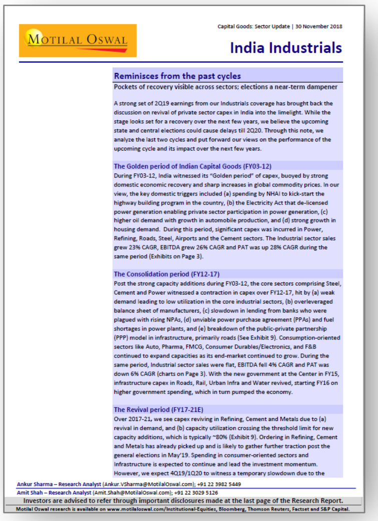
India Industrials


Capital Goods: Sector Update | 30 November 2018

India Industrials

Reminisces from the past cycles

Pockets of recovery visible across sectors; elections a near-term dampener

A strong set of 2Q19 earnings from our Industrials coverage has brought back the discussion on revival of private sector capex in India into the limelight. While the stage looks set for a recovery over the next few years, we believe the upcoming state and central elections could cause delays till 2Q20. Through this note, we analyze the last two cycles and put forward our views on the performance of the upcoming cycle and its impact over the next few years.

The Golden period of Indian Capital Goods (FY03-12)

During FY03-12, India witnessed its "Golden period" of capex, buoyed by strong domestic economic recovery and sharp increases in global commodity prices. In our view, the key domestic triggers included (a) spending by NHAI to kick-start the highway building program in the country, (b) the Electricity Act that de-licensed power generation enabling private sector participation in power generation, (c) higher oil demand with growth in automobile production, and (d) strong growth in housing demand. During this period, significant capex was incurred in Power, Refining, Roads, Steel, Airports and the Cement sectors. The Industrial sector sales grew 23% CAGR, EBITDA grew 26% CAGR and PAT was up 28% CAGR during the same period (Exhibits on Page 3).

The Consolidation period (FY12-17)

Post the strong capacity additions during FY03-12, the core sectors comprising Steel, Cement and Power witnessed a contraction in capex over FY12-17, hit by (a) weak demand leading to low utilization in the core industrial sectors, (b) overleveraged balance sheet of manufacturers, (c) slowdown in lending from banks who were plagued with rising NPAs, (d) unviable power purchase agreement (PPAs) and fuel shortages in power plants, and (e) breakdown of the public-private partnership (PPP) model in infrastructure, primarily roads (See Exhibit 9). Consumption-oriented sectors like Auto, Pharma, FMCG, Consumer Durables/Electronics, and F&B continued to expand capacities as its end-market continued to grow. During the same period, Industrial sector sales were flat, EBITDA fell 4% CAGR and PAT was down 6% CAGR (charts on Page 3). With the new government at the Center in FY15, infrastructure capex in Roads, Rail, Urban Infra and Water revived, starting FY16 on higher government spending, which in turn pumped the economy.

The Revival period (FY17-21E)

Over 2017-21, we see capex reviving in Refining, Cement and Metals due to (a) revival in demand, and (b) capacity utilization crossing the threshold limit for new capacity additions, which is typically ~80% (Exhibit 9). Ordering in Refining, Cement and Metals has already picked up and is likely to gather further traction post the general elections in May'19. Spending in consumer-oriented sectors and Infrastructure is expected to continue and lead the investment momentum. However, we expect 4Q19/1Q20 to witness a temporary slowdown due to the

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Identifying key themes for CY19

Capex recovery to gain momentum post general elections in May'19

As we step into the last month of CY18, we present the key themes that are likely to play out in the Industrials' space over next year. In this note, we list down our thoughts on CY19 and our preferred stock ideas.

CY19 a two-faced coin: Orders to slow in 1HCY19 and bunch up in 2HCY19

Orders are the lifeline for the Industrials' sector companies as these provide revenue visibility and have typically led the re-rating /de-rating of stock prices in the sector. While 1HFY19 witnessed preponement of orders due to the upcoming state and central elections, Q419/1HCY19 should witness a visible slowdown from both the government (as the government machinery gears up for the general elections) and the private sector (deferment of orders till after the elections). However, historically there is a bunching-up of orders in the quarters following elections; and in the case of 2HCY19, we don't believe it would be otherwise (See Exhibit 1). It is imperative that investors position their portfolios for the impending revival in orders in 2HCY19 while seeing through the transient slowdown in 1HCY19.

