MOTILAL OSWAL

1QFY07 Results Update

SECTOR: AUTOMOBILES

Ashok Leyland

STOCK INFO.	BLOOMBERG
BSE Sensex: 10,867	AL IN
	REUTERS CODE
S&P CNX: 3,177	ASOK.BO

Equity Shares (m)	1,323.7
52-Week Range	54/23
1,6,12 Rel. Perf. (%)	-6/-8/-19
M.Cap. (Rs b)	48.0
M.Cap. (US$ b)	1.0

7 August 2006

Buy

Previous Recommendation: Buy

Rs36

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
3/06A	52,477	3,056	2.3	21.0	15.7	3.5	24.0	19.5	0.8	8.0
3/07E	59,031	3,824	2.9	25.1	12.6	3.1	24.6	23.1	0.7	6.6
3/08E	66,325	4,375	3.3	14.4	11.0	2.7	25.0	26.4	0.6	5.4

- Ashok Leyland (ALL) reported results in line with our estimates. Sales, adjusted EBITDA and adjusted PAT grew by 34%, 41% and 126% YoY respectively.
- With net sales at Rs14.2b, revenue growth was 34% YoY, ahead of volume growth of 28% YoY, resulting in 4.5% YoY increase in average realization. Lower staff costs and other expenditure led to EBITDA growth of 41% YoY at Rs1.2b and adjusted EBITDA margin growth of 40bp YoY to 8.5%. Decline in the above stated costs more than countered the 260bp increase in raw material costs.
- Whilst disappointing on the EBITDA margin front, adjusted PAT grew 126% to Rs756m v/s our expectation of Rs772m due to lower-than-expected interest cost, higher other income, and lower tax rate.
- Due to higher CV demand from the goods segment, ALL focused increasingly in that direction, resulting in lower bus production. However, demand from State Transport Undertakings remains intact. Notwithstanding, ALL is concentrating on broadbasing revenues by focusing on the bus segment, sale of spares, exports and defense supplies. It plans to increase share of non-cyclicals to more than 35% (currently estimated at 23%-25%) of revenues.
- We remain positive on Ashok Leyland's growth prospects. We expect volumes to grow by 11% in FY07, indicating residual growth rate of 5% for the balance of the year. We estimate EPS of Rs2.9 for FY07 and Rs3.3 for FY08. The stock trades at valuations of 12.6x FY07E and 11x FY08E EPS. Maintain **Buy**.

QUARTERLY PERFORMANCE (RS MILLION)

	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE		
Total Volumes (nos)	13,320	14,895	13,038	20,373	17,067	15,500	15,000	20,838	61,626	68,405
Net Sales	**10,632**	**12,501**	**12,024**	**17,348**	**14,239**	**13,269**	**13,972**	**17,551**	**52,477**	**59,031**
Change (%)	*29.5*	*36.7*	*21.8*	*18.9*	*33.9*	*6.1*	*16.2*	*1.2*	*25.5*	*12.5*
Total Cost	9,774	11,338	10,863	15,161	13,026	11,876	12,533	15,274	37,595	52,708
EBITDA	**858**	**1,162**	**1,161**	**2,187**	**1,213**	**1,393**	**1,439**	**2,277**	**5,400**	**6,322**
As a % of Sales	*8.1*	*9.3*	*9.7*	*12.6*	*8.5*	*10.5*	*10.3*	*13.0*	*10.3*	*10.7*
Change (%)	*14.4*	*55.4*	*13.9*	*27.8*	*41.4*	*19.9*	*24.0*	*95.9*	*27.7*	*17.1*
Non-Operating Income	34	170	16	110	139	165	175	141	330	620
Interest	-12	7	71	98	5	65	85	103	165	258
Gross Profit	**903**	**1,325**	**1,106**	**2,199**	**1,346**	**1,493**	**1,529**	**2,315**	**5,566**	**6,683**
Less: Depreciation	297	342	290	330	328	342	345	357	1,260	1,372
PBT	**606**	**983**	**816**	**1,869**	**1,019**	**1,151**	**1,184**	**1,957**	**4,305**	**5,311**
Tax	271	215	250	513	262	315	400	510	1,250	1,487
Effective Tax Rate (%)	*44.8*	*21.9*	*30.7*	*27.5*	*25.7*	*27.4*	*33.8*	*26.1*	*29.0*	*28.0*
Extraordinary Income	334	0	0	0	0	0	0	0	302	0
Extraordinary Loss	25	18	21	21	65	0	0	0	85	0
Rep. PAT	**644**	**750**	**545**	**1,335**	**692**	**836**	**784**	**1,447**	**3,273**	**3,824**
Change (%)	*101.5*	*74.4*	*1.5*	*-6.5*	*7.5*	*11.5*	*43.9*	*8.5*	*20.6*	*16.9*
Adj. PAT (before extraordinary)	**334**	**768**	**566**	**1,355**	**756**	**836**	**784**	**1,447**	**3,056**	**3,824**
Change (%)	*-2.4*	*69.1*	*0.9*	*13.7*	126.0	9.0	*38.6*	*6.8*	*19.8*	*25.1*

