17 September 2012 │ 25 pages

Construction & Engineering (GICS) │ Conglomerates (Citi)
Asia Pacific │ India

Larsen & Toubro (LART.BO)

Management Meeting Takeaways

- Company Update
- Target Price Change
- Estimate Change

- **Targetting RoCE improvement** — Management cognizant of asset intensity of developmental projects and is taking steps to improve the same. Clear focus to increase cons RoCE from 11 => 15% & parent RoCE from 15 => 20% by FY16E.

- **…Focusing on** — (1) Listing (now done) L&T Finance Holdings (~2.5% RoCE business) and no incremental parent support; (2) Capping developmental projects equity infusion at Rs171bn; (3) Efforts to reduce same to Rs150bn; (4) Reported sale of stake in mature assets, Dhamra port and L&T IDPL; (4) No more capacity creation in subs; (5) Parent capex cut to ~Rs10bn; (5) Effort to maintain sales growth at 15-20% till FY16E. Businesses asked to work on a 90% of expense budget target for the year.

- **Inflow prospects for remaining 9 months of FY13E** — L&T won Rs196bn of orders in 1QFY13. In 2QFY13 so far company has announced Rs92bn of orders. For remaining 9 months L&T sees opportunities totalling US$77bn and expects to win US$12bn of orders (Infra: US$4bn, Hydrocarbon: US$3bn, Power: US$2.5bn, Others: US$1.5bn and Process: US$1bn). This implies inflow growth of +10% in domestic and +35-40% growth in exports in FY13E.

- **Target price increased to Rs1690** — We raise our TP to Rs1690 from Rs1531 to factor in (1) EPS increase and (2) increase in parent target P/E to 14x (3) roll forward of parent and L&T target P/E to Mar14E (from Dec13E).

- **Top India Industrial/ Infrastructure pick** — At the start of the year our strong Buy call on L&T was easy, given: (1) valuations were inexpensive (2) too much pessimism on inflows given L&T gains market share in slowdowns (3) Most FIIs/ DIIs were underweight industrials/ L&T. However, after L&T gained +55% and outperformed BSE Sensex 29% YTD the call is tougher, as the outperformance might tempt investors to book profits. But no other industrials/ infrastructure company (barring Cummins/ Havells) has displayed business robustness in a slowdown that L&T has shown. Hence we stick to our guns, and reiterate our Buy.

Buy	**1**
Price (17 Sep 12)	Rs1,485.00
Target price	Rs1,690.00
from Rs1,531.00	
Expected share price return	13.8%
Expected dividend yield	1.2%
Expected total return	**15.1%**
Market Cap	Rs911,509M
	US$16,785M

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 P/E	Cons RoE
31-Mar	Rsmn	Rs	%	x	x	%	Rsmn	Rs	%	x	%
FY09	27,092	46.3	34.4%	32.1	24.0	24.7%	30,059	51.3	31.4%	28.9	24.3%
FY10	31,076	51.6	11.6%	28.8	21.5	20.2%	37,946	63.0	22.8%	23.6	21.7%
FY11	36,763	60.4	17.0%	24.6	18.4	18.3%	42,382	69.6	10.5%	21.3	18.4%
FY12	44,131	72.1	19.3%	20.6	15.4	18.8%	46,487	75.9	9.0%	19.6	17.1%
FY13E	49,784	81.2	12.7%	18.3	13.6	18.4%	51,133	83.4	9.9%	17.8	16.4%
FY14E	57,513	93.9	15.5%	15.8	11.8	18.6%	60,191	98.2	17.7%	15.1	17.0%
FY15E	66,121	107.9	15.0%	13.8	10.3	18.6%	70,045	114.3	16.4%	13.0	17.2%

Source: Company, Citi Research estimates

Venkatesh Balasubramaniam
+91-22-6631-9864
venkatesh.balasubramaniam@citi.com

Deepal Delivala
deepal.delivala@citi.com

Atul Tiwari, CFA
atul.tiwari@citi.com

Vaishnavi G
vaishnavi.g@citi.com

LART.BO: Fiscal year end 31-Mar — **Price: Rs1,485.00; TP: Rs1,690.00; Market Cap: Rs911,509m; Recomm: Buy**

Profit & Loss (Rsm)	**2011**	**2012**	**2013E**	**2014E**	**2015E**
Sales revenue	439,059	531,705	624,754	718,467	811,867
Cost of sales	-368,975	-453,831	-532,317	-611,854	-692,091
Gross profit	70,084	77,874	92,437	106,613	119,777
Gross Margin (%)	16.0	14.6	14.8	14.8	14.8
EBITDA (Adj)	**56,396**	**62,826**	**70,597**	**81,905**	**93,365**
EBITDA Margin (Adj) (%)	12.8	11.8	11.3	11.4	11.5
Depreciation	-5,992	-6,995	-8,200	-9,119	-10,032
Amortisation	0	0	0	0	0
EBIT (Adj)	**50,404**	**55,832**	**62,397**	**72,786**	**83,333**
EBIT Margin (Adj) (%)	11.5	10.5	10.0	10.1	10.3
Net interest	-6,193	-6,661	-8,149	-8,190	-7,800
Associates	0	0	0	0	0
Non-op/Except	11,475	13,383	16,872	17,566	18,925
Pre-tax profit	**55,686**	**62,553**	**71,120**	**82,162**	**94,458**
Tax	-18,923	-18,423	-21,336	-24,649	-28,337
Extraord./Min.Int./Pref.div.	2,816	434	-264	0	0
Reported net profit	**39,579**	**44,565**	**49,520**	**57,513**	**66,121**
Net Margin (%)	9.0	8.4	7.9	8.0	8.1
Core NPAT	36,763	44,131	49,784	57,513	66,121
Per share data	**2011**	**2012**	**2013E**	**2014E**	**2015E**
Reported EPS (Rs)	65.01	72.77	80.81	93.86	107.91
Core EPS (Rs)	60.38	72.06	81.24	93.86	107.91
DPS (Rs)	14.50	16.50	18.50	20.50	22.50
CFPS (Rs)	49.11	22.12	60.48	94.36	104.40
FCFPS (Rs)	22.01	-4.45	35.67	73.63	87.75
BVPS (Rs)	358.45	411.52	470.60	540.64	622.40
Wtd avg ord shares (m)	609	612	613	613	613
Wtd avg diluted shares (m)	609	612	613	613	613
Growth rates	**2011**	**2012**	**2013E**	**2014E**	**2015E**
Sales revenue (%)	18.6	21.1	17.5	15.0	13.0
EBIT (Adj) (%)	16.9	10.8	11.8	16.6	14.5
Core NPAT (%)	18.3	20.0	12.8	15.5	15.0
Core EPS (%)	17.0	19.3	12.7	15.5	15.0
Balance Sheet (Rsm)	**2011**	**2012**	**2013E**	**2014E**	**2015E**
Cash & cash equiv.	17,304	19,053	23,781	29,305	52,055
Accounts receivables	124,276	187,298	220,076	253,087	285,988
Inventory	15,772	17,766	20,875	24,007	27,127
Net fixed & other tangibles	72,951	81,832	88,854	92,456	92,646
Goodwill & intangibles	983	1,381	1,360	1,338	1,317
Financial & other assets	339,594	369,387	404,038	435,792	468,909
Total assets	**570,879**	**676,718**	**758,984**	**835,986**	**928,043**
Accounts payable	0	0	0	0	0
Short-term debt	0	0	0	0	0
Long-term debt	71,611	98,958	110,000	100,000	100,000
Provisions & other liab	281,026	325,742	360,617	404,701	446,659
Total liabilities	**352,637**	**424,699**	**470,617**	**504,701**	**546,659**
Shareholders' equity	218,241	252,019	288,367	331,284	381,384
Minority interests	0	0	0	0	0
Total equity	**218,241**	**252,019**	**288,367**	**331,284**	**381,384**
Net debt	**54,308**	**79,905**	**86,219**	**70,695**	**47,945**
Net debt to equity (%)	24.9	31.7	29.9	21.3	12.6

