Automobiles

Speed breaker ahead

Key points

Sharp moderation in IIP growth to restrict auto growth in FY2013: Our analysis reveals that the automobile sector is likely to experience significant moderation in growth during 2012. We have used the long-term Index of Industrial Production (IIP) multiplier methodology (that relates the level of IIP to the volume growth in the automobile sector) to arrive at sustainable growth rates for different automobile segments. The long-term growth potential looks intact but rapid volume expansion in the last two years has now paved the way for a mid-cycle growth moderation or intermediate down cycle during calendar year 2012.

Risk of downgrade of consensus estimate high; outperformance of auto sector unlikely to sustain

Our optimistic estimate of a single-digit volume growth for FY2013 is lower than the consensus estimate. However, even a single-digit volume growth for FY2013 is challenging as the lag effect of a dismal IIP growth and high inflation sets in. The auto index has outperformed the Sensex in the last six months to one year period. However, the outperformance is at risk as the moderation in volume growth across segments exceeds the street's expectations for FY2013.

Return comparison

Particulars	3-month return (%)	6-month return (%)	12-month return (%)
BSE Sensex	-0.5	-12.44	-20.44
Auto Index	0.35	-2.38	-16.58
Bajaj Auto	6.58	16.51	11.45
Hero MotoCorp	-2.89	2.82	-0.55
Maruti Suzuki	-10.2	-13.59	-30.41
Mahindra	-9.15	4.45	-7.71
Ashok Leyland	-9.04	-1.25	-24.03

Downgrading earnings estimates for FY2013: We are downgrading our volume and earnings per share (EPS) estimates for all the automobile companies covered by us due to the challenging operating environment. Automobile companies whose earnings estimates have seen significant downgrades include Maruti Suzuki, Ashok Leyland and Mahindra and Mahindra (M&M).

High risk of disappointment in M&M and Bajaj Auto; switch to Maruti and Hero MotoCorp: Considering the volume growth, margin sustenance, capital expenditure (capex) intensity and cash generation of their respective businesses we have assigned a 15% premium to Bajaj Auto and Hero MotoCorp to their respective mid-term average multiples. On the other hand, we have assigned a 15% discount to Maruti Suzuki, M&M and Ashok Leyland based on their mid-term average multiples. In view of the same, we see a much higher risk of disappointment in M&M and Bajaj Auto. Thus, we recommend switching to Maruti Suzuki and Hero MotoCorp.

Switch from M&M to Maruti Suzuki as we believe that the impact of policy action against diesel vehicles/fuel is inevitable and not yet fully factored. For Maruti Suzuki, a 30% stock price correction in the last one year has priced in most of the negatives.

Switch from Bajaj Auto to Hero MotoCorp based on the 14% outperformance of the former. Hero MotoCorp's market share gains in the domestic market over the last few months have not been fully captured in the stock price nor has the loss of domestic market share affected the Bajaj Auto stock fully.

Change in FY2013 estimates and target price of Sharekhan coverage universe

Companies	CMP (Rs)	Old FY13E EPS	New FY13E EPS	5-year avg. normalised P/E	Assigned PE	Target price	CMP (Rs)	Returns (%)
Maruti Suzuki	968	97.8	84.5	14.7	12.5	1,056	968	9.1
Bajaj Auto	1,610	124.7	120.8	11.1	12.8	1,542	1,610	-4.2
M & M	702	53.0	49.7	16.0	13.6	676	702	-3.7
ALL	23.6	2.9	2.5	12.4	10.5	26	24	9.4
Hero Moto	1,938	143.9	138.6	13.7	15.8	2,184	1,938	12.7

Auto sector: Moderation in volume growth to exceed Street's expectations

Our analysis reveals that the automobile sector is likely to experience an intermediate contraction cycle during the next calendar year. The cyclical expansion that started in H2FY2010 is now nearing its tail end. There is a high probability that we may experience a period of poor volume growth across automobile segments in the next intermediate down cycle.

We have used the long-term IIP multiplier methodology to arrive at sustainable growth rates for different automobile segments. The long-term growth outlook looks intact. However, rapid volume expansion in the last two years has now paved way for a mid-cycle growth contraction. A dismal IIP growth, higher financing costs, rising commodity prices and global uncertainty are likely to hurt buyers' sentiments. In all likelihood, the automobile volumes over the next few quarters may negatively surprise the Street, and possibly drag stock valuations lower.

