Safal Niveshak StockTalk #1:

Larsen & Toubro

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Welcome to the first issue of the *Safal Niveshak StockTalk*.

Based on requests, we start with the analysis on L&T, which is India's largest engineering company, and one that has business spread across a wide domain in the engineering, capital goods, and construction spaces.

Since this is the first issue of the *Safal Niveshak StockTalk*, I expect to receive feedback from you on the quality of the analysis and reporting plus your suggestion for improving the analysis further.

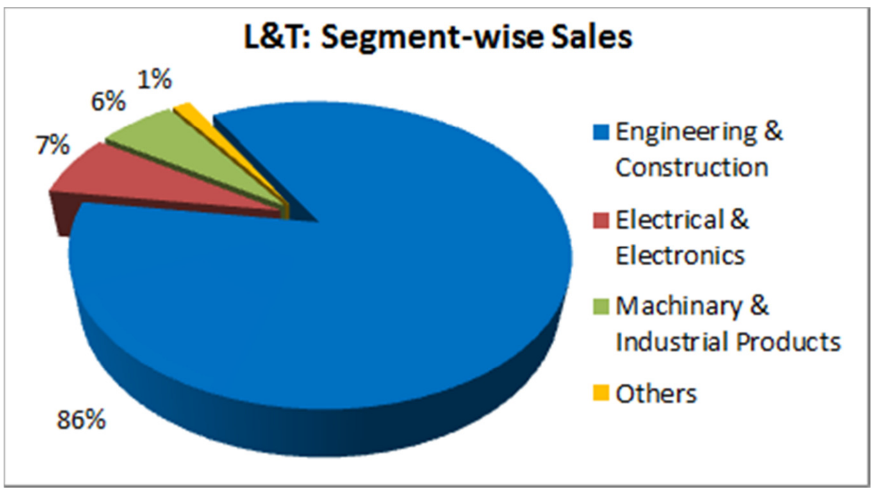
I won't say this report would perfectly capture the entire business and performance of L&T. But I've tried to be as comprehensive as possible while maintaining the simplicity of analysis that Safal Niveshak stands for.

Before we dive into L&T, here is a brief overview of the sections of this report:

1. About L&T

If you have ever travelled over a large, long bridge in India or have driven across a huge manufacturing plant, there are great chances you experienced something that was built by L&T, which is India's largest engineering and capital goods company by sales and profits.

L&T has business interests in sectors ranging from engineering, construction, manufacturing, information technology and financial services. It has a dominant presence in India's infrastructure, power, hydrocarbon, machinery and railway-related projects. The company has also expanded its global presence in recent times. The company was founded in Mumbai in 1938 by two Danish engineers, H. H. Larsen and S. K. Toubro (and thus the name 'Larsen & Toubro').



Its current order backlog (the amount of orders it has in hand and that are yet to be converted into revenues) stands at around Rs 1,420 billion (Rs 142,000 crore), which is a clear indication of the company's mammoth size and execution capabilities.

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2. Safal Niveshak's 25-Point Checklist

Keeping in mind the simplicity aspect that is otherwise missing in other company analysis reports you would come across, I've analyzed L&T by answering 25 important questions that span its:

- Business,
- Financial performance,
- Management quality, and
- Competition.

Here is the complete 25-point checklist with my explanations.

Before we move ahead, here are the symbols that I've placed against each checklist point and that will tell you at a glance whether I have a positive or negative view on that particular point.

Indicates my positive view

Indicates my negative view

Let's get started.

A. Business

1. Can I, in one sentence, say exactly what the company does?

Yes. It manufactures what India needs the most at this time and for the next many years – Infrastructure.

2. Is it in my circle of competence?

Yes. The business is simple to understand, as I explained for the first point above. I mean, you can draw L&T's business using crayons. As simple as that!

3. Is it a low risk business?

No. Despite the immense growth prospects, L&T's growth and profitability is highly dependent on the growth of Indian economy and capital expenditure by other companies, which is dependent largely on the pace of infrastructure spending of the Indian government. L&T's is a cyclical business, and thus has its share of large ups and downs. For instance, as can be seen by the company's recent performance, it has seen a slowdown in new order inflows, which is in line with the decline in India's industrial activity.

While the company is trying to spread its wings wider and across the globe, I believe it will remain an India-centric story and thus highly dependent on what happens in the Indian economy and industrial sector.

