BUSINESS ANALYSIS AND VALUATION

ASSIGNMENT-1

INDUSTRY: 2-Wheeler Bikes in India.

COMPANIES:

Hero MotoCorp Limited **Vs** **Eicher Motors Limited**

GROUP MEMBERS:

SUSARLA ANURAAG	2017A3PS0474H
MANUL GUPTA	2017B3PS0861H
NUKALA JAYADEEP	2017AAPS0249H
SUMANTH N	2017AAPS0445H
G V S SUMANTH	2017A3PS0561H

1) <u>INDUSTRY ANALYSIS</u>:

<u>Michael Porter's Five Forces model:</u>

<u>A.)</u> <u>Competitive Rivalry or Competition against Motorcycle industry:</u>

- Whenever there is rivalry between firms, it makes each push their **prices relatively close** to each other.
- There are only **few players** in the market. **Hero, Bajaj and Honda** controlling **almost 80% of the market share** in bikes**.** These firms have a **dominating presence**. This market **is considered as oligopolistic** in nature.
- As the rival companies are **few** in number, the **rivalry is moderate in range** between existing companies.
- Both the firms in study, Hero and Eicher face **low** rivalry because Hero controls half of the market and the latter controls the mid-size segment (250cc-750cc).

<u>B.)</u> <u>Threat of entry of new firms:</u>

- For **new firms** to enter and stay in the market and create value and profits, it **needs to have either large economies of scale** through a lot of research and development or advertising or huge manufacturing unit **or** through **cost leadership or through differentiation**.
- These are all **difficult for a new entrant** to achieve at the **beginning** itself owing to **high capital requirement, high sunk costs** to start a new manufacturing unit.
- For **differentiation**, the company needs a **good brand value in the market** or the **products must be highly differentiable** (as if consumer based **customised** bikes)
- The existing companies have an **extensive dealers and services** network and some, lasting decades. Therefore, it is very difficult for a potential entrant to arrange a dealer network so large and widespread as Hero Motocorp and Eicher Motors.
- The new entrants have **less advantage** compared to older ones in the case of **learning economies of scale**.
- **Hero Motorcorp** and **Eicher Motors** have the resources to fight back any potential entrant. These are debt-free companies with nearly INR 3000 crores in cash!

<u>C.)</u> <u>Threat of substitute products</u>:

- **Actually, there are a number of substitutes** for motorcycles like, public transportation, cars etc.
- **Nevertheless, flexibility** is high when having a bike when **compared to public transport, owing to uncertain timings in towns and villages**. However, **in the case of cities,** public transportation is a good means **for** carrying out **daily routine**, **where public transport means is almost regularised**
- Changing to **cars** on the other hand has **higher switching costs, maintenance (or) running costs etc.**
- Though **electrical vehicles** are available, they have **negligent market share** and **lack infrastructure** in order to consider them as a threat.

- Considering all these factors, though the number of available substitutes are high, the other factors nullify the effects of other substitutes and the **threat of substitutes is low.**

D.) Bargaining Power of Suppliers:

The **key components** required **from suppliers** by motorcycles industry are:

- **Steel(auto grade quality)**
- **Tyres**
- **Automotive components**
- **Battery**

- For **steel**, our country **relies more on imports due to cheap import duty and wide availability of suppliers from the international markets**. Steel, made by Iron and Carbon is considered as a commodity, which in turn makes it nearly impossible for steel companies to set the prices. As per statistics, **we import a higher percentage** of the steel that we use for automobiles. So due to this, the **suppliers have less say** and **bargaining power** in this case. **Seeing the potential profits,** many steel manufacturing firms in our country, started **joint ventures** with international sellers like **JFE and JSW, Tata and Nippon** etc.
- For **automotive components**, we have **more supplier's options than the no. of existing firms making motorcycles**, like RICO auto industries, JBM group, Mitsuba corporations etc. owing to which the **suppliers have lower bargaining power.** Since, a bike has many components; it has many alternative suppliers for the same parts, thereby reducing the risk associated with some firms.
- Fo**r batteries, many options** from companies like AMARON, Exide, luminous, action etc. **reduce the bargaining power of suppliers.**
- For **tyres, we have 40 listed companies** in our country. Firms like **MRF, Apollo,CEAT etc. have most of the market share** in their control and as the **two wheeler industry is the major consumer of tyres**, and they consume in **bulk**, the motorcycles firms are **given benefits and have huge brand association,** which is a **an advantage** for motorcycle manufacturers and **reduces the bargaining power of suppliers.**
- The products supplied to bike manufacturers are **mostly undifferentiated**, thereby giving the bike manufacturers advantage to engage in lowering prices.

