Scaling rural horizons

Auto sector takes rural route

IIFL
Premia Research

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India's insatiable rural binge

IIFL Premia Research

Swaraj Engines		
CMP	Target	Upside
1,800	2,037	13%

SML Isuzu		
CMP	Target	Upside
884	1,020	15%

Hero MotoCorp		
CMP	Target	Upside
3,310	3,976	20%

VST Tillers Tractors		
CMP	Target	Upside
2,200	2,616	19%

Prices as on 21/08/2018

Financials (₹cr)

Swaraj	FY19E	FY20E
Rev.	958	1,114
EBITDA Mar (%)	16.7	17.2
PAT	104	124
P/E x	21.1	17.7

SML	FY19E	FY20E
Rev.	1,432	1,831
EBITDA Mar (%)	5.8	7.7
PAT	29	74
P/E x	44.0	17.3

Hero Moto	FY19E	FY20E
Rev.	37,709	43,254
EBITDA Mar (%)	17.4	17.5
PAT	4,582	5,293
P/E x	14.4	12.5

VST Tillers	FY19E	FY20E
Rev.	903	1,031
EBITDA Mar (%)	16.3	16.7
PAT	126	141
P/E x	15.1	13.5

Source: IIFL Research

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August 23, 2018

Indian rural economy is witnessing positive transformation led by higher government spending, greater farm financing, farm loan waiver, MSP hike and normal monsoon. Visible effects are: (a) strong tractor volume growth in FY17 (16%) and FY18 (21%), (b) pick-up in domestic 2W sales in FY17 (7%) and FY18 (15%) after low single-digit growth in FY16. We expect rural buoyancy to continue due to election-led demand stimulation, government schemes and MSP hike.

Govt. rural allocation witnessing an upward trajectory: Government allocation towards rural development and agriculture & allied activities has increased by 15% and 39% CAGR respectively over FY16-19BE. MNREGS and PMAY-R allocation has grown at 14% and 28% CAGR respectively over FY16-19BE. The upcoming state and national elections in CY18 and CY19 will further boost rural spending.

Channel checks reveal buoyancy in 2Ws, tractors and trucks: Our interaction with dealers (pan India) of companies mentioned in this report revealed following yoy volume growth expectation for FY19: (i) tractors 12-15%, (ii) scooters 20-25%, (iii) motorcycles 10-15%, (iv) bus 10-15%, and (v) light trucks 20-25%. Growth for tractors and 2Ws will be led by normal monsoon, easy financing and government schemes. Scooters are seeing growing interest in rural areas. Bus demand was mixed in recently concluded school bus season (Apr-Jun) with wide regional variations. Small trucks are seeing good demand due to pick up in construction activities and overloading ban implementation (no impact of recent axle load hike).

Our best rural bets: We prefer companies with focus on rural themes such as (1) Swaraj Engines, since M&M is a diversified player with several businesses besides tractors under its fold, we have considered SEL as it is a focused play on M&M tractors (20x FY20E EPS), (2) SML Isuzu, growing demand for small CVs (20x FY20E EPS); (3) Hero MotoCorp, strong motorcycle sales and growing scooter penetration (15x FY20E EPS), (4) VST Tillers - foray into high HP tractors (16x FY20E EPS). All these companies have low or negligible debt on their books, coupled with superior return ratios and excellent management pedigree.

Government rural spending has grown swiftly over FY16-19E

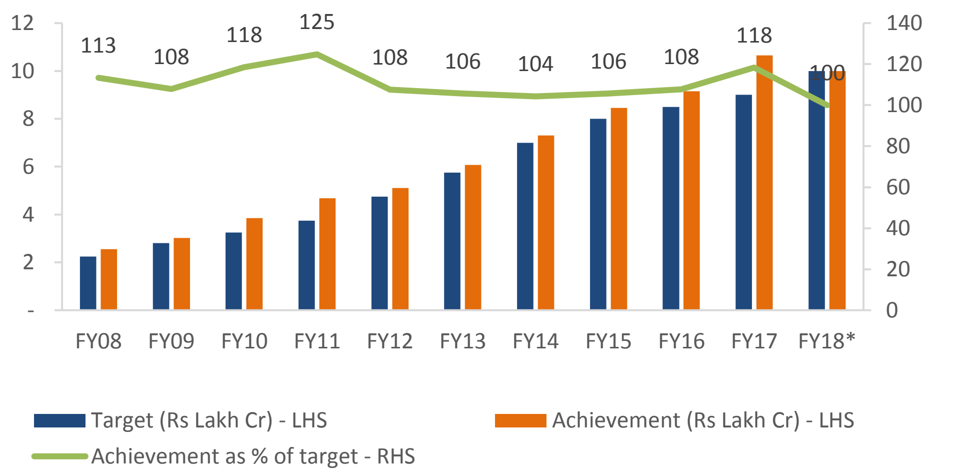
Barring two programs, government spending on major rural programs has seen a huge increase between 14% and 63% over FY16-19BE

Exhibit 1: Government opening its purse wide for Bharat

₹Cr	FY16A	FY17A	FY18RE	FY19BE	CAGR FY16-19 (%)
NRLM	2,514	3,158	4,350	5,750	*32*
yoy (%)		*25.6*	*37.8*	*32*	
PMAY-R	10,116	16,071	23,000	21,000	*28*
yoy (%)		*58.9*	*43.1*	*-9*	
PMGSY	18,290	17,923	16,900	19,000	*1*
yoy (%)		*-2.0*	*-5.7*	*12*	
MGNREGS	37,341	48,215	55,000	55,000	*14*
yoy (%)		*29.1*	*14.1*	*0*	
PMFBY	2,983	11,052	10,698	13,000	*63*
yoy (%)		*270.5*	*-3.2*	*22*	
PMKSY	7,781	5,134	7,392	9,429	*7*
yoy (%)		*-34.0*	*44*	*28*	
Agriculture & Allied	23,694	50,184	56,589	63,836	*39*
yoy (%)		*111.8*	*12.8*	*13*	
Rural Dvpmt	90,235	1,13,877	1,35,604	1,38,097	*15*
yoy (%)		*26.2*	*19.1*	*2*	

Source: CRISIL, Ministry of Rural Development. Abbreviation Key: NRLM = National Rural Livelihood Mission, PMAY-R = Pradhan Mantri Awas Yojna – Rural, PMGSY = Pradhan Mantri Gram Sadak Yojna, MGNREGS = Mahatma Gandhi National Rural Employment Guarantee Scheme, PMFBY = Pradhan Mantri Fasal Bima Yojana, PMKSY = Pradhan Mantri Krishi Sinchai Yojana. A = Actual, RE = Revised Estimates, BE = Budgeted Estimates

Exhibit 2: Formal credit flow to agriculture above target



Source: IIFL Research, Ministry Of Finance Annual Reports, Indiastats. Note: Exact "Achievement" number for FY18 is not available. Media reports suggest that target has been achieved. Hence, we have assumed the achievement percentage as 100%. The target for FY19 has been set to ₹11 lakh cr.

Government has consistently exceeded targeted agricultural credit flow to ensure unhindered credit supply to farmers, curb malpractices caused by moneylenders and to ensure that relief measures reach targeted recipients. This is among key measures taken to achieve its goal of doubling farm income by CY2022.

MSP growth has stayed healthy over the years. This has kept farm income growth buoyant but also fanned food inflation

Higher MSP to boost rural income: Minimum Support Price (MSP) is a handy tool used by Governments to boost farm income. It also addresses (at least temporarily) broader discontent amongst agricultural community. On July 04, 2018, Government approved MSP hike for FY19, in-line with its intent of hiking MSPs for kharif crops to 1.5x cost of production, as mentioned in Budget 2018. As seen in Exhibit 3, announced hike in MSP is quite steep for some crops such as Ragi (up 52%), Jowar (43%), Bajra (37%), Cotton (28%), etc. The hike was significantly higher than hikes taken over past 3 years.

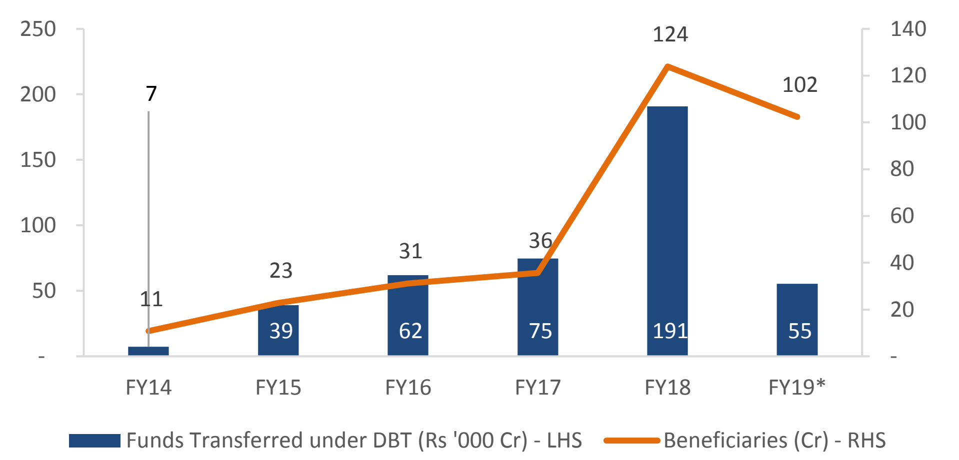
Exhibit 3: The latest MSP hike at a glance

Crop	₹/Quintal			MSP Hike (%)	3yr CAGR (%)
	Hike	Proposed MSP price	Old MSP Price		
Common Paddy	200	1,750	1,550	13	4
Fine Paddy	180	1,770	1,590	11	4
Cotton (Medium Staple)	1,130	5,150	4,020	28	2
Cotton (Long Staple)	1,130	5,450	4,320	26	2
Tur	225	5,675	5,450	4	8
Groundnut	440	4,890	4,450	10	4
Maize	275	1,700	1,425	19	3
Bajra	525	1,950	1,425	37	4
Soyabean	349	3,399	3,050	11	7
Urad	200	5,600	5,400	4	7
Jowar	730	2,430	1,700	43	4
Moong	1,400	6,975	5,575	25	7
Ragi	997	2,897	1,900	52	7

Source: IIFL Research

DBT - plugging leaks, boosting equipment sales: Government introduced Direct Benefit Transfer (DBT) in FY14 (1-Jan-13) to ensure faster fund flow towards targeted beneficiaries, avoid duplication and prevent fraud beneficiaries. DBT has helped Government save more than ₹90,000cr till March 31, 2018. DBT amount gets credited directly to a farmer's account, and hence tracking becomes easier. Effective implementation of DBT has stimulated tiller purchase, among other things, since tiller sales are largely subsidy-driven.

Exhibit 4: DBT's astounding success



Source: IIFL Research, Website of Direct Benefit Transfer, Government of India
**FY19 numbers are till date as per Government website*

Farm loan waiver, though a fiscally imprudent tool, results in uptick in demand for farm equipment

Farm loan waiver - positive fallout of fiscally imprudent measure: There have been farm loan waivers in recent times by Governments of Rajasthan, Madhya Pradesh, UP, Punjab and Maharashtra. Justification for waiver is that 52% of Indian farm households are under debt and biggest cause of agrarian distress is indebtedness. However, waiver is likely to widen combined fiscal deficit of states by ₹1.07 lakh cr. Farm loan waiver, irrespective of being right or wrong, has positive impact on rural income, albeit for short term. Sale of tractors and farm equipment gets spurred immediately after loan waiver. Nearly 66% of Indian farmers buy tractors through bank loan route, hence farmers tend to divert their loan repayment cash flow towards buying agricultural equipment. Tractor sales jumped 30% in CY2010 when UPA Government announced farm waiver in CY2009 to help farmers tide over failed monsoon. Subsequently, tractor sales went up 21% CAGR over FY09-12.

Overview of domestic tractor industry: At 7.97 lakh tractors sold (FY18, domestic + exports), India is world's largest tractor market (volumes) followed by China, USA and EU. M&M is largest tractor company in the world (sold 3.17 lakh tractors in FY18, of which ~3 lakh were sold in domestic market).

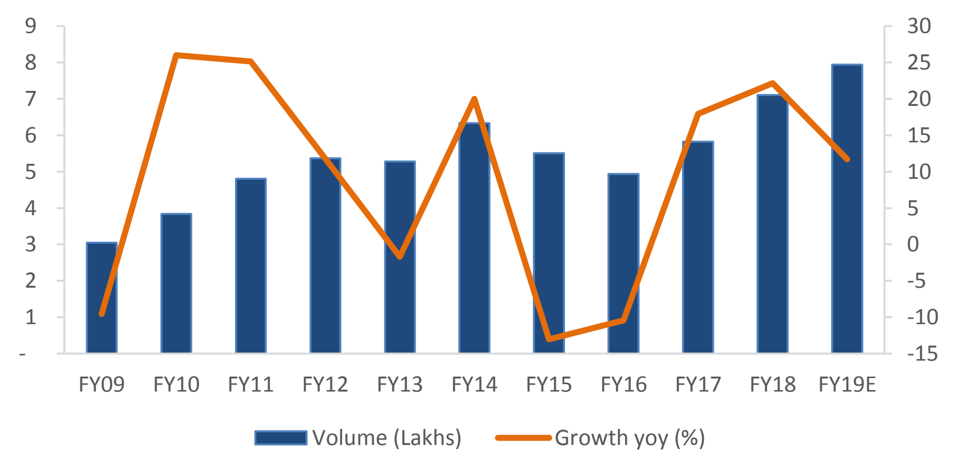
Exhibit 5: Top tractor manufacturers in India

Company	Domestic Volumes			CAGR (%)
	FY16	FY17	FY18	FY16-18
M&M (M&M + Swaraj)	2,02,628	2,48,594	3,01,934	*22.1*
TAFE	1,13,500	1,19,200	1,35,800	*9.4*
Sonalika	58,900	69,000	86,700	*21.3*
Escorts	50,698	62,699	78,446	*24.4*
John Deere	29,500	43,300	62,300	*45.3*
New Holland	22,800	22,500	26,100	*7.0*
VST	7,801	9,635	11,369	*20.7*
Others	7,670	7,156	8,351	*4.3*
TOTAL Sector	**4,93,497**	**5,82,084**	**7,11,000**	***20.0***

Source: http://www.autopunditz.com, company data, IIFL Research

As seen in Exhibit 5, M&M continues to beat tractor sector volume growth despite being the largest player. Fortunes of tractor sector are closely linked to agriculture, rural income and monsoon. Given structural tailwinds that this sector has, overall trajectory has been positive over a longer period, despite short term cyclicality.

