

HERO MOTOCORP

In the slow lane

India Equity Research | Automobiles



Hero Motocorp's (HMCL) Q1FY13 profit after tax of INR6.2bn (up 10.3% YoY and 2% QoQ) was 4.4% below our expectation (Street as well) on lower EBITDA margin (15.0% against our 15.6% estimate). Despite price hike during the quarter, average realisation was flat QoQ due to poor product mix. Pressure on margin is likely to persist in the near term due to higher marketing expenses (on new product launches) and INR depreciation. Management expects to outgrow industry in FY13 and estimates 10% growth, though risks are rising due to weak monsoon. We have estimated 7% volume growth in FY13. Maintain 'REDUCE' with a target price of INR1,870.

Numbers disappoint on weak margins

Major disappointment in Q1FY13 has been the 50bps QoQ contraction in gross margin despite the benefit of INR pullback in Q4FY12 (input cost hits with a quarter lag). Average realisation was flat QoQ despite price hike taken during the quarter due to poor product mix. Weak INR increased royalty amortisation by 6% QoQ to ~INR2.2bn. Consequently, PAT at INR6.2bn was 4% below our estimate.

Deteriorating outlook

Management accepted that off late, sales are slowing down and inventories have risen to one month at dealers' end. Weak monsoon is becoming a key risk, though the company still maintains 10% volume growth for FY13 (we expect 7%). Margin pressure is likely to continue due to weak INR in FY13 and partial loss of tax shield at the Haridwar plant in FY14. HMCL has increased capex guidance to INR25bn from our earlier expectation of INR13.5bn over FY13-14. As a result, we lower our FY13/14E EPS 1.2/2.7% to factor in higher depreciation and lower other income.

Outlook and valuations: Unfavourable; maintain 'REDUCE'

Outlook for HMCL is weak on poor monsoon and weak INR. Expensive valuation of 16x FY13E and 15x FY14E does not give comfort either. We maintain 'REDUCE/Sector Underperformer' recommendation/rating and roll forward target price to FY14E at INR1,870, valuing it 13.5x FY14E core EPS of INR120 + 0.8x FY14E cash/share of INR250.

EDELWEISS 4D RATINGS

Absolute Rating	REDUCE
Rating Relative to Sector	Underperformer
Risk Rating Relative to Sector	Medium
Sector Relative to Market	Overweight

MARKET DATA (R: HROH.BO, B: HMCL IN)

CMP	: INR 2,089
Target Price	: INR 1,870
52-week range (INR)	: 2,279 / 1,703
Share in issue (mn)	: 199.7
M cap (INR bn/USD mn)	: 417/ 7,562
Avg. Daily Vol.BSE/NSE('000)	: 561.0

SHARE HOLDING PATTERN (%)

	Current	Q4FY12	Q3FY12
Promoters %	52.2	52.2	52.2
MF's, FI's & BK's	5.9	5.4	4.2
FII's	33.2	33.8	34.8
others	8.6	8.7	8.8
* Promoters pledged share (% of share in issue)	:	NIL	

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Auto Index
1 month	0.0	1.0	(0.8)
3 months	(24.9)	(1.8)	(11.5)
12 months	(46.4)	(7.0)	7.4

Financials

(INR mn)

Year to March	Q1FY13	Q1FY12	% change	Q4FY12	% change	FY12	FY13E	FY14E
Net revenue	62,078	56,376	10.1	59,625	4.1	233,681	251,107	282,273
EBITDA	9,369	8,281	13.1	9,253	1.3	33,938	37,522	41,379
Adj, net profit	6,155	5,579	10.3	6,036	2.0	23,781	25,827	26,727
Dil. EPS (INR)	30.8	27.9	10.3	30.2	2.0	119.1	129.3	133.8
P/E (x)						17.5	16.1	15.6
EV/EBITDA (x)						10.9	9.5	8.5

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Quarterly analysis

Weak product mix negated the benefit of price hike undertaken in May, and as a result average realisation declined 30bps QoQ. It also reflected in lower gross and EBITDA margins. Other expenditure was low due to restricted promotion activities, which is likely to increase Q2FY13 onwards as new launches gather momentum. Weak INR increased royalty amortisation by 6% QoQ to INR2.2bn. Tax rate was low at 16.3% versus 19.2% in Q4FY12 due to higher production at the Haridwar plant.

