

## BAJAJ AUTO

INR 2,248

*Shocking options*

REDUCE

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Bajaj Auto (BAL) announced its plan to demerge its financial assets from the automotive business, along with its Q4 and FY07 results. It also provided details of the arrangement it has with Allianz regarding transfer of its stake in the life and general insurance ventures.

Given that the options provide for Allianz to acquire Bajaj Auto's stake in the two joint ventures at a nominal price, the valuations assigned to these businesses need to be revised significantly downwards. We have valued these ventures considering an effective 26% stake in the life insurance venture and an effective 50% stake in the general insurance venture. On this basis, we estimate the value of Bajaj Auto's holdings in the life and general insurance businesses at INR 446 and INR 114 per share, respectively.

We believe the demerger structure is effectively value-neutral as a large chunk of the surplus funds will remain with the holding company and continue to be deployed in liquid investments (market value of INR 63 bn). The management intends to make these funds available to the two demerged companies (primarily the financial services business in our view) for their strategic needs, such as for pursuing large acquisitions or new business opportunities, on arm's length basis, as well as to pursue new businesses for the holding company. Till such time as the funds are put to productive use, the holding company will continue to attract a significant discount to its underlying value.

While we remain non-consensually positive on the outlook of the core business, both on volume and margin fronts, at current price, the stock is fairly priced given the significant reduction in our estimate of the value of the company's insurance holdings. As a result, we are downgrading our recommendation on the stock to 'REDUCE' from 'BUY'. We will review our recommendation on a further decline in the price.

### Highlights

- Higher-than-expected results in Q4FY07 propped up by product mix  
Net sales in Q4FY07 were at INR 23.14 bn, up 6.8% Y-o-Y. This was driven by a 1.0 % Y-o-Y increase in volumes and a 5.8% increase in realizations. Average realizations increased 6.3% Q-o-Q reflecting improved product mix in favour of *Pulsar* at the expense of *Platina*. EBITDA margins were 10bps lower Q-o-Q, in line with our estimates, though down 540bps Y-o-Y. Adjusted net profit declined nearly 10% Q-o-Q (4% down Y-o-Y) primarily on lower revenues. We find the arrest of the decline in margins an encouraging sign from the standpoint of the core business, and expect margins to improve going forward.

### Financials

Year to March	Q4FY07	Q4FY07	Y-o-Y (%)	Q3FY07	Q-o-Q (%)	FY07E	FY08E
Net revenues (INR mn)	23,136	21,659	6.8	25,682	(9.9)	95,204	110,235
EBITDA (INR mn)	3,263	4,250	(23.2)	3,636	(10.3)	14,158	16,558
Net profit (INR mn)	3,208	3,336	(3.9)	3,571	(10.2)	12,857	14,436
EPS (INR)	31.7	33.0	(3.9)	35.3	(10.2)	127.0	145.6
P/E (x)						17.7	15.4
EV/EBITDA (x)						13.6	11.7
ROE (%)						23.2	23.0

May 21, 2007

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Reuters : BJAT.BO  
Bloomberg : BJA IN

### Market Data

52-week range (INR) : 3,325 / 2,085  
Share in issue (mn) : 101.2  
M cap (INR bn/USD mn) : 227.5 / 5,577.6  
Avg. Daily Vol. BSE/NSE ('000) : 308.4

### Share Holding Pattern (%)

Promoters : 29.9  
MFs, Fls & Banks : 7.6  
Fls : 19.5  
Others : 43.1

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\* **Update on insurance joint ventures: Option with Allianz**

Bajaj Auto disclosed that at the time of incorporation in 2001 of its two insurance joint ventures with Allianz SE—Bajaj Allianz Life Insurance Company and Bajaj Allianz General Insurance Company—it had given an option to Allianz to increase its equity holding in the ventures from the initial and current 26% up to a pre-specified limit subject to government regulations. Both the options run till 2016.

- In the life insurance venture, Allianz can increase its stake to 74% at a price of INR 5.42 per share (of Bajaj Allianz Life Insurance Company) plus interest compounded at the rate of 16% p.a. from 2001 till the date of exercise of the option. The current paid up capital of the life insurance company is around INR 1.6 bn.
- In the general insurance venture, the option can be exercised up to 50% stake, at a price of INR 10 per share, plus 16% compounded annual interest. The current paid up capital of the general insurance company is around INR 1.1 bn.

