NOMURA

Larsen & Toubro LART.NS LT IN

EQUITY: ENGINEERING & CONSTRUCTION

Well positioned for the upturn

Improving balance sheet profile in the face of potentially strong long-term opportunity; Buy

Action: FY15F marks earnings bottom; Buy for strong growth thereafter

We upgrade L&T to Buy as we believe that FY15F marks the earnings bottom for the company and that it is well positioned for 30% EPS CAGR over FY15-17F. Our change in view is also aided by the change in government at the centre, which once again opens up the long-term infrastructure investment potential in India for developers and contractors alike. In our view:

- L&T is well-positioned to capitalise on the infrastructure investments on the back of a de-leveraging balance sheet. We think that the next 2-3 years could be a sweet spot for the company as competitive intensity is low, while L&T has already de-leveraged and also increased management bandwidth through corporate restructuring.
- The current order mix can sustain growth in the near term, while revival in metals, hydrocarbons, defence and power are longer-term drivers.
- L&T has already surprised positively on order inflows and margins over the past few quarters; while sustaining margins will be a challenge, we think that reducing the burden of working capital and subsidiary support will lead L&T to become FCF positive in FY15F itself.

Catalysts: Strong order inflows and unlocking of subsidiary value

Valuation: Strong long-term growth opportunity justifies higher end of historical trading range; Buy with TP of INR1,955

Trading at ~20x FY16F standalone earnings (adjusted for dividends from subsidiaries), L&T is not inexpensive. However, we think that with improving ROE and FCF metrics and the long-term potential opening up again, these multiples can re-rate further, especially given the strong near- and long-term growth profile. Accordingly, we upgrade our rating on the stock to Buy (from Neutral) with a revised TP of INR1,955/share.

Year-end 31 Mar	FY14	FY15F		FY16F		FY17F	
Currency (INR)	Actual	Old	New	Old	New	Old	New
Revenue (mn)	565,989	757,161	631,727		754,668		971,925
Reported net profit (mn)	54,931	47,191	53,789		65,943		86,525
Normalised net profit (mn)	49,046	47,191	53,789		65,943		86,525
FD normalised EPS	52.91	51.12	58.03		71.14		93.35
FD norm. EPS growth (%)	18.6	5.6	9.7		22.6		31.2
FD normalised P/E (x)	30.9	N/A	28.2	N/A	23.0	N/A	17.5
EV/EBITDA (x)	24.2	N/A	21.6	N/A	17.5	N/A	13.2
Price/book (x)	4.5	N/A	4.0	N/A	3.6	N/A	3.1
Dividend yield (%)	0.9	N/A	0.9	N/A	1.1	N/A	1.5
ROE (%)	17.5	13.8	15.1		16.4		18.9
Net debt/equity (%)	28.7	17.7	22.2		13.7		6.1

Source: Company data, Nomura estimates

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

Global Markets Research

16 July 2014

Rating Up from Neutral	**Buy**
Target price Increased from 828	INR 1955
Closing price 15 July 2014	INR 1634
Potential upside	+19.7%

Anchor themes

We believe that L&T is among India's best plays on infrastructure and the corporate capex cycle. With the economy likely bottoming out and the potential re-investment in infrastructure, we believe L&T has a multi-year growth opportunity ahead.

Nomura vs consensus

Our TP of INR1,955 per share is 12% ahead of the consensus estimate.

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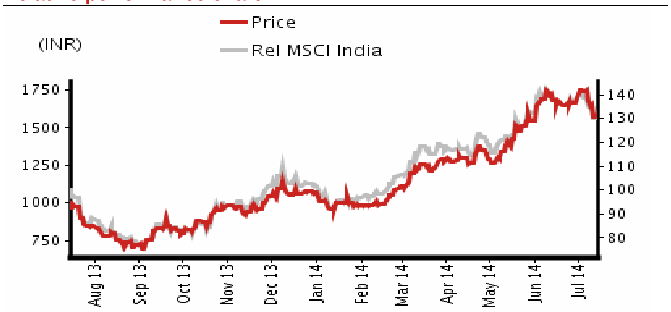
Key data on Larsen & Toubro

Relative performance chart



Source: Thomson Reuters, Nomura research

Notes:

Performance

(%)	1M	3M	12M		
Absolute (INR)	-3.1	25.9	62.3	M cap (USDmn)	25,202.5
Absolute (USD)	-3.8	26.2	61.7	Free float (%)	69.5
Rel to MSCI India	-2.1	16.5	42.4	3-mth ADT (USDmn)	64.5

Income statement (INRmn)

Year-end 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Revenue	516,110	565,989	631,727	754,668	971,925
Cost of goods sold	-447,935	-488,012	-544,344	-648,031	-833,024
Gross profit	68,175	77,977	87,383	106,638	138,901
SG&A	-20,721	-19,231	-21,538	-25,846	-32,308
Employee share expense					
Operating profit	47,454	58,746	65,844	80,792	106,593
EBITDA	54,731	66,670	74,127	90,023	117,032
Depreciation	-7,277	-7,924	-8,283	-9,231	-10,438
Amortisation					
EBIT	47,454	58,746	65,844	80,792	106,593
Net interest expense	-9,548	-10,761	-10,416	-9,842	-9,473
Associates & JCEs	0	0	0	0	0
Other income	18,873	18,809	17,260	18,163	19,804
Earnings before tax	56,779	66,794	72,688	89,112	116,925
Income tax	-15,413	-17,748	-18,899	-23,169	-30,401
Net profit after tax	41,366	49,046	53,789	65,943	86,525
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	41,366	49,046	53,789	65,943	86,525
Extraordinary items	7,740	5,885	0	0	0
Reported NPAT	49,107	54,931	53,789	65,943	86,525
Dividends	-12,244	-14,204	-13,909	-17,052	-22,374
Transfer to reserves	36,863	40,727	39,880	48,891	64,151
Valuations and ratios					
Reported P/E (x)	30.7	27.6	28.2	23.0	17.5
Normalised P/E (x)	36.5	30.9	28.2	23.0	17.5
FD normalised P/E (x)	36.6	30.9	28.2	23.0	17.5
Dividend yield (%)	0.8	0.9	0.9	1.1	1.5
Price/cashflow (x)	245.8	na	55.2	34.5	26.9
Price/book (x)	5.2	4.5	4.0	3.6	3.1
EV/EBITDA (x)	29.0	24.2	21.6	17.5	13.2
EV/EBIT (x)	33.5	27.4	24.3	19.5	14.5
Gross margin (%)	13.2	13.8	13.8	14.1	14.3
EBITDA margin (%)	10.6	11.8	11.7	11.9	12.0
EBIT margin (%)	9.2	10.4	10.4	10.7	11.0
Net margin (%)	9.5	9.7	8.5	8.7	8.9
Effective tax rate (%)	27.1	26.6	26.0	26.0	26.0
Dividend payout (%)	24.9	25.9	25.9	25.9	25.9
ROE (%)	18.1	17.5	15.1	16.4	18.9
ROA (pretax %)	7.0	8.0	8.3	9.3	11.0
Growth (%)					
Revenue	-2.9	9.7	11.6	19.5	28.8
EBITDA	-12.6	21.8	11.2	21.4	30.0
Normalised EPS	-7.2	18.1	9.7	22.6	31.2
Normalised FDEPS	-6.0	18.6	9.7	22.6	31.2

