

Hero Honda Motors

STOCK INFO.	BLOOMBERG
BSE Sensex: 9,849	HH IN
	REUTERS CODE
S&P CNX: 2,975	HROH.BO

30 January 2006

Buy
Rs851
Previous Recommendation: Buy

Equity Shares (m)	199.7
52-Week Range	887/480
1,6,12 Rel. Perf. (%)	-6/10/8
M.Cap. (Rs b)	169.9
M.Cap. (US\$ b)	3.9

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
3/05A	74,217	8,105	40.6	11.3	21.0	11.4	54.3	67.7	2.0	13.0
3/06E	87,952	9,740	48.8	20.2	17.4	8.7	49.9	63.9	1.7	10.9
3/07E	103,580	11,593	58.1	19.0	14.7	6.9	46.9	61.5	1.4	8.8

Hero Honda's net profit increased by 19.6% YoY to Rs2.6b, in line with our estimate. Net revenues grew 15.6% YoY, ahead of volume growth of 12.1%. Realizations increased 3% YoY despite the company offering a discount of Rs1,000 on all models. EBITDA margin increased to 16.3% (up 80bp YoY and 90bp QoQ).

Hero Honda would be a major beneficiary of the strong growth in two-wheeler demand over the next few years. Good response to its new products would further strengthen its position in the executive segment. We expect the company to record 17% CAGR in net revenues and 18% CAGR in earnings over FY05-08, with volumes likely to see 16% CAGR. We expect EPS to increase from Rs40.5 in FY05 to Rs66.4 in FY08.

We marginally increase our earnings estimates for FY06, FY07 and FY08 to Rs48.8 (up 1.5%), Rs58.1 (up 2.3%) and Rs66.4 (up 3.1%), respectively. The stock trades at a P/E of 14.7x and 12.8x; EV/EBITDA of 8.8x and 7.5x; and P/BV of 6.9x and 5.8x on FY07E and FY08E earnings. We re-iterate **Buy** with a target price of Rs982.

QUARTERLY PERFORMANCE										(Rs Million)
Y/E MARCH	FY05				FY06				FY05	FY06E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Total Volumes (nos)	609,123	614,796	712,062	685,419	687,567	742,425	798,301	827,531	2,621,400	3,055,824
Net Sales	17,223	17,572	20,019	19,403	19,771	21,663	23,148	23,371	74,217	87,952
Change (%)	30.1	39.3	26.6	15.5	14.8	23.3	15.6	20.4	27.3	18.5
Total Expenses	14,369	14,823	16,910	16,471	16,848	18,327	19,367	19,540	62,572	74,082
EBITDA	2,855	2,749	3,109	2,932	2,923	3,336	3,781	3,831	11,645	13,870
As % of Sales	16.6	15.6	15.5	15.1	14.8	15.4	16.3	16.4	15.7	15.8
Change (%)	33.8	32.1	15.3	2.7	2.4	21.3	21.6	30.7	18.9	19.1
Other Income	229	411	413	358	306	431	360	561	1,411	1,658
Interest	-2	-3	-2	-4	3	-8	-11	28	-11	12
Depreciation	205	208	217	264	250	267	324	280	894	1,122
PBT	2,881	2,955	3,307	3,031	2,975	3,508	3,827	4,085	12,173	14,395
Tax	980	1,011	1,118	960	937	1,129	1,209	1,380	4,068	4,654
Effective Tax Rate (%)	34.0	34.2	33.8	31.7	31.5	32.2	31.6	33.8	33.4	32.3
PAT	1,901	1,944	2,189	2,070	2,039	2,379	2,618	2,704	8,105	9,740
Change (%)	20.5	24.2	8.0	-2.0	7.2	22.4	19.6	30.6	11.3	20.2

E: MOST Estimates

Volume growth: momentum continues

Hero Honda reported a 12% growth in volumes to 798,301 units in 3QFY06. This follows a 16.8% growth during 1HFY06. We expect the company to sell 275,000 units per month in 4QFY06 as against the management guidance of 300,000 units per month.

