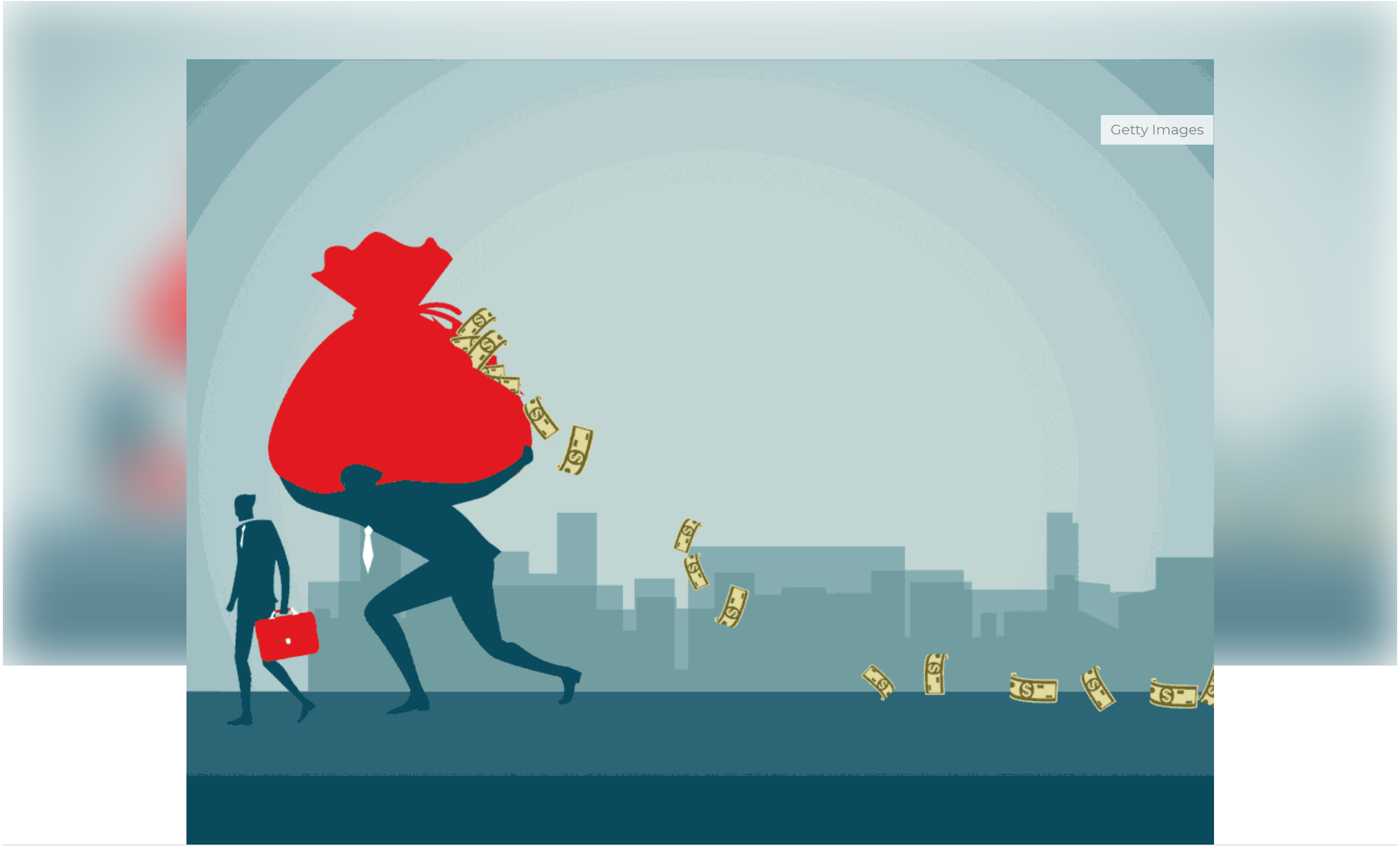
ECONOMY

L&T's asset-light vs. Adani's capital-intensive model: which infra major will balance a wobbly GDP?



