The Butterfly Effect (Vol III)

Investment cycle gradually gaining momentum; Exports hamstrung by weak global demand

- **Improvement in business confidence is visible with projects added at INR2.3t (3mma, Jan 2015), up 120% YoY. Still, this is yet to be reflected in on-ground actions with actual tenders invited (for project awards) at just INR1t (3mma, Jan 2015), down 40% YoY.**
- **India's Capex-J curve would be kick-started by accelerated public spending. Current trends suggest that increase in projects under implementation in government sector has been steady at INR4.6t (12mma); while for private sector is a negative number (indicating that projects completed are higher than projects added).**
- **Since Sep 2014, growth rates in Indian Machinery exports have decelerated meaningfully to just 2.6% (3mma, Dec 2014) v/s 13.6% (12mma, Dec 2014). Another important monitorable is the increased competitiveness of European players in the traditional markets, given the sharp EUR depreciation.**
- **Key trends to focus: Beneficiary of kick-starting stuck projects/Companies positioned in mid-value products. BHEL, VOLT, CRG are top picks. Despite near-term headwinds, prefer L&T from medium term perspective.**

Investment cycle gradually gaining momentum

- Economic activity has gathered some pace, and the improvement in business confidence has created congenial conditions for restarting the investment cycle. Policy initiatives in land acquisition as well as efforts underway to i) unlock mining, ii) increased FDI limits, iii) expediting approvals and iv) supportive monetary conditions should create a conducive setting for industrial revival in the medium term.
- We believe that the initial round of investment cycle revival will be triggered by i) sustained recovery in consumption demand leading to increased capacity utilization and ii) investment push by public sector leading to a virtuous cycle of cash flow generation in the system. Simultaneously, sustained progress in putting stalled projects back to work is important to crowd-in new investments and also provide a much needed stimulus to aggregate demand.

Exports hamstrung by weak global demand

- Since Sep 2014, growth rates in Indian Machinery exports have decelerated meaningfully to just 2.6% (3mma, Dec 2014) v/s 13.6% (12mma, Dec 2014). Export performance has been hamstrung by a multitude of factors, including: i) weak global demand, ii) geopolitical tensions and iii) sharp currency volatility in several markets. Decline in crude prices by ~USD50/bbl has impacted global trade by ~USD2t, leading to a sharp decline in investment demand. Project awards in the Middle East are near the lowest level of the range since 2007, and revenues of global industrial players suggests that the sluggishness has continued for ~8 quarters now.
- An important monitorable for Indian capital goods exporters is the sharp depreciation of EUR that has improved the competitiveness of European players in the traditional markets of SE Asia and Africa. The real appreciation (REER) of INR may also have had some effect on slowing exports.

Sector strategy: BHEL, VOLT, CRG are top picks

- Slowdown in consumption is a worrying signal and improvement in sentiments is yet to reflect in on-ground actions. Thus, revenue growth for capital goods players may possibly remain weak for few more quarters. While we do not dispute the possibility of a recovery in the investment climate in the medium term, FY16/FY17 earnings are prone to downgrades. Valuations are demanding.
- We believe that the initial round of project awards may well be a winner's curse. This is because PSU capex is characterized by tender based bidding, elongated working capital cycles and continued execution delays. In this environment, we identify key early cycle themes: (i) mid-value product companies are better positioned given exposure to base industries and also large replacement demand, plus better control on margins **(ABB, KKC, TMX, CRG)** (ii) beneficiaries of improved execution in stuck projects **(L&T, BHEL)**.

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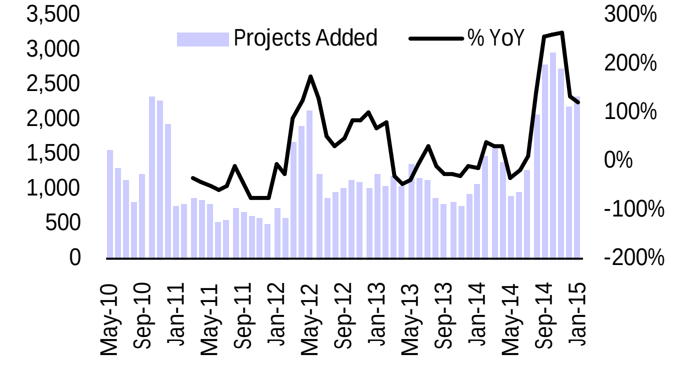
Charts in focus

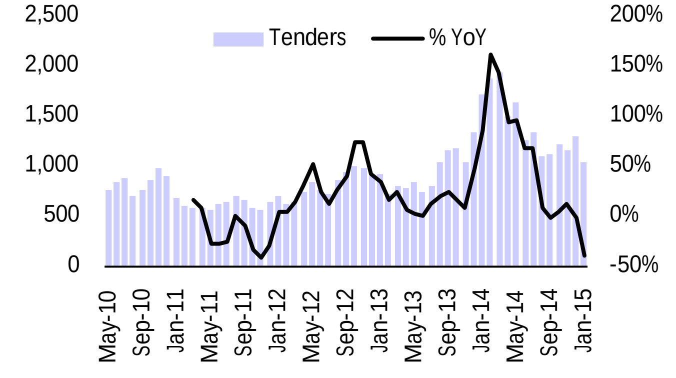
Improvement in sentiments yet to be translated in on-ground actions

Exhibit 1: Projects add up meaningfully at INR2.3t, +120% YoY (3mma, INR B)...



Source: Projects Today

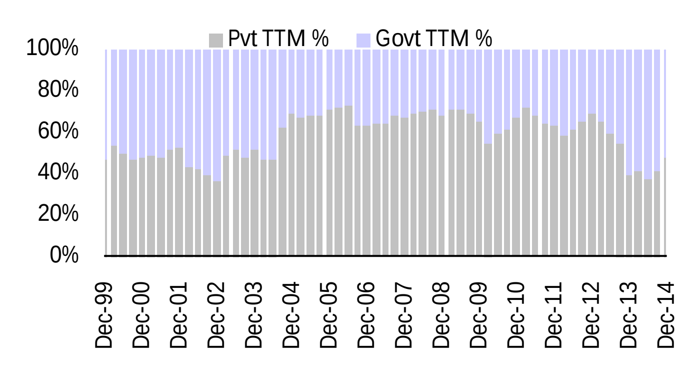
Exhibit 2: ...but, tenders invited at just INR1t, down 40% YoY (3mma, INR B)



Source: Projects Today

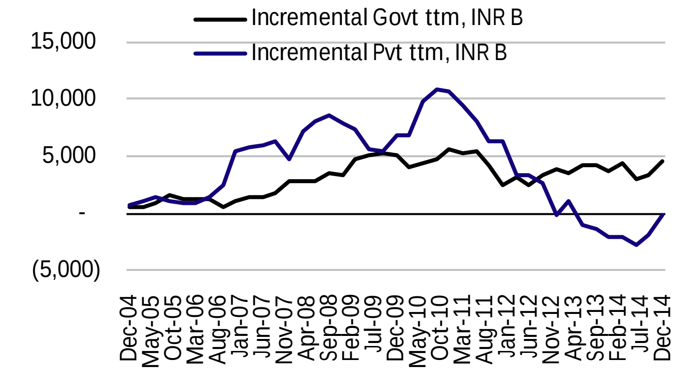
India's Capex J-Curve to be kick-started by accelerated public spending

Exhibit 3: Gross Projects added – Increased share of Government sector (12mma, % composition)



Source: CMIE

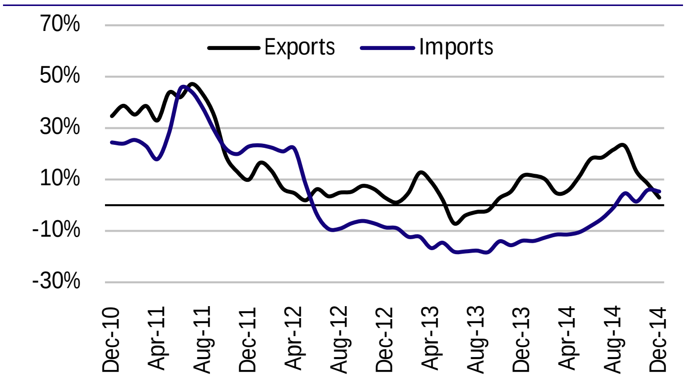
Exhibit 4: Even in recent times, net projects under implementation by Government is stable (12mma, INR B)



Source: CMIE

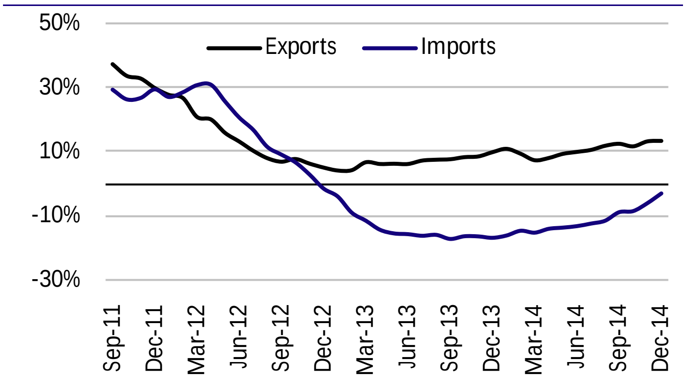
Engineering Exports growth has decelerated post Sep 2014

Exhibit 5: Machinery export growth has decelerated sharply to just 2.6% in Dec 2014 (3mma, % YoY)...



