ViewCube

April 2023

The march of capital goods

CRISIL Ratings webinar on the capital goods sector

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CRISIL Ratings ViewCube on the capital goods sector

ViewCube is a compilation of sector views expressed during CRISIL Ratings' webinars. These include CRISIL Ratings' own views, those of stakeholders, and those emanating from a poll done during the webinar.

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Key messages

Indian capital goods sector* revenue seen up 10-12% this fiscal, compared with 14-16% in fiscal 2023

- The sector has seen a strong order book, steady inflow of fresh orders, and improved execution in the past two fiscals
- Impetus from higher commodity prices, as well as rising government and private-sector spend, will drive growth
- The sector had been stagnant in the past decade, before growing by a strong 19% in fiscal 2022

Operating margin to improve 50-75 basis points (bps) to 10.5-11% this fiscal and remain steady next fiscal

- Improved execution, better coverage of overheads, and moderating raw material prices provide support

Credit risk profiles of capital goods players to remain stable

- Healthy cash generation given better operating leverage, will support higher capex and working capital needs
- Modest debt addition to enable debt metrics to sustain at comfortable levels for the portfolio rated by CRISIL Ratings

**Includes original equipment manufacturers (OEMs) and engineering, procurement and construction (EPC) companies, excluding road and civil construction companies)*

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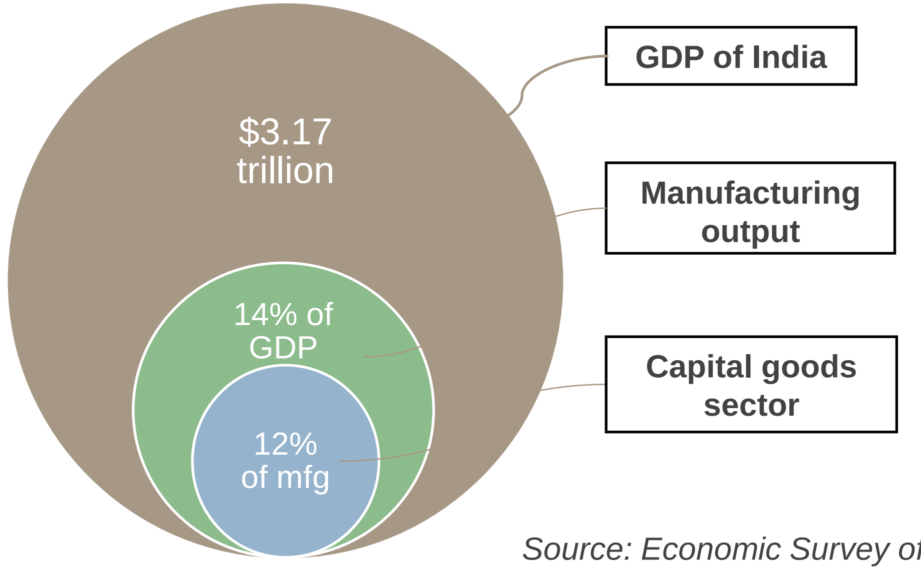
Overview

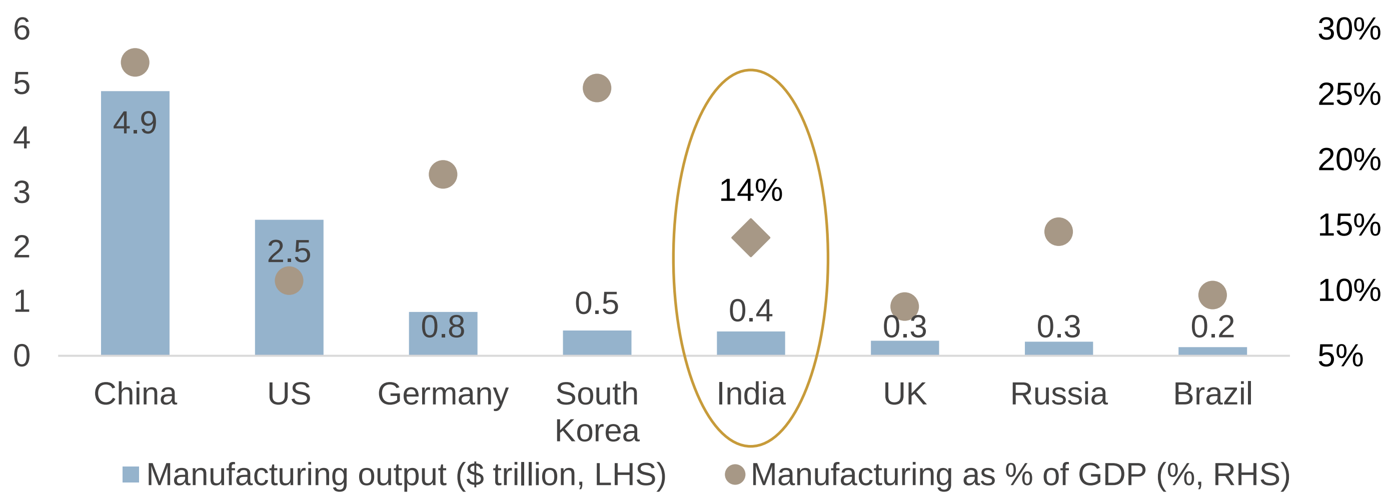
Indian capital goods production value estimated at Rs 3.25 lakh crore or ~1.3% of India's GDP in fiscal 2023



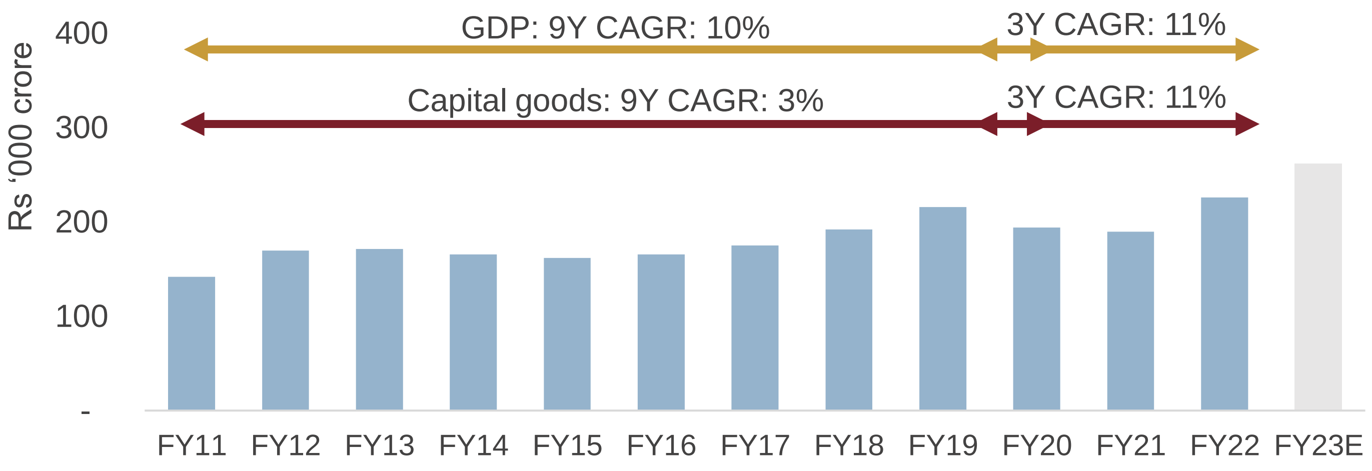
- Capital goods sector formed ~12% of manufacturing output in fiscal 2023
- India's manufacturing output at 14% of its GDP, is still a laggard
- Strong pick-up in growth in the capital goods sector from fiscal 2022 after being stagnant through fiscal 2021, despite a healthy GDP run-rate
- Strong policy support from the government and increase in private capex to drive growth over the medium term

Source: Economic Survey of India, 2023

India's manufacturing output lags global counterparts'; strong growth from fiscal 2022 onwards post a decadal lull



Source: World Bank



Source: CRISIL Ratings, Index of Industrial Production, Economic Survey of India, 2023