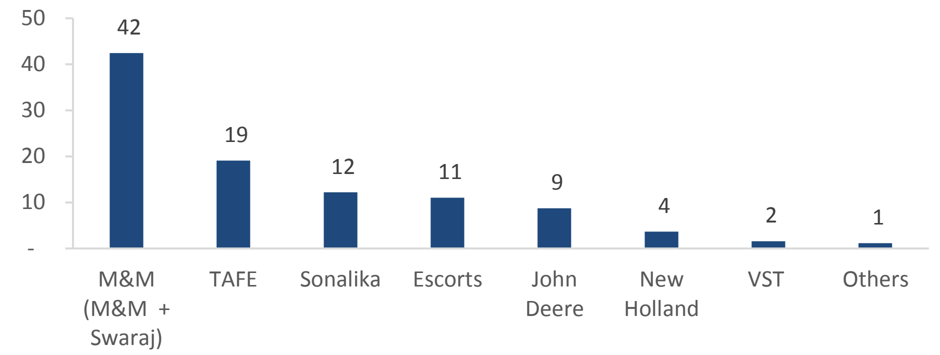
Exhibit 6: Domestic tractor volume trajectory



Source: IIFL Research

Swaraj Tractors recently unveiled the all-new Swaraj 963FE tractor in the ">60HP" engine segment. This segment enjoys better margins than lower engine capacity tractors

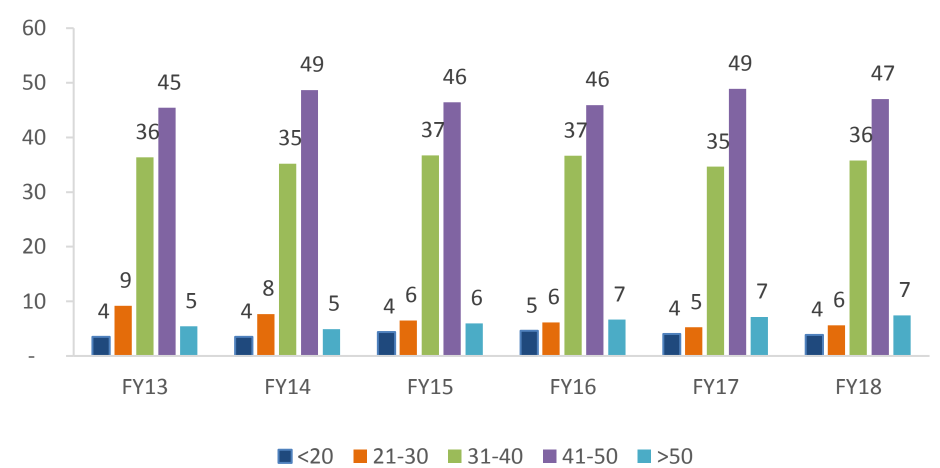
Exhibit 7: Market share of key players in FY18 (%)



Source: http://www.autopunditz.com, Company data

M&M has held on to its dominant position in the Indian tractor market due to its wide distribution network, presence across entire tractor product spectrum, brand value and steady product launches. Swaraj Tractors recently unveiled the new Swaraj 963FE tractor, based on new high power tractor platform and marking its entry into ">60HP" segment. The tractor is priced at ₹7,40,000 (ex-showroom Mohali).

Exhibit 8: HP-wise tractor volume distribution (%)



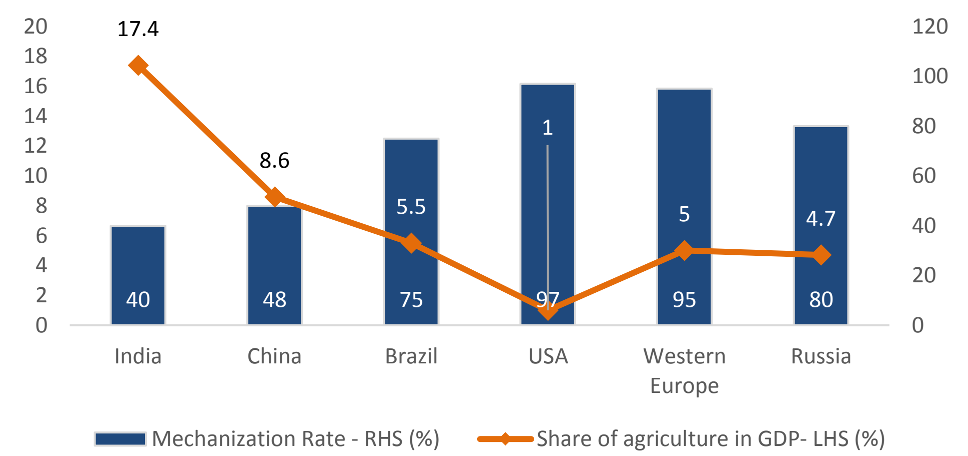
Source: M&M Annual Reports

Higher crop realizations owing to growing MSPs, increasing commercial (non-farm) usage and growing trend of collaborative farming has driven a shift towards higher HP tractor segments

Indian tractor market is dominated by 31-50HP tractors, contributing ~85% of total sector volumes. Recently, demand for higher HP tractors (>50HP) has gained prominence due to high crop realization over past 5-7 years, MSP hike, increasing non-agricultural tractor usage and growing collaborative farming. Indian tractor industry has grown at 18% yoy/22% yoy in FY17/FY18. We expect tractor industry to grow at 12% in FY19E and 10-12% CAGR over the long term led by:

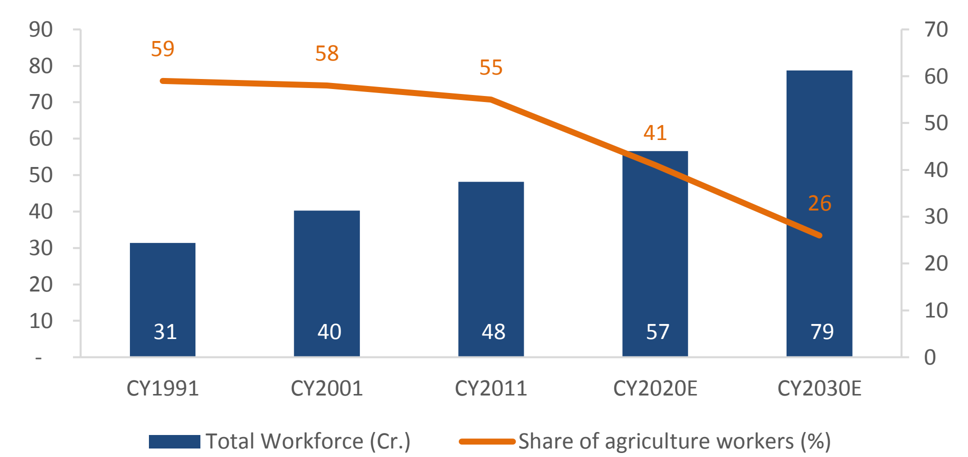
- New demand creation will be triggered once new tractor emission norms (Trem4) come into force in CY2020.
- At 20 tractors per 1,000 hectares, India's tractor penetration remains very low compared to several other major countries.
- Demand for tractors in non-farm applications is growing, 20% of tractors are used for construction, infrastructure activities.
- Current farm mechanization rate in India is much lower than major global economies (refer Exhibit 9).
- Share of agricultural workers to total workers is declining (refer Exhibit 10), increasing need for farm mechanization.
- Rising cost of employing labor (refer Exhibit 11) makes use of farm equipment more cost effective.

Exhibit 9: Mechanization rate comparison



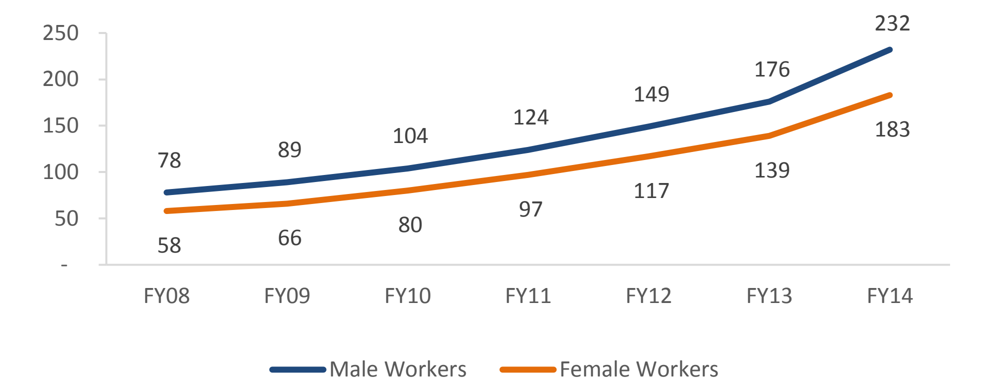
Source: Grant Thornton report on Mechanization, 2017

Exhibit 10: Workforce scenario in India



Source: Grant Thornton report on Mechanization, 2017

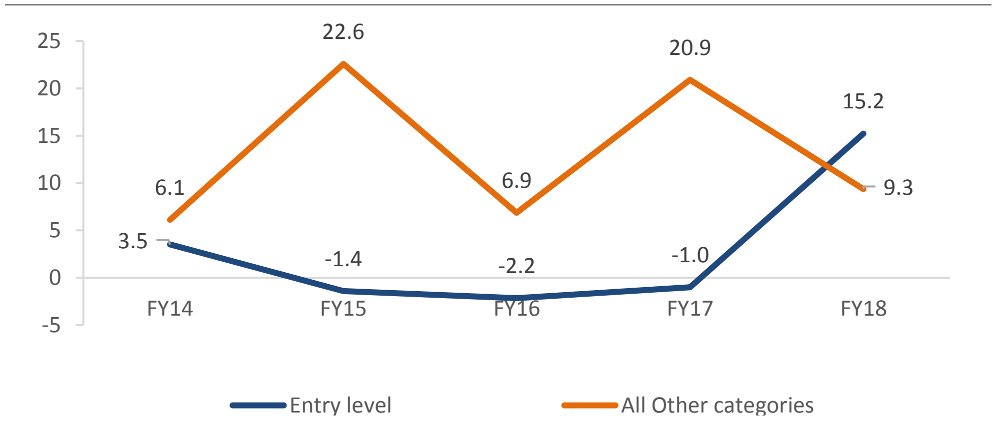
Exhibit 11: Average daily wage rate in agricultural operations (₹)



Source: Grant Thornton report on Mechanization, 2017

Entry level motorcycles stage a comeback: Motorcycles with capacity less than 125cc staged a comeback in FY18 after 3 year slump. Since these motorcycles are mainly sold in rural areas, the resurgence is clearly on the back of rural income recovery (Exhibit 12). Nearly 2/3rd of all entry level motorcycle (capacity less than 125cc) sales happen in rural areas. Entry level motorcycle sales were depressed over FY2015-17 due to lower than average rainfall in those years, exerting pressure on rural income. Demonetization too led to lower sales, as majority of rural bike sales happen in cash.

Exhibit 12: Comparison of motorcycle sales growth (%)



Source: SIAM Data, IIFL Research

After contracting 1%/2%/1% in FY15/FY16/FY17, entry level motorcycle volumes grew 15% yoy in FY18, buoyed by rural growth. It even surpassed growth rate of all other motorcycle categories (greater than 125cc). Going ahead, we project domestic motorcycle volumes (at a sector level) to grow at 12% in FY19E and 10% CAGR over FY18-20E.

Duopolistic nature of tiller market in India: Indian tiller market is a duopoly with VSTTL and Kerala Agro Machinery Corp (KAMCO), controlling ~90% of market. VST commands ~60% market share, KAMCO ~30%. Remaining 10% are Chinese players. Some companies like Greaves Cotton import Chinese components and indigenize them.

Exhibit 13: Cost comparison of indigenous power tillers

Sr. No.	Particulars	Cost (₹)	
		VST	Kamco
1	Avg RM cost	90,000	93,700
2	VAT on basic cost	2,500	2,350
3	Avg overhead expenses	25,000	21,900
4	Avg cost of accessories	7,500	7,600
5	Avg dealers' margin	10,000	9,510
6	Avg company profit	5,000	1,970
7	Avg other charges	25,000	27,465
8	**Avg selling price in India**	**1,65,000**	**1,64,495**

Source: IIFL Research, Report of the Expert Committee on Power Tillers submitted to the Ministry of Agriculture and Farmers' Welfare dated March 2017

Despite similar selling price, VST has higher profit (Exhibits 13, 14).

Exhibit 14: FY18 financials at a glance

FY18 ₹Cr	VSTTL	KIMCO
Revenue	763	156
PAT	112	4
PAT Margin (%)	*15*	*3*

Source: Company Data, IIFL Research

Tiller cannibalization by small tractors not as acute as imagined: It is believed that lower HP tractors could replace tillers. However, small and marginal farmers, accounting for more than 70% of total land holding cannot afford tractor. A small tractor (<27HP) costs more than ₹2.5 lakh, while power tiller costs less than half as much. Hence, small and marginal farmers will continue to prefer power tiller against tractor. As per a report by the "Expert Committee on Power Tillers" dated March 2017, power tillers are "the two-wheeled version of tractors that are targeted at farmers with small land holdings, or those who cannot afford expensive tractors. It works best on smaller land holdings (up to 2.5 hectares) and where the horse power requirement is lower. Most of the power tillers are diesel operated with a horse power ranging from 8 to 15".

