India Defence

Sept 02, 2022

Government push for indigenisation provides strong visibility

The Indian defence sector is going through a major transformational phase as the government looks committed to reducing imports and increasing indigenisation of various key defence platforms, systems and associated equipment required for these platforms. The share of imports, which is about ~35% of the total defence procurement budget, has come down in the last two to three years. It is likely to reduce further in coming years as the government continues to focus on allocating more budget to DRDO for indigenous development of new generation & modernised equipment, sign large scale orders for these equipment/platforms with defence PSUs and encourage more domestic private players, MSMEs and start-ups for manufacturing key components, which India used to import from countries.

Government push for indigenisation continues

The Ministry of Defence (MoD) has notified 310 major equipment/platforms in the last two years through three separate lists, which included combat aircraft, trainer aircraft, combat helicopters, utility helicopters, submarines, next generation corvettes, tank engines, MRSAM system, vessels, torpedoes, etc. These platforms are planned to be indigenised progressively till 2027. Moreover, during the same period, 1238 strategically important line replacement units (LRUs), sub-systems/components (used in the major platforms & equipment) have also been notified by the MoD through another three separate lists.

Significant execution pick-up witnessed in Q1FY23

All defence companies saw a noticeable pick-up in execution, which led to significant increase of in their revenues (highest growth being witnessed in Bharat Dynamics (BDL) where revenues jumped over 5x followed by 124% growth by Hindustan Aeronautics (HAL) and 80-90% growth seen in Bharat Electronics (BEL), Mazagon Dock Shipbuilders (MDL) and Garden Reach Shipbuilders (GRSE).

Increasing indigenisation of key sub-components to further drive execution of already strong order backlog

As mentioned above, 1238 sub-systems/components have also been notified in last two years that will be indigenised in phases over the next five years. The government has already indigenised 167 such components so far (163 from first list and four from second list). Moreover, 2500 components had already been indigenised by the government before announcing the first list. We believe indigenous manufacturing of these components by private players or MSMEs, will further help defence companies in picking up execution rate as the procurement time will be reduced. Going ahead, we see a strong revenue visibility for the defence companies looking at the strong order book (at 3-4x TTM revenues for HAL, BEL & BDL while it is at 6-7x for Cochin Shipyard, Mazagon Dock and about 12x for GRSE). Moreover, there is a healthy pipeline of orders that gives more comfort on longer term basis.

Valuations look attractive

Valuations look attractive for defence PSU stocks - HAL, BEL and BDL at 16-24x P/E on FY24E earnings considering the strong visibility on orders execution and, thus, earnings growth over the next two years. The healthy pipeline of orders gives us more comfort in terms of long term earnings growth of these companies. Balance sheet of these defence companies looks better with zero debt and working capital support from MoD. Cochin Shipyard is also well placed to benefit on India Navy's plan of warships procurement. Data Patterns is also expected to see significant earnings growth over FY22-24E led by strong execution and increase in order inflows. **Key top picks: HAL, BDL and BEL.**

Sector View: Positive

Top Picks in Defence Space

Company	CMP	TP	Upside (%)
HAL	2370	2860	21%
BEL	325	405	25%
BDL	833	1070	28%
DPIL	1060	1280	21%
CSL	379	465	23%

Defence stocks has been outperforming broader markets broadly on the back of

- Strong order backlog and healthy pipeline of orders
- Increasing indigenisation of key components driving execution

Key risks to our call

- Dependence on government contracts
- Delay in order finalisation, awards impacting future visibility

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Sector Update

ICICI Securities – Retail Equity Research

Top bets in defence space

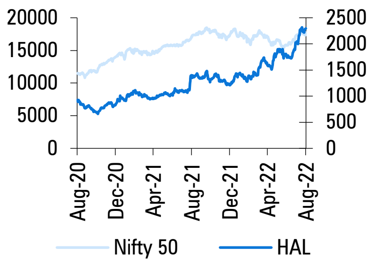
Hindustan Aeronautics (HAL)

Hindustan Aeronautics (HAL), the largest defence PSU in India, is engaged in design, development, manufacture, repair, overhaul, upgrade and servicing of a wide range of products including, aircraft, helicopters, aero-engines, avionics, accessories and aerospace structures. Order book is at ₹ 84800 crore as of June 2022 end (~3.2x TTM revenues) led by large scale orders in manufacturing aircraft/helicopters (Tejas LCA Mk1A, LCH and ALH).

