

**September 26<sup>th</sup>, 2014**

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NSE Code: BEL

Reuters Code: BAJE.NS

Bloomberg Code: BHE:IN

Bharat Electronics Ltd (BEL), the state-owned electronics company, was established in 1954. The company is engaged in the manufacture and supply of electronic products primarily to Indian Defence Services. BEL was set up at Bangalore, India, by the Government of India (GoI) under the Ministry of Defence to meet the specialized electronic needs of the Indian defence services. BEL also provides nondefense products, such as switching equipment, TV and broadcast, direct-to-home television (DTH), telecom, simputer, electronic voting machine and electronic components, including passive components, small signal transistors, power devices, integrated circuits and silicon detectors, and professional broadcast and communication equipment. Over the years, then company has grown into a multi-product, multi-technology, multi-unit company serving the needs of customers in diverse fields in India and abroad.

### Investor's Rationale

**Revenue to grow at a CAGR of ~6.1% over FY14-16E** - BEL witnessed a 3.9% YoY growth in revenue at ₹65,178.6 mn in FY14 due to a strong order book driven by rising defence expenditures. During FY14, EBITDA margins of the company improved by ~357 basis points to 14%, on account of lower employee cost and execution of the high-margin Akash Missile System (AMS) order, could also rise further, as BEL is to deliver six units of AMS in FY15E. We anticipate improvement in the pace of orders from the armed forces, given the government's mandate to quicken piled-up defence deals. Going forward, we expect BEL's revenues to grow at a CAGR of 6.1% for FY14-16E period.

**Government focus on development of defence equipment to augur well for the company** - BEL is emerging as a key beneficiary of an increase in defence capital expenditure by India. Further, the 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.

**Strong order backlog to provide higher upside** - BEL has a strong order book of ₹232 bn, equivalent to nearly four years of revenues. Backed by a healthy order book, we expect BEL to surpass the revenue of ~₹70,000 mn during FY15E. The company's order book is slated to grow over the next few years because of the steady demand for its existing product range; potential orders from high value projects and growth opportunities in the non-defence/ export segments. Major orders are expected to be finalised in FY15 include Weapon locating radars, Ground based elint, L70 gun upgrade, Electronic

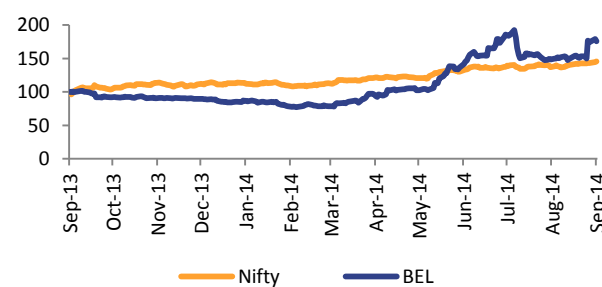
### Market Data

<b>Rating</b>	<b>BUY</b>
<b>CMP (₹)</b>	2,017.4
<b>Target (₹)</b>	<b>2,500</b>
<b>Potential Upside</b>	~23.9%
<b>Duration</b>	Long Term
Face Value (₹)	10.0
52 week H/L (₹)	2,318.0/893.0
Adj. all time High (₹)	2,318.0
Decline from 52WH (%)	13.0
Rise from 52WL (%)	125.9
Beta	1.4
Mkt. Cap (₹bn)	161.4
Enterprise Value (₹bn)	123.4

### Fiscal Year Ended

Y/E	FY13A	FY14A	FY15E	FY16E
Revenue (₹bn)	62.7	65.2	70.5	77.9
EBITDA (₹bn)	6.6	9.2	10.3	11.7
Net Profit (₹bn)	9.1	9.5	10.2	11.6
EPS (₹)	113.8	118.9	128.1	145.1
P/E (x)	18.6	17.8	16.5	14.6
P/BV (x)	2.6	2.3	2.1	1.9
EV/EBITDA (x)	17.5	13.4	12.35	11.2
ROCE (%)	16.4	15.5	15.1	15.5
ROE (%)	14.0	13.2	12.9	13.3

