

HEROMOTOCO

NEUTRAL

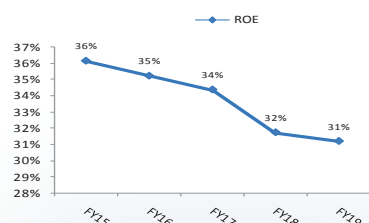
12-May-17

INDUSTRY - AUTOMOBILE
BSE Code - 500182
NSE Code - HEROMOTOCO
NIFTY - 9422

Company Data

CMP	3463
Target Price	3575
Previous Target Price	3800
Upside	3%
52wk Range H/L	3740/2844
Mkt Capital (Rs Cr)	69,171
Av. Volume ('000)	22

RoE to drop sharply by 320 bps in FY19

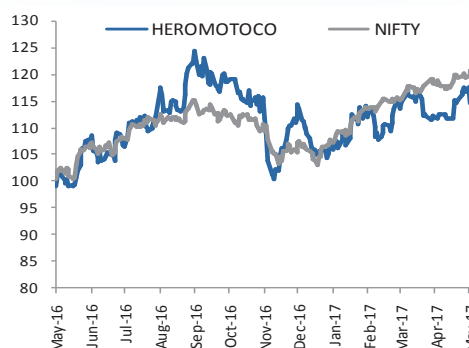


Shareholding patterns %

	4QFY17	3QFY17	2QFY17
Promoters	34.6	34.6	34.6
Public	65.4	65.4	65.4
Total	100.0	100.0	100.0

Stock Performance %

	1Mn	3Mn	1Yr
Absolute	8.2	7.4	16.9
Rel.to Nifty	6.2	0.3	(2.5)



NAVEEN KUMAR DUBEY

Naveen.dubey@narnolia.com

Key Highlights of the Report:

- ✓ Rising commodity prices and transition from BS-III to BS-IV restricted the company to expand its profitability and the company reported weakest EBITDA margin in last 8 quarters.
- ✓ Higher depreciation on Halol plant will lead to further contraction in profitability as the plants will take at least 6-8 months to ramp up.
- ✓ Hero Motocorp is the market leader in the entry segment motorcycle and commands over 50% market share in that segment. The company has lost 4-5 percent market share in FY17 to Honda Motorcycle, which has grown fiercely in the Indian two wheeler market.
- ✓ We expect 320bps deterioration in FY19E RoE. Considering the margin contraction and uncertainty regarding GST we reduce our target from Rs.3800 to Rs.3575 and change our rating from BUY to NEUTRAL.

Financials/Valu	FY15	FY16	FY17	FY18E	FY19E
Net Sales	27,538	28,457	28,585	30,971	33,473
EBITDA	3,497	4,398	4,576	5,206	5,926
EBIT	2,956	3,954	4,074	4,618	5,279
PAT	2,365	3,112	3,546	3,793	4,309
EPS (Rs)	118	156	178	190	216
EPS growth (%)	12%	32%	14%	7%	14%
ROE (%)	36%	35%	34%	32%	31%
ROCE (%)	45%	44%	39%	38%	38%
BV	328	442	517	599	692
P/B (X)	8	7	6	6	5
P/E (x)	22	19	19	17	15

RECENT DEVELOPMENTS:

- ✓ The Halol Plant at Gujarat has started commercial production in 4QFY17. The first phase capacity of Halol plant is 12 lakh units per annum, while overall production capacity planned is 18 lakh units. This plant will take care exports also.
- ✓ The company has planned Rs. 2500 crores of capital expenditure to be spent over next two years. This will be towards new product development, phase wise capacity installation & expansion at existing facilities.
- ✓ The company expanded its footprint in the international markets by commencing operations in two significant global markets like Argentina and Nigeria.
- ✓ The company has robust pipe line of new products in Scooter and Premium segment motorcycles. These products will be launched in FY18 & FY19.

