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Bangalore Real Estate

Housing Demand - Thumbs Up

Sector Report

January 12, 2012

- Expect positive demand in Bangalore housing market given the uptick in key determinants of property buying - affordability quotient and promising job environment
- We are equally positive on the office space segment of the city's real estate, but are negatively biased on the retail and hospitality segment owing to oversupply scenario
- Concerns: High inventory scenario on continuation of aggressive residential launches leading to lower net cash generation for the developers
- We initiate coverage on Prestige Estates with a HOLD rating and a TP of Rs 81 and have a Accumulate rating on Sobha Developers with a TP of Rs 272

Property prices of 2008 and purchasing power of 2011 raises the affordability quotient

As on September 2011, Bangalore's residential property capital values, unlike NCR or MMR, are either below its 2008 peak values or are nearing it. Considering the inflationary nature of the post crisis increase in prices and the purchasing power of 2011, the affordability quotient is likely to be healthy. We believe interest rate scenario is not a key parameter for the Bangalore property buyer as he is highly educated and understands the cyclical nature of it.

Promising job scenario to further aid demand

Bangalore, as a city, is driven by the middle-class job oriented families. The city's office space asset absorption run rate has been quite strong over the last six quarters. Also, hiring by IT sector has consistently improved along with increasing remuneration. All this depicts healthy local industry and hence, better job environment. This translates into positive sentiments for discretionary spending.

Continuation of mega launches in housing segment may lead to high inventory pile-up

Bangalore witnessed new launches of 31 msf in Q2FY12, which is more than launches made in the city over the last 3 quarters. Post-crisis, most of the developers had refrained from new launches with focus on clearing their unsold inventory and delivering the under construction projects. With majority of the projects launched in 2008-09 period nearing completion, most of the developers have gone for aggressive launches. If this aggression is not followed by absorption, the city will be left with very high inventory. At the current sales booking run rate (Q2FY12), the city's unsold inventory of more than 9 quarters is comfortable.

Sobha Developers & Prestige Estates – Same micro market, Different business approach

SDL and PEPL operate in same business environment with both commanding strong brand equity in Bangalore city. While SDL is a pure residential development play, PEPL has its forte in development of commercial assets viz office, retail & hospitality. Considering the current macro environment with headwinds, we prefer the former's model over the latter, for its ability to generate positive cashflows.

SDL's strong brand in the residential segment and good location of its on-going projects mitigates the risk of slowdown. We believe SDL's debt will not rise from here on, even with 30% fall in the volume run rate in FY13E over FY12E.

PEPL would require working capital to fund its near term growth in the Asset Sale segment and long term capital to fund its capex for developing Leaseable properties. We believe the working capital cycle to turn in FY13E which will meet its capital requirement for capex.

Tejas Sheth
tejas.sheth@emkayglobal.com
+91 22 6624 2482

Bangalore real estate: Residential – Well positioned

Bangalore real estate is well placed to reap sustained demand

- Bangalore city's residential demand is dominated by an immigrant salaried employee class working in the IT sector, with a high probability to purchase property by taking a loan.
- The property buying decision of this class is mainly determined by two aspects – 1) affordability quotient, which takes into account the current affordability situation of the buyer and 2) the job security sentiment, which is based on whether the buyer is comfortable about the stability of his future income to service the home loan.
- The location of the project and the quality of construction are not that important a criteria as Bangalore provides many options in terms of project choices in any given area and there is negligible product differentiation among the top developers.
- Interest rates, although an important parameter in determining the current affordability, is not that critical as most of the buyers are highly educated and informed. They are aware that the change in loan interest cost is cyclical. The change in property prices during economic cycles has a more profound impact on the buyer's financial strength than change in interest rates (which he is already prepared for).

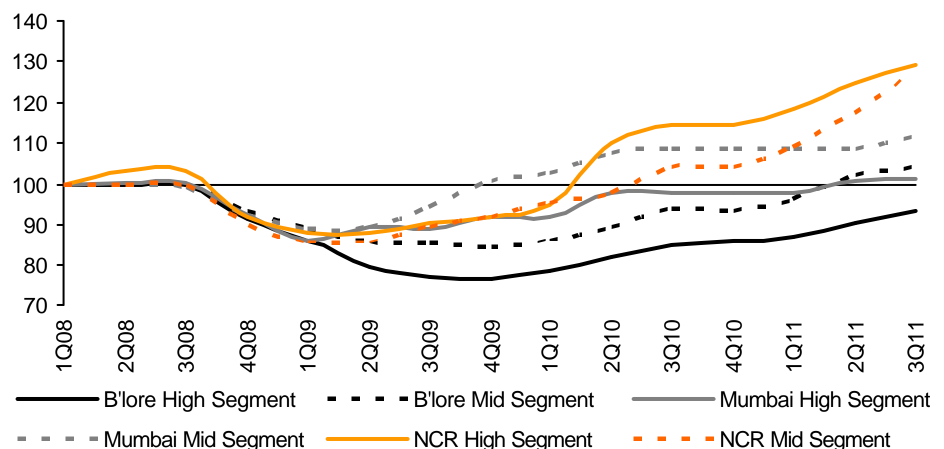
The Bangalore residential market scores strongly on the critical aspects influencing demand, as we have elaborated below:

2008 pricing, 2011 purchasing power

The Bangalore real estate market, unlike Mumbai and NCR, has not seen a steep increase in prices when compared to peak prices of early 2008. The change in prices is very much inflationary and hence, provides a strong affordability quotient. While the mid-segment housing prices are marginally up 4.1%, the high segment is still 6.3% away from the peak. As against the same, NCR mid-segment is 29.1% & high-segment 27.1% and Mumbai mid-segment is 12% & high-segment 1.3% above their 2008 peaks.

Bangalore Residential Capital Values are not above its 2008 peak, unlike NCR and MMR markets, thus providing high affordability quotient

Trending Capital Values Index for mid & high segment since crisis

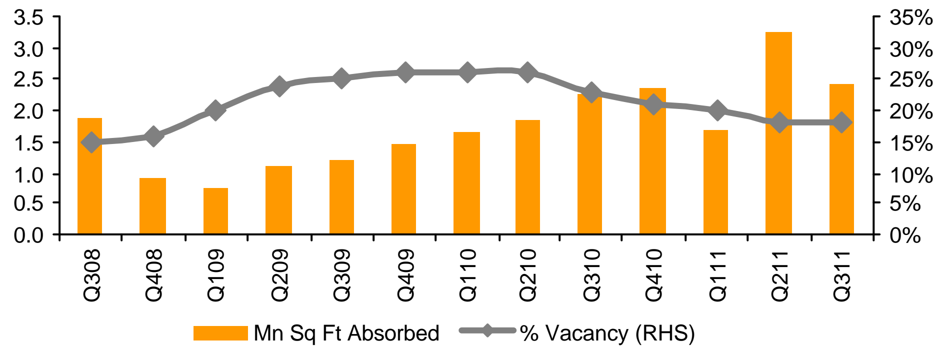


Source: Cushman & Wakefield, Emkay Research

Bangalore's stable office space absorption provides positive signal to the local industry's health, positively impacting buyers' sentiments

We believe the strength of an industry is measured initially by the demand and absorption of commercial space because any industry would initially curb its expansion plans and lay-off its employees as the last resort. But if the demand for the commercial space in the city is high, it indicates that the industry in that city is doing well which in turn, leads to better sentiments in terms of job opportunities, prospects and security. These positive sentiments lead to high discretionary spending (with some time lag when it comes to property purchase).

