

Indices	Last Close	% Chg 1-d	% Chg mtd
Sensex	20,589	(1.4)	2.1
Nifty	6,194	(1.3)	2.3
CNX 500	5,120	(1.3)	2.4
BSE Bank	14,588	(1.3)	3.0
BSE IT	6,132	(1.3)	1.8
BSE Oil & Gas	10,900	(1.8)	(0.9)
Dow Jones	11,283	(0.7)	1.5
Nasdaq	2,556	(0.9)	1.9
FTSE	5,815	(0.0)	2.5
DAX	6,723	0.1	1.8

Mkt Breadth	Advance	Decline	Unchanged
Nifty	10	40	0
Sensex	5	25	0

Turnover	INR Bn	% Chg
BSE Cash	61	4.5
NSE Cash	181	7.7
NSE F&O	1,251	46.6
Total	1,493	

Fund Flows	US \$ mn	MTD	YTD
FII Equity	24	3,650	28,483
MF	(22)	155	(6,095)

Forex/Bond	Last Close	Chg 1-d	Chg mtd
INR/USD	44.31	0.01	(0.13)
USD/EUR	1.367	(0.01)	(0.03)
YEN/USD	82.5	0.21	2.10
10 yr G-Sec	8.09	0.03	(0.04)

Commodities	Last Close	% Chg 1-d	% Chg MTD
Brent (\$/bbl)	88.8	(0.2)	6.8
Gold (\$/oz)	1,409	0.3	3.6
Copper (\$/mt)	8,830	0.8	7.7
Aluminium (\$/mt)	2,457	0.4	4.8

Most Traded			
Scrip	Last Close	% chg	Value*
Coal India	329	1.8	11.7
Reliance Pwr	191	10.0	10.2
SBI	3,176	(1.2)	9.3
Delta Corp	132	9.3	8.3
Tata Motor	1,276	(2.0)	5.8

* INR Bn.

ADR GDR			
Scrip	Last Close*	% chg	% Prem.
Dr Reddy's	39.6	0.5	1.1
HDFC Bank	184.7	(0.6)	15.9
ICICI Bank	55.6	(2.1)	(0.4)
ITC	3.9	(1.2)	(0.4)
Infosys	67.7	(1.0)	(1.9)
Satyam	3.9	(1.5)	(1.3)
Ranbaxy	13.3	(3.4)	1.1
Reliance	48.8	(1.1)	0.2
Wipro	14.6	(2.8)	50.5
SBI	141.8	(1.7)	(1.1)
Tata Motors	31.8	(7.2)	10.5

* US\$

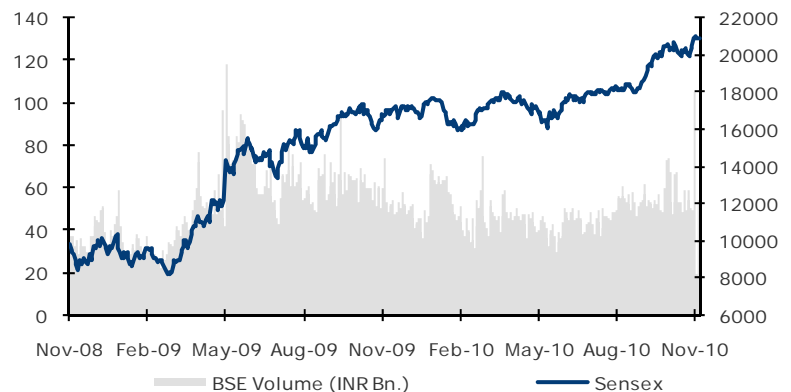
Contents

- Hero Honda Motors – Initiating Coverage

Headlines

- **Power Grid** issue subscribed nearly 10 times, a day before closure of the follow-on public offer. (Mint)
- **SAIL** has tied up with Geneva based **CBMM Technology Suisse SA** to develop high strength steel. (BL)
- **RBI** has reportedly downgraded **SBI's** rating from B to B- following an inspection of bank's books for FY2009. (Mint)
- **M&M** is reportedly looking to set up a one lakh capacity tractor unit in Tamil Nadu with an investment of Rs6bn. (ET)
- **Union Bank** plans to raise US\$175-200mn in overseas market through medium term notes. (BL)
- **DLF** has reportedly raised Rs4.1bn during 2QFY11 by selling its non-core assets, to reduce debt and generate cash flow for its ongoing projects. (Mint)
- **GMR Infrastructure** may reportedly sell its 50% stake in **InterGen** to **China Huaneng** for close to US\$1.5bn. (ET)
- **Parsvnath Developers** has reportedly won a bid for 38 acres of prime land in NCR from the Railways Development Authority for Rs.16.5bn. (Mint)
- **HDIL** is planning to launch residential projects spread across 27mn sq.ft. in the next six months. (ET)
- **Thermax** is set to partner with Icelandic firm **Reykjavik Geothermal** to set up a geothermal power project in India. (BL)
- Kalanithi Maran and his firm, **KAL Airways**, have raised their stake in **Spicejet** to 38.7% through purchase of additional 7.7% stake for Rs1.5bn. (ET)
- Global and domestic institutional investors to buy around 15% in loan-against-gold firm **Mannapuram General Finance** through QIP of Rs10bn. (ET)
- **Ranbaxy's** 2QFY11 profits up 168%YoY at Rs3.1bn. (ET)
- **Cipla's** 2QFY11 profits down 5%YoY at Rs2.6bn. (ET)
- **Jubilant Lifesciences'** 2QFY11 profits up 42%YoY at Rs820mn. (ET)
- **Bhusan Steel's** 2QFY11 profits up 37%YoY at Rs2.6bn. (ET)
- **Maytas Infrastructure's** 2QFY11 losses down 90%YoY to Rs0.5bn. (ET)
- **HDIL's** 2QFY11 profits up 43%YoY at Rs2.1bn. (Mint)
- **Apollo Tyre's** 2QFY11 profits down 59%YoY at Rs533mn. (ET)
- **Shree Cement's** 2QFY11 profits down 96%YoY at Rs105mn. (ET)

Sensex



From the Blogosphere

Irish Times: Merkel refuses to back down over debt burden (Source)

GERMAN CHANCELLOR Angela Merkel is refusing to back down from her push to force private investors to share the burden of the euro debt crisis, which helped send Irish borrowing costs to record levels. Speaking in Seoul, where she is attending the G20 summit, Dr Merkel acknowledged her demands have upset the markets but insisted it was unfair for taxpayers to be saddled alone with the cost of sovereign rescues. "Let me put it simply: in this regard there may be a contradiction between the interests of the financial world and the interests of the political world," Dr Merkel said. European Commission chief José Manuel Barroso moved to shore up confidence in Ireland by saying euro countries stand prepared to provide emergency aid if required, but officials stressed the Government has not asked for such assistance. Amid a loss of market confidence in Ireland, political anxiety in Europe centres on the fragility of the Government's position as it prepares to extract €6 billion in cutbacks and tax increases in the budget and a total of €15 billion in the four-year recovery plan. Further concern surrounds the position of Ireland's banks, whose shares have fallen steadily in recent days amid fears the €45 billion bailout bill might rise. In spite of discussions between major European governments and Brussels, Berlin dismissed German reports yesterday that it was "concerned" about Ireland's financial situation and readying a bailout.

Bloomberg: Norway Caps Junk-Graded Debt as Wealth Funds Grow More Cautious (Source)

Norway's government will require the country's \$520 billion oil fund to limit investments in junk-rated debt amid growing concern peripheral Europe's fiscal crisis may be escalating. The Government Pension Fund Global, the world's second-biggest sovereign wealth fund, will next year be expected to try to cap its holdings of non-investment grade debt at 3 percent of its total fixed-income portfolio, said Bunny Nooryani, a spokeswoman at Norges Bank Investment Management, which runs the fund, in an e-mailed reply to questions. It will be the first time the Finance Ministry imposes such a cap, she said. Yields on Irish, Greek, Spanish and Portuguese debt have soared this month on concern the euro region may be unable to solve its worst debt crisis since the single currency was created more than a decade ago. Russia's Finance Ministry on Nov. 3 told its two wealth funds to exclude Irish and Spanish debt from their bond holdings. Norway's oil fund the following day said Spanish debt was becoming "less attractive." Concerns that Europe's debt crisis may intensify prompted declines in the region's single currency. The euro fell against 14 of its 16 most-traded peers, approaching the lowest in more than a month against the dollar. Europe's single currency traded at \$1.3701 at 12:40 p.m. in London. Norway's oil fund, which had 2.7 percent of its total debt holdings invested in junk-graded and un-rated fixed-income assets at the end of the third quarter, said in August it was buying up junk-rated Greek debt, signaling it didn't expect the bailout-reliant euro nation to default. The Norwegian fund, Europe's biggest equity investor, is built from oil and gas revenue and invests abroad to avoid overheating the domestic economy. It allocates 60 percent to stocks, 35 percent to bonds and 5 percent in property. Only Abu Dhabi has a larger fund, according to the Sovereign Wealth Fund Institute in California.

