



India Equities
Automobile

Initiating Coverage

Hero Honda Motors Limited

BUY

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CMP **Rs 1,606**
Target Price **Rs 1,976**

Investment horizon 12 months
Sensex 16,790
Nifty 4,989

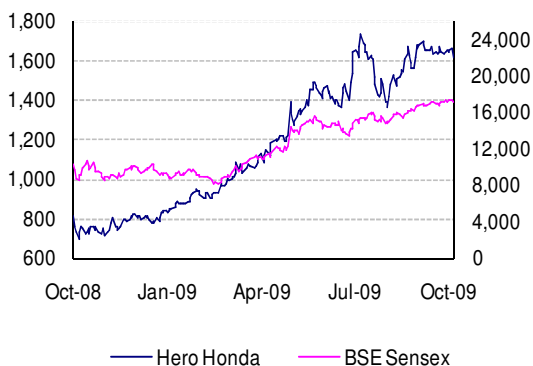
Stock Details

BSE Code 500182
NSE Code HEROHONDA
Reuters Code HROH.BO
Bloomberg Code HH IN
Market Cap (Rs cr) 32,061.4
Beta 0.42
52 W High / Low (Rs) 1,780.0 / 663.0
Avg Daily Volume 75,903
Face Value (Rs) 2.00

Shareholding Pattern (%) (as of Q2FY2009)

Promoters 54.96
MF/Banks/Indian FIs 8.20
FII / NRIs / OCBs 28.62
Indian Public 8.22

Price Chart



Investment Rationale

Strategy of rural focus, brand building and new launches to pay off: Hero Honda Motors Limited (Hero Honda) posted a good set of numbers even in bad times of recession just by following its very successful strategy of brand building and new launches at the right time. Hero Honda maintained its brand image by providing good models like Passion and Splendor with technology expertise of Honda. These two models remained main contributor over many years in the past. After successful launch of Hunk, the company launched Karizma ZMR in the premium segment just before festive season to boost further demand. Hero Honda provides reasonably priced, low maintenance and fuel efficient models in the rural area through its wide spread network of customer touch points. After adding 500 touch points to total 4,000 in FY2009, the company is planning to add further 500 touch points to boost rural demand which has a potential of real growth. We expect rural demand to boost further on lowering worries of monsoon and substantial increase in minimum support prices of commodities like paddy, wheat, etc. We believe with continuous rural focus and launch of new models, the company will gain market share in the Indian motorcycle segment.

Fiscal incentives at Haridwar plant to expand margins: The ramp up at Haridwar plant is fastest in the world. Hero Honda is planning to ramp up its current production capacity of 1.5mn units at this plant to 1.8mn units by FY2010. Haridwar plant is eligible for 100% excise duty and tax exemption as declared by the Government. We expect EBITDA margin to expand on account of lower excise payment and net margin to increase due to available tax exemption. We further expect effective tax rate in FY2010 to reduce to 23.5%.

Valuation: We have used Relative Valuation based on average of EV/EBIDTA and Price/Earnings (P/E) ratios. Considering the company's leadership position in the potentially growing industry, focus on rural market and strategy of new model launches, we recommend a Buy on the stock with a Target Price of Rs 1,976 representing a potential upside of 23.1%.

Exhibit 1: Financial Summary

| Particulars | FY2008 | FY2009 | FY2010E | FY2011E | FY2012E |
|----------------------|---------|---------|---------|---------|---------|
| Total Income (Rs cr) | 10331.8 | 12349.4 | 13818.4 | 15559.5 | 17417.2 |
| PAT (Rs cr) | 967.9 | 1281.8 | 1763.2 | 1970.7 | 2190.1 |
| PAT Margin (%) | 9.4% | 10.4% | 12.8% | 12.7% | 12.6% |
| EBIDTA Margin (%) | 13.1% | 14.1% | 16.5% | 16.3% | 16.1% |
| EPS (Rs) | 48.5 | 64.2 | 88.3 | 98.7 | 109.7 |
| P/E (x) | 14.2 | 16.7 | 18.2 | 16.3 | 14.6 |
| P/BV (x) | 4.6 | 5.6 | 6.3 | 4.9 | 3.9 |
| RoE (%) | 32.4% | 33.7% | 34.8% | 30.3% | 26.9% |
| RoCE (%) | 29.8% | 31.8% | 33.1% | 29.1% | 26.0% |
| EV/Sales (x) | 1.3 | 1.7 | 2.2 | 1.9 | 1.6 |

Source: Company data, Parsoli Research



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Hero Honda's market share has grown substantially from 72.1% to 77.0% in the executive segment in FY2009

Variants of Splendor and Passion have been the best selling product of Hero Honda over the past many years

The wide spread network of touch points and rural focus of the company makes it possible to gain market share in the two wheeler industry

