Equity | India | Autos & Components

RBS The Royal Bank of Scotland

19 October 2011

Produced by: The Royal Bank of Scotland N.V., (India) Office

Hero Motocorp

Margins bounce back

Buy

Target price
Rs2416.50 (from Rs2157.90)

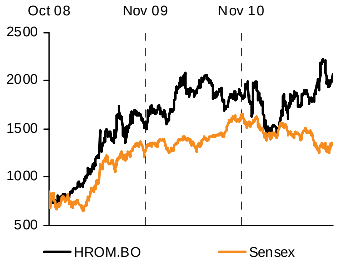
Price
Rs2066.90

Short term (0-60 days)
n/a

Market view
Underweight

Price performance

	(1M)	(3M)	(12M)
Price (Rs)	2201	1792	1837
Absolute (%)	-6.1	15.4	12.5
Rel market (%)	-8.0	25.9	31.6
Rel sector (%)	-5.5	38.9	17.9



Market capitalisation
Rs412.74bn (US$8.39bn)

Average (12M) daily turnover
Rs1175.71m (US$26.22m)

Sector: BBG AP Autos
RIC: HROM.BO, HMCL IN
Priced Rs2066.90 at close 19 Oct 2011.
Source: Bloomberg

2Q recorded a sharp EBIT margin recovery (after a 7-quarter dip) on the back of lower raw material costs and strong pricing power. Building rupee depreciation, we raise our EPS forecasts 4-5%. Buy as we believe that HMCL is a better play on strong rural demand and softening commodity prices, new TP at Rs2416.50.

Key forecasts

	FY10A	FY11A	FY12F	FY13F	FY14F
Revenue (Rsm)	158,605	194,012	238,836	277,343	310,702
EBITDA (Rsm)	27,643	26,170	38,528 ▲	45,158 ▲	51,029 ▲
Reported net profit (Rsm)	22,318	20,077	25,568	30,005 ▲	33,018
Normalised net profit (Rsm)[1]	22,318	20,077	25,568	30,005	33,018
Normalised EPS (Rs)	111.8	100.5	128.0	150.2 ▲	165.3
Dividend per share (Rs)	110.0	105.0	60.00 ▲	70.00 ▲	80.00 ▲
Dividend yield (%)	5.32	5.08	2.90	3.39	3.87
Normalised PE (x)	18.49	20.56	16.14	13.76	12.50
EV/EBITDA (x)	12.80	13.80	9.94	8.12	6.85
Price/book value (x)	11.90	14.00	10.30	7.65	6.03
ROIC (%)	465.8	-83.3	-455	139.5	336.2

Use of ▲ ▼ indicates that the line item has changed by at least 5%.
year to Mar, fully diluted
1. Post-goodwill amortisation and pre-exceptional items
Accounting standard: Local GAAP
Source: Company data, RBS forecasts

Results deliver on management's margin-expansion promise

For 2QFY12, Hero Motocorp Ltd (HMCL) achieved significant milestones: a successful brand change from Hero Honda to Hero Motocorp with significant promotion, historically high sales volume and reversal of a seven-quarter sliding trend in its EBIT margin. The results surprised us, with a huge 16% on EBIT and 21% on normalised PAT, driven by a 220bp reduction in raw material costs as a percentage of net sales, as well as vehicle price hikes (1.5% qoq) offsetting higher royalty charges towards rupee deprecation. Normalised EPS for the quarter is Rs33.2, representing growth of 31% yoy and 19% mom adjusted for a Rs600m one-time brand-change cost.

We raise our EPS forecasts, already higher than consensus, an additional 4-5%

Bloomberg consensus EPS for FY12 was nearly 9% below our forecast (pre-results). Given better-than-expected results, we believe consensus will catch up with our estimates soon. Building in an earlier-than-expected margin revival, continued strong rural demand and easing commodity prices, we raise our FY12F and FY13F EPS 4% and 5%, respectively. The mark to market of fixed royalty payments for rupee depreciation limits our EPS upgrade. We increase our dividend payout forecast to 50-55% from 35% to reflect management guidance, leading to an attractive dividend yield of 3% for FY12F.

Better defensive rural play, we recommend Buy and raise our target price

With split concerns (from Honda) easing and successful brand transformation, the stock has outperformed impressively (by 21% for past three months). With nearly 45% of sales coming from rural demand and EBIT margins starting a recovery path after a nearly 40% contraction in the past seven quarters, we think it offers the best defensive rural play in the Indian basket of stocks. On our revised EPS, the stock trades at an attractive valuation of 13.8x FY13F with an EPS CAGR of 22% for FY11-13F. We recommend Buy and raise our DCF-based TP to Rs2,416.5 (from Rs2157.90), at which the stock would trade at 16.1x FY13F.

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Important disclosures can be found in the Disclosures Appendix.

