

## BAJAJ AUTO

INR 2,721

*Heir-splitting*

BUY



There is a strong possibility of a roadmap for the long-awaited demerger of Bajaj Auto's investment portfolio emerging from the May 17, 2007 board meeting. The portfolio (book value of INR 60.2 bn on December 31, 2006) comprises fixed income instruments (roughly 75% of book value), equity investments in ICICI Bank, as well as other group companies such as Bajaj Auto Finance, and, most importantly, the life and general insurance joint ventures.

In the eventuality of a demerger, we believe, there could be a significant potential for value unlocking. We estimate the fair market value of Bajaj Auto's investments at INR 1,805 per share. While the quoted equity investments have been valued at prevailing market prices and the g-secs and debt mutual funds at book value, the insurance businesses have been valued based on embedded profit methodology. The core business is valued at INR 1,408 per share on the basis of 14.0x FY08E core EPS.

Further, over the next two-three months, there is also a possibility of a split and restructuring of the core promoter holding companies (Bajaj Sevashram, Jamnalal Bajaj & Sons, and Bachhraj & Co., which hold stakes in Bajaj Auto, Bajaj Hindusthan, and other Bajaj group companies. We have tried to put together the holding structure of the group, though we believe it will have minimal impact on Bajaj Auto.

We maintain our 'BUY' recommendation on the stock on expectations of a healthy growth in core business and significant value unlocking from the impending demerger.

**Highlights:**

- ♦ **Background for demerger:** For more than two years there have been persistent expectations of a possible demerger of Bajaj Auto's significant investment portfolio, which includes its investments in group companies such as Bajaj Auto Finance, its stake in ICICI Bank and the insurance businesses, in addition to fixed income instruments. These investments, now at nearly 85% of the capital employed and 115% of net worth, and earning approximately 9-10% returns, pull down the return ratios for the company as a whole. For instance, the overall RoE and RoCE for Bajaj Auto is at 23-24% compared to 36% and 48%, respectively, for Hero Honda.

**Financials**

Year to March	FY06	FY07E	FY08E	FY09E
Sales (INR mn)	76,285	95,142	111,030	129,929
Revenue growth (%)	29.6	24.7	16.7	17.0
EBITDA (INR mn)	13,368	14,046	17,406	20,945
Net profit (INR mn)	11,017	12,734	14,698	17,460
Shares outstanding (mn)	101.2	101.2	101.2	101.2
EPS (fully diluted)	108.9	125.9	145.3	172.6
EPS growth (%)	43.7	15.6	15.4	18.8
P/E (x)	25.0	21.6	18.7	15.8
EV/EBITDA (x)	18.0	17.2	13.8	11.5
ROE (%)	23.1	23.1	23.0	23.5
ROCE (%)	25.4	24.3	25.0	25.6

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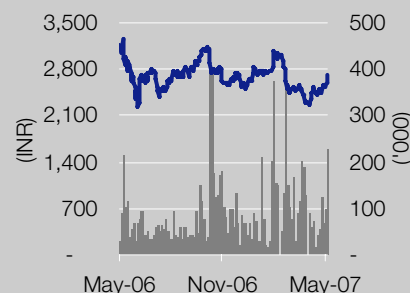
Reuters : BJAT.BO  
Bloomberg : BJA IN

**Market Data**

52-week range (INR) : 3,325 / 2,085  
Share in issue (mn) : 101.2  
M cap (INR bn/USD mn) : 275.3 / 6,662.9  
Avg. Daily Vol. BSE/NSE ('000) : 305.2

**Share Holding Pattern (%)**

Promoters : 29.9  
MFs, FIs & Banks : 7.6  
FII's : 19.5  
Others : 43.0



### \* Potential for value unlocking

We believe there exists a significant potential for value unlocking from the proposed demerger, particularly from the insurance business. Bajaj Auto holds a 74% share in each of the insurance joint ventures, the balance is held by Allianz AG, Germany. Based on sum-of-the-parts method, we estimate the value of Bajaj Auto's overall investment portfolio at INR 1,805 per share. A large chunk of this value is embedded in the insurance business, particularly the life insurance business (INR 1270 per share without discount). Reportedly, Allianz has an option to increase its stake in the JV's to 49%. A 30% discount has been applied to the valuations of the insurance business to reflect the uncertainties in the arrangement with Allianz.

### \* Likely structure for the demerger

Looking at the possible options for the structuring of the demerger from the point of view of tax efficiency and shareholder value creation, we believe the company is most likely to use the share swap route (similar to what was used in the Reliance Industries case). According to income tax rules, capital gains tax is not applicable (on either the company or shareholders) in the event of a demerger where shareholders of the parent are issued shares of the resulting company in proportion to their holding in the parent company, and the assets are transferred to the resulting company at book value. Following table explains the various provisions and definitions or the relevant sections of the Income Tax Act, 1961.

