Capital Goods

Investor feedback on capital goods sector road show

We met more than 100 institutional funds in India and Asia after publishing our Thematic Coverage Initiation report on the capital goods sector (report link). Given the sector's outperformance over the last three years, investor interest in the space remains high. Our interactions with investors reinforced our long-term positive thesis on the capital goods sector. Investors are positive on the multi-year capex cycle, with sectors like renewables, transmission, railways, defense and PLI driving a major part of capex growth. Private sector capex bottomed out in FY21, but all eyes are on the broad-based recovery in large private sectors, as government capex cannot continue to grow at the same high pace of >35% CAGR as seen over the last two years. Some investors are concerned about expensive valuations in the sector and are shuffling weights within the sector. However, the bias is to increase holdings on declines. Investors prefer large-cap market leaders but can consider value stocks that are trading at cheaper valuations. Key downside risks to valuations would come from lower-than-expected growth in government capex and a delayed broad-based recovery in private capex.

Investors are positive about long-term growth drivers for the sector

Our capital goods road show meetings with domestic (DIIs) and foreign institutional clients (FIIs) in the last one month indicate optimism for long-term growth for capital goods sector, including industrial, defense and railways. Some investors are concerned about the current valuations of companies, while others have mixed views. Most of the investors indicated that valuations will remain high as the sector total addressable market (TAM) is on an uptrend, while some are waiting for declines. Very few of them are of the view that TAM is going to decline from the current levels, resulting in lower inflows for companies over the medium to long term. We do believe that amid high valuations, most companies will see earnings-led growth, and further re-rating would be driven by 1) better-than-expected growth in government capex over the next five years, 2) faster and broader revival of private sector capex, and 3) faster recovery in exports. Lower-than-expected growth in government capex and delays in private capex can result in valuation de-rating.

Focus on either market leaders or value buys

Most funds have increased ownership in the last two months in the capital goods sector after trimming it in Sep'23 and Oct'23. FIIs pumped in more than INR433b into the capital goods sector in CY23, nearly six times higher than that in CY22. DIIs have also increased their allocation toward the sector in Dec'23. Large-cap market leaders, such as L&T, ABB, and Siemens, are the preferred bets of most investors on declines. These companies have enhanced their product portfolios, benefiting from both government and private capex. They have also increased their geographical reach to reduce cyclicality in the business, which can come either from the election schedule or weakness in exports. Investors also favor stocks that are available at cheaper valuations, have a strong business model and have a scope of re-rating in valuations, such as Kirloskar Oil Engines and Kalpataru Projects International.

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Sector sub-segments that are in focus

Key sub-segments within the capital goods sector in which investors are interested in investable opportunities: 1) Power – expected opportunity of 70-80GW awarding over next few years; 2) Renewable – government's plan to take renewable capacity to 500 GW by 2030; 3) T&D – corresponding spending on transmission network for thermal and renewable projects; 4) Railways – expected spending of INR10-11t by IR on upgradation of coaches, wagons, locomotives and metro projects; 5) Defense – indigenization opportunity of INR4-5t over next five years; and 5) Data Centers – expected spending of INR400b till 2025 and PLI led capex of nearly INR4-5t over next five years. With gross margins largely expected to remain stable, the focus is on operating levers that can drive further margin improvements, particularly for product companies such as ABB, Cummins, KOEL, Hitachi Energy, BHEL, and CG Power.

Investor feedback on individual companies

Our discussions were focused on beneficiaries of the entire value chain for renewable energy, transmission, railways, defense, PLI, industrial consumables, which we believe are expected to see a multi-year capex cycle. For our covered companies, following are broad investor views:

- **L&T**: L&T is trading above its historical peak valuation, led by sharp improvements in international order inflows. Investors do not expect further sharp valuation multiple re-rating and would focus on how the company is going to further ramp up international inflows and manage risks associated with high exposure to one geography.
- **ABB India**: ABB is viewed as a high-quality and ESG-focused play; hence, it is favored by most FIIs despite higher valuations. Investors are a bit concerned about plateauing order inflows in the short term, but they hope for a better turnaround in margins than the Street estimates.
- **Siemens**: Investors are positive about the company's higher TAM and expectations of 1-2 HVDC projects to be awarded to the company. Skepticism remains on promoter group transactions and lower margins in the mobility segment.
- **Bharat Electronics**: Select investors are positive about a ramp-up in the overall defense cycle; hence, they are comfortable with higher valuations, with the scope of further re-rating from current levels as spending moves up. Others are concerned about expensive valuations and are shuffling weights.
- **Cummins India:** Clients are positive about the company's market leading position and would watch out for the company's positioning when CPCB4+ is implemented in Jul'24.
- **Thermax**: ESG-focused funds are positive about Thermax despite higher valuations as the company has moved away from traditional thermal power projects. Others are concerned about its order inflow growth, margin recovery, and investments in new ventures on a BOT basis.
- **Triveni Turbine:** The company's focus on improving exports and aftermarket gives comfort on its sector-beating profit CAGR despite being a single segment focused company and trading at similar valuations as Thermax.

