



Hero Honda Motors

STOCK INFO.	BLOOMBERG
BSE SENSEX: 14,091	HH IN
	REUTERS CODE
S&P CNX: 4,083	HROH.BO
Equity Shares (m)	199.7
52-Week Range	950/637
1,6,12 Rel. Perf. (%)	-10/-29/-58
M.Cap. (Rs b)	143.3
M.Cap. (US\$ b)	3.2

31 January 2007

Neutral

Previous Recommendation: Neutral

Rs718

	YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
	END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
3/06A	87,140	9,713	48.6	20.8	14.8	7.1	48.3	60.7	1.4	9.0	
3/07E	100,367	9,055	45.3	-6.8	15.8	5.8	36.8	46.8	1.2	10.0	
3/08E	117,654	10,818	54.2	19.5	13.2	4.9	36.7	46.5	1.0	8.2	

- Hero Honda's 3QFY07 operating performance was below our expectations. EBITDA margin declined 500bp YoY to 11.3% (v/s our estimate of 12.6%). PAT at Rs2.1b was 11.6% below our estimate.
- The company reported sales growth of 15.2% YoY to Rs26.7b, driven by volume growth of 12.3% and 2.6% increase in realizations.
- EBITDA margin was adversely impacted due to higher raw material cost. RM/sales ratio was 73.6%, up 440bp YoY. As a result, EBITDA fell 20.1% YoY to Rs3b (v/s our estimate of 12.5% YoY decline to Rs3.3b).
- The management indicated that apart from higher raw material cost, significant investment in marketing too impacted margins. The company is continuing its aggressive brand-building exercise. We expect its selling and advertising expenses to remain high.
- Hero Honda's new plant in Haridwar with an initial capacity of 0.5m units is likely to be completed by mid-2007, further increasing its installed capacity.
- We expect Hero Honda to report volume growth of 14.4% CAGR over FY06-08. We have revised our FY07 EPS estimate by 5.8% to factor lower than expected EBITDA margin and profits. The stock trades at 15.8x FY07E EPS of Rs45.3 and 13.2x FY08E EPS of Rs54.2. We maintain our **Neutral** rating.

Y/E MARCH	QUARTERLY PERFORMANCE										(Rs Million)	
	FY06				FY07				FY06	FY07E		
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE				
Total Volumes (nos)	687,567	742,425	798,301	772,457	832,692	751,967	896,113	933,202	3,000,750	3,413,974		
Net Sales	19,771	21,663	23,148	22,559	23,644	22,300	26,661	27,763	87,140	100,367		
Change (%)	14.8	23.3	15.6	16.3	19.6	2.9	15.2	23.1	17.4	15.2		
Total Cost	16,848	18,327	19,367	18,953	20,454	19,465	23,641	24,412	73,495	87,972		
EBITDA	2,923	3,336	3,781	3,606	3,190	2,835	3,019	3,352	13,645	12,395		
As % of Sales	14.8	15.4	16.3	16.0	13.5	12.7	11.3	12.1	15.7	12.4		
Change (%)	2.4	21.3	21.6	23.0	9.1	-15.0	-20.1	-7.0	17.2	-9.2		
Other Income	306	431	360	466	523	595	336	515	1,563	1,968		
Interest	3	-8	-11	-45	-33	-65	-55	-64	-61	-217		
Depreciation	250	267	324	305	323	344	376	376	1,146	1,419		
PBT	2,975	3,508	3,827	3,812	3,423	3,151	3,034	3,554	14,122	13,161		
Tax	937	1,129	1,209	1,134	1,045	991	943	1,128	4,409	4,106		
Effective Tax Rate (%)	31.5	32.2	31.6	29.8	30.5	31.5	31.1	31.7	31.2	31.2		
PAT	2,039	2,379	2,618	2,678	2,377	2,160	2,092	2,426	9,713	9,055		
Adj. PAT	2,039	2,379	2,618	2,678	2,377	2,160	2,092	2,426	9,713	9,055		
Change (%)	7.2	22.4	19.6	29.4	16.6	-9.2	-20.1	-9.4	20.8	-6.8		

E: MOST Estimates

Volume growth: momentum continues

In 3QFY07, Hero Honda sold 896,113 two-wheelers. Volumes grew by 12.3% YoY, as compared to 10.8% YoY growth in 1HFY07. Hero Honda has adopted an aggressive new model launch strategy, with 5 new bikes / variants being offered in 3QFY07. These included the *CBZX-treme*, special festival edition of *Passion Plus*, new *Glamour* variant with alloy wheels, and *CD Delux* and *CD Dawn* with new engines and features customized for the Indian market.

