Company In-Depth

11 September 2007 | 13 pages

Larsen & Toubro (LART.BO)

Buy: London Investor Conference Takeaways

- Management reiterates guidance — Management reiterated its FY08E revenue growth guidance of 25–30% YoY. In the most optimistic case the maximum revenue growth could be 35% YoY, in our view. Further, the company also expects order inflow growth in FY08 of 25–30% YoY. We continue to rate the stock Buy/Low Risk (1L) with a target price of Rs2,765.

- Difficult to expand margin — L&T feels there is not much scope to raise margins beyond 11.5%. At best it might improve by a few basis points by increasing manufacturing content in its projects. The robust demand environment continues with no contractor desperate to undercut on prices and contractors being able to price all contingencies (high rate of commodities in bids).

- Listing of subsidiaries — L&T will consider IPOs (as widely reported by the press, e.g. *The Economic Times*): 1) L&T Infotech post September 2008, 2) L&T Finance, in 2010, and 3) L&T IDPL in 2011.

- Infrastructure capex gets bigger — According to the latest plan documents, India is targetting infrastructure investments of Rs14,717bn in the XIth Plan (FY07-FY12), a 133% expansion over that in the Xth Plan (FY02-FY07).

- Industrial and GCC capex also get bigger — L&T expects investments to the tune of Rs4,500bn in the industrial segment in the next five years compared with Rs1,070bn in the last five. Further, L&T could also target the US$1250bn capex planned in the Gulf Cooperation Council (GCC) countries over the next six years.

Buy/Low Risk	1L
Price (11 Sep 07)	Rs2,625.00
Target price	Rs2,765.00
Expected share price return	5.3%
Expected dividend yield	0.6%
Expected total return	**5.9%**
Market Cap	Rs752,229M
	US$18,574M

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

See Appendix A-1 for Analyst Certification and important disclosures.

Figure 1. Statistical Abstract

Year to	Net Profit	EPS	EPS Growth	P/E	Adj P/E #	P / Book	ROE	ROCE	Yield
31-Mar	(Rsmn)	(Rs)	(%)	(x)	(x)	(x)	(%)	(%)	(%)
2005A	6,305	24.32	13.6%	107.9	89.9	20.5	20.9%	11.4%	0.5%
2006A	8,632	29.50	21.3%	89.0	74.1	15.7	21.8%	13.2%	0.4%
2007E	13,846	47.32	60.4%	55.5	46.2	13.0	26.8%	15.8%	0.5%
2008E	19,526	66.73	41.0%	39.3	32.8	10.3	30.2%	18.6%	0.6%
2009E	26,176	89.46	34.1%	29.3	24.4	8.0	31.8%	20.7%	0.6%
2010E	33,997	116.18	29.9%	22.6	18.8	6.2	31.9%	21.7%	0.8%

Source: Company and Citigroup Investment Research estimates # Adjusted for value of subsidiaries

Venkatesh Balasubramaniam[2]
+91-22-6631-9864
venkatesh.balasubramaniam@citigroup.com

Deepal Delivala[1]
+91-22-6631-9857
deepal.delivala@citigroup.com

Atul Tiwari[2]
atul.tiwari@citi.com

[1]Citigroup Global Market India Private Limited; [2]Citigroup Global Markets India Private Limited

