MSE Financial Services Ltd

SECTORAL OUTLOOK

05 October, 2018

AUTOMOBILE STOCKS MAY SEE A VALUATION DE-RATING, MORE WEAKNESS EXPECTED

TWO-WHEELER, PASSENGER/UTILITY VEHICLES MAY SEE A SLOWDOWN IN SALES AND VOLUME GROWTH MAY DECELERATE WHILE THE OUTLOOK FOR COMMERCIAL VEHICLES CONTINUE TO REMAIN POSITIVE

Inferences from September 2018 Auto Sales Data: -

- Major domestic auto companies reported lower-than-expected auto sales number for the month of September due to a number of factors such as a delayed festive season, rising interest rates, rising fuel prices and higher insurance costs owing to the floods in Kerala.

- However, the Commercial Vehicles (CV) segment continued to do well as the logistics sector continues to grow in excess of 20% each year, rural economy sentiments seem to have improved on the back of a hike in Minimum Support Prices (MSP), the government's focus on improving road infrastructure, increased defence budgets, and increase in mining activities has been some major positives for the particular segment.

- Three-Wheeler sales witnessed good growth in volumes on the back of the government's decision to end the Permit Raj scheme.

- Two-Wheeler sales growth (%) seems to be declining on a declining trend when looking at sales figures on a 5-year basis. This is primarily due to domestic market saturation, and high sales base of the previous year which leads to slower growth.

- Tractor sales witnessed a temporary fall on account of a delayed festive season and a minor deficit in rainfall. However, sales volumes in the tractor segment should pick up in the next 2 quarters as the festive season in the month of November and the harvesting season in the month of January should increase cash circulation in the rural economy.

- The auto sector in India seems to be in transitory phase from the 'Growth Stage' to the 'Maturity Stage' when looking at the product life cycle. Such phases normally result in a drop in Price Earnings or Valuation multiples and thus, this is the rationale behind our view in the Auto Sector.

- Revenues from the After-Sales and Maintenance should grow in the high teens over the next three years given higher commodity costs, and a higher base of vehicles in the domestic market. However, margins may remain the same or decline slightly in this particular segment.

- Price related competition and regular discount offers are noticed especially in the two and three-wheeler segment. This has put considerable pressure on margins and such pressures on margins are expected to continue in the foreseeable future.

- We foresee major margin pressures in the sector on account of rising competition, increased metals and input related costs.

- We expect revenues to be flattish to single digit growth in volumes for FY19 for the automobile sector as a whole due to higher oil prices, higher interest rates and increase in insurance costs.

- The sector which saw major backlogs in their orderbook over the last four years has recently seen lesser order flows and backlogs have reduced drastically owing to higher manufacturing capacity and a slight drop in demand.

Our View on the 04th October Retail Fuel Price Cut by ₹2.50/litre: -

We continue to be of the view that sales growth for the automobile sector is expected to slow down and a minor 2-3% cut in retail oil prices shouldn't affect customer preferences or demand substantially. Thus, we continue to reiterate that more weakness should be seen in the auto pack in the near term.

September Sales Data: -

Commercial Vehicles

Company	Category	Sep-18	Sep-17	YoY
Eicher Motors	MHCV	6663	6083	**9.5%**
Tata Motors	MHCV LCV	16239 29930	12259 24419	**32.5%** **22.6%**
Ashok Leyland	MHCV LCV	14232 5141	11805 3566	**20.6%** **44.2%**
M&M	MHCV LCV	1064 21853	884 18319	**20.4%** **19.3%**
Maruti Suzuki	LCV Vans	2038 14645	879 13735	**131.9%** **6.6%**

Passenger and Utility Vehicles

Company	Category	Sep-18	Sep-17	YoY
Maruti Suzuki	PV	115228	116886	**1.4%**
M&M	PV	21411	25414	**15.8%**
Tata Motors	PV	18429	17286	**6.6%**
Maruti Suzuki	UV	21639	19900	**8.7%**

Two Wheelers

Company	Category	Sep-18	Sep-17	YoY
Eicher Motors	Bikes	71662	70431	**1.7%**
Bajaj Auto	Bikes (Indian Market)	273029	247418	**10.4%**
TVS Motor	Bikes Scooters Mopeds	166489 142562 101645	143923 121601 85330	**15.7%** **17.2%** **19.1%**
Hero MotoCorp	Bikes	769138	720739	**6.7%**

Tractors

Company	Category	Sep-18	Sep-17	YoY
M&M	Tractors	37581	45563	17.5%
Escorts	Tractors	10396	10144	2.5%

Three Wheelers

Company	Category	Sep-18	Sep-17	YoY
TVS Motor	Auto Rickshaws	13282	8996	**47.6%**
Bajaj Auto	Auto Rickshaws	38474	34361	**12.0%**
M&M	Auto Rickshaws	6940	5928	**17.1%**

