kotak Institutional Equities

Capital Goods

India

ATTRACTIVE

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UPDATE

BSE-30: 60,546

EPC business nearing the long-pending makeover. The recent guidelines for government procurement contracts coupled with the Gati Shakti program would help align (1) the interest of the government of maximizing return on investments with that of (2) EPC contractors efficiently deploying capital. We are more enthused of positive medium-term ramifications for EPC majors (volumes, pace of execution, working capital) than the near-term transient benefits (share gains). L&T (BUY, FV: Rs2,400) is the best play within our coverage.

Recently released guidelines on procurement and project management a game changer

We list below the key guidelines issued by the Ministry of Finance on October 29, 2021 (refer).

Shift away from L1 biding. Quality Oriented Procurement projects (read non-standard works) are proposed to have a maximum of 30% weightage to non-financial scores.

Empanelment of contractors and timely review. Performance of such empaneled contractors would get reviewed periodically for upgrades/downgrades/de-listing.

Single-bids not to be cancelled by default. Such process would be considered valid if certain conditions are fulfilled (sufficient time given for bids, reasonable pricing, etc.).

Timely approval of time extensions for projects. Such time extensions can be granted by the next higher authority and not necessarily by awarding entity.

Prompt payments after bill raise. Payment for a minimum 75% of the bill raised by EPC contractors is proposed to be made within 10 days of raising of bill. Deviations would require written explanation to the next higher authority within three working days.

Move away from arbitration and appeals. The guidelines share impetus on obviating arbitration and appealing against arbitration awards by procuring entity.

Government aligning interests with EPC contractors as it prioritizes timely execution

We note impetus from THE government to improve project planning (Gati Shakti) and project execution (above guidelines). The intent is to reduce the 40% excess investments made in government projects in THE form of cost overruns and time overruns. Such overruns pose a meaningful deterrent to growing volumes in the infrastructure sector on two key counts – (1) it saps more than required capital from the central government and (2) it limits prospects of the private sector participating in investments.

EPC majors to see medium-term positives beyond impending, transient share/pricing boosts

The government impetus on reducing cost and time overruns also has positive ramifications for EPC contractors in (1) higher EPC volumes, (2) higher pace of execution and (3) improved working capital terms. The benefits can be meaningful as reflected in the divergence between domestic and global EPC players in terms of pace of execution and working capital. Such medium-term benefits are bigger and more sustainable than the impending and transient benefits for EPC majors such as L&T (share gains, improved pricing).

