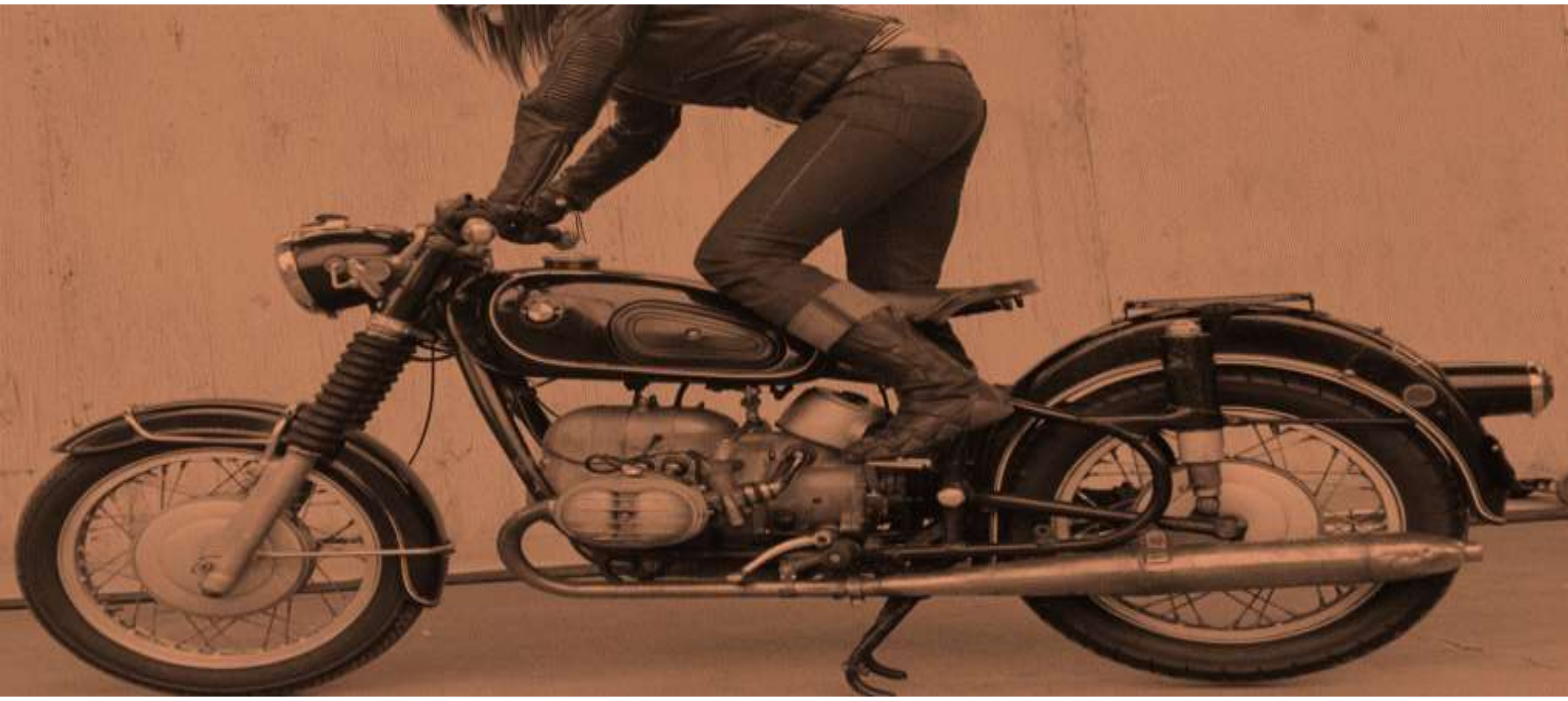
Kick-starting private investments

Is the investment cycle turning?



Investments are back. The long and painful (ongoing) process of cleaning up bank's balance sheets, dealing with stressed assets and improving the policy environment is finally starting to bear fruit. Initially the most important driver for investments was government expenditure on infrastructure – roads, highways, housing – which perhaps helped kick-start the upturn, increasing demand and raising capacity utilisation in the economy.

BUT, as the popular narrative seems to suggest, it is not all a government led story anymore. Private investments are also showing signs of genuine traction, across a number of sectors like electrical equipment and chemicals. While large investments are still absent, small ticket capex have started to come on stream. For now, the investment uptick remains sector specific rather than a full blown revival in institutional capacities. For instance, power generation capacities are not expanding, but sectors related to transmission and distribution are picking up.

Bottom-line, the pickup is not full throttle but the investment cycle has started gaining traction. 2019 could be the year of investments, finally.

Investment to GDP ratio has increased to 29.5% in 2018-19 after remaining stagnant at 28.5% since 2015-16

De-bottlenecking in the economy has led to an increase in capital productivity

The pickup is not all government led. Private capex cycle is also reviving

The private capex upturn not broad based yet, led by manufacturing

Capacity utilisation has risen above the long term average, estimated to be close to 80% in some sectors in 2018-19

Private capex revival in sectors such as electrical equipment, chemicals

On the funding side, credit growth has increased, and PE capital and FDI are rising

