Construction

PUJL.BO, Rs287	
Rating	BUY
Sector coverage view	Attractive
Target Price (Rs)	370
52W High -Low (Rs)	656 - 214
Market Cap (Rs bn)	92.2

Financials

March y/e	2008	2009E	2010E
Sales (Rs bn)	77.5	105.6	137.1
Net Profit (Rs bn)	3.2	4.8	6.9
EPS (Rs)	10.1	14.9	21.6
EPS gth	*93.0*	*47.6*	*45.0*
P/E (x)	28.5	19.3	13.3
EV/EBITDA (x)	15.9	11.3	8.4
Div yield (%)	0.3	0.5	0.7

Shareholding, March 2008

	Pattern	% of Portfolio	Over/(under) weight
Promoters	44.7	-	-
FIIs	24.4	0.3	0.1
MFs	12.6	0.8	0.6
UTI	-	-	(0.2)
LIC	-	-	(0.2)

Punj Lloyd: Problems localized in a single contract wherein breakeven may be realized, maintains margin guidance; Reiterate BUY

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- **Management believes that Rs3 bn of auditor qualification is recoverable based on negotiation with clients; Rs1.2 bn has already been approved**
- **Management very confident of managing rising commodity price environment; maintains margin guidance at 11-11.5%**
- **Management reiterates ambition of emerging as a global EPC major; targeting large orders of over US$1 bn**
- **Downgrade estimates and revise target price to Rs370 (from Rs420 earlier); reiterate BUY rating**

Management sees the Rs3 bn of 'likely losses' noted by auditors as an auditor qualification and not a post-facto loss, as the amount is likely recoverable based on discussions with the client (Rs1.2 bn has already been approved by the client). Punj has retained its EBITDA margin guidance of 11-11.5% for Punj orders and 7-7.5% for Sembawang orders (apart from legacy orders of about Rs7 bn that are likely to yield not more than 1%). Management believes that 90% of the order book is protected from commodity price increases through (1) price escalation clauses or (2) back-to-back ordering. Management reiterated its ambition of becoming a global EPC major. Punj is eyeing several large opportunities in the global EPC space, with single-order values of about US$ 1 bn, and expects some opportunity to likely materialize in FY2009. We revise our estimates downwards, revise target price to Rs370 (from Rs420 earlier) and reiterate BUY rating.

Management believes Rs3 bn of auditor qualification recoverable; Rs1.2 bn escalation already approved by client; highlight that issue pertains only to one particular order

Management believes that the Rs3 bn of 'likely losses' noted by auditors in the financial statements of Simon Carves (UK) is only an auditor qualification and not a post-facto loss as the amount is likely recoverable based on discussions with the client. All the losses pertain to a single LDPE plant order for SABIC, which was worth GBP140 mn at the time of award (current backlog is about GBP11 mn). However, subsequent design and scope changes as well as delays etc led to cost escalations. The client has agreed to enhance the order value by Rs1.2 bn (likely to be formalized in June 2008) post the finalization of FY2008 accounts. The order is estimated to be completed by November 2008 and the entire amount to be recovered is likely to be crystallized then (as clients typically settle such claims towards the end of contracts). Management was confident of recovering the amount based on its comfort with the client and the fact that its relations with the client extend beyond this order (based on fresh orders that may be awarded by SABIC). Write-off of Rs679 mn in 3QFY08 was also related to the same order, though that was write-off of profits recognized on the order in earlier years. Post recovery of the amount, management is confident of at least breaking-even on this project. We highlight that this issue pertains to only a particular order and is not a generic problem confronting Sembawang or Simon Carves. We believe that Sembawang, excluding Simon Carves, has likely made profits during the quarter.

No further provisions on legacy orders envisaged; all provisions had already been made in 3QFY08

Management reiterated that it had already provided for all possible losses on Sembawang's legacy orders (currently about Rs7 bn) in 3QFY08 itself, so as to reach a stage of break-even on all such orders. These were losses that were foreseen till 3QFY08 and the situation remains unchanged as of 4QFY08. All the legacy orders are likely to be executed in about another nine months.

