Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Larsen & Toubro

Strong order book; outlook optimistic amid margin stress

Capital Goods	Sharekhan code: LT
Reco/View: Buy ↔	CMP: **Rs. 2,364**	Price Target: **Rs. 2,700** ↑

↑ 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 Mar 08, 2023

High Risk

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

Source: Morningstar

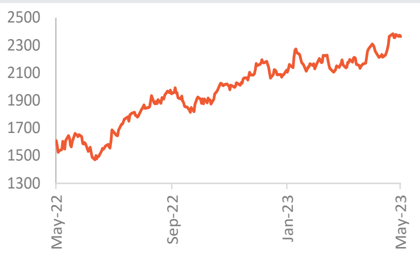
Company details

Market cap:	Rs. 3,32,225 cr
52-week high/low:	Rs. 2,416/1,456
NSE volume: (No of shares)	19.9 lakh
BSE code:	500510
NSE code:	LT
Free float: (No of shares)	140.5 cr

Shareholding (%)

Promoters	0.0
FII	24.5
DII	38.8
Others	36.8

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	2.7	10.6	18.5	46.9
Relative to Sensex	-0.2	9.0	17.3	33.6

Sharekhan Research, Bloomberg

Summary

- Q4FY2023 numbers slightly lagged estimates as revenue/OPM/PAT came lower by ~3%/~30 bps/~6%. Working capital/ sales improved considerably to 16.1%.
- Order inflow for Q4FY23 was up by 3%/19% y-o-y to Rs. 76,072 crore/Rs. 2,30,528 crore, respectively. Annual order inflow beat guidance of a 12-15% growth. Order book is at an all-time high at ~Rs 3.99 lakh crore (2.2xFY23 revenue).
- L&T targets 12-15% revenue and 10-12% order intake growth in FY24. OPM for the core business to be at ~9% (up 40/50bps y-o-y). Working capital/sales to be at 16-18%.
- Management expects order inflow /execution momentum to continue. Margins may remain under stress in H1FY24, after which a gradual expansion is possible. We maintain a Buy on L&T with a revised PT of Rs. 2,700, factoring in an optimistic outlook and revision in valuation of its subsidiaries.

Q4FY2023 consolidated numbers were below estimates as revenue/OPM/ PAT fell short of expectations by 3.3%/~30 bps/~6%. Consolidated revenues grew by ~10% y-o-y to Rs. 58,335 crore. Revenue growth was driven by energy and hi-tech manufacturing segments, while its largest- infrastructure segment grew at a moderate 5% y-o-y. Operating profit increased at a slower pace by ~5% y-o-y to Rs 6,833 crore. OPM, thus, came in lower by 60 bps y-o-y to 11.7%. Net profit grew by ~10% y-o-y to Rs 3,986 crore aided by higher other income. The company reported 19% y-o-y growth in order inflows, surpassing its guidance of a 12-15% growth. The order inflow for the quarter and year stands at Rs.76,072 crore/ Rs. 2,30,528 crore respectively. Order book grew by 12% y-o-y to Rs. 3,99,526 crore. L&T's order book stands at a record level translating to ~2.2x its FY23 consolidated revenue. It expects OPM in core projects business to expand by 40-50 bps to 9% in FY24. Working capital requirements would be at 16-18% of sales helped by faster collections from GCC region.

Key positives

- Order prospects for FY2023 stands at Rs 9.73 lakh crore (up ~14% y-o-y).
- L&T has guided for 10-12% order inflow growth on a higher base for FY24.
- Order inflows for FY23 grew by 19% y-o-y to Rs. 2,30,528 crore comprising of 38% of the international orders. Orders were received across multiple segments in infrastructure projects, hydrocarbon, defence engineering.
- Energy/hi-tech manufacturing segment secured orders of Rs. 8,892 crore/8573 crore, registering a healthy growth of 17%/41% respectively.
- Energy segment margins improved to 10.4% (from 8.8%) due to execution cost savings in power and favorable customer claims in hydrocarbon.
- Order book remains strong at Rs. 3.99 lakh crore, up 12% y-o-y – 72% domestic orders and 28% international orders.

Key negatives

- In Q4FY23, OPM declined by 60 bps y-o-y to 11.7% and PAT missed estimates by a small margin.
- The company has given cautious margin guidance of ~9% for the core business in FY24.
- Revenues in infrastructure projects grew moderately by 5% y-o-y. Infrastructure projects' order inflow for Q4FY23 was down by 9% y-o-y due to a high base, over the corresponding quarter of the previous year.
- Order inflows were muted in power sector.

