

## Company In-Depth

18 May 2007 | 12 pages

# Bajaj Auto (BJAT.BO)

## Demerger Plans: The Devil's in the Details. Cutting Target Price

 Rating change   
 Target price change   
 Estimate change 

- What's New?** — BJAT management stated that Allianz has a call option on both the life and general insurance subsidiaries, which permits the latter to increase its stake to 74% and 50% respectively in the ventures, for a fairly nominal consideration. BJAT's stock price declined c9% on the back of this news; we could expect further immediate downside on the stock due to these and attendant concerns on the demerger.
- Cut Target Price** — Revise target price downward to Rs2,600 to reflect lower insurance value (Rs388 / share, vsRs510 earlier) and downward revision in core value to Rs1,542 (Rs1,679 earlier). Core business valued at 13x FY09E EPS. As we roll forward to FY09E, multiple is pared to 13x from 14x due to the industry slowdown. Cash and investments valued at Rs670 / share.
- Demerger Details** — Bajaj Auto will demerge its businesses into 3 entities a) Bajaj Auto Ltd. (auto businesses + Rs15bn in cash); b) Bajaj Finserve Ltd. (windpower projects, investments in the insurance ventures, investment in Bajaj Auto Finance and Rs8bn in cash); and c) Bajaj Holdings and Investment Ltd (residual cash >Rs40bn, investment in ICICI and 30% stake in both Bajaj Auto and Bajaj Finserve). All current shareholders of Bajaj Auto will get 1 share each of the new businesses (for every 1 share held in Bajaj Auto). All 3 businesses will be listed by Dec 2007, once regulatory and statutory approvals are obtained.
- Reiterate Hold/Low Risk (2L)** — We believe that this convoluted structure could create an overhang on Bajaj Auto's stock price over the near term. We maintain our Hold rating on the stock.

<b>Hold/Low Risk</b>	<b>2L</b>
Price (17 May 07)	Rs2,500.30
Target price	Rs2,600.00
	<i>from Rs2,886.00</i>
Expected share price return	4.0%
Expected dividend yield	1.8%
<b>Expected total return</b>	<b>5.8%</b>
Market Cap	Rs252,989M
	US\$6,231M

### Price Performance (RIC: BJAT.BO, BB: BJA IN)



See Appendix A-1 for Analyst Certification and important disclosures.

### Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	11,174	110.44	39.4	22.6	5.3	25.1	1.6
2007A	12,371	122.27	10.7	20.4	4.6	24.0	1.6
2008E	13,545	133.87	9.5	18.7	4.0	22.8	1.8
2009E	15,329	151.50	13.2	16.5	3.5	22.4	2.0
2010E	17,606	174.01	14.9	14.4	3.0	22.3	2.2

