

Q2 likely trough; Neutral

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Below par performance, tweak forecasts/PO

Q2 profit at Rs5.1bn was lower than expectations, reflected in 460bps yoy decline in EBITDA margins at 13.4% (est 14%). EBITDA declined 18% yoy to Rs6.1bn, despite inline sales at Rs45.5bn (up 12% yoy). We believe this performance is a trough on volumes and margins, and only tweak forecasts and PO. Rate Neutral.

Margins disappoint, but could be trough

Q2 margin was impacted by higher input and emission related costs, as the company held on to prices in a relatively lean season. With competition already having raised prices of select models, we expect pricing action sometime soon. Still, we cut margins by 80/50bps to 14%/14.2% over FY11-12E.

We expect stronger two wheeler sales

H1 volumes grew 9.5% yoy, well behind industry at 28.6%. We however expect growth to catch up from H2, thanks to new launches across segments i.e. 100cc Splendor Pro, 125cc Splendor Pro and 150cc Hunk. Raise volume assumptions slightly to 5.25mn in FY11E (up 14% yoy) and 5.98mn in FY12E (up 13.5%).

Still Neutral, but prefer over Bajaj Auto

We believe company's operations have bottomed, on market share as well as growth trajectory. Following 64% stock underperformance relative to peers this year we switch preference to Hero Honda over Bajaj Auto on differential valuations (5% discount on FY12E EPS) and superior franchise.

Estimates (Mar)

(Rs)	2009A	2010A	2011E	2012E	2013E
Net Income (Adjusted - mn)	12,824	22,318	21,594	25,484	28,729
EPS	64.22	111.76	108.13	127.61	143.86
EPS Change (YoY)	32.5%	74.0%	-3.2%	18.0%	12.7%
Dividend / Share	20.00	110.00	40.00	45.00	50.00
Free Cash Flow / Share	68.58	138.41	126.28	142.29	148.22

Valuation (Mar)

	2009A	2010A	2011E	2012E	2013E
P/E	28.63x	16.45x	17.00x	14.41x	12.78x
Dividend Yield	1.09%	5.98%	2.18%	2.45%	2.72%
EV / EBITDA*	20.09x	12.69x	13.42x	11.60x	10.34x
Free Cash Flow Yield*	3.73%	7.53%	6.87%	7.74%	8.06%

* For full definitions of *iQmethod*SM measures, see page 5.

Stock Data

Price	Rs1,838
Price Objective	Rs1,965
Date Established	1-Nov-2010
Investment Opinion	C-2-7
Volatility Risk	HIGH
52-Week Range	Rs1,396-Rs2,075
Mrkt Val / Shares Out (mn)	US\$8,264 / 199.7
Average Daily Volume	467,861
BofAML Ticker / Exchange	HRHDF / BSE
Bloomberg / Reuters	HH IN / HROH.BO
ROE (2011E)	53.0%
Net Dbt to Eqty (Mar-2010A)	-53.1%
Est. 5-Yr EPS / DPS Growth	15.0% / 20.0%
Free Float	45.0%

Key Changes

(Rs)	Previous	Current
Price Obj.	1,988.00	1,965.00
2011E Rev (m)	186,358.0	186,948.7
2012E Rev (m)	213,599.6	213,623.9
2013E Rev (m)	239,502.1	239,972.4
2011E EPS	110.50	108.13
2012E EPS	127.46	127.61
2013E EPS	143.32	143.86
2011E EBITDA (m)	27,569.2	26,150.9
2012E EBITDA (m)	31,302.2	30,264.7
2013E EBITDA (m)	35,021.1	33,956.7
2011E DPS	50.00	40.00

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*iQprofile*SM Hero Honda

Key Income Statement Data (Mar)	2009A	2010A	2011E	2012E	2013E
(Rs Millions)					
Sales	123,566	158,605	186,949	213,624	239,972
Gross Profit	31,660	45,638	47,207	54,314	61,025
Sell General & Admin Expense	(14,187)	(17,969)	(21,056)	(24,049)	(27,069)
Operating Profit	15,666	25,755	23,883	27,850	31,282
Net Interest & Other Income	2,156	2,562	2,941	3,611	4,186
Associates	0	0	0	0	0
Pretax Income	17,821	28,317	26,824	31,461	35,468
Tax (expense) / Benefit	(4,997)	(5,999)	(5,231)	(5,978)	(6,739)
Net Income (Adjusted)	12,824	22,318	21,594	25,484	28,729
Average Fully Diluted Shares Outstanding	200	200	200	200	200

