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PATEL ENGINEERING LTD.

December 16, 2011

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Patel Engineering Ltd, (PEL) is one of the leading players in the Indian construction segment with expertise in hydro power, tunnelling, irrigation, railways and roads. PEL is the only Asian company to use a superior technology of under water Lake Tap works that is used for micro tunnelling in hydropower segment. PEL's scope of work includes heavy construction, housing complexes, dams, tunnels, bridges, factories, steel projects, thermal and hydro power house, marine works and public health works. The company intends to double its turnover from the core business over a 5 year period.

Investor's Rationale

- Despite sluggish order book growth due to slowing economic scenario, intense competition and multiple order cancellation on environmental issues, PEL's executable order book that stands at ₹62 billion, which provides stable earning visibility for FY12E. Besides, PEL also expecting to receive orders worth ₹25 billion from its captive power projects in FY12E.

- In order to mitigate business and environmental risk, PEL has been constantly working to diversify its revenue sources by tapping the international markets. The improved second quarter revenue of PEL mainly due to strong revenue contribution from its international subsidiaries stands in testimony to the materialization of PEL's revenue diversification strategy.

- As per PEL's strategic growth plans; it has started earning revenues from its first phase of real estate, which have commenced during the year. The real estate division of the company, in a very short span of its debut into the industry has developed several residential and commercial complexes. With increased focus of PEL in the real estate business, we expect that the company to book profits ~₹5,400 million during FY12 from this segment.

- PEL is setting up two Thermal Power Project of 1050 MW (Phase I) and 1600 MW (Phase II) at Nagapattinam District, Tamil Nadu with an estimated cost of ₹52,500 million and ₹80,000 million, which is expected to commence construction in FY12.

- Due to sluggish economic environment and slowing order book growth, the operational margins of PEL are likely to see some contraction. We expect PEL's top-line to reach a level of ~₹36 billion in the coming two years while, the company's near to medium term recovery to the growth path is likely to take some time.

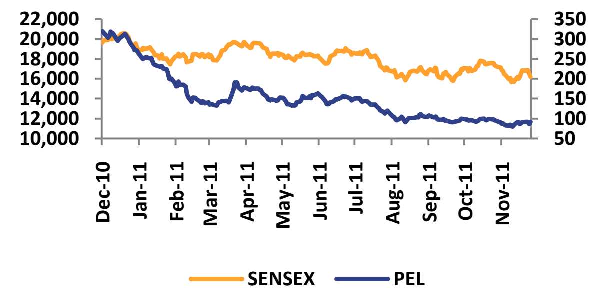
Market Data

Rating	ACCUMULATE
CMP (₹)	79
Target (₹)	101
Potential Upside	~28%
Duration	Long Term
52 week H/L (₹)	327.9/78
All time High (₹)	1,080.2
Decline from 52WH (%)	75.9
Rise from 52WL (%)	5.1
Beta	1.2
Mkt. Cap (₹ mn)	5,558
Enterprise Val (₹ mn)	31,188

Fiscal Year Ended

	FY10A	FY11A	FY12E	FY13E
Revenue (₹mn)	31,910	34,765	32,899	36,534
Net Profit(₹mn)	5,085	4,972	4,816	4,904
Share Capital	70	70	70	70
EPS (₹)	28.4	22.6	13.8	15.1
PE (x)	2.8	3.5	5.7	5.2
P/BV (x)	0.4	0.4	0.4	0.4
EV/EBITDA (x)	4.8	6.3	6.6	7.0
ROE (%)	15.6	11.6	6.9	7.2
ROCE (%)	13.9	11.7	11.0	10.7

One year Price Chart



Shareholding Pattern	Sep'11	Jun'11	Diff.
Promoters	45.6%	45.6%	-
Institutional	14.8%	16.1%	(1.30)
General Public	23.1%	21.7%	1.40
Others	16.5%	16.6%	(0.10)

Executable order book at ₹65 billion provides stable earning visibility for FY12E

