

8 December 2010

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

Buy

Target price
Rs2090.00

Price
Rs0.00

Equity | India | Autos & Components
Flashnote

Hero Honda Motors

Royalty hike speculation overblown

Recent speculation of nearly tripling royalty rates to 8% of sales as part of JV split deal seem illogical to us. Considering that Japanese auto majors spend just around 5% of sales on R&D, charging a higher proportion for Hero Honda, which uses fraction of parent resources, surprises us.

Royalty hike rumours seem overblown

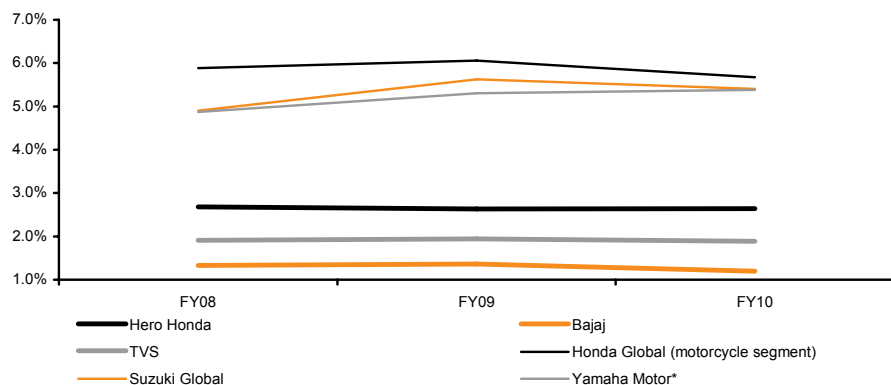
- Royalty hike speculation in recent newspaper articles (Business Standard, 1st Dec) speculate about hike from current 2.7% of net sales to around 8% as part of the split agreement between Hero group and Honda Japan (non-rated), till technical agreement validity period 2014. This seems out of context, as parent Honda's motorcycle division spends just around 5% of net sales towards Research & Development, and Hero Honda uses a fraction of this reasearch considering concentration of its sales towards Splendor and Passion. Also, when compared to other Japanese two-wheeler makers like Yamaha (non-rated) and Suzuki Motor (non-rated), Hero Honda's total R&D expenses are in line with peers.
- In worst case scenario, we feel only new product launches till 2014 may attract higher royalty rates, which may have low impact on overall profitability as we feel new product sales may not form more than 10% of Hero Honda sales.
- The higher royalty outlook for the entire company also doesn't gel with the thought that it will substantially deteriorate company profitability in the short term and limit developing in-house research capability in the coming years, at a time when Indian promoters are raising their holding in the company.

Hero Honda royalty payments are already higher than Indian peer R&D costs

- Hero Honda's royalty payment of 2.7% of net sales is already substantially higher than peers' R&D cost range of 1-2% of net sales (over FY00-10). This clearly states that Hero Honda's cost structure is completely out of context as compared to industry trend and technology requirement. In the medium term, if the split happens, we feel R&D costs would be drastically lower than current royalty payment structure and hence improve profitability.

(Continued on page 2)

Research and Royalty trend



Source: Company data

Important disclosures can be found in the Disclosures Appendix.

Analyst

Pramod Amthe
+91 22 6715 5319
pramod.amthe@rbs.com

83/84 Sakhar Bhawan, Nariman
Point, Mumbai 400 021, India

<http://research.rbsm.com>

Hero management delivery track record will be key stock driver in medium term

- We feel Hero's management stands out amongst peers in terms of excellent local delivery in terms of large distribution network build up, setting up and extracting full tax advantage from new plants, rural foray initiatives, service network build up helping extract benefit from large population of honda bikes, etc. These initiatives, we feel, played an equal or even larger role in driving volume growth than just Honda's technology in recent years. Going forward, with large cash in hand to support in-house R&D capability build up, we feel the company is best positioned to drive rural penetration-led growth for motorcycle industry. Buy.

Income statement

Rsm	FY09A	FY10A	FY11F	FY12F	FY13F
Revenue	123192	158605	189210	216619	239041
Cost of sales	-91907	-112967	-143012	-163145	-179224
Operating costs	-14187	-17969	-21002	-24478	-27490
EBITDA	17098	27670	25196	28996	32327
DDA & Impairment (ex gw)	-1807	-1915	-2184	-2446	-2813
EBITA	15291	25755	23013	26550	29515
Goodwill (amort/impaird)	n/a	n/a	n/a	n/a	n/a
EBIT	15291	25755	23013	26550	29515
Net interest	2524	2563	3150	4100	5425
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	17815	28317	26163	30650	34940
Taxation	-4997	-5999	-4971	-5670	-6289
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	12818	22318	21192	24979	28651
Normalised Items Excl. GW	0.00	0.00	0.00	0.00	0.00
Normalised net profit	12818	22318	21192	24979	28651

