

Equities

8 August 2011 | 13 pages

Larsen & Toubro (LART.BO)

Nothing Much to Cheer About

- Company Update
- Target Price Change
- Estimate Change

■ **PAT 13% below CIRA – Inline with muted consensus** — L&T's 1Q11 PAT at Rs7.5bn +12% YoY was 13% below CIRA but inline with muted consensus expectations. Surprisingly consensus expected PAT growth of ~ 11% in 1Q12 while consensus FY12E EPS estimates suggest 24% growth. The PAT growth was largely non operational (treasury income) as the 20% sales growth was neutralized by 89bps EBITDA margin compression (all segments showed an EBIT decline of 150+bps).

■ **Achieving 25% sales growth could be a stretch** — It is worth noting that 1Q11 sales growth was weak at 6.5% and the company grew 21.7% in the remaining 9 months of FY11. L&T would have to grow sales at 26% YoY in the remaining 9 months of FY12E on a very high base to meet the FY12E sales growth guidance of 25% (to meet CIRA sales expectations L&T must grow sales at 20% in the next 9 months).

■ **Inflows decent given the environment ...** — L&T booked Rs162bn of new orders in 1QFY12 up 4% YoY, commendable given the operating environment. Net additions (calculated from backlog and gross sales) were Rs155bn, which is largely flattish YoY.

■ **.....but does not inspire confidence** — (1) To achieve 15% growth L&T has to win Rs755bn more of orders in 9 months (vs. FY11 - Rs798bn) in a tougher environment than last year. (2) Unknown orders in 4Q11 at Rs124bn (41% of booking). (3) Rs28bn JP Power Karchana order facing land acquisition problems since Jan11. (3) Won Rs52bn of gas EPC projects in last 2 years. Is the fuel supply tied up here? (4) Won residential/ commercial real estate orders of Rs49bn, Rs40bn and Rs29bn in FY10, FY11 and 1Q12 respectively, which might face execution challenges..

■ **Maintain Hold (2L)** — Given the lack of any other credible large-cap liquid option in the infrastructure space and the large weightage on various indices. We revise our target price to Rs1767 to factor in: (1) ~ 1% EPS cut; (2) roll forward of P/E multiple to Dec12E (Sep12E); and (3) reduction in subsidiary value to Rs385 (Rs402).

Hold/Low Risk	2L
Price (08 Aug 11)	Rs1,629.85
Target price	Rs1,767.00
	<i>from Rs1,745.00</i>
Expected share price return	8.4%
Expected dividend yield	1.0%
Expected total return	9.4%
Market Cap	Rs996,101M
	US\$22,274M

Price Performance (RIC: LART.BO, BB: LT IN)



Figure 1. Statistical Abstract

Year End	Parent EPS	Growth	Parent P/E	Parent EV/EBITDA	Parent RoE	Cons PAT	Cons EPS	Growth	Cons P/E
31-Mar	Rs	%	x	x	%	Rsmn	Rs	%	x
FY09	46.3	34.4%	35.2	26.3	24.7%	30,059	51.3	31.4%	31.8
FY10	51.2	10.7%	31.8	21.9	20.2%	37,946	62.5	21.8%	26.1
FY11	59.9	17.0%	27.2	18.7	18.3%	42,380	69.0	10.5%	23.6
FY12E	67.6	12.9%	24.1	16.4	17.8%	48,977	79.6	15.3%	20.5
FY13E	79.8	18.0%	20.4	13.7	18.4%	57,378	93.3	17.2%	17.5
FY14E	94.1	17.9%	17.3	11.4	18.8%	67,821	110.3	18.2%	14.8

