

Stricter regulations to drive costs higher in next four years

2W EVs could be the next big thing, but have potential to be disruptive

We attended Autocar Professional's India Two-Wheeler Industry Conclave, where industry leaders (including key auto component suppliers) discussed the future of the 2W industry.

Key highlights from the conclave:

- Stricter regulatory norms are likely to pose challenges to the Indian auto industry, increasing costs by ~10-20% over next four years.
- These norms would also raise compliance costs. This means higher costs for customers without any perceptible difference in vehicle performance.
- Bharat stage (BS) VI adoption would result in convergence with Euro 5 norms by 2020, making it difficult for OEMs to get ready-made solutions from developed markets.
- The shift from carburetor-based engine to electronic fuel infusion (EFI) system opens up huge opportunity for players like Bosch to tap India's two-wheeler (2W) segment, with additional market opportunity of ~INR135b for BS VI, which includes EFI system (~INR120b) and three-way catalyst (~INR15b). However, tier-1 suppliers would have to invest ~INR35B in capex and further ~INR10b in localization.
- Scooterization is expected to continue, with this segment expected to account for ~45% share of the 2W industry by 2020.
- Electric vehicle (EV) 2Ws could be the next big opportunity (especially in urban markets), considering increasing excitement toward EVs, government's push toward EVs to control pollution, improving battery technology (increasing density) and ~50% decline in Li-ion battery prices over past three years.
- EV 2Ws would require different approach right from product development to manufacturing to distribution and service. With largely different critical success factors, 2W OEMs are vulnerable to competition from non-conventional sources like start-ups (Ather Energy, Stork Motorcycle, etc.).
- Valuation & view: While we estimate volume recovery for 2Ws (~12% CAGR in FY16-18E), intense competition would restrict pricing power of 2W OEMs. We expect value migration from motorcycle to scooters to continue, and within motorcycle we expect premium segment to outgrow executive segment. We are lowering our target multiples for the 2W stocks to near LPA (v/s at 10-20% premium to LPA earlier) to reflect in for uncertainty arising due to demonetization coupled with coupled with cost inflation due to regulatory norms. We prefer TVSL and EIM in 2W space.

Exhibit 1: Comparative valuation – Indian Auto OEMs

	CMP (INR)*	Rating	TP (INR)	P/E (x)		EV/EBITDA (x)		RoE (%)		RoCE (%)	
				FY17E	FY18E	FY17E	FY18E	FY17E	FY18E	FY17E	FY18E
Bajaj Auto	2,528	Buy	3,158	17.5	14.5	11.8	9.3	32.1	33.1	31.2	32.1
Hero MotoCorp	2,928	Neutral	3,227	15.5	13.2	10.1	8.4	42.6	40.6	41.6	39.8
TVS Motor	345	Buy	445	27.1	19.5	17.1	12.5	29.2	31.8	30.2	34.8
M&M	1,200	Buy	1,602	17.2	13.2	14.2	11.5	15.9	16.9	13.2	14.3
Maruti Suzuki	4,788	Buy	6,865	18.7	15.4	11.7	9.5	23.7	23.5	31.9	31.6
Tata Motors	457	Buy	633	15.2	8.4	4.8	3.3	12.3	19.0	9.4	14.0
Ashok Leyland	76	Buy	105	14.0	10.1	7.6	5.5	26.5	30.1	19.4	23.7
Eicher Motors	20,358	Buy	30,230	34.0	23.6	26.7	20.2	42.1	42.9	27.9	31.3

Nos. are on CY basis

Source: Company, MOSL

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We attended Autocar Professional's India Two-Wheeler Industry Conclave, where industry leaders (including key auto component suppliers) discussed the future of the 2W industry in terms of regulations, technologies and changing marketplace. Following are the key insights from the conclave.

Regulatory actions pose cost challenges to industry...