E.) Bargaining power of buyers:

- **Most of the buyers** use bikes for transportation and consider it a **necessity rather than a luxury.**
- The sales of bikes, be it Hero Motocorp or Eicher Motors, are **not concentrated** in few volume buyers, but are spread throughout the millions of buyers.
- Firms like Hero and Eicher earn huge profits in their respective bikes segment, meaning there is low power for buyers to bargain.
- The **entry segment and commuter bikes**, where buyers focus on price relative to the differentiation it offers, buyers have other alternatives. Nevertheless, due to the concentration of market share in 3-4 firms, buyers have to go with one or the other

amongst them. This in turn makes a point that buyers do not have bargaining power in this segment.

- However, this is **not the case with luxury bikes**, where the **consumers are willing to pay** for a particular product, because of **the brand value, or design etc**.

Due to all these factors, we can say that bargaining power is low for buyers.

SUMMARY OF FIVE FORCES:

⇒ Competitive Rivalry or Competition against Motorcycle industry:

As the companies competing for market share are few in number, the **rivalry is intense** between existing companies targeting the '**volumes**' segment, but other factors like **dealers network** and **service centres** contribute to the market belonging to a few firms.
Whereas, **niche** segment does not experience this intense competition. Nevertheless, they must always be on guard for new market 'niches', its competitors develop.

⇒ Threat of entry of new firms:

Threat of new entrants is **low.** It is further validated by the superior ROCE (Return on Capital Employed) that firms like Hero, Eicher, Bajaj Auto are generating, in excess of 25%, throughout the years.

⇒ Threat of substitute products:

Though the number of available substitutes are high, the other factors nullify the effects of substitutes. In the Indian context, the aspirations of youngsters are rising and there is a great practical utility for bikes in the Indian market.

⇒ Bargaining Power of Suppliers:

The bargaining power of suppliers is **low**.

⇒ Bargaining power of Buyers:

All factors considered the bargaining power of buyers is **low**.

2. <u>ORGANIZATION'S COMPETITIVE ADVANTAGES USING PORTER'S GENERIC STRATEGY.</u>

HERO MOTOCORP LIMITED:

