

MARCH 10, 2010

CHANGE IN RECO.

Coverage view: **Cautious**

Price (Rs): **1,874**

Target price (Rs): **1,930**

BSE-30: **17,053**

**Lowering rating on limited upside, margin risk.** We are reducing our rating on Bajaj Auto to ADD from BUY as we believe the stock at current levels largely prices in upside earnings potential. Bajaj remains better positioned to manage margin pressures given strong product cadence, a diversified revenue base and lesser competition in Bajaj's key premium segment. While volume growth could have upside, key risks include sharper margin compression on competitive & raw material cost pressures.

#### Company data and valuation summary

Bajaj Auto

Stock data		Forecasts/Valuations			
		2010	2011E	2012E	
52-week range (Rs) (high,low)	1,933-478	EPS (Rs)	110.7	137.9	149.7
Market Cap. (Rs bn)	277.0	EPS growth (%)	144.8	24.5	8.6
<b>Shareholding pattern (%)</b>		P/E (X)	17.3	13.9	12.8
Promoters	49.6	Sales (Rs bn)	114.3	140.2	154.1
FIs	16.0	Net profits (Rs bn)	16.0	19.9	21.7
MFs	4.3	EBITDA (Rs bn)	25.0	28.1	29.3
<b>Price performance (%)</b>		EV/EBITDA (X)	11.2	10.0	9.5
Absolute	1M 3M 12M	ROE (%)	64.0	50.4	38.0
Rel. to BSE-30	3.2 14.9 88.6	Div. Yield (%)	1.0	1.0	1.0

#### Raising FY2011E EPS estimate to Rs138 from Rs133 on higher volume estimate

Our Rs138 EPS estimate for FY2011E is based on 24% volume growth and a 170 bps decline in margins from FY2010E levels. We remain comfortable with our volume growth estimate as this is driven by the demonstrated success of new product launches in 2HFY10. Additionally, the easy year-ago comparisons in 1HFY10 make the volume growth appear high. Our FY2011E volume assumptions imply reasonable 10% growth from Bajaj's 2HFY10E volume run rate. The 24% volume growth estimate comprises 28% growth in domestic motorcycle volumes, 20% growth in 2-wheeler export and 15% growth in the domestic and export three-wheeler segments.

#### 170 bps margin decline reflects higher commodity cost and mix shift towards less expensive bikes

We expect EBITDA margins to decline to 19.4% for FY2011E from 21.1% in FY2010E. Fiscal year-to-date margins are at 21.2%. We believe the 170 bps decline adequately accounts for pressures from higher commodity costs and a mix shift towards lower margin motorcycles. The two new product launches made in the current fiscal year—Discover 100cc and Pulsar 135cc—are at the lower end of the Discover and Pulsar ranges. Additionally, the company is adding content to its three-wheelers at no extra cost to the consumer. Increasing competition could trigger a price war, further pressuring margins.

#### Competitive pressure on market leader could trigger price war—not fully discounted in stock price

Hero Honda has lost 10% points of share in the under 125cc motorcycle segment over the past six months (Exhibit 1). Some more marginal share loss could occur as Honda ramps up its CB Twister. Honda is expected to initially sell 20,000 units per month, but is looking to expand capacity. Exhibit 2 shows two-wheeler share by segment. As can be seen, HMSI is a strong player in both its segments. Mahindra Two Wheelers has garnered a 6% share of the scooter market over the past year and is planning to enter the motorcycle market in 2010E. Hero Honda and Bajaj Auto are currently enjoying significantly higher-than-average margins (Exhibit 3), which could tempt them to play the volume-over-price game. The excise benefits from their plants in Uttarakhand could add leverage in this game.

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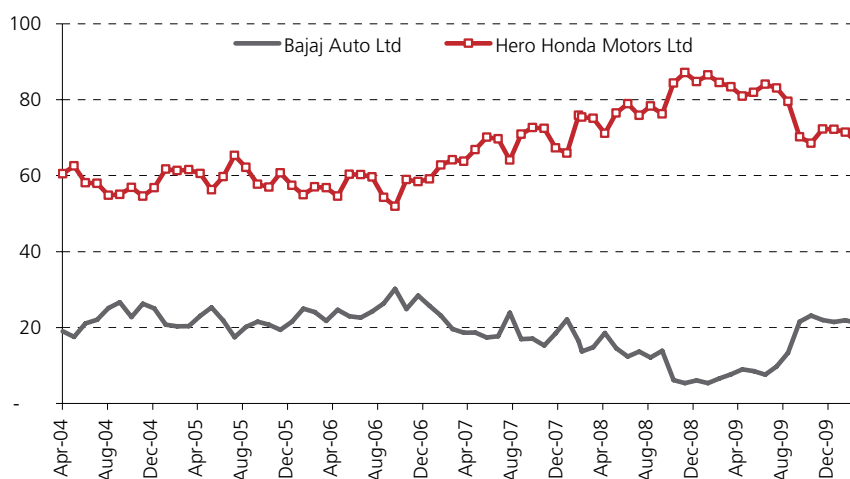
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### Raising target to Rs1,930; lowering rating to ADD on limited upside

