MOTILAL OSWAL

Two-wheelers

BSE Sensex: 8,529 S&P CNX: 2,579

6 October 2005

Burning bright

- Secular double-digit growth in two-wheeler volumes to continue unabated
- Top two players increasing their stranglehold and are now truly global sized players
- Exports the next big growth driver; larger players well-positioned to capitalize on the opportunity
- Most consistent and profitable segment of the automotive business; bet on the leaders – Hero Honda and Bajaj Auto

Amit Kasat (Akasat@MotilalOswal.com);Tel:+91 22 5657 5328/Aditya S Makharia (Adityamakharia@MotilalOswal.com);Tel:+91 22 5657 5319

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Two-wheelers

BSE Sensex: 8,529 S&P CNX: 2,579

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COMPANY NAME	PG.
Bajaj Auto *(Buy, Rs1,724)*	24
Hero Honda Motors *(Buy, Rs739)*	37
TVS Suzuki *(Neutral, Rs100)*	48

We expect the secular double-digit growth in two-wheeler volumes to continue unabated. Not only is there plenty of scope to increase motorcycle penetration, the target audience too is rising rapidly. The top two players in the industry are now truly global-sized players and have been increasing their stranglehold in a virtual duopoly. Exports represent the next big growth opportunity, which the larger players are well-positioned to capitalize on. The two-wheeler segment is the most consistent and profitable in the automotive industry. Bet on the leaders – Hero Honda and Bajaj Auto.

Two-wheelers to continue witnessing robust growth: Structural factors supporting two-wheeler demand remain intact. Favorable dynamics, rising income levels, wider availability of cheaper finance and lower vehicle prices would be the major growth drivers. Besides, replacement demand is also increasing.

Top two players likely to maintain their market share: Given the high consolidation prevalent in the industry and significant R&D and A&M costs, we expect the stranglehold of the top players to increase. The smaller players would see both their market share and margins shrinking.

Export potential – icing on the cake: Exports represent the next big growth opportunity for the large two-wheeler manufacturers. Being truly global-sized players, with products comparable with their Japanese counterparts both in terms of price and quality, the top-two players are well-positioned to capitalize on the opportunity.

Bet on the leaders – Hero Honda and Bajaj Auto: Our top picks in the two-wheeler segment are Hero Honda and Bajaj Auto. Together, they command about 80% market share and are only increasing their stranglehold, further. Their strong balance sheets and excellent earnings visibility make them must-haves in every portfolio.

COMPARATIVE VALUATION

	RECO.	CMP (RS)	TARGET PRICE (RS)	UPSIDE (%)	P/E (X)		ROE (%)		P/BV (X)		BV (RS/SH)	
					FY06	FY07	FY06	FY07	FY06	FY07	FY06	FY07
Bajaj Auto	Buy	1,724	1,960	13.7	19.0	16.0	19.6	20.4	3.7	3.3	463.1	527.6
Hero Honda	Buy	739	824	11.5	15.5	13.5	49.0	44.9	7.6	6.1	97.2	121.8
TVS Motors	Neutral	100	110	10.0	14.9	13.2	20.1	19.8	3.0	2.6	33.3	38.2

Two-wheelers to continue witnessing robust growth

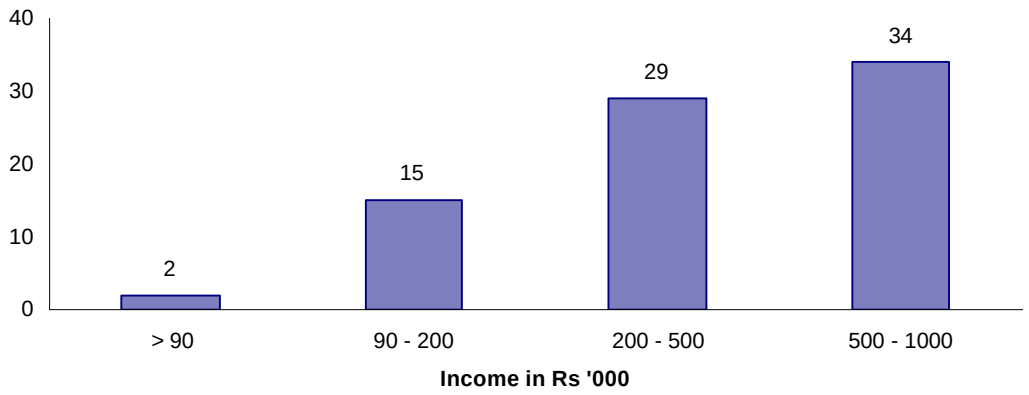
Structural factors supporting two-wheeler demand remain intact. Favorable demographics, rising income levels, wider availability of cheaper finance and lower vehicle prices (no change in affordability for customer even after sharp increase in fuel cost over the last four years) would be the major growth drivers.Therefore, contrary to popular market perception, we expect two-wheelers to continue witnessing robust growth and believe that the industry will grow at 10-12% for the next few years.

Demographic profile of the Indian market favors two-wheelers

While there is plenty of scope to increase the penetration of motorcycles in India…

As per National Council of Applied Economic Research (NCAER), just 15% of the households in the Rs90,000-200,000 annual income group and merely 2% of the households in the below-Rs90,000 annual income group owned motorcycles in CY01. While this percentage would have gone up in the last four years, we believe that there is plenty of scope to increase the penetration of motorcycles in India.

MOTORCYCLE PENETRATION BY HOUSEHOLD (%)



Source: NCAER

…the number of target households too would see a significant increase

Besides, the number of target households is likely to see a significant rise. According to NCAER estimates, an additional 64m households would enter the lower-middle and middle-high income category (income above Rs45,000 per year) during the period CY02-10.

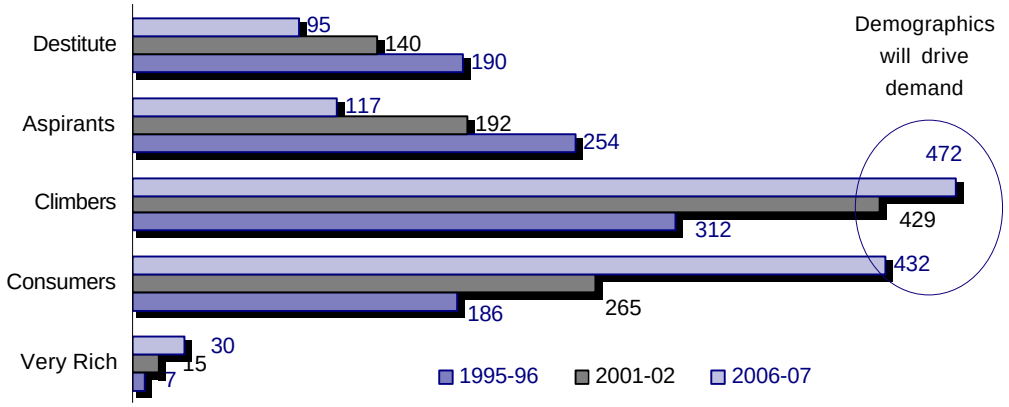
DISTRIBUTION OF HOUSEHOLDS BY INCOME CLASS (M)

	1989-90	2001-02	2009-10
Middle High (>90k)	20	53	107
Lower Middle (45k-90k)	38	70	80
Low (<45k)	84	65	35
Total	**142**	**188**	**222**

Source: Motilal Oswal Securities

(IN RS)	
Very Rich	>215000
Consumers	45000-215000
Climbers	22000-45000
Aspirants	16000-22000
Destitute	<16000

DISTRIBUTION OF POPULATION BY INCOME CLASS (M)



Source: NCAER/NASSCOM

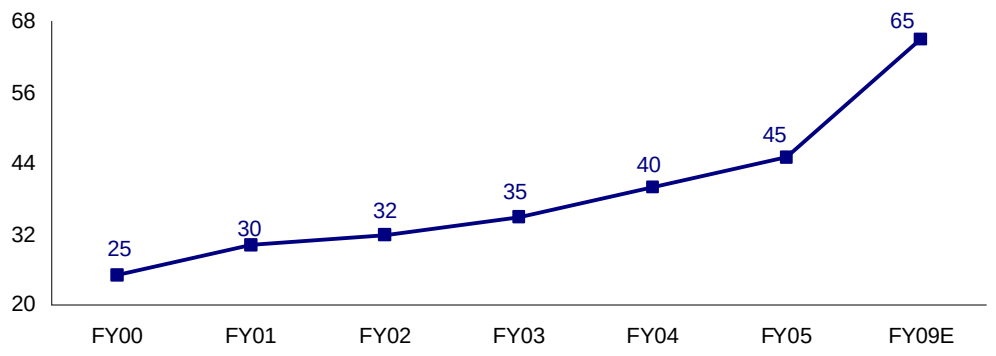
According to the Census of India, nearly 10m people will be added every year to the 20-44 age group over the next 15 years – a growth of about 2% per year. This is much faster than the overall population growth, thus significantly expanding the target customer base. Also, according to a study by Mckinsey and Nasscom, the Indian information export industry will employ 3.2m professionals by 2012. Most entry-level professionals could be potential two-wheeler users.

Easy financing to help increase two-wheeler penetration

Higher penetration of two-wheeler financing…

The penetration of two-wheeler finance has increased from 25% in FY00 to around 45% in FY05. This can be attributed to lower interest rates, aggressive entry of private banks into two-wheeler financing and increased demand. The penetration level is expected to rise to 65% by FY09, mainly on account of increasing focus of financiers on non-metro markets, enhanced focus of public sector banks on the two-wheeler finance market, and falling interest rates on two-wheeler financing.

PROPORTION OF TWO-WHEELERS FINANCED IS RISING (%)



Source: CRISINFAC

…and lower interest rates on two-wheeler loans would aid demand growth

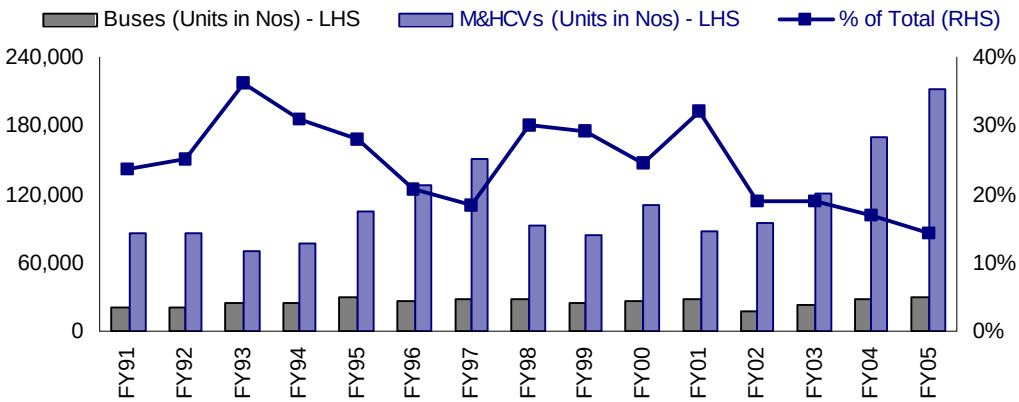
Interest rates on two-wheelers are currently at 17-18% per year on reducing balance method (flat rate of around 10%). The interest rate on two-wheeler loans is significantly higher than the interest rate on four-wheelers due to the lower value of the product as well as higher NPA levels. However, with increased competition – especially from public sector banks – we expect a 200bp fall in interest rates in two-wheeler financing in the next three years. This would help in higher penetration of two-wheelers.

Poor mass transport virtually necessitates two-wheeler ownership

Poor public transport makes two-wheeler ownership a virtual necessity

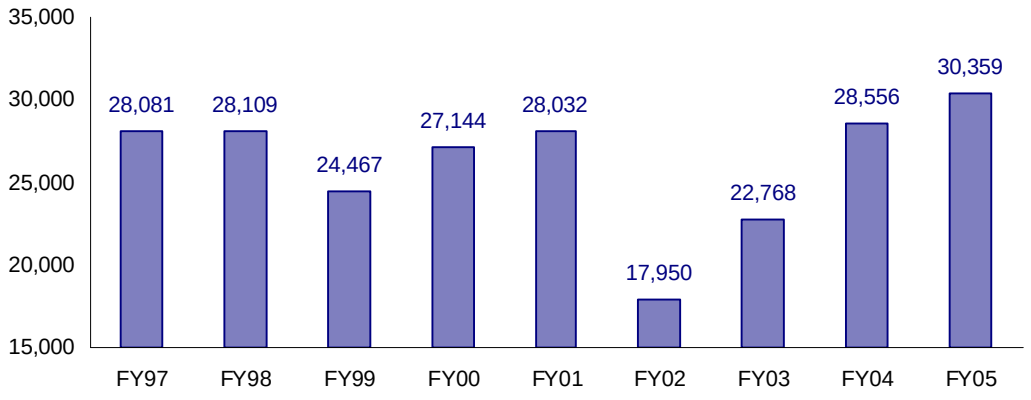
Volumes in the passenger bus segment have been almost flat for a decade because of the poor financial condition of the state transport units (STUs). India sold about 30,000 buses in the M&HCV segment in FY05, nearly the same number as in FY97, despite a significant increase in the population and income levels. In India, buses account for just 15% of the total CV market, as against 50% in China and 48% in Russia. This reflects on the poor state of transport in the country, which in turn is driving two-wheeler demand.

BUS SALES (MARGINAL GROWTH)



Source: Motilal Oswal Securities

BUS SALES (UNITS IN NOS)



Source: Motilal Oswal Securities

With STUs incurring heavy losses and their fleet age touching an all-time high, the public transport is in urgent need of upgrade. However, due to financial constraints, it will be extremely difficult for the STUs to improve their quality of service. They will not only need to upgrade the existing fleet but also add additional buses for the increased traffic.

Moreover, the condition of roads – especially in rural India and non-metro towns – is extremely poor. Several roads remain inaccessible due to their remote location or as a result of being affected by natural calamities. Hence, two-wheelers provide a practical and affordable solution for the masses over the unreliable and sub-standard public transport system in these areas.

Replacement demand to sustain growth

Increasing age of existing vehicles…

Replacement demand is emerging as a strong growth driver for sustained motorcycle demand. While two-wheelers have witnessed a CAGR of 10% over the last decade, motorcycles have seen a CAGR of 25%. Replacement demand is, hence, likely to be a strong demand driver. With new models launched and higher base of previous years, replacement demand is estimated to be 25% to 30% of total sales, which will be a significant growth driver. As the base increases, demand for motorcycles will only go up over time.

…rapid new launches would drive replacement demand

New product launches are pushing up replacement demand. In the last three years, two-wheeler companies have launched numerous products aiding quicker replacement of products. All the top players have launched 2-3 two-wheelers in every calendar year.

PRODUCT LAUNCHES FOR TWO-WHEELERS

Bajaj Auto	
Feb-03	Calliber 115 'Hoodibabaa' is launched
Jul-03	Wind 125 is launched
Oct-03	Pulsar is added with DTS-I engine
May-04	Bajaj CT100 launched
Sep-04	Discover DTS-I launched
Feb-05	Bajaj Wave launched
Jun-05	Avenger 180cc Cruizer launched
Hero Honda Motors	
Apr-03	CD Dawn launched
May-03	Karizma launched with slogan - 'Jet Set Go'
Sep-03	Passion Plus launched
Oct-03	Splendor plus launched
Jan-04	Ambition 135 launched
Apr-04	CBZ Launched
Apr-05	Super Splendor- 125cc launched
Jun-05	Glamour 125cc launched
TVS Motors	
Jun-03	Fiero F2 150cc launched
Jan-04	Centra - 100cc bike with VT-I Engine launched
Jun-04	Victor 125cc launched
Sep-04	TVS STAR launched
Oct-04	Upgraded Victor 110cc launched

Source: Motilal Oswal Securities

Shift in customer preference towards 125cc vehicles

With 125cc bikes being launched at the price of the high-end 100cc bike, incremental demand for two-wheelers is likely to shift to the 125cc segment. Thus, the 125cc segment is likely to play an important role over the next two years.

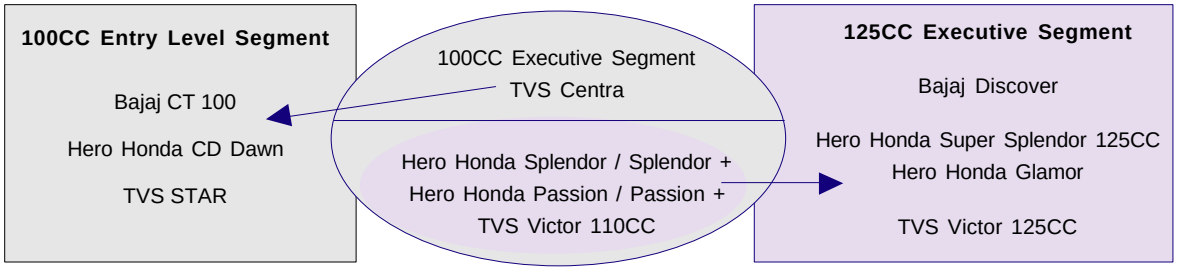
The market for two-wheelers is now witnessing a clear segregation based on engine size. Earlier, the entry level 100cc bikes were priced at Rs32,000–36,000, while the executive level 100cc bikes were priced at Rs40,000–44,000 and the premium segment bikes at Rs45,000 onwards. But once *Discover 125cc* entered the fray in September 2004, the market dynamics changed.

Bajaj Auto's *Discover* was launched at Rs40,500 – the price of the high-end 100cc bike. Then close on its heals, Hero Honda introduced the *Super Splendor 125cc* at Rs43,000. With these two 125cc bikes now available at the price of the high-end 100cc bike, customers are likely to migrate from the 100cc executive level bikes such as Splendor Plus and Passion Plus to the 125cc segment.

We believe the new segmentation, based on category and pricing, would be as follows: the entry level 100cc bikes priced at Rs32,000–36,000; the executive segment bikes priced at Rs41,000–45,000 and the premium segment bikes priced at Rs48,000 onwards.

We expect the 125cc segment to drive incremental demand in the two-wheeler industry over the next two years. New product launches and the entry of Suzuki in the segment will result in competitive (pricing) pressure in the 125cc motorbike segment for the top three players in the industry. Among the top three players, we believe Hero Honda is in a comfortable position to emerge as a winner in this segment.

INDUSTRY MOVING TOWARDS SEGMENTATION BASED ON CC (POWER) RATHER THAN PRICE



Top two players likely to maintain their market share

Robust growth potential for two-wheelers is attracting higher competition in the segment. However, given the high consolidation prevalent in the industry and significant R&D and A&M costs, we believe that the top two players are unlikely to be impacted. The competitive pressures will be evident in the market share of the smaller players.

A highly consolidated market

The Indian two-wheeler market is highly consolidated…

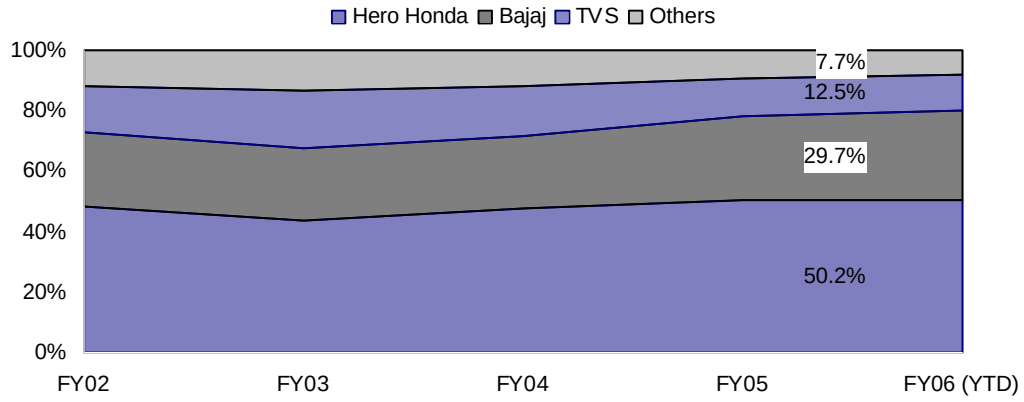
India is an extremely mature market with the second largest motorcycle volumes in the world, after China. The Indian market is also highly concentrated with the top three players together accounting for over 92% of motorcycle volumes, as is the case in any mature competition.

