Capital goods cycle looks to be in early stages of revival

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The The capital goods industry is usually a laggard in the business cycle. By definition, a recession or downcycle results in surplus capacity.

Industries don't opt for capex (capital expenditure) until there's enough recovery to give some confidence about demand expansion.

Profit expansion in the last two years was largely due to cost cutting. It's only now that many corporates are seeing the possibility of top lines rising above pre-Covid levels after three muted financial years.

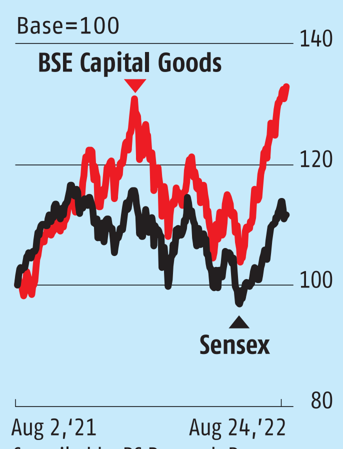
There are signs of renewed capex but it's early days. Many capital goods majors are highly-valued. However, in a cyclical industry, it is possible that earnings growth could outpace price rise, resulting in a situation where the PE ratio falls even though there's capital appreciation.

Gross fixed capital formation, which is closely correlated to investment, was running above 30 per cent of GDP in March 2022, versus 26 per cent in December 2019. This is the highest level since Q1 of 2019-20.

Q1 (April-June quarter) results and guidance backed up the macro data. Capital goods majors are reporting revenue and income gains accompanied by better operating margins. In addition, order books picked up. This was true for project-dependent companies as well as product based-companies and power sector players.

For example, L&T, Thermax, Triveni Turbine and Kalpataru Power Transmission saw strong order inflows. This was on the back of demand from infrastructure and power T&D.

Product-based companies registered revenue growth and margin improvement but some company managements cautioned about possible slowdown in Q2 (July-September quarter). They remained hopeful of better margins as raw material costs stabilised and dropped.



Compiled by BS Research Bureau

The consensus is, demand from mining, steel, cement, oil and gas is sustainable while there's new orders streaming in from mobility, data centres and defence, among others.

Infrastructure spending by the government has flattened out but private sector projects under implementation are up 9 per cent year-on-year (YoY) in 2021-22 after 2 per cent growth in 2020-21. This is the highest growth rate for private projects in the last decade. It is roughly two times that of 2019-20 (pre-Covid levels). Industrial credit expansion in banks has risen to 9 per cent YoY in Q1 of 2022-23. Many companies managed a fair amount of deleveraging over the past two financial years with aggregated net debt: Ebitda down to a decadal-low of 1.2x in 2021-22 for manufacturing companies. This makes capex expansion look more sustainable.

The sector still faces key challenges such as high inflation, supply chain disruptions and black-swan geopolitical risks. These could damage exports. Management guidance and results indicate that margins are improving for Siemens, L&T, Bharat Electronics (BEL) and ABB. These companies could see Ebitda growth of 20 per cent per annum for the current and next financial years. Order inflow is comfortably outrunning revenue growth at the moment, which implies guaranteed top-line growth. Across sectors, capacity utilisation has improved. In steel, it is up to 79 per cent (FY22) versus 67 per cent in FY21. Cement sector capacity utilisation is at 69 per cent and is expected to increase to 72-73 per cent.

In the auto sector, two-wheeler utilisation is low at 52 per cent. But passenger cars have seen it rise to 56 per cent in FY22 versus a historical low of 48 per cent in FY21. Capacity utilisation for both segments is expected to see double-digit gains over next two financial years.

It seems reasonable to speculate on the improvement being sustainable for the capital goods sector. We may be in the early stages of revival for the capital goods cycle.