

**SELL**

TP: Rs 2,700 | ▼ 8%

**HERO MOTOCORP**

Automobiles

29 October 2020

## Optimism priced in – downgrade to SELL

Hero MotoCorp's (HMCL) Q2FY21 operating performance beat estimates due to above-expected ASP. Gross margin declined (despite a steep price hike) but lower other expenses took EBITDA margin to 13.7% (12.7% est.). Our 2W channel checks suggest a flattish festive season ahead. The Harley Davidson licensing agreement is not revenue sharing yet. We continue to model for a 9% earnings CAGR over FY20-FY23 and retain our TP of Rs 2,700, but move to SELL (from REDUCE) as valuations look full at 17.3x FY22E EPS.

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**Better ASPs drive operating performance beat:** Q2 revenue at Rs 93.7bn (+24% YoY) came in ahead of our estimate of Rs 86.4bn, driven by a strong 15% YoY jump in ASP while volumes for the quarter grew 7% YoY. Despite below-expected gross margins, better operating efficiencies led to a 100bps beat on EBITDA margin to 13.7%. Adj. PAT inched up 2% YoY to Rs 9.5bn, which was 22% ahead of our projection.

Ticker/Price	HMCL IN/Rs 2,946
Market cap	US\$ 8.0bn
Shares o/s	200mn
3M ADV	US\$ 68.2mn
52wk high/low	Rs 3,395/Rs 1,475
Promoter/FPI/DII	35%/32%/19%

Source: NSE

**Remain cautious on near-term demand:** HMCL currently has 40-44 days of 2W inventory. Our channel checks with dealers suggest that 2W festive sales in the domestic market would remain flattish YoY at best. With inventories at regular levels, sustainability of production will now depend on a pickup in retail sales. We remain cautious on demand in view of the current economic climate.

## STOCK PERFORMANCE



Source: NSE

**Downgrade to SELL:** We expect HMCL to clock a revenue/EBITDA/PAT CAGR of 10%/9%/9% during FY20-FY23. Management indicated that the licensing agreement with Harley Davidson is not a revenue-sharing arrangement at present. We believe most optimism is priced in at current valuations of 17.3x FY22E EPS and downgrade our rating to SELL. Our Sep'21 TP of Rs 2,700 values the stock at an unchanged 15x one-year forward EPS.

## KEY FINANCIALS

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
Total revenue (Rs mn)	336,505	288,361	278,835	343,981	378,930
EBITDA (Rs mn)	49,301	39,580	32,605	45,858	50,953
Adj. net profit (Rs mn)	33,849	29,559	22,120	33,543	38,073
Adj. EPS (Rs)	169.5	148.0	110.8	168.0	190.7
Adj. EPS growth (%)	(8.5)	(12.7)	(25.2)	51.6	13.5
Adj. ROAE (%)	26.3	20.9	14.4	19.6	19.7
Adj. P/E (x)	17.4	19.9	26.6	17.5	15.5
EV/EBITDA (x)	11.9	14.8	18.0	12.8	11.6

Source: Company, BOBCAPS Research

**BOB Capital Markets Ltd is a wholly owned subsidiary of Bank of Baroda**

Important disclosures, including any required research certifications, are provided at the end of this report.



