

## Hero Honda Motors

STOCK INFO.	BLOOMBERG
BSE Sensex: 10,399	HH IN
	REUTERS CODE
S&P CNX: 3,071	HROH.BO

**31 May 2006**
**Buy**
*Previous Recommendation: Buy*
**Rs771**

Equity Shares (m)	199.7
52-Week Range	950/537
1,6,12 Rel. Perf. (%)	8/-22/-15
M.Cap. (Rs b)	153.9
M.Cap. (US\$ b)	3.3

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	9,714	48.6	19.9	15.8	7.5	47.0	59.4	1.5	9.8
3/07E	101,924	11,231	56.2	15.6	13.7	5.7	41.7	55.1	1.3	8.1
3/08E	116,385	12,752	63.9	13.5	12.1	4.5	37.4	50.5	1.1	6.7

- 4QFY06 results were in line with our expectation. Sales grew 16%, EBITDA grew 24% and PAT was up by 29%. EBITDA margins at 16.1% expanded 100bp YoY.
- For the full year FY06, sales grew 17% YoY at Rs87.1b, led by 14.5% volume growth at 3m units. EBITDA margin at 15.7% was, however, flat YoY. PAT grew by 19.8% YoY to Rs9.7b, led by 18% growth in EBITDA, higher depreciation and lower taxation, resulting in EPS of Rs48.6.
- Hero Honda is expanding capacity at its existing plants to 3.9m units (+30% YoY). Further the company announced plans for its third plant to be situated at Jaipur. Rs3.2b will be invested in the plant, which will have production capacity of 500,000 units.
- The company also announced eight new launches that would hit the market in FY07. These will strengthen Hero Honda's product portfolio across segments.
- We expect Hero Honda to report EPS of Rs56.2 and Rs63.9 on our FY07E and FY08E estimates. The stock trades at 13.7x and 12.1x on FY07 and FY08 estimates. Dividend declared was Rs20/share, short of expectation. We reiterate **Buy**.

QUARTERLY PERFORMANCE										(Rs Million)
Y/E MARCH	FY05				FY06				FY05	FY06
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q		
Total Volumes (nos)	609,123	614,796	712,062	685,419	687,567	742,425	798,301	772,457	2,621,400	3,000,750
<b>Net Sales</b>	<b>17,223</b>	<b>17,572</b>	<b>20,019</b>	<b>19,403</b>	<b>19,771</b>	<b>21,663</b>	<b>23,148</b>	<b>22,559</b>	<b>74,217</b>	<b>87,140</b>
Change (%)	30.1	39.3	26.6	15.5	14.8	23.3	15.6	16.3	27.3	17.4
Total Cost	<b>14,369</b>	<b>14,823</b>	<b>16,910</b>	<b>16,471</b>	<b>16,848</b>	<b>18,327</b>	<b>19,367</b>	<b>18,927</b>	<b>62,572</b>	<b>73,460</b>
<b>EBITDA</b>	<b>2,855</b>	<b>2,749</b>	<b>3,109</b>	<b>2,932</b>	<b>2,923</b>	<b>3,336</b>	<b>3,781</b>	<b>3,632</b>	<b>11,645</b>	<b>13,680</b>
As % of Sales	16.6	15.6	15.5	15.1	14.8	15.4	16.3	16.1	15.7	15.7
Change (%)	33.8	32.1	15.3	2.7	2.4	21.3	21.6	23.9	18.9	17.5
Other Income	229	411	413	358	306	431	360	430	1,411	1,527
Interest	-2	-3	-2	-4	3	-8	-11	-39	-11	-61
Depreciation	205	208	217	264	250	267	324	305	894	1,146
<b>PBT</b>	<b>2,881</b>	<b>2,955</b>	<b>3,307</b>	<b>3,031</b>	<b>2,975</b>	<b>3,508</b>	<b>3,827</b>	<b>3,797</b>	<b>12,173</b>	<b>14,123</b>
Tax	980	1,011	1,118	960	937	1,129	1,209	1,125	4,068	4,409
Effective Tax Rate (%)	34.0	34.2	33.8	31.7	31.5	32.2	31.6	29.6	33.4	31.2
<b>PAT</b>	<b>1,901</b>	<b>1,944</b>	<b>2,189</b>	<b>2,070</b>	<b>2,039</b>	<b>2,379</b>	<b>2,618</b>	<b>2,671</b>	<b>8,105</b>	<b>9,714</b>
Change (%)	20.5	24.2	8.0	-2.0	7.2	22.4	19.6	29.0	11.3	19.8

E: MOST Estimates

In 4QFY06, Hero Honda reported sales growth of 16% at Rs22.5b, which was driven by 13% volume growth. EBITDA margins at 16.1% expanded 100bp YoY. PAT grew by 29% at Rs2.7b, led by 24% growth in EBITDA and lower tax rate (29.6% in 4QFY06 v/s 31.7% in 4QFY05).

