

MARCH 18, 2010

CHANGE IN RECO.

Coverage view: **Cautious**

Price (Rs): **1,935**

Target price (Rs): **1,700**

BSE-30: **17,519**

Two's company, three's a crowd. We are downgrading Hero Honda stock to SELL from REDUCE as we believe the recent strength is unwarranted given the margin headwinds from increasing competition and higher commodity costs. While excise benefits from the Hardwar facility would continue to benefit margins, these could get competed away as competition has similar benefits. We raised our EPS estimates to reflect export volumes growing 3X in FY2012E from FY2010E and a lower tax rate.

Company data and valuation summary

Hero Honda

| Stock data | | Forecasts/Valuations | | | |
|---------------------------------|----------------|----------------------|-------|-------|-------|
| | | 2010 | 2011E | 2012E | |
| 52-week range (Rs) (high,low) | 1,954-975 | EPS (Rs) | 108.3 | 121.5 | 135.9 |
| Market Cap. (Rs bn) | 386.3 | EPS growth (%) | 68.8 | 12.1 | 11.9 |
| Shareholding pattern (%) | | P/E (X) | 17.9 | 15.9 | 14.2 |
| Promoters | 55.0 | Sales (Rs bn) | 156.7 | 178.6 | 200.6 |
| FIs | 28.7 | Net profits (Rs bn) | 21.6 | 24.3 | 27.1 |
| MFs | 3.2 | EBITDA (Rs bn) | 26.7 | 28.6 | 31.1 |
| Price performance (%) | | EV/EBITDA (X) | 12.5 | 11.0 | 9.5 |
| Absolute | 1M 3M 12M | ROE (%) | 45.4 | 37.1 | 31.6 |
| | 13.6 15.6 93.9 | Div. Yield (%) | 1.1 | 1.1 | 1.1 |
| Rel. to BSE-30 | 5.9 10.4 (0.7) | | | | |

Downgrading Hero Honda to SELL from REDUCE as margins, market share could be peaking

Our SELL rating on Hero Honda stock reflects peak valuations that don't adequately capture the risks to market share and margins from increasing competition and commodity prices. We believe Hero Honda's market share and margins are peakish, given the coming onslaught of new entrants (HMSI and M&M) in the near future (Exhibit 3). We show in Exhibit 6 how margin declines from peak levels have in the past coincided with a significant price correction. The almost concurrent decline in multiples seen in the past seems to indicate that they were not adequately discounting the possibility of margin declines prior to the actual happening of the event.

We are raising our FY2011E and FY2012E EPS estimates to reflect export potential

We raised our FY2011E and FY2012E EPS estimates to Rs121 and Rs136 from Rs116 and Rs129 to primarily reflect higher export volumes and a lower tax rate. We are now assuming 13% volume growth for FY2011E and FY2012E compared to 12% and 10% prior. The increase is largely driven higher growth assumption for motorcycle exports. We expect these to grow 56% and 93% in FY2011E and FY2012E, driving motorcycle export volumes to 3X FY2010E levels by FY2012E. On the margin front, we expect EBITDA margins at 16% in FY2011E and 15.5% in FY2012E versus 17.2% averaged fiscal year-to-date. We lowered our tax rate to 20% from 22% prior.

12% domestic volume growth estimate for FY2011E could have downside

Our volume assumptions seem reasonable given recent history. Over the FY2005-2010 period, industry motorcycle volumes grew at an 8% CAGR while Hero Honda grew at a faster 11% range, resulting in a 700bps increase in Hero Honda's share. Going forward we believe it would be difficult for the company to repeat the performance in the face of increasing competition.

We raised our target to Rs1,700 from Rs1,625 to reflect higher earnings estimates

Our Rs1,700 target reflects 14X our FY2011E EPS estimate of Rs122. If we base our target off our FY2012E EPS of Rs135, it would amount to Rs1,885, still below current price levels. The stock is currently trading at 16.5X FY2011E EPS estimates and 11X FY2011E EBITDA, both of which are 15% above long-term average multiples.