Management Commentary

- Order inflows would grow by 10-12% in FY24. Revenue growth guidance at 12-15% y-o-y.
- Projects and manufacturing business OPM may increase from 8.6% to ~9% for FY24 with expansion expected in H2FY24. working capital at 16-18% of sales for FY24.
- The company provided an optimistic long-term outlook on margins as the margin in the core business has bottomed out and is likely to improve from H2FY24 onwards.
- The company has removed slow moving orders of Rs. 5,300 crore/Rs 10,300 crore from order book in Q4FY23/FY23 respectively. Slow moving orders is 1% of the total order book.
- Order prospects for FY24 stands at Rs 9.73 trillion (up 14% y-o-y).
- Due to an increase in competitive intensity and cost side challenges it is difficult to revert to erstwhile OPM of over 11% in the core business. However, the company is improving internal efficiencies to achieve the best possible margin in the coming years.

Revision in estimates – We have marginally tweaked our estimates for FY2023-FY2025 following lower than expected margin in FY23.

Our Call

Maintain Buy with a revised PT of Rs. 2,700: L&T's Q4FY2023/FY2023 performance has been marginally below expectations particularly on the margin front. The company has provided optimistic outlook going forward w.r.t. revenue and order inflow growth, while OPM shall improve in H2FY24 as quite a few large projects are likely to achieve margin threshold during that period. Its all-time high order book provides strong revenue visibility and orders prospects are also promising. The international outlook is also buoyant, given a healthy order pipeline and emerging opportunities in non-oil segments as well. Given the weakness in margin and cautiously optimistic commentary of the management on margin front, the stock may witness pressure in the near term. Although in the long 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. Therefore, we maintain a Buy on the stock with a revised SOTP-based price target (PT) of Rs. 2,700.

Key Risks

A slowdown in the domestic macro-economic environment and geo-political conflicts on the international front can adversely impact its order prospects.

Valuation (Consolidated) Rs cr

Particulars	FY22	FY23	FY24E	FY25E
Revenue	1,56,521	1,83,341	2,11,287	2,39,811
OPM (%)	11.6	11.3	11.8	12.2
Adjusted PAT	8,573	10,335	13,220	16,384
% YoY growth	24.2	20.6	27.9	23.9
Adjusted EPS (Rs.)	61.2	73.7	94.3	116.9
P/E (x)	38.7	32.1	25.1	20.2
P/B (x)	4.0	3.6	3.3	2.9
EV/EBITDA (x)	19.3	15.9	12.9	10.6
RoCE (%)	7.8	8.9	10.7	12.4
RoNW (%)	13.0	14.4	13.7	15.3

Source: Company; Sharekhan estimates

Sub-par Q4 performance, order momentum continues

Q4FY2023 consolidated numbers were below estimates as revenue/OPM/ PAT fell short of expectations by 3.3%/~30 bps/~6%. Consolidated revenues grew by ~10% y-o-y to Rs. 58,335 crore. Revenue growth was driven by energy and hi-tech manufacturing segments, while its largest- infrastructure segment grew at a moderate 5% y-o-y. Operating profit increased at a slower pace by ~5% y-o-y to Rs 6,833 crore. OPM, thus, came in lower by 60 bps y-o-y to 11.7%. Net profit grew by ~10% y-o-y to Rs 3,986 crore aided by higher other income. The company reported 19% y-o-y growth in order inflows, surpassing its guidance of a 12-15% growth. The order inflow for the quarter and year stands at Rs.76,072 crore/Rs. 2,30,528 crore respectively. Order book grew by 12% y-o-y to Rs. 3,99,526 crore. L&T's order book stands at a record level translating to ~2.2x its FY23 consolidated revenue. It expects OPM in core projects business to expand by 40-50 bps to 9% in FY24. Working capital requirements would be at 16-18% of sales helped by faster collections from GCC region.

Long-term outlook optimistic

The management has provided strong guidance for both order intake and revenue despite a high base. ROE has also improved sequentially to 12.2% in FY23 and it expects working capital to improve due to better collection efficiencies in the GCC region. The infrastructure sector is witnessing healthy tendering and awarding activity, wherein private sector project announcements are also gaining momentum. Although margins have been under stress from past few quarters, improvement is expected fromH2FY24 onwards. 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. Further, unlocking current investments in a few non-core areas is being aggressively pursued.

