Asia Pacific | India
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Company

29 October 2009 | 16 pages

Punj Lloyd (PUJL.BO)

Equity ☑
Rating change ☑
Target price change ☑
Estimate change ☑

Downgrade to Hold – In Too Much Of A Hurry

- **Downgrade to Hold (2M) from Buy (1M)** — The 29% stock decline last week largely factors in the Ensus losses. However, we believe the following potential risks are yet to play out: (1) LDs in Ensus (2) delays beyond Dec 12, 2009 on Ensus (3) cost over-runs on the ONGC Heera project and (4) Rs701mn of disputed amounts in other projects. Investors with a higher risk appetite could accumulate (all else being equal) if the stock slides below Rs190.
- **There are positives, but company is in too much of a hurry** — We continue to believe Punj Lloyd is the only Indian mid-cap E&C company that has the necessary skill sets/ desire to leapfrog into the next level occupied by L&T. However, the company is trying to make this jump in too short a time with aggressive bidding – size/ geography/ pricing of orders. SABIC was a legacy order but Ensus/ONGC's Heera are results of aggressive bids not paying off.
- **Target price cut to Rs228 (from Rs311)** — New TP factors in (1) cut in target P/E multiple to 15x (discount to other mid cap E&C at 16x) from 17x (premium to other mid cap E&C), (2) downward earnings revision of 9-16% and (3) 50% discount to book value for shipyard, v/s book value earlier.
- **Disappointing 2QFY10; PAT down 63% YoY** — At Rs529mn was below CIRA estimates of Rs1.4bn on account of Rs1.0bn of losses in Simon Carves on cost overruns on the Ensus bio-ethanol project in UK. Sales growth was below expectations as despite Rs98bn of orders in Libya, the company could not book any sales as the threshold of revenue recognition could not be reached.

Hold/Medium Risk	**2M**
from Buy/Medium Risk	
Price (28 Oct 09)	Rs204.60
Target price	Rs228.00
from Rs311.00	
Expected share price return	11.4%
Expected dividend yield	0.2%
Expected total return	**11.7%**
Market Cap	Rs67,879M
	US$1,439M

Price Performance (RIC: PUJL.BO, BB: PUNJ IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2008A	3,213	10.31	47.2	19.8	2.3	16.0	0.2
2009A	1,962	6.30	-38.9	32.5	2.5	7.5	0.2
2010E	4,135	12.18	93.4	16.8	1.9	13.7	0.2
2011E	5,027	14.81	21.6	13.8	1.7	13.3	0.3
2012E	6,358	18.73	26.5	10.9	1.5	14.7	0.3