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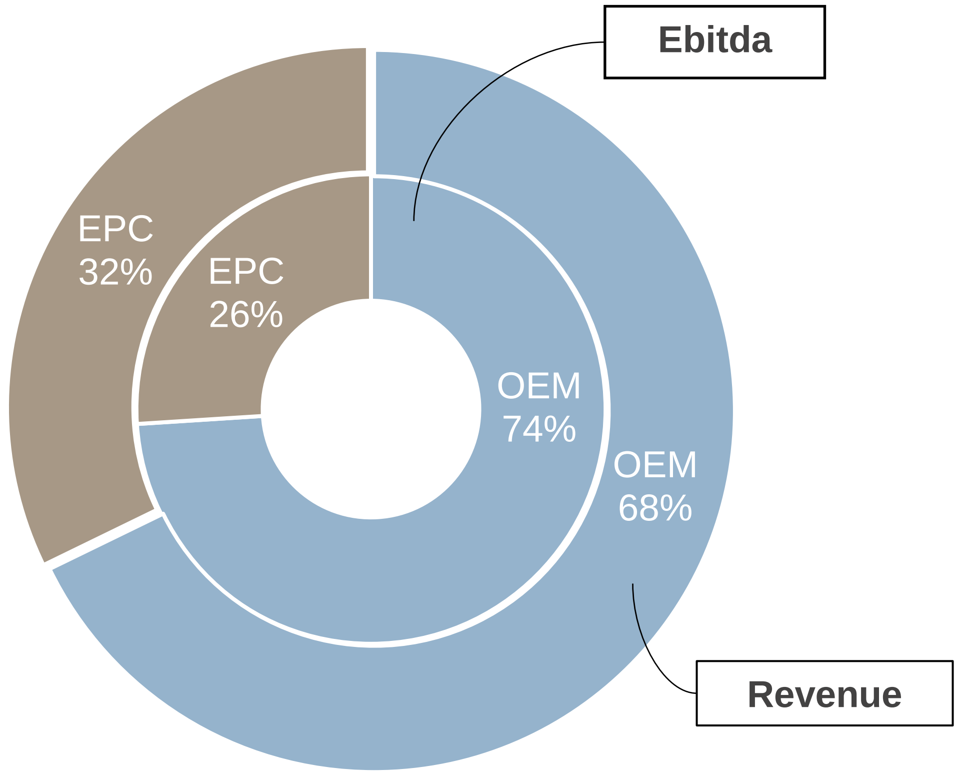
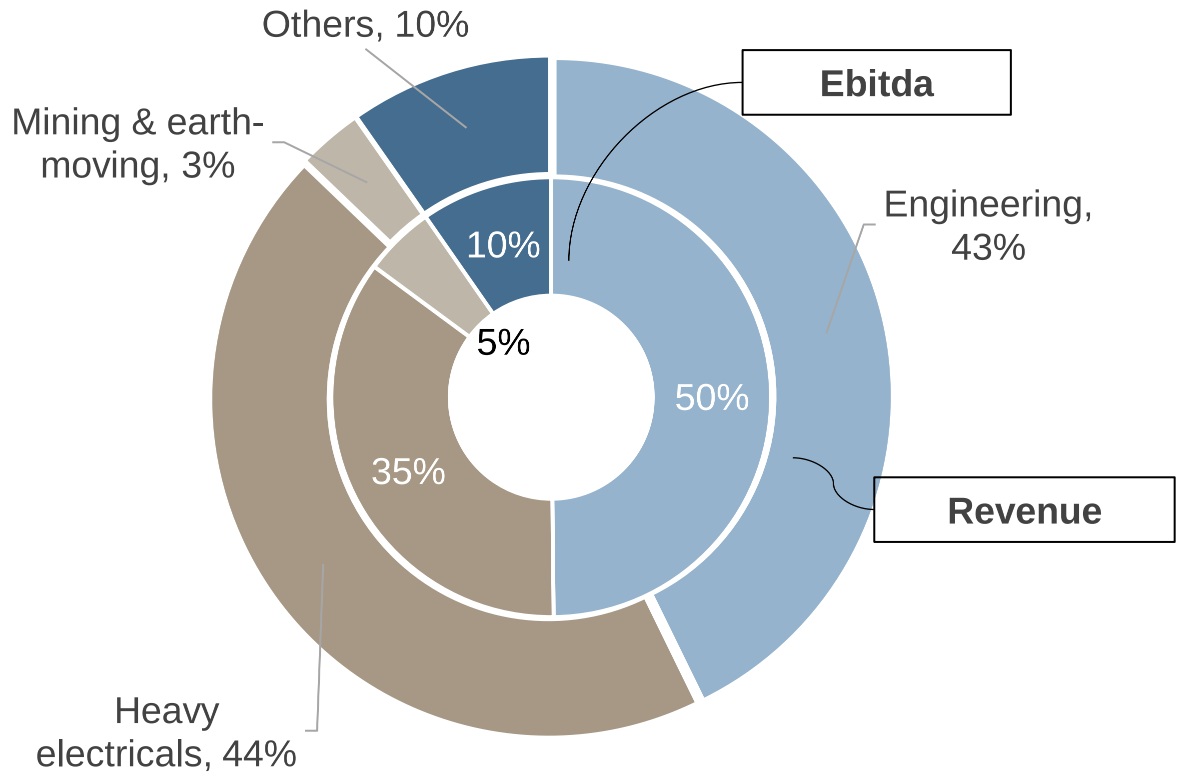
Sector dominated by OEMs delivering engineering & heavy electricals

By category, OEMs to contribute majority of revenue and profits in FY23(E)



By segment, engineering & heavy electricals to form majority of revenue and profits in FY23(E)



- By category, profitability of OEMs is better than that of EPC companies, given their market position, ability to pass on price increases, and shorter delivery times
- Segment-wise, engineering has better profitability than other segments owing to higher technological complexity of products and services

Source: Analysis of 75 companies (rated and non-rated) representing 54% of India's capital goods sector

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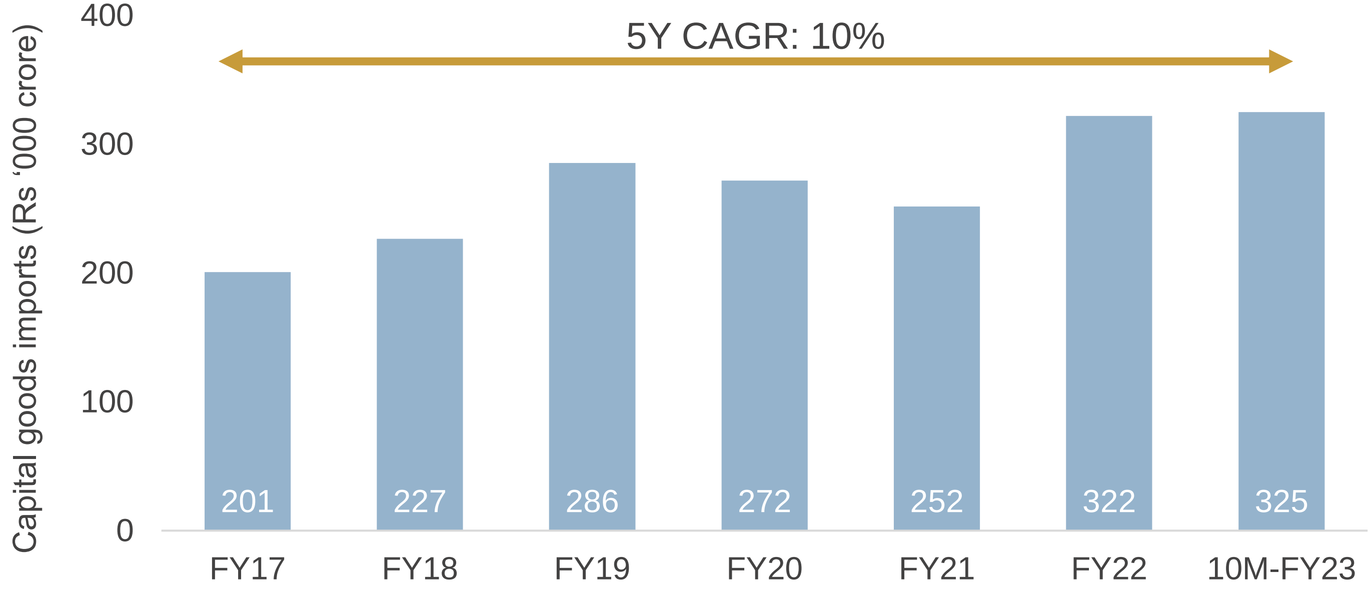
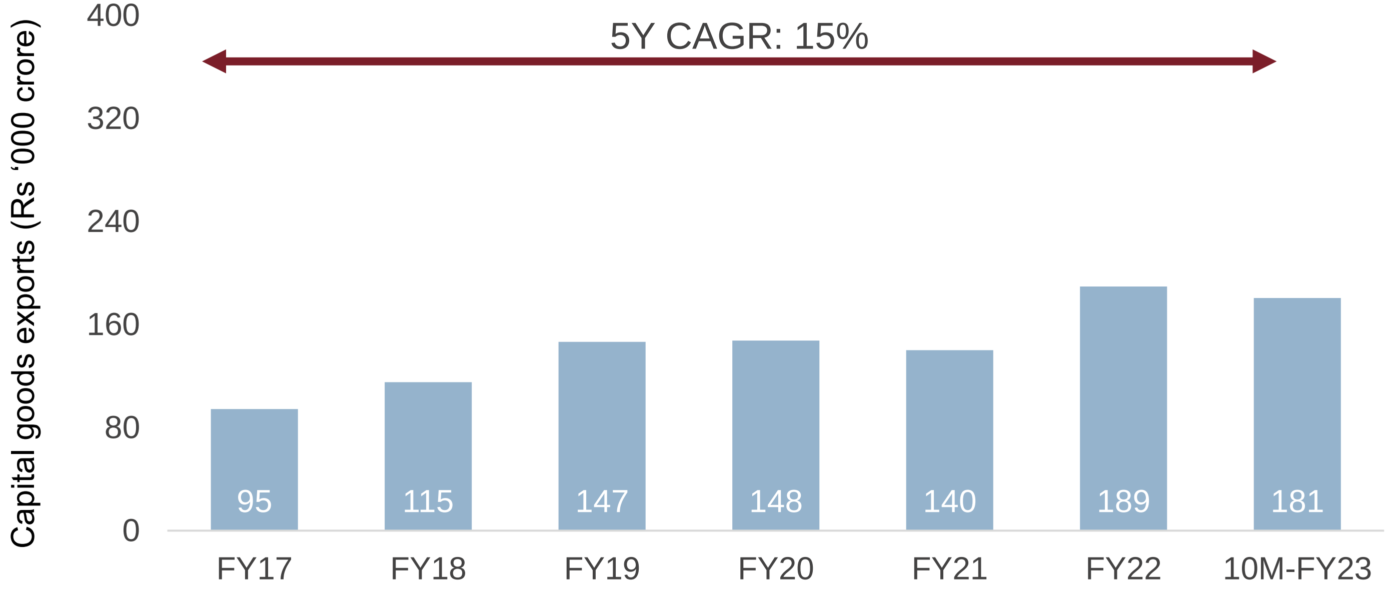
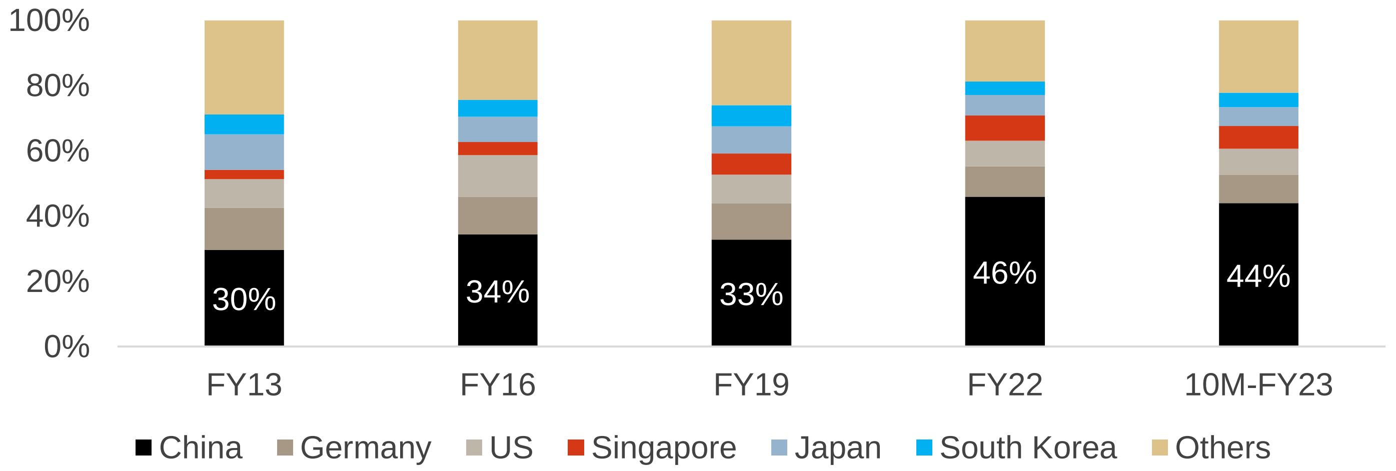
Capital goods sector continues to see high import dependence

Imports continue to meet a larger share of the growing domestic demand; exports picking up from fiscal 2022





China accounts for over 40% of India's imports



- A significant portion of capital goods demand in India is met through imports, primarily from China, Germany and the US
- Key imported products include high-technology equipment such as ADPs*, turbojets, pumps and compressors
- Exports lag imports in quantum but have been improving, especially since fiscal 2022. This growth has been driven by turbojets, engine and pump parts, gears, etc.

