Company Focus

28 January 2008 | 9 pages

Ashok Leyland (ASOK.BO)

Sell: 3QFY08 Results, Conference Call Takeaways

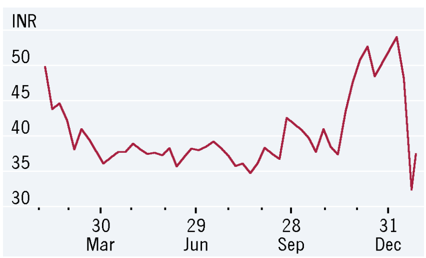
- **Recurring PAT declines 14% YoY** — Stripped of exceptional gains (Rs330m) on the sale of shares in IndusInd Bank, recurring profit declined, trailing EBITDA decline of ~10%Y/Y. EBITDA margins (at 9.4%) declined c110bps Y/Y, but remained static sequentially. Higher steel prices were reflected in material costs creeping up sequentially (and a sharp increase Y/Y). The impact of price hikes (~Rs16,000 / vehicle) is expected to be reflected in 4Q, but we think ALL might have to offer discounts to meet volume targets, given the weak demand environment and an imminent fuel price hike.

- **Conference Call Highlights** — 1) Management's demand outlook remains healthy, though concerns over the near term remain – management will focus on export markets and passenger vehicles to offset shortfall in goods demand, 2) Long term margin guidance at 12% (which we don't think is achievable, unless steel costs contract sharply), 3) Capex plans remain on schedule – management targets 180,000 units (vs 100,000 at present) by FY10, 4) Management targets market share of 35% over the next 2 years (we reckon this will be difficult, given competitive intensity in the industry), 5) LCV venture with Nissan remains on track – vehicle launch 2 years away (in early FY11e)

- **Maintain Sell** — Key upside risks to our rating include: a) stronger than forecast volume growth, accompanied by substantial margin expansion; and b) initiatives with Nissan could improve the company's product profile and lead to a re-rating of the stock, given a more balanced product profile.

Sell/Low Risk	3L
Price (25 Jan 08)	Rs37.50
Target price	Rs38.00
Expected share price return	1.3%
Expected dividend yield	4.0%
Expected total return	**5.3%**
Market Cap	Rs49,888M
	US$1,268M

Price Performance (RIC: ASOK.BO, BB: AL IN)



Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	3,094	2.32	25.1	16.1	3.2	24.0	3.2
2007A	4,579	3.46	48.8	10.8	2.6	27.7	4.0
2008E	4,255	3.20	-7.5	11.7	2.4	21.2	4.0
2009E	4,552	3.42	7.0	11.0	2.2	20.6	4.5
2010E	5,189	3.90	14.0	9.6	2.0	21.4	5.1

