

REDUCE

TP: Rs 2,360 | ▲ 5%

HERO MOTOCORP

Automobiles

20 February 2020

Visit to HMCL's R&D centre – key takeaways

We visited Hero Moto's (HMCL) R&D centre and attended its investor meet. Alongside BS-VI upgraded models and the new 'Xtreme 160', HMCL also showcased interesting prototypes of 'Quark1' – its shape-changing mobility solution, and 2021 two-wheeler launch 'E-Maestro'. The company plans to invest Rs 100bn over 5-7 years towards new products, network premiumisation and mobility solutions. Given potentially weaker FCF on elevated investments, we cut our target P/E multiple to 13x (vs. 14x) and TP to Rs 2,360 (vs. Rs 2,540).

Navin Matta | Nishant Chowhan, CFA

research@bobcaps.in

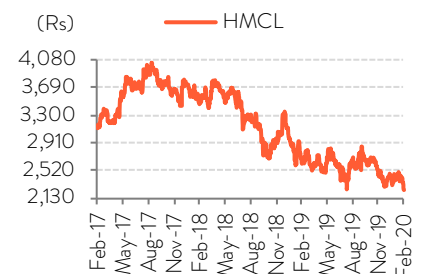
Visible scale-up in R&D capability: HMCL has made a concerted push towards building solid R&D capabilities with investments of ~US\$ 600mn over the past five years. Efforts are visible by way of 150 new projects being generated and notable improvement in build quality/finish of new models. The product development cycle has been cut by ~25% (to three years) with scope for further reduction. In addition to displaying new products in 2W segments, HMCL also showcased an interesting concept model – touted as a shape-changing mobility solution, and highlighted its readiness in EV technology.

Investing to diversify, build presence in emerging mobility: HMCL's vision entails being the future of mobility. In this regard, it has a Rs 100bn investment pipeline over the next 5-7 years for (1) scaling up its presence in scooters, premium motorcycles and in exports, (2) emerging mobility products/solutions, and (3) network premiumisation.

Maintain REDUCE: While we like HMCL's renewed efforts to expand beyond its core commuter segment and build an emerging mobility vertical, benefits if any will accrue after a long gestation period. High competitive intensity and a potential demand hit from BS-VI transition keep us cautious on the stock.

Ticker/Price	HMCL IN/Rs 2,252
Market cap	US\$ 6.3bn
Shares o/s	200mn
3M ADV	US\$ 28.0mn
52wk high/low	Rs 3,023/Rs 2,225
Promoter/FPI/DII	35%/36%/18%

Source: NSE

STOCK PERFORMANCE

Source: NSE

KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Total revenue (Rs mn)	322,305	336,505	305,212	345,898	371,622
EBITDA (Rs mn)	52,802	49,301	44,551	43,622	48,972
Adj. net profit (Rs mn)	36,974	33,849	32,352	32,380	36,285
Adj. EPS (Rs)	185.1	169.5	162.0	162.1	181.7
Adj. EPS growth (%)	9.5	(8.5)	(4.4)	0.1	12.1
Adj. ROAE (%)	31.4	26.3	21.8	20.3	21.0
Adj. P/E (x)	12.2	13.3	13.9	13.9	12.4
EV/EBITDA (x)	7.7	7.9	8.8	9.2	8.0

Source: Company, BOBCAPS Research

BOB Capital Markets Ltd is a wholly owned subsidiary of Bank of Baroda

Important disclosures, including any required research certifications, are provided at the end of this report.

