

February 01, 2019

Hero MotoCorp

Govt's Rural Focus, Strategy to Launch Multi Products and Attractive Valuations to aid Hero MotoCorp

Q3FY19 Decoded!

Hero MotoCorp posted operationally disappointing numbers in Q3FY19. It's net revenues grew by 7.5% YoY to Rs. 7,865 crores, led by volume increase of 5.3% to 17.8L units and realization improvement of 2.2% YoY to Rs. 43,720 per vehicle. The Q3 remained a very tough quarter for the whole automotive industry on account of depressed consumer sentiments, led by an increase in the fuel prices, rising interest rate scenario, insurance bouncer, a deficit in the rainfall and poor festive seasons. All this led to a low volume number for the leader. On the other side, the realization improved as the company has taken a price increase of Rs. 500-600 per vehicle at the start of October 2018.

The EBITDA Margin for the quarter fell sharply by 180bps YoY to 14.0%, majorly impacted by the rise in the commodity prices, which increased the RM to Net revenues (%) by 140bps YoY to 68.8% in Q3FY19. We have also observed an increase in the other expenses, which we think can be attributable to the launch cost of Destiny125cc scooter and other A&P spends. Moreover, weak operating leverage impacted the overall margins for the company.

The bottom-line declined marginally by 4.5% YoY to Rs. 769 crores in Q3FY19 on account of poor operational performance, higher effective tax rate (+380bps YoY to 32.4%); offset by a sharp rise in other income (+71% YoY to Rs. 188 crores). The other income increased due to higher MTM gains.

We believe there were temporary setbacks for the industry in the 3rd quarter and believe the 4th quarter and the next year will be better for the company. We expect higher single digit growth for the industry in FY20E and see Q4 to be better than Q3. The softening of commodity prices and pre-buying ahead of BS6 implementation, will provide more cushion for the company to grow in terms of top line as well as margins.

Margins Bottomed Out!

The company managed to hold on to its guided margin range of 14-16% in Q3FY19. This proves the leader's capability in managing the costs despite of multiple headwinds. Over the last 7-8 quarters, the industry has faced major headwinds on account of higher commodity costs, which seems to be softening a bit in Q3 & Q4 and Hero should expect to get the benefits of lower commodities in the upcoming quarters.

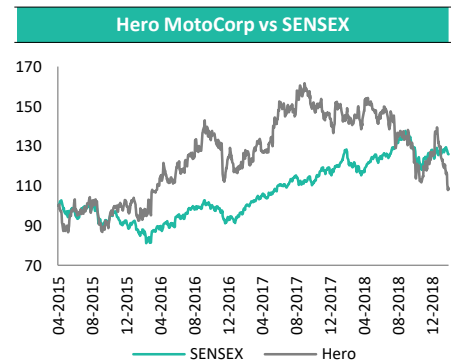
In addition to it, the company has taken price increase in the beginning of October of close to Rs. 500-600, this aid in improvement in the realization. We believe the margins have clearly bottomed out and there are multiple tailwinds to take it higher in the coming quarters.

STRONG BUY*

Downside Scenario	Current Price	Price Target	Upside Scenario
	2,612	3,071	
		17.6% ▲	

Market Data	
Industry	Automobile
Sensex	36,257
Nifty	10,831
Bloomberg Code	HMCL:IN
Eq. Cap. (INR Crores)	40
Face Value (INR)	2
52-w H/L	3,862/2,562
Market Cap (INR Crores)	52,424

Valuation Data	FY19E	FY20E	FY21E
OPM	14.7%	15.0%	15.4%
NPM	10.0%	10.2%	10.5%
P/E (x)	14.8	12.9	10.9
EV/EBITDA (x)	10.0	8.7	7.3



	Shareholding Pattern (%)		
	Dec-17	Mar-18	Dec-18
Promoters	34.6%	34.6%	34.6%
FII	42.3%	41.9%	40.0%
DII	11.5%	12.0%	15.4%
Retail	11.5%	11.4%	10.1%
Total	100%	100%	100%

