

Company

30 July 2010 | 10 pages

Hero Honda (HROH.BO)

 Equity
 Target price change
 Estimate change

Maintain Hold: 1QFY11 Results Disappoint

- 1QFY11 PAT at Rs4.9bn, 11% below our estimates** — EBITDA at cRs6bn was ~9% below our estimates, owing to higher other operating expense of cRs4.9bn (we estimated Rs 4.3 bn). Tax rates at ~19.5% were slightly above our estimates, also contributing to the earnings miss. At the EBITDA level, this was the second consecutive Q of an EBITDA miss. Gross contribution/bike has dipped ~12% Q/Q, and is 8% lower than 1QFY10 – clearly a disappointment in the context that pricing is reasonably buoyant.
- Guidance: Stronger volumes, weaker margins** — Mgmt has noted that FY11 volumes will be in the range from 5.3-5.4m (growth revised upward to 15-17% from 12-13% earlier), while margins should be range-bound between 14-15% (vs. our earlier forecasts of 17%). Mgmt notes that cost pressures are escalating – we believe mix is also deteriorating – we estimate that ~45% of the sequential growth was captured by the lower-margin CD Dawn.
- Earnings estimates have been cut 3-8%** — for FY11/12E, to reflect higher volumes (hiked by 3-4%), but offset 190-110 bps decline in margins. Sequentially, margins are expected to improve as benefits of increased localization of production at Haridwar flow through.
- Market share losses are a longer-term concern...** — HH has ceded market share of ~15ppts (from peak levels of ~80% in 1QFY10) in the key executive segment (~60-65% of industry sales) as a resurgent Bajaj Auto continues to gain share. HH's overall domestic market share (in bikes) has dipped to ~54% in 1QFY11, from 62% in 1QFY10. Mgmt plans to launch a new version of the Super Splendor, and also introduce more variants of the Splendor Pro and Hunk, in a bid to stem market share losses.
- Maintain Hold** — Our new TP is 1,952 based on 15x Dec11 EPS.

Hold/Low Risk	2L
Price (29 Jul 10)	Rs1,870.50
Target price	Rs1,952.00
	<i>from Rs2,002.00</i>
Expected share price return	4.4%
Expected dividend yield	1.9%
Expected total return	6.2%
Market Cap	Rs373,515M
	US\$7,988M

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	38.6	12.5	35.5	1.0
2009A	12,818	64.18	32.4	29.1	9.8	37.8	1.1
2010E	22,294	111.64	73.9	16.8	10.8	61.3	5.9
2011E	23,741	118.88	6.5	15.7	7.4	55.9	1.9
2012E	26,735	133.87	12.6	14.0	5.5	45.3	2.1

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2008	2009	2010E	2011E	2012E
Valuation Ratios					
P/E adjusted (x)	38.6	29.1	16.8	15.7	14.0
EV/EBITDA adjusted (x)	26.0	20.1	12.0	11.3	9.8
P/BV (x)	12.5	9.8	10.8	7.4	5.5
Dividend yield (%)	1.0	1.1	5.9	1.9	2.1
Per Share Data (Rs)					
EPS adjusted	48.47	64.18	111.64	118.88	133.87
EPS reported	48.47	64.18	111.64	118.88	133.87
BVPS	149.54	190.32	173.81	251.78	338.90
DPS	19.00	20.00	110.00	35.00	40.00
Profit & Loss (RsM)					
Net sales	103,318	123,191	158,605	186,387	213,312
Operating expenses	-91,428	-107,901	-132,852	-159,643	-183,393
EBIT	11,891	15,291	25,753	26,744	29,919
Net interest expense	-20	-25	-23	-30	-31
Non-operating/exceptionals	2,232	2,549	2,563	2,962	3,118
Pre-tax profit	14,103	17,815	28,293	29,676	33,006
Tax	-4,424	-4,997	-5,999	-5,935	-6,271
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	9,679	12,818	22,294	23,741	26,735
Adjusted earnings	9,679	12,818	22,294	23,741	26,735
Adjusted EBITDA	13,494	17,097	27,669	28,708	32,241
Growth Rates (%)					
Sales	4.4	19.2	28.7	17.5	14.4
EBIT adjusted	15.1	28.6	68.4	3.8	11.9
EBITDA adjusted	15.0	26.7	61.8	3.8	12.3
EPS adjusted	12.8	32.4	73.9	6.5	12.6
Cash Flow (RsM)					
Operating cash flow	14,831	16,751	20,663	26,592	28,888
Depreciation/amortization	1,603	1,807	1,916	1,963	2,322
Net working capital	3,549	2,126	-3,547	888	-168
Investing cash flow	-9,336	-11,075	-16,143	-1,000	-20,720
Capital expenditure	-3,407	-3,056	-2,000	-2,500	-3,000
Acquisitions/disposals	-5,929	-8,019	-14,143	1,500	-17,720
Financing cash flow	-4,771	-9,202	-25,576	-8,171	-9,338
Borrowings	-332	-535	15	0	0
Dividends paid	-4,439	-8,667	-25,592	-8,171	-9,338
Change in cash	724	-3,526	-21,057	17,421	-1,170
Balance Sheet (RsM)					
Total assets	50,523	60,765	76,378	76,139	96,116
Cash & cash equivalent	1,311	2,196	2,000	2,000	2,000
Accounts receivable	2,974	1,499	2,313	2,165	2,490
Net fixed assets	15,487	16,943	17,028	17,564	18,243
Total liabilities	20,821	22,757	41,668	25,859	28,437
Accounts payable	7,561	7,030	7,892	9,504	10,914
Total Debt	1,320	785	800	800	800
Shareholders' funds	29,862	38,008	34,710	50,280	67,679
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	13.1	13.9	17.4	15.4	15.1
ROE adjusted	35.5	37.8	61.3	55.9	45.3
ROIC adjusted	116.4	nm	na	na	nm
Net debt to equity	0.0	-3.7	-3.5	-2.4	-1.8
Total debt to capital	4.2	2.0	2.3	1.6	1.2

