23 December 2009

BSE Sensex: 17231

INDIA RESEARCH

Bajaj Auto

Rs1706

UPGRADE TO OUTPERFORMER

COMPANY UPDATE

Mkt. Cap: Rs247bn; US$5.3bn

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Key valuation metrics

As on 31 March (Rs m)	FY06	FY07	FY08	FY09	FY10E	FY11E
Net sales	76,290	95,204	90,461	88,103	117,140	136,854
% growth	*28.7*	*24.8*	*(5.0)*	*(2.6)*	*33.0*	*16.8*
EBITDA	12,947	13,849	13,084	11,921	24,163	25,989
% margin	*17.0*	*14.5*	*14.5*	*13.5*	*20.6*	*19.0*
Net Profit before extra-ordinary items	11,016	12,549	8,689	6,783	15,189	18,628
Shares in issue (m)	101	101	145	145	145	145
Adj. EPS (Rs)	108.9	124.0	60.1	46.9	105.0	128.8
% growth	*44.9*	*13.9*	*(51.6)*	*(21.9)*	*123.9*	*22.6*
PE (x)	15.7	13.8	28.4	36.4	16.3	13.3
Price/Book (x)	3.6	3.1	15.5	13.2	7.8	4.1
EV/EBITDA (x)	14.4	13.6	19.8	21.9	10.2	8.4
RoE (%)	24.7	24.4	24.4	39.2	60.3	40.7
RoCE (%)	18.4	17.3	21.8	26.4	48.6	37.6

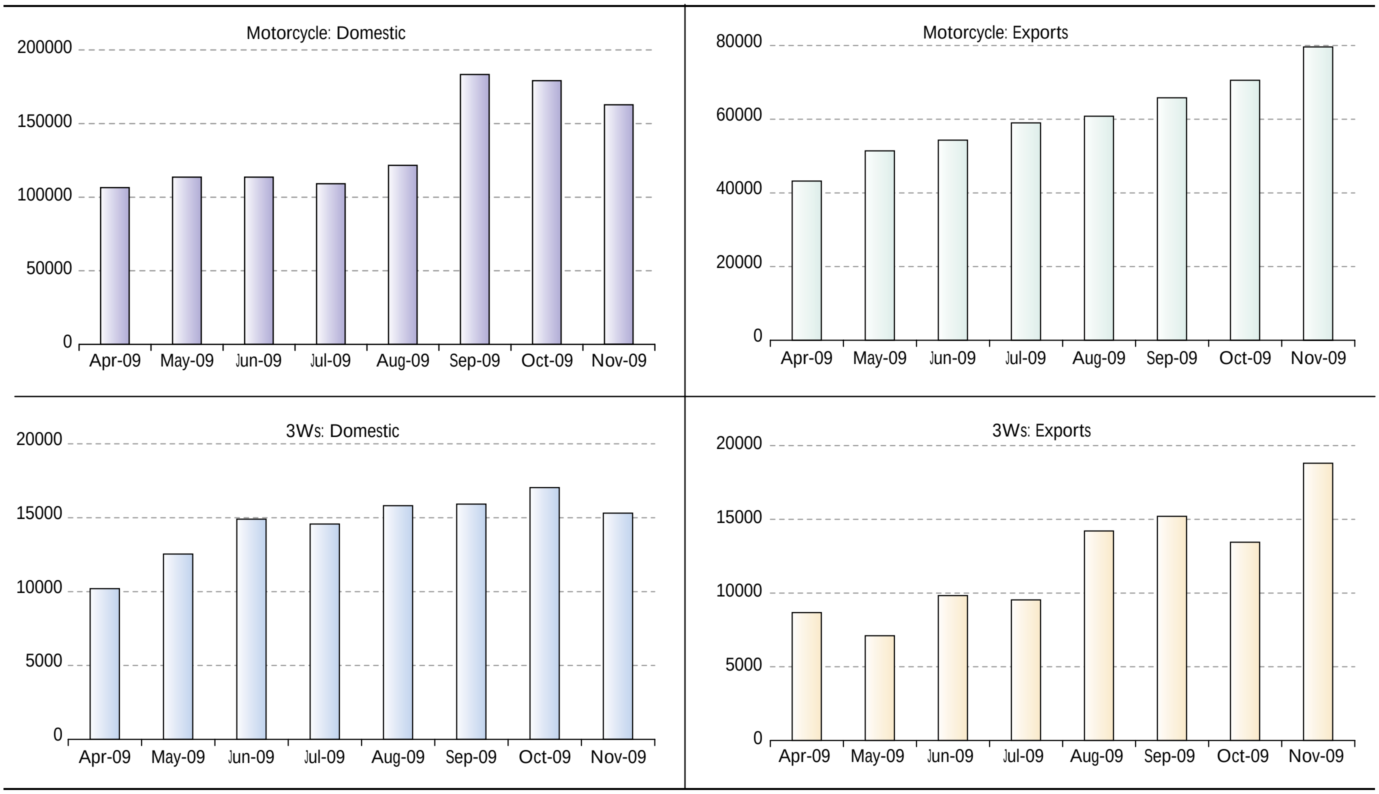
Source: Company data, IDFC-SSKI Research

