

BHARAT ELECTRONICS

Strong order inflows, pressure on margins

Key highlights of our recent meeting with the management of Bharat Electronics (BEL) are: (1) Strong order inflow to continue into FY12, with at least INR 100 bn orders in the pipeline; (2) modest sales growth of 10% likely in FY12, but FY13 could see higher growth; and (3) EBITDA margin likely to stabilise at ~16% by FY13 (18% in FY11) on higher proportion of lower-margin project orders. We expect the company to deliver 14% earnings CAGR over FY11-13, and maintain 'BUY' with target price of INR 2,080.

■ Strong order inflow key surprise in Q4; modest sales guidance for FY12

BEL ended FY11 with order backlog of INR 236 bn, up 108% Y-o-Y, implying a comfortable book-to-bill of 4x FY11 sales. However, execution timeline of these orders is longer, with the company guiding for only 10% sales growth in FY12. We have factored in a higher 25% sales growth in FY13, especially since FY12 is expected to be another good year for order inflows. However, it would still fall well short of the company's earlier guidance of INR 100 bn sales by FY13.

■ Margin dilution to continue on mix change

EBITDA margin is expected to fall to 16% by FY13 versus 18% in FY11. This will be on the back of change in sales mix with a higher proportion of lower-margin project-based orders (80% by FY13) versus largely product orders until FY11. We estimate that margin in project orders could be ~14% versus 18% in products. Further, product margin itself is expected to come down with increased competition, especially from the private sector. On the other hand, wage agreement has been finalised in FY11 and next revision is due only in FY16. Until then, wages are expected to rise only ~8% annually. This should help offset some of the margin decline due to mix change.

■ Outlook and valuations: A defensive bet; maintain 'BUY'

BEL, as a premier Indian defense electronics company, is poised to benefit from continued rise in govt.'s defense expenditure. The stock is currently trading at 16x FY12 and 13x FY13 earnings. We believe, this is inexpensive, given cash in balance sheet of INR 470/share. On core earnings (ex cash) BEL is trading at only 12x for FY13. We value the company at 16x FY13 earnings and arrive at a target price of INR 2,080.

Financials

Year to March	FY10	FY11	FY12E	FY13E
Revenue (INR mn)	53,810	56,351	62,568	78,210
Rev. growth (%)	15.8	4.7	11.0	25.0
EBITDA (INR mn)	11,097	10,034	10,425	12,838
Net profit (INR mn)	7,209	8,043	8,525	10,402
Shares outstanding (mn)	80	80	80	80
Diluted EPS (INR)	105.6	100.5	106.6	130.0
EPS growth (%)	2.5	(4.8)	6.0	22.0
P/E (x)	16.3	17.1	16.1	13.2
EV/ EBITDA (x)	9.2	10.0	8.9	6.7
ROAE (%)	20.7	17.3	16.1	17.2
ROACE (%)	24.4	19.0	17.2	18.9

May 20, 2011

Reuters : BAJE.BO

Bloomberg : BHE IN

EDELWEISS RATING

Absolute Rating

BUY

MARKET DATA

CMP	:	INR 1,720
52-week range (INR)	:	1,927 / 1,602
Share in issue (mn)	:	80.0
M cap (INR bn/USD mn)	:	138 / 3,024
Avg. Daily Vol. BSE/NSE ('000)	:	54.8

SHARE HOLDING PATTERN (%)

Promoters*	:	75.9
MFs, FIs & Banks	:	14.8
FIIs	:	5.4
Others	:	3.9
* Promoters pledged shares (% of share in issue)	:	Nil

RELATIVE PERFORMANCE (%)

	Sensex	Stock	Stock over Sensex
1 month	(5.4)	(8.8)	(3.4)
3 months	(1.9)	2.0	4.0
12 months	10.2	(4.6)	(14.9)

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Chart 1: Order book & order intake on the rise