Source: CMIE

Exhibit 6: ...On a 12mma basis, Machinery exports growth stood at 13.6% in Dec 2014 (12mma,% YoY)



Source: CMIE

Investment cycle: gradually gaining momentum

Demand recovery continues to be a mixed signal

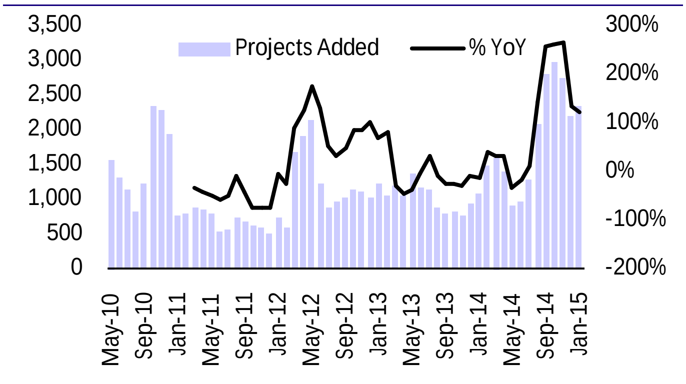
Economic activity has gathered some pace, and the improvement in business confidence has created congenial conditions for restarting the investment cycle. Policy initiatives in land acquisition as well as efforts underway to i) unlock mining activity, ii) widen the space for foreign direct investment in defence, insurance and railways, iii) expediting project approvals and iv) supportive monetary conditions should create a more conducive setting for industrial revival in the medium term.

The improvement in business confidence is clearly visible, but yet to be translated into actions on the ground. Continued contraction in consumption demand remains a worrying signal. We believe that the initial round of investment cycle revival will be triggered by i) sustained recovery in consumption demand leading to increased capacity utilization and ii) investment push by the public sector leading to a virtuous cycle of cash flow generation in the system. Simultaneously, sustained progress in putting stalled projects back to work is important to crowd-in new investments and also provide a much needed stimulus to aggregate demand. We expect that the initial round of demand improvement will be catered to by fast tracking stuck projects (during FY16), followed by announcements of greenfield capacities (in FY17).

#1 Improvement in sentiments yet to be translated in on-ground actions

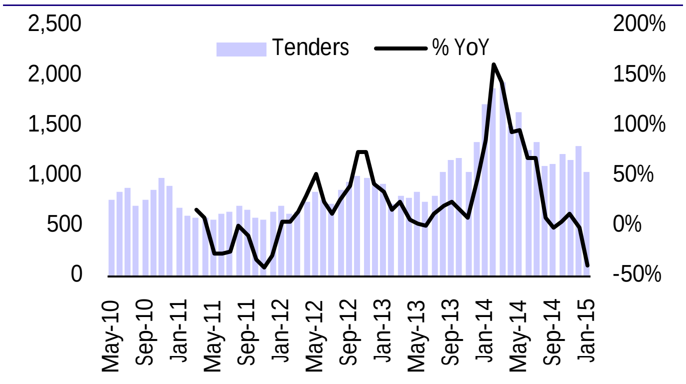
Economic activity has gathered some pace, and the improvement in business confidence has created congenial conditions for restarting the investment cycle. Policy initiatives in land acquisition as well as efforts underway to i) unlock mining activity, ii) widen the space for foreign direct investment in defence, insurance and railways, iii) expediting project approvals and iv) supportive monetary conditions should create a more conducive setting for industrial revival in the medium term. The improvement in business confidence is visible with projects added at INR2.3t (3mma, Jan 2015) up 120% YoY. Still, the challenges in surmounting the gridlock have proved to be formidable and is reflected in actual tenders invited (for project awards) at just INR1t (3mma, Jan 2015), down 40% YoY. Continued contraction in consumption demand remains a worrying signal.

Exhibit 7: Projects add up meaningfully at INR2.3t, +120% YoY (3mma, INR B)...



Source: Projects Today

Exhibit 8: ...but, tenders invited at just INR1t, down 40% YoY (3mma, INR B)



Source: Projects Today

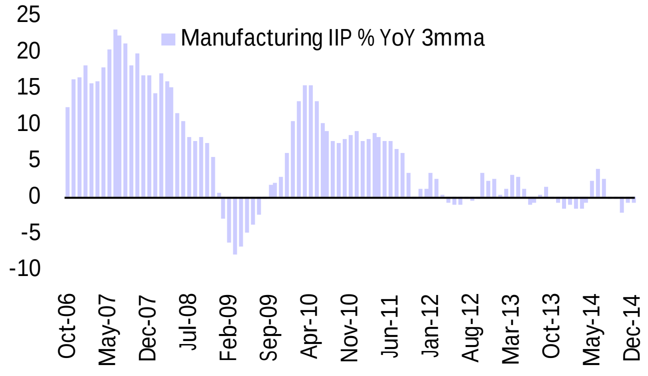
#2 Investment cycle recovery to be a gradual process

We expect that the initial round of demand improvement will be catered to by fast tracking these stuck projects (during FY16), followed by announcements of Greenfield capacities (in FY17)

While the initial phase of domestic investment cycle slowdown was impacted by policy logjams, there is a sense of guarded optimism now on the near term outlook. Manufacturing IIP remains sluggish and is down 0.8% in 3QFY15 (3mma), while capacity utilization (as monitored by RBI) has declined to 71% in 2QFY15 (from peak levels of 79% in 2QFY10). Increased consumption demand and lower interest rates would be important triggers for simulating the investment cycle. Projects completed (as a % of projects under implementation) have remained at abysmally low levels of 4.4%.

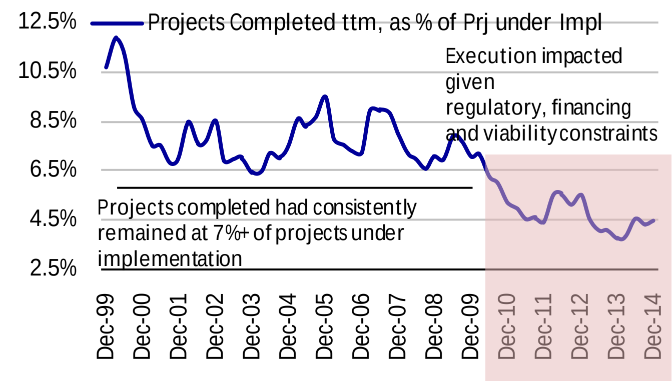
We believe that the initial round of investment cycle revival would be triggered by i) sustained recovery in consumption demand leading to increased capacity utilization and ii) investment push by the public sector leading to a virtuous cycle of cash flow generation in the system. Simultaneously, sustained progress in putting stalled projects back to work is important to crowd-in new investments and also provide a much needed stimulus to aggregate demand. We expect that the initial round of demand improvement will be catered to by fast tracking these stuck projects (during FY16), followed by announcements of greenfield capacities (in FY17).

Exhibit 9: Manufacturing IIP remains at baseline levels (% YoY, 3mma)



Source: CMIE

Exhibit 10: Projects completed (as % of projects under implemented) remains at low levels (ttm)



Source: MOSL, CMIE

Exhibit 11: Investment cycle will take at least a year to turn around

Company	Management Comments
M S Unnikrishnan, Thermax	If you were to be honest, nothing is going to change in ordering related to capital goods for a year atleast and you would see a spurt of that happening in selected sectors maybe in the next year i.e. FY17 not FY16. That is a realistic outlook.
Aditya Puri, HDFC Bank	Investments will follow a sequence and will take time. For this year, we are projecting a GDP growth of 5.2-5.5%. That growth was based on clearing stuck projects and faster decision making. As more and more efforts come, we can grow at 6% next year. The delta of the investment will take it to 7%. But private investment will probably follow public sector investment. Investment on ground takes time, may be another 18 months or so, from December.
A M Naik, Larsen and Toubro	It is still too early...But the fact is every other week, there are some policy decisions being taken in the right direction and they are all pending implementation for many years and at-least they are getting cleared one by one. The hard core capital intensive sectors like infra, power, heavy industries are yet to see a pickup in demand. But that's not due to the demand situation alone .These sectors need billions and billions of dollars and the question we need to ask ourselves is where is the money coming from with all the constraints in various segments?
Y M Deosthalee, CMD, L&T Finance	It is a bit premature to talk about a turnaround, given the complexity of issues. But there is an under-current of sincerity and urgency from the new government, to signal and demonstrate change through concrete action.

Source: MOSL, Company

#3 India's capex J-curve to be kickstarted by accelerated public spending

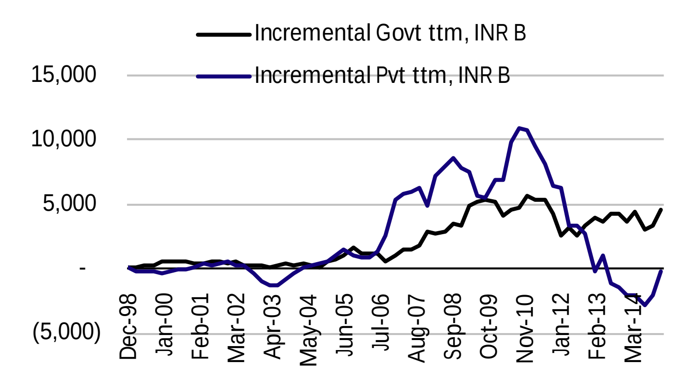
Please refer our detailed sector report on "India's Capex J-Curve" in April 2013

Post 2012, India's investment cycle has collapsed. In our opinion, India's capex J-Curve would be kick-started by (1) reorientation of fiscal expenditure which could accelerate spending on flagship government projects, and (2) government's attempt to address the contentious issues in several sectors, leading to increased capex by Central and State Public Sector Units. This phase will then be followed with revival in the industrial cycle culminating with traction in greenfield and mega projects.

