Cochin Shipyard Ltd | Defence

A robust play on India defence

LKP

Cochin Shipyard Ltd (CSL), a public listed company, incorporated on March 29, 1972, is a pioneer in defence shipbuilding and repairing, with a standalone ship repairing facility unlike any other competitor. Due to its expertise in shipbuilding & shiprepairing and strong, long lasting relations with its key clients, the company is benefitted to provide important warship products in the coming years. The order book size of these projects is at a healthy ₹153 bn to be delivered over the next 2-3 years. This visibility is enough long term and will lead to a good growth in revenues and profitability. Considering its strong order book with IAC and ASWC projects at the helm in the shipbuilding business, expectations of more order wins through RFP bidding, we expect a significant escalation of topline, margins and bottomline from FY21E over an elongated period of 2-3 years. On profitability front too we expect solid movement driven by higher contribution from competitively bid projects, positive operating leverage, zero LD provisions, higher contribution from the ship repairing projects & capacity expansion, superior efficiency ratios and balance sheet strength. We anticipate stable return ratios with maintenance of healthy dividend payouts and yield. CSL came out with its IPO in August 2017 at ₹432 and was oversubscribed by a whopping 76 times despite being a PSU. Now in April 2020 despite being the largest player in the public sector at a time when several of its private sector peers are either bankcrupt or on the verge of closing down, the street is less optimistic on CSL @260 despite acknowledging its vast strength across all metrics which itself to our mind presents an investment opportunity to the savvy investor At 4.7x the valuations for such a goliath in defence shipbuilding industry seems quite attractive. Hence, we initiate the company with a BUY rating and a target of ₹356 (valued at 6.5x FY 22E earnings)

A strong play in the defence industry; robust order book

CSL is a government owned company with 'Miniratna' status. It is the second largest shipyard and the largest public-sector shipyard in India with dock capacity to accommodate vessels up to 110,000 DWT. CSL has also the second largest ship repair capacity and largest among the public sector in India, which can accommodate vessels up to 125,000 DWT. The company along with the prestigious IAC project, boasts of ASWC and many other defence ship orders. The company expects new project pipeline to positively impact the revenues further.

Capacity expansion in ship repairing business to add significantly to the topline

The company is doubling its capacity at its dry dock facility used for both ship building and repairing. Also it is in the process of setting up new capacities at Mumbai, Kolkata and Andaman which are one by one coming on stream till FY22. This can accommodate more business and add to the topline of CSL.

Superior profitability and competitive moat

CSL has EBITDA margins superior than any other company within the sector, even better than most of its global peers. Historically, the company has reported strong margins in its ship repair business, the driver of overall business margins. Despite this business contributing just 20-28% of revenues in FY16-19, has been reporting margins in the range of 30-40%. Going forward, as the capacity in this business moves up and new projects like the ISRF comes up, we expect further escalation in margins. Also the company has a strong competitive moat in the form of highest margins, lowest employee to sales ratio and efficiency ratios. Although the company is in investment phase, CSL is maintaining superior return ratios and comfortable debt to equity ratio.

YE Mar	FY 18	FY 19	FY 20E	FY 21E	FY 22E
Total sales (₹ bn)	23.6	29.6	37.1	44.5	46.8
EBITDA margins (%)	19.7%	19.3%	17.7%	17.5%	18.0%
PAT margins (%)	16.8%	16.2%	16.3%	15.6%	15.8%
EPS (₹)	29.2	36.5	45.6	51.9	54.7
P/E (x)	8.7	7.0	5.6	4.9	4.7
P/BV (x)	1.1	1.0	0.9	0.8	0.7
EV/EBITDA (x)	5.8	5.6	3.6	2.4	1.2
ROE (%)	12.2%	14.4%	16.1%	16.4%	15.5%
ROCE (%)	12.6%	15.5%	15.8%	16.4%	15.8%
Dividend yield (%)	4.0%	6.4%	5.9%	6.8%	7.2%

Rating	Buy
Current Market Price (₹)	259
12 M Price Target (₹)	356
Potential upside (%)	37

Stock Data	
FV (₹)	10
Market Cap Full (₹ bn)	33
Market Cap Free Float (₹ bn)	8
52-Week High / Low (₹)	492 / 209
2-Year High / Low (₹)	544 / 209
1 Year Avg. Traded Volume	177,762
BSE Code / NSE Symbol	540678 / COCHINSHIP
Bloomberg	COCHIN:IN

Price Performance (%)

(%)	1M	3M	6M	1YR	2YR
CSL	-15%	-36%	-23%	-36%	-50%
Nifty 50	-13%	-25%	-19%	-22%	-13%

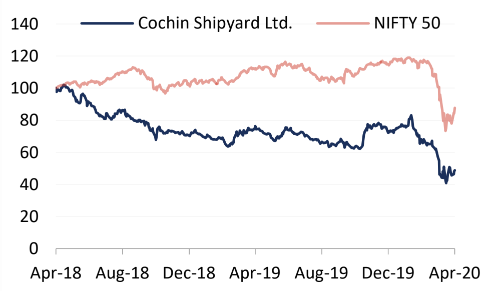
** To date / current date : April 9, 2020*

Shareholding pattern (%)

	Mar-20	Dec-19	Sep-19	Jun-19
Promoter (GOI)	72.86	75.21	75.21	75.21
FPIs	2.07	1.98	3.08	3.35
MFs	9.58	9.60	9.06	8.72
FI's / Banks	2.11	0.82	0.48	0.55
Insurance	1.35	1.27	1.27	-
Others	12.03	11.12	10.90	12.17

