SECTOR UPDATE

CONSTRUCTION

COVID-19 deals a knockout punch

India Equity Research | Construction

The construction sector, already grappling with lower capex amidst rising fiscal stress, has been dealt a body blow by the COVID-19 crisis. Going ahead, we expect: a) Fall in order intake amidst slower economic growth; b) Pressure on margins; c) Higher working capital intensity and d) Lower traffic on toll roads. Hence, we moderate our assumptions for order intake, execution, operating margins and traffic growth and cut earnings multiples; our FY21E earnings have been revised down 22-70%. Fiscal package from the government in the form of aggressive capex boost presents an upside risk to our estimates. As the focus shifts to cash flows, we prefer companies with lower scale of operations and healthy balance sheets like Ahluwalia Contracts and KNR Constructions. We upgrade NBCC to 'HOLD' and downgrade Texmaco Rail to 'HOLD', largely due to valuation being attractive and expensive, respectively.

COVID-19: A perfect storm sets the sector adrift

The EPC sector was already in choppy waters with order inflows declining over the past few quarters. The COVID-19 crisis has dropped another bombshell with the lockdown likely to lead to revenue loss and fall in margins due to inadequate fixed cost recovery. We believe execution will continue to get impacted over the next one-two quarters as many labourers have gone back to their native places and will take some time to return.

Second order effects more worrisome

Beyond the immediate impact on revenues and profits, we expect order accretion to tumble over the near term as the huge fiscal hit compels the government to cut capex. This will lead to margin decline; in addition, the payment cycle will get stretched as budgetary allocation comes under pressure. Asset values will also get impacted due to fall in traffic on roads. The only saving grace compared to the previous down cycle of 2012-14 is that leverage at the sector level is significantly down as companies have steadily moved from the asset ownership business. Hence we believe that a lot more companies will survive this downtrend compared to the previous one. An aggressive capex package from the government presents an upside risk to our thesis.

Outlook: An unexpected thunderbolt

The COVID-19 crisis has hit EPC stocks badly, which have plunged 30-50% over the past two months. We believe near-term outlook for the sector is cloudy and hence tone down assumptions for order intake, revenues, margins and traffic growth. We also assume working capital cycle build-up, cut earnings multiples and use higher discount rates; our FY21E earnings have been revised down 35-70%. We prefer KNR Constructions (**BUY**) and Ahluwalia Contracts (**BUY**) which have smaller scale of operations and healthy balance sheets. We upgrade NBCC to '**HOLD**' from 'REDUCE' and downgrade Texmaco Rail to '**HOLD**' from 'BUY', largely due to valuation being attractive and expensive, respectively.

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Capex growth was already trending down….

With lower economic growth eating into government's tax revenues, growth in budget allocation for infra sectors was already flattening. The Union Budget FY21 had witnessed muted growth in outlays for sectors like railways and roads.

Table 1: Railways—Breakdown of proposed central plan outlay **(INR bn)**

Particulars	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY20	FY21
							Budget	Revised	Budget
	Actuals	Actuals	Actuals	Actual	Actual	Actual	estimates	estimates	estimates
Budgetary support	271	301	350	452	434	528	658	678	700
IEBR	269	286	585	647	586	805	941	882	908
Total	**540**	**587**	**935**	**1,099**	**1,020**	**1,334**	**1,599**	**1,561**	**1,608**

Table 2: Roads—Breakdown of proposed central plan outlay **(INR bn)**

Particulars	FY14	FY15	FY16	FY17	FY18	FY19	FY20 (B.E.)	FY20 (R.E.)	FY21 (B.E.)
Budgetary support	207	253	275	412	508	676	721	722	820
IEBR	79	33	280	331	505	612	750	750	650
Total	**287**	**287**	**555**	**743**	**1,013**	**1,289**	**1,471**	**1,472**	**1,470**

Source: Government documents, Edelweiss research

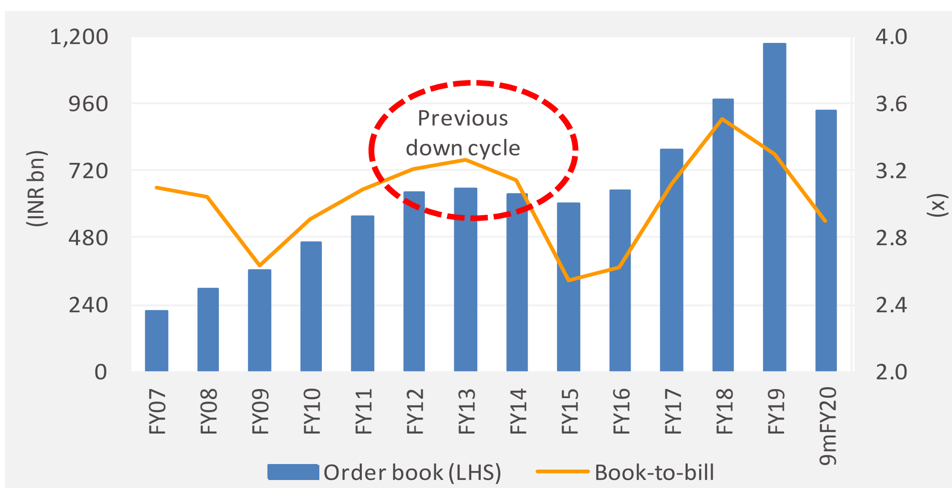
Note: RE – Revised Estimate, BE – Budgeted Estimate

For e.g., for the railways sector, the government allocated ~INR1.6tn in Budget FY21, a growth of mere 3% over the revised capex of INR1.56tn in FY20. The road network development, in fact, received a setback in the budget; **total road sector capex at INR1.47tn was marginally lower than the revised FY20 figure**.