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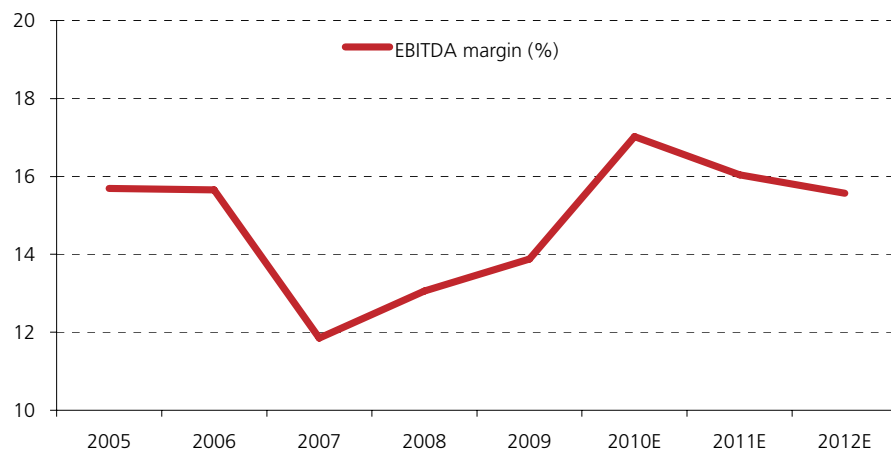
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Margin decline going forward need not be gradual

Exhibit 1 shows EBITDA margin trend for Hero Honda. As can be seen, Hero Honda is currently earning peak margins at 17%. A combination of lower commodity costs, strong volume growth and excise concessions have driven the yoy increase in margins. In FY2008-09, Hero Honda was able to increase its margins even in the face of rising commodity prices, excise concessions starting hitting numbers in a big way in 2HFY09. More recently, the company has benefited from its component manufacturers moving to Uttarakhand as well. We believe these benefits in a normal economic environment would get competed away, given that both the key players have facilities in excise free zones. While this has not happened till now, the historically peak margins currently enjoyed by both Bajaj Auto and Hero Honda could tempt one of them to play the volume over price game. Declining market share could be a trigger for such an action.

Exhibit 1: A duopoly in motorcycles have allowed excise concessions to be retained; this could change

EBITDA margins for Hero Honda, March fiscal year ends (2005-2012E, %)



Source: Company, Kotak Institutional Equities estimates

We believe current peak margins would be difficult to sustain going forward given the combination of higher commodity costs and increasing competition. The sharp decline in margins we saw in FY2007 was driven by an increase in competitive intensity in the 100cc segment with Bajaj launching the Platina 100cc. We are starting to see similar conditions in the domestic 100-125cc segment with Bajaj executing a successful Discover 100cc launch. Competition is only going to increase further with Honda's (HMSI) launch of CB Twister, an 110cc bike. M&M might not be far behind on its motorcycle launch. HMSI is planning to expand its capacity by 600,000 units by the 2HCY11. It's also expensing capacity of its existing plants to 1.6 mn units from 1.25 mn units next year. Total capacity of HMSI would increase by almost 1 mn units by 2HCY11. HMSI targets to sell 20,000 units per month of the Twister initially. We believe Twister monthly volumes could increase to the 70,000 unit range once the capacity is in place.

The increased competition would at the very least limit the ability of companies to pass on the commodity pressures to the consumer. Since the beginning of 2010, Hero Honda has made one price hike for the excise duty increase and has not taken any price increase for commodity cost increases. Bajaj on the other hand has, in addition to the excise duty-related increase raised prices for the Discover and Platina in January.

Exhibit 2: HMSI is strong in segments they participate while M&M has quickly garnered 6% of scooter market

Trailing 3-month market share by segment (%)

| | Motorcycles | | Scooters | Mopeds |
|----------------------------|-------------|-----------|----------|--------|
| | 100-125cc | 125-250cc | | |
| Bajaj Auto | 22 | 43 | — | — |
| Hero Honda | 71 | 14 | 14 | — |
| Honda Motorcycle & Scooter | 1 | 26 | 51 | — |
| TVS Motors | 6 | 7 | 17 | 100 |
| Yamaha | 1 | 8 | — | — |
| Mahindra & Mahindra | — | — | 7 | — |
| Suzuki | — | 2 | 11 | — |