NAV: Rs240.75, Discount to NAV: -517%

Valuation ratios	**2011**	**2012**	**2013E**	**2014E**	**2015E**
PE (x)	24.6	20.6	18.3	15.8	13.8
PB (x)	4.1	3.6	3.2	2.7	2.4
EV/EBITDA (x)	14.6	13.1	11.7	9.9	8.3
FCF yield (%)	1.5	-0.3	2.4	5.0	5.9
Dividend yield (%)	1.0	1.1	1.2	1.4	1.5
Payout ratio (%)	24	23	23	22	21
ROE (%)	19.7	19.0	18.3	18.6	18.6
Cashflow (Rsm)	**2011**	**2012**	**2013E**	**2014E**	**2015E**
EBITDA	56,396	62,826	70,597	81,905	93,365
Working capital	-17,533	-36,708	-20,862	-9,012	-12,382
Other	-8,964	-12,571	-12,677	-15,072	-17,012
Operating cashflow	**29,899**	**13,547**	**37,058**	**57,821**	**63,971**
Capex	-16,502	-16,274	-15,200	-12,700	-10,200
Net acq/disposals	-9,795	-11,871	-15,000	-15,000	-15,000
Other	0	-212	0	0	0
Investing cashflow	**-26,296**	**-28,357**	**-30,200**	**-27,700**	**-25,200**
Dividends paid	-9,957	-11,119	-13,172	-14,597	-16,021
Financing cashflow	**-618**	**16,559**	**-2,129**	**-24,597**	**-16,021**
Net change in cash	**2,985**	**1,749**	**4,729**	**5,524**	**22,750**
Free cashflow to s/holders	**13,398**	**-2,728**	**21,858**	**45,121**	**53,771**

For further data queries on Citi's full coverage universe please contact Citi Research Data Services at CitiRsch.DataServices.Global@citi.com
For definitions of the items in this table, please click here.

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Maintain Buy – Target Price Rs1690

Target price increased to Rs1690

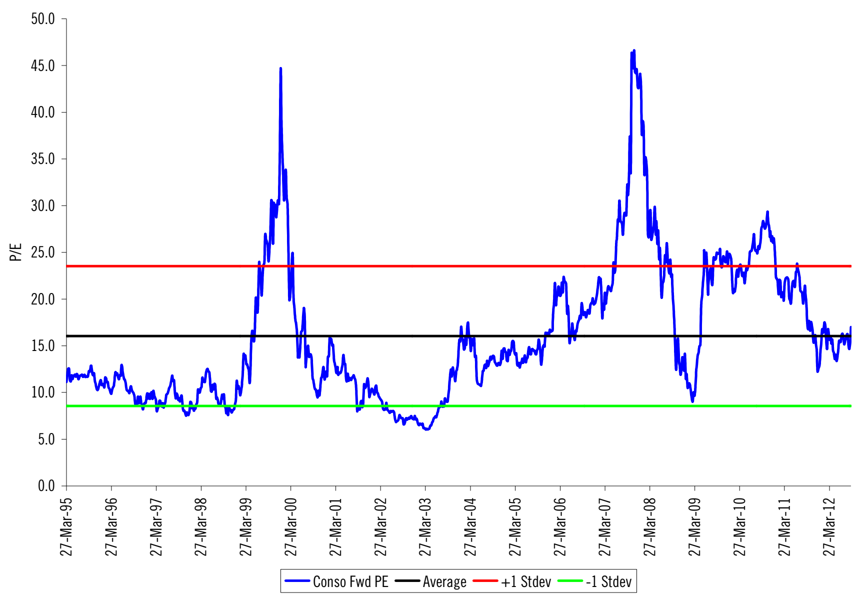
- We increase our target price +10% to Rs1690 (from Rs1531) to factor in (1) EPS increase and (2) increase in parent target P/E to 14x (from 13x) on better than expected inflows so far in FY13E (3) roll forward of parent and L&T Infotech target P/E to Mar14E (from Dec13E).

Figure 2. L&T – Sum Of The Parts

Part	Old Methodology	New Methodology	Old	New
Parent	**P/E Multiple 13x Dec13E EPS**	**P/E Multiple 14x FY14E EPS**	**1170**	**1,314**
Value of Subsidiaries			**362**	**376**
- L&T Infotech (100% Stake)	2nd tier IT 10x Dec13E EPS	2nd tier IT 10x FY14E EPS	92	106
- L&T IDPL (78.4% Stake)	Equity invested Jun12 = Rs63bn	Equity invested Jun12 = Rs63bn	103	103
- L&T Finance Holdings (82.64% Stake)	20% discount to CIRA TP = Rs52	20% discount to CIRA TP = Rs52	96	96
- Other Subsidiaries/Associates	P/BV of 1.0x FY12	P/BV of 1.0x FY12	61	61
- Satyam (1.96% stake)	At CMP	At CMP	3	4
- L&T MHI	At Book Value	At Book Value	6	6
Value/Share			**1,531**	**1,690**

Source: Citi Research estimates

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



Source: DataCentral and Citi Research estimates

Earnings revised upwards

Parent and cons EPS revised up by 0-2% and 0-4% respectively to factor in:

- Lower capex in parent leading to higher other income.
- Increase in L&T Infotech estimates to factor in the trends of 1QFY13.

We now expect L&T to grow parent EPS and cons EPS at 14% and 15% respectively over FY12-15E.

Figure 4. L&T – EPS Change Table

Mar31 (Rsmn)	FY13E	FY14E	FY15E
Net Sales			
New	624,754	718,467	811,867
Old	624,754	718,467	811,867
Change	0.0%	0.0%	0.0%
EBITDA margins			
New	11.3%	11.4%	11.5%
Old	11.3%	11.4%	11.5%
bps	0	0	0
Recurring PAT			
New	49,784	57,513	66,121
Old	49,696	56,936	64,755
Change	0.2%	1.0%	2.1%
Parent FD EPS			
New	81.24	93.86	107.91
Old	81.10	92.92	105.68
Change	0.2%	1.0%	2.1%
Consolidated FD EPS			
New	83.45	98.23	114.31
Old	83.31	96.09	110.44
Change	0.2%	2.2%	3.5%

