

Hero Motors

Building Blocks for Future

Hero Motors, one of the largest player in the Industry in the two-wheeler industry (38% market share as on FY2018); has been facing strong headwinds after its break-up with Honda. The company has been underperforming the industry growth; in spite of strong business fundamentals- like product basket, branding & strong distribution network. The key reason behind its underperformance has been the missing links like no main product in the premium / scooter segment and very less aggression in expanding the export markets. At this stage, the company is building blocks for future by investing in missing blocks to make sure that it emerges in next 4-5 years as a complete two wheeler player, having products across market segments. **Thus, we recommend a HOLD.**

Two-Wheeler space in a moderate growth space: Indian Two wheeler Industry that mirrors the Indian GDP growth has been growing at a CAGR of 8.1% (FY2011-2018) in volume terms (23mn at the end of FY2018). However, in the short and medium term, the industry is sensitive to the monsoon trends, rural income, inflation, government policies, crude, and interest rates & amongst others, the regulatory compliance like the BSVI norms, which will be implemented in India by FY2021. Going into FY2020E, the growth in the industry is likely to come in close to mid to high single digits (i.e a growth of 5-8%).

Hero Motors; inventing for future: Over FY2018-20E, the company will post a CAGR of 7.8% in sales terms. On net profit front, we expect the company to deliver a flattish performance during the period. The stock, has on the other hand has witnessed, a strong de-rating and trades now at 3.7x FY2020E BV (including cash & Investments). However, to protect a further de-rating the company has to exhibit all the characteristics of a leading player, which implies that its R&D efforts have to fructify, which should happen in next 4-5 years). In addition, company's strong balance sheet and high ROE of business, enables higher dividend payout and should restrict the underperformance from here on, even for long-term buyers. **Thus, we recommend a HOLD.**

Key financials (Consolidated)

Y/E March (₹ cr)	FY2017	FY2018	FY2019E	FY2020E
Net sales	28,610	32,458	34,655	37,739
% chg	0.5	13.4	6.8	8.9
Net profit	3,452	3,576	3,402	3,605
% chg	14.5	3.6	(4.9)	5.9
EBITDA margin (%)	16.0	16.4	14.5	14.8
EPS (₹)	172.9	179.1	170.4	180.5
P/E (x)	14.9	14.4	15.1	14.3
P/BV (x)	5.0	4.3	4.0	3.7
RoE (%)	36.1	32.1	27.3	26.7
RoCE (%)	39.6	39.3	32.8	34.0
EV/Sales (x)	1.8	1.6	1.5	1.4
EV/EBITDA (x)	11.3	9.7	10.2	9.2

Source: Company, Angel Research; Note: CMP as of March 26, 2019

HOLD

CMP ₹2,580

Target Price ₹2,870

Investment Period 12 Months

Stock Info

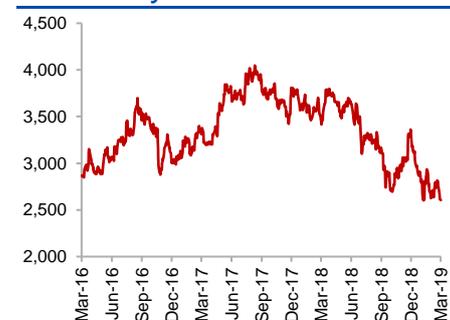
Sector	Auto
Market Cap (₹ cr)	51,524
Net Debt (₹ cr)	(6,395)
Beta	0.9
52 Week High / Low	3862/2545
Avg. Daily Volume	11,221
Face Value (₹)	2
BSE Sensex	38,233
Nifty	11,483
Reuters Code	HROM.BO
Bloomberg Code	HMCL.IN

Shareholding Pattern (%)

Promoters	34.6
MF / Banks / Indian FIs	17.3
FII / NRIs / OCBs	40.2
Indian Public / Others	7.9

