

**Industrials**  
**Autos**  
 Equity – India

## Indian Automobile Sector

SIAM seminar: optimism for FY10 but lacks conviction

- ▶ **Original Equipment Manufacturers (OEMs) expect growth in FY10 but see recovery starting from Q3FY10e**
- ▶ **Credit availability remains elusive; rural income has been strong and OEMs are increasingly targeting this segment**
- ▶ **Retain negative stance on sector. Hero Honda remains our key OW and Maruti Suzuki our key UW (V)**

**Confidence lacking:** We visited the Society of Indian Automobile Manufacturers (SIAM) Auto seminar in Delhi. Unlike last year, the mood this time was more one of caution and uncertainty. Even though all the OEMs are guiding for growth across automobile segments in FY10, their body language did not exude confidence, in our view. The biggest reason given for their growth expectation is the low base effect. They also believe that bankruptcies in the US led to the dip in consumer sentiment and thus affected sales. Since there are many Indian companies with stretched balance sheets, the bankruptcy of any big Indian company could dent consumer sentiment even more severely.

**Credit availability still a problem:** With rising non-performing assets, banks have restricted credit to the automobile sector. Those most affected are commercial vehicle manufacturers, which have a large proportion of first-time buyers who are the most vulnerable to default. The classification of a commercial vehicle loan as a priority loan has not improved credit availability. There are efforts underway by SIAM to try to bring automobile loans under the SARFESAI Act to enable repossession of assets. We do not expect the credit availability situation to ease in the near future given the sector's risk profile. One of the OEMs shared our concern that at a time of uncertainty, even if credit is available, people may not wish to leverage themselves.

**Rural income still strong:** Rural income is strong, as is evident from Hero Honda's sales growth, which has a high reliance on rural sales. All the OEMs (two-wheelers to four-wheelers) are currently focusing on rural India.

**Vendors under stress:** Vendors are also under stress, like OEMs, and many face the risk of closure. The industry already faces a shortage of quality vendors. If the vendors' chain is disrupted, OEMs would face difficulty in scaling up, in the event of any upturn.

**Raw material benefits may be passed on:** OEMs believe that excise duty relief (lowered in November 2008) did benefit buyers. In the event sales do not improve in FY10 and raw material benefits do reach them, we expect OEMs to pass on this benefit.

**Retain negative stance on sector. Hero Honda remains our key Overweight and Maruti Suzuki our key Underweight (V).**

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## Valuation and risks

### Hero Honda (Overweight, HROH.BO, INR878.05)

Hero Honda, due to its higher reliance on rural India (50% contribution to sales), has been least affected by the downturn. Also, due to production from the tax-free Haridwar factory, we expect margins to expand in FY10. Spot booking for raw materials and a softening in the prices of steel and aluminium should support further margin expansion. Also, the management is well regarded and the company is debt-free with no major capex requirement. Hence, it is our preferred stock in the sector.

We use a three-stage DCF to value Hero Honda. We have assumed the cost of equity at 13.5%. We have explicit estimates until FY10. In the semi-explicit period of 10 years, starting in FY13, we have assumed NOPLAT CAGR at 12.5% compared to FY12e. We assume the fade period begins in FY13. During the fade period, we assume the ROIC will decline to the level of cost of capital.

We assume the fade period will start in FY23 and last for 12 years. Our DCF-based fair value for Hero Honda is INR985, taking FY09 as the base year. At this value, the stock would trade at 12.7x FY10e EPS of INR78.

Under our research model, for stocks without a volatility indicator, the Neutral band is five percentage points above and below the hurdle rate for Indian stocks of 11%. This translates into a Neutral band of 6% to 16% around the current share price. Our 12-month target price of INR985 for Hero Honda shares suggests a potential total return of 12.2%, which is within the Neutral band, therefore, we rate the stock Overweight.

Downside risks, in our view, include lower-than-expected farm income, increasing competition and lower-than-expected production from the tax-free Haridwar factory.

### Maruti Suzuki India (Underweight (V), MRTI.BO, INR567)

In our view, the volume decline will continue in 2009 and could put pressure on margins. With weak sales visibility, it currently trades at 11x FY10e EPS of INR52 and is one of the most expensive stocks in the sector. Hence, it is our key Underweight (V).