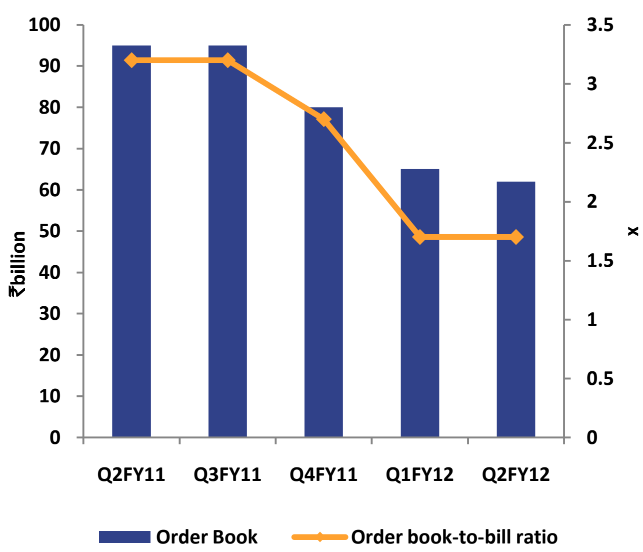
PEL's order book stands at ₹95 billion, out of which ₹62 billion is the executable backlog, with 34% composition of Hydro power, 42% from irrigation related and 24% from Urban Development projects. The L1 order book of the company stood at ₹33 billion comprising of ₹15 billion AP Irrigation project, ₹15 billion Kotli BHEL Hydroelectric project and ₹3 billion Tanzania project. The Company didn't received substantial order in Q2FY12 due to limited order inflow and intense competition. However the executable order book at ₹62 billion, provides stable earning visibility for FY12E.

However, after adjusting for AP (₹15 billion) and contentious orders (₹15 billion –Kotlibel, ₹3 billion from Tanzania), the order book to bill ratio fell to 1.7x. PEL also expects to receive orders worth ₹25 billion from its captive power projects in FY12E. Clearance is still awaited on the power project.

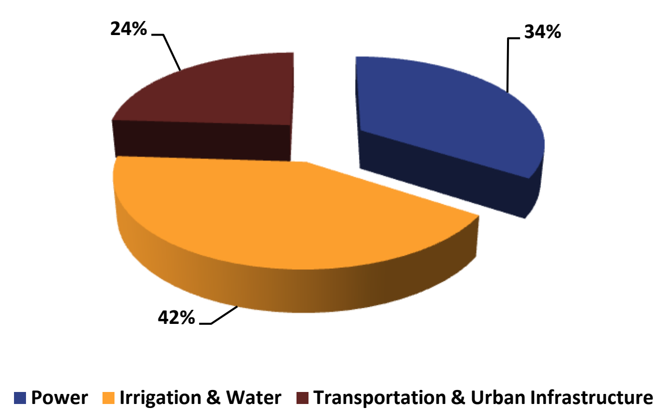
Due to environmental issues on the Ganges, NTPC has cancelled its Loharinagpala HRT Project and the Loharinagpala Power House Project, which were expected to be major contributors to the revenue growth of PEL. However, some of its major projects like Tapovan Vishnugad HEP (4x 130MW), Kameng HEP (4x150MW), Rampur HEP (434MW) and Teesta Low Dam H.E.P 132 MW, which were kept on halt for some time has resumed construction in Q4FY11.

The vicious cycles of crisis has lead to elongation in working capital cycle, higher borrowing cost and hence fall in profits. In order to mitigate business and environmental risk, the company has been working to diversify its revenue sources by tapping the international markets. The improved second quarter revenue of PEL due to significant contribution from its international business stands in testimony to the materialization of PEL's revenue diversification strategy. As per the plans, which were envisaged by the company a couple of years back to develop its large land bank and hence create more value for shareholders, the company has started earning revenues from its first phase of real estate, which have commenced during the year. Also, the advancement in the power vertical has been quite substantial during the year which is now showing a clear visibility of commencement by the end of next financial year.

