

HERO MOTOCORP

Weak quarter; deteriorating outlook

India Equity Research | Automobiles



Edelweiss
Ideas create, values protect

Hero Motocorp's (HMCL) Q2FY13 PAT at INR4.4bn (down 27% YoY and 28% QoQ) was in line with ours and Street expectation. EBITDA margins at 13.9% (15% in Q1FY13) surprised negatively on higher staff costs and other expenses. Margin pressure is likely to persist going forward due to higher input costs and marketing expenses (on new product launches). We have cut our earnings estimate for FY13 and FY14 by 10% and 7% to factor in lower volume estimates and shrinking margins. Maintain 'REDUCE' with a revised target price of INR1,575 (INR1,870).

Results disappoint on weak margins

PAT at INR4.4bn (down 27% YoY and 28% QoQ) was in line with our estimate but EBITDA margins at 13.9% (15% in Q1FY13) disappointed on higher staff costs and other expenses. Total revenue at INR51.9bn (down 11% YoY, down 17% QoQ) was largely in line with estimates. RM costs/vehicle increased by ~2% YoY and stronger INR lowered royalty amortisation by ~INR140mn during the quarter.

Deteriorating outlook

After seeing a weak quarter, the management is hopeful of sales recovery during the festive season. Though we see downside risks to our FY13 and FY14 volume estimates, we cut our estimates by 7% and 3% respectively. Also, margin pressure which we saw during quarter is likely to persist going forward as well due to higher input costs and marketing expenses (on new product launches). We cut our margin estimates by ~50bps to factor in these points. Accordingly our EPS for FY13 and FY14 is being revised downward by 10% and 7% respectively.

Outlook and valuations: Challenging; maintain 'REDUCE'

We see many challenges for HMCL to regain sales momentum on increasing competitive intensity by peers like Honda and Bajaj Auto. The stock currently trades at an expensive valuation of 14x FY14E core EPS of INR112. We believe that the valuation premium (~2x) which HMCL used to get over Bajaj Auto should go away due to challenging business environment. We revise our target price downward to INR1,575 (INR1,870), on 12x FY14E core EPS (same as Bajaj Auto). Maintain 'REDUCE/Sector Underperformer' recommendation/rating. We prefer Bajaj Auto over HMCL due to superior earnings visibility.

Financials

(INR mn)

Year to March	Q2FY13	Q2FY12	% change	Q1FY13	% change	FY12	FY13E	FY14E
Net revenue	51,512	57,843	(10.9)	62,078	(17.0)	233,719	235,215	274,061
EBITDA	7,192	9,187	(21.7)	9,369	(23.2)	34,126	34,336	39,329
Adj, net profit	4,406	6,036	(27.0)	6,155	(28.4)	23,861	23,139	24,958
Dil. EPS (INR)	22.1	30.2	(27.0)	30.8	(28.4)	119.5	115.9	125.0
P/E (x)						15.1	15.5	14.4
EV/EBITDA (x)						9.2	8.8	7.6

EDELWEISS 4D RATINGS

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

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

CMP	: INR 1,796
Target Price	: INR 1,575
52-week range (INR)	: 2,279 / 1,662
Share in issue (mn)	: 199.7
M cap (INR bn/USD mn)	: 359/ 6,660
Avg. Daily Vol.BSE/NSE('000)	: 509.2

SHARE HOLDING PATTERN (%)

	Current	Q1FY13	Q4FY12
Promoters *	52.2	52.2	52.2
MF's, FI's & BK's	6.7	5.9	5.6
FII's	32.3	33.2	33.4
others	8.8	8.6	8.8

* Promoters pledged shares : NIL
(% of share in issue)

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Auto Index
1 month	(6.4)	(0.0)	7.8
3 months	(12.3)	11.2	12.0
12 months	(12.3)	12.7	27.9

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Key takeaways from earnings conference call

Industry outlook: Challenging

Management has lowered industry growth forecast to ~5% from ~10% stated in July'12. Festive season so far has seen flat to positive volume growth and is likely to gain momentum further.

Company outlook: Banking on new launches

Hero is expecting sales to recover during festive season along with new launches. The company has commenced dispatches of 110cc Passion X Pro bike which will be available for retail sales before Diwali. Also, the scooter segment for the company is growing well with the help of newly launched *Maestro* and *Pleasure*. Recently launched bike, *Ignitor*, is also doing well in the motorcycle segment.