Source: Company and Citi Investment Research and Analysis estimates

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Other Per Share Data

NAV	240.75
Discount to NAV	-577%

Fiscal year end 31-Mar	2010	2011	2012E	2013E	2014E
Valuation Ratios					
P/E adjusted (x)	31.8	27.2	24.1	20.4	17.3
P/BV (x)	5.4	4.5	4.0	3.5	3.0
Dividend yield (%)	0.8	0.9	1.0	1.0	1.1
Payout Ratio (%)	24.4	24.2	23.7	21.3	19.1
Per Share Data (Rs)					
EPS adjusted	51.19	59.90	67.61	79.79	94.06
EPS reported	72.07	64.49	67.61	79.79	94.06
BVPS	303.69	358.45	407.28	467.89	541.72
DPS	12.50	14.50	16.00	17.00	18.00
Profit & Loss (RsM)					
Net sales	366,752	434,959	521,951	613,293	705,287
Operating expenses	-323,630	-385,037	-465,548	-546,390	-627,730
EBIT	43,122	49,923	56,403	66,903	77,557
Net interest expense	-5,100	-6,474	-6,803	-5,962	-4,567
Non-operating/exceptionals	9,177	12,260	13,396	13,402	14,642
Pre-tax profit	47,199	55,708	62,996	74,342	87,631
Tax	-16,123	-18,945	-21,419	-25,276	-29,795
Extraord./Min.Int./Pref.div.	12,679	2,816	0	0	0
Reported net income	43,755	39,579	41,577	49,066	57,837
Adjusted earnings	31,076	36,763	41,577	49,066	57,837
Adjusted EBIT	43,122	49,923	56,403	66,903	77,557
Growth Rates (%)					
Sales	9.0	18.6	20.0	17.5	15.0
EBIT adjusted	21.4	15.8	13.0	18.6	15.9
EPS adjusted	10.7	17.0	12.9	18.0	17.9
Cash Flow (RsM)					
Operating cash flow	59,625	30,325	59,057	68,487	90,151
Depreciation/amortization	4,146	5,992	7,221	8,469	9,826
Net working capital	11,434	-17,107	10,059	10,753	22,288
Investing cash flow	-70,287	-26,722	-43,200	-43,200	-43,200
Capital expenditure	-15,871	-16,928	-18,200	-18,200	-18,200
Acquisitions/disposals	-54,416	-9,795	-25,000	-25,000	-25,000
Financing cash flow	17,228	-618	-11,378	-27,091	-27,803
Borrowings	2,448	3,603	0	-15,000	-15,000
Dividends paid	-8,630	-9,957	-11,380	-12,091	-12,803
Change in cash	6,566	2,985	4,479	-1,804	19,148
Balance Sheet (RsM)					
Total assets	464,094	570,720	658,404	741,879	840,601
Cash & cash equivalent	14,319	17,304	21,783	19,979	39,127
Accounts receivable	111,637	124,276	149,131	175,229	201,514
Net fixed assets	61,998	72,149	83,162	92,927	101,336
Total liabilities	281,211	352,478	409,963	456,464	510,152
Accounts payable	0	0	0	0	0
Total Debt	68,008	71,611	71,611	56,611	41,611
Shareholders' funds	182,884	218,241	248,441	285,415	330,449
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	11.8	11.5	10.8	10.9	11.0
ROE adjusted	20.2	18.3	17.8	18.4	18.8
ROA adjusted	7.5	7.1	6.8	7.0	7.3
Net debt to equity	29.4	24.9	20.1	12.8	0.8
Total debt to capital	27.1	24.7	22.4	16.6	11.2

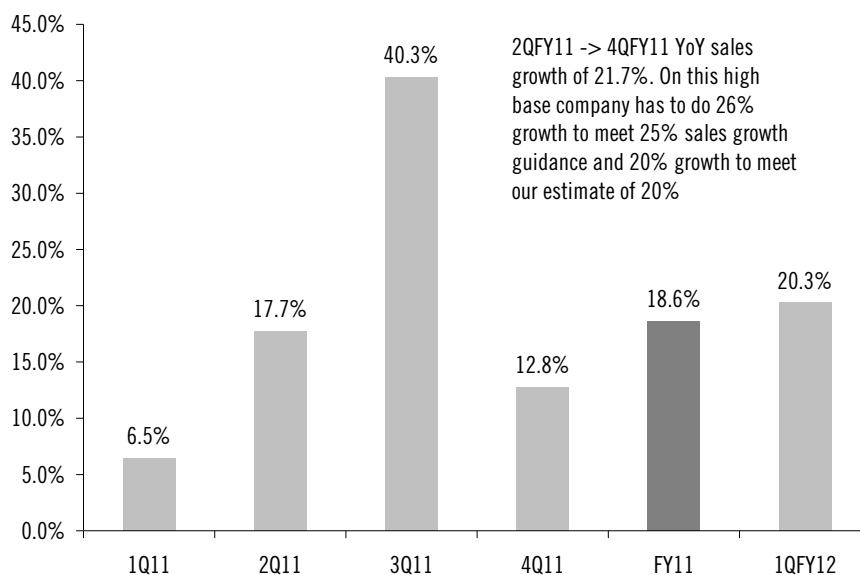
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PAT 13% below CIRA – But inline with muted consensus expectations

