Equity Research
June 3, 2023
BSE Sensex: 62547

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Q4FY23 result review

Defence

Target price: Rs600

Shareholding pattern

	Sep '22	Dec '22	Mar '23
Promoters	84.8	84.8	84.8
Institutional investors	3.8	3.5	3.6
MFs and others	0.6	0.2	0.3
Insurance Cos.	0.1	0.0	0.0
FIIs	3.1	3.3	3.3
Others	11.4	11.7	11.6

Source: BSE

ESG disclosure score

Year	2020	2021	Chg
ESG score	**NA**	**NA**	**NA**
Environment	NA	NA	NA
Social	NA	NA	NA
Governance	NA	NA	NA

Note - Score ranges from 0 - 100 with a higher score indicating higher ESG disclosures.
Source: Bloomberg, I-sec research

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INDIA

ICICI Securities

Mazagon Dock Shipbuilders

SELL
Maintained

Margins improve, but order inflow is still a concern

Rs838

Mazagon Dock Shipbuilders' (MDL) Q4FY23 performance was 50% ahead of our estimates mainly on higher-than-expected revenue. Key points: 1) Revenue grew 49% YoY (14.5% QoQ) to Rs20.8bn mainly led by the commissioning of 5th submarine (under P75 programme); 2) EBITDA margin was 10.1% YoY (Q3FY23: 16.3%) owing to higher cost of material consumed; 3) orderbook at Mar'23 end was Rs385bn, likely to get executed by FY27. Going ahead, we perceive peak execution through to FY25E based on the current orderbook visibility. However, long gestation period implies free cashflow is likely to decline FY25E onwards with the unwinding of contract liability, resulting in cash depletion. Our TP on DCF-based valuation methodology remains unchanged at Rs600. Maintain SELL on the stock. Repeat orders of P-17A frigates or P15B destroyers are a key risk to our thesis.

- **Performance exceeds estimates.** MDL's Q4FY23 EBITDA of Rs2.1bn (up 172% YoY) exceeded consensus estimates by a wide margin of 50% mainly led by the commissioning of 5th Scorpene class submarine - Vagir on, 23 Jan'23. Key points: 1) Gross margin fell to 29.3% mainly due to higher cost of materials consumed as 6th submarine and two remaining destroyers enter the equipment fitting phase; 2) manpower cost also declined to 10.1% of revenue (Q3FY23: 10.9%) owing to cost efficiencies; and 3) EBITDA margin was 10.1% (Q3FY23: 16.3%) tracking lower gross margin. During Q4FY23 earnings call, management indicated EBITDA in FY23 was aided by refund of Rs1.74bn (22% of reported FY23 EBITDA) of liquidated damages (LD) by the Indian Navy pertaining to second submarine delivered earlier. Going ahead, management expects the current orderbook to exhaust by FY27 with peak revenue recognition in FY25. For FY24, management expects revenue growth of 10-12% YoY and EBITDA margin to remain at similar level as FY23 - sans the impact of LD refund.
- **Lack of orderbook visibility is a key risk.** While we expect robust revenue growth until FY25, we believe earnings growth is likely to recede owing to an uncertain order pipeline. In Q4FY23 earnings call, management mentioned bids for P-75I programme are likely to be submitted by 01 Aug'23 with evaluation of bids taking another 18 months. For FY24, management indicated possible order inflow of Rs42bn along with Medium Refit and Life Certification (MRLC) of a submarine spread over 3-4 years. Besides, there is no clarity on the timeline of repeat orders for destroyers.
- **Outlook: Unfavourable risk-reward.** MDSL's lack of order visibility offsets its near-term robust revenue estimate. As a result, we perceive unfavourable risk-reward at CMP. We maintain **SELL** on MDSL stock with an unchanged TP of Rs600 (based on DCF methodology).

