The Royal Bank of Scotland

22 September 2010

Hero Honda Motors

Favourable technology options

We recently met management at Hero Honda. The company has favourable technology options when/if the JV ends, either from Honda itself or global consultants. Capacity can be dealt with at existing plants and, so, we believe HH is well placed to benefit from rising rural demand given the good monsoon. Buy.

Buy

Target price
Rs2116.00

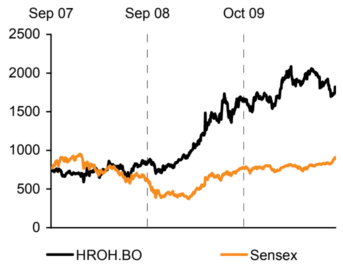
Price
Rs1809.05

Short term (0-60 days)
n/a

Market view
Underweight

Price performance

	(1M)	(3M)	(12M)
Price (Rs)	1916	2026	1680
Absolute (%)	-5.6	-10.7	7.7
Rel market (%)	-13.1	-20.2	-9.9
Rel sector (%)	-11.4	-17.8	2.7



Market capitalisation
Rs361.25bn (US$7.89bn)

Average (12M) daily turnover
Rs935.09m (US$20.39m)

Sector: BBG AP Autos
RIC: HROH.BO, HH IN
Priced Rs1809.05 at close 21 Sep 2010.
Source: Bloomberg

Key forecasts

	FY09A	FY10A	FY11F	FY12F	FY13F
Revenue (Rsm)	123,192	158,605	193,274	214,905	234,226
EBITDA (Rsm)	17,098	27,670	29,536	33,193	35,375
Reported net profit (Rsm)	12,818	22,318	24,737	28,523	30,980
Normalised net profit (Rsm)[1]	12,818	22,318	24,737	28,523	30,980
Normalised EPS (Rs)	64.20	111.8	123.9	142.8	155.1
Dividend per share (Rs)	20.00	110.0	34.00	42.00	46.00
Dividend yield (%)	1.11	6.08	1.88	2.32	2.54
Normalised PE (x)	28.20	16.20	14.60	12.70	11.70
EV/EBITDA (x)	19.10	12.00	10.70	8.95	7.85
Price/book value (x)	9.51	10.40	7.02	5.15	3.99
ROIC (%)	201.6	466.3	327.5	296.2	337.2

1. Post-goodwill amortisation and pre-exceptional items
Accounting standard: Local GAAP
Source: Company data, RBS forecasts

year to Mar, fully diluted

Favourable technology options

Rumours that the Hero Honda JV is to end continue, despite chairman Brij Mohan Munjal stating at the AGM that there was no immediate threat. If the rumours prove true, the JV agreement gives Hero the option of extending its technology sharing agreement with Honda until 2017 (vs the current 2014 expiry) or to discontinue the agreement and stop royalty payments immediately. Hero has limited in-house component design and testing capabilities and we believe it would take three years for it to establish full model development capabilities with the help of global design and technology consultants and at a cost of around 1.5% of net sales (ie, in line with peers).

Alternative capacity plans on track

Given the delays to its new plant, management is looking to set up additional assembly lines in existing plants to meet strong expected demand. This, plus capacity de-bottlenecking, may address short-term capacity issues until next year's festival season, beyond which we believe the new plant will be necessary. But, with new plants reducing in-house component manufacture drastically (to 18% the Haridwar plant vs 26% at the older Gurgaon plant), management is believes it can get new plants off the ground faster.

Valuation looks attractive on JV split fears: Buy

Hero Honda shares have underperformed the Sensex by 20% over the last three months on concerns about capacity constraint and that Honda will exit. We feel the JV agreement works in Hero's favour with regards to technology support and that the current valuation (12.7x FY12F) is attractive bearing in mind: 1) 44% of Hero Honda's sales come from the rural sector, which is best positioned for high growth from a good monsoon; and 2) 75% of its sales are from 100cc products, where incremental technology support is less critical and where Hero Honda has ambitious distribution plans. We reiterate our Buy recommendation. Our three-stage DCF-based target price of Rs2,116 is supported by cash in hand of Rs236 per share and a high ROE. At our target price, the stock would be trading at 14.8x FY12F.