E: MOSt Estimates

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Ashok Leyland posted revenue growth of 34% YoY, ahead of 28% YoY volume growth, on the back of 4.5% YoY increase in average realization. Lower staff costs (as a percentage of sales) and other expenditure, led EBITDA growth of 41% YoY at Rs1.2b and adjusted EBITDA margin growth of 40bp YoY to 8.5%. Staff costs as a percentage of sales were lower 70bp YoY in spite of wage hikes in 2HFY06. The decline in these costs more than countered a 260bp increase in raw material costs. Adjusted PAT grew by 126% YoY to Rs756b as a result of higher other income and lower tax rate than expected.

Volumes: Strong 28% YoY growth ...

In line with the strong growth witnessed by CV companies in 1QFY07, Ashok Leyland grew its volumes by 28% YoY to 17,067 units. The domestic goods segment, which witnessed 43% YoY growth, drove this, as a result of the government's ban on overloading. We believe demand pull owing to the ban will continue in 2QFY07 as well.

Due to stiff demand from the goods segment, ALL concentrated more on production in this segment, leading to 40% decline in domestic passenger vehicle sales. However, once the additional demand led by the ban on overloading slows, we expect the company to focus on the passenger segment. The latter demand arises mainly from STU orders, wherein the company enjoys certain flexibility in delivery schedules.

We are positive on CV sales for FY07 — sales will be driven by structural drivers in the economy such as highway development; industrial growth; as well as one-time demand resulting from the ban on overloading. We believe the one-time demand will extend until 1HFY07. We thereby expect volumes to grow 11% in FY07E and 10% in FY08E.

STRONG GROWTH IN GOODS SEGMENT (VOLUME IN UNIT NOS)

	1QFY07	1QFY06	% YOY
Passenger	2,184	2,608	-16.3
Goods	14,785	10,595	39.5
Total	**16,969**	**13,203**	**28.5**
LCV	98	117	-16.2
Total	**17,067**	**13,320**	**28.1**

Source: Company/Motilal Oswal Securities

... unable to arrest 330bp share decline in 1QFY07

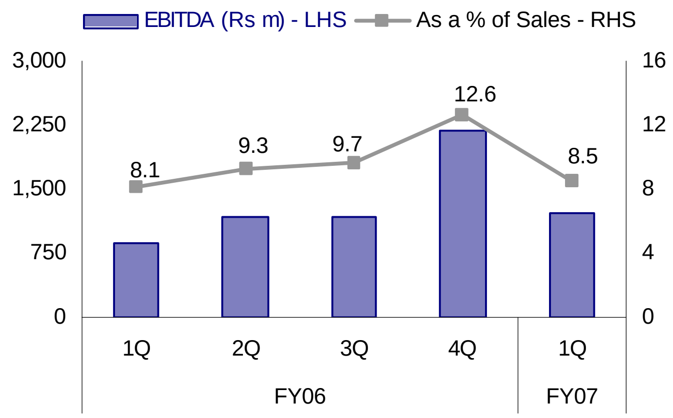
In 1QFY07, Ashok Leyland's share was 27.8% compared with 31.1% in 1QFY06 – a 330bp drop. This drop in market share is an indication that: (1) the company's installed capacities are saturated versus the demand growth; (2) recognition of the strong performance of its competitor in the HCV segment, Tata Motors. Further, Tata Motors had specific problems (non-recurring) in 1QFY06, which also distorted, to an extent, Ashok Leyland's performance that period. For FY07, Ashok Leyland targets to increase its share by 200bp-250bp YoY to 30%.

Adjusted EBITDA: Improves YoY despite raw material pressures

Ashok Leyland reported adjusted EBITDA growth of 41% YoY, led by lower staff costs and other expenditure as a % of sales (lower by 300bp). Raw material costs in 1QFY07 were significantly higher at 73.4% (up 260bp YoY) due to higher prices of non-ferrous metals including copper and increased tyre prices. Consequently, EBTIDA margins improved 40bp YoY to 8.5%, but recorded a drop of 410bp QoQ.