In FY06, Hero Honda reported sales growth at Rs87.1b, a growth of 17% YoY. Growth was led by a 14.5% volume growth at 3m units, while realization grew 2.6% YoY due to improved product mix. Led by the 18% growth in EBITDA, higher depreciation and lower taxation, PAT grew by 19.8% YoY to Rs9.7b, resulting in an EPS of Rs48.6.

**Volume growth: Lags industry growth**

In 4QFY06, Hero Honda reported volume growth of 12.7% at 772,457 units. This includes sales of the newly launched Pleasure. Excluding scooters, sales growth for motorcycles was 11%.

In FY06, Hero Honda has grown slower in the motorcycle industry — it has recorded 14% growth compared with industry growth of 18%.

For FY07, management has given guidance for a 15%-20% volume growth. We believe that with the proposed aggressive line up of new launches, Hero Honda will be well positioned to maintain the growth momentum.

VOLUME TABLE (IN UNIT NOS)

	FY06	FY05	GR.	FY06	FY05	GR.
	4Q	4Q	(%)	YTD	YTD	(%)
Total Sales	772,457	685,419	12.7	3,000,750	2,621,400	14.5
Domestic	752,605	664,845	13.2	2,908,084	2,557,385	13.7
Exports	19,852	20,574	-3.5	92,666	64,015	44.8

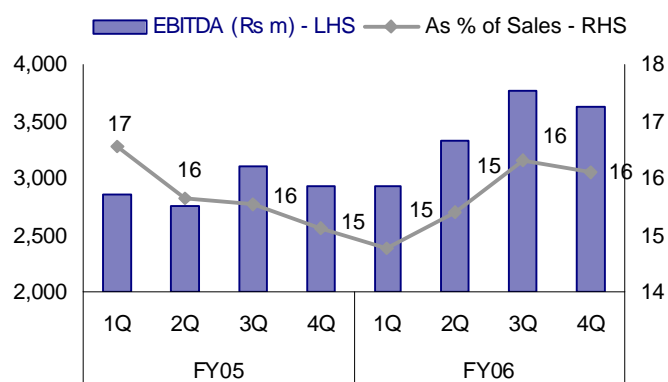
Source: Company/Motilal Oswal Securities

**EBITDA margins: witness YoY expansion**

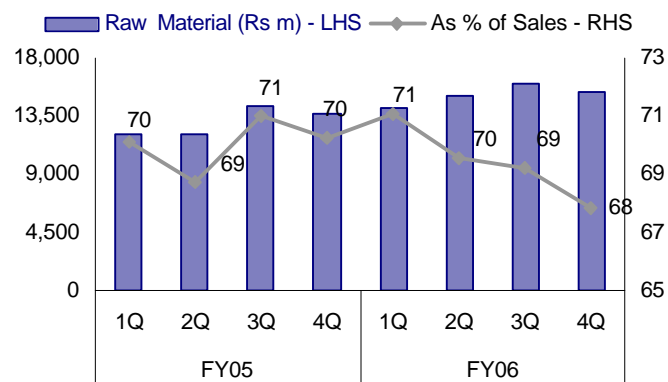
In 4QFY06, EBITDA margins at 16.1% expanded 100bp YoY. Margins were higher due to significantly lower RM costs. The RM/sales ratio was at 67.9%, a drop of 240bp YoY.

In FY06, EBITDA margin at 15.7% was flat YoY. Hero Honda incurred higher other expenses, which we believe were on account of the discount schemes offered during the year. Other expenses were at 11.2% of sales (v/s10.6% in FY05). However, lower material costs offset the increase in other expenses. RM/sales declined by 60bp to 69.5%.

EBITDA MARGIN: SHARP YOY IMPROVEMENT



RAW MATERIAL COSTS: SHOWING SIGNS OF SOFTENING



Source: Company/Motilal Oswal Securities

**New plant details announced**

Hero Honda is expanding capacity at its existing units to 3.9m units (+30% YoY). Expansion of 4,50,000 units at the Gurgaon plant has already been completed at an investment of Rs0.5b. Expansion of an additional 4,50,000 units is underway at the Dharuhera plant at an investment of Rs1b. This would be operational by August 2006.

