

Sector: Automobiles
Result Update

	Change
Reco: Hold	↔
CMP: Rs. 2,712	
Price Target: Rs. 2,900	↔

↑ Upgrade ↔ No change ↓ Downgrade

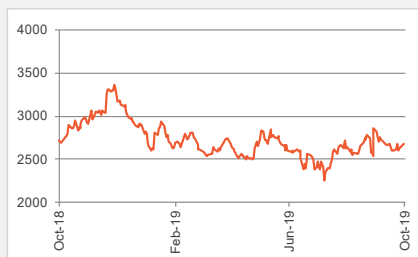
Company details

Market cap:	Rs. 54,171 cr
52-week high/low:	Rs. 3,383/2,228
NSE volume: (No of shares)	9.1 lakh
BSE code:	500182
NSE code:	HEROMOTOCO
Sharekhan code:	HEROMOTOCO
Free float: (No of shares)	13.0 cr

Shareholding (%)

Promoters	34.6%
Institutions	19.2%
Foreign	36.8%
Non Promoter Corp	1.1%
Public and Others	8.3%

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-6.6	11.3	0.7	1.0
Relative to Sensex	-8.9	8.3	-0.9	-12.6

Sharekhan Research, Bloomberg

Hero MotoCorp's (Hero) Q2FY2020 results were broadly in line with our estimates. Hero managed to marginally improve its margins on a q-o-q basis, driven by cost-control initiatives and softening commodity prices. While management indicated marginal growth in retail sales during the festive season, it stated the same may not be sustainable. Management also stated that a sustained recovery would take more time. Moreover, due to higher inventory, wholesale would continue to remain negative even in the festive period. Steep cost increases ahead of BS6 norms (10-12% price increase expected) would dampen demand. We expect demand to remain flat over the next four quarters. We retain our Hold rating on the stock with an unchanged price target (PT) of Rs. 2,900.

Key positives

- Hero's operating margin at 14.5% improved on a q-o-q basis and was marginally better than our estimate of 14.1%. Cost-control measures and softening commodity prices led to better-than-expected margins.
- Hero undertook price increase of Rs. 200/bike in July 2019, which boosted realisation during the quarter.

Key negatives

- Hero's volumes declined sharply by 21% y-o-y in Q2FY2020 and the company marginally lost market share. Hero's market share fell from 35.2% in Q2FY2019 to 34.9% in Q2FY2020.
- During the quarter, Hero realised exceptional charge of Rs. 60 crore on account of VRS scheme introduced during the quarter.

Our Call

Demand headwinds to persist; Retain Hold: The two-wheeler (2W) industry is likely to witness subdued demand due to higher inventory levels and steep cost increases with the advent of BS6 emission norms. Entry-level bikes, where Hero has a dominant share, are likely to witness steep cost increases of 10-12%. We expect flat demand for the industry over the next four quarters. We have broadly retained our earnings estimates. We retain our Hold rating on the stock with an unchanged PT of Rs. 2,900.

Key Risks

Any reduction in personal income tax or scrappage policy would lead to meaningful demand revival and is a key risk to our call.

Valuation

Particulars	Rs cr				
	FY17	FY18	FY19	FY20E	FY21E
Net Sales (Rs. cr)	28500.5	32230.5	33650.5	32889.3	35597.2
Growth (%)	0.2	13.1	4.4	-2.3	8.2
EBIDTA (Rs. cr)	4634.8	5280.2	4930.1	4762.2	4939.5
OPM (%)	16.3	16.4	14.7	14.5	13.9
PAT (Rs. cr)	3377.1	3697.4	3384.9	3507.5	3682.4
Growth (%)	6.9	9.5	-8.5	3.6	5.0
FD EPS (Rs.)	169.1	185.1	169.5	175.6	184.4
P/E (x)	16.0	14.6	16.0	15.4	14.7
P/B (x)	5.4	4.6	4.2	3.8	3.4
EV/EBIDTA (x)	10.4	8.8	9.7	9.9	9.4
RoE (%)	33.4%	31.4%	26.3%	28.0%	23.2%
RoCE (%)	44.0%	42.4%	37.2%	31.2%	29.8%

Source: Company; Sharekhan estimates

Results broadly in line with estimates: Hero's Q2FY2020 results were broadly in line with our estimates. Topline declined by 17% y-o-y because of 21% drop in volumes. Realisation improved by 5% y-o-y, driven by price hikes. Hero's operating margin dropped by 70 BPS y-o-y but improved by 10 BPS q-o-q. Margins at 14.5% were broadly in line with our estimate of 14.1%. Cost-control measures coupled with softening commodity prices led to marginal improvement in margins on a sequential basis. EBIDTA dropped by 20% y-o-y; however, due to lower tax rate (Tax/PBT) of 15.7%, adjusted net profit dropped by 6% y-o-y to Rs. 915 crore and was in line with our estimate of Rs. 899 crore. During the quarter, Hero realised exceptional charge of Rs. 60 crore due to VRS expense. Reported PAT stood at Rs. 875 crore, dropping by 10%.