Source: Citi Research estimates

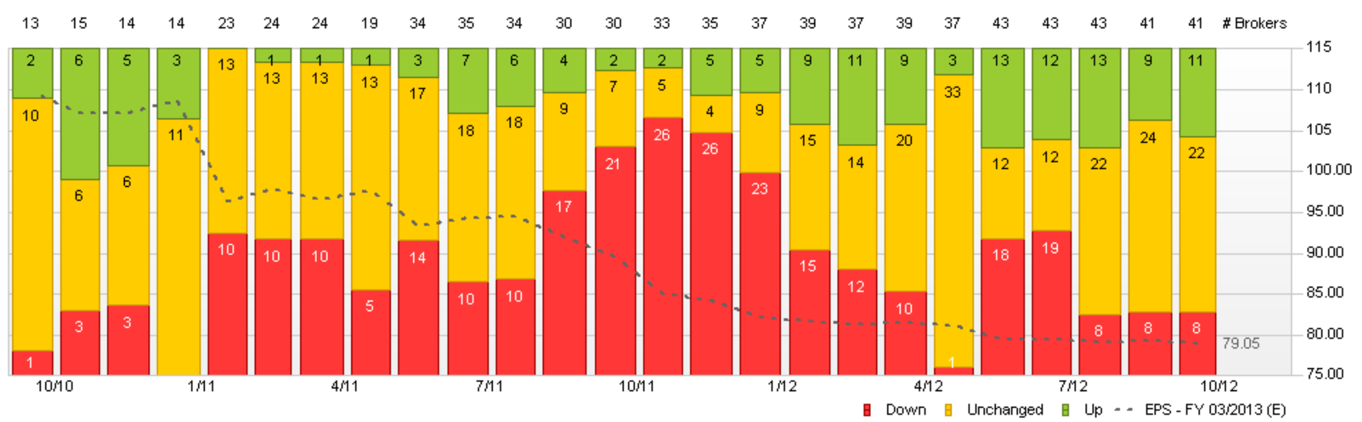
Figure 5. L&T Parent and Consolidated EPS – Citi vs. Bloomberg Consensus

Year End Mar31 (Rsmn)	FY13E	FY14E	FY15E
Parent EPS			
Citi	81.24	93.86	107.91
Bloomberg Consensus	83.15	92.04	106.88
Difference	-2.3%	2.0%	1.0%
Consolidated EPS			
Citi	83.45	98.23	114.31
Bloomberg Consensus	77.45	84.80	98.18
Difference	7.7%	15.8%	16.4%

Source: Bloomberg and Citi Research estimates

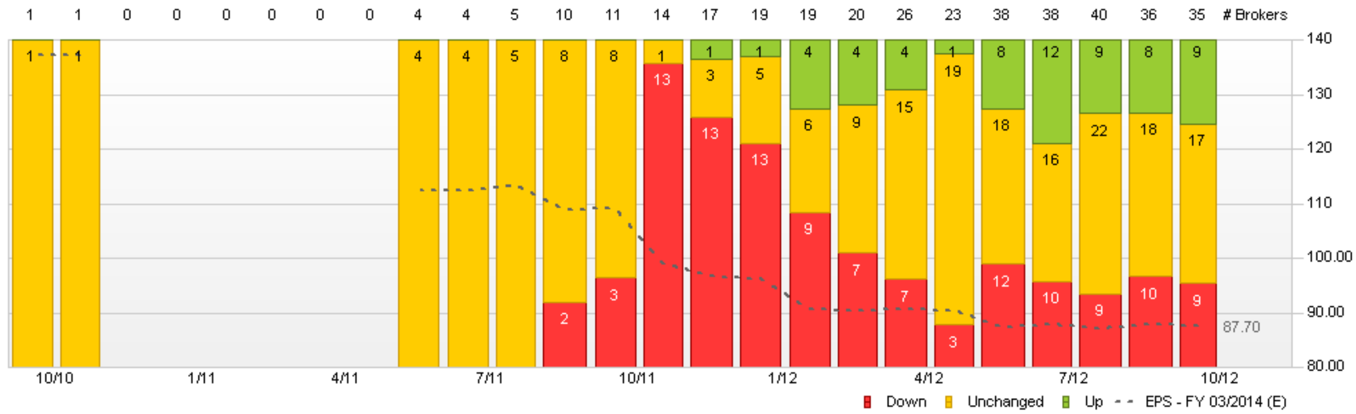
Development of consolidated consensus estimates