- **Kirloskar Oil Engines**: Extremely high interest is seen across funds on attractive valuations and potential to re-rate from the current levels, as the company delivers on portfolio ramp-up and margin improvement.
- **Hitachi Energy:** Select investors view this as a high-quality play on transmission and HVDC capex, despite having higher valuations than Siemens and closer to ABB. Others are skeptical of the company's margin recovery and expensive valuations.
- **KEC international**: KEC is ranked higher than other EPC players on corporate governance. Investors are waiting for a margin recovery and a reduction in debt and working capital.
- **Kalpataru Projects (KPI):** KPI is viewed as a rerating candidate as the promoter pledge is declining and as the company is operating in the fast-growing T&D market.

Near-term triggers for sector

Following are the key events to watch out for in the near term: 1) budgetary allocations, 2) private capex announcements, 3) order inflow momentum, particularly short-cycle orders, 4) gross margin and EBITDA margin trends, and 5) working capital cycle. Near-term risks: the escalation of issues in Red Sea, and correspondingly higher freight rates (can impact margins of export-oriented companies).

Valuations

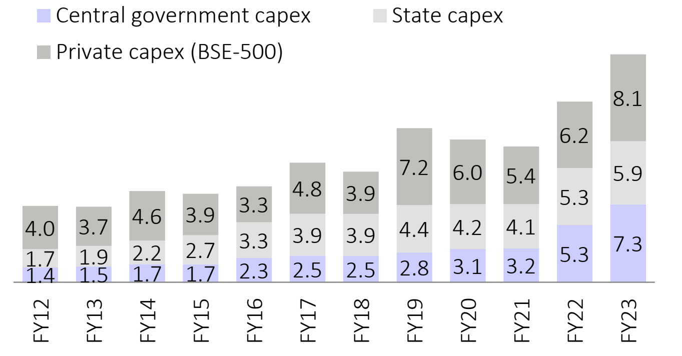
Sector valuations are already high in anticipation of the continuation of the capex cycle as the sector's TAM is expanding. Sustainability of these multiples depends on companies' ability to deliver on expected parameters, capex trends, and cost control. We prefer companies that are able to improve their TAM and market share. Our top picks are L&T, and ABB in large-caps and Kirlosker Oil Engine in mid-caps.

Exhibit 1: Sector valuation summary

Companies	CMP (INR)	Rating	Mcap (INRb)	EPS (INR)			P/E (X)			RoE (%)			RoCE (%)		
				FY24E	FY25E	FY26E	FY24E	FY25E	FY26E	FY24E	FY25E	FY26E	FY24E	FY25E	FY26E
L&T	3,710	Buy	4,485	98.1	121.9	147.2	37.8	30.4	25.2	15.1	17.6	18.7	7.0	8.1	8.8
ABB India	4,790	Buy	930	56.7	68.8	81.8	84.4	69.7	58.5	21.9	21.7	21.3	22.1	21.9	21.4
Siemens	4,308	Buy	1,337	65.0	77.5	92.4	66.3	55.6	46.6	16.6	17.5	18.2	16.5	17.3	18.1
Bharat Elect.	190	Neutral	1,078	4.7	5.3	6.0	40.4	36.0	31.5	22.0	21.5	21.5	23.6	23.0	23.0
Thermax	3,108	Neutral	311	51.8	61.0	72.1	60.0	51.0	43.1	14.4	15.2	15.9	12.6	13.1	13.7
Cummins India	2,257	Buy	532	45.5	54.4	64.1	49.6	41.5	35.2	22.4	24.4	25.9	10.1	12.0	14.7
Kirloskar Oil Eng.	686	Buy	85	23.9	29.9	36.9	28.7	23.0	18.6	14.1	15.8	17.3	13.8	15.6	17.1
Triveni Turbine	375	Buy	137	7.9	10.6	14.0	47.4	35.3	26.8	29.6	31.8	33.1	29.7	31.9	33.2
Hitachi Energy	5,790	Sell	201	28.4	74.5	109.4	204.0	77.7	52.9	9.0	19.1	21.9	10.1	18.8	21.3
KEC Int.	623	Neutral	152	16.9	30.0	43.6	36.9	20.8	14.3	10.9	17.1	21.0	12.4	15.0	17.6
Kalpataru Proj.	759	Buy	109	36.3	55.8	65.8	20.9	13.6	11.5	10.6	14.4	14.8	9.5	12.3	12.8

