

Hero Honda Motors Ltd ----- Initiating coverage with UNDERPERFORM

Competitors catch up

Govindarajan Chellappa / Research Analyst / 91 22 6777 3715 / govindarajan.chellappa@credit-suisse.com

- Competition is catching up with Hero Honda in technology and we believe that is putting the company's premium pricing of products at risk.
- Hero Honda's overdependence on executive segment (Splendour and Passion) is hurting as competition in that segment intensifies. The limited presence in the profitable premium segment is hurting the margin profile and pricing power of the company, in our view
- With diminishing pricing power, the increasing cost of new features and increasing royalty payments on new models, we believe Hero Honda's margins will remain under pressure (-410 bp) over FY06-09E. We forecast earnings 18% and 24% below consensus for FY08E and FY09E respectively.
- Hero Honda trades at the upper end of its historical P/E band. With anaemic earnings growth (a 6.5% CAGR in FY07-09E), we believe that this is unsustainable. We set a DCF target price of Rs676, implying 13.7x FY09E EPS.
- Key risks: Possible increase in dividend payout, corporate action from parent company, easing competitive pressure.

| | | | |
|---------------------------------|-----------------|------------------------|---------------------|
| Bbg/RIC | HH IN / HROH.BO | Price (19 Jan 07, Rs) | 730.15 |
| Rating (prev. rating) | U (NA) | TP (Rs) (prev. TP) | 676 (NA) |
| Shares outstanding (mn) | 199.70 | Est. pot. % chg. to TP | (7) |
| Daily trad vol-6m avg (mn) | 0.7 | 52-wk range (Rs) | 923.40 - 643.55 |
| Daily trad val-6m avg (US\$ mn) | 11.2 | Mkt cap (Rs/US\$ bn) | 145.8/ 3.3 |
| Free float (%) | 44.7 | Performance 1M 3M 12M | |
| Major shareholders | | Absolute | (3.0) (2.8) (13.2) |
| | | Relative | (8.7) (13.0) (42.3) |
| Year | 3/05A | 3/06A | 3/07E 3/08E 3/09E |
| EBITDRAF (Rs mn) | | | |
| Net profit (Rs mn) | 8,105 | 9,713.4 | 8,656 9,091 9,831 |
| EPS (Rs) | 40.6 | 48.6 | 43.3 45.5 49.2 |
| - Change from prev. EPS (%) | n.a. | n.a. | n.a. n.a. n.a. |
| - Consensus EPS (Rs) | n.a. | n.a. | n.a. n.a. n.a. |
| EPS growth (%) | 11.3 | 19.8 | (10.9) 5.0 8.1 |
| P/E (x) | 18.0 | 15.0 | 16.8 16.0 14.8 |
| Dividend yield (%) | 3.1 | 3.1 | 3.1 3.4 3.7 |
| EV/EBITDRAF (x) | | | n.a. n.a. n.a. |
| P/B (x) | 9.8 | 7.3 | 6.0 5.1 4.4 |
| ROE (%) | 54.3 | 48.3 | 35.7 32.0 29.9 |
| Net debt/equity (%) | 19 | 7 | 5 7 net cash |

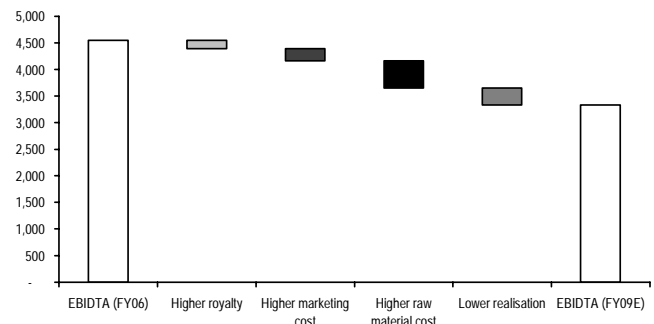
Note 1: Hero Honda is India's largest manufacturer of motorcycles

Leader under pressure: Hero Honda's traditional products, the Splendour and Passion (their variants) still account for over 60% of the volumes. While these models still enjoy a tremendous brand, they are old and do not command the same pricing power/premium that they once used to as new competition closes in. Thus, Hero Honda's key models are likely to see a price correction in some form or another. On the other hand, Hero Honda's new models have not been able to make meaningful impact on the market.

