Larsen & Toubro LT IN

INDUSTRIALS/ENGINEERING & CONSTRUCTION | INDIA

Maintained

BUY

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NOMURA
NOMURA FINANCIAL ADVISORY AND SECURITIES (INDIA) PRIVATE LIMITED

Action

We believe the recent correction in the stock price presents an attractive buying opportunity from a long-term perspective. In the short term, the stock performance may be impacted by macro concerns. However, we remain convinced on the long-term growth potential and believe the risk-reward is favourable. We recommend a Buy rating from a 12-month perspective.

Catalysts

News flow on new order wins, value unlocking of subsidiaries, decline in interest rates and commodity prices.

Anchor themes

L&T is a play on investment in infrastructure and a pick-up in corporate capex. It participates across various infrastructure and corporate sectors. The company is unparalleled in scale and capabilities among Indian contractors and developers, in our view.

Closing price on 17 Jan	Rs1,680
Price target	**Rs1,966**
	(from Rs2,310)
Upside/downside	17.0%
Difference from consensus	**-7.6%**
FY12F net profit (Rsmn)	45,949
Difference from consensus	**-5.4%**

Source: Nomura

Nomura vs consensus

L&T's order backlog remains high, providing visibility of ~20% revenue growth until FY13F

Short-term pain, long-term gain

① Results beat expectations

L&T reported revenue growth of 41% YoY in 3Q FY11, above our forecast of 26% growth, implying a substantial pick-up in execution. Although operating margin was lower on account of a higher proportion of early-stage revenues and high commodity prices, net profit was higher by 13% compared to our estimates. The company has maintained revenue growth guidance at 20% for FY11.

② Slippage in order inflows

Order intake at INR134bn for the quarter was lower than our estimate of INR150bn. As expected, the post-results commentary suggests the possibility of some slippage in FY11 order intake compared to guidance. Ex-BTG, ex-development order intake has failed to show an improving trend since December 2007. We now build in order inflows of INR827bn in FY11F.

③ Change FY11/FY12 ests; introduce FY13 ests

We cut our FY12/FY13 earning ests by 3-6% to build in lower order intake, 50bps lower EBITDA margins and higher interest rates. Given an order backlog ratio of 2.72 and current accretion rate, we expect L&T to deliver ~20% revenue growth over FY11F-13F.

④ Valuation attractive; Reset 12m TP to INR1966/sh

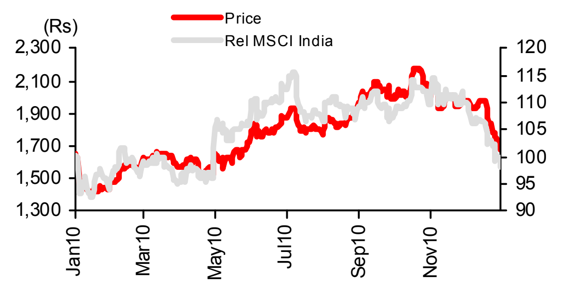
The stock currently trades at 16.85x FY12F EPS. We believe valuations are attractive given the long-term growth potential. However, until the macro headwinds ease, we expect the stock to trade at 15-20x one-year fwd EPS (compared to 20-25x expected earlier). We now value the standalone business at INR1,517/sh (12-month target) based on17.5x FY13F earnings. The subsidiary target price is unchanged at INR449/sh. Maintain BUY.

Key financials & valuations

31 Mar (Rsmn)	FY10	FY11F	FY12F	FY13F
Revenue	370,348	449,910	545,899	652,819
Reported net profit	43,755	39,602	45,949	54,384
Normalised net profit	31,650	38,594	45,949	54,384
Normalised EPS (Rs)	51.1	62.4	74.2	87.9
Norm. EPS growth (%)	13.8	21.9	19.1	18.4
Norm. P/E (x)	32.8	26.9	22.6	19.1
EV/EBITDA (x)	22.3	18.4	15.2	12.7
Price/book (x)	5.7	4.8	4.1	3.5
Dividend yield (%)	0.8	0.8	0.8	0.8
ROE (%)	28.4	19.9	19.6	19.7
Net debt/equity (%)	29.3	25.6	23.3	19.6
Earnings revisions				
Previous norm. net profit		39,776	49,090	na
Change from previous (%)		(3.0)	(6.4)	na
Previous norm. EPS (Rs)		64.3	79.3	na

Source: Company, Nomura estimates

Share price relative to MSCI India



	1m	3m	6m
Absolute (Rs)	(15.3)	(15.5)	(10.2)
Absolute (US$)	(15.6)	(18.2)	(7.8)
Relative to Index	(10.4)	(7.6)	(13.4)
Market cap (US$mn)			22,430
Estimated free float (%)			69.5
52-week range (Rs)			2,173/1,396
3-mth avg daily turnover (US$mn)			59.0
Stock borrowability			Hard
Major shareholders (%)			
LIC India			18.1
L&T Employees Welfare Foundation			12.4

Source: Company, Nomura estimates

Any authors named on this report are research analysts unless otherwise indicated.
See the important disclosures and analyst certifications on pages 11 to 14.