Source: BSE

CSL vs Nifty 50



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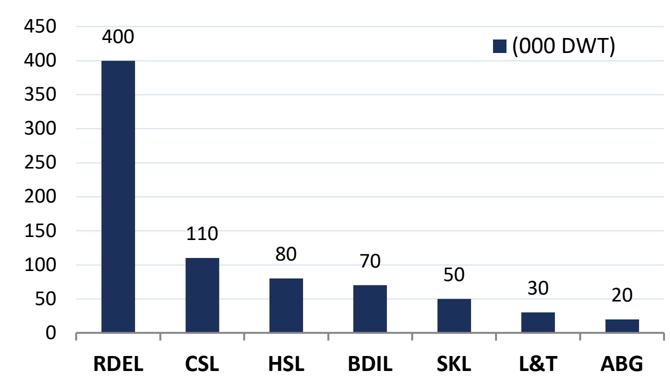
Company Profile

Cochin Shipyard Ltd (CSL), incorporated on March 29, 1972, is a government owned company with 'Miniratna' status. It is the second largest shipyard and the largest public-sector shipyard in India with dock capacity to accommodate vessels up to 110,000 DWT. CSL has also the second-largest ship repair capacity and largest among the public sector in India, which can accommodate vessels up to 125,000 DWT. Its shipyard is strategically located along the west coast of India, midway on the main sea route connecting Europe, West Asia, and the Pacific Rim – a busy international maritime route. In addition, its shipyard is located close to the Kochi port and to offshore oil fields on the western coast of India, and relatively close to the Middle East. Since its establishment in 1972 the yard has completed a large number of shipbuilding and ship repair projects for both domestic and international clients and is currently building India's first Indigenous Aircraft carrier(IAC) INS Vikrant. CSL has completed many orders for foreign companies like the Clippers Group, Bahamas and NPCC Abu Dhabi and locally for Shipping Corporation of India, ONGC, A&N Administration, and DCI.

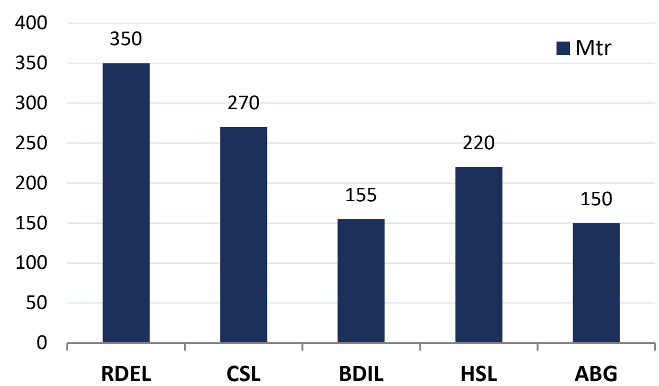
CSL commenced ship repair operations in the year 1982 and has undertaken repairs of all types of ships including up-gradation as well as periodical repairs and life extension of ships belonging to Navy, Union Territory of Lakshadweep, Coast Guard, various Port Trust, merchant ships of Shipping Corporation and other LNG carriers. The Yard was conferred the Miniratna status in the year 2008.

India's second largest shipyard, largest in public sector by capacities



Source: Company, LKP Research

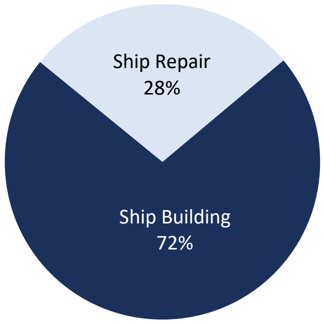
Second largest ship repairing capacity

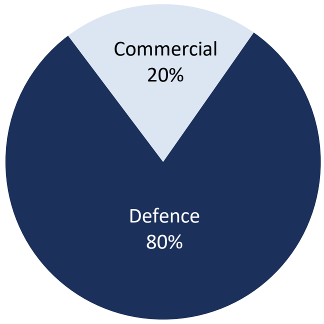


Source: Company, LKP Research

Business Segments: CSL has two major business segments, (1) Shipbuilding - which has contributed 72% of its revenues in FY19 (2) Ship repair (28% of revenues). It caters to clients from the defence sector in India and clients from commercial sectors globally for shipbuilding and ship repair. Defence shipbuilding is a complex and time-consuming activity. While commercial shipbuilding is relatively less complex, though it is subject to cyclical weaknesses. Over the last five years, CSL's defence clients have contributed to 70-80% of its revenues and have helped the company to overcome cyclical fluctuations or weaknesses in commercial shipbuilding.

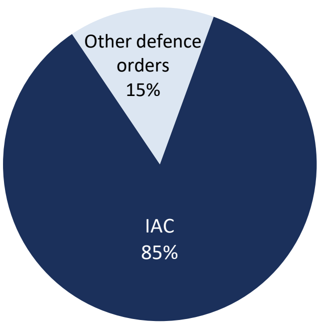
Segment wise revenue break-up(%) - FY 19





Source: Company, LKP Research

Shipbuilding revenues break-up (%) - FY 19



Source: Company, LKP Research

Shipbuilding revenues: CSL has begun its shipbuilding operations in 1975 and has transformed its capability from building bulk carriers to building smaller and more technically sophisticated vessels such as PSVs and AHTS'. It has built a wide range of vessels including bulk carriers, tankers, platform supply vessels (PSVs), anchor-handling tug-supply vessels (AHTSs), launch barges, tugs, passenger vessels, fast-patrol vessels (FPVs), and roll-on/roll-off (Ro-Ro) vessels. It has also worked with several leading technology firms including Rolls Royce Marine (Norway), and GTTs (Gaztransport & Technigaz SA), which helped increase its credibility in international markets. In the ship building segment, over the past two decades, CSL has built and delivered vessels across categories. Moreover, the company is currently building India's first IAC, joining the league of global shipyards capable of building aircraft carriers.

- **Defence shipbuilding:** Indian Navy and Indian Coast Guard Services are its two clients from the defence sector. CSL is currently building India's first indigenous aircraft carrier (IAC-1) for the Indian Navy, which is a major contributor (85%) to its defence shipbuilding revenues. It has already completed phase-1, almost completed Phase 2 and is in the middle of Phase 3. CSL has also completed the delivery of FPVs to the Indian Coast Guards. Defence has contributed 80% of its shipbuilding revenues in the last five years.