November 12, 2010

Recommendation	HOLD
CMP	1,820
Target	1,800
Stock Return	-1%

Nifty	6,194
Sensex	20,589

Key Stock Data

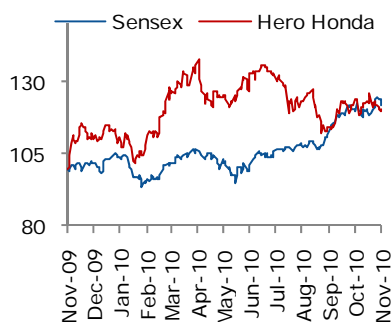
Sector	Automotive
Reuters Code	HROH.BO
BLOOMBERG Code	HH IN
No. of Shares (mn)	200
Market Cap (Rs bn)	363
Market Cap (\$ mn)	8,202
6 mth avg traded val (Rs. mn)	910

Stock Performance (%)

52 - Week high / low	Rs 2,075/1,420		
	3M	6M	12M
Absolute (%)	(2.5)	(4.2)	25.0
Relative (%)	(16.4)	(24.3)	2.8

Shareholding Pattern (%)

Promoters	52.21
FIs & Local MFs	5.80
FIIIs	31.75
Public & Others	10.24

Source: Company
Sensex and Stock Movement

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We initiate coverage on Hero Honda with a HOLD recommendation and a target price of Rs1,800. Hero Honda, the world's largest motorcycle manufacturing company, is well placed to benefit from the robust domestic demand for motorcycles. However the industry remains competitive and despite strong volume growth, earnings growth has been impacted due to weakening margins. The issue of the rumored split between both partners, Hero Group and Honda Motors Japan, remains a key overhang on the stock. YTD, the stock has underperformed the Sensex by 24% and we expect the under-performance to continue. However, we also expect the company to maintain its market leadership and stabilization in margins and improving market share remains key upside triggers.

Honda v/s Hero Group – a key overhang

Investor concern currently is focused on the outcome of the rumored split between Hero Honda's equity partners, viz. Hero Group and Honda Motors Japan. We believe the Hero Group can survive without Honda. Its current product portfolio does not require major technological up gradations in the short term and in the medium/long term The Group can invest into strengthening its R&D capabilities. Monies saved on royalties can thus be sent into building product skills and increasing brand awareness. We also see revenue potential from exports, which are currently limited (2.6% of sales, cf. 30% for Bajaj Auto). Hence, while we expect Hero Honda to maintain its market share post split, we expect competitive pressures from Bajaj Auto, TVS Motor and new players (including Honda) would only rise.

Indian Motorcycle Industry – growth momentum intact

After two years (FY08 and FY09) of sluggishness, motorcycle sales rose 26% in FY10 led by the Government stimulus and strength in rural demand. YTD growth has been robust at 25.6% as well. Penetration of motorcycles in rural areas is estimated at 10% and in urban areas at 28%, indicating enough headroom for growth. Motorcycle sales have also remained robust even after the Tata Nano's launch which should allay concerns on shift of motorcycle demand to entry-level cars. Our Economist, Sameer Narang, expects India's GDP growth to average 8.3% between FY11-13, which, we believe, should support a 15% CAGR in motorcycle sales.

Valuations and outlook – initiate with a HOLD

Since rumors of the split between the partners first began in July'10, HH's stock has underperformed the broader markets by 10%. In its recently declared results, HH's operating margins disappointed street expectations with margins under pressure as pricing power remains limited in a competitive environment. Currently the stock trades at 14.3x FY12E earnings estimate, which is at a discount to peer Bajaj Auto. Our target price of Rs 1,800 is based on a 5-year trading PE multiple of 14x, which is reasonable considering our forecasted FY11-13E earnings CAGR of 15%. Till the final outcome of the Hero Group-Honda Japan issue, we expect the stock price to remain range-bound. However, improving market share and stabilization in margins are key upside triggers, while an adverse split between partners remains the key risk. Initiate coverage with HOLD.

Table 1: Financials and Valuation

Particulars	FY09	FY10	FY11E	FY12E	FY13E
Net Sales (Rs Mn)	123,192	157,582	180,502	208,156	240,872
EBIDTA (Rs Mn)	17,097	26,619	25,143	31,077	35,479
EBIDTA margin (%)	13.9%	16.9%	13.9%	14.9%	14.7%
Net profit (Rs Mn)	12,817	22,318	21,653	25,481	28,723
EPS (Rs.)	64.2	111.8	108.4	127.6	143.8
EPS Growth (%)	32%	74%	-3%	18%	13%
PE (x)	28.4	16.3	16.8	14.3	12.7
RoCE (%)	43.7	66.7	55.3	51.5	45.7
RoE (%)	37.8	61.4	52.8	46.4	40.5

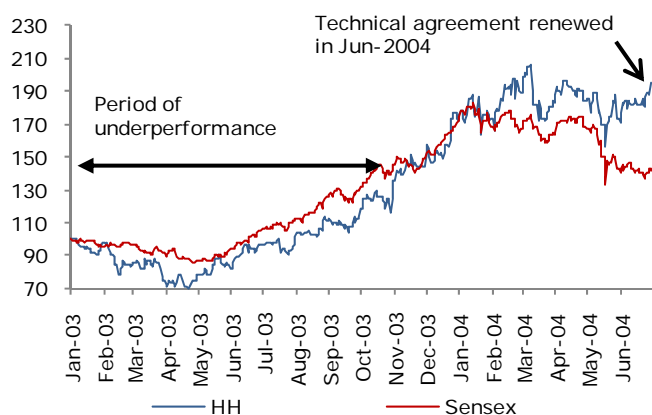
Source: HDFC Securities Institutional Research

Section 1: "Honda" and Hero "Honda": Possible scenarios

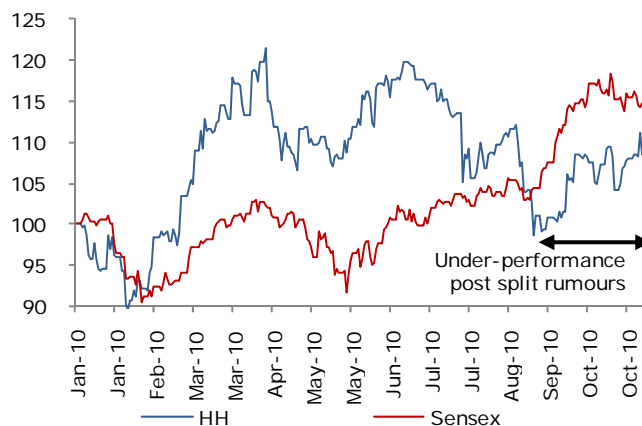
Hero Honda (HH) was formed in 1984 as a joint venture between Honda Motors Japan and the Munjal-owned Hero Group. Both partners hold an equal 26% stake and a technology sharing agreement is in place since 1984 which is renewed every 10 years. However, rumors about a split between the Munjals and Honda Motors, Japan have surfaced in the past and have been an investor concern.

Notably, in 2004, when the technological agreement was due for renewal, concerns were raised on whether Honda would continue their support to HH given that Honda's own 100% Indian subsidiary (Honda Motorcycles & Scooters India - HMSI) was fully operational. While the agreement was renewed in June-2004, HH's stock price remained under pressure in the period leading up to the renewal.

This time, while the technological agreement between the partners now comes up for renewal in 2014, rumors about a split between both partners have gathered pace once again since July-2010. Media reports indicate that The Hero Group will buy out Honda's stake in the venture. Once again, HH's stock price has been impacted by the rumors.

Chart 1: Hero Honda v/s Sensex 2003-04


Source : Bloomberg, HDFC Securities Institutional Research

Chart 2: Hero Honda v/s sensex YTD


Source : Bloomberg, HDFC Securities Institutional Research

We believe HHML can sustain with current R&D capabilities in the short term considering the company has internal capabilities to make cosmetic changes and minor technical modifications in 75-125cc segment models.

We believe The Hero Group is now better placed than it was in 2004 to withstand a split with Honda Motors, Japan. We look at certain issues:

1. What about Hero Group's R&D and product portfolio?

Our view: Over 85% of HH's sales come from the 75-125cc segment where the company commands 70% market share. HH has six products in the segment (in the price bracket of Rs. 35K to 45K) bringing a sale volume of over 4m per annum. We believe HH can sustain with current R&D capabilities in the short term considering this segment does not demand major technological up gradations and the company has ample internal capabilities to make cosmetic changes and minor technical modifications in these models.

However, we believe that the major challenge will be developing capabilities to design new platforms. Some options that might work:

- Developing internal R&D capabilities with the help of design consultants: We believe this will involve a time frame of 3-5 years and capital commitment of 2-3% of net sales per annum. Considering Hero is already paying close to 2.6%

Section 1: "Honda" and Hero "Honda": Possible scenarios

as royalty and technical fees to Honda, we expect the same can be diverted in developing the R&D capabilities.

- Getting into a technological collaboration like Bajaj Auto & Kawasaki: this option will involve royalty and technical consulting fees which we estimate to be lower than the current royalty levels with Honda. As most of the big global players are looking to capture the fast growing Indian two wheeler industry themselves, searching for an ideal partner could be a challenge.
- Another option could be to continue the technical agreement (with royalty payment) till 2014 and then go the independent way. This option will provide the requisite time for both the partners to plan the strategy after the agreement collapse. Hero can initiate building R&D capabilities whereas Honda can expand the network and product portfolio. We expect Hero group to pursue this option more aggressively considering better bargaining position.

2. Impact on HH's sales volumes

Splendor and Passion has been rated as the top two brands in two wheeler category by ET Brand Equity Survey.

Our view: In last couple of years, Hero Honda has followed a strategy of building product brands along with the corporate brands and have constantly dedicated marketing budget of over 2% of net sales each year. In our recent discussions with them, dealers appeared confident about Splendor's brand being strong enough to withstand a split between the promoters. The recent success of Splendor/Passion variants also indicates very strong brand value for these leading brands. While we do expect an impact on sales due to brand dilution in case of a break up, we expect higher ad-spend should recoup some losses for The Hero Group.