ANALYSIS OF MOTORCYCLE SEGMENT

	FY02	FY03	FY04	FY05	FY06 (YTD)
Volume (Nos)					
Hero Honda	1,425,302	1,679,129	2,072,983	2,621,400	1,163,921
Bajaj	723,969	922,453	1,056,135	1,468,512	688,044
TVS	450,206	720,343	706,610	679,535	289,470
Others	344,263	513,493	521,994	471,035	177,783
Total	**2,943,740**	**3,835,418**	**4,357,722**	**5,240,482**	**2,319,218**
Market Share (%)					
Hero Honda	48.4	43.8	47.6	50.0	50.2
Bajaj	24.6	24.1	24.2	28.0	29.7
TVS	15.3	18.8	16.2	13.0	12.5
Others	11.7	13.4	12.0	9.0	7.7

Source: Motilal Oswal Securities

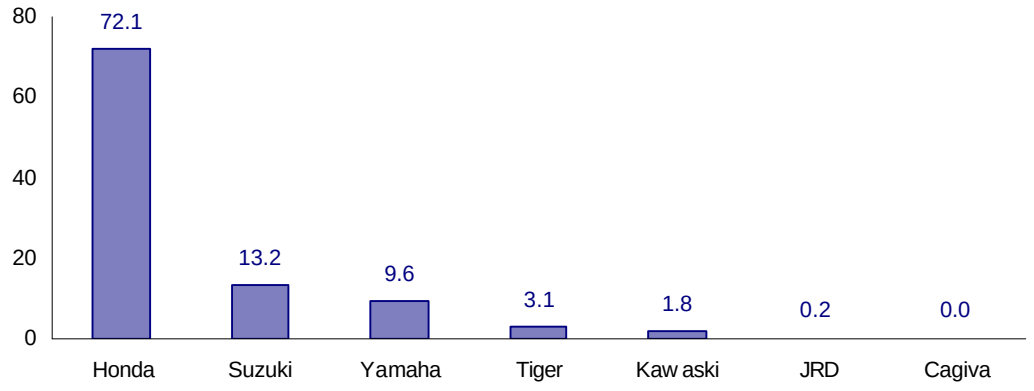
TOP THREE NOW CONTROL OVER 92% OF MOTORCYLE MARKET (%)



Source: SIAM/Motilal Oswal Securities

The Indian market is similar to some of the other Asean markets, where the top three companies have over 90% share. These countries have also seen their domestic motorcycle industry evolve over several decades – just as is the case with India.

THAILAND MARKET: DOMINATED BY THE JAPANESE



Source: Motilal Oswal Securities

The major difference is that India has its top three players of Indian origin rather than being dominated by the Japanese. This is due to the presence of Indian companies for several years and their ability to innovate in the face of increased competition. Indian companies have developed path-breaking technologies such as the Bajaj DTSi engine and the TVS Vti engine. Indian companies like Bajaj Auto and TVS Motors have invested heavily in R&D and have reduced their dependence on technological partners.

…with the top two players accounting for almost 80% market share

In India, Hero Honda has close to 50% market share, followed by Bajaj Auto with a 30% share and TVS with a 13% share. Despite competition from global players such as Yamaha and local players such as Kinetic and LML, Hero Honda increased its market share by 6% over the last couple of years while Bajaj Auto increased its market share by 6%. TVS, the third largest player, lost 6% market share over the same period.

Significant R&D and A&M costs

R&D and A&M costs are significant…

Increased competition in two-wheelers is likely to affect marginal players, not the top two. To test out this hypothesis we undertook a comparison of R&D and advertising and marketing (A&M) costs of the top three. Our analysis revealed that a smaller player had to spend a lot more than a larger player in R&D and A&M costs to achieve the same quantum of sales. Thus, in case of a price war, margins of a smaller player are likely to see more pressure than a player with higher market share.

EXPENDITURE OF TOP 3 PLAYERS (RS M)

	FY01	FY02	FY03	FY04	FY05
Bajaj Auto					
Sales	30,231	36,145	41,737	47,642	66,713
Advertisement	1,025	888	1,291	1,293	1,438
% to Sales	*3.4*	*2.5*	*3.1*	*2.7*	*2.2*
R&D	610	374	422	650	670
% to Sales	*2.0*	*1.0*	*1.0*	*1.4*	*1.0*
Hero Honda					
Sales	31,687	44,627	50,976	58,310	74,217
Advertisement	611	902	1,419	1,245	1,475
% to Sales	*1.9*	*2.0*	*2.8*	*2.1*	*2.0*
R&D	N.M.	N.M.	N.M.	N.M.	N.M.
TVS					
Sales	18,210	19,305	27,045	28,202	28,736
Advertisement	392	467	1,059	1,056	882
% to Sales	*2.2*	*2.4*	*3.9*	*3.7*	*3.1*
R&D	161	299	587	756	717
% to Sales	*0.9*	*1.5*	*2.2*	*2.7*	*2.5*

N.M.: Not meaningful *Source: Motilal Oswal Securities*

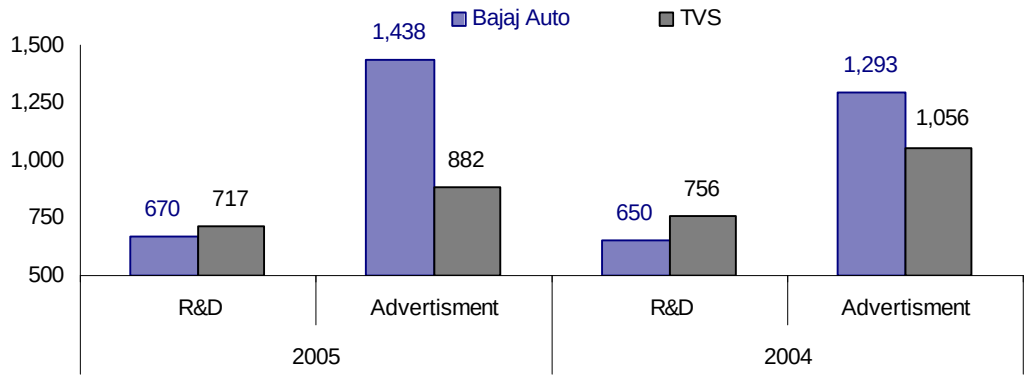
…and smaller players would see their margins shrinking

Despite the sales of Hero Honda and Bajaj Auto being 2.5x the sales of TVS Motors, TVS spends a higher amount as compared to Bajaj Auto on R&D and spends a higher proportion of sales on A&M. In FY05, the total R&D spend for Bajaj was 1% of sales while for TVS it was 2.5%. Similarly, ad spend to sales for Hero Honda was 2% while for TVS it was 3%. Even in FY04, the ad spend for TVS was much higher than that of Bajaj at 3.75%.

The stranglehold of larger players would increase further

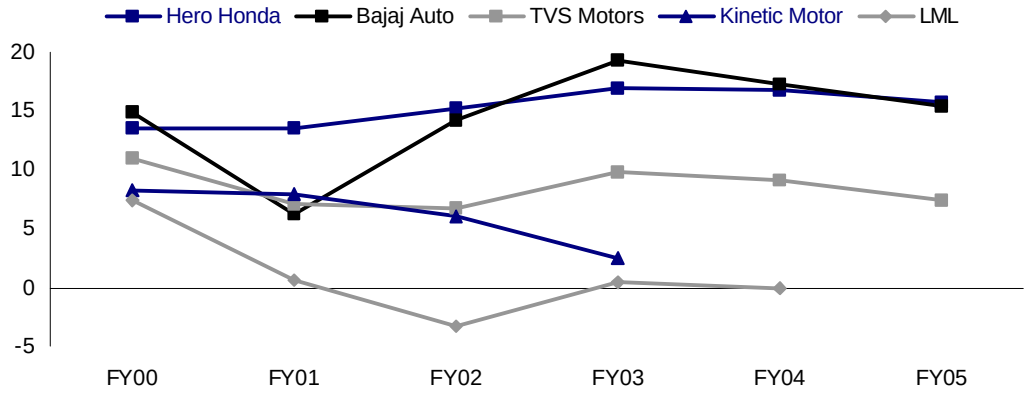
Smaller players have to incur huge costs in order to compete with the big players. It is no surprise then that the EBITDA margins of the smaller players have been shrinking. In fact, marginal players such as LML and Kinetic Motors are in the red and TVS Motors has witnessed an EBITDA margin erosion of 350bp over the last five years.

SMALLER COMPANIES SPEND AS MUCH AS THEIR LARGER COUNTER PARTS (RS M)



Source: Motilal Oswal Securities

EBITDA MARGINS (%): SMALLER COMPANIES UNDER PRESSURE

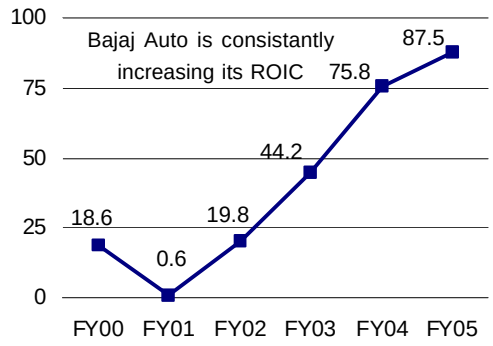


** LML and Kinetic Motors have reported losses hence the data has not been plotted from FY03/04*

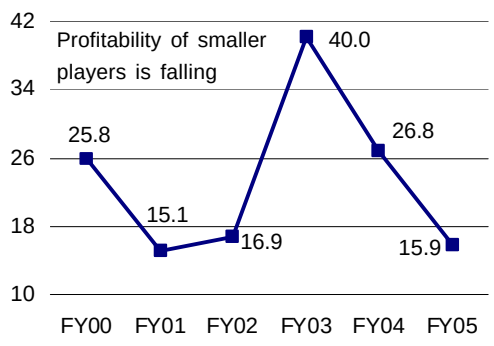
Source: Capitaline/Motilal Oswal Securities

ROIC (%)

BAJAJ AUTO



TVS MOTORS



Source: Capitaline/Motilal Oswal Securities

Export potential: icing on the cake

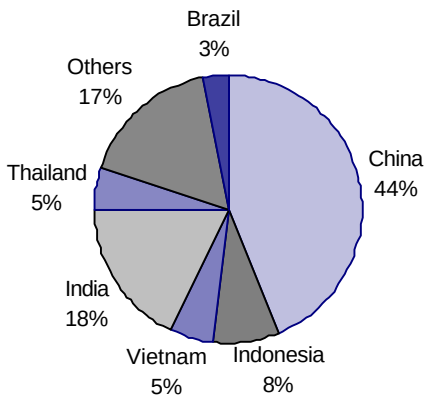
Asia is the largest market for two-wheelers in the world, dominated by Japan and China. Chinese products, though look alikes of Japanese makes, are inferior in quality. Indian bikes, however, are comparable with Japanese bikes both in terms of price and quality. To increase presence in the region, Indian two-wheeler majors are trying to set up their own marketing and distribution networks.

A large market, overseas

Two-wheeler exports present the next big growth opportunity…

The global market is dominated by the Asian continent, which accounts for sales of 30m units (as of FY03). In the Asian region, China has a 44% market share and India has an 18% market share. The other South Asian Nations of Indonesia, Thailand and Vietnam account for 18% of demand, while Brazil accounts for another 3%.

GLOBAL DEMAND AS OF FY03

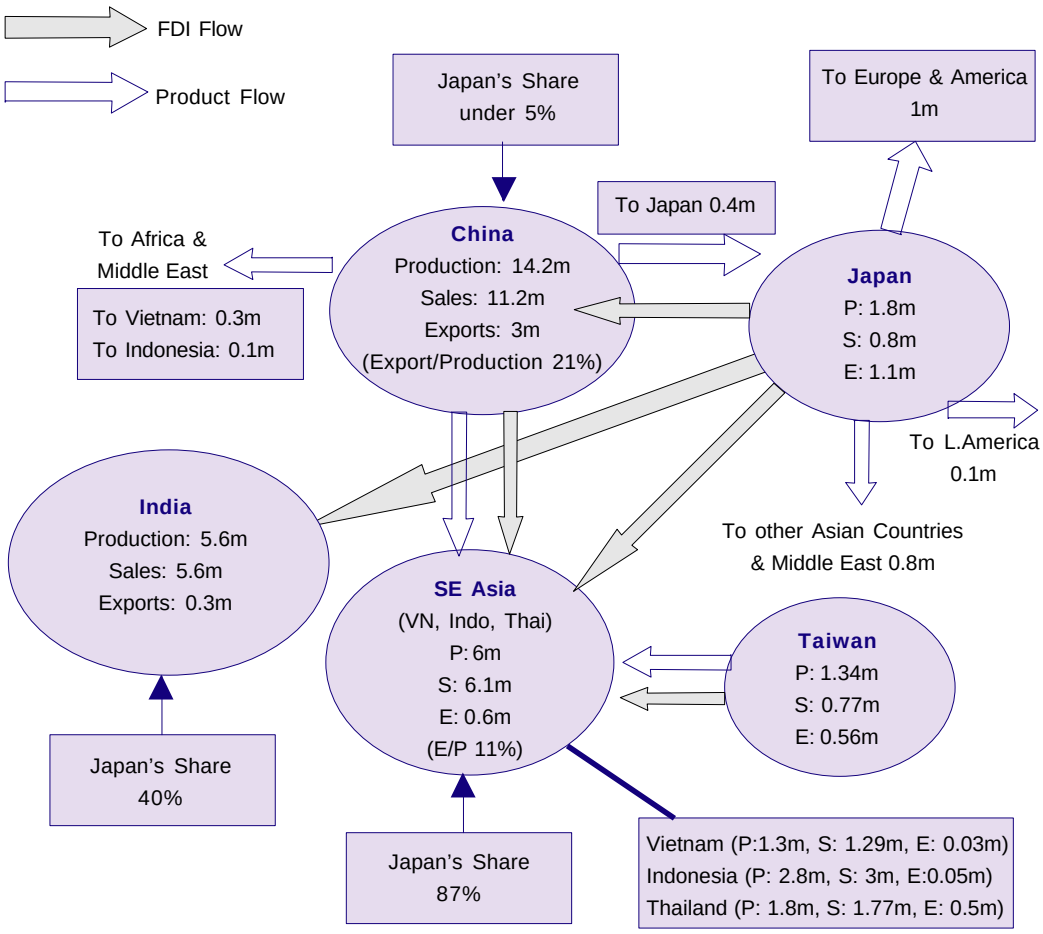


Source: Cris Infac

India's opportunity lies in the Asean and the African region. These countries have dynamics similar to India's – a large population base with low purchasing power. The Asean market (comprising Thailand, Indonesia, Vietnam and Philippines), with sales of 7m units per year is the key target export market for India.

The Asian region is dominated by Japanese companies – which have established subsidiaries since the 1960s. Hence, they have a strong foothold in the market. The Chinese are present through their low-cost exports in the region. However, Chinese products are typically low-priced look alikes of the Japanese counterparts. Japanese bikes are imitated by Chinese manufacturers and sold in countries such as Vietnam. However, the quality of Chinese products is extremely poor. With stricter intellectual rights regulations getting enforced, the Chinese will have to scale up their quality or face extinction.

ASIAN MARKET ACCOUNTS FOR 80% OF WORLD MARKET IN VOLUME TERMS: CURRENTLY DOMINATED BY JAPANESE



Source: Industry

Advantage India

…which the larger players are well-equipped to exploit

We believe that in the long run, Indian motorcycles will compete with the Japanese, globally. The cost efficieny of Indian bikes is comparable to the Japansese. Indian products are available from US$750 onwards – comparable with their counterparts in other countries. The key challenge for the Indian companies now is setting up their distribution and marketing networks in the Asean region.

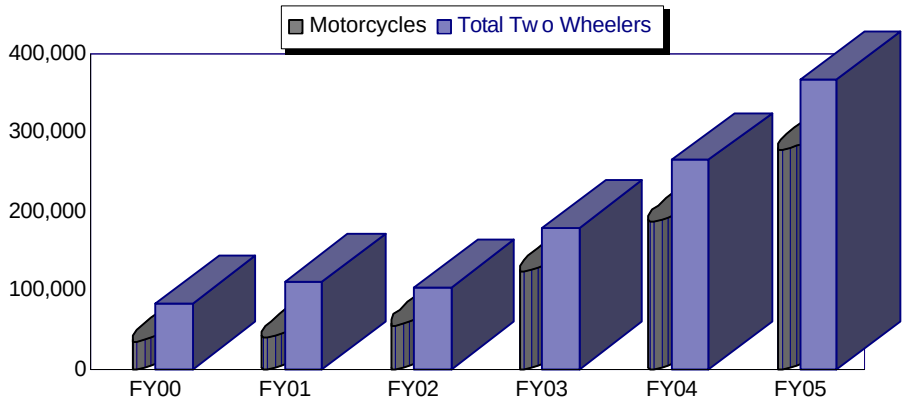
TWO-WHEELER EXPORTS

	FY02	FY03	FY04	FY05	FY06YTD
% of export market share					
Bajaj	28.8	29.8	34.1	35.7	24.9
TVS	7.6	5.4	10.6	13.4	17.6
Hero Honda	12.6	12.8	14.8	17.5	21.9
Others	51.0	52.0	40.5	33.4	35.7

Source: Motilal Oswal Securities

India exported 366,607 bikes in FY05 about 6% of total sales. We expect exports to grow at 20% over the next five years, with growth being led by Bajaj Auto. The major push will take place once Bajaj and TVS have their production units in place in Indonesia. It will take a minimum of three years for them to establish their presence and brand image.

EXPORTS: RISING STEADILY



Source: Cris Infac/Motilal Oswal Securities

High quality business to invest in

As against four-wheelers, which have witnessed volatile swings, the growth in two-wheelers has been steady over the years. Apart from that, two-wheeler companies have higher RoE and asset turnover than four-wheeler companies and hence superior earnings quality.

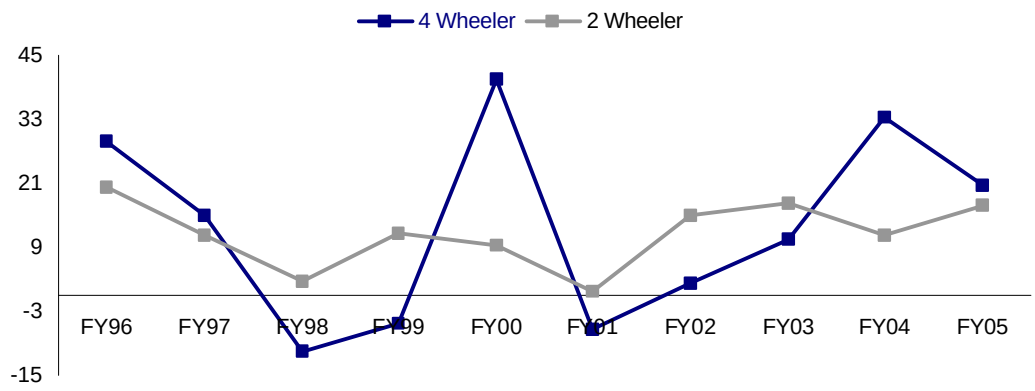
Two-wheelers have outperformed four-wheelers on several counts:

(i) Volume growth

Robust volume growth outlook…

If we compare the growth rate of two-wheelers and four-wheelers over the last decade, we find that the growth rate of four-wheelers as a class (which includes commercial vehicles and passenger vehicles) was subject to volatile swings while the growth in two wheelers was relatively secular.

GROWTH RATES OF AUTO-INDUSTRY (%)



4-Wheeler includes CV's and Passenger Cars *Source: CRISINFAC/Motilal Oswal Securities*

Over the last decade, the four-wheeler industry witnessed uneven volume growth – three years displayed negative growth, and while one year witnessed marginal growth. In comparison, two-wheelers consistantly delivered consistant growth over the same period.

Moreover, the demographics of the country continue to favor sustained two-wheeler demand for the next five years as well, while four-wheelers are likely to witness a slowdown – this year has already witnessed flat growth for both passenger cars and commercial vehicles have witnessed flat growth.

CAGR GROWTH PROJECTIONS (%)

	PAST 10 YEARS	PAST 5 YEARS	NEXT 5 YEARS
Passenger Vehicles	11.5	14.4	8.0
CV's	5.5	23.4	7.0
Two-wheelers	10.6	15.1	12.0

Source: Motilal Oswal Securities

(ii) Earnings quality

…and consistent, high margins…

Two-wheeler stocks have superior earnings as compared to their larger counter parts. A consistent volume growth and a higher net profit margin along with better asset utilization and strong working capital management has led to higher RoEs.

