

Industry In-Depth

3 May 2007 | 12 pages

India – 2 Wheeler Majors

FY08 – Commences on a Negative Note

- **Growth rates decline** — Two-wheeler majors' April sales declined c.6% YoY – motorcycle sales were marginally lower – down 8% YoY, as rising interest rates began to curb growth. Market leader Hero Honda managed to post marginally positive growth in motorcycle sales – but Bajaj Auto and TVS' sales fell c.13% and c.34%, respectively.
- **Rising interest rates to moderate growth** — Interest rates have risen sharply over the last few months (18-20% IRR at present) and should continue to remain at these levels over the near term. We believe this will moderate volume growth in FY08. BJAT has already guided c.10% volume growth in FY08E – far lower than its previous guidance of >20%.
- **HROH gains market share – we question sustainability** — HROH's recent market share gains are spurred because of increased share in the economy segment (we estimate its share has risen over 20% in this segment to almost 35%). But given that this segment has little product differentiation (with price being the key driver), we don't think these gains are sustainable.
- **New model launches** — Key model launches next fiscal are TVS' relaunch of the *Victor* in early FY08E), BJAT's launch of a new motorcycle platform in 2QFY08E. These are the most eagerly awaited new product launches for FY08E, and the market response to these will be keenly monitored.
- **Relative performance** — Over the past month, the sector underperformed the market by 640bps, as concerns about rising interest rates, slowdown in growth rates, and mounting competition resulted in a sell off in all the majors. In relative performance, TVS Motors was the best performer over the month.
- **Concerns persist** — We believe the two-wheeler segment is witnessing intense competition and a challenging cost environment. We maintain our negative view on the sector. We reiterate our Sell/Low Risk recommendations on Hero Honda (HROH.BO - Rs683.60; 3L) and TVS Motor (TVSM.BO - Rs64.45; 3M), and our Hold/Low Risk rating on Bajaj Auto (BJAT.BO - Rs2,445.00; 2L).

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Figure 1. 2 wheelers- April Unit Sales Performance

	Apr Sales (Nos)	YoY Chg (%)	MoM chg (%)
Hero Honda	262,544	4.9	-5.5
Bajaj Auto			
Motorcycles	164,304	-12.8	-0.7
2 wheelers	165,692	-12.8	-1.9
3 wheelers	24,360	15.1	-0.9
Total	190,052	-10.0	-47.1
TVS Motors			
Motorcycles	53,499	-33.8	-27.0
2 wheelers	104,893	-16.0	-18.2
Motorcycles	480,347	-7.6	-7.0
2 wheelers	533,129	-5.7	-7.3

Source: Company

Figure 2. 2 wheelers - Market shares

	FY06 %	FY 07 [^] %	FY08 YTD Relative* %	Apr Relative* %
Motorcycles				
Hero Honda	48.1	45.8	54.7	54.7
Bajaj Auto	30.8	33.5	34.2	34.2
TVS Motors	13.0	13.0	11.1	11.1
2 wheelers				
Hero Honda	39.6	39.5	49.2	49.2
Bajaj Auto	26.8	28.3	31.1	31.1
TVS Motors	17.7	18.0	19.7	19.7

Source: Company Reports

* Relative market shares amongst the 3 majors; Consolidated industry data awaited

[^] Market share up to f-1 month based on consolidated industry data

^{^^} Hero Honda's sales slightly distorted as they include scooter sales

Hero Honda – Market Share Gains Continue

Figure 3. Hero Honda- April 2007 Sales

	Apr Sales (Nos)	YoY Chg (%)	MoM chg (%)
Two Wheelers	262,544	4.9	-5.5

Source: Company

April volumes rose +5% YoY significantly better than those of industry peers. Our channel checks indicate that the newly launched CD Deluxe is reporting strong numbers. HROH targets c.1m unit sales of the *CD* series (entry level segment – sub Rs35,000) per annum over FY08E – which implies growth of c.38% (based on our FY07 volume estimates). This does not augur well for margins and profitability and signals management's emphasis on volumes and market share, rather than margins. Channel financiers indicate that HROH's

dealers' credit limits have been extended to 38-40 days (from 30 days) – a near 30% increase. We think this is an unhealthy sign and an indication that inventory levels in the dealer channel will rise structurally (also a function of the increase in variants).

