

Company Report

Wednesday, 10 August 2016

Company Update

Honda Atlas Cars (Pakistan) Ltd.

Automobile Assembler

Recommendation	HOLD
Target Price	379.9
Last Closing	394.8
Upside	-4%

Market Data

Bloomberg Tkr.	HCAR PA
Shares (mn)	142.8
Market Cap (PKRbn USDmn)	56.4 539.2
Exchange	KSE 100

Price Info.	90D	180D	365D
Abs. Return	37.2	40.6	44.8
Low	283.3	231.9	219.4
High	411.1	411.1	411.1

Key Company Financials

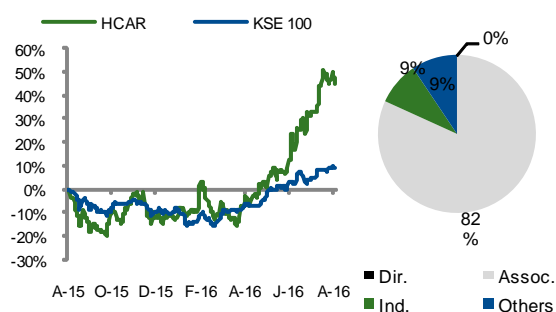
Period End: Mar

PKRbn	FY16A	FY17E	FY18F	FY19F
Total Revenue	40.1	53.8	63.2	65.1
Net Income	3.6	5.2	6.1	5.9
EPS (PKR)	24.9	36.4	42.4	41.4
DPS (PKR)	7.0	15.0	17.0	17.0
Total Assets	16.2	22.2	27.0	30.0
Total Equity	7.9	11.0	14.6	18.1

Key Financial Ratios

ROE (%)	45%	47%	41%	33%
P/E (x)	15.9	10.9	9.3	9.5
P/B (x)	7.1	5.1	3.9	3.1
DY (%)	1.8	3.8	4.3	4.3

Relative Price Performance & Shareholding



About the Company

The Company was incorporated on November 04, 1992 and commenced commercial production from July 1994. The principal activities are the assembling and progressive manufacturing and sale of Honda vehicles and spare parts.

Source: Bloomberg, KSE 100 & IGI Research

Analyst

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Honda Atlas Cars (Pakistan) Limited

All Positives Priced In; Throwing Into Neutral

Re-initiating Coverage, With a 'Hold' Call

We re-initiate our coverage on Honda Atlas Cars (Pakistan) Limited (HCAR) with a 'Hold' rating and Dec-16 target price of PKR 380/share, implying a downside of ~4% from its current levels. The stock has rallied nearly ~65% CYTD on new Civic model launch. However, we think the current price of PKR 395/share incorporates future prospects of the company. Based on FY17F forward pricing multiples of 11.0x and dividend yield of 3.8% the scrip looks fairly valued in our view. Compared to IGI auto-sector coverage INDU/PSMC offer 7.9%/2.8% dividend yield and trading at FY17F/CY16F PER of 7.63x/7.43x respectively.

Investment Case

After experiencing a rough sale patch in 1HCY16 in anticipation of new Civic Model, which is expected to perk up sales volume (launched in Jul-16). As per company, the Honda Civic is available in two different variants namely 1.8L i-VTEC / Oriol and 1.5L VTEC Turbo, with a price range between PKR 2.4-3.0mn. Given strong demand outlook for automobile sales, we estimate 10th Generation Civic sales to average ~13.0k units in the next 3yrs (peaking at 13.5k units in FY18F) compared to an average of 8.5k units in previous 3yrs (FY14-16), showing a growth of ~+50%.

Gross margins to stay tepid going forward, amid rising steel prices and volatile exchange rate outlook

Led by favorable exchange rates and commodity prices, company's gross margins in FY16 increased substantially to +15.1% from 4.8%/7.3% recorded in FY13/14. However, based on recent currency volatility and rebound in commodity prices after bottoming out back in Nov-15, we expect company's gross margins to average ~14% in the next 3yrs.

