India | Autos

Tata Motors (TTMT IN; TTM US)

April 27, 2014

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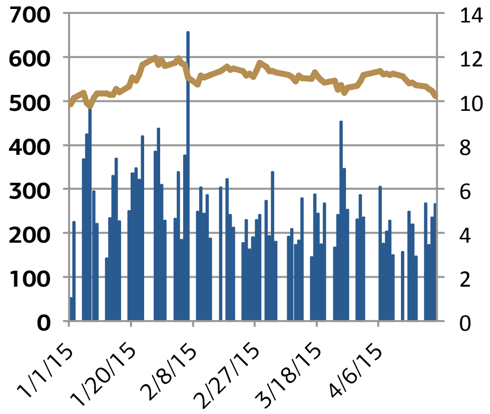
Ta-ta to the China boom

Tata Motors (TTMT IN) YTD share price in INR (gold, left) and volume (blue, in mln shares)



Source: Bloomberg

Tata (TTMT IN)

Price	INR 516.85
Rating	**SELL**
Price target	**INR 390**
Difference	**-24%**
Market Cap	IND 1,281.1 bln
Simple Moving Avg.	4.3 mln
P/E	11.99x
Float	64%

Source: Bloomberg

+ Tata's phenomenal China growth is ending

Jaguar Land Rover ("JLR") accounts for 83% of Tata's revenue. China accounts for 34% of JLR's revenue and this fell off a cliff in Q4 2015, with China unit sales down 20% YoY. The month of March alone saw a 35% decline.

+ Dealer checks saw 20-60% sales decline

Dealers were all negative. Inventory pressure is increasing, there are some signs of potential channel stuffing and price cuts are starting.

+ JLR makes ultra-fat margins in China

China has been a gold mine for JLR. JLR's ASP in China is GBP 64.9k, vs GBP 39k in the UK, a 67% premium. In 2012, China's ASP of GBP 76.3k was double the UK's ASP of GBP 34.4k!

+ The Street is not factoring in a China slowdown

Street estimates remain bullish and are still straight-lining Tata and JLR's sales growth. They don't take into account a China slowdown and moreover, the negative operating leverage that will result from price cuts and lower Chinese margins.

+ Valuation: INR 390

Our target price is 7x our forecast FY2016e EPS of INR 55.72. This assumes JLR China sales fall 15% in FY2016.

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A Chinese luxury car company

Tata is really a Chinese luxury car company in disguise

Since 2008, Tata Motors ("Tata"), India's largest auto manufacturer has quietly turned into the Land Rover company, deriving 83% of revenue from its Jaguar Land Rover (JLR) subsidiary. About 1/3 of this is from China. Tata is being valued based on China's amazing revenue growth, which has gone up 6.7x since FY2010. This revenue growth is ending and the market has yet to price this in.

In the first three months of 2015 (Q4 2015), JLR's China sales fell off a cliff. JLR reported that Q4 2015 China unit sales fell 20% YoY, while March alone saw a 35% YoY decline. This matches our dealer checks, which found Q4 2015 sales declines ranging from 20-60% YoY. We believe the JLR growth story in China ends this year.

Company background

Established in 1945, Tata Motors, a subsidiary of Tata Group, is India's largest automobile manufacturer, producing passenger vehicles, commercial vehicles, construction equipment and other vehicles. The company has expanded its international footprint through export of vehicles under the Tata brand, as well as acquisitions of Daewoo Commercial Vehicles Company in South Korea in 2004 and of Jaguar Land Rover from Ford in 2008.

Massive exposure to luxury cars in China

The JLR acquisition brought Tata into the Chinese market.

JLR accounted for 83% of total revenue for the first nine months of FY 2015, pushing Tata Motors to double-digit growth and making up for declines and losses from the India business.

