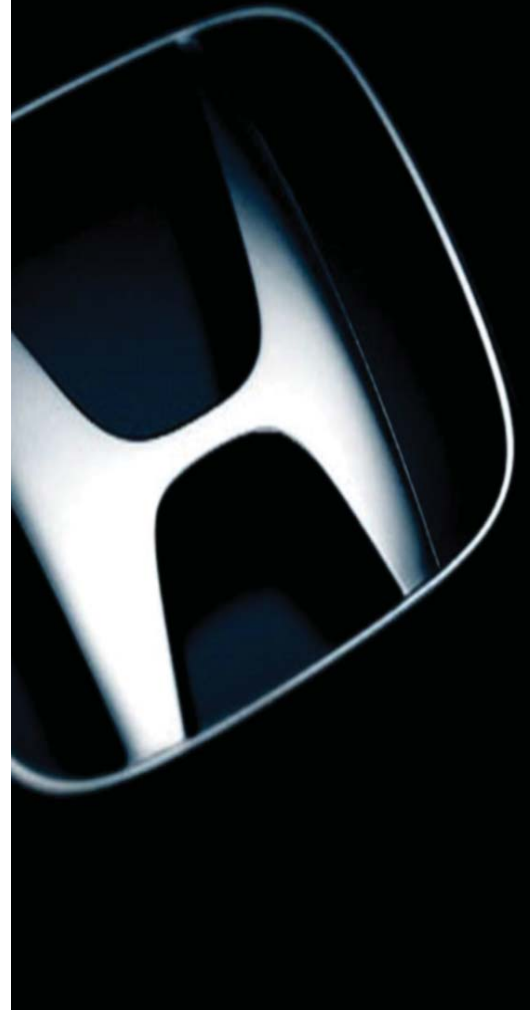


October 2007

AUTOMOBILES
PAKISTAN

Honda Atlas Cars Pakistan Ltd.

The Power of Dreams



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Fair Value: PRs89.95
Recommendation: Neutral

KSE Code HCAR
 Bloomberg Code HCAR PA
 Reuters Code HATC KA
 Market Price (PRs) 81.4
 Market Cap (PRs) 10.6bn
 Market Cap (US\$) 175mn
 Outstanding Shares 142.8mn

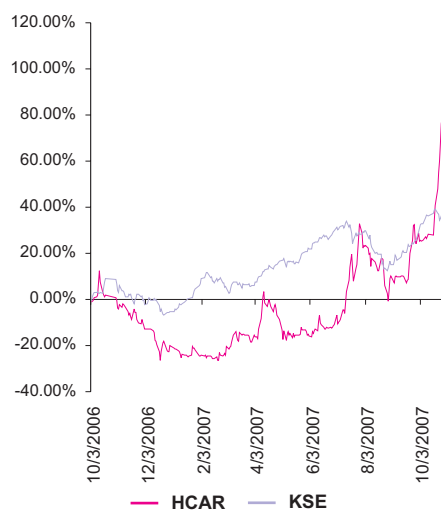
52 Week Price Data (PRs)

High 81.4
 Low 28.92
 Average 37.17

52 Week Volume Data (Shares)

Max 2,275,276
 Min 6,576
 Average 258,516

Chart 1: Relative Performance - HCAR



Source: Bloomberg & IGI Research

Investment Consideration

Honda Atlas Cars (Pakistan) Ltd. (HCAR) commenced production in 1994 with an annual production capacity of 6,500 cars. A nationwide demand surge for cars during recent years led to significant capacity expansion and now HCAR production facilities are capable of producing 50,000 cars annually.

Introduction of the new Honda Civic model has impacted on Honda's market share in Pakistan. This, along with a relatively low sales growth of passenger cars during FY07, had a significant impact on HCAR's earnings. The high cost of production of the new model made the company's gross profit margin to plunge and HCAR had to suffer loss during FY07. We believe that during FY08 and onwards, HCAR will experience a change of product-sale mix, i.e. sale of City cars is going to pick up while that of Civic is going to decline. Due to lower sale prices of City cars, the overall sales turnover of the company is expected to decline but the eventual cost of production will be low, thus leading to appreciable gross margins.

Overall, however, HCAR's topline is expected to grow with CAGR of about 11%YoY during the next five years as it picks up on lost sales. On the ground of its heavy capitalization and sale-mix changes, HCAR's earnings are likely to pickup from this year. The company is also swelling with economies of scale and the gross profitability of the company is expected to grow exponentially. The company is about to retire its long term debt by FY09 and hence reduce its financial costs. We forecast HCAR's EPS to be **PRs5.42** during FY08.

The company is likely to maintain a high payout ratio as no expansionary projects are on its agenda at the moment. We anticipate a cash dividend of **43.4%** during FY08, in addition to the 100% right share issue that was announced after the first quarter of the current financial year.

Applying the DCF model with the company's WACC at 13.36% and terminal growth rate of 4%, our fair value of the company is found out to be **PRs89.95**. At current market value, we have a **NEUTRAL** stance towards the stock.

Table 1: Estimates

	FY07A	FY08E	FY09E	FY10E	FY11E	FY12E
EPS	(3.71)	5.42	8.16	9.90	10.39	11.86
DPS	-	4.34	6.53	1.50	8.31	9.49
P/E Ratio	-21.97x	15.01x	9.97x	8.22x	7.84x	6.86x
Book Value per share (BVS)	34.18	23.18	24.81	33.21	35.29	37.66
Dividend Yield	0.00%	5.33%	8.02%	1.84%	10.21%	11.66%
Debt Ratio	2.40	1.51	1.05	0.71	0.76	0.82
ROE	-10.84%	23.41%	32.91%	29.81%	29.43%	31.49%
ROA	-3.03%	9.32%	14.98%	18.39%	17.45%	18.18%
Current Ratio	94.24%	105.28%	101.95%	148.18%	159.89%	168.60%
Quick Ratio	23.71%	38.55%	13.42%	35.18%	46.85%	55.09%
Gross Profit Margin	0.59%	10.58%	11.33%	11.21%	10.40%	10.26%
Operating Profit Margin	-1.03%	9.04%	9.98%	9.88%	9.16%	9.10%
Net Profit Margin	-1.55%	4.78%	6.18%	6.42%	5.95%	5.91%
Total Assets Turnover	1.95x	1.95x	2.42x	2.86x	2.93x	3.07x
Fixed Assets Turnover	4.53x	3.82x	5.14x	6.69x	8.51x	11.20x
Inventory Turnover	4.88x	5.20x	5.49x	5.50x	5.47x	5.52x
Days Inventory at Hand	74	69	66	65	66	65

Source: Company Reports & IGI Research

A Dream Begins...

The epic begins back in 1938 when a Japanese automobile mechanic discovered a new design for piston rings used in a car's engine. He set out on his venture with a basic motor engine attached to a regular bicycle as his first product. It was Sochiro Honda laying the foundation of the first company bearing the name "Honda": "The Honda Research Institute Company Ltd." Even though there was no actual research taking place in the modest manufacturing facility of the Honda Research Institute Company, the name clearly emits the vision of its founder.

The Honda Motor Co. was officially founded in 1948 in Japan. Ten years later, it expanded its operations to the U.S. and completely snatched the motorbike market from the then reigning European champions like Triumph and Norton. The European motorcycle manufacturers never realized what hit them until it was too late. The Honda motorcycles were cheaper, more robust, and more fuel-efficient than their European counterparts. Though there were also some other reasons for the downfall of the European motorcycle industry, but it's hard for one to overemphasize Honda's focus on innovation, experimentation, and engineering since its start.

Honda was the first Japanese automobile manufacturer to introduce a car to cater the luxury segment. The brand name Acura was the first global blend of Japanese technology with luxury. Later, this concept was also adopted by other Japanese manufacturers like Toyota came up with its Lexus, and Nissan introduced its Infiniti.

Honda has been an innovator of a number of technologies including the introduction of the first engine compliant with the 1970 Clean Air Act. Honda is the largest manufacturer of engines and motor cycles in the world today. It produces more than 14 million internal combustion engines each year; the passenger automobile sales forming only a segment of this brilliant empire.

Worldwide, Honda produced about 3.6mn vehicles during 2006 and is the fifth largest automobile manufacturer in the world by production volume today. It has a global presence in almost all the nations of the world which ranges from full fledged automobile manufacturing to CKD assembly lines to mere CBU trading.

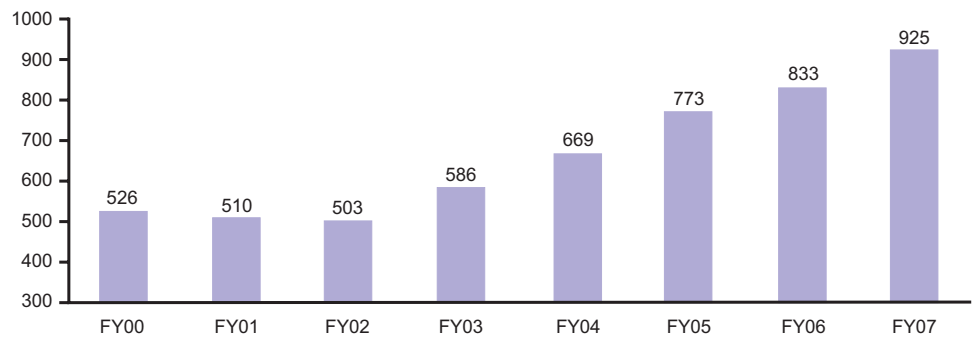
The automobile market in Pakistan is yet relatively smaller than the neighboring countries and thus the facilities in the country are mere CKD assembly lines. The nation, however, provides significant upward potential. From this point onwards, our discussion would be focused on the Pakistani automobile industry with Honda Atlas Cars Pakistan Ltd. mainly under perspective.