SALES VOLUMES (UNITS)

	3QFY07	3QFY06	% GR.	2QFY07	% GR.
Bikes-Total	896,113	798,301	12.3	751,967	19.2
Domestic	874,595	778,361	12.4	723,676	20.9
Exports	21,518	19,940	7.9	28,291	-23.9

Source: Company/ Motilal Oswal Securities

We have revised downwards our FY07 volume growth estimate by 1.3%, to factor in the sluggish growth in volumes. We now estimate two-wheeler volume growth of 13.8% YoY during the year, while we expect volumes to increase at 14.4% CAGR over FY06-08. At our revised volume estimates, we now expect 20.8% residual growth for FY07.

RESIDUAL GROWTH REQUIRED

HERO HONDA	FY07	FY06	GRTH. (%)
YTD FY07 Sales (units)	2,480,772	2,228,293	11.3
Our FY07 estimate (units)	3,413,974	3,000,750	13.8
Residual Growth Req.(%)			20.8

Source: Company/ Motilal Oswal Securities

Market share loss in bikes continues

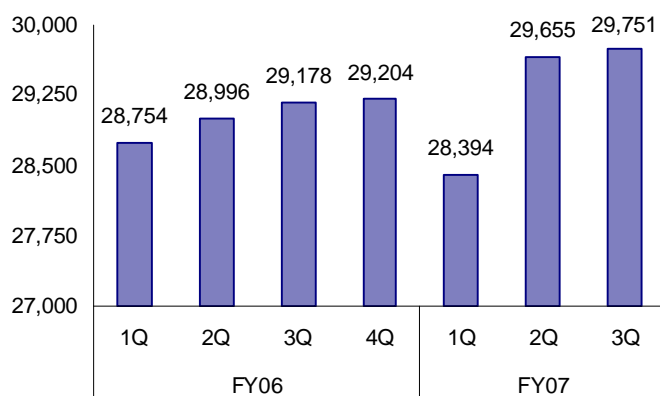
Hero Honda's market share in the domestic motorcycle market for 9MFY07 stood at 47%, which is 330bp lower as compared to 9MFY06. However, the decline in the overall domestic two-wheeler market share of the company was lower at 70bp to 40.7%. This has been mainly on account of the launch of its un-g geared scooter.

Realizations increase 2.6% YoY

In 3QFY07, net sales increased 15.2% YoY to Rs26.7b; net sales increase was higher than volume growth of 12.3%

YoY mainly due to an increase in realizations. Realizations increased by 2.6% YoY and 0.3% QoQ to Rs29,751/bike.

NET PER UNIT REALIZATIONS IMPROVE DUE TO PRICE HIKES (RS)



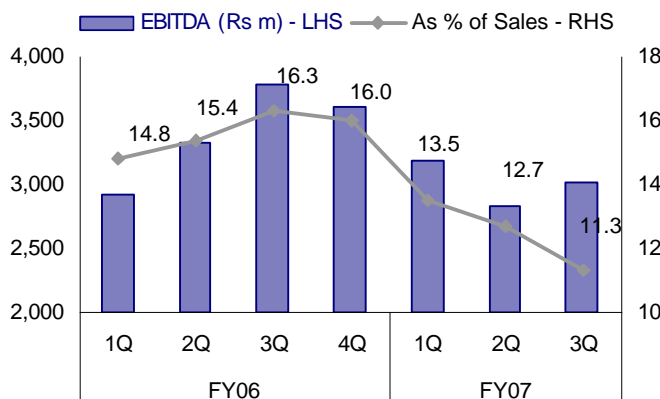
Source: Company/ Motilal Oswal Securities

EBITDA margin down 500bp YoY to 11.3%

EBITDA margin at 11.3% (v/s our estimate of 12.6%) declined 500bp YoY and 140bp QoQ due to higher raw material costs. RM/sales ratio was 73.6%, up 440bp YoY and 260bp QoQ. As a result, EBITDA fell by 20.1% YoY to Rs3b (v/s our estimate of 12.5% YoY decline to Rs3.3b).

