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Q4 FY07 Result Update

Hero Honda

Outperformer	Rs 705	May 14, 2007

The worst left behind

Company Details	
Market Cap:	Rs 140,740m
52-Week High/Low:	Rs 898 / 565
Bloomberg Code:	HH@IN
Reuters Code:	HROH.BO / NS
Shares O/s:	199m
Average Volume (3 months):	0.3m

Price Performance

(%)	1m	3m	12m
Absolute	12.1	(2.9)	(20.1)
Relative to Sensex	6.9	2.2	(32.4)

Result Snapshot

With a disappointing year, characterised by intense competition and rising costs, Hero Honda's Q4 FY07 margins plunged. Its top-line met our expectations, rising 17% to Rs 26.4bn. However, the yoy 576-bp drop in the EBITDA margin to 10.2% was entirely unexpected. The cricket world cup promotion spend has resulted in 'other expenses' increasing Rs 0.77bn to Rs 3.51bn. We had expected this expense would be spread over two quarters. PAT was therefore sharply down 27% to Rs 1.95bn.

The contribution per vehicle accelerated 4.5% qoq (and decelerated 11.6% yoy) to Rs 8,203. Due to the heavy charge of the cricket world cup, the EBITDA per vehicle plummeted by a third (33.4%) to Rs 3,101.

At the current market price, the stock is available at a valuation of 9.9x FY09E EPS of Rs 70.9. With pricing relief imminent after the CST cut and with cost benefits from the tax-free zone, we expect a better performance ahead. Upgrade to **OUTPERFORMER**.

Q4 FY07 Result Overview

(Rs m)

Y/e March	Q4 FY07	Q4 FY06	*YoY Gr. (%)*	Q3 FY07	FY06	FY07	*YoY Gr. (%)*
Net Sales	**26,396**	**22,559**	***17.0***	**26,661**	**87,140**	**99,000**	***13.6***
Expenditure							
Raw Material	19,290	15,394	*25.3*	19,629	60,523	71,787	*18.6*
as % of Net Sales	*73.1*	*68.2*		*73.6*	*69.5*	*72.5*	
Personnel Cost	905	822	*10.1*	917	3,207	3,538	*10.3*
as % of Net Sales	*3.4*	*3.6*		*3.4*	*3.7*	*3.6*	
Mfgr. Expenses	3,514	2,747	*28.0*	3,095	9,766	11,944	*22.3*
as % of Net Sales	*13.3*	*12.2*		*11.6*	*11.2*	*12.1*	
Total Expenditure	23,709	18,963	*25.0*	23,641	73,496	87,269	*18.7*
EBITDA	**2,687**	**3,596**	***(25.3)***	**3,019**	**13,644**	**11,730**	***(14.0)***
EBITDA Margin (%)	*10.2*	*15.9*		*11.3*	*15.7*	*11.8*	
Depreciation	355	305	*16.6*	376	1,146	1,398	*22.0*
EBIT	**2,332**	**3,291**	***(29.2)***	**2,643**	**12,498**	**10,333**	***(17.3)***
Net Interest	(77)	(39)	*95.7*	(55)	(61)	(230)	*275.0*
Non-Operating Income	445	466	*(4.4)*	336	1,563	1,899	*21.5*
PBT	**2,854**	**3,796**	***(24.8)***	**3,034**	**14,122**	**12,461**	***(11.8)***
Tax	904	1,125	*(19.7)*	943	4,409	3,882	*(12.0)*
Tax Rate (%)	*31.7*	*29.6*		*31.1*	*31.2*	*31.2*	
Adj. PAT	**1,950**	**2,671**	***(27.0)***	**2,092**	**9,713**	**8,579**	***(11.7)***

(Stock price as on May 11, 2007)

Result highlights

Hero Honda reported a 17% yoy rise in its Q4 FY07 net sales to Rs 26.4bn following a 12.1% rise in sales volumes. However, the adjusted PAT dropped steeply -- by 27% to Rs 1.95bn -- as expenses to promote the (cricket) world cup resulted in 'other expenses' shooting up by Rs 0.77bn, to Rs 3.51bn. The absolute EBIDTA fell 25.3% and the margin, at 10.2%, was a huge 576bp down yoy.