Table 2: Advertisement spend

Hero Honda (in Rs. Mn)	FY10	FY09
Net Sales	157,582	123,191
Expense on Advt & Publicity	3,650	2,496
Expense as % of net sales	2.3%	2.0%

Source : Company, HDFC Securities Institutional Research

3. Royalties v/s R&D costs:

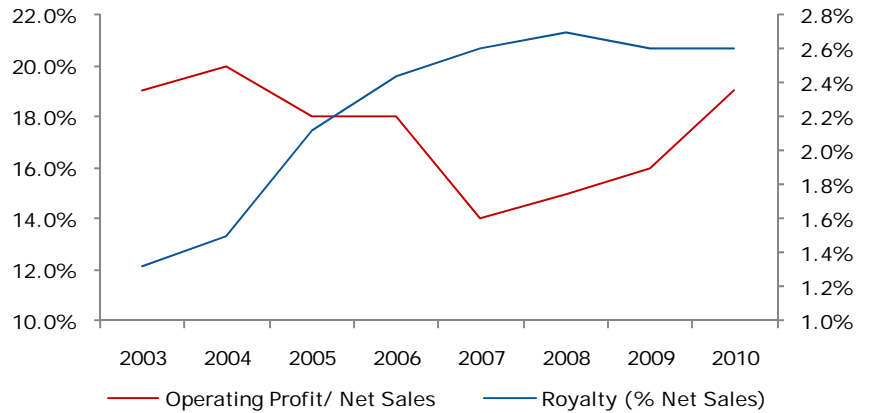
Our view: Royalty has been the third largest expenditure head (2.6% of net sales) for HH after Raw material cost (70% of net sales) and Employee cost (3.6% of net sales). This adds to pressure on the cost structure considering highly price competitive two wheeler market.

In comparison, TVS Motor in FY2000-01 had an outflow of 0.9% of net sales as royalty payment to Suzuki. Similarly, Bajaj Auto spends 0.10-0.14% of net sales as royalty and technical consultancy fees. The R&D expenses of the three companies vary in the inverse proportion as royalty outflow.

Comparing these figures with HH's Royalty outflow, we believe the company can invest the same amount in R&D to develop internal capabilities. Considering most of the vendors to HH share strong relationship with Hero group, company will have the advantage of strong backward integration.

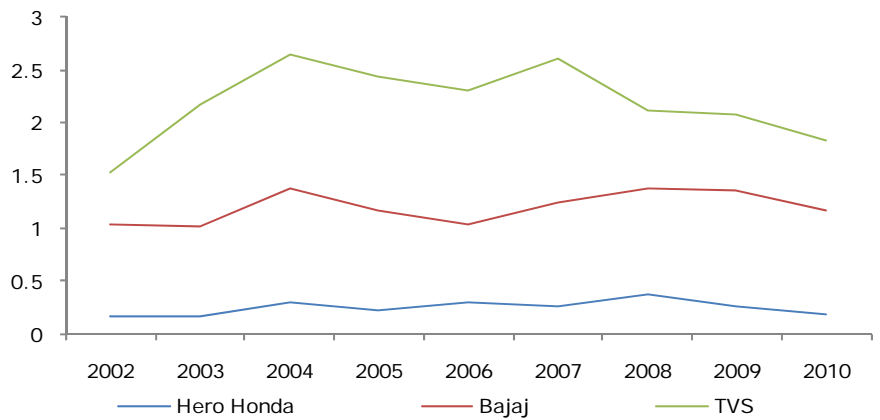
Section 1: "Honda" and Hero "Honda": Possible scenarios

Chart 3: Hero Honda – Declining operating profit with increase in Royalty



Source : Company, HDFC Securities Institutional Research

Chart 4: R&D Expenditure as % of Net Sales



Source : Company, HDFC Securities Institutional Research

R&D spends for TVS motor increased substantially from 0.88% of Net Sales in FY01 to 2.65% of Net Sales in FY04, after their break up with then technology partner – Suzuki Motors, Japan in the year 2001.

Hero Honda, in FY09-10 exported close to 100,000 units (+20% YoY) to Sri Lanka, Bangladesh and Columbia whereas Bajaj Auto exported close to 900,000 units.

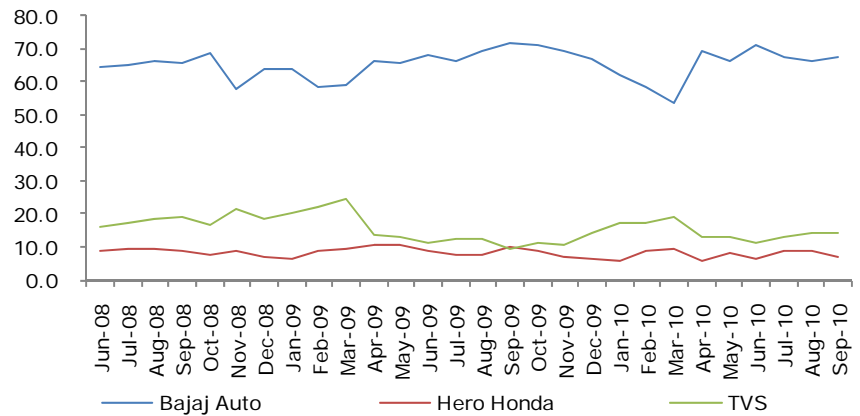
Over 30% of Bajaj Auto's volume comes from exports market, whereas for Hero Honda it's just 2.6%.

4. Potential for exports:

Our view: Given Honda's existing presence in overseas markets, HH has been unable to boost revenues from exports. Exports would have helped in strengthening HH's brand and expanding its network in existing export markets.

After the split, we expect HH to gain in volumes by venturing into the growing exports market. Our projection is an upswing from 10,000 units per month currently to 60,000 units per month in exports in next 2 years.

Chart 5: Export motorcycle sales trends (%YoY)



Source : SIAM, HDFC Securities Institutional Research

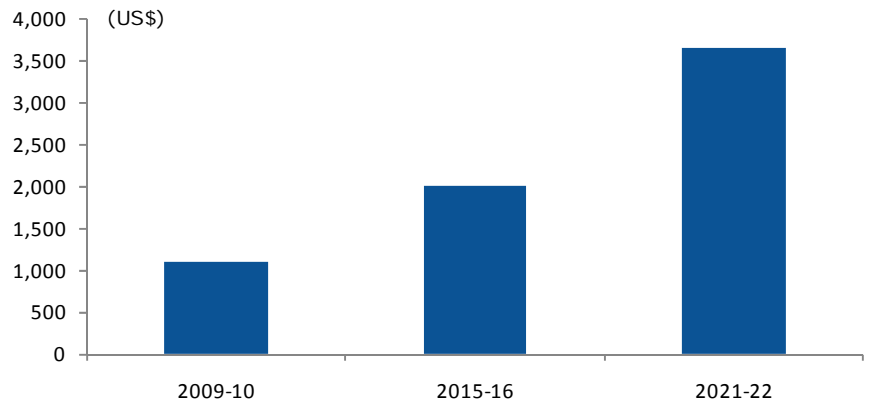
Section 2: Robust industry growth

Motorcycle sales in India have grown at a healthy 18% CAGR in the past decade (FY00-10) and we remain positive on the future outlook as well. While sales were hit during the global financial meltdown (-12.6% in FY08 and +1.2% in FY09), FY10 sales rebounded strongly and 1HFY11 growth at 22.5% has been robust as well. However, we expect 2HFY11 headline growth rates will be impacted by a high base.

Going forward, we expect industry volumes to grow at a healthy CAGR of 15% over FY10-13, driven by the overall economic growth, rising rural incomes and increasing penetration. Our Economist, Sameer Narang has pegged India's GDP growth rate to average 8.3% over FY11-13, with services growing at 9.3%, agriculture at 3.5% and industry at 8.6%. With two wheelers being the most affordable and popular mode of transport, we expect this will result in increased demand.

Chart 6: India's per capita income in the future

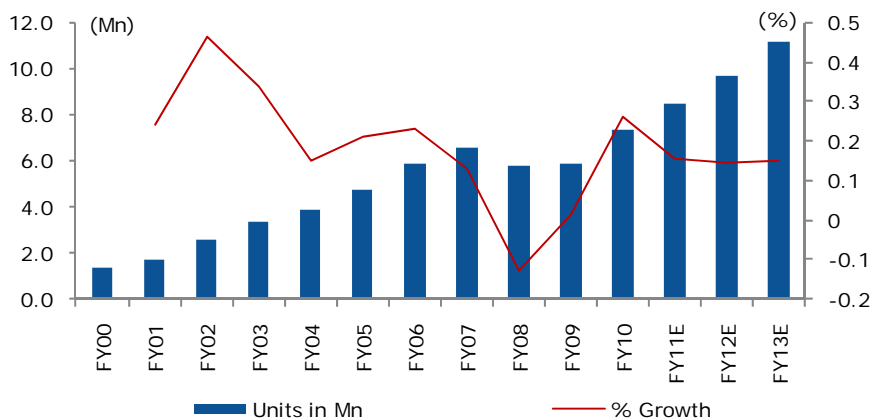
India's per capita income is projected to grow with a CAGR of 12.7% for next 5 years.