Abs.(%)	3m	1yr	3yr
Sensex	7.2	15.6	53.2
Hero Motors	(19.0)	(25.9)	(9.4)

3-Year Daily Price Chart



Source: Company, Angel Research

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Two-Wheeler space in a moderate growth space (FY2018-21)

Indian Two wheeler Industry that mirrors the Indian GDP growth has been growing at a CAGR of 8.1% (FY2011-2018) in volume terms (23mn at the end of FY2018). Domestic markets occupied a major chunk of the same (almost 88% of the volumes) delivering a CAGR of 8.0%, while exports (12% of the volumes) delivered a growth of almost 9.0%; albeit on a smaller base. Overall Two-wheeler industry occupies around 81% of the market share of overall domestic Auto Industry. Going forward the trend is likely to persist as the Industry still have levers, which will aid the Industry to grow in line with the GDP growth.

Long-term drivers are intact

Two-wheeler Industry has been mirroring its GDP growth. With Indian economy likely to continue to grow at 7-8% in real terms in near term, Two-wheeler Industry can easily mirror this growth. All the key levers i.e urbanization, improvement in technology, increased financial access and increased women participation, will enable the Indian GDP to grow at fast pace. Two-wheelers penetration in India is still lower at 102 bikes per 1000 people, which is lower than its Asian peers also, like Thailand & Indonesia, where the 2Wheeler penetration is 291 & 281 respectively. Even Malaysia has a higher penetration at 166 bikes per 1000 people. If we were to dissect the two-wheeler penetration in India, much of the growth has come on back of urban population, which forms 60% of the industry volumes and has a penetration of 40-45%, while rural India, which forms 40% of the volumes, has penetration levels of 20-25%, taking the average Indian penetration levels at 30-40% per household. In addition, if you dissect the market, around 51% of bike customers are first time buyers, 27-28% are replacement buyers and 22% are additional bike buyers. Thus, this leaves a lot of scope for the Two-wheeler industry to post a robust growth; at least in line with GDP growth.

However, if you dissect the Two-wheeler industry in terms of products, it is the Motorcycles, (which at 15mn at the end of FY018 constituted almost 66% of the volumes) posted a moderate growth of 5.3% during FY2011-2018. Major chunk of the growth came in through Scooters (which at 7mn at the end of FY2018 constituted 31% of the volumes), posted a growth of 18.8% during FY2011-2018. Moped, which is a minor constituent (3.8% of the overall volumes); underperformed growing at 3.2% during FY2011-2018. In Motorcycles, the growth was visible in the economy & premium segments, while posted a CAGR of 10.2% and 11.5% respectively, while the economy segment remained flat (data pretending to FY2013-2018).

Near term hiccups to impact growth

However, in the short and medium term, the industry is sensitive to the monsoon trends, rural income, inflation, government policies, crude, and interest rates & amongst others, the regulatory compliance like the BSVI norms, which will be implemented in India by FY2021.

This was already visible in FY2019, where the long-term trend saw a reversal V/s FY2018. The motorcycle segment gained ~200 bps share in 10M FY2019 in two-wheeler pie whereas it had been steadily losing share to scooters over the past ten years. Motorcycles grew at a faster pace than scooters in 10M FY2019 driven by the strong volume growth of entry-level motorcycles. In scooters, the traditional 110cc scooter growth faltered but the newly launched, feature rich 125cc scooters drove the growth

of the segment. Mopeds also staged a comeback this year with 3.6% growth in 10 Month FY2019 whereas in FY2018 they had de-grown by 3.5%.

