Equity | India | Aerospace & Defense

8 September 2010

Initiation of coverage

Buy

Target price
Rs2105.00

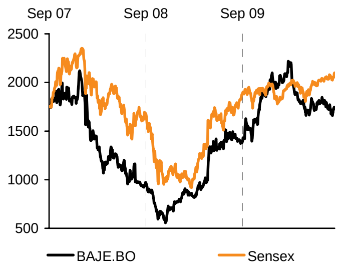
Price
Rs1745.55

Short term (0-60 days)
n/a

Market view
Underweight

Price performance

	(1M)	(3M)	(12M)
Price (Rs)	1750	1716	1400
Absolute (%)	-0.2	1.7	24.7
Rel market (%)	-2.9	-8.4	7.1
Rel sector (%)	-0.8	-7.8	21.8



Market capitalisation
Rs139.64bn (US$2.99bn)

Average (12M) daily turnover
Rs143.50m (US$3.15m)

Sector: BBG AP All Industrial
RIC: BAJE.BO, BHE IN
Priced Rs1745.55 at close 6 Sep 2010.
Source: Bloomberg

Researched by

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Bharat Electronics

Defensive defence play

BEL has strong exposure to India's defence capex. Its growth is independent of economic cycles and should be stimulated by India's historical underinvestment in defence. Government policy thrust through offsets to use local companies for defence equipment provides an opportunity for BEL. Initiate coverage at Buy.

Key forecasts

	FY09A	FY10A	FY11F	FY12F	FY13F
Revenue (Rsm)	45,836	51,804	58,048	64,304	71,341
EBITDA (Rsm)	10,658	8,211	9,926	12,218	14,910
Reported net profit (Rsm)	7,458	7,209	8,351	10,166	12,385
Normalised net profit (Rsm)[1]	8,242	6,856	8,351	10,166	12,385
Normalised EPS (Rs)	103.0	85.70	104.4	127.1	154.8
Dividend per share (Rs)	21.90	22.40	26.00	31.70	38.60
Dividend yield (%)	1.25	1.28	1.49	1.81	2.21
Normalised PE (x)	16.90	20.40	16.70	13.70	11.30
EV/EBITDA (x)	10.60	12.70	9.87	7.45	5.50
Price/book value (x)	3.67	3.21	2.81	2.43	2.10
ROIC (%)	78.20	39.00	75.80	90.10	103.1

1. Post-goodwill amortisation and pre-exceptional items
Accounting standard: Local GAAP
Source: Company data, RBS forecasts
year to Mar, fully diluted

Best play on India's defence capex story, in our view

BEL is the largest listed defence player in India based on sales. The Indian defence space, with low annual per capita spending of US$30 (US$75 in China) offers significant opportunities. Its revenue has historically accounted for c.9% of the country's annual defence capex. BEL has expertise in niche areas, making it the sole vendor for several defence orders. It is also a preferred supplier to Indian defence by virtue of being in part government owned. In addition, BEL's relationships with foreign vendors help it gain offset orders over competitors. We believe all this makes the company an ideal play on India's defence capex.

Little risk to growth and margins, in our view

BEL's growth and profitability are dependant on government spending on defence, and we see little risk here, despite a margin dip in FY10 due to wage provisions. Historically, defence spending in India has shown a linear uptrend despite fiscal deficit. Also, with the government aiming to increase the share of defence procurement from domestic vendors from 30% to 70%, it may not be averse to letting the companies retain margins as they try to attract talent, invest in R&D, or acquire facilities or technology to build indigenous abilities.

Strong net cash balance sheet; we expect RoE to improve

BEL had net cash/share of Rs447 in FY10 and we forecast a 17% CAGR to Rs608 in FY12. Declining profitability has led to a fall in RoE over the past couple of years, but we expect it to improve as margins expand. We expect BEL to register a top-line CAGR of 11% and PAT CAGR of 20% over FY10-13, with margin expansion as wage costs normalise in this period.

Initiate at Buy with Rs2,105 target price

We value BEL on a DCF basis (WACC of 12%) at Rs2,105, equal to 20x FY11F PE. BEL is not cheap vs global defence equipment companies, but we think its valuation is justified by its superior margin and growth profile, as a combination of low per capita spend and thrust on indigenisation opens up opportunities that should extend well beyond our forecast period.

The basics

Versus consensus

EPS (Rs)	RBS	Cons	% diff
2011F	104.4	116.8	-10.7%
2012F	127.1	136.1	-6.6%
2013F	154.8	NA	NA

Source: Reuters, RBS forecasts

Forced ranking*

Company	Rec	Upside/ downside
BEL	Buy	21%
BHEL	Buy	14%
L&T	Hold	5%
Crompton	Buy	0%

*by difference to target price as at time of publication. Recommendations may lie outside the structure outlined in the disclosure page.
Source: RBS forecasts

Key events

Date	Event
Oct 2010	2QFY11 result

Source: Company

Catalysts for share price performance

The main potential catalyst for share price performance is more orders than anticipated from defence due to offset/Buy & Make (Indian) opportunities. Any future JV/tie-up with foreign vendors could also act as a catalyst. We expect that any regulatory measures taken to increase domestic participation in defence should benefit BEL, and could act as a share price performance catalyst.

Earnings momentum

We forecast a FY010-13 top-line CAGR of 11% and bottom-line CAGR of 20%. Our higher profit growth forecast is mainly due to our assumption of 500bp margin expansion during FY10-13, as staff costs (which increased in FY10 due to a provision related to wage revisions) normalise. We expect sufficient order inflows during FY10-13 to provide at least two years' visibility into future revenues.

Valuation and target price

We use a three-phase DCF methodology to value the company. We value the company at Rs2,105/share using a WACC of 12%. The stock currently trades at 16.7x our FY11F EPS.

How we differ from consensus

This is not a widely covered company. Our FY11F EPS is 11% below Reuters consensus estimates, while our FY12F EPS is 7% below consensus – we build high wage costs into our forecasts as provisioning for wage revision continues in FY11. We believe that consensus has not built this into its numbers.

Risks to central scenario

The key risks to our central scenario are:

- any change in government policies pertaining to defence procurement;
- more competition from private sector participation that could lead to decline in margins and order inflows; and
- reduction in defence capex in the annual government budget.

Key assumptions and sensitivities

Table 1 : Revenue assumptions for BEL

	FY09A	FY10A	FY11F	FY12F	FY13F
Net sales (Rs m)	45,835.6	51,804.4	58,047.8	64,304.2	71,341.3
% change	12.9%	13.0%	12.1%	10.8%	10.9%

Source: Company data, RBS forecasts

Table 2 : EBITDA assumptions for BEL

	FY09A	FY10A	FY11F	FY12F	FY13F
EBITDA (Rsm)	10,657.6	8,210.8	9,926.2	12,217.8	14,910.3
EBITDA margin (%)	23.3	15.8	17.1	19.0	20.9

Source: Company data, RBS forecasts

Table 3 : Sensitivity of FY11F EPS to sales and EBITDA margin assumptions

	Base case	Upside	Downside
Scenario – sales (Rsm)	58,048	60,950	55,145
% change		5.0%	-5.0%
EPS	104.4	108.6	100.1
% change		4.1%	-4.1%
Scenario – margin (%)	17.1	18.1	16.1
bp change		100	-100
EPS	104.4	109.4	99.4
% change		4.8%	-4.8%

Source: Company data, RBS forecasts

Contents

BEL and defence – an ideal combination

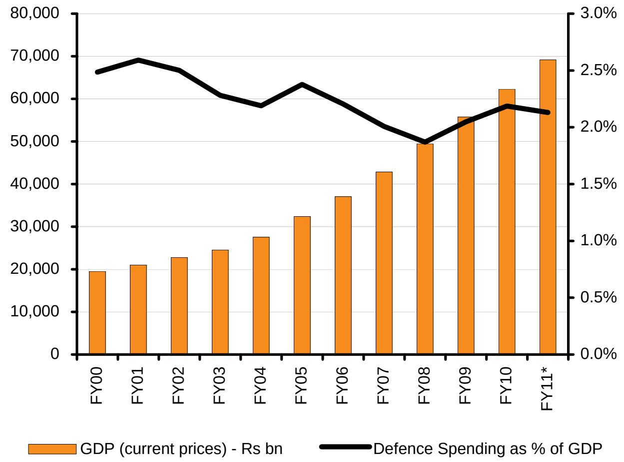
India's defence sector has seen long-term secular growth, unaffected by changing economic cycles. Given the sector's strategic nature, we expect it to follow a similar growth trajectory in the future. We see BEL well positioned to capitalise on this growth.

Indian military spending – significant potential for growth

India's defence spending has grown about 3x in the past decade

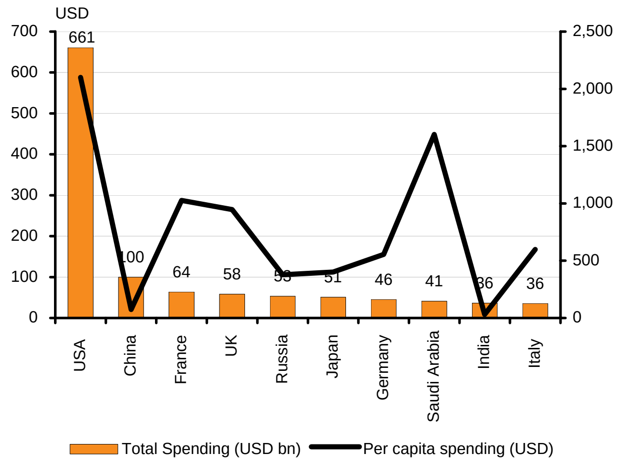
India's spending on defence has grown with the country's economy and has remained 2.0-2.6% of GDP (nominal) over the past decade. Actual defence expenditure in India grew 2.8x during FY00-10, with total spending for FY11 set at Rs147bn in the Union Budget, making India one of the largest defence spenders in the world today, although it still lags many nations on a per capital basis. Given the economic profile of the country and the strategic nature of the defence sector, we see the sector poised for similar or maybe even higher growth during the next decade. A similar growth profile could result in India's total defence expenditure doubling every five or six years.