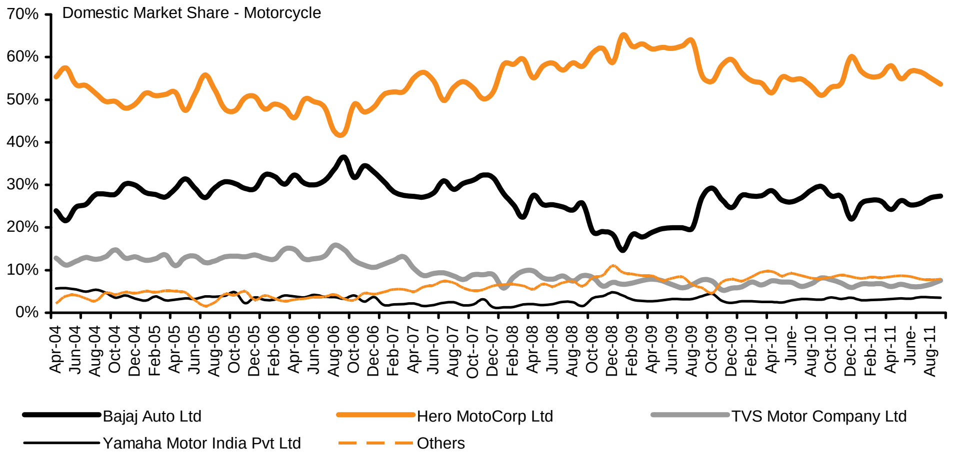
EBIT margins start their recovery journey

EBIT margins have begun to recover after a nearly seven-quarter slide (40%). Given pricing action supported by easing commodity prices, management believes it can be sustained. We raise our EPS forecasts 4-5%. Buy, as consensus catches up with our estimates.

Highest sales volume ever, but market share slid on capacity constraints

Hero registered 20% yoy and 1% qoq growth in its sales volumes during 2QFY12 – its strongest quarter ever. In September, it passed 0.5m motorcycles in a month for the first time. However, despite the strong volume numbers, its market share in 2Q slid 255bp qoq to 44.2%, due mainly to capacity constraints. Furthermore, Honda Motors (HMSI) and TVS kept gaining market share in the fast-growing scooter sub-segment during the quarter. We believe the upcoming launch of its new 110cc un-geared Scooter *Maestro,* targeted specifically to the male population, should enable Hero to bounce back in this sub-category.

Chart 1 : Domestic 2-wheeler industry market share trend



Source: SIAM

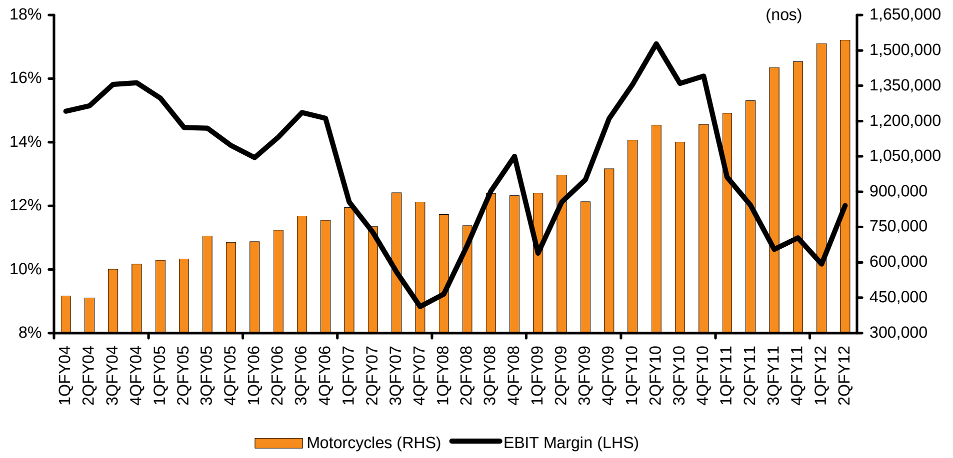
2QFY12 results surprise by 15% on EBIDTA on lower raw material costs

In our view, the key highlights of the 2Q results are as follows.

- Net sales of Rs58.3bn, up 28.1% yoy and up 2.6% qoq. Our forecast was Rs58.1bn.
- Management said most of the total re-branding budget of Rs1bn was incurred during the 2Q and the remainder will be spent in 3Q. However, it declined to give the actual amount spent in the 2Q. Being conservative, we assume it to be at Rs600m and treat it as one-time cost.
- The normalised EBITDA margin rose 240bp qoq to 16.8% as raw material expenses as a percentage of sales dropped 223bp qoq to 72.5% on pricing action taken in last week of 1Q and softening commodity prices. Our normalised EBITDA margin forecast was 14.6%.
- Normalised EBITDA was Rs9.8bn, up 19.7% qoq. Our forecast was Rs8.5bn, hence the result surprised us by 15.5% and consensus by 27.3%.
- Given that the accounting policy for fixed royalty payments changed in 4QFY11, we compare Hero Motocorp's results on an EBIT basis for yoy comparison.
- The normalised EBIT margin was 11.0%, flat yoy and up 184bp qoq. Our forecast was 10.4%. The yen impact on royalty payments dampened EBIT margins to the tune of about 45bp.
- Normalised EBIT improved 28% yoy and 21.2% qoq to Rs7.0bn, 16.2% above our forecast of Rs6.0bn.
- 'Other income' was Rs798m, up 1.8% yoy but down 9.8% qoq. Our forecast was Rs550m.

