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POWER & UTILITIES

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1QFY13: Earnings disappoint across the board

Quick Note

August 15, 2012

Rating Remains	**Buy**
Target price Remains	INR 30
Closing price August 14, 2012	INR 12

1QFY13 net loss exceeds our forecast, consensus expected profits

As against our forecast of a normalized loss of INR1.3bn (consensus forecast at INR48mn profit), Lanco posted a normalized net loss of INR2.1bn in 1QFY13; reported net loss (including exchange fluctuation loss) stood at INR4.4bn (vs. our forecast of INR3.9bn). Consolidated EBITDA surprised positively (30%/10% above our/consensus forecast) potentially on the back of greater proportion of profits in external sales. Higher-than-expected interest cost and depreciation on consolidation of financials of Udupi / Anpara and start-up of Budhil, along with steeper loss at Griffin Coal exaggerated normalized consolidated net loss.

Power – Fuel availability, mounting receivables take toll on profits

Profitability in its power generation business suffered on three counts –

- Profitability of Anpara facility suffered as Plant Availability (PAF) was only 60% coal handling / transport infrastructure constraints. Anpara operated at a PLF of 40% and incurred a net loss of INR1.8bn
- Mounting receivables at Udupi and Amarkantak (Unit-2) pending the notification of interim/final tariff order (for Udupi) and final tariffs by HERC (for Amarkantak, Unit-2) necessitated higher working capital funding, in turn denting profitability.
- Low PLF at Amarkantak (Unit-2) and Kondapalli-II due to fuel shortage

EPC – Lower sales, cost overruns and f/x loss take toll of profits

EPC business financials were disappointing – revenues declined 9% YoY and EBITDA margin shrunk by ~10pps YoY to 8.2% on account of f/x linked losses and costs overrun in near-completion projects (Anpara, Udupi and Budhil).

Group leverage crosses 6x; our investment thesis under review

Lanco's group leverage (including subsidiaries and Associates) reached 6.8x as of June 2012 (net debt to equity stood at 6.6x) indicating growing severity of cash flows. Our investment thesis (rating, TP and earnings estimates) for Lanco is under review until after a meeting with the management wherein we seek more colour on cash flows, leverage, planned equity infusion and project-specific regulatory issues. Stock trades at 0.5x FY12 P/Book.

Fig. 1: Lanco – 1QFY13 Consolidated Earnings – Actual vs. Consensus

Earnings disappoint across business lines; dent exaggerated by f/x losses

LANCO - 1QFY13 Results (Rs million)	Actual	Nomura Estimate	Actual vs. Est.	Cons. Estimate	Actual vs. Cons.
Sales	34,958	36,778	-4.9%	32,881	6.3%
EBITDA	**5,857**	**4,522**	**29.5%**	**5,311**	**10.3%**
Net Profit (Normalized)	**(2,109)**	**(1,319)**	**59.9%**	**48**	**NM**
Reported PAT	(4,412)	(3,863)	14.2%	(14)	NM

Consensus = Bloomberg mean estimates
Source: Company data, Bloomberg, Nomura estimates

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See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Fig. 2: Lanco – 1QFY13 Consolidated Earnings Snapshot

Loss exaggerated by margin shrinkage in EPC business, under recovery of costs in power projects and higher interest outgo

Qtrly - Snapshot	1QFY12	2QFY12	3QFY12	4QFY12	1QFY13	QoQ	YoY	1QFY13F	Actual
	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	(%)	(%)	Jun-12	vs Est
Revenues	**18,671**	**18,966**	**30,290**	**33,762**	**34,958**	**3.5%**	**87.2%**	**36,778**	**-4.9%**
EBITDA	**4,090**	**4,509**	**6,028**	**3,767**	**5,857**	**55.5%**	**43.2%**	**4,522**	**29.5%**
Margin	21.9%	23.8%	19.9%	11.2%	16.8%	50.2%	-23.5%	12.3%	36.3%
Depreciation	(1,265)	(1,243)	(1,501)	(1,619)	(2,554)	57.7%	101.9%	(1,987)	28.5%
EBIT	**2,826**	**3,266**	**4,526**	**2,148**	**3,303**	**53.8%**	**16.9%**	**2,535**	30.3%
Interest expense	2,308	2,508	2,682	3,040	5,389	77.3%	133.5%	3,742	44.0%
Non operating income	241	272	247	417	321	-23.0%	33.4%	250	28.4%
Elimination of profits on transaction with as	(92)	287	436	(194)	101	NM	NM	107	-5.8%
Profit before tax	**850**	**743**	**1,655**	**(281)**	**(1,866)**	**NM**	**NM**	**(1,064)**	**75.4%**
Tax	926	567	534	219	218	-0.4%	-76.4%	-	n/m
Minority interest	503	286	254	300	(6)	NM	NM	255	NM
Share of Associate income	103	96	(2)	345	31	-91.1%	-70.2%	-	n/m
Net Profit (Normalized)	**(682)**	**(206)**	**868**	**(1,145)**	**(2,109)**	**84.3%**	**209.1%**	**(1,319)**	**59.9%**
Extraordinary Items (Net)	820	(2,389)	(259)	1,872	(2,302)			(2,544)	-9.5%
Reported PAT	**138**	**(2,595)**	**609**	**727**	**(4,412)**	**NM**	**NM**	**(3,863)**	**14.2%**