Hero Honda's market share continues to strengthen (refer to figure 13), but we think it's on the back of gains in the entry-level segment – we view this strategy negatively – we believe it will result in a structural decline in EBITDA margins.

The newly launched *Achiever*, HROH's latest offering in the premium segment, has received a favorable response, but it's difficult to determine if the model is a success, given that the launch was so recent. What's noteworthy is that the main product in the premium segment – BJAT's *Pulsar* - continues to hold its market share (c.62%), whilst the CBZ Extreme and the Achiever have captured share from TVS' *Apache*. We would also not rule out cannibalization of the CBZ sales by the *Achiever* (and vice versa) and retain our cautious stance on HROH. HMSI's intent to launch a new product within the critical 100cc segment also does not augur well for HROH, given that Honda's strategy is to ensure collective dominance among HROH and HMSI.

Bajaj Auto – Core Business Remains Under Pressure

Figure 4. Bajaj Auto- April 2007 Sales

	Apr Sales (Nos)	YoY Chg (%)	MoM chg (%)
Total Sales	190,052	(10.4)	(1.8)
Motorcycles	164,304	(12.8)	(0.7)
Other Two Wheelers	1,388	(5.6)	(59.9)
Total 2 wheelers	165,692	(12.8)	(1.9)
3 wheelers	24,360	15.1	(0.9)

Source: Company

Overall, a disappointing performance as motorcycle volumes declined 13% YoY, on the back of rising interest rates, declining sales of the *Platina* as Hero Honda's CD Deluxe continues to grab market share in the economy segment. We think May sales will also be relatively subdued as the stocks in the channel are drawn down.

Platina has consistently lost market share over last few months to Hero Honda (CD Deluxe) and TVS Motors (TVS Star) in the economy segment. Bajaj Auto cut Platina prices by Rs3,000 (now priced at c.Rs33,000), passing on the tax benefits currently available at the new Pantnagar plant. This pricing strategy will continue till BJA launches its new platform (125cc offering) in 2QFY08.

3-wheeler volumes reported relatively healthy growth of around 15% YoY. But we expect the base effect to become more challenging from August, especially if volumes remain at the current level. This would also pose as a risk to our FY08E volumes – if volumes remain stagnant at around 25,000 units.

Over the month, the stock price has remained almost flat with no triggers to drive the stock. We maintain a neutral rating as margins will likely continue to remain under pressure due to competitive intensity and new model launches.

TVS Motor – Motorcycles Volumes Decline 34% YoY

Figure 5. TVS Motor- April 2007 Sales

	Apr Sales (Nos)	YoY Chg (%)	MoM chg (%)
Total Sales	104,893	(16.0)	(18.2)
Scooters/Mopeds	51,394	16.7	(6.5)
Motorcycles	53,499	(33.8)	(27.0)

Source: Company

TVS' April motorcycles sales declined sharply (-34% YoY), lagging those of its industry peers (Hero Honda +5% YoY and Bajaj Auto -13% YoY). Lackluster performance in the motorcycle segment was offset by stronger performance of the scooter / moped portfolio (which grew 17% YoY). In the backdrop of rising interest rates (and especially this last hike) we think our estimates for 2 wheelers could face more downside risk over the next year.

TVS' motorcycle portfolio partially resembles that of Bajaj Auto's – it has a strong product line up at the low end (in the StaR and its variants) and at the upper end (through the Apache). Within the executive segment (still the core of the 2 wheeler market), TVS' Victor has lost market share, notably to Bajaj Auto's Discover variants. The company plans to rectify this by re-launching the Victor next fiscal, but we believe that competitive intensity has increased across the industry, and TVS will have to launch products at a faster-than-industry pace, if it wishes to recoup market share conceded over the past three years.

TVS Motors moped sales grew faster-than-the-industry rate in FY07 by 19% YoY vs. 5% (industry). TVS now accounts for 88% of the moped market increasing its share by 10% from FY06. We believe that longer term, TVS' mopeds will grow/decline in line with the industry growth rate, given that further growth through market share gains appears difficult. Against this backdrop, we believe the motorcycle portfolio will be under greater pressure to drive volume growth for TVS.

