Industry In-Depth

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India Construction

Section 80 I (A) Boogey: Back to Haunt Construction

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- Cash contractors to pay full tax – According to the Budget, companies executing cash contracts cannot claim section 80I (A) benefits but BOT developers can. This would take effect retrospectively from April 2000.
- Confusion on cash contracts from BOT - There is still some confusion if companies can claim Section 80 I(A) benefits on cash contracts emanating from their own BOT projects. Quantum of BOT projects in the orders backlogs of Gammon, Nagarjuna and HCC are 17%, 8% and less than 5%, respectively.
- Write-offs and future PAT reduction — According to our discussions with companies, a likely one-time impact might be Gammon (Rs350mn), Nagarjuna (Rs260mn) and IVRCL (Rs579mn). Using a 33% marginal tax rate for simplistic calculations, FY07 -09E Recurring PAT would be negatively affected by 17-24% and PAT margins would likely compress 1-3%.
- Liquidity crunch could reduce profits more — Besides the negative effect of increasing tax rates, there is likelihood that lower PAT margins could exacerbate a liquidity squeeze forcing companies to raise more debt (that too at higher interest rates if banks demand higher interest rates on the likely deterioration of credit worthiness). This could cause an additional reduction of Recurring PAT by 3–5%.
- No effect on L&T and Punj — No effect on L&T as it pays full tax on all contracts and a neglible effect on Punj Lloyd as its effective tax rate is on the higher side.

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

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Tax status under Section 80I (A)

We had highlighted potential negative implications of claiming Section 80I (A) for cash contracts in our report *"India Construction: Sift For Value In The Capex Rush,"* dated February 9, 2006.

- Section 80I (A) of the Income Tax Act 1961 states that any company deriving profits by developing, constructing, and operating infrastructure projects is eligible for tax exemption for a period of 10 years in the first 15 years of operation.
- There were varying interpretations of this, as some believed this exemption was applicable to those owning the infrastructure asset, as it was originally aimed at BOT operators. Others, however, believed this exemption was also applicable to those constructing the asset. As a result, some corporates paid the full corporate tax while others paid the minimum alternate tax (MAT).
- The issue was further complicated by different authorities taking different views on this. Some construction companies even went for litigation against the authorities in the past.
- A judgment by the Income Tax Tribunal upheld the tax benefits of the construction companies in the Patel Engineering case. As a result, all construction companies started claiming these benefits.
- We had pointed out that if this judgment was to be overturned, the construction companies could suffer significant downsides in providing for these taxes retrospectively.

Budget clarification - Pay full tax on cash contracts

- According to Budget FY08, with effect from the 1st day of April, 2000 Section 80I (A) shall not apply to a person who executes a works contract entered into with the undertaking or enterprise, as the case may be.
- We have confirmed the change with Gammon, Nagarjuna and IVRCL.
- However, there is still some confusion if companies can claim Section 80 I(A) benefits on cash contracts emanating from their own BOT projects.

Figure 1. No Section 80 I(A) For Cash Contract On a Retrospective Basis from April 2000

"(*12A*) Nothing contained in sub-section (*12*) shall apply to any enterprise or undertaking which is transferred in a scheme of amalgamation or demerger on or after the 1st day of April, 2007.";

(*v*) after sub-section (*13*), the following *Explanation* shall be inserted and shall be deemed to have been inserted with effect from the 1st day of April, 2000, namely:—

"*Explanation*.—For the removal of doubts, it is hereby declared that nothing contained in this section shall apply to a person who executes a works contract entered into with the undertaking or enterprise, as the case may be.".

Source: Citigroup Investment Research

Snowballing effects of the change

- We called up Gammon, IVRCL, Nagarjuna and HCC to find out what quantum of Section 80 I(A) benefits have they claimed since April 1, 2000.

Figure 2. Section 80 I (A) Benefits Claimed According to Companies Involved

Company	Rsmn
Gammon	350
IVRCL	579
Nagarjuna	260
HCC	Not Available

Source: Citigroup Investment Research

- We however though it prudent to do a checkup on the numbers ourselves in our financial models. For the sake of simplicity we have assumed uniform 33% tax for financial years FY01–FY06. Please note we have not included the 9mFY07 tax benefits claimed in this analysis.

