September 29, 2011

IDBI capital

COMPANY REPORT

IRB Infrastructure Developers Ltd.

Scores on visibility; valuations reasonable ACCUMULATE

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Nifty: 4,946; Sensex: 16,446

CMP	**Rs163**
Target Price	**Rs180**
Potential Upside/Downside	**+10%**

Key Stock Data

Sector	Infrastructure
Bloomberg / Reuters	IRB IN / IRBI.BO
Shares o/s (mn)	332.4
Market cap. (Rs mn)	54,159
Market cap. (US$ mn)	1,107
3-m daily average vol.	321,406

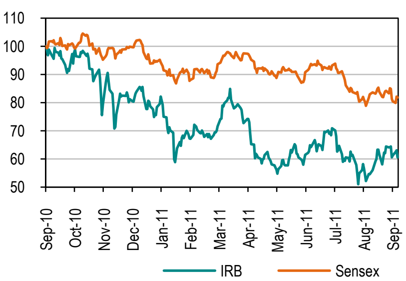
Price Performance

52-week high/low			Rs274/132
	-1m	-3m	-12m
Absolute (%)	11	(3)	(39)
Rel to Sensex (%)	11	8	(21)

Shareholding Pattern (%)

Promoters	74.8
FIIs/NRIs/OCBs/GDR	13.7
MFs/Banks/FIs	3.9
Non Promoter Corporate	2.7
Public & Others	4.9

Relative to Sensex



Source: Capitaline

Summary

In past 1 year, IRB has corrected by ~40% and underperformed BSE Sensex by ~20%. We believe most of the concerns have been largely priced-in and valuations now appear reasonable. We have valued IRB at Rs180 using the SOTP methodology with (1) BOT business valued at Rs114 based on discounted FCFE basis (COE–13%, Avg. Traffic Growth–5%, Interest Cost–11%) (2) EPC business valued at Rs56 based on 7x FY13 EPS (construction margins–20%) (3) Investments in real estate and cash on books contribute Rs10. Initiate coverage with an ACCUMULATE rating. Our assumptions relating to traffic, interest cost and EPC margins are conservative. Another project win based on aggressive bidding is the key downward risk to our recommendation.

Investment Highlights

- **Valuations reasonable post correction**
  Since Sep-2010, IRB has corrected by ~40% and underperformed BSE Sensex by ~20% over concerns of (1) increased competitive intensity in road sector (2) lower than expected traffic in key projects (3) aggressive bidding in the Ahmedabad - Vadodara project (4) high interest rate environment. In our view, the aforesaid negatives have been largely priced-in and the valuations now appear reasonable. With the stock currently available at 10% discount to our SOTP-based TP of Rs180, we initiate coverage on IRB with an **ACCUMULATE** rating.

- **Interest cost pressure manageable**
  ~55% of current outstanding BOT debt (Rs41 bn) is due for interest rate reset by April 2012. Also, interest outgo (as a % of revenue) for EPC business is expected to increase from 3.2% in FY11 to 5.2% in FY12E. Consequently, IRB's consolidated interest expense is expected to increase by 27%/16% in FY12/13E to Rs4.5/5.3 bn. However, given the strong operating cash flow generation (Rs7.3/10.3 bn in FY12/13E), we believe the interest cost pressure is manageable and the company will be able to comfortably meet the equity commitments of its under-construction projects.

- **Our traffic assumptions conservative v/s consensus**
  Optimistic traffic forecast by road developers is a global phenomenon. Traffic growth rate for IRB's major road projects like Surat - Dahisar and Mumbai - Pune have averaged 4-5% in the past four quarters, against street estimates of ~7% growth. Also, year-one traffic volumes (base traffic) in case of Surat - Dahisar and Bharuch - Surat projects were significantly lower than management estimates. Our projections assume (1) an average annual traffic growth of 5% v/s consensus estimate of 6-7% and (2) base traffic volumes of non-operational projects at 20% discount to its forecasted values (to adjust for 'optimism bias').

- **Intense competition = no new projects; another aggressive win downward risk to our reco**
  Lack of opportunities in other infrastructure sectors has led to construction companies aggressively targeting road projects to boost their order book. Competition intensity in roads sector has increased significantly (20-40 bids for most road projects and widening gap between L1 and L2 bidder), resulting in lower returns for developers. We believe new project wins in current scenario can only come at the cost of profitability, as in the case of Ahmedabad - Vadodara. This is the key downward risk to our recommendation.

