BUY (Maintained)

CMP: **INR 1,682** Target Price: **INR 2,450** ▲ 46%

ICICI Securities

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18 July 2024

India | Equity Research | Company Update

Azad Engineering

Defence

The best is yet to come!

We recently hosted Azad Engineering's (Azad) management for an interaction with investors. Key points: 1) At a vantage point for healthy earnings growth. 2) Execution visibility on the upcoming 95,000m^2 facility. 3) Targeting market share of up to 10% in the long run (currently 1%) in light of significant TAM. 4) Expect the recent order for ATGG engine to be a significant step in the next leg of growth. 5) Expect working capital days to reduce to 180, as upcoming verticals A&D and oil & gas achieve critical mass. In our view, the nature of current order wins suggests that Azad is expanding both its share and scope, aided by cost efficiencies and process innovation. Given the significant earnings growth potential and exciting long-term prospects, we shift to the DCF-based methodology, valuing Azad at INR 2,450.

Opportunities aplenty

Azad's current share in total addressable market (TAM) for the products (for which Azad has qualified) is a mere 1%. The company is an approved supplier for the major players in energy, Aerospace & Defence (A&D) and Oil & Gas (O&G) segments. Furthermore, its recent order wins are spread across the domains of: defence and commercial in aerospace, combustor in energy, and critical parts for O&G, enhancing Azad's presence across the verticals it operates in. In the domestic aerospace segment, the recent engagement with GTRE as sole development-cum-production partner (DoPP) for ATGG engines implies Azad's entry in the engine manufacturing space, which we believe would blossom over a period. There are many engines being imported for various platforms with massive opportunities in the defence ecosystem.

An extended period of steep earnings growth in sight

As a result of recent order wins, Azad's current order book stands north of INR 30bn (Dec'23: INR 16–18bn). Besides, the company has added new customers and domains such as combustor (for energy). Hence, the high earnings growth phase is likely to continue. This is also aided by Azad's cost efficiencies compared to peers. Management is on the path to increase Azad's wallet-share with existing customers, from 1% (currently) to ~10% in the long run.

Financial Summary

Y/E March (INR mn)	FY23A	FY24A	FY25E	FY26E
Net Revenue	2,517	3,408	4,658	6,011
EBITDA	723	1,166	1,635	2,121
EBITDA Margin (%)	28.7	34.2	35.1	35.3
Net Profit	85	586	992	1,299
EPS (INR)	1.4	9.9	16.8	22.0
EPS % Chg YoY	(71.2)	591.4	69.4	30.9
P/E (x)	1,173.0	169.7	100.1	76.5
EV/EBITDA (x)	109.6	65.6	47.3	36.4
RoCE (%)	10.8	13.9	14.3	14.8
RoE (%)	6.1	18.1	18.9	17.3

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Market Data

Market Cap (INR)	99bn
Market Cap (USD)	1,190mn
Bloomberg Code	AZAD IN Equity
Reuters Code	AZAD.BO
52-week Range (INR)	2,080 /642
Free Float (%)	24.0
ADTV-3M (mn) (USD)	4.3

Price Performance (%)	3m	6m	12m
Absolute	34.9	151.2	0.0
Relative to Sensex	24.2	140.8	0.0

Earnings Revisions (%)	FY25E	FY26E
Revenue	-	-
EBITDA	-	0.2
EPS	8.5	10.0

Previous Reports

24-05-2024: Company Update

23-05-2024: Q4FY24 results review

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Three-dimensional growth prospects intact

In our initiating coverage report (Link), we professed three vectors propelling Azad's earnings growth: 1) Industry growth, particularly A&D. 2) Higher wallet share from the player due to cost efficiencies and product quality. 3) Product diversification. In A&D, where Azad has just begun cornering greater market share of supplying components, there is sizeable opportunity to supply airfoils and other complex components.

In the past five months, we have seen progress on all the three above-mentioned fronts, evident in: 1) Five new orders since Feb'24 across segments and domains. 2) Broadening base in aerospace in both commercial and defence. 3) Transitioning from component supplier to solutions provider – GTRE contract. 4) Contract for combustor parts from GE Vernova. 5) Addition of new clients.

