



3R MATRIX

	+	=	-
Right Sector (RS)	✓	■	■
Right Quality (RQ)	✓	■	■
Right Valuation (RV)	✓	■	■

+ Positive = Neutral - Negative

What has changed in 3R MATRIX

	Old		New
RS	■	↔	■
RQ	■	↔	■
RV	■	↔	■

ESG Disclosure Score

NEW

ESG RISK RATING

Updated Aug 08, 2023

34.41

High Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

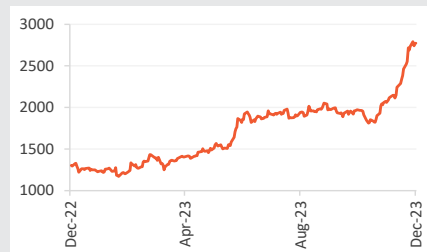
Company details

Market cap:	Rs. 1,85,508 cr
52-week high/low:	Rs. 2822/1151
NSE volume: (No of shares)	14.1 lakh
BSE code:	541154
NSE code:	HAL
Free float: (No of shares)	19.0 cr

Shareholding (%)

Promoters	71.6
FII	12.6
DII	9.7
Others	6.0

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	32.7	40.5	49.6	113.0
Relative to Sensex	25.4	36.6	37.5	98.9

Sharekhan Research, Bloomberg

Capital Goods

Sharekhan code: HAL

Reco/View: Positive

CMP: Rs. 2,774

Upside potential: 15.0%

Upgrade ↔ Maintain ↓ Downgrade

Summary

- Order pipeline is quite robust for HAL as the defence acquisition council has approved procurement of Light Combat Helicopters (LCH) for the Indian Air Force (IAF) & Indian Army, Light Combat Aircraft (LCA) Mk 1A for IAF and indigenous upgradation of Su-30 MKI aircraft.
- New JV for MRO services and helicopter engine would diversify its revenue stream, providing long-term growth opportunities for HAL.
- Domestic self-reliance goals in defence would aid product development. The company have identified several indigenization programs and earmarked funds in creating additional capacity for engines, avionics and accessories.
- HAL has strong government support, proven execution capabilities and a healthy cash balance. The stock currently trades at ~26x its FY2026E EPS. We have a Positive view on the stock and expect a 15% upside.

The company has a healthy order book of ~82,000 crore with more than three years of revenue visibility. Recently, the Ministry of Defence approved the procurement of Light Combat Helicopter (LCH) for Indian Air Force (IAF) & Indian Army, Light Combat Aircraft (LCA) Mk 1A for IAF and indigenous upgradation of Su-30 MKI Aircraft by HAL with the estimated cost of ~ Rs 1.6 lakh crore. The company is also pursuing export orders worth close to Rs 70,000 crore from 4 different countries. These new orders will provide company a sustainable long-term growth. The company is also creating additional capacity for engines, avionics and accessories to meet government's self-reliance goal in defence. The company has also set JV to offer commercial airlines a one-stop maintenance, repair, and operations (MRO) solution and help in growth of India's commercial aviation industry. The company has signed another JV for design, development, certification and production of helicopter engines in India.

- New orders to create sustainable long term growth:** The ministry of defence has approved procurement of Light Combat Helicopter (LCH) for Indian Air Force (IAF) & Indian Army and Light Combat Aircraft (LCA) Mk 1A for the IAF. The government has also approved indigenous upgradation of Su-30 MKI Aircraft by HAL. The estimated cost of these contracts might be ~ Rs 1.6 lakh crore. HAL is currently negotiating export orders for fighter planes and helicopters with four different countries with potential orders worth close to Rs 70,000 crore. To execute these orders, the company plans to ramp up its production to 24 aircraft per year from the Bengaluru and Nashik facilities from FY2026 onwards.
- JV for MRO solutions and helicopter engines will diversify revenue streams:** HAL has signed a contract to establish MRO facilities for the A-320 series of aircraft to build integrated MRO services in India and offer commercial airlines a one-stop MRO solution. This partnership will also result in the growth of India's commercial aviation industry, with HAL at the forefront. HAL has also incorporated JV to carry out business of design, development, certification, production, sale & support of helicopter engines. These engines will be used in Indian multi-role helicopter (IMRH) and its deck-based version. The production of engines is expected to begin in four years.
- Self-reliance goal will help in development of new products:** The government has released several Indigenization List to encourage domestic defence production and set strict timelines to produce military hardware within the country. The company have identified several indigenisation programs and earmarked an initial budget of Rs 1,800 crore. Apart from platforms like fighters and helicopters, HAL is also creating additional capacity for engines, avionics and accessories. The company has shifted its approach from waiting for orders to develop products to developing in-demand products, so they can execute orders quickly once the company receives order.