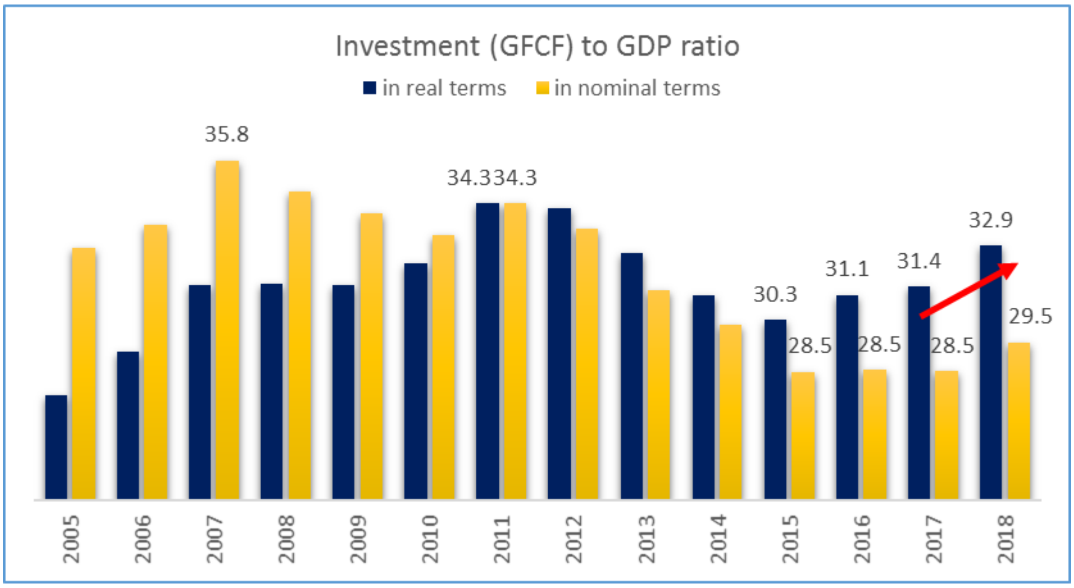
The Investment Recovery

The latest figures from the Central Statistical Organisation (CSO) estimate GDP growth at 7.2% in 2018-19 compared to 6.7% in the previous fiscal. While this is still lower than the so called "potential" growth rate of 8%, it is impressive given that the economy saw two major shocks (Demonetisation and GST) in the last three years, the global growth scenario has been gloomy, and domestic issues such as the NBFC crisis and rising farm rural distress have been a drag on growth.

Investment was the largest contributor to GDP growth in 2018-19. **Gross fixed capital formation, which is an indicator of total investments in the economy, grew at 12.2% in 2018-19 (according to CSO's first advance estimate) – the highest rate since the 2008 financial crisis.** To put things in perspective, the investment growth rate over the previous five years was 5.4% (2014-15 to 2017-18).

Infact, for 2018-19, investment growth has been almost double of the growth recorded in private consumption (6.4% y-o-y).

Investment share on the rise



Note: All years are fiscal years, 2018=FY19, GFCF = Gross Fixed Capital Formation. Source: CEIC, HDFC Bank

While growth rates are swayed by base effects – low growth in one year props up growth rate in the next year – a more robust measure of looking at demand side components is to look at their shares in GDP. **While the share of private consumption to GDP declined from 59.1% in 2017-18 to 58.4% in 2018-19, investment share recorded an increase during the same time. The share of investments to nominal GDP picked up to 29.5% in 2018-19 after remaining stagnant at 28.5% in the previous three years.**

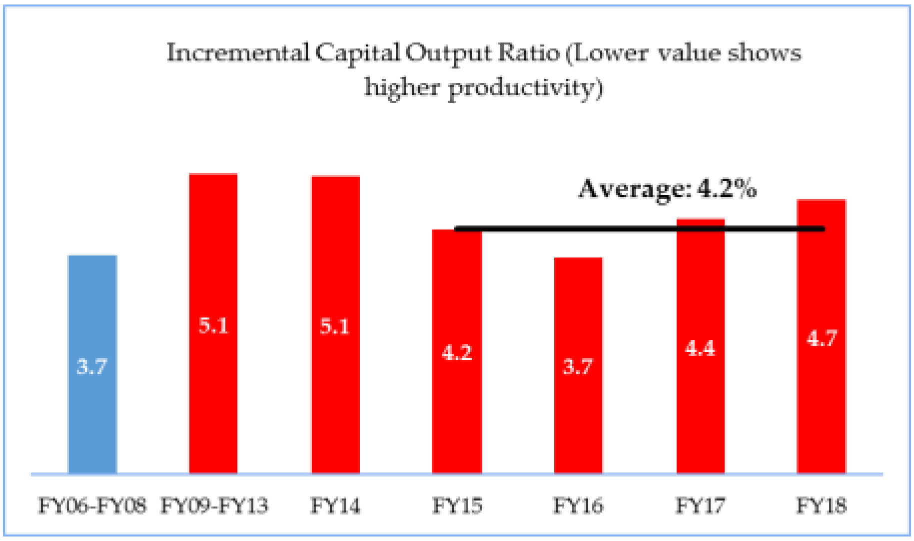
Is capital becoming more productive? Or is it the “de-bottlenecking effect”?

An encouraging sign in the investment story is the increase in capital productivity. The Incremental Capital Output ratio (ICOR), which measures how many additional units of capital are needed to produce one additional unit of output, has improved. **ICOR averaged at 4.2 between 2014-15 to 2017-18 compared to 5.1 during 2008-09 to 2013-14 (a phase of policy paralysis). A lower value of ICOR is better.**

Economic theory suggests that an increase in ICOR is usually accompanied/led by technological improvements and skill enhancements in the economy. However, this might not necessarily be the case in the current scenario. It is more likely that the increase in productivity could have come about due to an improvement in the regulatory environment and removal of bottlenecks. The government has initiated a number of steps to ease the business environment: big moves such as the GST and Insolvency and Bankruptcy Code (IBC), and others, such as introducing online single-window model for providing clearances and filing compliances, and fast-tracking foreign investments, have helped.

<u>Therefore, it is likely that the improvement in ICOR has more to do with an increase in efficiency in the system due to de-bottlenecking rather than significant technological improvements in the economy.</u>

Is capital becoming more productive?