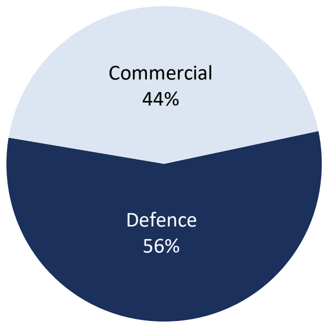
- **Commercial shipbuilding:** CSL has derived 20% of its shipbuilding revenues in the last five years from this segment. Currently, it is constructing four passenger cum-cargo vessels for the Andaman and Nicobar administration and a vessel for one of GoI's projects. It has delivered two of India's largest double-hull oil tankers to SCI. It has also exported 45 ships to various international clients such as NPCC, Clipper Group (Bahamas), Vroon Offshore (Netherlands), and SIGBA AS (Norway).

Ship Repair: CSL started its ship-repair operations in 1978, and since then it has developed adequate capabilities to handle complex and sophisticated repair jobs. It has undertaken repairs of various types of vessels, including up-gradation of ships for the oil-exploration industry and periodical maintenance, repairs, and life extension of ships. It has also partnered with Techcross Inc. for technical support, engineering, service support, and sharing of information in relation to the Ballast Water Treatment System (BWTS)'s products. In the ship repair segment, the company stands out by being the only shipyard capable of repairing air defence ships in India. Also, all dry docking repairs of Indian Navy's aircraft carriers (including INS Viraat and INS Vikramaditya) further burnish the company's credentials.

- **Defence ship repair:** CSL undertakes ship repair for the Indian Navy. In FY14-19, it repaired about 25 naval ships with scope of work varying from routine to complex. It has also completed refits of INS Aditya, INS Sukanya, INS Shardul, INS Viraat, and INS Vikramaditya for the Indian Navy. It is the only commercial shipyard to have undertaken repair work of Indian Navy's aircraft carriers - INS Viraat and INS Vikramaditya.

- **Commercial ship repair:** It has also undertaken major revamping and refurbishing of oil rigs in almost all major offshore vessels and rigs of ONGC, involving steel renewal, up gradation of drilling, cementing, mechanical, HVAC, and piping systems. It has MoUs with the Lakshadweep Development Corporation Ltd (LDCL), Directorate General of Lighthouses and Lightships (DGLL), and Dredging Corporation of India (DCI), to undertake ship-repair work on a bulk-volume basis. Key clients from the commercial sector include SCI, ONGC, and DCI.

Ship Repair revenues - FY 19



Source: Company, LKP Research

IAC, the pivotal project of CSL - One of the main projects undertaken by CSL is the IAC (Indigenous Aircraft Carrier - IAC), a 37,500 tn air defence ship (P 71). IAC contributed 85% of Shipbuilding revenues in FY 19. The ship has got three phases and will be commissioned into the Indian navy as INS Vikrant. CSL won the order to construct IAC-1 in 2007 and laid the keel in February 2009. The carrier was floated out of the dry dock in December 2011 and launched in August 2013. The project has missed multiple completion deadlines due to scale- and complexity-related issues and is expected to be complete by 2022-23 (against earlier estimate of December 2018); it may enter service by 2025.

The contract of the IAC is structured into three packages and sub divided into a fixed price contract and a cost-plus contract. Fixed price contract is for the scope that CSL will execute internally, while the cost-plus contract is for equipment to be procured from third-party approved vendors. The fixed-price contract has a high-value-add from CSL, and yields higher margins; the cost-plus revenues are booked with a normative margin of 12.5%.

CSL completed Phase -1 of the project in 2017 and has completed 80% of Phase-2 as of FY19. It expects to complete execution of Phase-2 by FY20, and will begin Phase- 3 concurrently. As of

FY19, CSL has booked cumulative revenues of INR 92bn on the project. The pending execution on the project is ~INR 68bn (₹ 41 fixed price and ₹27 bn cost plus), in our view, which should accrue as revenues between FY20E-22E. After delivery of the ship in FY22-23, the navy will conduct sea trials of the ship for about two years and it should induct the ship by FY25.

Industry

Global Defence Shipbuilding

The global naval shipbuilding market has witnessed a slowdown in the past few years due to the cutback on military spending by major western countries dealing with the aftereffects of the global economic crisis. However, the global shipbuilding market is expected to turn around given the need to replace older vessels in the naval fleet in major economies and the increase in the level of sophistication in combat technology. The global naval shipbuilding market would peak in 2021 driven by demand for both surface combatants and submarines. Globally, the average age of warships is as high as twenty-five years and around 180 procurement programs are under execution in various countries.

Global fleet strength

Country	Aircraft Carriers	Destroyers	Frigates	Corvettes	Submarines	Others*	Total Fleet
United States	19	63	8	0	70	255	415
Russia	1	15	6	81	63	186	352
China	1	35	51	35	68	524	714
India	2	11	14	23	15	230	295**
Japan	4	42	0	6	17	62	131
South Korea	1	12	13	16	15	109	166
UK	2	6	13	0	11	44	76
France	4	4	11	0	10	89	118
Germany	0	0	10	5	6	60	81

Source: globalfirepower.com; DRHP
**Others include Fleet Support Ships, Landing Platform Docks, Landing Craft Utilities, Offshore Support Vessels, etc.*
***includes both Indian Navy and Indian Coast Guard*

