

INITIATING COVERAGE

Bharat Electronics Limited

Buy

Share Data

Market Cap	Rs. 145.9 bn
Price	Rs. 1823.7
BSE Sensex	14505
Reuters	BAJE.BO
Bloomberg	BHE IN
Avg. Volume (52 Week)	0.04 mn
52-Week High/Low	Rs. 1494/493
Shares Outstanding	80 mn

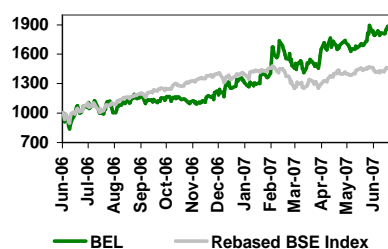
Valuation Ratios

Year to 31 March	2008E	2009E
EPS (Rs.)	90.5	134.4
+/- (%)	-0.1%	48.5%
PER (x)	20.2x	13.6x
EV/ Sales (x)	2.7x	2.3x
EV/ EBITDA (x)	12.6x	8.3x

Shareholding Pattern (%)

Promoters	76
FII's	12
Institutions	7
Public & Others	5

Relative Performance



Sufficient ammunition left to fight

Bharat Electronics Limited (BEL), the largest Indian defence contractor, has been experiencing a steady growth over the last couple of years. Due to increased spending by the Indian government for replacing its outdated defence equipment coupled with attempts to diversify into the civilian market, BEL should continue its steady growth. The Company's sales are expected to double during FY08-12 and with an order book of Rs. 90 bn, the company's growth prospects are in line with the projections of growth of 19% annually. BEL's continued investment in R&D would ensure that it keeps up with the new technological advances.

Key Figures

Year to March	FY05	FY06	FY07	FY08E	FY09E	CAGR (%)
(Figures in Rs mn, except per share data) (FY07-09E)						
Net Sales	33,401	36,550	40,515	46,780	55,200	16.7%
EBITDA	6,947	8,735	9,664	10,011	15,125	25.1%
Net Profit	4,545	5,985	7,246	7,240	10,750	21.8%
Margins(%)						
EBITDA	20.8%	23.9%	23.9%	21.4%	27.4%	
NPM	13.6%	16.4%	17.9%	15.5%	19.5%	
Per Share Data (Rs.)						
EPS	56.8	74.8	90.6	90.5	134.4	21.8%
PER (x)	32.1x	24.4x	20.1x	20.2x	13.6x	

- We expect BEL will grow at a CAGR of 16.7% through FY07-09E driven by increased Indian defence spending and its continuous effort to increase its market share in the civilian and international markets.
- At the current price of Rs. 1824, the stock is trading at a forward PE of 20.2x FY08E and 13.6x FY09E.
- Our target price of Rs. 2,150 is based on the DCF. We believe the stock is undervalued and we initiate coverage with a Buy with a one year perspective.

Investment Rationale

Increased spending by the Indian government to replace its outdated defence equipment

Over the past couple of years, India has been increasing its defence budget and investing actively in replacing its outdated equipment. BEL being the largest defence supplier in India could benefit from increased defence spending by the Indian government to modernize its defence forces. In the past, BEL has virtually enjoyed a monopoly in the defence sector and it is likely to remain in this position for the foreseeable future due to its good track record, past experience in dealing with the defence industry and strong R&D centre. Government of India owns close to 76% of BEL, ensuring a steady pipeline of future contracts for BEL from the Indian government.

Continued investment in R&D and good relations with Defence Research & Development Organization (DRDO)

BEL has been keeping up with the technological changes through continued investment in R&D. BEL's main R&D facility is located in Bangalore with each of its nine manufacturing facilities having their own R&D departments. BEL has skilled and experienced workforce, employing close to 2600 engineers and scientists. About 40% of these engineers and scientist work in the R&D facilities of BEL, working with cutting edge technology to come up with new products. In FY06, BEL invested close to Rs. 1.30 bn in R&D which amounted to 3.7% of the sales. With a close relationship with DRDO, Department of Defence's research branch, BEL would stay at the forefront of technology. Both BEL and DRDO have worked together on numerous projects which have resulted in orders for BEL from DRDO.