Source: HDFC Bank calculations, Note: Lower value of ICOR is better

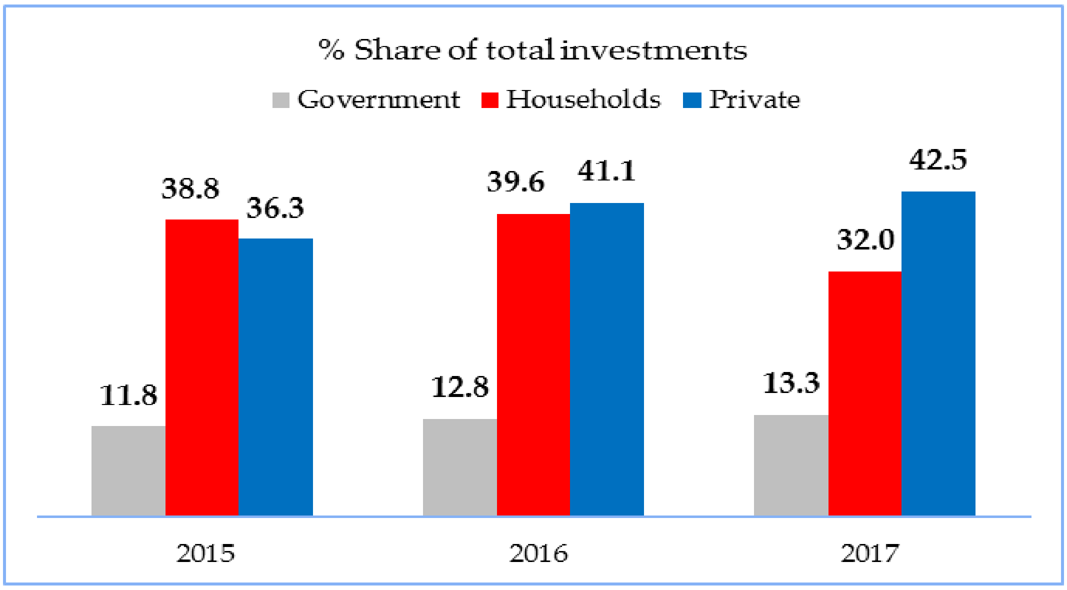
Not all government led!

So far the common narrative has been that the government has been the sole driver of investments. It's true that infrastructure spending - housing and roads construction - by the government has supported growth over the last couple of years. For instance, since 2014, general government investment (both centre + state) has recorded double digit growth (14.5% in 2016-17) compared to 4% in 2012-13. This has led to a steady increase in share of the government sector in total fixed investments.

But, it's not all a government led story. Private capex has been steadily recovering over the last few years. GDP data provides the breakup of investments by institutions from 2011-12 to 2016-17. **The share of private investments in total investments has risen steadily from 32% in 2011-12 to 42.5% in 2016-17 – a 10ppt rise in share over five years.**

Even if we assume a continued increase in the share of the government sector in investments over the last two years (for which data is not available), and a stagnant household investment share, private investments as a share of total investment would have remained above 43% in 2017-18 and 2018-19.

Private investments gaining traction



Source: CEIC, CSO, HDFC Bank; Note: Private investments is Non-Financial Corporations, Government includes centre + state

Normalising these shares, even if we look at the share of private investments to GDP (nominal), the share increased to 12% in 2016-17 from 10.8% in 2014-15.

That said, a closer look at the data tells us that the private capex revival has not been broad based so far. **Private investments have picked up primarily in the manufacturing sector while falling or**

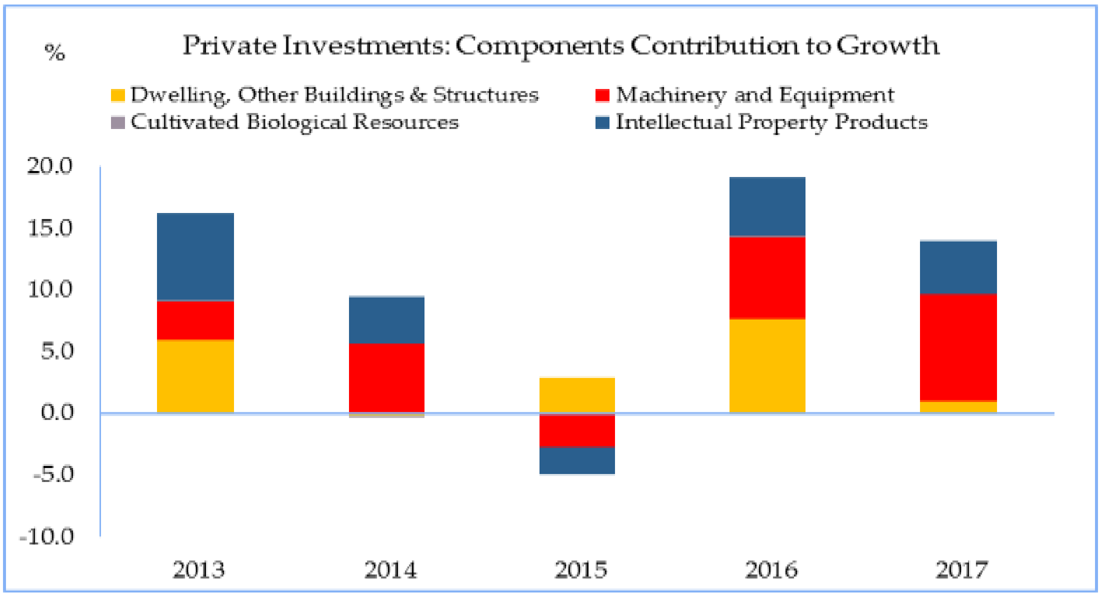
remaining muted in mining, electricity and gas, construction and transport, storage and communication. Also, Machinery and Equipment investment has been the biggest contributor to investment growth while Dwelling, other buildings and structures investment has lagged behind. Going forward, a revival in the construction (specially housing) sector could bode well for a broader recovery in private investments.

