

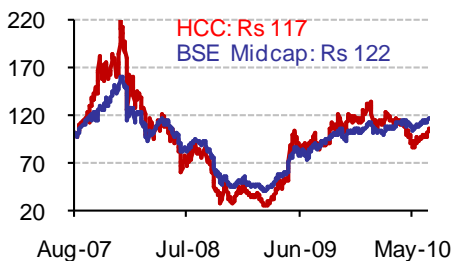
Hindustan Const. Co. Ltd.

Sell

Market data

Current price	Rs 68 (BSE)
Market cap	Rs 41,150 m
NSE symbol	HCC
BSE code	500185
No of shares	606.5 m
Free float	65.0%
Face value	Rs1.0
FY10 DPS (Rs)	Rs 0.7
52 week H/L	Rs 81.10/49.78

Rs 100 invested is now worth



Stock price performance

	HCC	Index*
6-Mths	3.4%	17.4%
1-Yr	37.4%	42.0%
3-Yr	5.3%	6.9%

Returns over 1 yr are compounded annual averages * BSE Midcap

Shareholding (June-10)

Category	(%)
Promoters	39.9
FII's	25.8
DII's	15.8
Others	18.5
Total	100.0

Report prepared by

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Investment Concerns

- **Leveraged balance sheet:** HCC has one of the highest debt/equity ratios in the industry. As of FY10 this ratio stood at 1.7x. Majority of the debt is taken to fund the working capital requirements. Since HCC has higher share of hydro power projects which typically have a long gestation period, the working capital requirements of the company are above industry average. We do not expect the working capital cycle to improve considering the nature of the business and higher share of hydro power projects. However, improving conditions in Andhra Pradesh should ease the concerns at least in the near term to a certain extent. Nevertheless, considering the stretched working capital cycle high debt will continue to plague HCC's balance sheet and impact the bottom line growth due to higher interest expenses.
- **Lavasa's valuations under cloud:** HCC is currently building one of its kind integrated mega township project – Lavasa, near Pune. The company plans to develop the entire township in 4 phases and has a 65% stake in it. Overall, it will launch approximately 193 m sq ft of constructed area. Out of this, around 64% will be for residential use and the balance for commercial purpose. HCC plans to complete the project over a period of 10-12 years. The launch for phase 1 (Dasve town) has received a strong response. While we do not have apprehensions over this unique hill city kind of a story, what worry us most are the valuations and the execution risk attached to it.

During 3QFY10 Lavasa was valued at Rs 100 bn as per the internal estimates of the management. This increased to Rs 120 bn in 4QFY10. Now the company plans to come out with an IPO of Rs 20 bn by diluting 10% stake in the company – implying a valuation of Rs 200 bn! Thus the valuation of Lavasa has in effect doubled over the last 9 months. We remain skeptical about the lofty valuations attached to the project considering the execution and longevity risk attached to it. Taking into account the uncertainty prevailing over the valuations and the long gestation cycle we maintain a conservative stance while valuing Lavasa.

We value Lavasa on a DCF basis. Here are our key assumptions:

Lavasa - Key assumptions

Total saleable area (m sq ft)	127
Duration	11 years
Realisation per sq ft	
Residential	3000
Commercial	3500
Construction cost per sq ft	1800
Revenue Escalation	5%
Cost Escalation	5%
Discount rate	20%
NPV Per share	37

Based on the above estimates, we value Lavasa at Rs 37 per share. We have been conservative in our assumptions considering the long gestation cycle and execution risk inherent the project. Nevertheless, we believe that Lavasa has great value unlocking potential if execution goes ahead as envisaged.

- **Andhra imbroglio to haunt topline:** High exposure to Andhra Pradesh had resulted in execution delays during the past few quarters. This has impacted HCCs topline growth and has resulted in piling up of receivables from Andhra Pradesh. However, the situation has improved in the recent past and the management expects restoration of normal conditions in the near future. It also plans to diversify the order book into other states. We believe that any delay towards diversification into other states may impact the company's sales growth as total exposure to Andhra Pradesh is at about 18% (1QFY11).
- **Stake dilution on the cards:** HCC is a mid-size company with a net-worth of roughly Rs 15 bn. It has also entered into various JVs to expand its bid capacity rather than diluting its stake to increase the net-worth. Right now, its promoters have 40% stake in the company. However, considering the nature of the industry, one cannot rule out potential dilution in the future.

Investment Rationale

- **Healthy order book:** HCC has a healthy order book to the tune of Rs 193 bn as of 30 June 2010. This represents a book to bill ratio of 4.9x trailing 12 months revenues. The order book mainly comprises of five verticals – Hydro Power projects (27% of the order book), Water Supply & Irrigation (20%), Roads (25%), Nuclear & Special projects (12%) and EPC projects (16%). The order inflow position of the company has been a bit rusty (declined in FY07 and FY10) in the past. The decline in FY10 was mainly due to spillover effect of elections. Going forward, the company expects to bag orders worth Rs 80-100 bn in FY11 – above the historical range of Rs 50-60 bn over the last 4-5 years. Considering the strong L1 position and improving macro economic conditions, this should not be a difficult proposition. Healthy order inflows imply strong revenue visibility over the next 2-3 years.

