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MORGAN STANLEY RESEARCH
ASIA/PACIFIC

JM Morgan Stanley Securities Private Limited+

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Stock Rating
Overweight

Industry View
Attractive

Gammon India

Mixed Bag

What's Changed

Price Target	**Rs479.00 to Rs392.00**

Conclusion: We maintain our Overweight rating on the stock, and given the recent fall in the stock, we like the risk/reward ratio better. While our estimates remain unchanged, our price target of Rs392 falls 18% due to a decline in the market multiple and dilution in company’s equity in the past six months. We believe that the higher-than-normal revenue growth in the quarter came through contracts that have not yet started yielding profits, and we expect to see a slackening in revenue growth along with an increase in operating profit margins over the next few quarters. We believe that Gammon’s continued focus on infrastructure development is gaining momentum.

What's New: Gammon posted C1Q06 net profit growth of 101% YoY on revenue growth of 45%, but much of the profit growth was due to non-operating items. The EBIDTA margin fell 220 basis points YoY as EBIDTA growth slowed to 21.3% YoY. Interest costs dropped 44% YoY as the company repaid debt with funds raised from its GDR issue early in the quarter. This, along with a large negative deferred tax and strong other income, more than offset 59% YoY growth in depreciation.

Implications: We continue to use a sum-of-the-parts approach to value the company. We value the construction businesses by applying the stock’s relative premium over the past three years to the forward EV/EBITDA multiple. We have benchmarked the value of the infrastructure projects to the price paid by strategic investor Och-Ziff for a 12.5% stake in the business last December.

Key Ratios and Statistics

Reuters: GAMM.BO Bloomberg: GMON IN
India Construction

Price target	Rs392.00
Shr price, close (Jun 29, 2006)	Rs314.00
Mkt cap, curr (mn)	Rs23,922
52-Week Range	Rs588.95-257.50
Sh out, basic, curr (mn)	76
EV, curr (mn)	Rs25,329
Net debt/cap (05e) (%)	23.1
ROE (05e) (%)	17.4
Sh out, basic, per-end (05e) (mn)	76
S'hldr eqty (05e) (mn)	Rs4,570
RNOA (05e) (%)	15.5

Fiscal Year (Dec)	2004	2005e	2006e	2007e
ModelWare EPS (Rs)*	7.51	9.01	14.10	20.04
Prior ModelWare EPS (Rs)	-	-	-	-
EPS, basic, rpt'd (Rs)	6.68	9.01	14.10	20.04
Prior EPS, basic, rpt'd (Rs)	-	-	-	-
Rev, net (Rs mn)	11,700	12,177	17,422	23,604
ModelWare net inc (Rs mn)	572	686	1,075	1,526
P/E	20.4	34.9	22.3	15.7
P/BV	3.0	5.2	4.3	3.4
EV/EBITDA	10.2	16.7	12.4	9.6
Div yld (%)	0.4	0.2	0.3	0.3

* = Please see explanation of Morgan Stanley ModelWare later in this note.
e = Morgan Stanley Research estimates

Investment Case

Summary & Conclusions

We maintain our Overweight rating on Gammon shares and our earnings estimates, but we are lowering our price target by 18%, to Rs392 per share, due to the downtick in the market multiple and dilution in the company's equity in the past six months. Our revised target implies 25% upside from the current price, and we think Gammon's strong order book (5.1x F2006 revenues) creates further upside potential. We believe that the higher than normal revenue growth in the first quarter reflected contracts that have not yet started yielding profits; we expect to see a slackening of revenue growth along with an increase in operating profit margins over the next few quarters. With the recent fall in the stock, we like the risk/reward ratio better, and we believe that Gammon's continued focus on infrastructure development is gaining momentum.

The company's current order book totals Rs75 billion, up 86% from December 31, 2004, and represents 5.1 times our F2006 revenue estimate (Exhibit 2). Given Gammon's order book execution period of around three years, the company is in a position to execute 105% of our C2006-08E revenues without any further addition to its order book over the next 36 months. This creates upside risk to our estimates, we believe, though we have maintained our earnings estimates.

