Larsen & Toubro – BUY

LT IN	Rs1607	Construction	18 May 2010	Earnings upgrade

Growth Ahoy

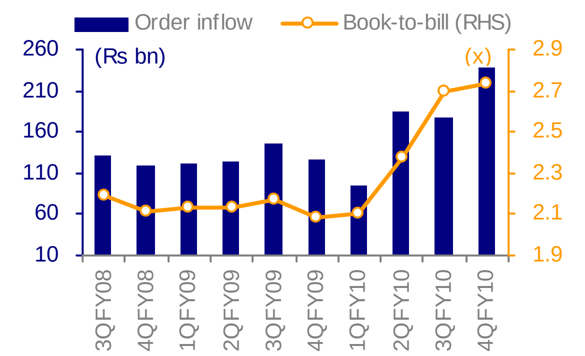
Better-than-expected FY11 guidance sets the tone for growth acceleration over FY11-12. Driven by 25% order intake guidance in FY11, we upgrade FY12 revenue estimates by 5%. Though maintaining margins at FY10 levels would be a challenge, margin erosion would be contained between 50bps-100bps. Balance sheet remains strong, with net D:E at -0.1x. Current liquidity of Rs94bn is sufficient to fund investment plans over the next 2-3 years. Buy-back of minorities in the infra subsidiary, IDPL, should increase flexibility to infuse capital for stronger growth in the asset portfolio. Driven by 8% upgrade to our FY12 earnings estimate, we increase our target price to Rs1,822 and reiterate BUY.

Broad-based recovery to aid order intake momentum: On top of 35% YoY order intake growth (higher end of the guidance) in FY10, the company has guided for 25% order inflow growth in FY11, driven by continued buoyancy in hydrocarbon, power, infrastructure and real-estate sectors. The company also indicated that industrial capex recovery is gradually taking root. In addition, higher pre-qualifications in the Middle East and opportunities in South East Asia should help overseas order booking.

Revenue growth to accelerate: Though the average execution cycle would increase as the proportion of power orders in the order book rises, return of short-cycle industrial orders would aid execution. The lengthening execution cycle is factored in our estimates—we model an execution rate of 40% in FY12 against 52% in FY10 and 64% in FY09.

Margins to move in a narrow band: FY10 EBITDA margin was helped by lower input costs, and the company admitted that it would be a challenge to maintain margins at current levels. However, the company categorically stated that fears of margin erosion on account of power sector orders are unfounded. We model 11.6% EBITDA margin for FY11-12—a 100bps contraction, which is the lower end of margin guidance.

Order coverage at historical high



Source: Company, IIFL Research

Financial Summary

Y/e 31 Mar	FY08	FY09	FY10ii	FY11ii	FY12ii
Revenues (Rs m)	248,779	339,264	369,550	452,625	566,218
EBITDA Margins (%)	11.4	11.4	12.6	11.6	11.6
Pre-exceptional PAT	20,862	27,091	31,650	35,701	44,161
Reported PAT (Rs m)	21,734	34,816	43,755	35,701	44,161
Recurring EPS (Rs)	35.7	46.3	53.0	59.8	74.0
Growth (%)	44.1	29.6	14.6	12.8	23.7
PER (x)	**45.0**	**34.7**	**30.3**	**26.9**	**21.7**
ROE (%)	27.2	24.6	20.7	18.3	19.4
Net debt/Equity (x)	-0.2	0.1	-0.1	0.0	0.1
EV/EBITDA (x)	**34.0**	**25.9**	**21.8**	**19.2**	**15.4**
Price/Book (x)	9.8	7.6	5.3	4.6	3.9

Price as at close of business on 17 May 2010

12-mth TP	*(Rs) 1822 (13%)*
Market cap (US$ m)	**21,023**
52Wk High/Low (Rs)	1800/1100
Diluted o/s shares (m)	603
Daily volume (US$ m)	45
Dividend yield FY10ii (%)	0.7
Free float (%)	100.0

