Honda Atlas Cars (Pakistan) Ltd (HCAR) **Feb 08, 2016**

BUY

Price Target : PKR 342.7/share

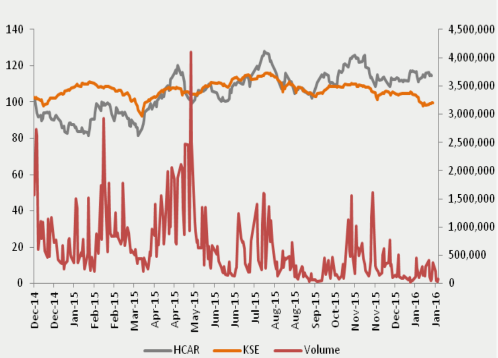
Closing Price : PKR 273.71/share

Company Data

52-week Price Range (PKR)	280.75-174.7
No. of Shares Outstanding (mn)	142.80
Market Cap (PKRmn)	39085.79
Market Cap (USDmn)	375.75
Free Float (mn shares)	28.56
Year End	Mar
KATS Code	HCAR

Source: PSX

Chart: Stock Performance



Source: PSX

- **We initiate our coverage on HCAR with 'BUY' rating:** Our Dec-16 DCF based price target of PKR 342.7/sh implies an upside potential of 25% from current price levels of PKR 273.71/sh. Our optimism on the company stems from the following factors:
- **New Model to boost volumetric growth:** 10^{th} Generation Civic to get the consumer interest back and boost the volumetric growth.
- **Margins likely to sustain:** HCAR attained highest ever margins last year amid favorable exchange rate fluctuations, declining commodity prices and shrinking expenses. We expect margins to sustain for the forecasted period.
- **Increasing utilization levels:** Higher production levels to benefit the company in terms of lower per unit fixed cost and bulk buying discounts.
- **Better working capital management:** Improved cash position has helped reduce the number of days in payables.
- **Key risks to our investment case are 1)** Performance of New Civic 2016 2) JPY recovery 3) Recovering global commodity prices 4) Change in interest rates 5) Delay in Auto policy (AIDP-II)

HCAR Financial Highlights

	Mar'13	Mar'14	Mar'15	Ma'16E	Mar'17E	Mar'18E
EPS (Before Tax)	3.67	14.69	26.38	30.44	36.57	45.4
EPS (After Tax)	1.71	7.52	22.15	21.31	25.6	31.78
DPS (PKR)	0.3	3	5	5	7	7
BVPS (PKR)	9.56	16.75	35.85	52.16	72.76	97.54
PE (x)	10.1	5.83	6.52	12.85	10.69	8.61
P/BV (x)	1.81	2.62	4.03	5.25	3.76	2.81
Div Payout (%)	17.54	39.9	22.58	23.44	27.34	22.03
EBITDA Margin (%)	4.34	7.21	11.88	12.62	11.63	11.8
ROE (%)	19.6	57.17	84.21	48.42	40.99	37.32
ROA (%)	1.61	8.72	22.71	23.77	23.97	26.01
Gross Margin (%)	4.78	7.3	12.64	14.46	12.48	12.67
Net Profit Margin (%)	0.81	2.74	8.37	7.71	7.2	7.49

Source: Company Accounts, NAEL Research

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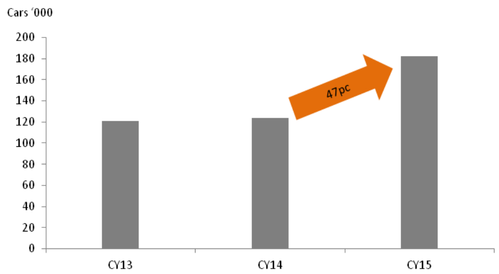
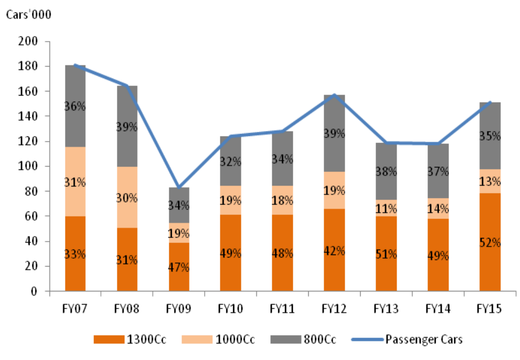
Fig: 1 **Passenger Cars Growth**



