

May 30, 2006

Stock Rating  
**Underweight**

Industry View  
**Attractive**

## Hero Honda Motor Ltd

### In-Line Results

**Quick Comment:** With a 13% increase in sales volumes in F4Q06, HH posted inline results with revenues, EBITDA and net earnings posting 16%, 24% and 29% YoY growth. While EBITDA margins on a YoY basis increased by 100 bps, on a sequential basis, they declined by 20 bps to 16.1%. Depreciation and other income grew by 16% and 20% YoY to Rs305mn and Rs430mn respectively. On a full year basis, HH posted 17%, 18% and 20% YoY growth in revenues, EBITDA and net earnings respectively, with full-year EBITDA margins at 15.7%, flattish at F2005 levels.

**EBITDA margins to come under pressure:** HH posted flattish EBITDA margins in F2006 at 15.7% despite 15% YoY growth in sales volumes because of pricing pressures, which negated the impact of operating leverage. Due to the changing product mix and pressure on prices for the 100cc versions of Splendor/Passion, margins for Hero Honda could fall and we expect EBITDA margins to be under pressure at 15.5% in F2007E and 15% in F2008E. HH, which has the highest margins in the 2-wheeler business because of its premium pricing and economies of scale, may have to drop prices of Splendor/Passion by nearly Rs2000-3000 over the next few quarters to retain market share, putting pressure on margins. Taking a cue from this, HH has already started offering cash discounts and freebies on selected models in high-volume markets. We believe that this scheme will impact operating margins negatively in the next quarter.

**HH sales underperform industry growth:** HH posted just 11%YoY growth in domestic motorcycle sales in F4Q06, underperforming the industry growth of 18.1%. HH's market share too has been on a declining trend; it lost nearly 180 bps in F2006, primarily to Bajaj Auto, ending F2006 with a market share of 49.7%. On a full-year basis, HH domestic sales grew by 13% while industry growth was 17%.

### Key Ratios and Statistics

Reuters: HROH.BO Bloomberg: HH IN

#### India Two-Wheelers

Price target	Rs710.00
Shr price, close (May 30, 2006)	Rs803.70
Mkt cap, curr (mn)	Rs160,489
52-Week Range	Rs950.00-537.00
Sh out, basic, curr (mn)	200
EV, curr (mn)	Rs142,058

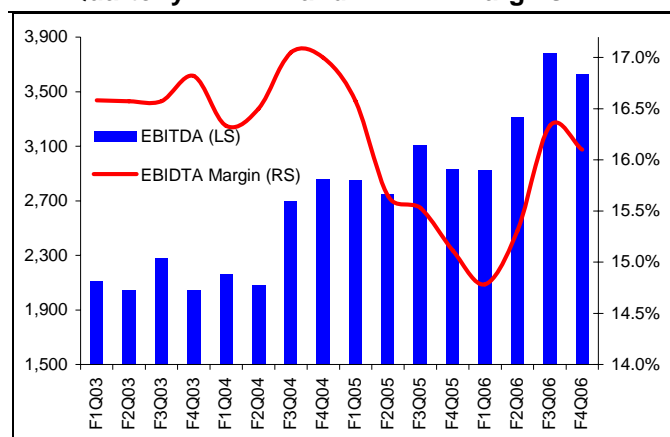
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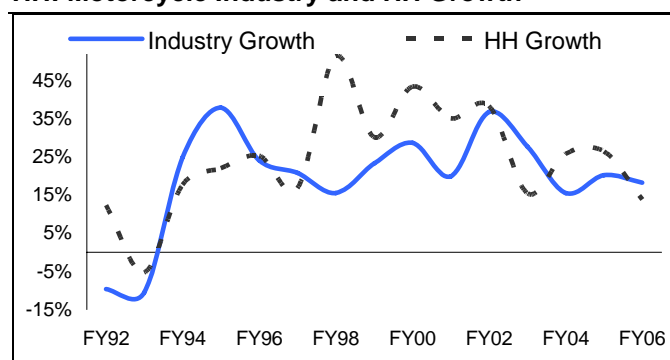
The main reason for HH's lackluster performance is that HH's new products are failing to gather traction and the company still depends on old products (Splendor/Passion) to drive its fortunes. Moreover, HH has failed to develop a blockbuster, with new products such as the Super-Splendor, Glamour, Pleasure and Achiever finding only moderate success.

