

LARSEN & TOUBRO

INR 1,614

Touchstone

BUY



Larsen & Toubro's (L&T's) Q3FY07 standalone results were softer in terms our revenue estimates, but ahead of profit estimates. Revenues grew 12% Y-o-Y to INR 41 bn for Q3FY07. The order intake traction continued in the quarter with 30% Y-o-Y growth, resulting in order backlog of INR 357 bn. EBIDTA margins improved by 360bps to 10.3%, while adjusted net profit rose to INR 3.4 bn in the quarter, up 46% Y-o-Y growth. With continued stellar performance from most of its subsidiaries and associates, L&T reported 21% Y-o-Y growth in consolidated revenues and 90% Y-o-Y growth in consolidated net profit (excluding extraordinary gains).

* **Plagued by soft revenue growth; EBIDTA margin expand 360bps Y-o-Y**

Standalone net revenue softly grew 12% Y-o-Y to INR 41.1 bn in Q3FY07 on account of slippages on some projects in the water and road segments. Despite modest revenue growth for the third quarter consecutively, the management maintains its guidance of 20% revenue growth for FY07E. The order backlog rose to INR 357 bn, 51% Y-o-Y growth on the back of traction in order intake. In this quarter, L&T also bagged single largest order of INR 54 bn for expansion and modernisation of Delhi International Airport.

EBITDA stood at INR 4.3 bn for Q3FY07, up 72% Y-o-Y. EBITDA margins expanded by 360bps Y-o-Y, to 10.3%, on account of profit booking for oil and gas (O&G) vertical projects nearing completion. Net margin improved to 8.4% for Q3FY07 as against 6.4% in Q3FY06. Net profit grew by 46% Y-o-Y to INR 3.4 bn, translating into EPS of INR 12.3 for Q3FY07.

* **Non-parent business continues its stellar show**

L&T's subsidiaries and associates continued to show stellar performance, thereby, boosting the group revenue and profitability. For Q3FY07, consolidated revenue was up 21% Y-o-Y to INR 52 bn and profit (excluding extraordinary gains) was up 90% Y-o-Y to INR 5 bn. The consolidated revenue and profit for 9MFY07 now stands at INR 141 bn and INR 11 bn respectively. This is in line with our expectations of consolidated revenue and profit of INR 210 bn and INR 16.6 bn, respectively, for FY07.

* **Attractive valuations for default India infrastructure story**

Post our calibration of consolidated earnings (incorporating stellar 9MFY07 performance of subsidiaries), on a consolidated EPS estimate of INR 60 and INR 81, the stock trades at P/E of 27x and 20x for FY07E and FY08E, respectively. We continue to see potential upside from current levels based on our EV value on SOTP basis of INR 499 bn. With significant near-term value unlocking opportunities arising out of L&T's subsidiary operations, we reiterate our 'BUY' recommendation on the default play on India Infrastructure.

Financials (Standalone)

Year to March	Q3FY07	Q3FY06	Change %	Q2FY07	Change %	FY07E	FY08E
Rev. (net) (INR mn)	41,184	36,910	11.6	37,361	10.2	178,311	226,725
EBITDA (INR mn)	4,255	2,469	72.3	2,382	78.7	15,550	20,659
Adj. net profit (INR mn)	3,439	2,358	45.9	2,012	70.9	12,151	16,145
Adj. EPS (INR) *	12.3	8.7	40.2	7.2	69.5	43.3	57.5
P/E (x)							0.1
EV/EBITDA (x)							21.6
ROAE (%)							26.9

* Adjusted for 1:1 bonus declared in Q2FY07

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Bloomberg : LT IN

Market Data

52-week range (INR) : 2,915 / 1,230
Share in issue (mn) : 278.0
M cap (INR bn/USD mn) : 448.7 / 10,147.1
Avg. Daily Vol. BSE/NSE ('000) : 888.2

Share Holding Pattern (%)

Promoters : 0.0
MFs, Fls & Banks : 37.9
Fls : 17.5
Others : 44.6

* Segmental snapshot

Revenues of L&T's engineering and construction (E&C) segment grew 6% Y-o-Y to INR 30 bn in Q3FY07. As a result of lower than expected growth in its E&C segment, the overall revenue growth was modest at 12%. However, we expect the revenue booking from E&C to be robust in Q4FY07. The E&C segment margins improved to 10.3% in Q3FY07 on account of profit booking for projects under O&G vertical that are nearing completion. However, such strong E&C segment margins do not seem sustainable with L&T now bagging big ticket size orders, wherein, profit booking is lower for the first 10-12 months on account of design and engineering work involved.

