

India Defense Sector

At the cusp of strong growth upcycle

Ministry of defense (MoD) organized defense expo 2022 in Gandhinagar, Gujarat with a theme “Path to Pride”. The aim was to showcase the might of the domestic defense industry. **Following is our key takeaways from our recent visit to the DefExpo 2022:**

1. **Concerted push towards indigenization/“aatmanirbhar” defence:** Inline with the current policy of boosting domestic defence industry, Govt. unveiled 4th positive indigenization list of 101 items. So, now total 411 items are placed in positive indigenization list. General buzz was that many things are surely changing positively, policy support is there, and many industry players - mainly smaller ones – indicated that we are at the cusp of strong growth cycle.
2. **But, many kinks still need to be ironed out:** Though large part of the industry participants was optimistic. But feedback also suggest many niggling issues are persisting, for example –
 - Consistent order flow for the private industry is still elusive: Many private companies has done large investments (e.g. L&T defence has done ~INR 8000 cr investments) but assembly line is lying idle/underutilised (Vajra K9 SPH plan Hazira, or Katupalli dockyard)
 - Insistence on “make in India” for low volume orders without roadmap for follow-on orders – there was feedback from one industry player that GoI wants “make in India” for 4 units only (without any Govt commitment for regular follow-on orders). Depreciation expense of new plant & machinery on 4 units will make the item exorbitantly expensive, but Govt wants L1 price as well.
 - Few foreign OEM’s cited they already an established supply chain, and it is unattractive to creating parallel supply chain in India for limited sized orders. Also, foreign OEM’s have to comply with local regulations in the home country (like UK, USA, etc) which prohibits export/transfer of sensitive IP/technology.
 - Another sticking point is IP ownership during commercial/production phase: Govt is willing to fund development projects, but wants to retain IP without committing to production orders later to same development partner. Govt idea is to develop IP separately and then use L1 route for production via transfer of technology/IP.
 - Multiple players indicated trouble with L1 bidding route. Many times requirements are diluted to avoid single-vendor situation and/or increase bidders. This creates a piquant situation for player(s) who has invested based on earlier/original requirements.

We believe, Govt is aware is some of these challenges and hence indigenization list of more focused of mostly on “low to medium tech” items spread over 7-8 years period moving gradually from low tech items to higher tech items.

3. **Mindset change:** Our interaction with industry participants showed signs of change in Armed forces mindset towards accepting homegrown technologies and made in India products. Additionally focus is beginning to shift to dealing with only large PSUs to smaller private sector players.
4. **Identifying Winners:** Companies which can be part of value chain of large domestic platforms, participate in offset programs of global vendors and become part of the Global vendors value chains are likely to emerge as winners.
5. **Focus on “Win” Ratios-to identify the winners:** one should focus on the Tender win ratios of the companies. “Win” ratio among private platform player suggest that L&T defense, TASL (Tata advanced systems ltd) has cracked the code of Govt. defense procurement process compared to other large domestic peers. Now, Adani defense is catching up fast

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Date: October 28, 2022

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6. **INR 8 Lakh crore worth of orders for domestic procurement:** On the sidelines of the DefExpo, Army chief said that domestic defense contracts worth INR 8 lakh crore is likely over next 7-8 years. This is ~3x of current domestic defense industry order book (We estimate current domestic order book of ~INR 2.7-2.8 lakh). We believe, given the trend growth in defense capital budget outlay with increasing share for indigenous products, total domestic orders are likely to exceed INR 8 crore by a wide margin.
7. **25-30 domestic projects will enter production phase:** Our interaction with DRDO and range of companies suggest that around 25-30 projects (like Pinaka ER/guided, VSHORAD, VL-SRSAM, QRSAM, Brahmos-NG, guided munitions, HTT-40 trainer, LUH etc.) have completed development. Hence, within next 1-3 years we may see "explosion" of contracts for production & procurements these items.
8. **Exports very likely to exceed target of US\$5bn by 2025:** General feedback was that Pinaka and Brahmos systems are emerging as a much sought after in the exports markets. Also, Govt of India (GoI) invited ~75 countries to showcase India domestic capabilities. Defense minister hosted IoR+ conclave with 40 countries and urged them to "leverage India's R&D ecosystem for mutual benefit".

EWM View:

Overall, based on the industry player's feedback, we believe that optimism is based not on hope but is coming from policy steps from GoI, competency building and maturity of domestic R&D, greater interaction & handholding by defense services, large of projects crossing over into production phase after completion of development phase, and acceptability of Indian products in Exports markets (most notably Brahmos and Pinaka systems).

