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Q4FY23 result review;
Rating and TP revision

Defence

Target price: Rs3,385

Target price revision

Rs3,385 from Rs2,850

Shareholding pattern

	Sep '22	Dec '22	Mar '23
Promoters	75.2	75.2	71.7
Institutional investors	14.8	19.9	23.0
MFs and others	7.5	7.4	8.8
Banks / FIs	0.1	0.1	0.1
Insurance Cos.	0.1	4.9	4.6
FIs	7.1	7.5	9.5
Others	10.0	4.9	5.3

Source: BSE

ESG disclosure score

Year	2021	2022	Chg
ESG score	35.6	39.4	3.8
Environment	31.2	33.2	2.0
Social	12.0	21.4	9.5
Governance	63.6	63.6	0.0

Note - Score ranges from 0 - 100 with a higher score indicating higher ESG disclosures.

Source: Bloomberg, I-sec research

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INDIA



Hindustan Aeronautics

ADD

Downgrade from **BUY**

Tejas Mk1A timelines are critical

Rs2,974

Hindustan Aeronautics' (HAL) Q4FY23 EBITDA was 8% ahead of consensus estimates mainly due to better than expected gross margin. Key highlights: 1) EBITDA margin improved QoQ to 26% at the upper end of 25-26% guidance for FY23-25; 2) provisions, as a percentage of revenue during the quarter, continued to remain high at 16.7% vs the historical range of 6-7%; 3) orderbook as of Mar-23 stood at Rs818bn; 4) manufacturing contracts worth Rs260bn and repair & overhaul (ROH) contracts worth Rs166bn were received during FY23; and 5) tax-related benefit pertaining to prior years of Rs9.8bn was recognised in FY23.

Despite an attractive orderbook, we envisage the execution of Tejas Mk1A as the next trigger for the stock. In the interim, we will keep a close tab on the execution of remaining LCAs and fresh orders of Do-230 and HTT-40. On DCF methodology, our target price works out to Rs3,385 (earlier Rs2,850), implying 14% upside from CMP. At this stage, we believe stock price is building in no delays in the execution of Tejas Mk1A, which in our view is a key risk. We downgrade HAL to ADD (earlier *Buy*). Our TP of Rs3,385 implies P/E of 19.5x on FY25E EPS which is 2.5 deviations above its past trading average, thus, capturing the potential upside from LCA Tejas Mk1A being executed on time.

- **Performance surpasses estimates.** HAL's Q4FY23 EBITDA at Rs32.4bn (up 29.8% YoY) was ahead of our consensus estimates. Key highlights: 1) Gross margin at 61.9% was higher compared to 59.9% in Q4FY22 on sustained sourcing efficiencies and higher proportion of ROH in overall revenue; 2) revenue growth was up a mere 8.1% YoY owing to lower manufacturing contract execution; 3) settled demand notice of Rs2bn issued by BBMP for Rs916mn against one-time settlement scheme; 4) recognised excess provision of tax of Rs9.7bn and an interest income of Rs5.6bn in FY23, pursuant to orders passed by the Income Tax Appellate Tribunal pertaining to a refund for prior years; and 5) loss of Rs786mn has been provided against damage of inventory of LCA division. In our view, EBITDA margin reaching 26% mark and steady inflow of ROH orders are the key positives for FY23.
- **Impressive orderbook, but execution remains the key.** As per the Standing Committee of Defence report, in its endeavour to indigenise 50% of its fighter squadrons by CY40, IAF plans to induct 73 Tejas MK1A in the first phase, followed by 108 Tejas MK2 and 140 AMCA fighter jets (40 AMCA Mk1 and 100 AMCA Mk2) and orders for 50 Tejas MK1a and 50 Tejas MK2 aircraft. Also, the number of AMCA fighter jets may cross 200 by CY50. Hence, potential orderbook remains impressive for HAL; however, we would keep a close tab on the execution.
- **Outlook: Sound prospects, but are they priced in?** While we believe HAL is in a sweet spot with firm orderbook potential, execution is the key and CMP partially reflects the same. Our revised TP for HAL works out to Rs3,385 on DCF methodology, implying 14% upside from the current level. Hence, we downgrade HAL to **ADD** (earlier *Buy*).