Figure 3. Calculated Retrospective Tax To Be Paid

Gammon						
Rsmn	**CY02P**	**CY03P**	**CY04P**	**FY06A**		
PBT	366	480	710	1112		
Tax Paid	143	178	158	83		
Tax Rate	38.9%	37.2%	22.3%	7.5%		
Extra Tax Not Accounted For	**0**	**0**	**76**	**284**		
Total Not Accounted For @ 33%				**359**		
Nagarjuna						
Rsmn	**FY01**	**FY02**	**FY03**	**FY04**	**FY05**	**FY06**
PBT	NA	156	233	404	700	1,262
Tax Paid	NA	24	49	88	127	223
Tax Rate	NA	15.5%	20.9%	21.8%	18.2%	17.7%
Extra Tax Not Accounted For		**27**	**28**	**45**	**104**	**193**
Total Not Accounted For @ 33%						**397**
IVRCL						
Rsmn	**FY01**	**FY02**	**FY03**	**FY04**	**FY05**	**FY06**
PBT	173	199	240	339	595	1037
Tax Paid	59	68	85	35	28	108
Tax Rate	34.0%	34.3%	35.4%	10.4%	4.6%	10.4%
Extra Tax Not Accounted For				**77**	**169**	**235**
Total Not Accounted For @ 33%						**480**

Source: Citigroup Investment Research

- However, we are still unsure if this one-time effect would be routed through the Profit & Loss Statement or would the reserves in the balance sheet be written down directly.

- Longer-term impact of the change could be even more severe (Please see Figure 4). There is a likelihood of a 17-24% profit reduction across the board for construction companies and a 1-3% reduction in PAT margins.

- Important to note with the reduction of PAT margins construction companies could squeeze liquidity consequently leading to increased debt and interest costs. This could further reduce Recurring PAT by 3–5%.

- Last but not least this could affect equity investor appetite for construction companies, which could affect prospective fund raising, which is inevitable every 2-2.5 years if the companies have to grow sales at 25–30% in the future.

Figure 4. Likely Recurring PAT Impact FY07E – 09E @ 33% Tax Rate

Nagarjuna			
Rsmn	**FY07E**	**FY08E**	**FY09E**
Net Sales	30350	42412	50496
PBT	2098	2963	3635
Currently Factored Tax	378	533	691
Current Factored Tax Rate	18.0%	18.0%	19.0%
Incremental Tax @ 33%	315	444	509
Current Recurring PAT	1720	2430	2944
New Likely Recurring PAT	1405	1985	2435
Decrease	**-18.3%**	**-18.3%**	**-17.3%**
Current PAT Margin %	6.9%	7.0%	7.2%
New Likely PAT Margin %	4.6%	4.7%	4.8%
Gammon			
Rsmn	**FY07E**	**FY08E**	**FY09E**
Net Sales	20000	27000	36450
PBT	1265	1844	2725
Currently Factored Tax	158	230	341
Current Factored Tax Rate	12.5%	12.5%	12.5%
Incremental Tax @ 33%	259	378	559
Current Recurring PAT	1107	1613	2385
New Likely Recurring PAT	848	1235	1826
Decrease	**-23%**	**-23%**	**-23%**
Current PAT Margin %	5.5%	6.0%	6.5%
New Likely PAT Margin %	4.2%	4.6%	5.0%
HCC			
Rsmn	**FY07E**	**FY08E**	**FY09E**
Net Sales	24006	32106	41856
PBT	1001	1709	2351
Currently Factored Tax	115	197	270
Current Factored Tax Rate	11.5%	11.5%	11.5%
Incremental Tax @ 33%	215	368	505
Current Recurring PAT	886	1513	2081
New Likely Recurring PAT	671	1145	1575
Decrease	**-24%**	**-24%**	**-24%**
Current PAT Margin %	3.7%	4.7%	5.0%
New Likely PAT Margin %	2.8%	3.6%	3.8%