Finally, a revival of industrial/private sector capex

The much delayed and widely discussed revival in private capex is finally starting to materialize, in our view, and would gain further momentum after the general elections. While we have already seen a pick-up in consumption-oriented sectors (Auto, Pharma, Consumer Electronics, F&B), the recovery is set to get more broad-based with Refining, Cement and Steel also joining in ***(See our recent note: 'India Industrials: Reminisces from the past cycles; pockets of recovery evident').*** Moreover, we do expect momentum in the cycle to continue for the next few years as a pick-up in end-market demand drives higher capacity utilizations and resultant capex (Exhibit 2 and 3). Thermax, L&T, Cummins India and Engineers India are our key **BUY** ideas to play the industrial capex recovery.

Refocus on Construction and Defense as general elections get priced in

The past few quarters have seen a sharp de-rating in stocks, which have significant end-market exposure to Central government-related ordering, especially in Infrastructure and Defense (Exhibit 4 and Exhibit 5). Ordering for the Industrials' sector are typically back-ended and elections in May'19 has already led to the street worrying about order deferments and a slowdown in execution in Q4FY19/Q1FY20. Moreover, we have been sensing a general risk aversion by investors towards the aforementioned sectors pending clarity on the outcome of the general elections in May'19. In our view, as the Street factors in a favorable verdict for the ruling coalition implying continued momentum in spends for road, rail and defense, we expect a significant re-rating in stocks from the road and rail construction, and the defense sector. Our key picks are **KNR Constructions (BUY, TP: INR 280), Ashoka Buildcon (BUY, TP: INR175) and BEL (BUY, TP: INR105)**.

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Demand for cooling products (air conditioners and coolers) to revive on above normal summer temperatures

CY18 witnessed a weak summer season leading to high inventory levels with manufacturers of air coolers and air conditioners. YTD FY19 sales for both coolers and air conditioners have declined in high single-digit to low double-digit. This has led to pricing pressure and discounts hurting margins of manufacturers who are under pressure to clear inventory. Expectations of a revival are set with eyes on the CY19 summer season. Further, the IMD in its recent forecast (Nov'18) indicated a higher probability of an El Nino by Feb'19, implying a higher-than-normal summer temperature with increased chances of strong/severe heat waves. Key beneficiaries of an intense summer and resultant high demand for cooling products are air conditioner manufacturers (Voltas, Blue Star, Havells, Johnson Hitachi) and air cooler manufacturers (Symphony, Voltas, Bajaj Electricals).

Margins to bounce back for consumer durable/electrical players on price hikes, stronger INR and lower commodity prices

A weak summer season with resultant fall in volumes and prices, along with a decline in the INR and higher commodity costs led to a sharp fall in margins for consumer durable companies in 1H19 (See Exhibit 6). Additionally, lighting segment margins (primarily for Crompton Consumer) were impacted due to price cuts by competition. To offset this, price hikes have been implemented in Lighting products, Refrigerators and Washing Machines from Oct'18, and there are plans for price hikes in Air conditioners from Jan'19. Plus the INR appreciation and fall in commodity prices should further support margins. Crompton Consumer witnessed a sharp de-rating on the back of lower margins in its lighting segment (See Exhibit 7), and we expect a sharp re-rating once margins bounce back over the next few quarters.