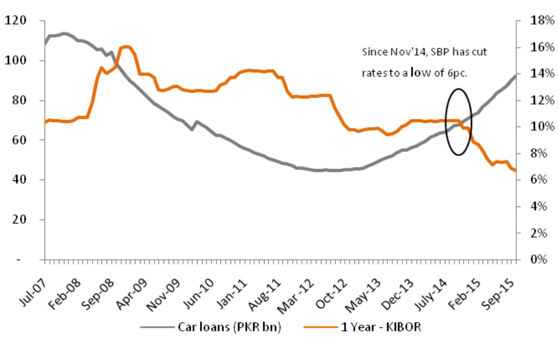
Source: PAMA, Nael Research

Fig: 2 **Segment Wise Market Share**



Source: PAMA, Nael Research

Fig: 3 **Rising Auto Financing amid lower interest rate**

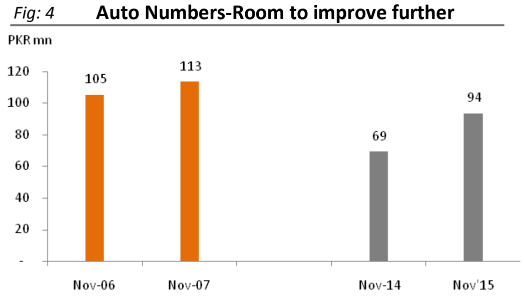


Source: SBP, Nael Research

Auto Financing as a portion of Consumer Financing			
Dec'14	Mar'15	Jun'15	Sep'15
27.1%	28.6%	29.6%	32.5%

Source: SBP, Nael Research

Fig: 4 **Auto Numbers-Room to improve further**



Source: SBP, Nael Research

Industry Outlook

Booming Auto Industry

Auto assemblers experienced a massive volumetric growth in the passenger cars segment (INDU, HCAR and PSMC).

Some of the contributing factors to boost such prominent growth are:

- Apna Rozgar Scheme (PSMC's Suzuki Bolan and Ravi)
- Cut in interest rates by the central bank making auto financing an attractive option
- The increasing interest of public in the new models, esp. the premium cars segment (1300 and above cc)
- Improving macroeconomic fundamentals and stabilizing security situation of the country

Since 2008, the market share of '1300 and above cc' segment has gone significantly up from around one third (31%) to more than half (52%) of the market. Some of the reasons of such prominent change in the market shares of these segments are:

- High frequency of facelifts and new models in '1300 and above cc' cars
- Well acceptability of the innovative models
- Rising rural income on the back of agricultural growth

Auto financing backing the sector growth

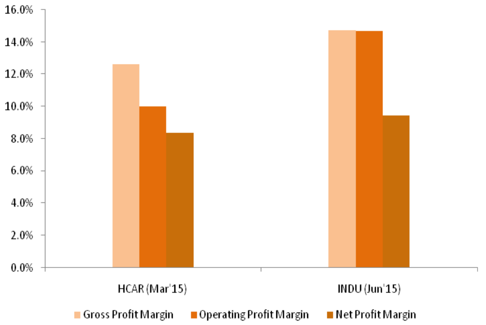
Car financing enjoyed a boom period during 2004-07, owing to liberal banking policies. Banks were sanctioning auto loans with 14-18% KIBOR+ interest rate depending on loan maturity. After 2008, it saw a downturn and bank policies on auto loans became more stringent in terms of equity portion and documentation in an effort to reduce the credit risk as the infection ratio (NPLs Vs Advances) surged.

Since Nov'14, SBP has gradually reduced the interest rates to a low of 6% (amid declining inflation) which has led to a decent growth in auto loans. As per SBP data, car loans for Nov'15 were PKR 93.5bn (highest in nearly 7 yrs). We expect there is further room in auto loans growth to touch the levels it previously did in the boom period, despite higher interest rates (refer Fig 3 & 4). On the other side, the financial institutions (supply side) are also having more interest in this part of consumer financing by getting more product innovation (e.g. financing imported used cars, etc).

