TVS Motor Company Ltd

Nearing an inflexion point

- **Initiate with Underweight:** We initiate coverage on TVS Motor with an Underweight rating and a Mar-07 PT of Rs95. TVS is benefiting from secular volume growth in the two-wheeler sector and a competitive product portfolio. However, an increase in competition is affecting profit margins and earnings growth.
- **Growth initiatives:** Management has made an attempt to boost growth and diversify risk away from competitive pressures in the local market through international sales and by entering the profitable three-wheeler segment.
- **Investment theme:** The benefits from new initiatives are expected to accrue with a lag. Despite management's track record on product development, these projects carry execution risks. Moreover, substantial investment in new projects, limited financial muscle as compared to larger peers, and halving of EBITDA margins to 5% over the last three years could impede TVS' ability to compete in the event of further price wars in the short term.
- **Valuation, PT, risks:** Our PT is pegged off 14x FY08E earnings of Rs6.8, in line with its peer group and TVS' own historic multiple. We will wait for progress on new growth initiatives for a more constructive recommendation. In the interim we see the stock confined to a narrow trading range. Key risks: (1) Stronger-than-expected industry growth, resulting in an easing of competitive intensity. (2) Re-rating on the back of growth initiatives that deliver results ahead of schedule.

Reuters: TVSM.BO; Bloomberg: TVSL IN

Rs in millions, year-end Mar	FY06	FY07E	FY08E	FY09E
Net sales	32,350	40,541	48,767	57,034
Net profit	1,170	1,172	1,610	2,088
EPS (Rs)	4.9	4.9	6.8	8.8
DPS (Rs)	1.3	1.3	1.4	1.6
Net sales growth (%)	12.5	25.3	20.3	17.0
EPS growth (%)	-15.0	0.2	37.4	29.7
ROE (%)	15.3	13.8	16.6	18.3
ROCE (%)	14.0	13.3	16.3	18.1
BVPS (Rs)	32.3	35.7	40.9	47.9
P/E (x)	19.2	19.2	14.0	10.8
P/BV (x)	2.9	2.7	2.3	2.0
EV/EBITDA (%)	12.3	10.7	8.0	6.2
Dividend yield (%)	1.4	1.4	1.4	1.7

Source: Company, JPMorgan estimates.

Initiation
Underweight

Rs94.70

07 December 2006
Price Target: Rs95.00

India
Automobile Manufacture

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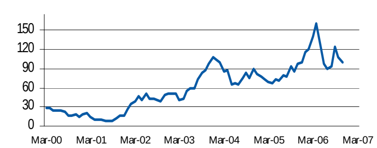
Seedlings

TVS: Five-year price performance



Source: Bloomberg.

Stock performance

	1M	3M	12M
Absolute (%)	(12)	(19)	(4)
Relative (%)	(15)	(31)	(39)

Source: Bloomberg.

Company data

52-Wk Range (Rs)	87-178
Mkt Cap. (RsB)	22.5
Mkt Cap. (US$MM)	502.9
Shares O/S (MM)	237.5
Free float (%)	44
Avg. Dly Volume (MM)	1.4
Liquidity (US$MM)	3.4
Exchange rate	44.7
Index Sensex	13,949
year-end	March

Source: Bloomberg.

J.P. Morgan India Private Limited

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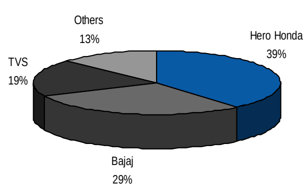
Company description

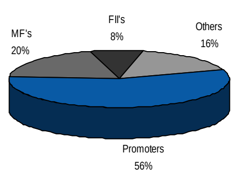
TVS Motor is the third largest manufacturer in the fast growing two-wheeler sector in India. The company has a market share of 19% out of a total market of 8.5 million units. TVS Motor is part of the TVS group with interests mainly in auto, auto components, dealerships and financing.

Figure 1: TVS—Two wheeler market share
%



Source: SIAM

Figure 2: TVS—Shareholding pattern
%



Source: Capital Line.