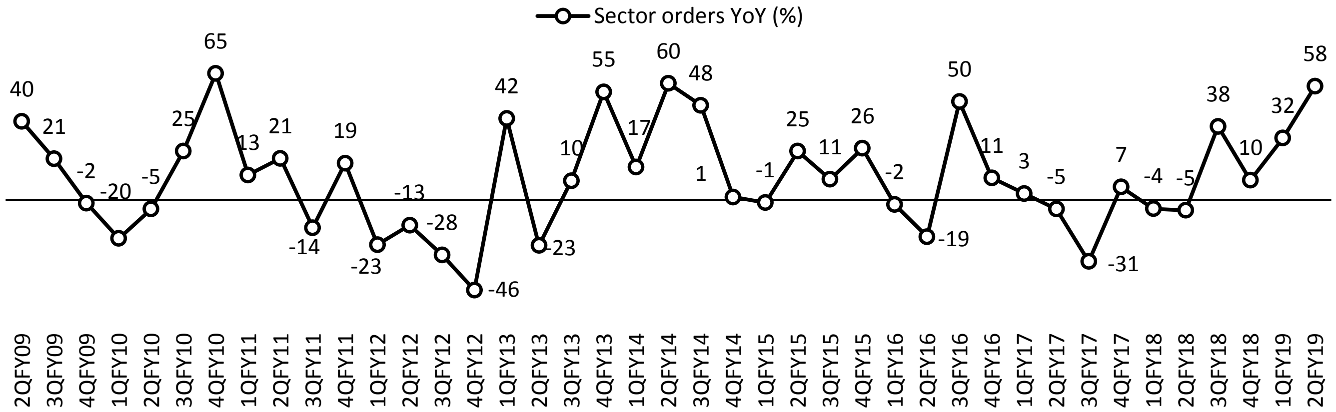
Spike in power demand prior to state and central elections belie a revival in power eqt demand

Given the upcoming state and central government elections over the next few quarters, we expect power demand to increase. Already current spot power prices are heading north due to ongoing state elections spread over Nov-Dec'18. As seen historically, power demand from state DISCOMS increase prior/during elections due to reduced load-shedding and power-cuts as the respective states head into elections which leads to higher spot power prices (See Exhibit 8). While the street may get excited on higher spot prices and higher plant-load factor (PLF) being a precursor for a revival in power equipment ordering, we remain circumspect currently as we believe it to be a temporary phenomenon until elections get over. We are structurally bearish on coal-fired power capacity addition over the medium-term, which drives our SELL call on BHEL (TP: INR60).

Industrials sector: Valuation and view

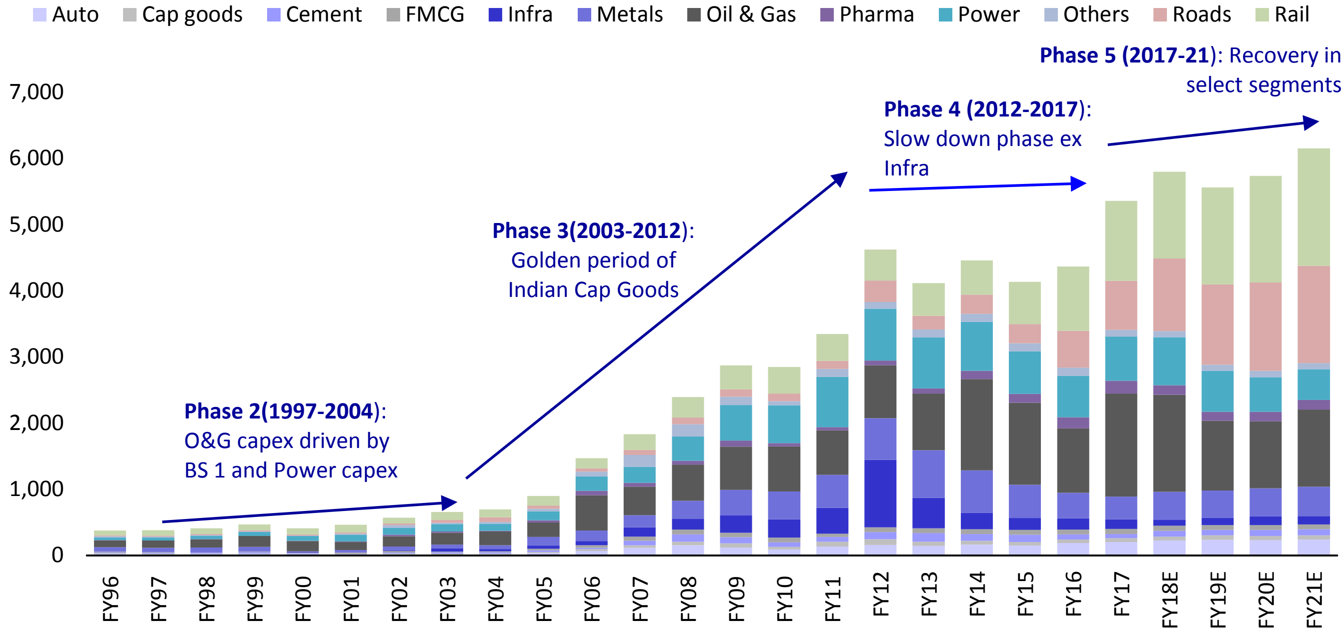
Our preferred plays in the Industrial sector are L&T (BUY, TP: INR1, 550), Bharat Electronics (BUY, TP: INR105), Cummins (BUY, TP: INR920), Thermax (BUY, INR1, 210), and Engineers India (BUY, INR150), driven by our view of capex revival in the Industrial and Infrastructure space over the next few years. Given our bearish view on new coal-fired capacity, we retain our SELL rating on BHEL (TP: INR60). We retain our BUY rating on Crompton Greaves Consumer (TP: INR250) as a margin recovery play over the next few quarters and our Neutral rating on Voltas (TP: INR510) and Blue Star (TP: INR620). Key risks to our ratings include (a) delayed recovery in corporate capex beyond 2HCY19, (b) an unfavorable outcome for the incumbent party in the upcoming general elections, and (c) sharp rise in commodity prices over the next few quarters.

