

OCTOBER 8, 2018

	5-Oct	% Chg		
		1 Day	1 Mth	3 Mths
Indian Indices				
SENSEX Index	34,377	(2.3)	(9.6)	(3.4)
NIFTY Index	10,316	(2.7)	(10.1)	(4.0)
NSEBANK Index	24,443	(1.5)	(10.7)	(7.8)
NIFTY 500 Index	8,625	(2.6)	(11.7)	(5.9)
CNXMcap Index	16,300	(2.6)	(15.3)	(10.1)
BSESMCAP Index	13,840	(2.0)	(17.3)	(13.4)

World Indices				
Dow Jones	26,447	(0.7)	2.0	8.1
Nasdaq	7,788	(1.2)	(1.4)	1.3
FTSE	7,319	(1.3)	0.6	(3.9)
NIKKEI	23,976	(0.6)	6.6	9.2
Hangseng	23,976	(0.6)	6.6	9.2
Shanghai	26,573	(0.2)	(2.5)	(7.2)

Value traded (Rs cr)	5-Oct	% Chg Day
Cash BSE	3,158	(4.7)
Cash NSE	39,712	(0.5)
Derivatives	-	-

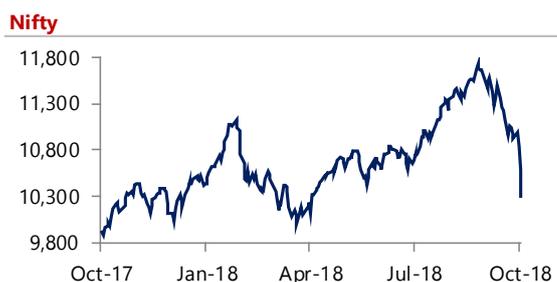
Net inflows (Rs cr)	4-Oct	MTD	YTD
FII	(2,261)	(5,396)	(20,458)
Mutual Fund	1,132	3,720	91,975

Nifty Gainers & Losers	Price	Chg	Vol
5-Oct	(Rs)	(%)	(mn)
Gainers			
Infosys Ltd	725	2.5	8.5
Titan Co Ltd	792	2.0	7.4
TCS	2,103	1.8	3.4
Losers			
HPCL	165	(24.0)	86.9
BPCL	266	(19.6)	55.7
Indian Oil Corp	118	(15.9)	80.9

Advances / Declines (BSE)					
5-Oct	A	B	T	Total	% total
Advances	55	222	42	319	100
Declines	375	778	99	1,252	392
Unchanged	1	23	17	41	13

Commodity	% Chg			
	5-Oct	1 Day	1 Mth	3 Mths
Crude (US\$/BBL)	83.3	(1.1)	8.4	8.0
Gold (US\$/OZ)	1,203.0	0.2	0.0	(4.7)
Silver (US\$/OZ)	14.6	0.4	2.2	(9.7)

Debt / forex market	5-Oct	1 Day	1 Mth	3 Mths
10 yr G-Sec yield %	8.0	8.2	8.1	7.9
Re/US\$	73.8	73.6	71.8	68.9



