

**Industrials**  
**Automobiles**

# Indian auto market

Few medium-term opportunities for  
Japanese automakers

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## Disclaimer & Disclosures.

This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, that form part of it.

- ▶ **We expect significant development in the Indian auto industry going forward, both as an area of increasing new auto demand and as a low-cost manufacturing base for exports.**
- ▶ **Global automakers are aggressively investing in the Indian market as part of their growth strategies, which has intensified competition.**
- ▶ **The Indian business has already begun to change, with a shift in the product mix, an expansion in exports of complete vehicles and components, and growth in the auto finance market.**
- ▶ **India represents an important frontier, but entry into the Indian market is still in its infancy, apart from a few pioneers. Toyota Motor, Honda Motor, and Nissan Motor are increasing capacity and building new facilities in the region, but Suzuki Motor is the only Japanese maker for whom the Indian business is a profit growth driver.**
- ▶ **However, some Indian automakers have attractive growth prospects and valuations. We prefer Maruti Udyog, Suzuki's JV, to Tata Motors.**

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# Indian auto business

- ▶ We focus on foreign automakers to examine trends and developments in the Indian auto business
- ▶ While profit contribution from the region is not yet a major factor in stock investment decisions, we feel India is likely to grow in strategic importance
- ▶ Suzuki was the pioneer in the market, and Toyota and Honda are prioritizing investment in the region in order to catch up

In this report, we focus on the activity of foreign automakers in order to examine the current situation and future prospects for the Indian auto business. We mainly highlight current trends and their impact on stock investment decisions. As a consequence, we do not comment much on local automakers, such as Tata Motor, Mahindra & Mahindra, and Hindustan Motors. These companies are covered in regular research reports from our analyst in Mumbai, Sanjay Satpathy.

The main findings of this report are as follows.

First, we expect significant future development in the Indian auto industry, both as an area of increasing new auto demand and as a low-cost manufacturing base for exports.

Second, the leading global automakers are aggressively investing in the Indian market as part of their growth strategies, which has intensified competition. We feel responses to this competition and to more stringent government regulation could lead to differing profit growth performance between companies in the long term.

Finally, the Indian business has already begun to change, including a shift in the product mix as consumer auto preferences diversify, an expansion in exports of complete vehicles and components, and growth in the auto finance market.

1: Ratings and target share prices for 8 Japanese automakers under coverage

Code	Stock	Rating	Target Price 20 Apr 2007 (JPY)	Price (JPY)
7201	Nissan Motor	Neutral	1,325	1,214
7202	Isuzu Motors	Overweight	720	648
7203	Toyota Motor	Underweight	6,080	7,380
7205	Hino Motors	Underweight	520	642
7261	Mazda Motor	Underweight	630	612
7267	Honda Motor	Underweight	3,240	4,090
7269	Suzuki Motor	Underweight	2,890	3,250
7270	Fuji Heavy Industries	Overweight	810	595
			<b>(INR)</b>	<b>(INR)</b>
MM IN	Mahindra & Mahindra	Overweight	950	744
TTMT IN	Tata Motors	Underweight	685	723
MUL IN	Maruti Udyog	Overweight	990	776

Source: HSBC

Entry into the Indian market is still in its infancy, apart from a few pioneers such as Suzuki. Participation in the region is not yet a major factor in stock investment decisions due to the limited direct impact on corporate profit growth, but we

believe India represents an important frontier for development at global automakers. We therefore think it is instructive to focus on the investment strategy, management stance, and strategic direction of each main player in this market.

The investment ratings and target prices for the eight main complete Japanese automakers that we cover are shown in Figure 1.

We have Overweight ratings on Isuzu Motors and Fuji Heavy Industries, and Underweight ratings on Toyota, Honda, Mazda, and Suzuki. We make no changes to our earnings forecasts or investment ratings in light of our study of the Indian business. At the same time, we believe the profit contribution from Indian operations could develop into a key factor in investment decisions in the long term.

Figure 2 shows our calculations and comparisons of the impact of Indian auto operations on the main Japanese makers under our coverage. We have assumed that planned production capacity increases through FY2010 will run at full capacity due to market growth. In addition, we have excluded any investment costs after FY2010, as investment plans for later years have not yet been concluded. Contrary to general opinion, we do not expect significant returns on investment for most Japanese automakers for many years, in part, because most of the investments are joint ventures.

**2: Impact of Indian auto operations on profits of Japanese automakers**

Company	Production volume in India (000units)		Share of Indian market in total profit	
	2006	- 2010e	2006	- 2010e
Nissan Motor	0	10	0.0%	0.0%
Isuzu Motors	0	0	0.0%	0.0%
Toyota Motor	48	200	0.1%	0.2%
Hino Motors	0	0	0.0%	0.0%
Mazda Motor	0	0	0.0%	0.0%
Honda Motor	56	150	0.3%	0.6%
Suzuki Motor	596	1,000	32.1%	43.5%
Fuji Heavy Industries	0	0	0.0%	0.0%

Notes: Total profits are based on recurring profit or pre-tax profit, and include minority interest.

Source: HSBC

Suzuki was the pioneer in the Indian auto business, and it remains strong. Its joint venture with the Indian government, Maruti Udyog Limited (MUL), was set up in 1982 and is India's largest automaker. Suzuki is investing aggressively in the region, not only in improving production capacity through a new assembly plant and engine facility, but also in developing new models to boost its line-up, against a backdrop of strong brand power and solid sales performance. This investment burden may pressure profit growth at MUL and Suzuki in the short term, but we feel it is the correct response to changing market needs and believe this strategy will support the growth of the business, such as by developing the export market.

We expect Toyota and Honda to exploit their solid brand images to achieve strong positions in the Indian market. They should benefit particularly from Indian consumers' focus on fuel efficiency. These two firms, along with Nissan Motor, which lately decided to participate in a joint business with Renault and Mahindra & Mahindra, have yet to fully increase their production capacity in India, and we expect initial investment burdens to increase further. We believe increasing competition could mean recovery of these costs takes upward of five years, longer than current market thinking.

There is a strong sense that other makers, such as Mazda, Fuji Heavy and Isuzu, are lagging behind in developing their Indian businesses. However, we expect continued growth in the Indian market to increase opportunities for these firms to enter the sector. Mazda is considering entering India and other BRIC markets, jointly with Ford, in some cases.

Suzuki is currently the only maker to receive a full profit contribution from its Indian business, through consolidated subsidiary MUL. We look for the Indian unit's share of Suzuki's consolidated recurring profit to increase to 44% in

FY Mar-11 from 32% in FY Mar-07. Suzuki's strategy for this business is to diversify operations in order to outpace its rivals decisively. This strategy includes developing new models, boosting capacity for diesel engines and other parts at its power train plant, and expanding exports.

We have an Underweight rating on Suzuki. This is not because of the Indian operation, but reflects our view that some of the company's valuations, especially PE, appear overstretched, with the shares currently trading on an EV/EBITDA of 3.6x and PE of 16.9x our FY Mar-08 forecasts and 3.2x and 15.6x our FY Mar-09 forecasts. We believe the rise in investment costs laid out in the company's medium-term business plan (not only for India) will place increasing downward pressure on profit growth. Moreover, Suzuki's pioneering status in the Indian business is old news for the stock market.

Increasing production capacity, developing new models for BRICS markets, and strengthening sales networks in the Indian market have become urgent management issues for Toyota and Honda. As stated previously, we do not expect these companies to reap large profits on their Indian operations for at least the next 3-5 years. However, given the time required to build up R&D and production facilities and a sales network, these

companies must promote this process now.

Although we expect them to be able to increase sales volume on the back of their strong models and solid brand images, we believe the recovery of investment costs may take until FY2010, due to increases in investments and sales costs, and to an increase in the sales weighting of compact models and a resulting worsening of their product mixes.

The stances of Toyota, Honda, and Nissan towards their Indian businesses should not be considered in isolation, but rather be seen as part of an overall investment strategy for emerging markets, including China and Russia.

Over the medium term, native Indian automakers offer better growth prospects and valuations than foreign automakers, including the Japanese. Our favourite Indian automaker is Suzuki Motor's joint venture, Maruti Udyog.

Risks to our forecasts for the Indian auto industry include:

1. a slowdown in demand, stemming from slower economic growth,
2. inadequate development of infrastructure,
3. loss of cost competitiveness accompanying rapid economic growth,
4. worsening terms of finance.

### 3: Valuations for Japanese automobile companies under coverage

Company	Code	Share price (4/20/2007) (Local Currency)	Target price	Market cap. (\$ million)	PE FY Mar-08e (X)	PE FY Mar-09e (X)	EV/EBITDA FY Mar-08e (X)	EV/EBITDA FY Mar-09e (X)
Nissan Motor	7201	1,214	1,325	46,406	8.0	7.4	8.7	7.8
Isuzu Motors	7202	648	720	9,115	12.1	11.6	9.3	8.5
Toyota Motor	7203	7,380	6,080	225,272	14.6	14.0	10.9	10.7
Hino Motors	7205	642	520	3,119	21.7	20.4	8.7	8.7
Mazda Motor	7261	612	630	7,322	11.7	11.3	5.7	5.8
Honda Motor	7267	4,090	3,240	63,455	11.9	11.5	8.8	8.6
Suzuki Motor	7269	3,250	2,890	14,912	16.9	15.6	3.6	3.2
Fuji Heavy Industries	7270	595	810	3,939	16.8	10.2	7.5	5.6
Mahindra & Mahindra	MM IN	744	950	4,278	13.1	10.6	7.5	6.4
Tata Motors	TTMT IN	723	685	6,534	12.9	11.9	6.5	5.3
Maruti Udyog	MUL IN	776	990	5,321	14.0	12.1	7.6	6.3

Sources: Factset, HSBC

# Edge with incumbents

- ▶ We expect car sales to grow by 14% in FY Mar-08 and 13% in FY Mar-09, compared to 22% in FY Mar-07, as rising interest rates could hurt
- ▶ Companies with increasing presence in diesel, LPG/CNG cars and small cars to gain the most as affordability becomes increasingly important
- ▶ We prefer Maruti Udyog over Tata Motors, due to better track record and visibility for outperforming domestic market in the near term

## Trend line growth to continue

Domestic demand for cars grew at a CAGR of 12% in the decade from FY Mar-97 to FY Mar-07, nearly 1.8 times the average GDP growth. We expect total car demand to grow at 14% in FY Mar-08 and 13% in FY Mar-09, almost in line with the trend line growth of last decade. Our expectation of a decline in growth rate to 13% from 22% in FY Mar-07 is on account of the

following changes to key drivers.