Earnings

Based on the new model launch and despite gross margin attrition, we estimate HCAR's earnings to register a +18% CAGR over next 3yrs peaking at PKR 42.4/share in FY18F from PKR 24.9/share recorded in FY16 (average earnings for next 3yrs are estimated at PKR ~40/share). Moreover, we expect company payout ratio to increase to ~40% owing to better cash position.

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Volumetric Growth

Civic sales expected to reach a New High

After experiencing a rough sales patch in 1HCY16 in anticipation of new Civic Model, which is expected to perk up sales volume (launched in Jul-16). As per company, the new Honda Civic is available in two different variants namely 1.8L i-VTEC / Oriol and 1.5L VTEC Turbo, with a price range between PKR 2.4-3.0mn.

Given strong demand outlook for automobile sales, we estimate 10th generation Civic sales to average ~13.0k units in the next 3Yrs (peaking at 13.5k units by FY18F) compared to an average of 8.5k units in previous 3yrs (FY14-16), showing a growth of nearly ~50%. For City variant, we expect Honda City 5th Generation to sustain its demand and average sales to remain at ~18k units for the period FY17-19F.

Auto Sector: Strong Demand Growth to Continue

We expect auto-sector demand to remain robust, owing to;

- Improving Pakistan growth outlook and increasing per capita income
- Decade low interest rate propelling healthy growth in auto-financing
- Lower international oil prices to induce sale for larger engine sizes passenger cars.

Exhibit: Sales volume and impact of New Models launch on Sales volume

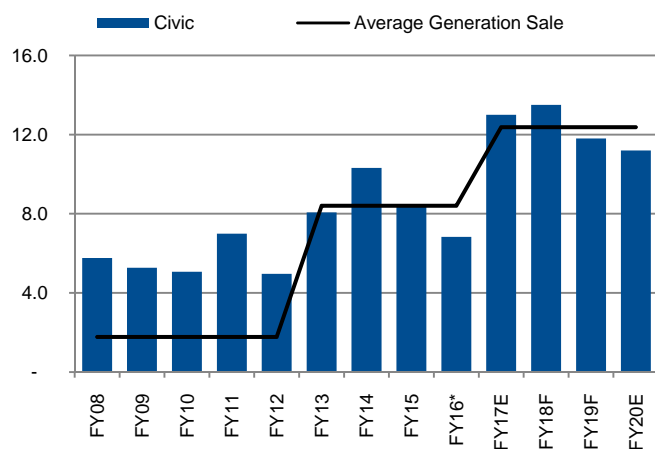
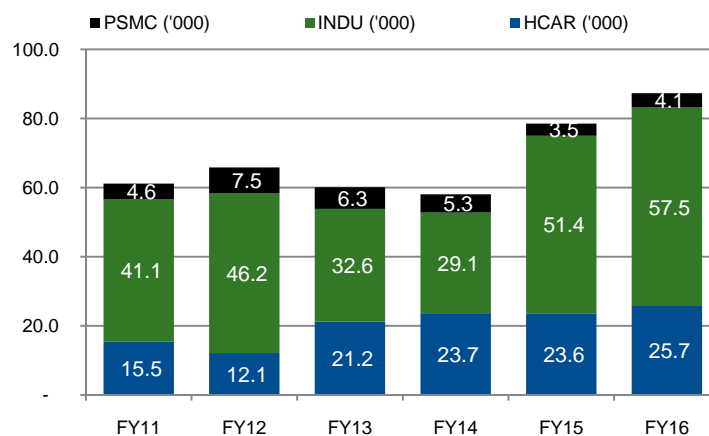


Exhibit: Rising trend of Auto credit quantum, nearing the peak CY2006-07 levels



Source: IGI Research, State Bank of Pakistan (SBP), Company's Financial, PAMA, *estimated