(INR Crores)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	28,500	32,230	35,168	39,824	45,330
Growth (%)	0.2%	13.1%	9.1%	13.2%	13.8%
EBITDA	4,635	5,280	5,160	5,965	6,999
Growth (%)	4.0%	13.9%	-2.3%	15.6%	17.3%
EBITDA Margin (%)	16.3%	16.4%	14.7%	15.0%	15.4%
PAT	3,377	3,697	3,529	4,057	4,771
Growth (%)	6.9%	9.5%	-4.6%	15.0%	17.6%
EPS (INR)	169	185	177	203	239
P/E (x)	17.7	19.0	14.8	12.9	10.9
EV/EBITDA (x)	12.9	13.3	10.0	8.7	7.3

Source: Company, NSPL Research

* Read last page for disclaimer & rating rationale



New Launches Can Kick-start Volume Growth

Hero has launched two new vehicles in the past few months viz. Destiny 125cc scooter and Xtreme 200 motorcycle in the premium segment. The strategy for a Destiny 125cc scooter is to provide upgrade to consumers in performance, features and styling. **The company would like to arrest its falling market share in the scooters category** and we expect multiple launches in this segment going ahead.

Its premium motorcycle Xtreme 200cc motorcycle was having a concerns about missing features, however, we believe these are early days in this category, the brand is uniquely positioned and will see far better new launches in the future. The management seems confident on growing this segment by launching newer feature oriented bikes. Its upcoming launch is xPulse in this category and more such launches expected in H1FY20.

Demand Outlook Positive

We expect Q4FY19 to be much better than Q3FY19 on account of marriage seasons, *Gudipadwa* festival, improved consumer sentiments on account of stabilization in the fuel prices & interest rates, understanding of the benefits of long term insurance & acceptance of the same. In addition, we think Hero will be the ultimate beneficiary of improving rural sentiments as the Government is focused on rural, which can improve the Agri as well as non-Agri income segments over there.

Moreover, due to rise in the cost of ownership, we got a feedback from our checks that the customers are preferring lower CC bikes, where Hero has a strong hold. In FY20, we expect pre-buying ahead of the implementation of BS6, expect some momentum to come from rural, a low base of FY19 and Hero's multiple new launches ahead can take its YoY volume growth higher in lower double digit in FY20E.

On Scooters, the industry has seen some stabilization on account of weak consumer sentiments in urban led by higher cost of ownership. Hence, people opted for a motorcycle, which is fuel efficient. The scooters got challenged from the value point of view in the rising fuel price scenario. Also, the 2W penetration level in urban household has increased and believe will see stable growth in the scooters going ahead. Hero has presence in 100-110 cc scooters, launched Destiny 125cc and expect to launch 125cc new maestro edge scooter, which we believe will provide a wider range of options for the customers in the fastest growing 125cc scooter segment.

The management sees improving retail momentum in the industry, especially post 15th January 2019. The retail sales in the 2nd half of Jan was higher by 35-50% vis-à-vis 1st half of January. The overall January month is looking better and expect the momentum to continue in Q4FY19.

On Exports, Hero is building it brick by brick by entering more countries and segments to pull sales. The company will keep investing in building scale and also making differentiated products as per the local countries requirements. For Hero, Bangladesh has been doing very well and has seen a pickup in Columbia with various actions. However, seen a setback in Sri Lanka.

Strong Product Pipeline

Hero has a strong hold in the lower CC motorcycles and its strategy is clear in the medium term that they want to grow its presence in the premium motorcycles and scooter segments. This will aid in improving its falling market share over the last few years. The company has launched Destiny 125cc scooter and will soon launch new Maestro Edge 125cc scooter. It also launched a new Xtreme 200cc motorcycle and multiple new launches are in the pipeline. **We believe the company's moat is in low cost manufacturing and its wide distribution reach and Hero's new launches would provide a stiff competition to the market leaders in the scooter and premium motorcycle. Moreover, the company's design capabilities also improved, this will aid in arresting its falling market share.**

Valuations

We expect the loan waivers will provide some relief to the farmers and would be sentimentally positive. Any measures in the upcoming budget for farmers and middle income families would be very positive for the rural focused stocks like Hero MotoCorp.

