

ASHOK LEYLAND LTD

BUY

Target Price : Rs.110

27-Jun-17

INDUSTRY -

AUTOMOBILE

BSE Code -

500477

NSE Code -

ASHOKLEY

Ashok Leyland: strong operational performance marred by inappropriate allocation of fund

Ashok Leyland has done many investments in foreign companies. Most of the investments didn't bode well for the company. These subsidiaries and associates have incurred huge losses and have eaten out big chunk of standalone profits. This shows that the capital allocation strategy of the management was not appropriate at all. Ashok Leyland has impaired around Rs.1400 crores in 10 JVs and subsidiaries in FY15, FY16 & FY17. Recent acquisition of Hinduja Foundries Limited has raised many questions in the mind of analysts regarding the allocation of fund. Though going by business operations Ashok Leyland has gained 33% market share and standalone business performance depicts currently good future cash flow in the hands of the company. **Will Ashok Leyland be able to pass on the profits to the share holders as dividends or will again inappropriately fund other investments is our utmost concern?**

(Amount in Rs. Crore)

Joint Venture	Investments as in FY16	Diminution (FY16)	Total Losses in 3 years
Ashok Nissan Vehicles Pvt Ltd	410	410	1028
Nissan Ashok Powertrain Pvt Ltd	74	74	2
Nissan Ashok Technologies Pvt Ltd	26	26	5
Albonair GmbH, Germany	427	107	48
Optare PLC, UK	150	150	124
Hinduja Foundries Limited	346		
Total Investments	1433	767	1207

Detailed Analysis of Investments

Joint Venture with Nissan Motor Co. Ltd., Japan

Ashok Leyland signed joint venture agreement with Nissan Motor Co. Ltd. leading to formation of 3 joint ventures companies for the Light Commercial Vehicles business in India for technology development, vehicle manufacturing and powertrain manufacturing. The JV manufactured various products named Dost, Mitr, Partner, Evalia and Stile.

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ASHOK-NISSAN issue

Ashok Leyland had total investment of over Rs.500 crore in this arrangement. Due to certain disputes over the jointly developed product Evalia and Stile, which were the biggest failure in LCV market. Ashok Leyland was forced to make an impairment of Rs.214 crore, Ashok Leyland's share in these products in FY15. The relationship between Nissan and Ashok Leyland got worse and Ashok Leyland impaired all its stake in these three JVs in FY16.

On 25th November 2016 Ashok Leyland acquired 100% ownership in the 3 JVs for a consolidated consideration of Rs.3 and the company will be associated with Nissan for the technology of the existing Dost, Mitr and Partner LCVs.

Albonair GmbH

Albonair does exhaust emission systems, selective catalytic reduction emission systems which are necessary for being Euro-VI compliant. The company had decided to sale this firm in 2014 but considering the potential lies in the subsidiary the company changed its decision and only diminished the value of investment by 25% in FY16.

(Amount in Rs. Crore)

Subsidiary	Investments as in FY16	Diminution (FY16)	Total Losses in 3 years
Albonair GmbH, Germany	427	107	48

Optare PLC, UK

Ashok Leyland acquired 26% stake in the Optare PLC, a leading bus manufacturer in UK with an investment of Rs.50 crore in FY11. The company further raised its stake to 75% looking at the growth potential in the bus division. Ashok Leyland impaired 100% equity investment in this subsidiary as situation became worse considering the losses.

(Amount in Rs. Crore)

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Acquisition of Hinduja Foundries Limited

Ashok Leyland sources all the casting requirements from Hinduja Foundries Ltd (HFL) and around 35% revenue of HFL comes from Ashok Leyland. Ashok Leyland has about 2.6% stake in HFL and preference share capital of Rs.322 crore. HFL has accumulated losses of over Rs.1000 crore and debt of Rs.512 crore in its books. The merger diluted the equity of Ashok Leyland by about 3%.

Is focus shifting again towards non-core business

Company's growth plans are centred around the core business of commercial vehicles and portfolio rationalisation for progressive exit from non-core businesses since last 2 years. But the acquisition of Hinduja Foundries Limited raises questions on the growth prospects of the company. We expect that this acquisition works as bail out for HFL and Ashok Leyland in turn will get tax benefit. The management of Ashok Leyland completely believes that it can be turned around case by making some structural changes and that's why they have shown interest in this loss making business.

Good fund allocation to give better rewards to shareholders

Ashok Leyland has been performing very well on the operational front but it's capital allocation strategy had some flaws and it went wrong for the company. The company had impaired overall Rs. 1400 crores in last 3 years in 10 JVs and subsidiaries due to huge losses. These subsidiaries/JVs has incurred around Rs. 1200 crore of loss in last 3 years which forced Ashok Leyland to take a call on these investments. Strong operating performance depicts good future cash flows and we expect Ashok Leyland to allocate its funds wisely from the future profits to give better rewards to its shareholders in the form of dividend.

View and valuation

We expect Ashok Leyland to generate healthy cash flow going forward keeping in mind strong traction in operating performance. The management has guided for double digit volume growth for full year FY18 considering the strong double digit growth in second half. The volume growth and product mix will be major trackable for the company. Ashok Leyland is also working towards a renewed thrust in the international markets, with network expansion and dedicated products. The company has also reduced its net debt to zero level on standalone basis and generating more cash to fulfill its future expansion requirements. We expect that the company will maintain a healthy RoE of over 20% going ahead. Currently, the stock is trading at 3.3x FY19E P/B. We maintain 'BUY' on Ashok Leyland considering the huge growth potential going ahead, with a target price of Rs.110.