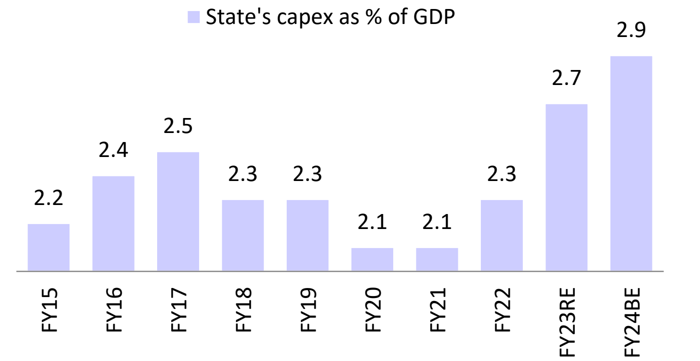
Centre has front-loaded capex; private capex bottomed out in FY21

Exhibit 2: Government capex grew well, while private capex was selective and bottomed out in FY21 (INR t)



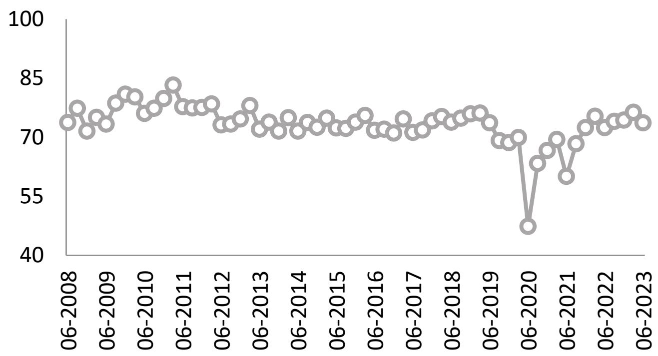
Source: Budget documents, Capitaline, MOFSL

Exhibit 3: State capex remains in the range of 2.1-2.3% of GDP and is budgeted to move up in FY24E (%)



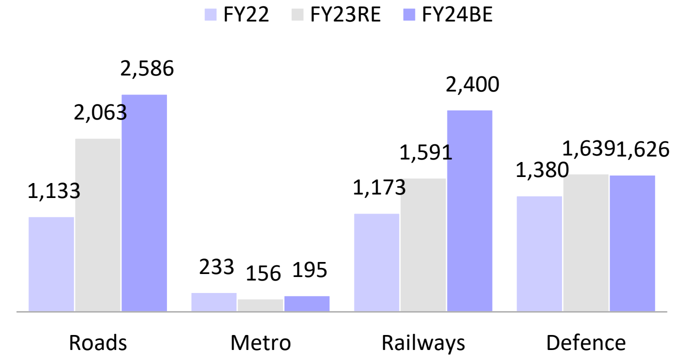
Source: Budget documents, Capitaline, MOFSL

Exhibit 4: RBI aggregate capacity utilization steadily inching up (%)



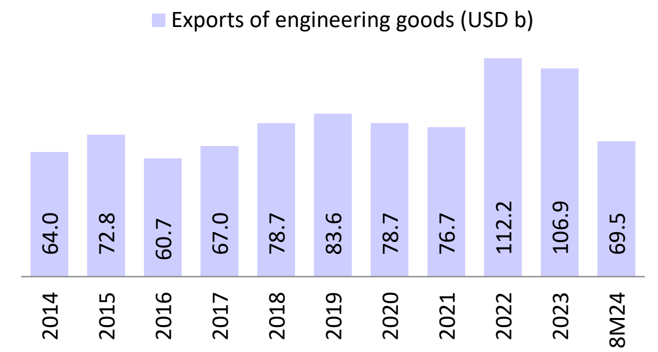
Source: CMIE, MOFSL

Exhibit 5: All eyes on budgetary allocations for FY25 for sectors like roads, metros, railways, defense (INR b)