Other Per Share Data

NAV	481.5
Discount to NAV	-445%

Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	107.9	89.0	55.5	39.3	29.3
P/BV (x)	20.5	15.7	13.0	10.3	8.0
Dividend yield (%)	0.5	0.4	0.5	0.6	0.6
Payout Ratio (%)	56.7	37.3	27.5	22.5	19.0
Per Share Data (Rs)					
EPS adjusted	24.32	29.50	47.32	66.73	89.46
EPS reported	37.95	34.59	47.95	66.73	89.46
BVPS	128.21	167.00	202.23	254.06	327.09
DPS	13.78	11.00	13.00	15.00	17.00
Profit & Loss (RsM)					
Net sales	130,918	146,976	175,716	237,217	314,312
Operating expenses	-122,995	-136,231	-159,895	-214,167	-283,244
EBIT	**7,923**	**10,745**	**15,821**	**23,050**	**31,068**
Net interest expense	-536	-751	-339	-390	-462
Non-operating/exceptionals	1,941	2,354	4,337	5,639	7,330
Pre-tax profit	**9,328**	**12,348**	**19,819**	**28,299**	**37,937**
Tax	-3,023	-3,717	-5,973	-8,773	-11,760
Extraord./Min.Int./Pref.div.	3,533	1,490	184	0	0
Reported net income	**9,839**	**10,122**	**14,030**	**19,526**	**26,176**
Adjusted earnings	6,305	8,632	13,846	19,526	26,176
Adjusted EBIT	7,923	10,745	15,821	23,050	31,068
Growth Rates (%)					
Sales	36.9	12.3	19.6	35.0	32.5
EBIT adjusted	32.0	35.6	47.2	45.7	34.8
EPS adjusted	13.6	21.3	60.4	41.0	34.1
Cash Flow (RsM)					
Operating cash flow	**4,574**	**14,785**	**19,400**	**17,714**	**24,154**
Depreciation/amortization	942	1,145	1,700	1,977	2,577
Net working capital	-6,018	3,691	4,032	-3,794	-4,605
Investing cash flow	**-1,576**	**-15,962**	**-17,598**	**-13,000**	**-13,000**
Capital expenditure	-1,640	-6,377	-5,753	-10,000	-10,000
Acquisitions/disposals	50	-9,586	-11,845	-3,000	-3,000
Financing cash flow	**1,789**	**-1,530**	**3,445**	**-4,845**	**-5,491**
Borrowings	5,347	-4,055	6,077	0	0
Dividends paid	-4,066	-3,446	-4,199	-4,845	-5,491
Change in cash	**4,786**	**-2,707**	**5,247**	**-131**	**5,663**
Balance Sheet (RsM)					
Total assets	**108,772**	**130,313**	**160,572**	**199,791**	**250,837**
Cash & cash equivalent	8,539	5,832	11,079	10,948	16,611
Accounts receivable	39,636	48,142	54,818	73,264	96,105
Net fixed assets	10,290	15,472	19,285	27,374	34,864
Total liabilities	**75,530**	**84,425**	**103,286**	**127,823**	**158,184**
Accounts payable	33,520	40,626	51,418	68,985	91,344
Total Debt	18,591	14,536	20,613	20,613	20,613
Shareholders' funds	**33,242**	**45,888**	**57,286**	**71,967**	**92,653**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	6.1	7.3	9.0	9.7	9.9
ROE adjusted	20.9	21.8	26.8	30.2	31.8
ROA adjusted	6.4	7.2	9.5	10.8	11.6
Net debt to equity	30.2	19.0	16.6	13.4	4.3
Total debt to capital	35.9	24.1	26.5	22.3	18.2

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Key Company Related Takeaways

FY08E revenue and order inflow guidance

L&T reiterated its FY08E revenue growth guidance of 25–30% YoY. In the most optimistic case the maximum growth could be 35% YoY, in our view. It also expects further order inflow growth of 25–30% YoY in FY008.

On EBITDA margins

According to the company there is no further scope to increase margins much higher than 11.5%. At best, from current levels margins might increase by a few basis points. L&T is trying to increase the manufacturing content in its projects to improve margins. The demand environment is strong with no contractors desperate to undercut on price and being able to price all contingencies with very high rate of commodities in bids**.**

Hydrocarbons is the key segment for profitable growth

Hydrocarbon is the main segment on which L&T is focusing, as margins are higher in this segment. Competition from foreign players is heating up in this segment, however, especially from Malaysian firms.

Delhi airport order

Currently the design and engineering works are on and the project is scheduled for completion by Mar10. The company won the Rs55bn order after L&T's chairman personally assured GMR of timely completion of the project

On the shipbuilding foray

Shipbuilding is a natural extension of the fabrication business and L&T is already building small sized ships (10,000 DWTs) at Hazira. The company plans to start production of large sized ships (150,000 DWTs to 350,000 DWTs), but the board resolution to that effect has not yet been passed. L&T plans an integrated facility, located on the east coast of India and this will be a port + shipbuilding + rig building integrated facility spread across 1,000 acres land. The Government used to provide a 30% subsidy project costs, but this facility expired on Aug 14, 2007. L&T expects the Government to renew the subsidy albeit at a lower rate. L&T believes it cannot compete with China on commoditized ships as their costs are very low. The company is, therefore, looking to build hi-tech ships like LNG carriers. It will take at least three yrs to set up facilities with a rough estimate capex of Rs20bn. L&T expects EBITDA margins of around 15% without factoring in the subsidy.

