Equities

12 October 2010 | 12 pages

Punj Lloyd (PUJL.BO)

Maintain Sell: Business Turnaround Still Some Time Away

- Company Update
- Target price change
- Estimate change

- **Maintain Sell (3M)** — Though Punj Lloyd has been a significant underperformer over various time frames, it has outperformed the BSE Sensex by 12% in the past month due to investors' interest in buying it as a laggard play. However, we once again re-iterate that discretion is the better part of valour and maintain our Sell/ Medium (3M) risk rating. We cut our target price to Rs111 (from Rs115 earlier) to factor in our 21-44% earnings cut and roll forward our target P/E multiple of 14x to Mar12E (from Sep11E earlier).
- **And the reasons for this are** — 1) 39% of the Rs256bn backlog consists of delayed Libyan orders; 2) Order cancellations in 1QFY11 implied that despite inflows of Rs32.8bn, backlog is down to Rs256bn (1QFY11) from Rs278bn (FY10); 3) Recent top and middle management departures; 4) Deterioration in working capital intensity/ client advances; and 5) If arbitration proceedings against ONGC fail, the company will have to write off Rs3.1bn (Rs9/share).
- **ONGC Heera project** — Punj Lloyd initiated arbitration against ONGC 3 months back to recover dues of over US$250mn (Rs11.5bn) it incurred to execute the project, allegedly due to a flawed design provided by ONGC. ONGC has rejected these charges and said that the design was Punj Lloyd's responsibility.
- **Libya orders update** — Certain portion of the Libyan projects being handled by Punj Lloyd totalling Rs39bn have started moving, with advances coming in and running bills getting submitted. Company hopes to book some revenues from these orders in 2QFY11E. The Sembawang portion of orders totalling Rs59bn is now under re-design and will start moving only in 4QFY11E.
- **Ensus project update** — The project operated at 98% utilization though 1QFY11 but the company saw a reversal of £2.5mn on settlement with a subcontractor.

Sell/Medium Risk	3M
Price (12 Oct 10)	Rs134.15
Target price	Rs111.00
from Rs115.00	
Expected share price return	-17.3%
Expected dividend yield	0.1%
Expected total return	**-17.1%**
Market Cap	Rs44,551M
	US$1,003M

Price Performance (RIC: PUJL.BO, BB: PUNJ IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2009A	1,962	6.30	-38.9	21.3	1.6	7.5	0.2
2010A	-4,155	-12.21	na	-11.0	1.5	-15.1	0.1
2011E	1,216	3.57	129.3	37.5	1.4	3.9	0.1
2012E	2,709	7.96	122.8	16.8	1.3	8.3	0.1
2013E	3,601	10.58	32.9	12.7	1.2	10.0	0.1

