Company Flash

4 January 2008 | 8 pages

Tata Motors (TAMO.BO)

Jaguar and Land Rover–Tata Motors Emerges as Preferred Bidder

- **What's new** — Ford announced in a statement today that it is committed to enter detailed discussions with Tata Motors (which has emerged as the preferred bidder) for the sale of the Jaguar and Land Rover brands. We reckon that the deal – if consummated – will likely occur by the end of this month.

- **Impact on Tata Motors** — We reckon the initial reaction to this deal will be adverse, given the negative press these brands have received. Issues pertaining to the funding of the transaction and the subsequent integration and restructuring of the businesses and the time lines for these will need to be promptly addressed by TAMO. Even so, we expect that over the near term, the share price will be extremely volatile.

- **Concerns**— 1) We expect that most of the purchase consideration will be paid for intangible assets like brand/goodwill, which are susceptible to impairment if expected synergies do not crystallize, 2) A weaker $/GBP exchange rate will erode the brands' competitiveness, given that manufacture is in the UK, and the US market accounts for ~25-30% of unit sales, 3) Extent of equity dilution in TAMO to fund the acquisition, 4) Volatile earnings streams, given that J/LR's earnings profile will be affected by currency movements, warranty and pension related charges and provisions.

- **Positives** — 1) The key positive is that Ford has stated (in its most recent 10Q filing) that both these brands are profitable, 2) Contrary to popular perception, Jaguar and Land Rover quality is at/above par with competing brands in the latest JD Power sales and quality satisfaction surveys.

Buy/Low Risk	**1L**
Price (03 Jan 08)	Rs796.90
Target price	Rs1,029.00
Expected share price return	29.1%
Expected dividend yield	1.9%
Expected total return	**31.0%**
Market Cap	Rs305,352M
	US$7,767M

Price Performance (RIC: TAMO.BO, BB: TTMT IN)

Figure 1. Jaguar and Land Rover Snapshot

CY2006	**Jaguar**	**Land Rover**
Dealers	871	1,376
Markets	64	138
Sales	74,953	193,640
Geographical Mix (%)		
N.America	29%	26%
Europe	55%	51%
Asia Pacific	10%	8%
S. America	0%	3%
Rest of World	6%	12%

Source: Ford Annual Report

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

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According to press reports (source: *Economic Times, Business Standard*, et al) Tata Motors is poised to acquire Ford's Jaguar and Land Rover brands for an outlay of c.US$2bn. Given the paucity of information available on this acquisition, most of our analysis below is based on information gleaned from various annual reports, presentations, and conference call transcripts of Ford Motors.

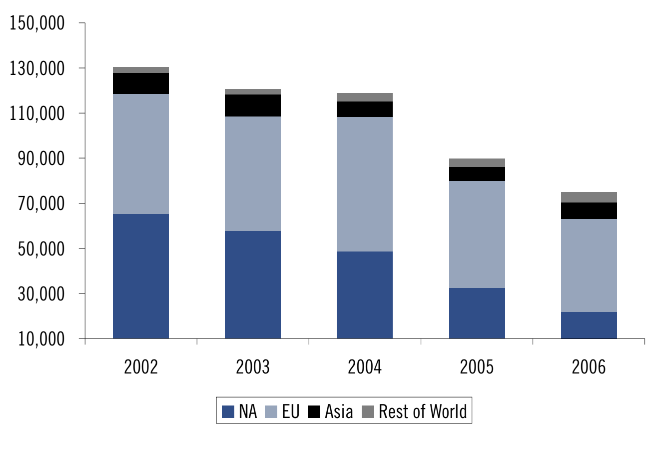
Briefly, our views on the central issues surrounding this deal are as follows:

The Negatives...

1) **Most of the purchase consideration will be paid for intangible assets like goodwill/brand** – where value is always difficult to assess, and sometimes driven by the acquirer's perception (in a buyout situation), rather than hard metrics. Goodwill in the US is subject to impairment, and the timing of impairment is difficult to predict.

