

DEFENCE

Defence Expo 2018: Gunning for indigenous firepower

India Equity Research | Defence

We recently attended Defence Expo 2018 held at Chennai. At the exhibition, we interacted with managements of 15 plus domestic and international companies engaged in the defence sector. Key takeaways:

a) Private players well equipped to capture emerging opportunities

More than 154 global players and 523 Indian defence companies participated in the expo. In our view, Tata Aerospace & Defence, L&T Defence and Bharat Forge have identified their core areas either as a lead integrator or top-tier sub-system/component supplier and anticipate significant ramp up in defence business over the ensuing three-five years. *All the three players displayed their products (artillery guns were the most appreciated, amongst others) and are likely to be potential beneficiaries of the world's largest artillery procurement programme.*

b) Dominance of defence PSUs in contract wins to sustain

Currently, most of the large defence contracts are awarded to DPSUs (BEL, HAL, BDL, CSL, etc) on nomination basis. And, opening up of the sector for private companies via strategic partnership model, *Make in India* programmes, among others, is unlikely to change this in the medium term, in our view. This despite the significant capabilities built by private companies. *Except for a few specific projects, the private sector is likely to complement delivery capabilities of DPSU as sub-systems/components suppliers.*

c) Defence procurement policy: Long term structural push towards import substitution in defense equipment

- To promote *Make in India* in the defence sector, the government has now finalised locations of the two upcoming defence corridors (Tamil Nadu and Uttar Pradesh) entailing setting up an INR200bn fund.
- While most companies have announced MoUs over the past few days, these are at a nascent stage and contract terms will be finalised only over the next one-two years. Hence, their benefits are likely to flow only over the medium term. *After DPP 2016, setting up of defence manufacturing corridors will help create complete defence manufacturing eco-system.*

Outlook: The above factors further bolster our conviction in companies under coverage catering to specific verticals—Cochin Shipyard (indigenous aircraft carriers & untapped repairs opportunity) and BEL (SAM missiles). We further believe private companies, viz., Bharat Forge (particularly artillery guns) and L&T (shipbuilding, defence artillery guns) will benefit from new upcoming large orders. We do not foresee significant shift of business from public to private companies over the medium term given that DPSU will continue to bag contracts on nomination basis, while delays in finalisation of large contracts are imminent.

Reiterate our top picks: Cochin Shipyard (BUY/SO), Bharat Forge (BUY/SO), Larsen & Toubro (BUY/SO).

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Interactions with managements: Key takeaways

A) Rated Companies

Cochin Shipyard (Mcap: INR71bn; BUY/SO; TP: INR660)

- IAC execution is on track and will have a high revenue billing in last two years (FY20-21), which may trigger strong P/L.
- **Ship repair:** Visibility on repair business post Hughes dock JV has improved substantially. CSL expects significant ramp up for repair business from Indian Navy. Management remains confident of bagging to large repair contracts (IAC and Oil rig) over the next year.
- The company will be focusing to strengthen its man power for weapons systems maintenance to tap upcoming Naval repair opportunity

Bharat Electronics (Mcap: INR345bn; BUY/SO; TP: INR230)

- FY19 is likely to be better than FY18 in terms of revenue as well as profitability, due to heavy salary bill in H2FY18E.
- Akash and LR-SAM are likely to be finalised by 1HFY19, driving INR100-120bn worth of new orders.
- Management does not foresee significant downside risk to margin due to value addition from value engineering.
- ~55% of raw material cost is generally indigenised content and balance 45% is imported. This is likely to be significantly higher in Akash (85-90%).
- BEL is looking to enhance partnership with larger players like L&T, BHFC etc. This is a clear change in the company's strategy and is focused toward optimizing growth opportunities.

Astra Microwave (Mcap: INR7bn; BUY/SP; TP: INR145)

- Apart from expected Akash inflow (which is currently delayed), the company expects increased order inflow from ISRO in F19E/20E.
- Most of the promoters in the company are industry veterans and thus Astra only has near to medium term growth plans. Beyond a couple of years, there is a clear road map for consolidation in ownership structure.

Bharat Forge (Mcap: INR343bn; BUY/SO; TP: INR930)

- **Howitzer programme:** BHFC has made significant inroads in the indigenized Howitzer programme. The company has already given input on 2 ATAGS (155 mm/52 calibre), which it is currently in the process of supplying four more shortly. Overall, more than 400 ATAGS weapon systems are due to be procured over the next few years, which opens up significant opportunity for BHFC.
- Management is confident of delivering an Ultra light gun at a substantially lower cost than its global peers.

“Indian Army’s proposed artillery gun procurement programme is valued at about INR 500bn over a period of 15 years”

*Mr Baba Kalyani
CMD - Bharat Forge*



Bharat 52

- The spares business is also likely to be significant opportunity with barrels constituting ~30% of the overall gun cost and need to replace it after firing ~2,000 rounds.
- Testing is underway with an American company for supply of Garuda 105 artillery gun. This is likely to open up international geographies for supply of artillery guns.

