India construction

Slow earnings recovery

Construction

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- **Order inflows likely to revive, but not rapidly**
  On average, companies in our coverage universe saw a 22% decline in order booking in 4Q FY09 and grew just 8% in entire FY09 (pulled up mainly by strong order inflow for HCC, which grew 143% YoY). We expect an improvement in FY10, but the pick-up in order flow will likely remain moderate owing to high fiscal deficit restraining government spending and a slowdown in private-sector capex. We estimate order inflow growth of 15–20% in FY10 (-50% for HCC, due to the high base in FY09) and 20–25% in FY11.
- **Earnings growth to be much lower than pre-FY09 levels, in the near term**
  After a rather forgettable FY09, earnings are likely to pick up from the current fiscal onwards. However, earnings growth is unlikely to reach pre-FY09 levels in a hurry. For companies in our coverage, we expect earnings CAGR of 17% over FY09–11E compared to 52% in FY03–08. We expect slow recovery on account of: (1) low revenue visibility (owing to low order inflows in FY09); (2) depressed EBITDA margins; and (3) high interest costs (despite a significantly lower cost of debt).
- **Quality of earnings remains weak, equity dilution risk lingers**
  Our biggest concern about the sector has been negative cash flows generated primarily due to an elongating working capital cycle. We expect the cycle to remain stretched, resulting in: (1) low or negative cash flows; (2) rising debt and low interest coverage; and (3) low return ratios (with ROIC below 12%). This will eventually lead to a series of equity dilutions, as was seen in the past.
- **Optimism is overdone, we are cautious on the sector**
  Post election results, all construction stocks have run up significantly on the back of optimism that the new government will push infrastructure spending aggressively. We believe an improvement in earnings is likely to be gradual rather than dramatic, thus leaving room for disappointment. Thus, we believe that construction stocks are not likely to trade at the high multiples they commanded in 2007-08. We are upgrading Simplex to **Buy** based on our revised valuation and maintain our **Sell** rating on HCC, IVRCL and NCC.

Figure 1: Ratings and target prices (in descending order of preference)

Units as shown

	Rating	CMP (Rs)	Target price (Rs)		
			Old	New	Upside
Simplex	Buy	374	153	461	23%
IVRCL	Sell	325	125	279	-14%
NCC	Sell	133	66	113	-15%
HCC	Sell	108	42	78	-28%

Source: Bloomberg, Reliance Equities estimates. Note: All data in this report is priced at COB 16 June 2009.

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Order inflows likely to revive, but not rapidly

A significant slowdown in order flow in the last few months

In 4Q FY09, there was a significant slowdown in new orders, with construction companies in our coverage universe reporting a decline of 22% YoY on an aggregate basis. IVRCL and NCC reported declines of 64% and 66%, respectively, while Simplex saw a 37% decline. However, HCC managed to buck the trend quite handsomely, growing its order book by 101%. The slowdown in order flow was primarily on account of: (1) a slowdown in government order flows owing to the general elections; (2) a complete halt to new order announcements in the international segment (primarily in the Middle East); and (3) a slowdown in industrial capex across sectors like metals, oil & gas, etc. However, order flows in sectors like hydropower and building structures (primarily social infrastructure like government buildings) have remained robust.

Figure 2: Net order inflows

Rs million (unless shown otherwise)

	4Q FY08	4Q FY09	% change	FY08	FY09	% change
HCC	21,600	43,361	101%	39,280	95,557	143%
IVRCL	25,967	9,305	-64%	81,436	78,819	-3%
NCC	28,841	9,750	-66%	74,860	54,900	-27%
Simplex	19,934	12,500	-37%	66,807	55,000	-18%
	96,342	**74,916**	**-22%**	**262,383**	**284,276**	**8%**

Source: Company data, BSE announcements. Note: In the case of Simplex, FY09 number is an estimate.

Revival of order flow will likely be constrained

Between FY04 and FY08, the order backlog of the construction companies under our coverage grew a staggering 44% CAGR on average. While we expect order inflow to revive from FY10, we believe the pace of order inflow growth is unlikely to return to pre-FY08 levels in the near term on account of: (1) a high fiscal deficit, which will restrain government spending; (2) a slowdown in private sector capex, which will take time to pick up steam, and (3) a significantly high base: all the construction companies under our coverage having order books in excess of US$ 2-2.5 billion dollar, which is 3-4 fold higher than the order book seen at the beginning of FY04. Thus, we expect moderate order inflow growth of 15–20% in FY10 (except HCC, where we expect a 50% decline owing to the high base of FY09) and growth of 20–25% in order inflows in FY11.

Figure 3: Order inflow estimates

Rs million (unless shown otherwise)

	FY09	FY10E	% change	FY11E	% change
HCC	95,557	47,779	-50%	57,334	20%
IVRCL	78,819	90,642	15%	108,770	20%
NCC	54,900	65,880	20%	82,350	25%
Simplex	55,000	66,000	20%	82,500	25%
	284,276	**270,300**	-5%	**330,954**	22%

Source: Reliance Equities estimates. Note: In the case of Simplex, the FY09 number is an estimate.

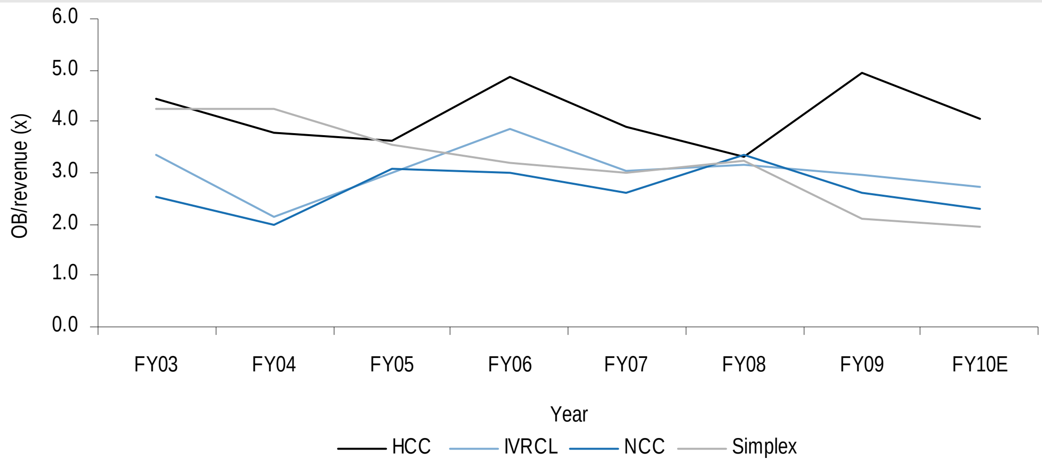
Earnings growth to remain low for the next two years

Revenue growth visibility is the lowest since FY05

Owing to a slow accretion in orders over the past few quarters, the order book-to-revenue ratio, a key indicator of revenue visibility, is currently near its lowest level since FY05. This is especially so for players with higher exposure to private sector spending viz. NCC and Simplex (among the companies we cover). Moreover, as discussed above, the order inflow growth is also likely to remain moderate in the near term. Thus, we expect revenue growth to remain moderate, with a CAGR of 23%, 25%, 15% and 17% for HCC, IVRCL, NCC and Simplex, respectively, over FY09–11. However, a significant pickup in order flow in FY11E would lay a strong foundation for growth and remain an important factor to monitor.

Figure 4: Revenue visibility

x



Source: Company data, Reliance Equities estimates. Note: In the case of Simplex, the FY09 number is an estimate.

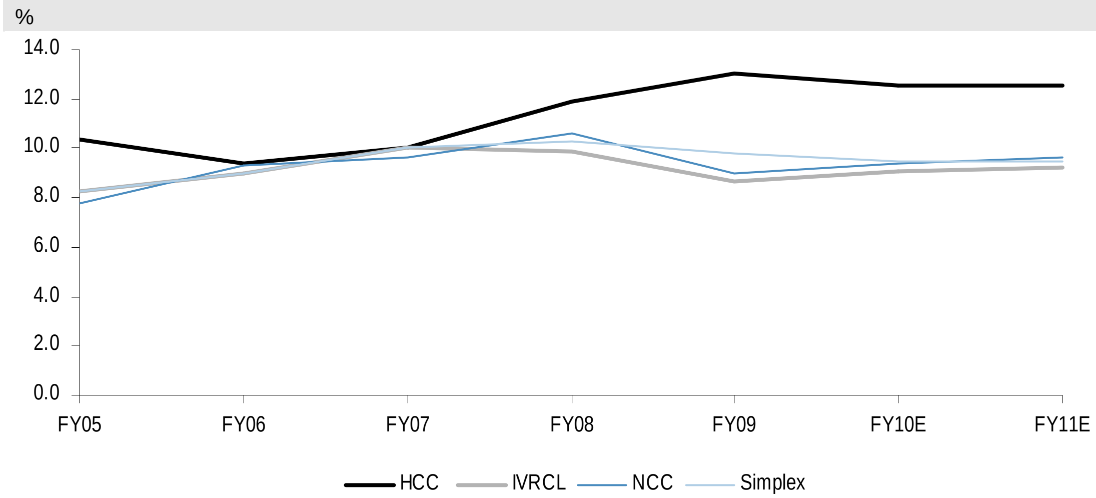
EBITDA margins likely to remain under pressure

Margins declined significantly over the past two quarters owing to various company-specific issues and are likely to remain under pressure mainly on two counts, viz. (1) lower margins in orders won in FY09 due to competitive pressure; and (2) an increasing share of public-sector orders versus private sector (including international) orders.

As the order flows have dried up significantly since the second half of FY09, we believe the orders that would have come up for bidding in this period would have seen increased competition as all the contractors vie for a small pie of available orders. Also, most of the available orders are likely to come from the public sector, as we expect private-sector spending to remain low in the near term. As these new orders start contributing to revenues in FY10 and FY11, EBITDA margins will likely remain under pressure. This is already visible in segments like irrigation, which has seen increased competition recently, as it has been one of the segments where order flow was robust. We do not think falling input costs will help improve margins because just as the impact of rising costs was largely negated by price variation clauses (PVC), falling prices are likely to benefit clients rather than contractors.

