INITIATION

EQUITY RESEARCH - REP 099

Indus Motor Comapany Limited (INDU)

Mar 30, 2016

BUY

Price Target : PKR 1195.5/share

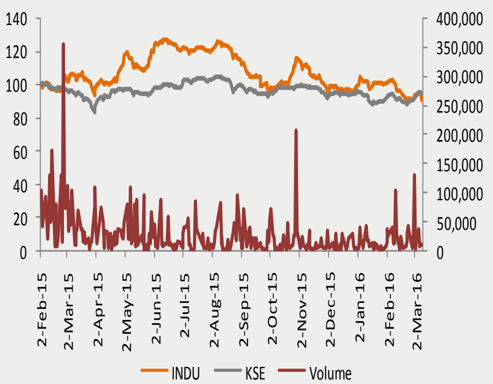
Closing Price : PKR 928.54/share

Company Data

52-week Price Range (PKR)	1309.16-909.95
No. of Shares Outstanding (mn)	78.6
Market Cap (PKRmn)	72983.24
Market Cap (USDmn)	696.7
Free Float (mn shares)	15.72
Year End	Jun
KATS Code	INDU

Source: PSX

Chart: Stock Performance



Source: PSX

- **We initiate our coverage on INDU with 'BUY' rating:** Our Dec-16 DCF based price target of PKR 1195.5/sh implies an upside potential of 28.8% from current price levels of PKR 928.54/sh. Our investment case is based on the following factors:
- **Robust Corolla sales:** INDU enjoys the highest capacity utilization among its peers. We expect its flagship corolla to keep the sales high.
- **High margins among the peers :** INDU's margins have been the highest among peers, though we believe that the recent Yen instability will force it to take a hit on margins.
- **Healthy cash position:** INDU enjoys hefty investment income on the healthy reserves, contributing heavily towards the bottom line.
- **High dividend yield with low P/E:** INDU is currently trading at low P/E with the highest dividend yield among its peers which makes it an attractive investment.
- **Key risks to our investment case are 1)** HCAR's new Civic 2016 2) Exchange rate movements 3) Recovering global commodity prices 4) Change in interest rates 5) New Auto policy (ADP 2016-2021)

INDU Financial Highlights

	FY13	FY14	FY15	FY16E	FY17E	FY18E
EPS (After Tax)	42.72	49.28	115.91	133.41	124.58	124.72
DPS (PKR)	25	29.5	80	92	86	86
BVPS (PKR)	225.1	253.38	305.8	344.71	384.29	425.00
PE (x)	21.41	18.56	7.89	6.96	7.45	7.45
P/BV (x)	4.06	3.61	2.99	2.65	2.38	2.16
Div Yield (%)	2.7	3.2	8.6	9.9	9.3	9.3
EBITDA Margin (%)	9.81	10.43	16.3	16.27	16.78	16.74
ROE (%)	28.119	19.4	37.9	38.7	32.4	29.3
ROA (%)	13.37	14.83	18.08	21.54	22.8	22.31
Gross Margin (%)	9.18	10.15	14.76	14.77	15.09	15.18
Net Profit Margin (%)	5.26	6.79	9.44	9.96	10.26	10.32

Source: Company Accounts, NAEL Research

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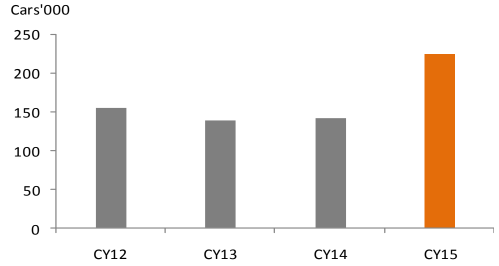
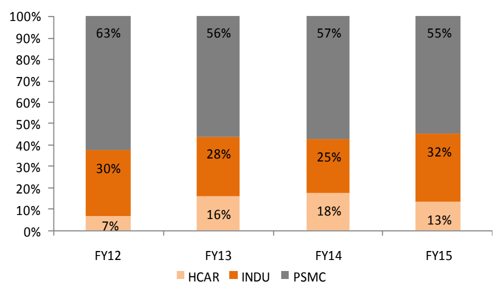
Fig: 1 **Growth - PCs, Jeeps and LCVs**



