

# Hero Honda Motors

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## Shrinking Earnings Visibility

- Steep OPM decline of 500 bps YoY, in 3Q07, surprises negatively
- EPS visibility deteriorates further
- We reduce our FY07E and FY08E EPS estimates by 12.2% and 12.7% to Rs 44.4 and Rs 50.3, respectively
- Downgrade to Underperformer, target price revised to Rs 654

### Investment Rationale

- Competition in motorcycles continues to get fierce—Hero Honda chooses market share over profitability
- During 3Q07, net profit dips 20%+, despite a healthy revenue growth of 15.2% YoY
- OPM deteriorates to 11.3% in 3Q07, down 500bps YoY and 140bps QoQ
- New launches are still not delivering according to expectations
- We maintain our volume growth estimates for FY07 and FY08 for now
- We revise downward our FY07E and FY08E EPS estimates by 12.2% and 12.7% to Rs 44.4 and Rs 50.3, respectively, largely on account of reduction in OPMs to 12.5% and 12.6% for respective periods

### Risks

- A slowdown in price wars may help in margin recovery, leading to better earnings growth than our estimates
- We have been conservative on FY08 volume growth at 10.8% YoY. Hence, any successful future product launch may result in higher-than-estimated volume growth, driving up the earnings

### Valuation

- Currently trades at 15.4x FY07 and 13.6x FY08 earnings estimates
- Downgrade to Underperformer with a revised target price of Rs 654, at which it would quote at 13x FY08E earnings.

### Valuation summary

Y/E Mar, Rs mn	FY04	FY05	FY06	FY07E	FY08E
Net Sales	58,324	74,217	87,140	99,057	111,432
Growth, %	14	27	17	14	12
Core EBIDTA	9,801	11,645	13,645	12,418	14,081
EBIDTA margins, %	16.8	15.7	15.7	12.5	12.6
Net profit	7,283	8,105	9,713	8,869	10,042
Net profit margin, %	12.5	10.9	11.1	9.0	9.0
EPS, Rs	36	41	49	44	50
EPS Growth, %	25.4	11.3	19.8	(8.7)	13.2
P/E, x	18.8	16.9	14.1	15.4	13.6
EV/EBIDTA, x	13.9	11.7	10.0	11.0	9.7
EV/Net Sales, x	2.3	1.8	1.6	1.4	1.2
Price/Book Value, x	12.0	9.1	6.8	5.9	4.9
ROIC, %	*	*	*	*	*
ROE, %	72.9	61.6	55.5	40.8	39.3
Dividend Yield, %	2.9	3.2	2.9	3.7	3.7

\* Since the company has negative working capital, the ratio is not meaningful

Source: Company, Man Financial Research Estimates

Downgrade to Underperformer  
Rs 684/Target Rs 654 (-5%)

#### Sector (Relative to market)

OW	N	UW

#### Stock (Relative to market)

B	OP	N	UP	S
> 10%	5% to 10%	5% to -5%	-5% to -10%	< -10%

This note should be read for

- Earnings and recommendation downgrade

Bloomberg code : HH IN  
 Reuters code : HROH.BO  
 www.herohonda.com

BSE Sensex : 12415  
 NSE Nifty : 3577

#### Company data

O/S shares :	200mn
Market cap (Rs) :	137bn
Market cap (USD) :	3bn
52 - wk Hi/Lo (Rs) :	940 / 611
Avg. daily vol. (3mth) :	0.5mn
Face Value (Rs) :	2

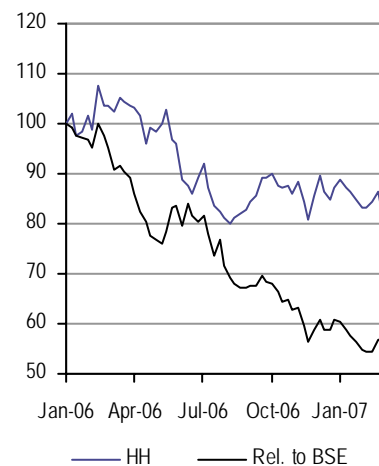
#### Share holding pattern, %

Promoters :	55.0
FII / NRI / OCBs :	26.5
FI / MF / Banks :	8.4
Non Promoter Corp. Holdings :	0.7
Public & Others :	9.5