SALES VOLUME (UNITS)

	3QFY06	3QFY05	% GR.	FY06YTD	% GR.
Bikes-Total	798,301	712,062	12.1	2,228,293	15.1
Domestic	778,361	695,349	11.9	2,155,479	13.9
Exports	19,940	16,713	19.3	72,814	67.6

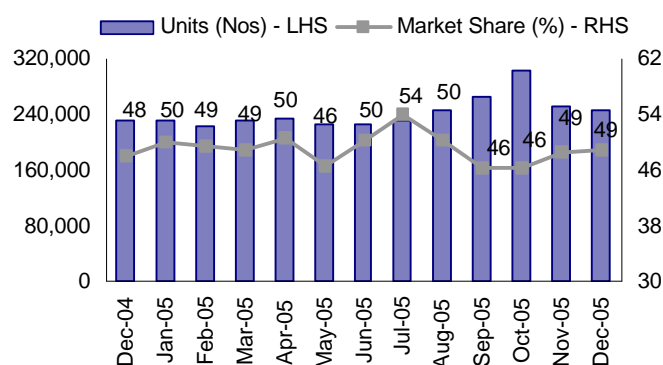
Source: Company/Motilal Oswal Securities

Hero Honda has recently launched a new ungeared scooter – Pleasure, targeted at women and senior citizens. The management expects to sell about 120,000 units in FY07. (We have factored sales of 20,000 units in FY07).

Market share: down marginally

Hero Honda’s market share in the domestic motorcycle market for the nine months ended December 2005 stood at 48.8% – down 120bp as compared to its share for the year ended March 2005. It has lost market share to Bajaj Auto, which has been growing at almost twice the industry growth rate. However, we expect Hero Honda to maintain its share at close to 50% over FY06-08.

MONTHLY MARKET SHARE MOVEMENT

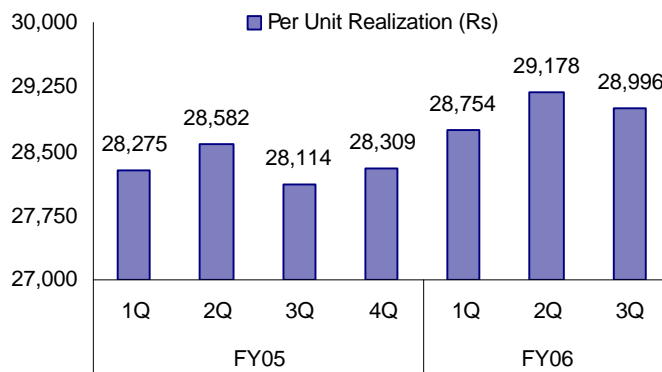


Source: Company/Motilal Oswal Securities

Realizations: up 3% YoY

In 3QFY06, Hero Honda’s realizations increased by 3.1% YoY (but fell by 0.6% QoQ) to Rs28,996/unit mainly on account of improved product mix.