Automobile Industry in Pakistan

Economy Under the Lens

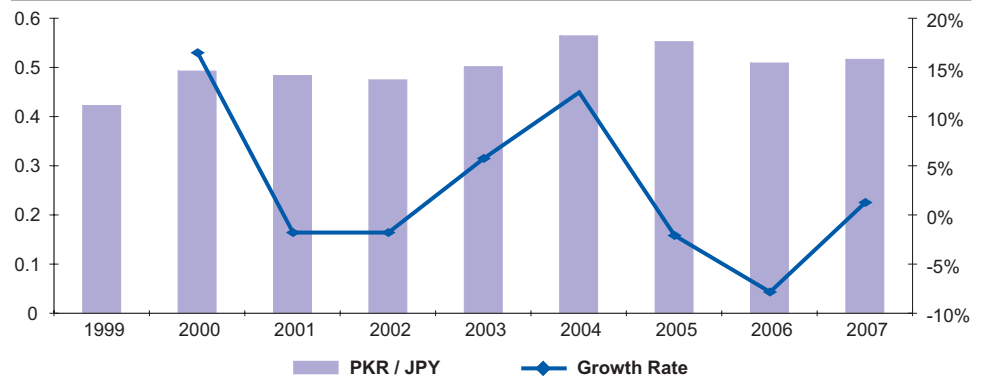
Pakistan's Gross Domestic Product (GDP) and Gross National Product (GNP) have grown at a considerable rate over the last few years. During FY07, the country's GDP grew by 7% while the GNP grew by 14.51%YoY to PRs8.87tn. The country's population growth rate has declined to 1.8% during FY07. Pakistan's population has historically also grown by 3%-4% at times. But now it appears to have fallen under control and we believe that the population is not likely to grow beyond a rate of 2%YoY over the coming years.

Chart 2: GNP per capita (US\$)



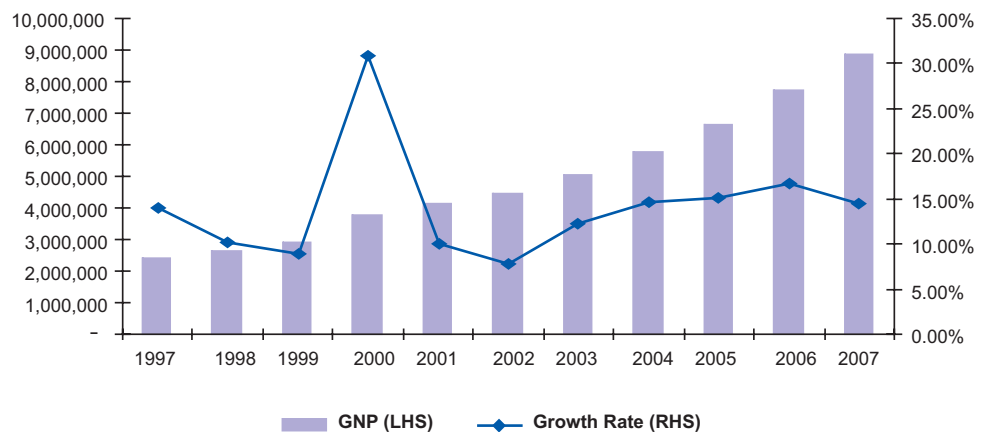
Source: SBP

Chart 3: PKR / JPY (PRs)



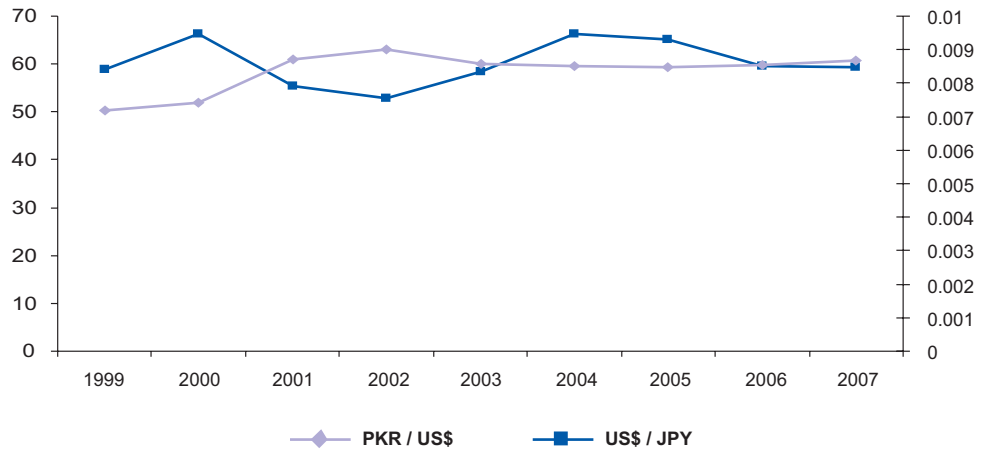
Source: finance.yahoo.com & IGI Research

Chart 4: GNP & GNP Growth Rate (%) (PRsmn)



Source: SBP

Chart 5: Rupee-Dollar-Yen Parity



Source: *finance.yahoo.com*

The Foundation- Stone of the Country's Automobile Industry

The Pakistani society is traditionally an automobile admirer where a car has always been a pride possession in the society. It wasn't until 1983 when Suzuki Motor Company, Japan, commenced a joint venture with a Pakistani automobile manufacturer and established the Pak Suzuki Motor Company Limited; Pakistan's first automobile manufacturing facility. Later, Toyota also signed a joint venture with Indus Motor Company and Honda collaborated with the Atlas Group to enter and cater the emerging Pakistani market.

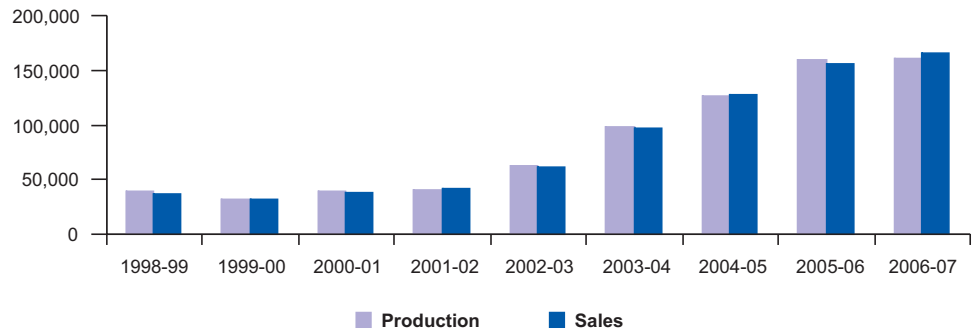
By 2002, Pakistan's booming economy and the country's steeply growing per capita income had a positive effect on the household disposable income of the society. The growing availability of credit facility added fuel to the fire and the automobile sales soared beyond anyone's anticipation.

At this stage, the automobile manufacturers found themselves lagging behind in terms of production capacities and were unable to cope with the domestic demand. The waiting time between the order placement and reception of a vehicle surpassed beyond six months and dealer-premiums on immediate delivery hovered over all limits. By law of substitutes, the customer's attention thus got drawn more towards imported re-conditioned cars.

Production Capacity Expansion in the Industry

The manufacturers finally realized the opportunity losses arising from these lost sales and went all out for expansion. Pakistan's annual automobile production has increased several folds since 2002. Now, Pak Suzuki Motor Company has a production capacity of 150,000 cars a year. Indus Motors (Toyota) and Honda Atlas Cars can produce 65,000 and 50,000 cars per year respectively. Though, our industry is still far behind than of other countries such as India and Korea but at least now we are on the path where we can show our presence somewhere down the road.

Chart 6: Automobile Production and Sales

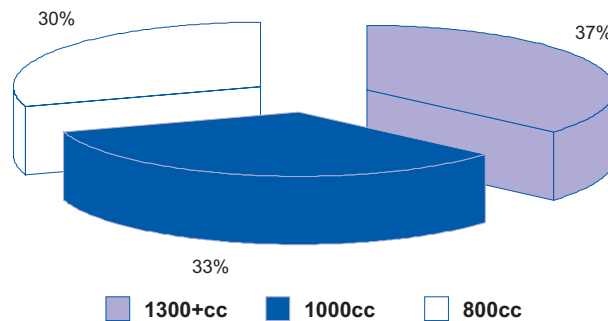


Source: PAMA Records & IGI Research

Big Cars in Bigger Demand

To one's surprise, most number of cars sold in Pakistan annually belong to the 1300+cc category than to either of the other categories. During FY07, 37% of the cars sold were of 1300+cc category while those of 1000cc and 800cc category were 33% and 30% respectively. It's also worth mentioning that the sale share of 1300+cc cars had actually dropped from 42% to 37% during FY07. This trend hints of the general taste of Pakistani society for cars. However, due to rising inflation and fuel prices, growth is observed in smaller car sales. With International oil prices hovering around US\$90 per barrel and inflationary pressure likely to persist during the country's economic boom, it is likely that most of the sales growth during the coming years will be observed in smaller car categories.