Our Call

Valuation – Maintain a Positive view; expect 15% upside: We are bullish on HAL's growth trajectory, as it is one of the key beneficiaries of structural reforms in the defence sector. The company has a healthy order book of ~82,000 with more than three years of revenue visibility. Once the execution of large orders like LCA (Mk1A) picks up pace, the company could post double-digit revenue growth from FY2025E, and it should stabilise at a 14-15% sales growth from FY2026. The company is debt-free and has strong cash and cash equivalents and healthy return ratios. The stock is currently trading at 26x its FY2026E EPS. We maintain our Positive view on the stock and expect an upside of 15% from current price levels.

Key Risks

- Fluctuations in raw-material prices and delays in the availability of critical components could impact execution.
- Opening up the defence sector to private players may intensify competition in the future.

Valuation (Consolidated)

Particulars	FY23	FY24E	FY25E	FY26E
Net sales	26,927	29,346	33,180	36,170
OPM (%)	24.8	24.4	24.8	25.5
Adjusted net profit	4,851	5,199	6,304	7,084
PAT growth (%)	24.8	7.2	21.2	12.4
Adjusted EPS (Rs.)	72.5	77.7	94.3	105.9
P/E (x)	38.2	35.7	29.4	26.2
P/B (x)	7.9	7.6	7.3	6.8
EV/EBIDTA (x)	19.6	18.4	15.4	13.4
RoCE (%)	30.6	28.9	34.2	36.5
RoE (%)	22.6	21.7	25.3	27.0

Source: Company; Sharekhan estimates

New orders: The ministry of defence has approved procurement of Light Combat Helicopter (LCH) for Indian Air Force (IAF) & Indian Army and Light Combat Aircraft (LCA) Mk 1A for IAF. The government has also approved indigenous upgradation of Su-30 MKI Aircraft by HAL. The estimated cost of these contracts might be ~ Rs 1.6 lakh crore of which Rs 65,000 crore might be allocated for LCA Mk-1, Rs 55,000 crore might be allocated for LCH and Rs 40,000 crore might be allocated for Su-30 upgrades.

International orders: HAL is currently negotiating export orders for fighter planes and helicopters with four different countries. Argentina is contemplating to buy 15 LCA MK-1As and 10 ALH helicopters from HAL, Nigeria & Egypt are considering buying 16-18 LCA MK-1A and 20 LCA MK-1A fighter jets respectively. While Philippines is contemplating to buy 20 ALH helicopters from HAL. The total estimated value of these potential orders is close to Rs 70,000 crore.

Foray into maintenance, repair, and operations (MRO) solution: HAL has signed a contract to establish MRO facilities for the A-320 series of aircraft to build integrated MRO services in India and offer commercial airlines a one-stop MRO solution. HAL wants to establish an Integrated MRO hub in the country and provide Airlines with an effective MRO solution. Through this partnership, lead times will be significantly shortened, turnaround times will be enhanced, and maintenance costs will be decreased, enhancing the fleet's availability for flight operations. This partnership will also result in the growth of India's commercial aviation industry, with HAL at the forefront.

JV to design and develop helicopter engines: HAL has incorporated JV to carry out business of design, development, certification, production, sale & support of helicopter engines. These engines will be used in Indian multi-role helicopter (IMRH) and its deck-based version. The production of engines is expected to begin in four years.

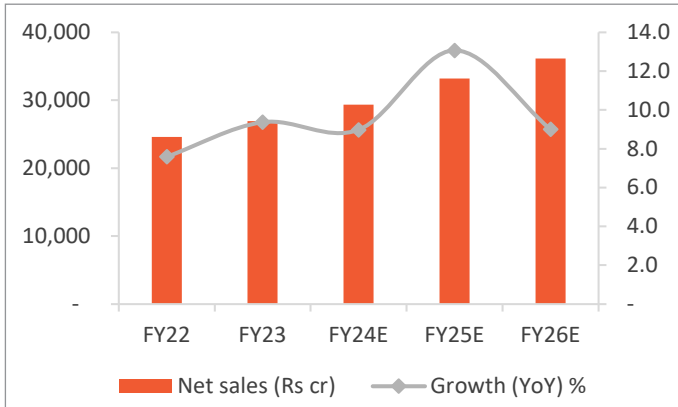
Ramp-up in production capacity of LCA Tejas: HAL plans ramp up its production and deliver 24 aircraft per annum from the Bengaluru and Nashik facilities from FY2026 onwards. Once company reached this goal, HAL plans to streamline the supply chain and further ramp up production to 30 aircraft per annum.

