

## Company Focus

31 January 2008 | 8 pages

# Mahindra & Mahindra (MAHM.BO)

 Target price change 

## Buy: 3Q Results Above Expectations

- Revise target price to Rs865** — from Rs945, as we adjust valuations to reflect lower valuations of Tech Mahindra and incorporate significantly higher value for Mahindra Holidays.
- Q3 results: Recurring PAT +3% YoY** — Recurring PAT at Rs2.5 bn was 10% above our estimates. Reported PAT was ~Rs4.05bn, including exceptional gains on revaluation of subsidiaries. Variance in recurring PAT attributed to higher EBITDA margins (at 11.3%, 70 bps ahead of estimates) and a low tax rate (reflecting fiscal incentives and tax exemptions on product development expenditure).
- Mounting capex a concern** — In the conference call, management indicated that overall capital expenditure for the next 3 years will aggregate around Rs90bn – far higher than our current estimates of ~Rs60bn. We await clarity from management on exact details and time lines before incorporating these revised numbers into our estimates. We also await details on Systech (the auto parts business) – where more inorganic initiatives could occur.
- Business outlook mixed**— We forecast around 12-13% growth in the UV business over the next 2 years – for the tractor business we forecast more sedate growth of around 7% CAGR.
- Reiterate Buy (1L)** — Key risk factors are a) Increase in input costs, b) Curtailment of credit to the farming sector, which could affect sales of the high-margin tractor business, and c) mounting capex.

|                              |                      |
|------------------------------|----------------------|
| <b>Buy/Low Risk</b>          | <b>1L</b>            |
| Price (31 Jan 08)            | Rs669.35             |
| Target price                 | Rs865.00             |
|                              | <i>from Rs945.00</i> |
| Expected share price return  | 29.2%                |
| Expected dividend yield      | 1.6%                 |
| <b>Expected total return</b> | <b>30.9%</b>         |
| Market Cap                   | Rs164,487M           |
|                              | US\$4,185M           |

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



### Statistical Abstract

| Year to | Net Profit | Diluted EPS | EPS growth | P/E  | P/B | ROE  | Yield |
|---------|------------|-------------|------------|------|-----|------|-------|
| 31 Mar  | (RsM)      | (Rs)        | (%)        | (x)  | (x) | (%)  | (%)   |
| 2006A   | 6,688      | 26.18       | -39.5      | 25.6 | 5.4 | 27.2 | 1.5   |
| 2007A   | 9,872      | 38.64       | 47.6       | 17.3 | 4.3 | 29.9 | 1.7   |
| 2008E   | 10,250     | 40.12       | 3.8        | 16.7 | 3.6 | 25.2 | 1.6   |
| 2009E   | 11,293     | 44.20       | 10.2       | 15.1 | 3.0 | 23.4 | 1.8   |
| 2010E   | 13,133     | 51.40       | 16.3       | 13.0 | 2.6 | 23.0 | 1.9   |

Source: Powered by dataCentral

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<sup>1</sup>Citigroup Global Markets India Private Limited