Gross Margin

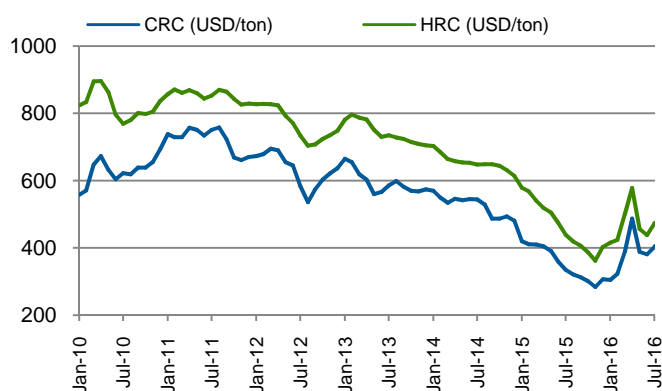
Gross margins to stay tepid going forward, amid...

Company's gross margins in FY16 increased substantially to +15.1% from 4.8%/7.3% recorded in FY13/14. This was mainly on the back of a) favorable currency movements in JPY against USD, and b) lower international steel prices. However, based on recent currency volatility and rebound in commodity prices after bottoming out back in Nov-15, we expect company's gross margins to average ~14% in the next 3Yrs.

...rising steel prices

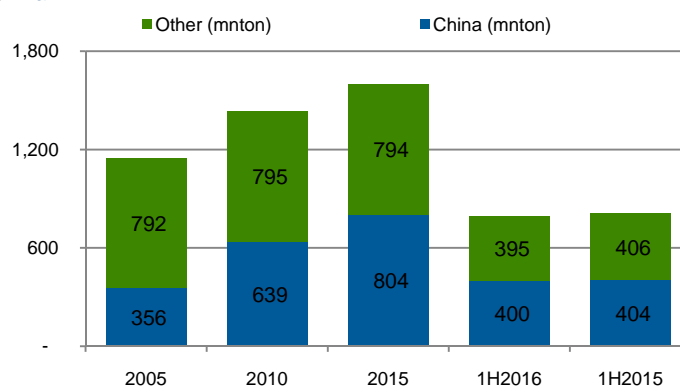
Steel prices after touching a 5Yr low of USD 362/ton in Nov-15 witnessed a reversal in trend on account of China curbing steel supply, causing a drop in overall world production. Going forward, we expect on average ~+3%YoY rise in steel (CRC) prices, as global growth outlook improves. On account of this trend, we expect company's margin to come under pressure, as increasing competition will limit company's ability to raise car prices.

Exhibit: International CRC prices up by +33% CY16 to date



Source: IGI Research, Bloomberg, World Steel

Exhibit: Global Steel production is expected to slowdown and so is for China



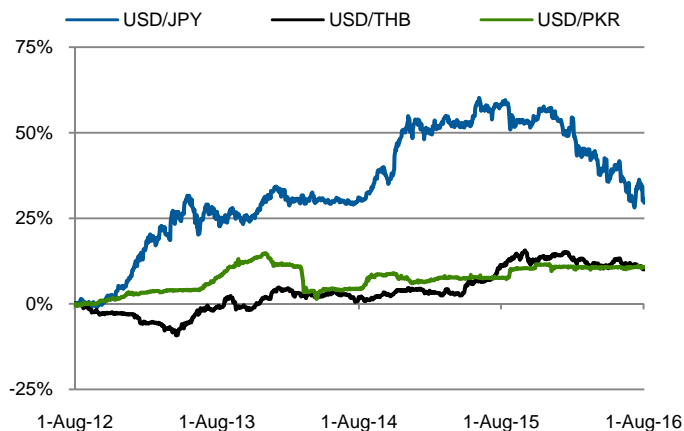
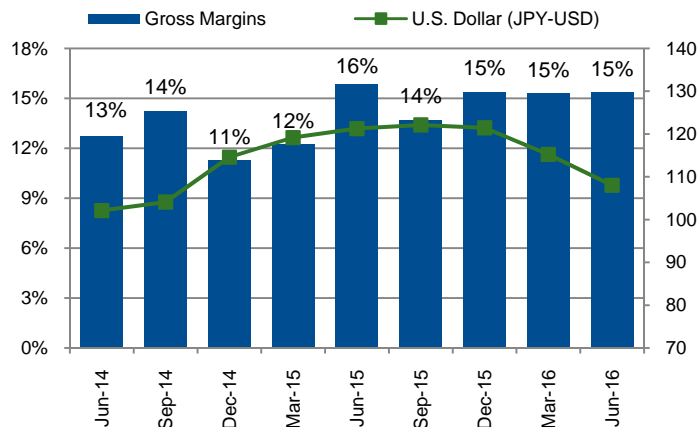
...and volatile exchange rate outlook