Listing of subsidiaries

L&T will consider IPOs for: 1) L&T Infotech post September 2008, 2) L&T Finance, in 2010, and 3) L&T IDPL in 2011. This has also been widely reported by the press.

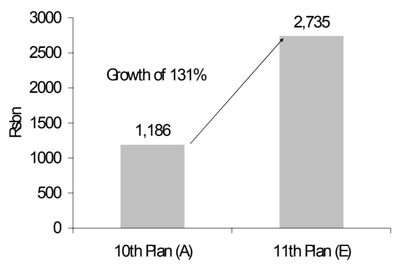
Manpower attrition is the key risk factor

As a manpower crunch and attrition are key risks to growth for the company, it is expanding its ESOP program from covering 2,700 employees (total number of employees is 29,000). Skilled workers generally leave to join MNCs and projects in the Middle East. L&T cannot compete with these companies in terms of salary. Wage inflation was 18% last year and average wage inflation over the past few years was 8%.

Robust Industry Growth Prospects

The government plans to increase investment in infrastructure from 4.6% of GDP to 7 – 8% of GDP in the XIth Plan (FY08E-12E) as this could increase GDP growth by 1%. Public private partnerships (PPP) are set to become the preferred route for investments as facilitating factors like: 1) 100% foreign direct investment (FDI) in infrastructure, and 2) tax incentives for developers (not for contractors) are in place. L&T also does not see change in Government as a risk that could slow down order inflow.

Figure 2. Investment in Roads



Source: CRISIL and L&T

Roads – Developing world class highways

India has the second largest road network (3.3m km) in the world, with highways/expressways constituting 6% of the total road network and carrying more than 80% of India's road traffic. The National Highway Development Programme (NHDP) has been established for the development of highways.

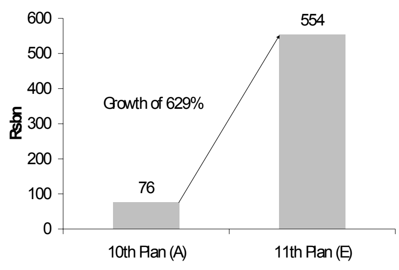
Figure 3. Status of Various NHDP Projects

Project under NHDP	Total Length (kms)	Awarded
GQ	5,846	100%
NSEW - Ph. I and II	7,300	86%
Phase - III A	4,000	47%
Phase - V	6,500	2%

Source: NHDP

Currently NHDP Phase III to Phase VII totaling to 37,500 kms are under implementation. Traffic is expected to grow @ 12-15% for passenger and @ 15-18% for cargo. Around 45% of the investments in roads are envisaged through the private sector and projects are being offered on BOT and DBFO basis and will follow the new Model Concession Agreement (MCA). It is expected that project sizes are set to increase, which will benefit larger players

Figure 4. Investments in Ports

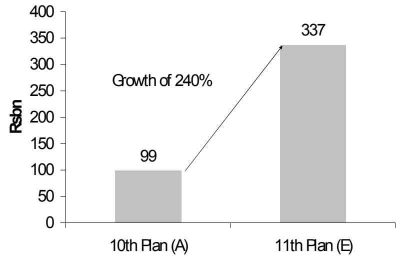


Source: CRISIL and L&T

Ports – Support increasing foreign trade

India has 12 major ports and 187 minor ports along a 7,517km long coastline and ports handle around 95% of foreign trade by volume. Out of this, major ports handle 70-75% of the total traffic. The NMDP was initiated for modernization and expansion of port capacities, which should lead to increased containerization of cargoes in line with international standard. Traffic is expected to grow at 10% per annum and the share of non-major ports should increase. It is expected that investments to the tune of Rs554bn (493 mtpa) in major ports and Rs359bn (345 mtpa) in minor ports would be required.

Figure 5. Investments in Airports



Source: CRISIL and L&T

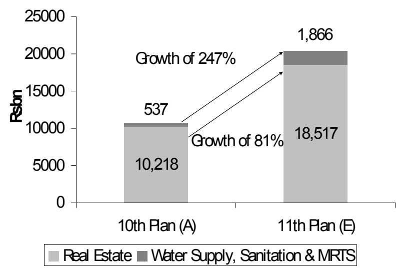
Airports – Facilitate increasing trade and tourism

India has 125 Airports of which 16 are international. The traffic handled in FY07 was 96mn passengers and 1.5mn tonnes of cargo. Four airports have already been privatized

- Greenfield airports at Hyderabad and Bangalore to be commissioned by March 2008
- Delhi Airport to be completed by 2010
- Mumbai Airport: Construction bids expected during the year

Passenger and cargo traffic are expected to grow at CAGRs of over 10% and 16%, respectively. Currently greenfield airports are being evaluated in Navi Mumbai, Noida and Nagpur with 35 non-metro airports to be upgraded and developed.

