

Ashok Leyland

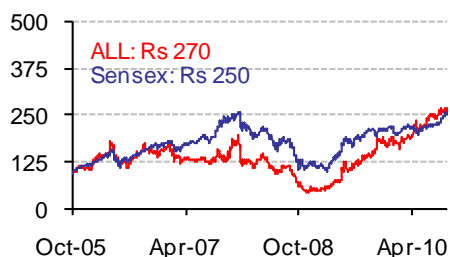
Sell

Investment Concerns

Market data

Current price	Rs 76 (BSE)
Market cap	Rs 100,507 m
Face value	Rs 1.0
FY10 DPS	1.5
BSE Code	500477
NSE symbol	ASHOKLEY
No. of shares	1330.0 m
Free float	61.0%
52 week H/L	Rs 79/41

Rs 100 invested is now worth



Stock price Performance

	Ashok Leyland	Index*
1-Yr	82.4%	22.3%
3-Yr	24.3%	1.3%
5-Yr	23.1%	20.7%

Returns over 1 year are compounded annual averages (CAGR)

* BSE Sensex

Shareholding (Sep-2010)

Category	(%)
Promoters	38.6
Banks, MFs & FIs	17.8
FIIIs	15.1
Public	15.1
Others	13.4
Total	100.0

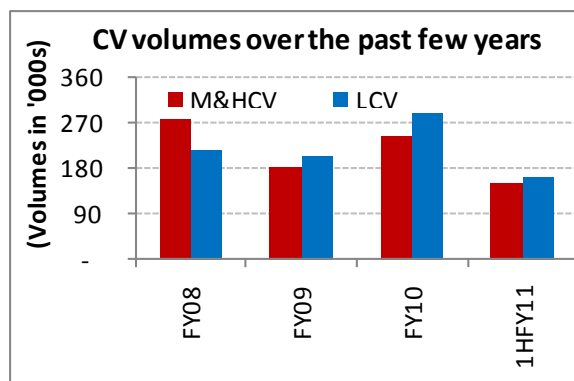
Report prepared by

Equitymaster Agora Research Private Limited.

www.equitymaster.com
info@equitymaster.com

- **Valuations running ahead of fundamentals:** With the strong surge in sales volumes witnessed by the commercial vehicle (CV) industry over the past year, stock prices of CV manufacturers have followed suit. Ashok Leyland (ALL) has been one of the major beneficiaries of the bounce back witnessed by the industry. However, we believe the stock's valuations have run ahead of its fundamentals. One may argue that FY11 will be the best year for the CV industry in terms of volumes. However, we believe that the volume off take that CV industry has enjoyed over the past two years was mainly due to demand playing 'catch-up'.

For instance, during the three years between FY04 to FY07, the domestic CV market grew at a compounded pace of about 21%. Thereafter, during FY08, the volume growth slowed down to about 5% YoY



before declining by 22% YoY in FY09. In FY10, domestic volumes for the CV industry surged by 38% YoY. The volumes surge has continued into the current year as well. During the year till date i.e. 1HFY11, CV volumes formed nearly 60% of full year FY10 volumes.

Apart from the reason of the demand playing catch-up, a few other factors such as easy financing options, lower interest rates, lower commodity prices, excise duty cuts, cut in fuel prices, amongst other helped in the CV volumes boost. However, with interest rates rising, coupled with higher commodity prices, CV manufacturers will feel the need to pass on these prices to the customers. This may be easy to do during times of strong demand. But, as and when the demand normalises, these factors play a determining role.

Further, it is quite possible that the CV industry has seen a high off take in volumes during 1HFY11 due to the Bharat Stage-III emissions norms coming into play from October this year. What this means is that the vehicles manufactured from here on will be equipped with better engines. These engines, however, cost about Rs 35,000 to Rs 40,000 more (approximately 3.5 to 4% of vehicle realisations). In order to maintain margins, CV manufacturers will have no option but to pass on these costs to customers. While ALL's management does not foresee a problem in terms of demand, it does expect some issue from the supply side. This would although, be on a temporary basis.

Anyways, coming back to our main point, we believe the demand for CVs should slow down to the long term normalised levels of about 8% to 10%. For ALL's stock to justify current valuations, it would need to continue to grow at a strong pace, well above the industry average growth rate. As mentioned above, we believe that the scenario should start getting normalised from next year onwards and as such, believe that there is not much upside left in the stock from here on.

