

Hero Honda

Q1FY12/ Estimate change

21 July 2011

Sell

Target Price: Rs1,621

CMP: Rs1,789*

Downside: 9%

*as on 21 July 2011

Operating results marginally below estimates

Hero Honda's (HH) operating results were marginally below our expectations with EBITDA margin at 14.4% vs our estimate of 15%. However, PAT at Rs5.6bn was higher than our estimate of Rs5.5bn largely on account of higher-than-expected other income and lower tax rate (16.7% vs estimate of 19.8%). We maintain our SELL rating on the stock with revised target price of Rs1,621.

- **Strong revenue growth led by volumes:** Net sales increased 32.3% YoY to Rs56.8bn (our estimate: Rs56.6bn), led by the 24% volume growth and 6.7% realization growth. On a sequential basis, sales were up 5.4%, led by equivalent growth in volumes as realizations remained flat QoQ (up 0.2%). HH hiked prices by ~1% (Rs500-Rs700/unit) effective from 21 June 2011. Management said the price hikes would partly help improve margins. However, peak EBITDA margins of 17-17.5% registered in FY10 are unlikely to be achieved in the near-future.
- **However, EBITDA marginally below estimate:** EBITDA for Q1FY12 stood at Rs8.2bn (estimate: Rs8.5bn), down 1.5% QoQ, while EBITDA margin came at 14.4% (estimate: 15%) vs 15.4% for Q4FY11. The drop in EBITDA margin was mainly on account of high raw material costs during the quarter (74.7% vs. 72.8% during Q4FY11). Employee costs and other expenses were lower.
- **Valuations and Recommendations:** We have upgraded our FY12E/FY13E estimates by 4%/2.6% to factor in the lower-than-expected tax rate guidance given. We are now factoring in tax rate of 17%/18% for FY12E/FY13E from 19.8% earlier. We continue to maintain SELL on the stock with a revised target price of Rs1,621 (earlier: Rs1,580).

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Key Data

Bloomberg Code	HH IN
Reuters Code	HROH.BO
Current Shares O/S (mn)	199.7
Diluted Shares O/S(mn)	199.7
Mkt Cap (Rsbn/USDbn)	356.5/8
52 Wk H / L (Rs)	2062/1376
Daily Vol. (3M NSE Avg.)	409674
Face Value (Rs)	2

1 USD = Rs44.5

One Year Indexed Stock Performance



Price Performance (%)

	1M	6M	1Yr
Hero Honda	1.3	1.8	(8.0)
NIFTY	5.1	(2.7)	2.7

Source: Bloomberg, Centrum Research
*as on 21 July 2011

Y/E Mar (Rsmn)	1QFY12	1QFY11	YoY (%)	4QFY11	QoQ (%)	1QFY12E	Var (%)
Net sales	56,833	42,966	32.3	53,909	5.4	56,557	0.5
Consumption of raw materials	42,448	30,594		39,269		41,240	
% of sales	74.7	71.2	348 bp	72.8	184 bp	72.9	
Employee costs	1,645	1,450		1,680		1,763	
% of sales	2.9	3.4		3.1		3.1	
Other expenditure	4,563	4,897		4,661		5,061	
% of sales	8.0	11.4		8.6		8.9	
EBITDA	8,178	6,025	35.7	8,299	(1.5)	8,493	(3.7)
EBITDA Margin (%)	14.4	14.0	37 bp	15.4	(101)bp	15.0	(63)bp
EBITDA Margin Adjusted*(%)	11.3	14.0	(275)bps	12.1	(84)bps		
Depreciation and amortisation	2,398	483		2,374		2,374	
Interest	(32)	(27)		81		(5)	
EBT	5,812	5,569	4.4	5,844	(0.6)	6,124	(5.1)
Other income	884	534		743		670	
PBT	6,696	6,103	9.7	6,587	1.6	6,794	(1.4)
Provision for tax	1,117	1,187		1,572		1,343	
effective tax rate	16.7	19.4		23.9		19.8	
PAT (reported)	5,579	4,917		5,015		5,451	
NPM (%)	9.8	11.4	(163)bp	9.3	51 bp	9.6	18 bp

