The Front Page

September 18, 2008

What's Inside: Idea Cellular (BUY), Hero Honda (ADD), Events calendar

Market Front Page

Index Movements	Closing	% Chg	% YTD
Sensex	13,263	(1.9)	(34.6)
Nifty	4,008	(1.6)	(34.7)
BSE Smallcap	6,215	(1.2)	(53.4)
CNX Midcap	5,212	(1.0)	(43.4)
Nasdaq	2,099	(4.9)	(20.9)
DJIA	10,610	(4.1)	(20.0)
IBOV	45,909	(6.7)	(28.1)
FTSE	4,912	(2.3)	(23.9)
CAC	4,000	(2.1)	(28.7)

Turnover		US$m	% Chg
BSE		1,237	12.6
NSE		2,648	(0.3)
Derivatives (NSE)		12,634	4.3

FII F&O (US$m)		Index	Stocks
Net buying		42	40
Open interest		7,617	4,599
Chg in open int.		40	(81)

Equity Flows (US$m)	Latest	MTD	YTD
FII (16/9)	(308)	(1,340)	(8,598)
DII (17/9)	205	1,279	12,729
MF (16/9)	52	125	2,646

ADR/GDR (US$)	Latest	% Chg	% Prem
HDFC Bank	77.0	(5.3)	0.2
Reliance	78.9	(2.6)	(2.5)
Infosys	34.4	(5.6)	0.9
Satyam	17.0	(6.6)	13.0
Wipro	9.6	(5.3)	11.0
ICICI Bank	23.3	(7.7)	(3.7)
SBI	63.3	(0.6)	(4.1)
ITC	4.0	(3.6)	0.4
Tata Motors	8.7	(3.1)	(3.4)

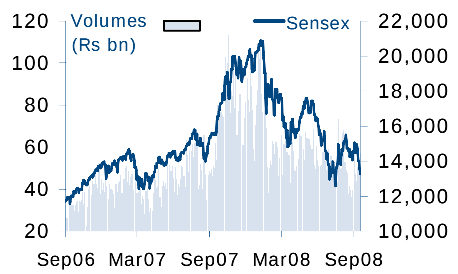
Commodities	Latest	%Chg	%YTD
Gold (US$/ounce)	873	1.1	4.7
Crude (US$/bl)	97	6.6	1.2
Aluminium (US$/MT)	2,500	(1.2)	3.8
Copper (US$/MT)	6,750	(1.7)	1.1

Forex Rates	Closing	% Chg	%YTD
Rs/US$	46.3	(0.3)	17.6
Rs/EUR	65.8	(0.7)	13.3
Rs/GBP	83.0	(0.8)	5.4

Bond Markets		Closing	bps Chg
10 yr bond		8.2	7.0
Interbank call		10.2	(85.0)

Charts Front Page

Sensex price volume



Sensex intraday

Corporate Front Page

- US FDA has banned the entry of over 30 medicines manufactured by **Ranbaxy**. (ET)
- **ONGC** to invest US$5.3bn in developing gas finds in two of its eastern offshore KG basin blocks. (FE)
- **RIL** to start D6 block gas output in November. (BL)
- **Wipro** Technologies acquires a US based mortgage solution provider Gallagher Financial System. (BS)
- **PNB** to raise Rs5bn by selling bonds. (BL)
- **RIL** files petition against Maharashtra government's decision to hold a referendum in 22 villages for its 10,000-hectare SEZ in Raighad. (BS)
- **BHEL** to raise power capacity to 20,000MW in three years. (DNA)
- **Aurobindo Pharma** receives a US FDA approval to manufacture and market Abacavir Sulfate tablets. (BL)
- Telecom-Italia acquires 49% stake in **Unitech's** telecom arm for US$2bn. (ET)
- **Jindal Stainless** to float a wholly owned subsidiary, JSL Ventures PT in Singapore to control all overseas mining operations. (ET)
- **Sanghi Industries** to commission the first part of its Rs2.5bn captive thermal power project in November. (ET)
- **Novartis** launches health care projects for rural markets. (BL)
- **NHPC** signs pact with Myanmar government to develop two hydel power projects. (BL)
- **IDBI** seeks RBI's approval for Rs15bn PE fund. (BS)
- **Gujarat NRE Coke** plans to float a right issue with differential voting rights to ward off takeover threat. (BS)
- **ONGC** finds traces of uranium in some of the 9,500 wells it has dug. (DNA)
- **Zensar Technologies** launches infrastructure management unit. (BL)

Market Front Page

Top Movers BSE 200

Top Gainers	Price (Rs)	Chg (%)	YTD (%)	Top Losers	Price (Rs)	Chg (%)	YTD (%)
Tata Motors	418	4.8	-41.8	BF Utilities	1634	-10.0	-27.0
Patni Computer	200	3.4	-39.8	Unitech	127	-9.1	-74.0
Yes Bank	134	2.9	-46.4	Hexaware Techno	37	-8.2	-57.3
Tata Tea	696	2.9	-23.3	Tanla Solutions	170	-8.1	-55.3
Petronet LNG	55	2.8	-48.3	Sterlite Ind.	440	-8.0	-57.5

Volume spurts

Company	CMP	M.Cap	Vol. (in '000)	10D A.Vol (in '000)	% Chg
Television 18	215	557	374	70	435
Jindal Saw	590	663	1,915	413	364
Cipla	218	3,657	8,421	1,987	324
United Spirits	1263	2,729	2,685	686	291
Colgate-Palmolive	370	1,085	476	134	256
Glaxosmithkline	1174	2,146	44	15	192
Asian Paints	1200	2,484	110	40	175
BEML	728	654	79	30	163
BF Utilities	1634	1,328	25	11	122
ICICI Bank	560	13,603	32,580	15,019	117

FII - FII trades

Scrip	16/9/2008			17/9/2008		
	Volume '000	Price	Prem %	Volume '000	Price	Prem %
Tata steel	954	490	1.2	853	482	0.5
Sbi	95	1,527	1.0	456	1,547	0.3
Obc	12	169	2.5	-	-	-
Union bank	435	149	4.5	555	154	4.0
Grasim	8	1,926	1.0	48	1,894	1.1
Allahabad bank	164	63	2.5	588	63	1.0
Iob	9	97	3.0	-	-	-
Pantaloon	75	363	21.0	5,800	359	18.0

Corporate Front Page

- **GSPC** plans to raise US$1bn in initial share sale by January 2010. (DNA)
- **Dewan Housing** to raise Rs1.5-2bn by end of March 2009 via equity issuance. (DNA)
- **Mastek** clarifies it doesn't depend on Merrill Lynch or Lehman Brothers for any part of its revenue. (FE)
- **Aban Offshore's** wholly owned subsidiary, Aban Singapore Pte is considering listing on Oslo stock exchange. (BL)
- **Glodyne Technoserve** secured a contract worth Rs2.8bn from Bihar's State Electronics Development Corporation. (BS)
- **Videocon Industries** set to acquire 10% stake in Thomson SA of France. (BS)