Bangalore office market trend

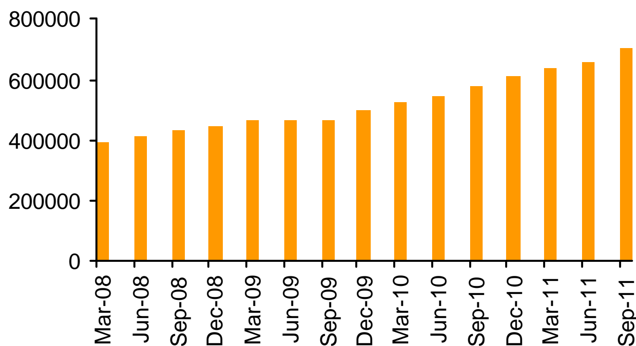


Source: DTZ, Emkay Research

In Bangalore, we are witnessing a healthy and stable absorption in office space. The vacancy levels are also seeing a downtrend and are lowest post the 2008-09 crisis.

Along with buying of property, the hiring of India's large five IT companies is also on an upswing after a stagnation, which adds to healthy outlook of the IT sector. Also, the fixed compensation has improved over the last two years, increasing the purchasing power and hence, the affordability quotient (discussed earlier)

Hiring by Big 5 IT cos has picked up…..



.. so has the fixed compensation of India-based employees

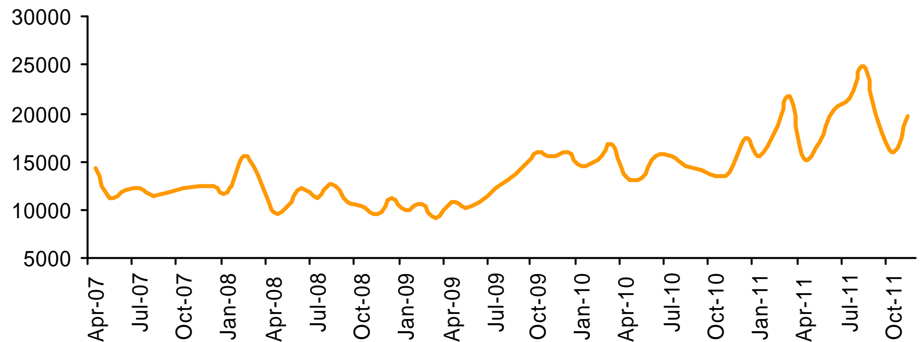
	FY09	FY10	FY11	FY12
Infosys	11-13%	8%	14%	10-12%
TCS	10%	NA	10%	12-14%
Wipro	8-9%	8-9%	8-10%	12-15%

Source: Company Data, Emkay Research

Bangalore City's property registration data shows strong resilience post-crisis

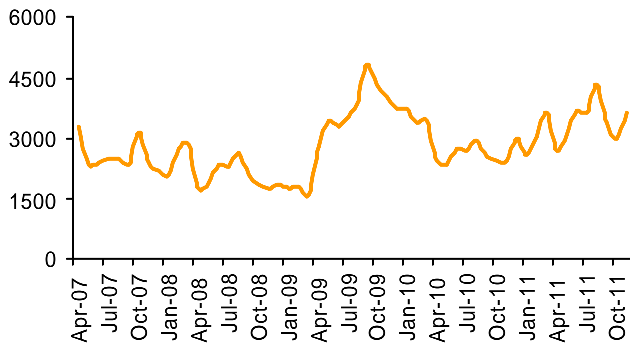
Bangalore property registration data has shown strong growth post-crisis and is also much above its early 2008 peak number. This data goes well with our argument that with 2011 purchasing power at 2008 pricing, the demand for property would remain healthy. The sharp movement in registration in CY11 is predominantly due to the significant new launches during that period.

Bangalore property registration trend



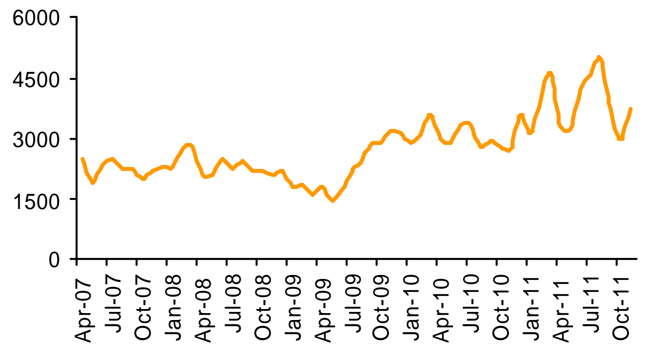
The southern region of the city is seeing maximum traction as developers are also focusing and launching projects in this region- mainly comprising of Sarjapur Road & Kanakpura Road. SDL currently has three residential projects in this region while PEPL has one residential project and two office spaces. The other region which is seeing huge traction is Hebbal as it is closer to Manyata Tech Park and also equidistant from CBD and airport. SDL has launched Sobha City, which is behind Manyata Tech Park while PEPL does not have any on-going projects in this area.

North Bangalore property registration trend



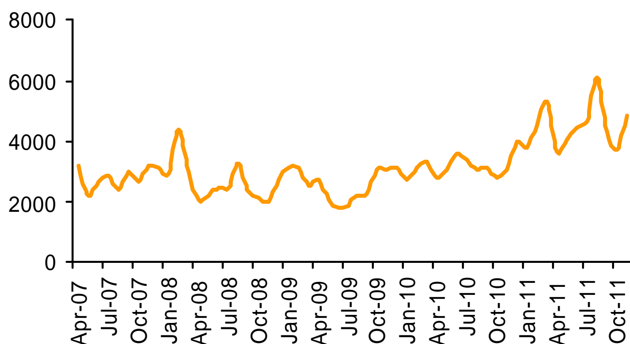
Key Locations: Hebbal, Yelahanka, Dodbollapur Road, Gandhi Nagar, Devanahalli

East Bangalore property registration trend



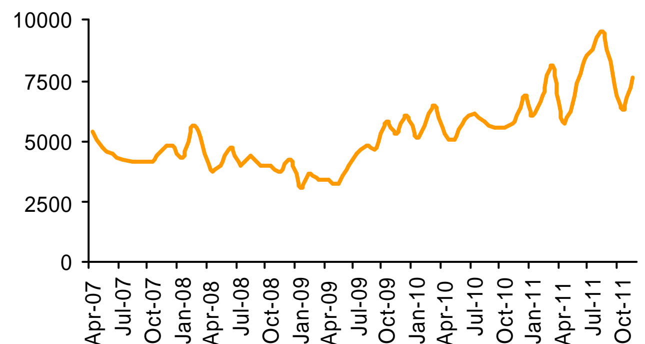
Key Locations: Banaswadi, K R Puram, Varthur, Whitefield, Domlur, Brookfield

West Bangalore property registration trend



Key Locations: Rajajinagar, Yeshwantpura, Peenya, Malleshwaram,

South Bangalore property registration trend



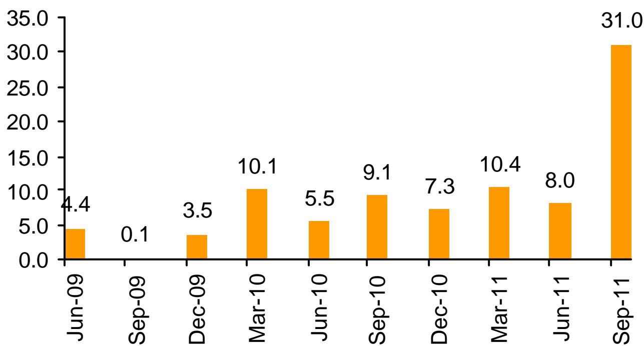
Key Locations: Sarjapur Rd, Kanakapura Rd, BTM, Jayanagar, J P Nagar,

Concerns

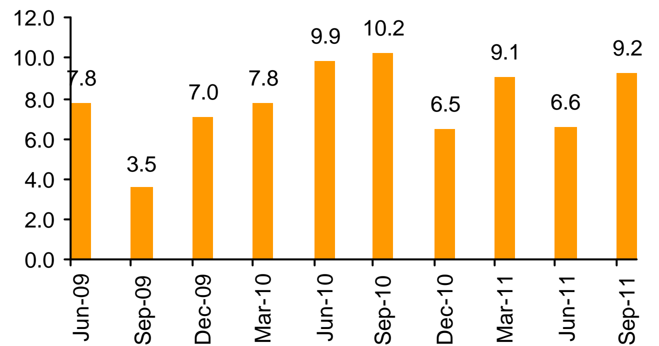
Housing supply could outpace demand in the near term

Bangalore real estate market has witnessed huge launches recently, which have led to strong sales bookings in the city. Post downturn, the city developers stayed at bay by launching few projects and instead, concentrated on reducing the huge inventory pile up from their launches made in 2008. With these inventories getting cleared, most of the developers have aggressively launched projects in Q2FY12.