- ▶ A reduction in the excise duty in Feb06 led to high growth in FY Mar-07. We do not expect any duty cut for FY Mar-08, and hence expect growth to be slower in FY Mar-08 and FY Mar-09.
- ▶ The interest rate on car loans has risen by more than 250bp recently, and our economists expect it to rise further. This could impact

Table 4: India – Car sales trend and expectation vis-à-vis macro environment

Fiscal year to March	Borrowing rate at the end of year	Change in borrowing rate (bp)	GDP growth	Excise duty	Domestic Car** sales	y-o-y car sales growth
1998	15.50	(50)	5.0%	40%	388,015	3.7%
1999	14.50	(100)	6.6%	40%	384,483	-0.9%
2000	13.75	(75)	6.1%	40%	615,544	60.1%
2001	12.75	(100)	4.4%	40%	567,734	-7.8%
2002	12.25	(50)	5.8%	32%	570,473	0.5%
2003	10.75	(150)	4.0%	32%	591,870	3.8%
2004	9.75	(100)	8.5%	24%	755,335	27.6%
2005	10.00	25	7.5%	24%	872,795	15.6%
2006	10.50	50	9.0%	16%*	948,460	8.7%
2007e	13.00	250	9.2%	16%*	1,157,121	22.0%
2008e	13.75	75	8.2%	16%*	1,307,547	14.0%
2009e	14.75	100	6.3%	16%*	1,477,528	13.0%

Sources: CMIE, SIAM, HDFC, HSBC, \* Excise duty on small cars, \*\* Passenger Cars

Table 5: Segment wise car demand trend and expectation

Fiscal year to March	Year-on-year growth			Contribution to total sales (%)	
	Small Car	Big cars	Total	Small Car	Big cars
2003	7.0%	11.0%	3.8%	82.0%	18.0%
2004	21.0%	61.0%	27.6%	77.0%	23.0%
2005	14.0%	30.0%	15.6%	75.0%	25.0%
2006	8.0%	7.0%	8.7%	75.0%	25.0%
2007e	25.0%	12.0%	22.0%	77.0%	23.0%
2008e	13.0%	14.0%	14.0%	77.0%	23.0%
2009e	14.0%	12.0%	13.0%	77.0%	23.0%

Sources: SIAM, HSBC

sales growth, as affordability could decline.

- ▶ According to our economists, India's average GDP growth in FY Mar-08 and FY Mar-09 could drop to 7.9%, from an average of 8.3% in the past three years.

We, however, believe that new product launches have the most significant influence in driving growth. We are expecting the number of new product launches to grow significantly in FY Mar-08 and FY Mar-09, compared to the number in the past two or three years. This is likely to help overcome the impact of an adverse macro environment.

## Affordability focus to pay off

We believe that the affordability of a car, ie, its overall ownership cost, will be the key driver of product success in India for the next five years. Manufacturers are trying to make cars affordable at three levels:

- ▶ The upfront cost of purchase
- ▶ Operating cost in terms of fuel efficiency and type of fuel.
- ▶ Maintenance cost

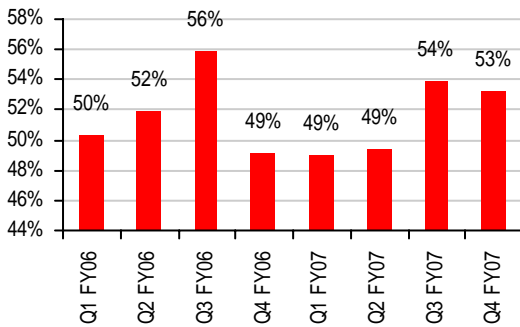
## Maruti on top

Maruti dominates the Indian passenger car market with over a 50% market share. The company's dominance is primarily due to its over 60% market share in small and compact passenger cars, which comprise close to 77% of India's passenger

car market. We expect Maruti to maintain its market share of 54%, achieved in the third quarter of FY Mar-07, driven by new product launches. Maruti has launched three new products in FY Mar-07, a modified WagonR in Q2, a new Zen Estilo in Q3, and the Swift Diesel in Q4. In Q1 FY Mar-08, the company is likely to introduce a new sedan to replace the Baleno, whose production was stopped recently. We expect Maruti to maintain the momentum of new product launches in FY Mar-07 by launching two to three new products per annum. We expect Maruti to maintain its leadership, despite new entrants, through the following strategy:

- ▶ Introduce two to three new products per annum, faster than its competitors.
- ▶ Offer cars which run on cheaper fuels, including diesel, CNG and LPG. Maruti to see the maximum momentum in this space.
- ▶ Expand presence in premium car and utility vehicles, where current market shares are relatively lower. Maruti's market share in big cars is only 13%. Maruti's market share in the utility vehicle and van segment is 29%, significantly lower than its market share in the compact car segment.
- ▶ Remain competitive in the entry level car segment by offering a convenient product at the most competitive price.

**Table 6: Maruti's market share in passenger cars is inching up**



Source: SIAM, Q4FY07 data assumes same market share in Mar07 as in Jan and Feb07

## Tata Motors has right strategy

Tata Motors is currently the third-largest passenger car manufacturer in India, with a 17% market share. The company plans to increase its market share in India through the following strategy.

- ▶ Expand product offerings across price points, independently and through its joint venture with Fiat. Tata Motors currently has two products in the INR300,000 to INR600,000 range. The company plans to increase this number to six by launching two new products of its own by early FY Mar-09 and two products of JV partner Fiat.
- ▶ Launch an entry-level car at the lowest price point by the end of FY Mar-09.
- ▶ Improve product quality through a combination of own effort and technical help from Fiat.
- ▶ Improve cost structure by expanding the scale of business by marketing products outside India.

We believe that this strategy could be effective, but it involves significant execution risk. Tata Motors' track record in terms of execution is worse than that of Maruti.

## Preferred maker is Maruti

We prefer Maruti to other Indian automakers. We currently have an Overweight rating on the company, with a target price of INR990

We have used a three-stage DCF analysis for valuing Maruti. Our FY Mar-08 DCF-based fair value is INR990. We have assumed the cost of equity to be 13.5%. We have explicit estimates until FY Mar-10. There is a semi-explicit period of 10 years starting in FY Mar-11 in which we have assumed the NOPLAT to grow at a 14.7% CAGR, compared to FY Mar-10 NOPLAT. We have assumed the fade period to start in FY Mar-21 and to last for 12 years. During the fade period, the ROIC of the company has been assumed to decline to the cost of capital. The positive and negative factors are evenly balanced, implying limited downside to our earnings estimates.

The key downside risks to our forecasts and rating are increased competition and a decline in profit margins as new product launch expenses accelerate.

1

<sup>1</sup> This section is contributed by our analyst in Mumbai, Sanjay Satpathy. Only in this section, (a) Automobile numbers are for Cars + MPVs only (no SUVs considered) and (b) "Small Cars" signify all cars up to 4000mm length, irrespective of their engine capacity.



# Indian auto business over next 20 years

- ▶ We expect three main developments in the Indian auto business: 1) increased auto usage and tougher regulation; 2) the risk of overcapacity from increased market entries and growth in local production; and 3) an increased external focus, including a rise in exports.
- ▶ We see five main business expansion opportunities for Japanese automakers.
- ▶ Risks to the auto industry in India include: 1) insufficient social infrastructure; 2) a shift to economic reform and geopolitical risks; and 3) a cooling in domestic demand due to tighter credit.

We expect continued development in the Indian auto business going forward. Domestic new car sales volume, including utility vehicles, was only 200,000 units in 1990, due to small demand for new vehicles, but sales accelerated from 2000 onward, reaching 1.34m (up 18% y-o-y) by 2006.

We expect ongoing expansion to 1.53m in 2007 and 2.0m in 2010. We estimate that there is overall latent demand for 7.1m vehicles through 2026, based on a rough estimate of penetration rates and considering likely population growth and replacement demand for new vehicles.

As we detail in the appendices later in this report, we forecast that India's population will overtake China's, reaching 1.39bn by 2026. Moreover, we expect the age of service for autos to shrink, in part because the Indian government is promoting

a shift away from older cars to new vehicles due to environmental and safety considerations.

Barring any major macroeconomic crises, we expect the expansion in consumer segments caused by population growth and the shortening in the replacement cycle to increase the number of vehicles per 1,000 people from 10 in 2005 to 53 in 2026.

We expect continued development of the Indian auto business, and the stock market is also focusing on this area. The potential events and turning points that may mark the next 20 years in this market are shown in Figure 7.

Three major trends are affecting the industry:

1) an increase in automobile usage and increased governmental regulation, which indicates the prospect of increased new car demand while at the

7: Indian automotive industry: 20 Important events for next 20 years

CY	Indian auto industry	Foreign companies	Indian companies	Other factors
1	2007	⇒Honda and Hyundai expand Indian production capacity		
2	2007	⇒Suzuki's unit sales in India exceed its unit sales in Japan		
3	2008	⇒Delhi Motor Show		
4	2008	⇒Length of two-lane highways in India to reach 7,300 km		
5	2008	⇒TATA to introduce mass-market auto priced at IRP100,000		
6	2008	⇒ Maruti Udyog Ltd/Suzuki to start exporting to Europe		
7	2008	⇒Auto safety regulations to be strengthened		
8	2008	⇒TATA and Mahindra & Mahindra may build plants overseas		
9	2009	⇒Nissan starts operations at a new plant, Daimler Chrysler, VW and Honda expand capacity		
10	2010	⇒Introduction of tougher emission standards in main cities		
11	2010	⇒TATA plans to earn 25% of sales overseas		
12	2010	⇒Toyota and GM each aim for 10% of the Indian auto market, Toyota starts to sell cars designed for BRICs		
13	2011	⇒Indian gov't. programme of investment in automotive R&D (NATRIP) to end		
14	2013	⇒TATA aims to sell 1m units of its mass-market auto that year		
15	2014	⇒India may produce 16m motorcycles, surpassing China's output		
16	2015	⇒Toyota may boost its Indian production capacity to 600,000 units per year		
17	2016	⇒Indian auto industry aims to sell 3m passenger cars domestically		
18	2016	⇒India and ASEAN nations to start eliminating taxes on autos imported from each other in stages		
19	2025	⇒India's population may surpass China's		
20	2026	⇒HSBC forecasts Indian demand for new autos will reach 7.1m units		

Source: HSBC

same time suggesting tougher laws on environmental and safety issues, generally signs of market maturation; 2) an increase in industry production capacity, reflecting the entry of foreign manufacturers and a rapid expansion of production capacity by Indian automakers; and 3) an increase in external focus, as native Indian automakers develop and all makers accelerate export growth.

These factors also characterize the auto business in other emerging nations, such as China.

However, India has several unique features, including: 1) a free economic structure with privatization of nationalized companies and a policy of openness toward foreign capital; 2) solid development of management structures at local makers; and 3) no immediate risk of oversupply in the auto business.

Against this industry backdrop, overseas automakers continue to enter the sector and expand existing production facilities.

