Powered by the Sharekhan 3R Research Philosophy

Larsen & Toubro Ltd

Healthy Q2 braves challenges; growth outlook promising

Capital Goods	Sharekhan code: LT

Reco/View	Reco: **Buy**	↔	CMP: **Rs. 1783**	Price Target: **Rs. 2150**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

3R MATRIX

	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)	✓		

\+ Positive = Neutral – Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

ESG Disclosure Score NEW

ESG RISK RATING 34.37

Updated Oct 08, 2021

High Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

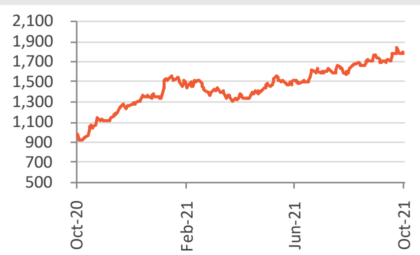
Company details

Market cap:	Rs. 250,422 cr
52-week high/low:	Rs. 1885/921
NSE volume: (No of shares)	2.5 lakh
BSE code:	500510
NSE code:	LT
Free float: (No of shares)	140.4 cr

Shareholding (%)

Promoters	0.0
FII	22.9
DII	33.3
Others	43.8

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	2.7	11.9	29.7	81.2
Relative to Sensex	0.2	-4.7	6.7	28.1

Sharekhan Research, Bloomberg

Summary

- Revenues were marginally lower than expected affected by supply chain disruptions and seasonality, while OPM remained in-line for Q1FY20222. Order inflow and order prospects remain healthy.
- Management retained FY2022 guidance for order intake, revenues, OPM and working capital levels. Cash reserve remained robust.
- Divestment of power assets, stake sale in road entity and restructuring of Hyderabad Metro project is under process.
- We maintain a Buy on L&T with a revised PT of Rs. 2150, factoring upwardly revised valuation of key IT & TS subsidiaries along with favourable valuation of core business.

Larsen and Toubro (L&T) reported marginally lower-than-expected execution in Q2FY2022 while OPM remained in line with estimates. Consolidated revenue grew by 12% y-o-y to Rs. 34,773 crore, where domestic revenues grew by 19% y-o-y at Rs. 22455 crore. Consolidated OPM at 11.5% (up 74 bps y-o-y). Consolidated adjusted net profit stood at Rs. 1,723 crore (up 55.7% y-o-y, adjusted for exceptional items in Q2FY2021). The management retained its guidance for low to mid-teens growth in order intake and revenues for FY2022, while it expects OPM and working capital requirements to remain at FY2021 levels. Order prospects as on September 2021 were healthy at Rs. 6.83 lakh crore. The company's order book is at a record level at Rs. 3.31 lakh crore translating to 2.2x its TTM consolidated revenues.

Key positives

- Order inflow was up 50% y-o-y at Rs. 42,140 crore driven by international orders, up 198% y-o-y at Rs. 22,116 crore.
- Project & manufacturing portfolio registered 110 bps y-o-y improvement in OPM at 9.2%.

Key negatives

- Execution affected by cyclones in Western India, September rains and re-skilling of labour force.
- Infrastructure orders were down 17% y-o-y at Rs. 12,108 crore

Management Commentary

- Expect execution to pick up in H2FY2022.
- Order intake, revenue growth, OPM and working capital guidance retained.
- Company aims to restructure Hyderabad Metro by March 2022 internally.

Revision in estimates – We have retained our estimates..

Our Call

Maintain Buy with a revised PT of Rs. 2,150: L&T's healthy operational performance despite supply chain challenges and seasonality along with retaining guidance related to execution, order intake, OPM and working capital for FY2022 are key positives emerging out of the Q2FY2022 results. International outlook looks buoyant with a pick-up in crude oil prices. On the longer term, L&T remains at the forefront to reap benefits from the AtmaNirbhar Bharat Scheme with its diversified businesses across sectors such as defence, infrastructure, heavy engineering, and IT. The company remains the best proxy for domestic capex and an improving business environment. We maintain our Buy rating on the stock with a revised SOTP-based price target (PT) of Rs. 2,150 factoring upwardly revised valuation of its key IT&TS subsidiaries and favourable core business valuation.

Key Risks

Slowdown in the domestic macro-economic environment or weakness in international capital investment can negatively affect business outlook and earnings growth.

