Company Focus

21 January 2008 | 10 pages

Bajaj Auto (BJAT.BO)

Upgrade to Buy: Recent Sell-Off Overdone

Change in opinion ☑
Rating change ☑
Target price change ☑
Estimate change ☑

- **Upgrade to Buy (1L) from Hold (2L)** — The recent sharp sell-off (stock price has corrected 16% over the last 5 days) provides an entry opportunity with a favorable risk-return profile and an overall return of c26% from current levels. Our target price of Rs2,545 (formerly Rs 2,671) is based on a sum-of-the-parts valuation derived from break-up valuations.
- **Valuations** — Our target price breaks down as: a) core auto business valued at Rs997/share (previously Rs1,145), based on 13x FY09E core earnings; b) Bajaj Finserve at Rs552/share (unchanged); and c) Bajaj Holdings & Investments at Rs996/share (Rs975/share earlier).
- **Demerger imminent** — Management stated that the High Court's approval for the demerger has been received – BJA should get the written order over the next few days, after which other formalities should be completed within 30-45 days. All 3 companies are expected to list by end March.
- **Core auto business** — will remain pressured. We have cut motorcycle and 3-wheeler volume assumptions by 5-10% and 3-10%, respectively, over the forecast period. Margins have also been pared by 80-120 bps to reflect lower 3-wheeler sales (relatively high-margin products). Overall EPS estimates have been cut by ~8-13% over the forecast period.
- **Downside risks** — a) Increased price competition, which would affect 2-wheeler margins, b) delay in demerger, which is viewed as a near-term positive catalyst, and c) decline in 3-wheeler sales.

Buy/Low Risk	**1L**
from Hold/Low Risk	
Price (21 Jan 08)	Rs2,064.35
Target price	Rs2,545.00
from Rs2,671.00	
Expected share price return	23.3%
Expected dividend yield	2.4%
Expected total return	**25.7%**
Market Cap	Rs208,878M
	US$5,327M

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

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	11,174	110.44	39.4	18.7	4.4	25.1	1.9
2007A	12,728	125.79	13.9	16.4	3.8	24.7	1.9
2008E	11,822	116.84	-7.1	17.7	3.4	20.2	2.2
2009E	13,364	132.08	13.0	15.6	3.0	20.4	2.4
2010E	14,841	146.68	11.1	14.1	2.7	20.2	2.7