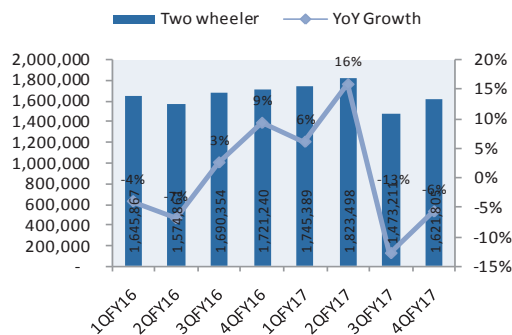
Quarterly Performance

Financials	4QFY16	1QFY17	2QFY17	3QFY17	4QFY17	YoY %	QoQ%	FY16	FY17	YoY %
Total Volumes ('000)	1,721	1,745	1,823	1,473	1,622	-6%	10%	6,631	6,664	0%
Realization(Rs./ bike)	43,644	42,391	42,755	43,202	42,639	-2%	-1%	42,912	42,895	0%
Net Sales	7,505	7,399	7,796	6,365	6,915	-8%	9%	28,457	28,585	0%
Other Income	117	120	152	132	118	1%	-10%	413	522	26%
COGS	4,964	4,965	5,183	4,128	4,736	-5%	15%	19,308	19,091	-1%
Employee Cost	351	336	357	374	328	-7%	-12%	1,339	1,432	7%
Other Expenses	1,001	867	887	783	893	-11%	14%	3,412	3,486	2%
EBITDA	1,189	1,230	1,369	1,080	958	-19%	-11%	4,398	4,576	4%
Depreciation	115	115	119	125	135	18%	8%	443	502	13%
Interest	1	2	2	2	1	21%	-3%	15	27	87%
PBT	1,190	1,234	1,400	1,085	939	-21%	-13%	4,353	4,568	5%
Tax	357	351	396	313	221	-38%	-29%	1,275	1,339	5%
PAT	833	883	1,004	772	718	-14%	-7%	3,112	3,546	14%

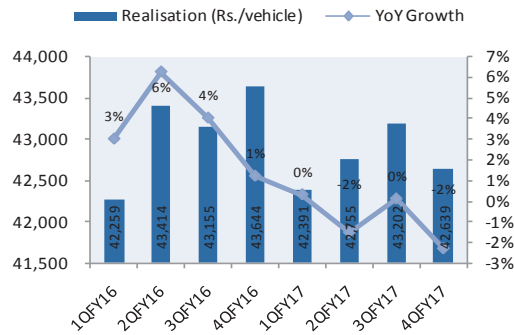
Volume de-growth of 6% YoY, realisations declined by 2% YoY

- ✓ Hero Motocorp reported 8%YoY decline in the net sales in 4QFY17. Total sales volumes contracted by 6%YoY and Realization also declined by 2%YoY.
- ✓ Reduction in the total sales volumes was the after effect of demonetization during the 3QFY17. 2 Wheeler sector was one of the most affected sectors due to currency ban. The company witnessed slow recovery during January and February months in the rural segment, where Hero has more than 50% exposure. 2 Wheeler sales increased in March on account of destocking of BS-III inventory
- ✓ Heavy discounts of up to Rs.10000 per vehicle because of higher BS-III inventory resulted in lower realization for the quarter.
- ✓ EBITDA declined by 19% YoY to Rs.958 crore in 4QFY17 due to increased commodity prices and higher other expenses.
- ✓ Depreciation for the quarter stood at Rs.135 crore, higher 18%YoY because of the production at Halol Plant has started in 4QFY17.
- ✓ Profit after tax also declined by 14% YoY to Rs.718 crore during the quarter.

Volume trend



Realisation trend

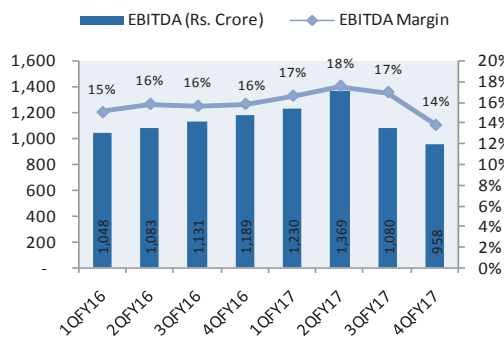


EBITDA Margins at 13.8% weakest in last 8 quarters

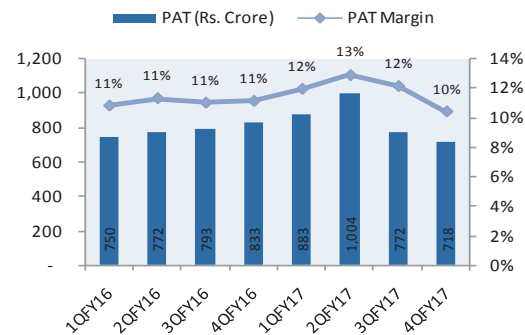
Margin %	4QFY16	1QFY17	2QFY17	3QFY17	4QFY17	YoY(+/-)	QoQ(+/-)	FY16	FY17	YoY(+/-)
Gross Margin	34%	33%	34%	35%	32%	(0.02)	-0.04	32%	33%	0.01
EBITDA Margin	16%	17%	18%	17%	14%	(0.02)	-0.03	15%	16%	0.01
PAT Margin	11%	12%	13%	12%	10%	(0.01)	-0.02	11%	12%	0.01

- ✓ Gross Margin contracted by 230 bps YoY to 32% due to higher commodity prices. Transition from BS-III to BS-IV has also put the margins under pressure. Full impact of increased commodity prices have not yet factored in 4QFY17 results and thus margins will also be under pressure in 1QFY18.
- ✓ EBITDA Margin declined by 200 bps YoY to 13.8% in 4QFY17 impacted by higher other expenses.
- ✓ Lower tax expenses during the quarter supported PAT and restricted the further decline in the PAT Margins.