Source: Company data, Nomura estimates

Cashflow statement (INRmn)

Year-end 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
EBITDA	54,731	66,670	74,127	90,023	117,032
Change in working capital	-27,131	-41,683	-17,385	-13,092	-20,954
Other operating cashflow	-21,440	-27,626	-29,315	-33,011	-39,873
Cashflow from operations	6,160	-2,639	27,428	43,919	56,204
Capital expenditure	-29,114	-42,910	-17,500	-20,000	-25,000
Free cashflow	-22,954	-45,549	9,928	23,919	31,204
Reduction in investments	13,928	17,180	0	0	0
Net acquisitions					
Dec in other LT assets				0	0
Inc in other LT liabilities				0	0
Adjustments	16,711	10,235	17,260	18,163	19,804
CF after investing acts	7,685	-18,134	27,187	42,082	51,009
Cash dividends	-12,244	-12,291	-13,909	-17,052	-22,374
Equity issue	9	8	0	0	0
Debt issue	-10,616	26,247	-19,822	-2,036	-5,020
Convertible debt issue					
Others	11,059	7,052	0	0	0
CF from financial acts	-11,791	21,016	-33,731	-19,088	-27,394
Net cashflow	-4,106	2,882	-6,544	22,994	23,615
Beginning cash	19,053	14,947	17,829	11,285	34,279
Ending cash	14,947	17,828	11,285	34,279	57,893
Ending net debt	73,395	96,761	83,482	58,453	29,818

Balance sheet (INRmn)

As at 31 Mar	FY13	FY14	FY15F	FY16F	FY17F
Cash & equivalents	14,947	17,829	11,285	34,279	57,893
Marketable securities	55,807	40,462	40,462	40,462	40,462
Accounts receivable	226,130	215,388	241,231	281,913	336,177
Inventories	138,075	174,011	192,286	208,824	255,494
Other current assets	92,537	101,300	108,019	119,926	140,967
Total current assets	527,496	548,990	593,283	685,404	830,993
LT investments	105,227	151,684	156,684	161,684	166,684
Fixed assets	87,100	80,453	84,670	90,439	100,001
Goodwill					
Other intangible assets	1,919	1,919	1,919	1,919	1,919
Other LT assets					
Total assets	721,742	783,046	836,556	939,446	1,099,597
Short-term debt	7,256	7,256	7,256	7,256	7,256
Accounts payable	204,928	183,037	209,766	240,148	295,835
Other current liabilities	129,602	143,767	150,489	176,143	221,476
Total current liabilities	341,786	334,059	367,511	423,547	524,567
Long-term debt	70,229	96,476	87,512	85,475	80,455
Convertible debt	10,857	10,857	0	0	0
Other LT liabilities	7,443	5,035	5,035	5,035	5,035
Total liabilities	430,315	446,428	460,058	514,057	610,057
Minority interest					
Preferred stock	0	0	0		
Common stock	1,846	1,854	1,854	1,854	1,854
Retained earnings	289,581	334,765	374,644	423,535	487,686
Proposed dividends					
Other equity and reserves					
Total shareholders' equity	291,427	336,618	376,498	425,389	489,540
Total equity & liabilities	721,742	783,046	836,556	939,446	1,099,597
Liquidity (x)					
Current ratio	1.54	1.64	1.61	1.62	1.58
Interest cover	5.0	5.5	6.3	8.2	11.3
Leverage					
Net debt/EBITDA (x)	1.34	1.45	1.13	0.65	0.25
Net debt/equity (%)	25.2	28.7	22.2	13.7	6.1
Per share					
Reported EPS (INR)	53.20	59.26	58.03	71.14	93.35
Norm EPS (INR)	44.81	52.91	58.03	71.14	93.35
FD norm EPS (INR)	44.63	52.91	58.03	71.14	93.35
BVPS (INR)	315.70	363.17	406.19	458.94	528.15
DPS (INR)	13.26	15.32	15.01	18.40	24.14
Activity (days)					
Days receivable	146.2	142.4	131.9	126.9	116.1
Days inventory	111.7	116.7	122.8	113.3	101.7
Days payable	159.0	145.1	131.7	127.1	117.4
Cash cycle	98.9	114.0	123.0	113.1	100.4

Source: Company data, Nomura estimates

Valuation

We value standalone L&T at 25x FY16F EPS of INR62.52 (ex dividend from subsidiaries). Our assigned multiple of 25x is at the higher end of its historical trading range of 15-25x one-year forward earnings, which we think is justified given the forecast strong EPS CAGR of 30% over FY15-17F and strong outlook thereafter as well. With the bulk of the infrastructure/industrial capex momentum likely to pick up by FY16, we believe L&T has a strong growth potential lined up over the next several years.