Market Cap	Rs994bn/US\$12.1bn
Reuters/Bloomberg	HIAE.BO / HNAL IN
Shares Outstanding (mn)	334.4
52-week Range (Rs)	3018/1510
Free Float (%)	28.3
FII (%)	9.5
Daily Volume (US\$'000)	37,082
Absolute Return 3m (%)	24.7
Absolute Return 12m (%)	99.9
Sensex Return 3m (%)	2.3
Sensex Return 12m (%)	18.5

Year to Mar	FY22	FY23	FY23E	FY25E
Revenue (Rs mn)	2,46,200	2,69,275	2,90,279	3,12,543
EBITDA (Rs mn)	54,086	66,792	69,799	74,492
Net Income (Rs mn)	50,799	58,277	47,322	50,325
EPS (Rs)	151.9	174.3	141.5	150.5
P/E (x)	19.6	17.1	21.0	19.8
CEPS (Rs)	185.1	227.7	198.7	211.5
EV/E (x)	15.8	11.9	11.2	10.4
Dividend Yield	1.3	1.3	1.5	1.6
RoCE (%)	21.7	20.3	18.5	17.6
RoE (%)	26.3	24.7	17.6	16.6

Please refer to important disclosures at the end of this report

Table 1: Q4FY23 result review

(Rs.mn)	Q4FY23	Q4FY22	% Chg YoY	Q3FY23	% Chg QoQ	FY23	FY22	% Chg YoY
Net Revenue	1,24,947	1,15,611	8.1	56,655	120.5	2,69,275	2,46,200	9.4
<i>Growth</i>	8.1%	7.7%		-3.8%		9.4%	8.2%	
Cost of material	49,639	35,770	38.8	20,511	142.0	99,937	87,522	14.2
Purchase of stock	4,663	2,841		1,835		7,992	6,567	
Change in inventory	(6,741)	7,762		2,552		(6,907)	5,923	
Total cost of materials	47,561	46,373		24,897		1,01,021	1,00,012	
<i>Cost of material as % of sales</i>	38	40		44		38	41	
Gross Margin	77,385	69,239	11.8	31,758	143.7	1,68,254	1,46,188	15.1
<i>Gross Margin (%)</i>	61.9	59.9		56.1		62.5	59.4	
Employee Expenses	16,150	14,027	15.1	11,328	42.6	49,104	46,044	6.6
Other expenses	4,168	3,640	14.5	4,413	(5.6)	15,606	12,109	28.9
Impairment loss	5,752	1,661		46		5,974	1,764	
Provisions	21,129	26,092	(19.0)	8,086	161.3	37,248	37,295	(0.1)
Expenses capitalised	(2,271)	(1,178)		(1,970)		(6,470)	(5,110)	
EBITDA	32,458	24,998	29.8	9,854	229.4	66,792	54,086	23.5
<i>EBITDA margin (%)</i>	26.0	21.6		17.4		24.8	22.0	
Interest	553	421	31.3	21		580	582	(0.4)
Other Income	7,222	5,007	44.3	4,972		16,701	9,849	69.6
EBIT	39,127	29,584		14,806		82,913	63,353	
<i>EBIT margin (%)</i>	31.3	25.6		26.1		30.8	25.7	
<i>EBIT margin ex other income (%)</i>	25.5	21.3		17.4		24.6	21.7	
Depreciation	10,556	3,825	176.0	2,689	292.6	17,847	11,105	60.7
Exceptional item	-	-		-		-	-	
PBT	28,571	25,759	10.9	12,117	135.8	65,066	52,248	24.5
Tax	125	(5,281)		578		6,818	1,447	
PAT	28,446	31,040	(8.4)	11,539	146.5	58,249	50,801	14.7
Share of Profit/(Loss) of Joint Ventures	(135)	11		13		29	(2)	

Source: Company data, I-Sec research

We downgrade HAL to ADD with a revised TP of Rs3,385

We value HAL using the DCF methodology. Our revised TP of Rs3,385 implies P/E of 19.5x which is 2.5 deviations above the mean of its historical trading range. Thus, the upside from timely execution of LCA Mk1A is built in the TP. The upside from CMP works out to 14%, hence, we downgrade HAL to ADD (earlier *Buy*).

