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Equity Research Report

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[LARSEN & TOUBRO]

Larsen & Toubro is a market leader in the Engineering & EPC segment in India. Its leadership comes not only from its size, but also from its capability to execute large and complex projects, which is unparalleled in India. In this report, we value its strengths and attempt to project the future benefits accruing to the company owing to these strengths.

Value Investment Philosophy and Analysis Framework

Value Investing is a discipline that assesses the performance of a business independent of market perceptions. This enables us to identify major mispricing of stocks and use this to our advantage. Popular investment theory believes in efficient markets free of any mispricing, a notion that 'the markets are always right'. We dispel such notions and specifically look for such mispricing as investment opportunities. The discipline of value investing believes that the markets have wild mood swings ranging from exuberance to pessimism, thus implying that 'the markets are always wrong' when it comes to pricing stocks.

The mispricing that we observe in the market often tends to last for very long periods. Hence, it is important for us to be very long term investors. If one does not have the patience to hold onto an investment for 3 to 5 years, this is not an appropriate investment approach for them.

Since we start with the notion that the market is inaccurate at pricing stocks, what consequently follows is that there is no single correct valuation for a company and that value is a perception of every individual investor. The problem for small investors under such an approach is that transactions can only be executed at the market price, whatever may be their perception of value. Thus there is always a risk that one's perceived value may never be realized in the market. In order to reduce this risk, we have a section on 'market perception' in our report, to keep us cognizant of how the market has historically valued a company and how different is it from our valuation.

Another major concept in our valuation approach is conservatism. We are fully aware of the fact that there a multitude of assumptions that go into a valuation, many of which could be wrong. Hence, it is important to maintain a margin of safety in our recommendations. It is because of this that we come up with a very wide price range between the 'undervalued' and 'overvalued' state for a stock. This reduces our ability to do frequent trades in a stock but enables us to do a few transactions whit very little risk and high return potential.

L&T's Business and our Valuation approach

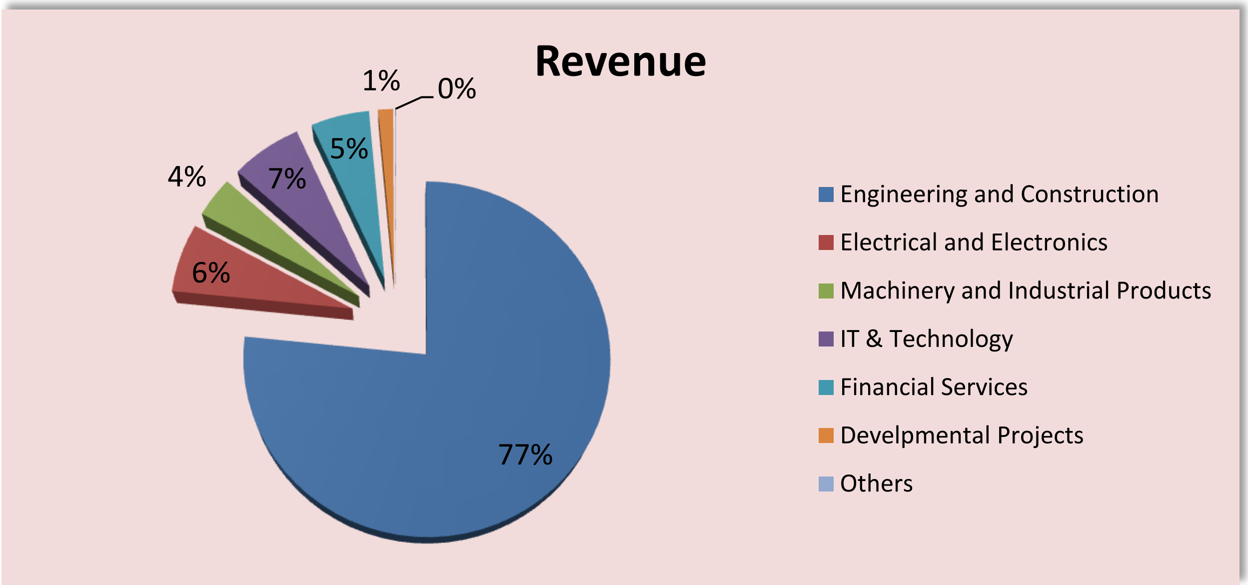
L&T is involved in various businesses, the primary one being engineering and construction. Our approach to valuing L&T is a bottom up one. Instead of looking at the Market Size and then coming down to Company level numbers, we first look at the company's capabilities and try to project what it can achieve based on these capabilities. It is only then that we look at the market to check if the growth we have projected is sustainable in the external environment.