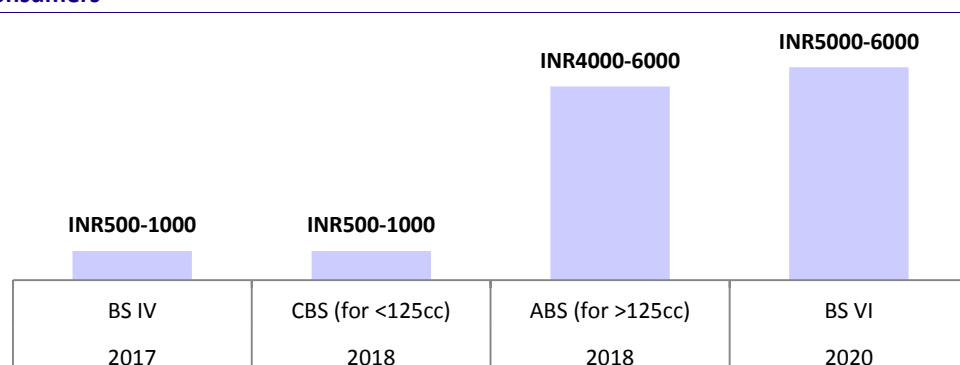
- Indian 2W industry will have to comply with BS IV norms from April-17 and then with more stringent BS VI norms from April-20.
- BS VI mandates reduction in emission by up to 80% and brings in additional norms for particulate matter. It seems compliance to BS VI would be based on EFI system and three-way catalyst (as against carburetor-based systems currently).
- Safety norms also mandate ABS/CBS for >125cc/<125cc 2Ws from April-18.
- The shift to BS VI would entail cost increase of at least 8-10%, while installing ABS/CBS would result in cost increase of up to 8%. Also, evolving regulatory norms should raise compliance costs.
- This means higher costs for customers without any perceptible difference in vehicle performance.
- EFI offers the advantage of software control, which can be leveraged to improve quality (such as drivability and fuel efficiency).
- India's emission norms have lagged global standards in the past. However, BS VI adoption would result in convergence with Euro 5 norms.

Exhibit 2: Emission norms for 2Ws in India

Year	Stage	Type	CO	HC	NOx	HC+NOx	NHMC	PM
1991		All	12-30	8-12	-	-	-	-
1996		All	4.5	-	-	3.6	-	-
2000	BS-I	All	2	-	-	2	-	-
2005	BS-II	All	1.5	-	-	1.5	-	-
2010	BS-III	All	1	-	-	1	-	-
		Class 1 & 2-1	1.403	-	0.39	0.59-0.79	-	-
2017	BS-IV	Class 2-2	1.97	-	0.34	0.47-0.67	-	-
		Class 3-1 & 3-2	1.97	-	0.2	0.2-0.4	-	-
2020	BS-VI	SI	1	0.1	0.06	-	0.068	0.0045
		CI	0.5	0.1	0.09	-	0.068	0.0045

Source: MOSL

Exhibit 3: Upcoming regulatory norms on emission and safety to increase cost to consumers



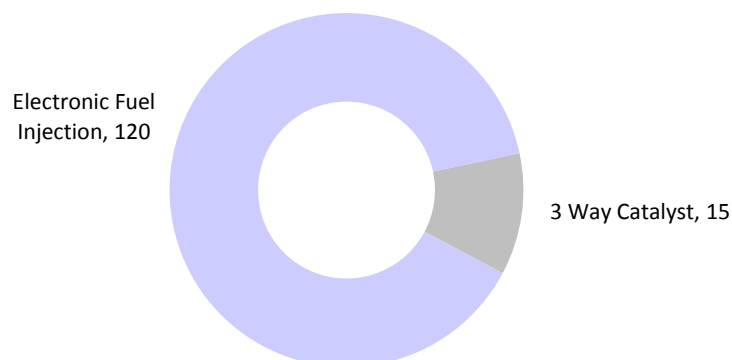
Source: MOSL

...but also provide opportunity for innovative companies...

- Although BS VI poses challenge for the 2W industry, it can be leveraged by OEMs to offer innovative products that meet emission norms.
- OEMs might use existing solutions like EFI + three-way catalyst, which would result in cost increase without any material improvement in performance.
- This also provides opportunity to innovate on new ICE architecture/EVs, which are more efficient and could meet future CO emissions norms. This would entail higher price, but also offer higher value-add to customers. This approach could lead to creation of a new category, giving first-mover advantage to the innovator.