Historical analysis suggests that government spending towards project investments has been consistent, while private spend has been more volatile:

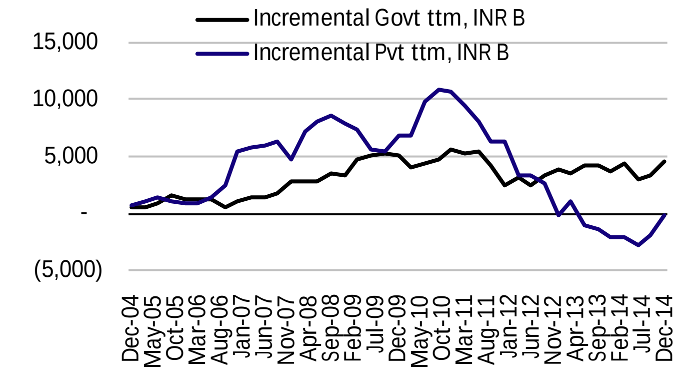
- During **1998-2004**, when the investment climate had collapsed, incremental projects under implementation by the government sector averaged at INR443b per annum v/s negative INR110b per annum by the private sector (negative number indicates that project completions were higher than projects added, and thus denote a decline in projects under implementation).
- During the **2004-2011** boom period, incremental projects under implementation by the private sector at INR5.5t per annum were ~2x of the government sector at INR2.9t. Thus, private capex bounced back sharply in a recovery.
- Current trends suggest that history is repeating itself, with increase in the private sector projects under implementation remaining at a negative number since Dec 2012; while for the government sector, it has been steady at INR4.6t (ttm).

Exhibit 12: Incremental projects under implementation by Government sector stable across cycles (12mma, INR B)



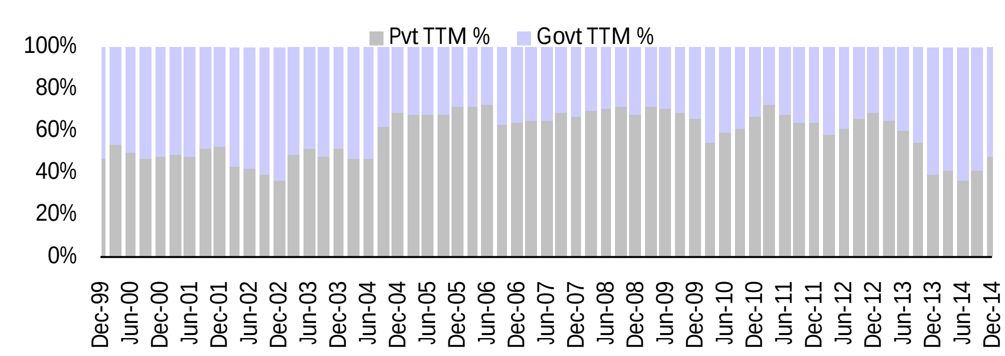
Source: CMIE

Exhibit 13: Even in recent times, net projects under implementation by Government is stable (12mma, INR B)



Source: CMIE

Exhibit 14: Gross Projects Added: Increased share of Government Sector (% composition)



Source: CMIE

India's Capex J-Curve: Comforting, yet Troubling

India's Capex J-Curve: Poised to kickstart

In our opinion, India's capex J-Curve will be kick-started by (1) reorientation of fiscal expenditure which could accelerate spending on flagship government projects, and (2) government's attempt to address the contentious issues in several sectors, leading to increased capex by Central and State Public Sector Units. This phase will then be followed with revival in the industrial cycle culminating with traction in greenfield and mega projects.

... public sector comforting, private sector troubling

As things stand, India's capex J-curve scenario is both comforting and troubling! It is comforting because net increase in projects under implementation by government sector remain at normative levels of INR5t (ttm basis). It is troubling because (1) private capex remains elusive, with net increase in projects under implementation in negative territory (at negative INR1t ttm) v/s peak levels of INR5t/qtr in 2008, and (2) Increased share of public projects in the aggregate mix imply a major compromise on RoE / RoIC for capital goods companies.

Ongoing

Key Drivers Debottlenecking / Brownfield, Buildings & Factories

Amount Low to Medium

Products Energy Efficiency Improving products, Standard Products, etc

India is here

Kick-start

Key Drivers PSU Capex / Flagship Govt Projects

Amount Medium to High

Sectors Infra, O&G, Utilities, Water

Segments Railways, Roads, DFCC, Urban Infra, Power, Hydro Carbons

Products Construction, Industrial Products, Abrasives, Bearings

Beneficiaries L&T, TMX, KKC, VATW, etc

Mid-cycle

Key Drivers Private Sector, Mid Sized Greenfield Projects

Amount Medium to High

Segments Cement, Food Processing, Auto, Chemicals, Textiles, etc and several mid sized projects

Products Mid-sized Industrial Products, Power T&D

Beneficiaries Several Capital Goods Players

Late-cycle

Key Drivers Private and PSU Mega Greenfield Projects

Amount Very High

Sectors Basic Industries, Utilities

Segments Metals, Hydrocarbons, Utilities etc

Products Construction incl Equipments, Power BTG, T&D, Large Industrial Products

Beneficiaries L&T, BHEL, SIEM and various Capital Goods players

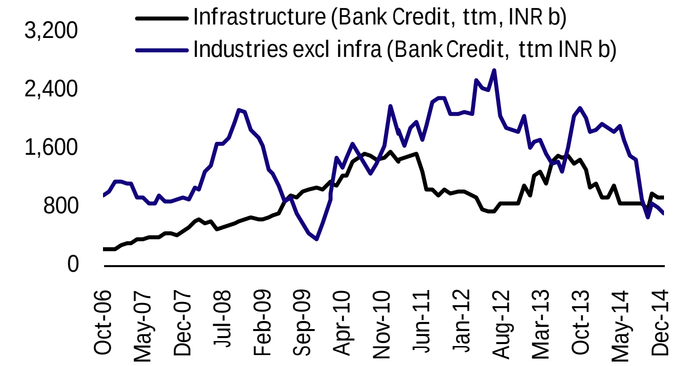
Time

#4 Sense of Guarded optimism on near term outlook

We expect few of the initial projects in consumption led industries to possibly kick-start in next 9-12 months; and then followed by investments in core industries in ~12-18 months

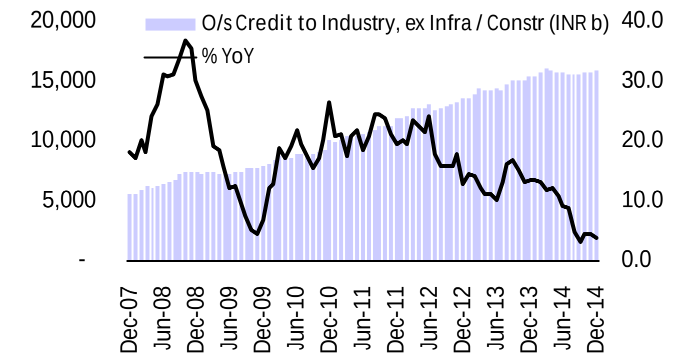
- Banking credit disbursement growth (net of repayments) to the industry (excluding infrastructure and construction) stood at just 4% on 12mma basis till Dec 14; and is at the lowest levels since 2007. The data suggests limited traction in project execution, given that a large part of the incremental growth is being led by working capital requirements. Incremental bank credit towards industries remains an important monitorable to access the momentum in terms of investment cycle.
- We expect the initial momentum in investment cycle to be led by new capacity announcements in consumption led industries (like FMCG, Pharma, Automobiles, Chemicals, etc), and then percolating down to core industries (like cement, steel, hydrocarbons and fertilizers). We expect few of the initial projects in consumption led industries to possibly kick-start in next 9-12 months; and then followed by investments in core industries in ~12-18 months.
- The key risk is continued slowdown and delayed uptick in consumer spending. During 3QFY15, several categories including Passenger Cars and FMCG products witnessed a slowdown in demand which was a worrying signal.

Exhibit 15: Net incremental bank credit growth to Industry and Infra sector remains muted (ttm, INR B)



Source: RBI

Exhibit 16: Outstanding credit to industry (excl infra / constr) is up just 4% YoY, lowest levels since 2007 (12mma)



Source: RBI

Exhibit 17: Industrial products – Capex environment remains constrained, with buoyancy in sentiments yet to translate into investment decisions

Company	Management Comments
Kirloskar Oil Engines	There has been buoyancy in overall sentiments, still yet to see this translating into the market in a big way. However we remain hopeful.
Blue Star	The market continued to be sluggish. While the macroeconomic indicators are positive and the economic environment is conducive for growth, the revival of the commercial construction cycle is likely to take a few more quarters.
Alstom T&D	Though there is positive sentiment in the industry, market continues to be challenging.
Apar Industries	The demand in the power sector remained reasonably sluggish through this period. It is quite clear to us that the CapEx cycle this time has to be fundamentally led by the government spending.
Thermax	The drop in order booking is attributable to the domestic segment where enquiry inflow and finalization remained subdued. We are still waiting for the real turnaround to happen at the ground level in the industry.
Cummins India	It's a very tough environment right now in general for capital goods in the country. So while financial sentiments in the financial markets are very positive, with the expectation that reforms will come and there will be stimulus, et cetera, we have not seen that yet in real demand in our industry.
Elgi Equipments	Indian economy continues to be sluggish. There's a lot of positive sentiment, lot of talk, but its not much of action happening at large project level. Lot of activity is happening, but activity is not getting converted. Lot more inquiries, lot more revival of old projects in the power sector, in the steel sector, but really in terms of orders and revenues, we still have to wait and see what happens. But that's on the large project side. On the normal industrial, we are beginning to see a marginal improvement in the product segments that serve the normal industrial – the non-project type of industrial demand. I am not elated about the increase, but definitely there is a consistent trend that we are seeing and we are hoping this trend will pick up and become stronger.
Larsen and Toubro	There is a time lag between policy decision and ground level implementations. Expect gradual and steady improvement. Lot of the action on the ground depends on fiscal prudence.
ABB India	Market situation continues to be depressed. People talk of newer projects, most of the customers not willing to commit to projects. Don't really see any action on the ground.
Voltas	Actually the number of the orders that we are actually seeing as being available in the environment has not really taken off.