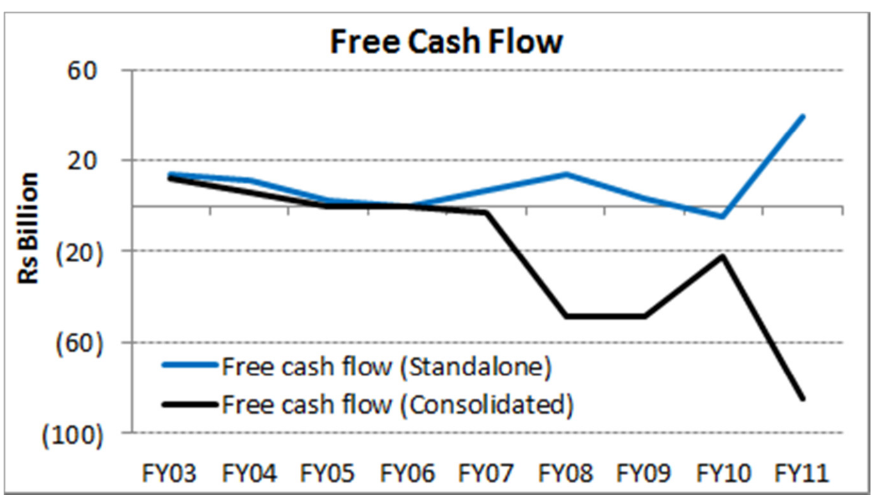
4. Does the business have high uncertainty?
Yes. However, while the business cycle in which L&T operates is volatile and uncertain, the company is able to bear the pain better than its competitors owning to the huge order backlog it maintains. Plus, even in a slowdown, the company is at a better chance to survive and grow due to its strong project execution capabilities and brand name.

5. Is it a good business?
Yes, largely because it caters to an industry that has a bright future in India for many years in the future. Of course you need to discount L&T's dependence on the pace of infrastructure spending by the Indian government and the private sector. However, one drawback about the business is that it is highly competitive, especially when it comes to low to medium quality engineering and construction works.

6. Has the business got an enormous moat?
No. As I said, it's a highly competitive business, especially when it comes to low to medium quality engineering and construction projects. Even for the complex and high-value projects where L&T has a stronghold, competition from both Indian and foreign companies is on a fast rise. Some of the competitive advantages that L&T used to enjoy are gradually waning, as competitors are fast catching up to the company's quality and size.

7. Is there room for future growth?
Yes, very much…for the reasons we discussed above. While there will be short to medium term pressure on growth, like what we are seeing as of now, the long term holds a big promise for L&T.

8. Does the business generate strong free cash flow?
No. While L&T's standalone business has seen some free cash flow generation over the years, these have been volatile owing to the company's consistent spending towards expansion. The picture gets even worse when you look at the consolidated free cash flows, which have been negative (and falling) over the past few years. So the overall picture doesn't look impressive here, despite the fact that negative free cash flow is a chronic problem across the engineering and construction companies.



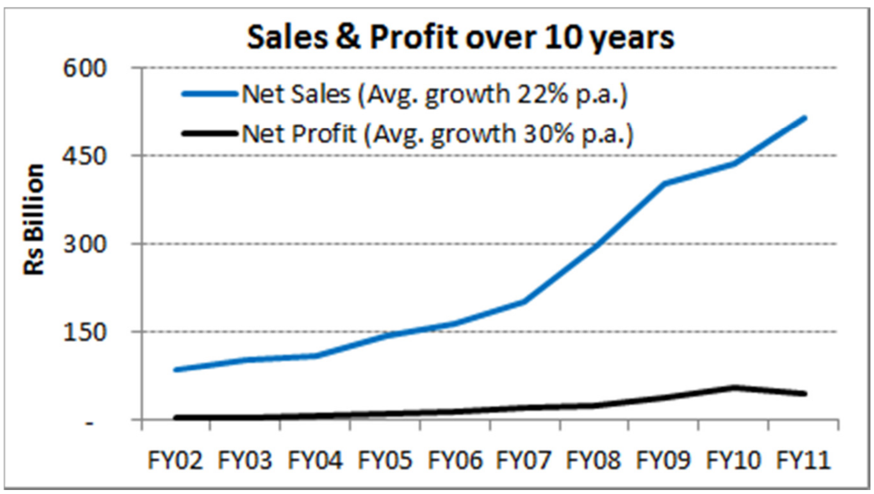
9. What is the bargaining power of suppliers and buyers?

High. Given the rising competition in the industry and with the coming of many large players in spaces where L&T operates, both the suppliers (of raw materials) and buyers (of L&T's products and services) have seen their bargaining power rise over the years. Of course L&T, owing to its size, still exerts a greater influence on its suppliers and buyers as compared to its smaller peers, but its influence is on a declining trend.