Concept by Priyanka Salve; Kankana Roy Choudhury

Synopsis

L&T is on a path to become an asset-light business, while Adani Ports prefers expansion and acquisition. Both infra giants have outperformed the benchmark in the last six months. However, the market has preferred an asset-heavy company like Adani over L&T. With the GDP numbers looking shaky post-pandemic, which company's model do the odds favour?

On May 16, 2014, **infrastructure** behemoth Larsen & Toubro's (**L&T**) subsidiary, Infrastructure Development Project Ltd (IDPL), and steel major Tata Steel signed a pact to sell a 100% stake in Dhamra Port in Odisha for INR5,500 crore to a Gujarat-based ports company—Adani Ports and Special Economic Zone.

L&T's market cap in March 2014 was INR1.1 lakh crore while that of **Adani Ports** was just around INR38,800 crore.

The day the deal was inked was also the day the Narendra Modi government got elected with a strong mandate. There was euphoria in markets, especially for elected with a strong mandate. There was euphoria in markets, especially for infrastructure companies, in hopes that the new government would remove bottlenecks in projects, provide steady investments, and strong economic growth.

After all, construction companies rely on investments — both from private and public sectors – while port operators and other asset owners depend on the rise in economic activity vis-à-vis economic growth to get higher traffic flow. These companies deploy large capital upfront and recover the invested amount and profits over a long stretch of time.

Having experienced the risks from the frailty of India's economic growth in the years prior to the deal, L&T wanted to exit its asset-owning businesses and increase its focus on its core strength — engineering and construction. Adani Ports, on the other hand, was eager to become a pan-India port asset owner and operator.

But seven years since, with a pandemic unraveling for over a year, the economic shock is a commonplace across the globe. For FY21, India's **economy** contracted 7.3%, a record low since Independence. So far for FY22, rating agencies and brokerage houses have been trimming estimates from low double digits to high single digits in quick succession.

Surprisingly, both L&T and Adani Ports have outperformed benchmark indices over a period of six months. However, the market has preferred an asset-heavy or capital-intensive company over an asset-light infrastructure business. In spite of the sharp correction a week ago, Adani Ports gave 56% returns over the last six months, against L&T's 20% and Nifty 50's 18%. Citibank in its report last week assigned a 'buy' rating to Adani Ports with a target price of INR1,000, which indicates an upside of little less than INR300 from Wednesday's closing price.

L&T has given total returns of 66% to its shareholders over the last five years, and Adani Ports over 250%. On a 52-weeks basis, L&T gave a total return of 59%, against Adani Ports' 109%.

Defying the lessons learnt by businesses and investors post the meltdown of the last infrastructure cycle, why has the market in the last few years preferred a private-sector capital-intensive asset owner over an asset-light construction business? And more importantly, with the GDP numbers looking shaky post pandemic, which company's model do the odds favour?