Table 2: DCF valuation yields target price of Rs3,385/share

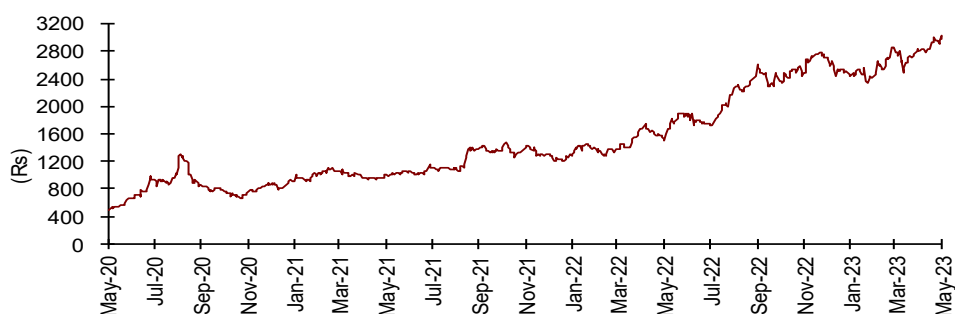
(Rs mn)	FY22	FY23	FY24E	FY25E	FY26E	FY27E	FY28E	FY29E	FY30E
Sales	2,46,200	2,69,275	2,90,279	3,12,543	3,37,691	3,64,956	3,94,334	4,26,035	4,60,289
EBITDA	54,086	66,792	69,799	74,492	81,084	88,289	96,084	1,04,538	1,13,723
Tax	1,447	6,818	15,774	16,775	19,704	23,054	26,339	29,283	32,904
PAT	50,799	58,277	47,322	50,325	59,113	69,162	79,017	87,848	98,713
NOPAT	52,639	59,974	54,025	57,717	61,380	65,235	69,745	75,255	80,818
Working Capital Change	12,654	4,515	(27,837)	(32,671)	55,758	64,009	40,721	(995)	22,254
Capex	(7,993)	(7,824)	(12,000)	(12,000)	(12,000)	(12,000)	(12,000)	(12,000)	(12,000)
FCF	57,300	56,665	14,188	13,046	1,05,138	1,17,245	98,466	62,260	91,073
Terminal Value									11,61,177
Total FCF	57,300	56,665	14,188	13,046	1,05,138	1,17,245	98,466	62,260	12,52,250
Cost of Equity	15%								
WACC	10%								
Terminal Growth	2%								
NPV of FCFF (FY24E)	9,21,637								
Net Debt at FY24E	(2,09,815)								
Net Equity value	11,31,451								
Value per share	3,385								

Source: I-Sec research

The key risk, to our understanding, is lack of diversification. As cashflow accumulates, we are witnessing a trend of vertical integration (latest two examples are Lockheed acquisition of Aerojet Rocketdyne and merger between Raytheon and UTC). HAL may also have to think about business diversification soon. Faster ramp up of unmanned vehicles through IAI, Dynamatic JV, focused entry into civilian space with LUH offering, trying to enter MRO for civilian space, trying to leverage the knowledge of propulsion systems to move towards integration of the same in hypersonic missiles – those are some of the potential areas of diversification for HAL, apart from increasing the production rate of the existing platforms.

Other key risks: Global aerospace defence primes like Lockheed Martin are rated in high-risk category (score of 30.6) by Sustainalytics with industry group rank of 15 out of 91. Similarly, we see Lockheed absent in S&P 500 ESG index and the reason for exclusion is shown as 'involved in controversial weapons' – we see similar predicaments for Boeing. MSCI on the other hand has assigned an 'A' rating to Lockheed Martin, with 17% of MSCI AWCI constituents in aerospace and defence getting an 'A' rating. HAL is currently not rated by any agency.

Price chart



Source: Bloomberg

Financial summary

Table 3: Profit and loss statement

(Rs mn, year ending March 31)

	FY22	FY23	FY24E	FY25E
Operating Income	2,46,200	2,69,275	2,90,279	3,12,543
Operating Expenses	1,92,115	2,02,483	2,20,480	2,38,052
EBITDA	54,086	66,792	69,799	74,492
% margins	22.0	24.8	24.0	23.8
Depreciation & Amortisation	11,105	17,847	19,127	20,408
Gross Interest	582	580	580	580
Other Income	9,849	16,701	12,904	13,497
Recurring PBT	52,245	65,095	63,096	67,100
Less: Taxes	1,447	6,818	15,774	16,775
Recurring Net Income	50,799	58,277	47,322	50,325