Market Cap	Rs169bn/US$2.1bn
Bloomberg	MAZDOCKS IN
Shares Outstanding (mn)	201.7
52-week Range (Rs)	914/235
Free Float (%)	15.2
FII (%)	3.3
Daily Volume (US$'000)	18,535
Absolute Return 3m (%)	15.7
Absolute Return 12m (%)	187.1
Sensex Return 3m (%)	6.7
Sensex Return 12m (%)	13.5

Year to Mar	FY22	FY23	FY24E	FY25E
Revenue (Rs mn)	57,333	78,272	86,000	97,000
EBITDA(Rs mn)	4,381	7,978	8,762	10,027
Net Income (Rs mn)	6,142	11,190	12,216	11,767
EPS (Rs)	30.3	55.5	60.6	58.3
P/E (x)	27.7	15.1	13.8	14.4
CEPS (Rs)	28.4	34.0	59.2	64.8
EV/E (x)	39.7	12.4	4.4	2.5
Dividend Yield	1.04	1.32	1.45	1.39
RoCE (%)	14.5	21.6	19.8	16.4
RoE (%)	15.9	23.5	21.3	17.6

Table 1: Q4FY23 result review

(Rs mn)

	Q4FY23	Q4FY22	% Chg YoY	Q3FY23	% Chg QoQ
Sales	**20,786**	**13,964**	*48.9*	**18,159**	*14.5*
Cost of materials consumed	13,769	4,116	*234.5*	7,537	*82.7*
Procurement of base and depot spares	917	4,368	- *79.0*	1,527	*(40.0)*
Gross Margin	**6,100**	**5,480**	*11.3*	**9,095**	- *32.9*
Gross Margin (%)	*29.3*	*39.2*		*50.1*	
Employee benefit expenses	2,092	2,013	*4.0*	1,979	*5.7*
% of topline	*10.1*	*14.4*		*10.9*	
Sub-contract	780	968	*(19.5)*	2,247	*(65.3)*
Power and fuel	52	32	*62.0*	45	*16.6*
Other expenses - project related	171	307	- *44.4*	415	*(58.9)*
Other expenses	687	887	- *22.6*	593	*15.8*
Provisions	213	500		860	
Total Costs	18,680	13,191	*41.6*	15,202	*22.9*
EBITDA	**2,106**	**773**	*172.3*	**2,957**	*(28.8)*
Margin (%)	*10.1*	*5.5*		*16.3*	
Other Income	2,112	1,290	*63.7*	1,758	*20.1*
Finance costs	20	14	*38.0*	15	*32.4*
Depreciation and amortization expenses	204	229	*(11.2)*	184	*10.9*
PBT	**3,995**	**1,820**	*119.5*	**4,517**	*(11.6)*
Exceptional	-	-			
PBT post Exceptional	3,995	1,820	*119.5*	4,517	*(11.6)*
Tax	**1,027**	**371**	*177.0*	**1,145**	*(10.2)*
Current Tax	495	443		1,821	
Deferred Tax	532	-72		-676	
PAT	**2,968**	**1,449**	*104.8*	**3,373**	*(12.0)*
Share of profit/loss of associate	294	141	*108.7*	169	*74.0*
PAT with associate	**3,262**	**1,590**	*105.1*	**3,542**	*(7.9)*

Source: Company data, I-sec research

Q4FY23 concall highlights

- The company has capacity to build 11 submarines and 10 warships simultaneously, hence, executing any add-on order is unlikely to be a constraint.
- The current orderbook of Rs385bn is likely to get exhausted by FY27 with peak revenue generation in FY25.
- The company is participating in the upcoming RFPs for next generation corvettes, patrol boats and interceptor boats.
- Revenue growth expectations for FY24: Management expects revenue growth of 10-12% YoY and margin at a similar level to FY23, adjusted for LD refund. That said, if LD refund is also received in FY24, margin could inch up further.
- In FY24, management is targeting the delivery of one destroyer. It expects cost structure to be similar to FY23.
- In FY24, the company is expecting an order worth Rs32bn for patrol vessels for Indian Coast Guard and an export order worth Rs10bn.
- In FY23, revenue from repairs was 3% of total. The company is expecting one more order for MRLC of a 36-year-old German submarine. The submarine is already at the company’s shipyard and the formal order is expected within the next 45-60 days.
- Pending orderbook as on Mar’23-end: P75 Kalvari Submarines- Rs158bn, P17A Stealth Frigates- Rs185bn and P75 Kalvari Submarines- Rs42.5bn. Besides, Medium Refit and Life Certification (MRLC) orderbook stands at Rs1bn.
- P75 Kalvari Submarines: MDSL has executed orders of 5 submarines between FY17 and FY22. The last submarine is likely to be delivered by FY25.
- Project 15B Destroyers: MDSL has delivered two destroyers in FY21 and FY22. The management expects to deliver the third one in CY23 and last one in CY24.
- P17A Stealth Frigates: Management expects to deliver these ships FY25 onwards.
- The company has a comfortable position with negative working capital, net cash position and zero debt.
- Management mentioned that in view of the long gestation period, it is unfair to look at the EBITDA margin trend every quarter. If deliveries happen ahead of time, cost efficiencies, particularly pertaining to manpower costs are captured.
- FY23 EBITDA was also aided by Rs1.74bn of refund pertaining to LD refund received from the Indian Navy for the second submarine. Management has submitted similar application for LD refund of Rs6bn for three other submarines. It is hopeful of a favourable decision on this account.
- On exports front, the company has submitted a techno-commercial proposal to a shipyard in Russia for participating in its shipbuilding programme. However, in view of the current geo-political situation and the nature of work being very different from what was initially expected, not much traction has happened on this front.
- 3nos. P-75I programme: MDSL and L&T have been shortlisted. MDSL has executed a mutually exclusive contract with TKMS to participate in the bidding process. The bid is being firmed up now and the date of submission of bids is 01