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1QFY11 Results Disappoint: Maintain Hold

1Q results were disappointing, with recurring PAT at Rs4.9bn, which was ~11% below our estimates. Operating profits (defined as EBITDA) were 9% below estimates as cost pressures on raw material and SGA rose significantly. Lower gross contribution and higher tax rates contributed to the PAT miss.

Figure 1. Hero Honda : Profitability Trends (Rs)

	1QFY10	4QFY10A	1QFY11A	% Chg YoY	% Chg QoQ
Sales Volumes	1,118,987	1,186,536	1,234,039	10.3%	4.0%
Average realization (Rs/bike)	34,058	34,742	34,817	2.2%	0.2%
Contribution / bike	10,915	11,410	10,026	-8.1%	-12.1%
Contribution margin (%)	32.0	32.8	28.8		
Material costs / bike	23,143	23,332	24,791	7.1%	6.3%
Other expenses / bike	3,969	4,182	3,968	0.0%	-5.1%

Source: Company, Citi Investment Research and Analysis

Figure 2. Hero Honda : 1QFY11 Results (Rs mn)

Hero Honda	1QFY10	4QFY10	1QFY11	% Chg YoY	% Chg QoQ	CIRA Comments
Gross Sales	40,594	44,027.5	46,222.2	13.9%	5.0%	
Excise	2,483	2,804	3,256	31.1%	16.1%	
Net sales	38,111	41,223	42,966	12.7%	4.2%	
Decrease/(Increase) in Stocks	124	(110)	(255)	-305.2%	131.4%	
Raw Materials	25,773	27,794	30,848	19.7%	11.0%	Raw material costs are a concern, notably with respect to tyres and component shortages
Staff costs	1,385	1,460	1,450	4.7%	-0.7%	
Other Expenses	4,441	4,962	4,897	10.3%	-1.3%	14% above estimates. Contributed significantly to EBITDA margin dip
Total Expenditure	31,723	34,106	36,941	16.4%	8.3%	
EBITDA	6,387	7,117	6,025	-5.7%	-15.3%	~9% below our estimates
Interest	(55)	(45)	(27)	-50.9%	-40.0%	
Other income	539	695	534	-0.9%	-23.2%	
EBDT	6,981	7,857	6,586	-5.7%	-16.2%	
Depreciation	456	487	483	5.9%	-0.8%	
PBT	6,525	7,370	6,103	-6.5%	-17.2%	
Exceptionals						
Tax	1,524	1,382	1,187	-22.1%	-14.1%	Tax rate was at c19% was above our expectations of c18.8%
PAT	5,001	5,988	4,917	-1.7%	-17.9%	
PAT (pre exceptionals)	5,001	5,988	4,917	-1.7%	-17.9%	

Profit Margins

EBITDA Margin(%)	16.8	17.3	14
Other income / EBDIT (%)	7.8	8.9	8.1
EBIT (%)	15.6	16.1	12.9
Pre tax margins (%)	17.1	17.9	14.2
Tax / PBT (%)	23.4	18.8	19.4
Net profit margins (%)	13.1	14.5	11.4

Cost ratios

Raw materials / sales	68	67.2	71.2
Staff costs / sales	3.6	3.5	3.4
Other expenses / sales	11.7	12	11.4

Source: Company, Citi Investment Research and Analysis

We maintain Hold, but revise our TP to Rs1,952, based on 15x Dec 11E EPS, as we roll forward from Sep 11.

