

REDUCE

TP: Rs 2,540 | ▲ 5%

HERO MOTOCORP

Automobiles

07 February 2020

Decent Q3 but outlook challenging

Hero Moto (HMCL) posted an operational beat in Q3FY20 led by healthy gross margins. Current BS-IV inventory stands at five weeks. The company plans to stop BS-IV production by mid-Feb and smoothly transition to BS-VI. With a 12-15% cost rise in price-sensitive segments, the near-term volume outlook looks challenging. Inability to increase presence in scooters and exports along with risk of 2W demand saturation over 5-10 years are structural concerns for HMCL. Maintain REDUCE with a revised TP of Rs 2,540 (vs. Rs 2,575).

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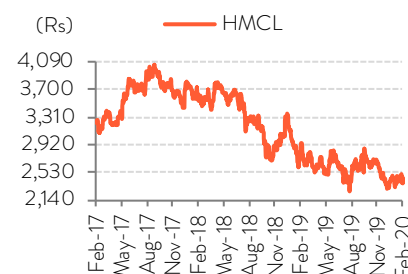
Margins ahead of estimates: Q3 revenues were in line with estimates at Rs 69.9bn (-11% YoY). Gross margins surprised positively with 110bps QoQ improvement led by a lagged impact from benign commodity costs and HMCL's cost-cutting efforts. EBITDA at Rs 10.4bn (-6% YoY) beat estimates by ~6%, aided by 80bps YoY/30bps QoQ margin expansion to 14.8%. A lower tax rate supported adj. PAT growth of ~15% YoY.

Ticker/Price	HMCL IN/Rs 2,411
Market cap	US\$ 6.8bn
Shares o/s	200mn
3M ADV	US\$ 27.0mn
52wk high/low	Rs 3,023/Rs 2,226
Promoter/FPI/DII	35%/36%/18%

Source: NSE

Tepid volume and margin outlook: HMCL hopes that good monsoons and higher finance penetration will partly mitigate demand headwinds. However, with a 12-15% cost rise across its models on account of BS-VI transition, the demand outlook appears bleak given a bulk of its volumes come from price-sensitive segments. Competitive intensity is likely to remain elevated with players such as Bajaj Auto adopting electronic injection systems (similar to e-carb) to enhance market share in lower-end segments. Limited pricing power and cost push from BS-VI transition are likely to dent margins.

STOCK PERFORMANCE



Maintain REDUCE: Current valuations at 15x FY21E EPS are at -1 SD of the five-year average. We trim our FY20-FY22 estimates by 1-2% as volume cuts offset higher margin assumption. We bake in a 6% earnings CAGR over FY20-FY22 – underwhelming after two years of decline.

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)	13.0	14.2	14.9	14.9	13.3
EV/EBITDA (x)	8.3	8.6	9.6	9.9	8.7

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.



FIG 1 – QUARTERLY PERFORMANCE – STANDALONE

Y/E Mar (Rs mn)	Q3FY20	Q3FY19	YoY (%)	Q2FY20	QoQ (%)	9MFY20	9MFY19	YoY (%)
Net Revenues	69,967	78,648	(11.0)	75,707	(7.6)	225,977	257,656	(12.3)
Raw Materials	46,598	54,145	(13.9)	51,257	(9.1)	153,775	178,792	(14.0)
% of Net Sales	66.6	68.8	-	67.7	-	68.0	69.4	-
Personnel	4,697	4,357	7.8	4,689	0.2	14,063	12,830	9.6
% of Net Sales	6.7	5.5	-	6.2	-	6.2	5.0	-
Manufacturing & Other Exp	8,282	9,098	(9.0)	8,750	(5.3)	25,159	27,427	(8.3)
% of Net Sales	11.8	11.6	-	11.6	-	11.1	10.6	-
Total Expenditure	59,578	67,601	(11.9)	64,696	(7.9)	192,996	219,048	(11.9)
EBITDA	10,390	11,048	(6.0)	11,011	(5.6)	32,981	38,608	(14.6)
EBITDA Margin (%)	14.8	14.0	-	14.5	-	14.6	15.0	-
Depreciation	2,037	1,518	34.2	2,034	0.1	6,433	4,518	42.4
EBIT	8,352	9,529	(12.4)	8,977	(7.0)	26,548	34,090	(22.1)
Interest Expenses	59	22	174.1	77	(22.8)	180	64	180.2
Non-operating income	1,822	1,876	(2.9)	2,078	(12.3)	5,589	5,270	6.0
Extraordinary Expenses	0	0	NA	601	NA	(7,274)	0	NA
Extraordinary Income	0	0	NA	0	NA	0	0	NA
PBT	10,115	11,384	(11.1)	10,377	(2.5)	39,231	39,296	(0.2)
Tax-Total	1,311	3,693	(64.5)	1,629	(19.5)	9,106	12,751	(28.6)
Tax Rate (%) - Total	13.0	32.4	(60.0)	15.7	-	23.2	32.4	(28.5)
Reported PAT	8,804	7,691	14.5	8,748	0.6	30,126	26,546	13.5
Adj. PAT	8,804	7,691	14.5	9,169	(4.0)	25,034	26,546	(5.7)
PAT Margin	12.6	9.8	-	12.1	-	11.1	10.3	-