Chart 7: Car sales share by category FY07



Source: PAMA Records & IGI Research

Financial Year 2007- Automobile Industry

Unfortunately, the car sales growth during FY07 was not up to the expectation of the industry. The booming industry that was growing with annual growth rates of around 40% for some years grew by just 6% during FY07. At a time when all the major industry-players were all ready to handle a demand surge, such low sales growth was quite depressing.

There could be a number of reasons for this slump in automobile sales growth. The central bank had raised the discount rates upto 10% during the year. The consequently increased car financing costs may have been a reason behind the lower-than expected sales. In addition, many financial institutions have incurred losses due to increasing number of default car lessee cases. Thus, banks have become more prudent while granting car financing loans and credit availability has become relatively less easy and expensive.

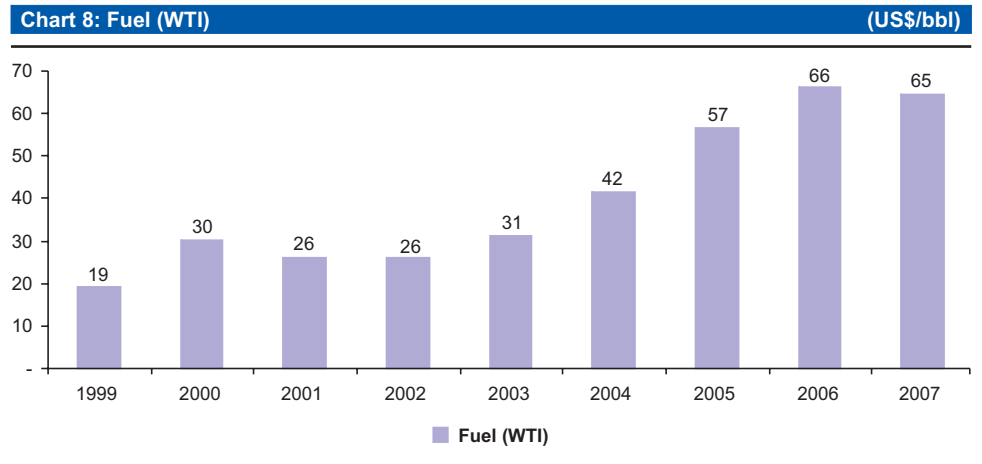
Historically however, and mainly due to immensely unequal distribution of wealth, Pakistan's urban society has largely remained indifferent to any monetary or fiscal policies changes

when it comes to spending behavior. It thus could all just be a phase. It must also be noted that when the demand for cars had increase and the local industry could not cater the demand, a lucrative opportunity was at hand for arbitragers and vehicle importers. Bulks of new and used cars have entered the country during the last two years which has greatly hurt the local industry.

The government has now enforced a ban on import of vehicles older than three years. This will likely help bring the domestic industry sales back up again to some extent, but to really help boost our automobile industry a more stringent stance may be required.

Cost Drivers of Automobile Production

Production cost of automobiles is very susceptible to steel and oil commodity prices, steel being the major constituent of cars. As the local automobile industry relies heavily on import of parts, a fuel price surge swells up production cost due to increased freight charges for import.

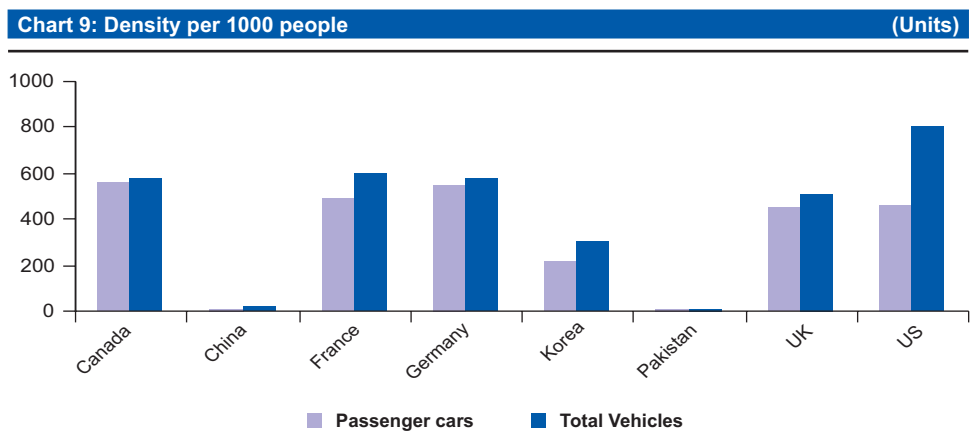


Source: Bloomberg

A Promising Automobile Market

A big concern is that all the foreign manufacturers are merely “vehicle assemblers.” No technology transfer is taking place and no research and development work is being carried out. Most of the critical parts are being imported from the respective parent company’s various manufacturing sites at nearby countries. The job of the local subsidiary is to integrate all such parts in a steel shell, paint it, and find good dealers to sell it.

The Pakistani automobile market is still very much un-catered and presents immense opportunity. According to World Bank, there are barely 10 passenger cars per 1000 people in Pakistan. There are 451 cars per 1000 people in UK and 10 cars per 1000 people in China. China is expected to soon become the world’s largest market for automobiles.



Source: World Bank

Table 2: Respective Car Densities in various countries

	Vehicles per 1000 people	Passenger cars per 1000 people
Canada	577	561
China	15	10
France	597	495
Germany	580	546
Korea	302	218
Pakistan	14	10
UK	510	451
US	808	465

Source: World Bank

Furthermore, Pakistan also is an excellent geographical spot for establishing a regional center to export vehicles to the entire Eastern Hemisphere. Unfortunately, such exceptional properties of the country have always been over shadowed by the unstable political conditions and inconsistent governmental policies.

To promote the local industry, the government would have to let go of certain short term gains and provide attractive opportunities to the foreign investors to lure them in. In our view, lowering of import duties on CBU’s has significantly hurt the domestic automobile market. Though the government may not be able to directly levy heavier import duties under WTO, but the foreign manufacturers could be compelled to manufacture more brands within the country in return of special tax waivers. In addition, domestic sales can also be bolstered through a comprehensive ban on import of used cars.

The government should pursue convincing the foreign manufacturers to establish R&D departments in their subsidiaries at Pakistan. It is worrisome that Pakistan doesn’t have a legitimate educational institution for automobile engineering. The foreign manufacturers could also be granted special and attractive tax subsidies in case of establishing and maintaining international-standard research institutions within the country.

Honda Atlas Cars Pakistan Limited

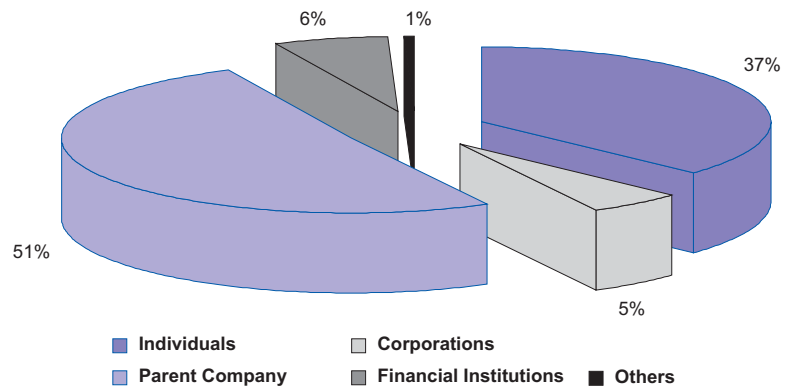
Company Overview

A joint venture agreement commenced between the Honda Motor Company of Japan and Atlas Group of Pakistan, giving birth to a new subsidiary in 1993 to cater the Pakistani market. The Honda Atlas Cars Pakistan Limited (HCAR) started its operations in 1994 witnessing its first car being rolled out soon afterwards.

The company sold its 50,000th car in September 2003, nine years after its first sale. However, the sharp boom in the automobile industry led Honda's sales to grow exponentially and the company sold its 100,000th car within a couple of years.

Automobile sales drastically increased in Pakistan since 2002 as the economy boomed and the auto financing facility gained much popularity in the society. Honda rode the wave and kept posting impressive growth rates over the years. During FY06, HCAR sold a whopping 30,719 cars yielding a growth of 53%YoY.

Chart 10: Shareholding Pattern



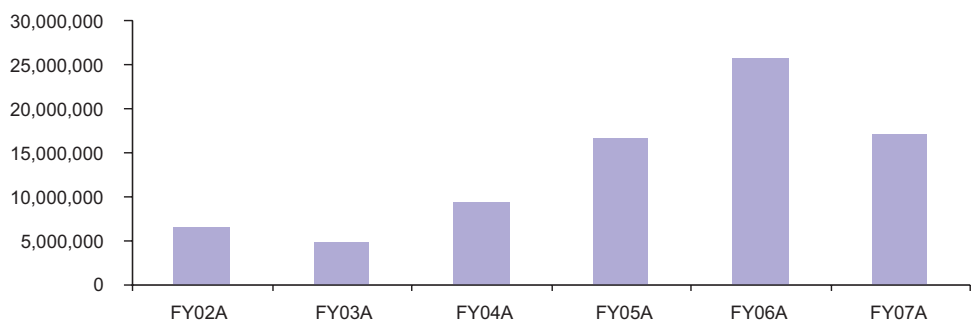
Source: Company Reports

Honda Motor Company Ltd., Japan, owns 51% shares in HCAR. Despite ownership, HCAR pays royalty to the parent company as per contract. Corporations have a marginal shareholding in the company. Honda Motor Co. of Japan and Atlas Group of Pakistan maintain bulk of the ownership in the company. It is thus HCAR doesn't have a very diverse ownership.

