

Company Focus

15 October 2007 | 13 pages

Bajaj Auto (BJAT.BO)

Target price change
 Estimate change

Reiterate Hold: Revise Target Price to Rs2,671, Driven by Higher Insurance Valuations

- Raise target price to Rs2,671 (from Rs2,275)** — Our new target price is based on a sum of parts that is derived from break-up valuations. Our target price revision is primarily driven by higher valuations accorded to Bajaj's stake in Bajaj Allianz Life Insurance (Rs600/share vs. Rs325/share earlier).
- Valuations** — Our target price breaks down as: a) core auto business valued at Rs1,145/share (previously Rs1,083), based on 13x FY09E core earnings; b) Bajaj Finserve at Rs552/share (Rs347 earlier); and c) Bajaj Holdings & Investments at Rs975/share (Rs845 earlier). Computations for both Bajaj Auto and Bajaj Finserve are based on the enhanced share capital (c145m shares).
- Core auto business** — will continue to remain under pressure. We have cut our motorcycle volume assumptions by 4-9% over FY08/10e. EBITDA has been pared by 4-6%, to reflect declining volumes, though margins have been hiked nominally to reflect higher contribution from the executive and premium segment products. Overall EPS estimates have been cut by ~5-7%.
- Risks** — Key upside risk factors are: a) Higher valuations ascribed to Bajaj's 26% stake in Bajaj Allianz; b) Better-than-forecast margin improvement in the core auto business. Key downside risk: Competitive action by other industry players, which would impact margins in the 2-wheeler business.

Hold/Low Risk	2L
Price (12 Oct 07)	Rs2,542.30
Target price	Rs2,671.00
	<i>from Rs2,275.00</i>
Expected share price return	5.1%
Expected dividend yield	1.8%
Expected total return	6.8%
Market Cap	Rs257,239M
	US\$6,572M

Price Performance (RIC: BJAT.BO, BB: BJA IN)



Figure 1. Statistical Abstract

Year to	Net Profit	EPS	EPS Growth	P/E	EV / EBITDA	ROE	ROCE	ROIC
	(Rs mills)	(Rs)	(%)	(x)	(x)	(%)	(%)	(%)
31-Mar								
2006	11,174	110.4	39.4	23.0	15.1	23.1	27.1	167.0
2007	12,728	125.8	13.9	20.2	13.9	22.4	26.3	199.9
2008E	12,784	126.4	0.4	20.1	13.7	20.4	23.3	140.7
2009E	15,017	148.4	17.5	17.1	11.9	20.9	23.8	125.2
2010E	17,027	168.3	13.4	15.1	10.7	20.7	125.2	132.5

Source: Company Reports and CIR Estimates

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See Appendix A-1 for Analyst Certification and important disclosures.

