

Lanco Infratech

Rs 200-240

Long-term bet

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7th Nov 2006

Issue Details	
Offer Price	Rs 200-240
Face Value	10.0
Shares Offered (in lakhs)	444.7
Type	Fresh Issue
Promoter	L. Madhusudhan Rao
Listing (Stock Exchange)	NSE & BSE
Offer Open Date	Nov 06, 2006
Offer Close Date	Nov 10, 2006
Website: www.lancogroup.com	

Scrip Estimates (At Rs 240)	
Market Cap (Rs Crores)	5336.6
EPS - FY07(E)	8.0
P/E(x) - FY07(E) (fully diluted)	30.0
Market Cap/Sales (x) FY07(E)	4.0

Share Holding Pattern	Pre Offer	Post Offer
Promoters	93.8	75.0
Employees	6.2	5.0
Public	-	20.0

Financials (Rs Crores)	FY05	FY06	Q1FY07
Sales	183.9	147.1	110.2
EBITDA	16.2	16.8	21.9
EBIT	12.2	14.9	19.0
Other Income	1.4	1.3	0.8
PBT	2.7	12.5	14.1
PAT	9.2	17.1	13.1
Equity	7.7	30.8	56.8
*EPS (Rs)	0.4	0.8	0.6

Investors should read the risk factors and more detailed information in the Prospectus and the Application form before investing in the issue.

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Lanco Infratech, a part of the Lanco Group, a diversified conglomerate with an asset base of US\$ 500 million, is primarily into construction development, including the execution of various civil contract works. The Company has commenced reorganisation, after which it would bring power and property development into its fold. It has an order book of ~Rs 1,600 crores in the construction business & is in the process of developing ~130 acres of land.

Expanding power portfolio provides growth visibility: Besides the six operational power plants, aggregating to 517.65 MW, the Company is implementing eight projects (aggregating to 3,275 MW), most of which has been won through a competitive bidding process. Recently, the Company signed a MoU with the Government of Orissa, to set up a 1,320 MW coal-fired thermal power project. Thus, the Company would add 8.9x its existing capacity, taking its total capacity to 5,112.65 MW. In a phased manner, all these plants would be fully operational by FY11 and would add significantly to the topline and bottomline. Power would contribute 50% to the topline, with the rest being equally shared between construction and property businesses.

Presence in high growth sectors: The Lanco Group currently operates in the three sunrise sectors of power, construction and realty. These three sectors are the key beneficiaries of the current capex boom. While the Company would benefit from the Government policy of *Power for All* that aims at adding 1,00,000 MW by 2012, its construction division would gain from the expertise in handling in-house projects. This would help the Company capitalise on outside opportunities. The Company also has plans to capture a slice of the growing property development business, which is estimated to touch US\$ 50 billion by 2010. The Company currently has rights to develop 21.5 million sq ft and plans to develop 40 million sq ft by 2011.

Ongoing bids for new power projects would provide incremental benefits: The Company has recently qualified for two ultra-mega power projects of 4,000 MW each, at Sasan, Madhya Pradesh and Mundra, Gujarat. As per media reports, the Company is also in the race for building two power projects of 200 MW each in Indonesia, at a cost Rs 1,500 crores. The Company is also planning to set up a 1,000 MW gas-based power project on the west coast in Gujarat, in association with Gujarat State Petroleum Corporation (GSPC). The Company has also submitted a request for qualification (RfQ) for the 4,000 MW Krishnapatnam ultra-mega power project in Andhra Pradesh.