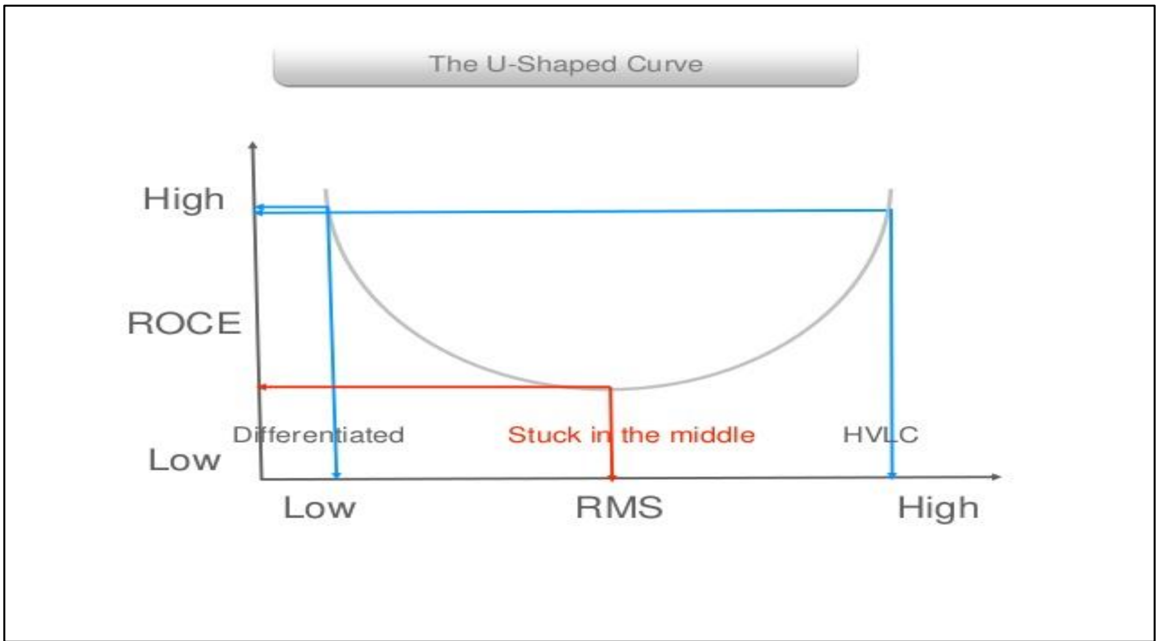
The largest selling two-wheeler manufacturer in the world is Hero MotoCorp Limited. Hero follows a "**Cost Leadership"** strategy. It offers best-in-class mileage (excellent fuel efficient) bikes at an economical price, often the lowest pricing amongst its competitors. It is a leader in the 'volumes' segment, evident from the market share it commands, a staggering **50%** in the 2-wheeler bikes segment.

EICHER MOTORS:

The revival of the CV (commercial vehicles) and bus manufacturer, Eicher Motors started with the introduction of the phenomenal '**Royal Enfield**' portfolio, which now is the flagship brand of Eicher Motors. Enfield operates in the '**niche**' market segment and dominates the mid-size(250cc-750cc) with a staggering market share of **96%**(2018-19) and overall market share of nearly **6%** in the motorcycle segment.

Royal Enfield follows a '**Differentiation**' strategy. The design and the brand perceived by the consumers is an enormous factor for its continuous success, through the years.

- **<u>Porter Curve</u>** illustrates the success of these firms aptly.



This is true in the case of these two firms, whose ROCE (Return on Capital Employed) is greater than 20% for most of the lifetime of the products, spanning nearly decades!.

3.) SPACE ANALYSIS: "Space Position and Action Evaluation Matrix"

Space analysis helps in formulating a strategy and identifying the competitive advantages present in a company.

External Factors:

- Industry attractiveness
- Environment Stability

Internal Factors:

- Financial Strength
- Competitive Advantage

➔INDUSTRY ATTRACTIVENESS:

- **Growth Potential:**
  The automobile sector is closely linked with the country's Gross Domestic Product (GDP) and the CAGR for 2-wheeler industry for the last 4 years (2014-18) was 8%. India is currently the world's largest two-wheeler market and is expected to grow at a good rate (trailing GDP). This growth can be supported due to the low penetration of 2-wheelers in our country. About 102 two-wheelers per 1000 people.
  So, the rating is **6**.
- **Ease of entry:**
  Potential entrants will face difficulties in gaining market share in the bikes segment. Bike industry is a slow changing industry. The incumbent major firms dominate the market with its cost leadership, strong dealers and supplier's network.
  'Volumes' segment:
  The new entrants are at a huge disadvantage if they wish to compete for volumes. One of the reasons is the 'Economies of Scale' prevalent in the incumbents. Furthermore, the capital intensity is large. It is tough for a new entrant to set up a manufacturing plant to produce millions of vehicles, and to set-up dealer's network extensively. Cost controlling should be the focus for new entrants if they want to compete with Hero and Bajaj, since they can lower their prices aggressively, if need arises. Developing a bike that is affordable and selling it in the millions is no easy task. Even, multinationals like Honda, which makes everything in the automotive space everywhere in the world is unable to take a larger share in the market (post de-merger from Hero).

