Industrials
India Autos

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Two wheelers: Good news not over yet

Why read this report?

- Comprehensive analysis of replacement and first-time buyer demand
- Detailed analysis of comparable emerging markets
- Sensitivity analysis assessing the threat of Honda to incumbent market leaders

Valuation summary

INRm	Hero MotoCorp (HMCL IN) FY12e	FY13e	Bajaj Auto (BJAUT IN) FY12e	FY13e
Net sales	235,360	269,911	191,581	216,828
EBITDA margin	15.6%	16.0%	20.8%	20.9%
EPS (INR)	124.7	153.3	107.4	116.8
PE	17x	14x	15x	14x
Rating	Overweight		Neutral	
Price	2,126.65		1,600.05	
Target price	2,400		1,745	
Upside to TP	12.9%		9.1%	
Dividend yield	4.2%		3.4%	
Potential return	17.1%		12.5%	

Source: HSBC estimates, Bloomberg. Stocks priced on 23 November 2011. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

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- **Our analysis shows healthy demand in the next few years, as penetration remains low with stable cost of ownership**
- **Margins should be stable with a positive bias, driving strong earnings growth**
- **Initiate coverage on HERO with OW (TP INR2,400) and Bajaj with N (TP INR1,745)**

We initiate coverage on the Indian two-wheeler industry with a positive view. Industry growth should moderate but still remain healthy at a c13% CAGR for FY12-14e. Furthermore, we believe the industry is attractive given stable margins with a positive bias, robust cash flows, strong dividend yield and reasonable valuations.

Structural growth drivers intact. Two-wheeler's Indian household penetration is only 30%. In other emerging markets, the sector has shown strong growth until penetration has hit 55-60%. Our analysis of other markets suggests India's two-wheeler sector will not reach these levels for three years. Furthermore, the cost of ownership has remained stable in India, despite a rise in fuel prices in recent quarters. With the falling average age of vehicles, replacement demand might recede in the near term, but it should be well offset by continued strength in rural demand and a strong scooter market.

Prefer HERO over Bajaj. Hero MotoCorp (HERO) seems better placed in FY13/14, due to its higher rural market presence, scooters exposure and stronger margin levers. In addition, it offers an attractive dividend yield. While HERO does face an uphill climb to develop in-house R&D, the results should become visible only after FY13. Bajaj has a similar defensive business, but it looks more vulnerable to moderating sector growth. Its margin upside appears limited as well.

Valuation. On a DCF basis, we value HERO at INR2,400 (OW) and Bajaj at INR1,745 (N), implying a 16x and 15x FY13e PE, respectively. Our FY13e earnings are nearly 10% higher than consensus for HERO and in line for Bajaj. An increase in commodity prices and significant slowdown in demand are the key risks to our investment thesis.

Investment summary

- Our analysis shows healthy two-wheeler demand in next few years, as penetration remains low with stable cost of ownership; industry growth may moderate, but still healthy at 13% CAGR for FY12-14e
- Stable margins with a positive bias, strong cash flow, high dividend yields and reasonable valuations support our view
- We initiate coverage on HERO with OW, and Bajaj with N

We expect a moderation in two-wheeler industry growth to 13% CAGR for FY12-14e from 20% CAGR during FY10-12. In the past few years, the industry has benefitted from a low comparative base, low penetration, high replacement demand, rising rural incomes and stable cost of ownership.

Going forward, growth could slow down from the cycle peak seen in FY10-12 led by lower replacement demand in FY13/14, as the average vehicle age has come down in the past 2 years. But it is unlikely to collapse, primarily due to rural demand and the fact that the market has yet to reach saturation. Also on the positive side, cost of ownership has remained stable, despite higher fuel prices.

Penetration levels are still 2-3 years away from reaching the first level of saturation. Household penetration in India is still only around 30%. In similar emerging countries, we note that sector growth remained robust until penetration reached 55-60%, largely due to cost of ownership trends, which seems favourable for India at this juncture, despite the increase in petrol prices. In the long term, we believe the industry is likely to grow in the higher single digits, as household penetration levels are likely to hit the 60% saturation level in 7-8 years (95-100% for eligible households).

Earnings growth outlook

We expect industry margins to remain stable in the next few years. Specifically, we see stronger margin levers for HERO, as its marketing costs normalise in FY13 and royalty costs continue to decline. Additionally, while R&D prospects remain a risk in the long term, the impact on HERO's margin is likely to be modest in FY13e.

Broadly speaking, we are not factoring any movement in commodity prices into our raw material cost estimates. However, even with the assumption that commodity prices will be constant at the current levels, we expect to see margin contraction in the next two years, beginning with a 75bps decline in FY12 and ending with a more than 100bps decline in FY13. Aluminium, cold-rolled steel, rubber and plastic are the key raw materials and all have seen prices correct from their peaks, but are still higher than the averages for FY11.

An increase in commodity prices is the key downside risk to our earnings estimates in the coming quarters. On the other hand, we are not factoring in any operating leverage into margins as capital expenditure is likely to increase in the next few quarters and there has been no significant improvement in vehicle realisations, which remains a positive risk to our margin forecasts.

Tables 1.1: Margin levers in FY13

HERO Margin levers	FY13e
RM costs	100 bp
Sales and marketing (branding)	40 bp
R&D costs	-50 bp
Increase in production in Haridwar	40 bp
Export investments	-25 bp
Realisation	25 bp
Royalty amortisation	40 bp
Total margin impact	170 bp

Source: HSBC estimates

Bajaj Margin levers	FY13e
Raw material cost impact	100 bp
INR depreciation	75 bp
DEPB withdrawal	-50 bp
Selling and Advertising expenses	-50 bp
Realisation (pricing)	25 bp
Total impact	100 bp

Source: HSBC estimates

Valuations and ratings

We consider both DCF and PE valuation methods (referencing both historical and relative to auto indices levels) to value these companies. While PE is the most followed valuation methodology, we believe long-term trends can only be captured in DCF analysis. Stocks may trade at a premium or discount to DCF depending on what stage of the cycle that the industry is in, but longer-term sustainable growth based on penetration levels and cost of ownership trends can only be reflected in DCF analysis. Our DCF assumptions are summarised in Table 1.2.

Our DCF analysis values HERO at INR2,400 and BAJAJ at INR1,745, implying multiples of 16x and 15x on FY13e EPS, respectively. Historically, HERO has traded in a PE range of 11-20x, with a mean of 15x. The implied valuations are in line with historical averages, as shown in Table 1.3.

We believe, at this stage of the industry cycle, with sales growth off the peak and fiscal benefits tapering off, stocks are unlikely to trade at a significant premium to the PE valuation implied by our DCF analysis. Our implied PE multiple is close to the historical average.

Risks

- **Stronger market share gains by Honda** are the key competitive risks to our estimates. Our estimates assume market share losses by HERO and Bajaj, but a more aggressive launch

Table 1.2: Valuation summary

DCF assumptions	FY12e	FY13e	CAGR FY13-18e	CAGR FY18-25e
HERO				
Total domestic motorcycle market sales growth	13.9%	13.0%	10.7%	6.1%
Market share of HERO in Domestic Motorcycle sales	55.5%	54.7%		
Sales growth rates of HERO	15.7%	12.0%	9.7%	5.9%
EBITDA margins (before the royalty payments to Honda)	15.6%	16.0%		
Terminal growth assumed	5%			
Total PV	482,510			
Value per share	2,400			
Bajaj				
Market share of BAJAJ in Domestic Motorcycle sales	25.8%	25.4%		
Sales growth rates of BAJAJ (including 3W)	15.2%	11.3%	9.4%	5.8%
EBITDA margins	19.9%	20.0%		
Terminal growth assumed	5%			
Total PV	505,438			
Value per share	1,745			

Source: HSBC estimates

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Table 1.3: Past cycle and corresponding valuations

	HERO	BAJAJ
FY05-10		
CAGR Revenue	16.4%	15.2%
CAGR earnings	22.5%	10.3%
Max PE	18.8x	20.2x
Min PE	11.2x	4.9x
Average PE (12-month forward)	14.6x	12.6x
FY10-12		
CAGR Revenue	21.8%	29.5%
CAGR earnings	5.6%	35.2%
Max PE	18.3x	18.3x
Min PE	11.7x	12.6x
Average PE	15.2x	15.1x
FY12-14e		
CAGR Revenue	14.0%	13.1%
CAGR earnings	12.3%	11.6%
Current PE on FY12e EPS	17.1x	14.9x
Current PE on FY13e EPS	13.9x	13.7x
Current EV/EBITDA on FY13e EBITDA	8.6x	9.1x

Source: Company data, HSBC estimates, repriced on 23 Nov

schedule and accelerated investments in capacity expansion may put our assumptions at risk.

- **An increase in commodity prices** is the primary risk to the margin. We assume commodity prices will remain flat at the current rates.
- **Government may announce more fiscal benefits** or extend existing benefits. This could be an upside risk for both Bajaj and HERO.
- **Currency risk** should be watched, with Bajaj exports and HERO's royalty payments prone to USD and yen fluctuations, respectively. A depreciation in the USD and an appreciation in yen are downside risks to our estimates.

How HSBC estimates are different from consensus

HSBC earnings estimates for HERO are 10% above consensus for FY13, led by both higher estimates for top-line growth and EBITDA margins. Our margin assumptions are explained in detail in the Company section. By contrast, for Bajaj, we are broadly in line with the consensus. For details, please refer Table 1.4.

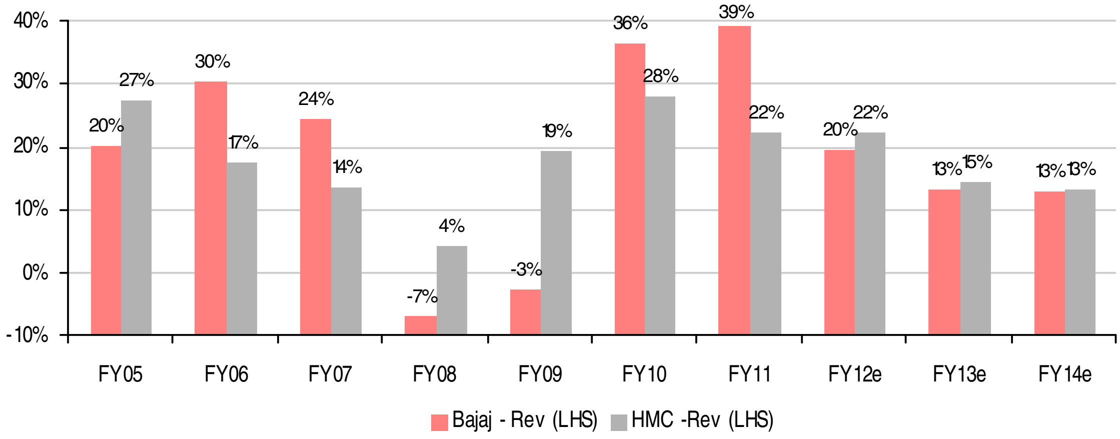
Table 1.4: HSBC vs. consensus

		HSBC		Consensus		Variance	
	FY11	FY12e	FY13e	FY12e	FY13e	FY12e	FY13e
HERO							
Revenue	192,450	235,360	269,911	230,758	262,579	2.0%	2.8%
EBITDA	26,164	36,602	43,186	32,480	37,652	12.7%	14.7%
EBITDA Margin	13.6%	15.6%	16.0%	14.1%	14.3%	148bps	166bps
Net Profit	19,279	24,893	30,622	23,868	27,879	4.3%	9.8%
EPS (INR)	96.5	124.7	153.3	119.2	139.3	4.6%	10.1%
Bajaj							
Net sales	159,981	191,581	216,828	197,594	223,894	-3.0%	-3.2%
EBITDA	33,849	39,863	45,263	38,323	41,927	4.0%	8.0%
EBITDA Margin	21.2%	20.8%	20.9%	19.4%	18.7%	141bps	215bps
Net Profit	33,397	31,065	33,805	30,928	33,846	0.4%	-0.1%
EPS (INR)	115.4	107.4	116.8	106.9	117.0	0.4%	-0.1%

Source: DataStream, Bloomberg, Company data, HSBC estimates

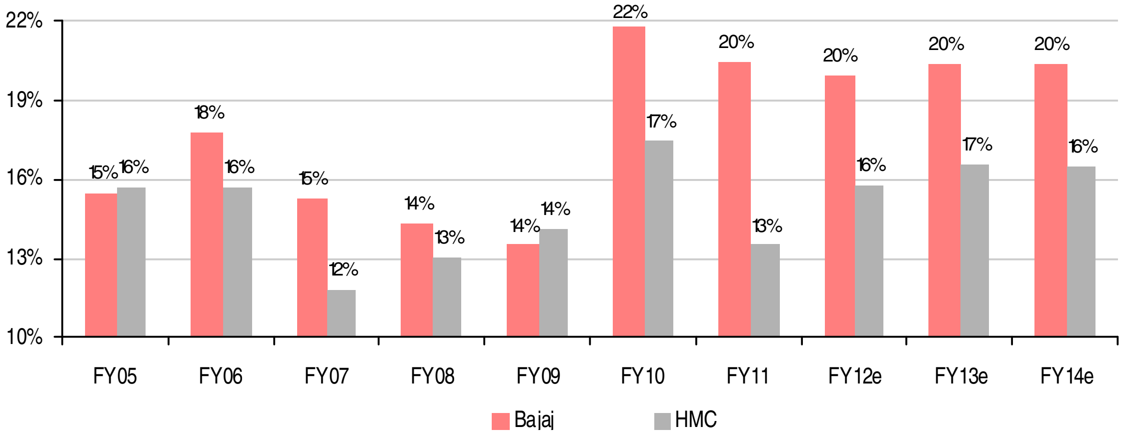
Sector at a glance I

Chart1.1: Sales and revenue growth forecasts (y-o-y)



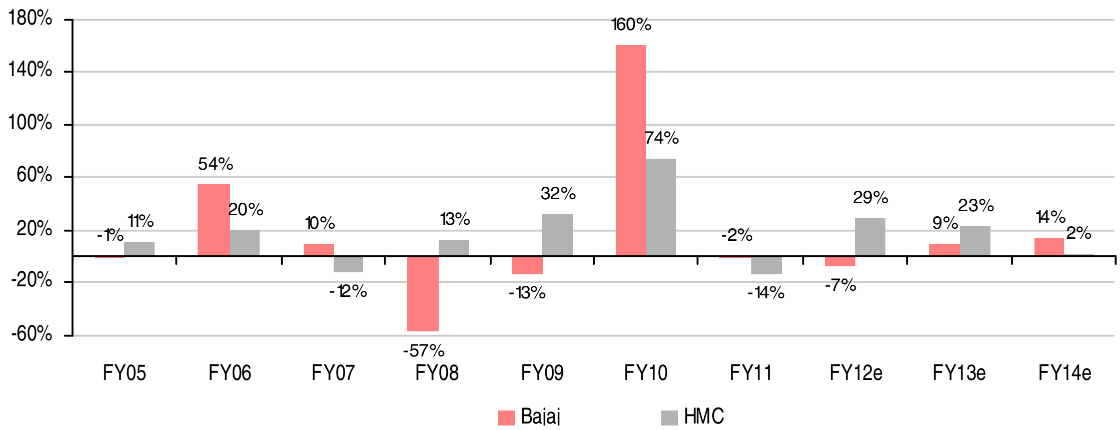
Source: Company data, HSBC estimate

Chart 1.2: EBITDA margin forecasts



Source: Company data, HSBC estimates. The above HERO estimates do not include the royalty costs.

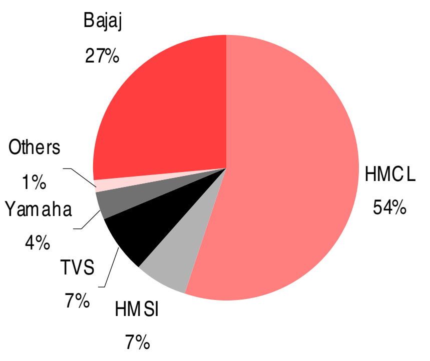
Chart 1.3: Earnings (EPS) growth forecasts



Source: Company data, HSBC estimate

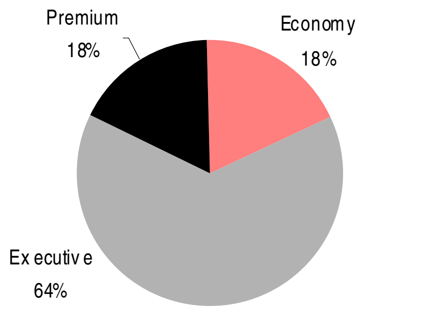
Sector at a glance II

Chart 1.4: Motorcycle market share



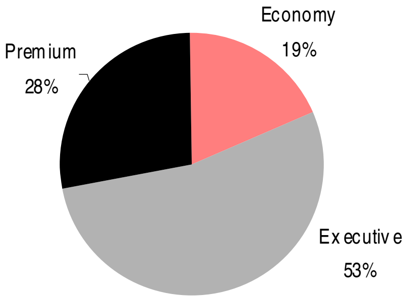
Source: SIAM, HSBC

Chart 1.5: Motorcycle segment share in domestic market



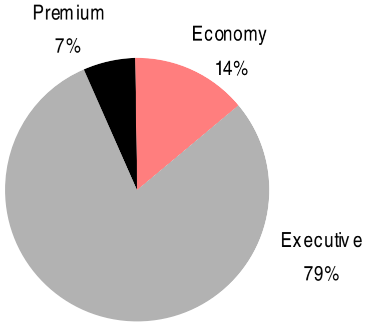
Source: Crisil, SIAM, HSBC

Chart 1.6: Bajaj segment analysis



Source: Crisil, SIAM, HSBC

Chart 1.7: HERO segment analysis



Source: Crisil, SIAM, HSBC]

Industry analysis

- As replacement demand recedes, industry growth may moderate, but still be healthy at 13% CAGR for FY12-14e vs. 20% in FY10-12
- Our analysis shows demand will remain robust in next few years, as penetration levels remain low with stable cost of ownership
- Honda may take a larger share of the pie, but is unlikely to dethrone the incumbents

Growth to moderate not collapse

We expect a moderation in two-wheeler industry growth to 13% CAGR for FY12-14e from 20% CAGR during FY10-12. In the past few years, the industry has benefitted from low penetration, high replacement demand, rising rural incomes and stable cost of ownership.

Going forward, growth could slow down from the cycle peak seen in FY10-12 led by lower replacement demand in FY13/14, as the average vehicle age has come down in the past 2 years.

Replacement demand is likely to recede in FY13, as the pent-up demand from weaker years of FY08-09 has been met in the past 2 years. The average age of a two-wheeler has again declined to 4.6 years (down nearly 3 months from FY10) and the percentage of two wheelers under 5 years is near 45% (the peak of the last decade).

But demand is unlikely to collapse, primarily due to rural demand and the fact that the market still has 2-3 years to go to reach saturation. In addition, the cost of ownership has remained stable, despite higher fuel prices.

Household penetration in India is still near 30%. Historically, sector growth in similar emerging countries has remained robust until penetration crossed 55-60%, largely driven by cost of ownership trends.

On a long-term basis, we believe the industry is likely to grow in the higher single digits, as there is a long way for household penetration to go before it hits the 60% saturation level – likely in 7-8 years (95-100% for eligible households) – versus the current 30% level. Till these saturation levels are hit, the cost of ownership (which seems favourable at this juncture despite the increase in petrol prices) will be largely influenced by the sales pattern. Beyond that, sales growth is likely to be highly volatile and cyclical.

Competitive intensity

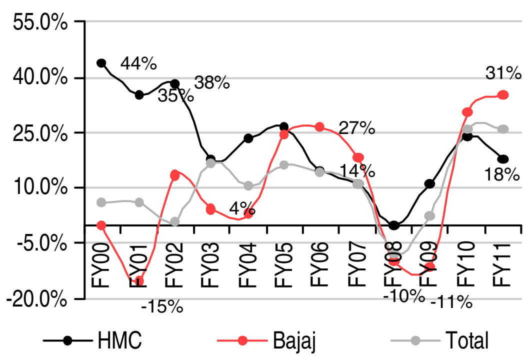
Honda Motorcycle & Scooter India's (Honda) split from HERO and its aggressive growth plans in India are the key competitive risks to the incumbent market leaders, HERO and Bajaj.
In the Competitive Threats section on page 14, we evaluate the threat of Honda. There are three parts to this story:

- While Honda may take incremental share from the incumbents, it is unlikely to dethrone them. Bajaj seems more vulnerable than HERO at this stage.
- While HERO is widely believed to be the most vulnerable, we disagree with this view. A low reliance on exports, strong presence in scooters and heavier exposure to rural India make HERO more resilient to new competition, in our view.
- Our study of other emerging countries with high two-wheeler usage suggests that it is rare for any new player to dethrone the incumbents, even if the challenger is as creditable as Honda.

Two-wheeler sales outlook

The two-wheeler industry has grown strongly in the past few years, at a CAGR of 20% over FY09-11. Even in FY12, notwithstanding a high base, the industry is expected to grow near 15% y-o-y.

Chart 2.1: Last 10 years 2W sales



Source: SIAM, HMC, Bajaj

We believe there are multiple structural drivers that have fuelled the growth of the industry in the past few years. These include:

Favourable economics

Two-wheelers are the most economical mode of transport for a burgeoning urban middle class and rural India. In urban cities, two-wheeler recurring expenses are not materially higher than public transport, making two-wheelers the preferred choice for commuters. The lower cost of ownership, along with the freedom that comes with owning one's own vehicle, has resulted in strong sales of two-wheelers in urban Indian.

Higher petrol prices do not impact demand materially either. We estimate that for every INR1 increase in petrol prices, the monthly bill for a motorcycle owner rises by just INR20-30/month.

Lower dependence on Interest rates

Post the era of high delinquencies seen in the two-wheeler industry in 2006-07, banks have largely been more cautious in expanding their exposure to this segment. Consequently, two-wheeler buyers have become less reliant on credit funding and the industry has remained relatively resilient to the latest interest rate up-cycle. We note that close to 70% of purchases of Bajaj Auto's motorcycles were financed before the 2008 crisis, versus only 30% currently; this is reflected in the resilience of the company's performance in the current slowdown versus the previous one.

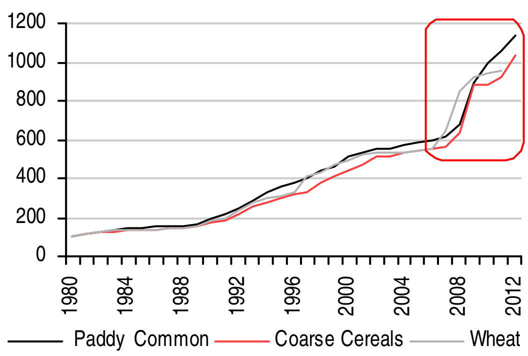
Additionally, it is worth noting that, due to the low ticket value, for every 100bps increase in interest rates, the impact on equal monthly instalments (EMI) is only near INR10-20, which is not material enough to impact buying decisions for an executive or premium vehicle buyer. The economy segment, where models cost less than INR40,000, are more dependent on financing. However, the segment itself is not growing, declining as a percentage of the total motorcycle market to 18% in 2Q12 from 23% in 1Q09.