Key highlights from Q4FY23 earnings call

- **Robust order book at ~Rs. 3.99 lakh crore (up 12% y-o-y):** Out of the total order book of Rs 3.99 lakh crore – ~Rs. 1.1 lakh crore is international. Of the international order book, 87% comes from the Middle East, 4% from Africa and the remaining 9% from various countries including South-East Asia. In the Domestic order book of Rs 2.88 lakh crore (78% of the total order book) – central government orders have a 14% share, state@ 30%, state-owned enterprises or PSU @ 36 % and private sector @ 20%. Also, 22% of the total order book is funded by bilateral and multilateral agencies. Of the total order book - 89% of orders are from infrastructure and energy segments.
- **Slow-moving orders –** The company has removed Rs. 5,300 crore and Rs 10,300 crore from order book in Q4FY23/FY23 respectively. Slow moving orders is 1% of the total order book.
- **Order prospects up by ~14% to Rs 9.73 trillion for FY24:** The order prospects for FY24 is robust at Rs 9.73 trillion (8.53 trillion in FY22). In total, the infrastructure segment has prospects of Rs 6.5 trillion (Rs. 5.72 trillion in FY23) of which domestic orders comprise of Rs 5.19 trillion and Rs 1.31 trillion is international. In energy: hydrocarbon is at Rs 2.44 trillion while power is at Rs 0.5 trillion. Hi-tech manufacturing prospects are at Rs 0.29 trillion.
- **Discontinuation of consolidation of L&T IDPL:** Given the sale of IDPL assets, its profit consolidation with L&T has been discontinued and the investment is classified as held for sale.
- **Order inflow grew by 19% surpassing guidance of 12-15% growth:** Q4FY23 order inflows were up 3% y-o-y to Rs. 76,072 crore, led by hydrocarbon and defence engineering sectors as infrastructure projects witnessed a 9% decline y-o-y due to high base of last year's corresponding quarter. International orders stood at Rs 36,046 crore and comprised 47% of the total order inflows. The annual order inflow grew by 19% y-o-y to Rs. 2,30,528 crore surpassing the company's guidance of 12-15% growth. The growth in order inflows for FY23 was driven by infrastructure projects (+25% y-o-y) and hi-tech manufacturing (+39%)

- **Strong order inflow guidance:** The company has provided order inflow guidance of 12-15% y-o-y growth in FY24 despite a high base. The company is confident of achieving the growth if the current tendering and award momentum continues at the same pace.
- **Revenue guidance:** The company expects a 12-15% y-o-y revenue growth driven by continued execution momentum and growth in its services business.
- **Margin guidance:** The company expects core projects' business margins to improve by 40-50 bps in FY2024 to ~9% from 8.6% in FY2023. The company may not be able to return to the erstwhile margin of 10-11% in the core business due to competitive intensity and supply side challenges and rising costs. The margin expansion is likely to occur in H2FY24 as many large projects would be achieving margin recognition threshold during that period. The company stated that 60% of order backlog with low-margin and high commodity cost has been executed by FY23 end and the rest 40% would be executed in the next two years. Therefore, in the long-term order backlog with better margin would kick in.
- **Changes in competitive landscape and cost structure has altered the margin profile:** L&T would aim to get back to 10-10.5% margin trajectory in core business. The erstwhile margin of over 11% may not be achievable due to increasing competitive intensity and significant commodity cost and supply chain.
- **Electrolysers plant to be commissioned by FY24 end:** Initially, electrolysers would be sold in India and then the company would tap the global markets depending on the acceptance of technology and cost viability. As far as EPC for green hydrogen is concerned, it shall take up to three 3 years for scalability.
- **Working capital update:** The company expects working capital to be 16-18% of the sales for FY2024 as compared to the 20-22% target for FY23 (later revised to 20%). Notably, L&T achieved working capital/ sales to 16.1% in FY23 led by robust operational cash flows and execution.
- **No change in bidding criteria for government backed orders:** The bidding is still decided on L1 basis without consideration of quality and technical capabilities despite the government directive.
- **Hyderabad metro monetisation update:** Average ridership has been significantly improving. Total external debt is at Rs 13,000 crore.
- **Debt/Equity and ROE:** Gross debt/equity is at 1.14. ROE is at 12.2% in FY23.

Results (Consolidated) Rs cr

Particulars	Q4FY23	Q4FY22	YoY%	Q3FY23	QoQ%
Net Sales	**58,335**	**52,851**	**10.4**	**46,390**	**25.8**
Total Expenditure	51,503	46,330	11.2	41,317	24.7
Operating Profit	**6,833**	**6,521**	**4.8**	**5,073**	**34.7**
Other Income	741	516	43.7	755	-1.9
Interest	813	705	15.3	802	1.3
Depreciation	854	769	10.9	825	3.4
PBT	**5,907**	**5,562**	**6.2**	**4,200**	**40.6**
Exceptional Item (net of tax)	-	-		(136)	
PBT	5,907	5,562	6.2	4,336	36.2
Tax	1,461	1,555	-6.1	1,271	15.0
Reported PAT	3,986	3,621	10.1	2,553	56.2
Adjusted PAT	**3,986**	**3,621**	**10.1**	**2,417**	**64.9**
Adj. EPS (Rs.)	**28.4**	**25.8**	**10.1**	**17.2**	**64.9**
Margins (%)					
GPM	34.9	34.2	*70*	40.1	*(514)*
OPM	11.7	12.3	*(62)*	10.9	*78*
PATM	6.8	6.9	*(2)*	5.2	*162*
Tax Rate	24.7	28.0	*(323)*	29.3	*(457)*

