Initial Opinion BUY

Equity | India | Autos/Car Manufacturers
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Sound business, attractive valuation; a new Buy

Bank of America Merrill Lynch

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Initiate with Buy, PO of Rs166 (40% potential upside)

Escorts Ltd, one of India's leading agri-machinery companies, is our new Buy with a SOTP-based PO of Rs166. Our investment opinion is driven by structural demand for tractor biz (85% of company's sales). We also expect non-agri operations (railway equipments, auto parts) to be less of a drag, and construction equipment biz to unlock value in the long term. As a result, we forecast 21% EPS CAGR over 2010-13E. On our sum-of-the-parts based methodology, we value the tractor biz at 10x Mar'12E EPS (20% discount to industry leader M&M's target multiple) and construction equipment biz at Rs.16 (7x Mar'12E EV/EBITDA).

Tractor business to sustain strong demand

We believe Escorts, which ranks 3rd in market share, is in the middle of a structural growth due to increasing mechanization, growing affordability and rising labor shortage in rural India. We expect Escorts to achieve higher-than-industry tractor sales CAGR of 15% over the next two years, on (1) new launches such as inverter-tractor, etc. and (2) marketing initiatives in South India, where it lags compared to other regions.

Construction equipment business to show sharp recovery

Escorts Construction Equipment (ECEL), the company's wholly owned subsidiary, has built its leadership in the niche segment of Pick 'n' carry cranes. ECEL is now focusing on front/backend loaders and with recent launch of newer products, we expect it to achieve significant scale, via 16% revenue CAGR in 2010-13E, and double EBITDA margin to 6%.

Compelling valuations

We expect Escorts to be free cash flow positive this fiscal, turn debt-free next year & improve RoE over forecast period. Based on superior prospects, we expect the company's stock valuations to improve from P/E of 7x & P/B of 0.6x (on Mar'12E).

Stock Data

Price	Rs119
Price Objective	Rs166
Date Established	10-Mar-2011
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	Rs94.00-Rs245.95
Mrkt Val / Shares Out (mn)	US$253 / 95.5
Average Daily Volume	1,542,878
BofAML Ticker / Exchange	XSOCF / NSI
Bloomberg / Reuters	ESC IN / ESCO.NS
ROE (2011E)	7.1%
Net Dbt to Eqty (Sep-2010A)	11.4%
Est. 5-Yr EPS / DPS Growth	21.5% / 14.5%
Free Float	73.0%

Estimates (Sep)

(Rs)	2009A	2010A	2011E	2012E	2013E
Net Income (Adjusted - mn)	627	1,263	1,232	1,966	2,536
EPS	7.4	14.8	12.9	20.6	26.6
EPS Change (YoY)	NM	100.3%	-12.9%	59.5%	29.0%
Dividend / Share	1.0	1.5	1.8	2.0	2.3
Free Cash Flow / Share	-13.9	-11.2	5.4	16.8	23.7

Valuation (Sep)

	2009A	2010A	2011E	2012E	2013E
P/E	16.1x	8.0x	9.2x	5.8x	4.5x
Dividend Yield	0.8%	1.3%	1.5%	1.7%	1.9%
EV / EBITDA*	6.5x	5.9x	5.4x	4.0x	3.3x
Free Cash Flow Yield*	-10.4%	-8.4%	4.5%	14.1%	19.9%

* For full definitions of *iQmethod* SM measures, see page 13.

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iQprofile SM Escorts Limited

