

COMPANY

UPDATE 

# Hero Honda Motors Ltd.

Hero-Honda split: Concerns overdone...

NOT RATED

## Analyst

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Nifty: 5,479; Sensex: 18,221

CMP Rs1,736

## Key Stock Data

Sector	Automobiles
Bloomberg / Reuters HH IN / HROH.BO	
Shares o/s (mn)	199.7
Market cap (Rs. mn)	346,679
Market cap (US\$ mn)	7,459
3-m daily average vol.	63,044

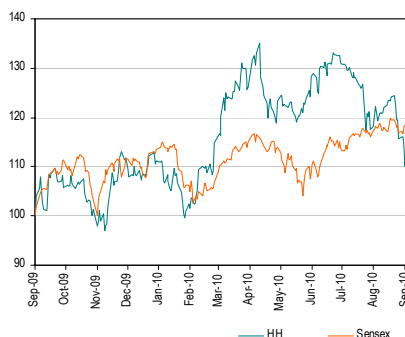
## Price Performance

52-week high/low	Rs2,094/1,452		
	-1m	-3m	-12m
Absolute (%)	(7)	(13)	12
Rel to Sensex (%)	(7)	(20)	(6)

## Shareholding Pattern (%)

Promoters	52.2
FII/NRI/OCBs/GDR	31.3
MFs/Banks/FIs	6.0
Non Promoter Corporate	1.4
Public & Others	9.1

## Stock vs Relative to Sensex



Source: Capitaline

## Background

Talks have been doing rounds of Honda looking to sell its 26% stake in Hero Honda Motors Ltd. (HH) and focus all its energies on its wholly owned subsidiary Honda Motorcycles and Scooters India Ltd. (HMSI). The deal size based on current market cap is likely to be ~Rs80 bn for 26% stake and media speculation indicates it to be funded by Munjal family in consortium with private equity player(s). We have tried to analyse the pros and cons for both HH and Honda if the split happens.

## Hero Honda

### Pros:

- Opening up of export markets for HH as at present it can't export its products to markets where Honda has presence.
- Munjals will have exclusive control over one of the most profitable 2-w player, if they decide to buy Honda's stake in HH.

### Cons:

- No access to Honda's superior technology, especially considering not too much is known of HH's in-house R&D capabilities and hence doubts remain over their future product pipeline. There could also be an arrangement between two parties to share technology, where HH could end up paying higher royalty or Honda could have access to HH's wide distribution network in lieu of its technology.
- The split could result in HH shelling out lot more on R&D and new product development and it could also result in longer time frame to develop and launch products. This could impact future cash flows and balance sheet profile and hence credit rating and investor perception. However, we believe Rs52 bn net cash as on March 2010 to be sufficient to fund its R&D and product development activities.

## Honda Motors

### Pros:

- Increased presence in the world's fastest growing 2-w market through focus on HMSI.
- Strong likelihood of more new products being available to HMSI.
- Should result in increased market share for HMSI.

### Cons:

- HH is very cost efficient (lowest fixed cost as % of sales among all auto OEMs, barring BJAUT) and it will be difficult to replicate the same by HMSI.
- HH's strong distribution network may no longer be available to Honda especially in fast growing rural areas.

## Our view

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The split is not as straightforward and simple as it seems. Both partners have benefited immensely from the association for over two decades – Hero Group with advanced technology and Honda with strong distribution network. It is also pertinent to note that both managements have categorically denied any possibility of such a split.