EBITDA and EBITDA Margin trend



PAT and PAT Margin trend



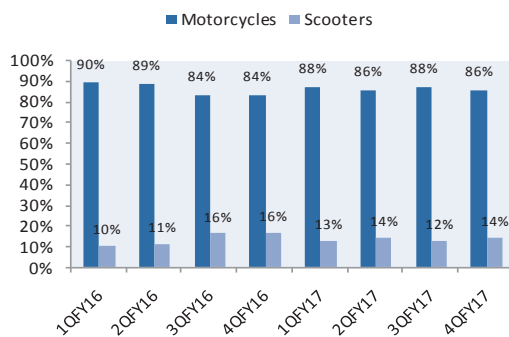
Concall Highlights:

- ✓ High single digit growth for industry in FY18.
- ✓ Double digit growth for Hero in FY18.
- ✓ EBITDA Margin would be in the range of 14-15%.
- ✓ There will be cost pressure in 1QFY18 also.
- ✓ Advertising & Promotion expenses will be 2.5% of sales in FY18.
- ✓ Depreciation will be high because of commencement of production in Halol Plant.
- ✓ Scooter segment growth will be higher than industry.
- ✓ Rural market is expected to post good growth backed by good monsoon and marriage season.
- ✓ Capex guidance of Rs.2500 crore to be spent on R&D (new product development) and Andhra plant.
- ✓ Inventory level stood at 5-6 weeks.
- ✓ The tax benefit for plants in Rajasthan and Gujarat will last for 7 years; and the benefit is restricted to the extent of investment
- ✓ Management expects benefit from LEAP program to be around 50-60 bps and additional 25-30 bps from other initiatives.
- ✓ Export market outlook remain sluggish for next couple of months.
- ✓ The management is also focusing on developing electric vehicles considering the government focus towards Mission Electric by 2020.

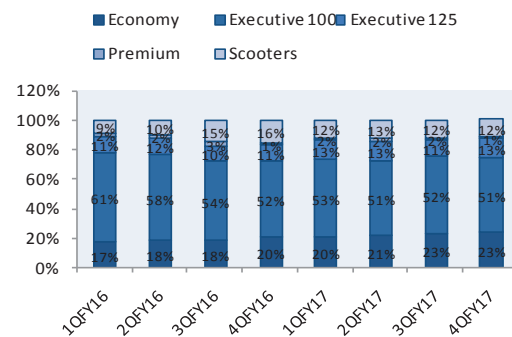
Investment Arguments:

- ✓ **Margins to remain under pressure-** The management has explained that the company has not yet fully factored the increased RM cost. Hero Motocorp took the price hike in the range of Rs.500-2000 which was not sufficient to net off the impact of higher commodity prices. So we expect that 1QFY18 will also be under pressure on margin front.
- ✓ **Higher Depreciation may affect the bottom-line-** The commercial production at Halol plant has started in 4QFY17. Considering the demand scenario we expect that it will take at least 6-8 months to ramp up and till then the company has to incur higher other expenses and depreciation on the plant.
- ✓ **Uncertainty regarding tax regime-** GST will come in effect from 1st July 2017 and the tax rates are still not certain which keeps the auto industry to on its toes. All the auto manufacturers will refrain from keeping higher inventory with them. The meeting has been scheduled on 19th May to decide the tax rates.
- ✓ **Rural Demand to drive growth-** Hero Motocorp has more than 55% exposure in rural segment. Expectation of good monsoon in the current fiscal may drive the demand going ahead. Marriage season in the North region will be key growth driver for the company in FY18.
- ✓ **New product launch in the scooter and premium segment-** The company has huge capex plan of Rs.2500 crore over next two years. The launches will be in the fast growing scooter segment and premium segment motorcycles. Hero Motorcorp has very minimal presence in the premium segment where peers like Bajaj Auto, TVS Motors and Yamaha has captured more than 80% market share.

Trend in Segment Mix



Share of Scooters & 125 cc segment increasing gradually



View & Valuation

Hero Motocorp is the market leader in the entry segment motorcycle and commands over 50% market share in that segment. The company has lost 4-5 percent market share in FY17 to Honda Motorcycle, which has grown fiercely in the Indian two wheeler market. Rising commodity prices and transition from BS-III to BS-IV restricted the company to expand its profitability. The management has stated that the margins will be under pressure as the full impact of increased commodity prices has not been factored yet. Higher depreciation on Halol plant will lead to further contraction in profitability as the plants will take at least 6-8 months to ramp up. The uncertainty regarding tax structure under GST will also keep automobile industry outlook hazy. We expect 320bps deterioration in FY19E RoE. Considering the margin contraction and uncertainty regarding GST we reduce our target from Rs.3800 to Rs.3575 and change our rating from BUY to NEUTRAL.

