

August 2, 2017

Bharat Electronics (BHAELE)

₹ 182

Recommend HOLD on margin headwinds...

- The company reported a strong operating income of ₹ 1724.8 crore, up 97.9% YoY (our estimate: ₹ 1084.8 crore for the quarter). However, total income grew 77.9% YoY due to 47.8% YoY drop in other income
- The company reported EBITDA profit of ₹ 163.3 crore vs. loss of ₹ 46.7 crore in Q1FY17. We estimate EBITDA of ₹ 55.7 crore for the quarter. EBITDA margins came in at 9.5% vs. our estimate of 5.1% crore for the quarter. Higher EBITDA margins were on account of strong order booking during the quarter. Employee expenses also witnessed an increase of 46.1% YoY to ₹ 462 crore for the quarter
- PAT came in at ₹ 125.3 crore, up 247% YoY. We estimate PAT growth of 144% YoY (₹ 88.1 crore) for the quarter

Continues strong execution, healthy order inflows

BEL reported a fourth consecutive quarter of strong results primarily on account of fresh booking of orders like Integrated Air command and control system (IACCS) in addition to existing orders like L70 gun upgrade, Akash weapon system (Army), weapon locating radar, etc. **Order inflows for Q1FY18 were at ~ ₹ 2,423 crore. This has taken the BEL order backlog to an all-time high of ₹ 41,052 crore as on July 1, 2017.** With strong execution in coming quarters, this will help BEL deliver a superior topline and bottomline growth in FY17-19E.

Strong moat, moderate capex to help sustain momentum

As highlighted in our earlier reports, BEL has strong competency in the area of defence electronics. Historically, a large part of defence capital spends (45-60%) has been in this segment. High-end technologies in the electronics segment, long gestation periods, heavy capital requirements, and secrecy related to defence projects act as key entry barriers in this segment. This gives companies like BEL a competitive advantage over any upcoming local and foreign competition. With a planned capex of ~₹ 1000 crore in FY17-19E, BEL is well placed to capitalise on the emerging defence sector.

R&D, exports, healthy balance sheet

BEL spends ~9% of sales on R&D for developing new products. New products have historically helped BEL achieve up to 25% of its turnover. With R&D spend likely to rise to 12% of sales; new product development is likely to gain further momentum. Exports for BEL came in at ~₹ 425 crore for FY17 (~5.1% of turnover). With the government's increasing focus on exports, BEL has set-up a dedicated business unit and marketing group to become key supply chain partner of global defence contractors. This is likely to increase exports contribution to 10% of the topline by FY20E. BEL also has a strong balance sheet with near nil debt and cash balance of ₹ 3790 crore (even after the buyback of ~₹ 2100 crore).

Recommend HOLD on margin softening over FY17-19E

Going forward, BEL is likely to execute large orders like IACCS, VVPAT and Akash. We believe these orders will be margin dilutive for the company as some of these are integration projects where the margin profile is the range of 5-15%. Accordingly, we pencil in EBITDA margins of 18.1% and 17.7% in FY18E & FY19E, respectively (down from 20.5% in FY17). Thus, we expect BEL to deliver PAT CAGR 5.8% over FY17-19E (despite sales CAGR of 17.3% during the same period). Accordingly, we value the company at 25x P/E on FY19E EPS of ₹ 7.8 to arrive at a target price of ₹ 194 per share. We have a **HOLD** recommendation on the stock.

Rating matrix	
Rating Matrix	
Rating	: Hold
Target	: ₹ 194
Target Period	: 12 - 15 months
Potential Upside	: 7%

What's changed?	
Target	Unchanged
EPS FY18E	Unchanged
EPS FY19E	Unchanged
Rating	Changed from Buy to Hold

Quarterly performance				
	Q1FY18	Q1FY17	YoY (%)	QoQ (%)
Revenue	1,724.8	871.4	97.9	3,987.7
EBITDA	163.3	-46.7	-449.8	979.6
EBITDA (%)	9.5	-5.4	1490 bps	24.6
PAT	125.3	36.1	247.2	791.7