Source: Bloomberg

News Highlights

- Foreign investors have pulled out over Rs 93 bn (USD 1.3 billion) from the Indian capital markets in the last four trading sessions on unabated fall in rupee and rise in crude oil price. The latest withdrawal comes following a net outflow of over Rs 210 bn from the capital markets (both equity and debt) last month. (ET)
- The government is planning steps to give significant autonomy to Air India's (AI's) board, in terms of capital expenditure and commercial decision-making. This, along with a debt-restructuring proposal and a financial support of Rs 150 billion, will be part of a package to improve the airline's operational efficiency.(BS)
- The telecom department is unlikely to give an early approval to **Reliance Communications'** spectrum sale to Reliance Jio Infocomm (Jio) with officials saying they won't accept land as a guarantee for the telco's spectrum dues and will file for a modification of a tribunal order. (ET)
- It may come as a surprise to **Infrastructure Leasing & Financial Services (IL&FS)** investors that the total liabilities, including parent liabilities, are estimated higher at Rs 1.31 trillion as of March this year, compared to consolidated liabilities of Rs 1.05 trillion mentioned in the annual report.(BS)
- Reliance** hikes petrochemical prices to offset rising oil. It increased prices of seven key petrochemicals by 10-21% in the second quarter of this fiscal year while the year-on-year increase is 17-61%. (Mint)
- Yes Bank** promoters Rana Kapoor and Madhu Kapur are in preliminary talks to withdraw a long-drawn and bitter legal case against each other and put an end to their decade-old feud. If taken to its logical conclusion, the move will remove uncertainties surrounding the bank's succession plans, simplify the board's functioning and possibly help burnish the bank's stained credentials. (Mint)
- No swift resolution in sight for **Essar Steel's** legal quagmire. The Supreme Court has directed Numetal Mauritius and ArcelorMittal to settle unpaid liabilities of all connected parties to become eligible bidders for Essar Steel.(Mint)
- Maruti Suzuki** has asked its key vendors to push their foreign suppliers to set up manufacturing facilities in India so that it can drive localization and reduce the overall import content in its cars by around 8 per cent in the coming years. The combined import content for the car maker and its vendors (who also import sub-components) averages between 15-16 per cent.(BS)
- Indiabulls** confident of growing business by over 20% in current fiscal. It has over the years followed strict discipline of maintaining an optimally matched balance sheet, high liquidity and high capital adequacy.(BS)
- Multiplex operator **Inox Leisure** will continue to add 50 to 60 screens every year and scout for inorganic growth opportunity in the segment as part of its growth journey.(ET).

What's Inside

- Company Update:** Bharat Electronics Ltd

Source: ET = Economic Times, BS = Business Standard, FE = Financial Express, IE = Indian Express, BL = Business Line, ToI: Times of India, BSE = Bombay Stock Exchange, MC = Moneycontrol

Company Update

Stock Details

Market cap (Rs mn)	:	196389
52-wk Hi/Lo (Rs)	:	193 / 74
Face Value (Rs)	:	1
3M Avg. daily vol (Nos)	:	13,666,090
Shares o/s (mn)	:	2437

Source: Bloomberg

Financial Summary

Y/E Mar (Rs mn)	FY18	FY19E	FY20E
Revenue	100,066	116,268	117,573
Growth (%)	13	16	1
EBITDA	19,997	22,971	23,822
EBITDA margin (%)	20	20	20
PAT	13,999	14,829	15,696
EPS	5.7	6.1	6.4
EPS Growth (%)	(9.5)	5.9	5.8
BV (Rs/share)	31.9	35.5	39.0
Dividend/share (Rs)	2.0	2.0	2.5
ROE (%)	18.3	18.1	17.3
ROCE (%)	16.9	16.8	16.1
P/E (x)	13.9	13.1	12.4
EV/EBITDA (x)	9.4	7.7	6.6
P/BV (x)	2.6	2.3	2.1

Source: Company, Kotak Securities - PCG

Shareholding Pattern (%)

(%)	Jun-18	Mar-18	Dec-17
Promoters	66.0	66.7	66.7
FII	6.1	8.6	8.1
DII	19.0	3.7	3.8
Others	9.0	21.0	21.4

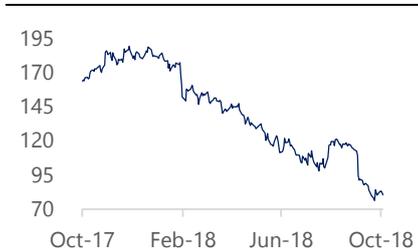
Source: Company

Price Performance (%)

(%)	1M	3M	6M
Bharat Electronics	(14.7)	(21.2)	(44.4)
Nifty	(10.1)	(4.0)	(0.1)

Source: Bloomberg

Price chart (Rs)



Source: Bloomberg

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BHARAT ELECTRONICS LTD (BEL)

PRICE Rs.80

TARGET Rs.96

BUY

In our recent interaction with the company, the management remained positive on the business outlook. However, change in government policy remains a key risk.

