

Industry In-Depth

2 January 2007 | 12 pages

India Two-Wheeler Majors

Dec Sales – Mixed Performance

- **Growth moderates** — Two-wheeler majors' Dec sales were moderate (+7% YoY), as Hero Honda disappointed with only 3% yoy growth. Buoyed by the *Platina* and *Discover*, Bajaj Auto's motorcycle volumes grew 26% yoy. TVS' motorcycle volumes declined ~15%YoY.
- **Bajaj Auto continues to gain market share** — Bajaj Auto's motorcycle market share gains persist as its products in all segments continue to do well. FY07 YTD, it has gained almost 350bps, while industry leader HROH has conceded a corresponding amount.
- **Price hikes** — Over the quarter, Bajaj hiked prices on all models by Rs500. Hero Honda announced it will increase prices by Rs500-1,000 / bike in Jan to mitigate escalating cost pressures. Despite price hikes, we contend that margin compression will persist as competitive pressures manifest themselves in higher discounts / schemes.
- **New model launches** — Over 4Q, Hero Honda is expected to launch two new models. BJAT will also launch a new scooter – the *Kristal* – this month. Press reports (*Business Standard*) also indicate that BJAT will launch higher cc versions of the Pulsar this quarter. TVS has indicated it will launch a new version of the *Victor* in early FY08E.
- **Relative performance** — The two-wheeler sector moderately underperformed the broad market in Dec. Over the quarter, underperformance was more severe – around 20%, as margin pressures in 2Q resulted in a sell-off in both BJAT and TVS.
- **Concerns persist** — We believe the two-wheeler segment is witnessing intense competition and a challenging cost environment. We maintain our Sell recommendations on Hero Honda (HROH.BO - Rs771.15; 3L) and TVS Motor (TVSM.BO - Rs85.00; 3M), and Hold rating on Bajaj Auto (BJAT.BO - Rs2,715.00; 2L).

Jamshed Dadabhoy¹

+91-22-6631-9883

jamshed.dadabhoy@citigroup.com

Deepak Jain¹

deepak3.jain@citigroup.com

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Figure 1. December Unit Sales Performance

	Dec Sales (Nos)	YoY Chg (%)	MoM chg (%)	YTD Sales (Nos)	YoY chg (%)
Hero Honda^^	252,462	3.0	-9.9	2,480,753	11.3
Bajaj Auto					
Motorcycles	187,063	26.2	-12.7	1,843,654	33.7
2 wheelers	187,179	19.8	-12.7	1,856,239	25.2
3 wheelers	27,749	49.7	-5.6	237,198	32.2
Total	214,928	22.9	-11.8	2,093,437	26.0
TVS Motors					
Motorcycles	58,756	-14.5	-14.7	712,095	21.3
2 wheelers	103,188	-3.9	-12.7	1,159,139	16.9
Motorcycles	498,281	7.8	-11.6	5,036,502	20.1
2 wheelers	542,829	6.7	-11.4	5,496,131	16.9

Source: Companies

^^Hero Honda's sales slightly distorted as they include scooter sales

Figure 2. Two-Wheeler Market Shares

	FY06 %	FY 07 YTD^ %	FY07 YTD Relative* %	Dec Relative* %
Motorcycles				
Hero Honda^^	48.1	44.6	49.3	50.7
Bajaj Auto	30.8	34.2	36.6	37.5
TVS Motors	13.0	13.5	14.1	11.8
2 wheelers				
Hero Honda	39.6	38.9	45.1	46.5
Bajaj Auto	26.8	29.1	33.8	34.5
TVS Motors	17.7	18.4	21.1	19.0

Source: Company Reports

* Relative market shares amongst the 3 majors; Consolidated industry data awaited

^ Market share up to f-1 month based on consolidated industry data

^^ Hero Honda's sales slightly distorted as they include scooter sales

Hero Honda – Hit Hard

Figure 3. Hero Honda – Dec Sales

	Dec Sales (Nos)	YoY Chg (%)	MoM chg (%)	YTD Sales (Nos)	YoY chg (%)
Two Wheelers	252,462	3.0	-9.9	2,480,753	11.3

Source: Company

Hero Honda recorded lackluster growth of 3% in December, despite the launch of three variants of the *CBZ*, *Glamour* and *Passion* in October. Over the quarter, HROH's volumes grew at ~12%YoY.

