

Company Focus

28 July 2008 | 10 pages

Larsen & Toubro (LART.BO)

Buy: 1QFY09; Positives ... Yes, but Monitor Order Inflows Closely

- Recurring PAT up 70% YoY** — L&T's 1QFY09 Recurring PAT at Rs4.9bn up 70% YoY was 25% ahead of CIR estimates of Rs3.9bn due to superior order backlog execution and Rs1.0bn of higher-than-expected other income. If one ignores the other income boost to the Recurring PAT, EBITDA at Rs6.6bn is up 56% YoY and ahead of CIR estimates of Rs6.3bn
- 70% of order backlog is covered** — L&T ended 1QFY09 with a backlog of Rs582bn up 40% YoY led by inflows of Rs122bn up 24% YoY. Management maintained that 70% of this order backlog has some form of margin protection (escalation clauses, cost-plus arrangements, or back-to-back supply arrangements).
- Management reiterate guidance** — Management re-iterated its full-year order inflow guidance of 30% YoY and sales guidance of 30% YoY and mentioned if execution is good it could very well achieve sales growth of 30-35% YoY.
- What worries us?** — L&T booked Rs122bn of orders in 1QFY09, up 24% YoY. However, the Rs15.6bn APGENCO order will be subcontracted out to the L&T – MHI JV and as a consequence if we knock this order off, order inflows at Rs107bn is up a tepid 8% YoY. This slow pick up in orders in 1QFY09 worries us, if this is a direct result of a difficult macro environment led by double-digit inflation, rising energy costs, volatile commodity prices and high interest rates.
- Does management guidance include L&T-MHI orders?** — Besides this we are also worried whether management guidance of 30% YoY inflow growth includes orders that might be won by the L&T-MHI JV?

Buy/Low Risk	1L
Price (28 Jul 08)	Rs2,723.55
Target price	Rs3,170.00
Expected share price return	16.4%
Expected dividend yield	0.6%
Expected total return	17.0%
Market Cap	Rs796,382M
	US\$18,890M

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



Figure 1. L&T – Statistical Abstract

Year to	Net Profit	EPS	EPS Growth	P/E	Adj P/E	P / Book	ROE	ROCE	Div. Yield
	(Rsmn)	(Rs)	(%)	(x)	(x)	(x)	(%)	(%)	(%)
2004A	5,328	21.41	nm	127.2	109.5	25.1	17.29%	7.16%	0.3%
2005A	6,305	24.32	13.6%	112.0	98.4	21.2	20.9%	11.4%	0.5%
2006A	8,632	29.50	21.3%	92.3	81.1	16.3	21.8%	13.2%	0.4%
2008E	20,123	67.49	42.6%	40.4	35.4	8.4	26.4%	17.1%	0.6%
2009E	27,302	91.57	35.7%	29.7	26.1	6.2	24.4%	17.1%	0.6%
2010E	36,035	120.86	32.0%	22.5	19.8	5.0	25.2%	18.9%	0.7%
2011E	46,680	156.56	29.5%	17.4	15.3	4.0	26.3%	21.0%	0.8%

Source: Citi Investment Research estimates

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

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¹Citigroup Global Markets India Private Limited