Separately, we value the subsidiaries at INR392 (including hydrocarbons and after 20% holding company discount) to arrive at our revised TP of INR1,955/share.

Given 20% potential upside from current levels, we upgrade the stock to a Buy rating.

Fig. 1: L&T – valuation

INR

Business	Value Per Share	Value - INR mn	Valuation driver
Core E&C business	1,563	1,448,745	P/E of 25x FY16F
Subsidiaries & Associates	392	362,139	
One year target price	**1,955**	**1,810,883**	

Source: Nomura estimates

What does the current stock price mean on reverse-DCF and risks to the key assumptions therein?

- Our analysis suggests that the current market price is factoring in a 21.3% revenue CAGR over FY14-24F in the standalone entity (excl. hydrocarbon), which is almost similar to the 21.4% revenue CAGR achieved over the FY04-14 period.
- This assumes that EBITDA margins for the standalone entity remains at 11-12% levels throughout the forecast period of FY15-24F (terminal year margin of 11%) resulting in ROIC of 31% in the terminal year compared to 22% ROIC currently.
- This compares with an average ROIC of 21% over the FY04-14 period for the standalone entity (including hydrocarbon though).

While these numbers are not too different from the past 10 years and we believe these are also achievable over the next 10 years, we note that the enabling factors behind these growth parameters have a daunting (but achievable) task ahead to fulfil, such as:

- India's GDP growth needs to revert to a 7.9% CAGR over FY14-24 vs. 7.9% in the FY03-13 period.
- Gross Fixed Capital Formation needs to revert to a 11.4% CAGR over the next 10 years vs. a similar number in the preceding 10 years.
- However, given the under-investment in power capacity over the past few years and growing lifestyle needs, we estimate that to meet a similar GFCF/GDP growth, power supply will have to grow at a CAGR of 10.2% over FY14-24F vs. 7.6% CAGR during the FY03-13 period.
- Our estimate of power supply builds in declining AT&C losses due to the current Government's enhanced focus on improving SEB health by way of improving metering and reducing pilferage/improving Grid efficiency

One of our basic tenets in this analysis is that the overall economic growth and GFCF is highly dependent on overall power supply situation in the country. Hence, even though L&T might have only a small exposure to power sector directly, ultimately the economic activity in the country cannot be too far ahead of actual power availability.

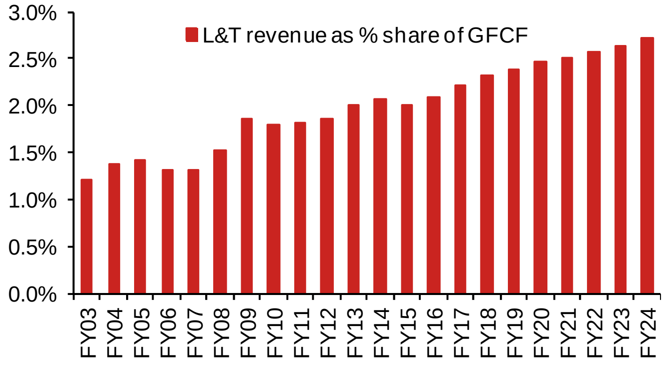
Accordingly, our assumptions on power supply additions are that:

- T&D losses reduce from ~23% currently to ~15% levels by FY24 (as a corollary some of the best managed SEBs in the country currently have a T&D loss of 14-15% level).

- Power supply addition thus adjusted for T&D losses grows at a CAGR of 10.2% over FY14-24F vs. a CAGR of 7.6% during FY03-13.

Fig. 2: We expect L&T's share of India's GFCF to rise further

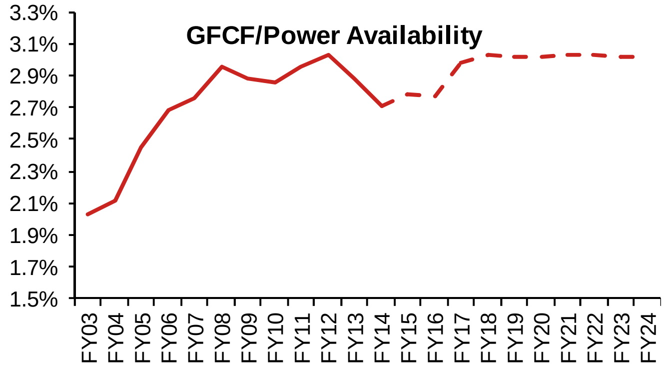
% share of Gross Fixed Capital Formation (GFCF)



Source: CMIE, company data, Nomura estimates

Fig. 3: We think GFCF can grow sustainably within overall power availability constraints (i.e. peak of FY12)

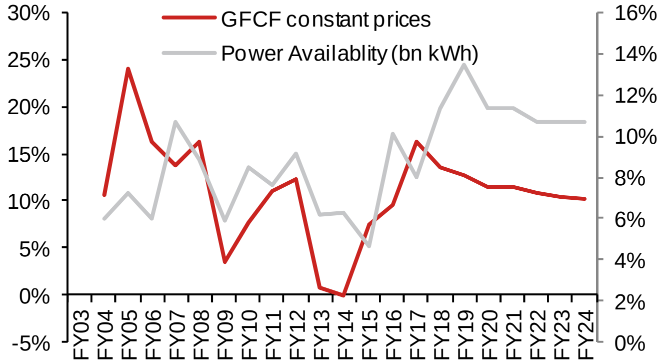
INR trillion/bn kWh



Source: CMIE, CEA, company data, Nomura estimates

Fig. 4: Medium-term potential is strong on account of improved power availability

% y-y



Source: CMIE, CEA, company data, Nomura estimates

Fig. 5: Implied growth rates over next 10 yrs vs. last 10 yrs

%

	CAGR FY03-13	CAGR FY14-24
Real GDP Grow th	7.9%	7.9%
Pow er Availablity (bn kWh)	6.3%	9.1%
Pow er availability adj. for T&D losses (bn kWh)	7.6%	10.2%
GFCF constant prices	11.4%	11.4%
L&T revenues incl hydrocarbons	23.8%	21.3%
GFCF current prices	17.7%	18.1%

Source: CMIE, CEA, company data, Nomura estimates

Only 20-25% of L&T's current order mix is directly exposed to power

On the positive side, we note that only 20-25% of L&T's FY14 order inflow is power-intensive and/or directly exposed to power supply driven economic growth.