Researched by

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www.rbs.in/broking

Favourable technology options

If Honda exits the JV, Hero looks well positioned on the technology front and would, in our view, face limited issues during any transformation. It could choose between paying for support from Honda and building its own capabilities. We reiterate our Buy rating.

More clarity emerges on technology agreement with Honda, Japan

We have discussed the JV agreement with management and understand that, if Honda should sell its 25.5% stake in the Hero Honda JV, the Hero group has the following options as regards technology support from Honda:

- To extend the technical agreement with Honda till 2017 (vs its current 2014 expiry) at the same royalty rate (currently averaging 2.7% of net sales);
- To cut all ties with Honda and stop paying royalties immediately – importantly, this means not having to pay in relation to vehicles in production from already-absorbed technology; or
- Renew the technical agreement (on new terms) when it expires in 2014 for sustaining long-term technology inputs from Honda.

We feel this puts Hero Honda in a good position as it would only need to pay royalties for future technology support and not for what it has already received. This gives it the option of evaluating incremental benefits from paying 2.7% of net sales as a royalty vs developing in-house R&D capabilities (peers spend 1.5-2% of net sales).

Currently Hero Honda spends 0.3% of net sales towards in-house R&D (in addition to its 2.7% royalty payment). This is primarily towards component design and testing, initial market research and road testing of vehicles.

Hero Honda has component development capabilities but not full model capabilities

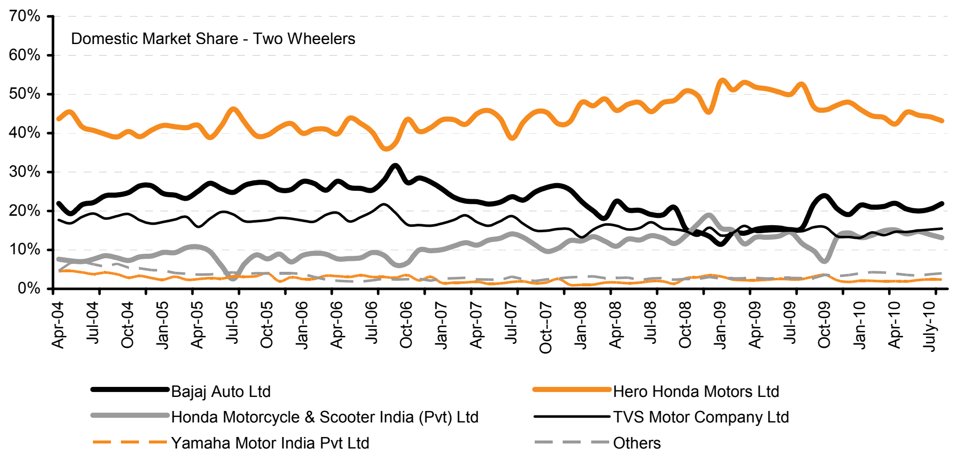
From discussions with industry experts and management, we understand that Hero Honda has in-house component development and testing capabilities, but lacks full model development capabilities. Given the experiences of new entrants like Mahindra and TVS (post its split with Suzuki), our industry sources believe it would take just three years for Hero Honda to build up full model development capabilities with the help of global design and technical consultants.

As regards emission technology, the same experts suggest that two-wheelers have the advantage of already complying with much stricter norms than the rest of the world. Hero Honda crossed one crucial short-term technology hurdle having successfully moved to BS-III norms by including catalytic converters on its 100cc bikes. Given it derives more than 75% of sales volume from 100cc bikes, we believe relatively less incremental technology is required in the medium term to compete in the bike segment.

Our estimates rely on a steep rise in sales during the festival period

Our FY11 sales volume assumption of 5.47m units requires a sharp increase in monthly sales volume for the rest of FY11, especially in the festival seasons. We forecast 15.7% sequential growth in sales volume for 2HFY11, over 1HFY11. We believe Hero Honda's strong hold in the rural market (44% of its sales volume) will help it benefit from the surge in rural demand expected following a good monsoon and lead it to outperform industry sales growth for the rest of its financial year.