Key Highlights

- As per the new pricing policy for nomination projects (35% of order book) finalized by the Ministry of Defense (MoD) in May 2018, a 7.5% PBT margin would be allowed v/s the earlier 10-12% margin.
- Order book continues to be strong. With the LRSAM order of Rs 92 bn, the order book now stands at Rs 500 bn plus, ~ 5x FY18 revenue.

Valuation and Outlook

BEL is trading at 13.1x and 12.4x FY19E and FY20E earnings. Although, the recent government policy on pricing of defence equipment has come as a negative, we take cognizance of the high order book providing strong revenue visibility and healthy balance sheet. However, to factor in the potential downgrade in long term margin profile, we cut target price to Rs 96. In view of the adequate upside from current levels, we reiterate BUY.

Highlights

New pricing policy to hurt margins, albeit in the long term

- As per the new pricing policy for nomination projects (35% of order book) finalized by the Ministry of Defense (MoD) in May 2018, a 7.5% PBT margin would be allowed v/s the earlier 10-12% margin.
- While on the face of it, this policy suggests an impairment in margin profile of the company, it needs to be noted that the policy allows pass-through of all costs and risks in the project, which was not the case earlier. This is a mitigating factor in our view.
- Also, the new policy does not affect existing INR500b order book and therefore no impact is expected for the next 2-3 years. However, the management expects a 70-200 bps downside on margins for nomination orders starting FY22 from this policy change.
- The management's assessment of the probable margin impact in FY22 is in the range of 0.2-0.7%. This does not include legacy orders (24% of order book) since these are repeat orders.

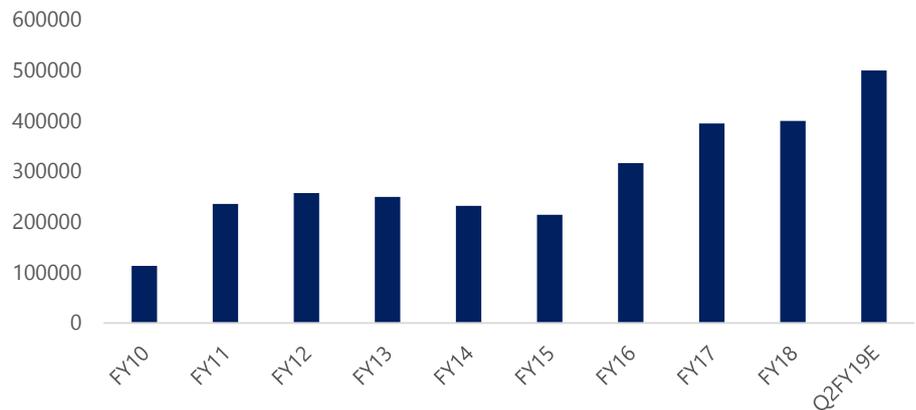
Order Book

- In the current fiscal, the company is expecting orders for Akash Missile System (7 Sqdn). Order for Long Range Surface to Air Missile (LRSAM) has already been placed with the company.
- With the LRSAM order of Rs 92 bn, the order book now stands at Rs 500 bn plus.
- As the lead integrator of Akash Missile system, BEL has already proven its prowess in the realm of Turnkey Missile Systems. The company is now geared up for futuristic programmes such as the Quick Response Surface to Air Missile (QRSAM) for the Army, Medium Range Surface to Air Missile (MRSAM)

for the Air Force and Long Range Surface to Air Missile (LRSAM) for the Navy. BEL is the lead integrator of LRSAM systems for the Navy's P-17A stealth frigates.

- The BEL will continue its indigenisation efforts in line with the 'Make in India' initiative. Strategies and action plans are in place to face competition, maintain its technological edge and retain its leadership position in strategic electronics.

Order book (Rs mn)



Source: Company

Industry developments

- Presently, India is the largest importer of defence equipment with many of its defence needs met through imports. The Government of India vision is to develop a strong self-reliant domestic industry in the defence sector with substantial participation from Private sector including MSMEs and Start-ups to reverse the trend of imports. MoD has introduced the Strategic Partnership model (SP) for the Indian private sector, as part of DPP 2016. SPs will be selected initially in 4 segments viz. Fighter Aircraft, Helicopters, Submarines and Armoured fighting vehicles (AFV) / Main Battle Tanks (MBT).
- The Strategic Partner would tie up with global OEMs to seek technology transfers to set up domestic manufacturing infrastructure and supply chains for major systems. The model aims to progressively build indigenous capabilities in the private sector to design, develop and manufacture identified platforms.
- Under these changing business scenarios, BEL is focusing on enhancing its interaction levels and building long term relationships with emerging Strategic Partners, Users and other key stake holders in the Indian defence industry.

