INDIAN CAPITAL GOODS SECTOR

Sustained order inflow reflects expansion in domestic investment, translating into comfortable revenue visibility

MARCH 2024

Highlights

ICRA

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The order book expansion reached a multi-year high as of December 31, 2023, reflective of the momentum in capex outlays in the domestic sector, pick-up in investment activity in select export markets like MENA region and the US, as well as increased manufacturing outsourcing by the MNCs from India.

The strong order book position is likely to be maintained in the near term with private sector capex expected to pick up supported by Government capital outlay, capacity enhancement across sectors, investments towards decarbonisation, digitalisation and exports demand. This will translate into comfortable revenue visibility, going forward.

Investment outlays paced up in 9M FY2024 – While recovery in domestic capex across sectors was evident in FY2022, the momentum picked pace over FY2023-9M FY2024, with healthy order intakes for capital goods players. While the Government continued to remain the key driver, capital outlays from states, as well as private sector, at varied paces across industries, coupled with higher overseas orders, especially from the MENA region, aided expansion in order books.

Pick-up in orders from international market – Enhanced investment outlays in global markets, especially the US, Europe and the Middle East for infrastructure upgrade/ expansions, decarbonisation, electrification, digitalisation brought in order flows for some sectors like electrical equipment, turbines, cables, etc. Technology transfers, enabling capability building in the backdrop of cost competitive operations, and supply chain realignment, aided order flows for select multinationals.

Overall healthy order intake and comfortable order book position – The strong order intake momentum continued in 9M FY2024 for the OEMs, which in turn allowed the order book to expand at the highest levels in the last seven years, thus providing healthy revenue visibility with Order Backlog/Operating Income (OB/OI) ratio (OB/OI) of 1.00 times for the OEMs in ICRA's sample set as on December 31, 2023 (typical order tenure ~3-12 months). After very strong order intake in FY2023, the intake momentum tapered off to some extent in 9M FY2024 with focus on execution of existing orders. The same is expected to pick up again going forward. OB/OI remained healthy at 1.79 times for EPC companies (typical order tenure 12-24 months) in the sample set, providing healthy near-term revenue visibility.

Capital goods – OEMs – ICRA's sample set of OEMs reported healthy growth in revenue during 9M FY2024 (+18% YoY) driven by robust order inflow with strong execution and order books. Besides scale economies, softening of the commodity prices along with favourable product/ service mix with improved value addition, aided margin expansion. This improvement in profit margins, partially offset by higher interest costs, resulted in largely stable coverage indicators, which remained comfortable during FY2023-H1 FY2024. The working capital intensity of ICRA's sample of OEMs displayed a consistent improvement in the past six years.

Highlights

Higher revenue was witnessed for ICRA's sample set of OEMs in 9M FY2024, driven by healthy execution levels and margins improving to nearly 15% for this period on account of softening of commodity prices and favourable product mix.

Despite the abatement in supply-side challenges, the margin profile for ICRA's sample set of EPC players remained at 7.5-8.5%, with further recovery expected in H1 FY2025 characterised by longer execution cycle for these players leading to margin recovery with a lag.

Increased focus on diversification in product basket and geographies coupled with improved penetration in end-user industries has continued over the nine-month period in FY2024.

Capital goods - EPCs – Notwithstanding strong order inflows and execution, margin pressures and higher working capital intensity characterised the performance of ICRA's sample of EPC companies over FY2022-9M FY2024. The margin pressures have been gradually abating in a protracted manner and are expected to normalise to double digit pre-Covid levels during H2 FY2025. Over 9M FY2024, relatively higher operating profitability was offset by higher interest costs due to increase in debt with expanding scale of operations, as well as slightly higher interest rates. Consequently, coverage metrices remained largely stable, but the same were inferior relative to their OEM counterparts. With relatively longer execution cycles, these companies remain more vulnerable to time and cost overruns.

Supply-side challenges gradually abating – While the order books expanded appreciably over FY2022-9M FY2024, softening of commodity prices as well as logistics costs positively impacted the operating margins of capital goods OEM companies in FY2023-9M FY2024. However, margin recovery in capital goods EPC companies is expected to further play out over Q4 FY2024-H1 FY2025, given the majority contracts under execution being fixed price in nature, which restricts the ability to pass on price hikes to customers, especially amidst an atmosphere of increased competition. Some EPC players were adversely impacted by additional supply challenges in Q3 FY2024 due to the Red Sea crisis, impacting key shipping routes in the Middle East, and freight costs as well as shipment durations. The same is a key monitorable.

Technology transfers for localisation capability enhancement and diversification focus continues – Major players focus on higher value addition and localisation, improved penetration in end-user verticals and diversification of product basket and geographies to reduce lumpiness in revenues. Persistent efforts to scale after-sales services/ refurbishment revenues and operations and maintenance contracts (O&M) (predominantly OEMs) through organic and inorganic routes continue. Investments in capability-building and technology partnerships with global majors gained traction. Additionally, consolidation (including acquisition) to expand/ complement product basket/ end user/ geographies also continued over FY2023-9M FY2024.

Agenda

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1 Key Drivers of Capex

2 Capital Goods – Product OEMs

3 Capital Goods – EPC Companies

4 Power Generation and Transmission Sector – A key driver for order intake

5 Trend in commodity prices

6 Key Takeaways

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Thank You!