If the split does take place, no doubt it will be worrying at least in the near term. However, we believe that concerns on Hero Group's future if Honda exits are overdone on the technology aspect led by the following:

1. HH's technological tie up with Honda will come up for renewal only by 2014 and hence Hero Group has three years to plug the technology gap. The fact that both peers – BJAUT and TVSL – have moved up the indigenous product development chain commendably in the last 3-4 years, underlines the fact that if it desires, then HH (sans Honda) could plug the technological gap, especially considering that HH would have already learnt a lot from Honda's R&D capabilities.
2. In case if they fail in developing products at a desired pace and of desired quality, HH still boasts of strong distribution network, existing well entrenched brands (Splendor and Passion have been dominant for the past 10 years) and profitable leadership. We believe it won't be easy to eradicate their presence, which in turn could attract other foreign players looking to strengthen their presence in the fast growing Indian 2-w market to enter into a tie-up with HH. This in turn could also mean lower royalty outgo compared to Honda (currently ~ 3% of net sales).
3. Moreover, the genes of the Hero Group promoters – Munjals – is largely auto/auto ancillaries (Munjal Auto, Munjal Showa, Hero Cycles, Majestic Auto are all in the related space of transportation) and hence Hero Group understands this business well and has strong brand recall in the consumer mind.
4. The distribution network, employees, production facilities and processes have evolved within the company and they will remain with them.

We believe that valuation at 13x FY12E (BJAUT trades at 16x FY12E) reflects the split led concerns partly (HH has corrected more than 15% from its recent peak). Any further correction in our view, would provide an opportunity for investors to take advantage of these overdone concerns. At this juncture, the risk reward is favourably shifting towards HH.

## Financial Summary

### Profit & Loss Account

(Rs mn)

Year-end: March	FY09	FY10	FY11E	FY12E
<b>Net sales</b>	<b>123,191</b>	<b>158,312</b>	<b>181,749</b>	<b>207,220</b>
Growth (%)	19.2	28.5	14.8	14.0
Operating expenses	-105,901	-130,643	-153,416	-174,871
<b>EBITDA</b>	<b>17,291</b>	<b>27,670</b>	<b>28,333</b>	<b>32,349</b>
Growth (%)	24.9	54.0	2.4	13.4
Depreciation	-1,807	-1,915	-2,182	-2,418
<b>EBIT</b>	<b>15,484</b>	<b>25,755</b>	<b>26,151</b>	<b>29,931</b>
Interest paid	-25	-30	-30	-30
Other income	2,356	2,592	2,648	2,785
<b>Pre-tax profit</b>	<b>17,815</b>	<b>28,317</b>	<b>28,769</b>	<b>32,686</b>
Tax	-4,997	-5,999	-5,754	-6,537
Effective tax rate (%)	28	21	20	20
<b>Net profit</b>	<b>12,818</b>	<b>22,318</b>	<b>23,015</b>	<b>26,149</b>
<b>Adjusted net profit</b>	<b>12,818</b>	<b>22,318</b>	<b>23,015</b>	<b>26,149</b>
Growth (%)	32.6	74.1	3.1	13.6
Shares o/s (mn)	199.7	199.7	199.7	199.7

### Balance Sheet

(Rs mn)

Year-end: March	FY09	FY10	FY11E	FY12E
Net fixed assets	16,942	15,501	16,119	15,501
Investments	33,688	36,403	41,403	41,403
Other non-curr assets	87	87	87	87
<b>Current assets</b>	<b>10,024</b>	<b>28,829</b>	<b>23,160</b>	<b>45,501</b>
Inventories	3,268	4,771	5,477	6,245
Sundry Debtors	1,499	6,072	6,971	7,948
Cash and Bank	2,196	15,421	8,606	29,199
Loans and advances	3,060	2,565	2,105	2,108
<b>Total assets</b>	<b>60,740</b>	<b>80,820</b>	<b>80,769</b>	<b>102,492</b>
<b>Shareholders' funds</b>	<b>38,008</b>	<b>34,865</b>	<b>50,871</b>	<b>70,011</b>
Share capital	399	399	399	399
Reserves & surplus	37,608	34,466	50,472	69,611
<b>Total Debt</b>	<b>785</b>	<b>185</b>	<b>185</b>	<b>185</b>
Secured loans	-	-	-	-
Unsecured loans	785	185	185	185
Other liabilities	2,316	1,866	2,016	2,166
<b>Curr Liab &amp; prov</b>	<b>20,417</b>	<b>44,088</b>	<b>27,882</b>	<b>30,315</b>
Current liabilities	19,900	43,572	27,287	29,632
Provisions	517	517	594	683
<b>Total liabilities</b>	<b>22,732</b>	<b>45,954</b>	<b>29,897</b>	<b>32,481</b>
<b>Total equity &amp; liabilities</b>	<b>60,740</b>	<b>80,820</b>	<b>80,769</b>	<b>102,492</b>
<b>Book Value (Rs)</b>	<b>190</b>	<b>175</b>	<b>255</b>	<b>351</b>