Source: Ministry of Commerce and Industry

**Automated data processing units*

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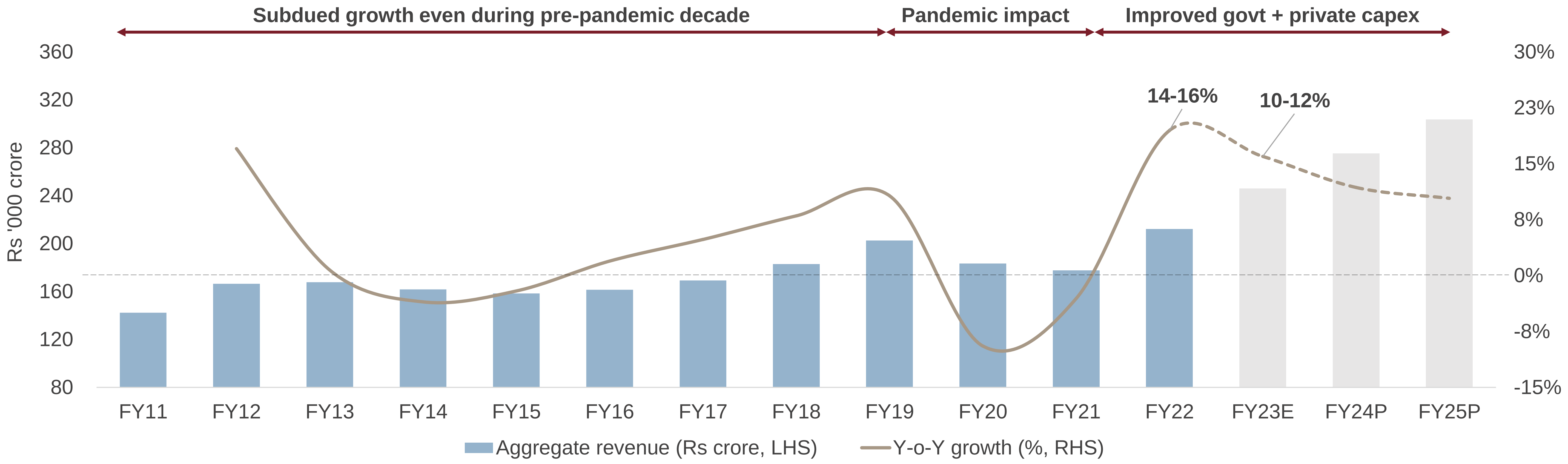
Revenue and profitability drivers and outlook

Double-digit revenue growth to continue over the medium term

Sector to witness strong growth over the medium term, breaking out of a decadal lull and pandemic woes



Source: Company data, CRISIL Ratings estimates

- Increasing government outlays on infrastructure, execution of higher-priced orders, and revival in private capex to support revenue growth in fiscals 2023 and 2024
- Revenue growth was strong at ~19% in fiscal 2022, albeit on a lower base, which was created because of two pandemic-affected years

Source: Analysis of 75 companies (rated and non-rated) representing 54% of India's capital goods sector

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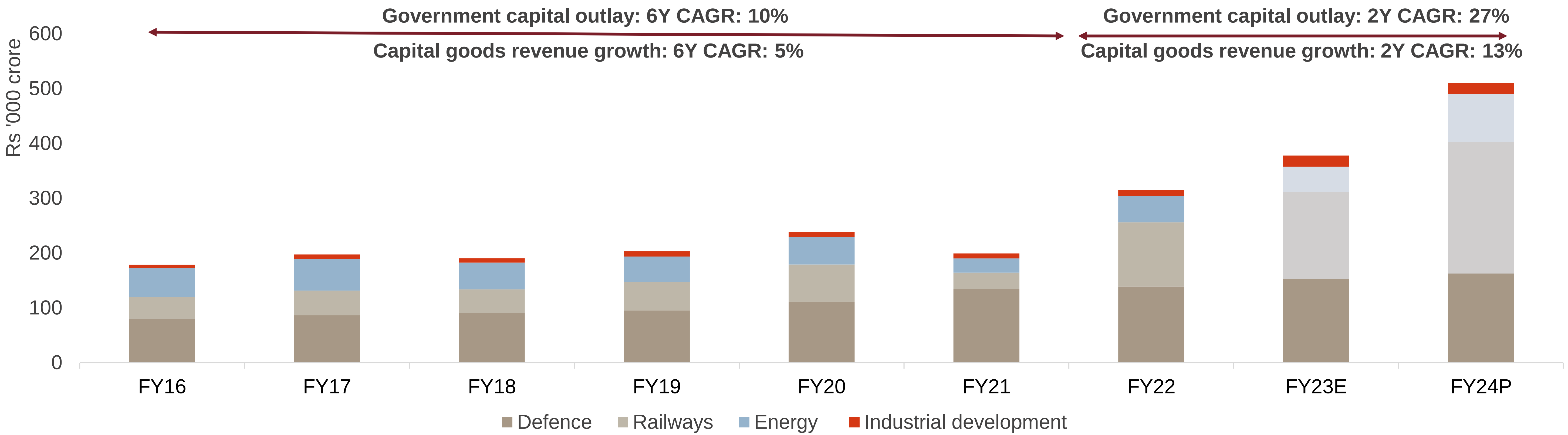
Higher government capital outlays to drive demand

Demand for capital goods has followed fiscal capex trends historically, which is taking off from fiscal 2022 onwards



Note: Above chart shows both state and central government capital outlays towards segments that drive significant capital goods' demand
Source: RBI, Ministry of Finance, CRISIL Ratings estimates

- Governmental capital outlays on defence, energy, railways and infrastructure contribute to a major share of demand for capital goods
- Strong momentum of outlays on these key segments to continue over the medium term, driving double-digit revenue growth for capital goods

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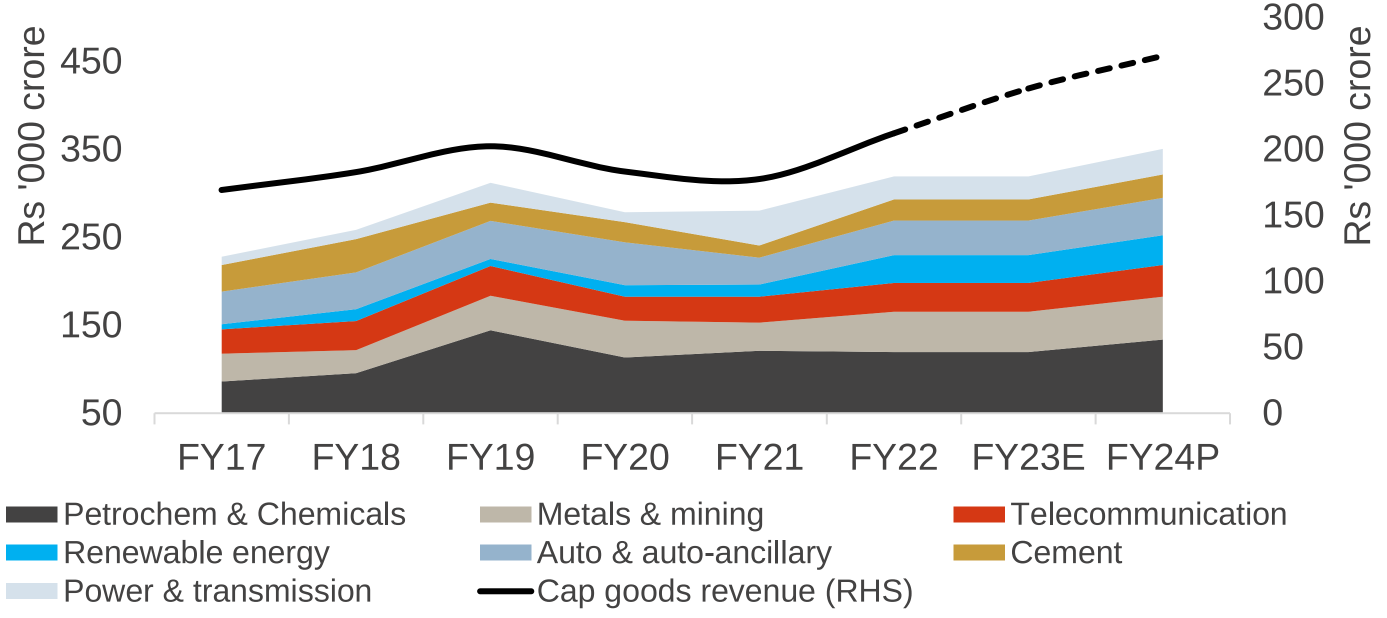
Private capex pickup to be supported by policy thrust