Going into FY2020E, the growth in the industry is likely to come in close to mid to high single digits (i.e a growth of 5-8%), driven again by rural economy, improved disposable income, moderate inflation. In addition, it places bets that the political scenario remains stable and monsoons are normal and well spread through India. In addition, FY2020 could also witness a pre-buying, as most companies believe before the BSVI is implemented in FY2021E. Moreover, the growth is likely to be very much back ended i.e visible during 2HFY2020. Thus, FY2021, forecasted is highly sensitive to the economic scenario panning out as BSVI implementation (effective April 2020), could easily add up to 6-8% to the overall cost of the ownership. Moreover, this will be the first for the Industry, as Industry interactions have pointed out that it is the first time in the world that the Two-wheeler are expected to comply with the BSVI Regulations. However, BSVI norms will be beneficial, as it will bring down the pollution emission by 90%. The ABS norms to be implemented, will not impact the Hero Motors as its for bikes more than 125CC, and Hero's only bike in the space higher than that is Xtreme 200, which is already ABS compliant.

Margins; should remain in line with FY2019 levels

Over FY2014-17, the margins have remained more or less in the range of 14%-18%. Barring few quarters, in between the Industry has witnessed a good times with soft commodity starting from FY2016- until date. In FY2019, the Industry has seen some impact of the rising raw material prices on the OPM's, especially during 1QFY219 and 3QFY2019. As, of now the key raw materials like crude, steel and Aluminum have witnessed a softening of prices and are at levels, which should not to be threat in terms of a pass through for the companies. Generally, the Two-wheeler companies take hikes of 1-2% yoy, much below the inflation levels. Thus, the industry is unlikely to achieve a severe price cuts or even high inflationary pressures sustainably over a long period & hence in long term such margins in the range of 14-16% is sustainable for the Industry. However, given that most of the company could witness sales growth mostly in line with FY2019, the margins could settle at around 16-17%.

Hero Motors; inventing for future

Largest Player in the Indian Two Wheeler market

Hero Motors dominates, the Indian two-wheeler market, enjoying a market share of 38% (as on FY2018). However, there has been a major shift in the market share of Hero Motors post its split with Honda. The overall market share of the company has declined from ~43% in FY2013 to around 36% as on 3QFY2019. However, this is more to do with the shift of the consumers towards the scooter market, which was created and till now is dominated by Honda, through its Brand *Activa*. This also evident from the fact that, scooters contribute around 31% of the overall market in FY2018 V/s 16% of the market in FY2011.

In Motorcycle market, the Hero still dominates with market-share of 50% as on 3QFY2019 V/s 53% in FY2013. During FY2018, Hero had a market share of 52%. Thus, the price cuts taken during the year by Bajaj Auto in FY2019 in the economy segment of Motorcycle segment; lead Hero loss its market share in the segment. In the economy

segment the company had a market share of 59% as on FY2018, which on back of aggressive pricing of Bajaj Auto; came down to around 53.1% as on 3QFY2019. Economy segment overall contributed around 26% of the overall domestic Motorcycle market.

In the executive segment, Hero Motors has a major dominance, having a market share of almost 70% as on FY2018. This segment has witness steady rise for the company. In FY2013, the company had market share of around 62%. However apart from these two segments, the company's presence has been almost zero in the premium segment and company has fully lost the opportunity to participate in the segment (it had 3% market-share in the premium motorcycle segment as on 3QFY2019). Apart from these disruptions, the Motorcycle market had been stable for the players, with TVS & Honda, being other players. Though there is a competition, the companies with strong hold are holding on to their market-share on back of strong brand franchises.

In the Scooters market, Honda's dominance is clear; Honda holds almost 57% of the overall domestic scooter market as on FY2018. Other key player in the market is TVS Motors, which has enjoyed a market share higher than Hero Motors at around 15-16% and had been steady player in the segment. Hero Motors has enjoyed a market share of 11% as on 3QFY2019V/s 19% it enjoyed in FY2013. Thus, Hero even though was strong player lost to the competition because of not reading the market well and not having strong product basket in the segment. In addition, unlike other players, which have grown at strong growth on back of the exports Hero Motors exposure to the exports have been minimal at ~3%. Thus, overall Hero Motors has maintained its dominance because exports of the Motorcycle segment posted a CAGR of 7.7%, while exports of scooters posted a CAGR of 29.8% during FY2011-2018. Overall exports for the whole industry stood at 12% as on FY2018.