Key financials				
₹ Crore	FY16	FY17	FY18E	FY19E
Revenue	7,295	8,612	10,848	11,856
EBITDA	1,461	1,762	1,964	2,100
EBITDA (%)	20.0	20.5	18.1	17.7
Net Profit	1,358	1,548	1,613	1,732
EPS (₹)	5.7	6.9	7.2	7.8

Valuation summary				
(x)	FY16	FY17	FY18E	FY19E
P/E	32.2	26.3	25.2	23.5
Target P/E	34.3	28.0	26.9	25.0
EV / EBITDA	22.8	19.8	17.4	15.8
P/BV	5.0	5.4	4.7	4.2
RoNW (%)	16	20.5	18.8	17.9
RoCE (%)	22.0	27.7	26.2	24.5

Stock data	
Stock Data	
Average Volumes (shares)	385000
Market Capitalization	₹ 40652 Crore
Total Debt (FY17E)	₹ 250 Crore
Cash and Investments (FY17)	₹ 3790 Crore
EV (FY17)	₹ 34936.3 Crore
52 week H/L (₹)	187 / 119
Equity capital	₹ 223.4 Crore
Face value	₹ 1
MF Holding (%)	16.8
FII Holding (%)	7.6
Promoter Holding (%)	68.2

Price performance				
Return (%)	1M	3M	6M	12M
Bharat Electronics	11.4	(2.8)	15.5	45.7
Astra Microwave	(3.6)	7.5	1.9	25.8
Centum Electronics	3.1	8.2	11.3	6.7

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Variance analysis

	Q1FY18	Q1FY18E	Q1FY17	YoY (%)	Q4FY17	QoQ (%)	Comments
Operating Income	1,725	1,085	871.4	97.9	3,988	-56.7	Strong Q1FY18 on account of higher revenue booking in large orders like IACCS, WLR, Aakash, etc
Other income	72	113	138.7	-47.9	91	-20.5	Other income is down 45% YoY as cash has decreased on account of buyback
Total Revenue	1,797	1,197	1,010.2	77.9	4,078.5	-55.9	
Raw materials costs	954	573	469.9	103.0	2,060	-53.7	
Employees Expenses	462	329	316.4	46.1	561	-17.6	
Other Expenses	145	127	131.9	10.1	387	-62.5	Reversal of provisions have led to only 10% YoY increase in other expenses against 97.9% YoY increase in topline
Total Expenditure	1,561	1,029	918.1	70.1	3,008	-48.1	
EBITDA	163.3	55.7	-46.7	LP	979.6	-83.3	
EBITDA margins (%)	9.5	5.1	-5.4	1483 bps	24.6	-1510 bps	Strong EBITDA margins due to lower other expenses
Interest	0.3	5.0	0.0		0.9		
Depreciation	56.1	45.0	43.5	29.0	57.1	-1.8	
Tax	54.0	30.1	12.5	331.6	220.8	-75.6	
Other Income	72.3	112.5	138.7	-47.9	90.9	-20.5	
PAT	125.3	88.1	36.1	247.2	791.7	-84.2	

Source: Company, ICICIdirect.com Research

Change in estimates

	FY17		FY18E		FY19E		
(₹ Crore)		Old	New	% Change	Old	New	% Change
Revenue	8,611.9	10,848.2	10,848.2	0.0	11,855.8	11,855.8	0.0
EBITDA	1,761.7	1,963.7	1,963.7	0.0	2,099.7	2,099.7	0.0
EBITDA Margin (%)	20.5	18.1	18.1	0 bps	17.7	17.7	1 bps
PAT	1,547.6	1,634.0	1,612.5	-1.3	1,731.9	1,731.9	0.0
EPS (₹)	6.9	7.3	7.2	-1.1	7.8	7.8	-0.6

Source: Company, ICICIdirect.com Research

Company Analysis

Key takeaways for Q1FY18

- **Strong order book:** Order book at the end of Q1FY18 was at ₹ 41,052 crore. Orders received during the quarter were at ₹ 2,423 crore
- **Major orders acquired in Q1FY18:**
 - Voter verified paper audit trail (VVPAT),
 - Network file server (NFS) sitcom terminal
 - Passive night vision devices

The export order book as on July 1, 2017 was at US\$82.2 million. Export turnover for Q1FY18 was US\$4.4 million.