A 100 bps lesser-than-expected margin decline could drive the stock up to Rs2,065. We view the likelihood of margin sustaining at levels last seen in 1999 as remote. Given the limited upside to our target, we are downgrading the stock to ADD from BUY. We continue to prefer Bajaj over Hero Honda, as the strong product cadence, diversified revenue base and a strong position in the greater than 125cc segment could allow the former to better manage margins.

**Exhibit 1: Hero Honda might not tolerate market share loss for long**  
Market share in the 100-125cc segment, Apr-06 to date, (%)



Source: SIAM, Kotak Institutional Equities

Hero Honda's market share decline in the 100-125cc segment started with the launch of the Discover 100cc by Bajaj Auto. Discover, priced marginally above the Splendor, targeted the commuter segment and was marketed as offering better fuel efficiency and a comfortable ride. The bike has been a success and is selling 70,000-80,000 units a month.

We expect Hero Honda's share to decline further though marginally as HMSI's 110cc entry, CB Twister, ramps up. In February, HMSI sold close to 7,500 Twisters and targets to ramp up to 20,000 units on a monthly basis. The Twister has been priced competitively, starting at the Rs43,000 range ex-showroom Delhi for a kick-start version. As shown in Exhibit 2, HMSI is a strong player in both segments—scooters and high-end bikes. We would therefore expect HMSI to target a significant share of the 100-125cc segment as well. The company is looking to expand capacity and press reports indicate that it is looking to add 600,000 units initially, to be doubled later. Assuming all of the capacity goes towards the Twister, volumes of the bike could increase to 70,000 per month of 12% of the 100-125cc segment.

Additionally, Mahindra Two Wheelers is expected to expand its portfolio from scooters to include motorcycles sometime in 2010E. M&M has managed to garner a 6% share of the scooter market over the last year. The company could be targeting a 5-10% share in the near term for motorcycles as well.

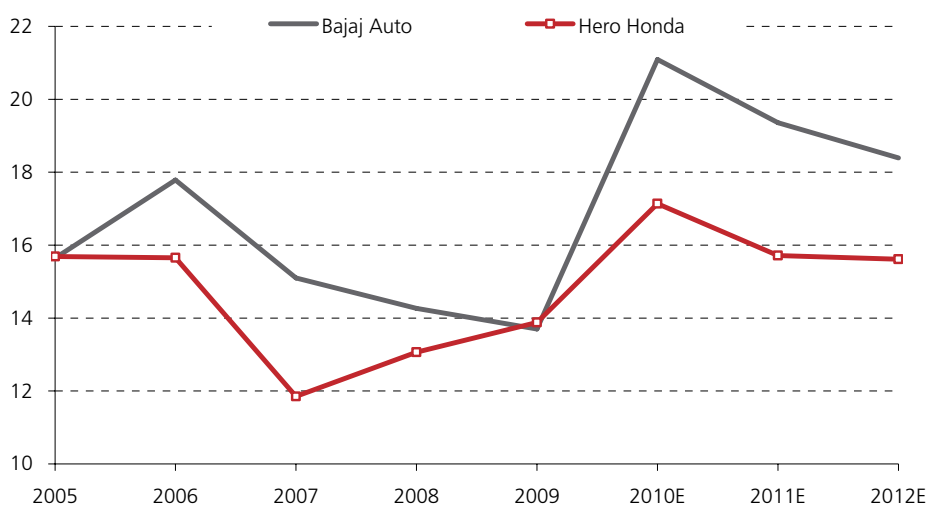
**Exhibit 2: HMSI is strong in participating segments; M&M has quickly garnered 6% of scooter market**

Trailing 3-month market share by segment, (%)

	Motorcycles		Scooters	Mopeds
	100-125cc	125-250cc		
Bajaj Auto	22	42	—	—
Hero Honda	71	13	13	—
Honda Motorcycle & Scooter	1	28	54	—
TVS Motors	6	8	18	100
Yamaha	1	8	—	—
Mahindra & Mahindra	—	—	6	—
Suzuki	—	2	10	—

Source: SIAM, Kotak Institutional Equities

Exhibit 3 below illustrates the margin trends of Bajaj Auto and Hero Honda. Both companies are currently earning peak margins at 21% and 17%, respectively. A combination of lower commodity costs, strong volume growth and excise concessions have driven the increase in margins. For Bajaj, a favorable exchange rate has offered an added advantage. We believe the significantly higher-than-average margins earned by the companies could afford them to play the volume over price game. Both companies have not significantly passed on the excise concession benefits accrued from their facilities in Uttarakhand.