Shareholding pattern (%)

Promoters	0.0
FIIs	16.4
Domestic MFs	37.2
Others	46.4

Price performance (%)

	1M	3M	1Y
L&T	2.1	9.0	62.5
Rel. to Sensex	6.4	6.5	24.2
BHEL	-7.0	-3.1	35.9
Punj Lloyd	-17.8	-24.7	4.9
Nag. Construc	-5.2	1.7	97.5

Stock movement

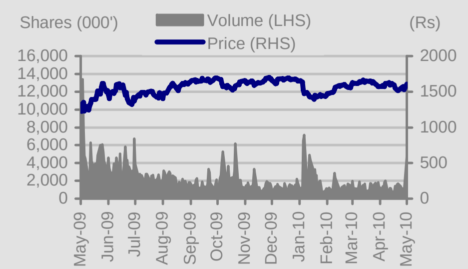


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Figure 1: Standalone 4QFY10 results—strong execution; margins maintained

Rs m	4QFY09	3QFY10	4QFY10	%YoY
Sales	**104,690**	**80,714**	**133,749**	**27.8**
Expenditure	90,181	71,153	115,343	27.9
EBIDTA	**14,509**	**9,561**	**18,406**	**26.9**
EBITDA margin (%)	13.9	11.8	13.8	-10 bps
Depreciation & Amortization	889	1,045	1,162	30.7
Interest(Net)	1,455	1,339	1,356	(6.8)
Other Income	3,668	2,844	5,401	47.2
PBT	**15,833**	**10,020**	**21,288**	**34.5**
Tax	4,409	3,058	7,914	79.5
Tax Rate (%)	27.8	30.5	32.0	
Adjusted PAT	**11,424**	**6,963**	**13,374**	**17.1**
Adjusted PAT margin (%)	10.9	8.6	10.0	-91 bps
Extra-ordinary item	(1,439)	626	1,007	
Reported PAT	9,985	7,588	14,381	44.0
Recurring EPS (Rs)	**19.5**	**11.7**	**22.4**	**14.9**
Order book	703,190	911,040	1,002,390	42.5
Order inflow	127,056	177,930	238,430	87.7

Source: Company, IIFL Research

Figure 2: Standalone segment results

Rs m	4QFY09	3QFY10	4QFY10	%YoY
Engineering and Construction				
Revenue	94,374	69,980	121,094	28.3
EBIT	14,682	8,554	18,466	25.8
EBIT Margin (%)	15.6	12.2	15.2	-31 bps
Electrical & Electronics				
Revenue	7,900	7,214	9,883	25.1
EBIT	980	873	1,329	35.6
EBIT Margin (%)	12.4	12.1	13.4	104 bps
Machinery & Industrial Products				
Revenue	6,206	5,911	6,819	9.9
EBIT	1,169	1,206	1,431	22.4
EBIT Margin (%)	18.8	20.4	21.0	215 bps

