

## Company Flash

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# Hero Honda (HROH.BO)

## 2Q Results: Uphill Climb as Margins Slide

- **2Q PAT declined 9%** — On the back of a 15% decline in EBITDA. The net profit was about 8% below our expectations – the variance due to higher-than-expected margin contraction on rising promotional costs.
- **Margins contract** — Operating margins declined by 270bps YoY and 80bps sequentially. This decline was due to a) the strong raw material cycle, b) continued promotional expenses, and c) escalating royalty payments. Lack of operating leverage has also rendered HROH's margins susceptible to fluctuations in material costs and SGA expenses.
- **New product launches** — Management had announced its intent to launch 8 new products this fiscal. Thus far, it has launched four variants of its current product portfolio. HROH's market share continues to decline (2Q market share at c.42% - down 800 bps YoY) as competition within the key executive segment intensifies.
- **Reiterate Sell/Low Risk (3L)** – Despite valuations moderating over the last few months (stock has corrected c.15%), we reiterate our Sell/Low Risk recommendation, in the absence of re-rating triggers. Near to medium-term competitive environment will remain challenging, given the new models being launched by players.
- **Key upside risks** – successful launch of models in 2HFY07 that stem market share losses and enable HROH to regain pricing power

<b>Sell/Low Risk</b>	<b>3L</b>
Price (23 Oct 06)	Rs749.30
Target price	Rs612.00
Expected share price return	-18.3%
Expected dividend yield	3.1%
<b>Expected total return</b>	<b>-15.3%</b>
Market Cap	Rs149,626M US\$3,310M

Figure 1. Statistical Abstract

Year to	Net Profit	EPS	EPS Growth	P/E	Price / CF	EV / EBITDA	P / Book	ROE	ROCE	DPS	Div. Yield
	(Rs mills)	(Rs)	(%)	(x)	(x)	(x)	(x)	(%)	(%)	(Rs)	(%)
31-Mar											
2004	7,283	36.5	25.4	20.5	18.6	13.1	13.1	72.8	93.1	20.0	2.7
2005	8,105	40.6	11.3	18.4	16.6	11.6	9.9	61.4	80.9	20.0	2.7
2006P	9,331	46.7	15.1	16.0	14.5	10.2	7.8	54.6	72.4	23.0	3.1
2007E	10,570	52.9	13.3	14.1	12.7	9.1	6.2	48.8	65.0	25.0	3.4
2008E	12,782	64.0	20.9	11.7	10.5	7.5	4.9	47.1	63.6	30.0	4.0

Source: Company Reports and Citigroup Investment Research

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Figure 2. 2Q07 – Operational Results

Hero Honda	2Q FY06	2Q FY07	% chg	CIR Comments
Two Wheelers (Nos)	742,425	751,967	1.3	Weak volume growth - reflects jaded product portfolio, intensifying competition, inventory pile up in dealer channel. Motorcycle sales decline by c2%.
Average realization (Rs/bike)	29,178	29,655	1.6	Slight rise in average realisations reflects shift to higher realization 125cc products
Market share (Motorcycles, %)	49.8	41.8		Intensifying competition in core 100cc segment has resulted in 800bps decline in market share
Market share (2 wheelers, %)	40.7	36.1		

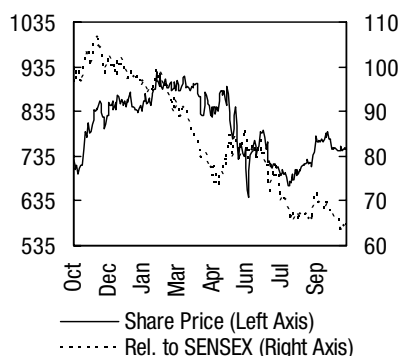
Source: Company Reports and Citigroup Investment Research