Table: Financial snapshot **(Rs mn)**

Year	Revenue	EBITDA	EBITDA (%)	Adj. PAT	EPS (Rs)	P/E (x)	EV/EBITDA (x)	RoE (%)	RoCE (%)
FY09	9,919	4,389	44.2	1,759	5.3	30.8	17.1	10.5	8.1
FY10	17,049	7,990	46.9	3,854	11.6	14.1	9.8	20.5	13.2
FY11	24,381	10,939	44.9	4,524	13.6	12.0	8.1	20.2	14.2
FY12E	33,077	14,122	42.7	4,991	15.0	10.9	7.4	18.6	13.4
FY13E	41,520	16,748	40.3	5,495	16.5	9.9	7.3	17.1	11.6

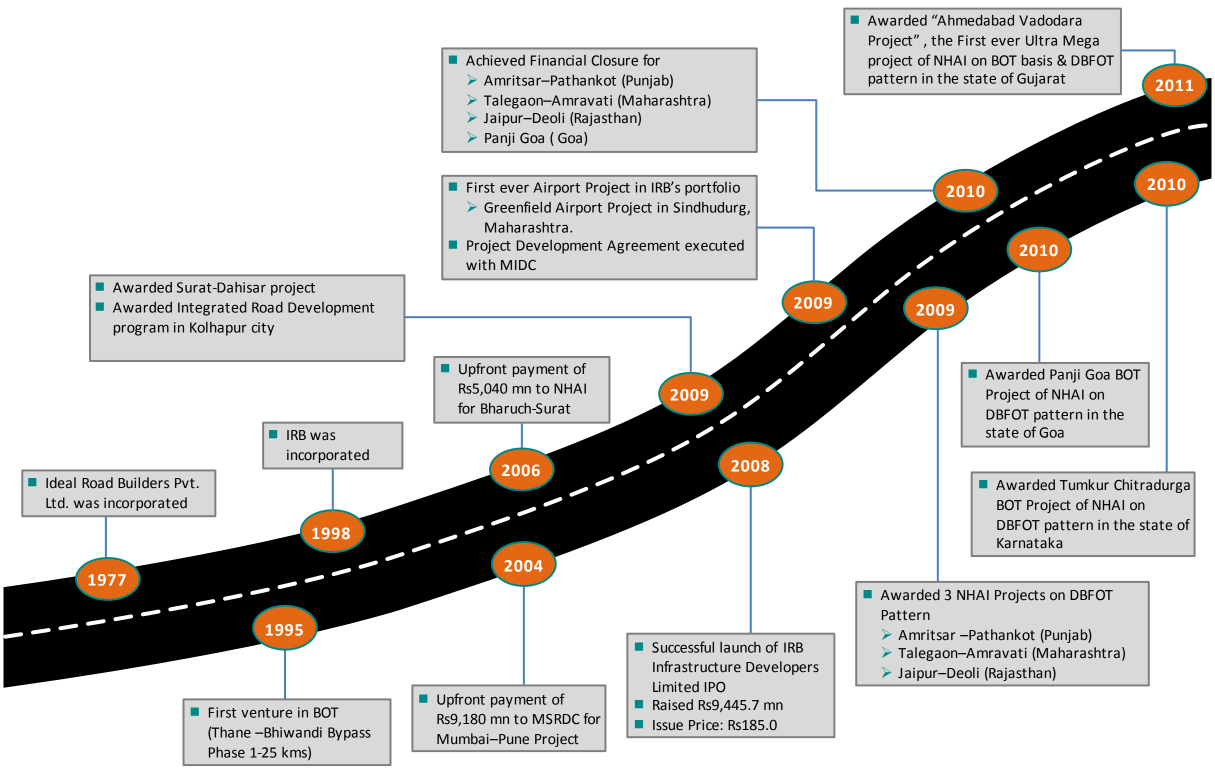
Source: Company; IDBI Capital Research

Company Background

IRB is one of the few pure-play listed road developers in India. The company commenced operations in 1977 as Ideal Road Builders Pvt. Ltd. In 1995, IRB was awarded its first BOT project – Thane Bhiwandi Bypass. The company currently has a road portfolio of 11 operational road BOTs and 6 projects are under implementation.

MRM, the company's in-house construction arm, undertakes the initial construction as well as the operation and maintenance (O&M) of road projects. In addition, IRB has its own fleet of construction equipments and aggregate quarries. This helps the company in capturing the entire road development value chain in-house. In comparison to 9-10% margins reported by other construction players, IRB's margins have been in the range of 18-25%.

Figure: The journey so far



Source: Company

Figure: Toll revenue break-up by project (FY11)

