

Equities

6 January 2012 | 18 pages

Larsen & Toubro (LART.BO)

Maintain Buy: Down, But Not Out

- Company Update
- Target Price Change
- Estimate Change

- **Maintain Buy; Cutting our target price to Rs1,328** — L&T remains our top industrial pick as its diversity/ strong BS allows it to withstand an extended slowdown and the shares should move up if the rate cut cycle starts as an interest rate cyclical. However, we cut target price to Rs1328 (Rs1511) to factor in: (1) 0 to -8% cut in EPS FY12E-14E (2) Cut in target P/E for parent 14x (15x) (3) Cut in L&T Infotech target P/E 10x (12x).
- **Revising inflows down** — The macroeconomic and political developments over the past 2-3 months not only forces us to cut FY12E inflows to -6% (from +5%) but also cuts FY13E inflows to +5% (from +15%). In an interview with *CNBC-TV18*, the L&T CMD mentioned that for FY13E there is a 25-30% probability that inflow growth would be flat YoY, 5-10% probability that it could be -ve and a 50-60% probability that L&T will recover with orders from outside India.
- **Our sales estimates remain conservative** — Management believes 25% YoY sales growth is achievable in FY12E. We believe it could be lower at 20% YoY on delays in Hyderabad Metro. L&T was expected to get Rs15.6bn towards construction bills from this projects but delay could imply this may not get booked in 4Q12E which could bring down 25% growth to 20% growth. The backlog has 9-10% of slow-moving orders (v/s 6-7% a year back and 8% during the financial crisis).
- **Margins will contract, but don't get too pessimistic** — The wider end of the margin contraction band (125bps) reflects the worst case and will likely fall only 75-100bps. The ~ 13.5% E&C margins that L&T achieved in FY10/FY11 were the historic peak. Ideally one should be working with E&C margins of 12-12.5% in coming years. Management expects to remain disciplined and not cut prices to chase growth incrementally as it prefers slower growth and less utilized capacity in FY13E/ FY14E than to make a loss on projects due to aggressive pricing today. The company is also making efforts to do cost cutting to a point where the impact of competitive pressures would be minimal.

Buy	1
Price (06 Jan 12)	Rs1,066.10
Target price	Rs1,328.00
	from Rs1,511.00
Expected share price return	24.6%
Expected dividend yield	1.5%
Expected total return	26.1%
Market Cap	Rs652,288M
	US\$12,338M

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



Figure 1. Statistical Abstract

Year End	Parent PAT	Parent EPS	Grwth	Parent P/E	Adj P/E	Parent RoE	Cons PAT	Cons EPS	Grwth	Cons Yield
31-Mar	Rsmn	Rs	%	x	x	%	Rsmn	Rs	%	x %
FY09	27,092	46.3	34.4%	23.0	15.8	24.7%	30,059	51.3	31.4%	20.8 1.0%
FY10	31,076	51.6	11.6%	20.7	14.2	20.2%	37,946	63.0	22.8%	16.9 1.2%
FY11	36,763	60.4	17.0%	17.7	12.1	18.3%	42,380	69.6	10.5%	15.3 1.4%
FY12E	40,617	66.5	10.1%	16.0	11.0	17.4%	46,945	76.8	10.4%	13.9 1.5%
FY13E	43,386	71.0	6.8%	15.0	10.3	16.5%	51,629	84.5	10.0%	12.6 1.6%
FY14E	49,143	80.4	13.3%	13.3	9.1	16.5%	59,228	96.9	14.7%	11.0 1.7%

Source: Company and Citi Investment Research and Analysis estimates

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Other Per Share Data

NAV	240.75
Discount to NAV	-343%

Fiscal year end 31-Mar	2010	2011	2012E	2013E	2014E
Valuation Ratios					
P/E adjusted (x)	20.7	17.7	16.0	15.0	13.3
P/BV (x)	3.5	3.0	2.6	2.3	2.1
Dividend yield (%)	1.2	1.4	1.5	1.6	1.7
Payout Ratio (%)	24.2	24.0	24.1	23.9	22.4
Per Share Data (Rs)					
EPS adjusted	51.61	60.38	66.46	70.99	80.41
EPS reported	72.66	65.01	66.46	70.99	80.41
BVPS	303.69	358.45	404.97	456.21	515.71
DPS	12.50	14.50	16.00	17.00	18.00
Profit & Loss (RsM)					
Net sales	370,344	440,134	526,855	595,346	666,788
Operating expenses	-327,222	-390,211	-472,434	-535,350	-599,933
EBIT	43,122	49,923	54,421	59,996	66,855
Net interest expense	-5,100	-6,474	-6,880	-8,500	-8,500
Non-operating/exceptionals	9,177	12,260	13,257	13,448	15,206
Pre-tax profit	47,199	55,708	60,799	64,944	73,561
Tax	-16,123	-18,945	-20,182	-21,558	-24,418
Extraord./Min.Int./Pref.div.	12,679	2,816	0	0	0
Reported net income	43,755	39,579	40,617	43,386	49,143
Adjusted earnings	31,076	36,763	40,617	43,386	49,143
Adjusted EBIT	43,122	49,923	54,421	59,996	66,855
Growth Rates (%)					
Sales	9.2	18.8	19.7	13.0	12.0
EBIT adjusted	21.4	15.8	9.0	10.2	11.4
EPS adjusted	11.6	17.0	10.1	6.8	13.3
Cash Flow (RsM)					
Operating cash flow	59,625	30,325	6,875	51,070	57,266
Depreciation/amortization	4,146	5,992	7,221	8,469	9,826
Net working capital	11,434	-17,107	-39,879	-985	-1,903
Investing cash flow	-70,287	-26,722	-11,360	-30,200	-30,200
Capital expenditure	-15,871	-16,928	-15,200	-15,200	-15,200
Acquisitions/disposals	-54,416	-9,795	3,840	-15,000	-15,000
Financing cash flow	17,228	-618	17,031	-12,073	-12,783
Borrowings	2,448	3,603	28,389	0	0
Dividends paid	-8,630	-9,957	-11,363	-12,073	-12,783
Change in cash	6,566	2,985	12,546	8,797	14,283
Balance Sheet (RsM)					
Total assets	464,094	570,720	651,839	721,111	796,848
Cash & cash equivalent	14,319	17,304	29,849	38,647	52,930
Accounts receivable	111,637	124,276	148,763	168,102	188,274
Net fixed assets	61,998	72,149	80,162	86,927	92,336
Total liabilities	281,211	352,478	404,339	442,297	481,674
Accounts payable	0	0	0	0	0
Total Debt	68,008	71,611	100,000	100,000	100,000
Shareholders' funds	182,884	218,241	247,500	278,814	315,175
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	11.6	11.3	10.3	10.1	10.0
ROE adjusted	20.2	18.3	17.4	16.5	16.5
ROA adjusted	7.5	7.1	6.6	6.3	6.5
Net debt to equity	29.4	24.9	28.3	22.0	14.9
Total debt to capital	27.1	24.7	28.8	26.4	24.1