Exhibit 1: Industrial sector orders see a dip prior/during general elections and recover in the quarters following the elections



Source: Company, MOSL

Exhibit 2: Industrial and Infra capex FY96-21E, Road & Rail key drivers over FY16-21E (b)



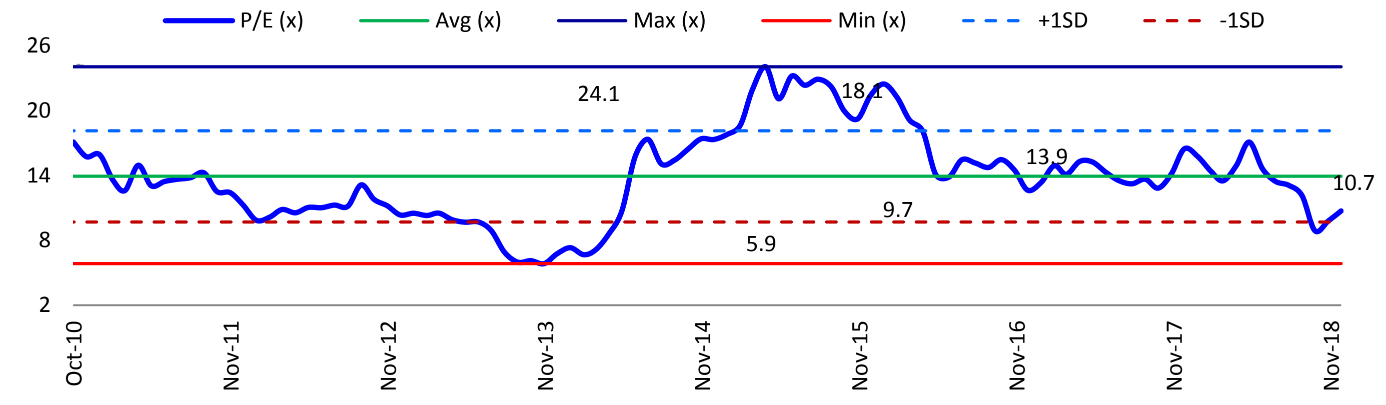
Source: Company, MOSL

Exhibit 3: Sector-wise capex growth FY97-21E; Steel, Cement, Refining drive the revival (%)