Demand headwinds to sustain in the medium term: We expect demand headwinds to sustain for the 2W industry in the medium term. Higher inventory levels (current industry inventory stands at 6-7 weeks) and steep cost increases on account of BS6 emission norms (price increase of 10-12% expected for entry-level bikes) would sustain demand pressures for the 2W industry. While Hero indicated marginal growth in festive demand at the retail level, management indicated that it may not sustain post the festive season. As per management, sustained recovery in demand would take longer time. Moreover, due to higher inventory, wholesale sales would continue their declining trend in the festive season. We expect the 2W industry to report flat volumes over the next four quarters.

Conference call highlights:

Price hikes: Hero announced price increases of Rs. 200/bike in July 2019.

Financing: The share of financing improved marginally to 46% in Q2FY2020 as against 44% in Q2FY2019.

Festive demand: Hero expects retail demand to show marginal growth in the festive month of October 2019; but the same will not be reflected in wholesale, as inventory levels are high.

Near-term demand outlook: Management indicated that although festive demand is positive, the same may not sustain beyond the festive season. Management indicated negative wholesale growth to continue in Q3FY2020.

Inventory: With inventory correction planned during the festive season, Hero is targeting to bring down inventory to 30-35 days post the festive season.

Pre-buying ahead of BS6 norms: Hero expects some pre-buying from customers in Q4FY2020 before the transition to BS6 norms. Management has not provided quantification of the same.

Transition to BS6 norms: Hero indicated that it would commence transition to BS6 norms post the festive season. Hero would do a calibrated launch of BS6-compliant products starting November 2019 and go model by model before fully transiting to BS6 by March 2019.

Results					Rs cr	
Particulars	Q2FY20	Q2FY19	%YoY	Q1FY20	%QoQ	
Total Income	7,570.7	9,090.9	-16.7	8,030.3	-5.7	
EBIDTA	1,101.1	1,378.7	-20.1	1,158.0	-4.9	
EBIDTA Margin (%)	14.5	15.2	(70) bps	14.4	10 bps	
Depreciation	203.4	151.8	34.0	236.1	(13.8)	
Interest	7.7	2.1	258.4	4.4	75.5	
Other Income	207.8	223.7	(7.1)	218.8	(5.0)	
PBT	1,097.9	1,448.5	(24.2)	1,136.4	(3.4)	
Tax	162.9	472.2	(65.5)	623.7	(73.9)	
Reported PAT	874.8	976.3	(10.4)	1,257.3	(30.4)	
Adjusted PAT	915.1	976.3	(6.3)	762.5	20.0	
EPS (Rs.)	45.8	48.9	(6.3)	38.2	20.0	