Source: Powered by dataCentral

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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)	18.7	16.4	17.7	15.6	14.1
EV/EBITDA adjusted (x)	14.6	13.6	14.8	12.7	10.7
P/BV (x)	4.4	3.8	3.4	3.0	2.7
Dividend yield (%)	1.9	1.9	2.2	2.4	2.7
Per Share Data (Rs)					
EPS adjusted	110.44	125.79	116.84	132.08	146.68
EPS reported	108.88	122.27	116.84	132.08	146.68
BVPS	471.51	546.98	611.17	684.75	767.08
DPS	40.00	40.00	45.00	50.00	55.00
Profit & Loss (RsM)					
Net sales	74,694	92,922	88,907	95,420	106,502
Operating expenses	-65,026	-82,937	-80,341	-85,659	-95,594
EBIT	**9,668**	**9,985**	**8,565**	**9,762**	**10,908**
Net interest expense	-3	-53	-20	-25	-30
Non-operating/exceptionals	6,370	7,838	8,047	8,825	9,593
Pre-tax profit	**16,034**	**17,770**	**16,592**	**18,561**	**20,471**
Tax	-4,791	-4,901	-4,770	-5,197	-5,629
Extraord./Min.Int./Pref.div.	-226	-498	0	0	0
Reported net income	**11,017**	**12,371**	**11,822**	**13,364**	**14,841**
Adjusted earnings	11,174	12,728	11,822	13,364	14,841
Adjusted EBITDA	11,578	11,888	10,732	12,181	13,618
Growth Rates (%)					
Sales	30.2	24.4	-4.3	7.3	11.6
EBIT adjusted	79.9	3.3	-14.2	14.0	11.7
EBITDA adjusted	60.2	2.7	-9.7	13.5	11.8
EPS adjusted	39.4	13.9	-7.1	13.0	11.1
Cash Flow (RsM)					
Operating cash flow	**15,262**	**12,398**	**10,867**	**17,472**	**19,616**
Depreciation/amortization	1,910	1,903	2,167	2,419	2,710
Net working capital	2,335	-1,876	-3,122	1,689	2,064
Investing cash flow	**-14,841**	**-9,247**	**-8,025**	**-14,603**	**-16,513**
Capital expenditure	-1,651	-2,843	-4,500	-4,500	-4,500
Acquisitions/disposals	-13,190	-6,404	-3,525	-10,103	-12,013
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	**-2,667**	**-2,546**	**-2,073**	**-2,604**	**-2,603**
Balance Sheet (RsM)					
Total assets	**98,702**	**115,667**	**123,850**	**138,874**	**155,424**
Cash & cash equivalent	821	835	1,000	1,100	1,200
Accounts receivable	3,016	5,298	5,505	5,895	5,921
Net fixed assets	11,558	12,964	15,297	17,378	19,168
Total liabilities	**50,995**	**60,324**	**62,012**	**69,591**	**77,811**
Accounts payable	11,802	14,697	12,208	13,227	14,760
Total Debt	14,672	16,254	18,498	21,056	23,973
Shareholders' funds	**47,707**	**55,343**	**61,838**	**69,283**	**77,613**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	15.5	12.8	12.1	12.8	12.8
ROE adjusted	25.1	24.7	20.2	20.4	20.2
ROIC adjusted	80.1	93.4	39.7	38.1	46.1
Net debt to equity	29.0	27.9	28.3	28.8	29.3
Total debt to capital	23.5	22.7	23.0	23.3	23.6

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Investment Summary

We upgrade Bajaj Auto to Buy (1L) from Hold (2L) as we believe the recent dramatic sell-off reflects the negative performance of the auto business and also provides an entry point from where we perceive a reasonable risk return trade-off.

Auto Business – Sluggish Outlook Continues

Our Hold (2L) recommendation on BJA over the past few years has been predicated on a) increasing competitive intensity in the 2-wheeler business, b) cost pressures that affect margins, and c) a strong franchise in a 3-wheeler business, which has extremely sporadic growth rates and is thus subject to considerable volatility, especially when assessed on a year-over-year comparison. Our views on these factors remain unchanged. Our reduction in the valuation of Bajaj Auto's overall sum of the parts reflects these concerns. But we reiterate that given the sharp sell-off, the risk reward ratio in this Sensex stock is favorable, at this juncture.

We reduce our target price to Rs 2,545 from 2,671 based on break-up valuations as follows:

a) **Bajaj Auto (core auto business):** We have reduced core business value to Rs997/share (from Rs 1145/share) based on 13x FY09E diluted EPS. Key reasons for reduction in core auto business are: 1) lower volume growth in motorcycles and 3-wheeler sales due to tightening of credit by banks and increased competitive intensity, and 2) we have also pared margins to reflect reduction in sales of higher margin 3-wheeler units.

b) **Bajaj Finserve (insurance + finance business):** We retain value of this entity at Rs552/share. Our banks team has valued the life insurance business at Rs600/share – based on a share capital of Rs102m shares. In our break-up value (which is assessed on an enhanced equity base of Rs145m shares) the life insurance value/share is correspondingly lower at Rs420/share.

Figure 1. 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
Parents 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

Figure 2. 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

c) **Bajaj Holdings and Investments (BHIL):** We increase the value of this entity slightly to Rs996/share (from Rs975/share) primarily factoring in higher valuation of the stakes in ICICI bank and Bajaj Hindusthan.