Exhibit 1  
**HH: Quarterly EBITDA and EBITDA Margins**



Source: Company data, Morgan Stanley Research

Exhibit 2  
**HH: Motorcycle Industry and HH Growth**



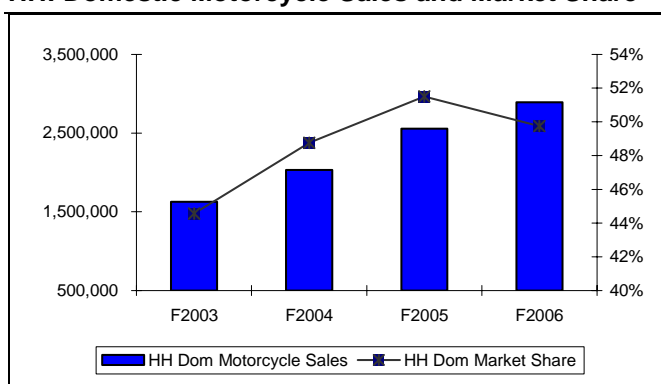
Source: Company data, SIAM, Morgan Stanley Research

**Competitive Pressures to Intensify**

BAL recently launched its 100cc model Platina, which is expected to strengthen its position in the 100-110cc segment, directly competing with HH's Splendour, which is the market leader in the segment. With new models coming into the market, such as Yamaha's 125cc motorcycle Gladiator and Suzuki launching its two 125cc motorcycles Heat and Zeus along with Honda's 125cc offering Shine, we expect competition to intensify in the coming quarters. HH derives a large proportion of its sales

and profits from the executive segment, which is being targeted by most motorcycle manufacturers. We expect this to affect HH's market share in F2007 and beyond.

Exhibit 3  
**HH: Domestic Motorcycle Sales and Market Share**



Source: Company data, SIAM, Morgan Stanley Research

**HH Gains Some Momentum in the Scooter Segment**

HH made its foray into the scooter segment in F4Q06 with a 102 cc scooter, Pleasure, which has received a favorable response. HH has clocked up volumes of nearly 15,000 units in three months, building market share of nearly 6.4% for the quarter, and has inadvertently become the third-largest player in the scooter segment after Honda and TVS Motors. (BAL has stopped manufacturing geared scooters and is revamping its scooter segment.)

**Export Sales Impressive**

HH has posted 45% YoY growth in export sales volumes at 92,666 units in F2006. The primary markets for HH are in Columbia, Bangladesh and Sri Lanka and the company is

**Company Description**

Hero Honda Motors Ltd manufactures and markets motorcycle and spare parts. The company is jointly promoted by Munjal Group and Honda Motors Japan and is the market leader in motorcycles with production facilities located in Gurgaon (Haryana)

**Industry View: Attractive**

Attractive

**MSCI Country: India**

Asia Strategist's Recommended Weight: 1.4%  
MSCI Asia/Pac All Country Ex Jp Weight: 6.0%

looking at exploring possibilities in new markets in Africa in consultation with Honda Motor Co Ltd, Japan. However, we do not estimate HH's exports to rise very significantly from hereon as HH is limited in the countries that it can export to because of the conflict it could have with Honda.

#### Valuations

HH trades at P/E of 14.5x, P/BV of 5.7x, and EV/EBITDA of 8.1x on our F2008E. We maintain our Underweight rating on the stock.

Exhibit 4

#### HH: Domestic Motorcycle Sales and Market Share

	F4Q06	F4Q05	YoY	F2006	F2005	YoY
<b>Motorcycles</b>						
Domestic Sales	1,532,833	1,297,479	18.1%	5,815,469	4,964,753	17.1%
Exports	103,498	87,906	17.7%	386,322	277,123	39.4%
<b>Domestic Sales Breakup</b>						
<b>Hero Honda</b>	<b>737,591</b>	<b>664,845</b>	<b>10.9%</b>	<b>2,893,070</b>	<b>2,557,385</b>	<b>13.1%</b>
Bajaj Auto	480,509	359,448	33.7%	1,747,806	1,344,922	30.0%
TVSM	206,254	166,865	23.6%	752,576	640,707	17.5%
Others	108,479	106,321	2.0%	422,017	421,739	0.1%
<b>Domestic Market Shares</b>						
<b>Hero Honda</b>	<b>48.1%</b>	<b>51.2%</b>	<b>-3.1%</b>	<b>49.7%</b>	<b>51.5%</b>	<b>-1.8%</b>
Bajaj Auto	31.3%	27.7%	3.6%	30.1%	27.1%	3.0%
TVS Motors	13.5%	12.9%	0.6%	12.9%	12.9%	0.0%
Others	7.1%	8.2%	-1.1%	7.3%	8.5%	-1.2%