Rural demand

Demand for two-wheelers has not just been driven by urban India; rural India has also played a large role in the growth story. For HERO, which is the largest player in the two-wheeler market, the contribution to sales from rural India has increased from near 38% of sales in FY09 to 45-46% currently, as reported in the last quarter.

Rural agrarian income has been on the rise, on the back of the increase in minimum sales prices (MSP) by the government and favourable monsoons in the last few years. According to government estimates[1], rural India has a population of near 700m people, or 140m households. Of these, around 30% or 43m households have meaningful land ownership and therefore are the primary target market for the two-wheeler industry.

Chart 2.2: MSP prices for major crops in India - Sharp increase in support prices since 2005 (rebased to 1980-- 100)



Source: CEIC, HSBC

Importantly, while farmers with sufficient land banks benefit from the increase in MSP for crops, the rest of rural India is also seeing an increase in income levels due to growth in non-agrarian sources of income.

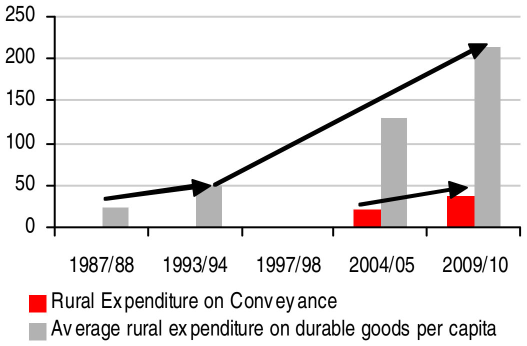
A number of rural areas are seeing the benefit of increasing industrialisation closer to villages and rural towns. Temporary employment in factories closer to villages and small towns is improving the average per capita income of rural people, in our view.

Chart 2.3: Rural wages

Source: Labour Bureau

Migration of labour to industrial towns is also resulting in a rise in remittances and disposable income. Expenditure on durable goods as a percentage of total income is also increasing among rural households; they are spending more on durables than in the past, positively impacting two-wheeler demand.

Chart 2.4: Expenditure on durable goods as a percentage of income



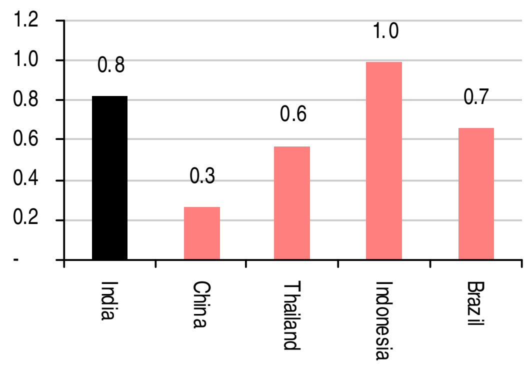
Source: CEIC, HSBC

Low penetration is promising, but cost of ownership is the key driver

Growth in motorcycle sales is largely attributed to a lack of adequate public commuting infrastructure and increase in per-capita income over the past decade. Penetration levels in India are close to 6%, compared with more than 20% in comparable emerging markets, such as Indonesia; this, in our opinion, strongly supports the view that the sector can sustain strong growth in the long term.

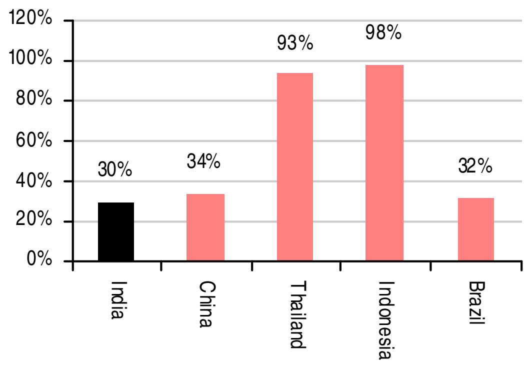
1 Source: NCAER

Chart 2.5: Affordability in terms of number of months of household income



Source: World Bank, CEIC, AISI, TAIA, Abraciclo, CAAM, HSBC estimates

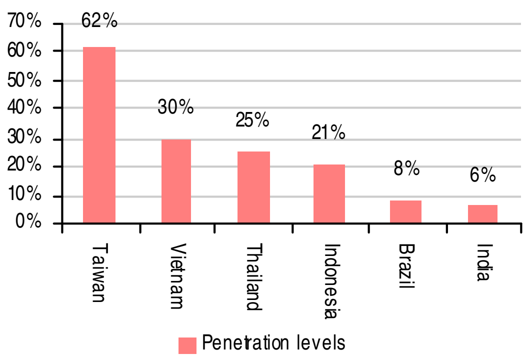
Chart 2.6: Penetration levels (number of households)



Source: World Bank, CEIC, AISI, TAIA, Abraciclo, CAAM, HSBC estimates

Two-wheeler penetration in terms of Indian households is near 30%. It appears higher (near 60%) when we look at only households with income above INR90,000 (i.e. excluding households categorized as deprived by National Council for Applied Economic Research (NCAER) – see Annexure 2 for details). As per capita income increases the number of households falling in the category with more than INR90,000 income has also been expanding.

Chart 2.7: Penetration levels (in terms of total population)



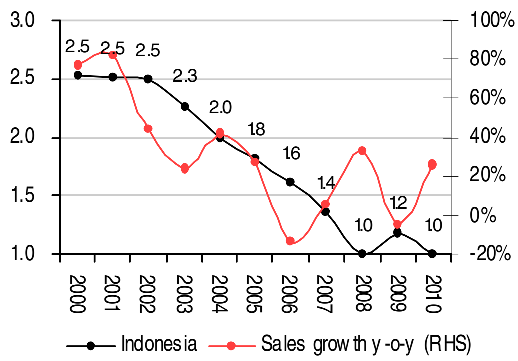
Source: World Bank, CEIC, AISI, TAIA, Abraciclo, CAAM, HSBC estimates

These penetration levels suggest long-term growth rates will remain in the range of higher single digits to low teens in India. In the near term (the next 2-3 years), however, we expect growth to remain healthy at 13-15%, as cost of ownership stays low. In our view, cost of ownership will continue to drive sales until penetration reaches a saturation point. As shown in the Chart 2.9, when penetration exceeded 55-60% in comparable emerging countries, sales growth became volatile and highly cyclical. Cost of ownership, in our calculations, factors in the increase in per-capita income, savings rate, and cost of buying and owning a vehicle.

As seen in Chart 2.8, Indonesia's two-wheeler market has been more volatile since penetration exceeded 55%. Prior to that, during 2000-06, sales growth remained positive and was evidently correlated to cost of ownership, albeit negatively. Similarly, in Thailand, penetration has been high since the beginning of the last decade and sales growth has been cyclical, resulting in a moderate compound annual decline of 2.7% for 2005-10.

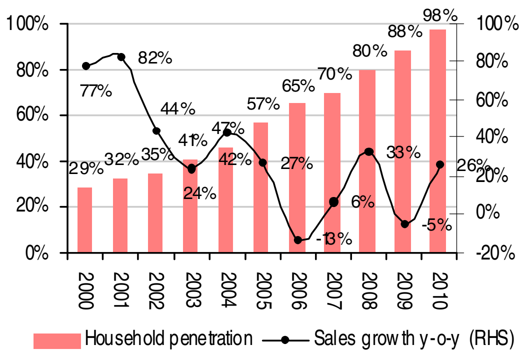
Overall, we expect two-wheelers sales in India will grow at a healthy FY12-14 CAGR of 13%, thereafter moderating to a growth rate of 7-13% annually till FY20. Cost of ownership, the key driver of sales in India, has not increased in the past few years, in our view (see Chart 2.12-E). While fuel and maintenance costs have risen, cost of ownership has remained stable thanks to higher per-capita income led by both growth in industrial salaries and rural income. Furthermore, the savings rate has declined in India, thereby increasing disposable income.

Chart 2.8: Cost of ownership (in terms of months of income) vs. vehicle sales



Source: World Bank, CEIC, AISI, TAIA, Abraciclo, CAAM, HSBC estimates

Chart 2.9: Household penetration vs. vehicle sales growth



Source: World Bank, CEIC, AISI, TAIA, Abraciclo, CAAM, HSBC estimates

Replacement demand to come down in FY13e

According to our estimates, replacement and first-time buyer demand contribute almost equally to overall sales. Replacement demand itself is evenly split between upgrade purchases and second or third vehicles for households.

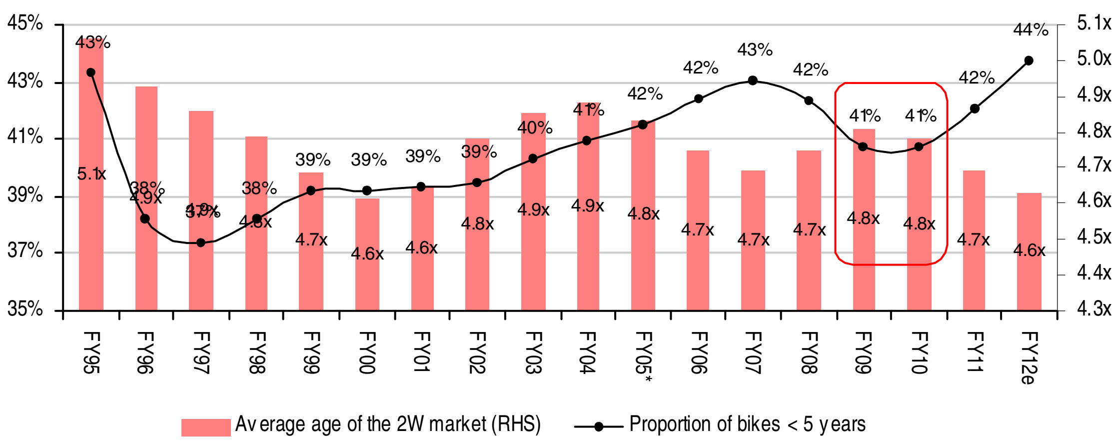
We calculated the average age of a two-wheeler in India and categorised them into less than 5 years and greater than 5 years to analyze replacement demand.

Due to slower industry growth, the average age of a two-wheeler rose to 4.8 years in FY07/08. A lower proportion of upgrades or replacements occurred in those two years, in our view. Subsequently, there was a strong recovery in sales in FY10/11, driven partly by pent-up replacement demand.

Unsurprisingly, the average age of two-wheelers fell to 4.6 years in FY12. The proportion of vehicles aged less than 5 years increased correspondingly to 44% compared to 41% in FY09 – near the peak of the past decade or more.

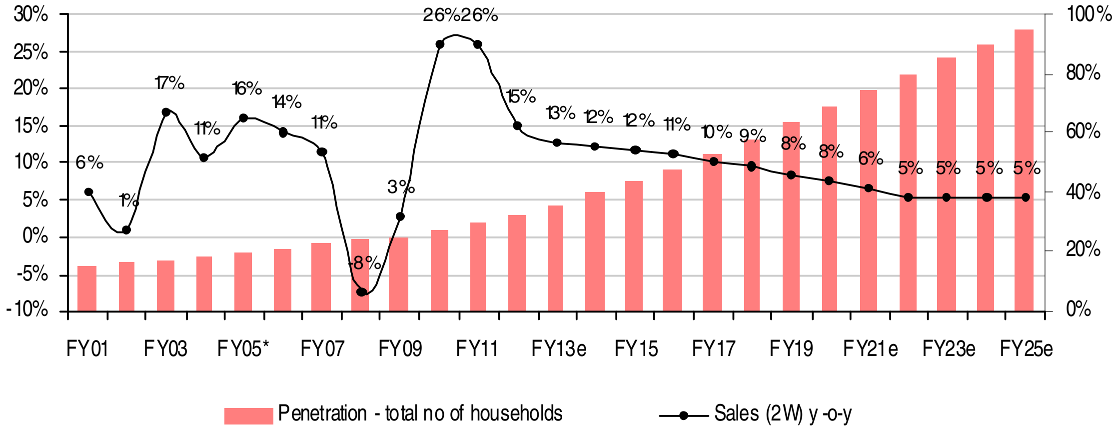
With a higher proportion of models under 5 years, we believe the extra push from pent-up replacement demand will be missing in FY13, leading to slower sales growth.

Chart 2.10: Replacement demand might taper off in FY13e



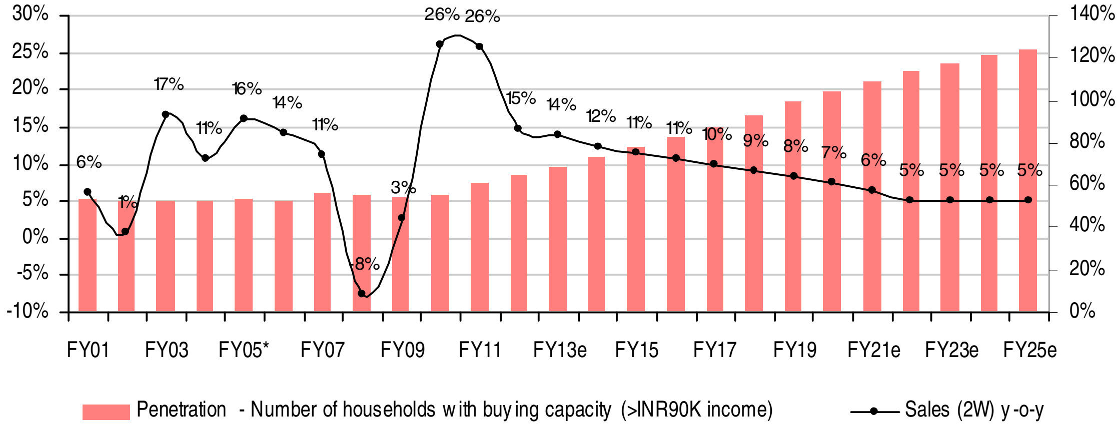
Source: SIAM, HSBC estimates

Chart 2.11: Long-term growth projections



Source: SIAM, HSBC estimates

Chart 2.12: Long-term growth forecasts

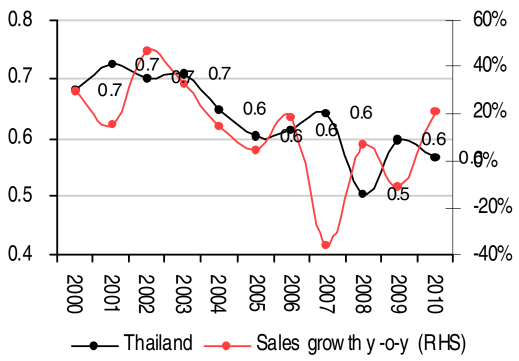


Source: SIAM, HSBC estimates

***Assumptions:** For our analysis we have assumed the life of a two-wheeler is 10 years. Based on this, scrap demand is near 5% of the total population of the two wheeler industry or near 30% of the annual sales every year.*

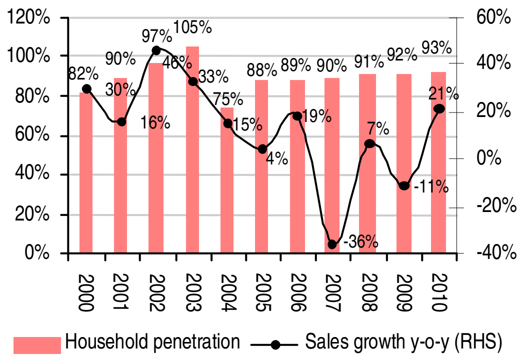
Charts 2.12: Cost of ownership vs. penetration levels

A). Cost of ownership (in terms of months of income) vs. vehicle sales



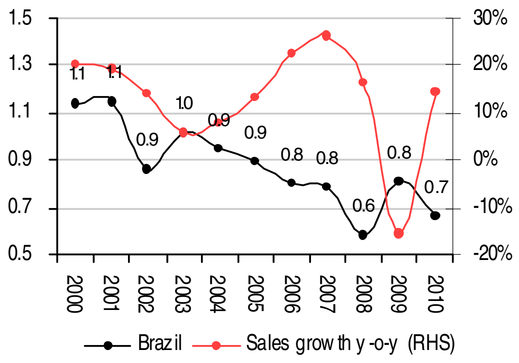
Source: World Bank, CEIC, AISI, TAIA, Abraciclo, CAAM, HSBC estimates

B). Household penetration vs. vehicle sales growth



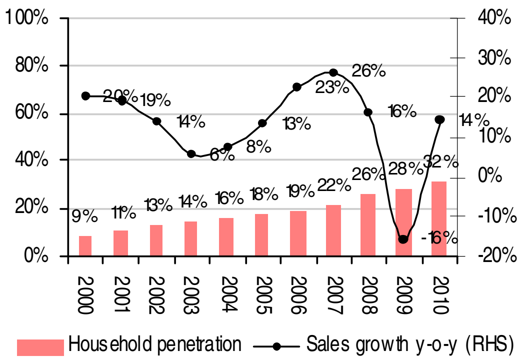
Source: World Bank, CEIC, AISI, TAIA, Abraciclo, CAAM, HSBC estimates

C). Cost of ownership (in terms of months of income) vs. vehicle sales



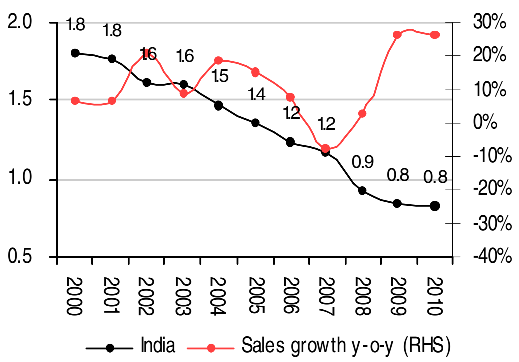
Source: World Bank, Abraciclo, CAAM, HSBC estimates

D). Household penetration vs. vehicle sales growth



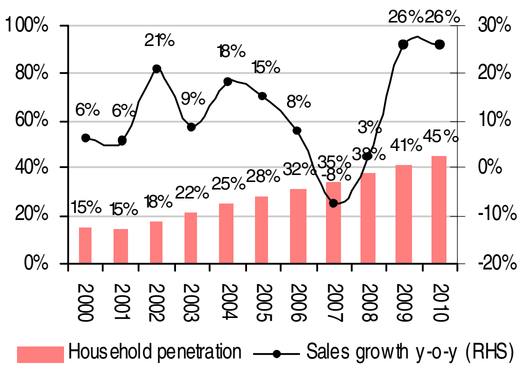
Source: World Bank, CEIC, NCAER, HSBC estimates,

E). Cost of ownership (in terms of months of income) vs. vehicle sales



Source: World Bank, SIAM, CEIC, NCAER, HSBC estimates,

F). Household penetration vs. vehicle sales growth



Source: World Bank, SIAM, CEIC, NCAER, HSBC estimates

Competitive threats

The two-wheeler industry in India is largely dominated by two players: Hero MotoCorp and Bajaj Auto. HERO and Bajaj have different market strategies and have had correspondingly different success. HERO has largely depended on specific brands and deployed flanker products around the brand, most of the time with the same engine power but additional features and thus price points. On the other hand, Bajaj has attempted to extend each brand across all segments with different engine capacities and features.

Thanks to internal R&D at Bajaj, the company has been able to churn out a greater number of engines and therefore more variants in each class of engine capacity. While this offers greater choice to customers (low-income buyers have the option to choose from either higher power or better features), it also causes cannibalisation among the other featured products of each family of brands (see Company Section).

While the dominance of these two players is likely to continue, there is an increasing competitive threat from new players – primarily Honda. Other players like Yamaha have also announced aggressive plans, but we focus on the Honda's threat in this report.

Honda Motorcycle & Scooter India

Honda's management has publicly expressed its intention to expand in India (post its split from HERO) and grow its market share, now that it has full freedom to introduce new models across all segments.

Firstly, it is worth noting that, notwithstanding its partnership with HERO, Honda already has multiple brands in India. Honda's current portfolio in the Indian market includes a number of models, such as the flagship Unicorn, 125cc Honda Shine, the 150cc Honda Eterno, the Honda Dio, and the Honda Aviator. Recently the company introduced a high-end CBR250 as well. Honda's best selling Shine competes with Glamour of HERO, but is less stylish and is attractive to older age groups. Unicorn competes with HERO's Karizma/Hunk and Bajaj's Pulsar. Overall, Honda currently has a market share of near 7% in the motorcycle market, or 14%, if we include both motorcycles and scooters.

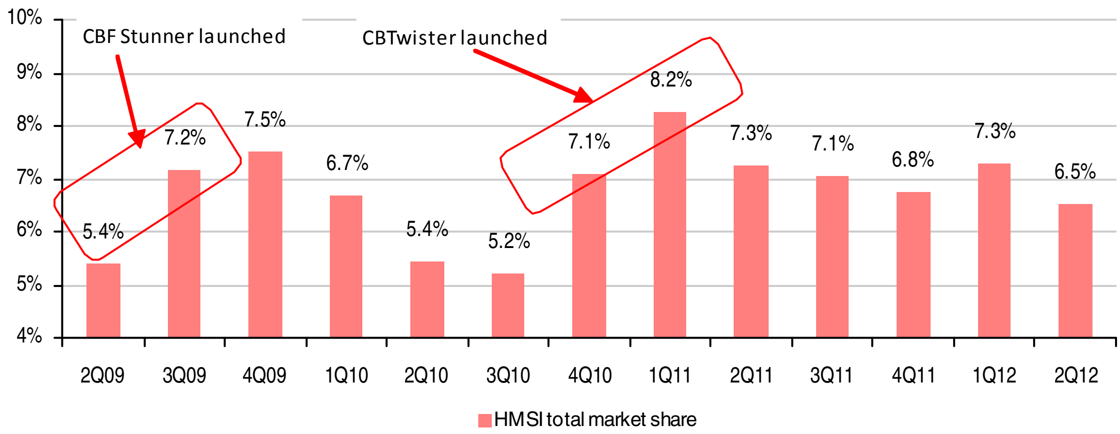
How real is Honda's threat to HERO and Bajaj?

Honda seems to have a number of bike variants in India (primarily in the 125cc range and premium segments). Every time they launch a new product their market share increases but then slowly fades (see Chart 3.1). While Honda is not limited by its product portfolio in India, we believe its growth potential is constrained by capacity and distribution reach.

Our analysis suggests Honda is unlikely to dislodge HERO and Bajaj as market leaders, but it is likely to gain market share, impacting the growth rates of HERO and Bajaj.

Incremental market share by Honda could impact HERO and Bajaj. Honda's top three brands – Shine, Twister and Unicorn – are at near-peak sales. Together these account for near 9% of the premium and executive segments (the company has no presence in the economy segment, which is 15% of the total market). Honda's total two-wheeler presence (including scooters) appears much more compelling as seen in the following chart. Activa and Dio have been very strong models for Honda in the scooter market, where it holds a 43% market share.

