

21 February 2018

Larsen & Toubro – BUY

CMP : 1,294
Target Price : 1,659
Upside : 28%+
Stop Loss : 1,174 (closing basis)

Investment Thesis

Recently, the stock price of Larsen & Toubro Ltd. (L&T) corrected by ~13% from 52-week high of Rs.1,470 despite reporting good set of numbers in the recent quarters.

L&T has planned a 5-year strategic plan 'Lakshya' to focus on doubling sales to Rs.2,000bn by FY21E, improving margins (ex-services) from 10% in FY16 to 11.2% by FY21E along with value unlocking either by listing the asset or by divesting non-core assets. L&T also has plan to improve its RoEs from 12% in FY16 to 18% in FY21E and bringing down working capital from 24% in FY16 to 18% by FY21E. L&T's efforts to successfully implement of Lakshya are visible in its recent performance on multiple fronts. It has able to successfully bring down net working capital to 20% in Q2FY18 from 24% in FY16 as well as the operating margin (ex-services) has also shown signs of pick up, 10.9% in Q3FY18. In the recent past L&T has unlocked the value by listing of L&T Finance, L&T Infotech and L&T Technology Services. L&T has also divest some of its non-core assets like, L&T cutting tools, EWAC alloys, L&T general insurance, Seawood retails, etc.

L&T has consciously developed a diversified order book, which help the company to de-risk any downtrend going ahead. L&T's current order backlog stand at Rs.2,710bn (excluding hydrocarbon & services), which is highly diversified across segments and geographies. Out of the current backlog, infrastructure segment (roads, buildings & factories, urban infra, airports) comprises 74% of backlog whereas power (generation and T&D) and process (metals & material handling) segments is at 4% and 5%, respectively while Others (defence, shipbuilding and electronic products) constitute 9% of the backlog. However, with the focus of the government on reforming the power sector and opening of the defence sector and L&T's vigorous efforts to scale up international hydrocarbon business, share of these segments can rise sharply in the next five years.

Financials

- During the past 5 years, revenue of L&T grew at a CAGR of 11.2% while PAT grew at a CAGR of 5.2% in the same period.

Consol. (Rs.Mn.)	FY15	FY16	FY17	FY18E	FY19E
Revenue	920,046	1,026,317	1,093,118	1,257,086	1,445,649
EBITDA	113,356	123,427	110,747	127,359	146,463
% growth	5.4	8.9	-10.3	15.0	15.0
PAT	47,648	50,905	60,412	69,293	79,479
EPS (INR)	51.3	54.6	64.8	74.3	85.2
P/E (x)	26.6	24.9	21.0	18.3	16.0
RoE (%)	11.6%	11.6%	12.0%	12.5%	13.1%

- L&T has reported 10.1% YoY growth in consolidated revenues to Rs.287.5bn in Q3FY18 on account of healthy 11.0% YoY growth in infrastructure segment revenues at Rs.138.1bn in Q3FY18.

Stock Data

Market Cap (INR MN)	1,904,002
Market Cap (\$ MN)	29,699.00
Shares O/S (in MN)	933.00
Avg. Volume (3 month)	2,972,000
52-Week Range (Rs.)	1,470 / 973

Shareholding Pattern

Promoters	0.00%
FIIIs	16.91%
Institutions	40.90%
Others (incl. body corporate)	42.19%

Performance (%)	1M	6M	1Yr
Absolute	1.6%	17.8%	35.1%
BSE CG	-2.4%	13.2%	27.0%

Key Ratios

Div Yield	1.6%
TTM PE	24.3x
ROE	11.7%
TTM EPS (INR)	56.0/-

- Consolidated EBITDA of L&T grew by 25.5% YoY to Rs.31,440mn in Q3FY18 as hydrocarbon and E&A segment witnessed margin expansion at 8% and 17.3%, respectively. As a result, EBITDA margin has also gained by 134 bps to 10.9% in Q3FY18.
- L&T has received new order worth Rs.481bn in Q3FY18, which grew by 38% YoY due to 82% YoY increase in domestic orders. As a result, total order book grew by 5% YoY to Rs2,710bn despite removing slow moving orders worth Rs.40-50bn.

Key Business Highlights

- L&T is India's largest E&C company, which is engaged in construction and engineering activity. L&T has also made significant inroads into a diverse range of products and services through its subsidiaries and manufacturing JVs in power BTG, forging and shipbuilding. It is involved in various developmental projects in roads, ports, railways and power.
- With over 7 decades of a strong, customer focused approach and a continuous quest for world-class quality, L&T has unmatched expertise across technology, engineering, construction, infrastructure projects and manufacturing sector and maintain a leadership in all major lines of business.
- L&T addresses critical needs in key sectors like, Hydrocarbon, Infrastructure, Power, Process Industries and Defence for customers in over 30 countries around the world.