Market share on a steady decline: We forecast that Hero Honda's share of the motorcycle market will drop 520 bp in FY06-09E, as competitors eat away into Hero Honda's main product segment, the executive segment. We forecast volume growth of 12% in FY06-09E. We expect exports to grow at 10% p.a. in FY06-09E

Ample scope for margins to drop: With diminishing pricing power, the increasing cost of new features (such as alloy wheel) and increasing royalty payments on new models, we believe that Hero Honda's margins will remain under pressure (-410 bp) over FY06-09E. Much of the margin drop is likely to occur in FY07E itself, with operating margins dropping 300 bp.

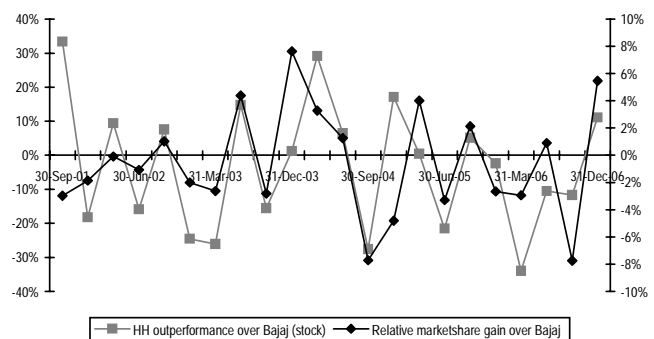
Figure 1: Sources of margin pressure (Rs/bike)



Source: Company data, Credit Suisse estimates.

Earnings stagnation not factored in: Hero Honda's performance relative to Bajaj has tracked the relative market share movement, as can be seen in the chart below. We expect Bajaj Auto to gain about a 520 bp market share relative to Hero Honda in FY06-09E

Figure 2: Relative stock performance Vs relative market share movement



Source: Company data, Credit Suisse estimates.

Despite the recent underperformance in the past one year (42% relative to the SENSEX), Hero Honda trades at the upper end of its historical P/E band. We initiate coverage of the stock with an UNDERWEIGHT stance, due to the near-term profitability pressures. Questions on the nature of its relationship with Honda remain. Honda's 100% subsidiary will compete with Hero Honda in the domestic market and for export opportunities as well. We have set a DCF-based target price of Rs676, implying 13.7x FY09E EPS

Key risks: Hero Honda's dividend payout has fallen from 75% in FY02 to 45% in FY06. A hike in dividend payout would provide ample support to the stock, in our view.

IMPORTANT DISCLOSURES AND ANALYST CERTIFICATIONS ARE IN THE DISCLOSURE APPENDIX. U.S. Disclosure: Credit Suisse does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the Firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision. Customers of Credit Suisse in the United States can receive independent, third party research on the company or companies covered in this report, at no cost to them, where such research is available. Customers can access this independent research at www.credit-suisse.com/ir or call 1 877 291 2683 or email equity.research@credit-suisse.com to request a copy of this research.

Companies Mentioned (Price as of 19 Jan 07)

Hero Honda Motors Ltd (HROH.BO, Rs730.15, UNDERPERFORM, TP Rs676, UNDERWEIGHT)

Bajaj Auto Ltd (BJAT.BO, Rs2729.70)

Honda Motor Corp. (7267, ¥4,810, NEUTRAL, TP ¥4,000, MARKET WEIGHT)

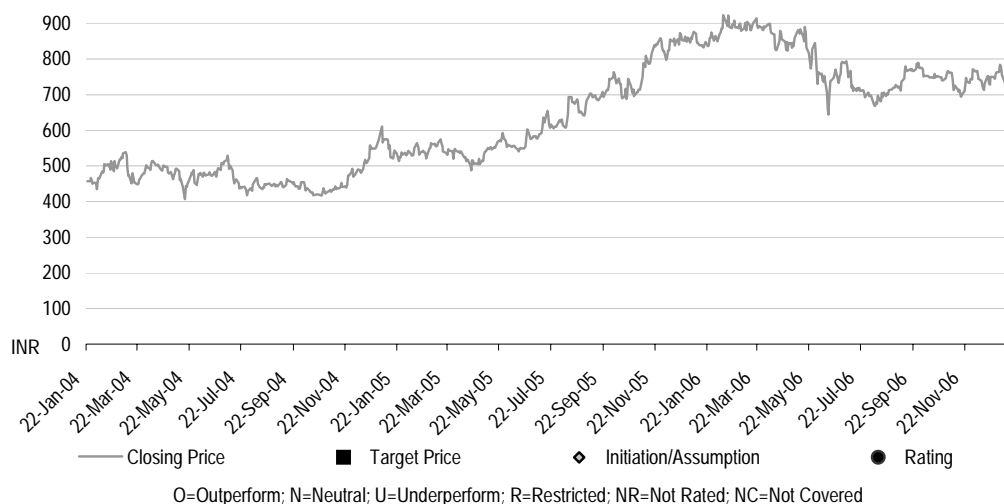
Disclosure Appendix

Important Global Disclosures

I, Govindarajan Chellappa, certify that (1) the views expressed in this report accurately reflect my personal views about all of the subject companies and securities and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

See the *Companies Mentioned* section for full company names.

