2012

# COMPANY RESEARCH REPORT

## INITIATING COVERAGE

## Larsen & Toubro Ltd.

RECOMMENDATION: 'BUY' below Rs.1075

TARGET: Rs. 1433

HOLDING PERIOD: 1-1.5 Years

RISK PROFILE: Moderate- Aggressive

Hedge Equities invest with an edge

| | |
|---|---|
| NSE Code: | **LT** |
| BSE Code: | **500510** |
| ISIN Code: | INE018A01030 |
| Reuters Code: | LART.BO |
| **Bloomberg Code:** | LT IN |
| Website: **www.larsentoubro.com** | |

| | |
|---|---|
| Sector: | Engineering – Construction |
| EPS (TTM): | Rs.71.63 |
| PE (TTM): | 20.20 |
| Industry PE: | 19.44 |
| Mkt. Cap (In crores): | 88,574.24 |
| 52 Wk High: | Rs. 1932.95 |
| 52 Wk Low: | Rs. 971 |
| P/BV: | 3.6x |
| Beta: | 1.19 |
| Dividend Yield (%): | 1 |
| Face Value (Rs.): | 2 |
| Debt/Equity: | 1.52 |
| Foreign Institutional Holding: | 13.84% |

- **Best stock to play the Indian infrastructure theme**

We believe L&T is best placed to benefit from the gradual recovery in the capex cycle, given its diverse exposure to sectors, strong balance sheet and cash flow generation as compared to its peers, which grapple with issues such as strained cash flow, high leverage and limited net worth and technological capabilities.

- **Presence in diversified businesses**

Larsen & Toubro's business as a whole are diversified in nature with the presence in different areas of businesses like Turnkey projects, construction, engineered products & systems, electrical & electronic products & systems, IT& Engineering services, Machinery Valves & Industrial Consumables, Financial Services, Shipbuilding etc would help the company to withstand the concerns in particular sectors.

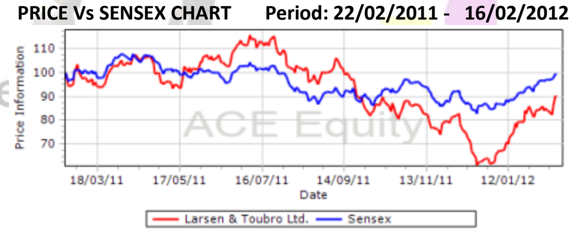
- **Strong order book**

As of 3QFY2012, L&T stands tall on an order backlog of 1, 45,768 crore against Rs 114,882 crore at the end of Q3 FY11 and Rs 142,185 crore at the end of Q2 FY12. With the current order book, book to book ratio (BTB ratio) stands at 3x its TTM revenue. L&T's order book is majorly dominated by the infra (40%) and power (29%) segments. Process (15%), hydrocarbon (11%) and others (5%) constitute the balance part of the order book.

- **Outlook and Valuations: Attractive; Initiate Coverage with 'BUY'**

Larsen and Toubro (L&T) had posted good set of numbers for 3QFY2012, which mainly on account of robust top-line growth and higher other income. Order inflow for the quarter grew by stunning 28.2% to 17,129 crore covering some of the lost ground in 1HFY2012. We prefer L&T over its peers being the market leader and fundamentally the strongest infrastructure company. We maintain L&T as our top pick in the sector. Hence, we initiate a 'Buy' recommendation on Larsen with the target price of Rs. 1433 with a 'Buy' below Rs.1075 for those who have a moderate to aggressive risk appetite, as the stock looks very attractive at the current levels, given the steep price correction in the recent past and the improved outlook on the infrastructure space going ahead.

**PRICE Vs SENSEX CHART** **Period: 22/02/2011 - 16/02/2012**




## Risks

At the macro level, the current global economic scenario is the most worrying risk factor, as a fall of the global economy into a double-dip recession may lead to a slower growth in our economy. Apart from that, the other concerns include the stiff competition in each of the industries which would cause aggressive bidding and a drop in order inflow, persistence of the higher interest rate leading to drop etc. The company may also get affected by the delays in the execution of the long gestation projects, which might affect the cash flow from the projects that have a specific concession period. Apart from these, the increasing debt level also poses some risk to the future journey of L&T as it will increase the financial burden in the form of interest. The company's debt to equity ratio, currently, stands at 1.52:1, which is further poised to go up as more projects are set to kick in.

**Shareholding Pattern (%)**

| | |
|---|---|
| Promoters | 0.00 |
| **Public Shareholding:** | |
| Foreign Institutional Investors | 13.84 |
| MF's ,Financial Institutions | 32.68 |
| Insurance Companies | 5.12 |
| Bodies Corporates | 7.38 |
| Retail Holding, Trusts, NRIs & Others | 37.8 |

## Contents

## Company Profile & Business Summary

Larsen & Toubro (L&T) is a technology, engineering, construction and manufacturing company. It is one of the largest and most respected companies in India's private sector. Larsen & Toubro Limited is the biggest legacy of two Danish Engineers, who built a world-class organization that is professionally managed and a leader in India's engineering and construction industry. It was the business of cement that brought the young Henning Holck-Larsen and S.K. Toubro into India. They arrived on Indian shores as representatives of the Danish engineering firm F L Smidth & Co in connection with the merger of cement companies that later grouped into the Associated Cement Companies.

Together, Holck-Larsen and Toubro, founded the partnership firm of L&T in 1938, which was converted into a limited company on February 7, 1946. Today, this has metamorphosed into one of India's biggest success stories. The company has grown from humble origins to a large conglomerate spanning engineering and construction. ECC was conceived as Engineering Construction Corporation Limited in April 1944 and was incorporated as wholly owned subsidiary of Larsen & Toubro Limited. L&T's founders Holck - Larsen and Toubro laid the foundation for ECC.

**Larsen & Toubro**

- Turnkey Projects
- Construction
- Engineered Products & Systems
- Electrical & Electronic Products & Systems
- IT & Engineering Services
- Machinery Valves & Industrial Consumables
- Financial Services
- Shipbuilding

The division undertakes engineering, design and construction of infrastructure, buildings, factories, water supply and metallurgical & material handling projects covering civil, mechanical, electrical and instrumentation engineering disciplines

**Engineering, Construction & Contracts Division**

Engineering, Construction & Contracts Division (ECCD) undertakes engineering, design and construction of infrastructure, buildings, factories, water supply and metallurgical & material handling projects covering civil, mechanical, electrical and instrumentation engineering disciplines. Supported by a proven track record of over sixty-seven years, covering all types of buildings, industrial sectors and infrastructure development, the Division undertakes lump sum turnkey construction with single-source responsibility. The Division has to its credit many prestigious landmark constructions in the country. The Division has secured the 34th rank amongst the top 225 Global Contractors improving its ranking over the last 5 years from 54th rank in ENR 2006.

