Company In-Depth

25 April 2007 | 14 pages

Maruti Udyog (MRTI.BO)

Buy: Revise Target Price to Rs945

Rating change ☐
Target price change ☑
Estimate change ☑

- Revising target price downward — We cut our target price to Rs945 (from Rs1107) as we roll forward to FY09 estimates. Reduction in target multiple at 11x FY09E CEPS (vs 15x FY08E CEPS earlier) reflects our concerns on deteriorating core profitability, given escalating cost pressures, changing product mix and increasingly competitive environment.
- Revise earnings upward by 6-7% over FY08E/09E — EPS revised upward primarily on account of higher non operating income; lower depreciation estimates. Core profitability should remain under pressure – EBITDA margin forecasts reduced 100-150bps over FY08E/09E. We expect operating leverage benefits to mitigate impact of shrinking contribution margins.
- Disappointing 4QFY07 results — 4Q earnings were ~4% above our estimates – but buoyed by lower depreciation, and higher non operating income. Core profitability was impacted, with margins declining to 12.4% (down 330bps Y/Y, and around 130bps lower than our expectations. Management indicated that cost pressures will continue into FY08E.
- Market share the focus — MUL's strategy will be to increase the share of new models within the overall car population, to control the longer term pricing of these vehicles. We expect medium term profitability to remain under pressure, as new models' contribution is lower than that of current product range.
- Maintain Buy/Low Risk (1L) — Key risks: 1) continued margin pressure; 2) lower than forecast volumes growth.

Buy/Low Risk	**1L**
Price (24 Apr 07)	Rs794.40
Target price	Rs945.00
from Rs1,107.00	
Expected share price return	19.0%
Expected dividend yield	0.6%
Expected total return	**19.6%**
Market Cap	Rs229,510M
	US$5,531M

Price Performance (RIC: MRTI.BO, BB: MUL IN)

See Appendix A-1 for Analyst Certification and important disclosures.

Figure 1. Maruti Udyog – Statistical Abstract

Year to 31-Mar	Net Profit (Rs mm)	EPS (Rs)	EPS Growth (%)	P/E (x)	Price / CEPS (x)	EV / EBITDA (x)	P / Book (x)	ROE (%)	ROCE (%)
2006	12,130	42.0	42.1	18.9	15.3	11.0	4.2	24.2	34.7
2007P	15,620	54.1	28.8	14.7	12.5	8.9	3.4	25.4	36.8
2008E	17,124	59.3	9.6	13.4	11.0	7.9	2.7	22.5	32.8
2009E	19,714	68.2	15.1	11.6	9.3	6.7	2.3	21.2	31.3
FY 2010E	23,044	79.8	16.9	10.0	7.8	5.7	1.9	20.5	30.3

