

## Company

19 April 2010 | 12 pages

# Hero Honda (HROH.BO)

 Equity   
 Target price change   
 Estimate change 

## 4Q Results in Line with Expectations

- 4Q PAT at Rs5.98bn was in line with expectations** — buoyed by a lower than expected tax rate of ~19% (21% est). At the EBITDA level, operating profits were a tad (~4%) below our estimates, given higher SGA (we est ~Rs300m for IPL ad spends) and expenses related to the continued ramp-up of the Haridwar facility.
- Mgmt guides to ~12-15% industry volume growth** — in FY11, and HH is expected to grow at the same pace (implying market share sustains at current levels). We factor vol. growth of ~12% — the lower end of guidance, as we think HH will continue to cede market share in the executive segment to Bajaj Auto.
- Earnings estimates are revised up by 16-17%** — for FY11/12E, to reflect a) higher volumes (hiked by 7-9%) and b) 100-110bps increase in margins (as benefits of increased localization of production at Haridwar should mitigate cost pressures (which we factor at ~Rs900-1,000 per bike).
- But market share losses are a longer-term concern...** — HH has ceded market share of ~12ppts (from peak levels of ~80% in 1QFY10) in the key executive segment (~60% of industry sales) as a resurgent Bajaj Auto continues to gain share. HH's overall domestic market share (in bikes) has dipped to ~55% in 4QFY10, from 62% in 1QFY10.
- ...And could cap recent re-rating** — We pare our target multiple to 15x from 16x, as we move into mid cycle, and also given our concerns of escalating competitive intensity in 2-wheelers. At 15x, the stock will trade at a slight premium to its long-term average (c13.5x), but we think this is merited given that earnings are supported by a slew of fiscal incentives from the Haridwar facility, which mitigate the impact of cost pressures. Our revised TP is based on 15x Sept 11E EPS.

<b>Hold/Low Risk</b>	<b>2L</b>
Price (19 Apr 10)	Rs1,896.90
Target price	Rs2,002.00
	<i>from Rs1,790.00</i>
Expected share price return	5.5%
Expected dividend yield	1.8%
<b>Expected total return</b>	<b>7.4%</b>
Market Cap	Rs378,787M
	US\$8,555M

### Price Performance (RIC: HROH.BO, BB: HH IN)



### Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2008A	9,679	48.47	12.8	39.1	12.7	35.5	1.0
2009A	12,818	64.18	32.4	29.6	10.0	37.8	1.1
2010E	22,318	111.76	74.1	17.0	10.9	61.4	5.8
2011E	25,866	129.52	15.9	14.6	7.2	59.4	1.8
2012E	27,448	137.45	6.1	13.8	5.4	44.6	2.1