We expect the consistent volume growth for two wheelers to improve the predictability of earnings. In comparison the four-wheeler stock will continue to witness cyclicality in volumes, hence leading to volatile earnings as well.

VOLUME GROWTH RESULTED IN HIGHER ROES (ROE BASED ON DU PONT MODEL)

	TATA MOTORS				HERO HONDA			
	FY02	FY03	FY04	FY05	FY02	FY03	FY04	FY05
RoE (%)	N.M.	11.7	23.5	30.3	67.6	67.4	64.0	54.3
Net Progit Margin (%)	-0.7	3.4	6.3	7.2	10.4	11.4	12.5	10.9
Asset Trunover (x)	1.5	2.2	2.7	2.6	5.6	4.8	4.2	4.1
Financial Leverage (x)	0.9	1.6	1.4	1.6	1.2	1.2	1.2	1.2

Source: Motilal Oswal Securities

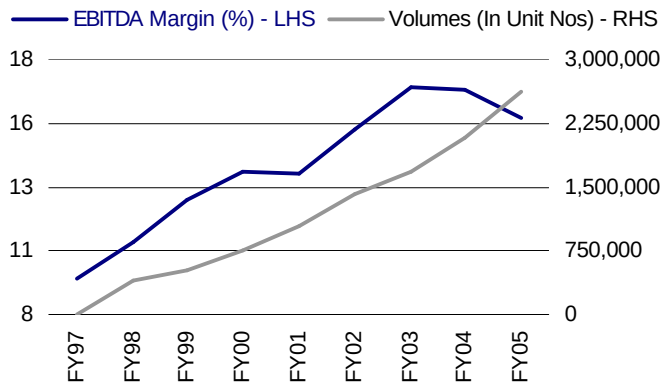
Operating leverage: headwind v/s tailwind

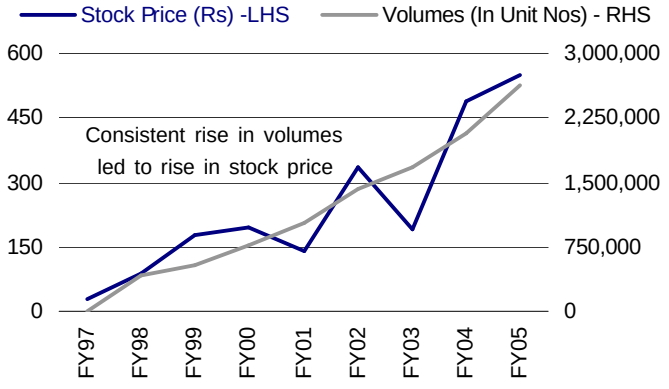
The earnings of four-wheeler companies are vulnerable to business cyclicality. Whenever the growth cycle is in a state of contraction, EBITDA margins witness a sharp decline due to reduced operating leverage. Hence, timing the cycle is critical for leveraging earnings growth. In comparison, two-wheelers have stable growth rates and have relatively stable margins, thus improving earnings predictability.

The charts below show that Tata Motors has witnessed wide swing in volumes compared to Hero Honda, which witnessed stable growth. As a result, Tata Motor's EBITDA margins as well as stock price has been volatile.

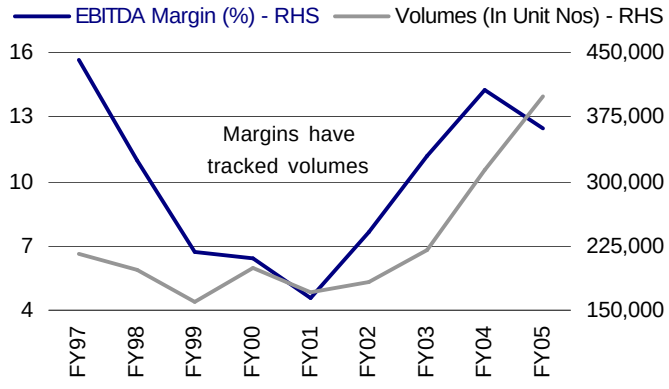
SHARP SWINGS IN VOLUMES AFFECT PROFITABILITY AS WELL AS STOCK PRICE

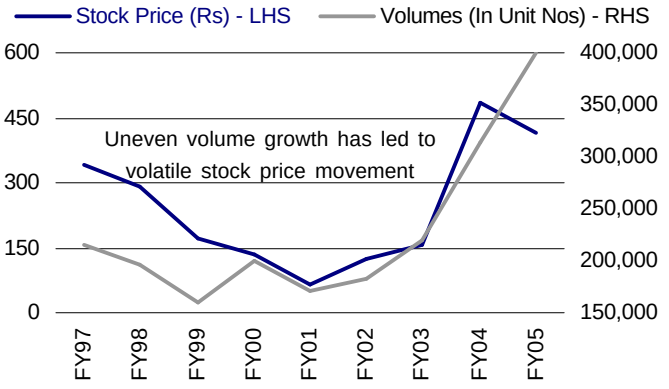
HERO HONDA





TATA MOTORS





Source: Motilal Oswal Securities

(iii) Market capitalization growth

Better return ratios resulted in two-wheelers' market capitalization growth outperforming four-wheelers' market capitalization growth by 90%.

…would drive stock performance

To highlight that two-wheelers have added more to shareholders' wealth than four-wheelers, we compared the market capitalization and returns generated since 1991 for both categories of vehicles. Under two-wheelers, we have included scooters, mopeds and motorcycles while under four-wheelers, we have included commercial vehicles, passenger cars and utility vehicles.

Methodology: We calculated the market cap of four-wheeler companies i.e. Tata Motors, M&M, Ashok Leyland and Maruti Udyog and compared it with the market cap of two-wheeler companies i.e. Hero Honda, Bajaj Auto and TVS Motors over a 15-year period. The data has been adjusted (spliced) to provide for new entrants - TVS Motors (September 2000) and Maruti Udyog (September 2003) - and indexed for better comparison.

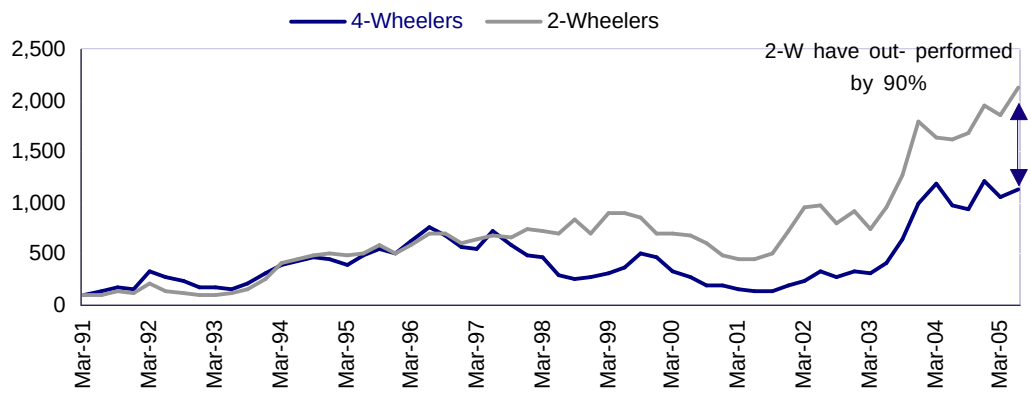
MARKET CAPITALIZATION

	YEAR	4-WHEELERS (RS B)	INDEX	2-WHEELERS (RS B)	INDEX
Base Year	1991	23.3	100.0	12.1	100.0
With TVS Added	2000	44.1	189.2	61.1	479.6
With Maruti Added	2003	336.9	996.3	229.4	1,800.0
As of 30 June 2005	2005	381.1	1,126.7	271.6	2,131.0

Source: Motilal Oswal Securities

Key findings: Starting from a common base of 100 in 1991, the four-wheeler index has risen to 1,126.7 in 2005. The two-wheeler index has risen much faster to 2,131. **This implies that investor wealth increased by 21.3 times over a 15-year period for two-wheelers while it increased only 11.3 times for four-wheelers.**

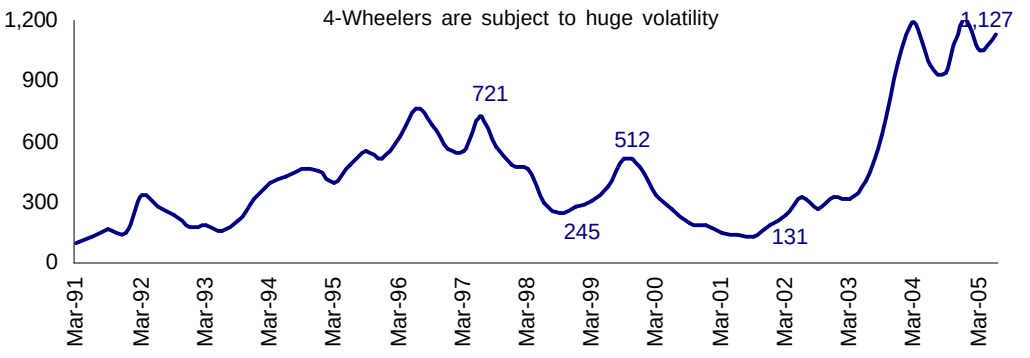
MARKET CAP (BASE OF 100)



Source: Motilal Oswal Securities

Besides, the four-wheeler index has been far more volatile. It fell from a high of 721.2 in FY97 to a low of 245.4 in FY98. The fall was even steeper in FY01 – when it fell from a high of 511.8 in FY99 to an extreme low of 131.2 in FY01. In FY91, the index was 100 while in FY01, (a decade later) it was just 131.2. The cyclical nature of the business was clearly reflected in the four-wheeler companies' stock prices.

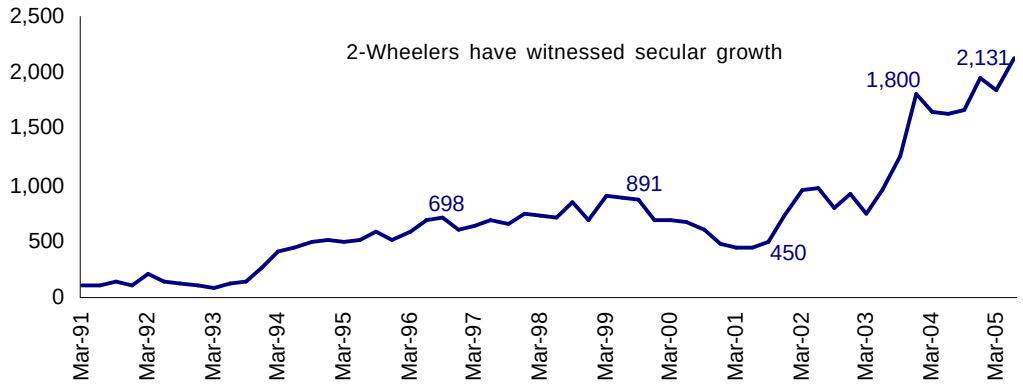
FOUR WHEELERS: EXTREMELY VOLATILE (BASE OF 100 IN 1991)



Source: Capitaline/Motilal Oswal Securities

On the other hand, two-wheeler companies witnessed a steady increase in market capitalization. And the largest fall that occurred – the index corrected from a high of 891.2 in FY99 to 449.7 in FY01 – was not as steep as that witnessed by four wheelers. Except for this fall, the market capitalization of two-wheeler companies has consistently increased.

TWO WHEELERS: CONSISTENT INCREASE IN MARKET CAP (BASE OF 100 IN 1991)



Source: Motilal Oswal Securities

Hero Honda and Bajaj Auto: our top picks

Our top picks in the two-wheeler segment are Hero Honda and Bajaj Auto. Both have been consistently gaining market share in motorcycles. We believe that they would at least be able to maintain their market share at current levels, despite intensifying competition. Besides, they both have strong balance sheets and good earnings visibility.

Hero Honda: the undisputed leader

Bet on the leaders – Hero Honda…

Hero Honda, which enjoys a market share of 50% in motorcycles, would be one of the major beneficiaries of the strong growth in two-wheeler demand. Good response to its new launches would further strengthen its position in the executive segment.

The company has a strong balance sheet with cash estimated at Rs120/share in FY07, which will account for over 90% of the balance sheet size. The huge cash is despite the Rs3b capex that will be incurred on the new plant. Its operational RoIC at over 100% is amongst the highest for any company. Hero Honda's strong dividend payout of 50% will result in a dividend yield of 3.3%.

We expect Hero Honda to record 16% CAGR in net revenues over FY05-07, with growth driven by motorcycles (14% CAGR over FY05-07). Volume growth, better product mix, and cost savings will result in a 16% EBITDA growth. Overall, we expect Hero Honda's net earnings per share to improve from Rs40.6 to Rs54.7 (a CAGR of 16%).

Bajaj Auto: good value

…and Bajaj Auto

Bajaj Auto has a share of 30% in motorcycles. It has been gaining share in a market, which is a virtual duopoly. Moreover, its new launches have been well received. There is a waiting period for its relatively high margin models – *Pulsar*, *Avenger* and *Discover*. The success of its newly launched *Wave* is also improving ungeared scooter sales.

In FY06 and FY07, we expect the company's product mix to improve in favor of high margin segments like three-wheelers, and executive and premium motorcycles. Aggressive focus on exports, upgradation of its three-wheeler platform and frequent launches across the two-wheeler segment would help Bajaj Auto to maintain strong volume growth.

With cash and liquid investments of Rs551/share, Bajaj's balance sheet will comprise of 90% cash in FY07. We estimate its operational RoIC at over 100% in FY06. Moreover, its investments in its insurance arm and Bajaj Auto Finance are valued at Rs205/share.

We expect Bajaj Auto to record 17% CAGR in net revenues over FY05-07. Volume growth, better product mix and cost savings will result in a CAGR of 18% in EBITDA. Overall, we expect its EPS to increase from Rs75.8 to Rs107.6 (a CAGR of 18%).

Bajaj Auto

STOCK INFO.	BLOOMBERG
BSE Sensex: 8,529	BJA IN
S&P CNX: 2,579	REUTERS CODE BJAT.BO

6 October 2005

Buy

Previous Recommendation: Buy Rs1,724

RS MILLION	2004	2005	2006E	2007E
Sales	47,552	57,364	68,308	78,960
EBITDA	8,528	9,134	10,964	12,731
PAT	7,315	7,668	9,191	10,884
EPS (Rs)	72.3	75.8	90.8	107.6
EPS Growth (%)	36.0	4.8	19.9	18.4
BV/Share (Rs)	365.0	408.6	463.1	527.6
P/E (x)	23.8	22.8	19.0	16.0
P/BV (x)	4.7	4.2	3.7	3.3
EV/EBITDA (x)	17.0	15.3	12.2	10.1
EV/Sales (x)	3.1	2.4	2.0	1.6
RoE (%)	19.8	18.5	19.6	20.4
RoCE (%)	21.3	20.7	22.4	24.3

KEY FINANCIALS	
Shares Outstanding (m)	101.2
Market Cap. (Rs b)	174.5
Market Cap. (US$ b)	4.0
Past 3 yrs. Sales Growth (%)	16.6
Past 3 yrs. NP Growth (%)	20.4
Dividend Payout (%)	33.0
Dividend Yield (%)	1.5

STOCK DATA	
52-Week Range (Rs)	1,830/918
Major Shareholders (as of June 2005)	(%)
Promoters	29.8
Domestic Institutions	8.7
FII/FDIs	20.8
Public	40.7
Average Daily Turnover	
Volume ('000 shares)	178.3
Value (Rs million)	217.8
1/6/12 Month Rel. Performance (%)	10/36/20
1/6/12 Month Abs. Performance (%)	17/66/69

Bajaj Auto's (BAL's) efforts to create an identity for Indian motorcycles in the global market and its innovative marketing and financing schemes, targeting both rural and semi urban customers, launched in the domestic market have resulted in a significant volume growth for the company. We expect BAL to be a major beneficiary of the strong volume growth in domestic market. Increasing exports and better product mix will improve profitability going ahead.

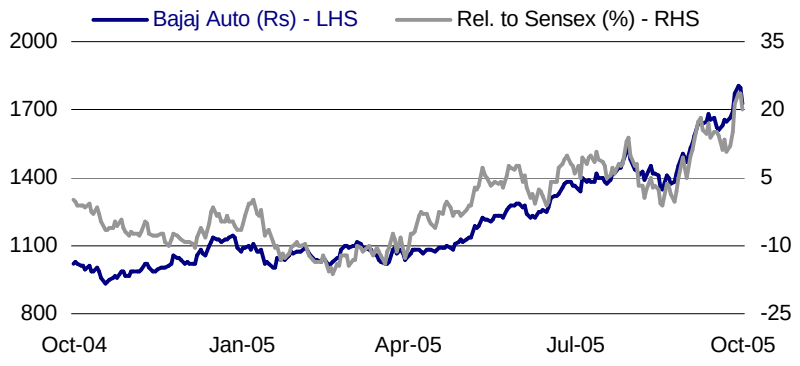
Market share gain in motorcycle segment to continue: BAL's market share in the motorcycle segment has increased by nearly 600bps in the past 18 months. We expect market share gains to continue as BAL overcomes production constraints on some of its models. We expect BAL's volumes to grow by 16% in the domestic market over FY05-08E.

Exports to drive growth further: BAL is all set to play a bigger role in the global motorcycle market. Its exports have increased nearly four fold over the last three years. Its entry into bigger and challenging markets should help BAL post 16% export growth over FY05-08E.

Significant value in balance sheet: A strong balance sheet, with Rs55.7b in cash and liquid investments, translates into an underlying value of Rs551 per share in FY07.

We maintain Buy: BAL trades at a P/E of 16x; EV/EBITDA of 10.1x on FY07E estimates. We maintian **Buy** with a price target of Rs 1,960 based on SOTP. valuation (core business at 14x FY07E EPS; cash at Rs551; Value of Insurance and Bajaj Auto Finance at Rs205).

STOCK PERFORMANCE (1 YEAR)



Investment arguments

Market share gain in motorcycle segment to continue

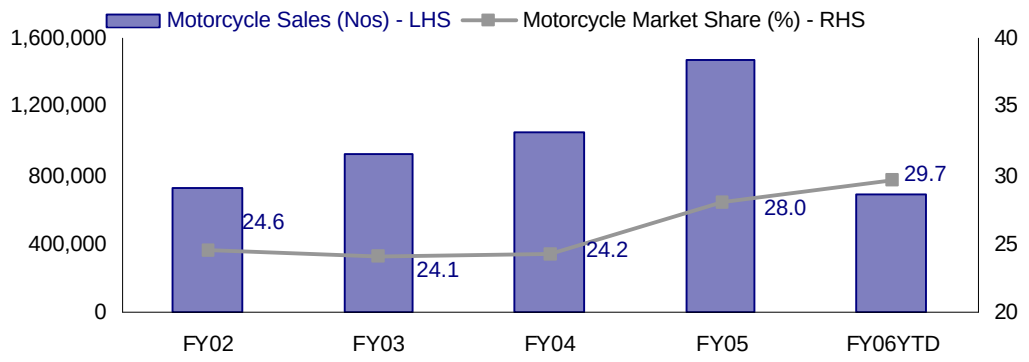
BAL has a successful product in every segment of the motorcycle market ...

With a successful product in every segment of the motorcycle market – CT100 in the Economy segment, Discover in the Executive segment and Pulsar Twins in the Premium segment – BAL is all set to expand its domestic market share. Over the last five years, the company has undergone a complete transformation and adjusted its product portfolio to faster-demand products – motorcycles. The success of its efforts is evident from the fact that its market share has risen sharply in the last 18 months from 24% to 30% in FY06 YTD.

... and leads the market in the entry level and premium segments

BAL already leads the market in the entry level and premium segments of the motorcycle market, but is still behind Hero Honda in the executive segment (which forms 55% of the motorcycle market). BAL's launches in the executive segment have received a good response. Success of these products could further improve its market share significantly.

RISING MARKET SHARE IN MOTORCYCLES (%)



Source: Motilal Oswal Securities

With new launches in the executive segment also doing well, this segment is now likely to drive market share gains

We expect BAL's market share to sustain above 30%, despite intense competition in the industry. According to us, Discover (a 125cc motorcycle) and the recently launched Avenger would start contributing to market share gains going forward – the initial response for both the models has been extremely positive. Also, BAL has taken taking initiatives to overcome its production constraints. Post this, there would be further market share gains for the company.

