Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

# Larsen & Toubro Ltd

## A strong case for robust execution and margin recovery

| Capital Goods | Sharekhan code: LT | | |
|---|---|---|---|
| Reco/View: Buy ↔ | CMP: Rs. 2,171 | Price Target: Rs. 2,600 ↑ | |

↑ 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 34.44
Updated Feb 08, 2023

High Risk

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

*Source: Morningstar*

**Company details**

| | |
|---|---|
| Market cap: | Rs. 3,05,101 cr |
| 52-week high/low: | Rs. 2,298/1,456 |
| NSE volume: (No of shares) | 19.3 lakh |
| BSE code: | 500510 |
| NSE code: | LT |
| Free float: (No of shares) | 140.5 cr |

**Shareholding (%)**

| | |
|---|---|
| Promoters | - |
| FII | 23.3 |
| DII | 40.1 |
| Others | 36.6 |

**Price chart**


**Price performance**

| (%) | 1m | 3m | 6m | 12m |
|---|---|---|---|---|
| Absolute | 1.8 | 0.1 | 9.9 | 30.8 |
| Relative to Sensex | 2.4 | 3.7 | 8.8 | 17.8 |

*Sharekhan Research, Bloomberg*

**Summary**

- L&T by virtue of its leadership and diversified offerings in the EPC domain would be a key beneficiary of the government's infrastructure thrust and capex revival in private sectors. Further, increased investments in infrastructure and hydrocarbon in the GCC region provide diverse opportunities.
- Given strong order book at ~Rs. 3.9 lakh crore (2.2x its TTM revenue) and order prospects of Rs. 4.87 trillion for Q4FY2023, we expect robust execution going forward. Multiple margin tailwinds – easing supply chain, stable commodity prices, and higher margin orders indicate margin recovery from FY2024.
- Focus on sunrise sectors such as green hydrogen, data centres, e-commerce as well as defence would lead to further diversification.
- We maintain Buy on L&T with a revised PT of Rs. 2,600 (upgrading our target P/E for the core business), given strong execution and margin tailwinds and improving return rations in the capex upcycle.

**L&T, the engineering conglomerate, by virtue of its leadership and commendable execution track record in the engineering, procurement, and construction (EPC) domain is well poised to benefit from capex upcycle in both public and private sectors. For FY2023, the company would most likely exceed its order intake guidance and would easily achieve the upper end of its revenue growth guidance (12-15%), given its robust order book of Rs. 3.9 lakh crore. Despite weak guidance for the core business margin in FY2023, we see multiple margin tailwinds in the medium to long term in the form of new orders secured at higher margins, declining commodity prices, increasing cost efficiencies, and easing supply chains. The company has chalked out a detailed five-year strategic plan 'Lakshya 2026' for pursuing profitable growth in its traditional businesses of EPC projects and manufacturing and expanding the size and scale of its IT&TS portfolio. Under the plan, the company aims to grow its order inflows/revenue at a 14%/15% CAGR and achieve core RoE of over 18% by FY2026E. Apart from strong growth visibility in its existing business, new avenues such as green hydrogen, data centers, and e-commerce businesses would contribute to its long-term growth. In addition, the unlocking of investments in Hyderabad metro and Nabha Power is being pursued and successful monetization of the same should improve its working capital and debt profile.**

**Bulging order book, capex upcycle to drive performance**

L&T's order book stands at a record level of Rs. 3.9 lakh crore (up 14% y-o-y), translating into 2.2x its TTM consolidated revenue. The company's 9MFY2023 order inflows jumped by ~30% y-o-y to Rs. 1.5 lakh crore. Order prospects for Q4FY2023 stand at Rs. 4.87 lakh crore, of which Rs. 1.05 trillion is international. Out of domestic orders prospects of Rs. 3.82 trillion, the share of private orders is 10-15%. The award-to-tender ratio for 9MFY2023 stood higher at 52% vs. 48% in 9MFY22. Hence, we believe L&T's quality and well-diversified order book would help the company in timely execution in the coming years. India's capital expenditure as a percentage of GDP has increased from 1.7% in 2014 to nearly 2.9% in 2022-2023. In 2023-2024 budget, Rs. 10 lakh crore (3.3% of GDP) was allocated for infrastructure, an increase of three times from 2019. These budget provisions build on the government's National Infrastructure Pipeline (NIP) and other initiatives such as Make in India and the production-linked incentives (PLI) scheme to augment growth of infrastructure sector. L&T, being the largest engineering and construction player, stands to be a key beneficiary of public capex spend comprising the centre, states, and PSUs.