Key Income Statement Data (Sep)	2009A	2010A	2011E	2012E	2013E
(Rs Millions)					
Sales	26,617	33,783	40,597	45,803	49,925
Gross Profit	8,876	10,558	12,359	14,373	15,850
Sell General & Admin Expense	(2,815)	(3,296)	(3,975)	(4,368)	(4,670)
Operating Profit	1,629	1,918	2,130	3,049	3,770
Net Interest & Other Income	(713)	(162)	(404)	(326)	(271)
Associates	NA	NA	NA	NA	NA
Pretax Income	916	1,756	1,727	2,723	3,499
Tax (expense) / Benefit	(290)	(490)	(492)	(753)	(957)
Net Income (Adjusted)	627	1,263	1,232	1,966	2,536
Average Fully Diluted Shares Outstanding	85	85	95	95	95
Key Cash Flow Statement Data					
Net Income	627	1,263	1,232	1,966	2,536
Depreciation & Amortization	595	532	559	567	570
Change in Working Capital	4,396	(1,974)	(771)	(425)	(385)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(158)	319	(3)	(5)	(6)
Cash Flow from Operations	5,460	140	1,018	2,103	2,714
Capital Expenditure	(6,641)	(1,098)	(500)	(500)	(450)
(Acquisition) / Disposal of Investments	1,315	(9)	0	0	0
Other Cash Inflow / (Outflow)	58	35	0	0	0
Cash Flow from Investing	(5,268)	(1,071)	(500)	(500)	(450)
Shares Issue / (Repurchase)	0	149	0	0	0
Cost of Dividends Paid	0	(106)	(185)	(216)	(246)
Cash Flow from Financing	348	1,084	(685)	(716)	(746)
Free Cash Flow	(1,181)	(958)	518	1,603	2,264
Net Debt	2,056	1,936	1,604	217	(1,801)
Change in Net Debt	(4,922)	(120)	(333)	(1,387)	(2,018)
Key Balance Sheet Data					
Property, Plant & Equipment	15,720	16,285	16,226	16,159	16,040
Other Non-Current Assets	2,866	2,536	2,536	2,536	2,536
Trade Receivables	4,261	4,501	6,673	7,529	8,207
Cash & Equivalents	1,964	2,117	1,950	2,837	4,355
Other Current Assets	5,489	7,403	9,600	10,567	11,381
Total Assets	30,299	32,842	36,984	39,628	42,518
Long-Term Debt	4,020	4,053	3,553	3,053	2,553
Other Non-Current Liabilities	1,441	1,399	1,399	1,399	1,399
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	10,187	10,446	14,075	15,504	16,641
Total Liabilities	15,648	15,898	19,027	19,956	20,593
Total Equity	14,652	16,944	17,957	19,672	21,925
Total Equity & Liabilities	30,299	32,842	36,984	39,628	42,518
iQmethod* SM - Bus Performance					
Return On Capital Employed	5.6%	6.5%	6.7%	9.4%	11.0%
Return On Equity	5.3%	8.1%	7.1%	10.5%	12.2%
Operating Margin	6.3%	5.8%	5.3%	6.8%	7.7%
EBITDA Margin	8.4%	7.3%	6.6%	7.9%	8.7%
iQmethod* SM - Quality of Earnings					
Cash Realization Ratio	8.7x	0.1x	0.8x	1.1x	1.1x
Asset Replacement Ratio	11.2x	2.1x	0.9x	0.9x	0.8x
Tax Rate (Reported)	31.6%	27.9%	28.5%	27.6%	27.4%
Net Debt-to-Equity Ratio	14.0%	11.4%	8.9%	1.1%	-8.2%
Interest Cover	2.3x	10.6x	5.0x	8.8x	13.0x
Key Metrics					

* For full definitions of *iQmethod* SM measures, see page 13.

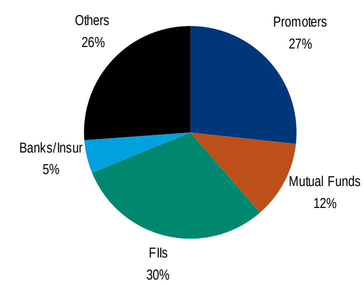
Company Description

Escorts is among India's leading agri machinery companies with 15% market share in tractors placing it at a number 3 position in India. It is also present in construction & material handling equipment, railway equipment and auto components businesses.The company's tractor business accounts for the majority of the company's revenues and profits.

Investment Thesis

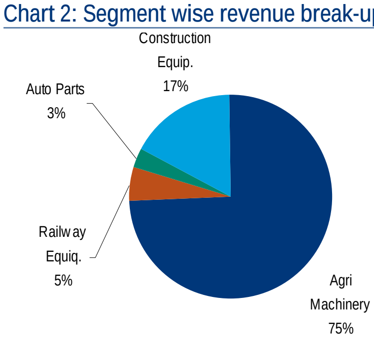
Escorts is the third largest tractor company in India. We expect the company to improve its core tractor business significantly on account of strong demand and improving utilization. We also believe its secondary operations (railway equipment, auto parts) will be less of a drag, and that its construction equipment division will unlock value over the longer term.

Chart 1: Shareholding



Source: BofA Merrill Lynch Global Research

Chart 2: Segment wise revenue break-up



Source: BofA Merrill Lynch Global Research

Stock Data

Price to Book Value	0.6x

Core tractor business accounts for ~85% of standalone sales.

Initiate at Buy, PO of Rs166

We initiate coverage on Escorts, a mid-sized Indian tractor company with a significant presence in North India, with a Buy rating and PO of Rs166, implying 40% potential upside. Over the past two years, Escorts has witnessed a turnaround, mainly due to its core tractor biz (accounts for ~85% of standalone sales), even as its marginal operations - railway equipment and auto parts - continue to restrict overall growth. The company also operates a construction equipment business through a fully owned subsidiary, which in our view will also register turnaround through better scale and efficiencies.

Tractor demand is structural

We forecast 12% CAGR over FY10-12E for domestic tractor volumes. This will be on the back of (a) increasing mechanization, (b) growing affordability, (c) rising labor shortage in rural India, and (d) increasing labor cost. We expect Escorts to achieve higher-than-industry growth, at 15% volume CAGR for tractors, and gain market share over the next two years, led by:

- **Innovative product launches:** Escorts is bringing innovative products, such as inverter tractor, to satisfy the different needs of the customers.
- **Improving presence in South India:** Escorts, traditionally weak in South India, is expected to gain market share in the region on the back of (a) offering South India-specific products and (b) bolstering dealer network.
- **Reinforcing the sales force:** In order to penetrate the market, Escorts is re-jigging its operations and ramping up its sales force.