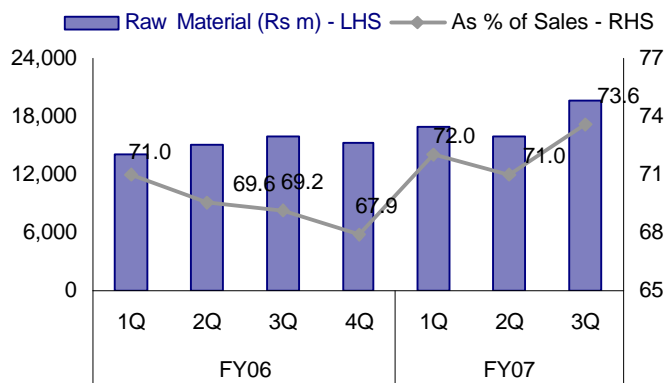
Management has indicated that significant investment in marketing coupled with high raw-material prices negatively impacted EBITDA margin. The company is continuing its aggressive brand-building exercise. We expect its selling and advertising expenses to remain high.

EBITDA MARGINS DECLINE SHARPLY...



Source: Company/ Motilal Oswal Securities

... ON INCREASED RM COST



Source: Company/ Motilal Oswal Securities

Net earnings fall 20.1% YoY

Hero Honda's net earnings declined 20.1% YoY in 3QFY07 to Rs2.1b – 11.6% lower than our estimate. This is mainly on account of lower than expected other income.

Growth outlook remains positive

We expect the secular double-digit growth in two-wheeler volumes to continue unabated. Not only is there adequate scope to increase motorcycle penetration, the target audience too is rising rapidly. The top two players in the industry – Hero Honda and Bajaj Auto – are now global-sized players and have been increasing their stranglehold in a virtual duopoly. After five years of no price hikes, Hero Honda announced price increases across products, due to margin concerns. We expect Hero Honda to report volume

growth of 14.4% CAGR over FY06-08. It remains the market leader, though it has lost market share in 9MFY07.

New plant to be set up in Uttaranchal

Hero Honda is setting up a manufacturing facility at Haridwar, Uttaranchal with an initial capacity of 0.5m units. The plant is likely to be completed by mid-2007. The new plant, coupled with expansion at existing plants at Dharuhera and Gurgaon will help the company achieve an annual production capacity of 4.4m units by mid-2007.

The Haridwar plant would be a flexible facility, capable of manufacturing any bike model. The capacity can be ramped up to 1.5m units by 2010, with a combined investment of Rs1.9b by Hero Honda and its ancillaries.

The company would be benefiting from tax sops – 100% excise exemption for 10 years, 100% income tax exemption for the first five years and 30% for the next five years.

Valuation and view

We expect Hero Honda to report volume growth of 13.7% CAGR over FY06-08. We are revising our estimates to factor lower margins and lower other income. We have revised our FY07 EPS estimate by 5.8% to factor lower than expected EBITDA margin and profits. The stock trades at 15.8x FY07E EPS of Rs45.3 and 13.2x FY08E EPS of Rs54.2. We maintain our **Neutral** rating with a price target of Rs744.

Hero Honda: an investment profile

Company description

Hero Honda is the largest two wheeler company in the world with revenues of more than US\$1.6 billion, it sells over 2 million motorcycles a year. It is a JV between Honda Corporation Japan and the Munjal family with both parties owning 26% each. Hero Honda has a dealership network of over 500 with close to 70% of sales coming from rural India.

Key investment arguments

- Hero Honda's substantial presence in rural India insulates it from the onslaught of the competition.
- The new product launches will allow Hero Honda to maintain its leadership position, while the new plant will address capacity constraint issues.

Key investments risks

- There have been several new launches by competitors in the past 6 months. Hence, the competitive scenario in the country is poised to increase.
- Competition is gaining market share in Hero Honda's strong hold – Executive segment.
- Margins are under pressure due to increased raw-material costs.

Recent developments

- Hero Honda is expanding capacity at its existing plants by 23% to 4.4m units p.a.
- The company also announced plans for its Haridwar plant, which will have an initial capacity of 0.5m units and will get tax sops as well.