Key Cash Flow Statement Data

Net Income	12,824	22,318	21,594	25,484	28,729
Depreciation & Amortization	1,807	1,915	2,268	2,415	2,675
Change in Working Capital	(413)	2,270	2,136	4,132	1,803
Deferred Taxation Charge	191	83	52	60	67
Other Adjustments, Net	2,549	3,097	2,594	(500)	(500)
Cash Flow from Operations	16,958	29,683	28,644	31,590	32,774
Capital Expenditure	(3,262)	(2,041)	(3,425)	(3,175)	(3,175)
(Acquisition) / Disposal of Investments	(8,019)	(5,570)	(500)	(500)	(500)
Other Cash Inflow / (Outflow)	0	0	0	0	0
Cash Flow from Investing	(11,281)	(7,611)	(3,925)	(3,675)	(3,675)
Shares Issue / (Repurchase)	0	0	0	0	0
Cost of Dividends Paid	(4,439)	(4,673)	(25,376)	(9,337)	(10,504)
Cash Flow from Financing	(4,974)	(4,797)	(25,496)	(9,337)	(10,504)
Free Cash Flow	13,696	27,641	25,219	28,415	29,599
Net Debt	(1,411)	(18,412)	(17,755)	(36,333)	(54,927)
Change in Net Debt	(1,238)	(17,399)	657	(18,578)	(18,595)

Key Balance Sheet Data

Property, Plant & Equipment	15,737	16,588	17,745	18,505	19,006
Other Non-Current Assets	34,979	39,817	40,239	40,739	41,239
Trade Receivables	1,499	1,084	1,152	1,053	1,183
Cash & Equivalents	2,196	19,072	18,295	36,873	55,468
Other Current Assets	6,440	8,670	9,259	9,540	9,845
Total Assets	60,851	85,231	86,690	106,710	126,740
Long-Term Debt	785	660	540	540	540
Other Non-Current Liabilities	1,531	1,606	1,659	1,718	1,786
Short-Term Debt	0	0	0	0	0
Other Current Liabilities	20,528	48,314	37,584	42,566	45,471
Total Liabilities	22,844	50,581	39,783	44,825	47,797
Total Equity	38,008	34,650	46,907	61,886	78,944
Total Equity & Liabilities	60,851	85,231	86,690	106,710	126,740

iQmethodSM - Bus Performance*

Return On Capital Employed	32.1%	53.7%	45.3%	40.7%	36.0%
Return On Equity	37.8%	61.4%	53.0%	46.8%	40.8%
Operating Margin	13.6%	17.4%	13.6%	13.8%	13.7%
EBITDA Margin	14.1%	17.4%	14.0%	14.2%	14.2%

iQmethodSM - Quality of Earnings*

Cash Realization Ratio	1.3x	1.3x	1.3x	1.2x	1.1x
Asset Replacement Ratio	1.8x	1.1x	1.5x	1.3x	1.2x
Tax Rate (Reported)	28.0%	21.2%	19.5%	19.0%	19.0%
Net Debt-to-Equity Ratio	-3.7%	-53.1%	-37.9%	-58.7%	-69.6%
Interest Cover	NM	NM	NA	NA	NA

Key Metrics

* For full definitions of iQmethodSM measures, see page 5.

Company Description

Hero Honda is the largest domestic manufacturer of motorcycles operating out of two manufacturing locations in Haryana, North India. The company is a JV promoted by Hero Cycles of India (promoters - Munjal Group) and Honda motors of Japan (26% stake). The latter provides financial and technology support. Its key models include Splendour and Passion Plus (100cc), Super Splendour (125 cc), Ambition (135 cc), CBZ(155 cc) and Karizma (225 cc).

Investment Thesis

We rate Hero Honda Neutral as we believe the stock is close to fair value, limiting potential upside. Over the longer term, the company's strong business fundamentals should enable increased penetration, and maintain steady growth.