Source: Citigroup Investment Research

Gammon India (GAMM.BO - Rs317.75; 1L)

Investment thesis

We rate Gammon as Buy/Low Risk (1L) with a target price of Rs461. Gammon has significantly underperformed the BSE Sensex in the past year. Post 3Q FY07E, the last quarter of significant margin contraction, Gammon's margins should stabilize and profitability should bounce back. We expect an EPS CAGR of 42% over FY06 -09E supported by a sales CAGR of 45% and stable EBITDA margins of 9.0-9.5% over FY06-09E. Although Gammon's management has internal stretch targets of Rs45bn of revenues by FY09, we choose to be conservative at this point. Further, GIPL, the asset-holding company, has increased its portfolio of projects to 13 from seven in the past year. Gammon enjoys a strong competitive advantage in BOT/Public Private Partnership (PPP), as it, along with L&T, is the only company in the Indian construction universe having substantial experience in the dynamics of this business.

Valuation

Gammon has two distinct businesses: cash contract and build-own-transfer (BOT). Construction business: Our target P/E for Gammon's core construction business is 19x FY08E, which is well supported by a strong EPS CAGR of 42% over FY06- 09E. Our target P/E is at a premium to that of Nagarjuna Construction's 16x FY08E (on account of Gammon's superior skills sets and a superior EPS CAGR over FY06 -09E) and a discount to that of L&T's 23x FY08E (on account of L&T's size, wider skill sets and better reputation). BOT projects: We value GIPL at a 10% premium to the value at which private equity investors took a 12.5% stake.

Risk

We rate Gammon as Low Risk. The rating differs from the Medium Risk rating assigned by our quantitative risk-rating, which tracks 260-day historical share price volatility, primarily because Gammon's beta is less than one and the current order book of Rs80bn implies sales coverage for the next three to four years. Further, steady EBITDA margins imply good earnings visibility in the medium term. The key risk factors that could impede the stock from reaching our target price include the construction business is subject to project risks; slower-than-expected order inflows and execution; sudden increases in price of steel, bitumen and cement; and non-allowance of Section 80I (A) benefits to non-BOT projects.

Hindustan Construction (HCNS.BO - Rs102.50; 3L)

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.

Risk

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.

Nagarjuna Construction (NGCN.BO - Rs155.90; 1M)

Investment thesis

We rate Nagarjuna Construction shares a Buy / Medium Risk (1M) with a target price of Rs272. We forecast a FD EPS CAGR of 42% for FY06-09E and ROE of ~20%, and expect order backlog growth of 29% during this period. Current order book is about 3.8x FY06 revenues, providing good visibility for the next four years. Nagarjuna's exposure to high-growth sectors such as transportation and irrigation should bolster order-inflows. Better cost management; nimble operations, operating leverage and improving revenue mix should enable it to maintain margins at the 9.5% level. The company intends to increase its focus on the high-growth road and irrigation sectors. We expect these initiatives to provide growth impetus to the company.

Valuation

Our sum-of-the-parts-based target price for NJCC of Rs272 per share is based on its four distinct parts: cash contract business, BOT projects, real estate projects and land bank. We value the core construction business at a P/E of 19x FY08E FD EPS to derive a value of Rs221 per share. We value its BOT projects at Rs19 per share, using the P/BV method to value its share in these projects. We then value its real estate projects at Rs22 per share based on book value. Finally, we value its 130-acre and 248 acres NCC Urban land bank at Rs11 per share, using management's estimates of its current market value.

Risk

We rate NJCC shares as Medium Risk. This differs from the High Risk rating suggested by our quantitative risk rating system, which tracks 260-day historical share price volatility. This is primarily because NJCC's current order book of Rs70bn implies sales coverage of 3.8x FY06E sales and provides good earnings visibility over the medium term. Risks to the shares reaching our target price include: changes associated with the new Model Concession Agreement, taxation issues related to Section 80 IA benefits, rising material prices, project risks, commercial risks associated with BOT projects, equity dilution and a shortage of skilled manpower. It also faces risk from exposure to government funded projects.

