

## Industry meetings re-confirm negative outlook Macro scenario remains worrisome even as stock outperforms; retain Reduce

September 13, 2012

|  |               |
|--|---------------|
| <b>Rating</b><br>Remains                   | <b>Reduce</b> |
| <b>Target price</b><br>Increased from 992  | INR 1100      |
| <b>Closing price</b><br>September 12, 2012 | INR 1409      |
| <b>Potential downside</b>                  | -21.9%        |

### Action: Retain Reduce rating on challenging macro conditions

- L&T has announced INR289bn of orders YTD (35% of FY13 guidance) despite challenging macro conditions. We think the momentum is likely to slow in 2HFY13 to ~INR150bn/quarter.
- Further, our meetings with peers/consultants confirm negative margin/ROE outlook from Middle East orders. We also note rising challenges in the roads sector, and despite good inflow in the buildings segment, we see risk of an elongated execution and payment cycle.
- Our analysis of foreign and other manufacturing subsidiaries' financials suggests subpar ROE generation at their level even as capital employed continues to increase, suggesting consolidated ROE is not hampered only by investments in developmental projects.

### Catalysts: Macro worsening, orders and margins

We believe worsening macro conditions, disappointment on order inflow guidance and margin squeeze will be key triggers for the stock's de-rating.

### Valuation: Raising estimates to factor in higher dividend from subsidiaries, while TP benefits from roll-over and switch to DCF

We switch our valuation methodology to DCF with 13.5% Ke, terminal year margin and growth assumptions of 10.5% and 6% respectively, to arrive at INR782/share value for the standalone entity. The implied FY14F P/E on adjusted EPS is thus 12.5x, which we see as reasonable. Our terminal year assumptions imply a 10.5% CAGR in orders over FY13-20 to reach USD25bn in FY20. We value the subsidiaries and other investments at INR318 and thus arrive at our revised TP of INR1100/share.

| 31 Mar                            | FY12    | FY13F   |         | FY14F   |         | FY15F   |      |
|-----------------------------------|---------|---------|---------|---------|---------|---------|------|
| Currency (INR)                    | Actual  | Old     | New     | Old     | New     | Old     | New  |
| <b>Revenue (mn)</b>               | 531,705 | 621,714 | 610,364 | 676,752 | 655,098 | 727,689 |      |
| <b>Reported net profit (mn)</b>   | 44,565  | 46,186  | 46,651  | 41,778  | 43,841  | 48,732  |      |
| <b>Normalised net profit (mn)</b> | 44,015  | 46,186  | 46,651  | 41,778  | 43,841  | 48,732  |      |
| <b>FD normalised EPS</b>          | 71.11   | 74.62   | 76.18   | 67.50   | 71.59   | 79.58   |      |
| <b>FD norm. EPS growth (%)</b>    | 20.1    | 4.9     | 7.1     | -9.5    | -6.0    | 11.2    |      |
| <b>FD normalised P/E (x)</b>      | 19.2    | N/A     | 18.0    | N/A     | 19.1    | N/A     | 17.2 |
| <b>EV/EBITDA (x)</b>              | 14.6    | N/A     | 13.0    | N/A     | 13.3    | N/A     | 11.7 |
| <b>Price/book (x)</b>             | 3.4     | N/A     | 2.9     | N/A     | 2.6     | N/A     | 2.4  |
| <b>Dividend yield (%)</b>         | 1.3     | N/A     | 1.6     | N/A     | 1.5     | N/A     | 1.6  |
| <b>ROE (%)</b>                    | 18.9    | 17.0    | 17.3    | 13.6    | 14.5    | 14.6    |      |
| <b>Net debt/equity (%)</b>        | 31.7    | 36.1    | 23.3    | 33.3    | 17.7    | 11.1    |      |

Source: Company data, Nomura estimates

**Key company data:** See page 2 for company data and detailed price/index chart.

### Anchor themes

L&T is arguably India's best play on the infrastructure and corporate capex cycle. However, an unfavourable macro-environment and impediments on new orders driven by policy paralysis across sectors plagues the medium-term growth and margin outlook for the company, in our view.

### Nomura vs consensus

We are 16% lower than consensus on FY14F PAT estimates and ~23% below consensus on the assigned target price.

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See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

# Key data on Larsen & Toubro

## Income statement (INRmn)

| Year-end 31 Mar             | FY11           | FY12           | FY13F          | FY14F          | FY15F          |
|-----------------------------|----------------|----------------|----------------|----------------|----------------|
| <b>Revenue</b>              | <b>439,059</b> | <b>531,705</b> | <b>610,364</b> | <b>655,098</b> | <b>727,689</b> |
| Cost of goods sold          | -368,975       | -453,831       | -523,940       | -569,492       | -632,471       |
| <b>Gross profit</b>         | <b>70,084</b>  | <b>77,874</b>  | <b>86,424</b>  | <b>85,606</b>  | <b>95,218</b>  |
| SG&A                        | -19,778        | -22,230        | -25,565        | -28,121        | -30,933        |
| Employee share expense      |                |                |                |                |                |
| <b>Operating profit</b>     | <b>50,306</b>  | <b>55,644</b>  | <b>60,859</b>  | <b>57,485</b>  | <b>64,285</b>  |
| <b>EBITDA</b>               | <b>56,298</b>  | <b>62,639</b>  | <b>69,026</b>  | <b>66,755</b>  | <b>74,658</b>  |
| Depreciation                | -5,992         | -6,995         | -8,167         | -9,270         | -10,373        |
| Amortisation                |                |                |                |                |                |
| EBIT                        | 50,306         | 55,644         | 60,859         | 57,485         | 64,285         |
| Net interest expense        | -6,193         | -6,661         | -8,311         | -7,169         | -6,333         |
| Associates & JCEs           | 0              | 0              | 0              | 0              | 0              |
| Other income                | 11,572         | 13,570         | 14,097         | 12,314         | 11,666         |
| <b>Earnings before tax</b>  | <b>55,686</b>  | <b>62,553</b>  | <b>66,645</b>  | <b>62,630</b>  | <b>69,617</b>  |
| Income tax                  | -19,436        | -18,538        | -19,993        | -18,789        | -20,885        |
| <b>Net profit after tax</b> | <b>36,250</b>  | <b>44,015</b>  | <b>46,651</b>  | <b>43,841</b>  | <b>48,732</b>  |
| Minority interests          |                |                |                |                |                |
| Other items                 |                |                |                |                |                |
| Preferred dividends         |                |                |                |                |                |
| <b>Normalised NPAT</b>      | <b>36,250</b>  | <b>44,015</b>  | <b>46,651</b>  | <b>43,841</b>  | <b>48,732</b>  |
| Extraordinary items         | 3,329          | 550            | 0              | 0              | 0              |
| <b>Reported NPAT</b>        | <b>39,579</b>  | <b>44,565</b>  | <b>46,651</b>  | <b>43,841</b>  | <b>48,732</b>  |
| Dividends                   | -9,957         | -11,119        | -13,179        | -12,385        | -13,767        |
| <b>Transfer to reserves</b> | <b>29,622</b>  | <b>33,446</b>  | <b>33,472</b>  | <b>31,456</b>  | <b>34,965</b>  |

## Valuation and ratio analysis

|                                       |      |      |      |      |      |
|---------------------------------------|------|------|------|------|------|
| Reported P/E (x)                      | 21.2 | 19.0 | 18.0 | 19.1 | 17.2 |
| Normalised P/E (x)                    | 23.1 | 19.2 | 18.0 | 19.1 | 17.2 |
| FD normalised P/E (x)                 | 23.1 | 19.2 | 18.0 | 19.1 | 17.2 |
| FD normalised P/E at price target (x) | 18.4 | 15.3 | 14.3 | 15.2 | 13.7 |
| Dividend yield (%)                    | 1.2  | 1.3  | 1.6  | 1.5  | 1.6  |
| Price/cashflow (x)                    | 21.9 | 90.5 | 22.6 | 18.8 | 17.8 |
| Price/book (x)                        | 3.8  | 3.4  | 2.9  | 2.6  | 2.4  |
| EV/EBITDA (x)                         | 15.7 | 14.6 | 13.0 | 13.3 | 11.7 |
| EV/EBIT (x)                           | 17.6 | 16.4 | 14.8 | 15.4 | 13.5 |
| Gross margin (%)                      | 16.0 | 14.6 | 14.2 | 13.1 | 13.1 |
| EBITDA margin (%)                     | 12.8 | 11.8 | 11.3 | 10.2 | 10.3 |
| EBIT margin (%)                       | 11.5 | 10.5 | 10.0 | 8.8  | 8.8  |
| Net margin (%)                        | 9.0  | 8.4  | 7.6  | 6.7  | 6.7  |
| Effective tax rate (%)                | 34.9 | 29.6 | 30.0 | 30.0 | 30.0 |
| Dividend payout (%)                   | 25.2 | 25.0 | 28.3 | 28.3 | 28.3 |
| Capex to sales (%)                    | 4.1  | 3.0  | 2.5  | 2.3  | 2.1  |
| Capex to depreciation (x)             | 3.0  | 2.3  | 1.8  | 1.6  | 1.4  |
| ROE (%)                               | 19.7 | 18.9 | 17.3 | 14.5 | 14.6 |
| ROA (pretax %)                        | 10.0 | 9.2  | 8.8  | 7.7  | 8.1  |