For example, we believe that road, railways, airports, hydrocarbon, water, urban infrastructure and defence orders could continue to grow even if power supply growth remains weak for the interim period, as these sectors are not too power-intensive unlike the metals sector.

Moreover, core infrastructure build-out and defence are focus areas for the existing government and one could expect a strong growth in award activity in these segments. Thus, in our view, L&T could still sustain a strong order growth momentum despite overall weak economic fundamentals.

Fig. 6: Share of power-intensive sectors in L&T order mix

INR bn

Segments	FY14 achieved (INR bn)	FY15 guidance (INR bn)	Power intensive
Hydrocarbons	**90**	**180**	**No**
Core Infrastructure	**660**	**660**	
Transport	*330*	*330*	*No*
Urban Infra	*240*	*210*	*No*
Water	*90*	*120*	*No*
Power	**180**	**300**	
Generation	*30*	*120*	*Yes*
T&D	*150*	*180*	*Yes*
Metals & Material Handling	**30**	**60**	**Yes**
Others*	**300**	**300**	**No**
Total	**1,260**	**1,500**	
Share of power-intensive sectors in order mix	**83%**	**76%**	

Source: Company data, Nomura research

Well positioned for the upturn

Change of guard at the centre presents significant opportunity over the foreseeable future

With the new government at the centre, India is once again looking forward to substantial investment in infrastructure segment and industrial capex alike over the next few years. While the timing of realisation of these investments is still debatable, we do not doubt the potential of these investment needs in an investment-short country like India.

The Planning Commission of India had at the start of the 12th Five Year Plan period estimated that India could potentially invest USD1 trillion over FY13-17. While those plans have not materialised, we believe such ambitious investment needs still exist. With the exception of power, we believe fructification of this demand in most other sectors is a medium-term possibility if the right reforms (viz. faster clearances) and land acquisition go through.

While it would be impossible to forecast how much of the actual opportunity is harnessed over the next 5-10 years, we present below a reiteration of the potential opportunity that exists for infrastructure in India over the next 5 years.

Fig. 7: US$600bn of infra investment opportunity exists over the next 5 years

US$ bn

	Total opportunity	Private opportunity	ROE/IRR range (%)	ROE trend	Construction opportunity	Risks	Comment
Contractors	400		15-16	↑		Receivables, interest rates	Includes infrastructure (US$350bn) (US$300bn) and real estate in key cities (US$50bn). Additional upside from corporate capex.
Equipment							
- Construction	30		15-30	↑		Derivative of construction, significant revenue volatility	
- Power generation	85		30	↓		Derivative of actual power capacity addition, execution risks	
- Power T&D	65		20-40	↑		Derivative of actual T&D capacity addition, execution risks, receivables, competition	
Developers							
- Roads	135	60	15-17	↓	108	Traffic, toll, construction, interest rate	US$80bn in NHAI, US$35bn in state roads, US$20bn in rural roads. Private participation $50bn under NHDP and US$10bn under state.
- Thermal power	135	90	17-40	↓	68	Construction, environment, financing, offtake, merchant prices	40GW in rest of 11th Plan + 110GW over FY13-15. Of this, ~65% is expected to be by private developers
- Hydro power	25	12	25-30	↔	20	Construction, environment, financing, offtake, merchant prices	30GW to be commissioned in the next 10 years. Of this, ~50% is expected to be by private developers
- Nuclear power	16	0	NA		5	Nuclear liability bill, environment	12000 MW to be constructed in next 5 years.
- Airports	5	2	17-20	↓	3	Environment, financing, regulatory, traffic pick-up	Based on analysis of projects planned (Nomura estimates)
- Ports	10	7	20-30	↓	5	Environment, financing, traffic pick-up	Based on analysis of projects planned (Nomura estimates)
- T&D	130	8	15	↔	29	Right of way, construction, environment, financing	Analysis of CEA targets and Nomura estimates
- Railways (incl Metros)	70	7	15-20(Metros)	↔	43	Right of way, construction, financing	Analysis of Indian Railways targets and Nomura estimates. Approx US$15bn to be invested in Metros, of which US$6bn from private developers
- Water supply and sanitation	33	2	15	↔	26	Receivables, interest rates	Assuming 10% pa growth. Private participation based on existing pipeline
- Irrigation	70	0	NA		56	Financing (from state govts)	Assuming 10% pa growth in other states excl Andhra Pradesh. In AP, no increase assumed y-y.

Source: Nomura estimates

L&T is positioned well to capitalise on the potential investment/construction opportunity

De-leveraging plans are yielding results

Over the past few months, L&T has successfully divested its stake in Dhamra port to Adani Ports & SEZ, thereby raising INR10.5bn against its 50% stake in the project and also releasing the loan given to the project.

Separately, L&T has already announced intentions to list L&T Infotech and L&T ITES by 2016 and has also plans to list its hydrocarbon subsidiary.

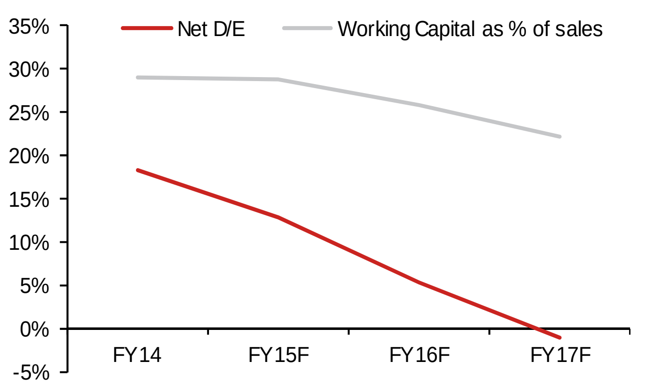
These measures will affectively mean that the existing equity needs of L&T's developmental businesses will be taken care of without the parent needing to support them. This, in turn, will keep L&T's own balance sheet in good stead.