Figure 6. Development Of FY13E Consensus Expectations



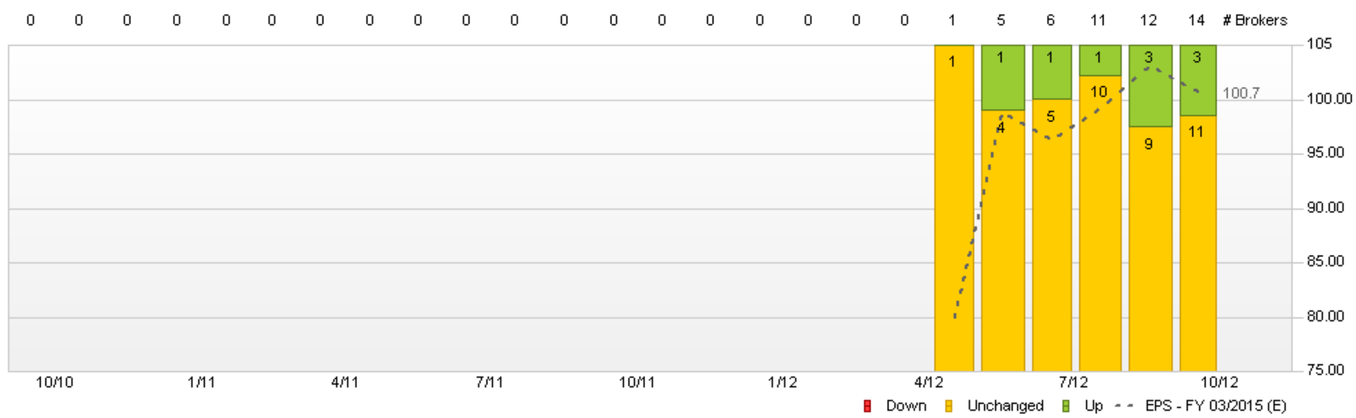
Source: Factset and Citi Research

Figure 7. Development Of FY14E Consensus Expectations



Source: Factset and Citi Research

Figure 8. Development Of FY15E Consensus Expectations



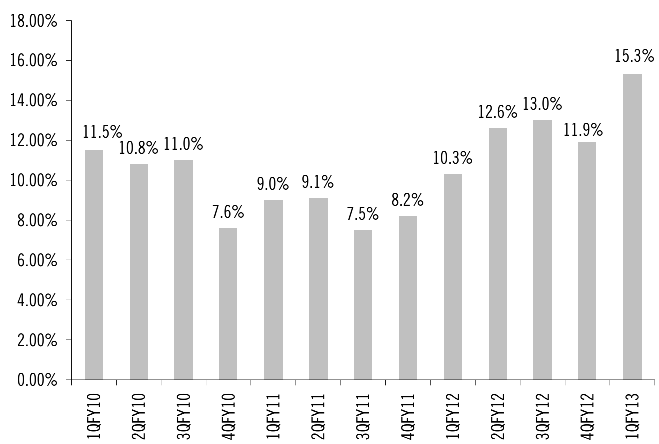
Source: Factset and Citi Research

Guidance Maintained

Reiterated sales and margin guidance for FY13E

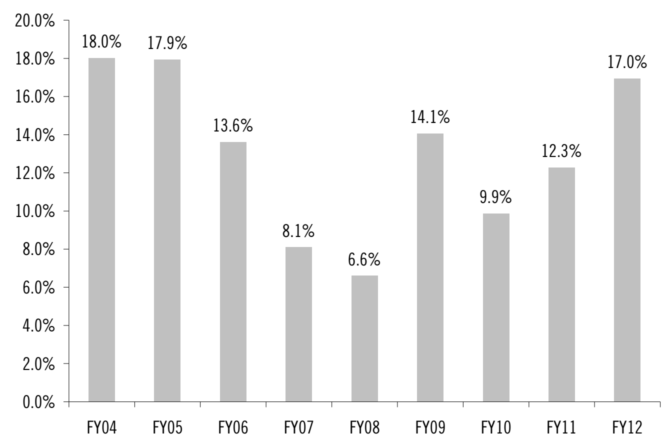
- Management reiterated guidance for FY13E, in terms of 15-20% inflow growth (Rs812 – Rs847bn of orders), 15-20% sales growth (Rs618 – 645bn of sales) and flat margins (fluctuating within a band of -50bps to +50bps).
- The key reason for sales growth of 15-20% in FY13E despite FY12 order backlog growth of only 12% is, execution cycle has reduced as proportion of power orders in backlog has reduced. The execution cycle has gone down to 23-24 months from 27 months. 9-10% of the backlog is slow moving currently.
- Though margins contracted in 1QFY13, management remains confident that a large portion of the same can be recouped in the next 9 months. The electrical and electronics (E&E) business margins are expect to bounce back, while MIP margins could deteriorate further. The others business PBIT was greater than both MIP and E&E in 1QFY13 and is expected to remain strong going forward.
- Segmental working capital (WC) as a % of sales has moved up to 15% end FY12. In the past L&T's segmental WC has gone up to ~15-20% when inflows slowed down. Management hopes to maintain working capital at 1QFY13 levels.

Figure 9. L&T – Segmental Working Capital As % Sales



Source: Company and Citi Research

Figure 10. L&T – Working Capital Intensity (NCA-Cash)/Gross Sale



Source: Company and Citi Research

Analyzing Inflows Prospects

L&T won Rs196bn of orders in 1QFY13. In 2QFY13 so far company has announced Rs92bn of orders. For remaining 9 months L&T sees opportunities totalling US$77bn and expects to win US$12bn of orders (Infra: US$4bn, Hydrocarbon: US$3bn, Power: US$2.5bn, Others: US$1.5bn and Process: US$1bn). This implies inflow growth of +10% in domestic and +35-40% growth in exports in FY13E.

FY12 spillover into FY13E was Rs100bn out of which Rs78bn has been booked in 1QFY13. One should not bother about this number because every quarter there is a spillover portion from the past.

Prospects at the end of FY12 for FY13E

- According to the management at the beginning of FY12 the total prospects were US$100bn. A significant chunk of the same has spilt over to FY13E. In FY13E they have been very stringent in their prospecting given the weak macroeconomic environment and hence overall prospects are lower at US$86bn.
- Out of the total US$86bn 78% are in India and 22% are outside India. Further, L&T expects to win US$16.5bn of orders from these prospects with US$4bn from power, US$3bn from hydrocarbons, US$7.0bn from infrastructure, US$1bn from process and US$1.5bn from others.

Figure 11. L&T – Geographical Order Inflow Prospects For FY13E

	Opportunity ($bn)	Domestic ($bn)	International ($bn)
Power	30.0	25.0	5.0
Hydrocarbon	14.0	5.0	9.0
Infrastructure	35.0	31.5	3.5
Process	4.0	3.5	0.5
Others	3.0	2.5	0.5
Total	**86.0**	**67.5**	**18.5**

Source: Company and Citi Research #Note: Assuming USDINR of 50

Figure 12. L&T – Sectoral Order Inflow Prospects For FY13E

	Opportunity ($bn)	Opportunity (Rsbn)	Target ($bn)	Target (Rsbn)
Coal based power	15.0	750	1.0	50
Power T&D	13.0	650	2.0	100
Other Fuels	2.0	100	1.0	50
POWER TOTAL	**30.0**	**1500**	**4.0**	**200**
Upstream	5.0	250		
Downstream	9.0	450		
HYDROCARBON TOTAL	**14.0**	**700**	**3.0**	**150**
Building and Factories	14.0	700	4.0	200
Transportation Infra	17.0	850	2.5	125
Water	4.0	200	0.5	25
INFRA TOTAL	**35.0**	**1750**	**7.0**	**350**
PROCESS TOTAL	**4.0**	**200**	**1.0**	**50**
OTHERS TOTAL	**3.0**	**150**	**1.5**	**75**
TOTAL	**86.0**	**4300**	**16.5**	**825**

Source: Company and Citi Research #Note: Assuming USDINR of 50

Prospects at the end of 1QFY13 for 9mFY13E

Figure 13. L&T – Sectoral Order Inflow Prospects For 9mFY13E

	Opportunity ($bn)	Opportunity (Rsbn)	Target ($bn)	Target (Rsbn)
Generation	13.0	650	1.0	50
Power T&D	12.0	600	1.5	75
POWER TOTAL	**25.0**	**1250**	**2.5**	**125**
HYDROCARBON TOTAL	**16.0**	**800**	**3.0**	**150**
Building and Factories	11.0	550	2	100
Transportation Infra	15.0	750	1	50
Water	3.0	150	1	50
INFRA TOTAL	**29.0**	**1450**	**4.0**	**200**
PROCESS TOTAL	**3.0**	**150**	**1.0**	**50**
OTHERS TOTAL	**4.0**	**200**	**1.5**	**75**
TOTAL	**77.0**	**3850**	**12.0**	**600**

Source: Company and Citi Research #Note: Assuming USDINR of 50

In a sweet spot over next 2 years in infra projects in India

- As most of the international competitors don't have the wherewithall to handle local labor and execution conditions. Further, most domestic competitors are overleveraged and cannot compete effectively with L&T.

Power prospects list does not include 2.6GW of Rajasthan orders

- The power prospects do no include 2 projects of 1320MW in Rajasthan where rebidding is likely to happen. L&T had not participated in the previous tender (where BHEL and BGR had put in their bids). This could add another US$2.5bn to the prospects list.

Defence orders could be another wildcard

- L&T has adopted a collaborative approach with Pipavav Shipyard for bidding for the Mazgaon Dock orders.
- Mazgaon Dock has Rs100bn (US$20bn) of orders which it has been unable to execute. Hence a decent portion of the same should spill over to L&T and Pipavav Shipyard. L&T will be getting a priority on the US$4bn submarine orders and Pipavav Shipyard will get a priority on the ship orders, according to L&T.
- This opportunity has also not been included in the inflow prospects list and could act as a buffer. Further, these orders could also help L&T utilize its ship building facilities in South India.
- These orders are expected in FY14E, though there is a possibility of some of them fructifying in FY13E.