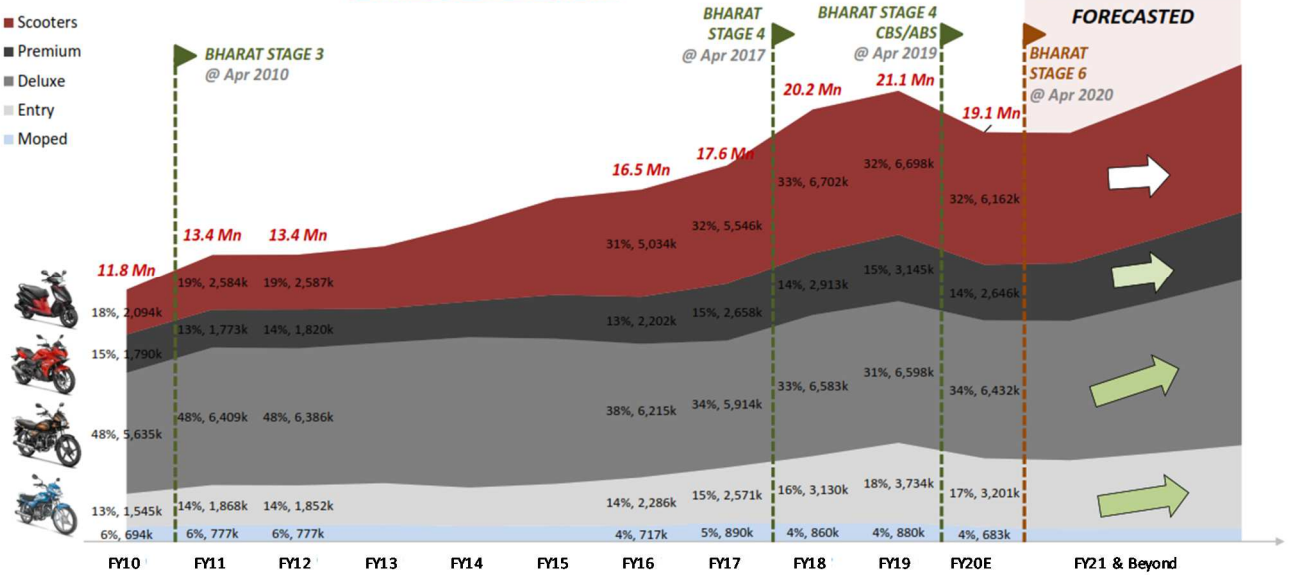


Other highlights

- **New launches:** HMCL rolled out BS-VI variants of 'Glamour 125cc' (Rs 69k-72k), 'Passion Pro' (Rs 65k-67k) and a newly introduced 'Xtreme 160R'. Despatches for Glamour and Passion have started while Xtreme sales will begin from March-end. The company also launched off-road rally kits priced at Rs 38k which can provide the ability to switch between regular and off-road bike capability. It is also looking at entering into 300cc+ motorcycles.
- **Upscaling R&D:** Over the last five years, HMCL has invested over US\$ 600mn in R&D and expanded its R&D team strength from 400 to 1,000. Unlike typical R&D setups which have a long gestation period, the company's Center of Innovation and Technology (CIT) in Jaipur, Rajasthan, has undertaken over 150 projects in the last four years.
- **Investment plans:** A total of Rs 100bn will be invested over the next 5-7 years, earmarked towards emerging mobility, scooters/premium bikes and network premiumisation.
- **BS-VI update:** HMCL has sold ~200k BS-VI vehicles and received a positive response from customers. Currently, only three models remain for mass BS-VI production. Management foresees some down-trading among segments on implementation of the new emission norms from Apr'20 as the transition has meant steep product price hikes. Downtrading from scooters to the deluxe motorcycle segment is also possible.
- **Premiumisation in scooters:** Management expects the scooter industry to move towards the 125cc segment and believes ICE (internal combustion engine) scooters will remain an important category for the company as sizeable ramp-up in electric models is some time away.
- **Expanding export footprint:** HMCL has achieved a footprint in most of its target export markets and is now looking to deepen its presence in these countries. In Bangladesh, it has been clocking sale volumes of ~100k units annually for the last two years. In Africa, it is growing thrice as fast as rivals (low base with volumes ~1/6th of competition) and will focus on rebranding the product line from 'Dawn' to 'Hunter'. Columbia remains another key market. Management expects industry revival and market share gains in Sri Lanka.
- **EVs and emerging mobility solutions:** HMCL plans to launch an in-house electric 2W in 2021, with more launches to follow from Ather Energy where it holds 35.1% stake. An electric 3W is also on the anvil. Added revenue streams are being targeted from battery manufacturing, energy, mobility services and data analytics.

