

MAHINDRA & MAHINDRA

INR 761

Consolidation in tractor industry

BUY



Mahindra and Mahindra (M&M) has agreed to acquire 43.3% stake in Punjab Tractors (PTL) from Actis and the Burman family at INR 360 per share in cash. M&M will make an open offer for another 20% as per regulations. The total cost of acquisition will be INR 13.88 bn, including the open offer. M&M (along with its 100% subsidiary Mahindra Holding and Finance) will fund the acquisition through a combination of its own cash resources and some amount of debt.

We believe the deal, though prima facie expensive, is earnings accretive for M&M, and is good for both the companies as well as the industry. We estimate the acquisition (at 63.3% stake) will be earnings accretive for M&M for FY08 up to a debt level of INR 7 bn. In the long run, the biggest benefit from consolidation in the industry will come from market discipline in the face of a sales slowdown. We reiterate 'BUY' recommendation on M&M.

Event update

- ◆ M&M announced the acquisition of Punjab Tractors (PTL) by agreeing to acquire the 29.1% stake held by Actis and 14.2% held by the Burman family. M&M will pay INR 360 per PTL share and make an open offer for acquiring an additional 20% from other shareholders, at the same price, as per SEBI takeover regulations. The total cost of the acquisition will be approximately INR 13.9 bn, including the open offer assuming it is fully subscribed.
- ◆ M&M will also make an open offer for Swaraj Engines (in which PTL has 33% equity), Swaraj Automotives (24%). PTL holds 14% in Swaraj Mazda (SML), hence an open offer may not be required for SML at this stage.
- ◆ We believe the acquisition is a positive for M&M in the short (in terms of earnings impact) as well as long term (in terms of market dominance, pricing power, and capacity enhancement). We believe the acquisition will be EPS accretive with the use of debt financing of up to INR 7 bn.
- ◆ We continue to like M&M on several potential triggers in the medium term, such as the launch of *Logan* and listing of Mahindra Holidays, as well as value creation possibilities in several new ventures, such as the JV with Renault-Nissan and the auto components business. The stock is available at 11.0x FY08E core earnings, excluding value of investments.

Financials

Year to March	FY06	FY07E	FY08E	FY09E
Revenues (INR mn)	81,366	98,859	116,741	132,936
Rev growth (%)	23.4	21.5	18.1	13.9
EBITDA (INR mn)	8,935	11,776	14,239	15,713
Adj. net profit (INR mn)	6,411	8,478	10,082	11,135
Adj. EPS (INR)	27.3	35.2	40.3	44.5
EPS growth (%)	27.8	29.2	14.3	10.4
Consolidated EPS (INR)	45.6	61.8	71.9	80.9
P/E (x)	27.9	21.6	18.9	17.1
P/E (x) consolidated	16.7	12.3	10.6	9.4
EV/EBITDA (x)	18.3	13.9	11.5	10.4
ROE (%)	29.5	22.8	19.2	18.8

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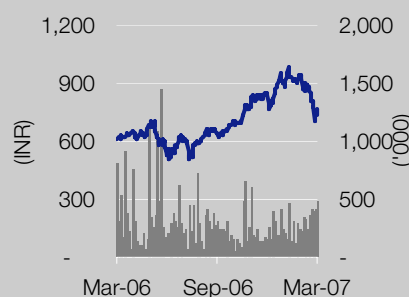
Reuters : MAHM.BO
Bloomberg : MM IN

Market Data

52-week range (INR) : 1,002 / 488
Share in issue (mn) : 240.9
M cap (INR bn/USD mn) : 183.4 / 4,146.7
Avg. Daily Vol. BSE ('000) : 228.6

Share Holding Pattern (%)

Promoters : 23.0
MFs, Fls & Banks : 21.3
Fls : 34.2
Others : 21.5



* Earnings impact

We estimate the acquisition of Punjab Tractors to be earnings accretive for M&M (consolidated basis). The company has announced that it will use a mix of internal liquid resources and debt to fund the acquisition (INR 13.9 bn). We calculate that up to a debt funding of INR 7 bn (50% of the total cost of acquisition) the acquisition would be EPS accretive for FY08. In the more likely scenario of up to INR 3-4 bn debt financing, we expect the acquisition to be EPS accretive to the extent of INR 1.1-1.3 per M&M share.

PTL's ordinary net profit for twelve months ending December 2006 was INR 777 mn on net sales of INR 9.8 bn, with EBIT margin of 11.6%. Given that the EBIT margin of M&M's farm equipment segment was 13.5% for twelve-months period ending December 2006, we expect PTL to have the potential of improving margins to similar levels with improved capacity utilization and sourcing synergies.