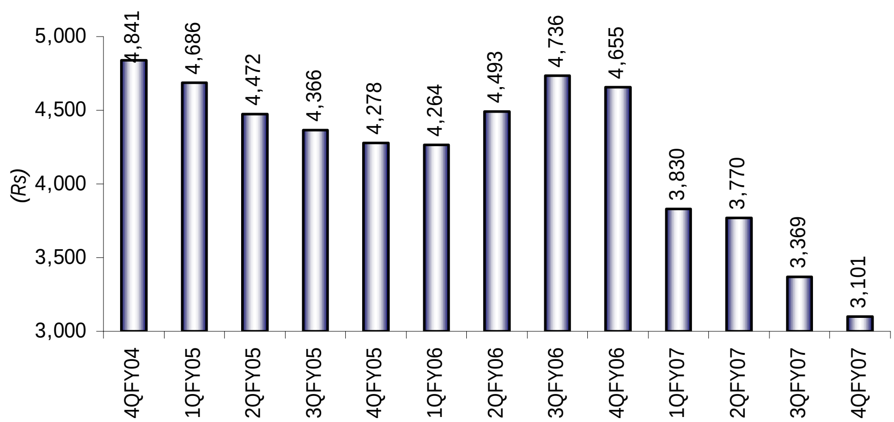
The contribution per vehicle accelerated 4.5% qoq (and decelerated 11.6% yoy) to Rs 8,203. The heavy charge due to the cricket world cup sunk the EBITDA per vehicle by just over a third (33.4%) to Rs 3,101. Two price hikes (one in Aug.'06, the other in Jan.'07) failed to keep cost pressures at bay.

The year ahead promises to be better as the price hikes of last year and the CST reduction would aid Hero Honda in improving profitability. It plans to raise capacity by 0.5m units (scalable to 1m), at an investment of Rs 3.2bn taking total capacity to 4.9m units within a year. This expansion, at Haridwar, would offer tax advantages like income-tax exemptions and excise duty relief for five and ten years respectively.

EBITDA per vehicle plunges

The EBITDA-per-vehicle trend worsened, as the rises in cost of raw materials coupled with the heavy expenditure on cricket world cup that the company chose not to defer left it just above the Rs 3,000 mark.

EBITDA per vehicle takes the plunge



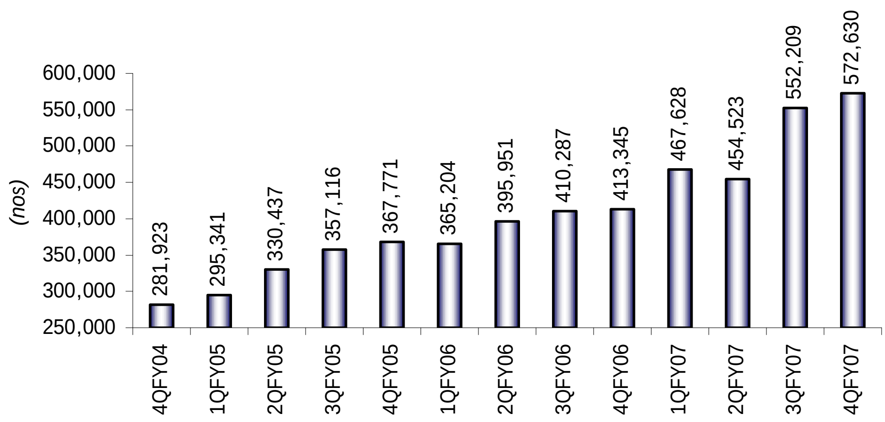
Source Company Data, PL Research

The present EBITDA per vehicle is a good Rs 1,340 down from that achieved in FY05. Surprisingly, though, the contribution per vehicle is but Rs 275 down, indicating that the profitability is not that worrisome.

Break-even point at a peak

Expenses in promoting the cricket world cup have resulted in 'other expenses' swelling Rs 0.77bn to Rs 3.51bn. That primarily led to the worsening of the PBT break-even point. At 0.572m, that BEP is 38% higher than a year ago.

Break-even point



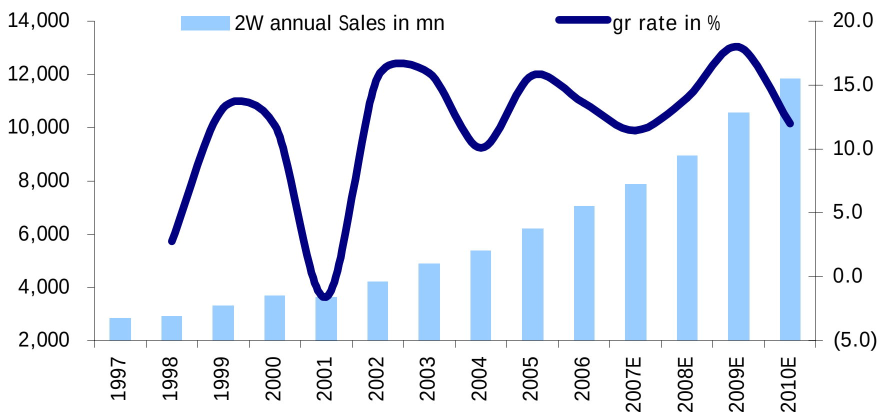
Source Company Data, PL Research

Commuting by bike has turned into a necessity

Road travel in India has been rising steadily. Estimated in terms of billion passenger-kilometres (BPKM), a large proportion (nearly 75%) is taken care of by buses. Reliance, though, on other modes of transport (cars, two-and three-wheelers) has rapidly increased. With rising incomes and the inadequate urban public transport system, in particular, the personalized mode of transport is likely to grow in importance in the coming years, as has been the past experience.