We see the five main business expansion opportunities for Japanese automakers as:

- 1) a gradual strengthening in environmental and safety regulations;
- 2) increases in local production capacity through 2010 at Toyota and Honda;
- 3) Toyota's target of a 10% market share in 2010;
- 4) the development of free trade with the ASEAN zone in 2016; and
- 5) Indian consumers' strong liking for fuel-efficient vehicles and their high brand awareness based on extensive overseas information.

However, as with other emerging markets, there are risks for Japanese firms. In our view, these include: 1) insufficient social infrastructure, such as transportation; 2) a shift to economic reform and geopolitical risks; and 3) a cooling in domestic demand due to tighter credit.

# Global automakers moving into India

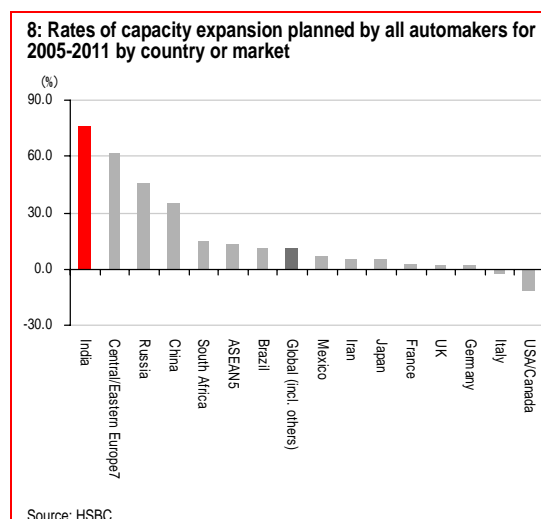
- ▶ Global automakers plan an 11% increase in global auto production capacity between 2005 and 2011. The highest increase, 76%, is planned for India.
- ▶ India's plant utilization rate, at 72%, is on a par with the global average, and there is little immediate risk of overcapacity. However the risk of overcapacity is the same as the risk in China, in our view
- ▶ Toyota has the most aggressive investment plan, followed by Honda and Suzuki/Maruti. Makers with no current facilities, such as Nissan, are planning joint ventures or solely owned plants.

Due to the continued rapid pace of expansion in the Indian auto market, the global automakers have begun to focus on the country as the next growth market.

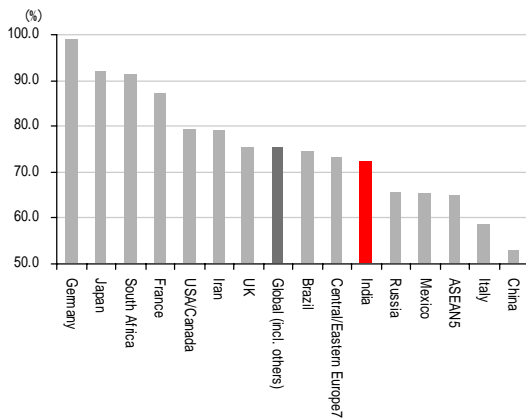
Figure 8 shows automakers' production capacity expansion plans in the main global regions, including India for the period 2005 to 2011.

According to this data, global auto production capacity is set to increase by 11.3%, from 86.36m in 2005 to 96.1m in 2011. Overall North American production will fall 11.5% due to restructuring at the North American Big Three, despite capacity increases by Japanese makers. Capacity expansion in Western Europe, Japan, and Korea is to be limited to between 2% and 5%. However, facilities in emerging nations are to see high growth, with planned increases in Brazil (11.6%), Central and Eastern Europe (61.5%),

Russia (45.6%), and China (35.5%). However, the highest growth is targeted for India, with an increase of 76.4%. Global auto production bases will therefore shift from developed countries to emerging nations.



9: Comparison of plant utilization rates



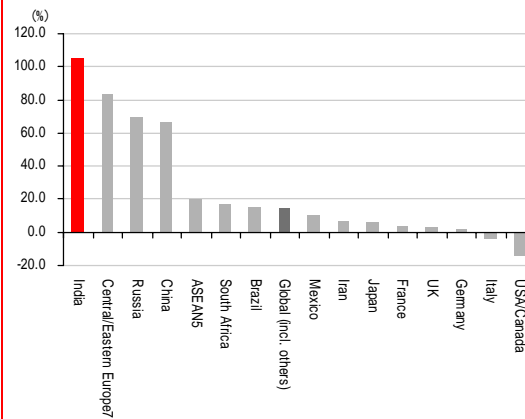
Source: HSBC

However, emerging markets, such as India, China, and Russia, are still in the take-off stage. Figure 9 gives a comparison of plant utilization rates in 2005. China had the lowest utilization rate, at 53%. Although the data is slightly problematic because it includes capacity at plants which had just come on stream in the calculation for the full year, this figure still indicates a serious overcapacity issue in China. This is the result of excessive investment competition between automakers.

Countries with high utilization rates include Germany (99%), Japan (92%), South Africa (92%), and France (87%). Management's main focus has been on responding to domestic market saturation in these developed nations by restructuring, curtailing new investment to ensure that existing facilities remain at close to full operations. However, South Africa is an exceptional case, in that it has long been used by makers such as BMW and Daimler Chrysler as a low-cost manufacturing base for exports.

The low utilization rates in emerging markets produced by increased investment are not a desirable outcome, and should be viewed as a temporary glitch as companies move toward sound operations aimed at growth. However, no

10: Comparison of aggressiveness indicator by region



Source: HSBC

one really knows whether the current level of investment activity is suitable for the level of latent growth potential. The individual automakers are doubtless making their own investment decisions based on logical management thinking, but we believe there is a danger of overcapacity in the market as a whole.

There are already signs of overcapacity in China. The Chinese government forecasts an expansion in the domestic auto market to 10m vehicles by the 2010-2020, but manufacturers plan to raise their aggregate production capacity in China to 15m units by that time. The Chinese government has responded by implementing policies to curb investment, including setting a condition that new investment be limited to existing facilities with utilization rates of at least 80%.

The utilization rate in India was 72% in 2005, roughly on a par with the global average, of 75%, and there is no immediate risk of overcapacity. However, this risk remains for the future, and India's utilization rate could fall to China's level if demand grew more slowly than expected. This is because investment activity is influenced by management assessments of high market growth potential as well as by financial capability at each company.

We can measure how planned capacity growth in 2005-2011 balances with the current utilization rate, and we call this the “aggressiveness indicator.” A high figure indicates that management’s stance is to aggressively increase capacity based on high growth expectations, irrespective of the current utilization rate.

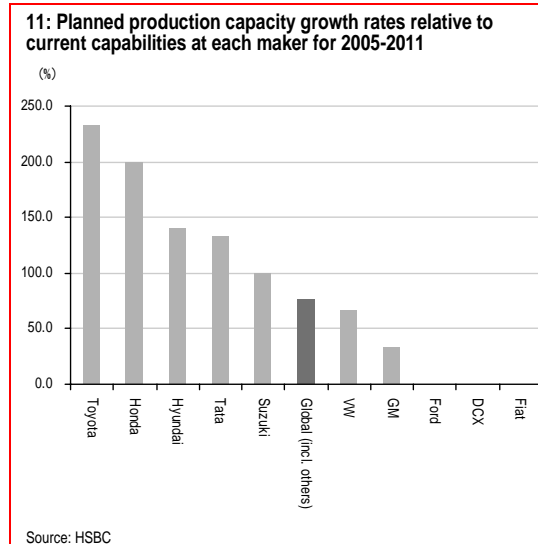
A comparison of aggressiveness indicator by region is shown in Figure 10. India’s indicator is very high, at 106. This shows that automakers have much higher growth expectations for India than for any other country, and explains the current competition to invest.

China’s figure is 67, lower than that of Russia (70) and Central and Eastern Europe (84), but it was previously higher than India’s indicator. The reason China’s figure declined was not that the utilization rate improved, but rather because the main foreign maker, Volkswagen, postponed new investment due to increased competition, and because the Chinese government tightened credit to curb domestic investment.

The issue is whether India is set to follow the same pattern. To that end, we feel it is useful to compare the growth expectations each maker has for the Indian market.

We have used the aggressiveness indicator to identify the automakers with the most bullish expectations for the Indian market.

Figure 11 compares planned production capacity growth rates relative to current capabilities at each maker for the period 2005-2011.



Nissan and BMW may have large, new plants in full operation by 2011, but as of 2005 neither had made a full-fledged start on these projects. We therefore cannot calculate their growth rates, and have omitted them from the comparison. Nissan plans to build a new facility in 2009, while BMW has just started operating its first assembly plant, in Chennai, with a capacity of about 1,700 units per year.

By contrast, Volkswagen/Skoda plans to boost its Indian production capacity by 67% during this period. Toyota may build a new 100,000-unit plant to make compact cars for BRIC countries, in addition to its current plant, and this would boost the company’s total capacity by 233%, from 60,000 in 2005 to 200,000 in 2011. Honda is planning a similar increase, aiming for automobile capacity in India in the 150,000 range by 2010, equivalent to an increase of 200%.

Other makers, such as Fiat, Daimler Chrysler, Ford, and PSA, are prioritizing business restructuring in their home markets, and have not yet announced clear investment plans for India.

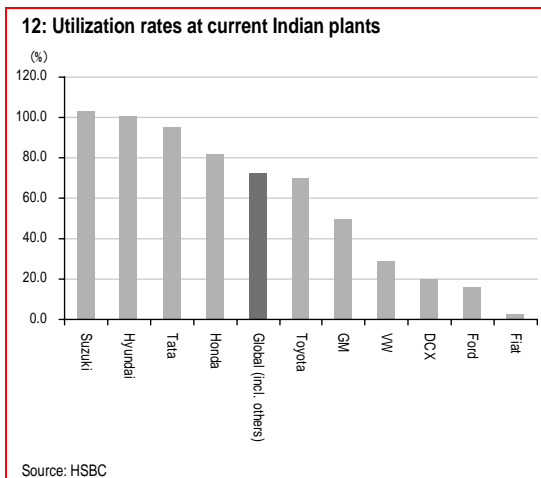


Figure 12 shows estimates for utilization rates at current Indian plants. Rates are higher than those in China overall, and capacity expansion plans at most companies are based on insufficient current capacity. As we saw earlier, the utilization rate for India as a whole is almost the same as the global average of 75%, and we believe this indicates the Indian auto business is healthy.

Suzuki/MUL and Hyundai are running at full capacity, while Volkswagen/Skoda have a low rate, of just 28.9%. We believe the latter could use its current plant to build other brands in the group, such as Audi and Volkswagen. Nevertheless, US and European makers have lower utilization rates than Japanese makers (including joint ventures). Moreover, although it is outside the scope of this report, domestic maker Tata has a utilization rate of 95% (including commercial vehicles).