Having said that, companies which saw large margin declines in FY09 (IVRCL: –130 bps, NCC: –160 bps) are likely to see improvement from the low base (we estimate 60 bps expansion for both IVRCL and NCC), but are unlikely to reach FY08 levels in the near term. We expect a decline of 50 bps and 30 bps for HCC and Simplex, respectively (please see the company section for details).

Figure 5: EBITDA margin estimates



Source: Company data, Reliance Equities estimates. Note: In the case of Simplex, the FY09 number is an estimate.

Cost of debt is falling, but interest costs will continue to rise

We expect the cost of debt to fall significantly in the near term and interest cost growth to moderate, but interest costs in absolute terms will continue to rise as funding needs remain high.

Figure 6: Interest cost estimates

Rs million (unless shown otherwise)

	FY09	FY10E	FY11E	CAGR
HCC	2,105	2,446	2,913	17.6%
IVRCL	1,306	1,581	1,992	23.5%
NCC	964	1,278	1,558	27.2%
Simplex	1,398	1,650	1,869	15.6%

Source: Company data, Reliance Equities estimates. Note: In the case of Simplex, the FY09 number is an estimate.

Earnings growth unlikely to return to pre-FY09 levels in the near term

After a rather forgettable FY09, earnings are likely to pick up from the current fiscal. However, earnings growth is unlikely to reach pre-FY09 levels in a hurry (for companies in our coverage universe, we forecast a CAGR of 16% over FY09–11 compared to 52% during FY03–08). We expect a slow recovery on account of: (1) low revenue visibility (owing to low order inflows in FY09); (2) depressed EBITDA margins; and (3) high interest costs (despite a significantly lower cost of debt).

Figure 7: Adjusted PAT estimates

Rs million

	FY03	FY08		FY09	FY11E	
HCC	287	834	24%	760	1,306	31%
IVRCL	155	2,176	70%	2,260	2,989	15%
NCC	183	1,641	55%	1,539	2,071	16%
Simplex	63	901	70%	1,393	1,842	15%
Total	**688**	**5,551**	**52%**	**5,951**	**8,208**	**17%**

Source: Company data, Reliance Equities estimates. Note: In the case of Simplex, the FY09 number is an estimate.

Earnings quality remains weak

Length of working capital cycle continues to be a worrying factor

The elongating working capital cycle has been one of our biggest concerns about the sector, as that has led to huge negative operating cash flow generation in the past five years of high growth (see figure below). The situation on this front seems to have gone from bad to worse during FY09 as most of the companies have struggled to keep their working capital cycle under control. A direct result of this has been a mounting debt burden and increasing interest cost.

Figure 8: Negative operating cash flow generation

Rs million (unless shown otherwise)

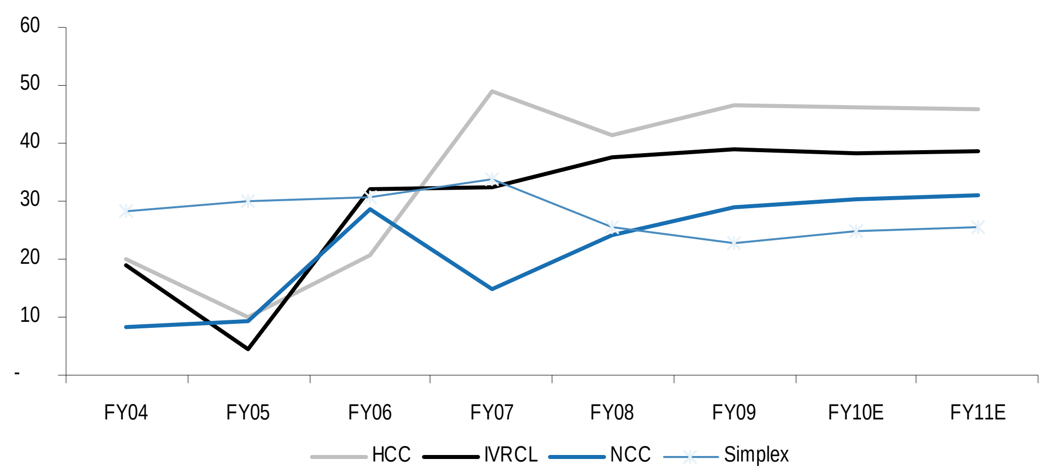
	Sales CAGR growth	PAT CAGR growth	Total PAT	Operating cash flow
HCC	26%	16%	4,697	-2,425
IVRCL	45%	49%	7,276	-9,956
NCC	41%	37%	5,924	-7,251
Simplex	49%	70%	3,462	23
Overall	***40%***	***40.9%***	**21,358**	**-19,609**

Source: Company data, Reliance Equities estimates. Note: Data is for FY05–09E. Note: In the case of Simplex, the FY09 number is an estimate

Going forward, as revenue growth moderates, we expect the working capital cycle to remain stable at the current level. However, going by the performance in the past five years, one cannot ignore the possibility of further extension of the cycle, which would mean higher capital requirement and, therefore, higher interest cost.

Figure 9: Adjusted working capital estimates

As a % of sales



Source: Company data, Reliance Equities estimates. Note: (1) In the case of Simplex, the FY09 number is an estimate. (2) We have adjusted working capital for any loans and advances given to non-construction subsidiaries.

Results in low/negative cash flows and suppressed return ratios

While earnings growth appears to be robust given the present tough economic scenario, a closer look suggests the quality of earnings will remain weak with (1) low or negative operating cash flows; (2) falling interest cover; and (3) ROICs at the sub-12% level.

Figure 10: Quality of earnings

Units as shown

	Op. cash flow/net income (x)		Interest cover (x)		ROIC (%)	
	FY10E	FY11E	FY10E	FY11E	FY10E	FY11E
HCC	0.93	1.49	1.6	1.6	7.4	8.3
IVRCL	-0.22	0.25	3.2	3.2	10.8	11.2
NCC	0.41	1.13	3.2	2.9	10.0	10.1
Simplex	0.42	1.24	2.4	2.4	11.0	11.3

Source: Reliance Equities estimates.

Risk of equity dilutions looms

During the period of high growth (FY04–08), construction companies saw a series of equity dilutions in order to fund the negative cash flows and investments in non-core businesses. Even at the end of FY09, the balance sheets of these companies continue to remain stretched. As revenue growth resumes, we expect the need for funds to rise further, leading to further equity dilution.

Figure 11: Major equity dilutions in the past five years

Units as shown

	Year	Mode	Price	Amount	Dilution
			(adj. Rs/shr)	(Rs bn)	
Gammon	FY05	Pref. issue	101	0.9	17.8%
	FY05	GDR	115	0.5	
	FY06	GDR	420	4.3	11.2%
HCC	FY05	Pref. issue	45	1.3	12.7%
	FY06	GDS	165	4.5	10.5%
IVRCL	FY05	Pref. issue	50	1.5	37.0%
	FY06	Public issue	77	1.5	20.0%
	FY07	QIP	370	5.5	17.5%
	FY07	FCCB	234	2.7	
NCC	FY04	Pref. issue	14	0.3	17.5%
	FY05	Pref. issue	28	1.0	28.0%
	FY06	GDR	117	5.5	23.0%
	FY08	Pref. issue	203	4.1	8.9%
Simplex	FY06	Pref. issue	163	1.1	15.0%
	FY08	QIP	625	4.1	13.3%

Source: Company data, Reliance Equities research.

Optimism is overdone, we are cautious on the sector

Raising our target prices to factor in the improved scenario
In our initiation of coverage note (*Construction: No Cash*, 11 December 2008), we had argued for a low price-to-earnings multiples of 5x for the sector owing to two key concerns:

- **Basic industry characteristic:** Lack of pricing power, which leads to low operating margins and a stretched working capital cycle, in turn leading to negative cash flows and suppressed return ratios;
- **Immediate challenges:** The significant order inflow slowdown and funding constraints will hurt growth.

With increased expectations of economic recovery speeding up and a significantly better funding scenario, the second concern above is significantly lower and we now expect improvement in earnings growth from FY10 onwards. With this in mind, we are rolling over our valuation multiples and basis to FY11 estimates and we also move to a more robust valuation methodology for arriving at fair values. We are now valuing our core construction companies based on a weighted average of three valuation methods, with equal weights assigned to each:

- EV/EBITDA multiple—a 45-55% discount to our target EV/EBITDA multiple for L&T (13.4x). We prefer to take L&T as our base, as it is the only company in the E&C space with a reasonable trading history. However, we apply the discount to factor in:
  - *Size:* Construction companies under our coverage are just 10–15% of L&T in terms of sales.
  - *Capability:* L&T's presence and execution capabilities are much wider.
  - *Significantly better earnings profile:* Consistent operating cash flows and superior return ratios.

  Our target multiple for L&T is based on the higher end of the trading range during FY01–05. We prefer this period as we believe the current scenario of economic recovery resembles that period to a great extent. We take the higher end of the trading range during the period to factor in any positive surprise on earnings.

  We have taken a discount of 50% in case of NCC and IVRCL. However, we have taken a higher discount of 55% in the case of HCC to factor in the relatively weak balance sheet strength. We give a lower discount (of 45%) in case of Simplex on account of: (1) stronger working capital management resulting in better operating cash flows, and (2) strong execution capabilities and management bandwidth.
- P/E multiple—a 45-55% discount to the implicit P/E multiple for L&T at our target valuation.
- DCF, assuming a WACC of 12.5% for HCC and Simplex and 13.5% for IVRCL & NCC.

Revisions in valuation of non-construction businesses
We are also revising target valuations for the non-construction businesses of our coverage universe to factor in increased risk appetite. We make the following changes in assumptions:

- *Infrastructure development:* For road BOT projects, we are reducing our long-term debt cost assumption by 100 bps to 10% for annuity-based projects and 11% for toll-based projects. We are also lowering our WACC assumption by 100 bps to 15% for annuity projects and 16% for toll-based projects.