Stock Data

Price to Book Value 7.8x

Table 1: Q2 results summary

(Rs mn)	2Q FY11	2Q FY10	1Q FY11	YoY	QoQ
Net Sales	45520	40696	42966	11.9%	5.9%
Other Income	784	687	534	14.0%	46.7%
Total Income	46303	41,383	43500	11.9%	6.4%
(increase) decrease in stock	-757	-50	-255	1423.5%	197.5%
Consumption of raw material	33857	27686	30848	22.3%	9.8%
Staff Cost	1498	1387	1450	8.0%	3.3%
Other Expenditure	4842	4231	4897	14.4%	-1.1%
Expenditure	39440	33,254	36941	18.6%	6.8%
Operating Profit	6079	7,442	6025	-18.3%	0.9%
Interest income (exp)	21	61	27	-66.1%	-22.2%
Depreciation (Provision)	-608	-503	-483	20.7%	25.8%
Profit before Tax & Extra Ord.	6276	7,686	6103	-18.3%	2.8%
Extraordinary Items (Exp)	0	0	0	NM	NM
Profit before Tax	6276	7,686	6103	-18.3%	2.8%
Tax (Provision)	-1220	-1715	-1187	-28.9%	2.8%
Profit after Tax	5056	5,971	4917	-15.3%	2.8%
Recurring net Profit	5056	5,971	4917	-15.3%	2.8%
OPM	13.4%	18.3%	14.0%	-493bps	-67bps
RM/Sales	72.7%	67.9%	71.2%	481bps	151bps
Staff Cost/Sales	3.3%	3.4%	3.4%	-12bps	-8bps
Other Expenses/Sales	10.6%	10.4%	11.4%	24bps	-76bps
Tax	19.4%	22.3%	19.4%	-287bps	0bps
Sales Volume (nos)	1,285,944	1,183,245	1,234,039	8.7%	4.2%
Avg Realisation (Rs)	35,398	34,394	34,817	2.9%	1.7%

Source: BofA Merrill Lynch Global Research, Company

Price objective basis & risk

Hero Honda (HRHDF)

Our PO of Rs 1965 is based on sum of the two wheeler business valued at 14x core FY12E P/E or Rs 1581/share, being in line with the industry, and (2) cash & equivalents of Rs 384/share. Risks: New models from competition, and higher interest rates, both of which could impact sales. Higher input costs will also impact profitability.

Link to Definitions

Industrials

Click [here](#) for definitions of commonly used terms.

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BUY				
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	Eicher Motors	XEICF	EIM IN	S.Arun
	M & M	MAHHF	MM IN	S.Arun
	M & M -G	MAHMF	MHID LI	S.Arun
	Maruti Suzuki India	MUDGF	MSIL IN	S.Arun
	Tata Motors Ltd.	TTM	TTM US	S.Arun
	Tata Motors Ltd.	TENJF	TTMT IN	S.Arun
	TVS Motor	XFKMF	TVSL IN	S.Arun

India - Autos Coverage Cluster

Investment rating	Company	BofAML ticker	Bloomberg symbol	Analyst
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	Hero Honda	HRHDF	HH IN	S.Arun
UNDERPERFORM				
	Bajaj Auto	XBJBF	BJAUT IN	S.Arun
RVW				
	Bharat Forge	XUUVF	BHFC IN	S.Arun

iQmethodSM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Sales	
	Other LT Liabilities	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

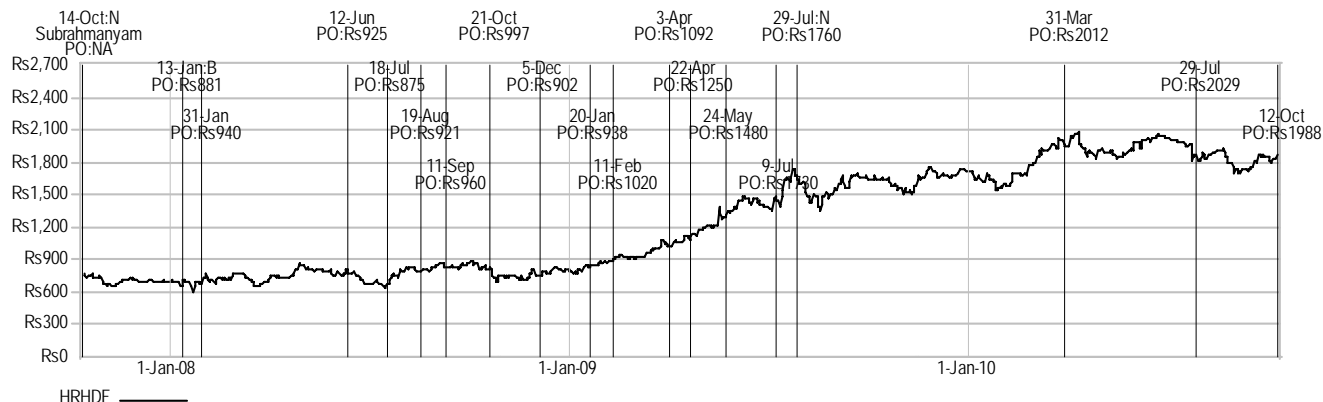
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Investment Rating Distribution: Autos Group (as of 01 Oct 2010)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	42	57.53%	Buy	24	66.67%
Neutral	14	19.18%	Neutral	7	58.33%
Sell	17	23.29%	Sell	4	30.77%

Investment Rating Distribution: Global Group (as of 01 Oct 2010)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1948	54.31%	Buy	821	46.73%
Neutral	891	24.84%	Neutral	397	49.07%
Sell	748	20.85%	Sell	259	37.16%

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