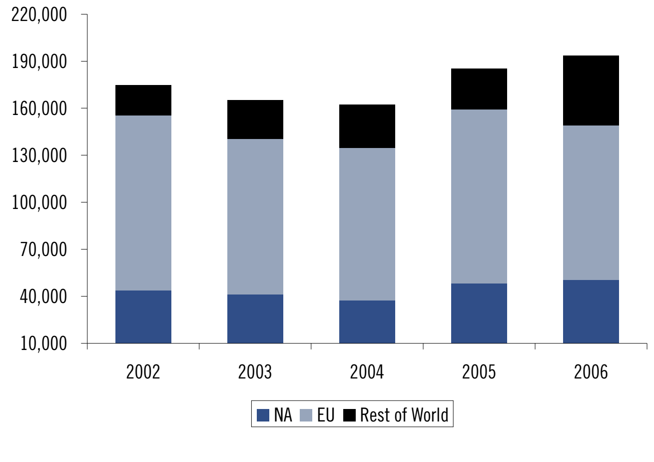
2) **Currency risk** – **We think that with a weakening USD/GBP exchange rate over the near term, vehicles manufactured in England and sold in North America will continue to become less competitive.** This will be a key challenge for any player acquiring these brands, with North America comprising a substantial portion of sales of both brands.

Figure 2. Jaguar – Historical Geographical Volume Trend



Source: Ford Annual Report

Figure 3. Land Rover – Historical Geographical Volume Trend



Source: Ford Annual Report

3) **Sales mix –** A fair proportion of Jaguar and Land Rover sales are to fleet operators like Hertz and Rent-a-Car[1]. The US – a major market for these brands – is experiencing soft growth rates. In this market environment, companies typically resort to aggressive discounting and financing deals to push volumes. We would not rule out such an occurrence in the near term, given the sedate near-term outlook.

4) **Regular infusion of capital in R&D and working capital**– Marque brands like Jaguar and Land Rover require continuous investment in R&D, which we reckon will exacerbate margin pressure. For

[1] As per Ford's 2002 annual report

companies like BMW, R&D is around 5-6% of revenues. For both Jaguar and Land Rover, we would not rule R&D at 3% of revenues, or around US$400m as annual recurring expenditure

The Imponderables...

1) **Royalty payments to Ford for engine technology –** Ford supplies engines to Jaguar and Land Rover. In the event that Ford chooses not to retain an equity stake in both brands, TAMO might have to make annual royalty payments to Ford to ensure power train supply, or buy out the technology upfront.

2) **Set-off and carry forward of losses –** In India, acquirers can absorb the losses of the acquired entity and use this as a tax shelter to offset against their own profitable operations. Assuming this was permitted even in this transaction, it could provide a substantial upside risk.

3) **Cost rationalization initiatives –** Again, media reports suggest that TAMO management might not be able to curtail overheads like employee expenses. We view this with some scepticism, given that Ford has steadily pared employee headcount in the PAG (Premier Automotive Group) of which Jaguar and Land Rover are a part. Over the past 5 years, Ford has pared headcount at the PAG to 42,000 employees (from 52,678 in 2002).

4) **Fuel efficiency norms –** In the US, the law decrees that Corporate Average Fuel Economy (CAFE) standards should increase by 40% to a market-wide 35 mpg by 2020. Jaguar's vehicles in the US typically have a mileage of only 16 mpg in the city and 25 mpg on highways, implying that Jaguar has to invest heavily in technology to meet the fuel efficiency norms. The extent to which TAMO might have to invest in incremental technology to meet these norms, remains indeterminate at this juncture, and might continue to impact recurring earnings of the consolidated business over the long term.

And the Positives...

1) **Profitable Operations – Jaguar and Land Rover were profitable in 3QFY07[2]. Ford notes that a modest profit at the Jaguar/Land Rover operations in 3QFY07 helped offset losses at Volvo.** We reckon that Land Rover's operating profits currently offset the operating losses at Jaguar. Land Rover is almost 3x Jaguar's revenues, and we think that undue focus has been given to Jaguar's troubled turnaround, rather than the improvement in Land Rover's operations, which (on account of its size) could hold the key to near-term profitability.