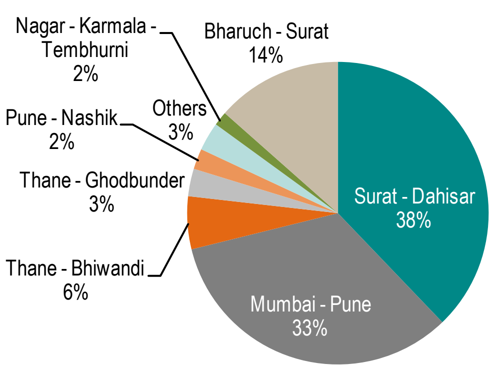
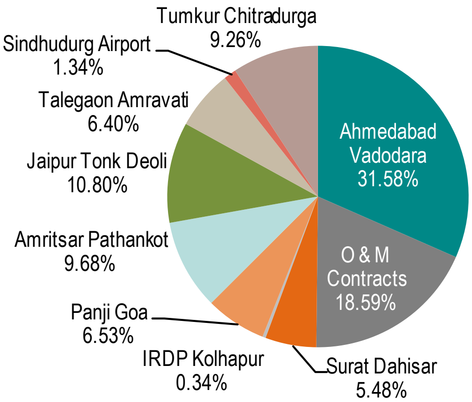
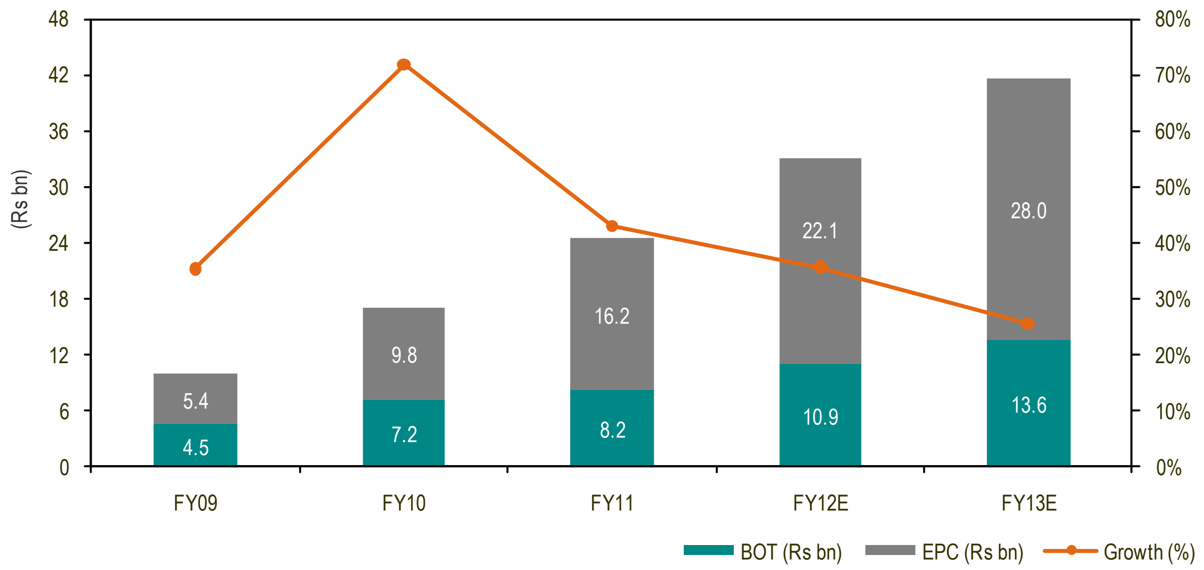


Figure: Order book break-up as of Q1FY12 (Rs111.7 bn)



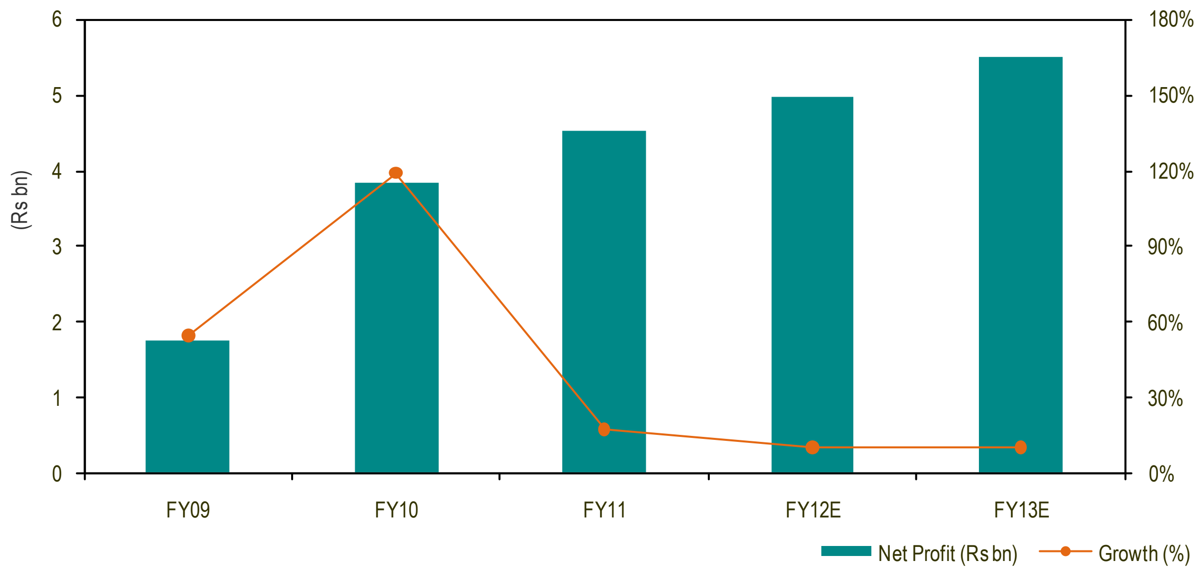
Source: Company

Figure: Revenue growth to be driven by EPC segment



Source: Company; IDBI Capital Research

Figure: Higher contribution from low margin EPC and interest expense to slow earnings growth