We continue to use a sum-of-the-parts approach to value the company. We value the construction businesses by applying the stock's relative premium over the past three years to the forward EV/EBITDA multiple. We have benchmarked the value of the infrastructure projects to the price paid by Och-Ziff (a strategic investor) for a 12.5% stake in the business last December. Given the decline in the market multiple and the equity dilution (through the issue of GDRs) since then, our target price has fallen 18%, to Rs392, implying a 25% return based on the current price.

Two Sides of the Coin: Revenue and Margins

Gammon reported 45% YoY growth in revenues in C1Q06, significantly stronger than the market had expected. However, we believe that much of this growth reflected the start of several contracts in the quarter. Given the lack of profitability in the early stage of the contracts, the company registered a 220 bps YoY drop in its EBIDTA margin for the quarter, to 8.7%, on EBIDTA growth of 16% (Exhibit 1). We believe that the quarter was an aberration and expect a slowdown in revenue growth coupled with an increase in EBIDTA margins in the next few quarters as the recently launched contracts start registering profits.

Non-Operating Items Lend Strength to PAT Growth

While the operating story was slightly disappointing due to the margin decline, non-operating items made up for the lack of growth. After raising Rs4.4 billion in the quarter, Gammon was able to pay back debt despite its higher working capital requirements. We believe that the company was close to being a net cash company (cash balance of the company was almost higher than debt) at the end of the quarter. We note, however, that potential investments in infrastructure projects that Gammon might win in the near future would require it to gear up again.

The company's repayment of debt, while not significant from a medium-term perspective, resulted in a 44% YoY decline in interest costs. This, along with an increase in other income (due to interest earned on the GDR proceeds raised by the company), outweighed a 59% YoY jump in depreciation to help Gammon register 49% growth in pretax profit. A large deferred tax write-back pushed net income growth to 101% YoY. However, we would focus on the 49% growth at the PBT level, since we view the deferred tax write-back as a non-recurring item.

Company Description

Gammon India Limited undertakes engineering and construction projects. The company provides specialists in reinforced concrete, engineers, architects, surveyors, estimators, and designers on a contractual basis to complete large-scale construction projects in India.

Industry View: Attractive

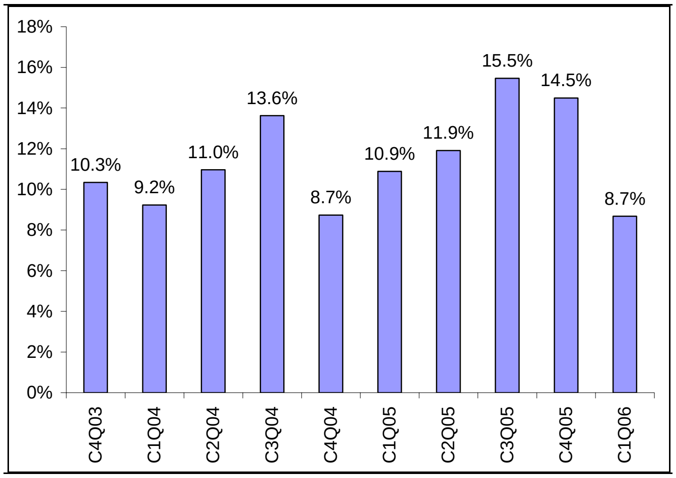
We have an Attractive view on the construction industry, as rapid top-line growth expected for the larger players should offset the margin compression due to commoditization of some parts of the industry, resulting in strong earnings growth in the medium to long term.

MSCI Country: India

Asia Strategist's Recommended Weight: 1.4%
MSCI Asia/Pac All Country Ex Jp Weight: 5.9%