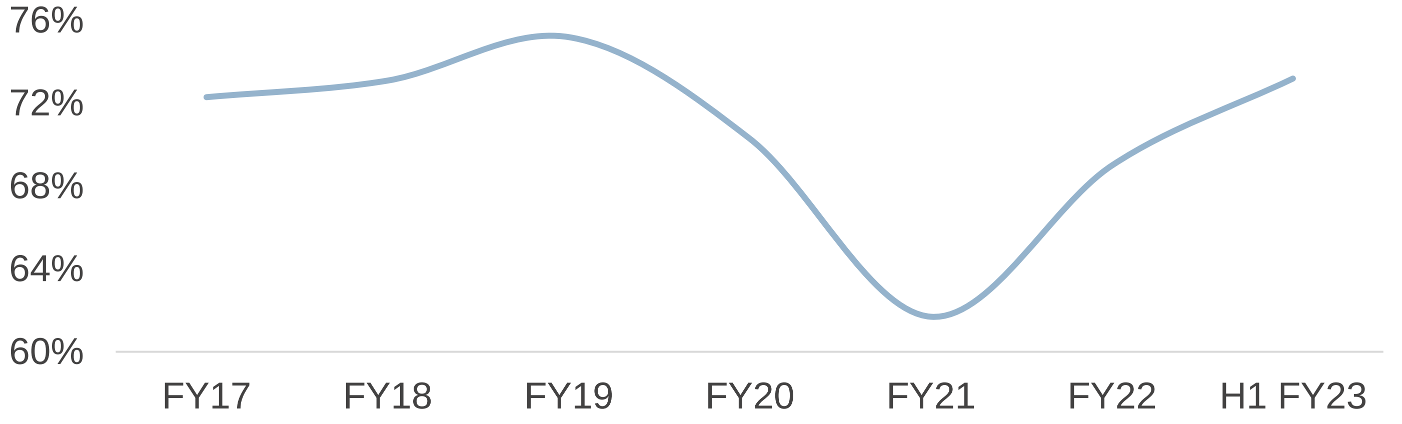
Capital goods revenue growth to trend with private capex



Source: CRISIL Ratings (private sector industrial capex based on top 100 companies by the size of capex)

- Starting from fiscal 2024, private capex is targeted towards the petrochemical & chemical, renewable energy, and metals and mining sectors
- Production-Linked Incentive (PLI) schemes announced across 14 sectors with a budgeted outlay of ~Rs 2 lakh crore over the next 4-5 years will create a domino effect and boost demand for capital goods
- Policy push with a strong 'Make in India' agenda, leveraging the prevalent supply-chain derisking strategy of global companies; sentiment boosts demand for capital goods

Capacity utilisation inching towards pre-pandemic levels



Source: RBI survey of over 700 participating manufacturing companies

PLI schemes in top sectors to attract investments

Sector	Subsidy outlay (Rs crore)	Status	Targeted investments	Investments attracted (actual vs planned)
Auto components	25,938	Successful	Rs 42,500 crore	Upwards of Rs 74,000 crore
ACC* batteries	18,100	Successful	50 GWh	About double capacity of 95 GWh against target
Solar modules	~24,000	Successful	Rs 45,000 crore	More than double against target
Telecom	12,195	Successful	Rs 4,115 crore	~20% more than target
Electronic component, IT hardware	~40,000	Moderately successful	Rs 54,400 crore	Strong acceptance in cell phones, while others are relatively slow
EV adoption	10,000	Slow	Rs 10,000 crore	Disbursed 32% of target

**Advanced chemistry cell*
Source: Annual reports and public releases of respective ministries

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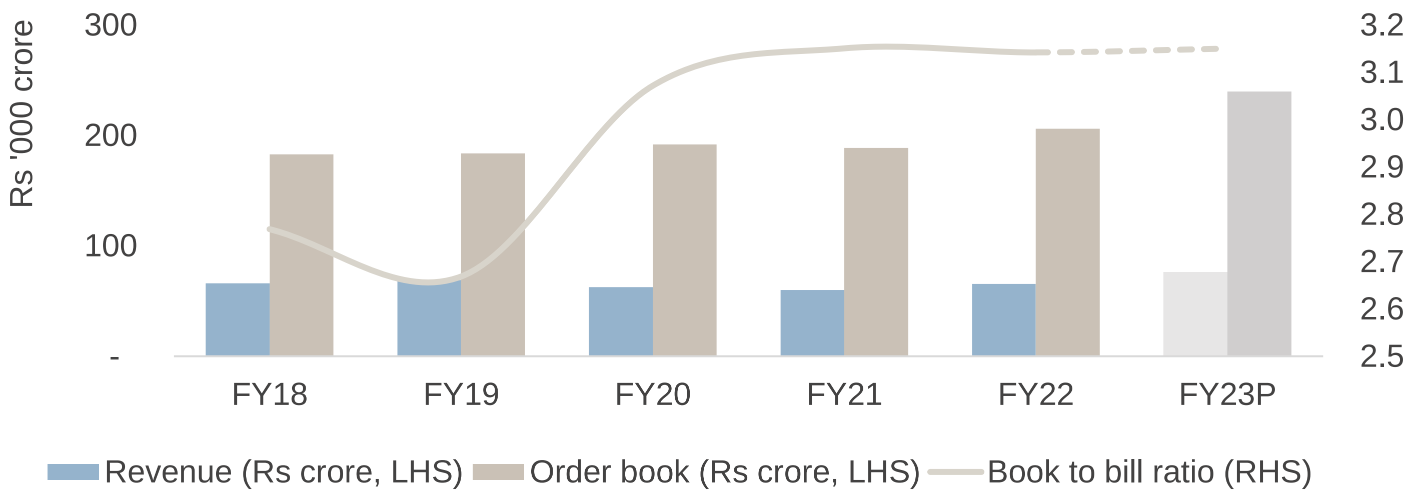
Healthy industrial demand and order book add to revenue visibility

Sectors	Revenue share	Demand CAGR FY22-24 (%)	OEM demand drivers
Energy & renewables	26%	10-13	PLI on renewables, growing demand for traditional power/energy, T&D infrastructure
Industrial machinery	12%	18-21	Automation across manufacturing value chain, smart city projects, electronic components
Railways	6%	16-20	Fleet modernisation, electrification, new rolling stock, high-speed lines, freight corridors
Auto & ancillary	5%	18-22	Growing vehicle demand, Make in India, PLI push on auto & ancillary
Metals & mining	5%	14-17	Increasing infrastructure demand, strengthened logistics infra
Oil & gas, refineries	4%	16-20	Exploration acreage expansion, rising demand for oil and plastic products in India
Chemicals	4%	16-20	Growing domestic demand, supplier substitution
Others	39%	12-15	Growing demand for defence, food, textile, earth-moving and aerospace equipment

Source: Company data, CRISIL Ratings analysis of sample set comprising 75 companies

- Auto & ancillary, industrial machinery and automation, railways, chemicals, and oil & gas to be the front-running sectors driving growth for OEMs
- For EPC companies, order intake has been strong from railways, transmission & distribution (T&D), green energy, railways and transportation

EPC revenue growth: Large order backlog and steady order inflow



Source: CRISIL Ratings analysis covering nine companies forming 92% of total EPC revenue

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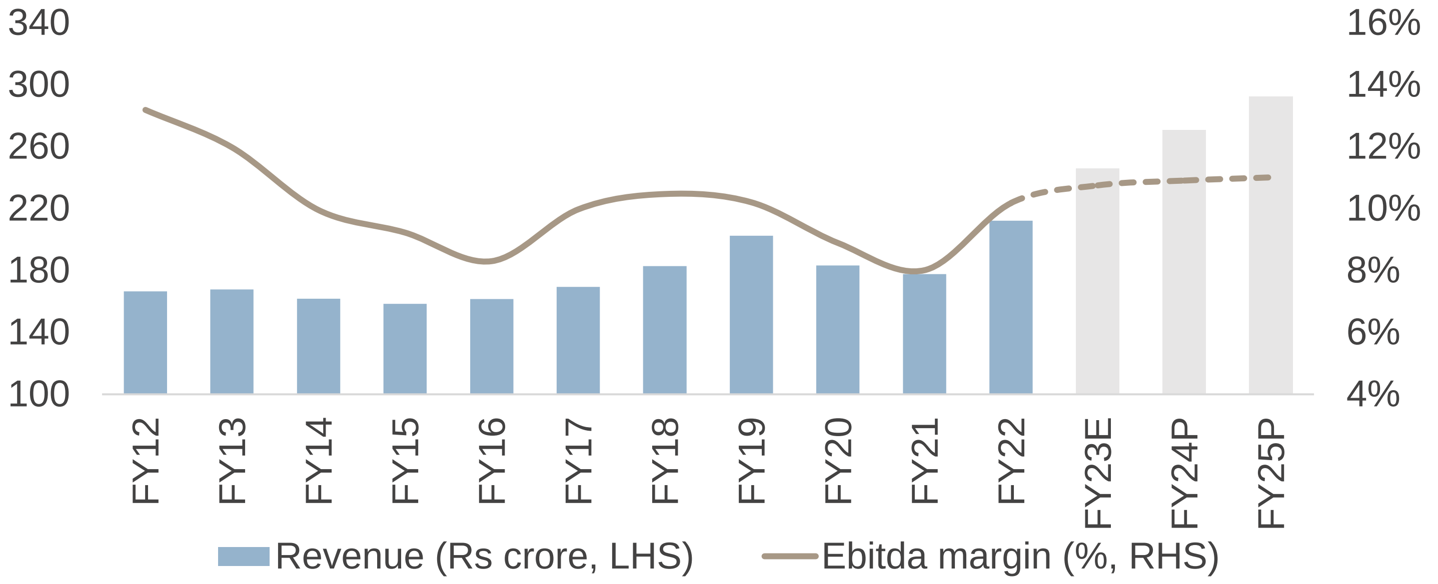
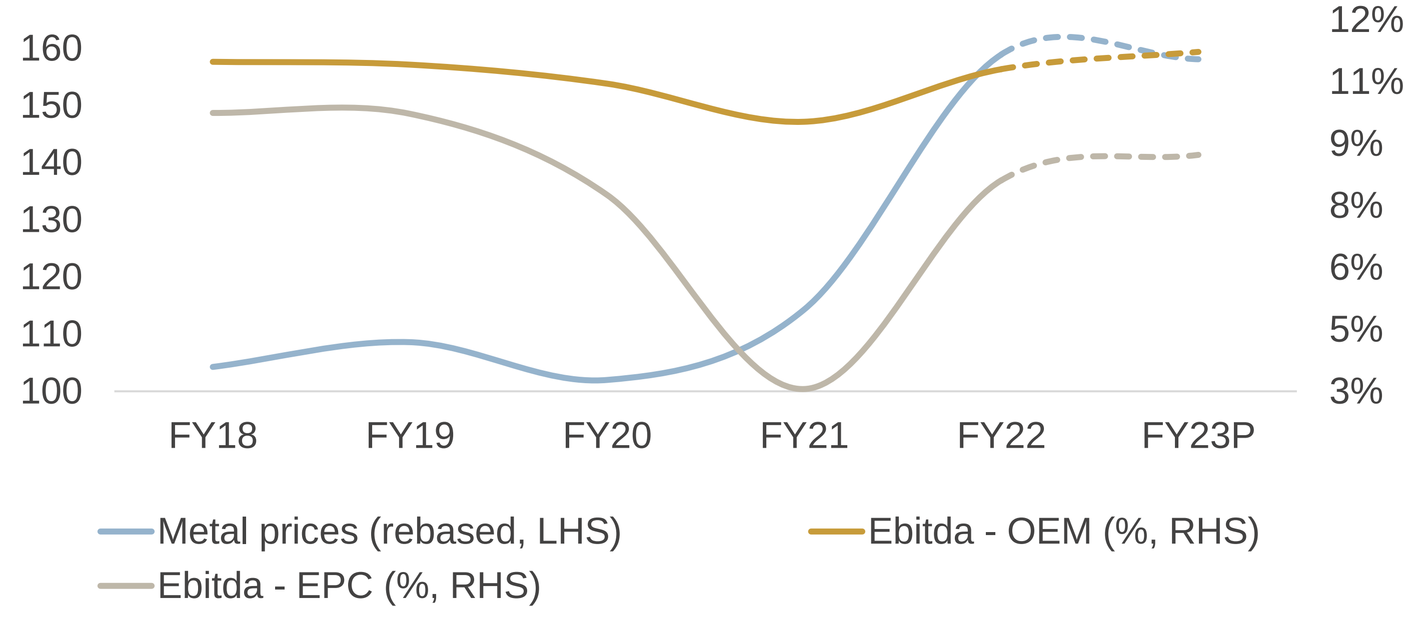
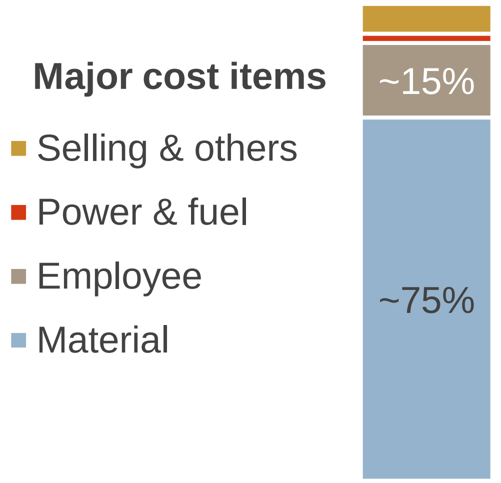
Softer raw material prices, better operating leverage driving margins