We have valued the company based on an average of PE and EV/EBITDA of FY20E. Hero MotoCorp in the past eight years has traded on an average 14.2x of its forward EPS and we have assigned the similar earning multiple to its FY20E EPS of Rs. 203. 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. 3,071 per share, maintained our strong buy rating.**



Q3FY19 Result Analysis

(INR Crores)	Q3FY19	Q3FY18	YoY (%)	Q2FY19	QoQ (%)	9MFY19	9MFY18	YoY (%)
Volumes (Nos)	17,98,905	17,09,107	5.3%	21,34,051	-15.7%	60,39,585	55,85,559	8.1%
Realization (Rs)	43,720	42,796	2.2%	42,599	2.6%	42,661	42,371	0.7%
Net sales	7,865	7,314	7.5%	9,091	-13.5%	25,766	23,666	8.9%
COGS	5,415	4,931	9.8%	6,300	-14.1%	17,879	16,042	11.5%
Employee Expenses	436	402	8.4%	434	0.4%	1,283	1,159	10.7%
Other Expenses	910	824	10.5%	978	-7.0%	2,743	2,556	7.3%
EBITDA	1,105	1,158	-4.6%	1,379	-19.9%	3,861	3,910	-1.2%
D&A	152	138	9.8%	152	0.0%	452	407	10.9%
Other income	188	110	70.6%	224	-16.1%	527	359	46.7%
EBIT	1,141	1,130	1.0%	1,451	-21.4%	3,936	3,862	1.9%
Interest Expense	2	2	37.6%	2	0.9%	6	5	36.1%
PBT	1,138	1,128	0.9%	1,448	-21.4%	3,930	3,857	1.9%
Tax	369	323	14.4%	472	-21.8%	1,275	1,127	13.1%
PAT	769	805	-4.5%	976	-21.2%	2,655	2,730	-2.8%
EPS in INR	39	40	-4.5%	49	-21.2%	133	137	-2.8%

Margin Analysis	Q3FY19	Q3FY18	YoY (%)	Q2FY19	QoQ (%)	9MFY19	9MFY18	YoY (%)
Material Expenses % Net Sales	68.8%	67.4%	1.4%	69.3%	-0.5%	69.4%	67.8%	1.6%
Gross Margin	31.2%	32.6%	-1.4%	30.7%	0.5%	30.6%	32.2%	-1.6%
Employee Expenses % Net Sales	5.5%	5.5%	0.0%	4.8%	0.8%	5.0%	4.9%	0.1%
Other Expenses % Net Sales	11.6%	11.3%	0.3%	10.8%	0.8%	10.6%	10.8%	-0.2%
EBITDA Margin (%)	14.0%	15.8%	-1.8%	15.2%	-1.1%	15.0%	16.5%	-1.5%
Tax Rate (%)	32.4%	28.6%	3.8%	32.6%	-0.2%	32.4%	29.2%	3.2%
PAT Margin (%)	9.8%	11.0%	-1.2%	10.7%	-1.0%	10.3%	11.5%	-1.2%

New R&D Facility: The company is in the process of building a tech centre in Germany, which will aid in building technically good products. Hero will make all the designing of its new products in its new tech centre, which is considered as an extension to its Jaipur tech centre. The new centre will also work on electric vehicles and other technologies.

On BS6, Hero would be ready before the implementation date. On CBS/ABS transition from 1st April 2019, the company's 50% of the portfolio has already migrated to it. The management has guided that the vehicle price increase would be Rs. 500 for CBS and Rs. 5,000 for ABS. Hero's portfolio is more skewed towards CBS vehicles & as there is a marginal price difference between CBS/Non-CBS vehicles, hence, there won't be much impact in this price sensitive Indian market.