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22E	FY23E	FY24E
Revenue	1,35,979	1,54,336	1,76,715	2,01,455.0
OPM (%)	11.5	11.6	11.7	12.1
Adjusted PAT	11,583	9,283	11,821	13,351
% YoY growth	21.3%	-19.9%	27.3%	12.9%
Adjusted EPS (Rs.)	82.6	66.2	84.3	89.2
P/E (x)	21.6	26.9	21.1	20.0
P/B (x)	3.3	3.4	3.1	2.8
EV/EBITDA (x)	17.1	14.2	11.5	9.1
RoNW (%)	4.7	12.4	15.3	14.8
RoCE (%)	7.2	8.1	9.5	11.4

Source: Company; Sharekhan estimates

Healthy performance amid challenges:

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Orders pipeline prospects healthy along with strong order book

The order book is at record level of Rs. 3.31 lakh crore (domestic orders' share - 77%, international orders - 23%). Of the total order book of Rs. 2.54 lakh crore of domestic orders, the share of the Central government is 10%, states - 33%, public 42% and private 15%. Further, 31% of the order book is funded by bilateral/multilateral agencies. Average execution cycle for L&T stands at 27-28 months. In Q2, tendering activity showed pick up while award activities were delayed. Order prospects are seen at Rs. 6.83 lakh crore with domestic segment comprising Rs. 4.66 lakh crore and international Rs. 2.16 lakh crore. L&T bagged orders worth Rs 42,140 crore at the group level during the quarter, rising by 50% over the corresponding period of the previous year. During the quarter, orders were received in various segments like Metros, Rural Water Supply, Minerals and Metal, Residential, Power Transmission & Distribution, Power and Hydrocarbon Offshore sectors. International orders surged by 198% y-o-y to at Rs 22,116 crore.

Key highlights from earnings call

- **Guidance for FY22:** The management retained low to mid teen digit order inflow and revenue growth guidance for FY2022. Net working capital and OPM are expected to remain at FY2021 levels.
- **Q2 environment:** The management termed Q2 as a comeback quarter for India. However, supply chain challenges persisted. The quarter has some delays in project awards while tendering activities had picked up.
- **Outlook:** Pent-up demand and festive demand augurs well for Indian economy. In the near term, the outlook is lot more positive led by a recovery in demand. Over medium to long term, inclusive growth is expected over a decade with resurgence in both government and private capex.
- **Order inflow:** Order inflow was up 50% y-o-y at Rs. 421bn for Q2. Project and manufacturing segment order inflow was up 73% y-o-y at Rs. 301 billion.
- **Order prospects:** Order prospects' pipeline as on Q2FY2022 is up 12% y-o-y at Rs. 6.83 trillion. The domestic segment comprise Rs. 4.66 trillion while international Rs. 2.16 trillion.
- **Order book:** The order book stood at Rs. 3.31 trillion with domestic orders comprising 77% and international 23%. In domestic order book, central share is 10%, state 33%, Public sector units 42% and private 15%. 31% of the order book is funded by bilateral and multilateral agencies. About 60-65% of the order book has price variation clause.
- **Divestments:** The company is exploring various options for divestment of Nabha power asset and its 51% stake in IDPL. It is also exploring various options for Hyderabad metro project.
- **Hyderabad metro project:** The average daily ridership increased from 55000 in Q1FY2022 to 146000 in Q2FY22. Currently, the ridership is 180000 to 200000 per day. It incurred PAT loss of Rs. 4.47bn during the quarter. The depreciation and amortisation stood at Rs. 0.75bn each while interest expense was Rs. 3.7-3.8 billion. Till date, the company has infused Rs. 1200 crore out of Rs. 2000 crore earmarked at the start of the year. Further, Rs. 1000 crore would be infused till March 2022. It is internally targeting to conclude refinancing and restructuring of the asset by March 2022.
- **Real estate:** The company has a 50 msf area including 17msf in Hyderabad Metro. Out of 7000 units launched, it has booked revenues of 2900 units, sold 2500 units and 2200 are left to be sold.
- **Projects & manufacturing segment:** The segment revenue grew 12% y-o-y to Rs. 228 billion. The company expects improvement in execution in H2. OPM improved 110bps y-o-y to 9.2% on account of better overhead recovery despite cost headwinds.
- **Working capital:** Working capital as a percentage of sales improved to 22% as against 26.7% in Q2FY21 and 22.3% in Q1FY22.
- **Collections:** Group level collections ex-services were at Rs. 322 billion versus Rs. 296 billion in Q2FY2021.
- **Capex:** Capex incurred during Q2 was up 48% y-o-y at Rs. 5.7 billion.
- **Cash:** Standalone cash position is at Rs. 19000 crore while IT&ITES cash is Rs. 7000 crore.