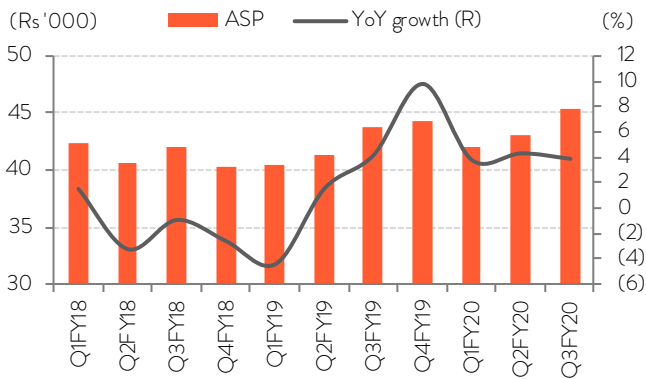
Source: Company, BOBCAPS Research

FIG 2 – PER UNIT PARAMETERS

Y/E Mar (Rs)	Q3FY20	Q3FY19	YoY (%)	Q2FY20	QoQ (%)	9MFY20	9MFY19	YoY (%)
Sales Volume (nos)	1,540,868	1,798,905	(14.3)	1,691,420	(8.9)	5,075,208	6,039,585	(16.0)
Net Realisation/Vehicle	45,408	43,720	3.9	44,759	1.4	44,526	42,661	4.4
Material cost/Vehicle	30,241	30,099	0.5	30,304	(0.2)	30,299	29,603	2.4
Gross Profit/Vehicle	15,166	13,621	11.3	14,455	4.9	14,226	13,058	8.9
Employee cost/Vehicle	3,048	2,422	25.9	2,772	10.0	2,771	2,124	30.4
Other expenses/Vehicle	5,375	5,058	6.3	5,173	3.9	4,957	4,541	9.2
EBITDA/Vehicle	6,743	6,141	9.8	6,510	3.6	6,498	6,392	1.7
Net Profit/Vehicle	5,714	4,275	33.6	5,421	5.4	4,933	4,395	12.2

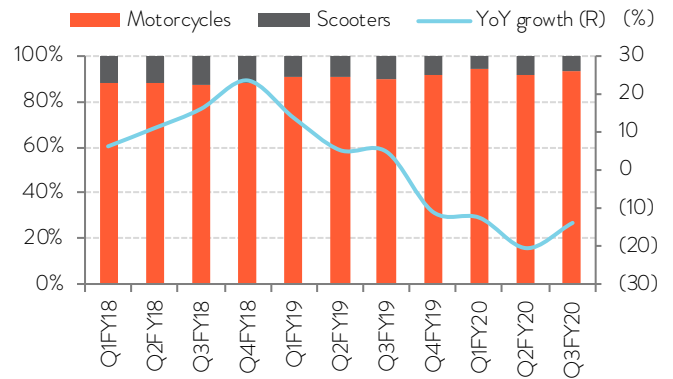
Source: Company, BOBCAPS Research

FIG 3 – AVERAGE SELLING PRICE (ASP)