Ebitda margins have recovered; set to improve further over the medium term





Source: CRISIL Research; Rebased price average of steel, copper and aluminium



- Operating margin should improve 50-75 bps to 10.5-11.0% in fiscal 2023, and sustain at similar levels in fiscal 2024, driven by improving execution, better coverage of overheads, and moderating raw material prices
- OEM margins are relatively stable as material price movements are passed on, albeit with a lag
- EPC companies pass on input price movements with a significant delay owing to large execution periods. Also, margins of EPC players are more susceptible to operating leverage

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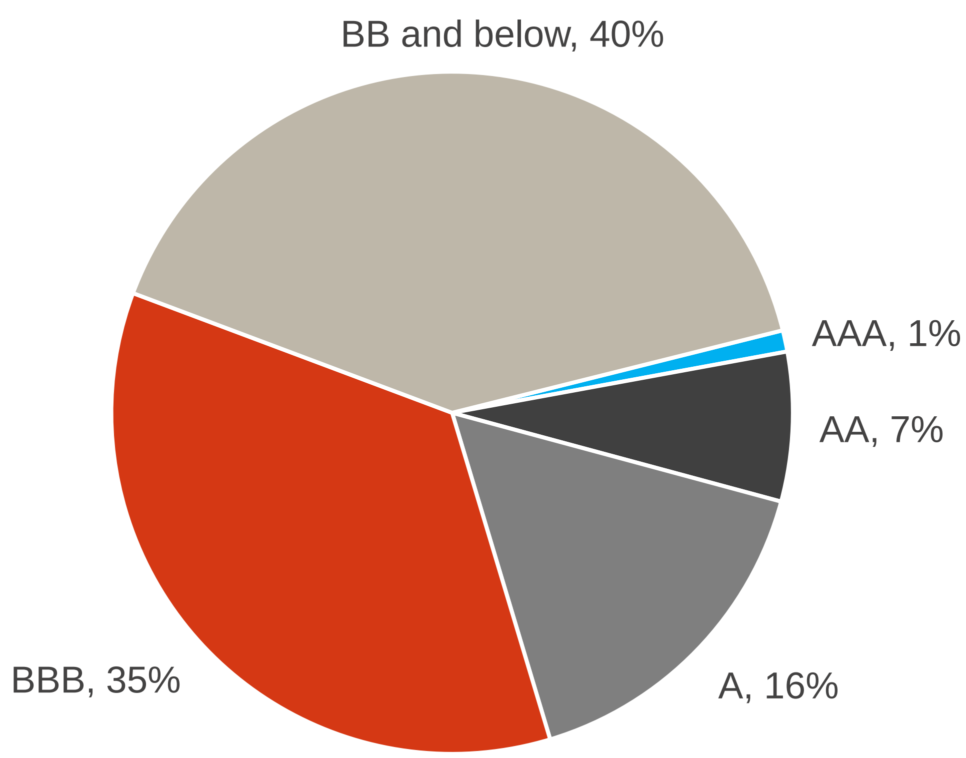
Credit outlook remains stable

CRISIL Ratings portfolio covers a wide range of capital goods players

Rating distribution



Source: CRISIL Ratings

Total debt rated by CRISIL Ratings in the capital goods sector stood at ~149,000 crore as of February 2023

- Outstanding ratings on 410 entities*, with total fiscal 2022 revenue of ~Rs 170,000 crore
- 60% of portfolio companies are investment-grade

**Credit perspective analysis considers 49 rated entities that make up 76% of the rated portfolio's revenue*

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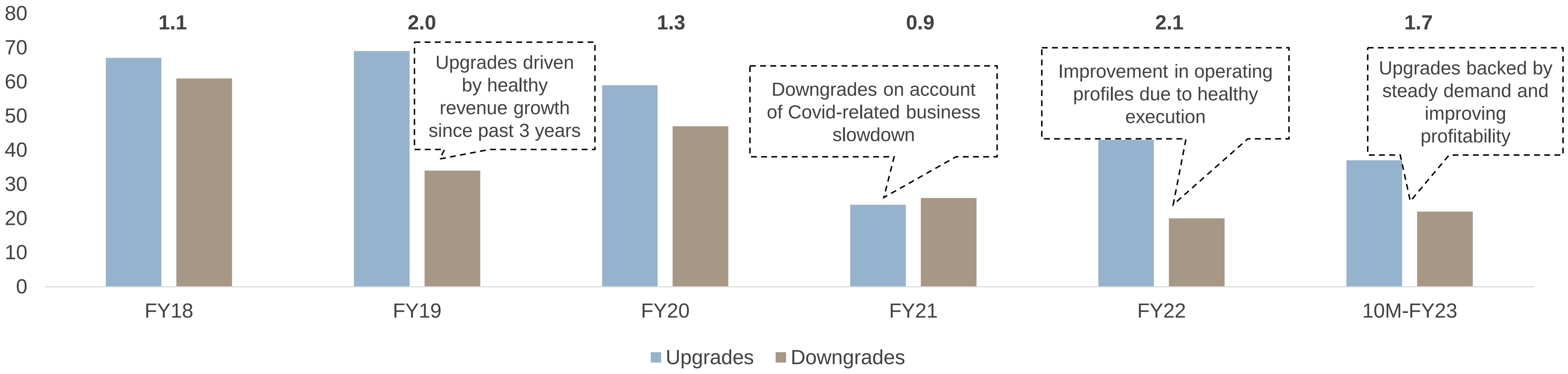
Credit outlook remains ‘stable’

- Healthy cash generation and strong balance sheets will support credit risk profiles going forward
- The credit ratio (ratio of upgrades to downgrades) has been above 1 since fiscal 2018 and peaked in fiscal 2022. Fiscal 2021 was an exceptional year due to the pandemic, and put pressure on the credit risk profiles of players
  - Upgrades were driven by better scale and ability to enhance operating profits, while improving balance sheet
  - Downgrades in ratings were due to the pandemic-induced slowdown and company-specific issues such as delays in funding

Cumulatively, upgrades have outpaced downgrades, indicating strong pliability to withstand macroeconomic tendencies