Indian Defence Shipbuilding-

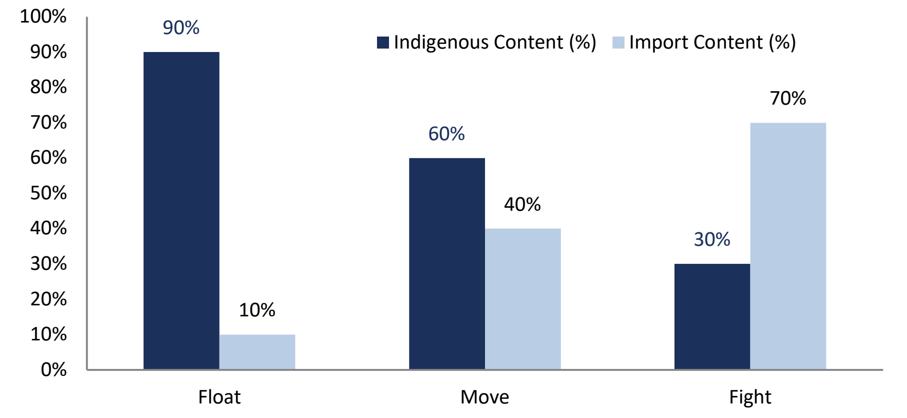
Defence shipbuilding in India is emerging as an area of focus for public and private sector shipyards alike. While, the public sector shipyards such as Garden Reach Shipbuilders & Engineers Limited (GRSE), Mazagon Dock Shipbuilders Limited (MDL), Goa Shipyard Limited (GSL) and Cochin Shipyard Limited (CSL) are the frontrunners in the defence shipbuilding space, an increasing number of private shipyards are undertaking specific measures to enhance competence and modify their existing shipbuilding repair facilities to suit the needs of the Indian Navy and the Indian Coast Guard. Among the private shipyards, Reliance Naval and Engineering Limited (RNEL), L&T Shipbuilding, and ABG Shipyard Limited, which entered the shipbuilding market as commercial shipbuilders, have been repositioning themselves as companies with defence shipbuilding capabilities.

The Indian Navy fleet includes mainly three categories of vessels/combat platforms:

1. Surface ships
2. Naval aviation
3. Sub-surface vessels/submarines

The Indian Navy fleet also includes landing platform docks such as the Austin Class (Jalashwa) and landing ship tanks such as the Shardul Class (built by GRSE) and Magar Class (built by Hindustan Shipyard Ltd.), fleet tankers, torpedo recovery vessels, ocean going tugs, offshore patrol vessels, etc. The Indian Navy categorises all warship equipment into three key categories, float (all systems and equipment related to the hull structures and fittings); move (the propulsion systems such as engines, alternators, etc.) and fight (all kinds of ship-borne weapons and sensor systems).

Level of indigenisation



Source: Indian Navy Indigenisation Plan; DRHP

Capabilities of shipyards in India

Company	Types of ships build
Mazagaon Dock	Submarines, Corvettes, Destroyers, Frigates, Dredger (Merchant Ship)
Cochin Shipyard	IAC, Anchor Handling Vessels, Platform Supply Vessels, Fast Patrol Vessels
Garden Reach	Frigates, Corvettes, Patrol Vessels, Landing Craft Utility, Landing Ship Tank, Survey Vessels
Goa Shipyard	Mine Sweepers, Landing Craft Utility, Offshore Patrol Vessels, Patrol Vessels, Survey Vessels, Fast Interceptor Boats
Hindustan Shipyard	In-shore Patrol Vessel, Patrol Vessels, Bulkcarriers, Cargo Liners
Reliance Naval	Landing Platform Dock, Patrol Vessels, Interceptor Boats
L&T Shipbhuilding	Landing Platform Dock, Patrol Vessels, Interceptor Boats
ABG Shipyard	Tug Vessels, Interceptor Boats, Cement Carriers, Diving Support Vessel

Source: Company, LKP Research

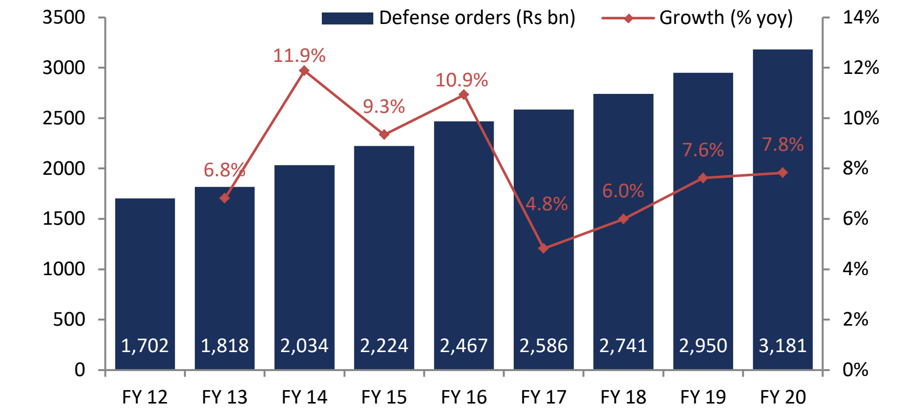
Defence Orders Potential up to 2027

Currently, the Indian Navy fleet includes 135-140 ships and submarines while the Indian Coast Guard fleet includes another 120 vessels. The Indian Navy and Indian Coastal Guard fleet are each expected to grow to about 200 vessels by 2027. The two defence units have jointly approved a shipbuilding programme spanning over fifteen years, under which they would place orders for 165 warships and 400 aerial resources by 2022. The Indian Coast Guard (ICG), with an existing fleet of 130 ships and 62 aircraft, plans to take its fleet strength to 200 ships and 100 aircraft by 2022. Currently, 70 ships for the ICG are under construction in 6 shipyards, while the bidding process for 30 more ships is in process. For the ICG, the government has approved a ₹320 bn action plan. The ICG recently acquired 34 interceptor boats out of the 36 being built by L&T Shipbuilding. These contracts for these boats are worth ₹300 mn each. According to industry sources, Indian Navy's estimated capital budget for up to 2027 amounts to ₹4.5 tn approximately. The planned expenditure includes a separate estimate for various vessel categories including submarines (₹ 2.2 tn approx.), destroyers/frigates (₹900 bn – ₹ 1 tn), aircraft carriers (₹450 bn – ₹ 500 bn), corvettes, landing platform docks, etc.