Chart 1 : Defence expenditure rose 3x during FY00-10



*Budgeted
Source: Union Budget India

Chart 2 : India among the largest military spenders, but still very low on a per capita basis



Source: SIPRI Arms Transfers Database

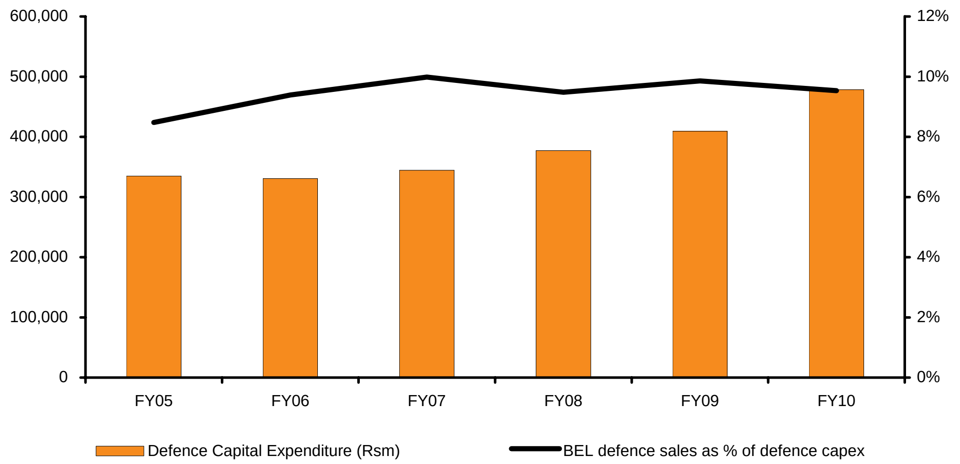
Potential opportunities from Indian defence expenditure can be seen in per capita defence spending, which in India is around US$30 compared with US$75 in China and an average US$624 for the top 10 spenders (ex the US) in the world.

BEL – looks well placed to capitalise on defence growth

During FY05-10, BEL accounted for 8-10% of annual defence capex

BEL is the second-largest defence player and the largest listed defence player in India based on sales, with expertise in several niche areas. During FY05-10, the company accounted for 8-10% of annual defence capex. However, the company's relatively large share of the domestic defence industry (30-35% in FY10) can be explained by past restrictions on private sector participation, which eased with outsourcing the production of components and subassemblies to private sector firms in the early 2000s.

Chart 3 : BEL is the second-largest defence company in India



Source: Union Budget, company data

But even with the impending increase in competition now that restrictions on private sector participation have been lifted, we believe BEL still looks well positioned to capture opportunities in defence: 1) by virtue of its long history in defence, the company has expertise in several areas that private companies do not possess; 2) although the government has promoted private sector participation, public sector units (PSUs) may continue to receive preferential treatment. This can be seen from the GOI not yet awarding Raksha Udyog Ratna (RUR) status to private players, which would have put them on equal footing with the PSUs; and 3) BEL has relationships with several foreign vendors for procuring technology and R&D, and as an offset vendor. This puts the company at an advantage vis-à-vis its competitors as the preferred partner for any investment or offset orders from these vendors in the Indian market.

Revenue CAGR of 13%, PAT CAGR of 21% over FY00-10 looks likely to continue

We forecast BEL will show an 11% CAGR in the top line and 20% CAGR in PAT over FY10-13

The company experienced strong growth during FY00-10, with a revenue CAGR of 13.2% over FY00-10 and PAT CAGR of 20.9%. We expect this trend to continue. We forecast an 11.3% CAGR in the top line and 19.8% CAGR in PAT in FY10-13.

Chart 4 : Sales, earnings have shown secular growth (Rsm)

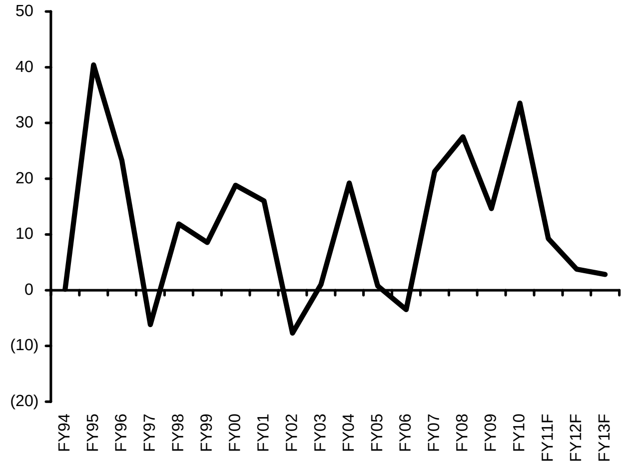
Source: Company data, RBS forecasts

We expect margins will increase as wage costs normalise

BEL's EBITDA margin fell during FY10, mainly as a result of provisioning for wage revisions. Historically, overall wage costs have fallen in the year after wage revisions. We believe this is mainly due to the effect of one-time arrears awarded during these revisions. The wage cost per employee increases due to revision, but growth in overall wage costs (and wage costs as a percentage of sales) declines in subsequent years. We expect this trend to continue and margins to increase in coming years, as wage costs normalise. The higher margin explains the comparatively higher profit growth (vis-à-vis revenues) during FY10-13F.

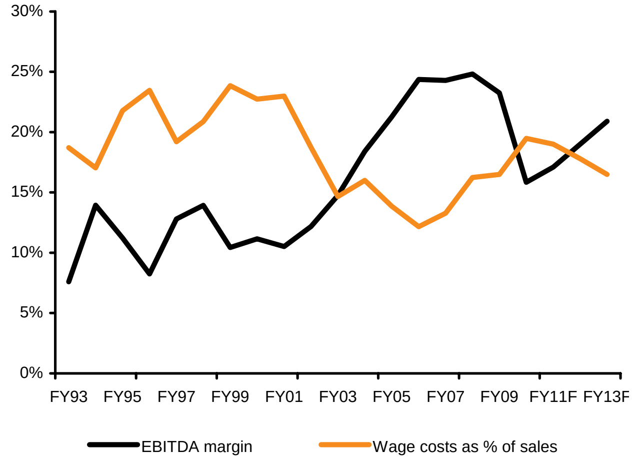
BEL's leverage on wage costs should continue for a long time beyond our explicit forecast period, as the company is not due for another wage revision for 10 years

Chart 5 : Wage costs (% yoy increase)



Source: Company data, RBS forecasts

Chart 6 : EBITDA margin to expand



Source: Company data , RBS forecasts

Advantage of growing markets; initiate at Buy with Rs2,105 target price

We initiate coverage at Buy with a target price of Rs2,105

We believe that the non-cyclical nature of the defence industry makes it extremely attractive, considering the Indian economy's growth potential. BEL, by virtue of its positioning in the domestic industry, appears poised to capture this growth. Its current order book position, which gives two years' revenue visibility, reinforces our faith in the stock. Also, we expect the net cash position (Rs447.2/share in FY10) to improve further in the coming years, allowing BEL to take advantage of any opportunities for acquisition or JVs. We value the company on a three-stage DCF.

The stock is currently trading at 16.7x our FY11F EPS and 2.8x FY11F BPS. At our target price, the stock would trade at 20x FY11F and 16.5x FY12F EPS. Ex cash, our target price implies a valuation of 16x FY11F and 13x FY12F.

The table below compares the stock with other global companies in the defence equipment space. While BEL is not cheap vs other global majors, we believe its valuations are justified by its better growth profile. For FY10-13, we forecast sales and PAT CAGRs of 11.3% and 19.8% for BEL, vs respective CAGRs of 2% and 7% for the other defence majors based on our forecasts and Bloomberg consensus. Historically as well, over the past decade the other defence majors have reported 8% sales CAGR and 12% PAT CAGR, vs BEL's 13% and 21%. Besides, BEL's EBIDTA margins are also in high teens, compared to the 11-12% range for the global majors.

Finally, another factor that we believe justifies BEL's higher valuation is market opportunity. India, with one of the lowest per capital spend on defence, offers immense future growth opportunities for companies like BEL, which should sustain even beyond our explicit forecast period. We think it will not be too difficult for BEL to replicate its sales CAGR of 13% and PAT CAGR of 21% of the past decade into the next decade.

Table 4 : Comparison of BEL with global defence equipment companies.

	P/E		P/B		EV/EBITDA		EBITDA margin		ROE (%)	
	FY11F	FY12F	FY11F	FY12F	FY11F	FY12F	FY11F	FY12F	FY11F	FY12F
Bharat Electronics*	16.7	13.7	2.8	2.4	9.9	7.4	17.1%	19.0%	17.9	19.0
EADS*	39.5	20.6	1.4	1.4	2.4	1.9	5.5%	6.4%	3.6	6.6
SAAB*	9.5	8.8	0.9	0.9	3.6	3.5	11.5%	12.5%	9.9	10.0
Singapore Technologies	20.2	18.7	5.7	5.4	12.9	11.9	12.8%	13.0%	28.8	29.7
Boeing	16.6	13.3	11.9	7.7	8.4	7.1	10.4%	10.6%	87.5	61.6
Lockheed Martin	9.5	9.2	5.8	4.9	5.4	5.3	11.4%	11.0%	64.5	59.7
Northrop Grumman	8.4	8.5	1.3	1.2	4.9	4.6	10.6%	11.0%	15.0	13.9
Raytheon	10.4	8.8	1.6	1.5	5.4	4.8	11.9%	12.7%	16.4	17.8
BAE Systems*	7.9	7.5	1.9	1.7	4.9	4.8	12.2%	12.6%	22.2	24.9
Rolls Royce*	9.0	8.1	1.4	1.3	8.1	7.4	11.6%	11.8%	16.2	16..4

Source: Company data, *RBS forecasts, Bloomberg consensus

BEL – a play on Indian defence

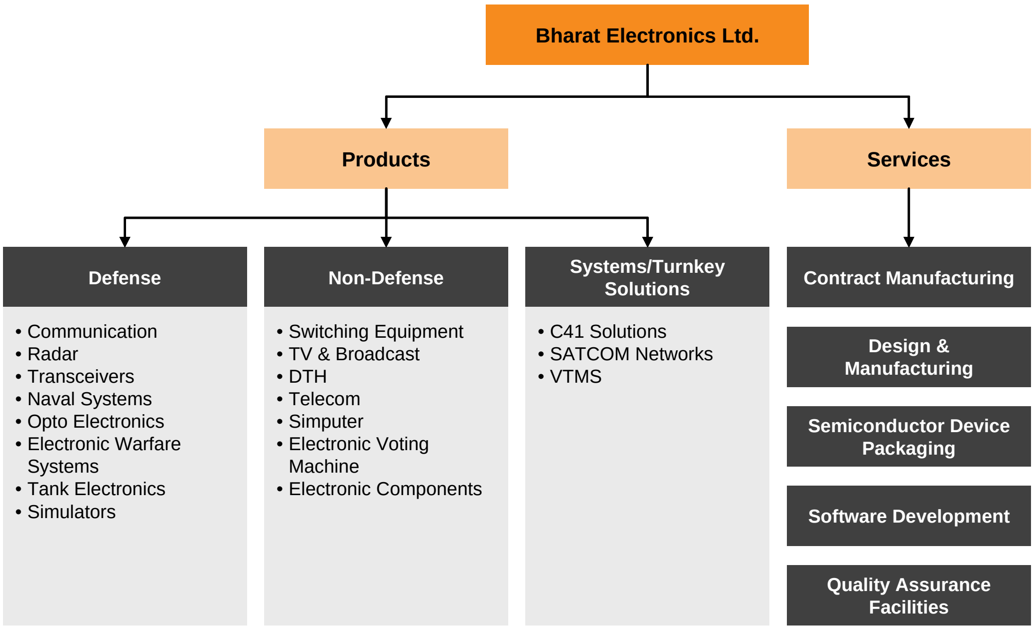
BEL derives around 83% of its revenue from the defence sector. It has a reassuring book to bill ratio of 2x, and higher inflows could lead to a rerating, in our view. We believe the company is well placed to capture growth in the defence sector.