There has been steep increase in launches (msf)…..



… absorption rate of under construction shows no trend

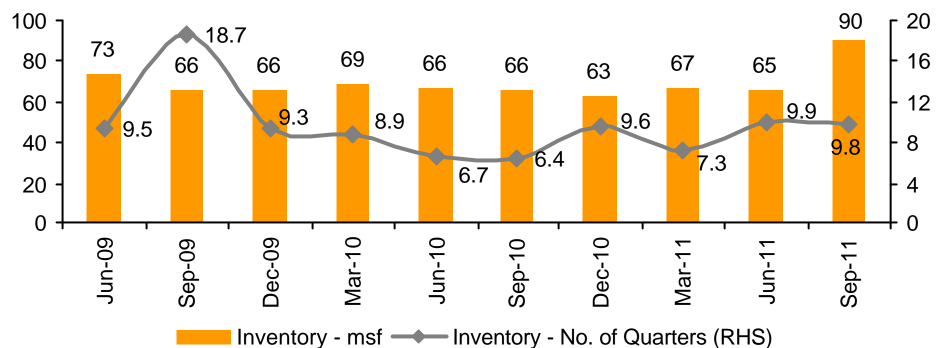


Source: Liases Foras, Emkay Research

The inventory in absolute terms has increased to 90 msf, which is not that alarming as the launches have just seen one quarter of sales. The inventory in number of quarters too, is comfortable at 9.8 quarters on the sales booking run rate of Q2FY12.

What is worrying is continuation of new launches leading to over supply or a fall in the sales booking run rate having the same impact. Having already experienced the downturn period, we believe developers would restrain from further aggressive launches but if the sales booking run rate falls, then most of the projects will not be able to meet the cost towards committed delivery timeline.

Bangalore 'under construction' housing inventory trend



Huge oversupply seen in the retail space and hospitality

As per Asiapac's, a real estate research firm, Bangalore has total 38 malls under construction with total 19.2msf of gross leasable area. When compared to the current mall space of 3.9msf (17 projects), this supply looks humongous. These malls expected by FY15, as per Asiapac, will lead to oversupply of an alarming 13.5msf over the demand for 9.7msf

Huge oversupply seen in the Bangalore retail space

	2010	2011	2012	2013	2014
Demand	7.4	7.9	8.5	9.1	9.7
Supply	0.5	4.4	4.4	6.2	3.8
Total Supply	4.4	8.9	13.3	19.5	23.2
Oversupply / (Shortfall)	**(2.9)**	**1.0**	**4.8**	**10.4**	**13.5**

Source: Asiapac

As per HVS, a renowned hotel industry consultant, Bangalore currently has supply of 5,947 rooms and has proposed supply addition of 12,509 rooms over the next five years. Historical data (last five years) shows that only ~ 65% of the proposed supply bears fruition. As a result, assuming 65% of the proposed supply of 12,509 rooms, a supply of 8130 rooms is expected over the next 5 years.

As per HVS, the city currently has an occupancy rate of 58.4% (lowest among metros) and it will remain under pressure going forward owing to huge over supply seen (again, highest among metros in % terms).

Huge addition in room keys in past has led to declining occupancy

	FY07	FY08	FY09	FY10	FY11
Room Keys	2414	3456	3889	5597	5947
Occupancy Rate	73%	65%	55%	53%	58%

Source: HVS

We believe this kind of oversupply will put pressure on the occupancy rates leading to single digit return on capital for the hotel assets.

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Prestige Estates Projects

Positive Operating Cashflows Awaited

Initiating Coverage

January 12, 2012

Reco
Hold

CMP	Target Price
Rs74	Rs81

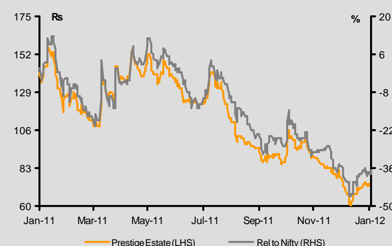
EPS change FY12E/13E (%)	NA
Target Price change (%)	NA
Nifty	4,831
Sensex	16,038

Price Performance

(%)	1M	3M	6M	12M
Absolute	1	(28)	(42)	(49)
Rel. to Nifty	5	(21)	(30)	(35)

Source: Bloomberg

Relative Price Chart



Source: Bloomberg

Stock Details

Sector	Real Estate
Bloomberg	PEPL@IN
Equity Capital (Rs mn)	3281
Face Value(Rs)	10
No of shares o/s (mn)	328
52 Week H/L	165/58
Market Cap (Rs bn/USD mn)	24/464
Daily Avg Volume (No of sh)	224334
Daily Avg Turnover (US$mn)	0.4

Shareholding Pattern (%)

	Sep-11	Jun-11	Mar-11
Promoters	80.0	80.0	80.0
FII/NRI	15.5	17.9	17.9
Institutions	3.2	1.1	1.1
Private Corp	0.8	0.7	0.7
Public	0.5	0.4	0.4

Source: Capitaline

- Prestige Estates Projects Ltd.'s (PEPL) growth over the next 2-3 years to be driven by capital availability - a value deterrent in the current scenario due to high cost of capital
- Negative operating cashflow (post working capital) despite rich asset portfolio, generating annual rentals of Rs 1.4bn, questions company business model
- We will re-rate the stock on turn of the investment cycle, operating cashflow visibility and company's strategy on commercial assets
- We initiate coverage with a HOLD rating and a TP of Rs 81, an upside of 9% from CMP. We have valued the ongoing assets at WACC of 16% and Cap-rate of 10.5%

A balanced player on Bangalore real estate, PEPL has diversified land bank (segment-wise), strong brand and rich experience

PEPL has a rich heritage of property development in Bangalore with a total experience of developing over 35 msf since inception. The company's core strength lies in developing commercial assets and has developed Bangalore's marquee retail space. The company currently has a land bank of 483 acres with saleable area of ~45 msf spread across 52 projects in six cities. The company is currently developing 24.3 msf with more than 75% of the development in the residential space.

PEPL has not generated positive operating cash flows since FY08, Company's growth model is a capital guzzler

PEPL has not generated operating cash flows (incl. working capital) over the last three years despite increasing contribution from high margin rental income. This is owing to huge working capital cycle in the asset sale model. Going forward, if the company wants to scale up its business its working capital cycle needs to be shorten. We see this happening in FY13E when investment cycle turns, improving company's cash conversion cycle.

