

## Company Flash

31 January 2008 | 7 pages

# Hero Honda (HROH.BO)

 Results 

## Sell: Good Results, Challenging Growth Outlook

- Strong 3Q08 results** — Recurring PAT at Rs2.75bn, +31% Y/Y, was 20% ahead of our and consensus estimates. Earnings quality was good – driven by a strong operating performance as EBITDA margins expanded (13.9%, +260bps Y/Y, +150bps Q/Q). The improvement was driven by a richer product mix, control over discounts and also lower material costs (zinc, aluminium).
- Higher realization product mix** — Average realizations rose ~3%/y (-1.3%q/q) as Hero Honda's product mix improved (management indicated that the low margin economy bikes are now ~9% of sales). Material cost pressures eased substantially – down ~0.6%Y/Y and ~3% sequentially as non ferrous metals (zinc and aluminium) continue to decline. Other expenses also declined substantially – discounts were sharply lower over the Q, and contrary to expectations, advertising and launch expenses for the Hunk were also not very high.
- Volume outlook muted, Reiterate Sell (3L)** — Overall volume growth (near and medium term) is forecast at ~5-7%. While discounts have abated at present, we believe that negative/static growth could spur more discounts from competition. Key upside risks are: a) shift in product mix to higher realization products; b) any corporate action that further strengthens the existing relationship between Honda Motors and Hero Honda.

<b>Sell/Low Risk</b>	<b>3L</b>
Price (31 Jan 08)	Rs676.95
Target price	Rs670.00
Expected share price return	-1.0%
Expected dividend yield	2.7%
<b>Expected total return</b>	<b>1.6%</b>
Market Cap	Rs135,178M US\$3,440M

### 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)	(%)	(%)
2006A	9,713	48.64	19.8	13.9	6.7	55.5	3.0
2007A	8,579	42.96	-11.7	15.8	5.5	38.3	2.5
2008E	8,793	44.03	2.5	15.4	4.6	32.6	2.7
2009E	10,292	51.54	17.0	13.1	3.9	32.0	3.0
2010E	12,105	60.62	17.6	11.2	3.2	31.5	3.2

Source: Powered by dataCentral

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Figure 1. Hero Honda – Operational Statistics

	3QFY07	3QFY08	% YoY chg Comments
Motorcycles (Nos)	896,113	893,581	(0.3) Flat growth – industry conditions remain challenging – banks continue to curtail credit to the sector
Average realization (Rs/bike)	29,751	30,697	3.2 Reflects shift to richer product mix – for 9MFY08, premium and executive bikes are 78% of sales. Realisations decline c1.3% Q/Q, reflecting some elements of discounting on CD Deluxe
Market share (Motorcycles %)	45.9	47.1	Captures market share from TVS Motor, Bajaj Auto

Source: SIAM, Company

Figure 2. Hero Honda – 3QFY08 Results

	3QFY07	3QFY08	% YoY chg Comments
<b>Net sales</b>	<b>26,661</b>	<b>27,431</b>	<b>2.9</b> Sales growth driven by the shift to higher realization executive and premium bikes, pricing remains constrained in the industry.
Decrease/(Increase) in Stocks	873	1,072	22.7
Raw Materials	18,756	18,377	(2.0) Material costs / bike decline by 0.6% - aluminum, zinc prices decline. Steel remains an area of concern
Staff costs	917	1,010	10.1 Reflects manpower recruitment at Haridwar
Other Expenses	3,095	3,146	1.6 Limited discounts - offered only on the CD Deluxe. Also commendable, given advertising outlay on Hunk
Total Expenditure	23,641	23,605	(0.2)
<b>EBITDA</b>	<b>3,019</b>	<b>3,826</b>	<b>26.7 Robust performance – 20% ahead of expectations</b>
Interest	(56)	(87)	55.5
Other income	336	521	55.2 ~30% ahead of forecasts
EBDT	3,411	4,434	30.0
Depreciation	376	408	8.6
Exceptionals			
Tax	943	1,276	35.3
<b>PAT</b>	<b>2,092</b>	<b>2,750</b>	<b>31.4 20% ahead of estimates</b>
<b>Profit Margins</b>			
<b>EBITDA</b>	<b>11.3</b>	<b>13.9</b>	170 bps ahead of expectations
EBIT (%)	9.9	12.5	
Pre tax margins (%)	11.4	14.7	
Tax / PBT (%)	31.1	31.7	
Net profit margins (%)	7.8	10.0	