Play on defence capex

In FY10, BEL's sales in the defence segment accounted for about 10% of India's total defence capex

BEL derives about 83% of its revenues from the defence industry, with the balance coming from civilian applications. The company has developed core competencies in the areas of radar, sonar, communication, electronic warfare systems, electro-optics and tank electronics, and generates most of its revenue from products based on these segments. In FY10, company sales in the defence segment accounted for about 10% of India's total defence capex. BEL's civilian portfolio includes products such as electronic voting machines, civilian radar, satellite communication networks, etc.

Figure 1 : Product profile



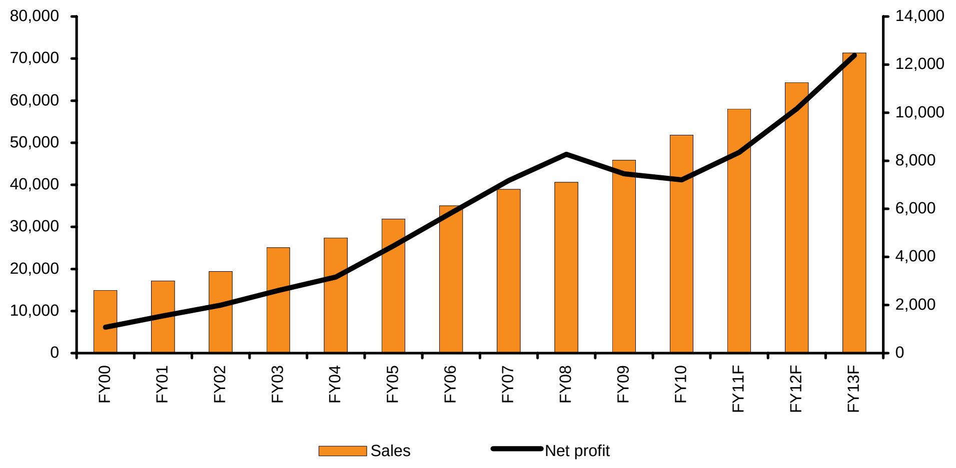
Source: Company Data

The company has one subsidiary (BEL Optronic Devices Limited, a 93% stake) and two joint venture companies (GE BE Limited, a 26% stake, and BEL-Multi-tone Limited, a 49% stake). It has nine operating units spread throughout the country.

Steady growth trend likely to continue

The company experienced strong growth during FY00-10, with revenue CAGR of 13.2% and PAT CAGR of 20.9%. Based on its performance, BEL has been awarded an 'excellent' rating in each of the past 10 years (except FY08) by the Ministry of Defence. We expect a similar trend in the future. The company looks well positioned to capture emerging opportunities in the domestic defence industry. We believe this may push the company's growth at a faster pace.

Chart 7 : Sales, earnings have shown secular growth trend (Rsm)



Source: Company data, RBS forecasts

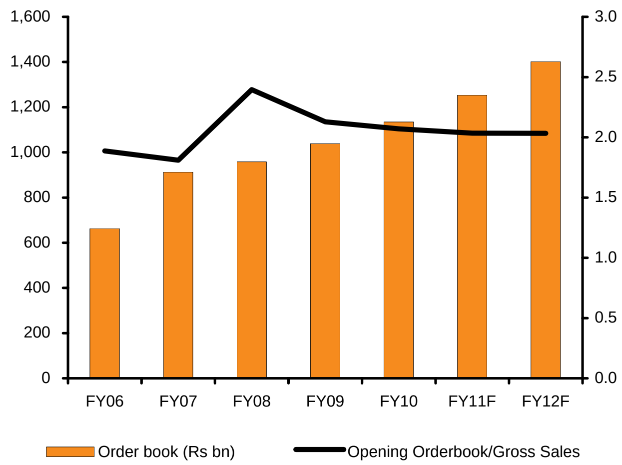
Book-to-bill ratio of 2x provides revenue assurance; higher inflows could lead to rerating

The company's order book has grown at a 13.2% CAGR over the past five years

The company reported an order book of Rs110bn in FY10, growing at a 13.2% CAGR over the past five years. We model a similar trend in the next couple of years, and expect the book-to-bill ratio to remain about 2x. However, we believe that the domestic defence industry is at an inflection point and BEL may benefit from the coming change. In terms of the addressable market, the company sees an opportunity of Rs500bn over the next three to four years for business in which BEL will be the single vendor for certain products due to security reasons. For other products, which will be open to competition, the company sees a possible opportunity of Rs1.5trn over the next five years. BEL currently enjoys a market share of about 70% in electronic applications used for defence purposes.

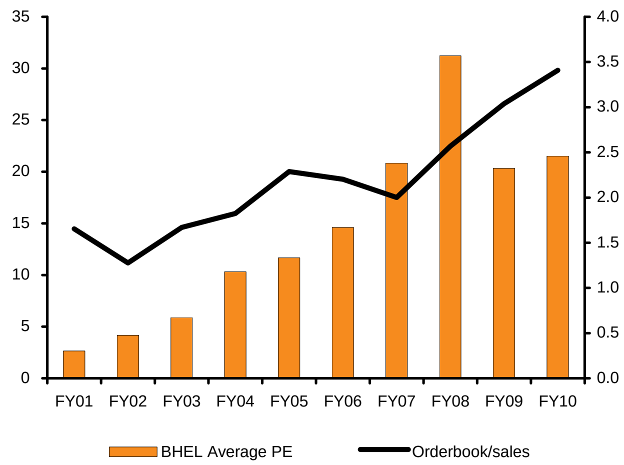
We believe that BEL's positioning in the domestic defence industry is somewhat similar to BHEL's in the power equipment industry and feel that BEL may follow a path similar to BHEL's experience. We observe that in BHEL's case, there was a definite PE rerating as the order book-to-sales ratio increased. We feel something similar could happen in BEL's case.

Chart 8 : 2x book-bill ratio is assuring



Source: Company data, RBS forecasts

Chart 9 : BEL – another BHEL in the making?

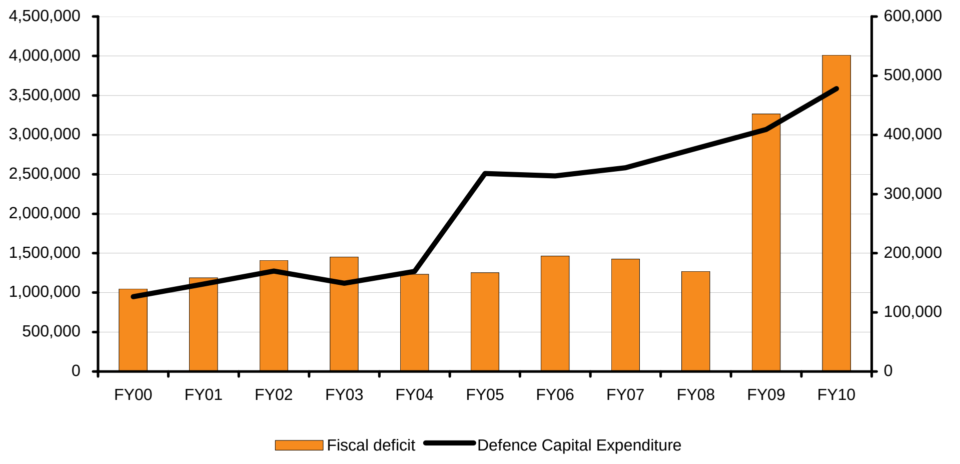


Source: Company data, Bloomberg

Limited risk to margins, in our view

Given the nature of the defence industry, we believe top-line growth will not be a problem for BEL in the foreseeable future. As seen in Chart 10, capital spending in defence has shown a linear growth trend and has been largely unaffected by the levels of fiscal deficit, as it is imperative for national security.

Chart 10 : Trend in fiscal deficit vs defence capex (Rs m)



Source: Union Budget India

The only risk that the company carries, in our view, is perhaps to its margins. As India remains in fiscal deficit (the Union Budget estimates 4.8% for FY11), there is a risk that the GOI may try to push defence vendors to lower margins in an attempt to get more out of its defence budget. However, we believe this is unlikely. Global experience shows that governments are benign about letting defence contractors make margins, given that defence companies have to invest in engineering skills as well as research to attract engineers.

With India seeking to make participation in defence indigenous, we feel the government is less likely to squeeze margins of defence vendors

In a country like India, whose government is seeking to make defence participation indigenous, we feel the government is less likely to squeeze a defence vendor. The government would not be averse to letting the companies retain margins as they try to attract talent and invest in R&D, or acquire facilities or technology to build indigenous capabilities. On the manpower front, we believe BEL is on a strong footing because its new wage cost structure will be applicable for a 10-year period. In terms of R&D, centralised R&D is carried out in the defence sector, within the Defence Research Development Organization (DRDO), as well as in-house R&D for companies such as BEL. In FY10, R&D spending for BEL was 6% of its turnover.

Another driver of margins for companies in the defence sector is the number of products developed through in-house R&D. In BEL's case, 75% of its turnover comes from indigenously developed products, with about 55% based on in-house R&D and the remaining 20% using the DRDO's R&D.

Hence, based on the above factors, we believe margin risk is limited and that operating leverage should be restored when wage provisioning is completed by end-FY11.