Sector	FY97-04	FY04-12	FY12-17	FY17-21E
Auto	**8**	**35**	**6**	**5**
Cap Goods	24	50	-8	3
Cement	**14**	**46**	**-7**	**9**
FMCG	16	25	2	-2
Infra	34	61	-30	0
TMT	16	50	21	-15
Metals	**7**	**38**	**-11**	**7**
Oil & Gas	11	25	19	-6
--Oil & Gas (Ex RIL and ONGC)	12	1	3	**8**
Pharma	19	30	24	-6
Power	**16**	**30**	**-3**	**-8**
Others	37	33	0	-2

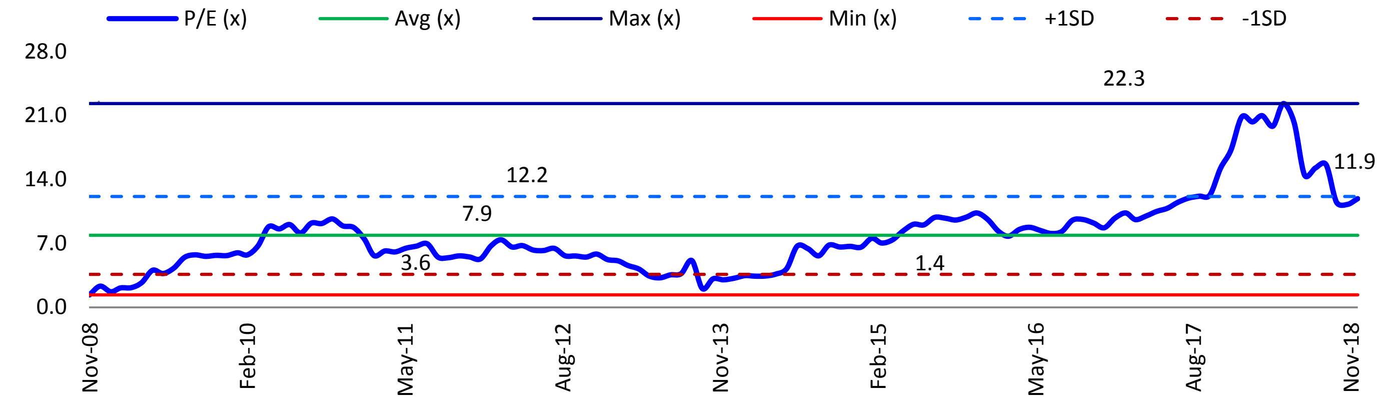
Source: Company, MOSL

Exhibit 4: ABL P/E multiple has come off its highs on concerns of a pick-up in execution of newly awarded projects and on weak new ordering



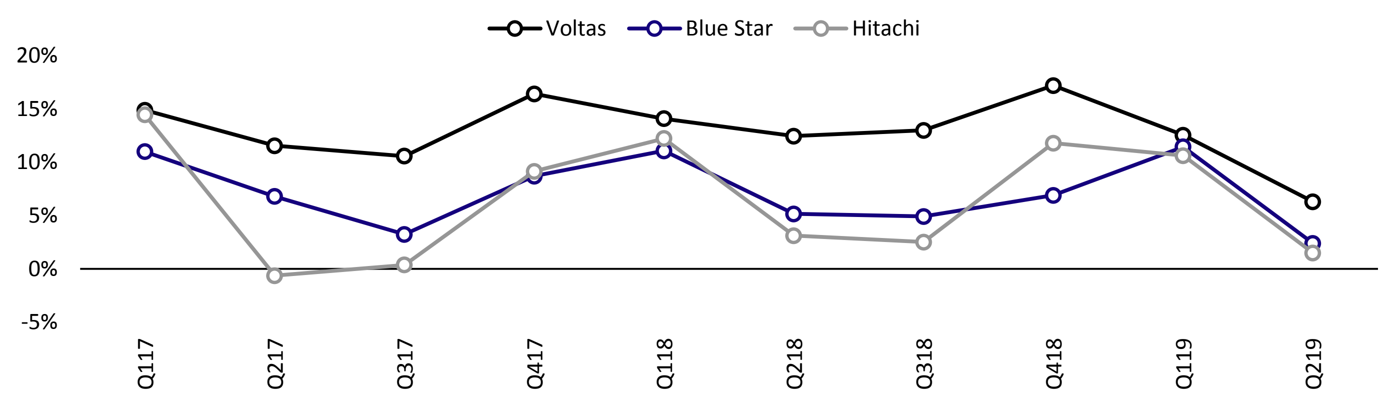
Source: Company, MOSL

Exhibit 5: KNR P/E multiple has come off its highs on concerns of a pick-up in execution of newly awarded projects and on weak new ordering



