Company Flash

9 May 2006 | 6 pages

# Ashok Leyland (ASOK.BO)

## April Sales: Robust Growth

- **April sales up 47%** — driven by MHCV goods sales (+61%). Bus sales declined 9% yoy. We note that these sales are typically 'lumpy' and dependent on contracts given by STUs (State Transport Undertakings).
- **MHCV roars ahead** — Overall, MHCV domestic sales were up ~67%, reflecting (a) strong industrial and construction activity and (b) benefits from the Supreme Court (SC) order banning overloading.
- **Geographical mix** — Domestic sales accounted for c94% of overall sales, while exports accounted for the remainder. Exports accounted for almost 8% of overall sales in FY06 – we would expect exports to account for around 5-8% of overall sales into FY07, given the robust growth expected in the domestic market.
- **Pricing power prevails** — Over the month, ALL hiked prices across product categories by 2.5% - an indication of the strong demand environment and the industry's ability to absorb price hikes.
- **April industry sales** — Both ALL and Tata Motors (TAMO) have grown 89% over April – ahead of our expectations. Over FY07, industrial production is expected to remain buoyant, on which we predicate our FY07 growth estimate of around 14% for both the MHCV majors. The SC ban is also expected to spur sales over the next two quarters.
- **Valuations** — Valuations are expensive at this juncture. Overall, we believe the recent c33% increase in the stock price factors in the positives – maintain Sell.

| Sell/Low Risk | 3L |
|---|---|
| Price (09 May 06) | Rs50.00 |
| Target price | Rs37.00 |
| Expected share price return | -26.0% |
| Expected dividend yield | 2.8% |
| **Expected total return** | **-23.2%** |
| Market Cap | Rs61,652M |
| | US$1,376M |

**Figure 1. April 06 Sales**

| | Apr-06 Nos | % chg YoY | % chg over Mar |
|---|---|---|---|
| MDV passenger | 585 | -9.2 | -63.3 |
| MDV goods | 4,437 | 61.1 | -35.7 |
| LCV | 17 | -29.2 | -78.2 |
| **Total** | **5,039** | **47.3** | **-41.2** |

Source: Company Reports

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See page 4 for Analyst Certification and important disclosures.



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# Ashok Leyland

## Company Description

ALL is owned by the Hinduja Group (an equity stake of 35.6%) and Iveco (a Fiat group company with an equity stake of 15.3%). 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 the company's revenue and earnings, especially during cyclical downturns.

## Investment Thesis

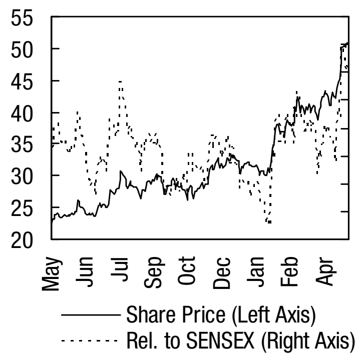
Our recommendation on Ashok Leyland is Sell /Low Risk (3L). Growth is expected to remain healthy over the medium term. Key reasons for a strong growth outlook in commercial vehicles include a sustained pickup in economic activity, a focus on infrastructure spending (expected to continue with funding in place) and a strong replacement cycle (35% of the existing fleet in India is more than 10 years old and needs to be replaced both for commercial and environmental reasons). Moreover, growth in the agriculture, infrastructure and manufacturing sectors – all segments with positive linkages to the freight business are all expected to remain positive. ALL looks well positioned to benefit from this growth: it is expanding capacity by 15% 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. We do not foresee a price war despite ALL's capacity expansion given a) the past record of pricing discipline among manufacturers, b) Price alone typically does not influence the purchase decision of freight operators, and c) Tata Motors is significantly larger than other players in the sector (around 70% market share in MHCVs in FY05) and more vertically integrated implying a better cost structure. We expect that ALL's ability to grow faster than the market over the long term would depend on its ability to expand in North and East India markets (where its dominance is less vs. markets such as South India) and on the success of its new initiatives such as the Newgen range (MHCV trucks in the >30-ton range). ALL's technology tie-ups with Hino, ZF and its recent initiatives to enhance collaboration with Iveco should augur well for its new product-development programs and export initiatives.