Valuation and view

- We expect Hero Honda to report volume growth of 14.4% CAGR over FY06-08. We are revising our estimates to factor lower margins and lower other income.
- The stock trades at 15.8x FY07E EPS of Rs45.3 and 13.2x FY08E EPS of Rs54.2. We maintain our **Neutral** rating with a price target of Rs744.

Sector view

- Numerous motorcycle launches will lead to an increase in the competitive scenario.
- Domestic two wheeler demand will continue to surpass estimates on back of rural pull.
- Despite large number of players market share remains concentrated amongst the top two.
- We maintain an overweight stance on the sector.

COMPARATIVE VALUATIONS

		HERO HONDA	BAJAJ AUTO	TVS MOT.
P/E (x)	FY07E	15.8	21.3	23.1
	FY08E	13.2	17.9	19.0
EPS Gr (%)	FY07E	-6.8	19.0	-25.7
	FY08E	19.5	19.4	21.8
RoE (%)	FY07E	36.8	23.3	9.6
	FY08E	36.7	23.4	10.9
EV/EBITDA (x)	FY07E	10.0	15.4	10.2
	FY08E	8.2	12.0	8.5

SHAREHOLDING PATTERN (%)

	DEC.06	SEP.06	DEC.05
Promoter	55.0	55.0	55.0
Domestic Inst	8.8	9.0	8.3
Foreign	26.2	25.9	26.8
Others	10.1	10.1	9.9

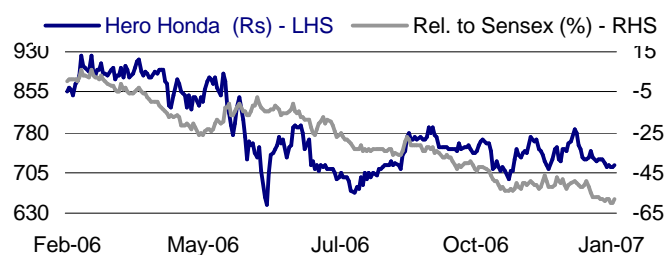
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	45.3	46.9	-3.5
FY08	54.2	53.3	1.8

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
718	744	3.6	Neutral

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)				
Y/E MARCH	2005	2006	2007E	2008E	2009E	
Net Sales	74,217	87,140	100,367	117,654	134,750	
Change (%)	27.2	17.4	15.2	17.2	14.5	
Raw Material	51,996	60,523	72,766	85,299	97,694	
Employee Cost	2,680	3,206	3,563	4,118	4,581	
Other Mfg. Expenses	3,154	3,598	4,015	4,589	5,255	
Selling & Distribution	4,741	6,169	7,628	8,883	10,174	
EBITDA	11,645	13,645	12,395	14,766	17,046	
Change (%)	18.8	17.2	-9.2	19.1	15.4	
% of Net Sales	15.7	15.7	12.4	12.6	12.7	
Depreciation	894	1,146	1,419	1,735	1,969	
EBIT	10,751	12,498	10,977	13,031	15,077	
Interest & Finance Charges	11	-61	-217	-217	-217	
Other Income	1,369	1,563	1,968	2,097	2,233	
PBT	12,109	14,122	13,161	15,345	17,527	
Tax	4,068	4,409	4,106	4,527	4,995	
Effective Rate (%)	33.6	31.2	31.2	29.5	28.5	
PAT	8,042	9,713	9,055	10,818	12,532	
% of Net Sales	10.8	11.1	9.0	9.2	9.3	
Adj. PAT	8,042	9,713	9,055	10,818	12,532	
Change (%)	10.4	20.8	-6.8	19.5	15.8	