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 the National Infrastructure Plan (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 FY2024/FY2025. Order inflows would grow by 10-12% in FY24 and revenue would grow by 12-15% y-o-y. Projects and manufacturing business OPM may increase from 8.6% to ~9% for FY24 with margins improving largely in H2FY24. Working capital is expected to be at 16-18% of sales for FY24. 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 – Buy with a revised PT of Rs. 2,700

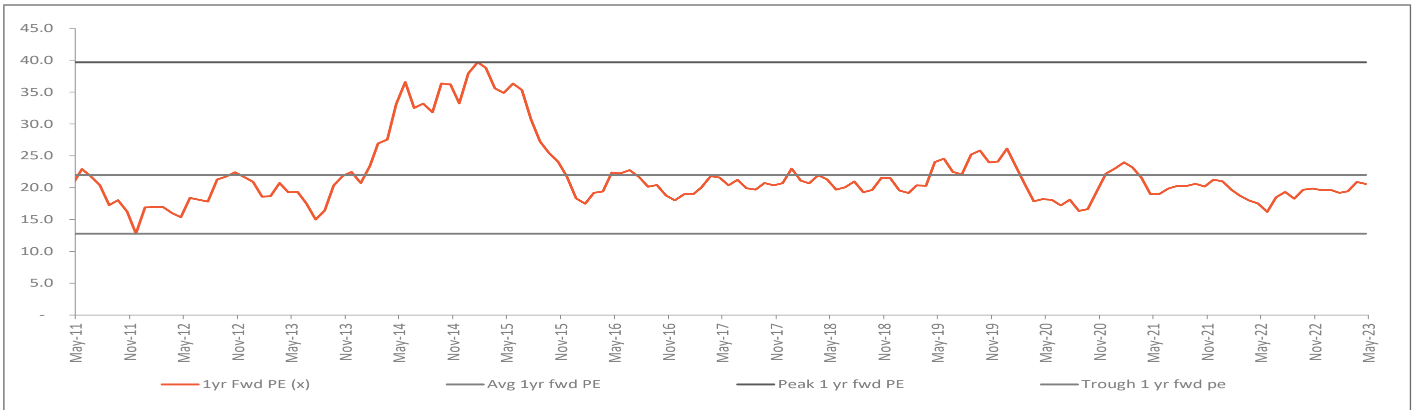
L&T's Q4FY2023/FY2023 performance has been marginally below expectations particularly on the margin front. The company has provided optimistic outlook going forward w.r.t. revenue and order inflow growth, while OPM shall improve in H2FY24 as quite a few large projects are likely to achieve margin threshold during that period. Its all-time high order book provides strong revenue visibility and orders prospects are also promising. The international outlook is also buoyant, given a healthy order pipeline and emerging opportunities in non-oil segments as well. Given the weakness in margin and cautiously optimistic commentary of the management on margin front, the stock may witness pressure in the near term. Although in the long 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. Therefore, we maintain a Buy on the stock with a revised SOTP-based price target (PT) of Rs. 2,700.

SOTP Valuation

Particulars	Remarks	Value (Rs cr)	Per share (Rs)
L&T's core business (standalone)	At 19.5x FY25E estimates	2,48,971	1,776
Subsidiaries			
LTI-Mindtree	Based on our target price	84,031	599
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	22,342	159
Development projects (including IDPL)	At 0.8x Book Value	6720	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		**1,29,538**	**924**
Fair value		**3,78,509**	**2,700**

Source: Company data, Sharekhan Research

One-year forward P/E (x) band



Source: Sharekhan Research

About the 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: Bloomberg

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Life Insurance Corporation of India	11.4
2	SBI Funds Management	4.4
3	Government of Singapore	3.3
4	Republic of Singapore	3.2
5	ICICI Prudential Asset Management	2.6
6	FMR LLC	2.2
7	Vanguard Group Inc	1.9
8	NPS Trust A/c UTI Retirement solutions	1.9
9	HDFC Asset Management Co	1.9
10	BlackRock Inc	1.6

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

Sharekhan

by BNP PARIBAS

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