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Fiscal year end 31-Mar	2008	2009	2010E	2011E	2012E
<b>Valuation Ratios</b>					
P/E adjusted (x)	39.1	29.6	17.0	14.6	13.8
EV/EBITDA adjusted (x)	26.4	20.4	12.2	10.5	9.6
P/BV (x)	12.7	10.0	10.9	7.2	5.4
Dividend yield (%)	1.0	1.1	5.8	1.8	2.1
<b>Per Share Data (Rs)</b>					
EPS adjusted	48.47	64.18	111.76	129.52	137.45
EPS reported	48.47	64.18	111.76	129.52	137.45
BVPS	149.54	190.32	173.93	262.54	353.23
DPS	19.00	20.00	110.00	35.00	40.00
<b>Profit &amp; Loss (RsM)</b>					
Net sales	103,318	123,191	158,605	181,774	205,759
Operating expenses	-91,428	-107,901	-132,852	-152,341	-174,700
<b>EBIT</b>	<b>11,891</b>	<b>15,291</b>	<b>25,753</b>	<b>29,433</b>	<b>31,059</b>
Net interest expense	-20	-25	-23	-30	-31
Non-operating/exceptionals	2,232	2,549	2,587	2,929	3,282
<b>Pre-tax profit</b>	<b>14,103</b>	<b>17,815</b>	<b>28,317</b>	<b>32,332</b>	<b>34,310</b>
Tax	-4,424	-4,997	-5,999	-6,466	-6,862
Extraord./Min.Int./Pref.div.	0	0	0	0	0
<b>Reported net income</b>	<b>9,679</b>	<b>12,818</b>	<b>22,318</b>	<b>25,866</b>	<b>27,448</b>
Adjusted earnings	9,679	12,818	22,318	25,866	27,448
Adjusted EBITDA	13,494	17,097	27,669	31,426	33,444
<b>Growth Rates (%)</b>					
Sales	4.4	19.2	28.7	14.6	13.2
EBIT adjusted	15.1	28.6	68.4	14.3	5.5
EBITDA adjusted	15.0	26.7	61.8	13.6	6.4
EPS adjusted	12.8	32.4	74.1	15.9	6.1
<b>Cash Flow (RsM)</b>					
<b>Operating cash flow</b>	<b>14,831</b>	<b>16,751</b>	<b>20,287</b>	<b>29,724</b>	<b>29,899</b>
Depreciation/amortization	1,603	1,807	1,916	1,993	2,385
Net working capital	3,549	2,126	-3,947	1,865	66
<b>Investing cash flow</b>	<b>-10,218</b>	<b>-8,824</b>	<b>-16,672</b>	<b>-5,037</b>	<b>-22,635</b>
Capital expenditure	-3,407	0	-2,000	-3,000	-3,000
Acquisitions/disposals	-5,929	-8,019	-13,767	-1,131	-18,729
<b>Financing cash flow</b>	<b>-4,771</b>	<b>-9,202</b>	<b>-25,576</b>	<b>-8,171</b>	<b>-9,338</b>
Borrowings	-332	-535	15	0	0
Dividends paid	-4,439	-8,667	-25,592	-8,171	-9,338
<b>Change in cash</b>	<b>-158</b>	<b>-1,275</b>	<b>-21,962</b>	<b>16,516</b>	<b>-2,074</b>
<b>Balance Sheet (RsM)</b>					
<b>Total assets</b>	<b>50,523</b>	<b>60,765</b>	<b>76,402</b>	<b>77,846</b>	<b>98,450</b>
Cash & cash equivalent	1,311	2,196	2,000	2,000	2,000
Accounts receivable	2,974	1,499	2,313	2,111	2,402
Net fixed assets	15,487	16,943	17,028	18,035	18,653
<b>Total liabilities</b>	<b>20,821</b>	<b>22,757</b>	<b>41,668</b>	<b>25,417</b>	<b>27,909</b>
Accounts payable	7,561	7,030	7,892	9,062	10,386
Total Debt	1,320	785	800	800	800
<b>Shareholders' funds</b>	<b>29,862</b>	<b>38,008</b>	<b>34,734</b>	<b>52,429</b>	<b>70,541</b>
<b>Profitability/Solvency Ratios (%)</b>					
EBITDA margin adjusted	13.1	13.9	17.4	17.3	16.3
ROE adjusted	35.5	37.8	61.4	59.4	44.6
ROIC adjusted	116.4	nm	na	na	nm
Net debt to equity	0.0	-3.7	-3.5	-2.3	-1.7
Total debt to capital	4.2	2.0	2.3	1.5	1.1

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## Hold: Competitive Intensity to Escalate as HH cedes market share

Overall 4Q Results were in line with estimates, with recurring PAT at Rs5.98bn. Operating profits (defined as EBITDA) were slightly (~4%) below estimates as cost pressures (primarily attributed to IPL related advertising spends and also – we surmise - a ramp-up in the Haridwar facility) escalated overall SG&A spends.

Figure 1. Hero Honda: Operational Results

	4QFY09	3QFY10	4QFY10	% Chg YoY	% Chg QoQ	CIRA Comments
<b>Volumes (Nos.)</b>						
Scooters	49,489	45,931	66,450	34.3%	44.7%	Scooters growth numbers reflect low base plus Bajaj's exit from the segment
Motorcycles	948,366	1,065,441	1,120,086	18.1%	5.1%	Low Base effect wearing off + competition intensifying from Bajaj as well as Honda and TVS
<b>Total Volumes</b>	<b>997,855</b>	<b>1,111,372</b>	<b>1,186,536</b>	<b>18.9%</b>	<b>6.8%</b>	

