

Hero Honda Motors

Rs705
NEUTRAL

RESULT NOTE

Mkt Cap: Rs140.7bn; US\$3.4bn

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Result: Q4FY07

Comment: Margin pressure continues

Last report: 31 January 2007 (Price Rs716; Recommendation: Neutral)

Key valuation metrics*

Year to March 31 (Rs m)	Net sales	yoy chg (%)	Net profit	EPS (Rs)	yoy chg (%)	PER (x)	EV/E (x)
2006	87,140	17.4	9,713	48.7	20.0	14.5	9.1
2007E	99,000	13.6	8,579	43.0	(11.7)	16.4	10.5
2008E	109,885	11.0	8,926	44.7	4.0	15.8	10.0
2009E	121,336	10.4	10,625	53.3	19.0	13.2	8.1

* - prices as on closing of Friday, May 11th 2007

Hero Honda's Q4FY07 revenues were in line with our expectations although operating margins and PAT were below expectations. Net sales grew by 17.0% yoy to Rs26.4bn, on the back of 12.1% yoy growth in volumes to 866,247 units. Operating margins were lower by 590bps yoy and 110bps qoq at 10.2% primarily due to higher input costs and huge marketing and sales promotion expenses – the company offered free holiday/world cup tickets on its Executive segment motorcycles during the quarter. Operating profit declined by 26% yoy to Rs2.69bn and net profit declined by 27% yoy to Rs1.95bn against our expectation of Rs2.05bn.

We have lowered our revenue estimates by 2% for FY08 on the back of a similar cut in volume estimates. We have also lowered our margin estimates by ~150bps for FY08 leading to a downgrade of 15% in our FY08 earnings estimates. We, however, expect a partial recovery in operating margins in FY09 as we expect the industry to exhibit improved pricing discipline over this period. We have introduced our FY09 estimates and expect 10.7% revenue CAGR and 11.3% earnings CAGR for Hero Honda over FY07-09 led by 9% volume CAGR over the same period. The stock currently trades at EV/EBITDA of 8.0x and P/E of 13.1x FY09 estimates. Hero Honda's market share has recovered to 55% in April-07 vis-à-vis its low of 42% in Sept-06 (albeit with margins coming under pressure). Given the company's huge rural penetration, strong brand image, recent market share gains and the leadership position that it enjoys, we maintain our NEUTRAL rating on the stock.

KEY RESULT HIGHLIGHTS

□ Net sales grow by 17%yoy to Rs26.4bn – in line

Hero Honda's Q4FY07 revenues were in line with our expectations. Net sales grew by 17% yoy to Rs26.4bn on the back of 12.1% yoy growth in volumes at 866,247 units. Volume growth for the quarter was driven by discounts and freebies offered by the company during the quarter – free holidays/tickets for the World Cup on purchase of executive segment motorcycles. Average realizations for the quarter grew by 2.4% on a qoq basis aided mainly by the success of the company's new premium segment motorcycle *CBZ Xtreme*.

❑ EBITDA margin at 10.2%, lower by 590bps yoy, 110bps qoq – below expectations

The company's operating margins were lower than our expectations by 80bps. Margins declined by 590bps yoy and 110bps qoq to 10.2% impacted mainly by higher raw material costs and higher marketing & sales promotion expenditure - the company offered free holiday/world cup tickets on its Executive segment motorcycles during the quarter. As a result, operating profit for the quarter declined by 26%yoy to Rs2.69bn.

❑ Net profit lower by 27%yoy at Rs1.95bn

In line with the fall in operating profits, the company's net profit declined by 27% yoy to Rs1.95bn as against our estimate of Rs2.05bn. While the other income for the quarter grew by 3.4% yoy to Rs445m, the effective tax rate for the quarter stood at 31.7% against 31.1% in Q3FY07 and 29.6% in Q4FY06.

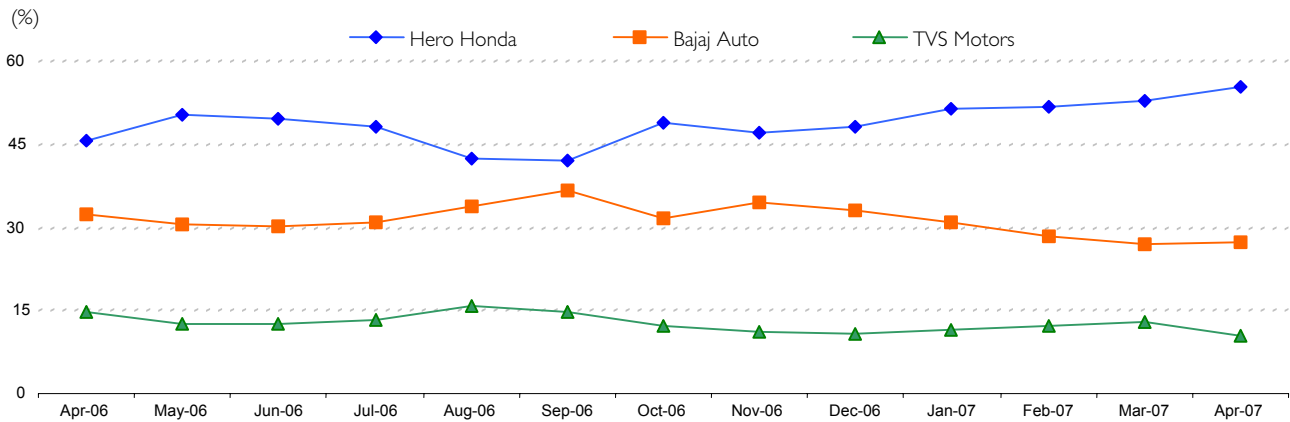
❑ Net sales grow by 13.2% to Rs98.7bn, net profit declines by 10.5% to Rs8.7bn in FY07