| Fiscal year end 31-Mar                   | 2006          | 2007           | 2008E          | 2009E          | 2010E          |
|--|---------------|----------------|----------------|----------------|----------------|
| <b>Valuation Ratios</b>                  |               |                |                |                |                |
| P/E adjusted (x)                         | 25.6          | 17.3           | 16.7           | 15.1           | 13.0           |
| EV/EBITDA adjusted (x)                   | 20.9          | 14.5           | 13.4           | 11.9           | 9.9            |
| P/BV (x)                                 | 5.4           | 4.3            | 3.6            | 3.0            | 2.6            |
| Dividend yield (%)                       | 1.5           | 1.7            | 1.6            | 1.8            | 1.9            |
| <b>Per Share Data (Rs)</b>               |               |                |                |                |                |
| EPS adjusted                             | 26.18         | 38.64          | 40.12          | 44.20          | 51.40          |
| EPS reported                             | 33.55         | 41.82          | 40.12          | 44.20          | 51.40          |
| BVPS                                     | 124.63        | 155.35         | 185.87         | 219.63         | 259.98         |
| DPS                                      | 10.00         | 11.50          | 11.00          | 12.00          | 13.00          |
| <b>Profit &amp; Loss (RsM)</b>           |               |                |                |                |                |
| Net sales                                | 79,772        | 98,076         | 108,932        | 122,523        | 139,873        |
| Operating expenses                       | -74,431       | -89,970        | -100,346       | -113,515       | -129,319       |
| <b>EBIT</b>                              | <b>5,341</b>  | <b>8,106</b>   | <b>8,587</b>   | <b>9,008</b>   | <b>10,553</b>  |
| Net interest expense                     | -270          | -198           | -250           | -520           | -600           |
| Non-operating/exceptionals               | 3,570         | 5,249          | 5,704          | 6,981          | 8,037          |
| <b>Pre-tax profit</b>                    | <b>8,641</b>  | <b>13,157</b>  | <b>14,041</b>  | <b>15,469</b>  | <b>17,990</b>  |
| Tax                                      | -2,424        | -3,501         | -3,791         | -4,177         | -4,857         |
| Extraord./Min.Int./Pref.div.             | 2,354         | 1,028          | 0              | 0              | 0              |
| <b>Reported net income</b>               | <b>8,571</b>  | <b>10,684</b>  | <b>10,250</b>  | <b>11,293</b>  | <b>13,133</b>  |
| Adjusted earnings                        | 6,688         | 9,872          | 10,250         | 11,293         | 13,133         |
| Adjusted EBITDA                          | 7,341         | 10,202         | 10,859         | 11,934         | 13,848         |
| <b>Growth Rates (%)</b>                  |               |                |                |                |                |
| Sales                                    | 22.5          | 22.9           | 11.1           | 12.5           | 14.2           |
| EBIT adjusted                            | 16.9          | 51.8           | 5.9            | 4.9            | 17.2           |
| EBITDA adjusted                          | 14.5          | 39.0           | 6.4            | 9.9            | 16.0           |
| EPS adjusted                             | -39.5         | 47.6           | 3.8            | 10.2           | 16.3           |
| <b>Cash Flow (RsM)</b>                   |               |                |                |                |                |
| <b>Operating cash flow</b>               | <b>10,316</b> | <b>11,321</b>  | <b>11,646</b>  | <b>13,208</b>  | <b>15,182</b>  |
| Depreciation/amortization                | 2,000         | 2,096          | 2,272          | 2,926          | 3,295          |
| Net working capital                      | -255          | -1,459         | -876           | -1,011         | -1,245         |
| <b>Investing cash flow</b>               | <b>-7,589</b> | <b>-10,940</b> | <b>-19,567</b> | <b>-14,000</b> | <b>-14,000</b> |
| Capital expenditure                      | -2,796        | -5,261         | -5,447         | -6,000         | -6,000         |
| Acquisitions/disposals                   | -4,793        | -5,679         | -14,120        | -8,000         | -8,000         |
| <b>Financing cash flow</b>               | <b>-37</b>    | <b>4,731</b>   | <b>-1,227</b>  | <b>792</b>     | <b>-1,182</b>  |
| Borrowings                               | -1,692        | 7,526          | 1,758          | 4,048          | 2,345          |
| Dividends paid                           | -2,782        | -3,121         | -2,985         | -3,256         | -3,528         |
| <b>Change in cash</b>                    | <b>2,691</b>  | <b>5,112</b>   | <b>-9,148</b>  | <b>0</b>       | <b>0</b>       |
| <b>Balance Sheet (RsM)</b>               |               |                |                |                |                |
| <b>Total assets</b>                      | <b>60,030</b> | <b>77,412</b>  | <b>88,756</b>  | <b>103,834</b> | <b>119,190</b> |
| Cash & cash equivalent                   | 7,303         | 11,148         | 2,000          | 2,000          | 2,000          |
| Accounts receivable                      | 6,380         | 7,905          | 9,158          | 10,683         | 12,629         |
| Net fixed assets                         | 15,544        | 18,710         | 21,884         | 24,958         | 27,663         |
| <b>Total liabilities</b>                 | <b>30,941</b> | <b>40,433</b>  | <b>44,513</b>  | <b>51,555</b>  | <b>57,306</b>  |
| Accounts payable                         | 13,707        | 16,603         | 18,610         | 20,983         | 23,917         |
| Total Debt                               | 8,834         | 16,360         | 18,118         | 22,166         | 24,512         |
| <b>Shareholders' funds</b>               | <b>29,089</b> | <b>36,978</b>  | <b>44,243</b>  | <b>52,279</b>  | <b>61,884</b>  |
| <b>Profitability/Solvency Ratios (%)</b> |               |                |                |                |                |
| EBITDA margin adjusted                   | 9.2           | 10.4           | 10.0           | 9.7            | 9.9            |
| ROE adjusted                             | 27.2          | 29.9           | 25.2           | 23.4           | 23.0           |
| ROIC adjusted                            | 19.6          | 26.0           | 21.8           | 18.5           | 18.9           |
| Net debt to equity                       | 5.3           | 14.1           | 36.4           | 38.6           | 36.4           |
| Total debt to capital                    | 23.3          | 30.7           | 29.1           | 29.8           | 28.4           |