Source: MOSL, Company

Exhibit 18: Volume growth across consumption categories has been impacted (% YoY)

Quarter Ending	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec 14
Asian Paints	15.0	12.0	18.0	-2.0	5.0	13.0	2.0	10.0	12.0	7.0	12.0	11.0	10.0	4.0
Colgate (Toothpaste)	15.0	15.0	14.0	13.0	11.0	8.0	11.0	11.0	9.0	11.0	7.0	5.0	7.0	5.0
Dabur	10.0	10.8	12.4	11.6	9.0	9.5	12.3	9.0	10.7	9.0	9.2	8.3	8.7	7.4
Godrej Cons (Soaps)	19.0	20.0	17.0	24.0	6.0	2.0	4.0	7.0	4.0	6.0	-4.0	0.0	2.0	LSD
GSK Consumer	8.0	12.0	7.0	7.4	4.5	6.0	8.0	7.0	10.0	11.0	8.0	3.0	2.0	5.0
Hindustan Unilever	9.8	9.1	10.0	9.0	7.0	5.0	6.0	4.0	5.0	4.0	3.0	5.0	5.0	3.0
ITC (Cigarette)	7.5	5.0	5.5	1.5	0.5	1.5	2.5	-2.0	-4.0	-2.0	-3.0	-2.5	-4.0	-13.0
Marico														
- Parachute	10.0	13.0	11.1	18.0	9.0	6.0	5.0	4.0	1.0	2.0	10.0	6.0	7.0	8.0
- Hair Oil	26.0	20.0	17.5	25.0	20.0	30.0	24.0	16.0	15.0	8.0	5.0	11.0	13.0	10.0
- Saffola	11.0	15.0	3.3	12.0	6.0	4.0	5.0	10.0	7.0	9.0	11.0	10.0	9.0	3.0
Radico Khaitan	9.7	10.5	6.8	8.2	7.8	6.5	7.2	7.6	7.2	9.9	3.5	-3.5	-3.9	-5.6

Source: MOSL, Company

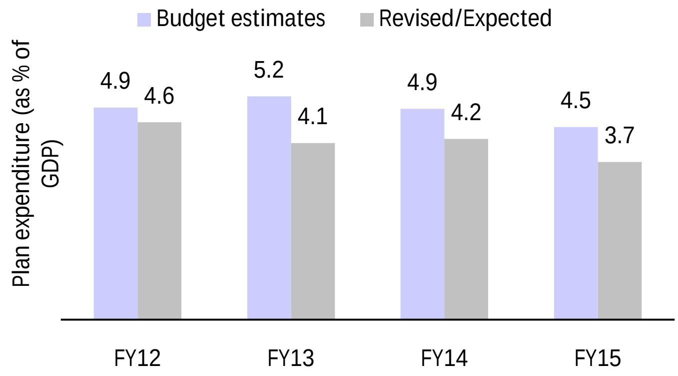
Exhibit 19: Consumption demand had been impacted in 3QFY15

Company	Management Comments
Hindustan Unilever	Volume growth for the industry was merely one percent and value growth five per cent. This is likely to be the last quarter where volume growth will be tepid. The slowdown has bottomed out and from the next quarter or so, we should start seeing volume pick up across segments.
Havells	Ground situation have not seen much change in 4QFY15 vs 3QFY15, and thus expect similar revenue growth rates in 4QFY15 as well.
V Guard	Revenue growth of 12% this quarter has been subdued on the back of continued weakness in consumer sentiment with footfalls not improving and construction demand yet to pick up. To conclude, the on ground scenario continues to be soft with channel health still to improve.

Source: MOSL, Company

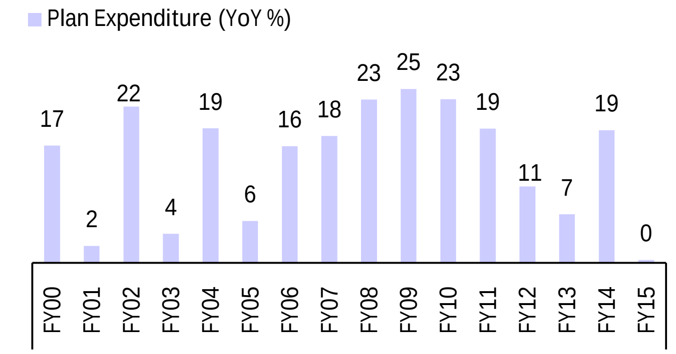
Government has also cut Planned Expenditure meaningfully, impacting the cash flow cycle for contractors and equipment manufacturers

Exhibit 20: Government has cut Planned Expenditure to achieve the deficit targets...



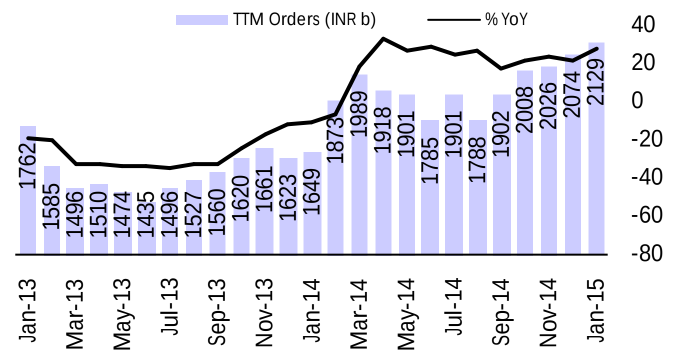
Source: Government, MOSL

Exhibit 21: ...and the amount has been stagnant YoY, lowest growth levels in several years



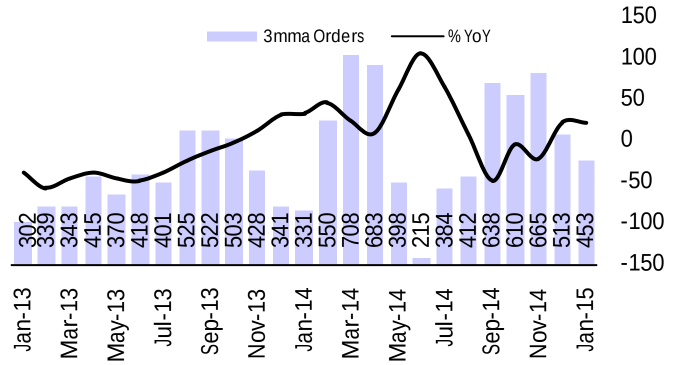
Source: Government, MOSL

Exhibit 22: 12mma Order awards at INR2.1t are up 29% YoY...



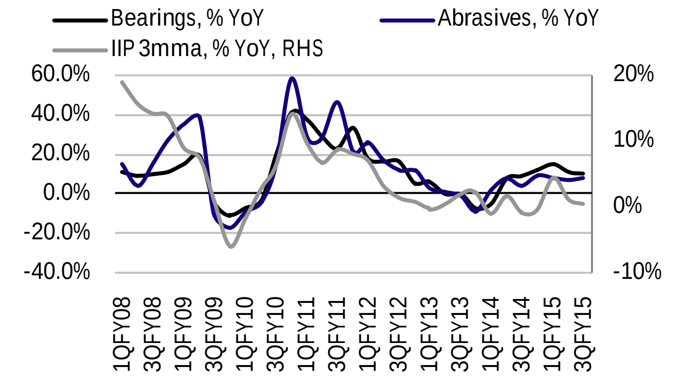
Source: MOSL, Industry

Exhibit 23: ..., but on 3mma basis, Order awards decline from peak levels in Sep-Nov 14



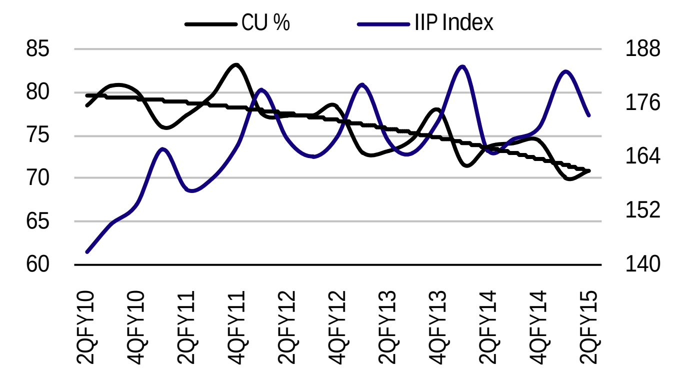
Source: MOSL, Industry

Exhibit 24: Bearings / Abrasives companies have reported some moderation in revenue growth (% YoY)



Source: MOSL, Company

Exhibit 25: Capacity utilization in the industry has declined meaningfully



Source: RBI

Exports hamstrung by weak global demand

Sharp decline in 'oil' prices has impacted global investment cycle

Since Sep 2014, growth rates in Indian Machinery goods exports have decelerated meaningfully to just 2.6% (3mma, Dec 2014) vs 13.6% (12mma, Dec 2014). Export performance has been hamstrung by a multitude of factors, including: i) weak global demand conditions, ii) geopolitical tensions and iii) sharp currency volatility in several markets. Sharp decline in crude prices by ~USD50/bbl has impacted global trade by ~USD2t and led to a meaningful decline in aggregate global investment demand. Overseas project awards, particularly in the Middle East, are down 52% YoY at USD17.7b (3mma) and are near the lowest level of the range since 2007. Revenues of global industrial players (eight companies accounting for ~7-8% of global capex) suggests that the sluggishness in both order intake and revenues have continued for ~8 quarters now.