Economy Front Page

- DoT to consider a proposal for allowing foreign telecom companies to bid as 100% entities in upcoming 3G auction. (ET)
- Indian ship owners seek approval from RBI to enter International freight derivatives market for forward freight agreement. (ET)
- PM says India to grow at 8% in FY09 despite global slowdown. (ET)
- Centre has no plans to review custom duty on Agriculture product. (ET)
- Government may consider relaxing ECB norms by this month end. (DNA)
- Government approves FDI worth Rs140bn. (FE)

Insider Trading

Company	Name of Acquirer / Seller	Transaction Date	Buy / Sale	Quantity	Price (Rs)	Deal Size (Rs m)	Shares Transaction (%)	Holding after Transaction (%)
Amtek India Ltd	Worhol Ltd	11/09/2008	Buy	4,495,307	75.0	337	4.0	9.8
Asian Oilfield Services Ltd	Consolidated Securities Ltd	11/09/2008	Buy	280,000	110.0	31	2.5	13.3
Oriental Hotels Ltd	Mrs. D Kameswari Reddy	05/09/2008	Buy	100,000	235.0	24	0.6	1.2
Oriental Hotels Ltd	Mr. D S Reddy	05/09/2008	Sell	100,000	235.0	24	0.6	2.9
Tribhuvan Housing Ltd	Hariram Goyal & Sachin Goyal	09/09/2008	Sell	863,400	28.5	25	8.6	-
Webel SL Energy Systems Ltd	Sohan Lal Agarwal	12/09/2008 - 15/09/2008	Sell	150,000	250.0	38	1.9	2.8

Deal Size worth more than Rs10m considered

BSE/ NSE - Bulk Deals

Company	Name of Acquirer / Seller	Transaction Date	Buy / Sale	Quantity	Price (Rs)	Deal Size (Rs m)
Educomp Soln	Deutsche Securities Mauritius Limited	17/09/2008	Buy	638,201	3,357.5	2,143
Educomp Soln	Morgan Stanley Mauritius Company Limited	17/09/2008	Sell	393,411	3,355.0	1,320
Educomp Soln	Morgan Stanley Investments Mauritius Limited	17/09/2008	Sell	138,708	3,355.0	465
Gujara Nre C	Morgan Stanley Mauritius Company Limited	17/09/2008	Sell	1,830,585	69.5	127
Jindal Saw	Deutsche Securities Mauritius Limited	17/09/2008	Buy	1,771,849	590.0	1,045
Jindal Saw	Morgan Stanley Mauritius Company Limited	17/09/2008	Sell	1,771,849	590.0	1,045
Lotus Choc C	Qvt Financial Lp Ac Qvt Mauritius West Fund	17/09/2008	Buy	78,294	25.6	2
Mahin Ugin	Swiss Finance Corporation Mauritius Limited	17/09/2008	Buy	492,175	45.0	22
Mahin Ugin	Merrill Lynch Capital Markets Espana S.A. S.V	17/09/2008	Sell	492,727	45.0	22
Opto Circuit	Jf Eastern Smaller Companies Fund	17/09/2008	Buy	690,277	287.0	198
Opto Circuit	Morgan Stanley Mauritius Company Limited	17/09/2008	Sell	752,227	287.0	216
Pantal Retai	Deutsche Securities Mauritius Limited	17/09/2008	Buy	5,746,880	359.0	2,063
Pantal Retai	Morgan Stanley Mauritious Company Ltd	17/09/2008	Sell	5,746,880	359.0	2,063
Sub Projects	Deutsche Securities Mauritius Limited	17/09/2008	Buy	805,942	114.0	92
Sub Projects	Morgan Stanley Mauritius Company Limited	17/09/2008	Sell	806,082	114.0	92
Tanej Aero A	Merrill Lynch Capital Markets Espana S.A. S.V.	17/09/2008	Sell	2,350,000	51.0	120
Unitd Spr	Goldman Sachs Investments Mauritius I Ltd	17/09/2008	Buy	2,550,734	1,328.0	3,387
Unitd Spr	Morgan Stanley Mauritius Company Limited	17/09/2008	Sell	2,550,734	1,328.0	3,387

Idea Cellular – BUY

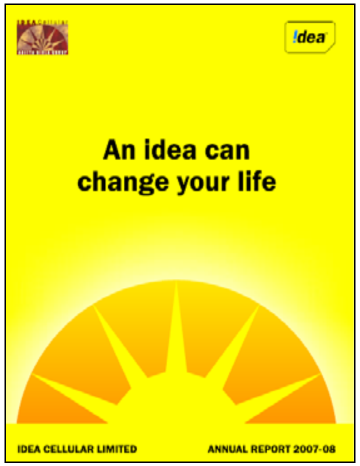
IDEA IN	Rs76	Telecom	18 September 2008	Annual Report Analysis

Holding its own in the big league

Idea Cellular is yet to receive the US$640m investment from the private-equity deal done in May this year, and the rupee's depreciation against the US$ will result in a gain exceeding Rs2bn for Idea. In FY08, Idea managed its FX exposure better than peers. Idea also sported the best asset turnover, highest depreciation rates and the highest ROE among the big carriers. It raised its market share in FY08 from 8.4% to 9.2% in terms of share of wireless subscribers. While minutes of usage increased by 5%, the rate per minute fell by 15%, resulting in a 12% drop in ARPU to Rs299. At 54%, Idea's YoY revenue growth rate was equal to that of Bharti. We build in higher cost of imports over the next 2 years and raise WACC to 14% and reduce our DCF target price from Rs141 to Rs112. BUY.

Idea stands to gain from rupee depreciation in the short term: On 28 May, when Idea announced the investment by Providence, the US$ was at Rs42.9 and since then has appreciated to Rs46.6. If this inflow of US$650m were to happen at current rates, Idea would gain almost Rs2.5bn. However, the next couple of years could see a significantly increased rupee capex due to this depreciation. Further, we feel that international companies are lining up as serious bidders for 3G auctions, and their bids can now be more aggressive in rupee terms. Since all bidders will have to match the highest bidder, there is a likelihood of the recent rupee depreciation making an impact in this indirect manner too.

Robust operational results and profitability in FY08: Idea increased its market share by 80bps in FY08 to 9.2% and posted a 54% increase in revenue despite a 12% drop in ARPU. EBITDA margin, however, did not expand because loss-making circles contributed a bigger proportion of overall revenue. Idea's depreciation rates are the most conservative among the major listed companies. The company's asset turnover was higher than that of Bharti and RCOM; this, combined with a debt-equity ratio of 1.5, higher than the other two companies, helped increase ROE to 39.2% for FY08. We expect Idea's expansion into the remaining nine circles in the country to entail capex of US$3.5bn in the next two years, and if 3G auctions are held soon, Idea could face spending needs of up to US$5bn. However, not needing to spend on tower capacity will prove very handy during this period, and could potentially save Idea more than US$2bn in the next three years.