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Fiscal year end 31-Mar	2009	2010	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	21.3	-11.0	37.5	16.8	12.7
EV/EBITDA adjusted (x)	7.9	58.4	14.9	9.6	8.4
P/BV (x)	1.6	1.5	1.4	1.3	1.2
Dividend yield (%)	0.2	0.1	0.1	0.1	0.1
Per Share Data (Rs)					
EPS adjusted	6.30	-12.21	3.57	7.96	10.58
EPS reported	-7.23	-3.19	3.57	7.96	10.58
BVPS	81.86	91.19	94.68	102.66	113.33
DPS	0.30	0.15	0.15	0.15	0.15
Profit & Loss (RsM)					
Net sales	119,120	104,356	94,058	115,651	126,498
Operating expenses	-113,491	-105,348	-91,166	-109,761	-119,366
EBIT	**5,629**	**-991**	**2,892**	**5,889**	**7,131**
Net interest expense	-2,208	-3,190	-3,260	-3,919	-4,072
Non-operating/exceptionals	-3,538	4,334	2,605	1,684	1,784
Pre-tax profit	**-116**	**153**	**2,237**	**3,654**	**4,843**
Tax	-2,199	-1,220	-969	-893	-1,190
Extraord./Min.Int./Pref.div.	62	-17	-53	-53	-53
Reported net income	**-2,253**	**-1,084**	**1,216**	**2,709**	**3,601**
Adjusted earnings	1,962	-4,155	1,216	2,709	3,601
Adjusted EBITDA	7,400	1,279	5,472	8,674	10,120
Growth Rates (%)					
Sales	53.6	-12.4	-9.9	23.0	9.4
EBIT adjusted	13.8	-117.6	391.7	103.6	21.1
EBITDA adjusted	15.4	-82.7	327.9	58.5	16.7
EPS adjusted	-38.9	-294.0	129.3	122.8	32.9
Cash Flow (RsM)					
Operating cash flow	**-9,805**	**-16,342**	**3,940**	**341**	**2,462**
Depreciation/amortization	1,771	2,270	2,580	2,784	2,988
Net working capital	-9,828	-17,867	91	-5,205	-4,180
Investing cash flow	**-8,417**	**-1,133**	**-4,500**	**-3,500**	**-2,895**
Capital expenditure	-7,265	-3,925	-4,000	-3,000	-2,395
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**19,186**	**15,485**	**1,942**	**3,542**	**-58**
Borrowings	19,520	8,962	2,000	3,600	0
Dividends paid	-107	-58	-58	-58	-58
Change in cash	**964**	**-1,990**	**1,382**	**383**	**-492**
Balance Sheet (RsM)					
Total assets	**111,292**	**115,481**	**117,622**	**129,712**	**137,267**
Cash & cash equivalent	8,122	6,110	7,387	7,664	7,067
Accounts receivable	26,686	21,847	19,691	24,211	26,482
Net fixed assets	19,768	21,410	22,839	23,065	22,482
Total liabilities	**86,027**	**84,783**	**85,818**	**95,310**	**99,376**
Accounts payable	28,836	22,045	19,869	24,431	26,722
Total Debt	35,592	44,554	46,554	50,154	50,154
Shareholders' funds	**25,265**	**30,698**	**31,803**	**34,401**	**37,891**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	6.2	1.2	5.8	7.5	8.0
ROE adjusted	7.5	-15.1	3.9	8.3	10.0
ROIC adjusted	8.3	-3.7	2.8	6.8	7.6
Net debt to equity	108.7	125.2	123.2	123.5	113.7
Total debt to capital	58.5	59.2	59.4	59.3	57.0

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Powered by: dataCentral

Maintain Sell (3M) – Target Price Rs111

Though Punj Lloyd has been a significant underperformer over various time frames, the company has outperformed the BSE Sensex by 12% in the past month due to investors' interest in buying it as a laggard play. However, we once again re-iterate that discretion is the better part of valour and maintain our Sell/ Medium (3M) risk rating on the stock given the following risks:

- 39% of the Rs256bn orders backlog consists of delayed Libyan orders
- Order cancellations in 1QFY11 implying that despite inflows of Rs32.8bn, the backlog is down to Rs256bn in 1QFY11 from Rs278bn at end FY10.
- Top and middle management departures of V. K. Kaushik (MD), Scott Bayman (Director), Atul Pasricha (CFO) and Ravi Keswani (Finance + IR)
- Deterioration in working capital intensity and client advances
- If Punj Lloyd's arbitration proceedings against ONGC fail, the company will have to write off Rs3.1bn (Rs9/share)

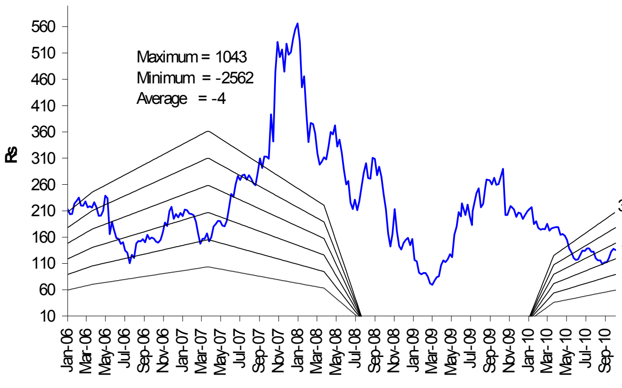
We cut our target price to Rs111 (from Rs115 earlier) to factor in our 21-44% earnings cut and roll forward of our target P/E multiple of 14x to Mar12E (from Sep11E earlier)

Figure 1. Punj Lloyd v/s BSE Sensex

	1 Week	1 Month	3 Months	6 Months	1 Yr	2 Yrs	3 Yrs	Since Listing
Punj Lloyd	-1%	20%	-2%	-26%	-50%	-30%	-62%	-36%
BSE Sensex	-1%	8%	14%	13%	22%	93%	8%	111%
Relative	-1%	12%	-16%	-39%	-72%	-123%	-70%	-147%