In our view, Azad is on the long runway of significant earnings growth with significant TAM still available.

Outlook and valuation: Maintain BUY

We believe that it is less than prudent to value Azad on relative valuation at this point in time, as its growth trajectory is much steeper compared to peers. Besides, the value of some of the orders in the public domain is still not known; hence, there is an upside risk to our existing earnings estimates in the medium term.

Given the orders, long-term contracts/agreements and roadmap worth upwards of INR 30bn, provided by the existing customers, we believe that four years of revenue is already covered. Besides, management mentioned that it has visibility on the entire 95,000m^2 facility due to commencement of operations from FY27, post which there is another 75,000m^2 facility awaiting commencement. In our view, both facilities will feed rapid earnings growth until FY35E.

Hence, we switch over to the DCF methodology until FY35 in order to value the earnings more appropriately. Our TP works out to INR 2,450/share, implying an upside of 46% on CMP. We maintain **BUY** on Azad.

Key Risks

- Delay in approvals from OEMs
- Product concentration around air foils
- Slowdown in aerospace sector might result in lower revenue growth

Recent order wins have pushed order book past INR 30bn

Since Jan'24, Azad has won overseas orders from GE Vernova and Siemens Energy in the energy segment which encompasses gas, thermal, nuclear and industrial domains. Further, the company has obtained an order from Baker Hughes and one of its subsidiaries in the O&G segment.

Exhibit 1: Recent order wins

Month	Client	Components	Segment	Other details
Jul-2024	Siemens Energy	Manufacture and supply of critical rotating components	Gas and Thermal Turbine Engines	
Jul-2024	GTRE	End to end manufacturing, assembly, and integration of ATGG	A&D	
Mar-2024	GE Vernova	High-complex rotating airfoils	Nuclear, Industrial and Thermal power industry	USD 35mn for a period of 7 years
Mar-2024	A subsidiary of Baker Hughes	Supply of high-complex and critical components	O&G	5 years
Mar-24	Baker Hughes Oilfield Operations LLC	Supply of medium-high complex precision machined components	O&G	5 years
Jan-2024	Rolls-Royce	Production/supply of critical engine parts for defence/military aircraft engines	A&D	

Source: I-Sec research, Company data

In the domestic market, Azad has received a contract from GTRE for end-to-end manufacturing, assembly, and integration of a complete assembled ATGG engine. Azad will be the single-source Industry Partner (IP) to GTRE for this engine and the first batch of fully-integrated turbo engines will be delivered by early-CY26.

These order wins have resulted in firm order, long-term contracts/agreements and roadmap to rise above INR 30bn compared to INR 18–20bn six months back. Further, the orders are distributed across different domains, clients and segments, showcasing the company's ability to broaden its earnings base within the TAM.

Order for ATGG engine – a giant leap

Azad has received a contract from GTRE for end-to-end manufacturing, assembly, and integration of a complete assembled ATGG engine. Azad will be the single-source IP to GTRE for this engine and the first batch of fully-integrated turbo engines will be delivered by early-CY26. In our view, this development showcases Azad's evolvement from component/sub-systems supplier to solution provider and will likely deepen its presence in domestic and global defence ecosystems. Currently, such engines are being imported by the Indian government for various defence programs. This capability will likely open the door to massive opportunities for Azad in both domestic and global engine ecosystems.

Currently, given the absence of deeper details, we have not considered the impact of this additional revenue stream in our FY26E numbers. In our view, this order could potentially open a new dimension of complete engine manufacturing and assembly for Azad and given the focus of the government on 'Aatmnirbharta' could have significant consequences both in scope and trajectory of future earnings.

Getting control over value chain to ensure better margins

The company is envisaging better control on value chain to drive process and cost efficiencies. In this regard, it has formed two subsidiaries – Azad VTC Pvt. Ltd. and Azad Prime Pvt. Ltd.

Azad VTC ltd has already acquired certain assets of VTC Surface Technologies. This acquisition would enable Azad to offer advanced wear, corrosion and heat resistant coatings; thus, reducing its reliance on approved third-party companies for surface coatings, eventually leading to margin expansion in the long-term. The total consideration paid for the acquisition of this asset was INR 1.92bn. We expect the payback period of this investment to be less than three years.