Financial summary

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Revenues (Rs m)	43,664	68,183	103,408	141,745	177,337
EBITDA Margins (%)	33.5	34.5	33.1	30.8	30.2
Pre-Exceptional PAT (Rs m)	5,012	11,406	12,292	12,271	18,669
Reported PAT (Rs m)	5,012	11,406	12,292	12,271	18,669
EPS (Rs)	1.9	4.3	4.7	4.7	7.1
Growth (%)	106.3	123.9	7.8	-0.2	52.1
PER (x)	**39.3**	**17.6**	**16.3**	**16.3**	**10.7**
ROE (%)	30.3	39.2	22.7	15.8	20.0
Debt/Equity (x)	1.1	1.5	1.6	1.5	1.1
EV/EBITDA (x)	**15.1**	**10.8**	**9.2**	**7.4**	**5.8**
Price/Book (x)	9.0	5.5	2.8	2.4	2.0

Price as at close of business on 17 September 2008

12-mth Target price (Rs) 112 (47%)

Market cap (US$ m)	**4,313**
52Wk High/Low (Rs)	161/74
Diluted o/s shares (m)	2635
Daily volume (US$ m)	15.2
Dividend yield FY08ii (%)	0.0
Free float (%)	42.3

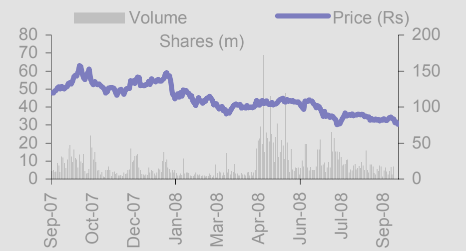
Shareholding pattern (%)

Promoters	57.7
FIIs	11.3
Domestic MFs/Insurance cos	5.4
Others	25.7

Price performance (%)

	1M	3M	1Y
Idea Cellular	-11.9	-30.1	-36.5
Rel. to Sensex	-2.0	-14.6	-22.0
Bharti	-4.8	-5.2	-7.5
RCOM	-13.0	-31.9	-33.2
MTNL	-13.5	-5.7	-39.6

Stock movement



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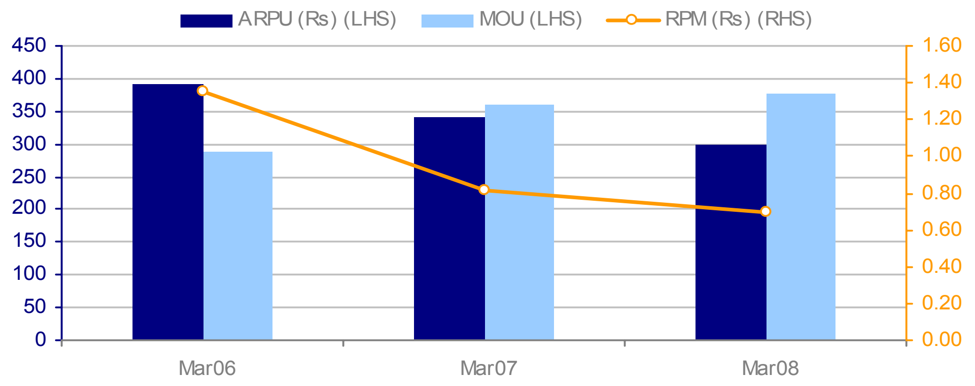
All-round gains in FY08

Figure 1: Idea Cellular improved its market share in FY08 by 80bps

Market share (subs)	Mar-06	Mar-07	Mar-08	Aug-08
Idea subscribers (m)	7.4	14.0	24.0	29.3
Total Wireless subscribers (m)	96.2	166.1	261.1	305.1
Idea Share of subs (%)	7.7%	8.4%	9.2%	9.6%

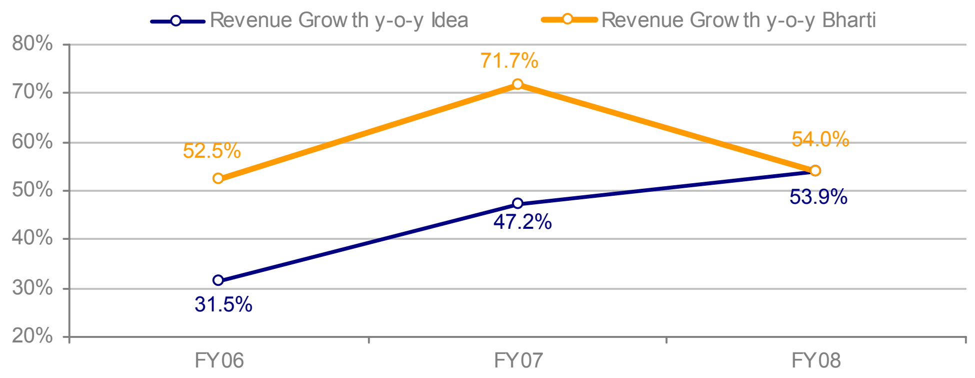
Source: Company, IIFL Research

Figure 2: Tariff fall has dominated usage increase, and ARPU fell by 12% in FY08



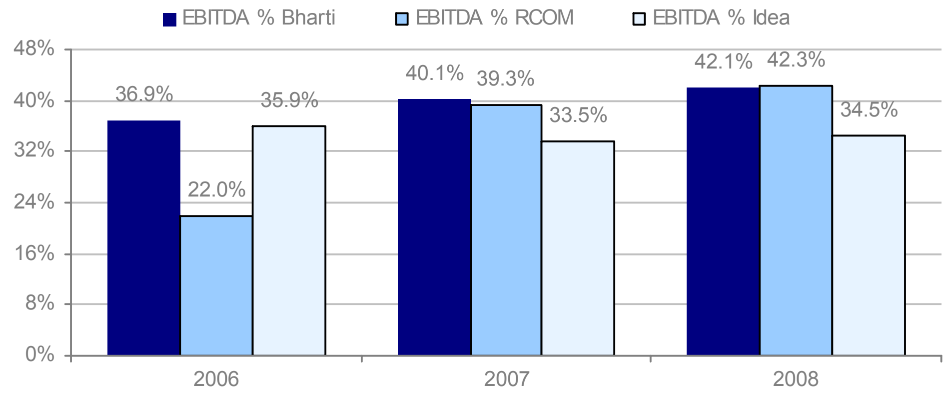
Source: Company, IIFL Research

Figure 3: Idea's revenue growth rate has now caught up with Bharti's



Source: Company, IIFL Research

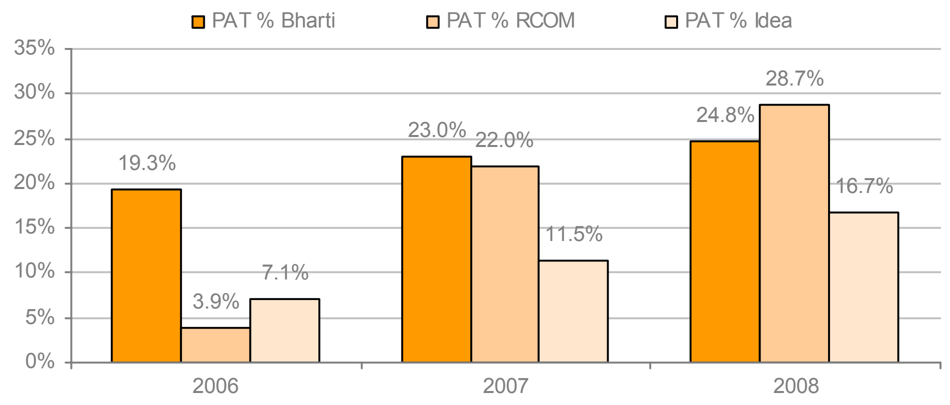
Figure 4: New circles have held back EBITDA margins, though Bharti's and RCOM's margins have risen



Source: Company, IIFL Research

Idea's three recent circles are still at an EBITDA margin of -10%, whereas the older profitable circles are in the mid-30s. As Idea expands its footprint across the country, margins will continue to be under pressure. However, Idea sports best-in-class fixed-asset turnover ratios.