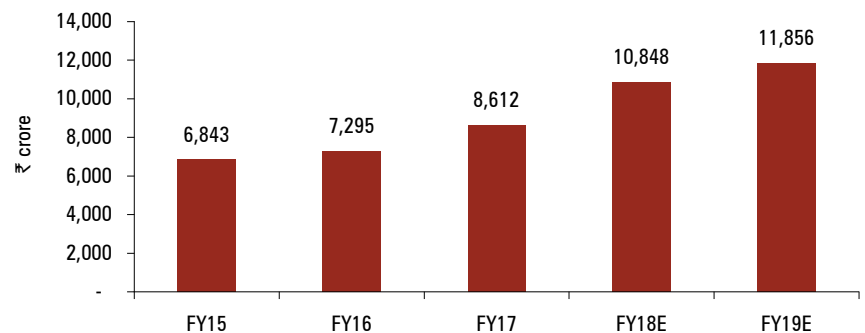
- **Major supplies during Q1FY18:**
 - Akash weapon system (Army),
 - L 70 gun upgrade,
 - Weapon locating radar
 - Integrated Air command and control system
 - Advanced composite communication system
 - Integrated communication system
 - Ship borne EW system
- **Major orders expected in FY18**
 - Akash Missile System (seven squadron),
 - Long Range Surface To Air Missile (LRSAM) for P17A,

Company Analysis

Order inflows, strong execution to drive revenue growth of 17.3% CAGR in FY17-19E

We expect standalone revenues to increase from ₹ 8612 crore in FY17 to ₹ 11856 crore in FY19E at a CAGR of 15%, mainly on the back of strong order inflows and execution of backlog orders over the next two years. Order backlog as on FY17 was at ₹ 40,000 crore. We expect order inflows of ~₹ 12000 crore and ~₹ 11000 in FY18E and FY19E, respectively. Assuming, execution rate of ~24% for backlog orders and ~12% execution rate for current year order inflows, we estimate BEL will post revenues of ₹ 11,324 crore in FY18E and ₹ 11,855 crore in FY19E.

Exhibit 1: Revenue trend

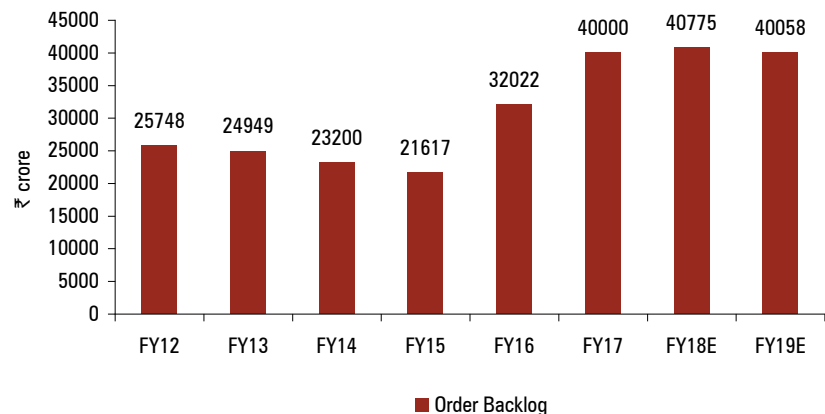


Source: Company, ICICIdirect.com Research

Order book growth to keep ticking

Order backlog for BEL has historically grown at 12.2% CAGR in FY13-17. However, going forward, we expect the order backlog of BEL to grow at ~1% CAGR in FY17-19E due a higher base of FY17.

