Quantum Information Services Private Limited
Independent Investment Research
12 August, 2006

Mahindra & Mahindra Limited

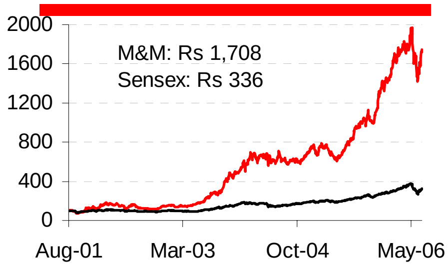
Hold **Target Price: Rs 790**

Market data

Current price	Rs 614 (BSE)
Market cap	Rs 147,913 m
Face value	Rs 10.0
FY06 Div/share	Rs 4.9
NSE symbol	M&M
No of shares	240.9 m
Free float	77.2%
52 week H/L	Rs 724 / 331

Share price chart

Rs 100 invested is worth



Shareholding

Category	(%)
Promoters	22.8
Banks, MFs & FIs	21.5
FIIs	34.9
Public	10.5
Others	10.3
Total	100.0

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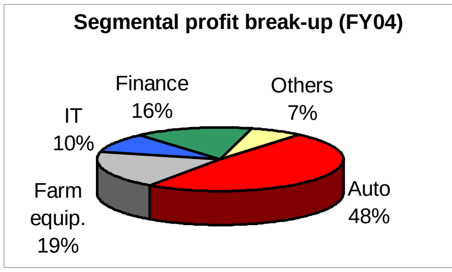
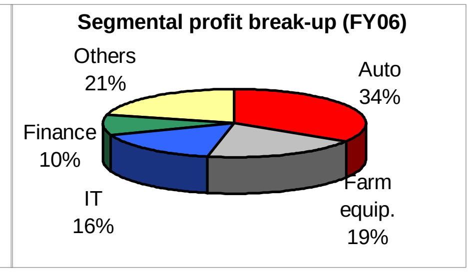
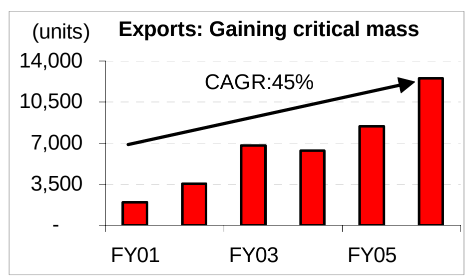
Investment Rationale

- **The coming of age of subsidiaries:** The immense growth potential of its major subsidiaries – Mahindra Gesco, M&M Financial Services and Tech Mahindra – is one of the primary reasons we are upbeat on the company's prospects. While we have valued M&M's investment in Tech Mahindra based on its IPO price, the other listed subsidiaries have been valued taking into consideration their market values as on 31 March 2006. We have been rather conservative in approach and there still exists a lot of headroom for these companies to grow. On account of M&M's sizeable investments in its subsidiaries, the growth will also reflect in M&M's market value going forward. Just to give an indication, while the automotive & the farm equipment segment of M&M accounted for 68% of the consolidated operating profits of the company in FY04, the contribution fell to 53% in FY06. With the management intending to continue with its subsidiary value unlocking process, M&M's prospects are likely to receive a further boost in the future.





- **Exports thrust:** Traditionally, M&M has been dependent on a single region i.e., India. This exposed it to the vagaries of monsoon (as indicated by its historical performance), as M&M's key segments are largely rural driven. However, over the last few years, the management has been working on a strategy to increase its geographical spread. Apart from developing its base in the US and SAARC regions, the company has also entered into the South African, Uruguayan, Chinese, Australian and Russian markets as a part of the strategy with others like East Europe in the foray. We believe that the next logical step would be to increase its market share in these regions. Though exports accounted for only 5% of total volumes in FY06, we expect the contribution to increase over the next three to five years. It should be noted that the management aspires to increase the share of exports to 20% of revenues over the next five years.



However, we have factored this share to increase to around 8% by FY08. Thus, there exists potential upside to our projections. Having said that, while exports are not necessarily highly profitable, these will enable the company to diversify into untapped markets and benefit from economies of scale due to better capacity utilisation.

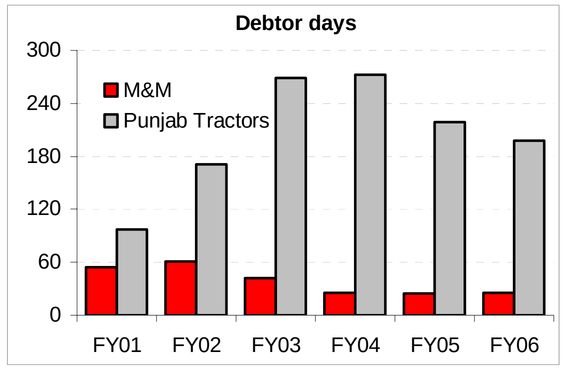
- **Auto portfolio–Filling the gap:** From being a predominantly utility vehicles (UVs) and tractor manufacturer, M&M is gradually progressing towards being a complete auto player. To this effect, the company has signed two joint ventures, one with Renault, the highly respected French automaker and the second with International Truck and Engine Corporation (ITEC), the US' leading medium and heavy commercial vehicle (M&HCV) manufacturer. Thus, from FY08 onwards, the company will start catering to two hitherto untapped segments viz., passenger cars and M&HCVs. While it will manufacture and sell Renault's extremely popular low-cost mid-sized sedan 'Logan' in India, details of the ITEC JV are still awaited. These forays will help the company in de-risking its business model, as it is largely dependent on the rural economy currently.