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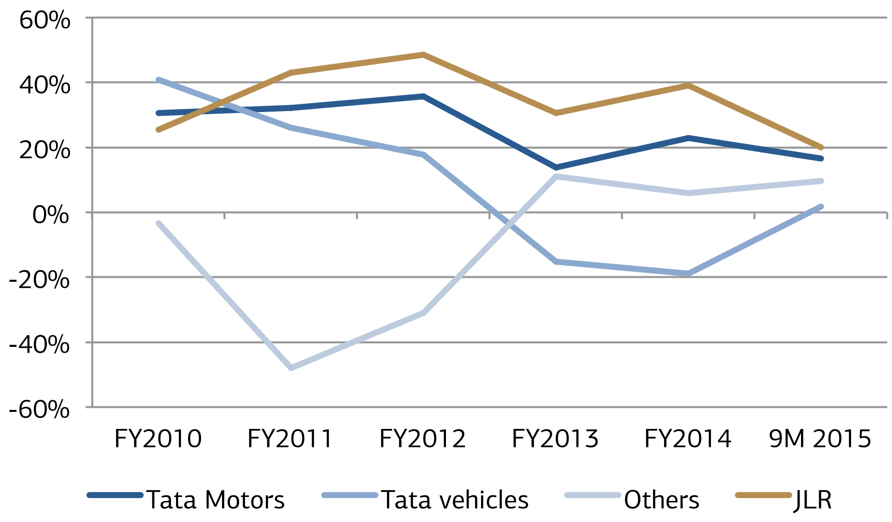
Chart 1. Tata YoY revenue growth: Reliant on JLR



Source: Company data, J Capital Research

JLR was late to China

JLR established a sales office in China in 2010 and signed distribution agreements with 248 dealers. Some 175 dealers were in operation as of February 2015.

The JLR brands were still, however, far behind market leaders BMW, Audi, and Mercedes. In order to catch up with German rivals, JLR committed to a RMB 10.9 bln investment plan and established a joint venture company with local automaker Chery to launch the Land Rover Evoque in Changshu, Jiangsu Province.

Tata Motors is listed on the Bombay Stock Exchange, and the company listed on the New York Stock Exchange in 2004.

But has done well

Riding Chinese growth

The JLR business contributes all of Tata's operating income, and China turns out to be the most profitable region. China revenue jumped to INR 659 bln (USD 10.5 bln) in FY 2014 from INR 116 bln (USD 1.9 bln) in FY 2011, representing a CAGR of 78.3%.

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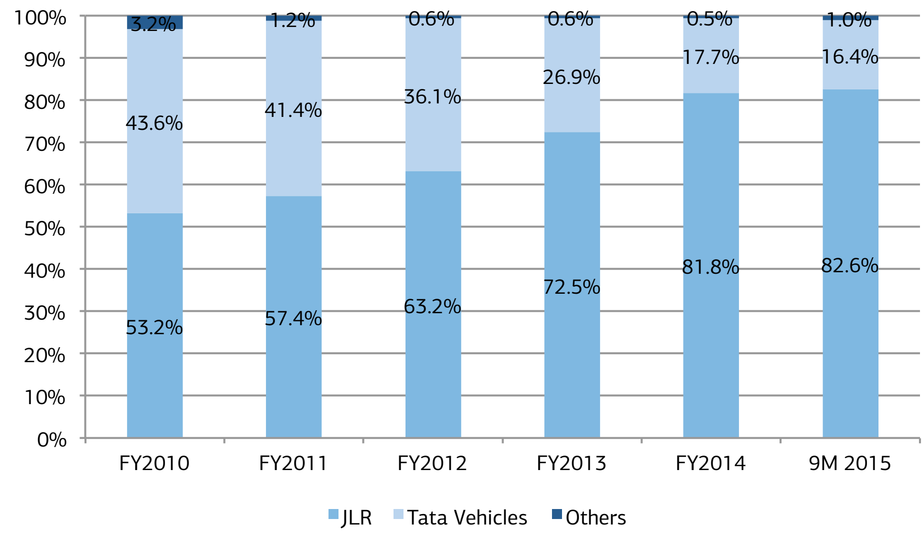
Chart 2. JLR contributes 83% of Tata's revenue



