June 27, 2022

Frontloading of government capex…

Contrary to expectations that the government's move like cutting excise duty and increasing fertiliser subsidy would prompt curtailing capex spend, the government wants to frontload capex for FY23 and expects to spend 60% of the capex pegged for FY23 in H1 itself. To support the argument, in April 2023, the capex spend is up 67% with segments like railways and roads leading. Also, fresh investments announced in FY22 have almost gone up 2x to ₹ 19.3 lakh crore vs.₹ 10.8 lakh crore in FY20. Fruition of the above investments will lead to increased order flows for capital goods sector. Given private balance sheets are in fine shape now, their participation in capex is likely to inch upwards. From the above data point, share of private sector in fresh projects announcements has gone from 55% in FY20 to 68% in FY22.

Strong inflows, revenue visibility

All capital goods companies in aggregate have witnessed 64% YoY growth in order inflows coupled with a strong backlog. We believe a pick-up in execution can lead to 15-18% growth in revenues for FY23 and FY24. The order inflows are coming from diverse sectors like railways, road, power T&D, digital automation, renewable sector, cement, oil & gas, etc, which reduces the risk of concentration.

Correction in steel prices augurs well for margin recovery

Steel is a primary raw material for all companies whether EPC based or product based. Product based companies have been successful in passing on input price pressure in a significant way whereas EPC companies lagged in terms of passing on in FY22. However, with steel prices already softening, margins of EPC companies are also likely to recover from FY22 levels thereby aiding revenue growth.

B/s pristine for product based companies, decently managed for EPC companies, rates may not be significant dampener

Product companies will not get impacted by increase in interest rates given most product capital goods companies are debt free and cash rich. As far as EPC goes, working capital cycle has improved substantially over FY20-22. Most of them are at comfortable leverage but any rise in finance costs will get cushioned by operational growth. For instance, EPC company like Thermax is completely debt free while a behemoth like L&T (barring L&T finance) has miniscule debt on balance sheet.

Valuations reasonable, relative under-ownership = Outperformance

Most EPC companies given their growth prospects are trading at 12-16x on FY24 EPS while products based companies are trading northwards of 25-30x and relatively under owned, which may lead to rerating given the robust performance outlook, lean balance sheet and reasonable valuations. **Key top picks: L&T, Siemens, Timken, AIA, Ador Welding, Data and BEL.**

Sector View: Positive

Top Picks in Capital Goods Space

Company	CMP(₹)	Target Price(₹)	Upside(%)
L&T	1,537.0	1,920.0	25%
Siemens	2,350.0	2,900.0	23%
Timken	2,350.0	2,810.0	20%
BEL	239.0	290.0	21%
AIA Engg	2,212.0	2,570.0	16%
Ador Welding	648.0	890.0	37%
IEX	176.0	240.0	36%

Capital Goods stocks has been outperforming broader markets broadly on the back of

- Pickup in execution amid return to normalcy post Covid
- Good order book giving decent outlook for coming quarters
- Declining raw material prices giving cushion in EBITDA margins

Key risks to our call

- Elevated geopolitical crisis, high commodity prices
- Delay in order finalisation, awards impacting future visibility

Research Analysts

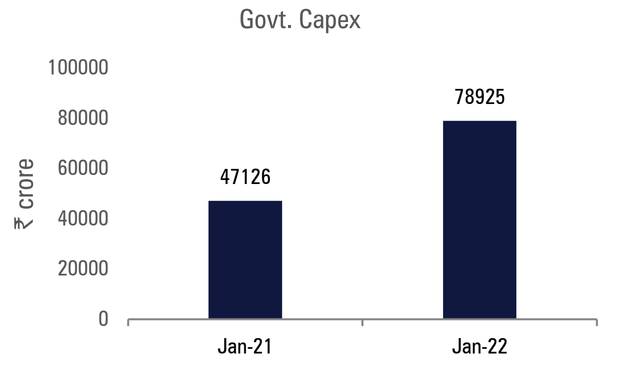
Chirag Shah
shah.chirag@icicisecurities.com