Figure 14. L&T Order Inflows YTD

2QFY13	Order	Client	Rsmn
12-Sep-12	50 MGD & 25 MGD for PCPIR Dahej. 10 MLD RO seawater desal plant in south	GIDC	7,930
12-Sep-12	Commissioning of substation extension packages	PGCIL	1,220
12-Sep-12	Ongoing projects	NA	1,500
3-Sep-12	Viaducts and stations for phase III of Delhi MRTS	DMRC	3,770
3-Sep-12	Rewari Manheru doubling of line	RVNL	2,120
3-Sep-12	IT Campus and residential towers		4,740
28-Aug-12	Ongoing projects in Buildings & Factories IC and Infrastructure IC	Unknown	3,160
28-Aug-12	11 kV distribution network and all associated HV equipment	UAE	1,680
28-Aug-12	74 MLD water treatment plant	PHED Rajasthan	5,180
27-Aug-12	4 Wellhead platforms in Mukta, Bassein and Mumbai High South	ONGC	7,490
27-Aug-12	Saih Rawl Depletion Compression Phase 2 (SRDC2) project	Petroleum Development Oman	13,020
21-Aug-12	171MW Lata Tapovan HEP	NTPC Hydro	7,810
21-Aug-12	Stretches of the Kishangarh – Udaipur- Ahmedabad Highway	GMR Infra	6,450
21-Aug-12	Construction of 23 multistoried towers	Unknown	3,600
21-Aug-12	220/33 kV grid station and related 220 kV cabling and overhead lines work	UAE	2,580
13-Aug-12	Nirantara Jyoti Yojana feeders to rural DTC's of Villages	Chamundeshwari Electricity Supply	1,012
13-Aug-12	Construction of 220kV & 765 kV switchyard in Uttar Pradesh	Unknown	2,023
13-Aug-12	Supply & Installation of new 220/33 kV Grid Station	UAE Customer	3,035
13-Aug-12	new integrated terminal building & allied works at Chandigarh Airport	AAI	4,740
13-Aug-12	IT Campus in Hyderabad	Unknown	2,000
13-Aug-12	Water and Effluent Treatment Order	Greater Mohali Area DA	1,550
13-Aug-12	4 lane flyover, rail overbridges and viaduct at various locations in Kolkata	Kolkata Metropolitan DA	2,750
13-Aug-12	Repeat order	Unknown	2,970
Overall Data For			**92,330**
1QFY13	**Order**	**Client**	**Rsmn**
NA	Cryostat for thermo nuclear fusion reactor	ITER	6,500
NA	Solar thermal plant, Rajasthan and EPC for pumping station at Bhavnagar district, Gujarat	Unknown	2,650
NA	Repeat Orders	Sadara Chemical (Saudi Aramco-Dow)	7,500
Jun-12	Commercial buildings and factories	Reputed Customers	5,460
Jun-12	Doubling between Hospet to Harlapur	South Western Railway	2,250
Jun-12	Water supply system at Sahibganj	Government of Jharkand	1,340
Jun-12	Solar PV system of 10MW	Reputed developer	1,250
Jun-12	Industrial electrification	Unknown	1,950
Jun-12	Add on minerals and metals order	Unknown	2,980
29-Jun-12	6 laning of existing road and ancillaries	Unknown	20,400
29-Jun-12	Electrical orders	Qatar	1,560
29-Jun-12	Rural Electrification works	WBSEB	8,460
15-Jun-12	CHP for 3X660MW Lalitpur project	Bajaj Infrastructure Development	4,070
15-Jun-12	Construction of 132/33kV substations in Middle East	International	3,345
15-Jun-12	R APDRP order	HESCOM	3,345
8-Jun-12	Four specialized commercial vessels	Halul Offshore Services, Qatar	4,830
7-Jun-12	Leading developers for residential towers across various cities in North India	Unknown	18,210
7-Jun-12	Viaducts and 3 elevated stations	DMRC	3,450
7-Jun-12	Upgrading existing water systems	BWSSB	2,440
6-Jun-12	Amravati Jalgaon Gujarat Maharashtra border (Assumed 80% of Rs48bn)	NHAI	37,280
21-May-12	Electrical, instrumentation and automation works for 4506 Cum blast furnace project	NMDC	1,198
21-May-12	400 KV switchyard and plant electrics, Tamnar	Jindal Power	1,198
21-May-12	Electrical works at Mauda and Solapur	NTPC	1,198
21-May-12	400 kV overhead transmission lines from Barh in Bihar to Gorakhpur	PGCIL	1,198
21-May-12	Construction of a solar thermal plant at Rajasthan	Unknown	1,325
21-May-12	Pumping station and allied works at Botad Branch Canal from Paliyad to Goma	Gujarat Water Infrastructure	1,325
18-May-12	Residential towers in Bangalore and Gurgaon	Unknown	12,060
18-May-12	Mixed use development, hospital building and other institutional buildings	Unknown	11,650
18-May-12	Automobile factory	Unknown	2,210
8-May-12	Construction of polyethylene and specialty elastomers package in Al-Jubail Industrial City II	Sadara Chemical (Saudi Aramco-Dow)	7,500
Overall Data For			**180,130**
Actual			**195,940**

Source: Company and Citi Research

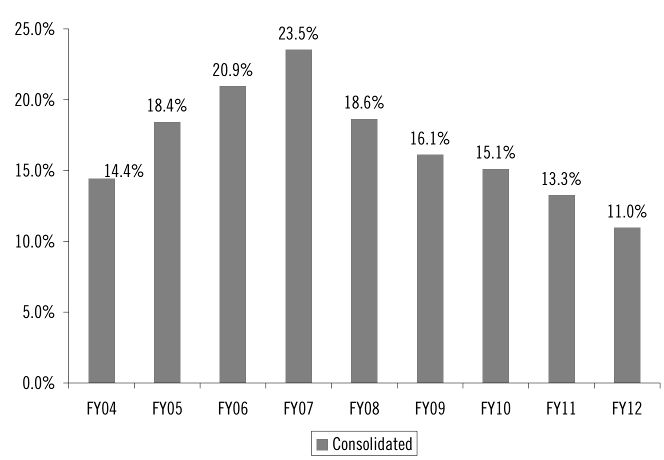
Focus To Improve RoCE

It is a fact that these steps will not immediately bear fruit in FY13E. In FY13E the company expects cash flow from operations of ~ Rs60bn out which ~ Rs20bn would be used to support developmental projects, ~ Rs20bn would fund standalone parent capex and ~ Rs20bn would fund working capital.

Management is cognizant of investor feedback about the asset intensity of developmental projects (L&T IDPL and power where current RoCE is being sacrificed for the sake of the longer term) and intends to take steps to improve RoCE. Management is targetting increasing consolidated RoCE from 11% to 15% and parent RoCE from 15% to 20% by FY16E.

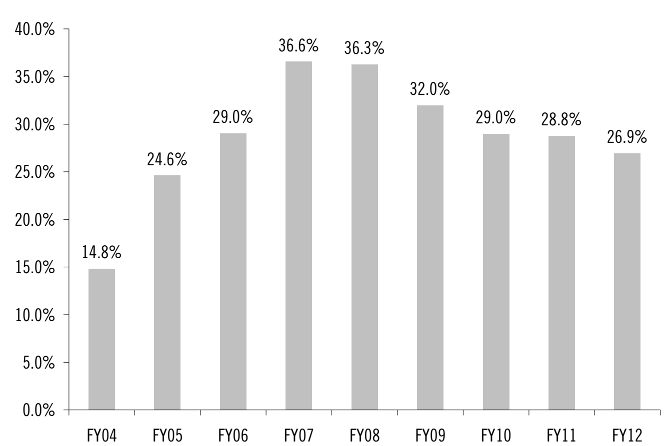
- **Step 1:** The financial services business by its very nature does not make more than ~2.5% RoCE and hence L&T decided it cannot keep funding the business. To this end L&T Finance Holding has completed its IPO and will manage its funding requirements on its own incrementally.
- **Step 2:** L&T IDPL and power projects have equity requirement of Rs171bn (out of which Rs63bn has already been invested). The first step is to cap the level of exposure at these levels given this is already 67% of parent networth.
- **Step 3:** Efforts are being taken to reduce the equity requirement to Rs150bn by (1) not executing unit 3 of 700MW of Rajpura and (2) L&T Power Development is working on 728MW of hydel projects. Management is evaluating selling some of these projects once the DPR is ready as that itself would have created value.
- **Step 4:** Management is reportedly also evaluating (1) selling some of the mature asset (3) stake sale in Dhamra port and (3) stake sale in L&T IDPL either to a strategic investor or private equity. L&T prefers a strategic partner as unlike private equity investors they do not demand an exit in 3 or 5 years and do not interfere in operations after taking a board seat.
- **Step 5:** Also planning to follow a policy of "no more capacity creation in subsidiaries till the current investments start yielding".
- **Step 6:** Parent capex has been between Rs15-20bn over FY08-12. There is conscious step to limit capex to maintenance levels and lease any incremental machinery. There is a possibility that parent capex could go down to Rs10bn.
- **Step 7:** There is an effort to maintain sales growth at 15-20% levels till FY16E. Businesses have been asked to work on a 90% of expense budget target for the year. Though the cost cutting is an aspirational target, L&T hopes to achieve it.