## Growth (%)

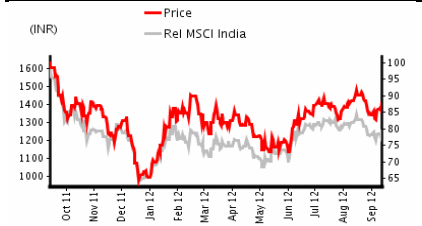
|                  |      |      |      |      |      |
|------------------|------|------|------|------|------|
| Revenue          | 18.6 | 21.1 | 14.8 | 7.3  | 11.1 |
| EBITDA           | 16.9 | 11.3 | 10.2 | -3.3 | 11.8 |
| EBIT             | 14.3 | 10.6 | 9.4  | -5.5 | 11.8 |
| Normalised EPS   | 15.8 | 20.1 | 7.1  | -6.0 | 11.2 |
| Normalised FDEPS | 15.8 | 20.1 | 7.1  | -6.0 | 11.2 |

## Per share

|                              |        |        |        |        |        |
|------------------------------|--------|--------|--------|--------|--------|
| Reported EPS (INR)           | 64.63  | 72.00  | 76.18  | 71.59  | 79.58  |
| Norm EPS (INR)               | 59.19  | 71.11  | 76.18  | 71.59  | 79.58  |
| Fully diluted norm EPS (INR) | 59.19  | 71.11  | 76.18  | 71.59  | 79.58  |
| Book value per share (INR)   | 356.73 | 407.52 | 466.53 | 517.89 | 574.99 |
| DPS (INR)                    | 16.26  | 17.96  | 21.52  | 20.22  | 22.48  |

Source: Company data, Nomura estimates

## Relative performance chart (one year)



Source: ThomsonReuters, Nomura research

|                                  |             |     |       |
|----------------------------------|-------------|-----|-------|
| (%)                              | 1M          | 3M  | 12M   |
| Absolute (INR)                   | -3.5        | 7.3 | -18.6 |
| Absolute (USD)                   | -3.7        | 6.5 | -32.1 |
| Relative to index                | -4.0        | 1.5 | -21.7 |
| Market cap (USDmn)               | 15,008.1    |     |       |
| Estimated free float (%)         | 69.5        |     |       |
| 52-week range (INR)              | 1723/969.15 |     |       |
| 3-mth avg daily turnover (USDmn) | 47.14       |     |       |
| Major shareholders (%)           |             |     |       |
| LIC India                        | 18.0        |     |       |
| L&T Employees Welfare Foundation | 12.2        |     |       |

Source: Thomson Reuters, Nomura research

## Notes

We forecast single-digit revenue growth in FY14F

**Cashflow (INRmn)**

| Year-end 31 Mar                      | FY11           | FY12           | FY13F          | FY14F          | FY15F          |
|--------------------------------------|----------------|----------------|----------------|----------------|----------------|
| EBITDA                               | 56,298         | 62,639         | 69,026         | 66,755         | 74,658         |
| Change in working capital            | -17,107        | -40,895        | -13,624        | -5,114         | -8,299         |
| Other operating cashflow             | -859           | -12,386        | -18,291        | -17,086        | -19,182        |
| <b>Cashflow from operations</b>      | <b>38,333</b>  | <b>9,358</b>   | <b>37,112</b>  | <b>44,555</b>  | <b>47,177</b>  |
| Capital expenditure                  | -17,987        | -15,938        | -15,000        | -15,000        | -15,000        |
| <b>Free cashflow</b>                 | <b>20,346</b>  | <b>-6,580</b>  | <b>22,112</b>  | <b>29,555</b>  | <b>32,177</b>  |
| Reduction in investments             | -9,795         | -11,871        | 0              | -10,000        | -5,000         |
| Net acquisitions                     |                |                |                |                |                |
| Reduction in other LT assets         | 256            | 2,651          | 212            | 0              | 0              |
| Addition in other LT liabilities     | 1,605          | -407           | 0              | 0              | 0              |
| Adjustments                          | 1,821          | 4,476          | 12,363         | 10,611         | 9,963          |
| <b>Cashflow after investing acts</b> | <b>14,233</b>  | <b>-11,731</b> | <b>34,686</b>  | <b>30,166</b>  | <b>37,139</b>  |
| Cash dividends                       | -8,670         | -11,119        | -13,179        | -12,385        | -13,767        |
| Equity issue                         | 3,473          | 3,913          | 0              | 0              | 0              |
| Debt issue                           | -214           | 27,347         | -16,290        | -8,826         | -19,755        |
| Convertible debt issue               |                |                |                |                |                |
| Others                               | -5,837         | -6,661         | -8,311         | -7,169         | -6,333         |
| <b>Cashflow from financial acts</b>  | <b>-11,248</b> | <b>13,480</b>  | <b>-37,780</b> | <b>-28,381</b> | <b>-39,855</b> |
| <b>Net cashflow</b>                  | <b>2,985</b>   | <b>1,749</b>   | <b>-3,094</b>  | <b>1,785</b>   | <b>-2,715</b>  |
| Beginning cash                       | 14,319         | 17,304         | 19,053         | 15,959         | 17,744         |
| Ending cash                          | 17,304         | 19,053         | 15,959         | 17,744         | 15,029         |
| Ending net debt                      | 54,308         | 79,905         | 66,709         | 56,097         | 39,058         |

Source: Company data, Nomura estimates

**Notes**

Free cash flow under strain due to increase in net working capital

**Balance sheet (INRmn)**

| As at 31 Mar                          | FY11           | FY12           | FY13F          | FY14F          | FY15F          |
|---------------------------------------|----------------|----------------|----------------|----------------|----------------|
| Cash & equivalents                    | 17,304         | 19,053         | 15,959         | 17,744         | 15,029         |
| Marketable securities                 | 74,703         | 69,735         | 49,735         | 39,735         | 24,735         |
| Accounts receivable                   | 124,276        | 187,298        | 219,712        | 235,815        | 261,945        |
| Inventories                           | 125,029        | 136,004        | 152,108        | 163,256        | 181,346        |
| Other current assets                  | 82,903         | 92,219         | 98,624         | 102,031        | 107,558        |
| <b>Total current assets</b>           | <b>424,214</b> | <b>504,309</b> | <b>536,138</b> | <b>558,580</b> | <b>590,613</b> |
| LT investments                        | 72,146         | 88,984         | 108,984        | 128,984        | 148,984        |
| Fixed assets                          | 72,370         | 82,044         | 88,908         | 94,638         | 99,265         |
| Goodwill                              |                |                |                |                |                |
| Other intangible assets               | 2,212          | 1,381          | 1,381          | 1,381          | 1,381          |
| Other LT assets                       | 2,863          | 212            | 0              | 0              | 0              |
| <b>Total assets</b>                   | <b>573,804</b> | <b>676,930</b> | <b>735,411</b> | <b>783,583</b> | <b>840,243</b> |
| Short-term debt                       | 7,641          | 25,948         | 25,948         | 25,948         | 25,948         |
| Accounts payable                      | 156,907        | 185,225        | 211,261        | 226,745        | 251,870        |
| Other current liabilities             | 121,325        | 135,427        | 150,689        | 160,748        | 177,073        |
| <b>Total current liabilities</b>      | <b>285,873</b> | <b>346,599</b> | <b>387,898</b> | <b>413,441</b> | <b>454,890</b> |
| Long-term debt                        | 55,051         | 62,835         | 46,545         | 37,719         | 28,139         |
| Convertible debt                      | 8,919          | 10,175         | 10,175         | 10,175         | 0              |
| Other LT liabilities                  | 5,497          | 5,090          | 5,090          | 5,090          | 5,090          |
| <b>Total liabilities</b>              | <b>355,341</b> | <b>424,699</b> | <b>449,708</b> | <b>466,425</b> | <b>488,120</b> |
| Minority interest                     |                |                |                |                |                |
| Preferred stock                       | 0              | 0              | 0              | 0              | 0              |
| Common stock                          | 1,218          | 1,225          | 1,225          | 1,225          | 1,225          |
| Retained earnings                     | 217,245        | 251,005        | 284,478        | 315,934        | 350,899        |
| Proposed dividends                    |                |                |                |                |                |
| Other equity and reserves             |                |                |                |                |                |
| <b>Total shareholders' equity</b>     | <b>218,463</b> | <b>252,230</b> | <b>285,703</b> | <b>317,158</b> | <b>352,124</b> |
| <b>Total equity &amp; liabilities</b> | <b>573,804</b> | <b>676,930</b> | <b>735,411</b> | <b>783,583</b> | <b>840,243</b> |

**Notes**

Net debt/equity ratio likely to improve over FY13-15F

**Liquidity (x)**

|                |      |      |      |      |      |
|----------------|------|------|------|------|------|
| Current ratio  | 1.48 | 1.46 | 1.38 | 1.35 | 1.30 |
| Interest cover | 8.1  | 8.4  | 7.3  | 8.0  | 10.2 |

**Leverage**

|                     |      |      |      |      |      |
|---------------------|------|------|------|------|------|
| Net debt/EBITDA (x) | 0.96 | 1.28 | 0.97 | 0.84 | 0.52 |
| Net debt/equity (%) | 24.9 | 31.7 | 23.3 | 17.7 | 11.1 |

**Activity (days)**

|                 |       |       |       |       |       |
|-----------------|-------|-------|-------|-------|-------|
| Days receivable | 98.1  | 107.2 | 121.7 | 126.9 | 124.8 |
| Days inventory  | 100.0 | 105.3 | 100.4 | 101.1 | 99.4  |
| Days payable    | 136.2 | 138.0 | 138.1 | 140.4 | 138.1 |
| Cash cycle      | 61.9  | 74.5  | 83.9  | 87.6  | 86.2  |

Source: Company data, Nomura estimates

## Meetings with industry bodies and peers in the roads and hydrocarbon verticals reconfirm negative outlook

We recently interacted with an industry representative for road developers, a hydrocarbon sector project consultant and a couple of competitors in the hydrocarbon and realty space. Below are the key takeaways from these meetings.

