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Foreword

The fierce second wave of Covid-19 pandemic took the healthcare ecosystem to the brink and beyond, but it does not seem to have hit economic activity as hard as the first wave did. The main reason for this would be decentralised and less-stringent lockdowns, that reflects the 'learning to live with the virus attitude' that authorities adopted. Many states also permitted construction and manufacturing activities to continue during the lockdown.

With private consumption taking a hit from the second wave, private investments will yet again be relegated to the backburner. Though large corporates have deleveraged and are in a position to invest now, low capacity utilisation and overall uncertainty on the economic course will discourage decision-making.

Smaller firms and services continue to face pressure amid the second wave. Private consumption remained weak. The economy is down but not out as it walks on the recovery path. Second half of fiscal to be led by better-spread economic growth, owing to increased inoculations and better adaptability to the pandemic, which would support sectors that are lagging.

Globally, pace of vaccination has acted as one of the key driving factor for recovery with US and UK recording GDP growth owing to faster vaccination while Japan witnessed decline in GDP owing to resurgence of cases and slow pace of vaccination.

Our forecast of 9.5% GDP growth in FY22 assumes that 70% of India's adult population gets vaccinated by Dec-end. If pace of vaccination is slackens and the third wave turns out to be intense, GDP growth could drop to 8%.

In this month's edition of the SME newsletter, the coverage is on the "Light Engineering" sector SME outlook. After witnessing declines for two consecutive fiscals, due to muted end-user industry demand, the sector is expected to witness growth recovery, though on a significantly low base. However, margin pressures may be felt due to elevated input prices this fiscal.

Macro Monitor

INDUSTRIAL OUTPUT (y-o-y %)

	Mar-21	Apr-21	May-21
Industrial (IIP)	22.4	134	29.3

CRUDE OIL (y-o-y %)

	Mar-21	Apr-21	May-21
Brent Crude	93.5	171.3	113

Exchange Rate

	Mar-21	Apr-21	May-21
Rs/$	72.8	74.5	73.3

Inflation (y-o-y %)

	Mar-21	Apr-21	May-21
CPI	5.5	4.3	6.3
WPI	7.4	10.5	12.9

TRADE (y-o-y growth %)

	Mar-21	Apr-21	May-21
Exports	60.3	201.5	67.4
Imports	53.7	167.6	68.5
Trade balance	39.6	118.1	74.7

GDP (y-o-y %)

	Q2FY21	Q3FY21	Q4FY21
Private consumption	-11.3	-2.8	2.7
Government consumption	-24	-1.0	28.3
Fixed investment	-6.8	2.6	10.9
GDP	-7.3	0.5	1.6

India's growth sliced by second wave of infections

Macroeconomic outlook	FY18	FY19	FY20	FY21	FY22F	Rationale for FY22 outlook
GDP growth (%)	6.8	6.5	4.0	-7.3	9.5	The second wave and the resultant localised lockdowns has impeded the path to economic recovery, leading us to revise down our growth forecast for this fiscal to 9.5%, from 11.0% earlier. That said, expected pick-up in economic activity post-vaccination and support from global growth would act as positives.
Inflation CPI (%)	3.6	3.4	4.8	6.2	5.3	Upside risks on inflation are growing from surging international commodity prices. While producers are bearing a greater burden of rising input costs for now, these could get passed to retail prices once demand recovers. Food inflation could also face pressure from disruptions to rural economy due to the pandemic's spread, and rising global prices.
Exchange rate (Rs/$, March)	65	70	74	74	75	Soaring Covid-19 cases posing a strong downside risk to India's growth forecast may weaken the rupee more against the dollar. Impact of a second wave amid inflationary pressures and stress on government finances are expected to weigh on sentiment.

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Global Snapshot

US

US inflation spikes again, unemployment rate declines

- CPI increased sharply to 5% on-year in May, up from 4.2% in the previous month. It has trend upwards since January, when inflation was at 1.4%. However, the on-year inflation reading is largely attributed to the low base of the previous year (when prices rose 0.1%).
- Total non-farm payroll employment increased by 5.6 lakh in May, significantly higher than the gains of 2.6 lakh the previous month.
- The unemployment rate, declined by 0.3% to 5.8%. Leisure and hospitality, education, and healthcare accounted for the largest gains.

UK

Eased restrictions support monthly uptrend in UK

- UK's GDP grew 2.3% in April — the fastest monthly rise since July 2020. The service sector grew 3.4% in April 2021, as restrictions eased and retail sales volumes grew by a sharp 9.2% on-month.
- CPI-linked inflation rose 1.5% in April on-year, up from 0.7% growth to March
- The trade deficit narrowed to £0.9 billion in April from £2.0 billion in March, as exports grew faster than imports.