Huge order cancellation reduces book-to-bill ratio



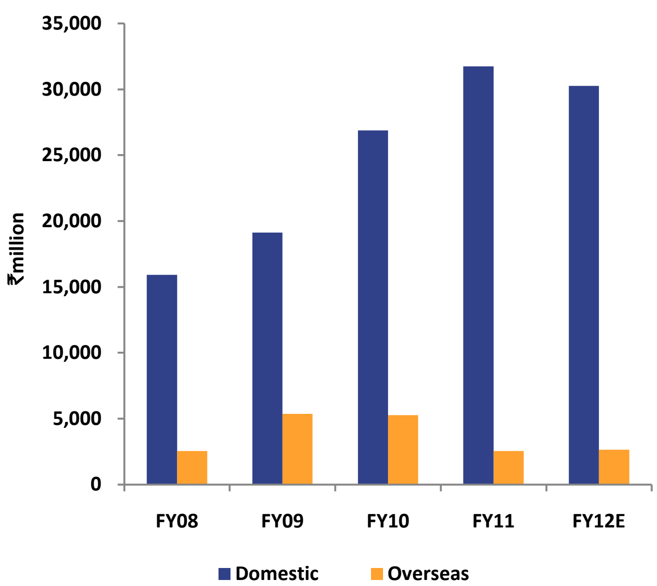
Order Book break up in Q2FY12



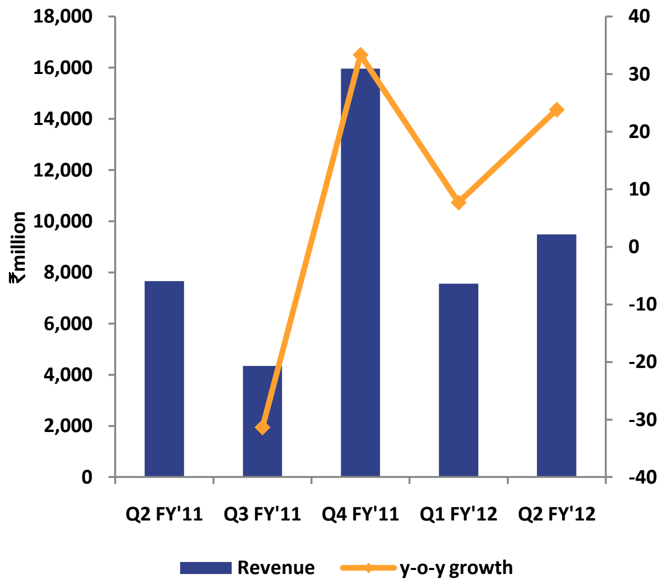
Sluggish economic environment to weigh on FY12E margins

During Q2FY11, PEL's consolidated revenue marked a significant improvement of 24% (y-o-y) and 25% (q-o-q) at ₹9,485.0 million, mainly due to strong revenue contribution from its international subsidiaries. However, PEL's operational efficiency felt the beating of rising input cost and interest rates, resulting in 4% (y-o-y) and 5% (q-o-q) decline in operating profits. Operating margins also shrunk 340 bps and 378 bps to 11.8% and 15.2%, respectively. Reported PAT for the quarter declined by 30.9% yoy despite a 73.2% yoy increase in interest cost, which was offset by lower depreciation cost. Delay in Government decision making policies, sluggish economic growth and seemingly untamable inflation has not only slashed the inflow of new orders in hydro-power and irrigation sectors but has also pressurized the profitability of PEL. The company is also yet to provide for the hedging loss incurred due to project cancellations, which we believe would materialize and impact the company's financials. We believe earnings will continue to reel under pressure given that the company's major segments (power and irrigation) are facing major headwinds and near to medium term recovery to the growth path is likely to take some time. As for FY12E, we expects PEL's top-line to reach a level of ~₹36 billion in the coming two years while net profit margins are likely to see some contraction of around 150-160 bps.