**Table 1: Demerger: Tax implications**

I-T Act section #	Deals with	Provides for
Section 19AA	Definition of demerger	1) All assets and liabilities to be transferred to the resulting company 2) Transfer should be at book value 3) Shareholders to be issued shares of resulting company on proportionate basis 4) Transfer should be on going concern basis
Section 47		
<i>Clause vib</i>	Capital gains tax	Demerged company (parent) not liable to capital gains on transfer of assets to resulting company
<i>Clause vid</i>	Capital gains tax	Resulting company not liable to capital gains tax

*Source: Edelweiss research*

*Note: As per I-T Act definition, Bajaj Auto would be the demerged company and the investment holding company would be the resulting company.*

### \* Sum-of-the-parts valuation

Bajaj Allianz Life Insurance has reported a 135% increase in Annualized Premium Equivalent (APE) for FY07 to INR 31.5 bn thereby commanding a market share of 22% among the private life insurers (as compared to 18.8% in FY06) Going forward we expect an APE growth of 34% CAGR for FY07-FY09. Considering this we value the life insurance business at INR 173bn or INR 1207 per share. We are using sum of underwriting surplus and investment returns as indicative earnings for general insurance business, as the reported profit is not true reflection of economic profit. The general insurance business is valued at INR 22.9 bn or INR 168 per share on the basis of 13x FY09E profit. We have applied a 30% discount to our insurance business valuations to reflect the uncertainties regarding the arrangements with Allianz.

**Table 2: Insurance valuations**

<b>Life insurance</b>			
	<b>ICICI Pru</b>	<b>Bajaj Allianz</b>	<b>Reliance</b>
Annuaized premium equivalent (FY07) (INR mn)	39,710	31,455	6,990
APE growth in FY07 (Y-o-Y)	86.8	132.8	832.7
<b>Market share (excl LIC) (FY07) (%)</b>	<b>27.7</b>	<b>22.0</b>	<b>4.9</b>
No of agents	234,000	200,000	106,337
Branch offices	583.0	900.0	217.0
Appraisal value (FY09E) (INR bn)	295.4	171.8	85.7
Value of business (USD bn)	7.2	4.2	2.1
<b>Value of stake (USD bn)</b>	<b>5.3</b>	<b>3.1</b>	<b>2.1</b>
NBAP multiple (FY09E)	21.0	19.5	22.2
% of holding	74.0	74.0	100.0
<b>Our fair value per share estimate</b>	<b>193.0</b>	<b>1,270.0</b>	<b>348.8</b>
Value to mkt cap	22.7	46.7	44.2

**General Insurance**

	<b>ICICI Pru</b>	<b>Bajaj Allianz</b>	<b>Reliance</b>
Gross written premium (FY07) (INR mn)	30,034	18,046	9,122
<b>GWP growth in FY07 (Y-o-Y)</b>	<b>88.7</b>	<b>40.1</b>	<b>462.0</b>
<b>Market share FY07 (%)</b>	<b>34.5</b>	<b>20.7</b>	<b>10.5</b>
<b>Net written prem (FY09E) (INR mn)</b>	<b>30,471</b>	<b>17,374</b>	<b>17,491</b>
NWP CAGR FY07-09E	44.9	44.9	86.7
Est. combined ratio (%)	97.0	96.0	97.5
Underwriting surplus (NWP)	3.0	4.0	2.5
Investment income as % of NWP (%)	8.7	8.4	6.1
<b>PAT (FY09E) (INR mn)</b>	<b>3,427.3</b>	<b>1,746.9</b>	<b>1,464.3</b>
P/E Multiple (x)	15.0	13.0	13.0
Value of business (INR bn)	51.4	22.7	19.0
Value (USD bn)	1.3	0.6	0.5
<b>Value of stake (USD bn)</b>	<b>0.9</b>	<b>0.4</b>	<b>0.5</b>
% of holding	74.0	74.0	100.0
<b>Fair value est. per share (INR)</b>	<b>33.6</b>	<b>167.9</b>	<b>77.5</b>
<b>Non life as % of mkt cap</b>	<b>4.0</b>	<b>6.2</b>	<b>9.8</b>

Source: Edelweiss research

We value the core business at INR 1,408 per share, on 14x FY08E core earnings. Going forward, we believe there is likely to be significant value accretion in both the insurance and core automotive businesses. We maintain our 'BUY' recommendation.