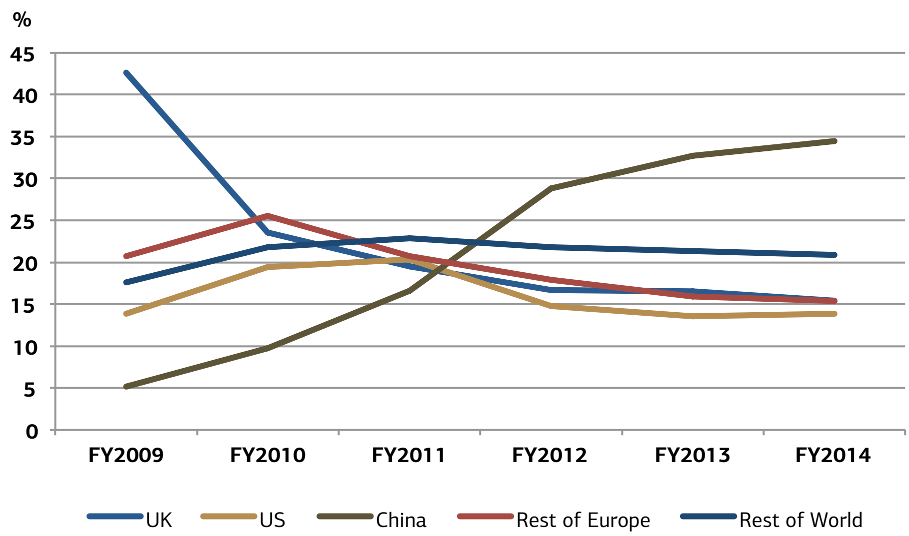
Source: Company data, J Capital Research

China has grown from 5% of JLR's revenue in FY2009 to 34% in FY2014. The next largest single country market is the UK at 15%, while the "Rest of the World" accounts for 21% of revenue.

Phenomenal China growth

JLR's FY2014 China revenues grew to GBP 6.7 bln (USD 9.96 bln), from below GBP 1 bln in FY2010. Revenue growth has started to taper over the last two years, but it was still 30% YoY in FY2014.

Chart 3. Revenue split: China has been JLR's key revenue driver



Source: Company data, J Capital Research

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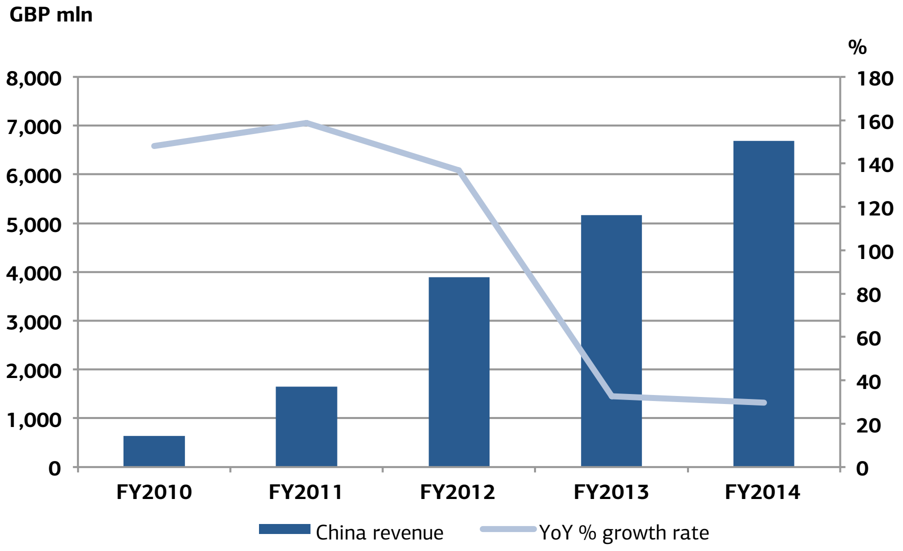
Chart 4. JLR China: superfast revenue growth



Source: Company data, J Capital Research

But China fell off a cliff in 4Q2015

In FY2015 JLR sold 115,969 retail vehicles in China, up 13% YoY. This was a slowdown from 34% growth in FY2014, 51% in FY2013 and 76% in FY2012.