**FIG 1 – QUARTERLY PERFORMANCE**

(Rs mn)	Q2FY21	Q2FY20	YoY (%)	Q1FY21	QoQ (%)	H1FY21	H1FY20	YoY (%)
Volume	1,814,683	1,691,420	7.3	563,426	222.1	2,378,109	3,534,340	(32.7)
Avg. Realisation per Vehicle (Rs)	51,620	44,759	15.3	52,741	(2.1)	51,885	44,141	17.5
Net Revenues	93,673	75,707	23.7	29,715	215.2	123,389	156,010	(20.9)
<b>Total Income (A)</b>	<b>93,673</b>	<b>75,707</b>	<b>23.7</b>	<b>29,715</b>	<b>215.2</b>	<b>123,389</b>	<b>156,010</b>	<b>(20.9)</b>
<b>Operating Expenses:</b>								
Raw materials consumed	66,600	51,257	29.9	20,939	218.1	87,539	107,177	(18.3)
Employee Expenses	5,112	4,689	9.0	3,824	33.7	8,936	9,366	(4.6)
Other Expenses	9,097	8,750	4.0	3,872	135.0	12,969	16,877	(23.2)
<b>Total Expenditure (B)</b>	<b>80,809</b>	<b>64,696</b>	<b>24.9</b>	<b>28,635</b>	<b>182.2</b>	<b>109,444</b>	<b>133,419</b>	<b>(18.0)</b>
<b>EBITDA (A-B)</b>	<b>12,864</b>	<b>11,011</b>	<b>16.8</b>	<b>1,081</b>	<b>1,090.6</b>	<b>13,945</b>	<b>22,591</b>	<b>(38.3)</b>
Other Income	1,413	2,078	(32.0)	1,485	(4.8)	2,898	4,267	(32.1)
Depreciation	1,732	2,034	(14.9)	1,708	1.4	3,439	4,395	(21.8)
EBIT	12,546	11,055	13.5	858	1,363.1	13,403	22,462	(40.3)
Finance Costs	46	77	(39.5)	63	(25.9)	109	120	(9.5)
PBT before excep items	12,500	10,979	13.9	795	1,472.5	13,294	22,342	(40.5)
Exceptional items	-	601	(100.0)	-	NA	-	(6,773)	NA
PBT after excep items	12,500	10,378	20.4	795	1,472.5	13,294	29,115	(54.3)
Tax expense	2,965	1,629	82.0	182	1,530.9	3,147	7,794	(59.6)
Reported PAT	9,535	8,748	9.0	613	1,455.1	10,148	21,321	(52.4)
<b>Adjusted PAT</b>	<b>9,535</b>	<b>9,349</b>	<b>2.0</b>	<b>613</b>	<b>1,455.1</b>	<b>10,148</b>	<b>14,548</b>	<b>(30.2)</b>
<b>Adj EPS (Rs)</b>	<b>47.7</b>	<b>46.8</b>	<b>2.0</b>	<b>3.1</b>	<b>1,455.1</b>	<b>51</b>	<b>72.9</b>	<b>(30.2)</b>

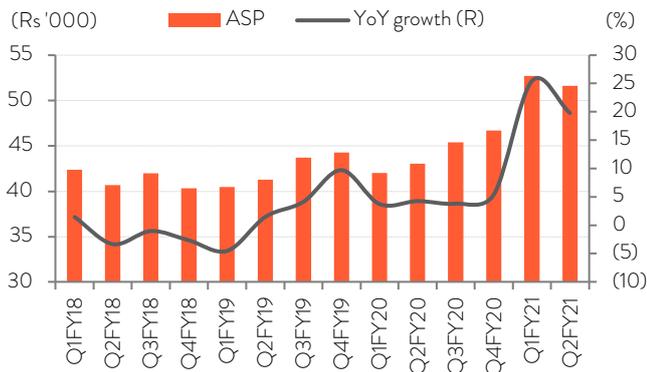
Source: Company, BOBCAPS Research

**FIG 2 – KEY PARAMETERS**

(%)	Q2FY21	Q2FY20	YoY (bps)	Q1FY21	QoQ (bps)	H1FY21	H1FY20	YoY (bps)
Gross Margin	28.9	32.3	(339)	30	(63)	29.1	31.3	(225)
EBITDA Margin	13.7	14.5	(81)	4	1010	11.3	14.5	(318)
EBIT Margin	13.4	14.6	(121)	3	1051	10.9	14.4	(354)
PBT Margin	13.3	14.5	(116)	3	1067	10.8	14.3	(355)
Tax Rate	23.7	15.7	802	23	85	23.7	26.8	(310)
Adj PAT Margin	10.2	12.3	(217)	2	812	8.2	9.3	(110)