Thus, overall Hero Motors has dominated the landscape of the Two-wheeler Industry, on back of its stronghold in the economy and executive segment (through Splendor and HF brand franchisee), though at the cost of underperforming the overall growth in the Industry.

Banking on Rural & new product launches; exports a weak link

Hero Motors, unlike its peers drives almost 50% of its volume sales through rural India and has a strong dealership network (6,500+), which has aided its leadership position in the Two-wheeler Industry. Going forward, the company is planning to invest in bridging the product gap that it has; either launching new products in the segments like Scooters & Premium Motorcycle segment. It has already invested around US\$125mn in setting up an R&D Center at Jaipur and spends around 1.5-2.0% of its sales on R&D, which is a big amount been invested by an Indian two wheeler company in the R&D set-up. Led by Dr Markus Braunsperger (CTO)/ 25 years of R&D experience in BMW, Germany. Engaged 700+ automotive experts with global, regional expertise across 6 nationalities. Company plans to launch at least 1-2 products every year for next 4-5 years and plans to capture market share of around 15-18% in each category; though addressing products across the 200-400CC premium category, as well as a scooter in the 125Cc space. In FY2019, the company had launched Xtreme200CC and Destini I, which so far have failed to capture a major share in the respective segments. Launch of Destini in Oct'2018 helped capture ~10% market share in the 125cc scooter segment at retail level.

Thus, it's imperative for Hero Motors to capture this market; in order to maintain its dominance in the industry along with outperform/ grow in line with the industry.

In addition, the company has invested in Ather Energy - a startup, investing US\$31mn, for a 30% stake in the company. The company has already launched the premium EV scooters in India. As of now, the company does not plan to take the product on board. As per its own EV strategy, the company plans to own in-house expertise to develop own EV products.

Margins likely to remain range-bound around 14-16%

In spite of spending on R&D, the company expects Hero Motors to maintain its margins in the range of 14-16%. Apart from the fixed costs, the raw material costs, which have a bearing on the OPM, is expected to soften and the results of the same are expected to reflect by 4QFY2019. However, during FY2020, we expect the margins to remain similar at around 14.4% v/s 14.8% in FY2018, as we conservatively built the volume growth to be bit similar to FY2018, with little perk-up in volumes on back of pre-buying before BS6 implementation. Thus, on a long run the company can deliver margins in the range of 14-16%, unless the competitive intensity increases.

Valuations & Outlook

Over FY2014-18, the company posted a sales and net profit CAGR of 6.5% and 17.1% respectively. Volume growth during the period was 5.0%. Over FY2018-20E, the company is expected to post a CAGR of 7.8%, aided by a 7.0% CAGR in volume terms. On the net profit front, we expect the company to deliver a flattish performance during the period, as we expect the margins to be under pressure. The stock, on the other hand, has witnessed a strong de-rating and trades now at 3.7x FY2020 BV (including cash & investments). Given that the industry is a high ROIC industry with few dominant players, the stock's downside is protected to a certain extent. However, to protect a further de-rating the company has to exhibit all the characteristics of a defensive nature, which implies that its R&D efforts have to fructify and aid the company to fortify its leadership position. At the current juncture, the two-wheeler market is clearly divided between Hero Motors, Honda, TVS Motors & Bajaj Auto. While the latter two players are trying to hold onto the market share, with exports & pricing strategy Hero Motors is trying to get in line with the players like Honda. Thus, we believe that R&D efforts of the company have to be delivered before this de-rating can be arrested. The company expects its R&D efforts to be clearly visible in the next 4-5 years. However, given that the company has a strong cash on balance sheet and high ROE of business, enabling higher dividend payout, we believe that further underperformance from here on should be restricted from here-on, even for long-term buyers. **Hence, we recommend a HOLD.**