Over the month, the stock performed better than its peers (up +3%) but we believe the stock will continue to remain range bound as volume growth stagnates, and margins remain under pressure due to escalating input costs and increasing S&D expenses.

Figure 6. Sector Absolute and Relative Performance

	Price (Rs)	1M (%)	3M (%)	6M (%)	12M (%)	YTD (%)
Bajaj Auto	2,456.5	1.3	-10.6	-11.4	-18.5	-6.2
Hero Honda	668.2	-2.5	-6.6	-9.7	-20.9	-12.3
TVS Motor	61.4	3.0	-20.7	-43.3	-61.7	-29.7
CIR India 2-wheeler Index	NA	0.0	-9.7	-12.6	-22.4	-9.4
BSE Sensex	13,909	6.4	-2.6	7.8	15.5	0.9

Source: Bloomberg

Bajaj Auto

Valuation

Our target price of Rs2,886 reflects accelerating margin pressures for FY07/08E and a de-rating of the core business to a 14x multiple, which is moderately higher than the multiple we assign to its peers Hero Honda and TVS Motor. We believe this multiple is warranted because we think BJAT's earnings growth prospects are stronger. Our target price of Rs2,886 is based on a sum-of-the-parts valuation that comprises: a) valuing 12-month forward earnings from operations (ex-financial income) of Rs119.9 for FY08E at 14x (above the peer group but merited given the company's higher earnings growth prospects). We thus arrive at a value of Rs1,679/share (119.9×14). Over the past year, the one-year forward P/E multiple (after stripping the value of the insurance business) has ranged from 11.9-19.8x with a mean of 15.7x. Our multiple of 14x is at a discount to this mean, but we think it is justified given rising competitive intensity in the industry with players focusing on market share at the expense of margins. A 20% CAGR in core earnings for FY06-09E should support these valuations, in our view. b) Estimated cash and investments per share of Rs697. c) We value Bajaj Auto's insurance joint ventures at Rs510/share.

Risks

We rate Bajaj Auto as Low Risk based on our quantitative risk-rating system, which tracks 260-day historical share price volatility. The key risks to Bajaj would be deterioration in macroeconomic variables (including growth, interest rates and fuel prices) or increase in competitive pressures that result in a slowdown in sales and/or erosion of margins. Competitive pressures in the 2-wheeler industry remain high and could intensify in view of the aggressive product pipelines of key competitors. This, coupled with the rising trend in input costs, could mute margin expansion. Success in the 3-wheelers segment is critical given that this is the company's most profitable segment and is a source of substantial cash flow. Predictability of this business remains relatively difficult, however, because its performance depends on the issuance of licenses by various government bodies. Upside risks include stronger-than-expected volume growth or a decline in material costs on a sustainable basis that would benefit margins. If any of these risk factors has a greater impact than we anticipate, Bajaj Auto's share price would have difficulty reaching our target price.

Hero Honda

Valuation

Our 12-month target price of Rs678 is based on 11.6x FY08E forward earnings, at the low end of the recent band. Hero Honda has traded at an average of almost 16x over the past fiscal. An 11% CAGR in earnings over FY06-09E should, we believe, support these valuations. At our target price the stock would trade at about 10.2x FY08E P/CEPS and 7.5x FY08E EV/EBITDA – the mid point of the recent trading band.

Risks

We rate Hero Honda Low Risk according to our quantitative risk rating system, which tracks 260-day historical share price volatility. The key upside risks to our target price and Sell rating on the stock are: 1) Any corporate action that further

strengthens the relationship between Honda Motors and Hero Honda from current levels; 2) Any meaningful and sustained improvement in profitability, driven by a beneficial shift in the product mix; 3) Faster-than-anticipated growth in the sector as a whole, which could ease market share concerns for Hero Honda; 4) Crystallization of export initiatives to Honda's markets, which could offset growth pressures in the domestic market; 5) A sustained and substantial decline in input costs, which could improve EBITDA margins over the long term; and 6) Greater-than-expected tax savings on Hero Honda's new plant.

