

Buy**Hero MotoCorp**

Industry: Auto and Auto Components



Demand shows sequential improvement, corporate tax cuts to support earnings

Better than expected numbers in Q2

Total net revenues in the quarter went down by 16.7% yoy and 5.7% qoq as volumes were down by 20% yoy and 8.3% qoq in the quarter. Net realizations were up by 4.9% yoy on price hike taken in July and new launches launched recently. RM costs to sales came down to 67.7% as against 69.3% yoy as the impact of softening RM prices was felt in the quarter. Employee costs moved up to 6.2% of sales v/s 4.8% yoy, as company introduced VRS scheme for employees and has considered a provision of ₹0.61 bn during the quarter. Other expenses to sales inched up to 11.6% v/s 10.8% on higher discounts and advertising expenses. Margins came in at 14.5% which were better than street expectations on cost optimization, softer commodity costs and LEAP program. Corporate tax cuts by GOI led to a 14.8% tax rate which according to the management; will normalize to 25% for full year. Reported PAT was down by 10.3% yoy at ₹8.7 bn. Adjusted for one off items, PAT came in at ₹9.34 bn, down 4% yoy.

Management sounds positive on retail demand pick up in festivals

According to management, retail demand across rural and urban markets has started to pick up from second half of September. Rural demand is higher than urban demand. They expect a single digit growth in festive season, up from a huge negative growth observed in the previous months. Post November, rural sentiments are expected to improve on good monsoon. Though the kharif crop may have got destroyed in certain pockets like MP and South India due to excess rains, but rest of the country is expected to produce a good crop output. Also Rabi crop is expected to be robust on plentiful availability of water. The management mentioned that inventory level is at 45 days and would strive to bring it to comfortable 30 days post festive season, which we believe is quite possible to get, considering discounts and ad initiatives taken by the company. The recent launches of Xtreme and XPulse are gaining good market share and are expected to do well hereon too. Low base of last year and pre-buying in Q4 should lift up FY20E volumes, though the growth rate will be in negative territory only. We expect -9%/10% growth rate in FY20E/21E respectively.

RM tailwinds to continue, higher promotional expenses to keep a check on FY 20 margins

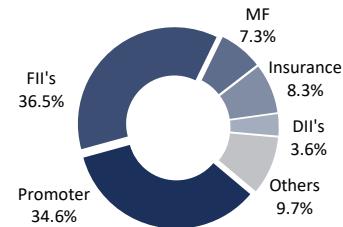
Hero's EBITDA margins in the quarter came at 14.5%, much better than expectations, mainly on price hike taken in July, cost optimization, softened RM costs and LEAP program. Going forward, new vehicle launch costs in line with introduction of new BS VI products and promotional expenses related with BS IV inventory clean up. Going forward, there will be some pressure on margins, but RM costs tailwinds are expected to arrest the decline up to some extent in FY20E. With volume growth in FY21E expected, margins may see an up-move on better operating leverage.

Stock Data

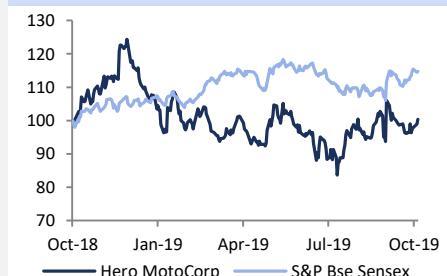
CMP (₹)	2,699
12M Price Target (₹)	2,975
Potential upside (%)	10
BSE / NSE Symbol	500182 / HEROMOTOCO
Reuters / Bloomberg	HROH.BO / HMCL IN
FV (₹)	2
Market Cap Full (₹ bn)	539
52-Week Range (₹)	3,383 / 2,228

What's Changed

12 M Price Target (₹)	From 2,702 to 2,975
FY2020E EPS (₹)	From 162 to 184
FY2021E EPS (₹)	From 180 to 198

Shareholding Pattern (September 2019)


YE Mar	FY18	FY19	FY20E	FY21E
Revenues(₹ bn)	322	337	324	361
EBITDA (%)	16.4	14.7	14.3	14.8
PAT (%)	11.5	10.1	11.3	11.0
EPS (₹)	185.2	169.5	183.5	198.3
EPS growth (%)	9.5%	-8.5%	8.2%	8.1%
P/E (x)	14.5	15.9	14.7	13.6
P/B(x)	2.4	2.2	2.0	1.9
EV/EBITDA (x)	9.3	9.6	9.4	8.9
ROCE (%)	33.4%	29.2%	27.1%	27.7%
ROE (%)	31.4%	26.3%	26.1%	25.9%
Divid. yield (%)	3.2%	3.2%	3.7%	4.1%