Vijay Goel
vijay.goel@icicisecurities.com

Ameya Mahurkar
ameya.mahurkar@icicisecurities.com

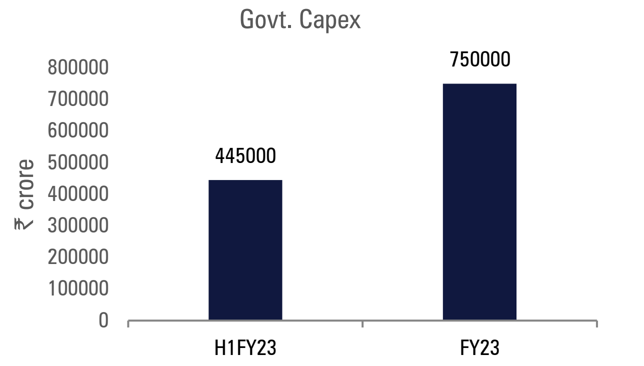
Yash Panwar
yash.panwar@icicisecurities.com

Exhibit 1: Government capex spend in April'21 vs. April'22



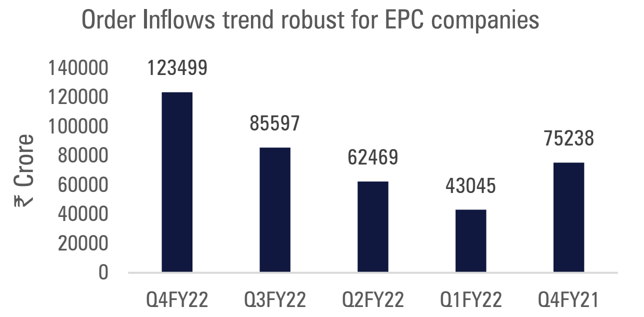
Source: Bloomberg, ICICI Direct Research

Exhibit 2: Capex distribution for FY23



Source: Bloomberg, ICICI Direct Research

Exhibit 3: Robust order inflows for EPC companies



Source: Bloomberg, ICICI Direct Research

In April 2022, the cumulative capital spending of all departments and ministries was ₹ 78,925 crore, up 67.5% YoY. Out of this, ₹ 58500 crore was spent by roads and railways sector (has highest allocation in budget). Share of private investments in the fresh projects has risen to 68% in FY22 from 55% in FY20. The same is reiterated by L&T where share of private clients is up to 19% in FY22 from 13% in FY21. Fresh projects investments have almost doubled from FY20 levels, with private share coming with a strong rebound. We believe, product based capital goods across segments like bearings, abrasives, welding's products, construction machinery are likely to benefit in terms of strong volumes, operating leverage and strong balance sheets

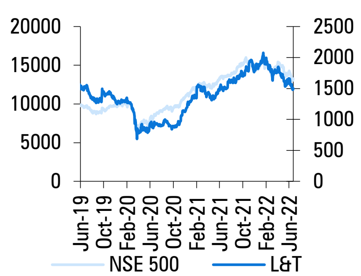
Top bets in Capital Goods Space

L&T

L&T's strong order book of ₹ 357600 crore suggest good revenue visibility in coming years. The company has come out with a five-year plan called "Lakshya 2026". In that L&T will focus on emerging portfolios like Green EPC, manufacturing electrolysers, battery & cell manufacturing, data centres and platforms (Sufin & Edutech). The company is targeting revenues and order inflow CAGR of 15% and 14%, respectively, over FY21-26 with a consolidated ROE of 18%. L&T has become more selective in choosing business opportunities coupled with a strong backlog gives convenience to the company to use discretion for winning relatively profitable orders, going forward.

Focus on asset monetisation to further strengthen the balance sheet and improve return ratios. The net working to capital ratio significantly improved from 23.2% in Q3FY22 and 22.2% in Q4FY21 to 19.9% in Q4FY22. The company has generated strong cash flow from operations in FY22 to the tune of ₹ 15000 crore. Also from a leverage perspective, standalone entity has very low debt while the debt for concessions portfolio is down by ₹ 2100 crore and standalone entity is down by ₹ 4300 crore in FY22. We have maintained our **BUY** rating and value L&T at ₹ 1920 on an SoTP basis.