Valuation

- L&T plans to simplify its business structure and right size capital allocation over long term. It plans to avoid entering into any new exotic business and instead plan to exit all non-core businesses at the earliest. The company expects few businesses like, defense, nuclear and smart cities are currently at nascent stage to drive incremental growth. L&T wants to remain selective in order picking and focus on execution of its large order book. The company's conscious efforts to bag orders with a better margin profile as well as its cost control measures will ensure margin improvement, going ahead. Further, with pickup in defense orders and turnaround in power turbines business, driven by expansion of Indian BTG market and exports, margin is expected to expand to ~12% during FY18-21E.
- Capex cycle in India has peaked in FY13, when the share of the private sector stood at a high of ~60% of total projects under implementation. Since then, the share of the private sector has been declining and is now down to 40% of total capex. In the meantime, government has stepped up infrastructure spending to offset the decline in private spending and it reverses the trend. Private sector project sanctions too saw a surge of 92% to Rs.1,800bn in FY17 after declining for six years, and we expect ordering and capex to follow. We believe a pick-up in private capex cycle supported by government capex will help EPC companies like L&T.
- With well executed 5-year strategic plan 'Lakshya', highly diversified order backlog across segments and geographies, plans to simplify business structure and pick-up in private capex cycle supported by government capex, we value L&T at 19.50x FY19E EPS of Rs.85.20 to arrive at target price of Rs.1,659.00, an upside of ~28%.

Risk & Concern

- Any further delay in recovery of the domestic capex cycle may adversely impact L&T order book in the years to come.
- Any deterioration in operational parameters or delay in timely execution of order backlog may be risk to the company.
- Capex due to sharp drop in global oil prices can severely impact L&T's order intake and revenue accruals from Middle East region.

Graphs & Charts

Figure 1: Net Sales Trend

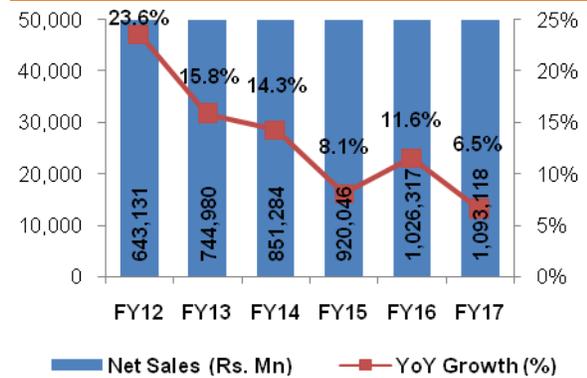


Figure 2: EBITDA & EBITDA Margin Trend

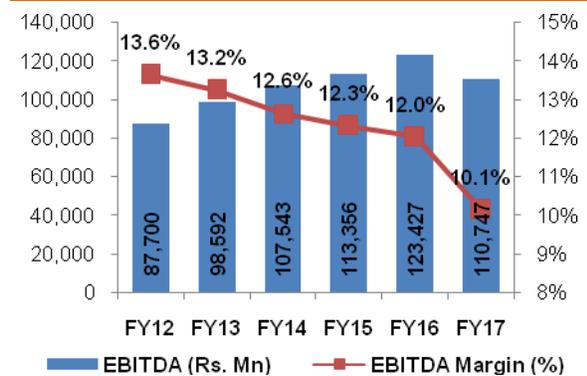


Figure 3: PAT Trend

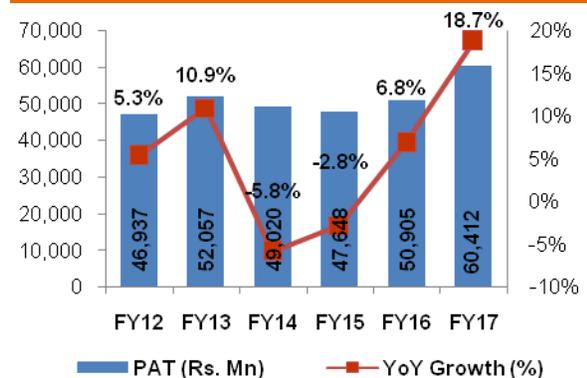
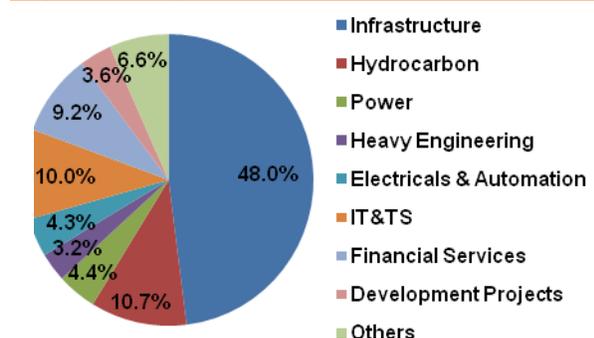


Figure 4: Segmental Revenue (Q3FY18)



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