During FY16, JPY depreciated nearly ~8% against USD, which partially along with lower commodity prices explains higher gross margin for HCAR during the year. Starting CY16, JPY has remained buoyant and in CY16 to date, JPY has appreciated nearly ~18% to reach 102.10 against USD from a high of 123.37 against USD witnessed seen in Dec-15. The contributing factors that have led to this rally are a) Bank of Japan (BoJ) ineffective monetary stimulus packages, b) fading expectation of further Fed rate hike, and c) global growth fears aggravated by slowdown in Chinese economy growth, Brexit and lower oil price.

Unlike PSMC and INDU, HCAR diversified exposure to THB and USD along with JPY, limits drastic impact of any single currency on gross margins. Going forward we expect THB to remain relatively stable, negating the negative impact of recent

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appreciation of JPY on gross margins to some extent. Our long-term outlook for JPY is depreciating at 3% annually from current FY16 average of 120.64 against USD.

Exhibit: Currency movements**Exhibit: Quarterly gross margins affected by fluctuating JPY**

Source: IGI Research, Bloomberg, Company Financials

Profitability and dividend

Double digit earnings growth over the next 3yrs

Based on the new model launch and despite gross margin attrition, we estimate HCAR earnings to register +18% CAGR over next 3yrs peaking at PKR 42.4/share in FY18F from PKR 24.9/share recorded in FY16 (average earnings for next 3yrs are estimated at PKR ~40/share). Moreover, we expect company payout ratio to increase to ~40% owing to better cash position.

Exhibit: Earning is expected to show +18% CAGR over the next 3yrs

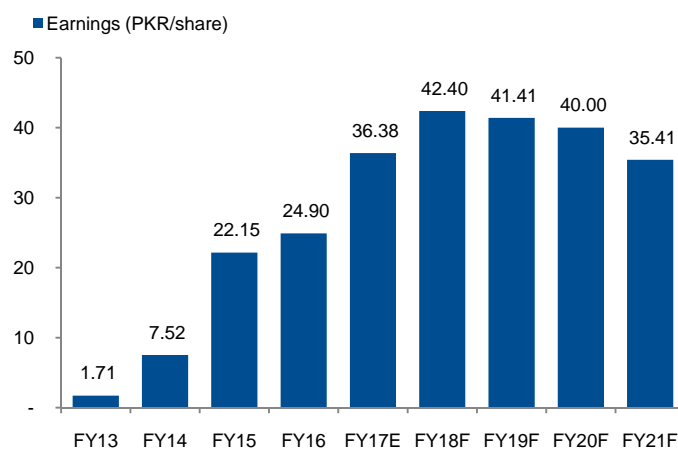
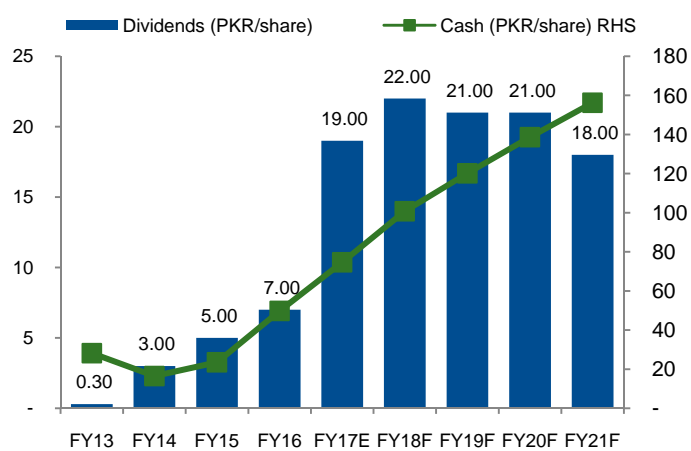