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Maintain Buy - Target price cut to Rs1,328

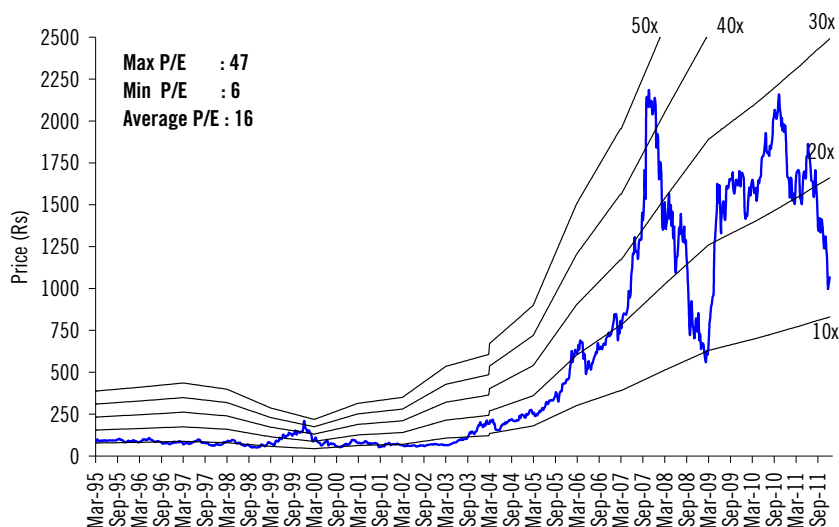
- We revise down our target price to Rs1,328 (from Rs1,511 earlier) to factor in:
- 0 to -8% change in parent/ consolidated EPS estimates for FY12E-14E
- Cut in target P/E multiple for parent business to 14x (from 15x earlier) to factor in slower EPS growth and RoE over next 3 years
- Cut in L&T Infotech target P/E multiple to 10x (from 12x earlier)

Figure 2. L&T – Sum Of The Parts

Part	Old Methodology	Methodology	Old	New
Parent	P/E Multiple 15x Mar13E EPS	P/E Multiple 14x Mar13E EPS	1114	994
Value of Subsidiaries			389	334
- L&T Infotech (100% Stake)	2nd tier IT 12x Mar13E EPS	2nd tier IT 10x Mar13E EPS	87	79
- L&T IDPL (100% Stake)	PE Stake Buy Back Valuations	PE Stake Buy Back Valuations	86	87
- L&T Finance Holdings (82.64% Stake)	At CIRA TP = Rs55	10% discount to CMP = Rs43	127	102
- Other Subsidiaries/Associates	P/BV of 1.0x FY11	P/BV of 1.0x FY11	57	57
- Satyam	At CMP	At CMP	3	3
- L&T MHI	P/E of 12x FY13E	P/BV of 1.0x FY11	38	6
Value/Share			1,576	1,328

Source: Citi Investment Research and Analysis estimates

Figure 3. L&T – 1 Year Forward Rolling Consolidated P/E Bands



Source: DataCentral and Citi Investment Research and Analysis estimates

Figure 4. L&T – EPS Revision Table

End Mar31 (Rsmn)	FY12E	FY13E	FY14E
Inflows			
New	750	788	866
Old	838	963	1,084
Change	-10.5%	-18.2%	-20.1%
Order Backlog			
New	1,519	1,705	1,897
Old	1,573	1,890	2,241
Change	-3.4%	-9.8%	-15.4%
Net Sales			
New	526,855	595,346	666,788
Old	526,855	611,244	702,931
Change	0.0%	-2.6%	-5.1%
EBITDA margins			
New	11.7%	11.5%	11.5%
Old	11.7%	11.5%	11.5%
bps	0	0	0
Recurring PAT			
New	40,617	43,386	49,143
Old	40,617	45,770	53,622
Change	0.0%	-5.2%	-8.4%
Parent EPS			
New	66.46	70.99	80.41
Old	65.93	74.29	87.04
Change	0.8%	-4.4%	-7.6%
Consolidated EPS			
New	76.81	84.48	96.91
Old	76.82	88.78	105.19
Change	0.0%	-4.8%	-7.9%

Source: CIRA estimates

Earnings revised downwards

We revise down parent/ consolidated EPS estimates by 0 to -8% over FY12E-14E to factor in the following:

- 11-20% reduction in inflows, which lead us to cut backlog by 3-15%
- 3-5% cut in sales estimates
- Tighter working capital environment leading to lower other income
- Given L&T's US\$200mn of FCCBs are out of money we no longer dilute for the same and treat the same as debt.
- Adjustments to our estimates for L&T Infotech and L&T Finance Holdings.