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	23.0	20.2	20.1	17.1	15.1
EV/EBITDA adjusted (x)	18.8	17.7	17.2	14.0	11.5
P/BV (x)	5.4	4.6	4.1	3.6	3.1
Dividend yield (%)	1.6	1.6	1.8	2.0	2.2
Per Share Data (Rs)					
EPS adjusted	110.44	125.79	126.35	148.42	168.29
EPS reported	108.88	122.27	126.35	148.42	168.29
BVPS	471.51	546.98	620.68	710.60	814.53
DPS	40.00	40.00	45.00	50.00	55.00
Profit & Loss (RsM)					
Net sales	74,694	92,922	92,734	104,069	116,929
Operating expenses	-65,026	-82,937	-82,904	-92,234	-103,301
EBIT	9,668	9,985	9,830	11,835	13,628
Net interest expense	-3	-53	-20	-25	-30
Non-operating/exceptionals	6,370	7,838	8,132	9,048	9,888
Pre-tax profit	16,034	17,770	17,943	20,857	23,486
Tax	-4,791	-4,901	-5,159	-5,840	-6,459
Extraord./Min.Int./Pref.div.	-226	-498	0	0	0
Reported net income	11,017	12,371	12,784	15,017	17,027
Adjusted earnings	11,174	12,728	12,784	15,017	17,027
Adjusted EBITDA	11,578	11,888	11,997	14,340	16,384
Growth Rates (%)					
Sales	30.2	24.4	-0.2	12.2	12.4
EBIT adjusted	79.9	3.3	-1.6	20.4	15.1
EBITDA adjusted	60.2	2.7	0.9	19.5	14.2
EPS adjusted	39.4	13.9	0.4	17.5	13.4
Cash Flow (RsM)					
Operating cash flow	15,262	12,398	12,281	20,051	22,767
Depreciation/amortization	1,910	1,903	2,167	2,505	2,756
Net working capital	2,335	-1,876	-2,670	2,528	2,983
Investing cash flow	-14,841	-9,247	-9,440	-17,182	-19,664
Capital expenditure	-1,651	-2,843	-4,500	-4,500	-4,500
Acquisitions/disposals	-13,190	-6,404	-4,940	-12,682	-15,164
Financing cash flow	-3,088	-5,698	-4,915	-5,473	-5,706
Borrowings	2,402	1,583	2,244	2,558	2,916
Dividends paid	-4,615	-4,735	-5,327	-5,919	-6,511
Change in cash	-2,668	-2,546	-2,073	-2,604	-2,603
Balance Sheet (RsM)					
Total assets	98,702	115,667	125,600	143,552	163,303
Cash & cash equivalent	821	835	1,000	1,100	1,200
Accounts receivable	3,016	5,298	5,742	6,429	6,501
Net fixed assets	11,558	12,964	15,297	17,292	19,036
Total liabilities	50,995	60,324	62,800	71,653	80,889
Accounts payable	11,802	14,697	12,608	14,258	15,977
Total Debt	14,672	16,254	18,498	21,056	23,973
Shareholders' funds	47,707	55,343	62,800	71,899	82,414
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	15.5	12.8	12.9	13.8	14.0
ROE adjusted	25.1	24.7	21.6	22.3	22.1
ROIC adjusted	80.1	93.4	50.1	54.2	74.8
Net debt to equity	29.0	27.9	27.9	27.8	27.6
Total debt to capital	23.5	22.7	22.8	22.7	22.5

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Investment Summary

We increase our target price for Bajaj Auto to Rs2,671 based on a break-up valuation as follows:

- a) **Bajaj Auto (core auto business):** We have revised upwards the core auto business value to Rs1145 / share (from Rs1083/share) based on 13x FY09E diluted EPS and add cash transferred to this business. The marginal value accretion arises from higher export incentives (increased to 9% from 6%, and also a revision in export estimates)
- b) **Bajaj Finserve (insurance + finance business):** We increase our fair value for this entity to Rs552/share (from Rs347/share), primarily to factor in a higher valuation of the life insurance business. Our banks team values the life insurance business at Rs600/share (from Rs325/share) – based on 102m shares. Our break up value is assessed on an enhanced equity base of 145m shares, with a correspondingly lower value of Rs420/share.

Figure 2. Bajaj Allianz Life Insurance Valuation

Valuation	Rs bn	Assumptions	FY08	FY12	FY15
Embedded Value	34	Margins	19.5	16.9	15
Appraisal Value	316-207	Tax	14.3	14.3	33.6
NBAP multiple	18.7-15.7	Growth Rates	3 yr CAGR	5 yr CAGR	8 yr CAGR
Parent's Stake	26%	Percent	42%	35%	27%
Investment by parent	5	Terminal Growth rate			4%
Value to parent based on 26%, 51% and 74% stake respectively	61, 124, 182	Discount Rate			15%
Per share Value to parent (26%)	599				
Per share Value to parent (51%)	1225				
Per share Value to parent (74%)	1801				

Source: Citi Investment Research estimates

Figure 3. Bajaj Allianz Life Insurance Valuation Range

	Bull Case		Base Case	Bear Case	
Growth - 5 yr CAGR	45	40	35	30	25
Margins	21.5	20.5	19.5	18.5	17.5
Value to firm	383058	316498	252774	207272	169180
NBAP Multiple - Derived	20.7	18.7	18.1	15.7	14.6
Value USD m	9576	7912	6319	5182	4229
Change in value	52%	25%	0%	-18%	-33%

Source: Citi Investment Research estimates

- c) **Bajaj Holdings and Investments (BHIL):** We value this entity at Rs975/share (Rs845 earlier). The difference arises because we value the listed investments in this business at a 20% discount (earlier 25%) to mitigate the impact of the double discounting that occurs (we also apply a 20% holding company discount to the entire business).