Bajaj Auto (BAL) has witnessed a jump in volumes across segments over the last few months with 280,000 units sold in November 2009 against the average monthly volumes of 205,000 units in H1FY10. While this has clearly come as a positive surprise, volume growth has come mainly from Discover100cc and the Pulsar family. Going forward, the recently launched Pulsar135cc, albeit potential cannibalization within the Pulsar family, is expected to bring in incremental volumes. Exports (both of 2Ws and 3Ws) too have significantly recovered with 98,417 units sold in the overseas markets in November against 51,887 units in April 2009. Notably, the management is confident of maintaining the export momentum (at least 80,000 units a month) over the next few months. In the 3W business, domestic offtake is expected to remain robust in H2FY10 led by opening up of new permits in various states. On the operational front, we believe the impact of rising raw material prices on margins would be partially offset by better operating leverage in H2FY10. Given the fact that INR has been steady against USD (at 46-47 levels) over the last couple of months indicates that BAL would likely be able to hedge its FY11 exports at favorable rates. Resultant, our estimates factor in only 160bp margin decline in FY11 to 19%. Given the strong volume momentum across business segments and high earnings visibility going forward, we upgrade the stock to Outperformer with a price target of Rs2,060.

❑ Significant volume ramp-up over the last few months comes as a positive surprise

BAL, driven by new model launches including Pulsar variants (150cc, 180cc and 220cc) and Discover100cc, has witnessed strong growth in domestic volumes over the last few months. Notably, BAL's average domestic monthly run rate for motorcycles has now gone up to 175,000 units – up 57% from the Q1FY10 average of 110,000 units. Similarly, average monthly motorcycle export volumes have gone up to 72,000 units – up 45% from the Q1FY10 average of 50,000 units. For 3Ws, volumes have increased to a monthly average of 32,000units – up 51% from the Q1FY10 average of 21,000 units.

Robust volume ramp-up across product segments



Source: Company

New model launches/ Upgrades have helped boost volumes

Model	Launch date
XCD135cc	Feb'09
Pulsar150cc	May'09
Pulsar180cc	May'09
Pulsar220cc	Jun'09
Discover100cc	Jul'09
Pulsar 135cc	Dec'09

Source: Company, IDFC-SSKI Research

❑ Bajaj exits the scooter segment; to focus on four core brands

BAL has decided to exit the scooter segment by the end of this fiscal as Kristal – the sole product in the segment – has failed to entice customers. We believe BAL's exit from the scooter segment would help it focus on the more profitable motorcycle segment. BAL has now divided its 2W and 3W businesses under four core brands – *Bajaj*, *KTM*, *Boxer* and *Re*. The company intends to use the brand *Bajaj* only for commuter and sports motorcycles sold in India while *KTM* would be leveraged to brand premium category bikes. BAL has also decided to use brand *Boxer* for low-cost motorcycles, which are being manufactured in China and exported to various countries in Africa and Brazil. Further, all new commercial vehicles would no longer have the *Bajaj* tag and will be brought under a new brand name called *Re* – indicating the rear engine which has been popular in 3Ws.

❑ Discover100cc and Pulsar family likely to be the key volume drivers in FY11

BAL has decided to leverage its two key brands – *Discover* (for commuting) and *Pulsar* (sporty), which have led its revival in the domestic market. While it is still early to comment on its success, Discover100cc has been well accepted in the domestic market – evident in the fact that ~72,000 units have been sold per month over the last three months. We expect volumes to stabilize at ~85,000 units a month for the Discover family (100cc & 135cc) going forward. BAL recently unveiled its new Pulsar135cc, priced at Rs51,000 (ex-showroom Delhi), which would be available across showrooms from January 2010. Despite a potential cannibalization within the family (135cc, 150cc, 180cc & 220cc), the model is expected to provide incremental volume growth for the company. BAL targets to sell ~1m units of the Pulsar family in FY11.

