

Rajeev Thakkar of PPFAS Mutual Fund presented his in-depth investment thesis on Suzuki Motor (Tokyo: 7269; OTC: SZKMY) at Asian Investing Summit 2018.

*Thesis summary:*

Suzuki Motor Corp. is a play on the underpenetrated Indian auto market. India accounts for ~ 2/3 of the profits of Suzuki Motor. Penetration in India is 22 cars per 1,000 persons, as compared to 102 in China, 569 in Western Europe, and 808 in the U.S., based on OICA data for 2016. Maruti Suzuki (56.2%-owned by Suzuki Motor Corporation) sells almost one of every two cars in India. It participates in the high-growth Indian market and benefits from the gradual shift towards higher-value premium cars.

India has been a tough market for other players to profit from, as seen by the difficulties faced by General Motors, Volkswagen, Toyota, and Ford. Maruti Suzuki benefits from scale efficiencies and a wider network; it is the incumbent and has been in the market since 1981, as compared to the relatively recent entry of other players. Suzuki Motor benefits not only from the 56.2% stake in Maruti but also gets significant royalty income from Maruti. Apart from participation in the Indian auto space, Suzuki Motor has optionality in the Japanese, ASEAN, and European markets in which Suzuki operates.

The shares trade at a P/E of ~13.5.

*The following transcript has been edited for space and clarity.*

Let me start by taking you through the auto sector in India before we look at Suzuki Motor Corporation. I should note that the overview reflects how we look at the sector and what we see in this company. I would urge participants to do their own research and not accept blindly the points discussed here. This is a general presentation dealing with ballpark values rather than precise point estimates.

Mary Barra, the CEO of General Motors, has said the auto industry will see more change in the next 5 years than in all of the previous 50 years. The reason is that numerous changes are happening in the auto space, creating quite a turmoil. For one thing, automobiles have long run on internal combustion engines, but today we see a big move towards electrification due to various reasons, one of them being the environmental factor. Down the road, it could be cost-efficiencies or moving away from oil dependence and its associated geo-politics.

We have also seen a big shift towards autonomous vehicles. There was an unfortunate incident that resulted in the first fatality in autonomous testing, but various companies are still doing research and field testing in this area. These include Waymo, which is part of Alphabet/Google, Uber, and Tesla, which has its own limited version of autonomy.

The other prevalent trend is the rise of app-based service providers like Uber and Lyft, Ola in India, and various companies in China and other parts of the world. This is a relatively recent phenomenon.

These three things — electrification, autonomy, and ride hailing/ride sharing — are setting the stage for a lot of business model innovation. There is talk that automobiles in the future will be provided as a service rather than as an asset purchase. People will maybe subscribe to a certain number of miles on a monthly basis. They would not own the asset but would have access to vehicles and mobility, usually on demand.

There's an interesting review on YouTube by Tony Seba, who has also written a couple of books. You can check out his YouTube video on what is happening in the renewable and auto spaces.

Let's look at where the various auto companies stand today. The situation in this sector today is one where value is in the eye of the beholder. At one end, you have General Motors, whose current market cap is about \$53 billion. Then you have Tesla, which sometimes overtakes General Motors in terms of market cap and sometimes trades below it. According to recent numbers, Tesla has a market cap of about \$58 billion.

General Motors, which has been around for many years, sells more than 10 million cars a year on a group basis and is a profitable enterprise. On the other hand, there is Tesla, which is essentially promising the new age. Its leader, Elon Musk, has a vision of electric cars taking over the world. One can bet on either camp — traditional auto or the new age.

In the Indian market, you have a company many people abroad may not have heard of. It's called Maruti Suzuki and has a market capitalization of close to \$41 billion, which is surprising when you compare it to, let's say, General Motors. The number of cars Maruti sells is only about 15% or thereabouts of what General Motors sells in a year. Cars in India command a lower price; they are smaller and have fewer features, so revenue would be even lower compared to that of General Motors - Maruti's turnover would be about 8%-10% of what General Motors has in a year. Why should this company be valued so much?

Suzuki Motor Corporation is the parent company of Maruti in India, with a market cap of about \$26 billion. The investment hypothesis for Suzuki rests on four pillars.