...and open up 2W segment for players like Bosch

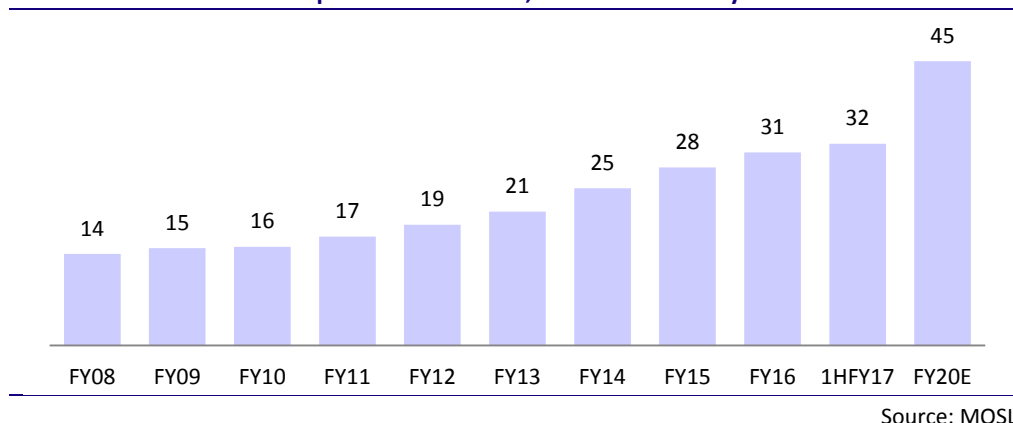
- The shift from carburetor-based engine to EFI framework opens up huge opportunity for players like Bosch to tap the 2W segment.
- Assuming domestic 2W industry volumes of ~25m by FY21 (~9% CAGR), it would imply additional market opportunity of ~INR135b for BS VI – EFIs (~INR120b) and three-way catalyst (~INR15b).
- With converging emission norms, economies of scale in the domestic market could also be leveraged for exporting EFIs to global markets.
- Tier-1 players would have to invest ~INR35B in capex and further ~INR10b in localization.

Exhibit 4: BS VI opens up ~135b additional opportunity for vendors like Bosch

Source: MOSL

Scooterization to continue, with share of ~45% by 2020

- Domestic 2W industry CAGR is expected at 8-10% by 2020, driven by 17-19% CAGR in scooters.
- As a result, the trend of scooterization is expected to continue, albeit a moderating pace. Scooters are expected to command ~45% share of the domestic 2W industry by 2020.
- While the domestic motorcycle industry is expected to grow at 3-5%, the premium segment (>150cc) is expected to outgrow both motorcycle and domestic 2W industry.
- Continued uptrading implies muted volumes for the 110cc segment, which would be largely driven by rural markets.

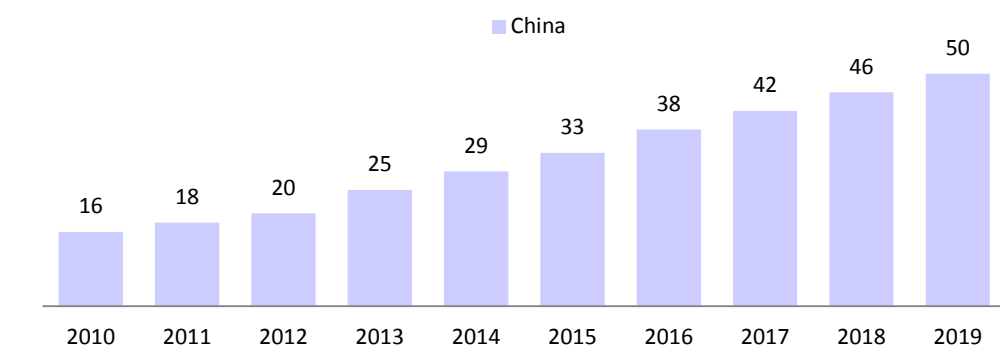
Exhibit 5: Scooterization expected to continue, with 45% share by 2020**EV 2Ws could be the next big opportunity...**

- Electric 2Ws segment has not been able to gain much traction in India by now due to the lack of attractive products, use of conventional lead acid batteries, higher charging time, lower range per charge and speed, and limited push from the government.
- While conventional 2W companies like Hero Electric, Mahindra and Bajaj are working on 2W EVs, a few start-ups like Ather Energy and Tork Motorcycle are also focusing on driving acceptance of 2W EVs.
- Increasing excitement toward EV, the government's gradual push toward EVs to control pollution, improving battery technology (increasing density) and falling Li-ion battery prices (~50% decline in three years) augur well for 2W EVs.
- Also, considering increasing awareness about pollution, improving driving range per charge and declining pricing gap as against mainstream 2Ws (also aided by subsidies), we expect faster adoption of 2W EVs in urban markets.
- However, there are few challenges which need to be addressed (e.g., charging infrastructure and replacement battery prices).
- To put things in perspective, China has largely shifted toward 2W EVs with annual volumes of ~33m units.