August-23. Post bid submission, there is a likely evaluation which will take another 18 months. The order value is likely to go up from the current estimate of Rs430bn.

- Management mentioned that while the standing committee report on defence does not mention explicitly the ordering of destroyers or submarines until FY25, discussions for these orders are on with the government.
- MRLC contracts are by nomination with margin at 7.5-8%. In case of competitive bidding, variable component has margin of 7.5-8%; however, in case of fixed component, the company can make better margins through cost efficiencies.
- Cash balance (own) as of FY23-end stands at Rs18bn.

Valuation methodology and key risks

We value Mazagon Dock Shipbuilders Limited (MDL) using the DCF methodology. We maintain **SELL** rating with TP of Rs600/share.

Table 2: DCF valuation yields target price of Rs600/share

(Rs mn)	FY22	FY23	FY24E	FY25E	FY26E	FY27E	FY28E	FY29E	FY30E
Sales	57333	78272	86000	97000	93000	91000	88500	88500	87500
EBITDA	4381	7978	8762	10027	9559	9337	8940	8634	8097
Tax	1862	3566	3917	3764	3365	4255	4214	4285	4395
PAT	6142	11190	12219	11772	10602	13211	13092	13299	13621
NOPAT	2518	4412	4845	6263	6193	5082	4726	4349	3702
Working Capital Change	**4743**	**8702**	**4619**	**(43619)**	**(27738)**	**64706**	**(3636)**	**2944**	**10180**
Capex	(240)	(1596)	(1600)	(1600)	(1600)	(1600)	(1600)	(1600)	(1600)
FCF	7022	11518	7864	(38956)	(23145)	68187	(511)	5693	12282
Terminal Value									**180723**
Total FCF	7022	11518	7864	(38956)	(23145)	68187	(511)	5693	193005
Cost of Equity	12%								
WACC	10%								
Terminal Growth	3%								
NPV of FCFE (FY24E)	**1,06,076**								
Net Cash attributable to MDL (Longer term)	**15,000**								
Equity Value	**1,21,076**								
Net Equity value	600								

Source: Company data, I-Sec research

Key risks

Land lease. Approximately 42% of MDL's land is leased from Mumbai Port Trust (MbPT), of the balance, a small portion is on pre-owned basis and the rest is through Maharashtra government. Land leased from MbPT is divided into 13 plots. The lease with respect to four plots expired in CY06 and requests have been made to MbPT for renewal as MDL continues to occupy and pay rent as per the agreement on account of non-finalisation of the land lease policy. A couple of years back, MbPT finalised its land lease policy and raised a demand on MDL.

MbPT has proposed the renewal of expired leases of four plots for a period of 30 years by an upfront payment of around Rs2,721.4mn (plus applicable taxes) towards the lease premium and Rs408.2mn (plus applicable taxes) towards the arrears of rent FY06 onwards. This proposal of lease renewal also provides the option of annual payment of lease rent for a period of 10 years amounting to ~Rs194mn p.a. (plus applicable taxes). MDL has contested MbPT's proposal and has recognised an estimated reasonable lease rent in its financial statements.