- *Real estate:* We had earlier valued real estate businesses on the basis of 0.3x FY10E P/BV (except in the case of HCC's Lavasa project, which we value on the basis of a mix of net present value and net realisable value methods). In line with the recent re-rating of real estate stocks, we are raising our target multiple to 0.7x FY11E P/BV.

Figure 12: Non-construction business valuations

Rs/share

	Infra development	Real estate	Others	Total non-construction	TP	% of TP
HCC	6	36	-	42	78	53.7%
IVRCL	30	28	12	69	279	24.8%
NCC	8	12	13	33	113	29.0%
Simplex	-	-	6	6	461	1.3%

Source: Reliance Equities estimates.

Remain cautious on the sector

After the election results, almost all construction stocks have run up significantly on the back of optimism that the new government will push infrastructure spending aggressively. We believe any improvement in earnings is likely to be gradual rather than dramatic, thus leaving room for disappointment. Thus, we believe that construction stocks are not likely to trade at the high multiples (15-20x, adjusting for the values assigned to non-construction business) they commanded in 2007-08. We are upgrading Simplex to **Buy** based on our revised valuation and maintain a **Sell** on HCC, IVRCL and NCC.

Figure 13: Ratings and target prices

Units as shown

	Rating	CMP (Rs)	Target price (Rs)		
			Old	New	Upside
HCC	Sell	108	42	78	-28%
IVRCL	Sell	325	125	279	-14%
NCC	Sell	133	66	113	-15%
Simplex	Buy	374	153	461	23%

Source: Bloomberg, Reliance Equities estimates.

Figure 14: Implied P/E at the current market price and our target price

Units as shown

	CMP (Rs)	Implied P/E (x)		TP (Rs)	Implied P/E (x)	
		FY10E	FY11E		FY10E	FY11E
HCC	108	17.1	12.9	78	9.4	7.1
IVRCL	325	13.9	11.6	279	11.4	9.5
NCC	133	12.1	11.1	113	9.7	8.9
Simplex	374	11.7	9.9	461	14.5	12.3

Source: Reliance Equities estimates. Note: Adjusted for value of the non-construction business.

Key risks to our call

- **Order inflow growth higher than estimated:** This is the biggest risk to our call, as better-than-expected order inflow growth would provide: (1) superior revenue growth visibility; and (2) better margins in new orders and, therefore, superior earnings growth.
- **Significant improvement in working capital cycle:** Cash flows of construction companies are negative mainly on account of an elongating working capital cycle. Any government initiative to improve terms of payments/advances for infrastructure projects would prove to be a great boost to contracting companies.
- **During the boom of 2006–08, construction stocks traded at much higher multiples:** The infrastructure story of India was discovered somewhere in 2005 and this was followed by a massive re-rating of all stocks related to infrastructure, especially ones in construction. Stocks which used to trade at 2–3x forward earnings until FY04 went up 10–15x in terms of multiples. This was partially aided by huge valuations assigned to non-construction businesses, real estate in particular. Even adjusting for embedded values, construction businesses were being assigned P/Es of close to 20x. We firmly believe that such high multiples are unwarranted given the low earnings quality and huge pile of negative cash flows being generated.
- **Can embedded value come back into favour?** The non-construction businesses viz. real estate, infrastructure development, etc. form an important part of valuations for almost all the construction companies. During the last bull rally (between FY06 and FY08), these businesses commanded much higher valuations despite their nascent stage and relatively risky nature. However, when the market turned in the last year or so, embedded values suddenly became a foul word. Most of these business initiatives continue to be at a nascent stage and are fraught with risks. An increased risk appetite could see embedded value coming back into favour.

Hindustan Construction Company

Stretched balance sheet

Sell

Rs 108

Target price: Rs 78

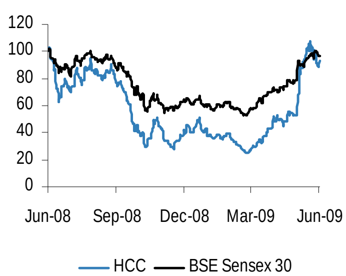
Bloomberg code	HCC IN
Reuters code	HCNS.BO
3m avg. traded value (Rs m)	591.5
52-wk H/L (Rs)	128.9/28.8
Sensex	14958
Mcap (US$ m/Rs bn)	577.4/27.6

Shareholding (%)	Mar-09	Dec-08
Promoters	47.2	47.2
MFs, FIs, banks	18.6	20.4
FIIs	8.7	6.6
Others	25.6	25.8

Stock performance (%)	1m	6m	1yr
Absolute	76.0	123.4	-6.9
BSE 30 index	22.9	49.9	-2.8

Share price performance

Base=100



Source: Bloomberg, Capitaline.

- **Huge funding requirement, QIP will not help much**
  At end-FY09, Hindustan Construction Company (HCC) had a net debt-equity ratio of 2.2x on a standalone basis and 4.4x on a consolidated basis. The company is also likely to have huge funding requirements over the next two years: ~Rs 6 billion for its construction business; ~Rs 2 billion for BOT projects' equity investment; and ~Rs 5 billion for the Lavasa project. FCCB repayment of ~Rs 5 billion is also due by March 2011. HCC has recently indicated that it plans to raise ~Rs 15 billion primarily by way of QIP. While the QIP, if successful, will help ease funding pressure in the near term, it would lead to huge equity dilution (possibly ~35%) and we believe the balance sheet will remain stretched.

- **Acceleration in execution will require compromise on EBITDA margin**
  HCC was one of the few companies in the sector to see a significant accretion in its order book in FY09 (~Rs 95 billion). However, its execution disappointed, coming in way below expectations. To speed up execution, HCC is likely to increase sub-contracting. Similarly, to keep the capex requirement low, it will rely more on hired machinery. Both these factors are likely to pull EBITDA margin below the five-year high of 13.0% seen in FY09 to 12.2% in FY11E.

- **Lavasa: It's the time to deliver**
  The Lavasa project is now at a crucial point in its development. The response has been tremendous as HCC has been able to sell almost the entire first phase of the project in the past 1.5 years. Management is now focusing on execution as delivery of the properties begins from 3Q FY10. The company has planned construction activity of ~Rs 10 billion for the year, which also means a substantial investment (~Rs 5 billion) will need to be put into the project during the year.

- **Stretched balance sheet to be a constraint to growth, maintain Sell**
  While we expect earnings to remain strong over the next two years (EPS CAGR of 26%), we believe the stretched balance sheet could prove to be a significant hurdle to growth, going forward. The stock is currently trading at 17.1x and 12.9x our FY10E and FY11E EPS, respectively (adjusting for our target valuation for the non-construction businesses). We continue to remain bearish on the stock and maintain our **Sell** rating with a revised target price of Rs 78 (up from Rs 42).

Figure 15: Key financials

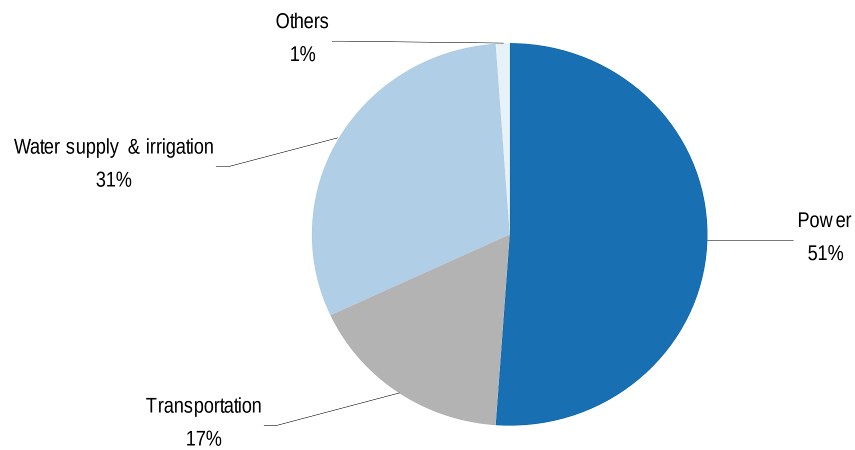
Rs million (unless otherwise stated), year-end March

	FY08	FY09	FY10E	FY11E
Sales	30,828	33,137	41,776	50,220
EBITDA	3,659	4,314	5,232	6,287
EBITDA (%)	11.9	13.0	12.5	12.5
PAT (adjusted)	834	760	986	1,306
FD EPS (Rs)	3.3	3.0	3.8	5.1

Source: Company data, Reliance Equities estimates.

Figure 16: Breakdown of order backlog (end-FY09)

%



Source: Company data, Reliance Equities research.

Figure 17: Order book growth and visibility

Rs million x

Source: Company data, Reliance Equities estimates.

Figure 18: Sum-of-the-parts valuation

Units as shown

Segment	Basis	Multiple (x)	Value (Rs mn)	Value per share (Rs)	Rationale
Construction	Average of EV/EBITDA, P/E and DCF		9,307	36	Average of EV/EBITDA (6.0x, 55% discount to L&T), P/E (7.7x, 55% discount to L&T and DCF (WACC: 12.5%, terminal growth: 5%)
Embedded value					
BOT projects (Road)	NPV	0.7-0.9	1,558	6	Based on equity IRR of ~16% for toll projects, CoE for toll projects at 16% and annuity projects at 14%
Real estate (Lavasa)	NPV+NRV	0.7	6,848	27	NPV for Phase 1 of the project of 1,250 acres and net realisable value for balance land bank of 11,250 acres @ Rs 2 million per acre
Real estate (others)	NPV	0.7	2,328	9	Vikhroli IT park valued based on Rs 70 per month per sq ft rental and taking capitalisation rate at 11%
Total fair value			**20,041**	**78**	

Source: Company data, Reliance Equities estimates.