Source: Powered by dataCentral

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

Fiscal year end 31-Mar	2008	2009	2010E	2011E	2012E
Valuation Ratios					
P/E adjusted (x)	19.8	32.5	16.8	13.8	10.9
EV/EBITDA adjusted (x)	11.5	11.1	8.2	7.3	6.3
P/BV (x)	2.3	2.5	1.9	1.7	1.5
Dividend yield (%)	0.2	0.2	0.2	0.3	0.3
Per Share Data (Rs)					
EPS adjusted	10.31	6.30	12.18	14.81	18.73
EPS reported	11.51	-7.23	12.18	14.81	18.73
BVPS	90.40	81.86	107.08	121.55	139.92
DPS	0.40	0.40	0.50	0.60	0.70
Profit & Loss (RsM)					
Net sales	77,529	119,120	135,002	153,302	176,546
Operating expenses	-72,581	-113,491	-125,936	-143,005	-164,347
EBIT	**4,948**	**5,629**	**9,066**	**10,297**	**12,199**
Net interest expense	-1,292	-2,208	-3,339	-3,462	-3,462
Non-operating/exceptionals	1,165	-3,538	309	309	308
Pre-tax profit	**4,821**	**-116**	**6,035**	**7,143**	**9,045**
Tax	-1,237	-2,199	-1,924	-2,139	-2,710
Extraord./Min.Int./Pref.div.	1	62	23	23	23
Reported net income	**3,584**	**-2,253**	**4,135**	**5,027**	**6,358**
Adjusted earnings	3,213	1,962	4,135	5,027	6,358
Adjusted EBITDA	6,410	7,400	11,221	12,724	14,830
Growth Rates (%)					
Sales	51.2	53.6	13.3	13.6	15.2
EBIT adjusted	84.5	13.8	61.0	13.6	18.5
EBITDA adjusted	71.3	15.4	51.6	13.4	16.5
EPS adjusted	47.2	-38.9	93.4	21.6	26.5
Cash Flow (RsM)					
Operating cash flow	**-5,307**	**-9,805**	**-3,971**	**4,078**	**4,526**
Depreciation/amortization	1,462	1,771	2,155	2,427	2,631
Net working capital	-10,907	-9,828	-10,237	-3,353	-4,441
Investing cash flow	**-8,125**	**-8,417**	**-5,600**	**-5,000**	**-4,000**
Capital expenditure	-4,366	-7,265	-4,100	-4,000	-3,000
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**10,139**	**19,186**	**6,411**	**-233**	**-271**
Borrowings	-920	19,520	-97	0	0
Dividends paid	-142	-142	-194	-233	-271
Change in cash	**-3,293**	**964**	**-3,160**	**-1,154**	**254**
Balance Sheet (RsM)					
Total assets	**77,511**	**111,292**	**128,302**	**142,321**	**159,362**
Cash & cash equivalent	6,898	8,122	4,985	3,854	4,131
Accounts receivable	20,901	26,686	33,269	37,779	43,507
Net fixed assets	14,590	19,768	21,723	23,306	23,685
Total liabilities	**49,856**	**86,027**	**92,394**	**101,619**	**112,573**
Accounts payable	19,284	28,836	31,373	35,626	41,028
Total Debt	16,072	35,592	35,495	35,495	35,495
Shareholders' funds	**27,655**	**25,265**	**35,907**	**40,702**	**46,789**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	8.3	6.2	8.3	8.3	8.4
ROE adjusted	16.0	7.5	13.7	13.3	14.7
ROIC adjusted	13.8	8.3	12.8	12.6	13.6
Net debt to equity	33.2	108.7	85.0	77.7	67.0
Total debt to capital	36.8	58.5	49.7	46.6	43.1

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Downgrade to Hold (2M) – TP Cut To Rs228

Downgrade to Hold (2M) from Buy (1M) earlier

- We continue to believe Punj Lloyd is the only Indian mid-cap E&C company that has the necessary skill sets and desire to leapfrog into the next level, a level that is occupied by L&T with its immensely diversified skill sets.
- However, we also believe the company is trying to make this quantum jump in too short a time span with its aggressive bidding strategies taking significant balance sheet risk – size, geography and pricing of orders. It is a fact that SABIC was a legacy order but Ensus and ONGC's Heera projects might be the result of aggressive bids not paying off.
- We believe the 29% decline in the stock price in the last week largely factors in the Ensus projects losses booked in the 2QFY10 results. However we also believe the following potential risks have not been qualitatively/quantitatively factored in: (1) LDs in the Ensus project (2) delays beyond Dec 12, 2009 on the Ensus project (3) cost overruns on the ONGC Heera project and (4) Rs701mn of disputed amounts in other projects. As a consequence we downgrade Punj Lloyd to Hold (2M) from Buy (1M).

Figure 1. Punj Lloyd v/s BSE Sensex Price Performance

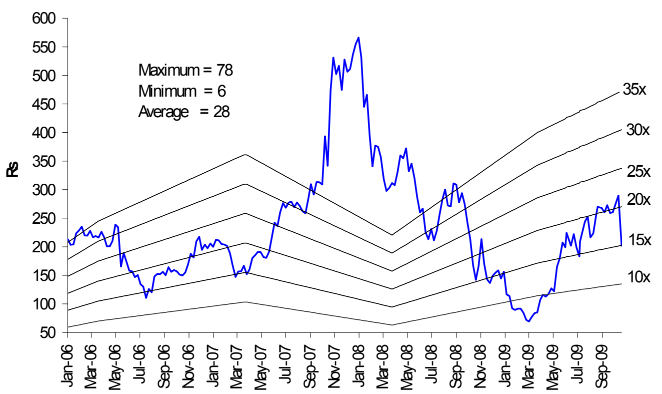
	1 Week	1 Month	3 Months	6 Months	1 Yr	2 Yrs	3 Yrs	Since Listing
Punj	-29%	-22%	-17%	72%	42%	-54%	31%	-5%
BSE	-5%	-2%	6%	44%	111%	-15%	27%	70%
Relative Performance	-24%	-20%	-23%	28%	-68%	-39%	4%	-74%