HCC's order book has grown at a healthy average annual growth rate of 18% between FY06 and FY10. Historically, hydro power projects constituted up to 40-50% of the order book. As hydro power is typically a high margin business, HCC's operating margins are 1-1.5% above industry average. However, the company has gradually diversified into other verticals as well, namely roads and nuclear projects. Further, the company has also acquired a 66% stake in Karl Steiner, the second largest total services contractor in the Swiss real estate market. This should facilitate its entry into the integrated building construction market in India with a presence in European region.

HCC's management expects revenues of approximately Rs 45 bn in FY11. It should be noted that the company has managed Rs 10 bn during 1QFY11 – a seasonally weak quarter. With 45% of the backlog in advanced stages of mobilization, we expect strong delivery in 2HFY11. Thus we believe that the company is right on track to meet/exceed the full year guidance.

- **BOT portfolio – Ramp up ahead:** Currently, HCC has 4 road BOT projects under its portfolio aggregating to Rs 55 bn. Out of these 4 projects - Nirmal annuity project is operational (prior to the schedule) and the Badarpur-Faridabad toll way is expected to commence operations by October 2010. HCC has also won bid to develop 3 stretches of roads in West Bengal (considered as 1 project) with an approved grant from NHAI. The company has signed the concession agreement but is yet to commit equity in this project. The Dhule (Maharashtra) project is 20% complete and the company has planned commercial operations by 2012.

HCC has ambitious plans to expand its BOT portfolio from Rs 55 bn to Rs 150 bn over the next 3-4 years comprising a mix of hydro power, airport and water projects. However, funding issues could pose a serious threat to the expansion plans. Nevertheless, the management is confident of plugging the funding gap via dilution at the SPV level. Currently HCC has invested Rs 2.4 bn in the 4 existing BOT assets while the total equity commitment stands at Rs 10.2 bn. Thus, it needs to infuse Rs 7.2 bn over the next 2-3 years as balance equity commitment. Although this appears to be challenging, dilution at the SPV level will not only take care of the funding woes but also

provide significant opportunity for value unlocking.

- **Blended margins to sustain:** HCC's EBITDA margins have been in the range of 11-13% over the last few years. However, in FY10, margins were at the lower end as certain projects did not reach the threshold revenue recognition limit. Going forward, we expect the margins of the company to sustain above the industry average as hydro power projects (even after diversification) constitute larger portion of the order book where the margins are higher. Further EBIT margins are also likely to improve due to expected decline in depreciation expenses. It should be noted that the company plans to reduce capex intensity by leasing the assets as oppose to owning them. This should reduce depreciation expenses in the future. Net margins are likely to expand but the growth is likely to be restrained by ballooning interest expenses as deteriorating working capital cycle will increase the dependence on debt (majority of the debt is used to fund working capital requirements).

Background

HCC is a mid size construction company operating across 5 business verticals – Hydro Power projects (27% of the order book), Water Supply & Irrigation (20%), Transportation (25%), Nuclear & Special Power projects (12%) and other EPC projects (16%). The company has a strong presence across Andhra Pradesh and Jammu & Kashmir. Both these geographies constitute 46% of the HCC's order book. The company has a healthy order book to the tune of Rs 193 bn and one of the highest book to bill ratio in the industry. The company's wholly owned subsidiary - HCC Infrastructure - houses the BOT assets of the company. Currently HCC has four BOT assets under its portfolio. It has also ventured into the real estate business and right now has one commercial project under its portfolio in Vikhroli. Apart from this, HCC is also currently building one of its kind integrated mega township project – Lavasa, near Pune. It has plans to develop the entire township in 4 phases and sell approximately 193 m sq ft of area over the period of 10 years.

Industry Prospects

India is on the verge of witnessing a sustained growth in infrastructure buildup. The construction

industry has clocked double digit growth over the past five years. As infrastructure plays a vital role in the Indian economy, many experts believe that in order to attain double digit growth, investment in infrastructure sector must be doubled in 12th five year plan to US\$1 trillion. (Infrastructure investments according to 11th five year plan are as per schedule). Here is a brief overview of couple of sectors in which HCC has a strong presence.

Water supply & irrigation: Despite India being an agrarian economy, the irrigated area comprises of 38% of the net sown area in the country, presenting significant scope for the development of irrigation projects in the country. The waste water treatment is also likely to experience stupendous growth because of growing industrialization. The government has launched special programs in irrigation and envisages investment of roughly US\$ 48 bn in irrigation, presenting significant opportunity for private sector participation. Increased investment in the sector and private participation should augur well for the sector.