TVS Motor

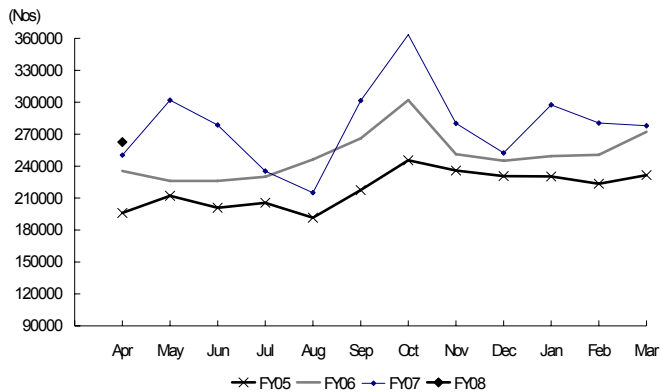
Valuation

Our 12-month target price for TVS of Rs65 is based on 13x FY08E earnings. The valuation multiple ascribed is at a discount to stock's 14.8x P/E multiple over the past five years. However, we think the historical multiple is inflated – TVS' stock price typically runs up on expectations of margin improvement / new initiatives, but then corrects on the back of disappointing earnings / delay in strategic initiatives. The historical forward P/E thus appears exaggerated. We also contend that 13x is appropriate, given the intense competitive pressures that we forecast for the sector. Our valuation multiple is comparable with TVS' peer group. Over the past year, TVS has underperformed its peer group, largely due to unabated margin pressure and a lacuna in its product portfolio (in the executive segment) which it will seek to address through the relaunch of the Victor. Its forecast earnings growth is much higher than peers over FY07-09E, because of a low base effect over FY07E. However, the company lags Hero Honda in terms of technology and doesn't have a huge cash pile like Bajaj Auto. In a price war scenario, these could constrain TVS' earnings growth. We are therefore not ascribing a premium for higher earnings growth forecast for TVS (we use a multiple of 13x for TVS, vs. c.12x for HROH and 14x (on core earnings) for BJAT). We contend that the P/E multiple is most suitable for the 2-wheeler sector, given relatively stable long-term growth trends and limited capex requirements, which ensure that profitability remains relatively stable (in comparison to the 4-wheeler sector).

Risks

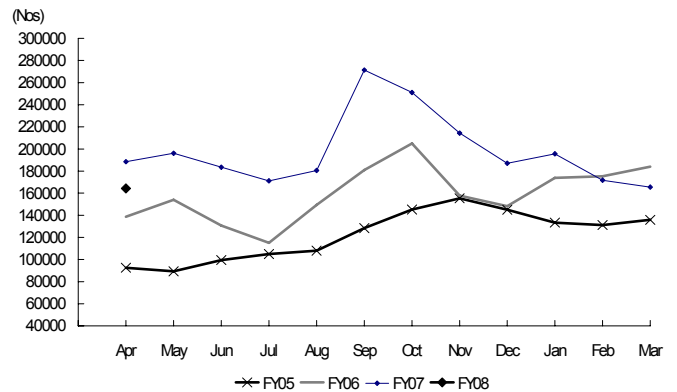
We rate TVS Medium Risk, in line with our quantitative risk rating system, which tracks 260-day historical share price volatility. The key upside risks to our Sell rating on the stock are: a) Meaningful and sustained improvement in profitability, driven by a beneficial shift in the product mix; b) Faster-than-anticipated ramp up in 3-wheeler volumes that would result in a richer product mix over the medium term; and c) Sustained increase in exports, especially after the establishment of the plant in Indonesia. Downside risks are as follows: a) Competitive pressures in the 2-Wheeler industry remain intense and could likely accentuate given declining product life cycles and increasing number of models being launched by not only new players, but also the 3 majors; b) Macro risk factors include a slowdown in sales (and commensurate erosion in margins) due to any deterioration in macroeconomic variables (including growth, interest rates and fuel prices); c) Low liquidity in the stock is also a risk as it implies higher transaction costs and volatile swings based on monthly sales numbers