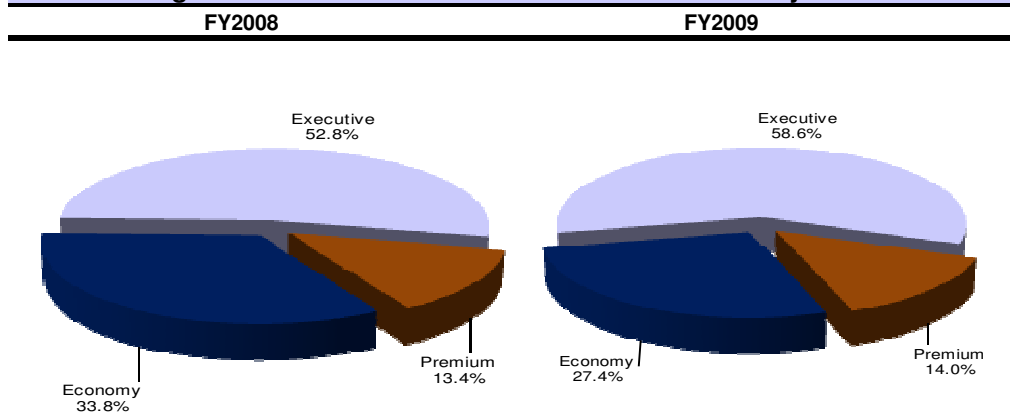
Investment drivers

Gain in market share continues despite slowdown

Despite its high base, Hero Honda has shown considerable market share gains mainly due to its strong presence in the rural segment through higher number of outlets. Hero Honda's market share has grown substantially from 40.3% in FY2008 to 45.4% in FY2009 in the economy segment (represents sub 100cc motorcycle), and from 72.1% in FY2008 to 77.0% in FY2009 in the executive segment (represents 100cc to 150cc motorcycle). Splendor (100cc and 125cc) and Passion (100cc) has been the best selling product for the company over the past many years. Hero Honda clearly has a stronger reach in the rural areas where its products are growing strongly. Weakening competition in the core executive segment is further helping the company consolidate its market leadership. Given its strong product profile, the company plans to expand presence and distribution network, whereas competitors like Bajaj Auto Ltd (BAL) are actually reducing touch points. Hero Honda is clearly focused on the executive segment (contributes 71% of the total volumes) where incremental competition is weak. Further, over the past year, this segment has been growing at the expense of the economy segment, adding to Hero Honda's advantages.

Over the years Hero Honda has been doing exceptionally well in the executive segment and we expect the company to further strengthen its position in this segment. During FY2009, Hero Honda posted strong growth as against declining volumes for BAL. We believe BAL to be the only player to provide some competition to Hero Honda in the sub 125cc category; but the change in tactic to upgrade the 100cc motorcycle in to 125cc+ motorcycle is posing problems for BAL and is very difficult for it to break into Hero Honda's dominance in the 100cc segment. BAL is looking to focus on the 125cc+ segment which has been their strength in the motorcycle segment. Strong demand for Hero Honda's products in the rural market makes presence of larger number of dealers feasible. Better distribution further leads to higher demand. The market share of economy segment is declining over the years as the new players are reluctant to enter in to this segment due to strong dominance of Hero Honda. The 100cc segment mainly caters to the rural areas and the small towns for which strong distribution network is crucial and to develop the distribution network is a time consuming process. Therefore, all new players are launching new models in the 100cc segment leading to reduction in market share for the 100cc segment. We believe strong presence in rural area and focus on brand building to make it possible for Hero Honda to gain further market share.

Exhibit 2: Segment wise market share of two wheeler motor cycle market



Source: Company data, Parsoli Research

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Hero Honda announced a total investment of Rs 19.0bn for Haridwar plant and ancillary facility

We expect excise and tax payment of the company to reduce going forward as Haridwar plant is eligible for central excise and tax exemptions

We expect per unit realization to increase due to successful launch of Karizma ZMR and Hunk in FY2009

Various tax benefits on Haridwar plant to improve margins

At the starting of FY2009, the company had a production capacity of 3.4mn units from its two facilities at Manesar and Dharuhera (Haryana). During FY2009, Hero Honda started production in Apr-08 with a plant capacity of 0.5mn units at Haridwar (Uttaranchal). The company plans to gradually increase the capacity at this plant to 1.5mn units by FY2011 (which is the deadline for availing various fiscal incentives). A total investment of Rs 19.0bn along with its ancillaries would be made in the project. With this new plant, the company would be able to take care of the demand in the medium term. To promote industrial activity in Uttaranchal, the state government is offering the following incentives under the New Industrial Policy at Haridwar for plants commencing operations before FY2011:

- 100% central excise exemption for 10 years
- 100% income tax exemption for first 5 years and 30% for next 5 years
- Central sales tax @1% for 5 years
- Capital investment subsidy @15% with a maximum of US\$ 73,170

As of FY2009, Hero Honda has approximately 30.0% of its vendors based in Haridwar. Due to this level of lower localization, the company cannot set-off excise duty paid on raw materials procured from outside due to excise exemption on the end product.

However, its tier-I vendors are in the process of setting up facilities at Haridwar, which would be completed by September 2009, thereby increasing localization of vendors to 65%. Therefore, we expect the net saving from excise duty from Haridwar plant will increase due to rise in localization. Hero Honda would enjoy 100% income tax exemption for the first five years and 30% exemption for the next five years at Haridwar. Due to this, its effective tax rate reduced from 31.4% in FY2008 to 28.1% in FY2009. We expect effective tax rate in FY2010 to reduce to 23.5% as the company plans to increase its existing capacity from 1.5mn units to 1.8mn units in FY2010 which will lead to higher profit growth and earnings per share. In addition, BAL also has a plant in Uttaranchal but unlike BAL, Hero Honda has not passed any benefit arising from Haridwar plant to customers resulting in higher margin for the company.

Per unit realization to increase on account of incentives at Haridwar plant and new launches

The company is continuously focusing on increasing its per unit realization. Despite lack of volume (unit sold) growth in FY2008, the company managed to increase its per unit realization by 4.4% yoy to 30,960 and, it registered 11.5% yoy growth in volume with 7.2% yoy increase in per unit realization in FY2009. This kind of growth in both volume and per unit realization in FY2009 was due to the excise duty benefit on production at Haridwar plant as well as due to 0.4% yoy gain in market share to 11.7% in the premium segment with new launches. Going forward, we expect per unit realization to increase on the back of company's plan to ramp up capacity at Haridwar plant which leads to lower excise payment for the company as this plant is eligible for 100% exemption in excise duty. Additionally, the company has recently launched new version of Karizma (Karizma ZMR-225cc) in its premium segment which is priced at Rs 91,000 per unit (ex-showroom, Delhi). We believe increasing focus on the premium segment with new launches should further increase per unit realization.

In Q2FY2010, per unit realization of Hero Honda increased by 4.0% yoy to 34,144 on the back of increased demand of its premium motorcycle. The company is also marketing its premium motorcycle very aggressively in the urban areas.