An important monitorable for Indian companies is the sharp depreciation of EUR, and this has improved the competitiveness of European players in the traditional markets of South East Asia and Africa. The real appreciation of INR may also have had some effect on slowing exports.

#1 Indian Machinery exports growth moderated meaningfully in 3QFY15

Since Sep 2014, the Machinery and Engineering goods exports growth has decelerated meaningfully to just 2.6% (3mma, Dec 2014) vs 13.6% (12mma, Dec 2014) and comes on the back of a very strong growth in the first 8 months of CY14. Export performance has been hamstrung by a multitude of factors, including: i) weak global demand conditions, ii) geopolitical tensions, iii) sharp currency volatility in several markets and iv) decline in energy and commodity prices impacting global investment cycle. The real appreciation of INR may also have had some effect, which had supported exports during the early part of 2014.

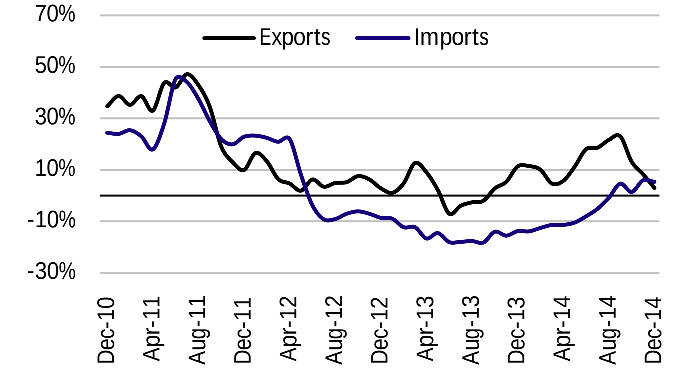
Another important monitorable for Indian companies is the sharp depreciation of EUR which has improved the competitiveness of European players. The traditional markets for Indian engineering exports have been South East Asia and Africa. Increased competitiveness of European players in these markets will be keenly watched.

Exhibit 26: Indian Engineering Exports – Increased caution

Company	Management Comments
Cummins India	When you look at our high-horsepower engine exports, when I look at the market picture, it's not very exciting. These engines are going into power generation and mining markets primarily, and both are very depressed markets right now all over the world. So, I'm not very optimistic of growth in that area. So unless there's a pickup in the global economy beyond North America, I would say probably low-teens is what I would guide.
Elgi Equipments	China, which is a source of huge concern, continues to be a problem for us. We are struggling to move our sales up. We are now re-grouping the entire strategy of the company as far as China is concerned.
Voltas	Europe remains weak and is in danger of continued recession. Meanwhile, with the steep correction of international crude oil prices, the Middle East geographies (more relevant to our operations), are expected to tone down their spending over a period of time. However, the respective countries have for now, maintained their budgets and growth targets, perhaps awaiting the outcome of the next OPEC meeting scheduled in June 2015.

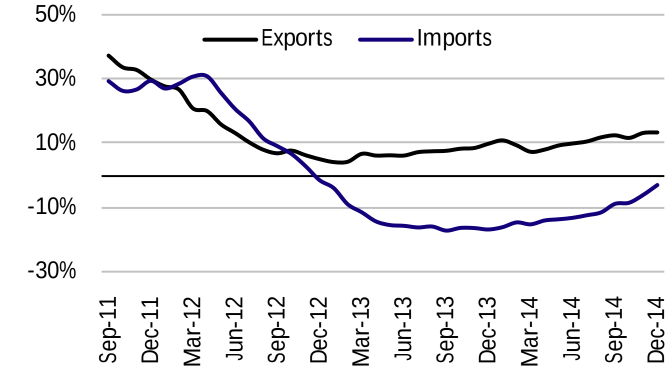
Source: MOSL, Company

Exhibit 27: Machinery export growth has decelerated sharply to just 2.6% in Dec 2014 (3mma, % YoY)...



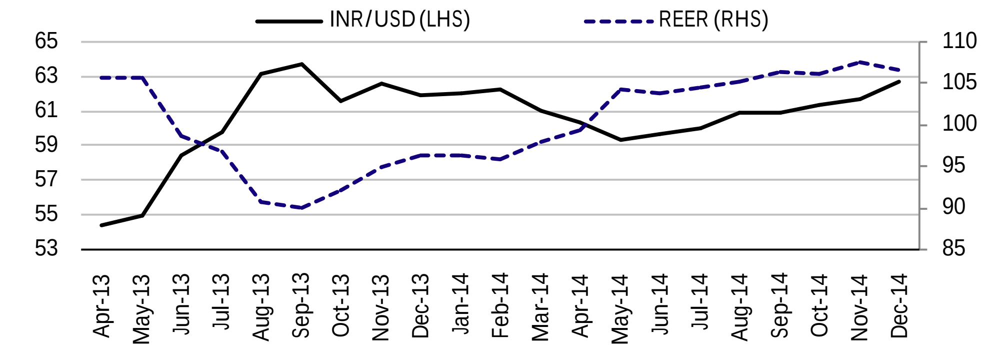
Source: CMIE

Exhibit 28: ...On a 12mma basis, Machinery exports growth stood at 13.6% in Dec 2014 (12mma,% YoY)



Source: CMIE

Exhibit 29: The Real appreciation of INR may also have had some effect, which also supported exports during the early part of 2014 (USD B, ttm)



Source: MOSL, Company, Company

Exhibit 30: Indian Capital Goods Players - FOB Exports (INR B)

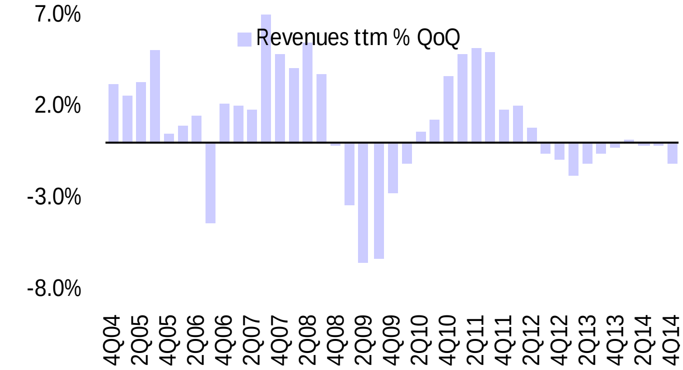
	FY09	FY10	FY11	FY12	FY13	FY14	% of Sales	CAGR (FY09-14)
SIEM	2.6	2.0	3.7	3.3	5.1	4.1	**3.9**	**10**
ABB	4.8	4.6	4.6	8.2	8.7	9.4	**12.3**	**14**
KKC	13.1	4.9	10.6	11.9	12.7	12.0	**30.8**	**-2**
TMX	6.4	7.1	6.2	7.3	6.7	10.4	**19.8**	**10**
CRG	10.3	10.0	8.6	7.7	7.5	8.9	**11.9**	**-3**
LT	16.5	5.1	5.6	8.4	10.2	10.1	**1.6**	**-9**
BHEL	15.7	12.3	7.7	10.1	4.4	13.6	**3.5**	**-3**
BEL	0.8	1.1	1.6	1.9	1.8	2.5	**4.1**	**25**
VOLT	0.3	0.3	0.5	0.3	0.3	0.3	**0.5**	**1**
KECI	7.2	4.7	4.4	7.6	7.6	8.8	**13.4**	**4**
VATW	0.0	0.0	0.6	2.2	1.9	3.2	**15.3**	
Total	**69.4**	**46.0**	**47.0**	**56.9**	**55.3**	**68.5**		
% of Rev	8.0	4.7	4.0	4.1	4.0	5.1		

Source: MOSL, Company

#2 Global industrial companies suggests several uncertainties surrounding growth; Revenues / orders remain sluggish for 8 quarters now

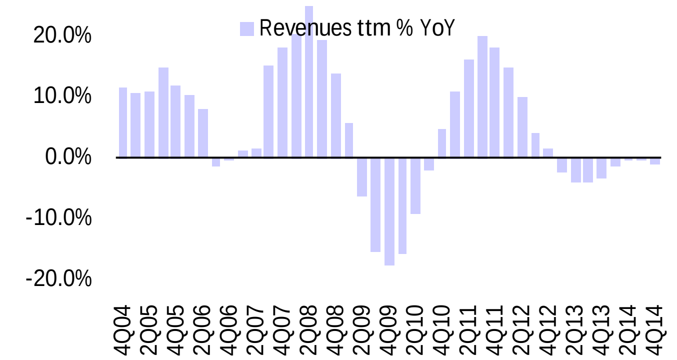
Revenues of the global industrial players (eight companies accounting for ~7-8% of global capex) suggests that the sluggishness in both order intake and revenues have continued for ~8 quarters now. There was a sense of cautious optimism during early 2014, and given the various uncertainties, the expected improvement during this period has remained elusive. Also, the outlook as stated by various companies suggests several uncertainties for CY15.