Management very confident of managing rising commodity price environment; maintains margin guidance at 11-11.5%

Punj Lloyd has retained its EBITDA margin guidance of 11-11.5% for Punj Lloyd orders and 7-7.5% for Sembawang orders (apart from legacy orders of about Rs7 bn that are likely to yield not more than 1%). Management believes that 90% of the order book is protected from commodity price increases through (1) price escalation clauses (primarily steel and cement) in civil works-related contracts or (2) back-to-back ordering of sub components in EPC or turnkey contracts (such ordering is typically done within eight weeks of contract award). Any impact on the balance 10% of the order book is likely to be not more than 1-1.5% in terms of margins and that may also be absorbed in the contingencies that Punj typically builds in each contract, according to management. All fresh contracts of Punj now contain price variation clauses and hence no problems on this account are foreseen in the future. We highlight that the proportion of orders where Punj Lloyd is covered for commodity price escalation is far ahead of our expectation and addresses one of the central concerns for near-term earnings.

Management reiterates ambition of emerging as a global EPC major; targeting large orders of over US$1 bn

Management reiterated its ambition of becoming a global EPC major and stressed that it is developing its organizational capabilities towards that end (and hence more focused on long-term achievements rather than quarterly results that may contain blips). Management highlighted that it is geography agnostic and would continue to cherry-pick high-margin orders across its global footprint (India contributed only 30% to order backlog of Punj Lloyd at the end of FY2008, Exhibit 1). Punj is eyeing several large opportunities in the global EPC space, with single-order values of about US$ 1 bn, and expects some opportunity to likely materialize in FY2009. We highlight that such orders will demonstrate Punj's ability to win large orders (and customer confidence in its abilities) and set it apart from smaller players in India (as currently only L&T has executed such large orders among Indian construction companies). We believe that given its strong order backlog (of Rs196 bn, that provides it comfort and revenue security to some extent), Punj may target larger orders only (that are likely higher-margin). Hence, order booking may become more bunched-up (we highlight that the recent pipeline order from Petronas Malaysia is about US$500 mn, Exhibit 2) with fewer order inflows. To execute its large backlog and achieve strong growth, Punj will continue to enhance its capacities. In addition to about Rs4.5 bn incurred in FY2008, Punj Lloyd is likely to undertake further capex of Rs4 bn in FY2009E.

Results broadly in-line with expectations led by higher-than-expected margins and lower-than-expected other income

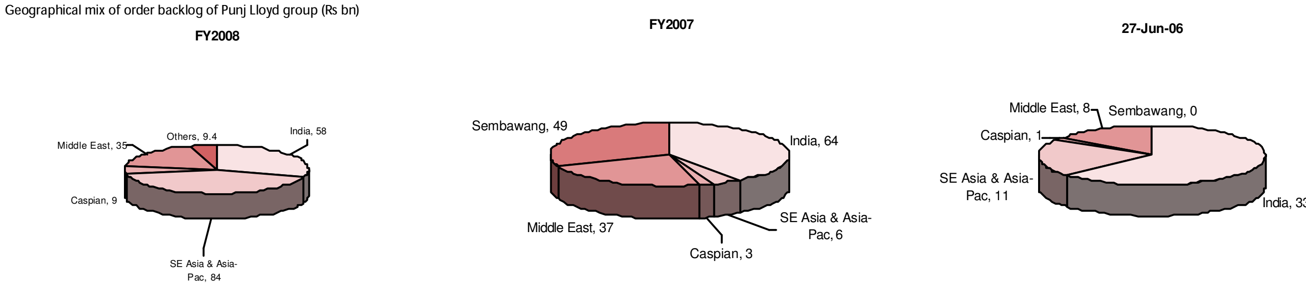
Punj Lloyd reported 4QFY08 consolidated revenues of Rs23.5 bn (up 38% yoy) and PAT of Rs1.2 bn (up 33% yoy) (Exhibits 3-4). Revenue growth was led by 88% growth in revenues of the standalone entity to Rs15 bn. Subsidiary revenues decreased by 6% yoy. Consolidated EBITDA margins in 4QFY08 expanded by 60 bps yoy to 10.6% versus 10% a year ago led by project execution-mix changes at the standalone entity (standalone margins expanded by 710 bps to 16.1% in 4QFY08). Interest and depreciation in 4QFY08 increased 26% and 24% (yoy) respectively, led by the increased capex. Other income was a negative of Rs183 mn primarily due to reversal of derivative gains recognized in earlier quarters of Rs218 mn (such a reversal was necessitated by a change in accounting policy whereby derivative gains are not to be recognized). Net current assets at Rs22.5 bn (excluding cash of Rs77 mn) (73 days of sales) suggests strong improvement in working capital utilization for the company at the end of FY2008.

