**CAUTIOUS**

FEBRUARY 16, 2012

UPDATE

BSE-30: 18,154

**Volume growth likely to remain subdued.** We believe automotive volume growth is likely to remain subdued, increasing 8-12% yoy in FY2013E as we see no visible triggers for demand to grow at a higher rate than the 10-year CAGR (12-15%). We believe low GDP growth, likely increase in fuel prices and excise duties are likely to put pressure on automotive volume growth. We downgrade ratings of some of the stocks to SELL and are underweight on the sector but prefer M&M and Ashok Leyland.

## Valuations move into expensive zone

Auto stocks have increased sharply since Dec 31, 2011 and outperformed the Sensex significantly, which we believe is based on sharp improvement in volume growth. However we highlight that real incomes are likely to grow only 4-5% yoy in FY2013E while cost of ownership of vehicles is likely to increase due to a rise in fuel and vehicle prices (as excise duty rates could be increased).

We believe most auto stocks except Tata Motors, Ashok Leyland and Mahindra and Mahindra are trading at a 10-20% premium to their 10-year CAGR, which we believe is unjustified as volume growth for auto manufacturers will be lower than their 10-year averages and EBITDA margins are unlikely to improve from current levels.

We believe EBITDA margins for auto companies are unlikely to improve yoy in FY2013E except for Maruti Suzuki (as margins were impacted by a significant decline in demand in FY2012E) as commodity cost pressure is likely to persist and there is no let up in competitive pressures. We believe as volume growth is unlikely to be very strong, auto companies will find it difficult to pass on input cost pressures to consumers.

## M&M remains our top pick in the sector

Our top pick in the sector is Mahindra and Mahindra and we retain our BUY rating on the stock due to inexpensive valuations and our expectations of strong volume growth in the utility vehicle segment and moderate growth in the tractor segment. We expect demand for utility vehicle is likely to continue, driven by an increase in capacity of XUV500 and Scorpio. Scorpio, XUV500 and Xylo are premium priced products and we do not expect any significant impact on demand even if diesel tax is imposed while Bolero is positioned at a very attractive price point where competition is limited. We expect tractor volume growth of 6% yoy in FY2013 and believe acute shortage of farm labor will support tractor volume growth. Stock currently factors flat volume growth for utility vehicle and tractors in our view. We believe volume growth is likely to surprise investors positively.

We also retain our ADD rating on Ashok Leyland due to recovery in market share in MHCVs which is currently at a 10-year low, driven by improvement in demand in South India. We have downgraded Maruti Suzuki and Bajaj Auto from ADD to SELL rating due to a sharp run-up in prices. We retain our SELL rating on Tata Motors (as we see limited triggers for EBITDA margin improvement for JLR), Exide Industries (we are concerned about pricing power of Exide, which is the key for improvement in EBITDA margins) and Bharat Forge (expensive valuations).

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## Downgrading some stocks to SELL on macro headwinds

We downgrade some of the stocks in the sector to SELL and we are underweight on the sector as we believe there are no visible signs of significant improvement in demand and volume growth is likely to remain below the 10-year long-term historical average, in our view. Auto stocks have run-up sharply since December 31, 2011 and have outperformed the Sensex significantly (Please see Exhibit 1) on hopes of improvement in volume growth. We recommend investors be underweight on the sector due to expensive valuations and significant outperformance of the sector. We recommend M&M and Ashok Leyland due to inexpensive valuations.

Exhibit 1: Auto sector has outperformed the Sensex by a fair margin
Auto sector price performance versus Sensex (%)

| Company | 3-month | 6-month | 12-month | CYTD |
|---|---|---|---|---|
| Ashok Leyland | 14.5 | 18.8 | 11.8 | 31.6 |
| Bajaj Auto | 5.0 | 24.4 | 36.0 | 13.8 |
| Hero Motocorp | 4.1 | 15.9 | 46.7 | 15.0 |
| Maruti Suzuki | 37.1 | 11.0 | 10.7 | 48.1 |
| Mahindra and Mahindra | (6.6) | (1.1) | 10.6 | 6.2 |
| Tata Motors | 51.3 | 72.1 | 11.4 | 54.4 |
| **Sensex** | **8.2** | **8.5** | **(0.8)** | **17.5** |

Source: Bloomberg

Exhibit 2: Valuations move into expensive zone except for Tata Motors, Mahindra and Ashok Leyland
Auto sector valuation summary (X)

| | PE (X) | | EV/EBITDA (X) | |
|---|---|---|---|---|
| Company | 2012E | 2013E | 2012E | 2013E |
| Ashok Leyland | 16.7 | 10.7 | 8.3 | 6.2 |
| Bajaj Auto | 17.0 | 14.8 | 12.7 | 11.4 |
| Hero Motocorp | 18.6 | 16.7 | 13.6 | 11.8 |
| Maruti Suzuki | 23.7 | 14.3 | 18.0 | 9.4 |
| Mahindra and Mahindra | 12.2 | 10.7 | 8.2 | 7.2 |
| Tata Motors | 10.3 | 8.8 | 5.6 | 4.6 |
| Exide Industries | 28.0 | 21.8 | 18.2 | 14.5 |
| Bharat Forge | 18.4 | 16.0 | 9.2 | 8.2 |

Source: Kotak Institutional Equities estimates, Bloomberg.

Note: Mahindra and Mahindra valuations are based on standalone estimates while Tata Motors valuations are based after including R&D capitalization.

## Triggers for significant improvement in demand are not visible

We believe volume growth in automobiles will remain below the 10-year long-term CAGR due to the following factors:

- Our economist expects real GDP to grow by 6.6% in FY2013, which basically indicates real incomes are likely to grow by only 4-5% in FY2013E. Cost of ownership is likely to increase further as petrol prices are likely to increase over the coming days. According to our energy team, under-recovery on petrol and diesel is about Rs 3/liter and Rs 13/liter after including marketing margins of oil companies.