We believe, companies like **BDL** (CMP INR 988, Mcap INR 18,105 cr) , **HAL** (CMP INR 2501, Mcap 83,640 cr) and **BEL** (CMP INR 108, Mcap INR 78,836 cr) among PSU's and **PTC Industries** (CMP INR 2859, Mcap INR 3,745 cr), **Paras Defense** (CMP INR 639, Mcap INR 2,490 cr), **Data Patterns** (CMP INR 1335, Mcap INR 6,930 cr) and **SOLAR industries** (CMP INR 3935, Mcap INR 35,611 cr) among private companies are better placed to exploit the upcoming opportunity.

We believe, Industry likely to growth at ~15% CAGR over next 5 years with resilient margins

Using combination of 3 factors) - 1st – Base/trend growth rate (8-9% = annual capital budget increase), 2nd – Incremental growth from Indigenization/Aatmanirbhar push (4-5% = annual shift towards domestic procurement), and 3rd – Incremental growth from Exports/Offset (~2% = Line of Credit + Offset + clear targets/dedicated policy support to drive exports).

- Above three factors will translate into ~14-15% long-term (5yrs+) sector/industry growth rate.
- Value migration will lead to differing individual sub-sectors growth trend – “Structural” players will be slower, while “Electronics/Sensors” will be faster.

Margins to be resilient going ahead as

- Since, revenue growth is accelerating so the operating leverage effect will support margins.
- Bulk of headwinds (chip shortage, Pandemic disruption, supply chain issues) is already behind and likely to moderate over FY23. These disruptions have impacted revenues (and margins), and since orders are still standing so deferred delivery will increase growth rate in FY23/24.
- Also in some companies (especially long/medium cycle product companies), refurbishment/repair & Overhaul segment is gradually becoming meaningful.

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Exhibit 01: Defense sector quick snapshot

	CMP, Rs		Revenue (Rs Cr)			EBITDA margins, %		EPS (Rs/sh)			P/E (x)		RoCE, %		RoE, %
	INR	INR cr	FY22	FY23E	FY24E	FY22	FY23E	FY22	FY23E	FY24E	FY22	FY23E	FY24E	FY22	FY22
BDL	988	18,105	2,817	3,550	4,260	25.8	26.4	27	38	46	36	25.9	21.3	26.1	18.3
HAL	2,501	783,640	24,620	26,757	28,790	22.7	23.5	152	136	148	16	18.3	16.9	30.5	29.4
BEL	108	78,836	15,368	17,847	19,865	21.7	21.8	3	4	5	34	29.0	23.0	27.1	20.5
GRSE	364	4,164	1,758	2,637	3,692	8.0	7.7	17	20	25	22	18.4	14.6	20.5	15.1
Mazagon Dock Ltd	516	10,400	5,733	6,937	8,186	7.6	7.8	30	34	36	17	15.3	14.2	25.4	19.1
Cochin Shipyards	478	6,290	3,191	3,670	3,890	19.5	20.5	43	48	46	11	10.0	10.3	18.7	14.1
DATA Patterns	1,335	6,930	311	3,917	4,857	45.3	42.4	22	23	28	62	59.1	47.7	33.4	24.0
MTAR Ltd	1,584	4,871	322	512	712	29.3	30.8	20	30	42	80	52.4	37.7	15.7	11.9
ASTRA Microwave	306	2,648	750	-	-	11.6	-	4	-	-	70	-	-	11.0	6.9
PTC Industries Ltd	2,859	3,745	179	-	-	23.5	-	10	-	-	292	-	-	9.6	8.6
Paras defense	639	2,490	183	-	-	28.4	-	7	-	-	92	-	-	12.4	9.2
Apollo Micro systems	220	457	243	-	-	18.9	-	7	-	-	31	-	-	8.7	4.7
SOLAR Industries	3,935	35,611	3,948	-	-	21.7	-	49	-	-	81	-	-	25.4	25.3
Premier Explosives	464	499	199	-	-	10.6	-	5	-	-	95	-	-	5.7	3.0
Zen Technologies	204	1,618	70	-	-	7.1	-	0.3	-	-	816	-	-	2.4	1.0

Source: Edelweiss Wealth Research, companies

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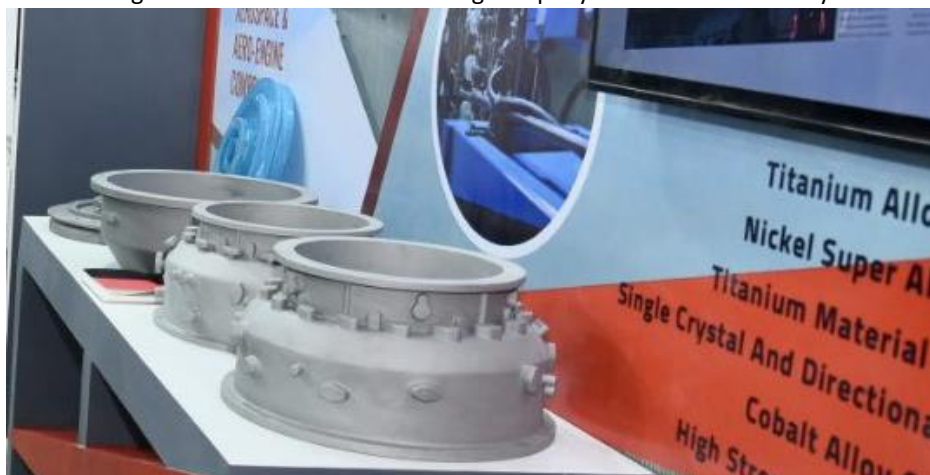
Appendix – Snapshots of few offerings from various companies in the DefExpo 2022