B. Financial Performance

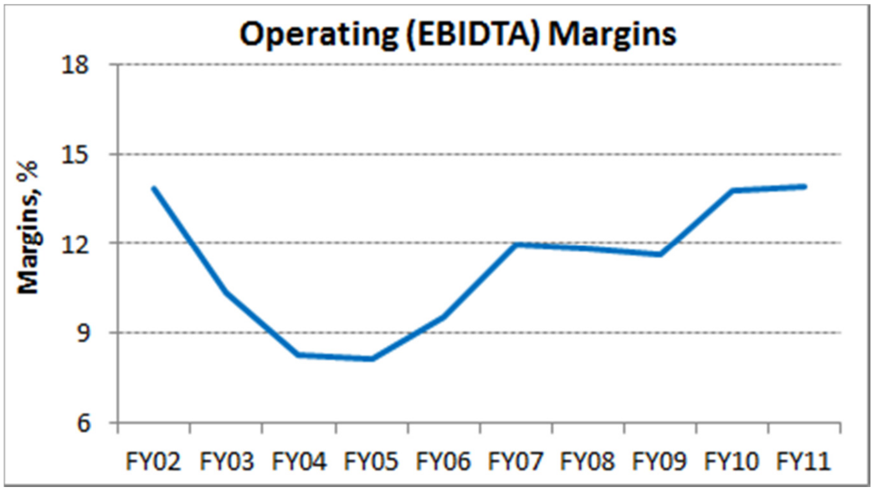
10. Does the business have a consistent sales and profit growth history?

Yes. L&T has grown its sales and net profits at an average rate of 22% and 30% per annum over the past 10 years, which is a decent pace of growth, especially given the company's large size. Also, during these 10 years, the company has not seen a single year of decline in sales, while its profit has declined just once on a year-on-year basis, and it was in the latest completed year (FY11). So overall, it's been a good performance from L&T on the sales and profit growth front.



11. Are EBIDTA margins higher than 15%?

No. L&T has a history of volatile operating margins, but that is the nature of the industry. A large part of this volatility can be attributed to the sharp movements in commodity prices, given that L&T consumes a lot of commodities (iron, steel, aluminum) in its manufacturing operations plus occasional economic slowdowns where the company has had to take price cuts. Anyways, more than the level of margins, I look for consistency in the same. L&T is lacking on this front as well.

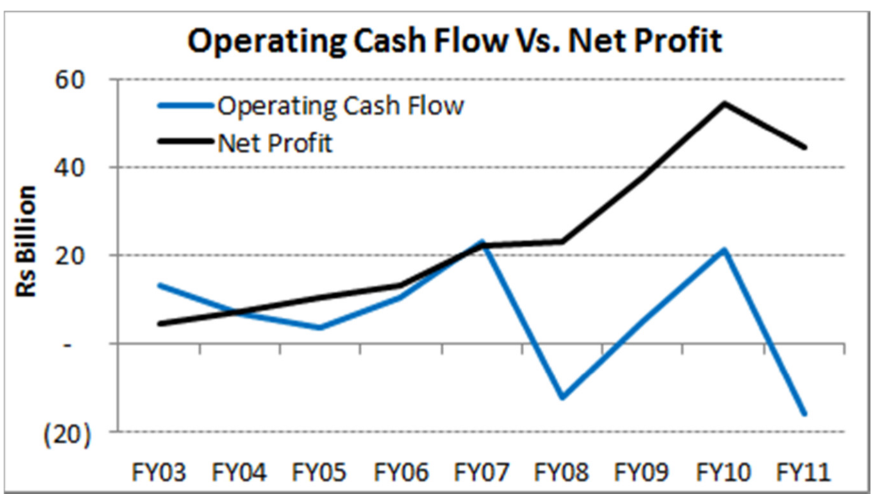


12. Is its operating cash flow higher than net profits?

No. Operating Cash Flow (also known as "Cash Flow from Operating Activities", or "Cash Flow from Operations") is a measure of the total cash generated from a company's operations. This figure is available in a company's balance sheet.

Operating Cash Flow or OCF tells how much cash a company has been able to generate from the operations of its business. Since it adjusts for working capital and depreciation, it is a more accurate measure of how much cash a company has generated (or used) than measures of profitability such as net profit. As such, a large and/or unexpected discrepancy between the net profit and operating cash flow of a company could be indicative of disproportionate non-cash income.