A long-term bet: Currently, the Company has operational only about 10% (517.65 MW) of its plants out of the proposed 5,112.65 MW in the future. Thus, valuing the Company on the basis of its current operations would be inappropriate, since most of its capacities would come on-stream from FY08 onwards. Also, its property business is still in the development phase and would take time, before it contributes to the topline. In the light of these expansions and strategic initiatives, the Company is well poised to achieve its ambitious target of *increasing its asset base and turnover by ten times, in the next five years*. At the upper end of the price band of Rs 240, the issue is available at PE of 30x its FY07(E) consolidated (post-reorganisation) annualised EPS of Rs 8 and 25x at the lower end of Rs 200, on fully diluted equity capital of Rs 222.4 crores. The above valuation does not reflect the true picture as the company has the potential to post even a better performance. We feel positive about the prospects of the Company and advise investors to SUBSCRIBE, with a long-term perspective.

Company Background

Lanco Infratech was incorporated in 1993 as **Lanco Constructions Ltd** in Andhra Pradesh, with interest in the construction development sector, including the execution of various civil contract works. The Company also had minority stakes in various group entities that were involved in the power sector.

However, in May 2006, the Company commenced its reorganisation in order to consolidate its power, construction and property development assets into one holding company, i.e. Lanco Infratech. Pursuant to this, the Company has acquired controlling stake in 19 entities, from the Promoter Group.

Currently, the Group operates six power plants, with a combined capacity of 517.65 MW. Besides this, the Company also undertakes civil construction and infrastructure projects, with a sizeable business coming from its affiliates. The Company's order book stands at Rs 1,611.83 crores (with more than 75% from its affiliates). The Group is now eyeing opportunities in the property development business and currently has rights to develop 132.5 acres of land.

Objects of the Issue

Through the IPO proceeds, the Company intends to consolidate its holdings in various subsidiaries in the power and property development businesses, as a part of the reorganisation. The Company would also subscribe up to 74% of the equity capital in the Nagarjuna Power Project on achieving the financial closure. Besides this, the Company would also increase its stake in Aban Power and Lanco Kondapalli.

Year-wise break-up of fund requirement

Particulars (Rs crores)	Estimated amount	Utilisation of proceeds as on			
		FY07	FY08	FY09	FY10
<i>Investment in subsidiaries</i>					
Lanco Amarkantak Power Plant	255.7	98.0	122.8	34.9	-
Lanco Green Power Pvt Ltd	39.9	14.8	25.1	-	-
Vamshi Industrial Power Project	7.1	0.1	7.0	-	-
Vamshi Hydro Power Project	6.8	0.1	6.7	-	-
Lanco Hills – Hyderabad Property Project	28.1	28.1	-	-	-
Investment in Nagarjuna Power Project	642.3	192.7	192.7	192.7	64.2
Acquisition of 13.3% equity in Aban Power from Aban Ventures	35.0	35.0	-	-	-
*Acquisition of 25.1% equity in Lanco Kondapalli from Globeleq	139.5	139.5	-	-	-
General corporate purposes	*	*	*	*	*
Issue expenses	*	*	*	*	*
Total	*	*	*	*	*

*The consideration to be paid is US\$ 30 million

Business Details

Lanco Infratech is primarily into construction development, with a track record in civil construction and infrastructure projects. However, with the reorganisation, the Company would bring power and property development into its fold.

Power Business

Currently, the Company operates six power plants, with a combined capacity of 517.65 MW, and would add 8.9x its existing capacity in the next 3-4 years. The Company, which is currently deriving most of its revenues from gas-based power, has embarked on new initiatives like generating power from coal and hydro-electricity. This would help the Company to diversify its power portfolio, making it less susceptible to increase in gas prices. Also, coal-based and hydro-based power plants are able to generate electricity at a lower cost, as compared to gas-based power plants, making them more competitive in the longer run. By FY11, when all its projects would be on-stream, coal would constitute ~77% of its power generation capacity. However, with most of these projects expected to contribute to the topline from FY08 onwards, the Company's ongoing power plants, ie Lanco Kondapalli and Aban Power would continue to be growth drivers.