Figure 15. L&T – Consolidated RoCE



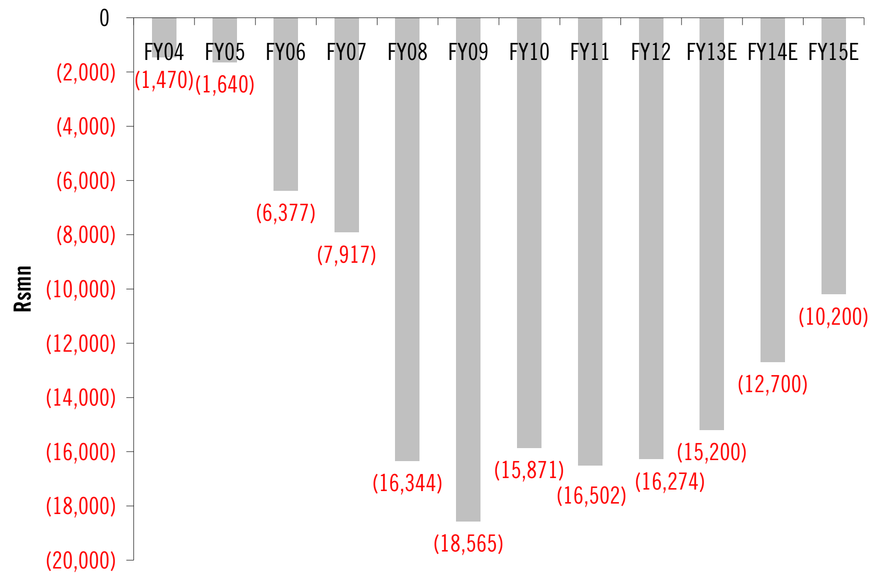
Source: Company and Citi Research

Figure 16. L&T – Parent Core Business RoCE Still Robust



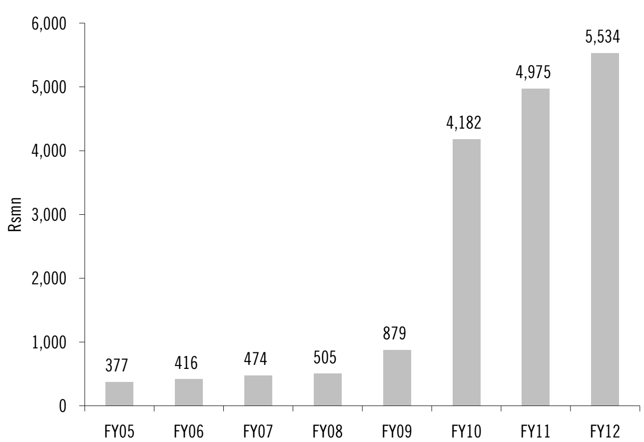
Source: Company and Citi Research (ex sub/associates dividends & equity investments)

Figure 17. L&T Parent – Annual Capex



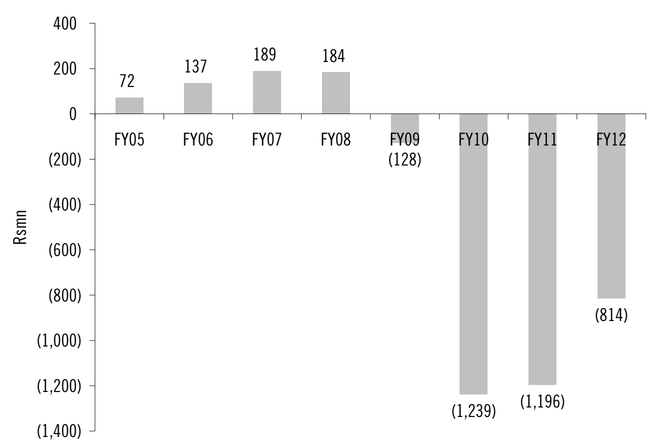
Source: Company and Citi Research

Figure 18. L&T Road Projects Toll Revenues



Source: Company and Citi Research

Figure 19. L&T Road Projects Profits/Losses



Source: Company and Citi Research

Figure 20. L&T IDPL – Roads, Ports and Metro Rail Portfolio

S. No	Project	Stake	State	Cost (Rsmn)	Equity (Rsmn)	D/E	FY11 Networth	FY12 Networth
	ROAD PROJECTS							
1	Panipat Elevated Corridor	100%	Haryana	4,220	843	20%	(376)	(801)
2	Narmada River Bridge	100%	Gujarat	1,440	474	33%	1,298	1,600
3	Krishnagiri-Thopur	100%	Tamil Nadu	5,250	788	15%	187	69
4	Jadcherla-Kothakotta	100%	Andhra Pradesh	3,730	565	15%	587	450
5	Coimbatore Bypass	100%	Tamil Nadu	1,040	414	40%	783	875
6	Palanpur-Swaroopganj	100%	Gujarat/ Rajasthan	5,540	572	10%	700	796
7	Vadodara-Bharuch	100%	Gujarat	14,500	435	3%	(1,079)	(1,677)
8	Rajkot-Jamnagar-Vadinar	100%	Gujarat	10,960	3,288	30%	894	940
9	Ahmedabad-Viramgam-Halvad-Maliya	100%	Gujarat	14,970	4,491	30%	963	1,482
10	Halol-Godhra-Shamlaji	100%	Gujarat	13,050	3,915	30%	1,298	1,298
11	Chennai-Tada	100%	Tamil Nadu	8,480	2,544	30%	418	418
	Operational Projects			**83,180**	**18,328**			
12	Pimpalgaon-Nashik-Gonde	74%	Maharashtra	16,910	5,073	30%	837	1,682
13	Beawar-Pali-Pindwara	100%	Rajasthan	24,720	7,416	30%	-	807
14	Sangareddy to KNT / MH border	100%	Andhra Pradesh	12,730	3,819	30%	-	1
15	Jalgaon to Maharashtra-Gujarat border	100%	Maharashtra	48,000	14,400	30%	-	-
16	Amravati - Jalgaon	100%	Maharashtra		-	30%	-	-
17	Krishnagiri-Walajahpet	100%	Tamil Nadu	13,700	4,110	30%	903	922
18	Samaikhiali-Ganghidham	100%	Gujarat	13,000	3,900	30%	753	805
19	Devihalli-Hassan	100%	Karnataka	4,940	1,482	30%	327	1,579
	Under Construction Projects			**134,000.0**	**40,200.0**			
	PORT PROJECTS							
P1	Dhamra Port	50%	Orissa	32,390	6,480	20%	-	-
P2	Kachchigarh Port		Gujarat				(0)	(0)
	METRO PROJECTS							
MR1	Hyderabad Metro	100%	Andhra Pradesh	163,750	27,680	17%	3,426	4,360

Source: Company and Citi Research

Focusing On Exports

Gettting more orders outside India is not a one-off plan to deal with the slowdown in domestic capex but a long-term objective.