  While we have not accounted for the JVs in our projections, given M&M's solid reputation and marketing strengths in India and technological expertise of its JV partners, these ventures will most likely be success stories. To that extent, there exists an upside to our target price.

Investment Concerns

- **High dependence on monsoons:** Since a vibrant rural economy is important for the sale of tractors, M&M's business gets seriously impacted if there is a failure of monsoons for two consecutive years or if there is a steep fall in the value of agricultural produce. The fall in demand in FY01, FY02 and in FY03 is a vindication of this argument. Delay in government's plans for irrigation development and poor fertilizer availability will also affect rural income and therefore tractor demand. In FY06, tractors accounted for 35% of the sales and we expect the same to contribute to 36% to 37% of sales in the next three years.

- **Unhealthy industry practices:** During the period FY01-FY03, the tractor sector suffered from excess inventory with dealers, which was estimated at more than 50,000 units (30% of FY03 industry volumes). Given the oversupply conditions in the market, price realisations had come under pressure. In order to maintain market share, credit sales rose in FY01 and FY02. Though M&M has taken corrective steps and the debtor days have returned to sustainable levels, there is no guarantee that the same will not be repeated again in case of down turn. This could put significant pressure on the working capital position of the company.



Background

Mahindra & Mahindra (M&M) is engaged in the manufacture of utility vehicles (UV), tractors, light commercial vehicles (LCV) and three-wheelers. While automotive division comprising UV, LCV and three-wheelers contributed to 65% of FY06 revenues, farm equipment division accounted for 28% of revenues. While M&M has a 44% market share in the domestic UV segment, its share in the tractor segment stands at 32%. Through investment in its subsidiaries, M&M has interests in sectors like software, hotels, real estate and financial services.

Industry Prospects

As against the historical mix of 70:30 skewed towards rural areas, demand from urban region for UVs is growing at a faster clip. Our interaction with the some industry players suggests that the mix is currently 60:40, which is a sign of things to come. Led by improved road connectivity, better economic growth prospects, and higher demand from urban markets, we expect UV demand to grow at a CAGR of 9% over the next three years.

As far as the tractor industry is concerned, while the dependence on monsoons is expected to continue, the government's thrust on developing rural economy, increasing rural credit flow, providing farm insurance, educating farmers on improving productivity and crop diversification and providing road connectivity augurs well for the agricultural sector and consequently the tractor industry. However, these are long-term structural drivers, which may not have significant impact in the short to medium term.

Risk Analysis

Sector: The growth of the auto industry is directly linked to the purchasing power of the country's populace, which in turn is a function of domestic GDP growth. Given the projected strong economic growth in the country, the auto sector is likely to witness double-digit growth rates in the medium to long term. However, one would be compelled to give a medium risk rating of 5 to the sector on account of pressure on cash flows of the company owing to intensifying competition, capital-intensive nature of the business and the need to upgrade product portfolios more frequently than ever.

Sales: M&M is one of the biggest auto companies in the country with leadership position in the tractor as well as UV segments. As a consequence, net sales of the company have averaged Rs 53 bn in the last five years and are expected to climb even higher, given the strength of its core business as well as subsidiaries. This is a strong enough case to assign a low risk rating of 7.

Current ratio: M&M's average current ratio during the period FY02-FY06 has been 1.1 times. This indicates that it is comfortably placed to pay off its short-term obligations, which gives comfort to its lenders. We assign a medium-risk rating of 4.

Debt to equity ratio: A highly leveraged business is the first to get hit during times of economic downturn, as companies have to consistently pay interest costs, despite lower profitability. We believe that a debt to equity ratio of greater than 1 is a high-risk proposition. Considering M&M's average debt to equity ratio of 0.6 over the past five fiscals, we have assigned a medium-risk rating of 4 to the stock.

Long term EPS growth: We expect the company's net profit to grow at a compounded rate of around 9% over the period FY06 to FY09 (CAGR of 35% during FY01 to FY06). Based on a normal scenario, we consider a historical compounded growth of over 20% in net profits over a 5-year period as healthy for a company. As such, the rating assigned to the stock on this factor is 5.

Dividend payout: A stable dividend history inspires confidence in the management's intentions of rewarding shareholders. M&Ms average payout ratio has been a healthy 42% over the past 5 fiscals. We have assigned a low-risk rating of 10.

Promoter holding: A larger share of promoter holding indicates the confidence of the people who run it. We believe that a greater than 40% promoter holding indicates safety for retail investors. At the end of March 2006, the promoter holding stood at 23%. We have assigned a high-risk rating of 3.