### One year Price Chart



### Shareholding Pattern

	Jun'14	Mar'14	Diff.
Promoters	75.0	75.0	0.0
FII	2.2	3.7	(1.5)
DII	17.7	16.9	0.8
Others	5.1	4.4	0.7

*BEL is among an elite group of public sector undertakings, which have been conferred the Navratna status by the GoI.*

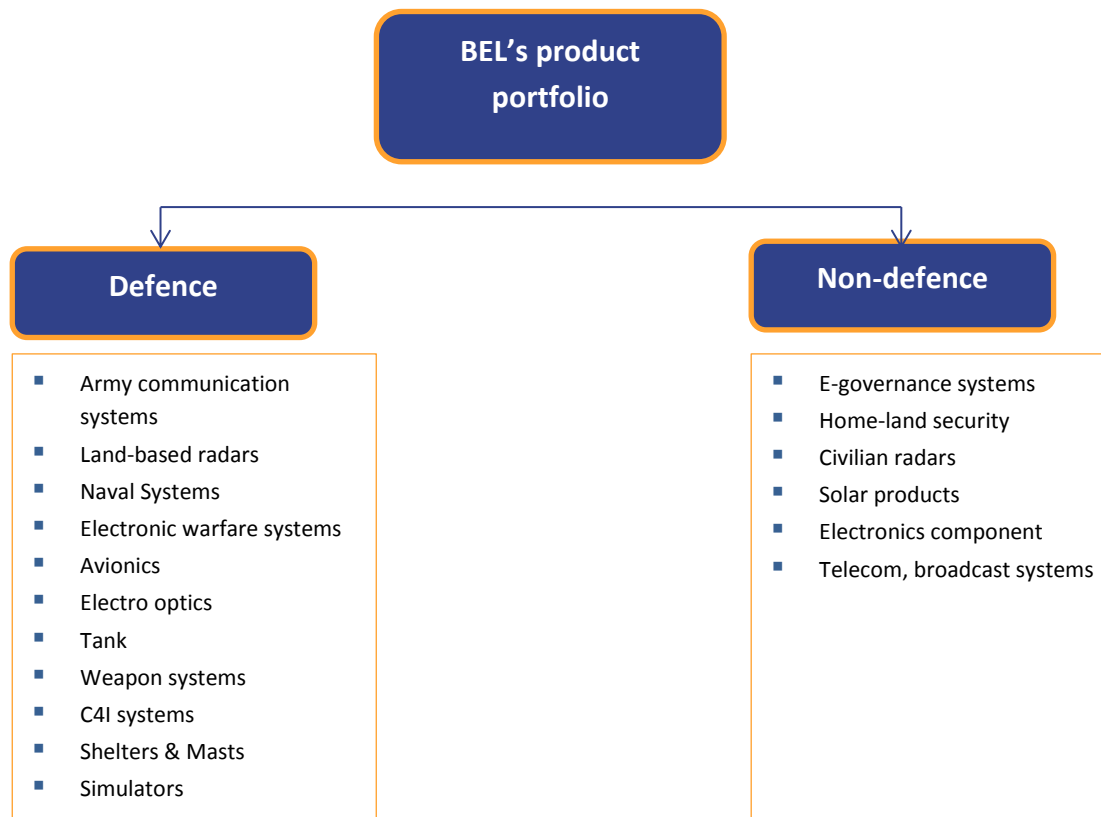
*BEL offers defence products including defence communication equipment, radars, sonars, naval systems, opto-electronics, electronic warfare systems, tank electronics, and simulators.*

### **BEL, a major defence equipment supplier**

Established by the Government of India (GoI) under the Ministry of Defence (MoD) in 1954 to meet the specialised electronic needs of the Indian defence services, Bharat Electronics Ltd (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 is among an elite group of public sector undertakings, which have been conferred the Navratna status by the GoI. BEL offers defence products including defence communication equipment, radars, sonars, naval systems, opto-electronics, electronic warfare systems, tank electronics, and simulators. The company also provides nondefence products, such as switching equipment, TV and broadcast, direct-to-home television (DTH), telecom, simputer, electronic voting machine and electronic components, including passive components, small signal transistors, power devices, integrated circuits and silicon detectors, and professional broadcast and communication equipment.