Trailing 3-month market share delta by segment (yoy, %)

| | Motorcycles | | Scooters | Mopeds |
|----------------------------|-------------|-----------|----------|--------|
| | 100-125cc | 125-250cc | | |
| Bajaj Auto | 15.5 | 0.5 | (0.5) | — |
| Hero Honda | (14.4) | 1.8 | (1.2) | — |
| Honda Motorcycle & Scooter | 0.6 | (0.7) | (7.8) | — |
| TVS Motors | (1.3) | 1.1 | (0.6) | 100 |
| Yamaha | (0.4) | (2.4) | — | — |
| Mahindra & Mahindra | — | — | 7.0 | — |
| Suzuki | — | (0.5) | 3.0 | — |

Source: Crisinfac, Company, Kotak Institutional Equities estimates

Exhibit 2 details market share by segment for all players in the 2-wheeler industry and the recent share trends on a yoy basis. We expect Hero Honda's market share in its bread and butter 100-125cc segment to continue to come under pressure, given launches by new entrants in the segment (Exhibit 3).

Exhibit 3: Mahindra and HMSI could be the key entrants to watch out for

Key products launched recently and expected launches over the next year

| Manufacturer | Model | Date | Segment | Price (Rs) | Monthly volumes |
|----------------------------|---------------|---------|-----------|------------|---|
| Bajaj Auto | Discover | July'09 | 100-125cc | 42,600 | 70,000 |
| | Pulsar 135 LS | Dec'09 | 125-150cc | 51,000 | 25,000 |
| | New bike | 1QFY10E | 100-125cc | na | na |
| Honda Motorcycle & Scooter | CB Twister | Mar'10 | 100-125cc | 45,684 | 20,000 initially; could go to 70,000 on capacity increase |
| Mahindra Two Wheelers | Flyte | May'09 | Scooter | 43,000 | 2,000 |
| | Rodeo | Sept'09 | Scooter | 41,299 | 4,000 |
| | Duro | Sept'09 | Scooter | 38,299 | 4,000 |
| | New bikes | CY2010E | 100-150cc | na | 50,000 |
| TVS Motors | Jive | Feb'10 | 100-125cc | 41,000 | 20,000 |
| | Wego | Mar'10 | Scooter | 42,500 | na |

Source: Crisinfac, Company, Kotak Institutional Equities estimates,

Exhibit 3 details recent and upcoming launches in the 2-wheeler space. We estimate that the new entrants in the 100-125cc segment have volume objectives exceeding 10% of current sales in the segment over the next two years. Assuming these entrants are able to achieve their objectives, the industry would need to grow in excess of 10% for the incumbents to show some growth.

Exhibit 4: Commodity costs have gone back to FY2008 levels

Automotive raw material index (Base Jan'03= 100)



Source: Company, Kotak Institutional Equities estimates

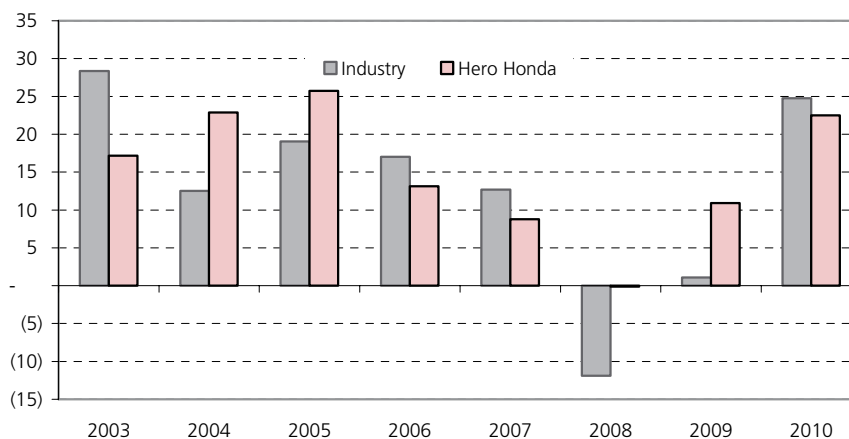
Exhibit 4 illustrates our raw material index based on spot commodity prices. Going forward, steel prices are expected to increase further based on increasing coking coal and iron ore contract prices. Our raw material index for March quarter average is up 10% from December quarter average. Some of this increase could be offset as was evident in 3QFY10 by the increased benefit from its component manufacturers moving to the excise free zone of Uttarakhand.