Figure 4. Bajaj Auto – Demerged Entity – Sum of Parts Valuation

Bajaj Auto (new entity)	
Net profit (Core business, Rs m)	11,528
Earnings multiple (at 13x FY09E)	13
Core earnings	149,861
Cash (Rs m)	15,804
No. of shares (m)	145
Value per share (a)	1,145
Bajaj Finserve (new entity)	
Cash transferred	8,429
Life insurance business value (Valuing above at 26% and subtracting the initial investment)	252,774 60,721
General insurance business value (Valuing above at 51%)	12,742 6,498
Bajaj Auto Finance (at 25% discount to CMP)	4,165
No. of shares (m)	145
Value per share (b)	552
Bajaj Holdings and Investments	
Cash transferred	16,916
ICICI Bank stake (at 20% discount to CMP)	30,986
Bajaj Hindustan stake (at 20% discount to CMP)	1,735
Stake in Bajaj Auto (30%)	49,700
Stake in Bajaj Finserve (30%)	23,944
No of shares	101
Value per share (c)	1,218
Value of BHIL at 20% discount	975
Total Value per share	2,671

Source: Citi Investment Research

Earnings Revision

We revise our earnings estimate downwards by ~5-7% over FY08 – 10E, primarily factoring in lower-than-expected volume growth. We have cut our motorcycle volume assumptions by 4-9% over FY08/10e. EBITDA has been pared by 4-6%, to reflect declining volumes, though margins have been hiked nominally to reflect higher contribution from the executive and premium segment products.

The near-term outlook remains challenging, with reports of weakness persisting in retail sales, despite the oncoming festive season. Banks remain wary of providing credit to the sector, and continue to discourage the 0% finance schemes that resulted in inventory pile-ups in the past. Going forward, we expect motorcycle volumes to recover in FY09E, benefiting primarily from the low base of FY08.

Figure 5. Key Earnings Metrics

	FY08E		FY09E		FY10E		Comments
	Old	New	Old	New	Old	New	
Motorcycle Volumes	2,498,474	2,264,552	2,823,276	2,623,662	3,105,603	2,989,215	Negative growth in FY08 due to high interest rates and credit tightening by banks; 60% export growth in FY08 mitigates impact Volumes to pick up in FY09 due to favourable base effect, exports continue to spur volume growth
% Growth YoY	5.0	-4.7	13.0	15.8	10.0	13.9	
Total 2 Wheeler Volumes	2,537,418	2,287,303	2,866,114	2,648,688	3,152,726	3,016,745	
% Growth YoY	5.7	-4.7	13.0	15.8	10.0	13.9	
3 Wheeler Volumes	341,328	315,962	365,492	336,271	392,051	358,272	Negative growth in FY08 due to slowdown in domestic market and increasing competition (in goods segment) from the ACE Volumes to recover in FY09 driven by exports and mild recovery in domestic market
% Growth YoY	6.1	-1.8	7.1	6.4	7.3	6.5	
EBITDA (Rs million)	12,596	11,997	14,890	14,340	17,357	16,384	We revise margin estimates upward, to reflect richer product mix
EBITDA Margin (%)	12.5	12.9	13.0	13.8	13.6	14.0	

Source: CIR Estimates

Figure 6. Bajaj Auto (Overall Business)- Earnings Revision Table

Year to 31 st March	Net Profit		Diluted EPS		
	Old	New	Old	New	% change
FY08E	13,797	12,784	136.4	126.4	-7.3
FY09E	15,914	15,017	157.3	148.4	-5.6
FY10E	18,186	17,027	179.7	168.3	-6.4

Source: Citi Investment Research estimates

Figure 7. Volume Assumptions – FY06-FY10E

	FY2006	FY2007	FY2008E	FY2009E	FY2010E
Scooters	116,870	20,497	22,752	25,027	27,530
% growth	13.7	-82.5	11.0	10.0	10.0
Motorcycles	1,912,306	2,379,499	2,264,552	2,623,662	2,989,215
% growth	30.2	24.4	-4.8	15.9	13.9
Total 2 wheelers	2,029,176	2,399,996	2,287,303	2,648,688	3,016,745
% growth	26.6	18.3	-4.7	15.8	13.9
3 wheelers	252,054	321,828	315,962	336,271	358,272
% growth	13.5	27.7	-1.8	6.4	6.5
Total 2 / 3 wheelers	2,281,230	2,721,824	2,603,266	2,984,959	3,375,017
% growth	25.0	19.3	-4.4	14.7	13.1

Source: Company reports, Citi Investment Research estimates

XCD125cc- The New New Thing!!