Source: SIAM, CIRA

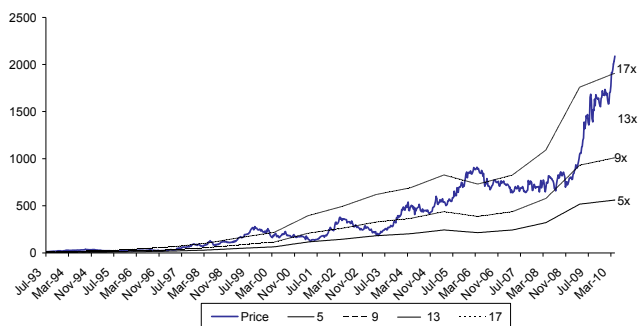
Figure 2. Hero Honda: 4QFY10 Results (Rs.m)

	4QFY09	3QFY10A	4QFY10A	% Change YoY	% Change QoQ	CIRA Comments
Sales Volume	997,855	1,111,372	1,186,536	19%	7%	
Average realization (Rs/bike)	34,192	34,435	34,742	2%	1%	Price increase on account of excise + slight shift in mix
<b>Net sales</b>	<b>34,118</b>	<b>38,270</b>	<b>41,223</b>	<b>21%</b>	<b>8%</b>	<b>In line with expectations</b>
Decrease/(Increase) in Stocks	86	95	(110)			
Raw Materials	23,479	26,051	27,794	17%		6% Material cost/bike is ~2% below estimates on account of increased localization levels at Haridwar
Staff costs	1,190	1,371	1,460	23%		6% ~6% above expectations – but in line with volume growth
Other Expenses	3,980	4,144	4,962	25%		20% ~19% above expectations. We estimate ~Rs300m for IPL – related ad spends, ramp up at Haridwar and continued brand building for the
<b>Total Expenditure</b>	<b>28,734</b>	<b>31,661</b>	<b>34,106</b>	<b>19%</b>	<b>8%</b>	
<b>EBITDA</b>	<b>5,384</b>	<b>6,609</b>	<b>7,117</b>	<b>32%</b>	<b>8%</b>	<b>~4% below our estimates</b>
Interest	(96)	(46)	(45)			
Other income	549	550	695	27%	26%	
EBDT	6,030	7,205	7,857	30%	9%	
Depreciation	444	469	487	10%		4% ~4% above our estimates
PBT	5,586	6,736	7,370	32%	9%	
Tax	1,564	1,378	1,382	-12%		0% ~10% below our estimates. Benefit from higher share of Haridwar unit in total production.
<b>Recurring PAT</b>	<b>4,022</b>	<b>5,358</b>	<b>5,988</b>	<b>49%</b>	<b>12%</b>	<b>In line with our estimates, ~8% above consensus.</b>
<b>Profit Margins</b>						
EBITDA (%)	15.8	17.3	17.3			
EBIT (%)	14.5	16.0	16.1			
Pre tax margins (%)	16.4	17.6	17.9			
Tax / PBT (%)	28.0	20.5	18.8			
Net profit margins (%)	11.8	14.0	14.5			
<b>Cost ratios</b>						
Raw materials / sales	69.1	68.3	67.2			
Staff costs / sales	3.5	3.6	3.5			
Other expenses / sales	11.7	10.8	12.0			
<b>EPS (Rs)</b>	<b>20.1</b>	<b>26.8</b>	<b>30.0</b>	<b>49%</b>		

Source: Company, Citi Investment Research and Analysis

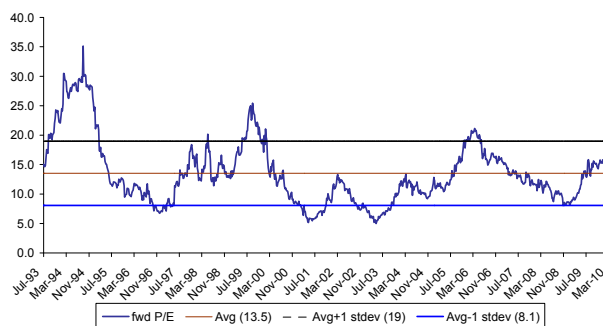
We maintain Hold, but revise our TP to Rs2002, based on 15x Sept 11E EPS, as we roll forward from Mar 11. Multiple pared to align with a) mid cycle and b) de-rating on account of market share losses.