Exhibit: Better cash position will lead to better payout ratios



Source: IGI Research, State Bank of Pakistan (SBP) and Company's Financials

Valuation and recommendation

We have used discounted cash flow method for our valuation, with a cost of equity of 13.9% (risk-free rate of 6.25%, beta 1.17 and risk premium 6.5%). Based on this, our Dec-16 target price for HCAR comes at PKR 380/share. In addition, for FY17E, we estimate HCAR to pay a cash dividend of PKR 15/share, (3.8% dividend yield).

However, we think the current price incorporates future prospects of the company. Based on FY17F forward pricing multiples of 11.0x and dividend yield of +3.8%, the scrip looks fairly valued in our view. Compared to IGI auto-sector coverage INDU/PSMC offer 7.9%/2.8% dividend yield and trading at FY17F/CY16F PER of 7.63x/7.43x respectively.

Valuation Parameters

Risk Free Rate	6.25%
Beta	1.17
Risk Premium	6.50%
Cost of Equity	13.90%
Sustainable Growth Rate	3.00%

Discounted Cash Flows	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21
PKRmn					
Net Income	5,195	6,054	5,913	5,712	5,057
+ Non-Cash Charges	550	491	448	408	372
+ Interest (net of taxation)	5	5	5	5	5
- CAPEX	(189)	(188)	(171)	(156)	(142)
- WC	712	504	(422)	(321)	(202)
FCFE	6,273	6,867	5,773	5,648	5,089
Sum of PV	22,693				
Terminal	26,864				
Cash	4,687				
Enterprise Value	54,244				
No. of Shares (mn)	143				
Target Price (PKR) - Dec2016	379.9				

Key Risks

- **Automotive Development Policy 2016-21 (ADP-II):**
The Automotive Development Policy 2016-21 (ADP-II) which was formally launched in Mar-16 (effective from Jul-16 onwards), mainly entices new/reviewing players with discounted duties on import of CKD units for 5/3 years respectively, It also reduces the CKD rates for existing OEMs with reduced duties on imported CKD by 2.5%/5% to 30%/45% for non-localized/localized parts, which will have positive impact on earnings, however it puts some restriction on existing players in the form of ceiling on advance payment to the tune of 50% of price and delivery time not longer than 2 months. HCAR's policy is in line with these requirements. In short to medium term, we foresee positive effect of ADP-II on current players, however in long term, entry of new/reviving player is going to reshape automobile market with increased competition and possible changes in pricing powers for existing OEMs.
- **Exchange Rate:** Despite a diversified currency exposure (USD, JPY, and THB), sharp unfavorable movement could easily impact company's margins and earnings.
- **Steel Prices:** Steel prices makes up nearly 60% of total company raw material cost. Changes in imported steel duty structure or changes in international steel prices will directly impact gross margins. We estimate +3%YoY increase in CRC prices will lead to roughly 1% gross margin or 5% of profitability erosion on average for FY17-19F.
- **Interest Rates:** Increase in interest rates could impact demand of auto-financing, leading to possible slowdown in sales volumes.
- **Imported Cars:** Under the Auto Development Policy (ADP) 16-21, the designated depreciation age of imported car is maintained at 3yrs and the various gift schemes for used imported cars also remain intact. Any unexpected increase in used car imports will be sales negative.
- **Super Tax:** In FY15, the Company has not booked in Super tax charge, as an additional tax measure introduced in FY16 federal budget. Similarly the FY17 budget has continued Super Tax of 3% for companies having profitability =>PKR 500mn. If taken, we estimate company profitability to take a one-time hit of PKR 1.0-1.2/share.