Hero Honda

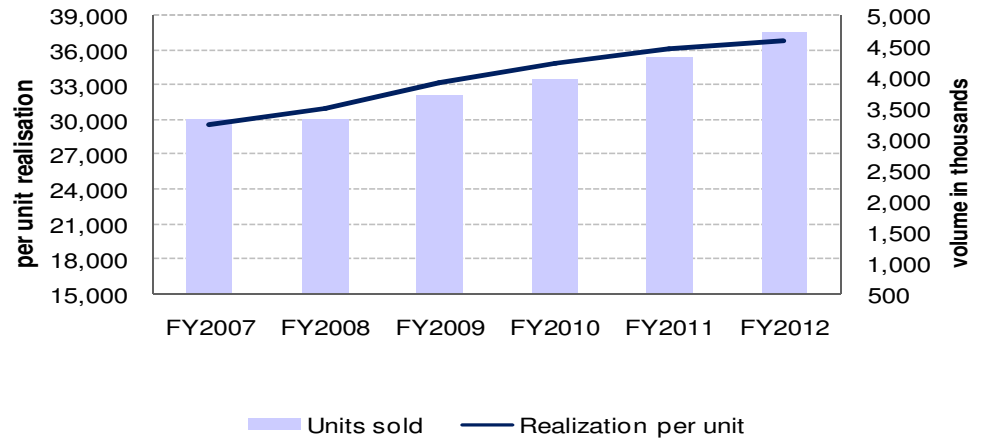
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Hero Honda recently launched Karizma ZMR in the premium segment

Hero Honda has lined up more than 6 of its new launch in form of variants or new model over next 12 months

We expect Hero Honda to gain further market share on account of its strong existing portfolio and expected new launches

Exhibit 4: Volume and realization per unit (FY2007-FY2012)

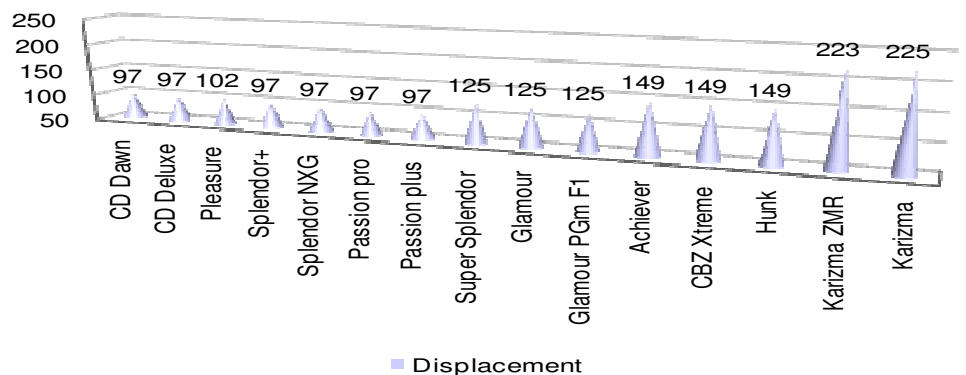


Source: Company data, Parsoli Research

Strong exiting portfolio and new launches to increase market share

Hero Honda holds 77.0% market share in the executive segment in FY2009. This segment mainly caters to the need of more than 100cc to 150cc motorcycle's customers. It dominates the less than 125cc segment with market share of 80.2% in FY2009. Splendor (Splendor NXG-100cc and Super Splendor-125cc) and Passion (100cc) has been the best selling products for the company over the past many years. The company is not only doing well in Economy and Executive segment but also performing well in Premium segment which caters to the needs of over 150cc motorcycle's customers. The company has increased its market share to 11.7% in this segment in FY2009 compared to 11.3% market share in FY2008 on the back of new launches including Hunk and CBZ-Xtreme during FY2009.

Exhibit 3: Hero Honda's Existing Portfolio of models with displacement (cc)



Source: Company data, Parsoli Research

While other players are more concentrating on increasing the profitability by increasing realization per unit, Hero Honda is increasing its market share by concentrating on branding and not pricing. Hero Honda is building its brand value by providing excellent products in the market like Splendor and Passion which are established models. Hero Honda is not only successful in maintaining its existing market share with the established products but also increases its market share by launching new models. We expect Hero Honda to increase its market share in the entire three segments as it has lined up more than 6 of its new products in the form of variants or new models over next 12 months. Hero Honda has technology sharing agreement with Hero Motors and has a launching schedule till FY2012.



Currently, Hero Honda has combined capacity of 3.9mn units at Gurgaon and Dharuhera and 1.5mn units at Haridwar

Rural market contributes about 45% of Hero Honda's total domestic sales

Hero Honda has a plan to add 500 more customer touch points in FY2010

Company Overview

Hero Honda is the world's largest two-wheeler company (in volume terms). Hero Honda is promoted as a joint venture (JV) between the Hero Group and Honda Motor Company, each holding 26% stake in the JV. It has a production capacity of 3.9mn two wheelers at its two manufacturing facilities at Gurgaon and Dharuhera (Haryana), and a new plant at Haridwar (Uttaranchal) with existing capacity of 1.5mn units. The company offers motorcycles in all the three major segments, viz. Entry (Economy), Executive and Premium. It also sells one model (Pleasure) in the ungeared scooter segment.

Hero Honda is a leader in domestic motorcycle segment with 77.0% market share in the executive segment. Unlike peers, Hero Honda is actively focused on building its presence in rural markets. In FY2008, it launched a pan-India program called 'Haar Gaon, Haar Aangan' (every village, every house) with an aim to reach mass rural public. As this program reaches to mass public, it will help the company to build a sustainable competitive advantage. Although it is difficult to segregate between urban and rural demand as the rural buyer also buys from urban dealers, the rural market contributes about 45% of Hero Honda's domestic sales. The rural market is underpenetrated and offers huge opportunity for two-wheeler players. Availability of two-wheeler at lower market price and lower operating cost are the key factors for a company's success in the rural market. Hero Honda is focusing on these points to succeed in the rural market along with its wide spread distribution network.

