

Hero Honda Motors

STOCK INFO.	BLOOMBERG
BSE Sensex: 10,930	HH IN
	REUTERS CODE
S&P CNX: 3,196	HROH.BO

12 July 2006

Neutral
Previous Recommendation: Buy
Rs725

Equity Shares (m)	199.7
52-Week Range	950/581
1,6,12 Rel. Perf. (%)	-13/-30/-30
M.Cap. (Rs b)	144.8
M.Cap. (US\$ b)	3.1

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
3/06A	87,140	9,714	48.6	19.9	14.9	7.0	47.0	59.4	1.4	9.1
3/07E	101,024	10,331	51.7	6.4	14.0	5.5	39.2	51.7	1.2	8.2
3/08E	114,821	11,492	57.5	11.2	12.6	4.4	35.0	47.1	1.0	7.1

- Hero Honda's 1QFY07 operating performance has been below our estimates. The company reported sales growth of 19.6% at Rs23.6b, driven by a 21% volume growth. Net sales grew slower than volume growth on account of the discount scheme on the *Splendour* family in 1QFY07. Realizations declined 1.3% YoY.
- EBITDA margins at 13.5% declined 130bp YoY and 260bp QoQ due to significantly higher raw material costs. RM/sales ratio was 72%, up 100bp YoY and 410bp QoQ. EBITDA grew by just 9% YoY against our expectation of a 30% growth. However, other income at Rs523m was higher than our estimate of Rs355m. Also, effective tax rate was 30.5% against our estimate of 32.3%. As a result, PAT grew 16% against our expectation of a 28% growth.
- Management has guided for price increases across products by end-July. Our estimates factor in an EBITDA margin of 14.6% for FY07 against 13.5% in 1QFY07.
- We downgrade our FY07 EPS estimate by 8% to Rs51.7 and our FY08 EPS estimate by 10% to Rs57.5. We maintain our volume growth for FY07 at 15% against management guidance of 20%. However, we downgrade our EBITDA margin estimate for FY07 from 15.7% (flat YoY) to 14.6% (down 110bp YoY) to factor in a higher RM/Sales and staff cost. Hero Honda plans to launch 7 new models in 2HFY07, resulting in higher selling and marketing expenses. However, some of the above cost pressures will be offset by the proposed price increases.
- The stock trades at 14x FY07E and 12.6x FY08E earnings. We revise our target price to Rs789 (8.8% upside) based on SOTP (12.5x FY08E Core EPS plus Cash) to factor in the earnings downgrade. The revised target price implies a P/E of 13.7x FY08E reported EPS. We downgrade our rating from Buy to **Neutral**.

QUARTERLY PERFORMANCE

(Rs Million)

Y/E MARCH	FY 06				FY 07				FY 06	FY 07E
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE		
Total Volumes (nos)	687,567	742,425	798,301	772,457	832,692	820,000	885,000	916,106	3,000,750	3,453,798
Net Sales	19,771	21,663	23,148	22,559	23,644	24,046	26,175	27,159	87,140	101,024
Change (%)	14.8	23.3	15.6	16.3	19.6	11.0	13.1	20.4	17.4	15.9
Total Cost	16,848	18,327	19,367	18,927	20,454	20,487	22,249	23,135	73,460	86,325
EBITDA	2,923	3,336	3,781	3,632	3,190	3,559	3,926	4,024	13,680	14,699
As % of Sales	14.8	15.4	16.3	16.1	13.5	14.8	15.0	14.8	15.7	14.6
Change (%)	2.4	21.3	21.6	23.9	9.1	6.7	3.9	10.8	17.5	7.4
Other Income	306	431	360	430	523	385	450	411	1,527	1,768
Interest	3	-8	-11	-39	-33	3	10	28	-61	8
Depreciation	250	267	324	305	323	295	300	349	1,146	1,267
PBT	2,975	3,508	3,827	3,797	3,423	3,646	4,066	4,058	14,123	15,192
Tax	937	1,129	1,209	1,125	1,045	1,225	1,350	1,241	4,409	4,862
Effective Tax Rate (%)	31.5	32.2	31.6	29.6	30.5	33.6	33.2	30.6	31.2	32.0
PAT	2,039	2,379	2,618	2,671	2,377	2,421	2,716	2,815	9,714	10,331
Change (%)	7.2	22.4	19.6	29.0	16.6	1.7	3.8	5.4	19.9	6.4

E: MOST Estimates

Volume growth: momentum continues

In 1QFY07, Hero Honda sold 832,692 two-wheelers. Volumes grew 21.1% YoY, which was higher than the 14.5% growth in FY06. Hero Honda recently launched India’s first two-wheeler featuring fuel injection technology – the 125cc *Glamour FI*.