Plans deploy additional capital of 20bn+ over next 3-5 years for development of commercial lease assets and hotel properties

PEPL has 12 commercial assets under construction in office and retail space which will be ready by FY15E. These have the potential to generate an additional Rs 1.9bn+ of rental income over its current rental run rate of Rs 1.4bn. The company will have to deploy additional capital of Rs 15.0bn over the next 5 years to make these assets operational. Company is also adding nearly 950+ room keys across 4 hotel properties by FY14E, which would require additional investment of Rs 5.0bn. We are not at all bullish on the hotel business in Bangalore city, considering the huge supply seen over the next 4 years

Initiate coverage with a HOLD rating & TP of Rs 81, 9% Upside from CMP

We have valued PEPL on SOTP of leased assets, ongoing projects, land bank and hotel assets (WACC rate of 16% and Cap-rate of 10.5%). We have discounted the value of on-going & planned leased assets as well as hotel assets by 50% considering low visibility on their execution and low shareholder value creation.

Financials (Rs Mn)

YE-Mar	Net Sales	EBITDA (Core)	EBITDA (%)	APAT	EPS (Rs)	EPS % chg	RoE (%)	P/E	EV/ EBITDA	P/BV
FY10	10,244	2,236	21.8	1,456	4.4	105.9	21.1	16.7	17.2	3.2
FY11P	15,431	3,739	24.2	1,800	5.5	23.6	12.5	13.5	9.6	1.1
FY12E	12,351	3,702	30.0	1,534	4.7	(14.8)	7.1	15.8	10.4	1.1
FY13E	19,073	6,573	34.5	3,111	9.5	102.8	13.2	7.8	5.9	1.0

Investment Rationale

Prestige Estates (PEPL) has not generated positive operating cashflows since FY08, despite an increase in its high margin annuity income

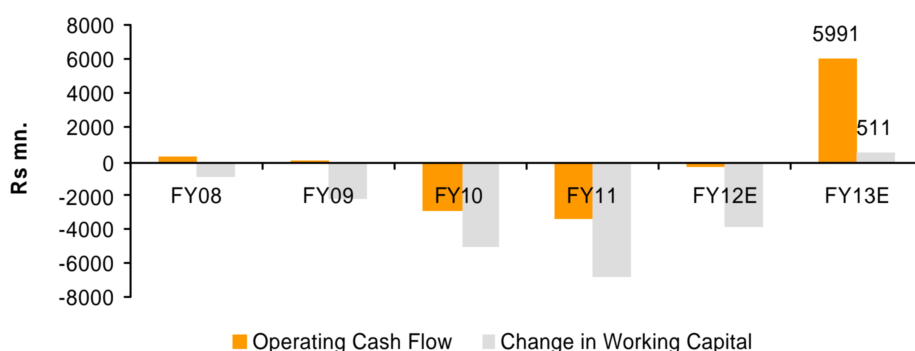
PEPL has been generating negative operating cashflows from its asset sale model since FY09. The company has filled the cash requirement gap through borrowings and issuance of equity shares in the primary market. Increase in the annuity income has not added any respite to company's cashflow management

The main reason for this has been the company's increasing working capital requirements along with its inability to generate milestone cash inflows to meet its construction cost commitments As on H1FY12, company's total debtors stood at Rs 9.5bn a main reason for bulging working capital and cash drain. What is worrying is that of these Debtors, Rs 5.6bn is from projects which are either 100% complete or wherein 100% revenue is booked.

Company attributes the high debtors to aggressive accounting method and delay in providing possession to the property buyers. PEPL's this stand is quite unlike to other developers who usually have very low cash inflows from property buyers at the fag end of project completion. The strategy of the other developers is much appropriate as the development cost of the project is financed by the property buyers and if everything goes right (in terms of sales), the project will also throw cashflows to finance pre-launch costs of the new projects. This churn improves the return on capital.

Going forward, as the scalability of the business increase, this strategy could be quite deterrent as it will lead to high Working Capital requirement and low Operating Cashflows. We, in our estimation, have considered these Debtors as one-off cases considering the downturn and disadvantage of large single location project. Hence, we believe the company will recover its large outstanding over next one year improving its Operating Cashflows in FY13E. If not, then this strategy will be quite deterrent on company's scalability and future growth.

We expect cashflows to improve substantially in FY13E with working capital easing

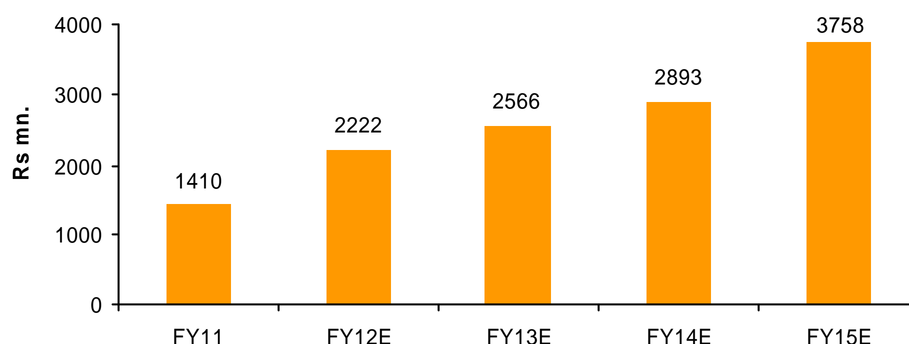


PEPL envisages strong asset portfolio to drive its annuity income, plans development of 8.3msf (PEPL share 4.1msf) over 4-5years for Rs 21.9bn

PEPL has a strong portfolio of ready assets, which generates net annuity income of Rs 1.4bn. The company is known for its execution of commercial assets in Bangalore and has city's best performing retail space, Forum Mall and UB City, in its portfolio. Company currently has 4.5msf of space leased (PEPL's share) through various JVs and another 4.1msf under development. On completion of these projects by FY15, we expect its rental income to increase two-fold.

Company will have to invest total capital of atleast Rs 10bn over of the next four years, over and above the Rs 3.9bn it has invested, to make these assets revenue generating.

Annual rentals (Rs mn) from commercial leases to rise… if planned capex is implemented



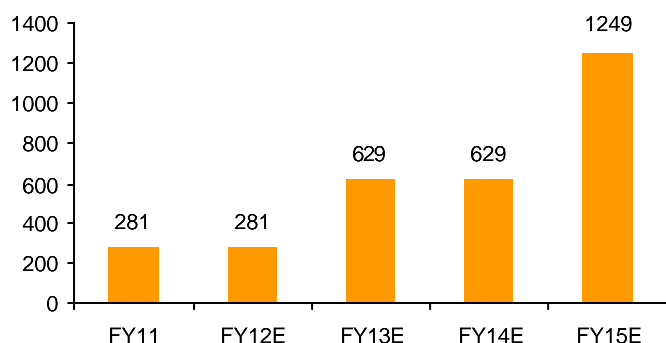
Development of commercial assets in slow economic growth cycle is always a catch-22 situation. If the developer develops the same in high interest rate and high inflationary period, the cost of development increases. And with low demand for these assets leading to low rentals, the yields on these assets are below the cost of capital. If the developer postpones the full development of the half-developed asset, the interest cost capitalized, on the debt taken to develop the half asset, will also lead to high development costs and lower investment yields. We believe company will stretch its commercial asset execution owing to high cost of capital.