The company also announced plans to set up a third plant, to be situated at Jaipur, at an investment of Rs3.2b. It will

have a production capacity of 500,000 units initially, with provision to expand capacity to one million units. The plant will be commissioned within one year.

These capacities will raise Hero Honda's total production capacity to 5m units (from the existing 3m units), up 66%. Assuming that the two-wheeler industry will grow at 15% CAGR over the next 4-5 years, the company is, we believe, well poised to seize the growth opportunity.

### New product launches announced

The company has announced that eight new models will be launched in FY07. This will strengthen Hero Honda's product portfolio across segments. Hero Honda will also launch its fuel injection technology in the 125cc model Glamour, in June 2006. With this, Honda Motor Co. will debut this technology globally in 125 cc category along with Hero Honda. This reflects Honda's commitment to the Indian partnership.

After the lukewarm success of Super Splendor and Glamour, new product launches are essential, considering that competition is firing on all cylinders. In fact, Hero Honda has lost market share of 190bp in FY06 (to 48.1%) in the motorcycle segment. New product launches are important to help Hero Honda regain lost share and maintain its leadership position.

#### MODELWISE SALES

	FY05	FY06
Splendor +	1,111,369	932,309
<b>Super Splendor</b>	<b>20,557</b>	<b>286,385</b>
Passion Plus	708,774	653,425
<b>Glamour</b>	-	<b>200,766</b>
<b>Delux Segment</b>	<b>1,840,700</b>	<b>2,072,885</b>
Ambition 135	75,316	-
Achiever	-	33,878
Karizma	15,065	23,272
CBZ	35,950	28,270
<b>Premium Segment</b>	<b>126,331</b>	<b>85,420</b>
CD Dawn	648,418	283,437
<b>CD Deluxe</b>	<b>5,951</b>	<b>539,435</b>
<b>Entry Segment</b>	<b>654,369</b>	<b>822,872</b>
Total Bikes	2,621,400	2,981,177
Pleasure Scooter		19,573
<b>Grand Total</b>	<b>2,621,400</b>	<b>3,000,750</b>

Source: Industry / Motilal Oswal Securities

Super Splendor and Glamour together sold fewer than 500,000 units, which is just 15% of total volumes. However, the CD Deluxe fared reasonably well, with volumes crossing 500,000 units. The total of all the new products accounted for 35% of total sales.

We believe that Hero Honda's decision to launch new products in every segment will strengthen its position across segments.

### Dividend payout disappoints

Hero Honda declared a dividend of Rs20 per share in FY06 that is unchanged from FY05, despite 20% profit growth. This is lower than our estimate of Rs24 per share. Over the last few years, the payout ratio has fallen from 75% in FY02 to almost 40% now.

However, the company has one of the best return ratios in the auto universe and will continue to generate free cash of Rs10b annually. Hence, we expect good dividend payout in the years ahead.

### Valuation and view

We expect Hero Honda to report EPS of Rs56.2 and Rs63.9 on our FY07E and FY08E estimates. The stock trades at 13.7x and 12.1x on FY07 and FY08 estimates. With triggers such as proposed new product launches and the announcement of a new plant in Jaipur, we believe Hero Honda will maintain its dominant market position. The new product launches will allow Hero Honda to maintain its leadership position whilst the new plant will address capacity constraint concerns. We reiterate **Buy** with a target price of Rs1,031, implying an upside of 33.8%.

#### SOTP VALUATION (RS/SHARE)

	FY06	FY07	FY08
Core EPS	43.4	50.2	57.6
Multiple	15.0	15.0	15.0
Value	651	753	864
Cash per Share	110	136	167
Price	760	889	1,031

Source: Motilal Oswal Securities

## Hero Honda: an investment profile

### Company description

Hero Honda is the largest two-wheeler company in the world with revenues of more than US\$1.6b. The company sells over 2m motorcycles a year. It is a JV between Honda Corporation Japan and the Munjal family, with each party owning 26%. 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 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 six months. Hence, the competitive scenario in the country is poised to increase.
- Competition is gaining share in Hero Honda's stronghold – the Executive segment.

### Recent developments

- Hero Honda is expanding capacity at its existing plants by 20% to 3.9m units p.a.
- The company also announced plans for its third plant to be situated at Jaipur with a capacity of 1m units.

### Valuation and view

- We expect Hero Honda to report EPS of Rs56.2 and Rs63.9 on our FY07E and FY08E estimates. The stock trades at 13.7x and 12.1x on FY07 and FY08 estimates.
- We reiterate **Buy** with a target price of Rs1,031 resulting in an upside of 33.8%.