Key orders in the pipeline for the next one to two years include 70 HTT-40, 25 advanced light helicopters (ALH) for Army, six Dornier aircraft, 12 light utility helicopters (LUH), 12 Sukhoi-30 MKI and 240 AL-31 engines for Sukhoi-30 MKI aircraft. Total estimated cost of these orders is at ₹ 45000 crore. In the longer term (three to five years), key orders in the pipeline are 145 LCH, 175 LUH, 60 Marine ALH, 36 HTT-40, 18 RD-33 engines for MiG-29 and medium weight fighter (Tejas MK2).

Execution of existing healthy order backlog with strong pipeline and continuous inflows of maintenance, repair & overhaul (MRO) contracts will drive earnings of HAL for the coming period. We expect HAL to deliver revenue and EBITDA CAGR of 7.7% and 14.1%, respectively, in FY22-24E. PAT is likely to grow at ~10% CAGR (FY21-24E). Increase in profitability with strong asset turnover will result in healthy return ratios over FY23-24E. We continue to remain positive on HAL and retain our **BUY** rating on the stock with a target price of ₹ 2,860 (valuing at 20x PE on FY24E EPS).

Price Chart



Particulars

Particular	Amount
Market Capitalisation (₹ Crore)	79,250
Total Debt (FY22 - ₹ Crore)	-
Cash (FY22 - ₹ Crore)	3,079
EV (₹ Crore)	76,172
52 Week H/L (Rs)	2425 / 1181
Equity Capital	334
Face Value	10

Exhibit 1: Financial summary for HAL

(₹ crore)	FY19	FY20	FY21	FY22	4 Year CAGR	FY23E	FY24E	2 Year CAGR
Revenues	20,008	21,438	22,882	24,620	5.3	26,227	28,556	7.7
EBITDA	4,543	4,896	5,336	5,409	4.5	6,425	7,039	14.1
EBITDA margin (%)	22.7	22.8	23.3	22.0		24.5	24.7	
Profit Before Tax	3,725	3,969	4,283	5,225	8.8	5,776	6,312	9.9
EPS (₹)	69.6	85.9	97.1	151.9		130.9	143.1	
P/E (x)	34.0	28.5	24.5	15.6		18.1	16.6	
EV/EBITDA (x)	18.3	17.3	13.5	12.0		10.2	9.2	
RoCE (%)	24.0	21.9	29.4	27.4		30.6	30.8	
RoE (%)	19.3	21.0	21.0	26.3		23.2	23.4	

Source: Company, ICICI Direct Research

Bharat Electronics (BEL)

Bharat Electronics (BEL), a leading aerospace and defence electronics company, primarily manufactures advance electronics products including radar, missile systems, electronic warfare & avionics, anti-submarine warfare, electro-optics, homeland security, civilian products. Order backlog at ₹ 55,333 crore as of June 2022 end (~3.3x TTM revenues).

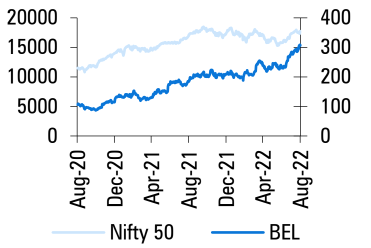
Orders inflow during FY23 is expected at ₹ 18,000-20,000 crore. The major orders in the pipeline are: Akash Prime from Bharat Dynamics worth ₹ 4,000 crore, Himshakti Electronic Warfare (EW) worth ₹ 3,200 crore, Arudhra Radar worth ₹ 3,000 crore, EW system for Mi-17 helicopters worth ₹ 1,500 crore, Electronic Warfare Systems for Ships worth ₹ 12,000 crore, 12 WDR (Weapon Detecting Radars) worth ₹ 1,000 crore.