Source : CSO, HDFC Securities Institutional Research

Chart 7: Motorcycle domestic industry projections

We expect domestic motorcycle industry to grow 15.3% in FY11 and 14.3% FY12 and cross 10 million units by FY13.



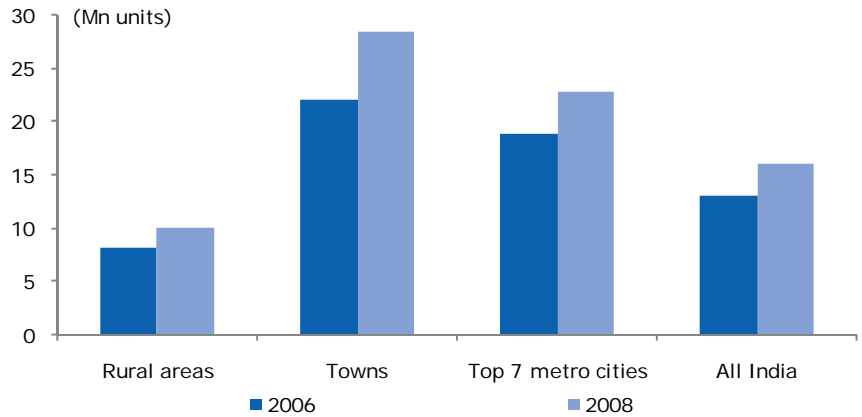
Source : Company, HDFC Securities Institutional Research

Rural demand - a key driver

As per NBS and Industry, motorcycle penetration in rural areas is estimated at 10% as compared to 28% in urban towns. HH has a strong rural presence, with rural areas contributing to 44% of sales, panning over 100,000 villages. HH has dedicated programs like HGHA – ‘Har Gaon Har Aangan’ & ‘Service Har Jagah’ with more than 2000 rural sales channel partners, focused on raising sales from these regions. Given the recent strong monsoons and the rise in agri-output, we expect demand outlook for motorcycles to remain strong and HH to be a key beneficiary.

44% of Hero Honda’s sales come from rural India – over 2 million units per year.

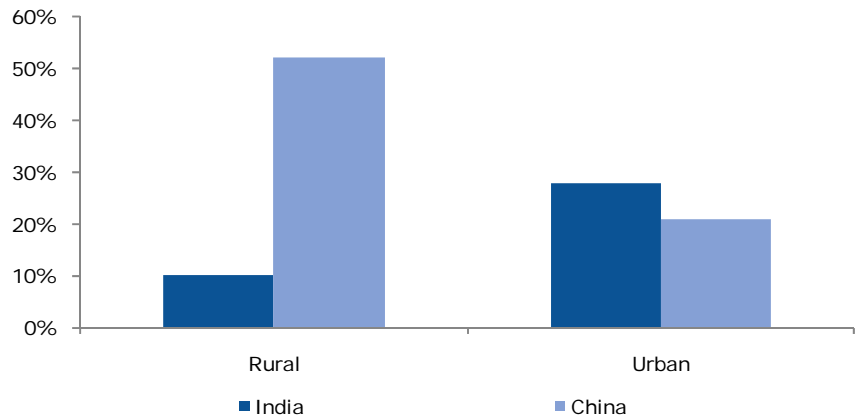
Chart 8: Penetration – Motorcycles – (Population Strata)



Source : Bajaj Auto, HDFC Securities Institutional Research

Rural India has just 10% penetration whereas rural China has 52%. Urban penetration matches in both countries.

Chart 9: Penetration – Motorcycles – India and China



Source : NBS, Bajaj Auto, HDFC Securities Institutional Research

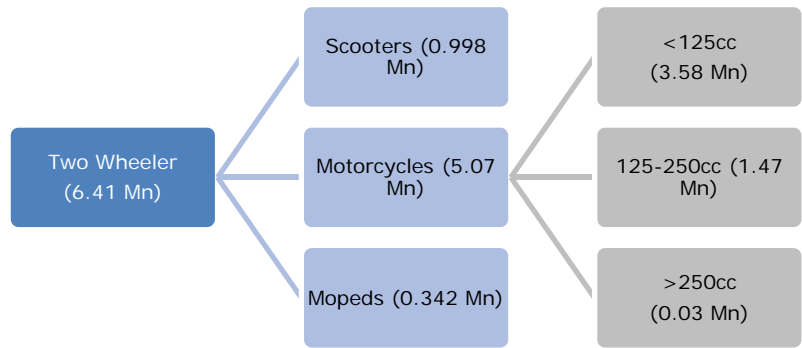
Exports also on an uptick

Despite HH’s inability to tap global markets, its exports have risen 34.5% in 1HFY10 led by successful new model launches in Sri Lanka, Bangladesh and Columbia. Similarly, Bajaj Auto’s exports are up 51.3% and account for 30% of volumes (cf. 2.6% for HH). Low cost of skilled manpower and rapidly growing design capabilities has enticed many international players to explore India as export hub. Key Markets for Two wheelers exports from India has been South Asia, South East Asia, Latin America, Africa and Middle East. We expect export trend to be positive barring concerns in Latin America, Middle East and South-East Asia due to slow recovery.

Key Markets for Two wheelers exports from India has been South Asia, South East Asia, Latin America, Africa and Middle East.

Motorcycles form close to 80% of the total two wheeler sales. 70% of Motorcycle sales come from <125cc segment whereas premium segment has been growing fast.

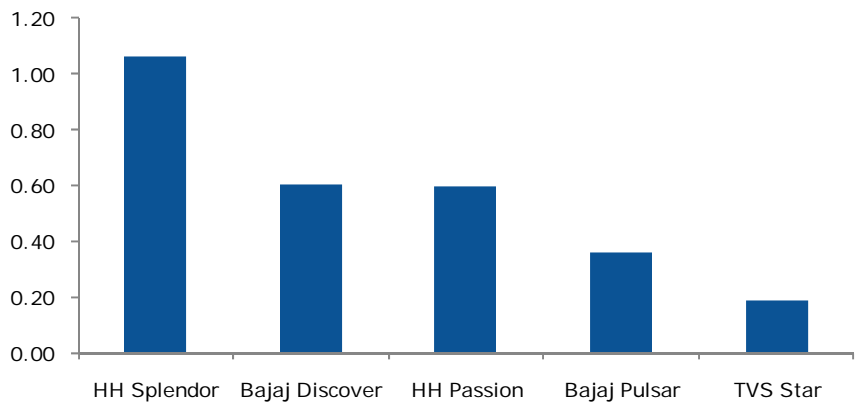
Chart 10: Two wheeler industry tree – Apr to Sep 2010



Source : SIAM, HDFC Securities Institutional Research

Splendor has been the fastest selling brand in India with Passion and discover as second best.

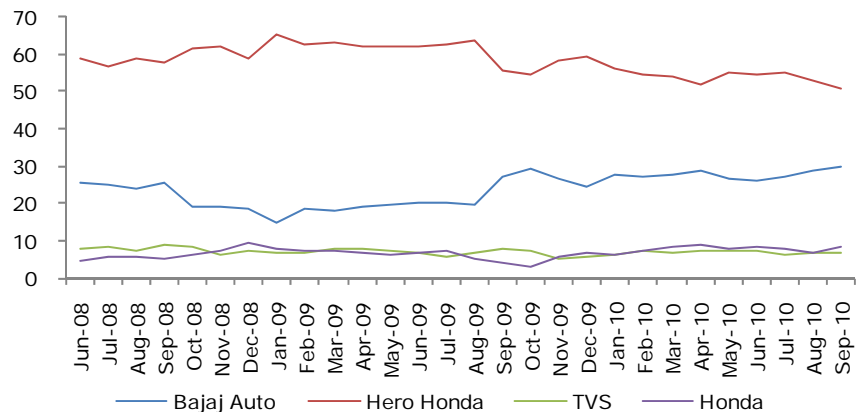
Chart 11: Brand wise sales for top models (Domestic) – Apr-Sep'10



Source : Company, HDFC Securities Institutional Research

Hero Honda is still the market leader in the domestic segment with a margin of more than 150,000 units than the nearest competitor, Bajaj Auto.

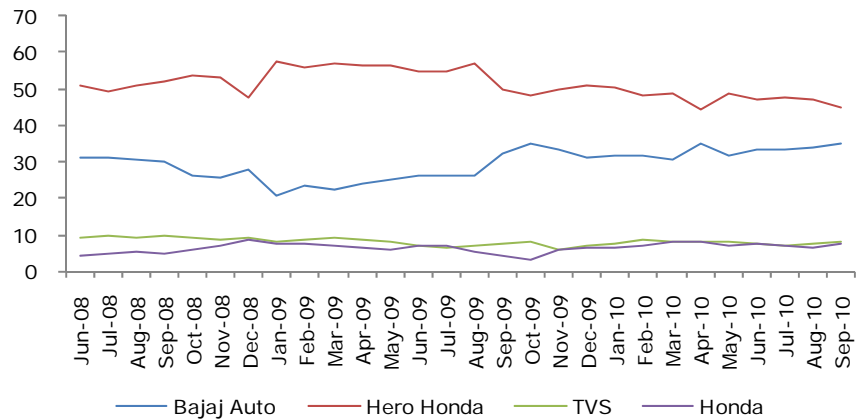
Chart 12: Domestic motorcycle sales trends (%YoY)



Source : SIAM, HDFC Securities Institutional Research

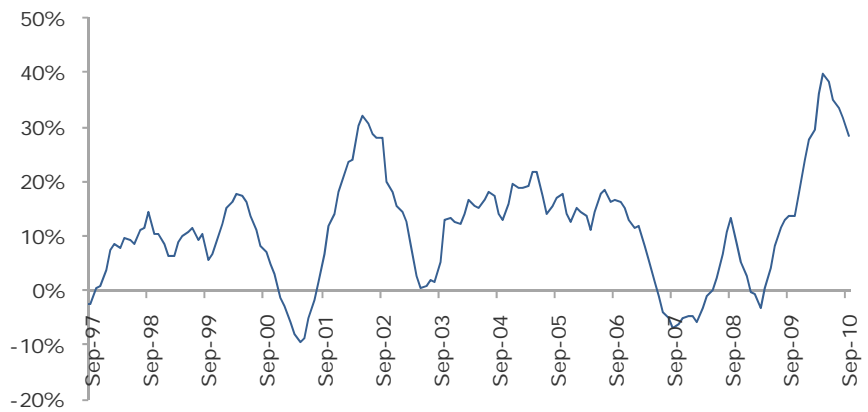
The volume difference between Hero Honda and Bajaj Auto becomes narrower considering Bajaj Auto's strong hold in exports market.