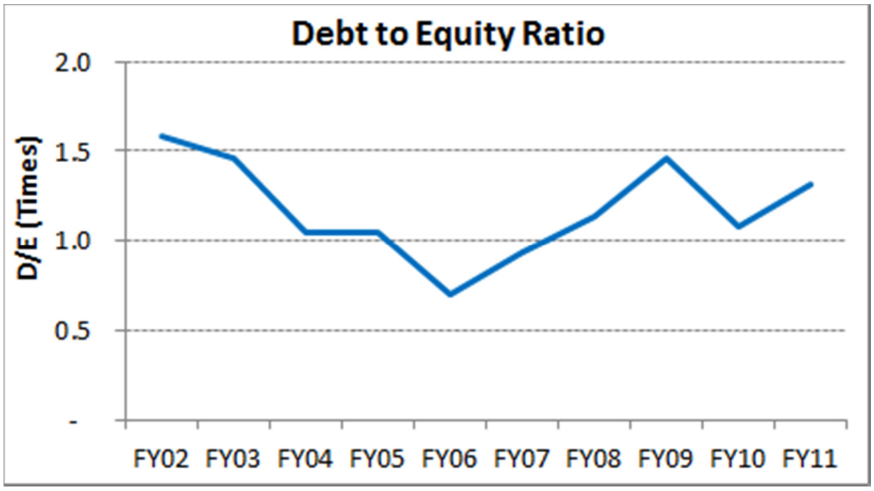
Like in case of L&T, there is a widening discrepancy between the company's net profit and OCF – with the latter being lesser than the former.



The company's cash flow statement suggests that this is largely because of a jump in working capital (required for day to day operations) of the company over the past 2-3 years. This isn't strange for a company that is trying to grow fast. But a consistently falling OCF despite a rising net profit is a cause for concern.

13. Is the debt to equity below 0.5 times?

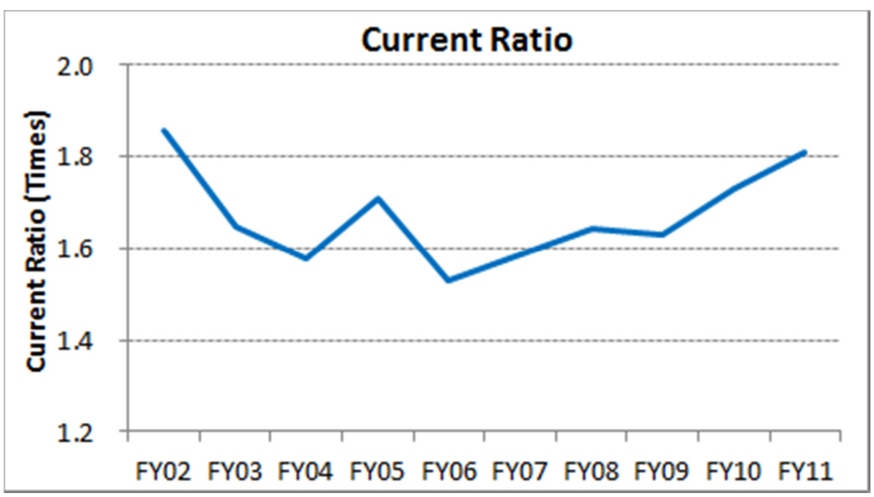
No. Given the rising capital spending needs, L&T has been taking up higher borrowings on its books. This has led to the company's debt to equity ratio averaging around 1.3 times over the past 3 years. Its average debt to equity ratio over the past 10 years has been around 1.2 times, which is beyond my comfortable levels.



14. Is the current ratio greater than 1.5?

Yes. L&T's average current ratio over the past 10 years has been 1.7 times, which is a comfortable number.

As a general rule, a current ratio of 1.5 or greater suggests that a company can meet its short-term operating needs sufficiently. However, a higher current ratio can suggest that a company is hoarding assets instead of using them to grow the business. While this is not the worst thing in the world to do, it is something that could affect long-term returns.



15. Does the company have a good dividend history?

Yes. In terms of dividend payout (amount of dividend paid as percentage of net profit), L&T has averaged around 25% over the past 10 years. This is an important number from a shareholder's point of view, especially given that company has seen its working capital requirements rise consistently over the years and thus has had to resort to external borrowing to fund the same. The company could have instead given lower dividends and instead replenish its cash flows to meet its capital requirements. Anyways, since the dividend payout has been reasonable all these years, I have a positive observation on this point.

16. Is the Altman Z score > 3?

No. But it's just there at 2.8, so the business looks comfortably protected against bankruptcy.

17. How capital intensive is the business?

Very much. Engineering companies like L&T need a continuous flow of fresh capital to provide for the expansion of their manufacturing capacities plus fund the initial portion of their construction projects.

The legendary investor, Warren Buffett wrote in his 1992 letter to shareholders – "The best business to own is one that over an extended period can employ large amounts of incremental capital at very high rates of return. The worst business to own is one that must, or will, do the opposite – that is, consistently employ ever-greater amounts of capital at very low rates of return. Unfortunately, the first type of business is very hard to find."