Source: Company, Citi Investment Research

Figure 3. Hero Honda – Cost Profile – 3QFY08

	3QFY07 Rs	3QFY08 Rs	% YoY chg Comments
Contribution / bike	7,847	8,932	13.8 Rising proportion of 125 / 150cc bikes
Contribution margin (%)	26.4	29.1	On a sequentially rising trend
Material costs / bike	21,905	21,766	(0.6) Decline reflects fall in aluminium, zinc prices, down 3% q/q
Other expenses / bike	3,454	3,520	1.9 Almost in line with 2Q – declining discounts offset by rising royalty, advertising for the Hunk
Staff costs / bike	1,024	1,130	10.4

Source: Citi Investment Research

# 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 Sell /Low Risk (3L) with a Rs670 target price. Our earnings estimates, we believe, factor in the strong growth outlook for the two-wheeler industry. We remain positive on growth prospects over the medium term. The easy availability of finance and lack of adequate public transportation remain structural growth drivers, and economic growth is expected to remain robust. However, competitive pressure remains intense and we expect it to accelerate as the three large two-wheeler majors struggle to maintain and improve market share. Moreover, new model launches from fringe players such as Suzuki, HMSI and Yamaha will also likely exacerbate competitive pressures. These pressures, coupled with escalating raw material prices, should adversely affect margins (and consequently earnings) over the medium term. The changing product mix (toward lower-margin bikes) could also mute margin expansion. We believe current valuations largely factor in the forecast earnings growth and further re-rating may not be justified against the backdrop of market share and margin pressures.

## Valuation

Our target price of Rs670 is based on 13x FY09E forward earnings, which is at the low end of the recent band. Hero Honda has traded at an average of almost 16x over the past fiscal. But, given our view that competitive pressures will only accelerate over the medium term, we see no rationale in revising the multiple to higher levels. A 12% CAGR in earnings over FY07-10E should, we believe, support these valuations. 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 (more than Rs20bn in cash and a substantial payout). Given the substantial increase in capital expenditure planned, we believe investor attention could focus on P/CEPS and EV/EBITDA-based valuations as well. At current valuations, Hero Honda trades at a discount to the BSE Sensex. We believe the discount is justified given the lower earnings growth forecast – we estimate a CAGR of 15% in earnings over FY07-10E for the BSE Sensex vs 12% for Hero Honda.

## Risks

We rate Hero Honda Low Risk according to our quantitative risk rating system, which tracks 260-day historical share price volatility. The key upside risks to our target price and Sell rating on the stock are: 1) Any corporate action that further strengthens the relationship between Honda Motors and Hero Honda from current levels; 2) Any meaningful and sustained improvement in

profitability, driven by a beneficial shift in the product mix; and 3) Faster-than-anticipated growth in the sector as a whole, which could ease market share concerns for Hero Honda.

# Appendix A-1

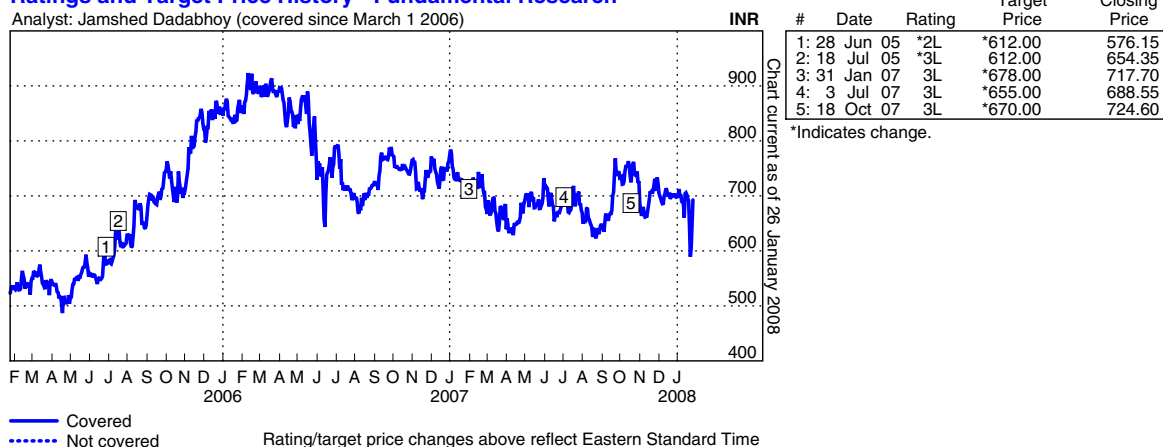
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Analyst: Jamshed Dadabhoy (covered since March 1 2006)



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