ONGOING PROJECTS	Location	Segment	Type	GLA (PEPL) Mn sq ft	Completion	Rent Rs / sq ft	Annual Rental Rs mn
Prestige Shantiniketan	Bangalore	Office	JV	2.42	Dec-11	34	987
Cessna Park Phase 2	Bangalore	Office	JV	1.53	Sep-14	48	881
Exora Business Park - Block 2 & 3	Bangalore	Office	JV	0.49	Mar-13	43	251
Forum Vijaya	Chennai	Office	JV	0.17	Feb-12	40	79
Prestige Tech Park Phase 3	Bangalore	Office	Own	0.40	Nov-13	39	187
Forum Sujana	Hyderabad	Retail	JV	0.21	Jan-13	60	150
Forum	Mangalore	Retail	JV	0.23	Jun-12	45	126
SKN Mall	Bangalore	Retail	JV	0.37	Dec-13	50	222
Forum	Mysore	Retail	JV	0.17	Dec-13	45	94
Forum Vijaya	Chennai	Retail	JV	0.35	Feb-12	70	294
Total				**3.92**			**2285**

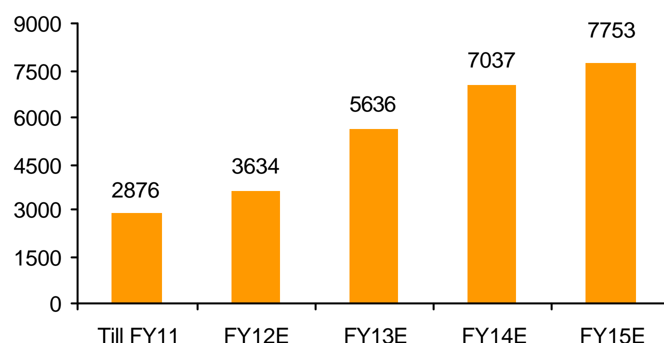
Investments planned in hospitality segment will further drain capital to the extent of Rs 5bn over the next three years

PEPL has three hotel assets operational in Bangalore with total 281 room keys, developed with an investment of Rs 2.3bn The company intends to develop another four properties comprising of 968 keys with a total investment of Rs 6.8bn, of which, it has already spent Rs 0.6bn. Company's all the seven properties are Bangalore based and will have operators like Hilton, Marriott, Oakwood, etc.

Total room keys to increase more than 4x by FY15…



… with investment of Rs 7.7bn, of which Rs 2.9bn is spent



We are not very excited about the hotel business as we see a huge oversupply in the segment, more so in Bangalore. As per HVS, a renowned hotel industry consultant, Bangalore currently has supply 7,767 rooms and has proposed supply addition of 12,509 rooms over the next five years. However, historical data suggests that only ~65% of the proposed supply comes into existence, which works out to 8130 rooms.

As per HVS, the city currently has an occupancy rate of 58.4% (lowest among metros) and it will remain under pressure going forward owing to huge over supply seen (again, highest among metros in % terms).

With this kind of supply, we believe the return on capital on investments in hotel will be in single digit and hence, is unlikely to create value for PEPL's investment. In our valuation estimation, we have taken OCR of 60%, leading to NAV of Rs 1.6bn for all the six hotels.

Valuations

We have valued PEPL on SOTP basis by valuing their operational, ongoing and planned assets. We have valued leased assets at a cap rate of 10.5%, while discounting cashflows of other assets at 16%.

We have assigned 50% discount to the NPV of Planned Leaseable Assets as we believe the same does not have any visibility to generate value. These assets comprise of planned development of 10.3msf and 39msf of strategic land bank.

We have also assigned 50% discount to NPV of Hotel assets as we are not optimistic on the overall hotel segment and expect much lower return on capital. We would not be surprised if the company may stall the development of the assets considering their business viability. We have seen the huge cost overruns in developing the hotel assets by companies like Phoenix Mills & Nitesh Estate leading to much extended pay-back period. We assign high probability of the same to PEPL's hotel development plan.

Risk to our target price is company's investment in commercial assets especially retail and hotel, which will not generate shareholder value. Although we have somewhat factored risk pertaining to same in our valuation, we see possibility of further downside. Another risk lies in company's capability to generate free cash from saleable assets, which we have mentioned earlier.

Leased Assets	14667
Ongoing Saleable Projects	16894
Planned Saleable Projects	3492
Ongoing Leaseable Assets	961
Planned Leaseable Assets	993
Hotel	1671
GAV	**38677**
Less: Net Debt	11983
NAV	**26694**
NAV / Share	**81**

Financials (Consolidated)

Income Statement

Y/E, Mar (Rs. mn)	FY10	FY11	FY12E	FY13E
Net Revenue	**10244**	**15431**	**12351**	**19073**
Growth (%)	*14.1*	*50.6*	*(20.0)*	*54.4*
Expenditure	**8008**	**11692**	**8650**	**12500**
Cost of Sales	7033	10479	7535	10985
Employee Cost	490	548	630	725
Other Exp	485	666	485	790
EBITDA	**2236**	**3739**	**3702**	**6573**
Growth (%)	*(13.6)*	*67.2*	*(1.0)*	*77.6*
EBITDA margin (%)	***21.8***	***24.2***	***30.0***	***34.5***
Depreciation	491	606	606	686
EBIT	**1746**	**3133**	**3096**	**5886**
EBIT margin (%)	***17.0***	***20.3***	***25.1***	***30.9***
Other Income	615	682	200	0
Interest expenses	783	1234	1179	1222
PBT	**1579**	**2580**	**2116**	**4664**
Tax	**330**	**823**	**582**	**1553**
Effective tax rate (%)	*20.9*	*31.9*	*27.5*	*33.3*
Adjusted PAT	**1249**	**1757**	**1534**	**3111**
Growth (%)	*66.7*	*40.7*	*(12.7)*	*102.8*
Net Margin (%)	***12***	***11***	***12***	***16***
(Profit)/loss from JVs/Ass/MI	(207)	(43)	0	0
Adjusted PAT After JVs/Ass/MI	1456	1800	1534	3111
E/O items	0	0	0	0
Reported PAT	**1456**	**1800**	**1534**	**3111**
Growth (%)	*99.1*	*23.6*	*(14.8)*	*102.8*

Balance Sheet

Y/E, Mar (Rs. mn)	FY10	FY11	FY12E	FY13E
Equity share capital	2,625	3,281	3,281	3,281
Reserves & surplus	5,013	17,862	18,935	21,586
Net worth	**7,638**	**21,142**	**22,216**	**24,866**
Minority Interest	**2,721**	**2,240**	**2,240**	**2,240**
Secured Loans	13,892	14,692	15,787	15,838
Unsecured Loans	2,123	483	483	483
Loan Funds	**16,015**	**15,175**	**16,270**	**16,322**
Net deferred tax liability	2	78	-	-
Total Liabilities	**26,376**	**38,636**	**40,726**	**43,428**
Gross Block	11,307	13,163	13,769	16,736
Less: Depreciation	2,066	2,971	3,577	4,264
Net block	**9,242**	**10,192**	**10,192**	**12,472**
Capital work in progress	2,054	3,975	4,286	5,758
Goodwill	1,098	1,078	1,078	1,078
Investment	**1,609**	**2,679**	**2,593**	**2,593**
Current Assets	**23,194**	**33,664**	**33,448**	**33,512**
Inventories	12,502	14,275	15,229	16,950
Sundry debtors	3,628	9,347	9,783	8,204
Cash & bank balance	1,729	3,679	2,133	2,055
Loans & advances	5,332	6,303	6,303	6,303
Other current assets	4	59	-	-
Current lia & Prov	**10,821**	**12,951**	**10,872**	**11,985**
Current liabilities	10,206	9,396	9,469	10,262
Provisions	615	3,555	1,403	1,723
Net current assets	**12,374**	**20,713**	**22,576**	**21,527**
Total Assets	**26,376**	**38,636**	**40,726**	**43,428**

Cash Flow

Y/E, Mar (Rs. mn)	FY10	FY11	FY12E	FY13E
PBT (Ex-Other income)	1171	2397	2377	5125
Depreciation	491	606	606	686
Interest Provided	783	1234	1179	1222
Other Non-Cash items	0	0	0	0
Chg in Working Cap	(5060)	(6845)	(3871)	511
Tax paid	(330)	(823)	(582)	(1553)
Operating Cashflow	**(2946)**	**(3430)**	**(291)**	**5991**
Capital expenditure	1358	3457	918	4438
Free Cash Flow	**(4304)**	**(6887)**	**(1209)**	**1553**
Other income	615	682	200	0
Investments	(484)	(1070)	86	0
Investing Cashflow	**131**	**(389)**	**286**	**0**
Equity Capital Raised	(4)	12161	0	0
Loans Taken / (Repaid)	4890	(840)	1095	52
Interest Paid	(783)	(1234)	(1179)	(1222)
Dividend paid (incl tax)	0	(456)	(461)	(461)
Income from investments	0	0	0	0
Others	388	(406)	(78)	0
Financing Cashflow	**4492**	**9226**	**(623)**	**(1631)**
Net chg in cash	**319**	**1950**	**(1546)**	**(78)**
Opening cash position	1410	1729	3679	2133
Closing cash position	**1729**	**3679**	**2133**	**2055**