#### Price performance, %

	1mth	3mth	1yr
Abs	-4.8	-10.8	-22.5
Rel to BSE	9.4	0.2	-38.2

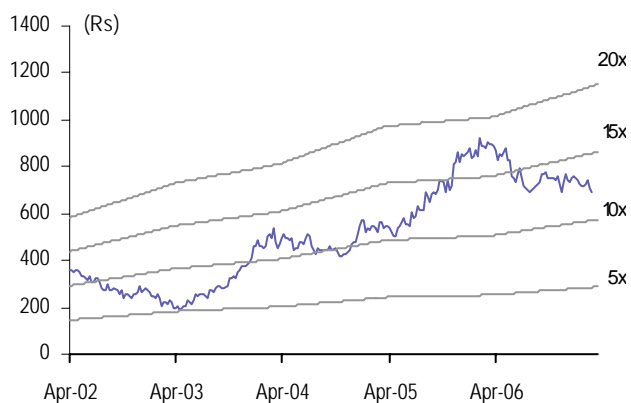
#### Price vs. Sensex



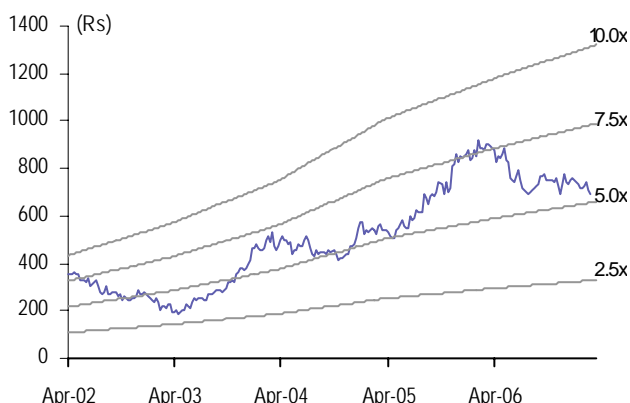
Source: Bloomberg, Man Financial Research