Financials

Honda Atlas Cars (Pakistan) Ltd. (HCAR)

Current Price (PKR): 394.8 Target Price (PKR): 379.9						Upside -4%		Recommendation HOLD			
Mar-end	FY15A	FY16A	FY17F	FY18F	FY19F	Mar-end	FY15A	FY16A	FY17F	FY18F	FY19F
Income Statement Items (PKRmn)						Valuation Ratios					
Net Sales	37,764	40,086	53,811	63,171	65,085	EPS (PKR)	22.1	24.9	36.4	42.4	41.4
Gross Profit	4,773	6,047	8,144	8,963	8,602	DPS (PKR)	5.0	7.0	15.0	17.0	17.0
S & M, Admin.	754	685	805	654	645	BVPS (PKR)	35.9	55.6	77.0	102.4	126.8
Other Op. Income	219	310	515	688	817	P/E (x)	17.8	15.9	10.9	9.3	9.5
Other Expenses	452	486	677	753	721	D/Y (%)	1%	2%	4%	4%	4%
EBITDA	3,786	5,186	7,178	8,244	8,052	P/B (x)	11.0	7.1	5.1	3.9	3.1
Finance Cost	19	7	7	7	7	Earnings Growth (%)	195%	12%	46%	17%	-2%
Pre-tax Profits	3,767	5,179	7,171	8,237	8,045	ROE	84%	54%	55%	47%	36%
Taxation	605	1,623	1,976	2,183	2,132	ROA	24%	24%	27%	25%	21%
Post- Tax Profits	3,163	3,556	5,195	6,054	5,913	Cash / Share	23.5	41.8	70.7	101.7	125.1
Balance Sheet Items (PKRmn)						Financial Gearing					
PPE	2,933	3,781	3,420	3,116	2,839	Debt/Equity	0%	0%	0%	0%	0%
Non Current Assets	3,377	3,867	3,506	3,202	2,925	Interest Coverage	0%	0%	0%	0%	0%
Stock-in-trade	5,524	4,010	6,227	6,825	6,740	Margins					
Loans and advances	1,489	1,006	1,006	1,006	1,006	Gross Margins (%)	13%	15%	15%	14%	13%
Stores and Spares	106	74	107	123	127	EBITDA Margins (%)	12%	14%	14%	14%	13%
Cash	3,358	5,963	10,090	14,524	17,865	Net Profit Margins (%)	8%	9%	10%	10%	9%
Total Assets	13,926	16,205	22,234	26,993	29,977	Macro- Assumption					
Long-term Finances	-	-	-	-	-	USD / PKR	101.40	104.07	105.80	109.01	112.31
Trade & other payables	8,735	8,031	11,007	12,140	11,638	JPY/PKR	0.89	0.88	0.98	0.98	0.98
ST Financing	-	-	-	-	-	CRC-USD/ton	592	420	436	449	463
Total Liabilities	8,806	8,264	11,240	12,372	11,871	Efficiency Ratio					
Share Capital	1,428	1,428	1,428	1,428	1,428	Current Ratio	1.21	1.53	1.70	1.96	2.32
Total Equity	5,120	7,941	10,994	14,621	18,107	Quick Ratio	0.57	1.04	1.14	1.40	1.74
Cash Flow Items (PKRmn)						Volumes (Units)					
Operating CF	1,858	4,089	6,458	7,050	5,939	Civic	8,383	6,832	13,000	13,500	11,800
Investing CF	(428)	(883)	(189)	(188)	(171)	City	14,904	18,927	17,684	18,500	18,500
Financing CF	(426)	(839)	(2,142)	(2,428)	(2,428)	Others	-	-	-	-	-
Closing Cash	3,358	5,963	10,090	14,524	17,865	Total	23,287	25,759	30,684	32,000	30,300

Source: IGI Research, Company Financials

Pakistan Auto-sector Outlook

Strong Demand Growth to Continue

Growth Outlook and increasing per capita income

Demand in passenger car sales is positively correlated to economic growth.