Exhibit 1

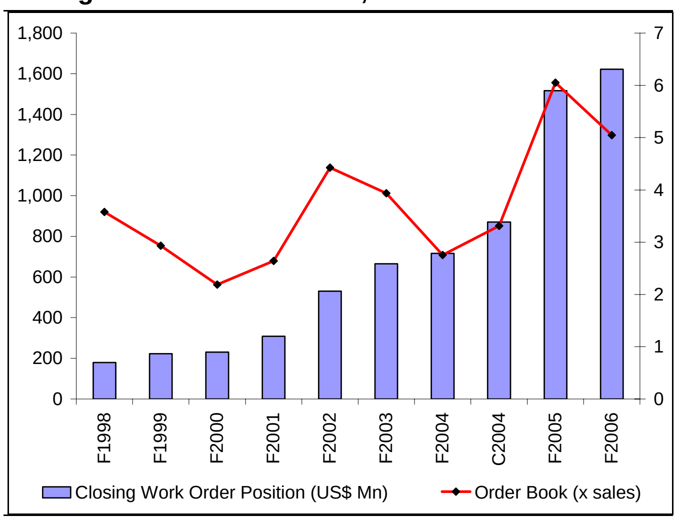
EBIDTA Margin, C4Q03–C1Q06



Source: Company data, Morgan Stanley Research

Exhibit 2

Strong Order Book Position, F1998–F2006



Source: Company data, Morgan Stanley Research

Valuation Methodology

Given the back-ended nature of Gammon's infrastructure development projects, we continue to use a sum-of-the-parts approach to value the company. We value the construction business based on its relative EV/EBIDTA multiple to the BSE Sensex index (to strip out changes in the market multiple over time). We expect Gammon's stock to trade at its long-term average valuation (around 1.6 times the broad market's EV/EBIDTA multiple) for the next 12 months.

We have applied our EV/EBIDTA multiple (assuming the stock trades at its average relative EV/EBIDTA multiple for the past three years) to the 12-month forward EBIDTA and subtracted the net debt to reach our expected market capitalization. The resulting market cap is divided by the number of shares outstanding, yielding our price target of Rs275 for the construction business.

We benchmark Gammon Infrastructure's valuation to the price paid by strategic investor Och-Ziff for a 12.5% stake in the business in December 2005. Based on the Rs1.2 billion paid by Och-Ziff, we arrive at a fair value of US$219 million for this business. The company's 82.5% stake gives us a value of Rs117 a share, which we believe is conservative in light of the projects Gammon has won since December.

Adding the value of the two businesses, we arrive at our target price of Rs392, which implies 25% upside from current levels. The downtick in the market (BSE Sensex) multiple, coupled with dilution (GDR issue) in the company's equity since last December, led us to lower our target by 18% despite no change in our earnings estimates.

Risks to achieving our price target include a slowdown in infrastructure spending, lack of profitability of infrastructure development projects undertaken by Gammon, and a margin fall greater than expectations. Upside risks include new infrastructure development projects won by the company, and a smaller/slower dip in construction business margins than we estimate.

Exhibit 3

Target Price Calculations

12 Month Fwd. Numbers	EV/EBIDTA	PE
3-yr Avg. Rel. Multiple	57%	36%
Sensex Multiple	6.9	13.8
Target Multiple	10.9	18.7
Enterprise Value	26,575	
Debt	3,831	
Cash	1,118	
Net Debt / (Cash)	2,713	
Market Cap	23,862	24,075
Per Share Value		
Construction Value	275	278
Infrastructure Projects	117	117
Target Price	392	394
Current Price	314	314
Return to Target	25%	26%

Source: Company data, Morgan Stanley Research

Exhibit 4

F4Q06 Results Quarterly Table

Rs. in millions	F2006**	F2005*	% YoY	F4Q06	F4Q05	% YoY
Net Sales	**14,851**	**11,581**	**28%**	**4,069**	**2,806**	**45%**
Expenses	12,919	10,317	25%	3,716	2,501	49%
Consumption of Raw Materials	4,941	4,279	15%	1,630	1,125	45%
Staff Cost	873	590	48%	219	152	44%
Sub Contract Expenses and other Site Expenses	6,922	5,294	31%	1,810	1,180	53%
Other Expenditure	183	154	19%	57	44	30%
EBITDA	**1,932**	**1,265**	**53%**	**353**	**306**	**16%**
Margin (%)	*13.0%*	*10.9%*	*19.1%*	*8.7%*	*10.9%*	*-20.3%*
Other Income	22	3	617%	18	0	4425%
Interest	471	380	24%	55	98	-44%
Depreciation	371	226	64%	97	61	59%
Profit before tax	**1,112**	**663**	**68%**	**219**	**147**	**49%**
Taxation	69	138	-50%	(69)	4	-2017%
Profit after tax	**1,043**	**524**	**99%**	**288**	**143**	**101%**

Source: Company data, Morgan Stanley Research
* Sum of 4 quarters (from April 2004 to March 2005)
** As restated by the company

Morgan Stanley
ModelWare[SM]

ModelWare is Morgan Stanley's new system for helping investors and analysts to uncover value, free from the distortions and ambiguities created by accounting data. Morgan Stanley has dissected and fundamentally redefined the components of corporate valuation, giving clients more consistent definitions, more comparable data, and more flexible analytic tools. ModelWare makes investment insights easier by making value more visible.

