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CAPITAL GOODS | Q3FY23 Review | 16 February 2023

Execution trends robust

- **Strong execution aided 18% YoY revenue growth for our capital goods coverage in Q3 (21% ex-LT) despite supply chain challenges**
- **Margins and pricing power showed resilience with aggregate gross/ EBITDA margin up 280bps/30bps YoY**
- **Q4 to be execution-heavy. Structural tailwinds from automation and digitalisation buoy sectoral outlook; we prefer LT, SIEM and AIAE**

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Execution momentum continues: Despite supply chain challenges, capital goods players under our coverage displayed impressive project execution in Q3FY23, clocking revenue growth of 18% YoY (21% ex-LT). Barring Hitachi Energy and KKC, most companies adeptly navigated the bottlenecks arising from chip and component shortages. Moreover, aggregate order inflow for our coverage has been robust, growing 13% YoY, and LT's intake at Rs 607bn surpassed expectations.

Margins resilient: Our capital goods universe has demonstrated resilience in the face of inflationary trends, indicative of pricing power and strategic product placement. Ex-EPC (engineering, procurement and construction) players, gross margin expanded by 280bps YoY in Q3. Though cost pressures appear to be abating, the issue of further supply chain constraints amid reopening in China has emerged as a fresh challenge, possibly exacerbating existing component shortages. This conundrum has been flagged by KKC, ABB and Hitachi. Aggregate EBITDA margin rose 30bps YoY, and the ex-EPC margin has swelled 450bps YoY.

Expect a strong Q4: We expect Q4FY23 to be an execution-heavy quarter with robust order flows. LT has guided for revenue and order inflow growth of 13-15% YoY which looks achievable. Contrary to earlier expectations of weakness, the sector has seen relatively healthy exports, particularly from KKC's perspective. In addition, semiconductor shortages are expected to ease, as per earnings commentary from global parent companies ABB and Honeywell.

Retain positive sector outlook: We maintain a positive outlook on the capital goods sector, buoyed by visibility from the government's capex-heavy budget and the likelihood of gradual margin improvement as supply bottlenecks ease. Moreover, we believe the sector is poised to benefit from structural demand tailwinds in the areas of automation, digitalisation and electrification, with product-based companies set to thrive in particular. Against this backdrop, we retain our bullish view on key players LT (BUY, TP Rs 2,440), SIEM (BUY, TP Rs 3,800) and AIAE (BUY, Rs 3,300).

Recommendation snapshot

Ticker	Price	Target	Rating
ABB IN	3,150	3,220	HOLD
AIAE IN	2,818	3,300	BUY
KECI IN	479	500	HOLD
KKC IN	1,629	1,600	HOLD
LT IN	2,175	2,440	BUY
POWERIND IN	2,990	3,500	BUY
SIEM IN	3,229	3,800	BUY
TMX IN	2,112	2,200	HOLD

Price & Target in Rupees | Price as of 15 Feb 2023

Capital Goods: Q3 result reviews

Company	Result review link
ABB IN	Q4 beat; retain HOLD on full valuations
AIAE IN	Stellar quarter despite challenging macro
KECI IN	Disappointing quarter – cut to HOLD
KKC IN	Robust quarter; positives in the price
LT IN	Revenue beat; commentary optimistic
POWERIND IN	Chip shortage takes a toll
SIEM IN	Stellar quarter
TMX IN	Scaling back on large project bids

Source: BOBCAPS Research

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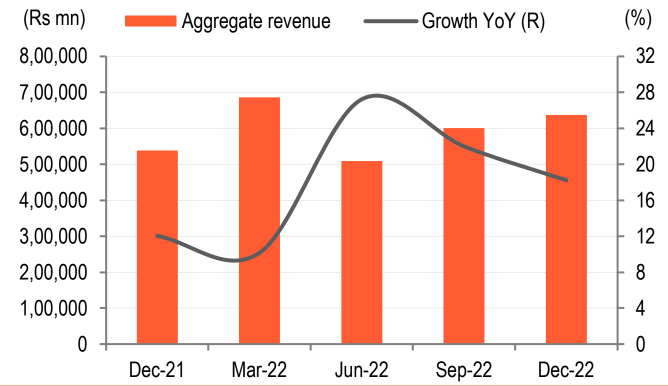
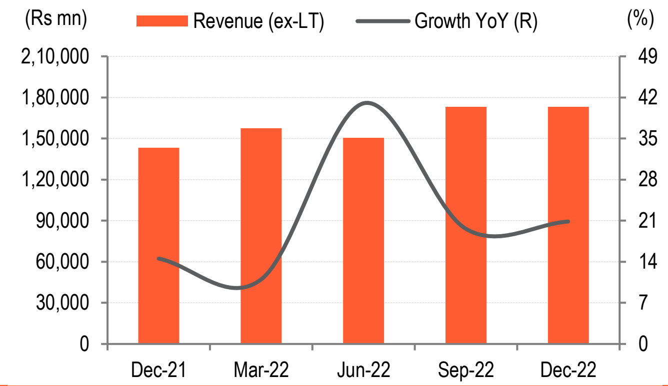
Focus charts