**Exhibit 3: Both Bajaj Auto and Hero Honda earning higher than average margins**  
EBITDA margins, March fiscal year-ends (2005-2010YTD %)

Source: Company, Kotak Institutional Equities

Bajaj Auto, Volume assumptions, March fiscal year ends, 2006-2012E

	2006	2007	2008	2009	2010E	2011E	2012E
<b>Volumes (# vehicles)</b>							
<b>Motorcycles</b>	<b>1,913,094</b>	<b>2,376,519</b>	<b>2,139,633</b>	<b>1,907,810</b>	<b>2,496,707</b>	<b>3,139,008</b>	<b>3,452,909</b>
Domestic	1,747,806	2,078,860	1,658,084	1,276,427	1,790,738	2,291,845	2,521,030
Exports	165,288	297,659	481,549	631,383	705,969	847,163	931,879
<b>Scooters</b>	<b>115,472</b>	<b>20,480</b>	<b>21,294</b>	<b>11,772</b>	<b>4,854</b>	—	—
Geared	62,860	5,254	—	—	—	—	—
Ung geared	52,612	15,226	20,817	9,692	3,877	—	—
Exports	-	-	477	2,080	978	—	—
<b>Total 2-wheelers</b>	<b>2,028,566</b>	<b>2,396,999</b>	<b>2,160,927</b>	<b>1,919,582</b>	<b>2,501,562</b>	<b>3,139,008</b>	<b>3,452,909</b>
<b>Domestic 3-Wheelers</b>							
Passenger 3-wheelers	141,351	138,759	127,379	125,273	169,119	194,486	213,935
Goods 3-wheelers	35,394	42,374	26,607	10,197	9,177	9,636	9,636
Exports	75,261	140,663	136,315	139,056	166,867	191,897	211,087
<b>Total 3-wheelers</b>	<b>252,006</b>	<b>321,796</b>	<b>290,301</b>	<b>274,526</b>	<b>345,163</b>	<b>396,020</b>	<b>434,658</b>
<b>Total vehicles</b>	<b>2,280,572</b>	<b>2,718,795</b>	<b>2,451,228</b>	<b>2,194,108</b>	<b>2,846,725</b>	<b>3,535,028</b>	<b>3,887,567</b>
<b>Growth rates (yoy %)</b>							
<b>Motorcycles</b>	<b>30.2</b>	<b>24.2</b>	<b>(10.0)</b>	<b>(10.8)</b>	<b>30.9</b>	<b>25.7</b>	<b>10.0</b>
Domestic	30.0	18.9	(20.2)	(23.0)	40.3	28.0	10.0
Exports	33.4	80.1	61.8	31.1	11.8	20.0	10.0
<b>Scooters</b>	<b>(13.5)</b>	<b>(82.3)</b>	<b>4.0</b>	<b>(44.7)</b>	<b>(58.8)</b>		
Geared	(38.7)	(91.6)	(100.0)	—	—	—	—
Ung geared	70.1	(71.1)	36.7	(53.4)	(60.0)	—	—
Exports	—	—	—	336.1	(53.0)	—	—
<b>Total 2-wheelers</b>	<b>26.6</b>	<b>18.2</b>	<b>(9.8)</b>	<b>(11.2)</b>	<b>30.3</b>	<b>25.5</b>	<b>10.0</b>
<b>Domestic 3-Wheelers</b>							
Passenger 3-wheelers	14.2	(1.8)	(8.2)	(1.7)	35.0	15.0	10.0
Goods 3-wheelers	9.1	19.7	(37.2)	(61.7)	(10.0)	5.0	-
Exports	14.5	86.9	(3.1)	2.0	20.0	15.0	10.0
<b>Total 3-wheelers</b>	<b>13.5</b>	<b>27.7</b>	<b>(9.8)</b>	<b>(5.4)</b>	<b>25.7</b>	<b>14.7</b>	<b>9.8</b>
<b>TOTAL Vehicles</b>	<b>25.0</b>	<b>19.2</b>	<b>(9.8)</b>	<b>(10.5)</b>	<b>29.7</b>	<b>24.2</b>	<b>10.0</b>