Chart 3.1: Honda trends in the past few years



Source: Company data, SIAM, Crisil, HSBC

Focusing on just motorcycles, Honda has gained nearly a 3% market share every time it has launched a new product. Assuming the current products continue to do well and the company introduces new brands/variants in the executive and premium segment, the company could gain market share, impacting the growth of HERO and Bajaj. To analyse Honda's threat to the market shares of HERO and Bajaj, we ran a sensitivity analysis for FY13. In the past, every successful model has taken nearly a 3% market share in the first year of launch. We assume Honda will launch two new bikes in FY12 and three in FY13, and the probability of these bikes making a

Table 3.1: Honda's threat quantified – sensitivity analysis

	FY12e	FY13e
Motorcycle domestic sales	10,322,315	11,668,814
Market growth expected (overall Motorcycle)	14.40%	13.00%
• New models expected from Honda	By end of FY12: 1) Aggressively priced 100cc bike 2) CBR 150R In FY13: 1)Couple of executive bikes in the 125-150 cc category 2) One 800cc Premium bike	
• No of new models to be released by Honda (assumption)	2	4
• Success rate assumed	25%	25%
• Average market share (annualized) by a successful model in the first year of introduction (historically)	3%	3%
• Expected Annual sales from new models for Honda in twelve months after launch	154,835	350,064
• Honda new motorcycle model sales (assumed two months of sales from FY12 launches and 4 months of sales for FY13 launches)	25,806	304,061
• Honda existing motorcycle sales without new launches	690,970	760,067
• Honda existing motorcycle sales with new launches (assuming new launch cannibalizes 20% of existing model sales)	685,809	699,255
• Honda total motorcycle sales	711,615	1,003,316
Honda motorcycle market share	6.90%	8.60%
Rest of market sales discounting for new Honda models (assuming 80% of new models sales by Honda are market share gains to Honda)	10,301,670	11,425,565
Rest of the market growth	14.20%	10.90%

Source: Company data, HSBC estimates

successful market launch is assumed at 25%. We also assume 20% of incremental sales generated by these new Honda models will cannibalize existing Honda sales while the rest would impact sales of corresponding products from Bajaj and HERO. This would result in y-o-y growth of 41% for Honda motorcycles in FY13 and a 1.7pt increase in market share to c8.6%. The rest of the market would grow 10.8%, underperforming total market growth of 13%.

It's noteworthy that even in this growth scenario, the capacity utilisation of Honda would be near 80% in FY13, much lower than historical levels (110% in FY11 and 120% in FY12). A lower sales pick-up could impact the sector's pricing trends and realisations. It is unlikely that Honda management would decide to pull out in the next two years even if capacity utilisation stays low.

Honda has aggressive capacity plans

Honda has announced plans to expand production capacity at their second manufacturing unit located in Tapukara, Rajasthan (which commenced recently). The initial plan was for an annual production capacity of 0.6m units, expected to double to 1.2m units by March 2012. Further to this, Honda is also constructing a facility near Bangalore in order to cater to growing demand from southern markets.

The Bangalore facility is set to become operational in the first half of 2013 and will have an annual production capacity of 1.2m units. With a southern location, Honda is looking at offering speedy delivery to the southern markets. Separately, the Manesar facility, where the company is producing 1.6 million units annually, is operating at full capacity. After the commencement of the second and third plant, Honda will have a total production capacity of 4m units annually.

Table 3.2: Underlying assumption: Capacity expansion will drive new model introduction and subsequent market share gains

Capacity constraints	FY12e	FY13e
Capacity of Honda by FY end	2,150,000	3,950,000.0
Weighted average capacity	1,850,000	3,050,000
Capacity utilisation	102%	79%
Honda other 2W Sales	1,177,135	1,412,562
Honda scooter sales growth (y-o-y)	18%	20%
Total sales by Honda	1,888,750	2,415,878
Domestic motorcycle sales by Honda	711,615	1,003,316
% of Motorcycles	37.7%	41.5%
y-o-y growth for Honda Motorcycle sales	8.1%	41.0%
Growth without new models for Honda	5.0%	10.0%

Source: HSBC estimates, Crisil.

** Capacity Utilisation (sales on average capacity) of Honda in FY10 and FY11 was near 110% and 120% respectively

** Capacity Utilization in FY10/11 (sales by year end capacity) is 106.5% for both years

Which incumbent will be impacted the most?

The key question is who is more vulnerable to market share losses to Honda. While there are multiple factors at play here, and HERO appears to be the most vulnerable, we believe the seemingly obvious trend may not materialise.

- **HERO's rural strength is creditworthy:** Honda is expected to launch a number of 100cc bikes in the next few quarters targeting the executive and may be the economy segment more aggressively. This poses a threat to HERO, which is the market leader in these segments. However, HERO's sales in these segments (which account for 50% of the total) are currently focused in rural areas where its reach and brand acceptance would be tough to displace in just a few quarters. Additionally, Honda bikes have more sporty looks, which are likely to appeal more to urban than rural buyers.

- Honda is also trying to target the African market, which could impact Bajaj more than HERO. For Bajaj, exports have been the key growth driver. Contributions from exports should increase from 16% of sales in FY07 to 35% in FY12e.

- Last but not least, for HERO, market share lost in motorcycles could be offset by market share gained in scooters. Scooter sales are growing faster than motorcycle sales. HERO is scheduled to launch its new Maestro scooter, which may allow it to gain market share from Honda, the market leader in scooters, as the latter company raises its focus on the motorcycle market.

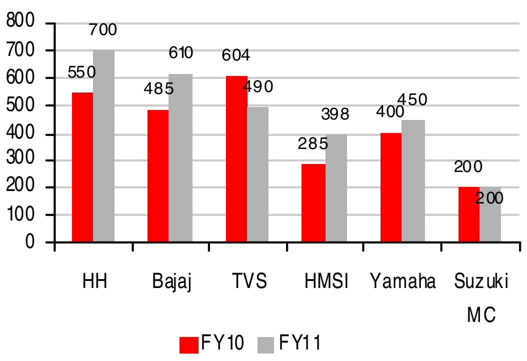
Impact on realisation

Along with the impact on volume growth, we believe competition from Honda is likely to impact realisations as well. Honda's aggressive push for market share gains and global economies of scale are likely to put pressure on realisations across the two-wheeler sector. For Honda, incremental sales in India are likely to come at better profitability as it leverages global R&D spend and improves sales per dealer in India.

Customer reach (dealership/outlets)

As seen in the following chart, Honda has a reasonably sized dealership network compared with HERO and Bajaj. However, HERO also has more than 5,000 customer touch points to complement its 700 dealers. Similarly, Bajaj has a sub-dealer network of approximately 3,600 to complement its nearly 600 primary dealers.

Chart 3.2: Size of dealership networks

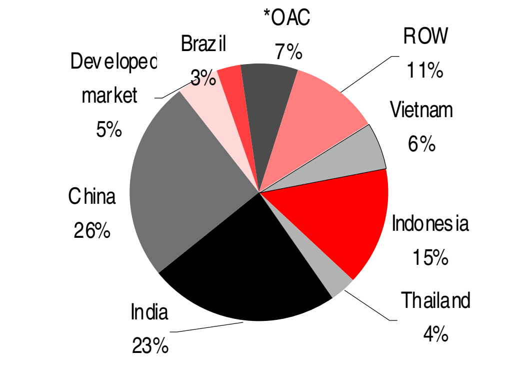


Source: Company data, HSBC estimates

Global references are encouraging

We also look at other emerging markets to gauge the risk of challengers dethroning incumbent market leaders. Apart from India and China, Indonesia, Vietnam, Thailand and Brazil are the other major two-wheeler markets in the emerging world.

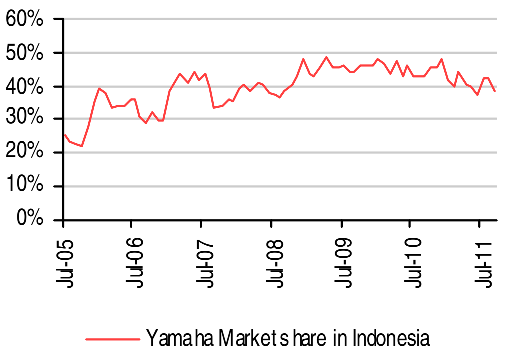
Chart 3.3: Global two-wheeler market



Source: Company data, HSBC

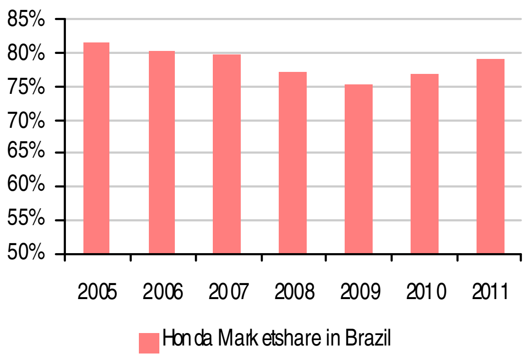
Indonesia: The motorcycle market is dominated by two players – Honda and Yamaha. Honda is the market leader in Indonesia, but has lost some ground to Yamaha in the past few years. However, fringe players have remained on the sidelines and the market share tussle has been restricted to the top two companies.

Chart 3.4: Yamaha market share in Indonesia



Source: AISI, CEIC, HSBC

Chart 3.5: Honda's market share in Brazil

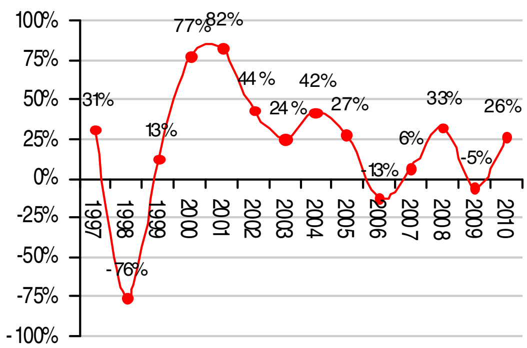


Source: Abraciclo, HSBC estimates

This is despite volatile motorcycle market growth in Indonesia (refer to Chart 3.5)

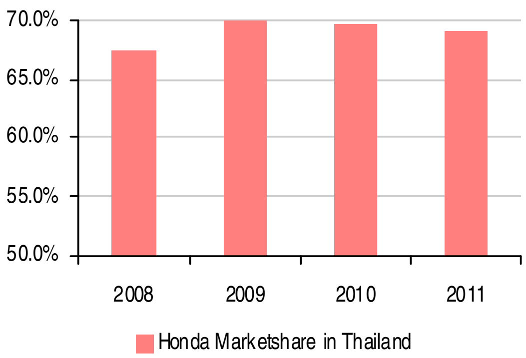
Thailand: Honda is the market leader in Thailand with above 65% market share for multiple years.

Chart 3.5: Indonesia two-wheeler sales growth trends



Source: AISI, CEIC, HSBC estimates

Chart 3.6: Honda's market share in Thailand



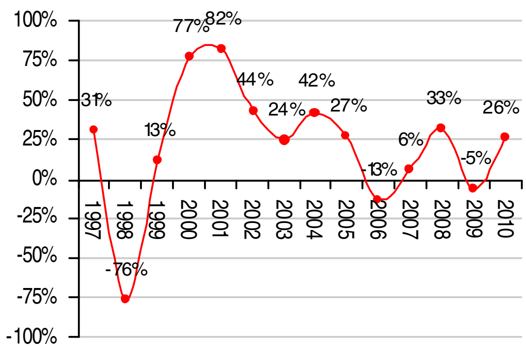
Source: TAIA, HSBC estimates

Brazil: Honda is the undisputed market leader in the Brazil motorcycle market. The company has close to a monopoly with a more than 80% market share. Despite the presence of multiple fringe competitors, Honda's market share has been unmoved.

Overall, we believe Honda's market push is unlikely to dethrone HERO or Bajaj from their top two positions in India. However, it is likely to gain some market share, on the back of aggressive go-to-market and higher capacity. This should impact growth of Bajaj and HERO, even if modestly.

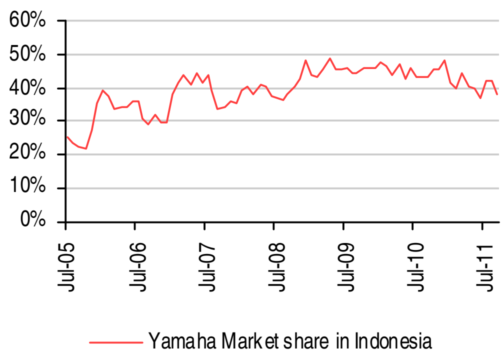
Chart 3.7: Incumbents have been hard to displace

A): Indonesia two-wheeler sales growth



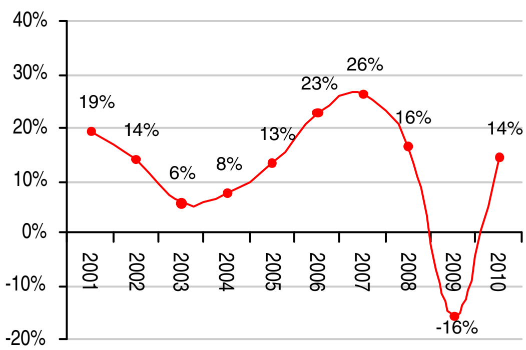
Source: AISI, CEIC, HSBC estimates

B). Yamaha market share in Indonesia



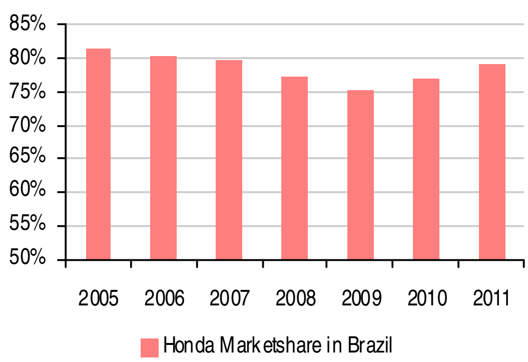
Source: AISI, CEIC ,Company data, HSBC

C) Brazil two-wheeler sales growth



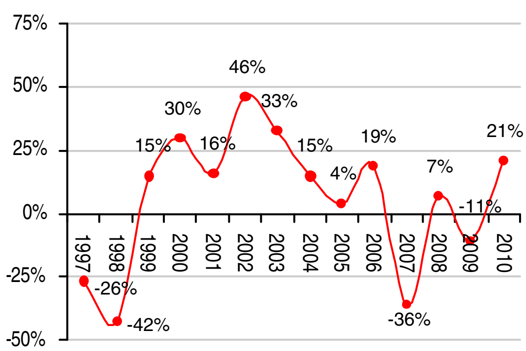
Source: Abraciclo, HSBC estimates

D) Honda market share in Brazil



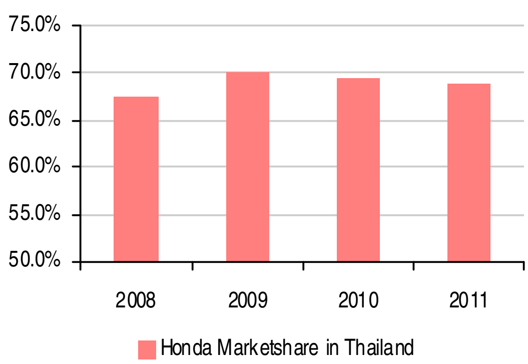
Source: Abraciclo

E) Thailand 2W sales growth



Source: TAIA, CEIC, HSBC estimates

F) Honda market share in Thailand

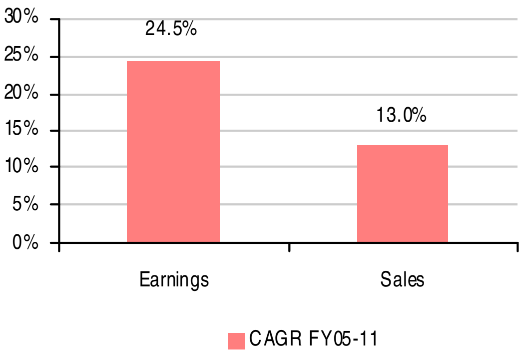


Source: TAIA, Honda, HSBC

Sector earnings outlook

Two-wheeler companies have reported strong earnings momentum in the past few years, with a 25% CAGR in FY05-11. However, during the same period, sales have grown at a 17% CAGR and margins have been almost flat.

Chart 4.1: Earnings growth vs. sales growth (FY05 to FY11 CAGR)



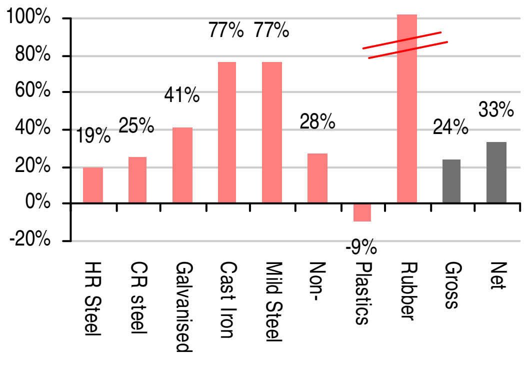
Source: Company data; Includes HERO and BAJAJ.

Margins likely to remain stable with positive bias

Chart 4.1 clearly shows earnings growth has outpaced sales growth in the past few years. This is despite a strong increase in raw material costs and a limited increase in pricing (on a like-for-like basis excluding product mix changes or customer upgrades to more expensive products).

As the following chart shows, the gross realisation (based on the prices at which customers are buying the vehicles) has increased only 24% since FY05. Compared to that, every raw material (except HR steel and plastics) has grown more than realisation. However, notwithstanding that, the companies have reported much stronger earnings growth in the period FY05-11.

Chart 4.2: Increase in raw materials costs (FY05 to FY11)

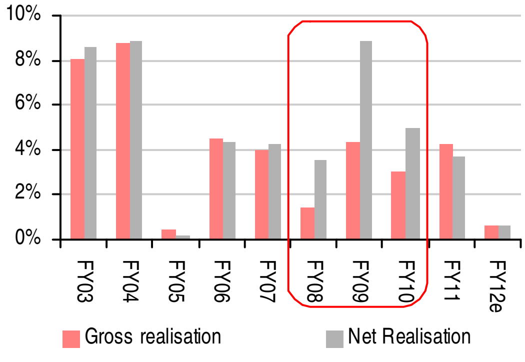


Source: Company data, HSBC estimates

Excise duty was a major stimulus for earnings

As companies expanded in the excise-free zones (such as Uttaranchal) they have been able to reduce excise duty on vehicles and this has contributed materially to the bottom line. Net realisations have improved more than gross realisations, as companies were able to retain the benefits of excise-free production. Going forward, we expect excise duty to remain at these levels (as a percentage of net revenues), as contributions from excise-free zones remain stable.

Chart 4.3: Bajaj realisation trends

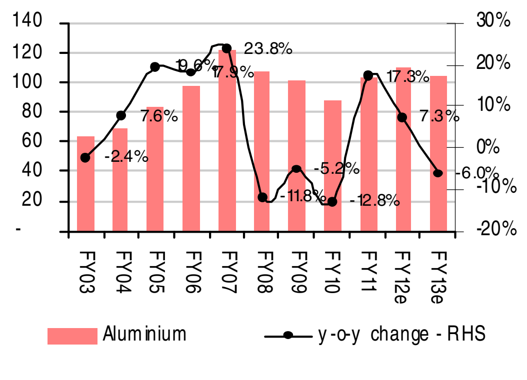


Source: Company data, HSBC estimates

Earnings outlook for FY11-13

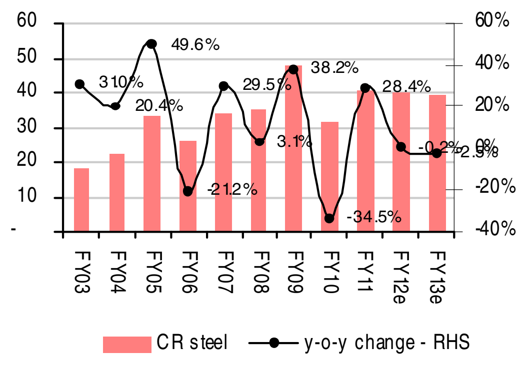
We expect overall industry margins to remain stable in the next few years. Specifically, we see stronger margin levers for HERO as marketing costs normalise in FY13 and royalty costs continue to decline. Additionally, while the results

Chart 4.4: Aluminium prices (INR/kg)



Source: Bloomberg, HSBC estimates

Chart 4.5: CR Steel (INR/kg)



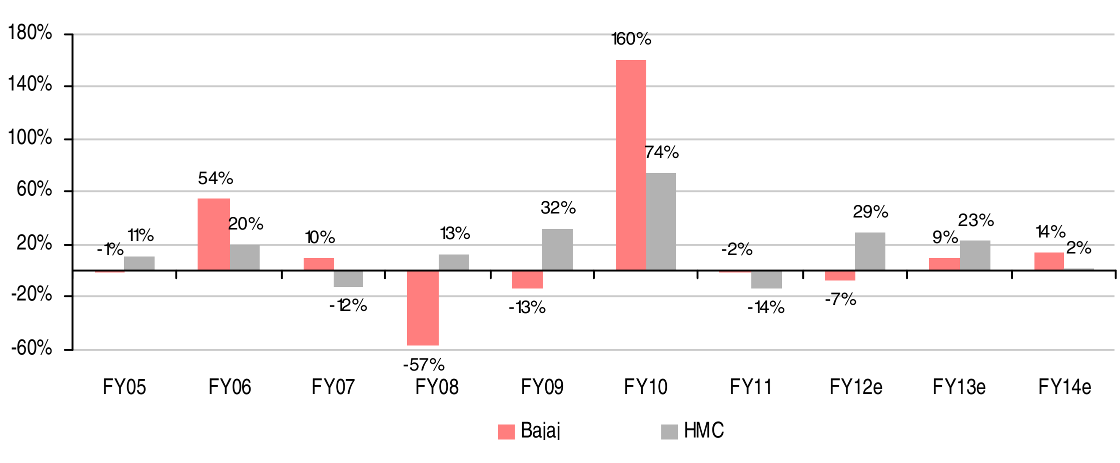
Source: Bloomberg, HSBC estimates

of R&D remain a risk in the long term, the impact on margins is likely to be modest in FY13.

Broadly speaking, we are not factoring any movement in commodity prices into our raw material cost estimates. However, even with the assumption that commodity prices will remain constant at current levels, we expect to see margin contraction in the next two years, beginning with a 75bps decline in FY12 and ending with a more than 100bps decline in FY13. Aluminium, cold-rolled steel, rubber and plastic are the key raw materials used and all have seen prices correct from peaks, but are still higher than the averages in FY11.

An increase in commodity prices is the key downside risk to our earnings estimates in the coming quarters. On the other hand, we are not factoring in any operating leverage into margins as capital expenditure is likely to increase in the next few quarters and there was no significant improvement in vehicle realisations, which remains a positive risk to our margin forecasts.

Chart 4.6: Earnings growth forecasts (Bajaj, HERO EPS y-o-y)



Source: Company data, HSBC estimates.