- L&T's 1Q11 PAT at Rs7.5bn up 12% YoY was 13% below CIRA expectations of Rs8.6bn but inline with consensus expectations of Rs7.4bn. The 12% YoY growth was largely non operational (driven by treasury income) as is evident from the segmental financials. The 20% sales growth was largely neutralized by the 89bps EBITDA margin compression (all segments showed an EBIT decline of +150bps).
- It is surprising to see that consensus estimates for the quarter projected PAT growth of only 11% in 1Q12 while consensus EPS estimates for FY12E suggest growth of 24%.
- It is worth noting that 1Q11 sales growth was weak at 6.5%, and the company actually grew 21.7% in the remaining 9 months of FY11. In conclusion the company would have to grow sales at 26% YoY in the remaining 9 months of FY12E on a very high base to meet the FY12E sales growth guidance of 25% (to meet CIRA sales expectations the company must grow sales at 20% in the next 9 months).

Figure 2. L&T Quarterly Sales Growth



Source: Citi Investment Research and Analysis

Figure 3. L&T – 1QFY12 Results Review

Year End Mar31 (Rsmn)	1QFY11	1QFY12	% Chg	1QFY12E	% Chg
Gross Sales	79130	95184	20.3%	102868	30.0%
Excise	(779)	(958)		(1012)	
% of sales	1.0%	1.0%		1.0%	
Net Sales	78351	94226	20.3%	101856	30.0%
Core EBITDA	9568	10665	11.5%	12223	27.7%
EBITDA Margin	12.2%	11.3%	(89)	12.0%	(21)
Operational Income	502	600		600	
EBITDA	10071	11265	11.9%	12823	27.3%
EBITDA Margin	12.9%	12.0%	(90)	12.6%	(26)
D&A	(1142)	(1679)		(1375)	
EBIT	8929	9586	7.4%	11448	28.2%
EBIT Margin	11.4%	10.2%		11.2%	
Interest	(1423)	(1613)		(1423)	
Other Income	2268	2962		2600	
PBT	9773	10935	11.9%	12624	29.2%
Total Tax	(3112)	(3474)		(4040)	
Tax Rate	31.8%	31.8%		32.0%	
PAT	6662	7461	12.0%	8585	28.9%

Source: Company and Citi Investment Research and Analysis estimates

Figure 4. L&T 1QFY12 Segmental Results

Year End Mar31 (Rsmn)	1QFY11	1QFY12	% Chg
Sales			
E&C	66438	80994	21.9%
E&E	7451	7462	0.1%
Machinery and Industrial products	5482	6904	25.9%
Others	1220	1990	63.1%
Total	80592	97350	20.8%
PBIT			
E&C	8167	8104	-0.8%
Margin	12.3%	10.0%	(229)
E&E	738	623	-15.6%
Margin	9.9%	8.3%	(156)
Machinery and Industrial products	1130	1220	7.9%
Margin	20.6%	17.7%	(295)
Others	335	422	26.1%
Margin	27.4%	21.2%	(622)
Total PBIT	10370	10369	0.0%
Margin	12.9%	10.7%	(222)
Less: Intersegment margins/ (loss) on capital jobs	(52)	89	
Less: interest expenses	(1292)	(1613)	
Add: Unallocable corporate income net of expenditure	748	2091	
PBT	9773	10935	11.9%

Source: Company and Citi Investment Research and Analysis

Orders okay given the environment – But do not provide comfort

- L&T booked Rs162bn of new orders in 1QFY12 up 4% YoY, which is commendable given the operating environment. Net inflows (calculated from the backlog and gross sales) are Rs155bn, which is largely flattish YoY.