Drilling down

A robust 3Q FY11

Pick-up in execution a positive, but order inflows disappoint

Exhibit 1. 3Q FY11 results

(INRmn)	3Q FY10	3Q FY11	y-y (%)	3Q FY11E
Net Sales	81,222	114,131	41	102,638
Total Expenses	71,153	101,752	43	90,718
Core EBITDA	10,069	12,379	23	11,921
Other Income	1,476	2,472	67	2,200
EBITDA	11,545	14,851	29	14,121
Interest	1,339	1,757	31	2,070
Depreciation and Amortization	1,045	1,281	23	1,273
PBT	9,160	11,813	29	10,778
Tax	3,058	3,707	21	3,589
Recurring PAT	6,103	8,105	33	7,189
Extraordinary and exceptional items	1,486	300		0
Reported PAT	7,588	8,405	11	7,189
Order Inflows (INRmn)	178,364	133,660	(25)	150,000
Order Backlog (INRmn)	911,040	1,148,820	(26)	1,201,292
%			**bp change**	
Core EBITDA margins (%)	12.4	10.8	(155)	11.6
EBITDA margins (%)	14.2	13.0	(120)	13.8
Net margins (%)	7.5	7.1	(46)	7.0

Source: Company data, Nomura estimates

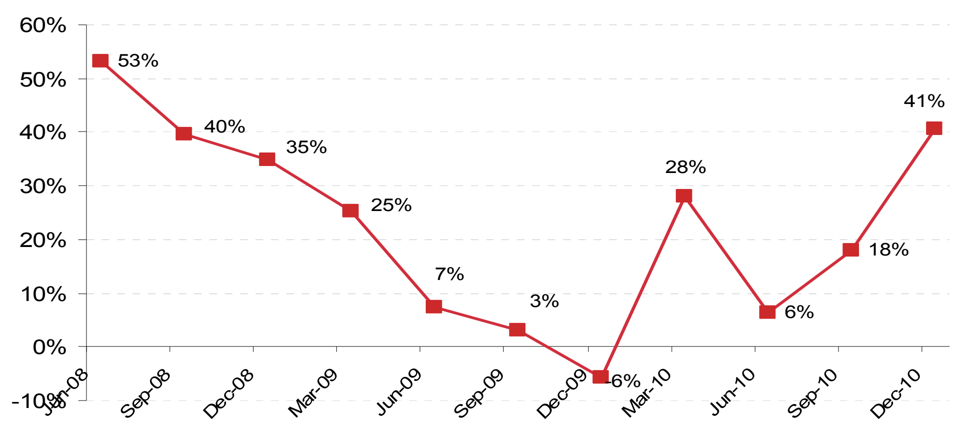
Other than the slippage in order inflows, the financial performance for 3QFY11 was ahead of our estimates. The quarter indicates a strong pick-up in execution.

Significant pick-up in execution; revenue guidance maintained

L&T reported revenues of INR114,131 mn for 3QFY11, well above our estimate of INR102,638 mn. On a y-y basis, sales grew 41% in 3QFY11 above our forecast of 26% growth as execution picked up in infrastructure orders, and boiler turbine generator (BTG) orders started contributing to revenues meaningfully. We anticipated some adverse impact due to rains during the quarter.

For 9M FY11, revenue growth stands at 22%. Management has maintained its guidance of 20% revenue growth for FY11F. This implies 16% growth in 4QFY11F. Keeping in view the current momentum in execution, we believe this should be achievable. We forecast revenue growth of 21.5% for FY11F, building in 20% growth in revenues for 4QFY11F.