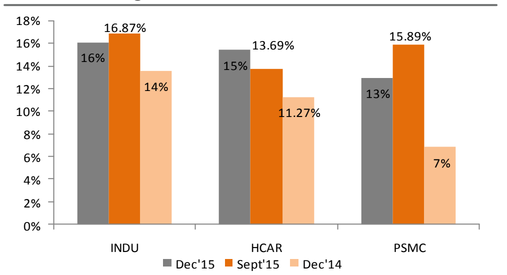
Source: PAMA, Nael Research

Fig: 2 **Major Players' Market Shares**



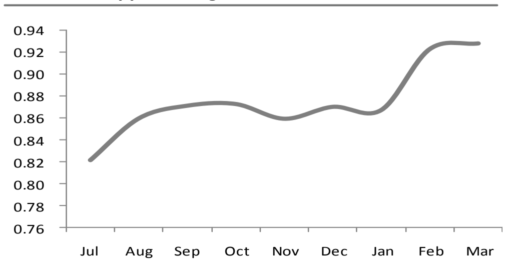
Source: PAMA, Nael Research

Fig: 3 **Margins vulnerable to Yen movement**



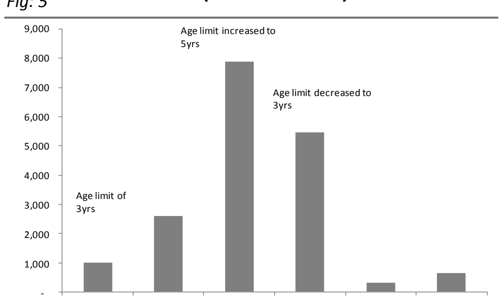
Source: Company Accounts, Nael Research

Fig: 4 **Appreciating 'Yen Vs. PKR' - FY16 TD**



Source: IMF, Nael Research

Fig: 5 **Impact of age limit policy over CBU imports - (1000 to 1300cc)**



Source: PBS, Nael Research

Industry Highlights

For auto assemblers, CY15 was a golden year with massive earnings due to factors like: i) massive volumetric growth ii) favorable exchange rate iii) record low commodity prices.

- **Volumes:** Corolla's new model, Apna rozgar scheme, record low interest rates, lower CPI boosting disposable income and other improving macroeconomic indicators helped the industry achieve a volumetric growth of ~57% last year. With interest rates to a low of 6%, has led to a decent growth in auto loans. As per SBP data, car loans for Jan'16 were ~PKR 98bn (highest in nearly 7 yrs).

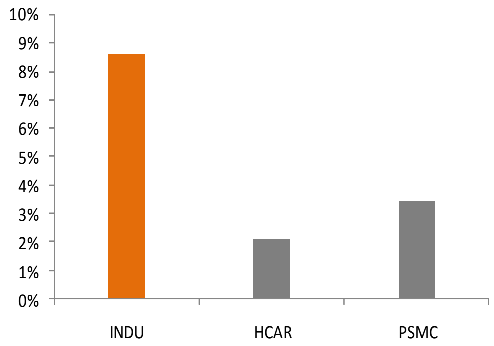
- **Market Share:** Viewing at the players' relative performance, INDU gained the share, HCAR lost and PSMC remained stagnant during FY15 (Fig: 2).

- **Margins:** The industry enjoyed high margins during CY15 due to low global commodity prices (steel lost 70.97% during the last year, as per trading economics), favorable Yen and stable USD movements. The trend is set to revert with recent unstable Yen movement. Despite BOJ's negative interest rate policy (partly aimed at preventing Yen from rising), Yen appreciated as inventors sought safety due to concerns over weak US economic figures. The downward trend in margins was visible from 2QFY16 results of auto assemblers, though HCAR was an exception (Fig: 3)**.** The duty concessions on CKD parts (without any condition of consequent price cut), announced in ADP (2016-2021) will have a minor improvement in the margins.