New Models

Advancing technology, competition pressure (from imported used cars) and the ever changing consumer behavior has urged the major players (INDU and HCAR) in the premium cars segment to come up with new models to retain the existing and attract new customers. The heavy influx of imported used cars is giving a tough competition to local auto assemblers, despite a heavy duty structure.

Fig: 5 **Margins Comparison with INDU**



Source: Company Accounts, Nael Research

Valuation

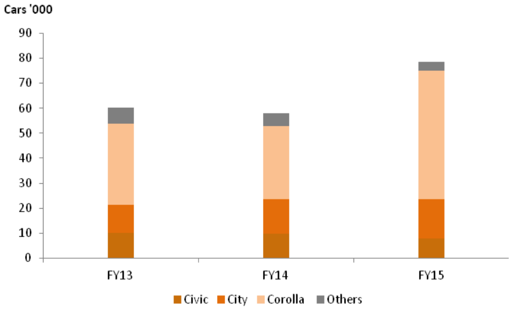
We initiate our coverage on HCAR with '**Buy'** recommendation using discounted free cash flow method. We have used Free Cash Flow to Firm methodology to derive the intrinsic value of HCAR at PKR 342.7/sh. The following assumptions have been incorporated to arrive at our target price

- Terminal growth rate of 4%
- Risk free rate of 8.85% (10yr PIB)
- Market Risk Premium of 6% & Adjusted Beta of 1.08 (using 7yrs data)

Based on the above assumptions, HCAR's Dec-16 TP arrives at PKR 342.7/share, offering an upside potential of 25% from its closing price of Feb 08, 2016, with a dividend yield of 1.8%.

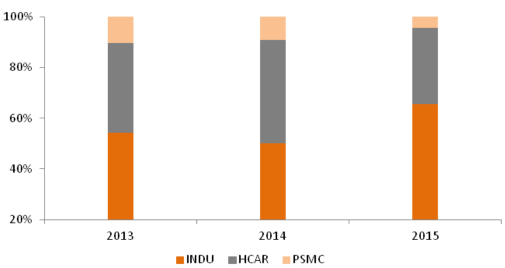
	Dec'16E	Mar'16E	Mar'17E	Mar'18E
PV of FCFF		4973	4347	3,893
WACC		15.3%	15.3%	15.3%
PV of FCFF	13,213			
Terminal Value	42,684			
PV of Terminal Value	35,731			
Ent Value	48,944			
PV of Debt	-			
Equity Value	48,944			
Target Price 12/31/2016	342.7			
Current Price	273.71			
Upside	25%			

Fig: 6 **Product Wise Market Share**



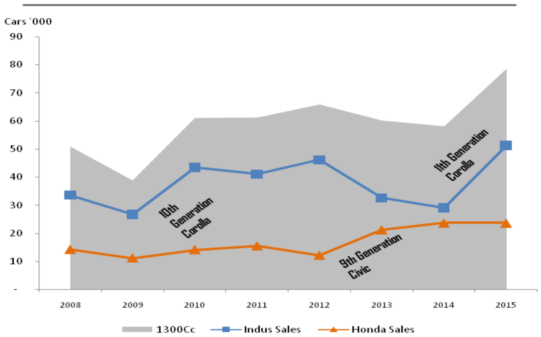
Source: PAMA, Nael Research

Fig: 7 **Market Share in '1300 and above cc' Cars**



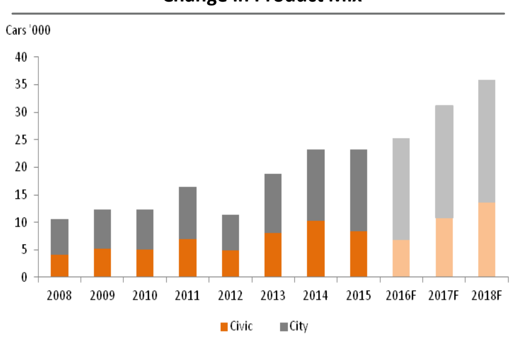
Source: PAMA, Nael Research

Fig: 8 **New Model launches**



Source: PAMA, Nael Research

Fig: 9 **Change in Product Mix**



Source: PAMA, Nael Research

Investment Argument

Our investment view on HCAR is based on following fundamentals:

1. Volumetric growth to elevate

- **Volumes to remain under pressure until the launch of 10th Generation Civic**

Civic sales have relatively underperformed the auto industry in CY15 due to stiff competition from corolla's new model (July 2014).