Construction business to achieve scale

Indian construction equipment industry is expected to show ~20% volume CAGR over the next five years. ECEL has built leadership in the niche segment of Pick 'n' carry cranes. We expect it to achieve significant scale, by posting 16% revenue CAGR over FY10-13E. We expect a reversal of EBITDA margin contraction from FY11 and doubling of EBITDA margin to 6% by FY13. This is on account of cost-reduction initiatives, development of new products which enjoy higher margins, and an already improving product mix.

We forecast 14% CAGR in standalone revenues over FY10-13E

Revenue growth strong; margins & EPS growth to follow

We expect strong revenue momentum across all key verticals. We forecast 14% CAGR in standalone revenues over FY10-13E, driven by the Agri Machinery Group which is likely to post revenue CAGR of 15%. However, a surge in commodity price and increased marketing costs for its South India operations would push margin recovery & EPS growth from FY12 onwards. We expect back-ended 24% CAGR over FY10-13E in standalone profit, driven by (a) 14% revenue CAGR, (b) 120bp EBIT margin gains due to operating leverage and (c) lower interest cost.

Attractive base valuations

At 7x Mar'12E consolidated EPS, Escorts trades at a huge discount to industry leader M&M and most of the auto companies under our coverage. On account of its strong growth, Escorts' tractor business should re-rate to 10x Mar'12E EPS (valued at Rs150/sh), which represents a 20% discount to our target multiple for M&M. We value ECEL at an early-cycle multiple of 7x Mar'12E EV/EBITDA (Rs16/sh).

Risks & concerns

Fall in tractor demand

A decline in tractor demand could severely hurt top-line as well as utilization, potentially leading to the company reporting losses once again

Poor agricultural growth could impact tractor demand. Escorts derives about 70% of its consolidated revenues from its tractor business. A fall in demand could severely impact its top-line as well as utilization, which would push the company into making losses once again.

Surge in input price

Raw materials, steel and aluminum are the key, accounting for 70% of the total costs. Any sharp increase in their prices would impact Escorts' profitability.

Delay in turnaround in non-agri business

The non-agri business has been a drag on Escorts' profitability. We expect the construction equipment business to expand its margins on account of better product mix and higher utilization. Any delay in achieving this would lead to a stress on the firm's overall profitability.

Table 1: Bull & Bear case

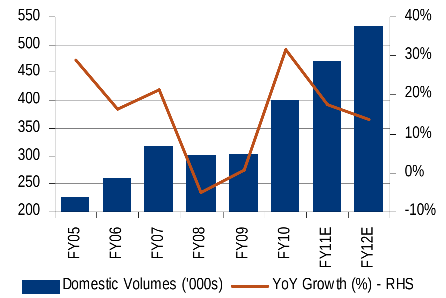
Theme	Bull Case	Bear Case	BofA-ML View
Demand	▪ Very good monsoons to result in a bumper agri harvest, leading to a very strong tractor sales. Better rural connectivity increases haulage demand. ▪ Stronger-than-expected pick up in construction activity to augment agri demand.	▪ Poor monsoons will lead to low demand for tractors. ▪ Fall in construction activity to further impact tractor sales.	▪ We believe a normal monsoon will keep the tractor demand strong, enabling Escorts to achieve ~15% volume CAGR over FY10-13E. ▪ We also believe the construction activity will augment agri demand only on a smaller scale.
Margin	▪ Higher utilization to result in an improvement in margins.	▪ Margins do not improve despite higher utilization on account of higher costs.	▪ We expect Escorts to improve its AMG margins moderately by 130bp over FY10-13E.
South India presence	▪ On the back of new strategies, Escorts is able to improve its market share in south India from ~5% to ~7.5%, which it had achieved in FY07.	▪ Escorts is not able to arrest the market share loss in South India.	▪ We expect Escorts to achieve small market share gains in South India on the back of new product launches and sales force ramp-up.
Export pick up	▪ Escorts is able to make inroads into overseas markets, resulting in higher tractor sales.	▪ Export remains muted.	▪ African focus to yield moderate export pick up.
Non-agri business turnaround	▪ Auto component business shows faster-than-expected recovery and achieves break-even in FY11. ▪ Construction equipment subsidiary achieves faster turnaround, and posts strong profit growth.	▪ None of the non-agri businesses turns around; they continue to post disappointing results.	▪ We expect the auto component business would continue to post losses for at least the next two years. ▪ We also expect the construction equipment business to show marginal improvement, and achieve an EBITDA margin of ~4% in FY11.
Interest rates	▪ Interest rates for the farmers to come down.	▪ Interest rates for the farmers rises.	▪ We continue to expect interest rates to be benign for the farmers and would have a muted impact if they go up.

Source: BofA Merrill Lynch Global Research

Tractors: Demand is structural

The tractor industry in India currently has structural demand drivers in place, especially with the government focus on rural India through steps such as raising minimum support price (MSP), interest subvention schemes, setting up of agricultural export zones, NREGA scheme, loan waivers – all of which boost the financial health of farmers. These factors, along with lower degree of agricultural mechanization, will keep the demand for tractors strong in the near to medium term.

