INITIATION

Hindustan Construction Company (HCNS.BO)

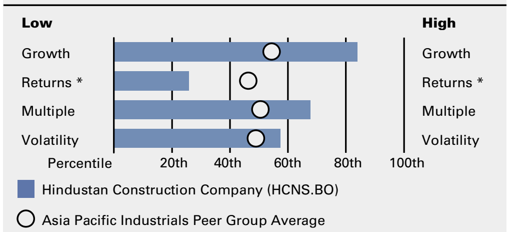
Neutral

Concerns on the core business; initiate with Neutral

Investment view

We initiate coverage of Hindustan Construction Company (HCC) with a Neutral rating and a 12-m SOTP-based target price of Rs67. HCC's potential to grow orders in hydro and nuclear power segments is counter-balanced with the recent muted order inflow and high working capital for the core construction business. The potential listing of Lavasa Corporation Ltd. (LCL, 64.99% owned by HCC; a draft prospectus was filed on September 14, 2010) could drive HCC's stock price higher in the short term. However, our valuation does not reflect a significantly higher upside to HCC's share price and thus our Neutral rating.

Investment Profile



* Returns = Return on Capital For a complete description of the investment profile measures please refer to the disclosure section of this document.

Core drivers of growth

HCC's Rs197 bn order book (about 5.4X FY2010 revenue) is spread across various construction segments. Its vast experience in the hydro and nuclear power construction and the potential growth in these segments provide a significant opportunity for HCC's core construction business over the medium term. We expect order inflows of Rs241 bn across various verticals over FY11E-FY13E, implying a 16% CAGR and resulting in revenue growth of 19% CAGR.

Risks to the investment case

Downside risks: increase in commodity and construction material prices; upside risks: stronger order inflows, translating to higher billings and improved working capital management.

Valuation

We value HCC using SOTP for the construction business, BOT projects, and the real-estate business to derive our 12-m Rs67 target price. HCC is trading at 30X our 12-m forward P/E and 2.3X P/B (parent basis), in line with its 5-yr median.

Industry context

India's construction industry is in a growth phase; the gov't plans US$1tn infrastructure spending over FY2012-2017.

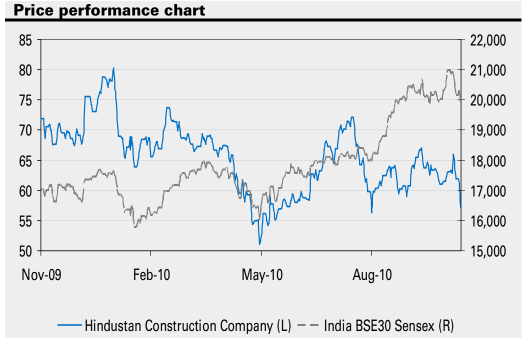
INVESTMENT LIST MEMBERSHIP
Neutral

Coverage View: Neutral
India
Construction

Key data	Current
Price (Rs)	57.20
12 month price target (Rs)	67.00
Market cap (Rs mn / US$ mn)	34,691.7 / 765.6
Foreign ownership (%)	27.0

	3/10	3/11E	3/12E	3/13E
EPS (Rs)	1.34	1.70	2.22	3.20
EPS growth (%)	(40.2)	26.4	31.1	43.8
EPS (diluted) (Rs)	1.34	1.70	2.22	3.20
EPS (basic pre-ex) (Rs)	1.40	1.77	2.32	3.33
P/E (X)	42.6	33.7	25.7	17.9
P/B (X)	2.3	2.2	2.0	1.9
EV/EBITDA (X)	13.0	11.8	10.2	8.9
Dividend yield (%)	0.7	0.9	1.2	1.7
ROE (%)	6.5	6.6	8.2	10.9
CROCI (%)	21.6	18.2	14.8	15.5

Price performance chart



Share price performance (%)	3 month	6 month	12 month
Absolute	(18.1)	(3.5)	(20.4)
Rel. to India BSE30 Sensex	(25.6)	(18.2)	(31.7)

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 11/16/2010 close.

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Hindustan Construction Company: Summary Financials

Profit model (Rs mn)	3/10	3/11E	3/12E	3/13E
Total revenue	**36,442.0**	**43,263.0**	**51,300.0**	**61,366.3**
Cost of goods sold	(25,225.8)	(30,022.9)	(35,343.8)	(42,095.0)
SG&A	(7,926.5)	(9,385.8)	(11,129.4)	(13,313.3)
R&D	--	--	--	--
Other operating profit/(expense)	0.0	0.0	0.0	0.0
EBITDA	**4,428.7**	**5,195.4**	**6,263.2**	**7,553.5**
Depreciation & amortization	(1,139.0)	(1,341.2)	(1,436.4)	(1,595.5)
EBIT	**3,289.7**	**3,854.3**	**4,826.8**	**5,958.0**
Interest income	210.0	169.5	191.2	227.2
Interest expense	(2,261.5)	(2,703.3)	(3,240.8)	(3,563.3)
Income/(loss) from uncons. subs.	(149.9)	50.0	50.0	50.0
Others	130.1	100.0	100.0	0.0
Pretax profits	**1,218.4**	**1,470.5**	**1,927.2**	**2,771.9**
Income tax	(404.0)	(441.1)	(578.2)	(831.6)
Minorities	0.0	0.0	0.0	0.0
Net income pre-preferred dividends	**814.4**	**1,029.3**	**1,349.0**	**1,940.3**
Preferred dividends	0.0	0.0	0.0	0.0
Net income (pre-exceptionals)	**814.4**	**1,029.3**	**1,349.0**	**1,940.3**
Post-tax exceptionals	0.0	0.0	0.0	0.0
Net income	**814.4**	**1,029.3**	**1,349.0**	**1,940.3**
EPS (basic, pre-except) (Rs)	1.40	1.77	2.32	3.33
EPS (basic, post-except) (Rs)	1.40	1.77	2.32	3.33
EPS (diluted, post-except) (Rs)	1.34	1.70	2.22	3.20
DPS (Rs)	0.42	0.53	0.69	0.99
Dividend payout ratio (%)	29.8	29.8	29.8	29.8
Free cash flow yield (%)	(10.7)	(8.4)	(5.0)	(6.4)