Figure 3. Bajaj Auto- Demerged Entity – Sum of Parts Valuation

Bajaj Auto (new entity)	
Net Profit (Core business, Rs m)	9,875
Earnings multiple (at 13x FY09E)	13
Core earnings	128,370
Cash (Rs m)	15,804
No. of shares (m)	145
Value per share (a)	**997**
Bajaj Finserve (new entity)	
Cash transferred	8,429
Life insurance business value	252,774
(Valuing above at 26% and subtracting the initial investment)	60,721
General insurance business value	12,742
(Valuing above at 51%)	6,498
Bajaj Auto Finance (at 25% discount to CMP)	4,229
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)	39,788
Bajaj Hindustan stake (at 20% discount to CMP)	2,080
Stake in Bajaj Auto (30%)	43,252
Stake in Bajaj Finserve (30%)	23,963
No of shares	101
Value per share (c)	1,245
Value of BHIL at 20% discount	**996**
Total Value per share	**2,545**

Source: Citi Investment Research

Earnings Revision

We revise our earnings downward by 8-13% over FY08-FY10E factoring in lower volume growth in motorcycle and 3-wheelers. We pare our motorcycle volume growth assumptions by 5-10% over FY08-FY10E and 3-wheeler volume growth assumptions by 4-10% over the same period. We believe that motorcycle volumes growth will be affected by continued credit tightening by banks into 1H FY09E, before easing in FY10. We also expect Hero Honda and

TVS to gain some market share from Bajaj due to superior product momentum. We reckon 3-wheeler volume growth will also remain muted due to increasing competition from Tata's Ace (in the freight segment) and from increasing competition from Piaggio (in the passenger segment).

We revise EBITDA by 11-17% over FY08-FY10E due to reduction in volume growth in the higher-margin 3-wheeler business and factoring in higher input cost pressures due to increase in competitive pressures.

Figure 4. Key Earnings Metrics

	FY08E		FY09E		FY10E		Comments
	Old	New	Old	New	Old	New	
Motorcycle Volumes	2,264,552	2,159,640	2,623,662	2,370,195	2,989,215	2,705,333	Negative growth in FY08 due to high interest rates and credit tightening of banks; export growth of 60% in FY08 mitigates impact
% Growth YoY	-4.8	-9.2	15.9	9.7	13.9	14.1	Volumes to pick up in FY09 due to favourable base effect, exports continue to spur volume growth
Total 2 Wheeler Volumes	**2,287,303**	**2,182,392**	**2,648,688**	**2,395,222**	**3,016,745**	**2,732,863**	
% Growth YoY	-4.7	-9.1	15.8	9.8	13.9	14.1	
3 Wheeler Volumes	**315,962**	**304,711**	**336,271**	**316,721**	**358,272**	**324,253**	Negative Growth in FY08 due to slowdown in domestic market and increasing competition (in goods segment) from the ACE
% Growth YoY	-1.8	-5.3	6.4	3.9	6.5	2.4	Volumes to recover in FY09 driven by exports and mild recovery in domestic market
EBITDA (Rs million)	11,997	10,732	14,340	12,181	16,384	13,618	
EBITDA Margin (%)	12.9	12.1	13.8	12.8	14.0	12.8	Revise margins downward due to reduction in volumes of higher margin 3 wheeler sales and input cost pressures

Source: Citi Investment Research

Figure 5. Bajaj Auto (Overall Business) – Earnings Revision Table

	Net Profit		Diluted EPS		
	Old	New	Old	New	% change
FY08E	12,784	11,822	126.4	116.8	-7.5
FY09E	15,017	13,364	148.4	132.1	-11.0
FY10E	17,027	14,841	168.3	146.7	-12.8

Source: Citi Investment Research

Figure 6. Volume Assumptions – FY06-FY10E

	FY 2006	FY 2007	FY 2008E	FY 2009E	FY 2010E
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	2,159,640	2,370,195	2,705,333
% growth	30.2	24.4	-9.2	9.7	14.1
Total 2 wheelers	**2,029,176**	**2,399,996**	**2,182,392**	**2,395,222**	**2,732,863**
% growth	26.6	18.3	-9.1	9.8	14.1
3 wheelers	252,054	321,828	304,711	316,721	324,253
% growth	13.5	27.7	-5.3	3.9	2.4
Total 2 / 3 wheelers	**2,281,230**	**2,721,824**	**2,487,103**	**2,711,943**	**3,057,116**
% growth	25.0	19.3	-8.6	9.0	12.7

Source: Citi Investment Research

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.