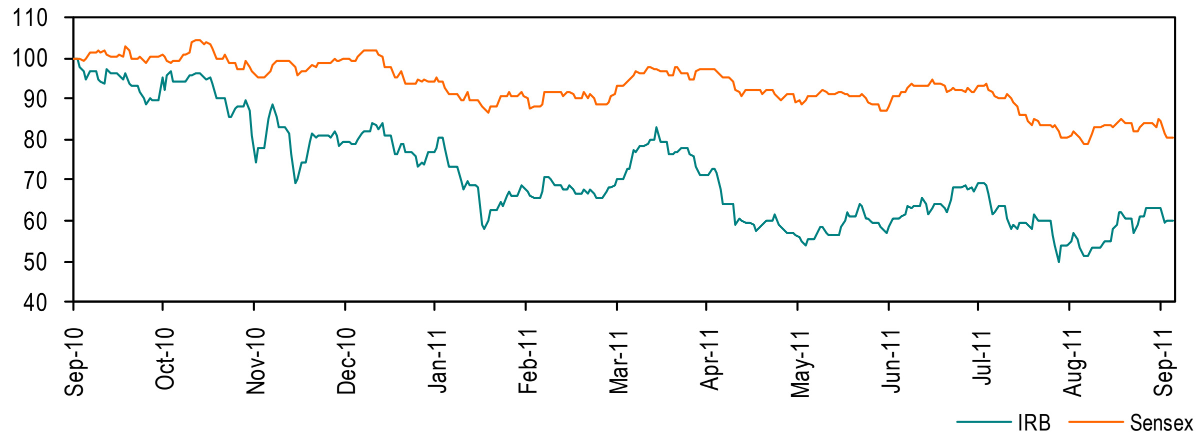
Source: Company; IDBI Capital Research

Investment Positives

Valuations reasonable post correction

Since Sep-2010, IRB has corrected by ~40% and underperformed BSE Sensex by ~20% over concerns of (1) increased competitive intensity in road sector (2) lower than expected traffic growth in key projects (3) aggressive bidding in the Ahmedabad - Vadodara project and (4) high interest rate environment.

Figure: IRB v/s BSE Sensex



Source: IDBI Capital Research

In our view, the aforesaid negatives have been largely priced-in and the valuations now appear reasonable. At CMP, the stock is currently available at 10% discount to our **SOTP-based TP of Rs180.**

Figure: IRB 12m fwd PBR (x)

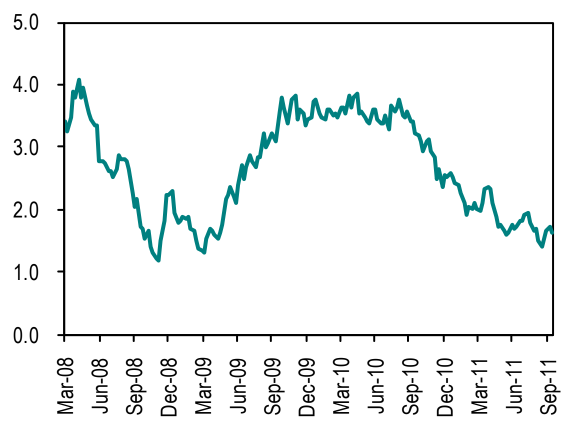
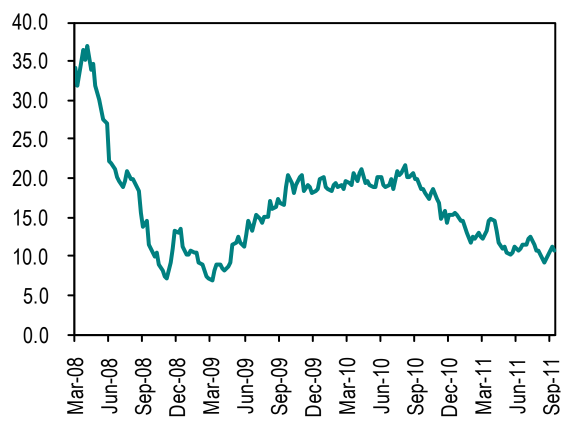


Figure: IRB 12m fwd PER (x)



Source: IDBI Capital Research

Our TP on IRB is based on sum-of-the-parts (SOTP) methodology. We value the BOT portfolio at Rs114 on discounted FCFE basis. Our key BOT assumptions: (1) cost of equity at 13% (2) interest rate of 11% (3) 5% average traffic growth across all roads projects and (4) 20% discount to company's base traffic estimates in case of non-operational projects. The EPC business has been valued at Rs56 based on 7x FY13 EPS (construction margin assumed at 20%). Investments in real estate business and cash on books together contribute Rs10 per share.

We initiate coverage on IRB with an **ACCUMULATE** rating. Key downside risk to our recommendation include: (1) another project win based on aggressive bidding (2) less than expected traffic volumes and (3) higher than expected interest rates.