SOLAR industries – Only ~5% of revenues is from defence business. However, Solar is part of supply chain of many key programs like Pinaka systems, Brahmos missiles, multi-mode grenades and ammunitions.



Source: Edelweiss Wealth Research, companies

PTC industries – A growth advanced manufacturing company with customer BAe systems and Safran



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Source: Edelweiss Wealth Research, companies

Paras aerospace (subsidiary of Paras defence and space technologies ltd)

Angular UAV – highly suitable for windy, mountainous regions



MALE (medium altitude, high endurance) dual role UAV – in drawing board stage currently



Source: Edelweiss Wealth Research, companies

Companies like L&T defense, Adani defense and Tata Advanced systems are diversified defense platform providers with varied offerings across segments

L& T defense: Diversified offering across guns, land systems, UAV's



Adani Defense: One of most varied set of offerings



Source: Edelweiss Wealth Research, companies

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TATA – C-295 tactical aircraft, Production facility coming up at Vadodara, Gujarat.



TATA – ATAGS artillery gun systems



Source: Edelweiss Wealth Research, companies

UAV's was the most prominent and most numerous offering in the DefExpo. Below is the image of UAV from BEML.



Source: Edelweiss Wealth Research, companies

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Multiple programs have crossed development phase: Single image below shows HELINA (Helicopter launched anti-tank missile), MPATGM (man-portable anti-tank guided missile), QRSAM (quick reaction surface to air missile), NAG (nag anti-tank missile)



Source: Edelweiss Wealth Research, companies

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Vivek Khanna	Delhi

Coverage Universe

Sr. No	Coverage
1	Aditya Birla Fashion & Retail Ltd
2	Aegis Logistics Ltd
3	Amber Enterprises India Ltd
4	Astral Ltd
5	Balaji Amines Ltd
6	Bata India Ltd
7	Birla Corporation Limited
8	Can Fin Homes Ltd
9	Century Plyboards India Ltd
10	Cholamandalam Inv and Finance Ltd
11	City Union Bank Ltd
12	CreditAccess Grameen Ltd
13	Crompton Greaves Consumer Electricals Ltd
14	CSB Bank Ltd
15	Deepak Nitrite Ltd
16	Easy Trip Planner Ltd
17	Escorts Ltd
18	Finolex Industries Ltd
19	Home First Finance Company India Ltd
20	Indo Count Industries Ltd
21	K P R Mill Ltd
22	KNR Constructions Ltd
23	Krishna Institute of Medical Sciences Ltd
24	Lumax Industries. Ltd
25	Metropolis Healthcare Ltd
26	Minda Industries Ltd
27	Motherson Sumi Ltd
28	Navin Fluorine International Ltd
29	Neogen Chemicals Ltd
30	Newgen Software Technologies Ltd
31	Orient Electric Ltd
32	PSP Projects Ltd
33	Rossari Biotech Ltd
34	Shriram Transport Finance Company Ltd
35	SRF Ltd
36	Vinati Organics Ltd
37	Voltas Ltd
38	Westlife Development Ltd
39	Zydus Wellness Ltd
40	Tarsons Products Ltd
41	MTAR Technologies Ltd.
42	S J S Enterprises Ltd

Sr. No	Tactical Buy
1	ACC Ltd
2	Ajanta Pharma Ltd
3	Ambuja Cements Ltd
4	Ashok Leyland Ltd
5	Axis Bank Ltd
6	Bharat Electronics Ltd
7	Brigade Enterprises Ltd
8	DLF Ltd
9	eClerx Services Ltd
10	Globus Spittits Ltd
11	GNA Axles Ltd
12	HDFC Life Insurance Co. Ltd
13	ICICI Bank Ltd
14	Indusind Bank Ltd
15	Jamna Auto Industries Ltd
16	JK Cement Ltd
17	Larsen & Toubro Ltd
18	Mahindra and Mahindra Ltd
19	Max Financial Services Ltd
20	Max Healthcare Institute Ltd
21	PNC Infratech Ltd
22	RBL Bank Ltd
23	Sun Pharma Ltd
24	TechMahindra Ltd
25	Ultratech Cement Ltd
26	Elecon Engineering Company Ltd
27	Kennametal India Ltd

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