Exports to drive growth further

A first mover advantage in export markets saw BAL's exports increase four fold in three years

BAL was the first Indian company to start aggressively exporting two wheelers and three wheelers to the developing countries. As a result of this, its exports increased nearly four fold over the last three years, with most of the growth coming from deeper penetration into its traditional export markets (SAARC and a few Latin American markets).

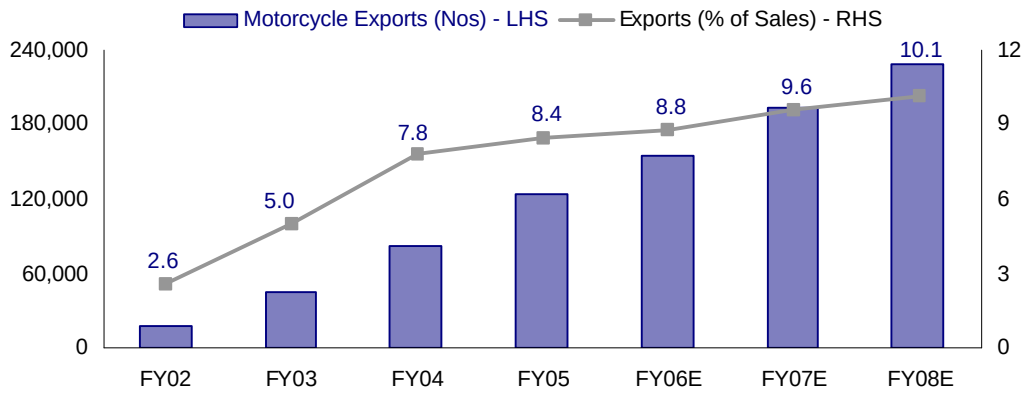
And having tasted success, BAL has decided to explore bigger and more-challenging markets

The company had planned its strategy well in the export market: to address 80% of the non-India, non-China market. As part of this plan, it first targeted the SAARC countries and the Latin American markets. And then, having tasted success in these markets, it decided to explore opportunities in newer, bigger and more challenging markets – namely the Asean countries comprising Thailand, Indonesia, Vietnam and Phillipines. With a strong product portfolio, BAL expects its foray into these markets to increase its global market share.

We believe, the global opportunity for BAL is huge and it has the product capability to address it

The global opportunity potential for the company is huge, considering that in its addressable market (below 250cc) the company has strong capabilities and the lower power segment accounts for over 85-90% of the 30-35m motorbikes sold globally every year.

EXPORT (MOTORCYCLE)



Source: Motilal Oswal Securities

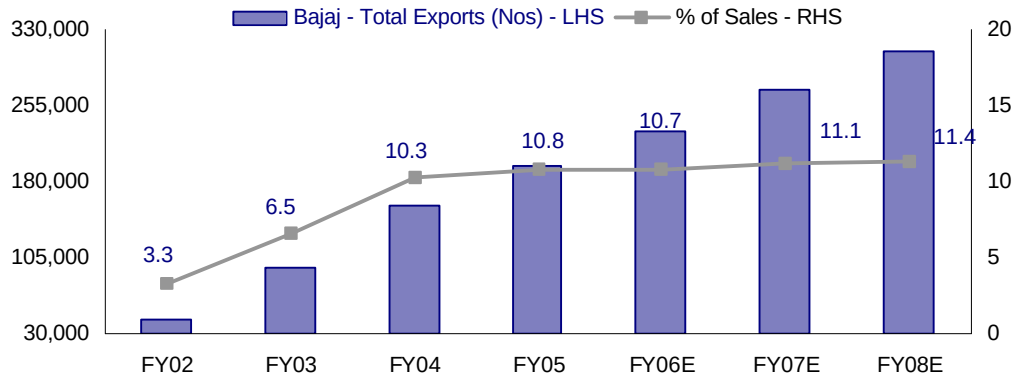
BAL is addressing the emerging opportunities in the Asean region through JVs in Indonesia and Phillipines

BAL is addressing the emerging opportunities in the Asean region through assemblies set up in Indonesia (with a local partner) and in Phillipines (with Kawasaki). These two ventures will enable it to access not only these two markets but also countries like Vietnam, Malaysia and Thailand. At the same time, BAL is also exploring opportunities in the Latin American and African markets which could provide a further boost to its export volumes and revenues.

Southeast Asia is likely to be its thrust export market over the next 2-3 years

For three wheelers, the export opportunities in Indonesia and Pakistan (depending on government approval) could be significant over the next two years. Hence, Southeast Asia is likely to be its thrust export market for two and three wheelers over the next 2-3 years. We forecast a 16% growth in exports over FY05-08E for BAL. Export volume, as a proportion to total volume, should increase from 6.5% in FY03 to 11.4% in FY08.

PROPORTION OF EXPORTS RISING IN SALES MIX (%)



Source: Motilal Oswal Securities

BAL has the highest probability of success in the export markets

Highest probability of success for BAL in the export market: Amongst the Indian two wheeler companies, we attach the highest probability of success for BAL in the global market based on the following factors:

As its competitors in the global market are the same as those on domestic turf

- Despite being a late entrant in the motorcycle market, BAL has tackled domestic competition smartly and emerged as the second largest motorcycle manufacturer in India. Almost all the companies that it would compete with in the global markets have a presence in India directly or through tie-ups with domestic players.

Also its skills and capabilities are already proven against international competition

- BAL has already proven product development skills and capabilities and has differentiated itself from its competitors in each of the motorcycle segments on the basis of its innovative and superior products. We believe skills and capabilities are already proven against international competition; brand building and setting up of a distribution network are key challenges ahead.

And its production cost and development time are comparable with Japanese peers

- Also, BAL has a strong R&D set up. Self-developed motorcycles were the key to its market share improvement. Its production cost is currently among the lowest in India and the company has also managed to bring down product development time. From a historical high of 36 months, product development time has come down to just 18 months. This is comparable to the average of the Japanese companies.

Significant value in balance sheet

BAL has a strong balance sheet with Rs50.5b in cash and investments

BAL has a strong balance sheet with Rs50.5b in cash and liquid investments, which translates into Rs499 per share in FY06. This is expected to increase further to Rs551 per share in FY07.

BALANCE SHEET DETAILS

	FY04	FY05	FY06E	FY07E
Book Value Per Share (Rs)	365.0	408.6	463.1	527.6
RoE (%)	19.8	18.5	19.6	20.4
Operational RoIC (%)	75.8	87.5	113.3	129.4
Debt / Equity	0.3	0.3	0.2	0.2
Cash Per Share (Rs)	389	461	499	551

Source: Motilal Oswal Securities

Which is likely to improve as it lowers its risk profile

Over the last few years, BAL has been making significant investment in the fixed income securities. While this has lowered the overall returns from this portfolio, in turn also depressing the return ratios for the company, it has lowered the risk profile as the proportion of equities have been on a decline.

DETAILS OF INVESTMENTS (RS M)

	FY01	FY02	FY03	FY04	FY05
Government Securities & Bank Deposits	4	5,797	8,653	19,861	25,609
Mutual Funds	696	510	1,739	1,568	935
Debentures & Bonds	2,860	4,040	8,698	9,268	9,849
Other Debt Instruments	5,627	3,710	2,645	1,085	697
Fixed Income Investments	9,187	14,057	21,735	31,782	37,090
Equity - Shares and Mutual Funds	7,174	8,499	7,355	7,290	8,792
Total	**16,361**	**22,556**	**29,090**	**39,072**	**45,882**
Market Value	N.A.	N.A.	29,267	45,108	53,299

Source: Company/Motilal Oswal Securities

Valuation of insurance business

BAL is the second largest private player in the general and life insurance business

BAL's insurance joint ventures (with Allianz) have been delivering good performance with significant market shares amongst the private players. BAL's General insurance subsidiary is the second largest private player, while even its life insurance subsidiary has in recent times emerged as the second largest private player in the Indian life insurance industry.The General Insurance venture posted profits of Rs350m where as the Life Insurance venture reported a loss Rs272m.

Valuation:

Bajaj Allianz Life Insurance

And is likely to see strong growth in the premium generated over the next five years

In order to compute the present value of Bajaj Allianz, we have discounted its future earnings streams. We expect a strong growth in the premium generated by Bajaj Allianz over the next five years on account of a low base and strong overall growth of the insurance sector. However, post FY10, we expect the growth to gradually slow down and expect the terminal growth rate to be around 5%. We estimate current margins at 20% in case of the non-single premiums and 5% in case of single premiums.

We value Bajaj Allianz Insurance at a current valuation of Rs30b. While BAL has a 74% stake, we believe that the beneficial ownership is 51% and BAL will have to divest its stake to the foreign partner whenever the regulations allow.

Thus, we value BAL's stake in its life insurance subsidiary at Rs153b (which works out to a per share value of Rs151).

BAJAJ ALLIANZ LIFE VALUATION	(RS M)
Embedded value	2,978
Value of future business	29,540
Appraisal value	32,518
Less: additional capital required	2,500
Estimated value of Bajaj Allianz	30,018
Value of Bajaj's stake (74%)	22,213
Value of Bajaj's stake (51%)	15,309

Source: Motilal Oswal Securities

Bajaj Allianz General Insurance

We have valued Bajaj Allianz General Insurance business at Rs7.6b (10x FY07E earnings). The value for BAL's 50% stake works out to Rs3.8b (that is Rs37.5 per share).

The life insurance business will be the real growth driver

Insurance business valued at Rs189 per share

Thus, the insurance ventures of BAL are valued at Rs189-(Rs151 for the life insurance business and Rs37.5 for the general business).

Recent quarter performance - an indication that BAL is gaining strength

Better-than-expected growth in motorcycles saw BAL's EBITDA margins improve

BAL's 1QFY06 numbers were above our expectations, with 27% YoY growth in net profit to Rs2.0b and 33% YoY growth in net revenues to Rs16.3b. The sales growth was lower despite 35% growth in volumes due to higher demand for economy segment bikes. Its operating margins improved 80bp YoY and 70bp QoQ due to better-than-expected growth (53% YoY) in motorcycles.

Volume growth: Riding on motorcycles growth of 53% YoY

In 1QFY06, motorcycles continued to lead BAL's overall volume growth. Total volumes grew by 35% YoY, led by a 53% growth in motorcycles. Three wheelers witnessed marginal de-growth, with sales declining by 1.4% YoY. The product mix was in favour of motorcycles during the quarter.

But with sales growth lagging volume growth, average realization declined

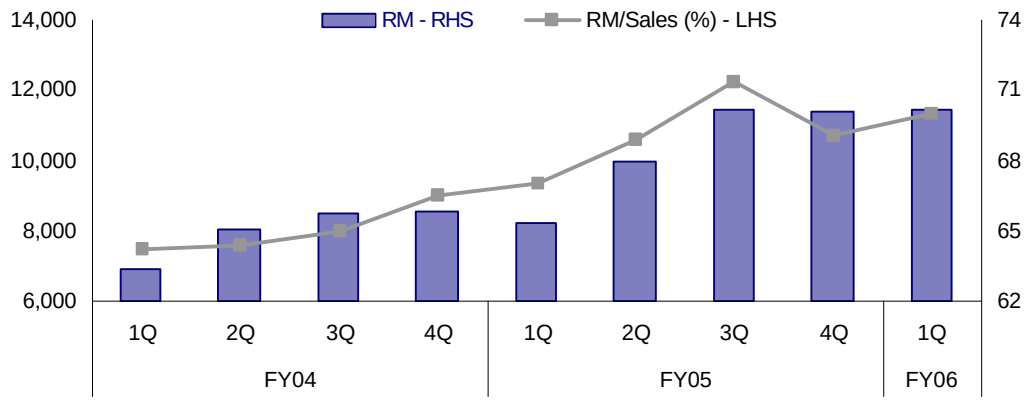
The 33% YoY sales growth in value terms at Rs16.3b, was lower than the 35% volume growth reflecting a 1.7% YoY decrease in average realization due to higher demand for economy-segment bikes.

Strong operating performance

BAL increased EBITDA margins despite higher input prices

BAL increased EBITDA margins to 15.8% in 1QFY06 despite higher raw material prices. A strong volume growth, further reduction in costs and higher productivity gains helped the company increase margins by 80bp YoY and 70bp QoQ. Margin expansion on a YoY basis was mainly on account of a sharp drop in other expenses and staff cost. Other expenses to net sales decreased to 10% in 1QFY06 from 13% in 1QFY05 and 4QFY05.

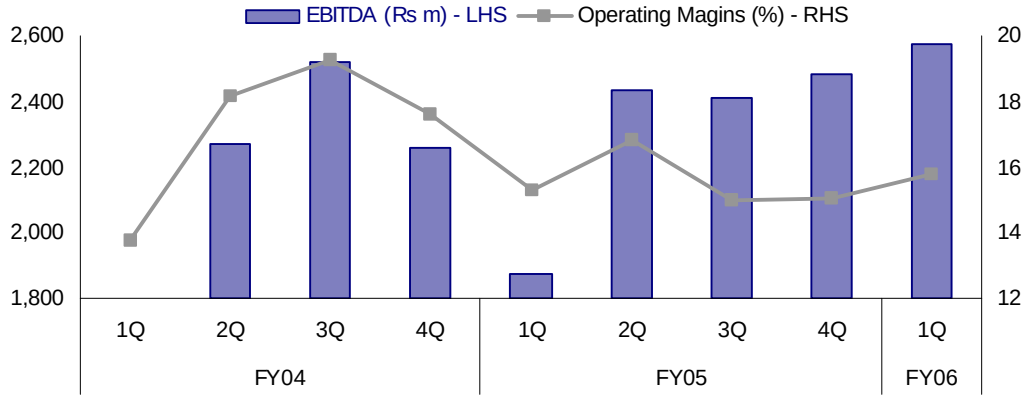
RAW MATERIAL COST DECLINING (RS M)



Source: Motilal Oswal Securities

Raw material costs in 1QFY06 were at 70% of sales, an increase of 90bp QoQ and 300bp YoY.

MARGINS EXPANDING



Source: Motilal Oswal Securities

Net profit registered a growth of 27% YoY

And registered a 27% growth in PAT

On the back of strong volume growth of 35.4%, sales growth of 33.3% and EBITDA growth of 40% in the quarter, PAT reported a 27% growth to Rs2b. Other income in 1QFY06 stood at Rs928m compared to Rs1b in 1QFY05.

QUARTERLY PERFORMANCE (RS MILLION)

Y/E MARCH	FY05				FY06				FY05	FY06E
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE		
Total Volumes (nos)	372,912	445,192	526,983	479,612	505,524	530,710	575,000	531,687	1,824,699	2,142,921
Net Sales	**12,261**	**14,483**	**16,057**	**16,470**	**16,342**	**17,230**	**18,221**	**18,614**	**59,271**	**70,406**
Change (%)	*14.2*	*16.0*	*22.6*	*28.3*	*33.3*	*19.0*	*13.5*	*13.0*	*20.5*	*18.8*
Total Expenses	10,417	12,048	13,645	13,987	13,766	14,525	15,378	15,723	50,137	59,443
Operating Profit	**1,845**	**2,435**	**2,412**	**2,483**	**2,575**	**2,705**	**2,842**	**2,891**	**9,134**	**10,964**
Change (%)	*24.8*	*7.2*	*-4.3*	*9.9*	*39.6*	*11.1*	*17.9*	*16.4*	*7.1*	*20.0*
As % of Sales	*15.0*	*16.8*	*15.0*	*15.1*	*15.8*	*15.7*	*15.6*	*15.5*	*15.4*	*15.6*
Other Income	1,064	882	869	1,266	928	938	1,072	1,139	4,081	4,076
Interest	2	-1	3	2	1	2	2	3	7	7
Depreciation	462	464	468	460	462	466	478	497	1,854	1,903
Extraordinary Expenses	45	163	170	171	0	0	0	0	490	0
Extraordinary Income	0	-5	0	0	0	0	0	0	0	0
PBT	**2,401**	**2,650**	**2,641**	**3,116**	**3,040**	**3,178**	**3,439**	**3,536**	**10,864**	**13,131**
Tax	800	850	820	1,046	950	922	1,066	1,002	3,196	3,939
Effective Tax Rate (%)	*33.3*	*32.1*	*31.1*	*33.6*	*31.3*	*29.0*	*31.0*	*28.3*	*32.8*	*30.0*
PAT	**1,646**	**1,963**	**1,990**	**2,070**	**2,090**	**2,256**	**2,373**	**2,534**	**7,668**	**9,191**
Adj. PAT	**1,691**	**2,130**	**2,160**	**2,241**	**2,090**	**2,256**	**2,373**	**2,534**	**8,221**	**9,191**
Change (%)	*5.2*	*-1.7*	*15.0*	*5.2*	*23.6*	*5.9*	*9.9*	*13.1*	*0.1*	*11.8*

E: MOSt Estimates

Valuation and view

Assumptions

ESTIMATE 14% CAGR OVER FY05-08E IN OVERALL VOLUMES FOR BAL

	FY05	FY06E	FY07E	FY08E	CAGR %
Motorcycles	1,449,710	1,754,149	2,017,271	2,259,344	15.9
Scooters-Geared	102,779	105,862	111,155	120,048	5.3
Scooters-Ungeared	30,959	33,436	36,779	40,457	9.3
Step Thrus	19,198	16,318	13,871	12,483	-13.4
Three-wheelers	222,053	233,156	251,808	271,953	7.0
Total Vehicles	**1,824,699**	**2,142,921**	**2,430,885**	**2,704,285**	**14.0**

Source: Company/Motilal Oswal Securities

EXPORT TO REGISTER 16% CAGR OVER FY05-08E; MOTORCYCLES TO REGISTER 23% GROWTH

	FY05	FY06E	FY07E	FY08E	CAGR %
Total Exports	196,710	230,117	270,690	307,474	16.1
Motorcycles	123,946	154,933	193,666	228,525	22.6
other Two-wheelers	6,999	6,789	6,585	6,388	-3.0
Total Two-wheelers	130,945	161,722	200,251	234,913	21.5
Three-wheelers	65,765	68,396	70,447	72,561	3.3

MOTORCYCLE PRODUCT-MIX TO SHIFT AWAY FROM ENTRY LEVEL

BREAK-UP	FY05	FY06E	FY07E	FY08E	CAGR %
Total Volume	1,449,710	1,754,149	2,017,271	2,259,344	15.9
Entry Level	913,029	1,059,114	1,186,207	1,304,828	12.6
Executive	257,895	381,685	494,282	597,586	32.3
Premium	278,786	313,634	336,780	356,987	8.6
Product-mix (%)					
Entry Level	63.0	60.4	58.8	57.8	
Executive	17.8	21.8	24.5	26.4	
Premium	19.2	17.9	16.7	15.8	

Source: Company/Motilal Oswal Securities

THREE-WHEELERS TO STABILIZE AT 10% OF OVERALL VOLUMES IN FY08E FROM 15% IN FY04

% OF TOTAL VOLUMES	FY05	FY06E	FY07E	FY08E
Two-wheelers	87.8	89.1	89.6	89.9
Three-wheelers	12.2	10.9	10.4	10.1

Source: Company/Motilal Oswal Securities

Revenue growth to be driven by strong motorcycle and exports growth

Driven by higher motorcycle sales, BAL's revenues will record a 15% CAGR

BAL is expected to record 15% CAGR in net revenues over FY05-08E – with growth primarily driven by motorcycles (16% CAGR over FY05-08E) and total exports (16% CAGR over FY05-08E; motorcycle exports 23% CAGR over FY05-08E). We expect overall volumes to grow at a CAGR of 14% over FY05-08E.

Strong volume growth, better product-mix, cost savings and higher productivity to result in 18% EBITDA growth

Margin expansion would result in 18% CAGR in EBITDA…

We expect EBITDA margin expansion of almost 30bp over next two years from 15.4% in FY05 to 15.7% in FY07E – leading to 18% CAGR in EBITDA over this period. Key drivers to this margin expansion would be strong growth in motorcycle and exports, better product mix, cost savings and higher productivity.

19% CAGR in net earnings over FY05-FY07E

…and 19% CAGR in net earnings

Overall, we expect BAL's net earnings to improve from Rs75.8 in FY05 to Rs107.6 in FY07E (a CAGR of 19%).

In FY06 and FY07, we expect its product mix to improve in favour of high-margin segments like three wheelers, and executive and premium motorcycles. An aggressive focus on exports, upgradation of its three wheeler platform and frequent launches across the two wheeler segment are expected to help BAL maintain a strong volume growth.

