

India Defence Sector

Looks like it is for real this time

INDIA | CAPITAL GOODS | Sector Update

10 August 2020

Ministry of Defence (MoD) has had a very busy 1HFY21

Starting with the launch of the latest iteration of Defence Procurement Procedure (DPP-2020) in April, followed by Rs 390bn DAC approvals in July, the draft Defence Production & Export Promotion Policy (DPEPP) earlier in August and today the announcement of a negative list of products coupled with a separate allocation of the defence budget for domestic industry. The back to back policy announcements by MoD, probably makes it one of the most active ministries in present times, contrary to popular perception.

Negative list 1.0 – the first of many. Limited near term impact - more structural

In a first, MoD announced a list of 101 defence products that would necessarily be procured domestically. As expected, the first list is backward looking, and contains products that are already manufactured in India or are under works and will be localised over the next 3-4 years. Hence 80 out of the 101 will be embargoed in 2020-21 and balance will be localised by 2025. We believe that while the first list does not have a material incremental impact on import substitution in the near term, just Rs 350-500bn over 6-7 years, but we expect subsequent lists over the next 5-10 years to be more forward looking. The negative list will work in tandem with the existing 15 year 'Long Term Integrated Procurement Plan' providing the industry a roadmap to invest, localise technologies and develop eco-systems.

Separate budget for domestic procurement is the real game changer

In the near term we believe the decision to set aside a separate portion of the defence capital budget for domestic procurement will have a more profound impact than the negative list. As widely known, India is one of the largest importers of defence equipment, globally. As a result expenditure on imports used to crowd out domestic procurement. This used to elongate timelines for order placements, typically 4-5 years after field tests, and in the past three years also led to deterioration in working capital, particularly of DPSU's (receivables turns increased to c.300 days from earlier 100 days). We believe a separate budget for domestic procurement should first lead to improvement in working capital of companies and then progressively lead to timely order placements. For FY21, the government has set aside 46% of the capital budget for domestic procurement vs. 41% in FY20. Based on our analysis this should not only help place Rs 600bn of new orders on local companies vs. Rs 250-300bn in FY20 but also improve NWC intensity of BEL and HAL.

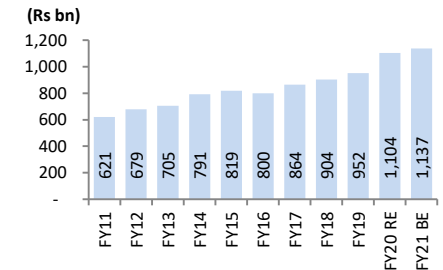
So, what next? Increased allocation to defence

In our view, the next and final reform would be a bottom up driven structural increase in defence capital spending (currently at 0.6% of GDP). The DPEPP alluded to a 15% yoy in domestic defence expenditure between CY2020-25. However, we do note that India does not have headroom to materially increase its defence budget in FY21-22 and hence meeting the targeted 15% yoy will be difficult. However, even a 10% yoy would imply a 40% increase over the current budget growth of 7% CAGR FY16-21. We expect clarity on this issue to emerge with the 15th Finance Commission report by end of CY20.

Our take: Govt walks the talk on policies but proof of the pudding when money flows in

Reforms in the defence sector have had many false starts in the past 10 years. However, the granularity that has gone into recent policy announcements highlights the serious intent of the government towards developing indigenous defence manufacturing capabilities. Recent geo political events only increase the urgency quotient. A regular follow up on future negative lists and sequential increase in budgetary allocation to domestic industry should lead to structural changes in the sector. We believe the defence theme is now here to stay. We would monitor improvement in cash flows followed by faster order placements as lead indicators of better times. **BUY Bharat Electronics within our coverage. Other first derivative beneficiaries are HAL, BDL, L&T and Bharat Forge.**