Successful acquisitions

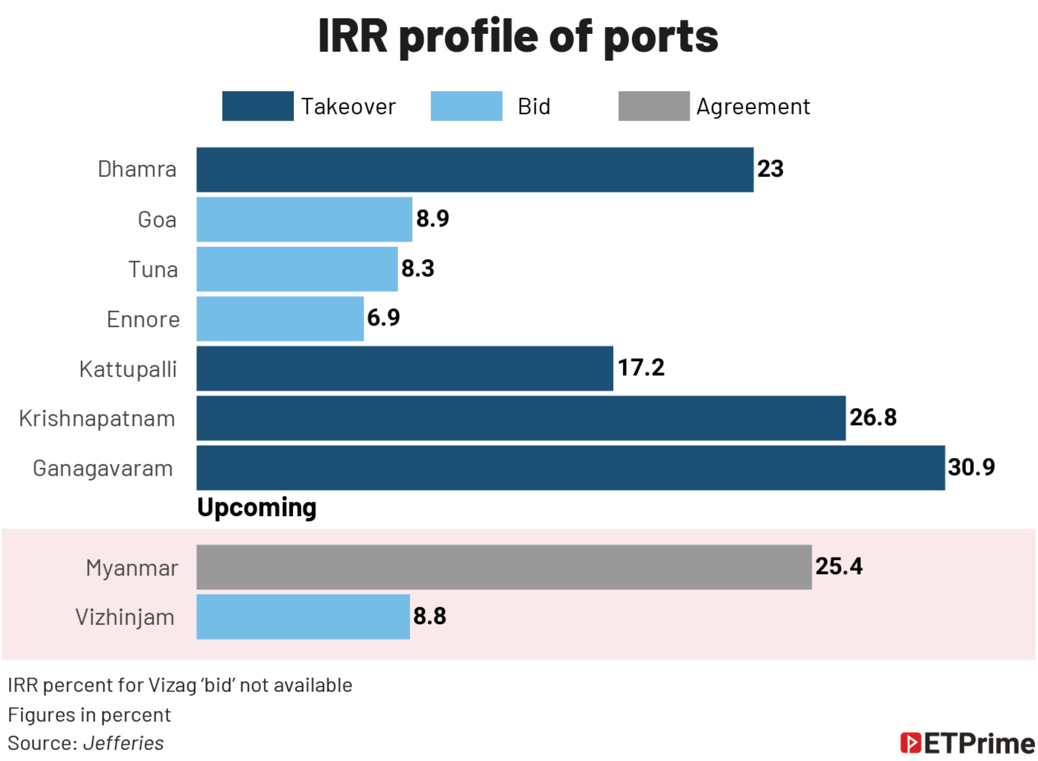
"The Dhamra Port acquisition now gives us an opportunity to replicate the development and phenomenal growth of the Mundra port on the eastern coast of India and thereby continue to execute on our pan-India strategy," Gautam Adani, chairman, Adani Group, had said in a release back in May 2014. The same release added that the continued expansion will allow Dhamra Port to exceed 100 million metric tonne of **cargo** capacity by 2020, and allow Adani Ports to fulfil its stated vision of becoming a 200 million metric tonne ports business well before 2020.

The year 2020 has gone by, and according to the most recent investor presentation, Dhamra Port has a total capacity of 45 million metric tonne. As for Adani Ports, its total capacity is almost close to 500 million metric tonne, more than double its target.

The rise of Adani Ports has been rapid, so has its expansion, which has made it the

largest commercial port operator in India — accounting for 25% of the country's sea-borne cargo in FY21. Adani Ports, which had listed in 2008 as Mundra Ports & Special Economic Zone, was a single-port operator in FY09. But its increasing appetite for assets led to the business being rechristened as Adani Ports and SEZ in 2012. By FY19, it had 10 ports, and two more are under construction as of FY21. Including the acquisition of other logistic assets and ports, Adani acquired a total of 19 various assets between 2013 and 2020, according to data from Refinitiv.

And it seems the company has made better returns from the acquisitions.



But all these acquisitions have come at a price, and debt. The company has a net debt of INR27,413 crore, of which foreign-currency debt is 70%, while 30% is rupee-denominated debt enabling lower interest cost (current cost of 6.5%). But as a natural hedge, 60% of its Ebitda is in dollar terms.

A dominant market share

Adani Ports' biggest strength comes from its dominance in the port sector. True, the government controls 12 major ports, but all these ports are run by different port authorities and, hence, cannot offer the same end-to-end service levels which Adani Ports offers. Around 56% of the traffic to Adani Ports is sticky cargo, though it is down from 64% earlier.

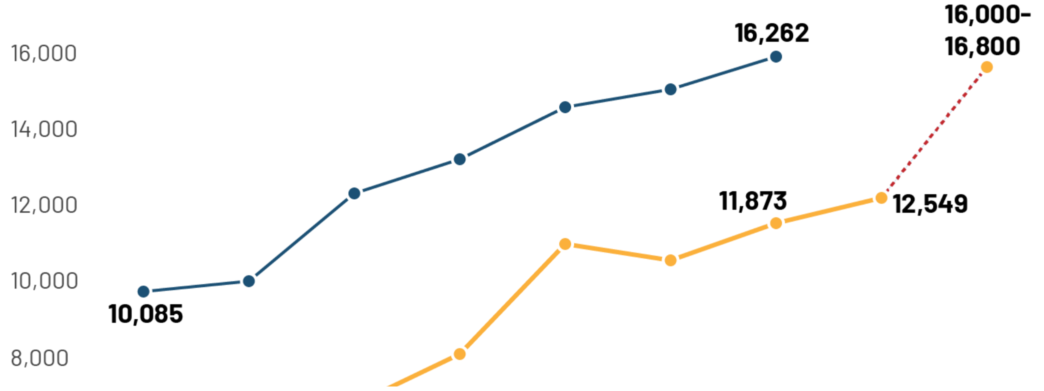
Adani Ports is close to matching the annual revenue of 12 major ports, without reaching similar cargo-handling volumes. "APSEZ throughput growth has consistently outperformed the wider industries in India. Cargo throughput for APSEZ rose by nearly 2%, or 11% if including the KPCL acquisition, in FY21, versus the 5% decline for all ports in India," Fitch Ratings said in a credit report last week.