Bajaj Auto has been consistently gaining share in a market which is a virtual duopoly. Moreover, its new launches have met with a strong reponse. There is a waiting period for its relatively high margin models- *Pulsar, Avenger and Discover.* Success of its newly launched *Wave* is also improving ungeared scooter sales. Going forward, key positive for Bajaj Auto would be revival in its three wheeler sales (high margin segment). This is mainly on account of demand generated from cities which are moving to CNG powered three wheelers.

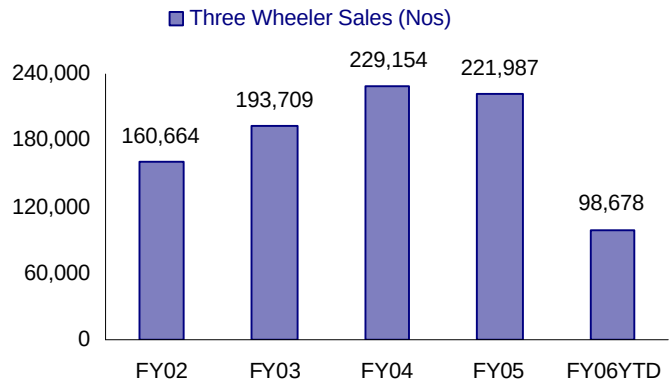
Trading at 12.2x FY06E, we maintain Buy

At CMP, BAL trades at a P/E of 19x and 16x; EV/EBITDA of 12.2x and 10.1x and P/BV of 3.7x and 3.3x on our FY06 and FY07 estimates, respectively. We maintian **Buy** with a price target of Rs 1,960 based on SOTP valuation (core business at 14x FY07E EPS; cash at Rs 551 per share; Insurance and Bajaj Auto Finance at Rs 205/share).

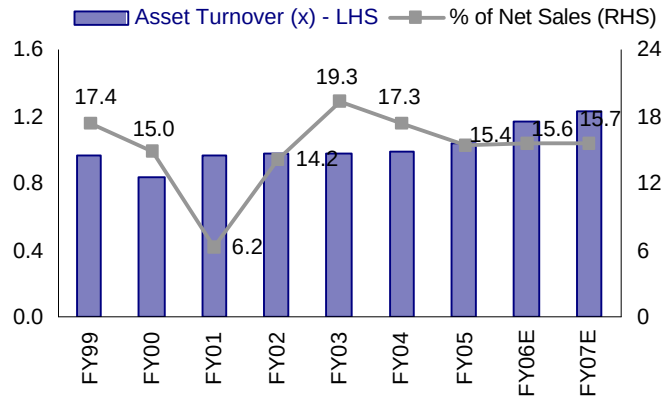
Investment concerns

- Slowdown in three wheeler sales – BAL's cash cow business
- Increased competition may lead to heavy discounts and pressure on profitability
- Any significant upmove in interest rates, leading to higher financing costs

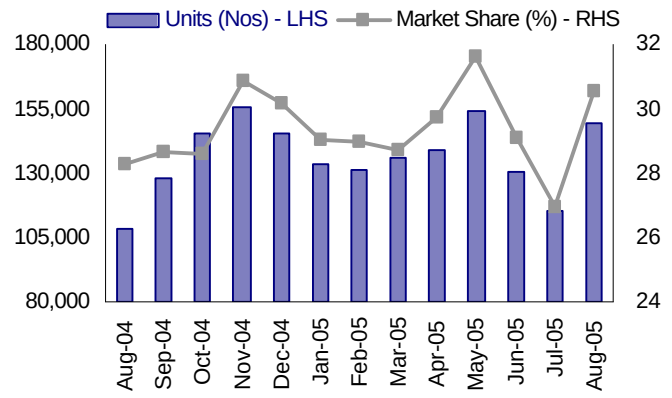
BAL: THREE WHEELER SALES



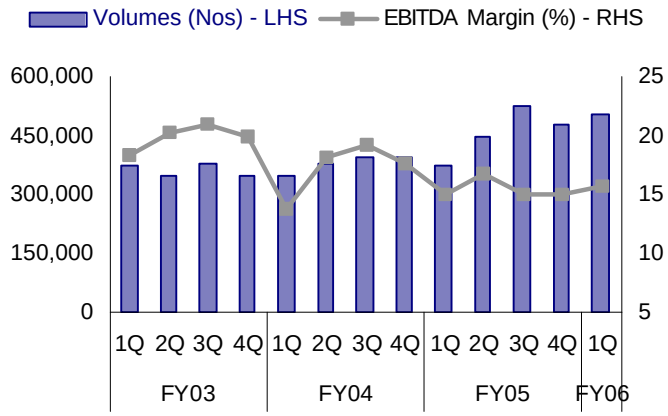
BAL: PERFORMANCE RATIOS



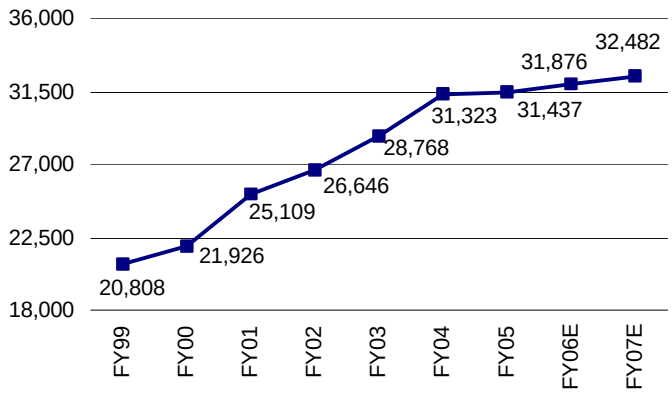
BAL: BIKE SALES - 12 MONTHS



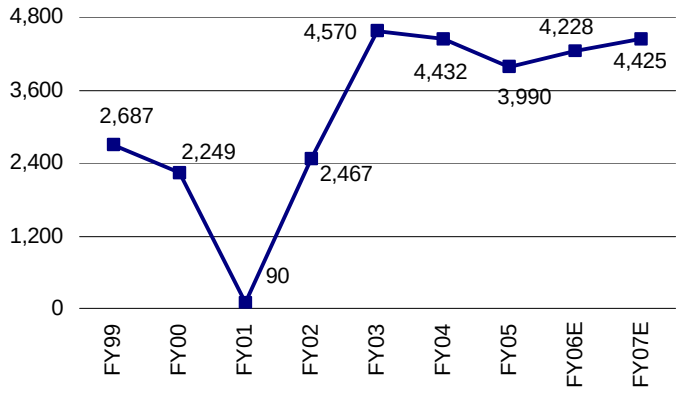
BAL: VOLUMES & MARGIN MOVEMENT



BAL - REVENUE PER VEHICLE (RS)



BAL - EBIT PER VEHICLE (RS)



Source: Company/Motilal Oswal Securities

INCOME STATEMENT (RS MILLION)

Y/E MARCH	2003	2004	2005	2006E	2007E
Net Sales	**41,591**	**47,552**	**57,364**	**68,308**	**78,960**
Change (%)	*14.9*	*14.3*	*20.6*	*19.1*	*15.6*
Operating Other Income	1,515	1,616	1,907	2,098	2,307
Total Income	**43,106**	**49,168**	**59,271**	**70,406**	**81,268**
Expenditure	**34,788**	**40,640**	**50,137**	**59,443**	**68,537**
EBITDA	**8,319**	**8,528**	**9,134**	**10,964**	**12,731**
Change (%)	*61.6*	*2.5*	*7.1*	*20.0*	*16.1*
% of Net Sales	*19.3*	*17.3*	*15.4*	*15.6*	*15.7*
Depreciation	1,712	1,799	1,854	1,903	1,973
Interest & Finance Charges	11	9	7	7	6
Other Income	1,746	3,535	4,081	4,076	4,798
PBT	7,881	9,604	10,864	13,131	15,549
Tax	2,502	2,289	3,196	3,939	4,665
Effective Rate (%)	*31.7*	*23.8*	*29.4*	*30.0*	*30.0*
PAT	5,379	7,315	7,668	9,191	10,884
% of Net Sales	*12.5*	*14.9*	*12.9*	*13.1*	*13.4*
Adj. PAT	5,379	7,315	7,668	9,191	10,884
Change (%)	*22.5*	*36.0*	*4.8*	*19.9*	*18.4*

BALANCE SHEET (RS MILLION)

Y/E MARCH	2003	2004	2005	2006E	2007E
Share Capital	1,012	1,012	1,012	1,012	1,012
Reserves	31,394	35,924	40,332	45,847	52,377
Net Worth	**32,406**	**36,936**	**41,343**	**46,858**	**53,389**
Deferred Tax	1,724	1,228	1,399	1,399	1,399
Loans	8,402	10,057	12,270	10,270	9,270
Capital Employed	**42,532**	**48,222**	**55,012**	**58,527**	**64,058**
Gross Fixed Assets	26,222	27,030	27,436	28,520	29,520
Less: Depreciation	13,455	14,967	16,286	18,189	20,162
Net Fixed Assets	**12,767**	**12,063**	**11,150**	**10,331**	**9,357**
Capital WIP	40	83	84	0	0
Investments	27,299	38,554	45,606	45,606	45,606
Curr.Assets, L & Adv.	**21,551**	**20,530**	**25,897**	**32,134**	**39,329**
Inventory	2,080	2,026	2,242	3,201	3,453
Sundry Debtors	1,670	1,339	1,763	3,201	4,933
Cash & Bank Balances	300	794	1,087	4,927	10,137
Loans & Advances	16,906	15,917	20,120	20,120	20,120
Current Liab. & Prov.	**19,407**	**23,261**	**27,940**	**29,759**	**30,450**
Sundry Creditors	4,136	6,232	7,351	9,176	9,867
Other Liabilities	413	494	499	494	494
Provisions	14,858	16,535	20,089	20,089	20,089
Net Current Assets	**2,144**	**-2,730**	**-2,042**	**2,375**	**8,879**
Application of Funds	**42,532**	**48,222**	**55,012**	**58,527**	**64,058**

E: MOSt Estimates

RATIOS

Y/E MARCH	2003	2004	2005	2006E	2007E
Basic (Rs)					
EPS	53.2	72.3	75.8	90.8	107.6
Cash EPS	70.1	90.1	94.1	109.6	127.1
Book Value per Share	320.3	365.0	408.6	463.1	527.6
DPS	14.0	25.0	25.0	36.3	43.0
Payout (Incl. Div. Tax) %	26.3	34.6	33.0	40.0	40.0
Valuation (x)					
P/E	32.4	23.8	22.8	19.0	16.0
Cash P/E	24.6	19.1	18.3	15.7	13.6
EV/EBITDA	18.7	17.0	15.3	12.2	10.1
EV/Sales	3.7	3.1	2.4	2.0	1.6
Price to Book Value	5.4	4.7	4.2	3.7	3.3
Dividend Yield (%)	0.8	1.5	1.5	2.1	2.5
Profitability Ratios (%)					
RoE	16.6	19.8	18.5	19.6	20.4
RoCE	19.6	21.3	20.7	22.4	24.3
Turnover Ratios					
Debtors (Days)	13	9	10	15	20
Asset Turnover (x)	1.0	1.0	1.0	1.2	1.2
Leverage Ratio					
Debt/Equity (x)	0.3	0.3	0.3	0.2	0.2

CASH FLOW STATEMENT (RS MILLION)

Y/E MARCH	2003	2004	2005	2006E	2007E
OP/(Loss) before Tax	6,607	6,729	7,280	9,061	10,757
Interest/Div. Received	1,746	3,535	4,081	4,076	4,798
Depreciation & Amort.	1,712	1,799	1,854	1,903	1,973
Direct Taxes Paid	-2,684	-2,785	-3,026	-3,939	-4,665
(Inc)/Dec in Working Capital	1,257	5,368	-395	-577	-1,294
CF from Oper. Activity	**8,638**	**14,646**	**9,795**	**10,524**	**11,569**
(Inc)/Dec in FA+CWIP	-990	-1,107	-905	-1,000	-1,000
(Pur)/Sale of Invest.	-7,638	-11,255	-7,051	0	0
CF from Inv. Activity	-8,628	-12,363	-7,956	-1,000	-1,000
Changes in Reserves	-215	-255	-731	0	0
Inc/(Dec) in Debt	2,141	1,655	2,213	-2,000	-1,000
Interest Paid	-11	-9	-7	-7	-6
Dividends Paid	-1,417	-2,530	-2,530	-3,677	-4,354
CF from Fin. Activity	499	-1,139	-1,055	-5,683	-5,360
Inc/(Dec) in Cash	**48**	**493**	**293**	**3,840**	**5,210**
Add: Beginning Balance	252	300	794	1,087	4,927
Closing Balance	**300**	**794**	**1,087**	**4,927**	**10,137**

E: MOSt Estimates

Hero Honda Motors

STOCK INFO.	BLOOMBERG
BSE Sensex: 8,529	HH IN
S&P CNX: 2,579	REUTERS CODE HROH.BO

6 October 2005 **Buy**

Previous Recommendation: Buy Rs739

RS MILLION	2004	2005	2006E	2007E
Sales	58,324	74,217	87,149	99,422
EBITDA	9,801	11,645	13,395	15,540
PAT	7,283	8,105	9,513	10,924
EPS (Rs)	36.5	40.6	47.6	54.7
EPS Growth (%)	25.4	11.3	17.4	14.8
BV/Share (Rs)	57.0	74.8	97.2	121.8
P/E (x)	20.3	18.2	15.5	13.5
P/BV (x)	13.0	9.9	7.6	6.1
EV/EBITDA (x)	13.6	11.1	9.6	8.1
EV/Sales (x)	2.3	1.7	1.5	1.3
RoE (%)	64.0	54.3	49.0	44.9
RoCE (%)	76.4	67.7	63.0	60.0

KEY FINANCIALS	
Shares Outstanding (m)	199.7
Market Cap. (Rs b)	147.6
Market Cap. (US$ b)	3.4
Past 3 yrs. Sales Growth (%)	18.5
Past 3 yrs. NP Growth (%)	20.5
Dividend Payout (%)	49.3
Dividend Yield (%)	2.7

STOCK DATA	
52-Week Range (Rs)	770/412
Major Shareholders (as of June 2005)	(%)
Promoters	55.0
Domestic Institutions	7.2
FII/FDIs	27.4
Public	10.4
Average Daily Turnover	
Volume ('000 shares)	522.1
Value (Rs million)	238.8
1/6/12 Month Rel. Performance (%)	-2/6/22
1/6/12 Month Abs. Performance (%)	5/37/72

Hero Honda has maintained its market leadership (gained market share) in the motorcycle industry despite stiff competition in the last couple of years. New launches in the 125cc segment would help it to maintain its leadership position in this category. Meanwhile, re-launch of Ambition in the 135cc and new 150cc model would further strengthen its product portfolio. With foray into scooters in FY06 and announcement of a new unit (removing concerns on capacity constraints), we expect strong volume growth beyond FY06.

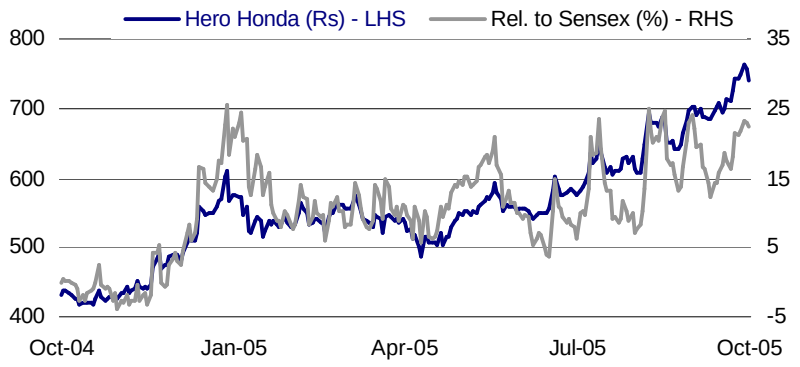
Volume growth to remain robust: Hero Honda has gained 8% market share over FY00-05. This is despite the intense competition from both the domestic and foreign players. We expect volume growth for the company to remain robust (13% CAGR over FY05-08).

To maintain leadership in 125cc segment: The newly-launched products in the 125cc segment demonstrate its ability to offer superior value to the customer at a competitive price. Hero Honda would remain the leader in the 125cc motorcycle segment, in our opinion.

EBITDA margins to stabilize: Hero Honda's EBITDA margins at 14.8% in 1QFY06 is the lowest in the last 13 quarters. We believe that the margins will remain stable over the next 3 quarters.

We maintain Buy: Hero Honda's efficiency ratios are the best in the industry.The stock trades at a P/E of 13.5x; EV/EBITDA 8.1x; FY07 estimates, respectively. We maintain **Buy** with a target price of Rs824 based on 15x FY07 EPS of Rs54.7.

STOCK PERFORMANCE (1 YEAR)



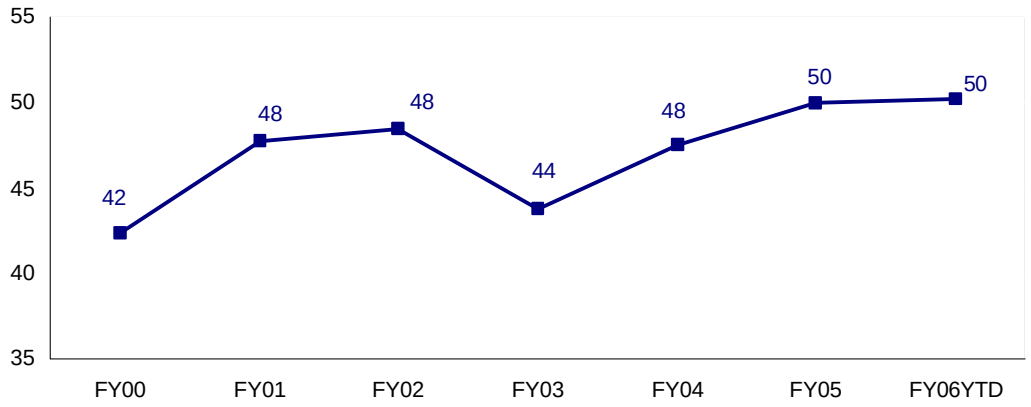
Investment arguments

Volume growth is likely to remain robust over the next few years

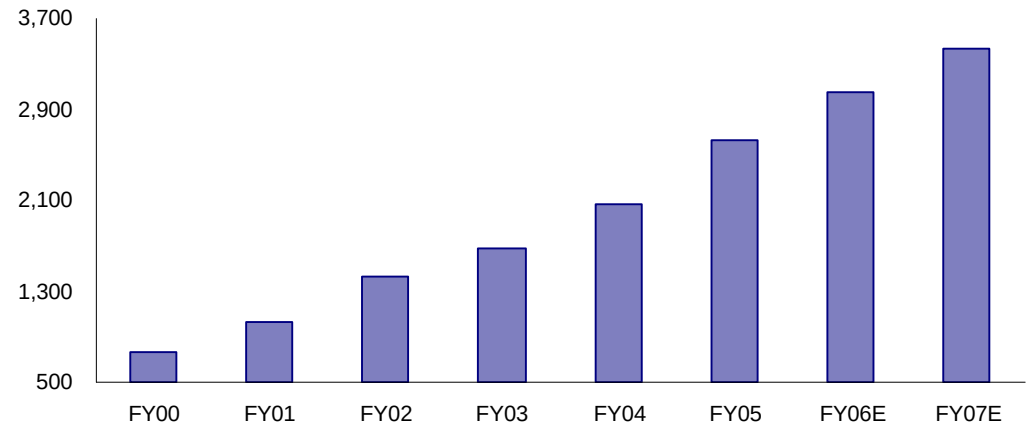
Volume growth to remain robust

Though competition would intensify going forward, with players like HMSI and Yamaha becoming aggressive and Suzuki set to re-enter the Indian market, we believe Hero Honda would retain market share. The company had managed to gain 8% market share over FY00-05 in the same competitive environment. Also, its volume growth is likely to remain robust over the next few years, thanks to new product launches and capacity addition.

MARKET SHARE GAINING STEADILY (%)



VOLUMES IN NOS ('000)



Source: Company/Motilal Oswal Securities

Hero Honda to maintain leadership in 125cc executive segment

Hero Honda successfully launched two products in the 125cc segment

Hero Honda's strengths lie in identifying customer needs and offering superior value to them at a competitive price. The company has recently launched two products – *Super Splendor* and *Glamour* – in the 125cc segment. We believe that these two products will be the growth drivers over the next couple of years. Based on its strong brand equity in the rural market and the initial feedback from dealers on both the above launches, we expect Hero Honda to lead in the 125cc segment.