Downgrade estimates and revise target price to Rs370 (from Rs420 earlier); reiterate BUY rating

We have revised our execution estimate to Rs106 bn (from Rs114 bn earlier) and Rs137 bn (from Rs152 bn earlier) for FY2009E and FY2010E respectively based on lower-than-expected order booking during the year. We have revised our EPS for FY2009E and FY2010E to Rs14.9 (From Rs16.9) and Rs21.6 (from Rs24.7). We revise our our FY2009E DCF-based target price to Rs370 (from Rs420 earlier, Exhibit 5) based on the changes in our earnings estimates. Our DCF valuation implies 25X Fy2009E earnings and 17X FY2010E earnings. We highlight that we continue to value Pipavav Shipyard, Ramprastha JV, Upstream business and civil aviation business at investment value. We reiterate our BUY rating based on likely strong growth in both Punj Lloyd group as well as Sembawang led by continued order inflows across various geographies and business segments.

Exhibit 1: Proportion of order backlog contributed by Indian gepgraphy has declined to 30% at the end of FY2008 from 40% at the end of FY2007

Geographical mix of order backlog of Punj Lloyd group (Rs bn)



Note:
Orderbacklog of SEC was about Rs69 bn at the end of FY2008

Source: Company data, Kotak Institutional Equities.

Exhibit 2: Strong order inflows continue for Punj Lloyd so far in this financial year
Key orders won by Punj Lloyd in FY2008 so far (Rs mn)

Date	Segment	Area	Client	Value (Rs mn)	Group entity	Description
7-Mar-08	Oil and Gas	Pipeline	Petronas, Malaysia	20,000	Punj Lloyd	EPC of a 512 km, 36" diameter onshore natural gas pipeline in Malaysia with support from local partners
14-Feb-08	Civil, Infrastructure and Power	Buildings	Marina Bay Sands Pte Ltd, Singapore	11,192	Sembawang Engineers and Constructors	Construction of the North Podium in the integrated resort comprising casino, theatres and retail arcade
12-Dec-07	Process	Process	Indian Oil Corporation	5,900	Punj Lloyd	Construction of coker unit & block for the Vadodara refinery in Gujarat
30-Nov-07	Civil, Infrastructure and Power	Infrastructure	Land Transport Authority, Singapore	12,720	Sembawang Engineers and Constructors	Construction of the MRT station in Marina Bay in Singapore
5-Nov-07	Process	Process	Jurong Aromatics Corporation Pte Ltd, Singapore	17,700	Sembawang Engineers and Constructors	EPC work for a new mega aromatics plant at Jurong island
12-Oct-07	Oil and Gas	Pipeline	Qatar Petroleum	3,890	Punj Lloyd	EPC on LSTK basis of 46 km of 18" multi-product pipeline
6-Aug-07	Process	Process	Bharat Oman Refineries Limited	5,900	Punj Lloyd	Lump-sum turnkey contract for building a sulphur block at Bina Refinery
2-Aug-07	Civil, Infrastructure and Power	Buildings	Sentosa Pte Ltd, subsidiary of Genting Group	6,660	Sembawang Engineers and Constructors	Sub-structural works at Sentosa Integrated Resort Development
27-Jul-07	Oil and Gas	Pipeline	Reliance Gas Transportation Infrastructure Ltd	3,180	Punj Lloyd	Laying of pipeline & associated facilities for East-West Pipeline project
23-Jul-07	Oil and Gas	Tankage	Saudi Kayan Petrochemical Company (SABIC)	1587(a)	Dayim Punj Lloyd Construction Contracting Company Ltd	EPC of tanks at Jubail Industrial city, Saudi Arabia
20-Jul-07	Process	Process	Gulf Fluor	500(b)	Simon Carves Ltd.	Fluorides plant incorporating a new Sulphuric Acid plant
14-May-07	Oil and Gas	Pipeline	GAIL (India) Ltd	1,227	Punj Lloyd	Phase II of Panvel — Dabhol Pipeline
16-Apr-07	Oil and Gas	Pipeline	Oman Gas Company	5,300	Punj Lloyd	24", 40 Km pipeline
19-Apr-07	Oil and Gas	Pipeline	Ras Laffan Olefins Company Ltd, USA	1,935	Punj Lloyd	Ethylene pipeline
23-Apr-07	Oil and Gas	Pipeline	Reliance Gas Transportation Infrastructure Ltd	1,802	Punj Lloyd	48", 122 Km pipeline
Total				**99,492**		

(a) Estimated share of Punj Llyod
(b) Estimated order value

Source: Company data, Kotak Institutional Equities estimates.