Table 1: Artillery gun portfolio

Company	Specifications
Bharat -52	155mm / 52 cal
ULH	155mm / 39 cal
ATAGS	155mm / 52 cal
B 45	155mm / 45 cal
Garuda 105	105mm / 37 cal
Mounted Gund system	155mm / 39 cal

Source: Company, Edelweiss research

Larsen & Toubro (Mcap: INR 1,905bn; BUY/SO; TP: INR1,680)

- L&T seems to be the sole beneficiary of the Landing platform dock project ~INR 250bn.
- The company has started manufacture of K9-Vajra (delivered 10 no's) and expects to complete delivery of balance 90 no's before schedule.
- L&T (with Nexter, France) and Bharat Forge are targeting the upcoming towed gun opportunity, which is likely to be awarded before FY20E

Table 2: Ship building pipeline over the next one–two years is encouraging, with projects worth ~INR350-370bn to be awarded

Project	No's	Value per vessel(INR bn)	Total project size (INR bn)
Next generation missiles vessels	6	10	60
Fast Patrol Vessels	7	2	14
Multi purpose support vessels	4	10	40
Pollution control vessels	2	6	12
Landing Platform Dock	4	63	250
Total			376

Source: Company, Edelweiss research

Table 3: L&T defence business pipeline over the next two years

Project	No's	Value (INR bn)	Total project size (INR bn)	Remarks
Pinnaka *	4	25.0	100	Award likely in FY19
Mounted gun program	100	0.3	30	Award likely in FY20
Towed gun program	400	0.3	100	Bids to open in Dec'18 and contract award in FY20
Futuristic Infantry Combat Vehicle	2610	0.2	650	Bids to open in Dec'18 and contract award in FY20
Total			880	

* Note –Value for complete regiment

Source: Company, Edelweiss research



ATAGS

Table 4: Suppliers for ATAGS

Subsystems	Source(s)
Barrel	OFB, Bharat Forge
Muzzle Brake	OFB, Punj Lloyd
Breech Mech	OFB, Bharat Forge, Tata Projects
Recoil Sys	Mahindra Defence, Tata Projects
Structure & Automative	Bharat Forge, Tata Projects
Automation & Control	Bharat Forge, Tata Projects
Optronic Sight	Tata Projects, Ex-Import
Tactical Computer	Bharat Electronics
Communication Sys	Bharat Electronics
MVR and AGAPS	Ex-Import
Battery Command Post	Bharat Forge
Towing System	Ashok Leyland
Ammunition (%)	OFB

Source: Defence Expo, Edelweiss research

B) Not Rated Companies

Boeing (Not Rated)

- Boeing has responded to the RFI for the procurement of Super Hornet fighter jets by Navy (57). An additional 110 are required for the Air Force. According to the management, USD100mn per aircraft is likely to be the conservative cost of these aircrafts.
- The company is likely to execute this contract via a JV with Indian partners Hindustan Aeronautics (HAL) and Mahindra. MoU is likely to be finalised by CY18.

Hindustan Aeronautics (Not Rated)

- MRO of Sukhois to turn a significant opportunity over the next two-three years. This has already started with HAL completing refits for six aircrafts.
- However, the company does not have the scope to charge exorbitant pricing during MRO, as can be done by most companies globally.

Table 5: Healthy book-to-bill for defence companies

Company	Approx defence revenues (INR bn)	Approx order book (INR bn)	Book to Bill (x)
Cochin Shipyard	20.6	130	6.3
Bharat Electronics	86.1	404	4.7
Astra Microwave	4.3	5	1.2
Larsen & Toubro	25 - 30	70-80	2.5
Bharat Forge	~4 - 5		

Source: Company, Edelweiss research

Table 6: Valuation Snapshot

Company	Reco/ Rating	CMP (INR)	TP (INR)	Revenue (INR bn)				EBITDA margins (%)				EPS (INR)				P/E (x)			
				FY17	FY18E	FY19E	FY20E	FY17	FY18E	FY19E	FY20E	FY17	FY18E	FY19E	FY20E	FY17	FY18E	FY19E	FY20E
Cochin Shipyard	Buy	524	660	21	23	27	34	18.5	18.3	18.2	18.1	23.0	26.8	30.5	32.4	22.8	19.6	17.2	16.2
Bharat Electronics	Buy	143	230	86	113	138	165	20.5	19.8	20.2	20.4	6.3	6.6	8.3	10.0	22.6	21.7	17.3	14.3
Astra Microwave	Buy	82	145	4	4	4	5	23.4	33.5	32.8	32.0	6.5	7.5	8.6	9.8	12.5	10.9	9.6	8.4
Bharat Forge	Buy	734	930	64	82	99	112	19.6	22.3	22.6	22.8	12.1	21.6	26.8	31.2	60.6	34.0	27.4	23.5
Larsen & Toubro	Buy	1,355	1,680	1,093	1,218	1,405	1,610	10.1	11.0	11.3	11.6	42.4	51.6	58.4	70.0	32.0	26.3	23.2	19.4

