Ashok Leyland

Ugly Duckling

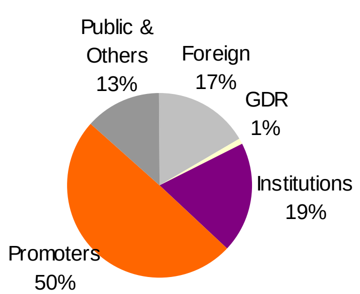
Riding high

Buy; CMP: Rs38

Company details

Price target:	Rs53
Market cap:	Rs4,605 cr
52 week high/low:	Rs54/23
NSE volume: (No of shares)	79 lakh
BSE code:	500477
NSE code:	ASHOKLEY
Sharekhan code:	ASHOKLEY
Free float: (No of shares)	60.1 cr

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	-9.9	-0.8	22.6	66.5
Relative to Sensex	3.4	-3.3	-0.4	1.7

Key points

- Ashok Leyland Ltd (ALL) is purely a play on the boom in the country's commercial vehicle (CV) industry. It has regained its market share in the last one year after a brief stagnation faced due to labour unrest in one of its facilities. With a good product mix and a strong distribution network, ALL should be able to outperform the CV industry and its volume should grow at a CAGR of 13.2% over FY2006-08.
- Over the years, ALL has diversified its revenue streams, thereby rendering stability to its business and de-risking its business model. Further, the company plans to significantly ramp up its non-cyclical businesses, enter new export markets like the African and Gulf markets, and strengthen its defence portfolio.
- In line with the demand, ALL is expanding its existing production capacity from 77,000 units to 100,000 units. It also plans to set up a gearbox unit and a new bus assembly unit in Dubai. It shall incur a total capital expenditure (capex) of around Rs600 crore over the next two years.
- ALL's focus on value engineering initiatives and plans to reduce the raw material cost through e-sourcing should result in significant savings and better operational efficiency. Consequently, we expect its operating profit margin (OPM) to improve by 70 basis points over FY2006-08.
- The stake sale by IVECO to another global CV major and ALL's plans to acquire a light commercial vehicle (LCV) business could act as big triggers and may lead to the re-rating of the stock. At the current market price of Rs38, the stock quotes at 10x its FY2008E earnings and 5.6x its FY2008 EV/EBIDTA. We believe the valuations are very reasonable and hence recommend a Buy on the stock with a price target of Rs53.

Company background

ALL is the second largest CV manufacturer in India with a market share of 27%. In 1955, the company started manufacturing CVs, with equity and technology participation from British Leyland. In 1987, Land Rover Leyland International Holdings (LRLIH), the holding company of ALL, was taken over jointly by the Hinduja group (a 70% share) and IVECO Fiat SpA (a 30% share).

Key financials Rs (cr)

Year ended March 31	FY2005	FY2006	FY2007E	FY2008E
Net profit (Rs cr)	281.0	305.6	406.7	503.5
% y-o-y growth		*9.0*	*33.0*	*24.0*
Shares in issue (cr)	118.9	122.1	133.2	133.2
EPS (Rs)	2.4	2.5	3.1	3.8
PER (x)	16.1	15.2	12.4	10.1
Book value (Rs)	9.6	11.4	15.0	15.6
P/BV (Rs)	4.0	3.3	2.5	2.4
EV/EBIDTA (x)	10.9	8.4	7.0	5.6
Dividend yield (%)	2.6	3.2	3.2	3.2
RoCE (%)	20.7	22.1	26.3	28.8
RoNW (%)	23.7	23.6	20.4	24.2

ALL's product portfolio includes passenger and goods carriers across all tonnage categories. It has six manufacturing facilities: three in Hosur (Tamil Nadu) and one each in Ennore (Tamil Nadu), Bhandara (Maharashtra) and Alwar (Rajasthan). It has enhanced its capacity to 77,000 vehicles per annum and is planning to expand it further to 100,000 vehicles by April 2008. ALL has built up strong technological tie-ups in the last few years, with Hino Motors (Japan) for engines and with ZF (Germany) for gearboxes.