Figure 3. Hero Honda : P/E (x) Band Chart



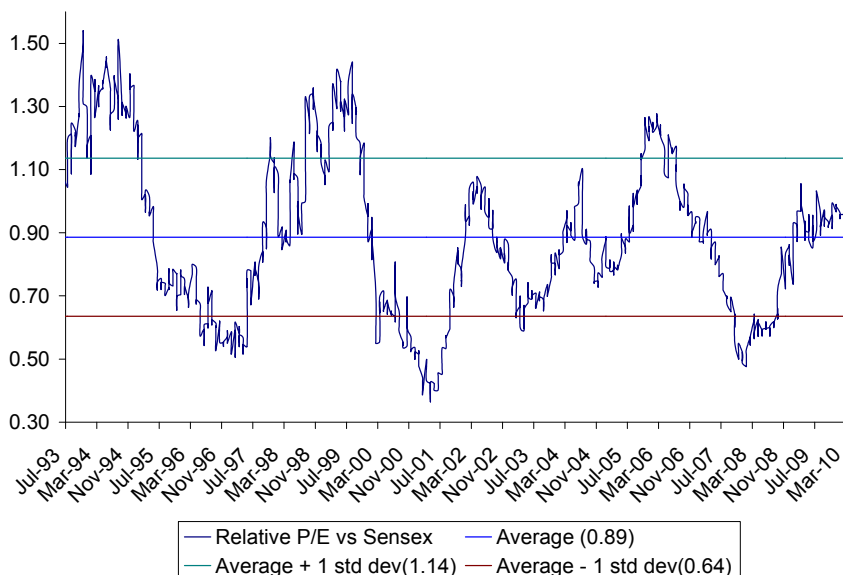
Source: Citi Investment Research and Analysis

Figure 4. Hero Honda : 1 Yr forward P/E (x)



Source: Citi Investment Research and Analysis

Figure 5. Hero Honda : Relative P/E vs SENSEX



Source: Citi Investment Research and Analysis

At our target multiple, the stock will trade at a c10% premium to its long-term average, which we think is merited given that HH's earnings profile has benefited structurally over the past 2 years on account of the Haridwar plant, which should account for ~35-40% of overall production in FY11. The benefits from this plant mitigate cost pressures meaningfully, and buffer earnings, given the tax incentives available.

Given the deceleration in earnings growth that is forecast over the next 2 years (we forecast 11% earnings CAGR FY10-12E vs. 52% CAGR in earnings FY08-10E), coupled with the accelerating competitive intensity, we believe it will be

very difficult for HH to retain its valuation multiple at the higher end of the current trading band, which is where it is currently trading.

We expect stock price performance to be limited on the downside, at least over the next 2 quarters, as visibility of moderate volume growth of ~12-15%, along with strong free cash flow yield (around 7%, based on FY11 estimates), should provide downside support.

