

October 17, 2018

Hero MotoCorp

Bumpy Ride Ahead!

Unexciting Q2FY19 Quarter

The company reported a 5.5% YoY volume growth to 21.3L units for the quarter aided by its popular motorcycles, while the scooters de-grew during the quarter. The realization growth of 2.9% YoY to Rs. 42,599 was supported by increase in the vehicle prices. The net revenue growth of 8.6% YoY to Rs. 9K crores came in-line with our estimates, but, the sharp lower margin profile for the quarter was came in as a surprise. The EBITDA Margin decelerated by 220bps YoY to 15.2% in Q2FY19. The other income was higher majorly due to one-off income from IT deposit refund. On the other side, the tax rate was higher by 300bps YoY to 32.6% due to expiry of incentives of Haridwar plant. Overall, Hero MotoCorp reported a decline in its bottom-line by 3.4% YoY to Rs. 976 crores in Q2FY19.

Weak macro factors on the radar

The first few days of *Navratri* has seen a flattish sales, however, the management is positive on the upcoming festive season and expects 8-10% volume growth and stayed firm on double digit growth for FY19E. But, we see the roads are patchy ahead as India remains highly a price sensitive market, hence, higher increase in the insurance costs along with rising fuel, interest rate scenario and rise in the vehicle prices would impact the short term demand and believe this festive season to remain flattish. On the top of it, Hero's ~50% sales comes from the rural market and we expect the rural demand to depress majorly led by 9% rainfall deficit in CY2018. Additionally, the intense competition from the domestic and foreign players has kept the rivalry high.

Gradually losing market share

It has been observed that the customers of 125cc motorcycle are gradually moving towards 125cc scooters, where Hero is not the leader & has lost its market share in Q2FY19. The company's domestic scooters market share has come down from 14.1% in FY17 to 13.1% in FY18 and has further slow down in Q2FY19. However, the domestic motorcycle market share remain firm at ~51.5%.

Valuations

We see certain uncertainties with respect to the weaker macro-economic factors & cut-throat competition and prefer to observe the performance of Hero's upcoming new launches in the scooters and premium motorcycles. We have valued the company based on an average of PE and EV/EBITDA of FY20E. Hero MotoCorp in the past five years has traded on an average 14.3x of its forward EPS and we have assigned the similar earning multiple to its FY20E EPS of Rs. 197. Similarly, we have assigned 9.7x to its FY20E EBITDA. Hence, based on the average, we have come across the fair value of Hero MotoCorp at **Rs. 3,036 per share, maintained our hold rating.**

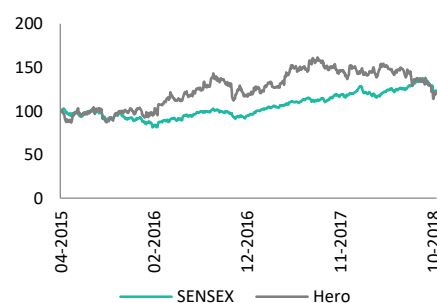
HOLD*

Downside Scenario	Current Price	Price Target	Upside Scenario
	2,899	3,036	
		4.7%▲	

Market Data	
Industry	Automobile
Sensex	35,119
Nifty	10,581
Bloomberg Code	HMCL:IN
Eq. Cap. (INR Crores)	40
Face Value (INR)	2
52-w H/L	3,895/2,695
Market Cap (INR Crores)	57,717

Valuation Data	FY19E	FY20E	FY21E
OPM	15.3%	15.5%	16.0%
NPM	10.1%	10.3%	10.6%
P/E (x)	16.9	14.7	12.6
EV/EBITDA (x)	11.1	9.6	8.3

Hero MotoCorp vs SENSEX



Shareholding Pattern (%)

	Sep-17	Mar-18	Sep-18
Promoters	34.6%	34.6%	34.6%
FII	42.3%	42.1%	38.9%
DII	15.7%	15.8%	14.8%
Retail	7.4%	7.5%	11.7%
Total	100%	100%	100%