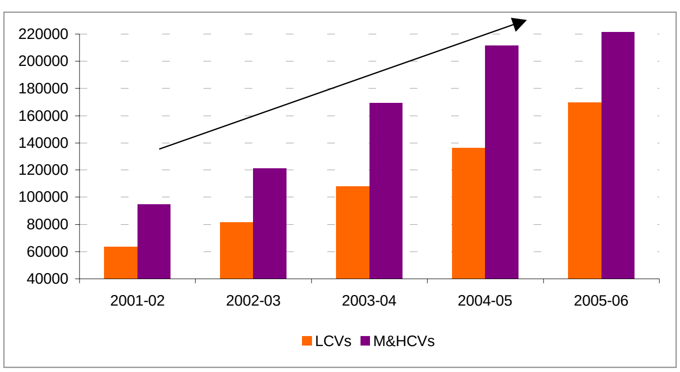
Investment arguments

CV industry on a roll

Owing to the increased focus of the government on road and highway development, the outlook for the CV industry remains positive. The construction of highways is going on in full swing in the country, with the work on the Golden Quadrilateral almost 91% complete and that on the North-South and East-West corridors progressing well. The improving road infrastructure is a long-term trigger for the CV industry as better roads lead to lesser turn-around time and higher fuel efficiency, thereby improving road transport economics.

The short-term triggers for the CV industry include the ban imposed on the overloading of trucks by the Supreme Court recently. At present, the order has been rigorously implemented in the states of Maharashtra, Haryana and Gujarat. We expect its stricter implementation in the other states including the southern region after the elections. In the last couple of years, we have also witnessed the "hub and spoke" model gain popularity in India which has further augmented the demand for CVs in the country. Taking all this into consideration, we believe the medium & heavy commercial vehicle (M&HCV) segment would grow at a compounded annual growth rate (CAGR) of 10-12% in the next two to three years.

Growth in the CV industry



Source: Sharekhan Research

...ALL regaining its market share

ALL is purely a play on India's booming CV industry. Due to labour unrest at one of its plants, the company's market share had declined to 24% in FY2005. Despite strong competition, ALL has regained its lost market share through an improved product mix, a shift to the technologically superior Hino engines and a strong distribution network in the last one year. Its market share has increased from 24% in FY2005 to 27% in FY2006. We expect its volumes to rise at a CAGR of 13.2% over the FY2006-08 period, outperforming the industry.

Diversifying revenue streams

Over the years, ALL has diversified its revenue streams, thereby de-risking its business model. The company plans to significantly ramp up its non-cyclical businesses, enter new export markets like the African and Gulf markets, and strengthen its defence portfolio.

a) *Proportion of non-cyclical revenue to increase*

ALL has been making continuous efforts to diversify its revenue streams by focusing on the non-cyclical businesses of passenger buses, spare parts, exports and defence supplies. It plans to increase the share of the non-cyclical revenues to more than 35% of the total revenues over the next two years. These businesses contributed 26.9% of the total revenues in FY2005, up from 22.9% in FY2004.

b) *Defence to drive incremental growth*

ALL has bagged an order worth Rs230 crore to supply 872 indigenously designed water bowzers to the Indian army. The order is expected to be completed by Q2FY2007. These are completely built vehicles, where both the realisations and the margins are high.

In another diversification effort, ALL has set up an auto component group, which will trade in auto components. The company is aiming to earn revenues of US$100 million in the next three years by targeting markets like the USA, Europe, Malaysia and Austria.

Capex plans

The company has been able to increase its capacity from 50,000 units in FY1998 to 77,000 vehicles in FY2006. It will be incurring a further capex of Rs600 crore during the next two years to increase its existing production capacity from 77,000 units to 100,000 units. The company also plans to set up a new bus body and a chassis assembly unit in Dubai with a capacity of 2,000 buses. Apart from this, the company has plans to set up a new gearbox unit, which will be used solely for captive purposes. The capex shall be mainly funded by internal accruals with about Rs200-300 crore to be raised as debt.

New markets and new launches to further fuel growth

ALL is aiming to increase its presence in the African countries as well as in the Philippines, Malaysia and Vietnam. Sri Lanka is already the largest export market for ALL with sales of around 2,000-2,500 vehicles per annum till date. ALL has a market share of 70% in Sri Lanka. Further the company plans to have alliances for bus and bus bodybuilding in Dubai. Currently ALL exports over 1,000 buses in the region and the volumes are expected to increase further. The company feels that the African countries and the Middle East shall be the major drivers of its exports, going forward.

The company plans the launch its *NEWGEN* range of trucks in Q1/Q2FY2007. Plans are also afoot to launch its new luxury bus called *Inter Century-Luxura* by Q3FY2007. The bus meets the latest norms for safety, seats, fire resistance and external noise. ALL is in a position to price the bus competitively which may help it seize a substantial market share from Volvo, which already has a product in this segment.

Operating performance to improve, going forward

ALL has been able to increase its operating efficiency in recent times. It has managed to increase its capacity from 50,000 units in FY1998 to 77,000 units in FY2006 through a marginal increase in its capex. The company is now aiming to reduce its raw material cost through e-sourcing and cost efficiencies. Further, it would continue to focus on its value-engineering initiatives. We believe these initiatives would help mitigate the impact of the higher raw material cost to some extent. We estimate a 70-basis-point improvement in its OPM over FY2006-08. The higher volumes in the coming quarters of FY2007 will increase its operating leverage.