FII holding: We believe that FII holding of greater than 25% can lead to high volatility in the stock price. The FII holding at the end of March 2006 stood at 34%. Therefore, the rating assigned is 2.

Liquidity: The average daily trading volumes over the past 5 years stood at over 0.9 m shares. This is good for a large market capitalisation stock like M&M. The rating assigned is 10.

Margin of safety: This is to determine the value of the stock relative to its price and the returns over a risk free rate. Margin of safety of a stock lies in its earning power, which is calculated as EPS divided by market price (reciprocal of P/E). Considering M&M's P/E of 11.6 times its FY06 consolidated earnings, the earning power is 0.3%, which is fairly low. Thus, the rating assigned is 1.

Considering the above parameters, the total ranking assigned to the company is 51. This makes the stock a medium-risk investment from a long-term perspective.

Risk Matrix

	High Risk	Medium Risk	Low Risk
Rating	(1 to 3)	(4 to 6)	(7 to 10)
Sector	High	Medium	Low
Sales (US$ m)	< 500	501 - 1,000	> 1,000
Current Ratio (x)	< 1	1 - 2	> 2
Debt to equity ratio (x)	> 1	0.5 - 1	< 0.5
Long term EPS growth (%)	< 10	10 - 20	> 20
Dividend Payout (%)	< 15	15 - 25	> 25
Promoter holding (%)	< 25	25 - 40	> 40
FII holding (%)	> 25	10 - 25	< 10
Liquidity (Nos. '000)	< 100	100 - 200	> 200
Margin of Safety (%)	< 3	3 - 6	> 6
Final Rating	< 30	30 - 60	> 60

Valuations

We had recommended M&M in November 2005 at Rs 397 with target price of Rs 570. The stock currently trades at Rs 614, implying a price to earnings multiple of 17.5 times our estimated standalone FY09 earnings and 12.9 times our estimated standalone FY09 cash flow. If one also takes the subsidiaries into consideration, the earnings receive a substantial leg up. We, thus, recommend a HOLD* on the stock with a target price of Rs 790 from an FY09 perspective. The company's prospects might receive a further boost if the joint ventures (with Renault and ITEC) have a successful run in the Indian market.

**By this recommendation of HOLD, what we mean is that existing shareholders would be better off holding on to the stock with a two-year perspective. However, if an investor would like to BUY this stock, then the upside from the current levels is about 29% point-to-point (10% CAGR). Investors could take the investment decision based on this premise.*

Valuation table

Standalone (Rs m)	FY06	FY07E	FY08E	FY09E
Revenue (Rs m)	81,412	89,003	96,662	108,959
PAT (Rs m)	6,479	5,937	6,770	8,437
EPS (Rs)	26.9	24.6	28.1	35.0
CEPS (Rs)	35.2	34.3	39.2	47.6
Price to earnings (x)	22.8	24.9	21.8	17.5
Price to cash flow (x)	17.4	17.9	15.7	12.9

Comparative valuation

Parameter (FY08E)	M&M*	Punjab Tractors	Tata Motors
EBDITA margin (%)	10.3	14.0	11.1
Net margin (%)	7.0	8.5	6.1
Return on equity (%)	20.1	14.3	20.9
Return on assets (%)	9.8	10.7	7.9
Working cap/sales (%)	5.7	52.4	4.1
Asset turnover (x)	1.4	1.3	1.3
Valuation ratios (FY08E)			
Price (Rs)	614	216	800
Price to earnings (x)	21.8	14.2	20.1
Price to book (x)	4.2	2.0	4.2
Price to cash flow (x)	15.7	12.2	11.6

* Standalone numbers

Financials at a glance

Standalone (Rs m)	FY06	FY07E	FY08E	FY09E
Sales	81,412	89,003	96,662	108,959
Sales growth (%)	22.1%	9.3%	8.6%	12.7%
Operating profit	8,865	8,468	9,984	12,424
Operating profit margin (%)	10.9%	9.5%	10.3%	11.4%
Net profit (before extraordinary items)	6,479	5,937	6,770	8,437
Net profit margin (%)	8.0%	6.7%	7.0%	7.7%
Balance Sheet				
Current assets	27,614	31,672	34,297	37,539
Fixed assets	15,544	18,208	20,527	22,501
Investments	16,691	16,653	16,653	16,653
Total Assets	59,849	66,533	71,477	76,694
Current liabilities	22,107	25,644	28,142	31,001
Net worth	28,908	32,055	35,351	39,459
Loan funds	8,834	8,834	7,984	6,234
Total liabilities	59,849	66,533	71,477	76,694

Sector Statistics

Sales (Rs m)		Market cap. (Rs m)		EBDITA margin (%)		Net profit margin (%)		Return on NW (%)	
Tata Motors	206,022	Tata Motors	304,900	Punjab Trac	13.2%	Punjab Trac	13.5%	Tata Motors*	27.6%
M&M	**81,412**	**M&M**	**147,913**	Tata Motors	10.9%	Tata Motors	7.4%	Punjab Trac	22.7%
Punjab Trac	9,586	Punjab Trac	13,400	**M&M**	**9.2%**	**M&M**	**6.2%**	**M&M**	**20.3%**