Bajaj Auto recently launched its new 125 cc bike the "XCD" which comes equipped with "Digital Swirl Induction Technology" – which essentially implies greater fuel efficiency (the company claims the bike offers a mileage of 109kmpl under standard test conditions). BJAT has priced the vehicle at Rs46,699 (on-road price in Pune). The company is currently producing 20,000 units and targets 70,000 units by November 2007.

BJAT's attempt – to provide the power of a 125cc bike with fuel efficiency that exceeds that of a 100cc bike - is audacious. The bike is being positioned to draw customers away from both its own 100cc bikes (Platina) as well as competing products in the 100cc segment.

We spoke to almost 20 Bajaj Auto dealers across the country who all indicated that the average fuel economy of the XCD bike would be around 75 kmpl. One dealer indicated that the fuel efficiency would go to 80-85kmpl, but the majority indicated a far lower fuel efficiency. We believe that if the fuel efficiency of the XCD is in the 70-75kmpl range, it would render the bike vulnerable to price competition from models in the economy segment, which currently provide 70-75kmpl fuel efficiency. But, if the bike is able to provide >85kmpl consistently, it will create a very strong price value proposition, which competition will be able to counter (over the long term) only with a similar engine (rather than focusing merely on pricing action).

Below is our analysis of the price-value proposition of the XCD versus other competing products, assuming 2 different levels of mileage – 75kmpl and 85kmpl.

Figure 8. Assessing the Price-Value Proposition – Assuming the XCD Provides 75km/l Mileage

	Splendor Plus	Splendor NXG	Passion Plus	CD Deluxe	Star City	Discover 135	XCD	Super Splendor	Platina
Km Driven	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000
Fuel efficiency (Km / L)	63	72	63	77	71	62	75	71	72
Total fuel (Litre)	714	625	714	584	634	726	600	634	625
Fuel cost/l	46	46	46	46	46	46	46	46	46
Total fuel cost	32,857	28,750	32,857	26,883	29,155	33,387	27,600	29,155	28,750
Fuel cost differential (vs XCD)	5,257	1,150	5,257	(717)	1,555	5,787	-	1,555	1,150
Product Price (on the road, Pune)	44,881	47,073	47,906	40,570	42,605	54,350	46,699	52,062	38,410
Price differential (vs XCD)	(1,818)	374	1,207	(6,129)	(4,094)	7,651	-	5,363	(8,289)
Overall Price+ Fuel Differential	3,439	1,524	6,464	(6,846)	(2,539)	13,438	-	6,918	(7,139)

Source: Overdrive, dealers, Citi Investment Research estimates

Figure 9. Assessing the Price-Value Proposition – Assuming the XCD Provides 85km/l Mileage

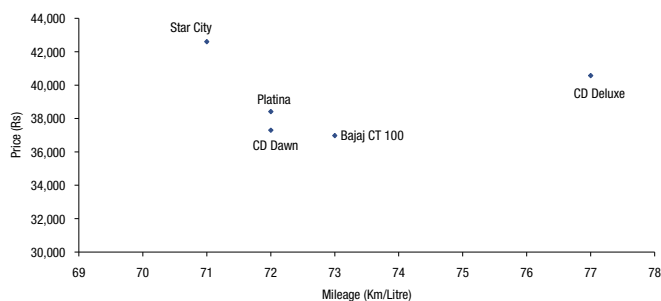
	Splendor Plus	Splendor NXG	Passion Plus	CD Deluxe	Star City	Discover 135	XCD	Super Splendor	Platina
Km Driven	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000
Fuel efficiency (Km / L)	63	72	63	77	71	62	85	71	72
Total fuel (Litre)	714	625	714	584	634	726	529	634	625
Fuel cost/l	46	46	46	46	46	46	46	46	46
Total fuel cost	32,857	28,750	32,857	26,883	29,155	33,387	24,353	29,155	28,750
Fuel cost differential (vs XCD)	8,504	4,397	8,504	2,530	4,802	9,034	-	4,802	4,397
Product Price (on the road, Pune)	44,881	47,073	47,906	40,570	42,605	54,350	46,699	52,062	38,410
Price differential (vs XCD)	(1,818)	374	1,207	(6,129)	(4,094)	7,651	-	5,363	(8,289)
Overall Price+ Fuel Differential	6,686	4,771	9,711	(3,599)	708	16,685	-	10,165	(3,892)