BETTER PRODUCT MIX DRIVING UP REALIZATIONS

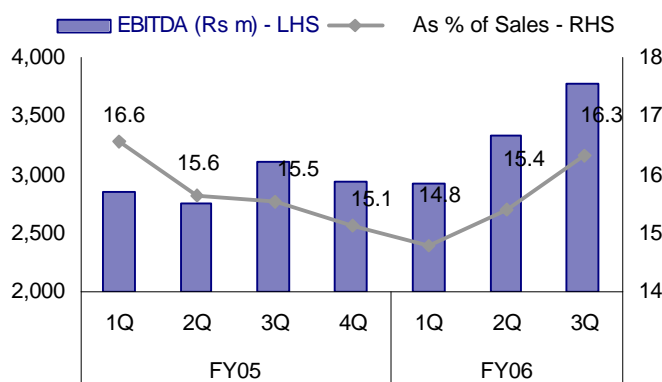


Source: Company/Motilal Oswal Securities

EBITDA margins: bounce back to 16%

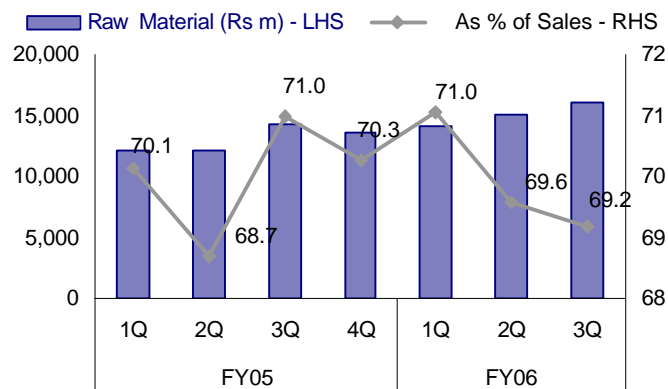
Hero Honda recorded EBITDA margins of 16.3% for 3QFY06 – up 80bp YoY and 90bp QoQ. Raw material cost, which constituted 71% of sales in 3QFY05 and 69.6% of sales in 2QFY06, declined to 69.2%. Also other expenditure and staff cost as a percentage of sales were lower by 30bp and 40bp, respectively on a QoQ basis. We expect the current margins to be sustained on account of continuing cost rationalization measures, volume growth (on high base) and better product mix.

SHARP IMPROVEMENT IN EBITDA MARGINS



Source: Company/Motilal Oswal Securities

RAW MATERIAL COSTS SOFTENING



Source: Company/Motilal Oswal Securities

Net earnings: up 20% YoY

Hero Honda's net earnings increased by 19.6% YoY to Rs2.6b, in line with our expectations despite lower other income and higher depreciation (up 49% YoY and 22% QoQ). Sales grew 15.6% in value terms to Rs23.1b, ahead of volume growth of 12.1%. Average realizations improved 3% YoY.

Growth outlook remains positive

We expect the secular double-digit growth in two-wheeler volumes to continue unabated. Not only is there plenty of scope to increase motorcycle penetration, the target audience too is rising rapidly. The top two players in the industry – Hero Honda and Bajaj Auto are now truly global

sized players and have been increasing their stranglehold in a virtual duopoly.

Hero Honda is best placed to benefit from the strong momentum in the two-wheeler industry. Consider the following:

- ✍ Market leader in the motorcycle segment, with a market share of 50%
- ✍ Well entrenched in rural and semi-urban areas (about 60% of sales) and enjoys very strong brand equity
- ✍ Most consistent operating history; huge free cash flows and negative working capital employed should ensure that growth is non-dilutive

Valuation and view

We marginally increase our earnings estimates for FY06, FY07 and FY08 to Rs48.7 (up 1.5%), Rs58.1 (up 2.3%) and Rs66.4 (up 3.1%), respectively. The company is expected to have cash per share of Rs127 in FY07 and Rs146 in FY08. The stock trades at a P/E of 14.7x and 12.8x; EV/EBITDA of 8.8x and 7.5x; and P/BV of 6.9x and 5.8x on FY07E and FY08E earnings. We re-iterate **Buy** with a target price of Rs982.

SOTP VALUATION (RS PER SHARE)	FY07
Core EPS	52.2
Multiple	16.4
Value	855
Cash per Share	127
Price Target	982

Source: Company/Motilal Oswal Securities

Hero Honda: an investment profile

Company description

Hero Honda is the largest two-wheeler company in the world, with revenues of more than US\$1.6b. It sells over 2m motorcycles a year. It is a JV between Honda Corporation, Japan and the Munjal family, each owning 26% stake. Hero Honda has a dealership network of over 500, with close to 70% of sales coming from rural India.

Key investment arguments

- Hero Honda's substantial presence in rural India insulates it from the onslaught of the competition.
- The market is upgrading to the 125cc and Hero Honda is best positioned to capitalise on it.

Key investment risks

- There have been several new launches by competitors in the past three months. Suzuki is planning to launch its 125cc products shortly. Yamaha has also announced a huge capex for India. Hence, competition is set to intensify.
- Any inroad by Bajaj Auto in the executive segment, where Hero Honda currently has a 55-60% market share.

Recent developments

- Hero Honda made an entry in the scooter segment with the 'Pleasure'
- Hero Honda is expanding capacity at its existing plants by 15% to 3.8m units p.a.
- Competition has launched several new products in the past 3 months - the TVS Apache 150cc, Bajaj Auto Discover 110cc, etc.