Bajaj Auto

- Robust sales and 30% earnings CAGRs for FY10-12e made Bajaj one of the best performing auto stocks in the past two years
- However, moderating industry growth may hit Bajaj the most; margin growth seems unlikely as well
- Initiate with Neutral rating and TP of INR1,745; we like its defensive business, but see limited upside in the stock at the current level

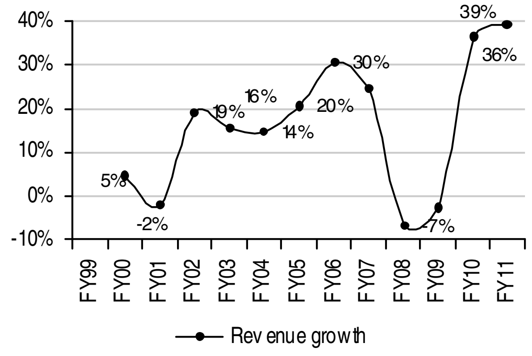
The operational performance of Bajaj, both in terms of new growth and margins, has been noteworthy in the past few years. Its share price performance has mirrored this strong operational record, with 135% absolute and 55% relative returns in the last two years.

We believe the industry cycle has peaked and is likely to grow at a moderate pace in 2012. In such a scenario – with industry growth off the peak, slower growth in the premium market (Bajaj's core strength) and an increase in competition from Honda in the premium segment – the stock is likely to remain range-bound at best, in our view.

Furthermore, margins are likely to remain stable at most, compared to HERO where margins could expand resulting in stronger earnings growth.

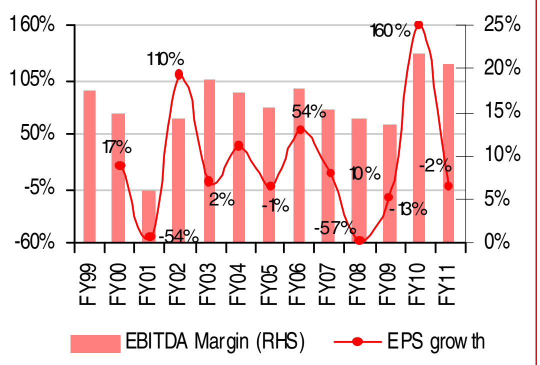
The stock is currently trading at a PE of 15x our FY13e EPS. We believe the defensive nature of the business and expected upside from the launch of the new Pulsar model might keep "hopium" levels high in the near term, but we don't see any material absolute upside on a one-year investment horizon. Based on our valuation, we initiate coverage on the stock with a Neutral rating and recommend investors to wait for a stock correction to become more constructive.

Chart 5.1: Revenue growth trend



Source: Company data, HSBC

Chart 5.2: EBITDA Margin and EPS growth

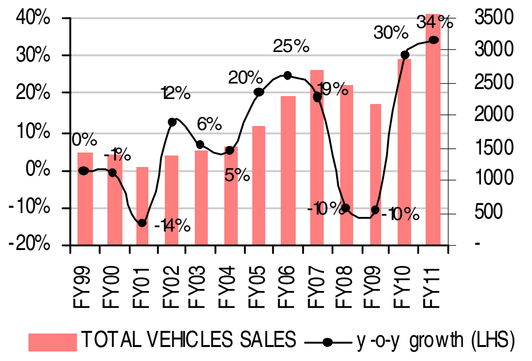


Source: Company data, HSBC

Sales analysis

Bajaj has come back strongly in the past two years, after a dismal performance during the 2008-09 recession. The company reduced its focus on financed-purchase-related sales and has also gained market share from HERO in its erstwhile weaker 100cc market.

Chart 5.3: Bajaj has come back strongly in the past 2 years



Source: Company data, HSBC

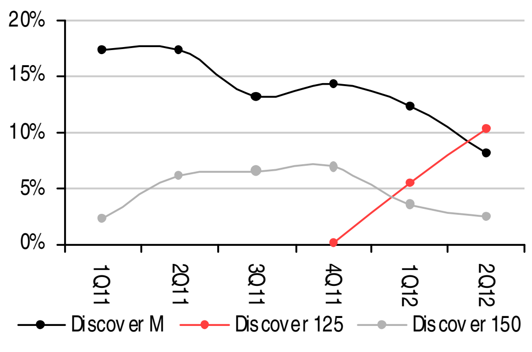
In the recent quarters, Bajaj's overall market share has remained relatively stable with a disparate performance across segments and models. Before we discuss each segment in detail, there are few noteworthy observations which are common across the segments:

- Bajaj is more aggressive than peers in terms of introducing new models. In the past 5 years, the company has introduced 27 new models (including refurbished variants), compared to 19 for HERO and 7 from Honda. Success has been sporadic, with a few models seeing strong sales in the early days and then fading away slowly.
- Generally, models that have not done well in the long term have contributed strongly in the year they were introduced.
- Across the family of Bajaj product range (including Discover and Platina), the introduction of new variants or flanker models has resulted in the cannibalisation of existing products. This clearly suggests buyers are not very savvy about or focused on engine specifications and adequate refreshes of existing models can last for multiple years.

Discover story

Bajaj launched Discover 100cc in June 2009 to compete against the HERO's Spender and Passion – the executive market where HERO still has unprecedented leadership. Discover 100cc was an instant hit with over 80,000 bikes sold in a month of the launch. The company has strengthened the Discover brand with the launch of Discover 150cc in May 2010 and Discover 125cc in May 2011. Discover 150cc was priced near 22% lower than the Pulsar 150cc to attract cost-cautious customers looking for higher-powered models. However, as mentioned earlier, the introduction of new variants has resulted in cannibalisation of existing models.

Chart 5.4: Discover performance (market share in the executive segment)

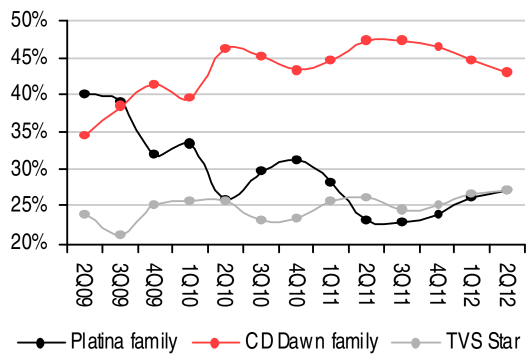


Source: Company data, Crisil, HSBC

Platina losing hold in the economy segment

As Bajaj gains market share in the executive segment, it continues to lose ground in the economy segment. Platina has lost market share to HERO's CD Dawn and Deluxe in the past few quarters.

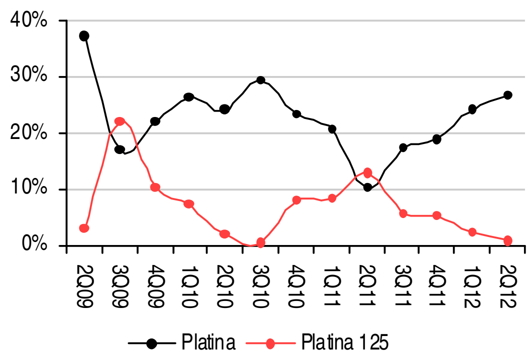
Chart 5.5: Platina vs. HERO's Deluxe performance (market share in the economy segment)



Source: Company data, HSBC estimates

Incidentally, as in the Discover product range, there has also been cannibalization among models within the Platina range, resulting in an overall decline in market share.

Chart 5.7: Platina family (market share in the economy segment)

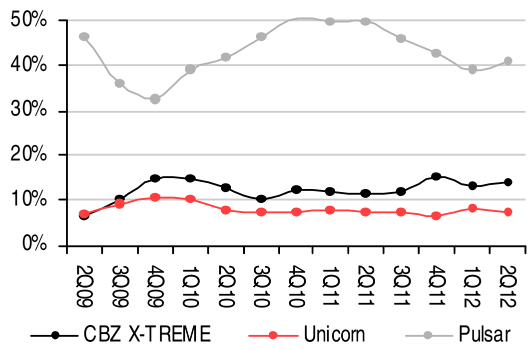


Source: Company data, HSBC estimates

Pulsar

Pulsar has been the flagship brand for Bajaj and the market leader in the key premium segment. The premium segment has +150cc motorcycles and represents 17.7% of the total market. Notably, as motorcycle commuters upgrade in India, the segment has grown by 122% from 2Q09, compared to total market growth of 62% in the same period.

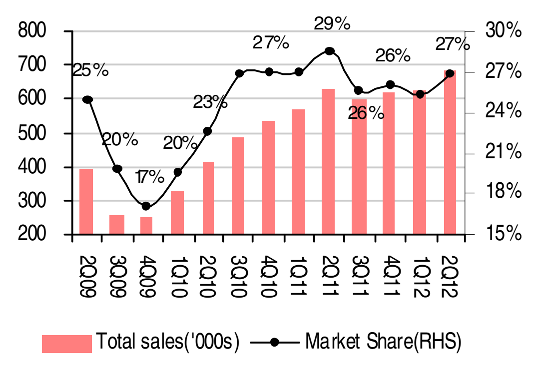
Chart 5.6: Pulsar vs. key competition (market share in the premium segment)



Source: Company data, HSBC estimates

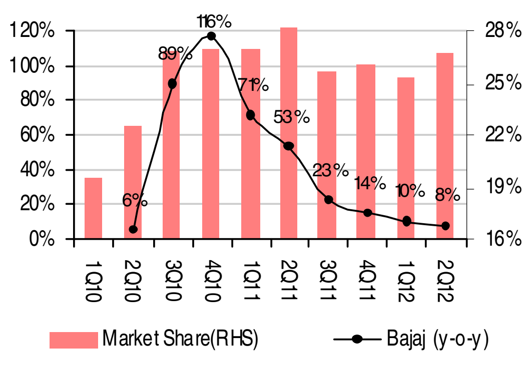
Pulsar sales have dropped in the past few months as the economic slowdown has impacted buyer decisions. We expect sales to pick up next year as the company introduces new Pulsar models early next year.

Chart 5.8: 2W market share in the past 10 quarters



Source: Company data, SIAM, HSBC

Chart 5.9: Overall 2W market share and growth trends for Bajaj



Source: Company data, SIAM, HSBC

Three-wheelers – the taxi of the emerging world

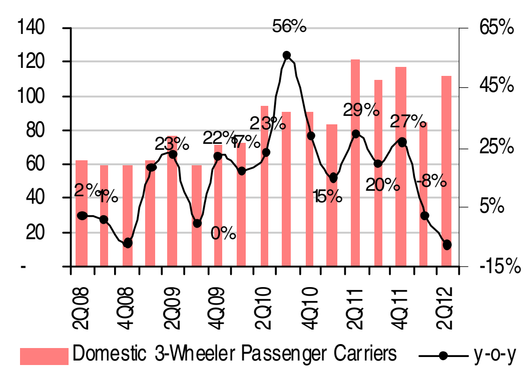
India has the largest three-wheeler market in the world with total annual sales near 529,000 vehicles in FY11. In India, three-wheelers are mainly used for commercial passenger transport, near 80% of the sales and the rest c20% for local goods transport. The underpenetrated public transport infrastructure and a rapid growth in urban population have resulted in the strong demand for economical means of transport to the last mile. Similar structural issues in other emerging countries have led to an exponential rise in three-wheeler export sales (c34% of total three-wheeler sales in FY11) as well.

Sales of three-wheeler sales, due to the commercial nature of their usage, are subject to new permits and licenses issued by various city and state authorities. Factors, like enforcing age limits, subsidies for cleaner fuels and ceilings on new registrations, have a direct impact on sales. Bajaj is the leader in the three-wheeler passenger carrier segment with a c48% market share.

The three-wheeler goods carrier sales have declined by 40% from 2Q07 to 2Q12 as illustrated in the chart 5.13. These three-wheeler goods carriers have been replaced by the mini four-wheeler goods carrier like the Tata Ace and Mahindra Maxximo.

Domestic three-wheeler passenger carrier sales have been robust in FY11. However, in the last two quarters the industry has seen a decline in growth to 1.9% y-o-y in 1Q12 and -7.9% y-o-y in 2Q12 owing to the increase in fuel prices, which has squeezed profit margins in the three-wheeler transport segment.

Chart 5.10: Domestic 3W passenger carrier sales



Source: SIAM, Industry, HSBC

While the domestic market has been patchy, the three-wheeler export story has been compelling. Three-wheeler export sales from India grew at a 29% CAGR in 2006-11 compared with a CAGR of 8% for domestic sales in the same period. The export sales are largely dominated by Bajaj with 85% of the market. Strong export demand has shifted the export to domestic sales proportion from 0.4x in FY04 to 1.14x in FY11 for Bajaj.

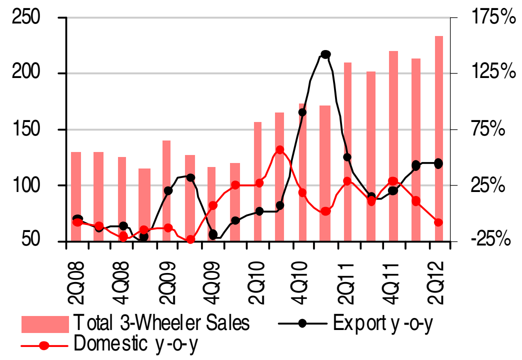
Outlook

We factor in continued strong growth in exports and weaker growth in domestic sales. We believe Bajaj is best positioned to increase its domestic market share and retain its export market share. We remain conservative on domestic growth due to the following factors offsetting growth drivers: 1) the threat of replacement by four-wheel vehicles with higher passenger capacity (like Maruti Suzuki Eeco, Tata Magic and Iris) replacing the need for three-wheelers especially in smaller towns and cities; 2) higher penetration of two- and four-wheelers in rural and urban India and 3) gradually improving public transport systems (like Metro trains) in major cities.

Bajaj has a strong thee-wheel foothold

Bajaj expanded its market share to near 60% of total three-wheeler sales (domestic and exports together) in the first half of FY12 from 55% for the whole of FY11. Three-wheelers contribute close to 12% of total unit sales for Bajaj and c20% of total exports.

Chart 5.11: Total 3Wheeler sales Bajaj

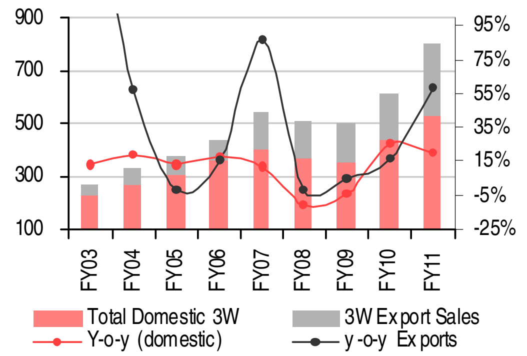


Source: Company data, HSBC

The average realization of three-wheelers in our estimates is near 2x the average realization per motorcycle, thus contributing to near 20% of the total vehicle revenues. The limited competition in the three-wheeler market and a wide service network favour Bajaj's ability to bill in higher margins for the segment. Its capacity utilization for three-wheelers was near 90% for FY11.

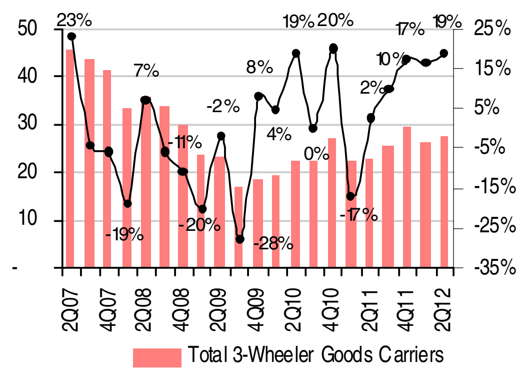
Bajaj benefits from a presence in other emerging markets to export its three-wheelers. As shown in Chart 5.14 three-wheeler exports have been growing at a significantly higher rate than for motorcycles.

Chart 5.12: Three-wheeler domestic and export sales trends



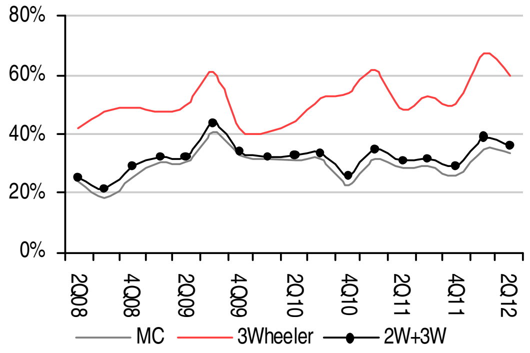
Source: Company data, HSBC

Chart 5.13: Three-wheeler goods carrier has seen steep decline in the domestic market



Source: SIAM, HSBC

Chart 5.14: Three wheeler exports grew significantly more then MC

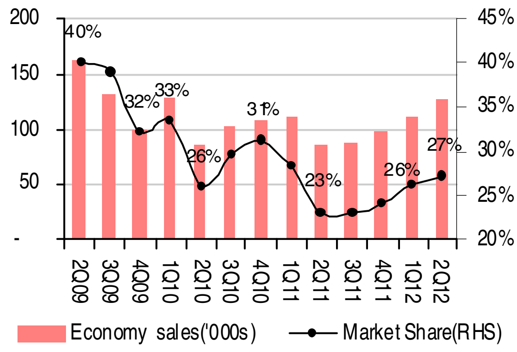


Source: Bajaj, HSBC

Given the high utility of three-wheeler vehicles in emerging markets at an affordable price point compared to other passenger vehicles, we believe Bajaj will continue to grow its three-wheeler exports at a 22% CAGR in FY11-13. To retain its domestic customer base in this segment, Bajaj is also expected to launch products in the mini four-wheeler segments in the less than 1.5 tonne category. While the launch would strengthen its product portfolio, the competition is well ahead of Bajaj in the mini four-wheeler segment. Additionally, the domestic 3W market is likely to remain flat y-o-y, excluding the new permits which may be issued during the year. There are multiple state governments which are likely to issue new permits, however we believe the risk of delays/cancellations remain high as always and we therefore are not very optimistic on the upside to our domestic 3W estimates. We forecast a 3% CAGR FY11-13 in domestic three-wheeler sales for Bajaj.

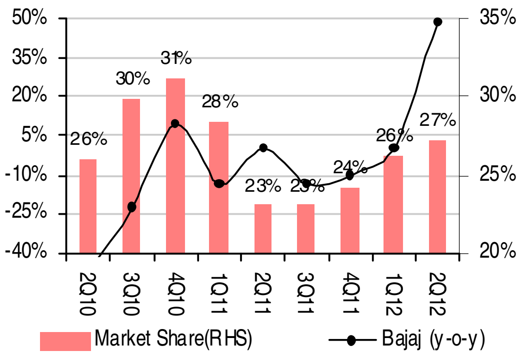
Charts 5.15: Bajaj sales at a glance

Economy segment - Platina range has lost market share to HERO's Deluxe



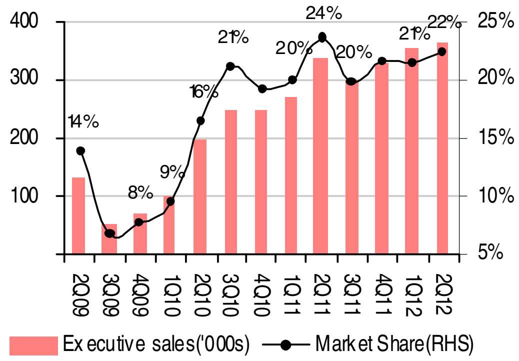
Source: Company data, SIAM, HSBC

Economy segment



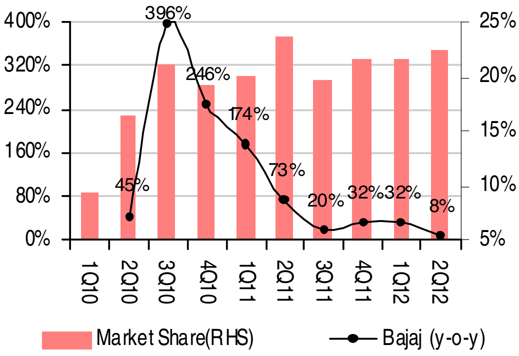
Source: Company data, SIAM, HSBC

Executive segment - Bajaj has seen improved market share in this segment - thanks to the Discover range. Discover 100cc launched in June 2009 saw significant success from 2Q10



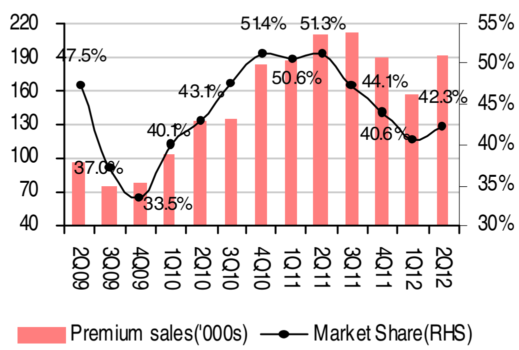
Source: Company data, SIAM, HSBC

Executive segment - While market share has been stable, monthly sales of Discover 100 and 150 needs a close watch. Initial success of Discover 125 may also not be sustainable



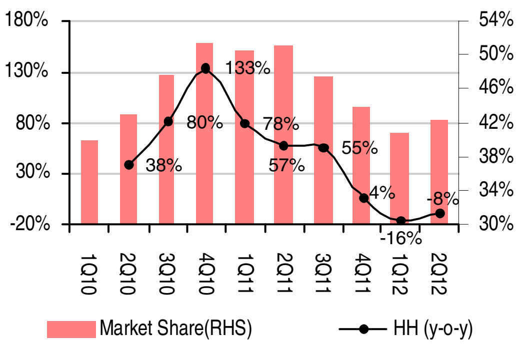
Source: Company data, SIAM, HSBC

Premium segment; Premium market has underperformed the overall market lately. HERO's revamped CBZ and Hunk could put further pressure on Bajaj's market share.



Source: Company data, SIAM, HSBC

Premium segment: New Pulsar could provide the offsetting force to HERO in FY13

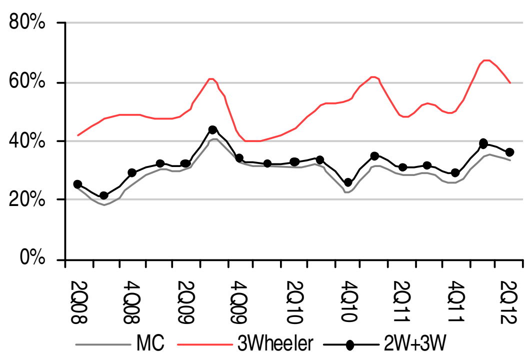


Source: Company data, SIAM, HSBC

Credible exports story

Bajaj has not only built a successful exports business, but has been consistently tapping new markets and diversifying across geographies. Five years back, the company was largely exporting to Sri Lanka (more than 55% of exports), but is now exporting to multiple countries on the African continent and has recently made inroads in Indonesia (the third largest two-wheeler market globally, just behind China and India).

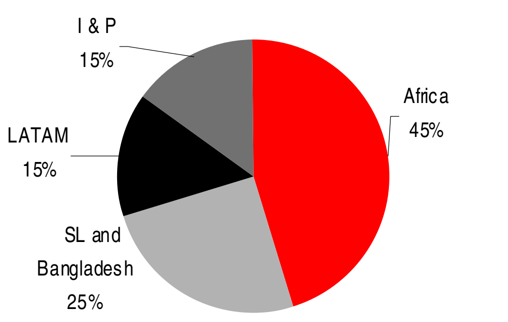
Chart 5.16: Exports as % of total sales



Source: Company data, HSBC

We believe the long-term growth outlook for the exports business would largely depend on its Africa growth. While in Sri Lanka, Bajaj already has a dominant position, it may remain a challenge for it to carve out a dominant position in other large two-wheeler markets such as Indonesia or Brazil (see page 19 for details about the competitive dynamics in these countries). Africa, therefore, is likely to be the company's key growth market in the next few years.