Source: Company data, Morgan Stanley Research

Exhibit 5

#### Hero Honda: 4QF2006 and Full year financial summary

Hero Honda	F4Q05	F3Q06	F4Q06	YoY	QoQ	YTD F05	YTD F06	YoY
<b>Volumes</b>	<b>685,419</b>	<b>798,001</b>	<b>772,457</b>	<b>12.7%</b>	<b>-3.2%</b>	<b>2,621,400</b>	<b>3,000,450</b>	<b>14.5%</b>
<b>Exports (%)</b>						<b>56,856</b>	<b>855,934</b>	<b>1405.4%</b>
<b>Sales</b>	<b>19,403</b>	<b>23,148</b>	<b>22,559</b>	<b>16.3%</b>	<b>-2.5%</b>	<b>74,217</b>	<b>87,140</b>	<b>17.4%</b>
Total Expenditure	16,471	19,367	18,927	14.9%	-2.3%	62,571	73,460	17.4%
<b>EBITDA (LS)</b>	<b>2,932</b>	<b>3,781</b>	<b>3,632</b>	<b>23.9%</b>	<b>-3.9%</b>	<b>11,645</b>	<b>13,680</b>	<b>17.5%</b>
Depreciation	264	324	305	15.6%	-6.1%	894	1,146	28.2%
EBIT	2,669	3,456	3,327	24.7%	-3.7%	10,751	12,534	16.6%
Other income	358	360	430	20.3%	19.4%	1,410	1,527	8.3%
Net Interest	(4)	(11)	(39)	793.2%	267.3%	(11)	(61)	462.4%
<b>PBT &amp; Extraordinary</b>	<b>3,031</b>	<b>3,827</b>	<b>3,797</b>	<b>25.3%</b>	<b>-0.8%</b>	<b>12,173</b>	<b>14,122</b>	<b>16.0%</b>
PBT	3,031	3,827	3,797	25.3%	-0.8%	12,173	14,122	16.0%
Tax	960	1,209	1,125	17.2%	-7.0%	4,068	4,409	8.4%
<b>PAT</b>	<b>2,071</b>	<b>2,618</b>	<b>2,672</b>	<b>29.0%</b>	<b>2.1%</b>	<b>8,105</b>	<b>9,713</b>	<b>19.8%</b>
<i>EBIDTA Margin (RS)</i> <i>(%)</i>	<i>15.1</i>	<i>16.3</i>	<i>16.1</i>	<i>0.99</i>	<i>-0.2</i>	<i>15.7</i>	<i>15.7</i>	<i>0.0</i>
<i>PBT Margin (%)</i>	<i>15.6</i>	<i>16.5</i>	<i>16.8</i>	<i>1.21</i>	<i>0.3</i>	<i>16.4</i>	<i>16.2</i>	<i>-0.2</i>
<i>Net Margin (%)</i>	<i>10.7</i>	<i>11.3</i>	<i>11.8</i>	<i>1.17</i>	<i>0.5</i>	<i>10.9</i>	<i>11.1</i>	<i>0.2</i>
<i>Tax Rate (%)</i>	<i>31.7</i>	<i>31.6</i>	<i>29.6</i>	<i>-2.04</i>	<i>-2.0</i>	<i>33.4</i>	<i>31.2</i>	<i>-2.2</i>

Source: Company data, Morgan Stanley Research

Exhibit 6

**Hero Honda: Cost Breakdown As % of Sales**

<b>% of sales</b>	<b>F4Q05</b>	<b>F3Q06</b>	<b>F4Q06</b>	<b>YoY</b>	<b>QoQ</b>	<b>YTD F05</b>	<b>YTD F06</b>	<b>YoY</b>
Raw Material (%)	70.3	69.2	68.2	-2.0	-0.9	70.1	69.6	-0.4
Staff Cost (%)	3.8	3.7	3.6	-0.1	-0.1	3.6	3.7	0.1
Other Expenditure (%)	10.9	10.8	12.0	1.2	1.3	10.6	11.2	0.5