Power Portfolio	Proposed stake (%)	Investment (Rs crores)	Capacity (MW)	Commissioning	Details
Gas-based					
Lanco Kondapalli Power Pvt Ltd	*59.0	1,099.0	368.1	Operational	Marked the Company's entry into power generation
Aban Power Company Ltd	51.0	439.0	119.8	Operational	On-stream since Aug05
Coal-based					
Nagarjuna Power Corp Ltd	74.0	4,342.4	1,015.0	Dec 09	Granted <i>Mega Power Project Status</i> by MoP
Lanco Amarkantak Power Pvt Ltd – I	76.0	1,290.0	300.0	April 08	Achieved financial closure and construction work has already begun
Lanco Amarkantak Power Pvt Ltd – II	76.0	1,340.0	300.0	Oct 08	Achieved financial closure
Lanco Anpara Power Pvt Ltd	74.0	4,000.0	1,000.0	March 10	Successful bidder against REL and Essar Group
Hydro-based					
Lanco Energy Pvt Ltd	74.0	2,950.0	500.0	Dec 09	To be built across the Theesta river in Sikkim
Lanco Green Power Pvt Ltd	90.0	420.0	70.0	April 08	Achieved financial closure in Mar06
Lanco Hydro Energies Pvt Ltd	91.1	413.0	70.0	April 09	Expected to achieve financial closure by Mar07
Vamshi Industrial Power Ltd	91.1	55.0	10.0	April 08	Achieved financial closure
Vamshi Hydro Energies Pvt Ltd	91.1	58.0	10.0	April 08	Achieved financial closure
Biomass-based					
Clarion Power Corp Ltd	86.0	47.0	12.0	Operational	One of the single largest biomass power plants in Andhra Pradesh
Rithwik Energy System Ltd	56.7	27.8	6.0	Operational	PPA with APTRANSCO, for purchase of its power for 20 years
Wind-based					
Lanco Infratech	100.0	14.7	3.0	Operational	Wind-based electric power generating station in Karnataka
Lanco Infratech	100.0	44.0	8.75	Operational	7 stations of 1.25 MW each, started in Sep06 in Tamil Nadu
Total		16,539.9	3,792.65		

* post acquisition of 25.1% stake of Globeleq

The Company has recently signed an MoU with the Government of Orissa, to set up a 1,320 MW coal-fired thermal power project at Talcher in Dhenkanal district, at an investment of Rs 4,525 crores, taking its installed capacity to 5s112.65 MW.

Apart from the above, the Company, through its 99.8% subsidiary *Lanco Electric Utility Ltd*, undertakes trading activities. The Company is the first in Andhra Pradesh to receive a 25-year license for interstate power trading from CERC. The Company commenced its trading activities in Jan06, and has generated a turnover of Rs 150 crores for H1FY07.

Construction Business

Lanco Infratech is an established construction company, with a proven track record in civil construction and infrastructure projects. Besides executing outside projects, the Company also gets significant in-house projects, which gives it better margins, as compared to outside projects. In future, the Company plans to execute all its power projects in-house. These large-size contracts would not only prove the Company's expertise but would find it in good stead while executing large external projects.

Currently, the Company is implementing various projects for its group companies, i.e. Lanco Amarkantak - I & II, Lanco Green Power, Vamshi Industrial Power Ltd and Vamshi Hydro Energies Pvt Ltd. Besides this, the Company is also implementing a number of transportation engineering projects including roads, highways, bridges, flyovers and pedestrian subways, and irrigation and water supply projects including the building of dams, tunnels, lift irrigation schemes and water transmission mains. The Company has, so far, constructed projects worth over Rs 1,600 crores and has an outstanding order book of Rs 1,611.83 crores (76.3% from the affiliates), which is nearly 11x its FY06 consolidated sales, thereby providing growth visibility for the future.

Property Development Business

The Company is a new entrant in the property development business. Though the Company was indirectly associated with property development through its construction business, it now wants to fully leverage its construction experience in developing its property business.