FIG 1 – INDIAN 2W INDUSTRY EXPECTED TO GROW AFTER BS-VI ADOPTION

RECOVERY EXPECTED POST H2-FY21, **ENTRY & DELUXE SEGMENT** TO BENEFIT FROM ABS/BS-VI PRICE PRESSURE



Source: HMCL Investor Presentation

FIG 2 – QUARK1 CONCEPT



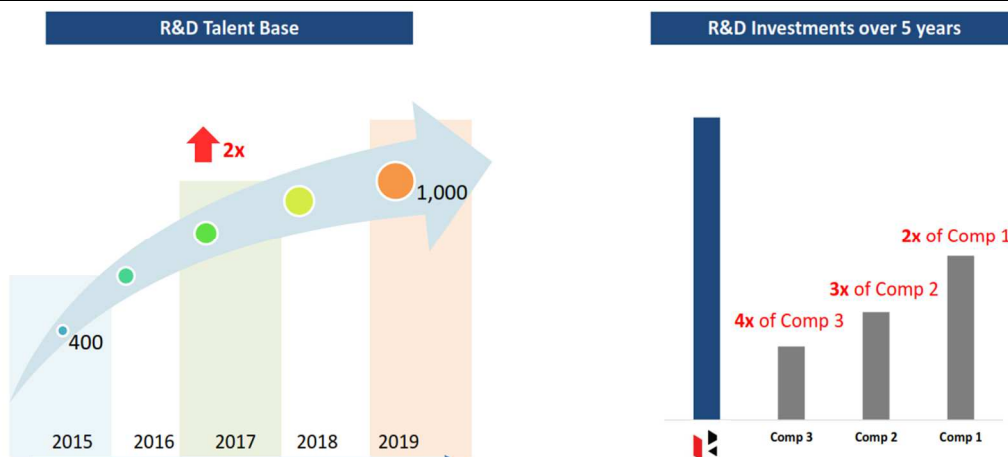
Source: Company, BOBCAPS Research

FIG 3 – E-MAESTRO PROTOTYPE



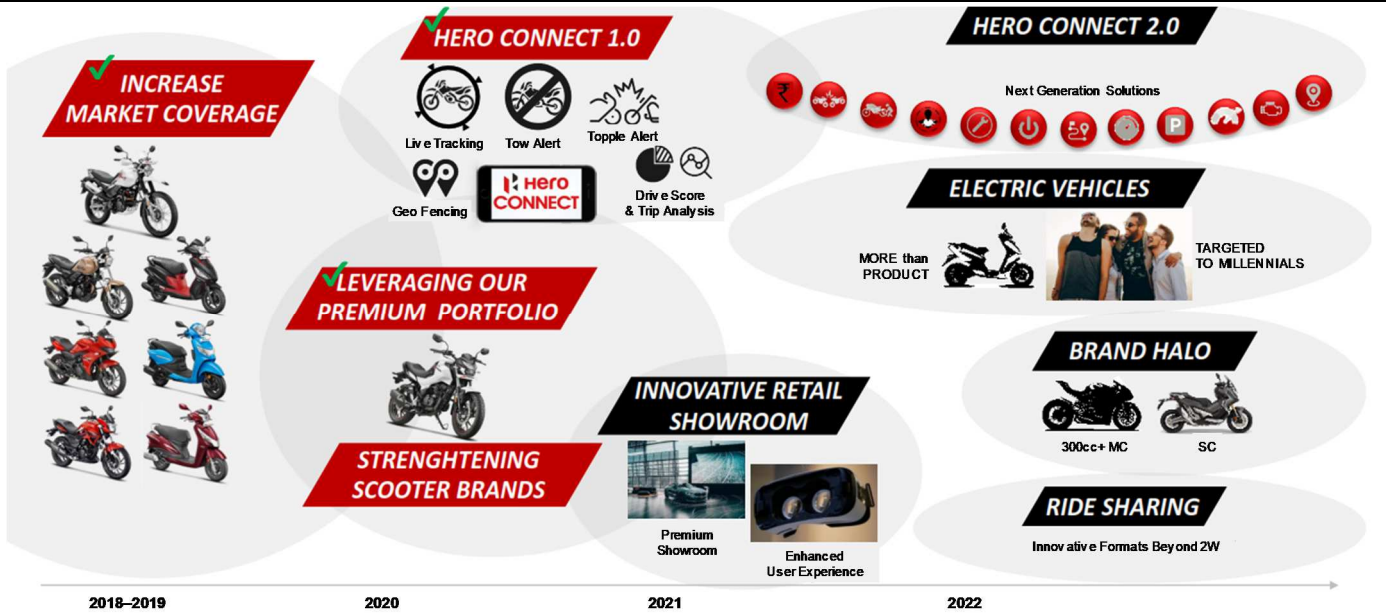
Source: Company, BOBCAPS Research

FIG 4 – RAPID RAMP-UP OF R&D



Source: Company, BOBCAPS Research

FIG 5 – STRATEGY AND SOLUTIONS TO GAIN SHARE IN SCOOTERS AND PREMIUM BIKES



Source: Company, BOBCAPS Research

FIG 6 – EXPORTS MARKETS – GROWTH ENABLERS



Source: Company, BOBCAPS Research

FIG 7 – TARGETED SEGMENTS AND SOLUTIONS IN EV SPACE



Participate as a leader or an eco-system player

Source: Company, BOBCAPS Research

Valuation methodology