Festive season demand check

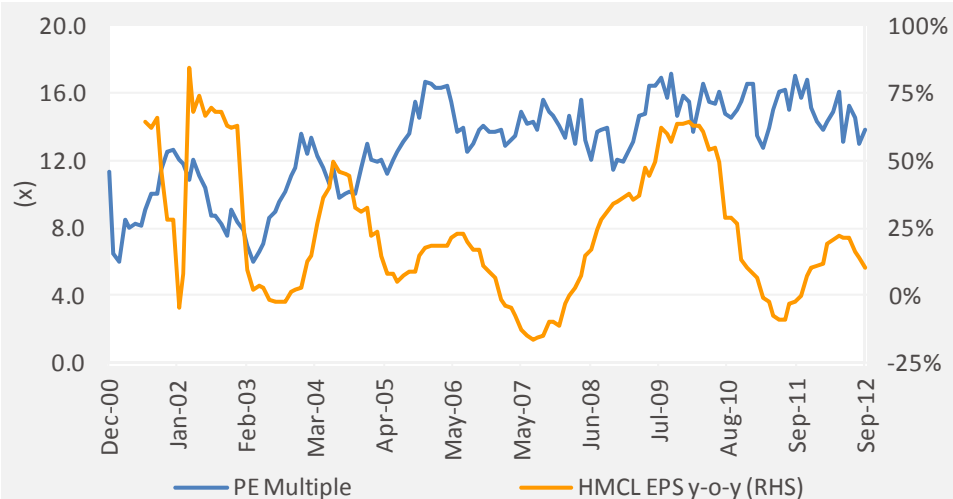
In the first 15 days of Oct, the company had lower sales of 10k units/day due to *Shradh*. But during Oct 15 to 25, the company has achieved average sales of 26k units/day and expects total sales to cross ~500k units for the month of Oct.

Inventory to correct post festive season

Currently, inventories at dealerships and in transit are around 4 weeks and 2 weeks respectively which should come down to normal level of 3-4 weeks post festive season.

Others:

- Company is currently not offering any discounts and freebies and would continue with the same policy.
- The company took a price hike of ~INR300/vehicle on Oct 1.
- Average realization is higher by ~INR900/ vehicle mainly due to higher sales of spares and parts (~INR4bn) and higher sales in the +125cc bike and scooter segment.
- SGA expenses should go up as company enters newer export markets.
- Staff cost is higher due to provision of future wage settlement at one of its plants.
- There was a forex gain of ~INR140mn on the royalty amortization during quarter on stronger INR.
- Tax rate for the FY13 should be ~16.8%.

Chart 1: Hero Motocorp 1-yr forward PE vs consensus 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	5,625,990	6,558,888
Domestic	4,293,991	4,926,390	5,655,659	5,485,990	6,308,888
Exports	91,867	114,581	133,979	140,000	250,000
Scooter	214,272	361,473	445,503	535,000	650,000
Domestic	208,440	342,991	409,780	500,000	600,000
Exports	5,832	18,482	35,723	35,000	50,000
Total	4,600,130	5,402,444	6,235,141	6,160,990	7,208,888

Source: Company, Edelweiss research

Table 2: Product mix (% total sales)

	FY10	FY11	FY12	FY13E	FY14E
Motorcycle	95.3	93.3	92.9	91.3	91.0
Domestic	93.3	91.2	90.7	89.0	87.5
Exports	2.0	2.1	2.1	2.3	3.5
Scooter	4.7	6.7	7.1	8.7	9.0
Domestic	4.5	6.3	6.6	8.1	8.3
Exports	0.1	0.3	0.6	0.6	0.7
Total	100.0	100.0	100.0	100.0	100.0

Source: Company, Edelweiss research

Table 3: Edelweiss Vs Bloomberg consensus

Particulars	FY13E			FY14E		
	Edelweiss	Consenses	% var	Edelweiss	Consenses	% var
Sales (INR mn)	235,215	254,165	(7.5)	274,061	296,517	(7.6)
EBITDA (INR mn)	34,336	35,829	(4.2)	39,329	40,642	(3.2)
EBITDA (%)	14.6	14.1		14.4	13.7	
EPS (INR)	115.9	126.5	(8.4)	125.0	137.4	(9.0)

