

Hero Honda

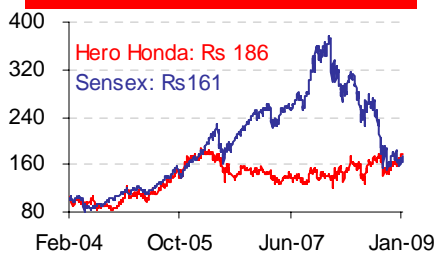
Hold

Target Price: Rs 1,160

Market data

Current price	Rs 912 (BSE)
Market cap	Rs 182,126 m
Face value	Rs 2.0
FY08 DPS (Rs)	5.0
BSE Code	500182
NSE symbol	HEROHONDA
No. of shares	199.7 m
Free float	45.0%
52 week H/L	Rs 940 / 630

Rs 100 invested is now worth



Stock price Performance

	Hero Honda	Index*
6-Mths	15.3%	-38.0%
1-yr	26.7%	-49.3%
2-yr	13.7%	-19.0%

2 yr returns on a CAGR basis
*BSE Sensex

Shareholding (Dec - 2008)

Category	(%)
Promoters	55.0
Institutions	11.1
FII's	24.7
Indian Public	7.1
Others	2.1
Total	100.0

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Investment Rationale

- Chugging along nicely:** In an environment where most of the other companies are struggling to even maintain their topline performance let alone enhance it, Hero Honda has managed to deliver a stellar topline performance. This is can be borne out from the company's nine month performance for FY09 where it registered an impressive topline growth of 18% YoY despite numerous economic headwinds. Factors such as a deeply entrenched distribution network, extremely competent management team, rock solid balance sheet and ownership of some of the most admired motorcycle brands combine together to give the company such an edge.

Given that the motorcycle demand in the country is far from reaching saturation levels, we expect the company to continue to add to shareholder value over the distant future. We project a CAGR of 14% in the company's net sales between FY08 and FY11. Although this is higher than the near 12% CAGR achieved between FY05 and FY08, much of the growth has already taken place in FY09, thus taking the growth between FY09 and FY11 to the past levels of 11% or thereabouts. Given the strengths mentioned above, we believe that this is a reasonable assumption to make.

- Good scope for margin expansion:** For the five year period starting from FY02 and ending in FY06, the company enjoyed average operating margins to the tune of 16%. However, the bull run in commodities eventually spoiled the margin party of the company, pulling it down to about 12%-13% over the next couple of years. Things are starkly different now. Prices of major inputs like steel, aluminium and plastics are down by a huge 40%-50% from their highs and are likely to remain so over the medium term on account of global economic slowdown. While this is not good for the profitability of commodity companies, Hero Honda, as a key user of these commodities (raw material costs account for anywhere between 80%-85% of the total costs of auto companies) could stand to gain from the fall in commodity prices. Although we have projected a margin expansion of only 50 basis point in FY11 over FY08, any further expansion, which is well within the realms of possibility, could positively influence the target price for the company. Just to put things in perspective, restoration of 16% margins of the past could result in our target price coming higher by 15%. This means an additional 7% gain per annum till FY11.
- Balance sheet strength:** Although motorcycles have continued to remain the most popular two-wheeler segment, product lifecycles have shortened dramatically, forcing companies to come out with new product launches at a faster rate. And since launching new products involves a fair amount of capital outlay, the need for a strong balance sheet is greater than any time in the past. And how does Hero Honda fare on this front? Quite well, we should say. Among all the two wheeler majors, the company possesses what could be called one of the strongest balance sheets. Not only is it

debt free but as of year ended FY08 had cash and liquid investments to the tune of Rs 27 bn. To give an idea, this amount is nearly 9 times the company's average capex over the last five years. Furthermore, the company's lean operations also throw off a substantial amount of free cash flow every year. Thus, given the abundant availability of funds, the company is not only well placed to maintain its market share from competitors but also enhance it.