Figure 7. Hero Honda: Motorcycle Sales Trends



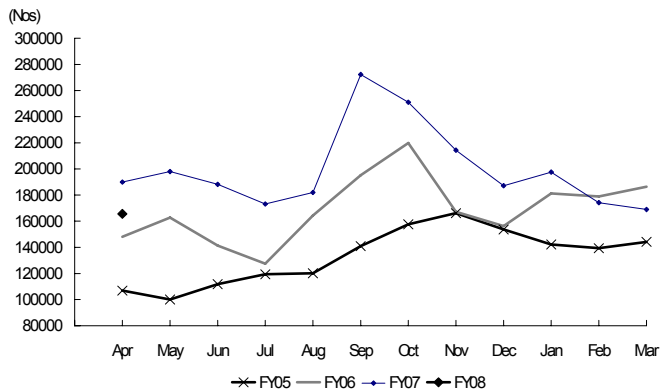
Source: Company Reports

Figure 8. Bajaj Auto: Motorcycle Sales Trends



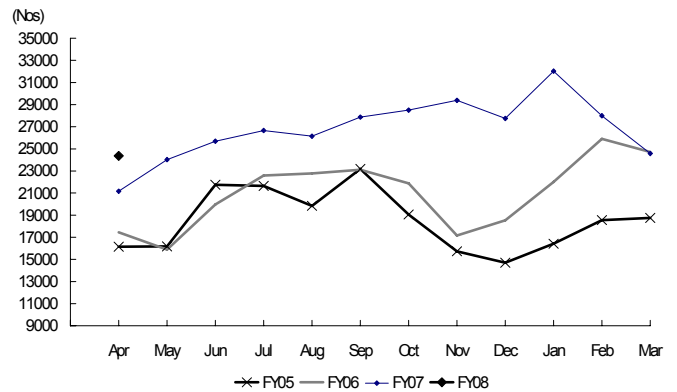
Source: Company Reports

Figure 9. Bajaj Auto: 2 Wheelers Sales Trends



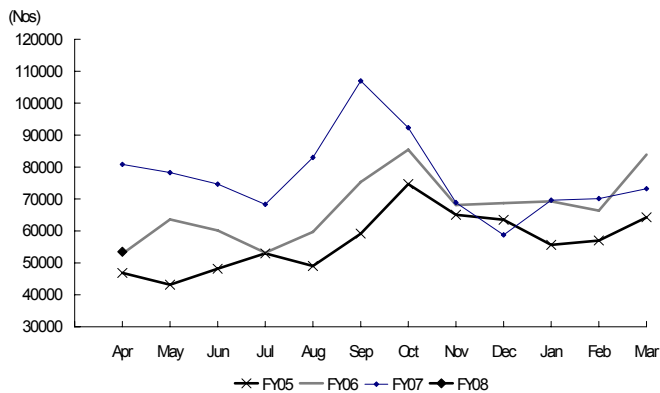
Source: Company Reports

Figure 10. Bajaj Auto: 3 Wheelers Sales Trends



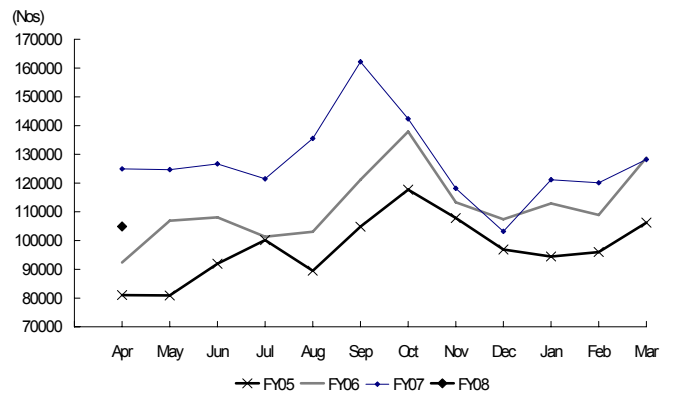
Source: Company Reports

Figure 11. TVS Motor: Motorcycle Sales Trends



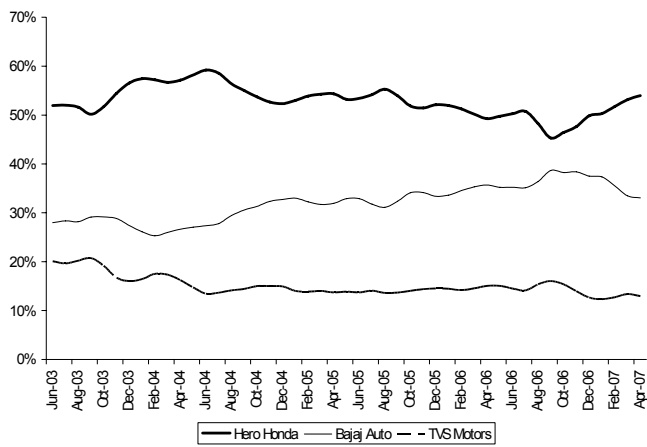
Source: Company Reports

Figure 12. TVS Motor: 2 Wheeler Sales Trends



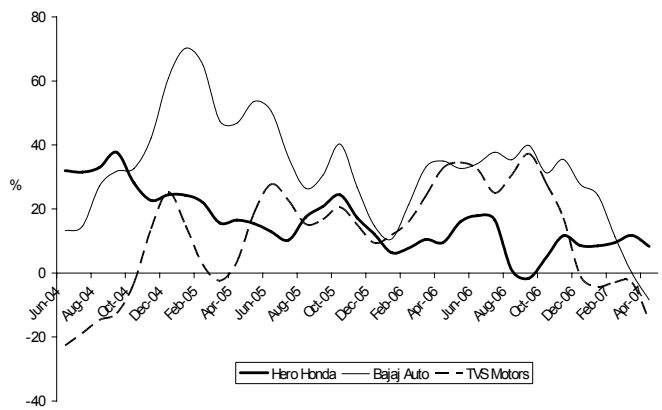
Source: Company Reports

Figure 13. 2 Wheeler Majors: Motorcycle Market Share (3mma, %)