Figure 19: Summary financials

Rs million (unless otherwise stated), year-end March

Income statement	FY08	FY09	FY10E	FY11E
Sales	**30,828**	**33,137**	**41,776**	**50,220**
Raw material	(9,711)	(12,364)	(15,591)	(18,738)
Employee expenses	(2,972)	(3,749)	(4,519)	(5,380)
SG&A expenses & Marketin	-	-	-	-
Other operating expenses	(14,478)	(12,710)	(16,445)	(19,815)
Other op. income	(8)	1	10	-
EBITDA	**3,659**	**4,314**	**5,232**	**6,287**
Depn and amort.	(962)	(1,152)	(1,418)	(1,550)
EBIT	**2,697**	**3,162**	**3,813**	**4,737**
Net int. income/exp.	(1,524)	(2,105)	(2,446)	(2,913)
Inc./loss from assoc.	-	-	-	-
Other non-op inc./exp.	23	95	104	126
PBT	1,196	1,152	1,472	1,949
Provision for taxes	(362)	(392)	(486)	(643)
Minority interest	-	-	-	-
Preference dividend	-	-	-	-
Reported net profit	1,088	1,254	986	1,306
REIPL net income	**834**	**760**	**986**	**1,306**
Wtd avg # of shares	256.2	256.2	256.2	256.2
EPS (basic, rep) (Rs)	4.2	4.9	3.8	5.1
EPS (dil., rep.) (Rs)	4.2	4.9	3.8	5.1
EPS (dil., adj.) (Rs)	**3.3**	**3.0**	**3.8**	**5.1**
DPS (Rs)	0.8	0.8	0.8	0.8
Divid payout ratio (%)	24.6	27.0	20.8	15.7
Balance sheet	**FY08**	**FY09**	**FY10E**	**FY11E**
Cash and equiv.	2,644	1,539	1,170	1,260
A/c.s receivable	45	47	59	71
Loans and adv.	4,328	7,878	9,317	10,719
Inventory	22,576	30,731	37,616	43,832
Other current assets	20	231	231	231
Total curr. assets	**29,613**	**40,426**	**48,394**	**56,114**
Accounts payable	-	-	-	-
Short-term debt	9,174	9,177	12,177	14,977
Other curr. liab.	12,686	19,778	24,181	27,985
Total curr. liab.	**21,860**	**28,955**	**36,358**	**42,962**
Net curr. assets	**7,752**	**11,471**	**12,036**	**13,152**
Net fixed assets	10,206	11,746	12,128	12,078
Net intangibles	-	-	-	-
Investments	2,955	3,655	4,655	5,655
Other long-term assets	-	-	-	-
Total assets	**20,914**	**26,872**	**28,819**	**30,885**
Total loans	9,275	14,041	15,241	16,241
Other long-term liab.	1,599	2,783	2,783	2,782
Shareholders' funds	10,041	10,049	10,795	11,861
Pref. shrs/other equity	-	-	-	-
Minority interest	-	-	-	-
Total liab. and equity	**20,914**	**26,872**	**28,819**	**30,885**
BVPS (Rs)	**39.2**	**39.2**	**42.1**	**46.3**
DuPont analysis	**FY08**	**FY09**	**FY10E**	**FY11E**
Margin (%)	2.7	2.3	2.4	2.6
Asset turnover (x)	0.8	0.7	0.7	0.7
Leverage (x)	4.1	4.9	5.8	6.1
ROE (%)	8.7	7.6	9.5	11.5

Cash Flow Statement	FY08	FY09	FY10E	FY11E
PBT	1,196	1,152	1,472	1,949
D&A add back	(962)	(1,152)	(1,418)	(1,550)
Taxes paid	(195)	(210)	(486)	(643)
(Inc)/dec in w. cap	2,303	3,722	3,565	3,916
Other op. cash flow	(246)	(2,826)	(2,215)	(1,729)
Cash flow from op. (A)	**2,096**	**685**	**917**	**1,943**
Cap exp. (B)	(2,194)	(2,692)	(1,800)	(1,500)
Acquisitions (C)	-	-	-	-
Divestitures (D)	-	-	-	-
Others (E)	(669)	(700)	(1,000)	(1,000)
Cash flow from investing	**(2,863)**	**(3,392)**	**(2,800)**	**(2,500)**
FCF (A+B+C+D+E)	(97)	(2,007)	(883)	443
Divids pd (com. and pref.)	(240)	(240)	(240)	(240)
Inc. in equity	-	-	-	-
Inc./(dec.) in debt	2,938	4,769	4,200	3,800
Other financing cash flows	(1,372)	(2,928)	(2,446)	(2,913)
Cash flow from financing	**1,326**	**1,602**	**1,514**	**647**
Total cash flow	**560**	**(1,105)**	**(369)**	**90**
Capital management	**FY08**	**FY09**	**FY10E**	**FY11E**
Inventory days	238.5	293.6	298.6	296.0
Receivable days	0.3	0.5	0.5	0.5
Growth and margins (%)	**FY08**	**FY09**	**FY10E**	**FY11E**
Sales growth	30.8	7.5	26.1	20.2
EBITDA growth	52.7	17.9	21.3	20.2
EPS growth	23.7	(8.9)	29.8	32.4
EBITDA margin	11.9	13.0	12.5	12.5
EBIT margin	8.7	9.5	9.1	9.4
Net margin	2.7	2.3	2.4	2.6
Rev. growth – peers	41.2	31.9	23.7	16.1
EBITDA growth – peers	50.8	22.5	24.2	17.6
EBITDA margin – peers	10.7	9.9	9.9	10.1
EPS growth – peers	35.8	6.9	16.4	18.5
Noplat	1,880.5	2,085.9	2,554.9	3,173.9
Invested capital	27,132.3	32,394.0	36,340.3	40,206.5
ROIC (%)	7.4	7.0	7.4	8.3
ROIC/WACC (x)	0.6	0.6	0.6	0.7
ROIC – peers (%)	10.6	9.9	9.7	10.1
Valuations	**FY08**	**FY09**	**FY10E**	**FY11E**
P/E (x)	33.1	36.3	28.0	21.1
P/E (peers) (x)	21.2	19.9	17.1	14.4
EV/sales (x)	1.4	1.5	1.3	1.1
EV/sales – peers (x)	1.2	1.0	0.9	0.8
EV/EBITDA (x)	11.9	11.4	10.3	9.2
EV/EBITDA (peer group)	11.3	10.4	9.1	8.1
P/B (x)	2.7	2.7	2.6	2.3
P/B peer group (x)	2.4	2.2	2.0	1.8
Div yield (%)	0.7	0.7	0.7	0.7
Free cash flow yield (%)	(0.4)	(7.3)	(3.2)	1.6
Quality of earnings	**FY08**	**FY09**	**FY10E**	**FY11E**
Op. cash flow/net income (x)	2.5	0.9	0.9	1.5
Capex/Depn (x)	2.3	2.3	1.3	1.0
Tax charge/pre-tax income (x)	30.3	34.0	33.0	33.0
Net debt/equity (%)	1.6	2.2	2.4	2.5
Interest cover (x)	1.8	1.5	1.6	1.6

Source: Company data, Reliance Equities estimates.

IVRCL Infrastructures & Projects

Negative cash flows continue

Sell

Rs 325

Target price: Rs 279

Bloomberg code	IVRC IN
Reuters code	IVRC.BO
3m avg. traded value (Rs m)	926.4
52-wk H/L (Rs)	390.9/56.5
Sensex	14958
Mcap (US$ m/Rs bn)	908.1/43.4

Shareholding (%)

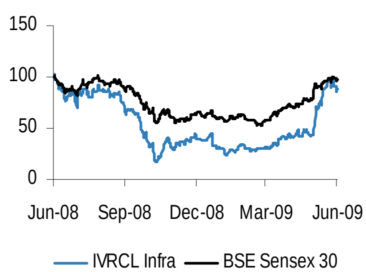
	Dec-08	Sep-08
Promoters	9.7	9.6
MFs, FIs, banks	23.1	18.3
FIIs	42.2	56.5
Others	25.0	15.7

Stock performance (%)

	1m	6m	1yr
Absolute	99.9	102.4	-12.5
BSE 30 index	22.9	49.9	-2.8

Share price performance

Base=100



Source: Bloomberg, Capitaline.

- **Continues to focus on its key vertical of water supply and irrigation**
  IVRCL Infrastructures and Projects (IVRCL) saw ~70% of its order inflow in FY09, coming from the core segments of irrigation and water supply. It also has over one-third of its order backlog concentrated in the state of Andhra Pradesh. Management has indicated that the water segment will continue to be a key focus area and expects its project pipeline to pick up soon, post the lull due to elections. The new government is expected to focus on the social sector and this likely means increased spending on water and irrigation, which augurs well for IVRCL.

- **Margin should improve post shock in FY09, albeit slowly**
  In FY09 IVRCL's EBITDA margin declined 130 bps to 8.6% due to the higher contribution of lower-margin projects in revenue, according to management. We expect the margin to improve from here, but believe it is unlikely to reach the peak level of ~10% in the near term. This is primarily because we expect margins for the new orders received in FY09 (and expected in FY10) to remain under pressure due to competition crowding in to the water and irrigation space. We expect the margin to improve to 9.0% in FY10E and 9.2% in FY11E.

- **Earnings growth slow, lower tax rate could swing the numbers**
  We expect EPS to grow at a CAGR of 15% over FY09–11E, which is lower than our expected sales growth CAGR of 25% during the same period, despite the likely improvement in EBITDA margin and slower growth in interest costs. This is due to an effective tax rate of 33% being factored in (17.5% in FY09 and 25.6% in FY08). IVRCL continues to take benefit of Section 80 IA based on legal opinion. In our view, providing for the full tax rate would be more prudent.

- **Significant negative cash flows is a worrying factor, maintain Sell**
  The working capital cycle has consistently expanded from 69 days in FY04 to 143 days in FY09P. This has led to significant negative operating cash flow and, eventually, to multiple equity dilutions and a levered balance sheet. While we have built in a stable working capital cycle for FY10 and FY11, a further increase would mean increased funding needs and would impact growth. We maintain our **Sell** with a revised target price of Rs 279 (up from Rs 125).