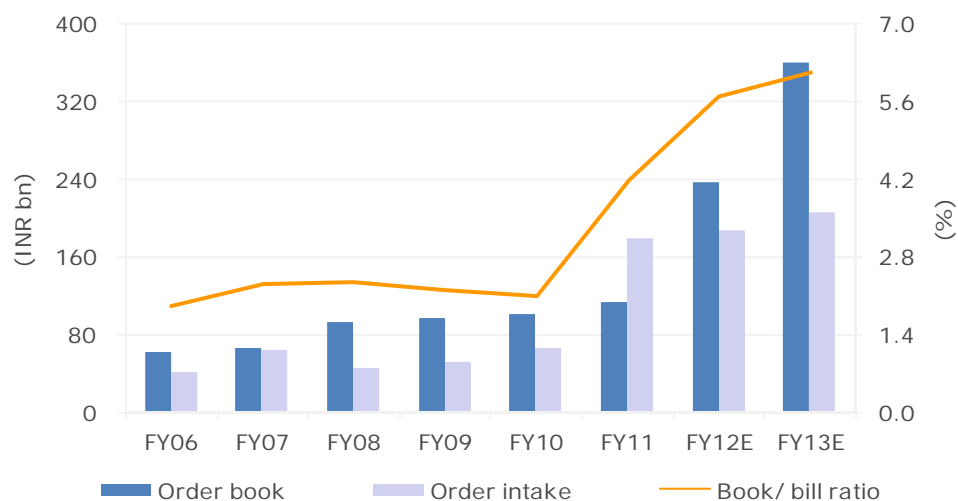


Chart 2: EDITDA margin likely to stabilize around 16%

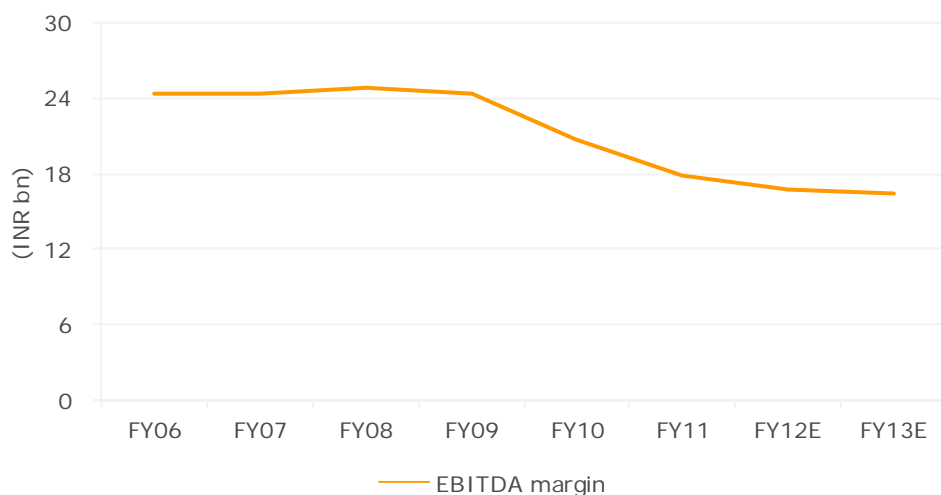
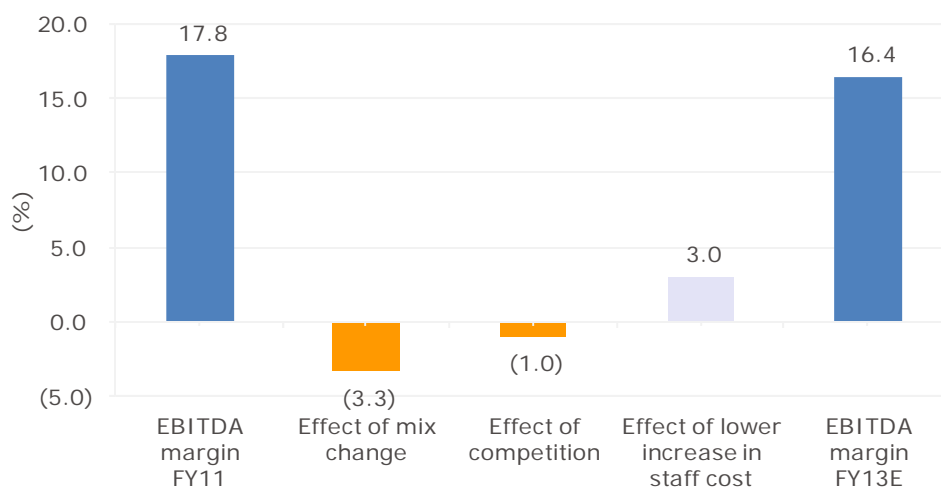