Table: SOTP Valuation

Project	IRB's Stake (%)	Equity Value (Rs mn)	Value/Share (Rs)
Thane - Ghodbunder	100	1,601	4.8
Thane - Bhiwandi	100	3,645	11.0
Pune - Solapur	100	1,088	3.3
Pune - Nasik	100	1,930	5.8
Mumbai - Pune	100	14,086	42.4
Mohol - Mandrup - Kamtee	100	464	1.4
Kharpada Bridge	100	273	0.8
Ahmednagar - Karmala - Tembhurni	100	594	1.8
Surat - Dahisar	90	2,469	7.4
Surat - Bharuch	100	3,794	11.4
Tumkur - Chitradurga	100	5,459	16.4
IRDP Kolhapur	100	2,327	7.0
Pathankot - Amritsar	100	1,045	3.1
Goa - Karnataka	100	2,447	7.4
Jaipur - Deoli	100	5,186	15.6
Talegaon - Amravati	100	1,850	5.6
Ahmedabad - Vadodara	100	(10,517)	(31.6)
Total BOT Value	**100**	**37,741**	**114**
EPC Business	**100**	**18,574**	**56**
Net Cash/(debt) on books		**1,783**	**5**
Investment in Real Estate business		**1,662**	**5**
Total Equity Value		**59,760**	**180**

Source: IDBI Capital Research

Interest cost pressure manageable

- Since infrastructure projects are highly leveraged, higher than expected interest outflow will have a negative impact on the project IRR. Lenders typically have reset clauses, which enables them to pass on the increase in interest rates to the concessionaire.
- Of the current outstanding BOT debt of Rs41 bn, ~55% of debt pertains to Surat - Dahisar, Bharuch - Surat and IRDP Kolhapur projects, which are due to for interest rate reset in the next six months. Post this reset, the weighted average interest cost of BOT segment is expected to increase from current 10.8% to ~11.5%, assuming interest rates stay at current levels. **For valuation purpose, we have assumed an average interest cost of 11% across all road projects for their entire concession period.**

Table: ~55% of current BOT debt due for interest rate reset in next 6 months

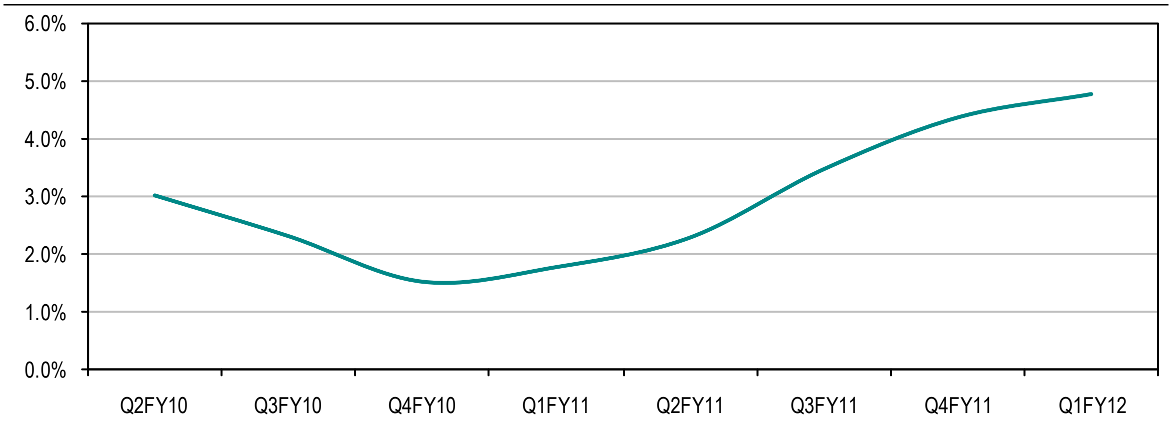
Project	Debt (Rs bn)**	% of total debt	Current rate of Interest (%)	Reset frequency	Next Reset
Surat - Dahisar	13.3	33	10.75	Annual	Sep-11
Mumbai - Pune	10.4	26	10.60	Fixed	NA
Surat - Bharuch	7.8	19	11.00	Annual	Apr-12
Tumkur - Chitradurga	1.4	3	10.75	Fixed*	2014
IRDP Kolhapur	1.8	4	12.00	Fixed*	Dec-11
Thane - Ghodbunder	0.5	1	10.75	Bi-annual	Dec-12
Under-construction projects	5.4	13	10.50	Fixed*	Dec-12
Total	**40.6**	**100**	**10.78**		

* Fixed for the construction period only; ** As of 30th June, 2011

Source: Company; IDBI Capital Research

- Higher interest rates have also resulted in higher interest outgo for the EPC segment. Financial expenses for EPC segment increased to 4.8% of revenue in Q1FY12, compared to 1.5% in Q4FY10. However, the negative impact of higher interest cost has been negated by the increase in EBITDA margins, which witnessed an expansion of 740bps during the same period. We have assumed FY12/13 financial expenses at 5.2%/3.9% of revenue (3.2% in FY11).

Figure: Finance expenses as a % of EPC revenues



Source: Company

- Consequently, IRB's consolidated interest expense is expected to increase by 27%/16% in FY12/13 to Rs4.5/5.3 bn. However, given the strong operating cash flow generation (Rs7.3/10.3 bn in FY12/13), we believe the interest cost pressure is manageable and the company will be able to comfortably meet the equity commitments of under-construction projects.

Our traffic assumptions are conservative vs. consensus

- Investors should be aware of the 'optimism bias' inherent in company's traffic projections. There are two important aspects to traffic forecast (1) base traffic i.e. traffic during the first year of operation and (2) the rate of traffic growth in the subsequent years.

