



Q2FY12 Result Update

CMP: Rs. 158.40

November 01, 2011

HDFC Sec Scrip ID	Industry	CMP	Recommended Action
AMTHITEQNR	Consumer Electronics	158.40	Exit between CMP and Rs.180

In our earlier update dated June 16, 2011, we had recommended buying the stock on dips to the Rs. 177-186 band for a target of Rs. 239. Thereafter the stock hit a high of Rs. 212.3 on 22nd July 2011 and a low of Rs. 136.0 on 26th August 2011. The stock is currently trading at Rs. 158.40.

Hitachi Home & Life Solutions (India) Ltd. (HHLI) recently declared its Q2FY12 results and reported net sales of Rs. 125.8 cr down 2.5% Y-o-Y and 61.4% Q-o-Q. The company reported an Operating loss of Rs. 5.7 cr in Q2FY12 vis-à-vis profits of Rs. 10.9 cr in Q2FY12 and Rs. 24.5 cr in Q1FY12. At the net level the company reported a loss of Rs. 7.3 cr vis-à-vis profits of Rs. 4.7 cr in Q2FY11 and Rs. 13.1 cr in Q1FY12.

Due to a milder summer, heightened competition and a slowdown in the economy due to global economic concerns, the company experienced a dip in YoY sales. QoQ dip in sales was expected (however not to such a large extent) as Q1 and Q4 are always the best quarters for the company due to the seasonal character of the industry. Sales are higher before and during the summer and cool off in Q2 and Q3. The company made an operating loss in the quarter as compared to profits in Q2FY11 and Q1FY12 largely because of rising commodity prices and a heavy forex loss.

Quarterly Financials

(Rs. Cr)

Particulars (Rs. Cr)	Q2FY12	Q2FY11	%YoY	Q1FY12	% QoQ	Q4FY11	Q3FY11
Net Sales	125.8	129.0	-2.5%	325.7	-61.4%	225.3	122.7
Other Operating Income	2.1	1.6	29.1%	2.4	-14.7%	2.0	1.2
Other Income	0.1	0.9	-94.1%	0.2	-78.0%	0.6	0.5
Total Income	127.9	131.4	-2.7%	328.4	-61.1%	228.0	124.4
Operating Expense	133.6	120.6	10.8%	303.9	-56.0%	214.7	119.5
Operating Profit	-5.7	10.9	-152.0%	24.5	-123.1%	13.3	4.9
OPM (%)	-4.5%	7.7%		7.4%		5.6%	3.5%
Interest	0.6	0.3	69.5%	0.9	-38.4%	0.8	0.5
Depreciation	4.4	3.7	17.7%	4.6	-5.3%	4.6	4.0
PBT	-10.6	6.8	-256.0%	18.9	-156.2%	7.9	0.4
Tax	-3.4	2.1	-258.2%	5.8	-158.1%	2.3	-0.1
PAT	-7.3	4.7	-255.0%	13.1	-155.4%	5.6	0.5
NPM (%)	-5.8%	3.6%		4.0%		2.5%	0.4%
EPS	-3.2	2.0	-255.0%	5.7	-155.4%	2.4	0.2
P/E	-12.5	19.4		6.9		16.2	171.2

(Source: HDFC Sec, Company)

Some of the key highlights of the quarter are as follows:

- HHLI reported a drop in sales – 2.5% YoY and 61.4% QoQ. The drop in sales can be attributed to lower volumes, which in turn was caused by a milder summer, heightened competition and economic slowdown. India's expected GDP growth for the year was revised downward during the quarter due to the poor performance of businesses in the quarter in line with the global meltdown caused by the European debt crisis.
- Operating margins were down YoY and QoQ due to higher operating expenses. The company's raw material expense was higher YoY despite lower sales. However, the largest unexpected expense was a forex loss of Rs. 7.8 cr on ECB loans borrowed. The appreciation of the Japanese Yen hurt HHLI heavily. HHLI had an ECB of 93 mn yen as on March 2011. This apart a lot of its raw materials and traded goods are imported (partly from group companies) denominated in USD and JPY. The Rupee depreciated against the JPY by 14.7% in Q2FY12 while it depreciated against the USD by 9.6%.
- AC sales have been sluggish this year due to a milder summer. There are reports of a ~15% decline in total AC sales in the industry compared to last year. HHLI's topline degrew 2.5% YoY, which is still better than the rest of the industry as the company increased its focus on new products launched specifically for smaller markets. However, unfavorable weather conditions and poor economic growth have definitely hindered growth for the year.



- Penetration in the AC industry in India is one of the lowest among the developing nations. Penetration in India is only ~3% while that in China is close to 20% and in US is ~90%. The AC industry in smaller nations such as Korea, Taiwan and Malaysia too has a higher penetration than that in India. On the other hand, per capita income is rising and could lead to higher sales if the economy stabilizes and grows. Reasonably priced stable power availability remains as issue in vast majority of the country (except metros and large cities).
- Bajaj Allianz Life Insurance Company Ltd bought a 2.6% stake in HHLI in the Q1FY12. However, total Indian Institutional holding fell in the quarter to 3.3% in Q2FY12 from 4.9% in the previous quarter.

Concerns

- Volatile raw material (especially copper and steel) prices have always been a significant threat. Raw material prices have been increasing, leading to lower operating profit margins. Raw material prices are expected to fall slightly going forward however, there may not be a major impact on the company's profitability.
- The company increased its loans in H1FY12 to Rs. 71.7 cr from Rs. 50.0 cr in H1FY11, however, loans fell from Rs. 90.0 cr at the end of FY11. While the company has a low gearing ratio of 0.40, the additional loan increases the gearing ratio and interest expense. Interest expenses were 69.5% higher YoY and 38.4% lower QoQ.
- Competition remains high from local and international players. HHLI's products are slightly higher in price than most competitors' products and Daikin is the only other significant competitor in that price range. However, the company has launched cheaper products targeting the Tier II and Tier III cities. Moreover, customers' preferences can get downgraded in times of economic distress leading a drop in sales and market share. The company has ~7% market share.
- HHLI's higher end products sell more in urban areas and the company is now trying to gain market share in rural areas as well. Majority demand in the AC industry comes from new product demand as compared to replacement demand. With a slowdown in the economy, real estate projects are taking longer than estimated to complete resulting in lackluster demand for new ACs in urban areas.
- Forex risk is high as HHLI imports raw material and traded goods from its group companies in Japan and elsewhere and the Yen/USD has been getting stronger in the recent months. The company has External commercial Borrowings (ECB) on which it reported forex losses of Rs. 7.8 cr in Q2FY12 as compared to Rs. 1.3 cr in Q2FY11, Rs. 1.6 cr in Q1FY12 and Rs. 5.3 cr in FY11. Forex loss in Q2FY12 was the biggest cause of losses in the quarter.
- The company operates in an industry that is seasonal in nature. Q4 and Q1 are good quarters as the sale of ACs increases before and during the summer. Q2 and Q3 are always dull quarters however the change in the economic and industry specific conditions have led to more disappointing results than expected. Moreover, sales in good quarters are also subject to the severity of the summer. Due to a milder than normal summer this year sales were lower than expected.
- Slowdown in the economy and high inflation could compel the consumer to prioritize his/her expenses differently as seen in Q2FY12.
- Employee cost in the quarter was higher than normal. Employee expense was 9.9% of net sales as compared to 7.5% in Q2FY11 and 3.6% in Q1FY12. Employee expense in FY11 was 5.8% of net sales.