Review of Indian Defence Spending

The defence budget for FY20 stood at ₹3.18 tn. The allocation made in the Union Budget is an increase of 6.87% over revised estimates of ₹2.98 tn given in FY19. The allocation of ₹3.18 tn has been estimated at around 1.6 % of the GDP. In a significant move, import of defence equipment not manufactured in India has been exempted from basic customs duty. This will have an impact of augmenting the defence budget by approximately ₹250 bn on account of savings in expenditure on customs duty over the next five years. Out of the total allocation, ₹1.08 tn has been set aside for capital outlay to purchase new weapons, platforms and military hardware. Under capital outlay, the Army was granted ₹294.5 bn, the Navy was given ₹ 231.6 bn and the Indian Air Force got an allocation of ₹393.02 bn. There was a reduction in Navy allocation due to overall financial stress in the economy. However, we believe that this will hardly impact CSLs order book as the orders given are for the long term and stage payments do happen from the clients. Hence, as the economy improves hereon, we are not overly worried about this scenario.

Budgetary allocation for defence sector(₹ bn)



Source: Company, LKP Research

Investment Argument

A strong play on Indian defence story

CSL offers investors an opportunity to play the India defence sector, as there are not many listed, sizeable companies currently. Even though CSL is rated a commercial shipyard, it derives 85% of its revenues and order book from the defence sector. It is also a play on the naval shipbuilding opportunity in India, as major government shipyards remain in the unlisted space. There are listed shipyards in the private sector such as Reliance Defence, ABG, and Bharati, but they are loss-making and still haven't won sizeable orders in defence. The company also has core competence in providing end to end ship repair services to government and commercial clients.

Robust order-book – 5x FY19 revenues

As of 3Q FY19, CSL has a total order book of ₹153 bn. It includes declared orders of ₹23.4 bn plus L1 status for ASW vessels (₹63 bn) and 56 boats (₹3.8 bn). CSL has received order for phase III of IAC worth ₹32.3 bn, which could take the total IAC revenue worth ₹70bn (₹42 bn as fixed price contract and ₹28 bn as cost-plus contract). Mini bulk carriers (4 nos.) order from JSW steel amounting to ₹3 bn, to be executed by December 2020. 9 FBOPs(Floating Border Outpost vessels) orders amounting to ₹2.7 bn is expected to be executed within 18-24 months. CSL also has order worth ~₹5 bn for ship-repairing division. This translates to 4x FY19 sales, providing a significantly long-term visibility on revenues. In addition to a robust order-book, CSL has an opportunity pipeline of new orders which are likely to be finalised in the ensuing years.

The order pipeline includes: a) 8 fast patrol vessels (INR 8bn), b) 12 air cushion vessels (INR 5.5bn), c) 6 next gen missile vessels (INR 13.6bn), d) multi-purpose vessels (INR 28-30bn) and e) survey and training vessels (INR 7.5bn).

Order book schedule

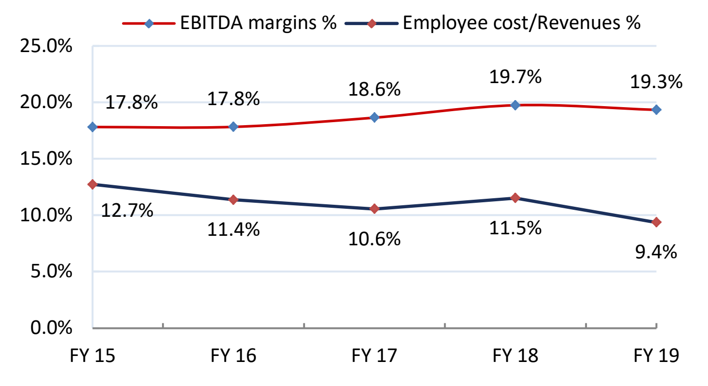
Order book	Total no. of Vessels	Balance order (₹ mn)
Order from Indian Navy (IAC & ASWC)	9	133,418
Orders from GOI, MOS	14	6,049
Orders from GOI, MOD & MHA	10	3,797
Fishing vessels (TN Gov) & other small vessels)	6	209
Small passenger ferry (KMRL) and mini cargo vessels	27	4,059
Ship repair orders		5,000
Total		**152,531**

Source: Company, LKP Research

Efficient, profitable and cost-competitive as compared to its peers

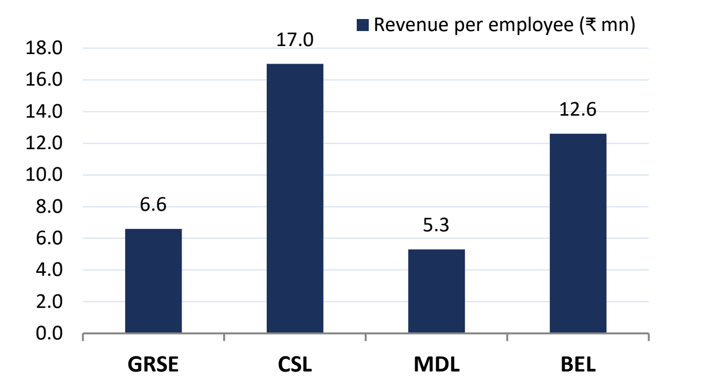
CSL can execute projects efficiently due to its system of sub-contracting, which helps it in ship-repair projects and production planning. Against a full-time employee size of 1,791 (March 2019) it employs about 600 contract employees and ~3000 daily subcontract workers, which allows it to maintain a flexible work force. Its integrated structure (build yard and repair facilities in the same location) allows interchangeability of employees, depending on workload on either business segments. In our view, CSL is the most efficient shipyard among all public-sector ones. We analysed its employee-cost intensity to revenues and gather that employee costs accounted for just 9.4% of sales in FY19 vs. 14.8%/21%/19.1%/22.1% for Mazgaon Dockyard Shipbuilders (MDL)/Garden Reach Shipbuilders & Engineers (GRSE)/Goa Shipyard (GSL)/Hindustan Shipyard (HSL) respectively. Also on the revenue per employee parameter, CSL ranks higher than all other shipyards at ₹17mn vs. INR 5.3/6.6/12.6/3mn for MDL/ GRSE/BEL/HSL. Its EBITDA margins are also highest and much superior to its peers. Even compared to global listed shipyards, CSL's margins are significantly higher than mean margins.