Between 2003 and 2005, Standard & Poor's (S&P) compared year-one forecast traffic levels with actual traffic volumes for 104 projects across the world. The results of the study showed that, during the first year, actual traffic volumes average about 76% of their forecasted values. Some of the major reasons were (1) miscalculations regarding user's willingness to pay, especially in case of commuters (2) economic slowdown – roads that are heavily dependent upon commercial vehicles for revenue are more sensitive to economic downturns (3) improvements to competing toll-free roads (4) time/cost savings that were lower than expected. It was further observed that only in few cases, did the gap between actual and projected traffic narrowed in subsequent years.

- Similar trends have been observed in India, with base traffic numbers for majority of toll projects turning out to be significantly lower than company estimates. In case of Surat - Dahisar and Surat - Bharuch projects, the year-one toll revenues were 66% and 57% of the original projections, respectively. Investors should therefore adjust the base traffic volumes of non-operational projects for the 'optimism bias'.

Table: Gap between actual and estimated base toll revenue

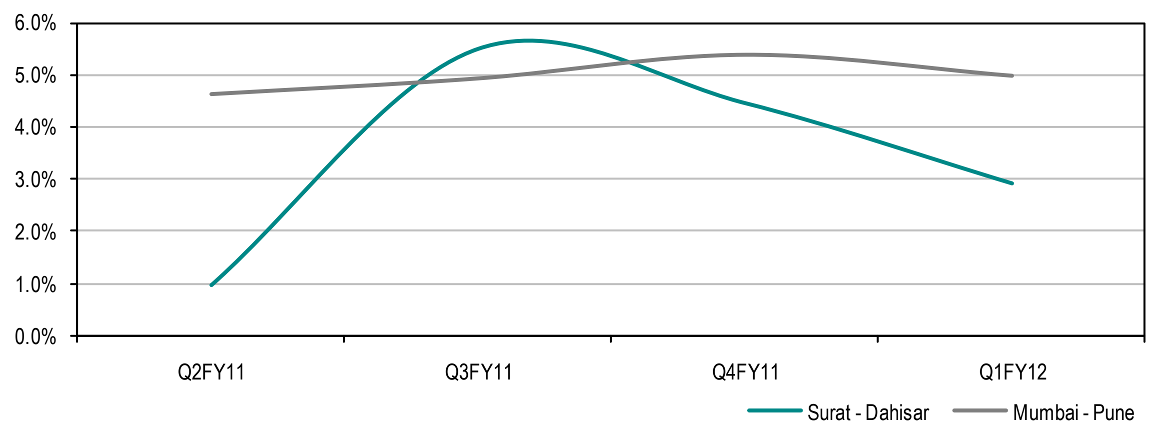
	Actual* (Rs mn/day)	Estimated (Rs mn/day)	Variation** (%)
Surat - Dahisar	9.1	13.8	66.3
Bharuch - Surat	3.4	6.0	56.8

* Based on year-one toll collections; ** Calculated as actual / estimated

Source: Company; IDBI Capital Research

- For roads with an operating history, the rate of traffic growth is the key value determinant. For instance, a 1% change in traffic growth assumptions changes our value for Surat - Dahisar project by 16%. Traffic growth rate for some of the IRB's key projects like Surat - Dahisar and Mumbai - Pune have averaged 4-5% in the past four quarters, against street expectation of 6-7% growth.
- **Our traffic projections assume (1) an average annual traffic growth of 5% across all road projects against consensus estimate of 6-7% and (2) base traffic volumes of non-operational projects at 20% discount to company's estimates.**

Figure: Traffic growth rate for key projects have been below expectations



Source: Company; IDBI Capital Research

Table: Our traffic growth assumptions

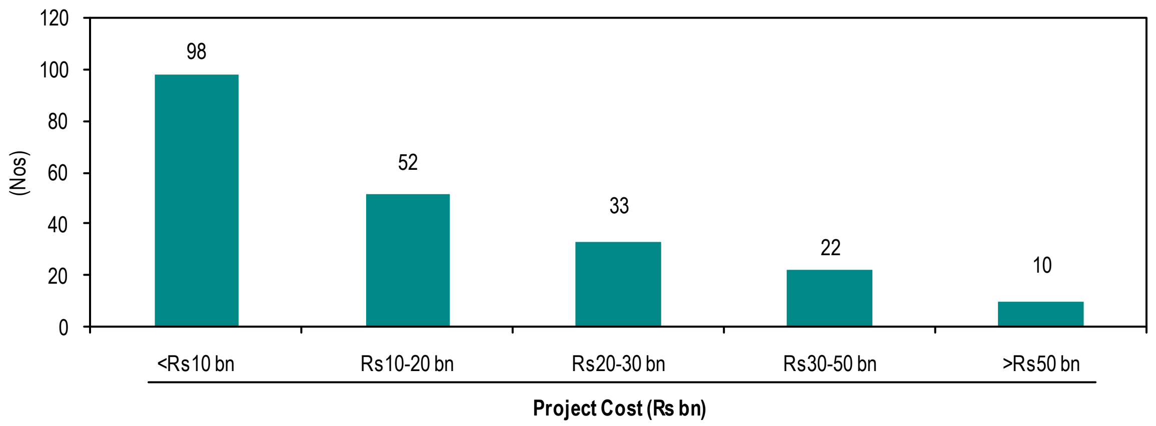
Project	Traffic growth (%)
Thane - Ghodbunder	3.8
Thane - Bhiwandi	6.1
Pune - Solapur	5.3
Pune - Nasik	5.5
Mumbai - Pune	5.0
Mohol - Mandrup - Kamtee	4.1
Kharpada Bridge	4.5
Ahmednagar - Karmala - Tembhurni	2.6
Surat - Dahisar	5.0
Surat - Bharuch	5.1
Tumkur - Chitradurga	5.1
IRDP Kolhapur	4.0
Pathankot - Amritsar	4.3
Goa - Karnataka	4.0
Jaipur - Deoli	5.2
Talegaon - Amravati	4.9
Ahmedabad - Vadodara	5.6
Average traffic growth	**4.7**