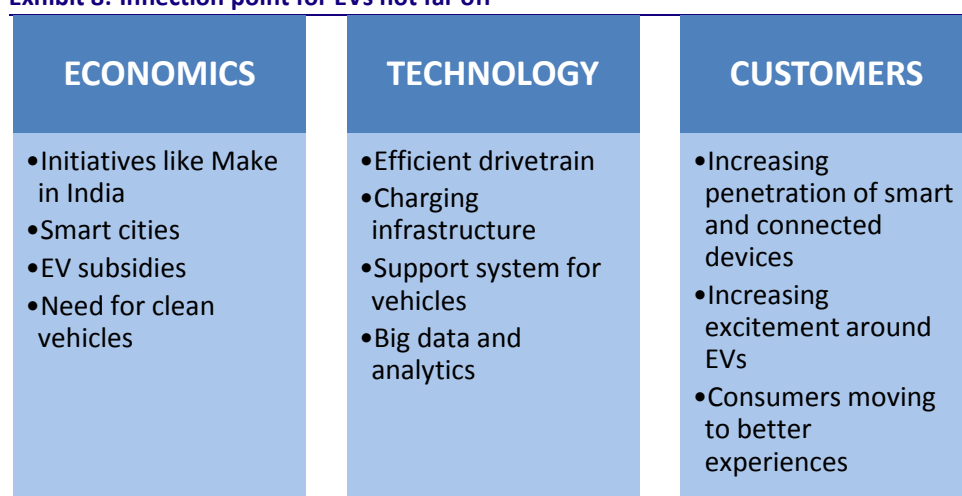
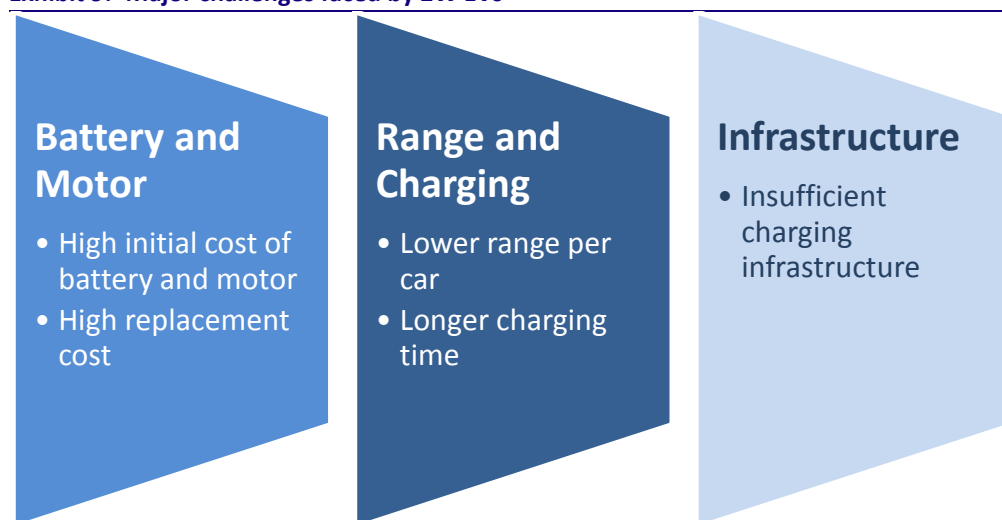
Exhibit 6: EVs superior to conventional 2Ws on both economic and environmental parameters

	For total petrol 2W population at present	For petrol 2W that will be purchased this year
No. of 2 Wheelers (m units)	160	20
Petrol consumed (m litres)	30000	3000
Fuel cost (INR b)	2100	21
CO (m tons)	5.4	0.6
HC+Nox ('000 Tons)	3000	0.4
CO2 (m tons)	111	13

Source: MOSL

Exhibit 7: China makes significant progress in EV 2Ws

Source: MOSL

Exhibit 8: Inflection point for EVs not far off**Exhibit 9: Major challenges faced by 2W EVs**