- **Competition will intensify:** While the emergence of India as one of the fastest growing CV markets in the world has come as a boon to players like ALL, it has brought its own set of disadvantages. That is of more and more international players coming in and crowding the market. Worse still, these players would first target the HCV space, which is ALL's key volumes generating segment. Apart from international players, domestic auto major Mahindra and Mahindra, along with US based Navistar, has made a grand entry into the HCV space, the meatiest portion of the Indian CV segment. Plus, their vehicles are also believed to be priced quite aggressively as compared to other players such as Tata Motors, ALL, Volvo Eicher Commercial Vehicles. While the company has started off with the 25 tonne segment, it expects to launch products up to 49 tonnes.

However, ALL is making efforts to maintain its strong position in the market. With the untimely exit of IVECO (for key technological inputs) a few years ago, ALL was forced to take matters in its own hands. While this did further compound the woes, ALL has been taking initiatives to counter competition. These are in the form of investments towards setting up new and better engine facilities, new generation cabins and higher R&D expenses towards migrating to new truck platforms. The company also acquired stake in various companies to take their experience with various technical matters.

Further, ALL is also looking at making a dent in the LCV segment as it has tied up with global auto major Nissan. However, we believe that it would be still some time before this effort makes a mark in the company's financials. Not to mention that the competition in the LCV segment is quite strong.

- **Rising fixed costs may hamper profits:** Over the past three years ALL's management has done well to improve operating margins from about 8% in FY08 to 10.3% in FY10. From FY00 to FY07, the company's operating margins averaged about 11%. During the year till date, the company's operating margins stood at 10.7%. However, for the rest of the year, the management has cautioned against any drastic improvement in margins on the back of higher input costs. The company has hiked prices of its vehicles this year. After taking a 4% hike in prices during the first half of the current financial year, it has hiked prices by about 3% on all the vehicles in the month of October this year. In addition to this, the company will be passing on the prices of the BS-III emission engines for which it has taken a similar hike in prices. However, since this is only a pass on to cover costs (which is a difficult thing to do as it is), the impact will be seen on the margins. This is the reason why we have taken a conservative approach and expect ALL to clock operating margins of 10.5% for the full year. Going forward, considering the input cost pressure to continue as well as the increase in competition, we expect ALL's margins to remain at its long term average levels of 10%.

In addition, ALL commissioned its Pantnagar plant in March 2010 for which it had taken a certain amount of debt. As such, interest costs, which were being capitalised, will no longer do so. The rise in interest costs (and even more if interest rates move up) will impact the company's overall profitability going forward. ALL has done a significant amount of capex in the past three year towards this facility. This will also lead to higher depreciation charges as well. Only if the company is able to strengthen its performance at the operating level will it be able to mitigate the effects of the rise in these costs. Another factor that will play a key role is the ramp up in production at this facility. But as pointed above, we believe that the ramp up will not be very quick on the back of expectations that the industry demand will normalise next year onwards.

Comparative Valuations

Parameter (FY13E)	ALL	Tata Motors
EBIDTA margin (%)	10	11.0
Net Margin (%)	5.5	9.2
ROE (%)	16	19.0
Working cap/sales (%)	3.3	11.0
Asset turnover (x)	2.6	2.6
Valuation ratios (FY13E)		
Price (Rs)	75	1,160
Price to earnings (x)	13.4	14.5
Price to book (x)	2.0	2.6
Price to cash flow (x)	9.5	11

Investment Rationale

- Transportation industry is witnessing a structural change:** The CV segment in India is going through a structural shift. With the government's thrust on road development projects, road sector has gained significant advantage over railways that has been a mainstay for transportation of coal, food grain and cement till now. If one considers the trends of the developed nation almost two-third of the non-bulk goods are transported through roads. The completion of the Golden Quadrilateral (aimed at connecting the four metros) and East-West-North-South corridor will result in availability of a network of 15,000 kms of connectivity. This will give a major fillip to road transport. Going forward, the important reasons for the growth in the road transport over railways will be flexibility, reducing transit and stoppage time apart from savings in terms of cost per tonne.

According to economic growth estimates by CMIE, the agriculture sector is expected to play a major role in the GDP growth of the country. The agency expects the sector to grow by about 5.8% during the current year. This is on the back of good monsoon witnessed in 2010. Considering that there will be a significant amount of harvest that will be needed to move around, the freight rates are expected to move up, which will in turn increase the demand for CVs. As per the management of ALL's industry rival Tata Motors, the average cost of transportation by road is cheaper as compared to railways by around 10% to 15% per tonne mile. With further development of road

infrastructure, the gap is likely to increase and therefore, will benefit the CV sector.