Exhibit 2. Significant pick-up in execution in 3Q FY11 – sales growth y-y

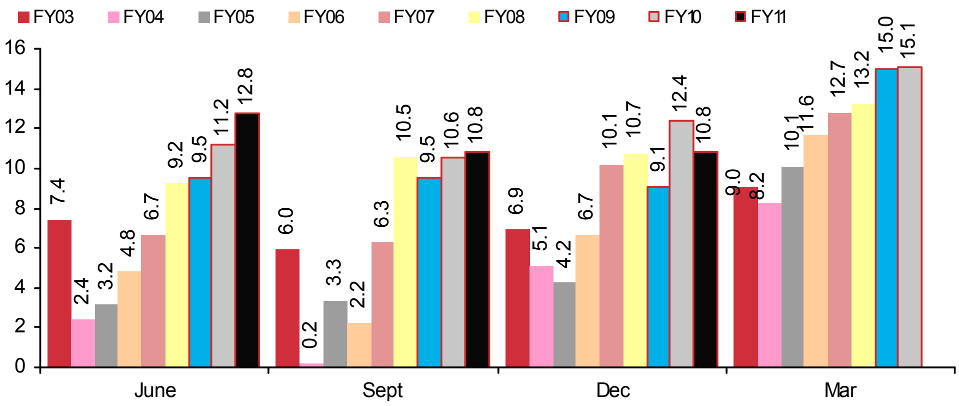


Source: Company data, Nomura research

Early stage projects drag down EBITDA margins

L&T reported core EBITDA at INR12,379 mn vs our estimate of INR11,921 mn. Core EBITDA margin was reported at 10.8% vs our expectation of 11.6% and 3QFY10 margin of 12.4%. According to management, a large proportion of revenues from early-stage projects which haven't yet reached the margin recognition threshold as well as higher raw material prices, resulted in the y-y decline in margins. Management has maintained its guidance of stable margins for FY11F vs FY10. We estimate core EBITDA margins of 13.0% for FY11F, in line with FY10 margins.

Exhibit 3. Core EBITDA margin trend



Source: Company data, Nomura research

Net profit above expectations

L&T reported net profit of INR8,405mn above our expectation of INR7,189 mn. Note that this includes exceptional profit of INR300 mn (post-tax) on account of a gain on the divestment of a part-stake in subsidiary and associate companies. Excluding this, recurring profit was INR8,105 mn, 13% above our estimate. This was mainly on account of higher-than-expected operating profit and lower-than-expected interest expenses.

Segment overview: E&C drives revenue growth, margins lower across segments

L&T reported strong revenue growth in the engineering and construction (E&C) business. In the E&C segment, domestic revenues delivered a 45% rise y-y and 25% q-q as execution picked up in infrastructure orders and BTG orders. Margins were lower in this segment on account of higher commodity prices, particularly steel and a change in job-mix.

The electrical & electronics (E&E) division reported 10% revenue growth y-y as industrial and agricultural demand showed some improvement. Here, margins were lower due to a sharp spike in input costs (mainly silver and copper), a drop in exports and increased competition. According to management, efforts are ongoing for better cost pass-through to customers.

In machinery & industrial products (MIP), growth in sales was led by increased offtake in industrial valves and mining & construction equipment business. Again, margins were lower as input prices increased.

Exhibit 4. Divisional results

(INRbn)	3Q FY10	3Q FY11	y-y growth %
Engineering & Construction segment			
- Revenues	68,020	98,690	45
- EBITDA	9,140	11,480	26
- EBITDA margin (%)	13.4	11.6	
Electrical & Electronics segment			
- Revenues	6,540	7,210	10
- EBITDA	940	940	0
- EBITDA margin (%)	14.4	13.0	
Machinery & Industrial Products segment			
- Revenues	5,710	6,540	15
- EBITDA	1,250	1,370	10
- EBITDA margin (%)	21.9	20.9	
Others			
- Revenues	950	1,680	77
- EBITDA	220	240	9
- EBITDA margin (%)	23.2	14.3	

Source: Company data, Nomura research

Performance of key subsidiaries

L&T Infotech — Growing in line with industry

In L&T Infotech, revenues grew by 18% y-y to INR6.04bn in 3Q FY11 from INR5.12bn in 3Q FY10. The growth is in line with IT industry growth. Net profit, though was flat at INR0.73bn.

Finance subsidiaries — IPO expected in 4QFY11F

L&T did not give any details on its financial services subsidiaries as the holding unit has filed the prospectus for an IPO. Management expects the IPO to be completed in the current quarter if market conditions stabilise.

Infrastructure development subsidiaries – On the growth path

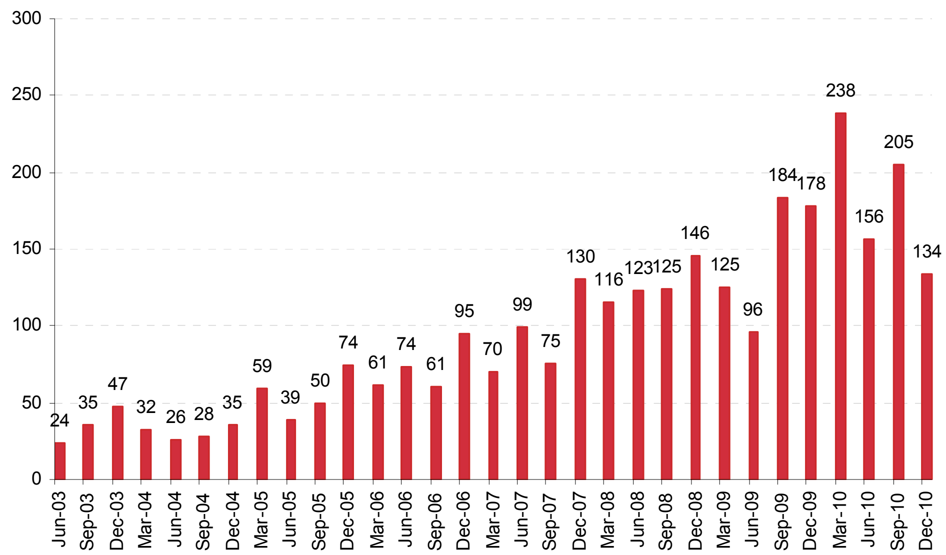
L&T currently has an infrastructure development portfolio of 15 road projects, one metro project, three port projects, five power projects and 14 urban infrastructure projects. The total cost of the project portfolio is INR613bn up from INR570bn at end-2Q FY11 as L&T has added two hydropower projects to its portfolio. Total equity invested in these projects at the end of 3Q FY11 was INR38bn versus INR34n at the end of the previous quarter.

