

Larsen & Toubro Ltd

BUY

CMP Rs1,361

Target Rs1,584

Upside 16%

Healthy core margins; Execution to pick up

L&T delivered healthy operational performance despite commodity price headwinds (Core EBITDA margins of 10.2%, up 80 bps yoy) led by efficient execution, favorable job mix & sale of commercial space by realty. Core business execution has almost reached to normalization level in Q3FY21 barring few project sites. We expect L&T's execution to gain traction in next few quarters on the back of strong order backlog of ~Rs3.3trn (3.5x TTM Core business sales). Hydrocarbon segment and heavy engineering should continue to see improving margin trends. Rising share of domestic execution backed by orders picked up in the last 2 years gives margin comfort. L&T's focus on cash flows has been evident from the past few quarters. Working capital as % of sales would likely to remain flat yoy by Q4FY21 due to better collections from customers & advance payments for large projects. Order book diversification, global competence, technology differentiation, proven track record and cost efficiencies bode well for the company. Raise our FY22 earnings estimates marginally (~2%) & retain BUY rating with SOTP based price target of Rs1,584 as we roll forward to FY23. Core business revenue ramp up, infra margin recovery, prudent capital allocation & improving return ratios over FY21-23E are key stock triggers.

Exhibit 1: Financial Summary

Y/e 31 Mar (Rs mn)	FY19	FY20	FY21E	FY22E	FY23E
Revenues	1,352,203	1,454,524	1,341,287	1,639,629	1,851,808
yoy growth (%)	12.8	7.6	(7.8)	22.2	12.9
EBITDA	153,296	163,290	144,406	187,206	220,476
EBITDAM (%)	11.3	11.2	10.8	11.4	11.9
Adjusted PAT	80,410	88,945	73,915	99,541	124,785
yoy growth (%)	11.0	10.5	(16.8)	34.7	25.4
EPS (Rs)	57.3	63.4	52.7	70.9	88.9
P/E (x)	23.8	21.5	25.9	19.2	15.3
P/BV (x)	3.1	2.9	2.4	2.2	2.0
EV/EBITDA (x)	19.0	18.6	20.2	15.2	8.7
Net D/E (x)	1.6	1.7	1.2	1.1	1.0
ROE (%)	13.6	13.8	8.9	11.4	12.4
ROCE (%)	5.9	5.9	4.0	5.1	5.6

Source: Company, YES Sec - Research

Earnings Call Highlights- Management Outlook

- ✓ The management has refrained from giving guidance on revenue and margins
- ✓ **Order prospect** - Order prospects for Q4FY21 are at Rs2.65tn with domestic orderbook constituting Rs2.2tn. It appears government has focused on key areas to boost economic recovery such as Metro, RRTS, HSR, roads, expressways, renewables, water and T&D.
- ✓ **Orderbook** - Order Book stands at Rs3,311bn with international order book constituting 20% of the total. Domestic orderbook is split across: Central govt - 12%, State govt - 34%, PSU-41%, and Private - 15%. In challenging times, a large proportion of orders from public space would mitigate credit risk. Out of this orderbook Rs90bn is Multi-lateral funded.

UMESH RAUT

Lead Analyst

umesh.raut@ysil.in

+91 7874052571



Tanay Rasal Associate

AMAR AMBANI, Sr. President, Head of Research

amar.ambani@ysil.in

- ✓ **Outlook** – Reflecting on 9MFY21, the management stated performance has been robust primarily due to Govt and RBI proactiveness to create ordering opportunities and abundant liquidity. Revenue and Margins were impacted due to lack of labor availability and supply chain bottleneck in Q1 and in Q2&Q3 due to lower productivity arising out of safety protocols at the site level. The management has refrained from giving guidance on revenue and margins for EPC business. Meanwhile, services business continues to pursue profitable opportunities. And once normalcy returns, the focus would be to address refinancing of Hyderabad metro. With pandemic yet lingering and aftereffects continuing business pursuit need to factor additional risk warranted to ensure responsible conduct toward news emerging opportunities and prospects. Against such a backdrop the group would continue to pursue large project wins, smart execution of orderbook, and continue to preserve liquidity and optimum use of capital.
- ✓ **Hyderabad Metro** – The company has infused Cash to the tune of Rs500 crore in Hyderabad Metro during Q3FY21. Currently average monthly traffic is at 0.1mn passengers per day, however, during weekdays ridership increases to 0.125-0.13mn passengers per day. (PnL for Hyderabad metro as of Q3FY21: Revenue - Rs0.50bn (Rs0.30bn due to passenger ridership), Operational expense – Rs0.50-0.60bn, Depreciation - Rs0.75bn, Interest - Rs3.65bn; Debt - Rs140bn, Equity – Rs25bn). Discussion are in process with stakeholders for refinancing, however, a substantial progress would be seen before Q1FY22E
- ✓ **Strategy for Q1 & Q2 claims** - As most of the customers are repeat customers, the company has adopted a conciliation approach which would be win-win situation for both the parties. As most of the customers are government parties, hence, an immediate settlement might not be possible. The management expects in the next 3-4 quarters some of the claims to materialize.
- ✓ **Realty Business** – Total units as per the plan are 5600. Of these, 2600 have been sold and of the balance 3000, 1900 are contracted to be sold while unsold inventory being 1100. Response to second phase in Navi Mumbai property and Bangalore property has been favorable. The mid-ticket segment has seen an uptick and would continue to be favorable in next 2-3 quarters. In contracting opportunity, mass housing opportunity is seen in a more pronounced form. The management does see uptick in in healthcare, data center and low cost residential housing. The overall exposure in real estate is Rs450bn with major part being moving/execution able orderbook barring Navi Mumbai International Airport.
- ✓ **Debt to prune** – As a pre-emptive measure during Covid, the parent undertook the borrowing of Rs120bn, the main reason debt levels shot up. And after EIC divestments, the company has started pruning debt. In the next 2-3 quarter, the management expects standalone debt to come down with incremental debt at parent level being ruled out. Currently, net debt to equity ratio is 0.1 at parent level which is expected to be negligible post March.

