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FIRST LIGHT

03 June 2023

RESEARCH

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CAPITAL GOODS | Q4FY23 REVIEW

Strong end to FY23; outlook robust

SUMMARY

INDIA ECONOMICS: COMMERCIAL PAPER

Commercial Paper (CP) issuances have carved an important space historically and remained a preferred choice for better rated corporates for raising capital in a cost effective way from the market. Further, flexibility in terms of adjusting the maturity of instruments to match expected cash inflows and buyback options, have put them at an advantage at times. Notably, in all these years (except FY18, which is a period of partial rising rate cycle), falling interest rate regime have given a cost advantage for borrowing through this route.

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INDIA ECONOMICS: CURRENCY OUTLOOK

INR depreciated in May'23 amidst renewed dollar strength. Safe-haven demand brought on by uncertainty over US debt ceiling buoyed the dollar. However, with the finalization and subsequent approval of the debt-deal market sentiments have settled down. Further denting the dollar's rise were dovish comments from Fed officials which hinted at a pause in Jun'23 meeting. As a result, INR has appreciated by 0.4% as DXY retreated. We believe that range-bound oil prices, FPI inflows as well as lower trade deficit will continue to support INR in the near-term, and any pressure on INR will be only short-lived. Furthermore, RBI has shored up enough forex reserves since the start of the year to help it manage any excess volatility in the exchange rate, if the need shall arise.

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Daily macro indicators

Ticker	30-May	31-May	Chg (%)
US 10Y yield (%)	3.69	3.64	(4bps)
India 10Y yield (%)	7.01	6.99	(2bps)
USD/INR	82.72	82.73	0.0
Brent Crude (US$/bbl)	73.5	72.7	(1.2)
Dow	33,043	32,908	(0.4)
Hang Seng	18,596	18,234	(1.9)
Sensex	62,969	62,622	(0.6)
India FII (US$ mn)	**29-May**	**30-May**	**Chg ($ mn)**
FII-D	(43.7)	78.4	122.1
FII-E	277.5	295.1	17.6

Source: Bank of Baroda Economics Research

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INDIA ECONOMICS: BONDS WRAP

UK and US 10Y yields' noticed quite a sharp upturn in May'23. In UK, more than expected public borrowing, favourable growth indicators and inflationary concerns resulted in inching up of its yield. In the US, higher than expected PCE index, tighter labour market conditions and uncertainty surrounding US debt limit deal, kept yields elevated. Now with the passage of the deal in the House, some comfort on global yields might be visible. India's 10Y yield on the other hand was comforted due to softening of headline CPI print and comfortable liquidity conditions. RBI's announcement of withdrawal of 2000 rupee notes also raised hopes of a favourable durable liquidity number in the near term. Post the announcement (19 May'23), reserve money balances have fallen and bank deposits increased.

Click here for the full report.

CAPITAL GOODS: Q4FY23 REVIEW

- Strong execution aided 14% YoY revenue growth for our capital goods coverage in Q4FY23 (25% ex-LT); gross and EBITDA margins robust
- FY24 outlook upbeat with structural tailwinds from the rail and power sectors given a focus on automation and digitalisation
- We continue to prefer LT, KKC, Hitachi and AIAE

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COMMERCIAL PAPER

01 June 2023

How funding through CPs have evolved?

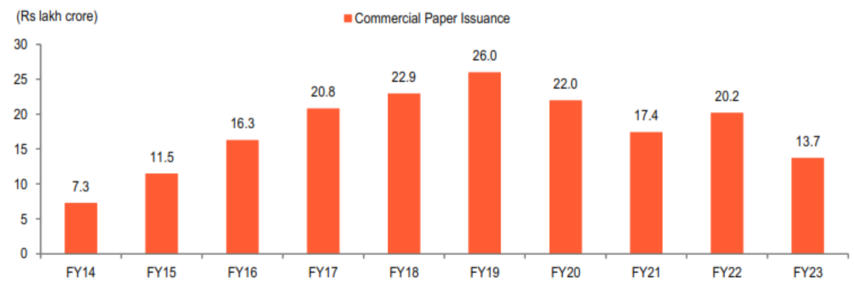
Dipanwita Mazumdar
Economist

Commercial Paper (CP) issuances have carved an important space historically and remained a preferred choice for better rated corporates for raising capital in a cost effective way from the market. Further, flexibility in terms of adjusting the maturity of instruments to match expected cash inflows and buyback options, have put them at an advantage at times. Notably, in all these years (except FY18, which is a period of partial rising rate cycle), falling interest rate regime have given a cost advantage for borrowing through this route.

The peak of CP issuances occurred in FY19, supported by stronger appetite from non-financial corporations for working capital needs (RBI Monetary Policy Report – October 2018) and also supported by easy liquidity conditions especially in H2 of the same year (~on an average Rs 84,300 crore).