  'Niche' segment:
  The new entrants can carve out a 'niche' for itself and dominate it. However, there are very few unpenetrated spaces in bike market. Some of the brands like Enfield, KTM have a niche of their own and it is difficult to take them head on without superior differentiation and specifications at a competitive price. Gaining consumers trust and perception towards the particular brand is of the essence in 'Niche' Segment**.**
  So, the rating is **3.**
- **Capital Intensity:**
  As mentioned earlier, to be in the '**volumes**' segment, there is huge up-front expenditure involved, in the forms of manufacturing plants, cutting-edge machinery, a robust supplier's

chain, and incentivized labour. Even though the **'niche'** segment makes considerably a smaller number of bikes, it needs all the above factors in lesser proportions. Therefore, a strong multinational with proper focus has the potential to do all this, whether it succeeds or not, a completely different strategy.
So, the rating is **3**.

Factor	**Rating**
Growth Potential	5
Ease of Entry	3
Capital Intensity	3
INDUSTRY STRENGTH	**3.6**

➔ENVIRONMENT STABILITY:

- **Technological Advancements and know-how**:

The core component of a bike is the internal combustion engine(IC engine) and the companies that are selling bikes have exclusive patent rights for it. There are developments of electric 2-wheelers going on, a few of the companies have launched Electric bikes but the traction for them is yet to happen. Even if some sort of disruption is to take place in EV space, Hero has already developed a platform for 2-wheelers in this space. Nevertheless, both companies have enough cash in bank (INR 3000 crores) to wither any changes. So, the score is **-2**.

- **Demand Variability:**

The automobile industry closely tracks the GDP numbers, which implies it is severely affected in times of recession. This is evident during the last six months, where GDP has de-grown to 5%; the numbers have come off drastically for some bike manufacturers.

Royal Enfield's sales have gone down by almost 19% and Hero's by 12%.

So, the score is **-5**.

- **Barriers to entry:**

1. Capital Intensive business.
2. Oligopoly like market structure. Market share concentrated in top three firms (80%).
3. Tough to set up extensive dealer networks.
4. Incumbent firms can lower the prices to force the potential entrants to severe losses.

So, the score is **-2.5**.

Factor	**Rating**
Technological Advancements	-2
Demand Variability	-5
Barriers to Entry	-2.5
ENVIRONMENTAL STABILITY	**-3.16**

➔FINANCIAL STRENGTH:

- **Return on Equity:**

  Return on Equity (ROI) is one of the most widely used parameter to measure the financial Performance of a company. It is calculated by dividing Net Income by Total Shareholder's Equity. Analysts use ROI to estimate Growth Rate.

Hero MotoCorp recorded average ROI of 33.36% over 29.33% average ROI by Royal Enfield. This shows that Hero MotoCorp is better utilising the Company's assets to create profits as compared to Royal Enfield.

Company	**Return on Investment** (3-Yr Avg)	**Score**
Hero MotoCorp	0.3336	5.5
Royal Enfield	0.2933	5

- **Return on Assets:**
  Return on Assets (ROA) is used to determine how profitable the company with respect to its Current and Non-Current Assets. It is calculated by dividing Company's Net Income by its Total Assets. Unlike ROI, which also measures the Company's profitability, ROA also takes the Company's debt into consideration.
  Average ROA for Hero MotoCorp was 22.52% which was not very different from ROA 22.88% of Royal Enfield. With respect to ROA, we can conclude that Performance of both companies is satisfactory.

Company	**Return on Assets** (3-Yr Avg)	**Score**
Hero MotoCorp	0.2252	5.8
Royal Enfield	0.2288	6

- **Financial Leverage**
  Financial Leverage is parameter to analyse the debt component of the Capital Structure of the Company and its ability to honour its financial obligations. It is calculated through Degree of Financial Leverage by dividing Change in Earning per Share (ΔEPS) by Change in Earnings before Interest and Taxes (ΔEBIT).

Company	**Financial Leverage** (3-Yr Avg)	**Score**
Hero MotoCorp	1.45	3
Royal Enfield	1.31	3.5

- **Book Value Growth**
  Book Value Growth is measured as the rate of increase the value of all the Assets of the Company.

