

BHARAT ELECTRONICS

Execution springs a positive surprise; robust outlook

India Equity Research | Defence

Bharat Electronics (BEL) reported a strong beat in top line and EBITDA which grew 24% and 8% YoY (9/7% higher than estimate). Key highlights: a) strong top line in Q4 led to healthy 18% YoY FY17 top line, an impressive 2x growth versus decade average; b) Q4FY17 EBITDA margin at 24.5% (down 350bps YoY) was impacted by sharp 66% YoY spike in salary bill (7th Pay Commission impact), despite which FY17 margin came a strong 20.5% (up 50bps YoY); and c) new orders stood at INR 165 bn(flat YoY), implying healthy revenue growth visibility with order book of 400 bn INR (25%YoY). We reiterate our conviction on BEL as delineated in our recent detailed note, "Moving up the value chain" where we highlighted a strong pick up in execution with stable operating margin. Maintain 'BUY' with TP of INR200 (23x FY19E earnings) given a reasonable 20/14 % CAGR in order book/ earnings over FY17-19E.

18% spurt in top line key surprise; sustainable OPMs stay strong

BEL's execution was robust in Q4FY17 with 24% YoY growth, led by execution of large value projects bagged over the past 12-15 months. This led to an impressive 18% YoY spurt in FY17 top line (2x past 10 years' average). Despite some low margin orders & sharp rise in salary bill in Q4, FY17 EBITDA margin improved 50bps YoY to 20.5% which is again a positive surprise corroborating BEL's high product throughput from its plants despite rising share of projects business.

Robust order book & profitability visibility over 2-3 years

Our bottom-up appraisal of defence projects lends comfort w.r.t. BEL's double digit order book growth over FY17-19E led by large value surface-to-air missile projects. Also, the company's focus on R&D & integration capability with reasonable 65% share of in-house value addition impart margin comfort despite rising systems business.

Outlook and valuations: Best defence pick; maintain 'BUY'

Despite more than 4x returns in the past 3 years, BEL still remains our preferred pick in the defence sector given its unparalleled positioning in the strategic defence electronic space, which we believe remains a key business MOAT. Key value driver over the next 2-3 years remains a healthy double digit growth in order book, sustainable OPMs and pick up in execution around large systems over FY17-19E. We maintain 'BUY/SO'.

Financials

(INR mn)

Year to March	Q4FY17	Q4FY16	% Chg	Q3FY17	% Chg	FY17	FY18E	FY19E
Net revenues	39,877	32,235	23.7	20,421	95.3	86,119	100,757	117,924
EBITDA	9,796	9,061	8.1	4,828	102.9	17,617	19,144	22,995
Adjusted Profit	7,917	7,447	6.3	3,735	112.0	15,476	16,032	19,264
Diluted P/E (x)						24.5	23.7	19.7
EV/EBITDA (x)						19.4	17.3	14.0
ROAE (%)						18.8	19.7	20.4

EDELWEISS 4D RATINGS

Absolute Rating	BUY
Rating Relative to Sector	Outperform
Risk Rating Relative to Sector	High
Sector Relative to Market	Overweight

MARKET DATA (R: BAJE.BO, B: BHE IN)

CMP	: INR 170
Target Price	: INR 200
52-week range (INR)	: 187 / 114
Share in issue (mn)	: 2,233.6
M cap (INR bn/USD mn)	: 380 / 5,880
Avg. Daily Vol.BSE/NSE('000)	: 4,323.3

SHARE HOLDING PATTERN (%)

	Current	Q3FY17	Q2FY17
Promoters *	68.2	74.4	75.0
MF's, FI's & BK's	17.7	15.7	14.5
FII's	6.7	4.3	4.0
Others	7.4	5.6	6.5
* Promoters pledged shares (% of share in issue)	:	NIL	

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Capital Goods Index
1 month	(7.0)	3.4	(1.7)
3 months	12.3	8.4	14.5
12 months	42.8	17.7	20.6

Amit Mahawar

+91 22 4040 7451
 amit.mahawar@edelweissfin.com

Swarnim Maheshwari

+91 22 4040 7418
 swarnim.maheshwari@edelweissfin.com

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Financial snapshot

(INR mn)

