



## Bharat Electronics

STOCK INFO.	BLOOMBERG
BSE Sensex: 12,907	BHE IN
	REUTERS CODE
S&P CNX: 3,739	BAJE.BO
Equity Shares (m)	80.0
52-Week Range	1,472/712
1,6,12 Rel. Perf. (%)	-3/-21/-12
M.Cap. (Rs b)	91.0
M.Cap. (US\$ b)	2.0

27 October 2006

Buy

Previous Recommendation: Buy

Rs1,138

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
3/06A	35,138	5,830	72.9	30.6	15.6	4.5	22.0	35.3	2.0	7.6
3/07E	41,623	6,847	85.6	17.4	13.3	3.5	20.1	31.8	1.6	6.2
3/08E	49,551	8,382	104.8	22.4	10.9	2.8	19.4	30.5	1.2	4.7

During 2QFY07, BEL reported revenues of Rs8,343m (up 0.7% YoY); EBITDA of Rs1,865m (down 9% YoY) and net profit of Rs1,483m (up 1% YoY). The reported numbers are lower than our estimates revenues Rs9.5b; EBITDA Rs2.3b and net profit Rs1.6b.

EBITDA margins stood at 22.4% during 2QFY07, down 240bp YoY. An analysis of costs indicates while raw materials declined as a percentage of revenues to 54.9% during 2QFY07 v/s 56.8% YoY, staff expenses rose to 13.9% (v/s 12.1% YoY) and other expenses were up 8.8% (v/s 6.4% YoY).

Due to the nature of defense orders, BEL has historically reported volatile quarterly earnings and lumpiness is noticed in the reported numbers. For instance during FY06, BEL reported revenue growth of 11% which could be split quarterwise as 1Q: -22%; 2Q: 2%; 3Q: 2% and 4Q: 39%. Thus, we believe performance of BEL cannot be judged on a quarterly basis. Even during 1HFY07, BEL's revenue growth stands at -1% YoY; further, management has given guidance for revenue growth of 18% (revenues of Rs42b) during FY07.

BEL has strong order backlog of Rs66.3b (March 2006) and management has given guidance for revenue growth 19% CAGR to FY12. We expect PAT CAGR growth of 19.2% over FY06-FY09E. At the CMP of Rs1,138, the stock trades at a P/E of 13.3x FY07E and 10.9x FY08E. Maintain **Buy**.

QUARTERLY PERFORMANCE										(Rs Million)	
Y/E MARCH	FY06				FY07				FY06	FY07	
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE			
<b>Sales</b>	4,791	8,288	6,772	15,757	4,831	8,343	7,856	20,593	35,608	41,623	
Change (%)	-22.4	2.2	2.3	39.0	0.8	0.7	16.0	30.7	11.4	16.9	
<b>EBITDA</b>	751	2,053	1,447	4,174	721	1,865	1,689	5,548	8,424	9,824	
Change (%)	-4.5	9.2	15.9	53.7	-4.0	-9.1	16.8	32.9	21.1	16.6	
As of % Sales	15.7	24.8	21.4	26.5	14.9	22.4	21.5	26.9	23.7	23.6	
Depreciation	193	176	181	228	208	198	214	226	778	846	
Interest	4	6	13	250	3	1	6	158	273	167	
Other Income	298	240	217	353	384	508	210	299	1,108	1,402	
Exceptional items (reported)	0	0	0	0	0	0	0	0	0	0	
<b>PBT</b>	852	2,111	1,470	4,049	894	2,175	1,679	5,464	8,481	10,212	
Tax	286	644	499	1,239	291	692	562	1,819	2,669	3,365	
Effective Tax Rate (%)	33.6	30.5	34.0	30.6	32.6	31.8	33.5	33.3	31.5	33.0	
<b>Reported PAT</b>	566	1,467	970	2,809	603	1,483	1,117	3,645	5,812	6,847	
Change (%)	-2.6	32.7	17.9	57.0	6.5	1.1	15.1	29.8	30.2	17.8	
<b>Adj PAT</b>	566	1,467	970	2,809	603	1,483	1,117	3,645	5,812	6,847	

E: MOSt Estimates

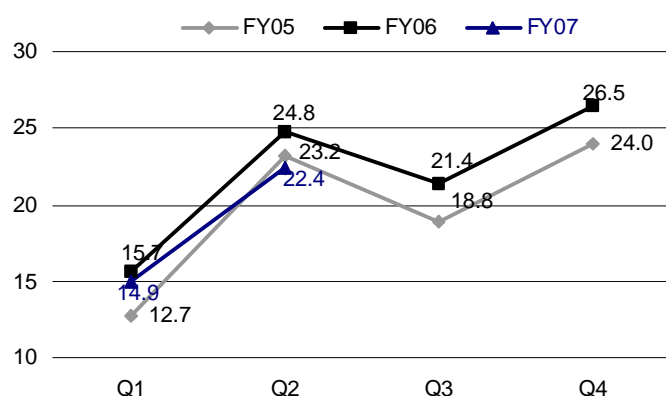
## 2QFY07 performance lower than estimates