Price Chart



Particulars

Particular	Amount
Market Capitalization	₹ 212542 Crore
Total Debt (FY22)	₹ 22808.7 Crore
Cash & Inv. (FY22)	₹ 3084.5 crore
EV	₹ 232266.2 Crore
52 week H/L	₹2079 / ₹ 1368
Equity capital	₹ 277.5 Crore
Face value	₹ 2

Exhibit 4: Financial summary for L&T

Particulars (₹ crore)	FY20*	FY21*	FY22*	5-Year CAGR (FY17-FY22)	FY23E	FY24E	2-Year CAGR (FY22-FY24E)
Net Sales	82,383.6	73,315.6	1,01,100.4	8.9%	1,12,698.8	1,28,539.2	12.8%
EBITDA	6,838.2	7,266.2	9,055.5	7.1%	10,628.1	12,250.2	16.3%
EBITDA Margin (%)	8.3	9.9	9.0		9.4	9.5	
Adj. Net Profit	6,679.3	5,414.6	7,879.5	10.7%	9,081.7	10,120.3	13.3%
Adj. EPS (₹)	48.1	39.0	56.1		65.5	72.9	
P/ E (x)	31.8	18.7	27.3		23.4	21.0	
RoNW (%)	12.9	18.8	12.2		12.9	13.2	
RoCE (%)	7.5	7.4	8.0		10.2	11.1	

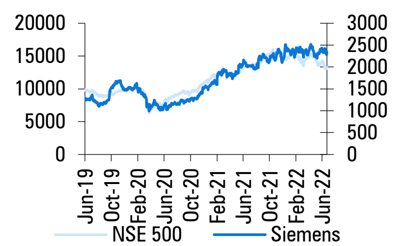
Source: Company, ICICI Direct Research

Siemens

It operates mainly in five key segments including energy/gas & power (34%), smart infrastructure (33%), digital industries (22%), mobility (7%). A 61% growth in order book with order backlog at an all-time high at ₹ 17174 crore is seen improving growth visibility, going ahead. Siemens has strong focus on technology leadership in digitisation and automation products to further strengthen its market share. Strong demand for short cycle products with clear traction from steel, cement, chemical, pharma, fertiliser industries to drive strong growth and margin expansion in smart infrastructure and digital industries segments. We expect revenue, EBITDA to grow at CAGR of ~15.3%, 19.7%, respectively, in FY21-23E owing to strong traction in short cycle products and services.

Overall, further penetration of automation & digitisation products and services across segments to drive long term growth. We remain long term positive on the stock. We have maintained our **BUY** rating and value Siemens at ₹ 2900 on an SoTP basis.

Price Chart



Particulars

Particular	Amount
Market Capitalization	₹ 84579 Crore
Total Debt (FY21)	₹ 3 Crore
Cash and Inv (FY21)	₹ 5159 Crore
EV (FY21)	₹ 79422 Crore
52 week H/L (₹)	2577 / 1920
Equity capital	₹ 71.2 Crore
Face value (₹)	2.0

Exhibit 5: Financial summary for Siemens

(₹ Crore)*	FY19	FY20	FY21	FY22E	FY23E	CAGR FY21-23E
Revenue (₹ crore)	13,083.9	9,946.5	13,639.2	15,621.8	18,124.9	15.3%
EBITDA (₹ crore)	1,526.1	1,003.6	1,518.5	1,718.4	2,175.0	19.7%
EBITDA margin (%)	11.7	10.1	11.1	11.0	12.0	
Net Profit (₹ crore)	1,135.6	769.5	1,050.1	1,305.1	1,715.4	27.8%
EPS (₹)	31.9	21.6	29.5	36.6	48.2	
P/E (x)	74.5	109.9	80.5	64.8	49.3	
Price / Book (x)	9.3	8.9	8.2	7.5	6.7	
EV/EBITDA (x)	52.1	78.6	52.3	45.9	35.9	
RoCE (%)	19.1	11.2	13.9	15.7	18.4	
RoE (%)	12.5	8.1	10.1	11.6	13.7	

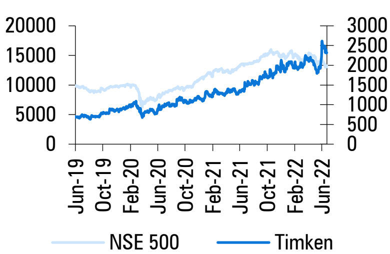
Source: Company, ICICI Direct Research

Timken

Timken India is into manufacturing, distribution and sale of antifriction bearings, primarily tapered roller bearings and cylindrical roller bearing. It is in the power transmission product brands and also offer products to defence, mining, aerospace, agriculture, rail, energy and automotive industry. It has a revenue breakup of 75% from domestic sales and 25% from export. Timken has a strong balance sheet coupled with decent growth prospects led by strong growth in railways, wind and exports. Announcement of 400 Vande Bharat train, 90,000 wagons in next three years will help Timken to utilise the railways segment capacity, which is hovering around 55-60%. Domestic market is also robust on the back of capex cycle, power, infra and mining looks brighter.