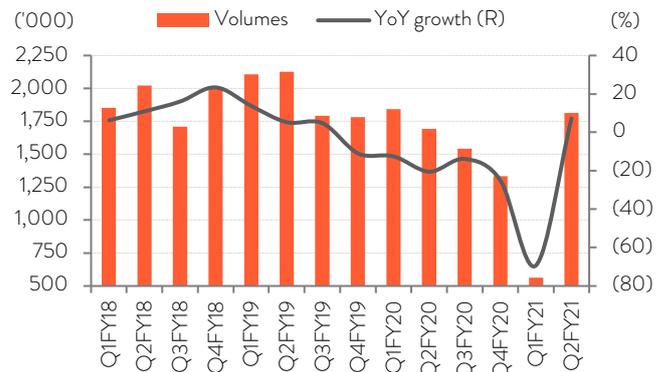
Source: Company, BOBCAPS Research

**FIG 3 – AVERAGE SELLING PRICE (ASP)**



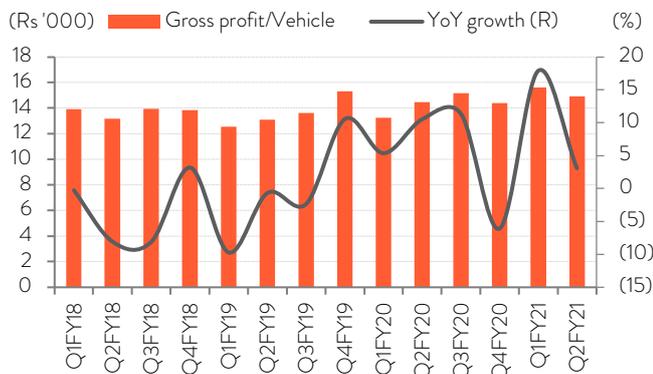
Source: Company, BOBCAPS Research

**FIG 4 – VOLUME GROWTH TREND**



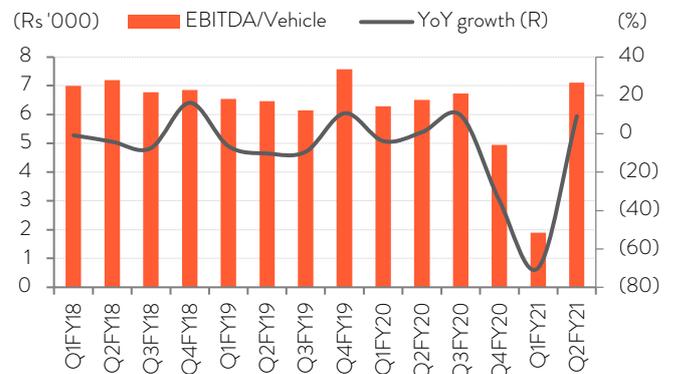
Source: Company, BOBCAPS Research

**FIG 5 – GROSS PROFIT/VEHICLE**



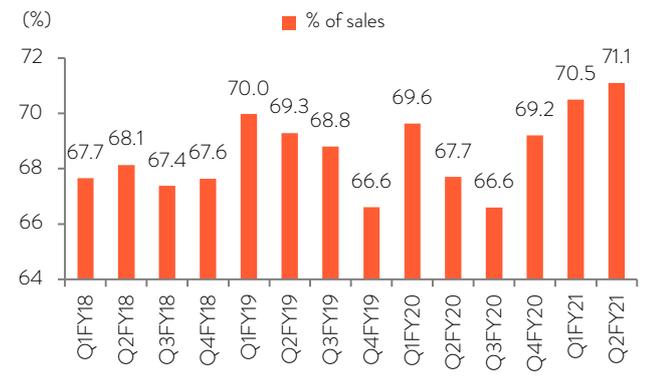
Source: BOBCAPS Research, Company

**FIG 6 – EBITDA/VEHICLE**



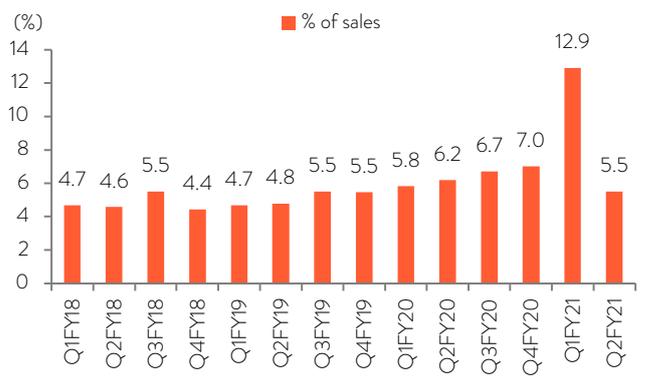
Source: BOBCAPS Research, Company

**FIG 7 – RM COST/SALES TREND**

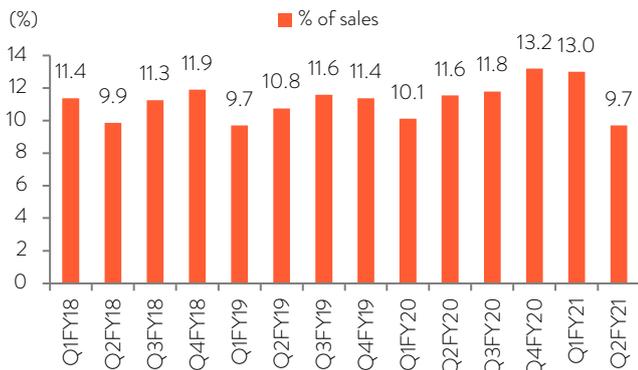


Source: Company, BOBCAPS Research

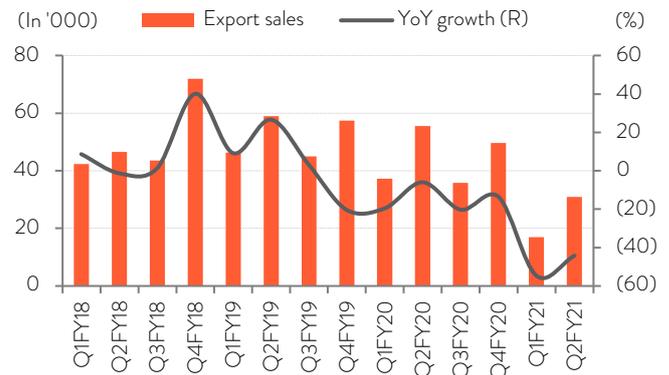
**FIG 8 – EMPLOYEE COST/SALES TREND**



Source: Company, BOBCAPS Research

**FIG 9 – OTHER EXPENSES/SALES TREND**

Source: Company, BOBCAPS Research

**FIG 10 – EXPORTS VOLUME TREND**

Source: Company, BOBCAPS Research

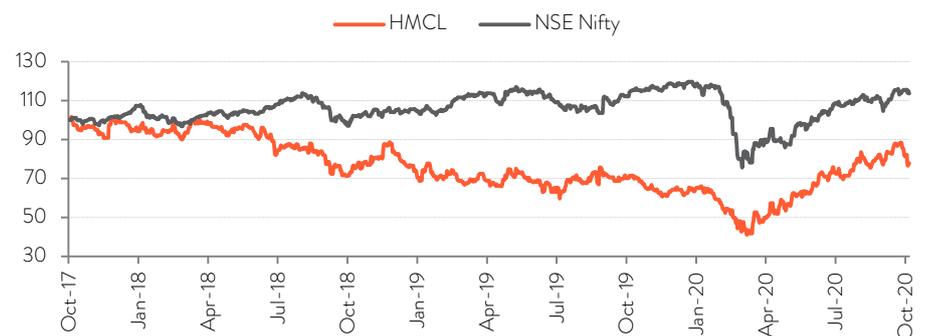
### Earnings call highlights

- HMCL mentioned that the initial days of the festive season look positive and retail sales have been at 96% of comparable festive sales in FY20.
- Growth in rural regions remains ahead of urban markets but the gap has been narrowing and urban/semi-urban demand appears to be returning to normal.
- HMCL indicated that competitors are being rational and not luring customers by providing discounts this festive season.
- Management believes that pent-up demand has now been catered to and macro fundamentals should drive demand going ahead. Also, personal mobility needs have surged given social distancing norms and limited public transport facilities, which should benefit the company.