Maintain tight control on working capital

The company has been able to maintain tight control over working capital, with net working capital days declining to five in FY10 (down 30 yoy). Inventory days have increased over FY08 due to BEL's efforts to achieve more even sales throughout the year; historically, a significant portion of sales has been registered in the fourth quarter. Management's drive to make sales more uniform throughout the year can be seen in the fourth quarter accounting for 36% of total sales in FY10 vs 60% in FY09. Debtors outstanding declined during FY10 to 152 days (down 30 yoy) due to more uniform sales throughout the year and better control.

Table 5 : Working capital has increased sharply

	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Inventory days	261.7	231.9	217.5	226.9	251.7	300.8	295.5
Receivable days	88.9	80.1	106.1	158.8	185.1	181.4	152.8
Payable days	322.0	230.5	234.9	265.3	295.9	339.3	312.2
Loans and advances days	73.5	85.0	78.6	22.2	43.4	39.6	30.5
Provisions days	59.7	86.3	97.4	46.3	44.6	42.0	38.2
Working capital days	-77.9	-23.7	-32.7	-6.7	15.9	34.8	4.9

Source: Company data

Strong cash position indicates comfort for future growth

Large amount of cash on the books provides the wherewithal to capitalise on future organic or inorganic opportunities

The company is debt free, with net cash/share of Rs447 in FY10, and we expect this to increase at an 18% CAGR to Rs619/share in FY12. The large amount of cash on the books means BEL is well placed to capitalise on opportunities that may arise as acquisitions, JVs, or any other expansion that the company may want to do, without resorting to equity dilution or too much debt raising.

RoE has declined over the years, but remains in the range of 16-18%. We expect RoE to improve in the coming years as sales grow and margins improve.

Increased competition, but legacy advantages should help BEL

With the Defence Ministry now more open to procuring supplies from the private sector, competition will increase for BEL. Key competitors in electronics applications are Larsen & Toubro and Tata Power's Strategic Electronics division. However, the government is still slow in taking to the private sector – it has not yet awarded Raksha Udyog Ratna (RUR) status to the private companies.

BEL has certain legacy advantages that we believe should help it maintain leadership in the electronic application market for defence products. Over the years, the company has forged a close working relationship with the armed forces and has developed knowledge of existing applications that can be leveraged.

The company is also helping the armed forces maintain legacy systems, some of which have come to BEL through past transfer of technology. This not only gives comfort to the customers, but also to the original vendor that transferred the technology. In many cases, the original technology-possessing company has shut manufacturing lines in those products and appreciates BEL helping continuity of maintenance service to the armed forces. Hence, these companies typically favour BEL, either to meet offset requirements for fresh orders of if they want a JV for a new application in Indian defence.

BEL obtains some business on a single-vendor basis in certain products treated as classified by the Defence Ministry

Finally, being a PSU gives BEL certain advantages. It obtains some business on a single-vendor basis in products treated as classified by the Defence Ministry. This also is a reason why BEL is sometimes preferred as an offset partner for many new contracts.

Tie-ups with major global players

BEL has tied up with major international arms suppliers to India to capture emerging opportunities in the country's defence sector. We expect the tie-ups to give the company an advantage on being selected as the preferred partner if any of these companies invest in the Indian market. In addition, we expect the tie-ups to help BEL gain a bigger share of the offset/Buy & Make (Indian) orders. The company has been selected by Boeing, Lockheed Martin and Northrop Grumman as the choice offset partner in India. Its existing relationships give the company access to the latest technology, allowing it to keep up with the domestic private sector.

Table 6 : Tie-ups with foreign players

Foreign player	Area of co-operation
Elbit Systems Electro Optics ELOP Ltd, Israel	Thermal imaging cameras, infrared equipment
Northrop Grumman Corporation	Aerospace and defence electronics
Rafael Advanced Defense Systems Ltd, Israel	Missile electronics and guidance technologies; JV for missile seeker
Israel Aerospace Industries Ltd	Unmanned vehicle systems
Elisra, Israel	Airborne electronic warfare programme
Lockheed Martin, US	Aerospace and defence electronics
Boeing	develop an analysis and experimentation centre in Bangalore
Thales, France	Civilian and defence radars

Source: Company data, RBS

In line with this strategy, BEL has upgraded its seven strategic business units to AS 9100, an aerospace specification that is a primary requirement for overseas firms to show interest in a local firm and its product development capabilities.

In addition, the company is exploring opportunities with domestic players. It has signed an MoU with BHEL to explore formation of a JV for solar photovoltaic business. It has also signed an MoU with Astra Microwave Products Ltd to set up a JV for microwave components. The company continues to look at various opportunities to partner with domestic and global players.

Defence spending to rise

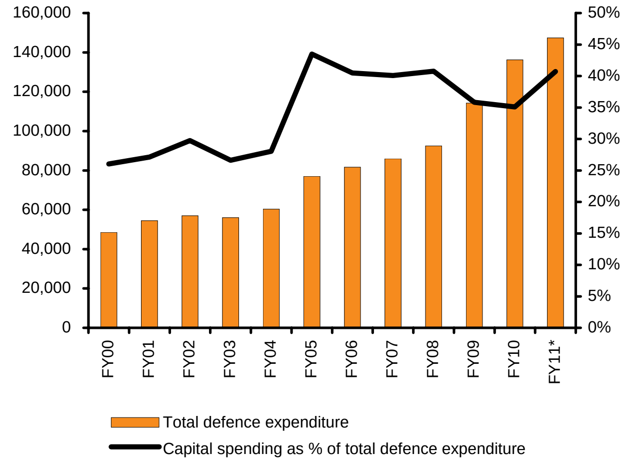
Defence spending around the world has been unaffected by the recessionary environment. India's story is no different – we expect defence spending to continue growing. Government initiatives could lead to many opportunities for the domestic defence industry.

Defence – on a growth trajectory

Capital spending accounts for about 40% of total defence spending

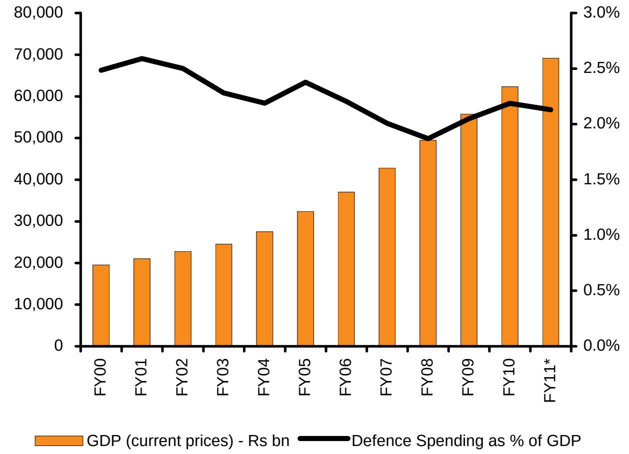
India spent Rs1,360bn on defence in FY10, making the country one of the largest defence spenders in the world. Defence spending currently accounts for 2.1% of India's GDP. Within the defence budget, capital spending accounts for about 40% of the total, making India one of the largest weapon procurers in the world.

Chart 11 : Increasing Defence expenditure, Rsm



*Budgeted
Source: Union Budget India

Chart 12 : Defence expenditure as % of GDP



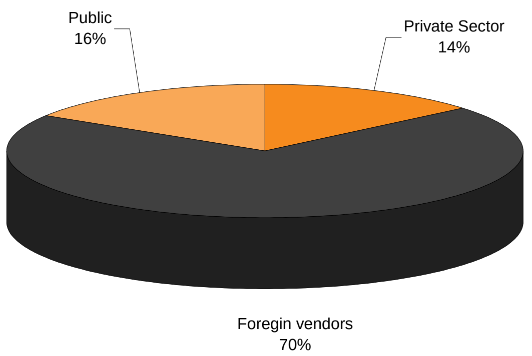
*Budgeted
Source: Union Budget India, RBI

Defence spending as a proportion of GDP has declined over the past few years, mainly due to delays in equipment procurement. The government has admitted that current spending is lower than the amount needed to modernise and equip India's armed forces. However, recent initiatives taken by the GOI to speed up procurement and the renewed focus on defence force modernisation are likely to result in higher spending.

Supply depends upon imports

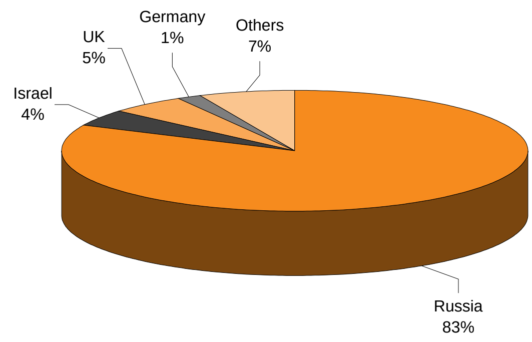
The majority of Indian defence capex is procured from foreign arms contractors. Among foreign suppliers, the majority of defence imports are from Russia and Israel. However, the size of the Indian defence industry and its long-term prospects are now attracting other major arms suppliers that recognise the country as a key strategic market. According to the Confederation of Indian Industry (CII), the domestic sector currently accounts for only 30% of the defence capex in the country, with 14% provided by private sector players and the rest coming from public sector units and ordnance factories.

Chart 13 : Defence supply breakdown by source, FY10



Source: CII

Chart 14 : Defence import breakdown by country, FY10



Source: SIPRI Arms Transfers Database

Domestic industry – private sector still catching up

India's domestic industry is largely government-owned

India's domestic defence industry is comprised mainly of public sector companies (eight companies and a board comprising 39 factories). These are supported by the DRDO, in addition to other government bodies. The domestic private sector has generally played second fiddle to the PSUs and its role in the past has been merely as a subcontractor for the PSUs. However, certain large private sector companies, such as Larsen & Toubro and Tata Power's Strategic Electronics division, are well established as defence suppliers.

The government has realised that to achieve its target for defence procurement (70% through domestic sources), there is an urgent need to review the current industry structure and encourage private sector participation and foreign investment in the industry. In line with this strategy, the GOI has implemented several reforms through defence procurement procedure and implementing Kelkar committee recommendations (refer to Appendix for details). We expect this, in conjunction with increased defence spending, to be positive for the current domestic players.