**Opportunities in sunrise sectors such as green hydrogen and defence would aid long-term growth**

L&T has a long-term plan to expand its presence in sunrise sectors such as green hydrogen development, electrolyser, and battery manufacturing, data centres, including scaling up of its digital and e-commerce businesses. L&T is eyeing a total investment of Rs. 1,500 crore for electrolysers for which a pilot green hydrogen plant has already been commissioned. L&T plans to pursue opportunities in the EPC of green hydrogen plants in the Middle East as well. In battery storage, the company plans an investment of Rs. 2,500 crore for battery storage and Rs. 1,800-2,000 crore for data centre over the next few years. Further, the company sees substantial opportunities in defence in the shipbuilding segment in the coming years and aims to double its order book in defence in the next two-three years.

**Easing supply chain and stability in commodity cost may expand margins from FY2024**

L&T expects to close FY2023 with margin below 9% as compared to its erstwhile run rate of ~10% before Covid-19 and commodity price inflation. However, there are multiple tailwinds, which if play out, can provide a fillip to margins after a quarter or two. Currently, the order mix in the domestic order book is largely public, which has lower margins as compared to private orders, which currently form ~20% of the order book. However, in order prospects, the private sector has seen an increase, driven by building and factories (B&F) and minerals and metals (M&M). Margins could improve if contribution from the private sector goes up to 22-25% going forward. Further, there has been a heavy correction in commodity prices, which should lead to a reduction in input cost. Moreover, supply-chain constraints are gradually easing out. Further, orders booked post the input cost escalation, including commodity prices, carry higher margins. Hence, operating margins should improve once these orders achieve a certain margin threshold level.

**Revision in estimates –** We have marginally tweaked our estimates for FY2023-FY2025E.

**Our Call**

**Maintain Buy with a revised PT of Rs. 2,600:** L&T's 9MFY2023 performance has been commendable despite cost pressures in its core business and supply-chain challenges. Further, a robust order book and strong order pipeline going forward give us comfort on execution from a long-term perspective. The company also expects margins to improve from Q4FY2023. The international outlook is also buoyant, given a healthy order pipeline and emerging opportunities in non-oil segments such as infrastructure, green energy, and hydrocarbon particularly in the GCC region. We believe L&T remains at the forefront to reap benefits from the AtmaNirbhar Bharat scheme with its leadership in the EPC domain and diversified offerings in infrastructure, heavy engineering, defence, and IT. Hence, the company remains the best proxy for the domestic capex upcycle. Therefore, we maintain our Buy recommendation on the stock with a revised SOTP-based price target (PT) of Rs. 2,600, increasing our target P/E multiple for the core business, given strong growth opportunities in the capex upcycle.

**Key Risks**

Any slowdown in the domestic macroeconomic environment and geopolitical conflicts on the international front can adversely impact its order prospects.