Getting bumpier with 4Q2015 sales falling off a cliff

4Q2015 (Jan-Mar 2015) sales fell off a cliff. JLR's published retail unit sales revealed a 20% YoY volume decline in Q4 2015 and a **34% YoY decline for March alone**. JLR sold 23.5k units in Q4 2015, vs 29.6k units in Q4 2014.

This was also reflected in our dealer checks, which saw YoY sales declines in Q4 2015 of 20-60% YoY.

JLR have publicly stated that FY2016 China sales growth could halve, which would still be sales growth of around 9-15%. Based on our checks and Q4 2015 sales, we think this is overly optimistic.

Why China is so lucrative – super fat margins

JLR has been milking the Chinese consumer

China has been a gold mine for JLR. Prior to 2015, all JLR cars sold in China were imported from the UK. ie. JLR cars sold in China have the same cost base as those sold in the UK.

JLR cars sold in China had an average selling price ("ASP)" of GBP 64.9k in 2014, vs GBP 39.0k in the UK, a large 67% premium. **In 2012, China's ASP of GBP 76.3k was double the UK's ASP of GBP 34.4k!**

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China's ASP is also a substantial premium to JLR's average ASP (GBP 64.9k vs GBP 44.6k).

The ASPs also show that any large sales increase in the UK and / or US may not necessarily buffer JLR from a China sales slowdown, given their much lower margins.

The "Rest of World", which includes "Asia-Pacific" and "Overseas" has high margins, but sales have been volatile. JLR announced that "Asia-Pacific" had 14% YoY growth in Q4 2015, while "Overseas", which is 3x the size of Asia-Pacific sales, fell 22%. Therefore it's unlikely that "Rest of World" will prove to be JLR's savior.

Table 1. China ASP is substantially higher

ASP (GBP)	2010	2011	2012	2013	2014
UK	26,933	33,093	37,638	36,054	38,959
US	30,362	39,883	34,410	33,940	35,456
China	**37,356**	**56,855**	**76,270**	**66,957**	**64,874**
Rest of Europe	28,040	31,235	35,362	31,039	35,943
Rest of World	43,110	59,063	53,169	53,027	55,319
Average	**31,352**	**40,973**	**44,176**	**42,131**	**44,636**
China premium to average	19%	39%	73%	59%	45%
China premium to UK	39%	72%	103%	86%	67%

Source: Company data, J Capital Research

What's in the China retail price?

Taxes levied on imported cars are very high.

Fat, fat margins

All JLR cars are hit with a 25% import tariff, a consumption tax based on engine size (6.6% to 42%) and a VAT, which ranges from 22.4% to 28.3%. In total, these taxes can add anywhere from 50-95% extra to the purchase cost.

But JLR doesn't make any money from these taxes, so takes the liberty of adding a massive premium to milk the Chinese consumer.

The imported Evoque is JLR's most popular car in China. In the UK, the list price (pre-UK VAT) is GBP 25.1k. The landed China price is GBP 38.7k once Chinese import taxes are applied.

JLR then adds an additional GBP 25k to the purchase price (equivalent to the UK list price!), which results in a China retail price of GBP 63.8k. Therefore, when selling an Evoque in China,

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JLR makes around the UK margin + the manufacturing cost of another UK-produced car.

JLR is currently being investigated by Chinese regulators over anti-competitive behavior, largely due to its high selling prices. It would not be surprising if JLR has to cut prices in the future to comply with a punitive regulator.

The table below shows the large premiums JLR makes in China:

- **Discovery Sport**: 69% premium over GBP 26.8k list price.
- **Range Rover:** 71% premium over GBP 62.1k list price.

Table 2. JLR makes substantial profits from China

Model	UK price (GBP)	Imported price (including Chinese tax)	China retail price (GBP)	Margin over UK (GBP)	Premium over UK price
Imported Evoque	25,120	38,672	63,791	25,119	100%
Discovery Sport	26,800	43,071	61,583	18,512	69%
Range Rover	62,120	121,134	165,326	44,192	71%
JV Evoque*		38,672	49,443	10,772	43%

Source: Company data, J Capital Research

Nice margins

*** JV Evoque**

JLR began producing a locally-made Evoque in its new JV-China plant in 2015. The JV is with Chery.