Year to March	Q4FY17	Q4FY16	% change	Q3FY17	% change	FY17	FY18E	FY19E
Net revenues	39,877	32,235	23.7	20,421	95.3	86,119	100,757	117,924
Staff costs	5,611	3,366	66.7	3,432	63.5	15,483	18,842	21,226
Direct costs	20,603	15,232	35.3	10,299	100.1	44,131	52,192	61,321
Other expenses	3,866	4,577	(15.5)	1,863	107.6	8,888	10,579	12,382
Total expenditure	30,081	23,175	29.8	15,593	92.9	68,502	81,613	94,929
EBITDA	9,796	9,061	8.1	4,828	102.9	17,617	19,144	22,995
Depreciation	571	489	16.8	455	25.6	1,915	2,250	2,456
Other income	909	1,383	(34.3)	776	17.1	4,710	4,612	5,288
Interest	9	41	(78.3)	106	(91.6)	118	130	143
Add: Exceptional items								
Profit before tax	10,125	9,914	2.1	5,043	100.8	20,294	21,376	25,685
Tax	2,208	2,467	(10.5)	1,307	68.9	4,818	5,344	6,421
Reported net profit	7,917	7,447	6.3	3,735	112.0	15,476	16,032	19,264
Adjusted Profit	7,917	7,447	6.3	3,735	112.0	15,476	16,032	19,264
Equity capital	2,237	2,400		2,237		2,234	2,234	2,234
No. of shares (mn)	224	240		224		2,234	2,234	2,234
Adjusted Diluted EPS	35.4	31.0	14.1	16.7	112.0	6.9	7.2	8.6
As % of net revenues								
Direct costs	51.7	47.3		50.4		51.2	51.8	52.0
Employee cost	14.1	10.4		16.8		18.0	18.7	18.0
Other expenses	9.7	14.2		9.1		10.3	10.5	10.5
EBITDA	24.6	28.1		23.6		20.5	19.0	19.5
Reported net profit	19.9	23.1		18.3		18.0	15.9	16.3

Company Description

Established by GoI under the Ministry of Defence in 1954 to meet the specialised electronic needs of the Indian defence services, Bharat Electronics Limited (BEL) has grown into a multi-product, multi-technology and multi-unit company, serving the needs of customers in diverse fields in India and abroad. BEL offers products and services in a wide spectrum of technology like radars, military communications, naval systems, electronic warfare systems, telecommunications, sound and vision broadcasting, opto-electronics, tank electronics, solar photovoltaic systems, embedded software and electronic components. The company also provides turnkey systems solutions like command control communication & computer intelligence (C4I), covering the requirements of all three forces.

Investment Theme

BEL, one of India's largest defence public sector undertakings (PSU), specialises in manufacturing defence electronics. It is emerging as a key beneficiary of increase in defence capital expenditure. The government's Make in India drive is likely to encourage domestic manufacturing. Further, domestic companies, including BEL, are likely to benefit from key changes in government policies, notably the offset clause (30% of an order must be subcontracted domestically). Despite the entry of private players, we believe BEL as a defence PSU is poised to benefit from increased defence capital expenditure and the offset policy. BEL has a strong order book, equivalent to over five years of revenues providing excellent visibility and hence is not affected by near term lull in intake. Its order book is slated to grow over the next few years because of steady demand for its existing product range; potential orders from high value projects (e.g., tactical communication systems) and growth opportunities in the non defence/ export segments.

Key Risks

Delay/lumpiness in execution of defence contracts

The defence market is monopolistic in nature with GoI being the sole buyer of defence equipment, which puts suppliers such as BEL at a disadvantage. Further, defence procurement procedures are complex and past experience suggests that they have tended to move at an extraordinarily slow pace. This has a dual impact: the equipment flow may not occur and it leads to a high degree of lumpiness in the order book.

Increased competition from private players

The government has shown increased intent of involving private players in the defence procurement process and to develop an active private sector supply to the armed forces. We believe DPSUs have strong competitive advantages over the private sector in the near-to-medium term. However, incremental competition, particularly for offset contracts, could make a negative impact on BEL's margins.

Financial Statements

Key Assumptions

Year to March	FY16	FY17	FY18E	FY19E
Macro				
GDP(Y-o-Y %)	7.4	7.9	8.3	8.3
Inflation (Avg)	4.8	5.0	5.2	5.2
Repo rate (exit rate)	6.8	6.0	6.0	6.0
USD/INR (Avg)	65.0	67.5	67.0	67.0
Company				
Order intake (INR bn)	171	168	188	216
Burning rate (%)	18.5	17.4	16.9	16.7
Excise duty as % of rev	5.5	0.8	0.8	0.8
Depreciation	6.4	6.4	6.4	6.4
Tax rate (%)	25.1	25.0	25.0	25.0

Income statement

(INR mn)