Conclusion

HHLI's business performance in Q2FY12 was poor, below our expectations at the operating and net profit levels. The drop in operating margin this quarter was due to an increase in raw material cost, employee expense, other expense and largely due to a forex loss of Rs. 7.8 cr. The core business of the company remains the same with an increase in focus on Tier II and Tier III cities as the company attempts to capture the untapped markets.

The improvement in the standard of living and an increase in disposable income bode well for the household appliance industry as well as the company. ACs are increasingly being viewed as a necessity rather than a luxury. The AC segment is expected to be the fastest growing segment of the household appliances industry.

Raw material prices, forex risk and high competition are the biggest concerns for the company. An increase in loans YoY (after which the company still has a strong balance sheet), seasonality of the industry and a slowdown in the economy are some other concerns. The economy has indeed slowed down in Q2FY12 as a result of global economic turmoil, the effect of which is seen in the poor performance of HHLI in the quarter.

We have revised our FY12 estimates with a possible overachievement in the topline but much lower profit levels. Stabilization of Yen, softening of commodity prices, warmer than normal monsoon/winter and greater efficiency/increase in offtake could add to the upside for FY12.

In our earlier report dated June 16, 2011 we had recommended buying the stock on dips to Rs. 177 to Rs. 186 for a target of Rs. 239. Post the issue of the report the stock touched a low of Rs. 136.0 on 26th August 2011 and a high a Rs. 212.3 in 22nd July 2011.

Fundamentally, the peak season in FY12 has come to an end on a weaker note than expected due to a milder summer and lower purchasing power as an outcome of the poor economic conditions. While the company could have a mild topline growth in FY12, margins could fall sharply at the operating and net levels. Growth in EPS is expected to be negative due to the huge forex loss in the quarter accompanied with other high operating expenses. At the CMP, HHLI is trading at 28.6x its FY12 (E) EPS of Rs. 5.5.

An investment in the AC space and especially in Hitachi (due to the large forex exposure) seems risky in present times. While the long-term prospect of the company remains bright due to the rising income levels and changing demography accompanied by the well-known parentage, the stock may not perform in the near term (till Q4FY12 is out of way) due to the issues discussed above. Long-term investors who are not rattled by the temporary fall in the share prices could continue to hold, however, short-term investors could exit the stock between the CMP and Rs.180.

Financials

Annual Profit & Loss Account

(Rs. Cr)

Particulars (Rs. Cr)	FY07	FY08	FY09	FY10	FY11 (A)	%YoY	FY12 (OE)	FY12 (RE)
Net Sales	324.9	446.6	469.9	640.5	758.5	18.4%	818.7	832.0
Other Operating Income	0.0	0.0	0.0	0.0	7.6	#DIV/0!	0.0	0.0
Other Income	5.4	9.3	7.2	11.8	2.8	-76.7%	13.0	11.0
Total Income	330.3	455.9	477.1	652.3	768.9	17.9%	831.7	843.0
Operating Expense	301.1	400.6	439.7	582.0	710.9	22.1%	757.5	804.0
% of sales	92.7%	89.7%	93.6%	90.9%	93.7%		90.8%	90.8%
Operating Profit	29.2	55.3	37.4	70.3	58.0	-17.5%	74.2	39.0
OPM %	7.3%	10.3%	6.4%	9.1%	7.2%		7.5%	3.4%
Interest	2.4	0.8	2.7	1.5	2.0	35.5%	2.2	2.8
Depreciation	4.5	7.6	8.0	11.8	16.1	36.3%	17.9	19.0
PBT	22.2	46.9	26.7	57.0	39.9	-30.0%	54.1	17.2
Net Tax	2.9	4.6	5.7	10.9	10.6	-2.5%	13.5	4.5
Effective Tax Rate %	13.1%	9.9%	21.2%	19.1%	26.6%		25.0%	26.2%
PAT	19.3	42.2	21.1	46.1	29.3	-36.4%	40.6	12.7
NPM %	6.0%	9.5%	4.5%	7.2%	3.9%		5.0%	1.5%
EPS	8.4	18.4	9.2	20.1	12.8	-36.4%	17.7	5.5
P/E	18.8	8.6	17.3	7.9	12.4		9.0	28.6