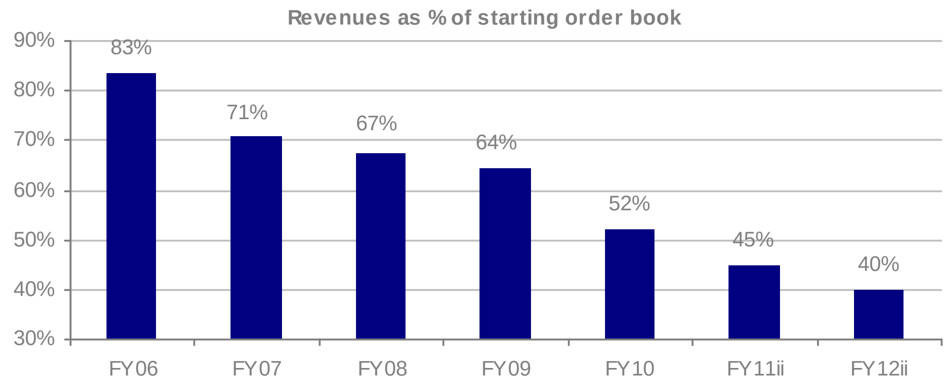
Source: Company, IIFL Research

Execution worries should abate post strong 4Q

Revenues increased 28% YoY to Rs133.8bn in 4QFY10, in line with our estimate and ahead of consensus estimates. The growth recovery was driven by the mainstay E&C segment, whose revenues rose 28% YoY. E&E revenues also grew strongly at 25% YoY. Growth in the MIP segment was subdued at 10% YoY, as the industrial-valves business catering mainly to export markets is yet to revive. The construction and mining equipment business have witnessed improved traction.

We are not overly concerned on revenue growth trajectory due to a lengthening execution cycle. Our revenue estimates factor in modest execution rate assumptions. In our view, there exist upsides to our revenue estimates, as large contracts enter execution phase and industrial clients expedite implementation of ongoing projects. Improving traction in industrial orders should also aid execution, as short-cycle order inflow momentum improves.

Figure 3: Margins at historical highs; should move in a narrow band



Source: Company, IIFL Research

Margin trajectory maintained; outlook not worrisome

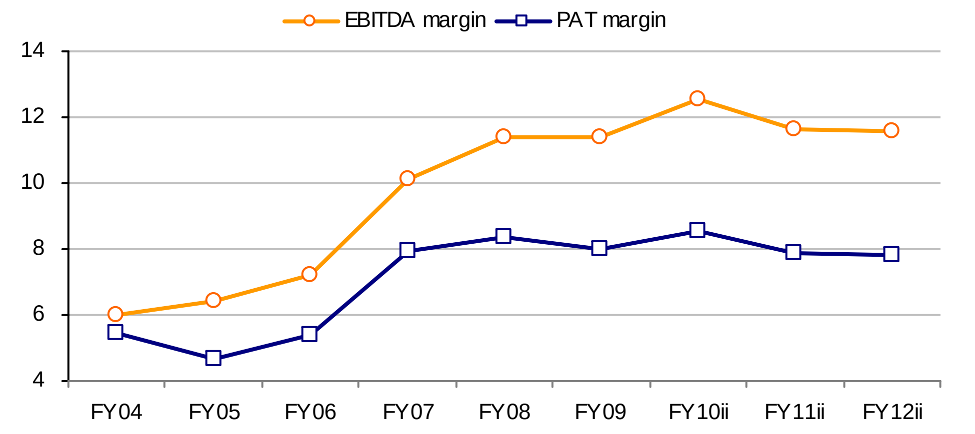
Against our expectation of a 120bps YoY decline in margins in 4Q, EBITDA margin at 13.8% was flat YoY, as the E&C segment witnessed marginal margin contraction of 30bps YoY, whereas the E&E and MIP segments witnessed robust margin improvements of 100bps and

220bps YoY. YoY margin comparisons were helped by Rs2bn forex loss included in SG&A costs in the year-ago period.

The management stated that it would be difficult to maintain margins at FY10 levels, as input cost environment is not as supportive. However, it clarified that higher proportion of power orders would not result in margin erosion, as EBITDA margins in the segment, at ~11.5%, would be close to the company average.

The company said it would strive to maintain current margins; it sees a risk of 50bps contraction in margins in FY11. We have estimated a 100bps contraction to factor in any adverse surprises in input costs.

Figure 4: Margins at historical highs; should move in a narrow band



Source: Company, IIFL Research

Client advances aid working-capital cycle; balance sheet remains strong to fund investment plans

Strong order inflows of Rs238bn in 4Q translated into robust client advances as well. As a result, segment net-working capital improved from 11.7% as at end-FY09 to 7.6% as at end-FY10. Working-capital changes resulted in Rs17.6bn of cash inflows in FY10, as against an outflow of Rs21.1bn during FY09.