Figure 20: Key financials

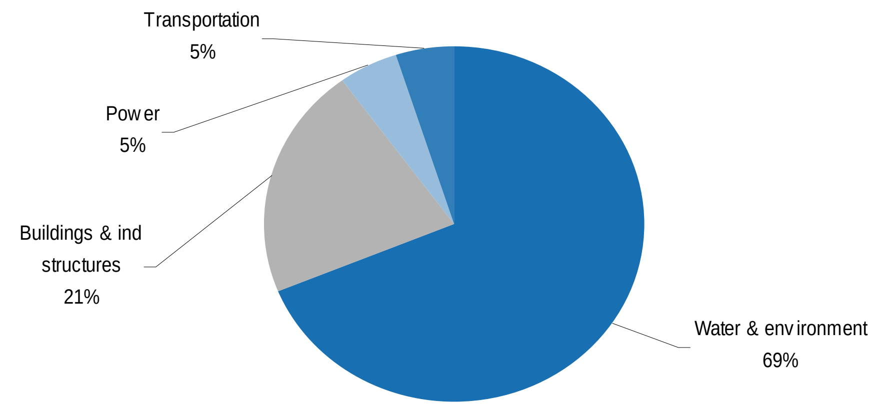
Rs million (unless otherwise stated), year-end March

	FY08	FY09P	FY10E	FY11E
Sales	36,485	48,819	63,330	76,088
EBITDA	3,614	4,218	5,725	7,030
EBITDA (%)	9.9	8.6	9.0	9.2
PAT (adjusted)	2,176	2,260	2,480	2,989
FD EPS (Rs)	16.3	16.7	18.4	22.1

Source: Company data, Reliance Equities estimates.

Figure 21: Breakdown of order backlog (end-FY09)

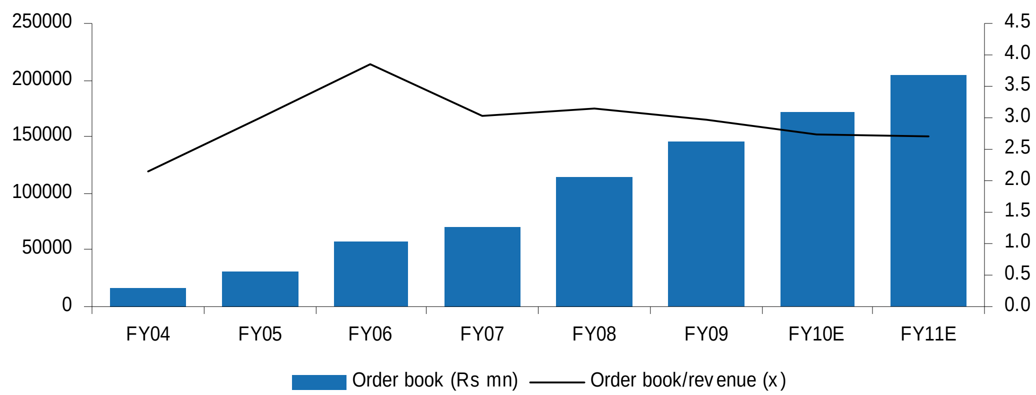
%



Source: Company data, Reliance Equities research.

Figure 22: Order book growth and visibility

Rs million x



Source: Company data, Reliance Equities estimates.

Figure 23: Sum-of-the-parts valuation

Units as shown

Segment	Basis	Multiple (x)	Value (Rs mn)	Value per share (Rs)	Rationale
Construction	Avg of EV/EBITDA, P/E and DCF		28,346	210	Average of EV/EBITDA (6.7x, 50% discount to L&T), P/E (8.6x, 50% discount to L&T and DCF (WACC: 13.5%, terminal growth: 5%)
Embedded value					
Road BOTs	NPV	0.9-1.0	2,745	20	Traffic assumption based on equity IRR of ~17%-18%, CoE at 16%
Water BOT	NPV	0.9	1,283	10	Our estimated equity IRR is ~21%, CoE is 16%
IVR Prime	FY09E P/BV	0.7	3,712	28	Almost entire land bank accumulated in last 3-4 years. Taken discount to book value to factor in fall in value of land
Hindustan Dorr Oliver	FY09A P/E	10.0	1,592	12	20% discount to core construction business implied FY09 P/E at our target valuation
Total fair value			**37,678**	**279**	

Source: Company data, Reliance Equities estimates.

Figure 24: Summary financials

Rs million (unless otherwise stated), year-end March

Income statement	FY08	FY09	FY10E	FY11E
Sales	**36,485**	**48,819**	**63,330**	**76,088**
Raw material	(12,393)	(16,578)	(21,380)	(25,687)
Employee expenses	(1,442)	(1,953)	(2,470)	(2,892)
SG&A expenses & Marketin	-	-	-	-
Other operating expenses	(19,156)	(26,069)	(33,755)	(40,479)
Other op. income	121	-	-	-
EBITDA	**3,614**	**4,218**	**5,725**	**7,030**
Depn and amort.	(328)	(473)	(601)	(729)
EBIT	**3,286**	**3,745**	**5,124**	**6,301**
Net int. income/exp.	(407)	(1,306)	(1,581)	(1,992)
Inc./loss from assoc.	-	-	-	-
Other non-op inc./exp.	45	299	158	152
PBT	2,924	2,738	3,701	4,461
Provision for taxes	(749)	(478)	(1,221)	(1,472)
Minority interest	-	-	-	-
Preference dividend	-	-	-	-
Reported net profit	2,105	2,260	2,480	2,989
REIPL net income	**2,176**	**2,260**	**2,480**	**2,989**
Wtd avg # of shares	133.5	135.0	135.0	135.0
EPS (basic, rep) (Rs)	15.8	16.7	18.4	22.1
EPS (dil., rep.) (Rs)	15.8	16.7	18.4	22.1
EPS (dil., adj.) (Rs)	**16**	**17**	**18**	**22**
DPS (Rs)	14	14	15	15
Divid payout ratio (%)	8.6	8.4	8.2	6.8
Balance sheet	**FY08**	**FY09**	**FY10E**	**FY11E**
Cash and equiv.	1,772	1,035	970	1,002
A/c.s receivable	6,585	11,369	14,748	17,719
Loans and adv.	12,311	17,375	21,351	24,846
Inventory	8,152	9,363	11,278	13,550
Other current assets	11	11	11	11
Total curr. assets	**28,831**	**39,153**	**48,359**	**57,128**
Accounts payable	-	-	-	-
Short-term debt	4,586	6,586	9,386	11,386
Other curr. liab.	8,893	15,045	19,107	22,895
Total curr. liab.	**13,479**	**21,631**	**28,493**	**34,281**
Net curr. assets	**15,352**	**17,521**	**19,865**	**22,847**
Net fixed assets	3,733	4,660	5,559	6,030
Net intangibles	-	-	-	-
Investments	3,409	3,909	3,909	3,909
Other long-term assets	-	-	-	-
Total assets	**35,973**	**47,721**	**57,827**	**67,067**
Total loans	6,093	7,288	8,288	8,988
Other long-term liab.	341	356	356	356
Shareholders' funds	16,060	18,447	20,690	23,442
Pref. shrs/other equity	-	-	-	-
Minority interest	-	-	-	-
Total liab. and equity	**35,973**	**47,721**	**57,827**	**67,067**
BVPS (Rs)	**120.3**	**136.7**	**153.3**	**173.7**
DuPont analysis	**FY08**	**FY09**	**FY10E**	**FY11E**
Margin (%)	6.0	4.6	3.9	3.9
Asset turnover (x)	1.1	1.2	1.2	1.2
Leverage (x)	2.2	2.4	2.7	2.8
ROE (%)	14.9	13.1	12.7	13.5

Cash Flow Statement	FY08	FY09	FY10E	FY11E
PBT	2,924	2,738	3,701	4,461
D&A add back	(328)	(473)	(601)	(729)
Taxes paid	(698)	(464)	(1,221)	(1,472)
(Inc)/dec in w. cap	6,196	4,169	5,144	4,981
Other op. cash flow	(11,802)	(6,823)	(7,569)	(6,481)
Cash flow from op. (A)	**(3,708)**	**(853)**	**(547)**	**760**
Cap exp. (B)	(1,626)	(1,400)	(1,500)	(1,200)
Acquisitions (C)	-	-	-	-
Divestitures (D)	-	-	-	-
Others (E)	(580)	(500)	-	-
Cash flow from investing	**(2,206)**	**(1,900)**	**(1,500)**	**(1,200)**
FCF (A+B+C+D+E)	(5,334)	(2,253)	(2,047)	(440)
Divids pd (com. and pref.)	(219)	(221)	(237)	(237)
Inc. in equity	8	3	-	-
Inc./(dec.) in debt	5,117	3,195	3,800	2,700
Other financing cash flows	541	(961)	(1,581)	(1,992)
Cash flow from financing	**5,448**	**2,016**	**1,982**	**471**
Total cash flow	**(467)**	**(737)**	**(65)**	**31**
Capital management	**FY08**	**FY09**	**FY10E**	**FY11E**
Inventory days	61.1	65.5	59.5	59.6
Receivable days	64.6	67.1	75.3	77.9
Growth and margins (%)	**FY08**	**FY09**	**FY10E**	**FY11E**
Sales growth	59.0	33.8	29.7	20.1
EBITDA growth	55.9	16.7	35.7	22.8
EPS growth	47.7	2.7	9.7	20.5
EBITDA margin	9.9	8.6	9.0	9.2
EBIT margin	9.0	7.7	8.1	8.3
Net margin	6.0	4.6	3.9	3.9
Rev. growth – peers	41.2	31.9	23.7	16.1
EBITDA growth – peers	50.8	22.5	24.2	17.6
EBITDA margin – peers	10.7	9.9	9.9	10.1
EPS growth – peers	35.8	6.9	16.4	18.5
Noplat	2,445.0	3,090.8	3,433.0	4,221.7
Invested capital	23,670.6	28,767.1	34,810.0	40,262.0
ROIC (%)	12.3	11.8	10.8	11.2
ROIC/WACC (x)	0.9	0.9	0.8	0.8
ROIC – peers (%)	10.6	9.9	9.7	10.1
Valuations	**FY08**	**FY09**	**FY10E**	**FY11E**
P/E (x)	19.9	19.4	17.7	14.7
P/E (peers) (x)	21.2	19.9	17.1	14.4
EV/sales (x)	1.4	1.2	1.0	0.8
EV/sales – peers (x)	1.2	1.0	0.9	0.8
EV/EBITDA (x)	14.5	13.4	10.6	9.0
EV/EBITDA (peer group)	11.3	10.4	9.1	8.1
P/B (x)	2.7	2.4	2.1	1.9
P/B peer group (x)	2.4	2.2	2.0	1.8
Div yield (%)	0.4	0.4	0.5	0.5
Free cash flow yield (%)	(12.3)	(5.1)	(4.7)	(1.0)
Quality of earnings	**FY08**	**FY09**	**FY10E**	**FY11E**
Op. cash flow/net income (x)	(1.7)	(0.4)	(0.2)	0.3
Capex/Depn (x)	5.0	3.0	2.5	1.6
Tax charge/pre-tax income (x)	25.6	17.5	33.0	33.0
Net debt/equity (%)	0.6	0.7	0.8	0.8
Interest cover (x)	8.1	2.9	3.2	3.2

Source: Company data, Reliance Equities estimates.