Source: Company, Citigroup Investment Research estimates

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	18.9	14.7	13.4	11.6	10.0
EV/EBITDA adjusted (x)	12.1	9.7	8.5	7.1	5.8
P/BV (x)	4.2	3.4	2.7	2.3	1.9
Dividend yield (%)	0.4	0.6	0.6	0.7	0.8
Per Share Data (Rs)					
EPS adjusted	41.99	54.06	59.27	68.23	79.76
EPS reported	41.16	54.06	59.27	68.23	79.76
BVPS	188.73	237.11	290.68	352.65	425.57
DPS	3.50	4.50	5.00	5.50	6.00
Profit & Loss (RsM)					
Net sales	120,871	146,539	166,896	206,121	246,098
Operating expenses	-107,110	-129,348	-148,209	-184,161	-220,115
EBIT	**13,761**	**17,191**	**18,686**	**21,960**	**25,983**
Net interest expense	-204	-376	-450	-600	-700
Non-operating/exceptionals	4,292	5,984	6,762	7,419	8,357
Pre-tax profit	**17,849**	**22,798**	**24,999**	**28,779**	**33,641**
Tax	-5,609	-7,179	-7,875	-9,065	-10,597
Extraord./Min.Int./Pref.div.	-349	0	0	0	0
Reported net income	**11,891**	**15,620**	**17,124**	**19,714**	**23,044**
Adjusted earnings	12,130	15,620	17,124	19,714	23,044
Adjusted EBITDA	16,615	19,904	22,426	27,058	32,259
Growth Rates (%)					
Sales	10.3	21.2	13.9	23.5	19.4
EBIT adjusted	44.9	24.9	8.7	17.5	18.3
EBITDA adjusted	16.8	19.8	12.7	20.7	19.2
EPS adjusted	42.1	28.8	9.6	15.1	16.9
Cash Flow (RsM)					
Operating cash flow	**13,561**	**18,649**	**18,561**	**22,147**	**26,739**
Depreciation/amortization	2,854	2,714	3,740	5,098	6,276
Net working capital	-1,184	316	-2,303	-2,664	-2,580
Investing cash flow	**-1,438**	**-14,120**	**-19,463**	**-19,338**	**-14,152**
Capital expenditure	0	-12,240	-20,000	-20,000	-15,000
Acquisitions/disposals	-1,438	-1,880	537	662	848
Financing cash flow	**-3,512**	**-1,500**	**-1,927**	**-2,091**	**-2,116**
Borrowings	-2,359	-17	-280	-280	-140
Dividends paid	-1,153	-1,483	-1,647	-1,811	-1,976
Change in cash	**8,611**	**3,029**	**-2,828**	**718**	**10,471**
Balance Sheet (RsM)					
Total assets	**75,880**	**93,000**	**110,212**	**130,892**	**155,073**
Cash & cash equivalent	14,016	36,298	33,470	34,188	44,659
Accounts receivable	6,548	7,515	8,374	10,354	12,370
Net fixed assets	17,872	27,398	43,659	58,561	67,285
Total liabilities	**21,354**	**24,496**	**26,231**	**29,008**	**32,122**
Accounts payable	5,551	6,939	7,916	9,812	11,717
Total Debt	717	700	420	140	0
Shareholders' funds	**54,526**	**68,504**	**83,982**	**101,884**	**122,952**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	13.7	13.6	13.4	13.1	13.1
ROE adjusted	24.7	25.4	22.5	21.2	20.5
ROIC adjusted	37.1	39.3	28.1	23.1	22.1
Net debt to equity	-24.4	-52.0	-39.4	-33.4	-36.3
Total debt to capital	1.3	1.0	0.5	0.1	0.0

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Revising Target Price Downward to Rs945

Figure 2. Revision in Key Metrics

	FY08E	FY09E	Citigroup Investment Research Comments
Domestic Volumes			
Old	674,534	729,832	
New	707,556	817,053	Volume growth over FY08E to remain subdued over FY08E, given recent hike in interest rates; expect demand growth to recover into FY09E
% Change Y/Y	11.3	15.5	
Export Volumes			
Old	27,547	110,186	
New	45,189	108,454	Upside risk to FY09 estimates – depends on when the 100,000 unit contract for European markets is executed
% Change Y/Y	15.0	140.0	
Net Revenues			
Old	157,520	192,282	
New	166,896	206,121	Forecast nominal improvement in net realisations – escalating discounts might depress average realisations
% Change Y/Y	13.9	23.6	
EBITDA Margin (%)			
Old	14.9	14.1	
New	13.4	13.1	Margin pressure to continue on account of changing product mix, competitive pressures, rising input costs
Net Profit			
Old	16,112	18,419	
New	17,124	19,714	PAT estimates revised upward on account of lower depreciation – plant 2 is fully depreciated
% Change Y/Y	9.6	15.1	
EPS (Rs)			
Old	55.77	63.75	
New	59.27	68.23	
% Change	6.3	7.0	

Source: Citigroup Investment Research estimates

Despite revising our earnings upward over FY08E/09E, we have cut our target price to Rs945 (from Rs1107) as we have pared our earnings multiple to 11x FY09E CEPS (earlier 15x FY08E CEPS). We have cut our target multiple for the following reasons:

1. Competitive intensity is expected to increase from FY09E and beyond, with the launch of new models by players like Toyota and Tata Motors. Going forward, as competitive intensity (and concerns about its impact on MUL's margins) increase, we reckon it will cap the multiple that investors are willing to ascribe to MUL.