Hero Honda has the largest number of touch-points compared to its peers. The company has added approximately 500 touch-points in FY2009 to approximately 4000. The company is focusing at adding another 500 touch-points in FY2010 largely in the form of service centers in rural areas to strengthen its rural base. The company has a total dealer network of around of 775 dealers across India.

Hero Honda's dominance in the 100cc segment is primarily on back of its two best selling models - Splendor and Passion. Over the years, competitors have failed to bring such a product in the market and the same to happen in the future is extremely difficult. Hero Honda's dependence on credit sales is lower as compared to its peers. The company has a strong rural network and cash sales in rural areas are higher as compared to urban areas.

During FY2006, Hero Honda ventured into the gearless scooter segments. Hero Honda's only model in the scooter category is "Pleasure" (102cc) which is targeted to the urban female segment. Activa model of the Honda is the largest fast-selling model in this segment.



The motorcycle segment contributed around 80% to total sales volume within the two wheeler sector

Auto industry were badly hit in FY2008 and FY2009 on account of stringent financial norms set by financial institutions

Despite the executive segment being dominated by 125/135cc offerings, Hero Honda's Splendor and Passion (100cc motorcycles) continue to rule the executive segment

Entry level segment generally offers features like kick start, four gear and spoke wheel

Industry Overview

Two wheeler sector is the most important segment of the Indian auto sector accounting for 75% of the total sales volume in the auto industry. The two wheeler industry is dominated by the motorcycle segment which contributed 80% to the sales volume in FY2009. Hero Honda, BAL, TVS Motors and Honda are the major players in this sector.

Two wheeler industry volumes were badly hit in FY2008 and FY2009 on account of stringent financing norms set by financial institutions and due to higher interest rates. After reporting a de-growth of 1.3% in FY2008 and a marginal growth of 2.6% in FY2009 the two wheeler industry has come up strongly on account of improvement in the overall macro economy along with easing of financing. Attractive interest rates led by public sector banks and new launches by companies have further boosted the demand in the Indian two wheeler industry. Scooters increased their share in the two-wheeler pie from 14% to 16% in FY2009. The entry segment made up of basic 100cc bikes had started slowing two years ago, and during the year in review, sales in this segment were down by more than 15%. This could be attributed to the fact that Deluxe segment bikes have become affordable on account of a 4% excise cut, 1% reduction in CST and the special package of reduction in excise duty in December-2008, which most manufacturers passed on to the consumers.

Hero Honda is a market leader in the economy segment and it has been improving its market share in executive and premium segment motorcycles. Despite the executive segment being dominated by 125/135cc offerings, Hero Honda's Splendor and Passion (100cc motorcycles) continue to rule the executive segment. Their market leadership in the executive segment is an indicator of their strong position vis-à-vis other 125/135cc offerings. BAL is a leader in the premium segment. However, despite a significant shift in the product mix of BAL (as indicated earlier), it continues to be the leader in the entry segment also. It's CT 100, Platina and Platina 125cc dominate the entry segment.

India's two wheeler sector can be divided into three main categories:

- A) Motor cycle segment
- B) Scooter segment
- C) Mopeds

A) Indian Motorcycle segment

Motorcycle segment can be further classified in to three categories on the basis of displacement:

- i) Entry/Economy level (upto 100cc motorcycle)
- ii) Executive level (between 100cc to 150cc motorcycle)
- iii) Premium level (more than 150cc motorcycle)

i) Entry level: Motorcycle in this segment is generally in the sub 100cc category, offering basic features like kick start, four gear and spoke wheel and are targeted towards price sensitive buyers. BAL has a strong grip in this segment with their two products; Platina and CT100 holding more than 50% of the economy segment. Hero Honda holds around 30% of the economy segment with CD Dawn as its key model in the segment. The reason for this segment losing its market share is the higher interest rate scenario since this segment is the most interest elastic and BAL had lowered its exposure in this segment in the recent past.

ii) Executive level: Executive/Deluxe segment caters to buyers who have selection criteria like fuel economy, style and purchase price of a model. This is the largest



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Executive segment caters buyers who have selection criteria like fuel economy, style and purchase price of a model

segment in the motorcycle space and motorcycle in this segment is generally in the 100-150cc category. Hero Honda is the largest player in this segment with approximately 70% market share. Both of Hero Honda's top selling models are a part of the executive segment. Splendor accounts for 45-50% of the sales volume and Passion accounts for 20-25% of the volumes in the executive segment. BAL with its key models like Discover and Xceed could have been the one to provide some type of competition to Hero Honda; however poor performance by BAL over the past one year has led to Hero Honda tightening its grip in this segment. Other models like Flame of TVS Motors and Shine and Stunner of Honda have so far not been able to challenge Hero Honda's dominance in this category.

iii) Premium segment: Premium segment targets customers who look for power, speed and style and accordingly they are least impacted by changes in the interest rates. BAL is the largest player in this category with its model Pulsar holding approximately 50% market share. Over the past one year, the gap between Pulsar and others that includes Unicorn of Honda, Apache of TVS Motors and FZ16 of Yamaha have started to narrow down. This segment is important from the perspective of improving overall operating margin for any two wheeler company.

B) Scooter segment

In FY2006, Hero Honda ventured into the gearless scooter segments and in less than 4 years, the company has managed to garner more than 15% market share. HMSI (Honda) is the market leader in the gearless scooter segment and accounts for more than 55% of the total market. Scooter segment accounts for about 16% of the overall domestic two wheeler market. Hero Honda's only model in the scooter category is "Pleasure" which is targeted to the urban female segment. Activa model of the Honda is the largest selling model in this segment. With growing female working population and with increasing popularity of gearless scooters among young girls, Hero Honda's Pleasure is expected to report robust 20.5% CAGR volume growth between FY2009 and FY2012. This will also help the company to reduce its dependence on the motorcycle segment.

C) Mopeds

Moped segment accounts for approximately 5.0% of the market share of Indian two wheeler market with TVS motors dominating the segment with over 90% market share. This segment is small in terms of both volume and value and only has limited number of players. Mopeds have seen a downward trend in sales and we expect similar trend to continue in future.