Order inflow guidance unlikely to be met for FY11

We expect slippage of INR43bn on order inflow guidance

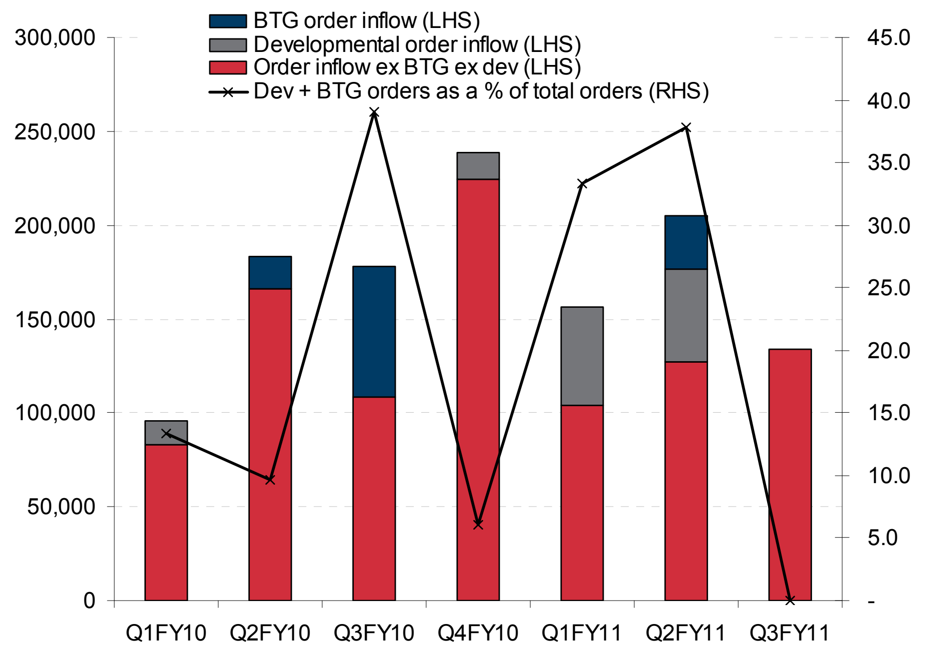
Order inflows for the quarter were below our expectations. Order booking at INR133.7bn was below our INR150bn estimate. Excluding the BTG and development project orders, order intake momentum has stagnated since Dec 2007, in our view (see below). During the quarter, the company didn't book any BTG and development project orders. The company ascribes the failure of order inflows to pick up in FY11 to: 1) a deferment of orders from private clients; 2) lack of policy action by the government; 3) issues surrounding land acquisition, environmental clearance, coal block allocation and 4) market-share loss to competition, particularly in the hydrocarbon sector.

Exhibit 5. Quarterly order inflows (INRbn)