Figure 5: Idea's IPO reduced interest burden, and enabled PAT margin to expand



Source: Company, IIFL Research

Figure 6: Apart from reduced interest, EBIT margin expansion boosted ROE

Dupont Analysis	FY06	FY07	FY08
Total asset turnover (x)	0.54	0.61	0.63
EBIT margin (x)	0.17	0.18	0.22
Interest burden (x)	0.43	0.64	0.82
Financial leverage (x)	5.34	4.30	3.69
Tax burden (x)	0.96	0.99	0.94
ROE (%)	21	30	39

Source: Company, IIFL Research

Figure 7: While depreciation % was lower, it is and has been higher than Bharti's

Depr. / Average Fixed Assets	FY06	FY07	FY08
Idea	10.1%	9.5%	8.4%
Bharti (wireless)	7.4%	7.7%	7.8%

Source: Company, IIFL Research

Figure 8: Asset turnover is best in class, and by a significant margin

Fixed-asset turnover (x)	FY06	FY07	FY08
Idea	0.67	0.74	0.75
Bharti	0.54	0.63	0.67
RCOM	-	0.63	0.54

Source: Company, IIFL Research

Idea stands to gain (temporarily) from INR fall

At the end of FY08, Idea's net FX position was as follows:

Figure 9: Idea faces limited risk from rupee depreciation

FX exposure	Amt	Whether hedged	Sensitivity to Re 1 change in US$/INR
Yen loans (Rs m)	5,658	Yes	NA since it is a Yen loan
Capital Credit (Rs m)	1,976	No	-46
Providence Investment	US$640m	NA	Rs640m

Source: Company, IIFL Research; Providence investment was announced on 28 May, when US$/INR was 42.9.

Note that the money from the investment made by Providence in Aditya Birla Telecom limited is yet to come in, hence Idea stands to gain at least Rs2.0bn, since the rupee has depreciated against the US$.

But watch out, INR depreciation will hurt all telcos:

As can be seen above, Idea is hedged on FX loans, and runs a minimal exposure on the deferred payment part on equipment imports. But the two aspects that can worry Idea are the following:

(a) Significant capex is planned for FY09 and FY10, and could easily exceed US$3.5bn in total.

(b) In the upcoming 3G auctions, the international bidders have an opportunity to increase their bid value within the same foreign currency budget, which means that Indian telcos will need to match this increased bidding strength.

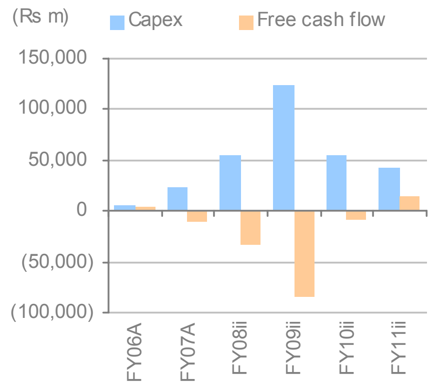
We increase our capex projection for Idea and accordingly reduce our target price to Rs112, based on the expected difference between the capex spend in INR for the next two years (due to the US$ appreciating from Rs40 at the beginning of 1QFY09 to 46.63 now).

Figure 10: Debt and green shoe option used to finance capex

Investment	Amount (Rs m)
Total investments	**59,768**
Capex (net addition to GFA)	55,576
Other investments, dividend, etc.	4,193
Cash generated by operations	**25,224**
PAT	10,423
Tax	294
Interest	4,160
Depreciation & Amortization	8,768
Working Capital Change	2,221
Other Items	-643
Financing	**21,319**
Green shoe option	3,188
Foreign Currency loan	5,658
Net INR Borrowing	12,474
Net change in cash	**-13,225**

Source: Company, IIFL Research

Figure 11: Idea should turn cash-flow-positive in FY11



Source: IIFL Research

Financial summary

In FY09, Idea has received US$640m investment from Providence, and an almost equal sum from TMI, apart from agreeing to buy out Spice

With the Providence and TM investments, Idea will become debt-free, with a significantly increased net worth and decision-making freedom

Income statement summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Revenue	43,664	68,183	103,408	141,745	177,337
EBITDA	14,643	23,502	34,206	43,728	53,474
EBIT	**7,925**	**14,733**	**20,639**	**23,790**	**30,507**
Interest income	0	1,816	632	868	1,405
Interest expense	-3,051	-4,593	-8,373	-11,782	-12,232
Exceptional items	0	0	0	0	0
Others	209	175	175	175	175
Profit before tax	**5,083**	**12,131**	**13,073**	**13,051**	**19,856**
Taxes	-70	-725	-781	-780	-1,187
Minorities and other	0	0	0	0	0
Net profit	**5,012**	**11,406**	**12,292**	**12,271**	**18,669**

Cashflow summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Profit Before Tax	5,083	12,131	13,073	13,051	19,856
Depr. & amortization	6,718	8,768	13,567	19,938	22,967
Tax Paid	-60	-75	-80	-80	-122
Working capital Δ	1,198	1,438	12,512	13,616	12,654
Other operating items	0	0	0	0	0
Operating cashflow	**12,939**	**22,263**	**39,072**	**46,524**	**55,355**
Capital expenditure	-22,819	-54,831	-122,864	-54,781	-41,743
Free cash flow	**-9,880**	**-32,568**	**-83,792**	**-8,257**	**13,611**
Equity Raised	25,000	3,227	23,040	0	0
Investments	-12	-5,548	4,060	0	0
Debt financing/disposal	9,649	22,649	55,762	20,000	-10,000
Dividends paid	0	0	0	0	0
Other items	-8,050	0	0	0	0
Net change in cash	**16,707**	**-12,240**	**-930**	**11,743**	**3,611**

Source: Company data, IIFL Research

Idea's working capital position was very healthy, given the nature of pre-paid business