Honda Civic lost considerable market to Corolla with the sales volume slipping by 18% in the year ended 2015. We expect that it will continue losing its market until it brings out the very talked about new Civic model as this news has made the customers hold their buying.

The sustainability of sales is quite dependent upon the launch of new models by the competitor in the premium cars segment. In late 2008, when INDU launched its 10th Generation Corolla, HCAR's sales went significantly down. Similarly, when HCAR brought its 9th generation civic in Sept'12, INDU's demand suffered (Fig 8).

For 1HCY16E, we expect the Civic sales to remain under pressure due to the news about upcoming new model and continued tough competition from Corolla's new model.

10th Generation Honda Civic has already been introduced to the world in 3QCY15 and we are expecting HCAR to release the same by Sept'16.

We anticipate a 60% (YoY) growth in the Civic sales volume for year ending 2017 and 25% (YoY) for the year ahead. Our sales growth calculations are based on the following factors:

1. The sales growth in 2013 and 2014 after HCAR launched its 9th generation civic in 2012
2. Well acceptability of the new Civic by the US market

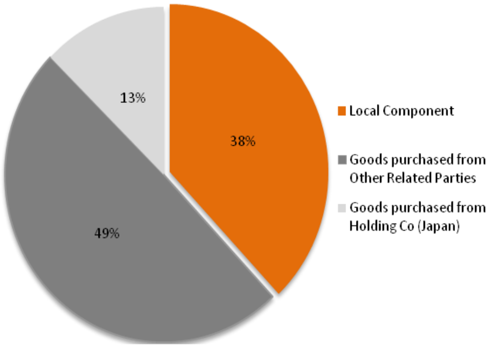
Our sales growth assumption is a bit conservative considering the industry growth level, up by 50% from CY13 to CY15.

- **City to grow nominally after the launch of Civic 2016**

HCAR skipped the 6th Generation of City and continued with the facelift of 5th Generation in Oct'14 which has depicted tremendous sales. City's wider product range (variants) gives an added advantage to the overall sales performance of HCAR.

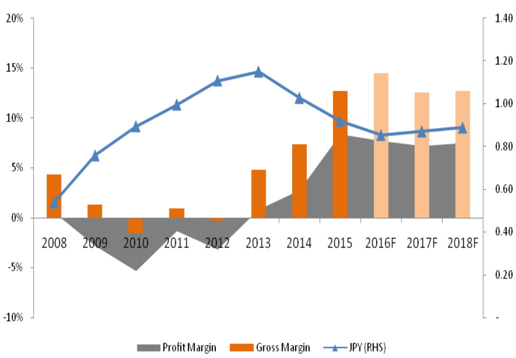
We expect that City would continue to show its charm till the new civic comes out. As City and Civic both serve the similar consumer bracket and often compete against each other, we expect a nominal growth of 10% (YoY) for 2016-17 since we're bullish on the success of new civic model.

Fig: 10 **Purchases Breakup**



Source: Company Accounts (Mar'2015), Nael Research

Fig: 11 **Margins amid weakening Yen**



Source: Company Accounts, Nael Research

- **All new HR-V**

HCAR launched a mini-SUV HR-V (1497cc) of Thailand origin in Jan'16 at a cost of ~PKR3.5mn, under its CBU (trading) section of the sales. The total 'trading sales' as a percentage of total 'gross manufacturing sales' stood at 3.8% during the year ended 2015. We anticipate the newly launched HRV will further add to the total sales for the forecasted period.

- **Other Factors**

Volumes will get a further boost from growing auto financing (in the presence of lower interest rates and banks' increasing willingness to provide auto loans) and the improving security situation of urban areas since HCAR's market is more triggered towards individuals and corporates residing in urban areas.

2. Margins likely to sustain

HCAR's gross margin increased by 530bps YoY during the period ended Mar'15 to 12.6% (highest ever earned by HCAR), compared to 7.3% in the period ended Mar'14. While Net margin surged by 560bps YoY to 8.37%, compared to 2.74% last year on the back of favorable exchange rate parity, low commodity prices, increased level of localization of auto parts and cost cutting measures.