Source: Powered by dataCentral

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

[1]Citigroup Global Markets India Private Limited

Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	16.1	10.8	11.7	11.0	9.6
EV/EBITDA adjusted (x)	8.8	6.9	6.5	6.0	5.7
P/BV (x)	3.2	2.6	2.4	2.2	2.0
Dividend yield (%)	3.2	4.0	4.0	4.5	5.1
Per Share Data (Rs)					
EPS adjusted	2.32	3.46	3.20	3.42	3.90
EPS reported	2.46	3.53	3.20	3.42	3.90
BVPS	11.56	14.31	15.87	17.35	19.08
DPS	1.20	1.49	1.50	1.70	1.90
Profit & Loss (RsM)					
Net sales	52,477	71,682	78,748	91,030	108,551
Operating expenses	-48,336	-66,161	-72,924	-84,487	-101,029
EBIT	**4,141**	**5,521**	**5,824**	**6,543**	**7,522**
Net interest expense	-384	-288	-455	-731	-759
Non-operating/exceptionals	766	1,074	710	691	650
Pre-tax profit	**4,523**	**6,307**	**6,078**	**6,502**	**7,413**
Tax	-1,250	-1,632	-1,823	-1,951	-2,224
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**3,273**	**4,674**	**4,255**	**4,552**	**5,189**
Adjusted earnings	3,094	4,579	4,255	4,552	5,189
Adjusted EBITDA	5,401	7,027	7,812	9,197	10,530
Growth Rates (%)					
Sales	25.5	36.6	9.9	15.6	19.2
EBIT adjusted	32.0	33.3	5.5	12.3	15.0
EBITDA adjusted	27.7	30.1	11.2	17.7	14.5
EPS adjusted	25.1	48.8	-7.5	7.0	14.0
Cash Flow (RsM)					
Operating cash flow	**4,233**	**4,668**	**8,124**	**7,355**	**8,198**
Depreciation/amortization	1,260	1,506	1,988	2,654	3,009
Net working capital	-849	-2,455	1,172	-541	0
Investing cash flow	**344**	**4,455**	**205**	**315**	**316**
Capital expenditure	0	0	0	0	0
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**-2,706**	**391**	**6,285**	**-2,895**	**4,833**
Borrowings	-1,885	-515	8,367	-317	4,833
Dividends paid	-1,822	-2,264	-2,275	-2,579	0
Change in cash	**1,872**	**9,514**	**14,614**	**4,775**	**13,347**
Balance Sheet (RsM)					
Total assets	**36,926**	**44,878**	**59,551**	**64,417**	**75,908**
Cash & cash equivalent	6,029	4,349	10,776	3,306	6,255
Accounts receivable	4,243	5,229	6,085	7,034	8,387
Net fixed assets	10,847	15,445	23,458	32,803	35,795
Total liabilities	**22,801**	**25,932**	**38,439**	**41,339**	**50,530**
Accounts payable	10,460	14,337	15,911	18,361	21,979
Total Debt	6,919	6,404	14,771	14,455	19,288
Shareholders' funds	**14,125**	**18,946**	**21,112**	**23,078**	**25,379**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	10.3	9.8	9.9	10.1	9.7
ROE adjusted	24.0	27.7	21.2	20.6	21.4
ROIC adjusted	23.1	23.0	17.5	15.5	14.6
Net debt to equity	6.3	10.8	18.9	48.3	51.4
Total debt to capital	32.9	25.3	41.2	38.5	43.2

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Figure 1. Ashok Leyland – Operational Performance

	3QFY07	3QFY08	% chg YoY	CIR Comments
Volumes (Nos.)				
H / MCVs	19,997	18,814	-5.9	13% y/y decline in MHCV sales due to slowdown in industry and loss of market share to Tata Motors partially offset by 11% y/y growth in bus sales
LCVs	71	151	112.7	
Total CVs	**20,068**	**18,965**	**-5.5**	
Product mix (%)				
H / MCVs	99.6	99.2		
LCVs	0.4	0.8		
Market share (%)				
H / MCVs	28.7	25.5		Loss of market share to Tata Motors in both passenger and goods segments
LCVs	0.1	0.2		

Source: Company reports, Citi Investment Research

Figure 2. Ashok Leyland – 3QFY08 Results

	3QFY07	3QFY08	% chg YoY	CIR Comments
Net sales	17,776	18,001	1.3	Marginally above expectations due to higher spare sales (~Rs 2 billion)
Raw Materials	14,505	14,147	21.2	Impacted by increase in steel costs
Staff costs	1,149	1,478	28.6	Headcount increase of 600 people, also recent wage settlements
Other Expenses	1,204	1,246	3.4	Other expenses remain under control
Total Expenditure	15,907	16,313	2.6	
EBITDA	1,869	1,688	-9.7	
Interest	26	152	494.5	Due to higher capex and working capital requirements
Other income	64	107	68.5	Excluding Rs 330 million gain on sale of Indus Ind shares
EBDT	1,878	1,609	-14.3	
Depreciation & Amortization	332	408	22.9	
PBT	1,546	1,201	-22.3	
Exceptional income	-	330		Gains on sale of IndusInd shares
Exceptional expenditure	21	13		Related to VRS expense
Tax	473	316	-33.2	
PAT	1,053	1,202	14.2	
PAT (pre exceptional)	**1,032**	**885**	**-14.2**	**7% below expectations**
Profit Margins (%)				
EBITDA (%) net sales	10.5	9.4		110 bps below expectations
Tax / PBT (%)	30.2	20.5		
Net profit margins (%)	5.8	5.1		
Cost ratios (%)				
Raw materials / sales	76.2	75.5		
Staff costs / sales	6.5	8.2		
Other expenses / sales	6.8	6.9		
EPS (Rs)	0.8	0.7		
CEPS (Rs)	1.0	1.0		