Key takeaways from earnings conference call

Industry outlook: Bleak

Management expects industry growth to be below 10% in FY13. Weak monsoon has shaken confidence. Demand has slowed down and inventories have risen to one month level at dealers' end.

Company outlook: Banking on new launches

Targeting to outgrow the industry on back of new launches and gain in market shares. HMC is banking on new scooter *Maestro* where marketing push will start from Q2FY13. It also launched *Ignitor* motorcycle recently.

Margin to be muted in Q2FY13 primarily on two counts:

- Higher marketing expenses.
- Part impact of INR depreciation felt in Q1FY13 and balance will come in Q2FY13.

Capex

- Total capex for domestic markets stands at INR25bn spread over 18-24 months.
- Neemrana plant with capacity of 700k units will be operation by H1FY14.
- Gujarat plant with initial capacity of 750k will be operational by March FY14.
- Total capacity will increase to 9mn by 2014.
- A part of capex will also be towards research and development.

Others:

- Despite price hikes, average realisation is flat QoQ due to poor product mix.
- Paid ~INR2.2bn as royalty during the quarter.
- Maintains dividend payout policy of 40-45%.
- Haridwar contributed 38% to total production.
- In June, HMC faced production constraints in scooters.
- Looking aggressively to increase contribution from exports led by 100/125cc models.

Financial snapshot
Volume analysis

Year to March	Q1FY13	Q1FY12	% change	Q4FY12	% change	FY12	FY13E	FY14E
Two wheelers	1,642,292	1,529,577	7.4	1,572,027	4.5	6,235,141	6,663,572	7,423,179
Net realisation (INR)	37,799	36,858	2.6	37,929	(0.3)	37,478	37,684	38,026

Financial analysis

Year to March	Q1FY13	Q1FY12	% change	Q4FY12	% change	FY12	FY13E	FY14E
Total revenues	62,473	56,817	10.0	60,349	3.5	233,681	251,107	282,273
Raw material	46,026	42,448	8.4	44,183	4.2	172,816	182,843	206,742
Staff costs	2,046	1,645	24.4	1,923	6.4	7,355	7,943	8,658
Other expenses	5,032	4,443	13.3	4,991	0.8	19,572	22,799	25,494
Total expenditure	53,104	48,536	9.4	51,097	3.9	199,743	213,585	240,894
EBIDTA	9,369	8,281	13.1	9,253	1.3	33,938	37,522	41,379
Depreciation and amorti	3,035	2,398		2,804		10,974	12,632	13,176
EBIT	6,334	5,883	7.7	6,448	(1.8)	22,963	24,889	28,203
Interest (net)	29	125	(76.6)	29	0.0	103	197	197
Other income	1,044	938	11.4	1,050	(0.5)	5,787	6,424	6,705
PBT	7,349	6,696	9.8	7,469	(1.6)	28,647	31,116	34,711
Tax	1,194	1,117	6.9	1,433	(16.7)	4,866	5,290	7,983
Adjusted net profit	6,155	5,579	10.3	6,036	2.0	23,781	25,827	26,727
Reported net profit	6,155	5,579	10.3	6,036	2.0	23,781	25,827	26,727

Margin analysis (as % of total revenues)

