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India Research
Construction & Hospitality

15 Dec 2005

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Important disclosure on the last page

Prajay Engineers Syndicate Ltd

www.prajayengineers.com

Prajay Engineers Syndicate Ltd (PESL), a Hyderabad-based construction & hospitality company with trailing net profit of Rs.123mn, is rapidly expanding both constructions and hospitality businesses to cater to buoyant market in these businesses. In FY07, it is launching four large housing projects, three of which will have 100% income tax deduction. It will also construct a 3-star hotel, a 5-star hotel, and a golf course in FY06-FY07 and these will contribute to revenues & profits from FY08 onwards.

DCF Value Rs.153 | **Price Rs.73** | **+110%**

The stock currently trades at 5.3 times and 3.5 times the estimated fully diluted EPS for FY07 and FY08 respectively. We expect the fully diluted EPS to grow at 72% and 50% in FY07 & FY08. We estimate one-year out DCF value at around Rs.153 (CoE 15%, WACC 13.8%). Our DCF value estimate is 6.4 times the estimated EPS of Rs.20.89 for FY08.

Key Data (08 Dec 2005)

Market Cap	Rs.850mn US$18mn
Shares Outstanding	11.67mn
52 week High-Low	Rs.144 / Rs.5
Average Daily Volume	No. of shares
BSE 365 days	139,575
BSE 30 days	138,191
BSE Scrip Code	531,746
BSE Group	B2

Shareholding %	30 Sep 05
Promoters	35.95
Institutions	2.45
Others	61.60

Multiple Valuation	YE Mar-07E
EV/EBITDA	2.3x
EV/ EBIT	2.7x
Market Cap/Sales	0.53x
P/E	5.3x
P/BV	1.1x

Key Trigger in F07

- Three large township projects on 40 acre+ land to begin by Apr-06. Income from all these projects will be tax-free. Another large project to begin in Oct-06.

Key Investment Points

- PESL is one of the well known names in housing construction in Hyderabad. It has been in this business for 15 years.
- PESL operates in construction (mainly housing) and hospitality businesses – two of the fastest growing businesses at present.
- Prajay Engineers has done very well lately on the back of buoyant market for housing.
- It has a long pipeline of housing construction projects, which extend well beyond FY08. Work is beginning on three large projects in Apr-06. Construction projects contribute to revenue & profits as soon as the work & bookings begin.
- After tasting the success in the hospitality segment with two properties, it is now constructing three more properties.

Value Kickers

- Additional projects not currently envisaged.
- Sale of properties held as stock-in-trade whose market value is over Rs.2bn, which is twice the enterprise value.

Points of Concern

- Peculiarities of payment structure in construction business
- Planned capacity addition in hotels in Hyderabad and PESL's planned huge investments relative to its networth in hotels.

Introduction

PESL is one of the well known housing construction companies in Hyderabad & Secunderabad. It started in 1997 as Engineers Syndicate, a partnership firm. In 1994, the firm was split and PESL was formed. PESL went public in 1995. The other part of the firm is now known as Janapriya Engineers Syndicate Pvt Ltd and is a closely held company. The two companies have completely separate ownership and management.

PESL has now over 15 years experience in construction. It has been mainly into the construction of low cost housing for masses. Lately it has gotten into construction of high end flats & bungalows, and commercial premises as well. Its focus has now shifted from low income groups to middle income groups, from flats to independent houses and from city to outskirts of the city.

Housing construction industry is mostly localized and fragmented. There are around 300 firms in construction business in Hyderabad. Some of the better known names include Nagarjuna Constructions, Janapriya Engineers Syndicate, and Ambience Properties. PESL's activities are also confined to twin-city of Hyderabad-Secunderabad and its outskirts. While most of its past projects are within the twin-city, most of its current & proposed projects are on the outskirts of the twin-city.