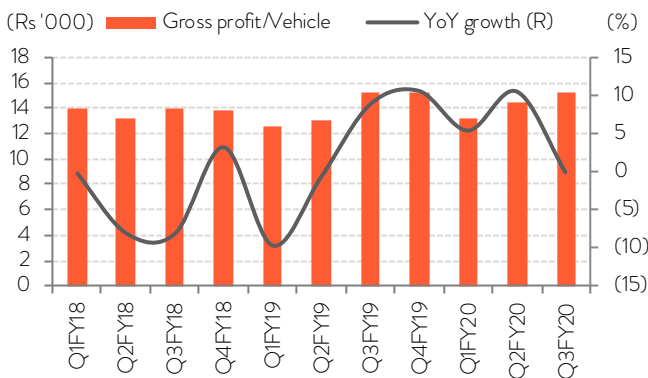
Source: Company, BOBCAPS Research

FIG 4 – VOLUME GROWTH TREND



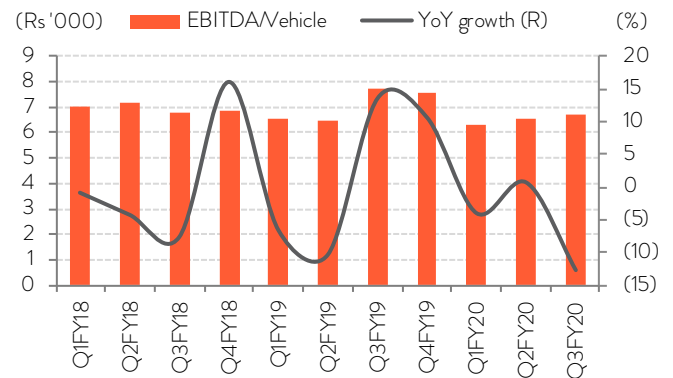
Source: SIAM, ET Autolytics, BOBCAPS Research