India's defence capex trend



Source: India Budget, PhillipCapital India

Company	Rating	CMP (Rs)	TP (Rs)
BEL	Buy	99	130
BDL	Neutral	417	400
CSL	Neutral	331	295
HAL	UR	944	-
L&T	Buy	916	1,100
Bharat Forge	Neutral	407	325
GRSE	Not rated	202	-
Midhani	Not rated	205	-

Source: PhillipCapital India

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List of products embargoed from 2020

S No	Name of Platform/ Weapon/ System/ Equipment	Indicative year	Beneficiaries
1	120mm Fin Stabilised Armour Piercing Discarding Sabot (FSAPDS) Mark II Ammunition	Dec-20	Under development
2	7.62x51 Sniper Rifle	Dec-20	Under development
3	Tracked Self Propelled (SP) Gun (155mm x 52 Cal)	Dec-20	L&T
4	Towed Artillery Gun (155mm x 52 Cal)	Dec-20	BFL,Tata
5	Short Range Surface to Air Missiles (Land variant)	Dec-20	BFL, BDL, BEL
6	Shipborne Cruise Missiles	Dec-20	BDL
7	Multi Barrel Rocket Launcher (MBRL) (Pinaka Variant)	Dec-20	Tata, L&T, BDL
8	Simulators Presenting Smart Ranges And Multi-Function Targets	Dec-20	
9	Battalion Support Weapons Simulators	Dec-20	
10	Container-based Simulators for Live Fire Training	Dec-20	
11	Tailor-made Simulators for Counter Insurgency (CI)/ Counter Terrorism (CT) based Training	Dec-20	
12	Force-on-force Live Tactical Simulators / Infantry Weapon	Dec-20	
13	Tank Simulators (driving, as well as, crew gunnery)	Dec-20	Zen Technologies
14	155mm/39 Cal Ultra-Light Howitzer	Dec-20	M&M
15	Successor of Flycatcher & Upgraded Super Fledermaus (USFM) / Air Defence Fire Control Radar	Dec-20	BEL
16	Component Level Repair Facility for Tank T-90	Dec-20	OFB
17	Shipborne Close in Weapon System	Dec-20	BEL
18	Bullet Proof Jackets	Dec-20	SMPP, Midhani
19	Ballistic Helmets	Dec-20	MKU, Midhani
20	Missile Destroyers	Dec-20	MDL
21	Multi-Purpose Vessel	Dec-20	HSL, L&T
22	Offshore Patrol Vessel	Dec-20	L&T, GRSE
23	Next Generation Missile Vessels	Dec-20	MDL, L&T, GRSE, CSL
24	Anti-Submarine Warfare Shallow Water Crafts	Dec-20	GRSE, CSL, L&T
25	Water Jet Fast Attack Craft	Dec-20	GRSE,L&T, HSL
26	Ammunition Barges	Dec-20	L&T, GRSE, HSL
27	50ton Bollard - Pull Tugs	Dec-20	L&T, MDL, GSL
28	Survey Vessels	Dec-20	GRSE, L&T
29	Floating Dock	Dec-20	L&T, MDL, HSL
30	Diving Support Vessels	Dec-20	HSL
31	Pollution Control Vessels	Dec-20	HSL, CSL, GRSE, L&T
32	Anti-Submarine Rocket Launchers	Dec-20	L&T
33	Shipborne Medium Range Gun	Dec-20	BHEL
34	Torpedo Tube Launcher for Light Weight Torpedoes	Dec-20	L&T
35	Magneto - Rheological Anti Vibration Mounts	Dec-20	Keltron- DRDO
36	All variants of Depth Charges	Dec-20	
37	Shipborne Sonar System for Large Ships	Dec-20	BEL
38	Hull Mounted Submarine Sonar	Dec-20	BEL
39	Short Range Maritime Reconnaissance Aircraft	Dec-20	HAL (DO-228)
40	Anti-Submarine Rocket	Dec-20	L&T
41	Chaff Rockets	Dec-20	BDL, OFB
42	Chaff Rocket Launcher	Dec-20	OFB
43	Integrated Ship's Bridge System	Dec-20	BEL
44	Light Combat Aircraft (LCA) MK I A - Enhanced Indigenised Content	Dec-20	HAL
45	Light Combat Helicopters	Dec-20	HAL
46	General Purpose Pre Fragmentation Bombs between 250-500 Kg	Dec-20	DRDO
47	Radar Warning Receiver (RWR) for Transport Aircraft	Dec-20	BEL
48	Ground Based Mobile ELINT System	Dec-20	BEL
49	Transport Aircraft (Light)	Dec-20	HAL-NAL-underdevelopment
50	GSAT-6 Satellite Terminals	Dec-20	BEL
51	Aerial Delivery Systems for Transport Aircraft	Dec-20	ADRDE-DRDO-under development
52	Digital Tropo Scatter/LOS Communication System	Dec-20	BEL
53	Low Level Transportable Radar	Dec-20	BEL
54	High Power Radar (HPR)	Dec-20	BEL
55	CBRN Detection & Monitoring System	Dec-20	DRDO - development)
56	CBRN Decontamination & Protection System	Dec-20	DRDO - development)
57	Parachute Tactical Assault (PTA)- G2	Dec-20	DRDO-OFB - under development
58	Dragunov Upgrade System	Dec-20	OFB