Source: Company reports, Citi Investment Research

Conference Call Takeaways

- **Outlook:** Management remained optimistic on the recovery in CV sales in 4QFY08. However management has revised its guidance downwards to 85,000 vehicles for FY08 (from 90,000 vehicles) implying volume growth of around 12-13% in 4QFY08 backed by strong export orders. Management stated that the company has firm export orders of around 4000-4500 vehicles (mainly African markets). The company has also built up sufficient inventory levels to service the domestic and export demand in 4QFY08. Management guided to volume growth of 10-12% in FY09 and 15-20% in FY10 as company targets to increase its market share to 35% by FY10E. *We reckon market share gains will be difficult considering a) greater competitive intensity from incumbents and also new players like MAN, b) ALL's concentrated geographic focus (mainly southern and western markets).*

- **Capacity expansion on schedule:** Management reiterated that its capacity expansion plan is on schedule and it expects to increase capacity to 130,000 units by June 2008. It also wants to add another 50,000 capacity by FY10 from its Uttaranchal plant. *We believe that capacity utilization will decrease from ~85% levels currently to 60-65% by FY10E, which will put pressure on operating margins. We think operating economies will be difficult to achieve, as engine and gearbox facilities will be across 3 locations, and axles and chassis assembly scattered across 5 locations.*

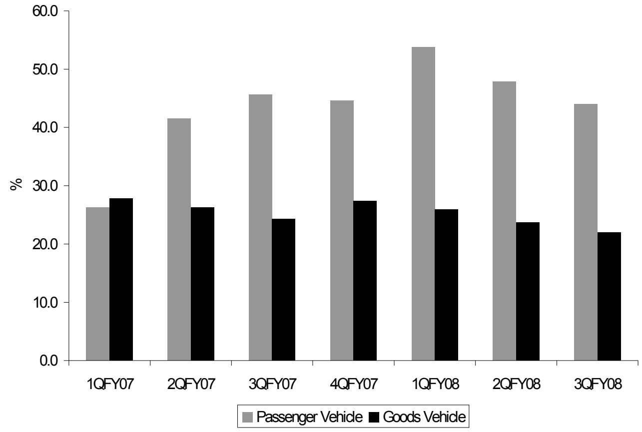
- **EBITDA margin outlook:** The company expects margins to improve to 12% over longer term due to richer product mix and operating leverage benefits. *We believe margins will remain range bound over the next 2 years (~10% levels) due to higher input cost pressures and dis-economies of scale. A sharp decline in steel prices (the key input) could have an upward impact on margins, though given the current pricing scenario in the steel industry, we think this likelihood appears weak, at present.*

- **Realizations and pricing:** Average realizations in 3QFY08 were up 7% YoY (but distorted) due to increased sales of spare parts and sales to the defence sector. Management stated that price hikes announced in last quarter were effected only in Dec – the full impact will thus be seen in 4Q. *We think that given the weak demand environment, these price hikes might be partially rolled back.*

- **Update on LCV project with Nissan:** Management indicated that Nissan-Ashok Leyland JV for LCVs is on track and new products are expected to be launched within 2 years. For initial Phase 1 capacity of 100,000 units, ALL will invest Rs2.5bn (total capex of Rs10bn, 50-50 funded by ALL and Nissan with debt – equity of 1:1).

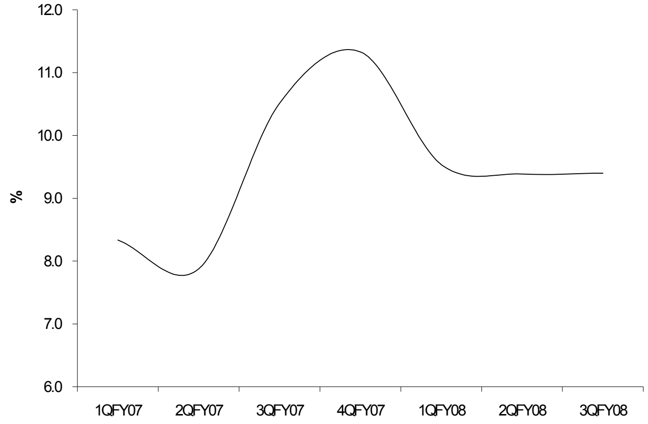
- **Competitive Positioning:** ALL has seen a marginal erosion in domestic market share in both goods and passenger segments, losing market share to Eicher Motors and Tata Motors, respectively in both segments. We thought the company's new product line up – exhibited at the Auto Expo – was both exciting and fairly competitively priced. According to truckers and fleet operators, ALL's distribution and after sales has lagged versus competitors, due to which products have not been as well received as they should be. We reckon this will remain a structural weakness for ALL.