Private investment revival is not broad based yet! Manufacturing has led the pickup

Investment % share of private GFCF		
	FY14	FY17
Manufacturing	**33.1**	**37.1**
Mining	**5.1**	**0.8**
Electricity, gas, and other utility services	**10.6**	**7.0**
Construction	**5.1**	**3.6**
Transport, storage and communication	**17.7**	**13.8**

Source: CEIC, CSO, HDFC Bank, Note: data at current prices (nominal)

Machinery & Equipment drive the investment turn



Source: CEIC, CSO, HDFC Bank

Enough signs pointing to a private capex revival

There has been a general lack of clarity over how the GDP figures are computed and a lot of debate on whether these figures effectively represent the situation on ground. Adding to this uncertainty is the fact that GDP figures usually undergo significant revisions in subsequent years, sometimes considerably altering trends that were seen earlier.

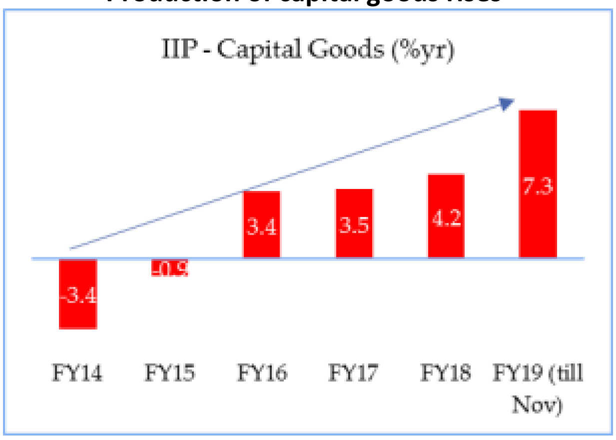
Recognising this reservations, the fact that investment trends showed by the GDP data are in sync with the other indicators in the economy, provides further confidence in the investment pickup. Also, given that the detailed GDP investment data comes with a two-year lag (last available data till 2016-17), these indicators show that the revival has only gained traction in the last year.

1. Production of Capital Goods on the rise

Capital goods output, a component of the Index of Industrial production (IIP), has shown significant traction in the last year. **Capital goods output – which is taken as a proxy for some part of investment activity by the CSO - grew by 7.3% in 2018-19 compared to 4.2% in the previous fiscal.** Capital goods imports have also picked up pace. Imports of machinery and metals have grown by over 20% so far this year compared to 2% and -2.5% in 2016-17 and 2015-16, respectively.

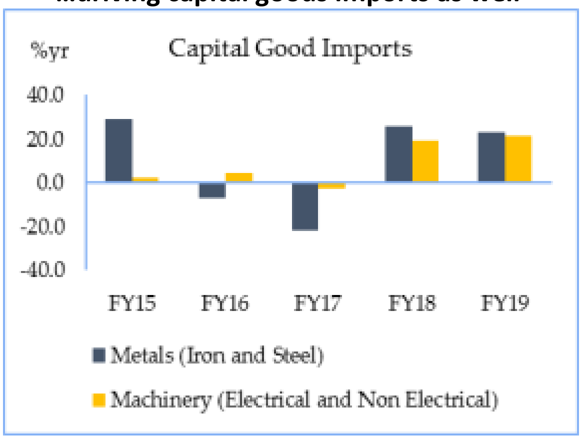
Further, in the last-concluded earnings season (September 2018), capital goods majors like L& T and ABB reported strong growth in order intake. **The BSE capital goods sector aggregate indicator shows that net sales growth for the sector have picked up consistently over the last 4 quarters - from 6.7% in December 2017 to 25% in September 2018.** These indicators signal that investment activity is gaining traction.

Production of capital goods rises



Source: CSO, CEIC, MOSPI, HDFC Bank

…driving capital goods imports as well



Source: CSO, CEIC, MOSPI, HDFC Bank

Earning results show rise in net sales of capital goods companies

BSE Capital Goods	Net Sales (%yr)			
Company	Dec-17	Mar-18	Jun-18	Sep-18
Sector Aggregate	**6.7**	**3.7**	**12.4**	**24.9**
Bharat Electronics	14.7	-14.6	16.6	36.6
HAVELLS IND	21.2	38.4	31	23.3
KALPATARU Power	22.4	26.9	9.8	28.7
L&T	9.4	10.5	17.9	21.3
Thermax Ltd.	14.8	-5	16	38.2
GE T&D INDIA	18.2	-35.3	-8	14.2
ABB INDIA LTD.	11.6	16.4	14.9	31.3