Source: Company, Centrum Research, * Note: Adjusted for change in royalty expense accounting

Y/E Mar (Rsmn)	Rev	YoY (%)	EBITDA	EBITDA (%)	Adj PAT	YoY (%)	Fully DEPS	RoE (%)	RoCE (%)	P/E (x)	EV/EBITDA (x)
FY10	158,220	28.1	26,618	16.8	21,678	69.1	108.6	59.7	74.1	16.5	11.3
FY11E	194,012	22.6	26,449	13.6	20,138	(7.1)	100.8	61.9	76.0	17.7	11.5
FY12E	222,101	14.5	33,030	14.9	21,786	8.2	109.1	62.3	74.2	16.4	8.9
FY13E	254,293	14.5	37,885	14.9	25,585	17.4	128.1	57.1	68.9	14.0	7.2
FY14E	285,869	12.4	43,027	15.1	29,059	13.6	145.5	51.8	65.8	12.3	5.6

Source: Company, Centrum Research Estimates

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Centrum Equity Research is available on Bloomberg, Thomson Reuters and FactSet

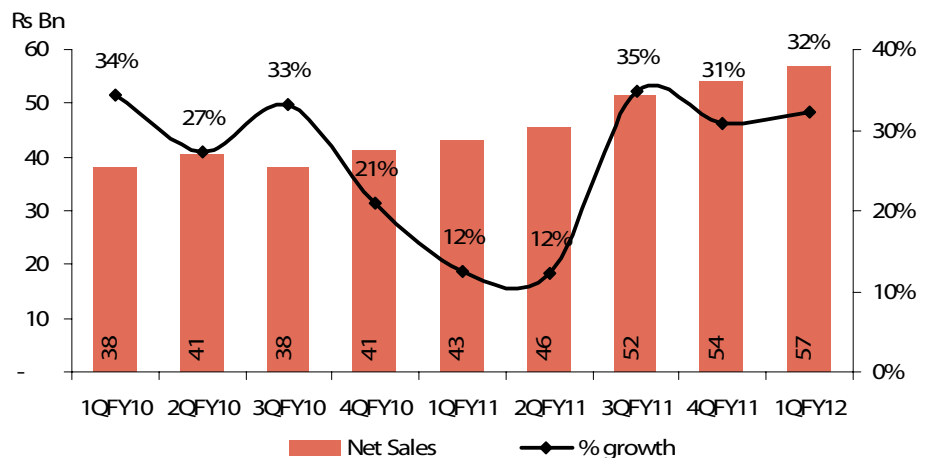
Conference Call highlights

- **Volume guidance of ~6mn units for FY12E:** Management maintained that the industry is likely to register ~15% growth during FY12E. We have modeled in volume growth of 12.7% for both FY12E and FY13E vs 17.9% in FY11. HH maintained its volume guidance of ~6mn units during FY12E (with 2mn units from Haridwar plant) and expects EBITDA margins to improve going forward led by easing of commodity cost pressure.
- **Expansion plans:** The company's current capacity stands at 6.15m units (Haridwar: 2.25 mn, Gurgaon: 1.95mn, Daruhera: 1.95mn) vs 5.1mn units in March 2010, which can be extended to ~6.4-6.5mn units via de-bottlenecking. Management said the fourth plant (with a capacity of 750,000 units per annum, capex ~Rs5bn) is being finalized and the location will soon be announced.
- **Capex plans:** The management maintained its capex guidance of about ~Rs8bn-9bn in FY12E. The funds would be used for capacity expansion (mainly on the new plant), R&D and the establishment of newer export markets.
- **Rural sales increase to 45%:** The contribution of rural sales has improved to 45% of total sales from 39% in FY09. Management indicated demand is strong from both the rural (penetration ~10%) as well as urban (penetration ~25-30%) pockets.