59	PKMG Upgrade System	Dec-20	OFB
60	Simulators for A Vehicles / B Vehicles	Dec-20	
61	Simulators for Towed and Self Propelled Guns of Air Defence	Dec-20	
62	Simulators for Correction of Fire by Observers	Dec-20	
63	Military trucks of 4x4 and above variants: 12x12, 10x10, 8x8, 6x6	Dec-20	Tata, Ashok Leyland
64	Fixed Wing Mini UAVs	Dec-20	HAL
65	500 Ton Self Propelled Water Barges	Dec-20	Indian shipyards
66	Software Defined Radio (TAC) for IN	Dec-20	BEL
67	Next Generation Maritime Mobile Coastal Battery (Long Range)	Dec-20	BrahMos Aerospace
68	Advance Landing Ground Communication Terminals (ALGCTs) for AGLs	Dec-20	
69	Field Artillery Tractor (FAT) 6X6 for Medium Guns	Dec-20	Ashok Leyland

Source: MoD, PhillipCapital India Research

List of products embargoed from 2021-25

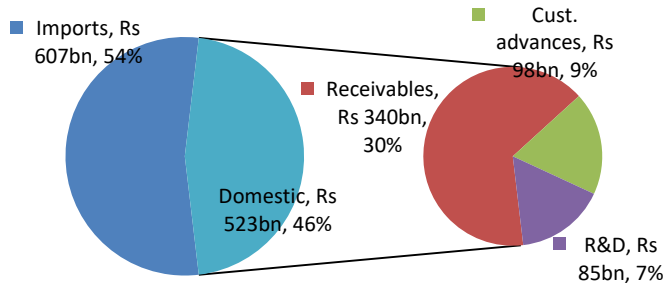
S No	Name of Platform/ Weapon/ System/ Equipment	Indicative year	Beneficiaries
70	Wheeled Armoured Fighting Vehicle (AFV)	Dec-21	200 nos to be imported
71	Light Machine Gun	Dec-21	OFB
72	125 mm Fin Stabilised Armour Piercing Discarding Sabot (FSAPDS) New Generation Ammunition	Dec-21	OFB
73	Assault Rifle 7.62 x 39mm	Dec-21	OFB
74	30 mm Ammunition for Infantry Fighting Systems	Dec-21	OFB
75	Mine Fragmentation	Dec-21	OFB
76	Mine Anti-tank	Dec-21	OFB
77	Mine Anti-Personnel Blast	Dec-21	OFB
78	Multipurpose Grenade	Dec-21	OFB
79	Inertial Navigation System for Ship Application	Dec-21	BEL
80	Conventional Submarines	Dec-21	MDL, L&T
81	40mm UBGL (Under Barrel Grenade Launcher)	Dec-22	OFB
82	Lightweight Rocket Launcher	Dec-22	BDL, L&T, Tata, OFB
83	155 mm Artillery Ammunition	Dec-22	OFB
84	EW Systems	Dec-22	BEL
85	Material Handling Crane 2.5 to 7.5 Tons (Vehicle Mounted)	Dec-23	
86	GRAD BM Rocket	Dec-23	OFB
87	30MM HEI/HET	Dec-23	OFB
88	ASTRA-MK I Beyond Visual Range Air to Air Missile (BVR AAM)	Dec-23	BDL
89	EW Suit for MI-17 V5	Dec-23	BEL
90	Communication Satellite GSAT-7C	Dec-23	BEL
91	Satellite GSAT 7R	Dec-23	BEL
92	Basic Trainer Aircraft (BTA)	Dec-23	HAL
93	Expendable Aerial Targets	Dec-24	DROD-OFB
94	Small Jet Engines with 120kgf thrust	Dec-24	HAL
95	Light Low Level Terrain Radar (LLLWR)	Dec-24	BEL
96	Close in Weapon System (Land based)	Dec-24	BEL
97	23 mm ZU Ammunitions	Dec-24	OFB
98	30mm VOG 17	Dec-24	OFB
99	Electronic Fuses for Artillery Ammunitions	Dec-24	Solar Industries, BEL, OFB
100	Bi- Modular Charge System (BMCS)	Dec-24	OFB
101	Long Range – Land Attack Cruise Missile	Dec-25	BDL