During 2QFY07, BEL reported revenues of Rs8,343 m (up 0.7% YoY), EBITDA of Rs1,865m (down 9% YoY) and net profit of Rs1,483m (up 1% YoY). The reported numbers are lower than our estimates of: revenues: Rs9.5b; EBITDA: Rs2.3b and net profit: Rs1.6b.

## EBITDA margins decline owing to increase in staff and other costs

During 2QFY07 EBITDA margins stood at 22.4%, down 240bp YoY. Cost analysis indicates that while raw materials, as percentage of revenues, declined to 54.9% during 2QFY07 v/s 56.8% YoY, staff expenses increased to 13.9% (v/s 12.1% YoY) and other expenses rose to 8.8% (v/s 6.4% YoY). 1QFY07 EBITDA margins too had declined by 75bp YoY.

TREND IN QUARTERLY EBITDA MARGIN (%)



Source: Company/Motilal Oswal Securities

## Quarterly numbers not a good indicator of full year performance

Due to the nature of the government's defense ministry orders, BEL has historically reported volatile quarterly earnings and lumpiness is noticed in reported numbers. For instance during FY06, BEL reported revenue growth of 11% which could be split quarterwise as 1Q: -22%; 2Q: 2%; 3Q: 2% and 4Q: 39%. Thus, we believe that the performance of BEL cannot be judged on a quarterly basis. Even during 1HFY07, BEL's revenue growth stands at -1% YoY; further, management has given guidance for revenue growth of 18% (revenues of Rs42b) during FY07.

## New product launches, capacity ramp-up

While BEL's strength lies in its defense business, the company has taken initiatives to expand into the civilian and export segment. During FY06, BEL launched several new products like upgraded radar warning receiver, CDMA encryptor (to provide secrecy in both GSM and CDMA networks), electronic voting machine, SHAKTI (artillery combat command and control system for network centric warfare), uncooled thermal imager, laser range finder integrated binoculars (long distance viewing and ranging of targets up to a distance of 20km), asynchronous digital subscriber line modem (to deliver broadband services on land lines by service providers such as MTNL and BSNL) etc.

Exports have also become a focus area for BEL, given the many opportunities like offsets (30% for defence contracts above Rs3b) and local manufacturing content. During FY06, export revenues stood at Rs611m (up 9% YoY) largely comprising of contract manufacturing for GE Medical and ETON Corporation, USA. For FY07, management has given guidance for export revenues of Rs1.1b (up 80% YoY). In line with this, BEL has announced the setting up of a new manufacturing unit for super components and an assembling unit for electronic circuit boards (ECBs) for target contract manufacturing business segment for exports (over and above its captive requirement). To increase focus on these segments, the company has reorganized the systems activity into a separate business unit. During FY06, civilian and exports together accounted for 16% of revenues, and we expect the contribution to increase to ~30% by FY08.

## Valuation and view

BEL is poised to witness strong order intake both from the domestic and international market on the back of its various initiatives. Going forward, management has guided for 19% revenue growth to FY2012. We expect a net profit CAGR growth of 19.2% over FY06-09E. At the CMP of Rs1,138, the stock trades at a P/E of 13.3x FY07E and 10.9x FY08E. We maintain **Buy**.

## Bharat Electronics: an investment profile

BEL is India's biggest defense equipment company accounting for 3.6% of India's total defense expenditure and 9% of India's defense capex. The company operates in a non-cyclical, non-capital intensive, near monopoly, cash cow business; with strong entry barriers and thereby enjoys high margins and return on equity. Since FY99, BEL has delivered 17% compounded revenue growth and 40% compounded earnings growth.

### Key investment arguments

- ✍ Order backlog at end-March 2006 stands at Rs66.3b, ~2x its FY06 revenue.
- ✍ Strong management guidance of 19% revenue growth to FY2012 provides high visibility as BEL has a track record consistently exceeding guidance.
- ✍ Recent policy changes by GoI to offset 30% of the foreign defense contracts by purchases, investments and transfer of technology in India augur well for BEL.

### Key investment risks

- ✍ Order backlog does not provide long term visibility (~2x FY06).
- ✍ Lack of clear visibility with respect to guidance due to poor disclosure owing to the varied nature of its business.
- ✍ Threat from increased private sector competition.

EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	85.6	85.4	0.2
FY08	104.8	98.3	6.6

SHAREHOLDING PATTERN (%)

	SEP06	JUN.06	SEP05
Promoters	75.9	75.9	75.9
Domestic Institutions	8.0	8.8	7.2
FII's/FDIs	10.5	10.3	12.1
Others	5.6	5.0	4.8

### Recent developments

- ✍ Launched 15 new products both for defense and civilian markets in FY06.
- ✍ Increased focus on civilian market, Won order from MTNL for Convergent Billing System worth Rs5b.

### Valuation and view

- ✍ BEL has impeccable positioning in the Indian defense sector, with niche positioning in the segment of defense electronics.
- ✍ Since FY99, BEL has delivered 17% compounded revenue growth and 40% compounded earnings growth. Going forward, management has guided for 19% revenue growth to FY12.
- ✍ The stock trades at a P/E of 13.3x FY07E and 10.9x on FY08E basis. We maintain **Buy**

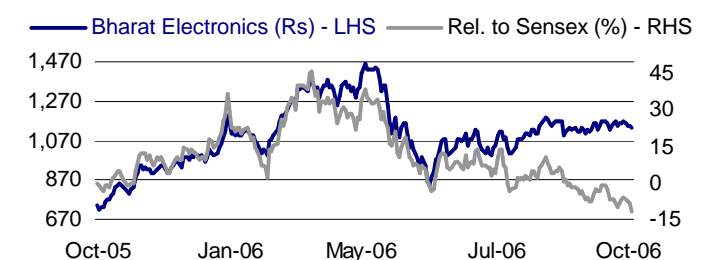
### Sector view

- ✍ India is amongst the top 15 military spenders globally and defense expenditure has increased significantly from Rs399b in FY99 to Rs890b as per the budget estimates for FY07; a CAGR of 9.5%.
- ✍ The share of capital expenditure in total spend has also increased from 27.6% in FY99 to 42.1% in FY07.

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
1,138	1,470	29	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)				
Y/E MARCH	2005	2006E	2007E	2008E	2009E	
<b>Net Sales</b>	<b>31,969</b>	<b>35,138</b>	<b>41,623</b>	<b>49,551</b>	<b>59,461</b>	
Change (%)	16.2	9.9	18.5	19.0	20.0	
Manufacturing Expenses	18,488	20,381	24,971	29,582	35,801	
Staff Cost	4,421	4,262	4,518	5,422	6,506	
Office and Site Establishmer	2,101	1,783	2,174	2,535	2,962	
<b>EBITDA</b>	<b>6,958</b>	<b>8,713</b>	<b>9,961</b>	<b>12,012</b>	<b>14,192</b>	
% of Net Sales	21.8	24.8	23.9	24.2	23.9	
Depreciation	715	797	846	939	1,048	
Interest	116	293	167	152	146	
Other Income	1,036	927	1,265	1,580	1,957	
<b>PBT</b>	<b>7,164</b>	<b>8,549</b>	<b>10,212</b>	<b>12,501</b>	<b>14,955</b>	
Tax	2,396	2,722	3,365	4,119	5,085	
Rate (%)	33.5	31.8	33.0	33.0	34.0	
<b>Reported PAT</b>	<b>4,767</b>	<b>5,827</b>	<b>6,847</b>	<b>8,382</b>	<b>9,870</b>	
EO Income (Net of Expense)	-304	4	0	0	0	
<b>Adjusted PAT</b>	<b>4,463</b>	<b>5,830</b>	<b>6,847</b>	<b>8,382</b>	<b>9,870</b>	
Change (%)	41.2	30.6	17.4	22.4	17.8	

BALANCE SHEET		(Rs Million)				
Y/E MARCH	2005	2006E	2007E	2008E	2009E	
Share Capital	800	800	800	800	800	
Reserves	15,133	19,625	24,937	31,514	39,580	
<b>Net Worth</b>	<b>15,933</b>	<b>20,425</b>	<b>25,737</b>	<b>32,314</b>	<b>40,380</b>	
Loans	153	88	79	73	73	
Deferred Tax Liability	-1,170	-1,274	-1,279	-1,286	-1,286	
<b>Capital Employed</b>	<b>14,917</b>	<b>19,238</b>	<b>24,537</b>	<b>31,102</b>	<b>39,167</b>	
Gross Fixed Assets	11,293	12,403	13,653	15,153	16,903	
Less: Depreciation	8,099	8,699	9,546	10,485	11,533	
<b>Net Fixed Assets</b>	<b>3,193</b>	<b>3,704</b>	<b>4,107</b>	<b>4,668</b>	<b>5,370</b>	
Capital WIP	474	211	546	606	676	
Investments	123	123	200	220	220	
<b>Curr. Assets</b>	<b>38,219</b>	<b>46,405</b>	<b>54,263</b>	<b>65,977</b>	<b>80,296</b>	
Inventory	10,650	10,371	12,313	14,664	17,604	
Debtors	6,991	10,177	9,749	11,611	13,939	
Cash & Bank Balance	13,159	18,314	22,992	28,732	35,585	
Loans & Advances	7,420	7,543	9,210	10,969	13,168	
<b>Current Liab. &amp; Prov.</b>	<b>27,130</b>	<b>31,227</b>	<b>34,602</b>	<b>40,391</b>	<b>47,417</b>	
Liabilities	20,116	22,534	25,174	29,968	36,034	
Provisions	7,013	8,693	9,428	10,423	11,383	
<b>Net Current Assets</b>	<b>11,090</b>	<b>15,178</b>	<b>19,661</b>	<b>25,585</b>	<b>32,879</b>	
Misc. Expenses	37	22	22	22	22	
<b>Application of Funds</b>	<b>14,916</b>	<b>19,238</b>	<b>24,537</b>	<b>31,102</b>	<b>39,167</b>	