Chart 13: Industry (domestic + exports) motorcycle sales trends (%YoY)



Source : SIAM, HDFC Securities Institutional Research

Chart 14: 2-wheelers sales (6 months moving average % yoy)



Source : SIAM, HDFC Securities Institutional Research

Market share: Likely to recover

With domestic market share in the 75-125cc segment down from 78% in Apr-Oct'09 to 69% in 2010, Hero Honda has lost ground in the motorcycle segment. This was primarily due to 1) production constraints, and 2) increasing competition. We expect some pressure to soften considering planned capacity expansion from 5.4 Mn to 5.7 Mn by year end. However, in the longer term we expect competition in this segment which accounts for 47% of overall domestic motorcycle sales to remain high, given plans for new model launches by competitors.

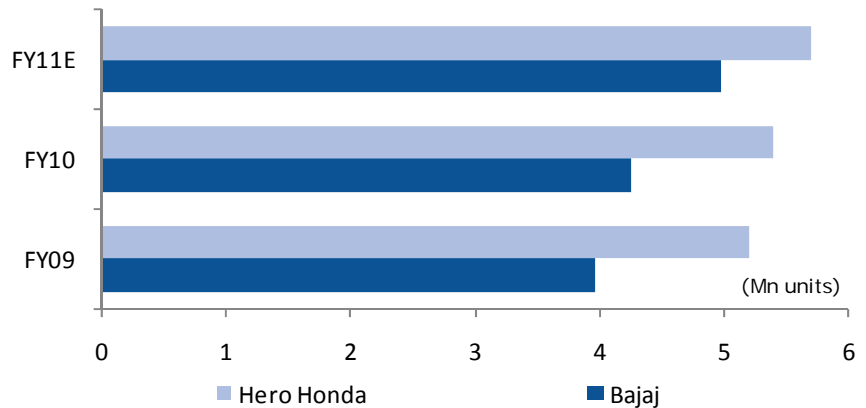
High competition will also impact the company's flexibility in passing any raw material price increase to consumers. Though with the demand on upswing and most manufacturers working on over 85-90% capacity utilization, we don't expect to see any price war in next 1-2 quarters.

Table 3: Domestic sales for 75-125cc Motorcycle segment

	Apr-Sep 2010	Apr-Sep 2009	% YoY
Hero Honda	2,158,813	2,032,101	+6.2%
Bajaj Auto	598,214	308,016	+94.2%
HMSI	90,444	13	-
TVS Motor	242,244	182,170	+33.0%
All Manufacturers	3,128,202	2,555,021	+22.43%

Source : SIAM, HDFC Securities Institutional Research

Chart 15: Installed Capacity



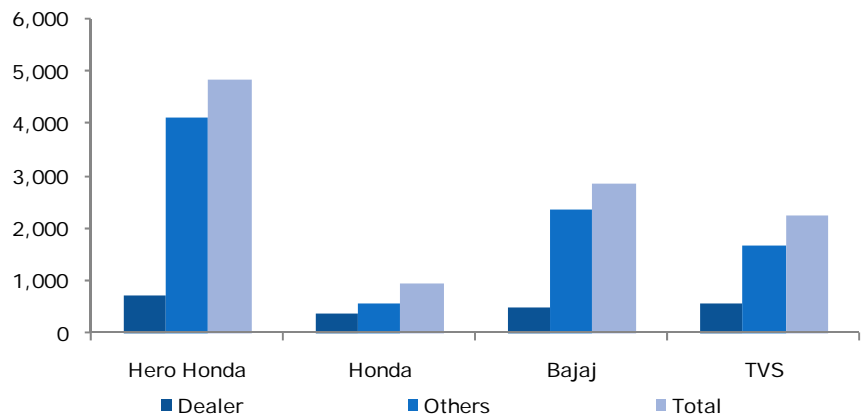
Hero Honda has plans to enhance the capacity to 57 Lacs units by FY11. Bajaj Auto is catching up fast with plans to enhance capacity to close to 50 Lacs by FY11.

Source : Company, HDFC Securities Institutional Research

Large Sales and Service network - key strength

Hero Honda continues to have the largest after-sales and service network among Indian two-wheeler manufacturers. As the company reaches out to smaller towns and cities, an established service network will (a) also increase spare sales and (b) entrench HH's brand. We expect this will be the biggest strength for the company over competition to expand the reach as well as brand visibility for the products. It offers easy reach and confidence to the customers and is very critical for success in rural segment.

Chart 16: Network comparison



Hero Honda has the largest sales and service network with the nearest competition being 60% in network size.

Source : Company, HDFC Securities Institutional Research

Chart 17: HHML Touch Points

Offers easy reach and confidence to the customer. More critical for success in rural segment.



Source : Company, HDFC Securities Institutional Research

Price hikes likely to stabilise operating margins

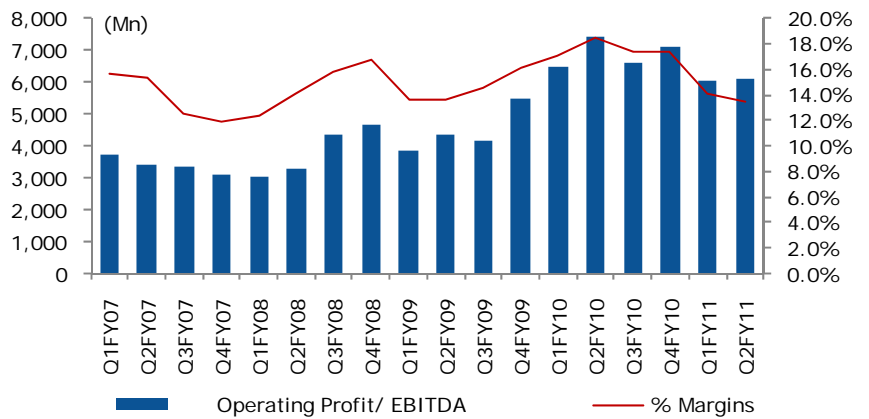
Going forward, we expect margins to stabilize at current levels – Hero Honda ~15%, Bajaj Auto ~20% & TVS Motor ~7% - given the recent softening in commodity prices.

Rising competitive pressures has restricted HH's ability to pass on higher raw material costs via price hikes to consumers. From highs of 17% in FY10, HH's EBITDA margins have dropped to 13.5% in Q2FY11. Higher costs due to implementation of emission norms added to the overall manufacturing costs, which could also not be fully passed on to the consumer.

However, HH raised prices on select models by 1.5-2% on 1st July and we expect the full impact of this price hike to be felt in 2HFY11 and expect margins to stabilise at 15% levels.

Chart 18: EBITDA margin trend

From highs of 17% in FY10, HH's EBITDA margins have dropped to 13.5% in Q2FY11.



Source : Company, HDFC Securities Institutional Research

Institutional Research

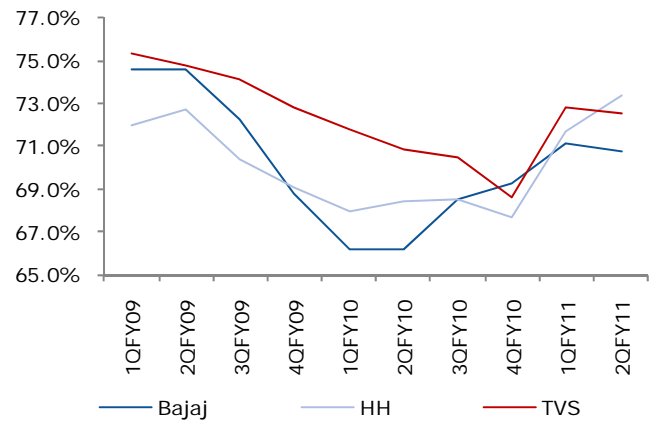
Table 4: EBITDA Margin %

	Q2FY11	Q2FY10	YoY bps
Hero Honda	13.5	18.4	(490)
Bajaj Auto	20.7	22.0	(130)
TVS Motor	7.6	6.9	70

	Q2FY11	Q1FY11	QoQ bps
Hero Honda	13.5	14.1	(60)
Bajaj Auto	20.7	20.0	70
TVS Motor	7.6	7.4	20

Source : Company , HDFC Securities Institutional Research

Chart 19: Raw material as a component of net sales



Source : Company , HDFC Securities Institutional Research

EBITDA margin for Hero Honda was under pressure in the last quarter considering high raw material cost and cost impact of technical up gradation due to emission norms. Hero Honda margin Q2FY11 was down to 13.5%. Bajaj Auto has been able to maintain the EBITDA margin of over 20% whereas TVS Motor has been struggling with sub 8% EBITDA margin.