Revenues of electrical and electronics (EBG) segment revenue grew 30% Y-o-Y to INR 4.4 bn, led by healthy sales growth in the company's electrical standard products division. However, the segment's margins reduced to 14.7% in Q3FY07 from 15.7% in Q3FY06.

Table 1: Segmental breakup of standalone financials

Year to March	Q3FY07	Q3FY06	Q2FY07
Segment revenue mix (%)			
Electrical & Electronics (EBG)	11.2	10.3	12.1
Engineering & Construction (E&C)	73.2	81.8	71.2
Machinery and Industrial products (MIP)	9.4	N.A	11.3
Others	6.2	7.9	5.5
EBIT margin (%)			
Electrical & Electronics (EBG)	14.7	15.7	15.8
Engineering & Construction (E&C)	10.3	7.4	7.8
Machinery and Industrial products (MIP)	13.6	N.A	14.4
Others	3.1	11.6	11.0
EBIT mix (%)			
Electrical & Electronics (EBG)	15.4	18.9	19.6
Engineering & Construction (E&C)	70.7	70.6	57.4
Machinery and Industrial products (MIP)	12.1	N.A	16.8
Others	1.8	10.6	6.2

Source: Edelweiss research

Financials snapshot (Standalone)								(INR mn)
Year to March (INR mn)	Q3FY07	Q3FY06	Change %	Q2FY07	Change %	FY06	FY07E	FY08E
Revenues (gross)	41,995	37,441	12.2	38,043	10.4	149,938	181,667	230,904
Less: Excise duty	811	531	52.6	682	18.8	2,308	3,355	4,179
Revenues (net)	41,184	36,910	11.6	37,361	10.2	147,631	178,311	226,725
Raw material	30,900	29,079	6.3	27,932	10.6	115,903	136,500	172,933
Staff cost	3,028	2,287	32.4	3,956	(23.4)	8,900	12,685	16,129
Other operating expenses	3,001	3,074	(2.4)	3,092	(2.9)	12,152	13,577	17,004
Total expenditure	36,929	34,441	7.2	34,979	5.6	136,955	162,761	206,066
EBITDA	4,255	2,469	72.3	2,382	78.7	10,676	15,550	20,659
Depreciation	357	266	33.9	336	6.0	1,145	1,399	1,765
EBIT	3,899	2,203	77.0	2,045	90.6	9,531	14,151	18,894
Interest	12	225	(94.6)	106	(88.5)	750	520	567
Other income	1,279	918	39.4	1,117	14.5	4,356	4,685	6,010
Extraordinary items	-	235	-	-	-	698	-	-
PBT	5,166	3,131	65.0	3,057	69.0	13,834	18,316	24,337
Tax	1,727	538	220.9	1,045	65.3	3,713	6,165	8,192
Reported net profit	3,439	2,593	32.6	2,012	70.9	10,121	12,151	16,145
Adjusted net profit	3,439	2,358	45.9	2,012	70.9	9,423	12,151	16,145
Equity capital(FV:INR 2)	561	270	108.0	278	101.6	275	561	561
# of shares (mn)	281	135	108.0	139	101.6	137	281	281
Adjusted EPS* (INR)	12.3	8.7	40.2	7.2	69.5	34.3	43.3	57.5
Market cap. (INR mn)								1,204
as % of net revenues								
Raw material	75.0	78.8	(4.8)	74.8	0.4	78.5	76.6	76.3
Staff cost	7.4	6.2	18.7	10.6	(30.6)	6.0	9.3	9.3
Other operating expenses	7.3	8.3	(12.5)	8.3	(11.9)	8.2	7.6	7.5
EBITDA	10.3	6.7	54.4	6.4	62.1	7.2	8.7	9.1
Adjusted net profit	8.4	6.4	30.7	5.4	55.0	6.4	6.8	7.1
Tax rate	33.4	17.2	94.5	34.2	(2.2)	26.8	33.7	33.7

* Adjusted for 1:1 bonus declared in Q2FY07

Company Description

Headquartered in Mumbai, L&T is a technology-driven engineering and construction organisation, and among the largest companies in India's private sector. It has additional interests in manufacturing, services, and information technology. The company's customer-focussed approach and constant quest for top-class quality have enabled it to attain and sustain leadership in the major business lines over the last seven decades.