Valuation and view

- We marginally increase our earnings estimates for FY06, FY07 and FY08 to Rs48.8 (up 1.5%), Rs58.1 (up 2.3%) and Rs66.4 (up 3.1%), respectively.
- We re-iterate **Buy** with a target price of Rs982 based on SOTP valuation

Sector view

- Numerous motorcycle launches will lead to an increase in competition.
- Despite a large number of players, market share remains concentrated amongst the top two.
- We maintain an Overweight stance on the sector.

COMPARATIVE VALUATIONS

		HERO HONDA	TVS MOTORS	BAJAJ AUTO
P/E (x)	FY06E	17.4	18.6	20.5
	FY07E	14.7	15.1	16.2
EPS Gr (%)	FY06E	20.2	2.5	43.2
	FY07E	19.0	23.3	26.4
RoE (%)	FY06E	49.9	18.1	22.5
	FY07E	46.9	19.5	23.4
EV/EBITDA (x)	FY06E	10.9	11.6	13.7
	FY07E	8.8	9.0	10.6

SHAREHOLDING PATTERN (%)

	DEC.05	SEP.05	DEC.04
Promoters	55.0	55.0	55.0
Domestic Institutions	8.3	8.0	8.1
FII's/FDIs	26.8	27.1	26.0
Others	9.9	9.9	10.9

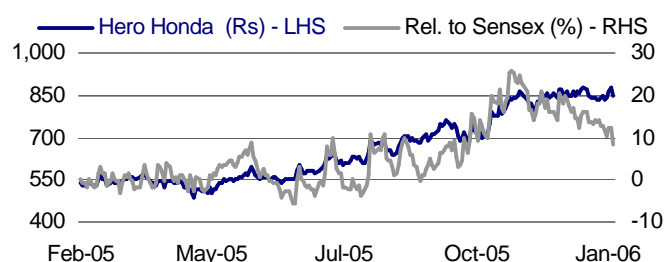
EPS: INQUIRE FORECAST VS CONSENSUS (RS)

	INQUIRE FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY06	48.8	47.4	2.9
FY07	58.1	53.7	8.1

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
851	982	15.4	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)				
Y/E MARCH	2004	2005	2006E	2007E	2008E	
Net Sales	58,324	74,217	87,952	103,580	119,261	
Change (%)	14.3	27.2	18.5	17.8	15.1	
Total Income	58,324	74,217	87,952	103,580	119,261	
Raw Material	40,306	51,996	61,522	72,143	82,886	
Employee Cost	2,315	2,680	3,149	3,729	4,353	
Other Mfg. Expenses	2,518	3,154	3,650	4,350	5,069	
Selling & Distribution	3,384	4,741	5,761	6,784	7,871	
EBITDA	9,801	11,645	13,870	16,573	19,082	
Change (%)	13.5	18.8	19.1	19.5	15.1	
% of Net Sales	16.8	15.7	15.8	16.0	16.0	
Depreciation	733	894	1,122	1,219	1,315	
Interest & Finance Charges	-14	-11	12	12	12	
Other Income	1,650	1,410	1,658	1,707	1,757	
PBT	10,725	12,173	14,395	17,049	19,512	
Tax	3,441	4,068	4,654	5,456	6,244	
Effective Rate (%)	32.1	33.4	32.3	32.0	32.0	
PAT	7,283	8,105	9,740	11,593	13,268	
% of Net Sales	12.5%	10.9%	11.1%	11.2%	11.1%	
Adj. PAT	7,283	8,105	9,740	11,593	13,268	
Change (%)	25.4%	11.3%	20.2%	19.0%	14.4%	