Commodity cost on a declining trend

Raw material costs have declined substantially in the past few months. Also, competition has eased in varying degrees across segments, enabling companies to retain benefits from the lower commodity cycle. Two wheelers have not seen a return to a price war. Automobile volumes have shown signs of revival since the beginning of this calendar year. While two wheelers continue to show growth, domestic car volumes are continuously improving since last eight months and commercial vehicles sales recorded positive growth in last two months, owing partly to strong rural demand. On a lower base, we expect a strong volume recovery going forward. More importantly, there is clearer visibility regarding a return to long term growth in FY2011 and beyond, particularly with a stable government in place. After touching a peak in FY2009 commodity prices have started softening since Q2FY2009 which has lead to improvement in margins of automobile players in the last 1-2 quarters.

HMSI (Honda) is a market leader with more than 55% market share in Scooter segment

Mopeds have seen downward trend in sales volume and we expect similar trend to continue in future



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Two wheeler players like BAL has higher dependence on auto finance for it sales

Hero Honda's market share gain is driven by focus on branding and not on pricing

Over the years, competitors have failed to challenge Splendor and passion in the market and the same to happen in the future is extremely difficult

Peer Comparison

After a recent economic slowdown, Financial Institutions have set stringent norms to provide auto finance to its customers. Two wheeler players like BAL has higher dependence on auto finance for its sales as it mainly caters to Premium and Executive segment customers in the urban area where the dependence on credit is higher. Hero Honda's dependence on credit is lower as compared to its peers mainly due to its strong rural network and cash sales in the rural areas. Hero Honda's ability of increasing its cash sales in the recent recession makes it possible to post higher growth in the domestic market and outperform the industry by a long distance.

Hero Honda gets the technology, design specification and R&D innovation from Honda (Japan) which puts them in a better position compared to its peers.

We believe Hero Honda offers best earnings visibility among its peers and expected to grow at a CAGR of 14.3% between FY2009 and FY2012 on the back of lower raw material prices as well as due to various incentives available on production at Haridwar plant. Hero Honda's market share gain is driven by focus on branding and not on pricing. This coupled with the highly consolidated nature of the domestic two wheeler industry and focus on profitability by peers has enabled Hero Honda to gain market share without impacting profitability.

Splendor (100cc and 125cc) and Passion (100cc) has been the best selling product for Hero Honda over the past many years. Over the years, competitors have failed to bring such a product in the market and the same to happen in the future is extremely difficult. While BAL has a strong grip in Economy segment with Platina and CT 100 and in Premium segment with Pulsar, Hero Honda has a strong hold in Executive segment with Splendor and Passion brands. Up to 125cc category accounts for approximately 78.0% of the Indian motorcycle industry and Hero Honda holds a market share of more than 80.0% (FY2009) in this category.

Exhibit 5: Segmentwise Portfolio

| Company | Entry Level | Executive Level | Premium Level |
|------------|--------------------|---|-------------------------------------|
| Hero Honda | CD Dawn, CD Deluxe | Passion Plus, Splendor NXG, Glamour, Super Splendor | Achiever, Hunk, CBZ Xtreme, Karizma |
| BAL | Platina, CT 100 | Discover, XCD 135 | Pulsar, Avenger |
| TVS | Star | Flame | Apache |
| Suzuki | - | Heat, Zeus | GS150R |
| Yamaha | Crux, Alba, G5 | Gladiator | FZ-16, YZF R15 |
| Honda | - | Shine, CBF Stunner | Unicorn |

Source: Company data, Parsoli Research

Hero Honda's excise duty (as % of net sales) declined from 16.5% to 9.9% in FY2009 mainly due to reduction in excise duty from 12% to 8% in H2FY2009. However, BAL and TVS has paid lower excise duty compared to Hero Honda. We expect Hero Honda's excise duty (as % of net sales) and tax payment to further decline on fiscal incentives available on production at Haridwar facility. Hero Honda has better margin picture and ROE among its peers on the back of its strategy to concentrate on brand building through customer service and advertising rather than price cut.



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Excise duty for FY2009 declined due to a 4% cut in excise duty

Hero Honda has better margin picture and ROE among its peers

EBITDA margin during the year also increased nearly 100bps to 14.1% due to decline in raw material prices and reduction in excise payment

Exhibit 6: Margins comparison (FY2009)

| Margins/ratios | Hero Honda | BAL | TVS |
|-------------------------|------------|-------|--------|
| Excise (% of net sales) | 9.9% | 7.2% | 8.4% |
| EBITDA margin | 14.1% | 11.6% | 3.2% |
| EBIT Margin | 14.0% | 9.5% | 0.3% |
| Tax (% of PBT)* | 28.1% | 35.0% | 29.9% |
| Net profit margin | 10.2% | 6.0% | (1.7%) |
| ROE | 33.7% | 29.5% | (9.9%) |

