

Hero Honda

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Market Performer

Rs250

Auto major Hero Honda (HH) has reported a 14.7% YoY and 9.3% QoQ jump in net profits to Rs1528mn for Q3FY03 which is in line with our estimates of Rs1529mn. Net sales have grown 12.8% YoY to Rs13760mn, though at a much slower pace than volumes, which grew 16.1% YoY. While the festival season sales were largely in line with market expectations, the company's December sales were worse than usual as a result of inventory correction taking place at the dealer level.

Cost rationalisation efforts continue...

The company continued to squeeze costs through greater indigenisation and vendor rationalisation initiatives. Raw material costs, as a percentage of net sales, dipped from 69.3% in Q3FY02 to 68% in the quarter under review, though slightly higher than Q2FY03 when raw material costs accounted for 67.7% of net sales. However, lower staff costs in Q3 (compared to Q2FY03) allowed the company to maintain its operating expenses, as a per cent of net sales, at Q2 levels. Going ahead, we believe that raw material prices could come under pressure on account of sustained increase in steel/metal prices.

...but negated in part by higher promotion costs

Promotion spends have remained high this quarter with HH offering a variety of sales offers and discounts on its motorcycles. Though these schemes are part-funded by the dealers as well, higher promotion costs have kept operating profit growth in check. Operating profits grew 20.0% YoY and 11.4% QoQ to Rs2281mn in Q3FY03. Combined effect of the cost rationalisation initiatives and higher promotion costs has been that HH has been able to hold its Q2FY03 OPM levels at 16.6%. However, OPMs expanded by 100 basis points on a YoY basis. Going forward too, we expect promotion costs to remain high in Q4, with *World Cup* related advertising expected to intensify.

Exhibit 1: Operating Cost break up and Margins

	Q3FY02	Q4FY02	Q1FY03	Q2FY03	Q3FY03
As per cent of net sales (%)					
Raw material	69.3	68.8	68.4	67.7	68.0
Personnel	3.6	3.5	3.8	4.1	3.8
Others	11.5	11.7	11.1	11.7	11.7
Total Operating Expenses	84.4	84.0	83.4	83.4	83.4
OPM (%)	15.6	16.0	16.6	16.6	16.6
NPM (%)	10.9	12.2	10.9	11.3	11.1

Outlook

In the current quarter much of HH's volumes have been driven by the *Splendor*, which has seen some sort of a pick up in sales during the festival season. *Splendor* accounted for nearly 54% and 60% of the total volumes in October and November '02, respectively. In the executive segment, *Splendor* and *Passion* together accounted for 77% and 80% of total volumes in October and November '02, respectively.

This, we believe going forward remains the main source of concern as the executive segment will see increasing competition and new launches (like *Ambition*) will not be able to combat this easily in the near term. *Ambition* will also face intense competition from the successful *Pulsar* and Yamaha's *Enticer* as also Bajaj's new 125cc bike. We continue to reiterate that HH will not be able to achieve its FY03 target of 1.8mn bikes.

View and Valuation

At current levels, HH trades at 9.0x FY03E EPS. Adverse news flow and a lack of triggers would keep interest limited in the stock. We expect the stock to trade in a broad range of Rs220-300 in the medium term. Our lower end target of Rs220 takes into account the fact that HH remains flush with cash and could declare a huge payout in the form of a dividend (or buyback). The company paid out over 75% of earnings as dividends in FY02. With the management indicating that the payout could be maintained at last year's levels,

it should translate into a dividend yield of 7-8%. This would support the stock on the downside. We maintain our **Market Performer** rating on the stock.

Exhibit2: Price/Earnings Chart

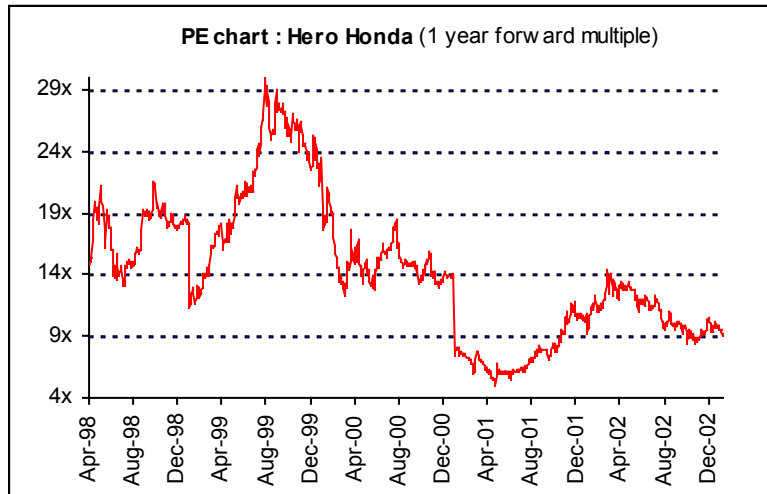


Exhibit 3: Quarterly Results

	Rs Million		
	Q3FY02	Q3FY03	% chg
No.of Motorcycles Sold	389272	452047	16.1%
Net Sales	12195	13760	12.8%
Total Expenditure	10294	11480	11.5%
Inc./Dec. in stock	83	-21	-125.1%
Consumption of R.M.	8371	9376	12.0%
Staff cost	438	521	18.9%
Other expenditure	1402	1604	14.5%
Operating Profit	1901	2281	20.0%
Interest	4	1	-75.0%
Depreciation	128	144	12.6%
Other income	257	218	-15.3%
PBT	2027	2354	16.1%
Current Tax	694	804	15.8%
Deferred Tax	-	22	
PAT	1332	1528	14.7%
OPM (%)	15.6	16.6	
NPM (%)	10.9	11.1	
EPS (Rs)	6.7	7.7	

Stock Ratings Absolute Returns

Buy	:	> 25%
Out Performer	:	16 - 25%
Market Performer	:	0 - 15%
Under Performer	:	< 0%

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