BALANCE SHEET		(Rs Million)				
Y/E MARCH	2004	2005	2006E	2007E	2008E	
Share Capital	399	399	399	399	399	
Reserves	10,989	14,534	19,112	24,329	28,973	
Net Worth	11,388	14,934	19,512	24,729	29,373	
Deferred Tax	900	1,015	1,015	1,015	1,015	
Loans	1,747	2,018	2,018	2,018	2,018	
Capital Employed	14,035	17,967	22,545	27,762	32,405	
Gross Fixed Assets	9,169	11,042	12,700	13,950	14,950	
Less: Depreciation	3,458	4,297	5,419	6,638	7,953	
Net Fixed Assets	5,711	6,745	7,281	7,312	6,997	
Capital WIP	177	409	0	0	0	
Investments	15,651	20,267	20,267	20,267	20,267	
Curr.Assets, L & Adv.	5,090	5,545	7,209	13,198	18,792	
Inventory	1,882	2,043	2,892	3,405	4,901	
Sundry Debtors	438	896	1,446	2,270	2,614	
Cash & Bank Balances	371	176	473	5,127	8,879	
Loans & Advances	2,399	2,396	2,399	2,396	2,399	
Current Liab. & Prov.	12,601	15,005	12,219	13,022	13,657	
Sundry Creditors	6,190	6,503	7,711	8,513	9,149	
Other Liabilities	3,849	3,655	3,655	3,655	3,655	
Provisions	2,562	4,847	853	853	853	
Net Current Assets	-7,511	-9,459	-5,010	177	5,135	
Application of Funds	14,035	17,967	22,545	27,762	32,405	

E: MOST Estimates

RATIOS						
Y/E MARCH	2004	2005	2006E	2007E	2008E	
Basic (Rs)						
EPS	36.5	40.6	48.8	58.1	66.4	
Cash EPS	40.1	45.1	54.4	64.2	73.0	
Book Value per Share	57.0	74.8	97.7	123.8	147.1	
DPS	20.0	20.0	25.0	32.0	43.0	
Payout (Incl. Div. Tax) %	54.8	49.3	53.0	55.0	65.0	
Valuation (x)						
P/E		21.0	17.4	14.7	12.8	
Cash P/E		18.9	15.6	13.3	11.7	
EV/EBITDA		13.0	10.9	8.8	7.5	
EV/Sales		2.0	1.7	1.4	1.2	
Price to Book Value		11.4	8.7	6.9	5.8	
Dividend Yield (%)		2.4	2.9	3.8	5.1	
Profitability Ratios (%)						
RoE	64.0	54.3	49.9	46.9	45.2	
RoCE	76.4	67.7	63.9	61.5	60.2	
Turnover Ratios						
Debtors (Days)	3	4	6	8	8	
Asset Turnover (x)	4.2	4.1	3.9	3.7	3.7	
Leverage Ratio						
Debt/Equity (x)	0.2	0.1	0.1	0.1	0.1	

CASH FLOW STATEMENT		(Rs Million)				
Y/E MARCH	2004	2005	2006E	2007E	2008E	
OP/(Loss) before Tax	9,068	10,751	12,748	15,353	17,767	
Interest/Div. Received	1,650	1,410	1,658	1,707	1,757	
Depreciation & Amort.	733	894	1,122	1,219	1,315	
Direct Taxes Paid	-3,313	-3,953	-4,654	-5,456	-6,244	
(Inc)/Dec in Working Capital	1,247	1,754	-4,153	-533	-1,207	
CF from Oper. Activity	9,387	10,857	6,721	12,291	13,388	
(Inc)/Dec in FA+CWIP	-1,451	-2,159	-1,250	-1,250	-1,000	
(Pur)/Sale of Invest.	-3,721	-4,616	0	0	0	
CF from Inv. Activity	-5,172	-6,775	-1,250	-1,250	-1,000	
Changes in Reserves	-512	-565	0	0	0	
Inc/(Dec) in Debt	404	271	0	0	0	
Interest Paid	14	11	-12	-12	-12	
Dividends Paid	-3,994	-3,994	-5,162	-6,376	-8,624	
CF from Fin. Activity	-4,088	-4,278	-5,174	-6,388	-8,636	
Inc/(Dec) in Cash	128	-195	297	4,653	3,752	
Add: Beginning Balance	243	371	176	473	5,127	
Closing Balance	371	176	473	5,127	8,879	

E: MOST Estimates



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Hero Honda Motors

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| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | Yes |
| 3. Broking relationship with company covered | No |

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