

Industrials
Autos
 Equity – India

Hero Honda

Overweight (V)

Target price (INR)	2340.00
Share price (INR)	1923.20
Potential total return (%)	21.7

Performance	1M	3M	12M
Absolute (%)	3.4	18.0	80.1
Relative [^] (%)	3.0	18.4	12.9

Index[^] BOMBAY SE SENSITIVE INDEX

RIC HROH.BO
 Bloomberg HH IN

Market cap (USDm) 8,661
 Market cap (INRm) 384,039

Enterprise value (INRm) 327,837
 Free float (%) 45

Note: (V) = volatile (please see disclosure appendix)

OW(V): Q4 results reinforce bullish outlook

- ▶ **Q4 PAT at INR6bn is 7% above consensus estimate, though in line with our expectation**
- ▶ **Q1 volume and new launches are the next likely positive catalysts, in our view; we stay 18% and 23% above consensus forecasts of FY11 and FY12 EPS, respectively**
- ▶ **Reiterate Overweight (V) rating with INR2,340 target price**

Strong Q4 numbers: Q4 PAT at INR6bn, 49% y-o-y growth, was 7% above consensus, though in line with our expectation. The difference was mainly due to favourable product mix leading to higher realization, higher production from the tax-free Haridwar plant resulting in lower tax rates, and higher component sourcing from Haridwar offsetting impact of rising input costs. (See details on pages three and four). For FY11, we expect demand to stay robust on the back of strong farm income and urban recovery. Higher production from Haridwar is positive for margins and tax rates. Hence, we are more bullish than the Street on sales and margins. Our EPS estimates for FY11 and FY12 of at INR138 and INR160, respectively, are 18% and 23% above consensus forecasts.

Triggers: These include strong sales volume as the wedding season kicks in from May 2010, three new launches in FY11, and strong earnings

Valuation: We reiterate our Overweight (V) rating and 12-month target price of INR2,340, which we derive from a three-stage DCF analysis. On FY11e EPS, the stock is trading at 14.2x. Our target price implies a 14.6x PE multiple on FY12e EPS of INR160, the average multiple of the past five years. In our view, consensus upgrades should lead to the multiple expansions.

Risks: Key downside risks, in our view, include more-intense competition than anticipated, higher-than-expected raw-material costs, slower-than expected off-take in urban demand, and weaker-than-expected farm income.

20 April 2010

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 the analyst certifications in
 the Disclosure appendix,
 and with the Disclaimer,
 which forms part of it

Hero Honda: Key financial data

	03/2009a	03/2010e	03/2011e	03/2012e
Revenue (INRm)	123,764	158,308	191,560	221,090
EBITDA margin (%)	14.3	17.3	16.7	16.4
HSBC EPS (INR)	67.19	111.6	137.57	160.23
PE	28.6	17.2	14	12
EV/EBITDA (x)	19.7	12	9.9	7.9

Source: Company reports, HSBC

Financials & valuation

Financial statements

Year to	03/2009a	03/2010e	03/2011e	03/2012e
Profit & loss summary (INRm)				
Revenue	123,764	158,308	191,560	221,090
EBITDA	17,670	27,401	32,050	36,303
Depreciation & amortisation	-1,807	-1,899	-1,858	-1,951
Operating profit/EBIT	15,864	25,502	30,192	34,353
Net interest	2,181	2,234	3,791	4,983
PBT	18,413	28,207	34,553	39,994
HSBC PBT	18,413	28,207	34,553	39,994
Taxation	-4,997	-5,923	-7,083	-7,999
Net profit	13,416	22,283	27,469	31,995
HSBC net profit	13,416	22,283	27,469	31,995

Cash flow summary (INRm)

Year to	03/2009a	03/2010e	03/2011e	03/2012e
Cash flow from operations	17,361	26,606	31,468	35,847
Capex	-3,262	-1,045	-2,000	-2,000
Cash flow from investment	-11,281	-24,259	-13,948	-29,817
Dividends	-4,310	-4,740	-18,212	-6,829
Change in net debt	-9,439	-21,103	-11,948	-27,817
FCF equity	13,731	25,091	28,899	33,189

Balance sheet summary (INRm)

Year to	03/2009a	03/2010e	03/2011e	03/2012e
Intangible fixed assets	0	0	0	0
Tangible fixed assets	16,943	16,088	16,230	16,279
Current assets	43,822	67,611	81,745	111,504
Cash & others	35,883	57,202	69,150	96,967
Total assets	60,765	83,699	97,975	127,783
Operating liabilities	15,788	20,682	25,009	28,852
Gross debt	785	1,000	1,000	1,000
Net debt	-35,098	-56,202	-68,150	-95,967
Shareholders funds	38,008	42,079	62,719	87,885
Invested capital	9,093	5,815	3,816	1,965

