Equity Research

August 11, 2022

BSE Sensex: 58817

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**Q1FY23 result review**

## Defence

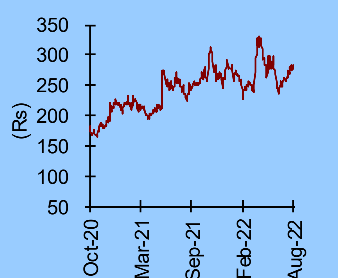
**Target price Rs295**

### Shareholding pattern

| | Dec '21 | Mar '22 | Jun '22 |
|---|---|---|---|
| Promoters | 84.8 | 84.8 | 84.8 |
| Institutional investors | 2.8 | 3.1 | 3.6 |
| MFs and others | 0.9 | 1.0 | 1.0 |
| Insurance Cos. | 0.0 | 0.0 | 0.2 |
| FIIs | 1.9 | 2.1 | 2.5 |
| Others | 12.4 | 12.1 | 11.6 |

Source: BSE

### Price chart





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# INDIA

# Mazagon Dock Shipbuilders

**HOLD**

**Maintained**

## Better than expected Q1FY23 print; order inflow visibility likely to improve

**Rs283**

**Mazagon Dock Shipbuilders' (MDL) Q1FY23 print was better than our estimates with revenue growth of 83.7% YoY. EBIDTA margin was 7.8% in Q1FY23 *vs* 5.8% in Q1FY22 and 5.5% in Q4FY22. MDL has achieved ~37% of its guided revenue for FY23 in Q1FY23 (10% revenue growth guidance for FY23). The percentage of indigenisation in the ships built by MDL has been steadily increasing from ~42% in P15 Delhi Class Destroyers (built in 1990s) to 75% in P17A Nilgiri Class Frigates (under construction). We expect execution to peak at >Rs80bn in FY24E. Orderbook remains at ~Rs460bn as at FY22-end. Maintain HOLD. Delay in order accruals (particularly in P75I) poses execution as well as working capital risks.**

- **Order potential.** Orderbook was at ~Rs460bn as at Mar'22-end. Potential orderbook includes: i) 7+4 next-generation offshore patrol vessels with an estimated total value of ~Rs100bn, ii) eight fast patrol vessels for the coast guard valued at ~Rs8bn, iii) seven next-generation Corvettes, iv) six high-speed landing craft, v) polar research vessel for National Centre for Polar and Ocean Research, one survey training vessel and acoustic research ship for NPOL Kochi. All these orders are valued at ~Rs210bn-Rs220bn. Response to RFPs amounting to Rs100bn has already been submitted and the bid for Rs250bn is expected over the next 1-2 years.

- **Trying to diversify revenue base in absence of visibility of concrete orderflow.** MDL has bagged two orders from Concor for manufacturing 2,500 shipping containers. Also, it received MbPT order for repair of launch boat. *MDL has initiated design & development of indigenous midget submarine.* Further, it has developed six Pax hydrogen fuel cell powered electric vessel, in collaboration with TATA Advanced Systems.

- **Export opportunities at MDL.** In the past, MDL exported 243 vessels to various international clients. It has approached potential clients in friendly countries for export and has been carrying out promotional activities in various international locations.

- **Indigenisation at MDL.** MDL's efforts towards indigenisation are evident from the fact that percentage of indigenisation in the ships built by it has increased from 42% in P15 Delhi Class Destroyers (built in the 1990s) to 75% in P17A Nilgiri Class Frigates (under construction). MDL has indigenised 20 items/equipment and currently indigenisation of 9 major items/equipment through Indian Industries is in progress. Out of 9 items, 2 items are being indigenised under MAKE II process. Management sees potential scope of participation in Rs500bn next-gen destroyers manufacturing order.