Source: Company data, I-Sec research

Table 4: Balance sheet

(Rs mn, year ending March 31)

	FY22	FY23	FY24E	FY25E
Assets				
Total Current Assets	4,49,918	5,18,835	5,37,183	5,62,284
of which cash & cash eqv.	1,43,477	2,03,166	2,15,065	2,24,943
Total Current Liabilities & Provisions	2,62,855	3,21,742	2,98,274	2,72,287
Net Current Assets	1,87,064	1,97,092	2,38,908	2,89,997
Investments	13,627	14,579	14,579	14,579
Net fixed assets (including CWIP)	92,388	87,194	80,067	71,658
Other non-current assets	27,961	51,404	51,404	51,404
Total Assets	3,21,040	3,50,269	3,84,958	4,27,638
Liabilities				
Borrowings	5,247	5,250	5,250	5,250
Advance from customers	1,22,624	1,09,260	1,11,340	1,19,880
Equity Share Capital	3,344	3,344	3,344	3,344
Reserves & Surplus	1,89,787	2,32,378	2,64,986	2,99,127
Net Worth	1,93,131	2,35,722	2,68,330	3,02,471
Total Liabilities	3,21,040	3,50,269	3,84,958	4,27,638

Source: Company data, I-Sec research

Table 5: Cashflow statement

(Rs mn, year ending March 31)

	FY22	FY23	FY24E	FY25E
Net Profit before tax	50,799	58,277	47,322	50,325
Depreciation	11,105	17,847	19,127	20,408
Working Capital Changes	12,654	4,515	(27,837)	(32,671)
Taxes Paid	(10,532)	(27,557)	(15,774)	(16,775)
Cash flow from Operating Activities	1,00,328	88,297	39,192	38,642
Capital Commitments	(15,006)	(17,812)	(12,000)	(12,000)
Free Cash Flow	85,323	70,485	27,192	26,642
Other investing cashflow	(1,12,589)	(39,468)	-	-
Cash flow from Investing Activities	(1,27,595)	(57,280)	(12,000)	(12,000)
Inc (Dec) in Borrowings	(91)	(37)	-	-
Other financing activities	(13,399)	(17,276)	(15,293)	(16,764)
Cash flow from Financing Activities	(13,491)	(17,313)	(15,293)	(16,764)
Chg. in Cash & Bank balance	(40,757)	13,704	11,899	9,878

Source: Company data, I-Sec research

Table 6: Key ratios

(Year ending March 31)

	FY22	FY23	FY24E	FY25E
Per Share Data (Rs)				
Basic EPS	151.9	174.3	141.5	150.5
Diluted EPS	151.9	174.3	141.5	150.5
Cash EPS (Fully Diluted)	185.1	227.7	198.7	211.5
OCF per share (Fully Diluted)	456.4	300.0	264.1	117.2
Book Value per share (Fully Diluted)	577.6	704.9	802.4	904.5
Dividend	40.0	40.0	44.0	48.4
Growth YoY (%)				
Net Sales	8.2	9.4	7.8	7.7
EBITDA	6.0	6.0	14.0	9.0
PAT	56.8	14.7	(18.8)	6.3
Valuation ratios				
P/E	19.6	17.1	21.0	19.8
P/CEPS	16.1	13.1	15.0	14.1
P/BV	5.2	4.2	3.7	3.3
EV / EBITDA	15.8	11.9	11.2	10.4
EV / FCF	6.4	9.3	9.9	28.9
Operating Ratios (%)				
Raw Material/Sales	40.6	37.5	35.5	36.0
Other Income / PBT	18.9	25.7	20.5	20.1
Effective Tax Rate	2.8	10.5	25.0	25.0
NWC / Total Assets	32.0	29.3	35.0	41.4
Inventory Turnover	72.9	87.2	87.2	87.2
Asset Turnover	42.2	40.1	42.5	44.7
Net D/E Ratio (x)	(0.7)	(0.8)	(0.8)	(0.7)
Profitability Ratios (%)				
Rec. Net Income Margins	20.6	21.6	16.3	16.1
RoCE	21.7	20.3	18.5	17.6
RoNW	26.3	24.7	17.6	16.6
Dividend Payout	23.0	31.1	32.2	30.1
Dividend Yield	1.3	1.3	1.5	1.6
EBITDA Margins	22.0	24.8	24.0	23.8

Source: Company data, I-Sec research

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