Source: Overdrive, dealers, Citi Investment Research estimates

The above assessment leads us to conclude, that on a price-value proposition (assuming the customer wants neither the power, nor the drive experience, nor a new product) the CD Deluxe and the Platina are relatively better positioned – even assuming that the XCD does provide 85kmpl mileage. It also implies that if competition wants to initiate a price war, the Splendor Plus, the Splendor NXG and the Star City appear to be the most rational choices. Discover 135cc's

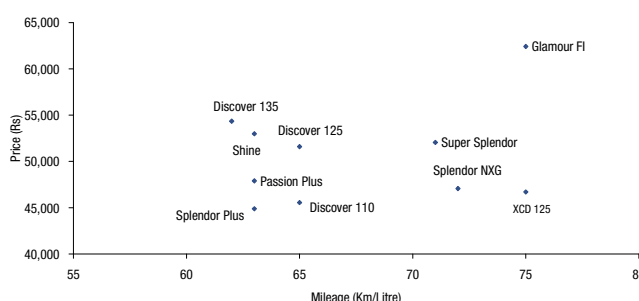
sales would probably be cannibalized very rapidly – given that the XCD 125cc is ~20% (at the very least) more fuel efficient and ~14% cheaper than Discover 135 cc.

Figure 10. Price vs. Mileage Comparison – Economy Segment



Source: Overdrive, Citi Investment Research

Figure 11. Price vs. Mileage Comparison – Executive Segment



Source: Overdrive, Citi Investment Research

Our view on the XCD launch is thus mixed – we think there are some significant positives, but also some meaningful concerns.

Positives

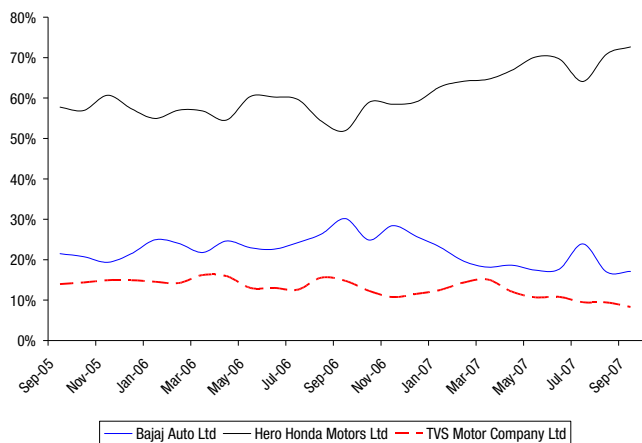
1. In all probability, the bike will improve BJAT's margins – management claims that the cost is the same as the Platina (the kerb weight of both bikes is the same at 113kg), whilst the on-road price is around Rs6,000 more (which means that BJAT gets an additional Rs3-4000/ bike per Platina substituted). We assume a minor substitution effect and the consequent improvement in margins is also reflected in our forecasts (we raise FY08-10e EBITDA margins by 40-80bps). We don't assume a mass migration of Platina customers to the XCD, because based on our analysis (refer to Figures 8 and 9), the price value proposition of the Platina continues to be better than that of the XCD.

Concerns

1. We think BJAT has prematurely killed off the Discover platform and the brand, after nurturing it over the past 3 years. We view this as a central flaw in BJAT's strategy – that of killing the product prematurely. We contend that this has a two-fold impact: a) it adversely impacts the re-sale value of extant bikes on the road, thus increasing the overall ownership costs for BJAT's customers, and b) it makes future customers wary of buying BJAT's products, given BJAT's past track record (of launching several new products, and then phasing them out rapidly). By phasing out the 112 and 125cc variants of the Discover, BJAT has increased its dependence on the XCD platform.
2. We think that the Street has not adequately factored in the competitive intensity in the industry, especially in the 125-150cc category. Honda's products – both the 125cc Shine and the 150cc Unicorn – have picked up momentum, and HMSI (Honda's 100% subsidiary) now has an 18% market share in the 125-150cc segment (up from 11% in 1HFY07). Whilst