+10% domestic orders and +35-40% export orders

- L&T has started recruiting locals (with language skills and contacts) in Saudi Arabia, UAE, Perth, Singapore, London, and Houston. This has already started yielding results with the company winning the recent Sadara Chemicals order (which we estimate is for US$150mn) and following this up with yet another Sadara Chemicals order recently. L&T's execution was always very strong in the GCC region. Now with the above efforts the marketing looks set to improve manifold.
- In Saudi Arabia < US$1bn are given only to IKEC (in kingdom E&C companies). L&T is increasing localization to become an IKEC where Koreans do not qualify. In Oman L&T is localizing to the extent of 30% to get preference in orders.
- To make sure L&T does not miss out on larger orders the company has started collaborating with Korean and European companies on the US$2-3bn jobs. For example it is in the fray for the Sohar refinery along with the Korean players.
- L&T is also entering newer regions, such as Malaysia, Indonesia, Thailand, Australia and Africa.

Figure 21. L&T – Geographical Order Inflows and FY13E Guidance

	FY08	FY09	FY10	FY11	FY12	FY13E
Domestic	350,859	438,779	660,934	717,921	578,707	636,577
Growth		*25%*	*51%*	*9%*	*-19%*	*10%*
Exports	69,331	77,432	34,786	79,769	127,033	177,846
Growth		*12%*	*-55%*	*129%*	*59%*	*40%*
Total	**420,190**	**516,210**	**695,720**	**797,690**	**705,740**	**814,424**
Growth		*23%*	*35%*	*15%*	*-12%*	*15%*

Source: Company and Citi Research estimates

Hydrocarbon IC

- This IC has a two decades successful track record of executing a number of international turnkey large size & complex projects including in GCC region where it has established a good presence.
- As a part of Internationalization initiatives key business development and regional heads have been appointed in select important geographies such as Australia, Houston, London, Malaysia, Perth, Saudi Arabia and Singapore.
- Further IC has entered into few alliances and collaborations with reputed international players in the area of subsea systems, FPSO/MOPU, refineries and fertilizers.

Heavy Engineering IC

- This IC has been exploring opportunities for export of power plant, CTL, gasifiers, fertilizer, hydrocarbons, petrochemicals, defence, nuclear power and aerospace equipment.
- Orders received from Israeli Aerospace Industries as key offset partner in the areas of weapon systems, radars and aerospace. The defence business is also interacting with major international players in the defence industry for technology tie ups and indigenous manufacturing.

Figure 22. L&T – Heavy Engineering IC

Products/ Companies	Opportunity
Seeking approvals with Alstom, Toshiba, ENEL, Skoda	As worldwide supplier for Power Plant Equipment
Seeking approvals from Saudi Electric Company	As supplier of Power Plant Equipment
Pursuing with Aker Solutions	Medicine Bow project in USA
Close interaction with Sasol	CTL Projects worldwide
Exploit supplying Shell gasifiers in China	To expand and acquire business of Shell gasification worldwide
Already has technology for	Fertilizer projects in gas rich region of Africa, Brazil, Middle East, Azerbaizan, Argentina and China.
Existing products	New markets of KSA, Kazakhstan, US & China
Existing products	EO / EG & methanol plant equipment for China
L&T Forged shell	For Ammonia Convertors and Reactors
Toyo qualification	for urea equipment
Nuclear BWR/ PWR technology for canisters	From the USA
Nuclear business	Europe for CUSK and also ITER project - France

Source: Company

Construction IC

- This IC is focused on power T&D, roads, airports, real estate and metro rail and other infrastructure orders. With the IC having firmly established in all GCC countries now, it has set its sight to expand to African countries and corner a significant market share in GCC market.

- The FY13E outlook for GCC countries remains positive despite the Eurozone crisis. With oil prices expected to be around US$100/barrel range in CY12E, GCC public finances should remain reassuringly strong. Due to Arab spring in 2011, Government will likely remain focused on their medium term development goals and propel the growth rate which should pave the way for enhanced business opportunities.

- On the cost side, the various welfare measures announced by GCC Governments for their nationals, including a steep hike in their salaries pose a challenge to L&T in terms of inflation and pressures on margin. In addition, recruitment & management of multinational staffs and workmen would add to the challenges to the company's project team.

Electrical & Automation IC

- Tamco Malaysia qualified for Achilles (UK) certification, has made an entry into Philippines and Vietnam markets, qualified in Kuwait and Iraq, and received Petronas approval for its MV products.

- Some of the focused international markets have started showing signs of recovery. The outlook for TAMCO holds good promise. Besides Malaysia, there is an anticipation of boom in mining and offshore industries as well as capacity addition in windmills in Western Australia, opportunities in the infrastructure sector in Qatar, UAE and Malaysia.

- The Maaden frame agreement has facilitated recognition of the IC's subsidiary with global EPC majors in KSA where higher government spending in infrastructure segment is expected to yield significant business.

- In UAE, the oil & gas, utility and infrastructure segments are showing signs of revival across Middle East, Africa and CIS countries with significant investments announced over next 3-5 years.

- Having strengthened its position in telecom system integration, the IC expects to grow significantly in this area in addition to the areas in control, electrical and instrumentation.

- Africa has become a destination of new opportunities. Prospects of turnkey automation projects are improving and opportunities in the energy management segment should contribute to better growth for automation products and solutions.

Power IC

- Power IC has identified export markets as key to growth for its gas-based power plants SBU. This is driven by lack of opportunities in the domestic market owing to sharp fall in gas availability, which led the Ministry of Power to advise IPPs not to plan any new gas-based power project until FY16E.

- Power IC has identified GCC and South East Asia as the potential markets. A good beginning is made in Bangladesh where the pre-qualification has been achieved successfully. Orders totaling approximately 1600 MW are expected to be ordered out in FY13E.

- Negotiations are also in progress with Mitsubishi Heavy Industries Limited to order components on the boiler and turbine manufacturing JVs.

B&F Don't Make Lower Margins

According to management it is a wrong perception that this segment has lower margins as 80-85% of these orders have been won on a negotiated basis and have margins which are inline or higher than company level margins. L&T enjoys a strong brand equity because of which it is able to command higher margins.

Figure 23. L&T – Buildings & Factories Order Wins

	FY10	FY11	FY12	1QFY13	2QFY13 So Far
Building & Factories Wins	**85,950**	**72,420**	**126,850**	**49,590**	**13,500**
- Real Estate	48,600	40,220	99,815	47,380	13,500
- Others	37,350	32,200	27,035	2,210	-
Total Order Wins	**695,790**	**797,690**	**705,740**	**195,940**	**92,330**

Source: Company and Citi Research

- We often get asked the same question from investors and decided to settle the debate. Our real estate analyst *Atul Tiwari* met Omkar Realty (unlisted), a large player (~10% market share) in the Mumbai slum rehabilitation market.
- Omkar expects ~Rs160bn of total revenue from slum rehab projects over the next 3-4 years. 70% - 80% of this revenue will come from their 3 large projects in Worli, Malad and Bhoiwada (i.e. ~Rs120bn). These 3 projects are being executed by L&T (both rehab and free sale portion).
- A rough estimate of total construction cost would be 25-30% of revenue = Rs35bn revenue which would accrue to L&T over the next 3-4 years.
- Omkar prefers L&T even though it realizes that L&T's prices may be actually ~10%-12% higher than competitors because:
  - Once L&T is involved, slum dwellers are more comfortable that the project will actually get completed on time and they will get their new homes. This enables the company to receive consent of slum dwellers more easily.
  - Other construction companies may give better pricing, but project execution may not be smooth at all. Historical experience of Omkar with smaller construction companies has not been good.
  - L&T's systems and processes are in place. Once you sign the contract, you know what you are going to get in terms of project execution. This is a big deal for the project developer.
  - And lastly, L&T's construction also helps in pricing of free sale buildings.