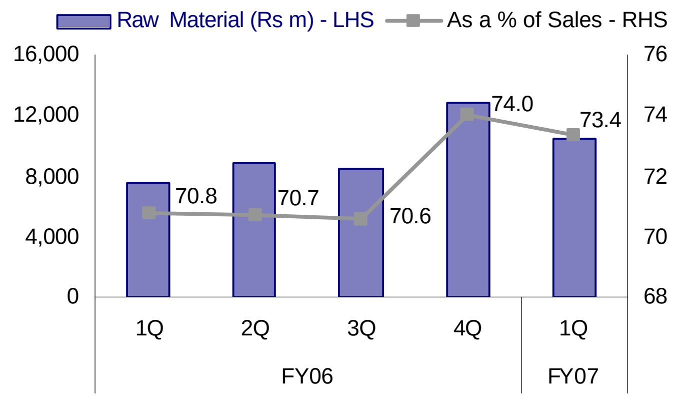
Based on lower-than-expected EBITDA margins in 1QFY07, we have lowered our expectation of EBITDA margins for the full year FY07 by 20bp to 10.7%.

EBITDA MARGINS: LOWER THAN OUR EXPECTATIONS



Source: Company/Motilal Oswal Securities

RAW MATERIALS COSTS: RISING SHARPLY IN THE PAST 6 MONTHS



Source: Company/Motilal Oswal Securities

Investment argument

We believe the structural parameters for the CV industry are still in place. We expect volumes for the company to grow at 10% CAGR over FY06-FY08E. ALL's focus on its non-cyclical business segments such as vehicle and aggregate exports is expected to cushion domestic business cyclicality. Earnings quality and earnings momentum are expected to improve in the forthcoming quarters, aided by capacity addition and expected improvement in EBITDA margins.

Share of non-cyclical revenue to increase dramatically: Efforts are on broadbase revenues by focusing on the passenger bus segment, sale of spare parts, exports and supplies to defense – all of which are non-cyclical segments. The company plans to increase share of non-cyclicals to more than 35% of revenues over the next two years.

Operating performance should improve ahead: Continuous efforts to effectively manage costs should yield benefits in FY07. We estimate 80bp improvement in EBITDA margins over FY06-FY08E. Higher volumes in forthcoming quarters and benefits of e-sourcing will likely result in margins expanding.

Valuation and view

Effective cost management should yield benefits in FY07 and FY08. We estimate 80bp improvement in EBITDA margin over FY06-FY08E. However, we have revised downward, by 20bp, our expectation of EBITDA margin to 10.7% in FY07E (1.9% YoY decline in absolute EBITDA). Again, due to lower interest income and higher other income, our adjusted PAT expectation has declined by a mere 0.7% to Rs3.82b.

We estimate ALL to report EPS of Rs2.9 in FY07 and Rs3.3 in FY08. We believe that structural factors for CV industry growth are in place. We expect ALL's volumes to grow at 10% CAGR over FY06-FY08E. Reiterate **Buy** with a target price of Rs49.

Conference call highlights

- Ashok Leyland plans to set up an assembly plant in the Middle East at an investment of Rs500m. Further details about this venture are yet to be disclosed.
- To fund its capex, Ashok Leyland plans to raise additional funds. The most likely route will be via FCCBs, where the amount will be US$150m.
- Acquisition of AVIA's trucking business unit will give Ashok Leyland a foothold in Eastern Europe. This unit has a capacity of 20,000 units, but is currently utilizing only 10% installed capacity. Ashok Leyland plans to take this percentage to 30%, initially over the next 2-3 years. Formalities related to this acquisition are expected to be completed by end-August.
- Of the funds raised via FCCBs, an amount valued at nearly US$20m is lying unutilized.

Ashok Leyland: an investment profile

Company description

Ashok Leyland is the second largest commercial vehicle manufacturer in India with a product portfolio comprising of passenger and goods carriers across all tonnage categories. An erstwhile regionally concentrated CV company, Ashok Leyland has made serious attempts in the last 12 months to broad base its markets to include not only northern India but also South East Asia.

Key investment arguments

- We remain positive on the growth rate for the CV segment, due to strong industrial growth and increased focus of the Government on highway development.
- While ramping up its installed capacity, ALL is also focusing on programs like e-sourcing, which will enable it to have better operating margin.
- ALL's focus on non-cyclical business segments such as vehicle and aggregate exports is expected to cushion domestic business cyclicality.