Chart 3: Reasons for decline in EBITDA margin



Source: Company, Edelweiss research

Chart 4: P/E band

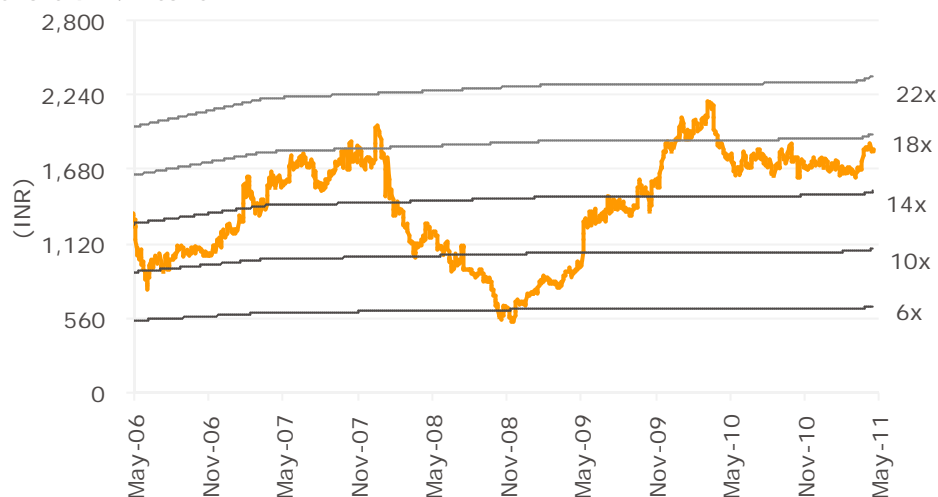


Table 1: Peer group comparison

Ticker	Short Name	Current PE	One year forward PE	Current EV/EBITDA	One year forward EV/EBITDA
Europe					
ULE LN Equity	ULTRA ELECTRONIC	14.3	13.5	8.8	8.4
CHRT LN Equity	COHORT PLC	7.0	5.9	3.8	3.2
CHG LN Equity	CHEMRING GROUP	10.9	10.2	8.3	7.7
QQ/ LN Equity	QINETIQ GROUP PL	8.3	8.4	6.1	6.5
BA/ LN Equity	BAE SYSTEMS PLC	8.1	7.8	4.4	4.3
KOG NO Equity	KONGSBERG GRUPP	12.0	11.3	6.5	6.2
COMROD NO Equity	COMROD COMMUNICA	8.4	7.1	4.6	4.1
HO FP Equity	THALES SA	12.0	9.7	5.2	4.4
Average		10.1	9.2	6.3	5.6
North America					
CRDN US Equity	CERADYNE INC	14.6	15.0	6.4	6.4
AVAV US Equity	AEROVIRONMENT IN	27.2	23.3	8.2	9.2
ORB US Equity	ORBITAL SCIENCES	21.2	16.7	7.6	6.7
CUB US Equity	CUBIC CORP	17.2	16.3	8.7	8.2
FLIR US Equity	FLIR SYSTEMS	20.9	17.9	11.0	10.3
MANT US Equity	MANTECH INTL-A	11.9	11.4	6.5	6.2
SWHC US Equity	SMITH & WESSON H	36.7	13.0	5.9	4.6
KTOS US Equity	KRATOS DEFENSE &	21.2	10.2	8.5	7.4
LMT US Equity	LOCKHEED MARTIN	11.1	9.2	6.0	5.4
ATK US Equity	ALLIANT TECHSYS	9.0	8.6	5.4	5.3
RTN US Equity	RAYTHEON CO	10.0	8.8	5.8	5.5
FRPT US Equity	FORCE PROTECTION	13.8	10.9	3.3	3.3
LLL US Equity	L-3 COMM HLDGS	9.8	9.3	6.6	6.7
NOC US Equity	NORTHROP GRUMMAN	9.8	9.1	5.3	5.1
Average		16.7	12.8	6.8	6.5
Global Average		13.2	10.8	6.0	5.6
	Bharat Electronics	13.3	12.4	7.6	6.1
	Bharat Electronics (core PE)	12.5	10		