- To achieve the FY12E lower end of the guidance of 15% the company has to win Rs755bn of orders in the remaining nine months of the years (vs. Rs798bn in FY11) in a tougher macroeconomic environment than last year.
- Our discomfort on the order backlog stems from the fact that: (1) the Rs35bn Apollo PPN gas EPC order was not booked in 4QFY11 and quantum of unknown orders in 4Q11 was Rs124bn (41% of orders booked). (2) The Rs28bn 3X660MW Karchana order from JP Power has been facing land acquisition problems since Jan11. (3) L&T has announced Rs52bn of gas-based projects in the last 2 years. We wonder if all these projects have fuel supply tied up and (4) L&T won residential/ commercial real estate projects totalling Rs49bn, Rs40bn and Rs29bn in FY10, FY11 and 1Q12 respectively, which might face execution challenges given the difficulties being faced by real estate developers.

Figure 5. L&T 1QFY12 Order Inflows and Backlog

Year End Mar31 (Rsmn)	1QFY11	1QFY12	% Chg	1QFY12E	% Chg
E&C	138,450	144,160	4.1%	na	nm
Total Inflow	156,260	161,900	3.6%	188,968	20.9%
Difference	(1,361)	(7,166)			
Net Inflows	154,900	154,734	-0.1%		
E&C	1,055,540	1,337,390	26.7%	na	nm
Total	1,078,160	1,361,720	26.3%	1,388,270	28.8%

Source: Company and Citi Investment Research and Analysis

Figure 6. L&T – Gas and Coal Orders Won

Qtr	Client	Order	Rsmn
1QFY12	Apollo Group	1x360MW EPC of gas power plant in TN	14,000
4QFY11	GSECL	1x375MW EPC gas power plant in Gujarat	11,250
1QFY11	GVK	BOP for 2x392 MW Gautami Stage-II CCPP	6,020
2QFY10	GMR	Vemagiri EPC	20,520
2QFY11	JP Power	3X660MW Karchana Coal	27,990
Total			79,780

Source: Company and Citi Investment Research and Analysis

Figure 7. L&T – Sectoral Breakdown Of Orders

	1QFY10	2QFY10	3QFY10	4QFY10	FY10	1QFY11	2QFY11	3QFY11	4QFY11	FY11	1QFY11
GCC Power T&D	-	21,640	-	13,900	35,540	8,110	-	9,870	-	17,980	25,760
GCC Roads	-	-	-	-	-	2,040	-	7,160	-	9,200	-
India T&D	10,450	-	-	6,350	16,800	-	-	7,780	-	7,780	1,103
Building and Factories	5,090	17,840	23,250	39,770	85,950	14,400	26,100	22,110	9,810	72,420	33,040
- Real Estate	2,990	6,210	14,250	25,150	48,600	12,940	8,040	9,430	9,810	40,220	28,930
- Others	2,100	11,630	9,000	14,620	37,350	1,460	18,060	12,680	-	32,200	4,110
Power BOP	3,640	8,530	20,270	7,650	40,090	13,630	16,100	22,660	-	52,390	2,400
Power EPC	-	38,250	69,630	14,330	122,210	52,000	58,650	-	11,250	121,900	14,000
Upstream Oil and Gas	-	53,920	-	20,730	74,650	3,760	11,950	-	14,500	30,210	-
Downstream Oil & Gas	6,510	-	-	34,350	40,860	-	-	-	-	-	-
Railways and Metro	4,530	2,920	3,030	-	10,480	-	-	11,260	59,000	70,260	12,000
Water	5,880	7,380	4,420	3,340	21,020	10,890	5,400	6,414	-	22,704	-
Metals and Mining	7,290	2,250	6,250	9,120	24,910	3,400	19,093	7,760	71,790	102,043	13,700
Nuclear	-	4,050	8,440	-	12,490	-	-	-	-	-	-
Shipbuilding	8,400	-	-	9,770	18,170	-	-	-	-	-	-
Fertilizers	-	-	9,870	21,550	31,420	-	-	-	-	-	-
Airports	-	-	-	-	-	-	-	-	-	-	7,960
GCC Airports	-	-	-	-	-	-	-	22,000	-	22,000	-
International Hydrocarbons	-	-	-	-	-	-	-	-	5,630	5,630	13,340
Roads	-	-	-	-	-	-	19,390	-	6,750	26,140	22,190
Defence	-	-	-	-	-	-	-	-	-	-	-
Solar	-	-	-	-	-	-	-	2,580	-	2,580	-
Not Announced	43,920	26,870	32,840	57,570	161,200	48,030	47,957	14,066	124,400	234,453	16,407
Total	95,710	183,650	178,000	238,430	695,790	156,260	204,640	133,660	303,130	797,690	161,900