QUARTERLY SALES VOLUMES (UNITS)

	1QFY07	1QFY06	GR. (%)	4QFY06	GR. (%)
Total Sales	832,692	687,567	21.1	772,457	7.8
Domestic	803,297	658,026	22.1	752,605	6.7
Exports	29,395	29,541	-0.5	19,852	48.1

Source: Company/Motilal Oswal Securities

The management has guided for total volumes of 3.6m in FY07 – a 20% growth. However, it has cautioned about operating margins because of high competition and rise in commodity prices.

RESIDUAL GROWTH REQUIRED TO ACHIEVE FULL-YEAR ESTIMATES

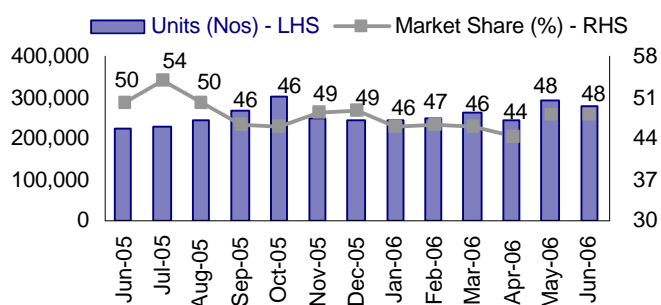
	FY07	FY06	GR. (%)
June 2006	278,660	226,073	23.3
YTD FY07	832,692	687,567	21.1
FY07 Estimate	3,453,798	3,000,750	15.1
Residual Growth Req. (%)	13.0		

Source: Company/Motilal Oswal Securities

Market share loss in bikes but gain in overall two-wheeler segment

Hero Honda’s market share in the domestic motorcycle market for 1QFY07 stood at 48.2%, which is 190bp lower as compared to 1QFY06. However, the company marginally improved its overall market share in two-wheeler industry to over 40%, mainly on account of its newly launched ungeared scooter (estimated market share 8.7%). The management expects to sell 120,000 units of ungeared scooters in FY07.

MONTHLY MARKET SHARE MOVEMENT

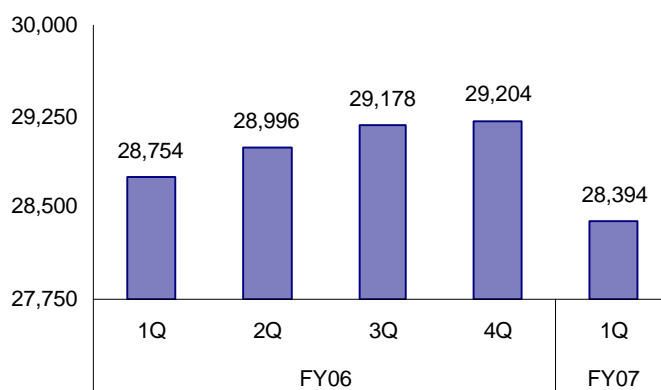


Source: Company/Motilal Oswal Securities

Realizations decline 1.3% YoY

In 1QFY07, realizations decreased by 1.3% YoY and 2.8% QoQ to Rs28,394. The company’s sales promotion scheme, offering a discount of Rs2,000 on its largest selling models adversely impacted realizations. Going forward, we expect net realizations to improve on account of discontinuation of discounts and the impending price hike.

NET REALIZATIONS IMPACTED DUE TO DISCOUNT SCHEME (RS)