In 2001, PESL diversified into hospitality. It commissioned Celebrity Club (www.celebrityclubindia.com) at Shamirpet, 20 Kms from Hyderabad. In FY05, it commissioned Celebrity Boutique Hotel comprising of 29 rooms, pub, restaurant, gym, conference hall, and banquet hall. This property is within the city and close to airport.

Annual Revenue Breakup

Rs.mn	FY04	FY05	FY06E	FY07E	FY08E
Construction	152	184	590	1,789	1,817
Hospitality	26	49	95	100	363
Total	**178**	**233**	**684**	**1,889**	**2,179**
Proportion %					
Construction	85.6	79.0	86.1	94.7	83.4
Hospitality	14.4	21.0	13.9	5.3	16.6
Total	**100**	**100**	**100**	**100**	**100**
Growth %					
Construction		20.8	220.8	203.5	1.5
Hospitality		91.2	94.2	5.3	262.5
Total		**31.0**	**194.2**	**176.0**	**15.3**

Quarterly Revenue Breakup

Rs.mn	QE Jun-05	QE Sep-05
Construction	124	80
Hospitality	24	21
Total	**148**	**101**
Proportion %		
Construction	83.9	79.1
Hospitality	16.1	20.9
Total	**16.6**	**15.1**

Seasonality
Both the business segments of the company are seasonal. Rainy season is a low season, as there is slow down in construction work, visits to projects by prospective customers, tourist arrivals, and outings by city residents. This is reflected in the company's performance for the QE Sep-05 wherein revenue & profits are lower than those in the QE Jun-05. This year the impact of seasonality was exacerbated due to very heavy rain fall in the city.

Near term historical performance
PESL's financial performance till FY04 is nothing to write home about with annual profit of less than Rs.10mn. A large amount of funds were blocked in its farmhouse project, which did not take off as expected. The project was a few years ahead of time. This project has now become a money spinner for it. The buoyant housing market in the city came as a savior. Unlike metros, the housing rally started in mini-metros and other towns only in 2004-05. PESL made a real turn around in FY05 with revenue growing 30% to Rs.237mn and PAT growing 283.5% to Rs.47mn.

In FY05, PESL completed two large housing construction projects – Prajay Sai Gardens and Prajay City. Prajay Sai Gardens is a township of 700 independent houses on the outskirts of the city. Prajay City is a township of 800 flats on the outskirts of the city.

It started work on Prajay Meadows in January 2005. It's a small project of eight row houses at Banjara Hills, which is in the heart of the city. The project is likely to be completed by Jun-06.

In the first half of FY06, revenues grew 295% to Rs.247mn and PAT increased 61 times to Rs.80mn. Part of the profit is also from sale of a land in QE Jun-05. The projects that contributed to revenues & profits in the first half are Prajay Meadows, Prajay Homes, Prajay Sai Garden Extension, and Celebrity Villas.

The excellent performance was driven by new projects, high housing prices, and a long term fixed price cement supply contract at Rs.90 per bag (current market price is Rs.120 per bag).

Key Investment Arguments

Seemingly unending Demand for housing

India has a huge shortage of quality dwelling units. Demand for housing is rising faster in metros and mini-metros like Hyderabad due to migration of people into these cities for business & jobs, rising income & aspiration levels of residents, easy availability of housing finance, and low rate of interest. To cut the long story short, demand for quality homes far outstrips the supply. There's currently all the enabling conditions for the twain (demand and supply) to meet.

Even in Hospitality, the growth drivers are rising income, rising population, rising standard of leaving and consequently rising proportion of family budget on entertainment including tourism & outings. The growing business activity in the city and consequent increase in business seminars & conferences are driving demand for hotel rooms, conference rooms, office & commercial spaces from the business segment.

Revenues & Profits accrue on percentage completion basis

Revenues & Profits accrue on percentage completion basis. If during a quarter, 20% of the project work is completed, revenues & profits are booked on the 20% of the project provided 20% of the project is sold (or booked) or the extent of project sold or work completed whichever is less.