Corporate governance metrics

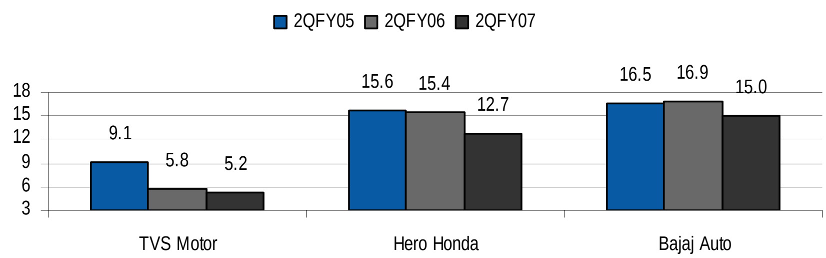
Company dividend policy	Dividend track record
Payout Ratio of about 25%	Rs.1.3 per share in FY06
# Days to publish quarterly report	# Days to consolidated annual report
31	120
% Independent directors	% Inter-company transactions
56	8 of raw materials consumed
History of share placement	Insider ownership (%)
NA	56

Source: Company.

Negative price drivers

Increasing competition taking a toll on profit margins
Over the last few years, the two-wheeler sector in India has seen an increase in competitive intensity between the lead players Hero Honda, Bajaj Auto and TVS. Prices have eroded in real terms and product life cycles have shortened considerably. TVS has borne the brunt of the margin pressure as it neither has easy access to technology as in the case of Hero Honda nor substantial cash balances and presence in the less competitive three-wheeler segment as in the case of Bajaj Auto.

Figure 3: Top 3 players EBITDA margins show a declining trend
%



Source: Company.

Competitive pressures are likely to accentuate in the future due to renewed focus from the Japanese multinationals (MNCs), Honda, Yamaha and Suzuki. While the Indian companies control nearly 90% of the market and have a competitive product portfolio, they will have to prepare for an increase in competition from the MNCs, which have huge financial resources. TVS' current EBITDA margins at 5% leave limited room to compete profitably in the event of further price wars.

Execution risk could strain balance sheet
TVS' growth initiatives of entering the high margin three-wheeler sector segment and setting up a subsidiary in Indonesia to manufacture two wheelers for sale in the South East Asian markets have a lot of appeal. However, they also have associated execution risks.

The three wheeler market has so far been dominated by Bajaj and Piaggio. Technology in this sector is demanding and TVS will have to establish its product across applications, passenger and freight; and across fuels, gasoline, diesel and CNG/LPG.

In the two wheeler project in Indonesia, the biggest challenge for TVS will be brand recognition as the company is entering that market for the first time (unlike Bajaj Auto which is already present). Also, TVS will have to ensure that customers have access to finance as currently the Indonesian banking system is not well developed for consumer finance.

Considering these challenges, the management expects the unit to be profitable only from the third year onward. However, the company has formed a subsidiary for its Indonesian operations and the impact will not be visible in the standalone results.

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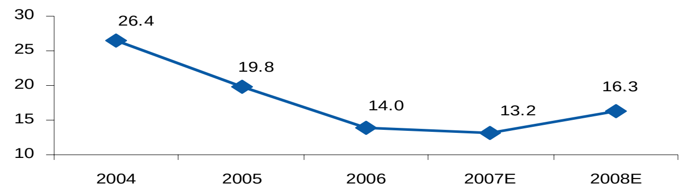
TVS is committing a significant capital expenditure of Rs5 billion over FY06-08E on these initiatives, mainly through borrowings. ROCE has fallen due to the increased balance sheet size without commensurate increase in revenue over the short term. While the additional burden on the balance sheet is typical of companies in the capex mode, it also increases the risk profile. In case of delays in implementation/failure the financial position of the company will be weakened.

Table 1: TVS—Capex details

	Rs. M	$ M
Indonesia	3,000	67
3 Wheelers	1,000	22
Himachal 2W	900	20
Total	4,900	109

Source: Company, JPMorgan estimates.

Figure 4: TVS—ROCE(%) reflects a declining trend

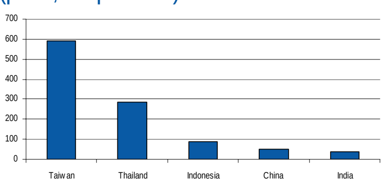


Source: Company, JP Moran estimates.

Positive price drivers

Two wheeler industry to witness secular growth over the next three years
The two wheeler sector is expected to sustain a growth rate of 14% Y/Y over the medium term on the back of strong nominal GDP growth (CAGR of 12.5% estimated), a deteriorating public transport system and easy availability of finance. Current penetration levels at an estimated 37 per 1,000 person imply a sustainable growth opportunity over the medium term.