Nagarjuna Construction Company

Diversification will take time to pay off

Sell

Rs 133

Target price: Rs 113

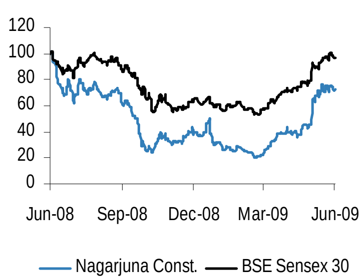
Bloomberg code	NJCC IN
Reuters code	NGCN.BO
3m avg. traded value (Rs m)	331.5
52-wk H/L (Rs)	190/34.3
Sensex	14958
Mcap (US$ m/Rs bn)	637.7/30.5

Shareholding (%)	Mar-09	Dec-08
Promoters	24.4	24.4
MFs, FIs, banks	22.3	25.1
FIIs	27.0	26.4
Others	26.3	24.1

Stock performance (%)	1m	6m	1yr
Absolute	59.6	73.8	-27.0
BSE 30 index	22.9	49.9	-2.8

Share price performance

Base=100



Source: Bloomberg, Capitaline.

- **Recent order cancellations have raised questions on new segments**
  In a bid to de-risk its business model, Nagarjuna Construction Company (NCC) has entered into various new segments, viz., oil & gas, power, metals and, recently, mining. Of the two large orders won in the oil & gas segment in FY08, one of the orders worth over Rs 12 billion was recently cancelled, bringing down the segment's share in the order backlog from 11% at end-FY08 to ~0.2% presently. This has raised concerns over the sustainability of order flows in these newer segments, which command higher margins.

- **Middle East order book sees strong accretion**
  Over one-fourth (27%) of the company's order book and ~35% of the net order inflow in FY09 was derived from the international segment in countries like UAE (Dubai) and Oman. Orders in this segment also include orders received from its own subsidiary, NCC Harmony, to the extent of ~Rs 9 billion (27% of international order book) and a few other real estate projects in Dubai. Owing to this exposure, the execution cycle for this order book is likely to remain long in the near term.

- **Revives investment plans in non-construction business**
  Management has indicated that it plans to invest ~Rs 2 billion in various non-construction businesses, viz., BOT road projects, hydro power projects and real estate. This is on top of ~Rs 6.5 billion already invested in these ventures. The company also has plans to diversify into development of thermal power, ports and airports. Not only these projects are long gestation and risky in nature, but they are also unlikely to generate cash flows in the near term, thereby suppressing the overall returns for the company.

- **Earnings growth likely to remain low, maintain Sell**
  Adjusting for the order backlog of international subsidiaries, the current order backlog stands at ~Rs 89.9 billion which is just 2.2x FY09 revenues, the lowest in the last five years. Even after assuming a robust order inflow of Rs 66 billion and Rs 82 billion (+22% CAGR) in FY10E and FY11E, respectively, we expect revenue and PAT growth to remain low—CAGRs of 15% and 16%, respectively, over FY09–11E. We maintain our **Sell** rating with a revised target price of Rs 113 (up from Rs 66).

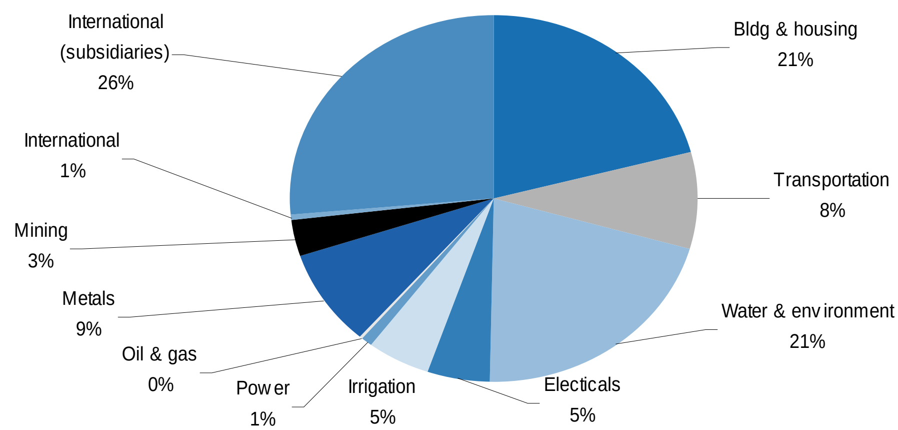
Figure 25: Key financials

Rs million (unless otherwise stated), year-end March

	FY08	FY09P	FY10E	FY11E
Sales	33,836	41,514	49,367	54,647
EBITDA	3,598	3,737	4,641	5,247
EBITDA (%)	10.6	9.0	9.4	9.6
PAT (adjusted)	1,641	1,539	1,900	2,071
FD EPS (Rs)	7.2	6.7	8.3	9.0

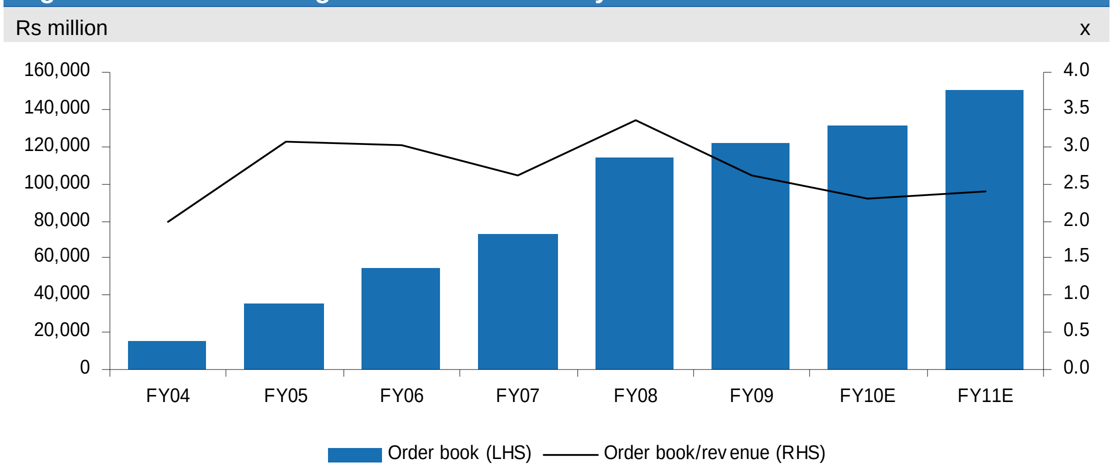
Source: Company data, Reliance Equities estimates.

Figure 26: Breakdown of order backlog (end-FY09)



Source: Company data, Reliance Equities research.

Figure 27: Order backlog and revenue visibility



Source: Company data, Reliance Equities estimates.

Figure 28: Sum-of-the-parts valuation

Units as shown

Segment	Basis	Multiple (x)	Value (Rsmn)	Value per share (Rs)	Rationale
Construction (standalone)	Average of EV/EBITDA, P/E and DCF		18,382	80	Average of EV/EBITDA (6.7x, 50% discount to L&T), P/E (8.6x, 50% discount to L&T and DCF (WACC: 13.5%, terminal growth: 5%)
Embedded value					
Construction (intl. subsidiaries)	FY11E, PE (x)	7.1	2,311	10	20% discount to the implied P/E for the Indian construction business
Road BOTs	NPV	0.7-1.0	1,872	8	Based on equity IRR of 17-18% for toll projects, CoE for toll projects at 16% and annuity projects at 14%
Power projects	FY11E P/BV	1.0	666	3	At book value of investments till FY11E
Real estate	FY11E P/BV	0.7	2,657	12	Almost entire land bank accumulated in last 3-4 years. Taken discount to book value to factor in fall in value of land
Total fair value			**25,888**	**113**	

Source: Company data, Reliance Equities estimates.