HMCL currently trades at ~14x FY21E EPS. Headwinds from BS-VI migration and competitive stress are likely to cap earnings growth at a 6% CAGR over FY20-FY22. Valuations appear inexpensive but are reflective of these near-term headwinds and the risk of growth stagnation over the mid-to-long term given structural demand concerns arising from potential saturation in the 2W market.

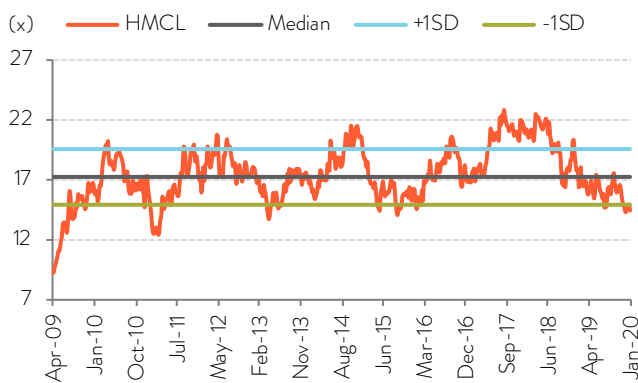
We value the stock at 13x FY22E EPS vs. 14x earlier to bake in a weaker FCF profile due to elevated investments – our target multiple is at ~25% discount to the past five-year median, translating to a Mar'21 target price of Rs 2,360 (revised from Rs 2,540). Reiterate REDUCE.

FIG 8 – KEY VOLUME ASSUMPTIONS

Particulars	FY20E	FY21E	FY22E
Total Sales	6,779,230	7,057,916	7,457,704
YoY Growth (%)	(13.3)	4.1	5.7
Domestic Sales	6,602,167	6,866,292	7,250,313
YoY Growth (%)	(13.3)	4.0	5.6
Export Sales	139,611	152,907	170,515
YoY Growth (%)	(32.9)	9.5	11.5