2. The increase in MUL's earnings over FY09E/10E, reflects the jump in volumes on account of its export commitments, which should commence meaningfully from FY09E. At this juncture, we don't expect this sharp growth in volumes to repeat, going forward. The reduction in the multiple is also thus a reflection of the steady – state growth that we expect, going forward into FY10E and beyond.

3. MUL's earnings are more sensitive to fluctuations in its EBITDA margins, than volumes. We think margins will remain under pressure for the next 2 years due to 2 factors – escalating input cost pressures, and a changing product mix with new products that are less profitable than current products. The lower target multiple also reflects the increased volatility of earnings, as EBITDA margins remain under pressure.

Quarterly Results

Figure 3. 4QFY07 Results

	4Q FY06	4Q FY07	% chg	CIR Comments
Passenger Vehicles (Nos)	154,400	200,112	29.6	Led by strong domestic growth; Alto, Zen and Swift growth drivers
Average net realization (Rs/vehicle)	213,423	220,548	3.3	New models led to an improvement in realization
Net sales	32,953	44,134	33.9	
Income from services	167	163	-2.2	
Total income from operations	**33,119**	**44,298**	**33.8**	
Decrease/(Increase) in Stocks	(2,356)	(249)	-89.4	
Raw Materials	26,723	33,915	26.9	50 bps above our estimates
Staff costs	567	807	42.3	In line with our estimates
Other Expenses	2,975	4,315	45.0	Reflects: a) Costs related to merger with MSAIL; b) Increase in Royalty, Power and Fuel expenses; and c) Advertising and promotion costs
Total Expenditure	**27,909**	**38,787**	**39.0**	
EBITDA	**5,211**	**5,510**	**5.7**	**Operating margins decline 330bps YoY; 130 bps below our estimates**
Interest	34	156	356.3	Increase in capital costs, reflects absorption of new plant into accounts
Other income	1,153	2,050	77.8	Higher interest income generated on cash surpluses
EBDT	6,329	7,405	17.0	
Depreciation	726	718	-1.0	
Exceptionals	349	-	0.0	
PBT	5,255	6,686	27.2	
Tax	1,645	2,201	33.8	
PAT	3,609	4,486	24.3	
PAT (pre exceptionals)	**3,849**	**4,486**	**16.5**	**~3.7% above our estimates**
Profit Margins				
EBITDA (%)	15.7	12.4		
EBIT (%)	13.5	10.8		
Pre tax margins (%)	15.9	15.1		
Tax / PBT (%)	31.3	32.9		
Net profit margins (%)	11.6	10.1		
Cost ratios				
Raw materials / sales	73.6	76.0		
Staff costs / sales	1.7	1.8		
Other expenses / sales	9.0	9.7		
EPS (Rs)	13.3	15.5		
CEPS (Rs)	15.8	18.0		

Source: Company Reports, Citigroup Investment Research

Result highlights:

Positives –

1. Capital costs lower than forecast – depreciation far lower than anticipated – management indicated that plant 2 is fully depreciated – consequently, we have lowered our depreciation estimates over FY08E/09E – one of the contributing factors due to which our earnings have been raised over the next 2 years.