Our volume assumptions seem reasonable from a historical perspective

We have modeled overall volume growth of 13% for FY2011E and 13% for FY2012E. For domestic motorcycles, we have modeled 12% growth for FY2011E and 10% for FY2012E. Exhibit 5 compares Hero Honda and industry growth trends for domestic motorcycles. In the so-called golden years of India growth story, the motorcycle industry has grown at a CAGR of 8% between 2005-2010. Hero Honda has grown at a faster CAGR of 11% over the same time period, resulting in a 7% point increase in market share.

Exhibit 5: Motorcycles have grown only at a 8% CAGR between 2005-2010

Sales growth for industry and Hero Honda, March fiscal year-ends



Source: Company, Kotak Institutional Equities estimates

Going forward, we don't believe Hero Honda would not be in a position to grow in excess of the industry. As a result, we believe our 10% growth estimate for domestic motorcycles seems reasonable and one could argue that it could even be aggressive given the historical perspective.

In addition, we are assuming a 56% growth in motorcycle exports in FY2011E and another 93% growth in FY2012E. Cumulatively, we are modeling motorcycle exports to grow 3X between FY2010E and FY2012E, implying an addition of 180,000 units.

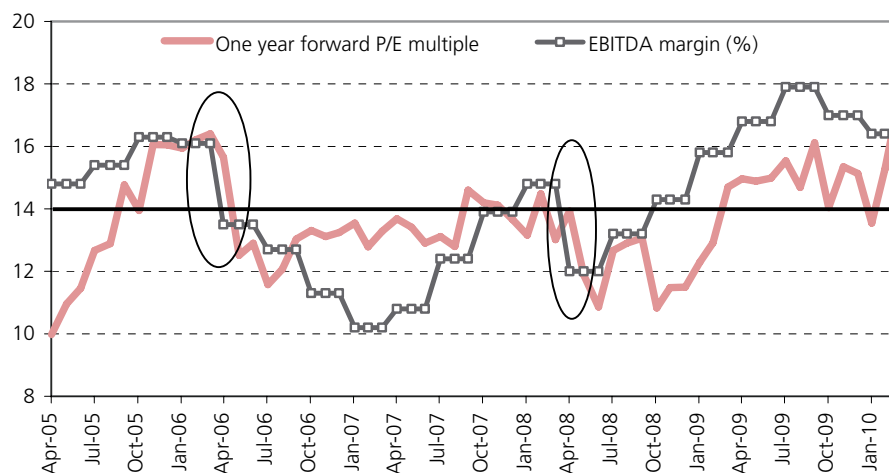
On the scooter side, we are modeling a 15% growth in each of FY2011E and FY2012E.

Margin declines have been a trigger for significant price correction

Exhibits 6 and 7 below separately illustrate how multiples have trended in relation to margins and volume growth. We would like to highlight two cases in April'06 and April'08. In both case, which we have circled, P/E multiples reacted immediately to a margin decline. In both cases one can argue with the benefit of hindsight that margins were at peak levels. Current margins are even higher than the 16% seen in FY2006.

We believe the market might be complacent in giving peak multiples of close to 16X forward 12 month earnings at the time of peak margins and peak market share as well, given the increasing competition.

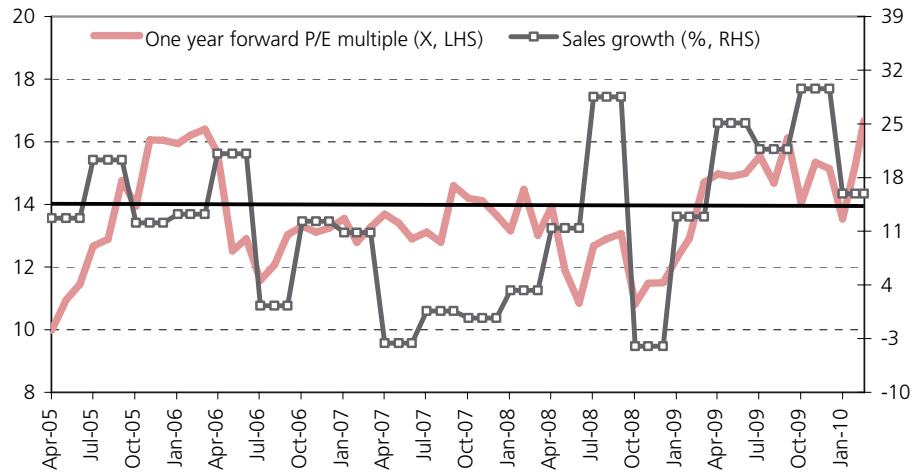
Exhibit 6: Multiples have had a concurrent relationship with margins
 One-year forward P/E multiples (X) versus EBITDA margins (%)