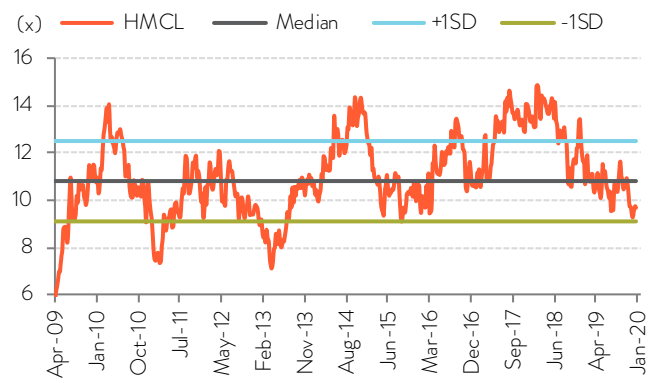
Source: Company, BOBCAPS Research

FIG 9 – P/E MULTIPLE



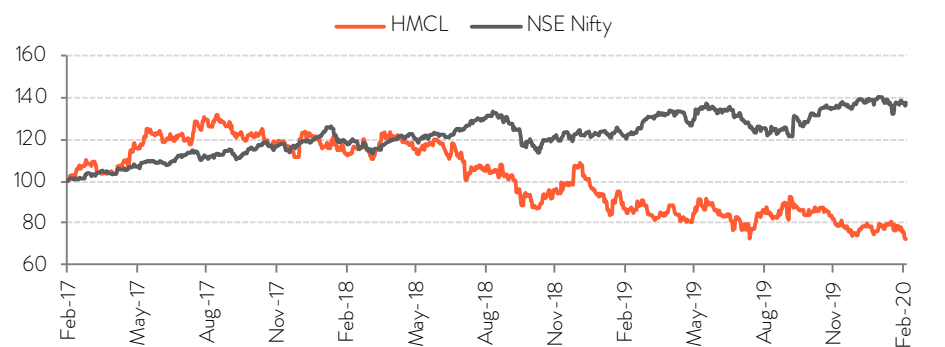
Source: Company, BOBCAPS Research

FIG 10 – EV/EBITDA MULTIPLE



Source: Company, BOBCAPS Research

FIG 11 – RELATIVE STOCK PERFORMANCE



Source: NSE

Key risks

- A sharp rise in financing ratio for 2Ws along with favourable credit terms such as extension of loan tenures may partly blunt the impact of BS-VI cost increase. This may reduce the expected negative impact on 2W demand.
- Above-expected pickup in rural demand on the back of good monsoons would disproportionately benefit HMCL given its higher volume mix from these markets – posing an upside risk to our volume estimates.
- Further declines in commodity costs could support margins despite tepid volume growth, though this may be priced away over time due to the elevated competitive intensity.

FINANCIALS

Income Statement

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Total revenue	322,305	336,505	305,212	345,898	371,622
EBITDA	52,802	49,301	44,551	43,622	48,972
Depreciation	5,556	6,020	8,541	8,559	9,328
EBIT	47,246	43,281	36,009	35,064	39,644
Net interest income/(expenses)	(63)	(86)	(215)	(215)	(237)
Other income/(expenses)	5,258	6,913	7,342	7,757	8,335
Exceptional items	0	0	7,274	0	0
EBT	52,442	50,107	50,410	42,606	47,743
Income taxes	15,468	16,259	10,784	10,225	11,458
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	0	0	0	0	0
Reported net profit	36,974	33,849	39,626	32,380	36,285
Adjustments	0	0	(7,274)	0	0
Adjusted net profit	36,974	33,849	32,352	32,380	36,285

Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Accounts payables	33,188	33,553	30,577	34,754	37,365
Other current liabilities	9,647	7,160	7,260	7,360	7,460
Provisions	1,747	1,762	1,862	1,962	2,062
Debt funds	0	0	0	0	0
Other liabilities	0	0	0	0	0
Equity capital	399	400	400	400	400
Reserves & surplus	117,289	128,172	147,933	159,279	172,193
Shareholders' fund	117,689	128,571	148,332	159,679	172,593
Total liabilities and equities	162,271	171,047	188,032	203,756	219,481
Cash and cash eq.	66,456	45,333	54,285	57,411	65,703
Accounts receivables	15,202	28,216	27,359	31,096	33,432
Inventories	8,236	10,724	9,656	10,975	11,799
Other current assets	17,556	24,817	29,317	31,917	34,517
Investments	10,209	15,717	16,717	17,718	18,718
Net fixed assets	46,545	46,186	56,063	60,004	60,677
CWIP	3,184	5,419	0	0	0
Intangible assets	0	0	0	0	0
Deferred tax assets, net	(5,117)	(5,365)	(5,365)	(5,365)	(5,365)
Other assets	0	0	0	0	0
Total assets	162,271	171,047	188,032	203,756	219,481