Balance sheet (Rs mn)	3/10	3/11E	3/12E	3/13E
Cash & equivalents	1,883.2	2,124.2	2,524.0	1,303.8
Accounts receivable	26.5	35.6	42.2	50.4
Inventory	35,652.2	44,151.3	50,491.2	58,465.3
Other current assets	8,680.5	1,000.0	1,000.0	1,000.0
Total current assets	**46,242.4**	**47,311.1**	**54,057.3**	**60,819.5**
Net PP&E	11,780.2	13,144.0	13,212.6	13,417.1
Net intangibles	65.2	60.2	55.2	55.2
Total investments	4,086.9	5,286.9	5,286.9	5,286.9
Other long-term assets	0.0	0.0	0.0	0.0
Total assets	**62,174.7**	**65,802.3**	**72,612.1**	**79,578.8**
Accounts payable	11,867.9	14,089.3	16,706.6	19,984.9
Short-term debt	7,463.9	7,463.9	7,463.9	7,463.9
Other current liabilities	8,342.9	3,962.4	4,112.4	4,262.4
Total current liabilities	**27,674.7**	**25,515.6**	**28,282.9**	**31,711.2**
Long-term debt	17,683.1	22,683.1	25,683.1	27,683.1
Other long-term liabilities	1,645.1	1,645.1	1,645.1	1,645.1
Total long-term liabilities	19,328.2	24,328.2	27,328.2	29,328.2
Total liabilities	**47,002.9**	**49,843.8**	**55,611.1**	**61,039.4**
Preferred shares	**0.0**	**0.0**	**0.0**	**0.0**
Total common equity	**15,171.8**	**15,958.5**	**17,000.9**	**18,539.4**
Minority interest	0.0	0.0	0.0	0.0
Total liabilities & equity	**62,174.7**	**65,802.3**	**72,612.1**	**79,578.8**
BVPS (Rs)	**25.02**	**26.31**	**28.03**	**30.57**

Growth & margins (%)	3/10	3/11E	3/12E	3/13E
Sales growth	10.0	18.7	18.6	19.6
EBITDA growth	2.7	17.3	20.6	20.6
EBIT growth	4.1	17.2	25.2	23.4
Net income growth	(35.0)	26.4	31.1	43.8
EPS growth	(42.8)	26.4	31.1	43.8
Gross margin	30.8	30.6	31.1	31.4
EBITDA margin	12.2	12.0	12.2	12.3
EBIT margin	9.0	8.9	9.4	9.7

Ratios	3/10	3/11E	3/12E	3/13E
CROCI (%)	21.6	18.2	14.8	15.5
ROE (%)	6.5	6.6	8.2	10.9
ROA (%)	1.5	1.6	1.9	2.5
ROACE (%)	6.2	6.8	7.6	8.6
Inventory days	458.8	485.1	488.7	472.4
Receivables days	0.4	0.3	0.3	0.3
Payable days	160.5	157.8	159.0	159.1
Net debt/equity (%)	153.3	175.6	180.1	182.5
Interest cover - EBIT (X)	1.6	1.5	1.6	1.8

Cash flow statement (Rs mn)	3/10	3/11E	3/12E	3/13E
Net income pre-preferred dividends	814.4	1,029.3	1,349.0	1,940.3
D&A add-back	1,139.0	1,341.2	1,436.4	1,595.5
Minorities interests add-back	0.0	0.0	0.0	0.0
Net (inc)/dec working capital	(6,547.3)	(6,286.8)	(3,729.0)	(4,704.2)
Other operating cash flow	5,161.4	4,383.8	2,899.6	3,186.1
Cash flow from operations	**567.5**	**467.5**	**1,956.0**	**2,017.8**
Capital expenditures	(2,858.1)	(1,500.0)	(1,500.0)	(1,800.0)
Acquisitions	(2,933.8)	(1,200.0)	0.0	0.0
Divestitures	1,445.0	0.0	0.0	0.0
Others	200.2	169.5	191.2	227.2
Cash flow from investments	**(4,146.7)**	**(2,530.5)**	**(1,308.8)**	**(1,572.8)**
Dividends paid (common & pref)	(201.3)	(242.6)	(306.6)	(401.9)
Inc/(dec) in debt	1,868.6	5,000.0	3,000.0	2,000.0
Common stock issuance (repurchase)	4,679.4	0.0	0.0	0.0
Other financing cash flows	(2,423.0)	(2,453.3)	(2,940.8)	(3,263.3)
Cash flow from financing	**3,923.7**	**2,304.1**	**(247.4)**	**(1,665.2)**
Total cash flow	**344.5**	**241.0**	**399.8**	**(1,220.2)**

Valuation	3/10	3/11E	3/12E	3/13E
P/E (analyst) (X)	42.6	33.7	25.7	17.9
P/B (X)	2.3	2.2	2.0	1.9
EV/EBITDA (X)	13.0	11.8	10.2	8.9
EV/GCI (X)	1.3	1.2	1.2	1.1
Dividend yield (%)	0.7	0.9	1.2	1.7

Note: Last actual year may include reported and estimated data.

Source: Company data, Goldman Sachs Research estimates.

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Prices in this report are based on market close of November 15, 2010, unless otherwise stated.

Strong order book to develop with hydro and nuclear projects, Lavasa to be the main focus in the near future

Hindustan Construction Company (HCC) is **well-positioned to leverage growth opportunities in the Indian construction space with its vast sectoral experience in the hydro and nuclear segment and estimated Rs300 bn of opportunities available over the next five to seven years**. We believe the company will also benefit from its build-operate-transfer (BOT) project portfolio providing sustainable revenue streams in the medium term. In addition, the company could benefit from the development of Lavasa (64.99% owned by HCC), a Greenfield city development planned in the form of regular annuity income and residential space sale.

However, we are **concerned about the timely and proper execution of projects and the amount of working capital required in the core business, which could remain high as has been the case in the last few years.**

We think that the Lavasa project is gaining momentum and the hill city is gaining interest from the tourist and investor community; however, the development of the city may take longer than the 11 plus years expected by Lavasa Corporation Ltd. (LCL) management, in view of the historical precedents and the topography of Lavasa.

Our SOTP-derived 12-month target price of Rs67 implies 9% potential upside from current levels; we initiate coverage of Hindustan Construction Company with a Neutral rating.

On the positive side, we expect:

- revenue growth for the construction business at **19% CAGR over FY2010-2013E (vs. 16% average between 2006-2010),** as the company executes its order book of Rs197 bn.
- **order inflows for FY11E of Rs70 bn**, representing 22% growth over the Rs57 bn of order inflows in FY10. Order inflows for 1H2011 were Rs26 bn, primarily in the hydro (Rs11 bn) and nuclear and special (Rs12 bn) segments. We expect more orders in these segments on the back of the strong opportunities in these verticals.
- **potential listing of Lavasa Corp. Ltd.,** a Greenfield city development based on the principle of new urbanization, could help HCC's share price if LCL is listed at either the conversion price for deep discount convertible bonds (DDCB) or above.

Offsetting these positives are:

- **execution concerns** over the past few years on the base business, with Rs32 bn of slow-moving orders and volatile order inflows resulting in revenue growth of 9% over FY08-FY10.
- **extended working capital** cycle of about 0.5X sales in FY10, which is one of the highest among HCC's peers and has resulted in high leverage for the core business. Any monetization of the claims filed by HCC for realization could reduce working capital.