Figure 29: Summary financials

Rs million (unless otherwise stated), year-end March

Income statement	FY08	FY09	FY10E	FY11E
Sales	**33,836**	**41,514**	**49,367**	**54,647**
Raw material	(10,963)	(13,042)	(15,411)	(17,059)
Employee expenses	(1,402)	(1,886)	(2,193)	(2,373)
SG&A expenses & Marketing	-	-	-	-
Other operating expenses	(17,874)	(22,849)	(27,122)	(29,968)
Other op. income	-	-	-	-
EBITDA	**3,598**	**3,737**	**4,641**	**5,247**
Depn and amort.	(482)	(533)	(575)	(652)
EBIT	**3,116**	**3,204**	**4,066**	**4,594**
Net int. income/exp.	(719)	(964)	(1,278)	(1,558)
Inc./loss from assoc.	-	-	-	-
Other non-op inc./exp.	56	42	49	55
PBT	2,452	2,282	2,837	3,091
Provision for taxes	(811)	(743)	(936)	(1,020)
Minority interest	-	-	-	-
Preference dividend	-	-	-	-
Reported net profit	1,619	1,539	1,900	2,071
REIPL net income	**1,641**	**1,539**	**1,900**	**2,071**
Wtd avg # of shares	228.8	228.8	228.8	228.8
EPS (basic, rep) (Rs)	7.1	6.7	8.3	9.0
EPS (dil., rep.) (Rs)	7.1	6.7	8.3	9.0
EPS (dil., adj.) (Rs)	**7.2**	**6.7**	**8.3**	**9.0**
DPS (Rs)	1.3	1.1	2.0	2.0
Divid payout ratio (%)	18.1	16.4	24.1	22.1
Balance sheet	**FY08**	**FY09**	**FY10E**	**FY11E**
Cash and equiv.	2,330	1,236	1,002	1,045
A/c.s receivable	8,677	10,236	12,173	13,474
Loans and adv.	14,923	16,657	19,024	20,615
Inventory	5,493	7,393	8,791	10,480
Other current assets	61	61	61	61
Total curr. assets	**31,484**	**35,584**	**41,052**	**45,676**
Accounts payable	-	-	-	-
Short-term debt	1,750	3,250	5,750	6,550
Other curr. liab.	15,564	15,994	18,321	20,558
Total curr. liab.	**17,314**	**19,244**	**24,071**	**27,108**
Net curr. assets	**14,170**	**16,340**	**16,980**	**18,568**
Net fixed assets	5,340	5,807	6,431	6,779
Net intangibles	-	-	-	-
Investments	5,648	6,648	8,148	8,648
Other long-term assets	-	-	-	-
Total assets	**42,471**	**48,038**	**55,631**	**61,103**
Total loans	7,188	9,188	10,188	10,688
Other long-term liab.	2,245	2,638	3,038	3,438
Shareholders' funds	15,724	16,968	18,333	19,868
Pref. shrs/other equity	-	-	-	-
Minority interest	-	-	-	-
Total liab. and equity	**42,471**	**48,038**	**55,631**	**61,103**
BVPS (Rs)	**68.7**	**74.1**	**80.1**	**86.8**
DuPont analysis	**FY08**	**FY09**	**FY10E**	**FY11E**
Margin (%)	4.9	3.7	3.8	3.8
Asset turnover (x)	0.9	0.9	1.0	0.9
Leverage (x)	2.8	2.8	2.9	3.1
ROE (%)	12.6	9.4	10.8	10.8

Cash Flow Statement	FY08	FY09	FY10E	FY11E
PBT	2,452	2,282	2,837	3,091
D&A add back	(482)	(533)	(575)	(652)
Taxes paid	(759)	(743)	(936)	(1,020)
(Inc)/dec in w. cap	6,807	3,670	3,140	2,388
Other op. cash flow	(11,212)	(6,011)	(3,685)	(1,469)
Cash flow from op. (A)	**(3,194)**	**(1,336)**	**780**	**2,337**
Cap exp. (B)	(1,593)	(1,000)	(1,200)	(1,000)
Acquisitions (C)	-	-	-	-
Divestitures (D)	-	-	-	-
Others (E)	(880)	(1,000)	(1,500)	(500)
Cash flow from investing	**(2,473)**	**(2,000)**	**(2,700)**	**(1,500)**
FCF (A+B+C+D+E)	(4,787)	(2,336)	(420)	1,337
Divids pd (com. and pref.)	(348)	(295)	(535)	(535)
Inc. in equity	41	-	-	-
Inc./(dec.) in debt	2,569	3,500	3,500	1,300
Other financing cash flows	3,302	(964)	(1,278)	(1,558)
Cash flow from financing	**5,563**	**2,242**	**1,686**	**(794)**
Total cash flow	**(104)**	**(1,094)**	**(234)**	**43**
Capital management	**FY08**	**FY09**	**FY10E**	**FY11E**
Inventory days	51.4	56.6	59.8	64.4
Receivable days	78.2	83.1	82.8	85.7
Growth and margins (%)	**FY08**	**FY09**	**FY10E**	**FY11E**
Sales growth	21.2	22.7	18.9	10.7
EBITDA growth	33.4	3.9	24.2	13.0
EPS growth	19.0	(6.2)	23.5	9.0
EBITDA margin	10.6	9.0	9.4	9.6
EBIT margin	9.2	7.7	8.2	8.4
Net margin	4.9	3.7	3.8	3.8
Rev. growth – peers	41.2	31.9	23.7	16.1
EBITDA growth – peers	50.8	22.5	24.2	17.6
EBITDA margin – peers	10.7	9.9	9.9	10.1
EPS growth – peers	35.8	6.9	16.4	18.5
Noplat	2,085.4	2,160.3	2,724.0	3,078.1
Invested capital	21,259.4	25,396.4	29,161.4	31,896.6
ROIC (%)	12.1	9.3	10.0	10.1
ROIC/WACC (x)	0.9	0.7	0.8	0.8
ROIC – peers (%)	10.6	9.9	9.7	10.1
Valuations	**FY08**	**FY09**	**FY10E**	**FY11E**
P/E (x)	18.6	19.8	16.0	14.7
P/E (peers) (x)	21.6	20.2	17.4	14.7
EV/sales (x)	1.1	1.0	0.9	0.9
EV/sales – peers (x)	1.2	1.0	0.9	0.8
EV/EBITDA (x)	10.3	11.1	9.8	8.9
EV/EBITDA (peer group)	11.4	10.6	9.2	8.2
P/B (x)	1.9	1.8	1.7	1.5
P/B peer group (x)	2.4	2.2	2.0	1.8
Div yield (%)	1.0	0.8	1.5	1.5
Free cash flow yield (%)	(15.7)	(7.7)	(1.4)	4.4
Quality of earnings	**FY08**	**FY09**	**FY10E**	**FY11E**
Op. cash flow/net income (x)	(1.9)	(0.9)	0.4	1.1
Capex/Depn (x)	3.3	1.9	2.1	1.5
Tax charge/pre-tax income (x)	33.1	32.6	33.0	33.0
Net debt/equity (%)	0.4	0.7	0.8	0.8
Interest cover (x)	4.3	3.3	3.2	2.9

Source: Company data, Reliance Equities estimates.

Simplex Infrastructures

Low visibility but our preferred play

Buy

Rs 374

Target price: Rs 461

Bloomberg code	SINF IN
Reuters code	SINF.BO
3m avg. traded value (Rs m)	21.9
52-wk H/L (Rs)	520/102
Sensex	14958
Mcap (US$ m/Rs bn)	387.1/18.5

Shareholding (%)

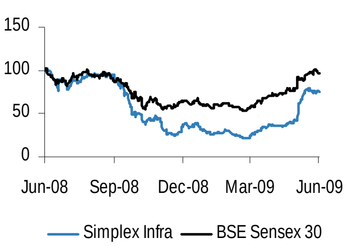
	Mar-09	Dec-08
Promoters	54.1	49.4
MFs, FIs, banks	14.6	13.4
FIIs	12.8	16.1
Others	18.5	21.1

Stock performance (%)

	1m	6m	1yr
Absolute	76.9	102.4	-25.1
BSE 30 index	22.9	49.9	-2.8

Share price performance

Base=100



Source: Bloomberg, Capitaline.

- **Commendable execution and low order inflow depletes revenue visibility**
  Simplex Infrastructures (Simplex) has surprised positively on execution over the past two years. However, due to low order inflow during FY09, the order book-revenue ratio is expected to be at 2.1x at end-FY09—the lowest level seen in the past eight years. Even assuming order inflow growth of 20% in FY10 (to Rs 66 billion) and 25% in FY11 (to Rs 82.5 billion), revenue growth is likely to remain low at 20% in FY10 and 13% in FY11, which is significantly lower than the growth rate seen in the recent past (~50% CAGR over FY04–09E).
- **International segment to play an important role**
  The international segment i.e., operations in countries like UAE (Dubai), Oman and Qatar, which constituted 31% of Simplex's order book at the end of 3Q FY09, has seen a significant slowdown in the last two quarters with hardly any order inflow. A revival in order inflows in these markets will play an important role in determining the growth profile of the company going forward.
- **Rising share of public projects to impact operational matrix adversely**
  As private capex has dried up and the order flow from international markets also slows down significantly, the share of government orders (which constituted 32% of the order book at the end of 3Q FY09) is expected to increase sharply in the next few quarters. This is expected to result in: (1) lower margin (we expect EBITDA margin to fall from 9.8% in FY09 to 9.5% in FY11E); and (2) increase in the working capital cycle (we expect the net working capital cycle to rise from 23% at end-FY09 to 26% at end-FY11).
- **Strong growth will take time to resume but stock is our preferred pick**
  We expect Simplex's diversified business model to help in reviving order flow, going forward. However, with revenue visibility (as measured by order book-to-revenue ratio) at its lowest level in the past eight years, growth is unlikely to return to the pace seen during the period of FY04–09E, in a hurry. However, given Simplex's strong execution capabilities and better working capital management, we believe that the company is best placed to take advantage of the turn in cycle and therefore should command a premium to its peers. We are upgrading Simplex to a **Buy** rating with a target price of Rs 461 (up from Rs 153).

Figure 30: Key financials

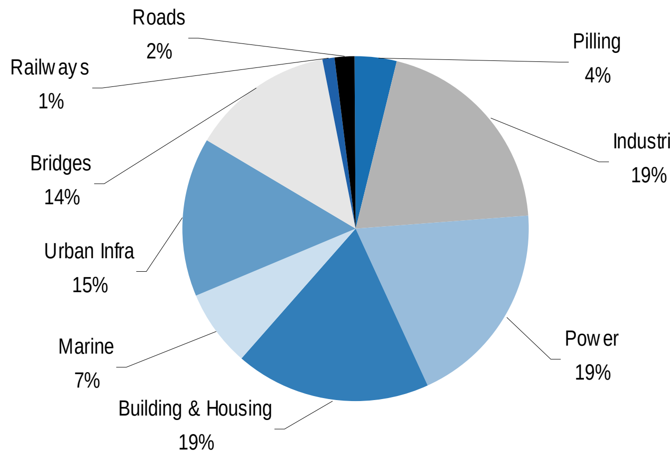
Rs million (unless otherwise stated), year-end March

	FY08	FY09E	FY10E	FY11E
Sales	27,907	46,746	56,124	63,614
EBITDA	2,882	4,581	5,332	6,043
EBITDA (%)	10.3	9.8	9.5	9.5
PAT (adjusted)	901	1,393	1,560	1,842
FD EPS (Rs)	18.2	28.1	31.4	37.1

Source: Company data, Reliance Equities estimates.