Exhibit 31: Global industrial companies report sluggish revenues for 4 quarters (down 1% in 4QCY14, ttm, % QoQ)



Source: Company ; Aggregate revenues of eight global companies contributing ~7-8% of the global capex

Exhibit 32: Revenues on a YoY basis also continue to remain sluggish, down 1.1% in 4QCY14 (ttm, % YoY)



Source: Company; Aggregate revenues of eight global companies contributing ~7-8% of the global capex

Exhibit 33: Global industrial companies - Increased uncertainty for 2015 led by volatile currencies, decline in raw material costs and geopolitical tensions

Company	Management comments
Caterpillar	We expect world economic growth to only improve modestly in 2015. The relatively slow growth in the world economy and continued weakness in commodity prices - particularly oil, copper, coal and iron ore - are expected to be negative for our sales. Back in October 2014, we expected sales and revenues would be flat to slightly up. Our current view is that sales and revenues will be about USD50b and that's down over 9% from 2014.
Siemens AG	There are continued risks from geopolitical tensions, volatile currencies, and the raw material prices. In the short term, we expect a significant CapEx decline and some project delays associated with the oil price development. These developments are already visible in the tendering activity of our oil-and-gas-related businesses, such as Power and Gas and Process Industries and Drives.
Honeywell	Our upstream backlog has held firm. We are beginning to see some delays further downstream in countries that are net oil producers, such as Russia and the Middle East, as refining and petrochemical product decisions are deferred.
Wartsila	How the current market uncertainties will impact customers' investment decisions is not yet clear, and therefore our market outlook remains cautious.
Cummins Inc	We are currently forecasting total company revenues to grow between 2% and 4% in 2015, with growth in North America, new products, and distributor acquisitions offsetting continued weak international markets and the negative impact of a stronger U.S. dollar.
ABB	In the short term, macroeconomic and geopolitical developments are signaling a mixed picture with increased uncertainty. Some macroeconomic signs in the US remain positive and growth in China is expected to continue. At the same time, the market remains impacted by slow growth in Europe and geopolitical tensions in various parts of the world.

Source: MOSL, Company

INTERESTING COMMENTS: M S Unnikrishnan, Managing Director and CEO, Thermax

"Oil price decline impacting Global Investment cycle: First and foremost is when the oil prices crashed from maybe USD110 in an average for the previous year to may be less than USD50, the world is going to be missing approximately USD50 per barrel at 93m barrels per day. Very simple Arithmetic will turn it to little more than USD2t that is going to be missing in trade from the world. That money normally will also get into reinvestment in various other sectors. So suddenly there will be a dip in the investment cycle for the entire globe".

"Increased competitive intensity in overseas markets: An important factor, which we need to be taking in the consideration is EUR becoming weaker, and the expectation of the market is that it may even touch almost at parity level with USD, making European companies very competitive in the limited market of South East Asia and Africa where we are currently able to compete against Japanese, American and Korean companies to pick orders. But if European companies were to look at this as an opening available for them based on the currency depreciation, the competition then becomes tough. Please remember against a Chinese when we compete, we get a price premium; against European we have to give a price discount to get an order. So that is why I mentioned about this specifically".

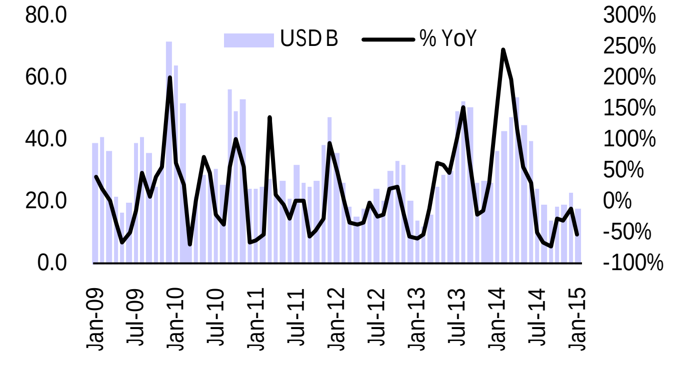
#3 The Middle East project awards have declined; margins bottoming out (after being impacted by project specific losses)

Overseas project awards, particularly in the Middle East, in 3QFY15 have been muted, impacted by the sharp decline in crude oil prices. Aggregate project awards in the Middle East are down 52% YoY at USD17.7b (3mma) and are near the lowest level of the range since 2007.

L&T has also witnessed a meaningful decline in overseas project awards at just INR45b (v/s average award of INR115b in 4 quarters till June 2014). Also, the EBIDTA margins in hydrocarbons were again negative at 4.8% v/s breakeven in 2QFY15 and project specific losses of INR8.9b in 1QFY15. Our analysis of the key Korean contracting companies (including Samsung, Daelim and Hyundai) indicates that the gross margins at just 3.1% (12mma) continue to remain sluggish.

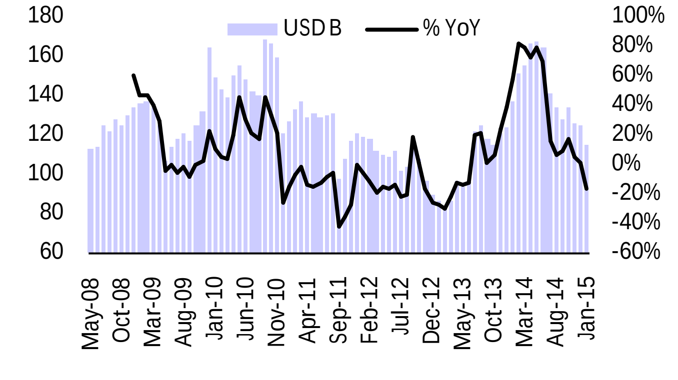
Several global contractors have stated that there exists enough liquidity in the system for the ongoing capex to continue in the interim period, we would still be watchful of the trends.

Exhibit 34: The Middle East project awards (3mma) have declined to near low levels since 2007



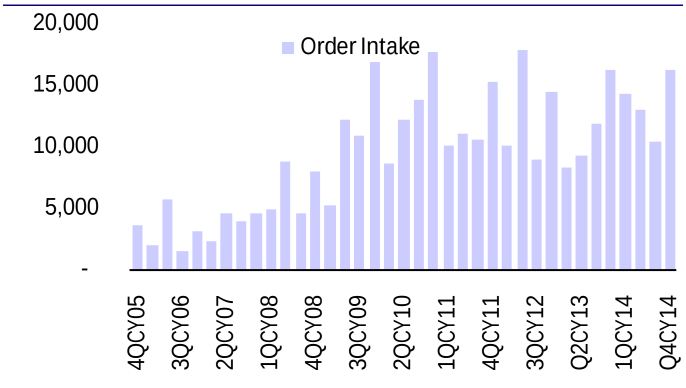
Source: CMIE

Exhibit 35: The Middle East Project awards (12mma) had peaked in mid 2014; down 30% from those levels



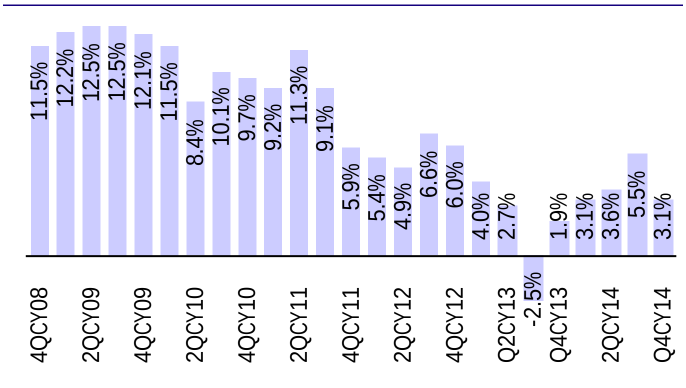
Source: CMIE

Exhibit 36: Korean contractors have witnessed stable order awards (KRW B)



Source: MOSL; Korean players quarterly results

Exhibit 37: Gross margins of the Korean contractors have remained sluggish (12mma, %)



Source: MOSL; Korean players quarterly results

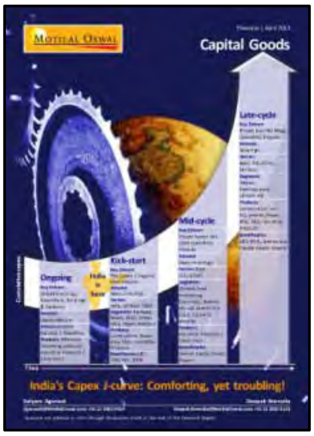
Ray of Hope: Initial signs of activity picking-up

Emerging areas: Defense, Renewables, Railways | Capex by Foreign players

While the step-jump in investment cycle during the earlier decade (2002-2012) was led by sectors like Telecom, Power, Roads; we believe that the step-jump in the coming decade would be primarily driven by the emerging sectors of Defense, Railways, Renewables and Water. Several announcements by the government and policy initiatives over the last six months now provide a Ray of Hope. Another important trend is the surge in projects added by the Foreign companies (with share increasing to 27% in Jul 2014 – Jan 2015 v/s just 8% in the preceding seven months) and the trends have been in-line with history. CEOs of global industrial companies have also echoed positive sentiments on increasing investments in India.