Source: CRISIL Ratings

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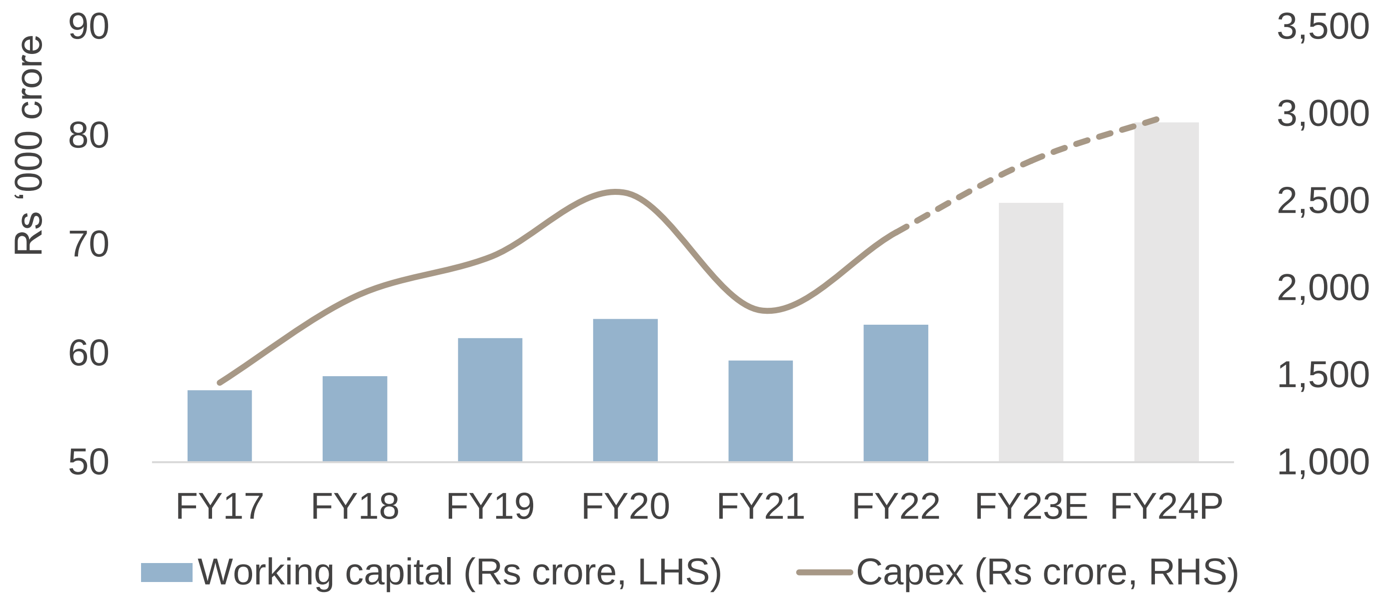
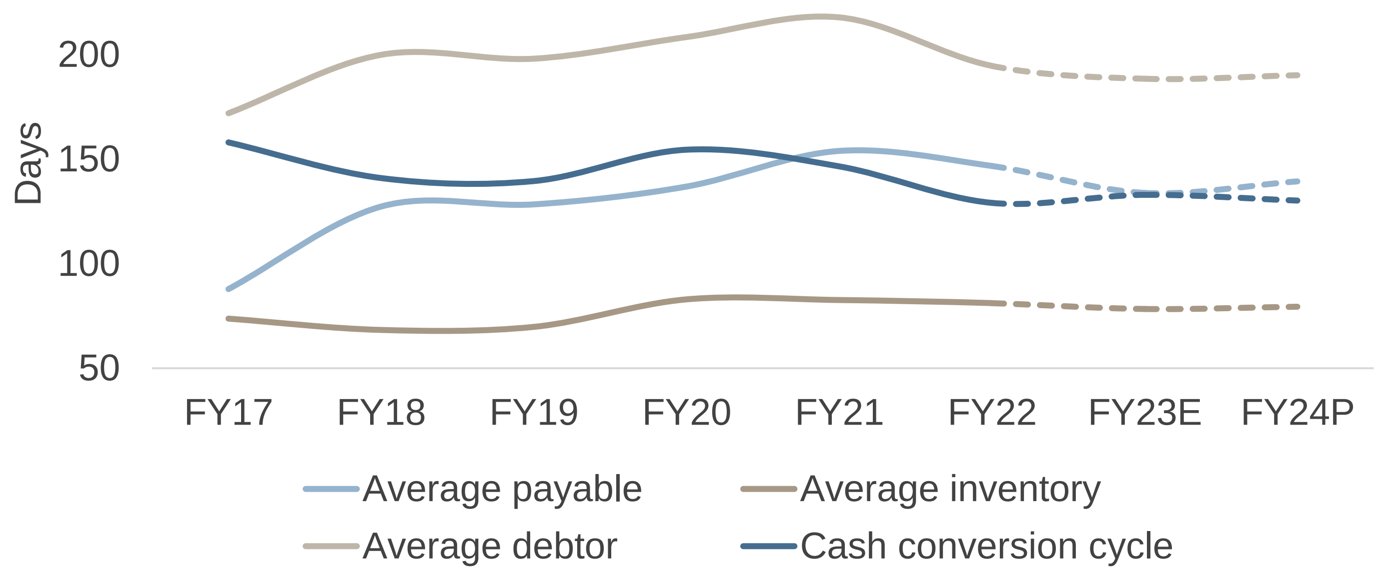
Moderate increase in working capital and capex to support growth

Increasing working capital and capex

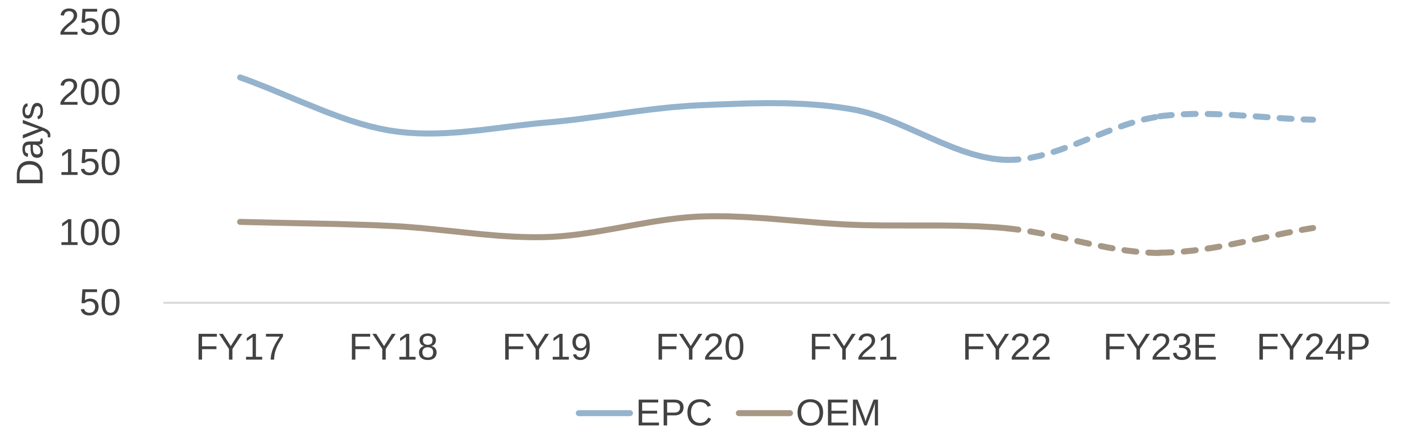


Creditors supporting working capital requirement



- Amid higher order book and pace of execution, players are undertaking capex to optimise utilisation levels
- Gradual rise in payables has supported the working capital cycle during the past two fiscals; same to continue going forward
- For EPC companies, the cash conversion cycle remains high owing to higher execution periods as compared with OEMs

Cash conversion cycles for OEMs and EPCs to remain stable



Source: CRISIL Ratings estimates
**Credit perspective analysis factors 49 rated entities that make up 76% of revenue of the rated portfolio*

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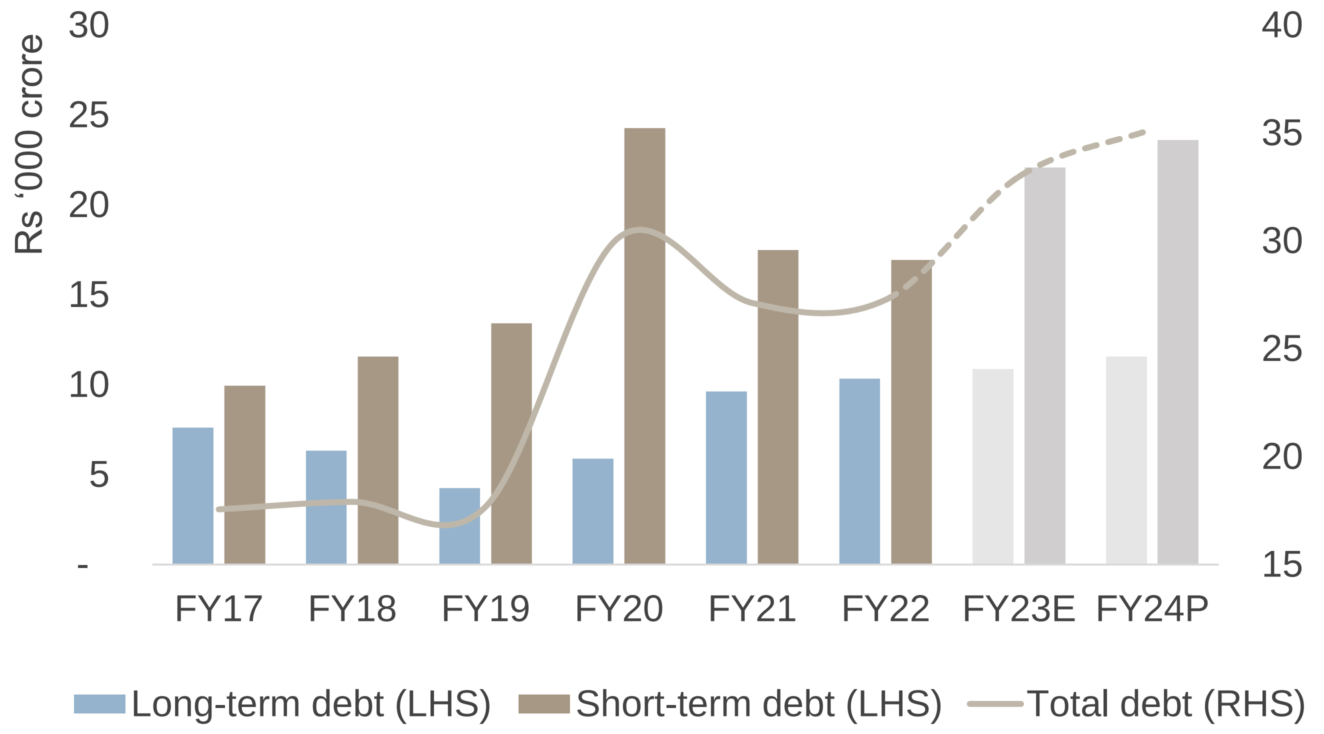
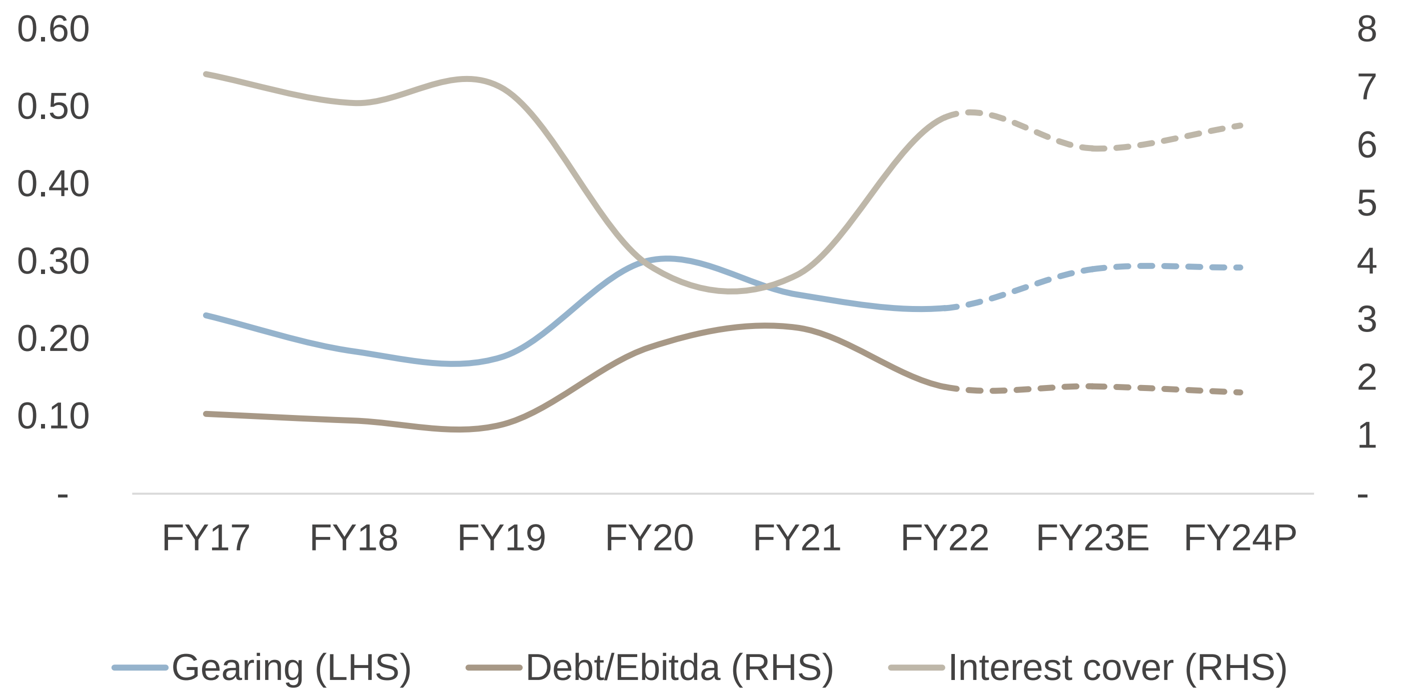
Better operating leverage, low debt addition to support debt metrics