Year to March	Q1FY13	Q1FY12	bps change	Q4FY12	bps change	FY12	FY13E	FY14E
Raw material	73.7	74.7	(104)	73.2	46	74.0	72.8	73.2
Staff costs	3.3	2.9	38	3.2	9	3.1	3.2	3.1
Other expenses	8.1	7.8	23	8.3	(21)	8.4	9.1	9.0
EBIDTA	15.0	14.6	42	15.3	(34)	14.5	14.9	14.7
EBIT	10.1	10.4	(22)	10.7	(55)	9.8	9.9	10.0
Adjusted net profit	9.9	9.8	3	10.0	(15)	10.2	10.3	9.5
Tax rate	16.3	16.7	(43)	19.2	(293)	17.0	17.0	23.0

Source: Edelweiss research
Revised estimates

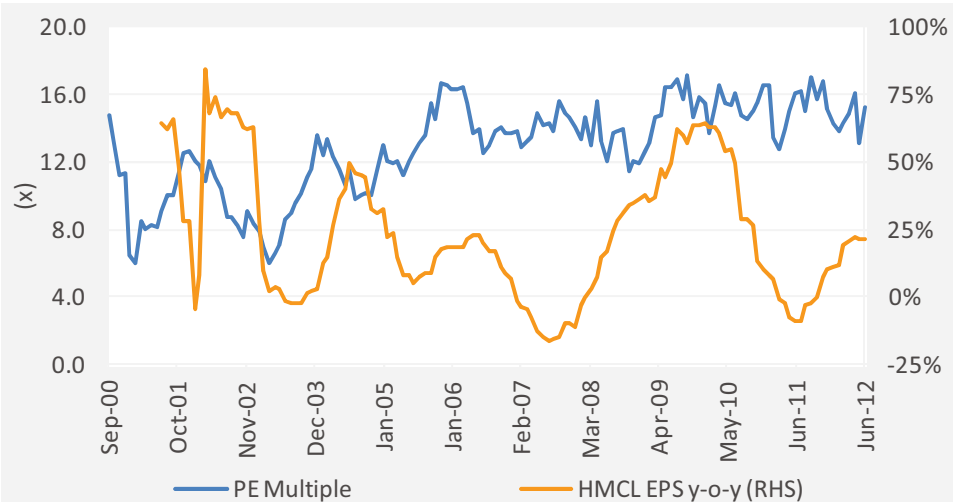
Year to March	FY13E			FY14E			Comments
	Earlier	Revised	% change	Earlier	Revised	% change	
Volumes (nos)	6,663,572	6,663,572	-	7,423,179	7,423,179	-	
Net sales	251,107	251,107	-	282,273	282,273	-	
EBITDA	37,522	37,522	-	41,379	41,379	-	
EBITDA margin (%)	14.9	14.9		14.7	14.7		
Adj. PAT	26,138	25,827	(1.2)	27,460	26,727	(2.7)	Lowered due to higher depreciation and lower other income as capex guidance has increased
PAT margin (%)	10.4	10.3		9.7	9.5		
EPS	130.9	129.3	(1.2)	137.5	133.8	(2.7)	
Capex	4,500	11,000	144.4	9,000	14,000	55.6	Increased for new plant and R&D

Source: Edelweiss research

Outlook and valuations: Unfavourable; maintain 'REDUCE'

On poor monsoon and weak INR, outlook for HMC is weak. Expensive valuation of 16x FY13E and 15x FY14E does not give comfort either (average multiple has been 13.5 in past 10 years with band being 6-17). We maintain 'REDUCE/Sector Underperformer' and roll forward target price to FY14E at INR1,870, valuing it 13.5x FY14E core EPS of INR120 + 0.8x FY14E cash/share of INR250.

