Company In-Depth

19 February 2007 | 13 pages

Mahindra & Mahindra (MAHM.BO)

Maintain Buy: Raising Target Price

Rating change ☐
Target price change ☑
Estimate change ☑

- **Raising estimates, target price** — Raising target price to Rs1,032 (from Rs702) as we are raising cash earnings by 9-10% over FY07E/09E, and factoring in higher subsidiary valuations (run up in Tech Mahindra's share price). We value M&M on a sum–of–parts methodology, core value at Rs543/sh (11x FY08E cash EPS) and Rs489/sh (for subsidiaries and the auto component initiatives).

- **Continued dominance in tractor market** — M&M has consolidated on its dominant presence in the domestic tractor market – current market share is around 30%, through greater focus on the sub 30hp segment (traditionally a weaker segment for M&M). We contend that M&M might further consolidate its leading position in the tractor industry through inorganic initiatives.

- **Recouping market share in core UV business** — M&M has recently recouped nearly 9% market share in the UV segment (market share currently at 53%), due to performance of the Maxx pick-up variant it launched in Sept 06. We expect M&M's core auto volumes to post a 10% CAGR over FY07E-09E. Operating leverage benefits should continue, mitigating material cost pressures.

- **New initiatives gain momentum** — M&M's Renault JV will launch the *Logan* in 1QFY08; JV with Navistar should be operational in mid CY08E. Both JVs have enhanced scope and scale of operations. M&M's auto components initiative (Systech) is ahead of its schedule of attaining its USD1bn revenue target (given recent acquisitions in Germany, with more on the anvil).

Buy/Low Risk	**1L**
Price (15 Feb 07)	Rs901.60
Target price	Rs1,032.00
from Rs702.00	
Expected share price return	14.5%
Expected dividend yield	1.4%
Expected total return	**15.9%**
Market Cap	Rs220,422M
	US$5,019M

Price Performance (RIC: MAHM.BO, BB: MM IN)

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

Figure 1. M&M – Statistical Abstract

Year to 31-Mar	Net Profit (Rs mills)	Core EPS (Rs)	EPS Growth (%)	P/E (x)	Price /CF (x)	EV / EBITDA (x)	ROE (%)	ROCE (%)	DPS (Rs)	Div. Yield (%)
2005	5,023	36.9	62.5	24.5	17.1	24.2	27.1	26.2	13.0	1.4
2006	6,688	24.3	-34.2	37.2	28.1	20.1	34.8	26.0	9.5	1.1
2007E	9,137	32.6	34.3	27.7	22.2	15.7	31.6	27.2	12.5	1.4
2008E	10,903	40.0	22.7	22.6	18.3	13.0	27.0	26.5	14.4	1.6
2009E	12,200	44.5	11.3	20.3	15.9	11.2	25.7	27.0	16.4	1.8