- Commodity prices are expected to trend upwards but management is confident of tackling this with better cost management and price hikes.
- HMCL will roll out its LEAP-II programme aimed at driving cost savings of ~100bps (as a percentage of sales), double the target of LEAP-I.
- Spare parts revenue for Q2 was at Rs 8bn while other operating revenue stood at Rs 1.9bn.

## Valuation methodology

We expect HMCL to clock a revenue/EBITDA/PAT CAGR of 10%/9%/9% during FY20-FY23. In our view, most optimism is priced in at current valuations of 17.3x/15.3x FY22E/FY23E EPS – we thus downgrade our rating from REDUCE to SELL. Our Sep'21 target price remains at Rs 2,700 as we continue to value the stock at 15x one-year forward EPS.

**FIG 11 – RELATIVE STOCK PERFORMANCE**



Source: NSE

## Key risks

- A sharp rise in financing ratio for 2Ws along with favourable credit terms such as extension of loan tenures may reduce the expected negative impact on 2W demand.
- Above-expected pickup in rural demand on the back of good monsoons would disproportionately benefit HMCL given its higher volume mix from these markets, posing an upside risk to our volume estimates.
- Further declines in commodity costs could support margins despite tepid volume growth, though this may be priced away over time due to the elevated competitive intensity.

## FINANCIALS

### Income Statement

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
<b>Total revenue</b>	<b>336,505</b>	<b>288,361</b>	<b>278,835</b>	<b>343,981</b>	<b>378,930</b>
EBITDA	49,301	39,580	32,605	45,858	50,953
Depreciation	6,020	8,180	9,130	9,770	10,474
EBIT	50,193	39,184	29,792	45,063	51,119