Presently, the Company is in the process of developing ~19.5 million sq ft of saleable area, spread over 120 acres of land. The Company would be developing a large integrated IT park & township and a residential housing project. The Company has one more property in Vishakhapatnam, which is under dispute.

Property Portfolio	Land (acres)	Saleable area (mn sq ft)	Details
*Lanco Hills Technology Park Pvt Ltd	100.0	18.5	Largest IT park in Hyderabad
Ocean Park Property project	21.8	1.0	Large residential project to be implemented over the next 3 years
Vizag Property Project	10.7	2.0	IT park & township to be developed in the next 3 years. The property is under dispute.

*Lanco Infratech currently owns 99.9% and proposes to have only a 74%-stake in the future

Financials

YE March 31 (Rs crores)	FY04	FY05	FY06	Q1FY07
Net Sales	129.3	183.9	147.1	110.2
EBITDA	17.0	16.2	16.8	21.9
PBT	5.3	2.7	12.5	14.1
*PAT	7.1	9.3	17.1	13.1
Equity Paid Up	7.7	7.7	30.8	56.8
Networth	69.2	78.4	95.4	378.2
Capital Employed	138.5	162.5	252.1	1,261.8
Gross Block	61.7	19.8	23.5	543.3
**EPS (Rs)	0.3	0.4	0.8	0.6
**CEPS (Rs)	0.5	0.5	0.8	0.7
Dividend (%)	-	-	-	-
Payout (%)	-	-	-	-
Debt: Equity (times)	0.8	1.0	1.5	2.9
ROCE (%)	10.4	8.3	6.4	#6.2
RONW (%)	10.3	11.9	17.9	#13.9
EBIDTM (%)	13.1	8.8	11.6	11.9

* after minority interest & share of associates; **on post-diluted equity; #annualised

(Note: The above financials are indicative only, since they pertain only to Lanco Infratech as a construction company. Also, the Company's holdings in various subsidiaries and associates have been taken prior to re-organisation.)

Investment Argument

- **Operational in high growth sectors:** The Lanco Group currently operates in the three sunrise sectors of power, construction and realty. These three sectors are the key beneficiaries of the current capex boom. The Government, under its policy of *Power for All*, aims at adding 1,00,000 MW by 2012. The state governments, too, have identified this opportunity and are currently on an MoU signing-spree with various companies. Lanco, being one of the pioneers in the power generation sector, would have a key role to play in taking advantage of the above opportunity.

Its construction division, too, would stand to benefit from the in-house expertise that it would gain from handling the projects of its affiliates. This would help the Company to capitalise on outside opportunities, with it set to witness huge investments across the key segments of the infrastructure sector - roads, ports, civil aviation, SEZ and real estate.

The Company also has plans to capture a slice of the growing property development business. The property market in India is estimated to touch US\$ 50 billion by 2010. The factors that are fuelling the growth are rapid expansion in IT/ ITES, retail boom, growth in middle-class income and low interest rates. The Company currently has rights to develop 21.5 million sq ft and plans to develop 40 million sq ft by 2011.

- **New initiatives in power sector would diversify portfolio:** Until now, the Company used to generate electricity only from gas, through its plants Lanco Kondapalli and Aban Power. However, gas-based projects are less competitive due to increase in gas prices. While, the tariff rate is Rs 4-5 per unit in gas-based projects, it is below Rs 2.5 per unit for coal and hydro projects. Thus, the Company would focus more on coal-based and hydro-based projects in the future. This would help the Company to mitigate the tariff risk. As such, the Company would have ~77% of electricity generated from coal and ~13% from hydro-projects, by 2011.

Apart from this, the Company is also looking at selling carbon credits that would be generated from these power plants. Currently, the Company sells carbon credits from Clarion Power and Rithwik Energy, with all the other projects in various stages of the validation process.

