August 6, 2020

Result Report | Sector: Capital Goods

YES SECURITIES
INSTITUTIONAL EQUITIES

Honeywell Automation India Ltd

BUY	CMP Rs27,340	Target Rs36,310	Upside 33%

HIGHLIGHTS

- HWA reported resilient set of results with beat on all fronts. Revenues came in at Rs7.4bn, up 4.5% qoq & down 14% yoy.
- Gross margin was at ~51%, expansion of ~200bps yoy led by better product mix. EBITDA stood at Rs1.3bn, down 24% yoy with EBITDA margin of 17.4% (-231bps yoy). HWA is focusing to offset revenue drop by managing its variable cost structure, rationalization of discretionary spends, productivity drives etc.
- Lower tax expenses (-45% yoy) negated the impact of decrease in other income (-6% yoy) & increase in depreciation cost (+36% yoy). Tax rate stood at 25.9% vs 35.4% in Q1FY20.
- PAT beat (+54% vs our estimates) led by, 1) Marginal impact of lockdown on execution, 2) Gross margin expansion & 3) Better cost control. PAT came in at Rs980mn, down 14% yoy.

Our View

- We like HWA based on its ongoing product portfolio upgradation, focus on software industrial business model, faster adoption of automated solutions by domestic market post Covid-19 episode & relentless execution on cost control.
- HWA would be able to mitigate the slowdown risk arising out of crude prices volatility through its diversified business exposure. Strong installed base of HWA in core sectors would aid higher services sales. Its parent has set a margin target of 25% by CY25, and we believe HWA too will follow a similar trajectory in margins, given the high entry barrier & access to parent's superior technology.

Valuation

- During CY07-FY15, HWA traded at average 1-yr forward P/E multiple of 21x & delivered average adjusted RoE (ex-cash)/ Core RoIC of 29%/22% respectively. However, post FY15, HWA's valuations got a significant re-rating (traded at average 1-yr forward P/E multiple of 45x) as it had strong profitability growth, free cash flow generation with average adjusted RoE/ Core RoIC of 51%/39% respectively over FY15-FY20. HWA's continued earnings outperformance among its peers, asset light tech model & robust return ratios justify its valuations. Retain 'BUY' with TP of Rs36,310 at 50x FY22E EPS.

Risk to our call

- Delay in revival of short cycle orders.

Exhibit 1: Financial Summary

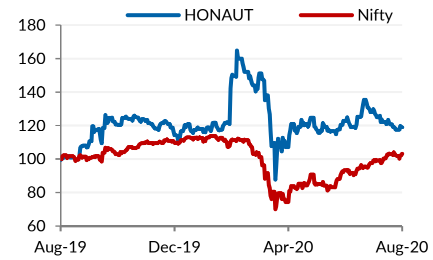
Y/e 31 Mar (Rs mn)	FY18	FY19	FY20	FY21E	FY22E
Revenues	26,900	31,747	32,900	31,443	37,557
yoy growth (%)	11.6	18.0	3.6	(4.4)	19.4
EBITDAM (%)	13.5	15.9	19.3	18.3	20.5
PAT	2,497	3,588	4,915	4,684	6,420
yoy growth (%)	47.4	43.7	37.0	(4.7)	37.0
EPS (Rs)	282.5	405.9	556.0	529.9	726.2
P/E (x)	96.8	67.4	49.2	51.6	37.6
P/BV (x)	17.0	13.8	11.1	9.3	7.5
EV/EBITDA (x)	63.9	45.6	35.6	38.6	28.2
Net D/E (x)	(0.6)	(0.7)	(0.7)	(0.7)	(0.8)
ROE (%)	19.2	22.7	25.0	19.6	22.1
ROIC (%)	39.8	52.9	58.3	47.8	63.9

Source: Company, YES Sec – Research

Stock data (as on August 06, 2020)

Nifty:	11,207
52 Week h/l (Rs)	39525 / 20149
Market cap (Rs/USD bn)	242 / 3.2
Outstanding Shares (mn)	9
6m Avg t/o (Rs mn):	135
Div yield (%):	0.3
Bloomberg code:	HWA IN
NSE code:	HONAUT

Stock performance



	1M	3M	1Y
Absolute return	-8.3%	1.1%	19.7%

Shareholding pattern (As of Jun'20 end)