Construction projects are low gestation projects, as revenues, profits, and cash inflows can start shortly after the project work begins.

Unlike construction projects, hospitality business requires large upfront investments and a gestation period of upto two years before profits & cash inflows can be seen. We are not too pleased with the company's foray into hotels, which is a highly capital intensive and low RoCE business. Even in the best of the times, hotel business does not make decent return on capital. The value of the company can be substantially higher if the company cancels its foray into 3-star and 5-star hotels. Given that there is so much potential to grow in the construction business, the company's planned investments of Rs.1680mn in two star hotels is a big negative from our viewpoint.

A key constraint now removed

PESL was operating on a credit limit of Rs.90mn till recently. Its credit limit has now been raised to Rs.400mn (current outstanding is Rs.150mn). Timely availability of cash was a key constraint earlier. Availability of credit limit gives it the holding power in housing projects. Bookings in housing projects typically start at very low prices but price rises smartly once the project shows progress. If the company can delay sales till the project shows some progress, it can make significantly more money. However, this requires cash to invest in working capital. Besides, when the lucrative land deals present themselves, immediate cash is required to strike the deal. In the absence of cash, the deals were being given either a go-by or were being bought in directors accounts. Either way, the minority shareholder looses. We hope gains on lands will now come to the company. Acquiring large lands at key locations is one of the key success factors in construction business.

At its project Celebrity Homes, the company sold plots upto Rs.3500 per sq yard. Now the outer ring road is being constructed and this will be built touching the main gate of Celebrity Homes. The company stopped further sales in the project. It expects to fetch Rs.6000 per sq yard once the outer ring road construction near this project is over. Nearly 40% of the project is still with the company. PESL would not have been able to hold on to its stock if it had been constrained by resources.

Construction projects are largely customer-financed

A large part of the cost of land and construction is covered by advances from customers either directly or through their housing finance companies. Therefore, construction business does not require large upfront commitments and long wait to realize the invested capital. Depending on the company's strategy, liquidity position, and future outlook on housing prices; advances from customers can cover upto 100% of the capital committed to the project.

100% deduction u/s 80IB (10) of the Income Tax Act

Residential housing projects built on more than one acre of land & where individual units are less than 1500 sq. ft. are eligible for 100% deduction u/s 80IB (10) of the Income Tax Act. This means that no tax is payable on profit from projects eligible u/s 80IB. MAT is, however, payable if current tax is less than 7.5% of total book profit including the profit from eligible projects. About half of its construction projects – current & proposed are eligible for this deduction. Three large township projects, which are being launched in April-06, will be eligible for this deduction.

Four housing projects are currently under implementation

Four housing construction projects are currently under implementation. These have started contributing to revenues and profits and will continue to do so till the completion of the projects.

Project	Commenced	Completion	Eligible for 80IB?
Prajay Homes	Apr-05	Mar-08	Yes
	Project comprises of 209 houses and 209 plots of 200 sq yards each at Aliabad, near Shamirpet Lake on Karimnagar Highway. Construction cost of house is Rs.7 lakh for standard and Rs.9 lakh for Deluxe. The land belongs to directors.		
Prajay Sai Garden Extension	Jul-05	Dec-08	Yes
	Township of houses and plots.		
Prajay Meadows	Jan-05	Jun-06	No
	Eight row houses on Road No.12 at Banjara Hills.		
Celebrity Villas	Jul-05	Sep-07	No
	80 High-end Villas on outer ring road		

Four large housing projects are commissioning in FY07

Project	Commencing	Completion	Eligible for 80IB?
Ankushapur Village	Apr-06	Sep-09	Yes
	Township of 600 houses on 40 acres of land		
Prajay Landmark	Apr-06	Mar-08	Yes
	750 Flats' project in village Nacharam		
Kuntloor Village	Apr-06	Sep-09	Yes
	Township of 600 houses on 50 acres of land		
Prajay Enclave	Oct-06	Sep-08	No
	400 Houses on 50 acres of land near Shamirpet opposite Genome Valley / Biotech Park.		
Prajay Surya Mall	Jul-06	Jun-08	No
	Commercial Mall		
Prajay Srinilayam, Siddipet			No
	Project comprises of 24 Flats, 8 Offices, and 8 Shops.		