Source: MOSL

Exhibit 10: Road ahead for 2W EVs

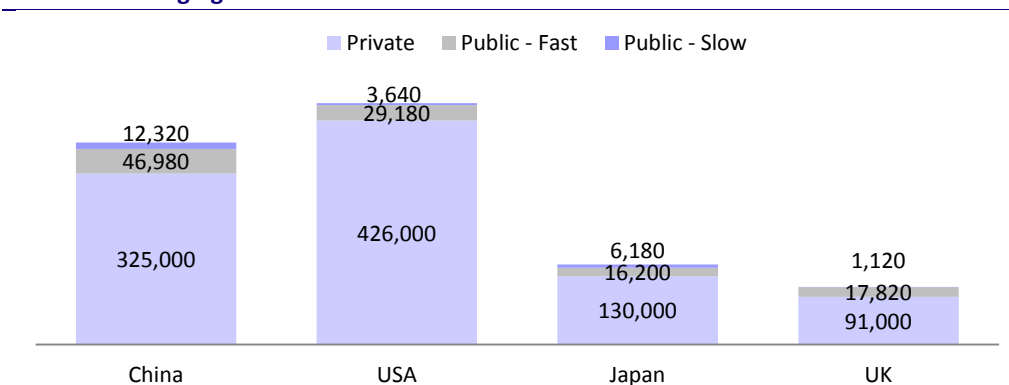
Policy	<ul style="list-style-type: none"> • Policy directive for a compulsory shift to electric vehicles for achieving critical volumes • Support for technology transfer and investment incentives for local manufacturing of batteries and motors
Manufacturer	<ul style="list-style-type: none"> • OEM-focus on optimization of battery consumption through software and controller • Development of charging infrastructure (joint participation of OEM and the government)
Tier-1	<ul style="list-style-type: none"> • Localization of EV components (battery, motor, controller, etc.) • Focus on technology innovation for fast charging

Source: MOSL

Exhibit 11: Government support initially critical for faster EV adoption

Push from the government		
State governments in 20 states reduced VAT and road tax. Reduced to almost zero in about 10 states	FAME (faster adoption and manufacturing of electric and hybrid vehicles) introduced subsidy for EVs with budget of ~INR750m for FY17, with total budget of ~INR7.95b till 2020	Electric motorcycle will be subsidized up to ~INR 29,000 each (maximum in 2Ws)

Source: MOSL

Exhibit 12: Charging infrastructure critical for shift to EVs

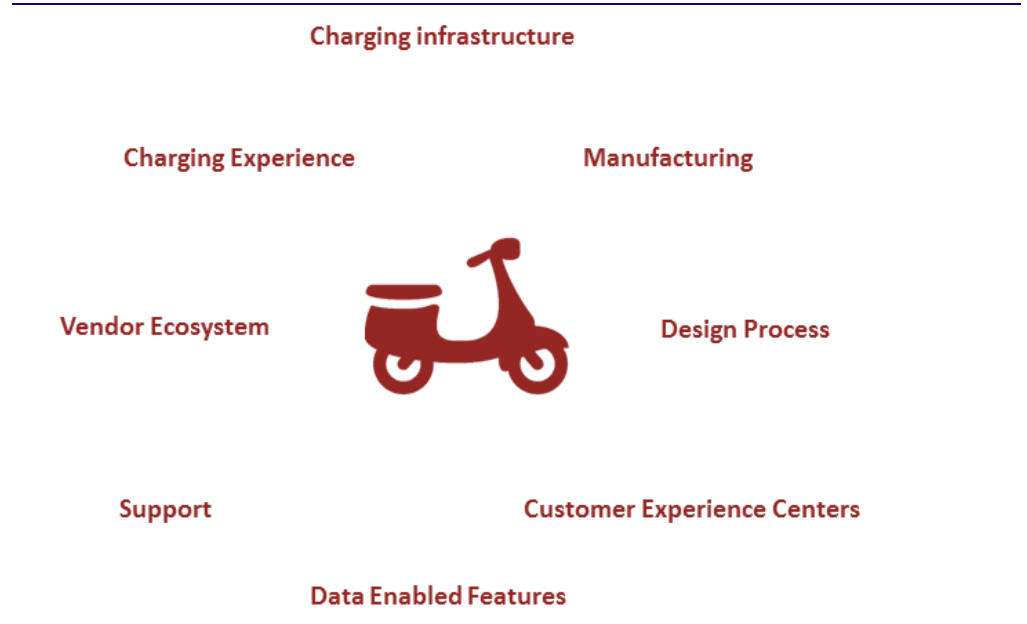
Source: MOSL

...but can be potentially disruptive as well

- While 2W EVs provide scope to differentiate among convention 2W OEMs, there would be competition from non-conventional sources like start-ups as well.
- 2W EVs would require different approach right from product development to manufacturing to distribution and service.

