

Hindustan Construction

STOCK INFO.	BLOOMBERG
BSE Sensex: 10,086	HCC IN
	REUTERS CODE
S&P CNX: 2,945	HCNS.BO

21 July 2006

Buy
Previous Recommendation: Buy
Rs89

Equity Shares (m)	274.3
52-Week Range	196/56
1,6,12 Rel. Perf. (%)	-20/-48/12
M.Cap. (Rs b)	24.4
M.Cap. (US\$ b)	0.5

YEAR	NET SALES	PAT	EPS *	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
3/06A	19,870	844	3.3	14.7	27.0	2.6	13.6	11.4	1.4	14.9
3/07E	26,194	1,559	5.7	72.7	15.6	1.7	13.3	8.0	0.9	10.0
3/08E	36,500	2,150	7.8	37.9	11.3	1.5	14.0	11.4	0.8	8.1

* Fully diluted

- 1QFY07 Performance below expectations:** During 1QFY07, HCC reported revenues of Rs5.7b, up 25% YoY; EBITDA of Rs461m, up 13% YoY and net profit of Rs251m, up 11% YoY. The numbers have been below estimates: Revenues Rs6.7b, EBITDA Rs618m and net profit Rs396m. Order backlog stands at Rs91.4b, v/s Rs94b in 4QFY06 and Rs53b in 1QFY06. HCC emerged L1 in projects worth Rs10b.
- Reasons for lower 1QFY07 performance:** The management stated that 1QFY07 performance was impacted by: (1) Bandra-Worli Sealink project Rs100 -120m (EBITDA margin impact: 170-210bp), (2) Higher cement prices Rs30m (50bp), and (3) Non-booking of other income on part FCCB proceeds (US\$100m).
- Key takeaways from concall:** (1) Expect notification on Bandra Worli Sealink revised project cost in 2QFY07, cumulative loss booked of Rs1.5b till date (2) Expect order intake of Rs50b in FY07, of which 54% from hydro and nuclear power projects (3) L1 in annuity road project (cost Rs2.7b, RoE 15%) 4) to acquire land banks of ~1,000 acres by March 2007 in Thane, Pune, Nashik and Mumbai.
- Downgrade in earnings estimates, Maintain Buy:** We downgrade earnings estimates for FY07 and FY08, to factor in possibility of continued losses on Bandra-Worli Sealink project. We now expect HCC to report net profit of Rs1.6b in FY07 (down from Rs2b earlier) and Rs2.2b in FY08 (down from Rs2.6b). At the CMP of Rs89/share, HCC quotes at a PER of 15.6x FY07E and 11.3x FY08E. Maintain **Buy**, with revised price target of Rs126/share.

QUARTERLY PERFORMANCE

(Rs Million)

	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE		
Sales	4,610	3,022	4,557	7,681	5,743	4,209	6,235	10,015	19,870	26,194
Change (%)	30.9	12.8	28.4	50.4	24.6	39.3	36.8	30.4	34.0	31.8
EBITDA	409	258	486	675	461	349	648	972	1,829	2,422
Change (%)	-4.2	10.7	20.5	40.9	12.8	35.3	33.4	44.0	17.3	32.4
As of % Sales	8.9	8.5	10.7	8.8	8.0	8.3	10.4	9.7	9.2	9.2
Depreciation	118	129	130	147	161	160	168	166	524	656
Interest	83	120	126	85	74	20	14	13	414	121
Other Income	35	29	9	8	62	18	18	19	61	117
Extra-ordinary income	0	400	1	12	0	0	0	0	431	0
PBT	243	437	239	463	288	187	484	811	1,383	1,763
Tax	16	81	12	25	36	22	49	96	135	203
Effective Tax Rate (%)	6.7	18.5	5.2	5.4	12.6	12.0	10.1	11.8	9.7	11.5
Reported PAT	227	357	227	438	251	164	435	716	1,248	1,559
Adj PAT	227	29	226	426	251	164	435	716	817	1,559
Change (%)	71.5	131.3	106.3	5.9	10.9	472.8	92.5	68.0	21.4	90.8

E: MOST Estimates

1QFY07: performance below expectations

During 1QFY07, HCC reported revenues of Rs5.7b, up 25% YoY; EBITDA of Rs461m, up 13% YoY and net profit of Rs251m, up 11% YoY. The numbers have been below estimates of: Revenues Rs6.7b, EBITDA Rs618m and net profit Rs396m. EBITDA margins during 1QFY07 stood at 8%, down from 8.9% YoY and below our estimates of 9.2%.