Indigenous upgrade of Su-30s fighter aircraft: HAL plans to upgrade 84 aircraft Su-30s fighter mainly through indigenous effort. The upgrade will involve equipping the Su-30s with the indigenous Uttam active electronically scanned array (AESA) radar, electronic warfare suites, weapon control systems, avionics and new weapons.

Domestic self-reliance goals to aid in product development: The government has released several Indigenization List to encourage domestic defence production and set strict timelines to produce military hardware within the country. The company has created an indigenization cell, which is funded with 3% of net operating profit. The company have identified several indigenization programs and earmarked an initial budget of Rs 1,800 crore. Apart from platforms like fighters and helicopters, HAL is also creating additional capacity for engines, avionics and accessories. The company has shifted its approach from waiting for orders to develop products to developing in-demand products, so they can execute order quickly once come received order.

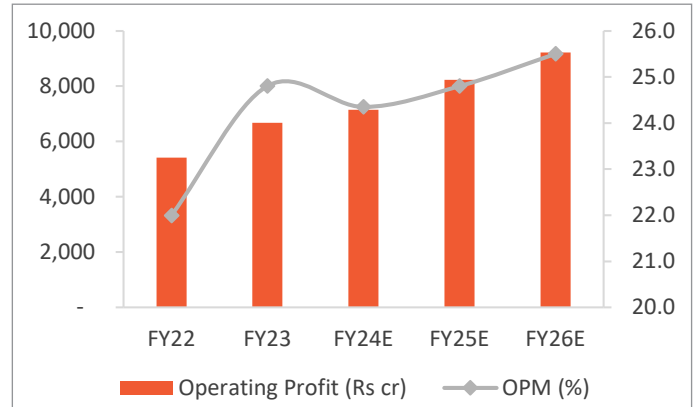
Financials in charts

Revenue Trend



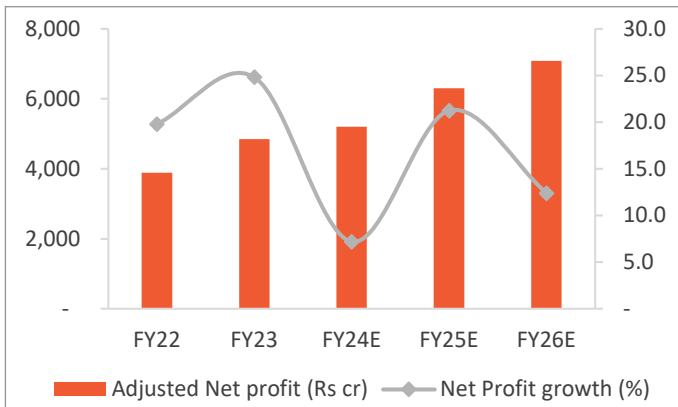
Source: Company, Sharekhan Research

Operating Profit/OPM Trend



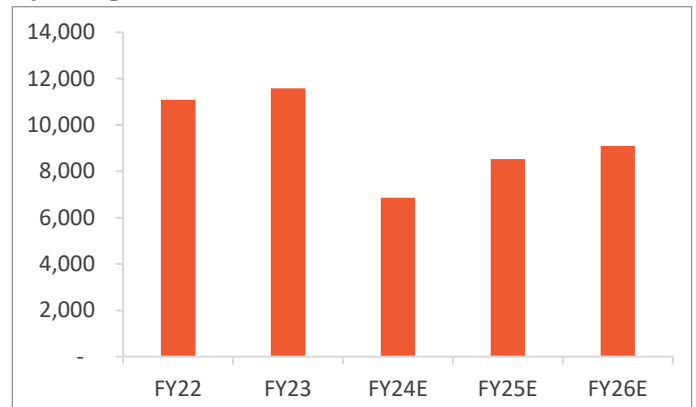
Source: Company, Sharekhan Research

Net Profit Trend



Source: Company, Sharekhan Research

Operating Cash Flows Trend



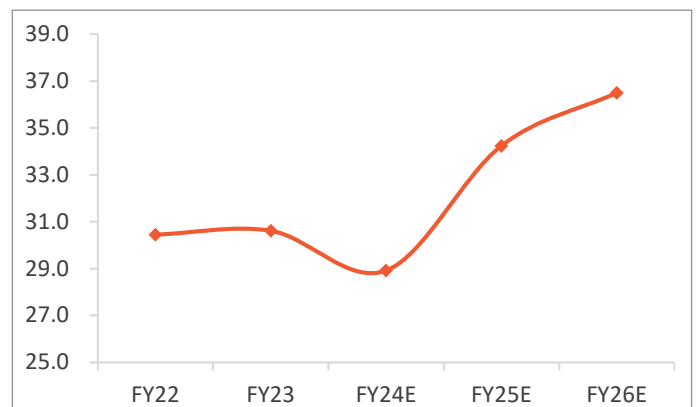
Source: Company, Sharekhan Research

RoE Trend



Source: Company, Sharekhan Research

RoCE Trend



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view - Indian defence sector in a sweet spot

As of 2020, India was the third largest military spending country globally, accounting for almost 3.7% of global military spending. In FY2021, ~56% of the defence budget was allocated to the Indian army, 23% to the air force, 15% to the navy, and 6% to others. India is one of the biggest importers of defence equipment as it imports ~50% of requirements and accounts for ~14% of global arms imports. The government aims to reduce its dependence on imports and boost domestic production through various innovations and advancements in the defence sector under the AtmaNirbhar Bharat vision of the government. Measures such as simplifying the 'Make in India' procedure for procurement of defence products, provision for funding of up to 70% of development cost by the government, and hike in FDI to 74% through the automatic route would boost investments in the sector. The current uncertain international (Russia-Ukraine war), as well as domestic (India-China border dispute) geopolitical scenario, calls for the strengthening of national security, which should lead to a significant rise in India's defence expenditure going forward. India would gradually ban several imported components through positive indigenisation lists to reduce imports. This compels Indian armed forces, comprising the army, navy, and air force to source the listed items from domestic manufacturers exclusively. Moreover, the Indian government has set an ambitious defence production target at \$25 billion by 2025 (including \$5 billion from exports by 2025). Thus, the government's focus on the defence sector bodes well for companies like HAL, BEL, and Bharat Dynamics, which are the leading defence PSUs with several years of execution expertise in the domain.