Segment Performance

- ✓ **Infrastructure:** Infrastructure Segment secured orders of Rs455bn, up by 80%YoY due to the receipt of two marquee orders of High Speed Rail. Besides, notable orders received included an order for a special bridge project (Assam), domestic orders for rural water supply schemes (Madhya Pradesh), international orders in Power Transmission & Distribution and Metallurgical and Material Handling business. International orders constituted 7% of the total order inflow for the segment during the quarter. The segment order book stood at Rs2453bn as on December 31, 2020, with the share of international order book at 19%. The segment recorded revenue of Rs158bn for Q3FY21, registering a sequential growth of 22%. However, compared to the corresponding quarter of the previous year, the revenue declined by 7% primarily on account of progress being impacted due to Covid-19 preventive measures. The share of international revenue was 23% of the total customer revenue of the segment during the quarter. The EBITDA margin of the segment for Q3FY21 is at 6.2% for the current quarter as compared to 6.1% for Q3FY20. The Smart World and Communication business which was reported under Infrastructure Segment has been reclassified to "Others Segment"

- ✓ **Power:** The Power Segment did not secure any major order during Q3FY21 due to absence of green field thermal power project opportunities. The order book of the segment stood at Rs137bn as on December 31, 2020, with the international order book constituting 6% of the total order book. The segment recorded customer revenue of Rs9bn, up by 29%YoY on the back of strong opening order book. International revenue constituted 7% of the total customer revenue. EBITDA margin for the quarter was at 2.0%, lower compared to 3.4% recorded in the corresponding quarter of the previous year. The margin for the quarter reflects a major portion of the jobs at their early stages of execution and yet to achieve the margin recognition threshold.
- ✓ **Heavy Engineering Segment:** Heavy Engineering Segment secured orders at Rs10bn, up by 100%YoY led by orders contracted in the Nuclear business. International orders constituted 61% of the total order inflow. The order book of the segment stood at Rs36bn as on December 31, 2020, with export orders having a 48% share. The segment recorded customer revenue of Rs7bn, marginally higher than the corresponding quarter of the previous year. International sales comprised 55% of the total customer revenue of the segment during the quarter. The EBITDA margin of the segment at 20.0% for Q3FY21 registered a decline over the corresponding quarter of the previous year at 23.5%, on account of changes in job mix.
- ✓ **Defence Engineering Segment:** Defence Engineering Segment received orders worth Rs7bn during Q3FY21 which were mainly domestic, registering substantial growth on a low base of the corresponding quarter of the previous year. The order book of the segment stood at Rs88bn as on December 31, 2020, with export orders constituting 13%. The segment recorded customer revenue of Rs10bn registering a marginal growth of 2% over the corresponding quarter of the previous year. Exports constituted 31% of the total customer revenue of the segment during the quarter. The EBITDA margin of the segment at 16.9% for Q3FY21 was lower as compared to the corresponding quarter of the previous year at 20.9%, as previous year witnessed a order reaching margin recognition threshold. The Military Communication Business of Defence Engineering Segment has been transferred to Smart World and Communication business and reclassified to "Others Segment".
- ✓ **Hydrocarbon:** The Hydrocarbon Segment secured orders valued at Rs128bn during Q3FY21, supported by receipt of some large value domestic orders in the petrochemicals space. International orders constituted 4% of the total order inflow of the segment during the quarter. The segment order book stood at Rs458bn as at December 31, 2020, with the international order book constituting 36%. The segment reported customer revenue of Rs44bn during the quarter ended December 31, 2020, marginally higher than the corresponding quarter of the previous year. The international revenue constituted 51% of the same. The EBITDA margin of the segment for Q3FY21 at 12.2% is almost in line with that of the corresponding quarter of the previous year.
- ✓ **Developmental Projects Segment:** The segment registered a revenue of Rs8bn during Q3FY21, a decline of 34% over the corresponding quarter of the previous year on account of lower ridership in Metro services at Hyderabad and lower PLF in Rajpura 1400 MW power station, affected due to rail roko agitation by farmers in the state of Punjab. The EBITDA margin of the segment for the quarter ended December 31, 2020 declined to 0.1% as compared to 17.3% during the corresponding quarter of the previous year due to under-utilization of Metro services on Covid-19 related restrictions.
- ✓ **"Others" Segment** comprises (a) Realty, (b) Construction & Mining Machinery, (c) Rubber Processing Machinery, (d) Valves and (e) Smart World and Communication. During the quarter, the Construction and Mining equipment business was awarded its biggest order ever for supply of 46 units of Komatsu Mining equipment to an esteemed customer. Customer revenue of "Others" Segment during the quarter ended December 31, 2020 at Rs20bn registered growth of 30% over the corresponding quarter of the previous year, with sale of commercial property in the Realty business. Export sales constituted 9% of the total customer revenue of the segment during the quarter, majorly pertaining to the Valves business. During the quarter ended December 31, 2020, the segment EBITDA margin stood