The company has 9 manufacturing units and 2 Research and Development (R&D) units. BEL has a three-layer R&D setup comprising Development and Engineering (D&E) Divisions at its 9 Units, Central D&E supporting other D&E divisions, and Central Research Labs (CRLs) at Bangalore and Delhi for carrying out futuristic, cutting-edge research. BEL maintains technological leadership with its strong in-house R&D and in association with development agencies such as DRDO, ISRO, CSIR, C-DOT, C-DAC and leading academic institutions such as IITs, IISc and NITs.

### **BEL's product classified into defence and non-defence segments**



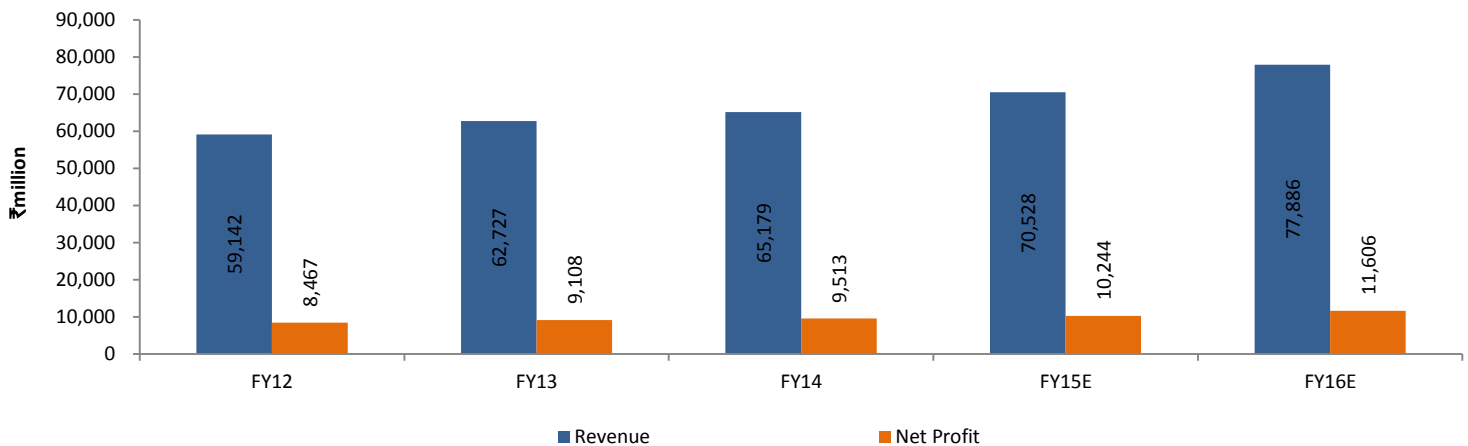
## Witnessed decent performance in Q1FY15

In a seasonally lean quarter, BEL reported 12.7% YoY rise in its Q1FY15 net sales to ₹9,967 mn on account of improved order execution. Pick-up in supply to major projects like Akash Missile System, Battlefield Surveillance Radar, Modular Combat Management System etc., helped in supporting healthy sales growth. However, owing to product mix changes, the company's gross profit margins contracted to 35% from 37% in Q1FY15. Employees cost fell marginally, which in turn helped the company to restrict the loss at EBITDA level. Consequently, the company narrowed down its EBITDA loss to ₹455 mn in Q1FY15 from an EBITDA loss of ₹560 mn in Q1FY14.

Further, on account of lower cash balance due to increased working capital and lower customer advances, the company posted muted growth of 3% YoY in other income at ₹1,152 mn. Tax rate for Q1FY15 remained stable at 23%; due to higher R&D spend during the quarter. The net profit of the company grew 49.1% YoY to ₹256.2 mn in Q1FY15.