First, more cars will be bought and sold in India in the years to come, and we will see significant volume growth in the country's car market. The second pillar of the hypothesis is Maruti Suzuki will play a significant part in the future and is a company to reckon with. Thirdly, even if somewhere down the road we move from internal combustion engines to a world dominated by electric cars, we could have a situation where certain companies focus on car manufacture and outsource battery cells. If that is not the case and it becomes a prerequisite to manufacture battery cells, then maybe the incumbents would lose out. Finally, there are a number of factors which make a strong case for buying parent company Suzuki rather than subsidiary Maruti.

Let's explore these pillars in depth, starting with volume growth. Why do we see volume growth in the Indian auto market? People argue the global auto market is at a saturation point and with ride sharing/ride hailing services offered by companies like Uber, we could probably see a decline in the number of cars manufactured and sold. However, these arguments are made primarily with the developed world in mind.

I have some data from 2016 and while it's slightly dated, not much would have changed significantly since then. According to these statistics, the United States has 808 vehicles per 1,000 people, or 0.8 vehicles for every man, woman, and child. For India, the number is just about 22. It is lower even than numbers for other emerging economies or countries which are not that rich. China, of course, is richer than India, but it has 102 vehicles for every 1,000 inhabitants. There has been a lot of volume growth in China.

Given that India is on a path to GDP growth and becoming more affluent, there is a strong possibility of major volume growth and we see signs of it in terms of the numbers coming in. The number 22 relates to cars, not all personal vehicles. Some may know that many people in India ride motorcycles and if we take this into account, the number would be closer to 130. However, as India grows affluent and more people can afford four-wheelers, we see more cars being bought and sold in the country.

The rise of companies like Uber, Lyft, and Ola is a factor discouraging car ownership in the developed countries. However, the impact in a country like India is somewhat different. It is increasing accessibility, and people who cannot afford to buy their own car are able to use these services as and when required. In fact, it is helping the number of cars in the country increase. These services are challenging the traditional auto rickshaws or 'tuk-tuks' in the cities in India, and a more formal, air-conditioned car is gaining market share.

As India is urbanizing, public transport is failing to meet the needs of the population, and this is where personal transportation (personally owned cars or ride hailing services) comes into picture. In 2017, the market growth exceeded 9% and is expected to sustain this momentum for quite a few years down the line.

Next comes the question of why look at Maruti seriously and not any other company operating in India. Let's start with market share: in India, Maruti accounts for every one in two cars sold. In other words, it has held a market share of around 50% over the years, and the rest is split between everyone else. At one point, Maruti's dropped to as low as 43%, but the company has rebounded from that.

As for that dip, it was the result of two things happening. One, diesel was gaining market share in India, and Maruti did not have diesel engines for some time. However, it now has diesel vehicles plus the market has shifted back to petrol. Two, foreign auto makers were getting aggressive in India around 2010-2012. However, they have been unable to run adequately profitable operations and have been losing market share, with some even exiting from the Indian market, for example, General Motors.

Auto biggies like General Motors, Ford, Toyota, Volvo, and Volkswagen have all tried to enter India, but they have been unable to gain traction and grow volume. While some have withdrawn from the Indian market, others have scaled quite significantly down their ambitions and operations.

The question is why Maruti dominates the market, operating in a Coca-Cola/Pepsi duopoly situation but without the Pepsi. Why does Maruti control 50% of the Indian market and everyone else is left with the other 50%?

One thing investors need to realize is the Indian car market is different from the car markets in other countries. There is a great emphasis on value for money and the capital cost of the car. Besides, one cannot just recreate the models working well elsewhere and sell them in India - they have to be relevant for the Indian conditions. It could be something as simple as a high ground clearance given that the roads are not that great in India, with problems including potholes and waterlogging.

The other thing is India's quite steep import tariffs. Whichever manufacturer builds cars in India has a big advantage over those that import cars or a significant amount of components. In other words, operators that have already achieved scale reap the benefit. A new entrant has to take a gamble and set up manufacturing capabilities without assurances it will be able to sell what it manufactures. Foreign auto makers which have tried to set up base in India and have been importing components have been at a big disadvantage in the Indian marketplace.

Maruti had a head start of more than a decade. Players like General Motors and Ford started in early 1980s, whereas the other foreign players came in the mid-1990s or even later. Maruti had a head start in terms of setting up manufacturing facilities, dealership networks, service networks, etc.

India is among the few countries where we drive on the left-hand side of the road. The steering wheel is on the right side, which requires certain adjustments to the car model.