Similarly, once the acquisition of relevant assets is complete, Azad Prime will enable the company to have a facility for thermal spray coating using plasma spray with high-velocity fuel system for coating various components. The company is looking to acquire a few more such facilities to have better control over supply chain, offer comprehensive solutions to the customers and reduce its dependence on third-parties.

Customer profile gets even better with significant market potential

Currently, Azad is well-entrenched in the energy sector with all three majors – GE, Mitsubishi and Siemens being its customers and providing orders. In the A&D segment, Azad has now reached qualification stage with all the five major players. In the O&G segment, Azad has received an order from Baker Hughes and one of its subsidiaries.

In our view, the market potential from all the segments is significant. As per our estimates, the company could scale up revenue by up to 10x (compared to FY23) to INR 25–30bn by FY31. In the energy segment, there is a possibility to rapidly escalate GE from USD 8–10mn to USD 20–25mn. Similarly, Siemens (just started) could ascend in-line with GE. In the medium term, the total potential from GE, Mitsubishi and Siemens can be USD 250mn.

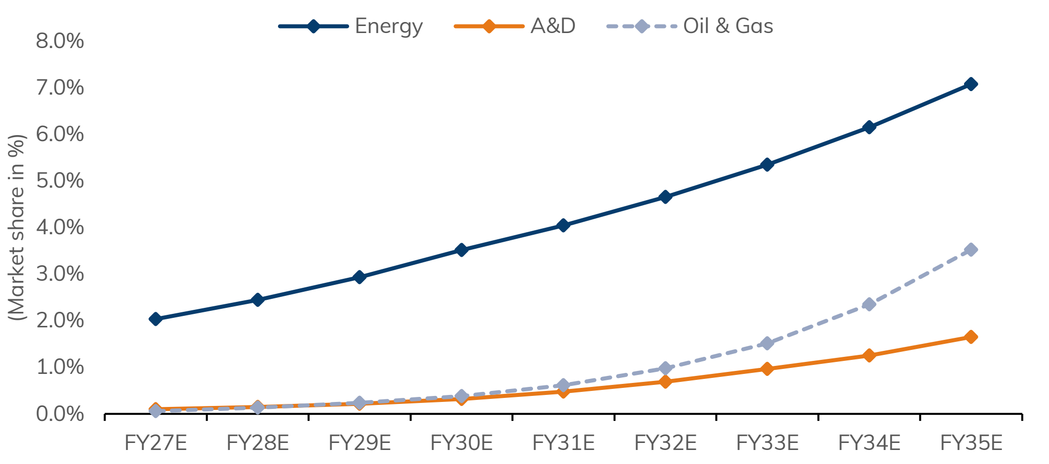
In A&D, revenue escalation to INR 2bn by FY28 is unlikely to be a challenge with three major customers having potential to generate INR 4bn in sales. In case of O&G, two of the largest players have potential to spend INR 5bn annually. As a result, revenue from O&G could escalate to INR 2bn by FY28 from a mere INR 500–600mn currently.

Market share: The journey from 1% to 10%

Azad is continuously in the journey of getting approvals for the components/parts. In the last six months, the number of approved components/parts has gone up to 1,600 (earlier 1,400). We expect Azad's share in energy/A&D/O&G segments to be 2%/0.1%/0.1% by FY27 for the currently approved 1,600 parts/components. We expect this share to increase progressively from 1% to 10% in the long-term as a result of: 1) approval of more components/parts; 2) higher wallet share from the existing customers; and 3) introduction of new products and moving to the solutions from components.

As per our estimates, even at 25–30% growth in revenue through to FY35, Azad will reach: 1) barely 7% of market share in (mature) energy market; 2) less than 2% of market share in the A&D market; and 3) a little less than 4% in case of the O&G market. This is based on our assumption of overall TAM remaining constant at FY27 levels.