Source: Factset, Company, Kotak Institutional Equities estimates

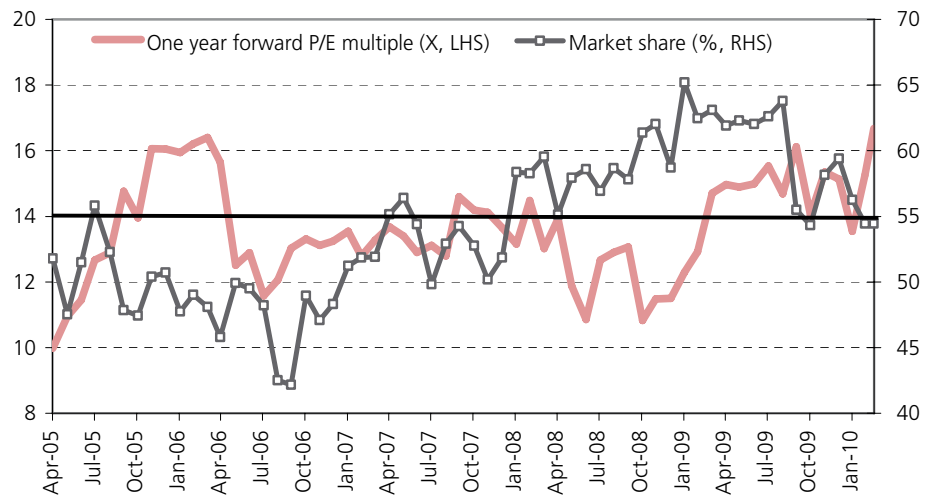
Exhibit 7 illustrates the relationship between multiples and volume growth. As can be seen, multiples have declined to below long-term average levels of 14X as sales growth declines to the 10% levels.

Exhibit 7: Multiples have been below 14X at 10% sales growth levels
 One-year forward P/E multiples versus volume growth



Source: Factset, Company, Kotak Institutional Equities estimates

Exhibit 8: Multiples have not taken market share declines well
 One-year forward P/E multiples versus motorcycle market share



Source: Factset, Company, Kotak Institutional Equities estimates

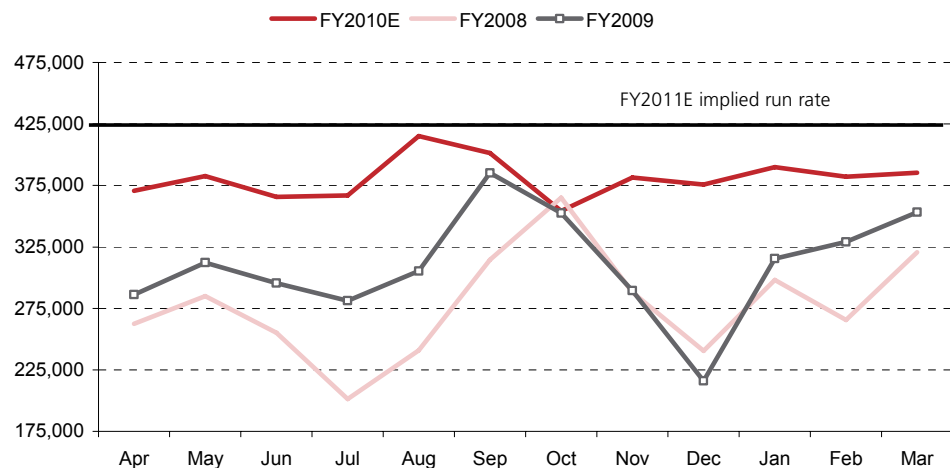
Hero Honda, Volume details, March fiscal year-ends, 2007-2012E