IIP lag effect to ripple across auto segments; slowdown feelers are already there

The table below shows long term growth of automobile segments over long term IIP growth. The automobile sector has shown strong outperformance in H2FY2010. It grew strongly yet again in FY2011 and created a large base for year till date (YTD) FY2012. We saw the auto sector/IIP ratio expanding in H2FY2012. However this is on account of an absurd IIP growth in Q2FY2012.

Light commercial vehicles (LCVs) in particular have shown strong outperformance from the broader auto sector growth. The segment continues to grow in the vicinity of 30%. The truck segment also bounced back strongly in the October - November 2011 period as compared to H1FY2012. This is on account of a low base of November 2010 in the new emission regime.

We expect the beginning of a full fledged intermediate down cycle spiraling across all auto segments from Q4FY2012 and it would probably extend strongly over the next few quarters. Given the mid single digit IIP expectation as an optimistic case; auto companies may restrict growth to approximately single digit as they retract towards long term IIP multiple. We expect major volume based downgrades from the Street in the next six months.

Below 5% IIP growth has marked the broad based decline in automobile volumes

Particulars	2W (%)	3W (%)	LCV (%)	Truck (%)	Bus (%)	Car (%)	UV (%)	Tractor (%)	IIP (%)
FY 00	11.8	-1.2	9.0	42.3	10.9	60.0	8.5	1.6	6.6
FY 01	**-1.6**	**5.7**	**-1.3**	**-32.5**	**3.3**	**-7.7**	**3.8**	**-4.3**	**5.0**
FY 02	**15.7**	**10.1**	**3.7**	**28.7**	**-40.0**	**0.6**	**-15.1**	**-13.8**	**2.7**
FY 03	14.5	15.6	32.3	30.8	18.8	4.0	9.0	-20.2	5.8
FY 04	11.5	22.7	31.7	42.9	23.1	27.3	28.8	11.7	7.0
FY 05	15.8	8.4	21.5	26.4	4.3	17.1	20.5	29.1	11.7
FY 06	13.6	16.9	19.7	3.7	9.7	7.2	10.3	18.3	7.9
FY 07	11.6	12.2	33.9	37.6	2.0	22.3	13.3	20.5	11.9
FY 08	-7.9	-9.7	12.3	-4.4	34.7	12.5	11.3	-1.8	8.7
FY 09	**2.6**	**-4.1**	**-7.0**	**-37.0**	**-9.7**	**1.7**	**-8.0**	**0.1**	**3.2**
FY 10	26.0	25.9	43.4	35.8	23.5	26.5	20.9	26.9	10.5
FY 11	25.8	19.4	22.9	36.3	10.4	30.8	18.9	23.8	7.8
FY12 YTD	16.1	0.4	29.4	13.2	-10.4	-2.4	10.9	19.8	3.5

Automobile volumes: CAGR growth across segments and timelines

Particulars	2W (%)	3W (%)	LCV (%)	Truck (%)	Bus (%)	Car (%)	UV (%)	Tractor (%)	IIP (%)
15 Yr CAGR	10.8	9.1	7.4	6.9	4.0	13.8	11.5	7.2	7.0
10 Yr CAGR	12.5	11.2	20.5	17.1	5.4	14.5	10.2	8.1	7.7
5 Yr CAGR	10.8	7.9	19.8	8.9	11.1	18.3	10.8	13.2	8.4
3 Yr CAGR	17.6	13.0	17.9	5.3	7.2	19.0	9.7	16.3	7.2

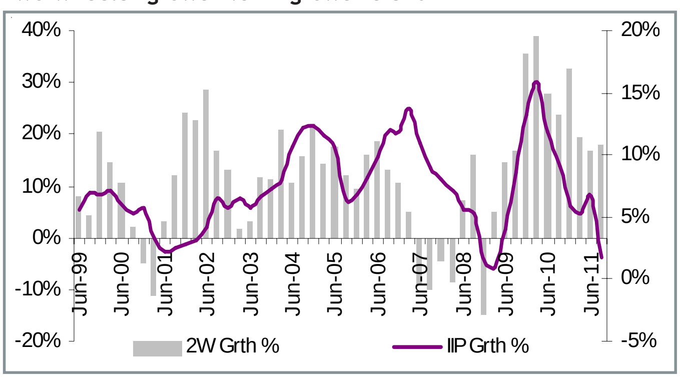
IIP multiplier effect: Expansion cycle from H2FY2010