- We do not expect any fiscal stimulus from the Government which could boost consumption due to a weak fiscal situation of the Government. In fact, there is a likelihood of increase in excise duty rates on automobiles or the Government could impose additional tax on diesel vehicles which could have a negative impact on demand.

- Our economist expects a gradual 100 bps reduction in interest rates over FY2013, which is unlikely to have a meaningful impact on improvement in demand in our view.

Hence we factor in 10% yoy growth in two wheelers, 12% yoy growth in passenger vehicles, 7% yoy growth in MHCVs and 15% yoy growth in LCVs in FY2013, which is below the last 10-year CAGR.

## Margins unlikely to improve significantly on commodity, competitive pressures

We believe EBITDA margins for auto companies are unlikely to improve yoy in FY2013 except for Maruti Suzuki (as margins were impacted by a significant decline in demand in FY2012E) as commodity cost pressures are likely to persist and there are no let up in competitive pressure. We believe as volume growth is unlikely to be very strong, auto companies will find it difficult to pass on input cost pressures to consumers.

Commodity costs (steel, aluminium, copper and lead) are up by 10% since Dec 2011 and are likely to exert pressure on auto companies' EBITDA margins.

## Valuations move into expensive zone

We believe most auto stocks except Tata Motors, Ashok Leyland and Mahindra and Mahindra are trading at 10-20% premium to their 10-year CAGR which we believe is unjustified as volume growth for auto manufacturers will be lower than their 10-year averages and EBITDA margins are unlikely to improve from current levels.

## Recommendations and earnings changes

Our top pick in the sector is Mahindra and Mahindra and we retain our BUY rating on the stock due to inexpensive valuations and our expectations of strong volume growth in the utility vehicle segment and moderate growth in the tractor segment. We expect demand for utility vehicle is likely to continue driven by increase in capacity of XUV500 and Scorpio. Scorpio, XUV500 and Xylo are premium priced products and we do not expect any significant impact on demand even if diesel tax is imposed while Bolero is positioned at a very attractive price point where competition is limited. We expect tractor volume growth of 6% yoy in FY2013 and believe acute shortage of farm labor will support tractor volume growth. Stock currently factors flat volume growth for utility vehicle and tractors in our view. We believe volume growth is likely to surprise investors positively.

We also like Ashok Leyland and maintain our ADD rating on the stock due to inexpensive valuations. We expect an 8% yoy growth in MHCVs as believe tipper segment is likely to remain strong as mining activity improves and we believe Ashok Leyland could potentially improve its market share if the South India market recovers. Domestic market share of Ashok Leyland in MHCV is at a 10-year low. We expect a gradual recovery in Ashok Leyland's EBITDA margins with improvement in demand for MHCVs. We also factor in Dost LCV volumes in our estimates (6,000 in FY2012E and 24,000 units in FY2013E) but Dost contribution to overall revenues is likely to be only 7% in FY2013E and hence it will not impact EBITDA margins negatively despite being a relatively low-margin product.

We have downgraded Maruti Suzuki and Bajaj Auto from ADD to SELL rating due to sharp run-up in prices. We retain our SELL rating on Tata Motors (as we see limited triggers for EBITDA margin improvement for JLR), Exide Industries (we are concerned about pricing power of Exide which is the key for improvement in EBITDA margins) and Bharat Forge (expensive valuations).

We increase target price of Ashok Leyland while keep most other target prices unchanged

| | Rating | | Target price (Rs) | | |
|---|---|---|---|---|---|
| **Company** | **Old** | **New** | **Old** | **New** | **% yoy chg** |
| Ashok Leyland | ADD | ADD | 26 | 33 | 26.9 |
| Bajaj Auto | ADD | SELL | 1,715 | 1,715 | - |
| Hero Motocorp | SELL | SELL | 1,815 | 1,850 | 1.9 |
| Maruti Suzuki | ADD | SELL | 1,250 | 1,250 | - |
| Mahindra and Mahindra | BUY | BUY | 835 | 835 | - |
| Tata Motors | SELL | SELL | 285 | 285 | - |
| Exide Industries | SELL | SELL | 105 | 105 | - |
| Bharat Forge | REDUCE | REDUCE | 315 | 315 | - |

Source: Kotak Institutional Equities estimates

"I, Hitesh Goel, hereby certify that all of the views expressed in this report accurately reflect my personal views about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report."

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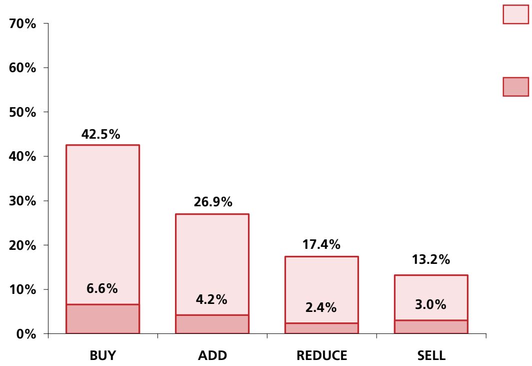


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Source: Kotak Institutional Equities — As of December 31, 2011

## Ratings and other definitions/identifiers

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**ADD.** We expect this stock to deliver 7.5-17.5% returns over the next 12 months.

**REDUCE.** We expect this stock to deliver 0-7.5% returns over the next 12 months.

**SELL.** We expect this stock to deliver less than 0% returns over the next 12 months.

Our target prices are also on a 12-month horizon basis.

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