| Volumes | 2007 | 2008 | 2009 | 2010E | 2011E | 2012E |
|-------------------------|------------------|------------------|------------------|------------------|------------------|------------------|
| Motorcycles | 3,243,832 | 3,232,320 | 3,565,340 | 4,362,617 | 4,926,280 | 5,538,302 |
| Domestic | 3,147,219 | 3,144,101 | 3,487,164 | 4,271,649 | 4,784,247 | 5,262,672 |
| < 125 cc | 3,041,143 | 2,966,329 | 3,302,095 | 4,038,462 | 4,523,078 | 4,975,385 |
| > 125 cc | 106,076 | 177,772 | 185,069 | 233,187 | 261,169 | 287,286 |
| Exports | 96,613 | 88,219 | 78,176 | 90,968 | 142,033 | 275,630 |
| < 125 cc | 93,692 | 80,620 | 69,644 | 82,180 | 131,488 | 262,976 |
| > 125 cc | 2,921 | 7,599 | 8,532 | 8,788 | 10,546 | 12,655 |
| Scooters | 92,921 | 104,822 | 156,210 | 208,249 | 239,184 | 275,062 |
| Domestic | 91,889 | 102,470 | 153,193 | 202,215 | 232,547 | 267,429 |
| Exports | 1,032 | 2,352 | 3,017 | 6,034 | 6,637 | 7,633 |
| Total 2-wheelers | 3,336,753 | 3,337,142 | 3,721,550 | 4,570,866 | 5,165,465 | 5,813,364 |
| Growth (yoy %) | | | | | | |
| Motorcycles | 8.6 | (0.4) | 10.3 | 22.4 | 12.9 | 12.4 |
| Domestic | 8.8 | (0.1) | 10.9 | 22.5 | 12.0 | 10.0 |
| < 125 cc | 8.0 | (2.5) | 11.5 | 22.3 | 12.0 | 10.0 |
| > 125 cc | 37.1 | 67.6 | 11.5 | 26.0 | 12.0 | 10.0 |
| Exports | 4.3 | (8.7) | (11.4) | 16.4 | 56.1 | 94.1 |
| < 125 cc | 10.8 | (14.0) | (13.6) | 18.0 | 60.0 | 100.0 |
| > 125 cc | (63.9) | 160.2 | 12.3 | 3.0 | 20.0 | 20.0 |
| Scooters | 518.9 | 12.8 | 49.0 | 33.3 | 14.9 | 15.0 |
| Domestic | | 11.5 | 49.5 | 32.0 | 15.0 | 15.0 |
| Exports | | 127.9 | 28.3 | 100.0 | 10.0 | 15.0 |
| Total 2-wheelers | 11.2 | 0.0 | 11.5 | 22.8 | 13.0 | 12.5 |

Source: Company, Kotak Institutional Equities estimates

Year-ago comparisons are not easy for Hero Honda

Monthly sales trend, Hero Honda, March fiscal year-ends, (2008-2010E, units)



Source: Company, Kotak Institutional Equities estimates

Comparison between Honda's Twister and Hero Honda Passion Pro

| | Honda | Hero Honda |
|-----------------------|------------|-------------|
| | CB Twister | Passion Pro |
| On-road Delhi (Rs) | 45,684 | 44,600 |
| Specifications | | |
| Engine | 109cc | 97.2cc |
| Power | 9 | 7.8 |
| Tyres | Tubeless | Tube |
| Kerb weight | 108kg | 119kg |

Source: Kotak Institutional Equities estimates

Hero Honda, Profit model, balance sheet and cash flow model, March fiscal year-ends, 2007-2012E (Rs mn)