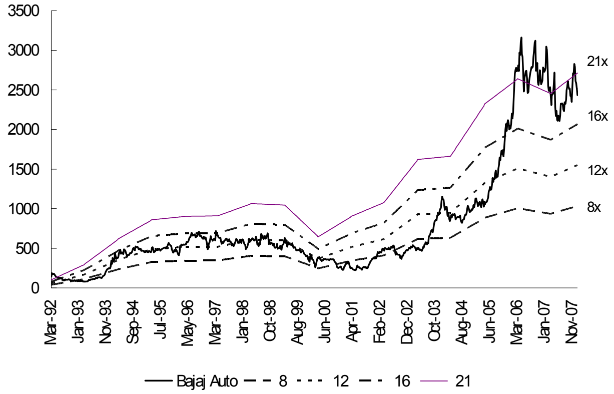
Investment strategy

We rate Bajaj Auto as Buy /Low Risk (1L). We believe that current valuations amply reflect concerns in the core auto business and provide reasonable upside from a risk-reward perspective. While the lack of adequate public transportation in India remains a structural growth driver, escalating competitive pressures and rising input costs are key concerns. Over the past three years, Bajaj has realigned 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 in the 2-wheeler space. Our estimates also reflect sedate growth prospects for the 3-wheeler sector.

Valuation

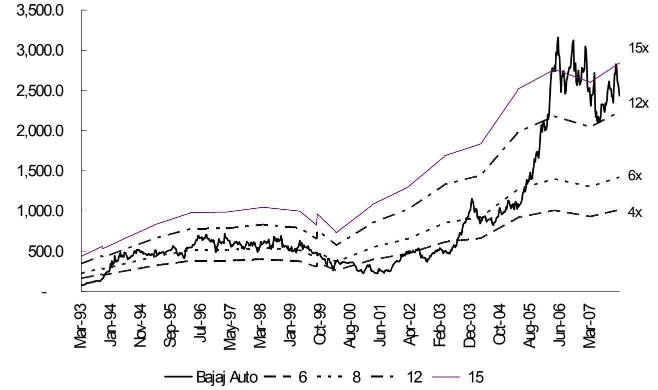
Our target price of Rs 2,545 is based on a sum-of-the-parts valuation that comprises: a) Bajaj Auto (core auto business) valued at Rs 997 at 13x FY09E EPS, b) Bajaj Finserve, which holds the financial services and insurance businesses at Rs 552/share, and c) Bajaj Holdings and Investments, which comprises cash and investments at Rs996/share. The stock has traded in the range of 13-21x with a mean of c.17x over the past one year. Our multiple of 13x is at a discount to this mean, but we think it is justified given rising competitive intensity in the industry. A 12% CAGR in core earnings for FY08E-10E should support these valuations, in our view.

Figure 7. P/E Band Chart



Source: Citi Investment Research

Figure 8. EV/EBITDA Band Chart



Source: Citi Investment Research

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.

Appendix A-1

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Bajaj Auto (BJAT.BO)
Ratings and Target Price History - Fundamental Research
Analyst: Jamshed Dadabhoy (covered since March 1 2006)

#	Date	Rating	Target Price	Closing Price
1:	14 Jul 05	2L	*1,438.00	1,383.00
2:	26 Mar 06	2L	*2,956.00	2,732.80
3:	16 Jan 07	2L	*2,886.00	2,774.60
4:	17 May 07	2L	*2,600.00	2,500.30
5:	3 Jul 07	2L	*2,275.00	2,098.25
6:	15 Oct 07	2L	*2,671.00	2,579.95

*Indicates change.

Covered
Not covered

Rating/target price changes above reflect Eastern Standard Time

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