FIG 5 – GROSS PROFIT/VEHICLE



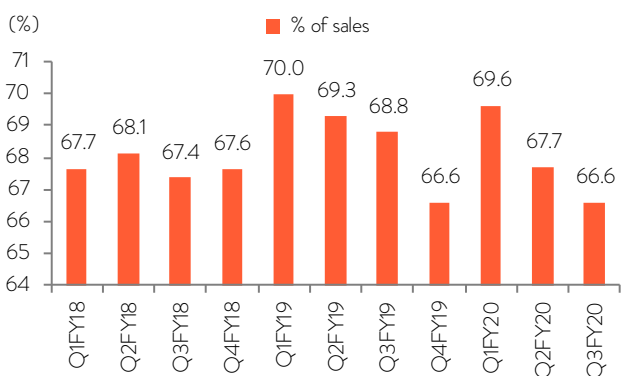
Source: BOBCAPS Research, Company

FIG 6 – EBITDA/VEHICLE



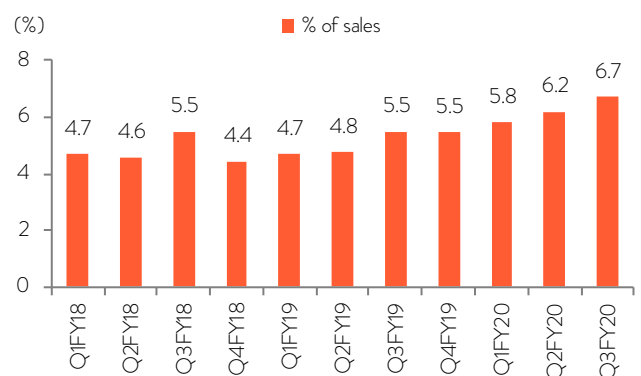
Source: BOBCAPS Research, Company

FIG 7 – RM COST/SALES TREND



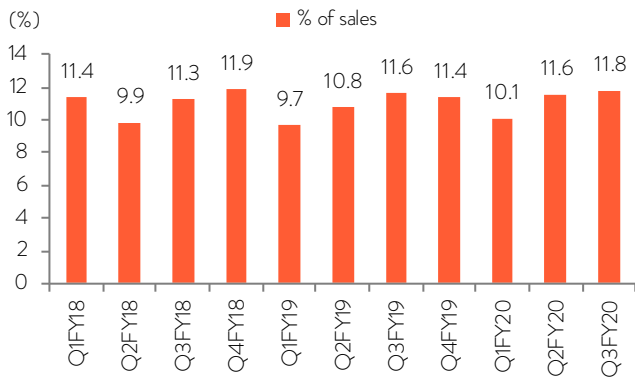
Source: Company, BOBCAPS Research

FIG 8 – EMPLOYEE COST/SALES TREND



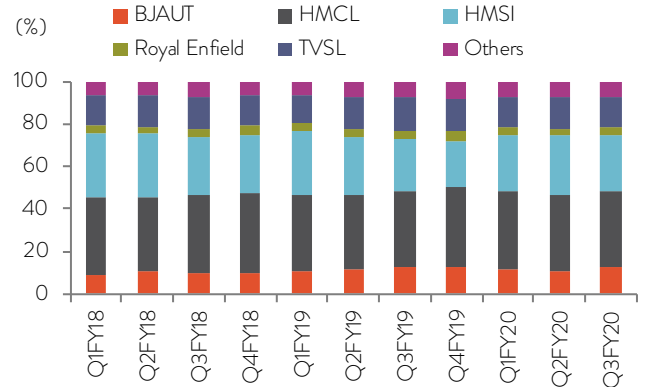
Source: Company, BOBCAPS Research

FIG 9 – OTHER EXPENSES/SALES TREND



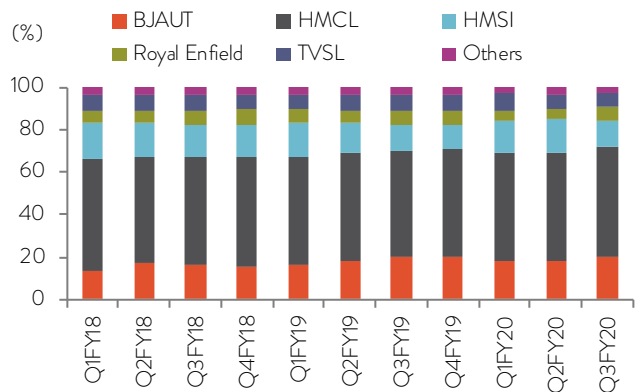
Source: Company, BOBCAPS Research

FIG 10 – DOMESTIC 2W MARKET SHARE



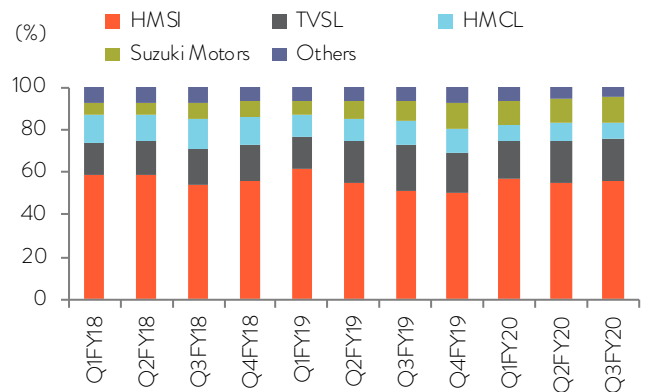
Source: SIAM, ET Autolytics, BOBCAPS Research

