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Indian Auto Pair Trade: BUY Tata Motors & SELL Maruti Suzuki
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We suggest the following Long-Short trade driven by fundamentals:

Tata Motors (TTMT IN, BUY, mcap $12 bn, TP Rs1,475, 57% upside): While we expect moderation in the domestic commercial vehicle segment, the volume outlook remains strong at Jaguar Land Rover (which constitutes nearly 65% of Tata Motors’ EBITDA), driven by the continued strong demand from China & other emerging markets and the expected launch of Range Rover's Evoque in September 2011. Our volume estimates for JLR at 280,164 units (implying 15% YoY growth) is sufficiently below management guidance of 3,00,000 units. Further, we expect Jaguar Land Rover margins to sustain at around 16% helped by better regional mix and increased sourcing from low cost countries. Consequently, despite challenges on the domestic front, we expect Tata Motors to post consolidated EBITDA and net earnings CAGR of 11% and 15% respectively over FY11-13E (EBITDA and net earnings adjusted for normalized R&D charges to P&L at 70% instead of current 20% levels). Given this earnings profile, the recent share price decline (25% in the last two months) and the current valuation (4x FY13 EBITDA and 7x FY13 net earnings), Tata Motors appears very attractive.

Maruti Suzuki (MSIL IN, SELL, mcap $7 bn, TP Rs1,250, 10% Upside): We believe passenger cars to be one of the most affected segments in the current auto slowdown. This adverse impact is on account of the increase in the cost of ownership with the impact being particularly severe in the urban areas (due to the deferment of replacement and upgradation demand). This has started reflecting in car sales with Maruti Suzuki’s domestic volume numbers for April and May 2011 put together recording a meagre growth of 6% YoY. With moderating demand, competitive intensity has intensified in the sector through a step-up in discount and incentive schemes (the company has also lost market share to the tune of 71bps since FY11 end in the domestic car segment). Moreover, with expected launch of Toyota's Etios Liva on 27 June 2011, Maruti Suzuki may come under further pressure should the pricing of Liva be competitive. This together with reduced pricing power (on account of moderating demand) in the face of high input costs is likely to put further pressure on Maruti Suzuki’s already fragile margins. Since we downgraded Maruti to SELL in our 3 June 2011 automobile thematic titled "Course Correction Ahead", its share price has declined by 7% and now implies  a 10% upside to our target price. This would technically imply a BUY recommendation according to our recently changed recommendation methodology. However, we are likely to review our target price and estimates given the recent strike at Manesar plant and continuing weak trends in volumes.

The price ratio Tatamotors over Maruti, currently at 0.818, trades over 1.7 standard deviations away from its 60 day mean of 0.925. The 0.8 ratio is a good support from the level as is clear from the chart above. We think these are attractive levels to play for a mean reversion and hence recommend longs on Tatamotors and shorts on Maruti on a value neutral basis.

The current valuation at 13.2x FY12 net earnings (compared to net earnings CAGR expectations of only 9% over FY11-13E) implies that the challenges surrounding volumes and margins are still not fully factored into the current stock price.
We expect to see moderation in volumes and rising margin pressure to be reflected in monthly auto numbers and quarterly results respectively.

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