Figure 5: Two Wheeler Penetration (per 1,000 persons)



Source: TVS Motor Co.

Table 2: Two wheeler sales

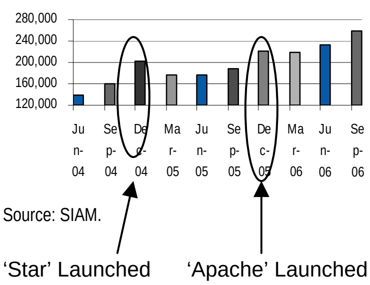
(in nos)

To cross 10m mark

	FY05	FY06	FY07E	FY08E	FY09E
Sales	6,572,743	7,569,744	8,705,206	9,923,934	11,313,285
Growth (%)	16.6	15.2	15.0	14.0	14.0

Source: JPMorgan estimates.

Figure 6: TVS— Qtrl. Motorbike Sales (nos)



Source: SIAM.

Strong product momentum

Subsequent to the initial hiccups post the split with Suzuki in 2001, TVS has transformed its product portfolio substantially, including a shift from two stroke engines to more fuel efficient four stroke engines.

Leveraging off in-house product development capabilities, TVS has launched products for each market segment, *Scooty* in the scooterette segment, *Victor* in the executive, *Star* in the economy and more recently *Apache* in the premium segment. All these products have been well rated and received by the market, enabling management to partially recover lost market share.

Due to the success of these products, TVS' motorcycle sales have grown at 30% YTD in FY07 (1.5x times the industry growth rate). We expect the growth momentum to sustain over the next 12-15 months as well, given the healthy demand for recently launched products.

Expansion at Himachal Pradesh to improve profits
TVS is expanding capacity at a new site in Himachal Pradesh with a capacity of 300,000 units (15% of current capacity), which will incur a capital expenditure of Rs900 million. The project to be commissioned in April 2007, is being set up in an

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underdeveloped area and is eligible for fiscal incentives.

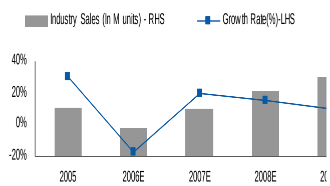
Adjusted for non-availability of MODVAT, the cost saving on excise duty alone is estimated at about 500 bp. A part of these savings could be neutralized due to start up costs and higher logistics expenses, but down the line it should support margin expansion. The income tax exemption should lead to a decrease in the TVS' effective tax rate.

Table 3 : Fiscal incentives

Tax Rate	Basis	Exemption	Duration
Central Excise	16% of Sales	100%	10 years
Income Tax	30% of PBT	100%	First 5 years
Income Tax	30% of PBT	30%	Next 5 years

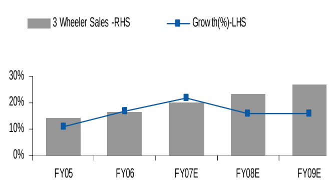
Source: JP Morgan estimates.

Figure 7: Indonesia—Two wheeler sales



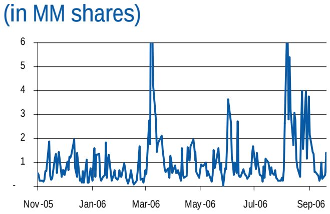
Source: JPMorgan estimates.

Figure 8: Three wheeler sales



Source: SIAM, JPMorgan estimates.

Figure 9: TVS—Traded volumes (in MM shares)



Source: Bloomberg.

Assembly plant in Indonesia to tap South East Asian market

Having gained confidence from competing effectively with Honda, Yamaha and Suzuki in India, management is now targeting exports as a growth driver. Exports have been growing at a CAGR of 98% over the last few years, albeit off a low base. TVS is now setting up an assembly plant in Indonesia, the third largest two-wheeler market in the world with annual sales of five million units and growing at 15% per annum. Currently, the Japanese MNCs have over 92% share of the market.

By 1Q08 TVS through a fully owned subsidiary will have a capacity of 300,000 units (primarily bebeks) at a total investment of $50 million.

Three wheelers, a new growth opportunity

TVS is diversifying into the three wheeler segment by setting up a project with a capacity of 60,000 units in Mysore (scalable up to 100,000 units) at a capex of Rs.1 billion. This project is expected to commence production by 1Q08. The three wheeler industry in India comprised of c360,000 units in domestic market and 77,000 units for the overseas market in FY06. A presence in the three wheeler segment is expected to be positive for TVS as: (1) the segment has lower competitive intensity (only two large manufacturers) and higher margins (currently 20%+); and (2) it will enable TVS to blunt Bajaj Auto's competitive position. Bajaj Auto's presence in the relatively sheltered three wheeler segment has helped management to be more aggressive in the two wheeler segment.