Exhibit 3. Punj Lloyd (standalone) - 4QFY08 - key numbers (Rs mn)

	yoy			qoq			12 months		
	4QFY08	4QFY07	(% chg)	4QFY08	3QFY08	(% chg)	FY2008	FY2007	(% chg)
Net sales	**14,994**	**7,983**	***87.8***	**14,994**	**12,438**	***20.6***	**44,886**	**22,397**	***100.4***
Operating costs	**(12,574)**	**(7,264)**	***73.1***	**(12,574)**	**(11,380)**	***10.5***	**(39,741)**	**(20,544)**	***93.4***
Material consumed and cost of goods sold	(4,953)	(2,607)	*90.0*	(4,953)	(4,355)	*13.7*	(16,254)	(5,902)	*175.4*
Contractor charges	(2,839)	(1,667)	*70.3*	(2,839)	(3,509)	*(19.1)*	(9,963)	(4,960)	*100.9*
Staff Cost	(1,210)	(734)	*64.7*	(1,210)	(928)	*30.4*	(3,585)	(2,366)	*51.6*
Other Expenditure	(3,572)	(2,256)	*58.3*	(3,572)	(2,588)	*38.0*	(9,939)	(7,317)	*35.8*
EBITDA	**2,421**	**719**	***236.8***	**2,421**	**1,058**	***128.8***	**5,144**	**1,853**	***177.7***
Other income	72	210	*(65.9)*	72	145	*(50.4)*	532	658	*(19.2)*
Interest costs	(301)	(261)	*15.4*	(301)	(239)	*25.8*	(1,133)	(692)	*63.6*
Depreciation	(318)	(242)	*31.4*	(318)	(294)	*7.9*	(1,134)	(845)	*34.2*
PBT	**1,874**	**427**	***339.1***	**1,874**	**669**	***180.1***	**3,409**	**973**	***250.3***
Taxes	(577)	(195)	*195.9*	(577)	(277)	*107.9*	(1,195)	(357)	*234.4*
PAT	**1,297**	**232**	***459.6***	**1,297**	**392**	***231.2***	**2,214**	**616**	***259.5***
Key ratios									
Material consumed and cost of goods sold	33.0	32.7		33.0	35.0		36.2	26.4	
Contractor charges	18.9	20.9		18.9	28.2		22.2	22.1	
Staff Cost	8.1	9.2		8.1	7.5		8.0	10.6	
Other Expenditure	23.8	28.3		23.8	20.8		22.1	32.7	
EBITDA margin (%)	**16.1**	**9.0**		**16.1**	**8.5**		**11.5**	**8.3**	
PAT margin (%)	8.7	2.9		8.7	3.1		4.9	2.8	
Effective tax rate (%)	30.8	45.7		30.8	41.5		35.1	36.7	

Source: Company data, Kotak Institutional Equities.

Exhibit 4. Punj Lloyd (consolidated) - 4QFY08 - key numbers (Rs mn)

	yoy			qoq			12 months		
(in Rs mn)	4QFY08	4QFY07	(% chg)	4QFY08	3QFY08	(% chg)	FY2008	FY2007	(% chg)
Net sales	**23,467**	**17,036**	***37.8***	**23,467**	**21,170**	***10.8***	**77,529**	**51,266**	***51.2***
Operating costs	**(20,981)**	**(15,329)**	***36.9***	**(20,981)**	**(20,126)**	***4.2***	**(71,122)**	**(47,523)**	***49.7***
Material consumed and cost of goods sold	(7,478)	(2,989)	*150.2*	(7,478)	(7,614)	*(1.8)*	(28,285)	(16,370)	*72.8*
Contractor charges	(5,966)	(6,461)	*(7.7)*	(5,966)	(6,747)	*(11.6)*	(21,339)	(14,181)	*50.5*
Staff Cost	(2,889)	(2,019)	*43.1*	(2,889)	(2,392)	*20.8*	(8,924)	(6,369)	*40.1*
Other Expenditure	(4,648)	(3,860)	*20.4*	(4,648)	(3,373)	*37.8*	(12,575)	(10,602)	*18.6*
EBITDA	**2,486**	**1,707**	***45.7***	**2,486**	**1,045**	***138.0***	**6,407**	**3,743**	***71.2***
Other income	(183)	164	*(211.9)*	(183)	459	*(139.9)*	811	794	*2.1*
Interest costs	(326)	(258)	*26.3*	(326)	(284)	*14.5*	(1,292)	(825)	*56.5*
Depreciation	(409)	(329)	*24.3*	(409)	(365)	*12.0*	(1,462)	(1,062)	*37.8*
PBT	**1,568**	**1,283**	***22.2***	**1,568**	**854**	***83.7***	**4,464**	**2,650**	***68.4***
Taxes	(374)	(398)	*(6.0)*	(374)	(308)	*21.4*	(1,235)	(690)	*79.1*
PAT	**1,194**	**885**	***34.9***	**1,194**	**546**	***118.8***	**3,229**	**1,960**	***64.7***
Minority interest/Exceptional items	(17)	-		(17)	-		356	-	
Reported PAT	**1,177**	**885**	***33.1***	**1,177**	**546**	***115.8***	**3,584**	**1,960**	***82.8***
Key ratios									
Material consumed and cost of goods sold	31.9	17.5		31.9	36.0		36.5	31.9	
Contractor charges	25.4	37.9		25.4	31.9		27.5	27.7	
Staff Cost	12.3	11.8		12.3	11.3		11.5	12.4	
Other Expenditure	19.8	22.7		19.8	15.9		16.2	20.7	
EBITDA margin (%)	**10.6**	**10.0**		**10.6**	**4.9**		**8.3**	**7.3**	
PAT margin (%)	5.1	5.2		5.1	2.6		4.2	3.8	
Effective tax rate (%)	23.9	31.0		23.9	36.1		27.7	26.0	