Key investment risks

- A slowdown in the economy, less government spending on infrastructure, and higher commodity and fuel prices are the key factors that could affect the company's profitability adversely.
- The increasing competitive threats with the entry of new players like MAN, Mahindra and Mahindra-International Trucks and Daimler Chrysler pose a risk to the company's market share.

Valuations

The sharp improvement in the company's realisations in FY2005 and FY2006 was on account of higher sales to the defence sector, a better product mix (in favour of HCV goods carriers and buses) and price hikes. ALL's focus on the non-cyclical business segments, such as passenger buses and exports, is expected to negate the impact of the cyclical nature of the CV business on the growth of the company.

Apart from these, there are other big triggers like the stake sale of IVECO and the company's plans to acquire an LCV business abroad. These may lead to re-rating of the stock. The likely stake sale by IVECO (a stakeholder in LRLIH, ALL's holding company) to another global player would provide ALL with a strong technology base to overcome competition from global majors making a beeline for India. The possibility of the new partner using ALL as a global sourcing base would also act as another trigger. The acquisition of the LCV business should help ALL broaden its product portfolio to capitalise on the growth opportunities.

At the current market price of Rs38, the stock quotes at 10x its FY2008E earnings and 5.6x its FY2008 enterprise value/earnings before interest, depreciation, tax and amortisation. We believe that the valuations are very reasonable and the stock is available at a discount to some of the other automobile stocks. Considering the growth potential of ALL, we believe that this discount is unjustified and recommend a Buy on the stock with a price target of Rs53.

Financials

Profit and loss account

Rs (cr)

Particulars	FY2005	FY2006	FY2007E	FY2008E
Net sales	4,182.4	5,247.7	6,415.9	7,644.9
Operating expenses	3,759.5	4,707.6	5,712.5	6,804.7
Operating profit	422.8	540.1	703.4	840.2
Other income	53.8	33.0	25.0	30.0
EBIDTA	476.6	573.0	728.4	870.2
Depreciation	109.2	126.0	135.0	140.0
Interest	2.8	16.5	12.5	11.0
PBT	364.6	430.6	580.9	719.2
Tax	83.6	125.0	174.3	215.8
PAT	281.0	305.6	406.7	503.5

Balance sheet

Rs (cr)

Particulars	FY2005	FY2006	FY2007E	FY2008E
Share capital	118.9	122.2	133.2	133.2
Reserves & surplus	1,024.3	1,266.3	1,863.6	1,946.2
Shareholders fund	1,143.2	1,388.5	1,996.8	2,079.4
Total debt	880.4	628.0	500.0	500.0
Total liabilities	**2,023.7**	**2,016.5**	**2,496.8**	**2,579.4**
Gross block	1,977.7	2,220.7	2,520.7	2,820.7
Net fixed assets	869.3	986.3	1,286.3	1,451.3
C/w in progress	85.2	100.0	100.0	50.0
Investments	229.2	230.0	230.0	230.0
Gross current assets	1,360.6	1,468.1	1,955.1	1,902.3
Gross current liabilities	1,165.7	1,318.8	1,536.7	1,706.6
Net current assets	194.9	149.4	418.3	195.7
Misc exp not w/o	19.3	10.0	10.0	10.0
Deffered tax liability	-170.8	-170.8	-170.8	-170.8
Total assets	**2,023.7**	**2,016.5**	**2,496.8**	**2579.4**

Valuation matrix

Particulars	FY2005	FY2006	FY2007E	FY2008E
EPS	2.4	2.5	3.1	3.8
PER	16.1	15.2	12.4	10.1
P/B	4.0	4.9	4.1	3.3
EV/EBIDTA	10.9	12.6	9.7	6.2
EV/Sales	1.1	0.9	0.8	0.6
M Cap/EBIDTA	10.7	8.6	7.2	6.0
M Cap/Sales	1.1	0.9	0.8	0.7

Key ratios

Particulars	FY2005	FY2006	FY2007E	FY2008E
OPM (%)	10.1	10.3	11.0	11.0
EBIDTA (%)	11.4	10.9	11.4	11.4
PAT (%)	6.5	6.2	6.3	6.6
RoCE (%)	20.7	22.1	26.3	28.8
RoNW (%)	23.7	23.6	20.4	24.2
Debt - equity (X)	0.8	0.5	0.3	0.2

The author doesn't hold any investment in any of the companies mentioned in the article.