Chart 1: One year forward PE versus EPS growth



Source: Factset, Edelweiss research

Table 1: Volume assumptions

	FY10	FY11	FY12	FY13E	FY14E
Motorcycle	4,385,858	5,040,971	5,789,638	6,171,492	6,845,191
Domestic	4,293,991	4,926,390	5,655,659	5,991,492	6,485,191
Exports	91,867	114,581	133,979	180,000	360,000
Scooter	214,272	361,473	445,503	492,079	577,988
Domestic	208,440	342,991	409,780	432,079	477,988
Exports	5,832	18,482	35,723	60,000	100,000
Total	4,600,130	5,402,444	6,235,141	6,663,572	7,423,179

Table 2: Product mix (% total sales)

	FY10	FY11	FY12	FY13E	FY14E
Motorcycle	95.3	93.3	92.9	92.6	92.2
Domestic	93.3	91.2	90.7	89.9	87.4
Exports	2.0	2.1	2.1	2.7	4.8
Scooter	4.7	6.7	7.1	7.4	7.8
Domestic	4.5	6.3	6.6	6.5	6.4
Exports	0.1	0.3	0.6	0.9	1.3
Total	100.0	100.0	100.0	100.0	100.0

Source: Edelweiss research

Table 3: Edelweiss Vs consensus

(INR mn)

Particulars	FY13E			FY14E		
	Edelweiss	Consenses	% var	Edelweiss	Consenses	% var
Sales (INR mn)	251,107	263,078	(4.6)	282,273	296,517	(4.8)
EBITDA (INR mn)	37,522	37,367	0.4	41,379	42,048	(1.6)
EBITDA (%)	14.9	14.2		14.7	14.2	
EPS (INR)	129.3	137.6	(6.0)	133.8	147.4	(9.2)

Source: Edelweiss research

Quarterly trend

Chart 2: Growth moderating

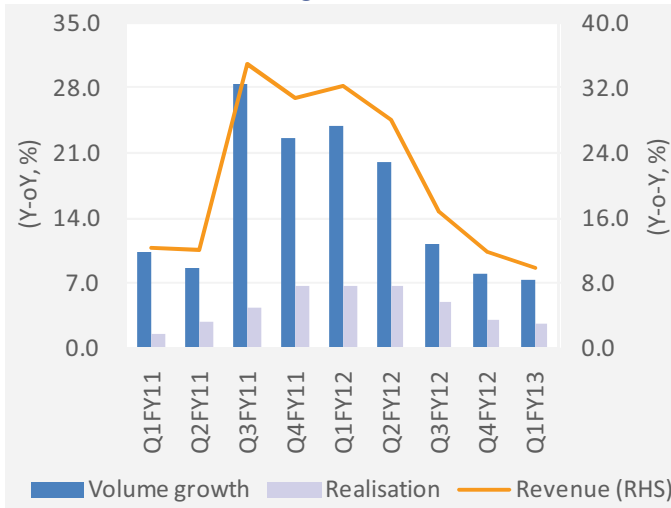
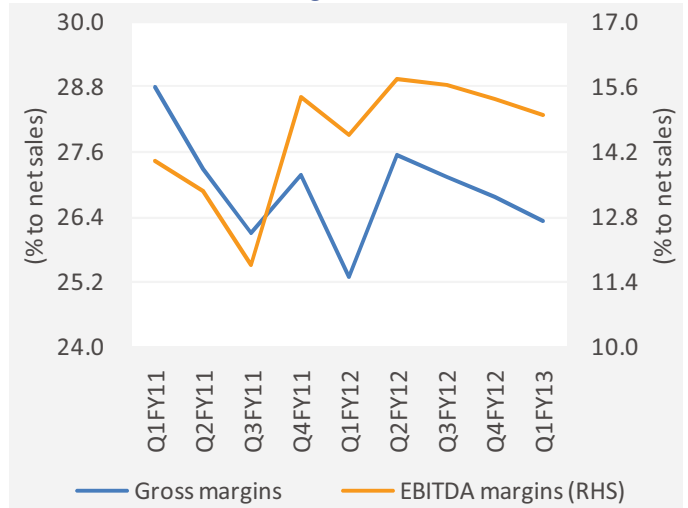
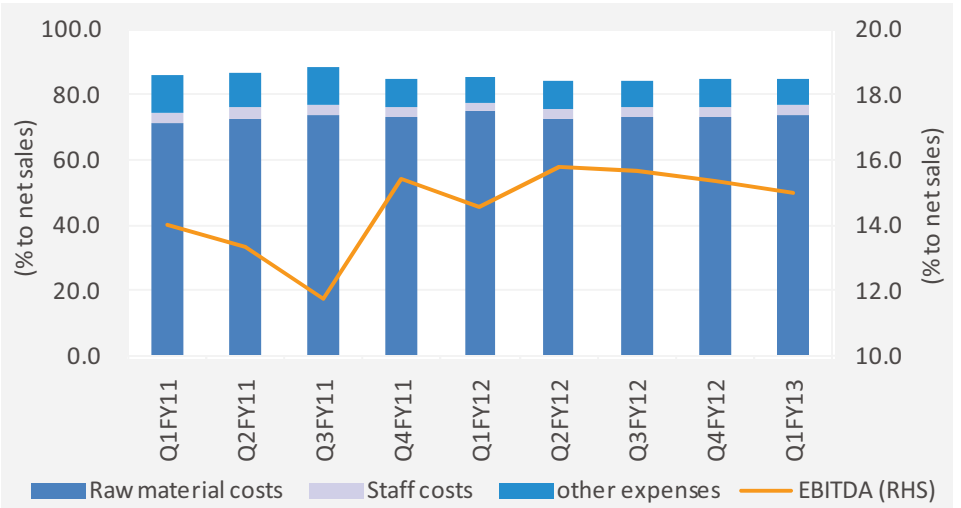