Major orders expected in FY24E are Quick Reaction Surface-to-Air Missile (QRSAM) worth ₹ 20,000 crore and Medium Range Surface to Air Missile (MRSAM) worth ₹ 15,000-20,000 crore. Army is in process of take up Acceptance of Necessity (AoN) post which they will issue RFP after approvals.

We have increased our earnings estimates for FY24E by 6.9% to factor in better visibility on execution & margin of existing orders and orders in pipeline. Strategy to diversify into non-defence areas, focus on increasing exports and services share would aid long term growth and help de-risk its business.

With the strong order backlog and healthy pipeline, we expect revenue, EBITDA to grow at a CAGR of 18.5%, 20.1%, respectively, in FY22-24E aided by sustained

Price Chart



Particulars

Particular	Amount
Market Capitalization	₹ 79189 Crore
Total Debt (FY22)	₹ 72.1 Crore
Cash and Inv (FY22)	₹ 1239.4 crore
EV (FY22)	₹ 76182 Crore
52 week H/L (₹) (BSE)	330 / 183
Equity capital	₹ 243.7 Crore
Face value	₹ 1

margins in range of ~22%. We remain positive on BEL and retain our **BUY** rating on the stock with a target price of ₹ 405 (valuing at 30x P/E on FY24E EPS).

Exhibit 2: Financial summary for BEL

(₹ crore)	FY19	FY20	FY21	FY22	5 Year CAGR	FY23E	FY24E	2 Year CAGR
Revenues	12,085	12,921	14,064	15,314	4.9	18,138	21,512	18.5
EBITDA	2,862	2,730	3,181	3,309	2.9	4,009	4,776	20.1
EBITDA margin (%)	23.7	21.1	22.6	21.6		22.1	22.2	
Net Profit	1,927	1,794	2,065	2,349	4.0	2,751	3,279	18.2
EPS (₹)	7.9	7.4	8.5	9.6		11.3	13.5	
P/E (x)	41.1	44.1	38.3	33.7		28.8	24.2	
EV/EBITDA (x)	27.4	28.3	23.9	23.6		19.5	15.8	
RoCE (%)	30.0	25.1	27.2	26.2		28.5	30.1	
RoE (%)	21.4	18.2	19.1	19.6		21.3	22.5	

Source: Company, ICICI Direct Research

Bharat Dynamics (BDL)

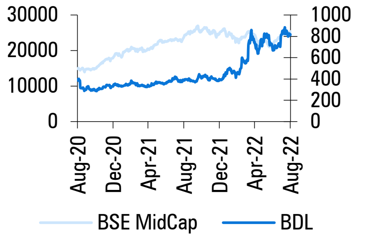
Bharat Dynamics (BDL), one of the leading defence PSUs in India, is engaged in the manufacture of surface to air missiles (SAMs), anti-tank guided missiles (ATGMs), air to air missiles (AAMs), underwater weapons, launchers, countermeasures and test equipment. BDL has been expanding its capabilities to enhance market position and competitiveness with continuous investment in R&D and expanding infrastructure to develop new generation products.

Order book at ₹ 13000 crore (4.6x FY22 revenues) gives strong revenue visibility. Moreover, ₹ 22000 crore worth of orders are in the pipeline for the next three to four years gives more comfort on future earnings. We see a huge opportunity for BDL in exports also (Akash SAM, ATGMs, Astra, Torpedoes) driven by rising interest from friendly countries and lower cost on high indigenisation levels.

The company, which was manufacturing mainly surface to air missiles and anti-tank guided missiles till FY22, has entered into manufacturing of Air to Air missiles also after receiving a large order from govt for Indian Air force and Indian Navy. Moreover, many products in missiles and torpedoes category are under development (which company is doing with DRDO) which are expected to drive its orders inflow in the coming period.