Our DCF-based one-year target price is INR468 for Maruti shares. For our DCF valuation, we have assumed the cost of equity at 13.5%. We have explicit estimates until FY2010. In our semi-explicit forecast period of 10 years starting in FY2011, we assume NOPLAT CAGR at 14.7% compared with FY2010e NOPLAT. We assume the fade period will start in FY2021 and last for 17 years. During the fade period, we have assumed ROIC declines to the level of cost of capital.

Under our research model, for stocks with a volatility indicator, the Neutral band is 10 percentage points above and below the hurdle rate for Indian stocks of 11%. This translates into a Neutral band of 1% to 21% around the current share price. Our 12-month target price of INR468 for Maruti Suzuki shares implies a negative potential total return of 17.5%, which is below the Neutral band of our model, therefore, we rate the stock Underweight (V).

Upside risks that we see include a stronger-than-expected performance by the new launches, lower-than-expected raw material prices, and any improvement in the macro environment.

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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.

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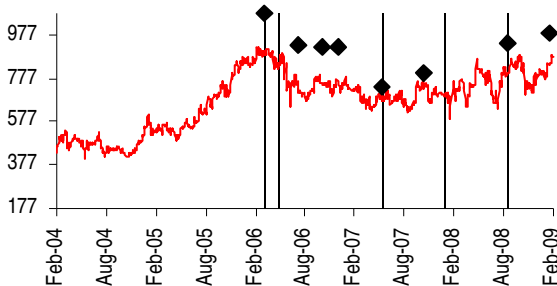
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## Share price and rating changes for long-term investment opportunities

Hero Honda (HROH.BO) Share Price performance INR Vs HSBC rating history



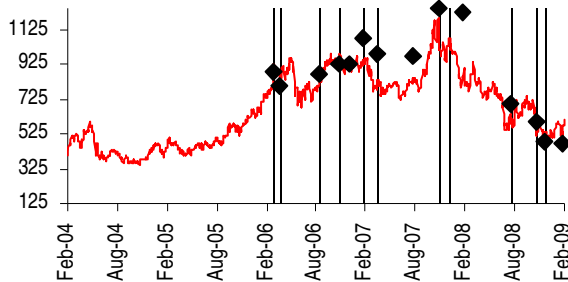
Source: HSBC

Recommendation & price target history

From	To	Date
Underweight	Neutral	09 March 2006
Neutral	Overweight	03 May 2006
Overweight	Neutral	15 May 2007
Neutral	Neutral	01 January 2008
Neutral	Overweight	21 August 2008
Target Price	Value	Date
Price 1	1078.00	09 March 2006
Price 2	935.00	12 July 2006
Price 3	919.00	10 October 2006
Price 4	925.00	05 December 2006
Price 5	740.00	15 May 2007
Price 6	800.00	18 October 2007
Price 7	938.00	21 August 2008
Price 8	985.00	21 January 2009

Source: HSBC

Maruti Suzuki India Ltd (MRTI.BO) Share Price performance INR Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
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
Overweight	Underweight	30 October 2007
Underweight	Overweight	05 December 2007
Overweight	Neutral	22 July 2008
Neutral	Neutral (V)	27 October 2008
Neutral (V)	Underweight (V)	24 November 2008

Target Price	Value	Date
Price 1	877.00	01 March 2006
Price 2	807.00	24 March 2006
Price 3	869.70	18 August 2006
Price 4	931.00	31 October 2006
Price 5	925.00	05 December 2006
Price 6	1080.00	23 January 2007
Price 7	990.00	21 March 2007
Price 8	980.00	27 July 2007
Price 9	1250.00	30 October 2007
Price 10	1225.00	29 January 2008
Price 11	695.00	22 July 2008
Price 12	600.00	27 October 2008
Price 13	481.00	24 November 2008
Price 14	468.00	29 January 2009

Source: HSBC

HSBC & Analyst disclosures

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Company	Ticker	Recent price	Price Date	Disclosure
MARUTI SUZUKI INDIA LTD	MRTI.NS	602.00	04-Feb-2009	4, 6, 7

Source: HSBC

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