Exhibit 2: Order backlog trend

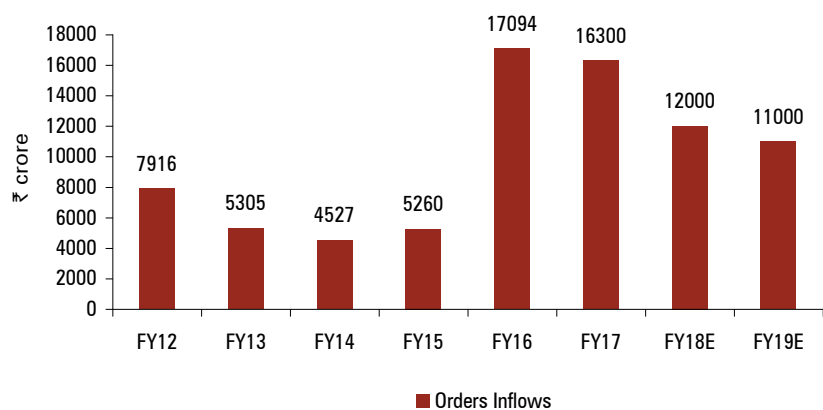


Source: Company, ICICIdirect.com Research

Strong order inflows over next five to seven years

BEL is expected to receive significant number of orders over the next five to seven year. Major orders are expected to be finalised in FY17-19E including orders Akash Missile (~₹ 4700 crore), Samyukta upgrade, mobile cellular communication system, L- band Tropo upgrade, low level lightweight radar, integrated sonar suite, passive night vision devices, etc. Apart from the above-mentioned orders, the company is also a contender for large orders like battlefield management system (BMS), the order size of which is ₹ 35,000 crore. Also, with Hindustan Aeronautics (HAL) commencing its production line for indigenous aircraft Tejas, BEL is expected to receive significant orders for its electronic components and systems. Thus, we expect the order pipeline for BEL to remain strong in FY17-20E. For FY18E and FY19E, we estimate order inflows of ₹ 12,000 crore and ₹ 11,000 crore, respectively, for the company.

Exhibit 3: Order inflows robust over FY17-19E



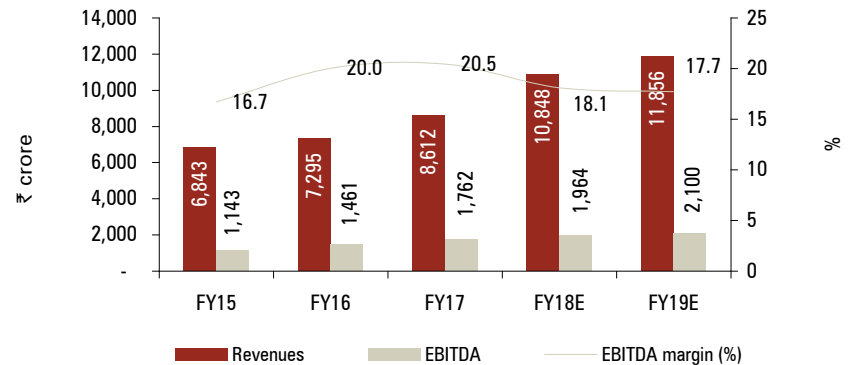
Source: Company, ICICIdirect.com Research

EBITDA margins to stabilise to 17.7% in FY19E

BEL reported strong EBITDA margins of 20% in FY16 vs. 20.5% for FY17. A sharp increase in margins was due to an overall reduction in material consumption mainly because of commodity correction and indigenisation initiatives of the company. However, we believe the same is unsustainable, going forward. Also, BEL has got transformed from a pure product-selling company to one that takes the contract as a system integrator. For instance, BEL used to win 25-30% of the contract for Akash missiles to supply its radars and related electronics. However, now BEL receives turnkey orders to supply Akash missiles. From just supplying the product, it now purchases equipment i.e. missiles from HAL and launchers from L&T, assembles the product and then supplies it to the air force. Though this has increased revenues and order inflows for the company, margins are expected to come off as the profitability on purchased equipment is not as high as its own product.