Promoter	75.00%
FII+DII	14.64%
Others	10.35%

∆ in earnings estimates

	FY21e	FY22e
EPS (New)	529.9	726.2
EPS (Old)	519.5	726.2
% change	2%	0%

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Exhibit 2: Result table

(Rs mn)	Q1FY21	Q1FY20	% yoy	Q4FY20	% qoq
Total sales	7,362	8,570	(14.1)	7,043	4.5
EBITDA	1,279	1,687	(24.2)	1,286	(0.5)
EBITDAM (%)	17.4	19.7	(230.8)	18.3	(87.8)
Depreciation	(116)	(85)	36.1	(118)	(1.7)
Interest	(15)	(22)	(29.6)	(15)	0.0
Other income	174	186	(6.4)	337	(48.3)
PBT	1,322	1,766	(25.1)	1,489	(11.2)
Tax	(342)	(625)	(45.3)	(378)	(9.6)
Adjusted PAT	980	1,141	(14.1)	1,111	(11.8)
Exceptional item	0	0		0	
Reported PAT	980	1,141	(14.1)	1,111	(11.8)
PATM (%)	13.3	13.3	0.3	15.8	(246.5)
EPS (Rs)	111	129	(14.1)	126	(11.8)

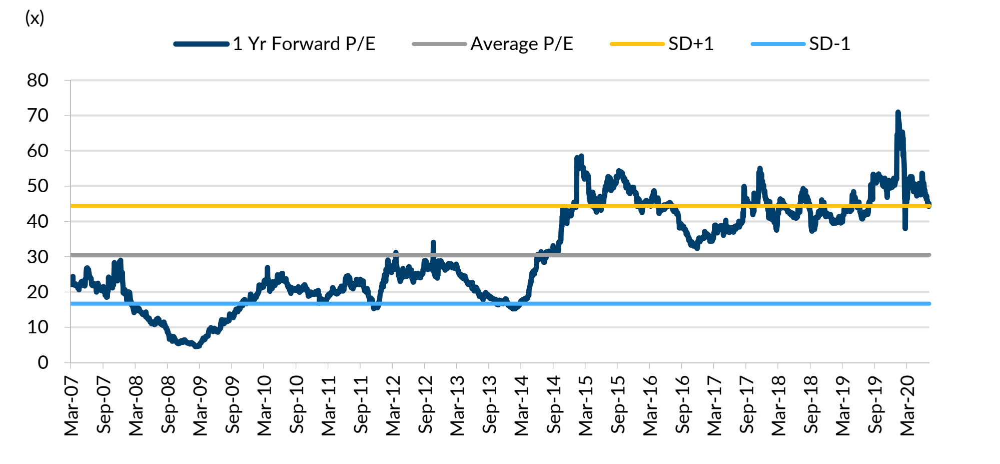
Source: Company, YES Sec – Research

Exhibit 3: Cost analysis

As a % of net sales	Q1FY21	Q1FY20	bps yoy	Q4FY20	bps qoq
COGS	49.0	51.0	(200.7)	46.0	302.7
Employee cost	18.1	16.4	169.9	19.3	(118.5)
Other expenses	15.5	12.9	261.6	16.5	(96.4)
Total costs	82.6	80.3	230.8	81.7	87.8

Source: Company, YES Sec – Research

Exhibit 4: Significant valuation re-rating post FY14 with sharp jump in returns



Source: Company, YES Sec – Research

BUSINESS OUTLOOK

COVID-19 impact on HWA's FY21 business outlook

- ✓ Current global economic conditions due to COVID-19 will adversely affect HWA's customers who operate in oil and gas, real estate and automotive end markets. Further, supply chain disruptions including discontinued factory operations, customers delaying or freezing their discretionary spends, extended credit terms and logistical challenges has and may continue to add to the impact. Its business related to pharma, healthcare sector is likely to see a positive impact. Public Sector Undertakings (PSUs) /smart city projects are expected to witness an uptick after a temporary set-back. The Company has begun and will continue to act to offset revenue drop by managing our variable cost structure, rationalization of discretionary spends, productivity drives etc.

- ✓ High returns expected from automation technologies such as artificial intelligence (AI), IoT (connected devices), cloud services and industrial software solutions. Hence, a major driver for HWA is that the Indian market is gaining traction toward offering services and technology that aim to digitally support and transform the existing and upcoming infrastructure and industrial projects.

Sectoral outlook

Growth in building segment is likely to be moderate in near term

HWA's revenue share from investment in projects such as roads, metro, smart cities, data centers, warehouses, water supply, railways & airports in construction is expected to rise with the concerted efforts from the government to boost investments in infrastructure. Growth in building segment is likely to be moderate as the number of new project launches is still on the lower side. However, tax incentive for buyers in affordable housing segment & capital outlay of Rs250bn would aid in completing stalled projects. National infrastructure pipeline (NIP) with an investment plan of Rs102trn over 2020-25 is likely to energize demand in other sectors. However, for FY21, delays in project award during Q4FY20 and Q1FY21 coupled with few challenges expected on people availability can impact demand in short term.