Source: Equity master, Company results, HDFC Bank

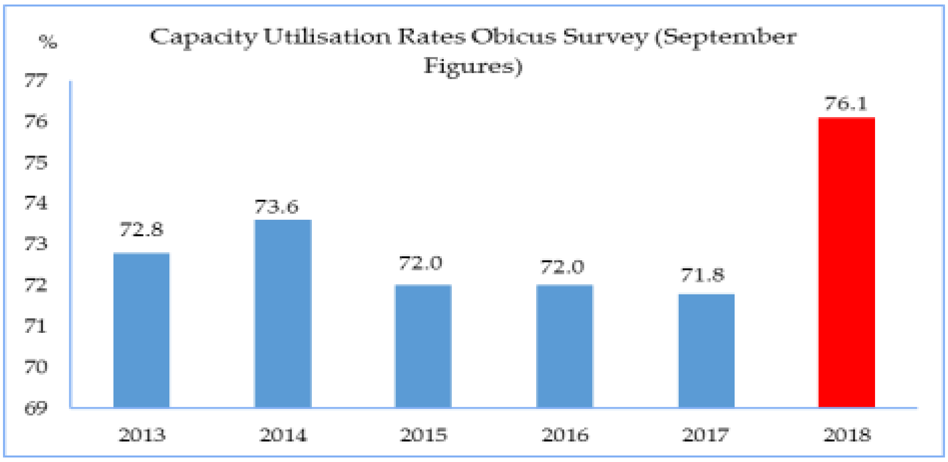
2. Pick up in capacity utilisation

The second reaffirming trend has been witnessed in the capacity utilisation figures, released by the RBI on a quarterly basis. Reserve Bank of India's Order Books, Inventories and Capacity Utilisation Survey, or OBICUS, data shows that in the quarter ending September 2018, **capacity utilisation rate rose to 76.1% in September 2018 from 73.8% in the June quarter. This is also higher than the long term average of 74.9% and significantly above CU rates for the second quarter of every year since 2013.**

Conventionally, as capacity utilisation rates move closer to 80%, firms tend to take on fresh investments. **Although, the increase in capacity utilisation rates so far has not been broad based, certain sectors have seen an improvement. Specifically, in sectors such as aluminium, steel, cars and UVs, chemicals and textiles, the CU rates are estimated to rise above or close to 80% by fiscal year end.**

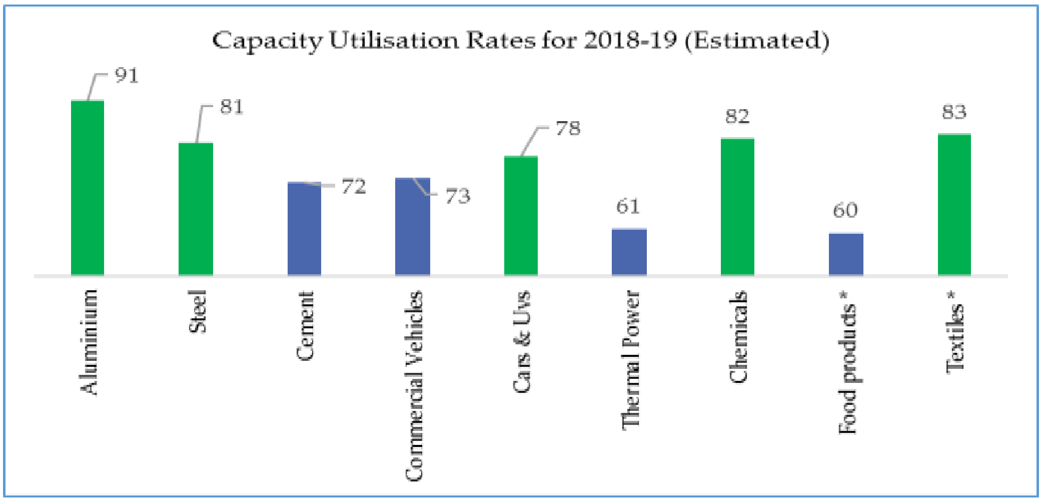
The investment outlook is further supported by an increasing number of plans to expand capacity over the next 6 months. A FICCI survey shows that the % of respondents planning expansion in the next 6 months has risen in sectors such as cement, chemicals, food products, textiles and metals.

CU rates rise above trend



Source: RBI, HDFC Bank

CU rates close to 80% in some sectors in 2018-19 (estimate)



Source: CRISIL Estimates, FICCI, Industry Research reports, HDFC Bank; Note: * latest CU rates from From FICCI survey

New capacity planned

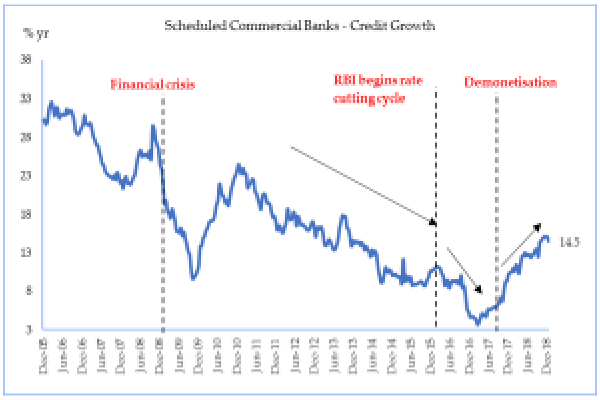
% of respondents planning expansion in next 6 months (FICCI Survey)	Mar-18	Oct-18
Cement and Ceramics	Not any significant plan	Most players looking to expand
Chemicals, Fertilizers, Pharma	41%	50%
Food Products	Not any significant plan	Most players looking to expand
Metal and Metal products	30%	34%
Textiles	25%	46%

Source: FICCI, HDFC Bank

3. Rise in credit growth

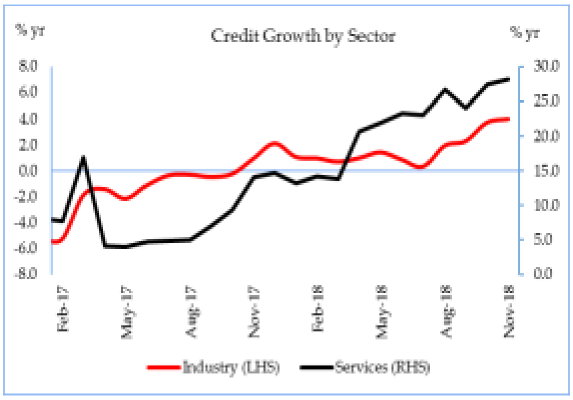
On the funding side, overall credit growth has picked up pace, rising by 14.5% y-o-y as of 4 January 2019 as compared to 10.4% same time last year. In 2018-19 so far, credit growth averaged 13.4% - more than double of what was recorded same time last year (6.4% in 2017-18). The uptick has been driven by an increase in credit to both industry and services. Although, the credit pick-up is still nascent, especially for industry, and a part of it could have been driven by some substitution away from the NBFCs.