Road transportation: India's road and highway network is second largest in the world, comprising of 3.3 m km. In addition to this existing dense network (which comprises mainly of rural roads), government plans to build 20 km of highway each day in order to expand the existing road network and thereby provide better transportation services. The government has taken various initiatives to promote road development in India like allowing 100% FDI through automatic route, providing capital grants for road projects, tax exemption for certain years etc. All these measures are likely to encourage private participation in the sector leading to overall road infrastructure growth.

Key Management Personnel

Mr Ajit Gulabchand is the Chairman and Managing Director of HCC. He is a graduate from Mumbai University and began his career as a CEO of Indian Hume Pipe Co Ltd. He is at the helm of the affairs since 1983 and has grown HCC into a modern and a vibrant infrastructure player.

Mr Y H Malegam is the director of the company since 1974. He is BCOM and FCA (England & Wales) and has wide and rich experience in the field of finance and accounts.

Mr K G Tendulkar is a non executive director of the company. He is a BCom, FCA and has over 27 years of experience as a consultant. He has

rendered services as a consultant in the areas of taxation, finance, MIS, auditing and contract management.

Risk Analysis

Note: See the 'Risk Matrix' table on the page 6

Sector: The Indian construction industry has grown at a double digit rate over the last 5 years. Government has undertaken various measures to encourage private sector participation in order to boost investment in the infrastructure sector. Considering significant under investment in the sector and measures taken by the government to boost infrastructure spending, we assign a 'medium' risk rating to the stock on this parameter.

Company standing: HCC is a mid size construction company catering to multiple verticals viz; Hydro power, Water Supply & Irrigation, Transportation, Nuclear & Special projects and Other EPC projects. The company also undertakes BOT projects and has exposure into the real estate space. HCC is also planning to build a hill city - Lavasa, near Pune. The company has strong order book and healthy margins. Nevertheless, it is saddled with debt and high working capital requirements. Hence we assign a 'medium' rating to the company on this parameter.

Sales: HCC has managed to grow its revenues at an average annual rate of 15% during FY07 to FY10. Considering the recent macro trend and healthy order backlog, we anticipate the company to maintain this growth rate over our investment horizon. We thus assign a rating of 10 to the stock on this parameter.

Operating margins: Operating margin is a measurement of what proportion of a company's revenues are left over after paying for variable costs of production such as raw materials, wages, and sales and marketing costs. A healthy operating margin is required for a company to be able to pay for its fixed costs, such as interest on debt. The higher the margin, the better it is for the company as it indicates its operating efficiency. HCC's average operating margins for the past three years have been in the region of 12.2% and we expect it to increase marginally over the next three years. As such, we assign a high risk rating of 4 to the stock on this parameter.

Long-term EPS growth: Over the last three years, company's EPS registered a negative growth as certain projects did not reach the threshold revenue recognition criteria. However, going forward we expect EPS to grow at an average annual rate of 35% over the next three years due to low base effect and better execution. As such, the rating assigned to the stock on this factor is 4.

Return on invested capital: ROIC is an important tool to assess a company's potential to be a quality investment by determining how well the management is able to allocate capital into its operations for future growth. A ROIC of above 15% is considered decent for companies that are in an expansionary phase. Considering HCC's last three years' average ROIC of 8.9%, we have assigned a rating of 2 to the stock on this parameter.

Dividend payout: HCC has had an average dividend payout of 20% over the last 3 years, which we expect to remain in the similar territory over the next three. Thus the rating assigned on this parameter is 5.

Promoter holding: A larger share of promoter holding indicates the confidence of people who run the company. We believe that a greater than 40% promoter holding indicates safety for retail investors. At the end of June 2010, the promoter holding in HCC stood at 40%. We have assigned a risk rating of 3 to the stock.

FII holding: We believe that FII holding of greater than 25% can lead to high volatility in the stock price. FII holding in HCC stood at 26% at the end of June 2010. Therefore, the rating assigned is 1.

Liquidity: The past 52-week's average daily volume of the stock is in the range of 713,000 shares, which indicates that the stock is high on liquidity. The rating assigned is thus 10.

Current ratio: HCC's average current ratio over the next three years is estimated to be around 2.2 times, indicating the company's ability to pay up short-term obligations. A ratio under 1 suggests that the company is unable, at that point, to pay off its obligations if they came due. We thus assign a low-risk rating of 9 to the stock.

Debt to equity ratio: A highly leveraged business is the first to get hit during times of economic downturn, as companies have to consistently pay interest costs, despite lower profitability. We believe that a debt to equity ratio of greater than 1 is a high-risk proposition. HCC's debt to equity is expected to remain at 1.7-1.8x in the next 3 years. We have thus assigned it a risk rating of 1.