Growth drivers: Opportunities in hydro and nuclear power construction to remain key

Established in 1926, Hindustan Construction Company is one of the veteran companies in the Indian construction space. The company has a strong presence in fast-growing industry sectors such as transportation, water and power (hydro and nuclear).

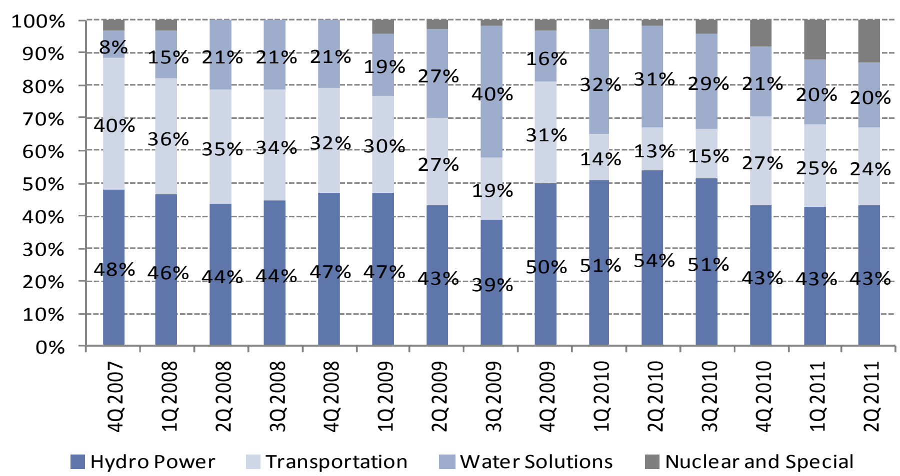
Exhibit 1: HCC – business segments
Broad classification of the various construction business divisions

Source: Company data, Goldman Sachs Research.

HCC has constructed about 40%-50% of India's current hydro power and nuclear power capacity. Visibility remains high on the core construction businesses due to the current order book of Rs197 bn (5.4X FY10 revenue). The order book comprises the following segments: hydropower (43%), water (20%), nuclear and special (13%), and transportation (24%).

Hydro power has been the stronghold of the company's order book in the past, comprising about 40%-50% of the total orders. We expect HCC to be a beneficiary of the Rs388 bn opportunity that is available in the hydro power segment over the medium term. In addition, we expect that nuclear power-related construction should increase due to the Rs290 bn of opportunities that will likely be available in the next five to seven years, as the 36 approved nuclear power plants come under construction over the long term.

Exhibit 2: Hydro power has been the key segment, and we likely expect it to continue
Quarterly segmental break-up of order book



Source: Company data, Goldman Sachs Research.

Exhibit 3: HCC is well-positioned to benefit from the spend in hydro power capacity…
Tentative hydro power opportunities for HCC

Hydro power opportunity	
Capacity addition during 12th FYP (2012-2017) MW	20,334
Hydro projects under construction (MW)	6,447
Hydro projects yet to be ordered (MW)	13,887
cost per MW (Rs mn)	70
Civil work	40%
HCC' share	40%
Total opportunity (Rs bn)	**156**

Source: Ministry of Power, CEA, India Infrastructure research, Goldman Sachs Research estimates.

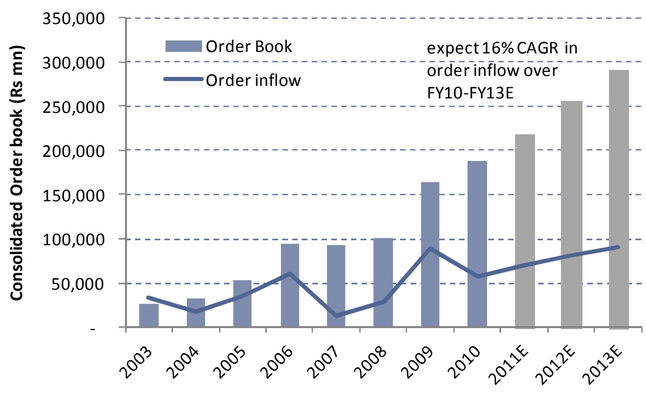
Exhibit 4: …as well as in nuclear power capacity
Tentative nuclear power opportunities for HCC

Nuclear power opportunity	
Planned addition by 2020 (MW)	20,000
Nuclear projects under construction (MW)	3,960
Nuclear projects yet to be ordered (MW)	16,040
cost per MW (Rs mn)	60
Civil work	30%
HCC' share	50%
Total opportunity (Rs bn)	**144**

Source: World Nuclear Association, Goldman Sachs Research estimates.

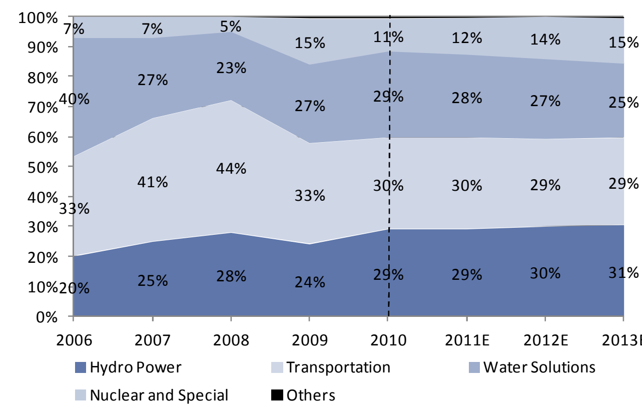
As a result of this spend in the hydro and nuclear power segments, we expect strong order inflows at a CAGR of 16% over FY2010-FY13E, and for revenue to grow at 19% CAGR over the same period as these order inflows are executed.

Exhibit 5: Strong order inflows will be reflected in the order book growth…
Order inflows and order book over time



Source: Company data, Goldman Sachs Research estimates.

Exhibit 6: …and revenue will be dominated by the hydro segment, though nuclear will increase its contribution over time
Revenue contribution by segment



Source: Company data, Goldman Sachs Research estimates.

HCC is also building its BOT project portfolio, with Rs3 bn of projects currently operational and Rs52 bn of projects under development. The company is currently receiving Rs238 mn semi-annual annuity for the Nirmal BOT project, and plans to begin tolling the Badarpur-Faridabad Elevated highway by the end of November 2010.

Exhibit 7: Two projects will be operational by the end of FY11
Current portfolio of BOT projects

Name of the Project	Capitalized Cost (Rs mn)	Target CoD	Holding	HCC's Equity (Rs mn)	Equity invested 9/30/2010 (Rs mn)
Raniganj - Dalkhola ***ROAD***	6,840	NA	100%		
Bahrampore - Farakka ***ROAD***	11,690	NA	100%	6,594	
Farakka - Raniganj ***ROAD***	13,780	NA	100%		
Badarpur-Faridabad Elevated (Toll) ***ROAD***	5,720	November-10	100%	1,716	1716
Dhule-Palasner (Toll) ***ROAD***	14,200	June-12	37%	1,314	690
Nirmal BOT (Annuity) ***ROAD operational***	3,160	November-09	100%	630	630
Total	**55,390**			**10,254**	**3036**

Source: Company data, Goldman Sachs Research estimates.