Spotlight on Past Performance

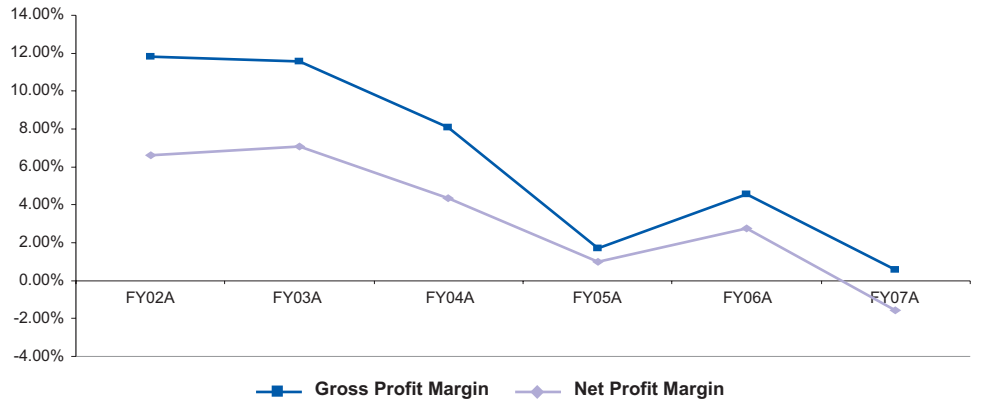
From FY04 to FY06, HCAR's topline grew at a CAGR of 132%YoY. It was the golden period for the entire automobile industry of Pakistan with automobile sales posting near 40%YoY growths.

Chart 11: Sales Turnover (PRs'000)



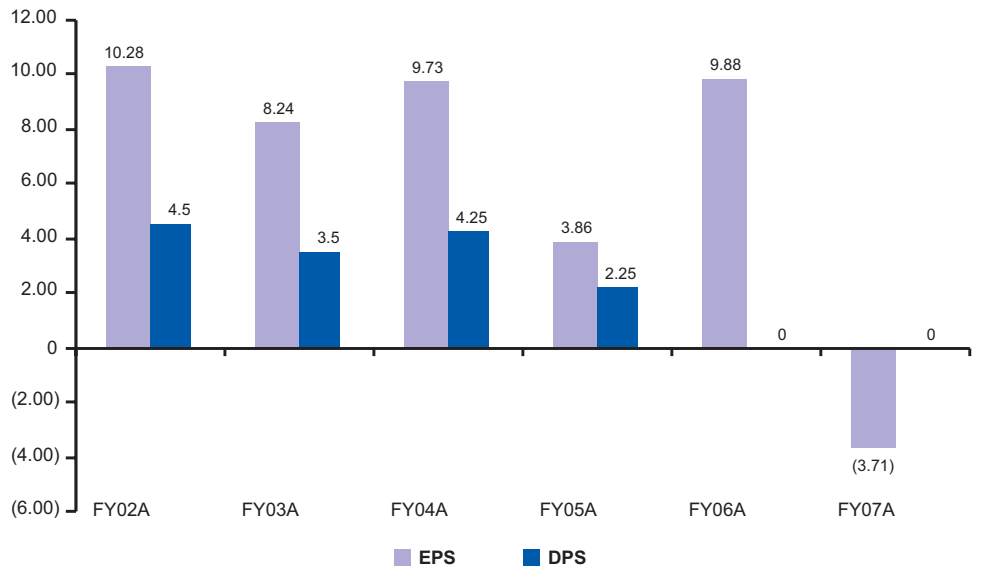
Source: Company Reports

Chart 12: Profit Margins (%)



Source: Company Reports & IGI Research

Chart 13: Earnings & Dividends (PRs)



Source: Company Reports

Financial Year 2007 Under Perspective

HCAR had a tough FY07. Nonetheless, we feel the company projects immense growth potential. The main challenges faced by the company were decreased sales, high finance cost, and high depreciation costs.

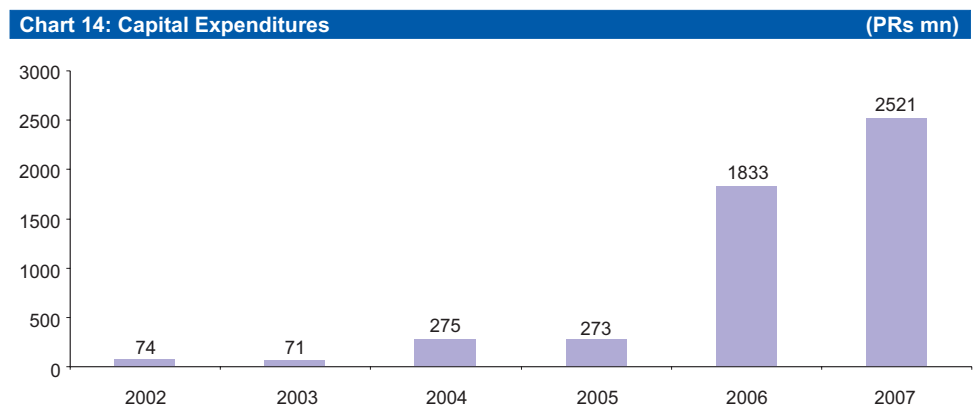
As mentioned earlier, the overall automobile sales growth in Pakistan was lower than expected believed to be mainly because of large number of reconditioned cars being imported in the country, increased commercial lending rates, and growing shortage of credit facility because of high loan defaults.

In addition, Honda had also introduced a new model of Civic in the 1800cc category in June 2006 and completely abandoned the production of 1600cc models. The increased cost of production led to an increase in sale price and thus low sales. The cost of production soared because of large depreciation and some one-time expenses that the company experienced during its capacity expansion venture. This caused the company's topline and gross profit margin to plunge. Making things worse were the added financial expenses arising from the long-term debt raised by the company to finance the expansion project.

The decision to upgrade the Civic to the 1800cc category was a global one. The local subsidiary, whether they liked it or not, had to discontinue the older model that was gaining popularity in the country. The new model of the car is undoubtedly an engineering marvel. The hitch is that most of its loyal customers are not able to afford it anymore. The parent company is probably too busy accepting acclaims and accolades from the European and North American markets to realize the new model may be difficult to afford in lower-economy countries.

HCAR plans to completely knock the long term debt off its balance sheet by 2009, so its finance cost shouldn't be of much concern in future. The company had announced 100% right shares after the 1QFY08 for the same purpose.

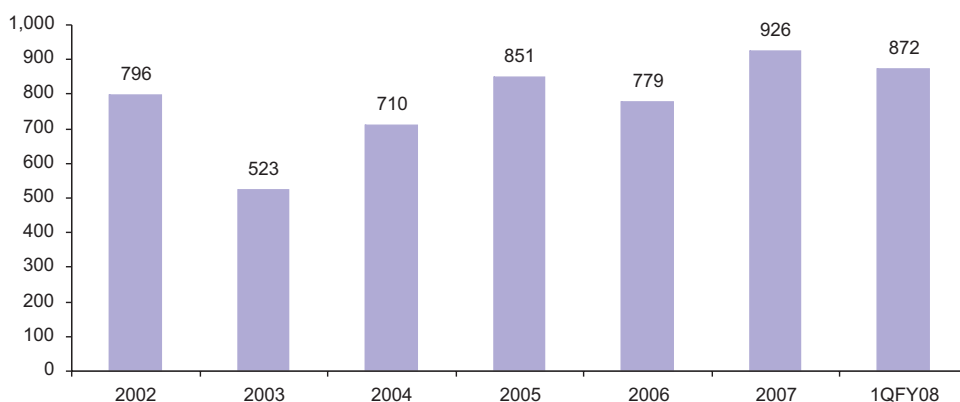
Capital expenditure of HCAR during FY07 increased by 538%YoY because of the company's expansion efforts. The production capacity of the company increased to 50,000 cars an year and new molding presses were installed. High capitalization has raised the company's fixed costs and depreciation expense. But the company is now well equipped with economies of scale. In addition, HCAR is likely to reduce its variable cost with time through the experience curve effect.



Source: Company Reports

In short, HCAR suffered a bad patch during FY07 when everything went in its opposite direction. The jinx is now broken and HCAR portrays good potential to us. The company shows significant reductions in its cost of manufacturing during the first quarter FY08.

Chart 15: Average Cost of Production Per Car (PRs'000)



Source: Company Reports & IGI Research

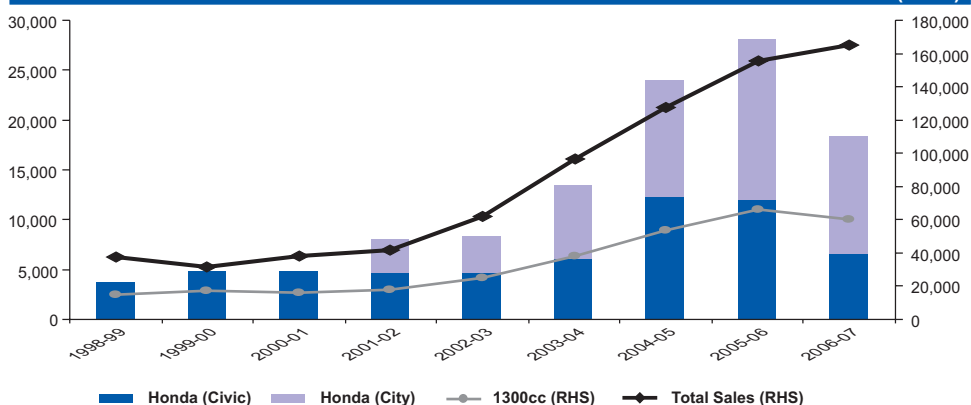
The above chart signifies that the cost of production of HCAR has surged during and after plant expansion or whenever the company introduces a new model of any of its cars, which eventually falls down rapidly soon afterwards. The same trend was witnessed during FY07 and we anticipate a declining cost of production during the coming years as the company is not interested in further expansion in near future.