Other Per Share Data

NAV	481.5
Discount to NAV	-466%

Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	92.3	57.6	40.4	29.7	22.5
P/BV (x)	16.3	13.5	8.4	6.2	5.0
Dividend yield (%)	0.4	0.5	0.6	0.6	0.7
Payout Ratio (%)	37.3	27.5	25.2	18.6	15.7
Per Share Data (Rs)					
EPS adjusted	29.50	47.32	67.49	91.57	120.86
EPS reported	34.59	47.95	72.89	130.20	120.86
BVPS	167.00	202.32	325.65	438.57	539.61
DPS	11.00	13.00	17.00	17.00	19.00
Profit & Loss (RsM)					
Net sales	146,976	175,716	248,547	335,538	436,200
Operating expenses	-136,231	-159,895	-222,288	-299,242	-388,425
EBIT	10,745	15,821	26,259	36,296	47,775
Net interest expense	-751	-339	-991	-1,228	-1,051
Non-operating/exceptionals	2,354	4,337	4,080	4,500	5,500
Pre-tax profit	12,348	19,819	29,348	39,568	52,225
Tax	-3,717	-5,973	-9,225	-12,266	-16,190
Extraord./Min.Int./Pref.div.	1,490	184	1,611	11,520	0
Reported net income	10,122	14,030	21,734	38,822	36,035
Adjusted earnings	8,632	13,846	20,123	27,302	36,035
Adjusted EBIT	10,745	15,821	26,259	36,296	47,775
Growth Rates (%)					
Sales	12.3	19.6	41.4	35.0	30.0
EBIT adjusted	35.6	47.2	66.0	38.2	31.6
EPS adjusted	21.3	60.4	42.6	35.7	32.0
Cash Flow (RsM)					
Operating cash flow	14,785	21,247	22,011	38,571	35,662
Depreciation/amortization	1,145	1,700	2,116	3,262	4,405
Net working capital	3,691	5,887	-2,057	-3,518	-4,784
Investing cash flow	-15,962	-19,765	-54,562	-31,714	-21,514
Capital expenditure	-6,377	-7,917	-16,387	-21,714	-12,514
Acquisitions/disposals	-9,586	-11,849	-38,176	-10,000	-9,000
Financing cash flow	-1,530	3,630	31,205	-8,814	-10,498
Borrowings	-4,055	6,242	15,053	-3,000	-4,000
Dividends paid	-3,446	-4,216	-5,814	-5,814	-6,498
Change in cash	-2,707	5,112	-1,346	-1,957	3,650
Balance Sheet (RsM)					
Total assets	130,313	171,859	262,957	336,692	412,501
Cash & cash equivalent	5,832	10,944	9,599	7,641	11,291
Accounts receivable	48,142	55,046	76,500	103,275	134,258
Net fixed assets	15,472	21,161	35,574	54,125	62,333
Total liabilities	84,425	114,552	167,764	208,491	254,763
Accounts payable	40,626	56,909	81,623	108,554	139,558
Total Debt	14,536	20,778	35,830	32,830	28,830
Shareholders' funds	45,888	57,307	95,193	128,201	157,738
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	7.3	9.0	10.6	10.8	11.0
ROE adjusted	21.8	26.8	26.4	24.4	25.2
ROA adjusted	7.2	9.2	9.3	9.1	9.6
Net debt to equity	19.0	17.2	27.6	19.6	11.1
Total debt to capital	24.1	26.6	27.3	20.4	15.5

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Positives – EBITDA up 56% YoY & 70% of OB has margin protection

- L&T's 1QFY09 Recurring PAT at Rs4.9bn up 70% YoY was 25% ahead of CIR estimates of Rs3.9bn on account of superior order backlog execution and Rs1.0bn of higher than expected other income. Reported PAT at Rs5.0bn was up 33% YoY on account of forex gains net of taxes of Rs881mn in 1QFY08 and Rs118mn in 1QFY09.
- If one ignores the other income boost to the Recurring PAT and looks at the EBITDA, the number is still robust at Rs6.6bn up 56% YoY and ahead of CIR estimates of Rs6.3bn
- Other income was boosted by Rs435mn of dividends from subsidiaries, associates and trade investments. Further, miscellaneous income and income from other investments has boosted other income.
- L&T ended 1QFY09 with an order backlog of Rs582bn, up 40% YoY led by order inflows of Rs122bn up 24% YoY. Management maintained that 70% of this order backlog has some form of margin protection (escalation clauses, cost-plus arrangements, or back-to-back supply arrangements).
- Management re-iterated its full year order inflow guidance of 30% and sales guidance of 30% and mentioned if the execution is good they could very well achieve sales growth of 30-35%.