The moderation in issuances in FY20 and FY21 despite a favourable interest rate regime can be attributed to the Covid-19 induced slowdown. In FY23, RBI's cumulative hike of 250bps in the current cycle had led to fall in issuances, on account of higher borrowing cost. From Rs 20.2 lakh crore, issuances fell to Rs 13.7 lakh crore in FY23. In Apr'23 and May'23 (till 26 May 2023), issuances amount to Rs 1.11 lakh crore and Rs 1.04 lakh crore respectively.

Figure 1: Commercial Paper Issuances have moderated in FY23



Source: CMIE, Bank of Baroda Research, Note: Only issuances in the primary market are accounted for as this comprises of around 77% of overall issuances

On an outstanding basis, CPs amounted to Rs 3.5 lakh crore in FY23, almost at the same level as seen in FY22. This is on account of rollover of CPs i.e. replacing one CP with another. The outstanding amount does not match with the issuance amount as many of the CPs are redeemed during the period. Comparing the outstanding CPs amount with overall outstanding bank credit, clearly shows that in years where bank credit growth has slowed down, there has been a preference for CPs. In quantum, of course the two sources of funds are not comparable. Years such as FY15, FY17 and FY21 reflect the same. Ratio of outstanding CP to the total sources of fund have gained momentum since FY14-FY19 (normal growth years without any shock). However, in FY23, the ratio dropped on account of higher interest rate regime and normalization in liquidity conditions of the economy.

CURRENCY OUTLOOK

01 June 2023

Pressure on INR to be short-lived

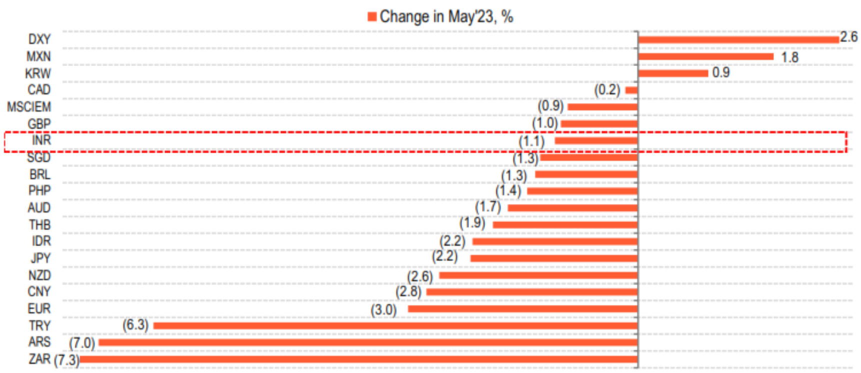
Aditi Gupta
Economist

INR depreciated in May'23 amidst renewed dollar strength. Safe-haven demand brought on by uncertainty over US debt ceiling buoyed the dollar. However, with the finalization and subsequent approval of the debt-deal market sentiments have settled down. Further denting the dollar's rise were dovish comments from Fed officials which hinted at a pause in Jun'23 meeting. As a result, INR has appreciated by 0.4% as DXY retreated. We believe that range-bound oil prices, FPI inflows as well as lower trade deficit will continue to support INR in the near-term, and any pressure on INR will be only short-lived. Furthermore, RBI has shored up enough forex reserves since the start of the year to help it manage any excess volatility in the exchange rate, if the need shall arise.

Movement in global currencies in May'23

Global currencies once again came under pressure amidst a risk-off sentiment brought about by uncertainty over US debt ceiling and the possibility of a debt default by the US. Investors flocked to the safety of the dollar leading to a 2.6% increase in the dollar index (DXY). Against this backdrop, robust macro data from the US along with mixed signals from Fed officials led to hopes that the Fed may hike rates again in Jun'23. Most global currencies dropped, with EM currencies such as South African Rand (ZAR) and Argentinean Peso (ARS) declining by more than 7% in May'23 alone. Even EUR declined by 3% as weakness in some of the major economies in the region such as Germany, weighed on the currency. JPY too depreciated by 2.2% amidst widening policy divergence between Fed and BOJ. The weakness in JPY prompted the government to step in and caution markets that it would take necessary action to stem the decline in the exchange rate. In China, macro data showed that while inflation has slowed down, economic momentum post the removal of Covid-19 restrictions has fizzled out. CNY slipped and fell below the 7/$ mark, for the first time since Dec'22.

Figure 1: Pressure on global currencies



Source: Bloomberg, Bank of Baroda Research | Note: Data as of 31 May 2023 | Figures in bracket denote depreciation against the dollar

BONDS WRAP

01 June 2023

Fortnightly review

Dipanwita Mazumdar
Economist

UK and US 10Y yields' noticed quite a sharp upturn in May'23. In UK, more than expected public borrowing, favourable growth indicators and inflationary concerns resulted in inching up of its yield. In the US, higher than expected PCE index, tighter labour market conditions and uncertainty surrounding US debt limit deal, kept yields elevated. Now with the passage of the deal in the House, some comfort on global yields might be visible. India's 10Y yield on the other hand was comforted due to softening of headline CPI print and comfortable liquidity conditions. RBI's announcement of withdrawal of 2000 rupee notes also raised hopes of a favourable durable liquidity number in the near term. Post the announcement (19 May'23), reserve money balances have fallen and bank deposits increased.