Strong operating cash flows of Rs54.8bn in FY10 against Rs14.8bn during FY09 resulted in the net D:E being quite comfortable at -0.1x. Cash and cash equivalents totalling Rs94bn provide necessary liquidity to fund capex and investment plans over the next 2-3 years. The company's capex plan involves an outlay of Rs20bn-25bn in FY11.

In addition, L&T intends to infuse Rs25bn-30bn in L&T IDPL to buy back minority PE investors and also fund equity in new projects. PE funds had invested Rs5.5bn in IDPL in 2006. Though the company has not indicated the valuations for buy-back deals, we estimate that L&T would likely pay Rs13bn-14bn for the transaction. Buy-back of minority shareholders in IDPL would improve L&T's flexibility in capital allocation and corporate structuring decisions, and would allow for faster growth in the asset portfolio.

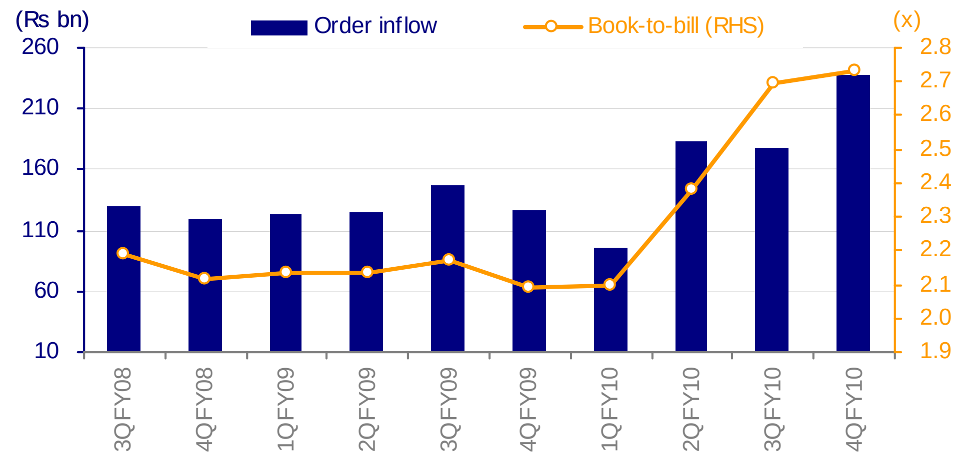
The power generation business is another area that would need large equity contribution from the parent balance sheet. The management foresees a need for Rs50bn over the next 2-3 years. The company is unlikely to infuse more funds in the financial-services business, as it plans to raise capital for this business either through M&A activity, PE funding, or an IPO. Hence, the total funding requirement over the next three years should be ~Rs100bn, which can be comfortably met out of the existing cash without raising further equity or debt. Given our estimate of almost constant gross debt, we forecast a moderate increase in interest costs and other income as interest income from liquid investments decreases.

Strong order inflows in 4Q; robust FY11 guidance

4Q witnessed highest-ever order intake of Rs238bn, aided by orders from upstream and downstream hydrocarbon sector; power generation and T&D; and strong recovery in award activity by the real-estate sector. Award activity from the metals sector was also robust during the quarter.