L&T's Hydrocarbon Business delivers 'design to build' world-class engineering and construction solutions on turnkey basis in oil & gas, petroleum refining, chemicals & petrochemicals and fertilizer sectors

**Engineering & Construction (Hydrocarbon) Division**

Engineering & Construction Division designs, engineers and executes worldclass projects for the hydrocarbon sector with single-point responsibility from front-end design through detailed engineering, modular fabrication, procurement, project management, construction and installation, to commissioning. Strategic alliances with world leaders enable the Division to access advanced know-how and deliver projects that meet stringent Health, Safety & Environment, quality requirements and time schedules. The Division has a good track record of executing large size and complex projects on turnkey basis in Oil & Gas, Petroleum Refining, Petrochemicals, Fertilisers and Water Technology sectors. Division's major capabilities include in-house engineering, R & D centers, engineering joint ventures with reputed international companies, offshore installation capabilities, world class fabrication facilities, experienced & competent project execution team and safe work culture.



L&T Power -an Independent Company of Larsen & Toubro, integrating its various offerings in the thermal power sector

**EPC Power Division**

The 2010-2011 has seen the emergence of EPC Power Division as a credible player in the power sector. This is gratifying as the success of EPC Power is critical to the Company's performance. Definitive steps have been taken by the Division, whereby, the Company will be providing equipment and services encompassing nearly 75% to 85% in value terms of a thermal power plant. On January 11, 2011, the Company dedicated its Boiler and Steam Turbine Generator manufacturing facilities at Hazira, Gujarat to the nation. The facilities have been set at an investment of nearly Rs. 2000 crore, to usher in a new era of super critical technology equipment in Indian power plants. The year also saw substantial progress in setting up the facilities for manufacture of Power Auxiliaries at Hazira. The high pressure piping fabrication facility was commissioned and production has commenced in March 2011.

L&T manufactures and supplies custom-designed, engineered critical equipment & systems to core sector industries like Fertilizer, Refinery, Petrochemical, Chemical, Oil & Gas, Thermal & Nuclear Power, Aerospace and Equipment & Systems for Defence applications

**Heavy Engineering Division**

Larsen & Toubro manufactures and supplies custom-designed, engineered critical equipment & systems to core sector industries like Fertilizer, Refinery, Petrochemical, Chemical, Oil & Gas, Thermal & Nuclear Power, Aerospace and Equipment & Systems for Defence applications. The division has manufacturing & fabrication facilities at Mumbai, Hazira, Baroda and Visakhapatnam. A Strategic Systems Complex for integration and testing of weapon systems, sensors and engineering systems is located at Talegaon in Maharashtra. A Precision Manufacturing Facility has been set up at Coimbatore in Tamil Nadu to cater to the needs of precision machined / manufactured components & assemblies.

Shipbuilding facility has been created at Hazira Works to cater to the needs of growing global demand for construction of specialized oceangoing vessels

**Ship Building Division**

The division has its ship building facility operational at Hazira in Gujarat. Construction of a new modern Shipyard is in progress at Katupalli in Tamilnadu. The new yard will focus on construction and repairs/refits of Defence and Specialized Commercial Vessels. The shipyard management is focusing on establishing proper systems and processes to increase the operational efficiencies and reduce cycle time to meet customer expectations on quality and delivery. There have been sustained efforts to tie-up with a major global shipyards for technology transfer.

Electrical & Automation business offers solutions in low & medium voltage categories. Its businesses comprise switchgear, electrical systems, energy meters, automation systems and medical equipment.

**Electrical & Electronics Division**

The division has Electrical & Automation and Medical Equipment & Systems businesses. While the former manufactures switchgear components and a host of electrical and automation products, the latter is a strategic business unit offering world class and state-of-the-art medical equipment to the medical fraternity. The Electrical & Automation has five manufacturing facilities in India and six overseas facilities located in the Gulf region, south-east Asia and the Asia Pacific. During 2010-2011, Medical Business saw increased acceptance for its Patient Monitors by renowned hospitals in the country. This business also upgraded the technology base for 'Pulse Oximetry' module and 'Non-Invasive Blood Pressure' module.

The division's portfolio comprises Construction Equipment Business, Mining Equipment Business, Construction & Mining Tipper Business, and Hydraulic Equipment Business

**Machinery & Industrial Products Division**

The division has maintained its leadership position in the Construction and Mining Equipment, exploiting opportunities in the market. Machinery & Industrial Products Division (MIPD) comprises three Strategic Business Groups - Construction & Mining Machinery (CM), Industrial Machinery (IM) and Industrial Products (IP). CM markets and renders support for Construction & Mining Equipment and comprises the Construction & Mining marketing unit, Service centers for Earthmoving Machines. Its manufacturing JV facility for Earthmoving Machinery is located at Bangalore and the facility for undercarriage systems of its Subsidiary is at Talegaon.

L&T Integrated Engineering Services has set up dedicated Centers-of-Excellence to adapt technologies for providing engineering solutions to its clients from all over the world.

**IT & Integrated Engineering Services**

Integrated Engineering Services (IES) provides leading-edge engineering solutions to multiple industry sectors covering automotive, aerospace, consumer electronics, consumer packaged goods, marine, medical devices, off-highway equipment, railways, pharmaceuticals, oil & gas, utilities and industrial products. It has global headquarter at Vadodara, Gujarat and operates from dedicated off-shore engineering centers at Vadodara, Mysore, Mumbai, Chennai and Bangalore in tandem with onsite teams to cater to engineering requirements of global clients, many of them are Fortune 500 Companies. It has more than 4,000 dedicated associates to deliver high-quality engineering and design solutions.

**Financial services**

L&T has a strong financial services division providing a range of services most of which are falling under the listed holding company of L&T Financial Holdings Ltd. The portfolio of the division comprises of Equipment finance, Infrastructure Finance, General Insurance, Mutual Fund, Portfolio Management Services etc

## Industry

Construction industry registered a higher growth of 8.1% for the year 2010-2011 led by an increased level of activity of industrial and infrastructure construction segments. The growth trend is likely to sustain through the next year on the back of renewed thrust on infrastructure. The real estate & ITeS facility construction has gained traction, despite stringent regulations and financing issues. Increasing award of public-private projects in Airports and Ports sectors, besides the conventional Roads & Bridges sector has also triggered the growth.

The growth trend in the construction industry is likely to revive through the next year on the back of renewed thrust on infrastructure. Increasing award of public-private projects in Airports and Ports sectors, besides the conventional Roads & Bridges sector would be the key catalysts for the growth.

The gross capital formation for 2010-2011 is lower at 7.6% as against 13.8% achieved in 2009-2010. The Core Industries registered a lower growth of 5.8% in 2010-2011, largely due to supply side constraints. The sluggish growth for the past 2-3 years in the Core Sector is dampening the fresh investment decisions. Similarly the industrial sectors saw an erratic growth trend during the year, thereby delaying new capex decisions. It is expected that with supply side constraints easing, the confidence will re-emerge for undertaking fresh capacity addition projects.

In the Hydrocarbon sector, many Greenfield and Brownfield projects in all segments of industry got deferred. Internationally the Middle East & North Africa (MENA) region is experiencing socio-political tensions, which is dampening the investment climate in the hydrocarbon and infrastructure sectors of the region. However, with the hardening of the crude prices, prospects for turnkey projects in the Hydrocarbon sector in India and the Middle East have increased.