Figure 2. L&T – 1QFY09 Results Review

(Rsmn)	1QFY08	1QFY09	YoY	1QFY09E	YoY	Remark
Gross Sales	45739	69928	52.9%	64034	40.0%	
Excise	(687)	(913)		(961)		
% of sales	1.5%	1.3%		1.5%		
Net Sales	45052	69014	53.2%	63074	40.0%	- Strong execution leads to sales growing 9% ahead of CIR estimates
Total Expenditure	(40822)	(62441)	53.0%	(56766)	39.1%	
Core EBITDA	4231	6574	55.4%	6307	49.1%	- Margins up 13bps (CIR expectations up 61bps) but more than made up
Core EBITDA Margin	9.4%	9.5%	13bps	10.0%	61bps	- by strong sales growth
Operational Income	14	35		5		
EBITDA	4244	6608	55.7%	6312	48.7%	
EBITDA Margin	9.4%	9.6%		10.0%		
D&A	(424)	(659)		(574)		
EBIT	3820	5950	55.7%	5738	50.2%	
EBIT Margin	8.5%	8.6%		9.1%		- Other income higher by Rs1.0bn further boosts PAT growth
Interest	(157)	(382)		(500)		- Dividend from subsidiary/associates/investments = Rs435mn in 1QFY09
Other Income	767	1807		800		- In 1QFY08 this numbers was only Rs25mn
PBT	4429	7374	66.5%	6038	36.3%	- Other items which have boosted other income are miscellaneous and
PBT Margin	9.8%	10.7%		9.6%		- income from other investments
Current Tax	(1956)	(2313)				
Deferred Tax	19	(110)				
FBT	(58)	(104)				
Tax Adjustment	454	59				
Total Tax	(1542)	(2467)		(2113)		
Tax Rate	34.8%	33.5%		35.0%		- Recurring PAT 25% ahead of CIR estimates
Recurring PAT	2888	4907	69.9%	3925	35.9%	- Can be largely attributed to the higher other income
Exceptional Items	881	118				
- Divestiture Gains	1335	177				- Forex gains
- Tax adjustment	(454)	(59)				
Reported PAT	3769	5020	33.2%	3925	4.1%	

Source: Company and Citi Investment Research estimates

Figure 3. L&T – 1QFY09 Segmental Results

(Rsmn)	1QFY08	1QFY09
Revenues		
E&C	34919	55417
E&E	5411	5776
Machinery and Industrial products	4227	6335
Others	2910	3760
Total	47468	71287
PBIT		
E&C	2970	5365
E&E	786	664
Machinery and Industrial products	898	1463
Others	121	249
Total PBIT	4774	7740
PBIT Margins		
E&C	8.5%	9.7%
E&E	14.5%	11.5%
Machinery and Industrial products	21.2%	23.1%
Others	4.2%	6.6%
Total	10.1%	10.9%

Source: Company and Citi Investment Research

Figure 4. L&T – 1QFY09 Order Backlog Statistics

(Rsmn)	1QFY08	1QFY09	
Order Booking			
E&C	82,180	105,160	28.0%
Total	98,810	122,340	23.8%
Closing Order Backlog			
E&C	396,900	563,360	41.9%
Total	416,340	581,950	39.8%
Sectorwise Backlog for Total OB			
Infra	149882	197863	32.0%
	36%	34%	
Hydrocarbon	91595	128029	39.8%
	22%	22%	
Power	58288	110571	89.7%
	14%	19%	
Process	45797	87293	90.6%
	11%	15%	
Others	70778	58195	-17.8%
	17%	10%	

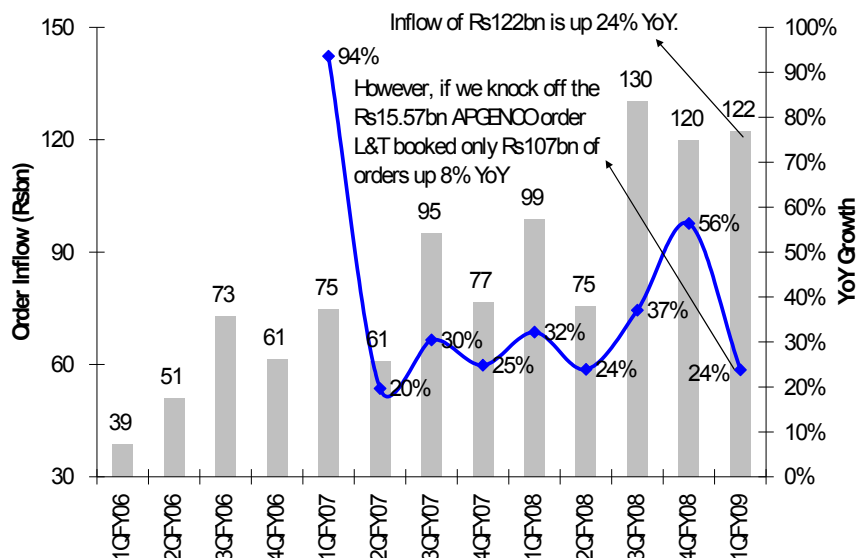
Source: Company and Citi Investment Research