ROE will descend from current lofty levels

Balance sheet summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Cash & equivalents	18,199	5,959	5,030	16,773	20,384
Sundry debtors	1,525	1,986	3,012	4,129	5,165
Inventories - trade	179	276	419	574	718
Other current assets	641	521	790	1,083	1,354
Fixed assets	**44,254**	**76,200**	**186,448**	**227,870**	**251,225**
Intangible assets	11,838	20,652	19,073	17,494	15,915
Other term assets	9,198	23,674	20,242	15,242	12,242
Total assets	**85,834**	**129,268**	**235,013**	**283,164**	**307,005**
Sundry creditors	16,109	17,599	26,691	36,586	45,773
Other current liabs	5,412	9,424	14,282	19,567	24,487
Short-term debt	7,305	16,574	50,916	50,916	50,916
Long-term debt/CBs	35,200	48,580	70,000	90,000	80,000
Other long-term liabs	11	661	1,362	2,062	3,126
Minorities/other equity	0	0	0	0	0
Net worth	**21,798**	**36,430**	**71,762**	**84,034**	**102,703**
Total liabs & equity	**85,834**	**129,268**	**235,013**	**283,164**	**307,005**

Ratio analysis

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Revenue growth (%)	47.2	56.2	51.7	37.1	25.1
Op Ebitda growth (%)	37.4	60.5	45.5	27.8	22.3
Op Ebit growth (%)	53.5	85.9	40.1	15.3	28.2
Op Ebitda margin (%)	33.5	34.5	33.1	30.8	30.2
Op Ebit margin (%)	18.1	21.6	20.0	16.8	17.2
Net profit margin (%)	11.5	16.7	11.9	8.7	10.5
Dividend payout (%)	0.0	0.0	0.0	0.0	0.0
Tax rate (%)	1.4	6.0	6.0	6.0	6.0
Net debt/equity (%)	111.4	147.2	159.4	145.9	106.2
Net debt/op Ebitda (x)	1.7	2.3	3.3	2.8	2.0
Return on equity (%)	30.3	39.2	22.7	15.8	20.0
ROCE (%)	12.7	14.5	11.0	9.0	10.4
Return on assets (%)	11.0	12.9	10.7	8.6	9.7

Source: Company data, IIFL Research

Hero Honda – ADD

HH IN	Rs817	Auto	18 Sep 2008	Company Update

Rural boost

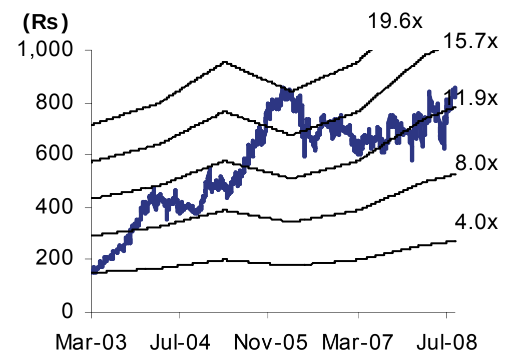
Hero Honda's annual report gives details on the company's market share gains in each segment. While it has traditionally been strong in the executive segment, it has gained significant traction in the premium segment. It has also gained from Bajaj's de-emphasis on the entry-level segment. HH's volumes have grown 19% YTD 2008, thanks mainly to its rural franchise and the buoyancy in rural markets. Discounts in the two-wheeler industry have dropped significantly on account of the change in competitive intensity. This has enabled HH to retain most of the benefits from its Uttaranchal plant. Its superior product selection strategy at Uttaranchal means that margins will improve by >100bps in the next three years. We upgrade our FY09 and FY10 EPS estimates by 5% and 7% respectively and upgrade the stock to ADD.

Competitive landscape changed in FY08: Bajaj's decision to focus exclusively on >100cc bikes has reduced the competitive intensity in the motorcycle industry. While volumes shrank, manufacturers chose to reduce discounts to protect their bottomlines. While HH has traditionally dominated the executive segment, in FY08 its volume growth outpaced that of the industry in each segment. The launch of the *Hunk* helped the company gain significant ground in the premium segment. Although volumes of entry-level bikes declined, Bajaj's withdrawal from the segment meant that HH gained market share in that segment as well. Overall, HH gained more than 650bps market share in FY08.

Rising rural income to boost earnings: Nominal agri GDP growth accelerated from a CAGR of 4.3% in 2002-05 to 11.1% in 2006-08. Increase in minimum support prices and increased farm yields have resulted in increased rural incomes. Going forward, HH, with a significant share of volumes from rural India, should be a key beneficiary.

Sound product selection at Uttaranchal plant augurs well for margins: While Bajaj is manufacturing its lowest-margin vehicle, *Platina,* in Uttaranchal, HH is manufacturing the high-margin *Splendor* in the state. HH started production in April 2008, without vendorisation. Over the next two years, 100 ancillaries will set up manufacturing base in Haridwar, beginning with 40 by the end of the current FY. We expect margins at Uttaranchal to be 250bps higher; and considering that a third of HH's volumes will come from Uttaranchal, this should result in a margin improvement of 100-150bps.

Given its superior growth, HH deserves to be trading at a premium to other auto stocks



Source: IIFL Research

Financial summary

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Revenues (Rs m)	99,000	103,318	120,129	134,280	146,908
EBITDA Margins (%)	11.8	13.1	13.4	13.8	14.0
Pre-Exceptional PAT (Rs m)	8,579	9,679	12,450	14,112	15,969
Reported PAT (Rs m)	8,579	9,679	12,450	14,112	15,969
EPS (Rs)	43.0	48.5	62.3	70.7	80.0
Growth (%)	-11.7	12.8	28.6	13.4	13.2
PER (x)	19.0	16.9	13.1	11.6	10.2
ROE (%)	34.7	32.4	33.7	30.9	28.4
Debt/Equity (x)	0.1	0.1	0.0	0.0	0.0
EV/EBITDA (x)	14.0	12.1	10.0	8.4	7.2
Price/Book (x)	6.6	5.5	4.4	3.6	2.9

Price as at close of business on 17 September 2008

12-mth Target price (Rs) 920 (13%)

Market cap (US$ m)	**3,520**
52Wk High/Low (Rs)	890/550
Diluted o/s shares (m)	200
Daily volume (US$ m)	6.0
Dividend yield FY08ii (%)	2.3
Free float (%)	45.0

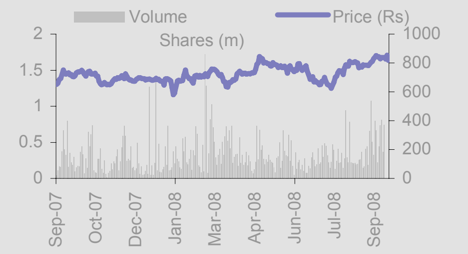
Shareholding pattern (%)

Promoters	55.0
FII	24.3
Domestic MF/Insurance	11.8
Others	9.0

Price performance (%)

	1M	3M	1Y
Hero Honda	3.2	3.6	20.9
Rel. to Sensex	13.1	19.1	35.4
Bajaj Auto	10.4	17.8	-
TVS Motors	0.3	-12.3	-55.7