❑ Motorcycle exports outlook appears strong

At 79,617 units, BAL reported its highest-ever motorcycle exports in November 2009 – up 84% from the low witnessed in March 2009. The strong performance has been driven by Boxer, which continues to do well in the African market. With the launch of the new Dicosver100cc and Pulsar135cc, export volume momentum is likely to accelerate Q4FY10 onwards. We take comfort in the fact that BAL management appears to be extremely confident of maintaining the current export momentum. Our estimates factor in 31%yoy growth in exports in FY11, which translates into a monthly hit rate of 87,000 units.

❑ 3W momentum to be robust in FY10, led by opening up of new permits and exports

The domestic 3W passenger segment has recovered smartly over the last few months on the back of opening up of permits by some state governments, including Mumbai and Delhi, for plying energy-efficient 3Ws. BAL has been the key beneficiary of these new permit issuances and has seen a higher monthly 3W volume run-rate of ~15,000 units in the domestic market against ~11,000 units in FY09. Further, led by strong demand from export markets, BAL recorded its highest-ever monthly 3W exports in Nov09. At 18,800 units, 3W exports are up >2x the monthly export volumes witnessed at the beginning of the fiscal. Overall, 3W volume momentum is likely to be sustained for the next 7-8 months – led by strong domestic demand as well as sustained demand from key export markets (Latin America, Bangladesh, Sri Lanka, Egypt, etc).

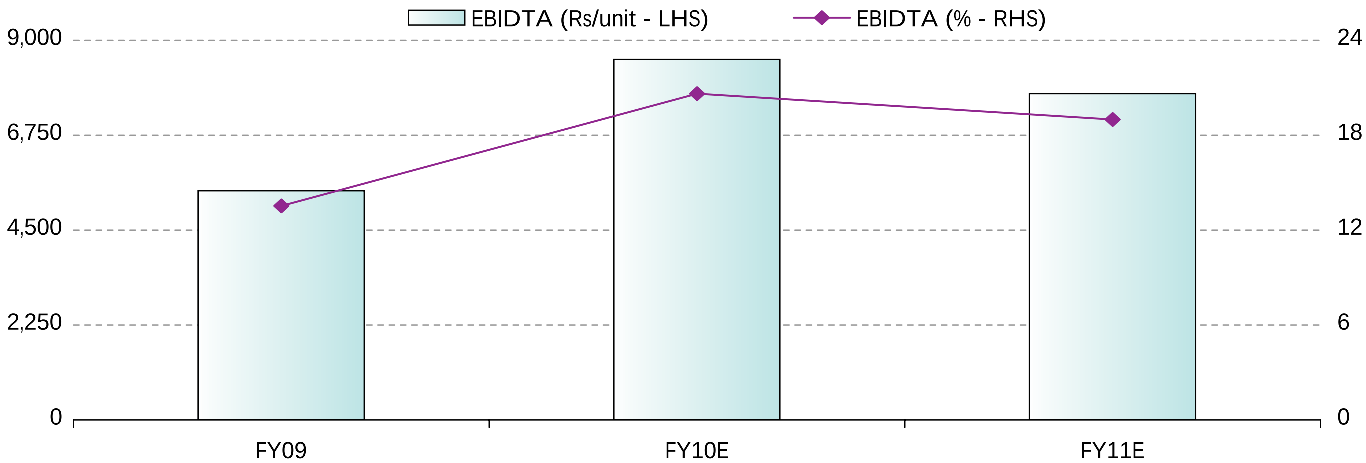
Bajaj Auto – key volume assumptions

	FY09	FY10E	FY11E
Motorcycles	**1,907,810**	**2,487,845**	**2,993,039**
yoy (%)	*(10.8)*	*30.4*	*20.3*
Domestic	1,276,427	1,686,723	1,944,883
yoy (%)	*(23)*	*32.1*	*15.3*
Exports	631,383	801,122	1,048,156
yoy (%)	*31.1*	*26.9*	*30.8*
Total 2 Wheelers	**1,919,852**	**2,492,929**	**2,993,039**
yoy (%)	*(11.2)*	*29.9*	*20.1*
Three Wheelers	274,526	334,080	367,500
yoy (%)	*(5.4)*	*21.7*	*10.0*
Total	**2,194,378**	**2,827,009**	**3,360,539**
yoy (%)	*(10.5)*	*28.8*	*18.9*

❑ Rising cost pressures to be partially offset by better operating leverage, improved product mix

Prices of commodities including steel, aluminium, crude oil, rubber, etc have all gone up in H1FY10. Resultant, raw material costs for auto OEMs are likely to significantly increase in H2FY10. However, a favorable product mix and robust volume offtake are expected to mitigate the impact of higher input prices on BAL. Further, we expect BAL to be able to hedge its FY11 export realization at favorable rates given that INR has been steady (at an exchange rate of 46-47 levels) against the USD over the last couple of months. To account for the rising cost pressure, we have assumed a 160bp decline in BAL's operating margins in FY11 to 19%.