Interest coverage ratio: This ratio is used to determine how comfortably a company is placed in terms of payment of interest on outstanding debt. The interest coverage ratio is calculated by dividing a company's earnings before interest and taxes (EBIT) by its interest expense for a given period. The lower the ratio, the greater are the risks. HCC's average interest coverage ratio during last three years remained at 1.6 and is expected to be around 1.8 over the next three. Thus, the rating assigned to the stock on this parameter is 2.

P/E Ratio: The P/E ratio (price-to-earnings ratio) of a stock is a measure of the price paid for a share relative to per share income or profit earned by the company. This is one of the important metrics to judge the attractiveness of a stock, and thus gets the highest weightage in our risk matrix. HCC's P/E on its earnings of the past four quarters currently stands

at around 23 times. As such, we have assigned a high risk rating of 1 to the stock on this parameter.

Considering the above analysis, the total ranking assigned to the company is 52, on a weighted basis, this stands at 3.8. This makes the stock a high risk investment from a long-term perspective.

Valuations

We value HCC based on SOTP (sum of the parts). The standalone core construction business is valued at Rs 24 by assigning a multiple of 9x our FY12 earnings estimates – discount to the industry average. We believe that the discount is justified considering the stretched working capital cycle, high exposure to Andhra Pradesh and leveraged balance sheet. The four BOT projects of the company are valued at book value/higher multiples after adjusting for proportionate stake depending upon the progress and equity invested in each of the project. Lavasa adds Rs 37 a share and the commercial real estate projects add about Rs 2 per share to our final SOTP target. We thus arrive at the SOTP value of Rs 69 which does not provide much headroom for upside from current levels. We thus advise a SELL on the stock

SOTP Valuations

Particulars	Methodology	Value (Rs)
Core Business	PE	24
Lavasa	DCF	37
Real Estate	NPV	2
BOT Assets	Book Value	5
SOTP Target		69

Valuations

Standalone (Rs m)	FY10	FY11E	FY12E	FY13E
Revenue (Rs m)	36,292	41,924	50,885	57,753
PAT (Rs m)	815	1,188	1,637	2,012
EPS (Rs)	1.3	2.0	2.7	3.3
Price to earnings (x)	52.2	33.9	25.1	20.6
EV/EBITDA (x)	15.0	12.2	9.7	8.2
EV/Sales (x)	1.8	1.5	1.3	1.1
RoE (%)	5.4%	7.4%	9.4%	10.6%
RoCE (%)	7.8%	8.7%	9.7%	10.4%

Risk Matrix

Rating	Weightage* (A)	Rating# (B)	Rating accorded	Weighted (A*B)
Sector Risk	-	Medium		NA
Company	-	Medium		NA
Performance parameters				
Sales	5.0%	10		0.5
Operating margins	5.0%	4		0.2
Long term EPS growth	10.0%	4		0.4
Return on invested capital	10.0%	2		0.2
Technical parameters				
Dividend payout	5.0%	5		0.3
Promoter holding	10.0%	3		0.3
FII holding	5.0%	1		0.1
Liquidity	10.0%	10		1.0
Safety parameters				
Current ratio	5.0%	9		0.5
Debt to equity ratio	10.0%	1		0.1
Interest coverage ratio	5.0%	2		0.1
P/E ratio	20.0%	1		0.2
Final Rating**		52		3.8

Rating has been assigned on the basis of the company's performance over the past five years and expected performance over the next 3 to 5 years. Rating is on a scale of 1 to 10, with 1 indicating highest risk and 10 indicating lowest risk. * 'Weightage' indicates the relative importance in percentage terms of the parameter. For instance, for an investor, given all the performance metrics, valuation (say P/E) should be the foremost criteria for buying/not buying stocks. ** The final rating has been arrived at by multiplying the rating/points given on each parameter with the respective weightage.

Financials at a glance

Standalone (Rs m)	FY10	FY11E	FY12E	FY13E
Total income	36,292	41,924	50,885	57,753
Sales growth (%)	9.5%	15.5%	21.4%	13.5%
Operating profit	4,279	5,261	6,615	7,797
Operating profit margin (%)	11.8%	12.5%	13.0%	13.5%
Net profit	815	1,188	1,637	2,012
Net profit margin (%)	2.2%	2.8%	3.2%	3.5%
Balance Sheet				
Current assets	46,242	53,401	64,886	74,327
Fixed assets	11,845	13,303	14,672	16,057
Investments	4,087	4,087	4,087	4,087
Total Assets	62,175	70,790	83,645	94,471
Current liabilities	21,856	25,647	31,873	36,966
Net worth	15,172	16,123	17,432	19,041
Loan Funds	25,147	29,021	34,340	38,464
Total liabilities	62,175	70,790	83,645	94,471

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