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Sector update

Bharat Electronics (BUY)
Target price Rs125

Hindustan Aeronautics (BUY)
Target price Rs2,850

Bharat Dynamics (ADD)
Target price Rs960

Solar Industries (BUY)
Target price Rs4,760

Mishra Dhatu Nigam (HOLD)
Target price Rs215

Garden Reach (SELL)
Target price Rs390

Mazagon Shipyard (SELL)
Target price Rs600

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Capital outlay allocation comes as a dampener

Indian defence capital budget rose a mere 6.8% YoY (FY24BE vis-à-vis FY23BE) to Rs1.62trn. Key points: 1) Capital budget rose at its slowest pace in the past six years; 2) capital budget as a %age of total defence budget is 28.5%; and 3) among broad categories, budget for aircraft, aero engine and naval fleet has been impacted the most while that for other equipment is at the highest-ever level of Rs670bn. On the positive front, R&D budget has been raised 7.3% YoY to Rs129bn- the highest-ever level. Allocation for ISRO has also been lowered with budget and capex on space research (FY24BE vis-à-vis FY23BE) down 8% YoY and 15% YoY, respectively. In absolute terms, FY24 space budget and capex on research is at the similar level as FY20.

In our view, HAL is likely to be impacted the most as incremental orderbook accretion might slow down, resulting in lower revenue growth from FY26. Similarly, shipbuilders might be adversely affected from lower spend budgeted for naval fleet. That said, we believe companies in other equipment such as missiles, radars and EW might benefit as spending is expected to increase in this category. We cut our revenue growth estimates for HAL (BUY) FY26 onwards to 6% (earlier 8%) resulting in our revised DCF-based TP of Rs2,850 (earlier Rs3,170). In case of BDL (ADD) as well, we lower our revenue growth estimates to 10% (earlier 12.5%), resulting in a revised TP of Rs960 (earlier Rs1,100) on DCF-based methodology. Factoring in lower space budget, in case of MIDHANI, we lower our multiple to 12x (earlier 14x) FY24 EBITDA, resulting in a revised TP of Rs215 (earlier Rs230).

- ▶ **Capital budget growth slows down.** For FY23, revised estimate (RE) of defence budget was up 11.5% compared to budgetary estimate (BE) mainly due to higher spending on pensions and revenue account. Capital budget was the only category where RE was lower than BE, down 1.5%. Among the major categories for capital outlay (FY23RE vis-à-vis FY23BE), aircraft and aero engines was up 29% while naval fleet was down 18%. Going ahead in FY24 (FY24BE vis-à-vis FY23BE), aircraft and aero engines is up a mere 4.7% at Rs282bn- down 19% compared to FY23 RE. Capital outlay on naval fleet on the other hand is budgeted at the similar level as FY23 RE at Rs242bn- down 18% compared to FY23 BE. Capital outlay for other equipment is the only category where despite FY23 RE being lower than BE, FY24 BE has been raised 12% (compared to FY23 BE). R&D is another bright spot where budget has been raised by 7.3% to an all-time high level of Rs129bn.
- ▶ **Recently, AONs point to the focus on other equipment.** Recently, Defense Acquisition Council (DAC) has accorded Acceptance of Necessity (AON) for 27 proposals amounting to Rs885bn for procurement of 1) Helina Anti-tank guided missiles, launchers and associated equipment; 2) VSHOARAD missile system; 3) Brahmos launcher and Fire control system for Shivalik class of ships and Nex-Gen Missile Vessels for Indian Navy; 4) futuristic infantry combat vehicles and light tanks; 5) naval anti-ship missiles and Nex-Gen offshore patrol vessels; and 6) new range of missile systems, guided bombs and advanced surveillance systems for Indian Air Force. We believe these are largely positive for BDL, Solar Industries and BEL though the delay in ordering of Akash 3rd and 4th regiment is likely to impact revenue growth for BDL.
- ▶ **Static naval fleet spending implies peak execution for shipbuilders in FY25.** We believe shipbuilders are at the risk of reaching peak execution in FY25/FY26 as the current orderbook will be past 65% execution (peak earnings) at that stage. The static budget for naval fleet spending implies that orders for high-value items such as Scorpene grade submarine, Nex-Gen Corvettes and Destroyers are likely to be delayed. This would keep utilisation at shipbuilders, MDSL and GRSE, low post FY25.