Manufacturers trying to replicate foreign models in India are at a cost disadvantage. Around the world, airbags are a significant component of the safety aspect, and people usually prefer having those in the vehicles. India is a strange country where people do not even wear seatbelts in some of the seats. In many cases, they even have the pre-installed seatbelts removed. There's no way an Indian buyer will pay for airbags, and people will always prefer a cheaper car model. Again, value for money is a big factor in India. In addition, driving speeds in India are typically slower than in other countries because you have narrower roads which are not in that great a shape for speeding.

A factor which people consider when buying a car is the service network and reliability. Allow me to share one of my own experiences to make my point. I was driving a Honda and something went wrong in a remote location. I couldn't locate a service center to fix the car. In a similar situation, a Maruti dealer or service center would be there to get me up and running. Finally, I had to go to a Maruti center for help to get my car back on the road. Given its head start of more than a decade, Maruti scores high on this count, and others have not been able to match it. In fact, Maruti used cars get a better price compared to other brands for the same mileage and age. This is another factor working in favor of Maruti.

The company also has a trade-in program where existing customers can drop off their old cars and buy a new one. Maruti sells the refurbished vehicles with a service guarantee.

Gradually, some more affluent people are moving to costlier and bigger cars. Maruti has been leveraging its advantage in the entry-level cars segment to gain market share in

premium cars. Maruti recently created a separate brand for the premium cars called Nexa. It has separate showrooms for the brand, which has been gaining good amount of volume. In fact, if this separate premium brand were a separate company, it would be the #3 auto maker in India. Despite its recent start, it has gained good traction.

Finally, Maruti is locking in major dealerships in prime locations across various cities, and competitors are finding it difficult to get good locations for setting up their dealerships. This is almost like McDonald's occupying prime real estate in most locations.

This company recognizes the fact that somewhere down the road you could see electric vehicles taking off in India, so it has started doing some work. It is working on fully plug-in electric vehicles as well as hybrids, which run part of the journey on batteries and if the charge runs out, they have a combustion engine as backup. Maruti is working on keeping the overall car cost low and making appropriate models for India.

The important thing to note about the Indian market is that even if one were to see electrification take off in a big way, our market is more akin to, say, the Chinese market - a company like BYD would be more relevant for the Indian market than something like Tesla. We will not have the super-premium cars or cars with a lot of features and huge range. We would have a car market where the cost of the vehicle would matter significantly and even a lesser range would be an acceptable compromise for local buyers.

The parent company of Maruti, Suzuki Motor Corporation, has set up a joint venture in India to manufacture batteries for use in electric vehicles. The battery cells will have to be imported; they won't be made in India. It is quite likely most EV manufacturers in India will outsource battery cell manufacture and import these components.

Just like in cell phone manufacturing, you can design and brand a phone and then outsource the production of chips, processors, batteries, and screens. Traditional auto companies in India will focus on vehicle design, safety, servicing, and things like that, while battery cells will be imported for the time being. Only when some scale is achieved will companies start setting up battery cell plants in India. We may not have giga-factories coming up in India soon; this will happen somewhere down the road.

We will not see traditional car manufacturers wither away and hand over the entire market to the new manufacturers like Tesla. We have seen the difficulties Tesla has had in terms of scaling up manufacture, and the likes of Nissan and General Motors have introduced electric vehicles of their own. Somewhere down the road, 5 or 10 years from now, it is quite likely Maruti will also make its transition into a player in the electric car market.

We are now left with the question of how one goes about investing in the Indian auto space if one is positive on the growth prospects.

Maruti Suzuki has done quite well in terms of profitability - its earnings have gone up 3x in the last 4 years. Margins have expanded and volumes have grown. There has also been a shift towards premium segments, which has also improved profitability. Sometimes the company hasn't been able to manufacture enough cars to meet existing demand. In general, we have seen good volume growth and earnings traction, but the stock is quite expensive,

especially when one considers the valuations of General Motors, Ford, or Nissan.

Let's go back to Suzuki Motor Corporation, which owns roughly 56% of Maruti. This not only gives Suzuki a 56% profit share but also a royalty on every car sold that goes directly to the shareholders of Suzuki. If someone is investing in Maruti, they do not benefit from the royalty payments, nor do they benefit from the motorcycle and marine business of Suzuki, the battery joint venture it is setting up in India, and the soon-to-be-launched export unit. These benefits don't go to Maruti shareholders in India.