HROH targets c.1million unit sales of the *CD* series (entry level segment – sub Rs 35,000) per annum over FY08E – which implies a growth of c38% (based on our FY07E volume estimates). It has just launched two more variants in the CD series. This does not augur well for margins and profitability, and signals management's emphasis on volumes and market share. Over the month, management indicated that margin pressure would continue at least until 1QFY08E. Management also stated that it will increase prices by around Rs500-1000 / bike this month to offset material cost pressures.

HROH has launched six variants/models in the current fiscal. It plans to introduce two new models into 4Q – we surmise there will be one new model in each of the executive and premium segments.

Bajaj Auto – Powering Ahead

Figure 4. Bajaj Auto – Dec Sales

	Dec Sales (Nos)	YoY Chg (%)	MoM chg (%)	YTD Sales (Nos)	YoY chg (%)
Total Sales	214,928	22.9	(11.8)	2,093,437	26.0
Motorcycles	187,063	26.2	(12.7)	1,843,654	33.7
Other Two Wheelers	116	(98.6)	N.A	12,585	(87.8)
Total 2 wheelers	187,179	19.8	(12.7)	1,856,239	25.2
3 wheelers	27,749	49.7	(5.6)	237,198	32.2

Source: Company

BJAT's December sales growth was exceptionally strong (especially in light of competitors' performance) with motorcycles growing at 26%YoY. The Rs1,500 price cut on the *Platina* has stimulated volume growth through the quarter (motorcycle volumes +28% YoY in 3Q). BJAT's market share continues to rise – management indicated its market share for December was at 35.5% – higher than the YTD 34%.

Three-wheeler volumes were also very strong – at c50%YoY – driven by exports. Over the quarter, three-wheelers reported 49% volume growth, driven by exports. Management has indicated that over the next quarter, three-wheeler sales would clock monthly volumes of around 30,000 units. We view this positively – the high margins in this segment should mitigate margin pressures from the lower-segment bikes.

BJA will launch the *Kristal* (an ungeared scooter) this month. The company is also reportedly expected to launch (Source: *Business Standard*) higher cc variants of the *Pulsar* this quarter. We believe this is a long-term positive – if BJA can successfully transition its product mix to higher cc bikes, it will help to offset material cost pressures.

TVS Motor – Moderate Decline in Volumes

Figure 5. TVS Motor – Dec Sales

	Dec Sales (Nos)	YoY Chg (%)	MoM chg (%)	YTD Sales (Nos)	YoY chg (%)
Total Sales	103,188	(3.9)	(12.7)	1,159,139	16.9
Scooters/Mopeds	44,432	14.8	(9.8)	447,044	10.5
Motorcycles	58,756	(14.5)	(14.7)	712,095	21.3

Source: Company, Citigroup Investment Research

Overall volumes declined c4%, due to the sharp decline in motorcycle sales (third consecutive month of declining volumes, and the lowest monthly volumes in almost 16 months). We surmise the steady decline in motorcycle sales exhibited over the last three months is due to draw-down of inventory levels in the distribution channels. A lackluster performance over 3Q (motorcycle sales declined 1% in 3Q) has dragged down overall motorcycle growth to 21% YTD (growth in 1H was 35%).

TVS' motorcycle portfolio partially resembles that of Bajaj Auto's – it has a strong product line-up at the low end (in the Star and its variants) and at the upper end (through the Apache). Within the executive segment (still the core of the two-wheeler market), TVS' Victor has lost market share, notably to Bajaj Auto's Discover variants. The company plans to rectify this by relaunching the Victor next fiscal, but we believe that competitive intensity has increased across the industry, and TVS will have to launch products at a faster-than-industry pace, if it wishes to recoup market share conceded over the past three years.

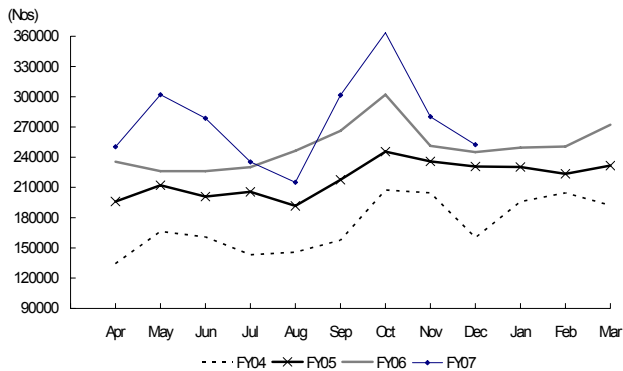
Scooter volumes also reported sedate growth (+3.5%YoY), while moped volumes grew 23%. Despite declining sales – Apr-Nov moped industry volumes declined c3% – TVS' moped sales have grown at c18% over the same period, as it has captured almost 13% market share from fringe players like Kinetic Engineering and Majestic Auto. We believe that longer term, TVS' mopeds will grow / decline in line with the industry growth rate, given that further growth through market share gains appears capped (TVS accounts for nearly 85% of the moped industry volumes). With this backdrop, we believe the motorcycle portfolio will be under greater pressure to drive volume growth for TVS.