Earnings, valuation and rating analysis

Positive earnings outlook

We forecast a CAGR of 21% in TVS' earnings over FY06-09E. We expect a CAGR of 14% in two wheeler sales over this period. Price and margin pressure is expected to continue in the sector given the current competitive dynamics. Margins for TVS are however expected to improve over the current low levels, particularly in FY09E due to: (1) Better economies of scale. (2) TVS' expansion in capacity in Himachal Pradesh. Tax sops for investments in this area include excise and income tax exemption for sales derived from this location. 3) TVS is entering the three wheeler market in FY08. Given lower competitive intensity (market dominated by Bajaj and Piaggio) margins in this segment are considerably higher. We estimate current EBITDA margins for incumbent majors in this segment at more than 20%.

Capital costs are expected to increase substantially, while financial income will decline, due to capital expenditure proposed for expansion of the two wheeler

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capacity, the three wheeler initiative, and investment in the Indonesian subsidiary. Consequently our earnings estimates are sensitive to delays/failures of these initiatives. Our current estimates for FY08E are 10% lower than consensus.

Table 4: PE(x) of Peers

	HH	Bajaj*	TVS
FY07E	15.0	17.9	19.2
FY08E	12.9	14.7	14.0

Source: JP Morgan estimates.

*Bajaj -is valued on core income after stripping off estimated surplus cash & investments of Rs.1,000 from price

Valuation

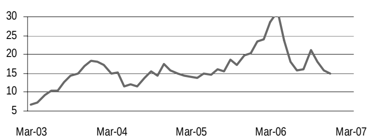
TVS shares hit a downturn after weak 3Q results, which indicate margin compression. After the sell-off, the stock currently trades at 14x FY08E earnings.

We base our March-07 price target of Rs95 on 14x forward earnings. Our valuation benchmarks are comparable with peer group and are in line with the stocks average historical multiple over the past three years.

Rating

The stock currently trades at our March-07 price target of Rs95. We rate the stock Underweight, as we believe it is fully valued.

Figure 10: TVS—P/E band



Source: JPMorgan estimates.

We expect TVS to deliver superior earnings growth to its peer group into FY08-09, however, this is contingent on the new initiatives taking off. In the interim, TVS is more vulnerable as compared to competition to further price wars in the two wheeler segment due to: (1) lower margins; and (2) a weaker balance sheet. This vulnerability is borne out by the flat trend in earnings over the last four years despite substantial volume growth.

We expect to have a more constructive recommendation as we see the execution risks in with new initiatives being mitigated.

SWOT analysis

Strengths

- **Product development skills:** Subsequent to the break-up with Suzuki, management has leveraged off in-house R&D capabilities to launch products across market segments. These products compete effectively with Japanese MNCs.
- **Strong brands and distribution network:** The TVS brand and sub brands for different market segments i.e., *Scooty*, *Victor* and *Star* are well regarded. The 500 strong dealer network is spread across the country.

Weaknesses

- **Competition better placed:** TVS neither has easy access to technology as in the case of the Japanese MNCs nor the substantial cash balances of Bajaj Auto.
- **Sub optimal product mix:** Low growth mopeds comprise 21% of TVS' product mix, impacting growth rates and market share improvement. TVS derives 75% of its volumes in motorcycles from the economy segment where margins are the lowest in the 2 wheeler sector.

Opportunities

- **2 wheelers:** The 2 wheeler market in India provides a secular growth opportunity. Having competed effectively with the Japanese MNCs management has been emboldened to enter international markets.
- **3 wheelers:** TVS is entering the3 wheeler segment (c.420,000 units) in FY07E. With only two dominant players in this segment, profitability is higher.
- **Fiscal incentives:** TVS' new plant in Himachal is eligible for excise and income tax exemption, which will aid competitive pricing/earnings.

Threats

- **Increasing competition.** Competition in the Indian 2 wheeler sector is intense leading to margin erosion. TVS has borne the brunt of this margin erosion. EBITDA margins have halved to 5% in the last three years, leaving limited room on the downside to compete profitably.
- **Execution risk on new initiatives.** Key growth initiatives are lined up for the next year including entering the ASEAN markets and manufacturing 3 wheelers. These initiatives are capital intensive (nearly US$100 million) and could strain the balance sheet in the event of project delays/failure.