FIG 11 – DOMESTIC MOTORCYCLE MARKET SHARE



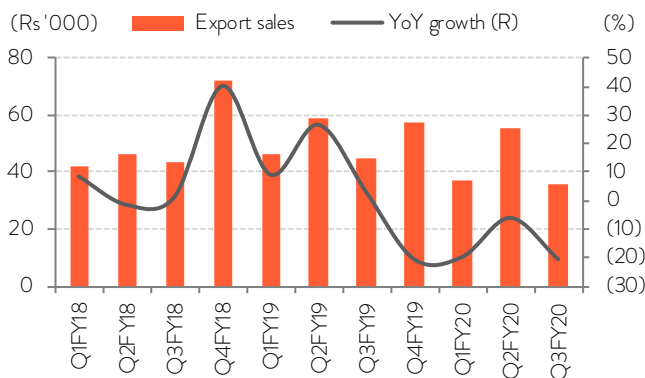
Source: Company, BOBCAPS Research

FIG 12 – DOMESTIC SCOOTER MARKET SHARE



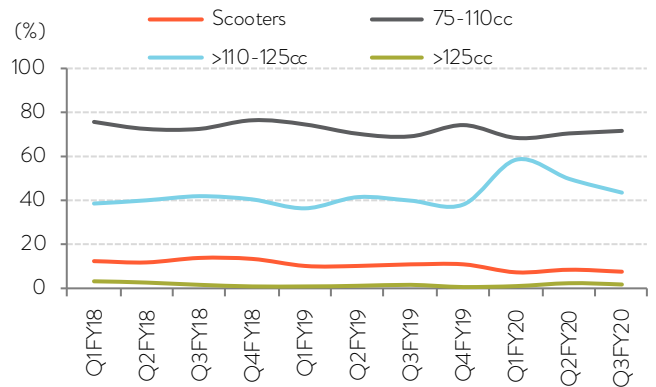
Source: Company, BOBCAPS Research

FIG 13 – EXPORT SALES TREND



Source: SIAM, ET Autolytics, BOBCAPS Research

FIG 14 – MARKET SHARE TREND



Source: SIAM, ET Autolytics, BOBCAPS Research

Earnings call highlights

- Production of BS-IV variants will be stopped in the middle of February. On transition to BS-VI, most of the cost increase will be passed to the customer.
- Dealer inventory has been brought down to five weeks in Jan'20 (as against six weeks in Dec'19).
- HMCL expects demand to improve on the back of healthy rural economy growth. Uttar Pradesh, Rajasthan, Maharashtra and Gujarat saw ~10% improvement in retail sales in Jan'20.
- In 9MFY20, the company gained 90bps market share in motorcycles whereas it lost 280bps share in scooters, partly due to a rundown of BS-IV stock (production of scooters stopped in Dec'19).
- Price differential between fuel injection (FI) and E-carb models (launched by competitor) is ~Rs 1k. However, FI provides premium technology and is equipped to meet the new OBD II guidelines.
- HMCL has not ruled out inclusion of E-carb technology and can consider it if it meets performance expectations.
- The Andhra Pradesh plant will be commissioned by Q4FY20 and will cater mainly to southern markets. Management does not foresee a major impact on FY21 earnings as the plant will ramp up gradually.
- Spare parts revenue for Q3FY20 was at Rs 8bn (vs Rs 7.3bn in Q3FY19). The credit period for spare part dealers is ~30 days (vs. 15 days for vehicles).

Valuation methodology

HMCL currently trades at ~15x FY21E EPS. Valuations appear inexpensive but are reflective of near-term headwinds and the risk of growth stagnation over the mid-to-long term. We value the stock at 14x FY22E EPS, ~20% discount to its past five-year median valuations, translating to a Mar'21 target price of Rs 2,540 (revised from Rs 2,575 as we pare earnings estimates 1-2% to bake in lower volumes).

Headwinds from BS-VI migration and competitive stress are likely to cap earnings growth at a 6% CAGR for FY20-FY22. Over the mid-to-long term, we see structural demand concerns from potential saturation in the 2W market. Reiterate REDUCE.

FIG 15 – REVISED ESTIMATES

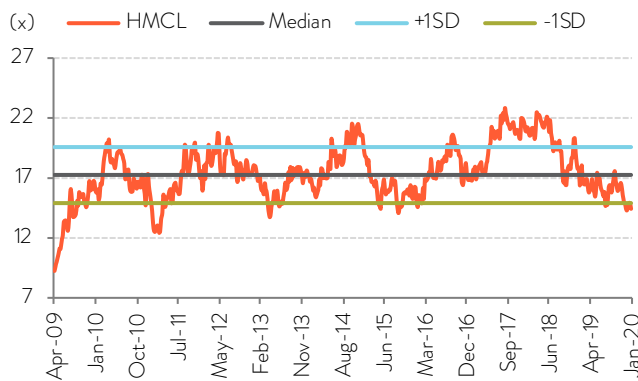
Change (%)	FY20E	FY21E	FY22E
Volume	(1.5)	(1.5)	(1.5)
Income	(2.0)	(2.1)	(2.1)
EBITDA	0.4	(1.9)	(1.6)
EBITDA Margin (bps)	35	2	7
Profit	(0.4)	(1.6)	(1.3)
EPS (Rs)	(0.5)	(1.6)	(1.3)