Revenue contribution across geographies



Consolidated top-line trend



Several Power Project to see construction commencement in FY12E

The company is setting up two Thermal Power Project of 1050 MW (Phase I) and 1600 MW (Phase II) at Nagapattinam District, Tamil Nadu with an estimated cost of ₹52,500 million and ₹80,000 million, which is expected to commence construction in FY12. PEL has already acquired land and has obtained Environmental Clearance for both the above mentioned projects. For the 1050 MW (Phase I) project, it has also received Coal linkage approval from the Government of India through Mahanadi coalfields.

In the hydro power segment, PEL's 144 MW Gongri Project in Arunachal Pradesh has seen significant progress and the financial closure are expected to be completed and the construction of the project is expected to commence in FY 12.

Apart from the above, the company has initiated to develop the following projects in Arunachal Pradesh and Nepal:-

- 24 MW Phudung Hydro Power Project
- 38 MW Meyong Hydro Power Project
- 46 MW Digin Hydro Power Project
- 260 MW Budhi Gandaki Kha Hydro Power Project (Nepal)
- 130 MW Budhi Gandaki Ka Hydro Power Project (Nepal)

PEL's Real Estate Business to see significant growth in the current fiscal

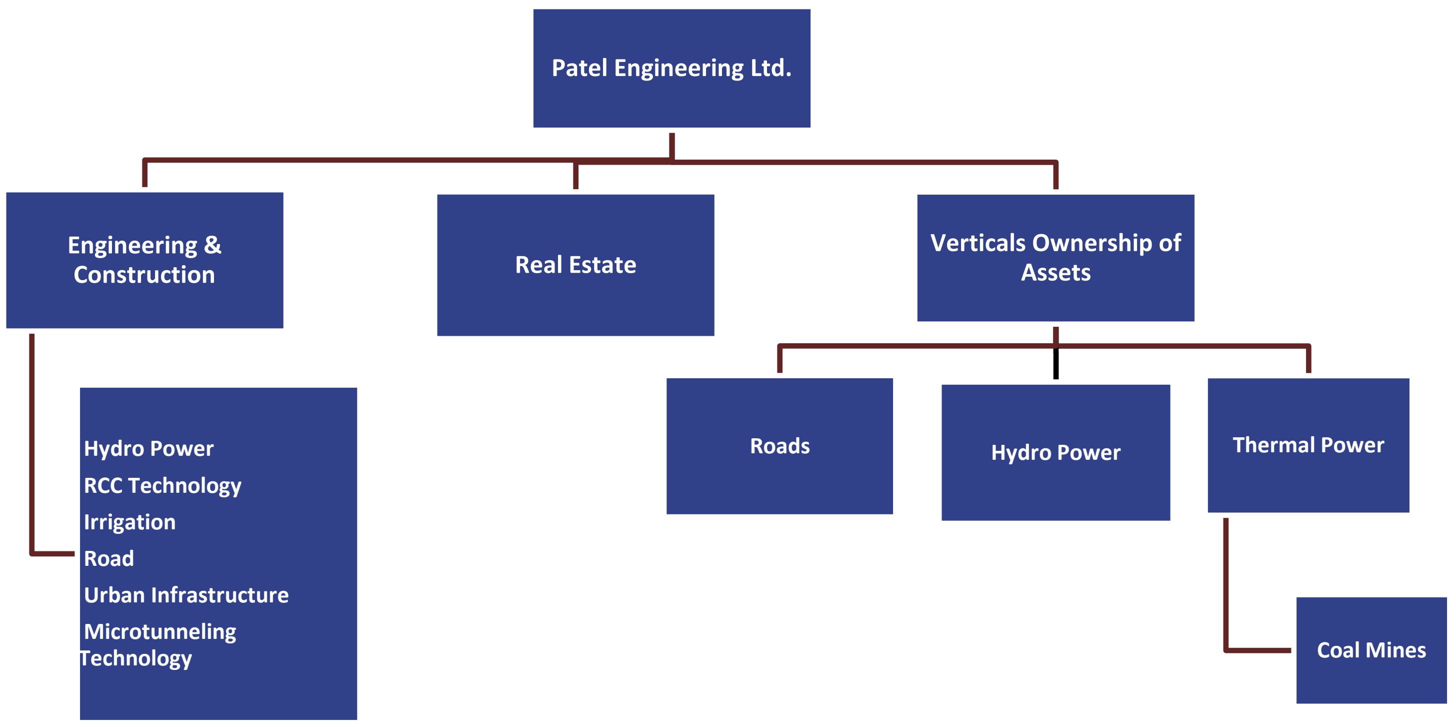
PEL's real estate division, which made its first revenue contribution in Q4FY11, has its operations mainly in Mumbai, Noida, Bangalore and Mauritius. In the commercial segment, Patel Corporate Park, and Patel Corporate Towers are the successful accomplishment of PEL in Mumbai while, Neomall is its proposed mall in Neotown, South Bangalore. Meanwhile, in the residential segment, the Company has launched 4 projects till date in excess of 2.4 million square feet and is developing an integrated waterfront project in Mauritius and Pan Oasis project in Noida is expected to generate revenues during FY12.