Figure 31: Breakdown of order backlog (end-FY09)

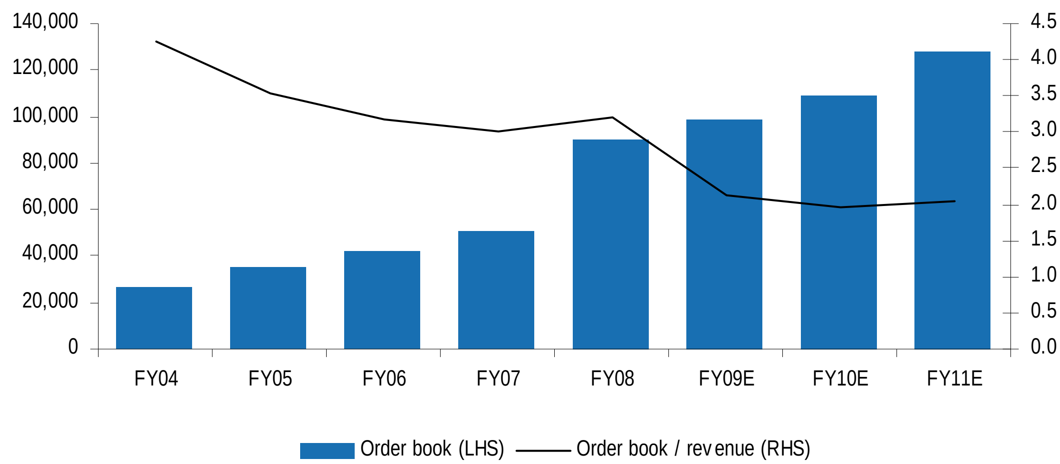
%



Source: Company data, Reliance Equities research.

Figure 32: Order backlog and revenue visibility

Rs million x



Source: Company data, Reliance Equities estimates.

Figure 33: Sum-of-the-parts valuation

Units as shown

Segment	Basis	Multiple (x)	Value (Rs mn)	Value per share (Rs)	Rationale
Construction	Average of EV/EBITDA, P/E and DCF		22,600	455	Average of EV/EBITDA (7.4x, 45% discount to L&T), P/E (9.4x, 45% discount to L&T and DCF (WACC: 12.5%, terminal growth: 5%)
Embedded value					
Oil Rig	P/BV	0.7	294	6	Discount to acquisition cost
Total Fair value			**22,894**	**461**	

Source: Company data, Reliance Equities estimates.

Figure 34: Summary financials

Rs million (unless otherwise stated), year-end March

Income statement	FY08	FY09	FY10E	FY11E
Sales	**27,907**	**46,746**	**56,124**	**63,614**
Raw material	(12,751)	(21,503)	(25,986)	(29,453)
Employee expenses	(523)	(935)	(1,122)	(1,272)
SG&A expenses & Marketin	-	-	-	-
Other operating expenses	(11,792)	(19,727)	(23,684)	(26,845)
Other op. income	40	-	-	-
EBITDA	**2,882**	**4,581**	**5,332**	**6,043**
Depn and amort.	(643)	(1,263)	(1,437)	(1,520)
EBIT	**2,239**	**3,318**	**3,895**	**4,523**
Net int. income/exp.	(1,007)	(1,398)	(1,650)	(1,869)
Inc./loss from assoc.	-	-	-	-
Other non-op inc./exp.	39	70	84	95
PBT	1,271	1,991	2,329	2,750
Provision for taxes	(370)	(597)	(768)	(907)
Minority interest	-	-	-	-
Preference dividend	-	-	-	-
Reported net profit	901	1,333	1,560	1,842
REIPL net income	**901**	**1,393**	**1,560**	**1,842**
Wtd avg # of shares	49.5	49.7	49.7	49.7
EPS (basic, rep) (Rs)	18.2	26.8	314	37.1
EPS (dil., rep.) (Rs)	18.2	26.8	314	37.1
EPS (dil., adj.) (Rs)	**18**	**28**	**31**	**37**
DPS (Rs)	2.0	2.5	2.8	2.8
Divid payout ratio (%)	110	8.9	8.9	7.5
Balance sheet	**FY08**	**FY09**	**FY10E**	**FY11E**
Cash and equiv.	1,232	827	1,177	1,229
A/c.s receivable	9,490	14,728	17,683	20,914
Loans and adv.	5,658	8,851	10,521	11,855
Inventory	4,927	8,069	9,687	10,980
Other current assets	21	21	21	21
Total curr. assets	**21,329**	**32,497**	**39,089**	**44,999**
Accounts payable	-	-	-	-
Short-term debt	3,694	3,694	5,494	5,994
Other curr. liab.	12,453	20,680	23,528	27,034
Total curr. liab.	**16,147**	**24,374**	**29,022**	**33,028**
Net curr. assets	**5,182**	**8,123**	**10,067**	**11,971**
Net fixed assets	6,537	9,868	10,023	10,301
Net intangibles	-	-	-	-
Investments	99	99	99	99
Other long-term assets	(0)	(0)	0	0
Total assets	**27,965**	**42,463**	**49,211**	**55,399**
Total loans	3,800	8,800	9,500	10,000
Other long-term liab.	488	488	488	488
Shareholders' funds	7,531	8,802	10,202	11,884
Pref. shrs/other equity	-	-	-	-
Minority interest	-	-	-	-
Total liab. and equity	**27,965**	**42,463**	**49,211**	**55,399**
BVPS (Rs)	**152.2**	**177.2**	**205.4**	**239.3**
DuPont analysis	**FY08**	**FY09**	**FY10E**	**FY11E**
Margin (%)	3.2	3.0	2.8	2.9
Asset turnover (x)	12	13	12	12
Leverage (x)	4.4	4.3	4.8	4.7
ROE (%)	17.5	17.1	16.4	16.7

Cash Flow Statement	FY08	FY09	FY10E	FY11E
PBT	1,271	1,991	2,329	2,750
D&A add back	(643)	(1,263)	(1,437)	(1,520)
Taxes paid	(276)	(597)	(768)	(907)
(Inc)/dec in w. cap	2,650	2,940	3,745	2,404
Other op. cash flow	(2,069)	(2,422)	(2,616)	154
Cash flow from op. (A)	**933**	**649**	**1,252**	**2,880**
Cap exp. (B)	(3,561)	(4,593)	(1,592)	(1,799)
Acquisitions (C)	-	-	-	-
Divestitures (D)	-	-	-	-
Others (E)	(46)	-	-	-
Cash flow from investing	**(3,607)**	**(4,593)**	**(1,592)**	**(1,799)**
FCF (A+B+C+D+E)	(2,628)	(3,945)	(340)	1,081
Divids pd (com. and pref.)	(116)	(143)	(160)	(160)
Inc. in equity	13	0	-	-
Inc./(dec.) in debt	617	5,000	2,500	1,000
Other financing cash flows	2,967	(1,318)	(1,650)	(1,869)
Cash flow from financing	**3,481**	**3,540**	**690**	**(1,029)**
Total cash flow	**806**	**(405)**	**349**	**52**
Capital management	**FY08**	**FY09**	**FY10E**	**FY11E**
Inventory days	519	50.7	57.7	59.3
Receivable days	109.5	94.5	105.4	110.7
Growth and margins (%)	**FY08**	**FY09**	**FY10E**	**FY11E**
Sales growth	64.9	67.5	20.1	13.3
EBITDA growth	69.0	59.0	16.4	13.3
EPS growth	45.3	54.1	12.0	18.1
EBITDA margin	10.3	9.8	9.5	9.5
EBIT margin	8.0	7.1	6.9	7.1
Net margin	3.2	3.0	2.8	2.9
Rev. growth – peers	412	319	23.7	16.1
EBITDA growth – peers	50.8	22.5	24.2	17.6
EBITDA margin – peers	10.7	9.9	9.9	10.1
EPS growth – peers	35.8	6.9	16.4	18.5
Noplat	1,587.7	2,322.6	2,609.6	3,030.4
Invested capital	15,413.4	21,684.0	25,584.2	28,266.5
ROIC (%)	12.6	12.5	110	113
ROIC/WACC (x)	10	10	0.9	0.9
ROIC – peers (%)	10.6	9.9	9.7	10.1
Valuations	**FY08**	**FY09**	**FY10E**	**FY11E**
P/E (x)	20.5	13.3	119	10.1
P/E (peers) (x)	216	20.2	17.4	14.7
EV/sales (x)	0.9	0.6	0.6	0.5
EV/sales – peers (x)	12	10	0.9	0.8
EV/EBITDA (x)	8.6	6.6	6.1	5.5
EV/EBITDA (peer group)	114	10.6	9.2	8.2
P/B (x)	2.5	2.1	18	16
P/B peer group (x)	2.4	2.2	2.0	18
Div yield (%)	**0.5**	**0.7**	**0.7**	**0.7**
Free cash flow yield (%)	(14.2)	(213)	(18)	5.8
Quality of earnings	**FY08**	**FY09**	**FY10E**	**FY11E**
Op. cash flow/net income (x)	10	0.5	0.8	16
Capex/Depn (x)	5.5	3.6	11	12
Tax charge/pre-tax income (x)	29.1	30.0	33.0	33.0
Net debt/equity (%)	0.8	13	14	12
Interest cover (x)	2.2	2.4	2.4	2.4

Source: Company data, Reliance Equities estimates.

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Key to REIPL recommendations
Buy = Expected return more than +15%
Sell = Expected return +15% or less
All returns calculated over a 12-month period.

DISCLOSURES

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