Chart 5.17: Composition of exports (approx)



Source: Company data, HSBC

LATAM – Latin America; Africa includes Nigeria Tanzania, Kenya, Sudan etc; I&P – Indonesia and Philippines

Considering the lack of data on most of these target markets it is tough to gauge the size of the addressable market for Bajaj. However, our ground checks with Bajaj dealers in these markets suggest penetration in these countries is still low and growth in these markets is more a function of the distribution network than brand or company positioning globally. In that context, Bajaj already has a strong network of distributors and dealers and therefore is likely to continue to see strong growth in the coming quarters.

In the next few quarter, the company is therefore likely to continue to see strong growth from exports. Even if the market share in the existing countries does not grow meaningfully in the foreseeable future, the sales volume is likely to grow on the back of its entry in new countries and regions.

Overall growth outlook

Table 5.1: Bajaj Overall sales forecasts

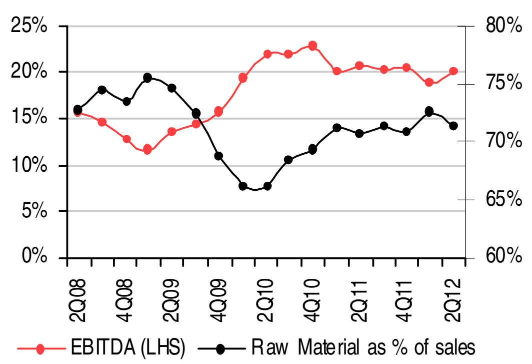
	FY10	FY11	FY12e	FY13e	FY14e
Domestic Sales Volume					
Motorcycle	1,781,768	2,414,603	2,652,489	2,941,271	3,255,095
3Wheelers	176,027	205,603	208,144	219,683	230,535
Export Sales Volume					
Motorcycle	725,097	972,437	1,239,217	1,398,197	1,583,739
3Wheeler	164,909	231,281	306,844	344,306	381,426
Total Units sold (nos)*	2,852,632	3,823,951	4,406,694	4,903,456	5,450,795
Y-o-Y					
Domestic Sales Volume					
Motorcycle	39.6%	35.5%	9.9%	10.9%	10.7%
3Wheelers	29.9%	16.8%	1.2%	5.5%	4.9%
Export Sales Volume					
Motorcycle	14.8%	34.1%	27.4%	12.8%	13.3%
3Wheeler	18.6%	40.2%	32.7%	12.2%	10.8%
Total Units sold (nos)*	30.0%	34.0%	15.2%	11.3%	11.2%
Market Share					
Domestic Motorcycle	24.1%	26.8%	25.8%	25.4%	25.0%
Total 3Wheeler	55.6%	55.2%	56.2%	56.0%	55.2%

Source: Company data, HSBC estimates. *FY09-11 nos include scooter sales

Profitability outlook

As explained in the Industry Analysis section (on page 19 and 20), we do not see any obvious margin levers for Bajaj. With fiscal benefits receding in terms of the withdrawal of Duty Entitlement Passbook (DEPB) and tax incentives from excise-free zones, margin expansion is largely contingent on a fall in raw material costs as a percentage of sales. Assuming commodity prices remain stable at the current levels, raw material cost as percentage of revenues should come down by nearly 100bps in FY13. We have not assumed any price correction in the commodity market and that remains the key upside risk to our estimates.

Chart 5.18: Margin trends



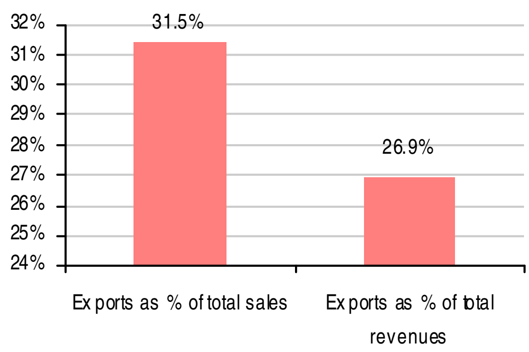
Source: Company data, HSBC

How real is the DEPB risk?

DEPB is an exports incentive scheme, which reimburses exporters the duties paid on imports, computing it as a percentage of the free-on-board value of the exports. Bajaj has been a prime beneficiary of the DEPB scheme among the auto companies in India, thanks to its strong exports business.

The scheme expired in September 2011, and Bajaj has lost this export duties refund, which is in the range of 9% of export revenues and represents nearly half of the total profits the company derives from its exports business. However, some of the lost DEPB benefits have been offset by the Duty Drawback scheme, which refunds 5.5%. The remaining 3.5% shortfall in lost duty refunds has been passed on to dealers through a 3.5% price increase from 1 October 2011. Additionally, the company should benefit from the increase in the Focused Market Scheme (FMS) rate to 4% from 3%, retrospective from 1 April 2011. This benefit should be margin-accretive by 30-40bps to 2HFY12 EBITDA margins, in our view.

Chart 5.19: Bajaj exports (FY11) - Realisations are near 20% lower in export markets



Source: Company data, HSBC

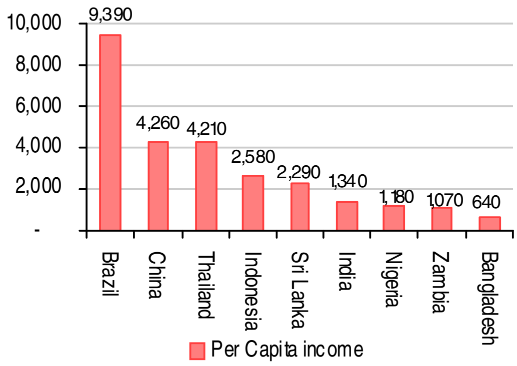
Will the price increase impact sales growth in export markets?

After the 3.5 % hike in prices, Bajaj vehicles are now much more expensive than competing China vehicles in these countries and in that regard increasing the price should not materially impact demand, according to management. We believe dealers/distributors in export markets enjoy better margins than domestic dealers and are therefore better positioned to help absorb some of the pain resulting from lost export duties refund.

In the long term, however, we believe it may not be obvious to increase prices without impacting demand. Key reasons why we think so –

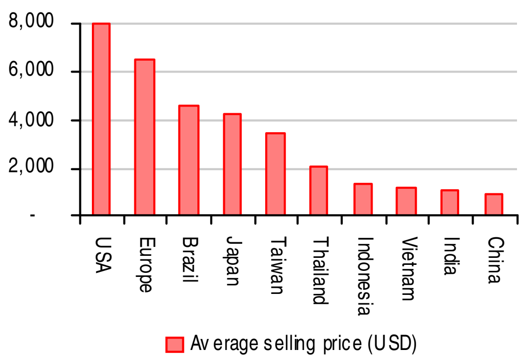
- Per-capita income in its key export market Nigeria (which represents 60% of Bajaj's African sales) is 12% lower than in India. The cost of a motorcycle in India is much lower than in other large motorcycle markets.

Chart 5.20: Per capita income in Nigeria compared to India and other emerging countries



Source: World Bank

Chart 5.21: Cost of motorcycles



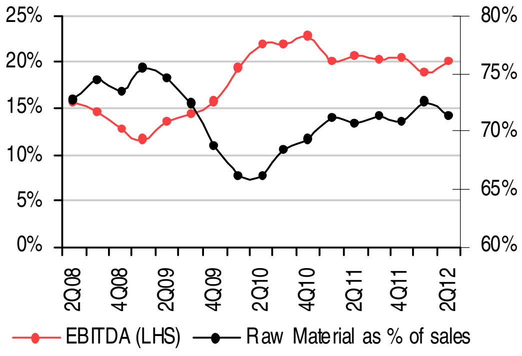
Source: Company data, HSBC estimates

Bajaj is already selling bikes at a 20% lower realisation in Nigeria than India (refer to Charts 5.20 and 5.21).

- Secondly, motorcycles in Nigeria are predominantly used as a mode of commercial transport making it tough to pass on the pricing increase.

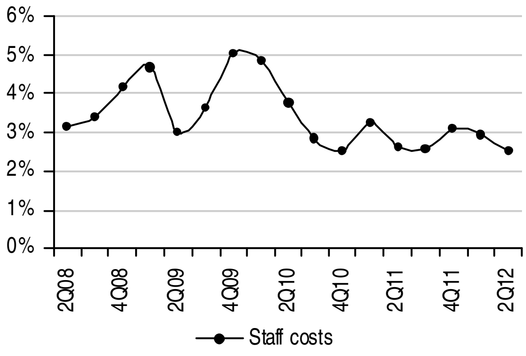
Charts 5.22: Margins profile

Raw material as a % of sales



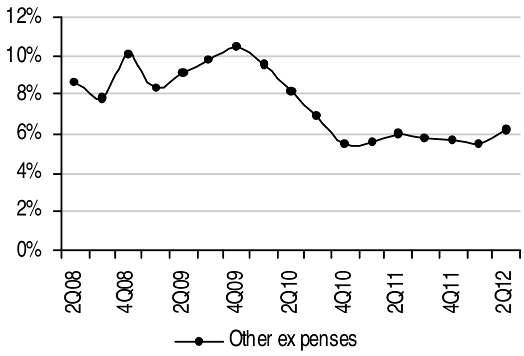
Source: Company data, HSBC

Employee cost as a % of sales



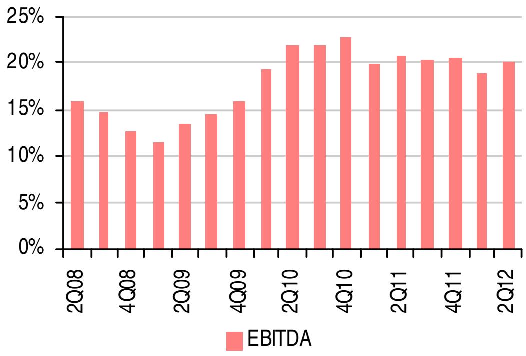
Source: Company data, HSBC

Other expenses as % of sales



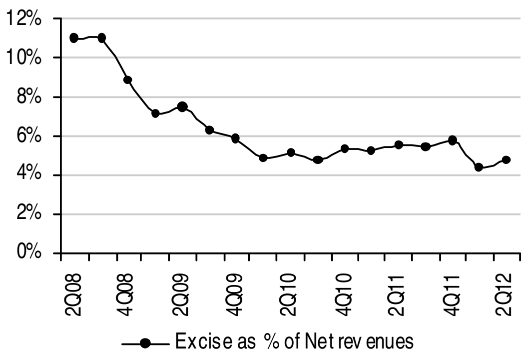
Source: Company data, HSBC

EBITDA margin



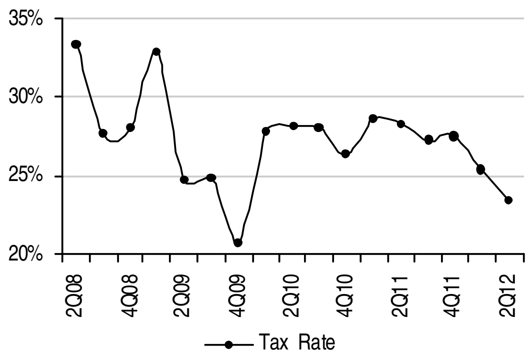
Source: Company data, HSBC

Excise duty as % of net revenues



Source: Company data, HSBC estimates

Tax rate

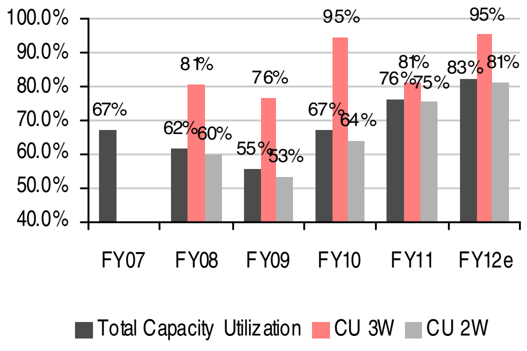


Source: Company data, HSBC estimates

Capacity not a constraint for Bajaj

Compared to its competitor HERO, Bajaj has been more aggressive in building capacity and has consistently run its production units below 65% in the past multiple years. While capacity utilisation has gone up recently and the company is likely to increase capital expenditure to ramp up further, we do not envisage any impact on sales due to lack of capacity.

Charts 5.23: Capacity utilisation



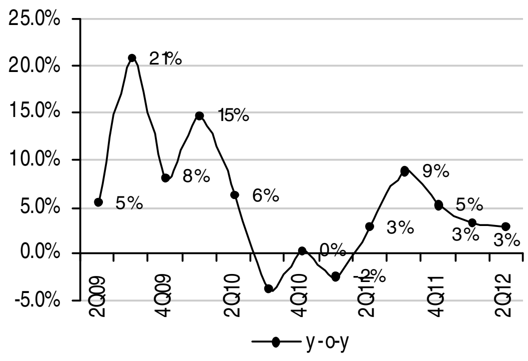
Source: Company data, HSBC estimates

Realisation – likely to remain stable

We see realisation remaining stable for Bajaj in FY13, with a modest positive bias. We believe with stronger sales of higher-value Pulsar and leveraging on the HERO's transition to the in-house R&D (and therefore lack of new product introductions in the market), the company will be in a better position than competition to raise prices. However, it's worth noticing that Bajaj has consistently increased prices of its products in the past few quarters. Recently, the company has raised export prices by 3.5% in October 2011 and domestic prices by INR500 (near 1-1.5% increase) in June.

Honda's aggressive capacity addition and an expected slowdown in the overall market (compared to a stellar last 2 years) may not be conducive enough to have another round of price increase.

Charts 5.24: Realisation per vehicle (y-o-y)

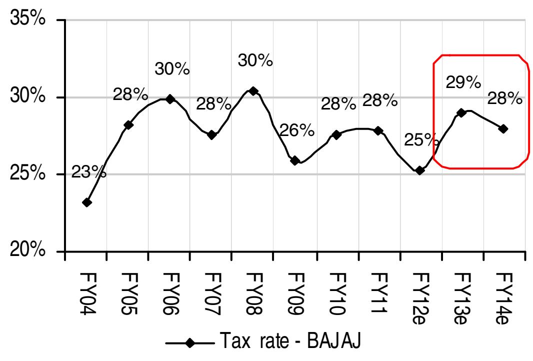


Source: Company data, HSBC

Tax rate – to go up

Tax rate for the company is likely to go up to 29-30%, from the current 25% in FY12e. Tax benefit from the Pantnagar plant should come down from 100% to 30%, starting FY13, resulting in this increase in tax rate.

Charts 5.25: Effective tax rate



Source: Company data, HSBC estimates

Currency tailwinds

As exports revenues have grown stronger than the domestic sales, the contribution from exports has continued to increase, resulting higher forex risk for the company. With INR depreciation in the past few months, the company has material tailwinds for its margins from better export realisation.

Table 5.2: Currency tailwinds

	1Q12	2Q12	3Q12e	4Q12e	FY11	FY12e	FY13e
INR/USD rate	44.8	46.4	48.9	48.9	45.5	47.3	48.9
q-o-q	0.7%	3.6%	5.4%	0.0%			
y-o-y					-3.8%	4.0%	3.4%
Exports as % of revenues		28%	30%	30%	27%	30%	30%
Export revenues (approx) in USDm*		297	297	297	1,005	1,189	1,289
Contribution from INR depreciation							
To exports		3.6%	5.4%	0.0%		4.0%	3.4%
Total revenues		1.0%	1.6%	0.0%		1.2%	1.0%
EBITDA margin contribution		100 bp	100-150 bp	00 bp		100 bp	80-100 bp

Source: Company data, HSBC estimates

Bajaj has fully hedged its forex exposure for 2H12 and near 90% for FY13. Most of the hedges are range forwards 47-49 for 2H and 47-51 for FY13. The company reported a market-to-market hedging loss of INR954m in 2Q12.

Assuming INR remains at the current INR/USD rate, we do not envisage material hedging losses in the coming quarters.

Overall earnings outlook

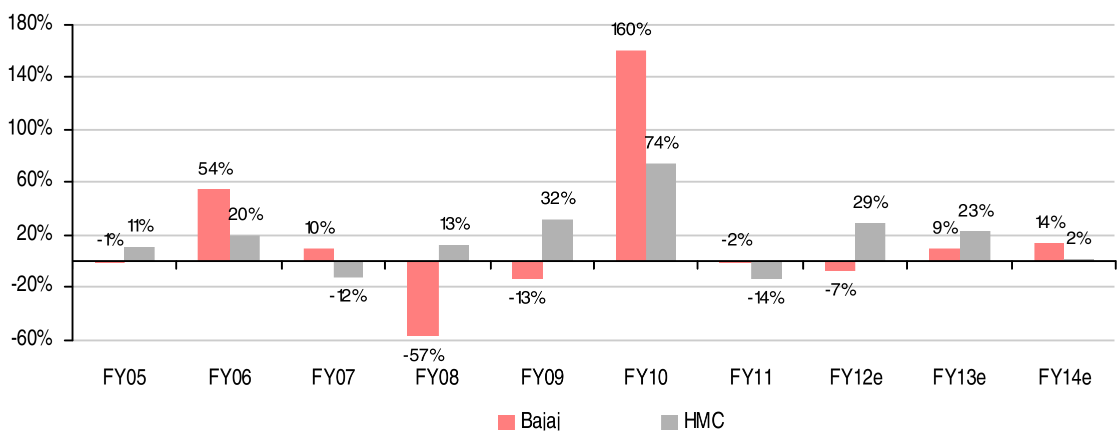
Overall, while we assume flat margins in FY13, the risks should remain to the upside. The upside could be driven by fall in raw material costs as commodity prices correct further. On the downside, an appreciation in the INR is the key risk to margins. INR appreciation will reduce the realisation per vehicle and increase the raw material costs in India. We are not assuming any benefit to operating leverage in our forecasts.

Table 5.3: Margin levers - BAJAJ

	FY13e
Raw material cost impact	100 bp
INR depreciation	75 bp
DEPB withdrawal	-50 bp
Selling and Advertising expenses	-50 bp
Realisation (pricing)	25 bp
Total impact	100 bp

Source: HSBC estimates

Charts 5.26: EBITDA margin and earnings (EPS) growth forecasts



Source: Company data, HSBC estimates

Financials & valuation: Bajaj Auto

Neutral

Financial statements

Year to	03/2011a	03/2012e	03/2013e	03/2014e
Profit & loss summary (INRm)				
Revenue	166,089	199,860	226,314	255,566
EBITDA	33,849	39,863	45,263	51,880
Depreciation & amortisation	-1,228	-1,397	-1,811	-2,425
Operating profit/EBIT	32,621	38,467	43,452	49,455
Net interest	-17	-210	-16	-16
PBT	43,507	41,526	47,613	53,744
HSBC PBT	36,262	41,526	47,613	53,744
Taxation	-10,110	-10,461	-13,808	-15,048
Net profit	33,397	31,065	33,805	38,696
HSBC net profit	26,152	31,065	33,805	38,696
Cash flow summary (INRm)				
Cash flow from operations	30,018	37,523	36,421	42,015
Capex	-1,543	-3,832	-4,337	-4,897
Cash flow from investment	-9,280	-3,832	-4,337	-4,897
Dividends	-2,854	-2,884	-4,615	-4,735
Change in net debt	-14,685	-15,070	-11,771	-16,805
FCF equity	21,508	23,376	26,215	32,813
Balance sheet summary (INRm)				
Intangible fixed assets				
Tangible fixed assets	15,483	17,918	20,444	22,916
Current assets	28,726	49,144	63,810	82,821
Cash & others	5,565	20,635	32,406	49,211
Total assets	92,204	115,057	132,249	153,732
Operating liabilities	24,267	27,630	29,637	32,738
Gross debt	3,252	3,252	3,252	3,252
Net debt	-2,313	-17,384	-29,155	-45,959
Shareholders funds	49,102	61,546	75,038	93,420
Invested capital	14,377	18,797	22,211	23,788

Ratio, growth and per share analysis

Year to	03/2011a	03/2012e	03/2013e	03/2014e
Y-o-y % change				
Revenue	39.3	20.3	13.2	12.9
EBITDA	30.5	17.8	13.5	14.6
Operating profit	32.7	17.9	13.0	13.8
PBT	80.7	-4.6	14.7	12.9
HSBC EPS	-29.9	18.8	8.8	14.5
Ratios (%)				
Revenue/IC (x)	8.7	12.0	11.0	11.1
ROIC	130.7	173.5	150.5	154.8
ROE	66.7	56.2	49.5	45.9
ROA	37.6	30.1	27.3	27.1
EBITDA margin	20.4	19.9	20.0	20.3
Operating profit margin	19.6	19.2	19.2	19.4
EBITDA/net interest (x)	2002.9	189.9	2784.1	3191.1
Net debt/equity	-4.7	-28.2	-38.9	-49.2
Net debt/EBITDA (x)	-0.1	-0.4	-0.6	-0.9
CF from operations/net debt				
Per share data (INR)				
EPS Rep (fully diluted)	115.41	107.35	116.82	133.72
HSBC EPS (fully diluted)	90.37	107.35	116.82	133.72
DPS	40.00	55.00	60.00	60.00
Book value	169.69	212.69	259.31	322.84

Valuation data

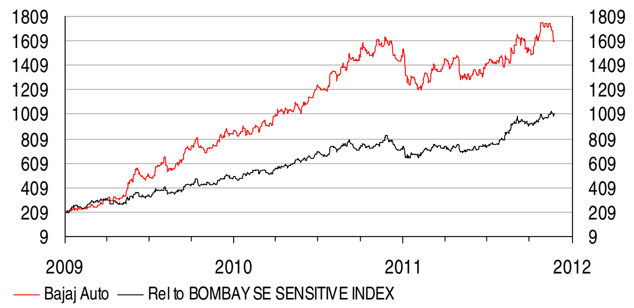
Year to	03/2011a	03/2012e	03/2013e	03/2014e
EV/sales	2.5	2.0	1.7	1.4
EV/EBITDA	12.2	10.0	8.5	7.1
EV/IC	28.7	21.2	17.4	15.5
PE*	17.7	14.9	13.7	12.0
P/Book value	9.4	7.5	6.2	5.0
FCF yield (%)	5.2	5.6	6.3	7.9
Dividend yield (%)	2.5	3.4	3.7	3.7

Note: * = Based on HSBC EPS (fully diluted)

Issuer information

Share price	(INR)1600.05	Target price	(INR)1745.00
Reuters (Equity)	BAJA.BO	Bloomberg (Equity)	BJAUT IN
Market cap (USDm)	8,857	Market cap (INRm)	463,002
Free float (%)	45	Enterprise value (INRm)	397623
Country	India	Sector	Autos
Analyst	Yogesh Aggarwal	Contact	+9122 2268 1246

Price relative



Source: HSBC

Note: price at close of 23 Nov 2011.