Net interest income/(expenses)	(86)	(220)	(220)	(220)	(220)
Other income/(expenses)	6,912	7,783	6,317	8,975	10,640
Exceptional items	(934)	6,774	0	0	0
EBT	49,173	45,737	29,572	44,843	50,899
Income taxes	16,259	9,404	7,452	11,300	12,827
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	0	0	0	0	0
<b>Reported net profit</b>	<b>32,915</b>	<b>36,333</b>	<b>22,120</b>	<b>33,543</b>	<b>38,073</b>
Adjustments	934	(6,774)	0	0	0
<b>Adjusted net profit</b>	<b>33,849</b>	<b>29,559</b>	<b>22,120</b>	<b>33,543</b>	<b>38,073</b>

### Balance Sheet

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Accounts payables	34,556	30,305	33,655	43,342	39,788
Other current liabilities	6,158	7,990	4,510	10,321	6,129
Provisions	590	2,689	2,689	2,689	2,689
Debt funds	0	0	0	0	0
Other liabilities	1,172	1,217	1,217	1,217	1,217
Equity capital	400	400	400	400	400
Reserves & surplus	128,172	140,965	153,042	170,609	192,707
Shareholders' fund	128,572	141,364	153,441	171,009	193,107
<b>Total liabilities and equities</b>	<b>171,047</b>	<b>183,565</b>	<b>195,513</b>	<b>228,577</b>	<b>242,929</b>
Cash and cash eq.	1,365	2,419	2,229	281	1,066
Accounts receivables	28,216	16,031	25,095	27,519	30,314
Inventories	10,724	10,920	10,038	13,071	13,641
Other current assets	9,181	7,244	7,742	8,067	8,242
Investments	59,686	82,227	86,227	113,227	123,227
Net fixed assets	46,186	61,171	60,041	62,271	61,797
CWIP	5,419	3,413	4,000	4,000	4,500
Intangible assets	0	0	0	0	0
Deferred tax assets, net	(5,365)	(3,928)	(3,928)	(3,928)	(3,928)
Other assets	15,636	4,070	4,070	4,070	4,070
<b>Total assets</b>	<b>171,047</b>	<b>183,565</b>	<b>195,513</b>	<b>228,577</b>	<b>242,929</b>