Relative Price Performance
**Ashwin Patil**

ashwin_patil@lkpsec.com

+91 22 6635 1271

LKP Research

Financial Highlights

All fig in ₹ mn	Q2 FY20	Q1 FY20	% qoq	Q2 FY19	% yoy
Total net sales	75,707	80,303	-5.7%	90,904	-16.7%
RM cost	51,257	55,919	-8.3%	62,997	-18.6%
Employee cost	4,689	4,677	0.3%	4,341	8.0%
Other expenses	8,750	8,127	7.7%	9,784	-10.6%
EBITDA	11,011	11,580	-4.9%	13,782	-20.1%
<i>EBITDA Margins %</i>	<i>14.5</i>	<i>14.4</i>	<i>10 bps</i>	<i>15.2</i>	<i>(70 bps)</i>
Other income	2,078	9,563	-78.3%	2,237	-7.1%
Depreciation	2,034	2,361	-13.8%	1,518	34.0%
Interest	76.7	43.7	75.5%	21.4	258.4%
PBT	10,979	18,738	-41.4%	14,479	-24.2%
Tax	1,629	6,165	-73.6%	4,722	-65.5%
PAT	9,349	12,573	-25.6%	9,757	-4.2%
<i>PAT margins %</i>	<i>12.3</i>	<i>15.7</i>	<i>640 bps</i>	<i>10.7</i>	<i>160 bps</i>
Exceptional items	601	4,948	N/A	-	N/A
Adjusted PAT	8,748	7,625	14.7%	9,757	-10.3%
<i>APAT margins %</i>	<i>11.6</i>	<i>9.5</i>	<i>20 bps</i>	<i>10.7</i>	<i>90 bps</i>

Outlook and valuation

Q2 witnessed demand deceleration on weak consumer sentiments, financing issues and higher pricing related with ABS implementation. However, with some green shoots seen in rural demand by the end of the quarter, we believe the festive demand will see some uptick, first on the retail side followed by wholesale. Inventory levels are also coming down comfortably as a result of higher promotional initiatives. Bountiful monsoon is expected to have a positive impact on rural demand from November as Rabi crop output is expected to be healthy. BS VI pre-buying, low base and good monsoons are expected to reduce the current uncertainty in demand. Margins may remain in similar range as H1 in H2 as well, as higher promotional expenses related with BS IV inventory may negate the impact of soft RM prices. We expect an improvement in margins in FY21 as pent up demand will have result in operating leverage. Reduction in corporate tax along with improved outlook on volumes leads us to raise our estimates and target price. Maintain BUY with a target of ₹2,975.

All figs in ₹	Q2 FY20	Q1 FY20	Q4 FY19	Q3 FY19	Q2 FY19	Q1 FY19	Q4 FY18	Q3 FY18
Volumes (mn)	1.69	1.84	1.78	1.80	2.13	2.11	2.00	1.71
Net Realization	44,815	43,574	44,266	43,720	42,739	41,827	42,786	42,744
Material Cost/Unit	30,342	30,343	30,532	30,099	29,619	29,270	28,942	28,799
Staff Cost/Unit	2,776	2,538	2,511	2,422	2,041	1,961	1,903	2,352
Other Expn/Unit	5,179	4,410	5,220	5,058	4,600	4,057	5,093	4,819
Total Expn/Unit	38,297	37,290	38,263	37,579	36,260	35,288	35,939	35,969
EBITDA/unit	6,518	6,283	6,003	6,141	6,480	6,539	6,847	6,775
Net profit /unit	5,534	6,822	4,100	4,275	4,588	4,317	4,833	4,713

Financials

Income statement

YE Mar (₹ mn)	FY 18	FY 19	FY 20E	FY 21E
Total Revenues	3,22,305	3,36,505	3,24,437	3,61,177
Raw Material Cost	2,18,346	2,33,177	2,23,861	2,51,018
Employee Cost	15,401	17,302	18,493	18,781
Other Exp	35,755	36,725	35,688	37,924
EBITDA	52,803	49,301	46,394	53,454
<i>EBITDA Margin (%)</i>	16.4	14.7	14.3	14.8
Other income	5258	6913	11000	7000
Depreciation	5,556	6,020	8,454	7,563
Interest	63	86	90	90
PBT	52,443	50,107	48,851	52,801
<i>PBT Margin (%)</i>	16.3	14.9	15.1	14.6
Exceptional items	0	0	0	0
Tax	15,468	16,258	12,213	13,200
PAT	36,975	33,849	36,638	39,601
<i>PAT Margins (%)</i>	11.5	10.1	11.3	11.0
Adj PAT	36,975	33,849	36,638	39,601
Adj PAT Margin (%)	11.5	10.1	11.3	11.0