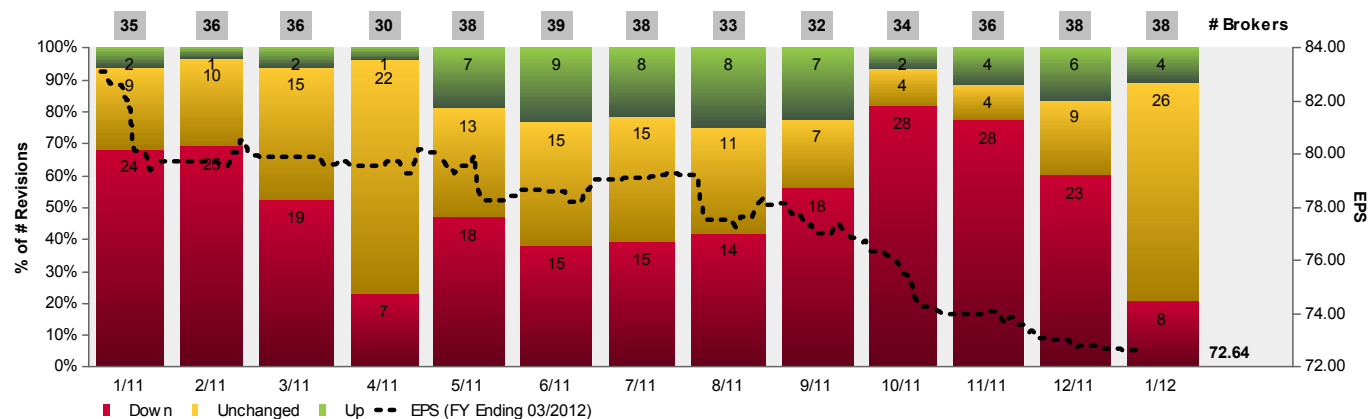
Figure 5. L&T – Parent and Consolidated EPS – CIRA v/s Consensus

Year End Mar31 (Rsmn)	FY12E	FY13E	FY14E
Parent EPS			
CIRA	66.46	70.99	80.41
Bloomberg Consensus	68.60	77.40	88.90
Difference	-3.1%	-8.3%	-9.5%
Consolidated EPS			
CIRA	76.81	84.48	96.91
Bloomberg Consensus	78.70	89.70	104.90
Difference	-2.4%	-5.8%	-7.6%
Consolidated EPS			
CIRA	76.81	84.48	96.91
Factset Consensus	72.64	82.36	95.96
Difference	5.7%	2.6%	1.0%

Source: Bloomberg, Factset and Citi Investment Research and Analysis estimates

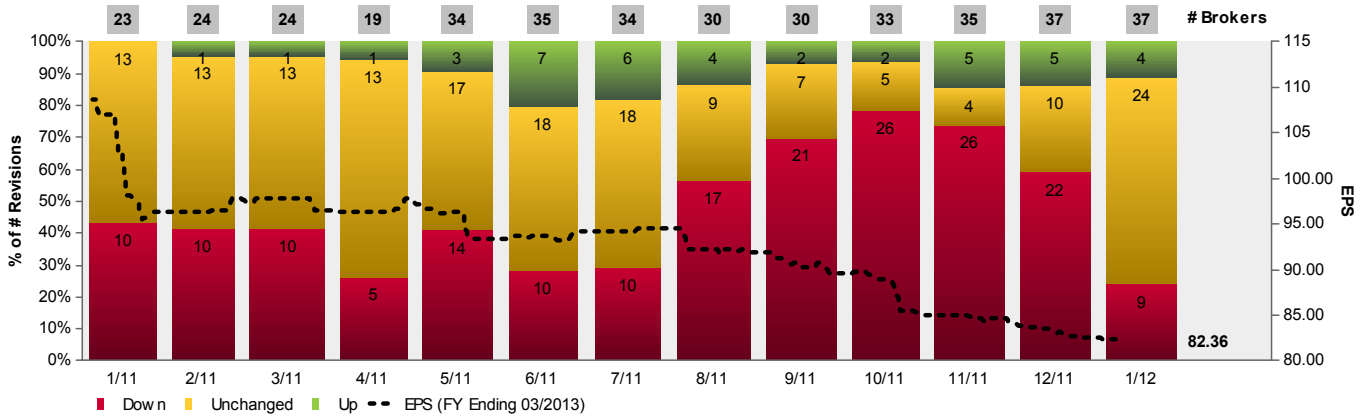
Development of consolidated consensus estimates