Source: BOBCAPS Research

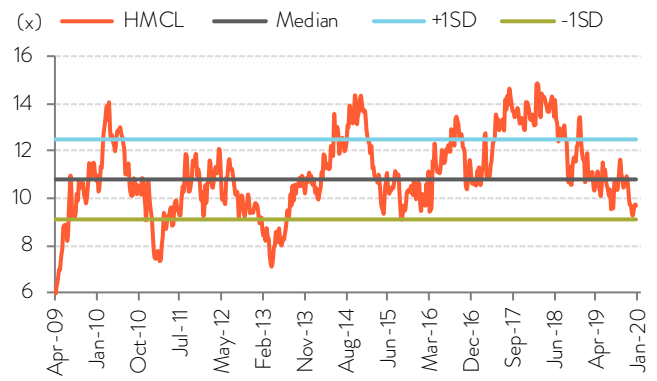
FIG 16 – KEY VOLUME ASSUMPTIONS

Key Volume Estimates	FY20	FY21	FY22
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

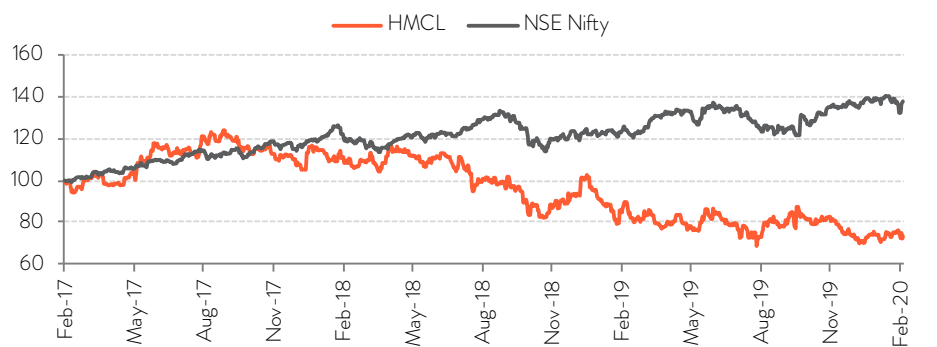
Source: Company, BOBCAPS Research

FIG 17 – P/E MULTIPLE

Source: Company, BOBCAPS Research

FIG 18 – EV/EBITDA MULTIPLE

Source: Company, BOBCAPS Research

FIG 19 – 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	1.4	1.3	1.4	1.2	1.1
EV/EBITDA	8.3	8.6	9.6	9.9	8.7
Adjusted P/E	13.0	14.2	14.9	14.9	13.3
P/BV	4.1	3.7	3.2	3.0	2.8

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%

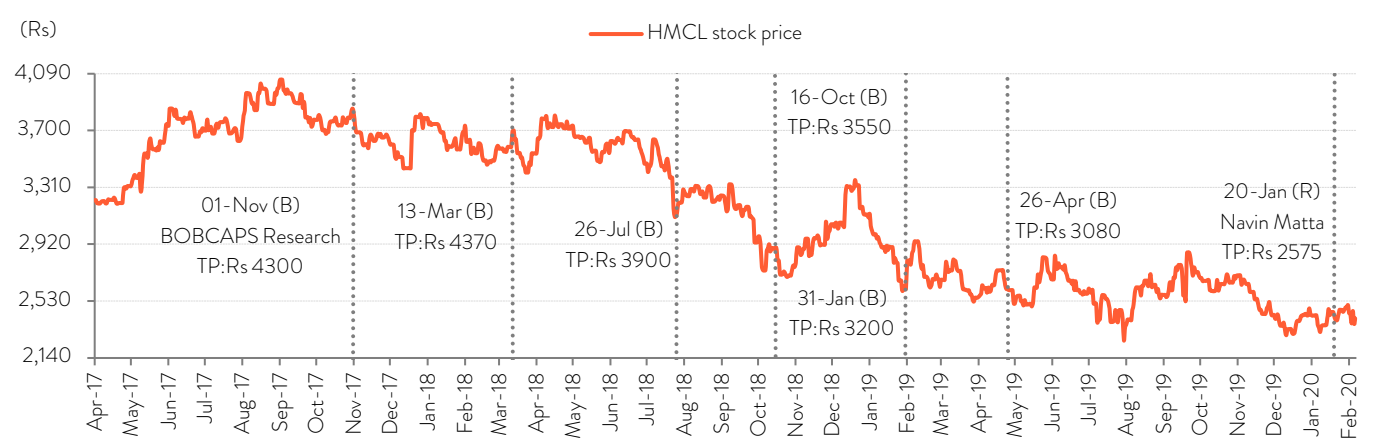
ADD – Expected return from >+5% to +15%

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

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