Healthy cash accrual limit incremental debt requirement



Debt metrics to remain comfortable



- Funding requirements have been met through improved cash generation, leading to modest increase in debt
- Healthy balance sheets and improving profitability to keep gearing and debt/Ebitda healthy at ~0.3 time and ~2 times, respectively, this fiscal. Leverage metrics in fiscals 2020 and 2021 were impacted by low profitability
- Interest cover to remain adequate, despite higher interest rates

Source: CRISIL Ratings estimates
**Credit perspective analysis factors 49 rated entities that make up 76% of revenue of the rated portfolio*

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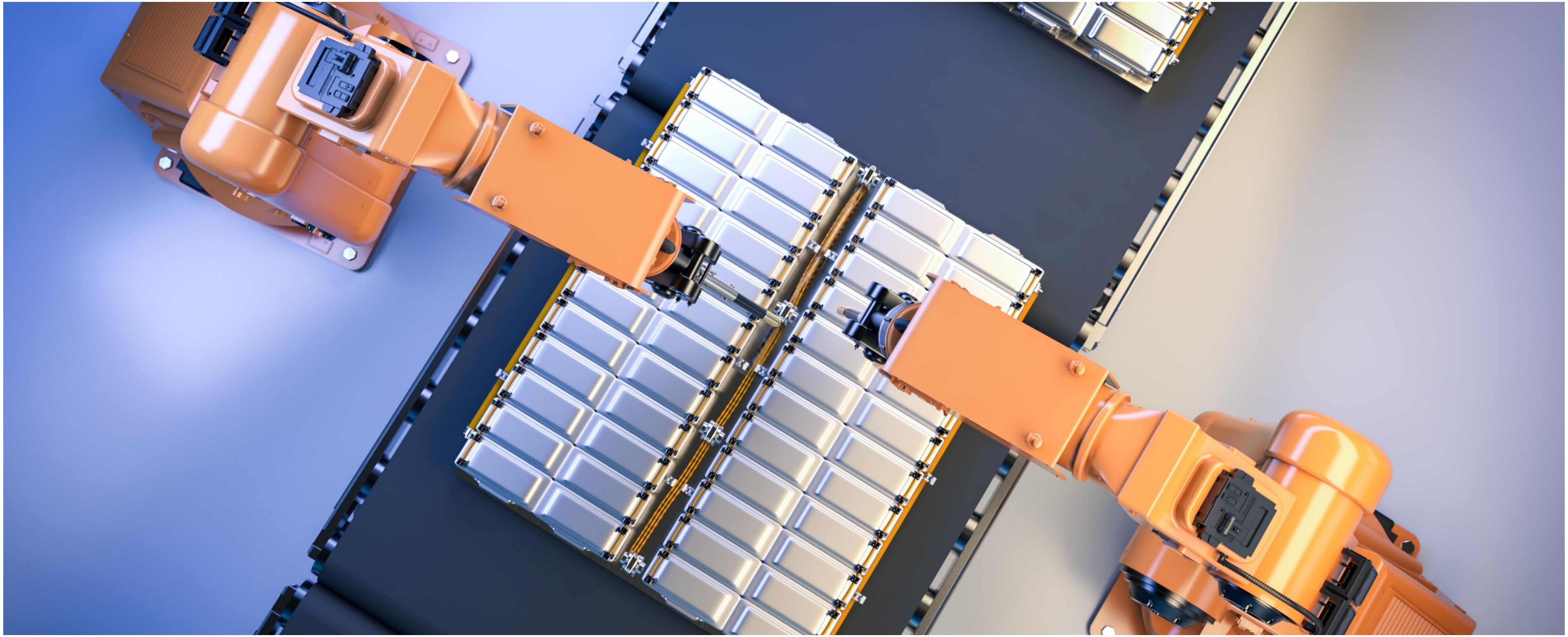
Summary

- **Better execution of strong order pipeline, government thrust** on infrastructure and revival of private capex to be the key revenue drivers
- **Operating margins may improve to 10.5-11.0% this fiscal and the next**, driven by better coverage of overheads as well as moderating raw material prices. These levels are slightly better than the pre-pandemic ones
- **Credit risk profile to remain 'stable'**
  - Improving operating leverage to enhance cash generation, which will support higher capex and working capital needs, keeping credit metrics comfortable
- **Monitorable:** Strong pick-up in private investment cycle, export environment, movement in commodity prices, and working capital management

Section 2

Their view



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Views excerpted from a panel discussion held during the webinar (1/3)

Eminent panelists

Alok S Kirloskar
Director
Kirloskar Brothers Limited

Rajendran Arunachalam
Group Chief Financial Officer
Thermax Limited

T K Sridhar
Chief Financial Officer
ABB Limited

Capital goods industry to benefit from favourable government policies and companies derisking their supply chains

- The government has announced significant capex through the budget. Certain sectors such as renewables, water and waste-water, warehousing and logistics, pharma, railways and metros, etc., are favourably positioned. The pace of growth in these sectors will be faster in the coming years as compared with sectors that have traditionally driven growth, such as electronics, food & beverages, etc.
- In addition to creating short-term demand for capital goods, this will lead to India becoming one of the most sought-after manufacturing destinations
- Pick-up in activity across sectors such as chemicals, metal, mining, etc., will push the demand for capital goods. This will further be strengthened by the energy scenario in the west, putting India and other south-east Asian countries in the spotlight for potential investments as companies aim to move away from China
- Private sector capex will be another important factor driving growth over the medium term, with capital expenditures for most sectors expected to be reasonably strong in the next couple of years. The PLI scheme will help OEMs and many end-customers

Views excerpted from a panel discussion held during the webinar (2/3)

Dependence on imports to reduce as countries focus more on localisation

- Energy issues in Europe has caused low-level components, such as that at a foundry level, to be outsourced to India. On the flip side, foreign companies with an established presence in India are exporting more to their parent company due to the favourable cost dynamics. A reasonably secure supply chain has also helped the exports
- Indian companies are also increasing exports of highly specialised industrial equipment. Despite this, the focus on localisation may hamper these exports as countries are imposing thresholds and duties to decrease the reliance on foreign products
- Most customers prefer a proven track record of product quality from companies domestically whereas counterparts in western economies are given the time and liberty to develop a track record. With the push from Make in India, this scenario is slowly changing, and companies are getting to develop technologies locally to help the players
- In a competitive market such as India, customers are willing to pay for relevant technology upgrades. These technologies are now built on open architecture platforms, making them more accessible to various players as compared with the previous generations where technology was highly proprietary

Views excerpted from a panel discussion held during the webinar (3/3)

Stabilising commodity prices to play a key role in profitability

- Increase in demand for capital goods through good recovery from the pandemic scenario coupled with government and private capex is ensuring growth. Economies of scale will be the key driver of profitability for large companies. Commodity prices having a stable performance will also help increase profitability
- Efficient working capital management, keeping the interest cost at an affordable level through prudent loan utilisation, will further support profitability. It is important to focus on debt metrics to avoid a debt trap to fuel growth
- Knowing the product being supplied to the export market, securing payment terms and ensuring a quality set of customers in this scenario will be key to maintaining profitability. Hedge accounting according to IFRS 9 will be important for listed entities which, if missed, will lead to high fluctuations in profit and loss due to mark-to-market gains and losses booked

Working capital management to not pose significant challenges to the companies

- Companies want to control raw material prices by ordering when the prices are low. Any delays in project implementation, could lead to a pile-up in the inventory.
- Advances from customers play a major role in managing working capital
- With increase in demand and growth rates, companies need a prudent capital allocation approach. Management of cost structure as well as the cash the company possesses is also a key factor in sectoral growth