Fig 1 – Aggregate revenue trend



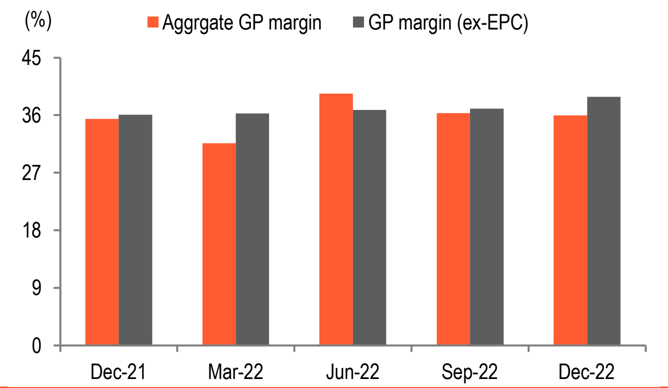
Source: Company, BOBCAPS Research

Fig 2 – Revenue (ex-LT) trend



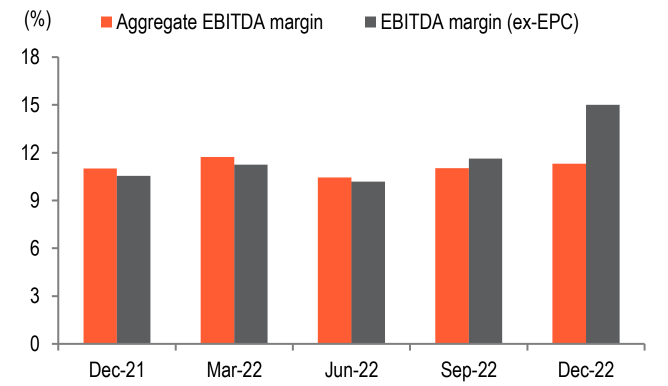
Source: Company, BOBCAPS Research

Fig 3 – Aggregate gross profit (GP) margin trend



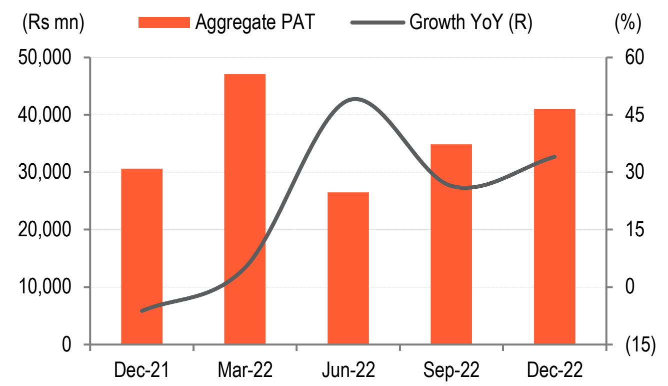
Source: Company, BOBCAPS Research

Fig 4 – Aggregate EBITDA margin trend



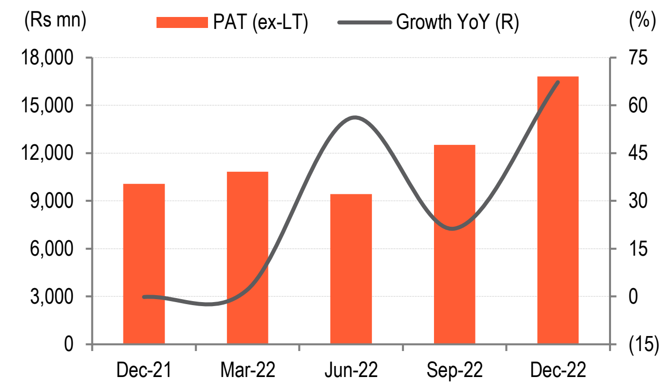
Source: Company, BOBCAPS Research

Fig 5 – Aggregate PAT trend



Source: Company, BOBCAPS Research

Fig 6 – PAT (ex-LT) trend



Source: Company, BOBCAPS Research

Q3FY23: Company-wise snapshot

- **LT:** During Q3FY23, LT reported strong order inflow of Rs 607bn. However, the core EBITDA margin outlook is soft, with guidance of 30-50bps compression to 8.8-9.0% in FY23. Management maintained its revenue and order inflow growth guidance of 13-15%. In a key positive, 32% of the inflow comes from private orders. Additionally, Hyderabad metro ridership has increased, and support is expected from the state. Improved working capital efficiency has also boosted Q3 ROE to 12.4%.

- **SIEM:** EBITDA margin expanded to 14.9% in Q3 aided by stronger profitability across businesses. Steady execution fueled a 13% YoY rise in revenue to Rs 40bn, with the smart infrastructure business growing 18% (to Rs 15.2bn) and digital industries growing 29% (to Rs 10.2bn). Additionally, C&S Electric turned a corner, posting an EBIT margin of 3.4% and EBIT of Rs 114mn for the quarter.

- **KKC:** Despite supply chain constraints, KKC managed to achieve 25% YoY revenue growth. The infrastructure segment, which was lagging previously, showed significant improvement, and exports continued to hold up. The company's EBITDA margin was robust at 18.9%, up 330bps YoY, thanks to healthy pricing power. Notably, sales to Europe, an area where management had previously expressed a cautious outlook, improved by 39% QoQ to reach Rs 970mn.