Source: Company, Citigroup Investment Research estimates

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	20.8	34.4	25.2	21.1	18.9
EV/EBITDA adjusted (x)	33.3	28.5	20.5	17.4	14.9
P/BV (x)	5.2	7.2	6.0	5.1	4.3
Dividend yield (%)	1.4	1.1	1.4	1.7	1.9
Per Share Data (Rs)					
EPS adjusted	43.30	26.18	35.76	42.67	47.75
EPS reported	44.19	33.55	40.90	42.67	47.75
BVPS	173.46	124.63	150.90	178.14	208.39
DPS	13.00	10.00	13.00	15.00	17.00
Profit & Loss (RsM)					
Net sales	65,110	79,772	94,843	108,276	123,086
Operating expenses	-60,539	-74,431	-86,988	-99,190	-112,997
EBIT	**4,571**	**5,341**	**7,855**	**9,086**	**10,088**
Net interest expense	-302	-270	-300	-350	-580
Non-operating/exceptionals	2,733	3,570	4,547	5,899	7,091
Pre-tax profit	**7,001**	**8,641**	**12,102**	**14,635**	**16,599**
Tax	-2,015	-2,424	-3,391	-3,732	-4,399
Extraord./Min.Int./Pref.div.	141	2,354	1,739	0	0
Reported net income	**5,127**	**8,571**	**10,450**	**10,903**	**12,200**
Adjusted earnings	5,023	6,688	9,137	10,903	12,200
Adjusted EBITDA	6,411	7,341	9,890	11,484	13,187
Growth Rates (%)					
Sales	33.6	22.5	18.9	14.2	13.7
EBIT adjusted	56.7	16.9	47.1	15.7	11.0
EBITDA adjusted	40.3	14.5	34.7	16.1	14.8
EPS adjusted	56.5	-39.5	36.6	19.3	11.9
Cash Flow (RsM)					
Operating cash flow	**5,148**	**9,882**	**10,393**	**12,456**	**14,461**
Depreciation/amortization	1,841	2,000	2,035	2,398	3,098
Net working capital	-1,819	-689	-2,092	-845	-837
Investing cash flow	**-3,375**	**-4,974**	**-2,969**	**-12,000**	**-12,500**
Capital expenditure	-2,733	-2,543	-4,708	-7,000	-7,000
Acquisitions/disposals	-642	-2,431	1,739	-5,000	-5,500
Financing cash flow	**2,110**	**-852**	**5,722**	**-3,601**	**-4,162**
Borrowings	3,228	-1,692	7,423	-150	-150
Dividends paid	-1,720	-2,782	-3,644	-4,204	-4,765
Change in cash	**3,883**	**4,056**	**13,146**	**-3,145**	**-2,200**
Balance Sheet (RsM)					
Total assets	**50,064**	**60,030**	**79,169**	**88,966**	**99,656**
Cash & cash equivalent	6,240	7,303	19,085	16,047	13,854
Accounts receivable	5,115	6,380	7,991	9,114	10,360
Net fixed assets	14,749	15,544	18,217	22,820	26,721
Total liabilities	**29,942**	**30,941**	**42,069**	**45,167**	**48,421**
Accounts payable	10,949	13,707	16,151	18,389	20,882
Total Debt	10,526	8,834	16,257	16,107	15,957
Shareholders' funds	**20,123**	**29,089**	**37,100**	**43,799**	**51,234**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	9.8	9.2	10.4	10.6	10.7
ROE adjusted	26.5	27.2	27.6	27.0	25.7
ROIC adjusted	18.2	19.6	25.9	25.1	22.2
Net debt to equity	21.3	5.3	-7.6	0.1	4.1
Total debt to capital	34.3	23.3	30.5	26.9	23.7

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Raising earnings for FY07E-09E

Citigroup Investment Research Ratings Distribution

Data current as of 31 December 2006	Buy	Hold	Sell
Citigroup Investment Research Global Fundamental Coverage (3106)	**43%**	**41%**	**15%**
% of companies in each rating category that are investment banking clients	45%	41%	34%
India -- Asia Pacific (118)	58%	14%	28%
% of companies in each rating category that are investment banking clients	48%	50%	39%
EBITDA (Rs m)			
Old	9,283	10,909	12,621
New	9,890	11,484	13,187
% Change	6.5	5.3	4.5
EBITDA Margin (%)			
Old	10.1	10.4	10.7
New	10.4	10.6	10.7
PAT (Recurring, does not include gains on stake sales, etc) (Rs m)			
Old	7,504	8,880	10,453
New	9,137	10,903	12,200
% Change	21.8	22.8	16.7
EPS (FD) (Rs)			
Old	29.9	35.4	41.7
New	35.8	42.7	47.8
% Change	19.5	20.5	14.5
Core EPS (fully diluted, excludes dividends from subsidiaries) (Rs)			
Old	28.2	33.3	39.2
New	32.6	40.0	44.5
% Change	15.6	19.9	13.6
CEPS (fully diluted, excludes dividends from subsidiaries) (Rs)			
Old	37.3	45.0	52.0
New	40.5	49.4	56.6
% Change	8.6	9.7	8.9