The company posted good EBITDA margins, mainly due to the fact that it has passed on the cost increase in raw material, improved product mix, capacity utilisation along with increased efficiency. Timken also has a strong balance sheet coupled with decent growth prospects led by strong growth in railways, wind and exports. We maintain our **BUY** rating and value Timken at ₹ 2810 i.e. 45x P/E on FY24E EPS.

Price Chart



Particulars

Particular	Amount
Market Capitalization (₹ crore)	18,203
Total Debt (FY21) (₹ crore)	33
Cash and Inv (FY21) (₹ crore)	129
EV (FY21) (₹ crore)	18,106
52 week H/L (₹) (BSE)	2156 / 1206
Equity capital (₹ crore)	75.2
Face value (₹)	10.0

Exhibit 6: Financial summary for Timken

(₹ Crore)	FY19	FY20	FY21	FY22	5 year CAGR (FY16-21)	FY23E	FY24E	3 year CAGR (FY21-24E)
Net Sales	1,664.4	1,617.8	1,410.5	2,203.2	6.1	2,609.2	3,013.3	28.8
EBITDA	288.6	363.3	251.8	510.6	9.2	613.2	708.1	41.2
EBITDA margin (%)	17.3	22.5	17.9	23.2		23.5	23.5	
Net Profit	148.6	246.1	143.2	327.1	9.3	412.0	469.8	48.6
EPS (₹)	19.8	32.7	19.0	43.5		54.8	62.5	
P/E (x)	122.5	74.0	127.1	55.7		44.2	38.7	
P/BV	13.6	11.5	13.5	11.0		11.0	11.0	
EV/EBITDA (x)	63.0	49.0	71.9	35.6		29.6	25.6	
RoCE (%)	15.7	18.6	13.7	25.3		32.3	36.9	
RoE (%)	11.1	15.6	10.7	19.7		24.9	28.4	

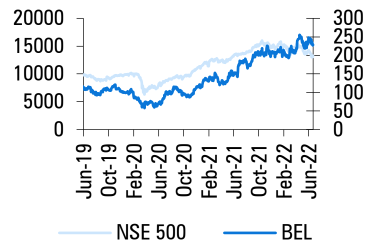
Source: Company, ICICI Direct Research

Bharat Electronics

Bharat Electronics (BEL) is a leading aerospace and defence electronics company. It primarily manufactures advance electronics products. The company's order book is at ₹ 57,570 crore as of March 2022 end after bagging contracts to the tune of ~₹ 19,200 crore in FY22.

BEL is well placed to benefit from the government's strong indigenisation push in the defence sector. The healthy order backlog at 3.7x FY22 revenues provide strong earnings visibility. Moreover, the company has a strong pipeline of orders and expects big ticket size orders in the coming period. The company's strategy to diversify into non-defence areas, focus on increasing exports and services share would further aid long term growth and help de-risk its business. We remain long term positive on BEL and retain **BUY** rating on the stock with a target price of ₹ 290 (24x P/E on FY24E EPS).

Price Chart



Particulars

Particular	Amount
Market Capitalization	₹ 57016 Crore
Total Debt (FY22)	₹ 72.1 Crore
Cash and Inv (FY22)	₹ 1239.4 crore
EV (FY22)	₹ 54009 Crore
52 week H/L (₹) (BSE)	260 / 141
Equity capital	₹ 243.7 Crore
Face value	₹ 1

Exhibit 7: Financial summary for BEL

(₹ crore)	FY20	FY21	FY22	5 Year CAGR (FY17-FY22)	FY23E	FY24E	2 year CAGR (FY22-24E)
Revenues	12,921	14,064	15,314	12.6%	18,138	20,903	16.8
EBITDA	2,730	3,181	3,309	13.4%	3,920	4,333	14.4
EBITDA margin (%)	21.1	22.6	21.6		21.6	20.7	
Net Profit	1,794	2,065	2,349	8.7%	2,684	2,960.7	12.3
EPS (₹)	7.4	8.5	9.6		11.0	12.2	
P/E (x)	31.8	27.6	24.3		21.2	19.3	
EV/EBITDA (x)	20.2	17.0	16.9		14.3	12.3	
RoCE (%)	25.1	27.2	26.2		27.9	27.9	
RoE (%)	18.2	19.1	19.6		20.9	20.9	