Source: Powered by dataCentral

### Jamshed Dadabhoy<sup>1</sup>

 +91-22-6631-9883  
 jamshed.dadabhoy@citigroup.com

### Hitesh Goel<sup>1</sup>

hitesh.goel@citigroup.com

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
<b>Valuation Ratios</b>					
P/E adjusted (x)	22.6	20.4	18.7	16.5	14.4
EV/EBITDA adjusted (x)	22.1	20.0	17.8	14.3	10.9
P/BV (x)	5.3	4.6	4.0	3.5	3.0
Dividend yield (%)	1.6	1.6	1.8	2.0	2.2
<b>Per Share Data (Rs)</b>					
EPS adjusted	110.44	122.27	133.87	151.50	174.01
EPS reported	108.88	122.27	133.87	151.50	174.01
BVPS	471.51	546.98	629.54	724.03	835.32
DPS	40.00	40.00	45.00	50.00	55.00
<b>Profit &amp; Loss (RsM)</b>					
Net sales	74,694	93,204	103,762	117,109	133,342
Operating expenses	-65,026	-82,937	-92,686	-104,083	-117,533
<b>EBIT</b>	<b>9,668</b>	<b>10,267</b>	<b>11,076</b>	<b>13,027</b>	<b>15,808</b>
Net interest expense	-3	-53	-60	-70	-80
Non-operating/exceptionals	6,370	7,556	8,062	8,633	9,069
<b>Pre-tax profit</b>	<b>16,034</b>	<b>17,770</b>	<b>19,078</b>	<b>21,590</b>	<b>24,797</b>
Tax	-4,791	-4,901	-5,533	-6,261	-7,191
Extraord./Min.Int./Pref.div.	-226	-498	0	0	1
<b>Reported net income</b>	<b>11,017</b>	<b>12,371</b>	<b>13,545</b>	<b>15,329</b>	<b>17,606</b>
Adjusted earnings	11,174	12,371	13,545	15,329	17,606
Adjusted EBITDA	9,668	10,267	11,076	13,027	15,808
<b>Growth Rates (%)</b>					
Sales	30.2	24.8	11.3	12.9	13.9
EBIT adjusted	79.9	6.2	7.9	17.6	21.4
EBITDA adjusted	79.9	6.2	7.9	17.6	21.4
EPS adjusted	39.4	10.7	9.5	13.2	14.9
<b>Cash Flow (RsM)</b>					
<b>Operating cash flow</b>	<b>13,352</b>	<b>12,388</b>	<b>17,436</b>	<b>18,588</b>	<b>22,643</b>
Depreciation/amortization	0	0	0	0	0
Net working capital	2,335	17	3,891	3,259	5,036
<b>Investing cash flow</b>	<b>-13,190</b>	<b>-8,738</b>	<b>-13,299</b>	<b>-14,475</b>	<b>-18,836</b>
Capital expenditure	0	0	0	0	0
Acquisitions/disposals	-13,190	-8,738	-13,299	-14,475	-18,836
<b>Financing cash flow</b>	<b>-3,088</b>	<b>-4,348</b>	<b>-4,384</b>	<b>-4,845</b>	<b>-4,966</b>
Borrowings	2,402	2,932	2,639	3,035	3,491
Dividends paid	-4,615	-4,735	-5,191	-5,768	-6,345
<b>Change in cash</b>	<b>-2,927</b>	<b>-698</b>	<b>-246</b>	<b>-732</b>	<b>-1,159</b>
<b>Balance Sheet (RsM)</b>					
<b>Total assets</b>	<b>98,689</b>	<b>112,711</b>	<b>130,919</b>	<b>150,387</b>	<b>172,605</b>
Cash & cash equivalent	821	1,000	1,200	1,400	1,400
Accounts receivable	3,016	3,788	4,200	4,740	5,397
Net fixed assets	11,558	13,656	15,498	17,255	18,783
<b>Total liabilities</b>	<b>50,995</b>	<b>57,517</b>	<b>67,372</b>	<b>77,279</b>	<b>88,238</b>
Accounts payable	11,802	13,416	14,913	16,784	18,983
Total Debt	14,672	17,604	20,243	23,279	26,769
<b>Shareholders' funds</b>	<b>47,707</b>	<b>55,343</b>	<b>63,697</b>	<b>73,258</b>	<b>84,518</b>
<b>Profitability/Solvency Ratios (%)</b>					
EBITDA margin adjusted	12.9	11.0	10.7	11.1	11.9
ROE adjusted	25.1	24.0	22.8	22.4	22.3
ROIC adjusted	80.4	110.5	120.2	nm	na
Net debt to equity	29.0	30.0	29.9	29.9	30.0
Total debt to capital	23.5	24.1	24.1	24.1	24.1

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## Deconstructing the Demerger

Bajaj's management announced today that it will demerge Bajaj Auto into 3 businesses –

- 1) Bajaj Auto Ltd. – which will have the auto businesses (2 and 3 wheelers and new initiatives in 4 wheelers) and Rs15bn in cash. This business will be headed by Mr Rajiv Bajaj
- 2) Bajaj Finserve Ltd. – which will hold the windpower projects, investments in the insurance ventures, investment in Bajaj Auto Finance and Rs8bn in cash. This business will be headed by Mr Sanjiv Bajaj
- 3) Bajaj Holdings and Investment Ltd (BHIL) – The current Bajaj Auto Limited will be renamed Bajaj Holdings and Investments Ltd. This business will hold the residual cash of around Rs41.7bn, and the investment in ICICI. BHIL will look to deploy its idle cash in other prospective business opportunities. *In addition, it will hold 30% stake in both Bajaj Auto and Bajaj Finserve. BHIL will subscribe to around 43.5m shares at par value in both the new Bajaj Auto and Bajaj Finserve. After the issue of the new shares, the existing shareholders will hold 70% in the new operating entities, whilst BHIL will hold the remainder.*