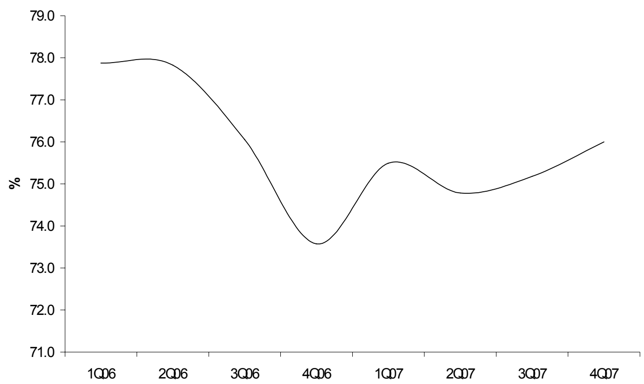
2. Operating leverage might improve, going forward – management indicated that there was a loss of over Rs550m in the current quarter, as the new plant is still scaling up in terms of efficiencies. We reckon this would have manifested itself in higher capital costs, rather than at the operating level, as utilization in the new plant was around 75-80% for the quarter. Going forward, there might be some benefits from operating leverage, which could mitigate the impact of declining contribution margins.

Negatives –

1. Input costs continue to adversely impact margins – Management indicated that increases in input costs (both ferrous and non ferrous metals) impacted margins over 4Q. Cost pressures are expected to remain going forward.

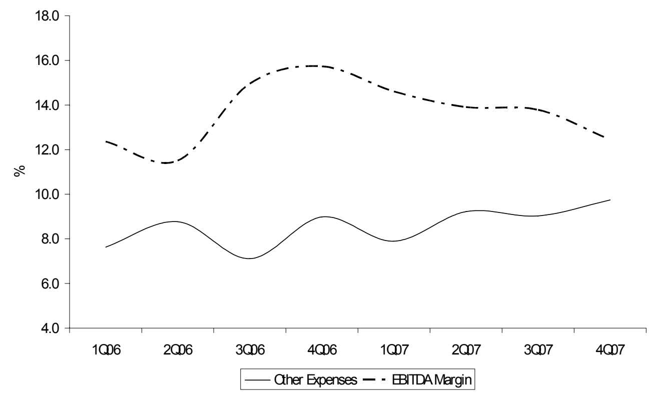
2. 4^{th} successive quarter of declining EBITDA margins – Margins have been impacted by rising input costs, as also the lower leverage from the new plant. Going forward, we expect operating leverage benefits to kick in, but this would mitigate, rather than offset margin pressure. Our downward revision to our margin forecasts over FY08E/09E reflects this view.

Figure 4. Quarterly trend - Raw Materials (% of Sales)



Source: Company Reports

Figure 5. Quarterly trend - EBITDA Margin & Other Expenses (% of Sales)



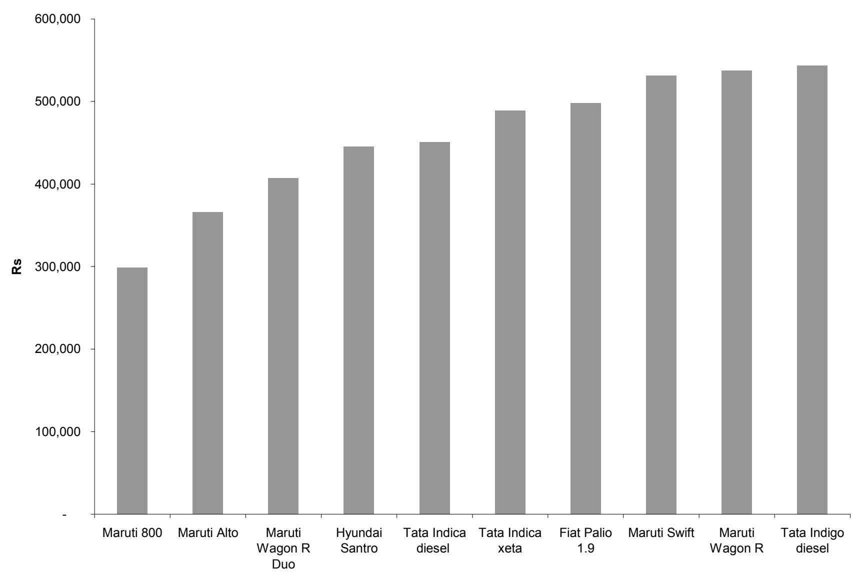
Source: Company Reports

Highlights from the Conference Call:

1) Near term focus is market share – not margins: Management indicated that over the near term, market share will be the key focus, rather than margins. We believe that as competitive pressures increase, MUL will resort to discounting / schemes to ensure that a) its overall market share doesn't decline substantially and b) to ensure that the market share of the new models increases to sustainable and healthy levels. *With the number of new models in MUL's overall product mix increasing over the next few years, we believe that MUL will try to ensure that their share in the overall car parc rises to healthy levels, so that when these models reach their first point of resale after 3-4 years (say 2011-12), there is a vibrant second-hand market for these models. Overall cost of ownership is more important than price per se, and the price of a vehicle, if relatively high at the first point of re-sale, significantly lowers overall ownership costs.*

MUL's competitive strengths today emanate from the fact that in terms of overall ownership costs (defined as: vehicle price + insurance cost for 3 years + maintenance costs + fuel costs for 50,000km - resale / residual value), 5 of its models feature in the top 10.

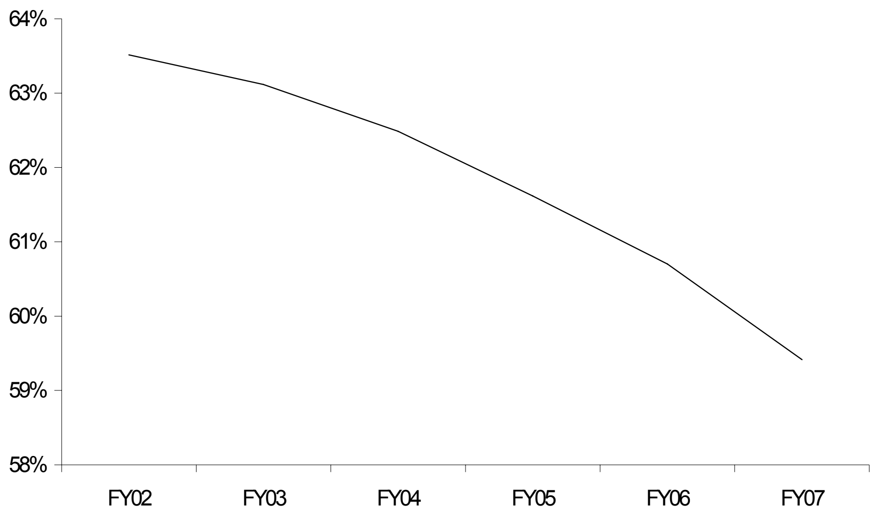
Figure 6. Models that have lowest total cost of ownership



Source: Overdrive study

We estimate the total passenger car parc to be around 8 million units today, and also estimate Maruti's share of the car parc at around 59%. We reckon that Maruti's share in the overall car parc has decreased from c64% in FY02 to around 59% in FY07. Maruti's strategy will be to increase the share of its new models in the parc so that it can control the pricing of these vehicles, going forward in FY11/12 and beyond. Thus over the next 1- 2 years, MUL's contribution margins might be impacted, due to higher royalties and attendant advertisement and sales promotion costs on the new products.

Figure 7. Maruti's Share in the Car Parc



Source: Citigroup Investment Research estimates

2) Margins to remain under pressure: Management indicated that MUL's margins will remain under pressure as commodity prices continue to escalate. A changing product mix (with new models that have higher royalties and lower contribution) will also impact margins going forward. Whilst operating leverage from the new plant should kick in from 1/2QFY08E, we expect MUL's contribution margins to remain under pressure due to a changing product mix. This, coupled with an increasingly competitive environment, will also not permit MUL to undertake positive price actions with the frequency with which it has done over the past few years.

3) Maruti True Value: Maruti's pre-owned car initiative will play an increasingly critical role going forward. The pre-owned car market is currently estimated at around 1m units, with 20% being in the organised market, and 80% being in the unorganized market. True Value bought and sold over 84,000 cars last fiscal – implying its market share is around 42% of the organised market – less than its current domestic market share, and far less than its share in the parc – implying that True Value's market share penetration can increase another few percent. More importantly, over 92% of the customers who sold their pre-owned cars to True Value, exchanged it for a new Maruti car. Going forward, we see True Value playing a critical role in ensuring that the residual values of MUL's models remain relatively healthy.