Strong volume-led revenue growth

HH reported net sales of Rs56.8bn in Q1FY12 (vs our estimate: Rs56.6bn), up 32.3% YoY, led by 24% volume growth and 6.7% realization growth. On a sequential basis, sales increased 5.4%, led by equivalent growth in volumes as realizations remained flat QoQ (up 0.2%). The company hiked prices by ~1% (Rs500-Rs700/unit) effective from 21 June 2011. Management indicated that price hikes should partly help improve margins. However, peak EBITDA margins of 17-17.5% seen in FY10 are unlikely to be achieved in the near-future.

Exhibit 1: Revenue trend



Source: Company, Centrum Research

Exhibit 2: Lower contribution from premium segment

% Contribution	Q1FY12	Q1FY11	YoY	Q4FY11	QoQ
Price	13.2	15.5	(229) bp	13.7	(50) bp
Executive	80.9	78.2	264 bp	78.5	236 bp
Premium	5.9	6.2	(35) bp	7.7	(185) bp
Total	100.0	100.0		100.0	

Source: SIAM, Crisil, Company, Centrum Research

EBITDA margin below estimate

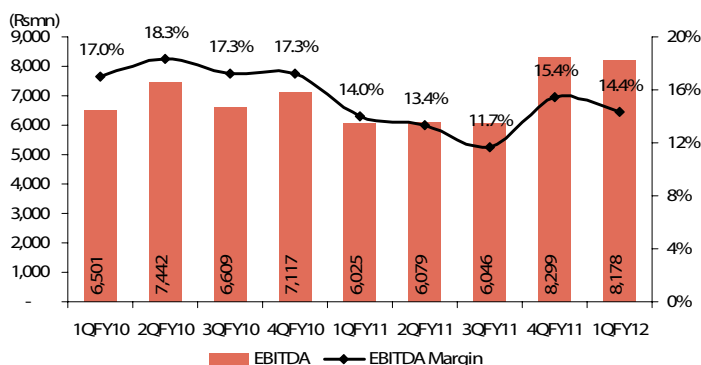
EBITDA dipped 1.5% QoQ to Rs8.2bn (vs estimate of Rs8.5bn). EBITDA margin was 14.4% (estimate: 15%) vs 15.4% for Q4FY11. The drop in EBITDA margin was mainly on account of higher-than-expected raw material costs during the quarter (74.7% vs 72.8% during Q4FY11 and estimate of 72.9%), even though the company managed employee costs (Employee Cost/Net sales was 2.9% in Q1FY12 vs 3.2% in FY11) and other expenses (other expenses/net sales was 8% for Q1FY12 vs 10.5% for FY11) well. RMC/unit for Q1FY12 stood at Rs27,751 vs Rs27,000 for Q4FY11 and Rs24,791 for Q1FY11.

Prima facie while EBITDA margin for 1QFY12 stood at 14.4%, the number needs to be adjusted for royalty expense accounting on a like-to-like comparison. On an adjusted basis, EBITDA margin comes to 11.3% compared to 14% in 1QFY11 and 12.1% in 4QFY12 (down 84 bps QoQ and down 275bps YoY).

HH has further taken a price hike of Rs500-Rs700 on 24 June 2011, which should help in maintaining margins.

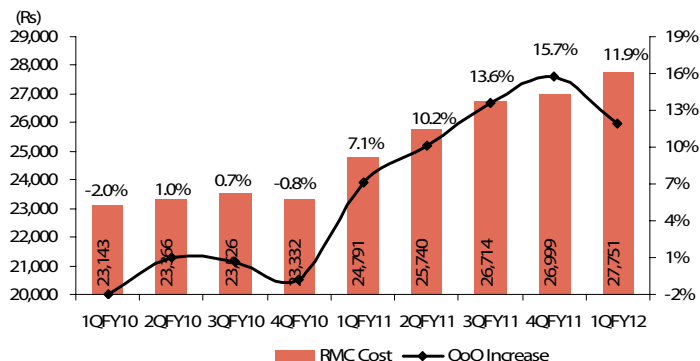
PAT for the quarter stood at Rs5.6bn (estimate: Rs5.5bn), up 13.5% YoY and 11.2% QoQ, aided by higher-than-expected other income (Rs884mn vs estimate of Rs670mn) and lower tax rate of 16.7% vs estimate of 19.8% for Q1FY12.