(INR Crores)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	28,500	32,230	33,724	38,402	43,183
Growth (%)	0.2%	13.1%	4.6%	13.9%	12.4%
EBITDA	4,635	5,280	5,154	5,947	6,896
Growth (%)	4.0%	13.9%	-2.4%	15.4%	15.9%
EBITDA Margin (%)	16.3%	16.4%	15.3%	15.5%	16.0%
PAT	3,377	3,697	3,422	3,941	4,580
Growth (%)	6.9%	9.5%	-7.4%	15.2%	16.2%
EPS (INR)	169	185	171	197	229
P/E (x)	17.7	19.0	16.9	14.7	12.6
EV/EBITDA (x)	12.9	13.3	11.1	9.6	8.3

Source: Company, NSPL Research

* Read last page for disclaimer & rating rationale

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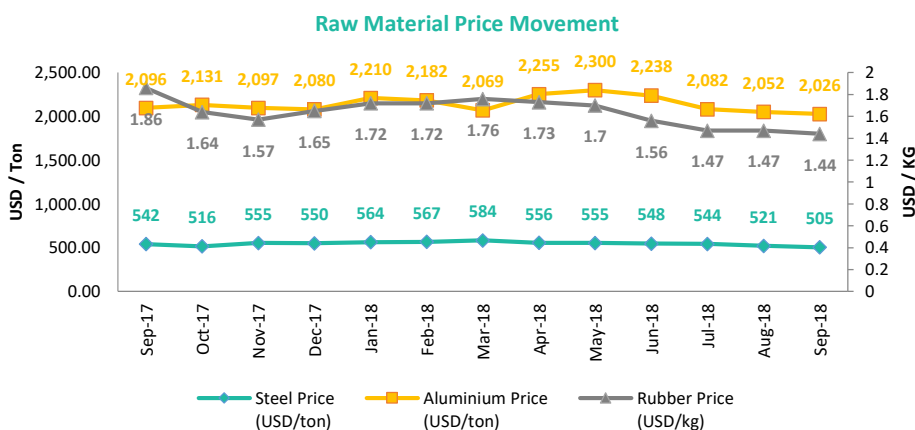


Q2FY19 Result Analysis

(INR Crores)	Q2FY19	Q2FY18	YoY (%)	Q1FY19	QoQ (%)	H1FY19	H1FY18	YoY (%)
Volumes (Nos)	21,34,051	20,22,805	5.5%	21,06,629	1.3%	42,40,680	38,76,452	9.4%
Realization (Rs)	42,599	41,387	2.9%	41,820	1.9%	42,212	42,184	0.1%
Net sales	9,091	8,372	8.6%	8,810	3.2%	17,901	16,352	9.5%
COGS	6,300	5,708	10.4%	6,165	2.2%	12,465	11,111	12.2%
Employee Expenses	434	384	13.2%	413	5.1%	847	757	11.9%
Other Expenses	978	825	18.7%	854	14.5%	1,833	1,732	5.8%
EBITDA	1,379	1,456	-5.3%	1,377	0.1%	2,756	2,752	0.2%
D&A	152	136	11.6%	148	2.4%	300	269	11.5%
Other income	224	118	90.2%	116	93.3%	339	249	36.1%
EBIT	1,451	1,437	0.9%	1,345	7.9%	2,795	2,732	2.3%
Interest Expense	2	2	37.2%	2	1.4%	4	3	35.4%
PBT	1,448	1,436	0.9%	1,343	7.9%	2,791	2,729	2.3%
Tax	472	425	11.0%	434	8.9%	906	804	12.6%
PAT	976	1,010	-3.4%	909	7.4%	1,885	1,925	-2.0%
EPS in INR	49	51	-3.4%	46	7.4%	94	96	-2.0%