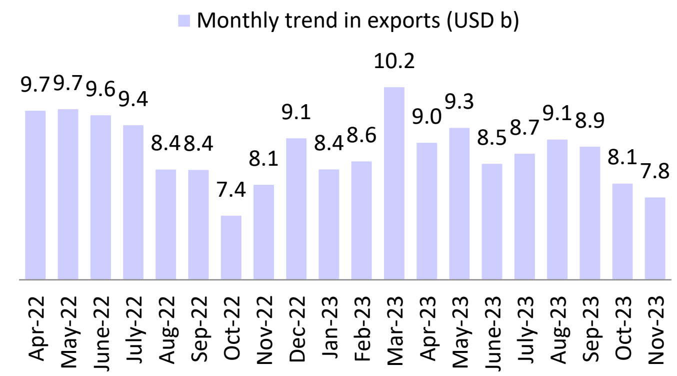
Source: Budget documents, MOFSL

Exhibit 6: Engineering exports from India have moved up sharply from FY22; FY24 may see some weakness (USD b)



Source: MOFSL

Exhibit 7: Monthly exports too have come down in last three months (USD b)



Source: MOFSL

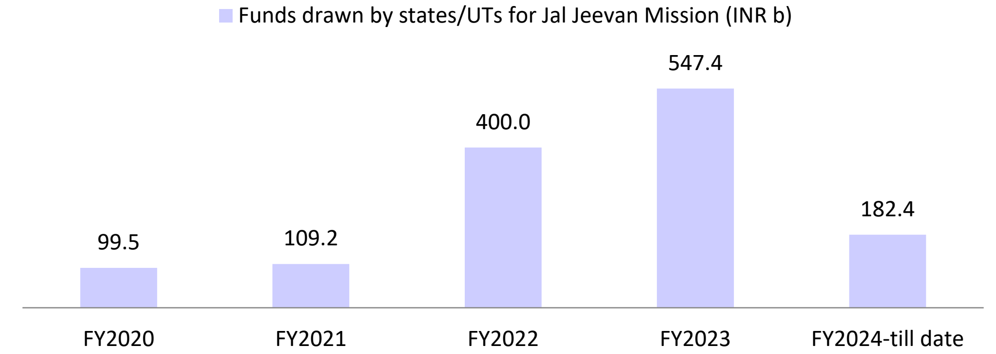
Sectors driving growth for companies

Exhibit 8: Transmission line network worth INR2.4t will have to be set up before renewable energy capacity is commissioned

Details	Capacity (GW)
RE capacity already commissioned	166
66.5 GW RE capacity to be integrated to ISTS network (8.8 GW already commissioned)	58
Additional RE capacity to be integrated to ISTS network (55 GW+181.5GW)	237
Margin already available in ISTS sub-stations which can be used for integration	34
Balance RE capacity from GEC-1 to be integrated to intra-state system	7
RE capacity from GEC-II to be integrated to intra-state system	19
Additional hydro capacity likely by FY30	17
Total RE capacity targeted till FY2030	**537**