### Sector view

- Numerous motorcycle launches will lead to an increase in the competitive scenario increased competition.
- Domestic two-wheeler demand will continue to surpass estimates on the back of rural pull.
- Despite increased 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 MOTORS
P/E (x)	FY07E	13.7	19.3	16.9
	FY08E	12.1	15.7	15.6
EPS Gr (%)	FY07E	17.3	30.8	23.3
	FY08E	13.5	22.9	8.2
RoE (%)	FY07E	41.7	24.8	19.6
	FY08E	37.4	25.2	18.8
EV/EBITDA (x)	FY07E	8.1	13.6	10.1
	FY08E	6.7	10.6	9.1

#### SHAREHOLDING PATTERN (%)

	MAR.06	DEC.05	MAR.05
Promoters	55.0	55.0	55.0
Domestic Institutions	8.1	8.3	7.6
FII's/FDIs	27.1	26.8	26.9
Others	9.9	9.9	10.6

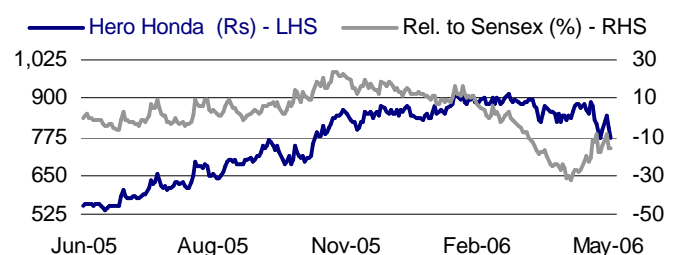
#### EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	56.2	55.6	1.1
FY08	63.9	62.7	2.0

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
771	1,031	33.8	Buy

#### STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)				
Y/E MARCH	2004	2005	2006E	2007E	2008E	
<b>Net Sales</b>	<b>58,324</b>	<b>74,217</b>	<b>87,140</b>	<b>101,924</b>	<b>116,385</b>	
Change (%)	14.3	27.2	17.4	17.0	14.2	
Raw Material	40,306	51,996	60,523	71,347	81,237	
Employee Cost	2,315	2,680	3,206	3,669	4,248	
Other Mfg. Expenses	2,518	3,154	3,616	4,281	4,946	
Selling & Distribution	3,384	4,741	6,114	6,676	7,681	
<b>EBITDA</b>	<b>9,801</b>	<b>11,645</b>	<b>13,680</b>	<b>15,951</b>	<b>18,272</b>	
Change (%)	13.5	18.8	17.5	16.6	14.6	
% of Net Sales	16.8	15.7	15.7	15.7	15.7	
Depreciation	733	894	1,146	1,195	1,346	
Interest & Finance Charges	-14	-11	-61	12	12	
Other Income	1,650	1,410	1,527	1,772	1,837	
<b>PBT</b>	<b>10,725</b>	<b>12,173</b>	<b>14,123</b>	<b>16,517</b>	<b>18,753</b>	
Tax	3,441	4,068	4,409	5,285	6,001	
Effective Rate (%)	32.1	33.4	31.2	32.0	32.0	
<b>PAT</b>	<b>7,283</b>	<b>8,105</b>	<b>9,714</b>	<b>11,231</b>	<b>12,752</b>	
% of Net Sales	12.5	10.9	11.1	11.0	11.0	
<b>Adj. PAT</b>	<b>7,283</b>	<b>8,105</b>	<b>9,714</b>	<b>11,231</b>	<b>12,752</b>	
Change (%)	25.4	11.3	19.9	15.6	13.5	

