

Hero Honda Motors Ltd (HHML)

CMP: 744
Target Price: 776
Change: 4.3%

Relative to sector: **Neutral**

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Recommendation: Hold

Comment: Pressure on margin and decline in market share

Key Stock Data

Sector	Automobiles
Shares Outstanding(m)	199.7
Market cap (Rs bn)	148.1
Market cap (US\$ m)	3,257

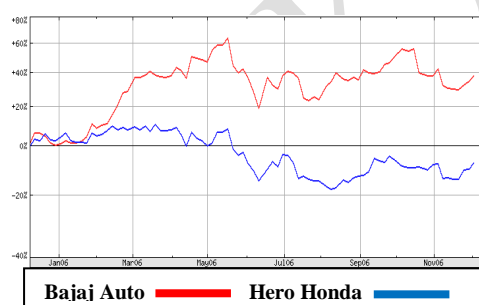
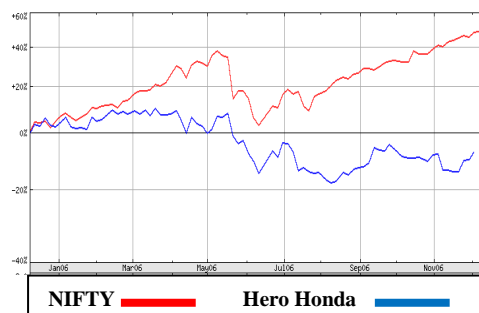
Shareholding Pattern (%)

Promoters	54.95
FII's/NRI's/OCB's/GDR	24.33
MF's/Banks/FI's	10.65
Non Promoter Corporate	0.67
Public & Others	9.40

Key Highlights:

The net profit margin has been continuously shrinking for Hero Honda Motors Ltd. (HHML). From a net profit margin of 10.17% in FY 2002 it has declined to 9.47% in FY 2006. In FY 2006 there was slight increase in the net profit margin resulting from launches of new models (Glamour, Achiever and Pleasure) during the year.

Though the volume of profit is increasing, the return on net worth and capital employed has fallen gradually every year. This fall in RONW and ROCE is a result of rising cost of manufacturing and increase in competition by entry of new players like Honda and aggressive launches of existing players.



- **Competition nibbling into market share** - Hero Honda Motors, the dominant player in the motorcycle segment has witnessed a slowdown in sales. The company had registered a continuous decline in the motorcycle sales, thereby resulting in erosion of market share.
- **Higher input costs weighing on margins** - The operating margins at 13.8% for the FY 2006 declined by 14bps. The margins remained under pressure due to inflationary costs of raw materials – steel, aluminium and rubber.

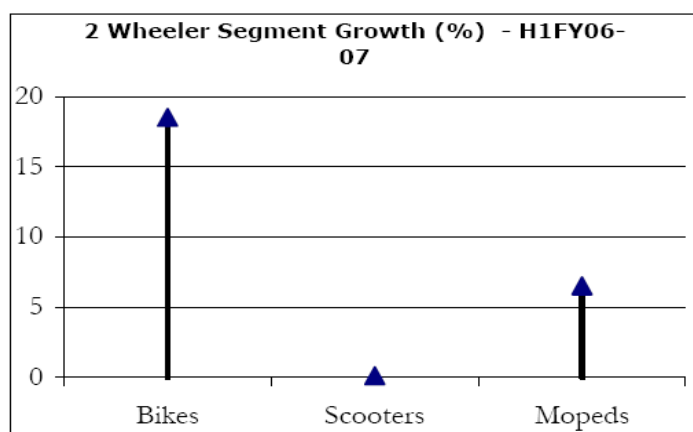
- **Outlook – Intensifying competition** - HHML is facing stiff competition from its rivals. HHML derives a large proportion of its sales and profits from its Executive segment, which is being targeted by most motorcycle manufacturers. New launches from the Bajaj and TVS stable are expected to arrest any further market share gains for Hero Honda in the Executive segment.

HHML had announced its plans to launch eight new motorcycles in FY07. After lukewarm success of recent launches – Super Splendor and Glamour, a successful launch of new products is very essential, considering that competition is firing from all cylinders.

Automobile Industry – 2 Wheelers - Recent Trend

Bikes top in 2 wheelers segment

Motor cycles have registered high growth among the two wheelers. The growth is due to increasing mobility requirement of the population and the younger generation's appetite to have bike for communication. The bike markers have introduced new models that is more fuel efficient than earlier ones.



But the floods in August 2006 have compelled bikes to crawl at 3.4%. In '01-02, the 100-cc segment was contributing nearly 94% volumes to the total motorcycle volumes. In '05-06, it is down to 72%. The second quarter figures, for this fiscal, show that the segment has further shrunk to 67%. Bike sales in the H1FY06-07 was 32, 05,497 units against 27, 04,466 units in the same period in 2005.