Source: Bloomberg, Edelweiss research

Financial snapshot								(INR mn)
Year to March	Q2FY13	Q2FY12	% change	Q1FY13	% change	FY12	FY13E	FY14E
Two wheelers	1,332,805	1,544,315	(13.7)	1,642,292	(18.8)	6,235,141	6,160,990	7,208,888
Net realisation (INR)	38,649	37,456	3.2	37,799	2.2	37,484	38,178	38,017
Total revenues	51,875	58,293	(11.0)	62,473	(17.0)	233,719	235,215	274,061
Raw material	37,702	42,237	(10.7)	46,026	(18.1)	172,816	170,760	201,803
Staff costs	1,922	1,794	7.1	2,046	(6.1)	7,355	7,943	8,579
Other expenses	5,059	5,075	(0.3)	5,032	0.5	19,422	22,176	24,351
Total expenditure	44,683	49,106	(9.0)	53,104	(15.9)	199,592	200,880	234,732
EBIDTA	7,192	9,187	(21.7)	9,369	(23.2)	34,126	34,336	39,329
Dep. and amortisation	2,895	2,785		3,035		10,973	12,632	13,176
EBIT	4,297	6,402	(32.9)	6,334	(32.2)	23,153	21,703	26,152
Interest (net)	30	(45)	165.7	29	0.7	213	196	196
Other income	993	798	24.6	1,044	(4.9)	5,787	6,304	6,456
PBT	5,261	7,245	(27.4)	7,349	(28.4)	28,727	27,812	32,412
Tax	855	1,208	(29.3)	1,194	(28.4)	4,866	4,672	7,455
Adjusted net profit	4,406	6,036	(27.0)	6,155	(28.4)	23,861	23,139	24,958
Reported net profit	4,406	6,036	(27.0)	6,155	(28.4)	23,861	23,139	24,958

As % of total revenues

Raw material	72.7	72.5		73.7		73.9	72.6	73.6
Staff costs	3.7	3.1		3.3		3.1	3.4	3.1
Other expenses	9.8	8.7		8.1		8.3	9.4	8.9
EBIDTA	13.9	15.8		15.0		14.6	14.6	14.4
EBIT	8.3	11.0		10.1		9.9	9.2	9.5
Adjusted net profit	8.5	10.4		9.9		10.2	9.8	9.1
Tax rate	16.3	16.7		16.3		16.9	16.8	23.0

Change in estimates

(INR mn)

Year to March	FY13E			FY14E			Comments
	Earlier	Revised	% change	Earlier	Revised	% change	
Volumes (nos)	6,663,572	6,160,990	(7.5)	7,423,179	7,208,888	(2.9)	Lowered to adjust recent months weakness
Net sales	251,107	235,215	(6.3)	282,273	274,061	(2.9)	Largely due to lower volume
EBITDA	37,522	34,336	(8.5)	41,379	39,329	(5.0)	
EBITDA margin (%)	14.9	14.6		14.7	14.4		
Adj. PAT	25,827	23,139	(10.4)	26,727	24,958	(6.6)	
PAT margin (%)	10.3	9.8		9.5	9.1		
EPS	129.3	115.9	(10.4)	133.8	125.0	(6.6)	
Capex	11,000	11,000	-	14,000	14,000	-	

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 be muted on weak market sentiment and inventory related issues. Margins should also see pressure due to increasing input costs and SGA expenses on higher competitive intensity and entry into newer export markets. Partial withdrawal of tax benefits at Haridwar plant should also lower net margin in FY14.

Key Risks

- Increasing competitive intensity from peers like Honda and Bajaj Auto may result in Hero losing market share further which would result in lower sales volume and margins as well.
- Weak INR is a key negative for increasing royalty charges.