Key investment risks

- Increased competition in the industry with several MNC players such as ITEC and MAN entering the Indian market.
- Any further increase in diesel prices will affect demand.

Recent developments

- Freight rates have increased by 27% in the past 3-4 months due to the ban on overloading.
- ALL has signed a framework agreement to acquire the truck business unit of Czech company AVIA. This acquisition is expected to be completed by August-end of the current year

Valuation and view

- We expect ALL's volumes to grow at 10% CAGR over FY06-08E
- Ashok Leyland's efforts to effectively manage costs should yield benefits in FY07 and FY08. We estimate a 80bp improvement in EBITDA margin over FY06-08E. We estimate ALL to report an EPS of Rs2.9 in FY07E and Rs3.3 in FY08E. We maintain **Buy.**

Sector view

- Demand related factor of IIP production remain strong for the sector.
- Freight rates have remained firm quelling any near term fears.
- We maintain a positive but cautious stance on the sector

COMPARATIVE VALUATIONS

		ASHOK LEY	TATA MOTORS	MAHINDRA
P/E (x)	FY07E	12.6	13.6	11.8
	FY08E	11.0	11.5	9.8
EPS Gr (%)	FY07E	25.1	24.3	25.5
	FY08E	14.4	18.9	20.9
RoE (%)	FY07E	24.6	26.8	23.9
	FY08E	25.0	25.9	23.3
EV/EBITDA (x)	FY07E	6.6	8.2	10.4
	FY08E	5.4	6.8	9.0

SHAREHOLDING PATTERN (%)

	JUN.06	MAR.06	JUN.05
Promoters	39.2	49.6	50.9
Domestic Institutions	20.0	19.3	24.1
FIIs/FDIs	24.9	17.8	8.6
Others	15.9	13.3	16.4

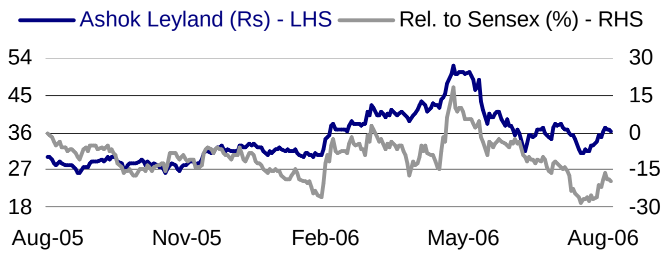
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	2.9	3.1	-6.1
FY08	3.3	3.4	-4.1

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
36	49	35.0	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					(Rs Million)
Y/E MARCH	2004	2005	2006	2007E	2008E
Net Sales	**33,920**	**41,824**	**52,477**	**59,031**	**66,325**
Change (%)	*25.7*	*23.3*	*25.5*	*12.5*	*12.4*
Raw Material	23,228	29,729	37,690	41,912	46,992
Employee Cost	3,097	3,540	4,039	4,781	5,240
Other Mfg. Expenses	1,873	2,096	2,519	2,833	3,184
Selling & Distribution	1,775	2,230	2,828	3,182	3,575
EBITDA	**3,946**	**4,228**	**5,400**	**6,322**	**7,336**
Change (%)	*23.2*	*7.2*	*27.7*	*17.1*	*16.0*
% of Net Sales	*11.6*	*10.1*	*10.3*	*10.7*	*11.1*
Depreciation	965	1,092	1,260	1,372	1,457
Interest & Finance Charge	594	304	165	258	300
Other Income	572	554	330	620	672
Non-recurring Expense	95	95	85	-	-
Non-recurring Income	-	260	302	-	-
PBT	**2,959**	**3,386**	**4,305**	**5,311**	**6,250**
Tax	929	836	1,250	1,487	1,875
Effective Rate (%)	*31.4*	*24.7*	*29.0*	*28.0*	*30.0*
Adj. PAT (bef. Extra)	**2,031**	**2,550**	**3,056**	**3,824**	**4,375**
% of Net Sales	*63.7*	*25.6*	*19.8*	*25.1*	*14.4*
Rep. PAT	**1,936**	**2,715**	**3,273**	**3,824**	**4,375**