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net income + Depreciation	42,530	39,869	48,167	40,939	45,612
Interest expenses	63	86	215	215	237
Non-cash adjustments	973	248	0	0	0
Changes in working capital	(27)	(24,871)	(5,351)	(3,279)	(2,950)
Other operating cash flows	0	0	0	0	0
Cash flow from operations	43,539	15,333	43,032	37,875	42,899
Capital expenditures	(6,679)	(7,895)	(13,000)	(12,500)	(10,000)
Change in investments	(1,551)	(5,509)	(1,000)	(1,000)	(1,000)
Other investing cash flows	0	0	0	0	0
Cash flow from investing	(8,230)	(13,404)	(14,000)	(13,500)	(11,000)
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	0	0	0	0	0
Interest expenses	(63)	(86)	(215)	(215)	(237)
Dividends paid	(22,197)	(20,333)	(19,865)	(21,034)	(23,371)
Other financing cash flows	1,799	(2,634)	0	0	0
Cash flow from financing	(20,460)	(23,052)	(20,080)	(21,249)	(23,607)
Changes in cash and cash eq.	14,849	(21,123)	8,952	3,126	8,292
Closing cash and cash eq.	66,456	45,333	54,285	57,411	65,703

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20E	FY21E	FY22E
Reported EPS	185.1	169.5	162.0	162.1	181.7
Adjusted EPS	185.1	169.5	162.0	162.1	181.7
Dividend per share	95.0	87.0	85.0	90.0	100.0
Book value per share	589.3	643.7	742.6	799.4	864.0

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20E	FY21E	FY22E
EV/Sales	1.3	1.2	1.3	1.2	1.1
EV/EBITDA	7.7	7.9	8.8	9.2	8.0
Adjusted P/E	12.2	13.3	13.9	13.9	12.4
P/BV	3.8	3.5	3.0	2.8	2.6

DuPont Analysis

Y/E 31 Mar (%)	FY18A	FY19A	FY20E	FY21E	FY22E
Tax burden (Net profit/PBT)	70.5	67.6	78.6	76.0	76.0
Interest burden (PBT/EBIT)	111.0	115.8	140.0	121.5	120.4
EBIT margin (EBIT/Revenue)	14.7	12.9	11.8	10.1	10.7
Asset turnover (Revenue/Avg TA)	211.3	201.9	170.0	176.6	175.6
Leverage (Avg TA/Avg Equity)	139.4	135.4	129.7	127.2	127.4
Adjusted ROAE	31.4	26.3	21.8	20.3	21.0

Source: Company, BOBCAPS Research | Note: TA = Total Assets

Ratio Analysis

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
YoY growth (%)					
Revenue	13.1	4.4	(9.3)	13.3	7.4
EBITDA	13.9	(6.6)	(9.6)	(2.1)	12.3
Adjusted EPS	9.5	(8.5)	(4.4)	0.1	12.1
Profitability & Return ratios (%)					
EBITDA margin	16.4	14.7	14.6	12.6	13.2
EBIT margin	14.7	12.9	11.8	10.1	10.7
Adjusted profit margin	11.5	10.1	10.6	9.4	9.8
Adjusted ROAE	31.4	26.3	21.8	20.3	21.0
ROCE	42.8	37.5	28.2	25.9	27.0
Working capital days (days)					
Receivables	17	31	33	33	33
Inventory	9	12	12	12	12
Payables	38	36	37	37	37
Ratios (x)					
Gross asset turnover	2.6	2.4	1.9	2.0	2.0
Current ratio	2.4	2.6	3.0	3.0	3.1
Net interest coverage ratio	755.9	503.3	167.5	163.1	167.6
Adjusted debt/equity	(0.6)	(0.4)	(0.4)	(0.4)	(0.4)