Financial Statements

Key assumptions

Hero Motocorp		FY10	FY11	FY12	FY13E	FY14E
Macro -	GDP (Y-o-Y %)	8.4	8.4	6.5	5.8	6.5
	Inflation (Avg)	3.6	9.9	8.8	7.8	6.0
	Repo rate (exit rate)	5.0	6.8	8.5	7.5	6.8
	USD/INR (Avg)	47.4	45.6	47.9	53.5	52.0
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 - dom. vol (% YoY)	23.1	14.7	14.8	(3.0)	15.0

Income statement

Income statement		(INR mn)				
Year to March	FY10	FY11	FY12	FY13E	FY14E	
Total volume (nos)	4,600,130	5,402,444	6,235,141	6,160,990	7,208,888	
% Growth in volume	23.6	17.4	15.4	(1.2)	17.0	
Income from operations	158,313	194,011	233,719	235,215	274,061	
Materials costs	107,364	141,111	172,816	170,760	201,803	
Manufacturing expenses	2,245	2,653	3,002	3,092	3,247	
Employee costs	5,603	6,190	7,355	7,943	8,579	
Total SG&A expenses	15,748	17,894	16,419	19,084	21,104	
EBITDA	27,353	26,164	34,126	34,336	39,329	
Depreciation & Amortization	1,915	4,024	10,973	12,632	13,176	
Non-Operational Income	3,633	4,425	5,787	6,304	6,456	
Interest expenses	21	158	213	196	196	
Profit before tax	29,050	26,407	28,727	27,812	32,412	
Provision for tax	5,999	4,928	4,866	4,672	7,455	
Net profit	23,051	21,479	23,861	23,139	24,958	
Extraordinary income/ (loss)	-	(639)	-	-	-	
Profit After Tax	23,051	20,840	23,861	23,139	24,958	
Basic EPS (INR)	115.4	107.6	119.5	115.9	125.0	
Shares outstanding (mn)	200	200	200	200	200	
Diluted EPS (INR)	115.4	107.6	119.5	115.9	125.0	
Dividend per share (INR)	110.0	105.0	45.0	50.0	52.0	
Dividend payout (%)	95.3	100.6	37.7	43.2	41.6	

Common size metrics - as % of net revenues

Year to March	FY10	FY11	FY12	FY13E	FY14E
Materials costs	67.8	72.7	73.9	72.6	73.6
S G & A expenses	9.9	9.2	7.0	8.1	7.7
EBITDA margins	17.3	13.5	14.6	14.6	14.4
Net profit margins	14.6	11.1	10.2	9.8	9.1

Growth ratios (%)

Year to March	FY10	FY11	FY12	FY13E	FY14E
Rev. growth (%)	28.5	22.5	20.5	0.6	16.5
EBITDA	62.4	(4.3)	30.4	0.6	14.5
PBT	63.1	(9.1)	8.8	(3.2)	16.5
EPS growth (%)	80.0	(6.8)	11.1	(3.0)	7.9

Balance sheet						(INR mn)
As on 31st March	FY10	FY11	FY12	FY13E	FY14E	
Equity capital	399	399	399	399	399	
Reserves & surplus	34,251	29,161	42,508	53,965	66,773	
Shareholders funds	34,650	29,561	42,908	54,365	67,172	
Unsecured loans	660	327	6,749	6,749	6,749	
Borrowings	660	327	6,749	6,749	6,749	
Deferred payment credit	-	14,585	20,268	11,148	2,028	
Deferred tax liability	1,528	2,468	2,468	2,468	2,468	
Sources of funds	36,838	46,940	72,392	74,729	78,417	
Gross block	27,510	55,385	75,245	86,245	100,245	
Depreciation	10,922	14,582	25,555	38,188	51,364	
Net block	16,588	40,803	49,689	48,057	48,881	
Capital work in progress	481	1,251	1,251	1,251	1,251	
Investments	39,257	51,288	51,288	62,518	67,570	
Inventories	4,364	5,249	6,330	6,369	7,426	
Sundry debtors	1,084	1,306	1,575	1,584	1,847	
Cash and equivalents	19,072	715	862	868	1,012	
Loans and advances	4,306	7,775	7,775	7,775	7,775	
Total current assets	28,826	15,046	16,543	16,596	18,061	
Sundry creditors and others	22,076	36,659	35,445	41,591	44,777	
Provisions	26,239	24,789	10,934	12,103	12,570	
Total current liabilities & provisions	48,314	61,448	46,379	53,693	57,346	
Net current assets	(19,488)	(46,402)	(29,836)	(37,097)	(39,286)	
Uses of funds	36,838	46,940	72,392	74,729	78,417	
Book value per share (INR)	173.5	148.0	214.9	272.2	336.4	