Figure 3. 2QFY07 Results

Hero Honda	2Q FY06 (Rs m)	2Q FY07 (Rs m)	% chg YoY	Citigroup Investment Research comments
Net sales	21,663	22,300	2.9	
Decrease/(Increase) in Stocks	(272)	(818)	201.0	
Raw Materials	15,341	16,657	8.6	Higher raw material costs - in line with our forecasts - reflect a change in product mix and strong raw materials costs (steel, aluminum, rubber)
Staff costs	814	848	4.1	
Other Expenses	2,443	2,778	13.7	Higher than estimated - impact of promotional activities greater than anticipated
Total Expenditure	18,327	19,465	6.2	
EBITDA	3,336	2,835	-15.0	Margins decline by 270bps - 140bps below our expectations, on account of higher S&D / promotional activities
Interest	(8)	(65)	680.7	
Other income	431	595	38.0	Robust rise - given the substantial cash and investment surpluses and rising interest rate environment
EBDT	3,775	3,495	-7.4	
Depreciation	267	344	28.9	Reflects capital investments on capacity expansion during last year.
PBT	3,508	3,151	-10.2	
Tax	1,129	991	-12.2	
PAT	2,379	2,160	-9.2	
<b>PAT (pre exceptionals)</b>	<b>2,379</b>	<b>2,160</b>	<b>-9.2</b>	8% below our estimates
<b>Ratios</b>				
EBITDA (%)	15.4	12.7		
Other income / EBDIT (%)	11.4	17.3		
EBIT (%)	14.2	11.2		
Pre tax margins (%)	16.2	14.1		
Tax / PBT (%)	32.2	31.5		
Net profit margins (%)	11.0	9.7		
<b>Cost ratios (%)</b>				
Raw materials / sales	69.6	71.0		
Staff costs / sales	3.8	3.8		
Other expenses / sales	11.3	12.5		
EPS (Rs)	11.9	10.8		

Source: Company Reports, Citigroup Investment Research

Figure 4. Price Performance Chart



Source: Datastream

Figure 5. Price Performance (%)

	3M	6M	12M
Absolute	5.3	-11.6	3.2
Relative	-14.8	-16.6	-35.3

Source: Datastream

## 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 Thesis

We have a Sell/Low Risk (3L) rating on Hero Honda. Our earnings estimates factor in a healthy growth outlook for the two-wheelers industry. However, competitive pressures remain intense and are expected to increase with the likely entry of new manufacturers. The rising trend in input costs and changing product mix could also mute margin expansion. We believe the current valuations largely factor in the forecast earnings growth, and further re-rating may not be justified against the backdrop of pressure on both market share and profit margins.

### Valuation

Our target price is Rs612 based on a target multiple of 12x FY07E forward earnings - at the high end of the recent trading band to factor in the robust volume growth potential. A 14% CAGR in earnings for FY05-07E should support these valuations. At our target price, the stock would trade at about 10x FY07E P/CEPS and 7.5x FY07E EV/EBITDA - the mid-point of the recent trading band. We use the P/E valuation metric to value Hero Honda given its high level of cash generation, reflecting its strong balance sheet. Given the large increase in capex, investor attention may focus on P/CEPS and EV/EBITDA valuations.

### Risks

We rate Hero Honda Low Risk based on our quantitative risk-rating system. The key upside risk to our Sell rating and target price is any further strengthening in ties between Honda Motors and Hero Honda. Downside risks include any slowdown in sales as a result of a weak economic environment, competition and higher raw-material costs. If any of these factors has a greater impact than we expect, the stock could have difficulty achieving our target price.

## Analyst Certification Appendix A-1

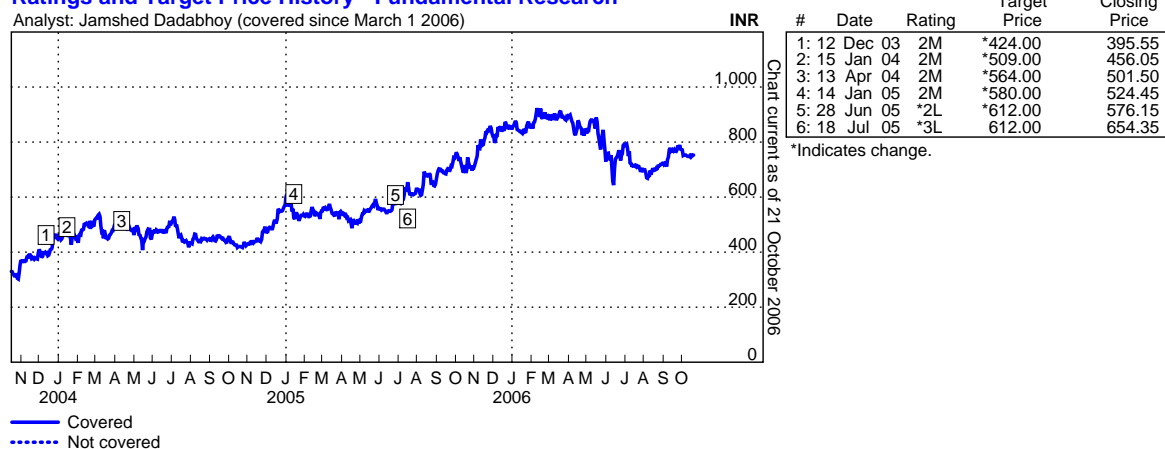
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Analyst: Jamshed Dadabhoy (covered since March 1 2006)



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