**Table 3: Valuation summary**

	# of shares/ (%)	BV (INR mn)	Value (INR mn)	Value to Bajaj (INR mn)	Value/share of BAL
Bajaj Auto Finance	6,597,060	661		2,970	29
ICICI Bank	37,033,612	11,293		31,425	311
Bajaj Allianz Life Insurance	74%	1,112	173,652	128,502	1270
Bajaj Allianz General Insurance	74%	814	22,971	16,999	168
Insurance Value with discount				101,851	1007
<b>Total</b>		<b>13,880</b>		<b>136,246</b>	<b>1,347</b>
Book value of total investment book (as on Dec 31, 2006)				60,229	
<b>Total investment value</b>				<b>182,595</b>	
No. of shares	101.2				
<b>Per share value</b>					<b>1,805</b>
Core EPS	FY08E	101	14x		1,408
	FY09E	125	14x		1,743

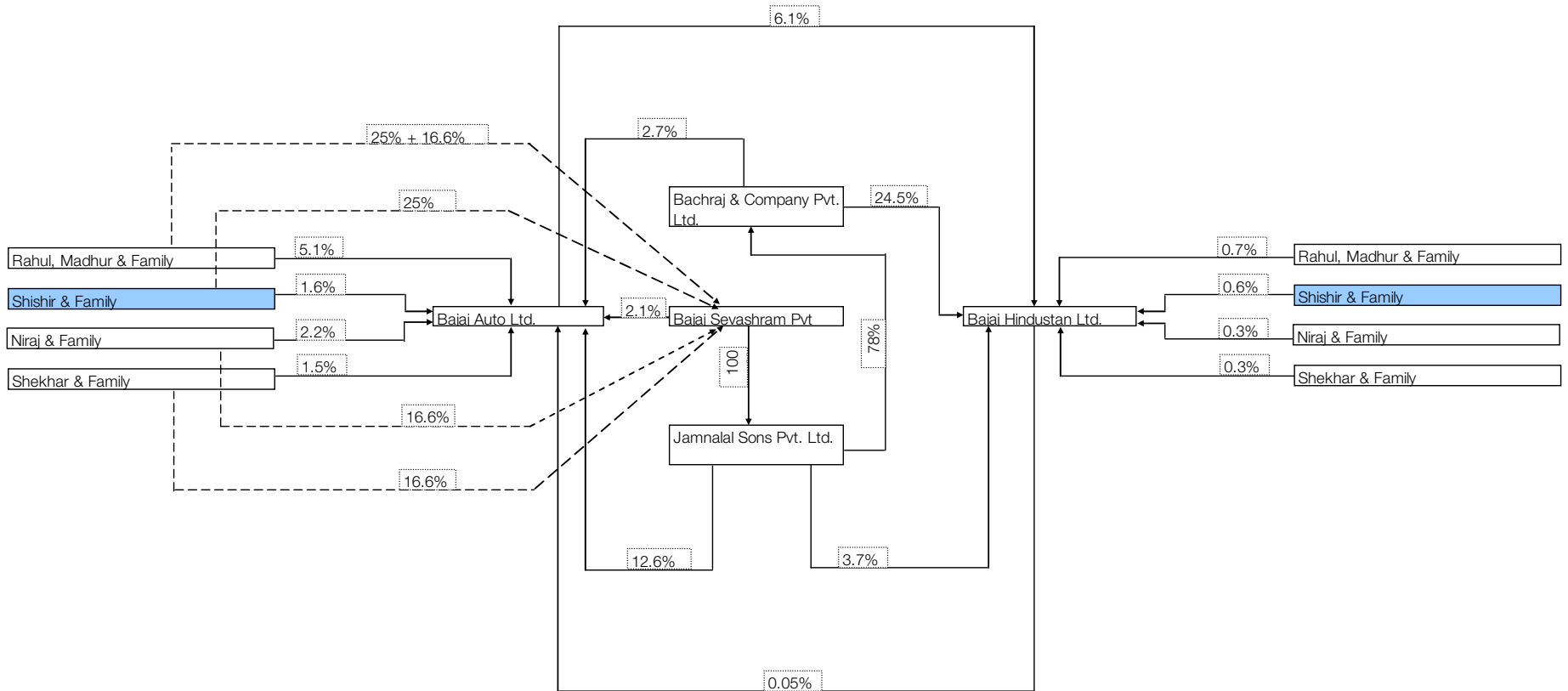
Source: Edelweiss research

# Annexure

In the past few months there also has been speculation regarding an imminent split of the Bajaj family holding companies which are primary vehicles of promoter holdings in the various group companies. Currently, the matter is in courts and the Company Law Board.

We have put together the holding structure of the group. We believe a split at the family level will be nearly neutral for Bajaj Auto.

**Fig. 1: Holding structure Bajaj Auto, Bajaj Hindustan**



Source: Edelweiss research

Note: The shaded box represents the faction which is separating from the rest of the group.

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*unless otherwise specified*

### RATING INTERPRETATION

<b>Buy</b>	Expected to appreciate more than 20% over a 12-month period	<b>Reduce</b>	Expected to depreciate up to 10% over a 12-month period
<b>Accumulate</b>	Expected to appreciate up to 20% over a 12-month period	<b>Sell</b>	Expected to depreciate more than 10% over a 12-month period
<b>Trading Buy</b>	Expected to appreciate more than 10% over a 45-day period	<b>Trading Sell</b>	Expected to depreciate more than 10% over a 45-day period

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