Source: SIAM, Company

Figure 14. 2 Wheeler Majors: Sales Growth (3mma, %)



Source: SIAM, Company

Appendix A-1

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Ratings and Target Price History - Fundamental Research

Analyst: Jamshed Dadabhoy (covered since March 1 2006)



— Covered
..... Not covered

Hero Honda (HROH.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Jamshed Dadabhoy (covered since March 1 2006)

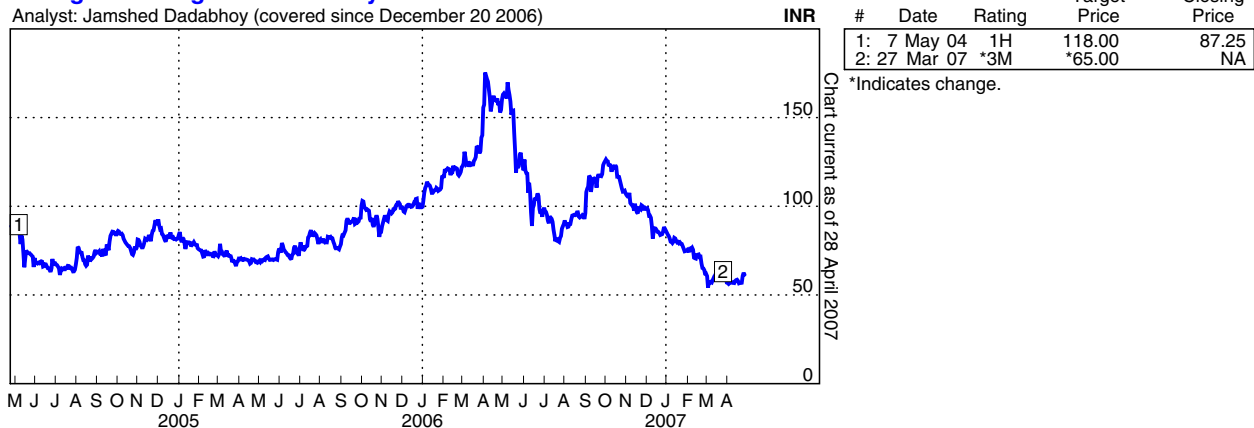


— Covered
..... Not covered

TVS Motor (TVSM.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Jamshed Dadabhoy (covered since December 20 2006)



— Covered
..... Not covered

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