Credit growth has picked up



Source: RBI, HDFC Bank

...driven by both a recovery in credit to industry & services



Source: RBI, HDFC Bank

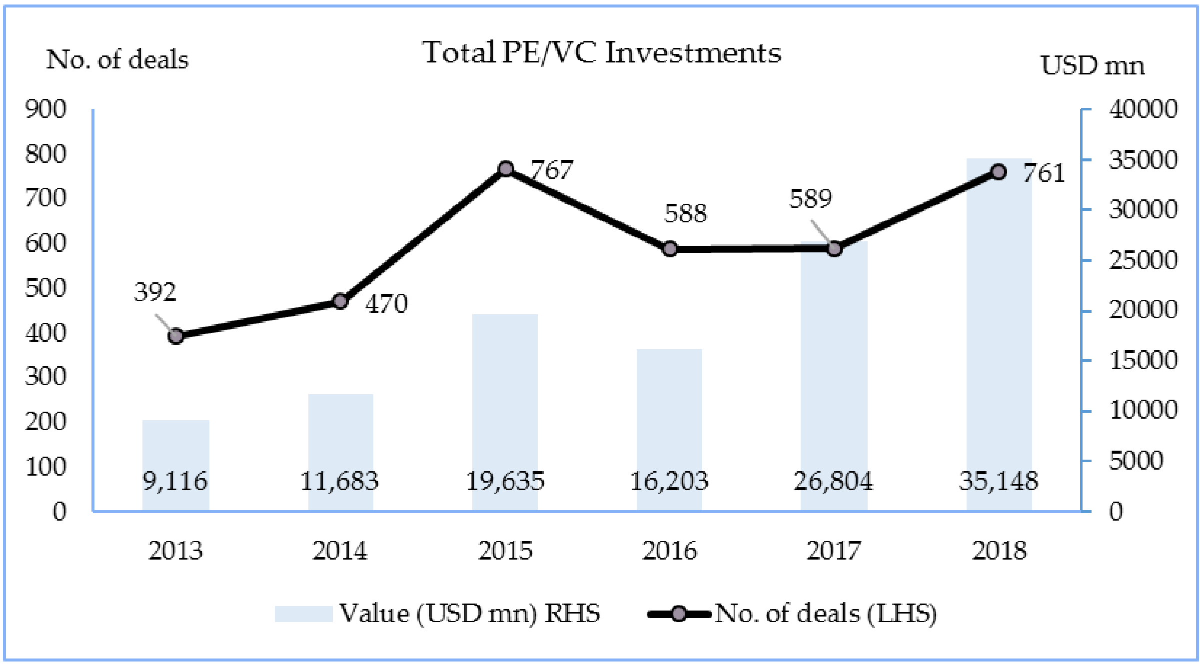
4. Private equity investments on the rise

Private equity firms have increased the amount of capital deployed over the last two years. In 2018, investments (PE +VC) increased by 35% in value terms compared to 2017 (US$35.1 billion vs US$26.1 billion in 2017) and deal volume increased by 28% (761 deals compared to 594 deals in 2017). The growth was led by strong pickup in buyouts and start-up investments ("Can private equity boom if public markets bust?" EY Annual Roundup 2018).

After record start-up investments in 2015 and subdued investments in 2016 and 2017, 2018 recorded a strong uptick in start-up investments. On a Y-o-Y basis, investment in start-ups increased 83% in 2018 to US$6.4 billion compared to US$3.5 billion in 2017. 2018 was also the best year for start-up investments, surpassing the previous high recorded in 2015.

An improvement in funding activity bodes well for the overall investment scenario and corroborates with the private investment pickup.

Private Equity Firms deploy higher capital



Source: "Can private equity boom if public markets bust?" EY Annual Roundup 2018, HDFC Bank

5. Foreign investment has also been supportive

Apart from PE funding, foreign investors with deep pockets are also deploying funds. For the first time in two decades, India has been getting more foreign investment than its neighbour China. In 2018, India saw more than $38 billion of inbound deals compared with China's $32 billion, buoyed by stable fundamentals, a bankruptcy code and fresh opportunities in sunrise sectors.

Overall, on the funding side, these are all supportive of the nascent recovery in private capex that we are witnessing. That said, the system continues to remain under stress and a full blown investment recovery would require further reforms, dealing with stressed assets, and clean-up of banks' balance sheets.

Pockets of revival

So where are these investments happening?

Using the Department of Industrial Policy & Promotion (DIPP) data we identify sectors which have seen the largest increase in investments over the last one year. The DIPP provides data (as part of the IEM Form B) on investments implemented by all non-MSMEs with an investment of above Rs 10 crore in plant and machinery for manufacturing sector and more than Rs 5 crore for the service sector which are exempted from obtaining an industrial license.