- Depreciation expense was Rs2.79bn, up 16% qoq, driven by the yen volatility impact on royalty payments of Rs272m. Our forecast was Rs2.45bn.
- Normalised PBT was Rs7.85bn, up 25.0% yoy and up 17.2% qoq. Our forecast was Rs6.63bn.
- The tax rate came at 15.4%, versus our forecast of 17.1% and 16.7% in the 1Q.
- Normalised PAT was Rs6.64bn, up 31.3% yoy and up 19.0 qoq. Our forecast was Rs5.50bn, with the result representing a surprise of 20.8%.
- Reported PAT was Rs6.04bn, up 19.4% yoy and up 8.2% qoq.
- Normalised EPS was Rs33.2 for the quarter and Rs61.2 in 1HFY12.

Chart 2 : Quarterly EBIT margin and sales volume trend



Source: Company data

Conference call highlights

- Management expects EBITDA margin expansion to continue in the coming quarters due to commodity prices softening from 2Q levels.
- Management said most of the total re-branding budget of Rs1bn was incurred during 2Q and the remainder will be spent in 3Q. However, it declined to give the actual amount spent in 2Q. The total amount spent was expensed in the quarter.
- Management clarified that the company didn't hedge its yen exposure (on account of royalty payments to Honda) because it believed that over the payment period of about three and half years, there would be no benefits of hedging this exposure. The deal is structured with USD-yen conversion at 80, at which level management takes hedges at regular intervals.
- The current installed capacity is at 6.1m per annum, but management said actual production capacity is 6.4m-6.5m vehicles per annum, which it expects to increase to 7m by end-FY12. Management plans to increase its scooter production to 50,000 per month from the current 35,000 per month in the coming months.
- Management noted that plans to build a new greenfield plant is almost finalised and its expects the new plant to begin its production by the end of 3QFY13. It further stated that the cost to set up the 1.5m-vehicle-capacity plant would be about Rs10bn.
- The company has begun to dispatch the country's first on-road/off-road bike, *Impulse*. The 150cc bike is priced at Rs66,800 (ex showroom Delhi). Management said it is looking for a low-volume niche positioning for this product.
- The company plans to launch the new *Maestro* scooter by the end of this quarter, which we believe should enable the company to compete more efficiently in the fast-growing scooter sub-segment.
- Management said the company expects to increase its dealer base to 5,000 by the end of FY12, from 4,500 as at the end of FY11.

- On export plans, management noted that it has chalked out the strategic road map for its entry into various exports markets (namely Latin America, Africa and South East Asia). The company is targeting 1m vehicle exports in the next five to six years, representing 10% of its total sales volume by then.

We raise our EPS forecasts 4-5% as a result of the impressive results

We build in the following factors for our EPS revisions.

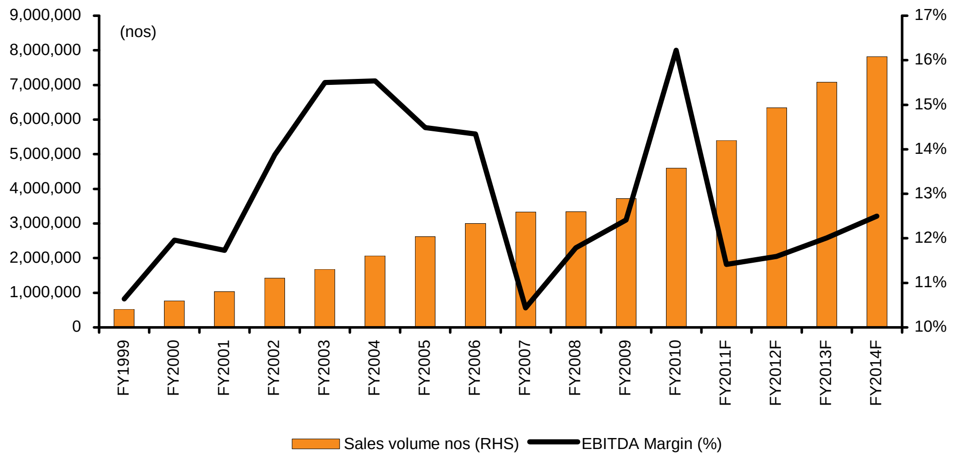
- Capacity constraint limits sales volume growth, so we marginally trim our volume estimate.
- Better-than-expected EBIT in 2Q prompts us to raise our EBIT margin forecast.
- We marginally raise our 'other income' forecast, as the dividend payout will ease investment book.
- We increase our tax rate forecast for FY13, because new plant production may not qualify for tax breaks, as was evident in the case of the Haridwar plant.