Source: Company data, Nomura estimates

Fig. 3: Lanco – Group leverage

Including loans pertaining to Griffin acquisition and working capital, leverage has crossed 6.5x

Lanco - Group leverage	1QFY12	2QFY12	3QFY12	4QFY12	1QFY13
(INR m)	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12
Net Worth (incl. minority interest)	56,089	54,620	61,481	60,112	57,313
Loan Funds	278,420	313,404	332,153	361,778	390,567
Cash and Cash Eq.	17,741	16,747	14,598	16,050	11,503
Net Debt/Equity	4.6x	5.4x	5.2x	5.8x	6.6x
Debt/Equity	5.0x	5.7x	5.4x	6.0x	6.8x

Note [1]: Figures include financials for Associates
Note [2]: Debt payable over the next twelve months = INR22bn; net current liabilities = INR14.8bn
Note [3]: Equity funding requirement in the next two years (up to FY14) = INR15-17bn

Source: Company data, Nomura estimates

Receivables expected to get liquidated beginning September

Receivables against sale of electricity to discoms rose to INR 27.7bn as of June 2012 (up from INR23.7bn as of March 2012); key consumers being Karnataka (INR10.6bn), UP (INR9bn), Tamil Nadu (INR3bn) and Haryana (INR1.5bn). Management expects: [1] Recovery of up to 60% of outstanding from Karnataka following the issuance of interim tariff order later this month; [2] Realization of receivables from Haryana by March 2013 (following judgment on tariffs by HERC) and from Tamil Nadu by December 2012; [3] Realization of receivables from UP to be contingent on central Government funding.

Amarkantak – Coal supply for Unit-2 restored in 2QFY13

Unit-2 (300MW) at Amarkantak operated at a PLF of 48% in 1QFY13 due to suspension of coal supply by Coal India (CIL) for 35 days pending clarification sought by CIL from the Government on interpretation of the eligibility criteria for securing linkage coal (whether a long-term PPA with a trading licensee, which in turn has a back-to-back PPA with a discom qualifies for securing linkage coal); coal supply has been restored in 2QFY13. Meanwhile, pending HERC's (Haryana electricity regulator) judgement on tariffs applicable under the PPA with Haryana discoms, receivables continue to rise as Lanco bills on regulated-return based tariffs, whereas revenue realization is at INR2.32/kWh.

Udupi – Interim tariff order expected shortly, Unit-2 COD in 2QFY13

As the transmission line linked to evacuation of power from Udupi is nearly complete, Unit 2 is expected to begin commercial operations within the current quarter. Management clarified that despite Unit-1 operating at a PLF of 85% and PAF of 92% in 1QFY13, losses were higher as interest outgo shot up (due to incremental working capital borrowings necessitated by mounting receivables). Further, Lanco expects the Karnataka regulator to issue an interim tariff order (wherein bulk of the increased project cost would be recognized) later this month, which would facilitate liquidation of ~INR6bn (of INR10.6bn) receivables on the books within a few months.

Anpara – Coal handling/supply bottlenecks hurting PAF

Anpara's profitability suffered in 1QFY13 as PAF was only 60% (PLF was 40%) due to coal handling / transport infrastructure constraints. While coal procurement from open market is permitted by the UP Government (in wake of sub-par linkage coal supply from CIL), existing infrastructure poses difficulty in handling multiple rakes and side-opening wagons. Management expects PAF and PLF to rise by 3QFY13 as linkage coal supply improves and coal handling bottlenecks are sorted out with the help of the Government.

Kondapalli-II – Remains eligible to secure KG-D6 gas supply

Kondapalli-II operated at a PLF of 39% in 1QFY13 (vs. 60% in 4QFY12) due to reduction in KG-D6 gas supply; realization was INR4.3/kWh. The facility remains eligible to secure KG-D6 gas as Lanco has signed a 1-yr PPA with APSEB at INR5.3/kWh, with realization being subject to gas availability (i.e. no penalty in case KG-D6 gas supply is curtailed further).