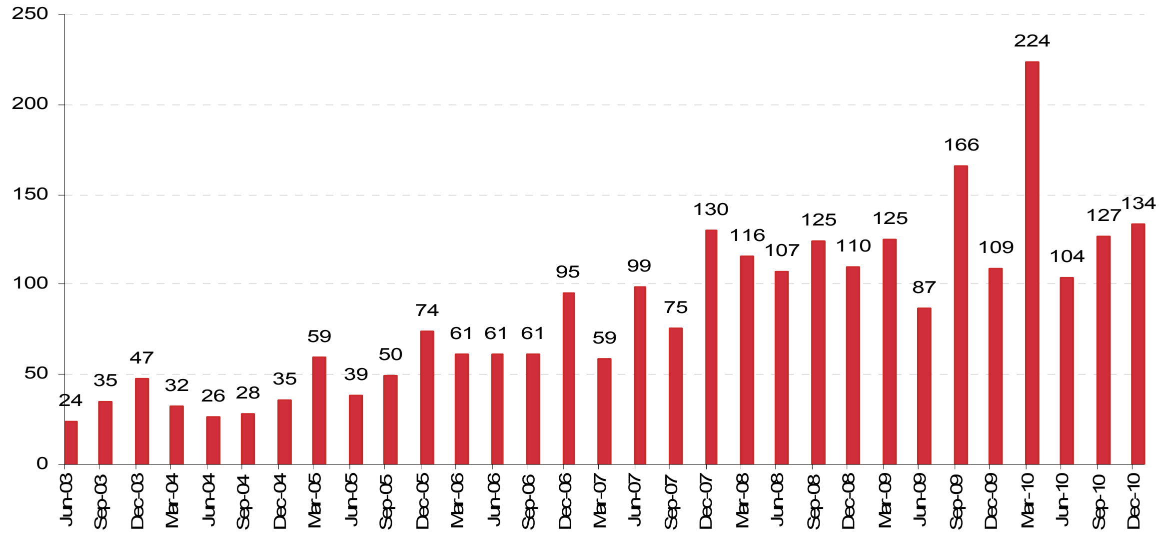
Source: Company data, Nomura research

Exhibit 6. Share of BTG and development project orders has been high



Source: Company data, Nomura research

Exhibit 7. Quarterly order inflows (INRbn) excluding BTG and development orders



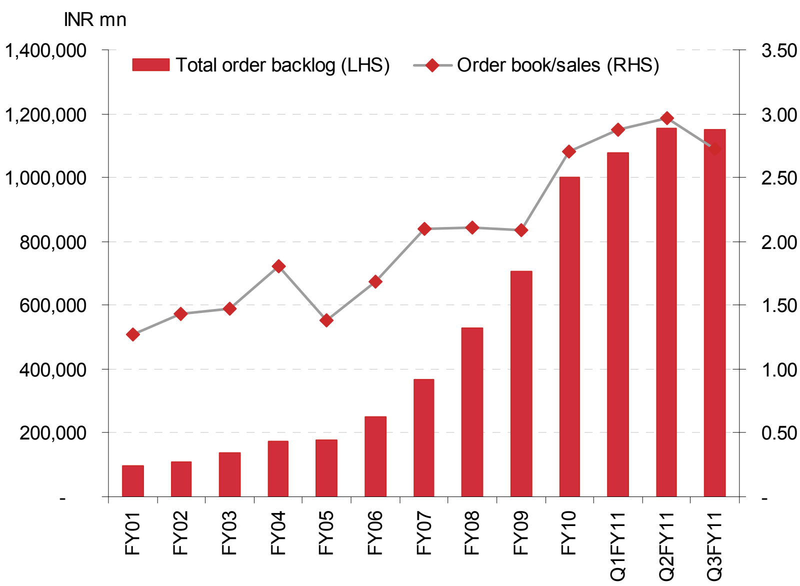
Source: Company data, Nomura research

Management commentary post 3QFY11 results suggests potential slippage in order inflow guidance for FY11. To meet the stated guidance of INR870bn, the company would need to book orders worth INR375bn in 4QFY11F. Even assuming the Hyderabad Metro development order of INR120bn (financial closure targeted by 4 Mar 2011) and boiler order related to NTPC bulk tender of INR40bn; L&T would have to book INR215bn worth of orders which is much higher than the current run rate of non-BTG, non-development orders.

Sequential dip in backlog ratio

Order backlog at the end of the quarter stood at INR1,149bn implying an order book-to-sales ratio of 2.72. There is a marginal sequential dip in backlog ratio as execution picked up and order inflow slowed down. In addition, the company has also taken out orders worth ~INR20bn related to commercial real estate projects where there has been no progress. We expect the backlog ratio to pick up in the near future with the booking of the Hyderabad metro order and NTPC BTG orders.

Exhibit 8. Order backlog and coverage ratio – remains high



Source: Company data

Earnings estimates and valuation

We revise FY11/FY12 ests; introduce FY13 estimates

We make the following changes to our earnings model:

a) We reduce FY11 and FY12 order inflow est by 5% and 9% respectively. The cut is to build in a delay of awards of key infrastructure projects and slowdown in corporate capex.

b) Revenue estimates are marginally adjusted

c) We reduce our EBITDA margin estimate for FY11, FY12 by 50bps to 13%. This is to account for higher input prices and uncertainty over margins in BTG and development projects. Note that we expect BTG and development revenues to contribute 16% of total revenues in FY12F vs 6% in FY11F.

d) Our net profit estimates are reduced by 3-6%.

Exhibit 9. Changes in estimates

	Old		New		% chg	
(INRmn)	**FY11**	**FY12**	**FY11**	**FY12**	**FY11**	**FY12**
Order inflows	869,957	970,541	826,799	881,198	(5)	(9)
Net revenues	445,740	557,492	449,910	545,899	1	(2)
Core EBITDA	60,175	75,261	58,488	70,967	(3)	(6)
Core EBITDA margin (%)	13.5	13.5	13.0	13.0		
PAT adjusted	39,776	49,090	38,594	45,949	(3)	(6)
EPS adjusted (INR)	64.3	79.3	62.4	74.2	(3)	(6)

Source: Nomura estimates

With the current order book and order accretion rate, we expect L&T to sustain its growth rate at ~20% over the next two years. We introduce our FY13 estimates with a 20% YoY growth rate and 13% EBITDA margin.