We expect BDL to deliver revenue and EBITDA CAGR of 28.8% and 26.8%, respectively, in FY22-24E. PAT is likely to grow at 25.1% CAGR (FY22-24E). Increase in profitability with strong asset turnover is expected to result in healthy return ratios over FY23-24E. We remain positive on BDL with a **BUY** rating and target price of ₹ 1070 (valuing at 25x P/E on FY24E EPS).

Price Chart



Particulars

Particular	Amount
Market Capitalisation (₹ Crore)	15,26
FY22 Debt (₹ Crore)	
FY22 Cash (₹ Crore)	1,90
EV (₹ Crore)	13,36
52 Week H/L (Rs)	905/36
Equity Capital (₹ Crore)	183.
Face Value	1

Exhibit 3: Financial summary for BDL

(₹ crore)	FY19	FY20	FY21	FY22	4 Year CAGR (FY19-22)	FY23E	FY24E	2 Year CAGR (FY22-24E)
Revenues	3,069	3,105	1,914	2,817	(2.8)	3,594	4,673	28.8
EBITDA	622	755	345	726	5.3	841	1,168	26.8
EBITDA margin (%)	20.3	24.3	18.0	25.8		23.4	25.0	
Net Profit	423	535	258	500	5.8	604	782	25.1
EPS (₹)	23.1	29.2	14.1	27.3		33.0	42.7	
P/E (x)	36.1	28.5	59.2	29.2		25.3	19.5	
EV/EBITDA (x)	23.9	19.3	39.8	18.4		15.6	11.1	
RoCE (%)	29.8	28.6	12.8	24.6		24.7	27.9	
RoE (%)	18.6	20.5	9.6	17.3		17.7	20.0	

Source: Company, ICICI Direct Research

Data Patterns (DPIL)

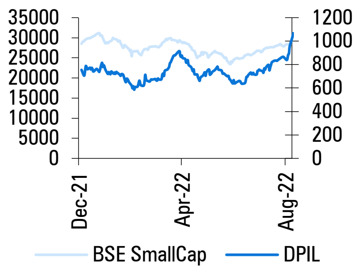
Data Patterns (DPIL), a vertically integrated defence and aerospace electronics solutions provider, caters to the indigenously developed defence products industry. The order book of the company currently stands at ₹ 1000 crore as of August 2022 end led by strong order inflow of ₹ 593 crore during YTDFY23.

The company expects ₹ 2000-3000 crore worth orders in the pipeline for the next three to four years. Fire control system for BrahMos Missile, Avionics for LCA, RWR for Fighter Aircraft, ELINT for Airborne and ground platform and Radar Subsystems are key orders in pipeline for FY23.

The company is in the process of doubling the existing manufacturing facility at Chennai, which is expected be fully operational from Q3FY23 onwards. Strong order inflows with healthy pipeline of orders in the next two to three years provides strong visibility. Radars, electronic warfare, avionics will continue to be major drivers for order book and revenues in the next couple of years.

We have increased our earnings estimates for FY23E and FY24E by 2.2% and 8.8% respectively to factor in better execution and better than expected increase in order inflows. DPIL is well placed to deliver revenue and PAT CAGR of 29.5% and 29.7%, respectively, over FY22-24E. Increase in profitability with strong asset turnover will result in healthy return ratios over FY23-24E. We remain positive and retain our **BUY** rating on the stock with a target price of ₹ 1280 (valuing at 42x on FY24E EPS).