### Cash Flow Statement

(Rs mn)

Year-end: March	FY09	FY10	FY11E	FY12E
Pre-tax profit	17,815	28,317	28,769	32,686
Depreciation	1,601	1,915	2,182	2,418
Tax paid	-4,866	-5,818	-5,604	-6,388
Chg in working capital	2,384	-2,726	1,099	687
Other operating activities	0	0	0	0
<b>Cash flow from operations</b>	<b>16,934</b>	<b>21,688</b>	<b>26,445</b>	<b>29,402</b>
Capital expenditure	-3,056	-475	-2,800	-1,800
Chg in investments	-8,019	-2,716	-5,000	0
Other investing activities	0	0	0	0
<b>Cash flow from investing</b>	<b>-11,075</b>	<b>-3,191</b>	<b>-7,800</b>	<b>-1,800</b>
Equity raised/(repaid)	0	0	0	0
Debt raised/(repaid)	-535	-600	0	0
Dividend (incl. tax)	-4,439	-4,673	-25,460	-7,009
Other financing activities	0	0	0	0
<b>Cash flow from financing</b>	<b>-4,974</b>	<b>-5,273</b>	<b>-25,460</b>	<b>-7,009</b>
<b>Net chg in cash</b>	<b>885</b>	<b>13,225</b>	<b>-6,814</b>	<b>20,593</b>

### Financial Ratio

Year-end: March	FY09	FY10	FY11E	FY12E
Adj EPS (Rs)	64.2	111.8	115.2	130.9
Adj EPS growth (%)	32.6	74.1	3.1	13.6
EBITDA margin (%)	14.0	17.5	15.6	15.6
Pre-tax margin (%)	14.5	17.9	15.8	15.8
ROE (%)	37.8	61.3	53.7	43.3
ROCE (%)	48.3	72.6	63.5	51.8
<b>Turnover &amp; Leverage ratios (x)</b>				
Asset turnover (x)	2.2	2.2	2.2	2.3
Leverage factor (x)	1.6	1.9	1.9	1.5
Net margin (%)	10.4	14.1	12.7	12.6
Net Debt/Equity (x)	0.0	-0.4	-0.2	-0.4
<b>Working Capital &amp; Liquidity ratio</b>				
Inventory days	9.7	11.0	11.0	11.0
Receivable days	4.4	14.0	14.0	14.0
Payable days	24.2	36.4	35.5	35.5

### Valuations

Year-end: March	FY09	FY10	FY11E	FY12E
PER (x)	26.6	15.3	14.8	13.1
Price/Book value (x)	9.0	9.8	6.7	4.9
PCE (x)	23.3	14.1	13.5	11.9
EV/Net sales (x)	2.8	2.1	1.8	1.5
EV/EBITDA (x)	17.3	10.8	10.7	8.9
Dividend Yield (%)	1.2	6.4	1.8	1.8



# Notes

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**Key to Ratings****Stocks:**

**Buy:** Absolute return of 15% and above; **Accumulate:** 5% to 15%; **Hold:** Upto  $\pm 5\%$ ; **Reduce:** -5% to -15%; **Sell:** -15% and below.

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