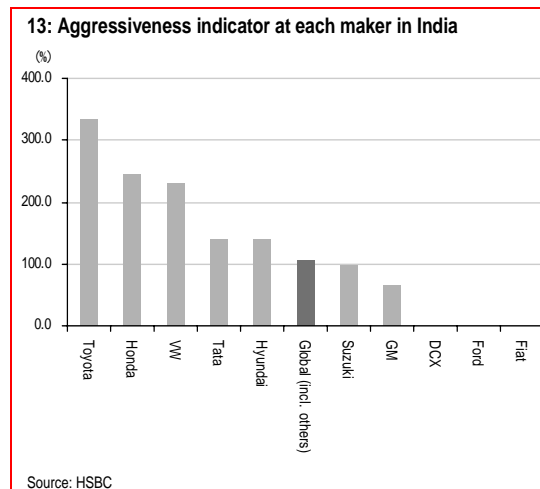


Figure 13 shows estimates for the aggressiveness indicator at each maker to allow a comparison of the bullishness and management stance of each maker toward the Indian business.

Toyota, with an index of 333, has the highest expectations for growth in the Indian business, indicated by its large investment plans, compared to its utilization rate of 70%. This firm is followed by Honda (244) and the Volkswagen group (231). In later chapters, we look at the businesses and strategy of each maker, but we note here that each company has decided on additional investment due to high utilization rates.

In addition, although a lack of full-fledged operations in 2005 means these companies are not shown in the analysis, Nissan, PSA, and Mazda are all considering building either joint venture plants or their own facilities.

# India – the new investment arena

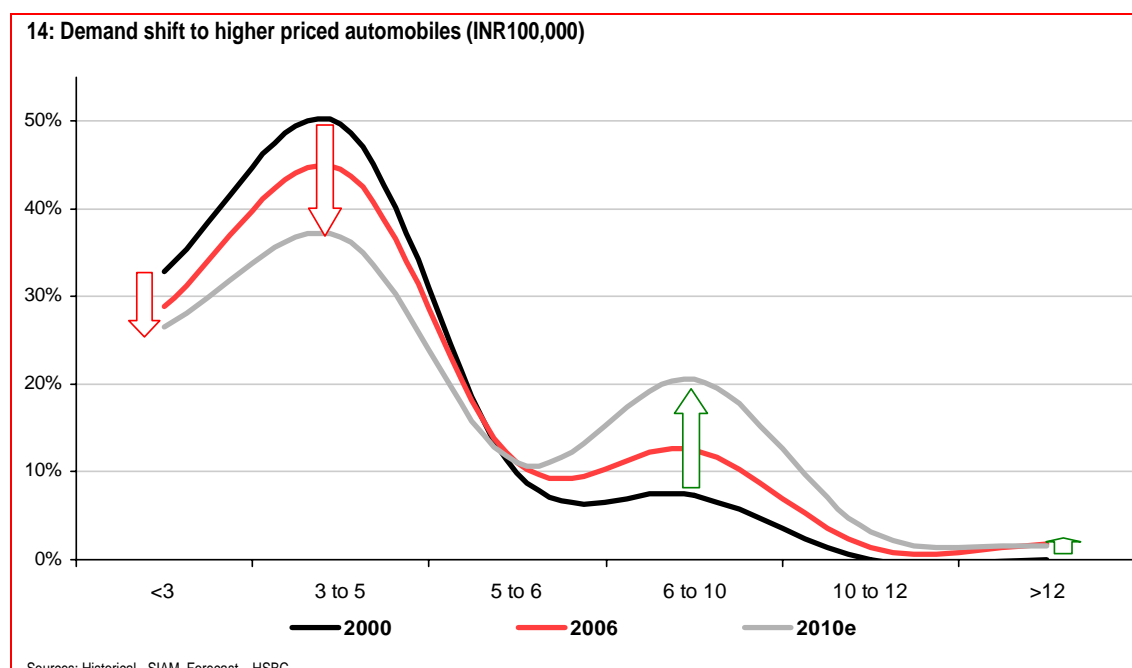
- ▶ Indian consumers buying larger autos as their income improves...
- ▶ ...and financing becomes more available
- ▶ Global automakers expanding production capacity in India to serve the domestic market and export markets

## Product mix expected to improve

Since FY2000 the Indian automobile market has witnessed substantial growth in the higher price segments (premium compacts and sedans). This trend highlights how the Indian customer has been moving up the price ladder and favouring better technologies and bigger cars. This augurs well for

automakers as bigger cars generally deliver higher margins.

However, the outlook for product mixes in India is still uncertain because Tata Motors plans to sell a small passenger car priced at INR 100,000 from 2008, with the ambition to sell 1 million units in 2013.



## Changing profile of Indian customers

In 2000, 32% of all cars sold in India, were 'A' segment autos (priced less than INR300,000). This segment was comprised almost entirely of Maruti-Suzuki's 800cc and Alto. By 2006, this segment contracted to 27%, and we expect it to shrink to 26.5% by 2010. Though we expect the A segment to grow at a CAGR of 10% from 2006 to 2010, this growth is likely to be driven by Tata Motor's much-anticipated INR100,000 car. We expect peak demand of at least 8,000 to 9,000 units per month for this segment.

In the INR300,000 to INR500,000 price bracket, we expect a slippage to 37% by 2010 from the current 45%, though this segment is currently witnessing stiff competition. Compacts in this range include Suzuki's Swift (Petrol) and new Zen Estilo, Chevrolet's Aveo U-VA and to be launched Spark, Tata's Indica, Fiat's Palio and Hyundai's Santro and Getz. As a result, margin pressures are going to be a vital concern for this segment in the near future.

The biggest shift has come in the INR600,000 to INR1m bracket, where positive momentum is expected to continue. From just 7% of total sales in FY2000, it moved up to 12.5% in FY2006 and is expected to reach 21% of total passenger car sales by 2010. This segment, comprising MUVs, SUVs, premium sedans and premium compacts, is expected to more than double its current volume by 2010. We believe that Suzuki will be broadly absent from this segment if it fails to introduce a replacement for its Baleno well in time. It may introduce a new sedan in this segment soon by modifying its SX-4, but its pricing strategy is not clear. A brief profile the autos sold in each price bracket is shown in Figure 12.

The INR1m to 1.2m price bracket is now dominated by Toyota's Corolla, Honda's Civic and Skoda's Octavia. We expect Ford and Suzuki to enter this fast expanding bracket very soon.

The INR1.2m plus price bracket, comprising luxury cars and SUVs, is also going to witness a surge in demand. New entrants, such as VW, BMW and Volvo, along with present makers Toyota, Honda, Skoda, Nissan, Porsche, Bentley, Audi and DaimlerChrysler, are poised to cater to this segment.



15: Prices of main automobile models sold in India

Category	Engine Displacement (cc)	MRP Low (INR mil)	MRP High (INR mil)	Price Range												
				0.2 mil	0.4	0.6	0.8	1.0	1.2	1.4	1.6	1.8	5.0	10.0	>10 mil	
<b>Toyota</b>																
Corolla	Sedan	1794	0.9	1.2												
Camry	Sedan	2362	1.8	1.9												
Innova	MPV	1998-2494	0.7	1.0												
Landcruiser Prado	SUV	3956	3.6	3.6												
<b>Honda</b>																
City	Sedan	1497	0.7	0.8												
Civic	Sedan	1799	1.0	1.1												
Accord	Sedan	2354-2997	1.5	1.7												
CR-V	SUV	2354	1.8	1.8												
<b>Suzuki</b>																
M-800	Mini	796	0.2	0.2												
Alto	Compact	796	0.2	0.3												
Wagon-R	Compact	1061	0.3	0.5												
Zen Estilo	Compact	993	0.3	0.4												
Swift	Compact	1298	0.4	0.5												
Esteem	Sedan	1298	0.5	0.5												
Baleno	Sedan	1590	0.6	0.7												
Versa	MPV	1298	0.4	0.5												
Omni	MPV	796	0.2	0.2												
Gypsy	SUV	1298	0.5	0.5												
<b>General Motors</b>																
Aveo	Sedan	1399-1598	0.6	0.7												
Aveo U-VA	Compact	1200	0.4	0.5												
Opra	Sedan	1599-1799	0.8	1.1												
SRV	Compact	1598	0.7	0.8												
Tavera	MPV	2499	0.6	0.9												
<b>Ford</b>																
Ikon	Sedan	1299	0.5	0.5												
Fiesta	Sedan	1399-1596	0.6	0.8												
Fusion	UAV	1596	0.6	0.6												
Endeavour	SUV	2499	1.4	1.4												
<b>Hindustan Motors</b>																
Ambassador	Sedan	1817-1995	0.5	0.6												
<b>Mitsubishi</b>																
Lancer	Sedan	1468-1998	0.7	0.8												
Lancer Cedia	Sedan	1999	0.9	1.0												
Montero	SUV	3200	3.0	3.0												
Pajero	SUV	2835	1.8	1.8												
<b>Skoda</b>																
Octavia	Sedan	1900	1.0	1.4												
Laura	Sedan	1896	1.7	1.7												
Superb	Sedan	2771-2496	1.7	2.4												
<b>Bentley</b>																
Arnage R	Sedan	6761	26.5	26.5												
Continental GT	Sedan	5998	16.5	16.5												
Flying Spur	Sedan	5998	16.5	16.5												
<b>Hyundai</b>																
Santro	Compact	1086	0.3	0.4												
Getz	Compact	1341	0.5	0.5												
Accent	Sedan	1495	0.5	0.7												
Verna	Sedan	1493-1599	0.6	0.7												
Elantra	Sedan	1795-1991	0.8	0.9												
Sonata Embera	Sedan	2359	1.4	1.4												
Tucson	SUV	1900	1.6	1.6												
<b>Tata Motors</b>																
Indica	Compact	1405	0.3	0.4												
Indigo	Sedan	1405	0.4	0.5												
Sumo	MPV	1948-2956	0.5	0.6												
Safari	SUV	2956	0.7	1.0												
<b>Mahindra &amp; Mahindra</b>																
Scorpio	SUV	2609	0.7	0.7												
Bolero	MPV	2523	0.5	0.6												
<b>Nissan</b>																
X-Trail	SUV	2200	2.0	2.0												
X-Pecial	SUV	2200	2.2	2.4												
<b>BMW</b>																
3-series	Sedan	2993-2996	3.1	3.5												
5-series	Sedan	2993-4398	4.5	4.6												
7-series	Sedan	2993-5772	6.5	6.9												
X3	SUV	1995-2979	4.2	4.2												
X5	SUV	4398	5.5	5.5												
M3	Sedan	3246	5.5	5.5												
M5	Sedan	4999	7.5	7.5												
RollsRoyce-Phantom	Sedan	6749	40.0	40.0												
<b>Audi</b>																
A4	Sedan	1968	2.7	2.9												
A6	Sedan	2976	4.5	4.5												
A8	Sedan	4172	6.5	7.2												
S4	Sporty	4163	na	na												
TT Quatro	Coupe	3200	na	na												
Q7	SUV	2967	7.9	7.9												
<b>DaimlerChrysler</b>																
C-class	Sedan	1796-2148	2.9	3.3												
E-class	Sedan	1796-2987	3.8	4.4												
S-class	Sedan	3222-3498	6.4	7.0												
CLS	Sporty	3498-4996	6.0	6.2												
SLK	Sporty	1796-3498	4.6	6.0												
SL	Sedan	4966	15.0	15.0												
Maybach	Sedan	5500	60.0	60.0												

Sources: company websites

## India as export hub

As product lifecycles shorten, major automakers are experiencing growing pressure to launch new models in quick succession. At the same time, the demand for additional features is increasing, yet consumers have an aversion to price hikes. In view of these pressures, automakers have been outsourcing more production to India, China and South-east Asia. India is one of the more preferred destinations for most major global automakers in this regard. For example:

**Suzuki:** having concluded a recent tie-up with Nissan, Maruti-Suzuki is poised for a substantial increase in its exports of compact cars. Suzuki plans to increase its capacity to 1 million units by 2010 and to export 150,000 units.