The first four projects in the table above are very large projects on the outskirts of Hyderabad. Three of them are expected to commence work in April-06 and the fourth one in Oct-06. The first three projects' profit will be 100% tax-free as well.

Hospitality: Construction work started for a 3-star hotel & Golf course

Construction work on a three-star hotel called "Celebrity Holiday Retreat" with 160 rooms has commenced at PESL's club premises at Shamirpet. This is expected to cost Rs.100-180mn and is expected to be completed by Apr-07. We have, however, considered revenues & profits from this hotel only from QE Sep-07. This is proposed to be converted later into a 5-star hotel.

Work has also begin on a 18-hole PGA class Golf Course on 130 acres of land at Anthyepalli given to it on for 33 years by APTDC (Andhra Pradesh Tourism Development Corporation) on BOT basis. The company has 80 acre of elevated land adjacent to the Golf Course land.

It proposes to build a 5-star hotel facing Golf Course with 300 rooms. The cost is estimated at Rs.1500mn. The project is expected to be completed by Mar-07. We have, however, considered revenues & profits from these projects only from QE Sep-07.

Return on capital on these projects is going to be substantially lower than that on construction business. We would have liked the company to stick to the construction business where there is still enormous potential for growth.

Input prices can be passed on in a buoyant market

Key inputs are cement and steel. While cement prices continue to rise, steel prices have cooled down. It is expected that cement prices will strengthen further and steel prices will weaken more. Hence, there is not much to be concerned about on input price front. Moreover, in a buoyant market like this, input price hike can be passed on to customers though there can be a lag depending on presence/absence of escalation clause in the agreements with buyers.

Risks / Concerns

Large investments in Hotels

Many large hotel chains have planned capacity addition in the hotel sector in Hyderabad. These will exert pressure on room rents and occupancy rates a few years down the line when these hotels open for business. In the interim, everyone is making good profits. There is anecdotal evidence suggesting huge shortage of rooms. At the time of a recent medical conference in Hyderabad, top doctors from all over India are said to have shared rooms with three doctors in a room. Even the hotels at outskirts were full. Not only this, some doctors were doing daily commute between Mumbai and Hyderabad to attend the conference, as they could not get the hotel rooms. This happens during a short period of time when large conferences are organized in the city. The new capacities will correct the room rents & occupancies on their commissioning.

Hotels are highly capital intensive and large gestation project. In addition, they require a regular dose of capital expenditure on renovation & refurbishing. Most of the well-known hotel chains are running on single digit RoCE even in the best times like these. We are of the view that while some hotels are making good returns currently, they are unlikely to cover the cost of capital over the period of a cycle.

Data analysis on top 10 listed hotel companies in India in terms of profits in the last one year (last four quarters) i.e Year Ended Sep-05 reveals that average RoCE (NOPLAT / CE) for these top hotels was only 9.8% (range 5.6% to 16.4%) in the last one year, which is supposed to be a very good year given the huge demand-supply mismatch in hotel room capacities. Over a business cycle i.e. over the last few years, averge RoCE is much less than the current RoCE. As more & more hotel rooms are added over the next few years, RoCE will fall. Over the complete business cycle that is till the next trough, RoCE is likely to be lower than the RoCE in a very good year. A viable business should be able to earn at least its cost of capital (CoC) over one cycle period. Some of the best hotels, which have been in this business for years, have not been able to meet CoC in one of the best years for hotel industry. We can simply forget about meeting CoC over a cycle period.