Source: Citigroup Investment Research estimates

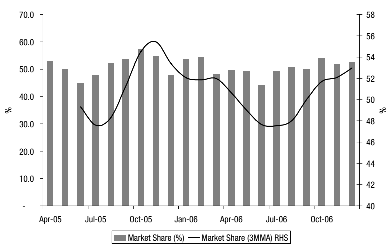
Core businesses – Revival in UV segment is encouraging; we expect tractors to slow in FY08

Figure 2. Mahindra & Mahindra – Volume Assumptions

	FY06	FY07E	FY08E	FY09E
Total UVs	114,694	127,368	139,740	152,440
% change YoY	3.2	11.1	9.7	9.1
3 wheelers	22,419	35,000	39,200	43,904
% change YoY	(2.3)	56.1	12.0	12.0
LCVs	4,944			
% change YoY	(37.3)			
Total Domestic Autos	142,057	162,368	178,940	196,344
% change YoY	0.1	14.3	10.2	9.7
Exports (Autos)	5,534	8,578	12,009	15,611
% change YoY	81.7	55	40	30
Total Autos	**147,591**	**170,946**	**190,949**	**211,955**
% change YoY	1.8	15.8	11.7	11.0
Tractors				
Domestic sales	78,048	94,438	105,771	114,232
% change YoY	30.1	21.0	12.0	8.0
Export sales	6,981	8,098	9,313	11,175
% change YoY	29.6	16.0	15.0	20.0
Total Tractors	**85,029**	**102,536**	**115,083**	**125,407**
% change YoY	30.0	20.6	12.2	9.0

Source: Company, Citigroup Investment Research estimates

Figure 3. M&M's UV Market Share (%)



Source: SIAM

Over the past few months, M&M has recouped nearly 900bps market share in the UV segment (market share currently at 53%), due to the performance of the Maxx pick-up variant that it launched in Sept 06. Consequently, non-*Scorpio* UV sales are up 8% YTD, while *Scorpio* sales are up 17% YTD. Factoring the gains in market share, which we expect to be sustained over the near term, we have raised our UV volume forecasts for both FY08 and FY09 by 3% and 2%, respectively. M&M's new platform development (Ingenio) remains on schedule, with models expected to be launched in CY08E. We expect the Ingenio platform to be positioned between the Bolero and the Scorpio (in terms of price points). Thus, by 2HFY09E / FY10E, M&M should have three primary UV platforms, which should enable the company to undertake cost-cutting initiatives, especially on components, aggregates and assemblies, and also result in platform rationalization over the longer term.

We forecast c.11% volume growth for tractors over FY08-09. After robust growth of 32%, 30% and 21% over FY05-FY07E, we expect growth rates to taper off in FY08, but believe that M&M is well positioned to maintain or improve upon its domestic market share, given its exposure to southern and western India. Moreover, support from MMFSL (its tractor/UV finance arm) should also enable Mahindra to offset some of the slowdown that we expect over the next fiscal. In addition, new product launches (like that of the 'Shaan', which finds application in haulage and farming activities), might result in M&M's tractor growth exceeding our estimates.

Joint ventures – scale of strategic initiatives enhanced

Over the past two years, M&M has entered into two JVs, with ITEC (International Truck and Engine Corporation (for MHCVs) and with Renault (for the manufacture of the Logan). M&M will hold 51% equity in both JVs. Subsequently, M&M has enhanced the scale of operations with both Renault and ITEC

Figure 4. JVs – Original Agreement

	Partner	Total outlay (Rs bn)	M&M's equity investment (Rs bn)	Product details	Expected launch
Mahindra International Ltd	ITEC	4.0	1.0	MHCVs from 9 - 45MT	CY07
Mahindra Renault Private Ltd	Renault	6.8	1.7	Renault Logan	1QFY08