Exhibit 3: EBITDA margin declines 1% QoQ...



Source: Company, Centrum Research

Exhibit 4: ...as raw material costs surged



Source: Company, Centrum Research

Estimates revised

We have upgraded our FY12E/FY13E estimates by 4%/2.6% to factor in the lower tax rate guidance given by the company. We are factoring in tax rate of 17%/18% for FY12E/FY13E from 19.8% each earlier.

Exhibit 5: Revised volume and financial estimates

Financials	Old Estimates		Revised Estimates		% Change	
	FY12E	FY13E	FY12E	FY13E	FY12E	FY13E
Net Sales (Rsmn)	222,101	254,293	222,101	254,293	0.0	0.0
EBITDA (Rsmn)	33,030	37,885	33,030	37,885	0.0	0.0
EBITDA margin (%)	14.9	14.9	14.9	14.9	0 bp	0 bp
Depr. & Amort. (Rsmn)	10,092	10,756	10,092	10,756	-	-
Adjusted PAT (Rsmn)	21,041	25,011	21,786	25,585	3.5	2.3
FDEPS (Rs)	105.4	125.2	109.1	128.1	3.5	2.3
Core EPS (Rs)	93.1	110.1	96.8	113.0	4.0	2.6

Source: Company, Centrum Research Estimates

Maintain Sell; Target price Rs1,621

At CMP of Rs1,789, the stock trades at 18.5x FY12E core EPS of Rs96.8 and 15.8x FY13E core EPS of Rs113. We maintain our SELL rating with a revised target price of Rs1,621 (from Rs1,590 earlier) valuing the stock at 12.15x FY13E Core EPS + Rs249 of cash.

Financials

Exhibit 6: Income Statement

Y/E March (Rsmn)	FY10	FY11E	FY12E	FY13E	FY14E
Sales Volume	4,583,312	5,402,444	6,090,264	6,860,979	7,608,376
% Growth	24.9	17.9	12.7	12.7	10.9
Net Sales	158,220	194,012	222,101	254,293	285,869
% Growth	28.1	22.6	14.5	14.5	12.4
Raw Materials	108,169	141,131	160,690	182,836	204,780
Personnel	5,603	6,190	7,056	8,114	9,332
Manufact. & Other Exp.	17,830	20,241	21,325	25,458	28,730
EBITDA	26,618	26,449	33,030	37,885	43,027
EBITDA Margin (%)	16.8	13.6	14.9	14.9	15.1
Depn. & Amortn	1,915	4,024	10,092	10,756	11,206
EBIT	24,703	22,426	22,938	27,128	31,820
Interest Expenses	(206)	(17)	(83)	(96)	(108)
EBT	24,909	22,442	23,022	27,224	31,928
Other Income	2,768	2,681	3,227	3,977	5,327
Extraord. (Income)/Exp.	-	1.00	-	-	-
PBT	27,677	25,123	26,249	31,201	37,256
Tax-Total	5,999	4,984	4,462	5,616	8,196
Tax Rate (%) - Total	21.7	19.8	17.0	18.0	22.0
Reported PAT	21,678	20,138	21,786	25,585	29,059
Extraord. items -Adj.	-	-	-	-	-
Adjusted PAT	21,678	20,138	21,786	25,585	29,059
PAT Margin	13.7	10.4	9.8	10.1	10.2
% Growth	69.1	(7.1)	8.2	17.4	13.6