Source: MoD, PhillipCapital India Research

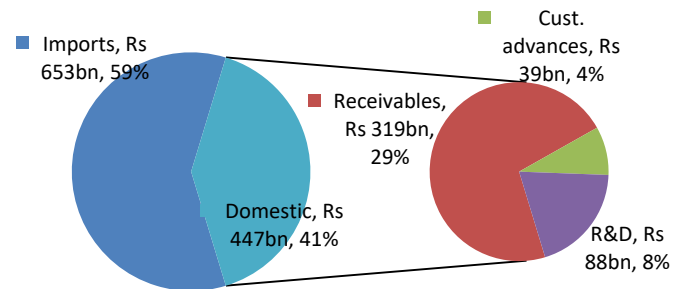
46% of India's FY21 defence capital budget has been set aside for domestic companies...

...vs 41% in FY20, based on our estimates

Defence capital budget - FY21BE



Defence capital budget - FY20



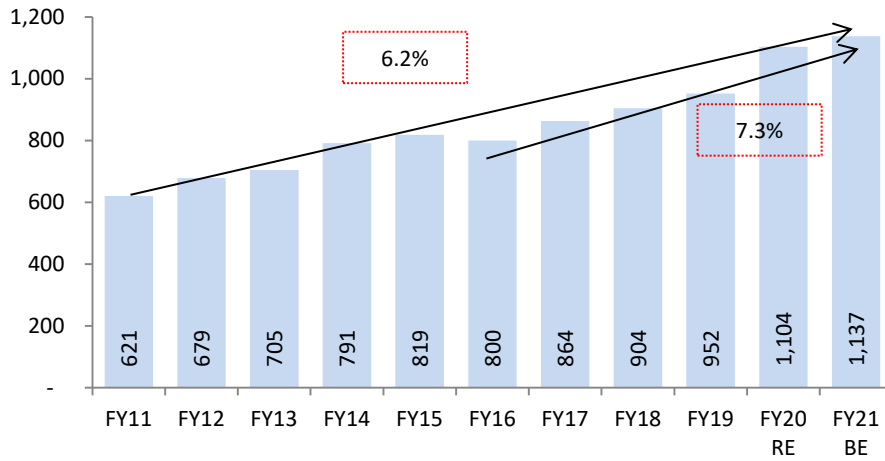
Source: PhillipCapital India Research, MoD