Dealer check

Following are the key takeaways from our interaction with various dealers of the four companies mentioned in this report:

Company	Product Segment	States covered during interaction	Takeaways	FY19E volume growth expectation
Swaraj Engines	Tractor	Maharashtra, Karnataka, Haryana, Bihar, Assam, Andhra Pradesh, West Bengal, Tamil Nadu, U.P., Gujarat	Demand for tractors has been encouraging so far in FY19, led by progress of monsoon and Government schemes. While regional growth expectations vary, on the whole, 12-15% growth is expected in FY19. M&M and Swaraj (owned by M&M) are two major tractor brands in India, with either one of them leading in any given geography. Other major brands are TAFE, John Deere, New Holland, Farmtrac, etc.	12-15%
SML Isuzu	Bus, Small trucks (5-12T)	Maharashtra, Punjab, Karnataka, Assam, West Bengal, Andhra Pradesh, Tamil Nadu, Uttar Pradesh, Gujarat, Goa	SMLI will be unaffected by axle load hike, since it sells trucks in 5-12T range, whereas axle load hike applies to vehicle capacity more than 16T. School bus demand is seasonal with Apr-Jun being key season. Recently concluded season was mixed, with wide regional variance. Most dealers expect lower double digit growth for buses. There is ample demand for SMLI's trucks, supply is an issue in some places due to high demand. New "Global Series" trucks are being very well received by customers due to their superior aesthetics and features. Dealers expect these trucks to steer volumes going ahead.	Bus 10-15%, Small truck 20-25%
Hero Moto	Scooter, Motorcycle	Maharashtra, Telangana, Punjab, Haryana, Kerala, Assam, Bihar, Delhi	Scooter sales are seeing stronger growth compared to motorcycles. While motorcycles continue to see brisk sales, scooters are catching up on a low base and growing interest among women riders and students. On the whole, dealers expect 10-15% growth for motorcycles and 20-25% growth for scooters in FY19. Barring couple of dealers, none of the others see any let up in growth. Interest level for new launches is high among customers.	Motorcycles 10-15%, Scooters 20-25%
VST	Tractors, Tillers	Cannot be revealed given the limited number of dealers	Tillers and tractors coexist without too much cannibalization, since they cater to different types of farmers. VST and KAMCO are preferred brands due to their quality and brand value. Tractor demand has been strong in FY19, despite two consecutive years of high growth. Tiller demand is steady, at 10-12%.	Tractor 15-18%, Tiller 10-12%

Source: Dealer Interaction

Swaraj Engines Ltd

CMP: ₹1,800; 1-year target: ₹2,037

IIFL Premia Research

Sector	Auto Anc.
Recommendation	BUY
Upside	13%

Stock Data

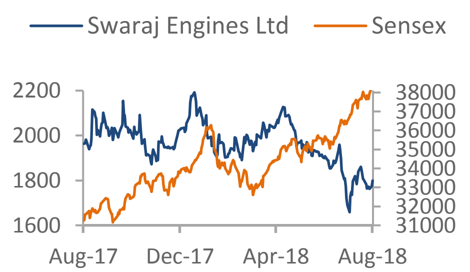
Sensex	37,286
52 Week h/l (₹)	2,208/1,650
Market cap (₹ Cr)	2,236
BSE code	500407
NSE code	SWARAJENG
FV (₹)	10
Div yield (%)	2.8

Shareholding Pattern

	Dec-17	Mar-18	Jun-18
Promoters	50.61	50.74	50.74
DII+FII	15.04	15.56	15.62
Individuals	34.35	33.70	33.64

Source: ACE Equity

Share Price Trend



Prices as on 21/08/2018

Swaraj Engines (SEL), engine maker for M&M's Swaraj tractors has several growth triggers; (a) demand-led capex (from 1,20,000 currently to 1,35,000 engines by FY21E), (b) assured business from M&M, (c) clear transfer pricing (100% input cost pass-through), (d) sector tailwind (double digit long term growth rate) and (e) growing proportion of high HP tractors (from 51% in FY13 to 54% in FY18). SEL enjoys zero debt, high return ratios, esteemed management, stable GPM and handsome dividend payout. We project revenue, EBITDA, PAT CAGR of 20%, 25% & 24% respectively over FY18-20E. At CMP, it trades at 18x FY20E EPS, 18% discount to average 3yr forward PE of 22x. We recommend BUY with target of ₹2,037 (20x FY20E EPS).

Assured business from M&M provides revenue visibility: SEL makes engines for M&M's Swaraj tractors and fulfills 30% of M&M's tractor engine requirement, hence orders are assured. Engine volume supplied by SEL has grown at 13% CAGR over FY15-18 vs. 11% CAGR for M&M's domestic tractors. We expect 20% revenue CAGR for SEL over FY18-20E, led by 17% volume CAGR and 3% price CAGR.

Clear transfer pricing policy shields margins: SEL has clear transfer pricing policy with M&M, ensuring 100% cost pass-through. It has maintained 22-25% GPM over FY15-18. We expect transfer pricing policy to lead to 60bps GPM expansion over FY18-20E. Greater operating leverage will lead to 141bps EBITDA margin expansion.

Outlook & Valuation: We are positive on SEL due to (a) assured business from M&M (30% market share in M&M's tractor volumes), (b) clear transfer pricing policy (steady GPM), (c) robust balance sheet and (d) high dividend payouts.

Financial Summary

Standalone ₹Cr.	FY17	FY18	FY19E	FY20E
Revenue	666	771	958	1,114
YoY growth (%)	*26.7*	*15.8*	*24.2*	*16.3*
EBITDA Margin (%)	*15.6*	*15.8*	*16.7*	*17.2*
PAT	69	80	104	124
EPS (₹)	56.8	66.1	85.4	101.8
RoE (%)	*25.2*	*31.3*	*42.8*	*44.9*
RoCE (%)	*31.7*	*40.4*	*57.5*	*61.7*
P/E (x)	31.7	27.3	21.1	17.7

Source: Company Data, IIFL Research

Balance Sheet Summary

Standalone ₹Cr.	FY17	FY18	FY19E	FY20E
Assets				
Fixed Assets	92	98	100	90
Investments	49	76	76	76
Other Non-current assets	4	11	6	6
Current Assets	227	163	207	268
Total Assets	**372**	**347**	**389**	**441**
Liabilities				
Shareholders' Funds	283	228	256	294
Current Liabilities	80	110	123	137
Other Liabilities	9	9	9	9
Total Liabilities	**372**	**347**	**389**	**441**

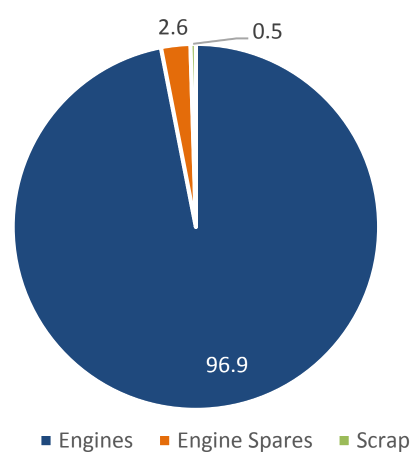
Source: Company Data, IIFL Research

SEL has an illustrious promoter ownership with M&M and Kirloskar Industries owning 33.31% and 17.44% stake respectively

Company Overview

Swaraj Engines is a manufacturer of diesel engines fitted into "Swaraj" brand of tractors manufactured by Mahindra and Mahindra (M&M). SEL also supplies engine components to SML Isuzu (SMLI).

Exhibit 1: Revenue break-up (FY18) (%)



Source: Company Annual Report, IIFL Research

SEL has illustrious promoter ownership with M&M and Kirloskar Industries (KIL) owning 33.31% and 17.44% stake respectively (June 30, 2018). Promoter pledging is nil. Institutional ownership is 15.62%.

Exhibit 2: SEL's marquee shareholders

Investor / Stakeholder	Category	Stake (%)
M&M	Promoter	33.31
Kirloskar Industries	Promoter	17.44
DSP Blackrock SmallCap Fund	Institutional - MF	3.42
L&T Midcap Fund	Institutional - MF	4.73
HDFC Children's Gift Fund	Institutional - MF	2.13
SBI Magnum Midcap Fund	Institutional - MF	1.29
National Westminster Bank PLC	Institutional - FPI	1.46

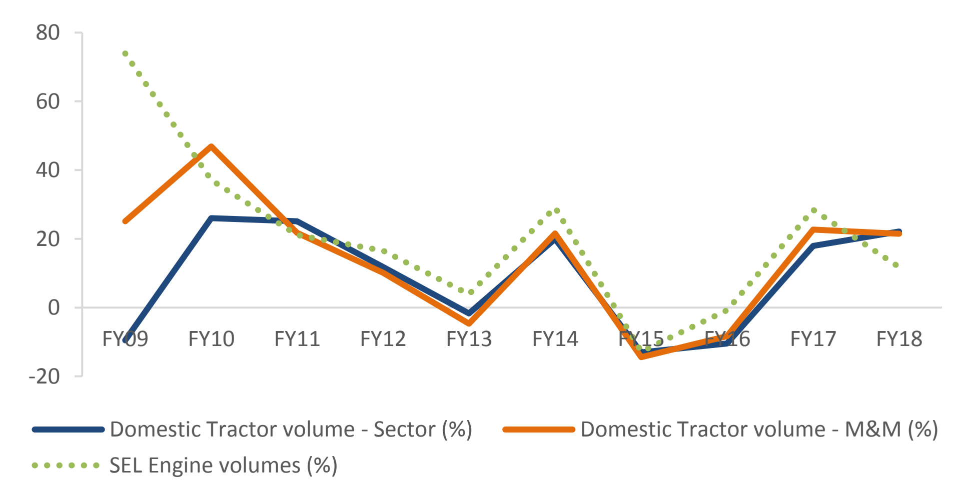
Source: BSE shareholding pattern as on June 30, 2018

SBI Mutual Fund has stayed invested for 7.5 years, National Westminster Bank for 5.5 years and L&T Mutual Fund for 4 years.

SEL's engine volume growth has outperformed domestic tractor volume growth in 8 out of past 10 years

Tractor volumes have remained stable despite market cycles: SEL has exhibited great resilience to tractor volume cycle in India. It has outperformed domestic tractor volume growth in 8 out of past 10 years. In fact, it has outperformed even M&M's tractor volume growth in 5 out of past 10 years (refer exhibit 3). In the remaining years, the underperformance has been very low. The tractor industry is cyclical and is dependent on factors such as rural income growth, strength and distribution of monsoon and Government spending on rural-focused schemes. The resilience of SEL's volume growth lends comfort w.r.t. the fact that SEL's growth story will not suffer a major setback even in the event of a sector-level down-cycle.

Exhibit 3: Volume growth comparison



Source: Company Data, IIFL Research

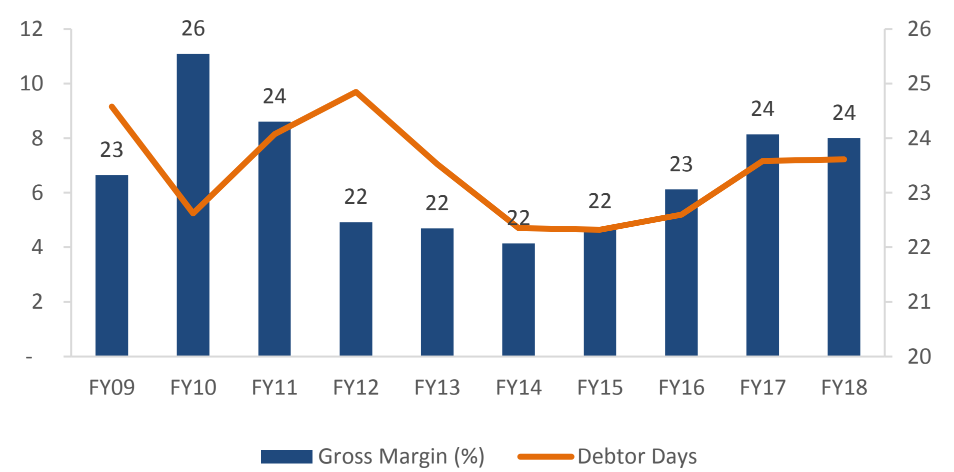
The "Swaraj" brand contributes nearly 30% to M&M's total tractor volumes. Even after acquisition from Punjab Tractors, M&M retained the brand instead of killing it, as is often the case in most acquisitions

Kirloskar Oil Engines, SEL's other promoter, also supplies engines to Swaraj Tractors

"Swaraj" brand is of prime importance to M&M's tractor portfolio (contributing 30% to total tractor volumes). Ever since acquisition of SEL from Punjab Tractors, M&M has retained focus on Swaraj brand rather than killing it, as is often the case after an acquisition. For M&M, Swaraj gave access to a large ready customer base in North India. Hence, the partnership was a win-win for both M&M and SEL.

Transfer pricing policy protects margins and debtor cycle: SEL has a clear transfer pricing policy with its client & promoter M&M. Transfer pricing has ensured that SEL's gross margins have largely remained between 22% and 25% with upward bias over past 10 years (Exhibit 4), shielding SEL from input cost fluctuation. Pass-through is nearly 100% and takes place with minimum lag. Kirloskar Oil Engines (KOEL), owned by SEL's other promoter, Kirloskar Industries, also supplies engines to Swaraj tractors. SEL supplies ~85% of volumes to M&M's Swaraj tractors while KOEL supplies ~10%. Hence, KOEL is unlikely to interfere with pricing agreement between SEL and M&M since it will adversely affect its own prospects. M&M has maintained strict payment discipline with SEL, which has kept debtor days in tight range.

Exhibit 4: Gross margin and debtor trajectory



Source: Company Data, IIFL Research

Incremental capex being undertaken at lower cost: Over past 10 years (FY09-18), SEL has tripled capacity from 36,000 engines to 1,20,000 engines. It plans to raise capacity to 1,35,000 engines by FY21E and 1,50,000 thereafter. It is significant to note that each capacity expansion has been done at a cheaper rate (₹/engine) than previous one (exhibit 5). Back-of-the-envelope calculations indicate that ongoing capacity expansion (from 1,20,000 to 1,35,000 by FY21E) could be undertaken at ₹10,000 per engine. SEL will incur ₹35cr over FY19-21E, comfortably funded from internal accruals. As on March 31, 2018, SEL had cash and liquid investments of ₹124cr. Expansion so far has been brown-field. If it decides to go in for green-field expansion, capex will be significantly higher. However, current land bank will suffice till FY21, and hence, green-field expansion is unlikely.