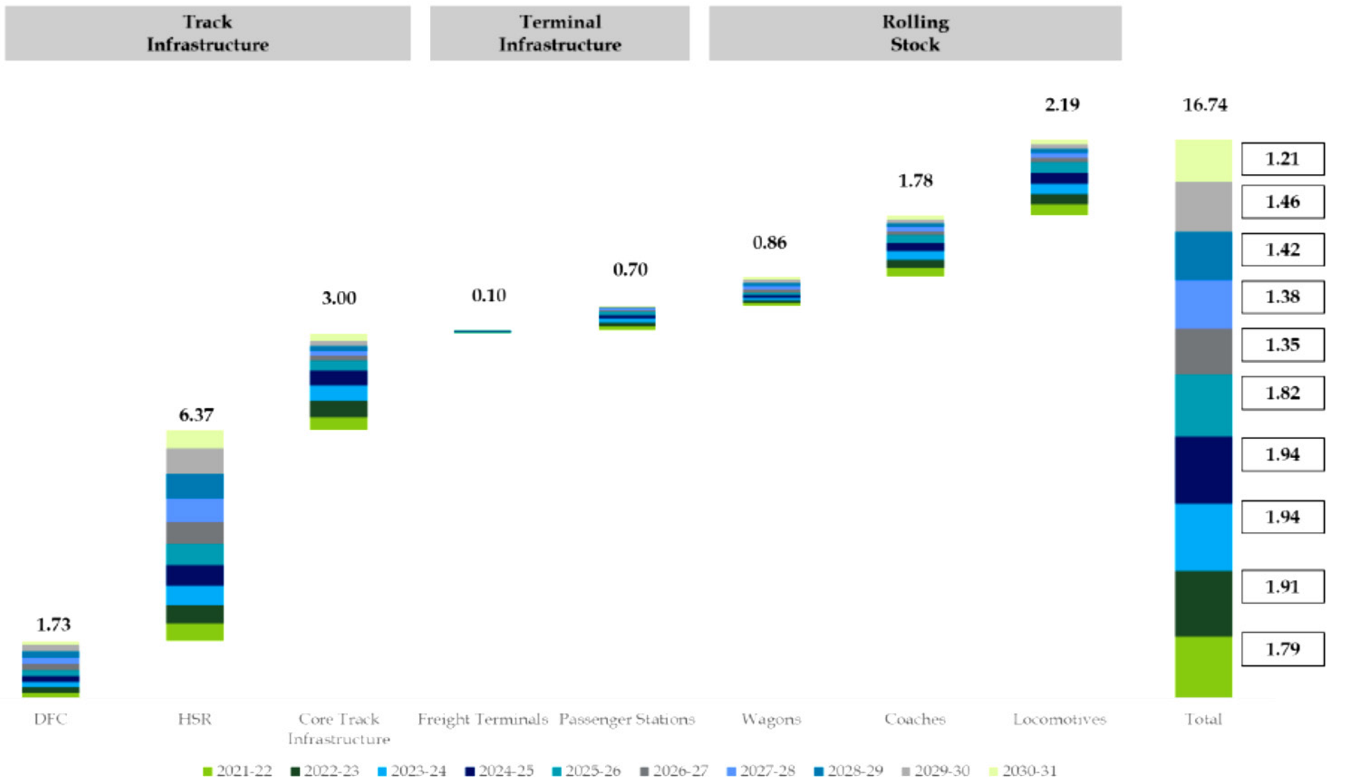
Source: Ministry of Power, MOFSL

Exhibit 9: Projects under Jal Jeevan Mission will continue to be awarded for next 2-3 years



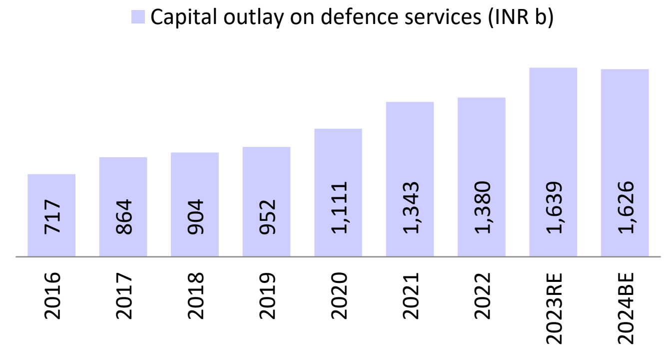
Source: Budget documents, MOFSL

Exhibit 10: Annual capex requirements till 2031 by Indian Railways will remain high (INR t)



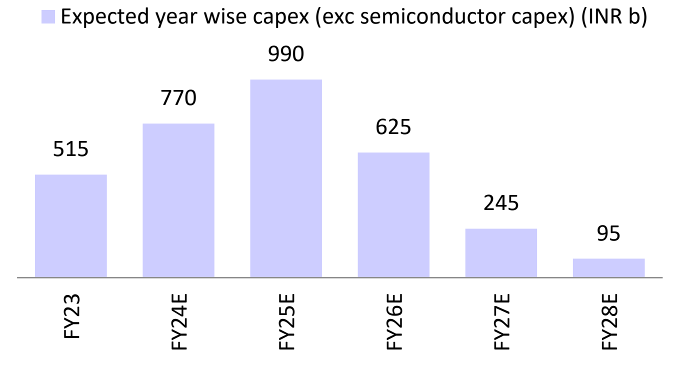
Source: National Rail Plan MOFSL

Exhibit 11: Capital outlay on defense services should start moving up in line with indigenization (INR b)