Margin Analysis	Q2FY19	Q2FY18	YoY (%)	Q1FY19	QoQ (%)	H1FY19	H1FY18	YoY (%)
Material Expenses % Net Sales	69.3%	68.2%	1.1%	70.0%	-0.7%	69.6%	67.9%	1.7%
Gross Margin	30.7%	31.8%	-1.1%	30.0%	0.7%	30.4%	32.1%	-1.7%
Employee Expenses % Net Sales	4.8%	4.6%	0.2%	4.7%	0.1%	4.7%	4.6%	0.1%
Other Expenses % Net Sales	10.8%	9.8%	0.9%	9.7%	1.1%	10.2%	10.6%	-0.4%
EBITDA Margin (%)	15.2%	17.4%	-2.2%	15.6%	-0.5%	15.4%	16.8%	-1.4%
Tax Rate (%)	32.6%	29.6%	3.0%	32.3%	0.3%	32.4%	29.5%	3.0%
PAT Margin (%)	10.7%	12.1%	-1.3%	10.3%	0.4%	10.5%	11.8%	-1.2%

- Hero MotoCorp's **net revenues** increased by 8.6% YoY to Rs. 9,091 crores in Q2FY19 driven majorly by the growth in its Passion, Splendor & HF models. On the other side, the scooters segment declined by 12.2% YoY to 2.11L units for the quarter.
- The growth in the **spare parts** revenue, which reported a robust growth of 24% YoY to Rs. 713 crores during the quarter also supported the top-line growth.
- Along with decent **volume growth**, the increase in the vehicle prices during the quarter has aided the realization to shoot up by 2.9% YoY to Rs. 42,599. Hero in total has increased the prices several times in YDFY19, which we believe is close to Rs. 1,000 approx.
- The **gross margin** contracted by 110bps YoY to 30.7% due to increase in its major raw material prices.
- Higher increase in the **other expenses and employee costs** has made the situation worse, which led to decline in the EBITDA Margin by 220bps YoY to 15.2% in Q2FY19.
- The **bottom-line** has reported a de-growth of 3.4% YoY to Rs. 976 crores in Q2FY19 due to poor operational performance & higher effective tax rate; offset by increase in the other income.



Source: LME



Volume Projections

Hero MotoCorp Volume Assumptions	FY17	FY18	FY19E	FY20E	FY21E
Scooters	8,29,786	9,09,986	9,28,975	9,94,004	10,44,443
YoY Growth (%)	-7.4%	9.7%	2.1%	7.0%	5.1%
2W Motorcycles	58,34,260	66,77,207	71,66,126	80,66,396	87,10,097
YoY Growth (%)	1.7%	14.4%	7.3%	12.6%	8.0%
<110cc	49,40,274	56,52,159	61,21,789	69,29,174	75,02,300
YoY Growth (%)	1.4%	14.4%	8.3%	13.2%	8.3%
110-125cc	7,74,640	9,15,400	9,52,196	10,39,798	11,05,291
YoY Growth (%)	6.4%	18.2%	4.0%	9.2%	6.3%
125-150cc	1,18,315	1,09,376	91,311	95,876	99,832
YoY Growth (%)	-9.3%	-7.6%	-16.5%	5.0%	4.1%
200-250cc	1,031	272	830	1,548	2,673
YoY Growth (%)	-84.3%	-73.6%	205.1%	86.4%	72.7%
Total Sales (Scooters + Motorcycles)	66,64,046	75,87,193	80,95,101	90,60,399	97,54,540
YoY Growth (%)	0.5%	13.9%	6.7%	11.9%	7.7%
Domestic	64,83,655	73,82,718	78,52,201	87,69,350	94,09,825
YoY Growth (%)	1.0%	13.9%	6.4%	11.7%	7.3%
Exports	1,80,391	2,04,475	2,42,900	2,91,049	3,44,714
YoY Growth (%)	-14.2%	13.4%	18.8%	19.8%	18.4%
Average Realization (Rs)	42,768	42,480	41,660	42,384	44,270
YoY Growth (%)	-0.3%	-0.7%	-1.9%	1.7%	4.4%