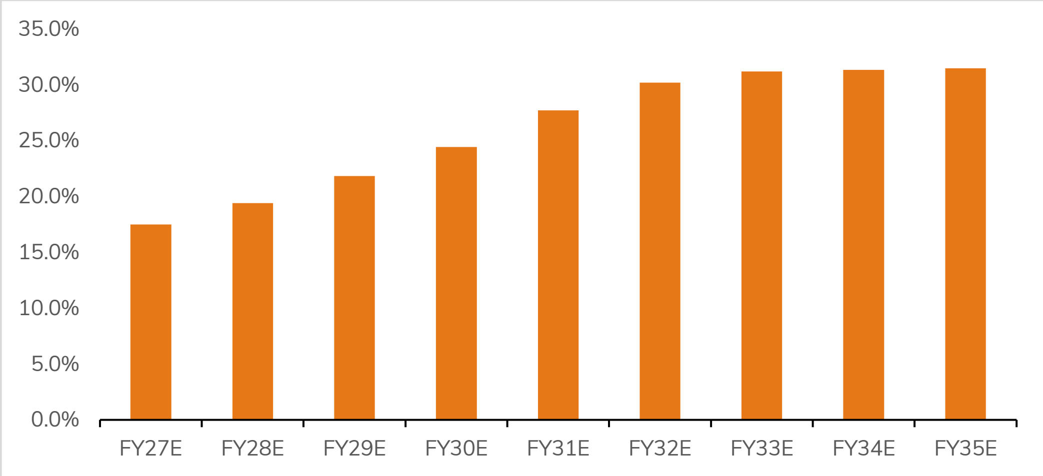
Exhibit 2: Likely market share growth across the three verticals



Source: I-Sec research

By FY35, we expect A&D to contribute slightly more than 30% of revenue – again lower than management's target of A&D being 50% of revenue in the long term. Hence, there is enough potential to boost market share further in the A&D segment, even based on our assumption of TAM remaining unchanged at FY27E levels of INR 1,530bn.

Exhibit 3: Revenue share of aerospace

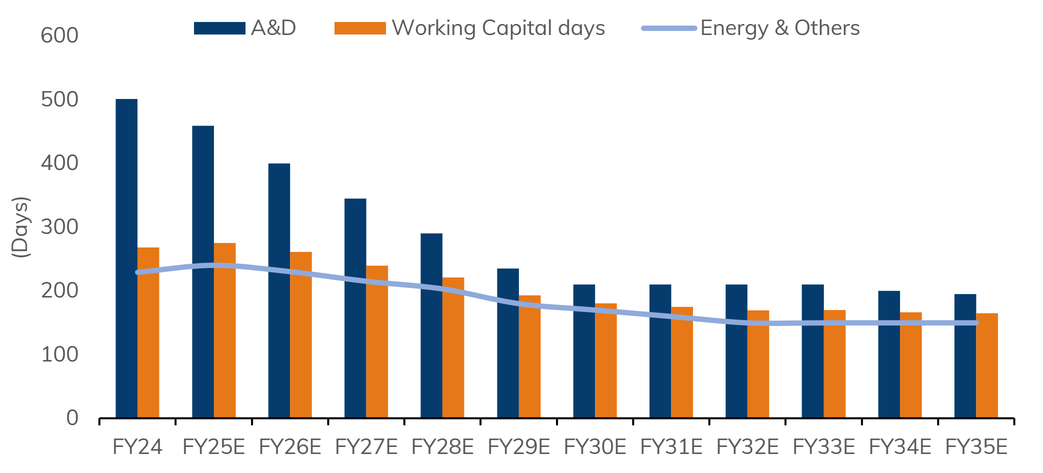


Source: I-Sec research

Working capital: Likely to stabilise at 165 days by FY35

Most of the investors are worried about the high working capital days of the business. While management expects to reduce working capital days to 150, we have factored in a slightly higher number at 165. Working capital days are currently high mainly due to aerospace segment, wherein development is not commensurate with revenue. We expect a meaningful reduction in working capital days in the A&D segment post FY26, when the new 95,000m^2 facility is operational.

Exhibit 4: Working capital days



Source: I-Sec research, Company data

Valuation: We value Azad at INR 2,450/share

We believe that Azad has just scratched the surface of potentially a huge opportunity. With its cost position in the market and focus on product development, we expect EBITDA growth at a healthy 35% through to FY35E.

Besides, we expect EBITDA margin to improve alongside management increasing Azad's presence in the A&D domain and securing more control over the value chain. Hence, there is a long and steep earnings growth curve ahead of the company.