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Investments in Power sector are expected to be good over the next 5 years. Power continues to be a thrust area in India due to the continuing scarcity across several regions. Several state owned entities and also Independent Power Producers (IPP) have planned new power plants as well as expansion of existing power plants based on thermal power, both gas and coal. Several measures are planned by the Government to promote investments in the power sector. While there is some slippage in achieving the targeted capacity additions during the $11^{th}$ Plan, major capacity additions in the thermal power segment have been planned during 12th Five-year Plan, with special thrust to super critical technology. The sector, however, needs to tackle environmental and social issues expeditiously, besides tying up fuel sources so as to achieve the targeted growth in capacity.

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In the heavy engineering division, the order inflow and sales were adversely impacted due to the overall sluggish global economic scenario. The deferment/cancellation of some of the planned projects across geographies has led to a drop in Export Orders. A number of domestic fertilizer projects are awaiting the announcement of Urea & Gas Allocation policy from the government. China offers a major business potential for Methanol plant equipment. With oil prices maintaining upward trends, the outlook for coal gasification equipment looks promising. In addition to China, there are opportunities in countries like Vietnam, Indonesia and Australia for coal gasification equipment. The IC also sees good business opportunity in prospective Indian CTL projects. Overall outlook for power plant business from Indian market is robust. However, competition from the Chinese and Korean suppliers is putting pressure on the pricing. Idle capacities with competitors are putting severe pressure on margins and terms of delivery. The localization policies of some of the countries and preference to local suppliers by some of the EPC Companies due to socio-political compulsions are putting the business at a disadvantage. Despite the intense competition, the IC sees good prospects from revival of overseas projects in grass root refineries and petrochemicals, as well as in refinery modification, revamps and upgrade at home.

The electrical sector in India is expected to significantly grow as a result of several Government initiatives. The business is optimistic of robust growth through its electrical and automation solutions in sectors such as power, infrastructure, oil & gas and cement in the coming years

The electrical sector in India is expected to significantly grow as a result of several Government initiatives. Allocation in Union Budget 2011-2012 for Rural Electrification projects under Rajiv Gandhi Grameen Vidyutikaran Yojana (RGGVY) is expected to boost electrical sector in the country. The Government has also envisaged significant capacity addition to meet its mission of power to all. These are major opportunities for the IC and will act as drivers of growth. The business is optimistic of robust growth through its electrical and automation solutions in sectors such as power, infrastructure, oil & gas and cement in the coming years. On international business front, Gulf markets are expected to be the major contributors. Various Oil & Gas projects in Gulf region are showing revival and Utility industries are coming up with new projects. The business envisages a major opportunity in Qatar for the FIFA 2022 World Cup for which preparations have already begun.

The potential for construction equipments is expected to improve in the years to come on account of the increase in spending in the urban infrastructure, roads, general construction sectors and spending by the Government on various infrastructure projects. It is expected that the Mining Equipment business will continue to see a growth on account of investments being made both in the public and private sectors to augment coal production.

Most International Construction equipment manufacturers are present in the Indian market on their own or in Joint Ventures with Indian Players. CMB continues to face close competition from other domestic players in excavator market. The business scenario in Oil & Gas looks very positive with close to US$ 170Bn investments in Middle East alone being planned. On Power sector front in India, many private players have successfully commissioned the supercritical power plants and confidently going ahead with more plants in 660MW size. This has attracted many international valve manufacturers to set up shop in India. The market demand for Hydraulic Excavators is expected to improve in the years to come on account of the increase in spending in the urban infrastructure, roads, general construction sectors and spending by the Government on various infrastructure projects. It is expected that the Mining Equipment business will continue to see a growth on account of investments being made both in the public and private sectors to augment coal production. The demand for metals like iron ore, zinc etc. is also expected to help growth of this business segment. The division is well placed to take advantage of these opportunities through supply of large size Mining Equipment both to the public and private coal producing companies. However, environmental and land acquisition issues may present impediments in the near term for expansion in mining equipment demand. The Valves business saw a return of order booking, both from the Hydrocarbon and Power sectors, during the year and this augurs well for the ensuing years. Overall, the Division envisages a moderate improvement in the Industrial growth indices going forward and its businesses are better equipped to harness the market potential.

Engineering R&D outsourcing to India is increasing at fast pace and analysts predict that this will quadruple to $ 40-45 billion by 2020 from $8.3 billion in 2009. The major growth in outsourcing to India is expected from Infrastructure, Energy, Chemical, Pharmaceutical, Consumer Electronics, Medical Devices, Automotive, and Aerospace domain because of the availability of capable technical workforce in India. Medical Devices and Aerospace are the most prominent sectors for the outsourcing having less competition between service providers. These industries are very reluctant to open captive units because of high cost of operation, giving a reasonable chance to service providers to harness the opportunity.

Increasing sophistication and maturity of Engineering R&D services industry has meant a significant change in customer perception of service providers. Customers have begun to view service providers as their strategic partners owing to greater confidence in their enhanced Engineering R&D capabilities. Companies are now providing services from basic process support to high value-added services such as full product development. In addition, customers have started looking to their Indian partners to leverage on their products.

The investment in emerging verticals of Aerospace and Medical Devices is expected to yield substantial results in terms of incremental revenues from these two verticals. Besides this, the addition of new services and European focused sales are also expected to be the main drivers of growth envisaged for the coming year.

## Financials

**Robust financial performance and expects the same to continue**

Larsen & Toubro has been registering a robust growth in revenue, at a CAGR of 50% between FY2008 and FY2011. During 2011, it has seen a surge of 18.45% over the previous year to reach Rs. 52089 crore from Rs. 43969.8 crore a year ago. Meanwhile, the profit after tax, during the five year period, grew at a CAGR of 24.5% to settle at Rs. 4384.31 crore. Meanwhile, the 9MFY12 performance was also impressive with the top line and bottom line inching up by 22% and 15% respectively. The strong performance, during the period, was mainly aided by the gigantic growth in the Engineering & Construction division. Going forward, we expect the company to post the revenue at a compounded growth rate of 19.4% during FY11-FY15E. Meanwhile, the PAT is estimated to grow at a CAGR of 11.1%.

The strong performance of L&T was mainly aided by the gigantic growth in the Engineering & Construction division. Going forward, we expect the company to post the revenue at a compounded growth rate of 19.4% during FY11-FY15E. Meanwhile, the PAT is estimated to grow at a CAGR of 11.1%.

**9M & Q3FY12 were impressive while margins took a hit**

Coming to the numbers of Q3FY12, Larsen has showcased a good picture. During the 9MFY12, the top line and bottom line have seen a growth of 21% and 17% respectively. Meanwhile, during Q3the top line and bottom line went up by 22.8% and 18% (yoy) respectively. During the period, the E&C division which contributes more than 85% to the topline, grew by 25% yoy to 12465 crores. On the margin side, the period saw a dip with the Ebitda going down to 9.6% from the earlier 10.7%.