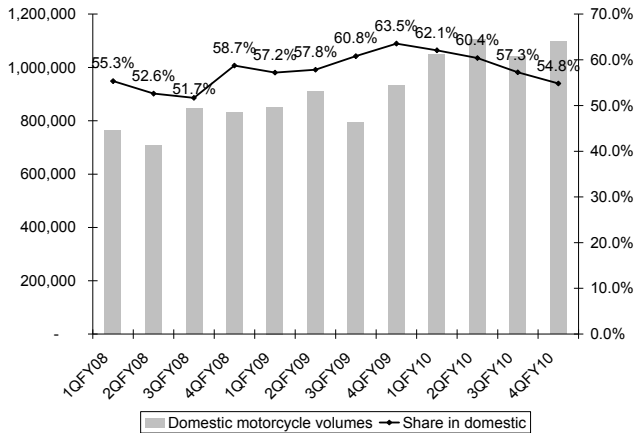
Figure 6. Hero Honda: Earnings Revision

	Old			New			% Change		
	FY2010E	FY2011E	FY2012E	FY2010	FY2011E	FY2012E	FY2010	FY2011E	FY2012E
<b>Volumes (nos)</b>	<b>4,391,960</b>	<b>4,831,156</b>	<b>5,314,272</b>	<b>4,600,130</b>	<b>5,152,146</b>	<b>5,770,403</b>	<b>5%</b>	<b>7%</b>	<b>9%</b>
% change YoY	18.0	10.0	10.0	23.6	12.0	12.0			
<b>Net Sales</b>	<b>150,556</b>	<b>168,164</b>	<b>187,273</b>	<b>158,605</b>	<b>181,774</b>	<b>205,759</b>	<b>5%</b>	<b>8%</b>	<b>10%</b>
% change YoY	22.2	11.7	11.4	28.7	14.6	13.2			
Raw material expenses	101,833	115,598	130,312	107,364	123,666	141,983	5%	7%	9%
% of net sales	67.6	68.7	69.6	67.7	68.0	69.0			
Other variable expenses	12,391	13,705	15,637	12,865	14,633	16,769	4%	7%	7%
% of net sales	8.2	8.2	8.4	8.1	8.1	8.2			
Manpower expenses	5,249	5,879	6,467	5,603	6,275	7,028	7%	7%	9%
% of net sales	3.5	3.5	3.5	3.5	3.5	3.4			
Other fixed expenses	5,104	5,774	6,360	5,104	5,774	6,534	0%	0%	3%
% of net sales	3.4	3.4	3.4	3.2	3.2	3.2			
<b>Operating profit</b>	<b>25,979</b>	<b>27,208</b>	<b>28,497</b>	<b>27,669</b>	<b>31,426</b>	<b>33,444</b>	<b>7%</b>	<b>16%</b>	<b>17%</b>
Interest	25	30	31	23	30	31	-8%	0%	0%
Other income	2,803	3,529	3,882	2,587	2,929	3,282	-8%	-17%	-15%
EBDT	28,757	30,707	32,348	30,233	34,325	36,695	5%	12%	13%
Depreciation	1,926	2,069	2,179	1,916	1,993	2,385	-1%	-4%	9%
PBT	26,831	28,638	30,169	28,317	32,332	34,310	6%	13%	14%
Tax	6,171	6,300	6,637	5,999	6,466	6,862	-3%	3%	3%
<b>Recurring PAT</b>	<b>20,660</b>	<b>22,337</b>	<b>23,532</b>	<b>22,318</b>	<b>25,866</b>	<b>27,448</b>	<b>8%</b>	<b>16%</b>	<b>17%</b>
EBDIT	28,782	30,737	32,379	30,256	34,355	36,726	5%	12%	13%
EBIT	26,856	28,668	30,200	28,340	32,362	34,341	6%	13%	14%
<b>EPS FD (Rs)</b>	<b>103.5</b>	<b>111.9</b>	<b>117.8</b>	<b>111.8</b>	<b>129.5</b>	<b>137.4</b>	<b>8%</b>	<b>16%</b>	<b>17%</b>
CEPS FD (Rs)	113.1	122.2	128.7	121.4	139.5	149.4	7%	14%	16%