We expect the margins to remain at the same level for H2FY11 considering high cost of raw material.

Section 3: Risks and Outlook

Key risks to our investment thesis include heavy dependence of Hero Honda on two brands – Splendor and Passion, and increasing competition & capacity constraints. Also a higher than expected industry growth might lead to recalibration of the outlook on the upside.

Heavy dependency on two brands

The Splendor and Passion brands (five models in total out of Hero Honda's product stable of fifteen models) have been the biggest contributor in Hero Honda's product stable with a combined volume contribution of more than 70%.

Table 5: Model-wise sales

Brand	Model	2009	2010
Splendor	Splendor+	39%	42%
	Super Splendor	4%	2%
	Splendor NXG	2%	2%
		45%	46%
Passion	Passion Pro	17%	21%
	Passion Plus	12%	5%
		29%	26%
% Contribution to Motorcycle sales		74%	72%

Source : Company , HDFC Securities Institutional Research

Both models enjoy a very strong brand franchise, with Splendor being the largest selling motorcycle in the world. While lower-priced models from competition have aimed at both brands, till now this has not resulted in any volume loss for HH. However, any serious threat to both brands could impact market share further and even result in a price war.

Table 6: Number of Models in the Price Range

Price INR	30K - 40K	40K - 50K	50K - 60K	60K - 70K	>70K
Hero Honda	4	6	4	0	2
Bajaj Auto	3	2	1	2	3
Honda	0	1	1	1	0
TVS Motor	2	3	1	1	0
Suzuki	0	3	1	0	0
Yamaha	1	3	1	1	2

Source : Company , HDFC Securities Institutional Research

Global Uncertainty and rising inflation

Though India's economy has been on a steady path to recovery, the debt-related trouble within the Euro zone and poor employment scenario in US could negatively impact and slowdown the global economic recovery. Also any tightening of liquidity in the market to control inflation will have negative impact on the auto sales.

Rise in commodity prices

Raw materials account for 72% of revenues for HH and 83% of costs. Of these, steel and aluminum account for a major share of raw material costs. Currently HH has agreements with most of the vendors to account for commodity prices on forward basis. Given that pricing power remains limited, the company could find it difficult to pass-through higher raw material prices to customers via price hikes. This can negatively impact operating margins.

Raw Material % of Net Sales	68.0%	69.0%	70.0%	71.0%	72.0%
EPS FY12E	148.1	139.8	131.5	123.2	114.9

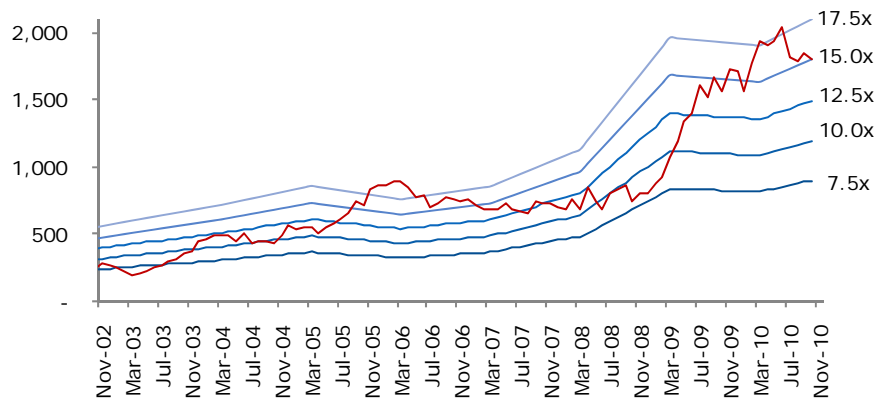
With every 1% change in the RM percentage point, the earnings get impacted by 6.3%.

With every 1% change in the RM percentage point, the earnings get impacted by 6.3%.

Section 4: Valuations: Fairly priced

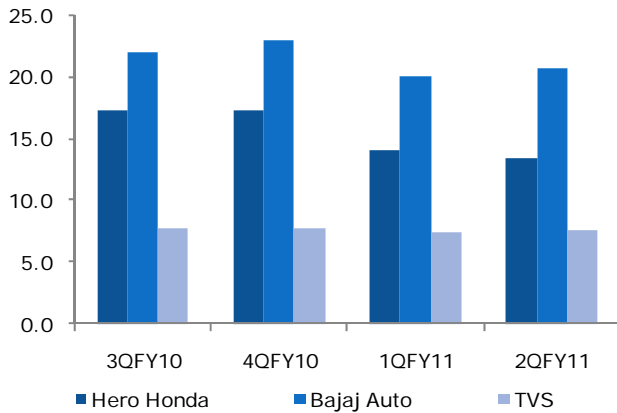
HH's stock price trades at 14.3x FY12E earnings, which we believe is fairly valued, considering our forecasted 15% FY11-13E earnings CAGR. HH was among the best performing stocks after the post-election rally (May 2009) as the market rewarded better-than-expected volume growth and stable margins. However, in 2010, since the Honda-Hero Group issue, the stock has underperformed broader markets by 10%. Moreover, Bajaj Auto has also gained significant ground with the success of its Discover and Pulsar brands. Going forward, given the overhang of the Honda-Hero Group issue, we expect HH's stock price will remain range-bound. At 14.3x FY12E earnings, the stock is on par with its 5-year trading average and at our target price. News-flow related to the Hero Group-Honda reported split remains the biggest driver for the stock price.

Chart 20: 1 year forward P/E Band



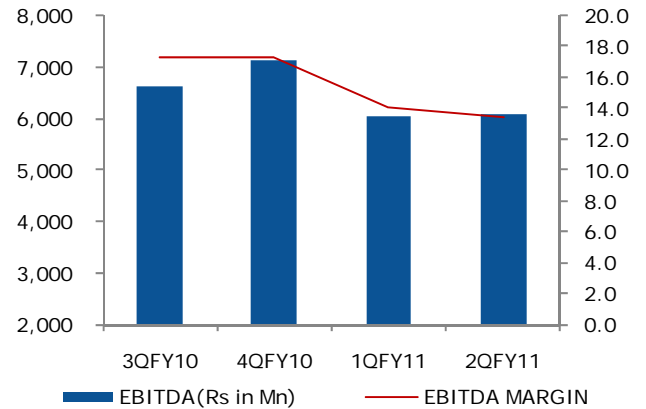
Source : Company, HDFC Securities Institutional Research

Chart 21: EBITDA margin trend



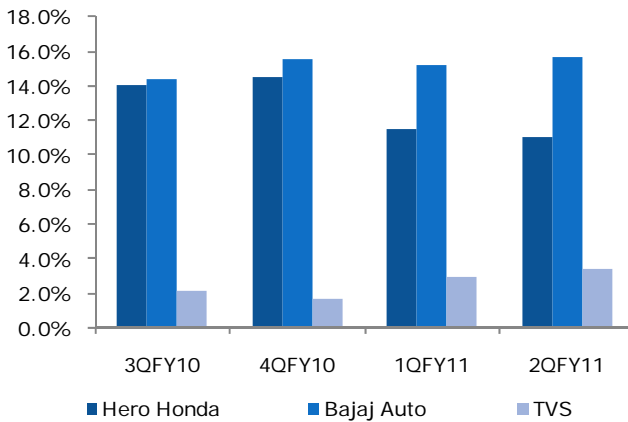
Source : Company, HDFC Securities Institutional Research

Chart 22: HHML - EBITDA margin trend



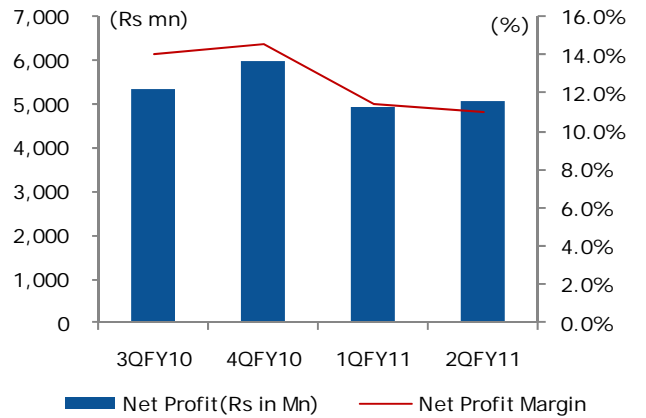
Source : Company, HDFC Securities Institutional Research

Chart 23: Net Profit Margin trend



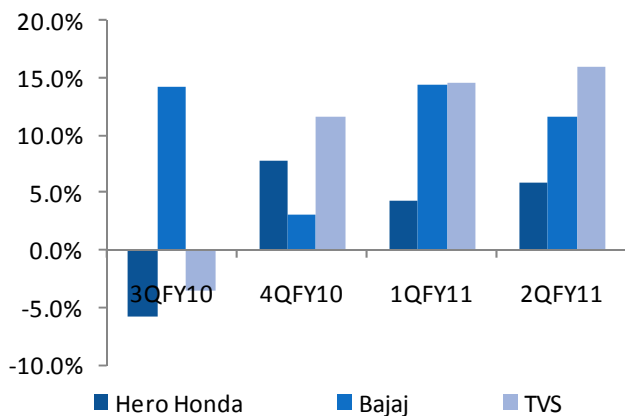
Source : Company, HDFC Securities Institutional Research