- The price at RMB 448k (GBP 49.4k) is not much cheaper than the imported Evoque at RMB 578k (GBP 63.8k).
- The margin over the imported Evoque landed price is GBP 10.8k. Given it is manufactured in China, the margin could be even higher because of lower Chinese manufacturing costs, though this could be offset by the stronger RMB vs GBP. However the impact of currency is likely not large as JLR hedges its currency exposure.

While it's still early days we are skeptical that the JV Evoque will see very strong sales:

- **Pricing:** the price is not substantially cheaper than the imported model. Dealers we spoke to also echoed these sentiments and noted that inventory is higher for the JV

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We don't think the JV Evoque will be a great success

Evoque. Dealers would also prefer a lower price.

- **Perceived lower brand quality:** Given it's a JV produced vehicle with Chery, the luxury positioning of JLR is negatively impacted. Our dealer checks also reflected this sentiment.

- **Product recall**: In March 2015 JLR recalled 36,451 Range Rover Evoque vehicles after CCTV claimed JLR used faulty gearboxes. These are not locally-made Evoques but imported models. Such a product recall will negatively impact the JLR brand, and both the imported and locally-made Evoques.

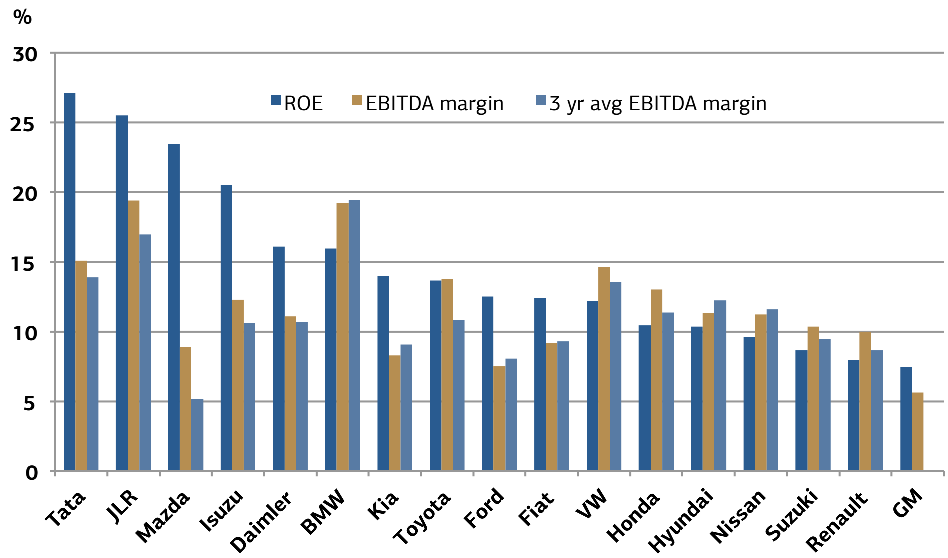
Industry-leading margins

Tata, via JLR's China sales has industry-leading EBITDA margins. JLR's EBITDA margin is around 19%, while Tata's EBITDA margin is 15.1%. TATA's EBITDA margin is only exceeded by BMW's 19.2% and is higher than Volkswagen's 14.6%. Tata has also had a high 3-year average EBITDA margin of 13.9%.

Highest ROE and margins amongst peers

In addition, Tata's high margins drive its industry-leading Return on Equity of 27%, the highest amongst its peers. We believe that Tata's ROE has likely peaked and will fall as JLR's China sales disappoint and price cuts erode margins.

Chart 5. Tata and JLR's returns are market-leading...but for how long?



Source: Bloomberg, J Capital Research

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Checks with dealers showed China sales cratering

We have recently done 20 interviews with JLR dealers across China. JLR has around 175 dealers in China, so these interviews are around 11% of all dealers.

Negative dealers

- **Sales crater: 1Q sales fell 20-60%.** The worst was a 60-70% decline. A couple of dealers had positive Jaguar sales (up 5-7%), but they are less than 10% of overall sales.