EBITDA has grown at 28.7% CAGR in FY13-17. **Going ahead, we expect growth rates to soften on account moderation in margins from 20.5% in FY17 to 17.7% in FY19E. Accordingly, we expect EBITDA to grow 9.2% over FY17-19E.**

Exhibit 4: EBITDA and EBITDA margin trend

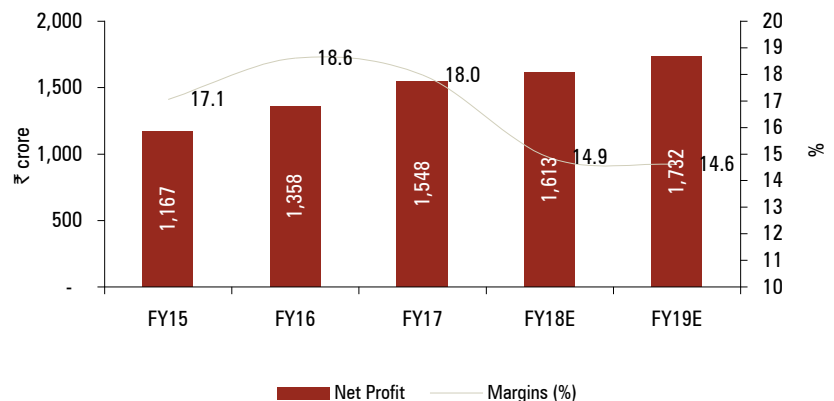


Source: Company, ICICIdirect.com Research

PAT to grow at 5.8% CAGR in FY17-19E

In FY13-FY17, PAT grew at 14.8% CAGR. This was mostly due to healthy topline growth and improvement in execution in FY16 and FY17. Going forward, we expect the bottomline to grow at 5.8% CAGR in FY17-19E.

Exhibit 5: PAT trend

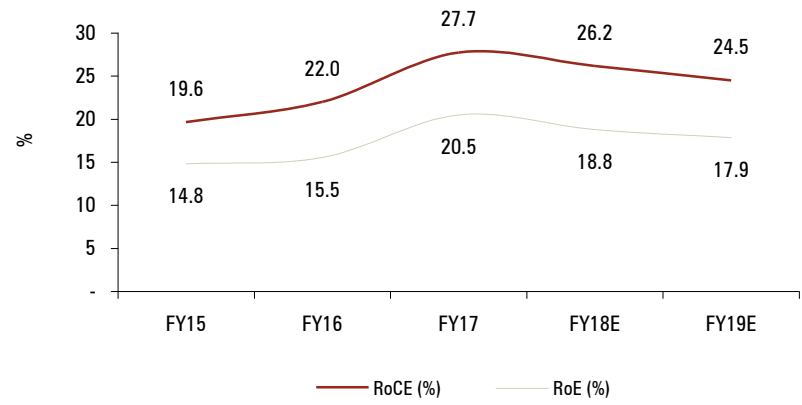


Source: Company, ICICIdirect.com Research

RoE, RoCE of 14.3% and 19.6% in FY18E

With moderate capex plans (₹ 1000 crore over FY18E and FY19E) and demand growth revival, capacity utilisation levels are expected to improve leading to stable return ratios. BEL has been a consistent debt-free company with a cash balance of ~₹ 3790 crore in FY17 (even after the buy-back of ~₹ 2100 crore in H1FY17). **However, due to dilution of operating margins, we expect RoE and RoCE to marginally head southwards. Accordingly, we expect RoE and RoCE to drop from 20.5% and 27.7% in FY17 to 17.9% and 24.5%, respectively, in FY19E.**

Exhibit 6: RoE, RoCE trend



Source: Company, ICICIdirect.com Research

BEL is among the few defence PSUs that has strong financials and a long history of efficient capital allocation. The company has delivered a topline and bottomline CAGR of ~6% and 7.3% over the past 15 years (FY01-16), with average RoCEs and RoEs of 21% and 18.8%, respectively. The company is characterised by consistent dividend payout of 20%, clean corporate governance, efficient working capital management, adequate R&D spend, ability to absorb latest technologies, timely execution of large projects, strong cash flow generation and prudent capital allocation