Takeaways from our interaction with industry representative for road developers:

- INR150bn worth of bills are pending as of Mar-12 with National Highway Authority of India (compared with INR110-120bn as of Mar-11) to be paid to various BOT and EPC companies. Much of this payment is disputed due to cost overrun issues, and some of these claims are as old as 10-15 years.
- Poor award activity in other infrastructure segments such as power, water etc. continues to drive an influx of new players in the road segment even now.
- In the last fiscal year, 53 projects were bid out by NHAI, of which 30 projects were bid at heavy premium by developers.
- In contrast, the last 10-15 projects haven't attracted many bidders.
- Out of these 53 projects awarded last year, not a single project has completed the mandatory 80% land acquisition by NHAI (in fact, the average is as low as 30-40%).
- 43 projects are still pending environment clearance.
- States such as UP, West Bengal and Kerala haven't seen even a single square kilometre of land acquisition in last several years.
- Do not expect any respite from the proposed land acquisition bill and the industry representative thinks it will only add to the cost burden for the developers.
- On a positive note, despite the poor balance sheet health of most companies in the sector, financial institutions prefer road developers and contractors as a sector over many other infrastructure segments such as even power because to date no road developer or contractor has ever defaulted on a bank loan.
- Several developers are looking to monetize pre-2009 projects which are potentially better IRR generating projects (and were bid at average grant received of 30%).

Interaction with a project consultant and a competitor in the hydrocarbon vertical:

Our discussion centred on the opportunity in the Middle East hydrocarbon sector and whether Indian companies including L&T could compete against the Koreans in that space.

- As per the representative, Korean companies enjoy strong support from their vendors and that is their key edge for winning projects in the Middle East. Further, the Korean and Japanese vendor bases regularly feature among the approved vendor list for projects in the ME, while the Indian vendor base is almost non-existent in the approved list.
- Managing and expediting supplies from the vendor base is a key skill and can be easily managed by Korean companies, as most of their vendors are local.
- Korean companies also enjoy price discounts with their local vendor base and scheduling preference. Similar benefits are also enjoyed by Japanese companies from their vendor base. However, Indian companies cannot enjoy these benefits as the Indian vendor base is non-existent, while vendors in Korea and Japan prefer to prioritize orders from local companies over orders from companies in other geographies.
- Offshore projects are less complicated and primarily require fabrication and manufacturing jobs, while refinery and petchem projects are much more engineering design oriented. Companies with a manufacturing and fabrication base can target offshore projects, but penetrating petchem and refinery projects will be difficult for Indian companies.

Feedback from this meeting corroborated with feedback from our Korean E&C analyst (please refer to the following link: [Engineering & Construction - Read across from Korean E&C experience in ME](#)).

Interaction with a competitor in the realty (buildings and factories) vertical:

- No signs of pick-up in activity from either residential or government sector projects.
- DLF and Jaiprakash Associates have been giving out projects to 3rd party contractors vs. in-house construction earlier.
- While metro cities are definitely slowing, Tier-2 cities are no exception – though the pace of slowdown is comparatively lower.
- L&T has probably been gaining market share, and that possibly explains the rise in orders from buildings segment.
- Almost all orders in the segment are likely to be affected by slow execution and payment cycle as the sector continues to be in distress.

## INR289bn of orders announced YTD, but we think momentum will slow

L&T has announced INR93bn worth of order inflows quarter-till-date, thus taking the YTD inflow total to INR289bn. This is 42% of our full-year FY13F forecast and ~35% of company guidance.

We think that the company is on track so far to meet our estimate of ~INR700bn order inflow in FY13F (company guidance is higher at INR800-840bn).

**Fig. 1: YTD order inflow breakdown**

INR mn

|                | Q1FY13     | QTD Q2FY13 | YTD total  |
|----------------|------------|------------|------------|
| Oil & Gas      | 4          | 21         | 25         |
| Infrastructure | 127        | 52         | 179        |
| Roads          | 58         | 9          | 67         |
| Railways       | 6          | 6          | 12         |
| Airport        | -          | -          | -          |
| Urban Infra    | 50         | 23         | 73         |
| Water          | 6          | 15         | 21         |
| Other          | 7          |            | 7          |
| Power          | 41         | 19         | 60         |
| Process        | 10         | -          | 10         |
| Other          | 14         | -          | 14         |
| <b>Total</b>   | <b>196</b> | <b>93</b>  | <b>289</b> |

Source: Company

While the order inflow trend does not follow a seasonal pattern for L&T, we also note that the economy is slowing much faster going into 2HFY13 and this will likely slow the momentum of order activity in the sector.

As per our estimates, the September to December 2012 period will witness a large number of order finalisations in the Middle East (where the company has been talking of large order potential), and would thus be the critical time period to watch.

## Rising dividend from subsidiaries is boosting standalone PAT, but it is not backed by corresponding increase in profits at the subsidiaries

Dividends received from subsidiaries and associates/JVs have increased sharply over the past 3 years largely on the back of higher payout ratio. Top dividend paying subsidiaries such as L&T Infotech and L&T Infocity have paid dividends from their reserves, leading to a fall in cash balance. While for entities such as L&T Infocity this

would have been a logical step as it is primarily a real-estate company with completing projects and hence little use of cash, we note that sustainability of such payouts in future is limited except for L&T Infotech. Further, profits in the subsidiaries/JVs are already captured in the consolidated statements reported by the company (where inter-company dividend payout will be eliminated).

**Fig. 2: Rising dividends from subsidiaries/JVs are not necessarily backed by similar increase in their profits but by a rising payout ratio**

INR mn

| Dividend from subsidiaries & JV                     | FY05       | FY06       | FY07       | FY08       | FY09       | FY10         | FY11         | FY12         |
|---|------------|------------|------------|------------|------------|--------------|--------------|--------------|
| LT Infotech   | 225        | 150        | 150        | 156        | 158        | 801          | 1,516        | 2,548        |
| LT Infocity   | -          | -          | -          | -          | -          | -            | -            | 1,153        |
| LT Komatsu  |            | -          | 180        | 36         | 288        | 42           | 144          | 132          |
| EWAC Alloys   | 34         | 51         | 91         | 15         | 124        | 46           | 131          | -            |
| Audco India   | 72         | 72         | 81         | 36         | 90         | 63           | 86           | 94           |
| HPL Cogeneration                                    | 197        | 476        | 257        | 285        | -          | -            | -            | -            |
| <b>Total dividend received in standalone entity</b> | <b>711</b> | <b>795</b> | <b>769</b> | <b>584</b> | <b>720</b> | <b>1,079</b> | <b>2,294</b> | <b>4,077</b> |
| <b>Payout Ratio</b>                                 |            |            |            |            |            |              |              |              |
| LT Infotech   | 49%        | 21%        | 10%        | 7%         | 6%         | 28%          | 48%          | 63%          |
| LT Infocity   | NA         | NA         | NA         | NA         | NA         | NA           | NA           | 325%         |
| LT Komatsu  | NA         | NA         | 62%        | 5%         | 303%       | 13%          | 47%          | 528%         |
| EWAC Alloys   | 68%        | 70%        | 81%        | 12%        | 124%       | 38%          | 48%          | NA           |
| Audco India   | 45%        | 33%        | 31%        | 10%        | 26%        | 39%          | 52%          | 31%          |
| HPL Cogeneration                                    | 32%        | 98%        | 61%        | NA         | NA         | NA           | NA           | NA           |

Source: Company

**Fig. 3: Dividends from L&T Infocity and L&T Infotech were funded out of cash balance and reserves**

INR mn

|             | Reserves & Surplus |        | Cash balance |       |
|-------------|--------------------|--------|--------------|-------|
|             | FY11               | FY12   | FY11         | FY12  |
| LT Infotech | 11,015             | 10,116 | 1,313        | 1,229 |
| LT Infocity | 3,587              | 2,480  | 1,664        | 669   |

Source: Company

## Capital employed in subsidiaries continues to rise without commensurate increase in returns; not just developmental projects but even manufacturing subs are generating subpar returns

While the company has been constantly infusing capital into its several manufacturing and developmental subsidiaries/associates/JVs over the past few years, we note that most of these entities are yet to generate meaningful returns. Below we highlight that the foreign subsidiary L&T International FZE is generating ROIE (Return on Invested Equity) in the range of 11-14% (not counting internal accruals post which return ratios will fall further).

