VA Tech 2QFY12 concall key takeaways: The real test begins

(VATW IN, mcap US$185mn, BUY, 86% upside)

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VA Tech hosted an earnings call to discuss 2QFY12 performance and the company's near-term outlook. The key highlights:

Expects strong order flow momentum in 2HFY12: After receiving orders worth ₹3.8bn only in 1HFY12, management expects to win orders worth ₹15bn-₹16bn in 2HFY12, mainly from the Indian geography (expected to contribute to ~66% of the order flow in 2HFY12). In India, apart from the two framework municipal contracts worth ₹4.6bn (Ulhasnagar and Aurangabad Municipal Corporation), which are expected to be received by March 2012, the company expects to receive large orders from the industrial sectors such as Steel, Oil and Gas etc. In the international markets (expected to contribute to 33% of the order flow in 2HFY12), strong order flow momentum is seen in countries such as Turkey, Switzerland and Vienna.

Payment delays in Chennai desalination plant project led to increase in working capital: Working capital turnover in the standalone entity has declined to 2.2x at September 2011 (compared with 2.5x at the end of FY11 and 2.8x at the end of 1HFY11), primarily on account of a steep increase in the debtors (86% increase YoY). Management highlighted that the increase in debtors is due to payment delays for the Chennai desalination plant project. However, the company expects to receive all the payments by end-FY12.

Maintains FY12E guidance: The company maintains its FY12E revenue and EBITDA margin guidance at ~₹14bn (15% YoY growth) and ~10%, respectively. However, we believe that whilst the company's EBITDA margin guidance is realistic, its revenue growth guidance is optimistic. We expect revenues to grow by ~10% only in FY12E, as we expect overseas revenues to decline by 10% YoY in FY12E.

Where we go from here? In our email dated November 10, 2011, we had highlighted that we would seek more clarification from the management on the order flow visibility for 2HFY12, both in the Indian and international markets (in 1HFY12, VA Tech has achieved only 20% of our order flow estimate). Given that 2H has always been significantly better than 1H in terms of order flow and given that managements of all the engineering and construction companies are highlighting strong order flow visibility in the Indian water infrastructure sector, presently we maintain our FY12 consolidated order inflow estimate of ₹21bn and will revisit the same post 3QFY12 results. We also maintain our estimates of revenue growth at 10% and EBITDA margin estimate at 9.9%.

Valuation and recommendation: VA Tech is currently trading at 12.7x FY12 estimated EPS of ₹27, which is a premium to other mid-sized construction/engineering companies. But digging deeper, the premium appears more than justified in the light of certainty of competitive and balance sheet strengths of the company in the current uncertain environment. Unlike other construction companies, which are saddled with high debt equity, VA Tech has a cash holding of ₹2.5bn and works on a capital-light business model. We expect VA Tech's valuations to rerate as the higher revenue growth and marginal EBITDA margin improvements drive not only EPS but more importantly, RoICs, to levels north of 18% (adjusted for 50% cash holding). Our DCF-based valuation of ₹635/share implies 86% upside (19x FY13 EPS). We maintain BUY.

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Explanation of Investment Rating

Investment Rating	Expected return (over 12-month period from date of initial rating)
Buy	>5%
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