As a result, we do not think it prudent to value Azad on the P/E or EV/EBITDA multiple on near-term or medium-term earnings. Hence, we shift our valuation to the DCF methodology in order to adequately value the potential cash flows of the company. We have factored in terminal value of 9% – significantly lower than the 35% explicit growth forecast. As a result, our TP works out to INR 2,450/share. Maintain **BUY**.

Exhibit 5: DCF Valuation

(INR mn)	FY24	FY25E	FY26E	FY27E	FY28E	FY29E	FY30E	FY31E	FY32E	FY33E	FY34E	FY35E
EBITDA	1,166	1,635	2,121	2,900	4,035	5,547	7,388	9,908	13,180	17,809	23,350	31,392
Tax	(222)	(376)	(493)	(683)	(971)	(1,377)	(1,868)	(2,552)	(3,390)	(4,627)	(6,134)	(8,317)
WC	(1,488)	(879)	(335)	(1,056)	(643)	(512)	(1,924)	(1,765)	(3,240)	(4,497)	(4,008)	(8,038)
Capex	(753)	(1,200)	(1,249)	(1,294)	(1,394)	(1,827)	(2,386)	(3,104)	(3,868)	(5,063)	(5,759)	(7,755)
FCF	(1,297)	(820)	45	(133)	1,028	1,830	1,211	2,487	2,681	3,621	7,449	7,282
Terminal value	**3,20,439**											
WACC	11.5%											
Debt	40.0%											
Equity	60.0%											
Cost of Debt	7.8%											
Cost of Equity	14.0%											
Terminal growth	9.0%											
NPV	1,44,894											
Net debt- FY24	90											
Market Cap	1,44,804											
Number of shares	59.1											
Fair value	**2,450**											

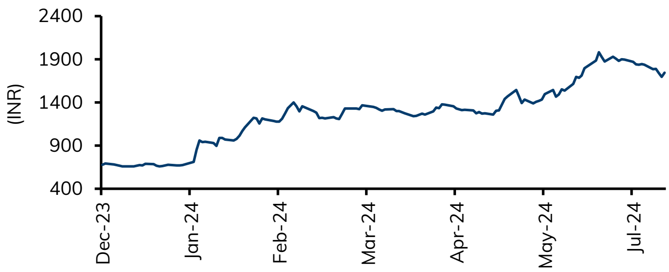
Source: I-Sec research

Exhibit 6: Shareholding pattern

%	Dec'23	Mar'24	Jun'24
Promoters	65.9	65.9	65.9
Institutional investors	10.4	12.0	13.2
MFs and others	4.9	4.3	3.2
Insurance / Bank	0.8	0.7	0.3
FIIs	4.7	7.0	9.7
Others	23.7	22.1	20.9

Source: Bloomberg

Exhibit 7: Price chart



Source: Bloomberg

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Financial Summary

Exhibit 8: Profit & Loss

(INR mn, year ending March)

	FY23A	FY24A	FY25E	FY26E
Net Sales	2,517	3,408	4,658	6,011
Operating Expenses	**1,492**	**1,782**	**2,223**	**2,808**
EBITDA	723	1,166	1,635	2,121
EBITDA Margin (%)	**28.7**	**34.2**	**35.1**	**35.3**
Depreciation & Amortization	166	205	258	316
EBIT	557	961	1,377	1,806
Interest expenditure	-	-	-	-
Other Non-operating Income	98	320	99	133
Recurring PBT	132	808	1,369	1,792
Profit / (Loss) from Associates	**-**	**-**	**-**	**-**
Less: Taxes	**47**	**222**	**376**	**493**
PAT	85	586	992	1,299
Less: Minority Interest	-	-	-	-
Extraordinaries (Net)	-	-	-	-
Net Income (Reported)	85	586	992	1,299
Net Income (Adjusted)	**85**	**586**	**992**	**1,299**

Source Company data, I-Sec research

Exhibit 9: Balance sheet

(INR mn, year ending March)