Source: Citi Investment Research and Analysis estimates

Target price cut to Rs228 from Rs311 earlier

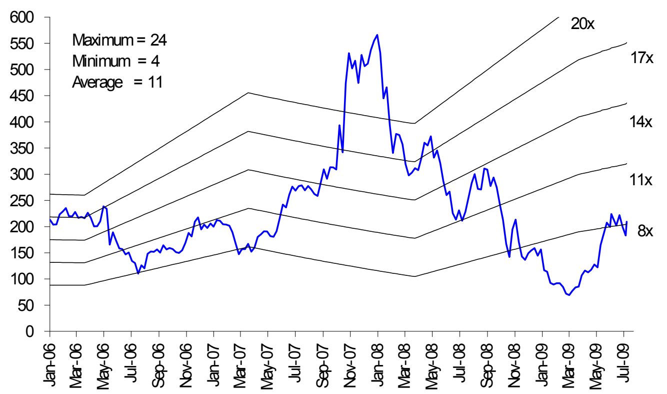
- Our target price cut factors in: (1) cut in our target P/E multiple to 15x (at a discount to other mid cap construction peers at 16x) from 17x (premium to mid cap construction peers) on the company's inconsistent track record and (2) downward earnings revision of 9-16%. (3) 50% to discount to book value for the shipyard on the west coast v/s book value earlier.

Figure 2. Punj Lloyd 1 Year Forward Rolling P/E Bands



Source: Citi Investment Research and Analysis estimates

Figure 3. Punj Lloyd 1 Year Forward Rolling EV/EBITDA Bands



Source: Citi Investment Research and Analysis estimates

Earnings revised downwards

Revise downward our FY10E-12 EPS estimates by 9 – 16% to factor in:

- Higher losses in Simon Carves totalling to £43mn vis-à-vis earlier expectations of £29mn on account of £13.5mn of losses on the Ensus bio-ethanol plant order.
- Further, we are concerned about the Rs2.5bn legacy orders, potential contractual disputes/LDs on the ONGC Heera project. We factor this in with our 20bps margin cut in FY11E.
- We believe there could be risk to our estimates in case of further delays in Ensus and ONGC than we are assuming. Last but not the least, Ensus does have the legal right to claim LDs on the bio-ethanol projects as the project is delayed and we have not factored this into our numbers yet.

Figure 4. Punj Lloyd – Earnings Revision Table

Year End Mar31	FY10E	FY11E	FY12E
Sales			
Old	135,193	153,302	176,546
New	135,002	153,302	176,546
% Chg	-0.1%	0.0%	0.0%
EBITDA			
Old	11,086	13,031	14,830
New	11,221	12,724	14,830
bps	1.2%	-2.4%	0.0%
EBITDA Margins			
Old	8.2%	8.5%	8.4%
New	8.3%	8.3%	8.4%
bps	11	(20)	0
Recurring PAT			
Old	4,524	5,992	7,333
New	4,135	5,027	6,358
% Chg	-8.6%	-16.1%	-13.3%
FD EPS			
Old	13.33	17.65	21.60
New	12.18	14.81	18.73
% Chg	-8.6%	-16.1%	-13.3%

Source: CIRA estimates

Figure 5. CIRA v/s Consensus Estimates

Year End Mar31 (Rsmn)	FY10E	FY11E	FY12E
CIRA	12.18	14.81	18.73
Consensus	13.64	17.19	20.51
Difference	-10.7%	-13.9%	-8.7%

Source: Bloomberg, Citi Investment Research and Analysis estimates

What Is The Right Way To Look At Punj Lloyd?

Approach 1: Ex Simon Carves, Punj Lloyd's numbers seem decent

- If we subtract Simon Carves from Punj Lloyd consolidated, one realizes that the underlying business is delivering healthy 5.5% - 5.9% PAT margins (at the upper end of the mid cap construction pack). We have wondered over the last 2 years, "Why is Punj Lloyd's superior and diversified skill sets not translating into superior profitability like that of L&T?" The answer lies in Simon Carves. Punj Lloyd needs to restructure Simon Carves fast and integrate the same into the overall group as an entity that contributes.