Particulars	12 Yr Avg	H2FY10	H1FY11	H2FY11	H1FY12	H1FY12 Actual Growth %	Oct+Nov 2011 Growth (%)
2W/IIP	1.9	2.6	2.5	4.6	6.4	17.3	12.5
3W/IIP	1.1	3.0	1.9	3.5	-0.7	0.6	1.5
LCV/IIP	2.2	4.9	2.7	3.9	11.7	28.7	30.8
Truck/IIP	1.3	9.5	6.4	3.4	3.5	8.9	28.0
Bus/IIP	-0.2	5.8	4.6	-2.2	-3.4	-8.5	-16.9
Cars/IIP	1.9	2.7	3.4	4.9	-1.3	0.9	-9.7
UV/IIP	0.4	3.3	1.9	2.9	4.5	9.8	14.3
Tractor/IIP	0.6	2.8	2.0	4.6	8.4	19.6	9.4

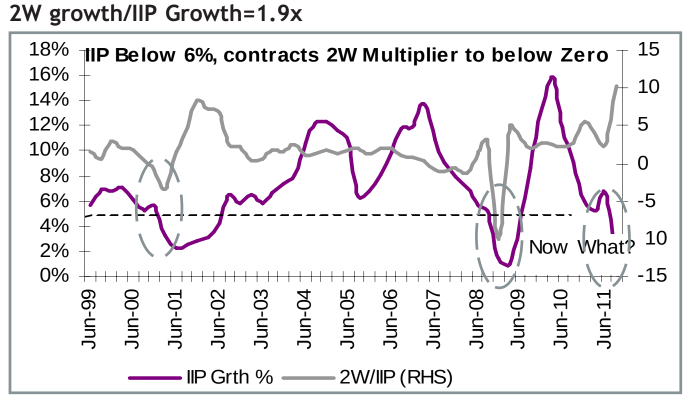
Sharp contraction in IIP is the prelude to the next intermediate down cycle

Two-wheelers: Alarm bells are ringing for even the most promising auto segment ie the two-wheelers segment. On the past two occasions when IIP growth broke the 6% mark from above, the domestic two-wheeler growth / IIP growth ratio contracted into the negative zone. Since the consensus expectation for IIP is now approximately 5% for the next few quarters, the two-wheeler growth can rapidly retard to just single digits.

Two-wheeler growth vs IIP growth trend



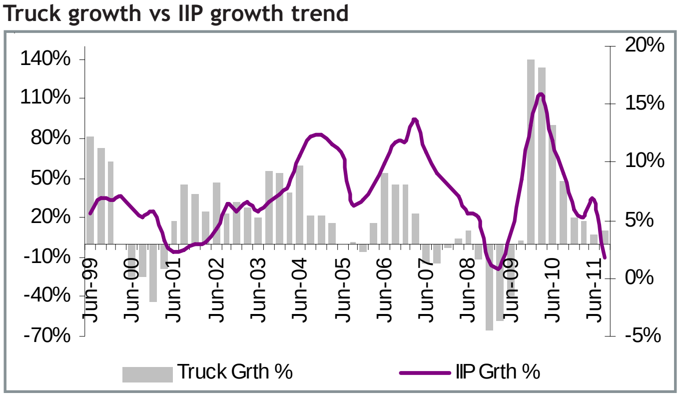
2W growth/IIP Growth=1.9x



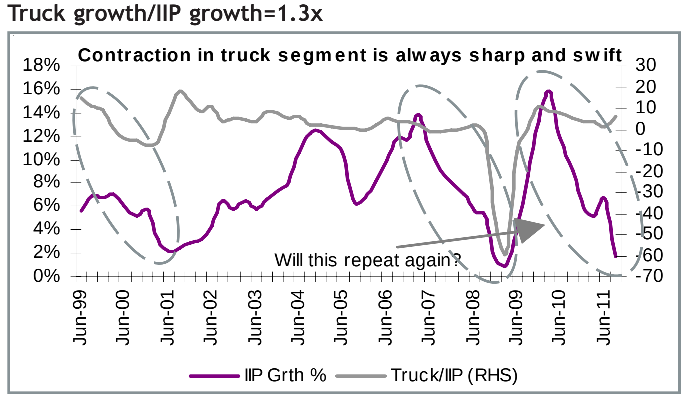
* IIP 1993-94 base series used for analysis

MHCV trucks: The truck growth has surprised on account of sustained agricultural freight availability in the October - November 2011 period. The domestic growth also appears strong on the low base of November 2011 which is the first month post implementation of new emission standards. We believe that agriculture growth alone cannot sustain truck growth for too long. Eventually truck growth has to retract back to 1.3x the IIP multiplier. The most optimistic of the estimates suggest only a high single digit growth for medium and heavy commercial vehicle (MHCV) trucks assuming the IIP growth is restricted to below 5%.