Source: Company data, RBS forecasts

year to Mar

Balance sheet

Rsm	FY09A	FY10A	FY11F	FY12F	FY13F
Cash & market secs (1)	35883	58329	48201	64753	83366
Other current assets	7939	9754	13848	17910	20948
Tangible fixed assets	16943	17069	18885	20439	22627
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	0.01
Total assets	60765	85152	80934	103102	126941
Short term debt (2)	n/a	n/a	n/a	n/a	n/a
Trade & oth current liab	20528	48314	29759	34712	39039
Long term debt (3)	784.9	660.3	660.0	660.0	660.0
Oth non-current liab	1444	1527	1658	1812	1986
Total liabilities	22757	50502	32078	37183	41685
Total equity (incl min)	38008	34650	48856	65919	85255
Total liab & sh equity	60765	85152	80934	103102	126941
Net debt	-35098	-57669	-47541	-64093	-82706

Source: Company data, RBS forecasts

year ended Mar

Cash flow statement

Rsm	FY09A	FY10A	FY11F	FY12F	FY13F
EBITDA	17098	27670	25196	28996	32327
Change in working capital	847.3	3404	-3220	-604.6	-711.1
Net interest (pd) / rec	2524	2563	3150	4100	5425
Taxes paid	-4806	-5857	-4840	-5517	-6114
Other oper cash items	1551	22568	-19429	1495	2000
Cash flow from ops (1)	17214	50346	857.6	28469	32927
Capex (2)	-3102	-2041	-4000	-4000	-5000
Disposals/(acquisitions)	0.00	0.00	0.00	0.00	0.00
Other investing cash flow	-8019	-5628	-5000	-18000	-20000
Cash flow from invest (3)	-11121	-7669	-9000	-22000	-25000
Incr / (decr) in equity	0.00	0.00	0.00	0.00	0.00
Incr / (decr) in debt	-535.1	-124.6	-0.30	0.00	0.00
Ordinary dividend paid	-4673	-25676	-6986	-7917	-9314
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)	-5208	-25800	-6986	-7917	-9314
Forex & disc ops (6)	n/a	n/a	n/a	n/a	n/a
Incl/(decr) cash (1+3+5+6)	884.8	16876	-15128	-1448	-1387
Equity FCF (1+2+4)	14112	48305	-3142	24469	27927

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

year to Mar

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 research produced by Nedbank Capital, a Buy implies upside in excess of 20%, a Sell implies an expected return less than 10%, and a Hold implies a return between 10% and 20%. 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 produced by Nedbank Capital and 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 08 Dec 2010)

	Global total (IB%)	Asia Pacific total (IB%)
Buy	718 (0)	455 (0)
Hold	443 (0)	244 (0)
Sell	116 (0)	72 (0)
Total (IB%)	1277 (0)	771 (0)

Source: RBS

Trading recommendations (as at 08 Dec 2010)

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

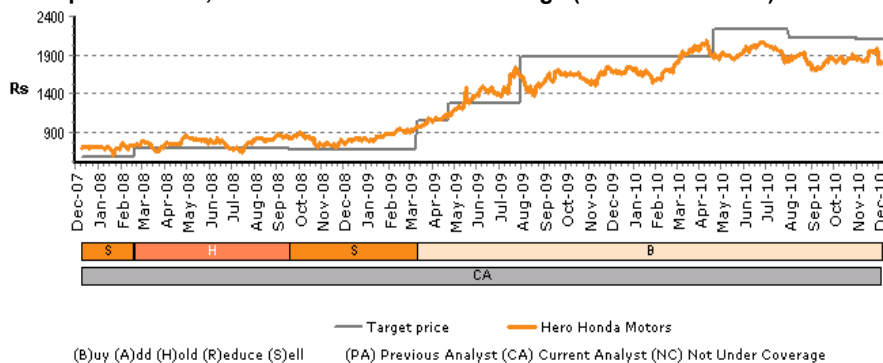
Source: RBS

Valuation and risks to target price

Hero Honda Motors (RIC: HROH.BO, Rec: Buy, CP: Rs1789.35, TP: Rs2090.00): The key risks to our DCF-based target price are: 1) a renewal of price wars by the competition forcing Hero Honda to join the race; 2) Honda's 100% subsidiary expanding its product portfolio, leading to head-on competition; 3) a delay in the tie-up of technology if a JV split happens, thereby affecting its volume growth.

Hero Honda coverage data (HROH.BO, HH IN)

Stock performance, recommendations and coverage (as at 08 Dec 2010)



Pramod Amth 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

Date	Rec	Analyst
n/a	n/a	n/a

Source: RBS

Price perf (at Close 07 Dec 2010)

	(1M)	(3M)	(12M)
Price (Rs)	1846	1709	1677
Absolute (%)	-3.1	4.7	6.7
Rel market (%)	2.1	-2.1	-9.1
Rel sector (%)	-4.8	-9.8	-2.8

Source: Bloomberg
Market: Sensex
Sector: Automobiles

Regulatory disclosures

None

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