Source: ISI Emerging Market

Performance of Hero Honda Ltd. (2002 – 2006)

Table 1. Performance of Hero Honda Ltd. (2002 – 2006) (INR Crores except per share data)

Particulars	Mar 2006	Mar 2005	Mar 2004	Mar 2003	Mar 2002
Sales Turnover & Other Income	10253.76	8746.23	6928.21	5209.86	4550.6
EBIT	1415.16	1219.18	1074.18	886.29	695.89
PAT	971.34	810.47	728.32	580.76	462.93
Earning Per Share (Rs.)	45.84	37.75	33.91	26.78	22.67
Fixed Assets Turnover Ratio	7.83	8.51	7.92	6.84	NA
Operating Margin	13.80%	13.94%	15.50%	17.01%	15.29%
Net Profit Margin	9.47%	9.27%	10.51%	11.15%	10.17%
ROCE (%)	72.75	81.04	83.21	99.22	NA
RONW (%)	55.46	61.58	65.11	75.09	NA

Source: Kotak securities

Table 1 given above depicts the performance of Hero Honda in the last five years, which has been discussed in the following section;

- **Sales:** The Company has past record of strong growth in top line every year, for the last five years the top line has increased with a CAGR of 17.65% YoY.

In the FY 2006 strong volume growth (13% YoY) and better realization (2% YoY) led to a 17.23% growth in the top line.

- **PAT:** Net profit margin has been continuously shrinking for the company from a net profit margin of 10.17% in FY 2002 it has declined to 9.47% in FY 2006. In FY 2006 there was slight increase in the net profit margin resulting from launches of new models (Glamour, Achiever and Pleasure) during the year.
- **Return:** Though the volume of profit is increasing but the return on net worth and capital employed has fallen gradually every year. This fall in RONW and ROCE is a result of rising cost of manufacturing and increase in competition by entry of new players like HONDA.

Comparative study of major companies in two wheelers segment.

Table 2 compares three major players in two wheelers segment on the following parameters;

- **Profitability** - Hero Honda has the highest Profit margin next to Bajaj Auto in the Automobile Industry with net profit margin hovering around 10%, while the ROCE and RONW is highest for the company showing the efficient utilization of capital and shareholders money.

Table 2. Comparative study of major companies in two wheelers segment.

	Hero Honda Motors Ltd.	TVS Motor Company Ltd.	Bajaj Auto Ltd.
Profitability			
Operating Profit Margin	13.80%	4.97%	17.20%
Net Profit Margin	9.47%	3.07%	11.99%
Fixed Assets Turnover	7.83	2.80	3.04
ROCE (%)	72.75	18.43	27.27
RONW (%)	55.46	14.36	24.74
P/BV	7.37	3.07	5.60
P/E Ratio	17.08	23.77	27.37
Growth			
Growth Rate - CAGR	15.98%	16.76%	16.15%
Risk			
Standard Deviation - ROCE	11.07	10.82	2.92
Coefficient of variation	13.17%	36.38%	12.73%

Source: Kotak securities, Reuters

- **Risk** - The Company faced risk measured as variance in the ROCE has been calculated as 13.17% which is quite close to the lowest risk figure of Bajaj Auto. On parameter of risk Bajaj is a leader again but Hero Honda is close second.
- **Growth** - Hero Honda is facing stiff competition from its near rivals and aggressive launches from Honda are an attempt to fight for its overall market share in the industry. This stiff competition doesn't allow the future growth path of Hero Honda to be smooth.

Valuation

Dividend Discounting Method

Table 3. Valuation of Hero Honda Motors Ltd. using DDM – Phased Growth Rate

(INR per share data)

Year	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
	Growth Phase				Transition Phase			Stable Phase			
GROWTH	20.0%	20.0%	20.0%	20.0%	17.4%	14.8%	12.2%	9.6%	7.0%	7.0%	7.0%
Retention Rate (RR)	58.9%	57.0%	55.1%	53.2%	51.3%	49.4%	47.6%	45.7%	43.8%	41.9%	40.0%
Risk Free Rate (RFR)	7.6%	7.6%	7.6%	7.6%	7.6%	7.6%	7.6%	7.6%	7.6%	7.6%	7.6%
Market Risk Premium	7.0%	6.9%	6.7%	6.6%	6.4%	6.3%	6.1%	6.0%	5.8%	5.7%	5.5%
Beta	0.76	0.78	0.81	0.83	0.85	0.88	0.90	0.93	0.95	0.98	1.00
Ke	12.9%	13.0%	13.0%	13.1%	13.1%	13.1%	13.1%	13.1%	13.1%	13.1%	13.1%
EPS	45.84	55.01	66.01	79.21	92.99	106.76	119.78	131.28	140.47	150.30	160.82
ROE (Growth/RR)	34.0%	35.1%	36.3%	37.6%	33.9%	29.9%	25.7%	21.0%	16.0%	16.7%	17.5%
Dividend Per Share (DPS)	18.85	23.66	29.63	37.06	45.26	53.97	62.82	71.33	78.98	87.34	96.49
DF			0.88	0.78	0.69	0.61	0.54	0.48	0.42	0.37	0.33
Present Value of DPS		0.00	26.22	28.99	31.29	32.96	33.89	34.00	33.26	32.52	31.79
Present Value of Terminal Value		491.78	555.63	628.03	710.10	803.11	908.49	1027.85	1162.98	1315.90	1488.85
Sum of PV of DPS	284.91										
Terminal Value	491.78										
Total Valuation	776.69										