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TVS MOTOR CO: Summary of financials

Profit and Loss statement				
Rs in millions, year-end Mar	FY06A	FY07E	FY08E	FY09E
Revenues	32,350	40,541	48,767	57,034
% change Y/Y	12%	25%	20%	17%
EBITDA	2,045	2,342	3,080	3,747
% change Y/Y	-3%	15%	31%	22%
EBITDA Margin (%)	6.3%	5.8%	6.3%	6.6%
Other Income	710	587	592	592
Depreciation	939	1,014	1,109	1,206
EBIT	1,816	1,915	2,563	3,133
Interest Charges	131	229	246	246
Earnings before tax	1,685	1,687	2,317	2,887
% change Y/Y	-16%	0%	37%	25%
Tax	515	514	707	799
as % of EBT	31%	31%	31%	28%
Net Income (Pre Exceptional)	1,170	1,172	1,610	2,088
% change Y/Y	-15%	0%	37%	30%
Shares Outstanding	238	238	238	238
EPS (pre exceptional)	4.9	4.9	6.8	8.8
% change Y/Y	-15%	0%	37%	30%

Cash flow statement				
Rs in millions, year-end Mar	FY06A	FY07E	FY08E	FY09E
EBIT	1,106	1,329	1,971	2,542
Depreciation & amortisation	939	1,014	1,109	1,206
Dec/(Inc) in Working Capital	(1,434)	(327)	(11)	(34)
Taxes	(510)	(514)	(707)	(799)
Cash flow from operations	101	1,500	2,362	2,914
Extra ordinary Items	0	0	0	0
Net Capex	-1,172	-930	-1,500	-1,250
Net Interest (Paid)/ Recd	-131	-229	-246	-246
Free cash flow	-1,202	341	616	1,419
Income from Investments	710	587	592	592
(Inc) / Dec in LT Investment	-1,275	-500	-500	-250
Equity raised/ (repaid)	55	0	0	0
Debt raised/ (repaid)	1,982	617	0	0
Other				
Dividends paid	-352	-353	-367	-429
Cash generated during the year	-82	693	341	1,332
Beginning cash	1,358	1,276	1,968	2,309
Ending cash	1,276	1,968	2,309	3,641

Balance sheet				
Rs in millions, year-end Mar	FY06A	FY07E	FY08E	FY09E
Cash and cash equivalents	1,276	1,968	2,309	3,641
Accounts receivable	582	889	1,069	1,250
Inventories	3,579	4,443	5,344	6,250
Others	2,152	2,364	2,600	2,860
Current assets	7,588	9,663	11,322	14,001
LT investments	2,410	2,910	3,410	3,660
Net fixed assets	7,938	7,854	8,246	8,290
Total assets	17,936	20,427	22,978	25,951
Liabilities	17,936	20,427	22,978	25,951
Payables	5,245	6,442	7,749	9,063
Others	624	482	482	482
Total current liabilities	5,869	6,924	8,231	9,545
Total debt	3,850	4,468	4,468	4,468
Other liabilities	1,490	1,490	1,490	1,490
Total liabilities	11,210	12,882	14,189	15,503
Shareholders' equity	6,726	7,546	8,789	10,448
BVPS	32.3	35.7	40.9	47.9

Ratio Analysis				
%, year-end Mar	FY06A	FY07E	FY08E	FY09E
Gross Margin	28.2	27.2	27.6	27.8
SG&A/sales	10.9	10.5	10.5	10.4
EBITDA margin	6.3	5.8	6.3	6.6
Net profit margin	3.6	2.9	3.3	3.7
Sales growth	12.5	25.3	20.3	17.0
Net profit growth	-15.0	0.2	37.4	29.7
EPS growth	-15.0	0.2	37.4	29.7
Debtors Days	7	8	8	8
Creditor Days	82	80	80	80
Inventory Days	43	42	43	43
Interest coverage (x)	14	8	10	13
Net debt to equity (%)	50.3	52.7	45.9	39.2
Sales/assets(%)	248.8	280.8	311.0	328.9
Assets/equity(%)	169.7	170.3	161.3	152.3
ROE(%)	15.3	13.8	16.6	18.3
ROCE(%)	14.0	13.3	16.3	18.1

Source: Company, JPMorgan estimates