Source: Company, Centrum Research Estimates

Exhibit 7: Balance Sheet

Y/E March (Rsmn)	FY10	FY11E	FY12E	FY13E	FY14E
SOURCES OF FUNDS					
Capital	399	399	399	399	399
Reserves & Surplus	34,251	30,024	39,077	49,709	61,785
Shareholders' Funds	34,650	30,423	39,477	50,108	62,184
Minority Interest					
Secured Loans	-	14,585	7,292	-	-
Unsecured Loans	660	327	327	327	327
Total Loan Funds	660	14,912	7,620	327	327
Deferred Tax Liabi. - Net	1,528	2,468	2,468	2,468	2,468
Total	36,838	47,803	49,564	52,903	64,979
APPLICATION OF FUNDS					
Gross Block	27,510	57,000	58,917	57,834	56,752
Accumulated Dep.	10,922	14,946	25,037	35,794	47,000
Capital WIP	481	500	500	500	500
Net Fixed Assets	17,069	42,554	34,380	22,541	10,251
Investments	39,257	51,288	56,288	76,288	101,288
Inventories	4,364	5,249	6,015	6,884	7,731
Sundry Debtors	1,084	1,306	1,496	1,713	1,923
Other Current Assets	-	-	-	-	-
Cash & Bank Balances	19,072	1,078	5,845	8,259	15,729
Loans and Advances	4,306	7,775	8,910	10,197	11,451
Total Current Assets, Loans	28,826	15,408	22,266	27,053	36,834
Current Liabilities	38,051	50,637	50,637	58,025	66,410
Provisions	10,264	10,811	12,733	14,953	16,984
Total Current Liab. & Prov.	48,314	61,448	63,370	72,978	83,394
Net Current Assets	(19,488)	(46,039)	(41,104)	(45,925)	(46,560)
Total assets	36,838	47,803	49,564	52,903	64,979

Source: Company, Centrum Research Estimates

Exhibit 8: Cash flow

Y/E March (Rsmn)	FY10	FY11E	FY12E	FY13E	FY14E
SOURCES	(2,123)	13,904	11,853	14,096	23,282
Cash Profit	23,676	24,163	31,878	36,341	40,266
(-) Dividends	25,675	24,510	12,733	14,953	16,984
Retained Earnings	(1,999)	(347)	19,145	21,388	23,282
Issue of Equity/Premium	-	-	-	-	-
Borrowings	(125)	14,252	(7,292)	(7,292)	-
APPLICATIONS	(2,123)	13,905	11,853	14,096	23,282
Capital Expenditure	1,623	29,509	1,917	(1,083)	(1,083)
Investments	5,570	12,030	5,000	20,000	25,000
Net Current Assets	(25,971)	(8,557)	168	(7,235)	(8,105)
Others	(221)	(1,084)	-	-	-
Change in Cash	16,876	(17,994)	4,767	2,414	7,470

Source: Company, Centrum Research Estimates

Exhibit 9: Key Ratios

Y/E March	FY10	FY11E	FY12E	FY13E	FY14E
O/s Shares	200	200	200	200	200
Fully Diluted Shares	200	200	200	200	200
Per share (Rs)					
Basic EPS	108.6	100.8	109.1	128.1	145.5
Fully diluted EPS	108.6	100.8	109.1	128.1	145.5
Book value	173.5	152.3	197.7	250.9	311.4
Valuation (x)					
P/E	16.5	17.7	16.4	14.0	12.3
P/BV	10.3	11.7	9.0	7.1	5.7
EV/EBITDA	11.3	11.5	8.9	7.2	5.6
EV/Sales	1.9	1.6	1.3	1.1	0.8
Margin Ratio (%)					
EBITDA Margin	16.9	13.7	15.0	15.0	15.2
EBIT Margin	15.7	11.7	10.4	10.7	11.2
PAT Margin	13.8	10.5	9.9	10.1	10.2
Return Ratio (%)					
ROE	59.7	61.9	62.3	57.1	51.8
ROCE	74.1	76.0	74.2	68.9	65.8
Other Ratios					
Interest coverage ratio (%)	(119.8)	(1,359.1)	(275.0)	(284.0)	(294.0)
Debt-equity (x)	0.0	0.0	0.0	0.0	0.0
Liquidity ratio (x)	0.6	0.3	0.4	0.4	0.4
Other income contrib. (%)	10.0	10.7	12.3	12.7	14.3
Dividend Payout (%)	101.3	104.1	50.0	50.0	50.0
Asset TO (x)	4.5	6.4	5.6	5.1	4.6
WC Turnover (days)	(83.9)	(83.2)	(72.4)	(73.0)	(74.7)

Source: Company, Centrum Research Estimates

Appendix A

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