Figure 6. Development Of FY12E Consensus Expectations



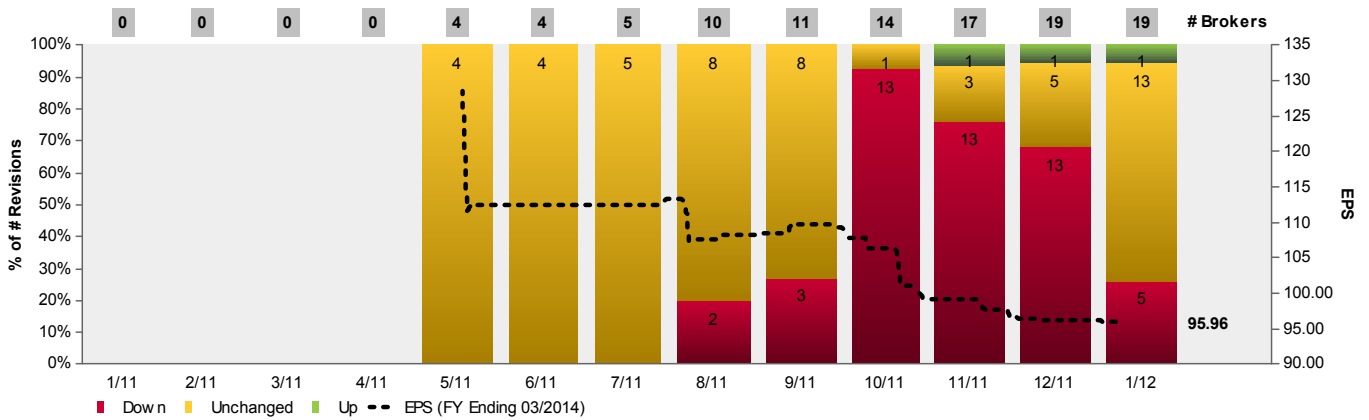
Source: Factset and Citi Investment Research and Analysis

Figure 7. Development Of FY13E Consensus Expectations



Source: Factset and Citi Investment Research and Analysis

Figure 8. Development Of FY14E Consensus Expectations



Source: Factset and Citi Investment Research and Analysis

Figure 9. Global Engineering & Construction Comparables

Company	Price	RIC /Rating	MCap (\$bn)	P/E		EPS		P/BV		ROE				EV/E		
				FY12	FY13	FY14	FY11-FY14	FY12	FY13	FY14	FY12	FY13	FY14	FY12	FY13	FY14
Asia E&C																
Hyundai	17750 KW	012630.KS/2 H	1.2	5.8	6.9	7.5	27%	0.5	0.5	0.5	9%	7%	6%	5.1	4.8	4.3
Doosan Heavy	65200 KW	034020.KS/1	6.0	14.9	9.7	7.9	na	1.5	1.3	1.2	11%	14%	15%	na	na	na
Daewoo E&C	10850 KW	047040.KS/2 H	3.9	21.4	14.4	12.1	na	1.2	1.1	1.0	11%	8%	9%	5.3	6.6	5.6
Halla E&C	13100 KW	014790.KS/NR	0.2	4.1	2.7	2.7	na	0.4	0.3	0.3	5%	11%	12%	na	na	na
Daelim	94000 RW	000210.KS/1 H	2.8	9.1	7.7	6.9	14%	0.8	0.7	0.7	11%	10%	10%	3.4	3.4	2.9
GS E&C	96500 KW	006360.KS/1	4.3	13.0	9.8	8.1	15%	1.2	1.1	1.0	12%	12%	13%	6.4	6.0	4.8
Hyundai E&C	72700 KW	000720.KS/1	7.0	12.7	11.7	10.2	15%	2.0	1.7	1.5	18%	16%	16%	7.3	6.5	5.4
Samsung C&T	68900 KW	000830.KS/1	9.4	27.4	22.4	19.2	7%	1.2	1.2	1.1	6%	6%	6%	5.1	4.8	3.8
Samsung Engineering	212000 KW	028050.KS/1	7.4	17.1	13.2	11.5	28%	6.1	4.5	3.5	42%	39%	34%	10.8	8.3	6.8
Gamuda Bhd	3.45 MYR	GAMU.KL/1	2.3	15.4	13.1	11.8	27%	1.8	1.7	1.5	13%	14%	15%	10.8	10.0	9.4
China Communications	6.3 CNY	1800.HK/2 H	12.0	7.4	6.5	6.2	8%	1.1	1.0	0.9	18%	16%	15%	4.6	4.6	4.2
China Railway Construction	4.31 CNY	1186.HK/3	1.2	6.0	6.6	7.5	11%	0.7	0.6	0.6	12%	10%	8%	1.2	2.3	2.8
China Railway Group Ltd	2.4 CNY	0390.HK/3	1.3	7.4	8.5	8.4	na	0.6	0.6	0.5	7%	7%	6%	2.8	3.7	4.1
Asia Average				13.1	10.9	9.8	17%	1.6	1.3	1.2	14%	13%	13%	5.7	5.6	4.9
US E&C																
Fluor Corp	52.09 USD	FLR.N/1 H	8.8	15.9	13.9	12.4	28%	2.6	2.2	1.9	17%	17%	17%	5.7	5.4	4.6
Jacobs	41.52 USD	JEC.N/NR	5.3	16.0	13.7	12.2	20%	1.6	1.4	1.4	11%	11%	12%	na	na	na
Shaw Group Inc	27.48 USD	SHAW.N/2 H	1.8	12.9	10.9	9.4	32%	3.1	2.5	2.1	17%	20%	19%	10.0	6.3	3.1
URS Corp	36.42 USD	URS.N/NR	2.9	10.1	9.5	8.7	5%	0.7	0.7	0.6	0%	10%	10%	na	na	na
Chicago Bridge and Iron	38.77 USD	CBI.N/1 H	3.8	15.2	13.3	11.5	18%	3.2	2.6	2.1	23%	22%	21%	7.7	6.2	5.0
Foster Wheeler AG	19.47 USD	FWLT.O/2 H	2.3	14.1	11.9	10.3	4%	2.7	2.2	1.8	18%	19%	18%	4.7	4.7	4.0
McDermott	11.82 USD	MDR.N/1 H	2.8	14.9	14.0	10.4	4%	1.6	1.4	1.3	12%	11%	13%	5.9	4.6	1.7
US Average				14.1	12.5	10.7	16%	2.2	1.9	1.6	14%	16%	16%	6.8	5.4	3.7
Australia E&C																
Boart Longyear Ltd	2.97 USD	BLY.AX/1	1.4	9.0	7.1	6.0	41%	1.2	1.1	1.0	14%	16%	17%	4.9	4.2	3.7
Downer EDI Ltd	3.29 AUD	DOW.AX/1	1.5	7.6	6.7	5.9	na	0.9	0.8	0.7	12%	12%	13%	3.5	3.4	3.0
Leighton Holdings Ltd	19.8 AUD	LEI.AX/2	6.9	11.0	9.7	8.7	1%	2.5	2.3	2.1	31%	24%	25%	3.4	3.0	2.8
UGL Ltd	12.32 AUD	UGL.AX/1	2.1	11.9	10.1	8.8	10%	1.7	1.6	1.5	14%	15%	16%	7.7	6.7	5.8
Worley Parsons Ltd	26.25 AUD	WOR.AX/2	6.6	17.0	14.3	12.4	16%	3.2	2.9	2.6	20%	21%	22%	10.6	9.0	8.0
Australia Average				11.3	9.6	8.4	17%	1.9	1.7	1.6	18%	18%	19%	6.0	5.3	4.7
India E&C																
L&T Adjusted Parent	1068.9 INR	LART.BO/1	12.4	11.2	10.5	9.3	10%				17%	16%	17%	8.5	7.6	6.6
L&T Consolidated	1068.9 INR	LART.BO/1	12.4	13.9	12.7	11.0	12%				18%	17%	17%			
Punj Lloyd Consolidated	42.15 INR	PUJL.BO/3 H	0.3	8.1	7.0	5.2	na				6%	6%	8%	7.2	6.8	6.4
NCC Adjusted Parent	35.8 INR	NCCL.BO/3	0.2	4.3	2.9	2.5	7%				5%	7%	8%	5.5	5.7	5.3
IVRCL Adjusted Parent	31.75 INR	IVRC.BO/1	0.2	3.6	2.8	2.5	4%				6%	7%	8%	5.2	4.6	4.4
India Average				8.2	7.2	6.1	8%				9%	9%	10%	6.6	6.2	5.7