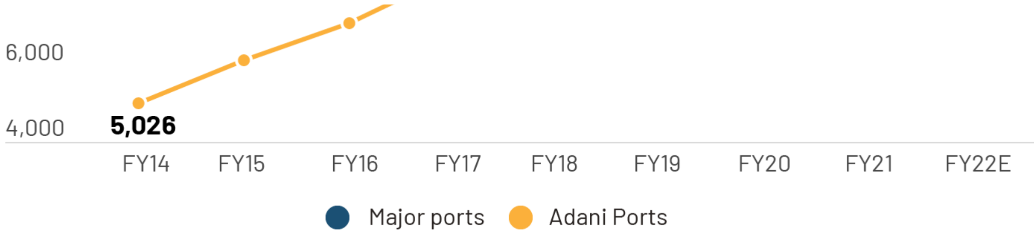
Adani Ports vs. major ports

Cargo handling in India

	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21
Major ports (a)	555.49	581.34	605.89	648.47	679.47	699.17	704.93	673
Non-major ports (b)	416.97	470.89	465.87	485.22	529.09	582.61	615.05	575
Adani Ports*	**113**	**144**	**152**	**169**	**180**	**208**	**223**	**247**
Total (a+b)	**972.46**	**1052.23**	**1071.76**	**1133.69**	**1208.56**	**1281.78**	**1319.98**	**1248**

Revenues





Figures in INR crore
Revenue for 12 major ports for FY21 is not available
E - Estimate
Source: *Ministry of Ports, Shipping, Waterways; Company*

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Cargo movement across major Asian countries

Cargo handled (million metric tonne)
Source: *CARE Ratings*

ETPrime

Another area for growth is container traffic. The rate of growth in container handling is higher and this is where Adani Ports has an upper hand over the major ports in the country. The company's container market share is around 40%. Even major ports have given most of container-handling capacity to third-party players for management, says Vidhyasagar L, director at CARE Ratings.

A further step towards the consolidation of the company's position is Adani Ports' reported bid to acquire a 30% stake in Container Corporation of India. According to a report by **Moneycontrol** in March, Adani Group is among the seven interested bidders. The acquisition of stake and management control of Container Corporation of India would help Adani offer another layer of services to its customers, enhancing the stickiness.

"Cargo is growing at 10% while growth in containers is expected to grow at

15%-20% going ahead," says Vidhyasagar.

Usually, for asset-owning, capital-intensive companies like Adani, a lower-than-expected GDP growth and subsequent slowdown in economic activity make projects unviable, as traffic wanes and the ability to service debt diminishes. But Adani Ports is not just relying on future growth, it is also acquiring customers from 12 major ports. Over the past seven years, the cargo-handling volumes for major ports grew at a CAGR of 3%, the total volume of cargo grew by 4%, while the volume of cargo handled by Adani grew 12%.

In the short term, credit-rating agency Fitch Ratings, which has a negative outlook on Adani Ports, says the company has enough liquidity to "weather near-term challenges".

Can the asset-light win the race?

While Adani Ports started pursuing the goal of becoming a successful asset owner by 2014, L&T around the same time made up its mind to become an asset-light engineering and construction-focused company. In fact, just a month after the sale of the port to Adani, L&T announced that Canadian Pension Plan Investment Board (CPPIB) would invest INR2,000 crore for a minority stake in L&T IDPL. The entity in 2014 developed and owned 23 assets worth INR45,000 crore. Over the next six years, L&T continued with its plan to de-leverage the business.