Reasons for lower 1QFY07 performance

The management stated that 1QFY07 financials were impacted by:

- ✍ Expenditure of Rs250m incurred on Bandra-Worli Sealink project, thus impacting profitability by Rs100-120m (EBITDA margin impact: 170-210bp)
- ✍ Impact of Rs30m from higher cement prices, not covered by escalation clauses (EBITDA margin impact: 50bp), and
- ✍ Non-booking of other income on part of FCCB proceeds (US\$100m), as the company accounts for other income on receipt basis. Thus, interest income on securities which had not yet matured, were not accounted for.

Bandra Worli Sealink project: a drag on margins

During 1QFY07, HCC incurred cost of Rs250m on the project, and accounted revenues of Rs130-150m, thus resulting in a net loss booked of Rs100-120m (EBITDA margin impact: 170-210bp). This is because while expenses were accounted in totality, revenues are booked based on original cost of the project. The management indicated that they expect the engineers certificate and notification on the revised project cost (Rs6.3b, vs original Rs4.3b) in 2QFY07. Till date, the company has booked cumulative revenues of Rs1.8b on this project, and incurred cost of Rs3.3b, thus incurring cumulative under-recovery of Rs1.5b (loss in P/L account). The management also seemed hopeful of recovering part of this amount going forward. The project is scheduled to be completed in March / April 2008.

BANDRA-WORLI SEALINK: REVISED COST (RS M)

Original Project Cost	4,300
Escalations, Based on Index	1,000
Variations to Original Work Scope	900
Revised Project Cost	6,300

Source: Company

Since FY03, HCC has reported cumulative revenues of Rs52b, and cumulative losses booked on Bandra-Worli Sealink project is Rs1.5b. This entails an EBITDA margin impact of 290bp over the past 4 years from this project. An early notification on the revised project cost will enable the company to curtail losses, and also recover part of the cumulative under recoveries of Rs1.5b.

Possible impact due to continued increase in input prices

During 1QFY07, hike in cement prices beyond escalation clauses impacted EBITDA margins by Rs30m (50bp).

The management stated that the under recovery during 1QFY07 has resulted from very steep increase in cement prices, due to constraints on the transport infrastructure as Supreme Court had banned overloading in trucks. Thus, despite escalation clauses in place, HCC could not pass on the entire hike under the contract terms. Going forward, management believes that a similar magnitude of price hikes every quarter may not happen, and thus a more gradual price increase would be covered by the escalation clauses. Further, since most of the projects are ongoing, any softening in cement prices going forward will enable the company to recoup past under recoveries.

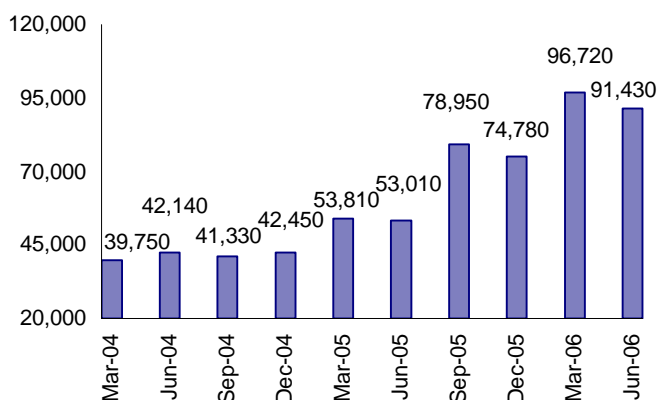
We believe that with escalation clauses, the construction companies to a certain extent seem insulated from increased commodity prices. This, is further evidenced from the fact that despite sharp increase in commodity prices during 1QFY07: (1) Cement price up 23.4% YoY and 13% QoQ (2) Steel prices at Rs27,000 per ton, from lows of Rs20,000

per ton in February 2006, etc, margin impact for HCC was restricted to Rs30m (50bp). In our opinion, the impact of ~50bp on EBITDA margins due to commodity price increase is manageable and can be offset by operating leverage and shift towards high margin segments. Thus, we believe that HCC's disappointing 1QFY07 performance was largely due to company specific reasons, rather than cost pressures across the industry.