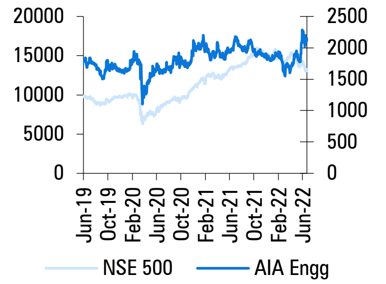
Source: Company, ICICI Direct Research

AIA Engineering

The company is the second largest hi-chrome producer in the world. New mining customer acquisition is expected to pick up as the travel situation has started to normalise and will allow AIA to gain incremental volume growth in coming years despite likely base volume impact due to anti-dumping in Canada, South Africa. The company is focusing on key geographies like Central America, Latin America, entire African region, Australia and CIS. AIA's mill lining capacity addition of 50000 MT is likely to be completed in June 2022. Post this expansion, total capacity will become 440000 TPA. Additional 30000-40000 tonnes extra volumes may come from this new capacity, going forward. The company has decided to go ahead with its brownfield capacity expansion of grinding media. It plans to add 80,000 MT of capacity at an estimated capex of ₹ 200 crore and commission it by the end of FY24. We expect revenue, EBITDA to grow at a CAGR of ~13.7%, 16.4%, respectively, in FY22-24E aided by sustained margins in range of 20-22%.

AIA's strong balance sheet, decent cash flows, efficient working capital management are expected to support long term growth. Working capital situation is quite stable, improving and likely to hover around 124-130 days in the medium term. We have maintained our **BUY** rating and value AIA at ₹ 2570 i.e. 30x P/E on FY24E EPS.

Price Chart



Particulars

Particular	Amount
Market Capitalization	₹ 21127.8 Crore
Total Debt (FY21)	₹ 2.8 Crore
Cash and Inv. (FY21)	₹ 1401.8 Crore
EV	₹ 17842.5 Crore
52 week H/L	₹ 2222/ 1475
Equity capital	₹ 18.9 Crore
Face value	₹ 2

Exhibit 8: Revised financial summary for AIA Engg

Particulars (₹ crore)	FY20	FY21	FY22	5 Year CAGR (FY16-FY21)	FY23E	FY24E	2 Year CAGR (FY22-FY24E)
Net Sales	2,980.9	2,881.5	3,566.5	6.5%	4,081.6	4,607.6	13.7%
EBITDA	680.3	655.3	720.9	1.5%	849.2	976.0	16.4%
EBITDA Margin (%)	22.8	22.7	20.2		20.8	21.2	
Net Profit	590.3	563.5	609.2	4.3%	719.9	808.1	15.2%
EPS (₹)	62.6	59.7	64.6		76.3	85.7	
P/ E (x)	35.8	34.1	31.6		26.7	23.8	
RoNW (%)	15.9	13.3	13.2		13.7	13.7	
RoCE (%)	18.7	16.4	16.5		17.2	17.1	

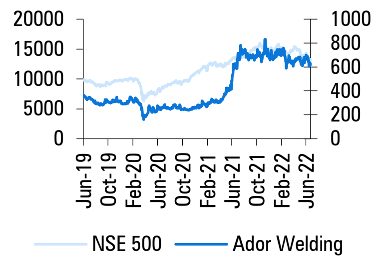
Source: Company, ICICI Direct Research

Ador Welding

Ador Welding (AWL) is a leading player in the welding consumables (~19% market share), welding equipment, automation and projects business. Welding consumables contributed ~81% of revenue in FY22. Better consumables volumes, rebound in equipment sales and projects business turnaround to drive growth, profitability. Recent merger with Ador Fontech will achieve Ador group's vision of becoming a market leader and consolidate market position. Ador is focusing more on exports business in the coming years and has set a target of 15-18% revenue coming from exports. Exports will be one of the growth drivers for the company. Also, it will focus on product mix, Make in India and upgradation of IT systems. We expect revenue CAGR of 13.5% in FY22-24E with margins rebounding to 11% levels.

Domestic welding & automation business to focus on improving margins and realisations with cost rationalisation, enhance advanced product portfolio, improving strike ratio of order wins and optimised product mix. We have maintained our **BUY** rating and value AWL at ₹ 890 i.e. 18x P/E on FY24E EPS.