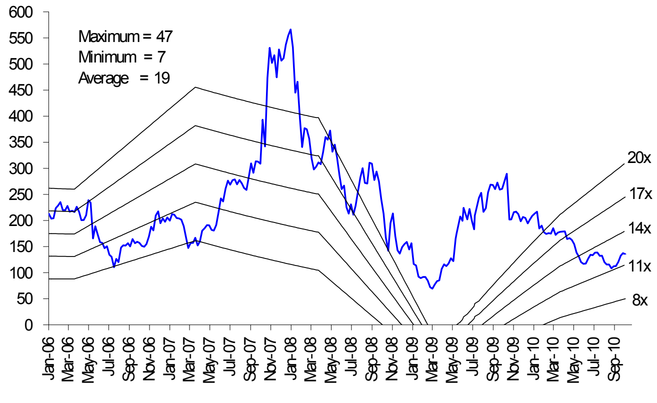
Source: DataCentral and Citi Investment Research and Analysis estimate

Figure 2. Punj Lloyd – 1 Year Forward Rolling P/E Bands



Source: DataCentral and Citi Investment Research and Analysis estimates

Figure 3. Punj Lloyd – 1 Year Forward Rolling EV/EBITDA Bands



Source: DataCentral and Citi Investment Research and Analysis estimates

Figure 4. Punj Lloyd – Earnings Revision Table

Mar31 (Rsmn)	FY11E	FY12E	FY13E
Order Inflows			
Old	193,684	222,736	256,147
New	120,000	144,000	165,600
% Chg	-38.0%	-35.3%	-35.3%
Order Backlog			
Old	365,858	460,544	564,711
New	303,835	332,378	371,674
% Chg	-17.0%	-27.8%	-34.2%
Sales			
Old	105,526	128,050	151,979
New	94,058	115,651	126,498
% Chg	-10.9%	-9.7%	-16.8%
EBITDA			
Old	7,929	10,259	12,935
New	5,472	8,674	10,120
bps	-31.0%	-15.5%	-21.8%
EBITDA Margins			
Old	7.5%	8.0%	8.5%
New	5.8%	7.5%	8.0%
bps	(170)	(51)	(51)
Recurring PAT			
Old	2,166	3,428	4,768
New	1,216	2,709	3,601
% Chg	-43.9%	-21.0%	-24.5%
FD EPS			
Old	6.37	10.08	14.02
New	3.57	7.96	10.58
% Chg	-43.9%	-21.0%	-24.5%

Source: CIRA estimates

Revising earnings downwards

Revising down FD EPS estimates by 21-44% over FY11E-13E to factor in:

- Order cancellations in 1QFY11 has made us cut our FY11E order inflow assumptions. We also reduce our inflow estimates over FY12E-13E
- Slower-than-expected pick up on the Libyan orders has led us to cut our sales estimates by 10-17% over FY11E-13E
- We also cut our margin assumptions by 51-170bps over FY11E-13E

Our estimates are 11- 44% below consensus estimates over FY11E-13E and we believe that consensus will have to significantly cut numbers post 2QFY11E.

Figure 5. Punj Lloyd – CIRA v/s Consensus Estimates

	FY11E	FY12E	FY13E
Consensus Estimates	6.43	10.08	11.93
CIR Estimates	3.57	7.96	10.58
Difference	-44.4%	-21.0%	-11.3%

Source: Bloomberg and Citi Investment Research and Analysis estimates

Disappointing 1QFY11 – Order cancellations and financial losses

- Punj Lloyd reported a 1QFY11 PAT loss of Rs306mn, significantly below CIRA estimates driven by sharp decline in sales by 46% to Rs16.1bn on delayed execution in Rs98bn of Libyan orders. Losses would have been higher but for Rs1.28bn (v/s Rs201mn in 1QFY10) other income which included Rs700mn of forex gains and Rs400mn of scrap sales.
- According to management, the company booked Rs32.8bn of orders in 1QFY11. Despite delivering only Rs16.1bn of sales the order backlog is down to Rs256bn in 1QFY11 from Rs278bn at the end of FY10. This can be explained by: 1) 50% reduction in Rs8bn Dighi port order to Rs4bn; and 2) removal of Jurong Aromatics project of Rs17.7bn from the backlog.

Ensus project losses mount to Rs5.52bn

The project operated at 98% utilization though 1QFY11 but the company saw a reversal of £2.5mn on settlement with a subcontractor.

