India Playbook 2024 – the India defence equity market story

ET CONTRIBUTORS • Last Updated: Mar 17, 2024, 06:04:00 PM IST

Synopsis
Indian defence sector stocks excel globally, benefiting from geopolitical risk, domestic manufacturers' rise, and strong order books. The sector shows resilience amidst global market fluctuations and government's increased defense expenditure, positioning for sustainable growth. India's aerospace industry has many legs of growth and Hindustan Aeronautics is the key player in the space.

Vinay Jaising
MD, Portfolio Management Services, JM Financial Services

Jaising has over 26 years of experience in the Indian equity markets. He serves as a Managing Direct...Show more »

Most of the Indian defence sector stocks have had a stupendous performance in the markets, with a simple average return of over 90% in the last year. This in our eyes has been due to three reason - a) Increasing geopolitical risk globally which is leading to higher defense budgets b) Indian government policy of "AtmaNirbhar" or depending on self for ones' requirement and hence domestic manufacturers getting a higher market share in the Country's capex spent c) The companies now have strong longer term Order books, a good return ratios and promising profit outlook.

How has India fared against its global peers?

The equity markets world over have been very strong and polarized with the best performing market being Nikkei (Japan) up 16% in just ~75 days in 2024 and MSCI China down 2% a huge differential of 18% for the investor. The Indian market despite being expensive on a relative market seems to be going from strength to strength, with MSCI India up 6%, in line with MSCI World. The mid and smaller cap indices have started showing clinks in their armor, especially small cap which is flat CYTD underperforming the broader indices. This could be largely due to the stupendous performance of 54% in the last year for small cap and 6-0% for midcaps and profit booking.

Index / Sector	Returns %								
	1w	1m	3m	6m	CYTD	FYTD	1Y	3Y CAGR	5Y CAGR
NASDAQ	0	0	10	16	7	31	44	6	16
MSCI World	1	3	9	13	6	19	25	4	9
MSCI EM	2	4	6	6	1	5	9	-8	0
Russell 2000	1	1	10	11	2	15	17	-4	6
Nikkei	-4	5	18	18	16	38	37	9	12
MSCI China	3	6	-1	-9	-2	-20	-14	-22	-8
MSCI India	0	4	11	17	6	38	37	16	15
Gold	2	8	10	14	6	11	17	8	11
Silver	4	8	8	6	3	2	19	-2	10
Barclay's Agg Bond Index	0	1	2	4	-1	2	3	-2	1
BSE Midcaps	-1	2	11	23	7	64	60	24	21
BSE Smallcaps	-5	-3	4	16	1	60	54	27	24

Sector	% Equity Returns								
	1w	1m	3m	6m	CYTD	FYTD	1Y	3Y CAGR	5Y CAGR
Hindustan Aeronautics	1	15	19	66	17	139	130	83	57
Mazagon Dock	-4	-8	-3	-3	-12	203	178	109	
Cochin Shipyard	-7	2	31	54	21	244	250	62	33
Garden Reach Shipbuilders & Engineers	-8	-1	-8	-6	-12	69	81	55	50
Bharat Dynamics	-4	6	26	60	0	74	87	68	43
Solar Industries	0	14	19	72	16	105	106	79	50
Bharat Electronics	-4	16	26	51	10	108	114	63	46
Ideaforge	-7	0	-10	-29	-14				
Data Patterns	-9	32	20	14	31	77	85		
Simple Average (Above Stocks)	-4	9	13	31	6	127	129	74	46
BSE 500	-1	2	8	15	4	38	36	17	16
Calculated Alpha	**-3**	**6**	**6**	**16**	**2**	**90**	**92**	**58**	**30**
Median (Above Stocks)	-4	6	19	51	10	106	110	68	48

Note:

1. Simple average is calculated for the above stocks in Defence

2. Note: The calculated Alpha is the difference between BSE500 & Simple Avg

(Source- Bloomberg)

The India defence equity market story

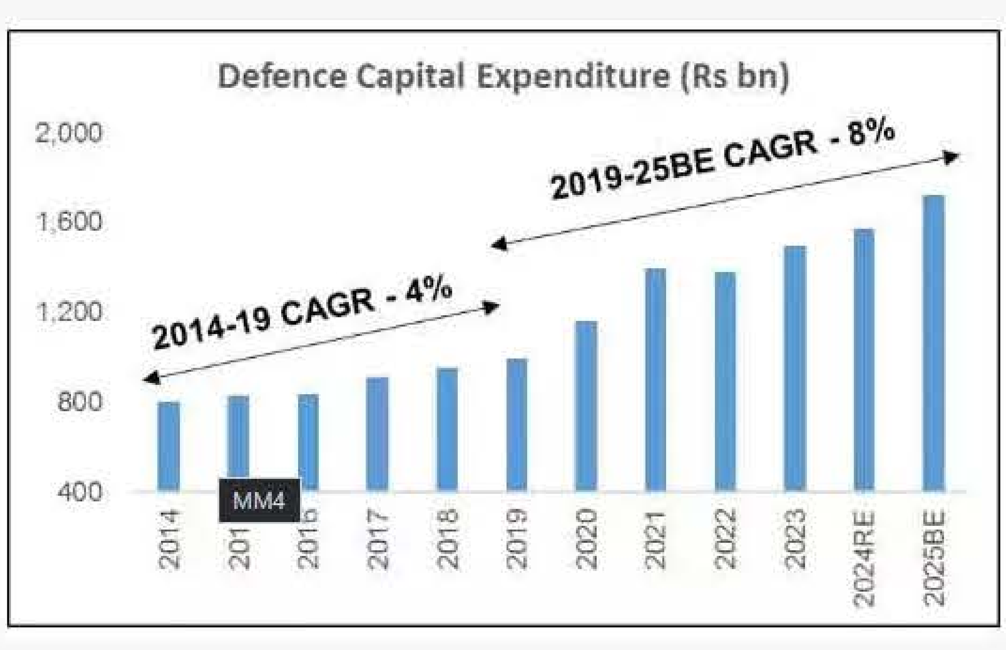
The Interim Budget for 2024 underscores the government's sustained commitment to enhance its defence capabilities. The allocation for the defence capital expenditure outlay has surged significantly, increasing from ~Rs800bn (in FY2014) to Rs1.72 trillion (in 2025BE) over the two terms of the Modi Government. Analysis of the data of past 11 years shows that the government's commitment towards domestic defence manufacturing has intensified over the last couple of years with the overall commitment increasing in absolute terms ~145% in the last 11 years.