4) Export Commitments Remain on track: MUL reiterated that it will commence exporting 100,000 units of a car to Europe in FY09. Our export volume estimates for FY09/10 will vary depending on when the exports exactly commence. What was also encouraging was the non-European exports (to markets like North Africa, South Asia, etc) increased 65%. We forecast export volumes to account for c12% of overall FY09 volumes (from 5.8% in FY07)

5) Diesel Initiatives – mixed fortunes: We believed that the Swift diesel variant would cannibalize volumes from the petrol variant. Thus far, we have been incorrect in our assessment. Management indicated that overall demand for both the Swifts (petrol and diesel) is around 7,000 units per month, with around 4,500 units of petrol, and remainder of diesel. But management also indicated that because of Suzuki Powertrain's export commitments, it would be able to provide only around 2,500 diesel engines / month to Maruti for its requirements. We expect that over the near-term, MUL's near-term market share in the diesel segment will be limited at around 10-12% (average industry monthly car sales are around 90,000 units – diesel penetration is ~22-22% – thus around 20,000 units of diesel cars are sold per month).

6) No Guidance on Volumes: MUL management refrained from providing an indication on volumes growth in the domestic market. We expect volume growth to remain constrained over 3–6 months, as buyers defer purchases in the expectation of a reduction in interest rates. Overall, for MUL's domestic sales, we forecast 11% and 16% volume growth over FY08/09. Our estimates for FY08 appear fairly achievable, whilst for FY09, our volume estimates are slightly more aggressive. We base our volume growth on the expectations that MUL will try to grow at faster than market rates over FY08/09 (as part of its longer term strategy), even though this might impact margins over these 2 years. Our reduction in our EBITDA margin estimates also reflects this scenario.

Figure 8. Maruti – Volume Estimates

Year ended 31 March	FY06	FY07	FY08	FY09E	FY10E
Domestic Volumes	527,038	635,629	707,556	817,053	945,378
% change YoY	8.1	20.6	11.3	15.5	15.7
Export Volumes	34,781	39,295	45,189	108,454	151,836
% change YoY	(28.9)	13.0	15.0	140.0	40.0
Total Volumes	**561,819**	**674,924**	**752,745**	**925,507**	**1,097,214**
% change YoY	4.8	20.1	11.5	23.0	18.6

Source: Company, Citigroup Investment Research estimates

Financial Outlook

Figure 9. Maruti - Profit and Loss Statement (Rs m)

Year to 31 March	FY 2006	FY 2007P	FY 2008E	FY 2009E	FY 2010E	Citigroup Investment Research Comments
Net sales	120,871	146,539	166,896	206,121	246,098	In line with volume growth, marginal impact of rising realisations
% change YoY	10.3	21.2	13.9	23.6	19.4	
Raw material expenses	86,769	105,365	119,397	147,855	177,004	
% of net sales	71.8	71.9	71.5	71.7	71.9	Cost pressures to continue
Manpower expenses	2,287	2,884	3,230	4,006	4,767	
% of net sales	1.9	2.0	1.9	1.9	1.9	
Other variable expenses	9,315	9,971	13,219	17,751	21,841	
% of net sales	7.7	6.8	7.9	8.6	8.9	Impact of changing product mix – manifests itself in escalating royalties; higher transportation costs because of export commitments in FY09E/10E
Other fixed expenses	5,885	8,415	8,623	9,452	10,228	
% of net sales	4.9	5.7	5.2	4.6	4.2	Operating leverage benefits over FY08E-10E to mitigate impact of cost pressures, changing product mix
Total Operating Costs	104,256	126,635	144,469	179,063	213,839	
% of net sales	86.3	86.4	86.6	86.9	86.9	
EBITDA	16,615	19,904	22,426	27,058	32,259	
Interest	204	376	450	600	700	
Other income	4,292	5,984	6,762	7,419	8,357	
Depreciation	2,854	2,714	3,740	5,098	6,276	Revised forecasts lower than earlier anticipated
Miscellaneous expenditure w/off	-	-	-	-	-	
Pre-Tax Profit	17,849	22,798	24,999	28,779	33,641	
Exceptionals	(349)	-	-	-	-	
Tax	5,609	7,179	7,875	9,065	10,597	Effective tax ratio over 2HFY08 onward could decline, if MUL obtains R&D tax benefits on engine development programmes
Net profit	11,891	15,620	17,124	19,714	23,044	
Net profits (pre-exceptionals)	**12,130**	**15,620**	**17,124**	**19,714**	**23,044**	
Profit Margins (%)						
EBITDA	13.7	13.6	13.4	13.1	13.1	Margins likely to remain under pressure
EBIT	11.4	11.7	11.2	10.7	10.6	
EPS (Rs)	42.0	54.1	59.3	68.2	79.8	
CEPS (Rs)	51.9	63.5	72.2	85.9	101.5	