Accordingly, we now assume no further investment by the parent into these businesses except for INR5-6bn p.a. that the company might need to seed new businesses.

Together with peaking working capital cycle and capex needs, this means that L&T will likely return to FCF generation over the next few years.

Fig. 8: De-leveraging balance sheet leaves room for opportunity ahead

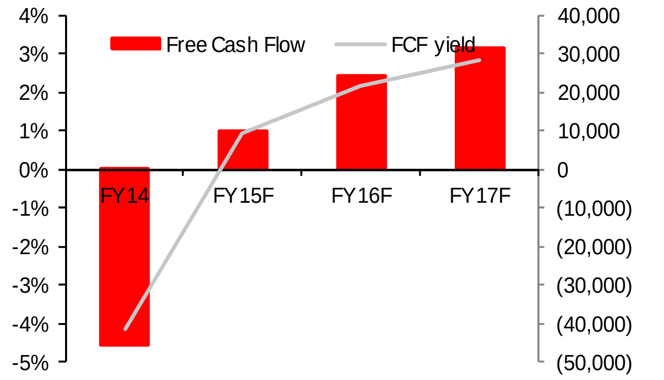
%



Source: Company data, Nomura estimates

Fig. 9: FCF generation to turn positive

INR mn



Source: Company data, Nomura estimates

Upcoming 2-3 years could be a sweet spot for the company as competition is ill-prepared

In our view, the upcoming 2-3 years could turn out to be very good for L&T from the perspective of margins and market share from new order inflows. Our assumption is premised on the basis that most of the other construction/infrastructure companies are loaded with significant debt and are currently struggling with deleveraging plans. Notably, a lot of pure construction companies had ventured into asset intensive businesses, which has led to significant balance sheet stress for them. While L&T had kept such exposure within manageable levels, most others went beyond their means.

Accordingly, we believe that L&T could garner a higher share of investments over the next few years until the time competition catches up.

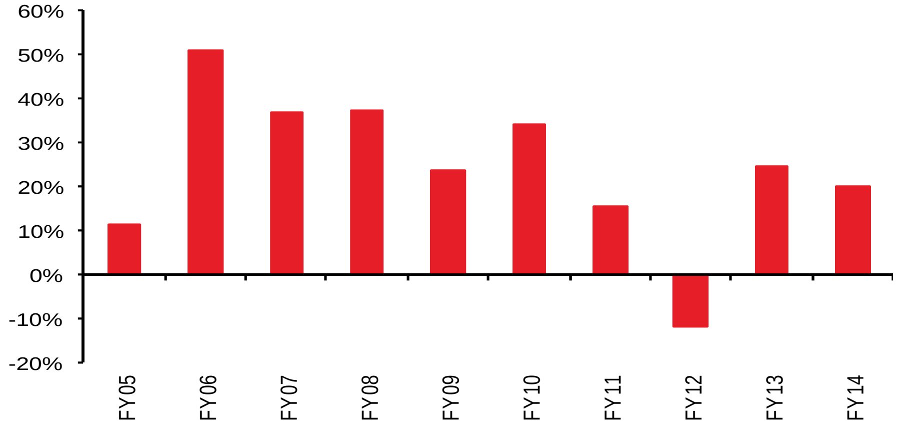
Order inflow growth has remained resilient despite downcycle

Meanwhile, order inflow growth for L&T has already remained strong during the past 2 years on the back of its diversification into newer segments/geographies such as buildings & factories, ME hydrocarbons and ME metro projects.

While this has led to elongation of its execution cycle (we estimate an increase from an average of 2.5 years earlier to ~3.5 years now), this does provide good revenue visibility over the next few years for the company.

Fig. 10: L&T – order inflow growth

% y-y



Source: Company data

Moreover, as we discuss later, the changed order mix means that while the near term looks promising on the back of rail/road/urban infra orders, longer-term growth opportunity remains from currently subdued investments in metals, domestic hydrocarbon, defence and power segments.

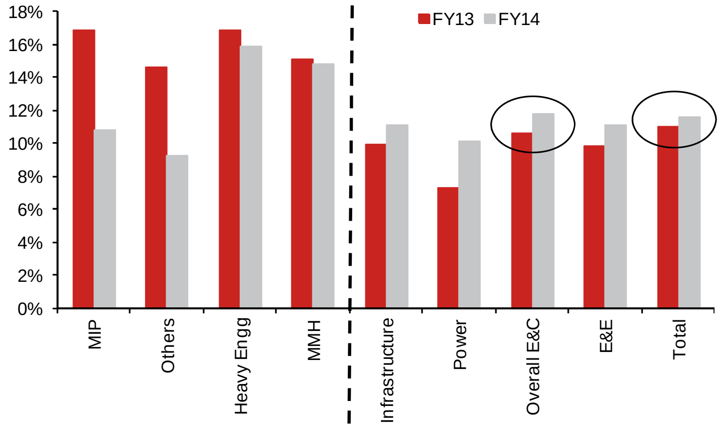
L&T has surprised positively on margins over the past year

What has been different in this downcycle for L&T is the fact that margins have remained fairly stable for the company so far. In fact, FY14 marked a modest increase of 120bps in EBITDA margins for L&T standalone (ex hydrocarbons). While this could be attributed partially to lower SG&A expenses (lower provisioning), we believe as revenue growth picks up again, margins at these levels could easily sustain.

In our assumptions, we are not building in any significant margin upsides from the current levels.