# ABSOLUTE ROLLING VALUATION BAND CHARTS

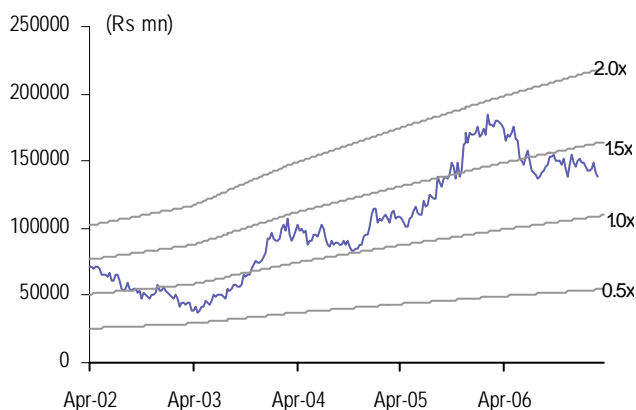
**P/E band**



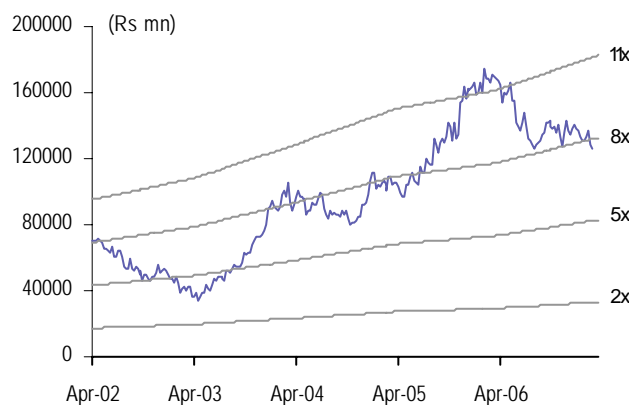
**PBV band**



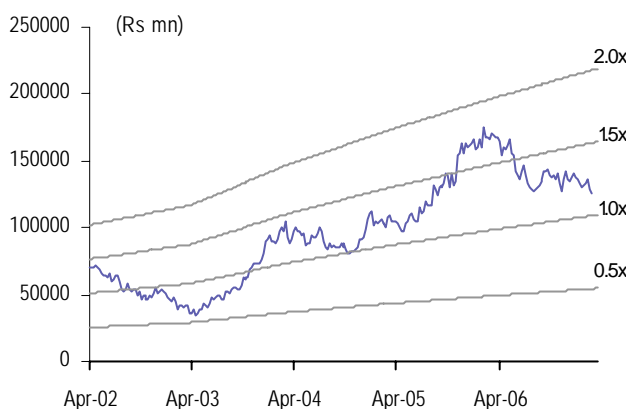
**MCap/Sales band**



**EV/EBIDTA band**



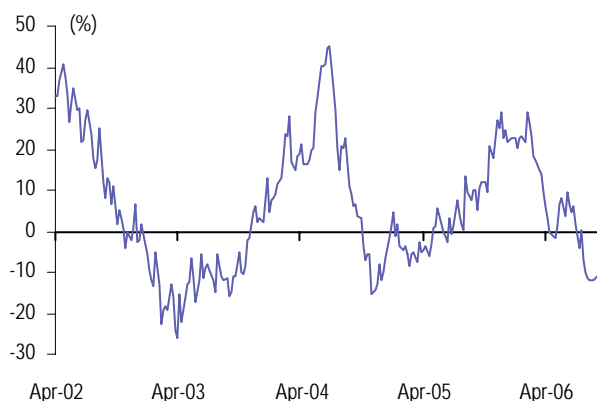
**EV/Sales band**



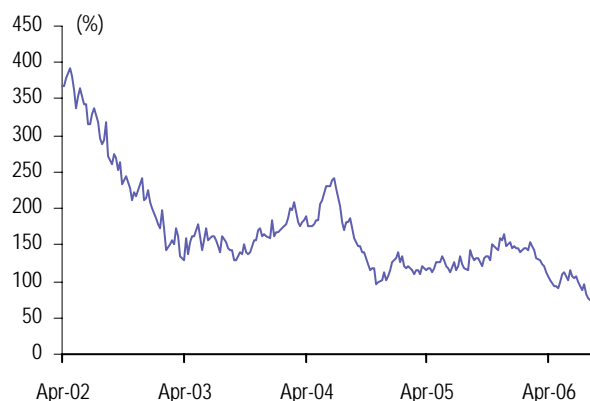
Source: Man Financial Research

## PREMIUM / DISCOUNT TO SENSEX

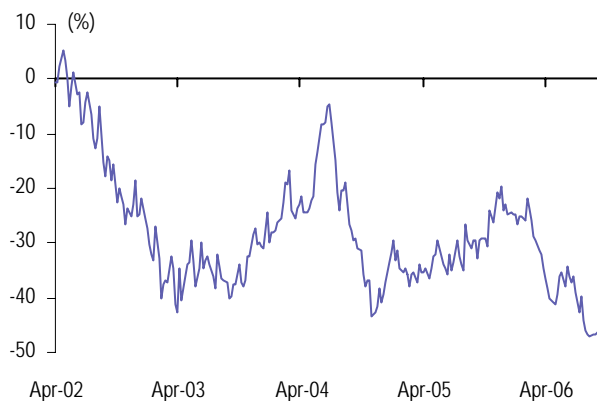
### P/E



### PBV

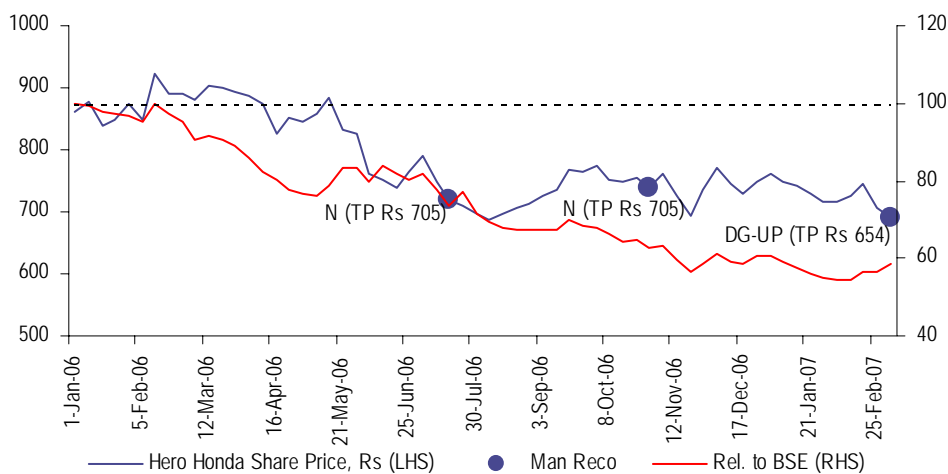


### MCap/Sales



Source: Man Financial Research

## Recommendation performance



IC = Initiating Coverage; DG = Downgrade; UG = Upgrade; TP = Target Price;  
 OP = Outperformer; UP = Underperformer; N = Neutral; S = Sell, B = Buy  
 Source: Bloomberg, Man Financial Research