Source: Company, NSPL Research

Demand Outlook

- Hero MotoCorp has retained its outlook of 10% volume growth in FY19E despite of on-going uncertainties. Also, the company expects demand to grow by 8-10% in this festive season despite of flattish start of Navratri. The management trust that the fundamental macro-economic drivers are very robust and will see good improvement in the coming days of festive seasons.
- The company is going to launch two new scooters in the coming months in the 125cc segment. In addition, it has plans to launch more premium motorcycles and we think they would eventually gain the market share in the premium motorcycles in the next 3-5 years. Despite of short term uncertainties, the company's new launch pipeline will remain unaltered. The management looks pretty serious on the premium segment and its ambitious are high on it.
- The exports outlook remains positive for the company as it reported a growth of 25% in the 2nd quarter majorly driven by growth in the Bangladesh.
- We also believe that cost of ownership of Hero Motorcycles are lower as compared to other OEMs and will have marginal benefit in the rising fuel price scenario. At present, the company sees rural demand is slightly better than the urban and fees that rural market will start looking even better majorly due to MSP hike. The few days of softness in the demand is considered as a hiccups.
- On the scooters demand, the industry is witnessing some softness in demand led by higher base of BS3 to BS4 conversion. In addition to it, earlier the growth was higher due to requirement of multiple ownership in the households and that demand is now flattening out.
- We think 125cc segment's demand is slowing down and would report negative growth in FY19E as the customers are preferring 125cc scooters, where Hero is not the leader and is losing market share.

Source: Company, NSPL Research

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On the demand side, we see certain concerns on the overall automotive industry for FY19E and especially w.r.t. Hero MotoCorp.

1. Firstly, the mandatory long term insurance and higher costs associated with it has softened the on-going festive demand so far.
2. Secondly, we have critically studied the past 10 years and observed that the deficit in the rainfall has impacted the automotive industry growth in the earlier years and we expect this year's 9% rainfall deficit has a negative role to play in the 2nd half. This will be offset by increase in the MSP. Hero's ~50% of the sales comes from the rural.
3. Thirdly, continuous increase in the fuel prices along with rising interest rate scenario to impact some demand in FY19E.
4. In addition, the OEMs increased the vehicle prices to offset the increase in the commodity prices.
5. On top of it, the intense competition from the foreign and domestic OEMs has resulted in the loss of market share of Hero MotoCorp in the past years.

However, we expect higher pre-buying demand to come in FY20E before the implementation of BS6.



Key Quarterly Highlights

Margin Outlook: Hero MotoCorp has maintained its long term EBITDA Margin outlook of 14-16%. Although the costs are moving up, however, the company is taking effective measures like price increase and growing volumes to get the benefits of operating leverage. We believe, Hero MotoCorp would be able to sustain 16% level of margin in the medium term driven majorly by BS6 and aggressive launches in the premium motorcycles and scooters.

Tax Rate Guidance: The effective tax rate increased by 300bps YoY to 32.6% in Q2FY19 majorly impacted due to expiry of incentives of Haridwar plant. Hence, we expect the tax rate will more or less remain at the similar level in the coming years.

Electric Bikes: Hero has adopted a dual strategy on electric vehicles. On one side, it continues to its in-house R&D and on other side, it has already bought a stake in Ather Energy, whose electric bikes are already running on Bengaluru roads. In the short term, the electric vehicle demand to remain soft as there are lots of stuff need to be sorted out such as infrastructure, target customers, design, convenience, etc. Hence, as the electric is a medium to long term story, however, the company is already working aggressively to invest in the future technologies.