Defence equipment procurement

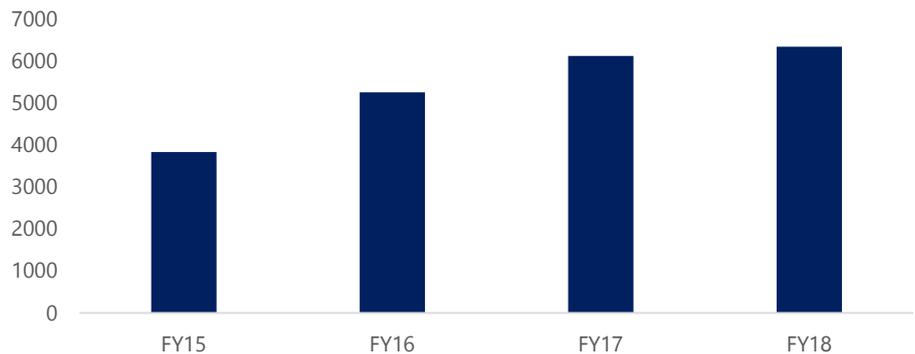
	Procurement from Indian vendors (Rs bn)	Percentage (%)	Procurement from Foreign vendors (Rs bn)	Percentage (%)	Total Procurement (Rs bn)
FY16	39	63	23	37	62
FY17	42	61	27	39	69
FY18	44	60	29	40	73

Source: Company

Capex and R&D

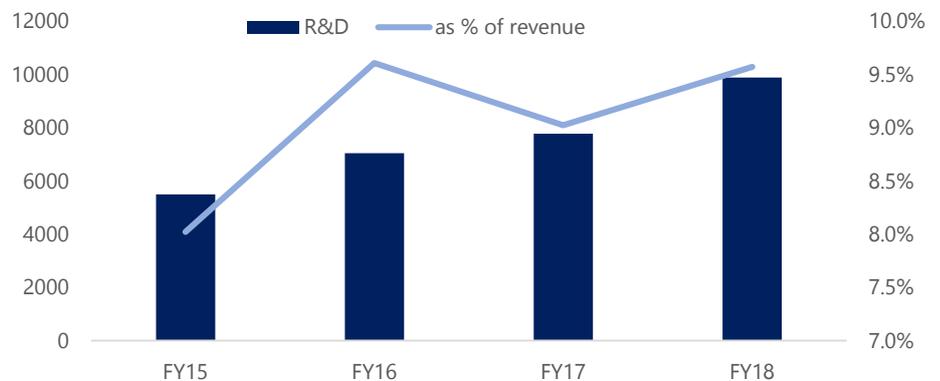
- BEL is spending capex in the range of Rs 6.0 bn on an annual basis on establishing manufacturing and testing facilities. The company is setting up two new factories at Devanahalli & Nagpur for which land is being acquired. In addition to this, it has set up testing facility for Missile systems and Antennas.
- BEL is the largest production partner of DRDO and 89% of its revenues are contributed from indigenous R&D. It also has 47% of its manpower in the R&D role.

Capex on expansion and modernisation (Rs mn)



Source: Company

R&D expenses Rs mn and as % of revenue



Source: Company

Management Feedback

- The management expects revenue growth of 15% in FY19E (Rs 115 bn in FY19E).
- On EBITDA margins, the management expects margins to remain around 18-19%, more or less in the same range as in FY18.

Future growth areas

- Future thrust areas for BEL includes cognitive and artificial intelligence, machine learning, cyber security, cloud computing and data analytics and image analytics among others, the management indicated.
- BEL has been shortlisted by India's space agency (ISRO) to assemble satellites as it looks to tap the industry to increase production and bridge the demand-supply gap for remote sensing and communication satellites in the country.