…leading to order accretion faltering for infra companies

Order accretion, which had improved significantly since FY16, had weakened over the past year, leading to fall in revenue visibility for EPC companies.

Chart 1: Lower order inflows have led to decline in revenue visibility recently

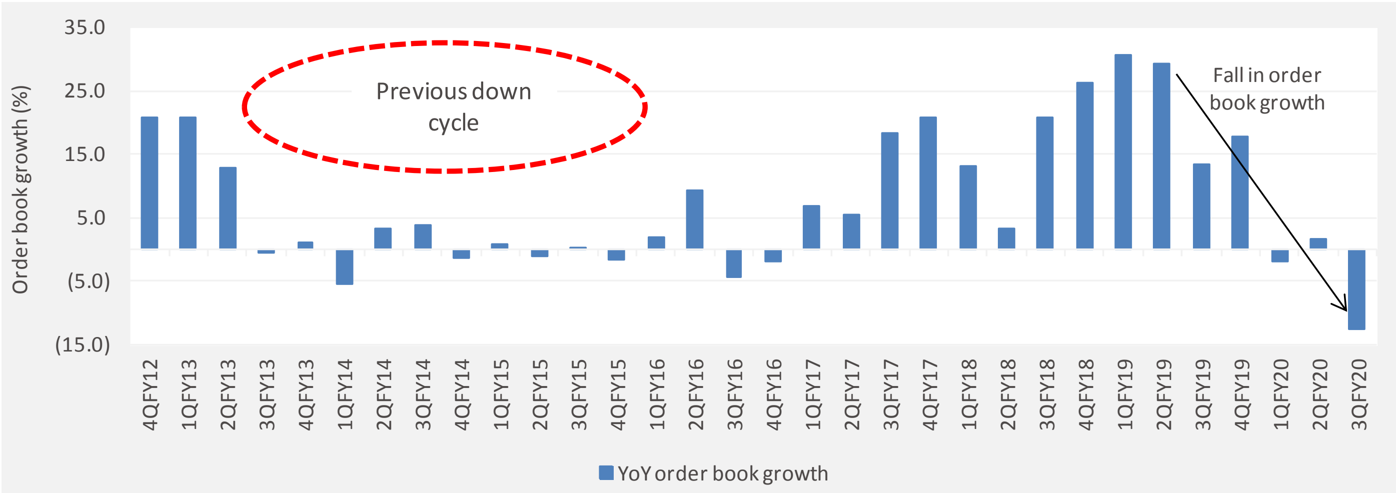


Source: Company, Edelweiss research

Note: Book-to-bill is based on TTM revenues

Data for representative set of companies which cover all major infra sub-segments

Chart 2: Order book growth had started falling over the past few quarters



Source: Company, Edelweiss research

The fall in order book growth had, in fact, started in FY19 itself; the trend has gathered pace in FY20.

COVID-19 to further roil awarding…

The ongoing crisis and the lockdown have imparted a massive shock to the economy. This implies that GDP growth is likely to correct significantly in the interim, hurting government's revenues. In addition, government's focus will turn to critical matters such as healthcare, ensuring food availability for poor sections of the society, etc.

The magnitude of the financial scarcity is evident from the fact that some state governments have already decided to cut pay of its employees. For e.g., Telangana, which has been a source of irrigation orders for many infra companies, has decided that:

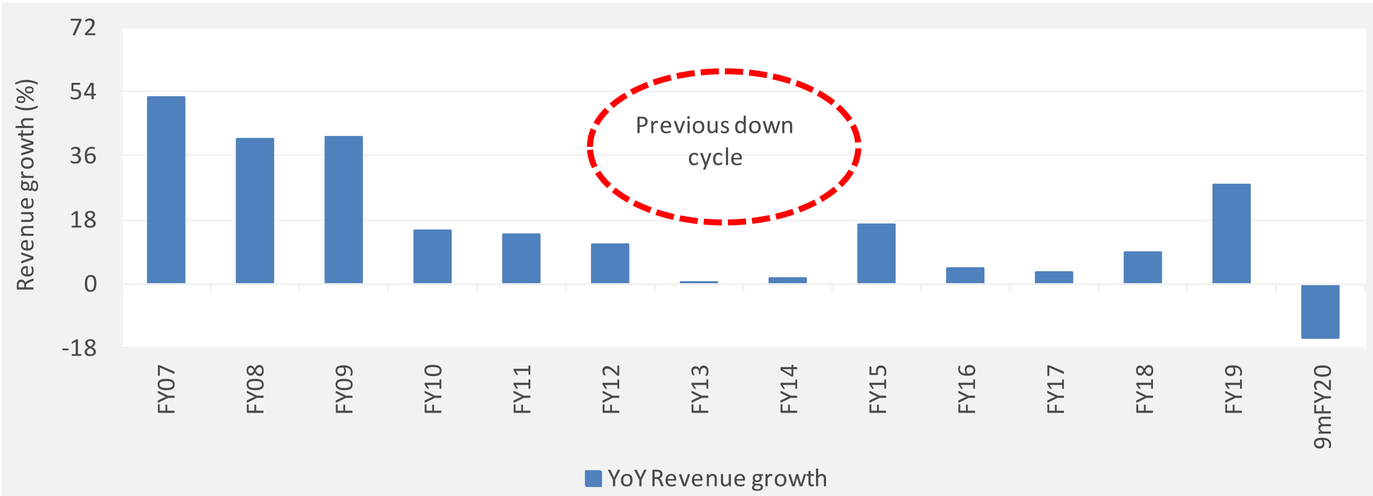
- There will be 75% cut in the salaries of the Chief Minister, state cabinet, MLCs, MLAs, state corporation chairpersons and representatives of local bodies.
- There will be a 60% salary cut for IAS, IPS, IFS and other such central services officers; for all other categories of employees, there will be a 50% salary cut. For class IV, outsourcing and contract employees, there will be a 10% pay cut.
- For all categories of pensioners, there will be a 50% pay cut. Pensions of class IV retired employees will be cut 10%.