Table 7 : Major domestic players

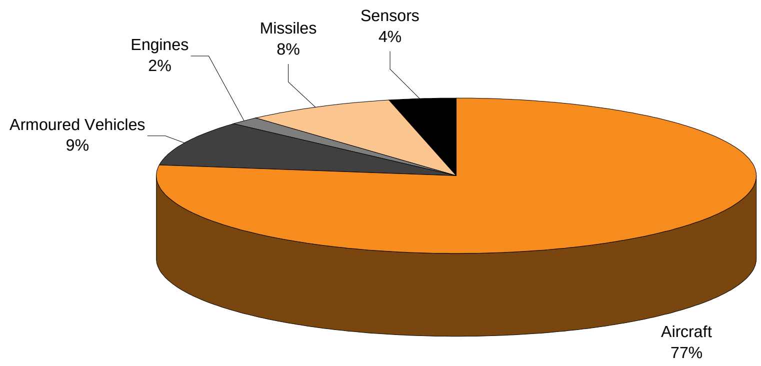
Public	Private
Ordnance Factory Board	Larsen & Toubro
Hindustan Aeronautics Limited	Tata Power
Bharat Electronics Limited	Mahindra & Mahindra
BEML Limited	Ashok Leyland
Mazagon Dock Limited	Kirloskar
Goa Shipyard Limited	Bajaj Tempo
Garden Reach Shipbuilders & Engineers	Bharat Forge
Hindustan Shipyard Limited (HSL)	Wipro
Bharat Dynamics Limited	Infosys
Mishra Dhatu Nigam Limited	

Source: Company data, RBS

Technology infusion needed for domestic industry to become competitive

The majority of defence spending in the country is to develop and modernise armed forces' capabilities. Domestic players have taken several initiatives to address this opportunity, but this is still largely dependent upon imports; domestic contribution is mainly peripheral work, such as light armoured vehicles, ammunition and contracts awarded through offset obligations. Major indigenous platforms, such as light combat aircraft, the Arjun main battle tank and other such programmes being developed by the domestic industry, have faced significant delays and the country still depends upon foreign suppliers for advanced technology equipment.

Chart 15 : Defence imports breakdown, 2009



Source: SIPRI Arms Transfers Database

The main hindrance to the development of domestic industry is the lack of technological know-how

The main hindrance to the development of the domestic industry, according to our discussions with industry players, is the lack of technological know-how. The current 26% limit on foreign direct investment (FDI) in defence has meant that foreign players have few incentives to invest in the sector because it would mean sharing proprietary technology without comparative rewards. In addition, the delay in regulatory approval for JVs between foreign and domestic companies and India's protectionist approach towards PSUs has further exacerbated the current state of the domestic defence industry. To achieve its stated target of making 70% of defence participation indigenous in 10 years, we believe the government needs to increase the FDI limit in the sector and put the private sector on a level playing field with the PSUs.

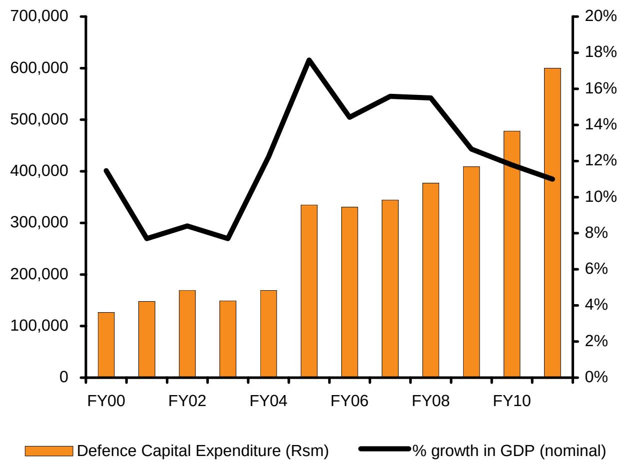
Domestic opportunities – time to attack

The current geopolitical environment in South East Asia, the perceived threat from rapid modernisation of neighbouring countries' armies and domestic problems have meant that the GOI has put modernisation of defence forces on the fast track. We expect modernising, upgrading and maintaining existing equipment to provide immense opportunities to the domestic defence industry.

We estimate the opportunity for domestic industry could increase 3x in the next five years

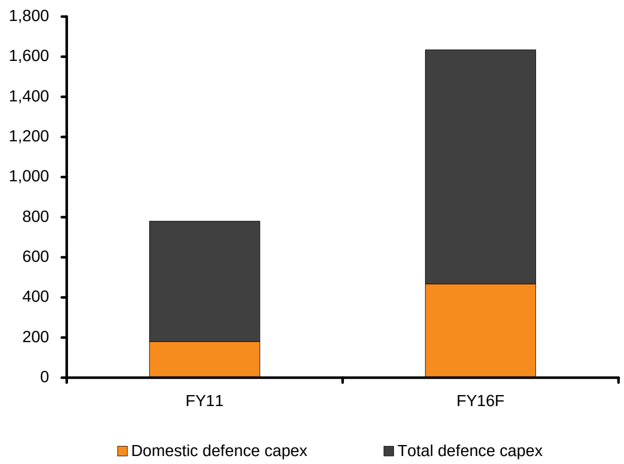
Over FY00-10, spending to procure defence equipment grew about four-fold, to Rs480bn in FY10. Expenditure grew at a CAGR of 14.2%, compared with a CAGR of 12.3% for the country's GDP (in nominal terms) over the same period. Currently, according to CII estimates, the domestic industry contributes about 30% of defence capex. However, the GOI has stated that its long-term strategy is to procure 70% of the sources indigenously. Given this, and assuming that the industry grows at the same CAGR over the next five years, we estimate an opportunity for the domestic industry to increase to three times its current size.

Chart 16 : 5x growth during FY00-11



Source: Union Budget, RBI, FY00 as base

Chart 17 : Significant opportunities for domestic sector (Rsbn)



Source: Union Budget, RBS forecasts

This potential for the domestic defence industry has been realised by private sector companies, which are now exploring several opportunities in the sector. The government is also now focusing on increasing the participation of private industry in defence to develop the domestic industry.

Table 8 : Major private players in defence

Private player	Associated products/services	Plans
Tata Group	Samyukta electronic warfare systems, Pinaka multi-barrelled rocket launchers and trucks	JV with Boeing – US$500m joint venture to produce equipment related to aerospace Israel Aerospace Industries – collaboration to manufacture missiles, UAVs, radars, electronic warfare systems and homeland security systems
Mahindra & Mahindra	Light specialist vehicles and mine-proof vehicles for the army, lightweight sea mines for the navy	JV with BAE for land systems
Larsen & Toubro	Submarine hull fabrication for Indian Navy, Pinaka multi-barrelled rocket launchers, offshore patrol vessels	Manufacturing of submarines for navy, JV with EADS for defence electronics and mobile systems
Godrej	Assembling airframe components of Brahmos missiles, supplying launchers to ISRO and equipment for civil and military nuclear reactors	Aerospace offset contracts
Wipro	Communication and IT systems	JV with Lockheed Martin – new technologies in communication JV with BAE Systems – subsystems for aircraft engines

Source: Company data

Valuation

BEL has outperformed the broader markets in the recent past, but we believe there is further upside potential. The stock is unique in its industry representation and possesses earnings stability due to secular growth. Initiate coverage at Buy.

Initiate coverage with a target price of Rs2105; Buy

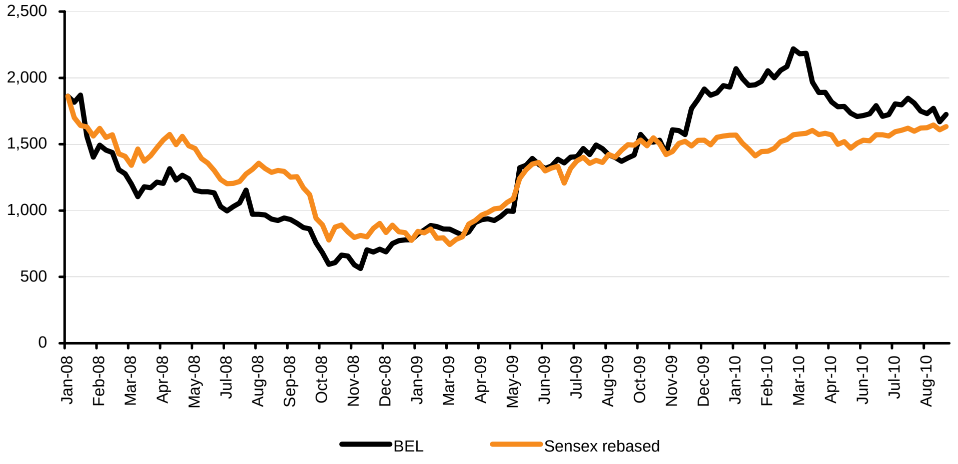
Company has potential to surprise on the upside due to more order inflow than anticipated

We use a three-stage DCF methodology to value the stock, with a WACC of 12%. We value the stock at Rs2,105/share. We believe earnings should remain on a growth trajectory, with potential to surprise on the upside due to more order inflow than anticipated from the defence sector.

Stock has outperformed broader markets

The stock has outperformed the Sensex over the past five years. However, the stock beta has actually fallen over the past few years to 0.63, from roughly 1.2 in 2005, reinforcing our view that the stock is defensive and should be relatively unaffected by economic cycles. The following chart shows that although the stock fell during the recession, it has already surpassed its previous high. We find this reflects the relative visibility of the company's earnings and feel the fall during the recession was due to market over-reaction (adjusted EPS grew 15% over FY07-09).

Chart 18 : Stock has outperformed market



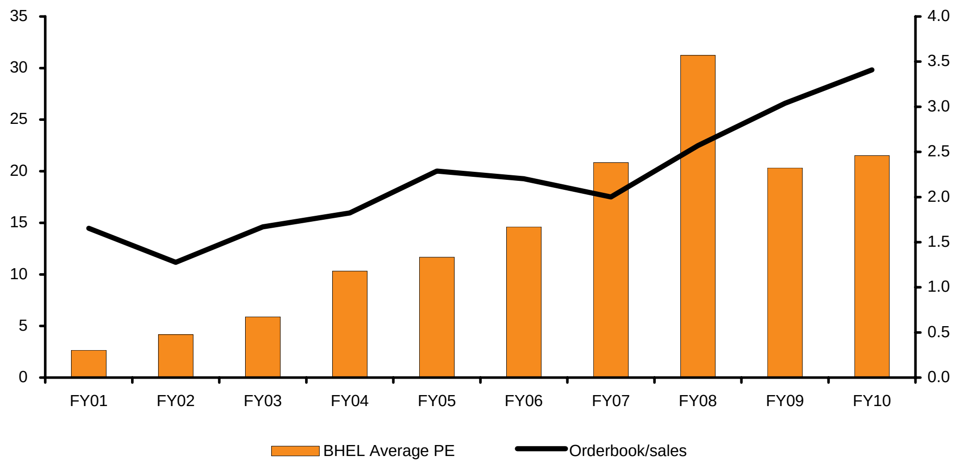
Source: Company data

Higher inflows could lead to a rerating

BEL's position today is similar to what BHEL saw five years ago

We believe that BEL's positioning in the domestic defence industry is somewhat similar to BHEL's in the power equipment industry, and we feel BEL may follow a path similar to BHEL's. We observe that in case of BHEL, there was a definite PE rerating as the order book/sales ratio of the company increased. We feel something similar could happen in BEL's case. Currently, BEL's book-to-bill ratio is 2x.