In our estimate, Bajaj Auto will realize INR 1.9 bn if Allianz exercised both the options in 2007. We believe that while the government is likely to raise the FDI limit in insurance to 49% in the near future (a bill to that effect is making its way through Parliament), further raising the limit to 74% could be a few years away. However, since Allianz's options run through 2016, we have valued Bajaj Auto's economic interest in the insurance ventures conservatively as if Allianz will exercise the option.

\* **Demerger plan**

Bajaj Auto also announced the long awaited plan to demerge its automotive business and investment portfolio in a three-way split. While a large chunk of the investment portfolio (INR 63 bn at market value, INR 41 bn book value) will remain with a holding company (Bajaj Holdings and Investment), the automotive business will be hived off into a separate company (to be eventually called Bajaj Auto). The insurance venture holdings along with the wind farm investments and the holding in Bajaj Auto Finance will be hived off into another company called Bajaj Finserv. Bajaj Auto will get INR 15 bn from the investment portfolio, largely in cash and equivalents, and Bajaj Finserv will get INR 8 bn.

Investors will get one share of Bajaj Holdings and Investment, Bajaj Auto, and Bajaj Finserv each for each share held in Bajaj Auto. However, we are concerned about the additional issue of capital by the demerged companies, and the fact that some of the holding of minority shareholders in the demerged companies will now be held indirectly through the holding company, thereby attracting valuation discounts.

While Bajaj Auto will continue to focus on the automotive business (comprising two wheelers, three wheelers, and later four wheelers), Bajaj Finserv will be a holding company for the investments in the financial services business and pursue new business opportunities, possibly in asset management and banking. However, the management does not expect any significant activity in Bajaj Finserv for the next 18-24 months.

The investment and cash pool of Bajaj Holdings and Investment will be available to Bajaj Auto and Bajaj Finserv on arm's length basis, for any strategic needs such as acquisitions and overseas expansion. We believe that this pool may at some stage be also used for buying back its own shares as well as that of the two demerged companies. Bajaj Holdings will also likely pursue new business opportunities of its own. Bajaj Holdings will also hold a 30% stake each in Bajaj Auto and Bajaj Finserv, through a fresh issue of shares by the two companies.

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The management expects the process of demerger and the listing of all the three companies to be completed by December 2007. We believe, barring delays in court approvals, the process could be completed as early as October-November.

**Table 1: Bajaj Auto demerger**

	Business	# of shares (mn)	Promoter holding	Shareholding distribution	Valuation (INR bn)	Expected post listing price (INR)	Remark
Bajaj Holdings and Investment	Investment holdings in BAL, BFL, ICICI Bank, other liquids	101.2	30.0	Existing BAL shareholders	135.1	1,002	At 25% discount to underlying net asset value
Bajaj Auto	2W, 3W, 4W, holdings in auto ancillaries	144.68	21.0	30% by BHIL, 70% by existing shareholders	167.9	1,161	12.5x FY09E core automotive profit and investments transferred
Bajaj Finserv	Wind energy, holdings in life and general insurance JVs and Bajaj Auto Finance	144.7	21.0	30% by BHIL, 70% by existing shareholders	70.9	367	Insurance JV valuation includes effective stake and price of option one-year forward; 25% discount to fair value
<b>Total</b>						<b>2,530</b>	

Source: Edelweiss research

We believe the demerger is largely value neutral as the large investment pool continues to be within a holding company with no near-term visibility on productive deployment, and therefore, attracting significant valuation discounts.

#### \* Valuations

While our sum-of-the-parts valuation for Bajaj Auto is INR 2,526 per share, we are downgrading our recommendation on the stock to '**REDUCE**' from '**BUY**' on account of concerns on the structure of the demerger, lack of visibility on the productive utilisation of investible surplus, substantial reduction in the valuations of insurance holdings, and muted outlook for the core business in the near term. We will review our recommendation on a further decline in the stock price.

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Table 2: Bajaj Auto demerger

	# of shares (mn)/ Effective economic interest (%)	BV (INR mn)	Price/Multiple	Value (INR mn)	Value to Bajaj (INR mn)	Value/share of BAL
<b>Bajaj Auto</b>						
Core automotive business			12.5x FY09E		156,674	1,548
Investments transferred					15,000	148
<b>Bajaj Finserv</b>						
Bajaj Auto Finance	6.6	661	425.4		2,806	28
Bajaj Allianz Life Insurance	<b>26.0</b>	1,112		171,800	4,466,800	44146
Bajaj Allianz General Insurance	<b>50.0</b>	814		22,700	1,135,000	11217
Price of Allianz option					1,923	19
Wind energy project		2,840		2,130	2,130	21
Investments transferred		800		800	8,000	79
<b>Bajaj Holdings and Investments</b>						
ICICI Bank	37.0	11,293	939.9		34,808	344
Book value of other investment					41,691	412