- **Expanding power portfolio provides growth visibility:** Currently, the Company derives majority of its revenues from Lanco Kondapalli and Aban Power, post-reorganisation. These two group companies have an installed capacity of 487.9 MW. The Company also operates four small power plants aggregating to 29.75 MW, but their contribution to topline is minimal. The Company is currently implementing eight projects (aggregating to 3,275 MW), most of which has been won through a competitive bidding process. Recently, the Company signed an MoU with the Government of Orissa to set up a 1,320 MW coal-fired thermal power project. Thus, the Company would add 8.9x its existing capacity, taking its total capacity to 5,112.65 MW. In a phased manner, all these plants would be fully operational by FY11 and would add significantly to the topline and bottomline. Power would contribute 50% to the topline, with the rest being equally shared between construction and property businesses.
- **Ongoing bids for new power projects would provide incremental benefits:** The Company has recently qualified for two ultra-mega power projects of 4,000 MW each, at Sasan in Madhya Pradesh and Mundra in Gujarat. As per the media reports, the Company is also in the race for building two power projects of 200 MW each in Indonesia, with the finalists being announced in Dec06. The projects would together cost Rs 1,500 crores. The Company is also planning to set up a 1,000 MW gas-based power project on the west coast, in Gujarat, where it would join hands with Gujarat State Petroleum Corporation (GSPC) for the proposed project. The Company has also submitted a request for qualification (RfQ) for the 4,000 MW Krishnapatnam ultra-mega power project in Andhra Pradesh. The project is likely to be awarded by mid-Apr07.

Concerns

- The Group currently operates two gas-based plants and proposes to build its power assets in the future by diversifying into coal and hydro-based power projects. Thus, the Company could face execution risk, since it has no expertise in these new ventures.
- The fortunes of the power sector are directly linked to the regulatory reforms. While Andhra Pradesh has been a front-runner in implementing reforms, the same cannot be said for other states, where the Group proposes to set-up power plants in the future. In such states, the regulatory framework is still under development and therefore, in the absence of a clear regulatory policy, it could increase the risk profile of the Company's proposed projects.
- The Construction division derives most of its revenues from in-house projects. In the future, the revenues would depend on the financial closure achieved by its various projects. Any delays could impact the revenues from the construction division, adversely.
- The most important feedstock for power plants is fuel. Currently, Lanco Kondapalli and Aban Power rely on a single fuel supplier, GAIL. Dependence on a single supplier makes them vulnerable to supply delays or failures by GAIL. Further, GAIL has been able to supply 82% of the fuel requirement from the Lanco Kondapalli plant, causing the plant to operate less than capacity. However, as per media reports, the Company plans to enter into a supply agreement with GSPC and also with Reliance Industries, for gas, which is expected to reach onshore from the K-G Basin by 2009. This would mitigate the risk arising out of shortage in gas supply.

Investment Argument

The Company's current financials do not reflect a true picture of its entire operations. While the consolidated financials pertain only to Lanco Infratech, which is a construction company, its power business is operational via various SPVs. The property business is still in the development stage and would start contributing from FY09 onwards. Also, most of the Company's power plants are under the implementation phase, and would be operational from FY08 onwards, in a phased manner. Hence, FY10 and FY11 would present the true and fair picture of the Company's financials, where it would have 50% contribution from power and 25% each, from construction and property development businesses.

Thus, valuing the Company on the basis of its current operations would be inappropriate, since most of its capacities would come on-stream from FY08 onwards. In the light of these expansions and strategic initiatives, the Company is well poised to achieve its ambitious target of *increasing its asset base and turnover by ten times in the next five years*. At the upper end of the price band of Rs 240, the issue is available at PE of 30x its FY07(E) consolidated (post-reorganisation) annualised EPS of Rs 8 and 25x at the lower end of Rs 200, on fully diluted equity capital of Rs 222.4 crores. The above valuation does not reflect the true picture as the company has the potential to post even a better performance. We feel positive about the prospects of the Company and advise investors to SUBSCRIBE, with a long-term perspective.

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