at 34.3%, higher compared to 18.7% in the corresponding quarter of the previous year on the back of the aforesaid commercial property sale in the Realty business.

Other details

- ✓ The company received one major advance of Rs4.5bn against High Speed Rail order during the quarter
- ✓ Hydrocarbon margins were at 11% mainly due to efficient execution
- ✓ Nabha Power – No conclusion yet
- ✓ The sharp jump in Other income was mainly due to high investable surplus
- ✓ NWC for the core business is Rs220bn while for group level it is 310bn. The management expects to maintain WC position at same level as of FY20. The management has adopted a strategy of ramping of operation where collections are visible, whereas in case of weak collection execution is in line with collection momentum

Key highlights from Q3FY21 Consolidated results:

- ✓ Revenues declined 2% yoy (-5 vs our est.) as core revenues (ex-services) were down 7% yoy while IT services posted 6.6% yoy growth.
- ✓ Order inflow stood at Rs732.3bn, up 76% yoy (vs our estimates of Rs725bn) led by biggest EPC contract in the country and first of its kind - the prestigious High Speed Rail order. International orders were at Rs102bn (14% of the total order inflow). Infrastructure segment secured orders of Rs456bn, up 80% yoy. International orders constituted 7% of the total. Other notable orders received included an order for a special bridge project (Assam), domestic orders for rural water supply schemes (Madhya Pradesh), international orders in Power Transmission Et Distribution and Metallurgical and Material Handling business.
- ✓ Consolidated Order Book stands at Rs3,311bn with international order book constituting 20% of the total.
- ✓ EBITDA came in at Rs42.9bn (+1% vs our est.), up 4% yoy.
- ✓ Infra EBIT margins was flat yoy at 5.2%
- ✓ Adjusted PAT came in at Rs22.6bn, up 4.5% yoy (+6.6% vs our est.) due to higher other income of Rs10.6bn.
- ✓ Reported PAT stood at Rs24.7bn, up 5% yoy.

Exhibit 2: Consolidated Result Table

(Rs mn)	Q3FY21	Q3FY20	% yoy	Q2FY21	% qoq	Q3FY21 YSEC Est.	% change
Order Inflow	732,330	415,780	76.1	280,390	161.2	250,000	192.9
Total sales	355,964	362,427	(1.8)	310,347	14.7	375,951	(5.3)
EBITDA	42,910	41,177	4.2	33,348	28.7	42,456	1.1
EBITDAM (%)	12.1	11.4	69.3	10.7	130.9	11.3	76.2
Depreciation	(7,131)	(6,602)	8.0	(7,131)	0.0	(6,932)	2.9
Interest	(9,620)	(7,092)	35.7	(10,425)	(7.7)	(9,500)	1.3
Other income	10,647	4,749	124.2	5,590	90.4	5,500	93.6
PBT	36,805	32,233	14.2	21,382	72.1	31,524	16.8
Tax	(10,408)	(7,110)	46.4	(6,754)	54.1	(7,944)	31.0
Minority Interest	(3,824)	(3,515)	8.8	(3,563)	7.3	(2,400)	59.3
Adjusted PAT	22,574	21,608	4.5	11,066	104.0	21,180	6.6
Reported PAT	24,667	23,521	4.9	55,203	(55.3)	22,480	9.7
EPS (Rs)	16.1	15.4	4.5	7.9	104.0	15.1	6.6