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(as of May 31, 2006)

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	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
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Equal-weight/Hold	**906**	**45%**	**303**	**46%**	**33%**
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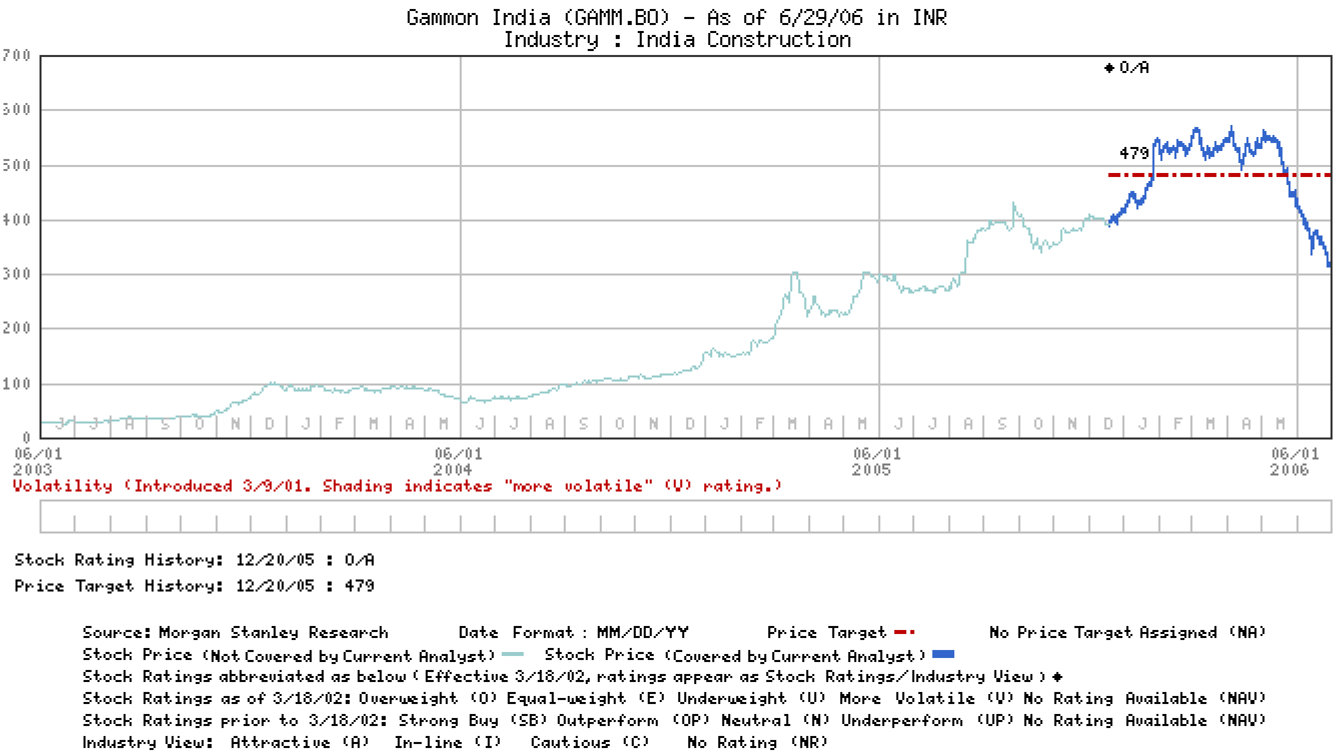
Stock Price, Price Target and Rating History (See Rating Definitions)



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Industry Coverage:India Construction

Company (Ticker)	Rating (as of)	Price (06/29/2006)
Akshay Soni		
Gammon India (GAMM.BO)	O (12/20/2005)	Rs314.00
Jaiprakash Associates Limited (JAIA.BO)	O (12/20/2005)	Rs356.40

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