Source: DataCentral and Citi Investment Research and Analysis estimates

Revising down FY12E inflow expectations to -6% YoY from +5% YoY

In an interview with *CNBC-TV18* L&T CMD mentioned that for FY13E there is a 25-30% probability that inflow growth would be flat YoY, 5-10% probability that it could be -ve and a 50-60% probability that L&T will recover with orders from outside India.

- Post 2QFY12 results, L&T management cut FY12E inflow guidance to +5%, implying inflows of Rs838bn. This inflow guidance cut was in line with our expectations then. We at that time were of the view that whether L&T does +5% or -5% is largely a function of (1) the macro-environment remaining at those levels or deteriorating further in the next six months and (2) the competitive intensity in various subsectors.
- The macroeconomic and political developments over the past 2-3 months not only forces us to cut our expectations for FY12E inflows to -6% (from +5%) but also cut our expectations for FY13E to +5% (from +15%).

Figure 10. L&T – Order Inflows Bottoms Up Collation

Year End Mar31 (Rsmn)	FY10	1QFY11	2QFY11	3QFY11	4QFY11	FY11	1QFY12	2QFY12	3QFY12 So Far	FY12E So Far
GCC Power T&D	35,540	8,110	-	9,870	-	17,980	25,760	13,730	3,850	43,340
GCC Roads		2,040	-	7,160	-	9,200	-	-	8,750	8,750
India T&D	16,800	-	-	7,780	-	7,780	1,103	4,630	10,970	16,703
Building and Factories	85,950	14,400	26,100	22,110	9,810	72,420	33,040	31,520	31,260	95,820
- Real Estate	48,600	12,940	8,040	9,430	9,810	40,220	28,930	31,520	16,960	77,410
- Others	37,350	1,460	18,060	12,680	-	32,200	4,110	-	14,300	18,410
Power BOP	40,090	13,630	16,100	22,660	-	52,390	2,400	-	-	2,400
Power EPC	122,210	52,000	58,650	-	11,250	121,900	14,000	-	-	14,000
Upstream Oil and Gas	74,650	3,760	11,950	-	14,500	30,210	-	-	-	-
Downstream Oil & Gas	40,860	-	-	-	-	-	-	-	-	-
Railways and Metro	10,480	-	-	11,260	59,000	70,260	12,000	-	7,590	19,590
Water	21,020	10,890	5,400	6,414	-	22,704	-	-	18,160	18,160
Metals and Mining	24,910	3,400	19,093	7760	71,790	102,043	13,700	6,870	-	20,570
Nuclear	12,490	-	-	-	-	-	-	-	-	-
Shipbuilding	18,170	-	-	-	-	-	-	-	-	-
Fertilizers	31,420	-	-	-	-	-	-	-	-	-
Airports		-	-	22,000	-	22,000	7,960	-	2,000	9,960
GCC Airports		-	-	-	-	-	-	-	-	-
International Hydrocarbons		-	-	-	5,630	5,630	13,340	35,010	-	48,350
Roads		-	19,390	-	6,750	26,140	22,190	-	34,840	57,030
Defence		-	-	-	-	-	-	-	-	-
Solar		-	-	2,580	-	2,580	-	4,000	-	4,000
Not Announced	161,200	48,030	47,957	14,066	124,400	234,453	16,407	65,200	-	81,607
Total	695,790	156,260	204,640	133,660	303,130	797,690	161,900	160,960	117,420	440,280