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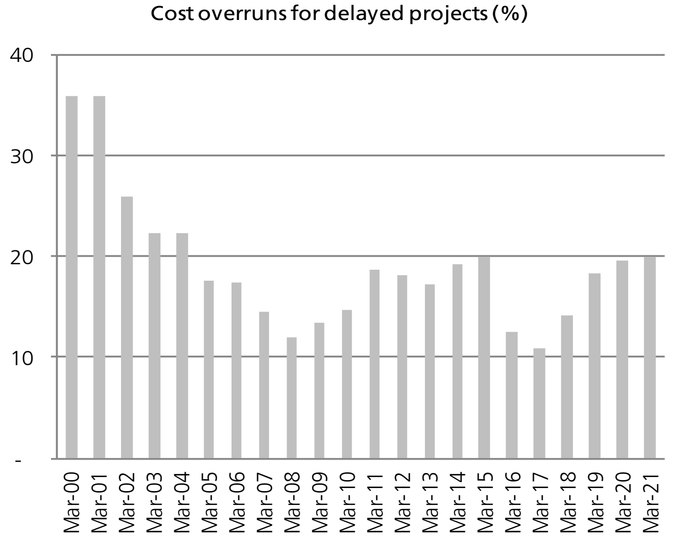
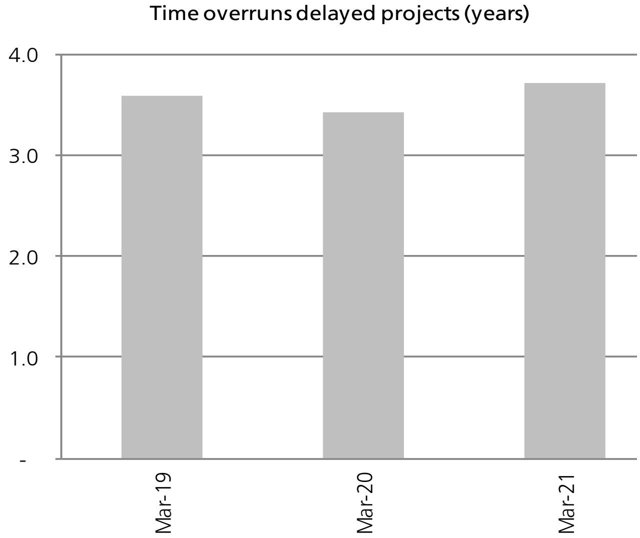
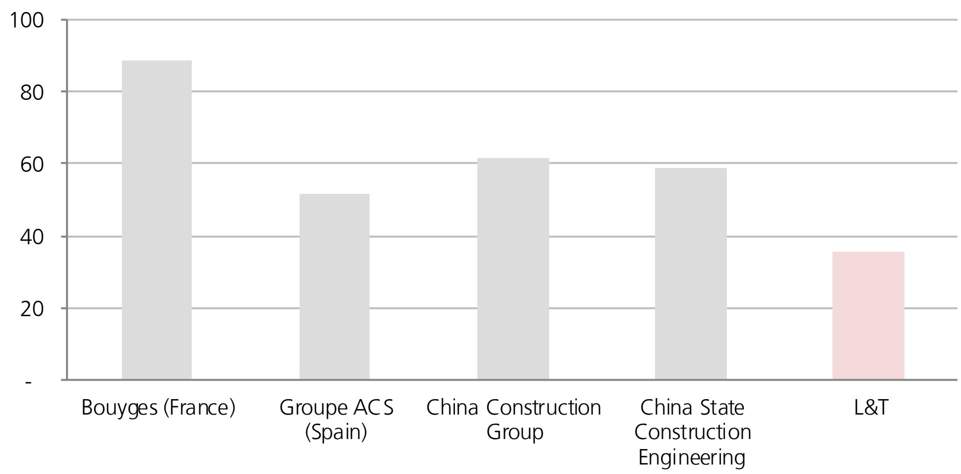
Exhibit 1: Cost overruns and time overruns have increased net investments of government by 40%
Cost and time overruns for delayed projects of the central government (%)





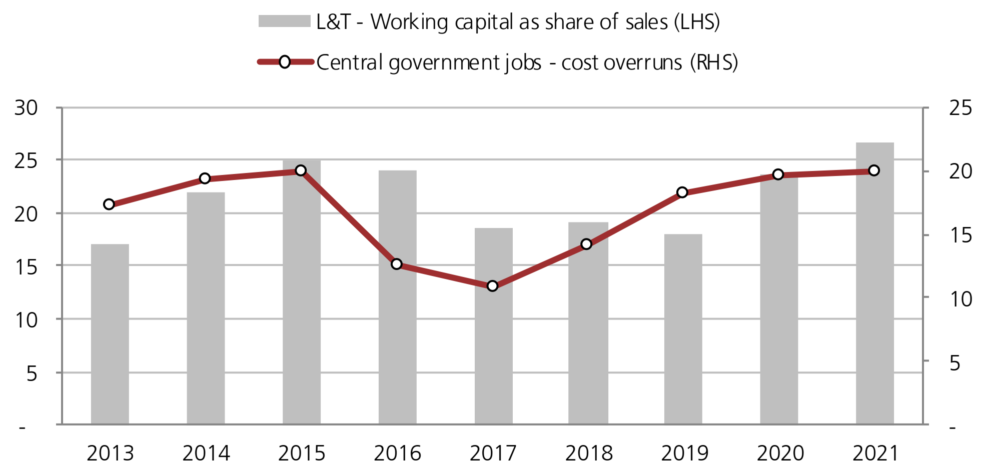
Source: Ministry of Statistics and Program Implementation (MOSPI), Kotak Institutional Equities

Exhibit 2: L&T has much lower pace of execution versus key global peers
Average bill to book ratio for global EPC companies averaged over the past five years (%)