Table 1 : EPS revisions summary

	FY12F		FY13F	
	Old	Revised	Old	Revised
Sales volume (nos)	6,374,898	6,340,414	7,092,432	7,083,301
Upgrade/(downgrade)		-0.5%		-0.1%
Net sales (Rsm)	239,401	238,836	270,781	277,343
Upgrade/(downgrade)		-0.2%		2.4%
EBIT (Rsm)	26,521	27,694	31,030	33,308
Upgrade/(downgrade)		4.4%		7.3%
PAT(Rsm)	24,591	25,568	28,520	30,005
Upgrade/(downgrade)		4.0%		5.2%
EPS(Rsm)	123.1	128.0	142.8	150.2
Upgrade/(downgrade)		4.0%		5.2%

Source: RBS forecasts

Chart 3 : EBIT margin recovery impressive, but short of historical mean margins



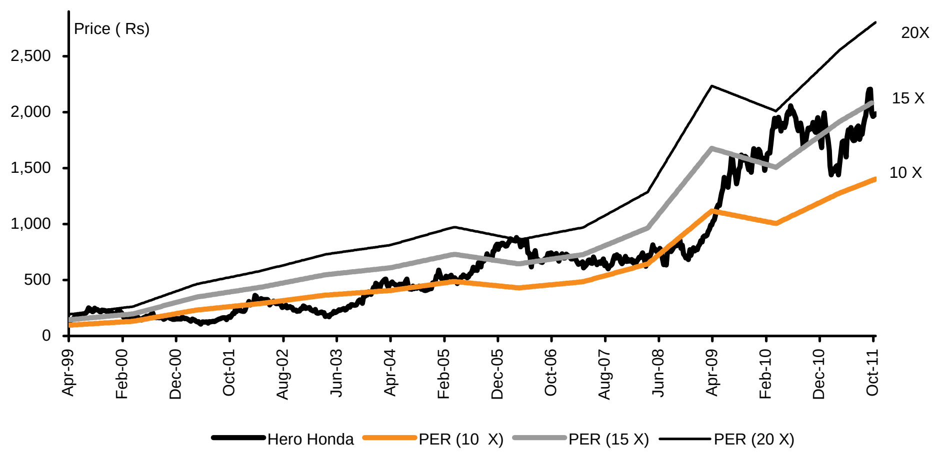
Source: Company data, RBS forecasts

We raise our TP 12% to Rs2,416.50 as the valuation still looks attractive to us

We raise our target price 12% to Rs.2,416.50 (from Rs2157.90) on EPS upgrades and improved dividend-payout forecasts. We believe the company will maintain a dividend-payout ratio at upward of 50% in FY12-14, which would result in a healthy dividend yield in the range of 3-4% for these years at the current market price. The cash flow yield is also expected by us to rise to 8.2% by FY13 from 4.6% in FY11, showing the company's cash-generation capabilities. The following PE band chart shows the upside potential from current levels as EPS upgrades should follow the impressive 2QFY12 results.

However, limited visibility on the outlook for the new plant (still in planning stage) limits our volume growth forecasts for FY14 and beyond, resulting in a limited revision to our target price.

Chart 4 : 1-year-forward PE band chart



Source: Company data, RBS forecasts, Bloomberg

Volume and operating assumptions

Table 2 : Key assumptions

Vehicle sales volume (units)	FY09	FY10	FY11	FY12F	FY13F	FY14F
Motorcycle	3,565,790	4,385,858	5,040,971	5,840,414	6,433,237	7,017,064
Growth (%)	10.3%	23.0%	14.9%	15.9%	10.2%	9.1%
Scooter	156,210	214,272	361,473	500,000	650,064	800,000
Growth (%)	49.0%	37.2%	68.7%	38.3%	30.0%	23.1%
Total	3,722,000	4,600,130	5,402,444	6,340,414	7,083,301	7,817,064
Growth (%)	11.5%	23.6%	17.4%	17.4%	11.7%	10.4%
Net realisation per vehicle (Rs)						
Motorcycle	34,324	34,539	36,049	37,385	38,500	39,000
Growth (%)	0.5%	0.6%	4.4%	3.7%	3.0%	1.3%
Scooter	30,772	31,388	33,271	35,267	36,678	37,411
Growth (%)	1.0%	2.0%	6.0%	6.0%	4.0%	2.0%
Total	34,175	34,392	35,863	37,218	38,333	38,837
Growth (%)	0.4%	0.6%	4.3%	3.8%	3.0%	1.3%
Operating matrix per vehicle (Rs)						
Net realisation	33,098	34,478	35,912	37,669	39,154	39,747
Growth	6.6%	4.2%	4.2%	4.9%	3.9%	1.5%
Contribution	9,611	11,139	9,792	10,152	10,689	11,010
Growth	8.3%	15.9%	-12.1%	3.7%	5.3%	3.0%
EBITDA	4,594	6,009	4,844	6,077	6,375	6,528
Growth	10.9%	30.8%	-19.4%	25.4%	4.9%	2.4%
EBITDA margin (%)	13.9%	17.4%	13.5%	16.1%	16.3%	16.4%
Change bp	54	355	-394	264	15	14
Net profit	3,444	4,852	3,716	4,033	4,236	4,224
Growth	18.7%	40.9%	-23.4%	8.5%	5.0%	-0.3%