Figure 6. Investments in Urban and Commercial

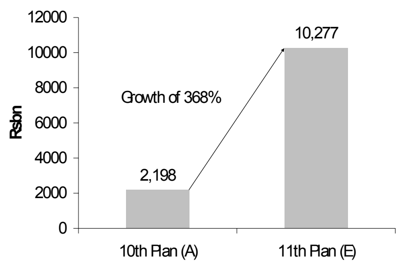


Source: CRISIL and L&T

Urban and commercial infrastructure – Growing urbanization

India is witnessing growth of urban population because of demographic changes, growing income levels and growth of offices. The Government has initiated National Urban Renewal Mission (NURM) covering 63 cities costing Rs500bn. There are increased opportunities in residential projects, IT parks, commercial malls, shopping Complexes, hotels, mass rapid transportation systems (MRTS), water supply and sanitation, and special economic zones.

Figure 7. Investments in Power



Source: CRISIL and L&T

Power – Critical for all round economic growth

India is the sixth largest consumer of electricity in the world and rapid economic growth has led to higher electricity demand. Capacity additions of over 78.5GW are targeted during FY08E-12E and 9 UMPPs of 4000MW each have been announced out of which two have been awarded. Further investments to the tune of Rs750bn are planned for the creation of the National Transmission Grid.

Hydrocarbon – For Growing Energy Needs

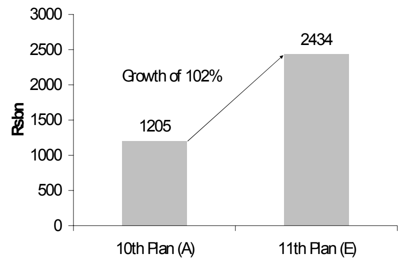
Petroleum and natural gas sector constitutes over 16% of GDP. Opportunities exist in the entire value chain of: 1) exploration, 2) refining and petrochemical, 3) pipelines, and 4) storage.

An additional 110MMT of refinery capacity is planned for implementation over the next five years and over 120MMSCMD of additional demand for natural gas is expected in next five years. The new policy for development of natural gas pipelines and distribution networks facilitates:

- The establishment of nation-wide gas grid
- Open access for all players to the pipeline network

Newer technology areas are being explored in: 1) LNG infrastructure – terminals, regasification, pipelines, 2) coal gassifiers, and 3) coal to liquid.

Figure 8. Investments in Hydrocarbons

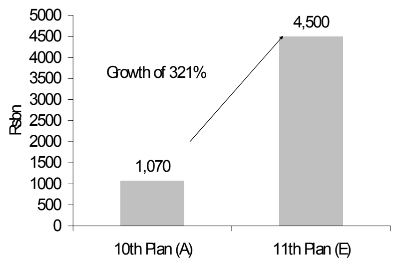


Source: CRISIL and L&T

Industrial capex – Increasing demand

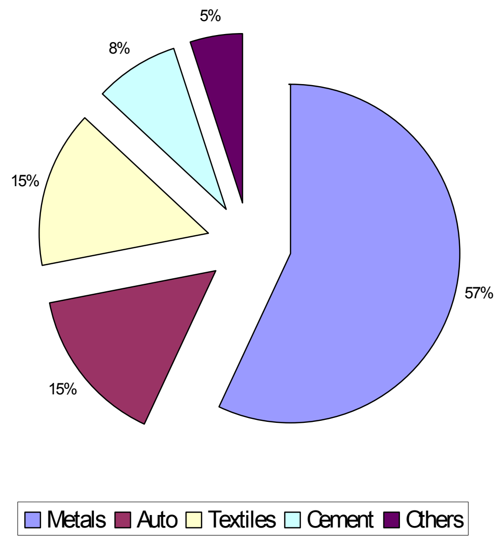
India is well endowed with high quality minerals and metals and is an attractive destination for setting up manufacturing plants. The growth in investments is driven by increasing demand and high existing operating rates. The current capacity of steel production is around 45 MTPA and of cement is 160 MTPA. The steel industry is adding 50MTPA of capacity and cement industry is adding 60 MTPA of capacity by end 2010. Infrastructure sectors and industrial capex will drive growth in construction and mining equipment, bulk material handling equipment, industrial machinery and electrical business. Investments to the tune of Rs4,500bn are expected in the next five years