- **TMX:** TMX's pipeline of large projects (>Rs 8bn) has experienced a decline over the past two quarters, particularly in the petrochemicals sector. However, management expects to manage this shift over the course of the cycle by accepting smaller orders in the Rs 500mn-1bn range. The company's focus on small-ticket projects is expected to slow revenue growth, even as a weak margin outlook in the chemicals division and the likelihood of back-ended returns from new clean energy businesses underpin our cautious view on the company.

- **ABB:** Q4CY22 results were robust with a 16% YoY increase in revenue and buoyant margins backed by the motion and industrial automation businesses. Order inflows have now crossed Rs 100bn, and management is guiding for revenue of Rs 100bn, gross margin of 35-37%, and PAT margin of 10% in CY23.

- **AIAE:** EBITDA margin received a significant boost thanks to a better mix and some one-off gains, reaching 29.8% in Q3. Management views a level of 20-22% as sustainable going forward. Volume guidance for FY23 remains unchanged at 294-300k mt, with an additional 30-35k mt expected for FY24. The structural story also remains intact, given incremental conversion across the sector from forged media to high chrome mill internals (HCMI).

- **Hitachi Energy (POWERIND):** Growth has been hampered by supply chain constraints, resulting in an 8% YoY drop in Q3 revenue. The chip shortage also took a toll on EBITDA margin, which decreased 3ppt. Despite these challenges, management remains optimistic about a swift recovery as a majority of the orders have a variable clause. Additionally, there is a potential opportunity worth Rs 40bn-45bn for locomotive transformers, which could provide a significant boost.

- **KECI:** EBITDA margin remained muted at 4.6% for the second consecutive quarter in Q3. The standalone margin plummeted to a multi-year low of 4.7%, dealing a blow to net profit which shrank 81% YoY. Despite this setback, management remains optimistic about achieving over 20% revenue growth for FY23 along with order inflows of Rs 180bn-200bn. KECI also indicated that the challenges at SAE Brazil were gradually easing with closure of the last EPC (engineering, procurement and construction) project, which should facilitate gradual recovery next quarter on.

Fig 7 – Valuation matrix

Companies	Rating	Target	Upside (%)	Revenue (Rs bn)				EBITDA (Rs bn)			
				FY23E	FY24E	FY25E	CAGR (%)	FY23E	FY24E	FY25E	CAGR (%)
AIAE	BUY	3,300	17	48,584	51,725	50,180	1.6	12,181	11,777	11,710	(2.0)
TMX	HOLD	2,200	4	75,317	88,633	1,01,102	15.9	5,264	6,695	9,042	31.1
KKC	BUY	1,600	(2)	72,950	81,549	91,080	11.7	11,408	11,611	13,268	7.8
ABB*	HOLD	3,220	2	85,675	1,02,044	1,23,098	19.9	9,619	10,423	13,379	17.9
SIEM**	BUY	3,800	18	1,96,656	2,33,094	2,83,697	20.1	23,402	28,965	37,245	26.2
POWERIND	BUY	3,500	17	43,364	56,577	61,349	18.9	1,908	4,624	5,861	75.3
KECI	BUY	500	4	1,65,926	1,97,516	2,33,275	18.6	8,229	13,302	18,554	50.2
LT	BUY	2,440	12	17,52,555	21,38,981	23,67,795	16.2	1,96,691	2,55,255	2,93,677	22.2

Companies	EBITDA Margin (%)			PAT (Rs bn)				ROE (%)			PE (x)		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	CAGR (%)	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
AIAE	25.1	22.8	23.3	10,224	9,804	9,797	(2.1)	19.8	16.6	14.8	26.0	27.1	27.1
TMX	7.0	7.6	8.9	4,141	5,160	7,163	31.5	11.4	13.1	16.5	60.8	48.8	35.1
KKC	15.6	14.2	14.6	10,690	11,347	13,065	10.6	19.9	19.3	20.3	42.2	39.8	34.6
ABB*	11.2	10.2	10.9	6,864	8,267	10,513	23.8	15.3	15.6	17.3	97.3	80.7	63.5
SIEM**	11.9	12.4	13.1	17,228	21,853	28,619	28.9	14.1	16.1	18.6	66.7	52.6	40.2
POWERIND	4.4	8.2	9.6	605	2,574	3,490	140.3	5.2	19.8	22.0	209.6	49.2	36.3
KECI	5.0	6.7	8.0	1,503	5,450	9,409	150.2	4.1	14.0	20.9	81.9	22.6	13.1
LT	11.2	11.9	12.4	1,00,705	1,42,114	1,68,290	29.3	11.7	15.0	16.0	30.3	21.5	18.1

Source: Company, BOBCAPS Research | *CY22E, CY23E, CY24E; **SY22, SY23, SY24

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Recommendation scale: Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

HOLD – Expected return from -6% to +15%

SELL – Expected return <-6%

Note: Recommendation structure changed with effect from 21 June 2021

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