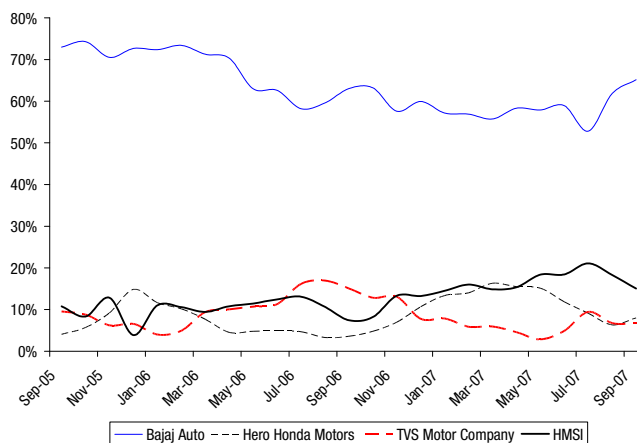
the consensus appears to be that Hero Honda might react (either by launching a new product / cutting prices of an existing product to bring the price-value proposition closer to that of the XCD), we think from a tactical perspective, HMSI is better equipped to launch a product to counter the XCD for 2 reasons: a) the XCD will initially be positioned as a product for metros and towns – where HMSI will also have adequate reach and dealerships; b) HMSI and Hero Honda's original strategy (a long time ago) was to focus on distinctive segments – HROH on the 100cc commuter bikes, HMSI on the 150cc and 125cc bikes. We think the threat to the XCD is greater from an HMSI product rather than from an HROH product.

Figure 12. Domestic Market share- 75-125cc (%)



Source: SIAM

Figure 13. Domestic Market share- 125-250cc (%)



Source: SIAM

- BJAT has strategically positioned itself toward the higher segment bikes, which typically retail in the urban areas. We view this as a strategic shift (from a company which 2 years ago focused on market share and tried to obtain it by increasing its rural presence). Over the long term, however, BJAT will have to contend with lower growth rates, as we believe that as income levels escalate in urban areas, consumers may scale up to passenger cars. If, at that juncture, BJAT decides to focus once again on market share, it will find it difficult to compete with HROH and TVS, both of which are focusing on the 100cc economy segment too.

Bajaj Auto

Company description

Bajaj Auto (BAL) is India's leading manufacturer of two- and three-wheelers. Its product range includes scooters, motorcycles and three-wheelers. The company holds 26% and 50% equity stakes, respectively, in life and general insurance ventures in association with Allianz.

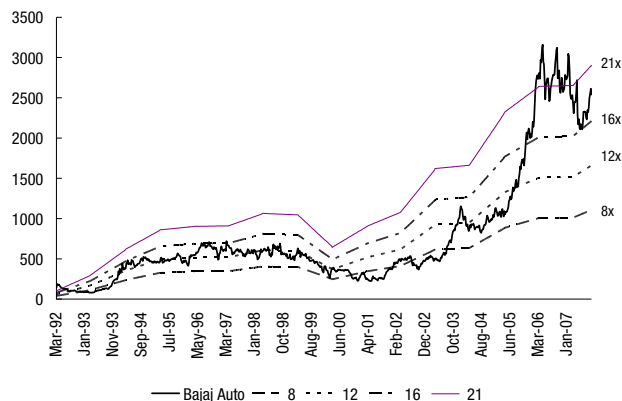
Investment Strategy

We rate Bajaj Auto as Hold/Low Risk (2L) with a target price of Rs2,671. We believe that current valuations of c17x FY09E earnings amply reflect lower growth rates in the core auto business and a lower valuation of the insurance business. While the availability of financing and the lack of adequate public transportation in India remain structural growth drivers, escalating competitive pressures and rising input costs are key concerns. Over the past three years, Bajaj has benefited by realigning its 2-wheeler product mix in-line with a market preference for motorcycles; its market share in motorcycles has risen from 24% (in FY03) to around 34% in FY07. But we expect competitive pressures to remain intense, and likely increase in the 2-wheeler space. Our estimates also reflect the sedate growth prospects for the 3-wheeler sector. Moreover, this segment is also being targeted by CV majors such as Tata Motors and M&M, which have developed, or are developing, small light trucks that will affect the 3-wheeler market in the longer term.