Table 3: P&L Statements - Honda Atlas Cars

	FY02A	FY03A	FY04A	FY05A	FY06A	FY07A
Sales	6,519,069	4,901,066	9,358,369	16,587,217	25,638,698	17,055,115
Cost of Good Sold	5,747,659	4,333,668	8,602,391	16,304,182	24,471,184	16,955,181
Gross Profit	771,410	567,398	755,978	283,035	1,167,514	99,934
	11.83%	11.58%	8.08%	1.71%	4.55%	0.59%
Distribution and marketing expenses	-	-	71,672	97,771	149,877	214,889
Administrative expenses	133,337	107,363	89,296	101,724	120,728	147,274
Subtotal	133,337	107,363	160,968	199,495	270,605	362,163
	638,073	460,035	595,010	83,540	896,909	(262,229)
Other operating income	68,311	51,338	73,083	197,190	377,865	150,585
	706,384	511,373	668,093	280,730	1,274,774	(111,644)
Other operating expenses	48,978	35,036	45,612	16,145	94,714	64,514
Profit from operations	657,406	476,337	622,481	264,585	1,180,060	(176,158)
Finance cost	1,252	505	2,288	5,956	46,356	305,491
Profit before taxation	656,154	475,832	620,193	258,629	1,133,704	(481,649)
Taxation	224,512	129,697	211,510	96,450	428,410	(217,109)
Net Profit / Loss	431,642	346,135	408,683	162,179	705,294	(264,540)
EPS	10.28	8.24	9.73	3.86	9.88	(3.71)

Source: Company Reports

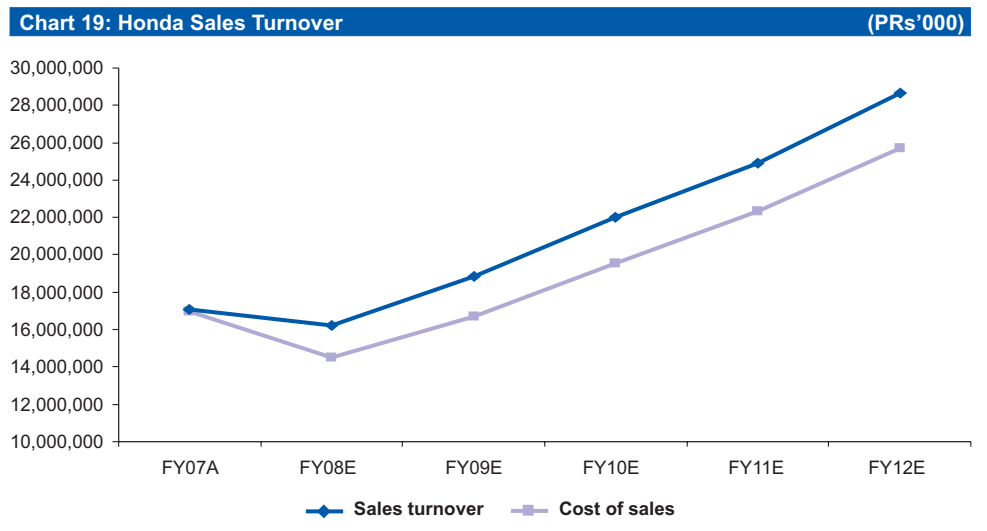
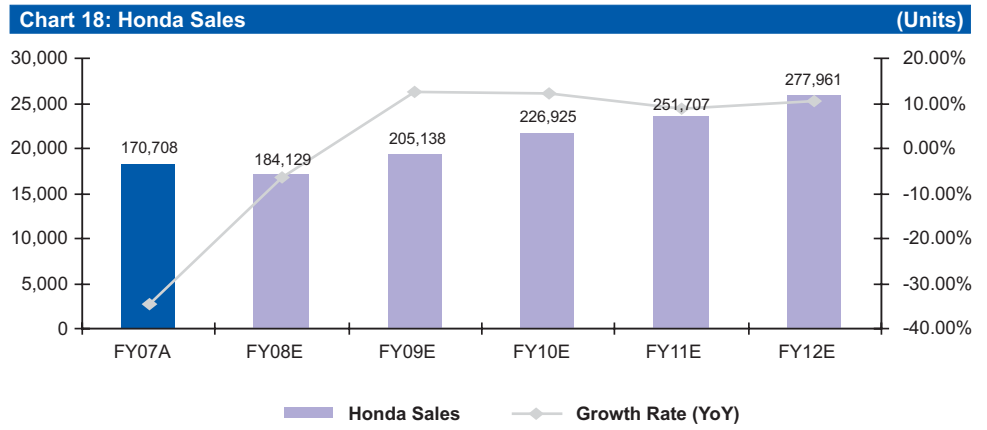
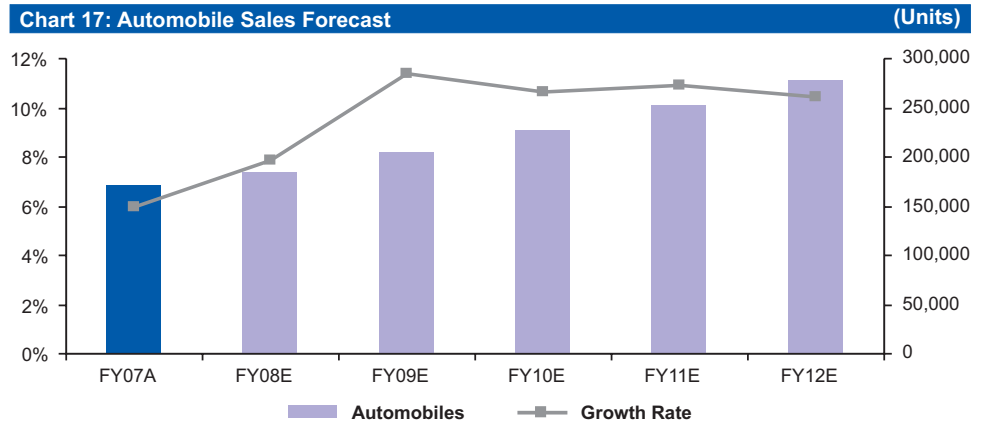
Chart 16: HCAR Automobile Sales (units)



Source: PAMA Records & IGI Research

Future Performance

Statistical techniques suggest that car sales in Pakistan will grow with a CAGR of approximately 9%YoY. We expect about 184,000 cars to be sold during FY08 out of which HCAR will sell a cumulative of about 17,000 cars. We expect Honda's unit sales to grow at a CAGR of 7% till 2012.



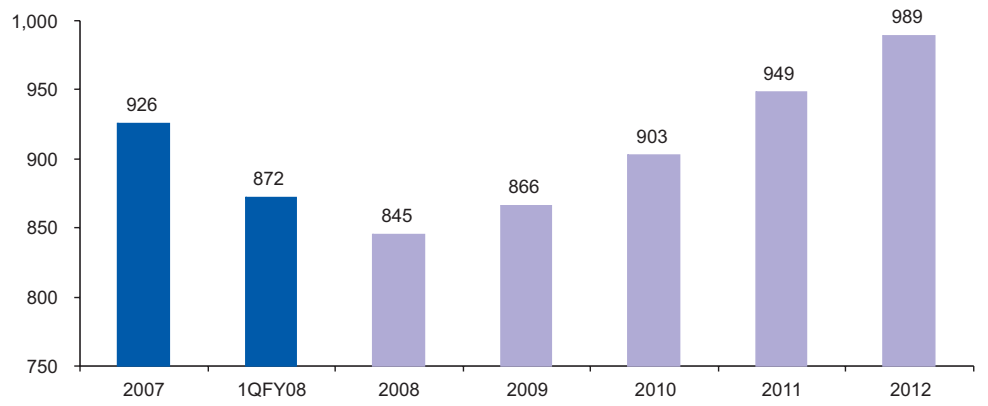
Even though the unit sales growth is not too impressive, we expect the gross profit margin to be so. Honda's plant is capable of producing 50,000 cars a year on double shift runs. However, currently Honda doesn't need to run on double shifts because of declined sales. As the company is heavily capitalized, lump some batch cost will at once incur with the introduction of the additional shift. We don't expect Honda to surpass the single shift margin in the coming five years. Thus, its cost of manufacturing will remain low.

It is also assumed that the sale price of City and Civic would be revised upwards each year by 4.5% and 4% respectively. This upward revision is based on the assumption of continued economic growth of the country as in recent years. Consequently, the increased per capita income of the nation would be able to cope with the annual inflationary price revision of the company.

We also believe that during FY08 and onwards, HCAR will experience a change of product-sale mix, i.e. sale of City cars is going to pick up while that of Civic is going to decline. Due to lower sale prices of City cars, the overall sales turnover of the company is expected to decline but the eventual cost of production will also be low.

In addition, the cost of production of HCAR, historically, has always surged during and after plant expansion or whenever the company introduces a new model of any of its cars, which eventually falls down rapidly soon afterwards. The same trend was witnessed during FY07 and we anticipate a declining cost of production during the coming years as the company is not interested in further expansion in near future.