EBITDA margins vs Employee cost / Revenues



Source: Company, LKP Research

Revenue per Employee (₹ mn)



Source: Company, LKP Research

EBITDA margins (%)

	FY 15	FY 16	FY 17	FY 18	FY 19
CSL	17.8	17.8	18.6	19.7	19.3
GRSE	1.1	5.3	-16.7	-1.3	3.0
MDL	8.7	5.3	3.5	3.3	5.4
GSL	-8	13	15	20	19
HSL	-22.2	-59.3	-3.8	9.2	13.8

Source: Company, LKP Research

Government initiatives and favourable policies:

Given below are a few key initiatives undertaken by the Government to aid the growth and development of the domestic shipbuilding industry.

- **Granting of infrastructure status to the shipbuilding sector:** In January 2016, the Government announced inclusion of stand-alone shipyards (those undertaking activities such as shipbuilding and ship-repair) under the harmonized list of infrastructure sectors. This inclusion would allow shipyards to seek flexible structuring of long-term project loans (until now Indian banks did not provide term loans longer than 8-9 year tenure often leading to cash flow mismatches), long-term funding from Infrastructure Funds at lower interest rates and for a longer tenure suitable to the economic life of their assets, relaxed ECB norms, and issuance of infrastructure bonds to meet working capital requirements. Overall, this move would broaden the funding options available to Indian shipyards, hence providing them the much-needed cushion to undertake capex to enhance and expand the existing yard facilities.

- **Shipbuilding financial assistance policy for Indian shipyards for contracts signed between 2016 -2026:** In December 2015, the Government approved the Shipbuilding Financial Assistance Policy for Indian shipyards. The policy involves a budget of ₹40 bn spanning a period of 10 years to provide an impetus to the domestic shipbuilding sector. Under this policy, all contracts signed between 2016 and 2026 would be eligible for a subsidy of 20% of the fair price or contract price (whichever is lower) of the contracted vessel. The rate of 20% would be reduced by 3% every 3 years over the decade. This scheme has been introduced after the expiry of the previous scheme which ended in 2007 but was extended until March 2014.

- **Sagarmala Programme to boost domestic demand for shipbuilding:** In August 2014, the government of India launched the Sagarmala programme, which lays out a total 415 projects with a combined infrastructure investment of ₹8 bn between FY2016 and FY2035. The

Sagarmala programme aims to modernize the country's ports and increase transportation of cargo and passengers through inland waterways. The programme entails development of 6 new ports and new waterways, which will create the requirement for dredgers and harbour crafts. There would be greater oil exploration activity in deepwater leading to greater demand for offshore rigs and vessels. Further, there would be increase in demand for ships and ports to handle liquid and gas cargoes. With the emphasis on Make in India, this initiative would also look at job creation in the shipbuilding sector, as a part of which, Cochin Shipyard Limited is planning a capacity expansion and setting up ship repair facilities in other ports.

Capacity expansion to drive growth

CSL plans to expand its capacity of Dry Dock (₹17.9 bn) in the existing premises and ISRF (International Ship Repair Facility) (₹9.7 bn) at Willingdon island in Cochin Port Trust premises, which is expected to be operational by FY21-22 and manufacture 70 small ships at a time. Till Sep 19, the company has spent ₹7bn on these projects. This is expected to double the operational capability of the yard by enabling it to construct and repair larger vessels like LNG carriers, new generation Air Craft carriers etc. Being the only yard in India to have undertaken the repairs of Aircraft carriers, CSL has proven track record in ship building and ship repair. CSL has also signed MoUs with Mumbai, Kolkata and Andaman & Nicobar port administrations to operate ship repair facilities which are likely to drive ship repair revenue. Management expects Mumbai facility to become fully operational by FY22, however to add ₹750 mn and ₹1.2 bn in FY 20E and FY21E respectively to the topline. Kolkata facility is expected to commission by FY 22 only, while the Andaman facility has just commisioned. We expect this capacity expansion to yield higher revenues of upto ₹20-25 bn from FY22 onwards.

Ship repair business portfolio growing well, despite cash flow issues from Indian Navy

The domestic commercial ship repair market is growing at a steady state 8-10%. CSL derives 44% of ship repair revenue from the commercial segment, while the balance 56% is from the defence vertical. The company clocked 32% CAGR over the past three years in ship repair driven by building additional capabilities to cater to repairs of vessels of the Indian Navy. Currently, it caters to ~80-100 ships from its single dry dock, limiting its potential. The new ISRF (International Ship Repair Facility) will increase CSL's capacity to ~150-180 vessels, almost doubling its current ship repair capacity. Further, the businesses at Mumbai and Kolkata will bolster its capacity and capability.

As any capital asset requires repairs during its lifetime, a ship requires refit during its lifecycle. This places CSL in a favourable position, providing it a steady stream of work, apart from the initial manufacturing. Under normal circumstances, an IAC undergoes a short servicing in 1.5 years (~INR 500mn) and the third year (~INR 1bn), followed by a normal servicing (~INR 2.5bn) in the fifth year and finally a medium servicing (~INR 5bn) in the seventh year. Hence, we would like to mention that ship repairing business is a recurring business and a strong forte of CSL.