| | |
|---|---|
| Market Cap | Rs57.1bn/US$718mn |
| Bloomberg | MAZDOCKS IN |
| Shares Outstanding (mn) | 201.7 |
| 52-week Range (Rs) | 331/208 |
| Free Float (%) | 15.2 |
| FII (%) | 2.5 |
| Daily Volume (US$'000) | 2,130 |
| Absolute Return 3m (%) | 2.8 |
| Absolute Return 12m (%) | 22.0 |
| Sensex Return 3m (%) | 9.1 |
| Sensex Return 12m (%) | 9.1 |

| Year to Mar | FY21 | FY22 | FY23E | FY24E |
|---|---|---|---|---|
| Revenue (Rs mn) | 40,478 | 54,600 | 60,000 | 81,000 |
| EBITDA(Rs mn) | 2,239 | 4,270 | 4,552 | 9,276 |
| Net Income (Rs mn) | 5,139 | 6,189 | 5,989 | 8,881 |
| EPS (Rs) | 25.5 | 30.7 | 29.7 | 44.0 |
| P/E (x) | 11.0 | 9.1 | 9.4 | 6.4 |
| CEPS (Rs) | 28.4 | 34.1 | 33.6 | 48.3 |
| EV/E (x) | (10.6) | (1.6) | (7.9) | 2.6 |
| Dividend Yield | 2.6 | 2.2 | 2.1 | 3.1 |
| RoCE (%) | 16.7 | 14.0 | 11.1 | 15.2 |
| RoE (%) | 15.0 | 15.8 | 13.6 | 17.4 |

- **Clarity on P75I order awaited.** RFP for construction of 6, P75I (conventional submarines fitted with Air Independent propulsion) was taken out of 28th July 2021 and the bid submission date was 9th November 2021, and there was a pre-bid meeting on 21st September 2021. It is a very large value project with a small timeline for bid submission (three months and 19 days). Five OEMs were supposed to collaborate in the construction of these submarines – three European OEMs (Navantia, Spain, TKMS, Germany and Naval group, France), one from Russia (Rubin or the ROE) and one from South Korea (DSME). RFP necessitated that the OEM should already have a technology to transfer and that they should have a submarine fitted with this particular system (AIP) or under fitment, and by April or May 2022 they should be able to demonstrate this product to the visiting field evaluation team of the Indian Navy and the shipyard and the Ministry of Defence. This condition has come in the way of a possible alignment with any foreign OEM for domestic players like MDL. Recently, French company Naval Group said it is unable to participate in India's P-75I project due to conditions mentioned in the request for proposal (RFP) related to air independent propulsion (AIP) system. **More recently, the earlier RFP deadline of 30th June 2022, which was already an extension, has now been extended by another six months till December 2022.**