**Valuation (Consolidated)** Rs cr

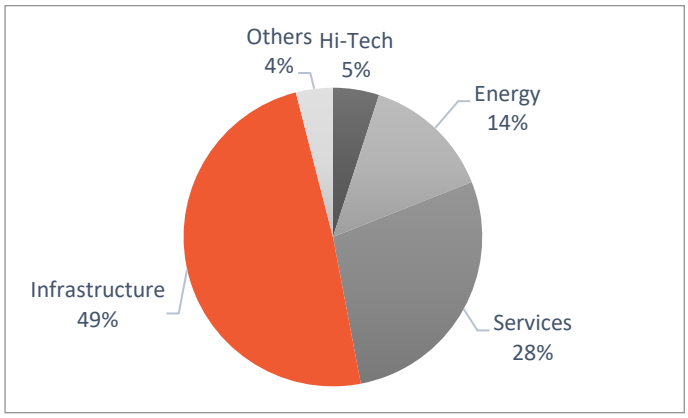
| Particulars | FY22 | FY23E | FY24E | FY25E |
|---|---|---|---|---|
| Revenue | 1,56,521 | 1,80,607 | 2,05,892 | 2,33,688 |
| OPM (%) | 11.6 | 11.4 | 11.7 | 11.8 |
| Adjusted PAT | 8,573 | 10,308 | 12,910 | 15,616 |
| % YoY growth | 24.2 | 20.2 | 25.2 | 21.0 |
| Adjusted EPS (Rs.) | 61.2 | 73.5 | 92.1 | 111.4 |
| P/E (x) | 35.5 | 29.5 | 23.6 | 19.5 |
| P/B (x) | 3.7 | 3.4 | 3.1 | 2.8 |
| EV/EBITDA (x) | 18.0 | 15.2 | 12.7 | 10.6 |
| RoCE (%) | 7.8 | 8.8 | 10.4 | 11.8 |
| RoNW(%) | 13.2 | 12.0 | 13.7 | 14.9 |

*Source: Company; Sharekhan estimates*

## Bulging and diversified order book provides strong revenue visibility

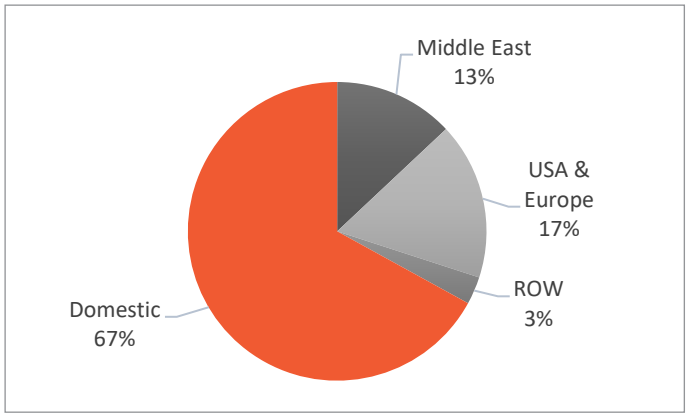
L&T's order book stands at a record level of Rs. 3.9 lakh crore (up 14% y-o-y), translating into 2.2x its TTM consolidated revenue. The company's 9MFY2023 order inflows jumped by ~30% y-o-y to Rs. 1.5 lakh crore. Management indicated that it could exceed the upper end of the order intake guidance of 12-15% y-o-y growth in FY2023E. The order book is well diversified, as out of the total order book of Rs. 3.9 lakh crore-Rs. 1 lakh crore is international. Of the international order book, 81% comes from the Middle East, 10% from Africa, and the remainder from Southeast Asian countries. In its 9M order inflows, order awards were strong in domestic markets, particularly in infrastructure from segments such as heavy civil infrastructure, metals and mining, T&D, and buildings and factories (B&F). Order prospects for Q4FY2023 stand at Rs. 4.87 lakh crore, of which Rs. 1.05 trillion is international. Out of domestic orders prospects of Rs. 3.82 trillion, the share of private orders is 10-15%. In total, the infrastructure segment has prospects of Rs. 3.89 trillion, hydrocarbon is at Rs. 0.61 trillion, power is at Rs. 0.20 trillion, while heavy engineering and defence together are Rs. 0.17 trillion. The award-to-tender ratio for 9MFY2023 stood higher at 52% vs. 48% in 9MFY2022. Hence, we believe L&T's quality and well-diversified order book would help the company in timely execution in the coming years.