Source: Company, BOBCAPS Research

Disclaimer

Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

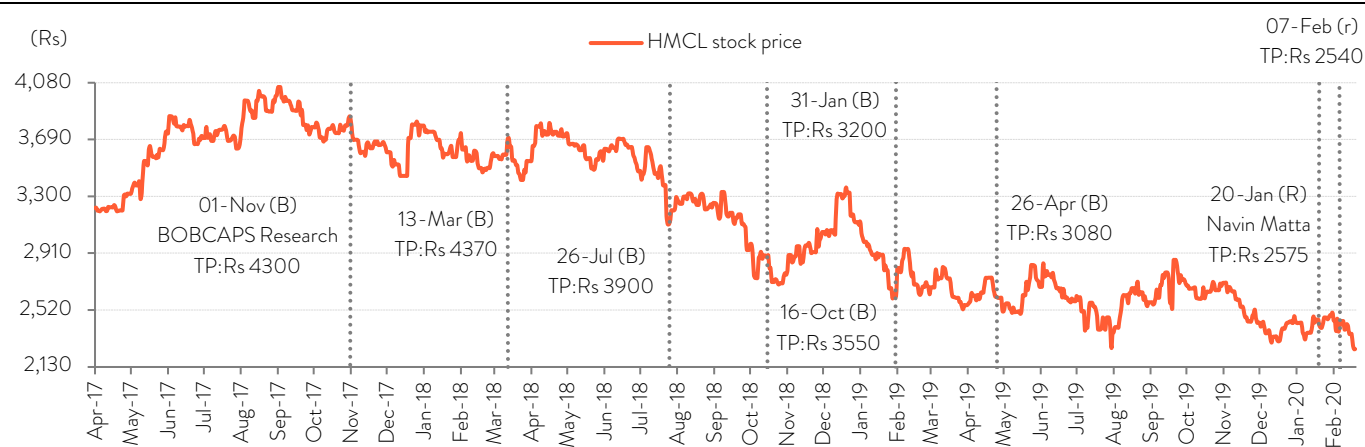
ADD – Expected return from >+5% to +15%

REDUCE – Expected return from -5% to +5%

SELL – Expected return <-5%

Note: Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

HISTORICAL RATINGS AND TARGET PRICE: HERO MOTOCORP (HMCL IN)



B – Buy, A – Add, R – Reduce, S – Sell

Rating distribution

As of 31 January 2020, out of 85 rated stocks in the BOB Capital Markets Limited (BOBCAPS) coverage universe, 50 have BUY ratings, 18 are rated ADD, 8 are rated REDUCE and 9 are rated SELL. None of these companies have been investment banking clients in the last 12 months.

Analyst certification

The research analyst(s) authoring this report hereby certifies that (1) all of the views expressed in this research report accurately reflect his/her personal views about the subject company or companies and its or their securities, and (2) no part of his/her compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) in this report. Analysts are not registered as research analysts by FINRA and are not associated persons of BOBCAPS.

General disclaimers

BOBCAPS is engaged in the business of Institutional Stock Broking and Investment Banking. BOBCAPS is a member of the National Stock Exchange of India Limited and BSE Limited and is also a SEBI-registered Category I Merchant Banker. BOBCAPS is a wholly owned subsidiary of Bank of Baroda which has its various subsidiaries engaged in the businesses of stock broking, lending, asset management, life insurance, health insurance and wealth management, among others.

BOBCAPS's activities have neither been suspended nor has it defaulted with any stock exchange authority with whom it has been registered in the last five years. BOBCAPS has not been debarred from doing business by any stock exchange or SEBI or any other authority. No disciplinary action has been taken by any regulatory authority against BOBCAPS affecting its equity research analysis activities.

BOBCAPS has obtained registration as a Research Entity under SEBI (Research Analysts) Regulations, 2014, having registration No.: INH000000040 valid till 03 February 2020. BOBCAPS is also a SEBI-registered intermediary for the broking business having SEBI Single Registration Certificate No.: INZ000159332 dated 20 November 2017.

BOBCAPS prohibits its analysts, persons reporting to analysts, and members of their households from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover. Additionally, BOBCAPS prohibits its analysts and persons reporting to analysts from serving as an officer, director, or advisory board member of any companies that the analysts cover.

Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients that reflect opinions contrary to the opinions expressed herein, and our proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations

expressed herein. In reviewing these materials, you should be aware that any or all of the foregoing, among other things, may give rise to real or potential conflicts of interest. Additionally, other important information regarding our relationships with the company or companies that are the subject of this material is provided herein.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of BOBCAPS's clients. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice.

The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide for future performance, future returns are not guaranteed and a loss of original capital may occur. BOBCAPS does not provide tax advice to its clients, and all investors are strongly advised to consult with their tax advisers regarding any potential investment in certain transactions — including those involving futures, options, and other derivatives as well as non-investment-grade securities — that give rise to substantial risk and are not suitable for all investors. The material is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. Opinions expressed are our current opinions as of the date appearing on this material only. We endeavour to update on a reasonable basis the information discussed in this material, but regulatory, compliance, or other reasons may prevent us from doing so.

We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material, may from time to time have “long” or “short” positions in, act as principal in, and buy or sell the securities or derivatives thereof of companies mentioned herein and may from time to time add to or dispose of any such securities (or investment). We and our affiliates may act as market makers or assume an underwriting commitment in the securities of companies discussed in this document (or in related investments), may sell them to or buy them from customers on a principal basis, and may also perform or seek to perform investment banking or advisory services for or relating to these companies and may also be represented in the supervisory board or any other committee of these companies.

For the purpose of calculating whether BOBCAPS and its affiliates hold, beneficially own, or control, including the right to vote for directors, one per cent or more of the equity shares of the subject company, the holdings of the issuer of the research report is also included.

BOBCAPS and its non-US affiliates may, to the extent permissible under applicable laws, have acted on or used this research to the extent that it relates to non-US issuers, prior to or immediately following its publication. Foreign currency denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of or income derived from the investment. In addition, investors in securities such as ADRs, the value of which are influenced by foreign currencies, effectively assume currency risk. In addition, options involve risks and are not suitable for all investors. Please ensure that you have read and understood the Risk disclosure document before entering into any derivative transactions.

In the US, this material is only for Qualified Institutional Buyers as defined under rule 144(a) of the Securities Act, 1933. No part of this document may be distributed in Canada or used by private customers in the United Kingdom.

No part of this material may be (1) copied, photocopied, or duplicated in any form by any means or (2) redistributed without BOBCAPS's prior written consent.

Company-specific disclosures under SEBI (Research Analysts) Regulations, 2014

The research analyst(s) or his/her relatives do not have any material conflict of interest at the time of publication of this research report.

BOBCAPS or its research analyst(s) or his/her relatives do not have any financial interest in the subject company. BOBCAPS or its research analyst(s) or his/her relatives do not have actual/beneficial ownership of one per cent or more securities in the subject company at the end of the month immediately preceding the date of publication of this report.

The research analyst(s) has not received any compensation from the subject company in the past 12 months. Compensation of the research analyst(s) is not based on any specific merchant banking, investment banking or brokerage service transactions.

BOBCAPS or its research analyst(s) is not engaged in any market making activities for the subject company.

The research analyst(s) has not served as an officer, director or employee of the subject company.

BOBCAPS or its associates may have material conflict of interest at the time of publication of this research report.

BOBCAPS's associates may have financial interest in the subject company. BOBCAPS's associates may hold actual / beneficial ownership of one per cent or more securities in the subject company at the end of the month immediately preceding the date of publication of this report.

BOBCAPS or its associates may have managed or co-managed a public offering of securities for the subject company or may have been mandated by the subject company for any other assignment in the past 12 months.

BOBCAPS may have received compensation from the subject company in the past 12 months. BOBCAPS may from time to time solicit or perform investment banking services for the subject company. BOBCAPS or its associates may have received compensation from the subject company in the past 12 months for services in respect of managing or co-managing public offerings, corporate finance, investment banking or merchant banking, brokerage services or other advisory services in a merger or specific transaction. BOBCAPS or its associates may have received compensation for products or services other than investment banking or merchant banking or brokerage services from the subject company in the past 12 months.