Griffin Coal – 1QFY13 loss sharply higher as exports took a hit

Although 1QFY13 coal production rose 10% YoY to 0.8mt, revenues were down 35% YoY and loss at EBITDA level stood at INR736mn. As per the management, [1] Exports took a hit as customers did not honor contracts and preferred to buy on spot, given the drop in seaborne thermal coal prices and negligible contractual penalties; [2] Overburden removal suffered in 1QFY13, which would impact production ramp-up in 2QFY13 as well; [3] Currently Griffin incurs a cash cost of A$45/ton – the aim is to bring it down to below A$40 as production is ramped up from 3.8mtpa currently to 5.5mpa by FY14; [4] No major capex towards mine expansion and evacuation is expected until FY14.

Fig. 4: Lanco – Updates on key power projects

Udupi (600MW) expected to begin commercial operations within 2QFY13

Project	Capacity (MW)	Update
Budhil	70 (2x35)	CoD on May 25, 2012. 1QFY13 PLF stood at 53%, realization w as >INR4/kWh
Udupi	1200 (2x600)	Transmission line nearly completed; Unit-2 CoD expected w ithin 2QFY13
		Interim tariff order by KERC expected by end-August
Anpara	1200 (2x600)	CIL supplies expected to improve from 3QFY13 as supply/infrastructure issues get sorted
Amarkantak-I	600 (2x300)	Coal supply for Unit-2 restored in 2QFY13
Amarkantak-II	1320 (2x660)	Boiler partes erection progress
Babandh	1320 (2X660)	Boiler #1 structural erection almost complete
Teesta	500 (4x125)	Barrage concreting completed

Source: Company data, Nomura research

Appendix A-1

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Lanco Infratech	LANCI IN	INR 12	14-Aug-2012	Buy	Not rated	A6

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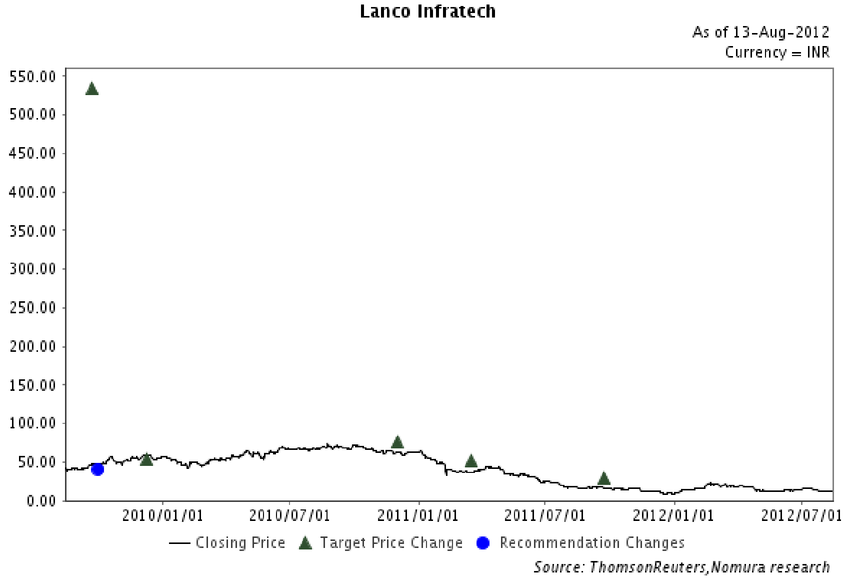
Issuer name	Previous Rating	Date of change
Lanco Infratech	Neutral	22-Sep-2009

Lanco Infratech (LANCI IN) **INR 12 (14-Aug-2012)** Buy (Sector rating: Not rated)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
23-Sep-11		30.00	16.25
17-Mar-11		51.00	36.00
01-Dec-10		76.00	62.40
09-Dec-09		53.40	58.46
22-Sep-09	Buy		48.18
22-Sep-09		534.00	48.18

For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology We use a sum-of-the-parts (SOTP) valuation methodology to arrive at a target price of INR30/share for Lanco (methodology unchanged). We discount FY12-14F free cash flows (effectively the FCF from existing order backlog) at 15.5% CoE to value the EPC/construction business, the power business using a milestone-adjusted FCFE valuation at 15.5% cost of equity, the power trading business at 7x FY12F P/E, the real estate business at a 30% discount to NAV calculated using 20% WACC, and toll roads using DCF at 15.5% cost of equity.

Risks that may impede the achievement of the target price Key downside risks: 1) High dependence on linkage coal/gas supply 2) Bulk of its under-construction capacity (coming up post FY12) is untied 3)Growing concern on execution capability and 4) High leverage, negligible margin of safety for net cash flows

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