- **Diversification:** Identifying the increasing competition in the domestic markets, the company is seriously considering to de-risk its business geographically. The announcement by the company to enter into Latin American and African markets is a desirable indicator in this direction. As per the management, the size of these markets is 6 m to 7m units per annum. It should be noted that the Honda Motorcycle, the company's technological partner, already has a presence in these markets. This can act in favour of Hero Honda. Apart from this, the company is also contemplating entering the ASEAN region. Currently, exports accounts for just 3% of the total motorcycles sales of the company as compared to 23% in case of Bajaj Auto. Further the management's decision of entering the ungeared scooter segment also seems to be bearing fruit as the company has already garnered a domestic market share of 10% in FY08, just the third year of its operations. Though it is too early to comment on these initiatives, having regards to its strong brand equity, distribution network and association with Honda Motorcycles, the company may be able to diversify its risk to some extent.
- **Healthy dividend yield:** Management of the company has always endorsed the policy of not keeping more cash than required and distributing the rest to the shareholders. As a result of its strong growth over the last few years, the company has rewarded its shareholders accordingly and has doled out substantial amount of profits as dividends. Given its limited capex requirements, we expect the dividend payments to remain as strong or may be even rise from the current levels.

Investment Concerns

- **The Honda threat:** Honda has set up a 100% subsidiary in India for the manufacture of

scooters in India. This company commenced operations in mid 2001 and had garnered an imposing 59% market share by the end of FY08. As per the agreement with Hero Honda, Honda, on a standalone basis, has already launched few motorcycles (though the response has been lukewarm at best). This issue is of high significance given Hero Honda's heavy reliance on the Japanese major.

- **Competition at its neck:** One of the key reasons for the stupendous growth recorded by Hero Honda in the past was the relatively weaker competition that it faced from both Bajaj Auto and TVS Motor. These two companies were concentrating on developing their R&D platforms for motorcycles to enable them to improve their product quality and reduce product development time. This directly benefited Hero Honda, which is evident from the fact that the company has increased its market share in the motorcycle segment (from 44% in FY98 to 50% in FY05). Going forward, we believe that competition is likely to intensify for Hero Honda, as Bajaj Auto and TVS Motor have already developed the necessary R&D platforms to introduce new products on a regular basis. Apart from this, there has been a marked improvement in the quality of offerings as evident by success of TVS Apache and Bajaj Discover. As a consequence, the company will have to spend more on new product development thereby hurting its returns.

Background

Hero Honda Motors, the largest manufacturer of motorcycles in the world, is a joint venture promoted by Hero Cycles (P) Limited and Honda Motor Company of Japan. Each partner holds 26% stake in the company. The company is solely engaged in manufacturing and sale of motorcycles. However, the company made its entry in the gearless scooterette segment with the launch of 'Pleasure' in FY06. While sale of motorcycles and scooters accounted for 94% of revenues in FY08, spare parts contributed the rest. Hero Honda's initial technology agreement with Honda expired in 2004. But the company has extended its technology agreement with Honda for a further period of ten years till 2014 and has plans to introduce a series of new models/improved versions of existing ones. It had a commanding 55% market share in the domestic motorcycle segment in FY08.

Comparative Parameters

Parameter (FY10E)	Hero Honda	Bajaj Auto
EBDITA margin (%)	13.0%	13.5%
Net margin (%)	9.9%	11.4%
Return on equity (%)	30.8%	38.3%
Return on assets (%)	18.8%	17.5%
Working cap/sales (%)	-6.7%	6.8%
Asset turnover (x)	7.1	5.7
Valuation ratios (FY10E)		
Price (Rs)	912	526
Price to earnings (x)	13.6	7.1
Price to book (x)	4.2	2.7
Price to cash flow (x)	11.7	5.7

Industry Prospects

The prospects of the two-wheeler industry are closely linked to economic growth, movement in interest rates and growth in per capita income. The CAGR in domestic volumes in the last five years stood at 10%. However, the motorcycle segment grew at a much faster pace of 12% in the same period. During this time, the geared scooter segment has seen huge decline in volumes sold, thus highlighting the dramatic change in two-wheeler volume mix in the last decade.