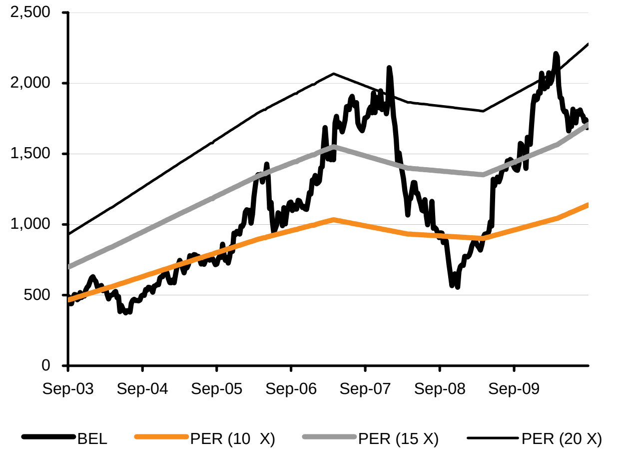
Chart 19 : BEL – another BHEL in the making?



Source: Company data

The stock is currently trading at 16.7x our FY11F EPS. Over the past five years, the stock has traded at average one-year-forward PE of 13.4x, while at its peak in FY08 the stock was trading at a PE of 22x.

Chart 20 : PE band chart



Source: Bloomberg

Chart 21 : EV/EBITDA band chart

Source: Bloomberg

Appendix

Here we provide some of the GOI's regulations for defence procurement, a management profile and a valuation table of global defence companies.

Appendix 1: Relevant policy and regulations for defence procurement

Kelkar Committee Report, 2005

The Kelkar Committee was set up by the GOI, headed by Mr Vijay Kelkar, to recommend policy actions to improve the defence acquisitions procedure and indigenous production, and better integrate armed forces requirements with the domestic industry.

The committee submitted its report in two parts in April 2005 and November 2005. The first part focused on reviewing the defence procurement procedure, integration of the armed forces, the Ministry of Defence and the industry. The report made the following recommendations:

- preparation of a 15-year term plan forming the basis for an armed forces acquisition programme;
- information sharing of requirements of the armed forces with the Industry;
- identification of entry points for the private sector in the defence acquisition process;
- awarding of RUR/Champion status to private sector companies;
- evolution of a policy framework to promote participation of small and medium enterprises in defence production;
- setting up a new professional agency for defence acquisition;
- providing defence R&D opportunities with both the DRDO and industry;
- promoting transparency in decision making;
- encouraging optimum utilisation of existing capacity;
- working out requests for proposal (RFP) to include an offset clause for contracts valued at Rs3bn and above; and
- re-examining the concept of Negative List for Defence exports and setting up an Export Marketing Organisation.

The second part of the report gave recommendations that the PSUs should be given more freedom in decision making, allowing them to form JVs etc. Many of these recommendations have been implemented by the GOI, while others are under consideration and are expected to be implemented in future.

Defence Procurement Procedure, 2008 (Amendment – 2009)

The Defence Procurement Procedure (DPP) establishes new and builds upon existing guidelines for acquisition of defence equipment by the armed forces of India. The main objective of these guidelines is to expedite defence equipment procurement while ensuring transparency and accountability.

The procurement of defence equipment in India falls into three categories:

Buy – Buy (Indian) and Buy (Global)

Procurement in this category results in an outright purchase of defence equipment. Based on the vendor, this category would be classified as Buy (Indian) or Buy (Global). Indian means Indian vendors only; Global means foreign as well as Indian vendors. In the case of procurement through Buy Indian, the order must have a minimum 30% indigenous content if the systems are being integrated by an Indian vendor

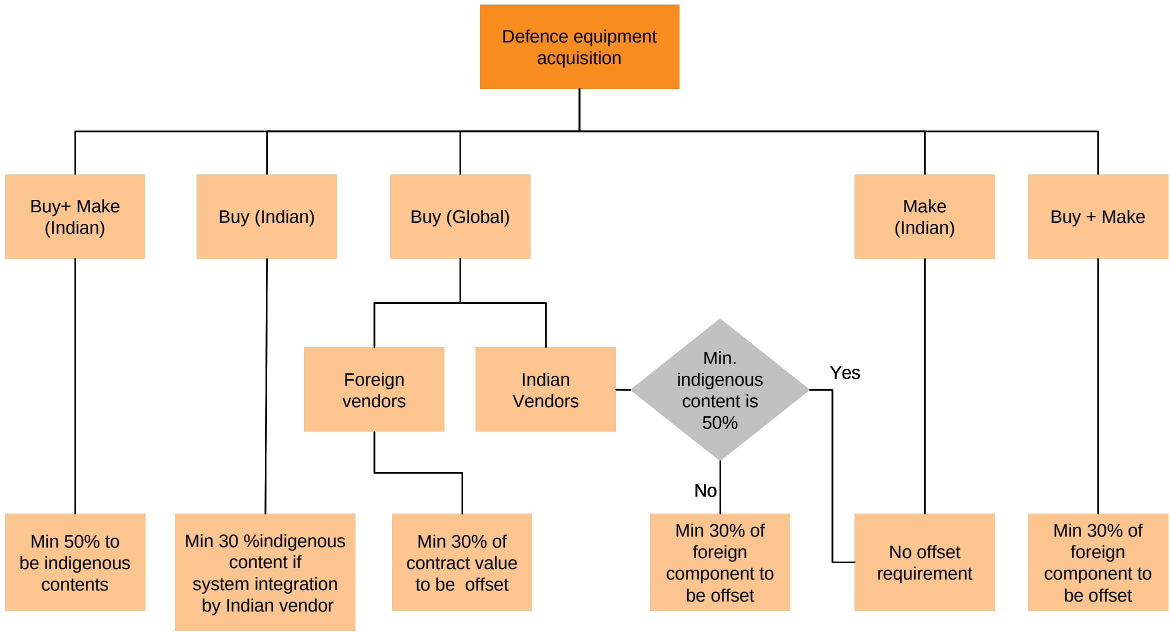
Buy & Make

Procurement under the Buy & Make decision means purchase from a foreign vendor followed by licensed production/indigenous manufacture in the country.

Make

Procurement in the Make category includes high-technology complex systems to be designed, developed and produced indigenously.

Figure 2 : Various categories of acquisitions



Source: Ministry of Defence, RBS

However, in the DPP's recent amendment, the GOI introduced another Buy and Make (Indian) category because the GOI felt that the Buy and Make category was not able to develop the requisite level of technical skills in domestic companies. In the new category, if an order is placed under Buy and Make (Indian) status, Indian firms will play a lead role in negotiations.

In addition, defence procurement is now more likely to be done in Buy Indian, Buy and Make Indian and Make categories. The option to Buy Global is likely to be resorted to only when equipment with requisite qualitative requirements cannot be procured through these methods within given timelines. In the Buy and Make (Indian) category, the product manufactured and supplied by the Indian company must have 50% indigenous content. This is intended to help proactive participation of Indian industry in manufacturing defence products through JVs with foreign manufacturers and through transfer of technology.

The major highlights of DPP-2009 are as follows.

- **Sharing information with private industry:** To ensure better co-ordination with domestic defence industry, a public version of the Long Term Perspective Plan of the Armed Forces outlining technology perspective and a capability roadmap will be made available. Further, to facilitate active participation of domestic industry in acquisition planning, representatives of companies and industry associations will be invited for presentations and consultations in procurement meetings before decisions on the source of procurement are taken.
- To enhance transparency in Defence procurement deals, DPP-2009 proposes to enhance the role of independent monitors to scrutinise complaints with regard to violations of the Integrity Pact, which prohibits corruption in Defence deals.
- To liberalise the offset provisions, it has been decided that the vendor may be permitted to change offset partners if such change would enable the vendor to fulfil an offset obligation.

Defence procurement planning

Capital acquisition by the armed forces is based on the defence procurement planning process. For procurement in Buy and Buy and Make categories, the planning process is done through long-term, medium-term and short-term agendas set up for the armed forces.

- **Long Term Integrated Perspective Plan (LTIPP):** The LTIPP is done by the Headquarters Integrated Defence Staff (HQIDS) in consultation with the Service Headquarters (SHQs), Defence Acquisition Council (DAC). This is formulated for the next 15 years and is based on long-term defence planning guidelines.
- **Services Capital Acquisition Plan (SCAP):** The SCAP is formed by the HQIDS under the guidance of DAC. The SCAP is formulated for the next five years and is a subset of LTIPP. SCAP mentions equipment to be procured based on operational requirements and the overall requirement of funds.
- **Annual Acquisition Plan (AAP):** AAP is a two-year roll-on plan for capital acquisitions and consists of schemes from approved SCAP. The AAP is prepared by SHQ in consultation with Defence Procurement Board (DPB).

The acquisition process under the Make procedure is done under Defence Planning Guidelines. HQ IDS formulates the Defence Capability Plan document and LTIPP, and checks feasibility of each project of LTIPP. HQ IDS then categorises some of these projects in the Make category. This is then approved by DAC, following which award of contract takes place through a series of steps and negotiation.

The offset clause

The DPP has an offset clause, which mandates that for any acquisition above Rs3bn under Buy (Global) and Buy and Make with Transfer of Technology (ToT), at least 30% of the estimated cost of acquisition (30% of foreign exchange component in the Buy and Make with ToT category) should be offset. This means that at least 30% of the amount of the order has to be built within the country.