Source: Company and Citi Investment Research and Analysis

Figure 8. L&T – Key Order Wins

2QFY12		Client	Rsmn
8-Aug-11	Habshan-Ruwais-Shuweihat gas pipeline project	Abu Dhabi Gas Industries	8,505
8-Aug-11	includes 4 wellhead towers and 1 manifold tower platform and associated stuff	ADMA-OPCO, a subsidiary of ADNOC	20,250
Total			28,755
1QFY12		Client	Rsmn
14-Jun-11	To supply energy meters	WBSEDCL	1,103
NA	Four Laning of 244 km stretch of NH 14 between Beawar & Pindwara, Rajasthan	L&T BPP Tollway Private Limited	17,100
NA	Civil Works	L&T Metro Rail	12,000
NA	LSTK Contract for Construction of Hosur Krishnagiri Road (NH 7), Tamil Nadu	R-Infra	5,090
NA	Construction of PO and LDPE plant	Technimont-Samsung JV at UAE	3,250
8-Aug-11	Zawtika Development Project, Phase-1A	PTTEP a subsidiary of PTT Public Co, Thailand	10,090
20-Jul-11	13 extra high voltage (EHV) substations in Qatar.	KAHRAMAA	12,100
24-Jun-11	Coal Handling Plants & Ash Handling Plant for Amravati & Nashik Thermal Power Projects (Phase II)	Indiabulls Power	2,400
24-Jun-11	4 new Coke Oven Batteries + Steel Melt Shop construction	Tata Steel	13,700
22-Jun-11	Banglore Airport Expansion	BIAL	7,960
22-Jun-11	Commercial buildings for hospitals, medical college and commercial buildings	Unknown	8,420
22-Jun-11	Residential buildings	Unknown	20,510
22-Jun-11	Factories	Unknown	4,110
21-Jun-11	Construction of the 225 km of 380kV transmission line project from SEC to Haramain High Speed Railway	Saudi Electricity Company	5,970
21-Jun-11	Construction of 5 MV substations and 33kV cabling works for Khalifa Port & Industrial Zone	Abu Dhabi Ports Company	4,220
21-Jun-11	Construction of 132 kV cabling and associated works	Dubai Electricity & Water Authority	750
21-Jun-11	66 km of 220 kV underground cabling works	KAHRAMAA	1,850
21-Jun-11	3 MV Substations including the associated 33 kV cabling works	Muscat Electricity Distribution Company	870
16-May-11	3 x 360 MW gas based power plant at Village Pillaiperumalnallur in Nagapattinam District	Apollo Group	14,000
Total			145,493