L&T has an international presence with offices across the globe. A thrust on international business over the last few years has seen overseas earnings growing to 18% of the total revenues. With factories and offices located around the country, further supplemented by a wide marketing and distribution network, L&T's image and equity extends to virtually every district of India.

Investment Thesis

L&T's standalone business operations have gathered significant traction over the past few years with revenue CAGR of 24% over FY04-06, which is commendable. L&T's order backlog currently stands in excess of INR 350 bn and will only swell with the company's entry into newer verticals like ship building, aviation, nuclear, and defense, which have immense potential. Going forward, as composition of backlog shifts from the low margin construction segment to high margin and high technology engineering projects, we expect a 35bps and 37bps EBIDTA margin improvement for FY08E and FY09E respectively. We expect L&T's standalone revenue and earnings to grow at a CAGR of 27% and 30% over FY07E-09E, respectively.

We expect L&T's subsidiary portfolio's consolidated earnings to grow 36% over FY07-09E, sprucing up the company's growth saga. The company's aggressive venture into lucrative international markets will lead to its geographical de-risking. A strong balance sheet, sound execution engine, array of capabilities, integrated set of operations tailored to suit the India infrastructure growth story, and multiple recurring value unlocking triggers over the medium term, lead us to repose faith in the default India infrastructure story—L&T.

Key Risks

As L&T is a play across India's growth spectrum, any slowdown in the broad economy will have an impact on L&T's operations.

As L&T scales up the technology chain, providing high-end engineering solution, hiring talented and qualified human resource remains a big challenge.

Higher raw material costs and execution delays could impact the margins/profitability.

Financial Statements (Consolidated)

Income statement					(INR Mn)
Year to March	FY05	FY06	FY07E	FY08E	FY09E
Income from operations	145,517	165,604	209,546	270,524	348,752
Direct costs	112,683	125,231	153,923	197,324	252,039
Employee costs	8,719	10,444	14,237	18,402	23,833
Other expenses	12,621	14,109	17,679	22,585	28,695
Total operating expenses	134,023	149,784	185,840	238,312	304,567
EBITDA	11,495	15,819	23,706	32,211	44,185
Depreciation and amortisation	1,957	2,416	2,737	3,373	3,955
EBIT	9,538	13,403	20,969	28,839	40,230
Interest expenses	1,021	1,303	1,269	1,480	1,522
Other income	1,987	4,582	3,997	5,057	5,509
Profit before tax	10,504	16,683	23,698	32,416	44,217
Provision for tax	2,775	4,313	7,103	9,791	13,165
Extraordinary items	(3,518)	(698)	-	-	-
PAT before min. int. & share of associate	11,246	13,067	16,594	22,625	31,052
Less: Additional tax on Dvd distributed/ proposed by subsidiary	105	-	-	-	-
Less: Minority interests	639	450	732	930	1,314
PAT after minority interests and before share of associate	10,502	12,617	15,862	21,695	29,737
Add: Share in profits of associates	(38)	715	737	865	1,001
Reported profit	10,464	13,332	16,599	22,560	30,738
Adjusted net profit	6,947	12,635	16,599	22,560	30,738
Basic shares outstanding (mn)	130	137	281	281	281
Diluted equity shares (mn)	130	137	282	282	282
Dividend per share	27.5	36.2	12.5	14.0	15.0
Dividend payout (%)	51.4	39.3	21.1	17.4	13.7

Common size metrics- as % of net revenues

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Operating expenses	92.1	90.4	88.7	88.1	87.3
Depreciation	1.3	1.5	1.3	1.2	1.1
Interest expenditure	0.7	0.8	0.6	0.5	0.4
EBITDA margins	7.9	9.6	11.3	11.9	12.7
Net profit margins (adjusted)	4.8	7.6	7.9	8.3	8.8

Growth metrics (%)

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Revenues	32.6	13.8	26.5	29.1	28.9
EBITDA	28.6	37.6	49.9	35.9	37.2
PBT	14.2	58.8	42.0	36.8	36.4
Net profit	16.0	81.9	31.4	35.9	36.3
EPS	16.0	81.9	31.4	35.9	36.3