Truck growth vs IIP growth trend

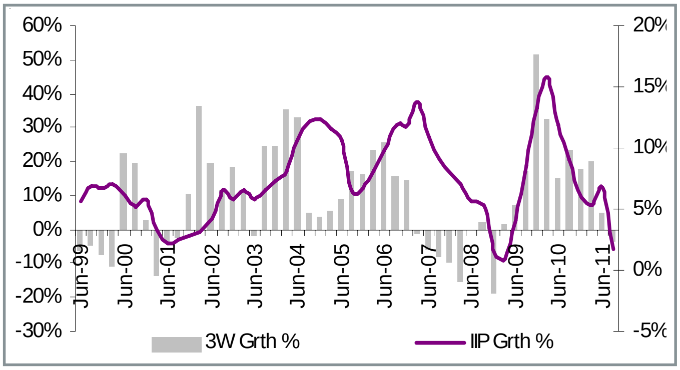


Truck growth/IIP growth=1.3x

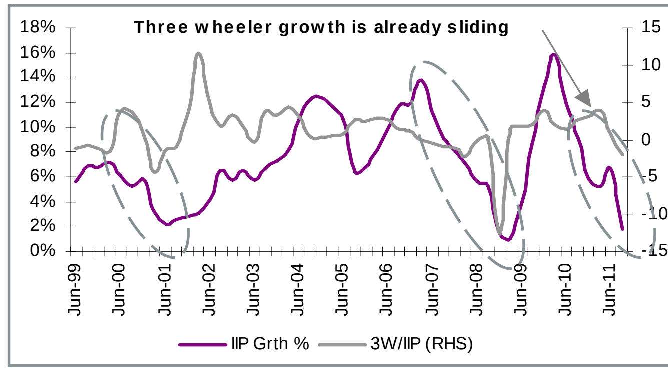


Three-wheelers: Three-wheelers have shown a marginal volume decline in YTDFY2012 and the segment is grossly underperforming the IIP. More than the IIP impact, three wheeler issues are specific to the segment itself. Lack of state government approvals for new permits has hit growth in the passenger segment and upgradation opportunities presented by LCVs have hit demand in the cargo segment.