Pakistan has averaged 4.8% growth in the past 20yrs, while going forward IMF expects average growth rate for FY16-20F of 5.1%.

Pakistan per capita income is expected to reach USD 2,000 (FY15: USD 1,450) in the next 5-years. Higher capita income is directly related to increase demand of passenger car.

Exhibit: Passenger car sales and economic growth are positively correlated.

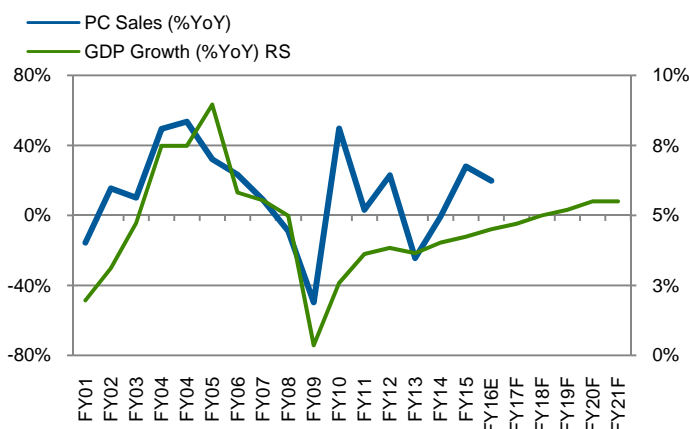
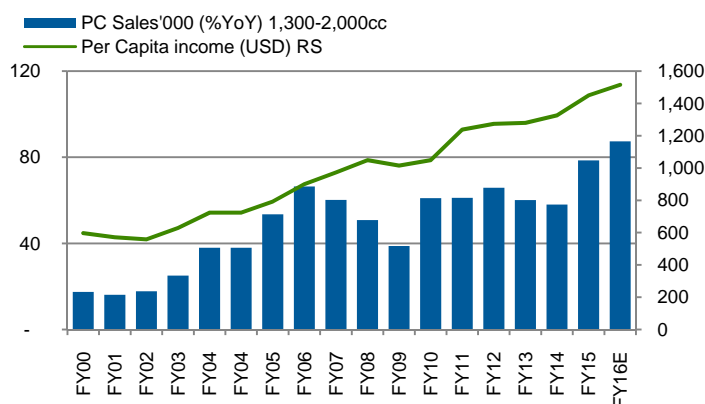


Exhibit: Rising per-capita income leads to increasing demand of luxury vehicles.



Source: IGI Research, Economic Survey of Pakistan

Decade low interest rate propelling healthy growth in auto-financing

Auto financing has leaped up by +32%YoY to multi-year high level, primarily on the back of lower interest rates. As per our management talks, nearly 25-30% of total passenger cars volume is being financed through auto credit. Hence we remain bullish on volumetric growth of new Civic Model.

Oil prices

The high end passenger cars (1300cc and above) are enjoying increasing market share from around 31% in FY08 to 48% in FY16, on the back of a) low running cost owing to lower international oil prices, b) increasing per capita income, c) launch of new models and variants in the high end segment of passenger cars.

Exhibit: Credit for purchase of car increased to PKR 108bn in May-16 (a level last seen in Apr-08)