**Segment Order Inflow Composition – 9MFY2023**



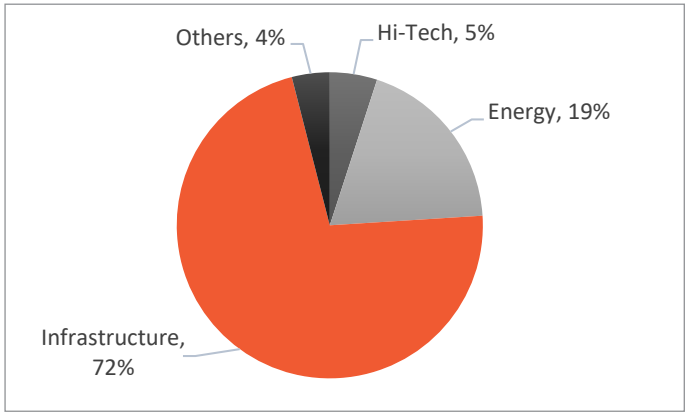

*Source: Company, Sharekhan Research*

**Geographical Order Inflow Composition – 9MFY23**



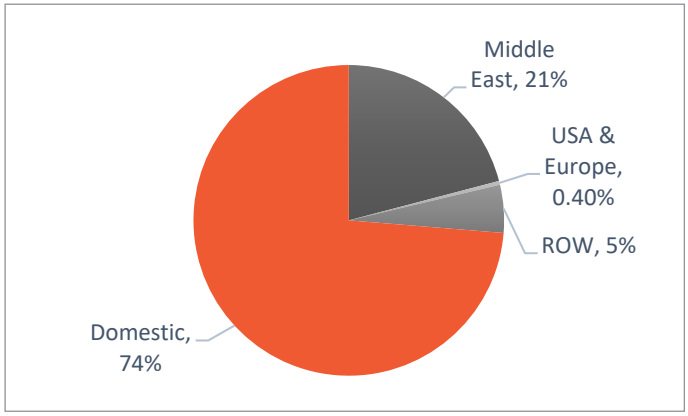

*Source: Company, Sharekhan Research*

**Segment Order Book Composition – 9MFY2023**



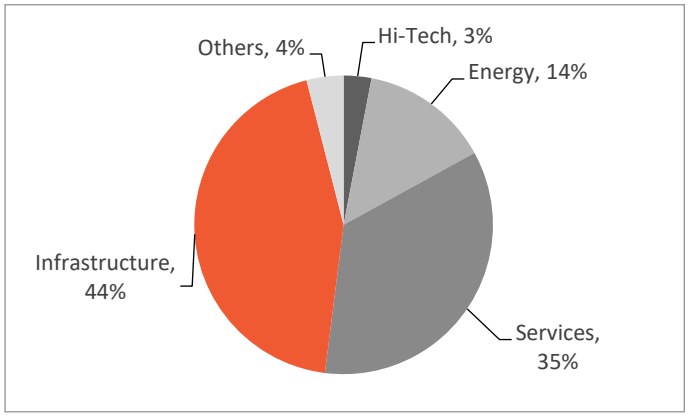

*Source: Company, Sharekhan Research*

**Geographical Order Book Composition – 9MFY2023**



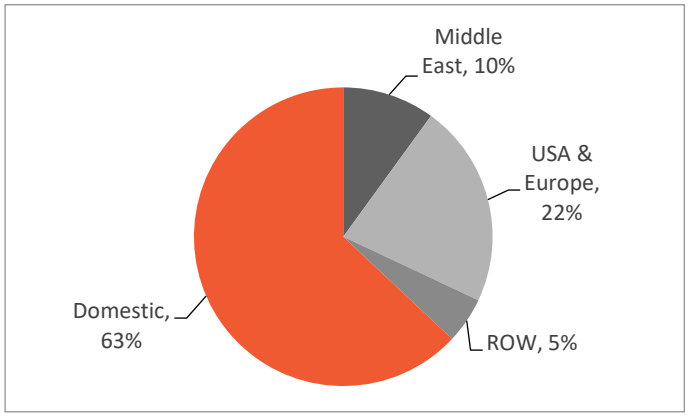

*Source: Company, Sharekhan Research*

**Segment Revenue Composition – 9MFY2023**




*Source: Company, Sharekhan Research*

**Geographical Revenue Composition – 9MFY2023**




*Source: Company, Sharekhan Research*

**Increasing focus on sunrise sectors including defence opens up new growth avenues**

L&T has a long-term plan to expand its presence in sunrise sectors such as green hydrogen development, electrolyser and battery manufacturing, data centres including scaling up of its digital and e-commerce businesses. L&T is eyeing a total investment of Rs. 1,500 crore for electrolysers for which a pilot green hydrogen plant has already been commissioned. The company is looking for a joint venture partner, which can assist the company in setting up the electrolysers JV. The plant should come on stream in the early part of FY2024. The company expects revenue from this segment to kick in from FY2025/FY2026. L&T plans to pursue opportunities in EPC of green hydrogen plants in the Middle East as well. In battery storage, the company plans an investment of Rs. 2,500 crore for battery storage and Rs. 1,800-2,000 crore for data centre over the next few years. Hence, a foray into sunrise sectors should help the company further de-risk its business profile and achieve consistent growth. Further, its defence order prospects for Q4FY2023 stand at Rs. 15,000 crore. The company sees substantial opportunities in defence in the shipbuilding segment in the coming years, as Ministry of Defence has granted Acceptance of Necessity (AoN) for new-generation corvettes; navy is also coming up with more Requests for proposals (RFPs) and coast guards have also issued three RFPs for offshore patrol vehicles. The company aims to double its order book in defence in the next two-three years.