*We expect the company to deliver better performance driven by strong order inflow during Q1FY15. Backed by a healthy order book, we expect BEL to witness 8.2% and 10.4% revenue growth in FY15E and FY16E, respectively*

### Revenue and net profit to grow at a CAGR of 6.1% and 6.9% over FY14-16E, respectively



## Aims to achieve export sales of USD 59.75 mn in FY15E

On the export front, BEL achieved all-time high export sales of USD 42 mn in FY14 registering a growth of 28% over the previous year's export turnover of USD 32.78 mn. On the export front, the company has bagged orders worth USD 141.85 mn in FY14. As on 31st March, 2014, the export order book of the company stood at USD 194 mn including offset orders of USD 28.45 mn. BEL targets to achieve export sales of USD 59.75 mn in FY15E. The long term export plan of BEL is to achieve export sales to total sales turnover ratio of 7% from the current ratio of 4% by FY19E. BEL for the first time exported state-of-the-art Sonar systems. Some of the other major equipments exported during FY14 include Automatic Identification System, Radar Warning Systems, Radar Finger Printing System, Casings, Stators, Electro Mechanical parts etc. BEL has successfully established itself as a supply chain partner of global players like Boeing & Hamilton Sunstrand. During FY14, BEL has successfully commenced manufacturing of aircraft cable looms for M/s Pilatus of Switzerland.

BEL is also anticipating sizable export orders on account of "Offset" policy in defence procurements. In this regard, BEL is interacting with many foreign companies, like Elbit Systems, Boeing, Lockheed Martin, Raytheon, Northrop Grumman, BAE Systems, SAAB, Thales, IAI for possible offset business arising out of various proposals issued by MoD India.

*As on 31st March, 2014, the export order book of the company stood at USD 194 mn including offset orders of USD 28.45 mn.*

## Healthy order book provides strong revenue visibility & greater opportunity ahead

The company's current order book at the end of Q1FY15 stood at ₹233 bn, which is to be executed over the next four years, providing strong revenue visibility. The order inflow during the quarter rose significantly by 35% YoY to ₹7.6 bn, providing revenue visibility. Major orders acquired during Q1FY15 include Mobile communication terminal and Combat management systems. The company sees long term order pipeline of ~₹400-500 bn including big ticket orders like Tactical Communication System (TCS) and Battlefield Management System (BMS).

Major projects, which the company executed during FY14 for the Army, Navy, Air Force, Coast Guard and non - defence customers include: Akash Missile Systems (Army & Air Force), Passive Night Vision Devices (PNVDs), Low Level Light Weight Radar, Missile Warning System (MWS), Hull mounted Sonar, Shipborne EW system, Central Acquisition Radar, Low Level Transportable Radar (LLTR), Coastal Surveillance System, Electronic Voting machines (EVMs), National Population Register (NPR), etc. In FY14, BEL saw a 20% YoY decline in the new order inflow at ₹42 bn. However, we anticipate an improvement in the pace of orders from the armed forces, given the government's mandate to quicken piled-up defence deals. BEL's order backlog remained healthy at ₹232 bn, which is about 3.7 times its FY14 revenue, bolster growth visibility for the next two to three years. This along with an improving order outlook, places BEL in a sweet spot.

*The company sees long term order pipeline of ~₹400-500 bn including big ticket orders like Tactical Communication System (TCS) and Battlefield Management System (BMS).*

### BEL's improving order-book outlook

Major supplies during Q1FY15	Major orders expected during FY15E
Akash Missile System	Weapon Locating Radar
Passive Night Vision Devices	Ground Based Elint
Missile Warning System	L70 Gun Upgrade
Shipborne Electronic Warfare System	Mobile Cellular Communication System
-	Electronic Warfare Suites
-	Hull mounted Sonar
-	Communication Sets