There is demand for assembling 45 large satellites from India, while globally, there is estimated requirement of 5000 small and micro satellites.

Stock correction likely overdone

The BEL stock has been derated in recent months which we understand could be due to

- Listing of BDL and HAL at attractive valuations has weighed on the valuations of BEL, which until the listing of the two defence PSUs was the only sizeable defence play available for investors
- Weak order intake in FY18, which missed the order intake target for the company.
- Recent norms on pricing of defence equipments which are ordered on a negotiated basis has led to risk of margin loss in the long term.

Revised target price

We are revising our target price on the company based on couple of factors including the rise in cost of capital. More importantly, we are pricing in the risk of change in government regulations and policies. The recent change in pricing of defence equipment is a case in point, which can potentially cut long term margins.

Other risks include rapid change in technology and policy interventions incentivizing private sector.

In view of these risks, we now value the stock at a 25% discount to our earlier target multiple of 20x FY20E. We arrive at a price target of Rs 96, which discounts FY20E at 15x (17% discount to median forward multiple of 18x).

Forward PE band



Source: Kotak Securities – Private Client Research

Fine-tuned future earnings

Rs mn	FY19		FY20	
	Earlier	Revised	Earlier	Revised
Revenue	115039	116268	126394	117573
EBITDA %	19.2%	19.8%	19.7%	20.3%
EPS	6.0	6.1	6.7	6.4
% change		1.5%		-3.8%

Source: Kotak Securities – Private Client Research

Reiterate BUY

BEL is trading at 13.1x and 12.4x FY19E and FY20E earnings. Although, the recent government policy on pricing of defence equipment has come as a negative, we take cognizance of the high order book providing strong revenue visibility and healthy balance sheet. However, to factor in the potential downgrade in margin profile, we cut target price to Rs 96 (Rs 135 earlier). In view of the adequate upside from current levels, we reiterate BUY.

Key Weaknesses

The defence business has long approval cycle as any equipment that needs to be procured needs to go through field-trials and several levels of approvals. Hence, order execution may take much longer resulting in delay in revenue translation.

Competition from private sector is on the rise as the government intends to go for higher indigenization of defence equipments.

Company Background

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.

Financials: Consolidated

Profit and Loss Statement (Rs mn)

(Year-end Mar)	FY17	FY18	FY19E	FY20E
Revenues	88,247	100,066	116,268	117,573
% change yoy	17.0	13.4	16.2	1.1
EBITDA	17,617	19,997	22,971	23,822
% change yoy	27.4	13.5	14.9	3.7
Depreciation	1,915	2,510	3,100	3,493
Other Income	4,710	2,004	876	1,785
EBIT	20,412	19,491	20,747	22,114
% change yoy	16.7	(4.5)	6.4	6.6
Net Interest	118	7	7	7
Earnings Before Tax	20,294	19,484	20,740	22,107
% change yoy	16.4	(4.0)	6.4	6.6
Provisions and amortisations	-	-	-	-
Tax	4,818	5,486	5,911	6,411
as % of EBT	23.7	28.2	28.5	29.0
Net Income adj	15,476	13,999	14,829	15,696
% change yoy	17.3	(9.5)	5.9	5.8
Shares outstanding (m)	2,234	2,436	2,436	2,436
EPS (Rs)	6.9	5.7	6.1	6.4
DPS (Rs)	2.3	2.0	2.0	2.5
CEPS	7.8	6.8	7.4	7.9

Source: Company, Kotak Securities – Private Client Research

Cash flow Statement (Rs mn)