#1 Emerging areas of Defense, Railways, Renewables and Water to drive accelerated pace in investment cycle

Please refer our detailed sector report on "India's Capex J-Curve" in April 2013



Please refer our detailed report "India Defence" in January 2015

Both Indian Defense and Railways present interesting opportunities for the contracting companies and capital goods equipment suppliers, given that ~INR2.4t of defense / INR300b of DFCC contracts are to be awarded over the next 1.5-2 years. In addition, several large projects in Railways (like High Speed Rail Corridors and Metro rails), Renewables (Solar, Wind with target to set up 160GW capacity, investments of USD250b) and Water (River Interlinking, River cleaning, Irrigation) also present sizeable investment possibilities over the medium term.

Exhibit 38: Indian Defense – 'Make in India' is a strong resolve; several steps in offing with key government decisions

Source: MOSL, Company, Company

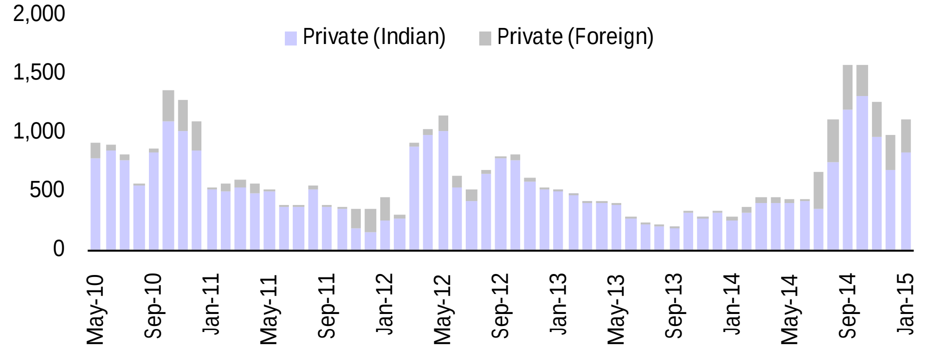
Illustration: NTPC's plan in Solar

"NTPC is developing the world's largest solar power project of 1GW at Anantpur in AP in a phased manner. In the first phase, NIT has been issued for 250MW for five blocks of 50MW each. Also, to kickstart domestic manufacturing cycle, NIT for additional 750MW solar has been issued. Out of this, projects of 250MW each will be set up in MP, Telangana and Rajasthan".

#2 Foreign companies looking to increase investments in India

Of the cumulative fresh projects added (conceptualized) by the private sector during Jul 2014 – Jan 2015, share of the Foreign companies stands at 27% (v/s just 8% in the preceding seven months), which has been a key surprise. Thus, while net projects added by the private (Indian) sector is up 2.4x in this period, net projects added by Private (Foreign) is up 9.6x. Several of these projects are largely in segments like Food Processing, Chemicals, Pharma and Automobile.

Exhibit 39: Projects add by the Foreign players have witnessed a strong surge (INR B, 3mma)



Source: Projects Today

We believe that sudden surge by the foreign players is possibly also explained by trends in history:

- Foreign players typically follow a more disciplined approach towards creating capacity, and the decisions are based by taking a more long-term view on anticipation of a possible demand surge. Recently also, Global CEOs of several MNCs have acknowledged the possible surge in Indian demand environment and need to augment capacities to prepare better.
- Indian players, on the contrary, will typically wait for improved clarity on the macro environment, in an attempt to match capacity with demand. As demand starts improving, several players start pressing the panic button to create capacity and push equipment manufacturers for accelerated deliveries. Similar trend was also witnessed during the past cycle, when Indian players in segments like power generation and cement threatened capital equipment manufacturers with Chinese competition, to reduce the project delivery time periods by ~30-35%.

Exhibit 40: CEOs of global industrial companies have echoed positive sentiments on increasing investments in India

Company	Management comments
Siemens AG	On the positive side, we expect to benefit from higher investment in infrastructure due to lower energy bills, in particular emerging economies such as India and increased demand from automotive and downstream customers.
Honeywell	India, there could be an awakening in India, and I've never seen such excitement in the business community in the 20-plus years that I've been going there. So I'm actually pretty encouraged about what they could be doing. And I really think there could be a takeoff there that we've all really been waiting for, for at least 10 or 12 years now. And that one could turn out to be quite a good positive.
Cummins Inc	In India, we expect total revenues, including joint ventures, to increase 5%. The new government has made infrastructure investment a big priority, and we're cautiously optimistic that demand will improve in the second half 2015.
ABB Inc	The Make in India policy, it is really a strong requirement to set up industrial value chains, even stronger than the country has done so far will accelerate growth and create jobs and create prosperity, so that is a good one. The easing off of export policy and making it possible to export easier from India is another element. The changes that we see and the legislation that is being put in place on the renewable energy side is another piece. So all together they are some really good pieces of the future jigsaw puzzle of the prospering India that will help to get this country to the next level of better quality growth.

Source: MOSL, Company

Sector strategy: BHEL, VOLT, CRG are top picks

Key trends to focus: Mid-value products; accelerated execution in 'stuck projects'

In our opinion, India's capex J-Curve would be kick-started by (1) reorientation of fiscal expenditure which could accelerate spending on government flagship projects, and (2) government's attempt to address the contentious issues in several sectors, leading to increased capex by CPSUs. This phase would be followed with revival in industrial cycle culminating with traction in greenfield projects.

Another important agenda will be to reap the benefits in terms of increased efficiency of the existing infrastructure assets that have been created and are largely stranded. For instance: Increased mining efforts and lowering AT&C losses would meaningfully lower electricity costs and improve viability in several sectors of the economy. During Tenth / Eleventh Five Year plans (from FY03-12), ~48% of the infra investments were towards power and roads, and given the stuck projects in these segments, the efficiency gains have not yet fully percolated in the system.

Sector View: Earnings prone to downgrades; Valuations demanding

While a sharp recovery in investment climate in the medium term is definitely possible, we believe that earnings growth in FY16/FY17 are prone to downgrades. Slowdown in consumption growth is a worrying signal and improvement in business sentiments are yet to reflect in on-ground actions. Thus, revenue growth may remain weak for few more quarters. Valuations for most companies are demanding, and factor in a sharp rebound in investment climate.

We believe that the initial round of project awards may well be a winner's curse. This is because PSU capex is characterized by tender based bidding, elongated working capital cycles and continued execution delays.

We identify three trends to focus based on structural drivers:

- Mid-value products business are typically early to mid cycle plays and have meaningful operating leverage **(TMX, KKC, CRG, ABB are key beneficiaries).** In this environment, we believe mid-value product companies are better positioned than project companies: (1) minimum threshold demand exists because of exposure to base industries and also large replacement demand, and (2) they enjoy a dominant position, and thus better control on margins.
- Projects business should witness improvements in free cash flow generation led by normalization of cyclical factors **(L&T, BHEL key beneficiaries)** and
- Increased contribution of overseas business **(L&T, TMX, KKC, VATW)**

Top Picks: BHEL, CRG & VOLT are Top Picks to play the possibility of an uptick in the investment climate. Despite near term headwinds, we remain positive on L&T, from a long-term perspective.