Fig. 11: Margins have surprised positively in FY14 on the back of better E&C margins

Segmental EBIT margins



Source: Company data

Value unlocking from hydrocarbons spin-off, though medium-term concerns as L&T moves up the learning curve

In FY14, L&T de-merged its entire hydrocarbons business into a 100% owned subsidiary. As per the company, the following rationale justified the move:

1) Ability to attract and retain global talent at a senior port

2) Ability to pay and rank people higher than that at the parent level, with hydrocarbons being a global business

3) Increases management bandwidth to focus on a dedicated business stream

Over time, L&T has indicated that it plans to list this subsidiary and, in our view, this will mark the value-unlocking process from the hitherto main construction entity.

In the medium term though, it could be plagued with teething issues relating to change of guard for the business as well as the huge competitive pressure in the Middle East. This could lead to some near-term margin pressure for the subsidiary, in our view.

Can L&T be successful in the competitive hydrocarbon segment in Middle East? Analysing L&T's value proposition

In the hydrocarbon space, L&T provides a wide range of EPC solutions and covers the entire value chain of oil & gas encompassing production, processing and transportation. We analyse L&T's advantages which keep it ahead of the competition.

- **Engineering**: L&T has developed engineering capabilities in-house as well as by forming JVs with reputed technology partners such as Chiyoda, Sargent & Lundy and Valdel. L&T-Valdel is a leader in providing detailed engineering services for the upstream oil & gas sector while the L&T-Chiyoda JV offers the complete gamut of engineering consultancy services to the hydrocarbon processing industry. As of Mar-13, L&T had employed over 1,500 engineers catering to the hydrocarbon sector across its various locations.
- **Modular fabrication facilities**: L&T has strategically located fabrication facilities at Hazira and Kattupalli (Chennai) in India and at Sohar in Oman. The facility at Hazira is one of the largest of its kind in South Asia, as per the company. These facilities meet international quality norms and can accommodate tight delivery schedule as well. Modular fabrication technology provides cost advantage over traditional manufacturing. We note that L&T has consistently upgraded these facilities over the past decade as per the changing business environment.
- **Owns derrick-cum-pipe laying barrage:** Earlier, installation capability was the missing link in L&T's EPC (engineering, procurement and construction) services as installation expenses comprise 15-30% of the cost of offshore projects and many a time, Indian companies would find it difficult to find capacity with foreign service providers for barges. Thus, to cut costs in L&T's upstream business as well as increase its scope to expand in international markets, in 2006, L&T entered into a JV (60:40) with Supracrest to build, own and operate a derrick-cum-pipe laying barrage valued at US$100mn. With the JV, L&T was the first Indian company to own an installation barrage in India.

Fig. 12: Comparison of regional fabrication facilities

Metric Tonnes

Company	Location	Annual fabricaton capacity (MT)	Comments
L&T	Hazira, Gujarat	50,000	Offshore platforms & modules
JV of L&T & Zubair Corporation	Sohar, Oman	50,000	Large offshore process platforms, Jackup rigs, Compression modules, Pow er generation modules, Integration of FPSO
L&T Shipbuilding (JV of L&T & TIDCO)	Kattupalli, Chennai	NA	Drilling semi-submersibiles and drill ships
Pipavav Defence	Pipavav, Gujarat		
Punj Lloyd	Sungaipurun, Indonesia	NA	
Das offshore	Alibaug, Mumbai, India	25,000	
NPCC	Mussafah, Abu Dhabi	NA	
Gulf piping	Mussafah, Abu Dhabi	NA	
Mcdermott	Batam Island, Indonesia	59,525	
Mcdermott	Altamira, Mexico	29,700	
Mcdermott	Jebel Ali, Dubai	49,500	
Mcdermott	Louisiana, USA	27,000	
Mcdermott	Qingdao, China	30,000	
Sime Darby	NA	NA	
PT Gunanusa	Indonesia	NA	
TH Heavy Engineering	Selangor, Malaysia	10,000	
Valentine Maritime	Mussafah, Abu Dhabi	24,000	Inlcudes yard of 20,000 under construction
Saipem	Ersai Kuryk, Kazakhstan	30,000	
Saipem	Dammam yard, Saudi Arabia	30,000	
Saipem	Angola	31,873	
Saipem	Nigeria	22,000	
Saipem	Italy	10,000	
Saipem	Karimun Island, Indonesia	35,000	
Hyundai Heavy Industries	Ulsan, Korea	NA	

Source: Company data, Nomura research

- **Supply Chain Integration**: In hydrocarbon projects, procurement accounts for 80% of the project cost, depending on the type of project. Over the past few decades, L&T's procurement team has developed an extensive network of suppliers around the globe. L&T has built its vendor base over the decades of operations. Steps like vendor registration, standardization of selection process as well as maintaining performance ratings for suppliers have helped the company to execute the project effectively. L&T has also set up procurement offices in low cost countries like China and we expect the benefit to flow in coming years. However, the vendor base of L&T is still not as strong as that of major Korean EPC players, according to us.
- **Pre-qualified with major customers**: L&T has scaled up its operations over the years along with maintaining stringent quality standards. Consequently, L&T is now pre-qualified for major producers in Middle-East and South East Asia such as ADNOC, KNPC, Saudi Aramco, GASCO and Petronas, among others.

Helped by these competencies, we expect hydrocarbons to be a key growth driver for L&T over the next few years. However, in the past couple of years, this sector has been lacklustre due to increased competition and lower opportunity in the domestic segment. Oil & gas, which used to contribute nearly 25% of revenue, now makes less than a fifth of total top line. However, with a dedicated subsidiary and its own management now in place, we see potential upsides to this business segment.

Mr. Krishnamurthi Venkataramanan (current CEO & MD) has been the backbone of L&T's upstream business

Mr. Krishnamurthi Venkataramanan, CEO & MD of L&T, has been instrumental in building L&T's hydrocarbon business from inception. He has been the backbone of L&T's upstream business, and has played a major role in setting up offshore yards at Hazira, Sohar and Kattupalli. Under his guidance, L&T fabricated the massive Mumbai High North (MHN) process platform for state-owned Oil & Natural Gas Corporation.