Going forward, we expect the motorcycles and ungeared scooter segment to grow at a steady pace. Though the rate of growth in motorcycles will decline to around 8% to 10% in the next three years, ungeared scooter market could grow by more than 10% levels. The scope for market expansion in the latter exists. Going forward, we also feel that the replacement demand, which currently accounts for around 30% of the total units sold, can touch 50%.

Risk Analysis

Please see 'Risk Matrix' table on page 5 of this report

Sector: With more and more automobiles plying on Indian roads and with demand for two-wheelers also likely to remain strong, we believe the industry will continue to grow at a steady pace over the medium term. However, considering the fact that greater proportion of two-wheelers is now being financed, which in turn makes them vulnerable to interest rate cycles, we assign a 'medium' risk rating to the sector. Based on these factors, we have assigned a medium risk rating to the stock.

Company standing: With the company being an industry leader in motorcycles, its standing in the

sector is definitely on the stronger side. As such, we assign a strong rating to the stock on this parameter.

Sales: Hero Honda generated average revenues to the tune of nearly Rs 84 bn (US\$ 1.7 bn) each year over the last three years. Further, in the latest fiscal (FY09), we estimate the company to generate nearly US\$ 2.4 bn in revenues. We thus assign a low risk rating of 7 to the stock on this parameter.

Operating margin: Operating margin is a measurement of what proportion of a company's revenue is left over after paying for variable costs of production such as raw materials, wages, and sales and marketing costs. A healthy operating margin is required for a company to be able to pay for its fixed costs, such as interest on debt. The higher the margin, the better it is for the company as it indicates its operating efficiency. Hero Honda's average operating margins for the past three years has been 14%, which we expect to remain more or less similar during the next three years. As such, we assign a medium risk rating of 5 to the stock on this parameter.

Long term EPS growth: Hero Honda has grown its net profits at a CAGR of 6% in the past three years. Between FY09 and FY11 however, we expect growth to come in at 20%. As such we assign a medium risk rating of 5 to the stock on this parameter.

Return on capital invested (ROIC): ROIC is an important tool to assess a company's potential to be a quality investment by determining how well the management is able to allocate capital to its operations for future growth. A ROIC of above 15% is considered decent for companies that are in an expansionary phase. Considering Hero Honda's last three years' average ROIC of almost 35%, we have assigned a low-risk rating of 9 to the stock on this parameter.

Dividend payout: A stable dividend history inspires confidence in the management's intentions of rewarding shareholders. Hero Honda's average payout ratio has been a decent 40% over the past 3 fiscals. Thus, we have assigned a low-risk rating of 9.

Promoter holding: A larger share of promoter holding indicates the confidence of the people who run it. We believe that a greater than 40% promoter holding indicates safety for retail investors. Promoter shareholding in Hero Honda at the end of December

2008 stood at 55%. As such, we assign a low risk rating of 9 to the stock on this parameter

FII holding: We believe that FII holding of greater than 14% can lead to high volatility in the stock price. The FII holding in Hero Honda at the end of December 2008 stood at 25%. Based on our parameters, the rating assigned is 4.

Liquidity: The average daily trading volumes of Hero Honda's stock over the past 52 weeks stand at 75,000 shares. Since this is slightly on the lower side, the rating assigned is 2.

Current ratio: Hero Honda's average current ratio during the period FY06 to FY08 has been 0.5 times. However, it should be noted that the company has enough cash resources at its disposal in the form of liquid investments that could take care of any near term fund shortfall. Hence, we assign a low-risk rating of 8.

Debt to equity ratio: A highly leveraged business is the first to get hit during times of economic downturn, as companies have to consistently pay interest costs, despite lower profitability. Considering Hero Honda's debt free status over the past five fiscals, we have assigned a low-risk rating of 10 to the stock.

Interest coverage ratio: It is used to determine how comfortably a company is placed in terms of payment of interest on outstanding debt. The interest coverage ratio is calculated by dividing a company's earnings before interest and taxes (EBIT) by its interest expense for a given period. The lower the ratio, the greater are the risks. Since Hero Honda is nearly debt free, there are no interest expenses worth considering. As such we assign a low risk rating of 10 to the stock on this parameter.