## FINANCIALS

### Income Statement

Y/E Mar, Rs mn	FY04	FY05	FY06	FY07E	FY08E
Net sales	58,324	74,217	87,140	99,057	111,432
<i>Growth, %</i>	14.4	27.2	17.4	13.7	12.5
Total income	58,324	74,217	87,140	99,057	111,432
Operating expenses	48,523	62,571	73,495	86,639	97,352
<b>EBITDA</b>	<b>9,801</b>	<b>11,645</b>	<b>13,645</b>	<b>12,418</b>	<b>14,081</b>
<i>Growth, %</i>	13.5	18.8	17.2	(9.0)	13.4
<i>Margin, %</i>	16.8	15.7	15.7	12.5	12.6
Depreciation	740	894	1,146	1,445	1,732
<b>EBIT</b>	<b>9,061</b>	<b>10,752</b>	<b>12,498</b>	<b>10,973</b>	<b>12,349</b>
<i>Growth, %</i>	14.6	18.7	16.2	(12.2)	12.5
<i>Margin, %</i>	15.5	14.5	14.3	11.1	11.1
Interest received	124.5	137.7	196.1	160.0	105.6
Interest paid	17	19	29	-14	0
Net interest expense	-107.3	-118.4	-166.9	-174.0	-105.6
Forex gains/(losses)	1	0	0	0	0
Non-recurring items	1,556	1,303	1,457	1,896	2,100
<b>Pre-tax profit</b>	<b>10,724</b>	<b>12,173</b>	<b>14,122</b>	<b>13,043</b>	<b>14,554</b>
Tax provided	3,441	4,068	4,409	4,174	4,512
<b>Profit after tax</b>	<b>7,283</b>	<b>8,105</b>	<b>9,713</b>	<b>8,869</b>	<b>10,042</b>
<b>Net profit</b>	<b>7,283</b>	<b>8,105</b>	<b>9,713</b>	<b>8,869</b>	<b>10,042</b>
Man net profit	7,283	8,105	9,713	8,869	10,042
<i>Growth, %</i>	25.4	11.3	19.8	(8.7)	13.2
Unadjusted shares (million)	200	200	200	200	200
Weighted average shares (million)	200	200	200	200	200

### Cash Flow

Y/E Mar, Rs mn	FY04	FY05	FY06	FY07E	FY08E
PBT	10,725	12,172	14,122	13,043	14,554
Depreciation, amortisation	740	894	1,146	1,445	1,732
Change in working capital	1,247	1,754	-633	5,157	838
Total taxes paid	-3,441	-4,068	-4,230	-4,174	-4,512
Other operating activities	41	189	0	0	0
<b>Cash flow from operating activities (a)</b>	<b>9,311</b>	<b>10,941</b>	<b>10,406</b>	<b>15,471</b>	<b>12,613</b>
Capital expenditure	-1,458	-2,159	-3,929	-2,867	-3,000
Change in investments	-1,472	-5,308	-174	0	0
Change in marketable securities	-2,249	693	-178	0	0
Other investing activities	51	175	0	0	0
<b>Cash flow from investing activities (b)</b>	<b>-5,128</b>	<b>-6,600</b>	<b>-4,281</b>	<b>-2,867</b>	<b>-3,000</b>
Free cash flow	4,183	4,341	6,125	12,605	9,613
Debt raised/ (repaid)	404	271	-160	0	0
Dividend (including tax)	-4,505	-4,956	-4,554	-6,758	-8,560
Other financial activities	45	149	0	0	0
<b>Cash flow from financing activities (c)</b>	<b>-4,055</b>	<b>-4,537</b>	<b>-4,714</b>	<b>-6,758</b>	<b>-8,560</b>
Net change in cash (a)+(b)+c	128	-195	1,411	5,847	1,053