- Unlike currently where OEMs are largely system integrators mainly sourcing standardized parts, EVs would require a more integrated approach as standardized parts would be lower. Also, different components would require different vendors as well.
- Also, the dealer and service network strategy would need rethinking as repair and servicing requirements will be very different. Further, 2W EVs would operate in a connected environment, which would enable remote monitoring by OEMs.
- These factors could be potentially disruptive as companies would require different skillsets to succeed in EVs and also face competition from unconventional sources.

Exhibit 13: 2W EVs would require different approach, right from product development to manufacturing to distribution and service



Source: MOSL

Valuation and view

- After a prolonged period of muted demand for 2Ws due to two consecutive years of below-average monsoon, we are witnessing a strong recovery led by normal monsoon and positive sentiment.
- We expect 2W recovery to lose momentum in the short term (especially in 3QFY17) due to impact of demonetization.
- While we estimate volume recovery for 2Ws (~12% CAGR in FY16-18E), intense competition would restrict pricing power of 2W OEMs. We expect value migration from motorcycle to scooters to continue, and within motorcycle we expect premium segment to outgrow executive segment.
- We are lowering our target multiples for the 2W stocks to reflect in for uncertainty arising due to demonetization coupled with coupled with cost inflation due to regulatory norms. We now value these stocks near LPA. We prefer TVSL and EIM in 2W space.
- **HMCL** has multiple challenges on its hand viz a) value migration towards scooters and its weak franchise in scooters and premium motorcycle, b) bigger

impact of safety regulations and c) headwinds to margins. We maintain **Neutral** on HMCL with TP of ~INR3227 (15x Sep-18 EPS).

- **BJAUT** is relatively better placed in the domestic premium segment with healthy product pipeline. With stability in exports, albeit at lower levels, we are hopeful of both domestic and export business growing simultaneously in FY18. We maintain **Buy** with TP of ~INR3,158 (~16x Sep-18 EPS).
- TVSL's earnings momentum is expected to remain strong over next 2-3 years led by a) ramp-up of Victor volumes and recovery in scooter market share, b) benefit of monsoons and 7th Pay commission to aid sustained volume growth in H2FY17, c) launch of BMW Alliance product in early 2017, d) recovery in export markets as crude oil prices recover and e) resultant margin improvement. We maintain **Buy** with TP of ~INR445 (~16x Sep-18 EPS + ~INR68/share for BWM alliance).
- **EIM** would benefit from continued strong traction in Royal Enfield, supported by new product launches and new capacity coming on-stream from 2QFY18. This would lead to further improvement in margins driven by benefit of vendor consolidation and operating leverage. Maintain **Buy** with target price of INR30,230 (Sep-18 SOTP-based, valuing RE at 30x EPS and VECV at 10x EV/EBITDA).

Exhibit 14: Comparative valuation


	CMP (INR)*	Rating	TP (INR)	P/E (x)		EV/EBITDA (x)		RoE (%)		RoCE (%)	
				FY17E	FY18E	FY17E	FY18E	FY17E	FY18E	FY17E	FY18E
Auto OEM's											
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Auto Ancillaries											
Bharat Forge	858	Buy	1,017	34.6	25.4	16.8	13.7	16.2	19.7	11.1	14.2
Exide Industries	170	Buy	249	20.8	17.3	12.9	11	14.8	15.6	15.3	16.3
Amara Raja Batteries	909	Buy	1,268	28.9	21.6	16.9	13.1	23.8	25.8	22.6	24.6
BOSCH	18,490	Neutral	24,532	35.6	27.4	27.7	19.9	20.9	25.8	29.6	36.5

Nos. are on CY basis

Source: Company, MOSL

Our recent reports on Maruti Suzuki

[illegible]



27th Annual

S&P178 Awards update | Sector

Maruti Suzuki

1st SENSE

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CMP. INR 484.15 TO INR 510.31(+2%)

Buy

Operating performance is flat as net operational contribution, higher other income, lower depreciation losses

Profit: Upgrade EPS

Me improvement continues, but Fx hurts margins margin-wise "2% YoY"