Chart 3: Tractor vol - Structural growth story



Source: BofA-ML Global Research

We forecast 12% volume CAGR

Led by the strong demand, we forecast tractor volumes to achieve a 12% CAGR over FY10-12E. Despite a drought year, FY10 witnessed a 30% surge in domestic tractor volumes. We continue to expect a strong run-rate over the next two years.

Agriculture: Key area of government focus

The first leg of India's growth story had been urban driven, when services took the lead in terms of growth. However, with government's increased emphasis on equitable growth, the agriculture sector is the next focus area as it employs two-thirds of India's working population. To improve productivity and yields, the Indian agriculture sector would take steps to increase mechanization, moving away from its present labor-intensive nature.

Govt focus on agriculture a strong positive for AMG business

Mechanization the only way forward

Farm growth can be achieved by a variety of steps (as shown in table 2). However, the other vectors of farm growth may not be implementable in the short term and so more focus would be on mechanization as an enabler of improved productivity and yields.

Table 2: Vectors of farm growth: Mechanization the only way forward

Vectors of farm growth	Implementable in short duration	Comment
Breakthrough seeds	No	No new breakthrough seeds have been developed in recent times
Fertilizers	No	Fertilizer usage already high in India
Pesticides	No	Pesticide usage already high in India
Irrigation	No	Not implementable in a short duration
Mechanization	Yes	Easily implementable as Indian agri sector is still very labor intensive in nature

Source: BofA-ML Global Research

Table 3: MSP has almost doubled in the last 5 years

Rs./ Quintal	Rice	Wheat	Pulse (Tur)	Cotton	Sugarcane
FY00	490	580	1105	1575	56.1
FY01	510	610	1200	1625	59.5
FY02	530	620	1320	1675	62.1
FY03	530	620	1320	1675	69.5
FY04	550	630	1360	1725	73.0
FY05	560	640	1390	1760	74.5
FY06	570	650	1400	1760	79.5
FY07	580	750	1410	1770	79.5
FY08	645	1000	1550	1800	80.3
FY09	850	1080	2000	2500	81.2
FY10	950	1100	2300	2500	107.8
FY11E	1030	1120	2400	2600	110.0

Source: BofA-ML Global Research

Increasing affordability

Rural income, a key factor influencing tractor demand, has been growing at a steady rate over the past few years, largely led by (a) rise in MSP for most crops, and (b) good Rabi crop followed by a good Kharif crop. Another key positive is the increased access to credit for the farmers.

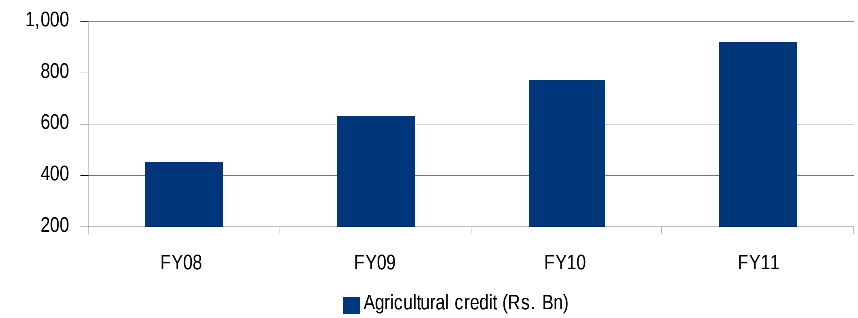
Rise in MSP helping farmers

In order to incentivize the farm sector, the government has been raising the MSP for most crops substantially over the past few years. This has greatly improved the profitability of most crops and enriched farmers who are a key driver for tractor demand.

Access to credit at low cost

Agricultural credit along with other rural spend has been going up steadily over the past five years. This, coupled with the loan waiver scheme, has greatly enhanced the affordability of the farmers, thus increasing their discretionary spends. Banks have significantly increased their lending to the agricultural sector.

Chart 4: Agri credit has almost doubled in 4 yrs



Source: BofA-ML Global Research

Table 4: Increasing rural spend

Rs. Bn	FY08	FY09	FY10	FY11
Agricultural credit (Rs. Bn)	450	633	768	921
NREGA	120	300	391	401
PMGSY	61	72	103	172
Rural housing	36	79	79	93
Rural spend	667	1,085	1,341	1,587

Source: BofA-ML Global Research

NREGA & other Govt schemes leading to labor shortages

The National Rural Employment Guarantee Act (NREGA) has enabled rural laborers to get a job with a minimum wage of Rs100 per day. Other government initiatives such as PMGSY (Pradhan Mantri Gram Sadak Yojna) and Bharat Nirman have also generated significant employment for landless laborers who were earlier employed by land-owning farmers for unskilled farm work. The indirect impact of such government initiatives is two-fold:

1. Lower availability of farm labor, and
2. Increase in cost of labor

This appears to have encouraged the land-owning farmers to opt for increased farm mechanization and buying more tractors.