Expansion into civilian and international market segment

BEL's civil and international sales have been steadily growing over the last couple of years. BEL anticipates that the future growth is going to come from these segments. BEL is trying to diversify into different civilian market segments to get a bigger customer base, hence a larger share of the civilian market. It is trying to negotiate deals to provide end-to-end solutions to the private FM broadcasters, it is exploring to expand GSM and CDMA networks

for OEMs and developing and supplying electronic voting machines to the Election Commission.

In 2007, BEL's revenue from international sales went up by 17% as compared to those of previous year. According to Mr. Sastry, Chairman and MD of BEL, BEL wants to capture 20-30% of the \$10 bn international defence market in India. In the next 3 years, BEL wants to generate 10% of their total revenue from international sales. In February 2007, BEL signed a Memorandum of Understanding (MOU) with Northrop Grumman, an American based defence and technology company, to explore business opportunities to jointly produce aerospace and defence electronics. This could increase BEL's exports as BEL would also provide contract manufacturing to Northrop Grumman.

Sales growth to continue

BEL's current order book shows orders of Rs. 90 bn an increase of 36% over the last year's number. Most of these orders are to be delivered either this year or the next year suggesting a strong growth for the next two years. BEL is continuously investing in its manufacturing and R&D facilities to ensure it can keep up with ever changing technology and continue its growth.

Key Risks

Competition from private sector for defence contracts

BEL has always enjoyed a monopoly in the defence sector, but recently government of India announced that private companies would be allowed to bid for the defence contracts. Defence contracts have been the 'bread and butter' for BEL, in FY07 close to 76% of the sales, but now with private companies bidding for the same contracts, it would be difficult for BEL maintain its monopoly. If BEL does not expand into other market segments then it might not be able to grow at the same rate.

Poaching of talent by the private sector

BEL has experienced and talented workforce of 12,000 employees out of which 2,600 are engineers and scientists. As the private companies enter the sector, BEL could be their key poaching ground. The Company's experienced and talented workforce is one of its strategic advantages over its competitors and the potential loss of this talent may blunt BEL's competitive edge.

Outlook

As India is trying to modernize its defence, its defence budget has been growing steadily for the last couple of years with a continuous effort to replace the outdated equipment. With India's defence spending growing, BEL might be able to get more and more contracts from the government. The government of India owns 76% of BEL which would allow BEL to get future contracts from the Indian government. Although BEL is expected to face competition from the private sector in the coming years, it fairs better against the private companies to receive the government contracts due to its good track record, experience in the industry and strong R&D centre.

BEL's civil and international market share has also been experiencing a strong growth. In an effort to get a bigger market share, BEL is diversifying into different market segments and also by diversifying its product portfolio. A testament to this strategy was BEL's execution of convergent billing project for MTNL, supplying electronic voting machines to the Election Commission and setting up satellite network system in Nigeria in FY07. According to the management of BEL, the Company is expected to double its revenue between FY08-12 to Rs. 85 bn with a CAGR of 19%. The management also mentioned that BEL anticipates generating 10% of its total sales from international sales.

Company Background

Founded in 1954 by the GoI, BEL is the largest defence supplier in India. Based in Bangalore, has 9 manufacturing facilities spread all over India and has procurement offices in New York, U.S.A. and Singapore. GoI holds 76% stake in the company. BEL has two joint ventures with two international companies. GE-BE Private Limited (GEBEL) is a joint venture between BEL and GE Medical Equipment, USA, which manufactures X-ray tubes for RAD&F and CT systems. GEBEL also manufactures high voltage tanks and detector modules for CT systems. These products are exported around the world. BEL-Multitone is the joint venture between BEL and Multitone Limited, UK, which manufactures customized mobile communication products.

BEL manufactures electronic communication equipment, night vision equipment, periscopes and tank electronics. BEL also provides outsourcing and contract manufacturing to other electronic manufacturers. In FY06, BEL setup a new manufacturing facility to assemble electronic circuit boards.

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