**Margins were hit across the segments and expect the same to reverse going forward**

EBITDA margins declined by 120 basis points largely due to lower margins in electrical and electronics (E&E) division. The segment saw higher input costs not fully passed on to the customers, due to stiff competition kept the operating margins range bound at 10.9 per cent. Coming to other segments, the E&C unit recorded an operating margin of 11.5 per cent against 11.6 per cent in the corresponding quarter last year with focused execution and efficient project management. Machinery and industrial products, the higher margin segment registered the same at 20.3 %. To be exact, the main culprits for the margin contractions were the employee cost and selling and distribution expenses, which were shot up by 30% and 42% (yoy) respectively. The total expenditure, all together, also has increased by 24% almost in line with the quantum of execution reflected in top line. Meanwhile, raw material cost (adjusted with change in raw material inventory, a significant item to the company (that accounts for more than 30% of the expenditure book) has also seen a growth same as revenue, indicating the pressure of raw material price has been wiped out. As a percentage of the revenue too, it stood at 26.6 % against the same figure a year ago. Meanwhile, a higher other income, which includes dividend from subsidiaries and treasury gains, has also caused for the impressive growth in bottom line of 18%. Other income has gone up by 79% yoy to 448 crores, from a just 250 crores. Among others was the depreciation cost which saw a surge of 41% yoy (to 180 crores) and interest expenses which registered a comparatively lower 13% growth yoy despite the higher interest scenario. We assumed an Ebitda of 10.0% in our models versus the 10.5% and 11.3% during the 9MFY12 and 9MFY11 respectively.

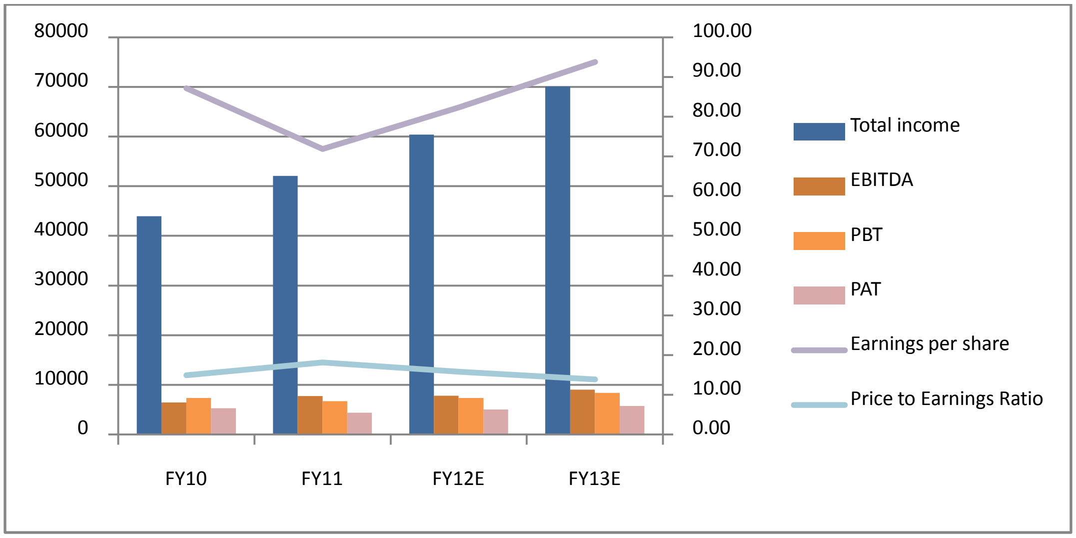
| *In Crores* | FY10 | FY11 | *FY12E* | *FY13E* |
|---|---|---|---|---|
| ***Total income*** | ***43969.8*** | ***52,089*** | ***60423.40*** | ***70091.15*** |
| Expenditures: | | | | |
| *Manufacturing, Construction and Opex (MCO)* | *32340.02* | *37540.89* | *44713.32* | *51867.45* |
| *Staff cost* | *3065.41* | 3801.95 | *4531.76* | *5256.84* |
| *Sales, admn and other expenses* | *2124.56* | 2988.80 | *3383.71* | *3925.10* |
| *Depreciation* | 979.32 | 1318.75 | *1510.59* | *1752.28* |
| *Other Income* | *758.51* | 919.13 | *1057.41* | *1226.60* |
| *interest and finance charges* | 691.92 | 830.86 | *966.77* | *1121.46* |
| Profit before exceptional items and tax | 5527.08 | 6527.02 | *6374.67* | *7394.62* |
| exceptional items | 1818.27 | 205.29 | *1000.00* | *1000.00* |
| *PBT* | *7345.35* | *6732.31* | *7374.67* | *8394.62* |
| Tax exp. | 2038.70 | 2355.39 | *2359.89* | *2686.28* |
| *PAT for the period* | *5306.65* | *4376.92* | *5014.77* | *5708.34* |
| Number of shares outstanding | 60.89 | 60.89 | 60.89 | 60.89 |
| Earnings per share | 87.16 | 71.89 | 82.36 | 93.76 |
| *Price to Earnings Ratio* | *14.92* | *18.08* | *15.78* | *13.87* |

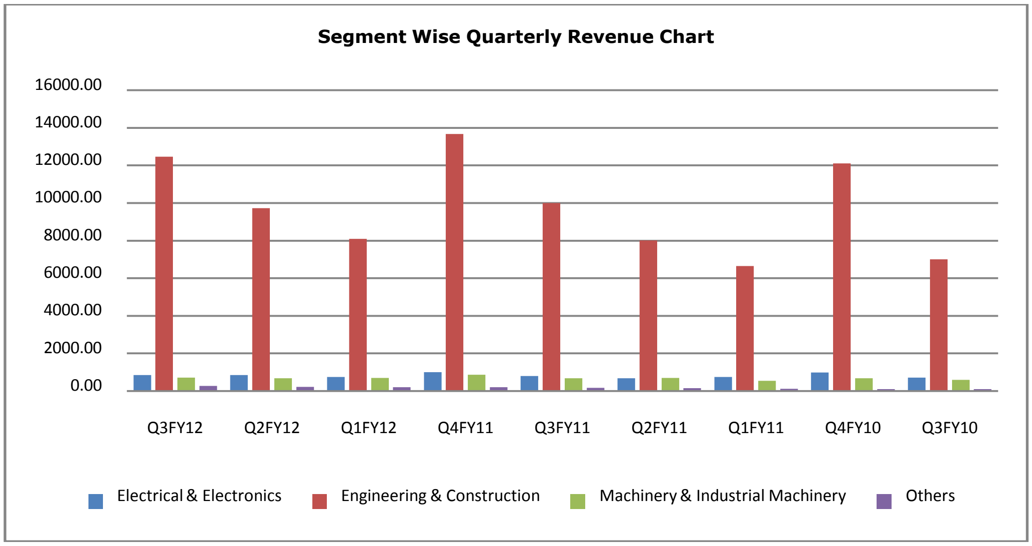
***Source: Company, Hedge Research***

We assume the E&C, E&E and MIP to grow at a decent, 20%, 10% and 20% respectively going forward and the profitability is also estimated to recover in the days to come.