New products & alternate usage augmenting traditional sales growth

Traditionally tractors were used by farmers who had large land-holdings as it was not economical to use the available high-HP tractors on small land pieces.

With the launch of small-HP tractors, it makes economical sense to use tractors even for small land-holdings.

Smaller-HP tractors and other multi-purpose innovative tractors have caught the attention of farmers with small land holding who earlier relied only on farm labor. Another area of demand for sub-40 HP tractors is from:

- **Rural transport:** The govt's thrust on rural connectivity by way of PMGSY, etc has led to the construction of paved roads. Tractors have successfully replaced bullock carts as the preferred mode of haulage and transport of agricultural produce.
- **Usage in other areas:** Tractors have recently found usage in the construction sector as well. They are often used to transport waste, soil/sand etc. They are also used by airlines/ hotels for hauling luggage.

Escorts: On road to recovery

We expect Escorts to be one of the key beneficiaries of the improved industry dynamics in its core business of tractors. Other smaller businesses of the firm are also going to benefit from the modernization drive of the Indian Railways and the construction boom.

Making amends

Escorts diversified into many unrelated businesses during the past two decades. This had a negative impact on its core tractor franchise, due to (a) lack of management focus, and (b) deterioration of balance sheet because of high gearing. Over the past few years, Escorts had been hiving off its non-core businesses and has been successful in bringing down the gearing. The new corporate structure is much simpler with a lot of focus on the core tractor business.

Table 5: Escorts share(%) in different segments

Seg	FY04	FY05	FY06	FY07	FY08	FY09	FY10
0-30 HP	19.4	11.7	13.4	8.6	7.1	7.5	9.2
31-40 HP	11.7	6.9	11.7	13.3	14.7	14.0	13.4
41-50 HP	18.5	11.5	16.1	17.6	16.7	17.5	17.7
50+ HP	2.2	2.8	3.8	5.3	6.4	9.7	10.7

Source: BofA-ML Global Research

Tractors should be the main growth driver

With increased focus on the tractors vertical post the business restructuring, we expect Escorts to grow ahead of the industry and gain market share. We expect tractors to remain the dominant business of Escorts, with 70% share in consolidated revenues and a 14% CAGR over FY10-13E.

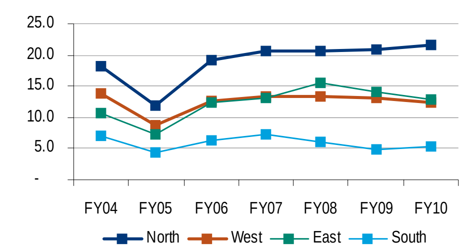
New products and branding

Historically, Escorts has dominated the market for high-end tractors (41-50HP). It has the highest market share in this category, at 16-20%. On the other hand, Escorts has only one tractor model in the sub-30 HP category, which has limited its growth. The company, therefore, plans to gain market share in the lower-HP market with the launch of new products. It also plans to launch 8-10 new variants in different categories which would help sustain growth.

Differentiated product portfolio in the pipeline

Escorts is trying to introduce innovative products which would be able to differentiate themselves from competition and satisfy the different needs of the customer. For example, it recently launched inverter tractor, rice puddlers, etc. which cater to the other needs of the customer apart from the core need.

Chart 5: Escorts market share in different regions- Lagging behind in South India



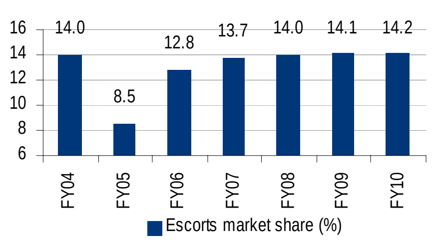
Source: BofA-ML Global Research

Focus on South Indian market

While Escorts is very strong in the North Indian market (21% share), it has very little presence in South India. The company's South Indian market share is at 4.8% as of 1HFY11, after having lost around 350bp of market share in the past five years. To improve its standing in South India, Escorts has started taking steps such as:

- **Launching products specific to South India's needs:** Escorts has launched South India-specific products such as rice-puddlers which can work in deep water as well. This is expected to enhance its market share in the region.
- **Bolstering the dealer network:** Traditionally, Escorts has had a very poor dealer network in South India, which it is in the process of rectifying. Increase in dealer network will help the company push sales into the region.
- **Sales-force re-jig:** Escorts is re-jigging its sales force by placing some of its successful sales managers in South India, to help implement its new strategy.

Chart 6: Gaining market share



Source: BofA-ML Global Research

Expect market share gains

We expect Escorts to gain market share over the next two years led by (a) innovative product launches, (b) improving presence in South India, and (c) reinforcing its sales force.

Focus on exports

In order to boost sales, Escorts has increased its focus on overseas markets, especially Africa. The firm had won a Tanzanian Govt. order for 1,430 tractors in FY10. It is planning two offices in Africa to widen its reach in the African market. We expect exports to become significant after 3-4 years.

