# India Capital Goods Sector

## Mid cap conversations

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- Over the past week, we have spoken with 10 mid caps in the capital goods sector to gauge trends in the order outlook and for reality check post recent market optimism. Corporates are of the view that although some slow-moving orders have restarted and order enquiries are better than lows in October 2008; the changes are not dramatic.
- Most expect: 1) order inflows to improve only from 2H FY10, 2) the recovery to be driven by strength in the infra and power sectors, 3) the industrial sector to be the last to recover, 4) margins to be flat/down YoY, and 5) YoY earnings growth to improve from 2H FY10.
- The sector has already seen a sharp rerating (23x Fwd P/E vs. 11x in October 2008, Fig. 1) and although consensus earnings revisions for FY10 may have troughed (Fig. 2) for the rally to sustain, earnings upgrades have to commence, in our view. The scope for FY10E earnings revisions may be limited but an order uptick in 2H could potentially trigger upgrades for FY11/12E later in the year.
- A slower pace of reforms or order activity in 2H could set the stage for a medium-term correction, giving an opportunity to rebuild positions. However, with large caps hitting a valuation ceiling, we expect interest in mid caps to continue.

### Order outlook for the power sector

While the order outlook for the power sector, especially that driven by government utility spend, has already been quite strong, BGR Energy (BGRL IN, Rs371, Not rated) highlighted that order activity from state utilities and NTPC (NTPC.BO, Rs222, N, TP Rs206) could accelerate post elections. On the T&D front, Areva T&D (ATD IN, Rs361, Not rated) pointed at continued weakness in private sector orders this year and near term, and orders for 765KV substations from PGCIL (PWGR IN, Rs125, Not rated) will likely be slow (only four of 14 substations yet to be awarded). However, KEC International (KECI IN, Rs425, Not rated) was optimistic of continued strength in T&D ordering for the rest of the year. In our view, order activity in the power sector was quite strong last year and the only positive this year could be a higher pace of activity from the private sector utilities, who find it easier to raise funds and complete financial closures of the projects.

### Order outlook for the infrastructure sector

For the infrastructure sector, there is an expectation that foreign fund inflows and measures by the government (e.g. divestment of PSUs) will increase funding sources and should help increase the pace of order activity. Corporates highlighted several positives: 1) likely return of strength in road projects that have witnessed a slower pace of bidding over the past year, 2) strength in railway capex (freight corridors and station modernisation projects), 3) an improvement in the activity of tier-2 airport development, and 4) ports.

### Order outlook for the industrial sector

The near-term outlook for industrial capex is not encouraging with companies, such as Elecon Engineering (ELCN IN, Not rated), highlighting continued weakness this year. One corporate, however, highlighted that its checks suggest some cash rich cement/steel companies were making blueprints for new projects, while some others pointed to strength in orders from the hydrocarbon segment (ONGC) with ~US$4-5 bn of bids outstanding. L&T expects to get orders from the fertiliser segment (oil to gas-based conversions). However, most of them echoed the view that the sector could be the last one to recover and will likely witness improved activity only from FY11 assuming macro remains strong for a sustained period.

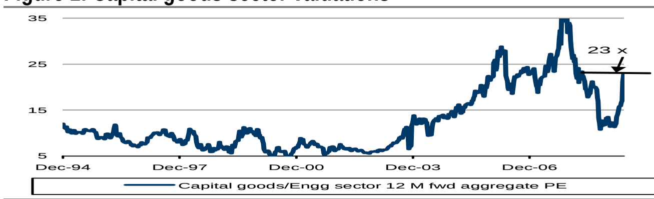
### Outlook for alternative energy

Elecon Engineering and Shriram EPC (SEPC IN, Not rated) both highlighted that domestic demand for wind turbines has still not improved. While several clients pushed out delivery schedules last year, sales of second-hand wind installations have started. Shriram EPC, however, highlighted that demand in Europe could be strong this year. For biofuels, Praj's (PRJ IN,Not rated) management highlighted that demand in geographies like the US is still challenging because of oversupply as well as corn ethanol dynamics which are still unfavourable. Domestic demand is constrained by lower availability of molasses.

### Post the rally, sector valuations appear rich

Post the recent rally, sector valuations have expanded sharply (23x fwd P/E from 11x in October 2008). With expectations being high, a slower-than-expected pace of reforms or order intensity could lead to a correction in valuations, giving an opportunity to rebuild positions.

**Figure 1: Capital goods sector valuations**

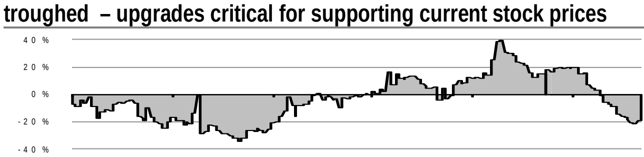



Source: Datastream.

### Earnings upgrades critical for sustenance of rally

Consensus earnings estimates have been revised down significantly over the past year (Fig 2). While the first leg of the rally was driven by an expansion in valuations on the hope that earnings would recover, it would be critical for the sector to witness earnings estimate upgrades to support current stock prices and also to set the stage for a further expansion in valuations. While earnings revisions for FY10 may have troughed, upgrades have not yet commenced, and given the project nature of the business, it appears unlikely that there would be significant earnings upgrades for FY10. However, we expect a recovery in order inflows in 2H to trigger upgrades for FY11 and FY12.

**Figure 2: One-year forward earnings revision momentum may have troughed – upgrades critical for supporting current stock prices**




Source: I/B/E/S.

**Companies Mentioned** *(Price as of 03 Jun 09)*
Larsen & Toubro (LART.BO, Rs1402.20, OUTPERFORM [V], TP Rs1258.80)
Power Grid (PWGR IN, 125, NOT RATED)
Areva T&D (ATD IN, 361, NOT RATED)
KEC international (KECI IN, 425, NOT RATED)
Elecon Engg (ELCN IN, 89, NOT RATED)
BGR Energy (BGRL IN, 371, NOT RATED)
Praj Indiustries Ltd (PRAJ.BO, Rs114.15, NOT RATED)
Shriram EPC (SEPC IN, 182, NOT RATED)

# Disclosure Appendix

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**3-Year Price, Target Price and Rating Change History Chart for LART.BO**

| LART.BO Date | Closing Price (INR) | Target Price (INR) | Rating | Initiation/ Assumption |
|---|---|---|---|---|
| 10-Jul-07 | 1,194.325 | 1379 | O | X |
| 02-Nov-07 | 2,230.525 | 2,409.222 | | |
| 30-May-08 | 1,490.675 | 1,697.48 | | |
| 07-Jul-08 | 1,182.4 | 1,351.034 | | |
| 15-Oct-08 | 893.15 | 1,115.157 | | |
| 22-Jan-09 | 663.9 | 605.791 | U | X |
| 02-Feb-09 | 661.95 | 605.79 | | |
| 14-Apr-09 | 822.3 | 692.862 | | |
| 18-May-09 | 1,231.65 | 1,258.802 | O | |


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|---|---|---|
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**Method:** Our Rs1259 target price for Larsen & Toubro Ltd is based on SOTP (20x FY11 standalone earnings discounted back at WACC of 13.7%). We use FY11 numbers as that will be the first year of return of growth for the company. The subsidiaries are valued separately. L&T finance at 1x PB, L&T Infotech at 8x FY10 earnings . L&T IDPL at private equity valuations
**Risks:** Potential risks to our Rs1259 target price for L&T is continued weakness in macro growth and any new diversification measures by L&T

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