**Hyundai:** has developed its Indian operation as an export base for compact cars.

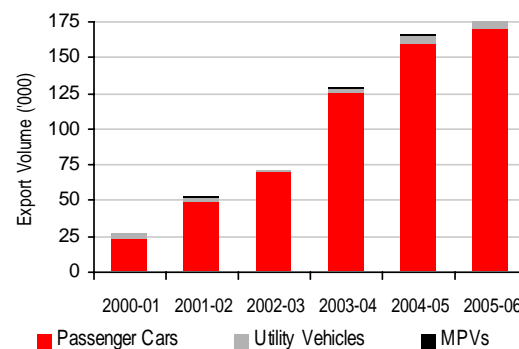
**Ford:** is exporting complete knock-down (CKD) kits to South Africa and other countries.

**Skoda:** has developed its Indian operations as a hub for the export of cars to neighbouring countries.

Today, Indian automobiles are being exported to about 80 countries, including the Netherlands, Italy, Germany, the UK and France. The lower cost of operations and availability of trained manpower is making India a sourcing hub for compact cars by global automakers.

India's automobile industry is constantly upgrading its technology base and diversifying its manufacturing range in line with global market requirements. During the past five years, passenger car exports from India have grown at a CAGR of 49% (from 22,990 units in 2000-01 to 170,193 units in 2005-06). More companies in the auto sector are acquiring ISO 9000 accreditation. Some of the major automakers that have already registered good growth in the export of complete autos and components are Maruti-Suzuki, Hyundai, Tata, Ford and Ashok Leyland (commercial vehicles).

16: Indian automobile exports



Source: SIAM

## Auto financing

The growth of the automobile industry is directly related to the maturity of the local finance market. Auto financing in India has come a long way. Until recently, rates had fallen below 10%, from around 12-14% in 2001. They are now back to 12.5%. Lower rates have supported a big boost in demand from individuals, especially middle-class buyers. The share of car financing as a percentage of sales has risen from 50% five years ago to over 80% now, owing to continuously sliding interest rates.

The Indian auto-finance market was close to USD6.9bn by the end of 2006. Several private companies specialising in auto finance at the regional and national level and most private and public sector banks offer auto finance in India.

The Indian auto loan industry is growing at 30% per annum. The availability of financing for used vehicles is currently limited, but is expected to be a major growth driver in the near future, as the used car market matures. Of late, car manufacturers have begun offering one-year interest-free loans to customers.

### Some concerns of the auto finance industry:

- ▶ Lending decisions are taken at the local level

and there is a lack of consistency. As local offices have to meet performance targets, they tend to approve marginal cases.

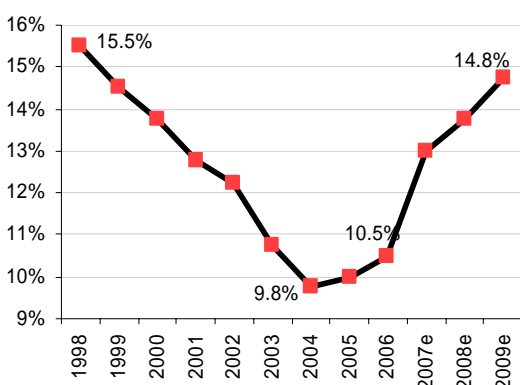
- ▶ Credit checks are sometimes inaccurate due to a lack of complete information.
- ▶ The recovery of loans from defaulters is difficult. This puts the finance provider in a tough spot.
- ▶ Automobile finance companies do not share consumer data among themselves. Consumers are often able to obtain automobile finance even after defaulting on previous occasions.

The majority of the auto financing market in India is held by private and public-sector banks, such as ICICI Bank (30%), HDFC Bank (11%), Citibank (8%), State Bank of India (SBI), Standard Chartered Bank and Bank of Baroda. Among non-banking financial corporations, GE Countrywide, Kotak Mahindra Primus, and Sundaram Finance are prominent. Apart from financing individual and corporate buyers of motor vehicles, they also finance dealers / distributors and influence the whole value chain of auto financing.

### Key advantages that make India an export hub:

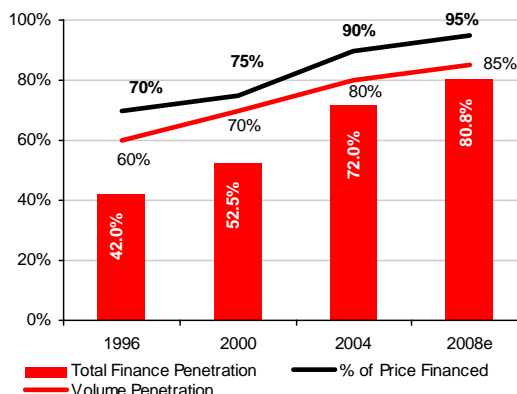
- ▶ Availability of skilled and cheap labour.

17: Interest rates on car loans in India



Sources: History - ACMA, Forecast - HSBC

18: Car finance penetration in India



Sources: History - ACMA, Forecast - HSBC

- ▶ Significant level of automation and achievement of global quality benchmarks at low cost.
- ▶ Achievement of lower production cost through Total Cost Management (TCM), Total Quality Management (TQM), and other modern techniques.
- ▶ Transparent legal and accounting systems that match global standards.
- ▶ Capability for in-house designing, process improvements and engineering.

India signed a free trade agreement with Thailand in 2003, eliminating customs duties on many auto components. Tariff eliminations/reductions for other products are also being negotiated. A Regional Trade Agreement (RTA) between India and ASEAN countries is also at an advanced stage of discussion.

# Major players

- ▶ Suzuki Motor's JV, Maruti Udyog Ltd., is the oldest foreign JV producer in India, and the largest, with 45% of the market
- ▶ Toyota Motor aims for a 10% market share by 2010, while Honda aims for 7.5%; Nissan is playing catch-up through alliances
- ▶ Hyundai Motor India is the second-largest foreign company, with a market share of 14%

## Toyota

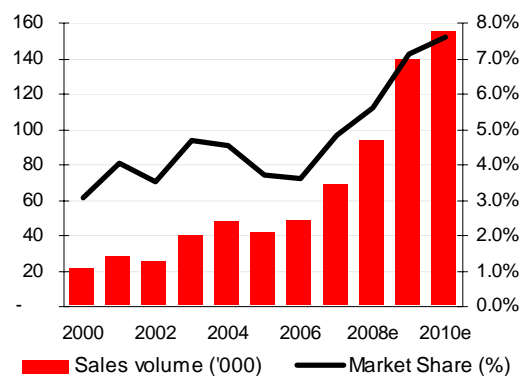
Toyota Kirloskar Motor Private Limited (TKM), the JV between Kirloskar Group and Toyota Motor Corporation (TMC), was incorporated in October 1997. As discussed in our last report, of September 2006, Toyota is considering setting up a new plant for compact cars next to its original plant near Bangalore, in southern India. The likely production capacity of the new plant is 100,000 units per year. The company is also planning to set up an R&D centre in India.

plans to invest USD90m in India for a small car project. Since it is difficult to profit in the low-end compact segment without economies of scale, it should launch a USD6,000 - 8,000 car on a common platform with other emerging markets.

**Key factors for success (KFS):** More 'value for money' products, attractive design and latest technology.

**Next move:** Toyota is set to expand away from its major production base in North America and spend more on new facilities in the BRIC countries, which are seen as a new frontier in the long term. The company is now planning a compact passenger car designed under a new platform to be made at its new plant in India, and is targeting 100,000 cars per year, with a likely investment of more than USD88m. Toyota is also planning to win 10% of the Indian market by 2010, which translates to around 200,000 vehicles. A major concern for Toyota is the long model life of its current Corolla in India.

19: Toyota sales / market share trend



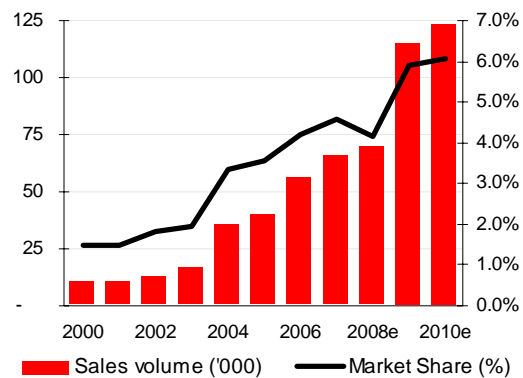
Sources: History - SIAM, Forecast - HSBC

**India strategy:** Toyota has no ultra-cheap, no-frills cars like Suzuki's in India. The company

## Honda

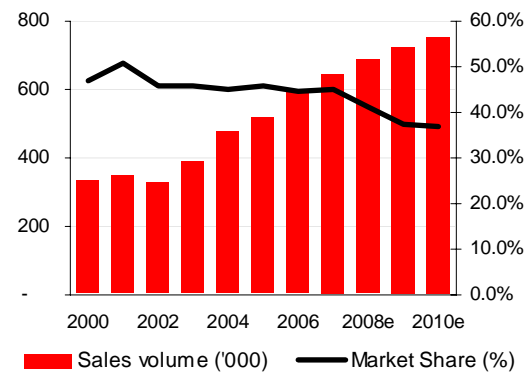
Honda Siel Cars India Ltd (HSCI) is a JV formed in 1995 between Honda Motor Co Ltd and Siel Limited, of India. Honda increased its production

20: Honda sales / market share trend



Sources: History - SIAM, Forecast - HSBC

21: Maruti sales / share of market for passenger cars & trucks



Sources: History - SIAM, Forecast - HSBC

to 60,000 units in 2006 and plans to increase it to 100,000 this year and to 150,000 by 2010. It has recently floated a new company named Honda R&D India Pvt Ltd to support group companies in India.