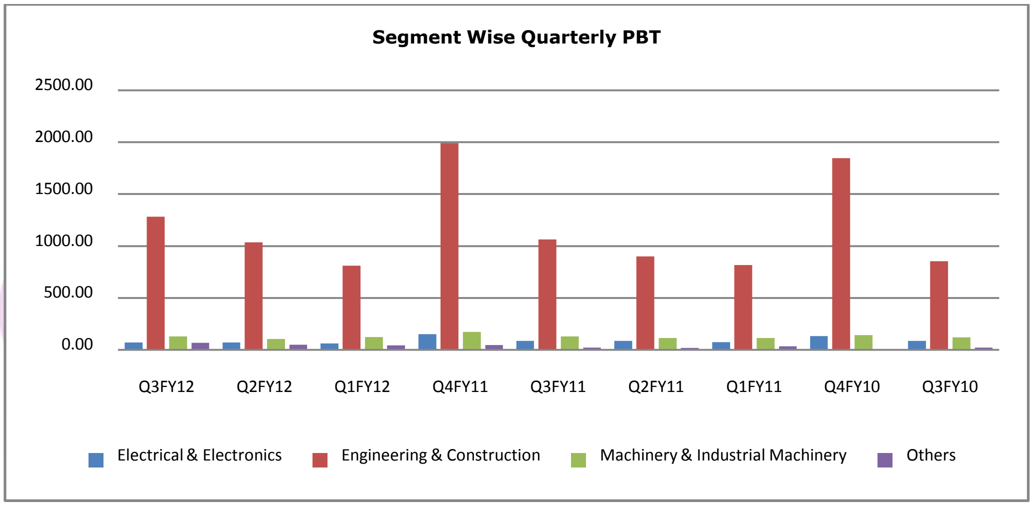
**E&C division segment to continue lead the company**

It has been E&C division that contributes the lion's share of the company's revenue (around 80-85%) and performs wells on the back of impressive order book, execution capabilities and higher cash flows. The segment saw a growth of 23% and 16% in revenues and EBITDA respectively. At the compounded rate, the business has witnessed a surge of 63% during FY08-FY12 on the basis of Q3 figures. And we expect the segment to sustain the momentum and grow at 20% going forward. Meanwhile, the performance of other segments like Electrical & Electronics (E&E) and Machinery & Industrial Products (MIP) during Q3FY12 were muted with the top line growth limiting to 6%. Meanwhile the E&E witnessed an 18% decline in the PBIT and that of MIP came in at a meager 1% yoy. We assume the E&E and MIP to grow at a decent 10% and 20% respectively going forward and the profitability is also estimated to recover in the days to come.



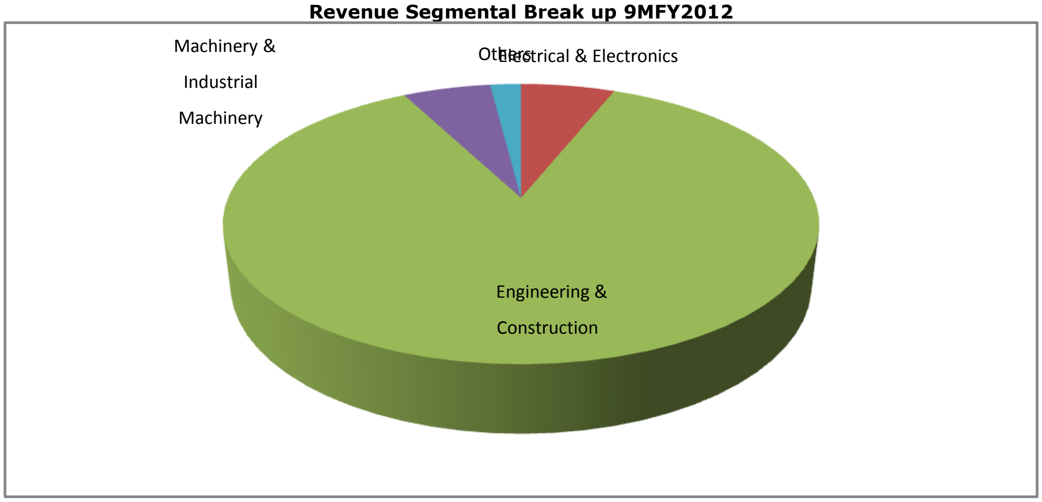



*Source: Company, Hedge Research*




*Source: Company, Hedge Research*

**Revenue Segmental Break up 9MFY2012**




*Source: Company*

## Order Inflow & Order book

### Order inflow - 3Q & 9MFY12

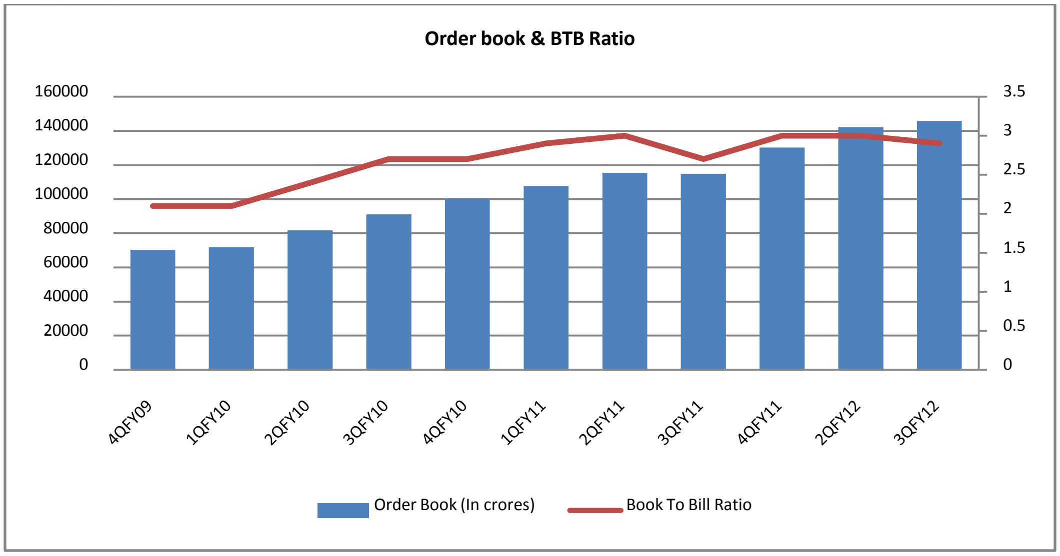
L&T registered strong growth of 28% in order inflows during the 3rd quarter. Order inflow for 3QFY2012 stands at 17,129 crore vs Rs 13,366 cr in Q3FY11, up by 28.2% yoy covering some of the lost ground in 1HFY2012. Major orders are bagged from the Infrastructure space (54.4%). The company is also witnessing good traction on the international front (hydrocarbon and T&D space) and sees a huge pipeline. Management has maintained its order inflow guidance to 5%, which implies a run rate of 13.3% yoy growth in 4QFY2012 to 34,342 crore, which looks steep considering the tough macro environment and high base. Over the last couple of quarters, the order inflows were affected by delays in the tendering process (such as environmental approvals and land acquisition), challenging business outlook with slowdown in capex activity and political issues.

Order inflow for 3QFY2012 stands at 17,129 crore vs Rs 13,366 crore in Q3FY11, up by 28.2% yoy covering some of the lost ground in 1HFY2012. As of 3QFY2012, L&T stands tall on an order backlog of 1, 45,768 crore against Rs 114,882 crore at the end of Q3 FY11 and Rs 142,185 crore at the end of Q2 FY12. With the current order book, book to book ratio (BTB ratio) stands at 3x its TTM revenue.