- At the end of 3QFY10 the Punj Lloyd management had communicated that the Ensus project has been completed in late January 2010 and the client had obtained the 'take over' certificate in March 2010. Punj Lloyd wrote off Rs300m in 1QY10, Rs1bn in 2QFY10 and Rs1.1bn in 3QFY10 on this project. Further, the client levied liquidated damages (LDs) for delay in completion of the project to the tune of 15% of contract value of £161m = £23mn (Rs1.65bn) which was to be booked in 4QFY10.
- The big negative surprise in 4QFY10 was that the company booked an additional £18mn (Rs1.3bn) of losses on the Ensus project. Under the terms of the contract the plant was supposed to achieve a minimum level of capacity utilization for the contract to be considered complete. However, this could not be achieved in 4QFY10. Management also highlighted that the handover is not complete with some more additional clean up required in 1QFY11.

- The company had tried to complete the project within the agreed time lines and parameters, but faced several challenges which included: 1) extremely low productivity from UK labour/ sub contractors, 2) adverse weather conditions (caused 3-4 weeks delay), 3) leakage in heat exchangers bought from Spain (caused 1 week delay), 4) local management failure to influence the union, 5) there were cases of deliberate sabotage, and 6) company failed to understand the complexity of construction management in UK

Figure 6. Punj Lloyd – Ensus Project Losses

	1QFY10	2QFY10	3QFY10	4QFY10	FY10	1QFY11	Overall
Cost over-run write offs	300	1,000	1,100	1,291	3,691		3,691
Liquidated Damages				1,650	1,650		1,650
Settlement with subcontractor						178	178
Total	**300**	**1,000**	**1,100**	**2,941**	**5,341**	**178**	**5,518**

Source: Company and Citi Investment Research and Analysis

ONGC Heera Redevelopment project update

According to the *Economic Times,* Punj Lloyd has initiated arbitration proceedings against ONGC three months back to recover dues of over US$250mn (Rs11.5bn) it had incurred to execute the project, allegedly due to a flawed design provided by ONGC. ONGC has rejected these charges and said that the design was Punj Lloyd's responsibility. ONGC has initiated action for appointment of arbitrator as per provision of the contract. ONGC had proposed settlement through outside expert committee (OEC) for faster resolution of the issue. However, Punj Lloyd has declined the offer.

- Project has been completed and all four offshore rigs are fully operational. Minimal maintenance work needs to be executed post the monsoon.
- According to management, the initial design used to bid and win this project was flawed and the corrected design increased the steel quantity required by three times. ONGC agreed to reimburse the company for the extra steel used but has not agreed to reimburse for additional cost of fabrication, labour charges and overheads.
- Punj Lloyd has Rs3.7bn of auditor qualifications in its 1QFY11 results which include Rs2.43bn of project claims and Rs655mn of liquidated damages related to the ONGC project.

Figure 7. Punj Lloyd Auditor Qualifications

Type	Rsmn
ONGC Heera Project Claims	2,430
ONGC LDs	655
Total Qualifications	**3,705**

Source: Company and Citi Investment Research and Analysis

Figure 8. Punj Lloyd – Recurrent Auditor Qualifications

Client	IPO	FY06	FY07	FY08	Jun-08	Sep-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	- Where is this?
IOCL - PIL	223	298	294	10	10	-	-	-	-	-	-	-	- Sundry Debtors
Spie Capag Petrofac	356	378	368	-	-	-	-	-	-	-	-	-	- Sundry Debtors
SABIC				3,053	1,948	2,216	-	-	-	-	-	-	
GAIL													
- Liquidated Damages	423	424	422	416	416	432	433	-	-	-	-	-	- Sundry Debtors
- Other Deductions	40	40	40	40	40	40	40	-	-	-	-	-	- Sundry Debtors
Petronet MHB Limited	4	4	4	4	4	4	4	-	-	-	4	-	- Sundry Debtors
	64	64	64	64	64	64	64	-	-	-	64	-	- Work in Progress
HPCL													
- Withheld							33	-	-	-	-	-	- Sundry Debtors
- Other deductions							13	-	-	-	-	-	- Sundry Debtors
- Claims							31	-	-	-	-	-	- Sundry Debtors
HPCL							36	-	-	-	-	-	
NHAI							45	-	-	-	-	-	
ONGC													
- Cost Overruns										2,430	2,430	2,430	
- LDs										-	655	655	
NA													
- LDs/ Deductions								601	601	594	588	591	- Sundry Debtors
- Bills not certified								95	95	32	31	32	- Work in Progress
Total	**1,111**	**1,208**	**1,192**	**3,588**	**2,483**	**2,756**	**701**	**696**	**696**	**3,056**	**3,773**	**3,707**	