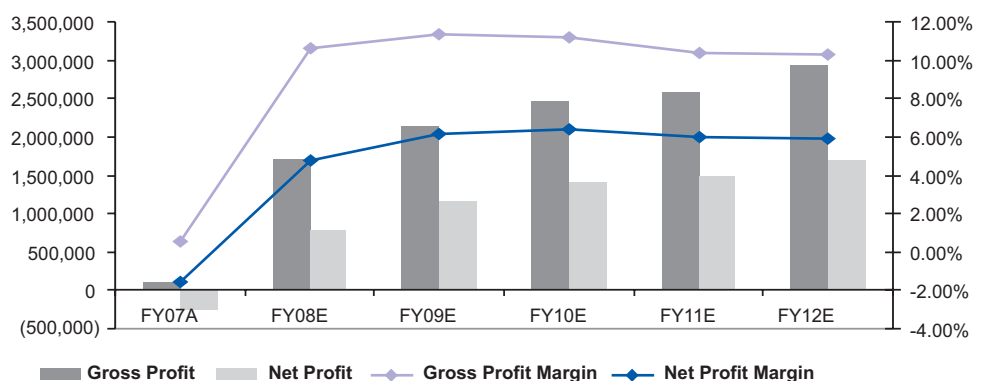
Chart 20: Average Cost of Production Per Car (PRs'000)



Source: IGI Research

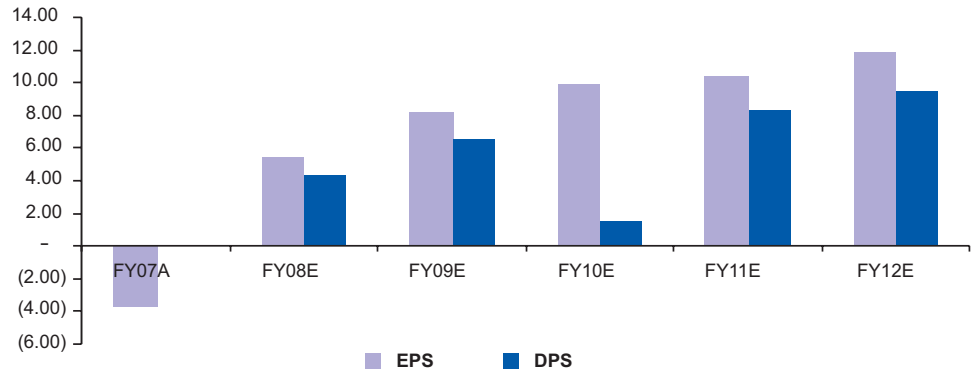
It is thus, the gross profit margins of the company are very promising. The gross profit margin is likely to hike from modest 0.6% during FY07 to an impressive 10.58%, backed by the operational efficiencies which the company claims to achieve over a period of time.

Chart 21: Gross and Net Profit Forecast



Source: IGI Research

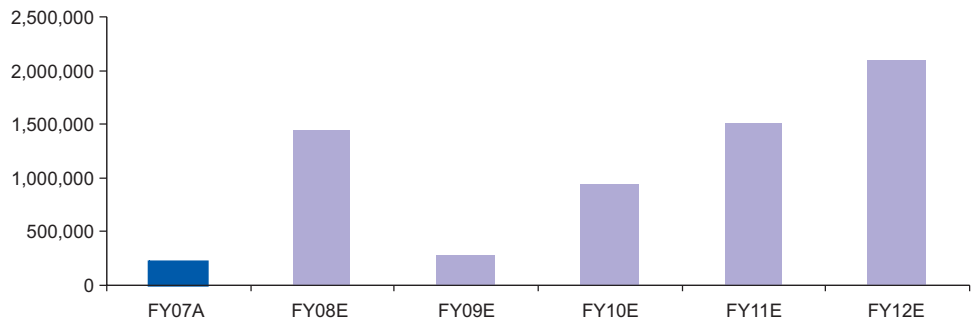
Chart 22: EPS and DPS Forecast



Source: IGI Research

One of our main concerns during our analysis was HCAR’s cash management. Honda plans to wipe out its liabilities during the coming years. Availability of appropriate cash is crucial for the company to meet its financial obligations as well as meet its operational needs. We did not find any significant cash crunches for the company in our simulation model. However, to meet the financial payments the company would have to maintain a lower payout ratio during the next two years until 2010.

Chart 23: Cash and Bank balance



Source: IGI Research

Valuation: NEUTRAL @PRs81.40

Applying the DCF model with the company's WACC at 13.36% and terminal growth rate of 4%, our fair value of the company is found out to be PRs89.95. At current market value, we have a **NEUTRAL** stance towards the stock.

Table 4: WACC

	2008	2009	2010	2011	2012
Debt weight	43%	18%	0%	0%	0%
Equity weight	57%	82%	100%	100%	100%
Debt Rate	11.21%	11.21%	11.21%	11.21%	11.21%
Tax	35%	35%	35%	35%	35%
Net Debt Rate	7.29%	7.29%	7.29%	7.29%	7.29%
Risk Free Rate	10%	10%	10%	10%	10%
Company beta	0.7	0.7	0.7	0.7	0.7
Risk Premium	6%	6%	6%	6%	6%
Cost of Equity	14.20%	14.20%	14.20%	14.20%	14.20%
WACC	11.25%	12.95%	14.20%	14.20%	14.20%
Average WACC	13.36%				

Source: IGI Research

Table 5: Fair Value

	2008	2009	2010	2011	2012	Terminal
EBIT	1,465,770	1,882,254	2,175,761	2,282,507	2,606,377	
Depreciation	421,196	427,758	434,242	440,723	447,188	
Amortization	41,923	39,540	27,379	27,379	27,379	
EBITDA	1,928,890	2,349,552	2,637,381	2,750,609	3,080,944	
NWC (change)	(773,088)	(147,310)	(163,760)	(138,638)	(189,742)	
Taxes	417,109	627,822	761,189	798,550	911,905	
Free Cash for Firm (FCFF)	738,692	1,574,420	1,712,432	1,813,421	1,979,297	
Net Capital Expenditure	112,121	107,074	106,833	106,727	106,727	
FCFF	626,570	1,467,346	1,605,600	1,706,694	1,872,570	20,808,176
Present Value	552,730	1,141,877	1,102,217	1,033,544	1,000,356	9,806,048
NPV	14,636,773					
Net Debt	1,791,667					
Value to the firm	12,845,106					
No. of shares	142,800					
Fair Value	89.95					

Source: IGI Research

Table 6: Sensitivity Analysis: Fair Value per Share

(PRs/Share)

		Terminal Growth Rate				
		2%	3%	4%	5%	6%
WACC	11.00%	103.08	113.89	127.78	146.31	172.25
	12.00%	90.37	98.63	108.97	122.26	139.97
	13.36%	76.77	82.73	89.95	98.91	110.29
	14.00%	71.47	76.63	82.82	90.38	99.84
	15.00%	64.27	68.45	73.38	79.31	86.56

Sources: IGI Research

Key assumptions and forecasts

Following are some key assumptions that we have incorporated in our DCF model.

Forecasting Automobile Sales

Forecasting Honda's sales volumes was a two phased process. First, we tried to estimate the overall industry sales of passenger cars. In the second step, we estimated the market share of each brand in the industry and spread the overall sales among them.

To forecast the automobile sales, we believe that the key three variables that could sufficiently describe the sale behavior in the country are: the per capita income of the country, the effective interest rate, and number of cars sold during the previous year.

Defined as the total GNP divided by population, the per capita income of the country depicts the average income per person in the society. The more the income, the more the spending is likely to be on non-basic-necessities. A briskly-growing per capita income is imperative for driving automobile sales growth. The statistic is based mainly on GDP and GNP growths of the country which are promising during the coming years. Our estimates predict the GDP to grow at 7% during FY08 and by a CAGR of about 6.5% until FY12. The country's population growth rate is assumed to remain stagnant at 2%. A good GDP growth, and hence sound GNP growth, translates into healthy per capita income growth which is about 9%YoY as per our estimates.

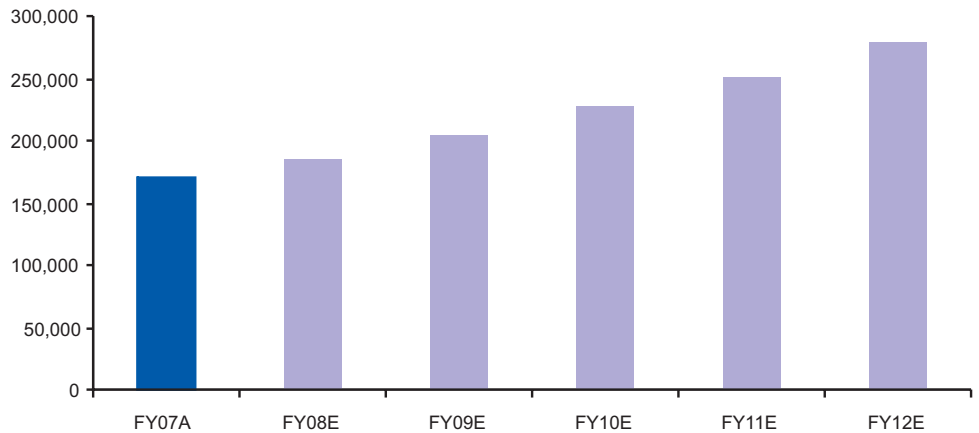
We define the effective interest rate as the difference between the average bank interest rate and country's inflation rate during the year. The high cost of borrowing has a doubly effect on industries. Low-cost and ease of availability of credit increases the purchasing power of the society as well as allows the manufacturers' to leverage more to enhance production. The rising interest rates could adversely impact on, both, the purchasing power of the customer and hence the production capabilities of the industries including the automobile industry. However, as per economic principles, if the inflation rate is high the society has less incentive to save and thus people spend more. Similarly, when the inflation rate is low people have more incentive to save up and spending decreases. It is thus we believe that it is actually the margin between the credit and inflationary rates that could determine the spending behavior of a society. We have considered this margin in our model while estimating future sales level of passenger cars in the country.