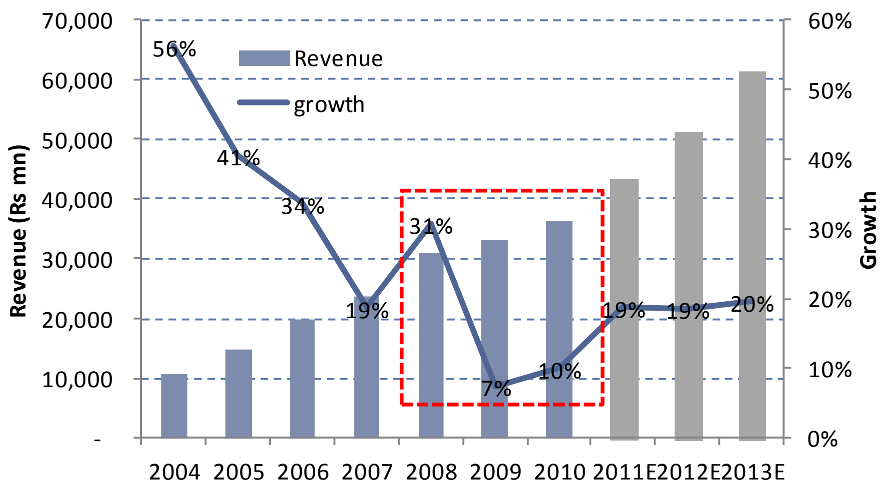
Execution and working capital management remain concerns

HCC is one of the oldest listed companies in the construction space and has displayed a strong ability to execute large and complicated projects. However, between 2008 and 2010, revenue growth for HCC declined to 9% (vs. 35% CAGR over 2003-2008) on execution of some projects, particularly delays the Bandra-Worli Sea link, irrigation projects in Andhra Pradesh, and a few road projects carried out in HCC's capacity as an engineering, procurement and construction (EPC) contractor for National Highways Authority of India (NHAI).

Though we likely expect execution to pick up in the next few years and generate revenue CAGR of 19% over FY10-13E due to newer focus and the company's historically strong ability, the high working capital currently blocked in some of the projects and the high leverage will continue to affect the company's performance, in our view.

Some of the orders currently in the book are slow-moving, with Rs19 bn of the Sawalkote hydropower project yet to begin work and about Rs13 bn of irrigation projects in Andhra Pradesh. However, we believe execution of the new projects and a strong order inflow should enable the company's growth rate to revert back to historical levels.

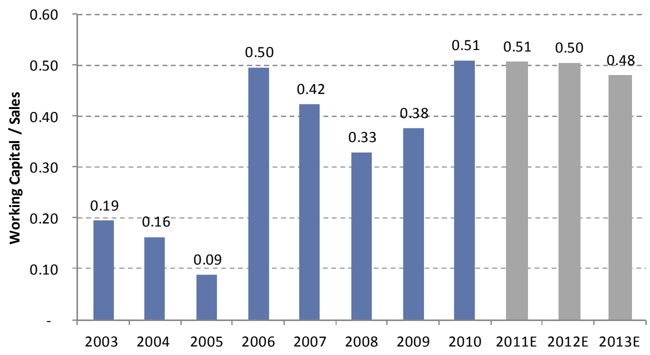
Exhibit 8: Revenue growth was flat between FY2008-10, but is now likely to be on track
Revenue for the construction business and growth rate



Source: Company data, Goldman Sachs Research estimates.

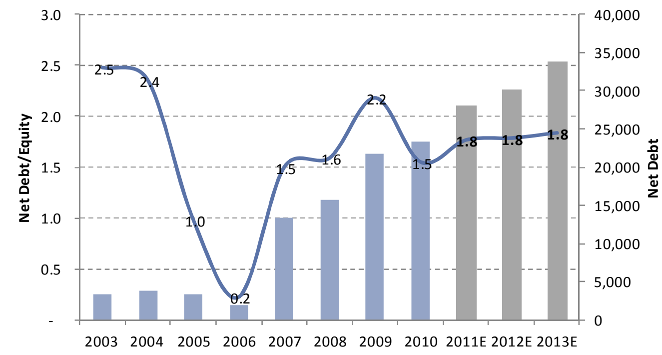
As a result of these delays, HCC had high working capital involved in the core construction business with almost 0.5X sales as of end-FY10. The company expects to receive Rs7.5 bn of claims in the medium term, which, if completed will help the funding needed.

Exhibit 9: A significant amount tied up in working capital…
Working capital/Sales over time



Source: Company data, Goldman Sachs Research estimates.

Exhibit 10: …as a result, leverage is also high and we expect it to remain so, at least through FY13E….
Net debt/equity over time

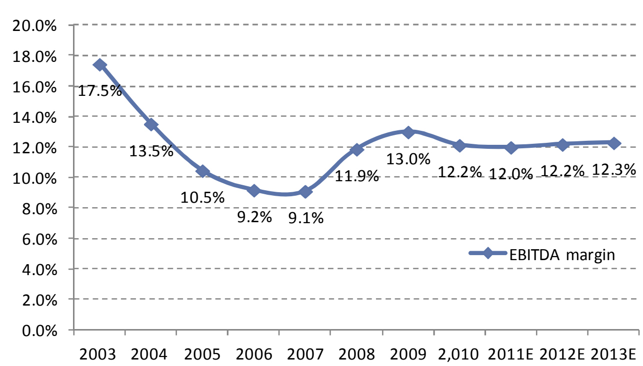


Source: Company data, Goldman Sachs Research estimates.

HCC has historically generated high operating margins at about 12%-13%, and we expect margins to remain in this range without a significant change in order mix. However, high debt could result in net margins in the sub-3% range on account of interest charges.

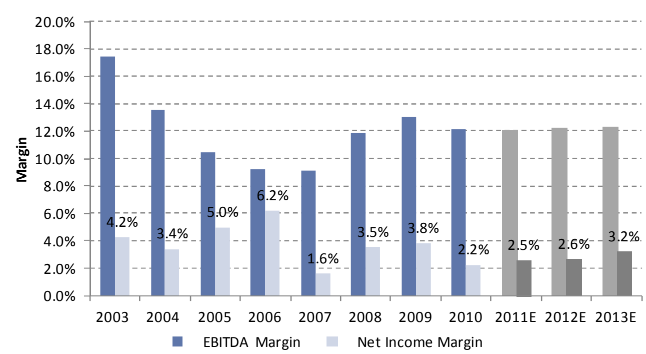
We expect HCC to continue generating positive operating cash flow, as has been the case in the past. However, the cash generated might not be sufficient to fund the company's future capex requirement, in our view.