- ▶ **Space capital budget lowered further.** Both space budget and capital outlay have been lowered as RE is down 23% and 39%, respectively, compared to BE. FY24 BE at Rs125.5bn of which capital outlay is at Rs63.6bn, both down at FY20 BE level. In our view, this does not bode well for MIDHANI as its long execution cycle is further exacerbated by potential slowdown in ordering.
- ▶ **Our revised TPs and recommendation.** Taking cognisance of the proposed capital outlay in defense budget, particularly lower spend for Air Force, aircraft and aero engines segment and sharpened focus on other equipment, we make the following changes to the TPs of the stocks under our coverage:
 - **HAL:** While contribution from manufacturing is likely to be lower until FY25, factoring in slower order-book accretion, we revise our revenue growth estimates lower from FY26 to 6% on average (earlier 8%). Our revised TP works out to Rs2,850 (earlier Rs3,170) on DCF-based methodology. We maintain BUY recommendation on the stock.
 - **BDL:** We believe successful testing of QRSAMs opens up Rs200bn opportunity for the company; however, delay in ordering of 3rd and 4th Akash regiment is the main risk for order-book accretion. That said, the recently issued AONs are focused on missile systems, hence, we lower our growth estimates FY26 onwards marginally to 10% (earlier 12.5%). Our revised TP works out to Rs960 (earlier Rs1,100). Maintain ADD rating on the stock.
 - **MIDHANI:** We believe current orderbook is likely to get executed by FY24E; however, in view of reduced budget for ISRO, we lower our valuation multiple to 12x corresponding to the mean level over the past three years (earlier 1 deviation above mean at 14x). As a result, our revised TP works out to Rs215 (earlier Rs230). Maintain HOLD rating on the stock.
- ▶ We maintain our existing ratings/TPs for other stocks in our coverage as we believe these will be beneficiaries of increased allocation for other equipment category.

Table 1: Expenditure heads for defence budget

<i>(Rs bn)</i>	FY22RE	FY23BE	FY23RE	FY24BE	FY24BE to FY23BE	FY24BE to FY23RE	FY23RE to FY23BE
Defence capital budget	1,386	1,523	1,500	1,626	6.8	8.4	(1.5)
Defence pensions	1,169	1,197	1,534	1,382	15.5	(9.9)	28.2
Defence Services (Revenue)	2,296	2,330	2,595	2,701	15.9	4.1	11.4
Total Defence Budget	4,851	5,050	5,629	5,709	13.1	1.4	11.5
Capital as % of total budget	28.6	30.2	26.6	28.5			

Source: I-Sec research, FY24 Expenditure Budget

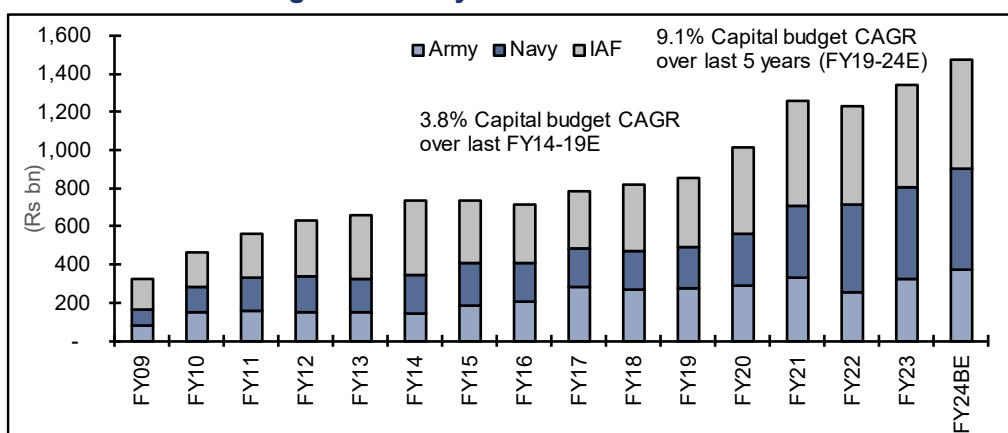
Defence budget allocation has reached ~Rs5709bn and capital budget was 28.5% of the overall budgetary allocation. Allocation towards defence pension has increased in FY24BE following the higher revised allocation of FY23; however, allocation for FY24BE is lower than revised estimates of FY23.