Focusing on healthcare & pharma sectors

The manufacturing slowdown is expected to sustain in most sectors till H1'21 while recovery will follow the improvements in the Covid-19 situation. HWA's management expects demand from healthcare and pharmaceuticals sectors to rise significantly as a larger share of investments will be directed towards capacity addition.

Energy: Strong growth prospect in India over long term

The domestic energy demand is expected to double over the next two decades. India is also aiming to ensure energy security by increasing domestic production and reducing its import dependence. The government targets raising share of renewables at 40%, accelerating investments in solar and wind outpacing investment in fossil fuel. Additional reform plans include biofuel development, investment and policy support to petrochemicals, updated technical standards for power plants and vehicles, and clean fuel. Government also announced in FY21 budget about allotting USD3bn for power and renewable energy and development of 10,800 Km of national gas grid.

Segment Strategies

Process Solution business

HWA has the expertise and breadth of resources to execute projects of every size and complexity in the oil and gas, refining, pulp and paper, industrial power generation, chemicals and petrochemicals, biofuels, pharma/ life sciences, and metals, minerals and mining industries. The Process Solutions business had a strong FY20 driven by providing leading technologies from the plant floor to the boardroom as well as comprehensive lifecycle services to ensure more productive and stable operations. HWA would be major beneficiary of India's move to build energy security, drive gas-based economy by encouraging digital solutions. HWA is well positioned to drive growth in areas such as pharmaceuticals, specialty chemicals, physical security and cyber security. Simultaneously, HWA is also enhancing its reach and coverage to serve the large and growing mass mid segment in India by expanding its local engineering, product development, and manufacturing capabilities.

Building Solutions business

This segment demonstrated good results in FY20 on the back of integrated building management systems based on Honeywell's Enterprise Buildings Integrator. Its track record in infrastructure, transportation, smart cities, information technology, pharmaceutical, Industrial and commercial space verticals helped expand its presence, while also positioning it well. There has been a continued government funding on building core infrastructure such as airports, metro and railways and safe cities. In the future, value- added services like analytics, energy optimization, healthcare is expected to be an evolution in critical operator segment. In addition, HWA is exploring the opportunities to create India-specific integrated products to cater to different sectors in India.

Building Management Systems

HWA is a global leader in the connected buildings space and maintains a leadership position in India with the widest range of building automation technologies. The solutions and products of this business are already present across multiple verticals in India, which include large mission-critical facilities, government infrastructure like airports, stadiums, metro stations, IT, residential, industrial and hospitality buildings. Building Management Systems has a diverse business portfolio comprising of building control solutions and global field devices. The portfolio was further enhanced with new product offerings like Mechanical PICVs, Variable Frequency drives and Piston type PRVs. BMS segment's focus will remain on sales deployment, on-boarding, channel excellence and pipeline management.

Sensing and Internet of Things (IOT)

The Electronic Sensing portfolio which includes board mount Pressure Sensors, Airflow Sensors, Hall ICs, Temperature Sensors etc. resulted in deal wins from Medical, EVs segments. Packaged Sensors covering Pressure and other critical parameters offer long term growth potential within Railways & Stationary power segments. HWA is restructuring its distribution model by consolidation of small business accounts into Masters distributors, which can allow direct sales team to focus on key account management with a wider portfolio. There is an exciting range of global and locally - developed products that are being introduced in the Indian market. The Company has planned to roll out few products from Pune plant for leveraging local manufacturing, better control on supply chain and quality, and increased customer satisfaction.

Global Services

It has increased its footprint globally through new portfolios, offerings and geographic expansion supporting Honeywell's global growth agenda. Global Services is making investments in talent development and retention strategies in the consultancy space for accelerated growth through newer verticals, Software and IIoT.

Global Manufacturing

This segment focuses on delivering high quality products and project solutions right and fast to India and global market. HWA continues to leverage localization and other sourcing strategies to improve overall speed of delivery to customer and cost competitiveness. The Company has recently setup line for face mask production at its Fulgaon factory in view of Covid-19 pandemic.