(Source: HDFC Sec, Company)

Balance Sheet

(Rs. Cr)

Particulars (Rs. Cr)	FY07	FY08	FY09	FY10	FY11 (A)	FY12 (OE)	FY12 (RE)
SOURCES OF FUNDS							
Shareholders' Funds:							
Capital	23.0	23.0	23.0	23.0	23.0	23.0	23.0
Reserves & Surplus	38.8	60.5	81.6	123.7	149.0	186.0	157.7
	61.8	83.4	104.5	146.6	172.0	209.0	180.6
Loan Funds:							
Secured Loans	0.2	0.0	0.8	15.3	40.0	9.0	18.0
Unsecured Loans	33.2	11.7	49.7	44.7	50.1	45.0	63.0
	33.4	11.8	50.5	60.1	90.0	54.0	81.0
Net Deferred Tax	0.0	1.0	1.2	0.6	0.4	1.0	1.0
Total	95.2	96.2	156.3	207.3	262.4	264.0	262.6



APPLICATION OF FUNDS							
Fixed Assets:							
Gross Block	62.9	73.3	109.9	158.9	198.6	215.0	218.0
Depreciation	36.2	41.8	44.9	54.3	67.7	87.7	87.0
Net Block	26.6	31.5	65.0	104.6	130.9	127.4	131.0
Capital WIP	4.1	9.7	17.7	15.2	6.5	14.0	14.0
	30.7	41.1	82.7	119.8	137.5	141.4	145.0
Current Assets:							
Inventories	90.6	120.5	116.5	180.4	326.7	213.0	224.0
Sundry Debtors	59.4	90.0	81.8	96.0	124.9	118.0	116.0
Cash & Bank Balances	3.8	6.3	22.9	28.4	2.1	47.6	14.6
Other Current Assets	1.5	5.8	0.2	0.1	0.5	0.0	0.0
Loans & Advances	15.5	22.1	19.1	25.3	30.7	34.0	43.0
	170.9	244.7	240.4	330.2	484.9	412.6	397.6
Current Liabilities							
Provisions	121.9	184.8	161.9	229.6	344.9	276.0	266.0
	5.1	4.8	4.8	13.1	15.1	14.0	14.0
	126.9	189.7	166.8	242.7	360.0	290.0	280.0
Net Current Assets	43.9	55.0	73.6	87.5	124.9	122.6	117.6
P&L Account							
	20.6	0.0	0.0	0.0	0.0	0.0	0.0
Total	95.2	96.2	156.3	207.3	262.4	264.0	262.6

(Source: HDFC Sec. Company)

Analyst: Kushal Sanghrajka (kushal.sanghrajka@hdfcsec.com)

RETAIL RESEARCH Fax: (022) 3075 3435

Corporate Office: HDFC Securities Limited, I Think Techno Campus, Bulding –B. "Alpha", Office Floor 8, Near Kanjurmarg Station, Opp. Crompton Greaves, Kanjurmarg (East), Mumbai 400 042 Fax: (022) 30753435 Website: www.hdfcsec.com Email: hdfcsecretailresearch@hdfcsec.com

Disclaimer: This document has been prepared by HDFC Securities Limited and is meant for sole use by the recipient and not for circulation. This document is not to be reported or copied or made available to others. It should not be considered to be taken as an offer to sell or a solicitation to buy any security. The information contained herein is from sources believed reliable. We do not represent that it is accurate or complete and it should not be relied upon as such. We may have from time to time positions or options on, and buy and sell securities referred to herein. We may from time to time solicit from, or perform investment banking, or other services for, any company mentioned in this document. **This report is intended for Retail Clients only and not for any other category of clients, including, but not limited to, Institutional Clients**