Source: Company data, RBS forecasts

Income statement

Rsm	FY10A	FY11A	FY12F	FY13F	FY14F
Revenue	158605	194012	238836	277343	310702
Cost of sales	-112967	-147301	-181650	-209885	-233885
Operating costs	-17995	-20541	-18659	-22300	-25788
EBITDA	**27643**	**26170**	**38528**	**45158**	**51029**
DDA & Impairment (ex gw)	-1915	-4024	-10834	-11850	-12200
EBITA	**25728**	**22146**	**27694**	**33308**	**38829**
Goodwill (amort/impaired)	n/a	n/a	n/a	n/a	n/a
EBIT	**25728**	**22146**	**27694**	**33308**	**38829**
Net interest	2589	2700	3000	3150	3775
Associates (pre-tax)	n/a	n/a	n/a	n/a	n/a
Forex gain / (loss)	n/a	n/a	n/a	n/a	n/a
Exceptionals (pre-tax)	n/a	n/a	n/a	n/a	n/a
Other pre-tax items	0.00	0.00	0.00	0.00	0.00
Reported PTP	**28317**	**24846**	**30694**	**36458**	**42604**
Taxation	-5999	-4769	-5126	-6453	-9586
Minority interests	n/a	n/a	n/a	n/a	n/a
Exceptionals (post-tax)	n/a	n/a	n/a	n/a	n/a
Other post-tax items	0.00	-0.00	0.00	0.00	0.00
Reported net profit	**22318**	**20077**	**25568**	**30005**	**33018**
Normalised Items Excl. GW	0.00	0.00	0.00	0.00	0.00
Normalised net profit	**22318**	**20077**	**25568**	**30005**	**33018**

Source: Company data, RBS forecasts

year to Mar

Balance sheet

Rsm	FY10A	FY11A	FY12F	FY13F	FY14F
Cash & market secs (1)	58329	52003	30432	46873	64401
Other current assets	9754	14331	19627	23257	26767
Tangible fixed assets	17069	42054	41756	35425	26725
Intang assets (incl gw)	n/a	n/a	n/a	n/a	n/a
Oth non-curr assets	0.00	0.00	0.00	0.00	-0.00
Total assets	**85152**	**108387**	**91815**	**105554**	**117893**
Short term debt (2)	n/a	n/a	n/a	n/a	n/a
Trade & oth current liab	48314	61448	41730	49729	47887
Long term debt (3)	660.3	327.1	660.0	660.0	1000
Oth non-current liab	1527	17052	9222	1204	595.1
Total liabilities	**50502**	**78827**	**51612**	**51593**	**49482**
Total equity (incl min)	34650	29561	40203	53961	68411
Total liab & sh equity	**85152**	**108387**	**91815**	**105554**	**117893**
Net debt	-57669	-51676	-29772	-46213	-63401

Source: Company data, RBS forecasts

year ended Mar

Cash flow statement

Rsm	FY10A	FY11A	FY12F	FY13F	FY14F
EBITDA	27643	26170	38528	45158	51029
Change in working capital	3404	2046	-4070	-2130	3147
Net interest (pd) / rec	2589	2700	3000	3150	3775
Taxes paid	-5857	-4627	-4972	-6271	-8095
Other oper cash items	22568	-2345	-21944	6500	-8500
Cash flow from ops (1)	**50346**	**23945**	**10542**	**46407**	**41356**
Capex (2)	-2041	-5569	-18520	-13719	-5600
Disposals/(acquisitions)	0.00	0.00	0.00	0.00	0.00
Other investing cash flow	-5628	-12030	21288	-15000	-15000
Cash flow from invest (3)	**-7669**	**-17600**	**2768**	**-28719**	**-20600**
Incr / (decr) in equity	0.00	0.00	0.00	0.00	0.00
Incr / (decr) in debt	-124.6	-333.2	332.9	0.00	340.0
Ordinary dividend paid	-25676	-24369	-13926	-16247	-18568
Preferred dividends (4)	n/a	n/a	n/a	n/a	n/a
Other financing cash flow	n/a	n/a	n/a	n/a	n/a
Cash flow from fin (5)	**-25800**	**-24702**	**-13593**	**-16247**	**-18228**
Forex & disc ops (6)	n/a	n/a	n/a	n/a	n/a
Inc/(decr) cash (1+3+5+6)	**16876**	**-18357**	**-283.4**	**1441**	**2528**
Equity FCF (1+2+4)	48305	18375	-7978	32688	35756

Lines in bold can be derived from the immediately preceding lines.
Source: Company data, RBS forecasts

year to Mar

Standard ratios

Performance	Hero Motocorp FY10A	FY11A	FY12F	FY13F	FY14F	Bajaj Auto FY12F	FY13F	FY14F	Maruti Suzuki India FY12F	FY13F	FY14F
Sales growth (%)	28.7	22.3	23.1	16.1	12.0	18.9	13.0	11.6	0.13	21.5	17.2
EBITDA growth (%)	61.7	-5.33	47.2	17.2	13.0	10.1	11.2	9.80	-10.7	30.3	22.6
EBIT growth (%)	68.3	-13.9	25.1	20.3	16.6	10.00	10.9	9.70	-22.2	31.5	24.9
Normalised EPS growth (%)	74.1	-10.0	27.3	17.4	10.0	8.18	11.0	10.2	-12.7	23.1	20.8
EBITDA margin (%)	17.4	13.5	16.1	16.3	16.4	19.0	18.7	18.4	8.82	9.46	9.89
EBIT margin (%)	16.2	11.4	11.6	12.0	12.5	18.3	17.9	17.6	5.55	6.01	6.40
Net profit margin (%)	14.1	10.3	10.7	10.8	10.6	14.4	14.2	14.0	5.47	5.54	5.71
Return on avg assets (%)	27.8	18.5	23.0	27.8	26.9	26.0	23.2	22.3	8.27	9.57	10.3
Return on avg equity (%)	61.4	62.5	73.3	63.7	54.0	51.8	47.0	43.0	13.7	14.8	15.6
ROIC (%)	465.8	-83.3	-455.7	139.5	336.2	245.7	796.8	264.9	18.8	16.4	18.3
ROIC - WACC (%)	452.6	-96.5	-468.9	126.3	322.9	231.2	782.3	250.4	5.56	3.17	5.12
					year to Mar			year to Mar			year to Mar