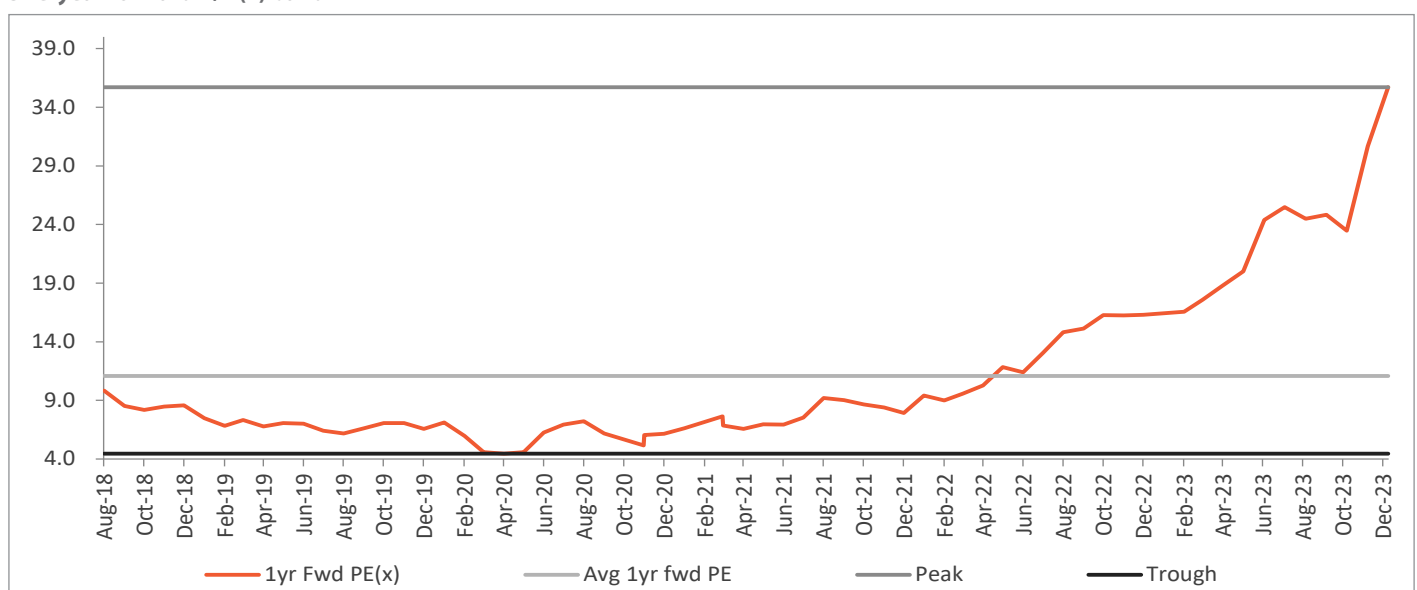
■ Company outlook - On a strong footing

The government is the majority stakeholder in HAL. The company has a strategic place in India's defence story as it is a dominant supplier of aircraft, helicopters, engines, avionics and accessories and the main provider of maintenance, repair and overhaul services to the Indian defence forces. HAL has a strong order book of ~Rs. 81,784 crore with an impressive order pipeline. It is the key beneficiary of the Indian government's focus on reforming the defence sector with a major push for indigenisation. HAL is looking to diversify into the civil market for manufacturing and MRO opportunities. The company plans to enhance indigenisation and ensure higher indigenous content in its products. HAL would also expand its operations globally through collaborations with global partners. Hence, we believe HAL is on a solid growth trajectory.

■ Valuation - Maintain a Positive view; expect 15% upside

We are bullish on HAL's growth trajectory, as it is one of the key beneficiaries of structural reforms in the defence sector. The company has a healthy order book of ~82,000 with more than three years of revenue visibility. Once the execution of large orders like LCA (Mk1A) picks up pace, the company could post double-digit revenue growth from FY2025E, and it should stabilise at a 14-15% sales growth from FY2026. The company is debt-free and has strong cash and cash equivalents and healthy return ratios. The stock trades at 26x its FY2026E EPS. We maintain our Positive view on the stock and expect an upside of 15% from the CMP.

One-year forward P/E (x) band



Source: Sharekhan Research

About company

HAL is an Indian state-owned aerospace and defence company headquartered in Bengaluru, India. Established in December 1940, HAL is one of the oldest and largest aerospace and defence manufacturers in the world today. HAL was conferred Navratna status in 2007. The company is involved in designing, developing, manufacturing, repairing and overhauling aircraft, helicopters, engines, and related systems like avionics, instruments, and accessories. HAL has 20 production divisions and 10 R&D centres co-located with the production divisions. These