Source: Company, NSPL Research

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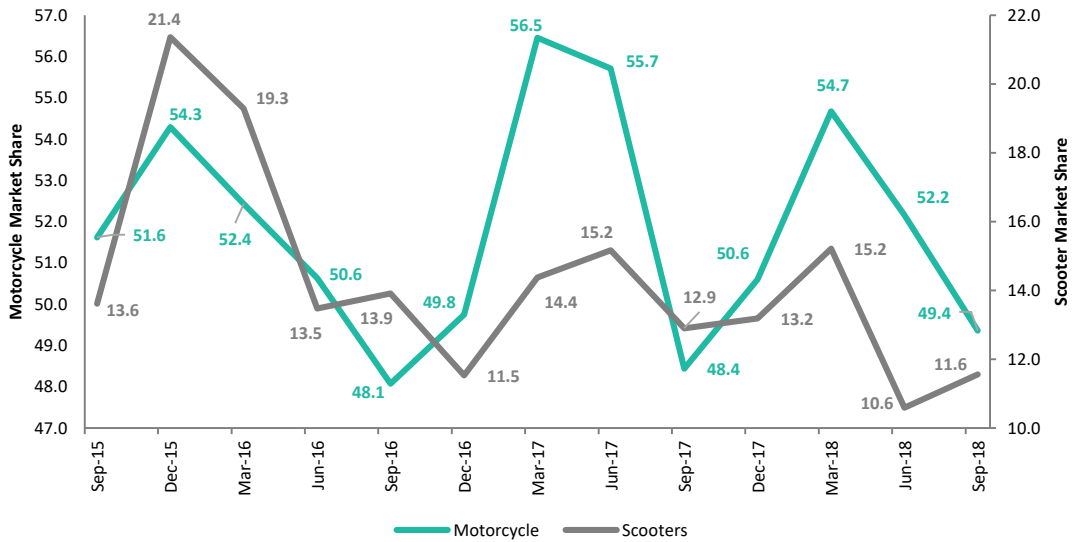
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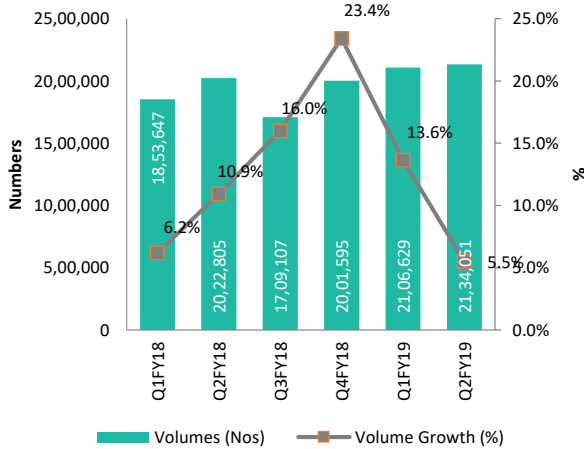