The matter is under discussion at the ministry level between Department of Defence Production and Ministry of Shipping, Port and Waterways.

Consistent stream of order inflows. A consistent stream of order inflows is required for: i) Sustaining and developing MDL's present skillset while ensuring utilisation of the shipyard, and ii) ensuring healthy working capital dynamics, given requisite upfront advances that MDL receives for each government order. The same will be ensured by follow-on large-ticket orders like P75(I). Yet, the management has clarified P75(I) will accrue in its entirety to L&T or MDL, with little possibility of sharing the same order.

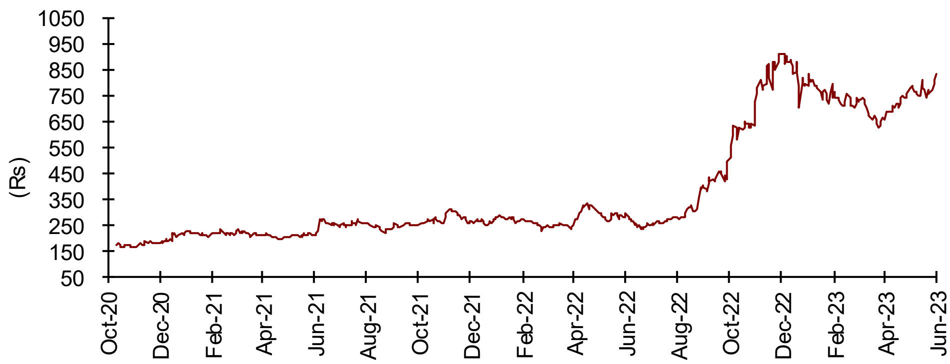
Changing laws, rules and regulations and legal uncertainties, including adverse application of tax laws and regulations, may adversely affect MDL's business, results of operations and cashflow.

Risks to execution. MDL's products are highly complex, require technically advanced and costly equipment and hazardous materials, and involve risks, including breakdown, failure or substandard performance of equipment, improper installation or operation of equipment, environmental and industrial hazards – which could result in damages and litigation. Dependency on suppliers for timely delivery of raw materials, equipment and components and non-adherence to the agreed timelines may adversely affect the company's delivery timelines.

Competition. Over the years, MDL has built capabilities and capacities to fulfil its contractual obligations (including timely delivery of vessels, warships, submarines; constructed, repaired or refitted). Since majority of contracts are awarded on a nomination basis, competition risk remains low. However, competitors of MDL in the shipbuilding division are Cochin Shipyard Limited, Garden Reach Shipbuilders and Engineering Limited, Bharati Defence and Infrastructure Limited, Goa Shipyard Limited, Hindustan Shipyard Limited, L&T Shipyard, ABG Shipyard Limited, and Reliance Defence and Engineering Limited. Its competitor in submarine and heavy engineering segments is Hindustan Shipyard Limited. Further, GoI has taken several measures to encourage private sector to invest and participate in defence production and acquisition of defence assets, which will increase competition going forward.

Significant dependence on a single customer. Currently, MDL's entire revenue comes from the work performed under MoD contracts. A substantial portion of the business is awarded through nomination of contractors by the MoD. These contracts depend upon the continuing availability of funds being extended to the MoD. Future revenue of the company under existing multi-year contracts is reliant on the continuing availability of budgetary appropriations by the MoD and release of such funds to the company in a timely manner. Any disruption to the availability of such appropriations, or release of such funds, could adversely impact the company's business.

Price chart



Source: Bloomberg

Financial summary

Table 3: Profit and loss statement

(Rs mn, year ending March 31)

	FY22	FY23	FY24E	FY25E
Operating Income (Sales)	57,333	78,272	86,000	97,000
Operating Expenses	52,952	70,294	77,238	86,973
EBITDA	**4,381**	**7,978**	**8,762**	**10,027**
% margins	*7.6*	*10.2*	*10.2*	*10.3*
Depreciation & Amortisation	745	756	851	947
Gross Interest	72	64	70	70
Other Income	4,103	6,868	7,562	5,790
Recurring PBT	**7,667**	**14,027**	**15,402**	**14,800**
Add: Extra ordinaries	140	-	-	-
Less: Taxes	1,862	3,566	3,916	3,763
Less: Minority Interest				
Add: Share of profit from associates	477	730	730	730
Net Income	6,142	11,190	12,216	11,767