Highlights: Honeywell International's (Parent) Q2CY20 Earnings Call

- ✓ Q2CY20 was challenging in terms of execution, however Honeywell focused aggressively on managing cost, driving sales growth where demand is strong, and investing in exciting new technologies related to safety & healthcare.
- ✓ Safety and Productivity Solutions (SPS) segment has affected least while Aerospace segment has witnessed adverse impact from COVID-19 pandemic & will take at least 4-5 quarters to normalize. Business demand for Honeywell Building Technologies (HBT) & Performance Materials and Technologies (PMT) segments likely to normalize in H1CY21.
- ✓ **Focus on cost rationalization:** USD500mn/ USD700mn in savings during Q2CY20/H1CY20 from the first phase of cost actions through, 1) Merit pay cancellations for CY20, 2) Curtailment in discretionary expenses, 3) Reduction in executive directors pay & 4) Reduced work schedules. In addition, second phase of cost actions will increase cost savings to USD1.4-1.6bn for full year 2020 through accelerated fixed cost reduction & workforce cut. Overall 60-70% cost reduction initiatives are permanent in nature.
- ✓ During Q2CY20, defense, warehouse automation, and personal protective equipment industries exhibited outstanding performance.
- ✓ **Launching healthy buildings solutions in a partnership with SAP:** Honeywell has formed tie-up with SAP to improve building performance with integrated & cloud based data. SAP along with Honeywell Forge Technology solution would provide building owners cost efficient solutions based on clean energy.
- ✓ **Investing in new business opportunities:** Mgmt. would be spending USD250mn of incremental growth capital expenditures for new projects to accelerate investments in personal protective equipment, Intelligrated, and other growth areas. Investing in and introducing new solutions, such as an efficient and effective ultraviolet light cleaner for aircraft, temperature and PPE compliance monitoring solutions, technologies that can help building owners comply with new hygiene and social distancing policies, and a new pharmaceutical packaging system for bottles and vials that preserves shelf-life and drug efficacy.
- ✓ Honeywell Forge platform helps building owners and building portfolio owners to decrease operating expenses, improve energy consumption, implement predictive maintenance and manage space optimization across an entire building portfolio while also enhancing the individual occupant experience. Honeywell Forge is a hardware agnostic platform which can help building owners optimize non-Honeywell systems using the platform. This software-focused approach allows to help reduce electronic waste because there's no need to rip and replace current systems.
- ✓ In case of COVID-19 pandemic, Honeywell's solutions like Electronic Air Cleaning and Ultra Violet in Air Handling Units (AHUs), are helping customers reduce the risk of spreading the infection through the HVAC (heating, ventilation, and air conditioning) systems.
- ✓ Due to the evolving nature of the COVID-19 pandemic and related supply chain and market disruptions, Honeywell previously announced that it has suspended providing full financial guidance until the economic impact of COVID-19 stabilizes. The company expects ongoing top-line challenges due to the current market conditions, particularly in the aerospace and oil and gas sectors. Revenues likely to de-grow by ~15% yoy in CY20.
- ✓ Expansion of PPE business: Collaborating with Mubadala subsidiary strata manufacturing to produce N95 masks in the UAE.

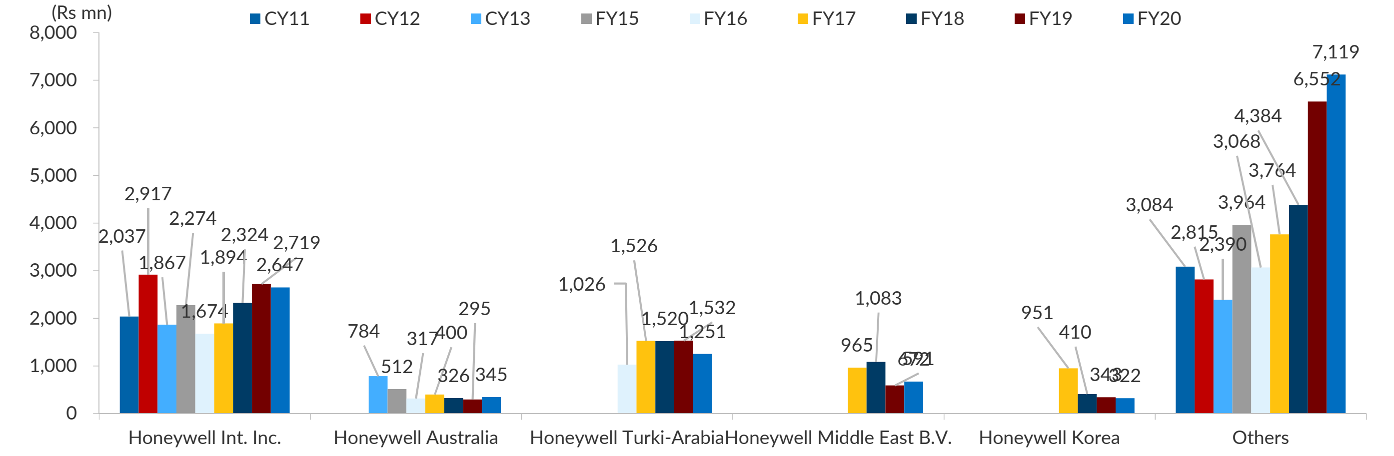
Sept'20 quarter preview shared by HWA's parent