Story in Charts

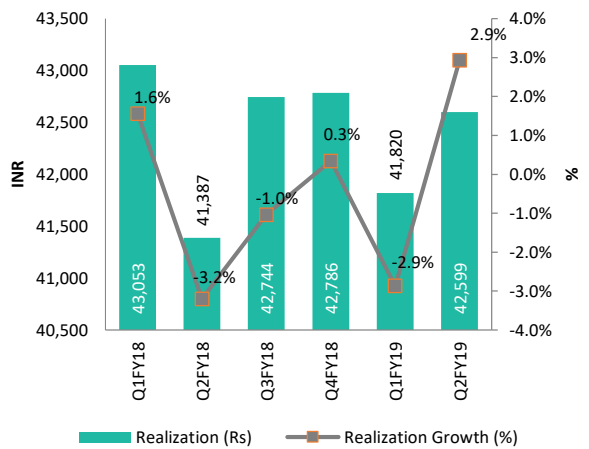
Gradually Sliding Market Share



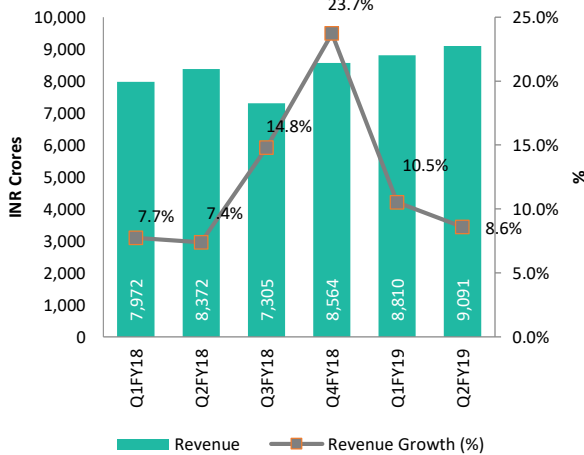
Slow Down in the Volume Growth



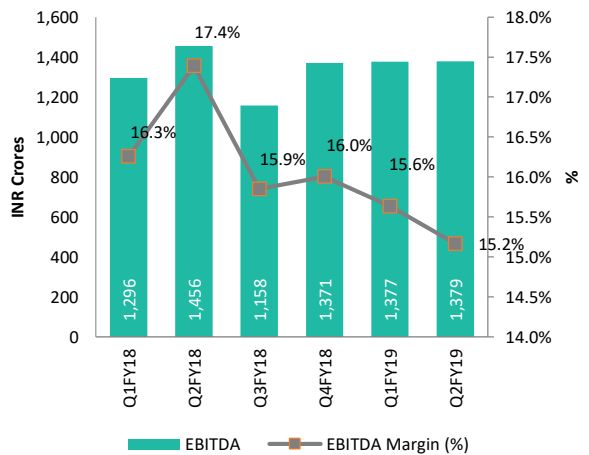
Subdued Realization Growth



Hero's Topline Performance



Lacklustre Margin Performance



Source: Company, NSPL Research

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Profit & Loss (INR Crores)	FY17	FY18	FY19E	FY20E	FY21E
Net sales	28,500	32,230	33,724	38,402	43,183
COGS	19,037	21,835	23,296	26,884	30,391
Employee Expenses	1,396	1,540	1,610	1,815	2,047
Other Expenses	3,432	3,576	3,664	3,755	3,850
EBITDA	4,635	5,280	5,154	5,947	6,896
D&A	493	556	646	736	811
Other income	522	526	561	626	697
EBIT	4,665	5,250	5,069	5,837	6,782
Interest Expense	6	6	7	7	7
PBT	4,658	5,244	5,063	5,831	6,775
Tax	-1,281	-1,547	-1,640	-1,889	-2,195
PAT	3,377	3,697	3,422	3,941	4,580
EPS in INR	169	185	171	197	229

Balance Sheet (INR Crores)	FY17	FY18	FY19E	FY20E	FY21E
ASSETS					
Non-Current Assets					
(a) Property, plant and equipment	4,311	4,486	5,155	5,750	6,083
(b) Capital work-in-progress	271	204	295	324	601
(c) Intangible assets	85	169	335	495	613
(d) Intangible assets under development	194	115	0	0	0
(e) Financial assets	1,397	1,980	2,071	2,359	2,653
(f) Income tax assets (net)	332	379	366	422	490
(g) Other non-current assets	651	559	585	666	749
Total Non-Current Assets	7,241	7,891	8,807	10,015	11,189
Current Assets					
(a) Inventories	656	824	894	1,031	1,166
(b) <u>Financial assets</u>					
(i) Investments	4,541	5,591	5,850	6,662	7,491
(ii) Trade receivables	1,562	1,520	1,571	1,789	2,011
(iii) Cash and cash equivalents	15	34	419	430	720
(iv) Bank balances other than (iii) above	121	107	149	195	269
(v) Loans	24	28	29	33	37
(vi) Others	145	539	564	643	723
(c) Other current assets	388	205	215	244	275
Total Current Assets	7,453	8,848	9,690	11,027	12,691
Total Assets	14,694	16,739	18,497	21,041	23,880