divisions/R&D centres are located at nine geographic locations in seven states across the country. One of the key thrust areas of HAL is indigenisation with the primary objective of achieving Make in India and lowering dependence on foreign countries, especially for critical components. HAL's primary consumers are the Indian Defence Forces comprising the Indian Air Force, Indian Army, Indian Navy, and the Indian Coast Guard.

Investment theme

India's defence sector is undergoing major reforms as the government is keen on strengthening the nation's defence prowess by reducing dependence on imports and making India more self-reliant. The government's focus on the 'Make in India' initiative bodes well for HAL, which is a leading player in India's defence and aerospace industry and is well placed for growth backed by a strong order book and promising order pipeline. We expect HAL to have a crucial role to play in the structural transformation of India's defence sector, which aims to achieve a production target of US\$25 billion by 2025 through indigenisation and boosting exports under the 'Make in India' initiative. The company has a diversified revenue mix covering the manufacturing of aircraft/products as well as spares and services and repair and overhaul (ROH).

Key Risks

- ◆ Fluctuations in raw-material prices and delays in the availability of critical components could impact execution.
- ◆ Opening up of the defence sector to private players may intensify competition.

Additional Data

Key management personnel

Shri R. Madhavan	Chairman and Managing Director
C.B. Ananthakrishnan	Director Finance and CFO
Shri Shailesh Bansal	Company Secretary and Compliance Officer

Source: Bloomberg

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	HDFC Asset Management Co Ltd	3.7
2	Life Insurance Corp of India	1.6
3	FMR LLC	1.4
4	Vanguard Group Inc/The	1.1
5	Republic of Singapore	1.0
6	BlackRock Inc	0.9
7	Nippon Life India Asset Management Ltd	0.7
8	Manulife Financial Corp	0.3
9	ICICI Prudential Asset Management Co Ltd/India	0.3
10	DSP Investment Managers Pvt Ltd	0.3

Source: Bloomberg

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Sharekhan

by BNP PARIBAS

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