Operating leverage and favorable product mix to partially offset raw material cost pressure



Source: IDFC SSKI Research

❑ Earnings raised by 9% for FY10E and 22% for FY11E to factor in the robust volume ramp-up

On account of the better-than-expected volume rate in both 2W and 3W businesses (domestic as well as export sales) as also led by a much-improved volume outlook for FY11, we have raised our earnings estimates for BAL by 9% for FY10 to Rs105 and by 22% for FY11 to Rs129.

Estimates revised upwards by 9% for FY10 and by 22% for FY11 led primarily by strong volume outlook

	Earlier		Revised		Revision (%)	
	FY10E	FY11E	FY10E	FY11E	FY10E	FY11E
2W volumes	2,312,608	2,536,615	2,492,929	2,993,039	7.8	18.0
3W volumes	324,488	353,498	334,080	367,500	3.0	4.0
EPS (Rs)	96	105	105	129	9.2	22.5

Source: IDFC SSKI Research

❑ Key concerns

Inability to ramp up volumes on expected lines

While it is still too early to comment on its success, Discover100cc has been very well received in the domestic market and the Discover family now contributes ~58% to BAL's domestic volumes. Inability of the model to maintain the volume momentum is a key risk to our estimates.

Financing concerns persist

Leading financial players (including private banks) have significantly curtailed their exposure to automobile financing, especially 2Ws, on account of the higher operating costs as well as increased delinquencies. While ICICI Bank has completely exited the 2W space, HDFC Bank too has substantially reduced its exposure to the sector. Also, stringent financing norms and a lower Loan to Value ratio (~25% down payment required) have only added to the woes of domestic 2W manufacturers. Going forward, though interest rates have reduced substantially, we do not expect financial institutions (particularly large private banks like ICICI Bank) to materially increase their exposure to this business in a hurry given the traditionally higher default rates here.

Increased competition may force a price war going forward

In the executive/ premium motorcycle categories, new players like Yamaha, Suzuki, etc have been aggressive on model launches to glean a share in the domestic market while existing 2W leaders are fiercely protecting their turf. Given that most 2W majors are currently witnessing record high margins, they may resort to price skimming as also offering discounts and freebies to lure customers in a bid to retain their respective market share.

Higher-than-expected increase in commodity prices may impact margins going forward

Prices of key commodities including steel, aluminium, crude oil, rubber etc have all gone up in H1FY10 and are expected to rise further in H2FY10 given a revival in the overall global economy. Any sharper-than-estimated movement in input costs may impact margins going forward.

❑ Valuations & View – upgrade to Outperformer

Bajaj Auto has witnessed a jump in volumes across segments over the last few months with 280,000 units sold in November 2009 against the average monthly volumes of 205,000 units in H1FY10. While this has clearly come as a positive surprise, volume growth has come mainly from Discover100cc and the Pulsar family. Going forward, the recently launched Pulsar135cc, albeit potential cannibalization within the Pulsar family, is expected to bring in incremental volumes. Exports (both of 2Ws and 3Ws) too have significantly recovered with 98,417 units sold in the overseas markets in November against 51,887 units in April 2009. Notably, the management is confident of maintaining the export momentum (at least 80,000 units a month) over the next few months. In the 3W business, domestic offtake is expected to remain robust in H2FY10 led by opening up of new permits in various states. On the operational front, we believe the impact of rising raw material prices on margins would be partially offset by better operating leverage in H2FY10. Given the fact that INR has been steady against USD (at 46-47 levels) over the last couple of months indicates that BAL would likely be able to hedge its FY11 exports at favorable rates. Resultant, our estimates factor in only 160bp margin decline in FY11 to 19%. Given the strong volume momentum across business segments and high earnings visibility going forward, we upgrade the stock to Outperformer with a price target of Rs2,060.

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2. Neutral: Within 0-10% to Index
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