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### Figure 1. Bajaj Auto – Capital Structures Pre and Post Demerger

#### Current capital structure

Bajaj Auto Ltd (101.18 m shares of Rs10 each)

#### Capital structures post demerger

Bajaj Holdings and Investments Ltd (the erstwhile Bajaj Auto) - 101.18 m shares of Rs10 each

Bajaj Auto Ltd (the new auto company) - 144.68 m shares of Rs10 each - Bajaj Holdings will subscribe to the incremental 43.5m shares, taking its overall stake to around 30%

Bajaj Finserve Ltd - 144.68m shares of Rs5 each - Bajaj Holdings will subscribe to the incremental 43.5m shares, taking its overall stake to around 30%

Source: Bajaj Auto

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### Implications of the demerger agreement in its current form:

- 1) A shareholder who holds 1 share in Bajaj Auto currently will get 1 share in each of the 3 entities mentioned above. All 3 of these entities will be listed separately by Dec 2007, once the requisite regulatory, statutory and corporate approvals are obtained.
- 2) In a vertical demerger, without a holding company structure, a current shareholder of Bajaj Auto would have got 1 share of the auto business and 1 share of the financial services business. But in the current scenario, this shareholder gets access to only 70% in both these companies (because 30% of the capital is subscribed to by BHIL). In addition, the current shareholder gets 1 share of BHIL, which gives him the right to the additional 30% in both these businesses (albeit indirectly)

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- 3) BHIL will be a listed holding company – but by virtue of its being a holding company, it will in all probability trade at a discount to its underlying NAV – implying that the demerger in its current form would not result in the value creation that a vertical demerger might have.

Bajaj Auto's management contends that this structure was evolved to ensure that the transfer of businesses occurred with minimal tax implications, and also to ensure that the holding company (BHIL) effects control over both Bajaj Finserv and Bajaj Auto (the auto business).

We believe that this convoluted structure could create an overhang on Bajaj Auto's stock price over the near term.

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## Salient Features of the shareholding agreement between Bajaj Auto and Allianz

### Bajaj Allianz Life Insurance:

- 1) Allianz has a call option (exercisable till July 30, 2016) to increase its shareholding in Bajaj Allianz Life Insurance from 26% (current stake) to 74% at a price of Rs5.42 / share, compounded annually at 16% pa from 31 July 2001. *This translates into a current effective price of Rs9 / share of Bajaj Auto for the 48% stake of Bajaj Auto in Bajaj Allianz life insurance business.* The long term economic value that can thus be attributed to Bajaj Auto is effectively only 26% of Bajaj Allianz Life Insurance (not the 50% as was being earlier attributed).
- 2) The call option can be exercised upto 74%, subject to receiving the various regulatory and statutory approvals, and also assuming that 74% FDI is permitted within the insurance sector.
- 3) After July 30, 2016, the call is exercised at a value which is the highest of the prevailing market price, the above – mentioned formula, and a fair value determined by a mutually accepted accounting form (if the insurance company is not listed).

**Figure 2. Insurance Ventures Computations**

	Value (Rs m)	Comment
Value of Life Insurance Venture	126,721	Valued at Average of Appraisal Method & 20X FY08E First Year Premiums
Value of Non-Life Venture	9,556	Present Value of Long Term Profit; Effective multiple 15X
Total Insurance Value	136,277	
Share of Bajaj Auto (at 50%)	68,139	
Share of Bajaj Auto (at 26% in the life insurance, 50% in the general insurance)	37,726	
Number of shares (Bajaj Auto)	101	
<b>Value per share (current)</b>	<b>373+15.6</b>	<b>(our value of Rs388 / share also incorporates the value attributable to Bajaj Auto for 48% stake in Bajaj Allianz Life and 24% in Bajaj Allianz General valued at the nominal option – methodology determined price)</b>
<b>Value per share (without the call option)</b>	<b>673</b>	