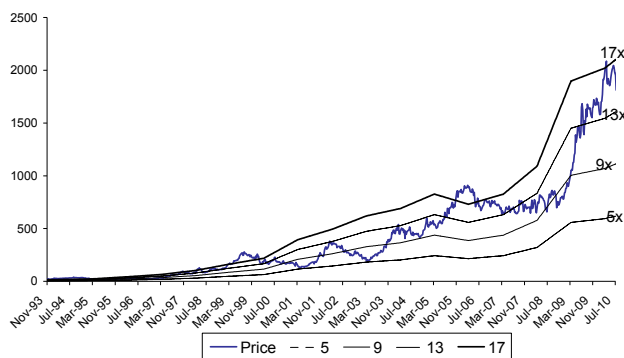
There has been notable deceleration in earnings growth that is forecast over the next 2 years (we forecast 10% earnings CAGR FY10-12E vs. 52% CAGR in earnings FY08-10E). In addition to this, competitive intensity in the sector has been accelerating, as evident by HH's falling market share

Figure 3. Hero Honda : Earnings Revision Table

	Old		New		Deviation	
	FY2011E	FY2012E	FY2011E	FY2012E	FY2011E	FY2012E
Total Volumes	5,152,146	5,770,403	5,290,150	5,977,869	2.7%	3.6%
Net sales	181,774	205,759	186,387	213,312	2.5%	3.7%
EBITDA	31,426	33,444	28,708	32,241	-8.7%	-3.6%
EBITDA Margin (%)	17%	16%	15.40%	15.11%		
PBT	34,361	36,845	30,842	35,395	-10.2%	-3.9%
Tax (Rs)	8,495	9,397	7,101	8,660	-16.4%	-7.8%
Tax Rate	25%	26%	23%	24%		
PAT	25,866	27,448	23,741	26,735	-8.2%	-2.6%
PAT Margin (%)	14%	13%	13%	13%		

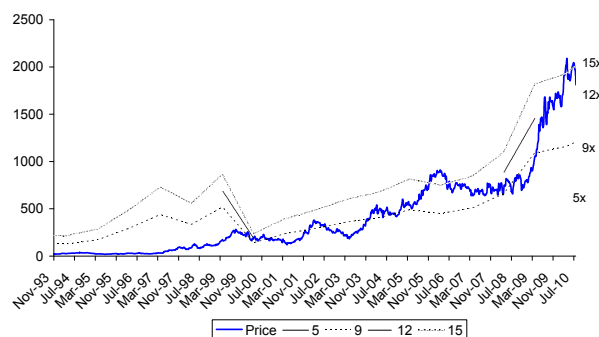
Source: Citi Investment Research and Analysis estimates

Figure 4. Hero Honda : 1yr Fwd P / EPS (x)



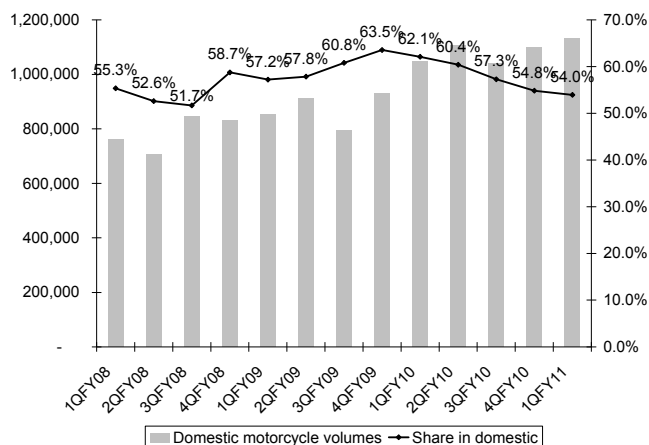
Source: Company, Citi Investment Research and Analysis

Figure 5. Hero Honda : 1yr Fwd P / CEPS (x)



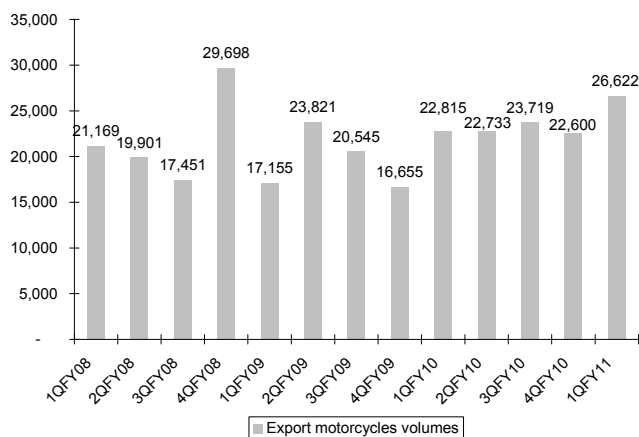
Source: Company, Citi Investment Research and Analysis