Exhibit 11: Margins likely to stay in the about 12% range as the higher margin hydro business contribution increase to be dampened by increasing input costs...
EBITDA margins over time



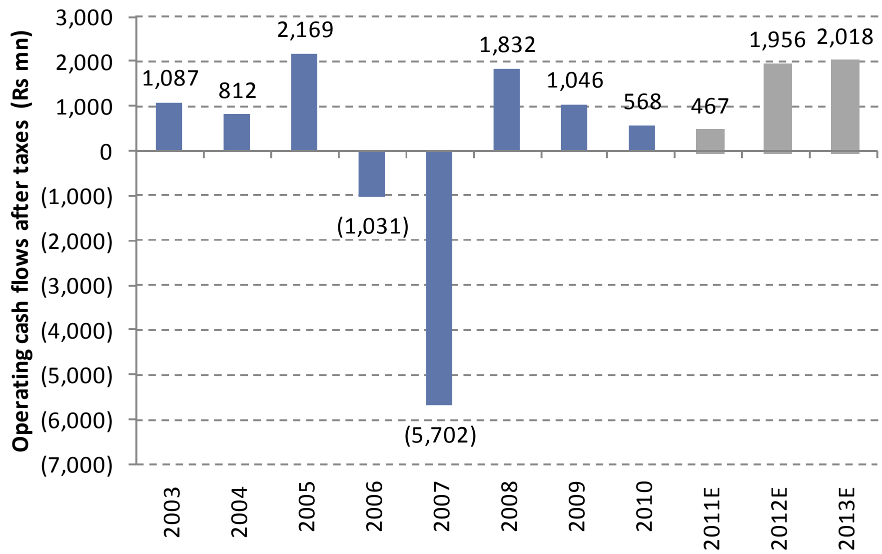
Source: Company data, Goldman Sachs Research estimates.

Exhibit 12: ......and net margins also likely to stay in the about 3% range given high financial costs...
EBITDA and EBIT margins



Source: Company data, Goldman Sachs Research estimates.

Exhibit 13: We expect HCC to generate positive operating cash flow
Operating cash flow after taxes (Rs mn)



Source: Company data, Goldman Sachs Research estimates.

We believe HCC will likely require Rs7,447 mn of investments in FY11E to fund the redemption of foreign currency convertible bonds (FCCB) and to fund its BOT projects, followed by Rs4,118 mn of equity requirement for BOT projects in FY12. We believe that the current cash in hand and the available credit limit with banks will be sufficient to fund these; however, any additional capex could require fund raising.

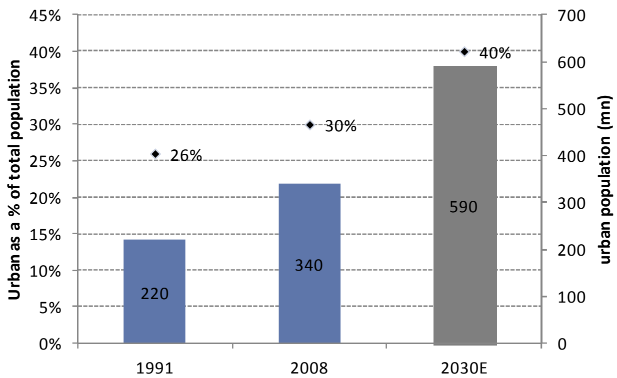
Urbanization to be a key theme in India

Based on a recent report by McKinsey, "India's urban awakening: Building inclusive cities, sustaining economic growth" on India's urbanization, 70% of new employment in India will be generated in cities and 40% of India's population will reside in urban areas by 2030 vs. 30% as of 2008. This is likely to put pressure on the existing cities and India is likely to have 68 cities with a population of more than 1 mn by 2030, up from 42 cities today.

Additionally, GS Global ECS Research highlighted in its July 28, 2010 report, *"Global Economics Paper No: 201: India's Rising Labour Force,"* that significant productivity gains in India's GDP over the next two decades could be due to urbanization.

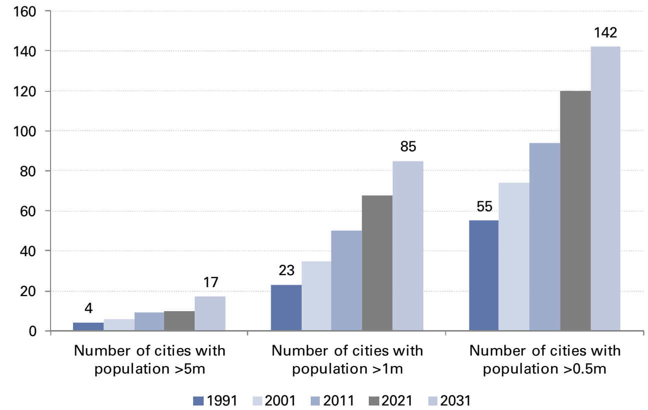
In the McKinsey report discussed above, India will require 20-25 new cities in the next 30 years located near the largest 20 metropolitans and provide adequate infrastructure. Five new cities are currently being planned in India based on the principle of new urbanization.

Exhibit 14: Large scale urbanization will likely occur in India over the next two to three decades...
Urban population expectation



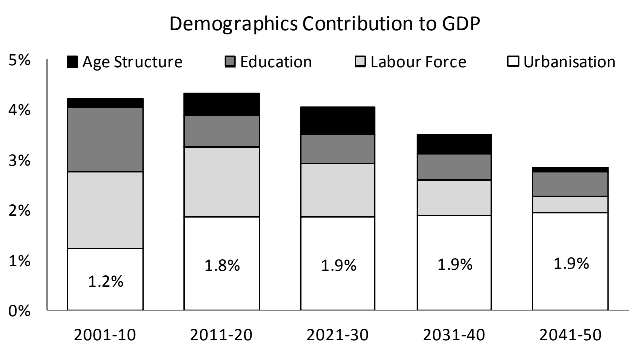
Source: McKinsey Research, Lavasa DRHP, Goldman Sachs Research estimates.

Exhibit 15: ...likely to put pressure on existing cities
Projections on number of new cities to open



Source: Ministry of urban development, WSA, Goldman Sachs Research estimates.

Exhibit 16: Urbanization will be key for India's GDP growth
Demographics contribution to GDP



Source: GS Global ECS Research estimates.

Exhibit 17: India may need 20-25 new cities in the next 30-40 years; five such planned cities are:
Some of the planned cities in India are along the Delhi-Mumbai Industrial Corridor

- Manesar-Bawal in Haryana
- Indore-Mhow in Madhya Pradesh
- Dighi and Nasik-Igatpuri in Maharashtra
- Dholera in Gujarat

Source: Goldman Sachs Research estimates.