Company Background

Hero Motors, one of the largest players in the industry in the two-wheeler industry (37% market share as on FY2018). In fact, Hero Motors is the largest Motorcycle Company in the world with the installed capacity of 84mn as on FY2018. The company has invested. It has already invested around US\$125mn in setting up an R&D Center at Jaipur and spends around 1.5-2.0% of its sales on R&D, which is a big amount. It has been invested by an Indian two-wheeler company in the R&D set-up. Led by Dr Markus Braunsperger (CTO)/ 25 years of R&D experience in BMW, Germany. Engaged 700+ automotive experts with global, regional expertise across six nationalities. The company plans to launch at least 1-2 products every year for the next 4-5 years.

Profit & Loss statement (Consolidated)

Y/E March (₹ cr)	FY2016	FY2017	FY2018	FY2019E	FY2020E
Net Sales	28,457	28,610	32,458	34,655	37,739
Other operating income	6	6	4	4	4
Total operating income	28,463	28,617	32,463	34,660	37,743
% chg	3.3	0.5	13.4	6.8	8.9
Total Expenditure	24,059	24,034	27,133	29,621	32,142
Net Raw Materials	19,358	19,019	21,996	23,878	25,927
Other Mfg costs	332	319	381	407	443
Personnel	1,339	1,432	1,584	1,821	2,094
Other	2,750	2,840	2,806	2,996	3,263
R&D Expenses	279	425	367	520	415
EBITDA	4,398	4,576	5,325	5,034	5,597
(% of Net Sales)	15.5	16.0	16.4	14.5	14.8
Depreciation & Amortisation	443	502	575	628	690
EBIT	3,954	4,074	4,750	4,406	4,907
Interest & other Charges	15	27	31	8	8
Other Income	314	738	423	669	720
Recurring PBT	4,224	4,791	5,146	5,072	5,624
Extraordinary Expense/(Inc.)	(127.4)	(94.0)	(145.8)	(145.8)	(145.8)
PBT (reported)	4,351	4,885	5,292	5,218	5,770
Tax	1,274.7	1,339.1	1,569.9	1,669.7	2,019.4
PAT (reported)	3,077	3,546	3,722	3,548	3,750
Basic EPS (Rs)	151.0	172.9	179.1	170.4	180.5

Balance sheet (Consolidated)

Y/E March (` cr)	FY2016	FY2017	FY2018	FY2019E	FY2020E
Equity Share Capital	40	40	40	40	40
Reserves & Surplus	8,794	10,276	11,932	12,945	14,020
Shareholders Funds	8,834	10,316	11,971	12,985	14,059
Minority Interest	55	67	93	93	93
Long-term provisions	68	76	119	119	119
Total Loans	232	261	228	228	228
Deferred Tax Liability	222	469	582	582	582
Total Liabilities	9,411	11,188	12,993	13,888	14,962
Net Block	3,784	4,599	4,961	5,533	6,042
Capital Work-in-Progress	653	581	355	355	355
Investments	4,502	6,066	7,669	7,985	8,570
Long-term loans and advances	1,126	1,039	999	999	1,067
Current Assets	2,832	3,026	3,411	3,716	4,047
Current liabilities	3,485	4,124	4,403	4,701	5,119
Net Current Assets	(654)	(1,098)	(992)	(985)	(1,072)
Non Current Assets	-	-	-	-	-
Total Assets	9,411	11,188	12,993	13,888	14,962

Cash flow statement (Consolidated)