BALANCE SHEET					(Rs Million)
Y/E MARCH	2004	2005	2006E	2007E	2008E
Share Capital	1,189	1,189	1,324	1,324	1,324
Reserves	9,329	10,489	12,325	14,237	16,206
Net Worth	**10,518**	**11,679**	**13,649**	**15,561**	**17,529**
Loans	4,989	8,804	7,554	6,804	5,554
Deferred Tax Liability	1,803	1,708	1,708	1,708	1,708
Capital Employed	**17,310**	**22,191**	**22,911**	**24,073**	**24,792**
Gross Fixed Assets	18,756	20,023	22,174	23,774	25,024
Less: Depreciation	10,008	11,084	12,344	13,716	15,173
Net Fixed Assets	**8,748**	**8,938**	**9,830**	**10,058**	**9,851**
Investments	1,466	2,292	2,292	2,292	2,292
Curr.Assets, L & Adv	**14,637**	**21,573**	**23,250**	**25,518**	**28,337**
Inventory	5,069	5,681	7,104	8,001	9,001
Sundry Debtors	4,056	4,588	5,751	6,469	7,269
Cash & Bank Balances	3,250	7,967	10,206	10,858	11,878
Loans & Advances	2,261	3,337	190	190	190
Current Liab. & Prov.	**8,327**	**11,657**	**12,654**	**13,988**	**15,881**
Sundry Creditors	6,041	8,619	10,064	11,321	12,720
Other Liabilities	816	993	66	66	66
Provisions	1,470	2,045	2,524	2,601	3,095
Net Current Assets	**6,310**	**9,916**	**10,596**	**11,530**	**12,456**
Miscellaneous Exp.	323	193	193	193	193
Application of Funds	**17,310**	**22,191**	**22,911**	**24,073**	**24,792**

E: MOSt Estimates

RATIOS					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Basic (Rs)					
EPS	**1.6**	**1.9**	**2.3**	**2.9**	**3.3**
Cash EPS	2.5	3.1	3.3	3.9	4.4
EPS Growth (%)	70.8	17.2	21.0	25.1	14.4
Book Value per Share	8.8	9.8	10.3	11.8	13.2
DPS	0.8	1.0	1.4	1.4	1.8
Payout (Incl. Div. Tax) %	46.1	48.7	56.1	50.0	55.0
Valuation (x)					
P/E		19.0	15.7	12.6	11.0
Cash P/E		11.9	11.1	9.2	8.2
EV/EBITDA		9.9	8.0	6.6	5.4
EV/Sales		1.0	0.8	0.7	0.6
Price to Book Value		3.7	3.5	3.1	2.7
Dividend Yield (%)		2.8	3.8	4.0	5.0
Profitability Ratios (%)					
RoE	18.4	23.2	24.0	24.6	25.0
RoCE	20.5	16.6	19.5	23.1	26.4
Leverage Ratio					
Debt/Equity (x)	0.5	0.8	0.6	0.4	0.3

CASH FLOW STATEMENT					(Rs Million)
Y/E MARCH	2004	2005	2006	2007E	2008E
OP/(Loss) before Tax	2,981	3,136	4,140	4,950	5,878
Depreciation & Amortisat	965	1,092	1,260	1,372	1,457
Direct Taxes Paid	-811	-930	-1,250	-1,487	-1,875
(Inc)/Dec in Working Capi	1,876	1,241	1,494	-283	94
Other Items	-120	-365	398	0	0
CF from Oper. Activi	**4,890**	**4,174**	**6,043**	**4,552**	**5,555**
Extra-ordinary Items	-95	165	217	0	0
CF after EO Items	**4,795**	**4,339**	**6,260**	**4,552**	**5,555**
(Inc)/Dec in FA+CWIP	-777	-1,671	-1,300	-1,600	-1,250
(Pur)/Sale of Invest.	110	-826	0	0	0
CF from Inv. Activity	**-667**	**-2,497**	**-1,300**	**-1,600**	**-1,250**
Issue of Shares	0	0	134	0	0
Inc/(Dec) in Debt	-2,183	3,815	-1,250	-750	-1,250
Interest Rec./(Paid)	-22	250	165	361	372
Dividends Paid	-892	-1,189	-1,771	-1,912	-2,406
CF from Fin. Activity	**-3,097**	**2,875**	**-2,721**	**-2,301**	**-3,285**
Inc/(Dec) in Cash	**1,031**	**4,717**	**2,239**	**652**	**1,020**
Add: Beginning Balance	2,219	3,250	7,967	10,206	10,858
Closing Balance	**3,250**	**7,967**	**10,206**	**10,858**	**11,878**

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Disclosure of Interest Statement	Ashok Leyland
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No