Figure 6. Punj Lloyd – Understanding the Simon Carves Impact

Year End Mar31 (Rsmn)	FY08	FY09	1HFY10	FY10E
Punj Lloyd Consolidated Revenues	77,529	119,120	58,316	135,002
- Contribution From Simon Carves	14,254	13,201	3,628	7,200
- Punj Lloyd Ex Simon Carves	63,275	105,920	54,688	127,802
Punj Lloyd Consolidated Reported PAT	3,584	(2,253)	1,800	4,135
- Contribution From Simon Carves	48.318	(8,514)	(1,336)	(3,326)
- Punj Lloyd Ex Simon Carves	3,536	6,261	3,136	7,460
Punj Lloyd Consolidated PAT Margins	4.6%	-1.9%	3.1%	3.1%
- Contribution From Simon Carves	0.3%	-64.5%	-36.8%	-46.2%
- Punj Lloyd Ex Simon Carves	5.6%	5.9%	5.7%	5.8%

Source: Company and Citi Investment Research and Analysis estimates

Approach 2: Averaging suggests company has not delivered much

- One can always ask the question - Punj Lloyd reported PAT of Rs1.3bn (up 14% YoY) in 1QFY10 and Rs529mn (down 64% YoY) in 2QFY10 – but is this the correct way to look at it, or is the true reflection of reality that Punj Lloyd reported (Rs1.3bn + Rs529mn)/2 = PAT of Rs900mn in 1QFY10 (down 20% YoY) and 2QFY10 (down 38% YoY)?

- We take note of the fact that given the nature of the business and the lumpiness and size of orders in Punj Lloyd a quarter on quarter comparison is not correct. As a consequence we take the average of the sales, reported profits and RoE over the last 5 years to smooth one-off events and accounting effects. This should also smooth out the effects of reporting profits in a quarter/year and writing them off in the next quarter/year on account of cost over-runs.

Figure 7. Punj Lloyd – Sales, PAT and RoEs over the last 5 years

Year End (Rsmn)	FY2005	FY2006	FY2007	FY2008	FY2009	Average
Sales	17900	16846	51266	77529	119120	56,532
Recurring PAT	264	545	1973	3213	1962	1,591
PAT Margins	1.5%	3.2%	3.8%	4.1%	1.6%	2.8%
PAT	1,006	547	1,969	3,584	(2,253)	971
PAT Margins	5.6%	3.2%	3.8%	4.6%	-1.9%	1.7%
Recurring RoE	5.2%	6.7%	16.4%	16.0%	7.5%	10.4%
Reported RoE	19.8%	6.7%	16.4%	17.8%	-8.6%	10.4%

Source: Citi Investment Research and Analysis estimates

History of Contractual Disputes

Punj Lloyd has had a history of contractual disputes with clients (IOCL–PIL; GAIL; Petronet; Spie Capag Petrofac; and SABIC). Management maintains that the nature of business is such that scope and design changes keep happening. This implies that similar problems cannot be ruled out in the future. As of June 2009 the company continues to have disputed amounts totalling Rs701mn on its books.

Ensus Bio Ethanol project – The story so far

This was not a legacy order and was booked post acquisition of Sembawang E&C and Simon Carves. The project had already been delayed significantly prior to the start of 2QFY10.

According to our estimates Simon Carves must have booked £13mn of losses on this project in FY09.

- **Background:** Simon Carves had been engaged by Ensus to design and construct one of the world's largest bio-ethanol production facilities at the Wilton International site in Teesside, an integrated petrochemical complex in the North East of England for an initial project size of £161mn. Construction started in 2QCY07 with full production expected to begin in early 2009. The production of bio-ethanol from the plant is expected to form a key contribution to the EU's strategy to scale-back dependency on fossil fuels and reduce greenhouse gas emissions. The facility designed and constructed by Simon Carves on behalf of Ensus will when fully operational substantially underpin the UK's entire target.

According to the management they had not anticipated that they would have to take losses on account of this project at the start of 2QFY10

Typically every month of delay beyond Dec12, 2009 will cost Simon Carves £5mn of additional costs

- **Reason for the cost over runs:** The project is a detailed EPC project and the estimated engineering/procurement costs were in line with the targets. All the cost overruns are on the construction side where Simon Carves is employing subcontractors to execute the project. Since the contractors are being paid on a time cost basis their productivity decline has led to delays and overruns.

The company did have Rs300mn of losses in the same project in 1QFY10 but had not disclosed this in the results, as according to the management they do not generally provide disclosures on small variations.