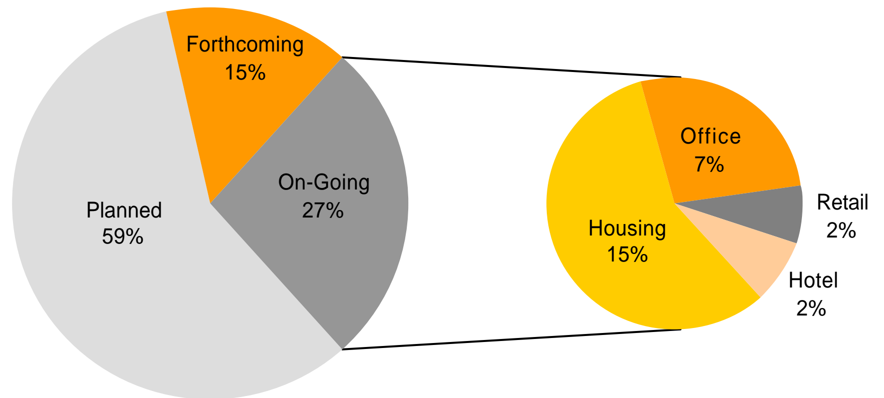
Key Ratios

Y/E, Mar	FY10	FY11	FY12E	FY13E
Profitability (%)				
EBITDA Margin	21.8	24.2	30.0	34.5
Net Margin	12.2	11.4	12.4	16.3
ROCE	7.6	9.6	7.8	14.0
ROE	21.1	12.5	7.1	13.2
RoIC	9.5	12.7	10.3	18.2
Per Share Data (Rs)				
EPS	4.4	5.5	4.7	9.5
CEPS	5.9	7.3	6.5	11.6
BVPS	23.3	64.4	67.7	75.8
DPS	2.0	2.0	2.0	2.0
Valuations (x)				
PER	16.7	13.5	15.8	7.8
P/CEPS	12.5	10.1	11.3	6.4
P/BV	3.2	1.1	1.1	1.0
EV / Sales	3.9	2.6	3.3	2.1
EV / EBITDA	17.2	9.6	10.4	5.9
Dividend Yield (%)	2.7	2.7	2.7	2.7
Gearing Ratio (x)				
Net Debt/ Equity	1.9	0.5	0.6	0.6
Net Debt/EBIDTA	1.8	0.5	0.6	0.4

Annexure

PEPL has land bank of 68msf of which ~54msf is in Bangalore and the balance spread across Chennai, Hyderabad and other small southern India cities.

Company has land bank of 68msf of which 17.7msf is On-Going



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Your success is our success

Sobha Developers

Debt reduction to trigger re-rating

Company Update

January 12, 2012

Reco	Previous Reco
Accumulate	NA
CMP	**Target Price**
Rs222	Rs272

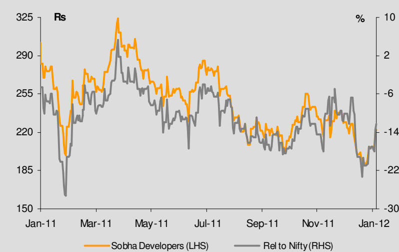
EPS change FY12E/13E (%)	NA
Target Price change (%)	NA
Nifty	4,831
Sensex	16,038

Price Performance

(%)	1M	3M	6M	12M
Absolute	(0)	1	(20)	(26)
Rel. to Nifty	3	11	(4)	(6)

Source: Bloomberg

Relative Price Chart



Source: Bloomberg

Stock Details

Sector	Real Estate
Bloomberg	SOBHA@IN
Equity Capital (Rs mn)	981
Face Value(Rs)	10
No of shares o/s (mn)	98
52 Week H/L	327/185
Market Cap (Rs bn/USD mn)	22/426
Daily Avg Volume (No of sh)	156036
Daily Avg Turnover (US$mn)	0.7

Shareholding Pattern (%)

	Sep-11	Jun-11	Mar-11
Promoters	60.6	60.6	60.6
FII/NRI	33.4	32.1	30.4
Institutions	1.7	2.9	4.6
Private Corp	1.4	1.5	1.5
Public	2.9	3.0	2.9

Source: Capitaline

Tejas Sheth
tejas.sheth@emkayglobal.com
+91 22 66242 482

- **Expect Sobha Developers' (SDL) strong sales booking traction in FY12E and FY13E to boost cashflows and subsequently lower absolute debt**
- **Foray into new cities to scale up business. Entry into Thrissur & Mysore in the last 2 years is followed by NCR & Chennai forays**
- **Our NAV works out to Rs 272 / share. NPV from the on-going projects equals the current net debt. Valued land bank at 1.2x BV of Rs 93 / sf**
- **Key risk remains high inventory (low net cashflows) if SDL's aggressive launches fail to pick up**

SDL confident that its aggressive launch strategy will not result in high inventory pile up

SDL launched 8.6msf in 9MFY12, highest in the history of the company (although area offered for sale is 3.1msf), this is over the 4.3msf launched in FY11 The concern over this strategy is that the company would end up selling a small portion in each of the projects leading to higher unsold inventories. As a result, lower sales but full project completion commitments will result in lower operating cashflows.

However, the management is confident on the success of this strategy as all the recent launches are either in new locations or are in existing locations, where substantial portion of their old offerings are sold. We are in partial disagreement as this strategy can fail if the economy takes a huge setback in FY13E.

Targets net debt reduction to Rs 10bn by FY12E from current Rs 13.6bn. We estimate net debt of Rs 11.5bn

SDL is the only listed real estate company which has committed to reduce its absolute debt by FY12 from core operational cash flows. Company's net debt in H1FY12 increased from Rs 11.8bn in FY11 mainly due to (1) investment of Rs 1.0bn towards pre-launch of NCR project, (2) stake acquisition of a PE investor for Rs 1.1bn in one of its project SPV and (3) Rs 430mn for capex towards construction equipment and new corporate office. Our estimation of cashflows leads to net debt of Rs 11.5bn in FY12E and Rs 9.4bn in FY13E

A good 'Value Buy' in real estate sector, with a TP of Rs 272

We have valued the company on SOTP basis, considering three segments – Contractual business, On-going projects & Land bank. The value of the former two equals Net Debt and hence, market cap equals the value assigned to the land bank. At our TP of Rs 272, SDL's P/BV stands at 1.3x FY12E and 1.2xFY13E book value.