Net sales (Rs. Crores) 1,20,000 (FY18) 1,20,000 (FY19) 1,20,000 (FY20) 1,20,000 (FY21) 1,20,000 (FY22) 1,20,000 (FY23) 1,20,000 (FY24) 1,20,000 (FY25) 1,20,000 (FY26) 1,20,000 (FY27) 1,20,000 (FY28) 1,20,000 (FY29) 1,20,000 (FY30) 1,20,000 (FY31) 1,20,000 (FY32) 1,20,000 (FY33) 1,20,000 (FY34) 1,20,000 (FY35) 1,20,000 (FY36) 1,20,000 (FY37) 1,20,000 (FY38) 1,20,000 (FY39) 1,20,000 (FY40) 1,20,000 (FY41) 1,20,000 (FY42) 1,20,000 (FY43) 1,20,000 (FY44) 1,20,000 (FY45) 1,20,000 (FY46) 1,20,000 (FY47) 1,20,000 (FY48) 1,20,000 (FY49) 1,20,000 (FY50) 1,20,000 (FY51) 1,20,000 (FY52) 1,20,000 (FY53) 1,20,000 (FY54) 1,20,000 (FY55) 1,20,000 (FY56) 1,20,000 (FY57) 1,20,000 (FY58) 1,20,000 (FY59) 1,20,000 (FY60) 1,20,000 (FY61) 1,20,000 (FY62) 1,20,000 (FY63) 1,20,000 (FY64) 1,20,000 (FY65) 1,20,000 (FY66) 1,20,000 (FY67) 1,20,000 (FY68) 1,20,000 (FY69) 1,20,000 (FY70) 1,20,000 (FY71) 1,20,000 (FY72) 1,20,000 (FY73) 1,20,000 (FY74) 1,20,000 (FY75) 1,20,000 (FY76) 1,20,000 (FY77) 1,20,000 (FY78) 1,20,000 (FY79) 1,20,000 (FY80) 1,20,000 (FY81) 1,20,000 (FY82) 1,20,000 (FY83) 1,20,000 (FY84) 1,20,000 (FY85) 1,20,000 (FY86) 1,20,000 (FY87) 1,20,000 (FY88) 1,20,000 (FY89) 1,20,000 (FY90) 1,20,000 (FY91) 1,20,000 (FY92) 1,20,000 (FY93) 1,20,000 (FY94) 1,20,000 (FY95) 1,20,000 (FY96) 1,20,000 (FY97) 1,20,000 (FY98) 1,20,000 (FY99) 1,20,000 (FY00) 1,20,000 (FY01) 1,20,000 (FY02) 1,20,000 (FY03) 1,20,000 (FY04) 1,20,000 (FY05) 1,20,000 (FY06) 1,20,000 (FY07) 1,20,000 (FY08) 1,20,000 (FY09) 1,20,000 (FY10) 1,20,000 (FY11) 1,20,000 (FY12) 1,20,000 (FY13) 1,20,000 (FY14) 1,20

MOTILAL OSWAL

28 April 2018

#MOTILAL Securities Update | Sector: Automobiles

Maruti Suzuki

CMV INR1,860 TP: INR5,525(+17%)

Buy

Strong momentum: Lower discounts and better track to one of the best growth drivers in the country
Strong realisation growth despite operating performance, but better other income

Key highlights: Lower discounts improved FY18Q4 volume growth to 14% (vs 12% in FY17Q4). Realisations improved FY18Q4 YoY (+5%) while by better export mix, domestic mix and lower discounts. Net sales grew +13.3% YoY (+5.9% QoQ) (+10.8% YoY) and FY18Q4 YoY (+10.8% QoQ). EBITDA grew 14.5% YoY (+7% QoQ) (+10.1% YoY) and FY18Q4 YoY (+10.1% QoQ). EBITDA margins improved +200bp QoQ to 15.4% (vs 15.2%), driven by lower discounts and better volume despite higher cost and other expenses. PAT declined 11.7% YoY to +1081.13 Cr (+1% QoQ) (+1082.26 Cr).

Keyways call highlights: At FY18, new sales +73% of domestic volume improved to FY18 FY18 +72% growth in FY18Q4. FY18Q4 export mix remained considerably better by Region, especially in Japan and Europe, driving higher export realisation. In FY18Q4, Q4 discounts declined +200bp QoQ from FY17Q4 to +1081.13 Cr, all FY18Q4 plant commissioning in FY18Q4. FY18Q4 net sales growth of +13.3%, with FY18Q4 export mix, 10% Volume Premium to be FY18Q4 volume, export mix to FY18Q4 and lower export rate, FY18Q4 YoY (+10.8% QoQ) and FY18Q4 YoY (+10.8% QoQ).