- **Imports:** FBR had reportedly proposed to increase the age limit of imported used cars from existing 3 to 5 years. The heavy influx of imported used cars was already giving a tough competition to local auto assemblers. The revised policy, however, kept the current import regime for used cars unchanged. Fig: 5 shows the heavy influx of used imported cars in 2011 when the import policy for age limit was relaxed to five years from three years. The lack of innovations and technology availed by the local auto industry is the major reason why it has been facing such a strong competition from the imported used cars.

- **Auto Development Policy:** The much awaited auto policy (2016-21) was formally launched by the Economic Coordination Committee (ECC), last week. As per the policy, the existing three Japanese assemblers will not be entitled to the same benefits as the new investors, in an attempt to promote new investment and encourage competition. The new policy will have varying impacts on all the stakeholders including existing players, new entrants, non-operational units, importers as well as consumers. The industry is set to experience the changing dynamics by enhanced competition and reduced barriers to entry. We believe that the new policy will bode well for the consumers as well as for the long-term growth of the industry. It poses a major threat to the existing auto assemblers and will force them to bring reasonable pricing and innovation.

Fig: 6 **INDU's highest dividend yield**



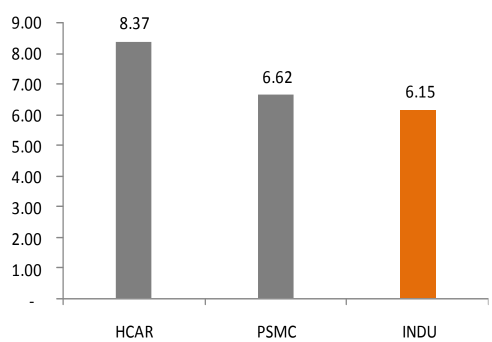
Source: Company Accounts, Nael Research

Fig: 7 **INDU's highest and increasing payout ratio**

	2011	2012	2013	2014	2015
INDU (Jun)	43%	58.5%	58.5%	59.9%	69%
HCAR (Mar)	-	-	18%	40%	23%
PSMC (Dec)	21%	21%	18%	21%	21%

Source: Company Accounts, Nael Research

Fig: 8 **INDU currently trading at lowest P/E**



Source: Company Accounts, Nael Research

Valuation

We initiate our coverage on INDU with '**Buy'** recommendation using discounted free cash flow method. We have used Free Cash Flow to Firm methodology to derive the intrinsic value of INDU at PKR 1195.5/sh. The following assumptions have been incorporated to arrive at our target price

- Terminal growth rate of 4%
- Risk free rate of 8.25% (10yr PIB)
- Market Risk Premium of 6% & Adjusted Beta of 0.78 (using 3 yrs data points)

Based on the above assumptions, INDU's Dec-16 TP arrives at PKR 1195.5/share, offering an upside potential of 28.8% from its closing price of Mar 30, 2016, with a dividend yield of 8.6%.

	Dec'16E	Jun'16E	Jun'17E	Jun'18E
PV of FCFF		7450	1940	6688
WACC		12.9%	12.9%	12.9%
PV of FCFF	16,078			
Terminal Value	93,427			
PV of Terminal Value	77,889			
Ent Value	93,967			
PV of Debt	-			
Equity Value	93,967			
Target Price 12/31/2016	1195.5			
Current Price	928.54			
Upside	28.8%			

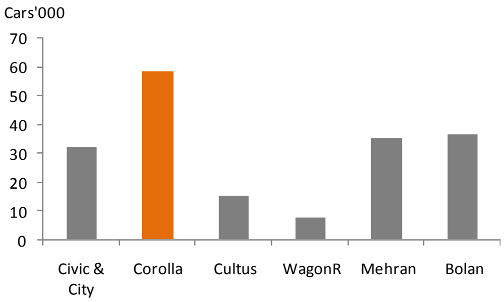
Attractive dividend yield

INDU has been consistently increasing its dividend payout ratio (Fig: 7) and its dividend yield has been the highest among its peers i.e. 8.6% (Fig: 6). The company worked at 105% capacity utilization in FY15 which indicates the need for enhancing existing capacity levels (higher CAPEX) and it is also rumored to enter into hatchback cars though there is no announcement of either from the company yet, we expect INDU to continue its the healthy payouts going forward.