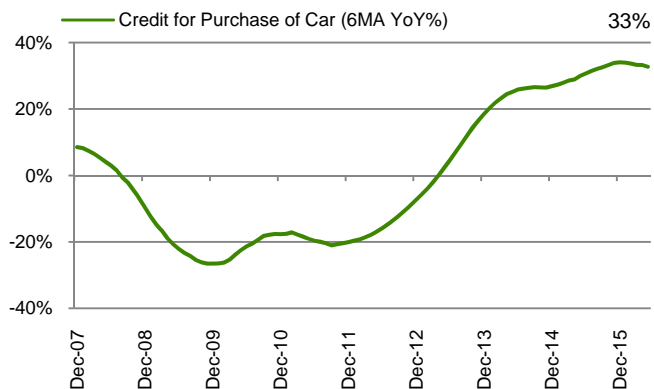
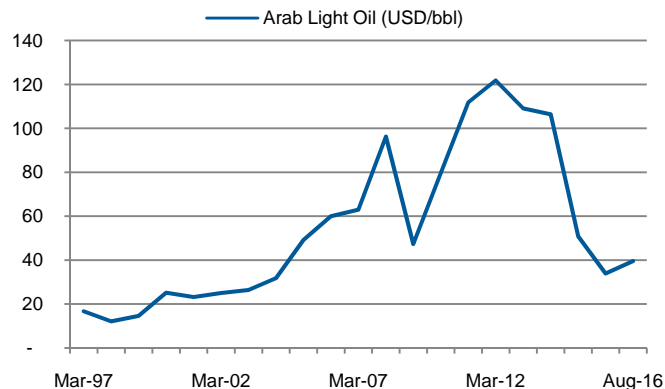


Exhibit: International oil prices



Source: IGI Research, SBP, Bloomberg

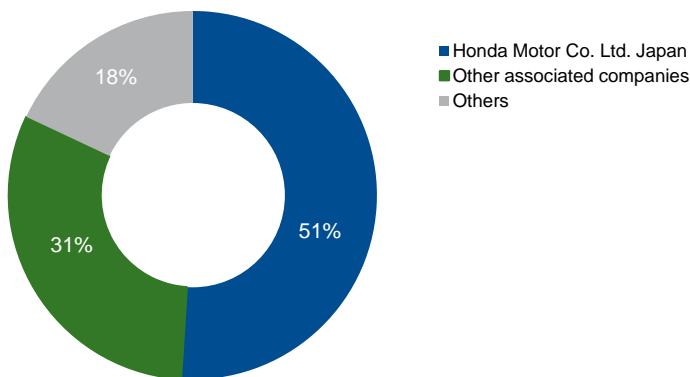
About the Company

Honda Atlas Cars (Pakistan) Limited is a joint venture between Honda Motor Company Limited Japan, and the Atlas Group of Companies, Pakistan. The company was incorporated on November 04, 1992 and joint venture agreement was signed on August 05, 1993. Its principal activities are assembling and progressive manufacturing and sale of Honda vehicles and spare parts. The Company commenced commercial production from July 1994. Company's products include Honda Accord, Honda CR-V, Honda CR-Z, Honda HR-V, Honda Civic (four models), Honda City Aspire (four models) and Honda City (four models) in wide range of colors with advanced technological features.

Background

- The first car rolled off the assembly line on May 26, 1994.
- Since the commencement of production in 1994, the company has produced and sold more than 200,000 cars till July 12, 2012.
- Since then the Dealerships network has expanded and now the company has Twenty One 3S (Sales, Service and Spare Parts), Eighteen 2S (Service and Spare Parts) and Five 1S (Spare Parts) authorized dealerships network in all major cities of Pakistan.

Exhibit: Shareholding Pattern



Source: IGI Research, Company's Financials

Analyst Certification

The analyst[^] hereby certify that the views about the company/companies and the security/securities discussed in this report are accurately expressed and that he/she has not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report. The analyst is principally responsible for the preparation of this research report and that he/she or his/her close family/relative does not own 1% or more of a class of common equity securities of the following company/companies covered in this report.

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Recommendation	Rating System
Buy	If return on aforementioned security(ies) is more than 10%, from its last closing price(s)
Hold	If return on aforementioned security(ies) is in between -10% and 10%, from its last closing price(s)
Sell	If return on aforementioned security(ies) is more than -10%, from its last closing price(s)

Valuation Methodology

The analyst[^] has used following valuation methodology to arrive at the target price of the said security (ies):

- FCF (Free Cash Flow)

Time Horizon

- Dec - 2016

Risk

- Changes in State Bank of Pakistan Policy Rate
- Change in Country (Pakistan) macro-economic environment
- Changes in Company(ies) operating structure
- Changes in Exchange rate

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