Order backlog: Rs91.4b v/s Rs94b QoQ

During 1QFY07, order backlog stands at Rs91.4b, as compared to Rs94b in 4QFY06 and Rs53b in 1QFY06. The company has emerged as L1 in projects of Rs10b, including annuity road project of Rs2.7b.

TREND IN QUARTERLY ORDER BACKLOG (RS M)



Source: Company

ORDER BOOK COMPOSITION (%)

Power (Hydro and Nuclear)	40%
Transportation	43%
Pipeline	13%
Others	4%

Source: Company

The management expects order intake of Rs50b in FY07, of which 54% is expected from hydro and nuclear power segments (current contribution to order book - 40%). These segments entail much higher margins, than road and irrigation projects. However as these are long gestation projects, revenue and margin bookings would be constrained in the initial stages.

BOT projects

HCC has emerged as L1 in annuity road project of 30kms stretch, costing Rs2.7b in Andhra Pradesh. Concession period is 20 years (including construction period of 2 years). Semi annual annuity receipt is Rs238.5m, and expected ROE is 15%. Apart from annuity projects in road sector, HCC is also bidding for BOT projects in power sector, and has targeted US\$50m as investments in this space. The company is already looking at hydro power projects in Uttar Pradesh, Uttaranchal, etc.

Real Estate, as a focused business segment

Realty development is emerging as a key business vertical for HCC, and the company is seeking opportunities in township development through Hincon Realty Ltd, 100% subsidiary. HCC plans to foray into construction of large integrated townships targeting middle and upper-middle class income households.

✍ **Lavasa – HCC's stake increased to 60%:** Post recent rights issue of Rs320m by Lavasa Corp, Hincon Realty's stake has increased to 60.47%, as the private developers did not participate in the rights issue.

LAVASA: REVISED SHAREHOLDING PATTERN (%)

	ORIGINAL	REVISED
HCC and Associates	50.0	60.5
BILT and Associates	12.5	15.6
Venkateshwara Hatcheries	12.5	12.5
Private Developers	25.0	11.9

Source: Company

The management stated that development expenses incurred till date is Rs3.5b, financed as equity Rs1.5b and debt Rs2.0b. Banks have also sanctioned further debt of Rs3b. HCC has sold ~40 acres at Rs4m per acre.

✍ **Land at Vikhroli:** HCC has also transferred development rights for 9 acres of land at Vikhroli (West), Mumbai to Hincon Realty and booked capital gains of Rs400m in FY06. The company is exploring various development options like construction of an IT park, shopping mall, etc.

✍ **Other land banks:** HCC intends to focus on large integrated townships (100-500 acres) targeting middle and upper middle income group house holds, and has identified outskirts of cities such as Thane, Pune, Nashik and Mumbai in the Western region as potential development locations. The management stated that 1,000 acres of land has already been identified and the company has made considerable progress in terms of scrutiny of titles, etc. By end FY07, the management expects to have land bank of 1,000 acres. The acquisition is to be financed through equity infusion of Rs1.5-2b in Hincon Realty, and the balance would be raised through debt.

Usage of Funds (US\$200m through GDR and FCCB in March 2006)

The management has indicated the following usage for funds raised: Equipments US\$60m, Working Capital US\$40m,

Real Estate US\$50m and Debt repayment US\$50m. Till June 2006, HCC has spent Rs1.5b for debt repayment, Rs1.4b as capex and Rs670m as working capital.

Downgrade in earnings estimates, Maintain Buy

We are downgrading our earnings estimates for FY07 and FY08, to factor in the possibility of continued losses on Bandra-Worli Sealink project. While the management has indicated that they expect notification of the revised project cost in 2QFY07, we do factor the same happening during FY07; and thus if the notification is received, there would be upgrades. We now expect HCC to report net profit of Rs1.6b in FY07 (down from Rs2b earlier) and Rs2.2b in FY08 (down from Rs2.6b). At the CMP of Rs89/sh, HCC quotes at a PER of 15.6x FY07E and 11.3x FY08E. **Maintain Buy**, with revised price target of Rs126/share.