Krishnamurthi Venkataramanan wants L&T to emerge as a world-class player in the deep-water market. He admits: "The Indian market is slow and the international market is fiercely competitive."

Excerpts from an interview to Business Today (February 2, 2014)

Q. Are you exploring opportunities in the US in the wake of rising shale gas output?
A. We are looking at the US for equipment. They [the US] have many new crackers and plants because [shale] gas is so cheap. There will be great scope for us to sell high-end equipment like reactors and heat exchangers. Each piece of equipment will cost around $70-80 million manufactured in Hazira. The US is going to become like Saudi Arabia in petrochemicals… I don't think we can do any construction work there… America has its own issues and strengths. We can supply all the critical equipment.

Q. What is the next step for the hydrocarbon subsidiary?
A. We are looking at newer areas like sub-sea and deep-water [projects]… On the mergers and acquisitions front, we have been a little conservative. We have not been as daring as some other people… We have to be a little more systematic and good at doing small technological acquisitions. We are not looking at acquiring big companies, but looking at technological association.

Q. How will you deal with cultural issues related to the hiring of foreign nationals?
A. When I started my career, the company's board was largely international. We worked under them, leant and we grew. In the mid-1970s, L&T got a completely indigenous board. Now, we are going international. By 2020 I won't be surprised if one or two people on the board come from overseas… In our type of work you have to work from the ground. We need an international team. L&T has always been international in outlook, collaboration and joint ventures. We are not new to it.

Q. What is the progress on the new verticals?
A. The philosophy behind the verticals is to focus on specialisations and bring attention to detail. As these verticals grow in scale they also help more talent to be developed in-house and more positions get created. It is the company's prerogative whether it wants to spin off some verticals through initial public offerings and monetise value… The senior management can spend more time focusing on the whole company… This way there is a little order in the conglomerate.

Fig. 13: EPC contractors rankings in L&T

L&T is currently a small player in global hydrocarbon space - small base offers substantial headroom for growth

	2010 rankings		2011 rankings		2012 rankings		2013 rankings
1	Petrofac	1	Petrofac	1	Petrofac	1	Petrofac
2	NPCC	2	Samsung Engineering	2	Saipem	2	Samsung Engineering
3	Technip	3	Saipem	3	Samsung Engineering	3	NPCC
4	Saipem	4	NPCC	4	Technip	4	Flour
5	JGC	5	Technip	5	Flour	5	Hyundai Heavy
6	Mott MacDonald	6	Mott MacDonald	6	KBR	6	Saipem
7	Hyundai Heavy Industries	7	Hyundai E&C	7	NPCC	7	KBR
8	Flour	8	Technicas Reuindas	8	CB&I	8	Hyundai E&C
9	J Ray Mcdermott	9	Foster Wheeler	9	Hyundai E&C	9	McDermott International
10	Technimont	10	Jacobs Engineering	10	Lamprell	10	JGC Corp
11	Samsung Engineering	11	Marie Technimont	11	Maire Technimont	11	KENTZ
12	KBR	12	McDermott International	12	Jacobs Engineering	12	Bechtel
13	Ajes	13	GS Engineering & Construction	13	Fooster Wheeler	13	Maire Tecnimont
14	Bechtel	14	KBR	14	Worley Parsons	14	Fooster Wheeler
15	Chiyoda Corp	15	SNC Lavalin	15	Technicas Reunidas	15	Chiyoda Corporation
16	Fooster Wheeler	16	Topaz Energy & Marine	16	JGC Corp	16	Worley Parsons
17	Worley Parsons	17	Al Jaber Energy Services	17	Hyundai Heavy Industries	17	Jacobs Engineering
18	SNC-Lavalin	18	Kentz	18	Bechtel	18	CH2M HILL
19	Black CAT E&C	19	Lamprell	19	SK E&C	19	Leighton Offshore
20	CB&I	20	Wood Group PSN	20	McDermott International	20	SNC-LAVALIN
21	Kents	21	Drydocks World	21	Wood Group	**21**	**Larsen Toubro**
22	Shaw Group	22	MIS	22	Leighton Offshore	22	Target Engineering
23	Topaz Engineering & Marine	23	Bechtel	**23**	**Larsen Toubro**	23	Wood Group
24	Aker Solutions	24	SK Engineering	24	CH2MHill	24	SK E&C
25	**Larsen & Toubro**	25	Petrojet	**25**	Punj Lloyd	25	Lamprell
		26	JGC	26	SNC Lavalin		
		27	Daelim	27	Chiyoda Corp		
		28	Doosan Heavy Industries	28	Topaz E&C		
		29	Black Cat	29	Mott MacDonald		
		30	Global Industries	30	Target Engineering		

Source: Arabian oil & gas

L&T has been trying to make inroads into the GCC hydrocarbon market and has recently won offshore oil related and pipeline projects in the region. How well L&T does in terms of executing such projects in the next 2-3 years will determine its competitive position against international competitors, especially Korean contractors who have been lapping up significant proportion of market opportunity arising in Middle East. For South Korean E&C firms, overseas projects' backlog has multiplied 10x since 2005. Korean companies have been able to achieve remarkable success as we believe: 1) they have consistently bid 15-30% below the bid prices offered by EU and Japanese peers and 2) introduced a 'culture' of on-time delivery of projects. Refer our note Engineering & Construction - Read across from Korean E&C experience in ME'' for further details on how Korean E&C companies have built up their niche in the Middle East and which could also provide lessons for L&T on what it could do.

Key company-specific watchables over medium term

- Rising exposure to Middle East is a key watchable as penalties on cost overruns and delays could be significant
- Growth for the next 12-18 months could be driven by Government funded orders, while longer-term growth has to be driven by PPP-driven orders and private capex

Changes in estimates

Our estimates have changed, apart from upgrades related to better revenue and margin outlook, also due to the de-merger of hydrocarbons business into a 100% subsidiary.