Source: Company Reports

Figure 5. Joint Ventures - Enhanced Scope of Operations

Partner	Capacity - by end FY12 / 13	Investment (USD bn)	CIR Comments
ITEC	250,000	0.5	Production to commence from end FY09E, first phase capacity of 250k units, could be further enhanced; gives M&M new opportunities in the domestic and export car markets. M&M might also get access to powertrain technology.
Renault	500,000	1	Initial installed capacity of 300,000 units, to be operationalised by end FY09E. We contend Renault will export at least 200,000 cars by CY10. Enables M&M to carve out a presence in the CV segment

Source: Company Reports, Citigroup Investment Research estimates

Q&As on the initiatives with ITEC and Renault

Do we incorporate value of these projects in M&M?

No. We incorporate the earnings streams from both JVs into M&M's core earnings. We believe that valuing these investments separately would result in double counting. We reckon that greater value will emerge once more clarity arises on: a) capex details; b) timelines; and c) details on the models to be launched, markets that will be addressed, etc. We contend that execution risk is also embedded in such large scale projects, which would not get adequately captured, if we were to value the businesses on a DCF-based methodology.

What is the expected capex for both these projects?

No details have been disclosed – but we estimate that for the car project, the total capex will be around US$1bn (Maruti will incur capex of around US$500m for a 300,000 unit plant). We estimate that M&M/Renault will incur around US$1bn for a plant with a capacity of 500,000 units. Our estimates appear slightly skewed toward the upper end, but we believe that if there are multiple platforms, etc, then overall capex will be around US$1bn. Our estimate for the CV plant is US$0.5bn.

What is M&M's contribution to these initiatives?

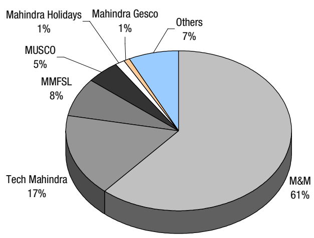
We believe that M&M will invest around US$750m over the next five years in these ventures, of which the equity contribution will be about US$375m. We factor M&M's equity contribution at US$233m over FY08E-09E (with the residual being invested in FY10E-12E), although if the pace of the projects is ahead of schedule, it could exceed our forecasts. M&M's balance sheet is fairly healthy at this juncture (est. debt/equity of 0.4x end FY07E), and thus there is scope to further leverage (either on M&M's balance sheet, or the consolidated balance sheet).

What are the near-term benefits for M&M from these initiatives?

None - M&M will benefit from access to technology and entry into the CV/passenger car industries, which will likely result in a more diversified revenue profile, but these will come through in a meaningful manner only from FY09E/FY10E. The only benefit for M&M (which might start coming through from early FY09E) will be an increase in its bargaining power with vendors (for components and parts), as it leverages off the economies of sourcing that will start coming through.

Subsidiaries – Summing up the parts

Figure 6. Consolidated group Profits (FY06, %)



Source: Company Reports

M&M's (parent entity)[1] profits accounted for around 61% of overall FY06 Mahindra group profits (vs. 74% in FY05). Given the significant contribution from the group companies, and the recent IPO of Tech Mahindra, we believe there is a compelling argument to value some of Mahindra's key subsidiaries (both listed and unlisted).

Figure 7. M&M – Valuation of Key Listed Subsidiaries

Company	M&M Holding	Value (Rs / share of MM)
Tech Mahindra	46.4%	297
MMFSL	67.7%	44.4
Mahindra Gesco	46.1%	36.4
Total		**377.8**

Source: Bloomberg, Company

Note: Shares are valued at 15% discount to market prices. Market prices are simple average of the preceding two weeks

Auto component initiatives – Too large to be ignored

M&M is targeting a near doubling of revenues in its auto component division's (Systech) revenues – to US$1bn by FY10, from c$600m currently. The division's current structure is shown in Figure 9.