## New product launches

We believe BEL's business transformation from a pure product supplier to a defence aggregator and integrator will stabilise over FY14-16E. The company has a high dependence on the defence segment, from which it derives almost 80% of its revenues. In order to reduce this dependence, the company is foraying into new areas such as telecom, solar energy and the civilian market. The company is developing new products, through in-house R&D or in collaboration with Defence Research and Development Organization (DRDO) and other research institutions. With the government emphasis on Indigenisation, BEL derived 85% of turnover from indigenously designed and developed products. Some of the new products introduced in FY14 include Bharani, Hull Mounted Sonar, Electronic Voting Machine, Voter Verifiable Paper Audit Trail (VVPAT) and Radio for LIC EW system.

- **Bharani** - a Low Level Light weight Radar (LLLR). It is a battery powered Compact Sensor providing two Dimensional Surveillance solutions to alert Air defence Weapon System against hostile targets at low and medium altitudes.
- **Hull Mounted Sonar** - for detecting, localizing and tracking surface & sub-surface targets in both active and passive modes. The sonar is designed to meet the naval requirements.

*With more focus on developed products, we expect BEL to introduce more technologically advanced products through joint development efforts with DRDO.*

Defence Sector is increasingly being opened up for private sector participation with evolutions of Defence Procurement Procedure. All this has pushed the company towards much higher competitiveness and productivity through initiatives for enhancing value addition.

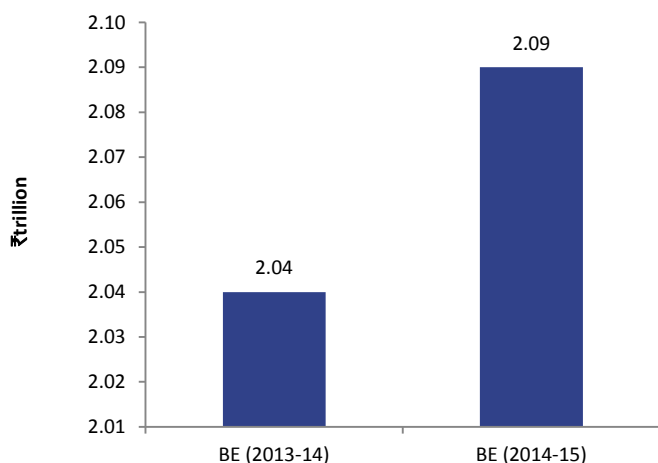
- **Electronic Voting Machine** - with new specification including digital certification and tamper evidence feature.
- **Voter Verifiable Paper Audit Trail (VVPAT)** - a Printing attachment to the Electronic Voting Machine (EVM) to facilitate comparison of votes in the event of a dispute.
- **Radio for LIC EW system** - Radio system for providing reliable back bone data communication.

We perceive BEL to be a lead defence supplier over the next three to five years, despite rising interest from private sector players, given its focused positioning in core areas like missile systems, radars etc.

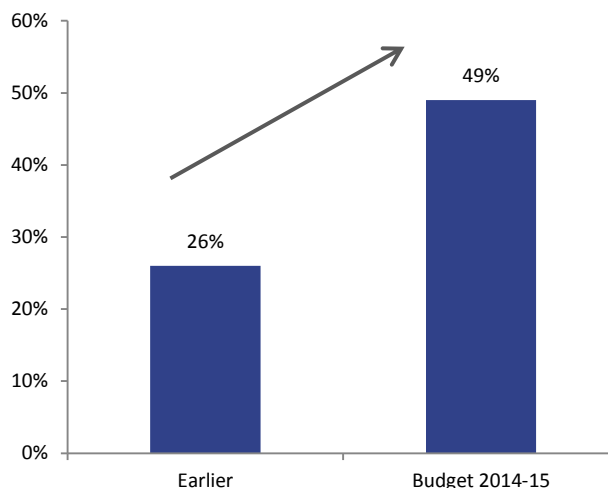
### Rising defence expenditure and increase in FDI limit to enhance its indigenization efforts

In the budget 2014-15, the GoI liberalized its defence sectors, by raising foreign investment caps to 49%. The raising of foreign direct investment (FDI) caps aims to turn India from an equipment importer to a defence equipment maker. With the lifting of the foreign direct investment (FDI) limit in the defence sector, the GoI also increased the country's annual defence outlay by 12.5% to USD 38.35 bn. To boost the military modernisation, the GoI allocated an additional ₹50 bn for capital expenditure for the acquisition of new weapon systems and hardware.