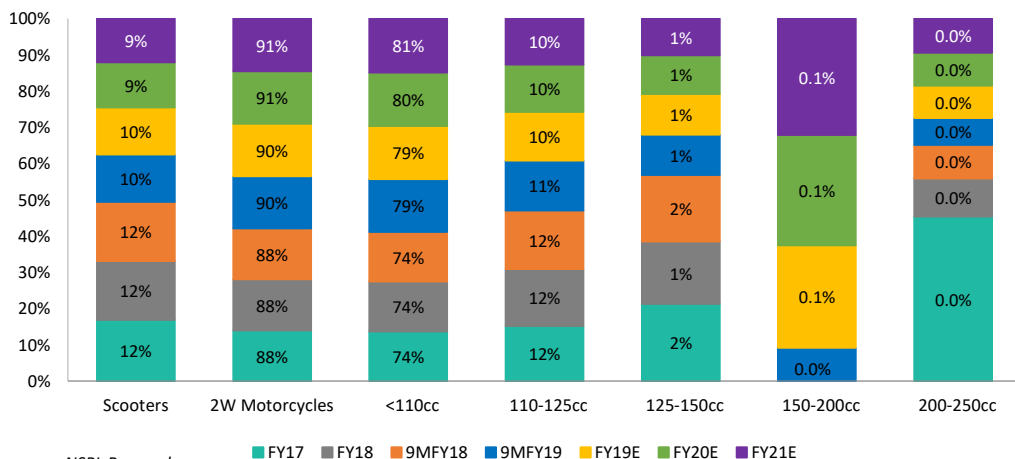
On Inventories: The normalized inventory levels are 4-6 weeks and at present it's 6-8 weeks across the industry as festive off take has not been good. The management expects it to come at normal levels by the end of Q4FY19.

Other income was higher by 71% YoY to Rs. 188 crores mainly due to higher MTM gains during the quarter.

Hero has invested Rs. 130 crores more in Ather Energy and its stake at present is 30% in it. Hero has been adopting two fold strategies on electric vehicles as they have their own in house R&D and invested in Ather Energy.

The revenues from spare parts is Rs. 730 crores in Q3FY19 vs. Rs. 692 crores, a growth of 5% YoY. In 9MFY19, it has seen a growth of 16% YoY to Rs. 2,045 crores.

Hero MotoCorp's Product Mix (%)



Source: Company, NSPL Research



Volume Projections

Hero MotoCorp Volume Assumptions	FY17	FY18	FY19E	FY20E	FY21E
Scooters	8,29,786	9,09,986	7,86,799	8,41,338	8,84,110
YoY Growth (%)	-7.4%	9.7%	-13.5%	6.9%	5.1%
2W Motorcycles	58,34,260	66,77,207	74,26,194	82,85,011	90,71,050
YoY Growth (%)	1.7%	14.4%	11.2%	11.6%	9.5%
<110cc	49,40,274	56,52,159	65,05,117	72,89,428	80,22,622
YoY Growth (%)	1.4%	14.4%	15.1%	12.1%	10.1%
110-125cc	7,74,640	9,15,400	8,43,772	9,14,390	9,63,693
YoY Growth (%)	6.4%	18.2%	-7.8%	8.4%	5.4%
125-150cc	1,18,315	1,09,376	77,055	80,908	84,415
YoY Growth (%)	-9.3%	-7.6%	-29.6%	5.0%	4.3%
200-250cc	1,031	272	250	285	319
YoY Growth (%)	-84.3%	-73.6%	-8.2%	14.0%	12.1%
Total Sales (Scooters + Motorcycles)	66,64,046	75,87,193	82,12,993	91,26,349	99,55,159
YoY Growth (%)	0.5%	13.9%	8.2%	11.1%	9.1%
Domestic	64,83,655	73,82,718	79,83,967	88,69,089	96,69,043
YoY Growth (%)	1.0%	13.9%	8.1%	11.1%	9.0%
Exports	1,80,391	2,04,475	2,29,026	2,57,259	2,86,116
YoY Growth (%)	-14.2%	13.4%	12.0%	12.3%	11.2%
Average Realization (Rs)	42,768	42,480	42,820	43,636	45,534
YoY Growth (%)	-0.3%	-0.7%	0.8%	1.9%	4.4%