Ratio, growth and per share analysis

Year to	03/2009a	03/2010e	03/2011e	03/2012e
Y-o-y % change				
Revenue	19.8	27.9	21.0	15.4
EBITDA	31.0	55.1	17.0	13.3
Operating profit	33.4	60.8	18.4	13.8
PBT	30.4	53.2	22.5	15.7
HSBC EPS	38.3	66.1	23.3	16.5

Ratios (%)

Year to	03/2009a	03/2010e	03/2011e	03/2012e
Revenue/IC (x)	13.1	21.2	39.8	76.5
ROIC	122.4	270.3	498.4	950.8
ROE	39.5	55.6	52.4	42.5
ROA	24.1	30.8	30.2	28.3
EBITDA margin	14.3	17.3	16.7	16.4
Operating profit margin	12.8	16.1	15.8	15.5
EBITDA/net interest (x)				
Net debt/equity	-92.3	-133.6	-108.7	-109.2
Net debt/EBITDA (x)	-2.0	-2.1	-2.1	-2.6
CF from operations/net debt				

Per share data (INR)

Year to	03/2009a	03/2010e	03/2011e	03/2012e
EPS reported (fully diluted)	67.19	111.60	137.57	160.23
HSBC EPS (fully diluted)	67.19	111.60	137.57	160.23
DPS	20.52	82.08	30.78	30.78
Book value	190.34	210.73	314.10	440.13

Key forecast drivers

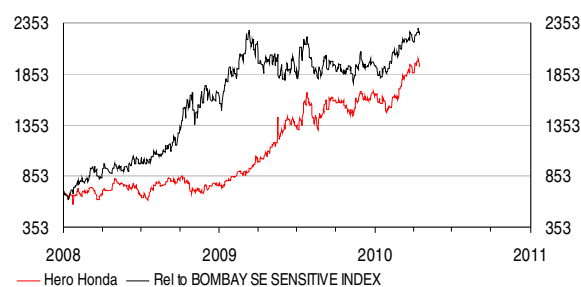
Year to	03/2009a	03/2010e	03/2011e	03/2012e
Sales Volume (UNITS)	3722000	4600130	5290852	5930230
Average Realization	33098	34414	36206	37282
Tax rate	27%	20%	18.5%	18%

Valuation data

Year to	03/2009a	03/2010e	03/2011e	03/2012e
EV/sales	2.8	2.1	1.6	1.3
EV/EBITDA	19.7	12.0	9.9	7.9
EV/IC	38.4	56.4	82.8	146.6
PE*	28.6	17.2	14.0	12.0
P/Book value	10.1	9.1	6.1	4.4
FCF yield (%)	3.6	6.5	7.5	8.6
Dividend yield (%)	1.1	4.3	1.6	1.6

Note: * = Based on HSBC EPS (fully diluted)

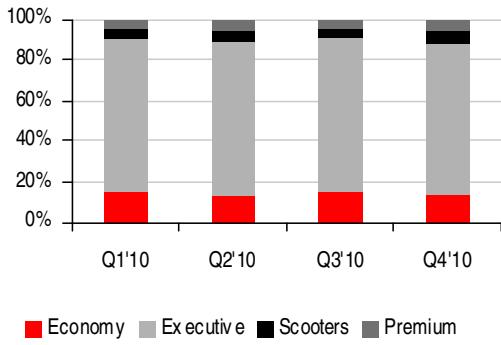
Price relative



Source: HSBC

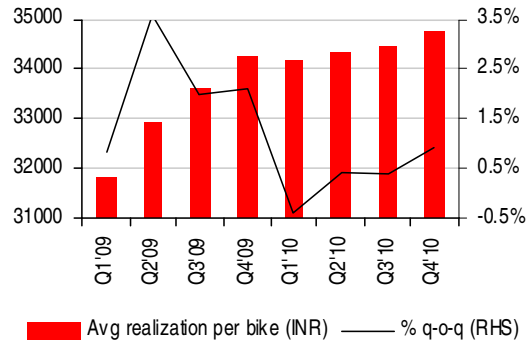
Note: price at close of 16 Apr 2010

Favourable change in product mix . . .