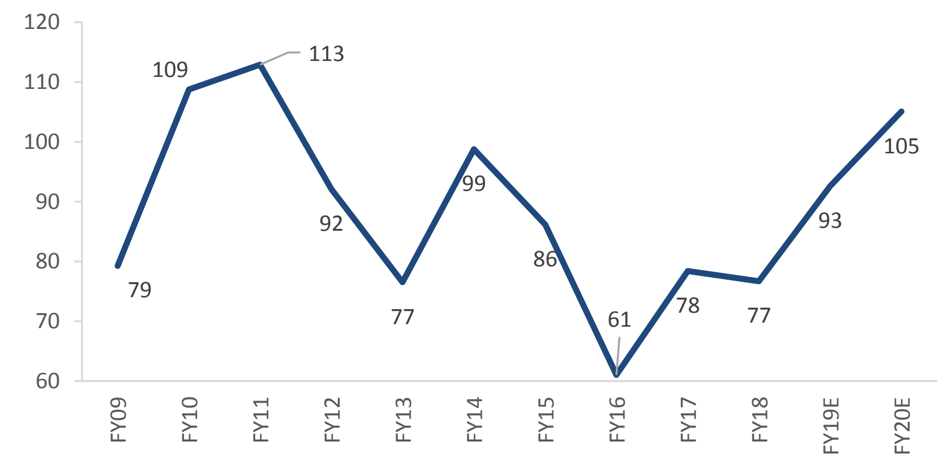
Exhibit 5: Cost of capacity expansion trending lower

Year	Capacity expanded (engines)	Exit capacity (engines)	Capex incurred per engine (₹)	Difference (%)
FY13	39,000	75,000	18,608	
FY16	30,000	1,05,000	16,525	*-11*
FY18	15,000	1,20,000	12,667	*-23*
FY21E	15,000	1,35,000	10,000	*-21*

Source: Company Data, IIFL Research

All capex has been undertaken in a manner that utilization has remained high. Capacity utilization has averaged above 85% over past decade. Based on capex plans highlighted by SEL, we expect utilization to trend towards 100% (Exhibit 6). Hence, SEL is planning to expand to 1,50,000 engines beyond FY21E.

Exhibit 6: Capacity utilization trend (%)



Source: Company Data, IIFL Research

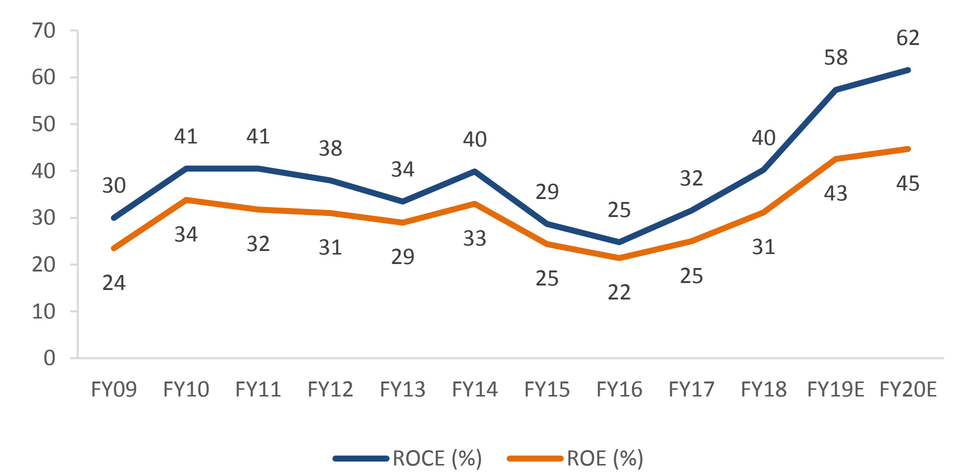
Exhibit 7: Capacity, utilization and market share at a glance

Particulars	Swaraj Engines (Tractors)
FY18 Capacity (Units)	1,20,000
FY19E Capacity (Units)	1,20,000
FY18 Sales Volume (Nos.)	92,022
FY19E Sales Volume (Nos.)	1,11,112
yoy (%)	*21*
FY18 Capacity Utilization (%)	77
FY19E Capacity Utilization (%)	93
FY18 Addressable Market Size (Units)	7,11,000
FY19E Addressable Market Size (Units)	7,94,323
yoy (%)	*12*
FY18 Market Share (%)	13
FY19E Market Share (%)	14

Source: Company Data, IIFL Research

Robust balance sheet metrics: SEL has extremely strong balance sheet with zero debt, high return ratios, disciplined working capital cycle and high cash balance (Exhibit 8 and 9). Hence, it is a high free cash flow generating company. Asset turnover has averaged above 3.5x over past decade. We expect SEL to retain zero debt status going ahead, since internal accruals are sufficient to fund capex.

Exhibit 8: Return ratios at a glance

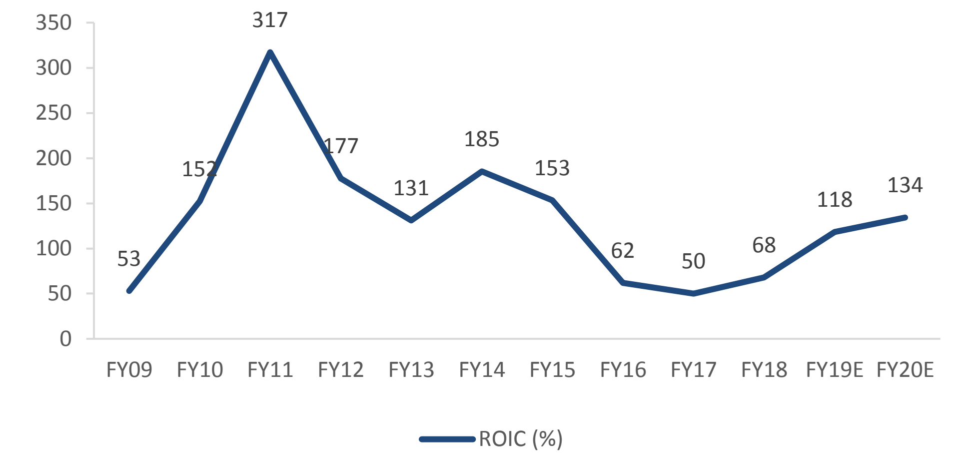


Source: Company Data, IIFL Research

Please note that ROA and ROE are almost equal given zero debt on books and negligible deferred tax liabilities, hence we have not shown ROA separately in the Exhibit.

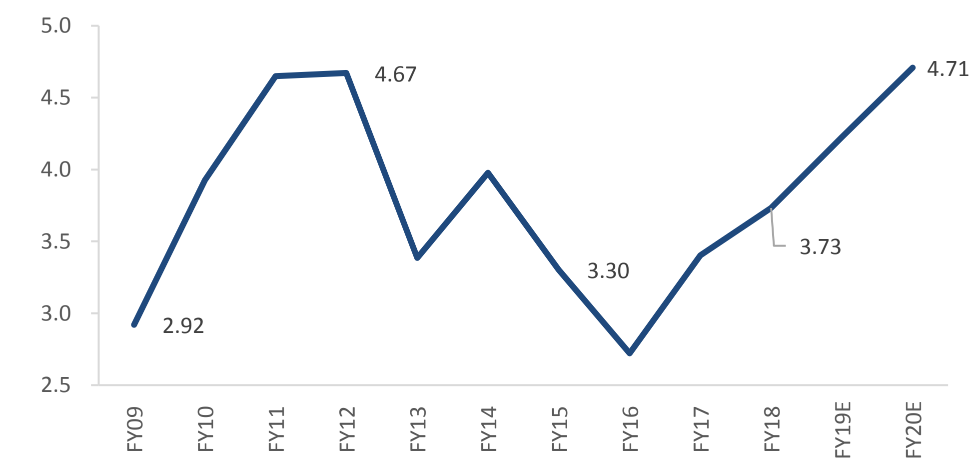
Given the high quantum of cash, cash equivalents and liquid investments on books of SEL, ROCE looks depressed. Hence, we consider another metric ROIC (Return on Invested Capital), which ignores the impact of high cash and liquid investments.

Exhibit 9: Return on invested capital - a cash neutral metric



Source: Company Data, IIFL Research

Exhibit 10: Gross asset turnover (x)

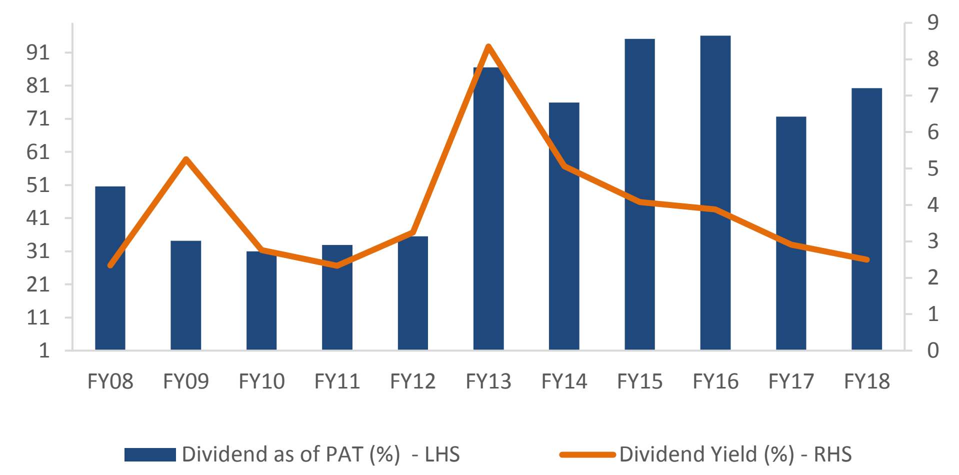


Source: Company Data, IIFL Research

High Dividend Payout

Given the high quantum of cash and liquid investments on its books, SEL has rewarded investors handsomely over the years through very high dividend payouts. In addition, the company also undertook a share buyback in February 2018 to the tune of ₹71cr (2.37% of total shares outstanding) to return cash to shareholders. Considering the high cash on books and comfortable funding of capacity expansion through internal accruals, another buyback cannot be ruled out in the near term.

Exhibit 11: Dividend payout trend



Source: Company Data, IIFL Research

Exhibit: Peer Comparison*

Company	Revenue yoy (%)		EBITDA Margin (%)		ROE (%)	
	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E
Kirloskar Oil Engines	15.8	10.5	9.0	9.8	11.4	12.5
Escorts	16.7	10.6	11.7	12.1	18.7	18.5
VST Tillers Tractors	18.3	14.2	16.3	16.7	19.3	18.4
Greaves Cotton	8.1	10.8	14.7	15.0	19.8	20.8
Average	**14.7**	**11.5**	**12.9**	**13.4**	**17.3**	**17.5**
Swaraj Engines	24.2	16.3	16.7	17.2	42.8	44.9

Company	PE (x)		EV/EBITDA (x)		P/BV (x)	
	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E
Kirloskar Oil Engines	19.9	17.4	9.8	8.2	2.2	2.1
Escorts	18.9	16.2	14.8	12.9	3.3	2.8
VST Tillers Tractors	15.1	13.5	13.1	11.2	2.7	2.3
Greaves Cotton	18.9	17.4	11.9	10.5	3.6	3.4
Average	**18.1**	**16.1**	**12.2**	**10.5**	**2.9**	**2.6**
Swaraj Engines	21.1	17.7	13.3	10.9	8.5	7.4

Company	FY18 (₹ Cr)			FY18 Margins (%)		Mcap
	Revenue	EBITDA	PAT	EBITDA	PAT	₹ Cr
Kirloskar Oil Engines	3,111	264	145	*8.5*	*4.7*	3,631
Escorts	5,080	554	347	*10.9*	*6.8*	11,014
VST Tillers Tractors	764	120	112	*15.7*	*14.7*	1,901
Greaves Cotton	1,840	255	202	*13.9*	*11.0*	3,607
Average				***12.2***	***9.3***	
Swaraj Engines	771	122	80	*15.8*	*10.4*	2,236

Company	Dividend Yield (%)	CMP (₹)	FY18 D/E (x)
Kirloskar Oil Engines	2.0	251	0.0
Escorts	0.2	899	0.0
VST Tillers Tractors	2.0	2,200	0.0
Greaves Cotton	3.7	148	0.0
Average	**1.9**		**0.0**
Swaraj Engines	2.8	1,800	0.0

Source: Company Data, IIFL Research

**IIFL estimates used for VST & Swaraj. Bloomberg consensus estimates used for the rest.*

We have considered peers which manufacture engines for agricultural equipment (Greaves Cotton and Kirloskar Oil Engines) and OEMs that manufacture tractors (Escorts and VST Tillers Tractors). SEL is uniquely placed since it manufactures engines for its client and promoter M&M. Most other tractor manufacturers make their own engines. As seen in the tables above, SEL has much superior margins and return ratios compared to peers. Despite being of a smaller size, this stock is a safe bet since it is secured by orders from M&M. Hence, it deserves a premium valuation compared to peers.

Key Risks:

- Dependence on a single product and limited number of clients (with M&M being the largest) poses a risk for its business.
- Company is subject to vagaries of agriculture and monsoon.
- Adoption of new emission norms (Trem4) from CY2020 could present some roadblocks w.r.t. implementation.

SML Isuzu Limited

CMP: ₹884; 1-year target: ₹1,020

Sector	Auto OEM
Recommendation	BUY
Upside	15%

Stock Data

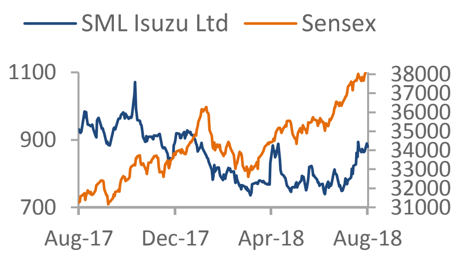
Sensex	38,286
52 Week h/l (₹)	1,090/720
Market cap (₹ Cr)	1,280
BSE code	505192
NSE code	SMLISUZU
FV (₹)	10
Div yield (%)	0.2

Shareholding Pattern

	Dec-17	Mar-18	Jun-18
Promoters	43.96	43.96	43.96
DII+FII	8.51	8.56	8.47
Individuals	47.53	47.48	47.57

Source: ACE Equity

Share Price Trend



Prices as on 21/08/2018

SMLI, which manufactures buses & medium-sized trucks (5-12T), will make a strong comeback in FY19 & FY20 led by new launches & sorting of inventory issues. It saw volume slump in FY18 due to unsold BS-III inventory & component supply issue from vendors. SMLI has low debt (0.6x) on books. Other than Ashok Leyland, it is the only listed pure play CV player. We forecast revenue, EBITDA & PAT CAGR of 27%, 76% & 195% respectively over FY18-20E. Numbers appear high due to low base of FY18. At CMP, it trades at 17x FY20E EPS. We recommend BUY with target of ₹1,020 (20x FY20E EPS).