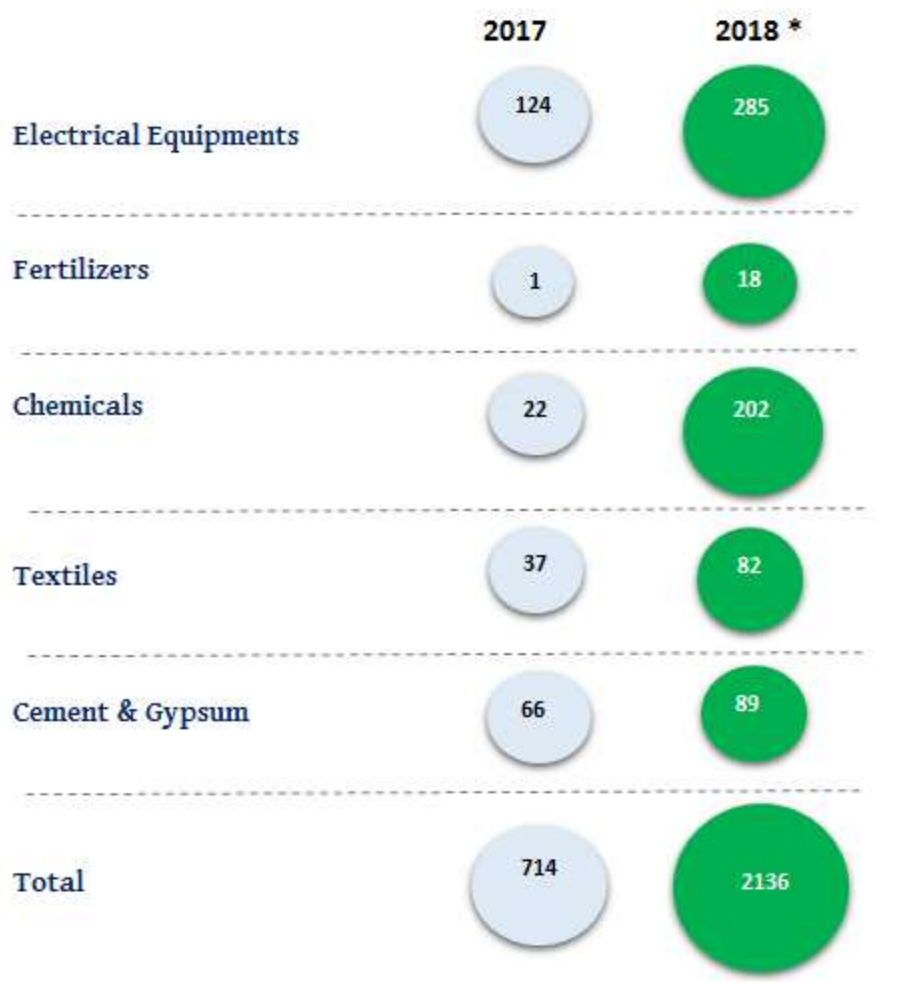
Data on investment proposal, as per the Industrial Entrepreneurs Memorandum (IEM), shows that 816 investment proposals (industrial units set up) were implemented in the eleven-month period between January and November 2018, compared to 571 during the same time last year. **In terms of value, the increase has been even larger, with Rs. 2136 billion worth of projects implemented this year compared to Rs. 714 billion in the previous year.**

The sectors that have seen the most significant increase include electrical equipment's, chemicals, cement, textiles and fertilisers. The detail on the size of projects implemented across these sectors shows that while large ticket investments might not be happening, small ticket capex has started to come on stream.

The traction in these sectors is further supported by corporate earnings data. The growth in profit after tax (PAT) for the quarter ending September 2018 was strong in sectors such as Chemicals, electrical equipment, textiles, fertilizers, cement and metals such as aluminium and steel.

PAT (%) Sep-18			
Aluminium	12.5	Engineering	23.6
Cement	13.7	Bharat Electronics	38.5
Ultratech cement	-11.3	Cummins India	38.4
Ambuja Cement	11.9	BHEL	60.4
ACC LTD	15.6	Kalpatru Power	27.8
Chemicals	48.6	L&T	30.0
Energy	6.1	Thermax	29.5
Reliance IND.	17.9	Fertilisers	9.2
ONGC	61.1	Power	-48.0
GAIL	49.9	Steel	31
IOC	-20.5	Textiles	13.1

Source: Company Earning Results, HDFC Bank



The Frontrunners: Private Sector Capex Implemented (Rs. bn)
Industrial Entrepreneur Memoranda (IEMs - PART B Form) filed by Entrepreneurs at DIPP, regarding the commencement of commercial production

Source: DIPP, 2018 data till November 2018

Note: all non-MSME industrial undertakings with an investment of above Rs 10 crore in plant and machinery for manufacturing sector and more than Rs 5 crore for service sector which are exempt from obtaining an industrial license are required to file IEMs.

The Front runners

The sector specific trends signal that the private investment revival so far has been more sector specific rather than a full blown revival in institutional capacities.

Based on the DIPP data, company level data and discussions with sector specialists, the following are the sector specific nuances:

- **Electrical equipment: Increase in distribution and transmission of power, while power generation capacities remain low.** Government initiatives to increase access to electricity have helped. Delicensing electrical machinery, allowing 100% FDI in the sector has been positive.

Demand driven by exports of power transformer and high voltage switchgear products, energy meters and cables and domestic demand for alternative energy sources (like solar).

- **Cement: Increased road connectivity has led to a rise in construction of houses and dwellings.** Institutional demand is weak. CU rates still at 70%, but better than past (around 66% in last two years). **South India driving the increase, especially irrigation projects.**

- **Chemicals: Shut down of chemical manufacturing units in China as they try and control air pollution has benefitted India.** Domestic chemical sector attracted FDI of $1.3 bn in 2017-18 – 3% of total FDI inflow.