Figure 3. Ashok Leyland – Domestic Market Share (%)



Source: SIAM

Figure 4. Ashok Leyland- EBITDA Margins (%)



Source: Company, Citi Investment Research

Ashok Leyland

Company description

ALL is owned by the Hinduja Group (which has an equity stake of 50.9%). ALL is the second-largest CV manufacturer in India, with a strong focus on medium and heavy commercial vehicles (MHCVs). The company's core product portfolio comprises MHCVs (goods vehicles and buses), and it also manufactures a range of vehicles suited for defense and special applications. Its recent successes in the export market are indicative of its product quality. Sales of spares and engines add to revenue and earnings, especially during cyclical downturns.

Investment strategy

We maintain our Sell/Low Risk (3L) rating because growth prospects for ALL appear limited, and a rising capital outlay poses a risk. At current prices, we believe the stock factors in most of the visible positives. Fundamentally, the key reasons for a healthy growth outlook in commercial vehicles include a sustained pick-up in economic activity, a focus on infrastructure spending and a strong replacement cycle (15% of the existing fleet in India is more than 15 years old and needs to be replaced both for commercial and environmental reasons). Moreover, growth in the agriculture, infrastructure and manufacturing sectors - all of which have positive linkages to the freight business - should remain positive. ALL is more than doubling capacity over the next two years to meet demand, and plans to launch new products. In the long term, exports could emerge as a growth driver as ALL leverages off its low-cost competitive advantage to enter foreign markets.

Valuation

Our 12-month target price of Rs38 for ALL is based on 7x FY09E CEPS, close to the mid-point of the stock's 4-year historical trading band of 6-9x to reflect slower-than-expected earnings growth due to margin pressure and higher capital costs. We prefer to use P/CEPS as a valuation metric to ensure proper comparison with historical trading bands, and reflect a restructuring of the balance sheet in FY03 and the capital-intensive nature of the business. At our target price, the stock would trade at a P/E of 11x FY09E EPS, at the lower end of its recent trading band.

Risks

We rate ALL Low Risk based on our quantitative risk-rating system, which tracks 260-day historical share-price volatility. The key risk factors to our target price are movements in economic variables - particularly GDP growth, interest rates and fuel prices, to which sales of commercial vehicles are very sensitive. Input costs are volatile and linked to global commodity prices for metals, plastics, etc. The profitability and viability of the STUs over the long term are an important risk factor, given that the STUs are the largest buyers of ALL buses. Key upside risks to our target price include: 1) Greater-than-expected volume growth on account of the Supreme Court ruling on overloading; 2) Reduction in input costs (notably steel and aluminium) would benefit earnings; and 3) Effective integration of the Avia acquisition could enable ALL to penetrate the domestic LCV market successfully.

Appendix A-1

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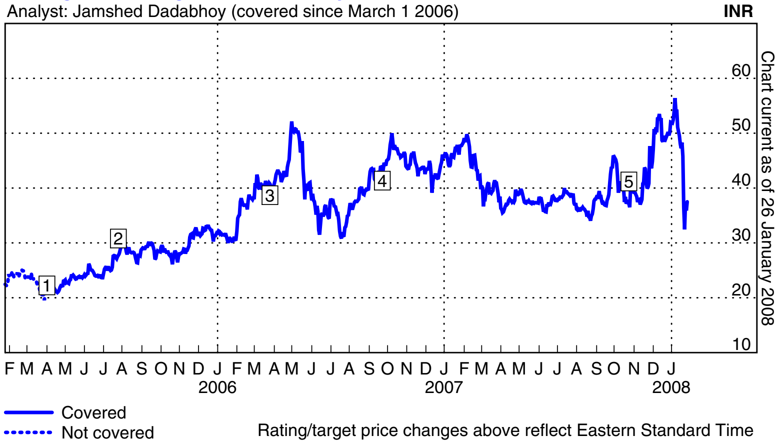
Analyst: Jamshed Dadabhoy (covered since March 1 2006)



#	Date	Rating	Target Price	Closing Price
1:	1 Apr 05	1M	26.00	21.70
2:	26 Jul 05	*1L	*31.00	27.75
3:	26 Mar 06	*3L	*37.00	40.75
4:	22 Sep 06	3L	*39.00	43.30
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