Source: Company data, Kotak Institutional Equities estimates.

Exhibit 5 Punj Lloyd Consolidated- DCF model, March fiscal year-ends (Rs mn)

	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E
Revenues	**105,605**	**137,063**	**176,224**	**219,161**	**269,102**	**326,412**	**388,912**	**447,249**	**514,336**	**591,486**	**662,465**
Revenue growth (%)	36.2	29.8	28.6	24.4	22.8	21.3	19.1	15.0	15.0	15.0	12.0
EBITDA	**9,313**	**12,805**	**16,524**	**20,544**	**25,250**	**30,641**	**36,514**	**42,489**	**48,862**	**56,191**	**62,934**
EBITDA (%)	8.8	9.3	9.4	9.4	9.4	9.4	9.4	9.5	9.5	9.5	9.5
Depreciation	(1,762)	(1,989)	(2,252)	(2,549)	(2,882)	(3,249)	(3,652)	(3,834)	(4,026)	(4,227)	(4,439)
EBIT	7,551	10,815	14,272	17,995	22,368	27,392	32,862	38,654	44,836	51,964	58,495
Tax	(2,121)	(3,002)	(3,970)	(5,006)	(6,231)	(7,636)	(9,162)	(12,756)	(14,796)	(17,148)	(19,303)
Change in net working capital	**(6,054)**	**(6,745)**	**(6,019)**	**(8,623)**	**(10,112)**	**(11,526)**	**(12,592)**	**(11,987)**	**(13,785)**	**(15,853)**	**(14,585)**
Capex	(3,000)	(3,500)	(4,000)	(4,500)	(5,000)	(5,500)	(6,000)	(6,261)	(7,201)	(8,281)	(9,275)
Free cash flow	**(1,861)**	**(443)**	**2,535**	**2,416**	**3,907**	**5,979**	**8,759**	**11,484**	**13,080**	**14,910**	**19,772**
PV of each cash flow	(1,861)	(393)	2,003	1,697	2,439	3,318	4,320	5,035	5,098	5,165	6,089

PV of cash flows	32,910	28%	FCF in terminal year (Rs mn)	19,772
PV of terminal value	85,240	72%	Exit FCF multiple: (1+g)/(WACC-g)	14.0
EV	118,150	100%	Terminal value of FCF (Rs mn)	276,802
Debt	(677)		Exit EBITDA multiple	4.4
Equity value	118,827			
Equity value (Rs/share)	**371**			

			Sensitivity of DCF value to WACC, Terminal Growth rate					
Weighted average cost of capital-WACC					**WACC (%)**			
Terminal growth - g (%)	5.0			**11.5**	**12.0**	**12.5**	**13.0**	**13.5**
Risk free rate-Rf (%)	8.0	Terminal	**3.0**	363	335	311	289	269
Market risk premium—(Rm-Rf) (%)	5.5	growth	**4.0**	400	366	337	311	289
Beta (x)	1.1	rate (%)	**5.0**	447	406	**371**	340	313
Cost of equity-Ke (%)	13.6		**6.0**	512	459	414	377	344
Cost of debt-Kd (%)	12.0		**7.0**	606	533	474	425	384
Tax rate (%)	33.9							
Debt/Capital (%)	43.1							
Equity/Capital (%)	56.9							
WACC (%)	11.1							
Used WACC (%)	**12.5**							

Source: Company data, Kotak Institutional Equities estimates