Chart 1 : Market share trend



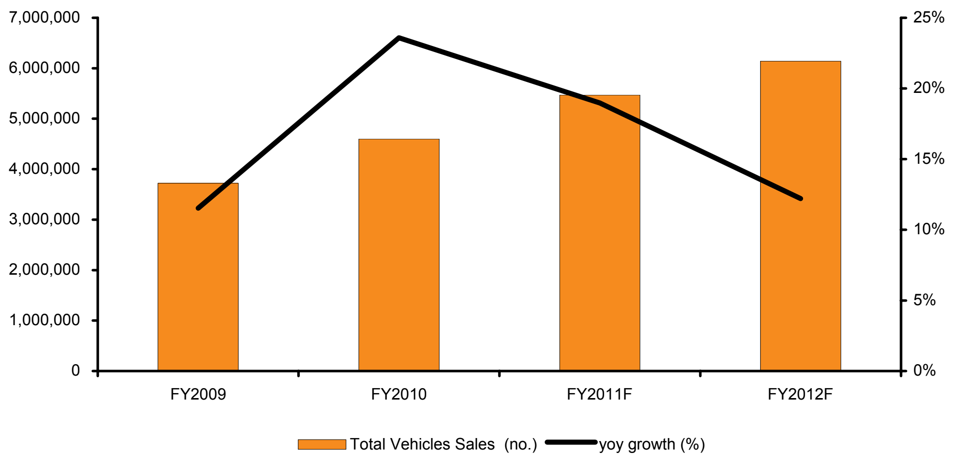
Source: SIAM

Capacity build-up plan at existing plants as new plant is delayed

Hero Honda's current capacity of 5.8m vehicles per annum is enough to cater for volume growth till mid-CY11.

Plans to a new assembly and components plant are currently have still to receive final approval. Management therefore aims to add assembly lines at one of its existing plants to make sure it can meet peak festival demand in September 2011. Once the plans are approved it will take about 12 months to construct the new plant.

Chart 2 : Yearly volume ramp-up plan



Source: Company data, RBS forecasts

Best placed to benefit from strong monsoon-driven rural demand

For coming quarters, price increases put through in June and July should help absorb the cost of meeting emission standards and increased steel prices. Elsewhere on the cost front, a qoq easing of marketing expenses may help qoq EBITDA margin expansion driven by improved festival-driven volume.

The sharp improvement in rainfall in recent weeks (vs the relative drought faced till early August) augurs well for the rural economy in the medium term. Hero Honda derives 44% of its sales volume from the rural sector – the highest of India's auto companies – which should mean it is well placed to benefit from any improvement in demand from this segment. In addition, Hero Honda should benefit from the increased availability of credit as it derives nearly 30% of sales volume through bank- or NBFC-financing.

To capture the rapid growth of lower-middle income household expected in the coming decade in India, Hero Honda plans to expand distribution in smaller towns aggressively in coming years by converting authorised service centres into dealers. By end-March 2010, Hero Honda had 4,300 customer touch points (covering 750 dealers, 3,000 authorised representatives and 1,000 authorised service centres).