While other manufacturing subsidiaries/associates/JVs that L&T has formed are generating better ROIE than the foreign subs, this again is at historical cost of invested equity. For example, we note that the bulk of PAT in these subs/JVs is being contributed by the Sargent & Lundy JV and Audco India Ltd JV, where the original invested equity by L&T is just INR12mn compared to L&T's share of FY12 PAT from these JVs being INR403mn. If we were to compare the ROE for these subs on current book value, ROE would be much lower, but has not been calculated due to lack of reported data in the annual report regarding some of these JVs' book value.

**Fig. 4: Continued rise in equity investment into subsidiaries/associates/JVs**

INR mn

|  | FY07          | FY08          | FY09          | FY10          | FY11          | FY12           |
|--|---------------|---------------|---------------|---------------|---------------|----------------|
| L&T IDPL                               | 3,834         | 3,834         | 3,834         | 6,291         | 13,568        | 26,965         |
| L&T Finance Holdings Ltd               | 4,840         | 9,910         | 10,786        | 16,286        | 17,786        | 17,786         |
| L&T Power Development                  |               | 290           | 860           | 9,200         | 13,300        | 13,620         |
| L&T International FZE                  | 1,804         | 5,168         | 10,498        | 11,474        | 11,474        | 11,474         |
| L&T Special Steels and Heavy forgings  |               |               |               | 1,110         | 2,220         | 3,330          |
| L&T General Insurance Co               |               |               |               | 290           | 2,000         | 3,250          |
| L&T Power                              | 1             | 105           | 513           | 1,535         | 1,535         | 1,535          |
| EWAC alloys                            |               |               |               |               | 1,502         | 1,502          |
| L&T Infotech                           | 680           | 883           | 1,044         | 1,343         | 1,343         | 1,343          |
| L&T-MHI Turbine Generators             |               |               |               |               | 1,276         | 1,276          |
| L&T MHI Boilers                        |               |               |               |               | 1,123         | 1,123          |
| L&T Sapura Shipping                    |               |               |               |               | 951           | 953            |
| L&T - AM Tapovan JV                    |               |               |               |               | -             | 713            |
| L&T Komatsu                            | 600           | 600           | 600           | 600           | 600           | 600            |
| Others                                 | 1,951         | 991           | 394           | 824           | 520           | 567            |
| L&T Realty                             | -             | 472           | 472           | 472           | 472           | 472            |
| PNG Tollway                            |               |               |               | 220           | 220           | 440            |
| L&T Kobelco Machinery                  |               |               |               |               | 153           | 255            |
| L&T aviation services                  |               |               |               |               | 240           | 240            |
| L&T Valdel                             | 90            | 252           | 252           | 239           | 239           | 239            |
| L&T Capital Company Limited            |               |               | 220           | 220           | 220           | 220            |
| L&T-Hochtief Seabird JV                |               |               |               |               | 148           | 194            |
| L&T Infocity                           |               |               |               |               | -             | 160            |
| L&T Howden                             |               |               |               |               | 50            | 150            |
| L&T Plastics Machinery Ltd             |               | 30            | 130           | 130           | 130           | 130            |
| Narmada Infrastructure Construction    | 127           | 127           | 127           | 127           | 127           | 127            |
| L&T-Shanghai Urban Corp Group JV       |               |               |               |               | 72            | 125            |
| L&T Transportation Infra Ltd           |               | 109           | 109           | 109           | 109           | 109            |
| L&T Chiyoda                            | 45            | 45            | 45            | 45            | 45            | 45             |
| L&T Metro Rail Hyderabad               |               |               |               |               | 34            | 44             |
| International seaport dredging         | 86            | 382           | 402           | 399           | -             | -              |
| L&T Western India Tollbridge           |               | 140           | 140           | 140           | 140           | -              |
| L&T Ahmedabad Maliya Tollway           |               |               | 10            | 630           | -             | -              |
| L&T Halol-Shamlaji                     |               |               | 10            | 653           |               | -              |
| L&T Rajkot-Vadinar                     |               |               | 10            | 550           | 550           | -              |
| L&T case                               | 120           | 120           | 120           | 120           | -             |                |
| <b>Total invested equity into subs</b> | <b>14,177</b> | <b>23,456</b> | <b>30,576</b> | <b>53,005</b> | <b>72,146</b> | <b>88,984</b>  |
| Add: Advance towards equity, of which  | 22            | 664           | 6,236         | 15,874        | 17,096        | 23,821         |
| Seawoods                               | -             | -             | 2,500         | 8,583         | 8,811         | 7,820          |
| Shipbuilding                           | -             | -             | 2,485         | 6,231         | 6,231         | 8,778          |
| Realty                                 | -             | -             | -             | -             | -             | 7,060          |
| L&T Infrastructure Finance Company     | 20            | -             | -             | -             | -             | -              |
| L&T International FZE                  | -             | 462           | -             | -             | -             | -              |
| L&T Power Development                  | -             | 200           | -             | -             | -             | -              |
| Others                                 | 2             | 2             | 1,251         | 1,061         | 2,055         | 163            |
| <b>Grand total</b>                     | <b>14,199</b> | <b>24,119</b> | <b>36,811</b> | <b>68,879</b> | <b>89,242</b> | <b>112,805</b> |

Source: Company

Pink highlights are entities that have witnessed maximum investments over the years

**Fig. 5: Total Capital employed in subsidiaries and associates/JVs**

INR mn

|  | FY07          | FY08          | FY09          | FY10          | FY11           | FY12           |
|--|---------------|---------------|---------------|---------------|----------------|----------------|
| <b>Loans &amp; advances and intercorporate deposits (ICDs)</b>   |               |               |               |               |                |                |
| Tractor Engineers Ltd  |               | 53            | 329           | 290           | 490            | 243            |
| L&T Capital company Ltd  |               | 750           | 7,708         | 1,242         | 1,035          | 1,035          |
| L&T Seawoods Pvt Ltd   |               | -             | 5,899         | -             |                | 2,562          |
| L&T Infotech   |               |               |               |               | 1,000          | -              |
| L&T IDPL   |               | -             | 350           | -             | 2,400          | -              |
| India Infrastructure Developers Ltd  |               |               |               | 1,250         | -              | -              |
| L&T Infra Finance  |               |               |               | 1,526         | 1,526          | -              |
| L&T Finance Holding  |               |               |               |               | 3,560          | -              |
| L&T shipbuilding   |               |               |               |               | 744            | 1,680          |
| L&T Uttraranchal hydro power   |               |               |               |               | 500            | -              |
| L&T Realty   |               |               |               | 2,920         | 2,920          | 4,650          |
| L&T Arun Excello IT SEZ  |               |               |               | 1,451         | 1,450          | 1,599          |
| L&T Arun Excello Commercial Projects   |               |               |               | 250           | 250            | 276            |
| Others   | 2,964         | 2,021         | 3,059         | 7,915         | 15,721         | 15,343         |
| <b>Total loans &amp; advances and ICDs (A)</b>   | <b>2,964</b>  | <b>2,825</b>  | <b>17,345</b> | <b>16,845</b> | <b>31,596</b>  | <b>27,388</b>  |
| <i>Of which</i>  |               |               |               |               |                |                |
| - Intercorporate deposits to subs  | 1,053         | 263           | 6,746         | 4,477         | 13,224         | 6,832          |
| - Loans & advances to subs (net of advance towards equity)   | 1,911         | 2,562         | 10,599        | 12,367        | 18,372         | 20,556         |
| Total invested equity into subs  | 14,177        | 23,456        | 30,576        | 53,005        | 72,146         | 88,984         |
| Add: Advance towards equity  | 22            | 664           | 6,236         | 15,874        | 17,096         | 23,821         |
| <b>Total equity + commitments (B)</b>  | <b>14,199</b> | <b>24,119</b> | <b>36,811</b> | <b>68,879</b> | <b>89,242</b>  | <b>112,805</b> |
| <b>Total capital employed into subs: equity + commitments + loans &amp; advances + corporate deposits i.e. (A) + (B)</b> | <b>17,163</b> | <b>26,944</b> | <b>54,157</b> | <b>85,724</b> | <b>120,838</b> | <b>140,193</b> |

Source: Company

**Fig. 6: L&T international subsidiaries are making subpar returns on invested equity**

INR mn

|                  | FY10   | FY11   | FY12   |
|------------------|--------|--------|--------|
| PAT              | 1,668  | 1,696  | 1,510  |
| Invested equity  | 12,340 | 11,997 | 13,643 |
| Return on equity | 13.5%  | 14.1%  | 11.1%  |

Source: Company, Nomura research

International subsidiaries refer to L&T International FZE; PAT calculated as sum of stake adjusted PAT for all subsidiaries of L&T International FZE and the parent entity (post eliminations); Invested equity refers to original equity invested and does not capture internal accruals.