Source: Citi Investment Research and Analysis estimates

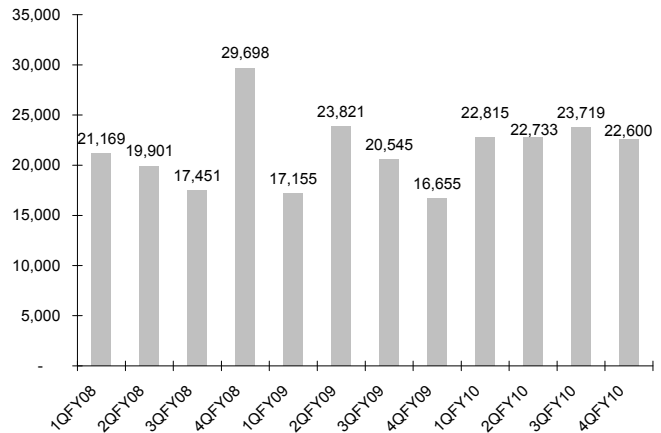
Hero Honda: Market Share Trends

Figure 7. Hero Honda: Domestic Motorcycles Sales



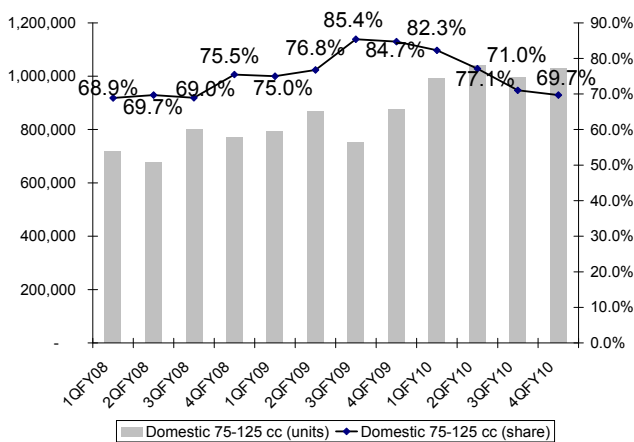
Source: SIAM

Figure 8. Hero Honda: Export Motorcycles Sales



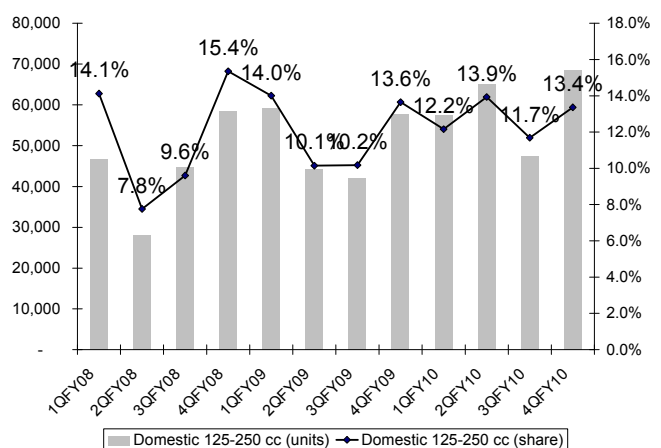
Source: SIAM

Figure 9. Hero Honda: Domestic Sales in 75-125cc Segment



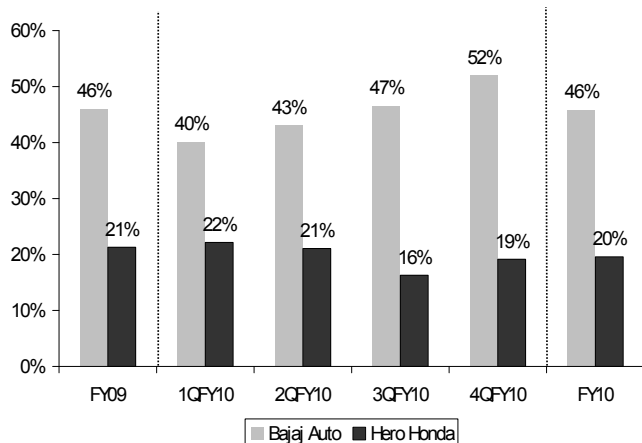
Source: Citi Investment Research and Analysis

Figure 10. Hero Honda: Domestic Sales in 125-250cc Segment



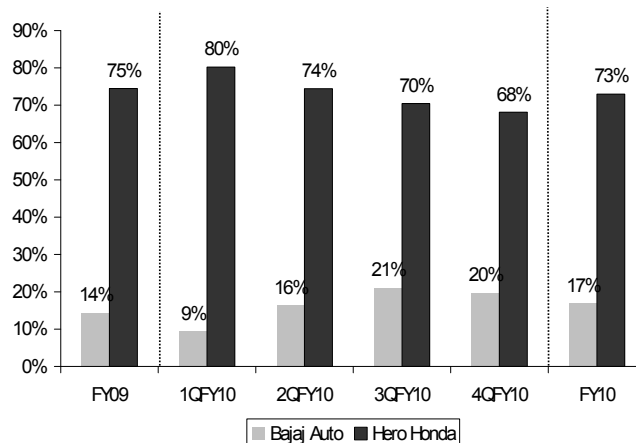
Source: Citi Investment Research and Analysis

Figure 11. Trends in Premium Bike Market Shares



Source: CRISIL estimates

Figure 12. Trends in Executive Bike Market Shares



Source: CRISIL estimates

## Hero Honda

### Company description

Hero Honda is India's largest manufacturer of two-wheelers. The company has benefited from the demand shift to motorcycles, as it focuses solely on this product segment. It has a strong product portfolio, and received technology and brand support from Honda Motors, Japan. With fuel efficiency and riding comfort as the main selling points, management has been able to address a wide market and post robust sales growth.