Income statement

Rsm	FY09A	FY10A	FY11F	FY12F	FY13F
Revenue	123192	158605	193274	214905	234226
Cost of sales	-91907	-112967	-140545	-156568	-170744
Operating costs	-14187	-17969	-23193	-25144	-28107
EBITDA	**17098**	**27670**	**29536**	**33193**	**35375**
DDA & Impairment (ex gw)	-1807	-1915	-2146	-2496	-2820
EBITA	**15291**	**25755**	**27390**	**30697**	**32556**
Goodwill (amort/impaired)	n/a	n/a	n/a	n/a	n/a
EBIT	**15291**	**25755**	**27390**	**30697**	**32556**
Net interest	2524	2563	3150	4300	5225
Associates (pre-tax)	n/a	n/a	n/a	n/a	n/a
Forex gain / (loss)	n/a	n/a	n/a	n/a	n/a
Exceptionals (pre-tax)	n/a	n/a	n/a	n/a	n/a
Other pre-tax items	0.00	0.00	0.00	0.00	0.00
Reported PTP	**17815**	**28317**	**30540**	**34997**	**37781**
Taxation	-4997	-5999	-5803	-6474	-6801
Minority interests	n/a	n/a	n/a	n/a	n/a
Exceptionals (post-tax)	n/a	n/a	n/a	n/a	n/a
Other post-tax items	0.00	0.00	0.00	0.00	0.00
Reported net profit	**12818**	**22318**	**24737**	**28523**	**30980**
Normalised Items Excl. GW	0.00	0.00	0.00	0.00	0.00
Normalised net profit	**12818**	**22318**	**24737**	**28523**	**30980**

Source: Company data, RBS forecasts year to Mar

Balance sheet

Rsm	FY09A	FY10A	FY11F	FY12F	FY13F
Cash & market secs (1)	35883	30462	45763	65210	84709
Other current assets	7939	11452	14584	15161	17358
Tangible fixed assets	16943	18528	20381	21886	24066
Intang assets (incl gw)	n/a	n/a	n/a	n/a	n/a
Oth non-curr assets	0.00	0.00	0.00	0.00	0.00
Total assets	**60765**	**60442**	**80729**	**102256**	**126133**
Short term debt (2)	n/a	n/a	n/a	n/a	n/a
Trade & oth current liab	20528	23206	26520	29129	32548
Long term debt (3)	784.9	1000	1000	1000	1000
Oth non-current liab	1444	1586	1739	1914	2102
Total liabilities	**22757**	**25792**	**29258**	**32043**	**35651**
Total equity (incl min)	38008	34650	51470	70213	90482
Total liab & sh equity	**60765**	**60442**	**80729**	**102256**	**126133**
Net debt	-35098	-29462	-44763	-64210	-83709

Source: Company data, RBS forecasts year ended Mar

Cash flow statement

Rsm	FY09A	FY10A	FY11F	FY12F	FY13F
EBITDA	17098	27670	29536	33193	35375
Change in working capital	847.3	218.1	-145.5	306.1	261.9
Net interest (pd) / rec	2524	2563	3150	4300	5225
Taxes paid	-4806	-5857	-5650	-6300	-6612
Other oper cash items	1551	-1053	326.5	1727	960.3
Cash flow from ops (1)	**17214**	**23540**	**27217**	**33226**	**35211**
Capex (2)	-3102	-3500	-4000	-4000	-5000
Disposals/(acquisitions)	0.00	0.00	0.00	0.00	0.00
Other investing cash flow	-8019	5000	-16000	-18000	-20000
Cash flow from invest (3)	**-11121**	**1500**	**-20000**	**-22000**	**-25000**
Incr / (decr) in equity	0.00	0.00	0.00	0.00	0.00
Incr / (decr) in debt	-535.1	215.1	0.00	0.00	0.00
Ordinary dividend paid	-4673	-25676	-7917	-9780	-10711
Preferred dividends (4)	n/a	n/a	n/a	n/a	n/a
Other financing cash flow	n/a	n/a	n/a	n/a	n/a
Cash flow from fin (5)	**-5208**	**-25461**	**-7917**	**-9780**	**-10711**
Forex & disc ops (6)	n/a	n/a	n/a	n/a	n/a
Inc/(decr) cash (1+3+5+6)	**884.8**	**-420.7**	**-699.7**	**1447**	**-500.3**
Equity FCF (1+2+4)	14112	20040	23217	29226	30211

Lines in bold can be derived from the immediately preceding lines. year to Mar
Source: Company data, RBS forecasts