Company	**Book Value Growth** (CAGR 5-Yr Avg)	**Score**
Hero MotoCorp	14.9%	4
Royal Enfield	24.8%	5.5

CAGR: Compound Annual Growth Rate

- **Asset Turnover Ratio**
  Asset Turnover Ratio is a measure of the value of the Company's Sales or Revenues with respect to the Value of its Total Assets. It measures how efficiently the Company is able to utilize its Assets in order to generate sales and revenue.
  The 3 Year Average Assets Turnover Ratio of Hero MotoCorp was 1.95 as compared to 1.03 Asset Turnover ratio of Royal Enfield. This reflects that Hero MotoCorp is more efficient in its production process as compared to Royal Enfield.

Company	**Asset Turnover Ratio** (3-Yr Avg)	Score
Hero MotoCorp	1.95	5
Royal Enfield	1.03	3.5

- **EBIT Margin**
  The Margin is calculated by dividing the Company's Earnings before Interest and Taxes to its Net Revenue earned. This is a measure of the Company's Operating Profitability over a specific period of time.

Company	**EBIT Margin** (3-Yr Avg)	Score
Hero MotoCorp	16.37%	4
Royal Enfield	30%	5.5

Factor	Hero MotoCorp Rating	Royal Enfield Rating
Return on Equity	5.5	5
Return on Assets	5.8	6
Financial Leverage	3	3.5
Book Value Growth	4	5.5
Assets Turnover Ratio	5	3.5
EBIT Margin	4	5.5
FINANCIAL STRENGTH	**4.55**	**4.83**

➔ COMPETITIVE ADVANTAGE:

- **Market Share:**

Hero MotoCorp is the Market Leader in bikes segment but it slowly losing some percentage points year on year due to many factors including introduction of new products by existing players in the market. Whereas, Royal Enfield is strengthening its competitive advantage by increasing the market share in the "niche" segment. The CAGR for Royal Enfield in the last five years stand at an amazing 18.5%.

	2014-15	2015-16	2016-17	2017-18	2018-19
Hero MotoCorp	52.8%	52.4%	51.1%	51.5%	50.69%
Royal Enfield	3%	4.7%	5.9%	6.35%	5.92%

So, Score for Hero MotoCorp is **-1.9**
Score for Royal Enfield is **-1.5**

- **Return on Invested Capital:**

Both the firms earn superior returns on invested capital and that implies these firms are protected by the threat of new entrants and other factors that might normalize the ROIC. It again proves the oligopolistic and the Porter's curve.

	2014-15	2015-16	2016-17	2017-18	2018-19
Hero MotoCorp	34.72%	36.12%	37.16%	31.86%	25.51%
Royal Enfield	18.16%	25.55%	30.91%	30.78%	26.02%

Average Return on Invested Capital for Hero MotoCorp is 33.07% and for Royal Enfield is 26.28%.