- ✓ Aerospace sales down>25% (Irrelevant for HWA)
- ✓ Honeywell Building Technologies sales down>10%
  - Customer site access expected to improve month on month
  - Expecting partial delays in ongoing projects
  - Deferred demand for products expected to return
  - Seeing new business opportunity in healthy buildings segments
- ✓ Performance Materials and Technologies Aerospace sales down>10%
  - Refining & petrochemical volumes likely to remain weak
  - Continued weakness in gas processing
  - Seeing customer capex constrained for new projects
- ✓ Safety and Productivity Solutions sales up<7%

Segment Performance in Q2CY20 by HWA's parent

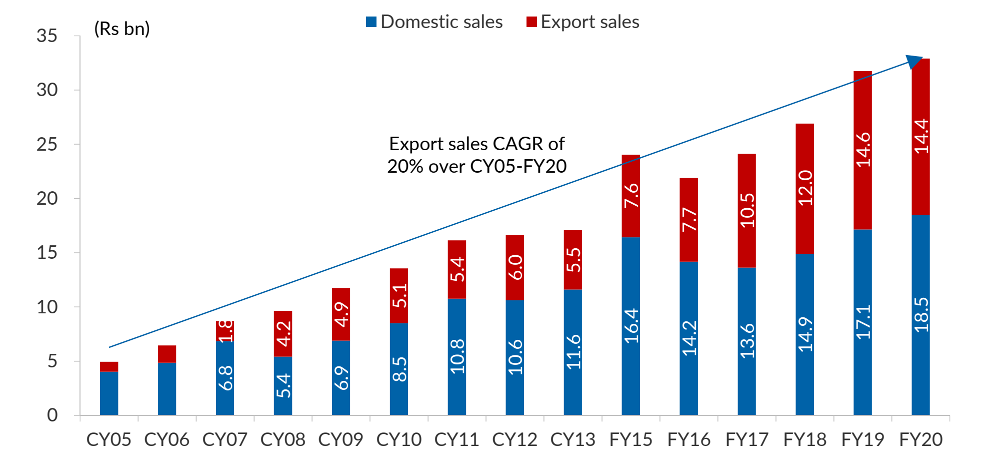
- ✓ **Aerospace** sales down 27% on an organic basis driven by lower commercial aftermarket demand due to steep declines in flight hours, reduced volumes in commercial original equipment, and the 737 MAX impact in air transport original equipment, partially offset by continued strength in the Defense and Space business. Segment margin contracted 510bps to 20.8% driven by lower volumes and sales mix.
- ✓ **Honeywell Building Technologies** sales were down 17% on an organic basis driven by lower demand for security, building management, and fire products, and delays in Building Solutions projects in key verticals. Segment margin expanded 50bps to 21.2%. Margin performance was driven by commercial excellence and productivity actions.
- ✓ **Performance Materials and Technologies** sales were down 17% on an organic basis driven by volume declines in products, including thermal solutions and smart energy, in Process Solutions; lower gas processing projects, catalyst shipments, and licensing due to softness in the oil and gas sector in UOP; and lower automotive refrigerant volumes in Advanced Materials, partially offset by strength in specialty products. Segment margin contracted 460bps to 18.9% driven by the impact of lower sales volumes, partially offset by productivity actions. PMT OB was up 3% yoy.
- ✓ **Safety and Productivity Solutions** sales were up 1% on an organic basis driven by double-digit Intelligrated growth and demand for respiratory personal protective equipment, partially offset by lower short-cycle sales volumes in sensing and IoT, productivity products, and gas sensing. Record high bookings of $0.7 billion in PPE and $1.2 billion in Intelligrated drove orders growth up approximately 90% year-over-year. Backlog was up over 100%yoy, including an all-time high Intelligrated backlog of over $2 billion. Segment margin expanded 150bps to 13.8% driven by productivity, net of inflation, and commercial excellence.