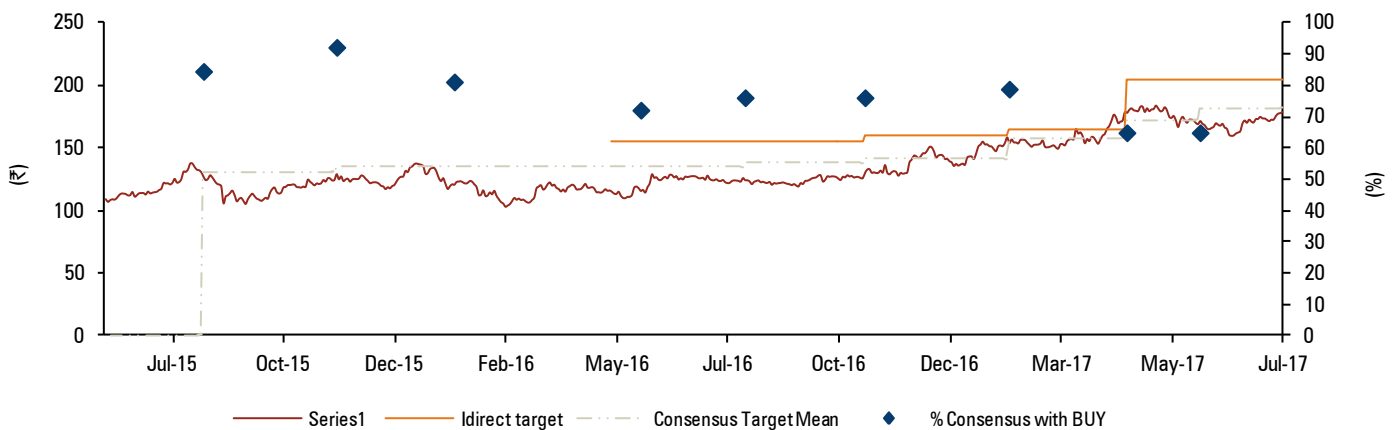
Outlook and valuation

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With large participation of private sector players kicking in the defence space, there have been apprehensions about BEL's ability to bag large orders in this space. However, we believe the same is not a major threat as BEL has proactively taken major steps including technology tie-ups with foreign majors to bid for the upcoming platform-based orders.

Going forward, BEL is likely to execute large orders like IACCS, VVPAT and Akash. We believe these orders will be margin dilutive for the company as some of these are integration projects where the margin profile is in the range of 5-15%. Accordingly, we have pencilled EBITDA margins of 18.1% and 17.7% in FY18E & FY19E respectively (down from 20.5% in FY17). Thus, we expect BEL to deliver PAT CAGR 5.8% in FY17-19E (despite sales CAGR of 17.3% during the same period). Accordingly, we value the company at 25x P/E on FY19E EPS of ₹ 7.8 to arrive at a target price of ₹ 194 per share. We have a **HOLD** recommendation on the stock.

Recommendation history vs. consensus



Source: Bloomberg, Company, ICICIdirect.com Research, Initiated coverage on 27th Jan 2016

Key events

Date/Year	Event
Dec-12	BEL signs an MoU with Israel Aerospace Industries (IAI) for cooperation on future Long Range Surface to Air Missile (LRSAM) Ship-defence Systems
Sep-14	BEL establishes a Joint Venture Company (JVC) with M/s. Thales Air Systems SA, France and M/s. Thales India Pvt. Ltd in Radar Business Area.
Nov-15	BEL delivers L70 upgraded guns to Indian Army
Feb-15	Ministry of Defence selects BEL - Rolta consortium as a Development Agency for the Battlefield Management System Project
Mar-15	BEL issues bonus shares in the ratio of 2:1
Oct-15	BEL signs ₹ 8000 crore IACCS (Integrated Air Command and Control System) deal with Indian Air Force
Mar-16	BEL, Rosoboronexport sign defence offset partnership agreement
May-16	BEL and HAL sign deal to co-develop avionics
May-16	BEL registers highest-ever order inflow of ₹ 17,094 for FY16.
May-16	BEL inaugurates 8.4 MW wind energy power plant at Harappanahalli, Karnataka. With this wind energy plant, 90% of BEL's energy requirement will be met through renewable energy resources.
Jan-17	BEL announces split, new face value at ₹ 1 per share, from existing ₹ 10 per share
Feb-17	BEL order book touches all-time of ₹ 40000 crore