Hero Honda's FY07 net sales grew by 13.2% to Rs98.7bn on the back of 10.7% growth in volumes to 3.34m units. The company's motorcycle volumes grew by 8.1% to 3.24m units, while sales of its scooter, launched in end FY06, grew from 15,015 units in FY06 to 92,977 units in FY07. The company's operating margins were impacted by higher raw materials costs and higher discounts & sales promotion costs in the wake of increased competitive intensity in the industry. Hero Honda's FY07 net profit before extraordinary items declined by 10.5% to Rs8.7bn. The company declared a dividend of 850% for FY07, lower than the dividend of 1000% in FY06.

❑ Gaining market share but at the cost of margins

Over the last few months Hero Honda has posted smart market share gains in the domestic market. Its market share which had dipped to a low of 42% in Sept-06 has recovered to 55% in April-07 with Bajaj Auto ceding market share gains to the leader. The increase in market share for Hero Honda has been on the back of various sales promotion schemes and price discounts offered by the company over the last six months. Further, the company has also benefited from the success of new launches in the premium segment (*CBZ Xtreme*) leading to ~40% volume growth in the premium segment, which accounts for ~15% of sales for Hero Honda at present.

Hero Honda with its aggressive discounting has seen a market share recovery



Source: SIAM, SSKI Research

□ Valuations and view – Maintain Neutral

We have lowered our revenue estimates by 2% for FY08 on the back of a similar cut in volume estimates. We have also lowered our margin estimates by ~150bps for FY08 leading to a downgrade of 15% in our FY08 earnings estimates. We, however, expect a partial recovery in operating margins in FY09 as we expect the industry to exhibit improved pricing discipline over this period. We have introduced our FY09 estimates and expect 10.7% revenue CAGR and 11.3% earnings CAGR for Hero Honda over FY07-09 led by 9% volume CAGR over the same period. The stock currently trades at EV/EBITDA of 8.0x and P/E of 13.1x FY09 estimates. Hero Honda's market share has recovered to 55% in April-07 vis-à-vis its low of 42% in Sept-06 (albeit with margins coming under pressure). Given the company's huge rural penetration, strong brand image, recent market share gains and the leadership position that it enjoys, we maintain our NEUTRAL rating on the stock.

Quarterly results

Year to 31 March (Rs m)	Q4FY06	FY2006	Q1 FY07	Q2 FY07	Q3 FY07	Q4 FY07	FY07
Sales	22,559	87,140	23,644	22,300	26,661	26,396	99,000
<i>yoy chg (%)</i>	16.3	17.4	19.6	2.9	15.2	17.0	13.6
Operating profit	3,632	13,645	3,190	2,835	3,019	2,687	11,730
<i>yoy chg (%)</i>	23.9	17.2	9.1	(15.0)	(20.1)	(26.0)	(14.0)
Other income	430	1,563	523	595	336	445	1,899
Interest	(39)	(61)	(33)	(65)	(55)	(77)	(230)
Depreciation	305	1,146	323	344	376	355	1,398
PBT and extraordinary items	3,797	14,122	3,423	3,151	3,034	2,854	12,460
Extraordinary items	-	-	-	-	-	-	-
PBT	3,797	14,122	3,423	3,151	3,034	2,854	12,460
Tax	1,125	4,409	1,045	991	943	904	3,881
PAT	2,672	9,713	2,377	2,160	2,092	1,950	8,579
<i>yoy chg (%)</i>	29.0	19.8	16.3	(9.2)	(20.1)	(27.0)	(11.7)
Cash profit	2,977	10,860	2,700	2,504	2,468	2,305	9,977
OPM (%)	16.1	15.7	13.5	12.7	11.3	10.2	11.8
NPM (%)	11.8	11.1	10.1	9.7	7.8	7.4	8.7
Other income/PBT (%)	11.3	11.1	15.3	18.9	11.1	15.6	15.2
Outstanding shares (m)	199.7	199.7	199.7	199.7	199.7	199.7	199.7
EPS (Rs)	13.4	48.7	11.9	10.8	10.5	9.8	43.0
Cash EPS (Rs)	14.9	54.4	13.5	12.5	12.4	11.5	50.0
PER (x)		14.5					16.4
P/CEPS (x)		12.9					14.1

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2. Neutral: Within 0-10% to Index
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