3-Year Price, Target Price and Rating Change History Chart for HROH.BO



| HROH.BO | Closing Price | Target Price | Initiation/ |
|---------|---------------|--------------|-------------|
|---------|---------------|--------------|-------------|

The analyst(s) responsible for preparing this research report received compensation that is based upon various factors including Credit Suisse's total revenues, a portion of which are generated by Credit Suisse's investment banking activities.

Analysts' stock ratings are defined as follows***:

Outperform: The stock's total return is expected to exceed the industry average* by at least 10-15% (or more, depending on perceived risk) over the next 12 months.

Neutral: The stock's total return is expected to be in line with the industry average* (range of $\pm 10\%$) over the next 12 months.

Underperform:** The stock's total return is expected to underperform the industry average* by 10-15% or more over the next 12 months.

*The industry average refers to the average total return of the analyst's industry coverage universe (except with respect to Asia/Pacific, Latin America and Emerging Markets, where stock ratings are relative to the relevant country index, and Credit Suisse Small and Mid-Cap Advisor stocks, where stock ratings are relative to the regional Credit Suisse Small and Mid-Cap Advisor investment universe.

**In an effort to achieve a more balanced distribution of stock ratings, the Firm has requested that analysts maintain at least 15% of their rated coverage universe as Underperform. This guideline is subject to change depending on several factors, including general market conditions.

***For Australian and New Zealand stocks a 7.5% threshold replaces the 10% level in all three rating definitions, with a required equity return overlay applied.

Restricted: In certain circumstances, Credit Suisse policy and/or applicable law and regulations preclude certain types of communications, including an investment recommendation, during the course of Credit Suisse's engagement in an investment banking transaction and in certain other circumstances.

Volatility Indicator [V]: A stock is defined as volatile if the stock price has moved up or down by 20% or more in a month in at least 8 of the past 24 months or the analyst expects significant volatility going forward. All Credit Suisse Small and Mid-Cap Advisor stocks are automatically rated volatile. All IPO stocks are automatically rated volatile within the first 12 months of trading.

Analysts' coverage universe weightings* are distinct from analysts' stock ratings and are based on the expected performance of an analyst's coverage universe versus the relevant broad market benchmark***:**

Overweight: Industry expected to outperform the relevant broad market benchmark over the next 12 months.

Market Weight: Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.

Underweight: Industry expected to underperform the relevant broad market benchmark over the next 12 months.

*Credit Suisse Small and Mid-Cap Advisor stocks do not have coverage universe weightings.

**An analyst's coverage universe consists of all companies covered by the analyst within the relevant sector.

***The broad market benchmark is based on the expected return of the local market index (e.g., the S&P 500 in the U.S.) over the next 12 months.

Credit Suisse's distribution of stock ratings (and banking clients) is:

| Global Ratings Distribution | | |
|-----------------------------|-----|-----------------------|
| Outperform/Buy* | 39% | (60% banking clients) |
| Neutral/Hold* | 43% | (56% banking clients) |
| Underperform/Sell* | 15% | (51% banking clients) |
| Restricted | 3% | |

*For purposes of the NYSE and NASD ratings distribution disclosure requirements, our stock ratings of Outperform, Neutral, and Underperform most closely correspond to Buy, Hold, and Sell, respectively; however, the meanings are not the same, as our stock ratings are determined on a relative basis. (Please refer to definitions above.) An investor's decision to buy or sell a security should be based on investment objectives, current holdings, and other individual factors.

Credit Suisse's policy is to update research reports as it deems appropriate, based on developments with the subject company, the sector or the market that may have a material impact on the research views or opinions stated herein.

Credit Suisse's policy is only to publish investment research that is impartial, independent, clear, fair and not misleading. For more detail please refer to Credit Suisse's Policies for Managing Conflicts of Interest in connection with Investment Research: http://www.csfb.com/research-and-analytics/disclaimer/managing_conflicts_disclaimer.html

Credit Suisse does not provide any tax advice. Any statement herein regarding any US federal tax is not intended or written to be used, and cannot be used, by any taxpayer for the purposes of avoiding any penalties.

See the Companies Mentioned section for full company names.