**Government's capex push and increased private capex bode well for growth**

India's capital expenditure as a percentage of GDP has increased from 1.7% in 2014 to nearly 2.9% in 2022-2023. In 2023-2024 budget, Rs. 10 lakh crore (3.3% of GDP) was allocated for infrastructure, an increase of three times from 2019. These budget provisions build on the government's NIP and other initiatives such as Make in India and PLI scheme to augment growth of the infrastructure sector. L&T being the largest engineering and construction player stands to be a key beneficiary of public capex spend comprising centre, states, and PSUs. Moreover, private sector capex is also seeing signs of revival. In Q3FY2023, project announcements by the private sector were at a multiyear high. Notably, L&T's share of private orders within domestic orders was 32% vs. 18% last year and orders largely came from buildings and factories and in the ferrous sector.

**Easing supply chain and stability in commodity cost may expand margins from FY2024**

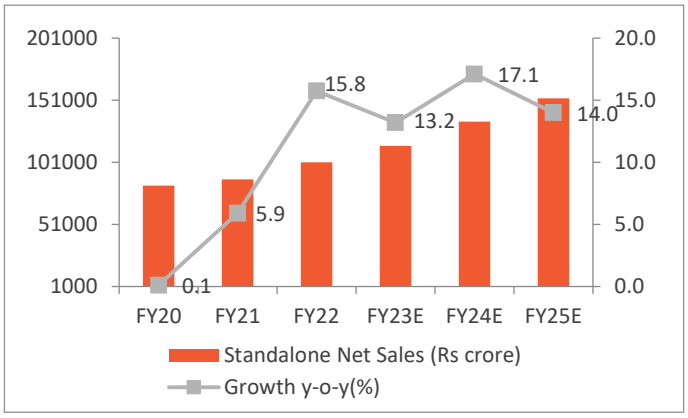
The company expects core projects' business margins to be lower by 30-50 bps in FY2023 as compared to ~9.3% OPM in FY2022. L&T expects to close FY2023 with margin below 9% as compared to its erstwhile run rate of ~10% before Covid-19 and commodity price inflation. However, there are multiple tailwinds, which if play out can provide a fillip to margins after a quarter or two. Currently, the order mix in the domestic order book is largely public, which has lower margins as compared to private orders, which currently form ~20% of the order book. However, in order prospects, the private sector has seen an increase, driven by B&F and M&M). The margin could improve if the contribution from the private sector goes up to 22-25% going forward. Further, there has been a heavy correction in commodity prices, which should lead to a reduction in input cost. Moreover, supply-chain constraints are gradually easing out. Further, orders booked post the input cost escalation, including commodity prices, carry higher margins. Hence, margins should improve once these orders achieve a certain margin threshold level.