So, Score for Hero MotoCorp is **-1.6**
Score for Royal Enfield is **-2.3**

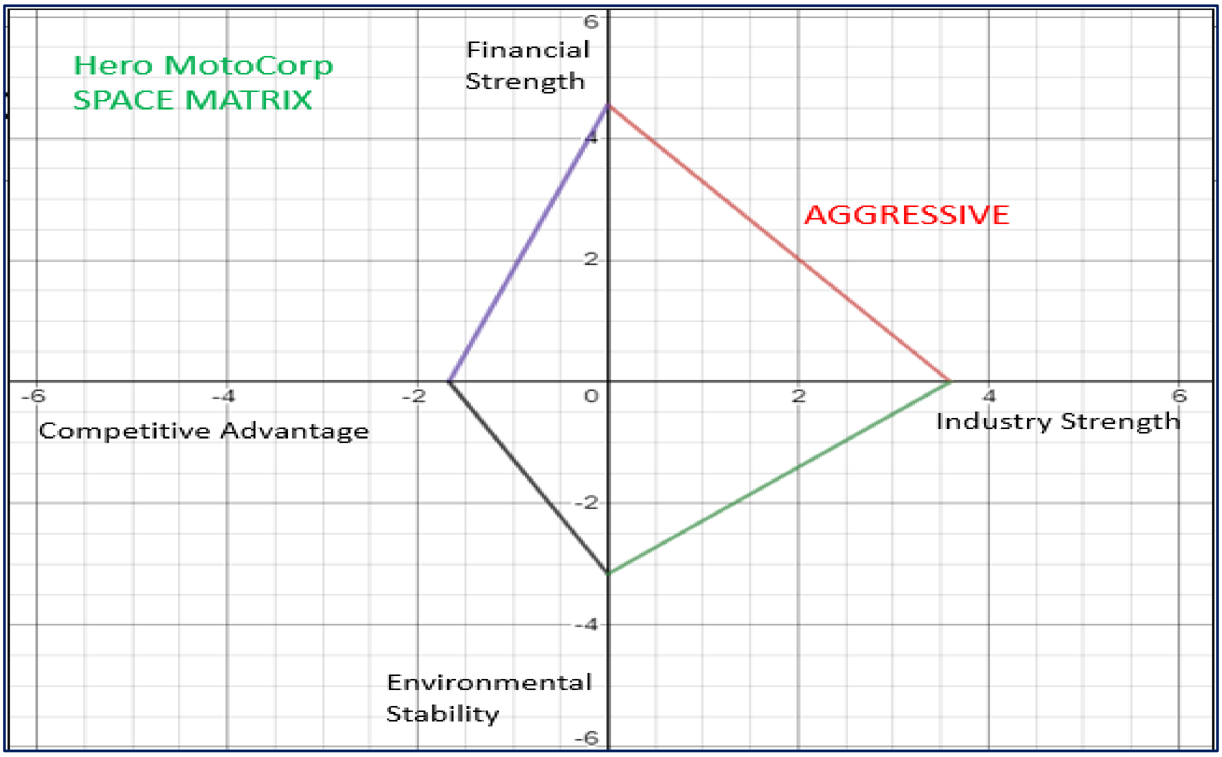
- **Barriers to Entry: (**specific to firms**)**

The motorcycle manufacturing business is a capital-intensive business, and potential entrants need vast amounts of capital to set-up plants, to advertise, to set-up dealer networks and after service centres and so on. In the volumes segment, it is very tough to take on 'Hero' because it benefits immensely from the economies of scale and experience; it has accumulated in the past three decades. It is not easy to compete with 'Royal Enfield' per se due to its excessive consumer loyalty. Nevertheless, it operates in a 'niche' segment; hence, some entrant can design and create a 'niche' and take the market share away from Enfield. However, on the contrary, Royal Enfield is strengthening its 'moat' by doubling the market share for the past 5-years!