Valuation	Hero Motocorp FY10A	FY11A	FY12F	FY13F	FY14F	Bajaj Auto FY12F	FY13F	FY14F	Maruti Suzuki India FY12F	FY13F	FY14F
EV/sales (x)	2.24	1.86	1.60	1.32	1.12	2.07	1.80	1.57	0.69	0.54	0.44
EV/EBITDA (x)	12.8	13.8	9.94	8.12	6.85	10.9	9.67	8.57	7.81	5.76	4.48
EV/EBITDA @ tgt price (x)	15.4	16.5	11.8	9.66	8.21	6.83	6.01	5.25	11.9	8.88	7.02
EV/EBIT (x)	13.8	16.3	13.8	11.0	9.00	11.3	10.1	8.94	12.4	9.07	6.92
EV/invested capital (x)	-16.5	-71.3	19.5	40.9	62.3	122.9	36.8	26.0	2.34	2.02	1.70
Price/book value (x)	11.9	14.0	10.3	7.65	6.03	7.67	6.31	5.27	1.94	1.70	1.47
Equity FCF yield (%)	11.7	4.45	-1.93	7.92	8.66	7.89	5.40	6.72	-5.15	4.35	5.13
Normalised PE (x)	18.49	20.56	16.14	13.76	12.50	16.35	14.73	13.37	15.03	12.21	10.10
Norm PE @tgt price (x)	21.6	24.0	18.9	16.1	14.6	11.0	9.91	8.99	21.6	17.5	14.5
Dividend yield (%)	5.32	5.08	2.90	3.39	3.87	3.11	3.42	3.73	0.57	0.71	0.83
					year to Mar			year to Mar			year to Mar

Per share data	FY10A	FY11A	FY12F	FY13F	FY14F
Tot adj dil sh, ave (m)	199.7	199.7	199.7	199.7	199.7
Reported EPS (INR)	111.8	100.5	128.0	150.2	165.3
Normalised EPS (INR)	111.8	100.5	128.0	150.2	165.3
Dividend per share (INR)	110.0	105.0	60.0	70.0	80.0
Equity FCF per share (INR)	241.9	92.0	-39.9	163.7	179.0
Book value per sh (INR)	173.5	148.0	201.3	270.2	342.6
					year to Mar

Solvency	FY10A	FY11A	FY12F	FY13F	FY14F
Net debt to equity (%)	-166.4	-174.8	-74.1	-85.6	-92.7
Net debt to tot ass (%)	-67.7	-47.7	-32.4	-43.8	-53.8
Net debt to EBITDA	-2.09	-1.97	-0.77	-1.02	-1.24
Current ratio (x)	1.41	1.08	1.20	1.41	1.90
Operating CF int cov (x)	-20.7	-9.58	-4.17	-15.7	-12.1
Dividend cover (x)	0.87	0.82	1.84	1.85	1.78
					year to Mar

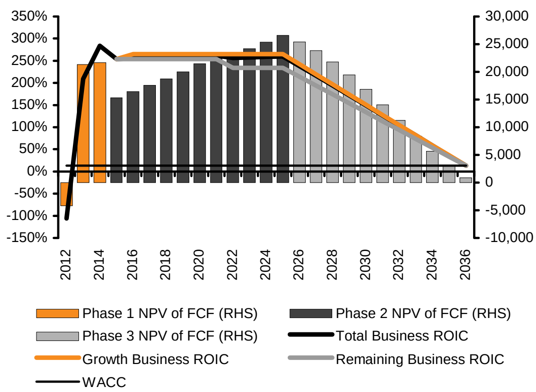
Priced as follows: HROM.BO - Rs2066.90; BAJA.BO - Rs1636.65; MRTI.BO - Rs1065.80
Source: Company data, RBS forecasts

Valuation methodology

Economic Profit Valuation	Rs m	%
Adjusted Opening Invested Capital	-4373.0	-1
NPV of Economic Profit During Explicit Period	50642.7	12
NPV of Econ Profit of Remaining Business (1, 2)	113273.1	26
NPV of Econ Profit of Net Inv (Grth Business) (1, 3)	270878.8	63
Enterprise Value	430421.6	100
Plus: Other Assets	0.0	0
Less: Minorities	0.0	0
Less: Net Debt (as at 19 Oct 2011)	-51675.6	-12
Equity Value	482097.2	112
No. Shares (millions)	199.5	
Per Share Equity Value	**2416.53**	
Current Share Price	2066.90	