Source: Company and Citi Investment Research and Analysis

Figure 9. L&T EPS Revision

Mar31 (Rsmn)	FY12E	FY13E	FY14E
Gross Inflows			
New	917	1,055	1,187
Old	917	1,055	1,187
Change	0.0%	0.0%	0.0%
Net Inflows			
New	871	1,013	1,151
Old	871	1,013	1,151
Change	0.0%	0.0%	0.0%
Net Sales			
New	521,951	613,293	705,287
Old	521,951	613,293	705,287
Change	0.0%	0.0%	0.0%
Core EBITDA margins			
New	11.0%	11.1%	11.2%
Old	11.2%	11.2%	0.112
bps	-20	-10	0
Recurring PAT			
New	41,577	49,066	57,837
Old	42,068	49,550	57,928
Change	-1.2%	-1.0%	-0.2%
Parent FD EPS			
New	67.61	79.79	94.06
Old	68.54	80.73	94.38
Change	-1.3%	-1.2%	-0.3%
Consolidated FD EPS			
New	79.65	93.31	110.29
Old	80.68	94.36	110.75
Change	-1.3%	-1.1%	-0.4%

Source: CIRA estimates

Target priced revised to Rs1767 (from Rs1745)

- We revise our target price to Rs1767 (from Rs1745 earlier) to factor in (1) ~ 1% EPS cut on both parent and standalone; (2) roll forward our target P/E of multiple on the parent of 18x to Dec12E (from Sep12E earlier); and (3) reduction in our subsidiary value to Rs385 (from Rs402 earlier).
- We believe consensus estimates are too aggressive as shown in the table below and will likely be revised downwards.

Figure 10. L&T Parent and Consolidated EPS Estimates – CIRA vs. Consensus

Year End Mar31 (Rsmn)	FY12E	FY13E	FY14E
Parent			
CIRA	67.61	79.79	94.06
Consensus	74.13	88.70	97.82
Difference	-8.8%	-10.0%	-3.8%
Consolidated			
CIRA	79.65	93.31	110.29
Consensus	85.13	100.66	123.85
Difference	-6.4%	-7.3%	-10.9%

Source: Bloomberg and Citi Investment Research and Analysis estimates

Larsen & Toubro

Company description

L&T is a diversified conglomerate with market leadership in engineering and construction (E&C) and electrical-equipment businesses in India. L&T Information Technology is its 100% subsidiary in software services. L&T demerged its cement business into a separate company, selling it to Grasim.

Investment strategy

We rate L&T Hold/Low Risk given: The L&T management guided for 15-20% YoY gross inflow growth in FY12E implying inflows of Rs917 – 957bn. Further, the sales growth guidance is 25% YoY which implies sales of Rs549bn in FY12E. Finally, the management has also guided for EBITDA margins contracting 50bps in FY12E. Similar to the tough macro-environment in 2HFY11 leading to a gross inflow miss of 8% in FY11, we believe that the tough macro-environment in 1HFY12 implies that achieving the gross inflow guidance would be a quite a stretch. As a consequence we assume L&T will achieve the lower end of the guidance band in FY12E. We find the sales growth guidance a bigger stretch as it assumes that the execution cycle will be the same in FY12E as in FY11. Logically this seems difficult. Further given L&T has almost ~ Rs300bn of BTG orders with average execution cycles > 4 years and the Hyderabad Metro is a 5 year project we have assumed sales growth of 20% v/s management guidance of 25%. Over FY04 to FY10 L&T expanded EBITDA margins by a remarkable 718bps. Given the rise in competition across sub-segments and rising commodity prices, we believe margins might have peaked out in FY10.

Valuation

Our Rs1,767 target price is based on sum-of-the-parts (SOTP). We use 18x Dec12E earnings for the parent (Rs1,381), well supported by EPS growth of 16% and average RoEs of 18%. We also believe that the parent's numbers do not capture the value inherent in subsidiaries, which we value at Rs385, with L&T Infotech at Rs83 (12x Dec12E EPS, in line with second-tier peers), 51% stake in L&T-MHI JV at Rs38, and L&T IDPL at Rs86.

Risks

We rate L&T shares Low Risk, in line with our quantitative risk-rating system, and because L&T's order backlog of Rs1,361bn represents two years' sales and provides earnings visibility.

Upside risks to our target price include: 1) better than-expected order booking; 2) a better-than-expected execution rate; and 3) higher-than-expected EBITDA margins.