Source: Company and Citi Investment Research and Analysis estimates

Figure 11. L&T – Order Inflows Top Down Collation

Mar31 (Rsmn)	1QFY10	2QFY10	3QFY10	4QFY10	FY10	1QFY11	2QFY11	3QFY11	4QFY11	FY11	1QFY12	2QFY12
Sectoral Inflow	95,710	183,650	178,000	238,360	695,720	156,260	204,640	133,660	303,130	797,690	161,900	160,960
Infra	36,370	36,264	46,280	68,931	187,844	39,065	61,987	67,098	134,972	303,122	79,331	49,813
	38%	20%	26%	29%	27%	25%	30%	50%	45%	38%	49%	31%
Hydrocarbon	11,485	61,148	5,118	61,393	139,144	10,938	17,934	802	26,165	55,838	17,809	40,306
	12%	33%	3%	26%	20%	7%	9%	1%	9%	7%	11%	25%
Power	28,713	60,682	98,122	42,070	229,588	81,255	88,368	43,038	42,600	255,261	35,618	41,868
	30%	33%	55%	18%	33%	52%	43%	32%	14%	32%	22%	26%
Process	8,614	13,735	23,387	44,708	90,444	12,501	19,980	7,084	88,066	127,630	16,190	16,096
	9%	7%	13%	19%	13%	8%	10%	5%	29%	16%	10%	10%
Others	10,528	11,821	5,093	21,259	48,700	12,501	16,371	15,638	11,328	55,838	12,952	12,877
	11%	6%	3%	9%	7%	8%	8%	12%	4%	7%	8%	8%
Geographical Inflow	95,710	183,650	178,000	238,360	695,720	154,339	206,561	133,660	303,130	797,690	161,900	160,960
Domestic	89,967	164,250	175,701	231,016	660,934	152,573	186,673	95,967	282,708	717,921	135,996	106,149
	94%	89%	99%	97%	95%	99%	90%	72%	93%	90%	84%	66%
Middle East	2,871	16,684	3,313	4,961	27,829	6,856	11,189	36,357	9,414	63,815	11,333	50,010
	3%	9%	2%	2%	4%	4%	5%	27%	3%	8%	7%	31%
Others	2,871	2,716	(1,014)	2,384	6,957	1,543	2,066	1,337	11,008	15,954	14,571	4,801
	3%	1%	-1%	1%	1%	1%	1%	1%	4%	2%	9%	3%
Customer Wise Inflow	95,710	183,650	178,000	238,360	695,720	156,260	204,640	133,660	303,130	797,690	161,900	160,960
Private	56,469	86,005	122,795	145,206	410,475	70,317	102,915	74,048	167,519	414,799	100,378	83,652
	59%	47%	69%	61%	59%	45%	50%	55%	55%	52%	62%	52%
Public (Including PSUs)	26,799	96,120	55,452	86,003	264,374	32,815	53,801	61,752	59,031	207,399	32,380	77,392
	28%	52%	31%	36%	38%	21%	26%	46%	19%	26%	20%	48%
Internal	12,442	1,526	(247)	7,151	20,872	53,128	47,924	(2,140)	76,580	175,492	29,142	(85)
	13%	1%	0%	3%	3%	34%	23%	-2%	25%	22%	18%	0%

Source: Company and Citi Investment Research and Analysis

Looking outside India as orders in India prove elusive

- L&T is scouting for newer territories outside India to maintain regular inflows namely Middle East and Far East (South Korea, Japan, Malaysia, Indonesia).
- L&T is predominantly looking at hydrocarbons, power and infrastructure and has opened offices in Saudi Arabia, Brazil and in a few South-East Asian countries to cater to the growing infrastructure and hydrocarbon demand in these regions.
- We believe 20% of FY12E inflows could come from outside India with the orders skewed toward hydrocarbons (35-40%) followed by T&D (~30%) and infrastructure (~20%).
- Our discussions with the management suggest that at the time of bidding margins are the same on both international and domestic orders. However, executing the project to meet this margin is much more challenging overseas (as there is limited scope to renegotiate terms during the project outside India than in India). Hence realized margins could be slightly lower given the higher execution risk (perhaps around ~ 50bp lower).

Update on slow moving orders

- The backlog has 9-10% of slow-moving orders (v/s 6-7% an year back and 8% during financial crisis). This is driven by 2 projects: (1) JPVL's Karchana BTG order which is on hold whilst a shift to new location for the plant is completed (the shift should happen by year end); and (2) Steel plant order in Orissa (client not disclosed) where mining rights is still getting settled / secured.

Maintaining our FY12E sales growth expectations below guidance

- Management believes that it can achieve 25% YoY sales growth in FY12E. Based on execution in 1HFY12, we believe sales growth of 22% is possible. However, given the backlog has 9-10% slow-moving orders (v/s 6-7% a year back and 8% during the financial crisis) we chose to continue with our 20% YoY sales growth estimate.
- We believe the lower than guidance sales growth could be due to Hyderabad Metro. Rs24bn was planned to be spent by March 2012, (~15% of project cost). Of this, L&T was expected to get Rs15.6bn towards construction bills. The project's delay means L&T may not be able to book those revenues in 4QFY12E. This could bring down L&T's 25% expected sales growth in FY12E (Rs555bn) to 21% (Rs539bn). We have factored in only 20% growth (Rs532bn)

Update on EBITDA margins

L&T is making efforts to do cost cutting to a point where the impact of competitive pressures would be minimal