We believe the tight fiscal situation will compel governments, both at the Center and state levels, to cut budgetary allocation for infra ministries. Faced with lower fund availability, public sector units will focus on execution of existing projects rather than awarding new ones. Consequently, order accretion is likely to fall going ahead.

…dealing a blow to execution, which was already dwindling

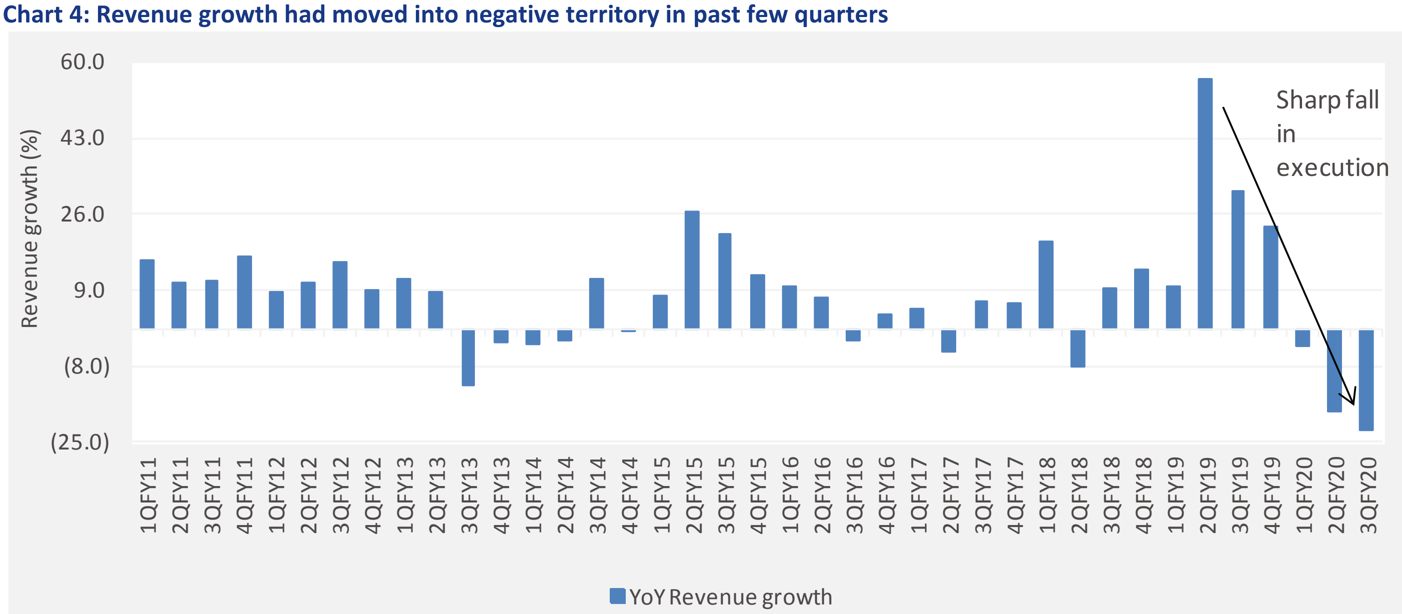
Falling revenue visibility for EPC companies meant that revenue growth, which had improved since FY16, tumbled sharply in 9mFY20.

Chart 3: After robust growth in FY19, top lines tumbled in 9mFY20



Source: Company, Edelweiss research

Chart 4: Revenue growth had moved into negative territory in past few quarters



Source: Company, Edelweiss research

The trend is likely to continue in Q4FY20 which is likely to witness sharp deceleration in execution of most infra companies. This is because the ongoing crisis and the subsequent lockdown have led to EPC companies losing out on a significant number of working days during March 2020. The fourth quarter is the most productive one during the year as far as execution is concerned with roughly 10% of annual revenues coming in March. The lockdown will, therefore, lead to adverse hit on top lines. We estimate Q4FY20 revenues of most infra companies to decline 10-20% YoY.

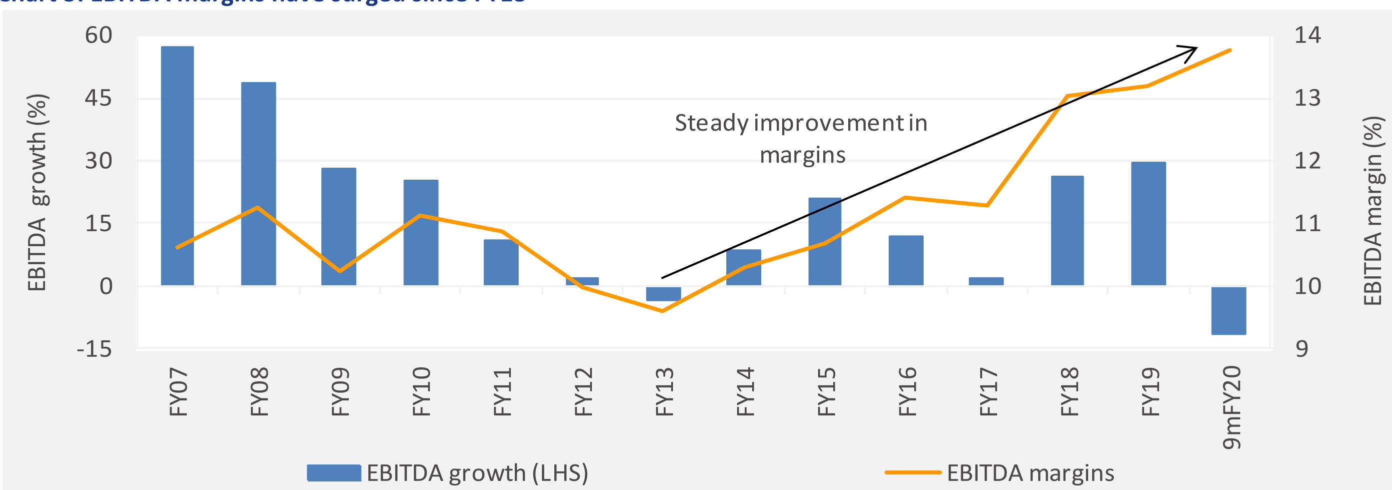
In fact, it looks that most of April 2020 will also go into a lockdown. Even when the lockdown ends, it will take companies some time to start work at full speed since many of the labourers who have gone back to their native places will take some time to return. This means that traction in execution is at least one-two quarters away. Consequently, FY21 may also see tepid revenue booking.