As such, even when L&T has incrementally employed large amounts of capital in the past, it has been able to earn a reasonable rate of return on this capital (of around 18%), which, despite falling in recent years, is higher than its cost of capital. So, this is a positive observation.

18. Has it got a high and consistent return on capital and return on equity?

High, but falling. L&T's average return on equity has been around 26% over the past 10 years while return on capital employed (that also takes into account the debt employed in the business) has averaged around 18%. On the face of it, these numbers seem comfortable for a business that invests a large amount of capital incrementally. However, what concerns me is that these ratios are falling, almost consistently, for the past 5-6 years. Given their importance, I will continue to keep a close watch on this number. But for now, I am concerned.

C. Management Quality

19. Is the management known for its capital allocation skill and integrity?

Yes to both integrity and capital allocation skill. As far as its operating business is concerned, the company has earned high return on capital over the past 10 years. However, one thing is worth mentioning here. The company has had a history of bad investments in unrelated areas like cement and aluminum refining. This has hurt the company's profitability at times. So you must watch out for this aspect, especially given that the company's mammoth size might occasionally bring in some ego issues within the management and they might once again wander into some unrelated, unprofitable businesses, thus wasting their precious capital.

20. Is management shareholding > 10%?
No. In fact, the company has zero promoter holding. As a group, banks & financial institutions are the largest shareholders in the company with 19.4% holding. Foreign institutional investors (FIIs) hold another 15.9%.

21. Has there been any substantial equity dilution in the past?
No. this is an important aspect to look out for but for L&T, I'm comfortable with the fact that the company has not diluted much of its equity in the past.

22. Are management's salaries too high?
No. The combined salary of L&T's top management was Rs 51 million in the latest completed year (FY11). At just around 0.1% of the company's consolidated net profits, this is low by any standards of measurement of management compensation in India.

23. What has management done with the free cash in the past?
As we've discussed above, L&T has invested a large part of its excess cash in meeting its working capital requirements, or what has been the need of the business.

D. Competition

24. Does the business face high competition?
Yes. Competition for L&T has increased manifold over the past few years, and especially since the arrival of MNC manufacturing firms that offer similar kind of quality products as L&T. Also, L&T is facing high competition not just in terms of business but also in terms of talent. In all my meetings with the company over the past few years, the management has talked about competition for talent as its biggest challenge and one that can mar the company's progress in the future.

25. Has the management focused on mrkt share or profitability in the past?
A mix of both. L&T has been able to earn average operating margins that are higher than industry standards. However, over the past few years, as the competition has risen manifold, the company has been very aggressive in chasing projects, some of which have not contributed well to the its profitability.

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3. Intrinsic Value Assumptions

Before I move into calculating the intrinsic or fair value range for L&T, let me make one thing very clear.

Intrinsic value isn't a definite figure but just a 'calculated' value. In fact, the calculation of intrinsic value of a business mostly throws up a highly subjective figure. And this figure changes as estimates of variable like future cash flows are revised (given that the future is unknown).

Anyways, what I have done here is rather than arrive at a single intrinsic value figure for L&T, I have calculated the value using 4 different methods and then arrived at a 'fair value range' for the stock.

1. Net present value based on a 3-stage 15-year DCF

The discussion about the calculation of net present value using a discounted cash flow model (DCF) can be found in the 7th lesson of my free course on investing – Value Investing for Smart People.

I have done a 3-stage DCF analysis for arriving at the intrinsic value for L&T.

But as a reference, here is the formula for calculating the NPV:

NPV = CFi / (1+k) + CF2 / (1+k)2 + … [TCF / (k - g)] / (1+k)n-1

Where:
PV = present value
CFi = cash flow in year i
k = discount rate
g = growth rate assumption in perpetuity beyond terminal year
TCF = the terminal year cash flow
n = the number of periods in the valuation model including the terminal year

I have calculated L&T's future cash flow for the next 15 years, assuming 3 different rates of growth in cash flows of 15% (years 1-5), 12% (years 6-10), and 8% (years 11-15).

Rs 980

As for the discount rate, I've assumed it at 12% assuming the average cost of capital for the company.

My expected terminal growth rate for the company's cash flows – expected growth in cash flow after 15 years and till eternity – is 2%.

Based on these numbers and after reducing the debt, the present or discounted value of future cash flows for L&T is coming at Rs 980 per share, which is also the stock's intrinsic value using this method.

2. Earnings Power Value (EPV)

After DCF, the second most reliable measure of a firm's intrinsic value is the value of its current earnings. This method is known as 'Earning Power Value' or EPV. This value can be estimated with more certainty than future earnings or cash flows, and it is more relevant to today's values than are earnings in the past.