"Our idea is to minimise or reduce the capital employed. IDPL is going through major restructuring towards that end...The central point is wherever there is a high capital-intensity business, either sell it, if it is not core and not important, or bring a partner, preferably financial, or at least minimise the likely impact on returns to the extent possible operationally and through cost reduction. So in short, we are going towards the direction of making the balance sheet as asset-light as possible," L&T group chairman AM Naik had said in an investor call in May 2016.

In 2018, L&T also sold 97% stake it owned in Marine Infrastructure Developer, which owns Kattupalli Port, to Adani Ports. According to a report by **VCCircle,** the asset was sold at an enterprise value of INR1,950 crore of which Adani was to pay

INR388 crore to acquire the shares. The rest was used towards paying off the project debt.

Since 2014, L&T has successfully managed to divest assets that it considered a non-core business. It has also managed to win bids for many crucial and complex projects — from sea links, bullet trains to metros. But despite the successful transition towards the asset-light model, L&T is yet to outperform Adani Ports on many key metrics.

L&T vs. Adani Ports

	Revenue 7 years (CAGR %)	Ebitda 5 years CAGR (%)	52-week total return (%)	RoC (FY21)	RoE 7-year avg (%)	Net debt-to-Ebitda (x)	Debt/ equity (x)

Larsen & Toubro	7	8	59	7.3	11.9	0.96*	0.4*
Adani Ports and SEZ	15	11.7	109	8.6	20.5	3.15	1.1

* Standalone
Source: *Refinitiv*

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However, just like Adani Ports has its dominant position in the ports business, L&T is a giant in the engineering space and has an order book of INR3.27 lakh crore. Of these, 79% were domestic orders and 21% international, as of March 2021. More importantly, around INR1 lakh crore worth of orders are funded by multilateral agencies. The chances of funding delays or investment cutbacks affecting a project funded by multilateral agencies are much less as the investment does not rely on the local economy.

"Cargo is growing at 10% while growth in containers is expected to grow at 15%-20% going ahead."

— Vidhyasagar L, director, CARE Ratings.

On the domestic front, public-sector corporations account for 44% share of orders for L&T, followed by state governments which account for 31%, and 16% of orders are from the private sector.

In the last three years, L&T's Ebitda growth rate has marginally improved against that of Adani Ports. Compared to the asset owner, L&T on a standalone level has a debt-to-equity ratio of 0.5x and net debt-to-Ebitda of just 1x. Compare this with Adani Ports, which has a debt-to-equity ratio of over 1.1x, which has come down from 1.5x in 2014. But while long-term project debt is being taken off L&T's books, the company's working capital on a standalone basis is still an issue.

One of the execution risks faced by L&T is the price rise in raw materials, especially steel, which makes for 72% of its raw materials. According to Nomura Research, this could have a slight negative impact on its FY22 Ebitda. Yet, the brokerage is very confident about L&T meeting its FY22 revenue guidance of 18% growth.

But the biggest factor in L&T's favour is the central government's commitment to the national infrastructure pipeline.

The bottom line

In February 2021, the government had reiterated its plan to make India a USD5 trillion economy by 2025, one key element of this plan was infrastructure investment. According to the latest numbers, in FY21, the Indian economy contracted by 7.7%. Even if this delays the USD5 trillion goal, whatever remedy the government comes up with is unlikely to leave behind the infrastructure sector. With its higher efficiency and logistical connection, Adani Ports has captured 25% of the port traffic in India, establishing a balanced exposure to both east-coast and west-coast ports.

L&T, on the other hand, despite lower return ratios, has its massive INR3.3 lakh crore order book and a balance sheet which is acquiring strength. L&T's expertise in complex engineering and construction projects is irrefutable, much like the near monopoly Adani Ports has acquired in commercial private-sector port operations in India.

So even though both the companies have a radically different approach, they may be the investor's safest infrastructure bets while India continues to be on the wobbly path of post-pandemic economic recovery.

(*Graphics by Sadhana Saxena*)