Source: Company, Citigroup Investment Research forecasts

Maruti Udyog

Company description

Maruti is a subsidiary of Suzuki Motor Corp (holds a 54% equity stake). The government of India remains a significant equity stakeholder (10%). With its early-mover advantage in the Indian market, Maruti retains a dominant market share despite increasing competition.

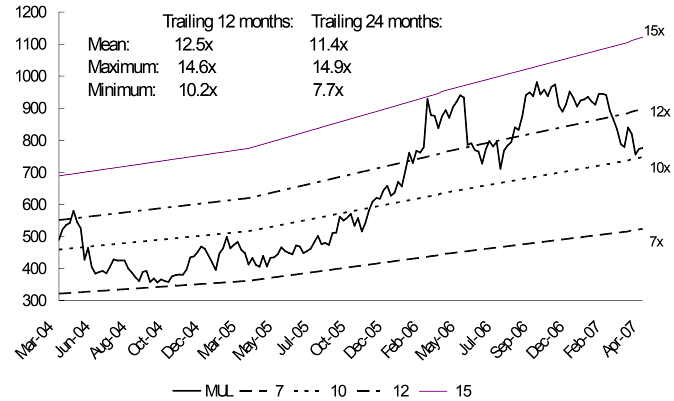
Investment thesis

We rate the stock as Buy/Low Risk (1L). The Indian car market is on a structural growth path (estimated CAGR of 12-15% over the medium term), driven by low penetration levels, improved demographics and infrastructure, tax cuts and availability of consumer finance at relatively low interest rates. Despite the presence of most global majors, Maruti has managed to remain the dominant India player. Its competitive advantage stems from an early start, a balanced product portfolio targeted at the sweet spot of the market, its having the largest distribution and service network, and its consistently high quality ratings. While competitive pressures increase, we expect market share erosion to be gradual and growth in absolute terms to be robust for Maruti. We estimate earnings growth and cash earnings growth of 12.3% and 16.3% CAGR respectively over FY07-09, driven by unit sales CAGR of 17%. We expect margins to contract around 50bps over this period, given cost pressures, a changing product mix and increasing competition, which will keep pricing pressure subdued.