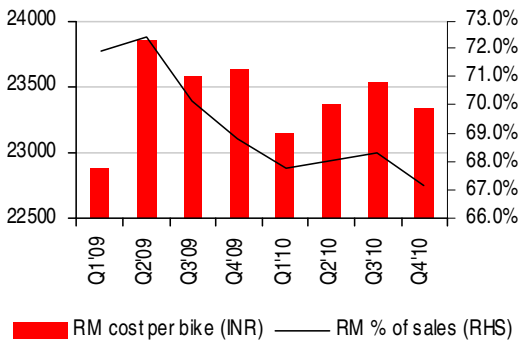
Source: Company reports, HSBC

. . . leads to improvement in net sales realization



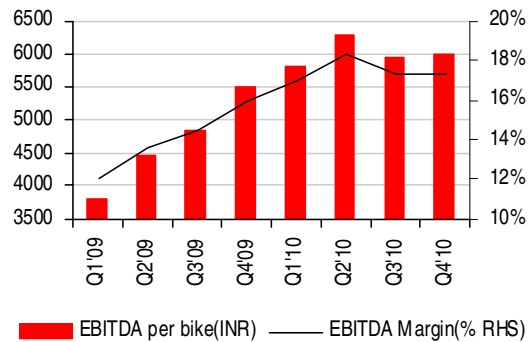
Source: Company reports, HSBC

Higher production and component sourcing from tax-free Haridwar plant leads to lower raw-material cost per bike . . .



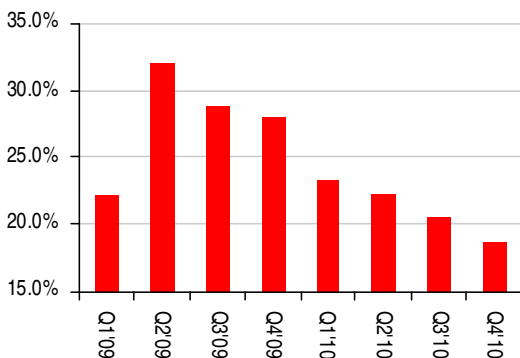
Source: Company report. RM = Raw material

. . . and sustained overall profitability



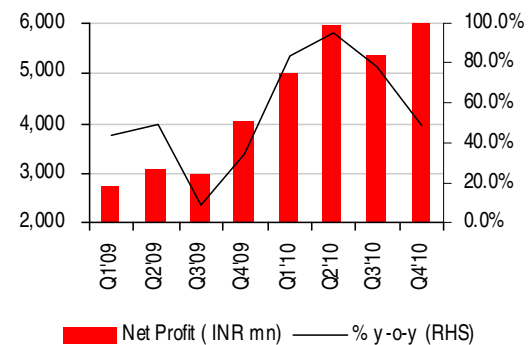
Source: Company reports, HSBC

Higher production from tax-free Haridwar plant (1.4m for FY10) and this has lowered effective tax rates



Source: Company reports, HSBC

PAT at INR6bn was 7% above consensus estimate, though in line with our expectation



Source: Company reports, HSBC

Q4 earnings were 7% above consensus estimate

Hero Honda: Q4 results

Year to March (INRm)	Q4 FY 2010	Q4 FY 2009	y-o-y	Q3 FY 2010	q-o-q	HSBC remarks
Vehicles sold	1,186,536	997,855	18.9	1,111,372	6.8	Rural and urban demand remains very strong; management guiding for 12-15% growth in FY11
EBITDA per unit (INR)	5,998	5,503	9.0	5,947	0.9	
Net sales	41,223	34,225	20.4	38,270	7.7	2% above consensus, though in line with our expectation; surprise was in higher realization
Total expenditure	34,106	28,734	18.7	31,661	7.7	
Raw material	27,685	23,565	17.5	26,146	5.9	Higher component sourcing and production from tax-free plant absorbed rise in input cost
Wages	1,460	1,190	22.7	1,371	6.4	
Other expenses	4,962	3,980	24.7	4,144	19.7	INR300m cost pertains to sponsorship of IPL and hockey world cup
EBITDA	7,117	5,491	29.6	6,609	7.7	3% above consensus, though in line with our expectation
EBITDA margin (%)	17.3	16.0		17.3		
Interest	-45	-96	-53.6	-46	-2.6	
Depreciation	487	444	9.7	469	3.8	
Other income	695	442	57.1	550	26.5	
PBT	7,370	5,586	31.9	6,736	9.4	
Tax	1,382	1,564	-11.6	1378	0.3	Lower tax rate due to higher production from tax-free Haridwar
Adjusted PAT	5,988	4,022	48.9	5,358	11.8	7% above consensus, though in line with our expectation
EPS (INR)	30	20	48.9	27	11.8	

Source: Company reports, HSBC

Q4 earnings were 7% above the consensus estimate but in line with our expectation. The key items to surprise were favourable product mix, leading to higher realization than expected by the consensus, and higher production and component sourcing from tax-free Haridwar, which offset the impact of a rise in input cost and resulted in lower-than-expected tax rates.