[1] Computed on total profits (including exceptional items), but excluding minority interest

Figure 8. Systech (formerly Mahindra Systems and Automotive Technologies Sector)

1	**ACBU - Auto Component Business Unit**	
	Name	**Description**
	MUSCO (Mahindra Ugine Steel)	Alloy and Precision Steel
	Siro Plast	Engineering Polymer Composites
	Stokes Group	Forgings
	Amforge's Chakan Unit	Forgings
	Pranay Sheet Metal Stampings Ltd	Sheet Metal Components
	Sar Auto Transmissions	Gear Unit
	Jeco	Forgings
	Schoneweiss	Forgings
	DGP Hinoday	Castings
2	**SSBU - Strategic Sourcing Business Unit**	
	Contract sourcing for global OEMs	
3	**Engineering Services**	
	Name	**Description**
	Mahindra Engineering Services	Design, Tools, Prototyping, Integration, Packaging, Testing
	Plexion Technologies	Design for automotive and aerospace
	Mahindra Engineering Design and Development Company	Engineering services for the auto sector

Source: Company Reports

Management indicated recently that the revenue target of US$1bn might be achieved in 2009 (vs. target of 2010). Given the sedate growth in the European market (to which the larger businesses like Jeco, Schoneweiss, etc.) cater to, we contend that the US$1bn revenue target will likely be achieved through inorganic, rather than organic initiatives, which implies that there are more acquisitions on the anvil. Systech appears to be following the strategy of companies such as Bharat Forge and Amtek Auto – acquiring companies in Europe to acquire customer share, and to scale up the technology curve. The recent acquisitions of Stokes, Jeco and Schoneweiss should enable M&M to effectively address the car and truck markets in Europe.

Figure 9. Primary Companies in the Systech Fold

Company	Mahindra's Stake (%)
MUSCO	51%
Mahindra Forgings	47%
Mahindra Composites	45%
Stokes	99%
Jeco	68%
Schoneweiss	90%
MEDDCL	100%
Plexion	99%
Mahindra SAR Transmission	51%
DGP Hinoday	67%

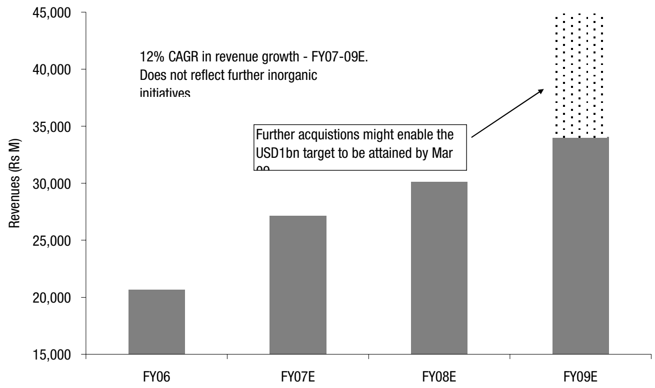
Source: Citigroup Investment Research

We believe that over the longer term, the auto component business will also cater to the Mahindra–Renault JV and the Mahindra–Navistar JV, which will provide it a substantial captive market in India, in addition to the outsourcing opportunity available. As per plan, M&M and its JV partners Renault and International Trucks are targeting to manufacture around 300,000 cars and 250,000 CVs from 2010. We estimates that even if 150,000 cars and 100,000 trucks are manufactured and exported (or sold in the domestic market) by FY10, it will provide an opportunity for forgings and castings of US$300m-400m p.a. (which will increase as export volumes increase).

We are thus optimistic about the long-term growth prospects of Systech, as we believe that outsourcing to low-cost countries like India is a structural shift that will endure over the long term. That said, our concerns with Systech and its related businesses, at this juncture, emanate from: a) integration issues of the various businesses; and b) lack of clarity on the balance sheets of the acquired companies. Per management, recent acquisitions (such as Jeco and Schoneweiss) have been undertaken at valuations of 5-6x EBITDA, but as yet we have limited clarity on the overall capex for all the businesses, and also the capital outlay for these businesses, going forward.