Budget Spending (Rs bn)	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024RE	2025BE	2014-19 CAGR	2019-25 BE CAGR	(%) over 2014-2025E
Defence Pension	455	604	602	878	920	1018	1178	1281	1368	1534	1421	1412	17%	6%	210%
Defence Services (Revenue)	1,179	1,211	1,297	1,624	1,821	1,956	2,076	2,058	2,286	2,562	2,987	2,828	11%	6%	140%
Pension + Revenue	1,634	1,815	1,899	2,502	2,741	2,974	3,254	3,339	3,454	4,096	4,408	4,240	13%	6%	159%
Capital Outlay	802	831	836	915	954	996	1,160	1,399	1,380	1,500	1,572	1,720	4%	9%	114%
Total	2,436	2,646	2,736	3,416	3,696	3,972	4,414	4,738	4,831	5,596	5,980	5,960	10%	7%	145%

(Source – Union Budget)

Though the defence capital expenditure (capex) experienced a modest 4% CAGR from FY14-19.... India's defence spending exhibited consistent growth during this period, primarily attributed to increased pension disbursements (17% CAGR) and a significant rise in salaries following the implementation of the 7th Pay Commission recommendations. While defence revenue expenditure (including Pension) saw a robust double digit (~13%) CAGR over FY14-19, defence capex witnessed only a modest 4% CAGR.

..... starting from FY20, defence capex gained momentum, doubling its growth to 9% CAGR over FY19-25BE. This upswing can be attributed to capital expenditures on submarines, fighter aircraft, communication systems, helicopters and armoured vehicles.



(Source - Union Budget)

... AtmaNirbhar Bharat - Thrust on indigenization lead to disproportioned growth for the Order book of Indian manufacturers

The current Government has taken several steps to become self-reliant in defence equipment and has opened the door for private sector participation, including strategic partnership with foreign players. The Government has also come out with a defence items list which will be prohibited from imports beyond Dec-27. The key beneficiary of these initiatives will be the domestic players, who are expected to register healthy growth.

(Source - Union Budget)

The Indian defence sectors can we broadly classified into four major segments a) Aerospace, b) Ship building and shipyard, c) Ammunitions and d) ancillary or part supplier. The sector opened up to private participation in early 2000's but due to preference given to PSUs, private-sector participation remained negligible until recently. We believe that despite various measures taken by the Government to encourage private participation, PSUs will continue to dominate the sector for at least next 5-10 years. The Government holding in most of the PSUs are more than 70-75%, with competitive intensity, either low or medium. Among defense PSUs, we believe Hindustan Aeronautics, Bharat Dynamics and Bharat Electronics to be key beneficiaries of rise in domestic defence capex, imports reduction/exports ramp-up.

India's aerospace industry has many legs of growth and Hindustan Aeronautics is the key player in the space. In near-term, HAL will witness double digit earnings growth once it start LCA Tejas delivery and in medium/ long term its should see significant growth due to the modernization of the Indian armed forces. The company has a) healthy order book and impressive manufacturing book to bill ratio of 8-9x, b) attractive +20% ROE and c) stable EBITDA margin of 23-25%.

In ammunitions space, Bharat Dynamics (BDL) is India's sole manufacturer of certain missiles like Surface-to-Air Missiles, Anti-Tank Guided Missiles, and torpedoes. It is DRDO's key production agency and it receives steady inflow of orders from them. Exports, which is 7-8% currently, has the potential to grow meaningfully as many of their missiles are approved for exports. The company order book stood at +Rs.200bn (as on Dec-23), implying healthy book to bill ration of >8x.

Bharat Electronics is an experienced market leader in defense electronics. The company has been supplying indigenous defense systems to Indian armed forces in the fields of radar, communication, electronic warfare, weapons and night vision devices, among other systems. The company's consistent and significant investments in R&D/capex give them competitive edge. The company witnessed significant increase in orders this fiscal year and has an attractive book to bill ratio of +4x.

Segments	Aerospace	Shipyard	Ammunitions	Ancillary or part supplier
Key Products	LCA, HTT Trainer, Light Combat Helicopter, ALH	Submarine; Destroyers, Frigate and Carriers	Missiles; Underwater; Launchers, Bombs, Grenades, etc	Communication system; Weapon system; Control system, Radar, Drones, Electronic warfare, etc
Key players	Hindustan Aeronautics	Mazagon Dock, Cochin Shipyard & Garden Reach Shipbuilders & Engineers	Bharat Dynamics; Solar Industries	Bharat Electronics; Data Pattern
Product execution cycle	5-6 years	>10years	3-4years	1-3years
Competitive Intensity among Domestic Players	Low	Medium	Low	High
EBITDA Margins	~23-25%	~10-12%	~20-22%	~20-40%
ROEs	~20-23%	~10-20%	~15-20%	~15-25%

(Source – JM Financial)

With favourable government policies and dedicated focus on indigenization, defence companies in India witnessed a substantial increase in government orders from FY2020-24, leading to stock rerating over the past 2-3 years.