Management claims to have achieved increased level of localization of auto parts which has helped the company ward off exchange rate fluctuations, supply disruptions and cut in freight charges.

Looking ahead, we expect margins to have an upbeat during the year ending 2016 on the back of:

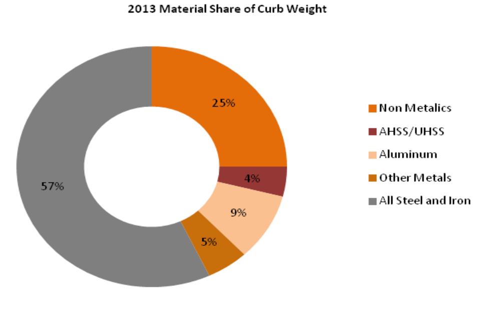
1. Weak JPY (↓~7.3%)
2. Higher sales volumes (↑ ~8.5%)
3. Low commodity prices

- **Favorable Exchange rate parity**

HCAR observed significant cost reduction due to favorable exchange rate movements during the year ended 2015 when PKR appreciated against JPY and USD by ~10% and ~2%, respectively (on average basis). Since then JPY has further depreciated which we have taken into our assumptions for the year ending 2016, though we have assumed that HCAR's cost has a major exposure to THB and USD movement.

For year ending 2017 and 2018, we expect a slight decrease in margins with the expectation of appreciating USD (considering the past years' data on average basis and in the absence of any major event) and JPY, up by 4% and 2% YoY, respectively (to affect the foreign component of raw material) and inflation (to affect the local component of raw material).

Fig: 12 **Material Content as Share of Curb Weight**

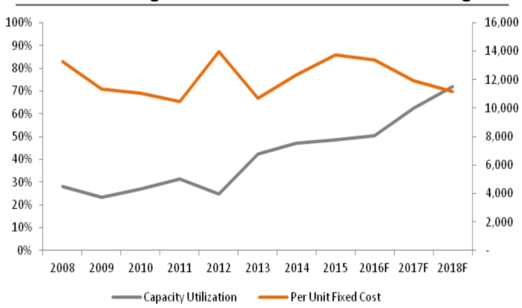


Source: American Chemistry Council & Ducker Analysis, Nael Research

Fig: 13 **Steel prices (USD/MT)**

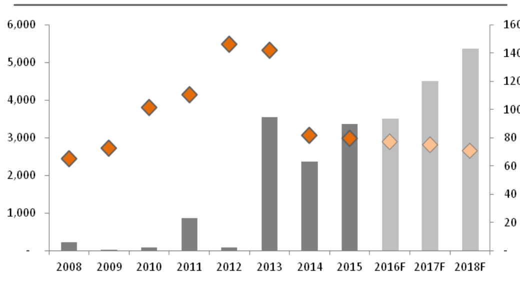
Source: Trading economics, Nael Research

Fig: 14 **Narrowing Per Unit Fixed Cost with Increasing CU**



Source: Company Accounts, Nael Research

Fig: 15 **Reducing Payable Days with Improving Cash Balances**



Source: Company Accounts, Nael Research

These expectations about the exchange rate parity would have an adverse impact on the cost and hence on the margins for year ending 2017 and 2018, but the depressed commodity prices outlook and contracting per unit fixed cost (due to higher volumes) would help the company lessen the upward impact on cost and maintain the margins at a reasonable level.

- **Declining Global Commodity prices**

Steel has a major portion in the assembling of cars. However, vehicle composition is changing as a result of new safety and fuel economy standards. Cars are becoming lighter and increasingly made with aluminum as a substitute for steel. Other commodities relevant to the auto industry are aluminum, iron, plastics, glass and rubber.

Weak demand (due to slowing Chinese economy), oversupply, falling raw material and energy prices along with competition from cheaper imports are all forcing low steel prices.

Lower steel and other used metal prices have helped the company achieve healthy profits during the recent 9Ms period.

3. Increasing utilization levels

HCAR's capacity utilization remained below 50% due to competition from Corolla during the year ended 2015. Going forward, the growing demand from industry and upcoming new model will increase HCAR's capacity utilization to ~70% by the year ending 2018.