Source: Company, NSPL Research

The street has concerns about the rise in the cost per vehicle post implementation of BS6, however, we expect the Government should take some measures to reduce the GST of 28% to 18% by that time, as 2Ws are not a luxury product and is generally used for mass mobility & income enabler for rural areas. There is a strong rationale behind reducing the GST, hence, we think the Government should reduce GST on 2Ws, which will benefit the industry as demand would remain intact.

Source: Company, NSPL Research

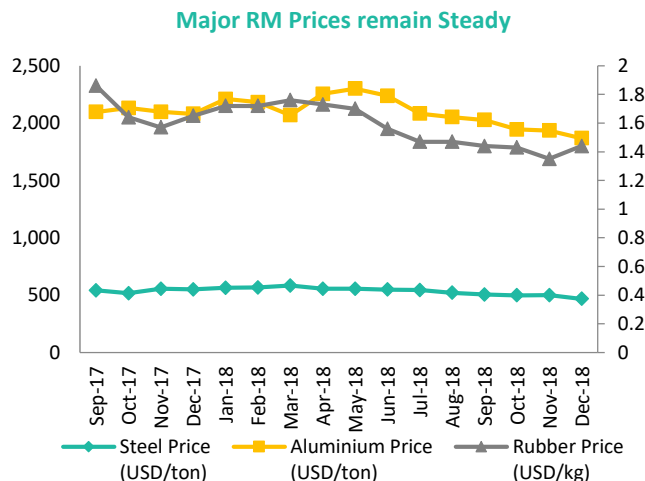
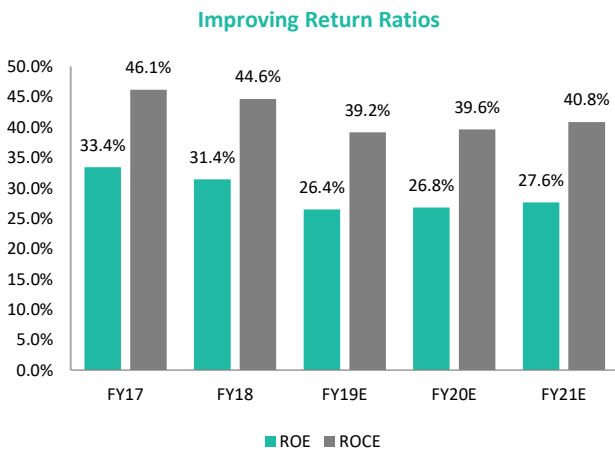
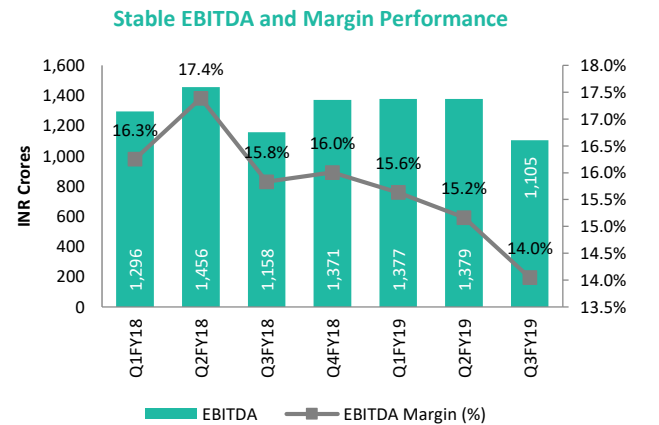
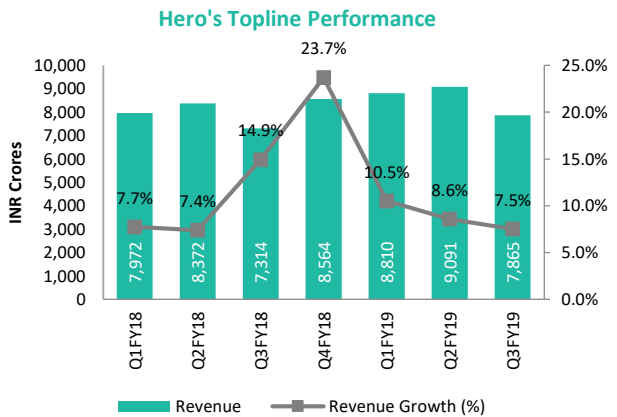
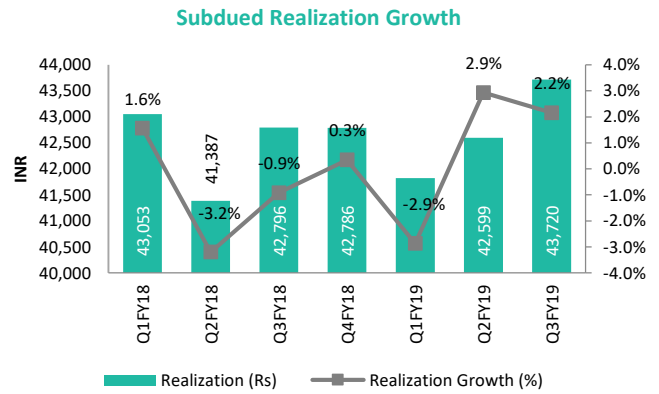
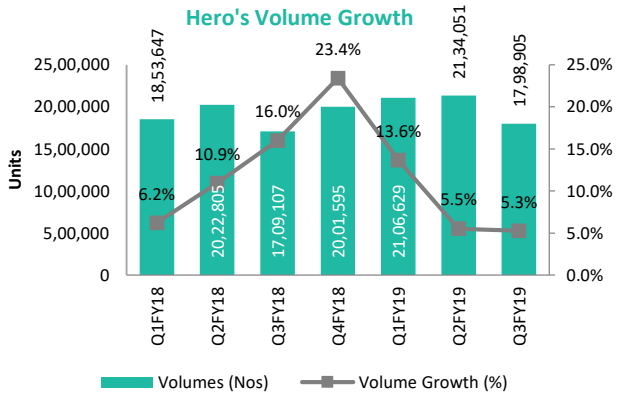
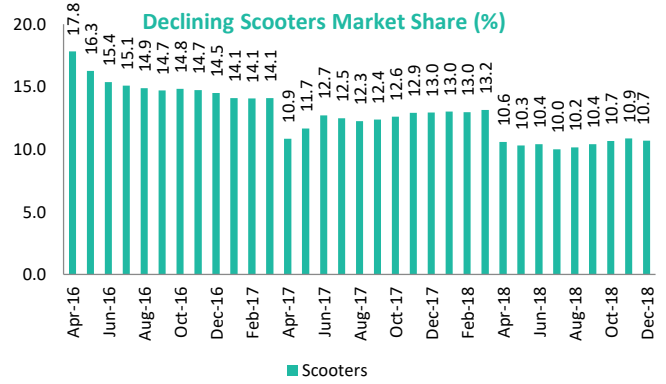
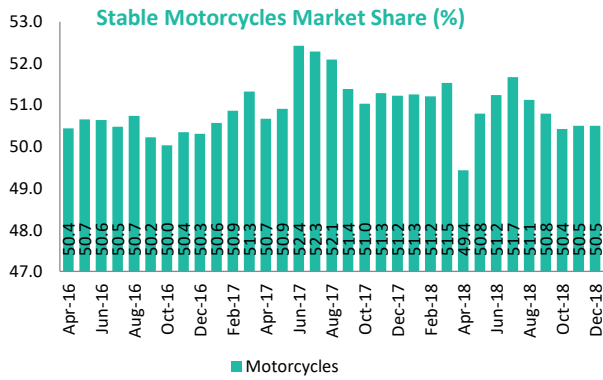
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Story in Charts