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Section 3

Poll view

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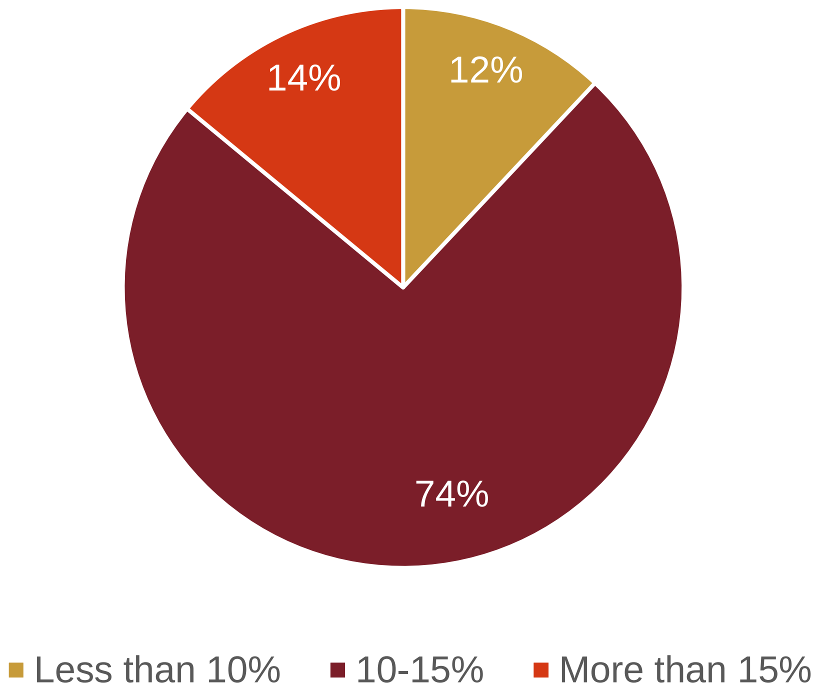
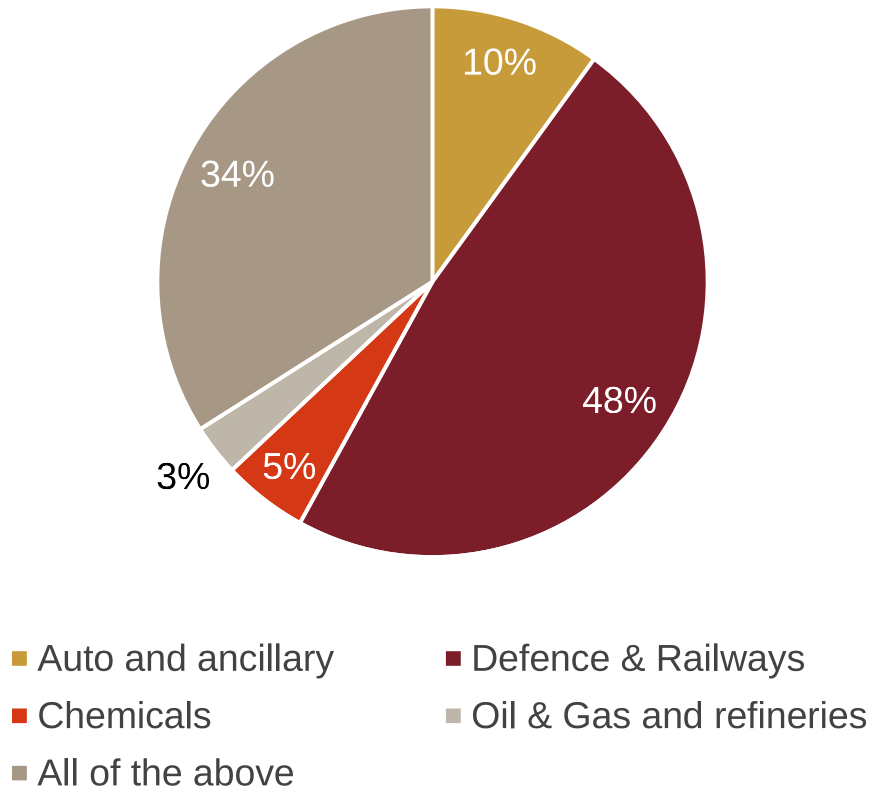
Results of a survey of over 340 webinar participants

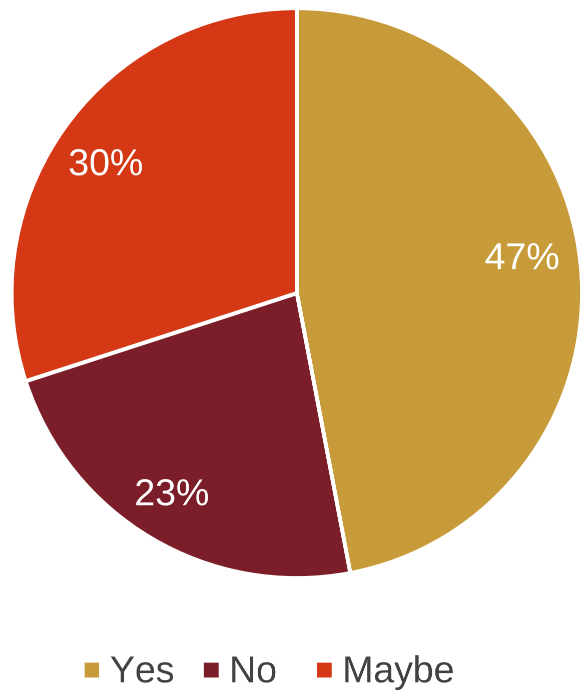
Q1. How do you see revenues of capital goods players growing this fiscal over the previous one?



Q2. Which industry verticals will drive this growth?



Q3. Do you expect a significant revival in private capex in fiscal 2024?



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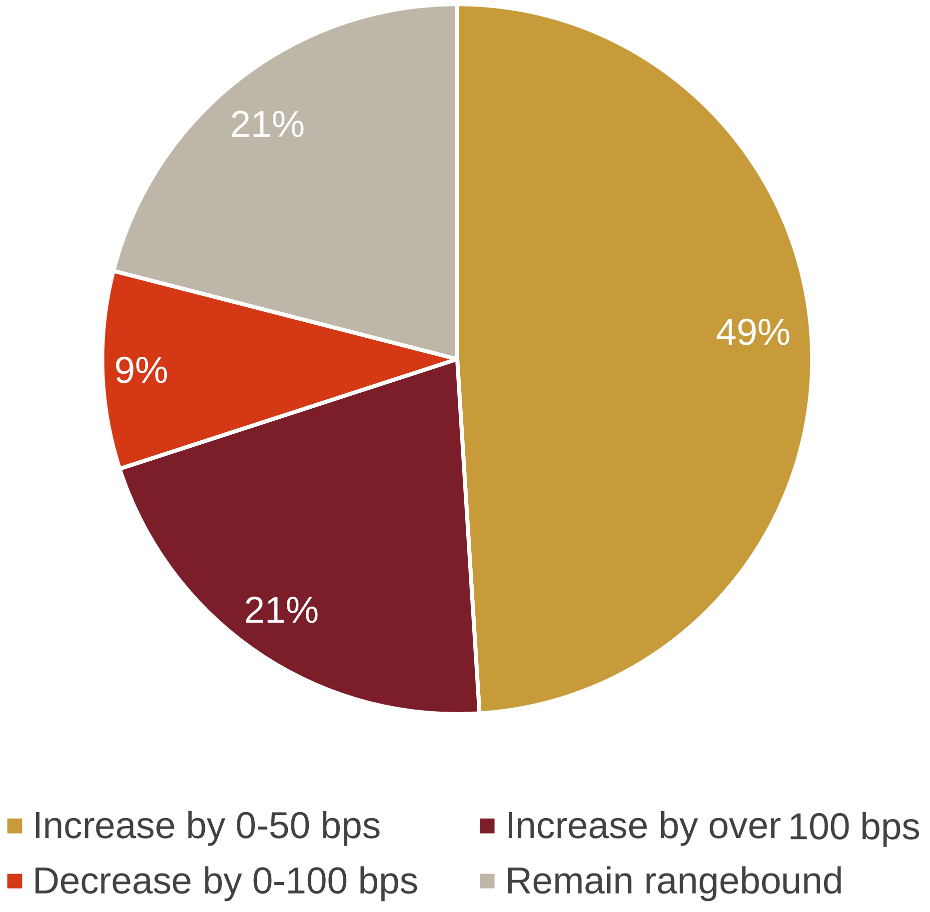
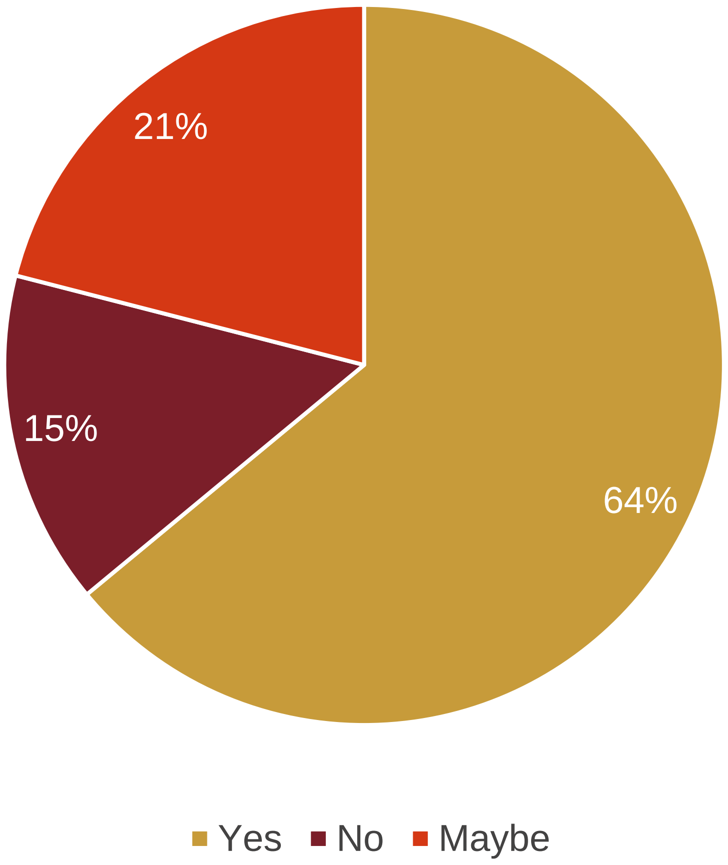
Results of a survey of over 340 webinar participants

Q4. How are the operating profits for capital goods players expected to fare in this fiscal over the previous one?



Q5. Do you expect working capital intensity to increase in fiscal 2024?



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List of capital goods companies rated by CRISIL Ratings

Company
Siemens Ltd
ABB India Ltd
Atlas Copco India Ltd
Thermax Ltd
Thermax Onsite Energy Solutions Ltd
Thermax Cooling Solutions Ltd
AIA Engineering Ltd
Carborundum Universal Ltd
Kirloskar Oil Engines Ltd
L&T - MHI Power Boilers Pvt Ltd
Fleetguard Filters Pvt Ltd
L&T Valves Ltd
Suprajit Engineering Ltd
Elgi Equipments Ltd
Praj Industries Ltd
Ingersoll Rand India Ltd
Banco Gaskets India Ltd
Kalpataru Power Transmission Ltd
Bharat Heavy Electricals Ltd

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