Free cash flow						(INR mn)
Year to March	FY10	FY11	FY12	FY13E	FY14E	
Net profit	23,051	20,840	23,861	23,139	24,958	
Depreciation	1,915	4,024	10,973	12,632	13,176	
Deferred tax	83	940	-	-	-	
Others	(83)	(2,763)	(9,111)	(8,177)	(9,120)	
Gross cash flow	24,966	23,041	25,724	27,595	29,014	
Less: Changes in WC	(5,268)	(452)	1,629	(5,155)	(1,865)	
Operating cash flow	30,234	23,494	24,094	32,750	30,879	
Less: Capex	2,041	3,490	6,000	11,000	14,000	
Free cash flow	28,193	20,003	18,094	21,750	16,879	

Cash flow metrics					
Year to March	FY10	FY11	FY12	FY13E	FY14E
Operating cash flow	30,234	23,494	24,094	32,750	30,879
Investing cash flow	(7,611)	(15,521)	(6,000)	(22,230)	(19,053)
Financing cash flow	(5,747)	(26,330)	(17,947)	(10,514)	(11,682)
Net cash flow	16,876	(18,357)	147	5	144
Capex	(2,041)	(3,490)	(6,000)	(11,000)	(14,000)
Dividends paid	(4,973)	(25,540)	(24,369)	(10,514)	(11,682)

Profitability & efficiency ratios

Year to March	FY10	FY11	FY12	FY13E	FY14E
ROAE (%)	63.5	66.9	65.9	47.6	41.1
ROACE (%)	75.4	63.4	48.5	38.1	42.6
Inventory day	13	12	12	14	12
Debtors days	3	2	2	2	2
Payable days	63	76	76	82	78
Cash conversion cycle (days)	(48)	(61)	(62)	(66)	(63)
Current ratio	0.6	0.2	0.4	0.3	0.3
Debt/EBITDA	-	-	0.2	0.2	0.2
Fixed asset turnover (x)	6.0	4.7	3.6	2.9	2.9

Operating ratios

Year to March	FY10	FY11	FY12	FY13E	FY14E
Total asset turnover	4.1	4.6	3.9	3.2	3.6
Fixed asset turnover	9.8	6.8	5.2	4.8	5.7
Equity turnover	4.4	6.0	6.5	4.8	4.5

Valuation parameters

Year to March	FY10	FY11	FY12	FY13E	FY14E
Diluted EPS (INR)	115.4	107.6	119.5	115.9	125.0
Y-o-Y growth (%)	80.0	(6.8)	11.1	(3.0)	7.9
CEPS (INR)	125.4	132.4	174.4	179.1	191.0
Diluted PE (x)	15.6	16.7	15.0	15.5	14.4
Price/BV (x)	10.3	12.1	8.4	6.6	5.3
EV/Sales (x)	1.9	1.6	1.3	1.3	1.1
EV/EBITDA (x)	11.0	11.7	9.2	8.8	7.5
Dividend yield (%)	6.1	5.8	2.5	2.8	2.9

Peer comparison valuation

Company	Price INR	Market-cap (INRbn)	PE (x)		EV/EBITDA (x)		RoE (%)	
			FY13E	FY14E	FY13E	FY14E	FY13E	FY14E
Hero Motocorp	1,800	359,460	15.5	14.4	8.8	7.6	47.6	41.1
Bajaj Auto	1,771	512	17.0	12.7	11.3	7.9	45.0	47.4
TVS Motor	42	20	9.0	7.6	6.0	5.4	19.0	19.6
Maruti Suzuki	1,370	399	19.6	13.0	10.4	6.4	12.4	16.4
Yamaha	523	183	16.0	10.3	7.4	5.5	5.8	8.6
Honda	1,751	3,171	9.6	8.2	8.3	7.3	10.8	11.5

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	HOLD	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



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Coverage group(s) of stocks by primary analyst(s): Automobiles

Ashok Leyland, Bajaj Auto, Eicher Motors, Exide Industries, Hero MotoCorp, Mahindra & Mahindra Ltd, Maruti Suzuki India Ltd, Tata Motors Ltd

Recent Research

Date	Company	Title	Price (INR)	Recos
23-Oct-12	Bajaj Auto	Product mix supports margins; <i>Result Update</i>	1,786	Hold
19-Oct-12	Exide Industries	Margins disappoint; <i>Result Update</i>	148	Hold
10-Oct-12	Auto Compass	September: A dull month; <i>Monthly Update</i>		

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	113	53	19	186
* 1 stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	114	58	14	

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period



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