L&T progresses on the road to recovery

Analysts say improving engineering and construction business, asset monetisation, and better return ratio will provide triggers

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New Delhi, 18 October

The lockdown-related disruption has significantly affected investor sentiment towards Larsen & Toubro (L&T). The concerns over labour availability, project execution, and new order flows meant that the stock continued underperforming.

But, analysts now feel concerns are overdone and L&T is seeing gradual but regular improvement in business prospects. The project execution is picking up with improved labour availability. Though the September quarter will be soft on a year-on-year (YoY) basis, it shall be much better sequentially and the second-half performance will improve significantly, say analysts. L&T is among the top picks of Credit Suisse and Jefferies, who say prudent capital allocation, revenue recovery in E&C (engineering and construction), and better return on capital employed (RoCE) in FY20-23 are triggers.

After the unlocking of the economy, supply-side issues and concerns over labour availability have largely been addressed, project execution is expected to show a smart pick-up in the second half of FY21, say analysts. The recent announcements on commissioning of a hydroelectric power plant, and order flows in September are also encouraging. Though private capex is expected to remain subdued and also will state government-led projects, order flows driven by various central government agencies is expected to provide the impetus. Umesh Raut at YES Securities expects higher ordering of highways, ports, railways, and other infrastructure projects by the central government with the easing of Covid-19 situation. Order flow in the September quarter is pegged at ₹25,000 crore, slightly better than ₹23,600 crore in Q1, yet analysts see order book growing 4.8 per cent YoY in FY21.

Nonetheless, the order book of more ₹3 trillion is strong enough to provide comfort against weak order inflows in the near term, say analysts, who believe stabilisation of project execution will continue driving prospects. The company is also to benefit from an increased focus on domestic manufacturing and large investments lined up in infrastructure projects. Domestic companies getting preference over Chinese peers should prove beneficial for L&T's order flows.

L&T has a healthy balance sheet, has cash, and long-term scalability, helping it sail through these turbulent times rather easily, say analysts at Reliance Securities.

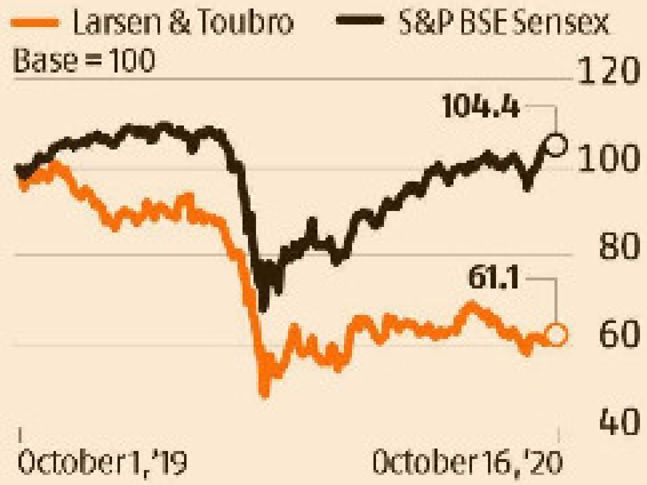
EARNINGS REBOUND IN FY22

(₹crore)

	FY20	FY21E	FY22E
Order book	3,03,857	3,18,359	3,34,163
% change yoy	10.4	4.8	5.0
Net sales	1,45,500	1,41,900	1,63,076
Ebitda	16,300	15,561	18,925
Ebitda margin (%)	11.2	11.0	11.6
EPS (₹/share)	63.4	48.7	64.7
% change yoy	10.5	-23.1	32.8

FY22 estimates; EPS: earning per share
Ebitda: earnings before interest, tax, depreciation, and amortisation Source: Motilal Oswal Financial Services

UPSIDE AHEAD



The company's ongoing non-core asset monetisation drive is also positive. While L&T recently completed the ₹14,000-crore deal involving the sale of its electrical and automation business to Schneider Electric, analysts at Jefferies see additional ₹1,100 crore monetisation prospects. Canadian pension fund CPIPB, too, had invested ₹1,000 crore for a 49 per cent stake in road/transmission assets last year. Analysts say that incremental 25 per cent stake sale and Nabha Power are easy assets to monetise. Additionally, the company has indicated that it will dilute stake in Hyderabad metro. The reducing share of low RoCE and long-gestation projects will boost return ratios.

Analysts say the increased focus on domestic manufacturing, given rising concerns over-dependence on China amid geopolitical tensions globally, hasn't been fully priced in the stock.

Overall, Credit Suisse says that margins and working capital concern have abated given the peak crisis quarter has passed and they maintain outperform rating on L&T on account of sector/geography diversification, balance sheet, track record, likely normalisation boosting prospects, and attractive valuations. The stock of L&T is currently trading at valuations lower than some of its smaller, albeit incomparable, peers.

On price-to-FY22 estimated book value, L&T is trading at 1.5x — a substantial discount to other capital goods peers like ABB, Siemens, Engineers India and KEC International trading at 1.8 to 4.6x.

Most analysts feel valuations are now comforting. Jefferies says L&T is trading at 1.3x its consolidated price to estimated FY23 book value, giving downside protection, as even in FY21 return-on-equity will be 10 per cent, which should recover to 14 per cent in FY23 (14 per cent annual growth between FY19 and FY23). The rally in services business stocks has lifted its sum-of-the-parts valuations with these being valued at close to ₹400 a share; the L&T stock is trading at ₹896 levels.