Balance sheet					(INR Mn)
As on 31st March	FY05	FY06	FY07E	FY08E	FY09E
Equity capital	260	275	561	561	561
Reserves & surplus	32,900	49,370	67,085	84,455	106,835
Shareholders funds	33,159	49,645	67,646	85,016	107,396
Minority interest	1,048	1,066	3,335	4,683	7,183
Secured loans	18,483	19,114	40,050	52,900	58,030
Unsecured loans	16,056	15,873	8,571	10,638	7,709
Borrowings	34,538	34,987	48,622	63,539	65,739
Sources of funds	68,745	85,698	119,603	153,237	180,318
Gross block	36,484	43,271	54,247	62,872	73,674
Depreciation	16,097	15,952	17,659	21,032	24,986
Net block	20,386	27,319	36,588	41,840	48,688
Capital work in progress	1,763	2,416	0	0	0
Total Fixed Assets	22,150	29,735	36,588	41,840	48,688
Assets under construction (WIP)	0	(0)	11,798	22,723	27,168
Investments	6,801	16,757	22,103	22,103	22,103
Inventories	24,342	24,774	29,112	36,905	46,743
Sundry debtors	42,518	52,823	72,397	89,525	112,256
Cash and equivalents	9,904	8,160	8,278	16,578	16,343
Loans and advances	24,456	30,636	28,206	33,809	45,699
Total current assets	101,220	116,392	137,994	176,816	221,041
Sundry creditors and others	52,056	65,243	73,724	92,296	117,582
Provisions	8,401	10,915	14,115	16,888	20,021
Total CL & provisions	60,457	76,158	87,839	109,184	137,603
Net current assets	40,763	40,234	50,155	67,632	83,438
Net Deferred tax	(1,376)	(1,268)	(1,239)	(1,239)	(1,239)
Others	407	240	198	178	160
Uses of funds	68,745	85,698	119,603	153,237	180,318
BV per share adjusted for stock split a	118	177	241	303	383

Cash flow statement					(INR Mn)
Year to March	FY05	FY06	FY07E	FY08E	FY09E
Net profit	10,495	13,332	16,599	22,560	30,738
Add: Minority interests	639	450	732	930	1,314
Add: Depreciation	1,957	2,416	2,737	3,373	3,955
Add: E.O.adjustments	72	167	42	20	18
Add: Deferred tax	(759)	(89)	-	-	-
Gross cash flow	12,403	16,276	20,111	26,882	36,025
Less: Dividends	3,572	3,491	3,945	4,419	4,734
Less: Changes in W. C.	7,509	1,215	9,802	9,178	16,041
Operating cash flow	1,322	11,570	6,364	13,286	15,250
Less: Change in investments	563	9,956	5,346	-	-
Less: Capex	2,194	7,440	8,561	8,624	10,802
Free cash flow	(1,434)	(5,825)	(7,543)	4,661	4,448

Ratios

Year to March	FY05	FY06	FY07E	FY08E	FY09E
ROAE (%) (on adjusted profits)	23.3	30.5	28.3	29.6	32.0
ROACE (%)	15.5	17.4	20.4	21.1	24.1
Current Ratio	1.7	1.5	1.6	1.6	1.6
Debtors (Days)	107	116	126	121	117
Fixed assets t/o (x)	6.6	5.6	5.7	6.5	7.2
Average working capital turnover (x)	3.6	4.1	4.2	4.0	4.2
Average capital employed turnover (x)	2.4	2.1	2.0	2.0	2.1
Net debt/equity	0.5	0.2	0.3	0.3	0.3
Gross debt/equity	1.0	0.7	0.7	0.7	0.6

Valuations parameters

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Basic EPS (INR)	24.8	45.0	59.2	80.4	109.6
<i>Y-o-Y growth (%)</i>	<i>16.0</i>	<i>81.9</i>	<i>31.4</i>	<i>35.9</i>	<i>36.3</i>
Diluted EPS (INR)	24.6	44.8	58.8	79.9	108.9
CEPS (INR)	31.7	53.6	68.9	92.4	123.7
PE (x)	65.2	35.8	27.3	20.1	14.7
Price/BV(x)	13.7	9.1	6.7	5.3	4.2
EV/Sales (x)	3.2	2.8	2.2	1.7	1.4
EV/EBITDA (x)	41.0	29.8	19.9	14.6	10.7

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RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period

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