The formula for EPV of a company is:

Rs 610

EPV = Adjusted Earnings x 1/R

Here, 'R' is the cost of capital.

L&T posted an EPS (earnings per share) of Rs 72.8 in FY11. If L&T's profits were to stagnate and remain at Rs 72.8 per share going forward, and applying the EPV formula here, I multiply Rs 72.8 with 1/12% (12% is the approx. cost of capital for the company). This gives me a value of Rs 610 per share, which is L&T's intrinsic value as per the EPV calculation.

3. Pricing relative to 10 year average P/E ratio

True value investors, as Graham has prescribed, won't pay a price based on the stock's latest P/E or the company's latest earnings. They will take a much longer term view…as long as 10 years.

Here, I have attempted to estimate the intrinsic value of L&T using the company's last 3 years average earnings, and last 10 years average P/E ratio. So the formula is:

Rs 1,630

Last 3 Years Average EPS x Last 10 Years Average P/E Ratio

L&T's average P/E ratio for the past 10 years has been around 24.3 times, while its last 3 years' average EPS has been Rs 70.6 per share. Based on the formula, L&T's intrinsic value is coming to Rs 1,630 per share.

4. Graham number

Graham number is the formula Ben Graham used to calculate the maximum price one should pay for a stock. As per this rule, the product of a stock's price to earnings (P/E) and price to book value (P/BV) should not be more than 22.5 i.e., P/E of 15 multiplied by P/BV of 1.5.

But why did Graham specifically used a P/E of 15 and P/BV of 1.5? Why didn't he use some other numbers?

Well, he thought that nobody should be willing to pay more than the AAA bond yield at that time. AAA bond yield at that time was 7.5%. Therefore, AAA P/E was arrived at 1/7.5 or 13.3, which was rounded up to 15. Similarly he thought that nobody should pay more than 1.5 P/BV for a stock.

Graham insisted that the product of the two shouldn't be more than 22.5. In other words…

(P/E of 15) x (P/BV of 1.5) = 22.5

Put another way:
(P/E) x (P/BV) = 22.5
Price(sqr)/(EPS x BVPS) = 22.5
Price(sqr) = 22.5 x EPS x BVPS

Rs 820

Take the square root of both sides, and you get the equation for the Graham Number.

Fair Value Price = Square Root of (22.5 x EPS x BVPS)

Applying this formula for L&T, the stock's intrinsic value comes to around Rs 820 per share.

Fair Value Range

We have calculated 4 different intrinsic values for L&T using 4 different methods. So much for the 'target prices' you hear on business channels every day as if these were the holiest numbers!

Rs 750 to Rs 1,000

As you can see from the above calculations, the 'target price' isn't such a holy number and can differ based on the method used to calculate it.

Anyways, based on the above calculated intrinsic values for L&T, we can arrive at a 'fair value range' for the stock. Here is how I calculate it:

High End of the Fair Value Range = [Average of above four intrinsic values]
Low End = [(Average of above four intrinsic values) – (0.5) x (Std Dev)]

Based on this, the fair value range for L&T's stock is Rs 750 to Rs 1,000.

Assuming a margin of safety of around 20%, I would be comfortable buying L&T's stock only at around Rs 800 or lower. This is around 25% lower than the stock's current price.

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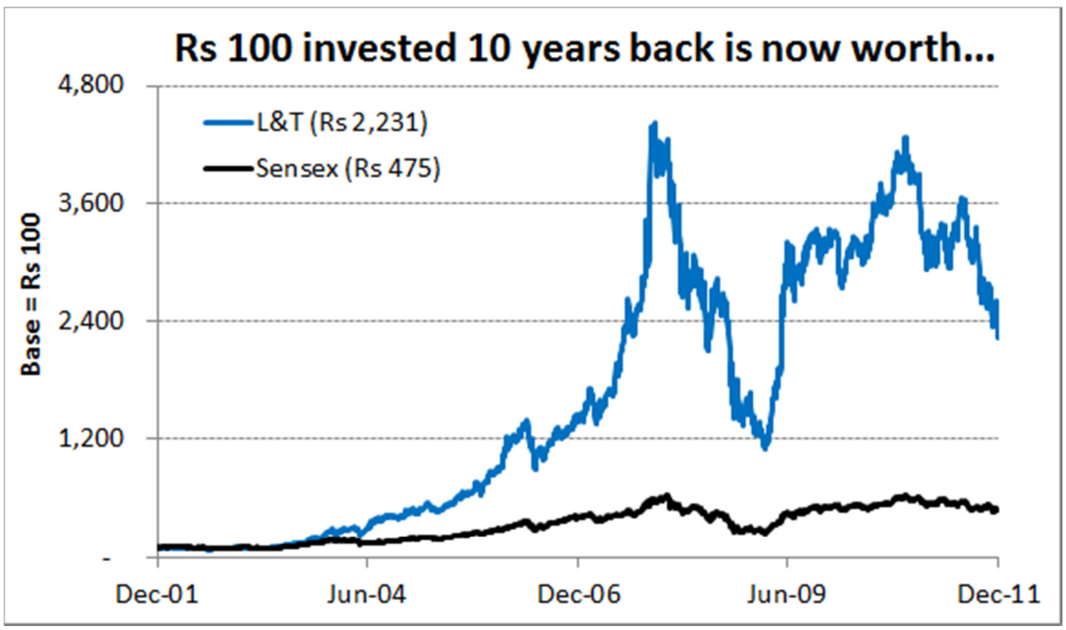
4. Financial & Market Snapshot