Price Chart



Particulars

Particular	Amount
Market Capitalization (₹ crore)	5,551.9
Total Debt (FY22) (₹ crore)	6.8
Cash and Inv (FY22) (₹ crore)	177.1
EV (FY22) (₹ crore)	5,381.6
52 week H/L (₹) (BSE)	1117/575
Equity capital (₹ crore)	10.4
Face value (₹)	2.0

Exhibit 4: Financial summary for DPIL

(₹ crore)	FY19	FY20	FY21	FY22	4 Year CAGR (FY19-22)	FY23E	FY24E	2 Year CAGR (FY22-24E)
Revenues	131	156	224	311	18.9	401	521	29.5
EBITDA	26	43	92	141	40.7	162	223	25.6
EBITDA margin (%)	19.5	27.7	41.1	45.4		40.5	42.7	
Net Profit	8	21	56	94	64.9	115	158	29.7
EPS (₹)	1.6	4.5	10.7	18.1		22.2	30.4	
P/E (x)	649.4	237.3	99.9	59.1		48.2	35.1	
EV/EBITDA (x)	219.6	130.0	60.6	38.2		32.8	23.8	
RoCE (%)	11.1	19.5	37.0	23.8		24.9	28.1	
RoE (%)	5.8	13.7	26.7	16.4		18.4	20.9	

Source: Company, ICICI Direct Research

Cochin Shipyard (CSL)

Cochin Shipyard, the largest shipbuilding and maintenance facility in India, has facilities to build vessels up to 1.1 lakh tonnes and repair vessels up to 1.25 lakh tonnes annually.

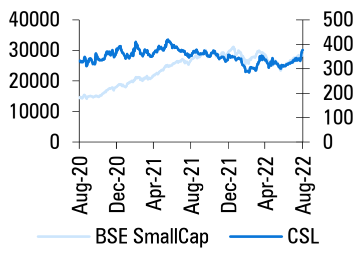
Order book was at ₹ 11260 crore as of June 2022 end (~3.5x of FY22 revenues), of which, the company has ~₹ 5900 order backlog for eight anti-submarine warfare shallow water crafts (ASW-SWC) corvettes. Apart from this, the company has been declared L1 for six next generation vessels order (valued at ₹ 10,000 crore).

Though growth in ship-building business is expected to be muted over the next 2 years (as the largest order of IAC-2 has been completed and the ASW-SWC contract is in initial phase of execution), the company is investing in margin accretive ship-repairing facilities, which will help the company to negate the muted growth expected in ship-building segment.

We believe that India Navy's future plan for procurement of warships is a huge opportunity for CSL. These include procurement of next generation corvettes and vessels which the company has been building. Moreover, discussions around India's need for third aircraft carrier (IAC-3) are already in the process and the company's management believe that CSL is ready to take on the massive project.

We upgrade our rating on the stock from Hold to **BUY** with a target price of ₹ 465 (valuing at 11x P/E on FY24E EPS).

Price Chart



Particulars

Particular	Amount
Market Capitalization*	₹ 4985 Crore
Total Debt (FY22)	₹ 123 Crore
Cash & Inv (FY22)	₹ 3213 crore
EV (FY22)	₹ 1896 Crore
52 week H/L (₹) (BSE)	394/281
Equity capital**	₹ 131.5 Crore
Face value	₹ 10

Exhibit 1: Financial summary for CSL

(₹ crore)	FY19	FY20	FY21	FY22	5 Year CAGR (FY17-FY22)	FY23E	FY24E	2 Year CAGR (FY22-24E)
Revenues	2,962	3,422	2,819	3,191	13.2	3,111	3,494	4.6
EBITDA	569	709	716	623	10.4	566	643	1.6
EBITDA margins	19.2	20.7	25.4	19.5		18.2	18.4	
Net Profit	478	638	611	564	11.9	508	557	(0.6)
EPS (₹)	36.3	48.5	46.4	42.9		38.6	42.3	
P/E (x)	10.4	7.8	8.2	8.8		9.8	9.0	
Price / Book (x)	1.5	1.3	1.3	1.1		1.0	1.0	
EV/EBITDA (x)	4.5	4.1	4.1	3.0		3.8	3.5	
RoCE (%)	19.0	17.6	14.2	10.9		12.2	12.4	
RoE (%)	14.5	17.1	15.1	12.7		10.5	10.8	

Source: Company, ICICI Direct Research

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