New launches to boost top-line: SMLI recently launched 3 truck models in its "Global Series" range of vehicles in 7-10T category. It also launched CNG bus with option of 20-31 seats. Launches will strengthen SMLI's presence in its core segment. Led by new launches & low base of FY18, we expect SMLI to report revenue/volume CAGR of 27%/20% respectively over FY18-20E.

Operating leverage to improve led by volume uptick: We expect strong CV demand & resurgence in bus volume to lead to 370bps EBITDA margin expansion over FY18-20E on greater operating leverage. We project bus & truck volume growth of 20% & 21% CAGR respectively over FY18-20E due to infrastructure spending, mining resurgence & high agro output. SMLI had seen steady EBITDA margin uptick over FY14-17, while FY18 was affected due to inventory issues.

Outlook & Valuation: We are positive on SMLI due to (a) volume uptick led by new launches and robust demand, (b) margin expansion led by operating leverage and (c) robust balance sheet. We value SMLI at 20x FY20E EPS to arrive at target of ₹1,020.

Financial Summary

Standalone ₹Cr.	FY17	FY18	FY19E	FY20E
Revenue	1,356	1,135	1,432	1,831
YoY growth (%)	16.3	(-16.3)	26.2	27.9
EBITDA Margin (%)	8.1	4.0	5.8	7.7
PAT	63	8	29	74
EPS (₹)	43.5	5.9	20.1	51.0
RoE (%)	16.9	2.1	7.1	16.6
RoCE (%)	17.4	2.9	7.7	16.0
P/E (x)	20.3	150.6	44.0	17.3

Source: Company Data, IIFL Research

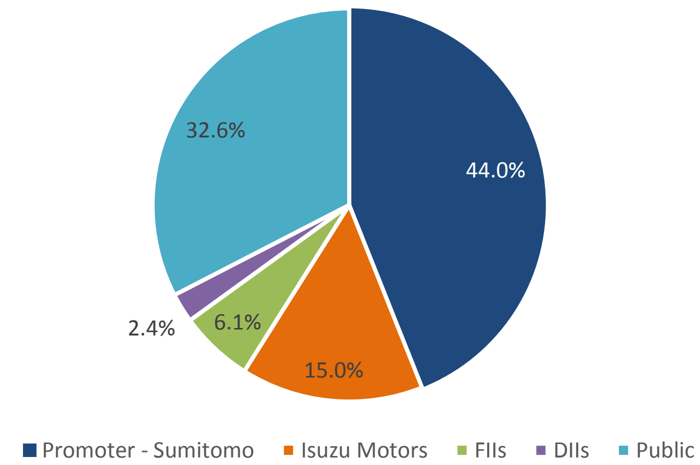
Balance sheet summary

Standalone ₹Cr.	FY17	FY18	FY19E	FY20E
Assets				
Fixed Assets	294	400	387	386
Investments	-	-	-	-
Other Non-current assets	42	30	67	86
Current Assets	450	556	568	711
Total Assets	**785**	**987**	**1,022**	**1,184**
Liabilities				
Shareholders' Funds	404	398	418	470
Current Liabilities	276	338	359	474
Other Liabilities	106	251	245	240
Total Liabilities	**785**	**987**	**1,022**	**1,184**

Source: Company Data, IIFL Research

Company overview: SML Isuzu (SMLI) is a manufacturer of commercial vehicles including buses, trucks and special application vehicles (ambulance, tipper, prison van, refrigeration van, etc). Isuzu Motors, which provides technical assistance to SMLI, owns 15% stake while promoter Sumitomo Corporation, Japan, holds 43.96% stake (June 30, 2018). Following chart shows shareholding in SMLI.

Exhibit 1: Shareholding in SMLI



Source: BSE Website. Data is as on June 30, 2018

Product portfolio: SMLI operates from a single plant in Shahid Bhagat Singh Nagar (Punjab) with installed capacity of 18,000 vehicles per annum, which it will ramp up to 24,000 in FY19. Product portfolio comprises of buses (13-52 seater) and cargo vehicles (5-12T trucks; refer Exhibit 2). In FY18, SMLI derived 54% volumes from buses and remaining 46% from trucks. Its vehicles are mainly sold in India (96% of total volumes) and has a small export business (4% of total volumes; refer Exhibit 3). SMLI sells products under two brands – SML and Isuzu. While it sells trucks, buses and specialized vehicles under the "SML" tag, it sells only buses under "Isuzu" tag.

Exhibit 2: Product portfolio

Category / Brand	Specification
SML	
Trucks	5-12T
Buses	13-52 seats
Special Application vehicles	Ambulance, Tipper, Dumper, Troop Carrier
	Prison Van
	Specialized trucks
	Vans - closed, refrigerated, recovery, etc.
ISUZU	
Buses	36-45 seats

Source: Company website

Exhibit 3: Volume mix

Segments	FY18 volume (%)
Bus	**53.7**
Domestic	*53.7*
Exports	*0.04*
Trucks	***46.3***
Domestic	*42.2*
Exports	*4.1*
TOTAL	***100.0***

Source: Company Data, SIAM Data

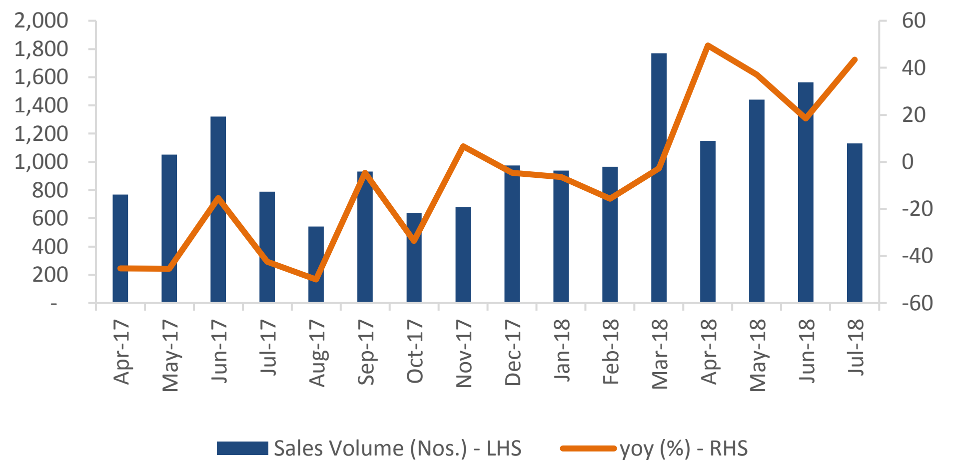
What went wrong in FY18?

The company faced several issues in FY18 such as huge unsold BS-III inventory, supply constraints from vendors for BS-IV components

SMLI had a disruptive FY18 wherein its volumes and revenue plunged 24% yoy and 16% yoy respectively. It faced issues in FY18 relating to huge unsold BS-III inventory, of 1,800 BS-III vehicles, which included unsold vehicles and vehicles returned by dealers. Additionally, SMLI also faced constraints from its vendors who could not supply several key components required for BS-IV vehicles. As a result of BS-III ban, *SMLI exported some BS-III inventory to compliant countries and wrote off non-usable inventory*

all dealers who held SMLI's BS-III stock returned the same to the company, resulting in sales return. Moreover, all unusable components in SMLI's inventory pertaining to earlier BS-III vehicles were written off. SMLI tried two ways to address this inventory issue, (a) convert BS-III vehicles to BS-IV vehicles. Cost incurred for this transition was charged to P&L resulting in increased costs (₹30,000-₹35,000 per unit) and (b) company tried to sell some of its BS-III vehicles in overseas markets where older emission norms were still existing. However, this too met with limited success. All these factors led to the company reporting extremely weak sales in FY18, which affected overall revenues. EBITDA and PAT in absolute terms were down 59% yoy and 87% yoy respectively in FY18. EBITDA margin halved from 8% in FY17 to 4% in FY18. The company began FY19 on a strong footing with volume growth of 49%, 37%, 18% and 43% in April, May, June and July 2018 respectively (Exhibit 4), helped by low base of year ago period and sorting of earlier issues.

Exhibit 4: Volumes set for a take-off after weak FY18



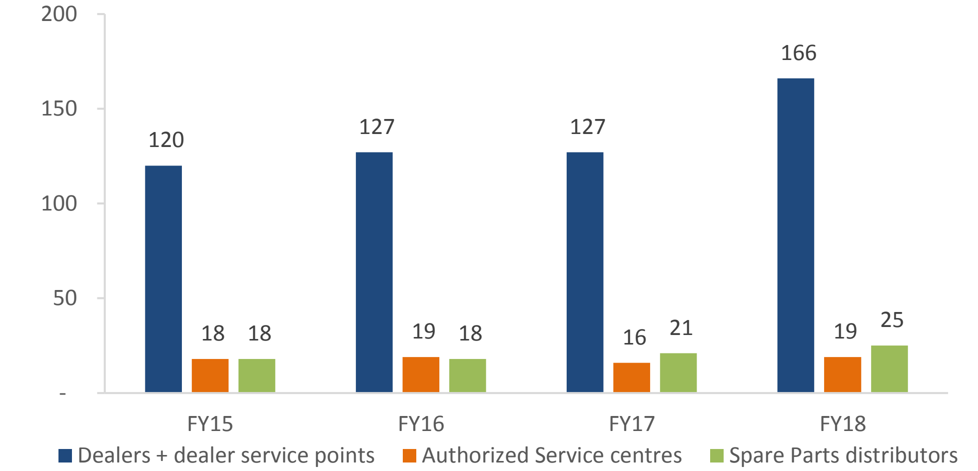
Source: Company Data, IIFL Research

What has SMLI done to get back to growth path?

After a difficult FY18, SMLI has taken several steps to get growth back on track; (a) cleaning books w.r.t. old inventory: Company wrote off inventory of non-usable components related to BS-III vehicles, after selling off BS-III vehicles in overseas markets where these were still accepted and converted some BS-III vehicles to BS-IV, (b) launching new "Global Series" trucks and a CNG bus (c) expansion of dealerships and service touch points to improve customer service (Exhibit 5) and

(d) SMLI is investing ₹30cr in an additional assembly line to ramp up production capacity from 18,000 units per annum to 24,000 units per annum. It is spending ~₹200cr over FY17-21E for technology, product development and up-gradation of plant infrastructure to improve manufacturing efficiency. The spending will be funded through internal accruals and need-based long-term fully hedged External Commercial Borrowings (ECBs).

Exhibit 5: SMLI network expansion over the years (Nos.)

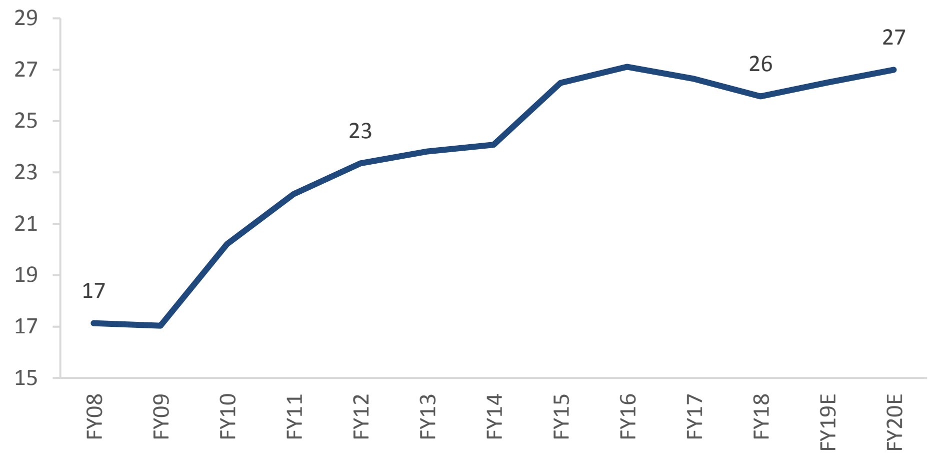


Source: Company Presentations, IIFL Research

Steady gross margin expansion across market cycles

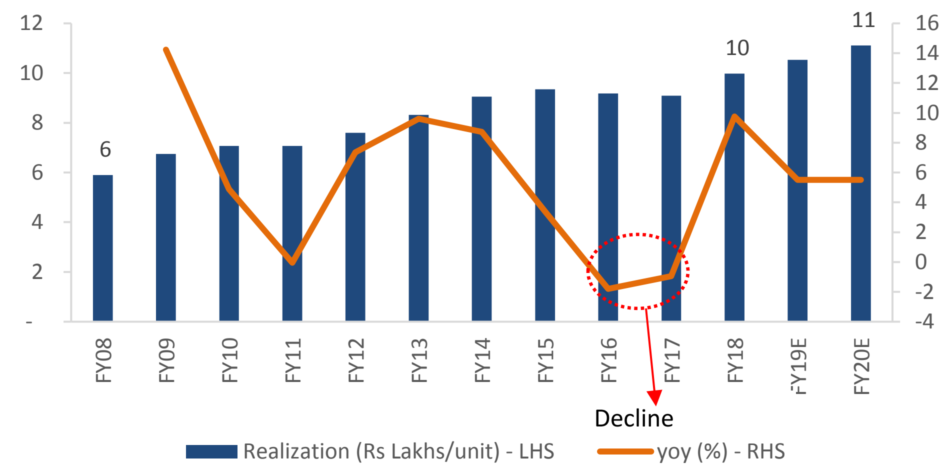
Over past decade, SMLI's gross profit margin (GPM) has seen a steady expansion across different market cycles (Exhibit 6). This has been led by strong realization growth. Over past 10 years, SMLI's realization has declined only twice, in FY16 and FY17 (Exhibit 7). Even in FY18 lean year, its GPM suffered only minor decline, while realization was up 10% yoy. We expect SMLI to report 102bps GPM expansion over FY18-20E, led by 5% CAGR realization growth. Going ahead, realization will be driven by BS-IV vehicles which have better realizations compared to BS-III counterparts. Introduction of BS-VI vehicles beyond FY20 will lend a further boost to realizations; however, we have not penciled those estimates in our current assumptions since BS-VI implementation is two years away and clarity is yet to emerge on SMLI's plans w.r.t. the implementation. Secondly, expectation of a robust market for CVs and buses will lend better pricing power to SMLI, boosting realization.