Source: Bloomberg, Edelweiss research

Financial snapshot - (Standalone)

(INR mn)

Year to March	Q411	Q410	% change	Q311	% change	FY11	FY12E	FY13E
Revenues	23,600	19,145	23.3	13,730	71.9	56,351	62,568	78,210
Materials cost	12,985	10,822	20.0	8,125	59.8	31,845	36,290	47,317
Staff costs	2,908	2,496	16.5	2,462	18.1	10,450	11,286	12,189
Other expenses	1,892	1,658	14.1	915	106.8	4,022	4,567	5,866
Total expenditure	17,786	14,976	18.8	11,502	54.6	46,317	52,143	65,372
EBITDA	5,815	4,169	39.5	2,228	161.0	10,034	10,425	12,838
Interest	2.0	1.4	39.0	0.4	348.1	3.5	0.7	0.7
Depreciation	327	299	9.4	296	10.6	1,219	1,329	1,414
Other income	776	425	82.7	460	68.6	2,430	2,819	3,113
PBT	6,262	4,294	45.8	2,392	161.8	11,242	11,914	14,537
Tax	1,780	864	106.0	686	159.3	3,198	3,389	4,136
Adjusted net profit	4,483	3,430	30.7	1,706	162.8	8,043	8,524	10,401
Extraordinary costs	-	(1,433)	-	-	-	(1,241)	-	-
Net profit	4,483	1,997	124.4	1,706	162.8	6,802	8,524	10,401
Equity capital	800	800		800		800	800	800
No. of shares (mn)	80	80		80		80	80	80
Adj. diluted EPS (INR)	56.0	42.9	30.7	21.3	162.8	100.5	106.6	130.0
Diluted P/E (x)						17.1	16.1	13.2
EV/EBITDA (x)						10.0	8.9	6.7

as % of net revenues

Raw material	55.0	56.5		59.2		56.5	58.0	60.5
Staff expenses	12.3	13.0		17.9		18.5	18.0	15.6
Other expenses	8.0	8.7		6.7		7.1	7.3	7.5
EBITDA	24.6	21.8		16.2		17.8	16.7	16.4
Net profit	19.0	10.4		12.4		12.1	13.6	13.3

■ 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 likely to be a key beneficiary of the anticipated increase in defence capital expenditure. 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 sub-contracted 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 nearly two years of revenues. Even without the offset clause, 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 monopsonistic 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

Income statement

(INR mn)