The government is expected to keep the interest rates up as per its tight monetary stance and the margin between bank deposits and advances rates will continue to remain wide. We, however, do not think the central bank would be able to raise the discount rate any further beyond the current rate of 10% without compromising on the local industries. We thus maintain the discount rate and hence commercial interest rates to be stagnant during the next five years.

It is likely that the government will miss its inflationary target during FY08 and we expect it to be 7%. However, over subsequent years, inflation growth rate is assumed to be declining marginally.

The number of cars sold during the previous year is taken to curve the graph downwards to simulate the effects of sales in case a saturation point is reached. Statistical model hence provides us with the following estimates of total passenger cars being sold during the coming five years.

Chart 24: Automobile Sale (PRs)



Source: IGI Research

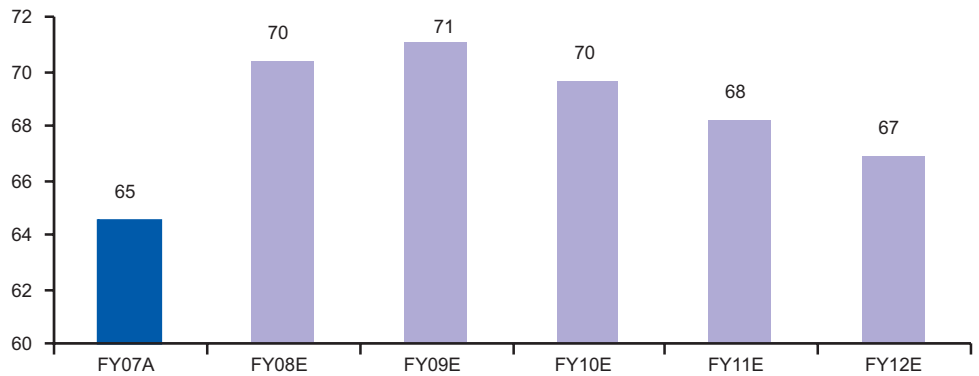
Our next step was to define the market share of brand of car. The consumer is likely to become skeptical from the current surge in oil prices and may believe that this rise in oil prices is permanent. We thus foresee a change in sale share among categories and feel a demand pressure more towards smaller, fuel-efficient cars. We have considered this changing trend while assigning market shares and have incorporated it in our model.

Rising Oil Prices

Fuel prices may to some extent impact on the overall demand of automobiles, but it more importantly impacts on the sales-mix among the different categories of cars. If the fuel prices continue to remain high, it will rather impact more on the sales of Honda cars than on the overall industry. The sale trend would shift more towards smaller cars (1000cc and 800cc) and HCAR could suffer a bad blow of lost sales; a company with only large cars (1300+cc) to offer.

The fuel prices this year have been hovering around US\$90 per barrel. Though, it is believed that it will not sustain at such high levels for very long and the annual average would not come out so high. We feel that oil supply will increase during the coming years to cope with the current shortage. Thus we have assumed the annual average fuel prices to fall in future.

Chart 25: Fuel Prices (PRs)



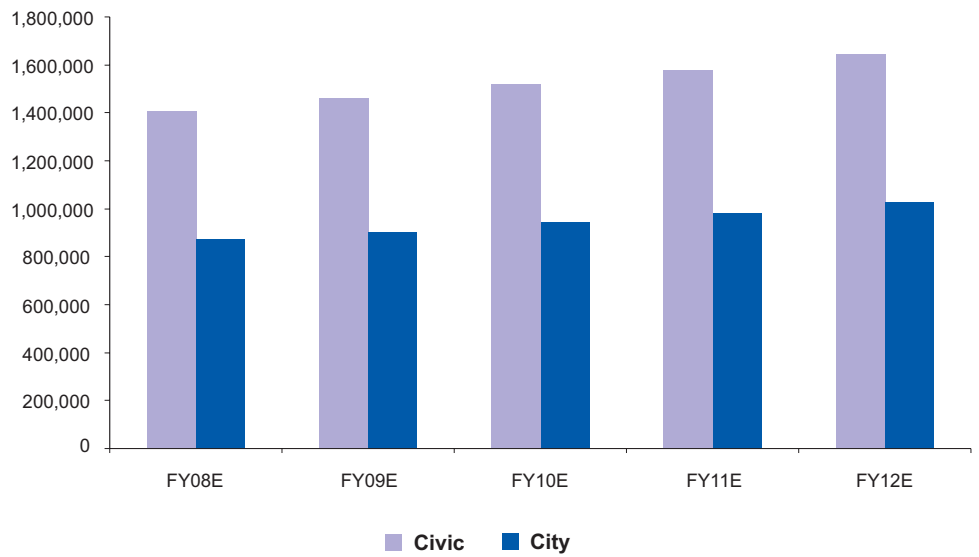
Source: IGI Research

Sale Price of Cars

The new Honda Civic model is having trouble finding acceptability because of its high price. It is thus uncertain that by how much the company would inflate its cars' prices during the coming years. We have however assumed that the company will revise the price of City cars such that the average price of all variants of City's sold would grow by 4.5%YoY, and similarly Civic's price would be raised by 4%YoY.

The reason why we feel that City's price is likely to rise more than the Civic's price is the lower base of City's current price. If Civic's price is revised upwards too quickly, finding a market segment for Civic would become an even greater challenge for the company.

Chart 26: Sale Price Estimates of Honda Cars (PRs)



Source: IGI Research

Sensitivity Analysis: Steel Prices

Our model is very susceptible to fluctuations in global steel prices. Being a major constituent in the manufacturing process of a car, steel can single handedly dictate the cost of production and hence have a significant impact on the valuation of the company.

A global demand surge has led to a sharp increase in steel prices last year by almost 8%. Shortage of steel is expected to continue during the current year and hence we have assumed steel prices to grow at 7% during 2008. However, as each industry gradually adapts to its demand, steel production will likely rise to cope with the demand and the prices will not increase at such high rate during the subsequent year. Nonetheless, in our base case we have assumed that the steel prices would increase by 5%YoY beyond 2008.

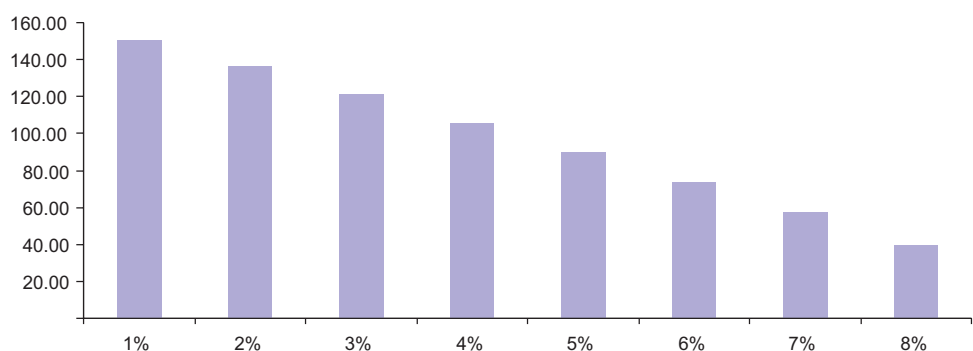
We present the following sensitivity analysis table which reflects the impact of changing steel prices as cost component on the company's fair valuation. Please note that the change in steel prices in addition to 7%YoY increase during FY08.

Table 7: Price sensitivity w.r.t. steel prices								
Steel Inflation Rate	1%	2%	3%	4%	5%	6%	7%	8%
Fair Price	150.71	136.12	121.14	105.75	89.95*	73.73	57.08	40.00

Note: The inflation rate during 2008 is assumed constantly to be 7%. The above rates are assumed to be fixed over subsequent years only.

