA
	Bajaj Hindusthan	BJJHF	BJH IN	Sanjaya Satapathy
	Balrampur Chini	BMPRF	BRCM IN	Sanjaya Satapathy
	Container Corp	CIDFF	CCRI IN	Sanjaya Satapathy
	Cummins India	CUIDF	KKC IN	Sanjaya Satapathy
	Housing Development and Infrastructure	XGHSF	HDIL IN	Gagan Agarwal
	India Cements	INIAF	ICEM IN	Reena Verma Bhasin, CFA
	India Cements -G	IAMUY	ICEM LX	Reena Verma Bhasin, CFA
	Jaypee Infratech	XJAYF	JPIN IN	Gagan Agarwal
	Jet Airways	JTAIF	JETIN IN	Anand Kumar
	Jindal Saw	SWPFF	JSAW IN	Sanjaya Satapathy
	Omaxe Limited	XOMXF	OAXE IN	Gagan Agarwal
	Puravankara Projects Ltd	XPJVF	PVKP IN	Gagan Agarwal
	Renuka Sugars	SRNKF	SHRS IN	Sanjaya Satapathy
	Sobha Developers	SBDRF	SOBHA IN	Gagan Agarwal
	SpiceJet Ltd	MDLFF	SJET IN	Anand Kumar
	Tata Chemicals Ltd	TTCXF	TTCH IN	Prasad Deshmukh
	UltraTech Cemen	XDJNF	UTCEN IN	Reena Verma Bhasin, CFA
	Voltas	VTSJF	VOLT IN	Sanjaya Satapathy
	Welspun Corp Ltd	XUORF	WLCO IN	Sanjaya Satapathy
<b>RSTR</b>				
	Nagarjuna Fertilizers & Chemicals Ltd	NFACF	NFCL IN	Prasad Deshmukh
<b>RVW</b>				
	Fortis Healthcare Limited	XFFTF	FORH IN	Prasad Deshmukh

**iQmethod<sup>SM</sup> Measures Definitions**

<b>Business Performance</b>	<b>Numerator</b>	<b>Denominator</b>
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A

**Quality of Earnings**

Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense

**Valuation Toolkit**

Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales} + \text{Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

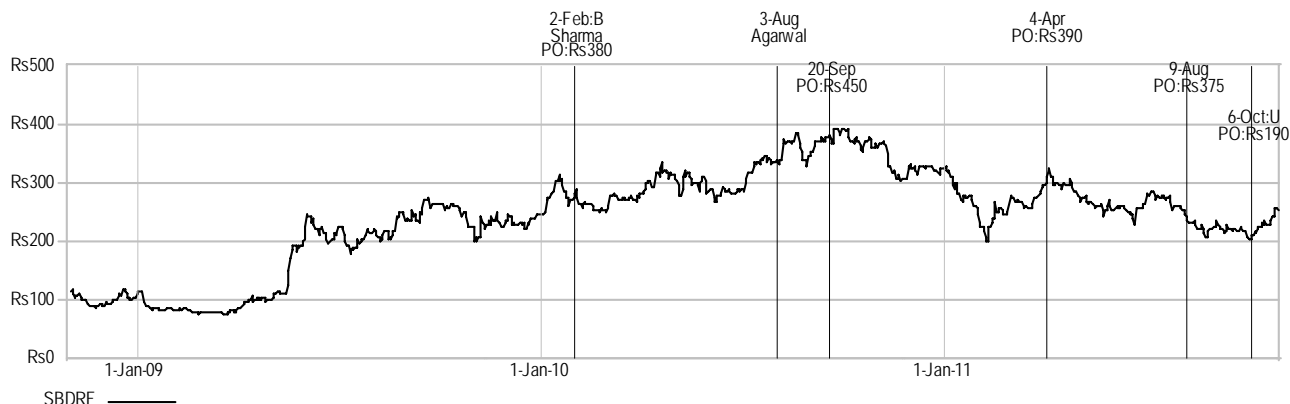
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## Important Disclosures

### SBDRF Price Chart



B : Buy, N : Neutral, U : Underperform, PO : Price objective, NA : No longer valid, NR: No Rating

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of [October 31, 2011] or such later date as indicated.

### Investment Rating Distribution: Real Estate/Property Group (as of 01 Oct 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	82	56.16%	Buy	20	25.64%
Neutral	31	21.23%	Neutral	3	9.68%
Sell	33	22.60%	Sell	6	18.75%

### Investment Rating Distribution: Global Group (as of 01 Oct 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	2073	54.13%	Buy	923	49.12%
Neutral	961	25.09%	Neutral	460	52.57%
Sell	796	20.78%	Sell	287	38.32%

\* Companies in respect of which BofA Merrill Lynch or one of its affiliates has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

\* Ratings dispersions may vary from time to time where BofA Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

**INCOME RATINGS**, indicators of potential cash dividends, are: 7 - same/higher (dividend considered to be secure), 8 - same/lower (dividend not considered to be secure) and 9 - pays no cash dividend. *Coverage Cluster* is comprised of stocks covered by a single analyst or two or more analysts sharing a common industry, sector, region or other classification(s). A stock's coverage cluster is included in the most recent BofA Merrill Lynch Comment referencing the stock.

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