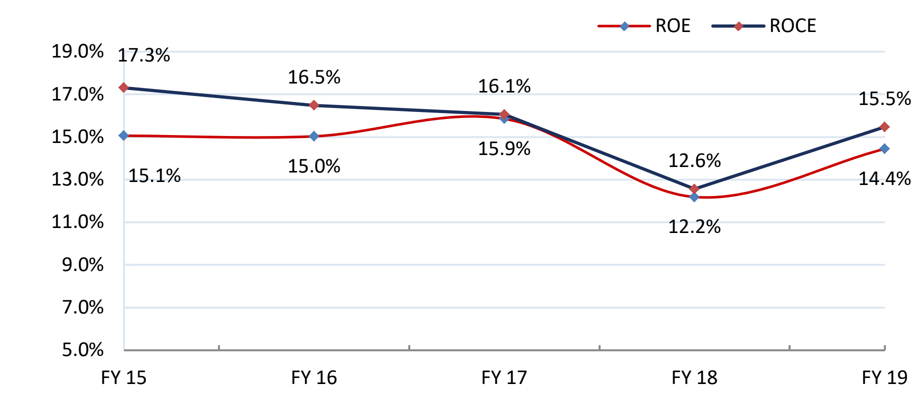
As mentioned in the above point, we expect the ship repair business to ramp up in terms of revenues with Mumbai ship repair facility gaining momentum, Kolkata facility completing the first few units and Port Blair facility recently commissioned. The business should clock ~₹6.6 bn of revenues in FY2020 and ~₹7.5 bn in FY2021. FY2022 is likely to see the Mumbai facility become fully operational (peak revenues of ₹2 bn+) and ISRF (peak revenues of ₹3.5 bn) getting commissioned. These would brighten prospects of the business growing to ₹10.8 bn in FY2022. A bulk of current ship repair jobs come from the Indian Navy, facing some build-up of receivables. We estimate CSL's ship repair revenue to post 10% CAGR over FY19-22E

Given the ₹1.8 bn combined starting depreciation of the ISRF& dry dock and ability of the former to do sub ₹1 bn EBIT at peak utilization, CSL would require to generate an annual business of at least ₹5 bn from the dry dock in order to break-even. CSL's marketing is scouting for commercial shipbuilding/ship repair jobs and rig revamp and upgrade jobs for this purpose.

Strong balance sheet, superior margins and competitive moat

CSL has EBITDA margins superior than any other company within the sector, even better than most of its global peers. Historically, the company has reported strong margins (>30%) in its ship repair business, the driver of overall business margins. Despite this business contributing just 28% of revenues in FY 19, has been reporting margins in the range of 30-40%. In Q3 FY20, due to some one offs, the segment reported just 13% margins. However, going forward, with new ISRF project coming up, along with new businesses opening up at the new plants at Mumbai, Kolkata and Andaman, we expect this to increase back to ~30%. Similarly, within the Shipbuilding segment, increased business from the competitively bid ASWC project will start pushing up the margins from FY 21E onwards. The efficiency ratio of the company as mentioned above (Revenues/number of employees) is also best in the industry at 17x. On the return ratios also the company has been constantly reporting numbers in the range of 15-17%, above any other peer, despite a strong dividend policy. Though the company is in capital intensive phase with a capex of ₹27-28 bn between FY 20-22E, the net debt to equity ratio is below 1x which is quite comfortable.

ROE vs ROCE (%)



Source: Company, LKP Research

Outlook and valuation

CSL, the biggest public sector defence shipbuilder and repairer offers investors an opportunity to play the India defence sector, as there are not many sizeable, listed companies currently. Backed by a strong and stable management, the company has a robust order book within both the businesses of shipbuilding and ship-repairing. The company boasts of bagging and successfully delivering the prestigious ongoing IAC project and has competitively won the ASWC project whose commissioning will start from FY21. On the ship repairing business side, the company is in a heavy capex mode, with doubling of the dry dock capacity and expansion of its repairing outlays at Mumbai, Kolkata and Andaman. This would help the company to increase its high margin ship repairing business to the government as well as the private players. CSL has the best margins and efficiency ratio (revenue to employee) ratio in the industry, with minimum employee costs to revenue ratio and almost zero liquidity damages. With a robust pipeline of bid projects in this space CSL stands a great array of opportunities in the defence space. On the balance sheet front, with superior return ratios and comfortable debt position, we find this company to continue to report increasing profitability. We believe with rising topline, margins and a strong visibility of projects over the next 2-3 years, the stock looks quite attractive at 4.7x FY22E earnings. We initiate CSL with a BUY rating and a target price of ₹356.

Key risks

- Any delay in execution may result in come back of LD provisions and lower than expected revenues.
- Any unplanned, unscheduled changes may result in missing the target
- Competition in the defence shipbuilding sector has increased as it has been opened for private sector
- Change in government policy regarding bidding or payment mode may impact the financials.
- Failure in winning the upcoming bids of newer projects may stall the growth.
- No hike in budgetary allocation for Navy may hamper growth

Consolidated Financial

Income Statement

YE Mar (₹ mn)	FY 18	FY 19	FY 20E	FY 21E	FY 22E
Total Revenues	**23,551**	**29,622**	**37,100**	**44,500**	**46,800**
Raw Material Cost	11,908	15,017	20,034	24,119	24,898
Employee Cost	2,714	2,776	3,154	4,139	4,680
Other Exp	4,279	6,101	7,346	8,455	8,798
EBITDA	**4,651**	**5,728**	**6,567**	**7,788**	**8,424**
EBITDA Margin(%)	*19.7%*	*19.3%*	*17.7%*	*17.5%*	*18.0%*
Depreciation	375	342	407	578	665
EBIT	**4,276**	**5,387**	**6,160**	**7,209**	**7,759**
EBIT Margin(%)	*18.2%*	*18.2%*	*16.6%*	*16.2%*	*16.6%*
Other Income	1,892	2,281	2,481	2,560	2,640
Interest	119	154	450	500	550
PBT	**6,049**	**7,514**	**8,191**	**9,269**	**9,849**
PBT Margin(%)	*25.7%*	*25.4%*	*22.1%*	*20.8%*	*21.0%*
Tax	2,081	2,702	2,130	2,317	2,462
Adjusted PAT	**3,968**	**4,812**	**6,062**	**6,952**	**7,387**
APAT Margins (%)	*16.8%*	*16.2%*	*16.3%*	*15.6%*	*15.8%*
Exceptional items	0	0	0	0	0
PAT	**3,968**	**4,812**	**6,062**	**6,952**	**7,387**
PAT Margins (%)	*16.8%*	*16.2%*	*16.3%*	*15.6%*	*15.8%*