Maintain BUY; revise price target to INR1,966

The stock has corrected 23% since its recent peak on 9 November 2010, underperforming the broader market by 13%. The key concerns on the stock are: 1) a slowdown in order accretion thereby impacting long-term growth potential and 2) a fall in margins and profitability. We believe the stock correction factors in these concerns and we see value emerging from a long-term perspective. The stock currently trades at 16.85x FY12F adjusted earnings, which we believe is attractive.

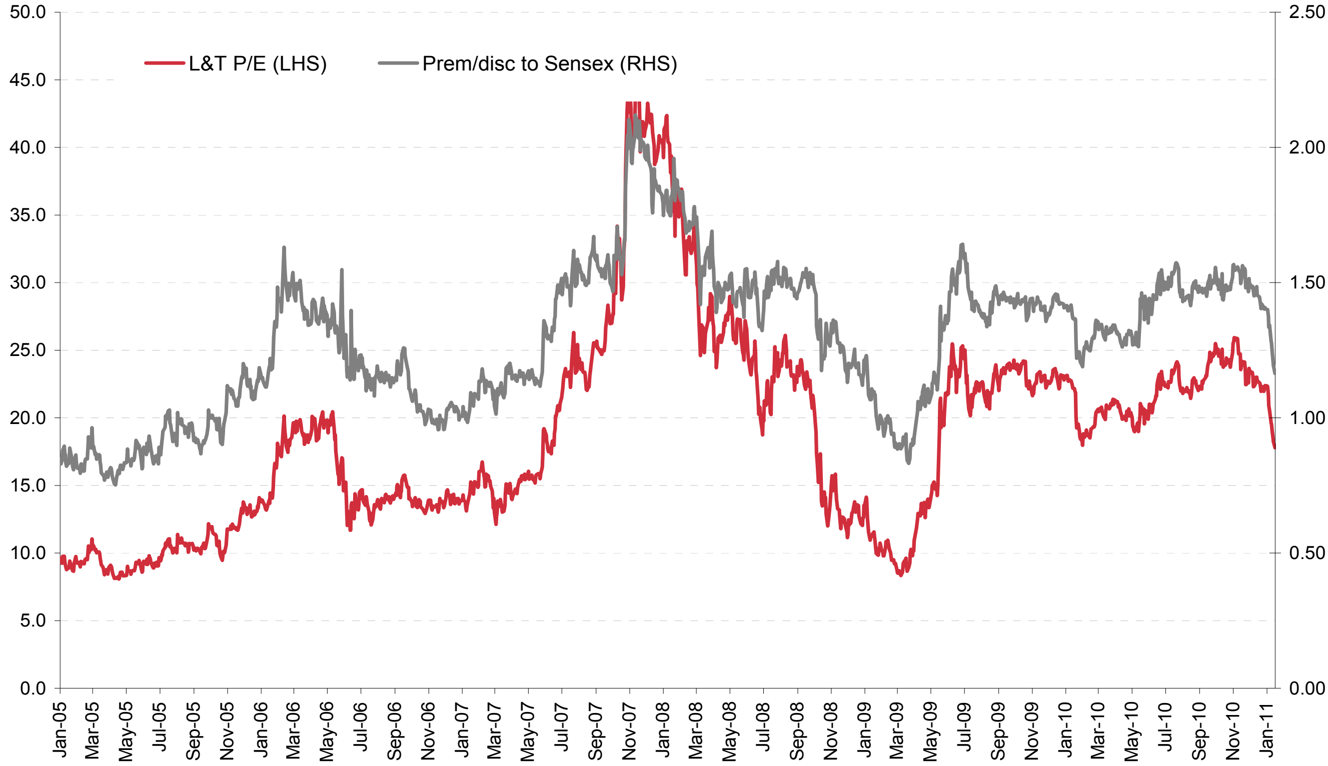
We believe, excluding periodic aberrations, the stable trading range for L&T has been 15-25x one-year forward earnings. We were valuing L&T at 22.5x one-year forward EPS assuming a fair value range of 20-25x. This assumes a favourable macro environment with an acceleration in the investment cycle. However, with the recent slowdown in ordering activity, increase in interest rates and tightening liquidity, the stock is most likely to trade in the range of 15-20x one-year forward earnings.

Therefore, we reset our parent business valuation at 17.5x FY13F to arrive at a one-year forward value of INR1,517/sh. We retain a subsidiary valuation at INR449/sh. Our price target is INR1,966/sh which presents potential upside of 17% over the next 12 months from current levels. Maintain BUY.

Risks to our investment view

Higher-than-expected slowdown in order inflows, rising interest rates, lower-than-expected execution, a substantial increase in raw material prices and a higher risk premium are the key risks to our price target.