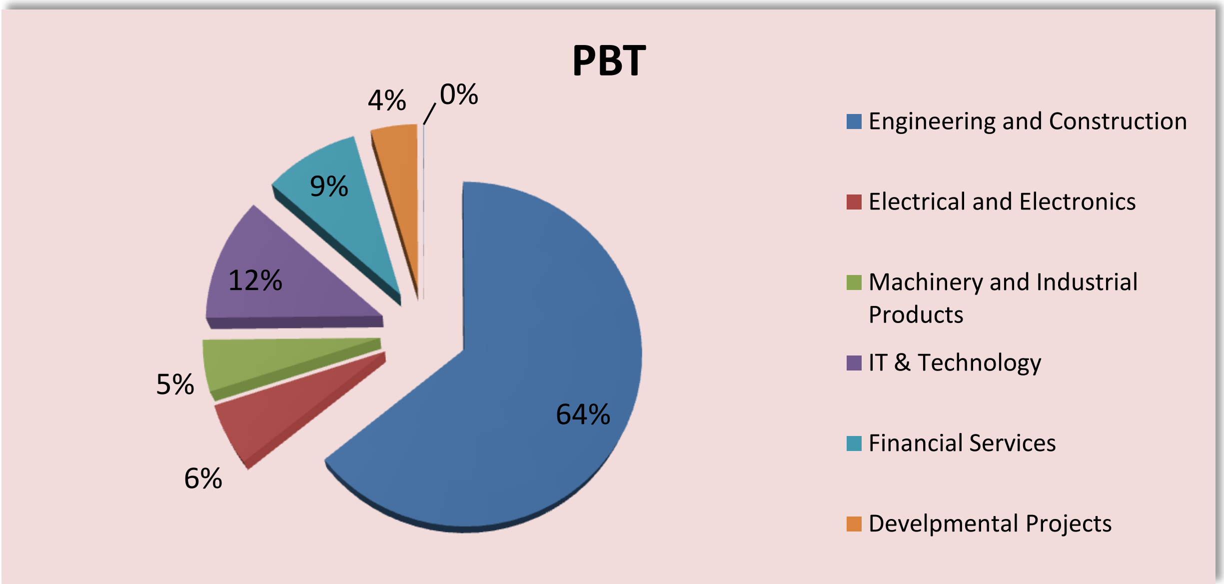
The reason for adopting such an approach is two-fold. Firstly, it is difficult to define a market for a company like L&T and to project its growth. Secondly, we believe that L&T's ability to grow in the future will be determined much more by its own technological and financial capabilities than by market forces, because of the unique nature of its business.

If we look at the market as India, L&T is a clear market leader. But in the global market, it is a small player. Hence, we believe, that market size should not be a constraining factor.