The higher production levels will benefit the company in terms of:

- Lower per unit fixed cost
- Availing bulk purchasing discounts (better negotiation with its suppliers)

4. Working Capital Management

Automobile industry works on 'No-Receivables' model except for some trade debts to government agencies but it has a major portion of payables to local and foreign suppliers (mostly related parties).

HCAR with strengthening profits and cash position over the recent past has improved its cash operating cycle and working capital. It has lowered the number of days it takes to pay its suppliers to 79days during the year ended 2015 from 142days in 2013. We have assumed a marginal downtrend of the payable days to continue in future as well.

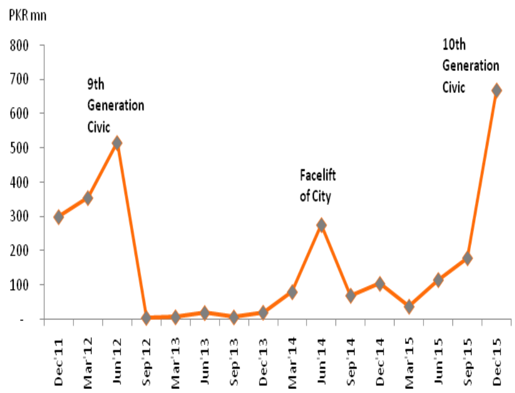
Shrinking Finance Cost

With no long-term debts on the balance sheet, HCAR bears financial charges on the 'Customer advances' and 'Short term borrowings' along with 'Bank charges'. During the last two years, charges on customer advances have gone considerably down since the company is now able to deliver the cars in 60 days of advance payment, as per the management. Thus, HCAR's finance cost has reduced significantly during the year ending 2015 and going further down in the recent 9Ms period.

	Mar'15	Mar'16E	Mar'17E	Mar'18E
EPS (BT)	26.38	30.44	36.57	45.4
EPS (AT)	22.15	21.31	25.6	31.78
Eff. Tax rate	16.5%	30%	30%	30%

Source: Company Accounts. Nael Research

Fig: 15 **Capital Work In Progress**



Source: Company Accounts, Nael Research

Fig: 16 **TP Sensitivity**

		Risk Free Rate				
		7.85%	8.35%	8.85%	9.35%	9.85%
Growth Rate	3.00%	343	331	320	310	201
	3.50%	356	343	331	320	310
	4.00%	370	356	**343**	331	320
	4.50%	386	370	356	343	331
	5.00%	403	385	370	355	342

Source: Nael Research

Taxation

HCAR charged an average effective tax rate of 16.05% to the P&L for year ended 2015 due to the tax credit (16.5%) gained by the company. This lower effective tax rate improved the after tax earnings of HCAR (refer to table). Despite arriving at a higher than previous year's before tax EPS, our after tax EPS (for the year ended 2016) is lower due to higher taxation estimate.

Rising CAPEX

When bringing a new model automobile assemblers make a hefty investment which spreads over a time period of 2-3 years. As per the company's management, HCAR will finance this investment from its healthy cash and reserves balance. The Fig 15 depicts that CWIP account is filling up which will capitalize on the launch of New Civic 2016.

Investment Risks

Performance of New Civic 2016

Any lower (higher) sales growth number than our forecast will negatively (positively) impact our valuation estimate of the company.

JPY Recovery

Higher than forecasted appreciation of Yen will negatively impact the profitability and valuation of the company. Although, BOJ took the interest rates in negative zone which was partly aimed at preventing the Yen from rising. In our expectation, appreciation seems highly unlikely in the current scenario.

Surge in commodity prices

Recovery in steel and other related metal prices can negatively impact the profitability of the company. Although looking ahead, global demand seems sluggish since China, the largest steel manufacturing country, is expected to cut capacity further based on environmental and scale factors.

Change in interest rates

Recovery in oil prices would push up the inflation which might result in SBP increasing the interest rate that will have a negative impact on auto financing. All auto assemblers including HCAR would suffer from a downturn in the ongoing organic growth of sales from auto financing. However, it also poses itself as an upside risk if SBP ends up reducing the discount rate further, amid lower oil prices and lower than expected YoY CPI number.