Standard ratios

Performance	Hero Honda FY09A	FY10A	FY11F	FY12F	FY13F	Bajaj Auto FY11F	FY12F	FY13F	Maruti Suzuki India FY10F	FY11F	FY12F
Sales growth (%)	18.9	28.7	21.9	11.2	8.99	40.1	13.4	12.2	42.8	18.8	16.3
EBITDA growth (%)	23.7	61.8	6.75	12.4	6.57	28.8	8.98	9.84	110.9	-5.83	23.9
EBIT growth (%)	25.2	68.4	6.35	12.1	6.05	29.8	8.85	9.95	166.6	-11.4	20.9
Normalised EPS growth (%)	32.4	74.1	10.8	15.3	8.62	32.2	10.9	11.2	83.2	-7.16	18.3
EBITDA margin (%)	13.9	17.4	15.3	15.4	15.1	20.0	19.2	18.8	13.5	10.7	11.4
EBIT margin (%)	12.4	16.2	14.2	14.3	13.9	19.1	18.3	18.0	10.8	8.02	8.34
Net profit margin (%)	10.4	14.1	12.8	13.3	13.2	14.8	14.4	14.3	8.63	6.75	6.87
Return on avg assets (%)	19.7	33.5	31.4	27.3	23.4	25.8	23.6	22.2	14.7	10.9	11.3
Return on avg equity (%)	37.8	61.4	57.4	46.9	38.6	66.7	51.5	43.0	24.3	18.6	18.6
ROIC (%)	201.6	466.3	327.5	296.2	337.2	212.3	167.8	113.9	38.5	30.4	27.3
ROIC - WACC (%)	188.4	453.0	314.3	283.0	324.0	197.8	153.3	99.4	25.3	17.2	14.0
					year to Mar			year to Mar			year to Mar

Valuation	Hero Honda FY09A	FY10A	FY11F	FY12F	FY13F	Bajaj Auto FY11F	FY12F	FY13F	Maruti Suzuki India FY10F	FY11F	FY12F
EV/sales (x)	2.65	2.09	1.64	1.38	1.18	2.34	2.02	1.74	1.19	1.00	0.86
EV/EBITDA (x)	19.1	12.0	10.7	8.95	7.85	11.7	10.5	9.25	8.75	9.28	7.48
EV/EBITDA @ tgt price (x)	22.7	14.2	12.8	10.8	9.58	8.91	7.95	6.91	7.43	7.88	6.35
EV/EBIT (x)	21.3	12.9	11.6	9.68	8.52	12.3	11.0	9.69	11.0	12.4	10.3
EV/invested capital (x)	74.9	49.0	37.5	37.5	31.3	28.6	17.3	13.3	5.73	4.24	3.23
Price/book value (x)	9.51	10.4	7.02	5.15	3.99	9.45	6.87	5.27	3.50	2.95	2.49
Equity FCF yield (%)	3.91	5.55	6.43	8.09	8.36	5.14	4.61	5.98	4.88	0.92	1.00
Normalised PE (x)	28.2	16.2	14.6	12.7	11.7	17.1	15.4	13.9	16.0	17.2	14.5
Norm PE @tgt price (x)	33.0	18.9	17.1	14.8	13.6	13.3	12.0	10.8	13.9	15.0	12.7
Dividend yield (%)	1.11	6.08	1.88	2.32	2.54	1.89	2.14	2.40	0.42	0.42	0.58
					year to Mar			year to Mar			year to Mar

Per share data	FY09A	FY10A	FY11F	FY12F	FY13F
Tot adj dil sh, ave (m)	199.7	199.7	199.7	199.7	199.7
Reported EPS (INR)	64.2	111.8	123.9	142.8	155.1
Normalised EPS (INR)	64.2	111.8	123.9	142.8	155.1
Dividend per share (INR)	20.0	110.0	34.0	42.0	46.0
Equity FCF per share (INR)	70.7	100.3	116.3	146.4	151.3
Book value per sh (INR)	190.3	173.5	257.7	351.6	453.1
					year to Mar