Valuation

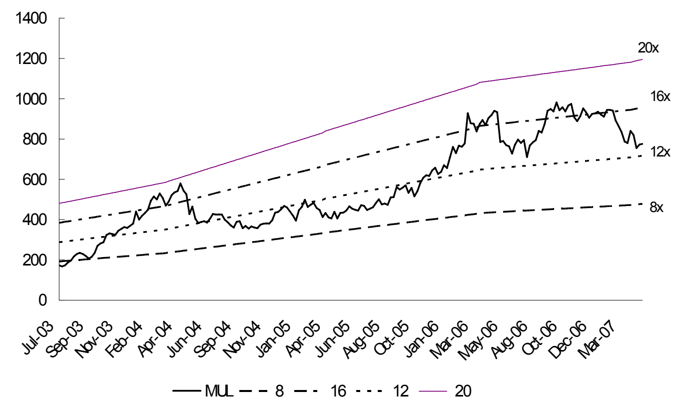
Our 12-month target price of Rs945 is based on 11x P/CEPS FY09E (earlier 15x FY08E). We believe the multiple compares favorably with the cash earnings CAGR of c16.3% over FY07E-09E. At our target price, the stock would trade at the mid-point of the current trading band. As we roll over to FY09E, we pare our target multiple to 11x Cash Earnings (from 15x CEPS) for the following reasons: 1) Competitive intensity is expected to increase with the launch of new models by players like Toyota and Tata Motors from FY09E and beyond. The increasing competitive intensity and concerns about its impact on MUL's margins will limit the upside on MUL's valuations; 2) The increase in MUL's earnings over FY09E/10E, reflects the jump in volumes on account of its export commitments, which commence meaningfully from FY09E. At this juncture, we don't expect this sharp growth in volumes to repeat, going forward. The reduction in the multiple is also thus a reflection of the steady – state growth that we expect, going forward into FY10E and beyond.

Figure 10. Maruti Udyog – P/CEPS (x) band chart



Source: Company Reports

Figure 11. Maruti Udyog – P/E (x) band chart



Source: Company Reports

Maruti has a relatively short trading history. Our multiple of 11x is at a marginal discount to the 11.4x trailing 2 year average – but merited, since competitive intensity will escalate going forward, and the macro economic environment is less conducive to growth (rising interest rates impact volumes growth across the car industry, given that 80% of vehicles are bought with finance). We prefer price/cash earnings as a valuation metric for the automobile sector, given the relatively high capital intensity (both on capacity and product development) of the business.

Risks

We rate Maruti as Low Risk based on our quantitative risk-rating system, which tracks 260-day historical share price volatility. Risks that could prevent the stock from reaching our target price and rating include: (1) sales of passenger vehicles are sensitive to economic variables – an appreciable rise in interest rates could impact volumes growth across the auto sector; (2) revised emission and safety norms could bring cost pressures; and (3) competitive pressures in the Indian market continue to increase, which could impact margins over the longer term.

Appendix A-1

Analyst Certification

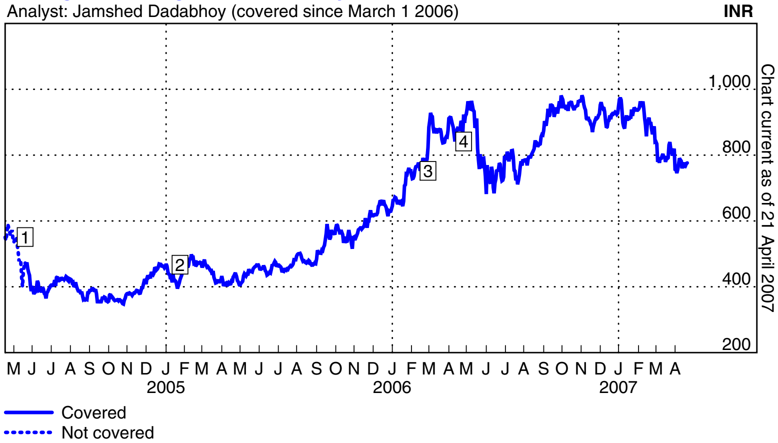
I, Jamshed Dadabhoy, research analyst and the author of this report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

Maruti Udyog (MRTI.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Jamshed Dadabhoy (covered since March 1 2006)



#	Date	Rating	Target Price	Closing Price
1:	20 May 04	1L	593.00	472.10
2:	25 Jan 05	*1M	593.00	421.50
3:	28 Feb 06	*1L	*966.00	822.60
4:	26 Apr 06	1L	*1,107.00	923.45

*Indicates change.

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