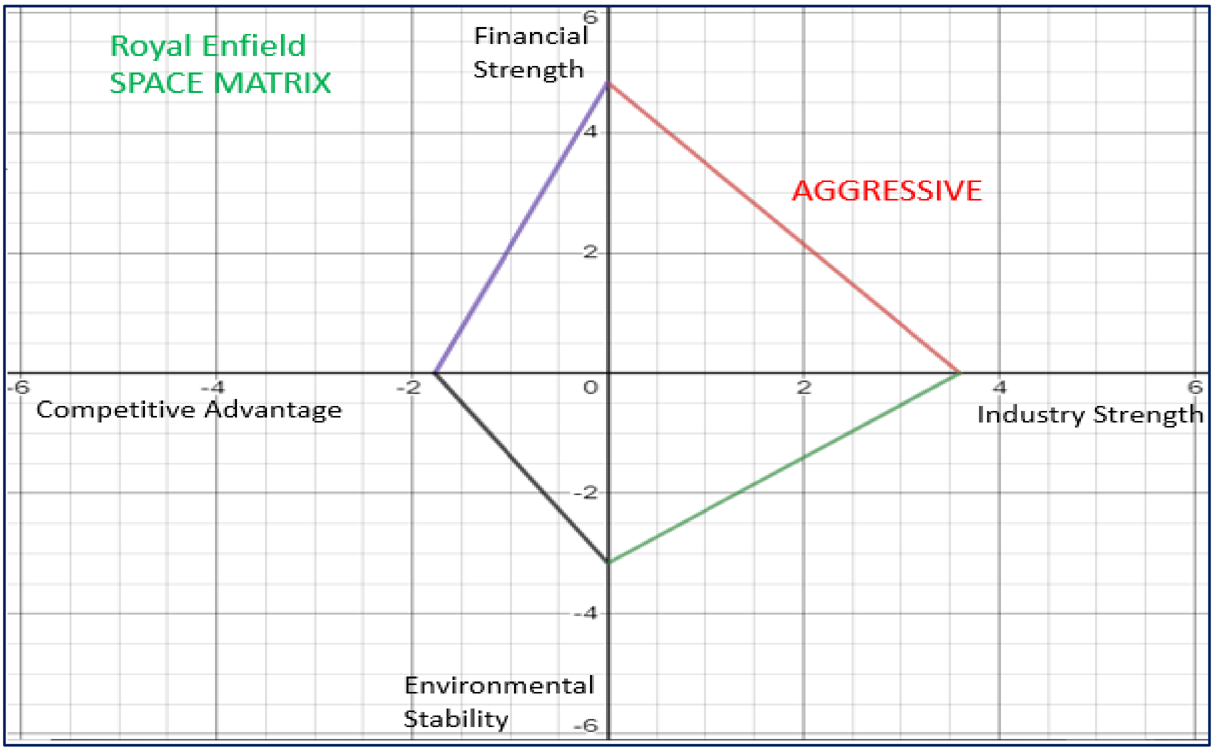
So, Score for Hero MotoCorp is **-1.5**
Score for Royal Enfield is **-1.5**

Factor	**Hero MotoCorp Rating**	**Royal Enfield Rating**
Market Share	-1.9	-1.5
Return on Invested Capital	-1.6	-2.3
Barriers to Entry	-1.5	-1.5
COMPETITIVE ADVANTAGE	**-1.67**	**-1.77**