The defence offset criterion can be met through the following methods:

- direct purchase or export orders for defence products and components manufactured or services provided by Indian defence industries, which includes Defence Public Sector Undertakings, the Ordnance Factory Board and private defence industry;
- direct foreign investment in Indian defence industries for industrial infrastructure for services, co-development, joint ventures and co-production of defence products and components;
- direct foreign investment in Indian organisations engaged in research in defence R&D, excluding investment in civil infrastructure and technologies that are easily available in the open market; and
- using banked offset credits acquired in anticipation of future obligations.

The Defence Offset Facilitation Agency (DOFA), has been set up to smoothly implement the offset policy. The DOFA assists potential vendors in interfacing with the Indian defence industry, helps in selecting offset proposals and carries out various other tasks.

Appendix 2: Management profile

Chairman and Managing Director Ashwani Kumar Datt

Ashwani Kumar Datt has been the chairman and managing director of the company since May 2009. He joined BEL in January 1973. In his previous assignments, Mr Datt served as director of company's other units. He has extensive experience in development and engineering, production, quality assurance and installation/commissioning of complex radar and communication systems. He has received intensive training in India and abroad on project management, technology transfer and quality management systems.

The other key personnel of the company are listed in the following table.

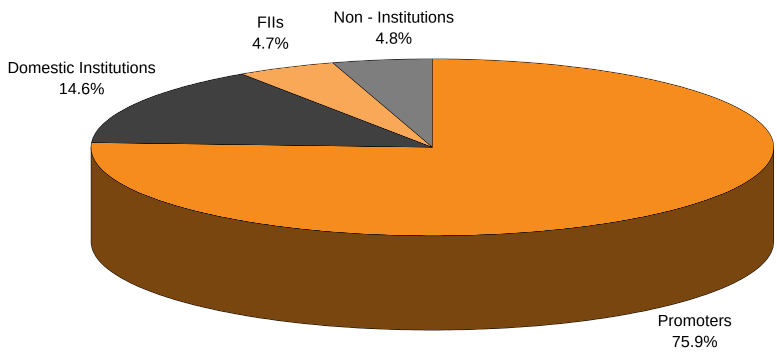
Table 9 : Key personnel

Name	Designation	Qualification	Year of joining	Experience (years)
H S Bhadoria	Director (Bangalore Complex)	B.E. (Mechanical)	1973	37
M L Shanmukh	Director (Human Resources)	BA, LLB	2004	30
I V Sarma	Director (Research & Development)	B.E.(E&C)	1975	35
M G Raghuveer	Director (Finance)	B.Sc, FCA	1997	33
H N Ramakrishna	Director (Marketing)	B.E.(Electronics)	1977	33

Source: Company data

The GOI is the largest shareholder in the company, holding a 76% stake. Among the other investors, FII's holds about 5%. Life Insurance Corporation (LIC) is the largest shareholder, with a 5% stake.

Chart 22 : Shareholding chart



Source: BSE India, As on June 2010

Table 10 : Valuation table - global defence companies

		P/E		P/B		EV/EBITDA		EBITDA margin		ROE	
	Bloomberg Code	**FY11F**	**FY12F**	**FY11F**	**FY12F**	**FY11F**	**FY12F**	**FY11F**	**FY12F**	**FY11F**	**FY12F**
EADS*	EAD FP Equity	39.5	20.6	1.4	1.4	2.4	1.9	5.5%	6.4%	3.6	6.6
SAAB*	SAABB SS Equity	9.5	8.8	0.9	0.9	3.6	3.5	11.5%	12.5%	9.9	10.0
Singapore Technologies	ST SP Equity	20.2	18.7	5.7	5.4	12.9	11.9	12.8%	13.0%	28.8	29.7
Boeing	BA US Equity	16.6	13.3	11.9	7.7	8.4	7.1	10.4%	10.6%	87.5	61.6
Lockheed Martin	LMT US Equity	9.5	9.2	5.8	4.9	5.4	5.3	11.4%	11.0%	64.5	59.7
Northrop Grumman	NOC US Equity	8.4	8.5	1.3	1.2	4.9	4.6	10.6%	11.0%	15.0	13.9
Raytheon	RTN US Equity	10.4	8.8	1.6	1.5	5.4	4.8	11.9%	12.7%	16.4	17.8
BAE Systems*	BA/LN Equity	7.9	7.5	1.9	1.7	4.9	4.8	12.2%	12.6%	22.2	24.9
Rolls Royce*	RR/LN Equity	9.0	8.1	1.4	1.3	8.1	7.4	11.6%	11.8%	16.2	16..4

Prices as on 6 September 2010
Source: Bloomberg consensus, *RBS forecasts, FY11 is CY10.

Income statement

Rsm	FY09A	FY10A	FY11F	FY12F	FY13F
Revenue	45836	51804	58048	64304	71341
Cost of sales	-23909	-29964	-33203	-36460	-40094
Operating costs	-11269	-13629	-14918	-15626	-16337
EBITDA	**10658**	**8211**	**9926**	**12218**	**14910**
DDA & Impairment (ex gw)	-1055	-1159	-1237	-1372	-1533
EBITA	**9602**	**7052**	**8690**	**10846**	**13377**
Goodwill (amort/impaired)	n/a	n/a	n/a	n/a	n/a
EBIT	**9602**	**7052**	**8690**	**10846**	**13377**
Net interest	-154.9	-54.3	-30.0	-31.5	-33.1
Associates (pre-tax)	n/a	n/a	n/a	n/a	n/a
Forex gain / (loss)	n/a	n/a	n/a	n/a	n/a
Exceptionals (pre-tax)	-784.7	352.8	0.00	0.00	0.00
Other pre-tax items	2296	3098	3531	4026	4348
Reported PTP	**10959**	**10448**	**12191**	**14840**	**17692**
Taxation	-3511	-3242	-3840	-4675	-5308
Minority interests	0.00	-5.00	-10.0	n/a	n/a
Exceptionals (post-tax)	n/a	n/a	n/a	n/a	n/a
Other post-tax items	9.84	2.13	0.00	0.00	0.00
Reported net profit	**7458**	**7209**	**8351**	**10166**	**12385**
Normalised Items Excl. GW	-784.7	352.8	0.00	0.00	0.00
Normalised net profit	**8242**	**6856**	**8351**	**10166**	**12385**

Source: Company data, RBS forecasts — year to Mar

Balance sheet

Rsm	FY09A	FY10A	FY11F	FY12F	FY13F
Cash & market secs (1)	26419	35784	41664	48668	57573
Other current assets	52819	50504	56591	62690	69550
Tangible fixed assets	5142	5214	5509	6043	6329
Intang assets (incl gw)	n/a	n/a	n/a	n/a	n/a
Oth non-curr assets	2024	1687	1687	1687	1687
Total assets	**86404**	**93189**	**105451**	**119088**	**135140**
Short term debt (2)	n/a	n/a	n/a	n/a	n/a
Trade & oth current liab	42602	44310	49651	55002	61021
Long term debt (3)	12.1	7.26	7.26	7.26	7.26
Oth non-current liab	5718	5415	6067	6721	7457
Total liabilities	**48332**	**49732**	**55725**	**61730**	**68485**
Total equity (incl min)	38071	43457	49726	57357	66655
Total liab & sh equity	**86404**	**93189**	**105451**	**119088**	**135140**
Net debt	-26407	-35777	-41657	-48661	-57565

Source: Company data, RBS forecasts — year ended Mar

Cash flow statement

Rsm	FY09A	FY10A	FY11F	FY12F	FY13F
EBITDA	10658	8211	9926	12218	14910
Change in working capital	-3485	4023	-746.5	-748.0	-841.4
Net interest (pd) / rec	-154.9	-54.3	-30.0	-31.5	-33.1
Taxes paid	-3511	-3242	-3840	-4675	-5308
Other oper cash items	1741	3426	4184	4680	5084
Cash flow from ops (1)	**5247**	**12364**	**9494**	**11443**	**13812**
Capex (2)	-1602	-1070	-1532	-1905	-1820
Disposals/(acquisitions)	0.00	0.00	0.00	0.00	0.00
Other investing cash flow	-0.01	0.00	0.00	0.00	0.00
Cash flow from invest (3)	**-1602**	**-1070**	**-1532**	**-1905**	**-1820**
Incr / (decr) in equity	0.00	0.00	0.00	0.00	0.00
Incr / (decr) in debt	-1.69	-4.85	0.00	0.00	0.00
Ordinary dividend paid	-1750	-1793	-2082	-2534	-3087
Preferred dividends (4)	0.00	0.00	0.00	0.00	0.00
Other financing cash flow	-9.30	-131.3	0.00	0.00	0.00
Cash flow from fin (5)	**-1761**	**-1929**	**-2082**	**-2534**	**-3087**
Forex & disc ops (6)	n/a	n/a	n/a	n/a	n/a
Inc/(decr) cash (1+3+5+6)	**1884**	**9365**	**5880**	**7004**	**8905**
Equity FCF (1+2+4)	3646	11294	7962	9538	11992

Lines in bold can be derived from the immediately preceding lines. — year to Mar
Source: Company data, RBS forecasts

Standard ratios

Performance	Bharat Electronics FY09A	FY10A	FY11F	FY12F	FY13F	Bharat Heavy Electricals FY11F	FY12F	FY13F	Larsen & Toubro FY11F	FY12F	FY13F
Sales growth (%)	12.9	13.0	12.1	10.8	10.9	25.9	16.5	10.1	19.1	33.2	9.31
EBITDA growth (%)	5.73	-23.0	20.9	23.1	22.0	32.9	16.0	7.46	15.6	33.1	13.2
EBIT growth (%)	4.89	-26.6	23.2	24.8	23.3	35.3	16.2	7.28	15.2	34.5	13.0
Normalised EPS growth (%)	2.33	-16.8	21.8	21.7	21.8	34.1	16.9	12.9	22.2	33.7	13.8
EBITDA margin (%)	23.3	15.8	17.1	19.0	20.9	20.1	20.0	19.5	12.6	12.6	13.1
EBIT margin (%)	20.9	13.6	15.0	16.9	18.8	19.0	18.9	18.4	11.5	11.6	12.0
Net profit margin (%)	18.0	13.2	14.4	15.8	17.4	14.0	14.0	14.4	8.66	8.69	9.05
Return on avg assets (%)	10.6	7.68	8.43	9.07	9.76	10.7	10.2	9.77	8.25	9.07	8.77
Return on avg equity (%)	23.4	16.8	17.9	19.0	20.0	31.3	28.7	25.9	19.3	22.0	21.2
ROIC (%)	78.2	39.0	75.8	90.1	103.1	125.5	77.6	79.8	21.1	24.9	23.5
ROIC - WACC (%)	0.00	0.00	0.00	0.00	0.00	114.3	66.4	68.7	10.5	14.4	13.0
					year to Mar			year to Mar			year to Mar