Railway equipment business- Steady state

Escorts is one of the major manufacturers of railway components in India. It has partnered Indian Railways for a long time and has a very broad product portfolio of brakes, couplers, shock absorbers etc. Although the current railways business is small (7% of total sales), it is expected to benefit from the railways modernization which India would have to implement eventually. We forecast railways business revenues to grow at a steady 10% CAGR over FY10-13E and maintain EBIT margin of ~10%.

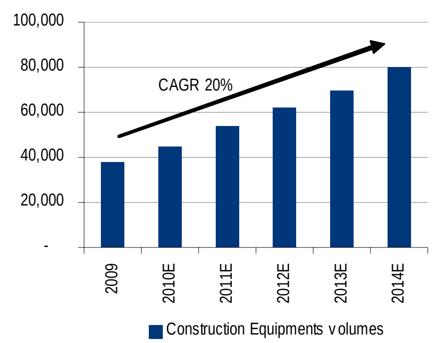
Indian Railways: Upcoming modernization & expansion

Indian Railways is expected to increase its capacity by adding more lines as well as doubling existing lines in the next 10 years. It plans to lay 2500 km of new lines and double or multiple ~30000 km of rail route by 2020. Escorts has been involved with Indian Railways for the past 3-4 decades and has forged strong relationships. This modernization and expansion drive would enable Escorts to get continuous orders.

Auto component business- still to recover

Escorts is one of the major manufacturers of auto suspension products including shock absorbers and automotive products including die casting components, brake shoes and clutch plates. This is a small business (~4% of revenue) with very few clients. It has currently very low utilization leading to EBITDA-level losses. We expect Escorts to continue making small losses in this segment over the next few years due to no significant change in strategy.

Chart 7: Construction equipments vol. growth



Source: Company update, BofA-ML Global Research

Construction equipment- riding the boom

ECEL is a wholly owned subsidiary of Escorts Ltd and is engaged in manufacturing and selling construction equipments like cranes, forklifts and loaders. It also has collaborations with various global players whose products are marketed by Escorts in India.

Construction equipment demand strong on high infra spend

The sharp spurt in infrastructure spend over the 11th and 12th 5-year plan is expected to keep the construction equipment demand strong. Total infrastructure spend for India is forecast to go up from ~5% (~$200bn) of GDP in the 10th 5-year plan to around 9% (~$1tn) of GDP in the 12th 5-year plan.

Table 6: Rising infra spend

	Tenth Plan (Anticipated)			Eleventh Plan (Projected)		
	Rs. Bn	USD Bn	Sectoral Share	Rs. Bn	USD Bn	Sectoral Share
Electricity (incl NCE)	2,919	65	33.1%	6,165	137	30%
Roads and Bridges	1,449	32	16.5%	3,118	69	15%
Telecom	1,234	27	14.0%	2,670	59	13%
Railways (incl MRTS)	1,197	27	13.6%	2,580	57	13%
Irrigation (incl Watershed)	1,115	25	12.7%	2,231	50	11%
Water Supply & Santitation	648	14	7.4%	1,991	44	10%
Ports	41	1	0.5%	739	16	4%
Airports	68	2	0.8%	347	8	2%
Storage	48	1	0.5%	224	5	1%
Gas	87	2	1.0%	205	5	1%
Total	8,806	196	100.0%	20,270	450	100%

Source: BofA-ML Global Research, planning commission

Financial Analysis

Over the near term, we expect Escorts to reap the benefits of the restructuring of its businesses over the past few years. We expect a 22% CAGR over FY10-13E in standalone profit driven by (a) 14% revenue CAGR, (b) 100bp EBIT margin gains due to operating leverage and (c) lower interest cost.

Revenue momentum across segments

We expect a 14% CAGR in standalone revenues over FY10-13E driven primarily by the Agri Machinery Group, which will likely achieve a revenue CAGR of 15%. Railway equipment business and auto ancillary product group are expected to clock 12% and 10% CAGR, respectively, over FY10-13E.

Agri Machinery Group, the key driving unit

Agri Machinery Group (AMG) which manufactures farm equipments is the key unit contributing about 88% of standalone revenues and 99% of standalone EBIT in FY10. AMG showed a strong 30% growth in sales in FY10 and is expected to record a 15% revenue CAGR over FY10-13E. Improving utilization would add 130bp to its EBIT margin over FY10-13E.

Railways & auto parts biz to show only small improvements

While both railways and auto parts business are expected to show modest top-line growth over FY10-13, margins for these divisions would remain under pressure on account of (a) lower margin products in railways and (b) lower utilization in the auto parts business.

Table 7: Revenue break up

	Revenue (Rs mn)				Growth rate				CAGR
	FY10	FY11E	FY12E	FY13E	FY10	FY11E	FY12E	FY13E	FY10-13
Agri Machinery Products	24738	29846	33595	36376	30%	21%	13%	8%	14%
Auto Ancillary Products	1109	1324	1478	1552	28%	19%	12%	5%	12%
Railway Equipment	1978	2108	2371	2606	-1%	7%	12%	10%	10%

Source: BofA-ML Global Research

Margins to expand 120bp…

We forecast 120bp standalone EBIT margin expansion over FY10-13E. This is driven by 150bp improvement in AMG EBIT margins over FY10-13E on account of improvement in utilization in its tractor business from 61% in 2010 to 87% in 2013E.