Even the average RoE for these best hotels in a good year is just 12.6% which is less than the averge CoE (cost of equity) of 15% (15% is the least that we expect from equity investments). The top 10 hotel companies in this analysis were Indian Hotels, ITC Ltd (Hotel

Segment), Hotel Leela, EIH Ltd, Asian Hotels, TAJ GVK, Jaypee Hotels, Oriental Hotels, Indian Resort Hotels, and Sterling Holiday Resorts.

PESL is investing Rs.1680mn in two hotel projects. This is an audacious capex into a cyclical, highly capital intensive industry by a company whose networth as at the end of Sep-05 was mere Rs.265mn. We hope management take a sagacious view of it and back out of the non-judicious hotel projects.

Peculiarities of Payment Structure in construction projects

Our discreet enquiries reveal that some of the peculiarities of payment structure in construction projects exist in some non-80IB projects of PESL. We hope these peculiarities will vanish in the interest of minority shareholders.

Conflict of interest with promoters in some land deals

Some of the lands were first bought by directors and later transferred to PESL at profit. We understand that this was being done based on availability of cash. If the company did not have enough cash, land was being bought by directors. To avoid conflict of interest, we hope that the promoters will infuse their own surplus cash to buy more equity into the company and use the company as a vehicle for all the land deals.

Part of the blame is also on Urban Land (Ceiling & Regulation) Act. Unlike many other states and all union territories, the state of Andhra Pradesh has not yet repealed this Act. As per the Act, a company or for that matter any entity or individual can not hold more than 1,000 sq. meter of vacant urban land in an urban agglomeration.

Attitude towards minority shareholders

PESL's apathy towards minority shareholders is evident from the following:

- The requirement of filing certain documents/statements on SEBI's EDIFAR (http://sebiedifar.nic.in) became applicable to PESL w.e.f. QE Jun-03. However, the company has not yet started online filing on SEBI EDIFAR.

- Promoters sold 12.81% stake in the company in QE Sep-05, but have not reported this to the stock exchange, as required under regulation 13 of SEBI (Prohibition of Insider Trading Regulations) 1992.

- The company had informed in the corporate governance report included in the annual report for FY05 that SEBI had issued it a letter dated 29 Nov 04 regarding non-compliance of Reg. 6 & 8 of Takeover Regulations. Compliance officer of the company informs us that the matter has been settled to the satisfaction of SEBI. This should have been informed to the shareholders through stock exchange in the interest of minority shareholders.

Ownership and Management

The company is managed and 35.95% owned by Promoters – Reddy family of Hyderabad. Major shareholder among promoters are DS Chandra Mohan Reddy, MD; D Vijay Sen Reddy, ED; Vijmohan Construction P Ltd, a promoter group company engaged in road construction; D Hymavathi Reddy, Director; and D Sharmila Reddy, Director. Morgan Stanely AMC's India Special Situation Fund holds 2.45% stake. Promoters have over 20 years experience in the construction business.

PESL has got the approval to raise $75mn through FCCB/GDRs. It plans to initially raise $15mn through FCCB. We estimate that $15mn should be sufficient to take care of its planned expansions and projects. We have taken into account the equity dilution from this issue assuming the conversion at Rs.75 in FY07.

There are currently 1.35mn warrants pending conversion at Rs.63.50 per share. There are held by promoters. After the conversion of these warrants, promoters' stake will rise to 42.6% if the current holding is maintained till the conversion. After the $15mn FCCB issue, the fully diluted stake of promoters (assuming Rs.75 as conversion price) will be 25%.

Valuation and key underlying assumptions

We estimate the fair value per share in the range of Rs.132-Rs.193 (point estimate: Rs.153) using the discounted cash flow methodology. Key assumptions for the valuation are 3% terminal growth and 3% terminal spread over WACC. Cost of equity was estimated at 15% based on beta of 1 (based on CAPM), risk free rate of 7% and market risk premium of 8%. We have considered the likely dilution from the proposed $15mn FCCB issue at a conversion price of Rs.75 (assumed) in FY07. Fair value range is based on extreme assumptions on key variables like construction cost, direct costs in hospitality, and timing of commissioning of projects.