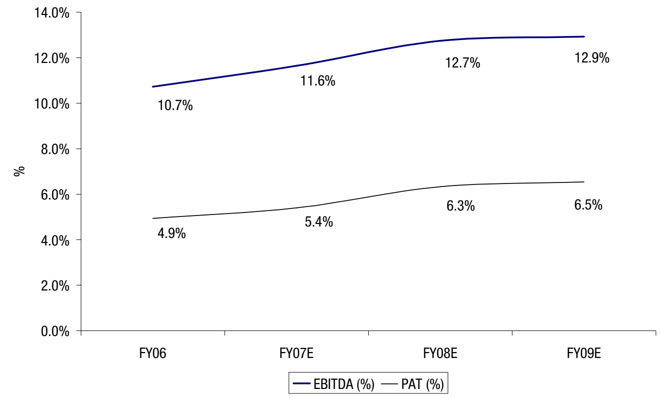
We value Systech at 12x FY08E P/E (for M&M's share), which implies a value of Rs57/share of M&M; or an equity value of US$323m. At this juncture, we think 12x is a fair multiple (nearly 15% discount to M&M's FY08E EPS multiple). Going forward, a re-rating of the business might occur as clarity emerges on issues like integration, growth strategy, etc.

Figure 10. Systech – Revenue Growth – FY06-09E



Source: Company, Citigroup Investment Research estimates

Figure 11. Systech – Margin Trends – FY06-09E



Source: Company, Citigroup Investment Research estimates

Mahindra & Mahindra

Company description

Mahindra and Mahindra manufactures utility vehicles, light commercial vehicles and tractors. It has recently entered the 3-wheeler segment. M&M is the market leader in both the utility vehicle and tractor segments.

Valuation

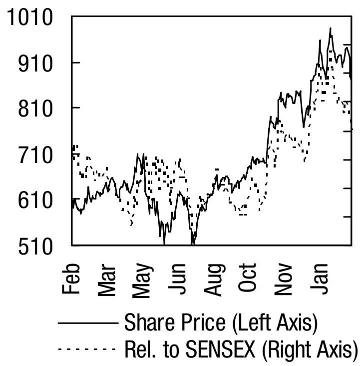
Figure 12. M&M – Valuation Summary

Target Price Computation	Valuation Metric	Rs / Share
Core business	11x FY08E Cash Earnings Per Share	543
Listed subsidiaries (Tech Mahindra, MMFSL, Gesco)	15% discount to market price	402
Mahindra Holidays and Resorts	18x FY06 PAT (at c40% discount to listed comparables like Indian Hotels, East India)	15
Systech (Auto component initiatives)	12x FY08E P/E	57
Other subsidiaries (at book value)	1x Book value	15
Total		**1,032**

Source: Citigroup Investment Research estimates

Our target price of Rs1032 is based on a sum-of-parts methodology. We value M&M's core business at Rs543 (formerly Rs495 – revised on the back of earnings upgrades – multiple remains unchanged at 11x FY08E core CEPS). We also incorporate value for M&M's listed subsidiaries (Rs402 / share), its auto component business (Rs57 /share) and M&M's investments in other subsidiaries (including Mahindra Holidays at Rs30 /share). Our core multiple of 11x, is supported by an 18% CAGR in core cash earnings (excluding dividends from group companies) for M&M over FY07E-09E. We value the key subsidiaries / associates / auto component initiatives at Rs459/share. At our core target price (of Rs543) the stock would trade at around 13.6x FY08E core EPS (excluding dividends from subsidiaries) and should be supported by 16% CAGR in earnings over FY07E-09E.

Figure 13. M&M – Share Price Vs. Sensex



Source: Datastream

Figure 14. M&M - Absolute and Relative Performance

	3M	6M	12M
Absolute	3.4	41.9	45.6
Relative	–1.7	12.7	5.1

Source: Datastream

We have chosen to use P/CEPS as our primary valuation metric to ensure proper comparison with historical trading bands — the company is undertaking a significant product development and capital expenditure program, and also undertook a restructuring of the balance sheet in FY02.