The sharp spurt in demand for multi-axle vehicles (MAVs) in the last few years is a clear indication that there is a skew towards demand for higher tonnage vehicles (above 16 tonne carrying capacity, accounting for around 40% to 45% of the M&HCV demand). This should have a positive impact on topline growth of ALL as it is a major player in M&HCV segment with a 27% share of the domestic demand in FY10. It should be noted in developed nations, nearly 90% of the demand is for such types of vehicles. Having said that, given the cyclical nature of the sector, we expect growth rates to slow down to normalised levels of 8% to 10% with a bias towards M&HCV.

- Bus segment is a growth story:** The bus segment has the potential to witness the exponential growth witnessed in the goods commercial vehicles during last few years. We agree with the view of the management about the potential that the bus segment has. Our belief stems from the fact that the State Transport Undertakings (STUs) are operating at significantly high utilisation levels (120% to 130% of their capacity). Though the STUs are facing resource crunch due to number of reasons, we believe that renewal of fleet is an eventuality in the long run.

Secondly, the potential growth in the inter-city transportation, which has been growing swiftly in light of the road expansion programmes. Though new players are expected in this category and existing players are likely to increase focus, we believe that there is adequate room for ALL to grow in this segment. In FY10, this segment witnessed a 23% YoY jump in volumes.

- Measures to tackle the cyclicity:** ALL is cognizant of the fact that the CV industry is cyclical in nature. Therefore, to keep its revenues growing at a stable pace, it will have to venture into non-cyclical businesses as well to reduce its dependence on any single market. In the past, the company has tackled this by way of increasing exports, selling engines and also supplying vehicles to the defence sector. It took a few more steps in recent times to ensure that the risk of cyclicity is further reduced. Some of the major steps include:

- The company has also entered into a JV with the Alteams Group, Finland to manufacture High Pressure Die Casting (HPDC) aluminium products, predominantly for the automotive and telecommunication sectors. The plant was inaugurated in January 2010.
- A 50:50 JV with John Deere to manufacture and market construction equipment. The JV will commence production next year and will initially roll out Backhoes and Four-wheel-drive Loaders.

We view these moves as a positive for the company and expect the non-cyclical revenues as a percentage of total revenues to go up. However, some of these large ventures will not contribute to the company's financials in the short term.

- **Renewed focus on LCVs:** By limiting its focus largely to M&HCVs, ALL has missed out on the LCV growth story that has been panning out in India for quite some time now. However, this may not be the case going forward. To capitalise on the LCV growth story, ALL entered into a joint venture with Nissan Motors Co. Ltd., Japan to develop and produce light commercial vehicles for both the domestic and export markets. The two organizations have been working closely over the past few months and the alliance is expected to roll out its first product sometime in the first half of FY12.

Background

Ashok Leyland is the second largest manufacturer of medium and heavy commercial vehicles (M/HCV) in India. It had a 27% market share in the domestic medium and heavy vehicles (M&HCV) segment in FY10 and a marginal presence in the LCV segment (light commercial vehicles). Ashok Leyland is also a key player in the passenger bus segment with close to 50% market share in FY10. CVs contributed to 85% of revenues in FY10 while engines, spare parts and defence kits contributed to the balance. Hinduja Automotive Ltd owns 51% of Ashok Leyland.

Historically, the company has been very strong in the southern market in the CV segment and a relatively weaker player in other regions. As a result, during phases of recovery when CV demand grows at a faster clip, Ashok Leyland has underperformed Tata Motors, the market leader. However, the

company has been stepping up its efforts in the northern and the eastern regions over time.

Industry Prospects

The auto industry has performed exceptionally well over the past year and a half, with the commercial vehicle segment making a comeback after a lull of two years during FY08 and FY09. In FY10, the total commercial vehicles volumes (domestic and exports) grew by 35% YoY. In the year till date i.e. 1HFY11, the volume surge has continued. Total commercial vehicle volumes during the first half of the current fiscal stood at nearly 60% of FY10's full year volumes.

In the long run, the CV segment will benefit from certain structural changes that are happening in the industry. For one, consolidation has gained pace in the road transportation sector. As bigger freight operators consolidate, demand for CVs above 16 tonnes and multi-axles CVs are expected to increase (account for more than 40% of CV sales). Besides, of the current CV population of 2.7 m vehicles on road, nearly one-third are more than a decade old. If one were to assume that this replacement demand would be spread over a period of next 10 years, the growth potential is promising. Though the CV sector is cyclical in nature, replacement demand would provide some cushion for players. Having said that, it has to be remembered that freight rates, interest rates and the performance of the manufacturing sector are the key factors that shall drive replacement demand.