Source: Company data, Parsoli Research

*incl defferd tax and FBT

Financial Performance

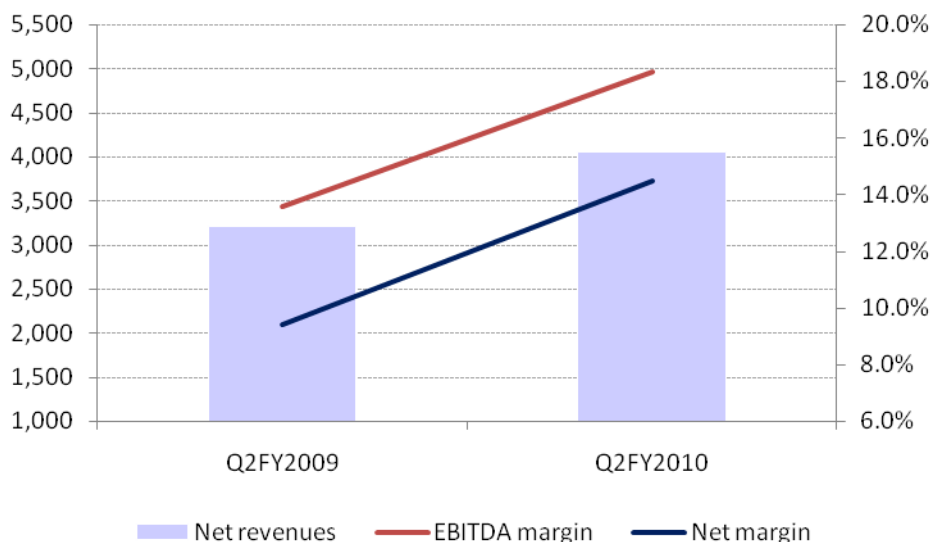
FY2009 performance review

Net revenues of Hero Honda increased 19.5% yoy to 12,349.4cr in FY2009 on the back of both volume growth and growth in per unit realization. Hero Honda's sales volume increased 11.5% yoy to 37.2lac units and realization per units increased by 7.2% yoy to Rs 33,179 per unit. EBITDA margin during the year also increased nearly 100bps to 14.1% with decline in raw material prices. Net margin increased nearly 100bps to 10.2% because tax payment as a percentage of sales declined on account of tax exemption available at Haridwar plant.

Q2FY2010 performance

Net revenues of Hero Honda increased 26.8% yoy to 4,059cr Q2FY2010 on the back of good demand during festive season and new launch in the premium segment. The company's sales volume increased by 21.7% yoy to 1.2mn units in Q2FY2010 and maintained over 59.0% market share in the domestic motorcycle market. EBITDA margin during the period also increased nearly 475bps to 18.3% and net margin witnessed similar trend and increased nearly 506bps to 14.5% on account of tax exemption available at Haridwar plant.

Exhibit 7: Net Sales and Margins, Q2FY2009-Q2FY2010



Source: Company data, Parsoli Research



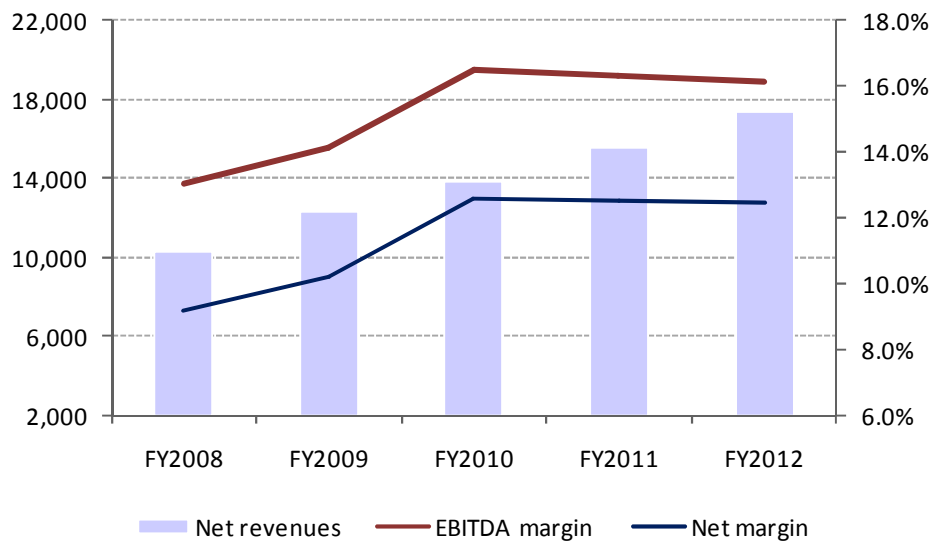
Margins expected to increase on availability of fiscal incentives at the Haridwar plant

Financial Performance

Margins expected to expand on availability of incentives at Haridwar plant

We expect Hero Honda's excise duty payment (as % of net sales) to decline on the back of company's plan to ramp up capacity at the Haridwar plant which leads to lower excise payment for the company as this plant is eligible for 100% exemption in excise duty. Haridwar plant will also be eligible for exemption from tax payment which will lead to further boost in net profit margin. As the prices of steel and aluminum stabilized after a decline, the company would be able to save at operational level which will lead to expansion in margins.

Exhibit 8: Net Sales and Margin Expectations, FY2008-FY2012E



Source: Company data, Parsoli Research



Successful launch of new model in entry level segment may drop down market share of the company

Delay in increasing capacity at Haridwar plant may impact earnings growth of the company

We expect revenues to increase at a CAGR of 9.0% between FY2009 and FY2012 on the back of capacity expansion at Haridwar plant

We expect margins expansion due to reduction in excise duty and incentives at Haridwar plant as well as new launch in premium segment

We expect two wheeler market to expand in size by 6.0% in FY2010 due to emerging demand in the domestic economy

Major Concerns

Competitors' new launches may drop down market share of Hero Honda

BAL has launched an entry segment bike (Discover 100cc) which has received a good response. Honda and TVS are also looking at launching a bike in the entry segment during FY2010. Successful launches of bikes from competitors could lead to drop in market share for Hero Honda.

Slower increment in production will impact earnings growth

Any delay in increasing production and increase in localization at Haridwar will impact Hero Honda's earnings growth. However, Hero Honda and its vendors would need to complete all expansion by March 2010 as the fiscal incentives (mentioned above) can be availed only if new/expanded capacity commences commercial production by 31 March 2010.

Unexpected rise in metal prices will put pressure on margins

We believe raw material prices to increase marginally over next two years. Any unexpected rise in metal prices will put pressure on company's margins.