Hero MotoCorp

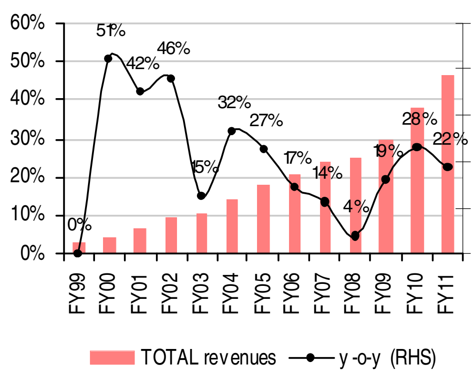
- HERO seems better placed for FY13/14, due to higher rural presence, scooters exposure and stronger margin levers
- The company faces an uphill task to develop in-house R&D, and results are likely to be visible only beyond FY13
- Initiate on HERO with OW and TP of INR2,400; dividend yield of 4.2% is another key attraction

Notwithstanding the risks from the split with Honda, we believe Hero MotoCorp (HERO) is in a better position to face slowing market growth and rising competition, at least for the next few quarters.

HERO has a strong rural presence (45-46% of sales from rural India in 2Q12, up from 38% in 1Q09). Rising rural income (both agrarian and non-agrarian) should continue to support sales growth. Additionally, even if it is not the market leader in the scooters market, the company is likely to benefit from the strong growth in the scooters market, aided by the launch of "Maestro". Overall, thanks to growth in the scooters market, a strong rural presence and lower dependence on exports, we believe competitive risks for HERO from Honda are equal or lower than for Bajaj.

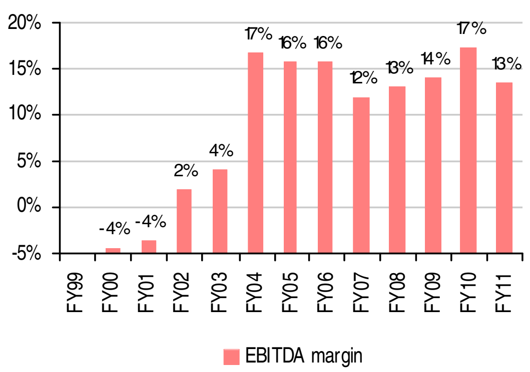
In terms of margins, HERO saw additional sales and marketing expenditure (relating to re-branding) and higher royalty payments in FY12. The company is likely to face margin tailwinds on both these fronts in FY13. Tax breaks on the Haridwar facility should also last one year more than on the Pantnagar facility of Bajaj.

Charts 6.1: Sales growth



Source: Company data, HSBC

Charts 6.2: Margin trends



Source: Company data, HSBC

Revenue outlook

HERO is the market leader in two-wheel vehicles in India with over 5.4m unit sales in FY11 and a dominant 55% share of India's motorcycle market in 2QFY12. While HERO's market share has declined from its peak of 64% in 4QFY09, as the company lost market share to Bajaj, it remains the dominant player in the market. The company has a strong rural presence with an almost 45% share of sales coming from rural areas. However, after its split from Honda (in December 2010), there are several questions the company should answer.

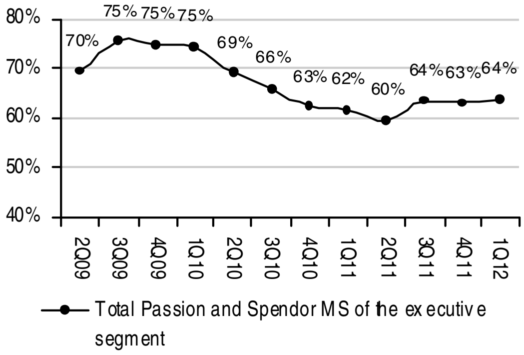
The key question: Can HERO maintain its market dominance without Honda?

We believe the company may not be impacted by the lack of in-house R&D in the near term and is likely to continue to sell the earlier models well (revamped or as is). Positively for the company, the executive segment, which is the largest segment of the overall market and HERO's key strength, is growing faster than the premium segment; therefore the relative lack of innovation may not impact the company in the near future. The company has guided to increase its R&D spend to 1-2% of revenues in FY12 and FY13, from less than 0.3% in the past three years. This compares favourably with its global and domestic competitors, such as Bajaj and Yamaha.

The magic of Splendor and Passion

HERO's Splendor and Passion have been the market-leading models in the executive segment for over a decade now.

Charts 6.3: Splendor and Passion share of the executive segment

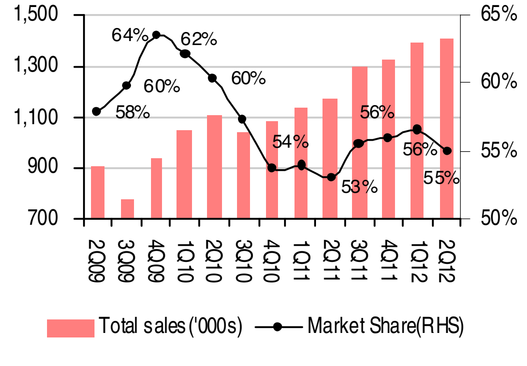


Source: Company data, Crisil, HSBC

Positively for HERO, the executive segment has not slowed down and has been growing in line or faster than the overall market.

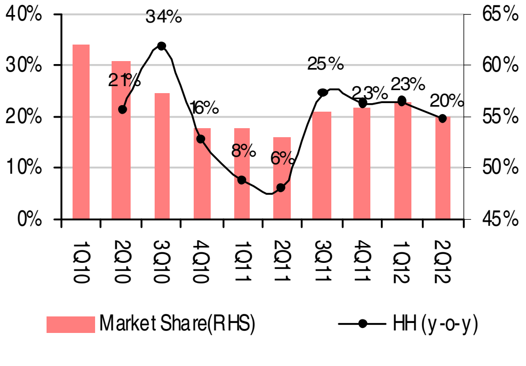
This is benefiting HERO as the proportion of revenues from the executive segment has been stable in the past few quarters, despite the increased competition from Bajaj.

Charts 6.4: Market share trends



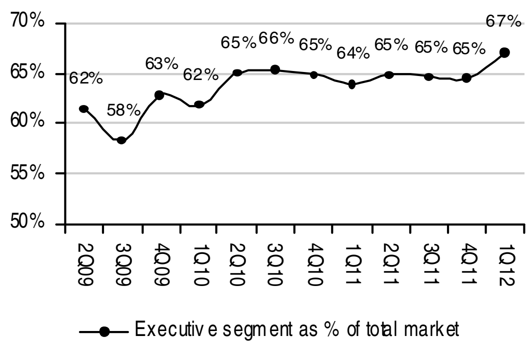
Source: Company data, SIAM, HSBC

Charts 6.5: Market share and y-o-y growth trends



Source: Company data, SIAM, HSBC

Charts 6.6: Executive segment as % of total 2W market

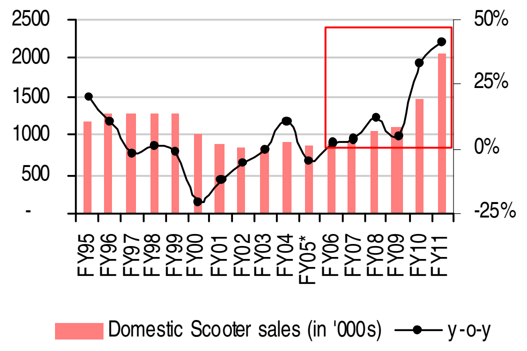


Source: Company data, Crisil, HSBC

In the economy segment, the company has been able to retain over a 40% market share (primarily from the CD family), although the segment is reducing as a share of the overall market. In the premium segment, HERO has multiple models, but the market share has been relatively stable as the following charts show. We believe HERO might face stiff competition in this segment in the coming quarters (with the launch of the new Pulsar from Bajaj and Honda's higher Unicorn production capacity). Although HERO has recently refreshed its Karizma and Hunk models, these motorcycles share an engine with Honda's Unicorn.

Overall, we believe HERO is likely to lose market share to Honda in the executive segment, but still maintain its leadership due to its strong presence in the rural market and continued traction of existing models. Furthermore, HERO's scooters could provide some upside to its total sales.

Charts 6.7: India's domestic scooter sales (FY95-11)



Source: SIAM, HSBC

Table 6.1: R&D spend as % of sales

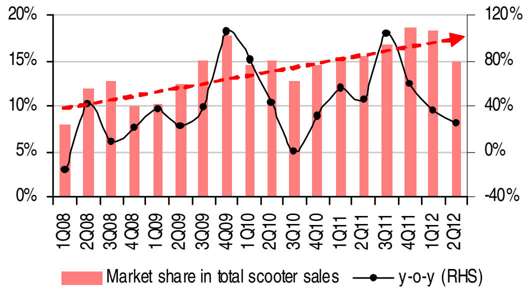
INRm	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11
Bajaj Auto												
Expenditure on R&D - capital	25	287	36	100	269	275	263	473	481	311	312	116.5
Expenditure on R&D - capital	316	324	338	323	381	395	504	677	706	838	1035	1129.5
Total	341	610	374	422	650	670	767	1150	1187	1149	1348	1246
Total R&D as a % of sales	1.1%	2.0%	1.0%	1.0%	1.4%	1.2%	1.0%	1.2%	1.4%	1.4%	1.2%	0.8%
Royalty	110	166	201	203	267	325	296	101	36	55	38	24
% of sales	0.4%	0.5%	0.1%	0.5%	0.6%	0.6%	0.4%	0.1%	0.0%	0.1%	0.0%	0.0%
Royalty + R&D as a % of sales	1.5%	2.6%	1.6%	1.5%	1.9%	1.7%	1.4%	1.3%	1.4%	1.4%	1.2%	0.8%
Hero Honda												
Expenditure on R&D - capital	57	4	14	16	74	34	107	81	194	86	32	38.9
Expenditure on R&D - capital	43	48	57	70	93	131	147	179	188	237	272	283
Total	100	51	71	85	168	165	254	260	382	323	303	322
Total R&D as a % of sales	0.5%	0.2%	0.2%	0.2%	0.3%	0.2%	0.3%	0.3%	0.4%	0.3%	0.2%	0.2%
Royalty	179	247	516	689	896	1574	2124	2544	2767	3240	4164	3681
% of sales	0.8%	0.8%	1.2%	1.4%	1.5%	2.1%	2.4%	2.6%	2.7%	2.6%	2.6%	1.9%
Royalty + R&D as a % of sales	1.3%	0.9%	1.3%	1.5%	1.8%	2.3%	2.7%	2.8%	3.0%	2.9%	2.8%	2.1%

Source: Company data, HSBC

Scooters in the fast lane

The scooter market has revived strongly in the past two years after fading away in the early 2000. This revival has been driven by demand from commuters looking for easy-to-use two-wheelers, including a rising number of working women. Honda is the market leader in scooters with a near-43% market share followed by TVS and HERO.

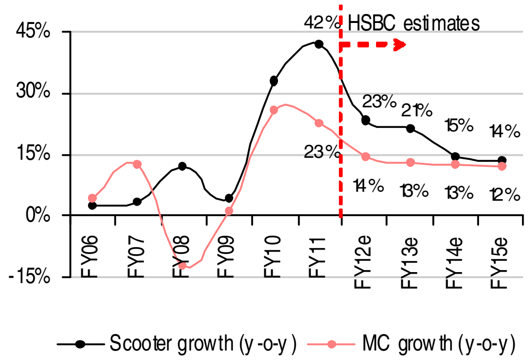
Charts 6.8: Market share of HERO in total domestic Scooters



Source: Company data, HSBC

Scooters are usually not the primary vehicle in a household in India and therefore cannot be purely judged based on household penetration. Rising household income and nuclear family growth, however, are resulting in stronger sales of scooters, which we believe is likely to continue for some years. We expect scooters to grow at a faster pace than motorcycles in FY13/14.

Charts 6.9: Growth expected in Scooters vs. Motorcycle



Source: SIAM, Company data, HSBC estimates.

For HERO, scooters are the key growth differentiator compared to Bajaj, in our view. HERO is scheduled to add another scooter model "Maestro" soon.

Table 6.2: Compared key specs of Active vs. Pleasure vs. TVS

	Price (INR '000s)	Engine capacity (cc)	Max power (bhp)	Fuel Efficiency (kmpl)
Activa (Honda)	43.7	109	8	55
Pleasure (HERO)	42.9	102	7	50
TVS Scooty	35.5	88	5	65

Source: Company data, HSBC

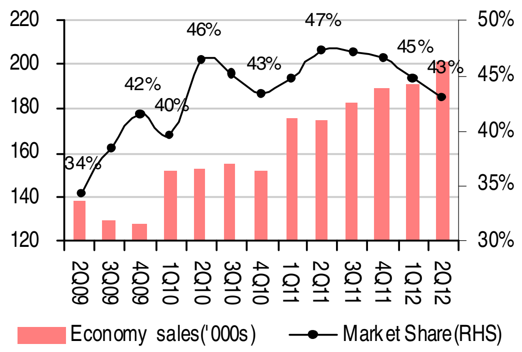
Exports story – how credible is it?

HERO is looking to expand it global exposure and grow exports, now that the company is free from all the constraints of its JV with Honda. This is likely to add a new growth lever for the company, as seen in the case of Bajaj. The obvious target markets are Africa, ASEAN and Latin America. While HERO has a decent range of products to target this market (CD Dawn), we believe it may take the company some time to develop exports into a significant contributor. Most of the target geographies are trading markets for two-wheeler companies and therefore a dealer network is key. Most Bajaj dealers bear the currency risk and investment cost to build the dealership, transit network, advertising and customer service stations. HERO would have to put up the investment itself to build this infrastructure, which would put pressure on profitability, or take more time to find the right partners in each markets.

We therefore do not expect exports will contribute meaningfully to overall growth in the next few years.

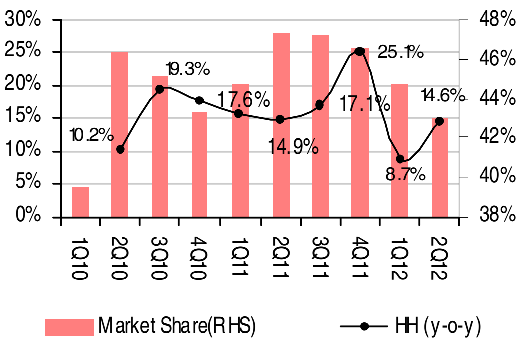
Charts 6.10: HERO sales/revenues trends

Economy segment – HERO has made significant market share gains in this segment from Bajaj's Platina in past few years, thanks to its CD Deluxe range



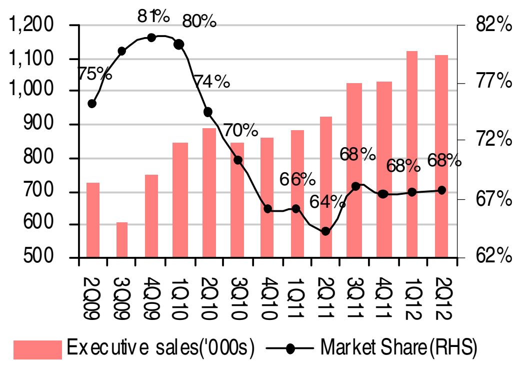
Source: Company data, SIAM, HSBC

Economy segment – The segment is declining overall as economy segment buyers have either opted out due to lower funding availability or are upgrading to executive segment



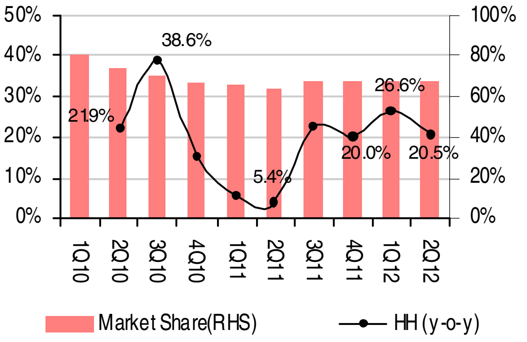
Source: Company data, SIAM, HSBC

Executive segment - HERO has lost market share to Bajaj's Discover in FY09/10/1H11; however, market share has been stable in the past three quarters



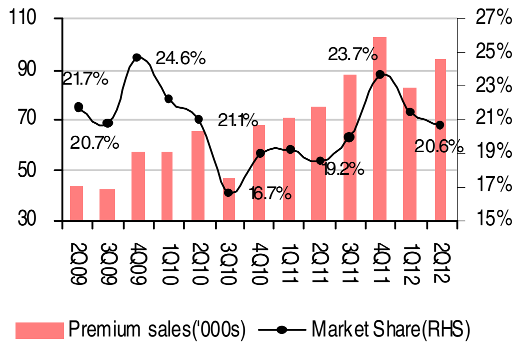
Source: Company data, SIAM, HSBC

Executive segment: This is the key segment facing threat from the entry of Honda, post split from HERO



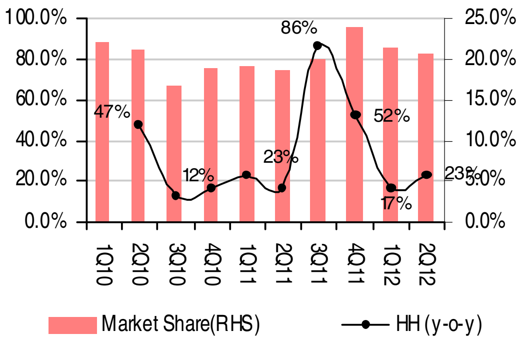
Source: Company data, SIAM, HSBC

Premium segment - Weakest link for HERO; has gained some share from Bajaj's Pulsar in the last one year



Source: Company data, SIAM, HSBC

Premium segment: Launch of new Pulsar early next year could again reverse trends for HERO in the segment



Source: Company data, SIAM, HSBC

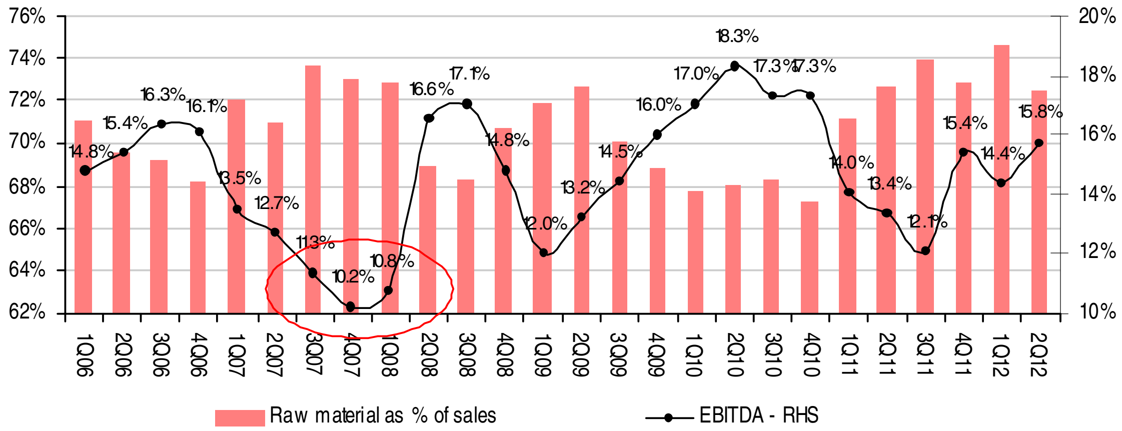
Profitability trends

HERO's profitability was materially impacted by the increase in commodity costs in FY11, with the EBITDA margin down 390bps in FY11. Similar to Bajaj, we don't expect fiscal stimulus, in terms of excise duty benefits, to provide significant tailwinds for the company. However unlike Bajaj, HERO seems to have multiple margin levers in FY13/14. While margins are likely to expand meaningfully after FY14 when royalty payments are fully amortised, we assume a rather sanguine margin performance in FY13 as well. In our view, the company has clearly reached a bottom in its margin trend, with a number of positive margin levers that should offset incremental investment in R&D and export markets. The following factors are key margin concerns:

- Realisation improvement could be tougher for HERO than Bajaj. HERO might find it tougher to increase pricing unless it develops new models, with refreshed models unlikely to be able to continue commanding incremental pricing. Furthermore, the company needs to invest intensively in R&D facilities. But while it is true that R&D costs will go up, it is unlikely to significantly impact margins. R&D expenses are less than 2% of sales for Bajaj and TVS, who conduct all R&D in-house. With HERO's scale, it should be less than 2% on a sustainable basis.
- Considering HERO's current high capacity utilisation, investments in new plants should impact other income and depreciation. We have factored that in our forecasts. It's worth noting that HERO capital expenditure in the past two years was 2% of sales, while for Bajaj it was less than 1%.
- Finally, to expand export business, the company might have to incur upfront expenditure to build its distributor network and for initial advertising and brand building, which could be a drag on margins, in our view.

While most of the above concerns have merit and have been factored in our forecasts, there are multiple factors that are positive for margins which are worth noting. Primarily, the expected fall in raw material costs, decline in royalty costs as a percentage of sales, decline in one-time branding costs made in 2011 and increase in production in the Haridwar plant could result in further improvement in the net realisation.