Table 1: M&M—EPS impact of PTL acquisition

PTL equity	Rs mn	607.6
	# of shares (mn)	60.8
PTL PAT (TTM)	Rs mn	650
FY08E (assuming INR 150 mn savings)	FY08E	800
M&M stake (post open offer)	%	63.3
Total cost of acquisition (excl. SML and SAL open offer)	INR bn	13.8
Earnings accruing to M&M on consolidation	Rs mn	506.4
M&M equity (fully diluted)	# of shares (mn)	250.3
Post tax cost of interest (for M&M)	%	5.94
EPS impact on M&M (consolidated)	Rs per share	
	Assuming debt financing of	
	0 INR bn	2.02
	3 INR bn	1.31
	4 INR bn	1.07
	7 INR bn	0.36

Source: Edelweiss research

Table 2: M&M—Total cost of acquisition

	From	# of shares (mn)	Price (INR per share)	Amount (INR mn)
PTL	Actis	26.31	360	9,471
	Open offer	12.15	360	4,374
Swaraj Engines	Open offer	2.48	151	375
Swaraj Automotives	Open offer	0.48	244	117
Total				14,337

Source: Edelweiss research

* Strategic rationale and long-term impact

We believe, the acquisition will bring about much needed consolidation in the tractor industry, and is a positive for M&M and the industry as a whole in the medium to long term.

- ♦ M&M and PTL will hold a combined market share of more than 40% in the tractor industry. Top four players (M&M, TAFE, Escorts, and International Tractors) will now account for 85% market share compared with 65% in FY04. We believe this will bring the required production, inventory, and pricing discipline in the face of any slowdown in the industry, which has on several occasions been plagued with indiscriminate channel inventory leading to prolonged sales slowdown (e.g., 2000-02).

- With acquisition of PTL, M&M will consolidate its market share in the northern region where it has been weak. The combined market share of M&M and PTL in North will stand at 34% compared with 25% share of M&M alone. The M&M-PTL combine will also dominate the 31-40 HP and 51 HP+ segments with nearly 50% market share, along with the 21-30 HP segment, which M&M already dominates.
- PTL is currently operating at 50% of its 60,000 units p.a. capacity. M&M is operating at nearly 75% of its capacity of 135,500 units p.a. in a market growing at around 10-12% p.a. PTL's spare capacity will, therefore, defer the need to expand M&M's capacity in the medium term.
- The spare capacity at PTL's foundry, which can be scaled up to nearly 20,000 tonnes p.a. from the current 8,000 tonnes p.a., will also provide opportunities in the auto components space.

Table 3: M&M-PTL—Overall market share

	Apr-Dec 2005	Apr-Dec 2006
M&M	30.1	30.3
PTL	8.9	11.1
Combined	39.0	41.4

Source: Tractors Manufacturers Association

Table 4: M&M-PTL—Region wise market share

		Apr-Dec 2005	Apr-Dec 2006
M&M	North	25.3	24.5
	South	40.4	39.7
	East	32.3	32.3
	West	31.8	31.3
	PTL		
PTL	North	11.8	9.5
	South	11.7	9.1
	East	13.4	10.4
	West	12.7	10.2
Combined	North	37.1	34.0
	South	52.0	48.8
	East	45.7	42.7
	West	44.4	41.5

Source: Tractors Manufacturers Association

Table 5: M&M-PTL—Segment wise market share

		Apr-Dec 2005	Apr-Dec 2006
M&M	21-30 HP	32.0	41.3
	31-40 HP	30.3	28.9
	41-50 HP	30.3	28.8
	51 HP+	23.3	18.8
PTL	21-30 HP	7.4	6.6
	31-40 HP	11.0	14.6
	41-50 HP	-	-
	51 HP+	27.8	30.3
Combined	21-30 HP	39.4	48.0
	31-40 HP	41.3	43.5
	41-50 HP	30.3	28.8
	51 HP+	51.1	49.1

Source: Tractors Manufacturers Association

* Financials and shareholding pattern of PTL's associate companies

With the acquisition of PTL, M&M will also acquire minority stakes in Swaraj Engines, Swaraj Mazda, and Swaraj Automotives, and is making an open offer for Swaraj Engines and Swaraj Automotives.

- ♦ **Swaraj Engines:** manufactures diesel engines which are supplied to PTL and Swaraj Mazda. It is a joint venture between PTL and Kirloskar Oil Engines (KOEL). The open offer price is INR 151 per share.
- ♦ **Swaraj Mazda:** manufactures light commercial vehicles (LCVs) in the range of 5-7.5 tonnes GVW and M&HCV in the 7.5-12 tonne GVW range. SML has about 2% market share in the overall CV industry (April-February 2006) and an 11% share in the 5-12 tonne segment.
- ♦ **Swaraj Automotives:** manufactures seats and seat components for tractors and LCVs and supplies to PTL and SML. The open offer price is INR 244 per share.