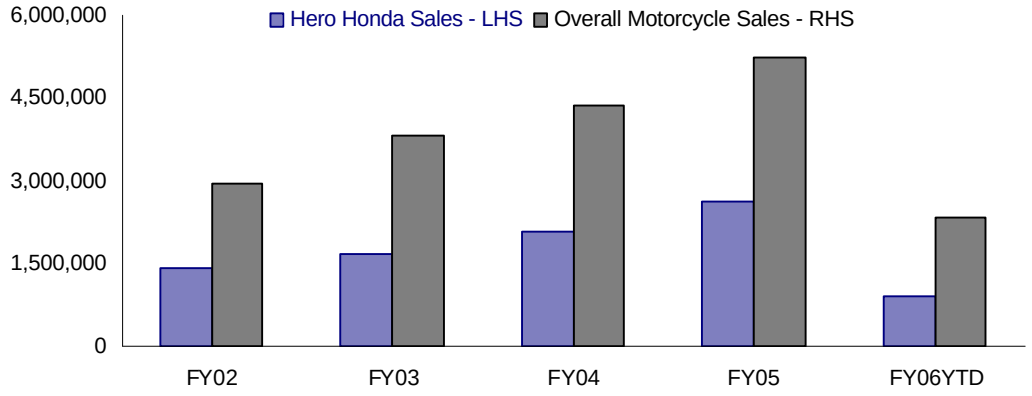
To launch new products in premium segment

In the premium segment, Hero Honda is planning to re-launch 135cc *Ambition* and is also launching a 150cc bike - *Achiever* in 2HFY06. These products will strengthen the companies product portfolio in the premium segment.

And indicated it will enter the scooters market

Apart from this, Hero Honda will commence manufacturing of scooters , with niche segment positioning, using Honda technology from FY07. Once fully operational, this would further add to Hero Honda's product portfolio, ensuring its leadership in the two-wheeler segment.

STRONG PERFORMANCE OVER THE YEARS (NOS)



Source: Company/Motilal Oswal Securities

EBITDA margins to stabilize

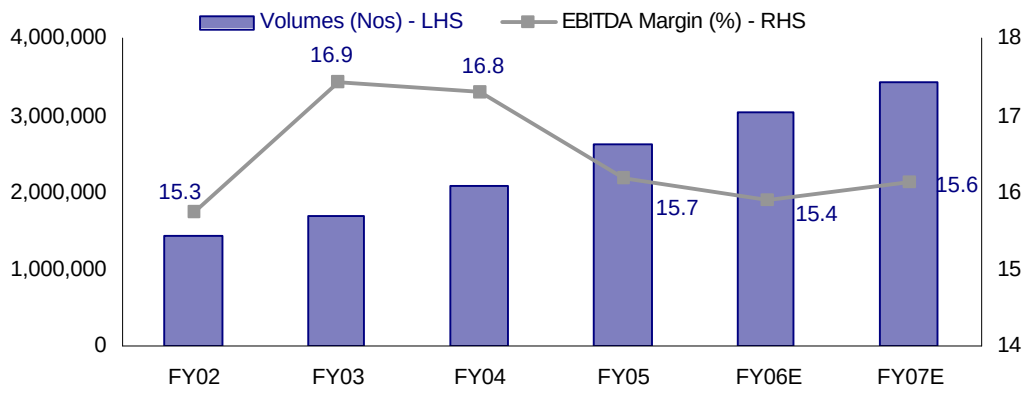
Its newly launched products have started delivering

Hero Honda's EBITDA margin, at 14.8% in 1QFY06, was the lowest in the last 13 quarters. This was primarily on account of higher input cost (especially steel) and other expenditure (incurred on new launches). Over the next two to three quarters, we believe that the margins will stabilise. This is because of a softening in steel prices and a normalisation of other expenditure as a percentage of sales. We believe EBITDA margins would settle at 15.4% for FY06 (full year).

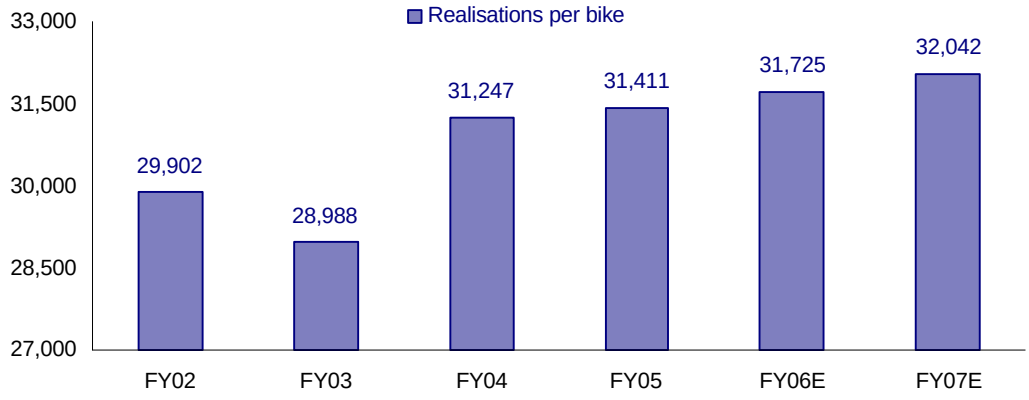
And are likely to stabilize margins

A good response to recently-launched motorcycles in the 125cc segment will support the growth momentum in the executive segment and remove fear of deteriorating margins. Hero Honda is also working on reducing costs across the value chain. It has been planning to source inputs from Tier2 vendors, in order to cut costs. Further, with new capacities going into production over the next two years, economies of scale are in Hero Honda's favor.

VOLUMES AND EBITDA MARGIN MOVEMENT



AVERAGE REALIZATIONS: IMPROVING DUE TO 125CC SEGMENT



Source: Company/Motilal Oswal Securities

Expansion to provide further visibility on volume growth

Hero Honda's normal capex is Rs700m-1b. It has an annual capacity to manufacture 2.5m vehicles per annum and we understand that this could be stretched to 3.2m vehicles per annum between the two existing plants.

And an expansion would only provide greater visibility

Hero Honda is also considering to set up a new unit in the near future. The new plant will be in the vicinity of the existing plants and will have an initial capacity of 250,000 bikes per annum. The capacity will be scaled up to 1m bikes per annum depending on demand. Capex for the new plant is estimated at $75m (Rs3.3b) for the initial capacity. In addition to this, an annual capex of $15m will be required for maintenance and gradual expansion.

The current capacity of the existing plants is 3.2m bikes per annum. After the recent wage agreement signed by Hero Honda, output will be scaled up by 150,000 units per annum at the existing plants, taking the total output to 3.35m bikes. Hero Honda's total capacity for FY07 will thus be as follows:

TABLE OF NEW CAPACITY	
Current Capacity	- 3.2 mn bikes
Brownfield expansion at existing location	- 0.15 mn bikes
Greenfield expansion	- 0.25 mn bikes
Total Capacity in FY07	**- 3.6 mn bikes**

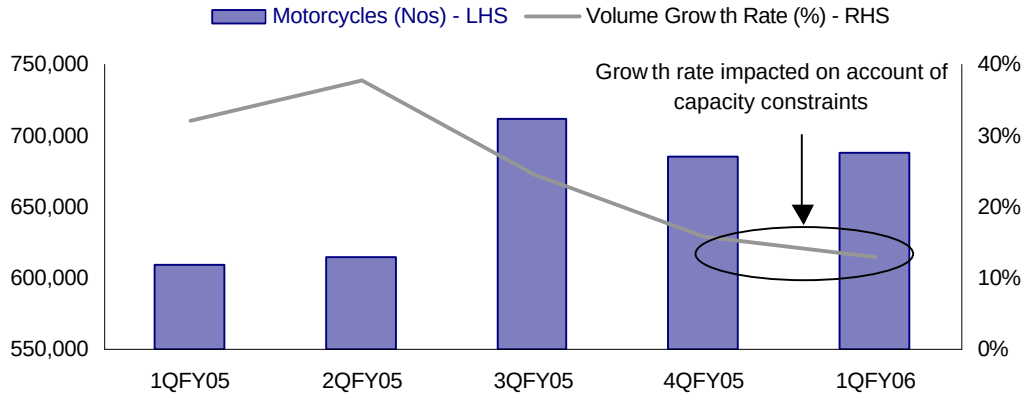
Recent quarter performance

Volume growth continues, but below industry growth rate

Though volume growth was below industry growth in 1QFY06

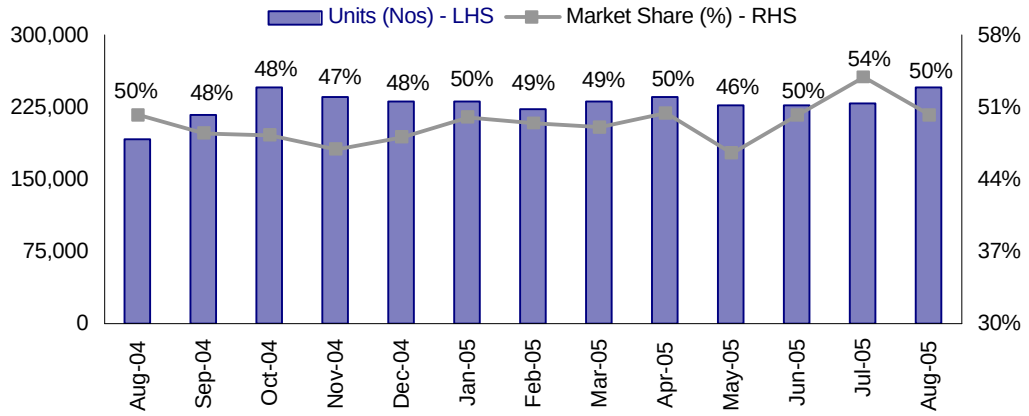
In 1QFY06, the company reported a 12.9% growth in volumes to 687,567 units. Growth has been lower than the industry growth (20.3% YoY) mainly on account of production and supplier constraints. Hero Honda launched *Glamour* during the quarter to strengthen its position in the 125cc category, along with *Super Splendor*. *Super Splendor* received a good response, clocking sales of around 150,418 units in the first four months of its launch.

VOLUME GROWTH DECELERATES ON ACCOUNT OF CAPACITY CONSTRAINTS



Source: Motilal Oswal Securities

MARKETSHARE IN DOMESTIC TWO-WHEELER MARKET



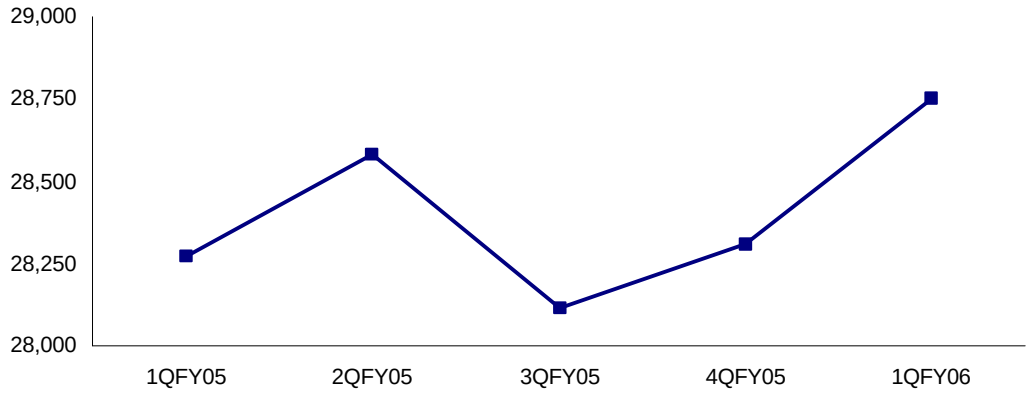
Source: Motilal Oswal Securities

Realizations improved 1.7% YoY

Realizations have improved

In 1QFY06, realizations increased by 1.7% on a YoY basis and remained flat on a QoQ basis at Rs28,754. This is mainly on account of a price hike (1-3%) effected in the last quarter, withdrawal of discounts and good response to the 125cc-*Super Splendor*).

REALIZATION PER UNIT (RS)

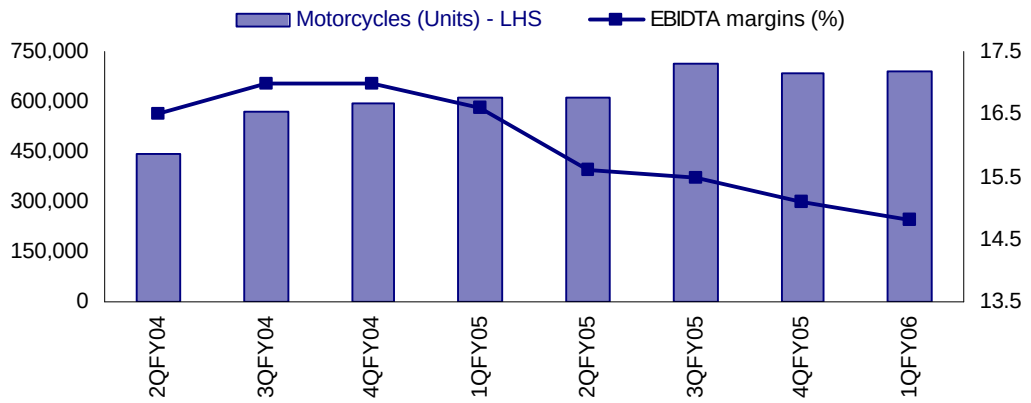


Source: Motilal Oswal Securities

Operating margins takes a hit – lowest in last 13 quarters

Hero Honda's EBITDA margins were 14.8% in 1QFY06 (a drop of 180bp YoY and 30bp QoQ). Higher input cost and other expenditure in the quarter led to a drop in margins. Raw material cost to net sales stood at 71% in 1QFY06 compared to 70.1% in 1QFY05 and 70.3% in 4QFY05. Other expenditure during the quarter increased to 10.6% from 9.6% in 1QFY05. The sharp increase in other expenditure was mainly due to new product launches.

EBITDA MARGINS ON A DECLINE



Source: Motilal Oswal Securities

Net earnings grew by 7.2% YoY in 1QFY06

And net earnings increased by 7.2%

Hero Honda's net earnings increased by 7.2% in 1QFY06 to Rs2b, which was below our expectations. Sales grew 14.8% in value terms to Rs19.8b ahead of volume growth of 12.9%. Average realization improved 1.7% YoY and remained flat on a QoQ basis.

QUARTERLY PERFORMANCE (HERO HONDA) (RS MILLION)

Y/E MARCH	FY05				FY06				FY05	FY06E
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE		
Volumes (nos.)	609,123	614,796	712,062	685,419	687,567	746,554	821,300	785,403	2,621,400	3,040,824
Change (%)	*32.0*	*37.7*	*24.4*	*15.6*	*12.9*	*21.4*	*15.3*	*14.6*	*26.5*	*16.0*
Net Sales	**17,223**	**17,572**	**20,019**	**19,403**	**19,771**	**21,402**	**23,309**	**22,668**	**74,217**	**87,149**
Change (%)	*30.1*	*39.3*	*26.6*	*15.5*	*14.8*	*21.8*	*16.4*	*16.8*	*27.3*	*17.4*
Total Expenses	14,369	14,823	16,910	16,471	16,848	18,149	19,696	19,061	62,572	73,754
Operating Profit	**2,855**	**2,749**	**3,109**	**2,932**	**2,923**	**3,253**	**3,613**	**3,606**	**11,645**	**13,395**
Change (%)	*33.8*	*32.1*	*15.3*	*2.7*	*2.4*	*18.3*	*16.2*	*23.0*	*18.9*	*15.0*
As % of Sales	*16.6*	*15.6*	*15.5*	*15.1*	*14.8*	*15.2*	*15.5*	*15.9*	*15.7*	*15.4*
Other Income	229	411	413	358	306	452	470	580	1,411	1,808
Interest	-2	-3	-2	-4	3	3	3	3	-11	12
Depreciation	205	208	217	264	250	251	288	279	894	1,068
PBT	**2,881**	**2,955**	**3,307**	**3,031**	**2,975**	**3,451**	**3,791**	**3,905**	**12,173**	**14,123**
Tax	980	1,011	1,118	960	937	1,104	1,289	1279	4,068	4,610
Tax/PBT (%)	*34.0*	*34.2*	*33.8*	*31.7*	*31.5*	*32.0*	*34.0*	*32.8*	*33.4*	*32.6*
Adj. PAT	**1,901**	**1,944**	**2,189**	**2,070**	**2,039**	**2,347**	**2,502**	**2,624**	**8,105**	**9,513**
Change (%)	*20.5*	*24.2*	*8.0*	*-2.0*	*7.2*	*20.7*	*14.3*	*26.8*	*11.3*	*17.4*

E: MOSt Estimates

Valuation and view

Buoyant demand for two wheelers in India should see the industry grow at 10-12% over the next few years, in line with middle and high-income household growth. Hero Honda is well placed to capitalize on this growth.

Assumptions over FY06-08E

Revenue growth to be driven by robust motorcycle growth
Hero Honda is expected to record 14% CAGR in net revenues over FY05-08 with motor cycle volumes growing by 13% CAGR over FY05-08.

Volume growth, better mix and cost savings to result in 14% EBITDA growth
We expect EBITDA margin to stabilize at the current levels over the next three years- leading to 14% CAGR over this period. Key drivers to this would be volume growth (on high base), better product mix and cost savings.

14% CAGR in net earnings through FY08E

With 14% CAGR in net earnings through FY08

We expect Hero Honda's EPS to improve from Rs40.5 in FY05 to Rs59.9 in FY08, a 3-year CAGR of 14%.

We maintain Buy

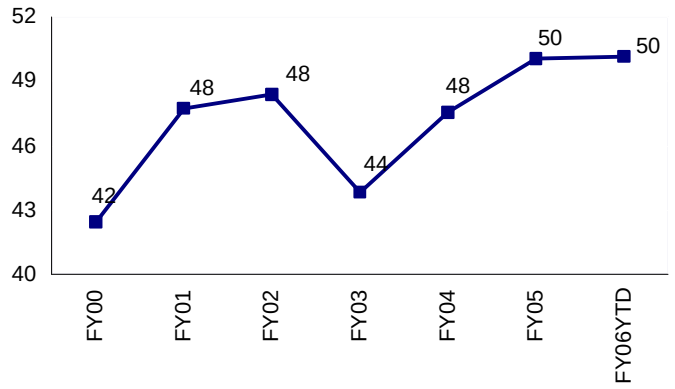
Hero Honda would be one of the major beneficiaries of the strong growth in the two wheeler demand over next few years. Good response to the new products would further strengthen its position in executive segment and take away the fear of deteriorating product mix. Positive news flow relating to the new plant would remove concerns on capacity constraints and give more visibility of strong volume growth beyond FY06.

Hero Honda's efficiency ratios are the best in the industry. The company is expected to have cash of Rs120 per share in FY07 and the stock has an attractive dividend yield (3.4% on FY06 estimated dividend of Rs 25). The stock trades at a P/E of 13.5x; EV/ EBITDA of 8.1x; and P/BV of 6.1x on FY07 estimates, respectively. We maintain **Buy** with a target price of Rs824 based on 15x FY07 EPS of Rs54.7.