Exports

Company	Category	Sep-18	Sep-17	YoY
Maruti Suzuki	Exports	8740	11671	**25.1%**
Eicher Motors	Exports	1597	1038	**53.9%**
M&M	Exports	3754	3207	**17.1%**
TVS Motor	Exports	49560	50971	**2.8%**
Bajaj Auto	Exports	190506	146973	**29.6%**
Tata Motors	Exports	5250	3887	**35.1%**
Escorts	Exports	221	209	**5.7%**

Nifty Auto Valuation Scan: -

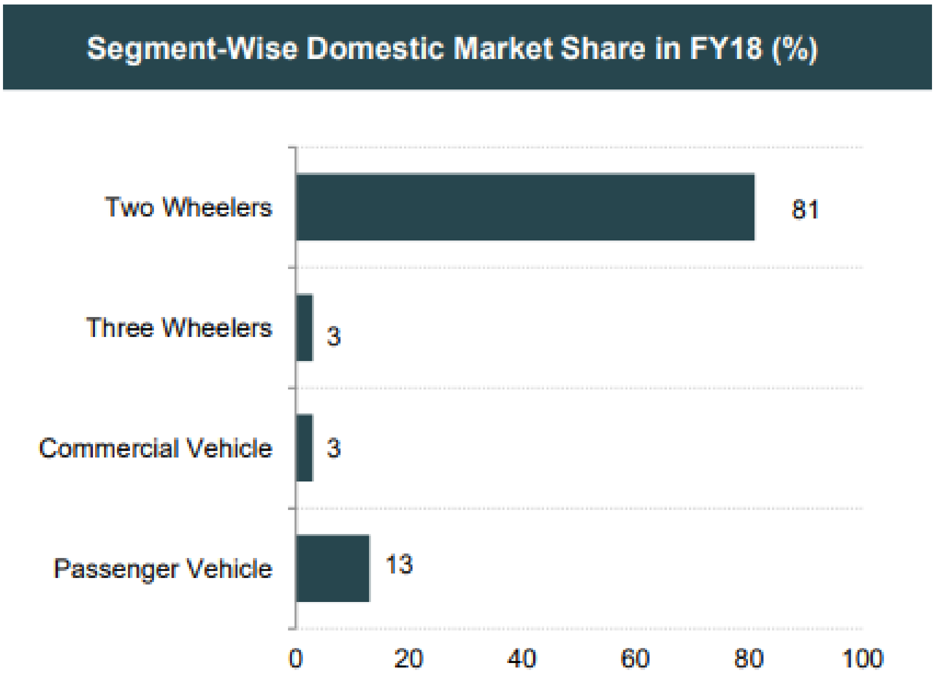
Date	P/E	P/B	Dividend Yield (%)
MSEFSL'S FY19(E)	23.00	4.00	1.40
04th October 2018	24.69	4.42	1.06
04th October 2017	42.42	5.86	0.57
04th October 2016	38.92	6.59	0.73
01st October 2015	46.97	5.88	0.84
01st October 2014	37.43	6.07	0.88

- We are of the view that P/E ratios should moderate at levels of 19, while P/B ratio should drop to levels close to 3 and Dividend Yield should increase by 100-150bps over the next three years (by FY21).

- We foresee higher dividend pay-out ratios for auto companies and we expect debt in the sector to reduce substantially over the next three years (until FY21) as necessary investment with regard to manufacturing and distribution for the sector has already been made over the past 5 years and thus, surpluses generated from now on would be used to reduce debt and increase dividend pay-out ratios.

- We expect Mergers & Acquisitions activities and share buyback activities to increase in the two-wheeler space as such companies have attained maturity in their business life cycle and are thus, producing more than sufficient free cash flows to look at acquiring other companies in the space and to conduct share buybacks. We expect share buybacks to become very common in the space over the next 3-5 years.

- The investment cycle in the sector should again start to kick in at around FY21 owing to the shift to electrical vehicles and investments in technology and research.



- With a five-year perspective, we expect market share of two wheelers and three wheelers to reduce substantially while passenger and commercial vehicle segments should take up the lost market share by two and three wheelers in the domestic market

Rationale Behind Our View: -

- Higher oil prices, rising interest rates, and rising insurance costs should reduce demand.
- The pickup in demand noticed for second-hand autos (especially in the PV and UV space) means that the customer propensity to consume should reduce in the new vehicle space.
- The Commercial Vehicle segment should continue to do well on the back of a higher GDP growth rate, better growth rates in the logistics sector, government's emphasis on road infrastructure, increased defence budgets and increased primary activities.
- The shift in business cycle from a 'Growth phase' to 'Maturity phase' should lead to a contraction in valuation ratios.

- Valuation multiples hasn't fully discounted lower growth rates in the future. India's valuation multiples for the auto sector continue to be expensive in comparison to other major markets and a sharp contraction in valuation multiples can be expected.

- Stock prices seem to have run ahead than earnings growth. Thus, a major wave of correction in the sector is yet to fully play out.

Dated: - 05th October 2018

Underlying Index on which the Report is Based: - Nifty Auto

References

- IBEF (India Brand Equity Foundation) Report on the Automobile Sector – September 2018
- ACE Analyser
- Money control
- NSE India
- Nifty Indices