

Financial Management at Hero Honda Motors Ltd

Background

Hero Honda Motors Limited came into existence on 19 January 1984. The company was formed by creating a joint venture between Hero Group and the Honda Motor Company of Japan. Owned by Hero (Munjal) Group, the company's current Chairman is Mr Brij Mohan Lai Munjal and Mr Pawan Kant Munjal is its Managing Director. The promoters of the company hold approximately 29% of the equity shares and the Indian public holds 9% of the total shares, while the institutional investors hold about 35%.

The company produces motorcycles and scooters. Some of the brand names of its products are Achiever, Karizma, CBZ, Splendor, Super Splendor, Splendor Plus, Glamour, Passion, Passion Plus, CD Deluxe, CD 100 SS, Slek, and CD Dawn. The company also manufactures the spare parts of these two wheelers. Besides, the company provides mobile after-sales service to its existing customers. The company has two plants located in Haryana, one at Dharuhera and the other at Gurgaon. In a little over two decades, it has emerged as the world's largest manufacturer of bicycles and a global leader in motorcycles. The company has sold over 15 million motorcycles and has consistently grown at double digits since its inception and today, every second motorcycle sold in the country is a Hero Honda. Hero Honda is a world leader because of its excellent manpower, proven management, extensive dealer network, efficient supply chain, and world-class products with cutting edge technology from Honda Motor Company, Japan.

Progressively through the 1980s, the 1990s, and now in the 2000s, Hero Honda has relied on 3 R's—*reach*, *research*, and *reliability* as its basic building blocks. Using feedback from the market, a fully-equipped R&D centre has consistently created best practices in designing, testing, and harmonization, besides placing strong emphasis on road safety and ride quality. This emphasis has helped Hero Honda build products that are ahead of their time. Hero Honda became the first company in India to prove that it was possible to drive a vehicle without polluting the roads. The company introduced new generation motorcycles that set industry benchmarks for fuel thrift and low emission.

Financing Policy

The company has been a debt-free company for the last five years. The unsecured loan of Rs 186 crores from the state government of Haryana on account of sales tax deferment is interest-free and has no holding costs. The company has been meeting its expansion and growth needs from its internal sources of financing. The financing mix of the company for the past six years has been as follows (Table A):

Table A Financing mix of Hero Honda

<i>Time</i>	<i>Debt-equity ratio</i>
March 2001	0.11
March 2002	0.17
March 2003	0.16
March 2004	0.15
March 2005	0.15
March 2006	0.09

The financing mix of the closest competitor, Bajaj Auto Ltd, stood as follows (Table B):

Table B Financing mix of Bajaj Auto Ltd

<i>Time</i>	<i>Debt-equity ratio</i>
March 2003	0.25
March 2004	0.27
March 2005	0.29
March 2006	0.30

Performance

The executive summary of Hero Honda Ltd is as follows (Table C):

(Rs in crores)

	Mar-01	Mar-02	Mar-03	Mar-04	Mar-05	Mar-06
Net sales	3171.22	4466.48	5097.95	5833.01	7419.86	8708.13
Other income	10.63	47.21	23.25	53.6	44.05	75.81
Cost of production	2581.28	3463.47	3922.35	4502.45	5842.09	6878.7
PBDIT	459.55	750.01	903.65	1054.6	1227.21	1438.05
PBDT	424.45	717.09	878.83	1031.65	1209.45	1422.47
PBT	380.18	666.08	815.44	958.32	1120.07	1307.85
PAT	250.1	434.63	511.64	614.18	713.29	866.95
Gross fixed assets	614.66	704.52	780.88	901.45	1074.73	1421.54
<i>Current assets</i>	663.83	536.46	1666.57	2068.8	2577.72	2850.92
Net worth	608.99	675.54	860.33	1138.81	1493.38	2009.33
Equity capital	39.94	39.94	39.94	39.94	39.94	39.94
Long term borrowings	66.48	116.44	134.28	174.7	201.76	185.78
Capital employed	675.47	791.98	994.61	1313.51	1695.14	2195.11
Current liabilities & provisions	460.12	880.21	1116.21	1260.05	1500.47	1562.8
Total assets/liabilities	1125.47	1733.34	2176.67	2652.08	3294.68	3875.07
			Growth (%)			
Gross Sales	40.97	40.75	14.22	32.24	27.42	17.32
Cost of production	41.61	34.18	13.25	14.79	29.75	17.74
PBDIT	34.19	63.21	20.49	16.7	16.37	17.18
PAT	35.66	73.78	17.72	20.04	16.14	21.54
GFA	22.45	14.62	9.3	13.95	19.09	29.27
Total Assets	33.26	54.01	25.58	21.84	24.23	17.62
Profitability Ratios (%)						
PAT/ Sales	7.87	9.72	10.02	9.09	8.29	8.59
PAT / Net worth	47.52	67.67	66.63	61.44	54.2	49.5
PAT/ Total Assets	25.39	30.41	26.17	25.44	23.99	24.18
PAT/ Capital Employed	42.75	59.24	57.28	53.22	47.42	44.57

Investment Policy

The company keeps on increasing the production capacity from time to time to cope up with the rising demand. During the year 2005-06, the company added Rs 399 crores in fixed assets to expand the manufacturing capacity. The production capacity of Gurgaon plant was increased from 5000 to 6500 units a day in the previous year. To tap the increasing demand for the motorbikes, the company decided to carry the process of expansion further and increase the capacity at the Dharuhera plant to 6500 units by the fall of 2006. This would take the installed capacity to roll out 13000 units a day. This capacity expansion will take care of the growing demand in the short run. The company is in the process of setting up a third plant to take care of the demand in the medium-term as it would also enable the company to realize its mandate of becoming a global scale and world-class manufacturer. A state-of-the-art manufacturing plant with an investment of Rs 400 crores to be operational by mid 2007 at Haridwar with an initial production capacity of Rs 5,00,000 is proposed. Besides, the company, in order to improve its efficiency and to cut down the cost, has made investment in augmenting its welding capacity. The company has also invested in technology that will help in localizing the production of gear boxes. By 2010, Hero Honda and its ancillaries will invest Rs 1900 crores in the new plant, achieving a capacity expansion to 15 lakh units, thereby enabling the company to cater to future market demand and consolidate its market leadership.