In addition, with order inflow and consequently order book likely to take a hit going ahead, top line will continue to be under pressure in the future. Thus, we believe, infra companies will face a slowdown in execution in the near to medium term.

Margins to come under pressure

One of the major positives for infra companies, over the previous decade, has been the sharp improvement in operating margins.

Chart 5: EBITDA margins have surged since FY13

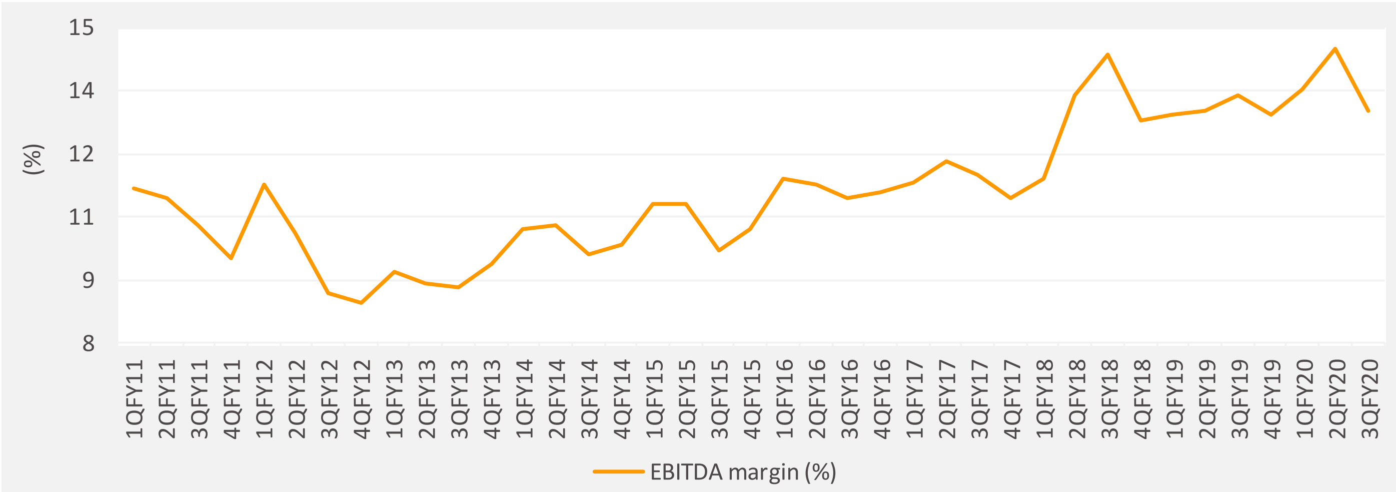


Source: Company, Edelweiss research

Since FY13, EBITDA margins of the sector have risen ~300-400bps with average industry margin moving up from ~9.5-10% to 13-13.5%. This has been a result of: a) Lower competition due to improvement in order inflows; and b) Operating leverage due to enhancement in execution.

Despite execution faltering in 9mFY20, operating margins have held up.