A separate domestic budgetary allocation of Rs 520bn in FY21 for domestic industry should not only improve working capital of large DPSU's but also leave room for higher order inflows

Company	FY20	FY21E	Comments
HAL	102	125	Rs60bn of ROH is funded through revenue route Ex of non-defence revenues (Rs20bn), 20% of Defence revenue is funded through revenue route
BEL	58	75	
MDL	47	35	
BDL	28	25	
CSL	24	21	Funding towards IAC
GRSE	9	12	
L&T	15	15	Direct sales
BEML	15	10	Defence segment sales
GSL	10	10	
HSL	7	7	
Midhani	5	5	Defence segment sales
R&D - DRDO	88	85	
Total Receivables funding	408	425	
Advances @ 15% of order inflows			
HAL	-	60	
BEL	18	23	
BDL	2	15	
CSL	9	-	
GRSE	9	-	
Total advances for orders (B)	39	98	Expect Rs 650bn of new orders to be placed in FY21 vs Rs 300bn in FY20
Outgo for domestic procurement (A+B)	447	523	-
Outgo towards Imports - balance	653	607	
India capital budget	1,100	1,130	
Domestic % of Defence capital budget	41%	46%	
Imports % of Defence capital budget	59%	54%	

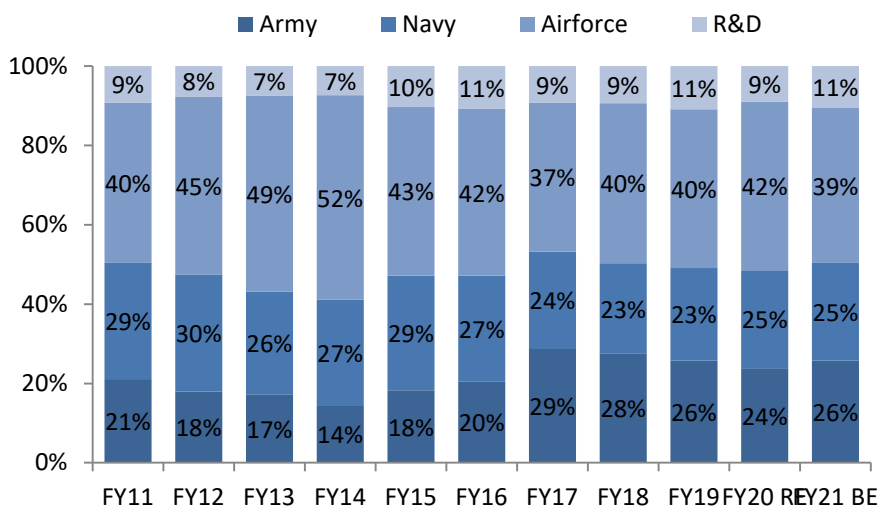
Source: PhillipCapital India Research

India's defence capital outlay has grown at 7% CAGR in the past five years. Expect this pace of growth to increase with the 15th Finance Commission recommendations (Rs bn)



Source: Defence budget, PhillipCapital India Research

Split of capital budget



Source: Defence budget, PhillipCapital India Research

Rating Methodology

We rate stock on absolute return basis. Our target price for the stocks has an investment horizon of one year. We have different threshold for large market capitalisation stock and Mid/small market capitalisation stock. The categorisation of stock based on market capitalisation is as per the SEBI requirement.

Large cap stocks

Rating	Criteria	Definition
BUY	$\geq +10\%$	Target price is equal to or more than 10% of current market price
NEUTRAL	$-10\% > \text{to} < +10\%$	Target price is less than +10% but more than -10%
SELL	$\leq -10\%$	Target price is less than or equal to -10%.

Mid cap and Small cap stocks

Rating	Criteria	Definition
BUY	$\geq +15\%$	Target price is equal to or more than 15% of current market price
NEUTRAL	$-15\% > \text{to} < +15\%$	Target price is less than +15% but more than -15%
SELL	$\leq -15\%$	Target price is less than or equal to -15%.

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