### Strong Order book gives a clear revenue visibility

As of 3QFY2012, L&T stands tall on an order backlog of 1, 45,768 crore against Rs 114,882 crore at the end of Q3 FY11 and Rs 142,185 crore at the end of Q2 FY12. With the current order book, book to book ratio (BTB ratio) stands at 3x its TTM revenue. Approximately two-third of the company's order book has pass through clause. L&T's order book is majorly dominated by the infra (40%) and power (29%) segments. Process (15%), hydrocarbon (11%) and others (5%) constitute the balance part of the order book. The company has given a guidance of 5% for order booking in FY2012, which is above our expectations.

Client wise, 38% of L&T's outstanding order book comes from the public sector and 48% from the private sector. Captive work orders account for the balance 14%. Notably, there has been a drop in the share of public sector orders in last few quarters. The order book mix between fixed and variable contracts stand at 2/3:1/3.




**Source: Company, Hedge Research**

Our SOTP based valuation model values the company at Rs. 1433 on the basis of the current projects. At the CMP of Rs.1351, Larsen is trading at 18.8x its TTM EPS of Rs.71.63 and 14.40x its FY13E EPS of Rs.93.76 which looks impressive as its peers, as a whole, are trading at 19.44x their TTM EPS. It may be noted here that the L&T stock has historically traded at a premium to the Peers as well as the market. At our SOTP target price, the stock would trade at 15.28x FY2013E EPS of Rs. 93.76, which is lower than the historical premium commanded by L&T over BSE Sensex and the industry peers.

## Valuations

### SOTP model values the stock at Rs.1433

Our SOTP based valuation model values the company at Rs.1433. We haven't factored in any projects that the company is likely to win in the future. The standalone business accounts for the major portion of the value to the tune of Rs. 841 to the share price (adjusted for the standalone cash balance), followed by the developmental projects at Rs.275.

| | *Method* | *Val Multiple* | *Value (In Cr.)* | *Value/share* |
|---|---|---|---|---|
| ***Standalone Business*** | *DCF* | | *INR 51,459* | *INR 841* |
| ***Subsidiary Companies*** | | | | |
| **L&T Infotech** | PE | 12 | INR 4,451 | INR 73 |
| **L&T Finance** | Book Value | 3 | INR 7,040 | INR 96 |
| **L&T Infra finance** | Book Value | 2 | INR 203 | INR 3 |
| **Larsen & Toubro International FZE** | Book Value | 2 | INR 1,719 | INR 28 |
| **Developmental Projects** | Capital infused | 3 | INR 16,800 | INR 275 |
| **JVs** | Capital infused | 2 | INR 7,200 | INR 118 |
| ***Subsidiaries' value*** | | | | *INR 592* |
| **Grand Total** | | | | **INR 1,433** |

*Source: Hedge Research*

For arriving at the parent company valuation, we took the standalone company and other business ventures one after another for the valuation. The DCF model of the standalone company is based on the conservative assumptions. As the standalone entity itself has different business segments, we've given separate assumptions for each segment. We assumed a 20% growth rate for the E&C segment, 10% for Electricals & Electronics and 20% for Machinery and Industrial equipments, which work out to an overall standalone growth rate of 19.45% till FY16. Our model also factors in the dip in the EBITDA margin assuming the margin at 10% vs. the 10.5% during the 9MFY12. Meanwhile, the subsidiaries as a whole constitute a value of Rs.592 per share. As per this, we initiate coverage with a 'BUY' recommendation on the stock below Rs. 1075.

### PE Valuation, too, looks attractive

At the CMP of Rs.1351, Larsen is trading at 18.8x its TTM EPS of Rs.71.63 and 14.40x its FY13E EPS of Rs.93.76 which looks impressive as its peers, as a whole, are trading at 19.44x their TTM EPS. Recently, the stock price has come down drastically making the valuations attractive mainly on the back of some global macro developments as well as some weakness seen in the industry. As the concerns started slackening, investors with a long term point of view can make use of this opportunity.

It may be noted here that the L&T stock has historically traded at a premium to the Peers as well as the market. At our SOTP target price, the stock would trade at 15.28x FY2013E EPS of Rs. 93.76, which is lower than the historical premium commanded by L&T over BSE Sensex and the industry peers.

## Investment Rationale

**Best stock to play the Indian infrastructure theme**

We believe L&T is best placed to benefit from the gradual recovery in the capex cycle, given its diverse exposure to sectors, strong balance sheet and cash flow generation as compared to its peers, which grapple with issues such as strained cash flow, high leverage and limited net worth and technological capabilities.

**Presence in diversified businesses**

Larsen & Toubro's business as a whole are diversified in nature with the presence in different areas of businesses like Turnkey projects, construction, engineered products & systems, electrical & electronic products & systems, IT& Engineering services, Machinery Valves & Industrial Consumables, Financial Services, Shipbuilding etc would help the company to withstand the concerns in particular sectors.

**Strong order book**

As of 3QFY2012, L&T stands tall on an order backlog of 1, 45,768 crore against Rs 114,882 crore at the end of Q3 FY11 and Rs 142,185 crore at the end of Q2 FY12. With the current order book, book to book ratio (BTB ratio) stands at 3x its TTM revenue. L&T's order book is majorly dominated by the infra (40%) and power (29%) segments. Process (15%), hydrocarbon (11%) and others (5%) constitute the balance part of the order book. The company has given a guidance of 5% for order booking in FY2012, which is above our expectations.

**Robust growth in the pipeline**

With the huge orders in hand, presence in diversified business and the reviving macro trend, the company is poised for a remarkable growth in the days to come. We expect the company to post the revenue at a compounded growth rate of 19.4% during FY11-FY15E. Meanwhile, the PAT is estimated to grow at a CAGR of 11.1%.

**International Presence**

L&T has got international presence which enables it to make use of growing opportunities in other emerging markets and to diversify the geographical risk. Recent developments in the Middle East & North Africa have also adversely affected the business prospects in our traditional markets with many projects on hold. In spite of such challenging trends, L&T has been able to sustain its momentum in the overseas markets with the 15% of the orders, during 9MFY12, coming from Middle East. Also, the company's total order book, as of Q3FY12, has a 10% of orders from Middle East.

**Concerns overdone**

The L&T stock has underperformed the BSE Sensex by around 25% in the last three months, owing to factors such as slowing order inflows and rising competition (especially in the BTG equipment segment), leading to fears of slippage on revised order inflow guidance. We believe though L&T would find it difficult to meet its guidance for FY2012, it is better placed than its peers on a number of parameters (such as diversification and balance sheet strength), and further its current market price factors in the short-term negatives.

## Risks

**Global situation stands as a foremost concern**
At the macro level, the current global economic scenario presents is the most worrying risk factor, as a fall of the global economy into a double-dip recession can lead to a slower growth in our economy which would translate into a contraction in the infrastructure sector as a whole, as any economy is directly and indirectly related to global economy.

**Further spike in commodity prices to hit bottom line**
Global commodity prices have shot up into buoyant levels, which had affected the company's margins. In spite of that, the company managed to bring down the cost by adopting different measures. Though our valuation model factored in high commodity prices, unusual further surge in the prices of commodities such as copper, steel etc would change the scenario whereby the earnings of the company would directly be affected.