Year to March	FY16	FY17	FY18E	FY19E
Income from operations	73,279	86,119	100,757	117,924
Materials costs	38,266	44,131	52,192	61,321
Employee costs	12,573	15,483	18,842	21,226
Other Expenses	8,723	8,888	10,579	12,382
Total operating expenses	59,561	68,502	81,613	94,929
EBITDA	13,718	17,617	19,144	22,995
Depreciation	1,722	1,915	2,250	2,456
EBIT	11,996	15,702	16,894	20,540
Add: Other income	5,370.8	4,710.1	4,611.71	5,287.8
Less: Interest Expense	45	118	130	143
Profit Before Tax	17,321	20,294	21,376	25,685
Less: Provision for Tax	4,248	4,818	5,344	6,421
Reported Profit	13,074	15,476	16,032	19,264
Adjusted Profit	13,074	15,476	16,032	19,264
Shares o /s (mn)	2,400	2,234	2,234	2,234
Diluted shares o/s (mn)	2,400	2,234	2,234	2,234
Adj. Diluted EPS (INR)	5.4	6.9	7.2	8.6
Dividend Payout Ratio(%)	24.0	24.0	24.0	24.0

Common size metrics

Year to March	FY16	FY17	FY18E	FY19E
Operating expenses	81.3	79.5	81.0	80.5
EBITDA margins	18.7	20.5	19.0	19.5
Net Profit margins	17.8	18.0	15.9	16.3

Growth ratios (%)

Year to March	FY16	FY17	FY18E	FY19E
Revenues	7.1	17.5	17.0	17.0
EBITDA	19.9	28.4	8.7	20.1
EPS	12.0	27.2	3.6	20.2

Balance sheet		(INR mn)			
As on 31st March	FY16	FY17	FY18E	FY19E	
Share capital	2,400	2,234	2,234	2,234	
Reserves & Surplus	87,484	72,852	85,039	99,683	
Shareholders' funds	89,884	75,085	87,273	101,917	
Sources of funds	93,146	78,093	90,281	104,925	
Gross Block	27,631	32,363	35,863	39,363	
Net Block	9,758	12,548	13,968	15,185	
Capital work in progress	2,219	3,639	3,739	3,839	
Intangible Assets	2,085	2,928	2,858	2,736	
Total Fixed Assets	14,062	19,115	20,565	21,760	
Non current investments	1	1	1	1	
Cash and Equivalents	73,319	37,900	48,808	56,953	
Inventories	41,775	49,050	55,767	65,521	
Sundry Debtors	37,119	46,324	53,829	61,385	
Loans & Advances	4,908	5,644	6,194	7,044	
Other Current Assets	5,449	7,205	7,205	7,205	
Current Assets (ex cash)	89,250	108,224	122,996	141,155	
Sundry creditors	15,927	19,412	22,879	26,880	
Provisions	67,560	67,735	79,210	88,064	
Total Current Liab	83,487	87,146	102,089	114,944	
Net Curr Assets-ex cash	5,764	21,077	20,907	26,211	
Net Deferred tax	(3,940)	(6,322)	(6,322)	(6,322)	
Uses of funds	93,146	78,093	90,281	104,925	
BVPS (INR)	37.5	33.6	39.1	45.6	

Free cash flow		(INR mn)			
Year to March	FY16	FY17	FY18E	FY19E	
Reported Profit	13,074	15,476	16,032	19,264	
Add: Depreciation	1,722	1,915	2,250	2,456	
Interest (Net of Tax)	34	90	97	107	
Others	(2,522)	(4,800)	(4,709)	(5,395)	
Less: Changes in WC	(10,222)	15,314	(170)	5,304	
Operating cash flow	22,530	(2,633)	13,841	11,128	
Less: Capex	6,459	7,160	3,700	3,651	
Free Cash Flow	16,071	(9,793)	10,141	7,477	

Cash flow metrics		FY16	FY17	FY18E	FY19E
Year to March					
Operating cash flow	22,530	(2,633)	13,841	11,128	
Investing cash flow	(14,721)	(2,450)	912	1,637	
Financing cash flow	(3,203)	(36,596)	(3,844)	(4,619)	
Net cash Flow	4,606	(41,679)	10,908	8,145	
Capex	(6,459)	(7,160)	(3,700)	(3,651)	
Dividend paid	(2,956)	(3,711)	(3,844)	(4,619)	

Profitability and efficiency ratios		FY16	FY17	FY18E	FY19E
Year to March					
ROAE (%)	15.5	18.8	19.7	20.4	
ROACE (%)	20.6	24.7	26.5	27.3	
Inventory Days	360	376	367	361	
Debtors Days	187	177	181	178	
Payable Days	130	146	148	148	
Cash Conversion Cycle	417	406	400	391	
Current Ratio	1.9	1.7	1.7	1.7	

Operating ratios		FY16	FY17	FY18E	FY19E
Year to March					
Total Asset Turnover	0.8	1.0	1.2	1.2	
Fixed Asset Turnover	7.5	6.3	6.2	6.8	
Equity Turnover	0.9	1.0	1.2	1.2	