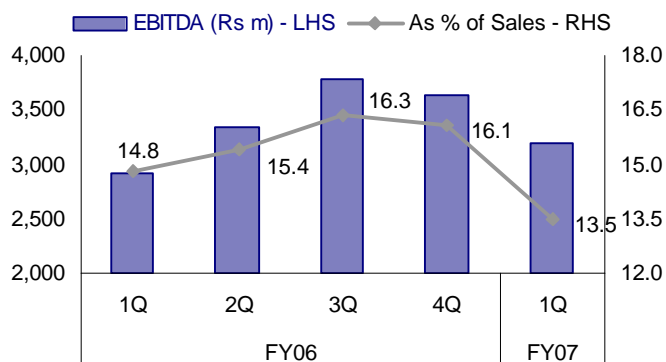


Source: Company/Motilal Oswal Securities

EBITDA margins down 130bp YoY to 13.5%

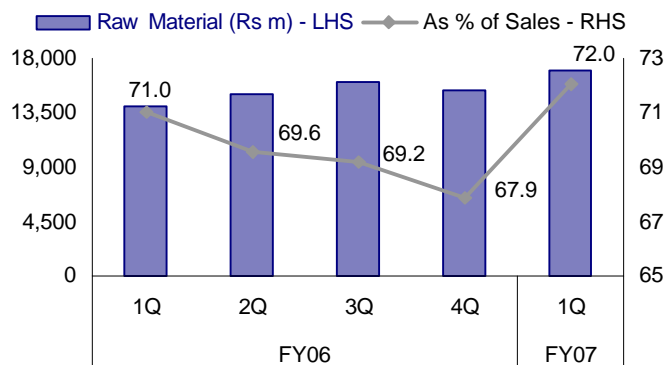
Hero Honda’s EBITDA margins for the quarter declined 130bp YoY and 260bp QoQ to 13.5%. The YoY decline was mainly on account of significantly higher raw material cost (RM). The RM/sales ratio increased 100bp YoY and 410bp QoQ to 72%. We expect margins to improve going forward on account of the impending price hike by the company, strong volume growth, and the management’s continuous efforts to rationalize costs and improve product mix.

EBITDA MARGINS DECLINE SHARPLY...



Source: Company/Motilal Oswal Securities

... ON INCREASED RAW MATERIAL COST



Source: Company/Motilal Oswal Securities

Net earnings grow 16.6% YoY

Hero Honda's net earnings increased by 19.6% in 1QFY07 to Rs2.4b, which is below our expectations, despite having higher other income and lower tax outflow on YoY basis. Sales grew 19.6% in value terms to Rs24b, lower than the volume growth of 21%. Average realizations declined 1.3% YoY.

Growth outlook remains positive

We expect the secular double-digit growth in two-wheeler volumes to continue unabated. Not only is there adequate scope to increase motorcycle penetration, the target audience too is rising rapidly. The top two players in the industry – Hero Honda and Bajaj Auto – are now global-sized players and have been increasing their stranglehold in a virtual duopoly. After five years of no price hikes, Hero

Honda has announced that it would be raising prices across products, alleviating concerns relating to margin pressure.

Valuation and view

We downgrade our FY07 EPS estimate by 8% to Rs51.7 and our FY08 EPS estimate by 10% to Rs57.5. We are maintaining our volume growth for FY07 at 15% against management guidance of 20%. However, we are downgrading our EBITDA margin estimate for FY07 from 15.7% (flat YoY) to 14.6% now (down 110bp YoY) to factor in higher RM/Sales and staff cost. Hero Honda plans to launch 7 new models in 2HFY07 and this will result in higher selling and marketing expense as well. However, some of the above cost pressures will be offset by the proposed price increases.

Hero Honda trades at 14x FY07E and 12.6x FY08E earnings. We revise our target price to Rs789 (8.8% upside) based on SOTP (12.5x FY08 Core EPS plus Cash) to factor in the earnings downgrade. The revised target price implies a P/E of 13.7x reported EPS. We downgrade our rating from Buy to **Neutral**.

SOTP VALUATION

	FY06	FY07E	FY08E
Core EPS (Rs)	43.4	45.7	51.2
Multiple (x)	12.5	12.5	12.5
Value (Rs)	542	571	639
Cash per Share (Rs)	110	128	149
Price (Rs)	652	699	789

Source: Company/Motilal Oswal Securities

DOWNGRADING FY07 AND FY08 ESTIMATES BY 8-10%

	OLD		NEW		CHANGE (%)	
	FY07E	FY08E	FY07E	FY08E	FY07E	FY08E
Net Sales (Rs m)	101,924	116,385	101,024	114,821	-0.9	-1.3
EBITDA (Rs m)	15,951	18,272	14,699	16,534	-7.9	-9.5
EBITDA Margins (%)	15.6	15.7	14.6	14.4	-7.0	-8.3
PAT (Rs m)	11,231	12,752	10,331	11,492	-8.0	-9.9
EPS (Rs)	56.2	63.9	51.7	57.5	-8.0	-9.9

Source: Company/Motilal Oswal Securities

Hero Honda: an investment profile

Company description

Hero Honda is the largest two-wheeler company in the world with revenues of more than US\$1.6b. The company sells over 2m motorcycles a year. It is a JV between Honda Corporation Japan and the Munjal family, with each party owning 26%. Hero Honda has a dealership network of over 500 with close to 70% of sales coming from rural India.