China

China's manufacturing activity stumbles

- In May manufacturing PMI came in at 51, 0.1pp lower on-month, since supply bottlenecks stifled production.
- Consumer prices sustained their upward trajectory on-year in China, with CPI-linked inflation at 1.3% in May, higher than 0.9% in the previous month.
- Exports increased by a robust 37.4% on-year. This is largely attributed to the base effect from 2020, though China's rapid recovery from the pandemic and rebound in other advanced economies in this quarter of 2021 supported trade figures.

Japan

Renewed surge of infections in early 2021 weaken economic recovery

- Japan's economy shrank 3.9% on-quarter in the first quarter of 2021, following an 11.7% expansion in the last quarter of 2020.
- Private consumption was the largest drag on domestic demand, declining 5.8%. Government consumption, too, was in the red, down 4.5%.
- Resurgence in cases and low vaccine coverage in Japan impeded economic recovery.

MSME News & Developments

PMI manufacturing witnessed moderation on account of second wave

Y-o-y growth	May-20	Jun-20	July-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20	Jan-21	Feb-21	Mar-21	Apr-21	May-21
PMI manufacturing	30.8	47.2	46.0	52.0	56.8	58.9	56.3	56.4	57.7	57.5	55.4	55.5	50.8

IIP across manufacturing of machinery, equipment and fabricated metal products, too, moderated

IIP	May-20	Jun-20	July-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20	Jan-21	Feb-21	Mar-21	Apr-21	May-21
Manufacturing of machinery & equipment	44.6	80.2	85.6	92.6	108.9	113.2	105.4	118.5	110.0	112.0	129.0	98.7	82.1
Manufacturing of electrical equipment	31.6	61.7	82.6	94.4	126.5	132.4	114.4	131.8	109.7	106.0	108.6	86.0	66
Manufacturing of fabricated metal products	44.2	67.3	82.0	83.9	92.1	95.7	81.8	99.0	93.7	93.2	100.9	80.0	65.7

Metal prices on an upward trajectory, to hurt MSME margins

Y-o-y growth	May-20	Jun-20	July-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20	Jan-21	Feb-21	Mar-21	Apr-21	May-21
Pig Iron	95	94	97	103	103	105	106	116	126	121	128	134	138
Aluminium	91	92	96	101	102	103	109	115	115	115	121	129	140
Steel (HR coil)	90	88	88	95	99	102	107	120	127	121	124	138	155

Note: Indexed to May 2019 prices | Source: CRISIL Research

Source: MOSPI, Industry, CRISIL Research

Light Engineering sector expected to witness an upturn this fiscal

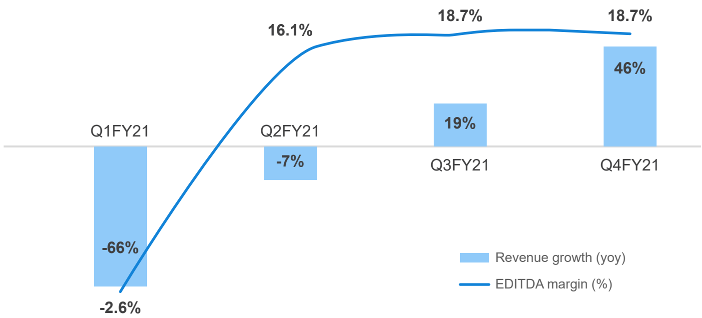
Automobile sector accounts for nearly 50% of demand across key light engineering segments

Segment	SME share	Products	Key end-user industries
Bearings	50-60%	Deep groove, angular contact and thrust ball bearings, cylindrical, needle, taper and spherical roller bearings	Automobile, electric motors, diesel engines, industrial machinery, machine tools and replacement market.
Ferrous castings	40-50%	Gears, pulleys, fly wheel, electric motor end castings, railings, finials, spindles	Automobile, industrial machinery, power, chemical and fertiliser plants etc.
Fasteners	55-65%	Nuts, bolts, studs, rivets and screws	Automobile accounts for bulk. Consumer durables and railways are the others.
Steel Forging	30-40%	Flanges, fittings, lap-joint stub-ends etc.	Automobile accounts for bulk. Agricultural machinery, general industrial equipment, off-highway & railroad equipment are others.

Source: Industry, CRISIL Research

Bearings, Castings, Fasteners and Steel forging are the key segments contributing bulk of the Light Engineering sector with key the end-user industry being automobile which drives ~50% of demand, rest contributed by industrial machinery, consumer durables, railway etc. After declining for two consecutive fiscals, the Rs 450-500 bn worth sector (as of FY20), is expected to grow by 12-17% in FY22 on the substantially low base.