- **Inventory increasing; Evoque growing:** Inventory pressure is growing, with 9 respondents stating inventory was higher than last year. 5 respondents said inventory was normal, while 2 said inventory was lower. 3 dealers noted that the JV Evoque had very large inventory.

- **JV Evoque brand erosion:** Evoque accounted for 30% of most sales. However a few dealers noted the JV Evoque has negatively impacted JLR's luxury brand. **The gearbox problems have also hit sales.**

- **Inventory pressure – JLR to sell cars on Alibaba:** An MOU was announced on 22 April 2015. A couple of dealers had heard of this plan and said it was still experimental. We interpret this move as an indication of inventory pressure.

- **Initial price cuts:** Price cuts are occurring, but are not massive. Dealers who reported industry inventory pressure have cut prices more. A Beijing dealer said prices were down 10-15% vs 2014.

- **Interest-free financing:** JLR offers interest-free instalment financing for 1-3 years. Buyers repay the full purchase price over the loan term. This is common practice in the luxury autos industry. Around 40% of buyers use this financing. Dealers said Minsheng and CITIC Bank provide the financing.

- **Low dealer margins:** A few dealers said their gross margins had fallen and some rely on after-sales service to make money.

- **Downstream dealer sales:** JLR has a requirement that downstream dealers cannot exceed 20% of all sales. A few dealers have made 30-40% of sales to downstream dealers. Therefore, there is a risk of channel stuffing and

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overstatement of sales.

- **Bonded zones:** We don't know how many vehicles are sold in bonded zones. They are likely to be 10% or less. These vehicles put pressure on cars sold by regular dealers as the prices can be as much as 70% lower. Technically, vehicles sold in bonded zones are supposed to be used within the zone or taxed, but buyers find ways to get them out.

See Appendix A for complete dealer check findings.

Not factoring in a China slowdown

The Street remains bullish on Tata Motors and we think these positive estimates have to come down.

- **86% say BUY:** The Street has 43 Buy ratings, 6 Holds and 1 Sell (Bloomberg consensus).

- **24% price upside**: As per Bloomberg, the 12-month target price is INR 649.35, or 24% upside from Tata's price of INR 520 (as at April 22, 2015).

- **18% EPS growth:** EPS estimates for FY2016 (March 31, 2015) are INR 66.18 up 18% from INR 56.136.

- **15% revenue growth – assuming straight-line growth**: The Street is forecasting FY2016 revenue of INR 3.02 tln, up 15% from forecast FY2015 revenue of INR 2.63 tln. This is essentially a **blind assumption of constant growth**, given Street estimates for FY2015 are 14% revenue growth. ie. Analysts appear to have just extended their Excel model an additional year without giving much thought to the potential downside. Moreover, given the ultra-high margins in China, a China slowdown will have **significant negative operating leverage.**

The Street is still straight-lining Tata and JLR's sales growth

Figuring on a China slowdown

In arriving at our estimate for FY2016e, we make the following assumptions:

- We assume Street estimates for FY2015e NPAT of INR 179 bln.

- **We don't have any visibility on JLR sales outside of China.** Therefore, we assume FY2016e revenue for each

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individual country grows at the same pace as FY2015e, except for the US and India. In the US we conservatively assume 17% growth given the 17% growth in 4Q2015 sales, while we assume 10% growth for India given a stronger Indian economy. We also assume 25% growth for Rest of World to be conservative, even though 4Q2015 sales fell 22%, as Rest of World has higher margins vs the US and UK.

- **Assume -15% growth for China.** Based on our 4Q2015 checks showing sales falling 20-50% at various dealers and JLR's unit numbers (down 20% for 4Q2015; down 35% for March), we think a -15% growth assumption is conservative.

- **Assume high NPAT margin of 6.50%.** If China continues to be bad, margins will crater as price cuts deepen, so this is conservative. Moreover, JLR has already guided that costs linked to the new China JV will result in reduced profitability.

- **The key question is whether you think China will continue to be bad:** We think it's unlikely that China will have positive revenue growth this year. There would need to be a game-changer such as stimulus for luxury cars (could happen if the Chinese economy continues to splutter), or a large-scale marketing push by JLR to rescue sales (though something like this would hit margins).