Source: Company, LME, NSPL Research

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Profit & Loss (INR Crores)	FY17	FY18	FY19E	FY20E	FY21E
Net sales	28,500	32,230	35,168	39,824	45,330
COGS	19,037	21,835	24,510	27,794	31,637
Employee Expenses	1,396	1,540	1,780	1,961	2,140
Other Expenses	3,432	3,576	3,718	4,104	4,554
EBITDA	4,635	5,280	5,160	5,965	6,999
D&A	493	556	646	736	811
Other income	522	526	713	779	877
EBIT	4,665	5,250	5,227	6,008	7,065
Interest Expense	6	6	7	7	7
PBT	4,658	5,244	5,221	6,001	7,058
Tax	-1,281	-1,547	-1,691	-1,944	-2,287
PAT	3,377	3,697	3,529	4,057	4,771
EPS in INR	169	185	177	203	239

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	204	227	240
(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	2,160	2,446	2,784
(f) Income tax assets (net)	332	379	378	434	510
(g) Other non-current assets	651	559	610	690	786
Total Non-Current Assets	7,241	7,891	8,841	10,042	11,017
Current Assets					
(a) Inventories	656	824	940	1,066	1,213
(b) <u>Financial assets</u>					
(i) Investments	4,541	5,591	6,101	6,908	7,864
(ii) Trade receivables	1,562	1,520	1,638	1,855	2,111
(iii) Cash and cash equivalents	15	34	293	342	809
(iv) Bank balances other than (iii) above	121	107	139	177	256
(v) Loans	24	28	30	34	39
(vi) Others	145	539	589	666	759
(c) Other current assets	388	205	224	253	288
Total Current Assets	7,453	8,848	9,953	11,302	13,339
Total Assets	14,694	16,739	18,794	21,345	24,356

EQUITY AND LIABILITIES

Equity

(a) Equity Share capital	40	40	40	40	40
(b) Other equity	10,071	11,729	13,308	15,123	17,258
Total Equity	10,111	11,769	13,348	15,163	17,298

LIABILITIES

Non-current liabilities

(a) Provisions	75	115	125	142	162
(b) Deferred tax liabilities (net)	414	512	509	586	689
Total Non - Current Liabilities	490	627	635	728	850

Current liabilities

(a) Financial liabilities					
(i) Trade payables	3,247	3,319	3,693	4,188	4,767
(ii) Other financial liabilities	353	202	221	250	284
(b) Other current liabilities	454	763	832	942	1,073
(c) Provisions	39	60	65	74	84
Total Current Liabilities	4,093	4,343	4,811	5,454	6,208
Total Equity and Liabilities	14,694	16,739	18,794	21,345	24,356