Results (Consolidated) Rs cr

Particulars	Q2FY22	Q2FY21	YoY (%)	Q1FY22	QoQ (%)
Net Sales	**34,773**	**31,035**	**12.0%**	**29,335**	**18.5%**
Total Expenditure	30,778	27,700	11.1%	26,163	17.6%
Operating profits	**3,995**	**3,335**	**19.8%**	**3,171**	**26.0%**
Other Income	532	559	-4.8%	648	-17.9%
Interest	779	1,042	-25.2%	827	-5.8%
Depreciation	729	713	2.2%	717	1.6%
PBT	**3,019**	**2,138**	**41.2%**	**2,275**	**32.7%**
Exceptional items	(97)	3,732	-	-	-
PBT	3,116	(1,594)	-	2,275	37.0%
Tax	885	675	31.0%	718	23.1%
PAT	**1,819**	**5,520**	**-67.0%**	**1,174**	**54.9%**
Adj. PAT	**1,723**	**1,107**	**55.7%**	**1,174**	**46.7%**
EPS	**12.3**	**7.9**	**55.7%**	**8.4**	**46.7%**
Margins (%)			**BPS**		**BPS**
OPM	11.5	10.7	74	10.8	68
PATM	5.0	3.6	139	4.0	95
Tax Rate	28.4	-	-	31.6	(320)

Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view - Continued government focus on infrastructure spending to provide growth opportunities

To make India a $5 trillion economy by FY2025 and to continue growing at an escalated trajectory until 2030, it is estimated that the government would need to spend $4.5 trillion on infrastructure. To achieve the desired goal, the government drew up National Infrastructure Pipeline (NIP) through bottoms-up approach, wherein all projects costing more than Rs. 100 crore per project under construction, proposed greenfield and brownfield projects and those at conceptualisation stage were captured. Consequently, the total capital expenditure in infrastructure sectors in India during FY2020-FY2025 is projected at ~Rs. 111 lakh crore. During the same period, sectors such as energy (24%), roads (18%), urban (17%) and railways (12%) amount to ~71% of the projected infrastructure investments in India. The huge outlay towards infrastructure is expected to provide healthy growth opportunities for companies in this space.

■ Company outlook - Expect improvement in revenue run-rate along with healthy order intake prospects

L&T's management expects domestic recovery with a focus on growth in both revenues and order inflows for FY2022. Hence, the management has guided for a low to mid-teens growth in order intake and revenues for FY2022. The OPM and working capital requirement (as a % of sales) are expected to remain the same as FY2021 as in FY2022. Despite a second wave of COVID-19, the order prospects have stayed healthy for FY2022 with management indicating Rs. 8.96 lakh crore worth of order prospects. On the asset divestment front, for the Hyderabad metro the company is evaluating various options while divestment of power assets to move towards the closure. Thus, we expect L&T to bounce back owing to multiple levers such as a strong business model, a diversified order book and a healthy balance sheet.

■ Valuation - Maintain Buy with an unchanged PT of Rs. 2,150

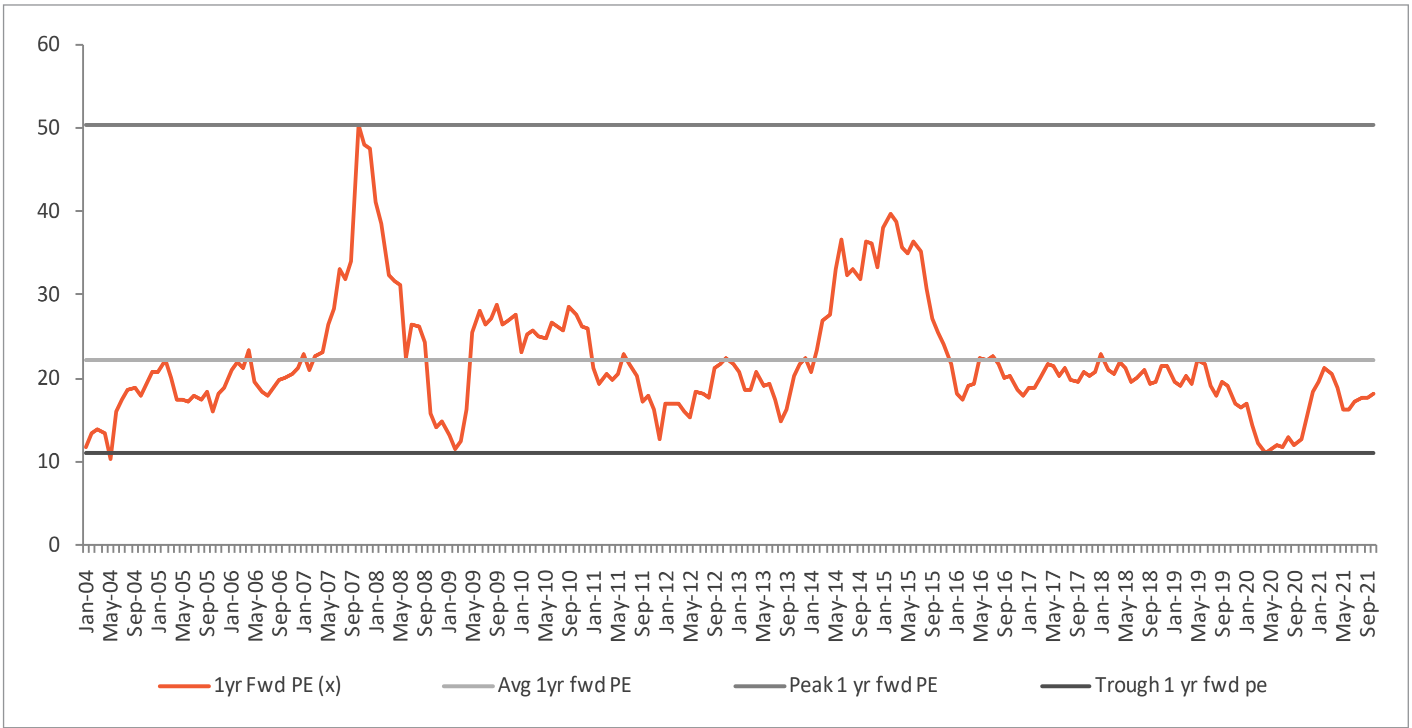
L&T's healthy operational performance despite supply chain challenges and seasonality along with retaining guidance related to execution, order intake, OPM and working capital for FY2022 are key positives emerging out of the Q2FY2022 results. International outlook looks buoyant with a pick-up in crude oil prices. On the longer term, L&T remains at the forefront to reap benefits from the AtmaNirbhar Bharat Scheme with its diversified businesses across sectors such as defence, infrastructure, heavy engineering, and IT. The company remains the best proxy for domestic capex and an improving business environment. We maintain our Buy rating on the stock with a revised SOTP-based price target (PT) of Rs. 2,150 factoring upwardly revised valuation of its key IT&TS subsidiaries and favourable core business valuation.