Financials **(Rs Mn)**

YE-Mar	Net Sales	EBITDA (Core)	EBITDA (%)	APAT	EPS (Rs)	EPS % chg	RoE (%)	P/E	EV/ EBITDA	P/BV
FY10	11,299	2,463	21.8	1,341	13.7	24.4	9.6	16.2	14.5	1.3
FY11	14,739	3,161	21.4	1,812	18.5	35.2	10.2	12.0	10.7	1.2
FY12E	15,413	3,218	20.9	1,808	18.4	(0.3)	9.4	10.8	9.7	1.0
FY13E	18,275	4,045	22.1	2,368	24.1	31.0	11.3	8.3	7.2	0.9

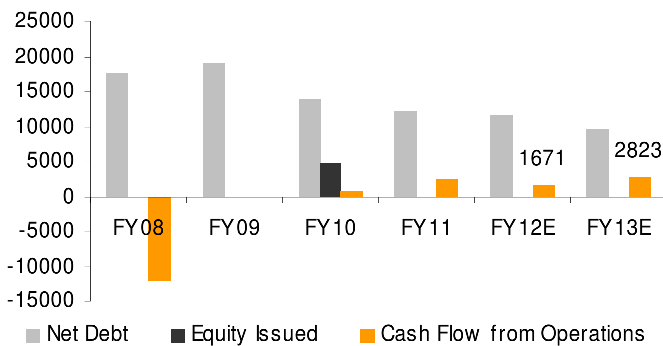
Investment Rationale

Cash generation from operations has been strong since crisis and should further strengthen by FY13E

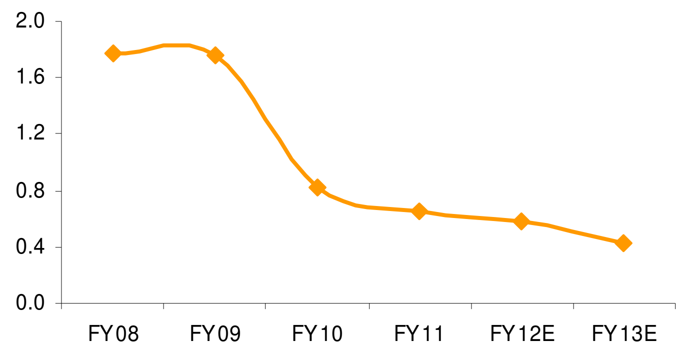
SDL reduced its debt considerably post the 2008-09 crisis period. The first tranche of debt reduction in FY10 came from issuance of new equity while the debt reduction in FY11 was through a combination of land sales transactions and cash generation from core business operations. We believe the net cash generation from operations would be lower in FY12E due to purchase of stake in a SPV and capex (towards new construction equipment purchase and new corporate office). We expect it to increase substantially in FY13E owing to strong sales bookings in FY12E and FY13E

As per our estimates, we expect the company to generate free cash of Rs.2.8bn from operations, which will help it reduce net debt to Rs 9.5bn in FY13E. This is without taking into account any cash generation from land parcel sale, which the company may resume.

Operating Cash inflows (Rs mn) to increase substantially…



...should lead to sharp reduction in debt-to-equity ratio



Some of the critical assumptions towards these estimates are;

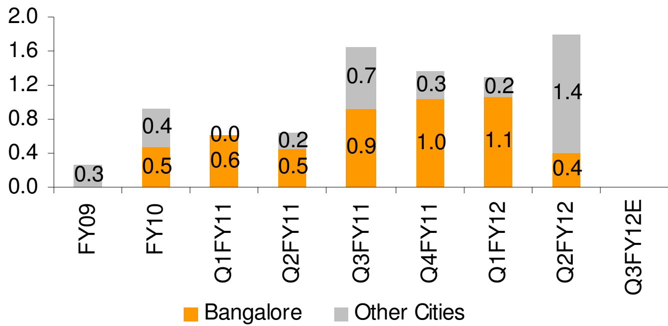
- 3.1 msf sales bookings for FY12E valued at Rs 15.2bn. For H1FY12, company has sold 1.6msf for Rs 7.8bn. We have assumed sales of 0.71msf in Q3FY12E for Rs 3.55bn and 0.79msf in Q4FY12E for Rs 3.8bn. Our assumption of higher sales bookings in Q4FY12E is due to new launches in Chennai. For FY13E, we have assumed sales booking to remain subdued at 2.9
- Gross Capex of Rs 815mn in FY12 and Rs 432mn in FY13. This excludes the cash outflow towards the stake / land purchase at project level. The capex in FY12 is towards purchase of construction equipment and new corporate office, while for FY13 it is towards maintenance.
- Average interest cost of 13.5% in FY12 and FY13. Company expects its interest cost to be lower in FY13E as it will get favorable rates due to its debt reduction programme as well as better debt servicing capability than its peers
- Dividend cash outflow of Rs 344mn in FY12 and FY13 each

Biggest risk to our TP is high inventory pile up on failure of company's aggressive launch strategy

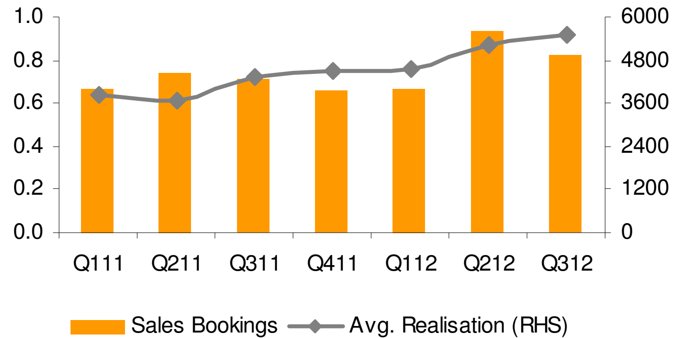
In a mid-segment project where pricing ranges from Rs 4000-5000 per sf, SDL has to sell ~55-60% of the project to self finance the construction cost. SDL has total 9.5msf of area under construction which is offered for sale. Of this, company has sold 4.22msf with a balance realizable cash inflow of Rs 10.2bn on the completion of these projects. As on Q2FY12, the unsold inventory of 4.53 msf in area-on-offer is valued at Rs 27bn. The company has to incur construction cost of Rs 18.4bn to realize the same.

Over the last 6 quarters, SDL has embarked on an aggressive launch spree, with the overall launches exceeding that of FY09 and FY10 put together. On the back of these launches, it has also been able to garner strong sales leading to generation of operational cashflows.

Aggressive launches (msf) provides business scalability...



....but will it translate into sales booking (msf) is to be seen

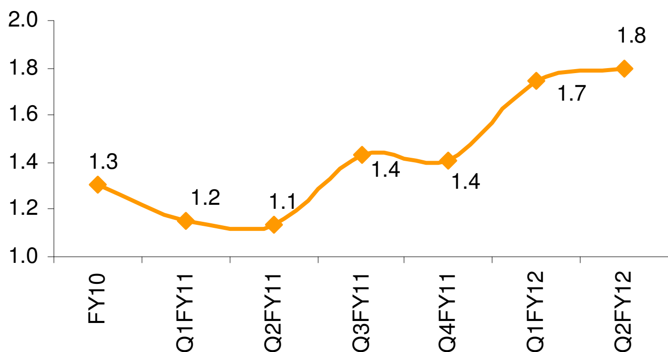


We have assumed sales of 3.0msf in FY13E with majority of the sales from old launched projects, thereby positively impacting cashflows. However, if the sales come predominantly from new launches, it will strain SDL's cashflow generation and delay their debt reduction programme.

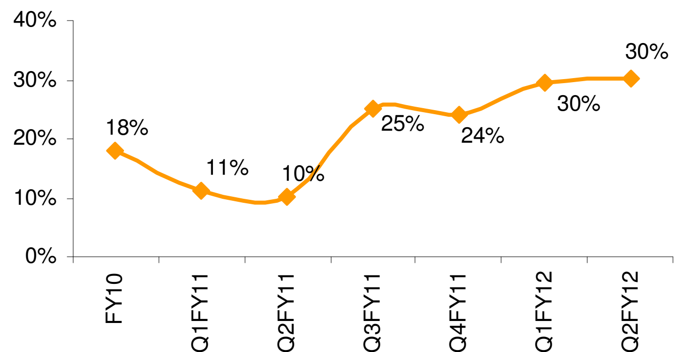
We fear that SDL's aggressive launch strategy can backfire with sales getting scattered across projects, thereby straining their cash flows. In such a scenario, their construction commitment is far likely to exceed milestone realizations, thereby raising cashflow requirements.