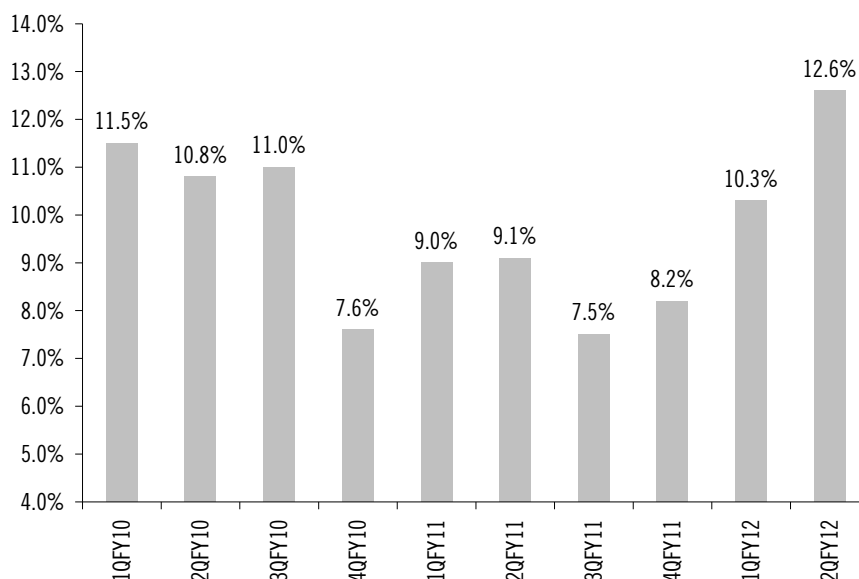
- L&T management had cut E&C margin contraction guidance to 75-125bps from 50-75bps post 2QFY12 results. According to the management, the backlog is comprised of fixed price (1/3rd) and variable price (2/3rd) orders. Typically, the company takes on fixed price contracts with ~3-5% buffer for contingencies arising due to cost escalations.
- The downward revision in E&C margin contraction guidance was due to unforeseen rise in commodity prices, beyond this available buffer. The company also mentioned that due to the longer gestation cycle and complexity of certain orders forecasting margins accurately is also a difficult task.
- We believe the wider end of this band reflects the worst case risk assuming inflation remains high. But most likely the fall in margins would be in the 75-100bp band. It is good that the management sensitized the market on the potential worst case.
- Unlike FY11 when L&T's margin did not come off despite guiding down, this time (FY12E) it is much tougher to recoup margins.
- The ~ 13.5% E&C margins that L&T achieved in FY10 and FY11 was the historic peak margins and may not be sustainable. Ideally one should be working with E&C margins of 12-12.5% in the coming years. However, assuming this would go to single digit margins would be too pessimistic.
- Management expects to remain disciplined and not cut prices to chase growth incrementally. L&T prefers slower growth now and less utilized capacity in FY13E and FY14E than to make a loss on projects due to aggressive pricing today.

Update on the cash flow and debt situation

- Working capital has moved up to 12% and could move up 15% by FY12E end. In the past L&T working capital has gone up to ~ 15-20% when inflows really slowed down. Lower customer advances follow on from the slower inflows and is the key reason for increased working capital.
- L&T in some cases is paying its vendors faster now given tighter financing for the vendors. The company supports them in this way as getting delivery on time from vendors remains very important. The company is talking to clients about increasing payment frequency milestones for projects underway but getting pushback on this as one would expect.

- The working capital increase is not driven by an increase in debtors (which remain stable at 105 days) and quality of receivables remains good. SEBs and distribution companies are about 2% of receivables.

Figure 12. L&T Segmental Working Capital As % Of Sales



Source: Company and Citi Investment Research and Analysis

- L&T would draw down debt facilities to fund working capital. The D/E stands at 35% end 2QFY12 (v/s 32% in Mar11) and could move up to 40% by FY12E end.

Update on capital deployment

- On the capex front L&T has invested higher during market weakness at lower costs than would have been otherwise. So whilst excess capacity will persist as long as inflows remain slower, when an upturn comes the company will be in a position to benefit without significant capex to meet demand.
- L&T Infotech is self funding and L&T Finance should incrementally access the stock markets to fund additional equity requirements
- On the infrastructure and power development the L&T has projects totaling Rs728bn which has equity commitments of Rs151bn. The company has already invested Rs54bn of equity and needs to arrange Rs97bn over the next 4-5 years. The company may look to monetize either L&T IDPL or some of the some of the individual projects to arrange at least some portion of above funding.
- There is a possibility that management may start capping further investments in development projects beyond announced equity commitments given it is capital intensive and offers back ended returns. Areas where additional investments can be considered are roads and rail sector if at all.

Update on new initiatives

- For the defence and naval business L&T has US\$500m in a yard in advance of the Government allowing private participation on naval fleet construction.

- On the nuclear business the company has invested US\$75mn of equity in a JV with NPCIL (L&T: 74% and NPCIL - 26%) but given the Japanese quake new projects are on hold.
- The management sees large long term opportunities and has made upfront investments in the same. However delays in naval and nuclear will lead to idle capacity which can be a drag in the medium term.

Larsen & Toubro

Company description

L&T is a diversified conglomerate with market leadership in engineering and construction (E&C) and electrical-equipment businesses in India. L&T Information Technology is its 100% subsidiary in software services. L&T demerged its cement business into a separate company, selling it to Grasim.

Investment strategy

We rate L&T a Buy given: (1) the current stock price already factors in the new inflow guidance being missed; (2) stock has underperformed BSE Sensex; (3) though more rate hikes cannot be ruled out, the rate hike cycle could be on its last legs; and (4) the stock does not look expensive (5) stock is geared to move up in case the rate cut cycle starts given it is an interest rate cyclical.

Valuation

Our Rs1,328 target price is based on sum-of-the-parts (SOTP). We use 14x Mar13E earnings for the parent (Rs994), well supported by EPS growth of 10% and average RoEs of 17%. We also believe that the parent's numbers do not capture the value inherent in subsidiaries, which we value at Rs334, with L&T Infotech at Rs79 (10x Mar13E EPS, in line with second-tier peers), L&T IDPL at Rs86 and L&T Finance Holdings at Rs102.