Valuation parameters		FY16	FY17	FY18E	FY19E
Year to March					
Adj. Diluted EPS (INR)	5.4	6.9	7.2	8.6	
Y-o-Y growth (%)	12.0	27.2	3.6	20.2	
Adjusted Cash EPS (INR)	6.2	7.7	8.1	9.7	
Diluted P/E (x)	31.2	24.6	23.7	19.7	
P/B (x)	4.5	5.1	4.4	3.7	
EV / Sales (x)	4.6	4.0	3.3	2.7	
EV / EBITDA (x)	24.4	19.4	17.3	14.1	

Additional Data

Directors Data

M V Gowtama	Chairman and Managing Director	Ajit T Kalghatgi	Director (Research & Development)
Nataraj Krishnappa	Director (Other Units)	Girish Kumar	Director (Bangalore Complex)
Anandi Ramalingam	Director (Marketing)	Ramchander N Bagdalkar	Director (Human Resources)
Kusum Singh	Part-time Government Director	Bhaskar Ramamurthi	Part-Time Independent Directors
R K Shevgaonkar	Part-Time Independent Directors	Usha Mathur	Part-Time Independent Directors
Sharad Sanghi	Part-Time Independent Directors		

Auditors - RGN Price & Co

**as per last annual report*

Holding – Top10

	Perc. Holding		Perc. Holding
Government of india	68.19	Life insurance corp	5.68
Hdfc asset managemen	1.81	Max new york life in	1.81
Sbi funds management	1.39	Birla sun life asset	1.36
Reliance capital tru	1.05	Icici prudential ass	1.05
Benchmark asset mana	1.02	Vanguard group	0.84

**in last one year*

Bulk Deals

Data	Acquired / Seller	B/S	Qty Traded	Price
No Data Available				

**in last one year*

Insider Trades

Reporting Data	Acquired / Seller	B/S	Qty Traded
27 Mar 2017	The President of India (acting through the Ministry of Defence)	Sell	8463499.00
02 Mar 2017	The President of India (acting through the Ministry of Defence)	Sell	2233628.00

**in last one year*

Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
Astra Microwave Products	BUY	SO	H	Bharat Electronics	BUY	SO	H

ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

Edelweiss Securities Limited, Edelweiss House, off C.S.T. Road, Kalina, Mumbai – 400 098.
Board: (91-22) 4009 4400, Email: research@edelweissfin.com

Aditya Narain
Head of Research
aditya.narain@edelweissfin.com

Coverage group(s) of stocks by primary analyst(s): Defence

Astra Microwave Products, Bharat Electronics

Recent Research

Date	Company	Title	Price (INR)	Recos
02-May-17	Astra Microwave Products	Domestic market spearheads spurt ; <i>Result Update</i>	131	Buy
06-Apr-17	Bharat Electronics	Moving up the value chain; <i>Company Update</i>	166	Buy
01-Nov-16	Astra Microwave Products	Ample growth arsenal; <i>Result Update</i>	116	Buy

Distribution of Ratings / Market Cap

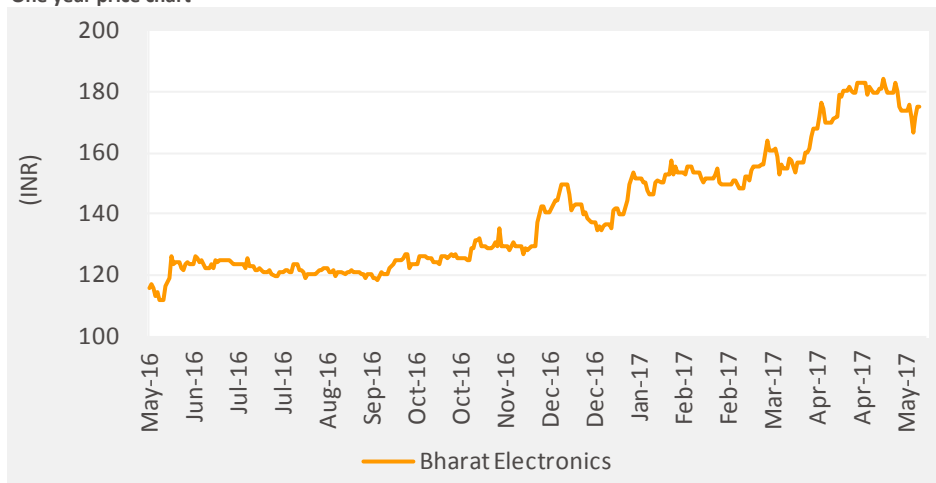
Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	161	67	11	240
* 1stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	156	62	11	

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

One year price chart



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