**India strategy:** The company offers its full array of mid-size sedans in India, including the City, Civic and Accord. After the success of the newly-launched Civic, Honda is looking for a new site to set up its compact car plant in India with an initial annual capacity of 50,000. The Fit/Jazz seems to be a quite suitable option for this segment. The company upgrades its product range in the Indian market regularly and launches all models concurrently with the global market.

**KFS:** Value for money, products for mass and class, low model age.

**Next move:** Riding high on the sales of City and initial sales of Civic, Honda has a firm footing in the Indian auto mart. It is certain to move into the volume segment with the launch of a compact car in the near future. It is also extending the international scope of its development of diesel engines, aiming for global development by 2009. The company plans to invest about USD650m in India over the next 10 years across all businesses, ie, four-wheelers, two-wheelers and engines.

Honda may also introduce its hybrid cars into the Indian market in the future.

## Suzuki / Maruti

Maruti Udyog Limited (MUL) is a JV between the Government of India and Suzuki Motor Co., of Japan; it was formed in 1982. Over the years, MUL has gained the dominant position in the Indian auto industry and remains the biggest player.

**India strategy:** MUL has been the market leader in India for the past two decades, though its market share of the combined market for passenger cars and trucks, including SUVs and MUVs, has been trending down in recent years, to 44.6% in 2006. In passenger cars alone, its market share is more than 50%. It is increasing its capacity and plans to offer the option of a diesel engine for most of its products after constructing a diesel engine plant. MUL plans to introduce five completely new models from 2005 to 2009, and is targeting potential first-time car buyers across all income segments. Suzuki Motor Co's R&D hub for Asia (outside Japan) is in India. Apart from the design and development of existing models, the R&D team in India has also taken part in the development of a fully global platform, the Swift.

**KFS:** Low cost, low maintenance, fuel economy, aggressive marketing

**Next move:** Maruti-Suzuki's second passenger car manufacturing plant in India is now on full stream with an initial capacity of 100,000 units, scheduled to rise to 250,000 units by 2009. The company plans to set up a complete automobile design centre in India, which will be Asia's second biggest. It will be part of the R & D centre to be planned as part of Suzuki's second expansion plan in India, which calls for an additional investment of USD591m. The company plans to construct a new diesel engine manufacturing facility with an initial capacity of 100,000 engines. Since it already has capacity for 200,000 gasoline engines per year, its total capacity will rise to 300,000 units per year with the completion of the diesel engine plant.

Suzuki management decided to increase the company's vehicle assembly capacity to 1 million units by 2010 and to export 15% of total production volume.

## Nissan

Japanese auto major Nissan is firming up its India strategy. The company's current medium-term plan is due for completion by 2007. It has a dealer in each of the five metropolitan areas in India now. So far, Nissan has launched two variants of its SUV model X-Trail in India, which are imported as complete vehicles.

**India strategy:** After launching the X-pecial, Nissan is focusing on a mid-size sedan (like the Cefiro) for the Indian market, to be positioned between Honda's Accord and Toyota's Camry. Nissan plans to use the Maruti-Suzuki facility for producing the Moco or similar models for export to Europe. This will give the company additional flexibility regarding the selection of models and cost structure.

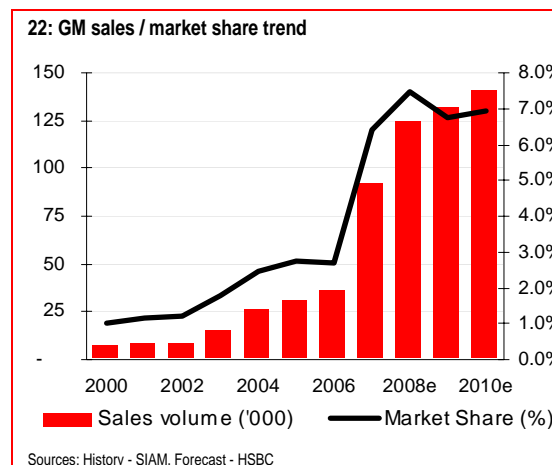
**KFS:** Nissan needs a plant in India. It has recently announced plans to contribute 25% of the JPY110bn estimated cost of an automobile plant

to be built in Chennai in 2009 by Renault and Mahindra & Mahindra. The production capacity of this plant is scheduled to be increased to 400,000 units over seven years.

## General Motors

GM India, now a fully-owned subsidiary of GM USA, started its Indian operations by launching the Opel Astra in 1995, followed by the Corsa, Corsa Sail, Chevrolet Optra and Tavera. All its cars are made at its plant in Halol, Gujarat.

Recently, GM has also launched the Chevrolet Aveo, Aveo UV-A and SRV in India, and it is expected to introduce the Chevrolet Spark soon. GM's Indian R&D carries out research in advanced vehicle design, vehicle analysis, lightweight materials, automotive electronics and controls.



**India strategy:** GM, despite being a global brand, has not been very innovative in India. Currently, it only sells re-branded cars under the Chevrolet brand, which is unlikely to take the company far; its market share in 2006 was only 2.7%. Its major plans include the launch of the Spark (erstwhile Daewoo Matiz) in 2007. In order to establish itself in the Indian market, GM has to take advantage of India's low-cost and skilled labour. The marketing of at least one premium product would improve its brand image in India.

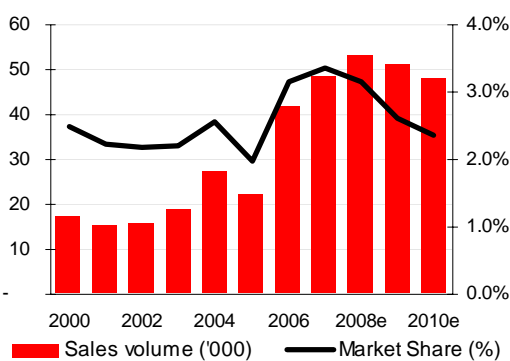
**KFS:** Needs a winner in volume products with low maintenance cost and better fuel economy.

**Next move:** The company is increasing its capacity from 80,000 to 85,000 at its existing plant, with likely higher output of its newly launched Aveo. The proposed launch of the Spark is ambitious, but it will not be easy for GM with players like Suzuki, Hyundai and Tata present in the same segment. GM is considering setting up its second plant in India with an additional capacity of 100,000 units (with new investment of around USD450m) with the target of achieving a 10% market share in India by 2010.

## Ford

Ford Motors, which earlier had a JV with Mahindra & Mahindra, is now a 100% subsidiary of its parent in the US. Its Chennai plant has a capacity of 50,000 vehicles, expandable up to 100,000 units, which should serve its requirements for the next five years. The company started the Indian operations with the Escort, and then launched the Ikon, Mondeo, Fusion, Endeavour (SUV) and its latest offering, the Fiesta. The next in line is likely to be the Focus. Ford India is already exporting CKD kits of its Ikon model to South Africa. It plans to develop India as a source for auto-components and increase its R&D facility in the country.

23: Ford sales / market share trend



Sources: History - SIAM, Forecast - HSBC

**India strategy:** Ford has had reasonable success so far with the Ikon and Fiesta, but it badly needs a real volume product for growth. The redefined aggressive product positioning of Fiesta and Ikon, which target youth, has increased its brand appeal. The launch of the Focus might add to its premium image. Ford is serious in its pursuit of opportunities to export cars and CKDs. It should focus on increasing localisation, with support of Tier-I suppliers, such as Visteon, in India.

**KFS:** Further increase in exports and development of Indian operations as a component hub can bring profits.

**Next move:** With the launch of the Fiesta, Ford has got a head start in India. Exports of the Ikon and components are also growing. The company is banking on the Fiesta to double its sales, to 50,000 units, by 2007. However, no small car features in its immediate plans. A further investment of USD75m is expected soon. The company's next offering is likely to be the Focus.

## BMW

German automotive giant BMW is looking to increase its presence in the Middle East and the Asia-Pacific, which is growing at a rate of about 20% per year, while mature markets like Europe and North America are struggling to cross the 5% mark. The company has started operating an assembly unit near Chennai to assemble 3-Series and 5-Series sedans from 2007 onwards from CKD kits imported from Germany. The initial capacity of the Indian plant is planned to be 20,000 units. Other BMW models are likely to be imported from BMW's South Africa plant. It also sells Rolls Royce cars in India, importing them as CBU's.

**India strategy:** Because India's import duty on complete autos is much higher than its duty on knock-down components, BMW has decided to build a plant in India to avail itself of the cost



advantage of an assembly plant. Maintaining quality and retaining the same features in the locally produced units as in imported vehicles will be important. The company is trying to consolidate its marketing strategy in India for manufactured and imported varieties.

**KFS:** Expanding customer base and product innovation.

**Next move:** The Indian subsidiary will commence production in March 2007 with an initial investment of EUR20m. BMW is looking at the option of outsourcing some of the design, prototyping and R&D for the Rolls-Royce division by setting up a new R&D centre in India. This will help the company to customise the luxury saloon to Indian conditions without delay and without compromising on quality.

## Skoda / Audi / VW

### Skoda

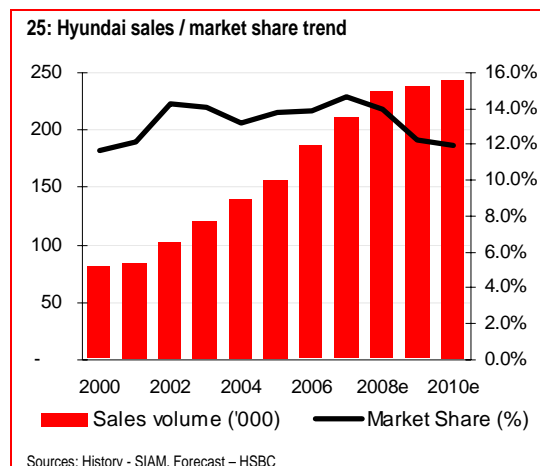
Skoda, part of the Volkswagen (VW) group, started its Indian operations in 2001 with just two dealers and a plant in Aurangabad. In just three years, the company has set up a network of 38 dealerships for its various models in India. Skoda Auto now intends to develop India as its manufacturing hub for the South Asia region. It has grown at a CAGR of more than 100% in past five years with Octavia variants, Laura and Superb. Soon the company will target the volume market with the Fabia, and perhaps also the Yeti (SUV). Skoda Auto is in the initial stages of planning an R&D centre in India. Skoda is planning to increase its own capacity from the current 30,000 units pa to 50,000 units pa within the next three years.