Key Ratios

YE Mar	FY 18	FY 19	FY 20E	FY 21E	FY 22E
Per Share Data (₹)					
Adj. EPS	29.2	36.5	45.6	51.9	54.7
CEPS	31.9	39.0	48.6	56.2	59.6
BVPS	239.4	252.4	282.4	316.5	352.4
DPS	7.5	12.4	11.4	13.0	13.7
Growth Ratios(%)					
Total revenues	14.4%	25.8%	25.2%	19.9%	5.2%
EBITDA	21.1%	23.2%	14.6%	18.6%	8.2%
EBIT	23.8%	26.0%	14.4%	17.0%	7.6%
PAT	23.4%	21.3%	26.0%	14.7%	6.2%
Valuation Ratios (X)					
PE	8.7	7.0	5.6	4.9	4.7
P/CEPS	8.0	6.5	5.2	4.5	4.3
P/BV	1.1	1.0	0.9	0.8	0.7
EV/Sales	0.9	0.9	0.6	0.3	0.2
EV/EBITDA	5.8	5.6	3.6	2.4	1.2
Operating Ratios (Days)					
Inventory days	96.4	68.9	71.0	73.0	75.0
Recievable Days	89.9	48.3	52.0	55.0	58.0
Payables day	42.2	42.7	43.0	43.0	44.0
Net Debt/Equity (x)	0.90	0.94	0.94	0.94	0.94
Profitability Ratios (%)					
ROCE	12.6%	15.5%	15.8%	16.4%	15.8%
ROE	12.2%	14.4%	16.1%	16.4%	15.5%
Dividend yield	4.0%	6.4%	5.9%	6.8%	7.2%

Balance Sheet

YE Mar (₹ mn)	FY 18	FY 19	FY 20E	FY 21E	FY 22E
Equity and Liabilities					
Equity Share Capital	1,359	1,315	1,315	1,315	1,315
Reserves & Surplus	31,199	32,005	36,242	41,102	46,265
Total Networth	**32,559**	**33,321**	**37,558**	**42,417**	**47,581**
Total debt	1,230	1,230	1,230	1,230	1,230
Long term provisions	254	270	270	270	270
Current Liab & Prov					
Trade payables	2,721	3,466	4,371	5,242	**5,642**
Short term prov + borrowings	2,899	4,218	4,218	4,218	4,218
Other current liabilities	15,118	9,930	9,930	9,930	9,930
Total current liab and privs	20,738	17,614	18,519	19,391	19,790
Total Equity & Liabilities	**54,781**	**52,435**	**57,577**	**63,309**	**68,871**
Assets					
Net block	2,845	3,130	3,023	2,745	2,380
Capital WIP	1,148	3,411	3,711	4,011	4,311
Other non current assets	2,524	5,260	5,260	5,260	5,260
Total fixed assets	**6,517**	**11,800**	**11,994**	**12,016**	**11,951**
Cash and cash equivalents(i)	7,913	9,783	14,307	19,669	26,274
Bank deposits other than (i)	26,991	15,445	13,445	11,445	9,445
Inventories	3,146	2,834	3,897	4,824	5,116
Trade receivables	5,801	3,923	5,285	6,705	7,437
Other current assets	4,413	8,648	8,648	8,648	8,648
Total current Assets	**48,264**	**40,634**	**45,583**	**51,292**	**56,920**
Total Assets	**54,781**	**52,435**	**57,577**	**63,309**	**68,871**

Cash Flow

YE Mar (₹ mn)	FY 18	FY 19	FY 20E	FY 21E	FY 22E
PBT	6,049	7,514	8,191	9,269	9,849
Depreciation	375	342	407	578	665
Interest	114	143	450	500	550
Chng in working capital	2,932	(8,515)	(1,520)	(1,475)	(624)
Tax paid	(1,561)	(2,006)	(2,130)	(2,317)	(2,462)
Other operating activities	0	0	0	0	0
Cash flow from operations(a)	**6,321**	**(4,483)**	**5,398**	**6,555**	**7,978**
Capital expenditure	(136)	(575)	(600)	(600)	(600)
Chng in investments	2	0	0	0	0
Other investing activities	(13,149)	11,012	2,000	2,000	2,000
Cash flow from investing (b)	**(13,283)**	**10,437**	**1,400**	**1,400**	**1,400**
Free cash flow (a+b)	**(6,963)**	**5,954**	**6,798**	**7,955**	**9,378**
Inc/dec in borrowings	0	0	0	0	0
Dividend paid (incl. tax)	(1,223)	(1,963)	(1,825)	(2,093)	(2,223)
Interest paid	(114)	(116)	(450)	(500)	(550)
Other financing activities	(160)	(2,010)	0	0	0
Proceeds from IPO	9,620	0	0	0	0
Cash flow from financing (c)	**8,122**	**(4,090)**	**(2,275)**	**(2,593)**	**(2,773)**
Net chng in cash (a+b+c)	**1,160**	**1,864**	**4,523**	**5,363**	**6,604**
Closing cash & cash equiv.	**7,919**	**9,783**	**14,307**	**19,669**	**26,274**

Source: Company, LKP Research

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