Key Ratios

YE Mar	FY 18	FY 19	FY 20E	FY 21E
Per Share Data (Rs)				
Adj. EPS	185.2	169.5	183.5	198.3
CEPS	213.0	199.6	225.8	236.2
BVPS	589.3	643.8	704.2	766.0
DPS	87.0	87.0	100.0	110.0
Growth Ratios (%)				
Total revenues	13.2%	4.4%	-3.6%	11.3%
EBITDA	13.9%	-6.6%	-5.9%	15.2%
PAT	9.5%	-8.5%	8.2%	8.1%
EPS Growth	9.5%	-8.5%	8.2%	8.1%
Valuation Ratios (x)				
PE	14.5	15.9	14.7	13.6
P/CEPS	12.6	13.5	11.9	11.4
P/BV	2.4	2.2	2.0	1.9
EV/Sales	1.7	1.6	1.7	1.5
EV/EBITDA	9.3	9.6	9.4	8.9
Operating Ratios (Days)				
Inventory days	14.0	13.0	13.0	13.0
Receivable Days	15.0	15.0	15.0	15.0
Payables day	42.0	42.0	42.0	42.0
Net Debt/Equity (x)	0.04	0.04	0.03	0.01
Profitability Ratios (%)				
ROCE	33.4%	29.2%	27.1%	27.7%
ROE	31.4%	26.3%	26.1%	25.9%
Dividend yield	3.2%	3.2%	3.7%	4.1%

Source: Company, LKP Research

Balance sheet

YE Mar (₹ mn)	FY 18	FY 19	FY 20E	FY 21E
EQUITY & LIABILITIES				
Equity Share Capital	399	399	399	399
Reserves & Surplus	1,17,289	1,28,172	1,40,236	1,52,564
Total Networth	1,17,688	1,28,571	1,40,636	1,52,963
Total debt	6,265	6,537	6,537	6,537
Deferred Tax Liability	0	0	0	0
Current Liab & Prov				
Current liabilities	33,188	33,553	29,439	30,947
Other liabilities & Provisions	10,245	7,751	7,751	7,751
Total Equity and Liabilities	1,67,385	1,76,410	1,84,361	1,98,196
ASSETS				
Net block	44,859	44,775	42,322	44,759
Capital WIP	2,038	3,607	5,607	8,607
Intangible assets	2,832	3,222	3,222	3,222
Deferred tax assets	0	0	0	0
Long term investments	19,341	28,015	32,015	38,015
Long term loans & advances	4,249	8,992	8,992	8,992
Other non current assets	5,587	6,644	6,644	6,644
Total non-current assets	78,906	95,256	98,802	1,10,239
Current Assets				
Current investments	55,911	31,671	30,671	24,671
Cash and Bank	1,413	1,365	1,992	5,416
Inventories	8,236	10,724	13,493	13,067
Sundry Debtors	15,202	28,216	30,221	35,623
Loan, Advances & others	7,720	9,181	9,181	9,181
Other current assets	276	250	250	250
Total Assets	1,67,388	1,76,412	1,84,360	1,98,196
Cash Flow				
YE Mar (₹ mn)	FY 18	FY 19	FY 20E	FY 21E
PBT	36,974	33,849	36,638	39,601
Depreciation	5,556	6,020	8,454	7,563
Interest	63	86	90	90
Chng in working capital	1,601	-19,189	-7,889	2,533
Tax paid	525	-4,255	12,213	13,200
Other operating activities	39,809	-6,720	-12,257	-19,200
Cash flow from operations (a)	39,809	9,791	37,248	43,788
Capital expenditure	-7,992	-9,179	-8,000	-13,000
Chng in investments	-11,812	25,577	-3,000	0
Other investing activities	652	-3,185	0	0
Cash flow from investing (b)	-19,152	13,213	-11,000	-13,000
Free cash flow (a+b)	20,656	23,004	26,248	30,788
Inc/dec in borrowings	0	0	0	0
Dividend paid (incl. tax)	-20,431	-22,874	-24,574	-27,274
Other financing activities	-63	-86	-90	-90
Cash flow from financing (c)	-20,467	-22,940	-24,664	-27,364
Net chng in cash (a+b+c)	190	64	1,585	3,424
Closing cash & cash equivalents	343	407	1,992	5,416