Exhibit 41: Comparative and valuation

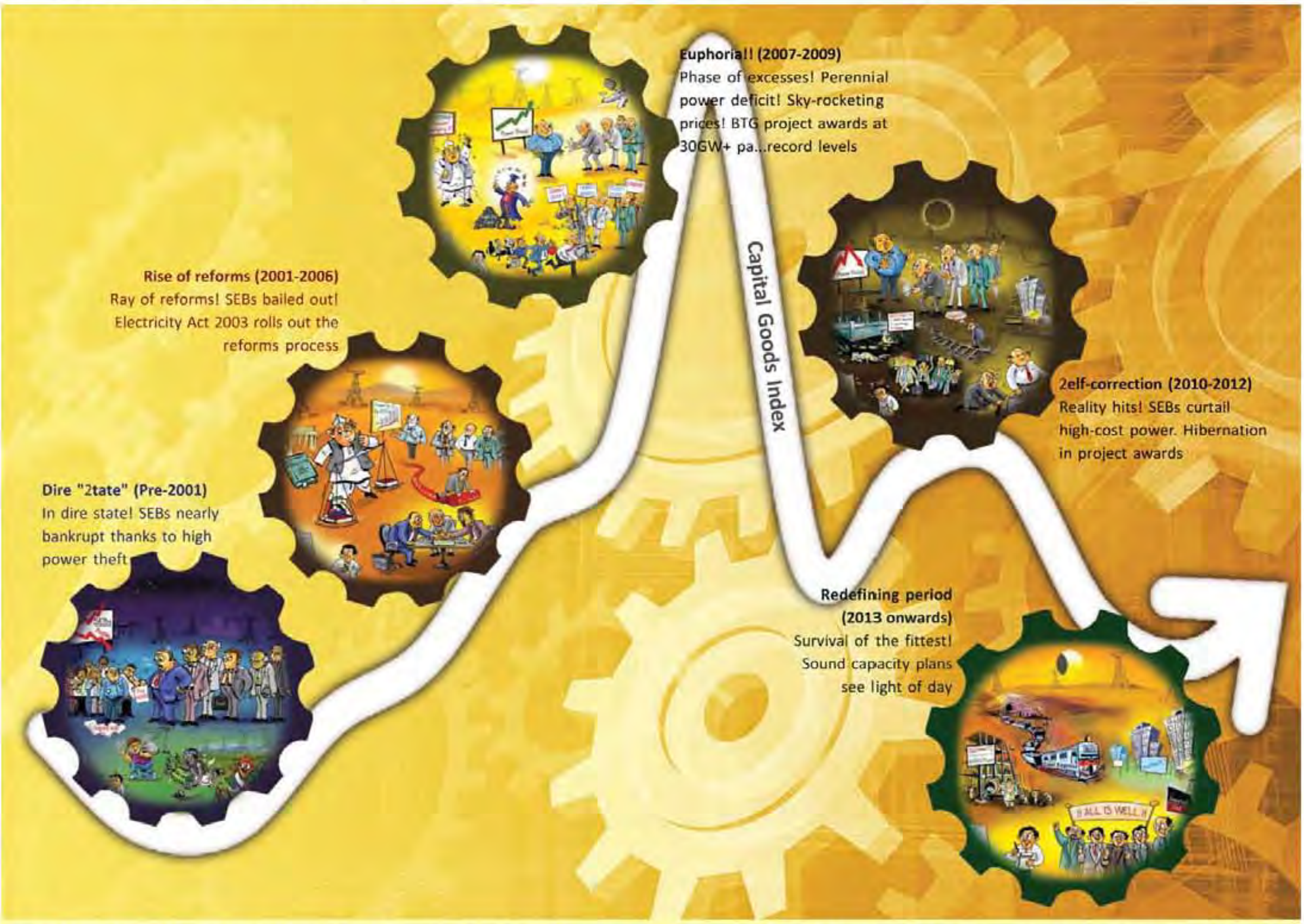
		M-Cap	CMP	EPS (INR)			P/E (x)			EV/EBITDA			RoE (%)		
Company	Rating	USD	INR	FY15E	FY16E	FY17E	FY15E	FY16E	FY17E	FY15E	FY16E	FY17E	FY15E	FY16E	FY17E
ABB#	Neutral	4.8	1,414	10.8	17.2	27.1	131.1	82.3	52.2	54.8	41.0	29.1	8.3	12.5	17.9
BHEL	Buy	10.8	273	7.3	12.2	17.7	37.2	22.4	15.5	21.2	12.4	8.5	5.3	8.4	11.3
Crompton	Buy	1.8	177	3.7	8.7	13.8	48.3	20.3	12.8	17.6	11.5	8.1	12.9	12.8	18.0
Cummins	Buy	4.0	897	24.1	26.8	32.2	37.2	33.5	27.9	32.0	29.0	24.2	24.3	24.6	27.4
L&T	Buy	25.2	1,686	41.4	53.9	72.2	40.7	31.3	23.4	24.4	21.0	17.0	12.6	13.7	14.9
Siemens##	Sell	7.3	1,279	8.7	14.2	18.7	146.9	90.2	68.4	74.7	48.0	38.6	7.4	10.6	12.6
Thermax	Buy	2.3	1,212	25.0	33.0	46.1	48.5	36.8	26.3	30.0	22.0	16.3	14.1	17.0	21.0
Havells	Neutral	2.7	268	8.0	9.8	12.2	33.6	27.2	22.0	19.4	16.3	13.5	27.9	27.3	28.8
Voltas	Buy	1.4	253	10.4	12.8	15.8	24.3	19.7	16.1	19.5	15.8	12.2	16.5	17.8	18.9
BEL	Buy	4.8	3,727	151.8	179.7	197.6	24.5	20.7	18.9	19.9	16.1	14.1	15.3	15.9	15.4
KEC Internl.	Not Rated	0.4	86	2.4	5.0	7.8	35.1	17.1	11.0	8.4	6.2	4.9	4.8	9.1	12.8
VATW	Buy	0.8	1,713	43.4	61.7	81.8	39.5	27.8	20.9	19.2	13.8	10.6	12.4	15.5	17.7

Dec Year end, ## Sept Year end

Source: Company, MOSL

Indian BTG: Emerging from the Eclipse

(Click here to see our Sector report, December 2013)



Powergen capex: Emerging from the 'Eclipse'

Our statistical analysis of the macro data-points on demand and supply dynamics in the power sector suggests that the new cycle of powergen capex could commence over the next 12-15 months. Despite aggressive assumptions on capacity additions and PLF; the electricity generation CAGR till FY19 when juxtaposed with aggregate FY13 demand stands at 8.8% and compares with last 10-years electricity consumption CAGR of 6.2%. Thus, we believe that SEBs will, sooner than later, start planning about capacity additions.

'Timing the recovery' remains the key moving variable. However we believe that what matters is not 'timing the project awards', but the time when markets believe that project awards 'could possibly' commence. And that time is now.

Expect 20GW of project awards, interplay of structural factors

During FY12 and FY13, power BTG project awards stood at just ~10GW pa, including 13GW of cumulative capacities being awarded under the bulk tender, and compares with annual run-rate of 25-30GW pa during FY07-10. Going forward, we believe that the pipeline is showing initial signs of recovery with projects of ~20GW likely to be awarded in 12-15 months. This could be a Tipping point, particularly for the equipment manufacturers, given that industry capacity for super-critical boilers and turbines stands at ~21-24GW pa.

An important driver has been the 'Case 2' Bidding Document (approved in Sept 2013) with bidding for 9.3GW has already been initiated. The trend of increased project awards could possibly be supported by interplay of structural factors: i) Improved demand planning by distribution companies ii) Ensuring financial viability of the Distribution business models iii) Coal mine allocations post gap of 5 years, etc.

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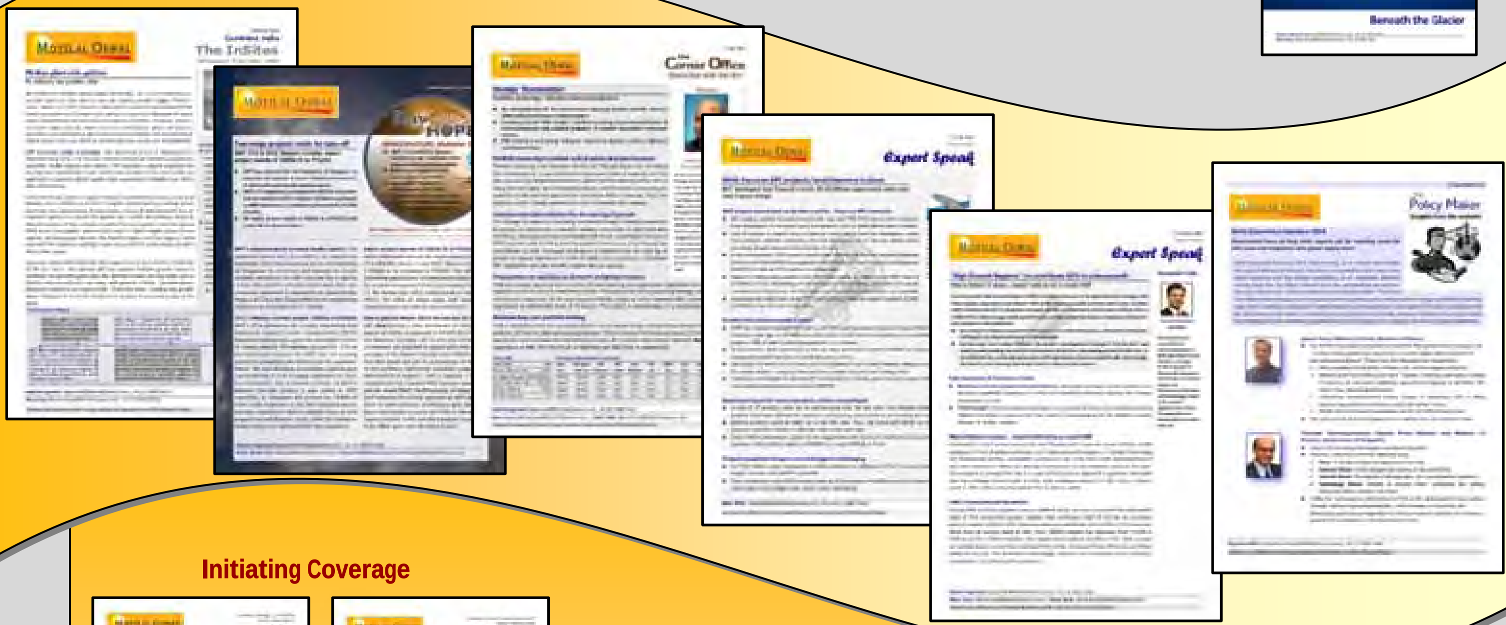

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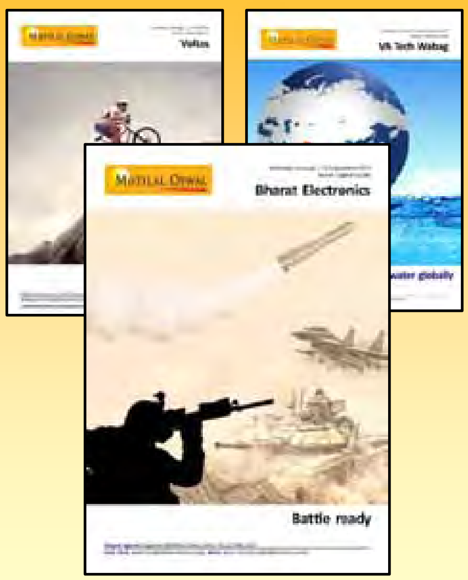

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