Table 2: Defence budget allocation across Army, Navy, Air Force, DRDO and others

(Rs bn)	FY22RE	FY23BE	FY23RE	FY24BE	% Chg		
					BE 24 to BE 23	BE 24 to RE 23	RE23 to BE 23
Army Acquisition Budget							
Land	4	6	4	3	(49.8)	(32.1)	(32.1)
Construction works	55	56	51	68	21.3	(8.4)	(8.4)
Aircraft & Aero-Engine	25	21	36	55	165.7	72.2	72.2
H&MV	19	18	24	30	65.1	31.2	31.2
Other Equipment	149	217	209	213	(1.9)	(3.8)	(3.8)
Rolling Stock	1	1	1	2	63.0	20.0	20.0
Rashtriya Rifles	1	1	1	1	-	(5.0)	(5.0)
NCC	0	0	0	0			
Others	0	0	0	1			
Total Acquisition Budget	254	320	326	372	16.4	1.9	1.9
Navy Acquisition Budget							
Land	0	0	0	16			
Construction works	13	11	19	19	79.9	75.7	75.7
Aircraft & Aero-Engine	80	59	75	70	18.1	26.6	26.6
H&MV	0	0	1	1			
Other Equipment	75	60	82	95	58.3	36.7	36.7
Joint Staff	10	13	14	18	45.0	10.7	10.7
Naval Fleet	247	295	242	242	(17.8)	(17.9)	(17.9)
Naval Dockyard	35	38	45	67	75.0	17.1	17.1
Total Acquisition Budget	460	475	477	528	11.1	0.4	0.4
Air Force Acquisition Budget							
Land	0	5	3	3	(37.9)	(48.1)	(48.1)
Construction works	24	27	20	23	(12.1)	(25.1)	(25.1)
Aircraft & Aero-Engine	267	190	237	157	(17.1)	25.0	25.0
H&MV	0	2	2	9		(22.9)	(22.9)
Other Equipment	219	323	266	362	12.1	(17.6)	(17.6)
Special Projects	7	9	10	16	75.2	8.8	8.8
Total Acquisition Budget	517	556	537	571	2.8	(3.3)	(3.3)
Defence Ordnance Factories	2	-	-	-			
Emergency authorisation for newly created DPSUs	25	25	25	-		-	-
Research and Development	99	120	120	129	7.3	-	-
Inspection - Director General Quality Audit (DGQA)	0	0	-	-			
Technology Development--MKI							
Projects of the Army		1	0	1			
Projects of the Air Force	14	13	1	11	(10.6)	(90.4)	(90.4)
Investment in public enterprise	16	13	13	13	-	-	-
Total Acquisition Budget	1,386	1,523	1,500	1,626	6.8	(1.5)	(1.5)