Key management personnel

Mr. Dheeraj G. Hinduja was appointed the company's Chairman in October 2010. Prior to this, he served as Co-Chairman of the company since July, 2007. He has been a Non Executive Director of Ashok Leyland since 1996. He is also the Director of Hinduja Global Solutions Ltd. (also known as HTMT Global Solutions Ltd.) since March, 2007. He has obtained an MBA degree in 1994 from the Imperial College, London.

Mr. Ramaswamy Seshasayee, B.Com, A.C.A. is the Managing Director of the company and has been holding this position since 1998. He has been with the company for over three decades. He also serves as vice President of Confederation of Indian Industry (CII). He also served as President of the Society of Indian Automobile Manufacturers. He has been an active member of the Central Council of the CII and served as its President during 2006-07. He served as Chairman and Member of various trade and

professional committees both at national and international levels.

Risk Analysis

Please see 'Risk Matrix' table on page 6 of this report

Sector: With more and more automobiles plying on Indian roads and with demand for CVs also likely to remain strong, we believe the auto industry will continue to grow at a steady pace over the medium term. However, since the demand is inherently cyclical in nature, we assign a medium risk rating to the company on this parameter.

Company standing: ALL is the second biggest player in the CV market with market share of about 27%. Therefore, we assign a strong rating to the company on this parameter.

Sales: ALL generated average revenues to the tune of nearly Rs 68 bn (US\$ 1.5 bn) each year over the last five years. In the first half of the current financial year (FY11), the company has already clocked revenues of about US\$ 1.1 bn. We thus assign a low risk rating of 10 to the stock on this parameter.

Operating margin: Operating margin is a measurement of what proportion of a company's revenue is left over after paying for variable costs of production such as raw materials, wages, and sales and marketing costs. A healthy operating margin is required for a company to be able to pay for its fixed costs, such as interest on debt. The higher the margin, the better it is for the company as it indicates its operating efficiency. ALL's average operating margins for the past five years have been 9%, which is likely to improve to levels of about 10% in the next three. As such, we assign a medium risk rating of 4 to the stock on this parameter.

Long term EPS growth: ALL has grown its net profits at a CAGR of 9% over the past five years. However, profits were lower by about 1% (on a compounded basis) over the past three years. The key reason for the decline in profits was the slowdown, which hampered the company's sales volumes. However, over the next three years, we expect profit the company's profits to grow at a pace of 21%, led by the recovery in sales volumes. As such we assign a medium risk rating of 5 to the stock on this parameter.

Return on capital invested (ROIC): ROIC is an important tool to assess a company's potential to be a quality investment by determining how well the management is able to allocate capital to its

operations for future growth. A ROIC of above 15% is considered decent for companies that are in an expansionary phase. Considering ALL's last five years' average ROIC of 12%, we have assigned a high-risk rating of 2 to the stock on this parameter.

Dividend payout: A stable dividend history inspires confidence in the management's intentions of rewarding shareholders. ALL's average payout ratio stood at 57% over the past five years. Thus, we have assigned a low-risk rating of 10.

Promoter holding: A larger share of promoter holding indicates the confidence of the people who run it. We believe that a greater than 40% promoter holding indicates safety for retail investors. Promoter shareholding in ALL at the end of September 2010 stood at 39%. As such, we assign a medium risk rating of 6 to the stock on this parameter

FII holding: We believe that FII holding of greater than 15% can lead to high volatility in the stock price. The FII holding in ALL at the end of September 2010 stood at 15%. Based on our parameters, the rating assigned is 5.

Liquidity: The average daily trading volumes of ALL's stock over the past 52 weeks stood at nearly over 933,000 shares. This level of liquidity is a matter of comfort, as this might protect the stock from undue volatility in case of exchange of large holdings among market participants/investors. The rating assigned is 10.

Current ratio: ALL's average current ratio during the period FY06 to FY10 has been 1.3 times. This indicates that the company is well covered to pay off its short-term obligations, which gives comfort to its lenders. We assign a medium-risk rating of 5 to the stock on this parameter.

Debt to equity ratio: A highly leveraged business is the first to get hit during times of economic downturn, as companies have to consistently pay interest costs, despite lower profitability. Considering ALL's average debt to equity ratio of 0.5 over the past five fiscals, we have assigned a medium-risk rating of 4 to the stock.