Exhibit 5: HWA has benefitted by supplying to several global Honeywell entities



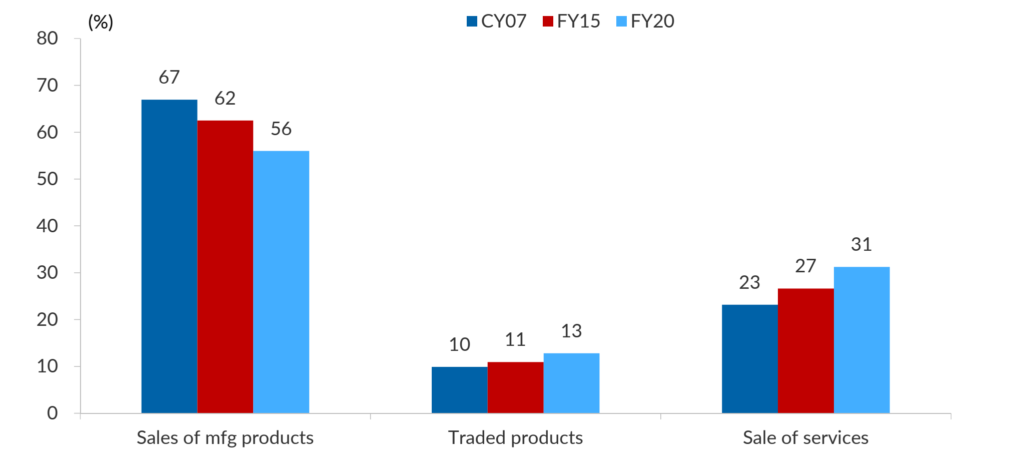
Source: Company, YES Sec – Research

Exhibit 6: Topline growth driven by exports



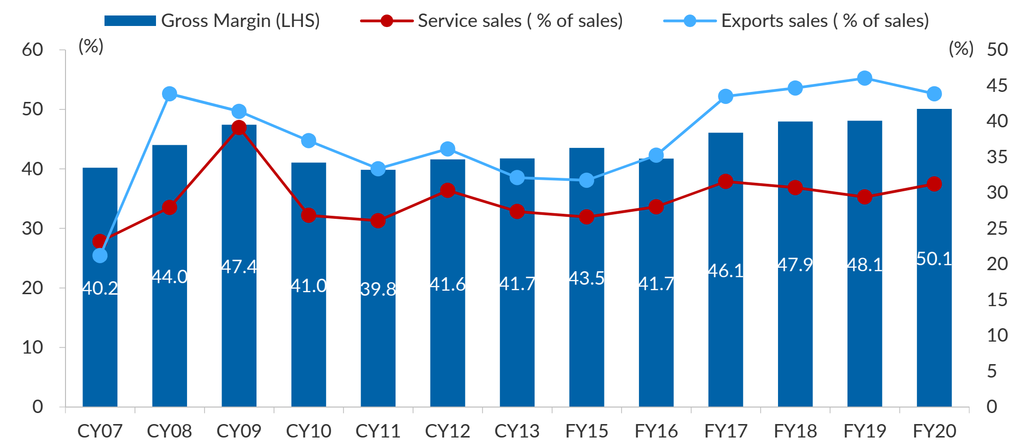
Source: Company, YES Sec – Research

Exhibit 7: Services revenues contribution is increasing at a steady pace



Source: Company, YES Sec – Research

Exhibit 8: Gross margin expansion led by better mix



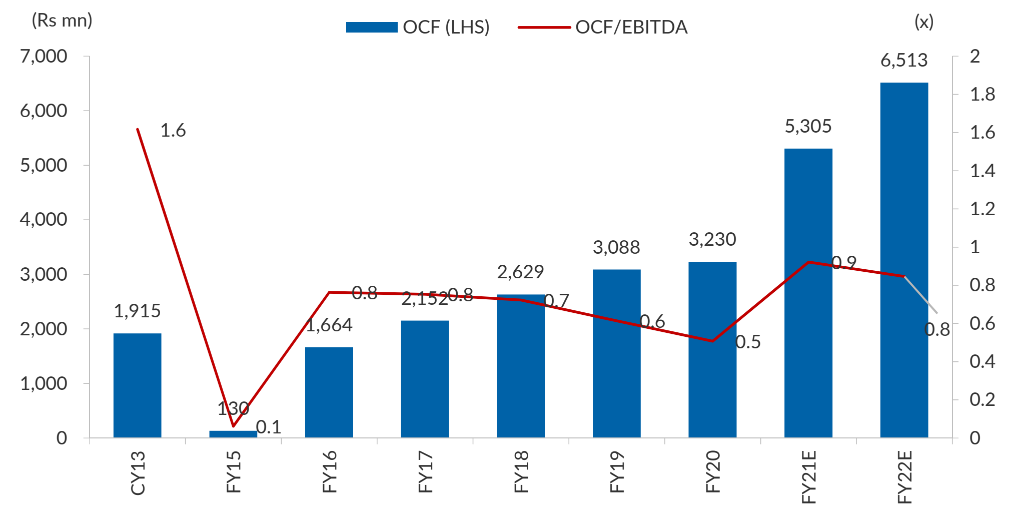
Source: Company, YES Sec – Research

Exhibit 9: HWA has better ability to keep control over costs as 75%+ of other expenses are variable in nature

Other Expenses (Rs mn)	CY13	FY15	FY16	FY17	FY18	FY19	FY20
Travelling and conveyance	1,014	1,636	1,472	1,670	2,178	2,367	2,517
Professional fees	160	379	241	278	302	251	297
Rates and taxes	115	131	90	159	131	184	60
Rent	179	255	212	225	226	236	74
Power & Fuel	87	111	85	84	91	114	122
Corporate overhead allocations	616	853	810	1,101	1,069	1,107	1,117
Others	736	691	447	584	679	570	372
Total	**2,906**	**4,056**	**3,356**	**4,101**	**4,675**	**4,829**	**4,559**
% of sales	**17.0**	**16.9**	**15.3**	**17.0**	**17.4**	**15.2**	**13.9**

Source: Company, YES Sec – Research

Exhibit 10: Asset light tech model to lead strong & sustainable OCF



Source: Company, YES Sec – Research

FINANCIALS

Exhibit 11: Income statement

Year ending March	FY18	FY19	FY20	FY21E	FY22E
Total operating revenues	26,900	31,747	32,900	31,443	37,557
Growth (%)	11.6	18.0	3.6	(4.4)	19.4
EBITDA	3,636	5,034	6,364	5,758	7,699