**KFS:** Should increase localisation and improve pricing. Skoda's plant in India has excess capacity, which may, in the future be used by Audi – if it wants to produce some models locally.

### Audi

Audi, Volkswagen's luxury brand, is set to give ample competition to its German rivals with offerings such as the A4, S4, A6, A8, Q7 and TT coupé in India. The company considers its entry into India as its most significant step since its entry into China. With three dealers and six models in India, it plans to sell about 1,000 vehicles over the next five years.

**KFS:** Needs good distribution network and effective marketing in a market already crowded with the likes of BMW, Mercedes, Bentley, Porsche, etc.

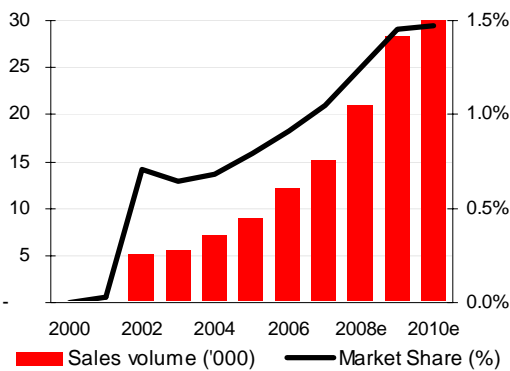


### VW

Volkswagen is finalising its plant site in India and eyeing the growing Indian market. However, its product positioning is still mostly under wraps. VW is making plans to set up a new plant in the state of Maharashtra by 2009, most likely offering the Passat and the Golf for the Indian market. Skoda Auto India's currently available capacity may be used by VW until it opens its own plant.

**KFS:** Needs to convert its global brand image into sales volume by effective product positioning and competitive pricing – as the mid-size compact car market is already cluttered with many products.

24: Skoda sales / market share trend



Sources: History - SIAM, Forecast - HSBC

## Hyundai

Hyundai Motor India Limited (HMIL), a wholly-owned subsidiary of Hyundai Motor Company, South Korea, is the second largest car manufacturer in India. HMIL currently markets 30 variants of passenger cars in six segments. These include the Santro, Getz, Accent, Verna, Elantra, Sonata Embera and Tucson (SUV). The company recorded sales growth of 19.1% in 2006. HMIL has announced plans for its second plant, near the existing plant in Chennai, which will increase its total production capacity to 600,000 units per annum by October 2007. The company exports to around 60 countries globally and recently made a foray into the highly competitive UK market. It has also been awarded the benchmark ISO 14001 certification for its sustainable environment management practices. The recent launch of the Verna is considered a result of the belief that companies cannot stretch old models in the fast-growing and competitive Indian market for too long. This is an interesting belief, as the Accent continues to be quite popular in the market and had a 13% share in the mid-size sedan segment in 2006.

**India strategy:** Hyundai has both volume and margin products in its range in India. Future volume might be assured by customer loyalty. However, the high average age of its models might have a negative impact. Being the biggest

exporter of cars in the country, it recently decided to make India its component manufacturing hub.

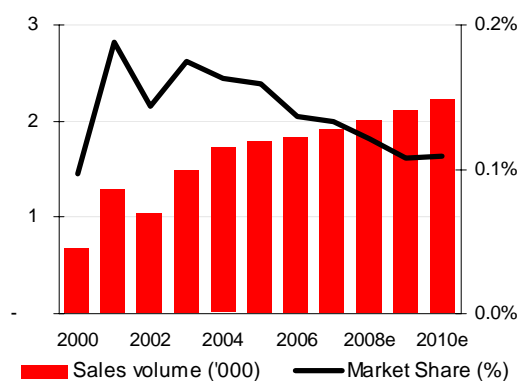
**KFS:** Needs quicker model changes and more exciting new products.

**Next move:** Hyundai is planning to increase its production capacity to meet the additional demand expected in the medium term. It is planning to shift certain R&D activities from Korea, such as designing engines, bodies, transmissions, etc., and make India the hub for R&D of specific functions.

## Renault

Renault teamed up with Mahindra & Mahindra (M&M) to form its Indian JV. Now, Nissan plans to join the venture. The joint assembly plant in Maharashtra, in western India, will build the no-frills Logan car and its derivatives exclusively for the Indian market. The Logan is one of the global platform C series of sedans to be launched in India for the volume market. The L90 and R90 - the seven-seater MPV, are also under consideration for an India launch in future. Renault India will also build a separate, fully-owned powertrain unit in India. The company pursues a strategy of profitable growth with a range of high-quality, innovative vehicles and services the world over.

26: DaimlerChrysler sales / Market share trend



Sources: History - SIAM, Forecast - HSBC

**India strategy:** India is a crucial market for Renault's future growth. Its budget car, Logan, targeted to Indian consumers, could cost around INR600,000. The Mahindra-Renault alliance, which is currently setting up the greenfield facility, will roll out the Logan in the second half of 2007.

**KFS:** Establish a 'value for money' image and strongly focus on the long-untapped lower C segment in India.

**Next move:** Nissan and Renault have targeted the procurement area as a means of saving costs since the start of their capital alliance in 1999. This business model will definitely be brought to India, as well. Based on Logan's success, its future strategy will be decided. Renault's future line-up for India includes the Twingo, Clio, Modus, Megane and the Laguna.

## DaimlerChrysler

DaimlerChrysler entered the Indian market by setting up a JV with Tata Motors (then Telco) in 1994. It changed its name and business outlook for India during the past decade. Today, it assembles the Mercedes-Benz S-class, E-class and C-class at its Pune factory. It also sells M-class, CLK, SLK and the top-of-the-line Maybach luxury sedan, imported as a CBU. The DaimlerChrysler facility near Pune is being utilised optimally. It has an R&D centre in Bangalore, involved in fundamental and applied research in avionics, simulation and software development.

**India strategy:** Being the technology leader in the luxury car market, this company has an array of products to offer in the Indian market. It wants to heavily increase global procurement of R&D from India, to about EUR100m, by fiscal 2006-07, and is also considering India as a significant sourcing hub.

**KFS:** Quality, value driven, product innovation and intensive customer service.

**Next move:** A pioneer in the luxury car segment, DaimlerChrysler has a firm plan for India. After launching the new S-class and E-class, it will bring in the new M-class and variants of the E-280 into the country. The company is targeting a 10% market share in India by FY2010.

# Indian auto industry: end of childhood

- ▶ Until the 1980s, the Indian automobile industry was protected by the government. Growth and modernisation were slow
- ▶ From the early 1990s, the scenario changed with the opening up of the economy. More foreign automakers started investing in India, envisaging growth opportunities
- ▶ Friendly government policies, a mature finance market and growth achieved during the past decade have put India among the countries who are forerunners of automobile growth today

The automotive industry is considered a key growth driver in most economies around the world. However, until the seventies, there were only three local manufacturers representing the automobile sector in India. Owing to low volumes of production and demand, they continued with dated technologies and were out of pace with global trends. Moreover, in view of the prevalent red tape, global automakers often shied away from India.

In 1982, Maruti Udyog, an Indian government initiative in collaboration with Suzuki Motor Corporation of Japan, was set up with the objective of producing a volume car. After the opening up of the market to foreign competition in 1993 and the privatisation of state-run companies, more global automakers began showing interest in setting up shops in India. So far, 17 ventures have been formed. Of these, 16 manufacture passenger cars. Today, the Indian

auto industry accounts for more than 4% of the country's GNP and 17% of the indirect tax revenue.

## Government promotes the auto industry

The government of any country is responsible for providing an environment conducive for the growth of industries. To monitor progress and boost investment, it has to have a clear vision of the growth path. The Government of India has been providing infrastructure and a suitable duty structure for the Indian auto industry. Steady reforms have included making manufacturing and imports free from licensing, allowing 100% foreign direct investment in the auto sector, abolishing local content requirements, continuously lowering import tariffs, etc. The government's new policy of an 8% excise duty relief on smaller cars (up to 1200cc for petrol engine cars and 1500cc for diesel engine cars)

will induce some additional demand in this segment, and new models are likely to be introduced in this category to reap the benefits of the new policy.

A Free Trade Agreement (FTA) is expected to be finalised soon with the ASEAN block. Negotiations at the WTO, the response to emission norms and moves to standardise the industry's validation practices have also been initiated. The rise of Indian exports of both automobiles and components has been largely attributed to the combined efforts of both the Indian government and the Reserve Bank of India (RBI). Both have played a vital role in encouraging export-related agencies and infrastructures to work in tandem to facilitate and support further growth. The Government of India has come up with an auto policy aimed at establishing a globally competitive automotive industry in the country, so as to enhance its contribution to the economy. The major objectives of the policy are:

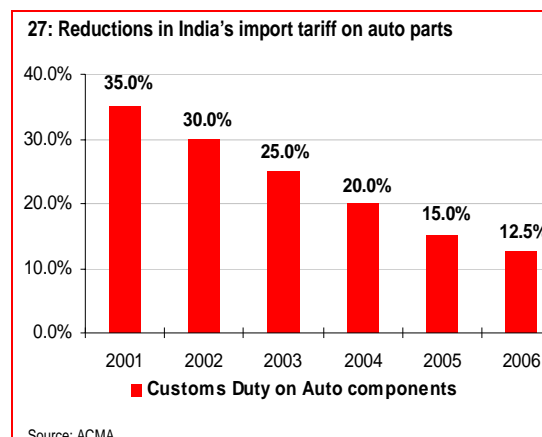
- 1 Project the auto sector as an instrument for overall industrial growth and employment and achieve a high level of value addition in the country
- 2 Project India as an international hub for the manufacture of compacts and affordable cars, two-wheelers and utility vehicles
- 3 Develop the Indian automotive industry as a globally competitive one to emerge as a hub for auto components sourcing
- 4 Effect constant modernisation of the industry and facilitate indigenous design, research and development
- 5 Assist indigenous development of vehicles powered by alternative energy sources

The Government of India is maintaining a level playing field for all auto manufacturers in India,

both domestic and foreign. However, import duties still exist for completely built units (CBUs) and completely knock-down (CKD) and semi-knock-down (SKD) components. According to the Ministry of Commerce, a framework agreement on comprehensive economic cooperation has been finalised with ASEAN countries. Negotiations at the WTO, the response to emission norms and moves to standardise the industry's validation practices have also been initiated.

## The road ahead

Before economic liberalisation (1991), the Indian automobile market was a sellers' market, with dated models and usually long waiting periods. Post-liberalisation, with higher household incomes, people have upgraded from two-wheelers to four-wheelers and from smaller to bigger and better cars. Moreover, a large proportion of buyers who are graduating from two-wheelers are moving directly to the premium compact segment. In view of this change, the recent past has witnessed a continuous influx of global auto majors into India. Many global automakers have established facilities here, and most of them are achieving good growth rates, which are inspiring them to invest in India further. With a surge in sales, the Indian automotive industry has emerged as one of the prominent sectors of the Indian economy.