### Table 1: Q1FY23 result review

*(Rs mn)*

| | Q1FY23 | Q1FY22 | % Chg YoY | Q4 FY22 | % Chg QoQ |
|---|---|---|---|---|---|
| **Sales** | **22,303** | **12,142** | **83.7** | **13,964** | **59.7** |
| Cost of materials consumed | 13,350 | 6,004 | 122.3 | 4,116 | 224.4 |
| Procurement of base and depot spares | 2,422 | 1,786 | 35.6 | 4,368 | (44.6) |
| Gross Margin | 6,532 | 4,352 | 50.1 | 5,480 | 19.2 |
| Gross Margin (%) | 29.3 | 35.8 | | 39.2 | |
| Employee benefit expenses | 1,818 | 1,784 | 1.9 | 2,013 | (9.7) |
| *% of topline* | 8.1 | 14.7 | | 14.4 | |
| Sub-contract | 729 | 1,225 | (40.5) | 968 | (24.7) |
| Power and fuel | 30 | 34 | (11.6) | 32 | (5.3) |
| Other expenses - project related | 1,790 | 224 | 697.9 | 307 | 483.7 |
| Other expenses | 327 | 228 | 43.6 | 887 | (63.1) |
| Provisions | 101 | 155 | | 500 | |
| Total Costs | 20,566 | 11,440 | 79.8 | 13,191 | 55.9 |
| **EBITDA** | **1,737** | **702** | **147.2** | **773** | **124.6** |
| Margin (%) | 7.8 | 5.8 | | 5.5 | |
| Other Income | 1,361 | 881 | 54.6 | 1,290 | 5.5 |
| Finance costs | 15 | 19 | (24.0) | 14 | 2.8 |
| Depreciation and amortization expenses | 184 | 172 | 6.9 | 229 | (19.8) |
| PBT | 2,900 | 1,392 | 108.3 | 1,820 | 59.3 |
| Exceptional | - | 140 | | | |
| PBT post Exceptional | 2,900 | 1,252 | 131.5 | 1,820 | 59.3 |
| Tax | 730 | 325 | | 371 | |
| Current Tax | 723 | 347 | | 443 | |
| Deferred Tax | 7 | (22) | | (72) | |
| | - | - | | | |
| **PAT** | 2,170 | 927 | 134.0 | 1,449 | 49.8 |
| Share of profit/loss of associate | 78 | 89 | (12.3) | 141 | (44.9) |
| PAT with associate | 2,248 | 1,016 | 121.2 | 1,590 | 41.4 |

Source: Company data, I-sec research

## Valuation methodology and key risks

We value Mazagon Dock Shipbuilders Limited (MDL) using the DCF methodology. We maintain **HOLD** with a target price of Rs295/share.

**Table 2: DCF valuation yields target price of Rs295/share**

| *(Rs mn)* | FY22 | FY23E | FY24E | FY25E | FY26E | FY27E | FY28E | FY29E | FY30E |
|---|---|---|---|---|---|---|---|---|---|
| Sales | 57333 | 60000 | 81000 | 90000 | 93000 | 88000 | 71000 | 73000 | 81000 |
| EBITDA | 4347 | 4552 | 9276 | 9610 | 10231 | 9392 | 5390 | 5431 | 6020 |
| Tax | 1862 | 1679 | 2557 | 2633 | 2648 | 2822 | 2143 | 2520 | 2775 |
| PAT | 6108 | 5930 | 8497 | 8718 | 8761 | 9270 | 7288 | 8389 | 9133 |
| NOPAT | 2485 | 2873 | 6719 | 6977 | 7584 | 6570 | 3246 | 2910 | 3245 |
| **Working Capital Change** | **(3345)** | **(33922)** | **(66221)** | **(5736)** | (14800) | **15941** | **15567** | **16093** | **(365)** |
| Capex | (375) | (1005) | (1005) | (1005) | (1005) | (1005) | (1005) | (1005) | (1005) |
| | | | | | | | | | |
| FCF | (1236) | (32053) | (60507) | 237 | (8222) | 21507 | 17808 | 17998 | 1874 |
| Terminal Value | | | | | | | | | 19117 |
| Total FCF | (1236) | (32053) | (60507) | 237 | (8222) | 21507 | 17808 | 17998 | 20991 |
| | | | | | | | | | |
| Cost of Equity | 12% | | | | | | | | |
| WACC | 10% | | | | | | | | |
| Terminal Growth | 2% | | | | | | | | |
| | | | | | | | | | |
| **NPV of FCFE (FY24E)** | **44,766** | | | | | | | | |
| **Net Cash attributable to MDL (Longer term)*** | **15,000** | | | | | | | | |
| **Equity Value** | **59,766** | | | | | | | | |
| Net Equity value | 295 | | | | | | | | |

* In the latest call, the management has guided Rs20bn as free cash available with the company
Source: Company data, I-Sec research

### Sensitivity to our DCF around WC scenarios: What if contract liability declines?

Biggest sensitivity to MDL's valuations arises from change in contract liabilities, which is the advance it receives from MoD. The extent of contract liability is based on the outstanding orderbook at any point in time. **Order inflows bring with it advances and higher cashflow for shipbuilders like MDL (advances are generally 15% of the contract value as per various defence procurement policy parameters).** Long absence of order inflows and winding down of orderbook create significant stress on cashflow and valuations. No significant accretion or a wind-down in contract liability manifests through change in working capital.