Apart from the above PEL real estate division's order book comprises of the following:

- Neotown's first phase under the brand 'Smondville' (construction of residential apartments) is scheduled to be completed by January 2012.
- Smondoville 2.0, the next version of Smondoville was launched to provide a customized solution with larger spaces, grand balconies, terraces, and a swimming pool. India's first and largest strip mall over 16 acres under the brand 'Neomall' was launched and is expected to be operation in 2013.
- The commercial project in Jogeshwari, Mumbai is in progress and the estimated time to complete the whole project is 30 months.
- The Mauritius project has commenced and is in line with the implementation program and infrastructure works have started.
- The execution and construction of the Nodia project under the brand Pan Oasis is running in full swing and the subsidiary executing the project has recognized revenues during the year from this project.

With increased focus of PEL in the real estate business, we expect that the company to book profits ~₹5,400 million during FY12 from real estate business.

Business Model



Foray into transmission Business to add another revenue wing

As a part of the strategic move in the power sector, PEL has also forayed in the transmission business with the acquisition of Raichur Sholapur Transmission Company Ltd from REC Transmission Project Company Ltd in consortium with two other partners, Simplex Infrastructure Ltd and BS Transcomm Ltd. The assignment that PEL received in this segment was from the Government of India to establish 765 KV transmission system associated with Krishnapattam UMPP through tariff based competitive bidding process. This project is for establishment of Transmission system for transmitting power to long term transmission customers, over 210 km from Raichur (Karnataka) to Sholapur (Maharashtra), assures significant revenue visibility in the coming years.

Technical View

PEL is trading in sideways range of ₹78-110 for the past three months and has touched the level of ₹78-76 ranges twice, completing the double bottom formation. PEL is trading at its all time low and the support of its falling channel; if it breaks above ₹89 then the first target would be ₹114 and above ₹114, it is likely to touch levels of ₹140 on sustain buying. At these levels PEL is showing some positive divergences as its 10 Day SMA has crossed its 20 Day SMA on the upside. Hence, we recommend the "ACCUMULATE" rating on the stock with the price of ₹105.