Future Outlook

We expect revenues to increase at a CAGR of 9.0% during FY2009 and FY2012 to reach a turnover of Rs 17,417.2cr by FY2012 on the back capacity expansion at Haridwar plant and due to its leadership position in growing executive segment. We don't expect any major threat to two of its well established brand (Passion and Splendor) in near term. Going forward, we believe Hero Honda will maintain its leadership position as it has already proved so by posting an excellent set of numbers in the last quarter during global turbulent times. We believe fiscal incentive at Haridwar plant is the key immediate driver for the upsurge in the stock price apart from the successful launch of Karizma ZMR in the premium segment coupled with a strong set of Q2FY2010 results. Going forward, we expect the EBITDA margins to improve by 238bps to 16.5% in FY2010 on the back of excise exemption available at Haridwar plant as well as a 4.0% cut in excise duty to 8.0% in H2FY2009. We don't expect any hike in raw material prices in the medium term after a fall in the recent past. Therefore, we believe stable raw material prices will boost operating profits. We also expect net profit margin to expand 236bps in FY2010 mainly due to the expected lower tax payment considering tax exemption at Haridwar plant.

By following the successful strategy of retaining market share with established brands and launching new models at the right time supported by reputation of brand name and technology of Honda, the company has maintained its leadership position since quite long and still growing. Domestic two wheeler industry posted a 2.6% yoy growth in FY2009 after de-growth in FY2008. We expect two wheeler market to expand in size by 6.0% in FY2010 on the back of growing export market as well as emerging demand in the domestic market due to easing of liquidity for auto finance and stable interest rates and fuel prices. Hero Honda holds 59.8% market share in the domestic motorcycle segment. We thus expect Hero Honda to gain market share steadily in the growing two wheeler industry by expanding its existing capacity and improvement in margins.



Using the EV/EBITDA method, we arrive at a target price of Rs 2,011 per share

Using the P/E ratio method, we arrive at a target price of Rs 1,943 per share

Taking the average from EV/EBITDA and P/E methodologies, we get a target price of Rs 1,976 per share

Valuation

For valuing the company, we have used Relative Valuation based on EV/EBIDTA and Price/Earnings (P/E) multiple methodologies considering FY2010 estimates. A comparative valuation using EV/EBIDTA methodology helps us in comparing the company's performance with its peers irrespective of their depreciation and finance expenditures. The P/E multiple methodology helps in comparing peer group performance with the company with respect to earnings potential. We have considered an investment horizon of 12 months for this stock.

Comparative Valuation

Hero Honda trades at current EV/EBIDTA of 15.6x which is at a discount of 33.6% to the peer group average of 23.4x. Going forward, we believe that the company will maintain its leadership position. Hero Honda has an edge over other players due to high margins and well known brand. We have discounted the industry average and assigned a EV/EBIDTA multiple of 17.0x to value the stock which is higher than the current multiple enjoyed by the company as we expect Hero Honda to expand its margins due to fiscal benefit available at Haridwar plant as well as due to stable prices of raw materials (steel, aluminum, etc) after a big fall last year. Using this target multiple on our FY2010 EBIDTA estimates of Rs 2,278.6cr, we arrive at a target price of Rs 2,011 per share.

The stock is currently trading at P/E multiple of 21.2x which is at discount of 45.4% to the peer group average of 38.9x. We expect the company's EPS to grow at a CAGR of 14.3% between FY2009-12E due to its successful strategy of rural focus and brand building as well as due to fiscal incentives available at the Haridwar plant. We are assigning a multiple of 22.0x to value the stock as we expect price appreciation in the stock to outpace its earning growth over next 12 months. Employing this target P/E multiple on our FY2010 EPS estimates of Rs 88.3, we arrive at a target price of Rs 1943.

Exhibit 9: Weighted Average Pricing for Hero Honda's Stock

| Pricing Methodologies | Weight assigned | Target price | Weighted average |
|---------------------------------------|-----------------|--------------|------------------|
| Target price using EV/EBITDA approach | 50.0% | 2,011.1 | 1,005.6 |
| Target price using PE ratio approach | 50.0% | 1,942.6 | 971.3 |
| Weighted average target price (Rs) | | | 1,976.9 |
| Current stock price (Rs) | | | 1,605.7 |
| Upside/(downside) from current levels | | | 23.1% |

Source: Parsoli Research

By taking the weighted average of the price estimated through EV/EBIDTA and P/E methodologies, which is Rs 2,011 and Rs 1,943 respectively, we arrive at a target price of Rs 1,976 representing an upside of 23.1%.

We recommend a BUY on the stock with a Target Price of Rs 1,976 over a 12 months horizon.



Financial Statements

| Exhibit 10: Income Statement | | | | | Rs cr |
|------------------------------|----------|----------|----------|----------|----------|
| Particulars | FY2008 | FY2009 | FY2010E | FY2011E | FY2012E |
| Net Sales | 10331.80 | 12349.37 | 13818.42 | 15559.55 | 17417.18 |
| % chg | 4.4% | 9.9% | 11.9% | 12.6% | 11.9% |
| Total Expenditure | 8982.43 | 10607.36 | 11539.85 | 13021.37 | 14606.65 |
| % chg | 2.9% | 18.1% | 8.8% | 12.8% | 12.2% |
| EBIDTA | 1349.37 | 1742.01 | 2278.57 | 2538.18 | 2810.53 |
| Margin (%) | 13.1% | 14.1% | 16.5% | 16.3% | 16.1% |
| Other Income | 185.42 | 188.43 | 188.43 | 188.43 | 188.43 |
| Depreciation & Amortisation | 160.32 | 180.66 | 190.19 | 192.08 | 194.93 |
| Interest | 35.81 | 31.68 | 28.03 | 24.79 | 21.93 |
| PBT | 1338.66 | 1718.10 | 2248.78 | 2509.73 | 2782.10 |
| Margin (%) | 12.7% | 13.7% | 16.1% | 15.9% | 15.8% |
| Total Tax | 442.40 | 499.70 | 541.64 | 588.64 | 635.84 |
| (% of PBT) | 33.0% | 29.1% | 24.1% | 23.5% | 22.9% |
| PAT | 896.26 | 1218.40 | 1707.15 | 1921.09 | 2146.26 |
| % chg | 12.8% | 32.4% | 37.6% | 11.8% | 11.1% |
| Margin (%) | 8.52% | 9.72% | 12.19% | 12.20% | 12.19% |