Interest coverage ratio: It is used to determine how comfortably a company is placed in terms of payment of interest on outstanding debt. The interest coverage ratio is calculated by dividing a company's earnings before interest and taxes (EBIT) by its interest expense for a given period. The lower

the ratio, the greater are the risks. ALL's average interest coverage ratio has been 6.8 for past three years. However, going forward we expect the interest coverage to reduce, although marginally. We have thus assigned a low risk rating of 8 to the stock on this parameter.

P/E Ratio: The P/E ratio (price-to-earnings ratio) of a stock is a measure of the price paid for a share relative to the per share income or profit earned by the company. This is one of the important metrics to judge the attractiveness of a stock, and thus gets the highest weightage in our risk matrix. ALL's

standalone P/E on a trailing twelve month basis stands at 16 times. We believe this is slightly on the higher side and as such don't see much of an upside in the stock from a long term perspective. We have assigned a high risk rating of 3 to the stock on this parameter.

Considering the above analysis, the total ranking assigned to the company is 72 that, on a weighted basis, stands at 5.4. This makes the stock a medium-risk investment from a long-term perspective.

Risk Matrix

(Rs m)	Rating accorded		
Rating	Weightage* (A)	Rating# (B)	Weighted (A*B)
Sector risk	-	Medium	NA
Company's standing	-	Strong	NA
Performance parameters			
Sales	5.0%	10	0.5
Operating margins	5.0%	4	0.2
Long term EPS growth	10.0%	5	0.5
Return on invested capital	10.0%	2	0.2
Technical parameters			
Dividend payout	5.0%	10	0.5
Promoter holding	10.0%	6	0.6
FII holding	5.0%	5	0.3
Liquidity	10.0%	10	1.0
Safety parameters			
Current ratio	5.0%	5	0.2
Debt to equity ratio	10.0%	4	0.4
Interest coverage ratio	5.0%	8	0.4
P/E ratio	20.0%	3	0.6
Final Rating**		72	5.4

Rating has been assigned on the basis of the company's performance over the past five years and expected performance over the next 3 to 5 years. Rating is on a scale of 1 to 10, with 1 indicating highest risk and 10 indicating lowest risk. * 'Weightage' indicates the relative importance in percentage terms of the parameter. For instance, for an investor, given all the performance metrics, Return on Equity should be the foremost criteria for buying/not buying stocks. ** The final rating has been arrived at by multiplying the rating/points given on each parameter with the respective weightage

Valuations

ALL is currently trading at Rs 76 implying a P/E multiple of 13.4 times and price to cash flow multiple of 9.5 times our estimated FY13 earnings and cash flow per share respectively. Based on our valuation criteria, the sell limit for the stock as per FY13 cash flow comes to around Rs 88 per share. This implies a point-to-point upside of 17% or alternatively, a CAGR of about 7% from the prevailing share price. Since there is not much upside to the stock from current levels, investors could do well to 'SELL' the stock from a March 2013 perspective.

Financials at a glance

(Rs m)	FY10	FY11E	FY12E	FY13E
Revenue	74,072	107,689	121,268	136,945
PAT	4,237	5,957	6,363	7,474
EPS (Rs)	3.2	4.5	4.8	5.6
CEPS	4.7	6.5	7.0	8.0
Price to earnings (x)	23.7	16.9	15.8	13.4
Price to cash flow (x)	16.0	11.5	10.8	9.5

Financials at a glance

(Rs m)	FY10	FY11E	FY12E	FY13E
Sales	74,072	107,689	121,268	136,945
Sales growth (%)	21.5%	45.4%	12.6%	12.9%
Operating profit	7,628	11,307	12,127	13,695
Operating profit margin (%)	10.3%	10.5%	10.0%	10.0%
Net profit	4,237	5,957	6,363	7,474
Net profit margin (%)	5.7%	5.5%	5.2%	5.5%

Balance Sheet

Current assets	41,397	44,004	53,429	61,248
Fixed assets	48,110	53,863	55,915	57,768
Investments	3,262	8,262	11,262	13,262
Total Assets	92,769	106,128	120,606	132,278
Current liabilities & prov.	29,608	33,844	43,399	48,830
Net worth	36,511	40,185	44,214	49,353
Loan funds	22,039	26,372	26,072	25,772
Other liabilities	4,611	5,728	6,921	8,322
Total liabilities	92,769	106,128	120,606	132,278

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