In our base case, we have assumed outstanding contracting liability at 24% of the year-end orderbook for FY30E. **If we assume the contract liability at 23%, our DCF changes to Rs178/share, and at 25% it becomes Rs427/share.** Base case assumes outstanding contract liability of Rs97bn at FY30E (FY20 was Rs114bn).

# Key risks

**Land lease**. MDL's ~42% of 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 approximately 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 hazards 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. And competitors in the submarine and heavy engineering include Hindustan Shipyard Limited. Further, GoI has taken several measures to encourage the 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 come 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 disruptions to the availability of such appropriations, or release of such funds, could adversely the company's business.

# Financial summary

## Table 3: Profit & Loss statement

*(Rs mn, year ending March 31)*

| | FY21 | FY22 | FY23E | FY24E |
|---|---|---|---|---|
| Operating Income (Sales) | 40,478 | 54,600 | 60,000 | 81,000 |
| Operating Expenses | 38,240 | 50,330 | 55,448 | 71,724 |
| **EBITDA** | **2,239** | **4,270** | **4,552** | **9,276** |
| % margins | *5.5* | *7.8* | *7.6* | *11.5* |
| Depreciation & Amortisation | 597 | 690 | 798 | 858 |
| Gross Interest | 84 | 77 | 93 | 93 |
| Other Income | 5,741 | 4,000 | 3,000 | 2,219 |
| **Recurring PBT** | **7,300** | **7,503** | **6,662** | **10,544** |
| Add: Extra ordinaries | 1,261 | - | - | - |
| Less: Taxes | 1,504 | 1,913 | 1,699 | 2,689 |
| Less: Minority Interest | | | | |
| Add: Share of profit from associates | 604 | 600 | 1,026 | 1,026 |
| **Net Income** | 5,139 | 6,189 | 5,989 | 8,881 |

Source: Company data, I-Sec research

## Table 4: Balance sheet

*(Rs mn, year ending March 31)*

| | FY21 | FY22 | FY23E | FY24E |
|---|---|---|---|---|
| **Assets** | | | | |
| Total Current Assets | 2,22,484 | 2,00,615 | 2,09,303 | 1,89,265 |
| of which cash & cash eqv. | 81,695 | 64,823 | 93,861 | 34,133 |
| Total Current Liabilities & Provisions | 2,15,588 | 1,89,083 | 1,93,187 | 1,66,191 |
| Net Current Assets | 6,896 | 11,532 | 16,116 | 23,074 |
| Investments | 5,187 | 5,187 | 5,187 | 5,187 |
| Net Fixed Assets | 8,069 | 8,384 | 8,591 | 8,738 |
| Capital Work-in-Progress | 802 | 802 | 802 | 802 |
| Other non-current assets | 14,845 | 14,845 | 14,845 | 14,845 |
| **Total Assets** | **35,797** | **40,749** | **45,540** | **52,645** |
| | | | | |
| **Liabilities** | | | | |
| **Borrowings** | | | | |
| Deferred Tax Liability | | | | |
| Other long term liabilities | 1,480 | 1,480 | 1,480 | 1,480 |
| Minority Interest | | | | |
| Equity Share Capital | 2,017 | 2,017 | 2,017 | 2,017 |
| Face Value per share (Rs) | 10 | 10 | 10 | 10 |
| Reserves & Surplus | 32,300 | 37,252 | 42,043 | 49,148 |
| Net Worth | 34,317 | 39,269 | 44,060 | 51,165 |
| **Total Liabilities** | **35,797** | **40,749** | **45,540** | **52,645** |