BALANCE SHEET		(Rs Million)				
Y/E MARCH	2004	2005	2006E	2007E	2008E	
Share Capital	399	399	399	399	399	
Reserves	10,989	14,534	20,254	26,566	33,707	
<b>Net Worth</b>	<b>11,388</b>	<b>14,934</b>	<b>20,654</b>	<b>26,966</b>	<b>34,107</b>	
Deferred Tax	900	1,015	1,015	1,015	1,015	
Loans	1,747	2,018	2,018	2,018	2,018	
<b>Capital Employed</b>	<b>14,035</b>	<b>17,967</b>	<b>23,687</b>	<b>29,999</b>	<b>37,140</b>	
Gross Fixed Assets	9,169	11,042	12,700	14,450	15,450	
Less: Depreciation	3,458	4,297	5,443	6,638	7,983	
<b>Net Fixed Assets</b>	<b>5,711</b>	<b>6,745</b>	<b>7,257</b>	<b>7,812</b>	<b>7,467</b>	
Capital WIP	177	409	0	0	0	
Investments	15,651	20,267	20,267	20,267	20,267	
<b>Curr.Assets, L &amp; Adv.</b>	<b>5,090</b>	<b>5,545</b>	<b>8,305</b>	<b>14,799</b>	<b>22,836</b>	
Inventory	1,882	2,043	2,865	3,351	4,783	
Sundry Debtors	438	896	1,432	2,234	2,551	
Cash & Bank Balances	371	176	1,609	6,818	13,104	
Loans & Advances	2,399	2,396	2,399	2,396	2,399	
<b>Current Liab. &amp; Prov.</b>	<b>12,601</b>	<b>15,005</b>	<b>12,148</b>	<b>12,885</b>	<b>13,436</b>	
Sundry Creditors	6,190	6,503	7,640	8,377	8,928	
Other Liabilities	3,849	3,655	3,655	3,655	3,655	
Provisions	2,562	4,847	853	853	853	
<b>Net Current Assets</b>	<b>-7,511</b>	<b>-9,459</b>	<b>-3,843</b>	<b>1,913</b>	<b>9,400</b>	
<b>Application of Funds</b>	<b>14,035</b>	<b>17,967</b>	<b>23,687</b>	<b>29,999</b>	<b>37,140</b>	

E: Most Estimates

RATIOS						
Y/E MARCH	2004	2005	2006E	2007E	2008E	
<b>Basic (Rs)</b>						
<b>EPS</b>	<b>36.5</b>	<b>40.6</b>	<b>48.6</b>	<b>56.2</b>	<b>63.9</b>	
Cash EPS	40.1	45.1	54.4	62.2	70.6	
Book Value per Share	57.0	74.8	103.4	135.0	170.8	
DPS	20.0	20.0	20.0	24.6	27.6	
Payout (Incl. Div. Tax) %	54.8	49.3	41.1	43.8	44.0	
<b>Valuation (x)</b>						
P/E		19.0	15.8	13.7	12.1	
Cash P/E		17.1	14.2	12.4	10.9	
EV/EBITDA		11.6	9.8	8.1	6.7	
EV/Sales		1.8	1.5	1.3	1.1	
Price to Book Value		10.3	7.5	5.7	4.5	
Dividend Yield (%)		2.6	2.6	3.2	3.6	
<b>Profitability Ratios (%)</b>						
RoE	64.0	54.3	47.0	41.7	37.4	
RoCE	76.4	67.7	59.4	55.1	50.5	
<b>Turnover Ratios</b>						
Debtors (Days)	3	4	6	8	8	
Asset Turnover (x)	4.2	4.1	3.7	3.4	3.1	
<b>Leverage Ratio</b>						
Debt/Equity (x)	0.2	0.1	0.1	0.1	0.1	

CASH FLOW STATEMENT		(Rs Million)				
Y/E MARCH	2004	2005	2006E	2007E	2008E	
OP/(Loss) before Tax	9,068	10,751	12,534	14,756	16,927	
Interest/Div. Received	1,650	1,410	1,527	1,772	1,837	
Depreciation & Amort.	733	894	1,146	1,195	1,346	
Direct Taxes Paid	-3,313	-3,953	-4,409	-5,285	-6,001	
(Inc)/Dec in Working Capital	1,247	1,754	-4,184	-547	-1,201	
<b>CF from Oper. Activity</b>	<b>9,387</b>	<b>10,857</b>	<b>6,615</b>	<b>11,890</b>	<b>12,908</b>	
(Inc)/Dec in FA+CWIP	-1,451	-2,159	-1,250	-1,750	-1,000	
(Pur)/Sale of Invest.	-3,721	-4,616	0	0	0	
<b>CF from Inv. Activity</b>	<b>-5,172</b>	<b>-6,775</b>	<b>-1,250</b>	<b>-1,750</b>	<b>-1,000</b>	
Changes in Reserves	-512	-565	0	0	0	
Inc/(Dec) in Debt	404	271	0	0	0	
Interest Paid	14	11	61	-12	-12	
Dividends Paid	-3,994	-3,994	-3,994	-4,919	-5,611	
<b>CF from Fin. Activity</b>	<b>-4,088</b>	<b>-4,278</b>	<b>-3,933</b>	<b>-4,931</b>	<b>-5,622</b>	
<b>Inc/(Dec) in Cash</b>	<b>128</b>	<b>-195</b>	<b>1,433</b>	<b>5,209</b>	<b>6,286</b>	
Add: Beginning Balance	243	371	176	1,609	6,818	
<b>Closing Balance</b>	<b>371</b>	<b>176</b>	<b>1,609</b>	<b>6,818</b>	<b>13,104</b>	



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**Hero Honda Motors**

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

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