Will International Orders Contract Margins?

It is a misconception that international margins are always lower than domestic margins and L&T does not expect a significant impact of international expansion on margins

- **Not competing directly with larger players:** Company is not directly competing with the Korean players in the large (>US$1bn) jobs. L&T's current focus is mainly on < US$500mn jobs where competition is not that much.
- **More integrated than larger players:** E&C business had margins of 12.7% in FY12 and management does not expect this go down below 12.2%. It is a fact that large international players like Samsung are operating at margins of 7-8%. But it is also a fact that they have RoEs of 35% which implies their business model is different. They bid for large orders, do in house design and outsource all other activities (asset light model). L&T's business model is more asset heavy and integrated with limited outsourcing which results in higher EBITDA margins.
- **Execution has to be spot on to realize margins similar to that in India:** 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 vs. in India). Hence realized margins could be lower if execution is not spot on (~ 100 - 150bp lower).
- Moreover these projects have 20-25% construction component where L&T is in the process of building a strong presence in the Gulf. Once this presence is built, L&T should have greater control on costs (unlike the Korean players).

Other Takeaways

Update on BTG and forgings facilities

- We had a detailed discussion of the above to discuss how the management plans to minimize the impact of unused facilities which have either been put up or will be put up in the near future.
- According to the management, the BTG facilities can continue operating at 100% utilization for 9 more months with the current backlog. If the company wins one order of US$1bn as expected in FY13E this would provide leeway for a further 1 more year. Post that, management expects investment momentum to pick up from FY14E onwards. They also believe there is a possibility of the JP Power Karchana project moving ahead in an alternate location.
- Utilizing the forgings facility which is coming up by Sep-Oct 2012 will be a little more difficult. However it is pertinent to note that the capacity is fungible between nuclear and hydrocarbons forgings. The scale of the facility is quite big with the ability to handle 500 ton ingots. Besides L&T, only Japan Steel has a similar facility in place globally today. The company is also in talks with other companies who are planning to put up their own independent facility globally to take an equity stake in L&T-NPCIL's (74:26 stake) facility and not build one on their own. Further, there are plans to make the rotor to be used in the turbine generator facility in the forgings facility in phase 2.

Have proved a point in the BTG and BOP orders

- Management has been long communicating to investors that their power generation bids have not been aggressive. This is evident from the fact that company has generated 12%+ margins on the EPC portion executed in the parent and also broken even at the BTG JVs EBITDA level last year.
- This is on account of high level of localization achieved at the BTG JV level which is well ahead of that mandated in the recently concluded bulk tenders.
- According to management, some of the recent price bids do not make sense and some of those bid winners are likely to make losses (given low levels of localization).
- There could be a major shakeout over next 3-4 years, with some players either going out of business or being consolidated leading to more rational competition.

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 Buy given the company is fundamentally one of the best proxies to India's infrastructure build-out. L&T's Rs1531bn order backlog and forecast stable margins provides good earnings visibility. Though L&T's valuations are no longer expensive, policy action and a revival in investment capex is critical for the stock to perform. With its diversified skill set (presence in almost all sub sectors in the infrastructure space) and strong balance sheet we believe L&T is much better suited to weather an extended slowdown.

Valuation

Our Rs1,690 target price is based on sum-of-the-parts (SOTP). We use 14x Mar14E earnings for the parent (Rs1314), well supported by EPS growth of 14% and average RoEs of 19%. We also believe that the parent's numbers do not capture the value inherent in subsidiaries, which we value at Rs376, with L&T Infotech at Rs106 (10x Mar14E EPS, in line with second-tier peers), L&T IDPL at Rs103 and L&T Finance Holdings at Rs96.

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

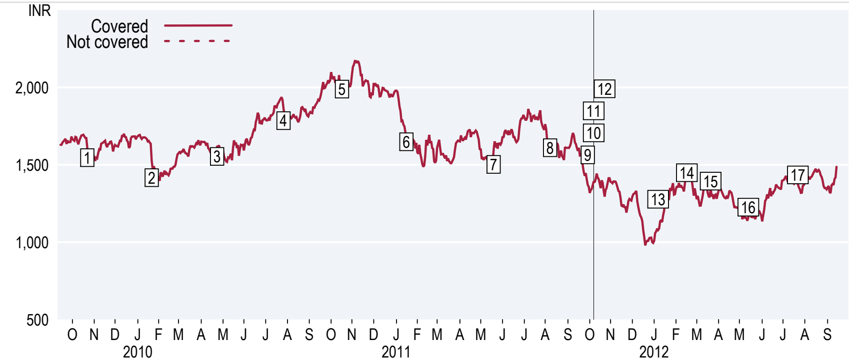
The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each 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	22-Oct-09	*1L	*1,828.00	1,608.50
2	21-Jan-10	1L	*1,748.00	1,524.35
3	23-Apr-10	1L	*1,875.00	1,617.85
4	27-Jul-10	1L	*2,110.00	1,863.25
5	18-Oct-10	1L	*2,210.00	2,013.15
6	17-Jan-11	*2L	*1,824.00	1,681.15
7	19-May-11	2L	*1,745.00	1,594.90
8	8-Aug-11	2L	*1,767.00	1,629.85
9	29-Sep-11	*1L	*1,576.00	1,369.55
10	7-Oct-11	Stock rating system changed		
11	7-Oct-11	*1	1,576.00	1,393.45
12	23-Oct-11	1	*1,511.00	1,336.00
13	6-Jan-12	1	*1,328.00	1,078.60
14	16-Feb-12	1	*1,647.00	1,447.05
15	21-Mar-12	1	*1,642.00	1,348.00
16	14-May-12	1	*1,436.00	1,159.80
17	23-Jul-12	1	*1,531.00	1,374.50

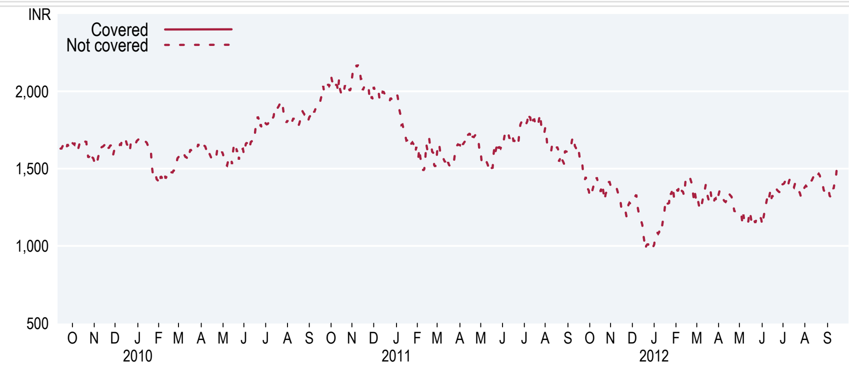
* Indicates change

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

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12 Month Rating ***Relative Rating***

Data current as of 30 Jun 2012	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
Citi Research Global Fundamental Coverage	53%	37%	10%	10%	80%	10%
% of companies in each rating category that are investment banking clients	44%	43%	40%	48%	43%	45%

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