HCC's subsidiary company, Lavasa Corporation Ltd. (LCL) (64.99% owned by HCC), plans to develop a hill city spread across 12,500 acres based on the concept of new urbanization with a self-sustained economy expected to be home to a permanent population of 0.3 mn. Lavasa Corporation Ltd. filed a draft prospectus for an IPO to raise about Rs20 bn to fund this development.

We have valued Lavasa on a free cash-flow-to-equity basis and arrive at equity value of Rs 31 bn (assuming a 25-year development period and following a developer model).

Lavasa could be the game changer for HCC, though developmental timeline appears aggressive...

Lavasa is a hill city with 12,500 acres of land aimed for development as a 365-day economy, meaning that Lavasa will not just be a weekend or tourist destination. Instead, it will be a holistic economy wherein LCL expects to share the revenue streams relating to the ongoing consumption and infrastructure businesses.

Lavasa lies in the busy and prosperous corridor of Mumbai-Pune economic zone and is about 200 kms from Mumbai and about 65 kms from Pune. It currently takes about four hours to reach Lavasa by road from Mumbai. However, the construction of a tunnel currently being carried out by HCC could reduce the travel time by one hour.

Lavasa has obtained a special planning authority (SPA) status from the government that allows it to develop the site without the need for regular permission and approval from the government.

The city will be run by the CSM (City Service Management) team, which will be a centralized city management agency for utilities and security.

Exhibit 18: Lavasa is within the Mumbai-Pune economic corridor

Route map to Lavasa

Source: Company data.

Exhibit 19: LCL plans to develop Lavasa as a hill city along Warasgaon Lake

Artist's impression of Lavasa (Dasve)

Source: Company data.

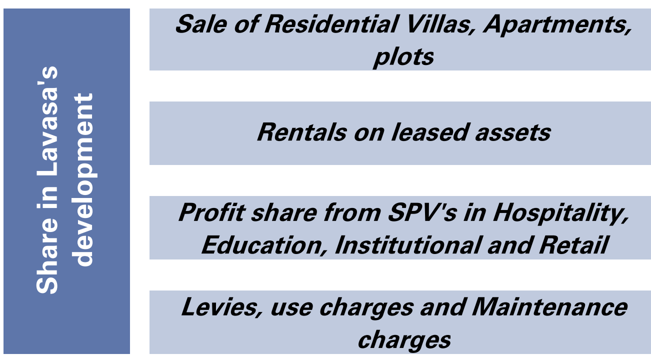
LCL plans to develop Lavasa by 2021, with a permanent population capacity of 0.3 mn and annual tourist traffic capacity of 20 mn. The city would be developed in various phases over the next 11 years, with cumulative development and sale of 199 mn sq ft of land. Some of the planned features for the city are included in exhibit 20.

Exhibit 20: The development plan for Lavasa appears comprehensive
Various facilities/amenities in existence and planned at Lavasa

- Convention centre with a capacity of 1,000 pax
- Apollo Hospital operational (bed capacity of 50)
- X-thrill adventure sports operational
- SBI opened its first branch in Lavasa
- Ashiana Housing is building ~200 retirement homes in the town
- 18-hole golf course designed by Nick Faldo
- Water-based theme park
- Hollywood/Bollywood-based theme park
- NASA theme park
- Manchester City (UK football club) Academy
- Apollo Medical City (research centre)
- Symbiosis is setting up an education facility

Source: Company data, Goldman Sachs Research.

Exhibit 21: How will LCL benefit from the development of Lavasa?
Various revenue streams to LCL



Source: Company data, Goldman Sachs Research estimates.

Exhibit 22: How will the phased development happen by 2021?
Phased development plans for Lavasa and current status

Phase	Town name	Area (acres)	End use	Current state
Phase I	Dasve	1,416	Residential, Hospitality	Late stage of construction
Phase II	Mugaon	2,466	Residential, Entertainment, Institutional	Construction started
Phase III	Dhamanhole	4,165	Commercial, Institutional	Construction to commence in 2012
Phase IV	Gadle	4,507	Commercial, Institutional	Planning stage

Source: LCL DRHP, Company data, Goldman Sachs Research.

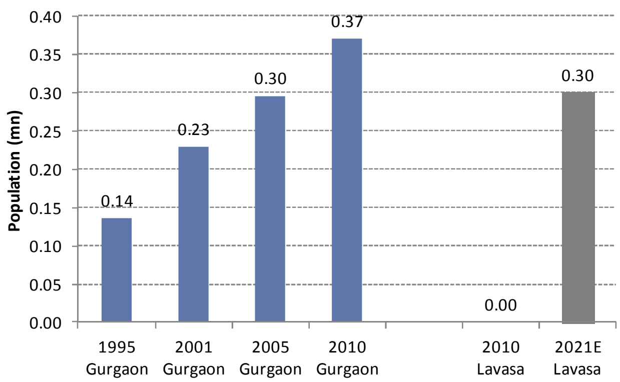
Based on management's developmental plans and **our visit to Lavasa**, we feel strongly about the management plans and vision for the development of Lavasa. Management is taking the right steps, in our view, and entering into meaningful partnerships for the development of the hill city. However, we think that the timeline for the project is aggressive and the city could take longer than management estimates to develop Lavasa as a self-sustainable city with a permanent population of 0.3 mn for the following reasons:

- Most of the real-estate sales in Lavasa in Phase-1 appear to be investment grade or weekend homes.
- Total area sold/developed is 11 mn sq ft (as of the date of the prospectus filing) vs. 21 mn sq ft planned by the end of 2011. Selling 131 mn sq ft of residential land by 2021 looks aggressive, in our view, unless there is already a permanent resident population.
- There is currently no direct railway connection and the nearest airport is 72 kms from Lavasa. The hilly terrain of Lavasa limits the development of such transportation infrastructure.
- Employment opportunities are currently not available, except for people working directly on the Lavasa project.

We draw a **comparison of Lavasa to Gurgaon**, as highlighted in LCL's prospectus, and conclude that the fast pace of Gurgaon's development can be attributed to the following:

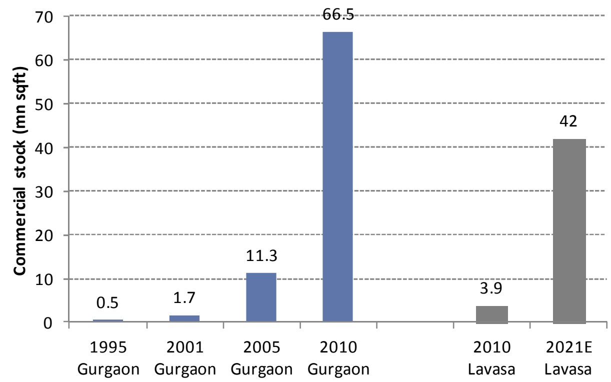
- Proximity to New Delhi: Gurgaon is 30 kms south of National Capital New Delhi.
- Proximity to an international airport: Gurgaon is 10 kms from Delhi Int'l Airport.
- Huge population commuting daily between Delhi and Gurgaon.
- Gurgaon had a basic city infrastructure; it was not a Greenfield development.