BALANCE SHEET		(Rs Million)				
Y/E MARCH	2005	2006	2007E	2008E	2009E	
Share Capital	399	399	399	399	399	
Reserves	14,534	19,694	24,221	29,090	34,102	
Net Worth	14,934	20,093	24,621	29,489	34,502	
Deferred Tax	1,015	1,201	1,201	1,201	1,201	
Loans	2,018	1,858	1,858	1,858	1,858	
Capital Employed	17,967	23,152	27,680	32,548	37,560	
Gross Fixed Assets	11,042	14,720	18,662	22,162	24,162	
Less: Depreciation	4,297	5,226	6,645	8,380	10,348	
Net Fixed Assets	6,745	9,494	12,017	13,782	13,813	
Capital WIP	409	442	0	0	0	
Investments	20,267	20,619	20,619	20,619	20,619	
Curr.Assets, L & Adv.	5,545	8,212	8,570	12,127	18,373	
Inventory	2,043	2,266	3,300	3,868	4,430	
Sundry Debtors	896	1,587	2,200	2,579	2,953	
Cash & Bank Balances	176	1,587	674	3,284	8,593	
Loans & Advances	2,396	2,738	2,396	2,396	2,396	
Current Liab. & Prov.	15,005	15,628	13,539	13,993	15,258	
Sundry Creditors	6,503	6,344	8,249	8,703	9,968	
Other Liabilities	3,655	4,385	4,385	4,385	4,385	
Provisions	4,847	4,899	905	905	905	
Net Current Assets	-9,459	-7,416	-4,969	-1,866	3,115	
Application of Funds	17,967	23,152	27,680	32,548	37,560	

E: MOST Estimates

RATIOS						
Y/E MARCH	2005	2006	2007E	2008E	2009E	
Basic (Rs)						
EPS	40.3	48.6	45.3	54.2	62.8	
Cash EPS	44.7	54.4	52.4	62.9	72.6	
Book Value per Share	74.8	100.6	123.3	147.7	172.8	
DPS	20.0	20.0	22.7	29.3	37.2	
Payout (Incl. Div. Tax) %	49.7	41.1	50.0	55.0	60.0	
Valuation (x)						
P/E		14.8	15.8	13.2	11.4	
Cash P/E		13.2	13.7	11.4	9.9	
EV/EBITDA		9.0	10.0	8.2	6.8	
EV/Sales		14	12	10	0.9	
Price to Book Value		7.1	5.8	4.9	4.2	
Dividend Yield (%)		2.8	3.2	4.1	5.2	
Profitability Ratios (%)						
RoE	53.8	48.3	36.8	36.7	36.3	
RoCE	67.5	60.7	46.8	46.5	46.1	
Turnover Ratios						
Debtors (Days)	4	7	8	8	8	
Asset Turnover (x)	4.1	3.8	3.6	3.6	3.6	
Leverage Ratio						
Debt/Equity (x)	0.1	0.1	0.1	0.1	0.1	

CASH FLOW STATEMENT		(Rs Million)				
Y/E MARCH	2005	2006	2007E	2008E	2009E	
OP/(Loss) before Tax	10,751	12,498	10,977	13,031	15,077	
Interest/Div. Received	1,369	1,563	1,968	2,097	2,233	
Depreciation & Amort.	894	1,146	1,419	1,735	1,969	
Direct Taxes Paid	-3,953	-4,223	-4,106	-4,527	-4,995	
(Inc)/Dec in Working Capital	1,754	-633	-3,359	-493	328	
CF from Oper. Activity	10,816	10,345	6,898	11,843	14,611	
(Inc)/Dec in FA+CWIP	-2,159	-3,929	-3,500	-3,400	-2,000	
(Pur)/Sale of Invest.	-4,616	-352	0	0	0	
CF from Inv. Activity	-6,775	-4,281	-3,500	-3,400	-2,000	
Changes in Reserves	-502	-560	0	0	0	
Inc/(Dec) in Debt	271	-160	0	0	0	
Interest Paid	-11	61	217	217	217	
Dividends Paid	-3,994	-3,994	-4,528	-5,950	-7,519	
CF from Fin. Activity	-4,236	-4,652	-4,311	-5,733	-7,302	
Inc/(Dec) in Cash	-195	1,411	-913	2,710	5,309	
Add: Beginning Balance	371	176	1,587	674	3,284	
Closing Balance	176	1,587	674	3,384	8,593	

E: MOST Estimates



For more copies or other information, contact

Institutional: Navin Agarwal. **Retail:** Manish Shah, Mihir Kothari

Phone: (91-22) 39825500 Fax: (91-22) 22885038. E-mail: inquire@motiloswal.com

Motilal Oswal Securities Ltd, 3rd Floor, Hoechst House, Nariman Point, Mumbai 400 021

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Hero Honda Motors

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|---|-----|
| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | Yes |
| 3. Broking relationship with company covered | No |
| 4. Investment Banking relationship with company covered | No |

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