Year to March	FY09	FY10	FY11	FY12E	FY13E
Income from operations	46,488	53,810	56,351	62,568	78,210
Total operating expenses	35,214	42,712	46,317	52,143	65,372
Materials costs	23,909	29,964	31,845	36,290	47,317
Employee cost	7,558	9,168	10,450	11,286	12,189
Other expenses	3,747	3,580	4,022	4,567	5,866
EBITDA	11,273	11,097	10,034	10,425	12,838
Depreciation and amortisation	1,056	1,159	1,219	1,329	1,414
EBIT	10,217	9,938	8,815	9,096	11,424
Interest	108	5	3	1	1
Total other income	1,644	1,759	2,430	2,819	3,113
Profit before tax	11,753	11,692	11,242	11,914	14,537
Provision for tax	3,511	3,242	3,198	3,389	4,136
Core profit	8,242	8,450	8,043	8,524	10,401
Extraordinary income/(loss)	(785)	(1,241)	-	-	-
Profit after tax	7,458	7,209	8,043	8,525	10,402
Shares outstanding (mn)	80	80	80	80	80
EPS (INR) basic	103.0	105.6	100.5	106.6	130.0
Diluted shares (mn)	80	80	80	80	80
EPS (INR) diluted	103.0	105.6	100.5	106.6	130.0
Dividend per share (INR)	18.7	19.2	20.7	20.7	20.7
Dividend payout (%)	21.2	21.2	24.1	22.7	18.6

Common size metrics- as % of net revenues

Year to March	FY09	FY10	FY11	FY12E	FY13E
Operating expenses	75.8	79.4	82.2	83.3	83.6
Material cost	51.4	55.7	56.5	58.0	60.5
Employee cost	16.3	17.0	18.5	18.0	15.6
Other expenses	8.1	6.7	7.1	7.3	7.5
Depreciation and amortisation	2.3	2.2	2.2	2.1	1.8
Interest expenditure	0.2	0.0	0.0	0.0	0.0
EBITDA margins	24.2	20.6	17.8	16.7	16.4
Net profit margins	17.7	15.7	14.3	13.6	13.3

Growth metrics (%)

Year to March	FY09	FY10	FY11	FY12E	FY13E
Revenues	14.5	15.8	4.7	11.0	25.0
EBITDA growth	12.2	(1.6)	(9.6)	3.9	23.1
PBT	2.1	(0.5)	(3.8)	6.0	22.0
Core net profit	2.3	2.5	(4.8)	6.0	22.0
EPS	2.3	2.5	(4.8)	6.0	22.0

Balance sheet**(INR mn)**

As on 31st March	FY09	FY10	FY11	FY12E	FY13E
Equity capital	800	800	800	800	800
Reserves & surplus	37,271	42,657	48,781	55,368	63,831
Shareholders funds	38,071	43,457	49,581	56,168	64,631
Secured loans	12	7	7	7	7
Borrowings	12	7	7	7	7
Sources of funds	38,083	43,464	49,588	56,175	64,639
Gross block	15,799	17,022	18,210	19,410	20,610
Depreciation	11,124	12,122	13,341	14,670	16,084
Net block	4,675	4,900	4,869	4,740	4,526
Capital work In progress	467	314	341	485	515
Investments	120	120	120	120	120
Deferred tax assets	1,466	1,567	1,567	1,567	1,567
Inventories	24,210	24,487	26,554	29,894	37,478
Sundry debtors	22,765	21,684	22,708	25,213	31,516
Cash and bank balances	26,418	35,783	37,580	44,473	50,925
Loans and advances	4,975	4,333	8,930	8,833	11,233
Total current assets	78,369	86,287	95,772	108,413	131,153
Sundry creditors and others	41,385	44,310	47,947	53,825	67,172
Provisions	5,629	5,415	5,136	5,327	6,073
Total current liabilities & provisions	47,014	49,725	53,083	59,152	73,245
Net current assets	31,356	36,563	42,690	49,262	57,909
Uses of funds	38,083	43,464	49,588	56,175	64,639
Book value per share (INR)	476	543	620	702	808

Free cash flow

Year to March	FY09E	FY10	FY11	FY12E	FY13E
Net profit	7,458	7,209	8,043	8,525	10,402
Depreciation	1,056	1,159	1,219	1,329	1,414
Deferred tax	(42)	(101)	-	-	-
Gross cash flow	8,472	8,267	9,262	9,853	11,815
Less: Changes in working capital	3,142	(4,157)	4,330	(321)	2,195
Operating cash flow	5,330	12,424	4,932	10,175	9,620
Less: Capex	(1,726)	(1,232)	(1,215)	(1,344)	(1,230)
Free cash flow	3,604	11,193	3,717	8,830	8,390