Exhibit 6: Gross profit margin (%) - defying the law of gravity



Source: Company Data, IIFL Research

Exhibit 7: Realization - unaffected by market cycle



Source: Company Data, IIFL Research

Capex nearly done, balance sheet will continue to shine

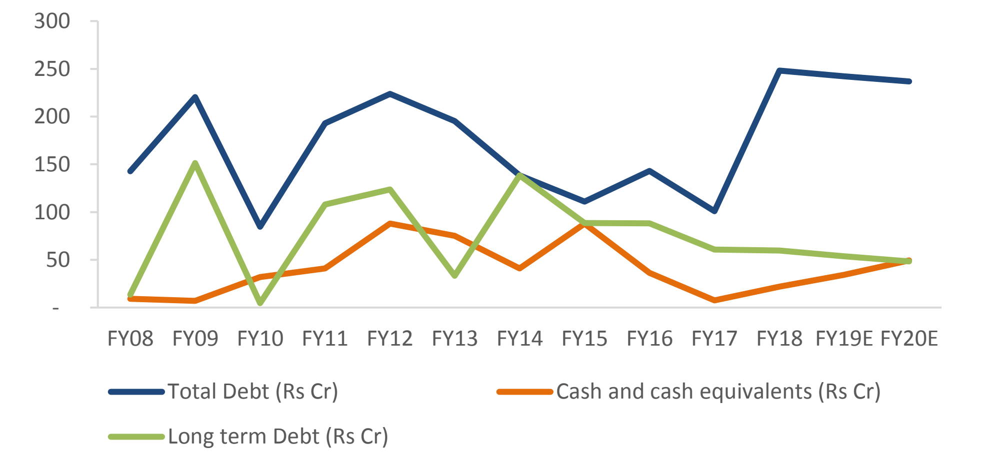
SMLI has almost completed capacity expansion from 18,000 vehicles per annum to 24,000 vehicles per annum, expected to come on stream in FY19E (refer exhibit 8). Therefore, we expect long term debt on books to reduce from ₹60cr in FY18 to ₹48cr in FY20E. We expect total cash on books to go up from ₹22cr in FY18 to ₹49cr in FY20E (refer Exhibit 9). We expect SMLI's return ratios, which suffered a decline in FY18 to stage a recovery in FY19E and FY20E (refer Exhibit 10).

Exhibit 8: Capacity, utilization and market share at a glance

Particulars	SMLI - Total	SMLI - Bus	SMLI - Truck
FY18 Capacity (Units)	18,000	-	-
FY19E Capacity (Units)	24,000	-	-
FY18 Sales Volume (Nos.)	11,369	6,109	5,260
FY19E Sales Volume (Nos.)	13,594	7,139	6,455
yoy (%)	*20*	*17*	*23*
FY18 Capacity Utilization (%)	63	-	-
FY19E Capacity Utilization (%)	57	-	-
FY18 Addressable Market Size (Units)	-	1,00,901	8,52,427
FY19E Addressable Market Size (Units)	-	1,13,009	9,37,670
yoy (%)	-	*12*	*10*
FY18 Market Share (%)	-	6	0.6
FY19E Market Share (%)	-	6	0.7

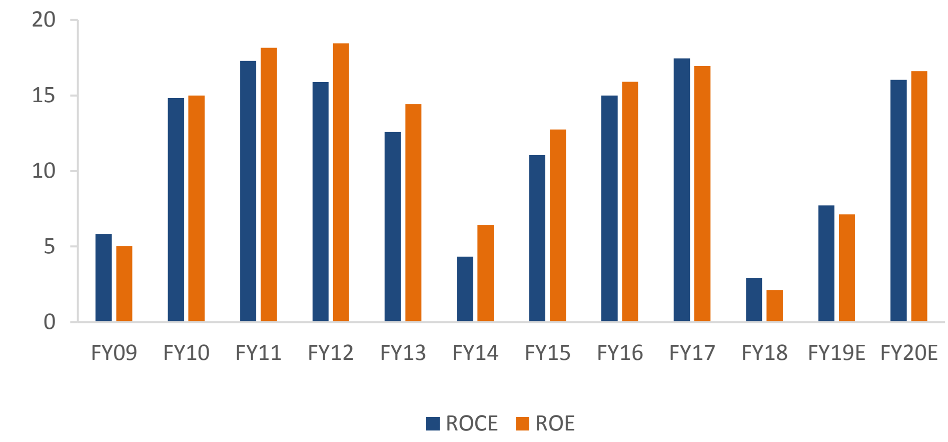
Source: Company Data, IIFL Research

Exhibit 9: Debt to trend lower and cash pile to grow



Source: Company Data, IIFL Research

Exhibit 10: Barring FY18 blip, return ratios continue to grow



Source: Company Data, IIFL Research

Will the recent proposed increase in axle load affect SMLI?

The Government recently issued a notification to increase truck axle load by 10-25% across various truck categories. As per the notification, trucks with tonnage greater than 16.2T will now be permitted to carry extra tonnage. Since SMLI manufacturers trucks in the 5-12T range, it will be unaffected by the notification.

Peer Comparison*

Company	Revenue yoy (%)		EBITDA Margin (%)		ROE (%)	
	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E
Ashok Leyland	*12.2*	*15.7*	*10.6*	*11.0*	*23.6*	*25.2*
Tata Motors	*10.7*	*10.5*	*11.8*	*12.7*	*8.7*	*11.0*
M&M	*-2.7*	*2.6*	*14.8*	*15.8*	*16.1*	*16.0*
Average	***6.7***	***9.6***	***12.4***	***13.2***	***16.1***	***17.4***
SML Isuzu	***26.2***	***27.9***	***5.8***	***7.7***	***7.1***	***16.6***

Company	PE (x)		EV/EBITDA (x)		P/BV (x)	
	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E
Ashok Leyland	20.7	16.8	11.2	9.3	4.6	4.0
Tata Motors	10.8	7.8	3.3	2.8	0.9	0.8
M&M	19.0	16.9	12.2	10.6	3.0	2.7
Average	**16.8**	**13.8**	**8.9**	**7.5**	**2.9**	**2.5**
SML Isuzu	**44.0**	**17.3**	**17.8**	**10.4**	**3.1**	**2.7**

Company	FY18 (₹ Cr)			FY18 Margins (%)		Mcap
	Revenue	EBITDA	PAT	EBITDA	PAT	₹ Cr
Ashok Leyland	29,901	4,248	1,760	*14.2*	*5.9*	37,628
Tata Motors	2,96,645	38,267	11,915	*12.9*	*4.0*	77,684
M&M	48,686	6,224	4,356	*12.8*	*8.9*	1,19,042
Average				***13.3***	***6.3***	
SML Isuzu	**1,135**	**45**	**8**	***4.0***	***0.7***	**1,280**

Company	Dividend Yield (%)	CMP (₹)	FY18 D/E (x)
Ashok Leyland	*1.9*	126	1.64
Tata Motors	*0.0*	269	0.24
M&M	*0.8*	958	1.23
Average			**1.04**
SML Isuzu	***0.2***	**884**	**0.62**

Source: Company Data, IIFL Research

**Street estimates have been used for peers*

SMLI's story is more of a turnaround of operations post the FY18 rout and normalization of performance to pre-FY18 levels.

As seen above, SMLI is better than its peers in aspects like revenue growth and comparable in terms of PE, EV/EBITDA and P/BV (in FY20E, since FY19E will be more of a recovery from FY18 lows, hence multiples could look distorted). SMLI's revenue growth and EBITDA margin are expected to stage a turnaround in FY19E and FY20E after the subdued performance in FY18. The company registered 16% yoy revenue decline in FY18, however, we expect revenue growth of 26% yoy and 28% yoy in FY19E and FY20E respectively. Similarly, EBITDA margin will improve from 4% in FY18 to 6% in FY19E and 8% in FY20E.

Key Risks:

- Presence in limited product segment (5-12T) in CVs as against peers such as Ashok Leyland, Tata Motors, etc., which are present across entire spectrum of CVs.
- Company is subject to cyclicality of the CV segment.
- Operating margin is susceptible to fluctuation in input prices such as steel, copper, etc.
- Pricing pressure from competitors. However, the level of discounting is less for the 5-12T segment, in which SMLI is present.

Hero MotoCorp Limited

CMP: ₹3,310; 1-year target: ₹3,976

Sector	Auto OEM
Recommendation	BUY
Upside	**20%**

Stock Data

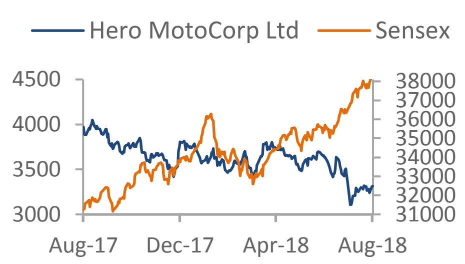
Sensex	38,286
52 Week h/l (₹)	4,200/3,037
Market cap (₹ Cr)	66,093
BSE code	500182
NSE code	HEROMOTOCO
FV (₹)	2
Div yield (%)	2.9

Shareholding Pattern

	Dec-17	Mar-18	Jun-18
Promoters	34.63	34.63	34.63
DII+FII	53.85	53.94	53.99
Individuals	11.52	11.43	11.38

Source: ACE Equity

Share Price Trend



Prices as on 21/08/2018

HMCL, India's largest 2W maker, dominates domestic 2W market in India with 38% market share. While its peers are facing volatile export markets (Bajaj), margin disappointment (TVS) and slowing growth (Eicher), HMCL stands out due to its continued dominance, steady margins and brisk growth despite high base. Though HMCL is present in a competitive space with peers launching new products at various price points, we remain positive due to its product line-up and resonance with Indian customer. We project revenue, EBITDA and PAT CAGR of 16%, 20% and 20% respectively over FY18-20E. We recommend BUY with target of ₹3,976 (15x FY20E EPS).

Strong rural tailwind for top-line: Rural India, which constitutes 55% of HMCL's volumes, is showing signs of consumption uptick led by two successive normal monsoons, farm loan waiver, MSP hike, greater government rural spending and CY2019 elections. Hence, we expect volume/realization growth of 13%/2% CAGR over FY18-20E.

Margin stability led by product premiumization: After cementing its leadership in entry-level motorcycles, HMCL has turned attention to higher capacity vehicles. It plans to launch two 200cc bikes and two 125cc scooters in FY19, thus plugging gaps in its portfolio. We expect these launches (along with intermittent price hikes) to offset impact of higher input costs, resulting in stable gross margin (~32%) and an upward trend in operating margin (16-17.5%) over FY18-20E.

Outlook & Valuation: We are positive on HMCL due to (a) leadership in domestic motorcycles (52% market share), (b) capacity expansion (from 91 lakh vehicles to 1.1cr vehicles in FY20E), (c) robust balance sheet and (d) product premiumization (high capacity models). We value HMCL at 15x FY20E EPS to arrive at target of ₹3,976.

Financial Summary

Standalone ₹Cr.	FY17	FY18	FY19E	FY20E
Revenue	28,500	32,230	37,709	43,254
YoY growth (%)	*0.2*	*13.1*	*17.0*	*14.7*
EBITDA Margin (%)	*16.3*	*16.4*	*17.4*	*17.5*
PAT	3,377	3,697	4,582	5,293
EPS (₹)	169.1	185.1	229.4	265.1
RoE (%)	*35.7*	*33.8*	*35.4*	*33.9*
RoCE (%)	*39.2*	*38.4*	*41.0*	*40.0*
P/E (x)	19.6	17.9	14.4	12.5

Source: Company Data, IIFL Research

Balance sheet summary

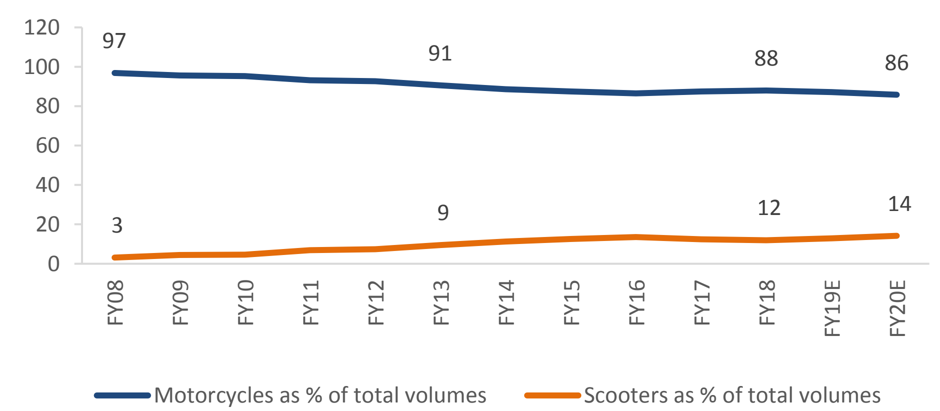
Standalone ₹Cr.	FY17	FY18	FY19E	FY20E
Assets				
Fixed Assets	4,861	4,973	5,664	6,775
Investments	5,890	7,525	9,078	10,643
Other Non-current assets	2,114	2,431	2,844	3,262
Current Assets	2,912	3,257	3,843	4,470
Total Assets	**15,776**	**18,186**	**21,429**	**25,150**
Liabilities				
Shareholders' Funds	10,111	11,769	14,120	17,071
Current Liabilities	4,093	4,343	5,236	6,005
Other Liabilities	1,572	2,074	2,074	2,074
Total Liabilities	**15,776**	**18,186**	**21,429**	**25,150**

Source: Company Data, IIFL Research

88% of HMCL's volumes came from motorcycles and remaining 12% from scooters in FY18.