## Balance Sheet

As at 31st Mar, Rs mn	FY04	FY05	FY06	FY07E	FY08E
Cash & bank	243	371	176	1,587	7,241
Marketable securities at cost	120	2,369	1,677	1,855	1,855
Debtors	1,415	438	896	1,587	1,189
Inventory	2,009	1,882	2,043	2,266	2,575
Loans & advances	1,098	2,399	2,396	2,738	3,012
Other current assets	0	0	35	35	0
Total current assets	4,522	4,719	5,369	6,625	6,776
Investments	11,810	13,282	18,590	18,764	18,764
Gross fixed assets	7,863	9,169	11,042	14,720	17,620
Less: Depreciation	2,784	3,458	4,297	5,226	6,671
Add: Capital WIP	92	177	409	442	409
Net fixed assets	5,171	5,888	7,153	9,936	11,357
Total non-current assets	16,987	19,170	25,743	28,700	30,122
<b>Total assets</b>	<b>21,873</b>	<b>26,629</b>	<b>32,965</b>	<b>38,767</b>	<b>45,993</b>
Current liabilities	6,815	10,039	10,158	10,729	12,685
Provisions	4,342	2,562	4,847	4,899	6,931
Total current liabilities	11,157	12,601	15,005	15,628	19,616
Non-current liabilities	2,106	2,640	3,027	3,046	3,046
Total liabilities	13,262	15,241	18,031	18,674	22,662
Paid-up capital	399	399	399	399	399
Reserves & surplus	8,211	10,989	14,534	19,694	22,932
Shareholders' equity	8,610	11,388	14,934	20,093	23,331
<b>Total equity &amp; liabilities</b>	<b>21,873</b>	<b>26,629</b>	<b>32,965</b>	<b>38,767</b>	<b>45,993</b>

## Per-share data

	FY04	FY05	FY06	FY07E	FY08E
MAN EPS (INR)	36.5	40.6	48.6	44.4	50.3
<i>Growth, %</i>	<i>25.4</i>	<i>11.3</i>	<i>19.8</i>	<i>(8.7)</i>	<i>13.2</i>
Book NAV/share (INR)	57.0	74.8	100.6	116.8	138.9
FDEPS (INR)	36.5	40.6	48.6	44.4	50.3
CEPS (INR)	40.2	45.1	54.4	51.6	59.0
CFPS (INR)	49.3	39.3	44.0	61.8	49.1
DPS (INR)	20.0	22.0	20.0	25.0	25.0

## Financial structure

	FY04	FY05	FY06	FY07E	FY08E
Operating cash flow/Total debt (x)	5.3	5.4	5.6	8.2	6.4
Total debt/Equity (x)	0.1	0.1	0.1	0.1	0.1
Net debt/Equity (x)	-0.1	0.0	-0.1	-0.3	-0.4

## Profitability, Productivity, Liquidity and Valuation Ratios

	FY04	FY05	FY06	FY07E	FY08E
Return on assets (%)	30.1	27.2	27.1	20.9	20.7
Return on equity (%)	72.9	61.6	55.5	40.8	39.3
Return on invested capital (%)	*	*	*	*	*
RoIC/Cost of capital (x)	*	*	*	*	*
RoIC - Cost of capital (%)	*	*	*	*	*
Return on capital employed (%)	46.1	41.2	38.3	28.9	28.7
Cost of capital (%)	13.8	13.8	13.8	13.8	13.8
RoCE - Cost of capital (%)	32.3	27.4	24.5	15.1	14.9
Asset turnover (x)	*	*	*	*	*
Sales/Total assets (x)	2.4	2.5	2.4	2.3	2.3
Sales/Net FA (x)	10.5	11.4	10.2	9.3	9.3
Working capital/Sales (x)	-0.1	-0.1	0.0	-0.1	-0.1
Fixed capital/Sales (x)	0.1	0.1	0.1	0.0	0.0
Receivable days	2.7	4.4	6.6	4.4	4.4
Inventory days	11.8	10.0	9.5	9.5	9.5
Payable days	46.6	37.9	31.7	31.8	31.8
Current ratio (x)	0.7	0.7	0.9	1.3	1.4
Quick ratio (x)	0.6	0.5	0.7	1.0	1.2
Interest cover (x)	N.A.	N.A.	N.A.	N.A.	N.A.
Dividend cover (x)	1.8	1.8	2.4	1.8	2.0
P/E (x)	18.8	16.9	14.1	15.4	13.6
PEG (x) – 2-yr CAGR growth				1.2	
PCE (x)	17.0	15.2	12.6	13.2	11.6
PCF (x)	16.6	13.9	15.5	11.1	14.1
Price/Book (x)	12.0	9.1	6.8	5.9	4.9
Yield (%)	2.9	3.2	2.9	3.7	3.7
EV/Net sales (x)	2.3	1.8	1.6	1.4	1.2
EV/EBITDA (x)	13.9	11.7	10.0	11.0	9.7
EV/EBIT (x)	15.1	12.7	10.9	12.4	11.1
EV/NOPLAT (x)	22.2	19.1	15.9	18.3	16.0
EV/CE	8.2	6.0	4.9	4.1	3.7
EV/IC (x)	*	*	*	*	*

\* Since the company has negative working capital, the ratio is not meaningful

Source: Company, Man Financial Research Estimates

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