**Slowdown in award activity**
An unfavorable political climate, logjams relating to clearances for projects stifle fresh order intake growth, hampering earnings growth, which would impede IRB's potential to secure new profitable projects. Company's construction business mainly caters to its BOT vertical and IRB's inability to get more BOT projects could affect MRM.

**Macro headwinds like higher interest rate, if don't ease, might affect the company in the long run**
The company has been majorly into long gestation projects which require huge investments with a significant amount of leverage. L&T has a debt equity mix of 67:33. Hence, increase in interest rates would adversely impact equity IRR and NPV of projects. Further higher interest rates would also mean higher discount rate. Delay or non- availability of long term funds could also be detrimental to the viability of the projects.

**Stiff competition leads to aggressive bidding, margin pressure, and slowness in order intake**
The company is operating in a highly competitive environment. Relatively, there have been different players in each of the industry the company operates like construction, power equipment, Electricals, IT, financial services etc. The hardening of competition has resulted into aggressive bidding. This may lead to margin pressure and slowness in order intake.

**Higher dependence on Capital investments**

Government's indecisiveness and policy paralysis amidst global concerns have turned out to be the single most important factor limiting fresh investments by Corporate India. Even seemingly non important events like loan scam, telecom scam, etc have, Eventually, clogged the wheels of growth for the ECG sector. Government spending, erstwhile considered secular, has seen a sharp slow-down in growth momentum. It has come down from 16-17% in FY06-08 period to about 7-9% during FY10-11 period. Investment decisions have been hit across sectors.

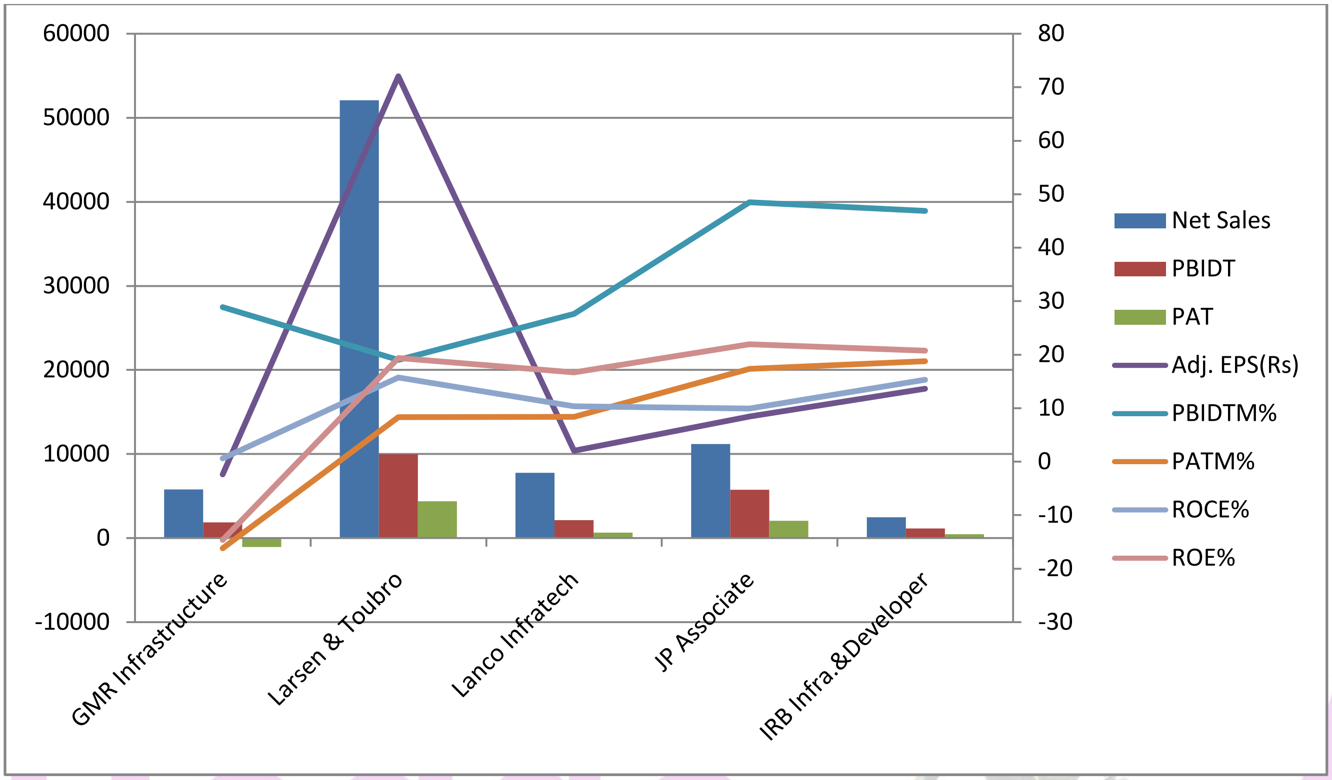
## Financial Highlights

| DESCRIPTION | Mar-11 | Mar-10 | Mar-09 | Mar-08 | Mar-07 |
|---|---|---|---|---|---|
| **Inc / Exp Performance** | | | | | |
| **Gross Sales** | 52515.58 | 44310.46 | 40931.93 | 29819.46 | 20877.32 |
| **Total Income** | 53313.19 | 46593.22 | 41178.65 | 29882.00 | 21406.58 |
| **Total Expenditure** | 43331.21 | 36748.36 | 34845.43 | 25327.93 | 17705.27 |
| **PBIDT** | 9981.98 | 9844.86 | 6333.22 | 4554.07 | 3701.31 |
| **PBIT** | 8663.13 | 8865.54 | 5604.90 | 4044.33 | 3356.45 |
| **PBT** | 6732.21 | 7345.35 | 4360.33 | 3418.62 | 3005.03 |
| **PAT** | 4384.31 | 5307.95 | 2935.46 | 2271.50 | 2272.31 |
| **Sources of Funds** | | | | | |
| **Equity Paid Up** | 121.77 | 120.44 | 117.14 | 58.47 | 56.65 |
| **Reserves and Surplus** | 24514.93 | 20521.37 | 13598.09 | 10628.33 | 6785.49 |
| **Net Worth** | 24607.05 | 20611.00 | 13682.84 | 10632.36 | 6797.13 |
| **Total Debt** | 37340.19 | 24607.32 | 20370.04 | 12315.93 | 6432.22 |
| **Capital Employed** | 63387.09 | 46655.02 | 35383.93 | 24015.22 | 13954.46 |
| **Application of Funds** | | | | | |
| **Gross Block** | 20521.62 | 16108.12 | 12461.96 | 7988.11 | 6227.67 |
| **Investments** | 9215.80 | 9860.86 | 6805.40 | 5552.28 | 2478.28 |
| **Cash and Bank balance** | 3645.44 | 3321.59 | 1459.04 | 1560.78 | 1718.02 |
| **Net Current Assets** | 26348.16 | 17999.06 | 13123.79 | 10087.09 | 6171.52 |
| **Total Current Liabilities** | 32493.42 | 24644.30 | 20855.83 | 15694.57 | 10541.79 |
| **Total Assets** | 63416.74 | 46685.83 | 35416.32 | 24069.66 | 13999.47 |
| **Cash Flow** | | | | | |
| **Cash Flow from Operations** | -1586.74 | 2117.84 | 495.96 | -1239.22 | 2324.39 |
| **Cash Flow from Investing activities** | -5957.59 | -4997.04 | -5076.89 | -6615.34 | -2562.49 |
| **Cash Flow from Finance activities** | 7868.18 | 4770.05 | 4479.19 | 7697.32 | 1140.13 |
| **Free Cash flow** | 5366.54 | 4690.04 | 2176.63 | 2989.18 | -290.24 |
| **Key Ratios** | | | | | |
| **Debt to Equity(x)** | 1.52 | 1.19 | 1.49 | 1.16 | 0.95 |
| **Current Ratio(x)** | 1.81 | 1.73 | 1.63 | 1.64 | 1.59 |
| **ROCE(%)** | 15.75 | 21.61 | 18.87 | 21.30 | 29.87 |
| **RONW(%)** | 19.39 | 30.96 | 24.15 | 26.07 | 38.93 |
| **PBIDTM(%)** | 19.01 | 22.22 | 15.47 | 15.27 | 17.73 |
| **PATM(%)** | 8.35 | 11.98 | 7.17 | 7.62 | 10.88 |
| **Market Cues** | | | | | |
| **High Price (Unit Curr.)** | 2212.00 | 1800.00 | 1631.00 | 2335.00 | 889.00 |
| **Low Price (Unit Curr.)** | 1463.05 | 663.00 | 557.00 | 754.00 | 451.31 |
| **Market Capitalization** | 100658.13 | 97938.80 | 39397.11 | 88430.03 | 45862.42 |
| **Adjusted EPS** | 72.03 | 88.26 | 51.51 | 39.77 | 39.54 |
| **Price / Book Value(x)** | 4.09 | 4.75 | 2.88 | 8.32 | 6.75 |
| **Equity Dividend %** | 725.00 | 625.00 | 525.00 | 850.00 | 650.00 |
| **Enterprise Value** | 134352.88 | 119224.53 | 58308.11 | 99185.18 | 50576.62 |
| **Dividend Yield %** | 0.88 | 0.77 | 1.56 | 0.56 | 0.80 |