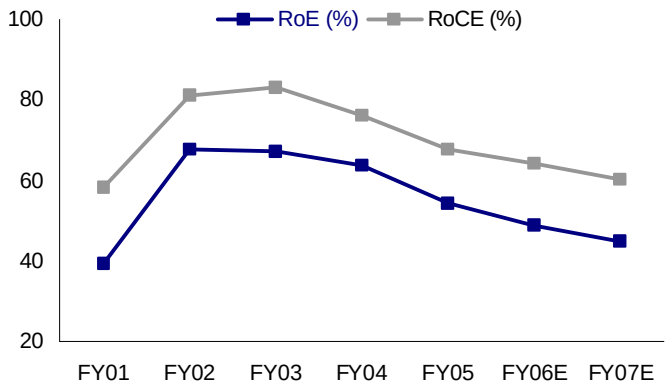
Investment concerns

- HMSI to launch 125cc motorcycles in 3QFY06
- Increased competition to lead to heavy discounts and pressure on profitability
- Any significant upmove in interest rates, leading to higher financing costs

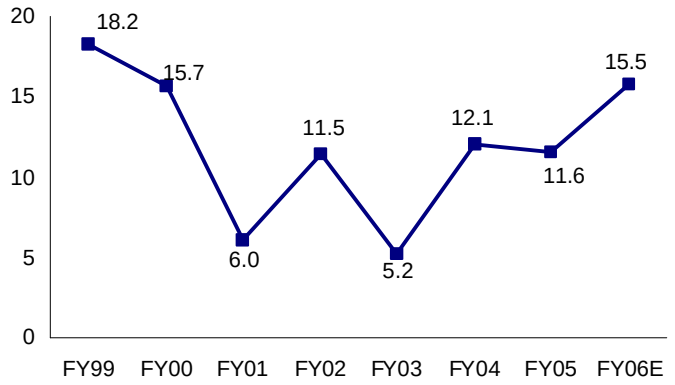
HERO HONDA: MARKET SHARE (%)



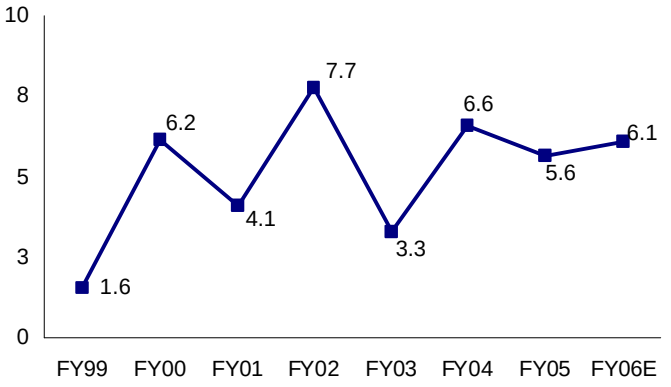
HERO HONDA: ROE/ROCE



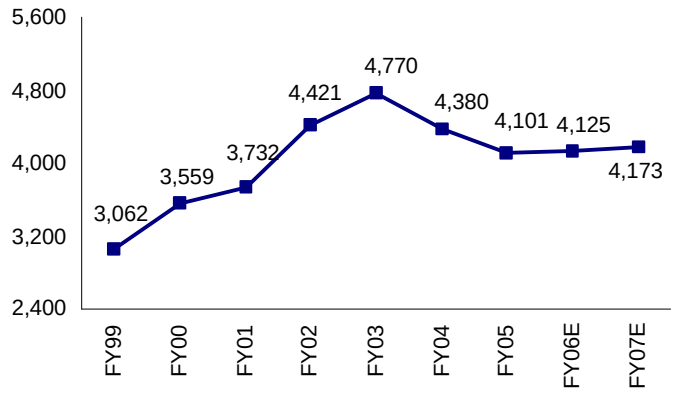
HERO HONDA: P/E



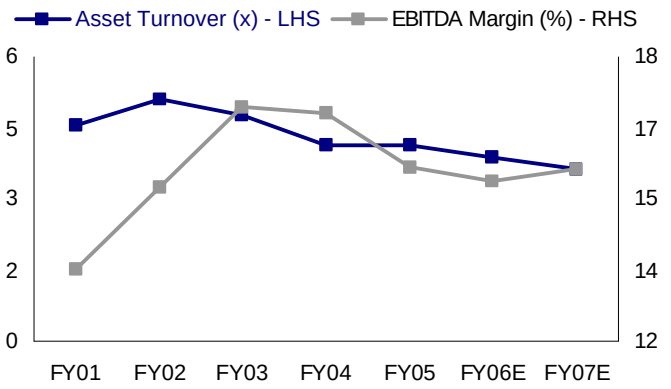
HERO HONDA:P/BV



HERO HONDA: EBIT/VEHICLE (RS)



HERO HONDA: PERFORMANCE INDICATORS



Source: Company/Motilal Oswal Securities

INCOME STATEMENT (RS MILLION)

Y/E MARCH	2003	2004	2005	2006E	2007E
Net Sales	51,017	58,324	74,217	87,149	99,422
Change (%)	*14.2*	*14.3*	*27.2*	*17.4*	*14.1*
Total Income	**51,017**	**58,324**	**74,217**	**87,149**	**99,422**
Expenditure	**42,381**	**48,525**	**62,576**	**73,758**	**83,885**
EBITDA	**8,636**	**9,801**	**11,645**	**13,395**	**15,540**
Change (%)	*26.8*	*13.5*	*18.8*	*15.0*	*16.0*
% of Net Sales	*16.9*	*16.8*	*15.7*	*15.4*	*15.6*
Depreciation	634	733	894	1,068	1,199
EBIT	**8,002**	**9,068**	**10,751**	**12,326**	**14,340**
Interest & Finance Charges	-10	-14	-11	12	12
Other Income	929	1,650	1,410	1,808	2,073
PBT	8,846	10,725	12,173	14,123	16,402
Tax	3,038	3,441	4,068	4,610	5,478
Effective Rate (%)	*34.3*	*32.1*	*33.4*	*32.6*	*33.4*
PAT	5,808	7,283	8,105	9,513	10,924
% of Net Sales	*11.4*	*12.5*	*10.9*	*10.9*	*11.0*
Adj. PAT	5,808	7,283	8,105	9,513	10,924
Change (%)	*25.3*	*25.4*	*11.3*	*17.4*	*14.8*

BALANCE SHEET (RS MILLION)

Y/E MARCH	2003	2004	2005	2006E	2007E
Share Capital	399	399	399	399	399
Reserves	8,211	10,989	14,534	19,005	23,921
Net Worth	**8,610**	**11,388**	**14,934**	**19,405**	**24,321**
Deferred Tax	772	900	1,015	1,015	1,015
Loans	1,343	1,747	2,018	2,018	2,018
Capital Employed	**10,725**	**14,035**	**17,967**	**22,438**	**27,353**
Gross Fixed Assets	7,863	9,169	11,042	12,700	13,950
Less: Depreciation	2,784	3,458	4,297	5,366	6,565
Net Fixed Assets	**5,079**	**5,711**	**6,745**	**7,335**	**7,386**
Capital WIP	92	177	409	0	0
Investments	11,930	15,651	20,267	20,267	20,267
Curr.Assets, L & Adv.	**4,765**	**5,090**	**5,545**	**6,979**	**12,375**
Inventory	2,009	1,882	2,043	2,865	4,086
Sundry Debtors	1,415	438	896	1,433	2,179
Cash & Bank Balances	243	371	176	282	3,714
Loans & Advances	1,098	2,399	2,396	2,399	2,396
Current Liab. & Prov.	**11,157**	**12,601**	**15,005**	**12,149**	**12,680**
Sundry Creditors	3,313	6,190	6,503	7,640	8,172
Other Liabilities	3,502	3,849	3,655	3,655	3,655
Provisions	4,342	2,562	4,847	853	853
Net Current Assets	**-6,392**	**-7,511**	**-9,459**	**-5,170**	**-305**
Miscellaneous Expenditures	16	7	6	6	6
Application of Funds	**10,725**	**14,035**	**17,967**	**22,438**	**27,353**

E: MOSt Estimates

RATIOS

Y/E MARCH	2003	2004	2005	2006E	2007E
Basic (Rs)					
EPS	29.1	36.5	40.6	47.6	54.7
Cash EPS	32.3	40.1	45.1	53.0	60.7
Book Value per Share	43.1	57.0	74.8	97.2	121.8
DPS	18.0	20.0	20.0	25.2	30.1
Payout (Incl. Div. Tax) %	61.9	54.8	49.3	53.0	55.0
Valuation (x)					
P/E	25.4	20.3	18.2	15.5	13.5
Cash P/E	22.9	18.4	16.4	13.9	12.2
EV/EBITDA	15.8	13.6	11.1	9.6	8.1
EV/Sales	2.7	2.3	1.7	1.5	1.3
Price to Book Value	17.1	13.0	9.9	7.6	6.1
Dividend Yield (%)	2.4	2.7	2.7	3.4	4.1
Profitability Ratios (%)					
RoE	67.4	64.0	54.3	49.0	44.9
RoCE	83.3	76.4	67.7	63.0	60.0
Turnover Ratios					
Debtors (Days)	10	3	4	6	8
Asset Turnover (x)	4.8	4.2	4.1	3.9	3.6
Leverage Ratio					
Debt/Equity (x)	0.2	0.2	0.1	0.1	0.1

CASH FLOW STATEMENT (RS MILLION)

Y/E MARCH	2003	2004	2005	2006E	2007E
OP/(Loss) before Tax	8,002	9,068	10,751	12,326	14,340
Interest/Div. Received	929	1,650	1,410	1,808	2,073
Depreciation & Amort.	634	733	894	1,068	1,199
Direct Taxes Paid	-2,973	-3,313	-3,953	-4,610	-5,478
(Inc)/Dec in Working Capital	2,007	1,247	1,754	-4,183	-1,433
CF from Oper. Activity	**8,589**	**9,387**	**10,857**	**6,410**	**10,701**
(Inc)/Dec in FA+CWIP	-897	-1,451	-2,159	-1,250	-1,250
(Pur)/Sale of Invest.	-4,672	-3,721	-4,616	0	0
CF from Inv. Activity	-5,569	-5,172	-6,775	-1,250	-1,250
Changes in Reserves	-461	-512	-565	0	0
Inc/(Dec) in Debt	178	404	271	0	0
Interest Paid	10	14	11	-12	-12
Dividends Paid	-3,594	-3,994	-3,994	-5,042	-6,008
CF from Fin. Activity	-3,866	-4,088	-4,278	-5,054	-6,020
Inc/(Dec) in Cash	**-846**	**128**	**-195**	**106**	**3,432**
Add: Beginning Balance	1,090	243	371	176	282
Closing Balance	**243**	**371**	**176**	**282**	**3,714**

E: MOSt Estimates

TVS Motors

STOCK INFO.	BLOOMBERG
BSE Sensex: 8,529	TVSS IN
S&P CNX: 2,579	REUTERS CODE TVSS.BO

6 October 2005

Buy

Previous Recommendation: Neutral Rs100

RS MILLION	2004	2005	2006E	2007E
Sales	28,202	28,759	33,264	38,048
EBITDA	2,594	2,116	2,526	2,948
PAT	1,385	1,376	1,585	1,799
EPS (Rs)	5.8	5.8	6.7	7.6
EPS Growth (%)	5.2	-0.7	15.2	13.5
BV/Share (Rs)	24.2	28.6	33.3	38.2
P/E (x)	17.1	17.2	14.9	13.2
P/BV (x)	4.1	3.5	3.0	2.6
EV/EBITDA (x)	9.0	10.9	9.3	7.9
EV/Sales (x)	0.8	0.8	0.7	0.6
RoE (%)	24.1	20.3	20.1	19.8
RoCE (%)	26.4	19.8	20.4	21.2

KEY FINANCIALS	
Shares Outstanding (m)	237.5
Market Cap. (Rs b)	23.8
Market Cap. (US$ b)	0.5
Past 3 yrs Sales Growth (%)	3.1
Past 3 yrs PAT Growth (%)	3.7
Dividend Payout (%)	22.5
Dividend Yield (%)	1.3

STOCK DATA	
52-Week Range (Rs)	106/65
Major Shareholders (as of June 2005)	(%)
Promoters	56.8
Domestic Institutions	9.9
FII/FDIs	13.1
Public	20.2
Average Daily Turnover	
Volume ('000 shares)	702.6
Value (Rs million)	58.7
1/6/12 Month Rel. Performance (%)	11/12/-31
1/6/12 Month Abs. Performance (%)	19/42/18

TVS Motors' sales were lagging for the last two years due to its weak performance in the motorcycle segment. The company is working to put a strong product portfolio, which is likely to drive growth going forward. However, pressure on margins remains a concern as TVS's sales mix is geared towards economy segment motorbikes.

Motorcycles are finally shaping up

TVS has products across segments in the motorcycle industry. It is a distant third in the fiercely competitive market, with a market share of 13%. Its future growth will be driven by the new launch *'Star'* in the economy segment.

Scooters and mopeds: Leading the way

TVS has maintained its leadership position in scooters and mopeds (these two segments have remained static in volumes for the last three years). TVS Scooty has been faring well in the women's segment enabling TVS to garner a market share of 23% in FY05. In mopeds, TVS has a market share of 75% in a stagnant market.

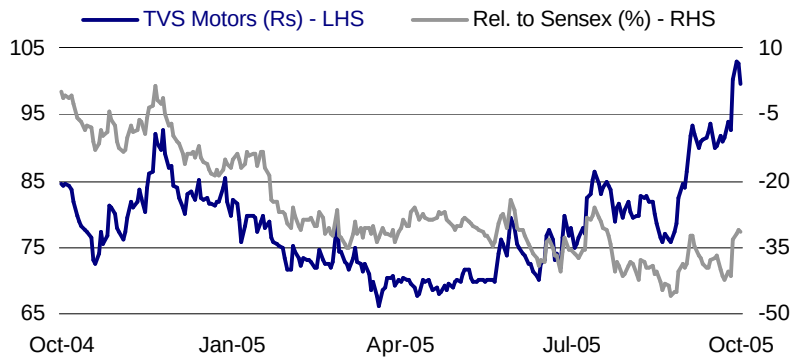
Capex to facilitate entry into new product segments

TVS has announced a huge capex of Rs4.1b (c.$100m) for its greenfield expansion which will allow it entry into new geographies and products.

We maintain Neutral

At CMP, TVS trades at P/E 13.2x, EV/EBITDA of 7.9x FY07E estimates. We maintain **Neutral** with a target price of Rs.110 based on P/E of 14.5x FY07E EPS of Rs.7.6.

STOCK PERFORMANCE (1 YEAR)



Investment arguments

Motorbikes are finally shaping up

TVS is re-working its product strategy

TVS has traditionally derived its volumes in motorcycles from *Victor* in the executive segment and *Max 100* – a 2-stroke model in the economy segment. But although *Victor* is an excellent product, its volumes have not accelerated to the desired levels. In the executive segment, TVS has recently cut prices of model 'Centra' in May '05 by Rs2,500 due to lower sales.

VOLUME (NOS)

	FY02	FY03	FY04	FY05	FY06YTD
TVS	450,206	720,343	706,610	679,535	289,470
Total	2,943,740	3,835,418	4,357,722	5,240,482	2,319,218
Market Share (%)	15	19	16	13	13

Source: Motilal Oswal Securities

It has phased out Max

In the economy segment, TVS phased out the outdated two-stroke bike *'Max'* in October 2004, which had seen its volumes drop substantially. The *'Star'*, which was launched in October '04 has witnessed a good response, with volumes reaching 30,000 units per month. We believe that *Star* will be able to regain the volumes, which it had lost out on due to the older *Max 100*. In fact, we believe TVS' growth over the next three years will be driven by the *Star.*

TVS finally has a strong product portfolio in place, comprising the Star (a 100cc bike), Centra (a 100 cc bike), Victor (a 125 cc bike) and Fiero (a 150 cc bike) competing in various segments of the two-wheeler market. And its recent product alignment would help arrest market share loss if not help it gain back market share. However, TVS' growth will be driven by lower-end products, namely the Star and the Centra, and this would result in lower realizations.

Scooters and mopeds: leading the way

The Scooty helped TVS gain share in scooters

TVS has successfully positioned the Scooty to be a women's bike with its promos and appeal targeting working women and college girls in particular. The success of this positioning can be gauged from the fact that the scooterette has been faring well in the women's segment helping TVS capture a 23% market share in the scooter segment in FY05. We foresee strong growth in this segment due to increasing urbanization and growing number of females in the working population. Competition in this segment is increasing with BAL launching the 'Wave' in May '05.

TVS'S SHARE IN SCOOTERS RISING ON THE BACK OF THE SCOOTY

	FY02	FY03	FY04	FY05	FY06YTD
TVS	144,087	148,843	188,933	224,314	108,679
Total	**936,569**	**862,382**	**930,315**	**984,059**	**391,082**
Market Share (%)	15	17	20	23	28

Source: Motilal Oswal Securities

But moped volumes remained stagnant

In mopeds, TVS remains the undisputed leader with a market share of 75%. But the moped segment over the last 4 years has been rapidly shrinking due to a shift in consumer preference towards ungeared scooters and motorcycles. Mopeds now find limited use and are only used for carrying sundry goods in rural areas and for personal transportation in a few southern states. We expect this segment to remain stagnant with volumes likely to stay at current levels.

MOPEDS WITNESSING STAGNANT VOLUMES

	FY02	FY03	FY04	FY05	FY06E
TVS	271,388	253,071	251,153	263,393	113,698
Total	**425,748**	**362,231**	**333,743**	**349,593**	**151,402**
Market Share (%)	64	70	75	75	75

Source: Motilal Oswal Securities

Capex to facilitate entry into new product segments

TVS is now entering new geographies and segments

TVS has announced a huge capex of Rs4.1b (c.$100m) for three greenfield units which will help it enter new geographies and product segments. Its greenfield plant at Mysore will address the three-wheeler segment, in which TVS has no presence while its two-wheeler unit at Himachal Pradesh will help it to expand operations in North India.

CAPEX PLANS

PLANT	LOCATION	CAPACITY (UNITS)	INVESTMENT (RS B)
2-wheelers	Indonesia	120,000	2.2
2-wheelers	Himachal Pradesh, India	300,000	0.9
3-wheeler	Mysore, India	100,000	1.0
			4.1

Source: Motilal Oswal Securities

It is setting up a three-wheeler plant at Mysore

Three-wheeler unit: The new three-wheeler plant being set up at Mysore with a capacity of 100,000 units will provide the company an entry into the rapidly growing three-wheeler segment. This segment has witnessed 20% growth in the last four years. Narrow and poorly maintained rural and semi urban roads, along with the emerging hub and spoke model of transportation (where three-wheelers are used for transporting goods across the last mile), will ensure sustained growth in the three-wheeler segment.

A two-wheeler unit at Himachal Pradesh

Two-wheeler unit: TVS is also setting up a greenfield plant to manufacture two wheelers in Himachal Pradesh with a capacity of 300,000 units for several strategic reasons. It will allow TVS the benefit of tax exemptions on excise and income tax as Himachal Pradesh has set up tax free zones. Also, having a plant in the North will help TVS shed its South-based image and allow it to access the markets in the North and Central parts of India.

And a unit in Indonesia to tap the Asean market

International presence: To address the opportunities in the Asean region, TVS is setting up a unit in Indonesia with a capacity of 120,000 vehicles. The unit will primarily cater to the huge Asean two-wheeler market, which has cumulative sales of nearly 7m vehicles. We believe, this unit will give TVS an inroad into the rapidly expanding Asean and African two-wheeler markets, which have dynamics similar to the Indian market – low per capita income, poor public infrastructure and a large population base.

Mode of financing: Apart from financing the above projects, TVS proposes to invest Rs400m by subscribing to the proposed issue of 6% redeemable preference shares of its associate company (TVS Finance and Services). However, we believe its finances will not be stretched. This is because, TVS has already organized a line of credit to the tune of US$100m (c.Rs4.3b). This, together with internal accruals, will be sufficient for funding the above projects.

Quarterly performance: margins under pressure

TVS' quarterly performance continues to disappoint on the margin front

TVS Motors reported a 20% YoY sales growth due to strong volume growth of 21% YoY in 1QFY06. Volumes bounced back for the company at 307,425 units due to the strong performance of the motorcycle segment, which witnessed 28% YoY growth. The effect of a low base and the good performance of the TVS Star resulted in the strong growth.