Income Statement

Rs. Mn.	Mar-06E	Mar-07P	Mar-08P
No. of months:	12	12	12
Revenues	689	1,894	2,184
EBIT	274	564	717
PBT	223	422	585
Adj. PAT	184	316	476
EPS (Rs.) (diluted)	8.08	13.89	20.89

Ratios

	Mar-06E	Mar-07P	Mar-08P
No. of months:	12	12	12
Revenue Growth %	190.3	174.8	15.3
EPS Growth %	291.9	71.9	50.4
RoE %	58.3	30.6	27.2
D/E x	1.2	0.4	0.1
Receivables days	85	75	65
Inventory days	341	130	144
Customer advance /Inventory %	50	60	70
Suppliers Credit days	150	120	90

Balance Sheets

Rs. Mn.	Mar-06E	Mar-07P	Mar-08P
Assets			
Net Block	791	1,991	1,991
Investments	0	0	0
Net Current Assets	190	230	233
Liabilities			
Equity Capital	138	222	222
Reserves	289	1,052	1,330
Preference Capital	0	0	0
Debt	513	890	576
Non-Current Liab.	42	110	167

Half Yearly Performance

Rs. Mn.	Sep-05	Mar-05	Sep-04
No. of months:	6	6	6
Net Revenues	247	170	62
EBITDA	112	63	11
Depreciation	5	5	4
EBIT	107	58	7
Interest	8	10	9
Other Income	2	2	3
PBT	101	50	1
Tax ~	21	7	-
PAT	80	43	1
Equity Capital	117	77	77
EPS –annualised (Rs.)	13.77	11.17	0.34

~ FBT not provided for HYE Sep-05

Half Yearly Ratios

%	Sep-05	Mar-05	Sep-04
No. of months:	6	6	6
EBITDA / Sales	45.5	36.9	18.1
EBIT / Sales	43.6	34.1	11.2
Tax/PBT	20.8	12.3	0.0
Operating cost/sales	44.9	50.9	57.3
Staff cost/sales	4.1	5.2	12.1
Other cost/sales	5.5	6.9	12.6

Multiple Valuation

	Mar-06E	Mar-07P	Mar-08P
EV/EBITDA x	4.8	2.3	1.8
EV/EBIT x	5.0	2.7	2.1
Mkt. Cap/Sales x	1.46	0.53	0.46
P/E x	9.0	5.3	3.5
Price/Book x	3.9	1.1	0.9

Free Cash Flow

Rs. Mn.	Mar-06E	Mar-07P	Mar-08P
No. of months	12	12	12
NOPLAT	201	422	530
Change in Net Working Capital	112	131	67
Operating Cash Flows	***89***	***291***	***463***
Net Capex & others	599	1,185	(57)
Free Cash Flow	**(509)**	**(894)**	**520**
Non-opr. Cash flow	0	0	0
Cash Flow to Investors	**(509)**	**(894)**	**520**

Financing Cash Flow

Rs. Mn	Mar-06E	Mar-07P	Mar-08P
No. of months:	12	12	12
Post-tax Interest	29	63	59
Repayment/ (issue) of Debt	(413)	(338)	314
Equity Share Dividend	16	70	147
Buyback/Redn/ (issue) of equity shares	(142)	(690)	0
Increase in excess cash	0	0	120
Financing Cash Flow	**(509)**	**(894)**	**520**

DCF Valuation

	Rs. Mn.	%
Key Assumptions		
Terminal Growth Rate		3.0
WACC		13.8
Cost of Equity		15.0
Terminal ROIC		16.8
Fair Value Range (Rs.)	132-193	
Per share Value (Rs.)	**153**	
Stress Value per share (Rs.)	100	

Important Disclosure

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