P/E Ratio: The P/E ratio (price-to-earnings ratio) of a stock is a measure of the price paid for a share relative to the per share income or profit earned by the company. This is one of the important metrics to judge the attractiveness of a stock, and thus gets the

highest weightage in our risk matrix. Hero Honda's P/E (trailing twelve months) stands at 15.6 times. As such, we have assigned a medium risk rating of 5 to the stock on this parameter.

Considering the above analysis, the total ranking assigned to the company is 83 that, on a weighted basis, stand at 6.7. This makes the stock a low-risk investment from a long-term perspective.

Valuations

We last recommended Hero Honda in October 2006 with a target price of Rs 960 from a medium term perspective. Since the stock is pretty close to reaching its target price, a review is in order. We believe that despite competition from other segments (ungeared scooters and entry level cars like Nano) motorcycles sales are far from reaching saturation levels. In fact, per capita consumption of motorcycles in India is way below other emerging economies like China, Thailand and Indonesia. Thus taking into account the growth prospects in Hero Honda's target market and the company's strong market position, we believe that the company should not trade below Rs 1,160 per share by FY11. This translates into a CAGR of 12% from the current levels, good enough for us to recommend a HOLD on the stock. Furthermore, if one takes into account the 2% dividend yield, the returns could rise up to as much as 14% per annum.

Valuation table

(Rs m)	FY08	FY09E	FY10E	FY11E
Revenue (Rs m)	103,318	123,445	135,728	152,875
PAT (Rs m)	9,679	12,255	13,410	16,786
EPS (Rs)	48.5	61.4	67.2	84.1
Price to earnings (x)	18.8	14.9	13.6	10.8
Price to sales (x)	1.8	1.5	1.3	1.2

Risk Matrix

Rating	Weightage* (A)	Rating accorded	
		Rating# (B)	Weighted (A*B)
Sector risk	-	Medium	NA
Company's standing	-	Strong	NA
Performance parameters			
Sales	5.0%	7	0.4
Operating margins	5.0%	5	0.3
Long term EPS growth	10.0%	5	0.5
Return on invested capital	10.0%	9	0.9
Technical parameters			
Dividend payout	5.0%	9	0.5
Promoter holding	10.0%	9	0.9
FII holding	5.0%	4	0.2
Liquidity	10.0%	2	0.2
Safety parameters			
Current ratio	5.0%	8	0.4
Debt to equity ratio	10.0%	10	1.0
Interest coverage ratio	5.0%	10	0.5
P/E ratio	20.0%	5	1.0
Final Rating**		83	6.7

Rating has been assigned on the basis of the company's performance over the past five years and expected performance over the next 3 to 5 years. Rating is on a scale of 1 to 10, with 1 indicating highest risk and 10 indicating lowest risk.* 'Weightage' indicates the relative importance in percentage terms of the parameter. For instance, for an investor, given all the performance metrics, Return on Equity should be the foremost criteria for buying/not buying stocks. ** The final rating has been arrived at by multiplying the rating/points given on each parameter with the respective weightage

Financials at a glance

(Rs m)	FY08	FY09E	FY10E	FY11E
Sales	103,318	123,445	135,728	152,875
Sales growth (%)		19.5%	9.9%	12.6%
Operating profit	13,494	16,048	17,645	20,638
Operating profit margin (%)	13.1%	13.0%	13.0%	13.5%
Net profit	9,679	12,255	13,410	16,786
Net profit margin (%)	9.4%	9.9%	9.9%	11.0%
Balance Sheet				
Current assets	9,420	15,156	17,462	22,349
Fixed assets	15,487	17,343	19,242	21,288
Investments	25,668	29,668	34,668	39,668
Total Assets	50,575	62,168	71,372	83,306
Current liabilities	19,553	24,466	26,536	29,540
Net worth	29,702	36,382	43,516	52,446
Loan funds	1,320	1,320	1,320	1,320
Total liabilities	50,575	62,168	71,372	83,306

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