SOTP Valuation

Particulars	Remarks	Value (Rs cr)	Per share (Rs)
L&T's core business (standalone)	At 15x FY2023 estimates	1,39,994	999
Subsidiaries			
L&T Infotech (LTI)	Based on our target price	66,678	476
L&T Finance Holdings (L&TFH)	Based on our target price	13,904	99
L&T Technology Services Ltd (LTTS)	Based on our target price	34,502	246
Mindtree	Based on current market cap at 20% discount	34,556	247
Development projects (including IDPL)	At 1x Book Value	7,392	53
Hydrocarbon subsidiary	At 1x Book Value	850	6
Other subsidiaries	At 1x Book Value	3,071	22
Associates & Other	At 1x Book Value	405	3
Total subsidiary valuation		1,26,803	1,151
Fair value		2,66,797	2,150

Source: Company, Sharekhan Research

One-year forward P/E (x) band



Source: Company; Sharekhan Research

About company

L&T is an Indian multinational engaged in technology, engineering, construction, manufacturing, and financial services and is one of the largest players in India's private sector. A strong customer-focused approach and constant quest for top-class quality have enabled the company to attain and sustain a leadership position in major lines of businesses over eight decades. The company operates in over 30 countries worldwide.

Investment theme

Capex in the economy continues to be driven by the public sector mainly in the areas of power (renewable and T&D), transportation (roads, railways, and metro projects) and defence (mainly towards indigenisation); and L&T remains the key beneficiary. With India expected to invest significantly in infrastructure creation over the next few years and with re-election of the governments providing thrust on domestic manufacturing through 'Make in India' project, companies focusing on the domestic market are in a sweet spot compared to export-centric companies. Continued emphasis on infrastructure spending with focus on rail, road, and renewable is expected to benefit L&T.

Key Risks

Slower-than-expected project execution in domestic and international markets due to various reasons such as pending approvals and clearances from government agencies and land acquisition could affect revenue. Further, weakness in domestic investment could impact growth and award of large projects, thus posing a downside risk. Moreover, unexpected political changes in some of the developed countries, trade barriers, and conflict in the Middle East are some of the risks that can affect the company's performance.

Additional Data

Key management personnel

A.M Naik	Group Chairman
S.N Subrahmanyam	Chief Executive office and Managing Director
R. Shankar Raman	Chief Financial Officer
Shailendra Roy	Sr. Executive V.P- Power, Heavy Engineering and Nuclear
D.K. Sen	Sr. Executive V.P- Infrastructure
M.V. Satish	Sr. Executive V.P- Building, Minerals and Metals
J.D. Patil	Sr. Executive V.P- Defence

Source: Bloomberg

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Life Insurance Corp of India	14.90
2	L&T EMPLOYEES TRUST	13.37
3	HDFC Asset Management Co Ltd	4.42
4	SBI Funds Management Pvt Ltd	4.02
5	Republic of Singapore	2.25
6	ICICI Prudential Life Insurance Co	1.82
7	General Insurance Corp of India	1.80
8	ICICI Pru AMC	1.74
9	Kotak Mahindra AMC	1.33
10	Reliance Capital Trustee Co Ltd	1.21

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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