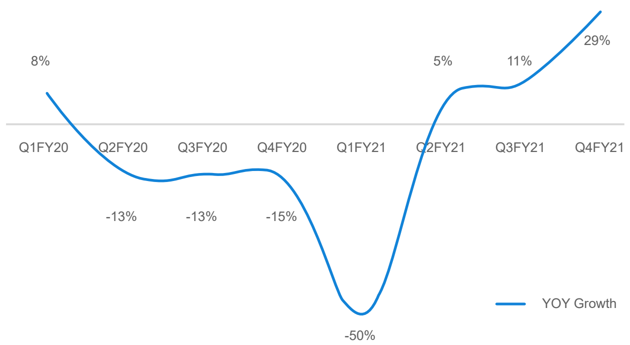
Sequential growth also witnessed in quarterly revenues of key light engineering players, margins also stabilised



Note: Data for 15 companies representative of 20-25% of market share
Source: Industry, CRISIL Research

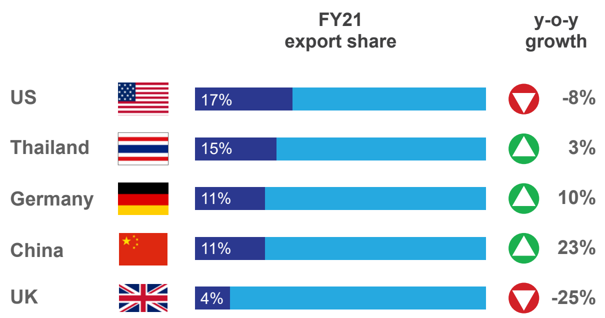
Exports of light engineering products are also on the rise since the past three quarters

Light Engineering exports growth on the upturn



Source: DGCIS, CRISIL Research

Top countries' share in exports: Exports to China gain share



After steep decline in domestic automobile production in the first half of last fiscal, recovery has been sequential, to benefit light engineering industry

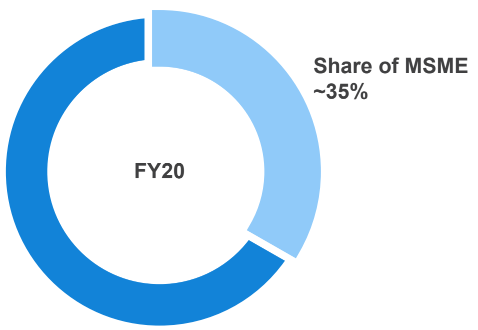
Y-o-y growth	Q1FY21	Q2FY21	Q3FY21	Q4FY21	Q1FY22E
Two-wheeler production	-67%	-29%	18%	29%	621%*
Cars and UV production	-84%	-3%	23%	27%	302%
Commercial Vehicle production	-88%	-16%	13%	53%	411%
Tractor production	-38%	23%	62%	54%	109%

Note: Two wheeler production for Q1FY22 is y-o-y growth in April-May data | Source: Industry, CRISIL Research

MSME Light Engineering sector to witness recovery after declining for two consecutive years

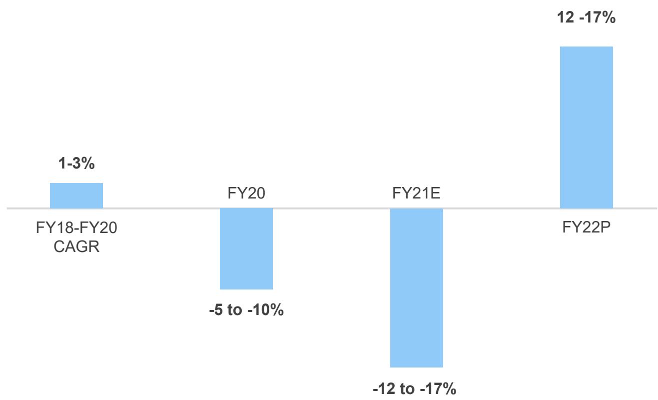
The sector is characterised by large presence of small and unorganised players, aided by low capital and technology intensity that manufacture low value-added and customised products. Their presence in the industry varies between 80-95%; however their contribution, in revenue terms, ranges from 30-40%

MSMEs hold ~35% of light engineering sector



Source: Industry, CRISIL Research

Double-digit growth expected in FY22 on low base



Light Engineering MSME revenue outlook

FY21: Though the demand from automobile and other end-user segments picked in H2FY21, the steep decline in Q1 and Q2 had pulled the full year revenue of MSME players by -12 to -17%.