Exhibit 23: It took Gurgaon city 15 years to reach a population of 0.37 mn from 0.14 mn in 1995



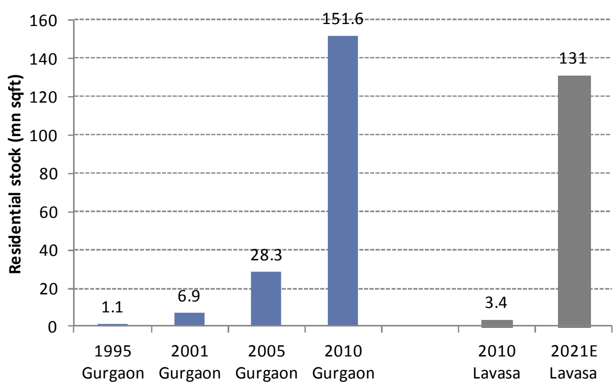
Source: LCL prospectus, Goldman Sachs Research.

Exhibit 24: As jobs were created, commercial spaces were developed in Gurgaon



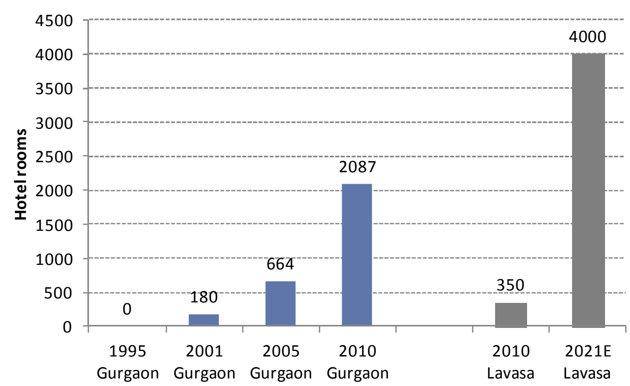
Source: LCL prospectus, Goldman Sachs Research.

Exhibit 25: Similarly, residential spaces developed and sold…



Source: LCL prospectus, Goldman Sachs Research.

Exhibit 26: Gurgaon city still has fewer rooms than what Lavasa is expected to have by 2021



Source: LCL prospectus, Goldman Sachs Research.

Here, we do not doubt the development of Lavasa but think that it will not be developed at the pace expected by management, i.e., it could take longer to develop.

In our view, the phasing out of Lavasa will be slower than management's estimates and that the city will be developed by 2035 (25 years) instead of 2021 (11 years) because cities of this magnitude can only develop when there is sufficient employment generated, which could take some time. In addition, because Lavasa is under the Hill Station Act, limited industrial development can take place in the hill city.

Exhibit 27: LCL expects to develop Lavasa by 2021; we think it could take longer
Timeline for the development of Lavasa based on management and GS estimates

LCL management estimates	Phase - 1 (2008-11)	Phase - 2 (2012-14)	Phase - 3 (2015-18)	Phase - 4 (2019-21)	Total (mn sq.ft)
Total (mn sq.ft.)	**21**	**43**	**70**	**66**	**199**
Residential	5	24	36	66	**131**
Commercial	1	8	33	0	**42**
Hospitality	4	1	0	0	**5**
Institutional	6	5	0	0	**11**
Social Infrastructure	5	5	1	0	**10**

GS estimates	Phase - 1 (2008-11)	Phase - 2 (2012-14)	Phase - 3 (2015-18)	Phase - 4 (2019-21)	Phase - 5 (2022-35)	Total (mn sq.ft)
Total (mn sq.ft.)	**15**	**16**	**26**	**18**	**50**	**123**
Residential	5	8	11	12	45	**80**
Commercial	1	4	10	6	5	**25**
Hospitality	2	1	1	0	0	**4**
Institutional	4	2	3	0	0	**8**
Social Infrastructure	3	2	2	0	0	**7**

Source: LCL DRHP, company data, Goldman Sachs Research estimates.

We think that the following are essential for the development of Lavasa:

- There has to be **generation of employment for the population** of Lavasa. As seen historically, once there is employment generation it will be easier to generate a permanent population.
- For soft industries to develop at a fast pace, there has to **some sort of benefit for companies to set up research centers and software development offices in Lavasa**.

Valuation: Upside may be driven by potential listing of Lavasa

We value HCC using sum-of-the-parts (SOTP) methodology to arrive at a base case 12-month target price of Rs67. We value the core construction business at 12X 12-month forward earnings which are at a 10% discount to the other construction peers like Nagarjuna Construction and IVRCL on account of lower returns and higher leverage.

We value the operational Nirmal BOT project on a free-cash-flow-to-equity basis, and the BOT projects under development based on equity invested into the projects.

We value Lavasa using a developer approach, with 123 mn sq ft (we only value the land currently under possession) being developed and sold in a phased manner keeping the proportion of Residential, Commercial, Retail, institutional, hospitality and social infrastructure close to LCL's estimates and phasing the development over 25 years.

We do not value the annuity businesses as such, given the current lack of visibility on the resident population for the hill city, and therefore value it on a developer model.

Exhibit 28: HCC – sum-of-the-parts valuation

Valuation	Valuation Methodology	Value per share (Rs)	% contribution to SOTP value
Construction business	**12 X FY12E EPS**	**26.7**	**40%**
Operational BOT road projects	**FCFE @ 13% COE**	**1.3**	**2%**
Under dev. BOT road projects	**1 X Equity invested**	**4.0**	**6%**
Lavasa	**FCFE @ 14% COE**	**33.1**	**50%**
Real estate	**deal value**	**1.7**	**2%**
Total		**67**	**100%**

Source: Goldman Sachs Research estimates.

Our assumptions in the valuation of Lavasa are shown in the exhibits below.

Exhibit 29: Our assumptions to value Lavasa as a developer is based the following assumptions
List of assumptions used

- Selling price and development cost increase by 5% p.a
- Infrastructure expenses to be incurred as planned
- 14% COE assumed
- 10% interest rate and debt repayment as per schedule

Source: Goldman Sachs Research estimates.

Exhibit 30: We assume the price and cost of construction will increase by 5% annually
Selling price and cost of development

Development (Rs/sqft)	Price	Cost
Residential	3000	1550
Commercial	3250	1700
Hospitality	4000	2200
Institutional	2250	1100
Social Infrastructure	2000	1000

Source: Goldman Sachs Research estimates.

Exhibit 31: Value of Lavasa shows great sensitivity to selling price as well as cost of construction
Sensitivity of Lavasa valuation to selling price and cost of construction (5% range)

		Weighted average construction cost (Rs/sqft)				
	33	**1,295**	**1,367**	**1,439**	**1,511**	**1,583**
Weighted average selling price (Rs/sqft)	**2,383**	29	26	23	20	17
	2,523	32	29	26	23	20
	2,663	36	33	30	27	24
	2,804	39	36	33	30	27
	2,944	43	40	37	34	31
	3,084	46	43	40	37	34
	3,224	49	46	44	41	38

Source: Goldman Sachs Research estimates.