Source: Company data, Parsoli Research

| Exhibit 11: Balance Sheet | | | | | Rs cr |
|-----------------------------|---------|----------|---------|---------|---------|
| Particulars | FY2008 | FY2009 | FY2010E | FY2011E | FY2012E |
| SOURCES OF FUNDS | | | | | |
| Equity Share Capital | 39.94 | 39.94 | 39.94 | 39.94 | 39.94 |
| Reserves & Surplus | 2946.30 | 3760.81 | 5033.40 | 6466.74 | 8096.17 |
| Net Worth | 2986.24 | 3800.75 | 5073.34 | 6506.68 | 8136.11 |
| Total Loans (Unsecured) | 132.00 | 78.49 | 70.64 | 63.58 | 57.22 |
| Deffered Tax Liabilities | 130.59 | 153.08 | 178.97 | 205.35 | 232.52 |
| Capital Employed | 3248.83 | 4032.32 | 5322.96 | 6775.60 | 8425.85 |
| APPLICATION OF FUNDS | | | | | |
| Gross Block | 1938.78 | 2516.27 | 2831.87 | 3146.87 | 3461.87 |
| Less: Acc. Depreciation | 782.52 | 942.56 | 1132.75 | 1324.83 | 1519.76 |
| Net Block | 1156.26 | 1573.71 | 1699.12 | 1822.04 | 1942.11 |
| Capital Work-in-Progress | 392.44 | 120.54 | 0.00 | 0.00 | 0.00 |
| Investments | 2566.82 | 3368.75 | 3368.75 | 3368.75 | 3368.75 |
| Current Assets | 936.78 | 1013.49 | 2464.06 | 4113.60 | 5952.14 |
| Current Liabilities | 1824.74 | 2052.82 | 2213.12 | 2532.92 | 2841.29 |
| Net Current Assets | -887.96 | -1039.33 | 250.94 | 1580.67 | 3110.85 |
| Miscellaneous Expenditure | 21.27 | 8.65 | 4.14 | 4.14 | 4.14 |
| Capital Deployed | 3248.83 | 4032.32 | 5322.96 | 6775.60 | 8425.85 |

Source: Company data, Parsoli Research



Exhibit 12: Key Ratios

| Particulars | FY2008 | FY2009 | FY2010E | FY2011E | FY2012E |
|-----------------------------|--------|--------|---------|---------|---------|
| Per Share Data (Rs) | | | | | |
| EPS | 48.47 | 64.19 | 88.30 | 98.69 | 109.68 |
| Cash EPS | 56.50 | 73.24 | 97.83 | 108.31 | 119.44 |
| DPS | 17.00 | 19.00 | 21.00 | 23.00 | 24.00 |
| Book Value | 149.55 | 190.34 | 254.08 | 325.86 | 407.46 |
| Returns (%) | | | | | |
| ROE | 32.41 | 33.72 | 34.75 | 30.29 | 26.92 |
| ROCE | 29.79 | 31.79 | 33.12 | 29.08 | 25.99 |
| Dividend Payout Ratio | 35.07 | 29.60 | 23.78 | 23.30 | 21.88 |
| Valuation Ratios (x) | | | | | |
| P/E | 14.24 | 16.67 | 18.18 | 16.27 | 14.64 |
| P/CashEPS | 12.22 | 14.61 | 16.41 | 14.82 | 13.44 |
| P/BV | 3.06 | 2.28 | 1.97 | 1.73 | 1.49 |
| EV/Sales | 1.33 | 1.72 | 2.22 | 1.87 | 1.58 |
| EV/EBITDA | 10.21 | 12.19 | 13.45 | 11.47 | 9.76 |

Source: Company data, Parsoli Research

Exhibit 13: Cash Flow Statement

| Particulars | FY2008 | FY2009 | FY2010E | FY2011E | FY2012E |
|--|----------|----------|----------|----------|----------|
| Profit before tax | 1410.28 | 1781.46 | 2304.84 | 2559.32 | 2825.97 |
| Depreciation & Amortisation | 160.32 | 180.66 | 190.19 | 192.08 | 194.93 |
| Change in Working Capital | (138.15) | 48.13 | (15.76) | (5.61) | (11.41) |
| Direct taxes paid & Fringe Benefit Tax | 35.73 | 34.18 | 41.68 | 50.64 | 65.18 |
| Other Non-cash Exp/(Inc) | (14.11) | 6.87 | 11.04 | (5.91) | (11.53) |
| Cash Flow from Operations | 1454.08 | 1982.95 | 2448.63 | 2689.23 | 2932.77 |
| (Inc.)/Dec. in Fixed Assets | (174.21) | (91.56) | (120.00) | (150.00) | (175.00) |
| Cap WIP | (33.59) | 27.43 | (3.53) | (4.33) | (4.96) |
| Free Cash Flow | 1246.28 | 1918.82 | 2325.10 | 2534.90 | 2752.82 |
| Inc./(Dec.) in Investments | (109.81) | (29.00) | 0.00 | 0.00 | 0.00 |
| Inc./(Dec.) in Capital | 0.30 | 0.00 | 0.00 | 0.00 | 0.00 |
| Inc./(Dec.) in Loans | 217.71 | (100.97) | (107.37) | 6.27 | 7.70 |
| Dividend paid (incl. tax) | (4.94) | (10.97) | (13.38) | (32.54) | (41.89) |
| Interest paid (Net) | (24.85) | (21.64) | (29.16) | (16.28) | (17.03) |
| Cash Flow from Financing | 213.00 | (32.60) | (149.90) | (42.55) | (51.21) |
| Inc./(Dec.) in Cash | 39.55 | 97.89 | (78.55) | 29.89 | 44.55 |
| Opening Cash balances | 63.13 | 101.20 | 199.08 | 120.53 | 150.42 |
| Closing Cash balances | 102.68 | 199.08 | 120.53 | 150.42 | 194.97 |

Source: Company data, Parsoli Research



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