Valuation	Bharat Electronics FY09A	FY10A	FY11F	FY12F	FY13F	Bharat Heavy Electricals FY11F	FY12F	FY13F	Larsen & Toubro FY11F	FY12F	FY13F
EV/sales (x)	2.47	2.00	1.69	1.41	1.15	2.58	2.10	1.80	2.49	1.86	1.67
EV/EBITDA (x)	10.6	12.7	9.87	7.45	5.50	12.9	10.5	9.20	19.7	14.8	12.8
EV/EBITDA @ tgt price (x)	13.3	16.2	12.8	9.80	7.43	15.0	12.3	10.9	20.1	15.0	13.0
EV/EBIT (x)	11.8	14.7	11.3	8.39	6.14	13.6	11.1	9.75	21.7	16.0	13.9
EV/invested capital (x)	9.36	13.5	12.1	10.5	9.03	9.10	8.28	7.38	5.99	4.99	4.43
Price/book value (x)	3.67	3.21	2.81	2.43	2.10	5.73	4.53	3.66	5.35	4.50	3.81
Equity FCF yield (%)	2.61	8.09	5.70	6.83	8.59	2.79	4.58	4.94	2.78	2.80	4.64
Normalised PE (x)	16.9	20.4	16.7	13.7	11.3	20.6	17.6	15.6	29.6	22.2	19.5
Norm PE @tgt price (x)	20.4	24.6	20.2	16.6	13.6	23.6	20.2	17.9	30.2	22.6	19.8
Dividend yield (%)	1.25	1.28	1.49	1.81	2.21	0.82	0.90	0.99	0.75	0.85	0.96
					year to Mar			year to Mar			year to Mar

Per share data	FY09A	FY10A	FY11F	FY12F	FY13F
Tot adj dil sh, ave (m)	80.0	80.0	80.0	80.0	80.0
Reported EPS (INR)	93.2	90.1	104.4	127.1	154.8
Normalised EPS (INR)	103.0	85.7	104.4	127.1	154.8
Dividend per share (INR)	21.9	22.4	26.0	31.7	38.6
Equity FCF per share (INR)	45.6	141.2	99.5	119.2	149.9
Book value per sh (INR)	475.9	543.2	621.6	717.0	833.2
					year to Mar

Solvency	FY09A	FY10A	FY11F	FY12F	FY13F
Net debt to equity (%)	-69.4	-82.3	-83.8	-84.8	-86.4
Net debt to tot ass (%)	-30.6	-38.4	-39.5	-40.9	-42.6
Net debt to EBITDA	-2.48	-4.36	-4.20	-3.98	-3.86
Current ratio (x)	1.86	1.95	1.98	2.02	2.08
Operating CF int cov (x)	57.5	288.2	445.5	512.7	579.1
Dividend cover (x)	4.71	3.82	4.01	4.01	4.01
					year to Mar

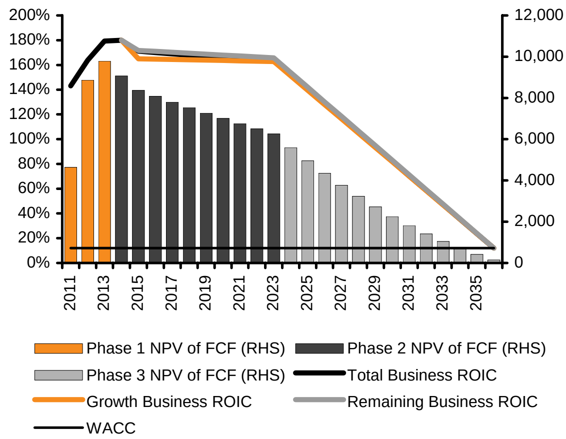
Priced as follows: BAJE.BO - Rs1745.55; BHEL.BO - Rs2444.50; LART.BO - Rs1833.90
Source: Company data, RBS forecasts

Valuation methodology

Economic Profit Valuation	Rs m	%
Adjusted Opening Invested Capital	6640.2	5
NPV of Economic Profit During Explicit Period	22599.5	17
NPV of Econ Profit of Remaining Business (1, 2)	64209.4	48
NPV of Econ Profit of Net Inv (Grth Business) (1, 3)	39148.2	30
Enterprise Value	132597.3	100
Plus: Other Assets	0.0	0
Less: Minorities	0.0	0
Less: Net Debt / Leases (as at 03 Sep 2010)	-35776.8	-27
Equity Value	168374.0	127
No. Shares (millions)	80.0	
Per Share Equity Value	**2105**	
Current Share Price	1745.55	

Discounted Cash Flow Valuation	Rs m	%
Value of Phase 1: Explicit (2011 to 2013)	23296.0	18
Value of Phase 2: Value Driver (2014 to 2023)	74656.4	56
Value of Phase 3: Fade (2024 to 2036)	32420.1	24
Terminal Value	2223.9	2
Enterprise Value	132596.4	100
FCF Grth Rate at end of Phs 1 implied by DCF Valuation		2.8
FCF Grth Rate at end of Phs 1 implied by Current Price		-0.4

Returns, WACC and NPV of Free Cash Flow



Sensitivity Table		No of Years in Fade Period				
		15	18	20	23	25
WACC	6.0%	3438.54	3704.34	3885.14	4161.84	4350.06
	7.0%	3143.58	3356.35	3498.86	3713.63	3857.50
	8.0%	2888.99	3059.87	3172.63	3340.08	3450.61
	9.0%	2668.30	2805.99	2895.56	3026.69	3112.04
	10.0%	2476.21	2587.50	2658.91	2762.05	2828.29

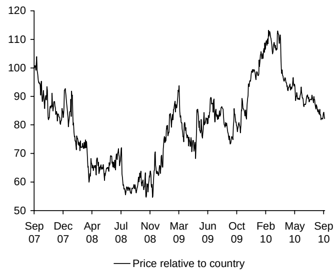
Performance Summary	2011	2012	2013	Phase 2 Avg (2014 - 2023)
Invested Capital Growth (%)	6.4	9.7	5.5	8.6
Operating Margin (%)	20.1	22.1	23.9	22.7
Capital Turnover (x)	9.5	9.9	10.0	10.0

1. In periods following the Explicit Period i.e. Phase 2 and Phase 3
2. Remaining Business is defined as Capital as at the end of Phase 1 and capex = depreciation thereafter
3. Net Investment is defined as capex over and above depreciation after Phase 1
Source: Company data, RBS forecasts

Company description — Buy

Bharat Electronics, a public sector unit (PSU), is the largest listed defence manufacturer in India based on sales. It was established in 1954 by the government of India under the Ministry of Defence to supply specialised electronic equipment to Indian defence services. Currently, about 83% of its turnover comes from supplying battlefield communication, radar surveillance and opto-electronic devices such as nightvision, electronic warfare, tank sights/ guidance, simulators etc to the Indian defence services. It also supplies some civilian equipment viz telecom equipment, electronic voting machines and electronic components. BEL has nine manufacturing locations spread across the country, joint ventures with GE and Multi-tone, and has also signed MOUs for future co-operation with global defence contractors such as Lockheed Martin, Boeing, EADS, Raytheon, Honeywell etc.

Price relative to country



Strategic analysis — Average SWOT company score: 3

Strengths — 4
As a PSU established back in 1954, BEL has close to five decades of experience working with the Indian defence establishment. It has nine manufacturing plants across the country as well as strong inhouse R&D capabilities and technological collaborations with several key global vendors.

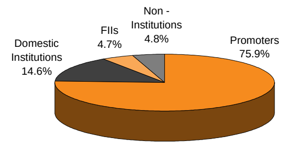
Weaknesses — 2
Being a PSU, BEL has relatively less flexibility than private players in decision making and charting new growth paths. Its wage policy is also tied closely to the GOI's wage policy, which reduces flexibility to cut wage costs.

Opportunities — 5
There is a clear drive to modernise the Indian army, which should benefit key suppliers such as BEL. India also has an "offset" policy by which foreign defence suppliers need to procure a certain percentage of indigenously manufactured components, which opens up significant opportunities for BEL.

Threats — 2
Private-sector players in India are gradually entering the defence equipment space through joint ventures with overseas companies. Any cuts in defence spending can affect defence suppliers such as BEL.

Scoring range is 1-5 (high score is good)

Shareholding chart



Source: BSE India, as on June 2010

Market data

Headquarters
Bharat Electronics Ltd
Registered Office, Outer Ring Road
Nagavara, Bangalore – 560 045

Website
www.bel-india.com

Shares in issue
80.0m

Freefloat
24%

Majority shareholders
Government of India (76%), LIC (5%), FII (4%)

Country view: India — Underweight

The macro picture for India has been constructive recently, with GDP and industrial production tracking in line with expectations, while portfolio allocators continue to favour the market for its domestic consumption orientation. However, these positives have already been priced in and we believe risks are rising from the increasing double deficit, demanding valuations and tightening liquidity.

The country view is set in consultation with the relevant company analyst but is the ultimate responsibility of the Strategy Team.

Country rel to Asia Pacific

Competitive position — Average competitive score: 3+

Supplier power — 3+
About 70-75% of BEL's products are designed in-house, of which 15-20% are based on the DRDO's design and the rest are from overseas suppliers. BEL intends to increase internal R&D efforts further.

Barriers to entry — 4-
Key barriers to entry are long-standing relationships with the Indian defence establishment. Also, BEL has experience in customising overseas technology to match Indian operating requirements.

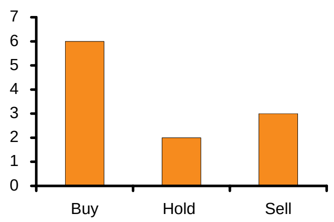
Customer power — 3+
With defence equipment accounting for over 80% of revenues, BEL is heavily dependent on the Indian defence procurement budget.

Substitute products — 4+
The Indian defence establishment would like to see a vibrant domestic manufacturing sector and to that extent, there would be a natural propensity to prefer locally developed weapon systems.

Rivalry — 3-
The private sector in India is gradually firming up investment plans to enter the defence manufacturing sector. However, plans are still in the early stage and competition will take time to develop.

Scoring range 1-5 (high score is good) Plus = getting better Minus = getting worse

Broker recommendations



Source: Bloomberg

Global disclaimer