Source: I-Sec research, FY23 Expenditure Budget

Chart 1: Defence budget over the years

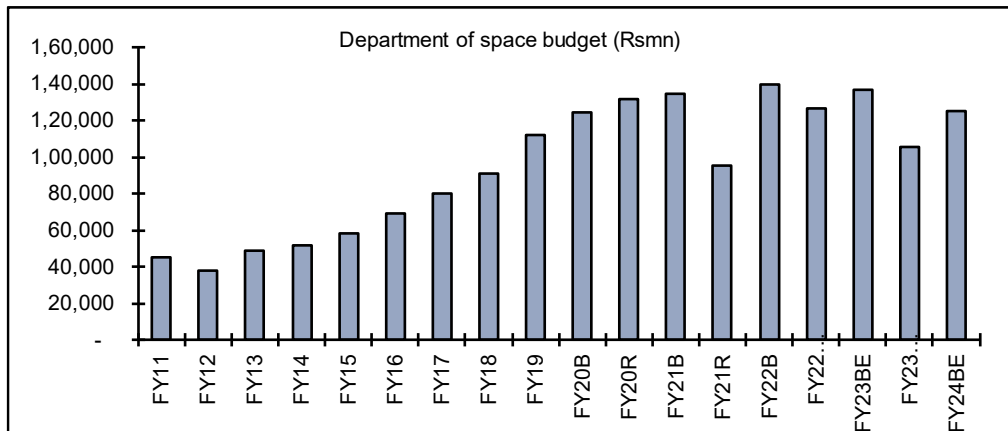


Source: Union Budget, I-Sec research

Space budget down to FY20 level

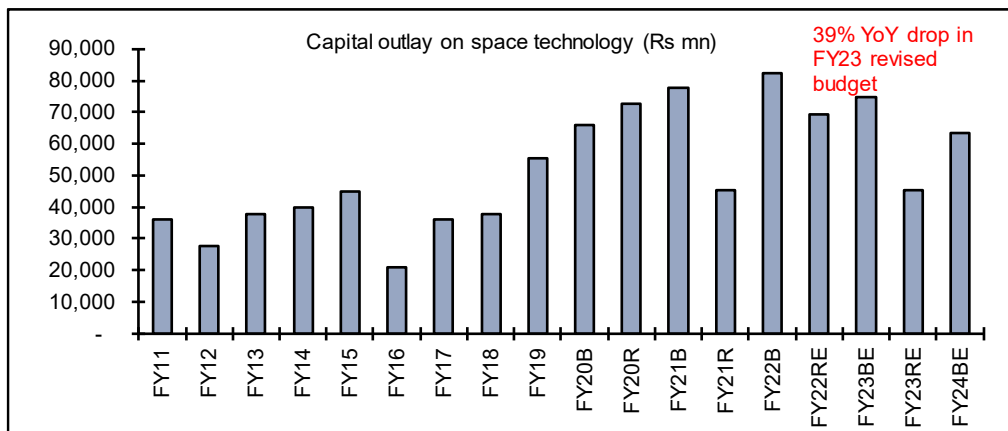
Space expenditure (capital outlay) for FY23RE is down 39% from FY23BE. Also, FY24BE is down 15% from FY22BE. As a cause for concern, FY24BE is still slightly lower than FY20 level.

Chart 2: Space budget expenditure of India witnessed a sharp reset in FY21...



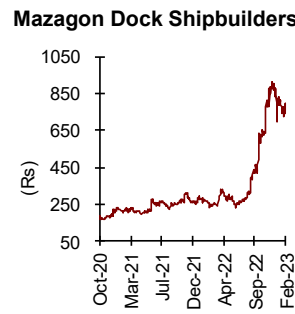
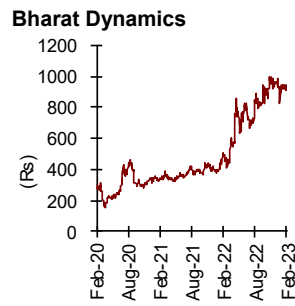
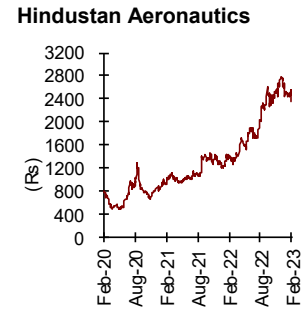
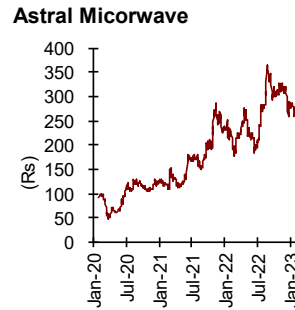
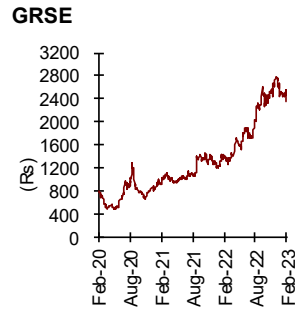
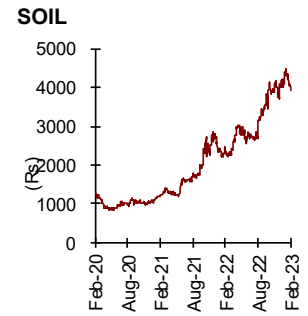
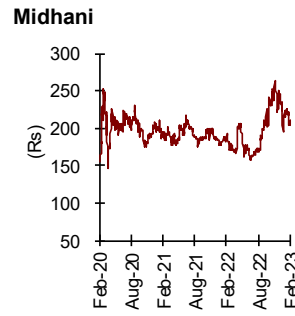
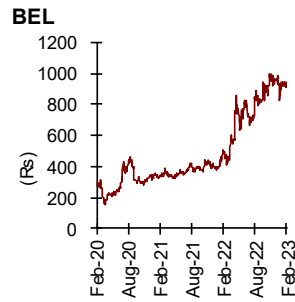
Source: Union Budget, I-Sec research

Chart 3: ...so did capital outlay



Source: Union Budget, I-Sec research

Price charts



Source: Bloomberg

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