Trading at a low P/E

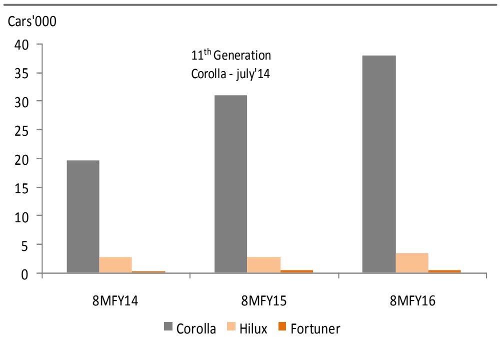
INDU is trading at a P/E of 6.03x (based on CY15 earnings), lowest among its peers (Fig: 7) which makes it even more attractive in terms of price appreciation potential.

Fig: 9 **Corolla remained prominent as a Star Performer**



Source: PAMA, Nael Research

Fig: 10 **Sales Mix**



Source: PAMA, Nael Research

Investment Argument

Our investment view on INDU is based on following fundamentals:

1. Robust Car sales

Corolla: Among the passenger cars, INDU's flagship product Corolla remained the star performer in CY15 due to its 11th generation charm (Fig: 8). After the new model launch, INDU saw a tremendous growth of ~77% in the volumetric sales of Corolla and then further grew by ~23% in the first 8MFY16 when compared to the SPLY. INDU's overall market share went up to 32% (Fig: 2).

For FY16E ahead, we see no stop to the INDU's growing sales on the back of:

- current booking status (that goes beyond June at some dealers);
- persistent buying from rural areas of Pakistan;
- growing auto financing (as per IMC's management, 30% of industry sales is currently due to auto financing compared to 22% last year);
- recent minor changes in the whole range of Corolla (except XLI) and
- a general feel good factor among the general public due to the growing economy and improved law and order situation of the country.

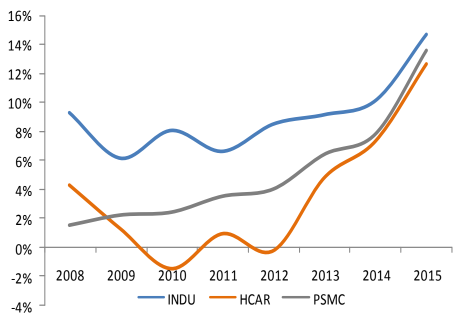
Besides the positive demand drivers, there are also some significant concerns over this growth. For FY17-18E, we have reduced the forecasted sales volume of Corolla due to:

- the fading out effect of the new generation of corolla which is now almost two years old;
- HCAR's upcoming Civic 2016 to give a direct competition to INDU's 1.8L section;
- weak performance of agricultural sector which is expected to miss the targets of its major crops and not even achieve the last year's level due to depressed prices (as per SBP's quarterly review on economy) and
- competition from the expected new entrants after the announcement of new auto policy, though not in near term.

Hilux: Due to major defense operations happening in the country, Hilux performed decently well (up by ~7% in FY15 and ~15% in FY16TD). Company has recently separated the assembly line of Hilux from that of Corolla and is expected to bring a whole new range of Hilux (causing rise in capital investment). We assume the sales will grow by 5% YoY.