Solvency	FY09A	FY10A	FY11F	FY12F	FY13F
Net debt to equity (%)	-92.3	-85.0	-87.0	-91.4	-92.5
Net debt to tot ass (%)	-57.8	-48.7	-55.4	-62.8	-66.4
Net debt to EBITDA	-2.05	-1.06	-1.52	-1.93	-2.37
Current ratio (x)	2.13	1.81	2.28	2.76	3.14
Operating CF int cov (x)	-7.72	-10.5	-9.43	-8.19	-7.00
Dividend cover (x)	2.74	0.87	3.12	2.92	2.89
					year to Mar

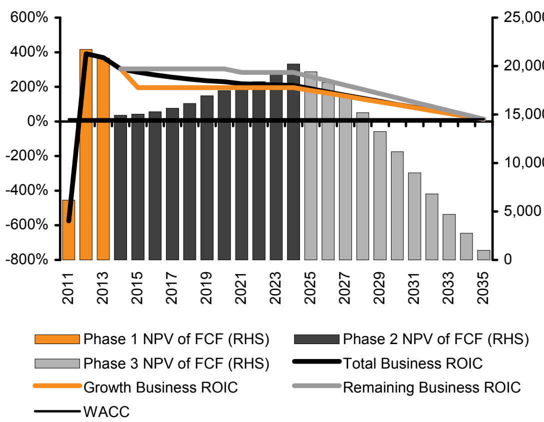
Priced as follows: HROH.BO - Rs1809.05; BAJA.BO - Rs1458.40; MRTI.BO - Rs1413.10
Source: Company data, RBS forecasts

Valuation methodology

Economic Profit Valuation	Rs m	%
Adjusted Opening Invested Capital	953.4	0
NPV of Economic Profit During Explicit Period	53781.6	15
NPV of Econ Profit of Remaining Business (1, 2)	112041.7	31
NPV of Econ Profit of Net Inv (Grth Business) (1, 3)	197711.7	54
Enterprise Value	364488.4	100
Plus: Other Assets	0.0	0
Less: Minorities	0.0	0
Less: Net Debt (as at 22 Sep 2010)	-57668.9	-16
Equity Value	422157.3	116
No. Shares (millions)	199.5	
Per Share Equity Value	**2116.08**	
Current Share Price	1809.05	

Discounted Cash Flow Valuation	Rs m	%
Value of Phase 1: Explicit (2011 to 2013)	48750.8	13
Value of Phase 2: Value Driver (2014 to 2024)	186952.0	51
Value of Phase 3: Fade (2025 to 2035)	118433.2	32
Terminal Value	10346.2	3
Enterprise Value	364482.3	100
FCF Grth Rate at end of Phs 1 implied by DCF Valuation		5.8
FCF Grth Rate at end of Phs 1 implied by Current Price		4.3

Returns, WACC and NPV of Free Cash Flow



Sensitivity Table

		No of Years in Fade Period				
		15	18	20	23	25
WACC	10.8%	2887.57	3200.34	3423.19	3780.65	4035.44
	11.8%	2610.05	2861.37	3037.94	3317.21	3513.54
	12.8%	2372.14	2574.68	2715.07	2934.12	3086.08
	13.8%	2167.37	2331.09	2443.08	2615.57	2733.71
	14.8%	1990.43	2123.15	2212.78	2349.14	2441.38

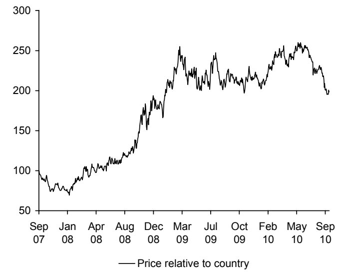
Performance Summary	2011	2012	2013	Phase 2 Avg (2014 - 2024)
Invested Capital Growth (%)	-264.2	12.5	4.6	20.9
Operating Margin (%)	14.2	14.3	13.9	14.6
Capital Turnover (x)	-49.0	33.2	32.1	27.0

1. In periods following the Explicit Period i.e. Phase 2 and Phase 3
2. Remaining Business is defined as Capital as at the end of Phase 1 and capex = depreciation thereafter
3. Net Investment is defined as capex over and above depreciation after Phase 1
Source: Company data, RBS forecasts

Company description — Buy

Hero Honda is the largest Indian two-wheeler company with an overall market share of 48%. The company is a joint venture between India's Hero Group, run by the Munjals, and Honda of Japan. While the Munjals concentrate on the day-to-day management of operations, Honda provides technology support. Hero Honda focused only on motorcycles until now, but it has recently entered the high-growth scooter segment. With the lauch of a third plant in a tax-haven state, the company plans to continue its volume momentum trend through its widespread rural network.