Source: Company, NSPL Research

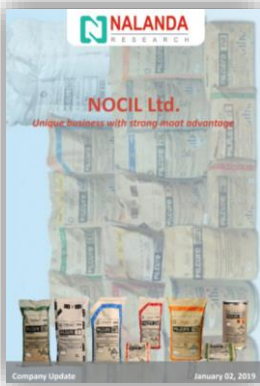


Cash Flow (INR Crores)	FY17	FY18	FY19E	FY20E	FY21E
Profit After Tax	3,377	3,697	3,529	4,057	4,771
Operating Profit before Working Capital Changes	4,815	5,315	5,164	5,969	7,004
Cash Generated from Operations	5,215	5,475	5,282	6,106	7,165
Less: income tax paid	1,186	1,494	1,691	1,944	2,287
Cash Flow from Operating	4,028	3,981	3,591	4,162	4,878
(Incr)/ Decr in Gross PP&E	-1,151	-802	-1,366	-1,514	-1,276
Cash Flow from Investing	-1,944	-1,915	-1,376	-1,864	-1,768
Dividends Paid (including tax on dividend)	-2,091	-2,043	-1,950	-2,242	-2,636
Finance costs	-6	-6	-7	-7	-7
Cash Flow from Financing	-2,096	-2,047	-1,957	-2,249	-2,644
Incr/(Decr) in Balance Sheet Cash	-12	19	258	49	467
Cash at the Start of the Year	27	15	34	293	342
Cash at the End of the Year	15	34	293	342	809

RATIOS	FY17	FY18	FY19E	FY20E	FY21E
Growth (%)					
Net Revenues	0.2%	13.1%	9.1%	13.2%	13.8%
EBITDA	4.0%	13.9%	-2.3%	15.6%	17.3%
PAT	6.9%	9.5%	-4.6%	15.0%	17.6%
Profitability					
Return on Capital (%)	46.1%	44.6%	39.2%	39.6%	40.8%
Return on Equity (%)	33.4%	31.4%	26.4%	26.8%	27.6%
Margin Trend					
EBITDA Margin (%)	16.3%	16.4%	14.7%	15.0%	15.4%
Net profit Margin (%)	11.8%	11.5%	10.0%	10.2%	10.5%
Solvency					
Total Debt / Equity	0.0	0.0	0.0	0.0	0.0
Valuation Ratios					
P/E	17.7	19.0	14.8	12.9	10.9
EV/EBITDA	12.9	13.3	10.0	8.7	7.3
P/B	5.9	6.0	3.9	3.4	3.0

Source: Company, NSPL Research

OUR RECENT REPORTS



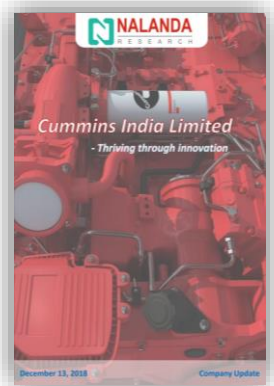
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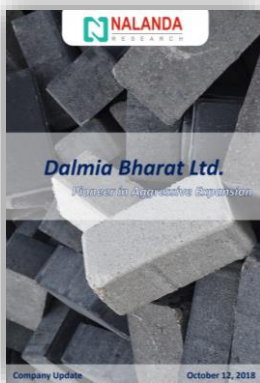
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Cummins India Ltd.



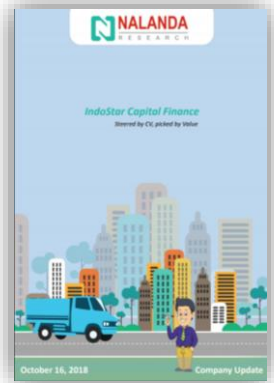
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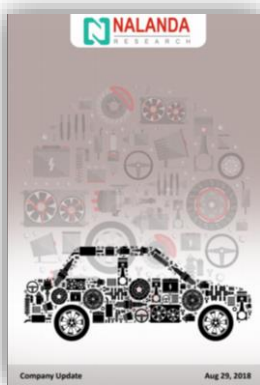
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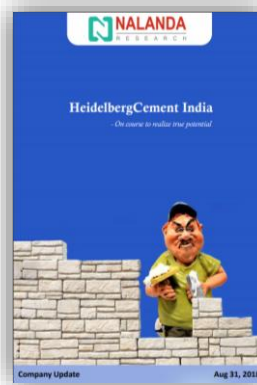
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Hero MotoCorp				Rating Legend	
Date	CMP (INR)	Target Price (INR)	Recommendation	Strong Buy	More than 15%
February 01, 2019	2,612	3,071	Strong Buy	Buy	5% - 15%
October 17, 2018	2,899	3,036	Hold	Hold	0 - 5%
				Reduce	-5% - 0
				Sell	Less than -5%

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