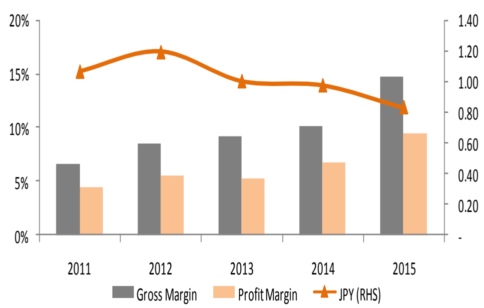
Fortuner: On the other hand, the SUV Fortuner has been facing a tough competition from other imported SUVs like Land Cruiser Prado. The second generation or Fortuner 2016, already revealed in some countries, is expected to come in Pakistan which might create some interest.

Fig: 11 **Gross Margins - INDU always on the top**



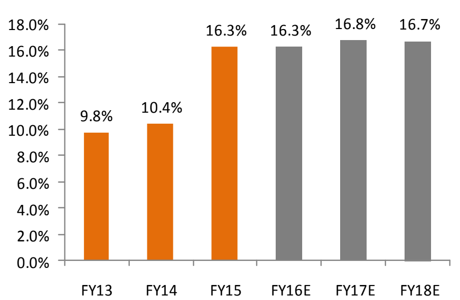
Source: Company Accounts (Mar'2015), Nael Research

Fig: 12 **Impact of fluctuating Yen on Margins**



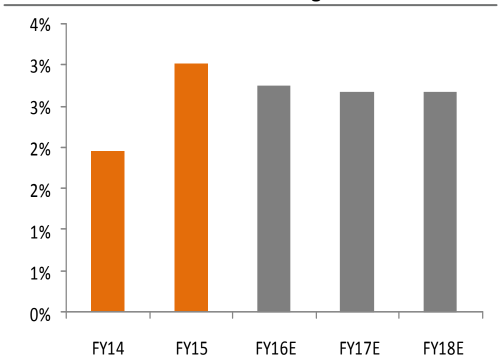
Source: PAMA, Nael Research

Fig: 13 **EBITDA margins to remain strong ahead**



Source: PAMA, Nael Research

Fig: 14 **Other Income as a %age of Sales**



Source: Company Accounts, Nael Research

2. Margins

INDU enjoyed high margins last year due to record low commodity prices and strong PKR against Yen. In 2QFY16, INDU's gross margin declined from 16.87%/1QFY16 to 16.05%. The Yen appreciation (up by ~6.5% CYTD against USD) will pressurize INDU to take a hit on gross margin and will not be able to pass on the entire impact in prices. We expect the gross margin to slip to 14.79%/15.14%/15.10% for FY16E/FY17E/FY18E. Nevertheless, INDU's margins have always been attractive and on the top among other players.

3. Strong other income due to healthy cash position

INDU's Cash and Equivalents reached PKR 31.6bn as of Jun'15 compared to PKR 11.19bn as of Jun'14 due to high earnings and customer advances which increased the company's other income by ~161% from last year. The company also has a long-term investment in PIBs (PKR 4.9bn as of Jun'15) , to mature by July, 2017.

With Corolla's sales to normalize in the near future and the working capital structure to change (advances to go down), the investment income will also come down from the existing levels though still remaining higher than previous years .

4. Distribution Cost

INDU's distribution cost in 1HFY16 declined significantly from ~1.68%/1HFY15 to ~0.77% of sales and hence contributing towards the bottom line. This reduction in distribution cost was due to the 'Advertising expense' which was cut during the time of high demand and we expect it to increase going forward when HCAR gets its new Civic 2016.

Fig: 15 **TP Sensitivity**

		Risk Free Rate				
		7.25%	7.75%	8.25%	8.75%	9.25%
Growth Rate	3.00%	1200	1141	1087	1039	995
	3.50%	1264	1198	1138	1085	1037
	4.00%	1336	1262	**1196**	1136	1083
	4.50%	1418	1334	1259	1193	1134
	5.00%	1512	1415	1331	1257	1291

Source: Nael Research

Investment Risks

HCAR's New Civic 2016

Any higher (lower) impact on INDU's sales than our forecast due to HCAR's new Civic 2016 will negatively (positively) affect value of the company. Any other new player's entry (esp. in the '1300 and above cc' category) would also be a down side risk to our investment case.