Source: Citigroup Investment Research

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## Earnings Revisions

Figure 3. Revision in Key Metrics

	FY08E	FY09E	CIR Comments
<b>Volumes</b>			
<b>2 Wheelers</b>			
Old	3,129,285	3,621,205	
New	2,664,610	2,984,364	Forecast low double digit volume growth on industry slowdown
% Change Y/Y	11.0	12.0	
<b>3 Wheelers</b>			
Old	365,973	419,556	
New	332,484	362,028	
% Change Y/Y	3.3	8.9	
<b>Net Revenues</b>			
Old	119,363	141,241	
New	103,762	117,109	Forecast nominal improvements in realizations- escalating discounts to maintain market share
% Change Y/Y	11.3	12.9	
<b>EBITDA Margin (%)</b>			
Old	14.7	14.6	
New	12.8	13.0	Margin pressure to continue due to material cost pressures and high promotional spends
<b>EPS (Rs)</b>			
Old	150.7	173.1	
New	133.9	151.5	
% Change Y/Y	6.4	13.2	

Source: Citigroup Investment Research estimates

## 4QFY07 Results

Figure 4. 4QFY07-Operational Results

Product	4Q FY06	4Q FY07	% Chg	CIR comments
2 wheelers	546,558	543,789	(1)	Decline partly reflects correction in inventory levels – BJAT dealer inventory down to 19 days
3 wheelers	72,638	84,598	16	Exports doubled leading to a strong growth
<b>Total</b>	<b>619,196</b>	<b>628,387</b>	<b>2</b>	
<b>Product mix (%)</b>				
2 wheelers	88.3	86.5		
3 wheelers	11.7	13.5		Richer mix led to improvement in realizations
<b>Market share (%)</b>				
Motorcycles	32.6	31.0		Loses share to Hero Honda on back of new model launches
2 wheelers	27.5	25.9		
3 wheelers	57.6	58.7		

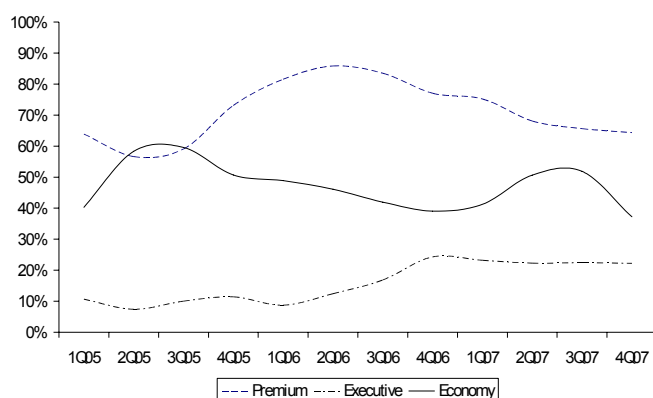
Source: Citigroup Investment Research

Figure 5. 4QFY07- Financial Results

(INR m)	4Q FY06	4Q FY07	% Chg	CIR comments
Gross Sales	24,738	26,271	6	Richer product mix as share of three wheelers increased.
Less: Excise duty	3,079	3,135	2	Lower than estimated due to excise benefits
<b>Net sales</b>	<b>21,659</b>	<b>23,136</b>	<b>7</b>	
Decrease/(Increase) in Stocks	(430)	(237)	(45)	
Raw Materials	15,291	17,155	12	Input cost pressures continue
Staff costs	682	688	1	In line with our forecasts
Other Expenses	1,930	2,407	25	Higher promotional expenses due to World Cup
Expenditure capitalised	(64)	(141)	121	
Total Expenditure	17,409	19,873	14	
<b>EBITDA</b>	<b>4,250</b>	<b>3,263</b>	<b>(23)</b>	Margin 40bps lower than our expectations due to higher material and promotional expenses
Interest	1	24		Reflects impact of higher working capital requirements
Other income	1,031	1,577	53	In line with our estimate
EBDT	5,280	4,816	(9)	
Depreciation	468	458	(2)	
PBT	4,694	4,234	(10)	
Exceptionals	119	124	5	
Tax	1,224	1,151	(6)	
PAT	3,470	3,083	(11)	
<b>PAT (pre exceptionals)</b>	<b>3,470</b>	<b>3,083</b>	<b>(11)</b>	Higher than estimates, but driven by lower tax provisioning, higher other income
<b>Profit Margins</b>				
OPM (%) (Net sales)	19.6	14.1		Margins -10bps QoQ; stabilizing at current levels
EBIT (%)	19.5	16.7		
Pre tax margins (%)	19.0	16.1		
Tax / PBT (%)	25.4	26.4		
Net profit margins (%)	14.0	11.7		
<b>Cost ratios</b>				
Raw materials / sales	60.1	64.4		
Staff costs / sales	2.8	2.6		
Other expenses / sales	7.5	8.6		