10-Year Financial Performance											
Description	**Unit**	**FY02**	**FY03**	**FY04**	**FY05**	**FY06**	**FY07**	**FY08**	**FY09**	**FY10**	**FY11**
Net Sales	Rs m	87,160	103,187	109,471	144,969	165,613	203,360	291,985	401,870	435,136	515,520
Operating profit/EBIDTA	Rs m	12,081	10,701	9,079	11,761	15,848	24,378	34,471	46,658	59,825	71,539
EBIDTA margin	%	13.9%	10.4%	8.3%	8.1%	9.6%	12.0%	11.8%	11.6%	13.7%	13.9%
Net profit (after tax)	Rs m	4,132	4,791	7,468	10,464	13,176	22,401	23,254	37,744	54,507	44,562
Net profit margin	%	4.7%	4.6%	6.8%	7.2%	8.0%	11.0%	8.0%	9.4%	12.5%	8.6%
Adjusted EPS	Rs	6.8	7.8	12.2	17.1	21.5	36.6	38.0	61.7	89.1	72.8
Equity	Rs m	31,376	32,166	26,473	33,160	49,645	69,216	108,311	139,877	209,913	250,506
Debt	Rs m	49,781	47,009	27,692	34,538	34,987	64,322	123,160	203,700	226,561	328,285
Debt/Equity	Times	1.6	1.5	1.0	1.0	0.7	0.9	1.1	1.5	1.1	1.3
Return on equity	%	11.6%	15.1%	25.5%	35.1%	31.8%	37.7%	26.2%	30.4%	31.2%	19.4%
Return on capital employed	%	11.3%	10.6%	15.9%	24.7%	23.6%	24.5%	19.7%	16.9%	15.9%	12.6%
Average P/E ratio	Times	-	15.1	25.8	15.6	22.5	29.9	38.9	26.3	23.4	20.9



Latest Stock Summary	
Latest Price (Rs)	1,076
52 Week High/Low (Rs)	2010 / 1063
Face Value (Rs)	10
Market Cap. (Rs m)	658,222
Number of shares (m)	612
Latest P/E (TTM, x)	16.2
Latest P/BV (x)	2.6

Shareholding Pattern (Dec-11)	
Category	**% Stake**
Promoter	NIL
Mutual Funds	11.8
Banks & Fin. Inst.	19.4
FIIs	15.9
Individuals	23.4
Others	29.5

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5. Summary

There is no denying the fact that L&T has done wonders to India's infrastructure in the past and continues to contribute to nation building through its manufacturing and construction services. The company continues to chug along on the growth path, aided by a huge order backlog and its vast execution capabilities.

However, I've come to fear the increasing size of the company which seems like a positive to others but a negative to me. Why negative? Simply because, as the company has shown in the past, 'getting big' has sometimes brought in the ego element and has given it the license to do things that have destroyed shareholder value. This can be seen in the company's profitability numbers, which while being better than its peers, have been volatile. Even the company's return on equity has moved on an unpredictable path.

Getting bigger by growing sales, profits, and order book is one thing, but what counts the most for shareholders is that the company gets more profitable each year and earns higher return on its capital, which hasn't been the case with L&T.

Also, at the cost of growing big in size, the company has sort of sacrificed strengthening its core – its competitive advantages – that is so important for business sustainability.