- **Completion schedule, losses and accounting treatment:** The company is expecting to finish this project by Dec12, 2009 and believes all incremental costs have already been accounted for by 2QFY10. If the execution gets delayed beyond Dec12, 2009 then additional costs might have to be booked. The cost overrun booked was £13.5mn in 2QFY10 (£6.5 of existing losses and £7mn of future expected losses till Dec12, 2009). Under the accounting standards all existing and future losses are booked as soon as they are identified and all past profits get reversed.

According to the management they will not do any more contracts in UK and specifically no more contracts in Europe on a time cost basis.

There are 2 – 3 more orders left to be executed on Simon Carves's books

- **Chances of recovery:** The plant currently being built has 15% more capacity than initially contracted for as Simon Carves has over-designed the project. As a consequence Simon Carves is trying to negotiate some amount of recovery based on every extra litre of bio-ethanol produced. Even if the client agrees, the recovery would be deferred over 2 years. Looking at labor laws in the UK, the chances of recovery from subcontractors seems remote.

Update on the Heera Redevelopment project

Punj Lloyd received this order in January 2007 and was expected to complete this project in 16 months.

- In FY09 Punj Lloyd experienced cost escalations in the ONGC offshore platform project (Heera Redevelopment).

Liquidated damages (LDs) and cost escalation claims for the project would be taken up only once the project has completed and is most likely to be settled through a dispute settlement mechanism.

- According to the FY09 annual report, in the ONGC Heera project on revision in estimates of projects, cost and revenue on the project has gone up by Rs3.6bn and Rs1.5 respectively. The company has filed claims with ONGC amounting to Rs5.1bn against the increase in cost estimates. Pending acceptance, these claims have not been accounted for in the books.
- The cost escalations were driven by design modifications on the client side which led to higher steel consumption than earlier estimated.

- Post FY09 nothing significant has been done due to bad weather and work is expected to restart on this project from November 2009 and the company expects to complete all the work by January 2010. According to the management based on current targetted schedule all costs have been accounted for.

SABIC order – What happened here?

- Simon Carves contracted with Huntsman Petrochemicals, UK (subsequently acquired by SABIC) in early 2006 to design, build and pre-commission a 400 kte per annum low density polyethylene plant (LDPE) at Wilton, Teesside in the UK. This contact was entered into between Simon Carves and SABIC prior to the acquisition of Simon Carves by Punj Lloyd in May 2006. After the completion of the initial front end engineering design works for the proposed plant, the contact was converted into a lumpsum EPC contract.

- SABIC terminated the contract on the basis that Simon Carves failed to undertake completion of the contractual works with due diligence. SABIC has also given 3 reasons for invoking the performance bonds: (1) poor quality of work, (2) poor quality of subcontractors and (3) poor engineering

- Simon Carves denies this on the basis that the contract has been significantly completed (~ 99% according to the Punj Lloyd management) and was on track to be completed within the scheduled completion date.

- SABIC called the performance and advance payment guarantees in the contract issued by Simon Carves amounting to £28.5mn.

- Simon Carves then commenced adjudication proceedings aimed at seeking restitution through UK courts of the above £28.5mn. Additional costs were also being sought by Simon Carves associated with the cost overruns in the project caused by changes in scope and design requested by SABIC.

- Simon Carves then received a decision in adjudication proceedings initiated on December 22, 2008, regarding the termination, by SABIC UK Petrochemicals, of a contract originally awarded in 2006. The adjudication decision has been received and is in favour of SABIC.

- Punj Lloyd wrote off £28.5mn in the 4QFY09 results. Simon Carves will exercise its right to have all the issues that were heard by the Adjudicator, determined by the Court and will proceed to the next stage of dispute resolution by taking the necessary steps in consideration of court proceedings.

Figure 8. SABIC Order Details

Details	£mn
Initial contract value	140.0
Deadline for completion of contract	Apr-08
Original bank guarantee	13.5
Mar-08	
Expected cost of completion	178.0
Auditor qualification in accounts	38.0
Jun-08	
Interim settlement and client agrees to pay extra	15.0
Bank guarantee given by Punj Lloyd for above amount	15.0
Auditor qualification in accounts after above reduction	23.00
Sep-08	
Estimated cost of completion increases by	2.0
New estimated cost of completion	180.0
Auditor qualification in accounts	25.0
Dec-08	
Project completed 99% according to Punj Lloyd	
SABIC terminates contract	
SABIC en-cashes original bank guarantees totalling to	28.5
Punj Lloyd's Total Exposure	**53.5**
Bank guarantees en-cashed by SABIC	28.5
Disputed amount in contract	25.0
3QFY09 Results	
Punj writes of auditor qualifications	Rs2072mn
Classifies performance guarantees encashed as recoverable from client	Rs2176mn
4QFY09 Results	
Performance guarantee encashment written off	Rs2235mn