EQUITY AND LIABILITIES					
Equity					
(a) Equity Share capital	40	40	40	40	40
(b) Other equity	10,071	11,729	13,260	15,024	17,073
Total Equity	10,111	11,769	13,300	15,064	17,113
LIABILITIES					
Non-current liabilities					
(a) Provisions	75	115	120	137	154
(b) Deferred tax liabilities (net)	414	512	494	569	661
Total Non - Current Liabilities	490	627	614	706	815
Current liabilities					
(a) Financial liabilities					
(i) Trade payables	3,247	3,319	3,510	4,051	4,579
(ii) Other financial liabilities	353	202	212	241	271
(b) Other current liabilities	454	763	798	909	1,022
(c) Provisions	39	60	63	71	80
Total Current Liabilities	4,093	4,343	4,582	5,272	5,952
Total Equity and Liabilities	14,694	16,739	18,497	21,041	23,880

Source: Company, NSPL Research

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Cash Flow (INR Crores)	FY17	FY18	FY19E	FY20E	FY21E
Profit After Tax	3,377	3,697	3,422	3,941	4,580
Operating Profit before Working Capital Changes	4,815	5,315	5,158	5,952	6,900
Cash Generated from Operations	5,215	5,475	5,218	6,102	7,036
Less: income tax paid	1,186	1,494	1,640	1,889	2,195
Cash Flow from Operating	4,028	3,981	3,578	4,213	4,841
(Incr)/ Decr in Gross PP&E	-1,151	-802	-1,200	-1,200	-1,200
Cash Flow from Investing	-1,944	-1,915	-1,296	-2,017	-2,013
Dividends Paid (including tax on dividend)	-2,091	-2,043	-1,891	-2,178	-2,531
Finance costs	-6	-6	-7	-7	-7
Cash Flow from Financing	-2,096	-2,047	-1,898	-2,185	-2,538
Incr/(Decr) in Balance Sheet Cash	-12	19	384	11	290
Cash at the Start of the Year	27	15	34	419	430
Cash at the End of the Year	15	34	419	430	720

RATIOS	FY17	FY18	FY19E	FY20E	FY21E
Growth (%)					
Net Revenues	0.2%	13.1%	4.6%	13.9%	12.4%
EBITDA	4.0%	13.9%	-2.4%	15.4%	15.9%
PAT	6.9%	9.5%	-7.4%	15.2%	16.2%
Profitability					
Return on Capital (%)	46.1%	44.6%	38.1%	38.8%	39.6%
Return on Equity (%)	33.4%	31.4%	25.7%	26.2%	26.8%
Margin Trend					
EBITDA Margin (%)	16.3%	16.4%	15.3%	15.5%	16.0%
Net profit Margin (%)	11.8%	11.5%	10.1%	10.3%	10.6%
Solvency					
Total Debt / Equity	0.0	0.0	0.0	0.0	0.0
Valuation Ratios					
P/E	17.7	19.0	16.9	14.7	12.6
EV/EBITDA	12.9	13.3	11.1	9.6	8.3
P/B	5.9	6.0	4.4	3.8	3.4

Source: Company, NSPL Research



Hero MotoCorp				Rating Legend	
Date	CMP (INR)	Target Price (INR)	Recommendation	Strong Buy	More than 15%
October 17, 2018	2,899	3,036	Hold	Buy	5% - 15%
				Hold	0 – 5%
				Reduce	-5% - 0
				Sell	Less than -5%

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Details of Disciplinary History of NSPL	No disciplinary action is / was running / initiated against NSPL
Research analyst or NSPL or its relatives'/associates' financial interest in the subject company and nature of such financial interest	No (except to the extent of shares held by Research analyst or NSPL or its relatives'/associates')
Whether Research analyst or NSPL or its relatives'/associates' is holding the securities of the subject company	NO
Research analyst or NSPL or its relatives'/associates' actual/beneficial ownership of 1% or more in securities of the subject company, at the end of the month immediately preceding the date of publication of the document	NO
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Other disclosures	NO