One of the working papers of the Planning Commission estimates the elasticity of BPKM with respect to GDP to be between 1.5 and 2.2. By its own reckoning, the estimated additional buses required in FY08 and FY09 are in the range of 80,000 to 90,000 and 110,000 to 115,000 for the two years, assuming a GDP growth of 8% to 8.5%. This implies that the motor vehicle industry needs to supply buses (large and small) at a 45 to 48% CAGR over its FY07 sale of 52,517 units. Selling such an immense number of buses is easier said than done, given the precarious financial conditions of STUs, which constitute major buyers. Hence, we may continue to see robust growth in para-transit modes at the expense of public transport.

Two-wheeler growth rates will remain high



Source: SIAM, PL Research

This bolsters our view that we can expect commuting the bike-way to be growing at a healthy 15.3% in the years to come, leading to a two-wheeler industry growth of 14% in FY08, 18% in FY09.

Estimates changed

HH has to get its margin act together, now that it has successfully defended its market share for the last three years. We are optimistic about this, given that the two price hikes and the CST reduction offer considerable leeway. Therefore, we believe that the 13% EBITDA margin now assumed (down from the earlier 13.4%) is achievable. Taking a fresh view on industry volumes, we have raised our top-line estimates for FY08 by 3.2%.

Estimates for FY08 drop 5%

	Revised Estimates		Earlier Estimates		*% Revision*	
	FY07E	FY08E	FY07E	FY08E	*FY07E*	*FY08E*
Net Sales *(Rs m)*	99,000	115,773	98,977	112,196	*0.0*	*3.2*
Adj. PAT *(Rs m)*	8,579	10,559	9,150	11,097	*(6.2)*	*(4.9)*
EPS *(Rs)*	43.0	52.9	45.8	55.6	*(6.2)*	*(4.9)*

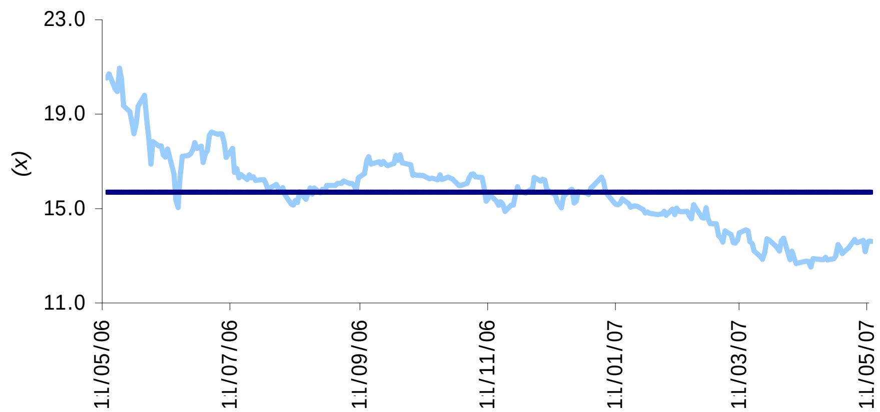
Source: PL Research

Valuations

The (standalone) one-year forward rolling P/E chart reveals that the stock currently trades at 13x, well below the average of 15x that it traded for the year. The underperformance has been attributable to the EBITDA margin collapse. HH has traditionally been one of the best RoCE performers -- 54% in FY05 and 50% the next year. The pressure on margins has been so severe that the latter has been lopped off by a third in FY07 to 34%. Recovering from these levels seems difficult but not entirely impossible as borne out by our 35.8% estimate for FY09.

At the current market price, the stock is available at a valuation of 9.9x FY09E EPS of Rs 70.9. With pricing relief imminent after the CST cut and cost advantage from the tax-free zone, we expect a better performance ahead. Upgrade to **OUTPERFORMER**.

One-year forward rolling P/E



Source: PL Research

Key Figures

Y/e March	FY06	FY07E	FY08E	FY09E
Revenue *(Rs m)*	87,140	99,000	115,773	140,133
EBITDA *(Rs m)*	13,644	11,730	15,108	19,676
Margin (%)	*15.7*	*11.8*	*13.0*	*14.0*
PAT *(Rs m)*	9,713	8,579	10,559	14,150
EPS *(Rs)*	48.6	43.0	52.9	70.9
PER *(x)*	14.5	16.4	13.3	9.9
EV / E *(x)*	8.8	10.6	7.7	5.5
EV / Sales *(x)*	1.4	1.3	1.0	0.8
RoCE (%)	*55.5*	*38.3*	*38.1*	*40.1*
RoE (%)	*50.0*	*34.0*	*33.5*	*35.8*