Delay in Auto policy (AIDP-II)

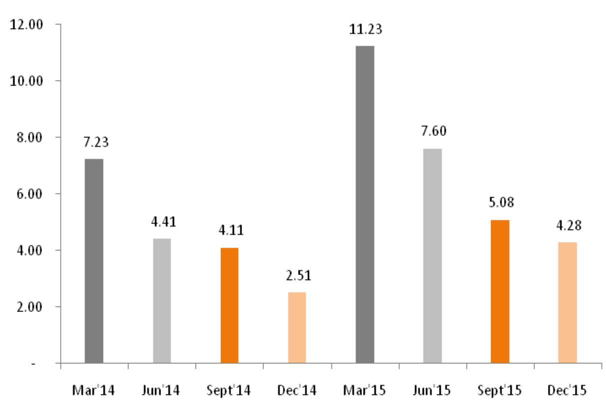
Lack of substantial progress on the approval of AIDP-II remains a threat for the subject company as well as the other existing players and potential new entrants. The prevailing rumors about lowering the barriers to entry for new investors and continuing with the existing policies on import of used cars will negatively impact the existing auto assemblers.

Financials

Income Statement (PKR'000)	Mar'12	Mar'13	Mar'14	Mar'15	Mar'16E	Mar'17E	Mar'18E
Net Sales	16,599,608	30,274,604	39,153,254	37,764,159	39,471,907	50,802,951	60,563,839
Cost of sales	16,643,607	28,827,522	36,296,009	32,991,341	34,317,186	44,463,821	52,889,755
Gross Profit	(43,999)	1,447,082	2,857,245	4,772,818	5,154,720	6,339,130	7,674,083
Distribution Expenses	130,550	218,707	340,556	434,257	352,112	564,042	535,009
Admin Expenses	158,943	201,938	287,028	319,940	339,021	372,889	401,053
Operating Profit	(333,492)	1,026,437	2,229,661	4,018,621	4,463,587	5,402,199	6,738,021
Other operating income	204,456	213,434	270,548	218,979	326,293	392,041	445,628
Other operating expenses	217,842	480,639	210,356	174,326	435,660	562,645	689,289
EBIT	(346,878)	715,754	2,135,319	3,785,703	4,354,220	5,231,595	6,494,360
EBITDA	312,882	1,315,158	2,821,757	4,484,495	4,965,865	5,881,935	7,118,779
Financial Charges	151,926	190,967	38,075	18,666	7,656	9,450	10,889
Profit before taxation	(498,804)	524,787	2,097,244	3,767,037	4,346,564	5,222,145	6,483,472
Taxation	33,409	280,530	1,023,576	604,660	1,303,969	1,566,643	1,945,042
Profit after Tax	(532,213)	244,257	1,073,668	3,162,377	3,042,595	3,655,501	4,538,430
EPS/ (LPS)	(3.73)	1.71	7.52	22.15	21.31	25.6	31.78

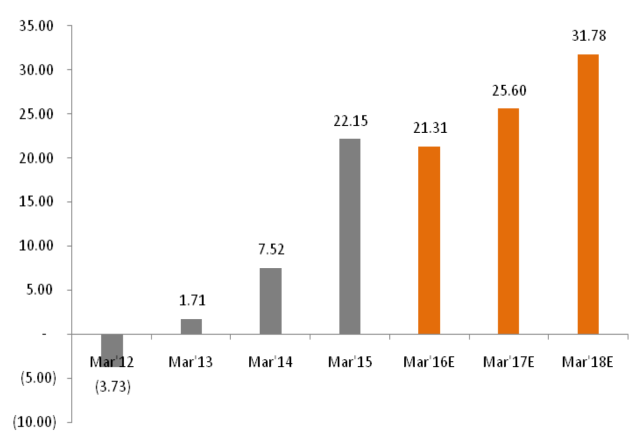
Source: Company Accounts, Nael Research

HCAR Quarterly EPS Trend



Source: Company Accounts, Nael Research

HCAR Annual EPS Trend



Source: Company Accounts, Nael Research

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Stock Recommendation	Return
BUY	> 15%
HOLD	> -15% to < 15%
SELL	< -15%