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**Figure 1. M&M 3QFY08- Operational Results**

|                                  | 3Q FY07       | 3Q FY08       | % YoY chg  | CIR Comments  |
|----------------------------------|---------------|---------------|------------|---|
| <b>Volumes (Nos.)</b>            |               |               |            |   |
| Utility vehicles                 | 33,312        | 39,282        | 17.9       | Driven by 44% YoY growth in Bolero sales and modest 6% YoY growth in Scorpio sales                          |
| Tractors                         | 28,130        | 26,318        | (6.4)      | Overall domestic tractor industry declined by 2% whereas M&M declined 8% YoY, implying loss of market share |
| 3-wheelers                       | 8,425         | 8,711         | 3.4        | Impacted by decline in large 2 wheeler sales  |
| <b>Total</b>                     | <b>69,867</b> | <b>74,311</b> | <b>6.4</b> |   |
| <b>Product mix (%)</b>           |               |               |            |   |
| Utility vehicles                 | 47.7          | 52.9          |            |   |
| Tractors                         | 40.3          | 35.4          |            |   |
| 3-wheelers                       | 12.1          | 11.7          |            |   |
| <b>Domestic Market share (%)</b> |               |               |            |   |
| Utility vehicles                 | 48.4          | 52.8          |            |   |
| Tractors                         | 31.1          | 28.9          |            |   |
| 3-wheelers                       | 8.2           | 9.4           |            |   |

Source: Company, Citi Investment Research

**Figure 2. M&M 3QFY08- Financial Results**

| (INR m)                       | 3Q FY07       | 3QFY08        | % YoY chg   | CIR Comments  |
|-------------------------------|---------------|---------------|-------------|---|
| <b>Net sales</b>              | <b>25,761</b> | <b>29,402</b> | <b>14.1</b> | <b>In line with estimates</b>   |
| Decrease/(Increase) in Stocks | 433           | (977)         |             |   |
| Raw Materials                 | 17,150        | 20,745        | 21.0        | Cost control through aggressive cost cutting actions, some synergies accrue from Punjab Tractors                        |
| Staff costs                   | 1,778         | 2,161         | 21.6        | Reflects employee ramp up in conjunction with capex plans   |
| Other Expenses                | 3,304         | 4,109         | 24.4        | Reflects increase in marketing, product development and fuel & power expenses   |
| Provision for contingencies   | -             | 49            |             |   |
| Total Expenditure             | 22,664        | 26,087        | 15.1        |   |
| <b>Operating profit</b>       | <b>3,096</b>  | <b>3,315</b>  | <b>7.1</b>  | <b>7% above expectations</b>  |
| Interest                      | (168)         | 72            | (143.1)     |   |
| Other income                  | 412           | 401           | (2.8)       | Below expectations due to use of cash for expansion plan  |
| EBDT                          | 3,676         | 3,643         | (0.9)       |   |
| Depreciation                  | 522           | 590           | 13.1        | In line with estimates  |
| PBT                           | 3,154         | 3,053         | (3.2)       |   |
| Exceptionals                  |               | 1,548         |             | Includes gain of Rs 1570 million as M&M received additional shares due to merger of 3 subsidiaries in Mahindra Forgings |
| Tax                           | 731           | 550           | (24.8)      |   |
| PAT                           | 2,423         | 4,052         | 67.2        |   |
| <b>PAT (pre exceptionals)</b> | <b>2,423</b>  | <b>2,503</b>  | <b>3.3</b>  | <b>10% above expectations</b>   |
| <b>Profit Margins (%)</b>     |               |               |             |   |
| EBITDA (%)                    | 12.0          | 11.3          |             | Declined 70 bps YoY, 70 bps above expectations  |
| Tax / PBT (%)                 | 23.2          | 18.0          |             | Tax rate lower due to tax incentives, deductions applicable to R&D  |
| Net profit margins (%)        | 8.4           | 7.5           |             |   |
| Raw materials / sales         | 68.3          | 67.2          |             | 70 bps above expectations   |
| Staff costs / sales           | 6.9           | 7.3           |             | 50 bps below expectations   |
| Other expenses / sales        | 12.8          | 14.0          |             | 80 bps below expectations   |

Source: Company, Citi Investment Research

# Mahindra & Mahindra

## Company description

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

## Investment strategy

We rate M&M shares Buy / Low Risk (1L) with a target price of Rs865. Tractor sales are benefiting from relatively low penetration levels and the government's emphasis on increasing credit to the agriculture sector. Apart from dominance of the lower end of the market, where competition has been limited, M&M's utility vehicle business is also benefiting from product initiatives, particularly the launch of the Scorpio and Bolero models and variants of these, which have enabled M&M to tap into the urban markets for passenger vehicles. Moreover, we also recognize management's efforts to retain market share within segments like three-wheelers, given the stiff competition in this segment. We remain positive on management's efforts to de-risk from the local market by pursuing sales in select international markets. The target is to raise international sales from around 10% at present to 20% over the next three years. Their efforts have met with substantial success particularly in the tractor segment, wherein they are currently ranked No. 4 (in terms of unit sales) globally. The substantial value of the company's real estate and investment holdings (particularly in the information technology business through Tech Mahindra and in the financial services business through M&M Financial Services) should provide downside support (especially with increasing dividends from key subsidiaries). Given recent initiatives to unlock value in subsidiaries – MMFSL and Tech Mahindra being the primary examples – we incorporate the value of key subsidiaries within our sum-of-parts valuation.