The charts below depict some of these concerns, as seen from the rising proportion of construction cost commitments to realizables from sold portion and also the % of unsold inventory the company should sell to meet the construction cost commitments of saleable area on offer. However, this poses a risk in the future only as the company has not launched anything in Q3FY12 and may affect positive cash generation in FY13E.

Ratio of Constn Cashoutflow-to-Realisables is on rise…



…so is % inventory to-be-sold to finance construction cost



Valuations

We have valued SDL in 3 segments – Contract business, Ongoing saleable projects of 9.5msf and Land bank of 213 msf.

- We have valued the contract business and manufacturing business on an annual run rate of Rs 5bn with 15% EBITDA margin and EV/EBITDA of 1x
- We have discounted NPV of ongoing projects at 15.1% WACC, with Cost of Equity at 15.4% and Cost of Debt at 14.8%
- We have valued the land bank at 1.2x the Book Value of Rs 93 / sf

Contract Business	750
Ongoing Saleable Projects	15194
Land Bank	23657
Gross GAV	**39601**
Less: Net Debt	12966
NAV	**26635**
NAV / Share	**272**

Financials (Consolidated)

Income Statement

Y/E, Mar (Rs. mn)	FY10	FY11	FY12E	FY13E
Net Revenue	**11299**	**14739**	**15413**	**18275**
Growth (%)	*16.0*	*30.5*	*4.6*	*18.6*
Expenditure	**8836**	**11578**	**12195**	**14230**
Cost of Sales	6537	8632	9114	10876
Employee Cost	768	1035	1139	1253
Other Exp	1531	1911	1942	2102
EBITDA	**2463**	**3161**	**3218**	**4045**
Growth (%)	*(11.6)*	*28.3*	*1.8*	*25.7*
EBITDA margin (%)	***21.8***	***21.4***	***20.9***	***22.1***
Depreciation	323	278	283	332
EBIT	**2140**	**2883**	**2934**	**3713**
EBIT margin (%)	***18.9***	***19.6***	***19.0***	***20.3***
Other Income	39	74	60	60
Interest expenses	521	444	393	358
PBT	**1658**	**2514**	**2601**	**3415**
Tax	**275**	**669**	**793**	**1047**
Effective tax rate (%)	*16.6*	*26.6*	*30.5*	*30.7*
Adjusted PAT	**1383**	**1845**	**1808**	**2368**
Growth (%)	*25.8*	*33.5*	*(2.0)*	*31.0*
Net Margin (%)	***12***	***13***	***12***	***13***
(Profit)/loss from JVs/Ass/MI	42	33	0	0
Adjusted PAT After JVs/Ass/MI	1341	1813	1808	2368
E/O items	0	(0)	0	0
Reported PAT	**1341**	**1812**	**1808**	**2368**
Growth (%)	*24.4*	*35.2*	*(0.2)*	*31.0*

Balance Sheet

Y/E, Mar (Rs. mn)	FY10	FY11	FY12E	FY13E
Equity share capital	981	981	981	981
Reserves & surplus	16,057	17,527	18,991	21,015
Net worth	**17,038**	**18,508**	**19,972**	**21,995**
Minority Interest	**291**	**324**	**324**	**324**
Secured Loans	14,466	12,335	12,067	10,091
Unsecured Loans	275	84	100	100
Loan Funds	**14,740**	**12,418**	**12,167**	**10,191**
Net deferred tax liability	(52)	(74)	-	-
Total Liabilities	**32,018**	**31,176**	**32,462**	**32,510**
Gross Block	2,942	3,148	3,931	4,363
Less: Depreciation	1,513	1,775	2,058	2,390
Net block	**1,429**	**1,373**	**1,873**	**1,973**
Capital work in progress	632	668	700	700
Goodwill	0	0	0	0
Investment	**27**	**37**	**37**	**37**
Current Assets	**36,459**	**36,808**	**38,662**	**40,070**
Inventories	11,101	10,685	14,662	15,129
Sundry debtors	4,430	4,252	4,434	5,257
Cash & bank balance	826	289	633	751
Loans & advances	20,102	21,583	18,933	18,933
Other current assets	-	-	-	-
Current lia & Prov	**6,529**	**7,709**	**8,809**	**10,270**
Current liabilities	5,984	6,766	7,780	9,050
Provisions	545	943	1,029	1,220
Net current assets	**29,930**	**29,099**	**29,853**	**29,800**
Total Assets	**32,018**	**31,177**	**32,462**	**32,510**

Cash Flow

Y/E, Mar (Rs. mn)	FY10	FY11	FY12E	FY13E
PBT (Ex-Other income)	1290	2064	2197	3011
Depreciation	323	278	283	332
Interest Provided	521	444	393	358
Other Non-Cash items	0	0	0	0
Chg in Working Cap	(1179)	294	(409)	170
Tax paid	(275)	(669)	(793)	(1047)
Operating Cashflow	**680**	**2411**	**1671**	**2823**
Capital expenditure	136	257	815	432
Free Cash Flow	**544**	**2153**	**856**	**2391**
Other income	39	74	60	60
Investments	(0)	(10)	0	0
Investing Cashflow	**39**	**64**	**60**	**60**
Equity Capital Raised	4823	(342)	(344)	(344)
Loans Taken / (Repaid)	(4581)	(2322)	(251)	(1976)
Interest Paid	(521)	(444)	(393)	(358)
Dividend paid (incl tax)	287	343	344	344
Income from investments	0	0	0	0
Others	21	11	74	0
Financing Cashflow	**29**	**(2754)**	**(571)**	**(2334)**
Net chg in cash	**612**	**(537)**	**345**	**118**
Opening cash position	214	825	288	633
Closing cash position	**825**	**288**	**633**	**751**

Key Ratios

Y/E, Mar	FY10	FY11	FY12E	FY13E
Profitability (%)				
EBITDA Margin	21.8	21.4	20.9	22.1
Net Margin	12.2	12.5	11.7	13.0
ROCE	6.9	9.1	9.2	11.4
ROE	9.6	10.2	9.4	11.3
RoIC	7.1	9.5	9.6	12.0
Per Share Data (Rs)				
EPS	13.7	18.5	18.4	24.1
CEPS	17.0	21.3	21.3	27.5
BVPS	173.7	188.7	203.7	224.3
DPS	2.0	2.0	2.0	2.0
Valuations (x)				
PER	16.2	12.0	10.8	8.3
P/CEPS	13.1	10.4	9.4	7.3
P/BV	1.3	1.2	1.0	0.9
EV / Sales	3.2	2.3	2.1	1.6
EV / EBITDA	14.5	10.7	9.7	7.2
Dividend Yield (%)	0.9	0.9	0.9	0.9
Gearing Ratio (x)				
Net Debt/ Equity	0.8	0.7	0.6	0.4
Net Debt/EBIDTA	0.7	0.5	0.4	0.3

Emkay Rating Distribution

BUY	Expected total return (%) (stock price appreciation and dividend yield) of over 25% within the next 12-18 months.
ACCUMULATE	Expected total return (%) (stock price appreciation and dividend yield) of over 10% within the next 12-18 months.
HOLD	Expected total return (%) (stock price appreciation and dividend yield) of upto 10% within the next 12-18 months.
REDUCE	Expected total return (%) (stock price depreciation) of upto (-)10% within the next 12-18 months.
SELL	The stock is believed to under perform the broad market indices or its related universe within the next 12-18 months.

Emkay Global Financial Services Ltd.

7th Floor, The Ruby, Senapati Bapat Marg, Dadar - West, Mumbai - 400028. India

Tel: +91 22 66121212 Fax: +91 22 66121299 Web: www.emkayglobal.com

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