DISCLAIMERS AND DISCLOSURES

LKP Sec. Ltd. (CIN-L67120MH1994PLC080039, www.lkpsec.com) and its affiliates are a full-fledged, brokerage and financing group. LKP was established in 1992 and is one of India's leading brokerage and distribution house. LKP is a corporate trading member of Bombay Stock Exchange Limited (BSE), National Stock Exchange of India Limited(NSE), MCX Stock Exchange Limited (MCX-SX).LKP along with its subsidiaries offers the most comprehensive avenues for investments and is engaged in the businesses including stock broking (Institutional and retail), merchant banking, commodity broking, depository participant, insurance broking and services rendered in connection with distribution of primary market issues and financial products like mutual funds etc.

LKP hereby declares that it has not defaulted with any stock exchange nor its activities were suspended by any stock exchange with whom it is registered in last five years. However, SEBI and Stock Exchanges have conducted the routine inspection and based on their observations have issued advice letters or levied minor penalty on LKP for certain operational deviations in ordinary/routine course of business. LKP has not been debarred from doing business by any Stock Exchange / SEBI or any other authorities; nor has its certificate of registration been cancelled by SEBI at any point of time.

LKP offers research services to clients. The analyst for this report certifies that all of the views expressed in this report accurately reflect his or her personal views about the subject company or companies and its or their securities, and no part of his or her compensation was, is or will be, directly or indirectly related to specific recommendations or views expressed in this report.

Other disclosures by LKP and its Research Analyst under SEBI (Research Analyst) Regulations, 2014 with reference to the subject company(s) covered in this report:-

Research Analyst or his/her relative's financial interest in the subject company. (NO)

LKP or its associates may have financial interest in the subject company.

LKP or its associates and Research Analyst or his/her relative's does not have any material conflict of interest in the subject company. The research Analyst or research entity (LKP) has not been engaged in market making activity for the subject company.

LKP or its associates may have actual/beneficial ownership of 1% or more securities of the subject company at the end of the month immediately preceding the date of publication of Research Report.

Research Analyst or his/her relatives have actual/beneficial ownership of 1% or more securities of the subject company at the end of the month immediately preceding the date of publication of Research Report: (NO)

LKP or its associates may have received any compensation including for investment banking or merchant banking or brokerage services from the subject company in the past 12 months.

LKP or its associates may have received compensation for products or services other than investment banking or merchant banking or brokerage services from the subject company in the past 12 months.

LKP or its associates may have received any compensation or other benefits from the Subject Company or third party in connection with the research report.

Subject Company may have been client of LKP or its associates during twelve months preceding the date of distribution of the research report and LKP may have co-managed public offering of securities for the subject company in the past twelve months.

Research Analyst has served as officer, director or employee of the subject company: (NO)

LKP and/or its affiliates may seek investment banking or other business from the company or companies that are the subject of this material. Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients that reflect opinions that are contrary to the opinions expressed herein, and our proprietary trading and investing businesses may make investment decisions that may be inconsistent with the recommendations expressed herein.

In reviewing these materials, you should be aware that any or all of the foregoing, among other things, may give rise to real or potential conflicts of interest including but not limited to those stated herein. Additionally, other important information regarding our relationships with the company or companies that are the subject of this material is provided herein. This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would subject LKP or its group companies to any registration or licensing requirement within such jurisdiction. Specifically, this document does not constitute an offer to or solicitation to any U.S. person for the purchase or sale of any financial instrument or as an official confirmation of any transaction to any U.S. person.

Unless otherwise stated, this message should not be construed as official confirmation of any transaction. No part of this document may be distributed in Canada or used by private customers in United Kingdom.

All trademarks, service marks and logos used in this report are trademarks or registered trademarks of LKP or its Group Companies. The information contained herein is not intended for publication or distribution or circulation in any manner whatsoever and any unauthorized reading, dissemination, distribution or copying of this communication is prohibited unless otherwise expressly authorized. Please ensure that you have read "Risk Disclosure Document for Capital Market and Derivatives Segments" as prescribed by Securities and Exchange Board of India before investing in Indian Securities Market. In so far as this report includes current or historic information, it is believed to be reliable, although its accuracy and completeness cannot be guaranteed.

All material presented in this report, unless specifically indicated otherwise, is under copyright to LKP. None of the material, nor its content, nor any copy of it, may be altered in any way, transmitted to, copied or distributed to any other party, without the prior express written permission of LKP.