Price Target: (12 months) for (HROH.BO)

Method: We set a discounted cash flow (DCF)-based target price of Rs676 for Hero Honda. Our preferred method of valuing Hero Honda is DCF, given its relatively predictable cash flows. Despite its weak earnings performance, we expect Hero Honda's cash flows to remain reasonably strong (+25% in FY08E and FY09E). Our target price of Rs676 values Hero Honda at 13.7x FY09E and implies a 10% discount to the company's target multiple, which we believe is justified considering the higher growth in Bajaj Auto.

Risks: A key risk to our Rs676 target price for Hero Honda Motors is a hike in the dividend payout. Hero Honda's dividend payout has fallen from 75% in FY02 to 45% in FY06. The motorcycle business is not too capital intensive, as demonstrated by the strong cash flows generated even in tough environment, and management might decide to increase the payout. Honda's India plans might have a significant impact on Hero Honda's prospects. Apart from competing with Hero Honda through its 100% subsidiary (HMSI), Honda also plans to set up a spare parts business. If Hero Honda is forced to join the spare parts venture, this could negatively impact margins. Honda might also decide to increase outsourcing from India (through Hero Honda) in order to take advantage of the huge scale that Hero Honda has.

Important Regional Disclosures

The analyst(s) involved in the preparation of this report have not visited the material operations of the subject company (HROH.BO) within the past 12 months.

Restrictions on certain Canadian securities are indicated by the following abbreviations: NVS--Non-Voting shares; RVS--Restricted Voting Shares; SVS--Subordinate Voting Shares.

Individuals receiving this report from a Canadian investment dealer that is not affiliated with Credit Suisse should be advised that this report may not contain regulatory disclosures the non-affiliated Canadian investment dealer would be required to make if this were its own report.

For Credit Suisse Securities (Canada), Inc.'s policies and procedures regarding the dissemination of equity research, please visit http://www.csfb.com/legal_terms/canada_research_policy.shtml.

As of the date of this report, Credit Suisse acts as a market maker or liquidity provider in the equities securities that are the subject of this report.

For disclosure information on other companies mentioned in this report, please visit the website at www.credit-suisse.com/researchdisclosures or call +1 (877) 291-2683.

Disclaimers continue on next page.

Disclaimers

References in this report to Credit Suisse or CS include all of the subsidiaries and affiliates of Credit Suisse, a Swiss bank, operating under its investment banking division. For more information on our structure, please follow the below link: http://www.creditsuisse.com/en/who_we_are/ourstructure.html.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would subject Credit Suisse, the Swiss bank, or its subsidiaries or its affiliates ("CS") to any registration or licensing requirement within such jurisdiction. All material presented in this report, unless specifically indicated otherwise, is under copyright to CS. None of the material, nor its content, nor any copy of it, may be altered in any way, transmitted to, copied or distributed to any other party, without the prior express written permission of CS. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of CS or its affiliates.

The information, tools and material presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or the solicitation of an offer to sell or to buy or subscribe for securities or other financial instruments. CS may not have taken any steps to ensure that the securities referred to in this report are suitable for any particular investor. CS will not treat recipients as its customers by virtue of their receiving the report. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about such investments or investment services. Nothing in this report constitutes investment, legal, accounting or tax advice or a representation that any investment or strategy is suitable or appropriate to your individual circumstances or otherwise constitutes a personal recommendation to you. CS does not offer advice on the tax consequences of investment and you are advised to contact an independent tax adviser. Please note in particular that the bases and levels of taxation may change.

CS believes the information and opinions in the Disclosure Appendix of this report are accurate and complete. Information and opinions presented in the other sections of the report were obtained or derived from sources CS believes are reliable, but CS makes no representations as to their accuracy or completeness. Additional information is available upon request. CS accepts no liability for loss arising from the use of the material presented in this report, except that this exclusion of liability does not apply to the extent that liability arises under specific statutes or regulations applicable to CS. This report is not to be relied upon in substitution for the exercise of independent judgment. CS may have issued, and may in the future issue, a trading call regarding this security. Trading calls are short term trading opportunities based on market events and catalysts, while stock ratings reflect investment recommendations based on expected total return over a 12-month period relative to the relevant coverage universe. Because trading calls and stock ratings reflect different assumptions and analytical methods, trading calls may differ directionally from the stock rating. In addition, CS may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and CS is under no obligation to ensure that such other reports are brought to the attention of any recipient of this report. CS is involved in many businesses that relate to companies mentioned in this report. These businesses include specialized trading, risk arbitrage, market making, and other proprietary trading.

Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information, opinions and estimates contained in this report reflect a judgement at its original date of publication by CS and are subject to change without notice. The price, value of and income from any of the securities or financial instruments mentioned in this report can fall as well as rise. The value of securities and financial instruments is subject to exchange rate fluctuation that may have a positive or adverse effect on the price or income of such securities or financial instruments. Investors in securities such as ADR's, the values of which are influenced by currency volatility, effectively assume this risk.

Structured securities are complex instruments, typically involve a high degree of risk and are intended for sale only to sophisticated investors who are capable of understanding and assuming the risks involved. The market value of any structured security may be affected by changes in economic, financial and political factors (including, but not limited to, spot and forward interest and exchange rates), time to maturity, market conditions and volatility, and the credit quality of any issuer or reference issuer. Any investor interested in purchasing a structured product should conduct their own investigation and analysis of the product and consult with their own professional advisers as to the risks involved in making such a purchase.

Some investments discussed in this report have a high level of volatility. High volatility investments may experience sudden and large falls in their value causing losses when that investment is realised. Those losses may equal your original investment. Indeed, in the case of some investments the potential losses may exceed the amount of initial investment, in such circumstances you may be required to pay more money to support those losses. Income yields from investments may fluctuate and, in consequence, initial capital paid to make the investment may be used as part of that income yield. Some investments may not be readily realisable and it may be difficult to sell or realise those investments, similarly it may prove difficult for you to obtain reliable information about the value, or risks, to which such an investment is exposed.

This report may provide the addresses of, or contain hyperlinks to, websites. Except to the extent to which the report refers to website material of CS, CS has not reviewed the linked site and takes no responsibility for the content contained therein. Such address or hyperlink (including addresses or hyperlinks to CS's own website material) is provided solely for your convenience and information and the content of the linked site does not in any way form part of this document. Accessing such website or following such link through this report or CS's website shall be at your own risk.

This report is issued and distributed in Europe (except Switzerland) by Credit Suisse Securities (Europe) Limited, One Cabot Square, London E14 4QJ, England, which is regulated in the United Kingdom by The Financial Services Authority ("FSA"). This report is being distributed in Germany by Credit Suisse Securities (Europe) Limited Niederlassung Frankfurt am Main regulated by the Bundesanstalt fuer Finanzdienstleistungsaufsicht ("BaFin"). This report is being distributed in the United States by Credit Suisse Securities (USA) LLC; in Switzerland by Credit Suisse; in Canada by Credit Suisse Securities (Canada), Inc.; in Brazil by Banco de Investimentos Credit Suisse (Brasil) S.A.; in Japan by Credit Suisse Securities (Japan) Limited; elsewhere in Asia/Pacific by whichever of the following is the appropriately authorised entity in the relevant jurisdiction: Credit Suisse (Hong Kong) Limited, Credit Suisse Equities (Australia) Limited, Credit Suisse Securities (Thailand) Limited, Credit Suisse Securities (Malaysia) Sdn Bhd, Credit Suisse Singapore Branch and elsewhere in the world by the relevant authorised affiliate of the above. Research on Taiwanese securities produced by Credit Suisse Taipei Branch has been prepared by a registered Senior Business Person. Research provided to residents of Malaysia is authorised by the Head of Research for Credit Suisse Securities (Malaysia) Sdn. Bhd., to whom they should direct any queries on +603 2723 2020.

In jurisdictions where CS is not already registered or licensed to trade in securities, transactions will only be effected in accordance with applicable securities legislation, which will vary from jurisdiction to jurisdiction and may require that the trade be made in accordance with applicable exemptions from registration or licensing requirements. Non-U.S. customers wishing to effect a transaction should contact a CS entity in their local jurisdiction unless governing law permits otherwise. U.S. customers wishing to effect a transaction should do so only by contacting a representative at Credit Suisse Securities (USA) LLC in the U.S.

Please note that this report was originally prepared and issued by CS for distribution to their market professional and institutional investor customers. Recipients who are not market professional or institutional investor customers of CS should seek the advice of their independent financial advisor prior to taking any investment decision based on this report or for any necessary explanation of its contents. This research may relate to investments or services of a person outside of the UK or to other matters which are not regulated by the FSA or in respect of which the protections of the FSA for private customers and/or the UK compensation scheme may not be available, and further details as to where this may be the case are available upon request in respect of this report.

Any Nielsen Media Research material contained in this report represents Nielsen Media Research's estimates and does not represent facts. NMR has neither reviewed nor approved this report and/or any of the statements made herein.

Copyright 2007 CREDIT SUISSE and/or its affiliates. All rights reserved.

ASIA/PACIFIC: +852 2101-6000

EUROPE: +44 (20) 7888-8888

UNITED STATES OF AMERICA: +1 (212) 325-2000