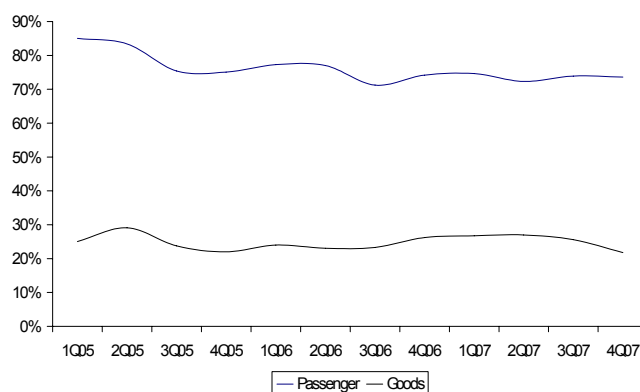
Source: Citigroup Investment Research

Figure 6. Bajaj Auto-Motorcycle Segment Market Share (%)



Source: Cris Infac

Figure 7. Bajaj Auto-Three Wheeler Market Share (%)



Source: SIAM

## Bajaj Auto

### Company description

Bajaj Auto (BAL) is India's leading manufacturer of two- and three-wheelers. Its product range includes scooters, motorcycles and three-wheelers. The company holds a 74% stake in a life and general insurance company.

### Investment thesis

We rate Bajaj Auto as Hold/Low Risk (2L) with a target price of Rs2,600. We believe that the stock at current valuations of 17x FY09E earnings amply reflects lower growth rates in the core auto business and lower valuation of the insurance business. Whilst the availability of financing and the lack of adequate public transportation remain structural growth drivers, escalating competitive pressures and rising input costs are key concerns. Over the past three years, Bajaj has realigned its 2-Wheeler product mix in line with market preference for motorcycles and has benefited; its market share in the motorcycles sector has risen from 24% (in FY03) to around 34% in FY07. But we expect competitive pressures to remain intense, and likely increase in the 2-Wheeler space. Our estimates also reflect the sedate growth prospects for the 3-wheeler sector. Moreover, this segment is also being targeted by CV majors such as Tata Motors and M&M, who have developed, or are developing, small light trucks that will affect the 3-wheeler market in the longer term.

### Valuation

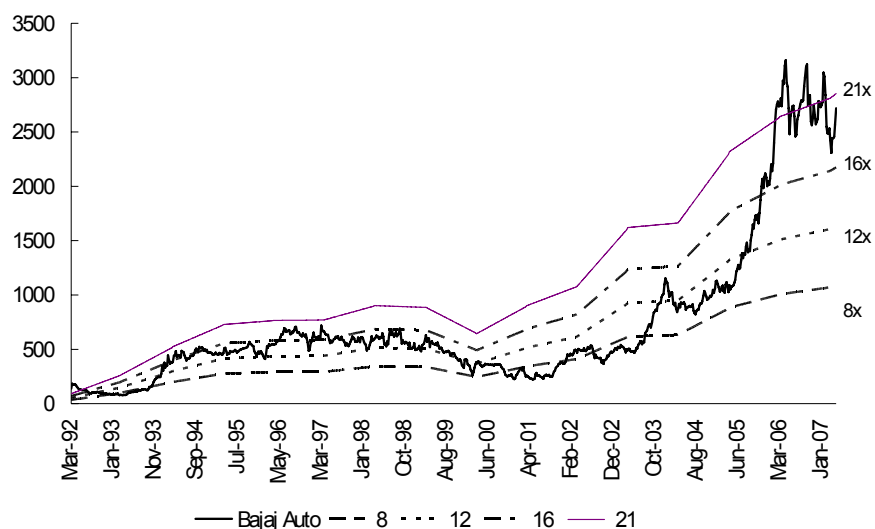
Our target price of Rs2,600 is based on a sum-of-the-parts valuation that comprises: a) valuing 12-month forward earnings from operations (ex-financial income) of Rs118.6 for FY09E at 13x (marginally above peer Hero Honda, but merited given the company's higher earnings growth prospects). We thus arrive at a value of Rs1,542/share. Over the past year, the one-year forward P/E multiple (after stripping the value of the insurance business) has ranged from 13-21x with a mean of 17x. Our multiple of 13x is at a discount to this mean, but we think it is justified given rising competitive intensity in the industry with