Figure 9. Investments in Industrial Capex



Source: CRISIL and L&T

Figure 10. Breakdown of Industrial Capex of Rs4,500bn



Source: CRISIL and L&T

Defence and aerospace

DRDO opening up to public private partnership and the offset clause for defence purchases is driving growth. The selection process for Raksha Udyog Ratna RUR) is currently under way.

Railways

Opportunities exist in dedicated freight corridor, railway locomotives, electrical multiple units, electrification, bridge construction, track laying, port connectivity projects and metro rail.

Electrical and electronics

Growth to be fuelled by: 1) focus on power sector, 2) capacity expansion, 3) continuous development in infrastructure, and 4) 100% metering of electricity.

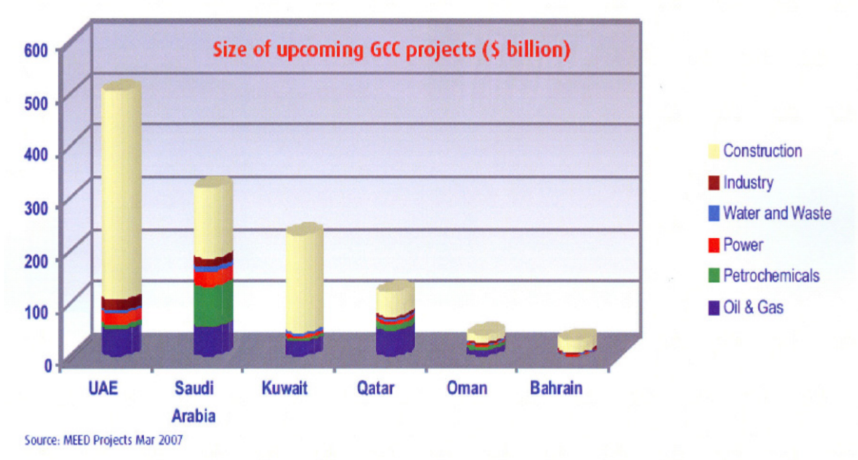
Machinery and industrial products

Growth to be driven by: 1) investments in the hydrocarbons sector, 2) thrust on infrastructure, and 3) increasing industrial capex.

Middle East prospects

Investments to the tune of US$1,250bn are planned in the Gulf Cooperation Council (GCC) countries over the next six years. This represents a significant growth opportunity.

Figure 11. Middle East Growth Prospects



Source: MEED Projects March 2007

Larsen & Toubro

Company description

L&T is a diversified conglomerate with market leadership in the engineering and construction (E&C) and electrical-equipment businesses in India. L&T Information Technology is its 100% subsidiary engaged in software services. L&T demerged its cement business into a separate company, and sold it to Grasim. L&T holds a residual stake of 11.5% in Ultratech Cemco.

Investment thesis

We rate L&T Buy/Low Risk (1L) with a target of Rs2,765. L&T's order backlog of Rs400bn-plus and forecast stable margins provide good earnings visibility. That most process industries are operating at near peak capacity utilization, together with the thrust on hydrocarbon and infrastructure spending, should augur well for the order pipeline. We are positive on management's efforts at improving the company's product mix by increasing the share of high-technology products for process industries, defense, nuclear, and aerospace applications; and of engineering and embedded services. These segments have better growth potential and margins than the projects business, in our view. The initial response to the new initiative has been encouraging. Management also appears to be on course to decrease its vulnerability to the business from the local cycle by increasing international sales as a proportion of total revenues.

Valuation

Using a comps-based P/E of 26x FY09E, we get a core business value of Rs2,326 for L&T's core business. We also believe that the parent numbers do not capture the value inherent in the subsidiaries of L&T. We use a sum-of-the-parts (SOTP) methodology to value the L&T group, resulting in a target price of Rs2,765. We value L&T's subsidiaries at Rs439 with L&T Infotech at Rs222 (16x FY09E EPS, in-line with second-tier peers) and L&T IDPL at Rs79 (a 20% premium to private equity valuations, because a number of projects will be commissioned over the next couple of years).