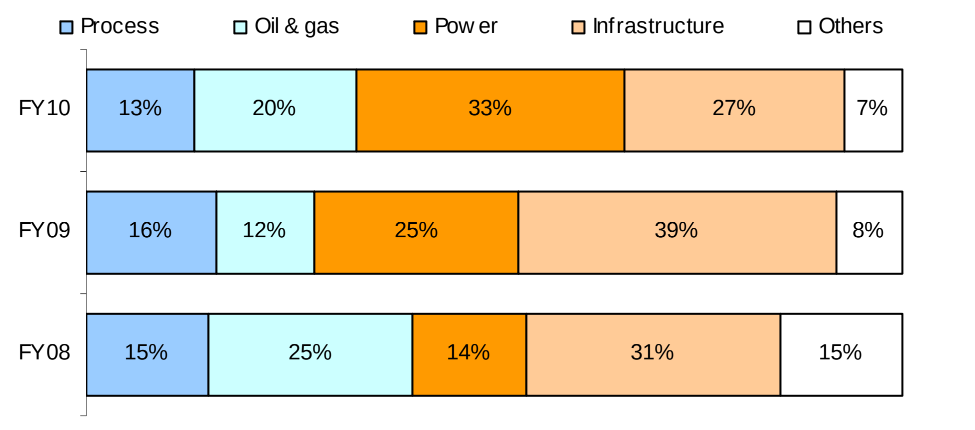
The company has guided for 25% YoY order inflow growth in FY11, driven by continued buoyancy in the above sectors and gradual pick-up in the industrial sector. The management also remained optimistic on revival in the export markets, which were muted during the year. The optimism stems from higher pre-qualifications in most of the Middle East countries and emerging opportunities in South East Asia.

Figure 5: Order inflows and order coverage ratios at historical highs



Source: Company, IIFL Research

Figure 6: Broad-based growth in order inflows



Source: Company, IIFL Research

Consolidated earnings ahead of expectations

FY10 recurring consolidated EPS, at Rs63.6, was higher than our estimate. Consolidated PAT increased 26% YoY to Rs39.97bn—that's Rs3.2bn higher than our estimate. Only a third of the variance is explained by the positive surprise in parent earnings.

Though the company did not share full details of the various subsidiaries, we believe the improved performance has likely resulted from higher-than-estimated profits at TAMCO, the Malaysian electrical company, Omani shipyard, and possibly lower-than-forecast losses in the power equipment JVs.

The management stated that the power equipment JVs would operate at ~6% EBITDA margins during the commencement phase. Margins would reach double-digit levels in two years, when the management intends to increase indigenisation levels to 80%.

- The finance subsidiaries witnessed strong growth in their loan books. L&T Finance's revenues grew 24% YoY in FY10, driven by rural equipment finance and micro-finance segments. Net profit growth was faster at 58% YoY, driven by higher net interest margin. Business assets as at end-FY10 stood at Rs70bn.
- L&T Infrastructure Finance also posted robust results. Income rose 53% YoY in FY10, driven by higher lending to most infrastructure segments. Business assets as at end-FY10 stood at Rs43bn.
- L&T Infotech's consolidated revenues declined 6% YoY in FY10, as they were hit by a slowdown in the key markets of USA and Europe. However, PAT increased by 5% YoY as margins improved.

Figure 7: Performance of key subsidiaries

	Total income			Net profit		
Rs bn	FY09	FY10	Growth (%)	FY09	FY10	Growth (%)
L&T Infotech (Consolidated)	20.40	19.11	-6.3%	2.66	2.80	5.3%
L&T Finance	7.96	9.86	24%	0.99	1.56	58%
L&T Infrastructure Finance	2.96	4.52	53%	0.77	1.11	45%

Source: Company, IIFL Research

Figure 7: L&T sum-of-parts valuation

	Rs m	Rs ps
FY12ii PAT (ex dividend from S&A companies)	43,276	
PER (x)	21.0	
Equity value of standalone business	**908,803**	**1,522**
L&T 51% stake in power equipment JV's	**50,948**	**85**
L&T Infotech FY11ii PAT	3,034	
PE	14.0	
LT Infotech equity value	**42,470**	**71**
L&T Finance FY11ii adjusted book	12,026	
PB	1.5	
LT Finance equity value	**18,039**	**30**
L&T Infra Finance FY11ii adjusted book	8,846	
PB	1.5	
LT Infra Finance equity value	**13,269**	**22**
LTIDPL	37,947	64
Manufacturing Associates	4,391	7
International Operations	8,885	15
Service JVs	2,701	5
Total value	**1,087,452**	**1,822**