Downside risks include: 1) attracting and retaining talent; 2) the E&C and electrical equipment businesses are sensitive to economic variables; 3) competitive pressures; and 4) L&T needs to keep abreast with technology trends to sustain valuations and earnings.

Appendix A-1 Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Larsen & Toubro (LART.BO) Ratings and Target Price History Fundamental Research

Analyst: Venkatesh Balasubramaniam

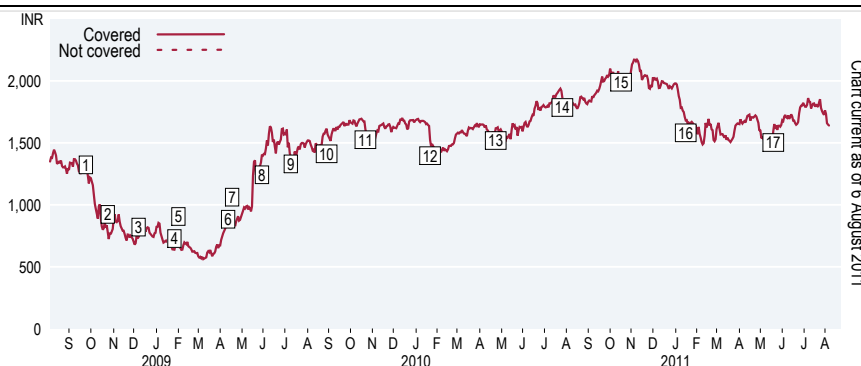


Chart current as of 6 August 2011

Date	Rating	Target Price	Closing Price
1 24-Sep-08	1L	*1,480.50	1,275.63
2 24-Oct-08	1L	*953.00	779.40
3 8-Dec-08	*2L	*787.00	740.20
4 27-Jan-09	2L	*697.00	638.20
5 1-Feb-09	*3L	*622.00	689.20
6 13-Apr-09	3L	*810.00	824.00

* Indicates change

Date	Rating	Target Price	Closing Price
7 17-Apr-09	*1L	*955.00	866.50
8 29-May-09	*2L	*1,437.00	1,405.60
9 9-Jul-09	2L	*1,466.00	1,389.40
10 28-Aug-09	2L	*1,784.00	1,614.60
11 22-Oct-09	*1L	*1,828.00	1,608.50
12 21-Jan-10	1L	*1,748.00	1,524.35

Date	Rating	Target Price	Closing Price
13 23-Apr-10	1L	*1,875.00	1,617.85
14 27-Jul-10	1L	*2,110.00	1,863.25
15 18-Oct-10	1L	*2,210.00	2,013.15
16 17-Jan-11	*2L	*1,824.00	1,681.15
17 19-May-11	2L	*1,745.00	1,594.90

Rating/target price changes above reflect Eastern Standard Time

Larsen & Toubro (LART.BO) Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Venkatesh Balasubramaniam

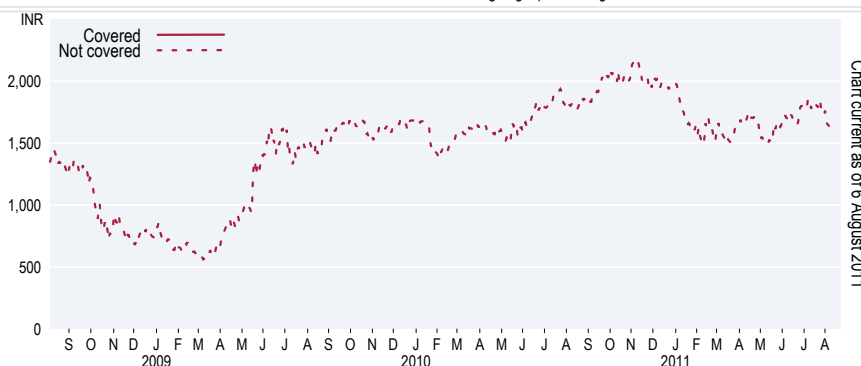


Chart current as of 6 August 2011

* Indicates change

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