**Indian defence spending rose 12.5%YoY in the union budget 2014-15**



**FDI limit in defence enhanced to 49% in the union budget 2014-15**



As the Indian defence budget is increasing over the years and likely to increase further, India will be an attractive market for the foreign defence vendors. This will boost the competition for supply of equipments to Indian armed forces. On one hand, BEL will face stiff competition but on the other hand, it gives an opportunity to forge alliances with these major vendors and also opens the Offset's market. India already has an offset policy for the Defence sector where foreign suppliers have to buy a certain percentage of the total value of the supplies locally and this Policy ensures unobstructed growth.

### Company's thrust on R&D; likely to roll out more new developed products

Approximately 41% of BEL's turnover is from products developed in-house, 44% from products developed in collaboration with DRDO, and 15% from products based on overseas

*The company is focusing on R&D by leveraging its capabilities and strengths in the defence business to develop more critical technologies/systems.*

*Recent amendments to Defence Procurement Procedure (DPP)-2011 announced by the defence ministry expressly mandate that the military will buy foreign weapons only if every other option for developing the system in India has been explored and found non-feasible.*

technologies. BEL invested around 7.56 % of its turnover in R&D during FY14. Additionally, the company has two Central Research Laboratories that work on futuristic technologies. Being the main thrust of the Government, the indigenous development of critical technologies/systems and strategic systems required for Indian defence, is an area restricted to the DRDO. We believe that BEL will be able to play a greater role in this space given its technological tie-up with DRDO. In order to reduce dependence on other countries for foreign technology, the company is focusing on indigenization. Therefore, efforts are being made to indigenize defence equipment wherever technologically feasible and economically viable. BEL is also taking adequate initiatives for joint developments with reputed foreign companies to quickly harness specialized technologies into the new products. This in turn has enabled the company to reduce costs due to availability of technology in India at a significantly lower cost. Recently, the company has received an approval from FIPB to form JV with Thales for design, development, marketing, supply & support of civilian and select defence radars. This in turn has enabled the company to reduce costs.

In FY14, BEL filed for 9 Patents in the areas of x-ray baggage scan images, radar scan converter, the gradient estimate for adaptive analog beam, accurate target bearing using digital compass, multiple voice streams in the packet based transmission, wide band switch limiter and monocyte impulse generator. Looking ahead, the company has decided to increase its R&D spend from the current 7% to between 8% and 10% in the coming years in order to increase self-reliance through indigenisation.

### **Recent amendment to DPP to increase competition from private players**

Recent amendments to Defence Procurement Procedure (DPP)-2011 announced by the defence ministry expressly mandate that the military will buy foreign weapons only if every other option for developing the system in India has been explored and found non-feasible. This shifts the onus for pursuing indigenisation onto the military. The recent amendments to DPP will provide the private sector with a level-playing field against the government-owned companies. For instance, now maintenance transfer of technology from foreign vendors will not go to an ordnance factory nominated by the defence ministry; instead, the foreign vendor can choose the Indian partner that it believes will best discharge the maintenance responsibility that the contract specifies. So far maintenance, repairs and overhaul contracts have largely been the preserve of ordnance factories and defence public sector undertaking (DPSUs). This remains a concern for BEL as it would increase competition from the private sector. However, in order to deal with the increasing competitiveness and productivity, the company is focusing on enhancing value addition by leveraging its capabilities and strengths in the Defence business, which in turn would open more avenues for JV with foreign Original Equipment Manufacturers (OEMs).