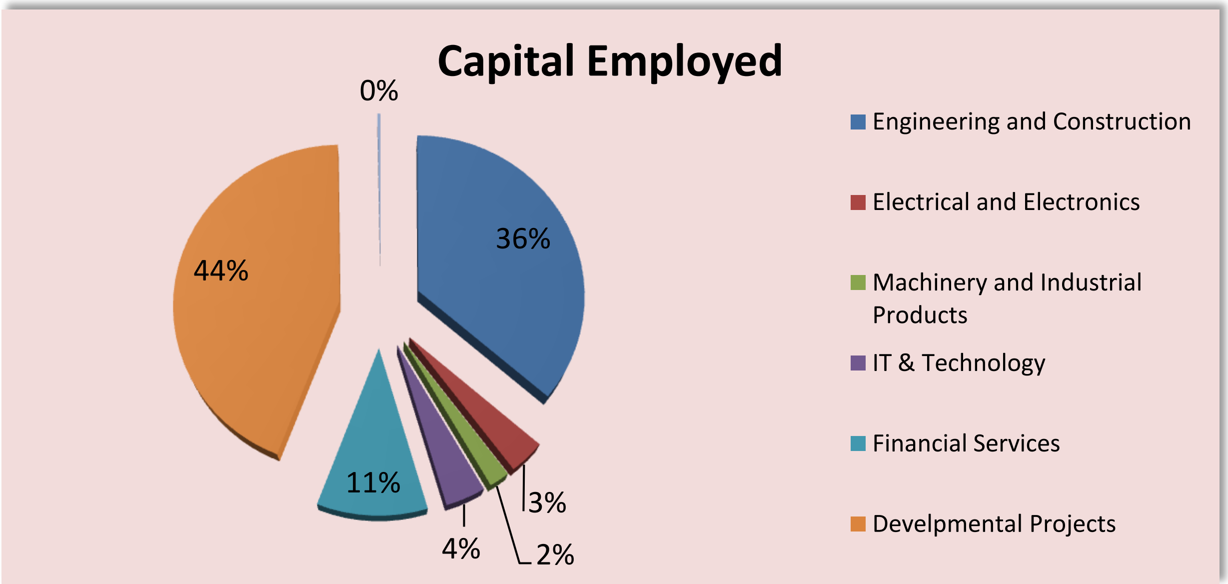
L&T's Businesses:

The relative size and importance of L&T's business in terms of Revenue, profits and capital employed are assessed below.





As we can see from the above chart, Engineering and Construction is the major business in terms of Revenue as well as profits.



However, when it comes to Capital Employed, the story is a little different. The total capital employed is very large in both Developmental Projects and Financial Services, as compared to the revenue and profit generated by them.

The capital employed in Developmental Projects is expected to yield future revenue and profits, as these projects have a long gestation period. In case of Financial Services, the Capital Employed is large, due to the very nature of the business.

Both these businesses are highly leveraged, debt funded businesses. Hence, valuing them in the same way as other businesses would be wrong. Hence, we look at these businesses separately.

Valuing L&T's Businesses

Projections for Cash flow based businesses:

We have made our cash flow projections based on the following assumptions

Revenue Growth	2014	2015	2016	2017	2018	2019	2020
Engineering and Construction	15%	15%	15%	15%	12%	12%	12%
Electrical and Electronics	14%	13%	12%	12%	12%	12%	12%
Machinery and Industrial Products	7%	7%	7%	7%	7%	7%	7%
IT & Technology	20%	20%	20%	15%	15%	12%	12%

Profit Margin	2014	2015	2016	2017	2018	2019	2020
Engineering and Construction	8.50%	8.00%	7.50%	7.00%	6.50%	6.00%	5.50%
Electrical and Electronics	9.00%	9.00%	9.00%	9.00%	8.00%	8.00%	8.00%
Machinery and Industrial Products	13.00%	13.00%	13.00%	12.00%	12.00%	11.00%	11.00%
IT & Technology	18.00%	18.00%	18.00%	15.00%	15.00%	15.00%	15.00%

Capital Employed/Revenue	2014	2015	2016	2017	2018	2019	2020
Engineering and Construction	0.45	0.46	0.47	0.48	0.49	0.50	0.51
Electrical and Electronics	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Machinery and Industrial Products	0.50	0.53	0.56	0.59	0.62	0.65	0.68
IT & Technology	0.55	0.52	0.49	0.46	0.43	0.40	0.37

In most of the above projections, we are being very cautious. We have assumed growth rate of the principal Engineering and Construction business to decline after a few years. We have also assumed dropping margins, in line with the trend over the past few years. We have also assumed the capital requirement per unit of revenue to increase over the years.