Nomura vs. consensus

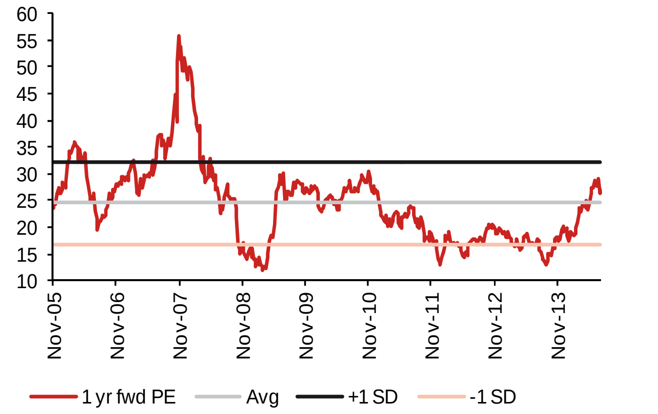
Fig. 14: Nomura vs consensus

	FY15F			FY16F		
	Nomura	Consensus	diff.	Nomura	Consensus	diff.
Revenue	632	671	-6%	755	787	-4%
EBITDA	74	76.2	-3%	90	91.4	-2%
EBITDA Margin	11.7%	11.3%	0.4%	11.9%	11.6%	0.3%
PAT	53.8	53	2%	65.9	63.1	5%
EPS (INR)	58.0	57.1	2%	71.1	68.1	5%

Source: Bloomberg, Nomura estimates

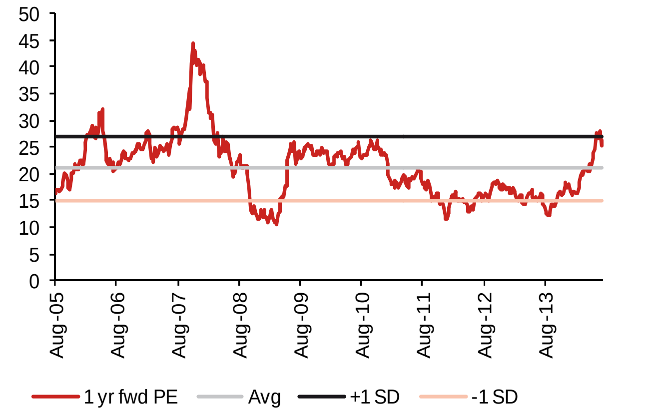
Valuations

Fig. 15: L&T – 1-year forward P/E (on consensus standalone earnings)



Source: Bloomberg, Nomura research

Fig. 16: L&T – 1-year forward P/E (on consensus consolidated earnings)



Source: Bloomberg, Nomura research

Investment risks

- Further delay in recovery of the investment cycle
- Greater-than-expected decline in margins
- Continued deterioration in working capital requirement.

Appendix A-1

Analyst Certification

We, Amar Kedia and Vineet Verma, 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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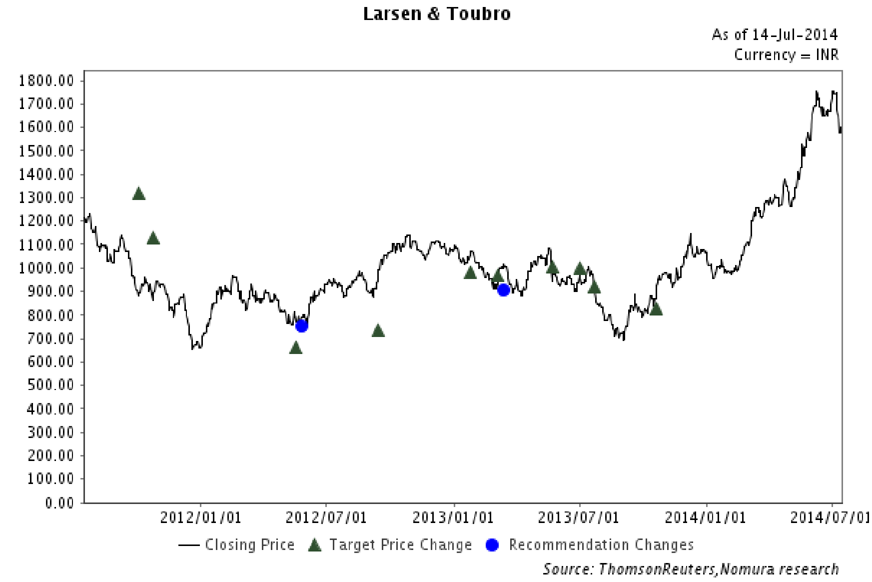
Issuer	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Larsen & Toubro	LT IN	INR 1634	15-Jul-2014	Buy	N/A	A1,A2

A1 The Nomura Group has received compensation for non-investment banking products or services from the issuer in the past 12 months.

A2 The Nomura Group had a non-investment banking securities related services client relationship with the issuer during the past 12 months.

Larsen & Toubro (LT IN) **INR 1634 (15-Jul-2014)** Buy (Sector rating: N/A)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
20-Oct-13		828.00	872.05
23-Jul-13		921.00	901.10
02-Jul-13		997.00	953.005
23-May-13		1,004.00	945.471
05-Mar-13	Neutral		930.405
05-Mar-13		969.00	930.405
25-Jan-13		983.00	1,074.205
13-Sep-12		733.00	945.538
17-May-12	Reduce		775.704
17-May-12		661.00	775.704
24-Oct-11		1,128.00	862.838
03-Oct-11		1,317.00	879.471

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

Valuation Methodology We value standalone L&T at 25x FY16F EPS of INR62.52 (ex dividend from subsidiaries). Our assigned multiple of 25x is at the higher end of its historical trading range of 15-25x one-year forward earnings, which we think is justified given the strong EPS CAGR of 30% over FY15-17F and strong outlook thereafter as well. Separately, we value the subsidiaries at INR392 (including hydrocarbons and after 20% holding company discount) to arrive at our TP of INR1,955/share.

Risks that may impede the achievement of the target price Downside risks include further delay in recovery of the investment cycle, greater-than-expected decline in margins, and continued deterioration in working capital requirement.

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