## Valuation

Our 12-month target price of Rs37 for ALL is based on a multiple of 8.55x FY08E cash earnings. We increase the multiple to 8.55x from 8x to reflect the revision in our P/ CEPS multiple on Tata Motors (which is imputed at around 10.3x FY08E CEPS on the core business - based on a 9.2x FY08E EV / EBITDA multiple). Our target multiple is at about a 20% discount to the multiple we assign to Tata Motors, which we believe, correctly reflects ALL's substantially smaller scale of operations and less diversified revenue profile (ALL is not present in passenger cars or utility vehicles and has an extremely modest presence in light commercial vehicles). Its c.15% CAGR in cash earnings over FY05-07E should support these valuations. We prefer to use P/CEPS as a valuation metric to ensure proper comparison with historical trading bands, a restructuring of the company's 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

13.1x FY07E EPS,which is in the middle of its recent trading band. This is well supported by a 17% CAGR in earnings over FY06-08E. The target price implies a tax-free dividend yield of 3.8% for FY07E. This is almost the same as the current one-year bank deposit rate of around 5-5.5% (taxable). The high dividend yields should offer downside support for the stock price.

Figure 2. Share Price Performance




Source: Datastream

Figure 3.

| | 3M | 6M | 12M |
|---|---|---|---|
| Absolute | 32.9 | 75.4 | 124.3 |
| Relative | 7.1 | 17.1 | 15.0 |

Source: Company Reports

## 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. Input prices could affect margins and, in turn, profitability. The financial profitability and viability of the STUs over the long term is an important risk factor. STUs are the largest buyers of ALL buses. Their ability to restructure operations would influence long-term demand for buses. The success of ALL's export initiatives and the company's ability to de-link its operations from the domestic cycle would also influence profitability and earnings in the long term. ALL is exposed to select niches like defense, special application vehicles and engines. A slowdown in these segments would impact revenues and profitability. ALL's concentration in South India also renders it vulnerable to a slow down in these markets. Key upside risks to our recommendation are 1) An indication that the Supreme Court ruling on overloading is being implemented over the longer term. This would provide a sustained growth impetus for the CV cycle. Given the operating leverage inherent in this business, it could result in substantially stronger earnings growth. 2) Reduction in input costs (notably steel) would also have a beneficial impact on profitability and earnings.

# Analyst Certification Appendix A-1

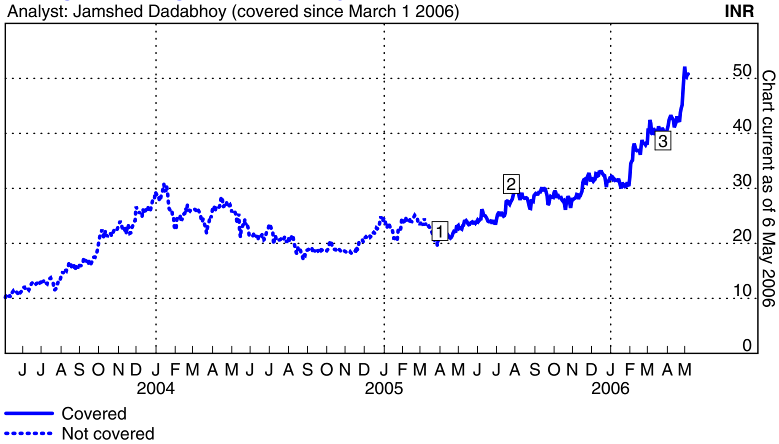
I, Jamshed Dadabhoy, research analyst and the author of this report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

## IMPORTANT DISCLOSURES

**Ashok Leyland (ASOK.BO)**

**Ratings and Target Price History - Fundamental Research**

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 |

*Indicates change.

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| *Data current as of 5 May 2006* | Buy | Hold | Sell |
|---|---|---|---|
| Citigroup Investment Research Global Fundamental Coverage (2722) | 41% | 41% | 17% |
| *% of companies in each rating category that are investment banking clients* | 45% | 42% | 33% |
| India -- Asia Pacific (110) | 47% | 21% | 32% |
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