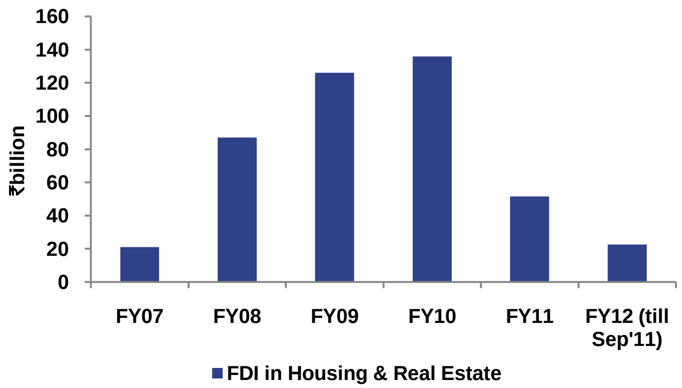
Indian Infrastructure Industry

The Infrastructure Industry in India has been experiencing a rapid growth in its different verticals with the development and urbanization leading to increasing interest shown by foreign as well as domestic investors and infrastructure players in this field. The Eleventh Five-Year Plan (2007-2012) of the Planning Commission of the Government of India identifies high quality infrastructure as the most critical physical requirement for attaining faster growth in a competitive global environment and also for ensuring investment in less-developed regions. Moreover, the Planning Commission states that the total investment needed in infrastructure would have to increase to 9.3% by the final year of the Eleventh Plan period to meet India's target GDP growth rate of 9%. In Budget 2011-12, the government of India has also allotted over ₹2,140 billion for infrastructure development, which was 23.3% higher than budget 2010-11 allocation.

20Km of Road and Highways to be constructed everyday

India has the second largest road network in the world spread across 3.3 million kms, handling more than 70% of freight and 85% of passenger traffic in the country. However, the country's network of Highways or Expressways, measured over 70,934 km comprises only of 2% of the length of total road network. In recent times, Indian roads sector has witnessed increased traction in terms of bidding activities. India built about 1,800 kms of roads in FY11. In FY12, the Indian government intends to award contracts to build 7,300 km of highway. So far, the road transport and highways ministry and NHAI have only managed to step up the award process to 20 km a day but the pace of construction has remained at 4-5 km a day. Actual construction of 20 km a day is only expected to commence by 2014.

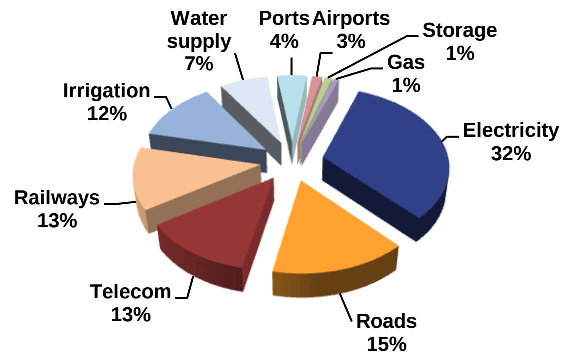
FDI in real estate sector sees massive decline



Sluggish infrastructure growth in October 2011

As the key to sustain India's growth rate lies in developing the country's infrastructure, the Government is targeting huge investment in the coming years. During the Eleventh Five year Plan (2007-2012), the Government aims to add power generation capacity of about 80,000 MW and provide electricity to all un-electrified hamlets and all rural households through the Rajiv Gandhi Grameen Vidyutikaran Yojna (RGGVY). In the recent times, beaten by consecutive rate hikes, seemingly untamable inflationary pressure, slowing economiv growth rate, the India's infrastructure output growth slowed to a meagre annual rate of 0.1% in October, sharply lower than 2.3% in the previous month.

Fund allocation to various infrastructure segments under 11th Five year plan



Outlook

In the first six months ended September 2011, the cumulative growth rate of eight key infrastructure sectors of the country has been sluggish at 4.9% against 5.6% registered in the same year-ago period, dragged down by decline in coal, natural gas and fertiliser output, rising interest rates and input costs. However, the growth scenario is expected to gain momentum in the next five years ending March 2017, considering India's plans to invest $1 trillion in building infrastructure, of which the government has set a target of $500 billion investment in 2012. With increasing investment, the share of private sector in total investment on infrastructure has increased rapidly. The contribution of private sector in total infrastructure investment in each of the first two years of 11th Plan (2007-2012) was around 34%. This is higher than the 11th Plan target of 30%, and 25% achieved in 10th Plan period. It is expected to rise to 36% by end of 11th Plan and 50% during the 12th Plan (2012-2017).