2) **Quality and Sales Satisfaction –** Both brands – Jaguar and Land Rover – rank on/above par with other luxury brands, according to the latest JD Power rankings. Contrary to popular perception, Jaguar ranks above the peer group on most parameters, while some models of Land Rover are below the group average[3].

[2] As per Ford's 3QFY07 10Q filing

[3] Refer to Annexure 1 for more details

Tata Motors

Company description

Tata Motors is the flagship company of the Tata Group, India's largest business conglomerate, and is among the country's largest manufacturers of automobiles with a dominant position in the commercial-vehicle business. It has a significant presence in the utility vehicle and passenger-car segments.

Investment strategy

We have a Buy/Low Risk rating on Tata Motors, with our positive view reflecting a) the impending spinning off of the auto finance business (which will release substantial funds locked into the business and positively impact TTMT's return / asset turnover ratios and b) stronger-than-expected growth in heavy trucks as the ban on overloading continues to be implemented (not as effectively as we would like, but far better than we had initially envisaged).

Key reasons for a strong growth outlook in commercial vehicles include a sustained pick-up in economic activity, a focus on infrastructure spending (expected to continue with funding in place) and a strong replacement cycle (27% of the existing fleet in India is more than 15 years old and needs to be replaced both for commercial and environmental reasons).

Valuation

Our 12-month target price of Rs1,029 is based on a sum-of-parts valuation methodology, which we believes captures the value embedded in subsidiaries and group holdings. Management has indicated its intent to unlock value, (to the benefit of Tamo's existing shareholders), for either / both HV Transmissions Ltd. and HV Axles Ltd., through an IPO or strategic sale to outside parties.

We value Tata Motors' core business at Rs 827 / share, which is based on 9.2x FY08E EBITDA, at the lower end of the recent trading band, and which should be comfortably supported by a 25% CAGR in EBITDA over FY06-08E. Over the past fiscal, the EV / EBITDA multiple has ranged between 6.2-11.4x. We value the subsidiaries at Rs201 / share.

Risks

We rate Tata Motors Low Risk based on our quantitative risk rating system, which tracks 260-day historical share price volatility. Key downside risks to our target price are movements in economic variables — particularly GDP growth, interest rates and fuel prices, to which sales of commercial and passenger vehicles are very sensitive. Competition in the passenger car business remains intense with the presence of most global majors in the Indian market. While the commercial vehicle business has been relatively less exposed to competition, the situation could change over the next three years with international companies eyeing the Indian market. Key upside risks to our target price include: a) Strategic sale/IPO of key subsidiaries; b) An indication that the Supreme Court ruling on overloading is being implemented over the longer term; and c) Reduction in input costs (notably steel).

Appendix A-1

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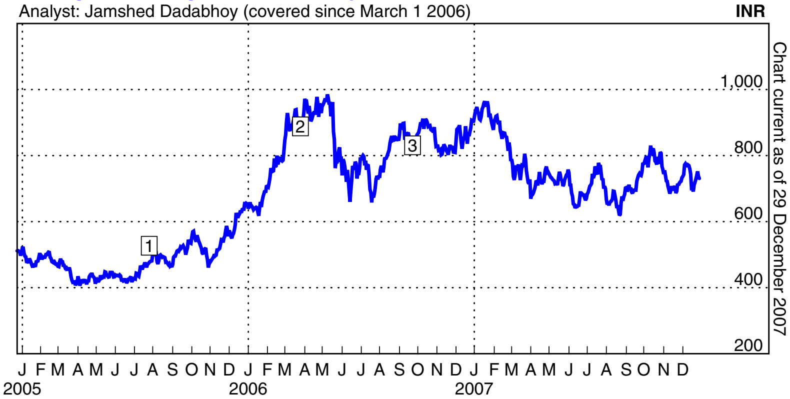
Tata Motors (TAMO.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Jamshed Dadabhoy (covered since March 1 2006)



#	Date	Rating	Target Price	Closing Price
1:	26 Jul 05	*1L	*656.00	476.50
2:	27 Mar 06	*2L	*974.00	901.35
3:	22 Sep 06	*1L	*1,029.00	835.45

*Indicates change.

Covered
Not covered

Rating/target price changes above reflect Eastern Standard Time

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