Price Chart



Particulars

Particular	Amount
Market Capitalization	₹ 869 Crore
Total Debt (FY22)	₹ 1 Crore
Cash and Inv (FY22)	₹ 3 Crore
EV (FY22)	₹ 924 Crore
52 week H/L (₹)	880 / 535
Equity capital	₹ 13.6 Crore
Face value (₹)	10.0

Exhibit 9: Financial summary for Ador Welding

(₹ Crore)	FY20	FY21	FY22	5-Year CAGR (FY17-22)	FY23E	FY24E	2-year CAGR FY22-FY24E
Revenue (₹ crore)	526.5	447.7	661.5	8.4%	751.3	851.5	13.5%
EBITDA (₹ crore)	42.9	20.1	58.4	14.2%	70.6	92.0	25.5%
EBITDA margin (%)	8.2	4.5	8.8		9.4	10.8	
Net Profit (₹ crore)	28.8	(10.4)	45.2	15.2%	51.0	67.0	-
EPS (₹)	21.2	(7.6)	33.2		37.5	49.3	
P/E (x)	30.2	(83.7)	19.2		18.2	13.8	
Price / Book (x)	3.2	3.9	3.5		3.1	2.7	
EV/EBITDA (x)	22.1	47.3	15.8		13.0	9.9	
RoCE (%)	12.0	6.1	19.9		23.8	26.8	
RoE (%)	10.8	3.1	13.6		17.1	19.3	

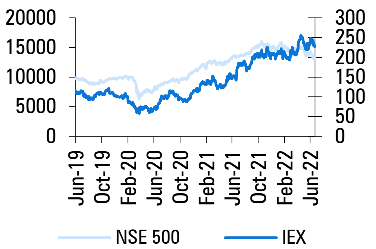
Source: Company, ICICI Direct Research

IEX

Indian Energy Exchange (IEX) is the premier electricity exchange in India, which facilitates trading of electricity. IEX commands a market share of ~95% in the power exchange market. The company has a debt free balance sheet with cash & investments to the tune of ~ ₹ 350 crore. Recently IEX has Introduced longer duration delivery bases contracts in power exchanges. Bhutan has also commenced trading in DAM and commencing of trade in hydropower contracts in GTAM. IEX will Launch of National Open Access Registry and Long duration contracts (up to 365 days) in the first half ofCY23.

For the past year, IEX has remained richly valued given its clean balance sheet, near monopoly and bright future prospects. We have maintained our **BUY** rating and value IEX at ₹ 240 i.e. 50x P/E on FY24E EPS.

Price Chart



Particulars

Particular	Amount
Market Capitalization	15,752
Total Debt (FY21) (₹ crore)	0
Cash and Inv (FY21) (₹ crore)	224
EV (FY21) (₹ crore)	15,527
52 week H/L (₹) (BSE)	318 /67
Equity capital (₹ crore)	89.5
Face value (₹)	1

Exhibit 1: Financial summary for IEX

	FY20	FY21	FY22	4 Year CAGR (FY 17-21)	FY23E	FY24E	3 Year CAGR (FY21-24E)
Revenue (₹ crore)	257.1	317.9	431.0	18.9	529.2	642.4	26.4
EBITDA (₹ crore)	202.2	250.6	363.7	21.3	429.1	521.6	27.7
EBITDA margin	78.6	78.9	84.4		81.1	81.2	
Net Profit (₹ crore)	175.7	205.4	308.6	34.0	363.8	482.2	32.9
EPS (₹)	2.0	2.3	3.4		4.0	4.8	
P/E (x)	121.7	104.1	69.5		58.8	44.4	
EV/EBITDA (x)	105.7	84.4	58.4		48.5	35.9	
RoCE (%)	55.8	50.6	56.1		65.8	77.4	
RoE (%)	45.3	39.0	43.9		49.3	58.0	

Source: Company, ICICI Direct Research

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Buy: >15%;
Hold: -5% to 15%;
Reduce: -5% to -15%;
Sell: <-15%

Pankaj Pandey Head – Research pankaj.pandey@icicisecurities.com

ICICI Direct Research Desk,
ICICI Securities Limited,
1st Floor, Akruti Trade Centre,
Road No 7, MIDC,
Andheri (East)
Mumbai – 400 093
research@icicidirect.com

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