Chart 3: Gross/EBITDA margin fell QoQ



Source: Company, Edelweiss research

Chart 4: Quarterly cost matrix



Source: Company, Edelweiss research

Company Description

HMC is the world's largest two-wheeler company (in volume terms). It has a production capacity of 6.5 mn two wheelers at its two manufacturing facilities at Gurgaon and Dharuhera in Haryana and one at Uttaranchal. The company offers motorcycles in all the three major segments—CD Dawn and CD Deluxe in entry; Splendour, Passion, and Glamour in executive; and Hunk, Achiever, CBZ and Karizma in premium. It also sells Pleasure in the ungeared scooter segment.

Investment Theme

Volume growth is likely to slow down as economy slows down. It increases the risk of company missing its sales guidance in FY13. Margins are also under pressure due to weak INR, poor product mix and partial withdrawal of tax benefits at Haridwar plant in FY14.

Key Risks

Higher-than-expected sales

Any government measures to boost the rural demand either in form of credit boost or agri prices boost could lead to better than expected industry demand.

Other risks

- Include below estimated metal cost inflation
- Rapid ramp up in exports are key upside risk.

Financial Statements

Key assumptions

Hero Motocorp		FY10	FY11	FY12	FY13E	FY14E
Macro -	GDP (Y-o-Y %)	8.4	8.4	6.5	6.4	7.0
	Inflation (Avg)	3.6	9.9	8.8	7.0	6.0
	Repo rate (exit rate)	5.0	6.8	8.5	7.3	6.8
	USD/INR (Avg)	47.4	45.6	47.9	53.5	50.0
Industry-	Motorcycle - dom. vol. (% YoY)	25.7	23.0	11.9	6.0	12.0
	Steel prices (INR/t)	32,792	36,854	38,500	39,200	39,200
	Aluminium prices (USD/t)	1,868	2,257	2,316	2,300	2,400
Company-	Motorcycle - domestic volume (% YoY)	23.1	14.7	14.8	5.9	8.2