Source: Company, Edelweiss research

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

Astra Microwave Products, Bharat Electronics

Recent Research

Date	Company	Title	Price (INR)	Recos
28-Feb-18	Cochin Shipyard	Sailing the high seas; <i>Initiating Coverage</i>	532	Buy
31-Jan-18	Bharat Electronics	Robust execution a new normal; business MOAT intact; <i>Result Update</i>	177	Buy
30-Jan-18	Astra Microwave Products	Delays drag revenue; growth prospects intact; <i>Result Update</i>	114	Buy

Distribution of Ratings / Market Cap

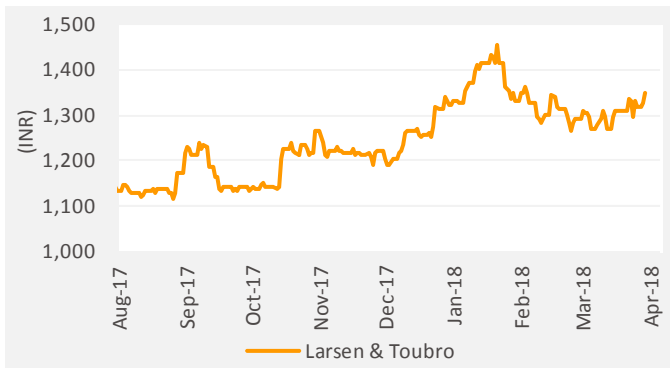
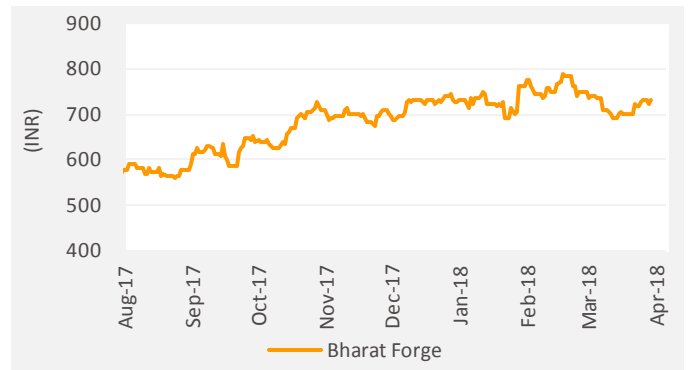
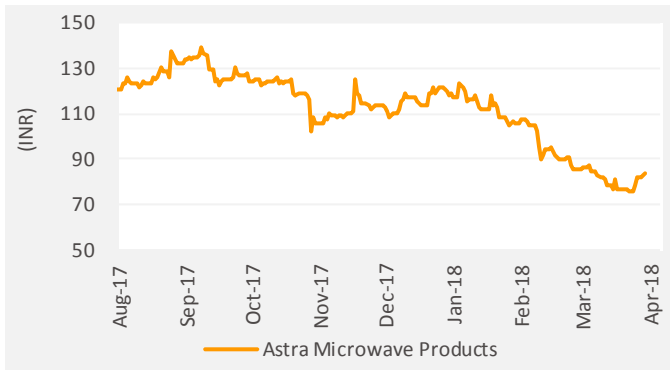
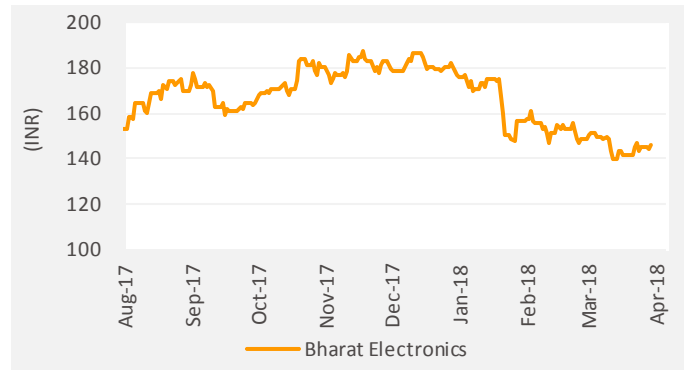
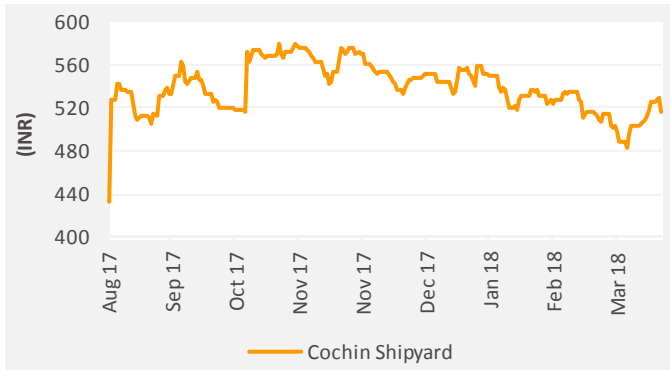
Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	161	67	11	240
* 1 stocks 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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