Table 6:-Financials

	Punjab Tractors		Swaraj Mazda		Swaraj Engines		Swaraj Automotives	
	FY06	TTM	FY06	TTM	FY06	TTM	FY06	TTM
Net revenues (INR mn)	9,586	9,810	6,102	5,956	1,282	1,329	407	516
Operating profit (INR mn)	1,988	1,392	354	285	269	257	34	58
Adj. net profit (INR mn)	838	777	168	113	140	143	15	31
Net profit (INR mn)	1,293	816	168	113	140	143	15	31
No. of shares outstanding (mn)	61	61	10	10	12	12	2	2
Adj. EPS (INR)	14	13	16	11	11	12	6	13
P/E (x)	22	24	20	30	13	13	4	2
ROCE (%)	16.7	21.3	13.4	14.3	24.9	35.0	22.1	53.6
ROE (%)	14.7	13.7	25.3	17.0	22.9	23.4	19.8	41.7
Networth (INR mn)	5,690	-	663	-	610	-	75	-
Debt (INR mn)	130	-	1,135	-	-	-	19	-
Investments (INR mn)	92	-	-	-	-	-	-	-
Cash (INR mn)	240	-	190	-	37	-	7	-

Source: Edelweiss research

Table 7: PTL—Shareholding pattern

	# of shares	% holding
Promoter Group	26,295,370	43.3
CDC Stake	17,781,145	29.3
Burman Family	8,514,225	14.0
Mutual Funds/ UTI	4,846,655	8.0
Reliance Capital Trustee Company	4,727,223	7.8
Insurance Companies / Financial Institutions / Banks	18,141,319	29.9
Life Insurance Corporation of India	8,802,429	14.5
General Insurance Corporation of India	4,740,903	7.8
FII's	2,178,916	3.6
JF India Fund	700,000	1.2
JM Morgan Fleming India Investment Company Mauritius	630,000	1.0
Others	14,993,640	15.3
Total	66,455,900	100.0

Source: Edelweiss research

Table 8: Swaraj Mazda—Shareholding pattern

	# of shares	% holding
Promoter and Promoter Group	5,775,000	55.1
Sumitomo Corporation	4,303,000	41.0
Punjab Tractors Ltd	1,472,000	14.0
CDC Stake	1,784,241	17.0
Actis Agribusiness Ltd	811,258	7.7
CDC Financial Services Mauritius Ltd	972,983	9.3
Mutual Funds/ UTI	781,403	7.5
Reliance Capital Trustee Company Ltd A/c Reliance Tax Saver		
Elss Fund	779,853	7.4
Insurance Companies / Banks	6,450	0.1
FII's	3,434	0.0
Others	2,136,172	20.4
Total	10,486,700	100.0

Source: Edelweiss research

Table 9: Swaraj Engines—Shareholding pattern

	# of shares	% holding
Promoter and Promoter Group	6,279,000	50.6
Punjab tractors Ltd.	4,119,000	33.2
Kirloskar Oil engines ltd.	2,160,000	17.4
Mutual Funds/ UTI	3,150	0.0
Insurance Companies / Financial Institutions / Banks	525,072	4.2
United India Insurance Company Ltd	291774	2.4
National Insurance Company Ltd	187398	1.5
FII's	0	0.0
Others	5,612,598	45.2
Total	12,419,820	100.0

Source: Edelweiss research

Table 10: Swaraj Automotives—Shareholding pattern

	# of shares	% holding
Promoter & promoter group	723,471	30.2
PTL	580,000	24.2
Total non-promoter	1,674,242	69.8
Non-promoter (Institution)	1,015,339	42.3
Non promoter (non-institution)	658,903	27.5
Grand Total	2,397,713	100.0

Source: Edelweiss research

Company Description

M&M is the flagship company of the Mahindra Group which has a significant presence in several high growth sectors. The company has two main divisions – Automotive division & Farm Equipment division. It is a dominant player in the UV segment with its ‘Scorpio’ and ‘Bolero’ models – the prime constituents of sales of the automotive division. M&M is also engaged in the manufacture of 3-Wheelers and LCV’s. It has recently tied up world giant Renault to make the ‘Logan’ car in India. It has also invested significantly in developing its auto-components business. M&M is also the leader in the Indian tractor market.

Investment Thesis

Both the operating divisions of M&M are expected to perform well in terms of growth and profitability. We expect significant expansion in M&M addressable market through its entry into the passenger car and M&HCV sector in JV with Renault and ITEC, respectively, and into the auto-component business through aggressive acquisition strategy. In addition, M&M has significant value embedded in its investments which cover information technology (Tech Mahindra), real estate and infrastructure (Mahindra Gesco), hospitality (Mahindra Holidays), financial services (Mahindra and Mahindra Financial Services) and auto-components (Mahindra UGINE Steel and Mahindra Forgings) sectors.

Risks to the Recommendation

Tractor sales are dependent on the monsoons and may suffer a downturn on account of successive failure of monsoons. Rising raw material and other input costs could hurt margins. Also, M&M faces stiff competition from a variety of quality passenger car makers. In addition, the new business segments (passenger cars and CVs) would face competition from existing and new players.

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INDIA RESEARCH

SECTOR

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RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period

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