Stock movement



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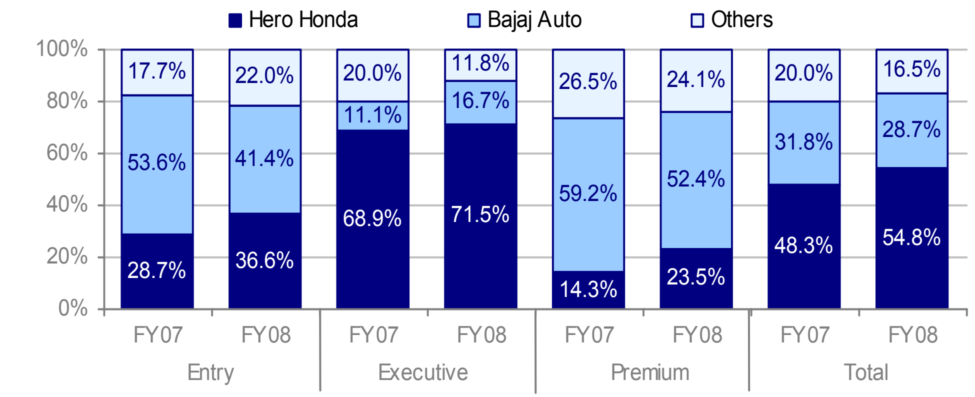
Competitive landscape changed in FY08

The annual reports of Hero Honda and Bajaj Auto provide an insight into how the two companies fared in various segments of the domestic motorcycle industry. The decision to focus exclusively on the 125cc+ segment had a negative impact on Bajaj Auto, with overall volumes declining more than 20%. Hero Honda, by virtue of its dominance in the executive segment, was able to maintain its volumes in a declining market. The highlight of the year was the success of *Hunk* in the premium segment. Overall, the company maintained its volume sales at the previous year's level (as against the industry's decline of 12%) and consequently gained market share. Its overall market share increased by 650bps, from 48.3% in FY07 to 54.8% in FY08, largely at the expense of Bajaj Auto and TVS Motors.

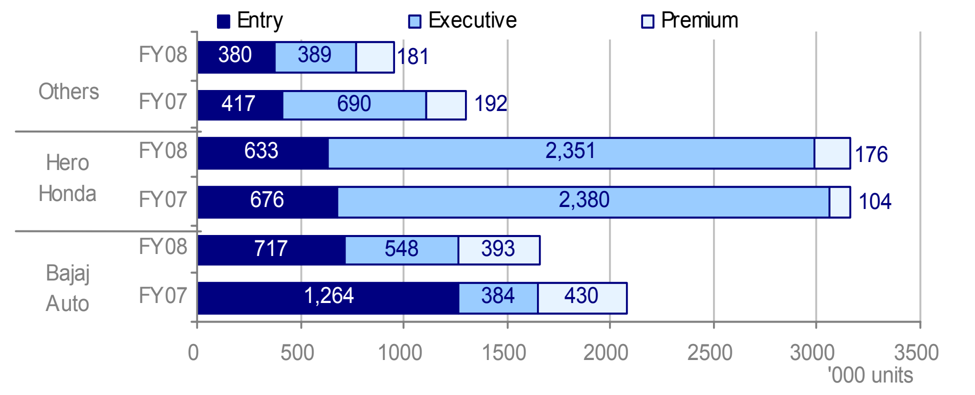
Bajaj's withdrawal from the 100cc segment led to a decrease in competitive intensity in the sector. Consequently, manufacturers were able to reduce discounting on products. The other key factor that has worked in HH's favour is its rural reach. While FY08 witnessed financing withdrawal to the sector, HH fared much better than its competitors (withdrawal of financing was particularly severe in the 100cc segment, in which Hero Honda is not a large player).

Figure 1: Hero Honda has gained significant market share in the premium segment



Source: HH and Bajaj Annual Reports, IIFL Research

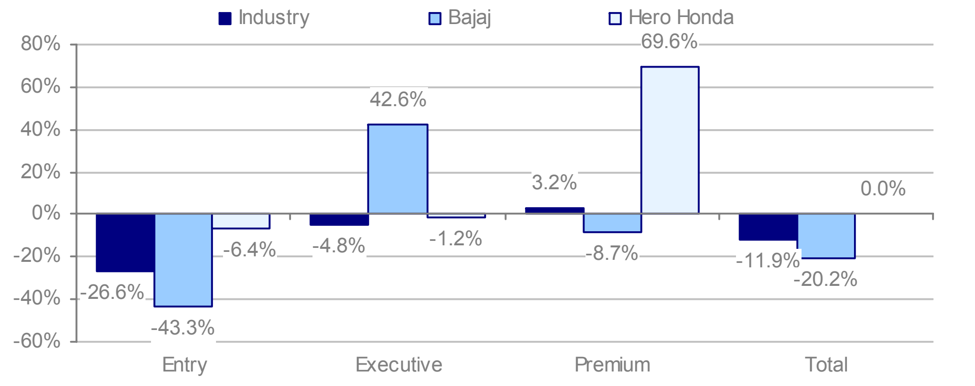
Figure 2: While Bajaj Auto's volumes declined, HH was able to maintain its volumes



Source: HH and Bajaj Annual Reports, IIFL Research

Bajaj has traditionally dominated the premium segment with its flagship product, the *Pulsar.* In FY08, however, *Pulsar* volumes declined by 9%, while Hero Honda's premium-segment volumes rose 70%, thanks mainly to the successful launch of the *Hunk*. With Bajaj's de-emphasis on the entry-level segment, HH's share in that segment has increased. Thus, HH gained share in the two segments where it was weak. The company thwarted competition from Bajaj and managed to maintain its dominance of the executive segment.

Figure 3: Bajaj's pullout from the Entry level segment affected industry dynamics



Source: HH and Bajaj Annual Reports, IIFL Research

Sound product selection at Uttaranchal augurs well for margins

Hero Honda commenced production at its Haridwar plant in April 2008 with an initial installed capacity of 500,000 vehicles. The company will ramp this up to 1,500,000 vehicles in two years. HH's managementexpects to produce 700,000 vehicles in FY09 and 1,000,000 vehicles in FY10. Unlike its key competitor Bajaj Auto, which chose to produce its least profitable bike (the 100cc *Platina*) in Uttaranchal, HH decided to use income-tax benefits in Uttaranchal to produce its highest-margin vehicle, the *Splendor*.

Excise benefit at the plant depends on the level of 'vendorisation' (sourcing of components from vendors' units in the same state) at the plant. Unlike Bajaj, which started production with almost 70% vendorisation, Hero Honda will take two years to achieve the desired level of vendorisation. Over the next two years, 100 ancillaries will set up manufacturing base in Haridwar, beginning with 40 by the end of the current FY.

Figure 4: Haridwar plant's contribution to EBITDA will increase to 33%

	FY09ii	% of total	FY10ii	% of total	FY11ii	% of total
No. of bikes sold	700,000	19.4%	1,000,000	25.6%	1,200,000	29.0%
Net revenues	22,134	18.4%	32,569	24.3%	39,864	27.1%
EBITDA	3,320	20.7%	5,374	29.0%	7,176	34.8%

Source: IIFL Research

We expect HH's margins on production from the Haridwar plant to expand by 250bps in the next three years. The increasing share of volume from that plant would result in a 100-150bps overall margin expansion for the company. The new plant also has 100% income-tax exemptions for the next five years and 30% exemption for a further five years.