**Value unlocking through monetization of Hyderabad metro**

L&T expects to unlock Rs. 1,000-1,500 crore through stake sale/divestment in Hyderabad metro each year over the next 2-3 years. On the liability side, it has Rs. 13,000 crore-Rs 8,000 crore of external debt and Rs. 5,000 crore in short-term borrowings, while L&T's equity exposure is Rs. 7,500 crore. The subsidiary has had cumulative losses of Rs. 4,500 crore so far. Structurally, the company is making a good amount of positive EBITDA to cover interest cost and L&T would not have to infuse further cash. The government has released Rs. 100 crore of interest-free loan so far and Rs. 900 crore of the first tranche (out of the total commitment of Rs. 3,000 crore) is expected to be received in the current quarter.

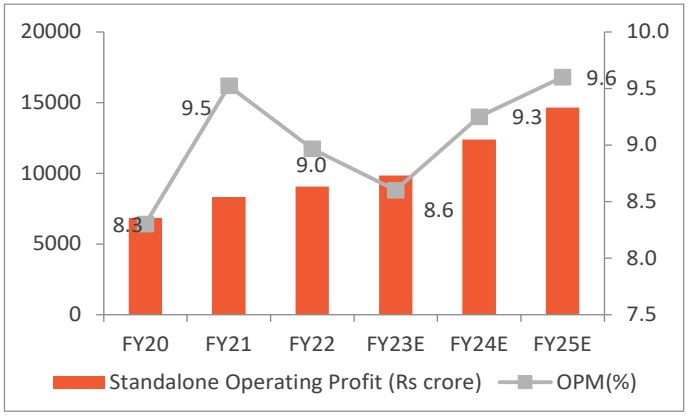
## Financials in charts

### Net sales growth trend



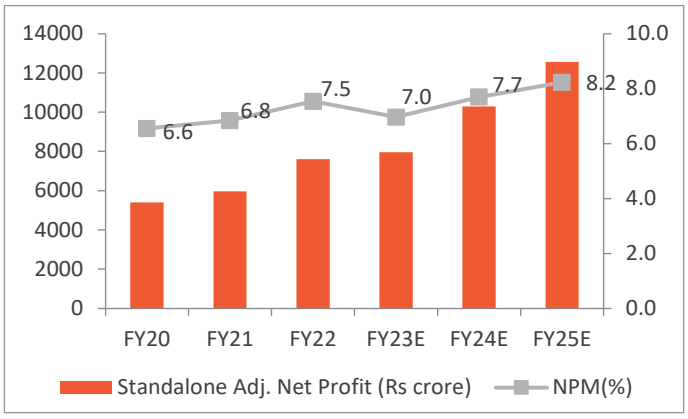

*Source: Company, Sharekhan Research*

### Operating profit and margin trend



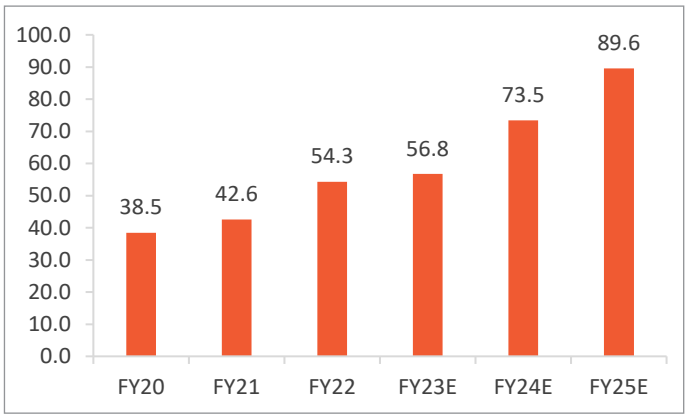

*Source: Company, Sharekhan Research*

### Net profit and margin trend



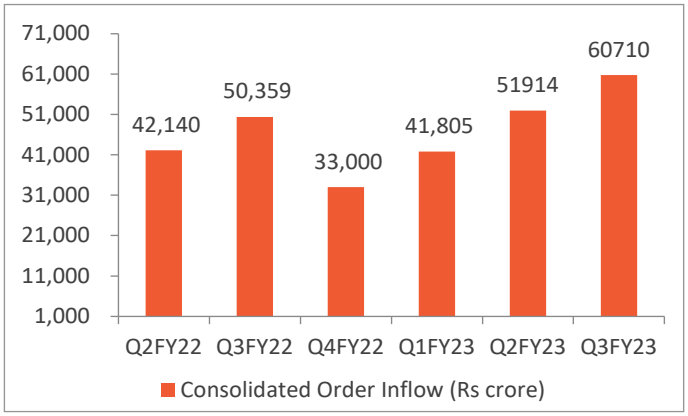

*Source: Company, Sharekhan Research*

### EPS growth trend



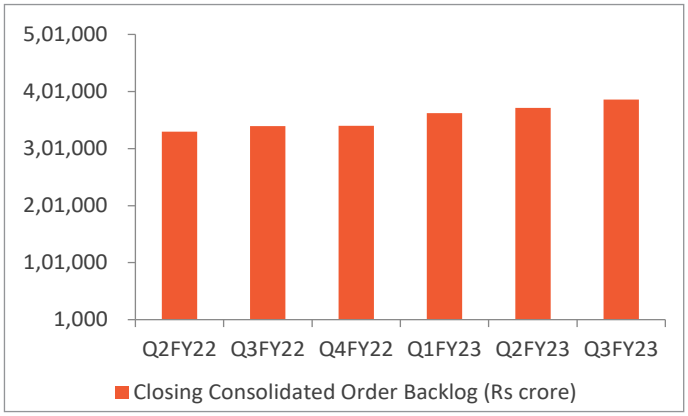

*Source: Company, Sharekhan Research*

### Order inflows ternd




*Source: Company, Sharekhan Research*

### Order backlog trend




*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 goal, the government drew up NIP through a bottom-up approach, wherein all projects costing over Rs. 100 crore per project under construction, proposed greenfield and brownfield projects, and those at conceptualization 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%) are likely to 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 healthy order inflows and improved execution

Management expects strong growth momentum to continue with a focus on growth in both revenue and order inflows for FY2023/FY2024. Management aims to exceed the order intake guidance for FY2023 and achieve revenue guidance, given the strong order book. OPM is expected to decline on a y-o-y basis for FY2023. However, margins have bottomed out for the core business and we could see improvement from current levels. Further, the working capital requirement (as a percentage of sales) would be at 19-20%. Order prospects are also healthy with the rise in government spend and private capex and strong traction in international orders. On the asset divestment front, for the Hyderabad Metro, the company is evaluating various options. Thus, we expect L&T to perform consistently owing to multiple levers such as a strong business model, a diversified order book, and a healthy balance sheet.