Source: Company, BOBCAPS Research

**Cash Flows**

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Net income + Depreciation	39,869	37,739	31,250	43,312	48,546
Interest expenses	(86)	(220)	(220)	(220)	(220)
Non-cash adjustments	(6,912)	(7,783)	(6,317)	(8,975)	(10,640)
Changes in working capital	(24,871)	25,218	(8,809)	9,714	(11,286)
Other operating cash flows	(4,078)	2,301	0	0	0
<b>Cash flow from operations</b>	<b>3,922</b>	<b>57,253</b>	<b>15,903</b>	<b>43,831</b>	<b>26,400</b>
Capital expenditures	(7,895)	(21,159)	(8,587)	(12,000)	(10,500)
Change in investments	15,566	(22,540)	(4,000)	(27,000)	(10,000)
Other investing cash flows	6,912	7,783	6,317	8,975	10,640
<b>Cash flow from investing</b>	<b>14,583</b>	<b>(35,916)</b>	<b>(6,270)</b>	<b>(30,025)</b>	<b>(9,860)</b>
Equities issued/Others	57	44	0	0	0
Debt raised/repaid	0	0	0	0	0
Interest expenses	(86)	(220)	(220)	(220)	(220)
Dividends paid	(18,974)	(19,170)	(9,984)	(15,975)	(15,975)
Other financing cash flows	249	(1,437)	0	0	0
<b>Cash flow from financing</b>	<b>(18,754)</b>	<b>(20,783)</b>	<b>(10,204)</b>	<b>(16,195)</b>	<b>(16,195)</b>
<b>Changes in cash and cash eq.</b>	<b>(249)</b>	<b>555</b>	<b>(571)</b>	<b>(2,388)</b>	<b>345</b>
<b>Closing cash and cash eq.</b>	<b>1,365</b>	<b>2,419</b>	<b>2,229</b>	<b>281</b>	<b>1,066</b>

**Per Share**

Y/E 31 Mar (Rs)	FY19A	FY20A	FY21E	FY22E	FY23E
Reported EPS	169.5	148.0	110.8	168.0	190.7
Adjusted EPS	169.5	148.0	110.8	168.0	190.7
Dividend per share	95.0	80.0	50.0	80.0	80.0
Book value per share	643.9	707.9	768.4	856.4	967.0

**Valuations Ratios**

Y/E 31 Mar (x)	FY19A	FY20A	FY21E	FY22E	FY23E
EV/Sales	1.7	2.0	2.1	1.7	1.6
EV/EBITDA	11.9	14.8	18.0	12.8	11.6
Adjusted P/E	17.4	19.9	26.6	17.5	15.5
P/BV	4.6	4.2	3.8	3.4	3.0

**DuPont Analysis**

Y/E 31 Mar (%)	FY19A	FY20A	FY21E	FY22E	FY23E
Tax burden (Net profit/PBT)	68.8	64.6	74.8	74.8	74.8
Interest burden (PBT/EBIT)	98.0	116.7	99.3	99.5	99.6
EBIT margin (EBIT/Revenue)	14.9	13.6	10.7	13.1	13.5
Asset turnover (Revenue/Avg TA)	270.7	211.8	187.6	210.5	206.8
Leverage (Avg TA/Avg Equity)	1.0	1.0	1.0	1.0	1.0
Adjusted ROAE	27.5	21.9	15.0	20.7	20.9