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players focusing on market share at the expense of margins. A 14% CAGR in core earnings for FY07-10E should support these valuations, in our view. b) Estimated cash and investments per share of Rs670. c) We value Bajaj Auto's insurance joint ventures at Rs388/share. At our target price, the stock would trade at 17x FY09E EPS, at the lower end of its recent trading band.

Figure 8. Bajaj Auto-PE Band Chart



Source: Citigroup Investment Research

## Risks

We rate Bajaj Auto Low Risk based on our quantitative risk rating system, which tracks 260-day historical share price volatility. The key risk to Bajaj is a slowdown in sales and erosion in margins on any deterioration in macroeconomic variables (including growth, interest rates and fuel prices) or increase in competitive pressures. Competitive pressures in the 2-wheeler industry remain high and could likely accentuate given the aggressive product pipelines of key players. This, coupled with the rising trend in input costs, could mute margin expansion. Success in 3-wheelers is critical as it is the most profitable segment for the company and is a source of substantial cash flows. The predictability in this business remains relatively difficult, as performance is dependent on issuance of licenses by various government bodies. Upside risks include stronger-than-expected volume growth or a decline in material costs on a sustainable basis that would benefit margins. If any of these risk factors have a greater impact than we anticipate, Bajaj Auto's share price will likely have difficulty attaining our target price.

## Appendix A-1

### Analyst Certification

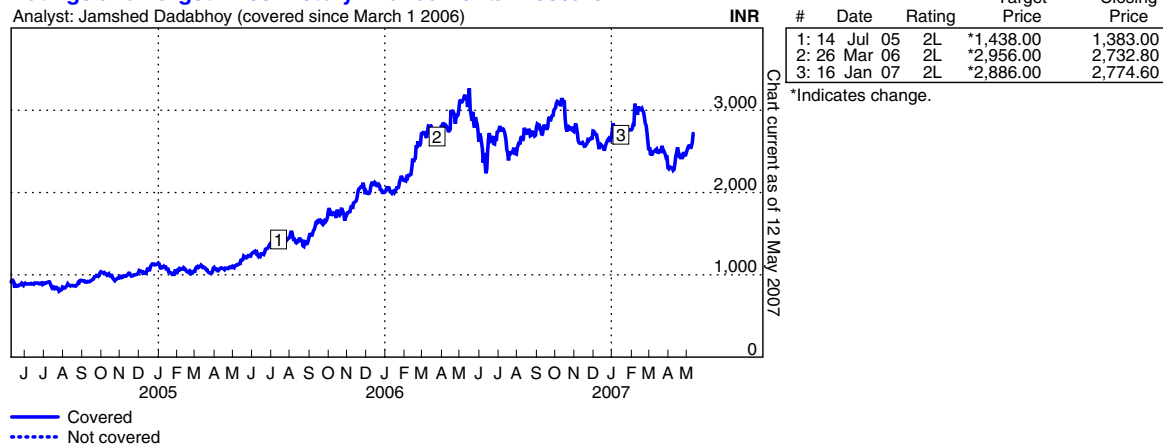
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#### Bajaj Auto (BJAT.BO)

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Analyst: Jamshed Dadabhoy (covered since March 1 2006)



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