## Valuation

Our target price of Rs865 is based on a sum-of-parts methodology. We value M&M's core business at Rs468 (9x FY09E core CEPS). We also incorporate value for M&M's listed subsidiaries (Rs222/share), its auto component business (Rs57/share) and M&M's investments in other subsidiaries (including Mahindra Holidays at Rs102/share). Our core multiple of 9x, is supported by an 14% CAGR in core cash earnings (excluding dividends from group companies) for M&M over FY07-09E. We value the key subsidiaries / associates / auto component initiatives at Rs397/share. At our core target price (of Rs468) the stock would trade at around 10.2x FY08E core EPS (excluding dividends from subsidiaries) and should be supported by 11% CAGR in earnings over FY07-09E. We have chosen to use P/CEPS as our primary valuation metric to ensure proper comparison with historical trading bands — the company is undertaking a significant product development and capital expenditure program, and also undertook a restructuring of the balance sheet in FY02. We believe valuations will also be supported by: a) management's continued efforts to unleash value from investments in group concerns (we

believe that the listing of the group's hotel / resorts venture is next on the anvil); and b) new initiatives announced in the passenger cars, commercial vehicles and auto components segments, which should fructify over the next 2-3 years.

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**Figure 3. M&M Sum of Parts Valuation**

| <b>Parts</b>                         | <b>Remark</b>  | <b>Value</b> | <b>Per M&amp;M Share</b> |
|--------------------------------------|--|--------------|--------------------------|
| Core Auto and UV Businesses          | 9x FY09 Price / Cash EPS   | 119,687      | 468                      |
| Principal Listed Subsidiaries        | At 25% discount to CMP   |              | 222                      |
| Systech (auto component initiatives) | 12x FY08E EPS  | 14,563       | 57                       |
| Mahindra Holidays and Resorts        | Valued at pre - IPO placement - adjusted for holding company discount, dilution post - IPO | 6,682        | 102                      |
| Other unlisted subsidiaries          | At Book Value  | 3,929        | 15                       |
| <b>Total Value / share</b>           |  |              | <b>865</b>               |

Source: Citi Investment Research

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## Risks

We rate M&M shares Low Risk, in line with our quantitative model which tracks 260-day historical share price volatility. Key Risk factors to our investment thesis which could prevent the shares from reaching our target price include: Any substantial rise in interest rates that could curb demand for farm equipment and utility vehicles. Given M&M's strong dependence on the rural economy (a substantial part of the demand for their products emanates herein), any weak trend in the prices of agricultural commodities could also impact demand and sales. Escalating competition within the UV segment, which might lead to an increase in discounts and result in margin pressure.

# Appendix A-1

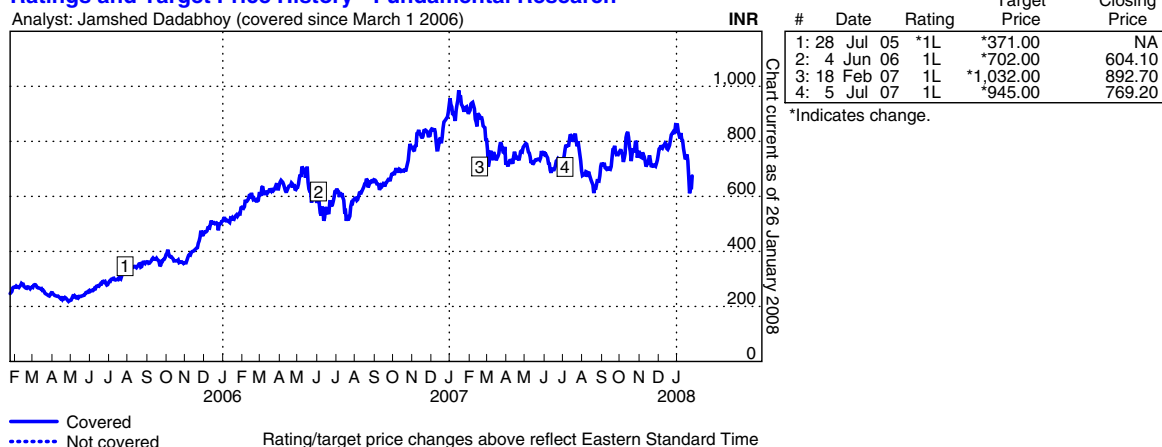
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Analyst: Jamshed Dadabhoy (covered since March 1 2006)



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