Company overview: Hero MotoCorp (HMCL) is world's largest manufacturer of 2Ws with installed capacity of 91 lakh units per annum in India and 2 lakh units in Colombia and Bangladesh combined in FY18. HMCL derived 97% of volumes from domestic sales and 3% from exports in FY18. Moreover, 88% volumes were from motorcycles and 12% from scooters. Proportion of scooters to overall mix has been growing from 3% in FY08 to 12% in FY18 (Exhibit 1). While motorcycles will remain mainstay of its product portfolio (86% to total volumes in FY20E), scooters will see faster rise (from 12% of total volumes in FY18 to 14% in FY20E) as scooter segment has been growing at a scorching pace over past decade (refer Exhibit 2). HMCL has lined up two scooter models i.e. Duet 125cc and Maestro Edge 125cc for launch in FY19.

Exhibit 1: Evolution of HMCL's product mix over the years



Source: IIFL Research, SIAM Data sourced from ACE Equity

Exhibit 2: Scooters have outpaced motorcycles (overall sector)

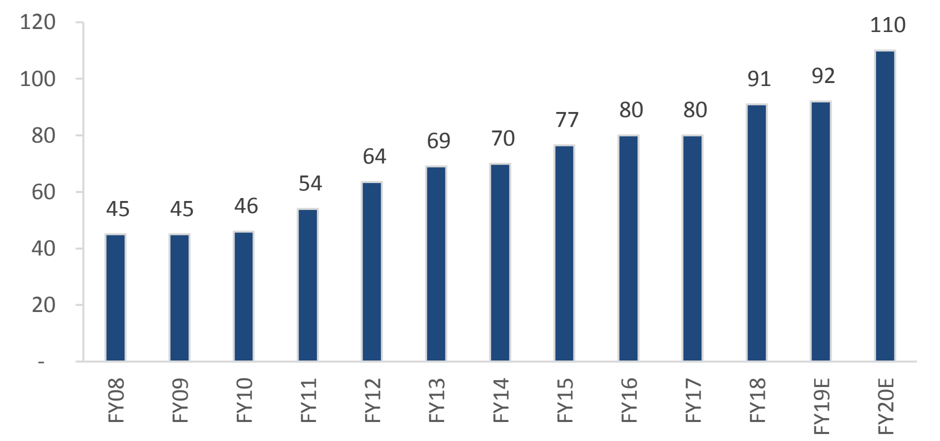
Particulars	FY08-18 Volume CAGR (%)		
	Domestic	Exports	Total
Total Two Wheelers	***11***	***13***	***11***
Scooters	*20*	*29*	*21*
Motorcycles	*8*	*12*	*9*
Mopeds	*8*	*0*	*7*

Source: IIFL Research, SIAM Data sourced from ACE Equity

HMCL biggest beneficiary of favorable macros: HMCL is favorably poised to benefit from ongoing recovery in rural India, led by farm loan waiver, two successive satisfactory monsoons, MSP hike and infrastructure building. HMCL sells ~55% of its 2Ws in rural areas vs. 30% for Honda Motorcycles and Scooters (HMSI). Scooters are increasingly gaining acceptance in semi-urban and rural areas. With improvement in rural roads, growing number of women riders and perception of scooter as a "unisex" mode of travel, scooters are increasingly gaining acceptance in semi-urban and rural areas. HMCL is best positioned to leverage its well-entrenched pan-India rural motorcycle network for its scooters, thereby putting it at an advantage vis-à-vis peers.

Capacity expansion to cater to a growing 2W market: HMCL's total installed capacity has more than doubled, from 45 lakh units per annum in FY08 to 91 lakh in FY18. It recently announced a new green-field plant in Sri Sri City (Andhra Pradesh) with capacity of 18 lakh units per annum to be commissioned by FY20E (refer Exhibit 3).

Exhibit 3: Trend in installed capacity (lakh units per annum)



Source: IIFL Research, Company Data

Exhibit 4: Capacity, utilization and market share at a glance

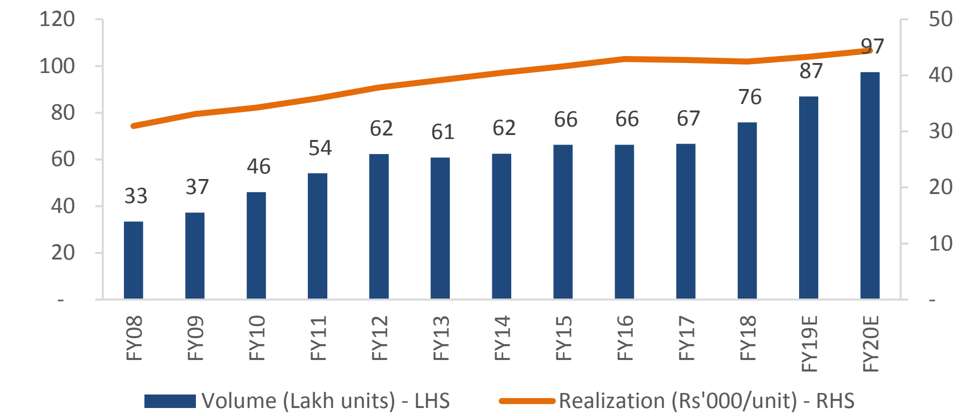
Particulars	HMCL - Total	HMCL - Motorcycles	HMCL - Scooters
FY18 Capacity (Units)	91,00,000		
FY19E Capacity (Units)	92,00,000		
FY18 Sales Volume (Nos.)	75,87,130	64,99,051	8,83,667
FY19E Sales Volume (Nos.)	87,02,745	73,45,953	11,27,780
yoy (%)	*15*	*13*	*28*
FY18 Capacity Utilization (%)	83		
FY19E Capacity Utilization (%)	95		
FY18 Addressable Market Size (Units)		1,26,13,244	67,12,976
FY19E Addressable Market Size (Units)		1,41,26,833	80,55,571
yoy (%)		*12*	*20*
FY18 Market Share (%)		52	13
FY19E Market Share (%)		52	14

Source: IIFL Research, Company Data

Four new launches – two scooters and two motorcycles, will propel volume growth going ahead

Volume led by pricing power, growth by strong balance sheet: HMCL's growth over the years has been led by strong volume and realization growth (Exhibit 5). HCML has not seen dip in revenues over past decade. Going ahead, we expect HMCL to report 16% CAGR revenue growth over FY18-20E, comprising of 13% CAGR volume growth & 2% CAGR realization growth. Domestic two wheeler market, which contributes 97% to total volumes, will grow at 14% in FY19 and 10% in FY20. We expect HMCL to report 80bps market share expansion over FY18-20E. Motorcycle market share gain will be led by new launches in FY19 in higher capacity segment (Xtreme 200R & Xpulse 200). HMCL will also launch two high capacity scooters – Maestro Edge 125cc and Duet 125cc. Exports will pick up pace on the back of efforts to cover more markets and capacity expansion in Colombia (from 80,000 units per annum to 1,20,000 units). Management has recently guided for double digit export growth in FY19E.

Exhibit 5: Volumes and realization continue to move up



Source: Company Data, IIFL Research

Realization to get boosted as HMCL enters high capacity segment: HMCL's product portfolio is set to get a boost as new launches have significantly higher engine capacity products and subsequently better realizations (Exhibit 6 demonstrates that overall realizations are set to get a boost for HMCL post new launches). While average selling price of HMCL's upcoming scooter is marginally higher than its existing scooter prices, average selling price for its upcoming motorcycles is 20-25% higher than existing models.

Exhibit 6: Scooter & Motorcycle price range*

Type of model	Name	Avg Price (₹)	Engine Capacity (cc)	Category
SCOOTERS				
Current Models	Duet	48,075	110	100-110cc
	Maestro Edge	50,600	110	
	Pleasure	47,100	100	
Upcoming Models	Duet 125	48,000	125	125cc
	Maestro Edge 125	52,000	125	
MOTORCYCLES				
Current Models	Passion Pro	53,020	100	Upto 125cc
	Splendor Pro	50,537	100	
	Splendor Plus	49,956	100	
	HF Deluxe	45,505	100	
	HF Dawn	39,470	100	
	Passion X Pro	54,595	110	
	Passion Pro 110	54,370	110	
	Splendor iSmart 110	53,530	110	
	Glamour	63,350	125	125-150cc
	Super Splendor	57,195	125	
Upcoming Models	Xtreme Sports	80,200	150	
	Achiever 150	66,900	150	
Current Model	Karizma ZMR	1,08,000	225	>150cc
Upcoming Models	Xtreme 200R	91,500	220	>150cc
	Xpulse 200	1,10,000	220	
	XF3R	1,85,000	300	

Source: SIAM data,www.bikedekho.com, HMCL website.

**Please note that the model list is not exhaustive. Prices are average prices ex-showroom Delhi. Prices are indicative and may not be accurate **Expected launch date is December 2018.*

**** Expected launch date is 15-Aug-18. #Expected launch date is October-18*

Following aspects of its balance sheet lend comfort to investors:

Particulars	Avg value over past decade	Unit
Total debt	0.13	Times (x)
Fixed asset turnover	3.72	Times (x)
Working capital	*-11%*	as % of sales
ROCE	*46%*	%
Return on Assets	*41%*	%
Return on Equity	*46%*	%
Cash and Equivalent	*60%*	as % of BS size

Source: IIFL Research, Company Data

Peer Comparison*

Company	Revenue yoy (%)		EBITDA Margin (%)		ROE (%)	
	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E
Bajaj Auto	*13.3*	*12.2*	*17.8*	*17.9*	*22.0*	*22.2*
TVS Motor Company	*17.3*	*15.0*	*8.1*	*8.8*	*25.6*	*27.1*
Average	***15.3***	***13.6***	***13.0***	***13.4***	***23.8***	***24.7***
Hero MotoCorp	***17.0***	***14.7***	***17.4***	***17.5***	***35.4***	***33.9***

Company	PE (x)		EV/EBITDA (x)		P/BV (x)	
	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E
Bajaj Auto	18.0	15.9	13.9	12.5	3.7	3.3
TVS Motor Company	31.9	24.4	16.6	13.8	7.4	6.0
Average	**24.9**	**20.2**	**15.3**	**13.1**	**5.5**	**4.7**
Hero MotoCorp	**14.4**	**12.5**	**10.3**	**8.9**	**4.7**	**3.9**

Company	FY18 (₹ Cr)			FY18 Margins (%)		Mcap ₹ Cr
	Revenue	EBITDA	PAT	EBITDA	PAT	
Bajaj Auto	25,165	4,783	4,068	*19.0*	*16.2*	78,926
TVS Motor Company	15,473	1,129	663	*7.3*	*4.3*	25,702
Average				***13.2***	***10.2***	
Hero MotoCorp	**32,230**	**5,280**	**3,697**	***16.4***	***11.5***	**66,093**

Company	Dividend Yield (%)	CMP (₹)	FY18 D/E (x)
Bajaj Auto	*2.2*	2,728	0.01
TVS Motor Company	*0.6*	541	0.36
Average	***1.4***		**0.19**
Hero MotoCorp	***2.9***	**3,310**	**0.13**

Source: Company Data, IIFL Research

**Street estimates have been used for peers*

Key Risks

- Inability to pass on rise in input costs to customers.
- Rise in competitive intensity due to aggressive product launch by competitors, price war, etc.
- Failure of new product launches.
- Aggressive eating away of motorcycle market share by HMSI.

IIFL Premia Research

VST Tillers Tractors Limited

CMP: ₹2,200; 1-year target: ₹2,616

Sector	Auto OEM
Recommendation	BUY
Upside	19%

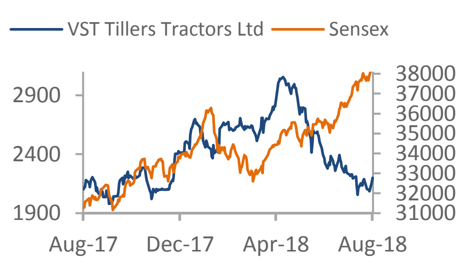
Stock Data	
Sensex	38,286
52 Week h/l (₹)	3,085/1,935
Market cap (₹ Cr)	1,901
BSE code	531266
NSE code	VSTTILLERS
FV (₹)	10
Div yield (%)	2.3

Shareholding Pattern

	Dec-17	Mar-18	Jun-18
Promoters	53.99	53.99	53.99
DII+FII	18.55	19.47	20.23
Individuals	27.46	26.54	25.78

Source: ACE Equity

Share Price Trend



Prices as on 21/08/2018

VST Tillers Tractors (VSTTL) is a play on farm income growth and tractor penetration. Purchase of tillers, which happens through subsidies, will grow at 10% in FY19E for the sector and 12% for VSTTL. Tractor sector is poised for 12% volume growth in FY19E, with VSTTL's tractor volume growing at 15% in FY19E. Consequently, we expect revenue, EBITDA and PAT CAGR of 16%, 20% and 12% respectively over FY18-20E (low PAT CAGR growth due to low tax rate in FY18). At CMP, VSTTL trades at 13x FY20E EPS. We recommend BUY with target of ₹2,616 (16x FY20E EPS).

Upswing in tractors, new launches to boost top-line: Tractor growth for VSTTL will be led by strong rural demand and company's entry into higher capacity tractors. VSTTL plans to launch two new tractors in FY19E, of which one will be in the 47HP range. We expect tractor volume and realization for VSTTL to grow at 12% and 4% CAGR respectively over FY18-20E.

Tiller segment to benefit from DBT: Indian Government's DBT scheme, through which tiller sales are funded, has grown at a staggering 126% CAGR over FY14-18 (DBT was introduced in FY14). About 95% of tiller sales take place via subsidy route, 55% of which is through DBT. Led by strong DBT disbursement and two successive normal monsoons, tiller volume/realization for VSTTL are expected to grow at 12%/2% CAGR respectively over FY18-20E.

Outlook & Valuation: We are positive on VSTTL due to (a) tractor segment up-cycle and company's shift towards higher capacity tractors, (b) strong DBT led tiller demand and (c) robust balance sheet. We value VSTTL at 16x FY20E EPS to arrive at target of ₹2,616.