EBITDA margin (%)	13.5	15.9	19.3	18.3	20.5
Growth (%)	27.2	38.4	26.4	(9.5)	33.7
Depreciation & amortization	152	159	406	458	469
EBIT	3,484	4,875	5,958	5,300	7,230
EBIT margin (%)	13.0	15.4	18.1	16.9	19.3
Interest	3	35	69	60	48
Other income	331	709	977	1,034	1,400
Profit before tax	3,812	5,549	6,866	6,274	8,582
Tax	1,315	1,961	1,951	1,590	2,163
Reported net profit	2,497	3,588	4,915	4,684	6,420
Extraordinary items	0	0	0	0	0
Adjusted net profit	2,497	3,588	4,915	4,684	6,420
Adjusted net margin (%)	9.3	11.3	14.9	14.9	17.1
Diluted EPS (Rs)	282.5	405.9	556.0	529.9	726.2
Growth (%)	47.4	43.7	37.0	(4.7)	37.0

Exhibit 12: Balance sheet

Year ending March	FY18	FY19	FY20	FY21E	FY22E
SOURCE OF FUNDS					
Share capital	88	88	88	88	88
Reserve & Surplus	14,098	17,386	21,694	25,981	31,958
Total shareholder's funds	14,187	17,475	21,783	26,069	32,047
Debt	-	-	-	-	-
Deferred tax liabilities/(assets)	140	374	1,099	799	499
TOTAL	14,327	17,849	22,882	26,868	32,546
APPLICATION OF FUNDS					
Gross block	1,260	1,387	2,875	3,275	3,875
Less: Depn. and amort.	421	536	942	1,400	1,869
Net block	839	852	1,933	1,875	2,006
Capital WIP	11	80	139	100	100
Other long term assets	2,754	2,830	2,936	2,975	2,975
Inventories	798	1,051	1,209	1,551	1,543
Debtors	5,911	5,171	7,236	7,409	8,437
Cash & cash equivalents	9,192	12,245	15,139	19,346	24,517
Other current assets	4,814	6,678	5,983	4,338	6,156
Creditors	7,708	8,310	8,480	7,581	9,775
Other current liabilities	2,284	2,747	3,213	3,144	3,414
Net current assets	10,723	14,087	17,873	21,918	27,465
TOTAL	14,327	17,849	22,882	26,868	32,546