Source: IGI Research

Chart 27: Fair Price Sensitivity on Steel (PRs)



Source: IGI Research

Table 8: Balance Sheet

	FY07A	FY08E	FY09E	FY10E	FY11E	FY12E
Operating Fixed Assets	4,082,955	3,724,852	3,356,291	2,981,005	2,599,132	2,210,793
Total Non Current Assets	4,623,904	3,870,080	3,470,617	3,110,682	2,743,426	2,368,922
Stock in trade	2,704,946	2,784,075	3,239,007	3,780,123	4,279,371	4,916,724
Cash and bank	219,859	1,443,988	285,110	944,361	1,515,925	2,095,535
Total Current Assets	3,681,213	4,447,328	3,776,067	5,018,110	6,127,902	7,394,031
Total Assets	8,305,117	8,317,408	7,246,684	8,128,792	8,871,328	9,762,953
Current Liabilities	3,906,115	4,224,480	3,703,899	3,386,570	3,832,502	4,385,419
Long Term Liabilities	1,958,334	783,334	-	-	-	-
Total Equity	2,440,668	3,309,594	3,542,785	4,742,222	5,038,826	5,377,534

Source: Company Reports & IGI Research

Table 9: Cash Flow Statement

	FY07A	FY08E	FY09E	FY10E	FY11E	FY12E
Cash from Operations	1,109,494	2,228,276	660,116	975,806	1,859,539	2,035,259
Cash from Investing Activities	(1,336,962)	76,559	(102,896)	(102,355)	(101,557)	(100,820)
Cash from Financial Activities	391,581	(1,080,706)	(1,716,098)	(214,200)	(1,186,417)	(1,354,830)
Opening cash balance	55,746	219,859	1,443,988	285,110	944,361	1,515,925
Closing cash balance	219,859	1,443,988	285,110	944,361	1,515,925	2,095,535

Source: Company Reports & IGI Research

Table 10: P&L Statement

	FY07A	FY08E	FY09E	FY10E	FY11E	FY12E
Sales Turnover	17,055,115	16,214,405	18,863,918	22,015,370	24,922,977	28,634,912
Cost of Sales	16,955,181	14,498,484	16,727,438	19,546,774	22,330,667	25,697,533
Gross Profit	99,934	1,715,921	2,136,480	2,468,596	2,592,310	2,937,379
EBIT	(176,158)	1,465,770	1,882,254	2,175,761	2,282,507	2,606,377
Financial Charges	305,491	274,029	88,477	935	935	935
EBT	(481,649)	1,191,741	1,793,777	2,174,826	2,281,572	2,605,442
Taxation	(217,109)	417,109	627,822	761,189	798,550	911,905
PAT	(264,540)	774,632	1,165,955	1,413,637	1,483,022	1,693,537
EPS	(3.71)	5.42	8.16	9.90	10.39	11.86

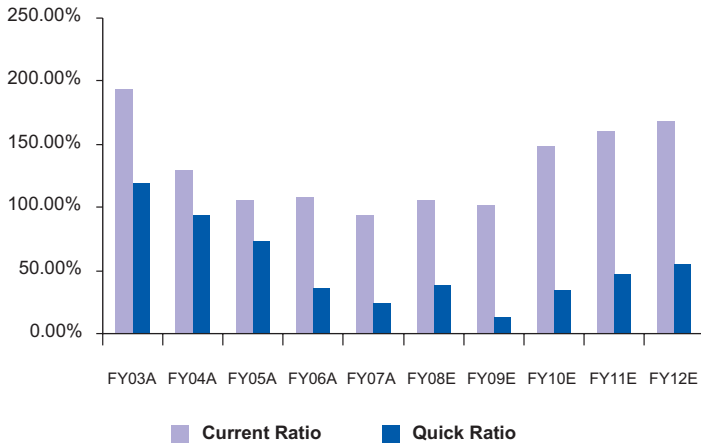
Source: Company Reports & IGI Research

Table 11: Important Ratios

	FY07A	FY08E	FY09E	FY10E	FY11E	FY12E
EPS	(3.71)	5.42	8.16	9.90	10.39	11.86
DPS	-	4.34	6.53	1.50	8.31	9.49
P/E Ratio	-21.97x	15.01x	9.97x	8.22x	7.84x	6.86x
Book Value per share (BVS)	34.18	23.18	24.81	33.21	35.29	37.66
Dividend Yield	0.00%	5.33%	8.02%	1.84%	10.21%	11.66%
Debt Ratio	2.40	1.51	1.05	0.71	0.76	0.82
ROE	-10.84%	23.41%	32.91%	29.81%	29.43%	31.49%
ROA	-3.03%	9.32%	14.98%	18.39%	17.45%	18.18%
Current Ratio	94.24%	105.28%	101.95%	148.18%	159.89%	168.60%
Quick Ratio	23.71%	38.55%	13.42%	35.18%	46.85%	55.09%
Gross Profit Margin	0.59%	10.58%	11.33%	11.21%	10.40%	10.26%
Operating Profit Margin	-1.03%	9.04%	9.98%	9.88%	9.16%	9.10%
Net Profit Margin	-1.55%	4.78%	6.18%	6.42%	5.95%	5.91%
Total Assets Turnover	1.95x	1.95x	2.42x	2.86x	2.93x	3.07x
Fixed Assets Turnover	4.53x	3.82x	5.14x	6.69x	8.51x	11.20x
Inventory Turnover	4.88x	5.20x	5.49x	5.50x	5.47x	5.52x
Days Inventory at Hand	74	69	66	65	66	65

Source: IGI Research

Chart 28: Liquidity Ratios



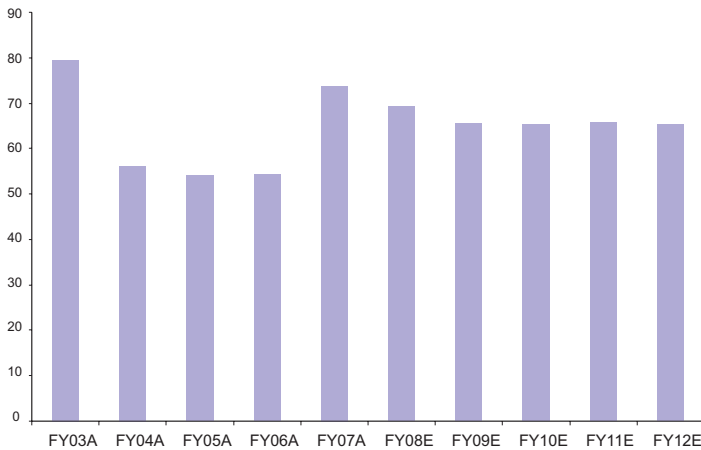
Source: Company Reports & IGI Research

Chart 29: ROE and ROA Forecasts



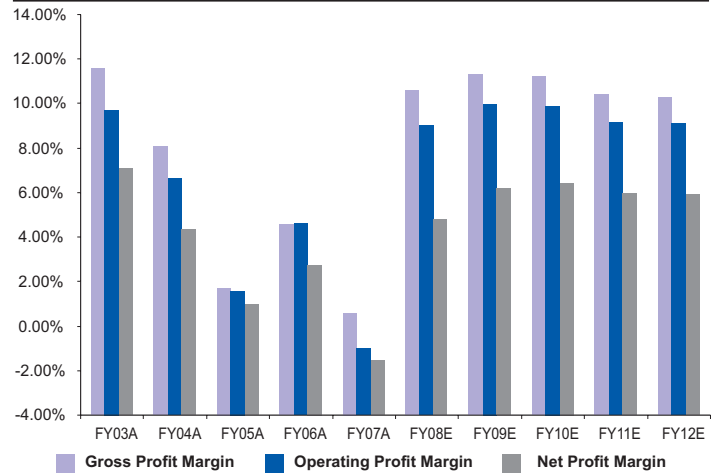
Source: Company Reports & IGI Research

Chart 30: Days Inventory at Hand



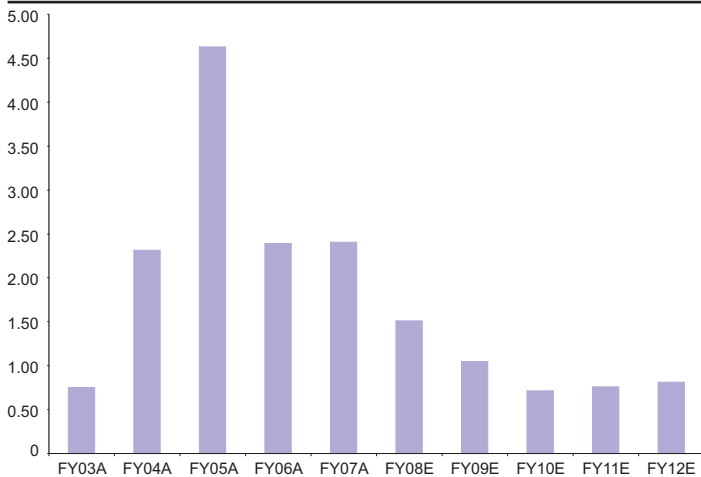
Source: Company Reports & IGI Research

Chart 31: Profit Margins



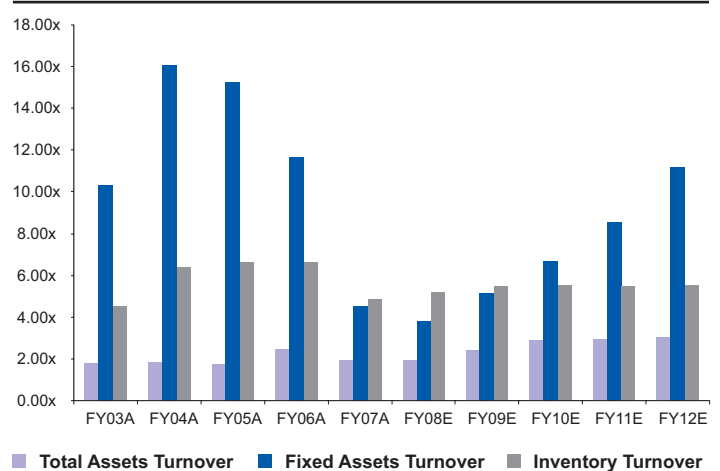
Source: Company Reports & IGI Research

Chart 32: Debt Ratio



Source: Company Reports & IGI Research

Chart 33: Asset Utilization Ratios



Source: Company Reports & IGI Research

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Analyst Certification

I, Muhammad Ashar Khaliq, hereby certify that the views expressed in this research report accurately reflect our personal views about the subject, securities and issuers. I also certify that no part of our compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

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