- **Textiles:** Make in India supporting the sector. Tax and production incentives provided by the government have spurred the revival.

Refer to the Appendix for greater detail on sector specific drivers.

Bottom-line

Investments are supporting growth. More importantly, the burden doesn't lie on the government anymore. The private sector is showing signs of traction as well. Although, the revival is sector-specific and primarily in the manufacturing sector. There are still issues related to funding, but the increase in overall credit growth, increased participation of private equity firms and continued FDI inflows are all encouraging signs. That said, we are a long way from a full blown revival in investments, especially with infrastructure investments remaining absent, given the build-up of stressed assets, stuck projects and capacity overhang in the sector. Therefore, a faster resolution of bad loans and deleveraging of the corporate balance sheet remains essential to make the investment pickup broad based.

Appendix: Sector Specific Drivers

Derived from sector specific industry data and announcements and from discussions with sector specialists

Sector	Detail
Electrical Equipment	**Demand Dynamics:** • Increase in distribution and transmission of power, while power generation capacities remain low • Government initiatives to increase access to electricity like 24X7 power, DDUGJY (Deendayal Upadhyaya Gram Jyoti Yojana), Pradhan Mantri Sahaj Bijli Har Ghar Yojna (SAUBHAGYA), IPDS (Integrated Power Development Scheme) have spurred demand for electrical equipment. • Delicensing electrical machinery, allowing 100% FDI in the sector has also been a positive. • Siemens India, Cummins and ABB, in their earnings call, said the growth was driven by demand from railways, metro and construction companies. • Conventional energy projects remain low, but demand for solar-invertors, fast charging infrastructure for electric vehicles, micro grids etc. positive for the sector. For instance, ABB India has signed agreements with Volkswagen to set up fast-charging stations for electric vehicles in the US. • Government has planned investment of $800mn in renewable generation capacity over next two years. • Bharat Heavy Electricals Limited (BHEL), has won an order for setting up 129 MW of solar power projects in Telangana from Singareni Collieries Company Limited (SCCL). • Demand has also been supported by upgradation in transmission capacities to next higher voltage system • Exports have risen especially in power transformer and high voltage switchgear products, energy meters and cables • Also demand for low voltage switch gears has picked up due to revival in realty, infrastructure, and other manufacturing industries

	Growth in segments like rotating machines by 12%, HT Motors 18%, cables 20% and Meters 28%. Growth is also seen in transmission mission line towers due to increase in demand in the domestic market.
Cement	- Increase in road connectivity has led to rise in construction of houses and dwellings. - Majority of the pickup in South India with increase in road and irrigation projects. - Institutional demand continues to remain weak. - CU rates have picked up from 66% in last two years to 70%.
Chemicals	- Chemicals and chemical products account for 7.9% in overall IIP index and accounts for 2% of GDP. - China's decision to shut many chemical manufacturing units in order to rein in air pollution has helped Indian chemical industry (chemical exports grew by 32% in 2017-18). - Domestic chemical sector attracted FDI of $1.3 bn in 2017-18 – 3% of total FDI inflow. **Investments:** India's largest agrochemical company, United Phosphorous, announced the acquisition of Arysta Life science for about USD 4.2 billion. Saudi Aramco showed interest in investing USD 44,000 million in mega petrochemical project, ONGC plans investment of USD 11,000 million in greenfield oil and gas project and Sabic is investing USD 4,300 million in brownfield petrochemical complex. - Data compiled by SBICAP Securities showed specialty companies such as Aarti Industries, Fine Organic Industries, Himandri Specialty Chemicals and Bodal Chemicals have lined up investments of Rs 9,200 crore for FY20 compared to Rs 1,400 crore for the previous financial year.
Textiles	This sector is starting to see some initial improvement. Indian Textile industry contributes to 7 per cent of industrial output in terms of value, 2 per cent of India's GDP and 15 per cent of country's export earnings.

- The government in June last year announced a Rs 6,000 crore special package for the textile and apparel sector, which included several tax and production incentives. And also announced Rs 1,300 crore Samarth scheme for skilling 10 lakh people in textiles industry and 100% FDI under the automatic route for single brand retail trading.

- Government also increased basic customs duty on 76 textiles and apparel products at 6-digit level from mid-July 2018, and followed it up by doubling of import duty on 328 textile products to 20 per cent from the earlier 10 per cent.

- Some of the top investors include Arvind Ltd, Trident Ltd, Shahi Exports, Welspun, AHP Garments, Siyaram Silk Mills, Dhanpriya Synthetics, Vardhman Textiles, Shivmay Denim, Pinaz Texfab.

- Grasim Industries has announced INR 5000 cr fresh investments to set up two plants in Gujarat.

- Production of textiles and apparel in the country rose between April and October this year as against the same period last year according to IIP data.

- Impact of GST and demonetisation on the sector are gradually fading.

- The stressed advance ratio of the textile sub-sector has been improving continuously. As per Reserve Bank of India (RBI)'s financial stability report, the ratio has improved from 23.70% in September 2017 to 18.70% in September 2018.

Treasury Economic Research team

Abheek Barua
Chief Economist
Phone number: +91(0) 124-4664305
Email ID: abheek.barua@hdfcbank.com

Tushar Arora
Senior Economist
Phone number: +91 (0) 124-4664338
Email ID: tushar.arora@hdfcbank.com

Tanvi Garg
Economist
Phone number: +91 (0) 124-4664372
Email ID: tanvi.garg@hdfcbank.com

Sakshi Gupta
Economist
Phone number: +91 (0) 124-4664372
Email ID: sakshi.gupta3@hdfcbank.com