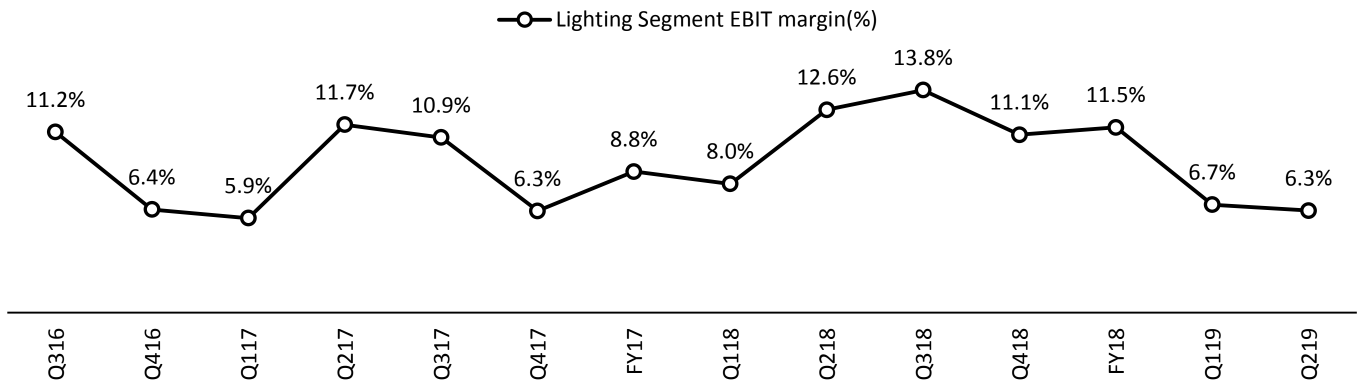
Source: Company, MOSL

Exhibit 6: Margins for air conditioner manufacturers dipped in 1H19 on a weak summer leading to high inventory and resultant discounts to clear inventory



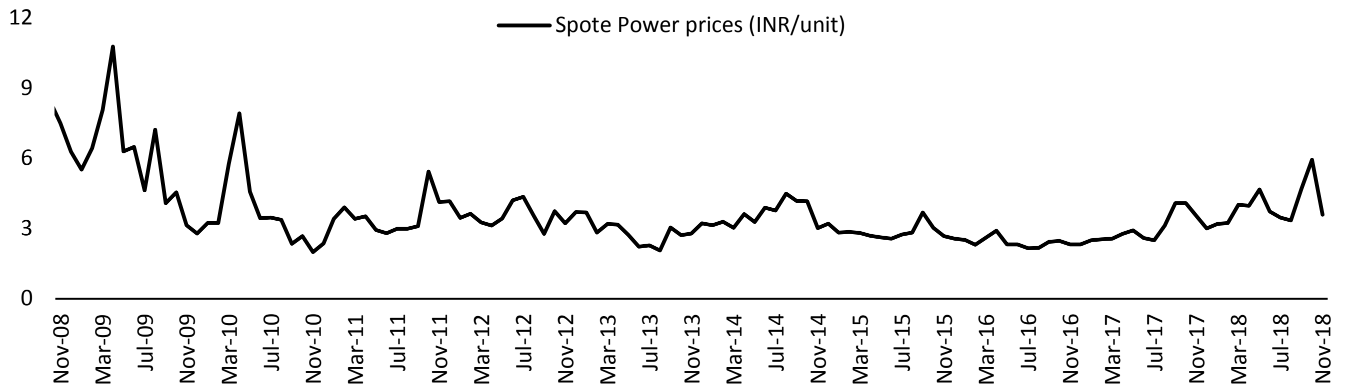
Source: Company, MOSL, ** UCP segment margin for Voltas and Blue Star