**Fig. 7: L&T: Other manufacturing subsidiaries generating decent returns but at historical cost of equity**

INR mn

|                  | FY09  | FY10  | FY11  | FY12  |
|------------------|-------|-------|-------|-------|
| PAT              | 433   | 779   | 676   | 589   |
| Invested equity  | 1,857 | 1,922 | 2,423 | 3,434 |
| Return on equity | 23.3% | 40.5% | 27.9% | 17.2% |

Source: Company, Nomura research

Other manufacturing subsidiaries refer to following subs/JVs: Ramboll Consulting Engineers, Sargent & Lundy, Chiyoda, Valdel, Audco India, Komatsu, Tractors Engineers, Shanghai Urban Corp, Plastics Machinery, Howden, Hochtief Seabird, Kobelco Machinery, AM Tapovan and Sapura Shipping. PAT calculated as sum of stake adjusted PAT for all of these subsidiaries/JVs; Invested equity refers to original equity invested and does not capture internal accruals – to that extent ROE calculated above is inflated.



## How big are these manufacturing subsidiaries anyways?

PAT from the manufacturing (excluding the power equipment JVs, developmental projects, Finance and IT subs) and foreign subsidiaries is ~6.7% of FY12 PAT reported by the parent. Similarly, total equity invested in the analysed subs is ~INR17bn as of Mar-12, which is ~7% of FY12 standalone book value. Additionally there might be loans and advances/intercorporate deposits in these subs/JVs from the parent which have not been analysed.

However, these subsidiaries together generated ~INR60bn of revenues in FY12, which is 11% of standalone revenues.

Further, consolidated sales for L&T International FZE was ~INR30bn in FY12 (almost half the size of standalone reported export revenues in FY12). If one takes a complete picture of export revenue i.e. summation of revenue booked in the parent entity and in the foreign subsidiaries, then the margins/ROE in this business appear much lower than what is reported in the standalone numbers.

As highlighted in the tables above, L&T International FZE ROIE is just 11-14%, compared with standalone adjusted ROE above 20%.

## How big can L&T become vs. how big are construction/engineering companies globally?

L&T's FY12 standalone revenues from the E&C segment were ~USD8.5bn, while order inflow over FY10-12 has been ~USD12bn. Of this, USD7.5bn of revenues and USD11bn of order inflow was from the domestic E&C segment alone.

These numbers compare very favourably against some of the other similarly or larger sized global construction/engineering giants such as Samsung Engineering, Hyundai, Vinci, Fluor, Technip, Alstom, ABB, Siemens, Linde, Saipem, Skanska and Areva, as most of these global giants have a large international market compared to the domestic/home market.

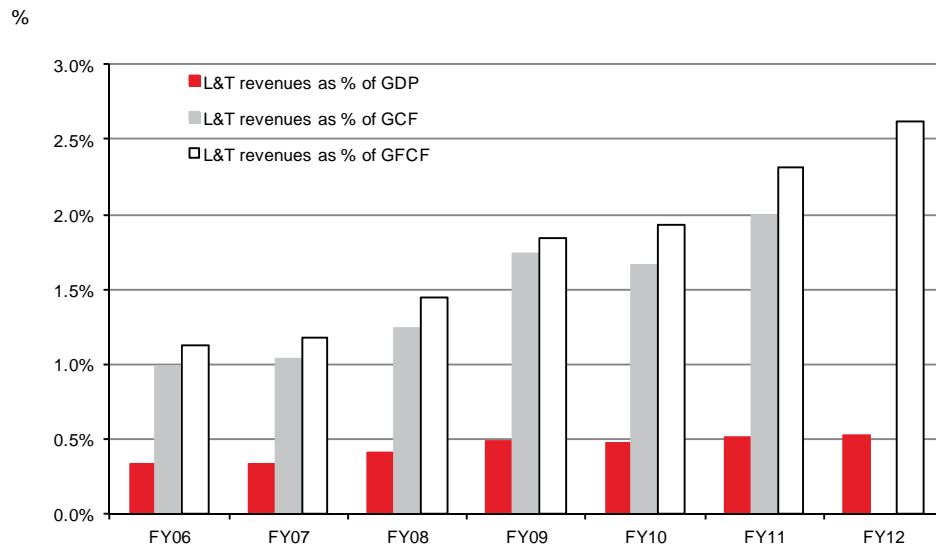
With the Indian market facing headwinds, we think L&T has been making the right choices in the form of geographical diversification. However, in addition to our concerns on margins and ROE, we are unsure of how big L&T can grow given that the global players have revenues of USD3-15bn, while L&T is already approaching this size. The only companies that exceed this revenue amount materially are the ones that are backed by strong technology differentiation such as Siemens, ABB and Areva.

Meanwhile, the leading global players are operating in more than 100 countries and with strong market share in their areas of focus. Compared to this, L&T is already the market leader in India but present in just 30 other countries and not a market leader in most of these countries outside India.

While opportunities are definitely present for L&T to try to take market share from incumbents, in a construction business we see an inherent increase in management bandwidth needed to handle the increased business.

In the Indian domestic market, we note that L&T has constantly been gaining market share over the past few years and this is evident in the following chart where L&T's domestic sales as a share of GDP, GCF and GFCF have all risen consistently over the past few years.

However, if we were to assume that L&T's share of Gross Fixed Capital Formation were to remain constant at FY12 levels in the 12<sup>th</sup> Five-Year Plan period, it would imply that on our estimated sales numbers for L&T, India would add USD2tn in GFCF in the 12<sup>th</sup> Five-Year Plan period compared to ~USD1.45tn in the 11<sup>th</sup> Five-Year Plan Period, implying a 40% growth in the fixed capital formation in the country in the next 5 years. Given the current macro conditions, we do not see significant upside to our numbers.

**Fig. 8: L&T has been gaining market share in India's overall capex spend**

Source: Nomura research

## Raising standalone earnings estimates by ~2-6% to factor in higher dividend income even as core earnings remain same

We are now factoring in higher dividend income to the standalone entity from subsidiaries (primarily L&T Infotech), thus leading to 2-6% increase in our EPS forecasts for FY13F and FY14F. Our key assumptions on order inflows and revenue remain largely the same, though our FY13F margin assumption changes modestly.

**Fig. 9: Revisions in estimates**

INR mn except for EPS data which is in INR

|               | Old     |         | New     |         | % Change |       |
|---------------|---------|---------|---------|---------|----------|-------|
|               | FY13F   | FY14F   | FY13F   | FY14F   | FY13F    | FY14F |
| Order inflows | 694,031 | 797,403 | 688,766 | 791,962 | -0.8%    | -0.7% |
| Revenues      | 621,714 | 676,752 | 610,364 | 655,098 | -1.8%    | -3.2% |
| EBITDA        | 72,129  | 67,741  | 69,026  | 66,755  | -4.3%    | -1.5% |
| EBITDA margin | 11.6%   | 10.0%   | 11.3%   | 10.2%   |          |       |
| Reported PAT  | 46,185  | 41,778  | 46,651  | 43,841  | 1.0%     | 4.9%  |
| Adj. PAT      | 46,186  | 41,778  | 46,651  | 43,841  | 1.0%     | 4.9%  |
| Adj. EPS      | 74.60   | 67.50   | 76.18   | 71.59   | 2.1%     | 6.1%  |

Source: Nomura estimates

## Nomura vs consensus (standalone)

We are significantly lower than consensus estimates on our FY14F EPS estimates primarily due to a sharp difference on margin assumption and slightly lower revenue expectation. Continued misses on order-inflow guidance and margin disappointment in 2HFY13 will likely drive consensus estimates down, in our view.

**Fig. 10: FY14F estimates significantly lower than consensus**

|               | FY13F   |           |            | FY14F   |           |            |
|---------------|---------|-----------|------------|---------|-----------|------------|
|               | Nomura  | Consensus | Difference | Nomura  | Consensus | Difference |
| Revenues      | 610,364 | 620,834   | -1.7%      | 655,098 | 703,736   | -6.9%      |
| EBITDA        | 69,026  | 71,292    | -3.2%      | 66,755  | 80,138    | -16.7%     |
| EBITDA margin | 11.3%   | 11.5%     | -1.5%      | 10.2%   | 11.4%     | -10.5%     |
| Net income    | 46,651  | 47,084    | -0.9%      | 43,841  | 51,661    | -15.1%     |
| Adj. EPS      | 76.18   | 77.63     | -1.9%      | 71.59   | 84.80     | -15.6%     |

Source: Bloomberg, Nomura estimates

## Valuation

We revise our target price to INR1,100 from INR992. With ~20% potential downside to our revised target price, we retain our Reduce rating.

Our change in target price is driven by a change in valuation methodology for the company as we now shift to DCF method for valuing the standalone business using a cost of equity of 13.5% and terminal EBITDA margin and FCF growth rate of 10.5% and 6% respectively beyond FY20. Based on this, we arrive at a INR782/share value for the standalone entity, which implies a P/E multiple of 12.5x on adjusted FY14F EPS (net of dividend and interest income from subsidiaries).

The implied orderbook and order inflow numbers for the terminal year (i.e. FY20) of our DCF forecast is ~US\$53bn and ~US\$25bn respectively, suggesting a 10-11% CAGR over FY13-20. We also undertake a comprehensive review of the subsidiaries and associates and now value each of these investments individually to arrive at INR318/share value.