Exchange rate movements

Any favorable/adverse movement than forecasted (Yen 113/$ and USD to depreciate by 4% YoY) will positively (negatively) impact the future earnings and hence value of the company.

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, negatively impacting the auto financing. All auto assemblers including INDU would suffer from a down turn 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.

ADP (2016-2021)

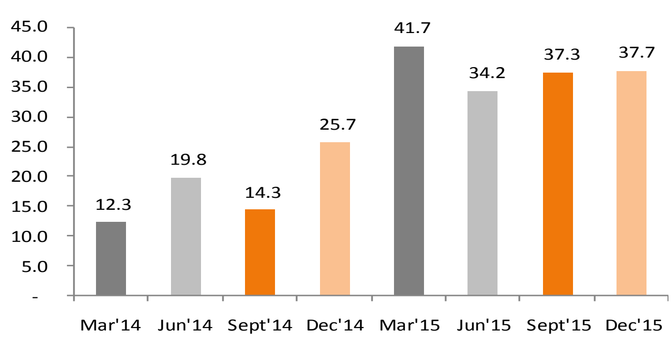
Doing little favor to the existing assemblers, the new auto policy has brought such attractive incentives for the new entrants and the ones who had exited from the market years ago like; Ghandhara Nissan and Dewan Motors. We believe that it will take at least 2-3 years for any new entrant to establish its operations here despite it poses a major threat to all auto assemblers including INDU. The new entrants' arrival will not only impact the market shares of existing assemblers but will also dampen their pricing power, hence impacting the margins.

Financials

Income Statement (PKR'mn)	FY12	FY13	FY14	FY15	FY16E	FY17E	FY18E
Net Sales	76,963	63,829	57,064	96,516	105,302	95,446	94,989
Cost of sales	70,401	57,972	51,270	82,272	89,747	81,046	80,566
Gross Profit	6,562	5,857	5,794	14,244	15,555	14,400	14,423
Distribution Expenses	820	814	794	996	719	750	843
Admin Expenses	628	644	635	799	827	868	911
Operating Profit	5,114	4,399	4,365	12,450	14,009	12,782	12,668
Other operating income	1,776	1,038	1,113	2,907	2,742	2,633	2,547
Other operating expenses	45	66	52	119	130	118	118
WPPF & WWF	471	370	372	1,052	1,135	1,0495	1,031
EBIT	6,373	5,000	5,055	14,184	15,486	14,252	14,066
EBITDA	7,662	6,260	5,950	15,729	17,132	16,013	15,896
Financial Charges	61	31	38	52	81	73	73
Profit before taxation	6,312	4,970	5,016	14,133	15,405	14,179	13,993
Taxation	2,010	1,612	1,143	5,022	4,919	4,386	4,190
Profit after Tax	4,303	3,358	3,873	9,110	10,486	9,792	9,803
EPS/ (LPS)	55	43	49	116	133	124	125

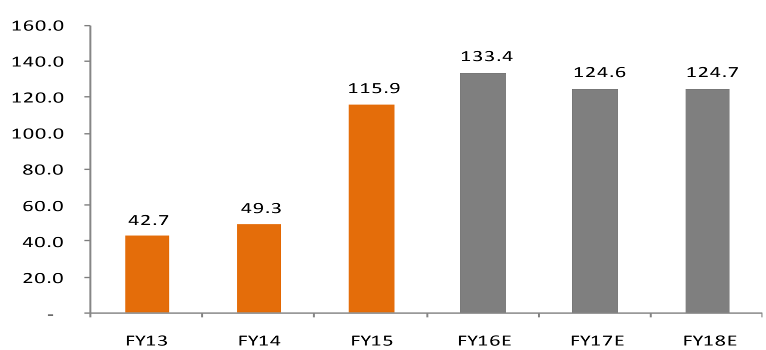
Source: Company Accounts, Nael Research

Quarterly EPS Trend



Source: Company Accounts, Nael Research

Annual EPS Trend



Source: Company Accounts, Nael Research

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