Figure 6. Sector Absolute Share Performance

	Price (Rs)	1M (%)	3M (%)	6M (%)	12M (%)	YTD (%)
Bajaj Auto	2,618.9	-2.0	-12.7	-4.3	31.0	30.9
Hero Honda	762.4	2.4	-1.6	-3.7	-10.1	-11.3
TVS Motor	87.3	-12.0	-29.9	-10.7	-11.6	-12.7
CIR India 2-wheeler Index	NA	-1.0	-10.1	-4.4	10.9	10.1
BSE Sensex	13,787	1.2	10.7	30.0	47.9	46.7

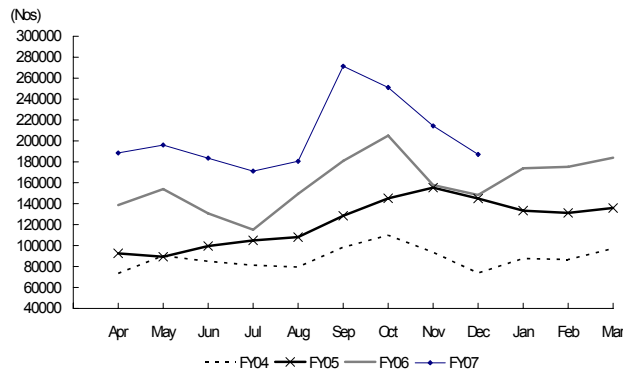
Source: Bloomberg; Pricing as at Dec 29, 2006