Similarly, we have been conservative in projecting the performance of other businesses as well. Furthermore, for a company like L&T with a professional and reputed management, we also need to understand the fact that unviable businesses would regularly be discontinued and capital would be re-deployed in new opportunities. This is what I call the 'Investment Effect', and it is a reason why a good management should command a premium. However, this premium is hard to calculate and we are not accounting for it, on the conservative side.

These assumptions yield the following projections for these businesses.

Details	2014	2015	2016	2017	2018	2019	2020
Revenue	80,646	92,680	1,06,484	1,21,966	1,36,703	1,52,903	1,71,032
PBT	7,578	8,345	9,172	9,658	10,188	10,712	11,266
Capital Employed	37,331	43,557	50,763	58,937	66,939	75,857	85,944

Capital Requirements / Dilution Analysis:

Overall Capital	2014	2015	2016	2017	2018	2019
Incremental Capital needed	6,226	7,206	8,174	8,002	8,917	10,088
Capital Generated from Business	7,578	8,345	9,172	9,658	10,188	10,712
Excess/(Shortfall)	1,353	1,139	997	1,656	1,271	624

A quick analysis shows that the internal capital generation can support the projected growth. Hence, we do not need to factor any dilution in our assumptions.

Projections for Asset based businesses:

Both financial services and projects businesses are still at a nascent stage to do a future projection on the basis of past performance. Hence, we have applied some thumb rules and used industry benchmarks for projecting the performance of these businesses.

Financial Services	2013	2014	2015	2016	2017	2018	2019	2020
Capital Employed	6,451	7,419	8,531	9,811	11,283	12,975	14,922	17,160
Return	581	593	597	589	564	519	448	343
ROCE	9%	8%	7%	6%	5%	4%	3%	2%

Projects	2013	2014	2015	2016	2017	2018	2019	2020
Capital Employed	27,097	31,162	35,836	41,211	47,393	54,502	62,677	72,079
Return	271	312	358	412	474	545	627	721
ROCE	1%	1%	1%	1%	1%	1%	1%	1%

In the Financial Services business, we have projected a 15% Asset Growth, which is reasonable considering the small capital base at present. However, the return on the capital currently is very high and is not sustainable. Hence, we have projected the ROCE (NII Margins) to progressively drop to 2%, which is the Industry standard.

In the Projects business, we have projected a return of 1% on the capital employed in the project. This is the value of PBT on the total project capital. Hence, assuming a 9:1 Debt Equity ratio, the return on equity would be 10%. We have projected a 15% increase in business and consequent increase in capital employed.

Valuation of the Company

Discounted Cash Flow Method

We have assumed a terminal growth rate of 2% and Discount Rate of 8% in the below valuation.

PBT	2013	2014	2015	2016	2017	2018	2019	2020
Financial Services	581	593	597	589	564	519	448	343
Project	271	312	358	412	474	545	627	721
Other Businesses	7,559	7,578	8,345	9,172	9,658	10,188	10,712	11,266
Total	8,411	8,483	9,301	10,172	10,697	11,252	11,787	12,330
PAT	**5,635**	**5,684**	**6,231**	**6,816**	**7,167**	**7,539**	**7,897**	**8,261**
PV		5,263	5,342	5,410	5,268	5,131	4,976	4,820
Terminal Value		81,946						
Valuation		1,18,157						
No. of Shares O/s		60.66						
Valuation per share		1,947.83						

Due to the complexity in making the projections, we are doing only a single valuation, which is on the conservative side. We are not making separate realistic and optimistic projections.

Asset Value Method

We have done a quick asset value calculation below.