Apart from the 56% ownership in Maruti, Suzuki is also a player in the Japanese market, in ASEAN countries, the European Union, and China. In addition to the car business, its a small motorcycle business, and marine and power product operations.

Let's take two different valuation approaches to Suzuki. Firstly, we'll try and value it independently, without considering the valuation of Maruti. Then we'll do a sum of parts in terms of how much the Maruti stake and the balance business are worth.

Suzuki, whose market cap is \$26 billion, booked a profit of about \$1.65 billion in its last financial year. Roughly two-thirds of it comes from India and the remaining from the rest of the business. The profit share of Maruti is \$0.64 billion plus a royalty of \$0.41 billion. Suzuki is available at a P/E ratio of about 13.5 compared to 35 for Maruti. As a company with significantly growing sales volumes, especially in its Indian operations, it has seen its profits double in 4 years and has pretty decent financials in terms of return on equity and growth rate.

The bulk of the profits come from the Indian market. If other markets turn around or start contributing more, that is a potential upside, but we are not currently paying too much for the other markets the company operates in. They are not profitable for now. It can be seen as a participation in the Indian market with the optionality of an upside in the other markets.

Suzuki has seen its net income grow over the years, and the payout ratio is not high given that it has some capital expenditure to take care of the volume growth it is experiencing. But on a net basis, it does not have any significant amount of debt. There's plenty of cash flow coming in, part of which goes towards capital expenditure.

Let's look at Suzuki as a proxy to holding Maruti. It has a market capitalization of \$26 billion, and the value of its 56% stake in Maruti is worth close to \$23 billion. For a net value of \$3 billion, you participate in the royalty income from Maruti's Indian operations plus you get all the other businesses more or less for free.

*The following are excerpts of the Q&A session with Rajeev Thakkar:*

**Q:** We always like to ask about capital allocation, so could you tell us if you agree with the management's priorities on that front or would you like to see them prioritize anything differently?

**A:** Given the significant growth opportunities in India, investing in the battery plant and in the export plant is a rational capital allocation decision by the management. And a dividend payout ratio of about 15% should be reasonable. Since the business generates a decent return on capital, it is better for the company to reinvest when opportunities are there rather than try to pay it out. Overall, I'm happy with what the management is doing on capital allocation.

**Q:** Could you elaborate a bit more on management incentives or any stock ownership of note?

**A:** Suzuki Motor Corporation has been an owner-operated business for generations in Japan. Over time, the family's stake has been coming down, as can be expected, and institutional ownership has increased. But Mr. Osamu Suzuki has been at the helm for many years and has only recently taken a less active role. The management has had a long tenure, sticking around and guiding the company over the years.

**Q:** If someone were to consider investing or tracking this as an idea, what would be some data points they could look at and monitor to either validate or challenge your thesis?

**A:** One key factor would be the market share of Maruti in India - is it holding steady or declining? The other would be whether the 9%-10% volume growth we have seen in the Indian auto market continues or not. The third thing to track would be developments in the electric vehicle space — is that a longer-term disruption or a near-term thing? Another thing to monitor is whether incumbents make the transition to the new technology or a completely different set of players gain in the electric car space.

**Q:** Finally, perhaps you could tell us a bit about how you discovered this idea and your idea generation process.

**A:** First of all, we do not try to capture every stock upside in the marketplace. We have a well-defined universe in terms of the number of stocks we track, and that list is updated once every year. When including companies in our coverage universe, we take into account management quality, capital allocation, return on capital ratios, and growth prospects. We also consider whether we can understand the business or not.

Maruti is a company we have been tracking for a long time. Given that Suzuki is its parent, it was only logical to look at it as well, especially since Suzuki seemed to offer a compelling valuation point compared to the Indian auto space. That was our starting point with Suzuki.

*About the instructor:*

Rajeev Thakkar possesses over 24 years of experience in various segments of the Capital Markets such as investment banking, corporate finance, securities broking and 15 years of experience managing clients' investments in equities. His tenure at PPFAS began in 2001. He managed the equity investments of the Portfolio Management Service from 2003 to 2013.

and since 2013 has been managing PPFAS Mutual Fund's "Parag Parikh Long Term Equity Fund". Rajeev is a strong believer in the school of "value-investing" and is heavily influenced by Warren Buffett and Charlie Munger's approach. He is a Chartered Accountant, Cost Accountant and a CFA Charterholder.