Figure 7. Hero Honda: Motorcycle Sales Trends



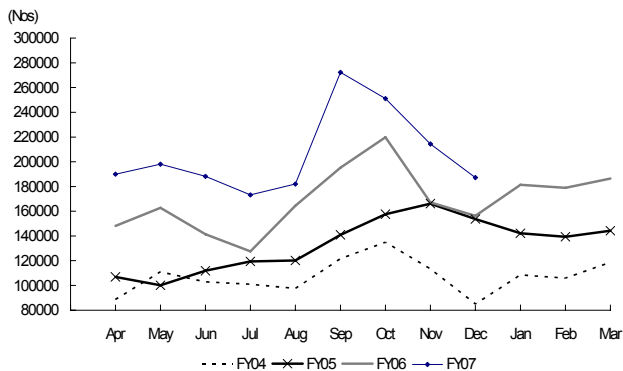
Source: Company Reports

Figure 8. Bajaj Auto: Motorcycle Sales Trends



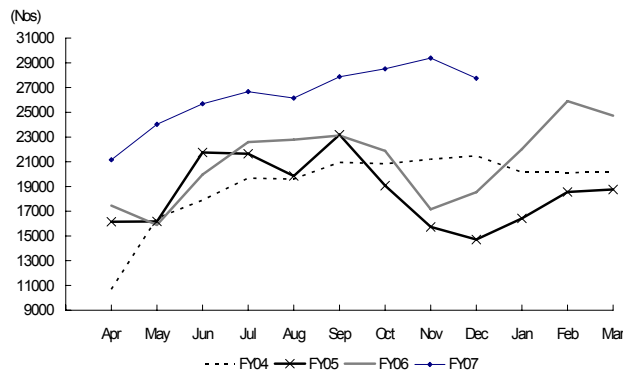
Source: Company Reports

Figure 9. Bajaj Auto: Two-Wheelers Sales Trends



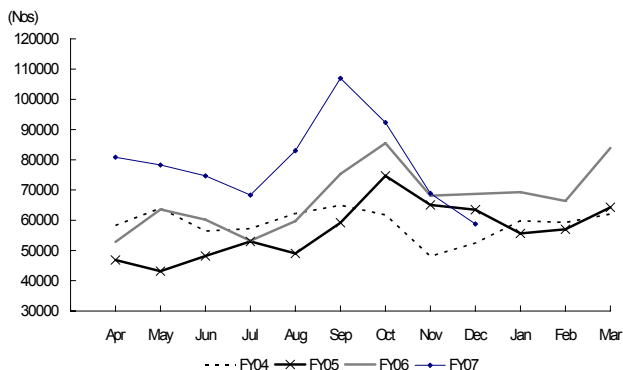
Source: Company Reports

Figure 10. Bajaj Auto: Three-Wheelers Sales Trends



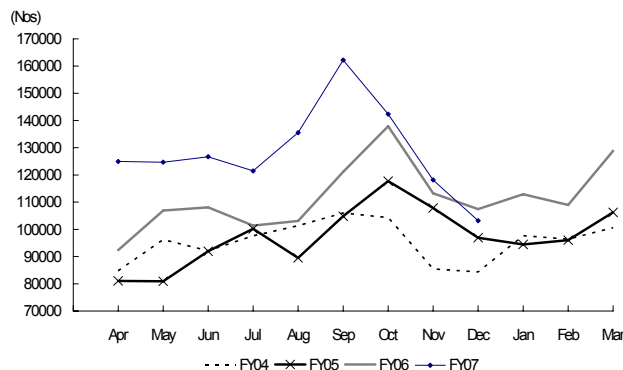
Source: Company Reports

Figure 11. TVS Motor: Motorcycle Sales Trends



Source: Company Reports

Figure 12. TVS Motor: Two-Wheeler Sales Trends



Source: Company Reports

Valuation and Risks

Hero Honda (HROH.BO - Rs771.15; 3L)

Valuation

Our 12-month target price is Rs678. Our target multiple of 11.6x FY08E forward earnings is at the low end of the recent band. Hero Honda has traded at an average of almost 16x over the past fiscal. But, given our view that competitive pressures will only accelerate over the medium term, we see no rationale in revising the multiple to higher levels. An 11% CAGR in earnings over FY06-09E should, we believe, support these valuations. We have chosen to use the P/E valuation metric to value Hero Honda, given the company's high level of cash generation, reflecting its strong balance sheet (more than Rs20bn in cash and a substantial payout). Going forward, given the substantial increase in capital expenditure planned, we believe investor attention could focus on P/CEPS and EV/EBITDA-based valuations as well.

At our target price the stock would trade at about 10.2x FY08E P/CEPS and 7.5x FY08E EV/EBITDA – the mid-point of the recent trading band.

At current valuations, Hero Honda trades at a c.25% discount to the BSE Sensex. We believe the discount is justified given the lower earnings growth forecast – we estimate a CAGR of 19.4% in earnings over FY06-08E for the BSE Sensex vs 9.7% for Hero Honda. Peer group (mainly Bajaj Auto) trades at a c.11% premium (after stripping out value of the insurance business) to Hero Honda due to positive sentiment on the back of recent market share gains.

Risks

We rate Hero Honda shares as Low Risk according to our quantitative risk rating system, which tracks 260-day historical share price volatility.

The key upside risks that could cause the shares to continue to trade above our target price include: 1) Any corporate action that further strengthens the relationship between Honda Motors and Hero Honda from current levels; 2) Any meaningful and sustained improvement in profitability, driven by a beneficial shift in the product mix; 3) Faster-than-anticipated growth in the sector as a whole, which could ease market share concerns for Hero Honda; 4) Crystallization of export initiatives to Honda's markets, which could offset growth pressures in the domestic market; 5) A sustained and substantial decline in input costs, which could improve EBITDA margins over the long term; and 6) Greater-than-expected tax savings on Hero Honda's new plant.

TVS Motor (TVSM.BO - Rs85.00; 3M)

Valuation

Our 12-month target price for TVS of Rs85 is based on 13x FY08E earnings, which is line with that for the peer group. The valuation multiple ascribed is at a discount to stock's 14.8x P/E multiple over the past five years. However, we reckon the historical multiple is inflated – TVS' stock price typically runs up on expectations of margin improvement / new initiatives, but then corrects on the back of disappointing earnings / delay in strategic initiatives. The historical forward P/E thus appears exaggerated. We also contend that 13x is appropriate, given the intense competitive pressures that we forecast for the sector. Our valuation multiple is comparable with TVS' peer group. Over the past year, TVS

has underperformed its peer group, largely due to unabated margin pressure and a lacuna in its product portfolio which it seeks to address through the StaR (and its variants). Its forecast earnings growth is much higher than peers over FY07-09E, because of a low base effect over FY07. However, the company lags Hero Honda in terms of technology and doesn't have a huge cash pile like Bajaj Auto. In a potential price war scenario, these could constrain TVS' earnings growth. We are therefore not ascribing a premium for higher earnings growth forecast for TVS (we use a multiple of 13x for TVS, vs. c12x for HROH and 14.5x for BJAT). We have chosen to use the P/E valuation metric given TVS' steady earnings growth and healthy capital structure, and to facilitate comparison with the peer group.