China – how bad? And how large will Street downgrades be?

The table below shows our FY2016e EPS forecasts for different China sales decline scenarios. We assume a 15% sales decline, which yields FY2016e EPS of INR 55.72. This is 16% below consensus Street estimates of INR 66.27.

China sales falling 30%, would see EPS of 53.45, 19% below Street estimates.

Table 3. Street downgrades are coming

China sensitivity (INR)	FY2016e EPS	Vs Street
Street estimate (Bloomberg consensus)	66.27	
China 0% growth	57.99	-12%
China -10% growth	56.47	-15%
China -15% growth	55.72	-16%
China -20% growth	54.96	-17%
China -30% growth	53.45	-19%

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Source: Bloomberg, J Capital Research

Our FY2016e EPS estimate of INR 55.72 would see 6% YoY EPS growth vs consensus of 18% YoY EPS growth.

The Street will be revising down its estimates

Table 4. FY2016e EPS estimate assuming -15% China growth in FY2016e

Revenue	FY2014	FY2015e	FY2016e	FY2015e growth	FY2016e growth
China	659	758	644	15%	0%
Rest of World	471	589	737	25%	25%
India	344	344	379	0%	10%
UK	293	331	374	13%	13%
Rest of Europe	293	310	329	6%	6%
US	268	278	326	4%	17%
Reconciliation	-22	0	0		
Total revenue	**2,307**	**2,611**	**2,902**	**13%**	**11%**
NPAT margin	6.07%	6.84%	6.50%		
NPAT (INR bln)	140	179	181	28%	6%
EPS (INR)	**43.01**	**54.91**	**55.72**	**28%**	**6%**

Source: Company financials, J Capital Research

SELL: Target price of INR 390

Our price target is INR 390, which is 7x our forecast FY2016e EPS and 26% downside from Tata's price as at 22 April 2015. We think this is conservative given we assume:

- -15% China growth, while JLR's published numbers have shown a 20% decline and our checks show 20-60% sales declines.
- Higher US, Indian and Rest of World growth.
- High NPAT margin of 6.50%: JLR's margins will likely fall if China slows, because of China's ultra high margins and operating leverage.

Risks

- JLR China sales are resilient.
- The fall in sales in 4Q2015 is actually related to the Evoque recall and once the air clears, sales will rebound.
- **Markets outside of China outperform**. We caution that we have little visibility on these markets, but have compensated for this by assuming higher growth rates in our estimates. In

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addition, margins in markets like the US and UK are much lower than China, so any significant increase in US or UK sales may not buffer a China slowdown.

- **Macro-stimulus targeted at luxury cars:** Unlikely given the anti-corruption crackdown. However if the Chinese economy continues to crash, all types of stimulus cannot be ruled out.
- **RMB appreciation vs GBP:** This would be a tailwind for JLR's business, however we don't think the impact would be that large given JLR hedges it currency exposure.

Appendix A. JLR dealer checks

City, Region	Sales	Inventory	Pricing	Financing
Changzhou, East	This year not good. **Down 15%.** 2014 saw a 10% YoY increase. JV Evoque is about the same quality. Thinks will sell more. Around RMB 400k. **Downstream dealers are 35% of buyers.**	Inventory down 20% YoY. 20 units.	2H2014 larger models cut by 100-200k, but large models have less volume.	30% use loans. 10% use 1-2yr interest-free financing.
Hangzhou, East	**1Q down 50%** due to Hangzhou plate restrictions.	Inventory very large, especially **locally made Evoque.**	Prices fell due to competition. In 2011 there were 100 dealers, now almost double.	30% instalments. 2-3 years
Nantong, East	**1Q down 20%.** Gross margins fall 30% every year. T Mall still early stages. Not sure if it'll have a positive impact.	1.5 mths inventory, ok.		70% pay upfront.
Ningbo, East	**Jaguar sales up 5-7%.** Overall sales pressure is large because the economy is not good.		Small price decrease.	
Shanghai, East	1Q not good, especially due to **Evoque gearbox** incident.			50% use instalments, 1-2-3 years
Wuxi, East	**1Q down 20%**. New Land Rover models not popular. **Not because of gearbox problem. After JV Evoque, customers see it as less high-end. Pessimistic on 2015.**	Inventory higher.		20% use instalments. We have downstream dealer customers. They pay cash up-front.
Yantai, East	**1Q up 40%** as we are a new store and have a low comparison base.			We use cash to pay the manufacturer or bank acceptance notes (but less).