Chart 6: No let up in operating margins in FY20 despite weak execution



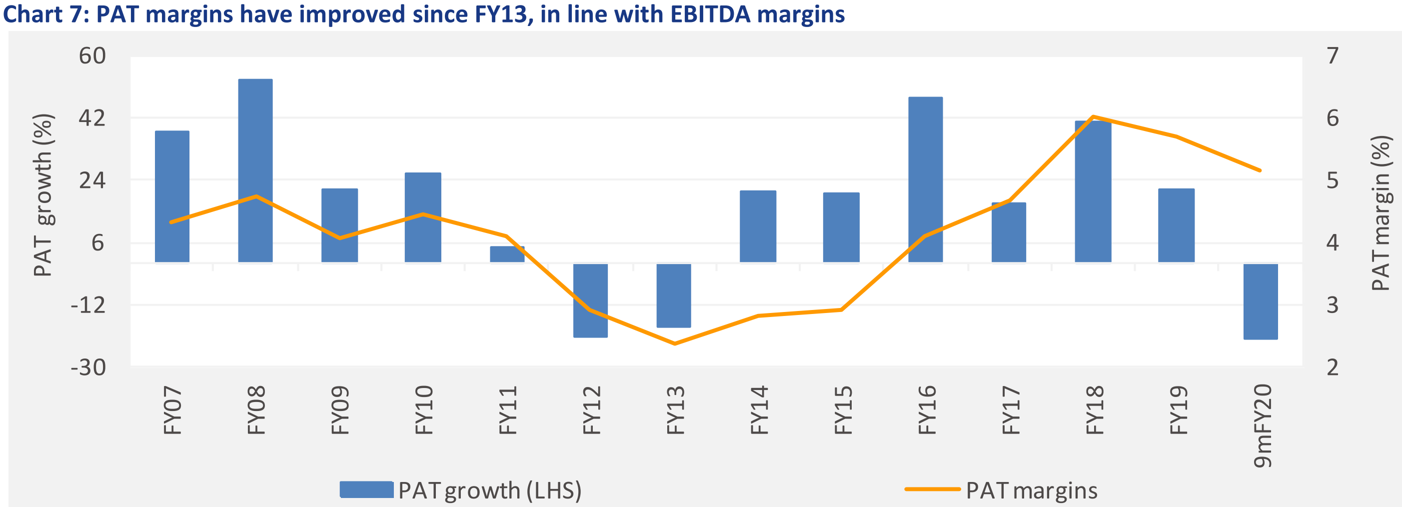
Source: Company, Edelweiss research

However, going ahead, we expect operating margins to come under pressure with the reversal of the two factors cited above which had aided margin expansion. We expect increase in competitive intensity due to paucity of orders and operating de-leverage due to muted execution to result in margins trending down going ahead.

PAT margins to decline

The improvement in EBITDA margins since FY13 has been accompanied by a similar uptick in PAT margins.

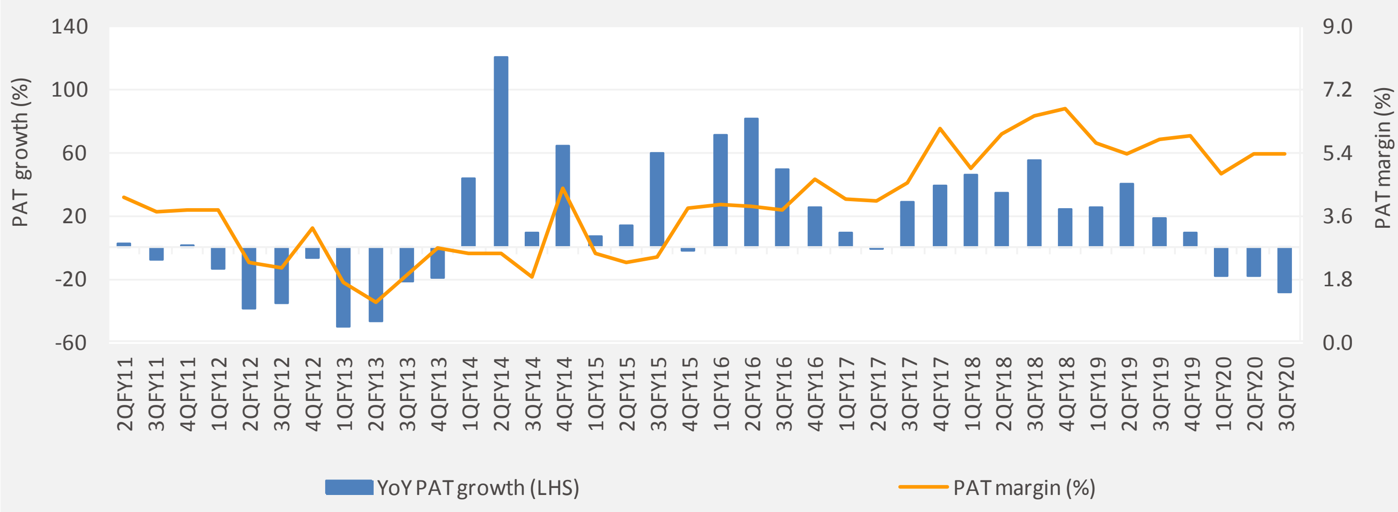
Chart 7: PAT margins have improved since FY13, in line with EBITDA margins



Source: Company, Edelweiss research

During this period, PAT margins have jumped 300-350bps on an average. This has been a result of: a) the upwards trajectory of EBITDA margins; and b) Decline in leverage (discussed in detail later).

Chart 8: FY20 PAT margins have been impacted by adoption of new tax regime



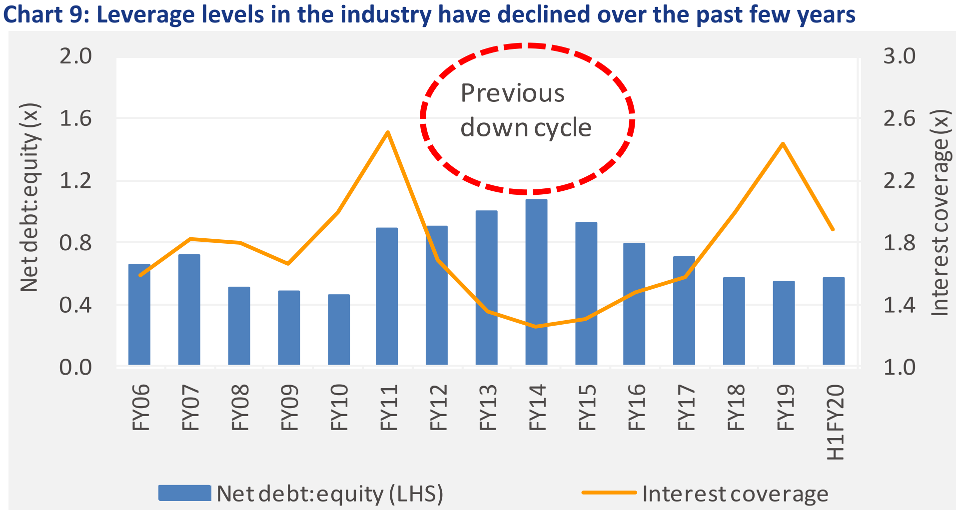
Source: Company, Edelweiss research

PAT margins during 9mFY20 have been impacted due to adoption of new tax regime by some companies. Nevertheless, going ahead, we expect PAT margins to come under pressure due to reversal of the two factors mentioned above.