We believe valuations will also be supported by: a) management's continued efforts to unleash value from investments in group concerns (we believe that the listing of the group's hotel / resorts venture is next on the anvil); and b) new initiatives announced in the passenger cars, commercial vehicles and auto components segments, which should fructify over the next 2-3 years.

Investment thesis

We rate M&M Buy/Low Risk (1L) with a target price of Rs1,032. Tractor sales are benefiting from relatively low penetration levels and the government's emphasis on increasing credit to the agriculture sector. Apart from dominance of the lower end of the market, wherein competition has been limited, M&M's utility vehicle business is also benefiting from product initiatives, particularly the launch of the Scorpio and Bolero models and variants of these, which have enabled M&M to tap into the urban markets for passenger vehicles. Moreover, we also recognize management's efforts to retain market share within segments like 3 wheelers, given the stiff competition in this segment.

We remain enthused by management's efforts to de-risk from the local market by pursuing sales in select international markets. The target is to raise international sales from around 10% at present to 20% over the next three years. Their efforts have met with substantial success particularly in the tractor segment, wherein they are currently ranked No. 4 (in terms of unit sales) globally.

The substantial value of the company's real estate and investment holdings (particularly in the information technology business through Tech Mahindra and in the financial services business through M&M Financial Services) should provide downside support (especially with increasing dividends from key subsidiaries). Given recent initiatives to unlock value in subsidiaries – MMFSL and Tech Mahindra being the primary examples – we incorporate the value of key subsidiaries within our sum–of-parts valuation.

Risk

We rate M&M Low Risk, in line with our quantitative model that tracks 260-day volatility. Key Risk factors to our investment thesis:

1) Substantial rise in interest rates that could curb demand for farm equipment and utility vehicles;

2) Given M&M's strong dependence on the rural economy (a substantial part of the demand for their products emanates herein), any weak trend in the prices of agricultural commodities could also impact demand and sales;

3) Escalating competition within the UV segment, which might lead to increase in discounts and result in margin pressure;

4) Input costs are volatile and linked to global commodity prices for metals, plastics, etc. and could impact margins and in turn, profitability; and

5) Any substantial capital outlay for inorganic initiatives.

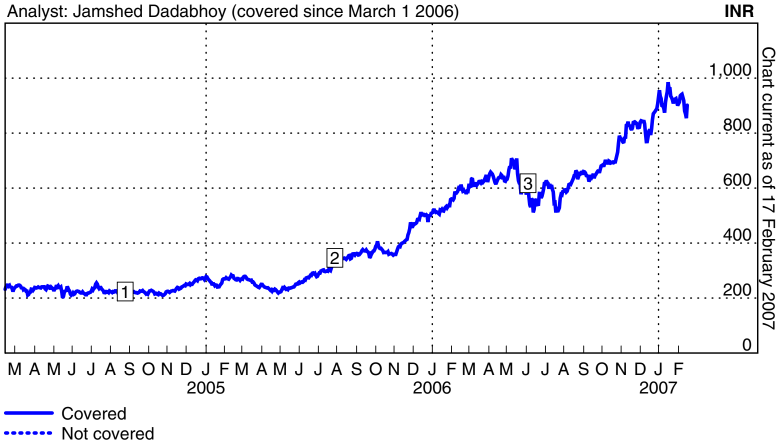
Appendix A-1

Analyst Certification

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

Mahindra and Mahindra Ltd (MAHM.BO)
Ratings and Target Price History - Fundamental Research
Analyst: Jamshed Dadabhoy (covered since March 1 2006)



#	Date	Rating	Target Price	Closing Price
1:	25 Aug 04	*1M	*261.50	212.55
2:	28 Jul 05	*1L	*371.00	NA
3:	4 Jun 06	1L	*702.00	604.10

*Indicates change.

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