Discounted Cash Flow Valuation	Rs m	%
Value of Phase 1: Explicit (2012 to 2014)	38836.9	9
Value of Phase 2: Value Driver (2015 to 2025)	231098.1	54
Value of Phase 3: Fade (2026 to 2036)	150526.1	35
Terminal Value	9945.4	2
Enterprise Value	430406.4	100
FCF Grth Rate at end of Phs 1 implied by DCF Valuation		7.1
FCF Grth Rate at end of Phs 1 implied by Current Price		5.9

Returns, WACC and NPV of Free Cash Flow



Sensitivity Table

WACC	No of Years in Fade Period: 5	8	11	14	17
11.0%	2270.05	2575.38	2900.64	3246.86	3615.10
12.0%	2109.02	2369.50	2642.19	2927.48	3225.79
13.0%	1964.92	2187.49	2416.53	2652.16	2894.52
14.0%	1835.70	2026.16	2218.91	2413.98	2611.42
15.0%	1719.60	1882.83	2045.33	2207.18	2368.47

Performance Summary	2012	2013	2014	Phase 2 Avg (2015 - 2025)
Invested Capital Growth (%)	-150.8	-11.4	-2.2	18.9
Operating Margin (%)	11.6	11.6	12.0	12.6
Capital Turnover (x)	-11.2	22.0	28.8	25.0

Source: Company data, RBS forecasts

1. In periods following the Explicit Period ie, Phase 2 and Phase 3

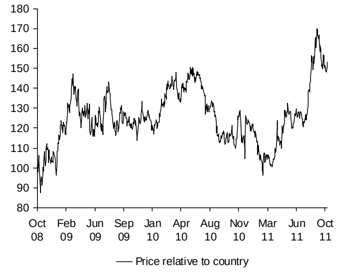
2. Remaining Business is defined as Capital as at the end of Phase 1 and capex = depreciation thereafter

3. Net Investment is defined as capex over and above depreciation after Phase 1

Company description — Buy

Hero Honda is the largest Indian two-wheeler company, with an overall market share of 45%. The company is a joint venture between India's Hero Group, run by the Munjals, and Honda of Japan. While the Munjals concentrate on the day-to-day management of operations, Honda provides technology support. Traditionally, Hero Honda focused only on motorcycles, but recently entered the high-growth scooter segment. With the launch of a third plant in a tax-haven state, the company plans to continue its volume momentum trend through its widespread rural network. However, a recent amicable JV split announcement opens up new opportunities (exports, new products) and challenges (technology for long term).

Price relative to country



Strategic analysis — Average SWOT company score: 3

Strengths — 4
Hero Honda has the largest customer base in the Indian two-wheeler industry and enjoys strong customer goodwill. We believe this is key to it maintaining its leadership status.

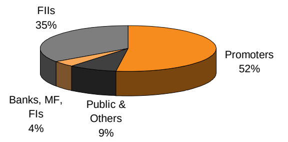
Weaknesses — 2
Poor presence in the premium motorcycle segment is an apparent weakness for Hero Honda, as is its dependence upon Honda Japan for new models.

Opportunities — 2
An extended product portfolio and planned plant capacity should help the company build on its leadership position. Entry into the scooter market should help it leverage its brand image and customer goodwill. The JV split opens export markets and new product opportunities for the medium-long term.

Threats — 2
Entry of MNCs such as Suzuki and Honda into the Indian motorcycle market is a significant threat to Hero Honda. Tata's mini car (for Rs100,000) could lead to faster upgrades by two-wheeler owners to cars, and thus have an impact on two-wheeler replacement demand.

Scoring range is 1-5 (high score is good)

Shareholding, 30 Sept 2011



Source: Company data

Market data

Headquarters
34, Community Centre, Basant Lok, Vasant Vihar, New Delhi.110057

Website
www.herohonda.com

Shares in issue
199.7m

Freefloat
48%

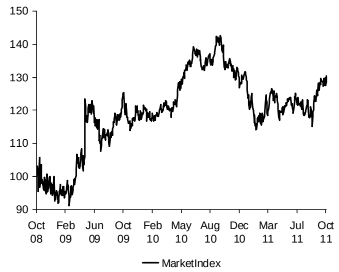
Majority shareholders
Europacific Growth Fund (5%), Aberdeen (5%), LIC of India (1%)

Country view: India

India performed in line with the region in 3Q having substantially underperformed in preceding months. We are sceptical that the recent bout of better relative showing is anything other than a technical reaction following the sharp previous descent. While it's true that incrementally India can be said to benefit from lower commodity prices and a pause in domestic rate hikes, we think these positives are well offset by more structural challenges, including malinvestment, ongoing supply bottlenecks, a complete lack of reform and a shortage of capital. The consequence, in our view, is that growth will continue to slow, possibly substantially. Combining all this with still-high valuations, we believe the risk reward remains unattractive, albeit with the decline seen to date, it's improving.

The country view is set in consultation with the relevant company analyst but is the ultimate responsibility of the Strategy Team.

Country rel to Asia Pacific



Competitive position — Average competitive score: 2+

Supplier power — 4+
Component suppliers have negligible power, as they are highly dependent on the company. This is one reason why Hero Honda has managed its raw material costs well.

Barriers to entry — 2+
No defendable entry barriers as two-wheeler technology is readily available. Capital cost for product development is also low, but distribution and service network are major barriers to building size.