The Negative – Need to monitor order inflow growth closely

- L&T booked Rs122bn of orders in 1QFY09 up 24% YoY. However, the Rs15.6bn APGENCO order will be subcontracted out to the L&T-MHI JV and as a consequence if we knock this order off, order inflows at Rs107bn is up a tepid 8% YoY. This slow pick up in orders in 1QFY09 worries us, if this is a direct result of the of the difficult macro environment led by double-digit inflation, rising energy costs, volatile commodity prices and high interest rates.
- Besides this we are also worried whether management guidance of 30% YoY inflow growth includes orders that might be won by the L&T-MHI JV?

- Lastly, the electrical and electronics division is facing a moderate slowdown in low voltage switchgears, petrol pump equipments and metering equipment on account of the difficult macro environment.

Figure 5. L&T – Quarterly Order Inflow



Source: Company and Citi Investment Research estimates

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 strategy

We rate L&T Buy/Low Risk (1L) with a target price of Rs3,170. With an earnings CAGR of 32% over FY08E-11E in the core business and the spawning of new businesses like shipbuilding and power equipment, which could reach critical mass in the next 3-4 years, L&T remains one of the fundamentally best proxies to India's infrastructure build-out, in our view. Buoyed by strong infrastructure tailwinds, L&T is in an enviable position of picking and choosing orders. L&T's order backlog of Rs527bn-plus and forecast stable margins provides 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.

Valuation

Using a comps-based P/E of 25x Dec 09E which is set a 25% premium to BHEL, we get a core business value of Rs2,838 per share 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 Rs3,170. We value L&T's subsidiaries at Rs331 with L&T Infotech at Rs111 (12x FY09E EPS, in-line with second-tier peers); L&T Finance at Rs46 (1.5x FY09E P/BV); and L&T IDPL at Rs98 (1.5x private equity valuations).

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.Rs527bn 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

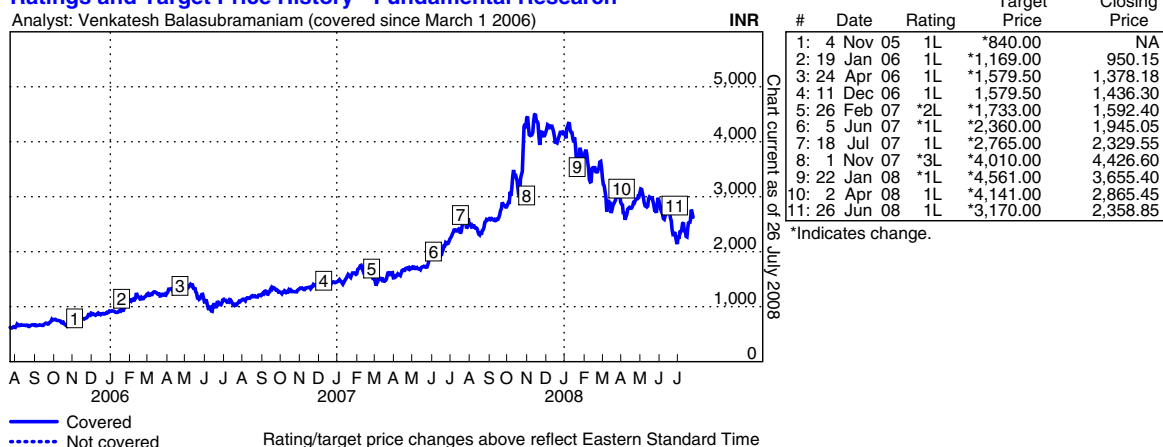
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Analyst: Venkatesh Balasubramaniam (covered since March 1 2006)



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