Source: Company Results & Annual Reports and Citi Investment Research and Analysis

39% of order backlog from slow moving Libyan orders

In a recent interview with *NDTV Profit* , Mr. Atul Punj mentioned that a certain portion of the Libyan projects being handled by Punj Lloyd totalling Rs39bn have started moving, with advances coming in and running bills getting submitted. The company hopes to book some amount of revenues from these orders from 2QFY11E. The Sembawang portion of orders totalling to Rs59bn is currently under redesign and will start moving only in 4QFY11E

- Out of the 1QFY11 end order backlog of Rs256bn, ~ 39% of the orders totalling to Rs98bn are from Libya, where project execution and revenue recognition has not taken off yet. The first set of Libyan orders was won in Jan 2009 and the second set of Libyan orders was won in July 2009. The company has received some amount of advances for 2 out of 5 projects totalling to US$54mn till date.
- According to management, in large township orders, engineering takes almost six months. Further delays occurred on the client side as the architect was changed and the start of work on this project was postponed. The orders also have a long gestation period, with average execution cycles of 32-34 months.

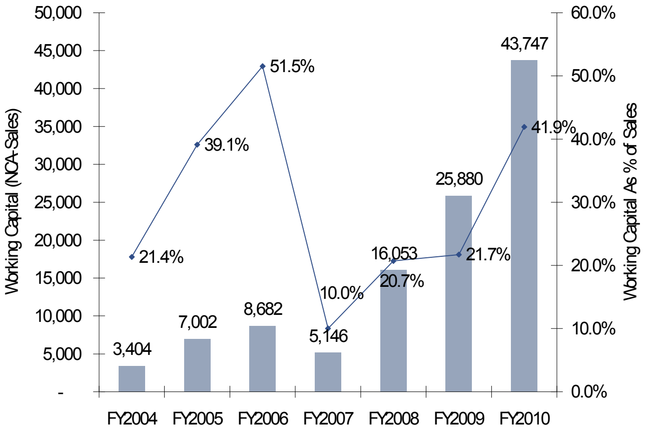
Figure 9. Punj Lloyd – Libya Order Concentration

	Date	Client	Rsmn	Stake	Rsmn	Months	- Remarks
1	10-Jul-09	IISCO, Libya	59,040	100%	59,040	42	- Al-Mea'tega Resort Village on a 40-hectare site adjacent to the domestic airport
2	10-Jul-09	IISCO, Libya			-	30	- Al-Ghiran Village in Tripoli for total built-up area of 110,000 square metres.
3	10-Jul-09	IISCO, Libya			-	30	- Al-Froseya Hotel, a five star 150-room hotel comprising solely of suites
4	1-Jul-09	Libya	18,732	100%	18,732	48	- Utilities at Zawara, Ragdaleen and Al Jamail towns in Libya (3 orders)
5	15-Jan-09	Housing and Infra Board	13,119	89%	11,660	40	- Execution of utilities in Souk Al Jama , Libya
6	07-Jan-09	Housing and Infra Board	10,501	85%	8,930	48	- EPC of infra network , water , sewage, roads, and other facility
	Libya Orders		**101,391**		**98,362**		
	Backlog				**255,565**		
	%				**38.5%**		

Source: Company and Citi Investment Research and Analysis estimates

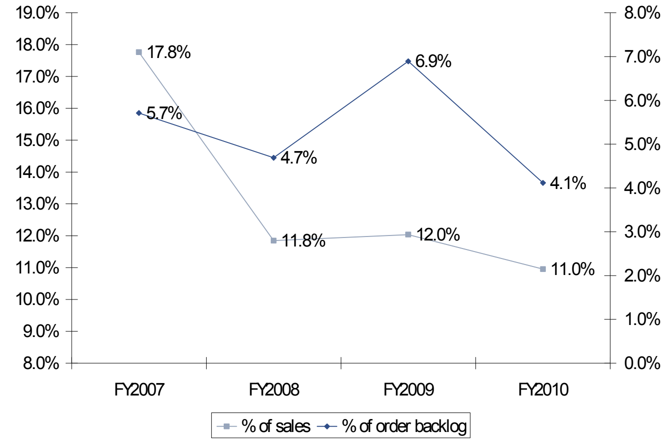
Working capital – Not in the best of shape