Exhibit 10. L&T one-year forward P/E and prem/disc to Sensex P/E



Source: Bloomberg, Nomura research

Exhibit 11. L&T: Price target revised to INR1,966

Change in value/share (INR)	Previous	Revised	Comment
Core E&C business	1,860	1,517	17.5x FY13F earnings
L&T Infotech	85	85	14x FY12F earnings; peer group trading at 12-14x
L&T Finance+ Infrastructure Finance+ Capital	136	136	2.5x FY11F book; in line with peer group.
L&T IDPL, Power Devel. and other infra development subs	165	165	At 3x current book, in line with average of peer group
ECC subsidiaries and associates	2	2	Multiples on FY12F earnings (15x FY12F)
Engineering construction & projects subsidiaries and associates	9	9	Multiples on FY12F earnings (15x FY12F)
Manufacturing associates	30	30	Multiples on FY12F earnings (15x FY12F)
Foreign subsidiaries	20	20	1x book value
Satyam	3	3	At current market price
Total	**2,310**	**1,966**	

Source: Nomura estimates

Financial statements

Income statement (Rsmn)					
Year-end 31 Mar	**FY09**	**FY10**	**FY11F**	**FY12F**	**FY13F**
Revenue	339,264	370,348	449,910	545,899	652,819
Cost of goods sold	(285,373)	(312,473)	(381,798)	(465,514)	(558,932)
Gross profit	**53,890**	**57,875**	**68,112**	**80,386**	**93,887**
SG&A	(18,640)	(13,866)	(14,559)	(15,287)	(16,051)
Employee share expense					
Operating profit	**35,251**	**44,010**	**53,553**	**65,099**	**77,836**
EBITDA	**38,324**	**48,156**	**58,488**	**70,967**	**84,867**
Depreciation	(3,073)	(4,146)	(4,935)	(5,868)	(7,031)
Amortisation					
EBIT	**35,251**	**44,010**	**53,553**	**65,099**	**77,836**
Net interest expense	(3,502)	(5,053)	(7,083)	(7,263)	(7,443)
Associates & JCEs	-	-	-	-	-
Other income	7,656	9,103	11,132	10,237	10,177
Earnings before tax	**39,404**	**48,059**	**57,602**	**68,073**	**80,569**
Income tax	(12,312)	(16,409)	(19,009)	(22,124)	(26,185)
Net profit after tax	**27,092**	**31,650**	**38,594**	**45,949**	**54,384**
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	**27,092**	**31,650**	**38,594**	**45,949**	**54,384**
Extraordinary items	7,725	12,105	1,008	-	-
Reported NPAT	**34,817**	**43,755**	**39,602**	**45,949**	**54,384**
Dividends	(10,814)	(7,811)	(7,811)	(7,811)	(7,811)
Transfer to reserves	**24,003**	**35,944**	**31,791**	**38,138**	**46,574**
Valuation and ratio analysis					
FD normalised P/E (x)	37.4	32.8	26.9	22.6	19.1
FD normalised P/E at price target (x)	43.7	38.4	31.5	26.5	22.4
Reported P/E (x)	29.1	23.8	26.3	22.6	19.1
Dividend yield (%)	1.1	0.8	0.8	0.8	0.8
Price/cashflow (x)	68.5	19.0	24.4	24.1	21.9
Price/book (x)	8.1	5.7	4.8	4.1	3.5
EV/EBITDA (x)	28.1	22.3	18.4	15.2	12.7
EV/EBIT (x)	30.6	24.4	20.1	16.6	13.9
Gross margin (%)	15.9	15.6	15.1	14.7	14.4
EBITDA margin (%)	11.3	13.0	13.0	13.0	13.0
EBIT margin (%)	10.4	11.9	11.9	11.9	11.9
Net margin (%)	10.3	11.8	8.8	8.4	8.3
Effective tax rate (%)	31.2	34.1	33.0	32.5	32.5
Dividend payout (%)	31.1	17.9	19.7	17.0	14.4
Capex to sales (%)	6.1	4.3	4.4	3.7	3.1
Capex to depreciation (x)	6.8	3.8	4.1	3.4	2.8
ROE (%)	31.6	28.4	19.9	19.6	19.7
ROA (pretax %)	11.3	10.8	10.9	11.2	11.4
Growth (%)					
Revenue	35.7	9.2	21.5	21.3	19.6
EBITDA	29.1	25.7	21.5	21.3	19.6
EBIT	27.8	24.8	21.7	21.6	19.6
Normalised EPS	24.7	13.8	21.9	19.1	18.4
Normalised FDEPS	24.7	13.8	21.9	19.1	18.4
Per share					
Reported EPS (Rs)	57.8	70.7	64.0	74.2	87.9
Norm EPS (Rs)	44.9	51.1	62.4	74.2	87.9
Fully diluted norm EPS (Rs)	44.9	51.1	62.4	74.2	87.9
Book value per share (Rs)	206.7	295.9	347.2	408.8	484.1
DPS (Rs)	17.9	12.6	12.6	12.6	12.6