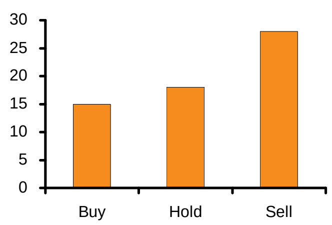
Customer power — 2-
A low entry barrier has resulted in increasing competition in the sector. As a result, wide choices are available to customers. Also, low differentiation results in poor bargaining power.

Substitute products — 2+
Scooters are motorcycle substitutes. Ungeared scooters in particular, targeted at women and middle-aged men, may take off. Low-cost cars such as Nano and electric two-wheeler are emerging as threats.

Rivalry — 2-
Low product differentiation and very few defensible entry barriers have resulted in intense rivalry in the sector. However, low maintenance costs and sustained product performance build brand value.

Scoring range 1-5 (high score is good) Plus = getting better Minus = getting worse

Broker recommendations



Source: Bloomberg

Recommendation structure

Absolute performance, short term (trading) recommendation: A Trading Buy recommendation implies upside of 5% or more and a Trading Sell indicates downside of 5% or more. The trading recommendation time horizon is 0-60 days. For Australian coverage, a Trading Buy recommendation implies upside of 5% or more from the suggested entry price range, and a Trading Sell recommendation implies downside of 5% or more from the suggested entry price range. The trading recommendation time horizon is 0-60 days.

Absolute performance, long term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price and, except as follows, only reflects capital appreciation. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%. For UK-based Investment Funds research, the recommendation structure is not based on upside/downside to the target price. Rather it is the subjective view of the analyst based on an assessment of the resources and track record of the fund management company. For research on Australian listed property trusts (LPT) or real estate investment trusts (REIT), the recommendation is based upon total return, ie, the estimated total return of capital gain, dividends and distributions received for any particular stock over the investment horizon.

Performance parameters and horizon: Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months.

Market or sector view: This view is the responsibility of the strategy team and a relative call on the performance of the market/sector relative to the region. Overweight/Underweight implies upside/downside of 10% or more and Neutral implies less than 10% upside/downside.

Target price: The target price is the level the stock should currently trade at if the market were to accept the analyst's view of the stock and if the necessary catalysts were in place to effect this change in perception within the performance horizon. In this way, therefore, the target price abstracts from the need to take a view on the market or sector. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value, the target price will differ from 'fair' value.

Distribution of recommendations

The tables below show the distribution of recommendations (both long term and trading). The first column displays the distribution of recommendations globally and the second column shows the distribution for the region. Numbers in brackets show the percentage for each category where there is an investment banking relationship. These numbers include recommendations produced by third parties with which RBS has joint ventures or strategic alliances.

Long term recommendations (as at 19 Oct 2011)

	Global total (IB%)	Asia Pacific total (IB%)
Buy	867 (11)	567 (3)
Hold	417 (7)	225 (4)
Sell	90 (6)	49 (0)
Total (IB%)	1374 (9)	841 (3)

Source: RBS

Trading recommendations (as at 19 Oct 2011)

	Global total (IB%)	Asia Pacific total (IB%)
Trading Buy	1 (100)	1 (100)
Trading Sell	1 (0)	1 (0)
Total (IB%)	2 (50)	2 (50)

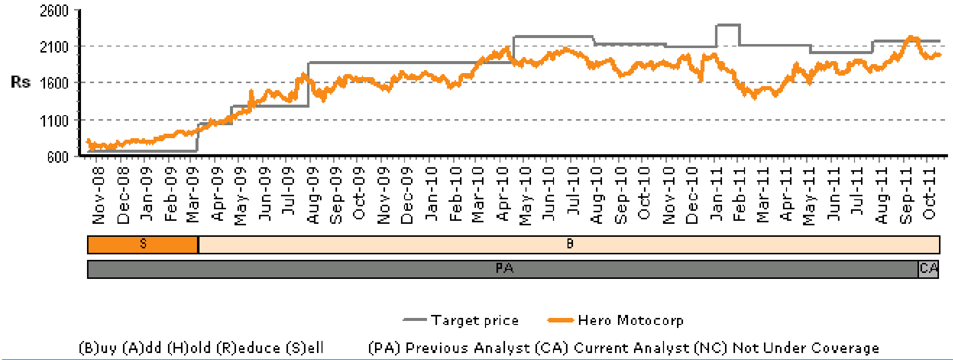
Source: RBS

Valuation and risks to target price

Hero Motocorp (RIC: HROM.BO, Rec: Buy, CP: Rs2066.90, TP: Rs2416.50): The key risks to our DCF-based target price are: 1) renewed price wars, forcing Hero Honda to join the fray; 2) Honda's 100% subsidiary expanding its product portfolio, leading to head-on competition; and 3) sharp dilution in the Hero Honda brand after the recent JV split, affecting demand for its vehicles.

Hero Motocorp coverage data

Stock performance, recommendations and coverage (as at 19 Oct 2011)



Pramod Amthe started covering this stock on 17 Oct 05. Moved to new recommendation structure between 1 November 2005 and 31 January 2006. Source: RBS

Trading recommendation history (as at 19 Oct 2011)

Date	Rec	Analyst
	n/a	

Source: RBS

Regulatory disclosures

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