Hindustan Construction: an investment profile

Company description

Established in 1926 by the Walchand Hirachand group, HCC is one of the oldest and largest construction companies in India with pre-qualification skills and proven execution capabilities across sectors like power, roads, bridges, ports, water irrigation and supply, urban infrastructure and pipelines. HCC specializes in the construction of technologically complex and long-gestation period projects. HCC has successfully and gradually transformed from a civil engineering contractor to an integrated EPC executor.

Key investment arguments

- ✎ Possesses pre-qualifications and proven execution capabilities across sectors; will benefit from large ticket sized orders in hydro and nuclear sectors
- ✎ Has the youngest fleet of specialized equipments, skilled manpower, in-house fabrication facility and EPC execution capabilities
- ✎ Lavasa project could be value accretive, and 10% increase in FSI can enhance shareholder returns by 100%.

Key investment risks

- ✎ Focus on key large projects increases the project specific risks
- ✎ Retention of experienced manpower is a challenge

Recent developments

- ✎ Raised US\$200m through GDR and FCCB offering
- ✎ Along with consortium partners, HCC is developing the 1,200MW Sawalakote hydel power plant in Jammu and Kashmir.

Valuations and view

- ✎ At the CMP of Rs89/share, HCC quotes at a PER of 15.7x FY07E and 11.4x FY08E. Maintain **Buy**, with revised price target of Rs126/share.

Sector view

- ✎ Increased government commitment towards infrastructure projects has led to several large projects taking off the ground
- ✎ We notice a trend of margin expansion, driven by changing composition of order book and higher margins at bidding stage

COMPARATIVE VALUATIONS

		HIND.CON.	NCC	GAMMON
P/E x)	FY07E	12.1	10.9	16.2
	FY08E	9.3	7.0	10.6
P/BV (x)	FY07E	1.6	1.9	2.4
	FY08E	1.4	1.6	2.0
RoE (%)	FY07E	16.9	18.6	14.7
	FY08E	16.3	24.5	19.0

SHAREHOLDING PATTERN (%)

	MAR.06	DEC.05	MAR.05
Promoters	46.9	52.4	52.3
Domestic Institutions	9.9	11.3	11.9
FII's/FDIs	23.7	15.2	12.1
Others	19.5	21.1	23.7

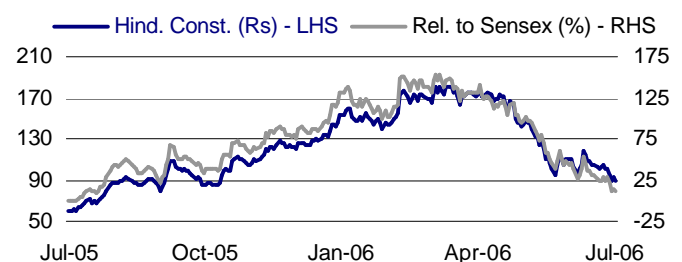
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	5.7	5.8	-1.2
FY08	7.8	7.9	-1.0

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
89	126	41.8	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2004	2005	2006	2007E	2008E
Net Sales	10,579	14,873	19,870	26,194	36,500
Change (%)	56.2	40.6	33.6	31.8	39.3
Construction Expenses	7,871	11,814	16,011	21,358	29,706
Staff Cost	768	954	1,314	1,647	2,180
Office and Site Establishment E	507	546	716	768	1,154
EBITDA	1,433	1,559	1,829	2,422	3,460
% of Net Sales	13.5	10.5	9.2	9.2	9.5
Depreciation	438	453	524	656	759
Interest	376	395	414	121	352
Other Income	17	56	461	47	47
Share of turnover in JV	-32	-17	31	70	90
PBT	605	750	1,383	1,763	2,486
Tax	248	10	135	203	335
Rate (%)	41.0	1.3	9.7	11.5	13.5
Reported PAT	357	740	1,248	1,559	2,150
Extra-ordinary Income (net of ex)	0	82	404	0	0
Adjusted PAT	357	658	844	1,559	2,150
Change (%)	46.9	84.3	28.3	84.8	37.9