Source: Company, ICICIdirect.com Research

Top 10 Shareholders

Rank	Name	Latest Filing Date	O/S	Position	Position Change
1	Government of India	30-06-2017	68.19%	1,523.04M	0
2	Life Insurance Corporation of India	30-06-2017	3.80%	84.84M	-20.00M
3	HDFC Asset Management Co., Ltd.	30-06-2017	1.81%	40.41M	0
4	Birla Sun Life Asset Management Company	30-06-2017	1.42%	31.82M	+0.40M
5	SBI Funds Management Pvt. Ltd.	30-06-2017	1.35%	30.04M	+0.00M
6	Goldman Sachs Asset Management (India) I	30-06-2017	1.11%	24.84M	0
7	Reliance Nippon Life Asset Management Lir	30-06-2017	1.05%	23.41M	0
8	ICICI Prudential Asset Management Co. Ltd.	30-06-2017	0.88%	19.65M	+0.00M
9	The Vanguard Group, Inc.	30-06-2017	0.84%	18.77M	+0.19M
10	Tata Asset Management Limited	30-06-2017	0.71%	15.84M	+0.13M

Source: Reuters, ICICIdirect.com Research

Shareholding Pattern

(in %)	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Promoter	75.0	75.0	74.4	68.2	68.2
FII	3.9	3.9	4.3	6.7	7.6
DII	15.0	14.5	15.8	17.7	16.8
Others	6.1	6.7	5.6	7.4	7.4

Recent Activity

Buys			Sells		
Investor name	Value	Shares	Investor name	Value	Shares
Norges Bank Investment Management (NBIM)	+5.69M	+2.81M	Life Insurance Corporation of India	-50.00M	-20.00M
Goldman Sachs Asset Management (US)	+5.22M	+1.83M	Amundi Hong Kong Limited	-1.35M	-0.48M
Axis Asset Management Company Limited	+4.20M	+1.68M	Capital Investment Trust Corporation	-0.81M	-0.40M
Goldman Sachs Asset Management International	+3.67M	+1.29M	Excel Funds Management Inc.	-0.73M	-0.30M
L&T Investment Management Limited	+2.41M	+0.85M	Calamos Advisors LLC	-0.62M	-0.22M

Source: Reuters, ICICIdirect.com Research

Financial summary (Standalone)

Profit and loss statement ₹ Crore				
(₹ Crore)	FY16	FY17	FY18E	FY19E
Net Sales	7,154	8,296	10,615	11,601
Other operating income	141	316	234	255
Total Revenue	7,295	8,612	10,848	11,856
% Growth	6.6	18.0	26.0	9.3
Other income	532.2	471.0	450.0	470.0
Total	7,834	9,101	11,324	11,856
% Growth	7.0	16.2	24.4	4.7
Total Raw Material Costs	3,791	4,413	5,732	6,311
Employee Expenses	1,302	1,548	2,017	2,204
other expenses	741	889	1,136	1,241
Total Operating Expenditure	5,834	6,850	8,884	9,756
Operating Profit (EBITDA)	1,461	1,762	1,964	2,100
% Growth	27.8	20.5	11.5	6.9
Interest	5	12	25	30
PBDT	1,989	2,221	2,389	2,540
Depreciation	169	192	239	261
PBT before Exceptional Items	1,820	2,029	2,150	2,279
Total Tax	455	482	516	547
PAT before MI	1,365	1,548	1,634	1,732
Minority Interest	-	-	-	-
PAT	1,358	1,548	1,634	1,732
% Growth	16.3	14.0	5.6	6.0
EPS	5.7	6.9	7.3	7.8