Figure 10. Punj Lloyd – Deteriorating Working Capital Intensity



Source: Citi Investment Research and Analysis

Figure 11. Punj Lloyd – Deteriorating Client Advances



Source: Citi Investment Research and Analysis

Punj Lloyd

Valuation

Our Rs111 target price for Punj Lloyd is based on a target P/E multiple of 14x Mar2012E. Our target multiple is more or less in line with other mid-cap construction peers (like HCC at 12x, IVRCL at 13.5x and Nagarjuna at 15x) and is set at a ~ 39% discount to L&T given L&T's superior skill sets, backlog and execution track record.

Risks

We have a Medium Risk rating on Punj Lloyd shares, as opposed to the Speculative Risk flag suggested by our quantitative risk rating system, which tracks 260-day historical share price volatility. We believe Medium Risk is more appropriate given this is consistent with the risk flag applied to other mid-cap construction peers. Key upside risks include: 1) Favorable settlement with ONGC; 2) Positive change in macro-economic variables; and 3) Better-than-expected order inflows and sales execution. Key downside risks to our target price include: 1) Integration risks relating to Simon Carves; 2) Revenue volatility due to project-driven nature of business; 3) Exports being subject to geopolitical risks; 4) Project implementation risks, bad debts and receivables; 5) Sensitivity to raw material costs and foreign currency fluctuations; and 6) Employee retention, which could be a key challenge.

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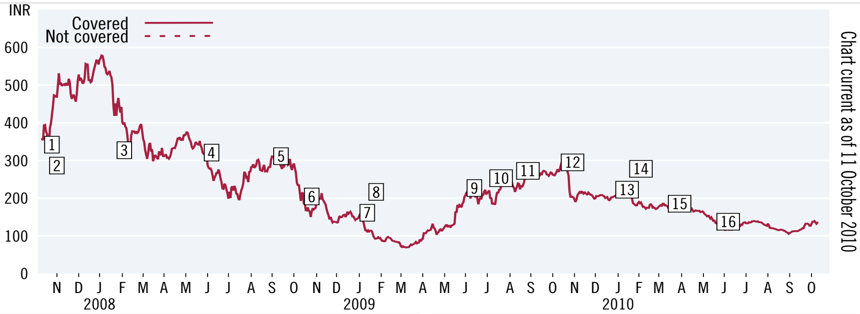
Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of all or any identified portion of this research report hereby certifies that, with respect to each issuer or security or any identified portion of the report with respect to an issuer or security that the research analyst covers in this research report, all of the views expressed in this research report accurately reflect their personal views about those issuer(s) or securities. The research analyst(s) also certify that no part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this research report.

IMPORTANT DISCLOSURES

Punj Lloyd (PUJL.BO)
Ratings and Target Price History
Fundamental Research
Analyst: Venkatesh Balasubramaniam



	Date	Rating	Target Price	Closing Price
1	25-Oct-07	1L	*464.00	420.95
2	1-Nov-07	1L	*593.00	468.85
3	5-Feb-08	1L	*493.00	400.70
4	6-Jun-08	*1M	*366.00	272.85
5	12-Sep-08	1M	*395.00	284.45
6	27-Oct-08	1M	*218.00	165.35

	Date	Rating	Target Price	Closing Price
7	13-Jan-09	*2H	*142.00	109.80
8	25-Jan-09	*3H	*85.00	92.30
9	12-Jun-09	*3M	*217.00	212.50
10	21-Jul-09	*1M	*263.00	231.15
11	27-Aug-09	1M	*311.00	264.00
12	29-Oct-09	*2M	*228.00	202.90

	Date	Rating	Target Price	Closing Price
13	14-Jan-10	*3M	*197.00	222.45
14	3-Feb-10	3M	*191.00	188.55
15	30-Mar-10	3M	*179.00	175.45
16	6-Jun-10	3M	*115.00	118.65

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following as clients, and the services provided were non-investment-banking, securities-related: Punj Lloyd.

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Data current as of 30 Sep 2010	**Buy**	**Hold**	**Sell**
Citi Investment Research & Analysis Global Fundamental Coverage	53%	36%	11%
% of companies in each rating category that are investment banking clients	48%	45%	39%

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