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2004	2005	2006	2007E	2008E
Share Capital	200	229	256	274	274
Reserves	1,439	3,300	8,642	14,297	15,979
Net Worth	1,639	3,530	8,898	14,572	16,253
Loans	4,195	4,257	12,978	7,289	8,822
Deferred Tax Liability	748	725	677	677	677
Capital Employed	6,583	8,511	22,554	22,538	25,753
Gross Fixed Assets	5,482	6,208	7,728	9,502	11,002
Less: Depreciation	1,874	2,305	2,807	3,463	4,222
Net Fixed Assets	3,609	3,903	4,921	6,039	6,780
Capital WIP	86	478	1,074	800	800
Investments	486	1,899	1,265	4,745	8,245
Curr. Assets	6,321	7,721	23,067	21,011	23,602
Inventory	5,213	5,833	10,987	11,482	16,000
Debtors	13	31	28	37	52
Cash & Bank Balance	407	875	10,060	7,391	5,209
Loans & Advances	684	982	1,991	2,100	2,341
Other Current Assets	4	0	1	1	1
Current Liab. & Prov.	3,918	5,489	7,773	10,058	13,675
Creditors	2,388	4,039	5,910	7,899	10,987
Other Liabilities	1,308	1,167	1,491	1,600	1,850
Provisions	223	283	372	559	838
Net Current Assets	2,403	2,232	15,294	10,953	9,927
Application of Funds	6,583	8,511	22,554	22,538	25,753

E: MOST Estimates

RATIOS					
Y/E MARCH	2004	2005	2006	2007E	2008E
Basic (Rs)					
Adjusted EPS	1.8	2.9	3.3	5.7	7.8
Growth (%)	46.9	61.0	14.7	72.7	37.9
Cash EPS	4.0	4.8	5.3	8.1	10.6
Book Value	8.2	15.4	34.7	53.1	59.3
DPS	0.5	0.6	0.7	1.1	1.5
Payout (incl. Div. Tax.)	31.7	21.2	16.4	22.1	21.8
Valuation (x)					
P/E (standalone)		31.0	27.0	15.6	11.3
Cash P/E		18.3	16.6	11.0	8.4
EV/EBITDA		17.8	14.9	10.0	8.1
EV/Sales		1.9	1.4	0.9	0.8
Price/Book Value		5.8	2.6	1.7	1.5
Dividend Yield (%)		0.7	0.8	1.2	1.7
Profitability Ratios (%)					
RoE	23.5	25.5	13.6	13.3	14.0
RoCE	16.4	15.4	11.4	8.0	11.4
Turnover Ratios					
Debtors (Days)	0	1	1	1	1
Inventory (Days)	180	143	202	160	160
Creditors. (Days)	111	125	135	135	135
Asset Turnover (x)	1.7	2.0	1.3	1.2	1.5
Leverage Ratio					
Debt/Equity (x)	2.6	1.2	1.5	0.5	0.5

CASH FLOW STATEMENT					
(Rs Million)					
Y/E MARCH	2004	2005	2006	2007E	2008E
PBT before Extraordinary Items	605	750	1,383	1,763	2,486
Add : Depreciation	438	453	524	656	759
Interest	376	395	414	121	352
Less : Direct Taxes Paid	248	10	135	203	335
(Inc)/Dec in WC	-503	639	-3,877	1,672	-1,156
CF from Operations	667	2,226	-1,691	4,008	2,105
(Inc)/Dec in FA	-550	-1,139	-2,139	-1,500	-1,500
(Pur)/Sale of Investments	-174	-1,413	634	-3,481	-3,500
CF from Investments	-724	-2,552	-1,504	-4,981	-5,000
(Inc)/Dec in Networth	157	1,284	4,278	4,458	0
(Inc)/Dec in Debt	430	61	8,722	-5,690	1,533
Less : Interest Paid	376	395	414	121	352
Dividend Paid	113	157	205	344	469
CF from Fin. Activity	98	794	12,381	-1,697	713
Inc/Dec of Cash	41	468	9,186	-2,669	-2,182
Add: Beginning Balance	366	407	875	10,060	7,391
Closing Balance	407	875	10,060	7,391	5,209

N O T E S



For more copies or other information, contact

Institutional: Navin Agarwal. **Retail:** Manish Shah, Mihir Kothari

Phone: (91-22) 39825500 Fax: (91-22) 22885038. E-mail: inquire@motilaloswal.com

Motilal Oswal Securities Ltd, 3rd Floor, Hoechst House, Nariman Point, Mumbai 400 021

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Disclosure of Interest Statement

Hindustan Construction

1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No

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