(Year-end Mar)	FY17	FY18	FY19E	FY20E
PBDIT	17,617	19,997	22,971	23,822
Tax and adjustments	(9,711)	(5,266)	(5,911)	(6,411)
Cash flow from operations	7,906	14,732	17,060	17,411
Net Change in WC	(10,657)	(25,812)	320	11,568
Net Cash from Operations	(2,751)	(11,080)	17,380	28,979
Capital Expenditure	(6,970)	(6,322)	(2,684)	(3,000)
Cash from investing	38,448	(1,175)	876	1,785
Net Cash from Investing	31,478	(7,497)	(1,809)	(1,215)
Interest paid	(118)	(7)	(7)	(7)
Issue of Shares	(21,712)	(3,721)	(203)	-
Dividends Paid	(6,774)	(5,700)	(5,700)	(7,125)
Debt Raised	1,084	(5,487)	-	-
Net cash from financing	(27,520)	(14,916)	(5,910)	(7,132)
Net change in cash	1,207	(33,492)	9,661	20,631
Free cash flow	(9,721)	(17,402)	14,696	25,979
cash at end	37,902	7,300	16,963	37,596

Source: Company, Kotak Securities – Private Client Research

Balance sheet (Rs mn)

(Year-end Mar)	FY17	FY18	FY19E	FY20E
Cash and cash equivalents	37,902	7,300	16,963	37,596
Accounts receivable	43,549	71,404	62,116	62,813
Stocks	48,558	45,877	54,152	54,760
Loans and Advances	433	-	-	-
Others	6,075	15,307	15,306	15,306
Current Assets	136,517	139,888	148,537	170,476
LT investments	4,597	9,748	9,748	9,748
Net fixed assets	12,549	16,044	15,944	15,452
Deferred tax assets	5,323	4,312	4,312	4,312
CWIP	6,567	8,354	8,038	8,038
Other non current assets	6,009	4,037	4,037	4,037
Total Assets	171,562	182,381	190,616	212,061
Payables	77,122	93,907	93,212	106,085
Others	13,003	4,380	4,380	4,380
Current liabilities	90,125	98,286	97,592	110,465
LT debt	167	-	-	-
Other liabilities	6,183	6,485	6,486	6,487
Equity & reserves	75,086	77,611	86,537	95,107
Total Liabilities	171,562	182,381	190,616	212,061
BVPS (Rs)	33.6	31.9	35.5	39.0

Source: Company, Kotak Securities – Private Client Research

Ratio Analysis

(Year-end Mar)	FY17	FY18	FY19E	FY20E
EBITDA margin (%)	20.0	20.0	19.8	20.3
EBIT margin (%)	23.1	19.5	17.8	18.8
Net profit margin (%)	17.5	14.0	12.8	13.4
Adjusted EPS growth (%)	17.3	-9.5	5.9	5.8
Receivables (days)	180.1	260.5	195.0	195.0
Inventory (days)	200.8	167.3	170.0	170.0
Sales / Net Fixed Assets (x)	7.0	6.2	7.3	7.6
ROE (%)	18.8	18.3	18.1	17.3
ROCE (%)	17.6	16.9	16.8	16.1
EV/ Sales	1.6	1.9	1.5	1.3
EV/EBITDA	8.0	9.4	7.7	6.6
Price to earnings (P/E)	11.5	13.9	13.1	12.4
Price to book value (P/B)	2.5	2.6	2.3	2.1
Price to cash earnings	10.3	11.8	10.9	10.2

Source: Company, Kotak Securities – Private Client Research

RATING SCALE

Definitions of ratings

- BUY** – We expect the stock to deliver more than 12% returns over the next 12 months
- ACCUMULATE** – We expect the stock to deliver 5% - 12% returns over the next 12 months
- REDUCE** – We expect the stock to deliver 0% - 5% returns over the next 12 months
- SELL** – We expect the stock to deliver negative returns over the next 12 months
- NR** – **Not Rated.** Kotak Securities is not assigning any rating or price target to the stock. The report has been prepared for information purposes only.
- SUBSCRIBE** – We advise investor to subscribe to the IPO.
- RS** – **Rating Suspended.** Kotak Securities has suspended the investment rating and price target for this stock, either because there is not a Sufficient fundamental basis for determining, or there are legal, regulatory or policy constraints around publishing, an investment rating or target. The previous investment rating and price target, if any, are no longer in effect for this stock and should not be relied upon.
- NA** – **Not Available or Not Applicable.** The information is not available for display or is not applicable
- NM** – **Not Meaningful.** The information is not meaningful and is therefore excluded.
- NOTE** – Our target prices are with a 12-month perspective. Returns stated in the rating scale are our internal benchmark.

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