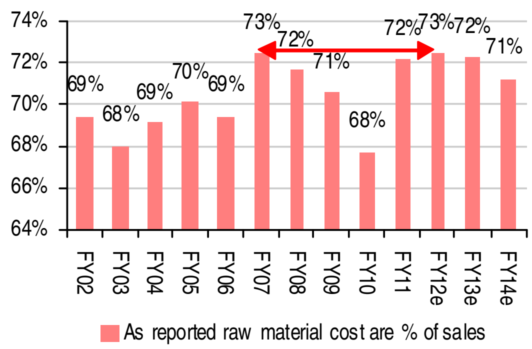
Charts 6.11: Profitability trends



Source: Company data, HSBC

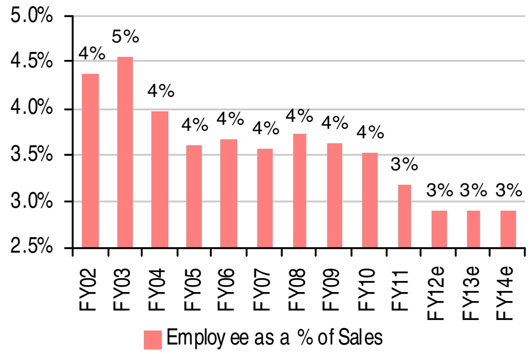
Charts 6.12: Margin levers trend analysis

Raw material cost as % of sales



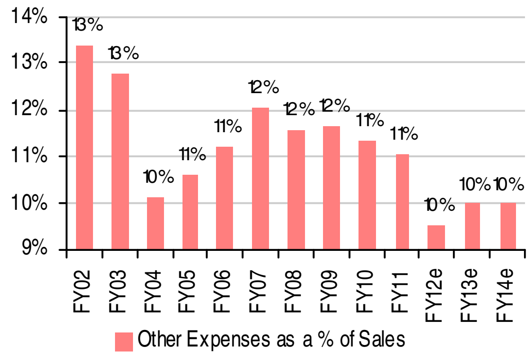
Source: Company data, HSBC estimates

Employee cost as % of sales



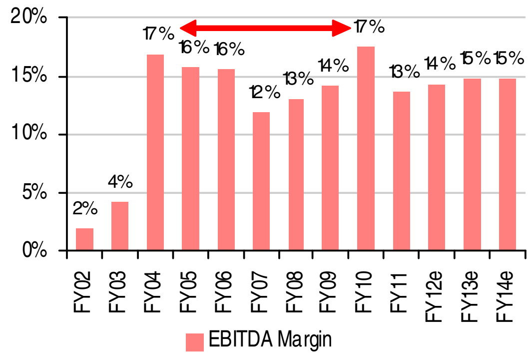
Source: Company data, HSBC estimates

Other expenses



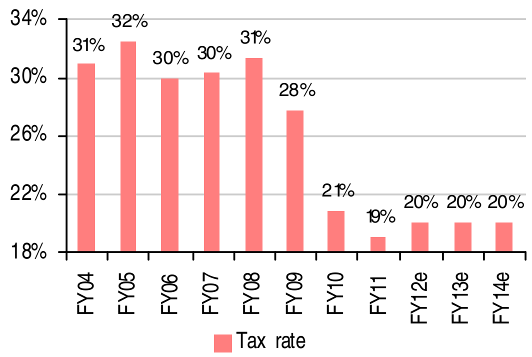
Source: Bloomberg, HSBC estimates

EBITDA margin



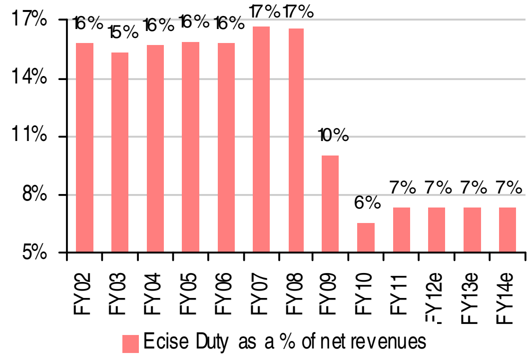
Source: Company data, HSBC estimates

Tax rate



Source: Company data, HSBC estimates

Excise duty as % of net revenues



Source: Company data, HSBC estimates

Overall, we expect margin expansion to continue in FY13. There are multiple levers at play here. While a decline in raw material costs, should it occur, would undoubtedly act as the main lever; a decline in one-time branding costs in FY12, increase in production in the Hardiwar plant, and decrease in royalty amortisation (as a percentage of sales) are more visible key positive margin levers. These levers should not only fully offset the margin concerns as discussed above, but result in margin expansion in FY13 and beyond.

Table 6.3: Margin levers in FY13

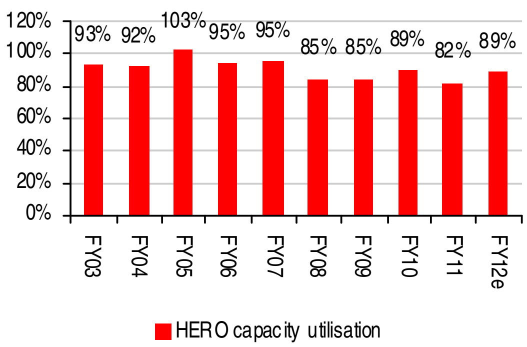
Margin levers	FY13e
RM costs	100 bp
Sales and marketing (branding)	40 bp
R&D costs	-50 bp
Increase in production in Haridwar	40 bp
Export investments	-25 bp
Realisation	25 bp
Royalty amortisation	40 bp
Total margin impact	170 bp

Source: HSBC estimates

Capacity utilisation

HERO is adequately investing into capacity expansion and seems to be well on track to achieve our estimate of 6.3m vehicles in FY12.

Charts 6.13: Capacity utilisation



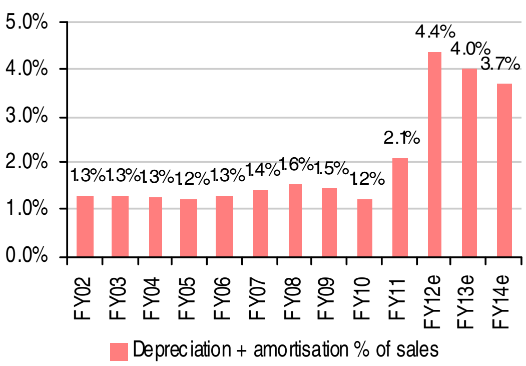
Source: Company data, HSBC estimates

The company has a planned capital expenditure of INR6bn in FY12 (down from the earlier guidance of INR8-9bn), including INR5-5.5bn for a greenfield project with an estimated initial capacity of 750k vehicles.

Royalty payments

One of the side effects of the amicable separation from Honda in December 2010 was a one-time royalty payout of INR24.8bn. The company is amortising this payment till 2014, resulting in an increase in D&A by INR1770m every quarter. This has increased the D&A as percentage of sales from 1.2% in FY10 to 2.1% in FY11 and 4.6% in FY12. Lately, the yen appreciation has further increased the liability. Yen has appreciated by nearly 16% in 2Q12, resulting in an increase in the amortisation amount to INR2,080m (from INR1770m in 1Q12) per quarter.

Charts 6.14: Depreciation and amortisation as % of sales



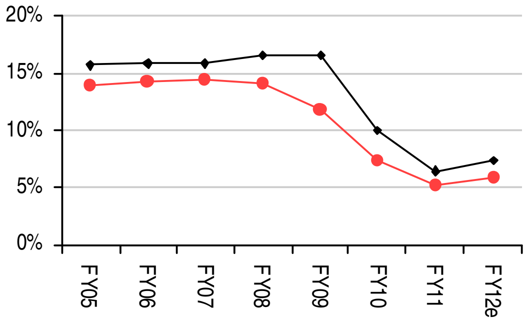
Source: Company data, HSBC estimate

Realisation per vehicle

Realisation per vehicle for HERO is nearly 12% lower than for its closest competitor Bajaj. We believe the difference is understandable and is attributed to multiple reasons. The two most apparent are: 1) Bajaj realisation per vehicle includes three-wheelers, which are higher value models than two-wheelers and 2) Bajaj is more dominant in the premium segment (through its Pulsar range) versus HERO which occupies the top slot in the economy and executive segment.

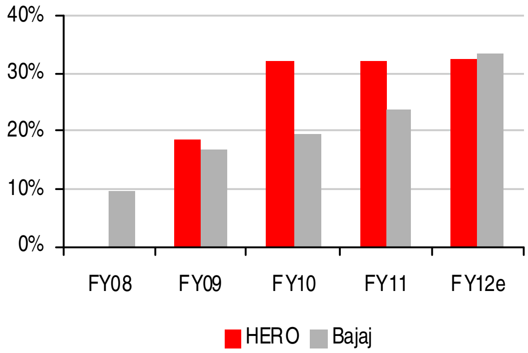
While the difference in realisation is obvious, we have not seen the gap increasing, as has been widely perceived. While the quarterly differences are plausible, HERO's realisation per vehicle has increased by near 28% in the past 6 years (since

Charts 6.18: Excise duty as % of net revenues



Source: Company data, HSBC estimates

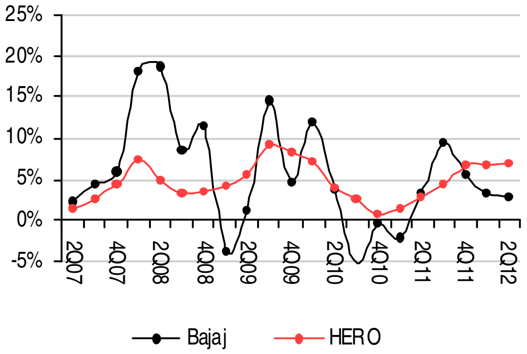
Charts 6.19: Percentage contribution to sales from excise duty free zones



Source: Company data, HSBC estimates

1QFY06), which is only less than 2pts lower than for Bajaj.

Charts 6.16: Realisation per vehicle



Source: Company data, HSBC

Excise duty

HERO is currently paying excise duty of 7.1% (as a percentage of net revenues in 2Q12), down from a peak of nearly 19% in 4QFY07, but still higher than the 4.7% paid by Bajaj.

The decline in excise duties is largely the result of the reduction in excise duty from 10% to 8% in February 2009 made by the government as an export incentive. Furthermore, both Bajaj and HERO have ramped up capacities in excise-free zones in Uttranchal, such as Haridwar for HERO and Pantnagar for Bajaj (see Chart 6.18 and 6.19).

HSBC

Financials & valuation: Hero MotoCorp

Overweight

Financial statements

Year to	03/2011a	03/2012e	03/2013e	03/2014e
Profit & loss summary (INRm)				
Revenue	194,012	235,360	269,911	305,743
EBITDA	26,164	36,602	43,186	48,764
Depreciation & amortisation	-4,024	-10,786	-11,966	-12,755
Operating profit/EBIT	22,140	25,816	31,220	36,009
Net interest	601	114	79	52
PBT	24,048	29,938	36,893	40,747
HSBC PBT	24,846	29,938	36,893	40,747
Taxation	-4,769	-5,045	-6,272	-9,372
Net profit	19,279	24,893	30,622	31,375
HSBC net profit	19,279	24,893	30,622	31,375
Cash flow summary (INRm)				
Cash flow from operations	32,658	45,860	44,707	44,618
Capex	-29,009	-8,238	-8,637	-9,172
Cash flow from investment	-16,978	-1,238	1,363	828
Dividends	-24,533	-21,028	-23,365	-23,365
Change in net debt	18,357	-5,589	1,455	2,079
FCF equity	-518	32,691	29,877	26,126
Balance sheet summary (INRm)				
Intangible fixed assets	0	0	0	0
Tangible fixed assets	42,054	39,506	36,178	32,595
Current assets	15,046	23,838	24,515	24,020
Cash & others	715	6,304	4,849	2,770
Total assets	108,387	121,632	128,981	134,903
Operating liabilities	68,016	63,357	61,112	59,024
Gross debt	0	0	0	0
Net debt	-715	-6,304	-4,849	-2,770
Shareholders funds	29,561	33,425	40,682	48,692
Invested capital	-11,631	-6,317	-5,268	-5,179

Ratio, growth and per share analysis

Year to	03/2011a	03/2012e	03/2013e	03/2014e
Y-o-y % change				
Revenue	22.3	21.3	14.7	13.3
EBITDA	-5.4	39.9	18.0	12.9
Operating profit	-13.9	16.6	20.9	15.3
PBT	-15.1	24.5	23.2	10.4
HSBC EPS	-13.6	29.1	23.0	2.5
Ratios (%)				
Revenue/IC (x)	-15.5	-26.2	-46.6	-58.5
ROIC	-153.1	-313.4	-566.6	-653.4
ROE	60.0	79.0	82.6	70.2
ROA	20.1	21.8	24.5	23.9
EBITDA margin	13.5	15.6	16.0	15.9
Operating profit margin	11.4	11.0	11.6	11.8
EBITDA/net interest (x)				
Net debt/equity	-2.4	-18.9	-11.9	-5.7
Net debt/EBITDA (x)	0.0	-0.2	-0.1	-0.1
CF from operations/net debt				
Per share data (INR)				
EPS Rep (fully diluted)	96.54	124.65	153.34	157.11
HSBC EPS (fully diluted)	96.54	124.65	153.34	157.11
DPS	105.00	90.00	100.00	100.00
Book value	148.03	167.38	203.72	243.82

Valuation data

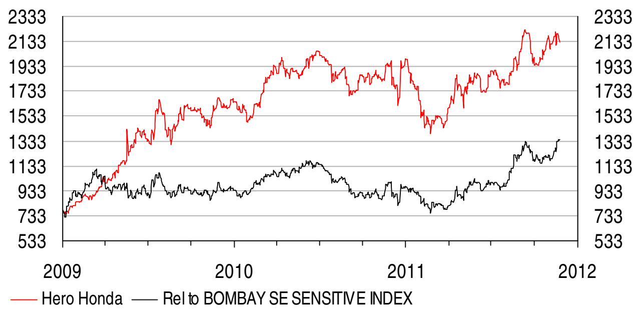
Year to	03/2011a	03/2012e	03/2013e	03/2014e
EV/sales	1.9	1.5	1.3	1.1
EV/EBITDA	14.2	9.8	8.1	7.0
EV/IC				
PE*	22.0	17.1	13.9	13.5
P/Book value	14.4	12.7	10.4	8.7
FCF yield (%)	-0.1	8.9	8.4	7.5
Dividend yield (%)	4.9	4.2	4.7	4.7

Note: * = Based on HSBC EPS (fully diluted)

Issuer information

Share price	(INR)2126.65	Target price	(INR)2400.00
Reuters (Equity)	HROM.BO	Bloomberg (Equity)	HMCL IN
Market cap (USDm)	8,124	Market cap (INRm)	424,665
Free float (%)	45	Enterprise value (INRm)	360074
Country	India	Sector	AUTOS
Analyst	Yogesh Aggarwal	Contact	+9122 2268 1246

Price relative



Source: HSBC

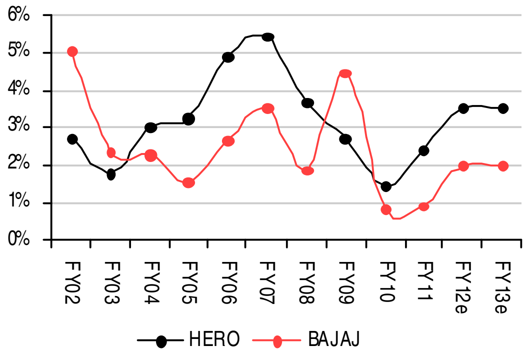
Note: price at close of 23 Nov 2011

Valuation and risks

- Stocks are trading at valuations in line with historical averages
- We use both DCF and relative valuation methodologies to value the companies
- Initiate on HERO with OW rating (TP INR2,400) and on Bajaj with Neutral rating (TP INR1,745)

The two-wheeler industry has low capital requirements and the margins are relatively stable compared to any other auto segment (as passenger vehicles or commercial vehicles). For both HERO and Bajaj, capex as a percentage of sales has been low at 2-3% in the past 10 years.

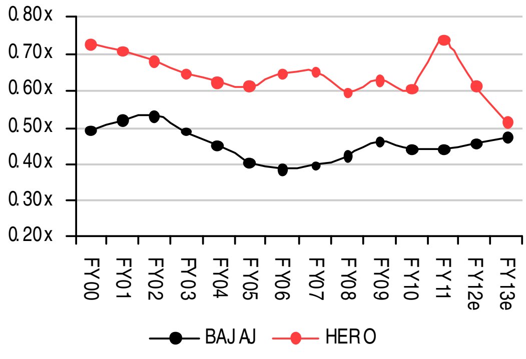
Chart 7.1: Capex to sales ratio



Source: Company data, HSBC estimates

This has also resulted in a strong asset turnover ratio. Bajaj, in particular, had extremely low capital expenditure at less than 1% of sales in the past two years. This has resulted in low depreciation charges as a large proportion of the assets is already depreciated. Currently, both the companies are running at high capacity utilisation rates and therefore are likely to increase the capital expenditure in the next few years, which should result in an increase in depreciation charges (as a percentage of sales in FY13/14).

Chart 7.2: Net assets to gross assets

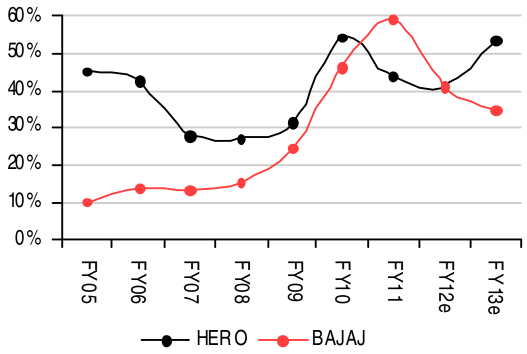


Source: Company data, HSBC estimates

Low capital intensity, negative working capital and multiple fiscal incentives have resulted in strong free cash flow (FCF) generation in the past. HERO in the past 6 years had on average a FCF to net profit ratio of near 100%.

As mentioned earlier, strong demand and high capacity utilisation may result in high capital expenditure in the near term (as guided by HERO as well). However, the return ratios and FCF would still remain healthy.

Chart 7.3: ROACE trends



Source: Company data, HSBC estimates

Valuation methodology

We consider both DCF and PE valuations (referencing both historical and peer group levels) for valuing these companies. While PE is the most followed valuation methodology, we believe long-term trends can only be captured in DCF analysis. Stocks may trade at a premium or discount to DCF, depending on what stage of the cycle that the industry is in, but the long-term sustainable growth trend, based on penetration levels and cost of ownership trends, can only be captured in DCF. Our assumptions for DCF are in the following Table 7.2.

Bajaj

Bajaj is currently trading at 14x our FY13e earnings. Bajaj has had a much better run-up in its share price in the last two years compared to the CNX Auto – 2/3W cluster, as illustrated in Chart 7.3-F.

We arrive at a WACC of 11% for Bajaj based on the HSBC methodology assuming a risk free rate of 3.5%, cost of equity of 11% and cost of debt of 9.2%. We assume a terminal growth rate of 4.5% for Bajaj.

Our DCF analysis values Bajaj at INR1,745, implying a PE of 15x on FY13e EPS. This is in line with the average multiple of the last two year. We estimate adjusted EPS will grow at a 14% CAGR FY11-13. At this stage of the industry cycle, with sales growth off the peak and financial incentives coming to an end, we continue to value the stock at 15x FY13e EPS and initiate coverage on Bajaj with a Neutral rating and target price of INR1,745.

Table 7.1: Historic valuation range and DCF summary

	HERO	BAJAJ
DCF value per share	2,416	1,747
Implied PE on FY13e EPS	15.8x	15.0x
5-year historic average PE*	14.8x	13.7x
2-year historic average PE*	15.3x	15.0x
5-year max PE	18.8x	20.2x
5-year Min PE	11.2x	4.9x
Currently trading on FY13e EPS	13.9x	13.7x

Source: Datastream, Company data, HSBC estimates, repriced on 23 Nov 2011.

Under our research model, for stocks without a volatility indicator, the Neutral band is 5ppts above and below the hurdle rate for Indian stocks of 11%. As the potential return of 12.5% (including dividend yield) is within the Neutral band, we rate the stock Neutral. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

Risks

On the downside, increasing intensity of competition in the premium segment bikes from Honda, Yamaha and even TVS (with the recent introduction of Apache with ABS) is a significant threat for Bajaj which commands 42% of the segment sales in the upper segment.

Bajaj, due to its significant proportion of exports, is fairly subject to changes in export regulations which could have a material affect on earnings, in our view.

On the upside, Bajaj with a history of new launches and quick technology adoption has often delivered vehicles that have boosted sales in the year of launch.

Margin expansion remains a key upside risk, considering a likely correction in commodity prices, increase in three wheeler sales, and significant benefit of operating leverage.

HERO

In the past 15 months, HERO has seen significant downward revisions in consensus earnings estimates as illustrated in Chart 7.3c. Subsequently, the stock has been underperforming the CNX Auto – 2/3W cluster. The stock is currently trading at 14x our FY13e EPS, lower than its 5-year historical average of 15x 12-months forward PE.

We arrive at a WACC of 11% for HERO based on the HSBC methodology and assume a terminal growth rate of 4% for HERO. We assume a risk free rate of 3.5%, cost of equity of 11% and cost of debt of 10.1% as per the HSBC methodology. Our DCF analysis values HERO at INR2,400, implying a multiple of 16x on FY13e EPS. Historically, HERO has traded in the PE range of 11-20x,

We believe strong customer reach and an impressive share in the economy and executive segment of bikes make a strong case for our optimism over HERO. With a foot in the scooter market as well, we believe HERO is well-placed to clock a 14% CAGR in earnings for FY11-13e while expanding its margins as well. Our target price implies the stock will trade at 16x our FY13e EPS. The stock is unlikely to trade at a significant premium to the PE multiple implied by our DCF analysis as sales growth are off the peak due to the industry cycle.

Under our research model, for stocks without a volatility indicator, the Neutral band is 5ppts above and below the hurdle rate for Indian stocks of 11%. As the potential return of 17% (including dividend yield) is above the Neutral band, we rate the stock Overweight. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

Risks

The primary risk to our estimates will be HERO's new product introduction strategy for the next two years. While HERO's R&D, successful or otherwise, will not yield results until FY13, HERO could lose customer trust and market share if the new products set to be introduced in the next year and half, with contractual support from Honda, turn out to be sub-par.

Further appreciation of yen could further dent margins and profitability.