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Yuzhou, East	Monthly sales **fell by 60-70% YoY**, from 100 units to 30-40/mth. Individual buyers are 60%; rest are lower-level dealers, despite manufacturer wanting to cap at 20%. We have many ways to hide such transactions	30 cars. Down 50% YoY.		10% lease; 50% loan. A lot of customers also pay upfront and then use the car as collateral for a bank loan.
Beijing, North	**1Q down 20%**. Sold 100 units	Sold 100 cars in 1Q. Now have 1-200 inventory, so **3-6 months** of inventory	No real change.	30-40% use loans. 1 year term
Beijing, North	**1Q down 50%. Evoque problems** and bad macro. 2015's goal is to push JV Evoque, but hard due to gearbox problems. We don't sell to dowstream dealers. Beijing has 8 dealers. 2-3 do sell downstream because of volume. **Jaguar sales better than 2014, but only small increase. Only 10% of our total sales.**	A lot of JV Evoque (2-3mths worth). Haven't sold one.	Price down 10-15% vs 2014.	25% use instalment financing with a 2.99% interest rate. Some dealers can offer lower interest rates, but Beijing manufacturers don't allow.
Beijing, North	**1Q not as good**. **Land Rover sales very large, mainly due to JV Evoque**. JV Evoque pricing not appropriate, marketing not good, advertising too late. Think it'll take 1-2 months for the negative impact of the gearbox issue to fade. Imported Evoques have stopped coming. **More competition and more dealers lose money. Rely on after-sales service to make money.**	Evoque inventory large, but last year we didn't have enough stock.	Gross Margins - already lost money in 2014, because too many discounts. **Have heard about online purchases, still experimental at the moment.**	
Qinhuangdao, North	2014 sales fell from competition. 2013 sold 432 units, sold 411 in 2014. 2014 gross margin was 4%. 1.5% manufacturer rebate.	Normal inventory is 1-1.5 months. Currently 1.5 months inventory. 2013 was 1-1.2 mths	JV Evoque is around 450-500k, vs Imported Evoque at 500-600k. But after discounts to the import, the price is almost the same. If JV was sold for 300k, we'd have interest.	30% instalments. Use JLR recommended banks like Minsheng and CITIC.
Wuhai, North	**1Q down 50%**. Sold 40 cars. Bad economy.	Have 26 car inventory, vs 40 sold in 1Q. Higher vs last year.	No change.	60% use loans
Heilongjiang, North-East	Heilongjiang not good. **Our sales were good** (sold 160-170 units) due to **price cuts**, but margins are thin. Volumes same as last year. Last year's price was higher.	Heilongjiang inventory pressure is large. Ours is ok because of low price.	Prices fell for dealers. 1Q price down by 100k	
Liaoning, North-East	**1Q down 20%**. Sold 100 units.	Normal	Not less than a 5% change	35% use loans, 2-3 year terms mostly

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Shanxi, North-West	1Q not good.	Normal		60% use loans
Fujian, South	1Q not good market, whole industry bad.	Not that high, 1.5-2mths vs 1mth last year.	Prices fell. New car prices still high, but old lower.	60% use instalments
Guangdong, South	**1Q down 20%.**	Normal	Every model has had a 10-20k price cut, with some 40k. Market demand less.	30% use loans
Shenzhen, South	**1Q down 40%.**	**2-3 months**, much higher vs last year.	Best-selling car prices are rising.	
Chongqing, South-West	**1Q down 50%.**	**3 months inventory**, much higher than last year - last year no inventory		40-50% use instalments. Also have interest-free periods.

Source: J Capital Research

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