Leverage levels to inch up

One area where the industry is definitely better placed now compared to the previous down cycle is the extent of leverage. Debt/equity at an industry level currently is far lower compared to that in 2012-13.

Chart 9: Leverage levels in the industry have declined over the past few years

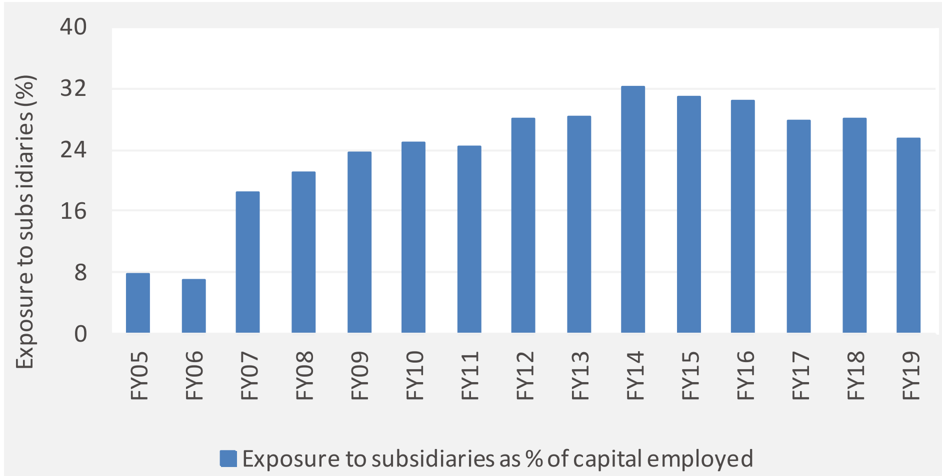


Source: Company, Edelweiss research

There are two main reasons behind this:

- **Reduction in exposure to asset ownership ventures**: The 2003-07 boom period was marked by rising exposure of EPC companies to asset ownership ventures like BOT projects, power, real estate, etc. This was typically done through investment and loans given to SPVs floated for each individual project. The huge exposure to these ventures was a major reason behind the rise in leverage at an industry level.

Chart 10: Exposure to asset ownership ventures has declined since FY14

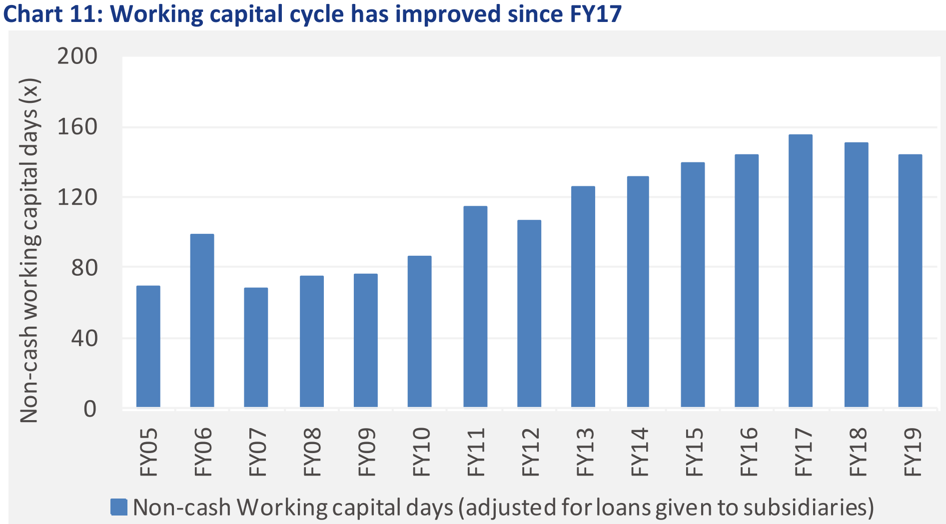


Source: Company, Edelweiss research

However, after the painful FY12-14 experience when many companies ran in to cash flow issues on account of their huge debt, they took conscious steps to reduce this exposure through asset monetisation. Consequently, their exposure to subsidiaries reduced, debt fell and interest servicing coverage ratios improved.

- **Improvement in working capital cycle**: The working capital cycle of EPC companies has improved over the past couple of years.

Chart 11: Working capital cycle has improved since FY17



Source: Company, Edelweiss research

This happened as execution gathered pace and the payment cycle improved.

However, COVID-19 crisis means that:

- Traffic on toll road assets may take a hit and hence the parent company may have to extend support to subsidiaries for debt repayment; and

- The payment cycle could worsen due to deterioration in fiscal situation of the government.

This means that leverage should inch North going ahead and interest servicing may come under pressure. Nevertheless, EPC companies are far better prepared to handle the slowdown compared to the FY12-14 period, courtesy their lower debt levels.

Outlook: In a spot of bother

We foresee order intake falling sharply in the near term for companies in our coverage as the government shifts focus away from capex to more pressing concerns. This will mean that order book and hence revenue visibility will trend down.

Execution growth is likely to come under pressure as work-in-hand declines. Operating de-leverage should mean that the trend of expansion in operating margins will reverse. With payment cycle likely to get extended, leverage should rise, impacting PAT margins.

In every downturn, while a few companies fail to survive and exit the arena, new competitors emerge who gain market share. We believe this time will be no different. Companies which have healthy order books currently and are financially sound should be able to survive the next few years as well.

COVID-19 impact leads to revision in target prices

Keeping in mind the anticipated slowdown in the near term, we are toning down order intake, execution and margin assumptions for our coverage companies. The overall risk-off in the market compels us to cut earnings multiple and increase cost of discounting.