**Fig. 11: TP revised to INR1100/share**

INR mn

| Business                     | Value Per Share (INR) | Value          | Valuation driver              |
|------------------------------|-----------------------|----------------|-------------------------------|
| Core E&C business            | 782                   | 479,144        | 12.5x FY14F adjusted earnings |
| Subsidiaries & Associates    | 314                   | 192,480        |                               |
| Stake in Satyam              | 4                     | 2,301          | At the current market price   |
| <b>One year target price</b> | <b>1,100</b>          | <b>673,925</b> |                               |
| Subsidiary value             | 318                   | 194,780        |                               |

Source: Nomura estimates

**Fig. 12: Subsidiaries and other investments valuation breakdown**

INR mn

| Subsidiaries   | Value/share (INR) | Net value | Valuation driver                                  |
|--|-------------------|-----------|---|
| L&T Finance Holding Ltd                                    | 87                | 53,138    | 1.25x FY13F P/BV; in-line with peers              |
| L&T Infotech   | 87                | 53,288    | 10x FY14F earnings - inline with mid cap IT peers |
| L&T General Insurance Co. Ltd                              | -                 | -         | Zero value  |
| L&T International FZE                                      | 25                | 15,100    | 10x FY12 Consolidated earnings                    |
| L&T MHI Boilers  | 2                 | 1,123     | 1x Invested equity                                |
| L&T-MHI Turbine Generators                                 | 2                 | 1,276     | 1x Invested equity                                |
| L&T Special Steels and Heavy forgings Pvt Ltd (NPCIL JV)   | 11                | 6,660     | 2x Invested equity                                |
| EWAC Alloys  | 5                 | 2,922     | At the transaction price paid by L&T              |
| L&T Power Ltd (cash balance)                               | 3                 | 1,692     | Cash balance in the non-operational sub           |
| L&T Power Development Ltd                                  | 29                | 17,520    | 1.1x final equity less equity commitment          |
| L&T IDPL   | 59                | 36,050    | 97.45% stake in IDPL;                             |
| L&T Real estate projects                                   | 16                | 9,773     |   |
| L&T Shipbuilding   | 14                | 8,778     | 1x Invested equity - inline with Korean comps     |
| Other manufacturing subs & JVs                             | 10                | 5,893     | 10x FY12 Consolidated earnings                    |
| Loans and advances to subs (net of advance towards equity) | 45                | 27,388    | 1x invested amount                                |
| <b>Total</b>   | <b>393</b>        |           |   |
| <b>Less: 20% Holding company discount</b>                  | <b>79</b>         |           |   |
|  | <b>314</b>        |           |   |

Source: Nomura estimates

**Fig. 13: Valuation of developmental subsidiaries**

INR mn

| L&T Power Development Ltd                                   | Final equity         | FY12 invested equity | P/BV on final equity | Less: Equity to be invested | Net value      |
|---|----------------------|----------------------|----------------------|-----------------------------|----------------|
| Nabha Power Ltd - phase 1 (Rajpura 1400 MW)                 | 19,250               | 9,600                | 1.3                  | 9,650                       | 14,413         |
| Nabha Power Ltd - phase 2 (Rajpura 700 MW)                  | 9,625                | -                    | 1.0                  | 9,625                       | -              |
| Other hydro-electric projects (total 728 MW)                | 30,576               | 3,002                | 1.0                  | 27,574                      | 3,002          |
| Investment in Konaseema Gas Power Ltd                       | 211                  | 211                  | 0.5                  |                             | 105            |
| <b>Total value for L&amp;T Power Development Ltd</b>        | <b>59,662</b>        | <b>12,812</b>        |                      | <b>46,849</b>               | <b>17,520</b>  |
| L&T Real estate projects                                    | FY12 invested equity | Assigned FY12F P/BV  | Net value            |                             |                |
| L&T Bangalore Airport Hotel                                 | 533                  | 1.5                  | 799                  |                             |                |
| CSJ Infrastructure Pvt Ltd (Mall in Chandigarh)             | 1,840                | 1.5                  | 2,760                |                             |                |
| L&T Arun Excelllo ITSEZ Pvt Ltd                             | 719                  | 1.0                  | 719                  |                             |                |
| Balance BV in L&T Urban Infrastructure Ltd                  | 3,660                | 0.8                  | 2,745                |                             |                |
| <b>Total value for L&amp;T Urban Infrastructure Ltd</b>     | <b>6,752</b>         |                      | <b>7,023</b>         |                             |                |
| L&T Infocity  | 2,750                | 1.0                  | 2,750                |                             |                |
| L&T Seawoods Pvt Ltd  | 7,820                | -                    | -                    |                             |                |
| <b>Total value for L&amp;T</b>                              | <b>17,322</b>        |                      | <b>9,773</b>         |                             |                |
| L&T IDPL  | Final equity         | Invested equity      | P/BV on final equity | Less: Equity to be invested | Net value      |
| Road projects   | 42,120               | 16,930               | 1.0                  | 25,190                      | 16,930         |
| Port projects   |                      | 3,549                | 2.0                  |                             | 7,098          |
| Hyderabad Metro   | 40,270               | 4,330                | 1.0                  | 35,940                      | 4,330          |
| <b>Total IDPL projects value</b>                            |                      | <b>24,809</b>        |                      |                             | <b>28,358</b>  |
| <b>Add: 10% for terminal growth value</b>                   |                      |                      |                      |                             | <b>2,836</b>   |
| <b>Less: Equity invested post Mar-12 but factored above</b> |                      |                      |                      |                             | <b>(3,000)</b> |
| <b>Add: loans &amp; advances, cash - debt etc</b>           |                      |                      |                      |                             | <b>8,800</b>   |
| <b>Net IDPL value</b>                                       |                      |                      |                      |                             | <b>36,994</b>  |

Source: Nomura estimates

**Fig. 14: L&T – standalone entity FCF estimates for DCF**

INR mn

|   | FY11     | FY12     | F13F     | F14F     | FY15F    | FY16F    | FY17F    | FY18F    | FY19F     | FY20F     |
|---|----------|----------|----------|----------|----------|----------|----------|----------|-----------|-----------|
| <b>Sales</b>                            | 439,059  | 531,705  | 610,364  | 655,098  | 727,689  | 814,672  | 904,168  | 999,120  | 1,091,826 | 1,186,389 |
| % growth YoY                            | 18.6     | 21.1     | 14.8     | 7.3      | 11.1     | 12.0     | 11.0     | 10.5     | 9.3       | 8.7       |
| EBIT Margins                            | 11.46    | 10.47    | 9.97     | 8.78     | 8.83     | 9.00     | 9.15     | 9.25     | 9.25      | 9.25      |
| EBIT                                    | 50,306   | 55,644   | 60,859   | 57,485   | 64,285   | 73,320   | 82,731   | 92,419   | 100,994   | 109,741   |
| Add Depreciation                        | 5,992    | 6,995    | 8,167    | 9,270    | 10,373   | 10,823   | 11,811   | 12,886   | 13,590    | 15,025    |
| EBITDA margin                           | 12.8%    | 11.8%    | 11.3%    | 10.2%    | 10.3%    | 10.3%    | 10.5%    | 10.5%    | 10.5%     | 10.5%     |
| Net taxes                               | (15,672) | (15,889) | (18,093) | (17,107) | (19,153) | (21,996) | (24,819) | (27,726) | (30,298)  | (32,922)  |
| Tax rate                                | -31.2%   | -28.6%   | -29.7%   | -29.8%   | -29.8%   | -30.0%   | -30.0%   | -30.0%   | -30.0%    | -30.0%    |
| Adjusted NOPLAT                         | 40,626   | 46,750   | 50,934   | 49,648   | 55,505   | 62,147   | 69,723   | 77,579   | 84,285    | 91,843    |
| (Increase)/ Decrease in working Capital | (8,396)  | (48,072) | (13,413) | (5,114)  | (8,299)  | (13,329) | (12,144) | (13,479) | (13,834)  | (15,130)  |
| Working Cap/Sales                       | 12.3%    | 17.9%    | 17.8%    | 17.3%    | 16.8%    | 16.6%    | 16.3%    | 16.1%    | 16.0%     | 16.0%     |
| Capex                                   | 16,916   | 15,838   | 15,031   | 15,000   | 15,000   | 17,108   | 18,988   | 20,982   | 22,928    | 24,914    |
| Capex/ sales                            | 3.9%     | 3.0%     | 2.5%     | 2.3%     | 2.1%     | 2.1%     | 2.1%     | 2.1%     | 2.1%      | 2.1%      |
| <b>Free Cash Flow</b>                   | 15,314   | (17,161) | 22,490   | 29,533   | 32,206   | 31,710   | 38,592   | 43,118   | 47,523    | 51,799    |
| <b>PV of Free Cash Flow</b>             |          |          |          | 27,721   | 26,635   | 23,105   | 24,775   | 24,388   | 23,683    | 22,743    |