Source: Nomura estimates

Revenue growth of ~20% p.a. expected in FY11F- FY13F

Cashflow (Rsmn)					
Year-end 31 Mar	**FY09**	**FY10**	**FY11F**	**FY12F**	**FY13F**
EBITDA	38,324	48,156	58,488	70,967	84,867
Change in working capital	(31,623)	11,437	(976)	(7,896)	(13,448)
Other operating cashflow	8,085	(4,765)	(14,939)	(19,863)	(23,924)
Cashflow from operations	**14,786**	**54,828**	**42,573**	**43,208**	**47,495**
Capital expenditure	(20,794)	(15,840)	(20,000)	(20,000)	(20,000)
Free cashflow	**(6,009)**	**38,987**	**22,573**	**23,208**	**27,495**
Reduction in investments	(13,415)	(54,416)	(17,060)	(20,000)	(20,000)
Net acquisitions					
Reduction in other LT assets	(2,037)	748	-	-	-
Addition in other LT liabilities	1,908	(459)	-	-	-
Adjustments	1,253	9,250	8,071	7,976	7,916
Cashflow after investing acts	**(18,300)**	**(5,890)**	**13,584**	**11,184**	**15,411**
Cash dividends	(5,054)	(7,192)	(7,811)	(7,811)	(7,811)
Equity issue	230	21,327	-	-	-
Debt issue	23,606	3,636	-	3,000	-
Convertible debt issue					
Others	(2,374)	(5,315)	(7,083)	(7,263)	(7,443)
Cashflow from financial acts	**16,408**	**12,456**	**(14,894)**	**(12,074)**	**(15,254)**
Net cashflow	**(1,892)**	**6,566**	**(1,310)**	**(890)**	**157**
Beginning cash	9,645	7,753	14,319	13,009	12,119
Ending cash	7,753	14,319	13,009	12,119	12,276
Ending net debt	57,807	53,690	54,999	58,889	58,733

Source: Nomura estimates

Balance sheet (Rsmn)					
As at 31 Mar	**FY09**	**FY10**	**FY11F**	**FY12F**	**FY13F**
Cash & equivalents	7,753	14,319	13,009	12,119	12,276
Marketable securities	52,062	85,136	85,136	85,136	85,136
Accounts receivable	100,555	111,637	135,531	168,849	207,328
Inventories	58,051	77,234	93,765	116,084	144,228
Other current assets	68,124	60,426	66,129	73,031	80,718
Total current assets	**286,545**	**348,752**	**393,570**	**455,218**	**529,687**
LT investments	30,576	51,918	68,978	88,978	108,978
Fixed assets	50,538	62,231	77,296	91,428	104,397
Goodwill					
Other intangible assets	1,408	1,427	1,427	1,427	1,427
Other LT assets	3,867	3,119	3,119	3,119	3,119
Total assets	**372,933**	**467,446**	**544,389**	**640,169**	**747,607**
Short-term debt	11,155	7,714	7,714	7,714	7,714
Accounts payable	97,384	118,421	143,767	174,440	208,606
Other current liabilities	81,040	94,008	113,814	137,783	164,481
Total current liabilities	**189,579**	**220,143**	**265,295**	**319,937**	**380,801**
Long-term debt	54,405	51,314	51,314	54,314	54,314
Convertible debt	-	8,980	8,980	8,980	8,980
Other LT liabilities	4,352	3,893	3,893	3,893	3,893
Total liabilities	**248,336**	**284,330**	**329,482**	**387,124**	**447,988**
Minority interest					
Preferred stock					
Common stock	1,171	1,204	1,204	1,204	1,204
Retained earnings	123,426	181,912	213,703	251,841	298,415
Proposed dividends					
Other equity and reserves					
Total shareholders' equity	**124,597**	**183,116**	**214,907**	**253,046**	**299,619**
Total equity & liabilities	**372,933**	**467,446**	**544,389**	**640,169**	**747,607**
Liquidity (x)					
Current ratio	1.51	1.58	1.48	1.42	1.39
Interest cover	10.1	8.7	7.6	9.0	10.5
Leverage					
Net debt/EBITDA (x)	1.51	1.11	0.94	0.83	0.69
Net debt/equity (%)	46.4	29.3	25.6	23.3	19.6
Activity (days)					
Days receivable	93.7	104.6	100.3	102.0	105.2
Days inventory	64.7	79.0	81.7	82.5	85.0
Days payable	113.5	126.0	125.3	125.1	125.1
Cash cycle	44.8	57.5	56.7	59.4	65.1

Source: Nomura estimates

Net debt/equity remains low even in FY13F

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Mentioned companies

Issuer name	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Larsen & Toubro	LT IN	1681.15 INR	17-Jan-2011	Buy		

Previous Rating

Issuer name	Previous Rating	Date of change
Larsen & Toubro	Reduce	07-Sep-2009

Larsen & Toubro (LT IN) **1681.15 INR (17-Jan-2011)** Buy

Chart Not Available

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Explanation of Nomura's equity research rating system for Asian companies under coverage ex Japan published prior to 30 October 2008

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