Balance Sheet (Consolidated)

(₹million)	FY10A	FY11A	FY12E	FY13E
Share Capital	70.0	70.0	70.0	70.0
Reserve and surplus	13,561.0	14,213.0	14,762.4	15,402.8
Net Worth	13,631.0	14,283.0	14,832.4	15,472.8
Loan funds	21,382.0	28,061.0	29,387.0	31,225.0
Deferred Tax Liability	110.0	130.0	130.0	130.0
Minority Interest	620.0	700.0	700.0	700.0
Capital Employed	**35,743.0**	**43,174.0**	**45,049.4**	**47,527.8**
Gross Block	8,610.0	10,082.0	11,124.0	12,754.0
Accumulated Depreciation	3,060.0	3,642.0	4,532.0	5,442.0
Net Block	5,550.0	6,440.0	6,592.0	7,312.0
Capital Work in Progress	2,041.0	2,090.0	2,663.0	3,749.0
Total Fixed Assets	7,591.0	8,530.0	9,255.0	11,061.0
Investments	700.0	780.0	2,000.0	2,000.0
Net Current Assets	27,372.0	33,785.0	33,794.4	34,466.8
Miscellaneous Expenses	80.0	79.0	-	-
Capital Deployed	**35,743.0**	**43,174.0**	**45,049.4**	**47,527.8**

Key Ratios

	FY10A	FY11A	FY12E	FY13E
EBITDA Margin (%)	15.9	14.3	14.6	13.4
EBIT Margin (%)	12.5	11.9	11.9	10.9
NPM (%)	6.2	4.5	2.9	2.9
ROCE (%)	13.9	11.7	11.0	10.7
ROE (%)	15.6	11.6	6.9	7.2
EPS (₹)	28.4	22.6	13.8	15.1
P/E (x)	2.8	3.5	5.7	5.2
BVPS	194.7	204.0	211.9	221.0
P/BVPS (x)	0.4	0.4	0.4	0.4
EV/Operating Income (x)	0.8	0.9	1.0	0.9
EV/EBITDA (x)	4.8	6.3	6.6	7.0

Profit & Loss Account (Consolidated)

(₹million)	FY10A	FY11A	FY12E	FY13E
Net Sales	**31,910.0**	**34,765.0**	**32,889.0**	**36,534.0**
Total Expenditure	26,825.0	29,793.0	28,073.0	31,630.0
EBIDTA	**5,085.0**	**4,972.0**	**4,816.0**	**4,904.0**
EBITDA Margin %	15.9	14.3	14.6	13.4
Interest	1,921.0	2,840.0	3,496.0	3,492.0
EBDT	**3,164.0**	**2,132.0**	**1,320.0**	**1,412.0**
Other Income	980.0	890.0	1,042.0	1,100.0
Depreciation	1,090.0	820.0	890.0	910.0
Profit Before Tax	**3,054.0**	**2,202.0**	**1,472.0**	**1,602.0**
Tax	930.0	540.0	441.6	480.6
Profit After Tax	**2,124.0**	**1,662.0**	**1,030.4**	**1,121.4**
Minority Interest	139.0	81.0	61.0	61.0
Net Profit	**1,985.0**	**1,581.0**	**969.4**	**1,060.4**
NPM%	6.2	4.5	2.9	2.9

Valuation and view

At the CMP, PEL is trading at a P/E of 5.2x FY'13E earnings of ₹15.1 per share. PEL trades at discount on the distress regarding execution delays in construction segment, concerns over margins, lower visibility on the current order book, high debt level and lack of clarity over tax raids. However, Q2 FY'12 numbers surprise positively due to lower depreciation and interest cost. Management expectation pick-up in order inflow from the power segment during H2 FY'12, ramping up of execution capabilities, tied with capital raising plan to bring the debt under comfort zone provides the much needed cushion. Hence, we recommend ACCUMULATE with an SOTP price target of ₹101.

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