Source: Company, ICICIdirect.com Research

Balance sheet ₹ Crore				
(₹ Crore)	FY16	FY17	FY18E	FY19E
Equity Capital	240.0	223.4	223.4	223.4
Reserve and Surplus	8,494	7,325	8,376	9,489
Total Shareholders funds	8,734	7,549	8,599	9,712
Minority Interest	-	-	-	-
Other Non Current Liabilities	2.1	7.1	15.0	20.0
Total Debt	6	250	275	275
Total Liabilities	8,742	7,806	8,889	10,007
Gross Block	2,841	2,978	3,671	4,221
Acc: Depreciation	1,883	2,074	2,313	2,574
Net Block	958	904	1,358	1,647
Capital WIP	430	743	500	400
Total Fixed Assets	1,388	1,647	1,858	2,047
Non Current Assets	447	447	447	447
Inventory	4,168	4,719	5,647	6,171
Debtors	3,712	4,247	5,498	6,107
Loans and Advances	599	775	868	948
Other Current Assets	58	69	87	95
Cash	7,332	5,966	6,783	7,675
Total Current Assets	15,869	15,775	18,883	20,996
Current Liabilities	8,118	9,438	11,591	12,668
Provisions	1,162	944	1,159	1,267
Net Current Assets	6,589	5,394	6,132	7,062
Total Assets	8,742	7,806	8,889	10,007

Source: Company, ICICIdirect.com Research

Cash flow statement ₹ Crore				
(₹ Crore)	FY16	FY17	FY18E	FY19E
Profit after Tax	1,358	1,548	1,548	1,732
Depreciation	169	192	192	261
Interest	5	12	12	30
Cash Flow before WC changes	1,531	1,751	1,751	2,023
Changes in inventory	(798)	(551)	(928)	(525)
Changes in debtors	74	(535)	(1,251)	(608)
Changes in loans & Advances	153	(176)	(93)	(81)
Changes in other current assets	(5)	(11)	(18)	(8)
Net Increase in Current Assets	(576)	(1,273)	(2,290)	(1,221)
Changes in creditors	1,591	1,319	2,154	1,077
Changes in provisions	385	(218)	215	108
Net Inc in Current Liabilities	1,976	1,101	2,369	1,184
Net CF from Operating activities	2,931	1,579	1,830	1,986
Changes in deferred tax assets	(35)	-	-	-
(Purchase)/Sale of Fixed Assets	(646)	(450)	(450)	(450)
Net CF from Investing activities	(964)	(445)	(442)	(445)
Dividend and Dividend Tax	(490)	(523)	(551)	(584)
Net CF from Financing Activities	(516)	(2,501)	(570)	(649)
Net Cash flow	1,450	(1,366)	817	892
Opening Cash/Cash Equivalent	5,882	7,332	5,966	6,783
Closing Cash/ Cash Equivalent	7,332	5,966	6,783	7,675

Source: Company, ICICIdirect.com Research

Key ratios				
(Year-end March)	FY16	FY17	FY18E	FY19E
Per Share Data				
EPS	5.7	6.9	7.3	7.8
Cash per Share	30.5	26.7	30.4	34.4
BV	36.4	33.8	38.5	43.5
Dividend per share	1.7	2.0	2.1	2.2
Dividend payout ratio	0.3	0.3	0.3	0.3
Operating Ratios				
EBITDA Margin	20.0	20.5	18.1	17.7
PAT Margin	19.0	18.7	15.4	14.9
Return Ratios				
RoE	15.5	20.5	19.0	17.8
RoCE	22.0	27.7	26.2	24.5
RoIC	242.4	241.5	168.2	136.0
Valuation Ratios				
EV / EBITDA	21.0	18.3	16.0	14.6
P/E	30.1	24.5	23.2	21.9
EV / Net Sales	4.2	3.7	2.9	2.6
Sales / Equity	0.8	1.1	1.3	1.2
Market Cap / Sales	5.2	4.4	3.5	3.2
Price to Book Value	4.7	5.0	4.4	3.9
Turnover Ratios				
Asset turnover	5.2	4.1	4.6	4.5
Debtors Turnover Ratio	1.9	2.2	2.2	2.0
Creditors Turnover Ratio	1.0	1.0	1.0	1.0
Solvency Ratios				
Debt / Equity	0.0	0.0	0.0	0.0
Current Ratio	0.9	0.9	0.9	1.0
Quick Ratio	0.5	0.5	0.5	0.5

Source: Company, ICICIdirect.com Research

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