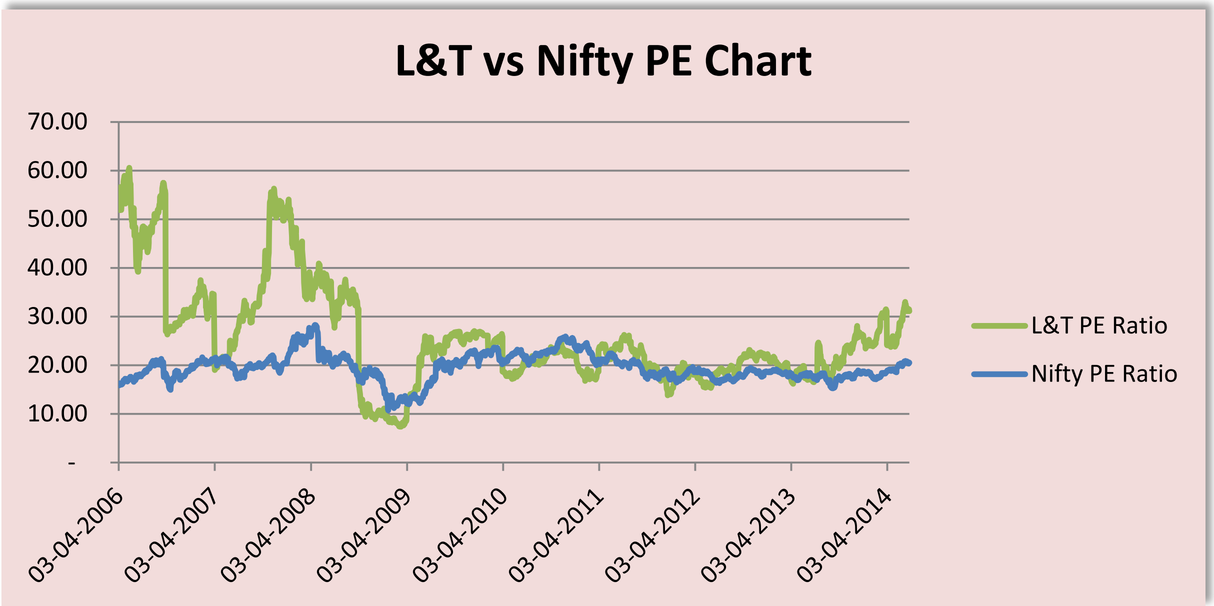
Details	2013 (Est)	2012	2011
Shareholder's Funds		29,387	25,051
No. of Shares o/s		60.66	60.66
Book Value per share	570	484	413
Intangibles per share	820		
Asset Value	1,390		

The Intangibles in the above represent 5 years of Employee Cost and 5 years of Selling Expenses. These are the expenses that a new competitor would have to incur to develop the technical expertise as well as the brand name to reach L&T's scale.

Our EPV Valuation of Rs. 1948 per share infers 8.4 years employee and selling costs as intangibles. This is not unreasonable for a company like L&T.

Market Perception

Larsen & Toubro's pricing is strongly correlated with the investment cycle in the economy. In the boom period from 2006 to 2008, the company's PE was far higher than the Nifty PE. Since then, the company's PE has stayed mostly in line with the Nifty PE. Recently, it has increased again on an anticipation of revival in the investment cycle. Thus, taking a call on multiple growth in L&T is essentially taking a call on the revival of the investment cycle in India.



Summary and Recommendation

Larsen & Toubro is a Stalwart in our categorization of stocks. The company is a clear leader in its industry. Its capability to execute complex and large projects in the engineering and infrastructure create an intangible value that few competitors can copy. However, due to the nature of its business, L&T's fortunes are strongly tied to the investment and capex cycle. Thus, taking a call on L&T is essentially taking a call on the revival of the Investment cycle in India.

Currently, the market is pricing this company based on its financial performance, which has been constrained due to market conditions. In better economic conditions, L&T has the capability to improve on this performance substantially. This makes L&T a good value investment right now.

Based on our analysis, we consider a fair valuation of the company at Rs. 1950 per share. Due to the complex nature of this business, we have come up with a single point valuation instead of a valuation range as we normally do.

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