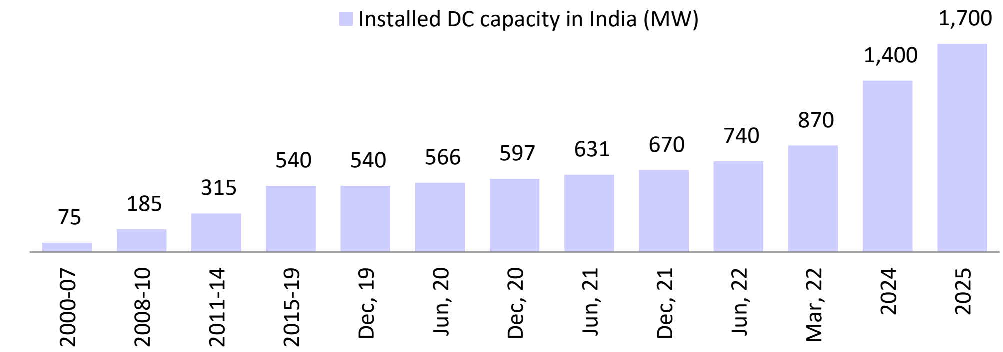
Source: Budget documents, MOFSL

Exhibit 12: PLI-led capex will increase over next two years thereby aiding private capex (INR b)



Source: MeiTY, MOFSL

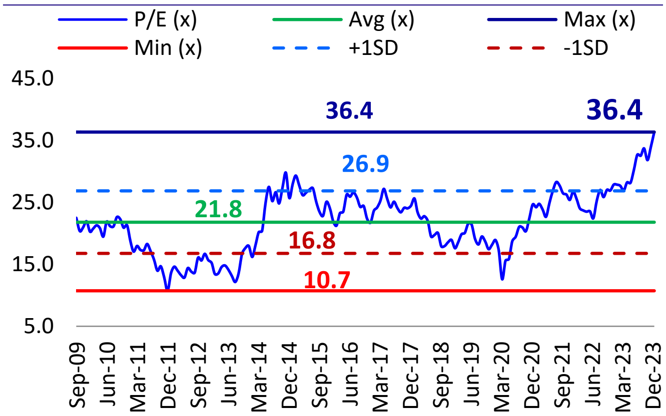
Exhibit 13: Data Center market seeing high investments in capacity remap-up (MW)



Source: Industry, MOFSL

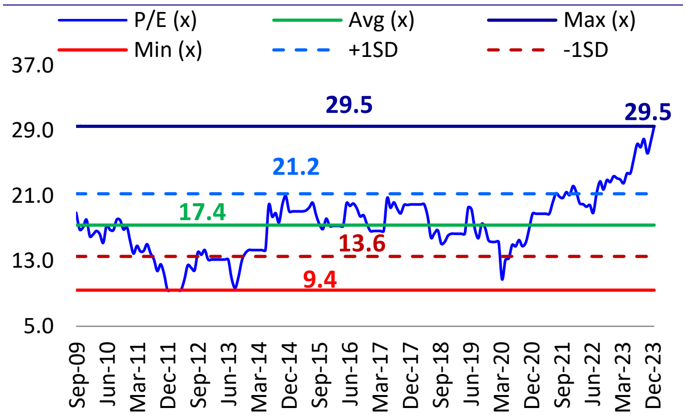
Sector valuations are high in expectations of multi-year capex cycle

Exhibit 14: BSE Capital Goods - 1 Yr Fwd P/E



Source: Bloomberg, MOFSL

Exhibit 15: BSE Capital Goods - 2 Yr Fwd P/E



Source: Bloomberg, MOFSL

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SELL	< - 10%
NEUTRAL	< - 10 % to 15%
UNDER REVIEW	Rating may undergo a change
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Exhibit 2: Grievance Redressal Cell:

Contact Person	Contact No.	Email ID
Ms. Hemangi Date	022 40548000 / 022 67490600	query@motilaloswal.com
Ms. Kumud Upadhyay	022 40548082	servicehead@motilaloswal.com
Mr. Ajay Menon	022 40548083	am@motilaloswal.com

Exhibit 3: Registration details of group entities.: Motilal Oswal Financial Services Ltd. (MOFSL): INZ000158836 (BSE/NSE/MCX/NCDEX); CDSL and NSDL: IN-DP-16-2015; Research Analyst: INH000000412 . AMFI: ARN .: 146822. IRDA Corporate Agent – CA0579. Motilal Oswal Financial Services Ltd. is a distributor of Mutual Funds, PMS, Fixed Deposit, Insurance, Bond, NCDs and IPO products.

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