Source: Company and Citi Investment Research and Analysis

2QFY10 Recurring PAT Down 63% YoY

- 2QFY10 PAT at Rs529mn was below CIRA estimates of Rs1.4bn on account of Rs1.0bn of losses in Simon Carves on cost overruns and project disputes on the Ensus bio-ethanol project in UK.

- Sales growth was below expectations as despite Rs98bn of orders in Libya the company could not book any sales as the threshold of revenue recognition could not be reached on these orders. Company ended 2QFY10 with an order backlog of Rs268bn up 24% YoY (Rs114bn inflows in 1HFY10)

Figure 9. Punj Lloyd 2QFY10 Results Review

Year End Mar31 (Rsmn)	1QFY09	1QFY10	Change	2QFY09	2QFY10	Change	2QFY10E
Order Backlog	201,620	278,890	38.3%	216,750	268,000	23.6%	275,630
Net Sales	**26,488**	**29,551**	**11.6%**	**29,261**	**28,764**	**-1.7%**	**31,261**
Growth	89.9%	11.6%		54.5%	-1.7%		6.8%
Consumption of Raw materials	(7,028)	(8,960)		(10,470)	(11,053)		
as a % of sales	26.5%	30.3%		35.8%	38.4%		
Contractor Charges	(9,043)	(9,346)		(8,420)	(7,954)		
as a % of sales	34.1%	31.6%		28.8%	27.7%		
Staff Costs	(3,276)	(3,239)		(2,687)	(3,133)		
as a % of sales	12.4%	11.0%		9.2%	10.9%		
Other expenditure	(5,024)	(5,090)		(4,959)	(4,456)		
as a % of sales	19.0%	17.2%		16.9%	15.5%		
Total Expenditure	(24,371)	(26,634)		(26,536)	(26,596)		
as a % of sales	92.0%	90.1%		90.7%	92.5%		
EBITDA	**2,116**	**2,918**	**37.9%**	**2,724**	**2,168**	**-20.4%**	**3,001**
EBITDA Margin	**8.0%**	**9.9%**		**9.3%**	**7.54%**		**9.6%**
Depreciation	(392)	(541)		(439)	(514)		(588)
EBIT	**1,725**	**2,377**	**37.8%**	**2,286**	**1,654**	**-27.6%**	**2,413**
EBIT Margin	**6.5%**	**8.0%**		**7.8%**	**5.8%**		**7.7%**
Interest	(368)	(744)		(490)	(796)		(744)
Other Income	94	239		280	(43)		310
PBT	**1,451**	**1,872**	**29.0%**	**2,076**	**816**	**-60.7%**	**1,979**
Tax	(469)	(622)		(647)	(301)		(594)
Tax Rate %	32%	33%		31%	37%		30%
Share of Profit of Associates	(10)	(19)		9	31		9
Share of loss transferred to Minority	4	41		3	(18)		3
Recurring PAT	**976**	**1,272**	**30.3%**	**1,441**	**529**	**-63.3%**	**1,397**
Total Exceptionals	143	0		0	0		0
Reported PAT	**1,119**	**1,272**	**13.7%**	**1,441**	**529**	**-63.3%**	**1,397**

Source: Company data, Citi Investment Research and Analysis

Other takeaways from the post results conference call

- **Flat sales in 2QFY10:** Libya with Rs98bn of orders accounts for ~ 37% of order backlog and progress on these projects has not been sufficient to book sales and profits on these projects according to accounting standards. The company expects to book sales and profits on these projects from 3QFY10. Margins are higher than 8% and the execution period is 24-48 months with an average of 34 months

- **Order backlog and inflows:** Expects to get a construction contract of Rs11bn on the 181km Hyderabad Vijayawada road project soon and is in the fray for ONGC's Rs45bn B193 order. Bidding activities continue to be robust and there is no slowdown. Only the Rs17.7bn Jurong Aromatic order is slow moving currently. However, even in this project there is renewed interest from Singapore Government and Korean EXIM bank. The project is in the market for financial closure and the company is hopeful this will be concluded in the next 2-3 months. Average execution cycle of current backlog is 26-28 months.