Three-wheelers vs IIP growth trend

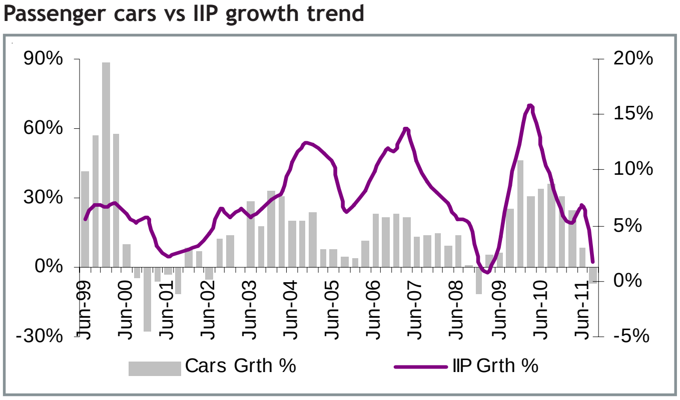


3W growth/IIP growth=1.1x

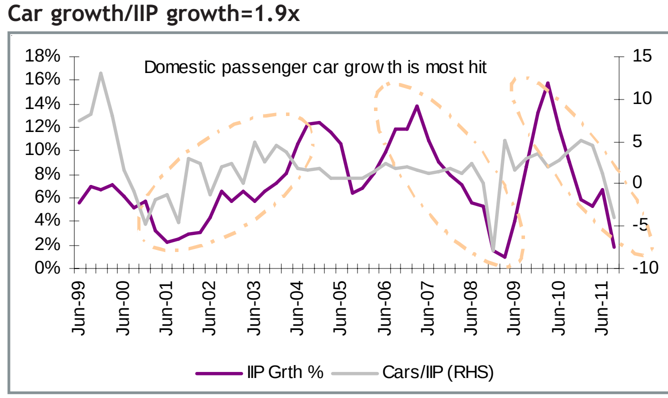


Passenger cars: Passenger cars reported a marginally positive growth in H1FY2012 and declined sharply in October-November 2011 owing to the impact of the strike at Maruti Suzuki. A sharp increase in interest rates over the last 12 months coupled with a deregulation of petrol prices has caused significant stress in the petrol cars segment. On the contrary there was considerable demand for diesel cars. A structural shift in demand towards diesel cars impacted all major players. We do not see ownership cost moderating in the medium term. Additional price hikes in the range of 2-3% are also going to be announced with effect from January 2012. The demand for passenger cars may deteriorate in the medium term with large scale demand deferment.

Passenger cars vs IIP growth trend

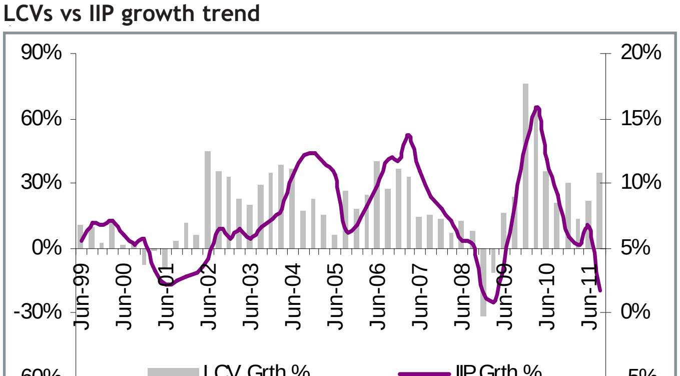


Car growth/IIP growth=1.9x

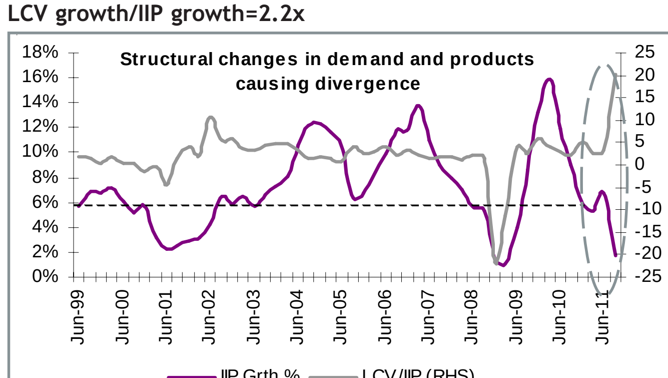


LCVs: LCVs have shown a maximum IIP growth multiplier of 2.2x amongst our auto universe. The high growth has been aided by the emergence of the hub and spoke model of logistics coupled with a shift from three-wheelers to four-wheelers in the cargo segments. An extension of LCVs to the passenger segment has given them the next leg of growth. LCVs are likely to defy the slowdown gravity. However, the growth rate may be significantly moderate as compared to 25-30% range it achieved in the past. Our expectation is a mid double digit growth for LCVs in the next few quarters.

