

INDIA

## Hero Honda

14 May 2007

HH IN Not Rated

Stock price as of 11 May 07	Rs	705
Market cap	Rs m	140,740
3 mth avg turnover	US\$m	5.39
Market cap	US\$m	3,432

### Steady decline - PAT down 27%

#### Event

- Hero Honda reported 4Q and full-year results for FY07.

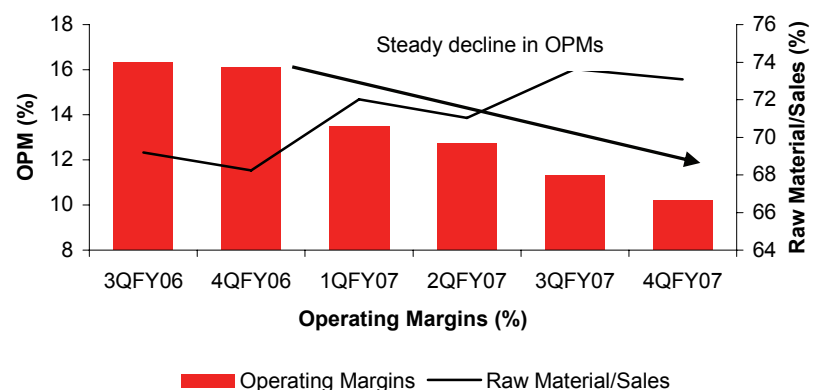
#### Impact

- Profits down 27%** - Profits fell 27% YoY to Rs1.95bn (vs Rs2.67bn in 4Q FY06), which was about 2% below the consensus estimate. The variance was on account of lower-than-expected EBITDA margins.
- Margin pressure continues** – Operating margins declined by 590bp YoY and 110bp QoQ to 10.2%. This is Hero Honda's lowest operating margin in nearly seven years. Raw material costs increased by 390bp and promotional expenses rose 29%, reflecting the strong competitive pressures, a high commodity cycle and a negative shift in product mix.
- New plants/products** - The company's plant at Uttarakhand, with an initial capacity of 0.5m units, is expected to come on-stream shortly. While the plant offers tax benefits, these may be passed to consumers. The company also plans to launch a new variant *Splendor* in the first half of FY08.

#### Outlook

- The competitive environment remains harsh. We expect margin pressure to remain in the coming year. Higher interest rates have led to increased subvention and have impacted sales. New product launches from competitors, notably Bajaj (BJA IN, Rs2,719, Not Rated), Honda and TVS Motors (TVSL IN, Rs63, Not Rated) would further impact profitability. Channel checks suggest a strong inventory build-up among dealers, which could lead to greater discounting.

**Fig 1 Hero Honda – declining operating margins**



Source: Company, Macquarie Research, May 2007

#### Analyst

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**Fig 2 Hero Honda – 4Q sales results (Rs m)**

	4Q FY06	4Q FY07	% chg	Macquarie comments
Motorcycles (numbers)	772,457	855,984	10.8	
Average realisation (Rs/bike)	29,204	30,837	5.6	Marginal price hike; Greater promotions rather than cash discounts
Market share (motorcycles %)	46.3	49.2		Gains market share by default; competitors show negative growth
Market share (2 wheelers %)	38.9	41.4		

Source: SIAM, Macquarie Research, May 2007

**Fig 3 Hero Honda - 4Q financial results (Rs m)**

	4Q FY06	4Q FY07	% chg	Macquarie comments
<b>Net sales</b>	<b>22,559</b>	<b>26,396</b>	<b>17.0</b>	
Decrease/(Increase) in Stocks	87	113	29.9	
Raw Materials	15,307	19,177	25.3	Negative change in product mix; proportion of Splendor constantly declining
Staff costs	821	905	10.1	
Other Expenses	2,711	3,514	29.6	Includes Rs220mn expenditure on account of world cup
Total Expenditure	18,927	23,709	25.3	
<b>Operating profit</b>	<b>3,632</b>	<b>2,687</b>	<b>-26.0</b>	<b>Lowest operating margin in 7 years</b>
Interest	(39)	(77)	95.7	
Other income	430	445	3.4	In line with previous quarters
EBDT	4,102	3,209	-21.8	
Depreciation	305	355	16.5	
PBT	3,797	2,854	-24.8	
Tax	1,125	904	-19.7	
<b>PAT</b>	<b>2,672</b>	<b>1,950</b>	<b>-27.0</b>	<b>2% below consensus estimates</b>
<b>Profit Margins</b>				
OPM (%)	16.1	10.2		Competitive pressures; negative product mix
Other income / EBDIT (%)	10.6	14.2		
EBIT (%)	14.7	8.8		
Pre tax margins (%)	16.8	10.8		
Tax / PBT (%)	29.6	31.7		Slightly higher than anticipated
Net profit margins (%)	11.8	7.4		
<b>Cost ratios</b>				
Raw materials / sales	68.2	73.1		Declined on a qoq basis; strong product cycle
Staff costs / sales	3.6	3.4		
Other expenses / sales	12.0	13.3		Stronger promotional activities

Source: Company, Macquarie Research, May 2007

## Important disclosures:

## Recommendation definitions

## Macquarie Australia/New Zealand

Outperform – return >5% in excess of benchmark return (>2.5% in excess for listed property trusts)  
 Neutral – return within 5% of benchmark return (within 2.5% for listed property trusts)  
 Underperform – return >5% below benchmark return (>2.5% below for listed property trusts)

## Macquarie Asia

Outperform – expected return >+10%  
 Neutral – expected return from -10% to +10%  
 Underperform – expected return <-10%

## Macquarie First South Securities (South Africa)

Outperform – expected return >+5%  
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 Underperform – expected return <-5%

## Recommendations – 12 months

**Note:** Quant recommendations may differ from Fundamental Analyst recommendations

## Recommendation proportions

	AU/NZ	Asia	RSA
Outperform	44.37%	58.37%	42.60%
Neutral	44.01%	21.30%	46.80%
Underperform	11.62%	20.33%	10.60%

For quarter ending 31 March 2007

## Volatility index definition\*

This is calculated from the volatility of historic price movements.

**Very high–highest risk** – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

**High** – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

**Medium** – stock should be expected to move up or down at least 30–40% in a year.

**Low–medium** – stock should be expected to move up or down at least 25–30% in a year.

**Low** – stock should be expected to move up or down at least 15–25% in a year.

\* Applicable to Australian/NZ stocks only

## Financial definitions

All "Adjusted" data items have had the following adjustments made:  
 Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense  
 Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

EPS = adjusted net profit / efpowa\*

ROA = adjusted ebit / average total assets

ROA Banks/Insurance = adjusted net profit / average total assets

ROE = adjusted net profit / average shareholders funds

Gross cashflow = adjusted net profit + depreciation

\*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

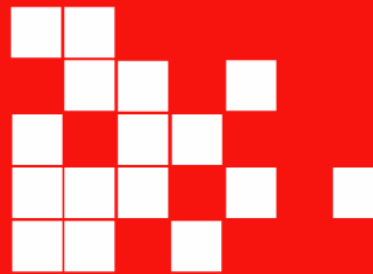
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