Key investment arguments

- Hero Honda's substantial presence in rural India insulates it from the onslaught of competition.
- The new product launches will allow Hero Honda to maintain its leadership position, while the new plant will address capacity constraint issues.

Key investments risks

- There have been several new launches by competitors in the past six months. Hence, the competitive scenario in the country is poised to increase.
- Competition is gaining share in Hero Honda's stronghold – the Executive segment.

Recent developments

- Hero Honda is expanding capacity at its existing plants by 20% to 3.9m units p.a.
- The company also announced plans for its third plant to be situated at Jaipur with a capacity of 1m units.

Valuation and view

- Downgrade our FY07 EPS estimate by 8% to Rs51.7 our FY08 EPS estimate by 10% to Rs57.6. Maintain our volume growth for FY07 at 15% against management guidance of 20%.
- We downgrade to **Neutral** with a target price of Rs789 resulting in an upside of 8.8%.

Sector view

- Numerous motorcycle launches will lead to an increase in the competitive scenario increased competition.
- Domestic two-wheeler demand will continue to surpass estimates on the back of rural pull.
- Despite increased number of players, market share remains concentrated amongst the top two.
- We maintain an overweight stance on the sector.

COMPARATIVE VALUATIONS

		HERO HONDA	BAJAJ AUTO	TVS MOTORS
P/E (x)	FY07E	14.0	19.3	14.7
	FY08E	12.6	15.7	12.5
EPS Gr (%)	FY07E	6.4	28.2	30.7
	FY08E	11.2	22.6	17.7
RoE (%)	FY07E	39.2	25.1	17.7
	FY08E	35.0	25.4	18.5
EV/EBITDA (x)	FY07E	8.2	13.8	8.7
	FY08E	7.1	10.7	7.4

SHAREHOLDING PATTERN (%)

	MAR.06	DEC.05	MAR.05
Promoters	55.0	55.0	55.0
Domestic Institutions	8.1	8.3	7.6
FII's/FDIs	27.1	26.8	26.9
Others	9.8	9.9	10.5

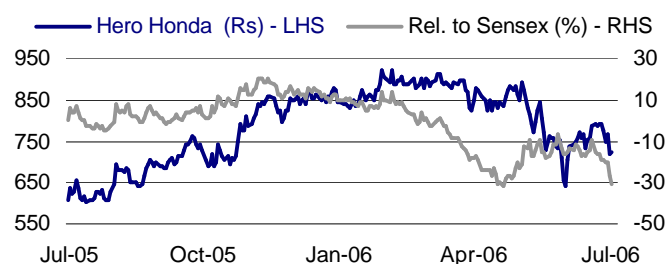
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	51.7	55.4	-6.7
FY08	57.5	62.6	-8.2

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
725	789	8.8	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)				
Y/E MARCH	2004	2005	2006	2007E	2008E	
Net Sales	58,324	74,217	87,140	101,024	114,821	
Change (%)	14.3	27.2	17.4	15.9	13.7	
Raw Material	40,306	51,996	60,523	71,727	81,236	
Employee Cost	2,315	2,680	3,206	3,637	4,306	
Other Mfg. Expenses	2,518	3,154	3,616	4,243	4,995	
Selling & Distribution	3,384	4,741	6,114	6,718	7,750	
EBITDA	9,801	11,645	13,680	14,699	16,534	
Change (%)	13.5	18.8	17.5	7.4	2.5	
% of Net Sales	16.8	15.7	15.7	14.6	14.4	
Depreciation	733	894	1,146	1,267	1,503	
Interest & Finance Charges	-14	-11	-61	8	8	
Other Income	1,650	1,440	1,527	1,768	1,877	
PBT	10,725	12,173	14,123	15,192	16,900	
Tax	3,441	4,068	4,409	4,862	5,408	
Effective Rate (%)	32.1	33.4	31.2	32.0	32.0	
PAT	7,283	8,105	9,714	10,331	11,492	
% of Net Sales	2.5	10.9	11.1	10.2	10.0	
Adj. PAT	7,283	8,105	9,714	10,331	11,492	
Change (%)	25.4	11.3	19.9	6.4	11.2	