## Getting noticed

Envisaging growing domestic demand, better manufacturing facilities, and narrowing technology gaps with global industry standards, foreign automakers have recognized India as a preferred location for low-cost manufacturing and R&D. While Suzuki and Hyundai have already been exporting from their Indian facilities, Ford and Nissan are formulating strategies in this direction.

In 2005, the Indian passenger car market grew by only 7%, but in 2006, it expanded by 18%. Considering various parameters, we estimate the Indian automobile industry (passenger cars + SUVs/MUVs) will grow at a CAGR of 9% over the next 20 years, reaching 7.1m units in 2026, from 1.3m units in 2006. We project the number of vehicles per 1,000 adults will rise from 10 in 2005 to 53 in 2026.

To formulate these projections, we have considered India's adult population projection<sup>(1)</sup>, our own assumptions for cars per thousand adults and assumptions on the maximum age of used cars stipulated by the government of India. The following figure shows the basic data at major milestones:

We have considered the adult age bracket as between 14 and 60 years, and the target population in the driving age bracket is forecast to steadily increase from 58% in 2001 to 64% in 2025. We have assumed that during this time, the number of cars per thousand adults will grow at a CAGR of 8.5% from 2001 to 2026 due to various factors. Currently as per regulation of the Government of India, passenger cars have a maximum usable life of 15 years. We expect this maximum to be lowered to 10 years by 2026.

After considering the driving population, we have estimated the total car population by

28: Base data for the Indian auto industry

Year	Autos per '000 adults	Population (million people)	Target adult pop.	# autos in use (million units)	Sales (million units)
2001	7.0	1,034	57.7%	4.2	0.7
2005	10.0	1,095	59.9%	6.6	1.2
2010e	16.5	1,170	62.2%	12.0	2.0
2015e	25.5	1,244	63.6%	20.2	3.2
2020e	38.0	1,314	64.1%	32.0	5.4
2025e	50.5	1,381	64.2%	44.8	6.8
2026e	53.0	1,393	64.2%	47.4	7.1

Source: HSBC

multiplying cars per thousand adults by the driving population. Sales figures are derived using the inventory calculation method as:

$A - B + (A \times C)$ , where:

A = beginning of the year car population

B = end of the year car population

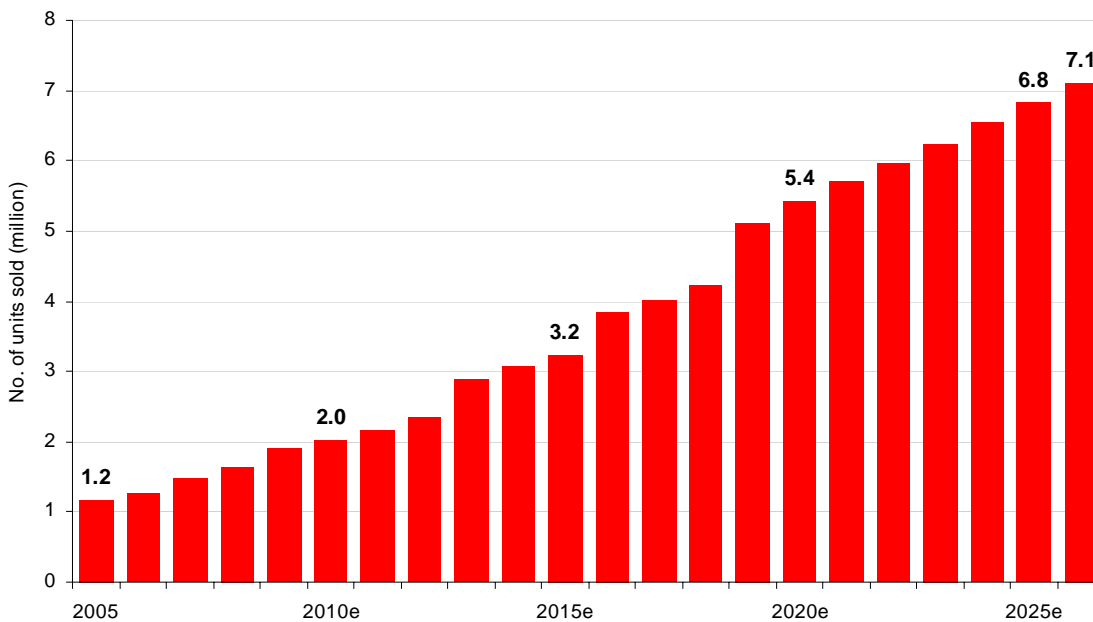
C = depreciation rate

Summarising our 20-year forecast of Indian automobile sales, we expect the passenger car market to grow at a CAGR of 9% from now to 2026. As a result, car sales of 1.1m units in 2005 will reach 7.1m in 2026. During this time, a consistent rise in the car ownership rate (presently 10 per thousand) will bring it above 50.

Realising this latent opportunity, many global automakers have established manufacturing facilities in India already. As most of them have achieved impressive growth, they are motivated to invest in India further. With a surge in sales, the automotive industry has emerged as one of the prominent sectors of the Indian economy.

India's automobile market is slowly maturing and gaining a reputation for advanced technology, having been seen as just a low-cost manufacturer a few years ago. Growing economies like India's are now even figuring as promising markets for the latest hybrids and alternative fuel vehicles for major automakers,

29: Projected sales of passenger cars in India



Sources: SIAM - History, HSBC - Forecast

like Toyota, Honda, etc. The hybrid market is still in its nascent stage in China, with very few offerings, and sales figures are not very inspiring either. However, with growing awareness of environmental problems in India, tax incentives from the government may prompt Toyota and Honda to launch hybrids targeting Indian consumers who can afford to pay a premium for cleaner technologies.

## Risks to our assumptions

The risks to our forecasts for the Indian auto industry are:

- ▶ **Demand growth:** If the current economic growth fails for any internal/external reason in the future, thereby hampering the per-capita GDP growth rate, the demand for automobiles may be adversely affected
- ▶ **Infrastructure:** The quality of roads, supply of electricity, etc. which are provided by both public and private sectors, may not grow quickly enough to meet the increased demand from the auto industry

- ▶ **Cost competitiveness:** The continued growth of the Indian economy at its current rate may result in an increase in salaries and wages in all sections of society. This may increase labour costs in the long run, causing India to lose its current cost competitiveness
- ▶ **Finance market:** If the easy availability of car loans at low interest rates disappears due to government policies, individual car buyers will be affected and sales volumes may not grow as expected

(1) Population projections are taken from Census of India 2001, Population Projections for India; National Commission on Population 2006



# Disclosure appendix

## Analyst certification

The following analyst(s), who is(are) primarily responsible for this report, certifies(y) that the views expressed herein accurately reflect their personal view(s) about the subject security(ies) and issuer(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Sanjay Satpathy, Seiji Sugiura and Sanshiro Fukao

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## Rating definitions for long-term investment opportunities

### Stock ratings

HSBC assigns ratings to its stocks in this sector on the following basis:

For each stock we set a required rate of return calculated from the risk free rate for that stock's domestic, or as appropriate, regional market and the relevant equity risk premium established by our strategy team. The price target for a stock represents the value the analyst expects the stock to reach over our performance horizon. The performance horizon is 12 months. For a stock to be classified as Overweight, the implied return must exceed the required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile\*). For a stock to be classified as Underweight, the stock must be expected to underperform its required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile\*). Stocks between these bands are classified as Neutral.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

\*A stock will be classified as volatile if its historical volatility has exceeded 40%, if the stock has been listed for less than 12 months (unless it is in an industry or sector where volatility is low) or if the analyst expects significant volatility. However, stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past



month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

Prior to this, from 7 June 2005 HSBC applied a ratings structure which ranked the stocks according to their notional target price vs current market price and then categorised (approximately) the top 40% as Overweight, the next 40% as Neutral and the last 20% as Underweight. The performance horizon is 2 years. The notional target price was defined as the mid-point of the analysts' valuation for a stock.

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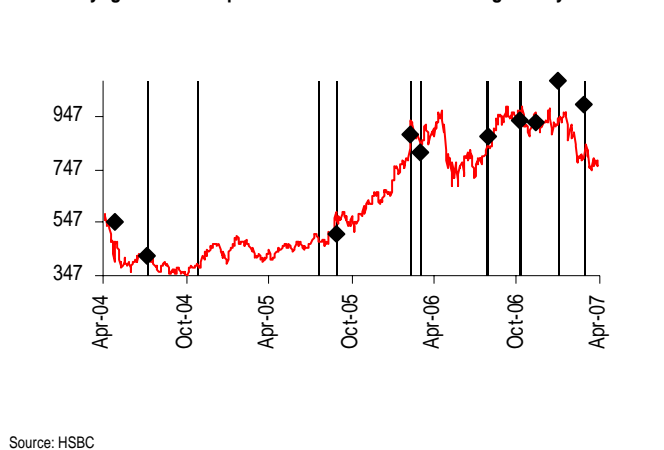
## Rating distribution for long-term investment opportunities

As of 23 April 2007, the distribution of all ratings published is as follows:

<b>Overweight (Buy)</b>	44%	(15% of these provided with Investment Banking Services)
<b>Neutral (Hold)</b>	35%	(16% of these provided with Investment Banking Services)
<b>Underweight (Sell)</b>	21%	(12% of these provided with Investment Banking Services)

## Share price and rating changes for long-term investment opportunities

Maruti Udyog Share Price performance INR Vs HSBC rating history



Recommendation & price target history

From	To	Date
Buy	Hold	27 July 2004
Hold	N/R	15 November 2004
N/R	N/R	11 August 2005
N/R	Underweight	21 September 2005
Underweight	Neutral	01 March 2006
Neutral	Underweight	24 March 2006
Underweight	Neutral	18 August 2006
Neutral	Underweight	31 October 2006
Underweight	Neutral	23 January 2007
Neutral	Overweight	21 March 2007
Target Price	Value	Date
Price 1	550.00	18 May 2004
Price 2	423.00	27 July 2004
Price 3	N/R	15 November 2004
Price 4	506.00	21 September 2005
Price 5	877.00	01 March 2006
Price 6	807.00	24 March 2006
Price 7	869.70	18 August 2006
Price 8	931.00	31 October 2006
Price 9	925.00	05 December 2006
Price 10	1080.00	23 January 2007
Price 11	990.00	21 March 2007

Source: HSBC

## HSBC & Analyst disclosures

### Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
MARUTI UDYOG	MRTI.NS	778.60	20-Apr-2007	4

Source: HSBC

1 HSBC\* has managed or co-managed a public offering of securities for this company within the past 12 months.

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- 2 All market data included in this report are dated as at close 20 April 2007, unless otherwise indicated in the report.
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