LCVs vs IIP growth trend

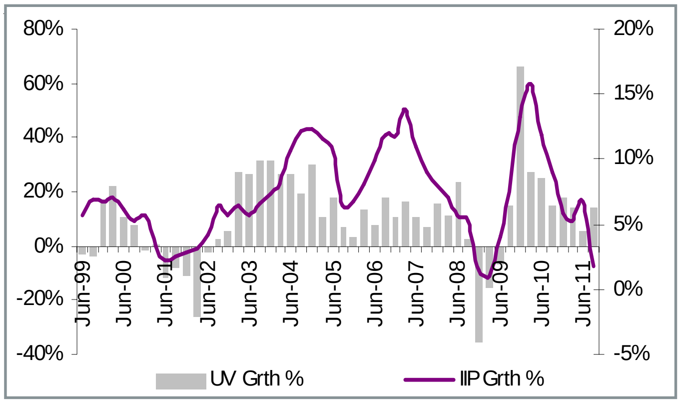


LCV growth/IIP growth=2.2x

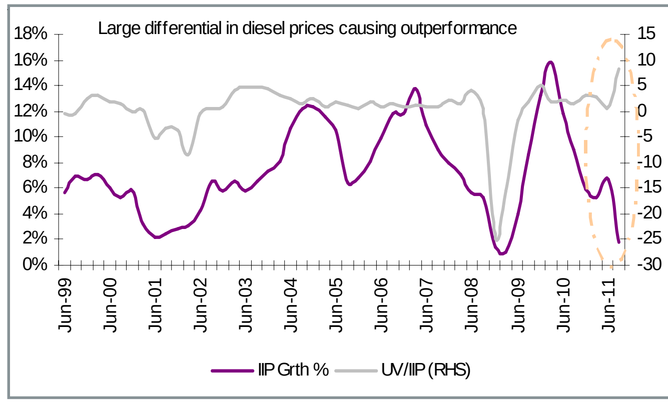


UVs: Utility vehicles (UVs) have always faced policy challenges with differential excise structures. Hence, long term growth looks modest with just a 0.4x IIP multiplier. However, UVs have always grown strongly due to the diesel price differential. Post de-regulation of petrol, the price differential has increased significantly, thereby creating healthy demand for diesel UVs. Exciting product launches have created a lot of aspirational value for UVs. However investor sentiments are expected to get hurt as there is a broad consensus of further excise hike on diesel vehicles in the budget.

UVs vs IIP growth trend

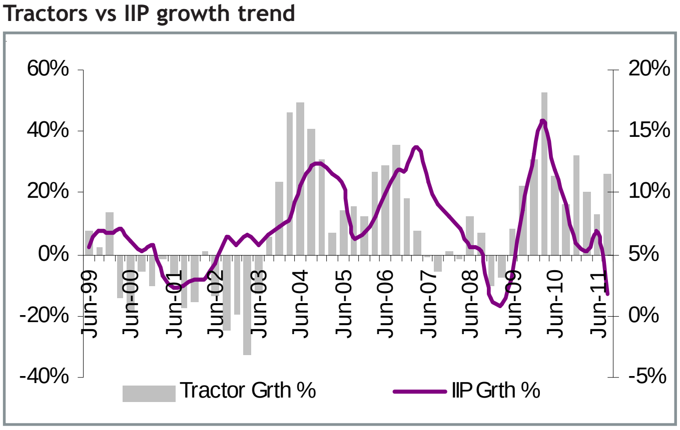


UV growth/IIP growth=0.4x

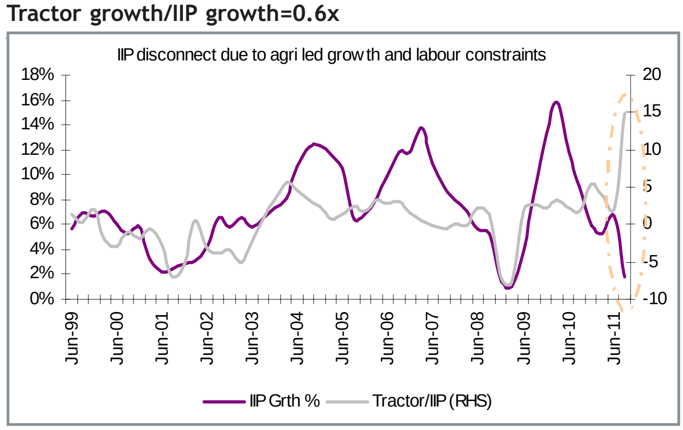


Tractors: The tractors chart mapped with the IIP below is a significant trending chart chasing the IIP growth. Tractors are the only auto segment where the last five year compounded annual growth rate (CAGR; FY2006-11) is greater than the ten year CAGR growth. Also during last five years, tractors have grown by 1.2x the IIP growth. This is significantly different than the long term averages, signaling a structural step in tractor demand. A strong growth in farm incomes and shortage of labour are expected to support tractor demand. However, the macro economic slowdown is expected to moderate growth rates to high single digit in the future.

Tractors vs IIP growth trend



Tractor growth/IIP growth=0.6x



Conclusion: Optimistic estimates suggest only a single-digit growth in FY2013.

A downward revision in both, the gross domestic product (GDP) and the IIP growth estimates for FY2013 has raised the risk of broad-based moderation and a declining growth scenario for the Indian automobile segment. MHCVs, UVs and passenger cars remain the most vulnerable in the current cycle also. The most resilient are LCVs and two-wheelers but even here only a lower double-digit growth is expected.

Downgrading earnings estimates for FY2013: We are downgrading our volume and earnings per share (EPS) estimates for all the automobile companies covered by us due to the challenging operating environment. Automobile companies whose earnings estimates have seen significant downgrades include Maruti Suzuki, Ashok Leyland and Mahindra and Mahindra (M&M).

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