Valuation

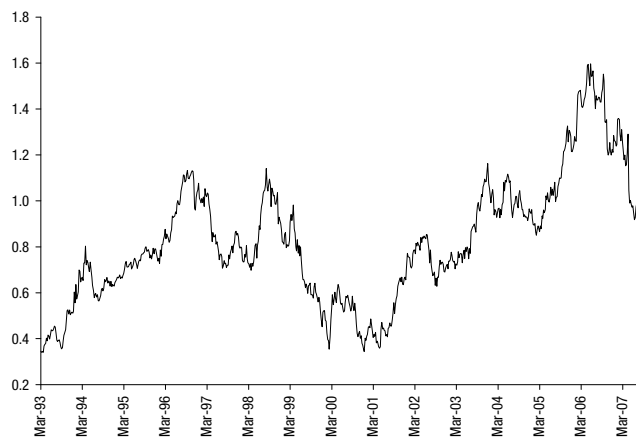
Our target price of Rs2,671 is based on a sum-of-the-parts valuation that comprises: a) Bajaj Auto (core auto business) valued at Rs1,145 (13x FY09E EPS), b) Bajaj Finserve, which holds the financial services and insurance businesses, at Rs552/share, and c) Bajaj Holdings and Investments, which comprises cash and investments at Rs975/share. The stock has traded in the range of 13-21x with a mean of c.17x over the past one year. Our fair-value multiple for the core business of 13x is at a discount to this mean, but we think it is justified given rising competitive intensity in the industry. A 14% CAGR in core earnings for FY07-10E should support these valuations, in our view.

Figure 14. Bajaj Auto- P/E Band Chart



Source: Company, Citi Investment Research, Bloomberg

Figure 15. Relative P/E Chart- Bajaj Auto vs. Sensex



Source: Company, Citi Investment Research, Bloomberg

Risks

We rate Bajaj Auto Low Risk based on our quantitative risk rating system, which tracks 260-day historical share price volatility. The key risk to Bajaj is a slowdown in sales and erosion in margins on any deterioration in macroeconomic variables (including growth, interest rates and fuel prices) or increase in competitive pressures. Competitive pressures in the 2-wheeler industry remain high and could likely accentuate given the aggressive product pipelines of key players. This, coupled with the rising trend in input costs, could mute margin expansion. Success in 3-wheelers is critical as it is the most profitable segment for the company and is a source of substantial cash flows. The predictability in this business remains relatively difficult, as performance is dependent on issuance of licenses by various government bodies. Upside risks include stronger-than-expected volume growth or a decline in material costs on a sustainable basis that would benefit margins. If any of these risk factors have a greater impact than we anticipate, Bajaj Auto's share price will likely have difficulty attaining our target price.

Appendix A-1

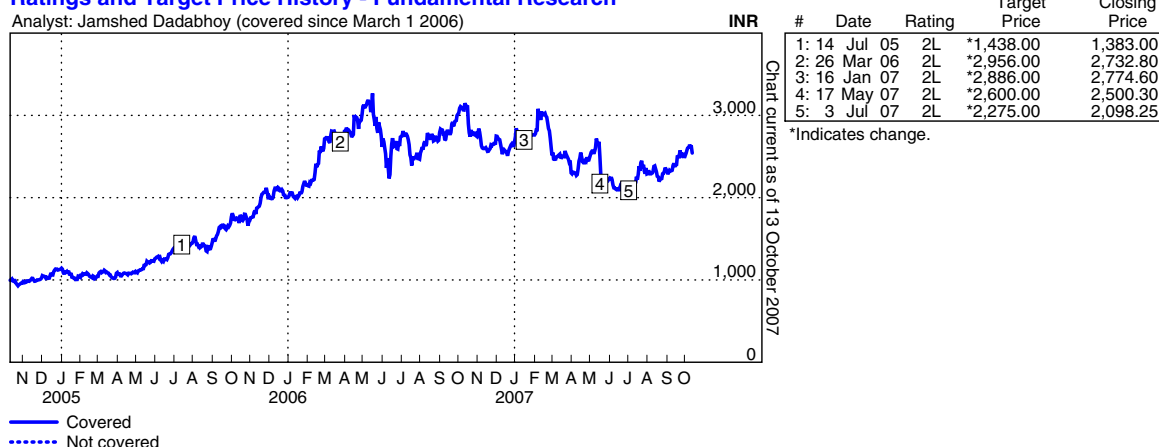
Analyst Certification

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Analyst: Jamshed Dadabhoy (covered since March 1 2006)



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