Exhibit 7: Crompton Consumer lighting segment margin dipped to 6.3% in 2Q19 v/s 12.6% in 2Q18 on pricing pressure



Source: Company, MOSL

Exhibit 8: Spot power prices typically spike prior/during elections on higher demand from power discoms



Source: Company, MOSL

Exhibit 9: Summary of recommendation

Company	Rating	CMP	EPS (INR)			P/E			EV/EBITDA			RoE (%)		
		INR	FY18	FY19E	FY20E	FY18	FY19E	FY20E	FY18	FY19E	FY20E	FY18	FY19E	FY20E
ABB#	Sell	1,381	19.8	25.6	32.5	69.7	54.0	42.4	23.6	17.9	13.4	11.6	13.5	15.3
GE T&D	Neutral	228	7.5	10.0	10.5	30.4	22.7	21.7	19.0	13.1	12.6	17.3	20.2	18.8
BHEL	Sell	67	2.2	3.2	4.0	30.7	20.9	17.0	7.0	6.6	6.1	2.5	3.6	4.4
Blue Star	Neutral	666	14.5	18.5	24.4	45.9	36.1	27.3	23.9	18.4	15.7	16.7	19.3	22.9
Crompton Consumer	Buy	220	5.2	6.0	7.4	42.6	37.0	29.6	26.9	23.4	19.6	48.7	42.2	42.3
Cummins	Buy	786	23.5	27.3	32.8	33.4	28.7	23.9	29.4	22.6	18.4	18.3	18.3	20.2
Engineers India	Buy	113	6.3	6.5	7.9	18.1	17.4	14.3	10.6	11.5	8.0	15.7	17.2	19.0
L&T	Buy	1,404	51.7	59.5	73.7	27.2	23.6	19.1	21.8	18.6	14.8	13.7	14.2	14.7
Siemens##	Neutral	919	19.8	25.1	29.1	46.5	36.6	31.6	27.2	22.1	18.6	9.1	10.8	11.5
Thermax	Buy	1,110	20.5	28.9	37.8	54.1	38.4	29.3	31.0	26.4	19.5	8.8	11.5	13.7
Havells	Buy	692	11.2	13.2	16.2	61.7	52.5	42.8	39.7	34.1	27.3	18.7	19.5	21.0
Voltas	Neutral	553	17.3	17.8	20.1	32.0	31.1	27.5	27.4	23.5	20.5	15.9	14.3	14.5
Bharat Electronics	Buy	83	5.7	6.4	7.0	14.4	12.9	11.8	9.7	7.9	7.1	18.0	17.9	17.6
KEC Internl.	Neutral	276	17.9	20.1	24.9	15.4	13.7	11.1	8.5	8.1	6.7	23.1	21.3	21.5
VA Tech Wabag	Neutral	260	24.1	28.0	33.4	10.8	9.3	7.8	6.4	4.4	3.8	12.4	12.0	13.9
Solar Industries	Neutral	1,023	24.4	28.3	36.4	42.0	36.2	28.1	23.4	19.8	15.4	21.9	21.6	23.2
# Y/E Dec.; ## Y/E Sep.														
Infrastructure Sector														
Ashoka Buildcon	Buy	126	-4.2	2.6	4.2	-29.7	49.1	29.5	7.2	6.3	5.3	-30.2	20.4	26.7
IRB	Neutral	145	23.9	22.5	20.9	6.1	6.4	6.9	5.5	5.9	6.5	14.6	12.3	10.4
KNR	Buy	198	19.4	14.3	16.9	10.2	13.9	11.7	7.6	7.1	5.9	26.5	16.0	16.2
Sadbhav	Buy	211	12.9	16.0	15.8	16.4	13.2	13.3	11.9	9.3	7.3	12.5	13.8	12.1

Source: Company, MOSL

Explanation of Investment Rating	
Investment Rating	**Expected return (over 12-month)**
BUY	>=15%
SELL	< - 10%
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