### ■ Valuation - Maintain Buy with a revised PT of Rs. 2,600

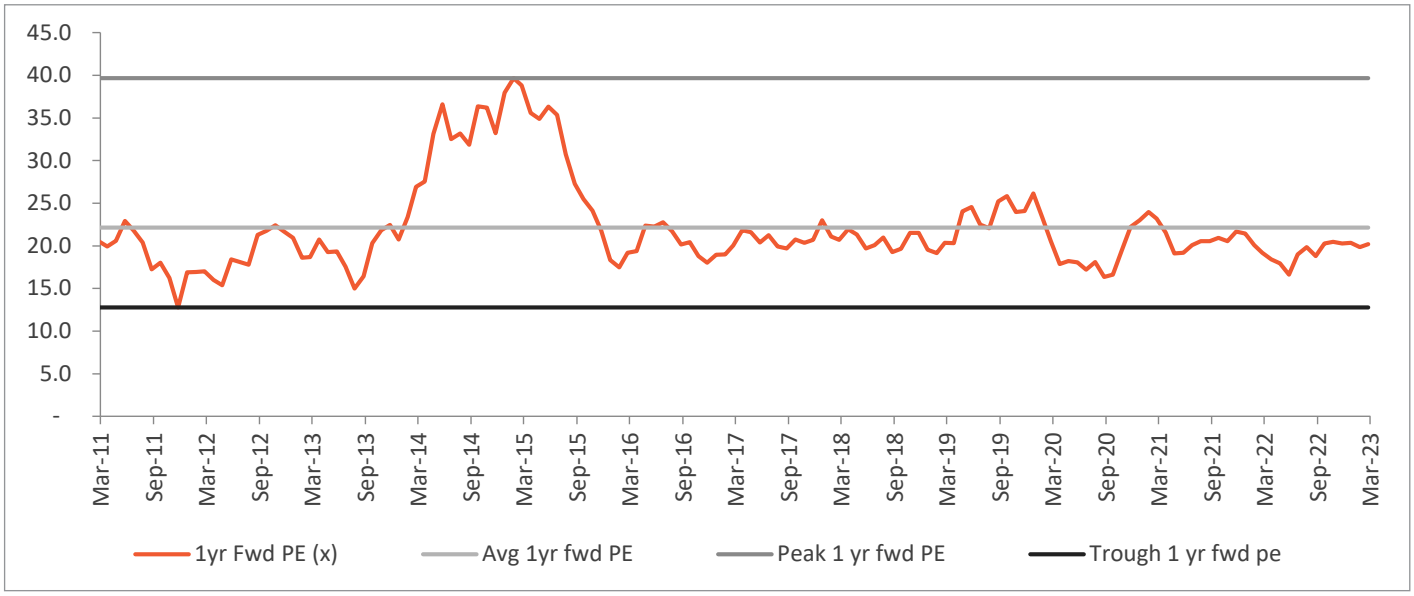
L&T's 9MFY2023 performance has been commendable despite cost pressures in its core business and supply-chain challenges. Further, a robust order book and strong order pipeline going forward give us comfort on execution from a long-term perspective. The company also expects margins to improve from Q4FY2023. The international outlook is also buoyant, given a healthy order pipeline and emerging opportunities in non-oil segments such as infrastructure, green energy, and hydrocarbon particularly in the GCC region. We believe L&T remains at the forefront to reap benefits from the AtmaNirbhar Bharat scheme with its leadership in the EPC domain and diversified offerings in infrastructure, heavy engineering, defence, and IT. Hence, the company remains the best proxy for the domestic capex upcycle. Therefore, we maintain our Buy recommendation on the stock with a revised SOTP-based PT of Rs. 2,600, increasing our target P/E multiple for the core business, given strong growth opportunities in the capex upcycle.

**SOTP Valuation**

| Particulars | Remarks | Value (Rs cr) | Per share (Rs) |
|---|---|---|---|
| **L&T's core business (standalone)** | **At 19x FY25E estimates** | **2,38,633** | **1,702** |
| Subsidiaries | | | |
| LTIMindtree | Based on our target price | 81,807 | 584 |
| L&T Finance Holdings (L&TFH) | Based on our target price | 12,372 | 88 |
| L&T Technology Services Ltd (LTTS) | Based on our target price | 20,784 | 148 |
| Development projects (including IDPL) | At 0.8x Book Value | 6,720 | 48 |
| Hydrocarbon subsidiary | At 0.8x Book Value | 800 | 6 |
| Other subsidiaries | At 0.8x Book Value | 2,890 | 21 |
| Associates and Other | At 0.8x Book Value | 382 | 3 |
| **Total subsidiary valuation** | | **1,25,755** | **897** |
| **Fair value** | | **3,64,388** | **2,600** |

*Source: Company, Sharekhan Research*

**One-year forward P/E (x) band**




*Source: Sharekhan Research*

## About company

L&T is an Indian multinational company 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 a 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.
- Weakness in domestic investment could impact growth and award of large projects, thus posing a downside risk.
- 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: Company*

**Top 10 shareholders**

| Sr. No. | Holder Name | Holding (%) |
|---|---|---|
| 1 | SBI Funds Management Ltd | 4.36 |
| 2 | ICICI Prudential Asset Management Co Ltd | 2.56 |
| 3 | HDFC Asset Management Co Ltd | 2.02 |
| 4 | Vanguard Group Inc | 1.92 |
| 5 | Blackrock Inc | 1.46 |
| 6 | Nippon Life India Asset Management Ltd | 1.35 |
| 7 | Capital Group Cos Inc | 1.28 |
| 8 | ICICI Prudential Life Insurance Co Ltd | 1.23 |
| 9 | Kotak Mahindra Asset Management Co Ltd | 1.19 |
| 10 | UTI Asset Management Co Ltd | 1.14 |

*Source: Bloomberg (old data)*

## 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*

Sharekhan

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