Table 3: Estimates revised for coverage stocks

Company	Old estimates			New estimates			% change		
	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E
NCC									
Revenue	84,991	99,315	115,679	77,836	79,167	87,674	(8.4)	(20.3)	(24.2)
EBITDA	10,214	11,736	13,670	9,120	8,247	9,221	(10.7)	(29.7)	(32.5)
PAT	3,865	3,526	5,336	2,849	1,594	2,508	(26.3)	(54.8)	(53.0)
EPS	6.4	5.9	8.9	4.7	2.7	4.2	(26.3)	(54.8)	(53.0)
KNR Constructions									
Revenue	23,466	27,595	31,368	21,004	22,704	30,808	(10.5)	(17.7)	(1.8)
EBITDA	4,851	5,097	5,543	4,048	3,536	5,106	(16.6)	(30.6)	(7.9)
PAT	2,239	2,337	2,519	1,707	1,201	2,345	(23.8)	(48.6)	(6.9)
EPS	15.9	16.6	17.9	12.1	8.5	16.7	(23.8)	(48.6)	(6.9)
PNC Infratech									
Revenue	50,593	61,273	71,970	46,437	46,019	48,414	(8.2)	(24.9)	(32.7)
EBITDA	7,899	8,236	9,674	6,925	5,643	5,888	(12.3)	(31.5)	(39.1)
PAT	4,766	4,232	5,018	4,021	2,413	2,266	(15.6)	(43.0)	(54.8)
EPS	18.6	16.5	19.6	15.7	9.4	8.8	(15.6)	(43.0)	(54.8)
Ashoka Buildcon									
Revenue	39,066	39,244	43,719	36,066	34,539	34,050	(7.7)	(12.0)	(22.1)
EBITDA	5,030	5,096	5,490	4,354	3,638	3,594	(13.4)	(28.6)	(34.5)
PAT	3,192	2,978	3,120	2,476	1,357	1,022	(22.4)	(54.4)	(67.2)
EPS	11.4	10.6	11.1	8.8	4.8	3.6	(22.4)	(54.4)	(67.2)

Source: Edelweiss research

Table 3: Estimates revised for coverage stocks (Contd...)

Company	Old estimates			New estimates			% change		
	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E
J Kumar Infraprojects									
Revenue	31,354	35,455	40,034	28,570	29,147	31,370	(8.9)	(17.8)	(21.6)
EBITDA	5,065	5,727	6,447	4,187	3,980	4,581	(17.3)	(30.5)	(28.9)
PAT	2,383	2,634	3,034	1,733	1,204	1,395	(27.3)	(54.3)	(54.0)
EPS	31.5	34.8	40.1	22.9	15.9	18.4	(27.3)	(54.3)	(54.0)
NBCC									
Revenue	82,506	112,625	132,817	73,587	92,940	106,254	(10.8)	(17.5)	(20.0)
EBITDA	1,957	4,023	6,338	1,745	3,599	5,389	(10.8)	(10.5)	(15.0)
PAT	1,671	4,060	5,974	911	3,165	4,455	(45.5)	(22.0)	(25.4)
EPS	0.9	2.3	3.3	0.5	1.8	2.5	(45.5)	(22.0)	(25.4)
Capacit'e Infra									
Revenue	16,625	24,937	29,925	15,195	17,474	23,939	(8.6)	(29.9)	(20.0)
EBITDA	2,810	3,990	4,579	2,431	2,446	3,543	(13.5)	(38.7)	(22.6)
PAT	1,086	1,600	1,855	722	423	1,166	(33.5)	(73.6)	(37.1)
EPS	16.0	23.6	27.3	10.6	6.2	17.2	(33.5)	(73.6)	(37.1)
Ahluwalia Contracts									
Revenue	17,171	20,262	23,909	14,894	16,383	18,840	(13.3)	(19.1)	(21.2)
EBITDA	1,762	2,568	3,225	1,436	1,648	2,143	(18.5)	(35.8)	(33.6)
PAT	825	1,466	1,880	562	780	1,110	(31.9)	(46.8)	(40.9)
EPS	12.3	21.9	28.1	8.4	11.6	16.6	(31.9)	(46.8)	(40.9)
Titagarh Wagons									
Revenue	13,165	15,316	16,710	12,151	9,273	11,059	(7.7)	(39.5)	(33.8)
EBITDA	1,103	1,298	1,433	921	647	783	(16.5)	(50.2)	(45.4)
PAT	519	603	668	413	191	260	(20.4)	(68.3)	(61.1)
EPS	4.5	5.2	5.8	3.6	1.7	2.2	(20.4)	(68.3)	(61.1)
Texmaco Rail									
Revenue	18,375	17,669	22,025	17,821	15,714	17,201	(3.0)	(11.1)	(21.9)
EBITDA	1,611	1,584	2,019	1,420	1,173	1,456	(11.9)	(25.9)	(27.9)
PAT	438	552	843	243	160	323	(44.4)	(71.1)	(61.7)
EPS	1.9	2.5	3.8	1.1	0.7	1.4	(44.4)	(71.1)	(61.7)

Source: Edelweiss research

Table 5: Target prices revised for coverage stocks

			Current valuation framework		Proposed valuation framework			
Company	RECO	CMP	P/E multiple	Asset value (INR/share)	P/E multiple	Asset value (INR/share)	TP (INR)	Upside (%)
NCC	Buy	24	10.0	1	8.0	1	35	46.3
KNR Constructions	Buy	185	16.0	76	12.0	69	231	24.7
PNC Infratech	Buy	112	12.0	100	7.0	73	149	32.8
Ashoka Buildcon	Buy	50	11.0	83	6.0	52	67	36.2
J Kumar Infraprojects	Buy	80	6.0	0	5.0	0	108	35.5
NBCC	Hold	19	12.0	0	10.0	0	21	10.7
Capacit'e Infra	Buy	78	12.0	0	8.0	0	108	38.2
Ahluwalia Contracts	Buy	159	16.0	0	13.0	0	198	24.6
Titagarh Wagons	Buy	34	15.0	8	13.0	8	41	22.9
Texmaco Rail	Hold	23	18.0	0	15.0	0	25	7.3

Source: Edelweiss research

With the entire infra pack correcting sharply over the past two months, we believe realty stocks have entered the 'value zone' from a medium-term perspective. Notwithstanding chances of near-term volatility, we believe current prices provide excellent entry points for investors willing to take medium-term exposure.