Risks

Downside risks 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 with technology trends to sustain valuations and earnings. These risks could impede the stock from reaching our target price.

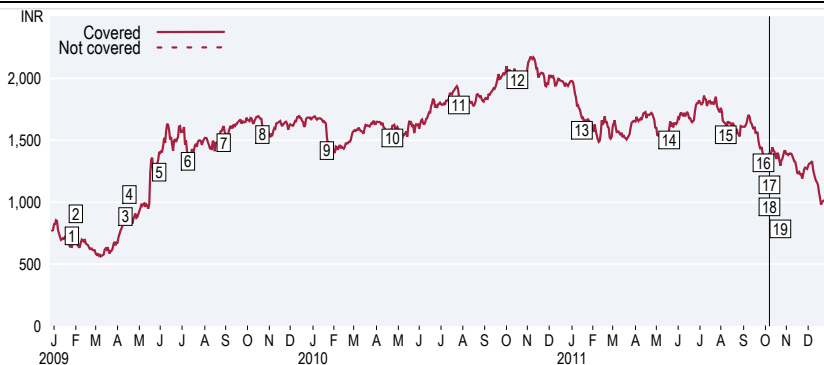
Appendix A-1 Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Larsen & Toubro (LART.BO) Ratings and Target Price History Fundamental Research

Analyst: Venkatesh Balasubramaniam



Date	Rating	Target Price	Closing Price
1 27-Jan-09	2L	*697.00	638.20
2 1-Feb-09	*3L	*622.00	689.20
3 13-Apr-09	3L	*810.00	824.00
4 17-Apr-09	*1L	*955.00	866.50
5 29-May-09	*2L	*1,437.00	1,405.60
6 9-Jul-09	2L	*1,466.00	1,389.40
7 28-Aug-09	2L	*1,784.00	1,614.60

Date	Rating	Target Price	Closing Price
8 22-Oct-09	*1L	*1,828.00	1,608.50
9 21-Jan-10	1L	*1,748.00	1,524.35
10 23-Apr-10	1L	*1,875.00	1,617.85
11 27-Jul-10	1L	*2,110.00	1,863.25
12 18-Oct-10	1L	*2,210.00	2,013.15
13 17-Jan-11	*2L	*1,824.00	1,681.15
14 19-May-11	2L	*1,745.00	1,594.90

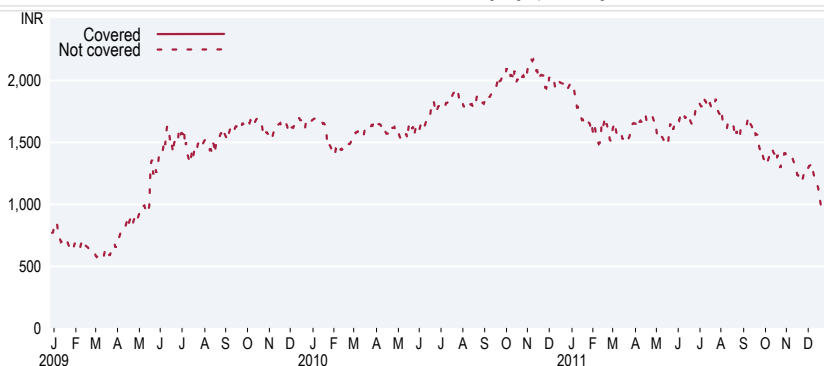
Date	Rating	Target Price	Closing Price
15 8-Aug-11	2L	*1,767.00	1,629.85
16 29-Sep-11	*1L	*1,576.00	1,369.55
17 7-Oct-11	Stock rating system changed		
18 7-Oct-11	*1	1,576.00	1,393.45
19 23-Oct-11	1	*1,511.00	1,336.00

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Larsen & Toubro (LART.BO) Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Venkatesh Balasubramaniam



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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<i>Data current as of 31 Dec 2011</i>	12 Month Rating			Relative Rating		
	Buy	Hold	Sell	Buy	Hold	Sell
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<i>% of companies in each rating category that are investment banking clients</i>	45%	41%	40%	49%	43%	41%

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Analysts may place covered stocks "Under Review" in response to exceptional circumstances (e.g. lack of information critical to the analyst's thesis) affecting the company and / or trading in the company's securities (e.g. trading suspension). As soon as practically possible, the analyst will publish a note re-establishing a rating and investment thesis. To satisfy regulatory requirements, we correspond Under Review and Neutral to Hold in our ratings distribution table for our 12-month fundamental rating system. However, we reiterate that we do not consider Under Review to be a recommendation.

Relative three-month ratings: CIRA may also assign a three-month relative call (or rating) to a stock to highlight expected out-performance (most preferred) or under-performance (least preferred) versus the geographic and industry sector over a 3 month period. The relative call may highlight a specific near-term catalyst or event impacting the company or the market that is anticipated to have a short-term price impact on the equity securities of the company. Absent any specific catalyst the analyst(s) will indicate the most and least preferred stocks in the universe of stocks under consideration, explaining the basis for this short-term view. This three-month view may be different from and does not affect a stock's fundamental equity rating, which reflects a longer-term total absolute return expectation. For purposes of NASD/NYSE ratings-distribution-disclosure rules, most preferred calls correspond to a buy recommendation and least preferred calls correspond to a sell recommendation. Any stock not assigned to a most preferred or least preferred call is considered non-relative-rated (NRR). For purposes of NASD/NYSE ratings-distribution-disclosure rules we correspond NRR to Hold in our ratings distribution table for our 3-month relative rating system. However, we reiterate that we do not consider NRR to be a recommendation.

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