Source: Company, Kotak Institutional Equities estimates

Bajaj Auto, Profit model and Balance Sheet, March fiscal year-ends, 2008-2012E (Rs mn)

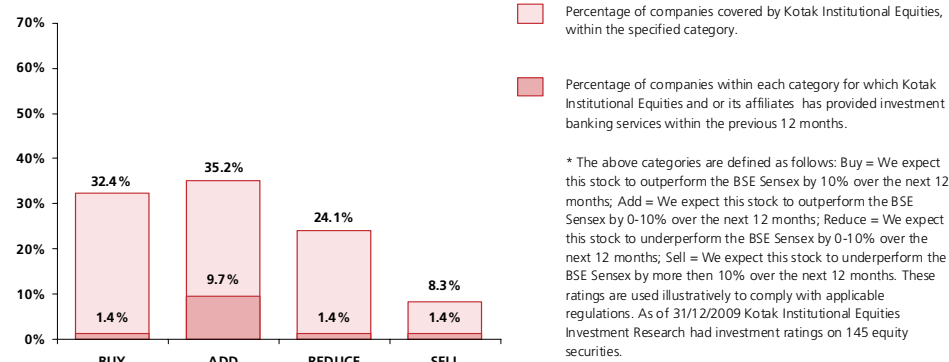
	2008	2009E	2010E	2011E	2012E
<b>Profit model (Rs mn)</b>					
Net sales	86,633	84,369	114,298	140,223	154,056
<b>Operating profit</b>	<b>12,900</b>	<b>12,097</b>	<b>25,026</b>	<b>28,127</b>	<b>29,306</b>
Other income	1,262	1,043	1,275	2,329	3,720
Interest	(52)	(210)	(60)	(60)	(60)
Depreciation	(1,740)	(1,298)	(1,406)	(1,488)	(1,580)
<b>Profit before tax</b>	<b>12,371</b>	<b>11,632</b>	<b>24,836</b>	<b>28,907</b>	<b>31,385</b>
Extra-ordinary items	(1,025)	(2,071)	(1,615)	-	-
Taxes	(3,788)	(3,016)	(7,198)	(8,961)	(9,729)
<b>Net profit</b>	<b>7,558</b>	<b>6,545</b>	<b>16,022</b>	<b>19,946</b>	<b>21,656</b>
<b>Earnings per share (Rs)</b>	<b>54.2</b>	<b>45.2</b>	<b>110.7</b>	<b>137.8</b>	<b>149.7</b>
<b>Balance sheet (Rs mn)</b>					
Equity	15,876	18,697	31,334	47,894	66,165
Deferred tax liability	110	42	-	-	-
Total borrowings	13,343	15,700	14,379	13,189	12,119
Current liabilities	18,773	24,376	28,079	31,839	33,782
<b>Total liabilities</b>	<b>48,102</b>	<b>58,814</b>	<b>73,791</b>	<b>92,922</b>	<b>112,065</b>
Net fixed assets	12,928	15,481	15,825	16,587	17,257
Investments	18,571	18,085	25,560	41,533	56,504
Cash	561	1,369	9,844	9,823	11,839
Other current assets	15,936	21,884	22,150	24,205	25,295
Miscellaneous expenditure	105	1,996	163	163	163
Deferred tax assets	-	-	250	613	1,007
<b>Total assets</b>	<b>48,102</b>	<b>58,814</b>	<b>73,791</b>	<b>92,922</b>	<b>112,065</b>
<b>Ratios</b>					
Operating margin (%)	14.3	13.7	21.1	19.4	18.4
PAT margin (%)	8.4	7.4	31.0	13.7	13.6
Debt/equity (X)	0.8	0.8	0.5	0.3	0.2
Net debt/equity (X)	0.0	0.2	(0.4)	(0.6)	(0.7)
Book Value (Rs/share)	114.6	129.5	216.5	331.0	457.3
RoAE (%)	21.0	37.7	64.0	50.4	38.0
<b>RoACE (%)</b>	<b>72.5</b>	<b>44.1</b>	<b>83.2</b>	<b>92.6</b>	<b>92.6</b>

Source: Company, Kotak Institutional Equities estimates

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Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of December 31, 2009

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**ADD.** We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

**REDUCE.** We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

**SELL.** We expect this stock to underperform the BSE Sensex by more than 10% over the next 12 months.

Our target price are also on 12-month horizon basis.

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