Financials Snap Shot

Income Statement				
	Rs in Crores			
Y/E March	FY16	FY17	FY18E	FY19E
Revenue from Operation	28,457	28,585	30,971	33,473
Change (%)	3%	0%	8%	8%
<i>Other Operating Income</i>				
EBITDA	4,398	4,576	5,206	5,926
Change (%)	26%	4%	14%	14%
Margin (%)	15%	16%	17%	18%
Dep & Amortization	443	502	588	647
EBIT	3,954	4,074	4,618	5,279
Interest & other finance cost	15	27	27	27
Other Income	413	522	697	825
EBT	4,353	4,568	5,288	6,078
Exceptional Item	-	(262)	-	-
Tax	1,275	1,339	1,550	1,823
Minority Int & P/L share of Ass.	34	55	55	55
Reported PAT	3,112	3,546	3,793	4,309
Adjusted PAT	3,112	3,546	3,793	4,309
Change (%)	32%	14%	7%	14%
Margin(%)	11%	12%	12%	13%

Balance Sheet				
	Rs in Crores			
Y/E March	FY16	FY17	FY18E	FY19E
Share Capital	40	40	40	40
Reserves	8,794	10,276	11,914	13,776
Networth	8,834	10,316	11,954	13,816
Debt	230.04	248.0	245.3	242.6
<i>Other Non Current Liab</i>				
Total Capital Employed	9,064	10,563	12,199	14,058
Net Fixed Assets (incl CWIP)	4,437	5,180	5,529	6,013
Non Current Investments	1,030	1,522	2,730	2,804
Other Non Current Assets	848	658	658	658
Non Current Assets	6,592	7,741	8,966	9,524
Inventory	762	709	768	830
Debtors	1,282	1,552	1,681	1,817
Cash & Bank	75	74	75	70
Other Current Assets	562	524	568	613
Current Assets	6,303	7,571	8,290	9,925
Creditors	2,675	3,266	3,539	3,825
Provisions	98	118	114	124
Other Current Liabilities	506	457	495	535
Curr Liabilities	3,487	4,137	4,437	4,766
Net Current Assets	2,816	3,434	3,852	5,160
Total Assets	12,896	15,312	17,255	19,449

Key Ratios				
Y/E March	FY16	FY17	FY18E	FY19E
ROE	35%	34%	32%	31%
ROCE	44%	39%	38%	38%
Asset Turnover	2.2	1.9	1.8	1.7
Debtor Days	16.4	19.8	19.8	19.8
Inventory Days	9.8	9.0	9.0	9.0
Payable Days	34.3	41.7	41.7	41.7
Interest Coverage	270.7	149.3	171.1	197.8
P/E	18.9	18.6	17.3	15.3
Price / Book Value	6.7	6.4	5.5	4.8
EV/EBITDA	13.4	14.4	12.7	11.1
FCF per Share	5,504	6,095	5,749	6,203
Dividend Yield	2.4%	2.6%	2.8%	3.1%

Assumptions				
Y/E March	FY16	FY17	FY18E	FY19E
Volume ('000)	6,631	6,664	7,174	7,773
Volume Growth	0%	0%	8%	8%
Realization(Rs./vehicle)	42,912	42,895	43,169	43,061
Realization Growth	3%	0%	1%	0%
Capex(Rs crore)	1,476	1,432	1,250	1,250

Cash Flow Statement				
	Rs in Crores			
Y/E March	FY16	FY17E	FY18E	FY19E
PBT	4,312	4,568	5,288	6,078
(inc)/Dec in Working Capital	4,508	5,570	6,290	6,806
Non Cash Op Exp	447	502	588	647
Interest Paid (+)	12	27	27	27
Tax Paid	(1,104)	(1,339)	(1,550)	(1,823)
others	(260)	-	-	-
CF from Op. Activities	3,796	4,850	4,813	5,072
(inc)/Dec in FA & CWIP	(1,708)	(1,245)	(936)	(1,131)
Free Cashflow	2,088	3,605	3,876	3,941
(Pur)/Sale of Investment	(549)	-	-	-
others	169	(1,565)	(1,813)	(1,469)
CF from Inv. Activities	(2,286)	(2,810)	(2,749)	(2,600)
inc/(dec) in NW				
inc/(dec) in Debt	132	18	(3)	(3)
Interest Paid	(11)	(27)	(27)	(27)
Dividend Paid (inc tax)	(1,682)	(2,014)	(2,155)	(2,448)
others	133	18	(3)	(3)
CF from Fin. Activities	(1,561)	(2,024)	(2,184)	(2,477)
Inc(Dec) in Cash	(50)	16	(121)	(5)
Add: Opening Balance	155	75	74	75
Closing Balance	104	74	75	70