Our analysis suggests that If 50% of the total INR 2000 notes (Rs 3.62 lakh crore) are deposited then we can expect bank deposits to go up by Rs 1.8 lakh crore. This will further put downward pressure on yields in the near term. We expect India's 10Y yield to remain in the range of 6.95-7.05% in the current month. Any cautionary call by RBI against inflation can however result in some volatility.

Global yield: UK's 10Y yield noticed sharp uptick

- Sovereign 10Y yield in UK and US firmed up sharply on MoM basis in May'23. For UK, better than expected industrial production, modest improvement in consumer confidence, higher than expected CPI reading and pickup in BRC shop price index; all pointed towards firming up of growth and inflation numbers. This was reflected in inching up of its yield by 46bps.

- In the US, inflationary concerns remain elevated with core PCE QoQ as well as the PCE deflator remaining stickier than anticipated. Even labour market conditions remained tighter with JOLTS job opening firming up. Other than this, uncertainty over US debt limit deal also kept its 10Y yield elevated, which rose by 22bps. However, with the passage of the deal in the House and the next lies with the Senate; post that we can expect some moderation in yields, on account of higher supply of securities.

- On Fed fund rate, market is in a fix with 57.6% probability for a pause and 42.4% probability for a rate hike of 25bps. Even mixed macros of the US (retail sales excluding auto and gas and new home sales pointing to revival, whereas flash manufacturing PMI and consumer confidence remained disappointing), also enumerate bit of confusion. The commentary of Fed officials also gave conflicting signals with Minneapolis Fed President and St. Louis Fed President signaling more rate hikes, while Fed Governor Phillip Jefferson and Philadelphia Fed President speaking of pause.

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CAPITAL GOODS | Q4FY23 Review | 01 June 2023

Strong end to FY23; outlook robust

- **Strong execution aided 14% YoY revenue growth for our capital goods coverage in Q4FY23 (25% ex-LT); gross and EBITDA margins robust**
- **FY24 outlook upbeat with structural tailwinds from the rail and power sectors given a focus on automation and digitalisation**
- **We continue to prefer LT, KKC, Hitachi and AIAE**

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Growth momentum continues: Capital goods players under our coverage displayed impressive project execution in Q4FY23, which underpinned revenue growth of 14% YoY (25% ex-LT). Aggregate order inflow was robust, growing 36% YoY. LT's intake stood out at Rs 761bn.

Margins resilient: Our capital goods universe has demonstrated operating leverage on the back of improved project execution. Ex-EPC (engineering, procurement, and construction) players, gross margin expanded by 83bps YoY in Q4. Aggregate EBITDA margin was flat YoY while the ex-EPC margin increased 180bps YoY.

Supply chain constraints easing: Companies such as Hitachi Energy (Hitachi) and KKC, which had complained of supply shortages earlier, navigated the bottlenecks better in Q4 and delivered sequential margin improvement. KKC expects the supply shortages, especially for chips, to end next year, whereas Hitachi was more sanguine, indicating an easing in H2FY24.

Expect a strong FY24: We expect a strong year ahead with robust order flows. LT has guided for revenue and order inflow growth of 12-15% YoY and 10-12% YoY respectively for FY24 despite being the run-up to election year. Contrary to expectations, exports are performing well, particularly from KKC's perspective. Also, supply constraints are likely to moderate, as per earnings commentary from Hitachi and KKC as well as global players such as Siemens.

Retain positive sector outlook: The capital goods sector has strong growth visibility considering the government's capex thrust, with scope for gradual margin improvement as supply bottlenecks ease. We anticipate structural demand tailwinds in the areas of automation, digitalisation and electrification, and retain our bullish view on key players LT (BUY, TP Rs 2,630), KKC (BUY, TP Rs 2,000), Hitachi (BUY, TP Rs 4,400) and AIAE (BUY, Rs 3,500).

Recommendation snapshot

Ticker	Price	Target	Rating
ABB IN	4,126	3,700	HOLD
AIAE IN	3,065	3,500	BUY
KECI IN	523	500	HOLD
KKC IN	1,760	2,000	BUY
LT IN	2,206	2,630	BUY
POWERIND IN	3,846	4,400	BUY
SIEM IN	3,552	3,700	HOLD
TMX IN	2,335	2,400	HOLD

Price & Target in Rupees | Price as of 31 May 2023

Capital Goods: Q4 result reviews

Company	Result review link
ABB IN	Strong showing but priced in
AIAE IN	Robust performance
KECI IN	Standalone margin remains weak
KKC IN	From strength to strength; upgrade to BUY
LT IN	Strong finish; robust outlook for FY24
POWERIND IN	Improving outlook
SIEM IN	Strong momentum continues
TMX IN	Cautious outlook continues

Source: BOBCAPS Research

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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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