Appendix A-1

Analyst Certification

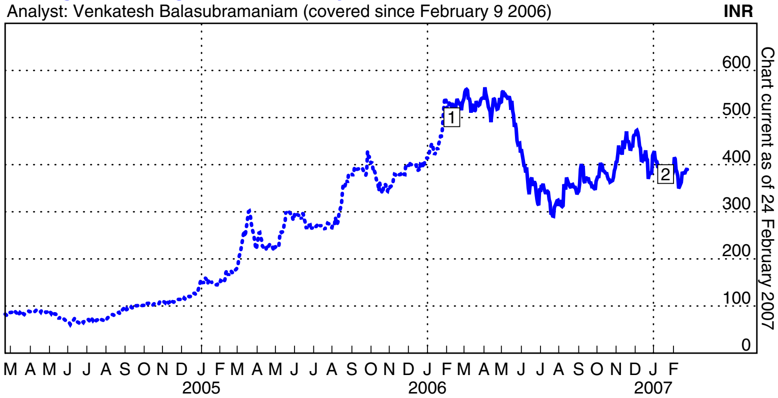
We, Venkatesh Balasubramaniam and Deepal Delivala, research analysts and the authors of this report, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

Gammon India Ltd (GAMM.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	426.00	NA
2:	19 Jan 07	*1L	*461.00	382.20

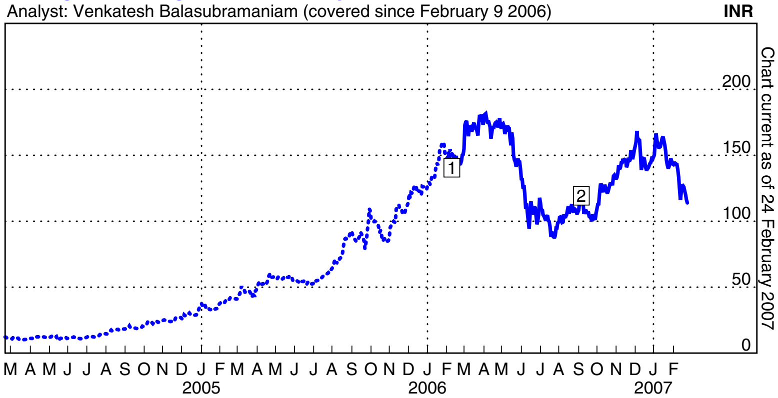
*Indicates change.

Covered
Not covered

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

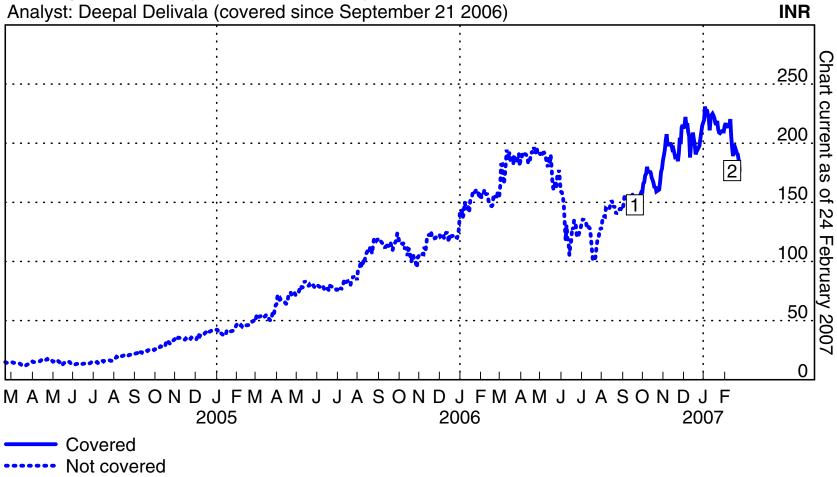
*Indicates change.

Covered
Not covered

Nagarjuna Construction Co Ltd (NGCN.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Deepal Delivala (covered since September 21 2006)



#	Date	Rating	Target Price	Closing Price
1:	20 Sep 06	1M	191.00	149.75
2:	13 Feb 07	1M	*272.00	195.85

*Indicates change.

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