We believe in the near term, investors will focus more on financial stability/balance sheet health rather than growth. In such a scenario, companies with robust execution skills, relatively smaller scale of operations and low leverage will find favour with investors.

Our preferred picks are KNR Constructions and Ahluwalia Contracts.

Our thoughts on individual companies are given below:

- **NCC (INR24, BUY)**: NCC has struggled over the past year with order cancellations from the Andhra government. This has led to order book falling sharply and hurting top line. We believe the company has the requisite segmental diversification to enable it to gain orders from multiple avenues. However, it needs to keep its working capital cycle in check to ensure that profitability is not adversely impacted.

- **KNR Constructions (INR185, BUY)**: KNR Constructions (KNR) benefits from having a robust balance sheet (net D/E of 0.2) courtesy its lean working capital cycle. It has also sold partial stake in HAM projects at the right time. We believe its strong balance sheet can help it to still bid for HAM projects; this provides it with an ability to win NHAI orders at a time when competition for EPC projects is likely to be intense.

- **PNC Infratech (INR112, BUY)**: PNC Infratech's healthy execution skills and its lean balance sheet have enabled it to perform well over the past few years. Its recent HAM wins have shored up revenue visibility and alleviated concerns on the order book front in the near term. However, it needs to diversify into other segments since NHAI ordering alone is unlikely to be sufficient to cater to its growth needs. Also, timely monetisation of additional BOT assets will provide comfort to investors as far as leverage is concerned.

- **Ashoka Buildcon (INR50, BUY)**: Ashoka has successfully diversified into segments like power T&D and railways which have allowed it to grow its order book. However, investors will be concerned about: a) Likely weakness in traffic on toll assets; b) Exit for SBI-Macquarie; and c) Growing leverage due to equity infusion in HAM projects. We believe the sooner the company sorts out the exit of SBI-Macquarie and monetises its HAM assets, the faster will investors get clarity on its leverage front.

- **J Kumar Infraprojects (INR80, BUY)**: J Kumar has done well over the past few years aided by its ability to win metro rail projects and a lean balance sheet. We believe there could be a slowdown in awarding of new metro rail projects in the near term. Going ahead, how the company manages its order book growth and its working capital cycle will be key to watch.

- **NBCC (INR19, HOLD)**: The company's execution and its operating margins have been on a downwards trend over the past year. In addition, the real estate monetisation for its 'self revenue generation' projects hasn't seen any great success.

  Nevertheless, its PSU status, cash-rich balance sheet and the sharp correction in stock price mean that risk:reward is in favour of investors now. Consequently, we upgrade the stock from '**REDUCE**' to '**HOLD**'.

- **Capacit'e Infra (INR78, BUY):** The company has seen its order book swelling over the past year; however, execution on major public sector projects is yet to gather traction. Pick up in pace of work on these projects is imperative for top-line growth to pick up. Also, considering that realty sector projects are also likely to get hit due to the COVID-19 crisis, how the company manages payment cycle for its private sector projects going ahead will determine the stock trajectory.

- **Ahluwalia Contracts (159, BUY):** A cash-rich balance sheet and a strong order book are key positives for Ahluwalia Contracts (ACIL). While the company's performance had been adversely impacted in the previous downturn, the strategic shift towards public sector projects over the past few years means that ACIL is well placed to handle the slowdown.

- **Titagarh Wagons (INR34, BUY):** Wagon ordering from Indian Railways, which has seen repeated deferment over the past year, is an important monitorable for Titagarh Wagons (TWL). TWL also has operations in Italy, which have been badly impacted by COVID-19; resumption of operations here along with execution of the Pune Metro rail coach order will be a key factor in its performance going ahead.

- **Texmaco Rail (INR23, HOLD):** The company's order book has declined due to order cancellation and lack of wagon order wins from Indian Railways. At the same time, it has seen its leverage building up due to payment delays. How the company manages its order book and balance sheet health will be critical factors going ahead. We believe its profitability will remain under pressure in the near term and hence downgrade it from '**BUY**' to '**HOLD**'.

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Coverage group(s) of stocks by primary analyst(s): Infrastructure - Construction

Ahluwalia Contracts, Ashoka Buildcon, Capacit'e Infraprojects Limited, Hindustan Construction Co., J Kumar Infraprojects, KNR Constructions, NBCC, Nagarjuna Construction Co, PNC Infratech, Sadbhav Engineering,

Recent Research

Date	Company	Title	Price (INR)	Recos
25-Feb-20	**Simplex Infrastructure**	No end to liquidity woes; *Result Update*	57	Drop Coverage
14-Feb-20	**Ahluwalia Contracts**	Order intake boost; now over to execution; *Result Update*	326	Buy
13-Feb-20	**NBCC**	Another soft quarter; *Result Update*	32	Reduce

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution* * 1stocks under review	161	67	11	240

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	156	62	11

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

All price charts cannot be included given the large number of companies in our coverage. Specific charts may be available upon request.

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