Source: Kotak Securities, Reuters, ISI Securities

Assumptions

- 1 For DDM Method terminal value has been calculated assuming the perpetuity growth rate to be 7%.
2. Cost of Equity (Ke) has been adjusted with the rise in Beta as it will approach the index average in long-term.
3. Retention Ratio has been assumed to reach 40% by the end of FY 2016
4. ROE has been calculated as growth divided by Retention Rate

Going ahead, we expect the margins to remain under pressure. This is attributed to the prevailing discount schemes offered by the company in the festive season and the high advertising and marketing costs incurred by the company for the new launches. Moreover the company is loosing its foot hold on the Indian auto-mobile sector with the entry of new player and aggressive launches by the existing players.

While the company has planned 6-7 new product launches over the next 6 months, only about two of them are likely to be completely new products while the balance are likely to be variants of existing products. The company has already announced the launch of 2 New Models Passion plus Limited Edition & the New Glamour with Alloy Wheels. Moreover this company has been named amongst top 10 companies in India by Wall Street Journal Asia".

Notwithstanding the pressure on the company's margins and lower earnings growth, valuations appear reasonable at current levels especially considering the company's leadership position in the Indian two-wheeler industry (43% market share). We give our HOLD rating on the stock.

Relative Multiple Model

Table 4. Relative Multiple Valuation

Figures in Crores except per share data.

	PE	P/BV	P/S	Market Cap
Hero Honda	17.08	7.37	0.07	14861.67
TVS Motors	23.77	3.07	0.03	2354.81
Bajaj Auto	27.37	5.60	0.29	27049.46
Kinetic Motors Company Ltd.	-1.31	12.87	0.16	73.35
Industry Average	23.68	6.07	0.20	

Source: Kotak Securities, Reuters, ISI Securities

The (standalone) current P/E is hovering around the 17x band in the past twelve months. This is at a discount to the industry P/E and leads us to conclude that the stock is available at a compelling valuation. HHML has traditionally been one of the best ROCE and ROE performers and hence deserves far better valuations than its peers but considering the present pressure on earning, decline in market share and stiff competition from competitors we rate this company as Hold and accumulate on a valuation of 14.11x FY07E EPS of INR 55.01.

Outlook 2007 and onwards and other developments

- Two wheeler stories will continue to unravel in future with the rising crude prices and insufficient rains. The above factors give motorcycles a natural advantage over four wheelers.
- Motor cycles have registered high growth among the two wheelers. The growth is due to increasing mobility requirement of the population and the younger generation's appetite to have bike for communication.
- Hero Honda dominates the Executive segment (market share of 73%), which accounts for 50% of the ~6mn motorcycle market. We believe aggressive launch

of Bajaj Twins in this segment will arrest Hero Honda's further market share gain. Even Honda plans to invest Rs.4bn for expanding its capacity to 2mn by 2010 and has already launched its second bike "Shine" in 125cc segment after Unicorn Hero.

- Honda launched `Pleasure`, its first gearless scooter in the Indian market on a national scale. It was earlier launched only in Delhi in January clocking a sale of nearly 20,000 numbers, but it is very early to comment on the response of its newly launched Achiever in the premium segment, which is dominated by Bajaj.

Risk and concerns for the company

- The possibility of lower growth rates in two segments: Premium and deluxe cant be ruled out, and therefore constitute a risk factor for Hero Honda.
- Expansion plans of wholly owned subsidiaries of global automobile players (e.g. Honda) could increase the scope and level of completion in the Indian two wheeler industry posing a threat for the company.
- A further rise in steel and aluminium prices may bring down the profitability even lower.
- In the executive segment, Hero Honda's Super Splendor and Glamour have failed to create any substantial excitement among the customers.

Recommendation

Based on the above analysis, we give a **HOLD** recommendation for this stock with a target price of INR 776 for 31st March 2006. Though this stock is going through the phase of rising cost and market share erosion, the future plans and management dedication towards growth path shows the unlocked value in the stock, it just requires to get out of the phase in which this company is and aggressively launch new products considering that competition is firing from all cylinders.

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Explanation of Ratings:

1. **Buy:** More than 10% upside
2. **Hold:** Within (-) 10% - 10% change in the price
3. **Sell:** Less than 10% downside

Disclosure of interest:

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