Source: IIFL Research

Financial summary

Income statement summary (Rs m)

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Revenue	248,779	339,264	369,550	452,625	566,218
EBITDA	28,378	38,567	46,473	52,600	65,700
EBIT	**26,242**	**35,494**	**42,327**	**47,500**	**59,800**
Interest expense	1,227	3,502	5,100	5,700	6,000
Others items	5,668	7,411	10,832	10,702	11,142
Profit before tax	**31,555**	**47,128**	**60,164**	**52,502**	**64,942**
Tax expense	9,821	12,312	16,409	16,801	20,782
Extraordinary items	**872**	**7,725**	**12,105**	**0**	**0**
Net Profit	**21,734**	**34,816**	**43,755**	**35,701**	**44,161**

Cashflow summary (Rs m)

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Operating profit	31,555	47,128	60,164	52,502	64,942
Depreciation & amortization	2,136	3,073	4,146	5,100	5,900
Tax paid	(9,821)	(12,312)	(16,409)	(16,801)	(20,782)
Working capital change	(2,123)	(31,651)	15,408	(29,003)	(20,205)
Operating cash-flow	21,748	6,238	63,309	11,798	29,856
Capital expenditure	(15,732)	(17,281)	(16,000)	(20,000)	(15,000)
Free Cash flow	**6,016**	**(11,043)**	**47,309**	**(8,202)**	**14,856**
Equity raised	21,876	707	18,728	-	-
Investments	(38,178)	(13,415)	(55,755)	19,600	(10,050)
Debt financing/disposal	15,062	29,720	2,440	-	-
Dividends paid	(5,686)	(7,168)	(7,683)	(7,683)	(7,683)
Other items	(391)	(694)	(1,213)	-	-
Net change in Cash & cash equivalents	**(1,300)**	**(1,892)**	**3,825**	**3,715**	**(2,877)**

Source: Company data, IIFL Research

Balance sheet summary (Rs m)

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Cash & cash equivalents	9,645	7,753	14,334	18,050	15,173
Sundry debtors	73,650	100,555	117,444	144,766	181,098
Trade Inventories	43,059	58,051	63,318	78,048	97,635
Other current assets	36,812	68,124	55,876	68,825	86,043
Fixed assets	**35,534**	**50,538**	**62,392**	**77,292**	**86,392**
Intangible assets	920	1,408	1,408	1,408	1,408
Other assets	71,052	86,504	142,259	122,659	132,709
Total assets	**270,672**	**372,933**	**457,032**	**511,048**	**600,458**
Sundry creditors	136,838	178,424	203,740	229,738	282,670
Long-term debt/Convertibles	35,840	65,560	68,000	68,000	68,000
Other long-term liabilities	2,443	4,352	4,352	4,352	4,352
Networth	**95,551**	**124,597**	**180,940**	**208,958**	**245,436**
Total liabilities & equity	**270,672**	**372,933**	**457,032**	**511,048**	**600,458**

Ratio Analysis

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Sales growth (%)	41.3	36.4	8.9	22.5	25.1
Core EBITDA growth (%)	59.1	35.9	20.5	13.2	24.9
Core EBIT growth (%)	62.8	35.3	19.3	12.2	25.9
Core EBITDA margin (%)	11.4	11.4	12.6	11.6	11.6
Core EBIT margin (%)	10.5	10.5	11.5	10.5	10.6
Net profit margin (%)	8.7	10.3	11.8	7.9	7.8
Dividend payout ratio (%)	22.7	17.7	15.0	18.4	14.9
Tax rate (%)	31.1	26.1	27.3	32.0	32.0
Net Debt/Equity (%)	(19.5)	7.2	(14.4)	4.8	9.3
Return on Equity (%)	27.2	24.6	20.7	18.3	19.4
Return on Assets (%)	9.4	8.4	7.6	7.4	7.9

Source: Company data, IIFL Research

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.