Figure 5: Return ratios should not stabilize

	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09ii	FY10ii
Tax burden (x)	0.67	0.66	0.68	0.67	0.69	0.69	0.69	0.77	0.76
Interest burden (x)	1.00	1.00	1.00	1.00	1.00	1.02	1.03	1.02	1.02
EBIT Margin (x)	0.16	0.17	0.18	0.16	0.16	0.12	0.13	0.13	0.14
Asset Turnover (x)	2.55	2.59	2.41	2.49	2.43	2.44	2.22	2.16	2.05
Financial Leverage (x)	2.56	2.55	2.43	2.26	2.05	1.81	1.71	1.66	1.57
Return on Equity	**67.5%**	**75.1%**	**72.8%**	**61.6%**	**55.5%**	**38.3%**	**35.5%**	**38.0%**	**34.6%**

Source: Company, IIFL Research

Strong cash-flow generation

Figure 6: Operating cashflow doubled with better working capital management

	FY02	FY03	FY04	FY05	FY06	FY07	FY08
Cash flow from operation							
Net profit before tax	6,949	8,846	10,725	12,173	14,123	12,461	14,103
Less:Other income	(741)	(929)	(1,650)	(1,410)	(1,563)	(1,899)	(1,854)
Add: Depreciation	510	580	733	894	1,146	1,398	1,603
Add: Interest expense	15	17	17	19	30	16	20
Less: increase in NWC	1,068	2,007	1,247	1,754	(633)	(2,986)	3,707
Less: Direct taxes	(2,175)	(2,982)	(3,311)	(3,952)	(4,230)	(3,788)	(4,412)
Total Operating cash flow	**5,626**	**7,540**	**7,761**	**9,477**	**8,873**	**5,203**	**13,166**
Cash flow from investing							
Other income	741	929	1,650	1,410	1,563	1,899	1,854
Less: Capex	(706)	(664)	(1,438)	(2,104)	(3,711)	(4,744)	(3,407)
Less: Increase in investments	(4,376)	(4,672)	(3,721)	(4,616)	(352)	880	(5,930)
Total Investment cash flow	**(4,342)**	**(4,407)**	**(3,509)**	**(5,310)**	**(2,501)**	**(1,965)**	**(7,482)**
Cash flow from financing							
Increase in debt	500	178	404	271	(160)	(206)	(332)
Less: Interest expense	(15)	(17)	(17)	(19)	(30)	(16)	(20)
Less: Dividend	(599)	(3,395)	(4,055)	(4,505)	(4,559)	(4,554)	(3,972)
Add: Other items	0	0	0	0	(212)	309	(408)
Total Financing cash flow	**(115)**	**(3,234)**	**(3,668)**	**(4,254)**	**(4,961)**	**(4,467)**	**(4,731)**
Net change in cash	**1,170**	**(101)**	**585**	**(87)**	**1,412**	**(1,230)**	**953**

Source: Company, IIFL Research

Figure 7: Company continues to manage its working capital cycle efficiently

	FY02	FY03	FY04	FY05	FY06	FY07	FY08
Cash Conversion cycle	-10.3	-5.1	-30.7	-19.0	-10.9	-1.6	-5.2
Inventory days	15.3	15.0	12.4	10.6	10.7	10.5	12.0
Debtor days	8.5	10.6	2.9	4.6	7.0	9.7	11.2
Creditor days	34.1	30.7	45.9	34.2	28.7	21.8	28.4

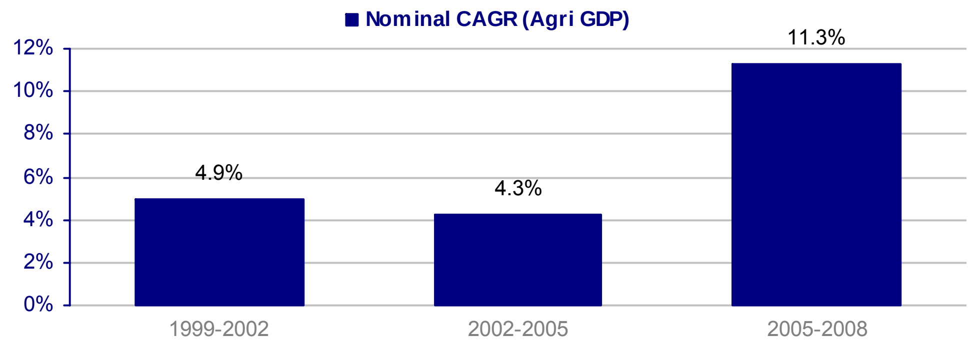
Source: Company, IIFL Research

Operating cash-flow more than doubled in FY08, largely on account of efficient working-capital management. In FY07, faced with increasing margin pressures, the company chose to pay its creditors upfront to avail of bill discounting and hence invested a large sum in working capital.

Rising rural incomes to boost earnings

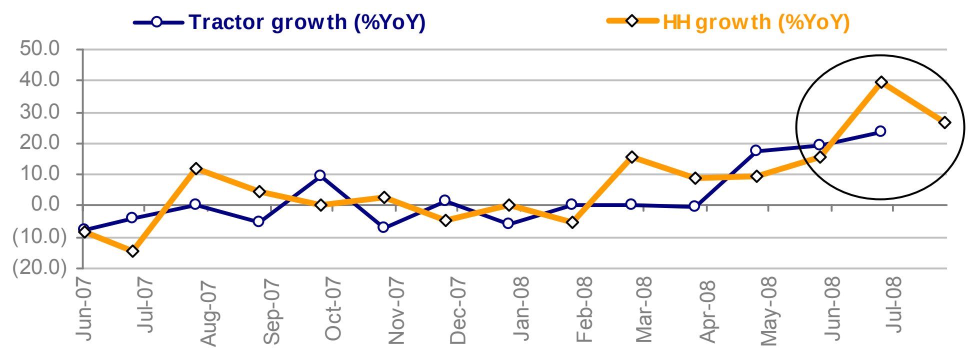
Increase in minimum support prices and higher yields from farms have resulted in an increase in rural incomes. Minimum support prices of wheat have been increased from Rs750/qtl to Rs1,000/qtl and those of rice from Rs775/qtl to Rs875/qtl. Agricultural GDP growth has accelerated in the last three years. With the farm-loan waiver package by the government, tractor volumes and two-wheeler volumes have also shot up in the last few months. HH, which derives more than 50% of its volumes from rural India, should be a key beneficiary. Also, most of these are cash purchases and hence are not affected by withdrawal of financing.

Figure 8: Agri GDP growth has accelerated in the last three years



Source: Central Statistical Organisation, IIFL Research

Figure 9: Farm loan waiver has seen rural demand shoot up



Source: IIFL Research

We upgrade stock to ADD with a target price of Rs920

After a subdued FY08 affected by withdrawal of financing, FY09 has been a good year so far for the two-wheeler industry. HH has done better than the industry and its volumes have grown by ~20% YTD, surpassing our estimate as well as the street's. Two-wheelers being small-ticket items, the conversion from financing purchases to cash purchases has been quite quick. In fact, share of cash purchases has risen from ~35% of overall volumes a year earlier to almost 70% now. We revise our FY09 volume growth estimate for Hero Honda to 8% from the previous 5%. HH has attained volumes of 1.48m till August 2008 and will need only 1% YoY growth through the rest of the year to meet our estimates. There exists an upside to our FY09 volume estimate, considering that Pay Commission arrears are due in October 2008.