BALANCE SHEET		(Rs Million)				
Y/E MARCH	2004	2005	2006	2007E	2008E	
Share Capital	399	399	399	399	399	
Reserves	10,989	14,534	20,254	25,988	32,481	
Net Worth	11,388	14,934	20,654	26,387	32,880	
Deferred Tax	900	1,015	1,015	1,015	1,015	
Loans	1,747	2,018	2,018	2,018	2,018	
Capital Employed	14,035	17,967	23,687	29,420	35,913	
Gross Fixed Assets	9,169	11,042	12,700	15,450	17,950	
Less: Depreciation	3,458	4,297	5,443	6,710	8,213	
Net Fixed Assets	5,711	6,745	7,257	8,740	9,737	
Capital WIP	177	409	0	0	0	
Investments	15,651	20,267	20,267	20,267	20,267	
Curr. Assets, L & Adv.	5,090	5,545	8,305	13,219	19,220	
Inventory	1,882	2,043	2,865	3,321	4,719	
Sundry Debtors	438	896	1,432	2,214	2,517	
Cash & Bank Balances	371	176	1,609	5,287	9,586	
Loans & Advances	2,399	2,396	2,399	2,396	2,399	
Current Liab. & Prov.	12,601	15,005	12,148	12,811	13,316	
Sundry Creditors	6,190	6,503	7,640	8,303	8,808	
Other Liabilities	3,849	3,655	3,655	3,655	3,655	
Provisions	2,562	4,847	853	853	853	
Net Current Assets	-7,511	-9,459	-3,843	407	5,903	
Application of Funds	14,035	17,967	23,687	29,420	35,913	

E: M0St Estimates

RATIOS						
Y/E MARCH	2004	2005	2006	2007E	2008E	
Basic (Rs)						
EPS	36.5	40.6	48.6	51.7	57.5	
Cash EPS	40.1	45.1	54.4	58.1	65.1	
Book Value per Share	57.0	74.8	103.4	132.1	164.6	
DPS	20.0	20.0	20.0	23.0	24.5	
Payout (Incl. Div. Tax) %	54.8	49.3	41.1	44.5	43.5	
Valuation (x)						
P/E		17.9	14.9	14.0	12.6	
Cash P/E		16.1	13.3	12.5	11.1	
EV/EBITDA		10.8	9.1	8.2	7.1	
EV/Sales		1.7	1.4	1.2	1.0	
Price to Book Value		9.7	7.0	5.5	4.4	
Dividend Yield (%)		2.8	2.8	3.2	3.4	
Profitability Ratios (%)						
RoE	64.0	54.3	47.0	39.2	35.0	
RoCE	76.4	67.7	59.4	51.7	47.1	
Turnover Ratios						
Debtors (Days)	3	4	6	8	8	
Asset Turnover (x)	4.2	4.1	3.7	3.4	3.2	
Leverage Ratio						
Debt/Equity (x)	0.2	0.1	0.1	0.1	0.1	

CASH FLOW STATEMENT		(Rs Million)				
Y/E MARCH	2004	2005	2006	2007E	2008E	
OP/(Loss) before Tax	9,068	10,751	12,534	13,432	15,031	
Interest/Div. Received	1,650	1,410	1,527	1,768	1,877	
Depreciation & Amort.	733	894	1,146	1,267	1,503	
Direct Taxes Paid	-3,313	-3,953	-4,409	-4,862	-5,408	
(Inc)/Dec in Working Capital	1,247	1,754	-4,184	-572	-1,197	
CF from Oper. Activity	9,387	10,857	6,615	11,034	11,806	
(Inc)/Dec in FA+CWIP	-1,451	-2,159	-1,250	-2,750	-2,500	
(Pur)/Sale of Invest.	-3,721	-4,616	0	0	0	
CF from Inv. Activity	-5,172	-6,775	-1,250	-2,750	-2,500	
Changes in Reserves	-512	-565	0	0	0	
Inc/(Dec) in Debt	404	271	0	0	0	
Interest Paid	14	11	61	-8	-8	
Dividends Paid	-3,994	-3,994	-3,994	-4,597	-4,999	
CF from Fin. Activity	-4,088	-4,278	-3,933	-4,605	-5,007	
Inc/(Dec) in Cash	128	-195	1,433	3,678	4,299	
Add: Beginning Balance	243	371	176	1,609	5,287	
Closing Balance	371	176	1,609	5,287	9,586	



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Hero Honda Motors

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|---|-----|
| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | Yes |
| 3. Broking relationship with company covered | No |
| 4. Investment Banking relationship with company covered | No |

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