### Investment strategy

We rate Hero Honda shares Hold/Low Risk (2L), given limited upside to our target price of Rs2,002. Moreover, cyclical headwinds - cost pressures from higher input costs and initial signs of resumption of competitive pressures - are beginning to emerge, as a result of which we think it will be difficult for the stock to re-rate meaningfully from current levels. Longer term, we believe Hero Honda will retain its competitive advantage in a challenging operating environment given its superior strategy, significant fiscal incentives and lower dependence on financing. We forecast strong 11% earnings CAGR for Hero Honda over FY10-FY12E driven by a richer product mix and fiscal incentives at its Uttaranchal plant. We forecast 10% growth in EBITDA (core operating profits) over FY10-12E. The growth outlook for two-wheelers remains stable over the next two years, in our view. The vehicle financing cycle is incrementally improving, which augurs well for the volume outlook for both Hero Honda and its competition.

### Valuation

Our target price of Rs2,002 is based on 15x Sep11E earnings, which we believe is well supported by a robust earnings CAGR of 11% over FY10-12E. While this is to a certain extent driven by tax breaks at the Uttaranchal facility, we derive comfort from our expectations that core EBITDA (operating profits)

will grow at 10% CAGR over the same period. Our target multiple of 15x is at a c10% premium to HH's 5-year P/E multiple of 13.8x, which we think is justified given Hero Honda's earnings CAGR of 10% over FY10-12E. We have chosen to use the P/E valuation metric to value Hero Honda, given the company's high level of cash generation, reflecting its strong balance sheet (around Rs49bn in cash and liquid investments).

### **Risks**

We rate Hero Honda Low Risk according to our quantitative risk rating system, which tracks 260-day historical share price volatility. The key downside risks that could impede the stock from reaching our target price are: 1) Slower-than-forecast growth in the two-wheeler industry, 2) Any substantial increase in interest rates and greater than forecast increase in material costs. Upside risks to our target price include: 1) lower-than-forecast increase in material costs and volumes; 2) lower-than-expected competitive intensity.



# Appendix A-1

## Analyst Certification

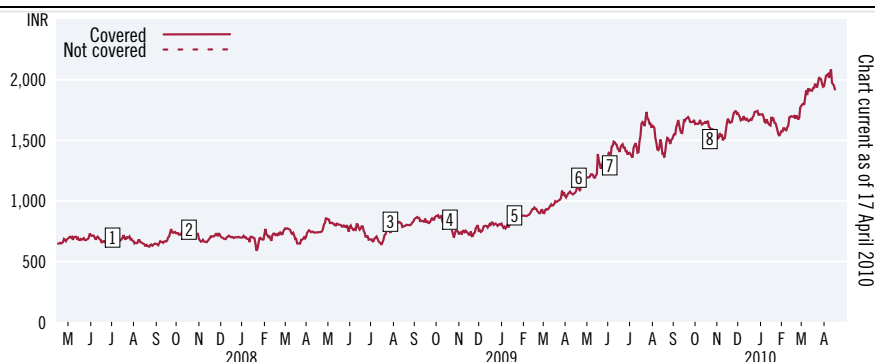
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### Hero Honda (HROH.BO)

#### Ratings and Target Price History Fundamental Research

Analyst: Jamshed Dadabhoy



	Date	Rating	Target Price	Closing Price
1	3-Jul-07	3L	*655.00	688.55
2	18-Oct-07	3L	*670.00	724.60
3	29-Jul-08	*2L	*764.00	736.15

	Date	Rating	Target Price	Closing Price
4	21-Oct-08	2L	*867.00	826.15
5	20-Jan-09	2L	*931.00	834.05
6	21-Apr-09	*1L	*1,258.00	1,100.90

	Date	Rating	Target Price	Closing Price
7	3-Jun-09	1L	*1,593.00	1,392.05
8	22-Oct-09	*2L	*1,790.00	1,605.65

\* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 31 Mar 2010

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% of companies in each rating category that are investment banking clients	48%	46%	39%

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