	FY23A	FY24A	FY25E	FY26E
Total Current Assets	2,836	4,217	5,792	6,703
of which cash & cash eqv.	527	589	1,100	1,478
Total Current Liabilities & Provisions	660	854	1,039	1,237
Net Current Assets	**2,177**	**3,363**	**4,753**	**5,466**
Investments	-	-	-	-
Net Fixed Assets	2,167	2,545	3,801	4,854
ROU Assets	-	27	27	27
Capital Work-in-Progress	380	454	-	-
Total Intangible Assets	-	-	-	-
Other assets	509	727	727	727
Deferred Tax Assets	-	-	-	-
Total Assets	**5,232**	**7,117**	**9,308**	**11,074**
Liabilities				
Borrowings	**3,006**	**372**	**1,710**	**2,057**
Deferred Tax Liability	**161**	**239**	**239**	**239**
provisions	26	36	36	36
other Liabilities	-	-	-	-
Equity Share Capital	17	118	118	118
Reserves & Surplus	2,023	6,332	7,185	8,604
Total Net Worth	**2,040**	**6,451**	**7,303**	**8,722**
Minority Interest	-	-	-	-
Total Liabilities	**5,232**	**7,117**	**9,308**	**11,074**

Source Company data, I-Sec research

Exhibit 10: Cashflow statement

(INR mn, year ending March)

	FY23A	FY24A	FY25E	FY26E
Operating Cashflow	**(102)**	**(70)**	**380**	**1,294**
Working Capital Changes	(810)	(1,488)	(879)	(335)
Capital Commitments	(856)	(753)	(1,200)	(1,249)
Free Cashflow	**(958)**	**(823)**	**(820)**	**45**
Other investing cashflow	**(155)**	**201**	**99**	**133**
Cashflow from Investing Activities	(1,012)	(553)	(1,101)	(1,116)
Issue of Share Capital	573	2,400	-	-
Interest Cost	(524)	(473)	(107)	(147)
Inc (Dec) in Borrowings	1,214	(1,215)	1,339	347
Dividend paid	-	-	-	-
Others	-	-	-	-
Cash flow from Financing Activities	1,263	710	1,232	200
Chg. in Cash & Bank balance	**150**	**88**	**511**	**378**
Closing cash & balance	194	282	793	1,170

Source Company data, I-Sec research

Exhibit 11: Key ratios

(Year ending March)

	FY23A	FY24A	FY25E	FY26E
Per Share Data (INR)				
Reported EPS	1.4	9.9	16.8	22.0
Adjusted EPS (Diluted)	1.4	9.9	16.8	22.0
Cash EPS	4.2	13.4	21.2	27.3
Dividend per share (DPS)	-	-	-	-
Book Value per share (BV)	34.5	109.1	123.6	147.6
Dividend Payout (%)	-	-	-	-
Growth (%)				
Net Sales	29.4	35.4	36.7	29.0
EBITDA	16.1	61.3	40.3	29.7
EPS (INR)	(71.2)	591.4	69.4	30.9
Valuation Ratios (x)				
P/E	1,173.0	169.7	100.1	76.5
P/CEPS	396.7	125.6	79.5	61.5
P/BV	48.7	15.4	13.6	11.4
EV / EBITDA	109.6	65.6	47.3	36.4
P / Sales	30.5	22.5	16.5	12.8
Dividend Yield (%)	-	-	-	-
Operating Ratios				
Gross Profit Margins (%)	88.0	86.5	82.8	82.0
EBITDA Margins (%)	28.7	34.2	35.1	35.3
Effective Tax Rate (%)	35.6	27.5	27.5	27.5
Net Profit Margins (%)	3.4	17.2	21.3	21.6
NWC / Total Assets (%)	-	-	-	-
Net Debt / Equity (x)	1.2	0.0	0.1	0.1
Net Debt / EBITDA (x)	3.4	(0.2)	0.4	0.3
Profitability Ratios				
RoCE (%)	10.8	13.9	14.3	14.8
RoE (%)	6.1	18.1	18.9	17.3
RoIC (%)	11.8	15.2	16.0	16.8
Fixed Asset Turnover (x)	-	-	-	-
Inventory Turnover Days	166	185	175	155
Receivables Days	228	236	249	205
Payables Days	91	70	71	69

Source Company data, I-Sec research

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