…but mostly from FY12E

We expect margins to decline by 100bps in FY11E on account of (a) a sharp rise in commodity prices (16% YoY increase in steel price & 10% YoY increase in aluminum price) and (b) increased marketing spend to improve market position in South India. We expect the benefit of operating leverage to kick in with a lag reflected in margin expansion from FY12E.

Table 8: Segment-wise EBIT Margins

Segmental EBIT Margin	FY09	FY10	FY11E	FY12E	FY13E
Agri Machinery Products	8.0%	9.0%	8.4%	9.9%	10.5%
Auto Ancillary Products	-12.2%	-15.6%	-18.0%	-17.0%	-15.0%
Railway Equipment	20.2%	11.5%	9.0%	9.5%	10.0%
Total EBIT Margins	8.3%	8.3%	7.3%	8.8%	9.5%

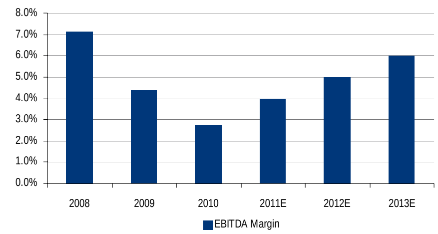
Source: BofA-ML Global Research

EPS growth back-ended; to pick-up from FY12

We expect benefits of rising utilization and better volumes to translate into strong EPS growth from FY12E. We forecast about 24% standalone PAT CAGR over FY10-13E, largely driven by:

- Sales growth of ~14% on the back of ~15% increase in tractor sales over FY10-13E.
- EBIT margin gain of ~130bp over FY10-13E on the back of improving utilization.
- Lower interest cost as the company becomes net cash surplus in FY12.

Chart 8: ECEL EBITDA Margins (%)



Source: BofA-ML Global Research

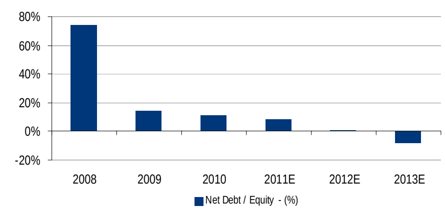
Construction business to show recovery

ECEL accounts for around 16% of the consolidated revenues. We expect a 16% CAGR in ECEL revenues over FY10-13E. We also expect a reversal of EBITDA margin contraction from FY11 onwards on account of cost-reduction initiatives, development of new products which enjoy higher margins, and an already improving product mix. The company can potentially surprise on the margin front if it delivers on all these aspects.

Balance sheet no longer a concern

Escorts has cut its debt over the past few years by (a) monetizing its non-core businesses and (b) conversion of FCCBs. We expect Escorts to become net cash positive in FY12E.

Chart 9: Net cash in FY12



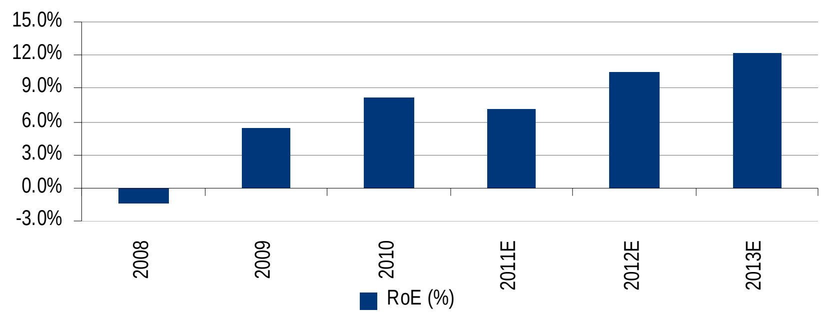
Source: BofA-ML Global Research

RoE set to improve

Escorts is expected to improve its RoE to 12.2% from -1.4% over FY08-13E. This is on account of:

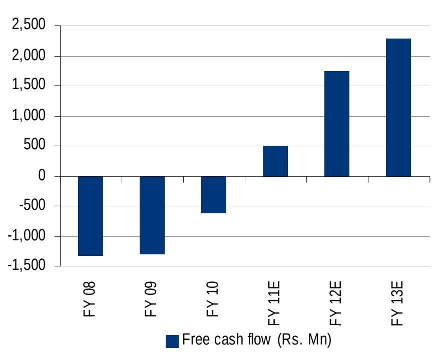
- Improving utilization from sub-40% to around 88% over the same period.
- Improving EBITDA margins from 5.2% to 8.7% over FY08-13E.

Chart 10: RoE to recover



Source: BofA-ML Global Research

Chart 11: Improving free cash flows



Source: BofA-ML Global Research

Low capex requirement

The utilization for most of Escorts' businesses is currently low with the tractor business utilization at around 61%. We do not foresee any significant capex spend over the next 2-3 years. The company has guided for a very small capex plan of Rs1.45bn over FY11-13E to upgrade its existing facility.