FY22: Post two fiscals of consecutive decline, an expected recovery in auto demand coupled with improvement in consumer and industrial activity is projected to drive revenue for SME players.

Margin outlook for MSME Light Engineering

FY21: Operating margins estimated to have contracted by 125-170 bps in FY21 due to low demand as well as increase in raw material prices; fixed costs account for 32-37% of overall costs

FY22: Operating margins would expand by 100-150 bps in FY22. Despite revenue expansion, margin pressure may remain as input costs of raw materials such as Pig iron, Steel and Aluminium are expected to remain elevated in FY22.

Opportunities galore for Light Engineering entities

1. Indirect benefit via PLI scheme in automobile

The government earmarked Rs 570 billion towards the automotive and auto-components sectors. Though, large players will be major beneficiary of the PLI scheme, PLI presents an indirect opportunity for MSMEs with greater domestic production and subsequent higher demand for ancillary industries such as light engineering.

2. Pent up demand across industries to drive domestic growth

On the low base of FY21, demand across industries such as automobile, consumer durables, industrial machinery etc. is expected to remain healthy and witness double-digits growths as the economy ramps up over the medium term.

3. Exports market

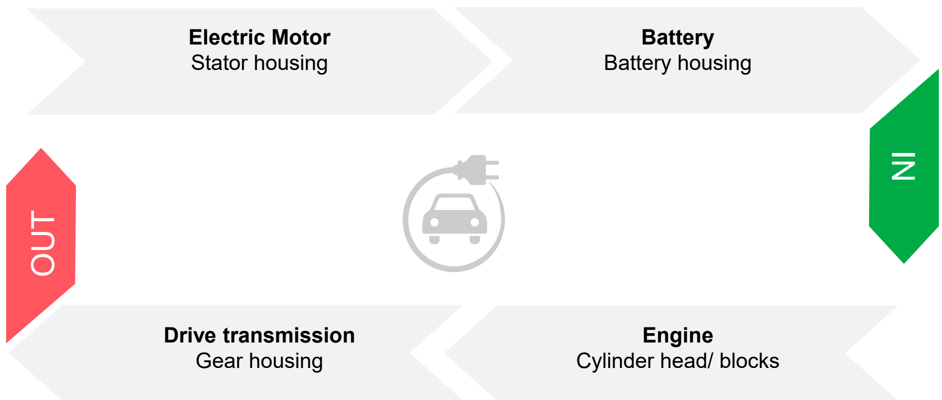
Exports to developed nations such as US and EU account for a large chunk of the industry's total exports revenue. As economies open up with higher pace of vaccination in these countries, export growth is expected to bounce back over a low base.

Key risks / monitorables

1. EV adoption

Proliferation of EVs poses a threat to the traditional Internal Combustion Engines (ICE). Major casted engine components such as cylinder heads, cylinder blocks, gear housing (these comprise around 50% of the casted components) run the risk of becoming obsolete. Industry demand growth to reduce by 1-2% CAGR in the next five years due to EVs as cylinder heads, cylinder blocks and gear housing will no longer be needed. Players would need to focus on newer products like stator housing, battery housing to offset the loss in demand for traditional casted products once EV demand pick up.

Auto casting players would need to focus on newer components (battery & stator housing) for EVs



Source: CRISIL Research

2. Availability of skilled labour

The light engineering industry is only ~15% automated, the rest dependent on labour. Availability of labour remained a concern during COVID-19 induced lockdowns as migrant labours returned to their hometowns amidst the fear of the virus spread.

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Solution provided to an Industrial Manufacturing company for managing their working capital

Problems faced by customer :

The customer is into manufacturing and supply of complete range of Machine and Self Tapping screws & Special fasteners. Some of its customers include major engineering & automobile companies. While the co. had to offer credit period of 75-90 days to these clients, its suppliers would extend a credit period of max 30 days only due to which the firm was facing working capital cycle gap and was looking for ways to bridge the same without having to pay substantial rate of interest.

Solution offered :

We informed the promoters to explore procurement of supplies under LC route where the cost involved was substantially lower vis-à-vis interest on an OD facility. While the suppliers agreed to accept LCs in lieu of payment, they did not extend the credit period of 30 days. As such, we also sanctioned purchase LCBD facility wherein the LC would be discounted by YBL after 30 days and payment would be released to the supplier.

How it has helped the Customer :

The company has now effectively closed its working capital cycle gap and is able to operate at much lower costs. Further, they have also added new suppliers by replicating the LC model and have successfully managed to increased their sales in the process.

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