Figure 6. Hero Honda : Domestic Motorcycles Sales



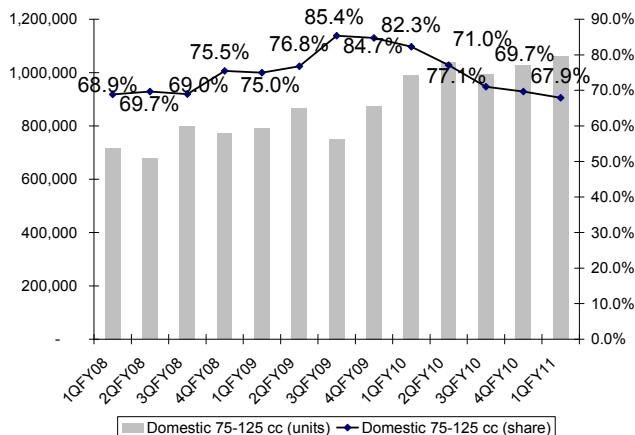
Source: Citi Investment Research and Analysis

Figure 7. Hero Honda : Export Motorcycles Sales



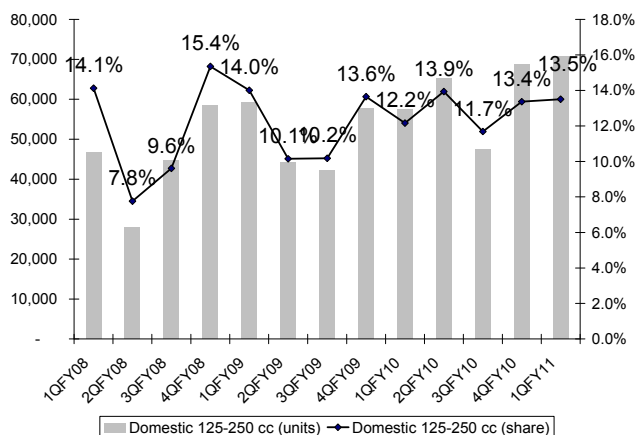
Source: Citi Investment Research and Analysis

Figure 8. Hero Honda : Domestic Motorcycles Sales in 75-125 cc Segment



Source: Citi Investment Research and Analysis

Figure 9. Hero Honda : Domestic Motorcycles Sales in 125-250 cc Segment



Source: Citi Investment Research and Analysis

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 Rs1,952. Moreover, cyclical headwinds - cost pressures from higher input costs and initial signs of resumption of competitive pressures - are evident, 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 10% earnings CAGR for Hero Honda over FY10-FY12E driven by a richer product mix and fiscal incentives at its Uttaranchal plant. We forecast 8% 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 Rs1,952 is based on 15x Dec11E earnings, which we believe is well supported by an earnings CAGR of 10% 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 8% 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 Rs 50bn 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

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Hero Honda (HROH.BO)

Ratings and Target Price History

Fundamental Research

Analyst: Jamshed Dadabhyo

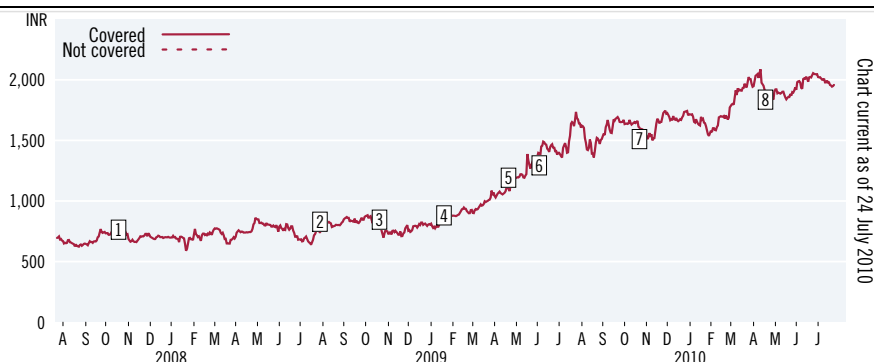


Chart current as of 24 July 2010

	Date	Rating	Target Price	Closing Price
1	18-Oct-07	3L	*670.00	724.60
2	29-Jul-08	*2L	*764.00	736.15
3	21-Oct-08	2L	*867.00	826.15

	Date	Rating	Target Price	Closing Price
4	20-Jan-09	2L	*931.00	834.05
5	21-Apr-09	*1L	*1,258.00	1,100.90
6	3-Jun-09	1L	*1,593.00	1,392.05

	Date	Rating	Target Price	Closing Price
7	22-Oct-09	*2L	*1,790.00	1,605.65
8	19-Apr-10	2L	*2,002.00	1,896.90

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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