Source: Edelweiss research

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(INR mn)

Financials snapshot								
Year to March	Q4FY07	Q4FY06	Y-o-Y%	Q3FY07	Q-o-Q%	FY06	FY07E	FY08E
Volumes								
Motorcycles	532,864	533,018	(0.0)	652,406	(18.3)	1,912,306	2,376,518	2,614,170
Scooters-gearred	0	7,531	(100.0)	0	-	63,384	0	0
Scooters-ungeared	7,895	6,009	31.4	173	4,463.6	52,611	22,882	57,205
Stepthrus	0	0	-	0	-	864	0	0
Total 2 wheelers	540,759	546,558	(1.1)	652,579	(17.1)	2,029,165	2,399,400	2,671,375
Three wheelers	84,598	72,638	16.5	85,640	(1.2)	252,054	321,778	350,738
Total units sold (nos)	625,357	619,196	1.0	738,219	(15.3)	2,281,219	2,721,178	3,022,113
Exports( of the above)	113,684	73,403	54.9	115,619	(1.7)	250,204	442,411	619,375
Realisation (INR)	36,996	34,979	5.8	34,790	6.3	33,613	34,986	36,476
Revenues (gross)	26,271	24,738	-	29,267	-	87,484	108,343	121,895
Less: Excise	3,135	3,079	-	3,585	-	10,805	13,139	12,495
Revenues (net)	23,136	21,659	6.8	25,682	(9.9)	76,679	95,204	110,235
Total revenues	23,136	21,659	6.8	25,682	(9.9)	76,679	95,204	110,235
Dec/(inc) in stock	(237)	-430	-	(47)	-	(490)	9	
Raw material	17,155	15,291	12.2	18,903	(9.2)	53,736	69,001	80,470
Staff costs	688	682	1.0	757	(9.1)	2,741	3,027	3,300
Other expenses	2,407	1,930	24.7	2,492	(3.4)	7,377	9,330	10,276
Expenses capitalised	(141)	-64	-	(59)	-	-248	(321)	-368.575
Total expenditure	19,873	17,409	14.2	22,046	(9.9)	63,116	81,046	93,677
EBITDA	3,263	4,250	(23.2)	3,636	(10.3)	13,563	14,158	16,558
Interest	24	1	3,883.3	2	986.4	3	53.4	18
Depreciation	458	468	(2.1)	472	(3.1)	1,910	1,903	2,254
Other income	1,577	1,031	53.0	1,610	(2.0)	4,385	5,556	6,040
PBT	4,358	4,813	(9.4)	4,771	(8.7)	16,034	17,758	20,326
Tax	1,151	1,476	(22.0)	1,200	(4.1)	4,791	4,901	5,590
Adj. net profit	3,208	3,336	(3.9)	3,571	(10.2)	11,243	12,857	14,736
prior period items/ write-	125	-133	(193.5)	120	4.4	10	487	-300
Net profit	3,083	3,470	(11.2)	3,452	(10.7)	11,233	12,371	15,036
Equity capital (FV INR 10)	1,012	1,012	0.0	1,012	-	1,012	1,012	1,013
Number of shares (mn)	101	101	0.0	101	-	101	101	101
Adj. EPS (INR)	31.7	33.0	(3.9)	35.3	(10.2)	111.1	127.0	145.5
EPS	30.5	34.3	(11.2)	34.1	(10.7)	111.0	122.2	148.4
P/E (x)						20.3	18.4	15.1
EV/EBITDA (x)						22.1	21.6	19.1
<b>As % of net revenues</b>								
Raw material	73.1	68.6		73.4		69.4	72.5	73.0
Staff costs	3.0	3.1		2.9		3.6	3.2	3.0
Other expenses	9.8	8.6		9.5		9.6	9.8	9.3
EBITDA	14.1	19.6		14.2		17.7	14.9	15.0
Adj. net profit	13.9	15.4		13.9		14.7	13.5	13.4
Adj. net profit	26.4	30.7		25.1		29.9	27.6	27.5

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## Company Description

Bajaj Auto Ltd. is the second-largest two-wheeler manufacturer in India with a market share of 35%. It offers products in all motorcycle segments—*Platina* (entry), *Discover* (executive), and *Pulsar* (premium). It is also the largest three-wheeler manufacturer in India. In addition, it has presence in the life and general insurance businesses in joint venture with Allianz SE, in which it has 74% stake each.