Valuations and other: We upgrade our FY17/FY18 P/E to 19.7x/19.7x in order for a better mix, lower discounts, Q4 volume & Q4, maintain price inflation. The stock trades at 18.8x/18.4x FY17/FY18 EPS. Maximum price with a target P/E of 19.7x (FY18, FY19 EPS).

SECTOR	S&P 500
Auto	14.5%
Maruti Suzuki	14.5%
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Company	2017	2018	2019
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EBITDA	88.8	101.8	101.8
PAT	457	481.3	481.3
EPS	20.0	20.0	20.0
QoQ	14.5	14.5	14.5
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YoY	14.5	14.5	14.5
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YoY	14.5	14.5	14.5

Our recent reports on Auto Sector

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Sector updates | June 2018

Automobiles



CMP: INR4,162 TP: INR4,525 (Upside 8.7%) Buy

New EVs set to launch within 12-18 months, growth of ~7% YoY

Below set at 123k units (vs est. 130.4k), growth of ~2% YoY

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 ₹100.00 36.11

Estimates ₹100.00 36.11
Roce (Operating) 36.11
EPS (Basic) ₹100.00 36.11
EPS (Diluted) ₹100.00 36.11
EPS (Adj.) ₹100.00 36.11
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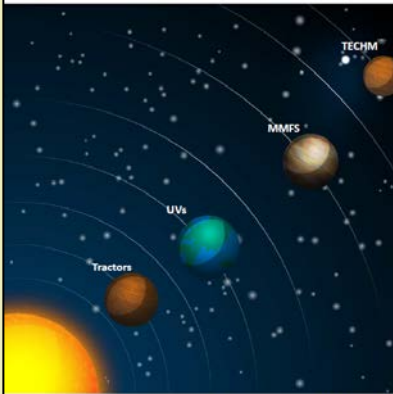
Our recent reports on other Auto Companies

		8th Edition Updated Latest Auto-motivated	
TATA MOTORS		CMP: INR465 TP: INR524 (+13%) Buy	
Annual Report Annual Report 2023-24 Tata Motors Limited and its Subsidiaries ASAT 2024		JAN-Jun 16 sales ahead est at 47,197units (+35%) YTD Ramp-up of recently launched products led strong performance; growth driven across all segments; strong sales in Range Rover	
Key Highlights		Jaguar volume +55% YTD, ahead by 19,375 units (estimate: 43,700 units), driven by Discovery Sport, E-Pace and F-Pace; Jaguar volume +83% YTD to 13,242 units (estimate: 10,730 units), led by XE and F-PACE. However, volumes of other Jaguar models continued to decline. Land Rover volume +29% YTD to 34,225 units (estimate: 31,000 units), driven mainly by growth in Discovery Sport and supported by Discovery. Volumes of other models declined due to product refresh. Jaguar India retail volume +37% YTD to 1,41,746 units (+1% MoM) to 46,416 units, driven by Range Rover in retail volumes. Jaguar India volume +88% YTD, led by a sharp increase in XE (+72% YTD) and the newly launched F-PACE (+846 units), while volumes of IS (+1% MoM) and L500 (+4% MoM) declined. Land Rover's retail volume was up 38% YTD, with growth driven by Discovery Sport (+458%) and supported by Discovery (+18%). However, the strong launch of PHEV Land Rover Discovery L290 contributed to decline. In terms of regional retail sales performance, UK volumes +44% YTD, Europe sales increased by 18% YTD and China volumes grew 18% YTD. Both the UK and USO grew 8.3% YTD. Commenting on the performance, Anand Jeyaraj, Group CEO, Tata Motors Operations Division, said "with record-breaking sales in both segments, Range Rover backed up by a strong performance in North America, Jaguar Land Rover has added 35,000 additional volumes during the first half of 2024. Jaguar has now surpassed growth targets by the accelerated introduction of the Jaguar F-PACE as well as continued strong sales of the XE. Land Rover has delivered a solid performance, particularly for the Discovery Sport, which is now the best-selling SUV in the world. The new launch of IS, 7x, 7xL, 7xH, 7xH L and 7xH L extended off-road, US, we maintain our strong belief in the growth of the company. With 2024 SIPR/2024 SIPR, the company and MNC/2024 SIPR/2024 SIPR will be a top priority."	
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Detailed Report | 4 July 2016
Sector: Automobile

Mahindra & Mahindra



All stars aligning!

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