Exhibit 13: Cash flow statement

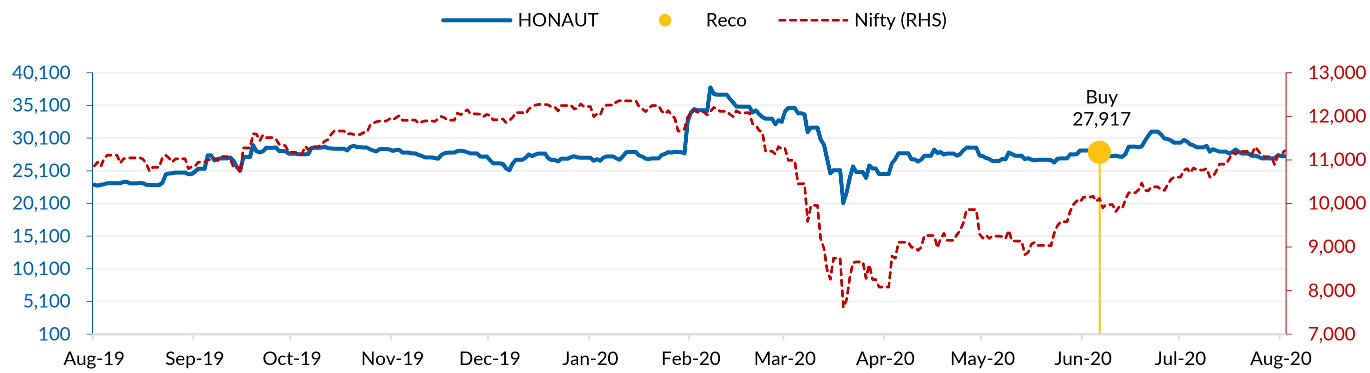
Year ending March	FY18	FY19	FY20	FY21E	FY22E
PBT	2,497	3,588	4,915	6,274	8,582
Depreciation	152	159	406	458	469
Others	1,069	1,152	888	800	800
Tax Paid	(1,602)	(2,113)	(2,018)	(1,590)	(2,163)
Changes in Working Capital	513	302	(961)	162	(376)
Net Cash from Operations	2,629	3,088	3,230	6,105	7,313
Capex	(179)	(202)	(591)	(400)	(600)
Change in Investment	(1,745)	(4,684)	(2,411)	0	0
Others	182	458	736	0	0
Net Cash from Investing	(1,742)	(4,428)	(2,266)	(400)	(600)
Change in debt	0	0	0	0	0
Change in Equity	0	0	0	0	0
Others	(106)	(341)	(695)	(1,498)	(1,542)
Net Cash from Financing	(106)	(341)	(695)	(1,498)	(1,542)
Net Change in Cash	781	(1,681)	269	4,207	5,171
Ending Cash Balance	9,192	12,245	15,139	19,346	24,517
Free cash flow (FCF)	2,416	2,587	2,103	4,207	4,779

Exhibit 14: Ratio analysis

Year ending March	FY18	FY19	FY20	FY21E	FY22E
PROFITABILITY RATIOS					
EBITDA Margin (%)	13.5	15.9	19.3	18.3	20.5
Adjusted net margin (%)	9.3	11.3	14.9	14.9	17.1
Return on invested capital (%)	39.8	52.9	58.3	47.8	63.9
Return on equity (%)	19.2	22.7	25.0	19.6	22.1
EFFICIENCY RATIOS					
Asset Turnover	31.6	34.1	15.9	15.9	17.8
Debt to equity	0.0	0.0	0.0	0.0	0.0
Net debt to equity	(0.6)	(0.7)	(0.7)	(0.7)	(0.8)
Interest coverage	1,244.3	140.1	86.7	88.0	150.6
Debtor days	80.2	59.4	80.3	86.0	82.0
Inventory days	10.8	12.1	13.4	18.0	15.0
Payable days	104.6	95.5	94.1	88.0	95.0
PER SHARE DATA					
Diluted EPS (Rs)	282.5	405.9	556.0	529.9	726.2
Book value per share (Rs)	1,604.8	1,976.8	2,464.1	2,949.0	3,625.2
DPS (Rs)	32.0	45.0	45.0	45.0	50.0
VALUATION RATIOS					
P/E	96.8	67.4	49.2	51.6	37.6
P/BV	17.0	13.8	11.1	9.3	7.5
EV/EBITDA	63.9	45.6	35.6	38.6	28.2
Dividend Yield (%)	0.1	0.2	0.2	0.2	0.2

Honeywell Automation India Ltd

Recommendation Tracker



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