Source: Company

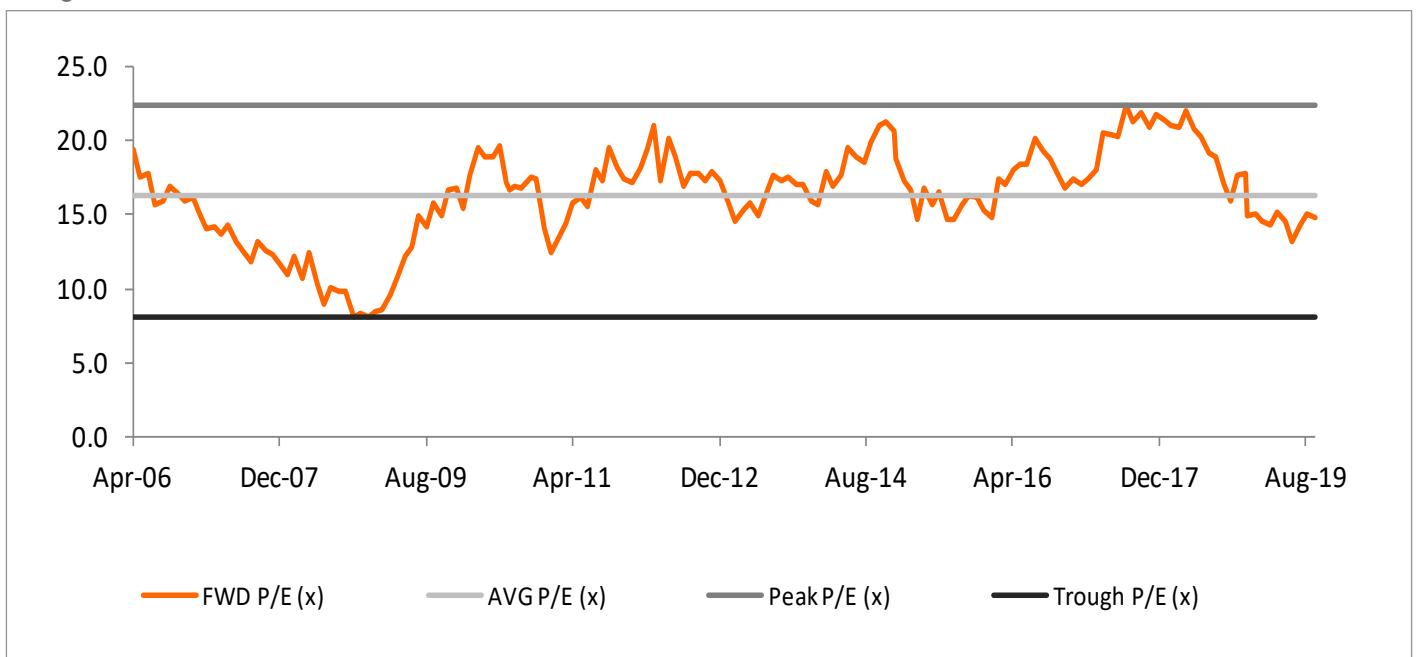
Outlook

Demand challenges to remain in the medium term: The 2W industry’s demand headwinds are likely to sustain over the next four quarters. Higher inventory coupled with steep cost increases due to BS6 norms would dampen demand. We expect the 2W industry’s volumes to remain flat over the next four quarters.

Valuation

Retain estimates; Maintain Hold with unchanged PT of Rs. 2,900: Hero’s Q2FY2020 results were broadly in line with our estimates. Demand environment is expected to remain challenging in the medium term. Steep cost increases on account of BS6 norms (10-12% cost increases for entry level bikes) would impact profitability. We have broadly retained our earnings estimates. We retain our Hold rating on the stock with an unchanged PT of Rs. 2,900.

One-year forward PE chart



Source: Sharekhan Research

Peer Comparison

Particulars	P/E (x)		EV/EBITDA (x)		P/BV (x)		ROE (%)	
	FY20E	FY21E	FY20E	FY21E	FY20E	FY21E	FY20E	FY21E
Bajaj Auto	18.1	17.2	12.0	9.4	3.7	3.3	20.5	19.4
Hero Motocorp	15.4	14.7	9.9	9.4	3.8	3.4	28.0	23.2
TVS Motors	32.1	28.9	15.2	12.8	5.8	5.1	18.1	17.8

Source: Company, Sharekhan estimates

About company

Hero is the market leader in the 2W industry with a market share of 36%. Hero is present in both the motorcycles and the scooter segments, having market share of about 51% and 11%, respectively. Motorcycles form the major chunk of revenue, contributing about 90% to volumes, while scooters contribute 10% to volumes. Hero is a domestically focused company deriving about 97% of volumes from the Indian market. Entry-level motorcycles (75 cc to 110 cc) form a major chunk of about 78% of overall volumes.

Investment theme

Hero is the largest 2W manufacturer having the widest portfolio of motorcycles right from entry level to the premium segment. The company has an unparalleled reach in rural areas and derives about half of its revenue from hinterlands. Going ahead, outlook for the domestic 2W industry is depressing, given weak consumer sentiments, rural stress and elevated channel stocks. Further, the transition to new BS6 emission norms would adversely impact volumes. Management expects volumes to drop in FY2020 and revenue is likely to decline by 2%. Operating de-leverage and high costs are likely to impact margins, which are expected to be on the declining trend.

Key Risks

- ♦ Hero derives about half of its volumes from rural areas. Any slowdown in the rural segment/agricultural sector would have an adverse impact on volumes.
- ♦ Yen-denominated imports account for 15% of revenue. Any adverse INR-Yen movement can have an adverse impact on volumes.
- ♦ Any adverse government policy for full switchover to electric vehicles would impact the company's market positioning.

Additional Data

Key management personnel

Dr. Pawan Munjal	Chairman, Managing Director and CEO
Niranjan Gupta	Chief Financial Officer
Sanjay Bhan	Head Sales and Aftersales
Neerja Sharma	Company Secretary and Chief Compliance Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Bahadur Chand Investments Pvt. Ltd.	20
2	Pawan Munjal	13.98
3	Life Insurance Corp of India	5.54
4	Standard Life Aberdeen PLC	3.37
5	SBI Funds Management Pvt. Ltd.	3.02
6	BlackRock Inc.	2.65
7	Franklin Resources Inc	2.06
8	Lazard Ltd.	1.82
9	Vanguard Group Inc/The	1.03
10	Government Pension Fund - Global	1.0

Source: Bloomberg

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