- 70% of procurement value in the existing order backlog has been de-risked from commodity price volatility and 30% is exposed. But the contingency is only for normal volatility

- **Update on other disputed cases:** On the GAIL (Dahej-Vijaypur pipeline projects) amounting to Rs470mn the company resolve this in FY10E. The decision on the Rs70mn Petronet MHB dispute is likely to come next quarter.

- **Casino project update:** There is no delay on this project and there are chances of improvement in margins here.

- **Simon Carves restructuring:** Current staff count is 79 people (80 people laid off in 2QFY10). 2QFY10 includes cost of laying off these people ~ £1.2-1.4mn (~ £4mn booked in 1QFY10). Employee count in Simon Carves will be brought down to 50.

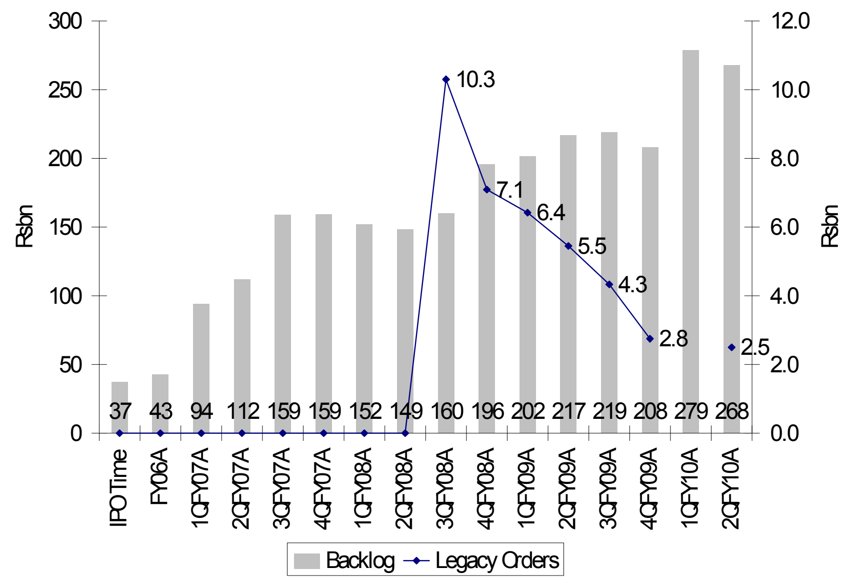
- **Capex for FY10E:** ~ Rs3-3.5bn mainly on replacement capex and some investment in off-shore barge. Rs2.58bn of capex has been already been spent in 1HFY10.

- **Debt situation:** Despite raising Rs6.7bn through a QIP placement in Aug09 and Rs6bn through NCDs the debt at Rs43.9bn (Rs35.5bn end FY09) remains high with cash of Rs5.7bn (Rs8.1bn end FY09). This is because of increased working capital requirement in 2 large projects (Qatar US$800mn pipeline and US$572mn Malaysia project). Majority of the debt is working capital in nature and the company expects this will taper down as projects get completed. The costs of recently issued NCDs are 9.5% for 3 year NCD and 10%% for 5 year NCD.

- **Tax rates:** Are skewed as the company is not creating any deferred tax assets on Simon Carves' losses. When Simon Carves' losses subside overall tax rates would go down to ~ 25%

- **Legacy orders:** Was at Rs2-2.5bn at the end of 2QFY10 and most of it will get completed in FY10E with 1-2 projects getting spilled over to FY11E. The company does not expect cost over-runs in these projects.

Figure 10. Punj Lloyd Backlog and Legacy Orders



Source: Citi Investment Research and Analysis

Punj Lloyd

Company description

Punj Lloyd is an Indian Engineering & Construction (E&C) major catering to the hydrocarbons and civil construction sectors across India, Asia and the Middle East. Services include laying pipelines, building roads, and constructing refineries and tankages, power plants, and other infrastructure facilities. In FY07 Punj Lloyd acquired Semb, which helped it scale up its expertise to upstream oil & gas, airports, jetties, MRT/LRT and tunnelling amongst others, in the infrastructure domain. Enabled by the extended capabilities accruing from this acquisition, Punj Lloyd is now also pre-qualified for larger and more complex project bids.