Source: IDBI Capital Research

Intense competition = no new projects for IRB

- Lack of opportunities in other infrastructure sectors like power, port, railways, and airport has led to construction companies aggressively targeting road projects to boost their order book. With ~100 players pre-qualified to participate in NHAI projects, 20-40 bids have been received for most road projects. The competition is stiff even for large road projects (>Rs20 bn), which have attracted 13-15 bidders.

Figure: Number of pre-qualified bidders for NHAI projects



Source: NHAI

- Intense competition has resulted in developers quoting irrational bids to win projects. For some of the recently awarded toll projects, the gap between L1 and L2 bidder has widened to ~60%. While difference in traffic projections may partly explain the wide variation in bids, different return expectations seems to be the key factor influencing bidding decisions. For instance, a large developer with in-house EPC capabilities and a dwindling order book may have a lower IRR expectation as the cost of sitting idle may be substantial.

Table: Competition has been intense even in large road projects

Project	Concessionaire	Premium p. a. (Rs bn)	Project cost (Rs bn)	Road length (kms)	Concession period (Years)	Premium quoted by L2	Gap between L1 and L2 (%)
Kishangarh - Udaipur - Ahmedabad	GMR	6.4	53.9	555	26	5.2	23
Ahmedabad - Vadodara	IRB	3.1	21.0	97	25	1.9	61
Beawar- Pali - Pindwara	L&T	2.5	23.9	244	23	2.3	9
Shivpuri - Devas	GVK	1.8	28.2	330	30	1.1	64

Source: NHAI; IDBI Capital Research

- Also, most construction companies think of road projects in terms of EPC earnings rather than BOT profitability. The same is substantiated by the tendency of road developers to capture higher margins in the EPC segment. This strategy results in following benefits: (1) higher revenue and earnings recognition in the P&L (2) increase in bidding capacity on account of higher net worth and (3) availability of surplus funds for investments in other projects. Although, this comes at the expense of higher project cost and lower IRR for the SPV, the overall impact in terms of value accretion is largely neutral, in our view.
- We expect competition to remain intense in the near to medium-term as the ordering activity in other sectors is unlikely to pick-up soon, given the macro economic conditions. We believe new project wins in current scenario can only come at the cost of profitability.

… another aggressive project win key downward risk to our recommendation

- In April 2011, IRB emerged as the preferred bidder for Ahmedabad - Vadodara project. The company is required to pay a premium of Rs3.1 bn to NHAI in the first year, which will increase by 5% annually thereafter. The premium quoted by IRB, was 61% higher than the L2 bidder. Despite the hefty premium, the management is confident of delivering 16-17% IRR, which in our view is optimistic. Although the project increases the visibility of the construction business (adds Rs33 bn to the order book), the NPV contribution to the BOT segment, works out to negative Rs10.5bn or Rs32/share.

  We have not factored any new project win into our projections and hence another aggressive project win like Ahmadabad - Vadodara is the key risk to our recommendation. Other downside risks include (1) lower than expected traffic volumes and (2) higher than expected interest rates.

Financial Summary

Profit & Loss Account (Rs mn)

Year-end: March	FY09	FY10	FY11	FY12E	FY13E
Net sales	**9,919**	**17,049**	**24,381**	**33,077**	**41,520**
Growth (%)	*35.4*	*71.9*	*43.0*	*35.7*	*25.5*
Operating expenses	(5,530)	(9,059)	(13,442)	(18,955)	(24,772)
EBITDA	**4,389**	**7,990**	**10,939**	**14,122**	**16,748**
Growth (%)	*6.6*	*82.1*	*36.9*	*29.1*	*18.6*
Depreciation	(1,144)	(1,819)	(2,254)	(3,135)	(4,411)
EBIT	**3,245**	**6,171**	**8,686**	**10,988**	**12,337**
Interest paid	(1,377)	(2,494)	(3,572)	(4,541)	(5,279)
Other income	282	490	645	270	372
Pre-tax profit	**2,150**	**4,167**	**5,758**	**6,717**	**7,431**
Tax	(378)	(133)	(1,117)	(1,746)	(2,006)
Effective tax rate (%)	*17.6*	*3.2*	*19.4*	*26.0*	*27.0*
Net profit	**1,772**	**4,034**	**4,641**	**4,971**	**5,424**
Adjusted net profit	**1,759**	**3,854**	**4,524**	**4,991**	**5,495**
Growth (%)	*54.4*	*119.1*	*17.4*	*10.3*	*10.1*
Shares o/s (mn nos)	*332*	*332*	*332*	*332*	*332*

