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Rafale contract or not, HAL has its own issues

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That the Rafale aircraft contract wasn't awarded to Hindustan Aeronautics Ltd (HAL) has led to much political mud-slinging. But it's not just missing that contract that's plaguing the company.

HAL is beset by execution delays. Despite a gigantic order book, its revenue in the previous five fiscal years increased just 4.3% per annum on average. Profits decelerated from ₹2,997 crore in FY13 to ₹2,070 crore in FY18.

The company is only partly to be blamed. A significant amount of time is spent awaiting clearances. As analysts at IndiaNivesh Institutional Equities explain in a note, a mere receipt of an order does not trigger execution.

For bulk production to begin, the clearance for an aircraft/helicopter takes at least three-four years. "After -12 years of awarding, HAL is still executing its first order of 20 aircraft (Tejas light combat aircraft). Work on the second order of 20 aircraft has not

started for more than seven years, as final operational clearance is awaited," analysts at IndiaNivesh said in a note.

Of course HAL goes through learning cycles, especially if it has to build an aircraft from scratch (such as Tejas). Certain products do take a longer time. Even so the company has consistently displayed poor operating metrics.

The IndiaNivesh analysis shows HAL has the most

stretched working capital cycle vis-à-vis its global peers. HAL's outstanding inventories exceeded revenues for most of the past decade.

"After a new order is won, HAL tends to receive 5-15% of the contract value as customer advances, and almost 50-60% of it is spent on inventories. With delays in the ramp-up of flagship projects, almost 50% of the current inventory is in the work-in-progress stage,"

add analysts at IndiaNivesh.

High inventories and stretched working capital cycle are weighing on the company's earnings quality.

As large platform orders (Sukhoi 30 and advanced light helicopters) near completion and Tejas light combat aircraft orders face execution delays weighing on revenue momentum, IndiaNivesh warns HAL's earnings and return ratios will come under pressure in FY21.

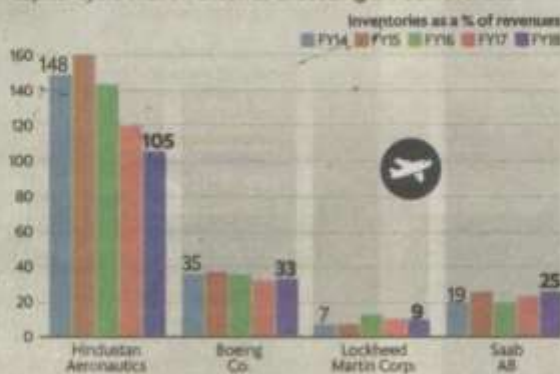
The concerns are weighing on the stock, which has lost more than a fifth of its value since listing in March this year. Rafale contracts may have helped offset the revenue cycle slowdown HAL is projected to face in the coming year. But the key problem of inefficient execution remains.

A significant portion of the problem lies in the prolonged approval processes for which the government and Armed Forces are to be partly blamed. Instead of trading barbs, policymakers would do well to address this.

HAL will be better prepared when the next big opportunity arises.

Stuck with inventories

Hindustan Aeronautics has the most stretched working capital cycle with inventories exceeding annual revenues.



For Boeing, Lockheed Martin and Saab, the ratios are for calendar years 2013 to 2017. Source: IndiaNivesh Institutional equities

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