However, with the **Lavasa IPO likely to occur, we find the risk-reward profile may shift in favor of HCC** and we present HCC's valuation in a scenario analysis in Exhibit 32.

We believe that if the development of Lavasa occurs as planned by 2021, then there is significant upside risk to our target price.

Exhibit 32: Scenario analysis
Scenario analysis of HCC's implied valuation

	Bear case	Base case	Bull case
	Value of Capital employed so far	123 mn sqft developed by FY2035 (25 years)	199 mn sqft developed by FY2021 (11 years)
EV (Rs mn)	27500	49060	106667
EV (US$ bn)	*0.61*	*1.09*	*2.37*
Price per HCC's share	15	33	95
Value of other businesses	34	34	34
Implied valuation (Rs)	***49***	***67***	***128***

Source: Goldman Sachs Research estimates.

Exhibit 33: HCC trades as expensive relative to other Indian construction companies and generates lower returns (Parent basis)
Valuation table for India construction stocks

Ticker	Company	Rating	Mkt cap $ mn	Current price (Rs)	12-m target price (Rs)	Potential upside/(downside)	FY11 P/E (X)	FY12 P/E (X)	FY11 P/B (X)	FY12 P/B (X)	FY11 ROE	FY12 ROE
HCNS.BO	**Hindustan Construction**	**Neutral**	**821**	**61.20**	**67.00**	**9%**	**36.1**	**27.5**	**2.3**	**2.2**	**6%**	**8%**
NGCN.BO	Nagarjuna Construction Company	Neutral	808	142.40	192.00	35%	15.9	13.2	1.5	1.4	9%	10%
PUJL.BO	Punj Lloyd	Neutral	906	123.40	145.00	18%	17.5	11.9	1.3	1.1	7%	9%
IRBI.BO	IRB Infrastructure Developers	Buy*	1,816	247.10	338.00	37%	15.5	12.8	3.3	2.7	20%	20%
IVRC.BO	IVRCL Infrastructure and Projects	Neutral	800	135.45	157.00	16%	14.4	11.1	1.2	1.1	7%	9%
JAIA.BO	Jaiprakash Associates	Buy	5,986	128.05	169.00	32%	19.5	15.6	2.9	2.5	15%	16%
LART.BO	Larsen & Toubro	Neutral	26,927	2,080.85	2,109.00	1%	30.2	23.7	5.2	4.4	16%	18%
	Median (ex HCC)						**16.7**	**13.0**	**2.2**	**1.9**	**12%**	**13%**

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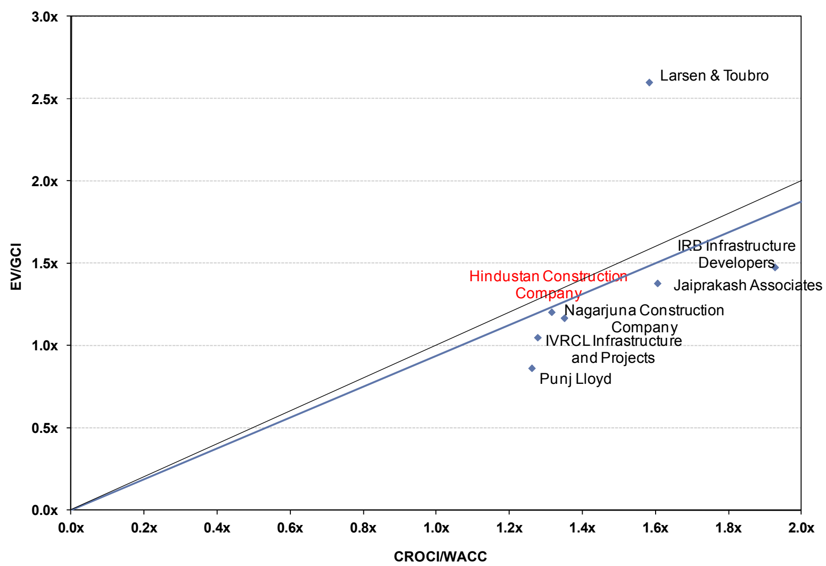
Source: Datastream, Goldman Sachs Research estimates.

Exhibit 34: HCC looks fairly valued using Director's Cut methodology
FY12E EV/GCI-CROCI/WACC for Indian construction companies



Source: Datastream, Goldman Sachs Research estimates.

Key risks

Downside

- Failure of the Lavasa IPO could result in a shortage of development funds required for the project.
- The company is hopeful it will recover a portion of the claim filed with various clients to help reduce the working capital involvement in the business; failure to recover a portion of the claim could result in working capital involvement being high and an increase in leverage.
- Increase in commodity and construction material prices.

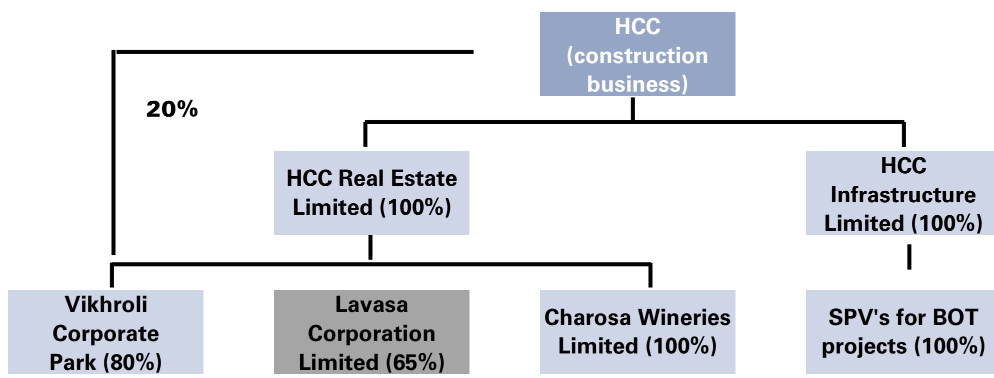
Upside

- Successful IPO for Lavasa could help unlock value and affect the valuation of the parent company (HCC).
- Tie-up with any soft industry to start set up in Lavasa will help the migration of a permanent population to the hill city and speed up value creation from the asset.
- Stronger order inflow translating in higher billings and improved working capital management.

Company profile

HCC has built several landmark projects in India's hydro power and water resources sector, with at least 10 of these projects situated in the geologically challenging Himalayan region. HCC has a track record of executing over 321 bridges, 43 dams and barrages, 15 hydel power plants and 11 nuclear reactors, 160 kms of tunneling and 2,227 kms of roads and expressways.

Exhibit 35: Business structure
Business structure for HCC



Source: Company data.

Reg AC

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