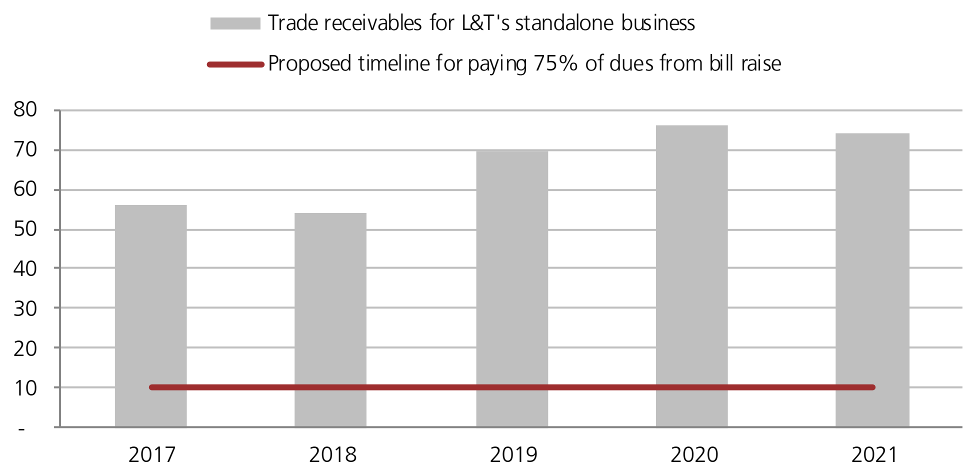
Source: Companies, Kotak Institutional Equities

Exhibit 3: L&T's working capital has healthy correlation with cost overruns for government jobs
Comparison of L&T's working capital and cost overruns for government jobs, March fiscal year-ends, 2013-21 (%)



Source: Company, MOSPI, Kotak Institutional Equities

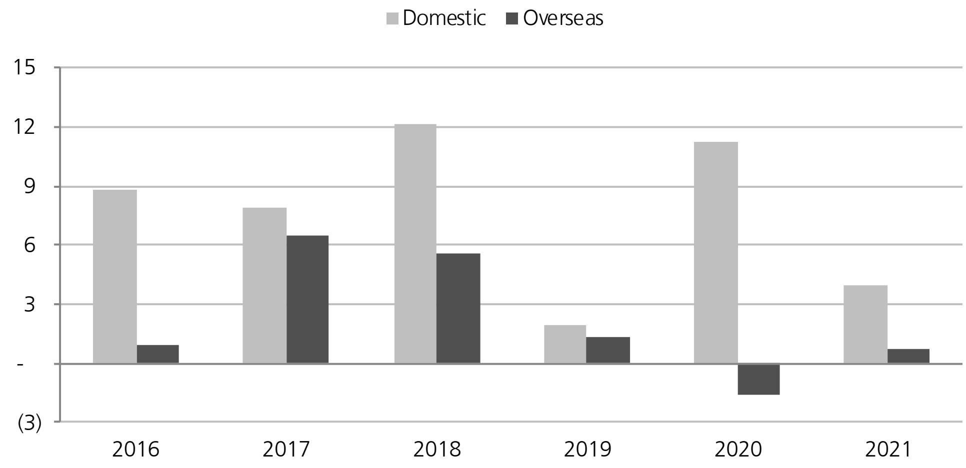
Exhibit 4: Proposed guidelines can make a meaningful reduction in the ~70 days of current working capital of L&T
Comparison of trade receivables for L&T (standalone) versus proposed guidelines, March fiscal year-ends, 2017-21 (#, days of sales)



Source: Company, Ministry of Finance, Kotak Institutional Equities

Exhibit 5: L&T has a much better track record in international versus domestic in terms of order cancellations

Comparison of order cancellations as share of order backlog for L&T, March fiscal year-ends, 2016-21 (%)



Source: Company, Kotak Institutional Equities

Kotak Institutional Equities Research coverage universe

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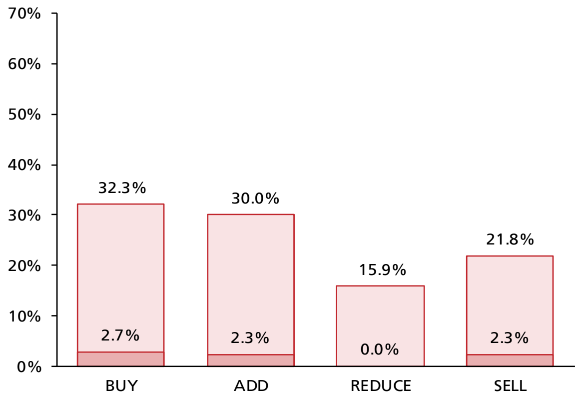

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Source: Kotak Institutional Equities

As of September 30, 2021

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ADD. We expect this stock to deliver 5-15% returns over the next 12 months.

REDUCE. We expect this stock to deliver -5-+5% returns over the next 12 months.

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