Source: Company data, I-Sec research

## Table 5: Cashflow statement

*(Rs mn, year ending March 31)*

| | FY21 | FY22 | FY23E | FY24E |
|---|---|---|---|---|
| Operating Cashflow | 1,465 | 2,956 | 3,879 | 7,613 |
| Working Capital Changes | -782 | -21,508 | 24,454 | -66,686 |
| Capital Commitments | -419 | -1,005 | -1,005 | -1,005 |
| **Free Cashflow** | 179 | -19,634 | 27,236 | -60,170 |
| | | | | |
| Investing Cashflow | 3,483 | 2,995 | 1,995 | 1,213 |
| Issue of Share Capital | | | | |
| Buyback of shares | 0 | 0 | 0 | 0 |
| Inc (Dec) in Borrowings | | | | |
| Dividend paid | -1,553 | -1,238 | -1,198 | -1,776 |
| Others | | | | |
| Extraordinary Items | | | | |
| **Chg. in Cash** | **2,566** | **-16,872** | **29,038** | **-59,728** |

Source: Company data, I-Sec research

## Table 6: Key ratios

*(Year ending March 31)*

| | FY21 | FY22 | FY23E | FY24E |
|---|---|---|---|---|
| **Per Share Data (Rs.)** | | | | |
| EPS(Basic Recurring) | 25.5 | 30.7 | 29.7 | 44.0 |
| Diluted Recurring EPS | 25.5 | 30.7 | 29.7 | 44.0 |
| Recurring Cash EPS | 28.4 | 34.1 | 33.6 | 48.3 |
| Dividend per share (DPS) | 7.2 | 6.1 | 5.9 | 8.8 |
| Book Value per share (BV) | 170.1 | 194.7 | 218.5 | 253.7 |
| | | | | |
| **Growth Ratios (%)** | | | | |
| Operating Income | (17.5) | 34.9 | 9.9 | 35.0 |
| EBITDA | (13.5) | 90.7 | 6.6 | 103.8 |
| Recurring Net Income | 9.2 | 20.4 | (3.2) | 48.3 |
| | | | | |
| **Valuation Ratios (x)** | | | | |
| P/E | 11.0 | 9.1 | 9.4 | 6.4 |
| P/CEPS | 9.8 | 8.2 | 8.3 | 5.8 |
| P/BV | 1.6 | 1.4 | 1.3 | 1.1 |
| EV / EBITDA | (10.6) | (1.6) | (7.9) | 2.6 |
| EV / FCF | (132.5) | 0.3 | (1.3) | (0.4) |
| | | | | |
| **Operating Ratios (%)** | | | | |
| Gross Margin (%) | 39.2 | 37.0 | 42.0 | 42.0 |
| SG&A/Sales (%) | 2.8 | 2.3 | 2.2 | 2.2 |
| Other Income / PBT | 78.6 | 53.3 | 45.0 | 21.0 |
| Effective Tax Rate | 20.6 | 25.5 | 25.5 | 25.5 |
| NWC / Total Assets | 19.3 | 28.3 | 35.4 | 43.8 |
| Inventory Turnover | 873.6 | 550.0 | 440.0 | 440.0 |
| Receivables (days) | 88.5 | 60.0 | 60.0 | 60.0 |
| Payables (days) | 608.7 | 400.0 | 400.0 | 450.0 |
| D/E Ratio (x) | 0.0 | 0.0 | 0.0 | 0.0 |
| | | | | |
| **Profitability Ratios (%)** | | | | |
| Rec. Net Income Margins | 12.7 | 11.3 | 10.0 | 11.0 |
| RoCE | 16.7 | 14.0 | 11.1 | 15.2 |
| RoNW | 15.0 | 15.8 | 13.6 | 17.4 |
| EBITDA Margins | 5.5 | 7.8 | 7.6 | 11.5 |

Source: Company data, I-Sec research

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