Figure 12. L&T Sum of the Parts

Part	Methodology	Value
Parent	P/E Multiple 26x FY09E FD EPS	2,326
Value of Subsidiaries		439
- L&T Infotech (100% Stake)	In line with a 2nd tier IT Company 16x FY09E EPS	222
- L&T IDPL (78.4% Stake)	20% premium to Private Equity Investment Valuation	79
- L&T UIL (58.8% Stake)	In line with Private Equity Investment Valuation	8
- Ultratech Cemco (11.5% Stake)	Current Mkt Value	41
- L&T Finance (100% Stake)	P/BV of 2.5x FY09E	56
- L&T IIDL (100% Stake)	P/E Multiple of 13x on FY06 PAT	12
- HPL Co Gen (51% Stake)	P/E Multiple of 13x on FY06 PAT	22
Value/Share		**2,765**

Source: Citigroup Investment Research estimates

Risks

We rate L&T Low Risk, as opposed to the High Risk suggested by our quantitative risk-rating system, because L&T's order backlog of c.Rs369bn represents two years' sales and provides earnings visibility. Downside risks to our target price 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 of technology trends to sustain valuations and earnings.

Appendix A-1

Analyst Certification

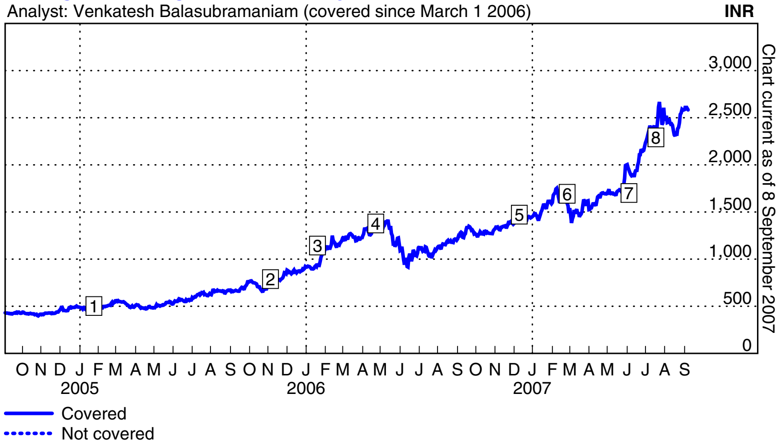
We, Venkatesh Balasubramaniam and Deepal Delivala, research analysts and the authors of this report, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

Larsen & Toubro (LART.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Venkatesh Balasubramaniam (covered since March 1 2006)



#	Date	Rating	Target Price	Closing Price
1:	25 Jan 05	1L	*578.50	453.05
2:	4 Nov 05	1L	*840.00	NA
3:	19 Jan 06	1L	*1,169.00	950.15
4:	24 Apr 06	1L	*1,579.50	1,378.18
5:	11 Dec 06	1L	1,579.50	1,436.30
6:	26 Feb 07	*2L	*1,733.00	1,592.40
7:	5 Jun 07	*1L	*2,360.00	1,945.05
8:	18 Jul 07	1L	*2,765.00	2,329.55

*Indicates change.

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Data current as of 19 July 2007	Buy	Hold	Sell
Citigroup Investment Research Global Fundamental Coverage (3320)	47%	39%	14%
% of companies in each rating category that are investment banking clients	71%	70%	70%
India -- Asia Pacific (144)	64%	11%	25%
% of companies in each rating category that are investment banking clients	89%	94%	83%

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Citigroup Investment Research's stock recommendations include a risk rating and an investment rating.

Risk ratings, which take into account both price volatility and fundamental criteria, are: Low (L), Medium (M), High (H), and Speculative (S).

Investment ratings are a function of Citigroup Investment Research's expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating.

For securities in emerging markets (Asia Pacific, Emerging Europe/Middle East/Africa, and Latin America), investment ratings are: Buy (1) (expected total return of 15% or more for Low-Risk stocks, 20% or more for Medium-Risk stocks, 30% or more for High-Risk stocks, and 40% or more for Speculative stocks); Hold (2) (5%-15% for Low-Risk stocks, 10%-20% for Medium-Risk stocks, 15%-30% for High-Risk stocks, and 20%-40% for Speculative stocks); and Sell (3) (5% or less for Low-Risk stocks, 10% or less for Medium-Risk stocks, 15% or less for High-Risk stocks, and 20% or less for Speculative stocks).

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