Given the reduced competitive intensity in the business, we also expect HH to retain excise duty benefits that it will get from its Haridwar plant and hence factor in a 150bps improvement in the next three years. Domestic aluminium prices have dropped by Rs4,000/tonne in the past 15 days. HH, which buys most of its requirements in the spot market, should benefit from this decline in metal prices. We have not built in any decline in raw-material prices, so there is an upside to our margin estimates.

Figure 10: Revision in estimates

	FY09ii			FY10ii		
	Old	New	% change	Old	New	% change
Volumes	3511208	3,608,232	2.8%	3796718	3,901,505	2.8%
Sales (Rs m)	117,157	120,129	2.5%	129,773	134,280	3.5%
EBITDA (Rs m)	14,937	16,050	7.5%	17,058	18,505	8.5%
PAT (Rs m)	11889	12,450	4.7%	13,221	14,112	6.7%

Source: IIFL Research

We expect a 19% CAGR in HH's EPS from FY08-11ii and hence revise our target multiple from 12x to 13x. We value the stock at 13x FY10ii EPS and revise our target price to Rs920 from Rs795. We upgrade the stock to ADD. The key risk to our call is that any worsening in the competitive scenario could result in aggressive discounts, putting margins under pressure.

Financial summary

Income statement summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Revenue	99,000	103,318	120,129	134,280	146,908
EBITDA	11,731	13,494	16,050	18,505	20,639
EBIT	**10,333**	**11,891**	**13,734**	**16,084**	**18,196**
Interest income	246	378	416	458	503
Interest expense	16	20	20	20	20
Exceptional items	0	0	0	0	0
Others	1,899	1,854	2,039	2,047	2,060
Profit before tax	**12,461**	**14,103**	**16,169**	**18,569**	**20,739**
Taxes	3,882	4,424	3,719	4,457	4,770
Minorities and other	0	0	0	0	0
Net profit	**8,579**	**9,679**	**12,450**	**14,112**	**15,969**

We expect a profit CAGR of 19% over FY08-11ii

Cashflow summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Profit before tax	12,461	14,103	16,169	18,569	20,739
Depr. & amortization	1,398	1,603	2,316	2,421	2,443
Tax paid	-3,788	-4,412	-3,719	-4,457	-4,770
Working capital Δ	-2,986	3,707	-465	150	183
Other operating items	0	0	0	0	0
Operating cashflow	7,085	15,000	14,300	16,683	18,596
Capital expenditure	-4,744	-3,407	-1,704	-1,907	-1,945
Free cash flow	**2,341**	**11,594**	**12,597**	**14,776**	**16,651**
Equity raised	0	0	0	0	0
Investments	880	-5,930	-5,000	-5,000	-5,000
Debt financing/disposal	-206	-332	0	0	0
Dividends paid	-4,554	-3,972	-4,439	-5,392	-5,392
Other items	309	-408	0	0	0
Net change in cash	**-1,230**	**953**	**3,158**	**4,384**	**6,259**

Source: Company data, IIFL Research

HH will spend around Rs3bn to expand capacity at its Haridwar plant

Balance sheet summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Cash & equivalents	358	1,311	4,469	8,853	15,112
Sundry debtors	3,353	2,974	4,010	4,487	4,908
Inventories - trade	2,756	3,171	3,702	4,142	4,530
Other current assets	2,667	1,912	2,202	2,458	2,683
Fixed assets	**12,752**	**14,741**	**14,356**	**13,916**	**13,499**
Intangible assets	803	907	680	606	525
Other term assets	19,739	25,668	30,668	35,668	40,668
Total assets	**42,426**	**50,684**	**60,087**	**70,130**	**81,925**
Short-term debt	257	277	249	224	202
Sundry creditors	5,548	7,561	8,746	9,787	10,703
Other current liabs	8,987	10,410	11,597	11,904	12,226
Long-term debt/CBs	1,652	1,320	1,320	1,320	1,320
Other long-term liabs	1,282	1,252	1,252	1,252	1,252
Net worth	**24,702**	**29,864**	**36,922**	**45,643**	**56,221**
Total liabs & equity	**42,426**	**50,684**	**60,087**	**70,130**	**81,925**

Ratio analysis

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Revenue growth (%)	13.6	4.4	16.3	11.8	9.4
Op Ebitda growth (%)	-14.0	15.0	18.9	15.3	11.5
Op Ebit growth (%)	-17.3	15.1	15.5	17.1	13.1
Op Ebitda margin (%)	11.8	13.1	13.4	13.8	14.0
Op Ebit margin (%)	10.4	11.5	11.4	12.0	12.4
Net profit margin (%)	8.7	9.4	10.4	10.5	10.9
Dividend payout (%)	46.3	45.9	43.3	38.2	33.8
Tax rate (%)	31.2	31.4	23.0	24.0	23.0
Net debt/equity (%)	6.3	1.0	-7.9	-16.0	-24.2
Return on equity (%)	34.7	32.4	33.7	30.9	28.4
Return on assets (%)	20.2	19.1	20.7	20.1	19.5

Source: Company data, IIFL Research

Tax rate will drop as increased revenues come from the tax-free Haridwar plant. First-year tax rate will be lower as deferred taxes reversible in the tax-free

Events calendar – September 2008

Monday	Tuesday	Wednesday	Thursday	Friday	Saturday
1 Jul Imports ↑ 48% July Exports ↑ 31%	**2**	**3**	**4** WPI for 23 Aug — 12.3%	**5**	**6**
8	**9**	**10** SAIL–10	**11** WPI for 30 Aug — 12.1%	**12** July IIP ↑ 7.1%	**13**
15	**16**	**17**	**18** WPI for 6 Sep	**19**	**20**
22	**23**	**24**	**25** WPI for 13 Sep	**26**	**27**
29	**30** 1QFY09 BoP	HDFC – 17 Oct			

Blue: Economic data, Orange: AGM

Oct-Dec 08

- Indus Tower expected to get towers from three shareholders Bharti, Vodafone and Idea
- Nov 4 – US Presidential elections
- 3G auctions expected to be held
- Ranbaxy – announcement of the acceptance / rejection of tendered shares of Ranbaxy by Daiichi Sankyo
- Jubilant Organosys – generic sestamibi approval by US FDA
- Dr Reddy's Labs – Imitrex authorized generic launch in US
- Sun Pharma – Israeli supreme court decision on enforceability of special tender offer rule in Taro acquisition
- Grasim's Shambupura 4.5mtpa cement plant to start commercial prod.
- Madras Cements 2mtpa cement plant at Ariyalur to start Prod.

Jan-Mar 09

- RCOM expected to launch GSM services nationwide
- Grasim's Kotputli 4.4 mtpa expansion to commence prod.

Apr-Jun 09

- India's national elections
- New licencees expected to 2g spectrum in most circles

July-Sep 09

Oct-Dec 09

- BHEL Capacity goes up from 10 GW to 15 GW

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.