Financial Summary

Standalone ₹Cr.	FY17	FY18	FY19E	FY20E
Revenue	675	763	903	1,031
YoY growth (%)	*4.4*	*13.1*	*18.3*	*14.2*
EBITDA Margin (%)	*15.0*	*15.7*	*16.3*	*16.7*
PAT	83	112	126	141
EPS (₹)	95.7	129.6	145.5	163.5
RoE (%)	*18.0*	*20.4*	*19.3*	*18.4*
RoCE (%)	*17.9*	*18.5*	*19.0*	*19.0*
P/E (x)	23.0	17.0	15.1	13.5

Source: Company Data, IIFL Research

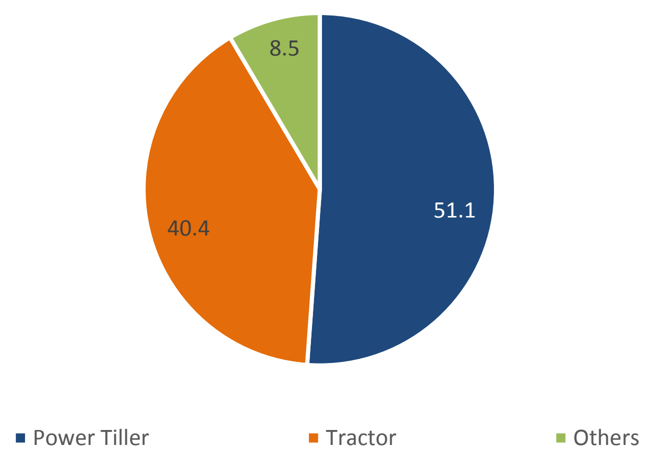
Balance sheet summary

Standalone ₹Cr.	FY17	FY18	FY19E	FY20E
Assets				
Fixed Assets	137	192	246	297
Investments	208	227	238	250
Other Non-current assets	6	8	10	11
Current Assets	280	358	406	459
Total Assets	**631**	**786**	**900**	**1,017**
Liabilities				
Shareholders' Funds	500	596	705	829
Current Liabilities	83	144	151	144
Other Liabilities	48	45	45	45
Total Liabilities	**631**	**786**	**900**	**1,017**

Source: Company Data, IIFL Research

Company overview: VST Tillers Tractors (VSTTL) is a Bengaluru-based company manufacturing tractors, power tillers and other agricultural equipment (rice transplantor, power reaper, engines, etc). Company derives 51% of its revenues from power tillers, 40% from tractors and remaining 9% from other agricultural equipment (refer Exhibit 1).

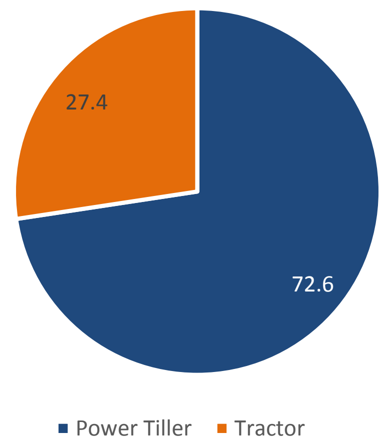
Exhibit 1: FY18 Revenue composition (%)



Source: Company FY18 Annual Report.

In terms of volume, power tillers contribute 73% to total volume, while tractors contribute the remaining 27% (refer Exhibit 2). The disparity in volume and revenue contribution of tiller and tractor is due to the yawning gap in their respective realizations. Power tillers (~₹1.3 lakh) have less than half the realization commanded by tractors (~₹2.7 lakh).

Exhibit 2: FY18 Volume mix (%)



Source: Company Data, IIFL research

There is a huge difference in realization of power tiller (₹1.3 lakh / unit) vs tractor (₹2.7 lakh / unit). That is why power tillers are called "mini-tractors" that are preferred by small and marginal farmers

VSTTL has four manufacturing plants; one for tractors (Hosur, capacity 35,000 units), two for power tillers (Bengaluru and Malur, combined capacity 60,000 units) and a plant in Mysuru for auto components. VSTTL also exports products to Africa, Russia, Myanmar, UK and Europe. However, export sales are very small as proportion of total revenues (majority of revenue is derived from India).

Ownership details: VSTTL is owned by VST Group (family members and companies of Sri. V. S. Thiruvengadaswamy Mudaliar) with promoters owning 53.99% stake, as on June 30, 2018. It has a technical collaboration with Mitsubishi Heavy Industries, Mitsubishi Corporation and Mitsubishi Agricultural Machinery Company Ltd, Japan. It has institutional shareholding of 20.23% (refer Exhibit 3).

VSTTL has entered into a technical agreement with South Korean company Kukje for developing higher HP tractors

Exhibit 3: Marquee shareholding

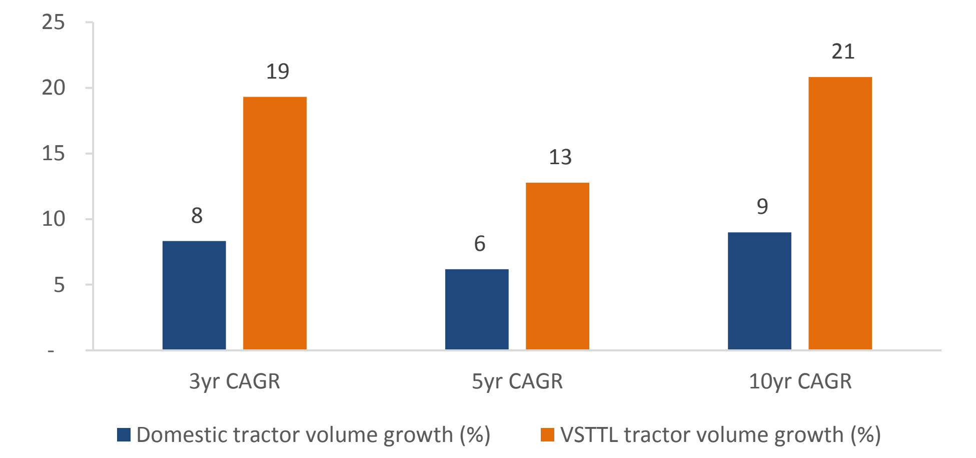
Shareholder	Holding (%)
HDFC Small Cap Fund	3.13
Kotak Equity Hybrid	2.47
L&T Emerging Businesses Fund	2.96
India Whizdom Fund	2.36
Pinebridge Investments of Mauritius Limited	3.47
Sundaram Rural and Consumption Fund	1.11

Source: BSE Website. Holding is as on June 30, 2018

HDFC MF has stayed invested since CY2013 and Pinebridge Investments since CY2014.

New launches and entry into higher capacity tractor: VSTTL is present in lower capacity tractor segment (18.5-22HP). Despite remaining restricted to smaller tractors, VSTTL has historically outperformed sector volume growth comfortably (Exhibit 4). In May 2018, VSTTL launched two sub-30 HP tractors, i.e., VST Shakti Viraat Plus (27HP) and Samraat (17HP) continuing focus on core segment.

Exhibit 4: VSTTL's outperformance over domestic tractors



Source: Company Data, IIFL Research

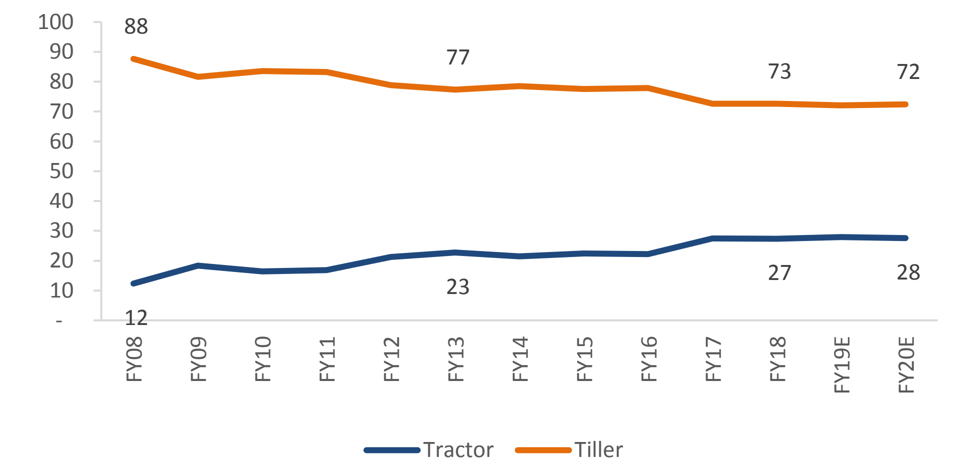
Tractor market size is nearly 8 lakh while the same for power tillers is only 50,000 units per annum. Hence, it makes sense for VST to increase focus on tractors

Small tractors are used only for agricultural purposes, unlike large tractors that are used for construction, mining and other applications. In order to plug this product gap and increase product acceptability, VSTTL has turned its attention towards higher-HP segment. It recently entered into a technology transfer agreement with M/s. Kukje Machinery Co., Ltd, Korea (Kukje) for manufacture of higher HP tractor, which will be co-branded as VST Shakti Branson. Management has guided for 14,000 tractors in FY19E. We feel that this will be achieved in FY20E. Led by new launches, strong tractor sector demand and entry into higher HP tractor in FY19E, tractor volume/sales will register 12%/17% CAGR growth over FY18-20E.

Company's evolving product mix ensures a larger addressable market size: VSTTL's largest business is tillers. However, its product mix has been evolving continuously over the past decade. Tractors contributed 27% to total volumes in FY18 against 12% in FY08. Tractor revenue contribution has gone up from 18% in FY08 to 40% in FY18. We feel that this is a prudent strategy on two counts.

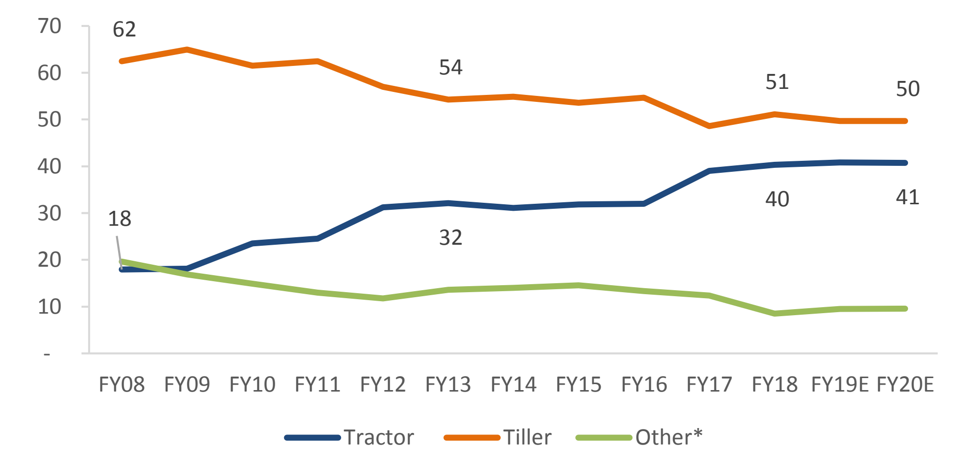
Firstly, addressable market size for power tillers is limited (~50,000 units in FY18), while that for tractors is huge (~8,00,000 in FY18). Secondly, there is scope for moving from lower to higher HP tractors with better margins. Scope for value addition in power tillers is limited, since market is highly price sensitive. Consequently, we expect volume contribution from tractor segment to stay in the 27-28% range over FY18-20E (Exhibit 5). Revenue contribution too will be higher than previous years at 40% (Exhibit 6).

Exhibit 5: VSTTL's volume mix trajectory (as % of total volumes)



Source: IIFL Research, Company Data

Exhibit 6: VSTTL's revenue mix trajectory (as % of total revenues)



*Source: IIFL Research, Company Data. *Others includes segments such as sale of spares, rice transplantors, reapers, other equipment and other operating income.*

Exhibit 7 takes a brief look at VSTTL's existing capacity, capacity utilization and the addressable market size of both of its products.

Exhibit 7: Capacity, utilization and market share at a glance

Particulars	VSTTL - Tillers	VSTTL - Tractors
FY18 Capacity (Units)	60,000	35,000
FY19E Capacity (Units)	60,000	35,000
FY18 Sales Volume (Nos.)	30,135	11,369
FY19E Sales Volume (Nos.)	33,751	13,074
yoy (%)	*12*	*15*
FY18 Capacity Utilization (%)	50	32
FY19E Capacity Utilization (%)	56	37
FY18 Addressable Market Size (Units)	48,605	7,11,000
FY19E Addressable Market Size (Units)	53,465	7,94,323
yoy (%)	*10*	*12*
FY18 Market Share (%)	62	1.6
FY19E Market Share (%)	63	1.6

Source: IIFL Research, Company Data

Peer Comparison*

Company	Revenue yoy (%)		EBITDA Margin (%)		ROE (%)	
	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E
Escorts	*16.7*	*10.6*	*11.7*	*12.1*	*18.7*	*18.5*
VST Tillers Tractors	***18.3***	***14.2***	***16.3***	***16.7***	***19.3***	***18.4***

Company	PE (x)		EV/EBITDA (x)		P/BV (x)	
	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E
Escorts	18.9	16.2	14.8	12.9	3.3	2.8
VST Tillers Tractors	**15.1**	**13.5**	**13.1**	**11.2**	**2.7**	**2.3**

Company	FY18 (₹Cr)			FY18 Margins (%)		Mcap ₹ Cr
	Revenue	EBITDA	PAT	EBITDA	PAT	
Escorts	5,059	554	347	*10.9*	*6.9*	11,014
VST Tillers Tractors	**763**	**120**	**112**	***15.7***	***14.7***	**1,901**

Company	Dividend Yield (%)	CMP (₹)	FY18 D/E (x)
Escorts	*0.2*	899	0.01
VST Tillers Tractors	***2.3***	**2,200**	**0.07**

Source: Company Data, IIFL Research

**Street estimates have been used for peers*

As seen in the tables above, VSTTL is expected to grow at a faster rate compared to peer Escorts, which we have considered since it also manufactures tractors and other agricultural equipment. VSTTL has superior margins, yet cheaper valuations compared to Escorts.

Key Risks

- Inability to scale up operations in the higher HP tractor segment.
- Presence of well-entrenched players in tractor segment such as M&M, TAFE, Sonalika, Escorts, etc.
- Delay in subsidy disbursement or change in pattern of the same due to impending elections.
- Monsoon failure (unlikely this year) or any other disruptive event that leads to dip in rural income.

Recommendation Parameters for Fundamental/Technical Reports:

Buy – Absolute return of over +10%
Accumulate – Absolute return between 0% to +10%
Reduce – Absolute return between 0% to -10%
Sell – Absolute return below -10%

Please refer to http://www.indiainfoline.com/research/disclaimer for recommendation parameter, analyst disclaimer and other disclosures.

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