Source: Company, YES Sec - Research

Exhibit 3: Segment Revenues

Revenues (Rs mn)	Q3 FY21	Q3 FY20	% yoy	Q2 FY21	% qoq
Consolidated (ex-services)	251,822	270,971	(7.1)	215,240	17.0
Infrastructure	159,732	171,758	(7.0)	130,957	22.0
Power	9,037	6,983	29.4	6,887	31.2
Heavy Engineering	8,034	8,061	(0.3)	7,081	13.5
Defence Engineering	10,240	10,042	2.0	7,688	33.2
Electrical & Automation	48	14,198	(99.7)	8,460	(99.4)
Hydrocarbon	44,224	43,926	0.7	40,497	9.2
Others	20,507	16,004	28.1	13,672	50.0
IT and Technology services	65,301	61,259	6.6	61,998	5.3
Financial services	34,007	35,501	(4.2)	33,419	1.8
Developmental projects	8,138	12,382	(34.3)	11,396	(28.6)
Total revenues	359,268	380,114	(5.5)	322,053	11.6
Inter-segment revenue	3,256	3,489	(6.7)	3,246	0.3
Discontinued ops rev.	48	14,198	(99.7)	8,460	(99.4)
Net revenue	355,964	362,427	(1.8)	310,347	14.7

Source: Company, YES Sec - Research

Exhibit 4: Segment EBIT

EBIT (Rs mn)	Q3FY21	Q3FY20	% yoy	Q2 FY21	% qoq
Consolidated (ex-services)	22,497	22,406	0.4	14,208	58.3
Infrastructure	8,226	8,796	(6.5)	6,586	24.9
Power	88	139	(36.9)	125	(29.7)
Heavy Engineering	1,347	1,586	(15.1)	187	619.1
Defence Engineering	1,384	1,746	(20.8)	1,508	(8.3)
Electrical & Automation	(32)	2,571	(101.3)	698	(104.6)
Hydrocarbon	4,932	4,930	0.0	2,990	65.0
Others	6,553	2,638	148.4	2,114	209.9
IT and Technology services	13,595	9,955	36.6	11,307	20.2
Financial services	3,520	7,269	(51.6)	3,283	7.2
Developmental projects	(760)	1,825	(141.6)	(168)	351.2
Total EBIT	38,853	41,455	(6.3)	28,630	35.7

Source: Company, YES Sec – Research

Exhibit 5: Segments EBIT margins

EBITM (%)	Q3 FY21	Q3 FY20	bps yoy	Q2 FY21	bps qoq
Consolidated (ex-services)	8.9	8.3	66	6.6	233
Infrastructure	5.2	5.1	3	5.0	12
Power	1.0	2.0	(102)	1.8	(84)
Heavy Engineering	16.8	19.7	(291)	2.6	1,412
Defence Engineering	13.5	17.4	(387)	19.6	(611)
Electrical & Automation	(66.7)	18.1	(8,477)	8.3	(7,492)
Hydrocarbon	11.2	11.2	(7)	7.4	377
Others	32.0	16.5	1,547	15.5	1,649
IT and Technology services	20.8	16.3	457	18.2	258
Financial services	10.4	20.5	(1,013)	9.8	53
Developmental projects	(9.3)	14.7	(2,407)	(1.5)	(786)

Source: Company, YES Sec – Research

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YES Securities (India) Limited

Registered Address: Unit No. 602 A, 6th Floor, Tower 1 & 2,
One International Center, Senapati Bapat Marg, Elphinstone Road,
Mumbai - 400013, Maharashtra, India
Email: research@ysil.in | Website: <https://yesinvest.in>

Registration Nos.: CIN: U74992MH2013PLC240971 | SEBI Single
Registration No.: NSE, BSE, MCX & NCDEX : INZ000185632 | Member
Code: BSE - 6538, NSE - 14914, MCX - 56355 & NCDEX - 1289 |
MERCHANT BANKER: INM000012227 | RESEARCH ANALYST:
INH000002376 | INVESTMENT ADVISER: INA000007331 | Sponsor and
Investment Manager to YSL Alternates Alpha Plus Fund (Cat III AIF) SEBI
Registration No.: IN/AIF3/20-21/0818 | AMFI ARN Code - 94338 |

Details of Compliance Officer: Vaibhav Purohit (For Broking / Research /
Investment Adviser): Email: compliance@ysil.in /
Contact No.: 022-33479208 | Dhanraj Uchil (For Merchant Banking):
Email: dhanraj.uchil@ysil.in / Contact No.: 022-33479684

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