**Balance Sheet (Consolidated)**

Y/E (₹mn)	FY13A	FY14A	FY15E	FY16E
Share Capital	800	800	800	800
Reserve and surplus	64,075	71,403	78,543	86,397
<b>Net Worth</b>	<b>64,875</b>	<b>72,203</b>	<b>79,343</b>	<b>87,197</b>
Minority Interest	34	38	38	38
Government grant	1,597	2,206	2,868	3,728
Loans	2	3	3	3
Other long term liability	368	76	76	76
Long-term provisions	3,491	3,568	3,760	4,155
Deferred tax Liability	0	0	0	0
Current Liability	78,143	71,664	65,198	60,623
<b>Total Liabilities</b>	<b>148,509</b>	<b>149,757</b>	<b>151,285</b>	<b>155,820</b>
Fixed assets	9,282	11,530	12,315	13,256
Deferred tax assets	2,740	3,015	3,015	3,015
Investments	0	0	0	0
Loans & adv	1,607	687	756	847
other asset	799	937	1,012	1,114
Current Assets	134,081	133,588	134,187	137,588
<b>Total Assets</b>	<b>148,509</b>	<b>149,757</b>	<b>151,285</b>	<b>155,820</b>

**Key Ratios (Consolidated)**

Y/E	FY13A	FY14A	FY15E	FY16E
EBITDA Margin (%)	10.6	14.1	14.6	15.0
EBIT Margin (%)	18.4	18.5	18.4	18.9
NPM (%)	14.5	14.6	14.5	14.9
ROCE (%)	16.4	15.5	15.1	15.5
ROE (%)	14.0	13.2	12.9	13.3
EPS (₹)	113.8	118.9	128.1	145.1
P/E (x)	18.6	17.8	16.5	14.6
BVPS (₹)	810.9	902.5	991.8	1,090.0
P/BVPS (x)	2.6	2.3	2.1	1.9
EV/Net sales (x)	1.9	1.9	1.8	1.7
EV/EBITDA (x)	17.5	13.4	12.4	11.2

**Profit & Loss Account (Consolidated)**

Y/E (₹mn)	FY13A	FY14A	FY15E	FY16E
<b>Revenue</b>	<b>62,727</b>	<b>65,179</b>	<b>70,528</b>	<b>77,886</b>
Expenses	56,098	55,963	60,231	66,203
<b>EBITDA</b>	<b>6,629</b>	<b>9,215</b>	<b>10,297</b>	<b>11,683</b>
Other Income	6,254	4,373	4,285	4,714
Depreciation	1,365	1,499	1,589	1,684
<b>EBIT</b>	<b>11,519</b>	<b>12,089</b>	<b>12,994</b>	<b>14,713</b>
Interest	26	-	-	-
Interest	8	35	30	25
<b>Profit Before Tax</b>	<b>11,536</b>	<b>12,054</b>	<b>12,964</b>	<b>14,687</b>
Tax	2,363	2,544	2,722	3,084
Minority Int	4	4	4	4
Prior period adjustment	(61)	6	6	6
<b>Net Profit</b>	<b>9,108</b>	<b>9,513</b>	<b>10,244</b>	<b>11,606</b>

**Valuation and view**

Holding a dominant position in the Indian defence industry, we believe the growth opportunity for BEL is large, given the increased focus of the new government on defence spending, both for capital equipments and modernization of technologies. The company continues to be a market leader, with ~60% market share in defence electronics in India. Thrust on R&D by the company will continue with roadmaps drawn for future products and key technologies. BEL's order backlog remained healthy at ₹233 bn, which is about 3.7 times its FY14 revenue, provides growth visibility of two to three years. The roll out of new products with good business potential is also expected to boost the orders inflows.

Considering the above aspects, we rate the stock as 'BUY' at a current CMP of ₹2,017.4 attractively placed at P/BVPS of ~2.1x and ~1.9x, for FY15E and FY16E, respectively to arrive at a target price of ₹2,500, with a potential upside of ~23.9% for the coming 12 months.



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