FCF to turn positive in FY11

We expect free cash flow (FCF) to turn positive for Escorts from FY11 on account of (a) increasing profits, (b) lower capex requirements, and (c) working capital discipline.

Valuations- Buy for 40% upside

We believe Escorts should be valued on sum-of-the-parts basis as its construction equipment business and core tractor business are in different stages of recovery. While the tractor business has already returned to profitability, its construction business is expected to turn around only in FY11. Our PO of Rs166 is based on sum-of-the-parts of Escorts' core tractor business and its construction equipment subsidiary. We value Escorts' core tractor business at 10x Mar'12E EPS (value Rs150/share) which is at a 20% discount to our industry leader M&M's target multiple. Construction equipment business (ECEL) is valued at 7x Mar'12E EV/EBITDA (Rs16/share).

Trades at a discount to other auto companies

Escorts trades at a discount to most of the auto companies under our coverage and especially vs M&M, another tractor major. Escorts is currently trading at 8x FY11E consolidated EPS, which represents ~40% discount to M&M on FY11E EPS. However, as the company's tractor business has recovered and is expected to show strong 20% EPS CAGR over FY10-13E, we believe this discount should narrow.

Table 9: Peer valuation

	P/E (x)			EV/EBITDA (x)			P/BV (x)			EV/Sales (x)		
	FY10	FY11	FY12	FY10	FY11	FY12	FY10	FY11	FY12	FY10	FY11	FY12
Escorts Limited	8.2	9.5	5.9	5.1	4.4	2.7	0.7	0.7	0.6	0.4	0.3	0.2
M & M	17.1	12.4	11.1	8.4	6.9	5.7	3.9	2.9	2.3	1.5	1.1	0.9
Maruti Suzuki	14.4	15.3	12.1	7.9	8.4	6.8	3.1	2.6	2.1	1.1	0.9	0.7
Ashok Leyland	16.8	12.5	9.7	11.2	7.6	6.2	2.0	1.8	1.6	1.2	0.8	0.7
Tata Motors	62.2	8.2	7.4	12.2	5.8	5.0	9.1	3.6	2.3	1.1	0.8	0.7
Bajaj Auto	22.6	16.1	14.6	15.5	12.0	11.2	14.7	8.6	5.9	3.3	2.4	2.1
Hero Honda	13.8	15.2	12.8	10.6	12.1	10.2	8.9	6.7	5.2	2.0	1.6	1.4
TVS Motor	73.7	18.7	11.3	12.8	8.0	6.1	4.2	3.6	2.9	0.6	0.4	0.4

Source: BofA-ML Global Research

ECEL gives a value of Rs16 per share

We value ECEL separately as we believe it is at a different stage of recovery vs the parent. At 7x FY11E EV/EBITDA, the valuation comes to Rs26 per share. The higher multiple is justified as ECEL is still in the early stage of recovery.

Table 10: Value of ECEL

ECEL	Rs. Mn
2011E EBITDA	276
2012E EBITDA	396
Mar'12E EBITDA	336
7X FY11E EBITDA	2,353
EV of ECEL	2,353
Debt of ECEL	820
Equity Value	1,533
Per share equity value (Rs)	16

Source: BofA-ML Global Research

Price objective basis & risk

Escorts Limited (XSOCF)

Our PO of Rs166 is based on sum of parts of the constituent businesses. We value (1) standalone business at 10x Mar'12E EPS (Rs150/share), a 20% discount to the target mulitple for our industry leader M&M, and (2) Escorts Construction Equipment Ltd (ECEL) at a multiple of 7x Mar'12E EV/EBITDA (Rs16/share). Downside risks: Slowdown in the economy and increasing competition that would adversely affect volume growth, and rising input costs.

Link to Definitions

Industrials

Click here for definitions of commonly used terms.

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India - Autos Coverage Cluster

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	Eicher Motors	XEICF	EIM IN	S.Arun
	Escorts Limited	XSOCF	ESC IN	Anand Kumar
	Hero Honda	HRHDF	HH IN	S.Arun
	M & M	MAHHF	MM IN	S.Arun
	M & M -G	MAHMF	MHID LI	S.Arun
	Maruti Suzuki India	MUDGF	MSIL IN	S.Arun
	Tata Motors	XTXMF	TTMT/A IN	S.Arun
	Tata Motors Ltd.	TENJF	TTMT IN	S.Arun
	Tata Motors Ltd.	TTM	TTM US	S.Arun
	TVS Motor	XFKMF	TVSL IN	S.Arun
NEUTRAL				
	Ashok Leyland	XDBVF	AL IN	S.Arun
UNDERPERFORM				
	Bajaj Auto	XBJBF	BJAUT IN	S.Arun

***iQ**method* SM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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Buy	59	64.13%	Buy	35	71.43%
Neutral	15	16.30%	Neutral	7	58.33%
Sell	18	19.57%	Sell	3	20.00%

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Sell	798	21.37%	Sell	276	36.75%

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
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Underperform	N/A	≥ 20%

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