Income statement

		(INR mn)				
Year to March		FY10	FY11	FY12	FY13E	FY14E
Total volume (nos)		4,600,130	5,402,444	6,235,141	6,663,572	7,423,179
% Growth		23.6	17.4	15.4	6.9	11.4
Income from operations		157,582	192,450	233,681	251,107	282,273
Materials costs		107,364	141,111	172,816	182,843	206,742
Manufacturing expenses		2,245	2,653	2,786	2,925	3,071
Staff costs		5,603	6,190	7,355	7,943	8,658
S G & A expenses		15,748	17,894	16,787	19,874	22,423
Total operating expenses		130,960	167,848	199,743	213,585	240,894
EBITDA		26,622	24,603	33,938	37,522	41,379
Depreciation and amortisation		1,915	4,024	10,974	12,632	13,176
Interest		21	158	103	197	197
Non-operational income		3,633	4,425	5,787	6,424	6,705
Profit before tax		28,319	24,846	28,647	31,116	34,711
Provision for tax		5,999	4,928	4,866	5,290	7,983
Adjusted net profit		22,320	19,918	23,781	25,827	26,727
Profit after tax		22,320	19,279	23,781	25,827	26,727
Diluted EPS		111.8	99.7	119.1	129.3	133.8
Dividend per share		110.0	105.0	45.0	50.0	52.0

Common size metrics- as % of net revenues

Year to March		FY10	FY11	FY12	FY13E	FY14E
Materials costs		68.1	73.3	74.0	72.8	73.2
S G & A expenses		10.0	9.3	7.2	7.9	7.9
Depreciation		1.2	2.1	4.7	5.0	4.7
EBITDA margins		16.9	12.8	14.5	14.9	14.7
Net profit margins		14.2	10.3	10.2	10.3	9.5

Growth metrics (%)

Year to March		FY10	FY11	FY12	FY13E	FY14E
Revenues		27.9	22.1	21.4	7.5	12.4
EBITDA		58.1	(7.6)	37.9	10.6	10.3
Net profit		74.3	(10.8)	19.4	8.6	3.5
EPS		74.3	(10.8)	19.4	8.6	3.5

Balance sheet					
(INR mn)					
As on 31st March	FY10	FY11	FY12E	FY13E	FY14E
Equity capital	399	399	399	399	399
Reserves & surplus	34,251	29,161	42,428	56,573	71,150
Shareholders funds	34,650	29,561	42,828	56,972	71,550
Unsecured loans	660	327	6,792	6,792	6,792
Borrowings	660	327	6,792	6,792	6,792
Deferred payment credit	0	14,585	20,268	11,148	2,028
Deferred tax (Net)	1,528	2,468	2,468	2,468	2,468
Sources of funds	36,838	46,940	72,355	77,379	82,837
Gross block	27,510	55,385	75,245	86,245	100,245
Depreciation	10,922	14,582	25,556	38,189	51,365
Net block	16,588	40,803	49,688	48,056	48,880
Capital work in progress	481	1,251	1,251	1,251	1,251
Investments	39,257	51,288	51,288	65,951	72,436
Inventories	4,364	5,249	6,374	6,849	7,699
Sundry debtors	1,084	1,306	1,586	1,704	1,915
Cash and bank balance	19,072	715	868	933	1,049
Loans and advances	4,306	7,775	7,775	7,775	7,775
Total current assets	28,826	15,046	16,603	17,262	18,439
Sundry creditors	22,076	36,659	35,541	43,038	45,600
Provisions	26,239	24,789	10,934	12,103	12,570
Total current liab. & provisions	48,314	61,448	46,476	55,141	58,170
Net current assets	(19,488)	(46,402)	(29,872)	(37,879)	(39,731)
Uses of funds	36,838	46,940	72,355	77,379	82,837
Book value per share (BV) (INR)	174	148	214	285	358

Free cash flow

Year to March	FY10	FY11	FY12E	FY13E	FY14E
Net profit	22,320	19,279	23,781	25,827	26,727
Depreciation	1,915	4,024	10,974	12,632	13,176
Deferred tax	83	940	0	0	0
Others	(83)	(2,763)	(9,111)	(8,177)	(9,120)
Gross cash flow	24,235	21,480	25,645	30,282	30,783
Less: Changes in WC	(5,268)	(452)	1,588	(5,960)	(1,500)
Operating cash flow	29,503	21,933	24,057	36,243	32,283
Less: Capex	2,041	3,490	6,000	11,000	14,000
Free cash flow	27,462	18,442	18,057	25,243	18,283