Cash Flow Statement (Rs mn)

Year-end: March	FY09	FY10	FY11	FY12E	FY13E
Pre-tax profit	2,150	4,167	5,758	6,717	7,431
Depreciation	1,144	1,819	2,254	3,135	4,411
Tax paid	(424)	(812)	(1,463)	(1,746)	(2,006)
Chg in working capital	(1,401)	1,849	1,314	(852)	442
Other operating activities	176	(102)	162	-	-
Cash flow from operations (a)	**1,644**	**6,921**	**8,025**	**7,253**	**10,277**
Capital expenditure	(8,114)	(10,657)	(17,561)	(25,370)	(31,976)
Chg in investments	829	803	(97)	-	-
Other investing items	953	(713)	(6,679)	-	-
Cash flow from investing (b)	**(6,332)**	**(10,567)**	**(24,337)**	**(25,370)**	**(31,976)**
Equity raised/(repaid)	-	-	-	-	-
Debt raised/(repaid)	4,579	4,315	17,287	12,889	20,212
Dividend (incl. tax)	(223)	(429)	(753)	(597)	(597)
Chg in minorities	305	-	-	-	-
Other financing items	(96)	0	(4)	2,560	3,170
Cash flow from financing (c)	**4,565**	**3,886**	**16,530**	**14,852**	**22,786**
Net chg in cash (a+b+c)	**(123)**	**241**	**217**	**(3,264)**	**1,087**

Balance Sheet (Rs mn)

Year-end: March	FY09	FY10	FY11	FY12E	FY13E
Net fixed assets	34,707	43,477	58,706	80,941	108,506
Investments	1,108	451	551	551	551
Current assets	**10,180**	**11,477**	**20,384**	**18,091**	**20,003**
Inventories	2,054	1,698	1,638	2,238	2,491
Sundry Debtors	130	297	397	503	631
Cash and Bank	4,147	5,102	12,000	8,735	9,822
Loans and advances	3,849	4,380	6,349	6,615	7,058
Total assets	**45,996**	**55,405**	**79,641**	**99,583**	**129,060**
Shareholders' funds	**17,291**	**20,390**	**24,317**	**28,711**	**33,609**
Share capital	3,324	3,324	3,324	3,324	3,324
Reserves & surplus	13,977	17,076	21,002	25,397	30,294
Total Debt	**24,859**	**29,152**	**46,255**	**59,144**	**79,357**
Secured loans	24,741	29,035	41,139	54,028	74,240
Unsecured loans	117	117	5,116	5,116	5,116
Other liabilities	25,640	30,198	47,383	62,812	86,124
Curr Liab & prov	**4,827**	**8,046**	**11,039**	**11,154**	**12,420**
Current liabilities	3,065	4,816	7,941	8,058	9,324
Provisions	1,762	3,229	3,099	3,096	3,096
Total liabilities	**28,704**	**35,015**	**55,324**	**70,870**	**95,448**
Total equity & liabilities	**45,996**	**55,405**	**79,641**	**99,583**	**129,060**
Book Value (Rs)	**52**	**61**	**73**	**86**	**101**

Source: Company; IDBI Capital Research

Financial Ratios

Year-end: March	FY09	FY10	FY11	FY12E	FY13E
Adj EPS (Rs)	5.3	11.6	13.6	15.0	16.5
Adj EPS growth (%)	54.4	119.1	17.4	10.3	10.1
EBITDA margin (%)	44.2	46.9	44.9	42.7	40.3
Pre-tax margin (%)	21.7	24.4	23.6	20.3	17.9
ROE (%)	10.5	20.5	20.2	18.8	17.6
ROCE (%)	8.1	13.2	14.2	13.5	11.7
Turnover & Leverage ratios (x)					
Asset turnover (x)	0.2	0.3	0.4	0.4	0.4
Leverage factor (x)	2.5	2.7	3.0	3.4	3.7
Net margin (%)	17.7	22.6	18.6	15.1	13.2
Net Debt/Equity (x)	1.2	1.2	1.4	1.8	2.1
Working Capital & Liquidity ratios					
Inventory days	76	36	25	25	22
Receivable days	5	6	6	6	6
Payable days	86	64	131	96	92

Valuation

Year-end: March	FY09	FY10	FY11	FY12E	FY13E
PER (x)	30.8	14.1	12.0	10.9	9.9
Price / Book value (x)	3.1	2.7	2.2	1.9	1.6
PCE (x)	18.7	9.5	8.0	6.7	5.5
EV / Net sales (x)	7.5	4.6	3.6	3.2	3.0
EV / EBITDA (x)	17.1	9.8	8.1	7.4	7.4
Dividend Yield (%)	1.2	1.4	1.1	1.1	1.1

Notes

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Key to Ratings

Stocks:

BUY: Absolute return of 15% and above; **ACCUMULATE:** 5% to 15%; **HOLD:** Upto ±5%; **REDUCE:** -5% to -15%; **SELL:** -15% and below.

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