Source: Company, Nomura estimates

**Fig. 15: L&T – standalone entity DCF valuation**

INR mn

| Valuation parameters                     |            |
|--|------------|
| Cost of equity                           | 13.5%      |
| Terminal Multiple on FCF                 | 14.1       |
| Terminal Year growth                     | 6.0%       |
| PV of FCF to FY2020E                     | 173,050    |
| Terminal value                           | 732,097    |
| PV of terminal value                     | 321,437    |
| Firm Value                               | 494,487    |
| Less Net Debt                            | 15,343     |
| NPV                                      | 479,144    |
| Number of equity shares outstanding (mn) | 612        |
| <b>NPV/L&amp;T share (INR)</b>           | <b>782</b> |

Source: Nomura estimates

**Fig. 16: One-year fwd P/E chart**



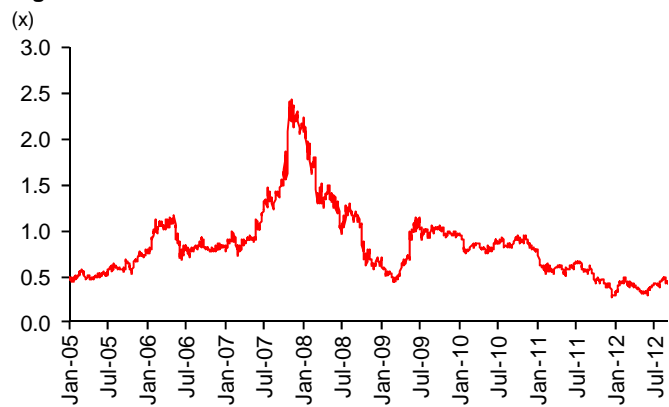
Source: Company data, Bloomberg, Nomura estimates

**Fig. 17: One-year fwd P/B chart**



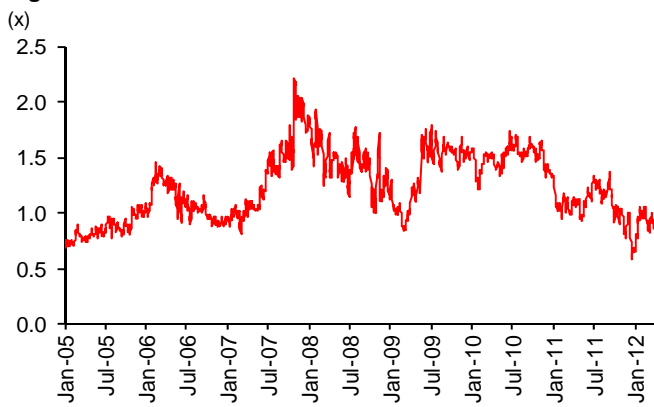
Source: Company data, Bloomberg, Nomura estimates

Fig. 18: EV/Order book



Source: Company data, Bloomberg, Nomura estimates

Fig. 19: Premium/Discount to SENSEX



Source: Company data, Bloomberg, Nomura estimates

Fig. 20: Global peers valuation comps

|                | Rating        | Ticker       | Price (USD) | Mkt Cap (Bn USD) | P/E (x)     |             | P/BV (x)   |            | ROE (%)     |             | EPS CAGR   |
|----------------|---------------|--------------|-------------|------------------|-------------|-------------|------------|------------|-------------|-------------|------------|
|                |               |              |             |                  | FY13F       | FY14F       | FY13F      | FY14F      | FY13F       | FY14F       | FY12-14F   |
| ABB Ltd        | Not Rated     | ABBN VX      | 19          | 44               | 13.0        | 11.4        | 2.4        | 2.2        | 18.7        | 19.8        | 3%         |
| Samsung Engg   | Buy           | 028050 KS    | 182         | 7                | 13.6        | 12.1        | 4.4        | 3.4        | 37.5        | 32.5        | 15%        |
| JR Mcdermott   | Not Rated     | MDR US       | 12          | 3                | 12.9        | 11.7        | 1.5        | 1.4        | 13.5        | 13.5        | 16%        |
| SNC Lavalin    | Not Rated     | SNC CN       | 36          | 5                | 27.6        | 18.0        | 2.6        | 2.4        | 13.4        | 16.2        | 9%         |
| Hyundai E&C    | Buy           | 000720 KS    | 61          | 7                | 17.8        | 11.9        | 1.6        | 1.5        | 8.7         | 12.3        | 2%         |
| Vinci          | Not Rated     | DG FP        | 46          | 27               | 10.8        | 10.5        | 1.5        | 1.4        | 14.2        | 14.0        | 1%         |
| Fluor          | Not Rated     | FLR US       | 57          | 10               | 15.1        | 13.0        | 2.4        | 2.1        | 16.6        | 15.0        | 15%        |
| Technip        | Reduce        | TEC FP       | 113         | 13               | 19.3        | 14.4        | 2.6        | 2.3        | 14.4        | 17.7        | 20%        |
| Chiyoda Corp   | Buy           | 6366 JP      | 14          | 4                | 16.1        | 14.2        | 1.6        | 1.5        | 10.3        | 11.3        | 32%        |
| JGC Corp       | Buy           | 1963 JP      | 32          | 8                | 13.4        | 12.3        | 2.0        | 1.8        | 15.6        | 15.7        | 13%        |
| Toyo Engg      | Not Rated     | 6330 JP      | 4           | 1                | 14.7        | 9.7         | 0.9        | 0.8        | 6.1         | 8.9         | 23%        |
| Alstom         | Not Rated     | ALO FP       | 38          | 11               | 9.0         | 8.2         | 1.7        | 1.5        | 19.6        | 19.6        | 9%         |
| Siemens AG     | Not Rated     | SIE GY       | 101         | 93               | 13.1        | 12.0        | 2.1        | 2.0        | 15.6        | 16.4        | -9%        |
| Jacobs Engg    | Not Rated     | JEC US       | 42          | 5                | 14.3        | 12.6        | 1.4        | 1.3        | 10.2        | 10.3        | 12%        |
| Linde AG       | Neutral       | LIN GR       | 168         | 31               | 16.7        | 14.9        | 1.7        | 1.7        | 10.6        | 11.1        | 7%         |
| Saipem         | Buy           | SPM IM       | 50          | 22               | 16.7        | 14.4        | 3.2        | 2.8        | 20.1        | 20.4        | 15%        |
| Skanska Ab-B   | Not Rated     | SKAB SS      | 16          | 7                | 16.1        | 13.0        | 2.3        | 2.2        | 15.4        | 17.8        | 7%         |
| Areva          | Not Rated     | AREVA FP     | 17          | 7                | 39.5        | 13.3        | 0.8        | 0.8        | 2.5         | 5.7         | NA         |
| <b>Average</b> |               |              |             |                  | <b>16.7</b> | <b>12.6</b> | <b>2.1</b> | <b>1.8</b> | <b>14.6</b> | <b>15.4</b> | <b>11%</b> |
| <b>Median</b>  |               |              |             |                  | <b>14.9</b> | <b>12.5</b> | <b>1.9</b> | <b>1.7</b> | <b>14.3</b> | <b>15.4</b> | <b>12%</b> |
| <b>L&amp;T</b> | <b>Reduce</b> | <b>LT IN</b> | <b>26</b>   | <b>16</b>        | <b>14.4</b> | <b>15.3</b> | <b>2.4</b> | <b>2.1</b> | <b>17.3</b> | <b>14.5</b> | <b>0%</b>  |

Closing prices as of 12 Sep 2012

ABB Ltd, Samsung Engineering, JR Mcdermott, SNC Lavalin, Hyundai E&amp;C, Vinci, Fluor, Technip, Linde AG, Saipem, Skanska, Areva FY12/13/14 correspond with CY11/12/13 estimates, while Siemens, Jacob Engineering FY12/13/14 is Sep-11/12/13

Source: Bloomberg consensus estimates for Not Rated stocks, Nomura estimates

Fig. 21: Infrastructure developers valuation comps

P/BV multiples (x)

| Company                    | Ticker   | Price | FY12        | FY13F       | FY14F       |
|----------------------------|----------|-------|-------------|-------------|-------------|
| GMR Infra                  | GMRI IN  | 19.7  | 0.81        | 0.81        | 0.77        |
| GVK Power & Infrastructure | GVKP IN  | 11.4  | 0.46        | 0.43        | 0.43        |
| IRB Infrastructure         | IRB IN   | 125.1 | 1.40        | 1.23        | 1.07        |
| JP Associate               | JPA IN   | 67.9  | 1.16        | 1.05        | 0.92        |
| IL&FT Transport Network    | ILFT IN  | 162.8 | 1.16        | 0.99        | 0.85        |
| Lanco Infratech            | LANCI IN | 11.0  | 0.54        | 0.49        | 0.48        |
| Jaypee Infratech           | JPIN IN  | 45.8  | 1.08        | 1.01        | 0.95        |
| <b>Average</b>             |          |       | <b>0.94</b> | <b>0.86</b> | <b>0.78</b> |
| <b>Median</b>              |          |       | <b>1.08</b> | <b>0.99</b> | <b>0.85</b> |