Source: Company data, I-Sec research

Table 4: Balance sheet

(Rs mn, year ending March 31)

	FY22	FY23	FY24E	FY25E
Assets				
Total Current Assets	2,67,461	2,62,472	2,94,301	2,78,999
of which cash & cash eqv.	1,16,216	1,35,078	1,48,721	1,13,863
Total Current Liabilities & Provisions	2,55,868	2,43,525	2,66,330	2,42,267
Net Current Assets	11,592	18,947	27,971	36,732
Investments	5,423	5,886	5,886	5,886
Net Fixed Assets	7,216	7,950	8,699	9,352
Capital Work-in-Progress	869	616	616	616
Other non-current assets	14,880	15,537	15,537	15,537
Total Assets	**39,981**	**48,937**	**58,710**	**68,123**
Liabilities				
Borrowings				
Deferred Tax Liability				
Other long term liabilities	1,404	1,335	1,335	1,335
Minority Interest				
Equity Share Capital	2,017	2,017	2,017	2,017
Face Value per share (Rs)	10	10	10	10
Reserves & Surplus	36,560	45,585	55,358	64,771
Net Worth	38,577	47,602	57,375	66,788
Total Liabilities	**39,981**	**48,937**	**58,710**	**68,123**

Source: Company data, I-Sec research

Table 5: Cashflow statement

(Rs mn, year ending March 31)

	FY22	FY23	FY24E	FY25E
Operating Cashflow	4,469	10,905	5,575	6,994
Working Capital Changes	4,743	8,702	4,619	(43,619)
Capital Commitments	(240)	(1,596)	(1,600)	(1,600)
Free Cashflow	(1,937)	6,917	8,525	(38,295)
Investing Cashflow	3,264	5,083	5,962	4,190
Issue of Share Capital				
Buyback of shares	0	0	0	0
Inc (Dec) in Borrowings				
Dividend paid	(1,801)	(2,164)	(2,443)	(2,353)
Others				
Extraordinary Items				
Chg. in Cash	(194)	11,480	13,643	(34,858)

Source: Company data, I-Sec research

Table 6: Key ratios

(Year ending March 31)

	FY22	FY23	FY24E	FY25E
Per Share Data (Rs.)				
EPS(Basic Recurring)	30.3	55.5	60.6	58.3
Diluted Recurring EPS	30.3	55.5	60.6	58.3
Recurring Cash EPS	34.0	59.2	64.8	63.0
Dividend per share (DPS)	8.7	11.1	12.1	11.7
Book Value per share (BV)	191.3	236.0	284.5	331.1
Growth Ratios (%)				
Operating Income	41.6	36.5	9.9	12.8
EBITDA	95.7	82.1	9.8	14.4
Recurring Net Income	19.5	82.2	9.2	(3.7)
Valuation Ratios (x)				
P/E	27.7	15.1	13.8	14.4
P/CEPS	24.7	14.1	12.9	13.3
P/BV	4.4	3.6	2.9	2.5
EV / EBITDA	12.4	4.4	2.5	5.6
EV / FCF	(28.0)	5.1	2.5	(1.5)
Operating Ratios (%)				
Gross Margin (%)	37.1	34.3	34.0	33.3
SG&A/Sales (%)	3.2	2.8	2.8	2.8
Other Income / PBT	53.5	49.0	49.1	39.1
Effective Tax Rate	24.3	25.4	25.4	25.4
NWC / Total Assets	29.0	38.7	47.6	53.9
Inventory Turnover	779.2	522.5	520.0	520.0
Receivables (days)	65.1	47.6	47.6	47.6
Payables (days)	425.5	231.4	231.4	231.4
D/E Ratio (x)	0.0	0.0	0.0	0.0
Profitability Ratios (%)				
Rec. Net Income Margins	10.7	14.3	14.2	12.1
RoCE	14.5	21.6	19.8	16.4
RoNW	15.9	23.5	21.3	17.6
EBITDA Margins	7.6	10.2	10.2	10.3

Source: Company data, I-Sec research

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