Source: Company data, Morgan Stanley Research



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*(as of April 30, 2006)*

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<b>Equal-weight/Hold</b>	<b>883</b>	<b>45%</b>	<b>295</b>	<b>46%</b>	<b>33%</b>
<b>Underweight/Sell</b>	<b>367</b>	<b>19%</b>	<b>84</b>	<b>13%</b>	<b>23%</b>
<b>Total</b>	<b>1,963</b>		<b>640</b>		

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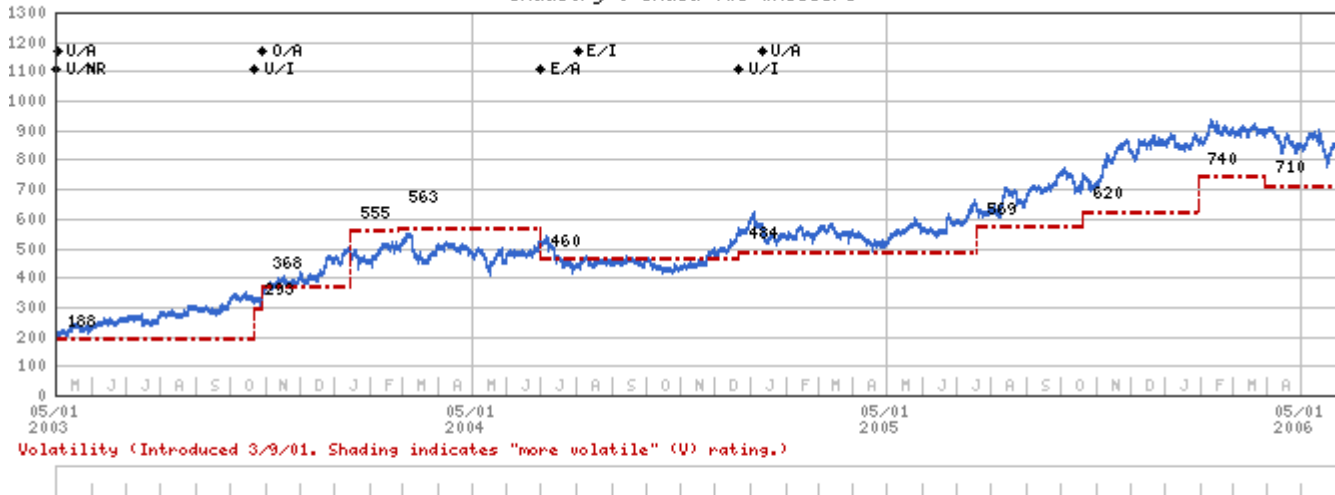
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**Stock Price, Price Target and Rating History (See Rating Definitions)**

Hero Honda Motor Ltd (HROH.BO) - As of 5/30/06 in INR  
Industry : India Two-Wheelers



Stock Rating History: 2/21/03 : U/NR; 5/2/03 : U/A; 10/22/03 : U/I; 10/30/03 : O/A; 6/30/04 : E/A; 8/2/04 : E/I;  
12/22/04 : U/I; 1/11/05 : U/A  
Price Target History: 4/11/03 : 188; 10/22/03 : 293; 10/30/03 : 368; 1/15/04 : 555; 2/26/04 : 563; 6/30/04 : 460;  
12/22/04 : 484; 7/19/05 : 569; 10/21/05 : 620; 1/30/06 : 740; 3/30/06 : 710

Source: Morgan Stanley Research Date Format: MM/DD/YY Price Target --- No Price Target Assigned (NA)  
Stock Price (Not Covered by Current Analyst) — Stock Price (Covered by Current Analyst) ■  
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Tel: +44 (0) 20 7 425 8000

**Japan**

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Tokyo 150-6008

**Japan**

Tel: +81 (0) 3 5424 5000

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**Hong Kong**

Tel: +852 2848 5200

**Industry Coverage: India Two-Wheelers**

<b>Company (Ticker)</b>	<b>Rating (as of)</b>	<b>Price (05/30/2006)</b>
<b>Satish Jain</b>		
Bajaj Auto Ltd. (BJAT.BO)	O (04/24/2002)	Rs2829.00
Hero Honda Motor Ltd (HROH.BO)	Underweight (12/22/2004)	Rs803.70
TVS Motors (TVSM.BO)	O (01/10/2005)	Rs125.25

Stock Ratings are subject to change. Please see latest research for each company.