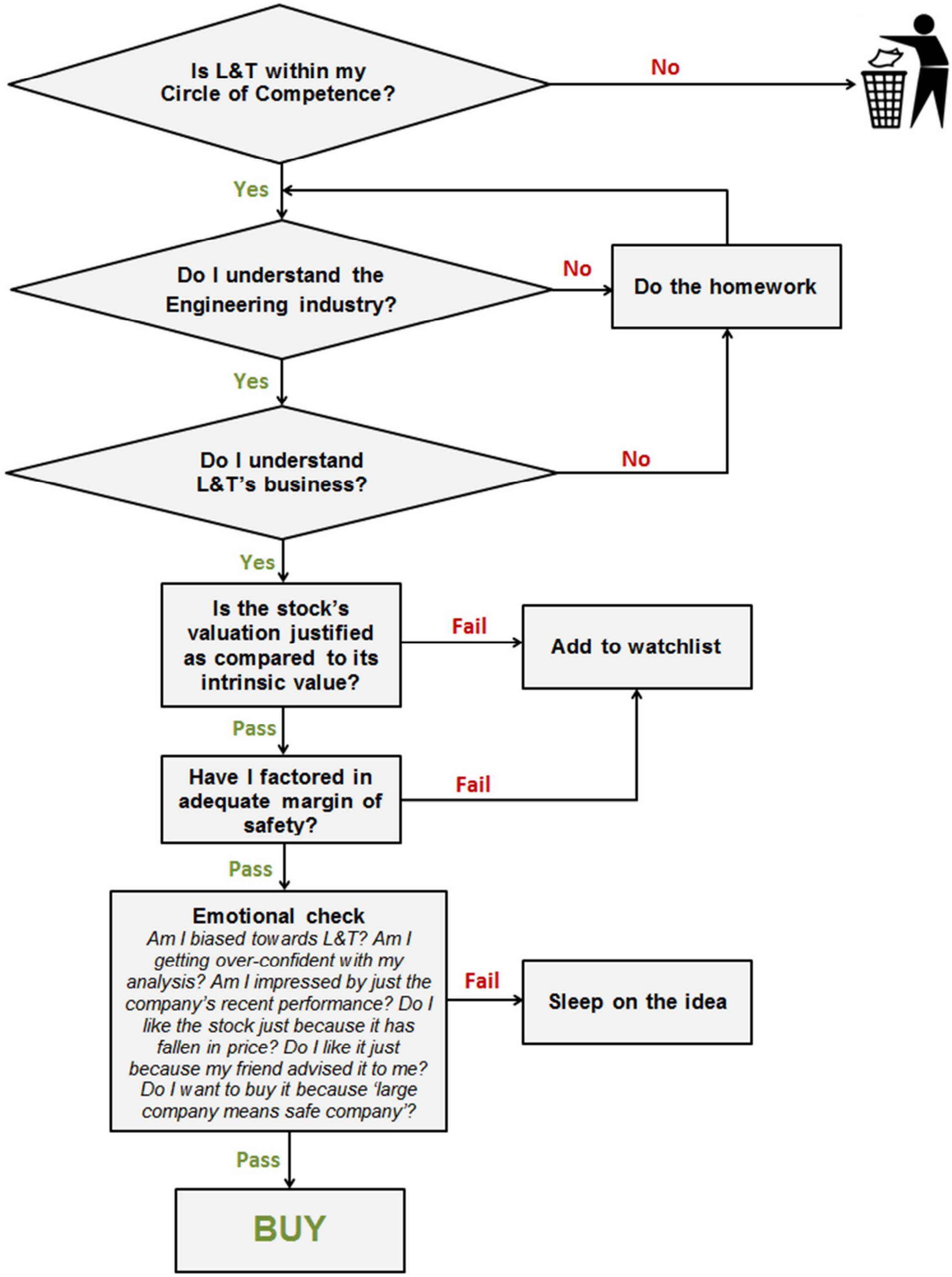
So overall, I see the risks for L&T's business on a rise going forward. Plus, based on my intrinsic value calculations above, the stock's current valuations do not provide much comfort.

As an investor, the first aspect I must worry about is to have downside protection. L&T's current valuations do not provide me that protection. Of course, if I were to bet on India's infrastructure, I can't do without an L&T.

However, it's the price that I must get right. And when will I get L&T at the right price? Well, I wish I knew the answer.

But whenever I want to go back to L&T and check whether I must buy it or not, I will work through the following checklist.

6. "Should I Buy L&T?" Checklist



Your Feedback is Important!

So that was my take on L&T as part of the *Safal Niveshak StockTalk* initiative.

I've tried to be as comprehensive in my analysis, while trying to keep the report very simple.

Let me know what you think of this report, and of the analysis.

Do you think I've missed mentioning something specific here?

Can the Safal Niveshak 25-Point Checklist be modified or expanded any further?

Do you find this report simple enough for your understanding?

Your answers would help me in making the *Safal Niveshak StockTalk* report, and the entire initiative, more beneficial for you.

So just let me know your feedback on this report.

Also, if you want to see your choice of stock covered here, just send me your request using the request form.

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With respect,
Vishal Khandelwal
Editor, Safal Niveshak StockTalk

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