Cash flow metrics

Year to March	FY09	FY10	FY11	FY12E	FY13E
Operating cash flow	5,330	12,424	4,932	10,175	9,620
Financing cash flow	(1,719)	(1,828)	(1,919)	(1,938)	(1,938)
Investing cash flow	(1,726)	(1,232)	(1,215)	(1,344)	(1,230)
Net cash flow	1,885	9,365	1,798	6,893	6,452
Capex	(1,726)	(1,232)	(1,215)	(1,344)	(1,230)
Dividend paid	(1,750)	(1,793)	(1,938)	(1,938)	(1,938)

Ratios

Year to March	FY09	FY10	FY11	FY12E	FY13E
ROAE (%)	23.4	20.7	17.3	16.1	17.2
ROACE (%)	29.1	24.4	19.0	17.2	18.9
Inventory (days)	196	208	201	198	188
Debtors (days)	170	151	144	140	132
Payable (days)	385	366	364	356	338
Cash conversion cycle	(19)	(7)	(19)	(19)	(17)
Current ratio	1.7	1.7	1.8	1.8	1.8
Fixed assets turnover (x)	10.6	11.2	11.5	13.0	16.9
Total asset turnover(x)	1.3	1.3	1.2	1.2	1.3
Equity turnover(x)	1.3	1.3	1.2	1.2	1.3

Du pont analysis

Year to March	FY09	FY10	FY11	FY12E	FY13E
NP margin (%)	17.7	15.7	14.3	13.6	13.3
Total assets turnover	1.3	1.3	1.2	1.2	1.3
Leverage multiplier	1.0	1.0	1.0	1.0	1.0
ROAE (%)	23.4	20.7	17.3	16.1	17.2

Valuation parameters

Year to March	FY09	FY10	FY11	FY12E	FY13E
Diluted EPS (INR)	103.0	105.6	100.5	106.6	130.0
Y-o-Y growth (%)	2.3	2.5	(4.8)	6.0	22.0
CEPS (INR)	116.8	121.4	115.8	123.2	147.7
Diluted P/E (x)	16.7	16.3	17.1	16.1	13.2
Price/BV(x)	3.6	3.2	2.8	2.4	2.1
EV/Sales (x)	2.4	1.9	1.8	1.5	1.1
EV/EBITDA (x)	9.9	9.2	10.0	8.9	6.7
Dividend yield (%)	1.1	1.1	1.2	1.2	1.2

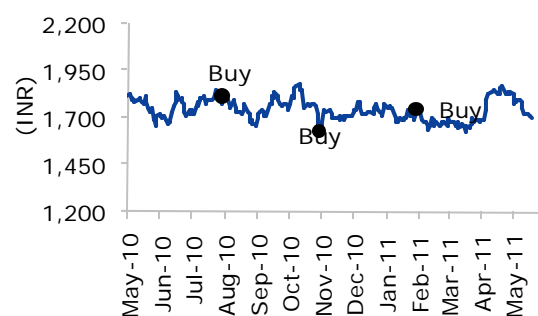
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Coverage group(s) of stocks by primary analyst(s): Miscellaneous

Bharat Electronics, Educomp Solutions and Everonn Education

Bharat Electronics



Recent Research

Date	Company	Title	Price (INR)	Recos
17-Feb-11	Educomp Solutions	Strong SmartClass accretion; Result Update	483	Hold
31-Jan-11	Bharat Electronics	Looking at Q4; Result Update	1,690	Buy
12-Nov-10	Educomp Solutions	Focusing on K-12; Result Update	512	Hold
29-Oct-10	Bharat Electronics	Disappointing quarter; expects better times ahead; Visit Note	1,632	Buy

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	118	51	17	189

* 3 stocks under review

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	111	61	17

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

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