Chart 24: HHML - Net Profit Margin trend



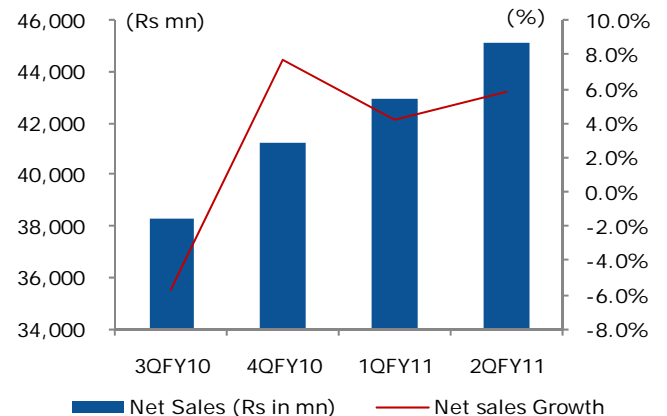
Source : Company, HDFC Securities Institutional Research

Chart 25: Net sales growth trend



Source : Company, HDFC Securities Institutional Research

Chart 26: HHML - Net sales growth trend



Source : Company, HDFC Securities Institutional Research

Section 5: Financials

Table 7: Balance Sheet

(Rs. Mn)	FY09	FY10	FY11E	FY12E	FY13E
SOURCES OF FUNDS :					
Share Capital	399	399	399	399	399
Reserves & Surplus	37,608	34,251	47,037	62,083	79,044
Total Shareholder's Funds	38,008	34,650	47,436	62,482	79,443
Total Debt	785	660	660	660	660
Total Liabilities	38,792	35,311	48,096	63,143	80,103
APPLICATION OF FUNDS :					
Gross Block	25,163	27,510	32,491	36,491	42,491
Less : Accumulated Depreciation	9,426	10,922	13,022	15,436	18,201
Net Block	15,737	16,588	19,469	21,055	24,290
Investments	33,688	39,257	39,257	39,257	39,257
Current Assets, Loans & Advances					
Inventories	3,268	4,364	4,371	5,703	6,599
Sundry Debtors	1,499	1,084	1,480	2,851	3,300
Cash and Bank	2,196	19,072	10,364	24,318	41,181
other current assets	59	248	248	0	0
Loans and Advances	3,113	4,058	4,107	5,703	6,599
Total Current Assets	10,135	28,826	20,569	38,576	57,679
Total Current Liabilities	20,528	48,314	29,672	34,217	39,595
Net Current Assets	-10,393	-19,488	-9,102	4,358	18,083
Net Deferred Tax Asset	-1,444	-1,528	-1,528	-1,528	-1,528
Total Assets	38,792	35,311	48,096	63,143	80,103

Source : Company, HDFC Securities Institutional Research

Table 8: Revenue Statement

(Rs. Mn)	FY09	FY10	FY11E	FY12E	FY13E
Net Sales	123,192	157,582	180,502	208,156	240,872
<i>% Growth</i>	<i>19.2%</i>	<i>27.9%</i>	<i>14.5%</i>	<i>15.3%</i>	<i>15.7%</i>
Total Expenditure	106,095	130,963	155,359	177,079	205,392
EBITDA	17,097	26,619	25,143	31,077	35,479
<i>% Margins</i>	<i>13.9%</i>	<i>16.9%</i>	<i>13.9%</i>	<i>14.9%</i>	<i>14.7%</i>
Interest	317	206	188	188	188
Gross Profit	17,414	26,825	25,332	31,265	35,668
Other Income	2,207	3,406	3,500	3,000	3,000
Depreciation	1,807	1,915	2,100	2,414	2,764
Profit Before Tax	17,814	28,317	26,731	31,851	35,904
Tax	4,757	5,999	5,079	6,370	7,181
Profit After Tax	12,817	22,318	21,653	25,481	28,723
<i>% Margins</i>	<i>10.2%</i>	<i>13.9%</i>	<i>11.8%</i>	<i>12.1%</i>	<i>11.8%</i>
Adjusted Net Profit	12,817	22,318	21,653	25,481	28,723
Dividend	3,994	21,966	7,578	8,918	10,053
EPS	64.2	111.8	108.4	127.6	143.8

Source : Company, HDFC Securities Institutional Research

Table 9: Cash Flow Statement

(Rs. Mn)	FY09	FY10	FY11E	FY12E	FY13E
CASH FROM OPERATING ACTIVITIES					
PBT	17,814	28,317	26,731	31,851	35,904
Adjustments					
Depreciation	1,807	1,915	2,100	2,414	2,764
Non Operating Income	-2,207	-3,406	-3,500	-3,000	-3,000
Interest Income	-317	-206	-188	-188	-188
Tax	-4,806	-5,916	-5,079	-6,370	-7,181
Change in Working Capital	2,399	25,971	-19,094	494	3,137
Net Cash From Operations	14,689	46,675	970	25,201	31,436
CASH FROM INVESTING ACTIVITIES					
Capital Expenditure	-3,102	-2,041	-4,500	-4,000	-6,000
Investments	-8,019	-5,570	0	0	0
Interest Income	317	206	188	188	188
Non Operating Income	2,207	3,406	3,500	3,000	3,000
Net Cash From Investments	-8,597	-3,999	-812	-812	-2,812
CASH FROM FINANCING ACTIVITIES					
Equity	0	0	0	0	0
Debt	-535	-125	0	0	0
Dividends	-4,673	-25,676	-8,867	-10,434	-11,762
Others	0	0	0	0	0
Net Cash From Financing	-5,207	-25,800	-8,867	-10,434	-11,762
Net Change in Cash	885	16,876	-8,708	13,955	16,862

Source : Company, HDFC Securities Institutional Research

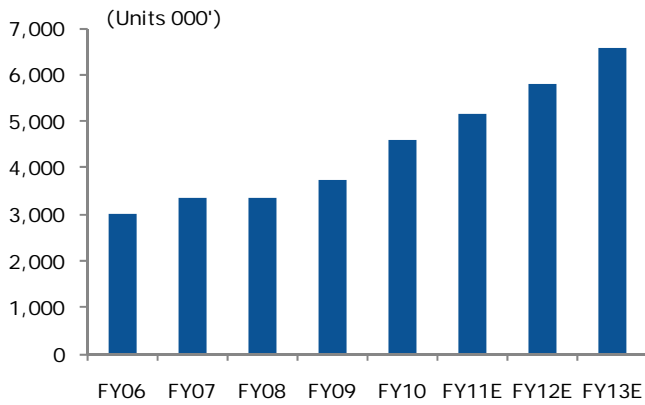
Table 10: Ratios

	FY09	FY10	FY11E	FY12E	FY13E
Working Capital (Days)					
Inventories	10	9	9	10	10
Sundry Debtors	7	3	3	5	5
Loans and Advances	7	8	8	10	10
Creditors	57	80	60	60	60
Operating Cycle	(34)	(60)	(40)	(35)	(35)
Leverage Ratios					
Debt/Equity	0.0	0.0	0.0	0.0	0.0
Net Debt/Equity	(0.0)	(0.5)	(0.2)	(0.4)	(0.5)
Debt/EBITDA	0.0	0.0	0.0	0.0	0.0
Interest Coverage Ratio	54.0	129.1	133.4	164.9	188.3
Profitability Ratios (%)					
EBIDTA Margins	13.9%	16.9%	13.9%	14.9%	14.7%
Net Profit Margins	10.2%	13.9%	11.8%	12.1%	11.8%
RoE	37.8%	61.4%	52.8%	46.4%	40.5%
RoCE	43.7%	66.7%	55.3%	51.5%	45.7%

Source : Company, HDFC Securities Institutional Research

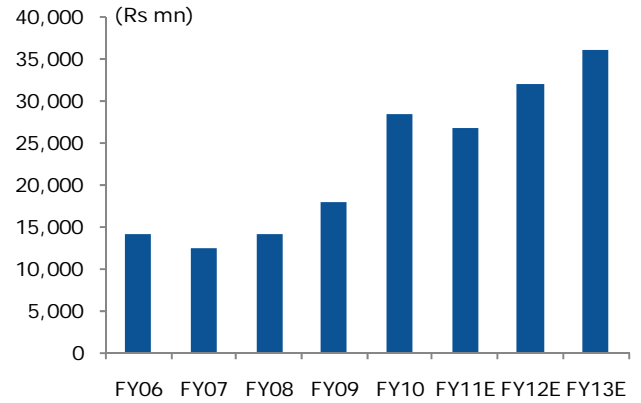
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Chart 27: Sales Numbers



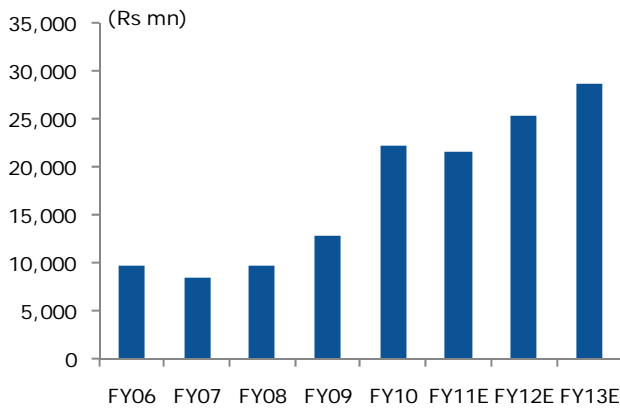
Source : Company, HDFC Securities Institutional Research

Chart 28: Profit Before Tax



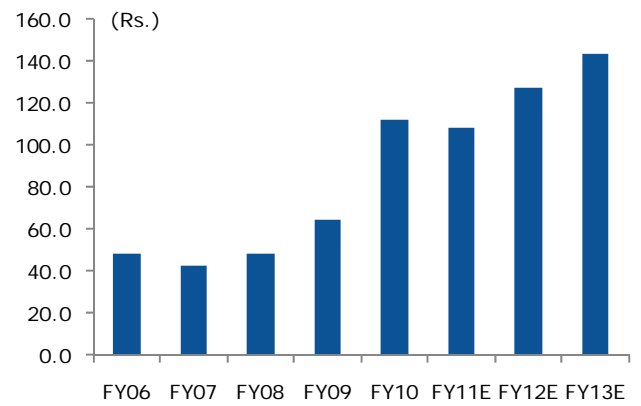
Source : Company, HDFC Securities Institutional Research

Chart 29: Profit After Tax



Source : Company, HDFC Securities Institutional Research

Chart 30: EPS



Source : Company, HDFC Securities Institutional Research

Appendix 1: Company Description

Hero Honda Motors Ltd.