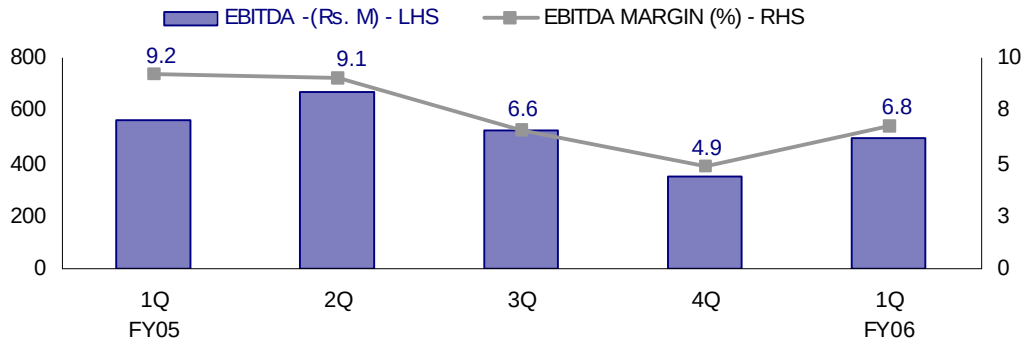
VOLUME GROWTH REMAINS STRONG

	1QFY06	1QFY05	% CHANGE
Scooters	62,562	54,832	14
Motorcycles	176,580	138,220	28
Mopeds	68,283	60,820	12
Total	**307,425**	**253,872**	**21**

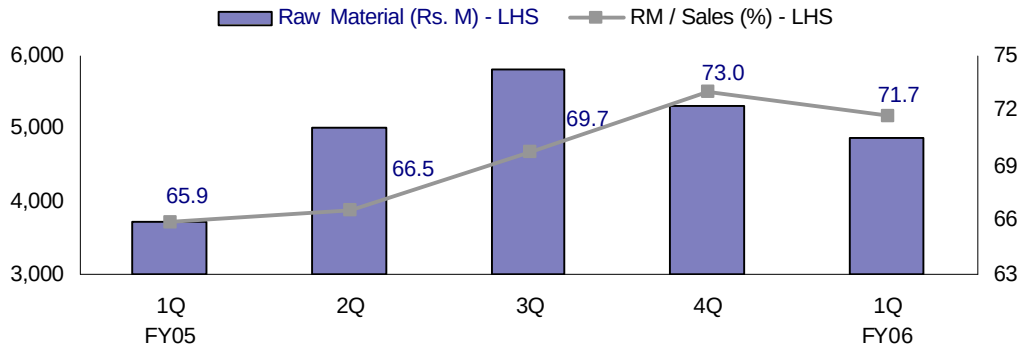
Source: Motilal Oswal Securities

However, TVS Motors' results continued to disappoint on the margins front, with EBITDA margins declining by 240bp YoY to 6.8%. The fall in margins is due to higher raw materials cost, with RM/Sales ratio increasing by 580bp YoY. The company reported an EBITDA of Rs497m resulting in a fall of 11.7% YoY.

EBITDA (%) UNDER PRESSURE



RAW MATERIAL RISING STEADILY



Source: Company/Motilal Oswal Securities

Despite the lower EBITDA, TVS Motors reported a growth of 3.4% in PAT at Rs249m. This was due to higher other income and lower tax rate.

QUARTERLY PERFORMANCE (RS MILLION)

Y/E MARCH	FY05				FY06				FY05E	FY06E
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE		
Total Volumes (nos.)	253,872	294,253	322,412	296,705	307,425	324,500	345,000	336,669	1,167,242	1,313,594
Net Sales	**6,111**	**7,429**	**8,037**	**7,183**	**7,351**	**8,356**	**9,143**	**8,415**	**28,759**	**33,264**
Change (%)	*-7.8*	*-2.8*	*19.6*	*-0.4*	*20.3*	*12.5*	*13.8*	*17.2*	*2.0*	*15.7*
Total Expenses	5,548	6,755	7,508	6,833	6,854	7,729	8,411	7,743	26,643	30,737
Operating Profit	563	674	529	350	497	627	731	671	2,116	2,526
Change (%)	*-5.6*	*-1.4*	*6.5*	*-57.3*	*-11.7*	*-7.0*	*38.3*	*92.0*	*-18.4*	*19.4*
As % of Net Sales	*9.2*	*9.1*	*6.6*	*4.9*	*6.8*	*7.5*	*8.0*	*8.0*	*7.4*	*7.6*
Other Income	70	87	115	521	115	115	115	474	793	821
Interest	1	8	-1	0	24	0	0	-4	8	20
Depreciation	212	223	223	239	227	249	249	271	896	996
PBT	**420**	**530**	**422**	**632**	**361**	**493**	**598**	**879**	**2,005**	**2,331**
Tax	148	188	140	153	112	153	179	302	629	746
Effective Tax Rate (%)	*35.3*	*35.4*	*35.0*	*24.2*	*31.0*	*31.0*	*30.0*	*34.3*	*31.4*	*32.0*
PAT	**272**	**342**	**282**	**479**	**249**	**340**	**418**	**577**	**1,375**	**1,585**
Change (%)	*-15.3*	*-7.4*	*2.5*	*14.3*	*-8.4*	*-0.7*	*48.4*	*20.5*	*-0.7*	*15.2*
Adj.PAT	272	342	282	479	249	340	418	577	1,375	1,585
As % of Net Sales	*4.4*	*4.6*	*3.5*	*6.7*	*3.4*	*4.1*	*4.6*	*6.9*	*-0.7*	*4.8*

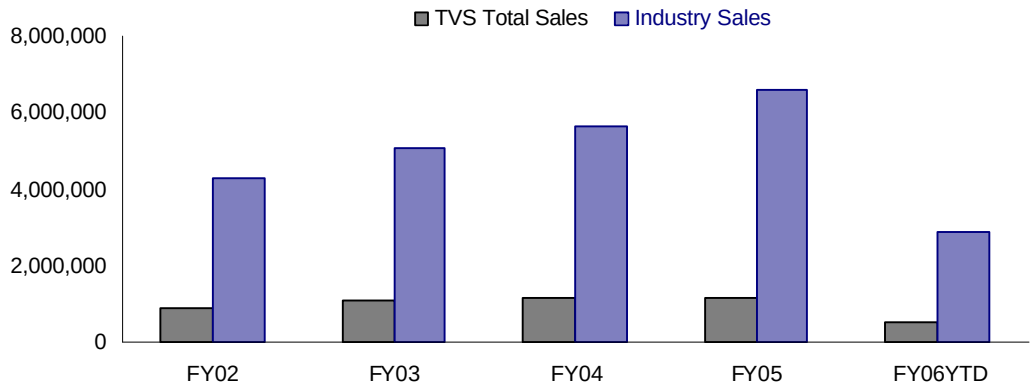
Valuations and view: We remain Neutral

Notwithstanding its long-term plans and the fact that its scooters are doing well, TVS Motors' has been losing market share. Its share has declined from 22% in FY03 to 18% in FY05 in the total two-wheeler industry due to a sharp 6% loss in market share in the motorcycle segment, which accounts for 80% of the two-wheeler market.

Loss of share in motorcycles saw TVS lose share in the two-wheeler market

In the last couple of years, TVS has gained a strong footing in the scooter segment with a gain of 8% in market share due to the success of the Scooty Pep. Meanwhile, in the moped segment, though TVS has a 75% share, its volumes have not increased since the last three years due to the shrinking market size. As a result, TVS is placed strongly in the smaller 20% market (scooters) while loosing share in 80% of the market (motorcycles), leading to an overall 2% decline in its two-wheeler market share.

MOTORCYCLES: DELAYED LAUNCHES AND STRONG COMPETITION AFFECTING MARKET SHARE (UNIT NOS)



Source: Company/Motilal Oswal Securties

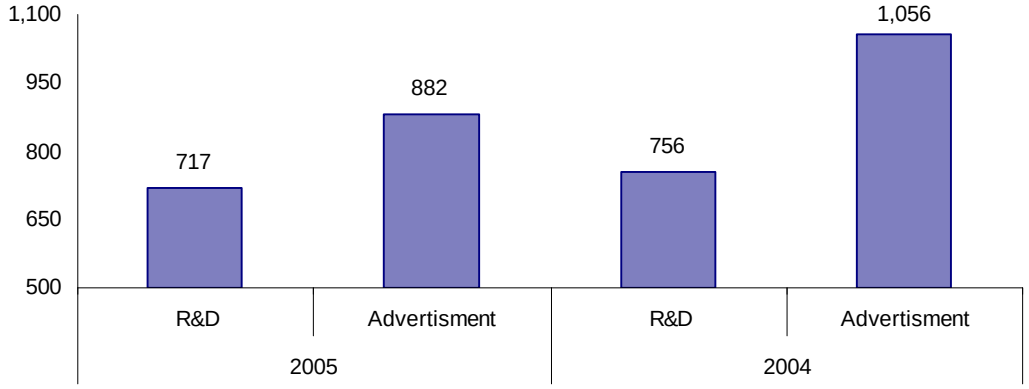
Susceptible to market weakness: TVS Motor's balance sheet size is much smaller relative to Hero Honda and BAL. Lower amount of cash of Rs2.2b v/s Rs50.5b for BAL make its position vulnerable in the event of a slowdown in industry sales or increase in competitive activity.

And even resulted in falling EBITDA margins…

Limited room for margin expansion: Apart from losing market share, the last three years have also seen TVS witness a drop in EBITDA margins. Going forward, the product mix of the company is going to be in favour of lower end products with higher sales of entry-level bikes such as the Star and increased sales of scooters.

TVS Motors also has to spend a higher amount as a percentage of sales in advertising and R&D. This is essential to maintain competitiveness and brand presence in the face of competition. Hence, we expect margins to remain at current levels.

TVS MOTORS: R&D AND AD-SPEND



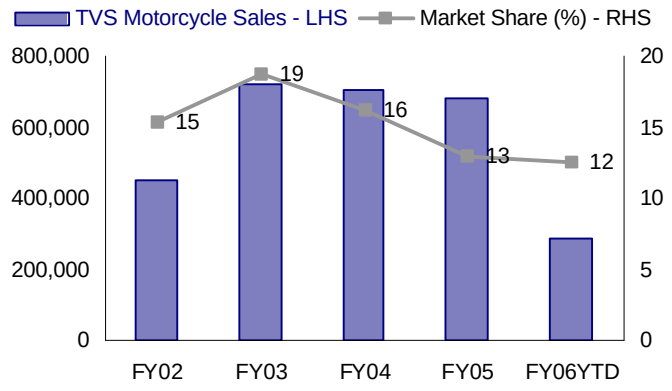
Source: Company/Motilal Oswal Securities

….falling RoEs and stagnant asset turnover

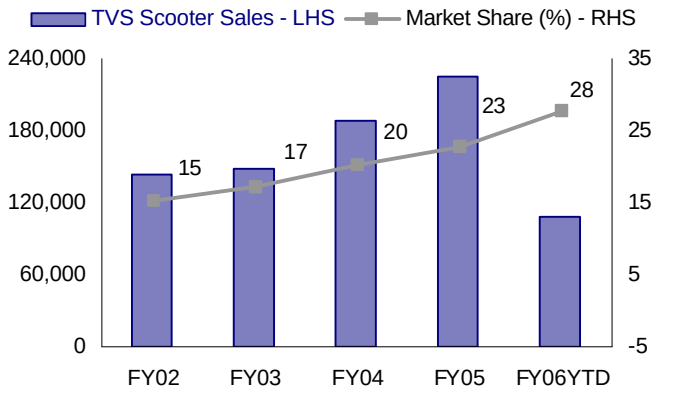
The RoE of the company has fallen over the last three years due to a dip in profitability as well as stagnant asset turnover.

At CMP, TVS trades at P/E of 15x and 13.2x, EV/EBITDA of 9.4x and 7.9x and P/BV of 3.0x and 2.6x on FY06 and FY07 estimates respectively. We maintain **Neutral** with a target price of Rs.110 based on P/E of 14.5x FY07E EPS of Rs.7.6.

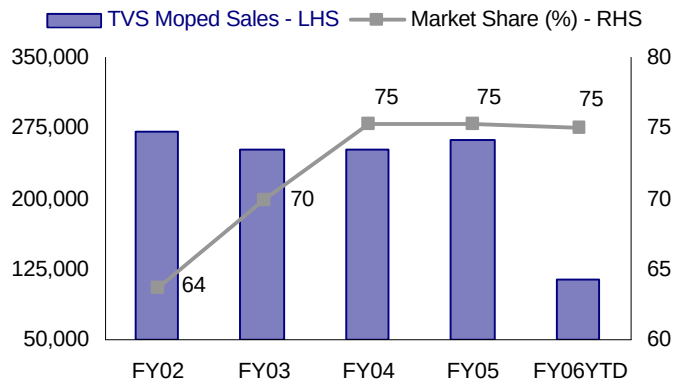
TVS: MOTORCYCLE SALES (NOS)



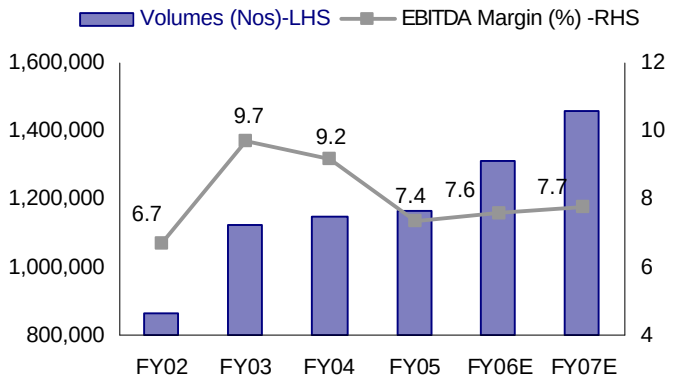
TVS: SCOOTER SALES (NOS)



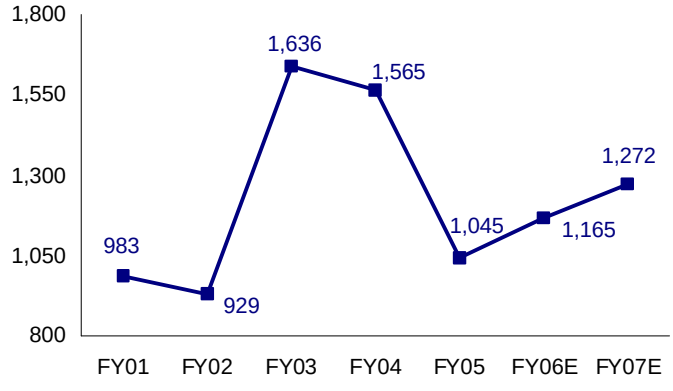
TVS: MOPED SALES (NOS)



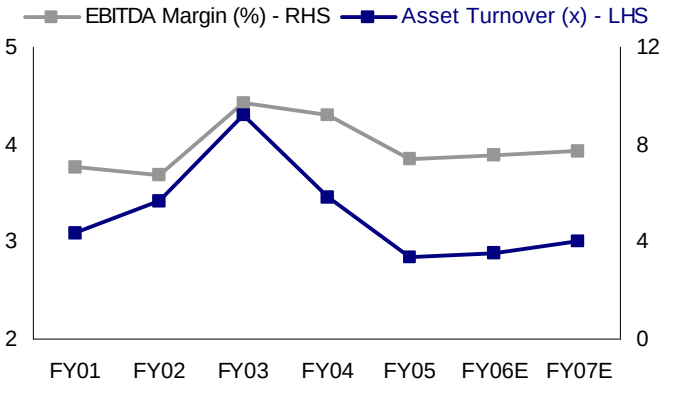
TVS: VOLUMES AND MARGIN



TVS: EBIT PER VEHICLE (RS)



TVS: PERFORMANCE INDICATORS



Source: Company/Motilal Oswal Securities

INCOME STATEMENT (RS MILLION)

Y/E MARCH	2003	2004	2005	2006E	2007E
Net Sales	27,045	28,202	28,759	33,264	38,048
Change (%)	*40.1*	*4.3*	*2.0*	*15.7*	*14.4*
Total Expenditure	**24,415**	**25,608**	**26,643**	**30,737**	**35,100**
EBITDA	**2,630**	**2,594**	**2,116**	**2,526**	**2,948**
Change (%)	*102.8*	*-1.4*	*-18.4*	*19.4*	*16.7*
% of Net Sales	*9.7*	*9.2*	*7.4*	*7.6*	*7.7*
Depreciation	799	799	896	996	1,093
Interest & Finance Charges	28	12	8	20	21
Other Income	209	362	793	821	831
PBT	2,011	2,145	2,005	2,331	2,664
Tax	732	760	629	746	866
Effective Rate (%)	*36.4*	*35.4*	*31.4*	*32.0*	*32.5*
PAT	1,280	1,385	1,376	1,585	1,799
% of Net Sales	*4.7*	*4.9*	*4.8*	*4.8*	*4.7*
Adj. PAT	1,280	1,385	1,376	1,585	1,799
Change (%)	*137.3*	*8.2*	*-0.7*	*15.2*	*13.5*

BALANCE SHEET (RS MILLION)

Y/E MARCH	2003	2004	2005	2006E	2007E
Share Capital	231	238	238	238	238
Reserves	3,999	5,512	6,551	7,660	8,829
Net Worth	**4,230**	**5,750**	**6,788**	**7,898**	**9,067**
Deferred Tax	828	1,231	1,485	1,485	1,485
Loans	1,219	1,190	1,868	2,118	2,118
Capital Employed	**6,277**	**8,170**	**10,142**	**11,501**	**12,670**
Gross Fixed Assets	8,065	11,326	12,872	14,027	15,478
Less: Depreciation	3,020	4,379	5,236	6,233	7,326
Net Fixed Assets	**5,045**	**6,947**	**7,636**	**7,795**	**8,153**
Capital WIP	282	95	69	0	0
Investments	879	1,280	1,754	1,754	1,754
Curr.Assets, L & Adv.	**4,488**	**4,360**	**5,067**	**6,684**	**8,111**
Inventory	2,141	2,167	2,332	2,734	3,336
Sundry Debtors	522	519	346	1,823	2,293
Cash & Bank Balances	825	180	739	480	835
Loans & Advances	1,000	1,493	1,647	1,647	1,647
Current Liab. & Prov.	**4,417**	**4,641**	**5,078**	**5,426**	**6,043**
Sundry Creditors	4,086	4,210	4,522	5,012	5,629
Provisions	331	431	556	414	414
Net Current Assets	**71**	**-281**	**-12**	**1,258**	**2,069**
Miscellaneous Expenditures	0	129	695	695	695
Application of Funds	**6,277**	**8,170**	**10,142**	**11,501**	**12,670**

E: MOSt Estimates

RATIOS

Y/E MARCH	2003	2004	2005	2006E	2007E
Basic (Rs)					
EPS	5.5	5.8	5.8	6.7	7.6
Cash EPS	9.0	9.2	9.6	10.9	12.2
Book Value per Share	18.3	24.2	28.6	33.3	38.2
DPS	1.2	1.3	1.3	2.0	2.7
Payout (Incl. Div. Tax) %	21.7	22.7	22.5	30.0	35.0
Valuation (x)					
P/E	18.0	17.1	17.2	14.9	13.2
Cash P/E	11.1	10.8	10.4	9.2	8.2
EV/EBITDA	8.6	9.0	10.9	9.3	7.9
EV/Sales	0.8	0.8	0.8	0.7	0.6
Price to Book Value	5.4	4.1	3.5	3.0	2.6
Dividend Yield (%)	1.2	1.3	1.3	2.0	2.7
Profitability Ratios (%)					
RoE	30.3	24.1	20.3	20.1	19.8
RoCE	32.5	26.4	19.8	20.4	21.2
Turnover Ratios					
Debtors (Days)	7	7	4	20	22
Asset Turnover (x)	4.3	3.5	2.8	2.9	3.0
Leverage Ratio					
Debt/Equity (x)	0.3	0.2	0.3	0.3	0.2

CASH FLOW STATEMENT (RS MILLION)

Y/E MARCH	2003	2004	2005	2006E	2007E
OP/(Loss) before Tax	1,831	1,795	1,219	1,530	1,855
Interest/Div. Received	209	362	793	821	831
Depreciation & Amort.	799	799	896	996	1,093
Direct Taxes Paid	-662	-358	-374	-746	-866
(Inc)/Dec in Working Capital	1,132	-293	289	-1,528	-456
CF from Oper. Activity	**3,313**	**2,182**	**2,258**	**1,073**	**2,457**
(Inc)/Dec in FA+CWIP	-1,733	-2,514	-1,559	-1,086	-1,451
(Pur)/Sale of Invest.	-735	-401	-474	0	0
CF from Inv. Activity	-2,468	-2,915	-2,033	-1,086	-1,451
Changes in Reserves	-7	443	-28	0	0
Inc/(Dec) in Debt	-451	-29	678	250	0
Interest Paid	-28	-12	-8	-20	-21
Dividends Paid	-277	-314	-309	-475	-629
CF from Fin. Activity	-763	88	334	-245	-651
Inc/(Dec) in Cash	**82**	**-645**	**559**	**-258**	**355**
Add: Beginning Balance	743	825	180	739	480
Closing Balance	**825**	**180**	**739**	**480**	**835**

E: MOSt Estimates

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For more copies or other information, contact
Institutional: Navin Agarwal. **Retail:** Manish Shah, Mihir Kothari
Phone: (91-22) 56575200 Fax: (91-22) 22885038. E-mail: inquire@motilaloswal.com

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2. Group/Directors ownership of the stock	No	Yes	No
3. Broking relationship with company covered	No	No	No

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