Closing prices as of 12 Sep 2012

Source: Bloomberg estimates

**Fig. 22: Domestic sector valuation summary**

(x)

|                                  | Rating        | Ticker       | Price<br>(INR) | P/E (x)     |             | P/BV (x)   |            | ROE (%)     |             | EPS CAGR<br>FY12-14F |
|----------------------------------|---------------|--------------|----------------|-------------|-------------|------------|------------|-------------|-------------|----------------------|
|                                  |               |              |                | FY13F       | FY14F       | FY13F      | FY14F      | FY13F       | FY14F       |                      |
| <b>Capital Goods</b>             |               |              |                |             |             |            |            |             |             |                      |
| ABB India                        | Reduce        | ABB IN       | 737            | 33.9        | 26.7        | 5.0        | 4.3        | 15.9        | 17.5        | 37%                  |
| BHEL                             | Neutral       | BHEL IN      | 198            | 7.5         | 8.5         | 1.6        | 1.4        | 23.2        | 17.8        | -10%                 |
| Crompton Greave                  | Reduce        | CRG IN       | 108            | 12.9        | 10.3        | 1.7        | 1.5        | 14.1        | 15.6        | 34%                  |
| Cummins India                    | Neutral       | KKC IN       | 457            | 19.1        | 16.5        | 4.8        | 4.2        | 31.0        | 29.8        | 18%                  |
| <b>Larsen &amp; Toubro</b>       | <b>Reduce</b> | <b>LT IN</b> | <b>1409</b>    | <b>14.4</b> | <b>15.3</b> | <b>2.4</b> | <b>2.1</b> | <b>17.3</b> | <b>14.5</b> | <b>0%</b>            |
| Voltas                           | Buy           | VOLT IN      | 114            | 14.9        | 12.8        | 2.0        | 1.7        | 18.4        | 19.5        | 4%                   |
| Thermax                          | Reduce        | TMX IN       | 494            | 17.6        | 14.2        | 3.2        | 2.8        | 19.5        | 21.0        | 3%                   |
| <b>Covered companies average</b> |               |              |                | <b>14.4</b> | <b>12.9</b> | <b>2.6</b> | <b>2.3</b> | <b>20.6</b> | <b>19.7</b> | <b>8%</b>            |
| AIA Engineering                  | Not Rated     | AIAE IN      | 347            | 15.7        | 13.4        | 2.3        | 2.0        | 15.8        | 16.2        | 17%                  |
| Alstom                           | Not Rated     | ALST IN      | 373            | 17.1        | NA          | 3.1        | NA         | 18.4        | NA          | NA                   |
| Areva T&D India                  | Not Rated     | ATD IN       | 181            | 27.2        | 19.8        | 4.2        | 3.5        | 18.2        | 20.2        | NA                   |
| Bharat Electronic                | Not Rated     | BHE IN       | 1187           | 10.9        | 9.7         | 1.5        | 1.3        | 14.5        | 14.5        | 11%                  |
| Blue Star                        | Not Rated     | BLSTR IN     | 170            | 16.7        | 11.4        | 3.5        | 3.0        | 20.1        | 26.1        | NA                   |
| Carborundum Un                   | Not Rated     | CU IN        | 148            | 13.2        | 11.5        | 2.5        | 2.1        | 19.2        | 19.1        | 7%                   |
| Greaves Cotton                   | Not Rated     | GRV IN       | 70             | 11.4        | 9.7         | 2.4        | 2.0        | 22.2        | 22.5        | 8%                   |
| Kirloskar Oil Engi               | Not Rated     | KOEL IN      | 154            | 11.9        | 10.2        | 1.9        | 1.7        | 17.1        | 17.7        | 7%                   |
| Siemens India                    | Not Rated     | SIEM IN      | 679            | 28.6        | 30.1        | 5.0        | 4.7        | 17.8        | 18.3        | -6%                  |
| <b>Sector Average</b>            |               |              |                | <b>15.9</b> | <b>13.8</b> | <b>2.8</b> | <b>2.4</b> | <b>19.1</b> | <b>19.5</b> | <b>8%</b>            |

Pricing as of Sep 12, 2012

ABB India and Areva T&amp;D India FY12/13/14 correspond with CY11/12/13 estimates, while Siemens India FY12/13/14 is average of Sep-11/12/13/14 and Sep-12/13/14/15 estimates, respectively.

Averages for P/E, EPS CAGR and ROE do not include ABB India given the highly volatile trend.

L&amp;T's P/E, ROE and EPS adjusted for subsidiary valuation and earnings

Source: Company data, Nomura estimates, Bloomberg, Bloomberg consensus estimates for Not Rated companies

## Risks

Upside risks to our target price include better-than-expected order inflows, better-than-expected margin and execution, a substantial decrease in raw-material prices and a lower risk premium.

# Appendix A-1

## Analyst Certification

We, Amar Kedia and Indrajit Yadav, hereby certify (1) that the views expressed in this Research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Research report and (3) no part of our compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

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| Issuer name     | Ticker | Price    | Price date  | Stock rating | Sector rating | Disclosures |
|-----------------|--------|----------|-------------|--------------|---------------|-------------|
| Larsen & Toubro | LT IN  | INR 1409 | 12-Sep-2012 | Reduce       | Not rated     | A4,A6       |

A4 A Nomura Group Company had an investment banking services client relationship with the issuer during the past 12 months.

A6 A Nomura Group Company expects to receive or intends to seek compensation for investment banking services from the issuer in the next three months.

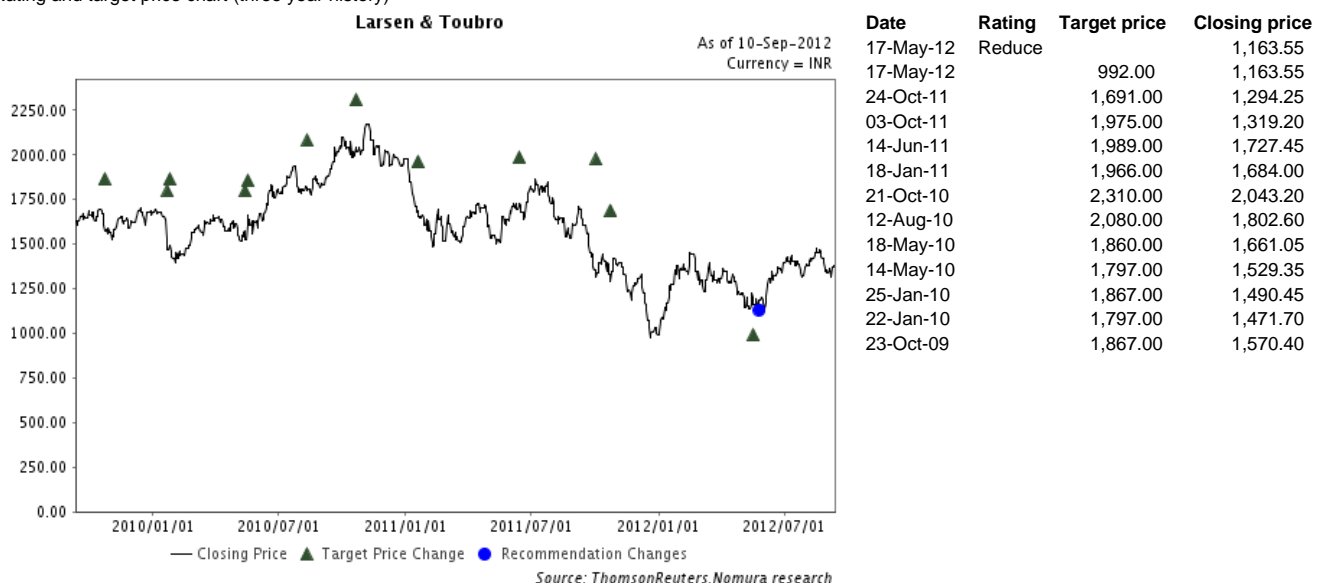
## Previous Rating

| Issuer name     | Previous Rating | Date of change |
|-----------------|-----------------|----------------|
| Larsen & Toubro | Buy             | 17-May-2012    |

## Larsen & Toubro (LT IN)

INR 1409 (12-Sep-2012) Reduce (Sector rating: Not rated)

Rating and target price chart (three year history)



For explanation of ratings refer to the stock rating keys located after chart(s)

**Valuation Methodology** We use a DCF method for valuing the standalone business using a cost of equity of 13.5% and terminal EBITDA margin and FCF growth rate of 10.5% and 6% respectively beyond FY20. For the subsidiaries and associates, we value each of these investments individually to arrive at INR318/share value.

**Risks that may impede the achievement of the target price** Risks to our target price include better-than-expected order inflows, better-than-expected margin and execution, a substantial decrease in raw material prices, and lower risk premium.



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A rating of '**Buy**', indicates that the analyst expects the stock to outperform the Benchmark over the next 12 months. A rating of '**Neutral**', indicates that the analyst expects the stock to perform in line with the Benchmark over the next 12 months. A rating of '**Reduce**', indicates that the analyst expects the stock to underperform the Benchmark over the next 12 months. A rating of '**Suspended**', indicates that the rating, target price and estimates have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including, but not limited to, when Nomura is acting in an advisory capacity in a merger or strategic transaction involving the company.

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Benchmarks are as follows: **United States**: S&P 500; **Europe**: Dow Jones STOXX 600; **Global Emerging Markets (ex-Asia)**: MSCI Emerging Markets ex-Asia.

### Explanation of Nomura's equity research rating system in Japan and Asia ex-Japan

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