E: MOST Estimates

RATIOS						
Y/E MARCH	2005	2006E	2007E	2008E	2009E	
<b>Adjusted EPS</b>	<b>55.8</b>	<b>72.9</b>	<b>85.6</b>	<b>104.8</b>	<b>123.4</b>	
Growth (%)	41.2	30.6	17.4	22.4	17.8	
Cash EPS	76.6	91.4	106.2	127.8	149.0	
Book Value	198.7	255.0	321.4	403.7	504.5	
DPS	11.2	15.0	17.0	20.0	20.0	
Payout (incl. Div. Tax.)	20.1	20.6	19.9	19.1	16.2	
<b>Valuation (x)</b>						
P/E (standalone)		15.6	13.3	10.9	9.2	
Cash P/E		12.4	10.7	8.9	7.6	
EV/EBITDA		7.6	6.2	4.7	3.6	
EV/Sales		2.0	1.6	1.2	0.9	
Price/Book Value		4.5	3.5	2.8	2.3	
Dividend Yield (%)		1.3	1.5	1.8	1.8	
<b>Profitability Ratios (%)</b>						
RoE	22.7	22.0	20.1	19.4	18.1	
RoCE	35.3	35.3	31.8	30.5	28.4	
<b>Turnover Ratios</b>						
Debtors (Days)	80	106	85	86	86	
Inventory (Days)	121	107	107	107	107	
Asset Turnover (x)	9.3	9.3	9.7	10.0	10.5	

CASH FLOW STATEMENT		(Rs Million)				
Adjusted EPS	2005	2006E	2007E	2008E	2009E	
PBT before Extraordinary Itc	7,164	8,549	10,212	12,501	14,955	
Add : Depreciation	715	797	846	939	1,048	
Interest	116	293	167	152	146	
Less : Direct Taxes Paid	2,396	2,722	3,365	4,119	5,085	
(Inc)/Dec in WC	-3,781	1,067	194	-183	-441	
<b>CF from Operations</b>	<b>1,817</b>	<b>7,984</b>	<b>8,055</b>	<b>9,290</b>	<b>10,623</b>	
Extra-ordinary Income	-304	4	0	0	0	
<b>CF from Operations aft</b>	<b>1,513</b>	<b>7,988</b>	<b>8,055</b>	<b>9,290</b>	<b>10,623</b>	
(Inc)/Dec in FA	-1,165	-1,046	-1,585	-1,560	-1,820	
(Pur)/Sale of Investments	0	0	-77	-20	0	
<b>CF from Investments</b>	<b>-1,165</b>	<b>-1,046</b>	<b>-1,662</b>	<b>-1,580</b>	<b>-1,820</b>	
(Inc)/Dec in Networth	-221	-97	-5	-6	0	
(Inc)/Dec in Debt	-176	-65	-9	-6	0	
Less : Interest Paid	116	293	167	152	146	
Dividend Paid	1,021	1,332	1,534	1,805	1,805	
<b>CF from Fin. Activity</b>	<b>-1,534</b>	<b>-1,787</b>	<b>-1,715</b>	<b>-1,969</b>	<b>-1,951</b>	
<b>Inc/Dec of Cash</b>	<b>-1,186</b>	<b>5,155</b>	<b>4,678</b>	<b>5,741</b>	<b>6,852</b>	
Add: Beginning Balance	14,345	13,159	18,314	22,992	28,732	
<b>Closing Balance</b>	<b>13,159</b>	<b>18,314</b>	<b>22,992</b>	<b>28,732</b>	<b>35,585</b>	

**N O T E S**

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**Disclosure of Interest Statement**

**Bharat Electronics**

1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No

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