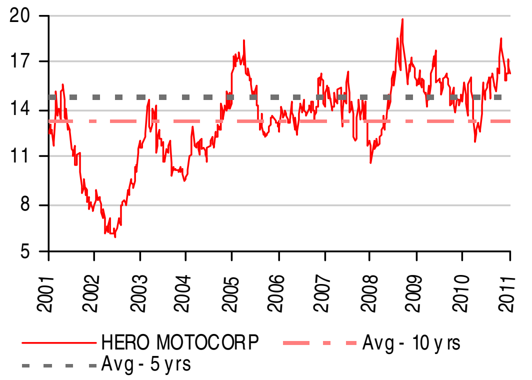
Table 7.2: Valuation summary

DCF assumptions	FY12e	FY13e	CAGR FY13-18e	CAGR FY18-25e
HERO				
Total domestic Motorcycle market sales growth	13.9%	13.0%	10.7%	6.1%
Market share of HERO in Domestic Motorcycle sales	55.5%	54.7%		
Sales growth rates of HERO	15.7%	12.0%	9.7%	5.9%
EBITDA margins	15.6%	16.0%		
Terminal growth assumed	4%			
Total PV	482,510			
Value per share	**2,400**			
Bajaj				
Market share of BAJAJ in Domestic Motorcycle sales	25.8%	25.4%		
Sales growth rates of BAJAJ (including 3W)	15.2%	11.3%	9.4%	5.8%
EBITDA margins	19.9%	20.0%		
Terminal growth assumed	4%			
Total PV	505,438			
Value per share	**1,745**			

Source: HSBC estimates

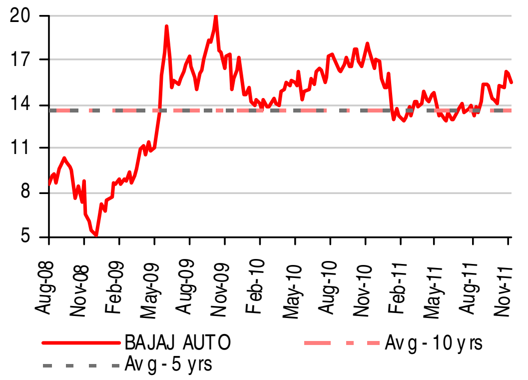
Chart 7.3: Historical valuation trends

A) PE (12-month forward) – HERO



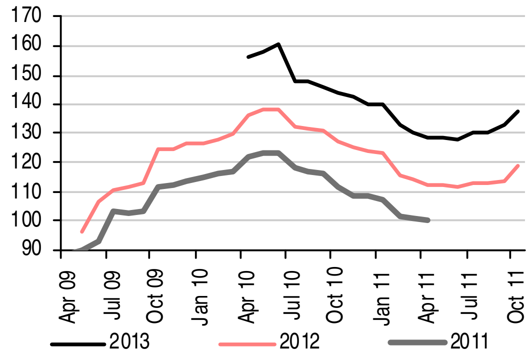
Source: Datastream

B) PE (12-month forward) - BAJAJ



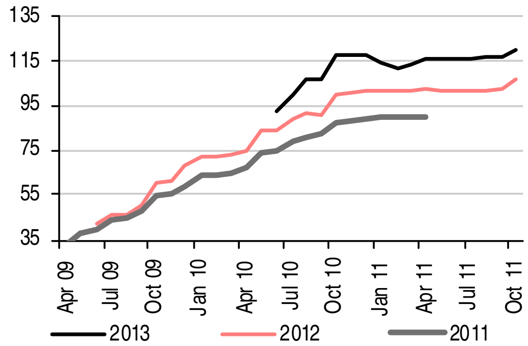
Source: Datastream

C) EPS revision – HERO



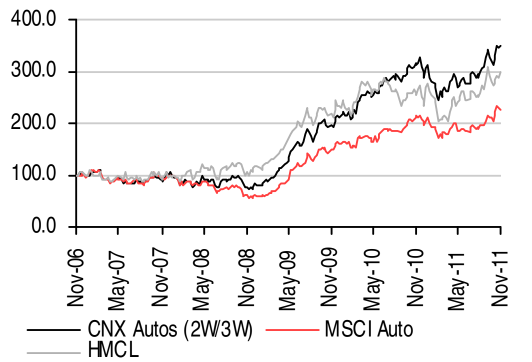
Source: Factset

D) EPS revision - BAJAJ



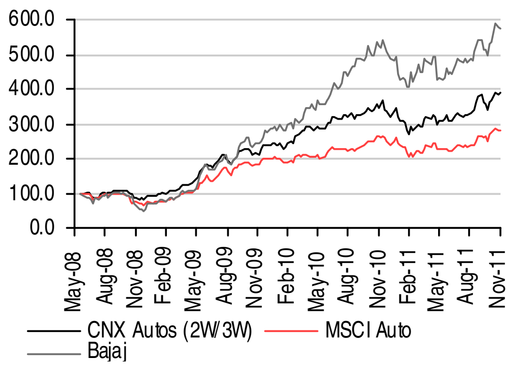
Source: Factset

E) Stock price (absolute and relative to sector last 5 years) - HERO



Source: Datastream

F) Stock price (absolute and relative to sector last 5 years) - BAJAJ



Source: Datastream

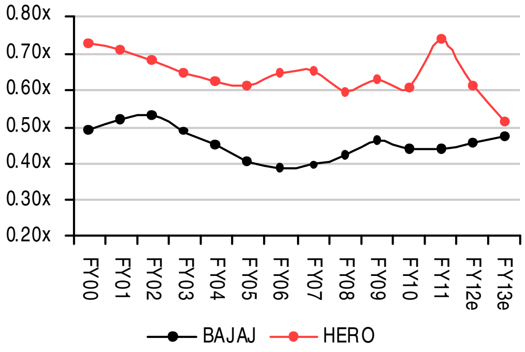
Table 7.3: Past cycle and corresponding valuations

	HERO	BAJAJ
FY05-10		
CAGR Revenue	16.4%	15.2%
CAGR earnings	22.5%	10.3%
Max PE	18.8x	20.2x
Min PE	11.2x	4.9x
Average PE	14.6x	12.6x
FY10-12e		
CAGR Revenue	21.8%	29.5%
CAGR earnings	5.6%	35.2%
Max PE	18.3x	18.3x
Min PE	11.7x	12.6x
Average PE	15.2x	15.1x
FY12-14e		
CAGR Revenue	14.0%	13.1%
CAGR earnings	12.3%	11.6%
Current PE on FY12e EPS	17.1x	14.9x
Current PE on FY13e EPS	13.9x	13.7x
Current EV/EBITDA on FY13e EBITDA	8.6x	9.1x

Source: Company data, HSBC estimates. Repriced on 23 Nov 2011

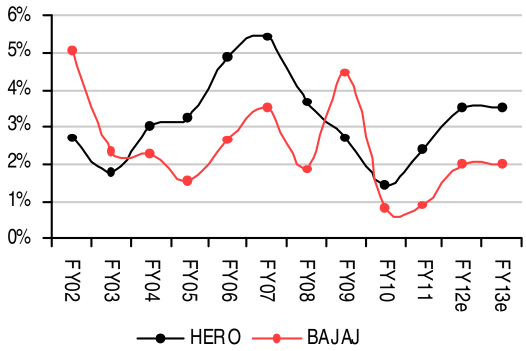
Charts 7.4: Financial ratios

Net Assets to gross assets



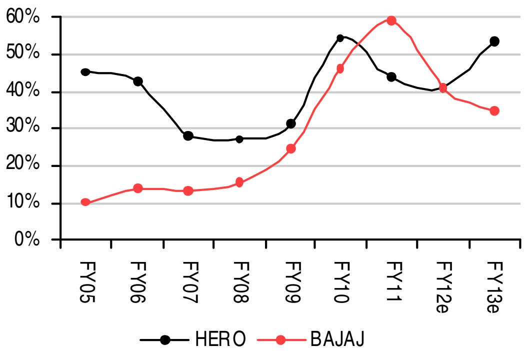
Source: Company data, HSBC estimates

Capex to sales ratio



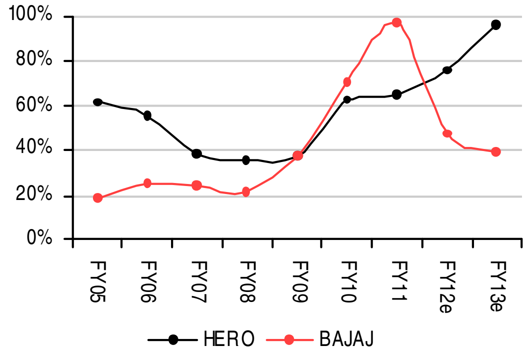
Source: Company data, HSBC estimates

ROACE



Source: Company data, HSBC estimates

ROE



Source: Company data, HSBC estimates

HSBC

Table 7.4: Bajaj - Summary of financials

INRm	FY11	FY12e	FY13e	FY14e
Profit and Loss				
Net Sales	159,981	191,581	216,828	244,854
Operational income	6,108	8,279	9,486	10,712
Total operational income	166,089	199,860	226,314	255,566
Total Costs	132,240	159,997	181,051	203,686
EBITDA	**33,849**	**39,863**	**45,263**	**51,880**
Depreciation	1,228	1,397	1,811	2,425
Non-Operational Other Income	3,658	3,269	4,177	4,305
Interest expense	17	210	16	16
PBT	36,262	41,526	47,613	53,744
Tax	10,110	10,461	13,808	15,048
Adjusted profit	26,152	31,065	33,805	38,696
Net Profit	33,397	31,065	33,805	38,696
Adjusted EPS	**90.4**	**107.4**	**116.8**	**133.7**
EPS	115.4	107.4	116.8	133.7
Dividend (Rs/share)	40.0	55.0	60.0	60.0
Balance Sheet				
Equity Capital	2,894	2,894	2,894	2,894
Reserves & Surplus	46,209	58,653	72,144	90,526
Loan Funds	3,252	3,252	3,252	3,252
Total Funds Employed	52,651	65,095	78,586	96,968
Application of Funds				
Net Fixed Assets	15,483	17,918	20,444	22,916
Cash, Bank Bal & Deposits	5,565	20,635	32,406	49,211
Inventory	5,473	6,575	8,433	9,487
Sundry Debtors	3,628	7,873	8,911	10,063
Current Assets	28,726	49,144	63,810	82,821
Sundry Creditors	19,431	22,794	24,802	27,902
Current Liabilities	24,267	27,630	29,637	32,738
Proposed dividend	11,575	18,621	20,314	20,314
Total Net Assets	52,651	65,095	78,586	96,968
Summary of Cashflow statement				
Profit Before Tax (adjusted)	36,262	41,526	47,613	53,744
Depreciation	1,228	1,397	1,811	2,425
Operational Cash Flow	30,018	37,523	36,421	42,015
Fixed Assets Purchase	1,543	3,832	4,337	4,897
NET CASH FLOW	4,551	15,070	11,771	16,805
Beginning Cash Balance	1,014	5,565	20,635	32,406
Ending Cash Balance	5,565	20,635	32,406	49,211

Source: Company data, HSBC estimates.

HSBC

Table 7.5: Bajaj: Key ratios

	FY11	FY12e	FY13e	FY14e
Ratios & Margin				
EBITDA	20.4%	19.9%	20.0%	20.3%
EBIT	19.6%	19.2%	19.2%	19.4%
Net Profit	20.1%	15.5%	14.9%	15.1%
Raw Material Cost	71.0%	71.5%	71.0%	71.0%
Employee Cost	2.9%	2.8%	3.0%	3.0%
Factory and Administrative expenses	4.5%	3.8%	4.0%	3.7%
Selling and Adv Expenses	0.8%	1.5%	1.5%	1.5%
Tax rate	27.9%	25.0%	25.0%	25.0%
Net Realisation per Vehicle	41,835	43,475	44,219	44,921
No. of Days of Inventory	14	15	17	17
No. of Days of Creditors	52	52	50	50
No. of Days of Debtors	7	15	15	15
ROE	85.2%	56.2%	49.5%	45.9%
ROACE	49.4%	49.0%	45.4%	42.3%
ROA	37.6%	30.0%	27.3%	27.1%
Asset turnover	1.8x	1.7x	1.7x	1.7x
Capex as % of avg sales	0.9%	2.0%	2.0%	2.0%
Debt to Equity	6.6%	5.3%	4.3%	3.5%
Operating cash flows to EBITDA	88.7%	94.1%	80.5%	81.0%
FCF to EBIT	87.3%	87.6%	73.8%	75.1%
Growth rate (y-o-y)				
Sales volume	34.1%	15.2%	11.3%	11.2%
Net Realisation per Vehicle	3.7%	3.9%	1.7%	1.6%
Net Sales	39.0%	19.8%	13.2%	12.9%
Operational income	47.6%	35.5%	14.6%	12.9%
EBITDA	30.5%	17.8%	13.5%	14.6%
Adjusted net profit	40.2%	18.8%	8.8%	14.5%
EPS growth	-1.8%	-7.0%	8.8%	14.5%

Source: Company data, HSBC estimates.

HSBC

Table 7.6: HMCL - Summary of financials

INRm	FY11	FY12e	FY13e	FY14e
Profit & Loss				
Total operational income	194,012	235,360	269,911	305,743
Total costs	167,848	198,758	226,725	256,979
EBITDA	26,164	36,602	43,186	48,764
Depreciation	2,254	2,776	3,646	4,435
Amortisation of royalty	1,770	8,010	8,320	8,320
Non-Operational Other Income	2,864	4,279	5,831	4,895
Gross interest paid	158	158	158	158
Profit Before Tax	24,846	29,938	36,893	40,747
Current tax	4,758	5,045	6,272	9,372
Adjusted profit	20,077	24,893	30,622	31,375
Net Profit	19,279	24,893	30,622	31,375
Adjusted EPS	100.5	124.7	153.3	157.1
EPS	96.5	124.7	153.3	157.1
Dividend (Rs/share)	105.0	90.0	100.0	100.0
Summary of balance Sheet				
SOURCES OF FUND				
Total Equity	29,561	33,425	40,682	48,692
Loan Funds	327	327	327	327
Total Funds Employed	46,940	46,800	49,896	53,746
APPLICATION OF FUNDS				
Net Fixed Assets	42,054	39,506	36,178	32,595
Investments	51,288	58,288	68,288	78,288
Cash, Bank Bal & Deposits	715	6,304	4,849	2,770
Inventory	5,249	6,535	7,454	8,449
Sundry Debtors	1,306	3,224	4,437	5,026
Current Assets	15,046	23,838	24,515	24,020
Sundry Creditors	14,268	13,614	15,529	17,601
Current Liabilities	50,637	49,982	51,898	53,970
Proposed dividend	6,989	21,028	23,365	23,365
Total Net Assets	46,940	46,800	49,896	53,746
Summary of Cashflow				
Profit Before Tax (adjusted)	24,846	29,938	36,893	40,747
Depreciation	4,024	10,786	11,966	12,755
Operational Cash Flow	32,658	45,860	44,707	44,618
Fixed Assets Purchase	29,009	8,238	8,637	9,172
NET CASH FLOW	(18,357)	5,589	(1,455)	(2,079)
Beginning Cash Balance	19,072	715	6,304	4,849
Ending Cash Balance	715	6,304	4,849	2,770

Source: Company data, HSBC estimates

HSBC

Table 7.7: HMCL – Key ratios

INRm	FY11	FY12e	FY13e	FY14e
Ratios				
EBITDA margin	13.5%	15.6%	16.0%	15.9%
EBIT	11.4%	11.0%	11.6%	11.8%
EBITDA margin (excl. amortisation of royalty)	12.6%	12.1%	12.9%	13.2%
Net Profit Margin	10.3%	10.6%	11.3%	10.3%
Raw Material cost	72.3%	72.8%	72.0%	72.1%
Employee costs	3.2%	3.0%	3.0%	3.0%
Factory and Admin costs	8.5%	5.6%	6.2%	6.1%
S&M	2.1%	2.7%	2.4%	2.5%
Tax rate	19.1%	16.9%	17.0%	23.0%
Net Realisation per vehicle	35,582	37,278	38,148	38,711
No. of Days of Inventory	10	12	12	12
No. of Days of Creditors	28	25	25	25
No. of Days of Debtors	2	5	6	6
ROAE	60.0%	79.0%	82.6%	70.2%
ROACE	43%	46%	54%	54%
ROA	19.9%	21.6%	24.4%	23.8%
Asset turnover	1.8x	1.9x	2.1x	2.3x
Capex as % of avg sales	2.4%	3.5%	3.2%	3.0%
Debt to Equity	1.1%	1.0%	0.8%	0.7%
Operating cash flows to EBITDA	124.8%	125.3%	103.5%	91.5%
FCF to EBIT	16.5%	145.7%	115.5%	98.4%
Growth rate (y-o-y)				
Sales volume	17.6%	15.7%	12.0%	11.6%
Net Realisation per Vehicle	3.8%	4.8%	2.3%	1.5%
Net Sales	22.1%	22.3%	14.7%	13.3%
Operational income	22.3%	21.3%	14.7%	13.3%
EBITDA	-5.4%	39.9%	18.0%	12.9%
Adjusted net profit	-10.0%	24.0%	23.0%	2.5%
EPS growth	-13.6%	29.1%	23.0%	2.5%

Source: Company data, HSBC estimates

Annexure 1: Company description

Hero MotoCorp Limited

Hero MotoCorp (HERO) is the world's largest manufacturer of two-wheelers in terms of volume and commands nearly 55% of domestic motorcycle sales in India. Formerly known as Hero Honda Motors Ltd, the company terminated its long-lasting joint venture with the Honda Group as of December 2010.

The company is known for their low maintenance iconic motorcycles like Splendour, Passion and CD100 series, which have proven successful for over a decade. HERO's product portfolio consists of a wide range of motorcycles, catering to various customer segments, and has a presence in the high growth scooters market. They have two main manufacturing locations in Gurgoan and Haridwar, with a combined capacity of 6.5 million two-wheeler units per year.

The company's strength lies in its extensive sales and service network with more than 5,000 customer touch points across the country.

Table 8.1: Shareholding pattern

S.No	Main investors	% Holding
1	Hero Investments	43.3%
2	Aberdeen Asset Management	10.2%
3	Axis Trustee Service	8.8%
4	Bahadur Chand Investments	8.7%
5	IL&FS Trust company	8.6%
6	IDBI Trusteeship	7.4%
7	Capital World Investment	5.0%
8	Vanguard Group Inc	1.5%
9	Life Insurance Corp	1.3%

Source: Bloomberg as on 16 Nov 2011

Table 8.2: Board of directors and key management

Management

Name	Designation
Anadi S Pande	V P-HRM Corp Plan&Strategy
Analjit Singh	Non.Exe.Independent Director
Anand C Burman	Non.Exe.Independent Director
Anil Dua	Sr. V P -Sales&Marketing
Brijmohan Lall Munjal	Chairman / Chair Person
Ilam C Kamboj	Secretary
Meleveetil Damodaran	Non.Exe.Independent Director
Neeraj Mathur	Vice President
Paul Edgerley	Non Executive Director
Pawan Munjal	Managing Director & CEO
Pradeep Dinodia	Non.Exe.Independent Director
Pritam Singh	Non.Exe.Independent Director
Ravi Nath	Non.Exe.Independent Director
Ravi Sud	Sr. Vice President & CFO
Suman Kant Munjal	Non Executive Director
Sunil Kant Munjal	Joint Managing Director
V P Malik	Non.Exe.Independent Director
Vijay Sethi	Vice President
Vikram Kasbekar	Plants Head-Operations

Source: Company data

The company sold more than 5.4m vehicles in 2011 with a total turnover of more than INR194bn and profits of INR19.3bn. The majority of shares as of end of FY11 were held by Indian Promoter Group (52.21%), followed by FII (32.79%). HERO has historically been generous in its dividend payouts. Most recently, it paid a dividend of INR105 per share in FY11.

Bajaj Auto Limited

Bajaj Auto is the second largest two-wheeler manufacturer after HERO in India. Bajaj Auto pioneered production of scooters and has subsequently shifted its product portfolio to motorcycles and three wheelers. Bajaj Auto is part of the Bajaj Group, a leading business house in India.

A series of successful product launches in the last decade has been instrumental in Bajaj Auto's c19% CAGR in revenues in the last 10 years. Among its flagship models, the Pulsar, Discover and Platina series are the most well known. Bajaj sold 3.82m vehicles in FY11 and had a production capacity of 5.04m, all together from its manufacturing plants in Waluj, Chakan and Pantnagar.

Table 8.3: Shareholding pattern

S.No.	Investor	% of outstanding
1	Bajaj Holdings and Investments	31.5%
2	Jamunalal Sons Pvt Ltd	9.0%
3	Jaya Hind Inest Pvt	3.5%
4	Life Insurance Corp	2.7%
5	Maharashtra Scooter	2.3%
6	Bajaj Sevashram Limited	1.6%
7	Bachhraj & Co Ltd	1.3%
8	Sikkim Janseva	1.3%
9	Genesis India Investments	1.3%
10	Vanguard Group Inc	1.2%
11	Rahul Bajaj	1.0%

Source: Bloomberg as on 16 Nov 2011

On 26 May 2008, Bajaj Holdings and Investments (BHIL) was demerged into three separate entities namely Bajaj Auto Ltd, Bajaj Finserv Ltd, and BHIL. Bajaj's promoter group is the major shareholder of Bajaj Auto with c42% of the total shares. The average dividend payout ratio in the past 5 years has been c44%.

Bajaj is aggressive in its product launches with more than 25 launches or upgrades in the past 9 years. Bajaj strategically focused on high-end bikes where it commands a leadership position with a more than 42.3 % market share. Export markets for Bajaj Auto have also been very lucrative, accounting for more than 63% of two-wheeler exports from India. It also exports more three-wheelers than it sells domestically in India.

Table 8.4: Board of directors and management

Name	Designation
Rahul Bajaj	Chairman / Chair Person
Madhur Bajaj	Vice Chairman
Rajiv Bajaj	Managing Director
Sanjiv Bajaj	Executive Director
Kantikumar R Podar	Director
D J Balaji Rao	Director
J N Godrej	Director
Suman Kirloskar	Director
Nanoo Pamnani	Director
P Murari	Director
Shekhar Bajaj	Director
D S Mehta	Director
S H Khan	Director
Naresh Chandra	Director
Manish Kejriwal	Director
Niraj Bajaj	Director
Pradeep Shrivastava	COO
Abraham Joseph	CTO
Kevin P D'Sa	President (Finance)

Source: Company data

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Annexure II

Table 8.5: Income distribution and trends

('000 households)	Income bracket (INR '000 p.a.)	2006-07E	2009-10E	Annual addition
Deprived	<90	121,852	114,394	(2,486)
Aspirers	90-200	60,096	75,304	5,069
Seekers	200-500	15,877	22,268	2,130
Strivers	500-1,000	3,816	6,173	786
Near rich	1,000-2,000	1,368	2,373	335
Clear rich	2,000-5,000	560	1,037	159
Sheer rich	5,000-10,000	127	255	43
Super rich	>10,000	68	141	24
Total households		203,764	221,945	6060

Source: NCAER

Notes

Disclosure appendix

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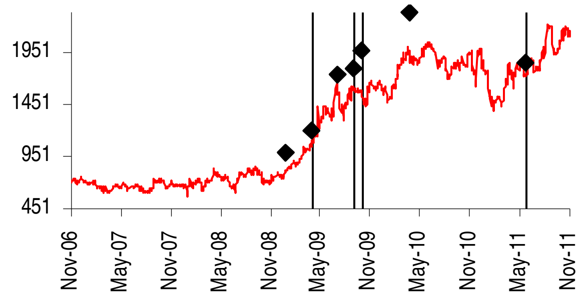
Neutral (Hold)	34%	(22% of these provided with Investment Banking Services)
Underweight (Sell)	11%	(14% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities

Hero MotoCorp (HROM.BO) Share Price performance INR Vs HSBC rating history



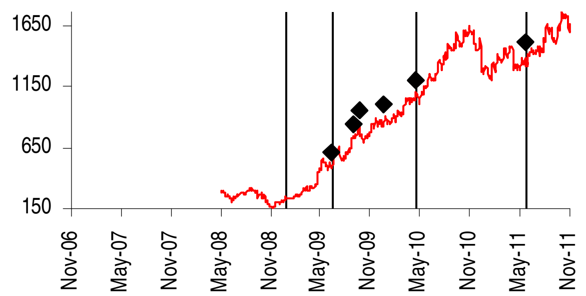
Source: HSBC

Recommendation & price target history

From	To	Date
Overweight	Neutral	21 April 2009
Neutral	Neutral (V)	24 September 2009
Neutral (V)	Overweight (V)	21 October 2009
Overweight (V)	Neutral	20 June 2011
Neutral	N/A	21 June 2011
Target Price	**Value**	**Date**
Price 1	985.00	21 January 2009
Price 2	1210.00	21 April 2009
Price 3	1740.00	29 July 2009
Price 4	1800.00	24 September 2009
Price 5	1980.00	21 October 2009
Price 6	2340.00	15 April 2010
Price 7	1855.00	20 June 2011

Source: HSBC

Bajaj Auto (BAJA.BO) Share Price performance INR Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Neutral (V)	Underweight (V)	20 January 2009
Underweight (V)	Overweight (V)	08 July 2009
Overweight (V)	Neutral (V)	12 May 2010
Neutral (V)	Neutral	20 June 2011
Neutral	N/A	21 June 2011
Target Price	**Value**	**Date**
Price 1	610.00	08 July 2009
Price 2	840.00	24 September 2009
Price 3	950.00	15 October 2009
Price 4	1000.00	12 January 2010
Price 5	1200.00	12 May 2010
Price 6	1506.00	20 June 2011
Price 7	N/A	21 June 2011

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
BAJAJ AUTO	BAJA.BO	1654.80	24-Nov-2011	7

Source: HSBC

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