Cash flow metrics

Year to March	FY10	FY11	FY12E	FY13E	FY14E
Operating cash flow	29,503	21,933	24,057	36,243	32,283
Financing cash flow	(5,016)	(24,769)	(17,904)	(10,514)	(11,682)
Investing cash flow	(7,611)	(15,521)	(6,000)	(25,664)	(20,485)
Net cash flow	16,876	(18,357)	153	65	116
Capex	(2,041)	(3,490)	(6,000)	(11,000)	(14,000)
Dividend paid	(4,973)	(25,540)	(24,369)	(10,514)	(11,682)

Profitability & liquidity ratios

Year to March	FY10	FY11	FY12E	FY13E	FY14E
ROAE (%)	61.4	62.0	65.7	51.8	41.6
ROACE (%)	73.5	59.7	48.2	41.8	43.6
Inventory days	13	12	12	13	13
Debtors days	3	2	2	2	2
Payable days	63	76	76	78	78
Cash conversion cycle (days)	(47)	(61)	(62)	(63)	(63)
Current ratio	0.6	0.2	0.4	0.3	0.3
Debt/EBITDA	0.0	0.0	0.2	0.2	0.2
Gross Fixed asset turnover (x)	6.0	4.6	3.6	3.1	3.0

Operating ratios

Year to March	FY10	FY11	FY12E	FY13E	FY14E
Total asset turnover	4.1	4.6	3.9	3.4	3.5
Net Fixed asset turnover	9.7	6.7	5.2	5.1	5.8
Equity turnover	4.3	6.0	6.5	5.0	4.4

Valuation parameters

Year to March	FY10	FY11	FY12E	FY13E	FY14E
EPS (INR)	111.8	99.7	119.1	129.3	133.8
Y-o-Y growth (%)	74.3	(10.8)	19.4	8.6	3.5
CEPS (INR)	121.8	124.6	174.0	192.6	199.8
Diluted adjusted P/E (x)	18.7	20.9	17.5	16.1	15.6
Price/BV (x)	12.0	14.1	9.7	7.3	5.8
EV/Sales (x)	2.3	1.9	1.6	1.4	1.2
EV/EBITDA (x)	13.5	14.8	10.9	9.5	8.5
Dividend yield (%)	5.3	5.0	2.2	2.4	2.5

Peer comparison valuation

Company	Bloomberg Ticker	Price INR	Market-cap (INRbn)	PE (x)		EV/EBITDA (x)		RoE (%)	
				FY13E	FY14E	FY13E	FY14E	FY13E	FY14E
Hero Motocorp	HMCL IN	2,088	416,974	16.1	15.6	9.5	8.5	51.8	41.6
Bajaj Auto	BJAUT IN	1,549	448	14.3	11.1	9.2	6.6	46.3	46.7
TVS Motor	TVSL IN	39	19	7.3	6.6	5.1	4.7	20.8	19.8
Maruti Suzuki	MSIL IN	1,117	323	12.2	9.6	6.0	4.4	16.0	17.3
Yamaha	7272 JP	477	167	7.4	5.7	4.5	3.7	10.3	12.4
Honda	7267 JP	1,703	3,085	8.5	7.4	7.6	6.7	11.3	11.8

Source: Bloomberg, Edelweiss research

Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
Ashok Leyland	BUY	SP	H	Bajaj Auto	BUY	SO	H
Eicher Motors	BUY	SO	M	Exide Industries	HOLD	SP	L
Hero MotoCorp	REDUCE	SU	M	Mahindra & Mahindra Ltd	BUY	SO	M
Maruti Suzuki India Ltd	BUY	SO	H	Tata Motors Ltd	BUY	SP	H

ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return