For FY11, production from Haridwar should increase further, from 1.4m units to 1.8 m units (30% of total sales to 34%). Also, component sourcing from the tax-free factory is likely to double in FY11e. These two factors could add 30bps to the margins, we estimate. Also, we expect the effective tax rate to fall from ~21% to ~18.5% in FY11.

Investment thesis

Hero Honda is the leading two-wheeler manufacturer in the country. We expect it to surprise on volumes on the back of strong farm income, revival of urban demand in line with economic revival, and three new launches in FY11. Margin surprise could come from higher production from the tax-free Haridwar factory, where excise duty and income tax are waived. Key potential triggers, in our view, include new-product launches, strong monthly sales, and earnings surprises.

Valuation

We use a three-stage DCF analysis to value Hero Honda. We assume the cost of equity to be 13.5%. We have explicit estimates until FY2012. In the semi-explicit period of 10 years, starting in FY2013, we assume a NOPLAT CAGR of 14.5%, compared to FY2012. We assume that the semi-explicit period begins in FY2013. During the fade period, we assume ROIC declines to the level of cost of capital. We assume the fade period starts in FY2023 and lasts for 12 years. (Equity risk premium: 5.5%; beta: 0.44;

and risk-free rate: 7.5%.) Our one-year forward DCF-based value of Hero Honda is INR2,340, which is our target price.

Under our research model, for stocks with a volatility indicator, the Neutral band is 10 percentage points above and below our hurdle rate for Indian stocks of 10.5%, or 0.5-20.5% around the current share price. Our target price of INR2,340 for Hero Honda shares implies a potential total return of 21.7%, which is above the Neutral band; thus, we reiterate our Overweight (V) rating.

On relative valuation, we offer the following arguments: From the consensus point of view, the stock is trading at 17x FY11e PE, which on our FY11e EPS implies a target price of INR2,340. And the stock is trading at 14.0x FY11e EPS of INR138. Our target price implies a PE multiple of 14.5 on FY12e. In our view, multiple expansions are justified, as we believe that the stock is likely to surprise positively on earnings. Sensex is currently trading at a 17x one-year forward PE multiple. In our view, Hero Honda, which should see earnings growth of c19% over FY10-12, has a strong balance sheet and a low beta of 0.44, and it should at least trade in line with Sensex.

Risks

Key downside risks, we believe, include stronger-than-anticipated competition, higher-than-expected input cost, slower-than-expected off-take in urban demand, and weaker-than-expected farm income due to poor monsoons in FY11.

Disclosure appendix

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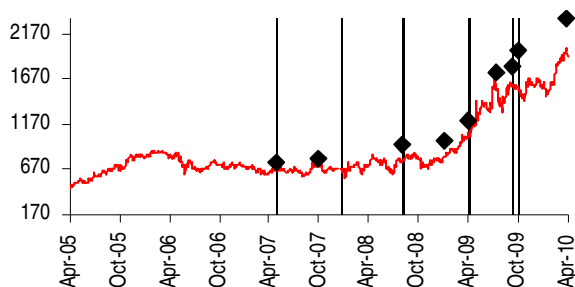
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As of 19 April 2010, the distribution of all ratings published is as follows:

Overweight (Buy)	48%	(13% of these provided with Investment Banking Services)
Neutral (Hold)	38%	(10% of these provided with Investment Banking Services)
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Share price and rating changes for long-term investment opportunities

Hero Honda (HROH.BO) Share Price performance INR Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Overweight	Neutral	15 May 2007
Neutral	Neutral	01 January 2008
Neutral	Overweight	21 August 2008
Overweight	Neutral	21 April 2009
Neutral	Neutral (V)	24 September 2009
Neutral (V)	Overweight (V)	21 October 2009
Target Price	Value	Date
Price 1	740.00	15 May 2007
Price 2	800.00	18 October 2007
Price 3	938.00	21 August 2008
Price 4	985.00	21 January 2009
Price 5	1210.00	21 April 2009
Price 6	1740.00	29 July 2009
Price 7	1800.00	24 September 2009
Price 8	1980.00	21 October 2009
Price 9	2340.00	15 April 2010

Source: HSBC

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