Risks

We rate TVS shares as Medium Risk, in line with our quantitative risk rating system, which tracks 260-day historical share price volatility.

The key upside risks that could drive the shares above our target price include:

- a) Meaningful and sustained improvement in profitability, driven by a beneficial shift in the product mix;
- b) Faster-than-anticipated ramp up in three-wheeler volumes that would result in a richer product mix over the medium term; and
- c) Sustained increase in exports, especially after the establishment of the plant in Indonesia.

Downside risks that could pull the shares below our target price include:

- a) Competitive pressures in the two-wheeler industry remain intense and could likely accentuate given declining product life cycles and increasing number of models being launched by not only new players, but also the three majors;
- b) Macro risk factors include a slowdown in sales (and commensurate erosion in margins) due to any deterioration in macroeconomic variables (including growth, interest rates and fuel prices);
- c) Low liquidity in the stock is also a risk as it implies higher transaction costs and volatile swings based on monthly sales numbers.

Bajaj Auto (BJAT.BO - Rs2,715.00; 2L)

Valuation

Our target price of Rs2,886 reflects accelerating margin pressures for FY07/08E and a de-rating of the core business to a 14x multiple, which is moderately higher than the multiple we assign to its peers Hero Honda and TVS Motor. We believe this multiple is warranted because we think BJAT's earnings growth prospects are stronger.

Our target price of Rs2,886 is based on a sum-of-the-parts valuation that comprises: a) valuing 12-month forward earnings from operations (ex-financial income) of Rs119.9 for FY08E at 14x (above the peer group but merited given the company's higher earnings growth prospects). We thus arrive at a value of Rs1,679/share (119.9*14). Over the past year, the one-year forward P/E multiple (after stripping the value of the insurance business) has ranged from 11.9-19.8x with a mean of 15.7x. Our multiple of 14x is at a discount to this

mean, but we think it is justified given rising competitive intensity in the industry with players focusing on market share at the expense of margins. A 20% CAGR in core earnings for FY06-09E should support these valuations, in our view. b) Estimated cash and investments per share of Rs697. c) We value Bajaj Auto's insurance joint ventures at Rs510/share.

At our target price, the stock would trade at 19x FY08E EPS, at the higher end of its recent trading band. We use sum-of-the-parts to value Bajaj Auto given that more than 90% of its balance sheet is in investments and cash, which generates high Other Income. We use a P/E valuation metric to value Bajaj Auto's earnings from operations in view of its high level of cash generation.

Risks

We rate Bajaj Auto shares as Low Risk based on our quantitative risk-rating system, which tracks 260-day historical share price volatility.

The key risks that could prevent the shares from reaching our target price would be deterioration in macroeconomic variables (including growth, interest rates and fuel prices) or increase in competitive pressures that result in a slowdown in sales and/or erosion of margins. Competitive pressures in the two-wheeler industry remain high and could intensify in view of the aggressive product pipelines of key competitors. This, coupled with the rising trend in input costs, could mute margin expansion. Success in the three-wheelers segment is critical given that this is the company's most profitable segment and is a source of substantial cash flow. Predictability of this business remains relatively difficult, however, because its performance depends on the issuance of licenses by various government bodies.

Upside risks, which could drive the shares above our target price, include stronger-than-expected volume growth or a decline in material costs on a sustainable basis that would benefit margins.

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I, Jamshed Dadabhoj, research analyst and the author of this report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

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Hero Honda Motors (HROH.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Jamshed Dadabhoj (covered since March 1 2006)



#	Date	Rating	Target Price	Closing Price
1:	15 Jan 04	2M	*509.00	456.05
2:	13 Apr 04	2M	*564.00	501.50
3:	14 Jan 05	2M	*580.00	524.45
4:	28 Jun 05	*2L	*612.00	576.15
5:	18 Jul 05	*3L	612.00	654.35

*Indicates change.

TVS Motor Co Ltd (TVSM.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Jamshed Dadabhoj (covered since December 20 2006)



#	Date	Rating	Target Price	Closing Price
1:	7 May 04	1H	118.00	87.25

*Indicates change.

Bajaj Auto Ltd (BJAT.BO)
Ratings and Target Price History - Fundamental Research

Analyst: Jamshed Dadabhoy (covered since March 1 2006)



#	Date	Rating	Target Price	Closing Price
1:	14 Jul 05	2L	*1,438.00	1,383.00
2:	26 Mar 06	2L	**2,956.00	2,732.80

*Indicates change.

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Data current as of 31 December 2006

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<i>% of companies in each rating category that are investment banking clients</i>	48%	50%	39%

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