## Investment Theme

We have a positive stance on Bajaj Auto's core automotive business on back of visibility on strong volume growth, both in domestic and export markets. It has a wide product portfolio and new model line up based on its in-house research and development capability. We expect margins to remain stable to improving slightly over the next two years. However, the announced demerger plan does little to unlock value of its investment portfolio. Also, valuations of the insurance business have been downgraded significantly on account of the option with Allianz to raise its stake cheaply.

## Key Risks

Increasing input costs and higher selling costs due to intense competition can continue to keep margins under pressure. Further, given a slew of new model introductions planned over the next few quarters, non-performance of one or more key models could affect volume growth.

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## Financial Statements

Income statement					(INR mn)
Year to March	FY05	FY06	FY07E	FY08E	FY09E
Total volume (nos)	1,824,699	2,281,219	2,721,178	3,022,113	3,477,915
<i>% growth</i>	<i>20.2</i>	<i>25.0</i>	<i>19.3</i>	<i>11.1</i>	<i>15.1</i>
Income from operations	58,878	76,285	94,712	110,235	128,049
Materials costs	40,897	53,246	69,010	80,470	93,745
Stores and tools	630	742	836	985	1,081
Staff costs	2,491	2,741	3,027	3,300	3,665
S G & A expenses	5,945	6,435	8,293	9,291	10,544
Less: Expenses capitalised	198	248	321	369	424
Total operating expenses	49,763	62,917	80,846	93,677	108,612
EBITDA	9,114	13,368	13,866	16,558	19,438
Non-Operational Income	4,101	4,580	5,849	6,040	6,546
PBDIT	13,215	17,947	19,715	22,597	25,983
Interest	7	3	53	18	20
Depreciation and amortisation	1,854	1,910	1,903	2,254	2,481
Profit before tax	11,355	16,034	17,759	20,326	23,482
Prior period adjustments (net)	(18)	217	(104)	-	-
Extraordinary income/ (loss)	(848)	(226)	(386)	(300)	(250)
Provision for tax	3,196	4,791	4,901	5,590	6,105
Adjusted profit after tax	8,158	11,243	12,858	14,736	17,377
Reported profit after tax	7,292	11,234	12,369	14,436	17,127
Shares outstanding	101	101	101	101	101
Dividend per share	28.5	45.6	46.8	57.1	67.7
Dividend payout (%)	35.4	41.0	36.8	39.2	39.4

### Common size metrics- as % of net revenues

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Operating expenses	84.5	82.5	85.4	85.0	84.8
Materials costs	69.5	69.8	72.9	73.0	73.2
Staff costs	4.2	3.6	3.2	3.0	2.9
S G & A expenses	10.1	8.4	8.8	8.4	8.2
Depreciation	3.1	2.5	2.0	2.0	1.9
Interest expenditure	0.0	0.0	0.1	0.0	0.0
EBITDA margins	15.5	17.5	14.6	15.0	15.2
Net profit margins	13.0	13.9	12.8	12.7	12.9

### Growth metrics (%)

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Revenues	20.4	30.5	25.7	16.5	16.2
EBITDA	7.5	46.7	3.7	19.4	17.4
PBT	15.4	41.2	10.8	14.5	15.5
Net profit	8.1	37.8	14.4	14.6	17.9
EPS	8.1	37.8	14.4	14.6	17.9