Y/E March (` cr)	FY2016	FY2017	FY2018	FY2019E	FY2020E
Profit before tax	4,351	4,885	5,292	5,218	5,770
Depreciation	443	502	575	628	690
(Inc)/Dec in Working Capital	218	374	(103)	83	184
Less: Other income	314	738	423	669	720
Direct taxes paid	(1,275)	(1,339)	(1,570)	(1,670)	(2,019)
Cash Flow from Operations	3,424	3,684	3,771	3,590	3,905
(Inc.)/Dec.in Fixed Assets	(1,111)	(1,190)	(655)	(1,200)	(1,200)
(Inc.)/Dec. in Investments	(1,383)	(1,565)	(1,603)	(316)	(585)
Other income	314	738	423	669	720
Cash Flow from Investing	(2,181)	(2,016)	(1,835)	(846)	(1,065)
Issue of Equity	1	1	3	-	-
Inc./(Dec.) in loans	132	29	(33)	-	-
Dividend Paid (Incl. Tax)	(1,398)	(1,737)	(1,698)	(2,388)	(2,530)
Others	(59)	39	(151)	(158)	(281)
Cash Flow from Financing	(1,324)	(1,668)	(1,879)	(2,546)	(2,811)
Inc./(Dec.) in Cash	(80)	(1)	57	197	29
Opening Cash balances	155	75	74	131	328
Closing Cash balances	75	74	131	328	357

Key ratios

Y/E March	FY2016	FY2017	FY2018	FY2019E	FY2020E
Valuation Ratio (x)					
P/E (on FDEPS)	17.1	14.9	14.4	15.1	14.3
P/CEPS	14.6	12.7	12.0	12.3	11.6
P/BV	5.8	5.0	4.3	4.0	3.7
Dividend yield (%)	2.8	3.3	3.7	4.0	4.2
EV/Sales	1.8	1.8	1.6	1.5	1.4
EV/EBITDA	11.7	11.3	9.7	10.2	9.2
EV / Total Assets	5.5	4.6	4.0	3.7	3.4
Per Share Data (Rs)					
EPS (Basic)	151.0	172.9	179.1	170.4	180.5
EPS (fully diluted)	151.0	172.9	179.1	170.4	180.5
Cash EPS	176.3	202.7	215.2	209.1	222.4
DPS	72.0	85.0	95.0	102.2	108.3
Book Value	442.4	516.6	599.5	650.2	704.0
Dupont Analysis					
EBIT margin	13.9	14.2	14.6	12.7	13.0
Tax retention ratio	70.7	72.6	70.3	68.0	65.0
Asset turnover (x)	7.7	7.0	8.0	7.9	7.7
ROIC (Post-tax)	76.0	72.1	82.3	68.6	65.1
Cost of Debt (Post Tax)	6.2	8.0	8.9	2.2	2.1
Leverage (x)	(0.0)	0.0	0.0	(0.0)	(0.0)
Operating ROE	75.6	72.5	82.5	68.3	64.5
Returns (%)					
ROCE (Pre-tax)	49.1	39.6	39.3	32.8	34.0
Angel ROIC (Pre-tax)	55.2	42.9	41.6	34.4	35.7
ROE	39.2	36.1	32.1	27.3	26.7
Turnover ratios (x)					
Asset Turnover (Gross Block)	3.3	2.9	2.9	2.9	2.8
Inventory / Sales (days)	49	53	57	58	58
Receivables (days)	52	47	33	33	33
Payables (days)	57	58	53	52	52
Working capital cycle (ex-cash) (days)	(12)	(14)	(14)	(13)	(13)
Solvency ratios (x)					
Net debt to equity	0.0	0.0	(0.0)	(0.0)	(0.0)
Net debt to EBITDA	0.0	0.0	(0.0)	(0.0)	(0.0)
Interest Coverage (EBIT / Interest)	270.7	149.3	154.2	585.9	652.5

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1. Financial interest of research analyst or Angel or his Associate or his relative	No
2. Ownership of 1% or more of the stock by research analyst or Angel or associates or relatives	No
3. Served as an officer, director or employee of the company covered under Research	No
4. Broking relationship with company covered under Research	No

Ratings (Based on expected returns over 12 months investment period):

Buy (> 15%)

Accumulate (5% to 15%)

Neutral (-5 to 5%)

Reduce (-5% to -15%)

Sell (< -15)