

C&C Constructions

On the growth corridor

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BUY

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The beaten down valuation of construction contractor — C&C Constructions — provides a good opportunity for investors to buy the stock. While remaining a small-sized company in the road segment, C&C has distinguished itself from peers through its focus on projects in tough terrains.

Strong growth in topline is suggestive of fast paced execution while the continuing inflow of orders indicate that the company has fared better than others even as the sector is threatened by macro risks to growth. Being a small-cap stock with liquidity issues and vulnerable to steep price declines, investing in C&C Constructions would, however, call for an above-average risk appetite in the current market.

The growth prospects over the long-term could, however, compensate for the short-term risks involved. At the current market price of Rs 109, the stock trades at 4.9 times its per share earnings. Investors can consider buying the stock in small lots, on declines linked to broad markets. Further, small-cap stocks such as C&C should form a limited proportion of one's overall exposure to stocks in markets such as the present one.

RULING IN TOUGH TERRAINS

C&C made a mark in Afghanistan by undertaking challenging projects in the road and buildings segment, funded by multilateral funding agencies. For the higher



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risks undertaken, the company was compensated with superior profit margins. Operating profit margins (OPMs) for projects undertaken in this region are typically over 25 per cent. As a result, C&C could showcase profit margins far superior to the domestic industry average.

The company's experience in Afghanistan earned it a reputation for working under harsh conditions that also challenged logistics, thus providing a niche in bidding for projects in regions such as the North East, Jammu and Kashmir or Bihar where there are negligible number of bidders. Here again, the profit margins tend to be higher than regions with higher competition.

However, over the last couple of years, with the proportion of assignments in India overtaking Afghan projects, C&C has seen a steady decline in its OPMs from over 23 per cent in FY06 to about 19 per cent now. We believe that the shift in focus to India may be a better strategy for the long term in terms of opportunities as well as lower risk, for the business. While OPMs could stabilise at these levels, they are likely to remain superior to the industry range of 10-12 per cent.

Another noteworthy strategy of C&C is its attempt to qualify for larger projects through the joint venture route. The company has had a longstanding part-

nership with established contractor B. Seenaiiah. Partnerships could be the only way forward for mid-sized companies given the larger size of orders being awarded and the increasing complexity involved. The company's first build operate transfer (BOT) was made possible only through a joint venture with B. Seenaiiah.

Even as the company attempts to move forward as a road developer over the long term, its sub-contracting skills would stand in good stead in the near future as a number of large infrastructure developers bid for increasingly large projects. For instance, the company's role as a road contractor for Jaiprakash Associates is evidence of road developers seeking partnership with quality contractors.

IMPROVING ASSET TURNOVER

The high investment in assets and the relatively lower asset turnovers are limitations that apply to most players in the road sector. To overcome this, C&C Constructions has diversified into water and power transmission projects.

While it has already won orders in the water sanitation and sewerage space, it is in advanced stages of bidding for a number of projects in the power transmission segment. Revenues from these segments, which call for

little fresh investment, may help improve asset turnover, apart from aiding business diversification. The company seeks to ramp up orders from 'other segments' to 30 per cent of total projects over the next couple of years.

INTEREST COSTS WORRY

Cost overruns on its BOT project (being fixed price in nature) and higher interest cost resulted in muted growth in net profit for the first quarter ended September 2008. Sales, however, grew at a scorching 162 per cent over a year ago, suggesting healthy pace of order execution.

Apart from the BOT project, C&C's total order book of Rs 2,100 crore is largely protected by price-escalation clauses. Besides, given the current softening of commodity prices, the pressure on profits from this source is likely to ease.

However, a larger debt base and higher interest rates have resulted in mounting interest costs. While interest costs have gone up compared to a year ago, the average borrowing cost of 13 per cent appears moderate compared to the 16-17 per cent rates resorted to by even bigger infrastructure players. This may also imply that lenders may be foreseeing lower risks in a road contracting company than in a road developer.