SPACE MATRIX FOR HERO MOTOCORP



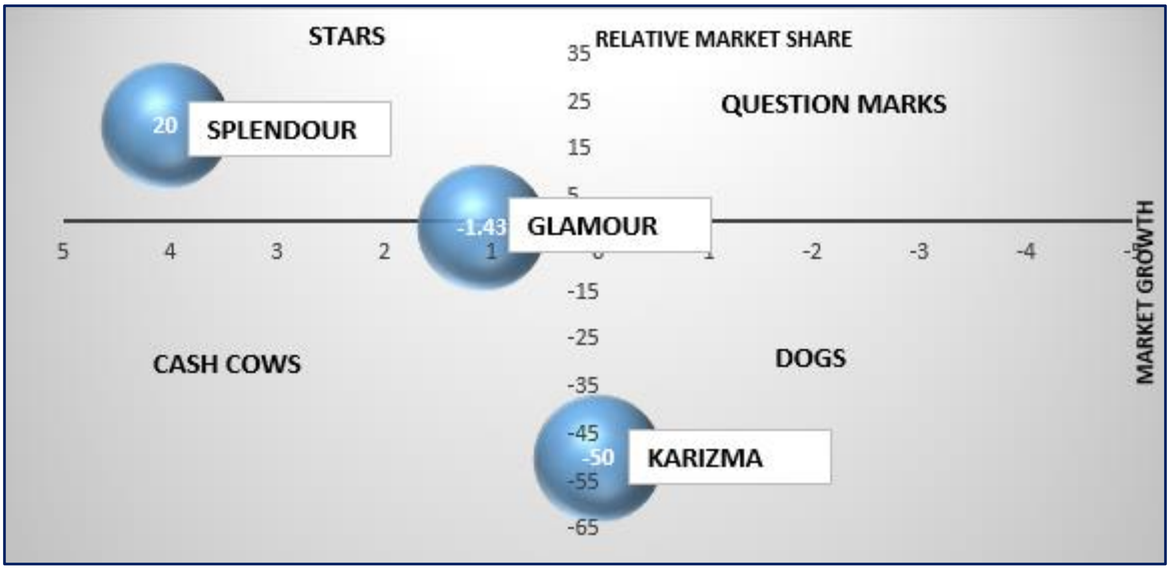
SPACE MATRIX FOR ROYAL ENFIELD



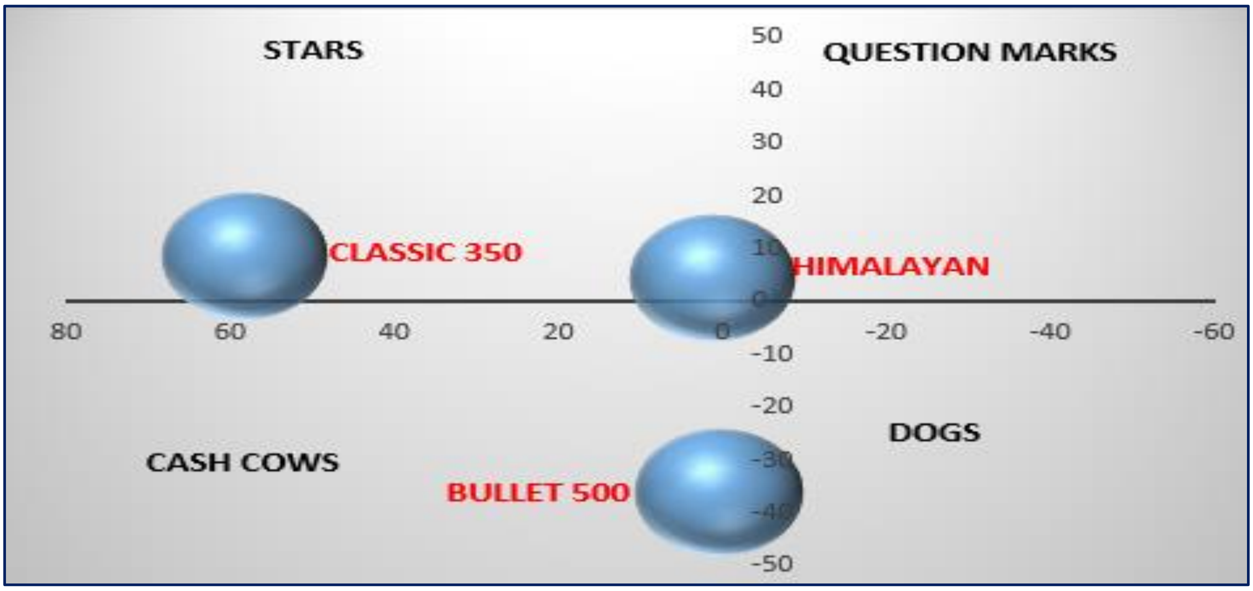
4.) BCG MATRIX:

Every company has different product units and some stand out due to their enormous success and some die out. It is the job of the company to figure where it wants to **allocate capital**, either to generate **superior returns in the future by investing in the growth areas** or **return it to the shareholders**. It also has to decide which **segments have to be divested**; the products that are dragging down the returns and are a cash-burning machine. This is an extremely important aspect of strategic analysis.

➔**BCG MATRIX FOR HERO MOTOCORP LIMITED**:



➔ **BCG MATRIX FOR ROYAL ENFIELD:**



REFERENCES:

1. “Competitive Strategy” by Michael E. Porter c1980.
2. “Business Analysis and Valuation Using Financial Statements (5th edition)” by Krishna G. Palepu and Paul M. Healy.
3. https://www.hdfcbank.com/assets/pdf/privatebanking/Sector-Update-Auto-Two-Wheeler-Industry-Jan-2019.pdf
4. http://www.differentiateyourbusiness.co.uk/space-analysis-strategic-position-and-action-evaluation-matrix
5. http://www.autopunditz.com/news/fy19-sales-analysis-two-wheelers/
6. https://www.autocarpro.in/analysis-sales/bajaj-auto-biggest-2w-market-share-gainer-in-fy2019-42685
7. Annual Reports and Investor Presentations of Hero MotoCorp Limited.
8. Annual Reports and Investor Presentation of Eicher Motors Limited.