Investment strategy

We rate Punj Lloyd shares Hold/Medium Risk (2M).

- We continue to believe Punj Lloyd is the only Indian mid cap E&C company that has the necessary skill sets and desire to leapfrog into the next level, a level that is occupied by L&T with its immensely diversified skill sets.
- However, we also believe the company is trying to make this quantum jump in too short a time span with its aggressive bidding strategies taking significant balance sheet risk – size, geography and pricing of orders. It is a fact that SABIC was a legacy order but Ensus and ONGC's Heera projects might be the result of aggressive bids not paying off.

- We believe the following potential risks have not been qualitatively/ quantitatively factored in: (1) LDs in the Ensus project (2) delays beyond Dec 12, 2009 on the Ensus projects (3) Rs5.1bn of claims on the ONGC Heera project and (4) Rs701mn of disputed amounts in other projects.

Valuation

Our target price of Rs228 is based on a target P/E multiple of 15x March 2011. Our target multiple is pegged at a discount to other mid cap construction peers like IVRCL at 16x and Nagarjuna at 15x given the risks inherent in numerous contracts that Punj Lloyd is executing and given the company's inconsistent track record; and it is set at ~ 35% discount to L&T given L&T's superior skill sets, backlog and execution track record. We also value Punj Lloyd's stake in the shipyard on the west coast at a 50% discount to the FY09 end book value.

Risks

We have a Medium Risk rating on Punj Lloyd shares, as opposed to the Speculative Risk flag suggested by our quantitative risk rating system, which tracks 260-day historical share price volatility. We believe Medium Risk is more appropriate for Punj Lloyd given: (1) The quantum of legacy orders has progressively decreased from ~ Rs41bn at the time of acquisition of Sembawang E&C to ~ Rs2.5bn; (2) Though there are still some grey areas in terms of accounting of orders, the company has written off a significant portion of the same in its profit & loss statement in the past few years; (3) Our Medium Risk rating is consistent with the risk flag applied to other mid-cap construction peers.

The key downside risks to our target price include: 1) Integration risks relating to Simon Carves; 2) Revenue volatility due to project-driven nature of business; 3) Exports being subject to geopolitical risks; 4) Project implementation risks, bad debts and receivables; 5) Sensitivity to raw material costs and foreign currency fluctuations; and 6) Employee retention, which could be a key challenge. The key upside risks include: 1) Favorable settlement with SABIC; 2) Positive change in macro-economic variables; and 3) Better-than-expected order inflows and sales execution.

Appendix A-1

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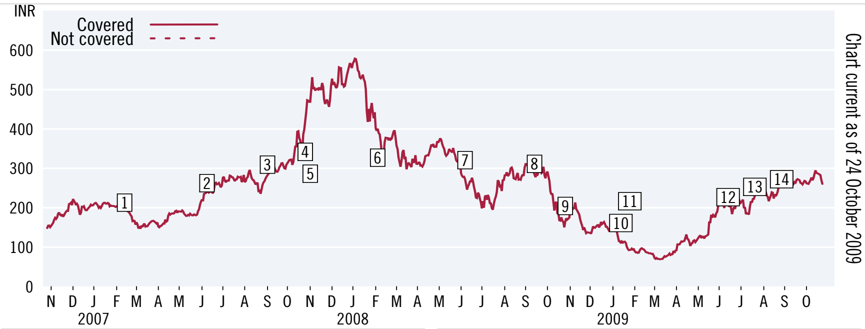
Analyst: Venkatesh Balasubramaniam



	Date	Rating	Target Price	Closing Price
1	13-Feb-07	*3M	*175.40	197.13
2	8-Jun-07	*1L	*305.00	239.60
3	3-Sep-07	1L	*353.00	282.70
4	25-Oct-07	1L	*464.00	420.95
5	1-Nov-07	1L	*593.00	468.85
6	5-Feb-08	1L	*493.00	400.70
7	6-Jun-08	*1M	*366.00	272.85
8	12-Sep-08	1M	*395.00	284.45
9	27-Oct-08	1M	*218.00	165.35
10	13-Jan-09	*2H	*142.00	109.80
11	25-Jan-09	*3H	*85.00	92.30
12	12-Jun-09	*3M	*217.00	212.50
13	21-Jul-09	*1M	*263.00	231.15
14	27-Aug-09	1M	*311.00	264.00

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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