Source: Company, BOBCAPS Research | Note: TA = Total Assets

**Ratio Analysis**

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
<b>YoY growth (%)</b>					
Revenue	4.4	(14.3)	(3.3)	23.4	10.2
EBITDA	(6.6)	(19.7)	(17.6)	40.6	11.1
Adjusted EPS	(8.5)	(12.7)	(25.2)	51.6	13.5
<b>Profitability &amp; Return ratios (%)</b>					
EBITDA margin	14.7	13.7	11.7	13.3	13.4
EBIT margin	14.9	13.6	10.7	13.1	13.5
Adjusted profit margin	10.1	10.3	7.9	9.8	10.0
Adjusted ROAE	26.3	20.9	14.4	19.6	19.7
ROCE	27.0	22.9	15.0	20.6	20.9
<b>Working capital days (days)</b>					
Receivables	24	28	27	28	28
Inventory	10	14	14	12	13
Payables	54	60	59	58	57
<b>Ratios (x)</b>					
Gross asset turnover	0.3	0.5	0.5	0.5	0.4
Current ratio	1.2	0.9	1.1	0.9	1.1
Net interest coverage ratio	(583.6)	(177.9)	(135.4)	(204.8)	(232.4)
Adjusted debt/equity	0.0	0.0	0.0	0.0	0.0

Source: Company, BOBCAPS Research

## Disclaimer

### Recommendations and Absolute returns (%) over 12 months

**BUY** – Expected return >+15%

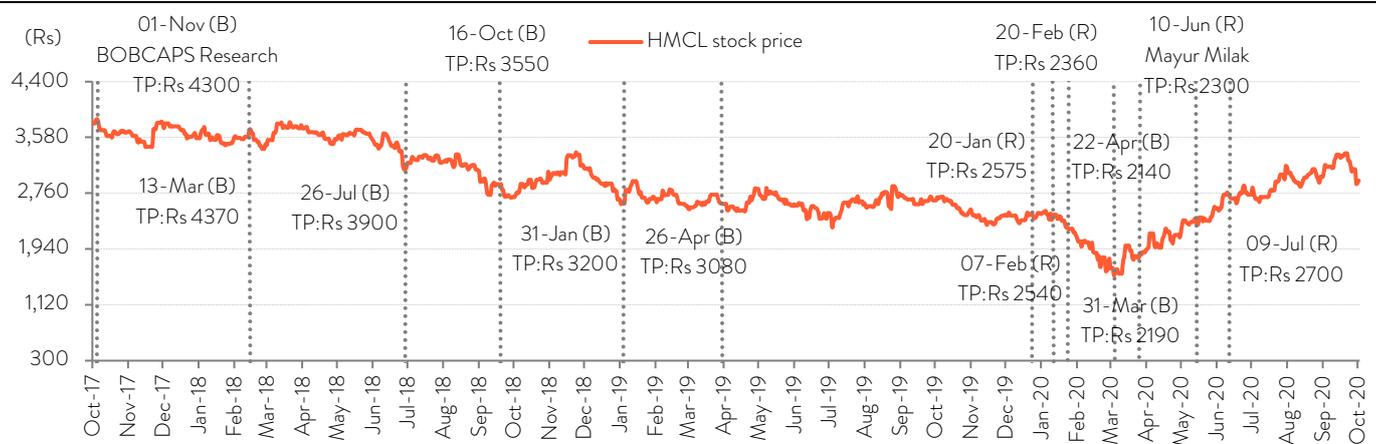
**ADD** – Expected return from >+5% to +15%

**REDUCE** – Expected return from -5% to +5%

**SELL** – Expected return <-5%

**Note:** Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

### RATINGS AND TARGET PRICE (3-YEAR HISTORY): HERO MOTOCORP (HMCL IN)



B – Buy, A – Add, R – Reduce, S – Sell

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