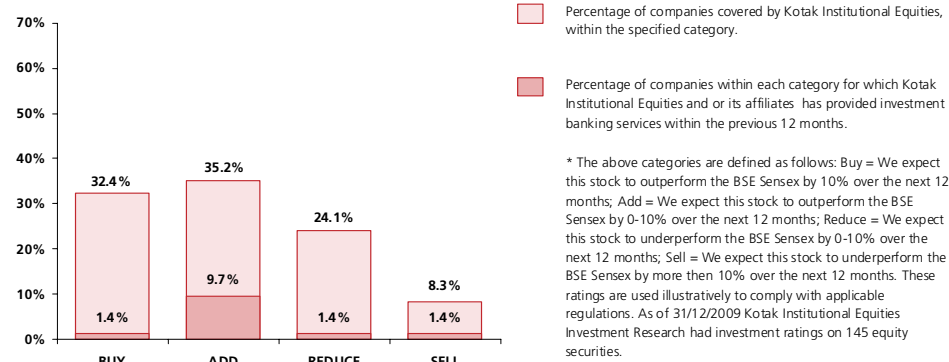
| | 2007 | 2008 | 2009 | 2010E | 2011E | 2012E |
|---|---------------|---------------|---------------|---------------|----------------|----------------|
| Profit model (Rs mn) | | | | | | |
| Net sales | 99,000 | 103,318 | 123,191 | 156,732 | 178,585 | 200,638 |
| EBITDA | 11,730 | 13,494 | 17,097 | 26,679 | 28,587 | 31,157 |
| Other income | 1,899 | 1,854 | 2,207 | 2,744 | 3,620 | 4,497 |
| Interest | 230 | 358 | 317 | 237 | 243 | 250 |
| Depreciation | (1,398) | (1,603) | (1,807) | (1,921) | (2,126) | (2,371) |
| Profit before tax | 12,461 | 14,103 | 17,815 | 27,738 | 30,325 | 33,533 |
| Current tax | (3,788) | (4,412) | (4,806) | (6,178) | (6,155) | (6,461) |
| Deferred tax | (94) | (12) | (191) | 76 | 90 | 90 |
| Net profit | 8,579 | 9,679 | 12,818 | 21,636 | 24,260 | 27,162 |
| Earnings per share (Rs) | 43.0 | 48.5 | 64.2 | 108.3 | 121.5 | 136.0 |
| Balance sheet (Rs mn) | | | | | | |
| Equity | 24,701 | 29,862 | 38,008 | 54,503 | 73,623 | 95,645 |
| Deferred tax liability | 1,282 | 1,254 | 1,444 | 1,369 | 1,278 | 1,189 |
| Total Borrowings | 1,652 | 1,320 | 785 | 285 | — | — |
| Current liabilities | 14,792 | 18,247 | 20,528 | 26,377 | 28,241 | 30,024 |
| Total liabilities | 42,426 | 50,684 | 60,765 | 82,534 | 103,142 | 126,857 |
| Net fixed assets | 13,555 | 15,487 | 16,943 | 17,521 | 17,896 | 19,025 |
| Investments | 19,739 | 25,668 | 33,688 | 48,688 | 63,688 | 78,688 |
| Cash | 358 | 1,311 | 2,196 | 3,570 | 6,962 | 12,708 |
| Other current assets | 8,775 | 8,057 | 7,939 | 12,755 | 14,597 | 16,437 |
| Miscellaneous expenditure | - | 161 | - | - | - | - |
| Total assets | 42,426 | 50,684 | 60,765 | 82,534 | 103,142 | 126,857 |
| Free cash flow (Rs mn) | | | | | | |
| Operating cash flow excl. working capital | 8,474 | 9,506 | 12,605 | 20,501 | 22,432 | 24,697 |
| Working capital changes | (2,224) | 2,612 | 985 | 1,033 | 22 | (57) |
| Capital expenditure | (5,152) | (3,739) | (3,135) | (2,500) | (2,500) | (3,500) |
| Free cash flow | 1,099 | 8,379 | 10,455 | 19,034 | 19,954 | 21,139 |
| Ratios | | | | | | |
| Operating margin (%) | 11.8 | 13.1 | 13.9 | 17.0 | 16.0 | 15.5 |
| PAT margin (%) | 8.7 | 9.4 | 10.4 | 13.8 | 13.6 | 13.5 |
| Debt/equity (X) | 0.1 | 0.0 | 0.0 | 0.0 | - | - |
| Net debt/equity (X) | (0.7) | (0.8) | (0.9) | (0.9) | (0.9) | (0.9) |
| Book Value (Rs/share) | 130.1 | 155.0 | 197.6 | 279.8 | 375.1 | 484.9 |
| RoAE (%) | 36.3 | 34.0 | 36.4 | 45.4 | 37.1 | 31.6 |
| RoACE (%) | 33.2 | 31.5 | 34.7 | 44.5 | 36.7 | 31.4 |

Source: Company, Kotak Institutional Equities estimates

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Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of December 31, 2009

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