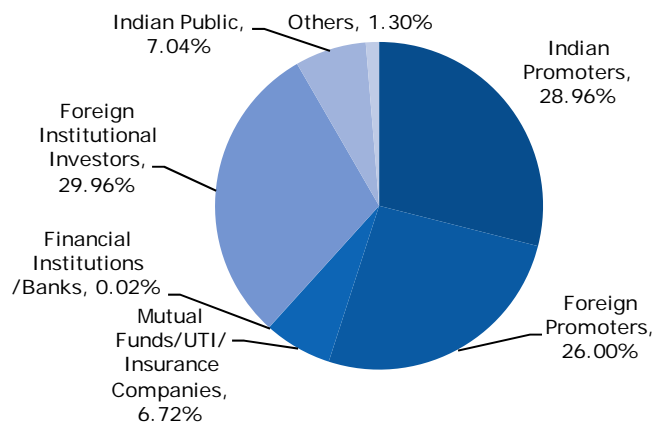
Hero Group, India and Honda Motor Company, Japan formed Hero Honda in 1984 to tap the Indian two wheeler industry. Hero Honda sold over 4.6 million two-wheelers (+23.6% YoY) in FY10 maintaining its world largest manufacturer status for eighth consecutive year. Vast network presence has also helped Hero Honda to penetrate deep in India's population reach.

Table 11: Financials

	FY10	% YoY
Net Operating Income (in Rs. Cr)	15,860	+28.1%
PAT (in Rs. Cr)	2232	+74.1%
EBITDA Margin	17.4%	-
EPS	111.77	+74.1%

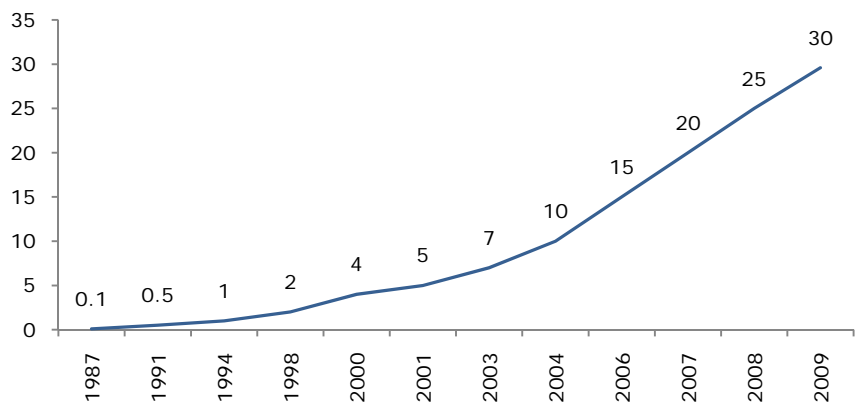
Source :

Chart 31: Shareholding Pattern



Source : Company, HDFC Securities Institutional Research

Chart 32: Production Milestone (in units Million) - Cumulative



Source : Company , HDFC Securities Institutional Research

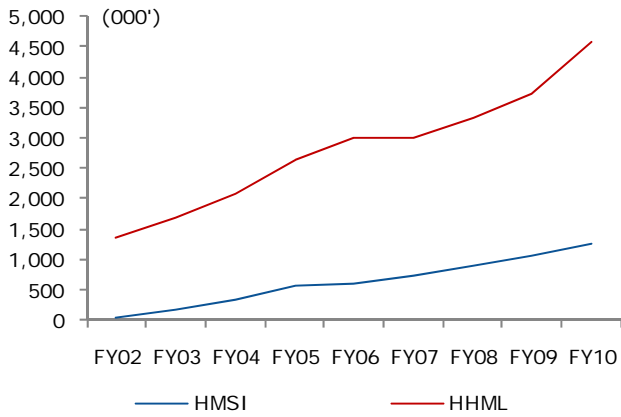
Institutional Research

Table 12: Honda network in India

Honda Network in India	Core Business Area
Hero Honda Motors Ltd.	Manufacture and distribution of motorcycles
Honda Motorcycle & Scooter India (Private) Ltd.	Manufacture and distribution of motorcycles
Honda Motor India (Private) Ltd.	Wholesale of service parts and accessories for Honda products
Honda Siel Cars India Ltd.	Manufacture and distribution of automobiles
Honda Siel Power Products Ltd.	Manufacture and distribution of power products

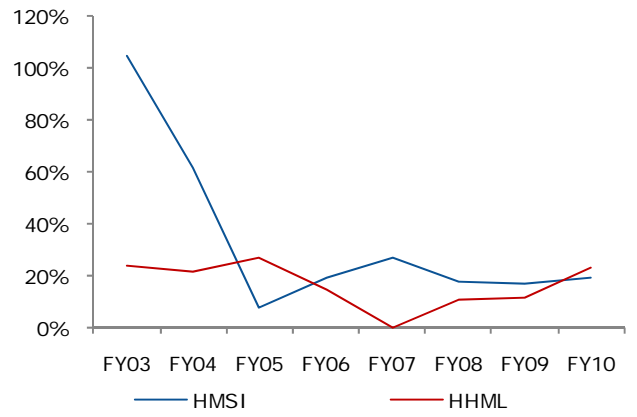
Source : Company

Chart 33: Sales Volume



Source : Company , HDFC Securities Institutional Research

Chart 34: Growth YoY



Source : Company , HDFC Securities Institutional Research

Institutional Research

SWOT Analysis – Hero Honda

<p>Strengths</p> <ul style="list-style-type: none"> World’s largest two wheeler manufacturer for nine years in succession. 59% market share in the domestic motorcycle market and 48% market share in the domestic two wheeler market. A debt free company for the last 9 years. Over 1mn bikes ahead of its competitors. A widespread reach in rural India panning over 100,000 villages with a network of more than 2000 rural sales channel partners. Has a network of 4,500+ customer touch points which enables easy access. Customers connect initiatives like ‘GoodLife’ and ‘Service Har Jagah’. Proven record of good marketing and sales strategies. 	<p>Weakness</p> <ul style="list-style-type: none"> Capacity constraints in a growing market. Reports of split between Hero and Honda. Weak R&D base - depended on Honda for technological support. Limited presence in exports market vis-à-vis competition. Low market share in the premium segment.
<p>Opportunities</p> <ul style="list-style-type: none"> Growing aspirations and growth of satellite townships. Growth in middle class segment. Increase in fuel prices would spur purchasing of fuel efficient two wheelers. Changing lifestyle among women enable them to view scooters as a transportation option. Expanding road networks and infrastructure. Improving rural economy and purchasing power. 	<p>Threats</p> <ul style="list-style-type: none"> A slowdown in the economy. Increasing competition especially in the 75-125cc segment. Entry of new players like Mahindra. Increase in prices of Raw Materials could impact the margin performance severely. Uncertainty over Global economy.

Source : Company , HDFC Securities Institutional Research

Institutional Research
Company results calendar

Monday	Tuesday	Wednesday	Thursday	Friday	Saturday	Sunday
				12-Nov-10	13-Nov-10	14-Nov-10
				BEML Birla Power Solutions Educomp Solutions HPCL India Cements JK Lakshmi Cement Oil India Parsvnath Developers Shiv-Vani Oil & Gas Exploration Services Spice Mobility Tata Power Co Tata Steel Tulip Telecom Wockhardt	Ahluwalia Contracts Balrampur Chini Mills Bartronics India Hindustan Dorr Oliver Indian Oil Corp IVRCL Infrastructures & Projects KS Oils Reliance Capital Reliance Communications Unitech	Kingfisher Airlines Pantaloon Retail India
15-Nov-10	16-Nov-10	17-Nov-10	18-Nov-10	19-Nov-10	20-Nov-10	21-Nov-10
Bajaj Auto City Union Bank Ltd Gitanjali Gems Kaveri Seeds Kohinoor Foods Satyam Computer Services				Triveni Engineering & Industries Mphasis		
22-Nov-10	23-Nov-10	24-Nov-10	25-Nov-10	26-Nov-10	27-Nov-10	28-Nov-10
			MRF			
29-Nov-10	30-Nov-10	01-Dec-10	02-Dec-10	03-Dec-10	04-Dec-10	05-Dec-10
Escorts						

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