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<b>Balance sheet</b>						(INR mn)
<b>As on 31st March</b>	<b>FY05</b>	<b>FY06</b>	<b>FY07E</b>	<b>FY08E</b>	<b>FY09E</b>	
Equity capital	1,012	1,012	1,012	1,012	1,012	
Reserves & surplus	40,332	46,696	54,329	62,991	73,267	
Shareholders funds	41,343	47,707	55,341	64,003	74,279	
Unsecured loans	12,270	14,671	16,671	18,671	20,671	
Borrowings	12,270	14,672	16,672	18,672	20,672	
Deferred tax (Net)	1,399	876	876	876	876	
Deferred Tax liability	2,128	1,902	1,902	1,902	1,902	
Deferred Tax Assests	729	1,026	1,026	1,026	1,026	
<b>Sources of funds</b>	<b>55,012</b>	<b>63,255</b>	<b>72,889</b>	<b>83,550</b>	<b>95,827</b>	
Gross block	27,436	28,929	32,671	36,671	39,671	
Depreciation	16,286	17,787	19,690	21,943	24,424	
Net block	11,150	11,142	12,981	14,727	15,246	
Lease adj. account-plant & m/c	175	175	175	175	175	
Capital work in progress	84	242	0	0	0	
Technical know-how	41	13	13	13	13	
Investments	45,606	58,570	63,746	72,481	83,648	
Inventories	2,242	2,729	3,860	4,496	5,226	
Sundry debtors	1,763	3,016	3,088	3,597	4,181	
Cash and bank balance	1,087	821	1,657	1,930	2,243	
Loans and advances	20,120	21,274	21,274	21,274	21,274	
Other current assets	685	721	721	721	721	
Total current assets	25,897	28,561	30,599	32,017	33,646	
Sundry creditors and others	7,851	12,289	10,779	10,977	10,939	
Provisions	20,089	23,159	23,846	24,886	25,962	
Total current liab. & provisions	27,940	35,448	34,625	35,863	36,902	
Net current assets	(2,042)	(6,887)	(4,026)	(3,846)	(3,256)	
<b>Uses of funds</b>	<b>55,012</b>	<b>63,255</b>	<b>72,889</b>	<b>83,550</b>	<b>95,827</b>	
Book value per share (BV) (INR)	409	471	547	633	734	

<b>Cash flow statement</b>						(INR mn)	(INR mn)
<b>Year to March</b>	<b>FY05</b>	<b>FY06</b>	<b>FY07E</b>	<b>FY08E</b>	<b>FY09E</b>		
PBIT	7,471	11,837	12,494	14,862	17,559		
Less: Actual tax paid	3,384	5,186	4,901	5,590	6,105		
Less: Tax shield on interest	2	1	15	5	5		
Add: Tax on int. & invt. income	1,095	1,255	1,468	1,508	1,545		
NOPLAT	5,180	7,906	9,046	10,775	12,993		
Add: Depreciation	1,854	1,910	1,903	2,254	2,481		
Gross cash flow	7,034	9,816	10,949	13,028	15,475		
Less: Capital expenditure	905	2,033	3,500	4,000	3,000		
Less: Working capital investment	(480)	(1,020)	1,022	947	1,353		
Less: Increase in other assets	4,434	1,190	-	-	-		
Add: Inc. in other liab./provisions	3,559	3,058	687	1,040	1,076		
<b>Free cash flow</b>	<b>5,734</b>	<b>10,671</b>	<b>7,115</b>	<b>9,121</b>	<b>12,198</b>		



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**Ratios**

Year to March	FY05	FY06	FY07E	FY08E	FY09E
ROE (%)	19.7	23.6	23.2	23.0	23.4
ROCE (%)	20.7	25.4	24.4	24.3	24.5
Inventory days	14	14	15	15	15
Debtors days	11	11	12	12	12
Fixed asset turnover (x)	2.1	2.6	2.9	3.0	3.2
Debt/Equity	0.3	0.3	0.3	0.3	0.3

**Valuations parameters**

Year to March	FY05	FY06	FY07E	FY08E	FY09E
EPS (INR)	80.6	111.1	127.1	145.6	171.7
<i>Y-o-Y growth (%)</i>	<i>8.1</i>	<i>37.8</i>	<i>14.4</i>	<i>14.6</i>	<i>17.9</i>
CEPS (INR)	98.9	130.0	145.9	167.9	196.3
P/E (x)	27.9	20.2	17.7	15.4	13.1
Price/BV (x)	5.5	4.8	4.1	3.6	3.1
EV/Sales (x)	3.3	2.5	2.0	1.8	1.5
EV/EBITDA (x)	21.2	14.4	13.9	11.7	9.9

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Sunil Jain - 2286 4308	Alternative & Quantitative	Vikrant Oak - 4019 4712
Yogesh Radke - 2286 4328	Alternative & Quantitative	Abhijit Chakraborty - 4019 4823

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### RATING INTERPRETATION

<b>Buy</b>	Expected to appreciate more than 20% over a 12-month period	<b>Reduce</b>	Expected to depreciate up to 10% over a 12-month period
<b>Accumulate</b>	Expected to appreciate up to 20% over a 12-month period	<b>Sell</b>	Expected to depreciate more than 10% over a 12-month period
<b>Trading Buy</b>	Expected to appreciate more than 10% over a 45-day period	<b>Trading Sell</b>	Expected to depreciate more than 10% over a 45-day period

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