## Financial Ratios

| DESCRIPTION | Mar-11 | Mar-10 | Mar-09 | Mar-08 | Mar-07 |
|---|---|---|---|---|---|
| **Operational & Financial Ratios** | | | | | |
| Adjusted EPS (Rs.) | 72.03 | 88.26 | 51.51 | 39.77 | 39.54 |
| Adj DPS(Rs) | 14.50 | 12.50 | 10.50 | 17.00 | 13.00 |
| Book Value (Rs) | 404.16 | 342.26 | 233.62 | 363.69 | 239.97 |
| Adjusted Book Value (Rs) | 404.16 | 342.26 | 233.62 | 181.84 | 119.98 |
| Dividend Pay Out Ratio(%) | 20.13 | 14.16 | 20.38 | 21.37 | 16.44 |
| **Margin Ratios** | | | | | |
| PBIDTM (%) | 19.01 | 22.22 | 15.47 | 15.27 | 17.73 |
| EBITM (%) | 16.50 | 20.01 | 13.69 | 13.56 | 16.08 |
| Pre Tax Margin(%) | 12.82 | 16.58 | 10.65 | 11.46 | 14.39 |
| PATM (%) | 8.35 | 11.98 | 7.17 | 7.62 | 10.88 |
| CPM(%) | 10.86 | 14.19 | 8.95 | 9.33 | 12.54 |
| **Performance Ratios** | | | | | |
| ROA (%) | 7.96 | 12.93 | 9.87 | 11.93 | 20.14 |
| ROE (%) | 19.39 | 30.96 | 24.15 | 26.07 | 38.93 |
| ROCE (%) | 15.75 | 21.61 | 18.87 | 21.30 | 29.87 |
| Asset Turnover(x) | 0.95 | 1.08 | 1.38 | 1.57 | 1.85 |
| Inventory Turnover(x) | 19.14 | 17.91 | 10.89 | 6.86 | 6.78 |
| Debtors Turnover(x) | 3.89 | 3.69 | 4.15 | 4.16 | 3.67 |
| Fixed Asset Turnover (x) | 2.87 | 3.10 | 4.00 | 4.20 | 3.92 |
| Sales(x)/Working Capital | 1.99 | 2.46 | 3.12 | 2.96 | 3.38 |
| **Efficiency Ratios** | | | | | |
| Fixed Capital/Sales(x) | 0.35 | 0.32 | 0.25 | 0.24 | 0.25 |
| Receivable days | 93.84 | 98.90 | 87.95 | 87.79 | 99.59 |
| Inventory Days | 19.07 | 20.38 | 33.53 | 53.23 | 53.81 |
| Payable days | 124.40 | 105.14 | 89.24 | 90.61 | 91.93 |
| **Growth Ratio** | | | | | |
| Net Sales Growth(%) | 18.47 | 8.54 | 37.53 | 43.60 | 23.86 |
| Core EBITDA Growth(%) | 1.39 | 55.45 | 39.07 | 23.04 | 65.99 |
| EBIT Growth(%) | -2.28 | 58.17 | 38.59 | 20.49 | 68.98 |
| PAT Growth(%) | -17.40 | 80.82 | 29.23 | -0.04 | 83.71 |
| EPS Growth(%) | -18.39 | 71.34 | -35.24 | 0.57 | -12.89 |
| **Financial Stability Ratios** | | | | | |
| Total Debt/Equity(x) | 1.52 | 1.19 | 1.49 | 1.16 | 0.95 |
| Current Ratio(x) | 1.81 | 1.73 | 1.63 | 1.64 | 1.59 |
| Quick Ratio(x) | 1.72 | 1.63 | 1.51 | 1.32 | 1.24 |
| Interest Cover(x) | 4.49 | 5.83 | 4.50 | 6.46 | 9.55 |
| Total Debt/Mcap(x) | 0.37 | 0.25 | 0.52 | 0.28 | 0.28 |

## Financials Graph and Peer Group Comparison




### Peer Group Comparison FY2011

| Company Name | Net Sales | PBIDT | PAT | Adj. PS(Rs) | PBIDTM% | PATM% | ROCE% | ROE% |
|---|---|---|---|---|---|---|---|---|
| **GMR Infrastructure** | 5773.78 | 1866.79 | -1046.6 | -2.4 | 28.87 | -16.19 | 0.63 | -14.6 |
| **Larsen & Toubro** | 52089.14 | 9981.98 | 4384.31 | 72.03 | 19.01 | 8.35 | 15.75 | 19.39 |
| **Lanco Infratech** | 7783.73 | 2148.66 | 654.52 | 2.02 | 27.6 | 8.41 | 10.39 | 16.67 |
| **JP Associate** | 11196.67 | 5757.06 | 2059.03 | 8.43 | 48.5 | 17.35 | 9.93 | 21.93 |
| **IRB Infra.&Developer** | 2470.54 | 1158.41 | 464.09 | 13.61 | 46.89 | 18.79 | 15.32 | 20.76 |

## Analyst Notes And Company News

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