Price relative to country



Strategic analysis — Average SWOT company score: 3

Strengths — 4

Hero Honda has the largest customer base in the Indian two-wheeler industry and enjoys strong customer goodwill. We believe this is key to it maintaining its leadership status.

Weaknesses — 2

Poor presence in the premium motorcycle segment is an apparent weakness for Hero Honda, as is its dependence upon Honda Japan for new models.

Opportunities — 2

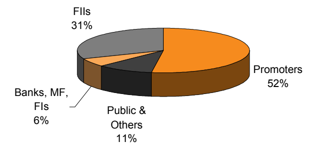
An extended product portfolio and new plant capacity should help the company build on its leadership position. Entry into the scooter market should help it leverage its brand image and customer goodwill.

Threats — 2

Entry of MNCs such as Suzuki and Honda into the Indian motorcycle market is a significant threat to Hero Honda. Tata's mini car (for Rs100,000) could lead to faster upgrades by two-wheeler owners to cars, and thus have an impact on two-wheeler replacement demand.

Scoring range is 1-5 (high score is good)

Shareholding as of June 2010



Source : Company data

Market data

Headquarters
34, Community Centre, Basant Lok, Vasant Vihar, New Delhi.110057

Website
www.herohonda.com

Shares in issue
199.7m

Freefloat
48%

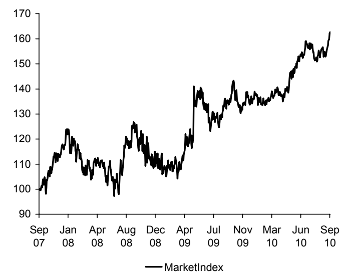
Majority shareholders
Copthall (4%), Aberdeen (2%), Europacifio Growth (2%)

Country view: India

The macro picture for India has been constructive recently, with GDP and industrial production tracking in line with expectations, while portfolio allocators continue to favour the market for its domestic consumption orientation. However, these positives have already been priced in and we believe risks are rising from the increasing double deficit, demanding valuations and tightening liquidity.

The country view is set in consultation with the relevant company analyst but is the ultimate responsibility of the Strategy Team.

Country rel to Asia Pacific



Competitive position — Average competitive score: 2+

Supplier power — 4+

Component suppliers have negligible power as they are highly dependent upon the company. This is one reason why Hero Honda has managed its raw material costs well.

Barriers to entry — 2+

No defendable entry barriers as two-wheeler technology is readily available. Capital cost for product development is also low. But distribution and service network are major barriers to building size.

Customer power — 2-

A low entry barrier has resulted in increasing competition in the sector. As a result, wide choices are available to customers. Also, low differentiation results in poor bargaining power.

Substitute products — 2+

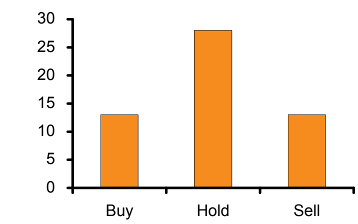
Scooters are motorcycle substitutes. Ungeared scooters in particular, targeted at women and middle-aged men, may take off. Low-cost cars like the Nano and electric two-wheeler are emerging as threats.

Rivalry — 2-

Low product differentiation and very few defensible entry barriers have resulted in intense rivalry in the sector. However, low maintenance cost and sustained product performance build brand value.

Scoring range 1-5 (high score is good) Plus = getting better Minus = getting worse

Broker recommendations



Source : Bloomberg

Global disclaimer