Working Capital

The company has already endeavoured to set benchmarks in its working capital management and has continued to operate on negative working capital for the past several years. The continued focus on working capital has helped the

company to enhance cash flows through better management of inventory, receivables, and payables. As a part of cost rationalization drive, the company has aggressively availed cash discount from its vendors by making the payments before due date. This has not only helped to improve its operating margins but has also allowed it to deploy the surplus funds in its core business operations. The tight monitoring and control of the working capital components has been the main source of satisfactory working capital management, which is reflected in the following figures:

Table D Working capital management and liquidity ratios

	2004-05	2005-06
Inventory period (days)	11.30	10.50
Operating cycle (days)	14.00	14.90
Cash cycle (days)	-33.00	-23.90
Current ratio	0.53	0.74
Acid-test ratio	0.34	0.54

The company has made sustained efforts to prune manufacturing variable costs over the years through the process of localization and process improvement. To a large extent, these costs have been controlled and the cost per vehicle came down from Rs 837 to Rs 353 in March 2005. However, due to sharp increase in the cost of electricity and its erratic supply, the declining trend in the variable manufacturing costs was reversed in 2005-06. To address this problem, the company has commissioned HFO-based generator sets at each of its facilities. In the coming months and years, these measures will help Hero Honda to prune its material and manufacturing costs substantially.

As 60-70% of the revenue of the company is made up of material costs, vendor management is a critical factor. To improve plant efficiency and inventory turns, the company has extended Just-In-Time (JIT) beyond the shop floor. An online vendor connectivity programme has been implemented and extended to 94 vendors from 46 in the previous year. As a result, the company has been able to access 70% of the materials (in value terms) by maintaining zero inventory. For the balance, the average inventory period is about 34 days. The cost of raw materials as a percentage of total sales decreased from 70.1% in 2004-05 to 69.5% in 2005-06 primarily due to favourable changes in sales mix and continued focus on cost rationalization. To rationalize the supply chain further, the company is now switching to system purchases and also looking at the possibilities for global procurements. The working capital performance of Hero Honda Motors Ltd. is given in Table E.

Compared to the company, the working capital cycle of the other firms in the automobile sector was as follows:

Table E Working capital performance of Hero Honda Motors Ltd

	March 2001	March 2002	March 2003	March 2004	March 2005	March 2006
Working Capital in crore)	203.71	-343.75	550.36	808.75	1077.25	1284.57
Average current assets (Rs in crore)	488.89	600.14	1101.51	1867.68	2323.26	2714.32
Avg. days of debtors	4	5	8	5	2	4
Avg. days of creditors	31	32	35	42	40	32
Gross working capital cycle (days)	33	27	28	22	16	17
Net working capital cycle (days)	2	-5	-7	-20	-24	-15
Liquidity ratios (times)						
Current ratio	1.44	0.61	1.49	1.64	1.72	1.82
Quick ratio	0.18	0.25	1.21	1.30	1.42	1.52
Interest cover	11.83	21.23	33.85	42.76	64.07	84.94

Table F Working capital cycle of automobile companies

Company name	2004		2005		2006	
	Gross working capital cycle	Net working capital cycle	Gross working capital cycle	Net working capital cycle	Gross working capital cycle	Net working capital cycle

	(in days)					
Bajaj Auto	30.38	-15.43	24.18	-18.76	14.24	-10.56
Maharashtra Scooters	69.49	-74.21	78.40	-72.33	108.66	-63.08
TVS Motors	39.31	-11.93	38.71	-14.23	42.30	-11.01
Yamaha	113.16	50.38	85.01	44.85	94.29	54.45

Dividend

The company has been continuing with a liberal dividend policy during the past few years. The company believes that the shareholders should benefit appropriately from the company's continued success consistently. The company is extremely conscious about the efficient use of capital employed and has always endeavoured to earn a return higher than the cost. Further, after giving due consideration to the cash generating capacity, expected capital needs of the business and strategic considerations, the board has recommended a dividend of 1000% for the third year in succession.

Table G : Dividend Payout by Hero Honda

Year	Dividends (Rs in crore)	Retained earnings (Rs in crore)	Total Dividend Rate (in percentage)	Dividend per share (in Rs)
March 2001	66.01	180.86	150	NA
March 2002	349.67	113.26	850	17
March 2003	405.49	175.27	900	18
March 2004	450.54	277.78	1000	20
March 2005	455.90	354.57	1000	20
March 2006	455.39	515.95	1000	20

The dividend payout by BAJAJ Auto Ltd. during past four years was as follows:

Year	Dividends per share (in Rs)	Payout ratio (%)
March 2003	14.00	29.68
March 2004	25.00	38.64
March 2005	25.00	39.55
March 2006	40.00	41.89

The adjusted closing prices of shares of Hero Honda Motors Ltd were as follows:

Year	Share Price (in Rs)
March 2001	140.35
March 2002	333.70
March 2003	188.40
March 2004	490.45
March 2005	548.15
March 2006	888.30

Discuss

1. Is the financing policy of Hero Honda Motors satisfactory? How is the unlevered capital structure of the firm justified?
2. What are the factors that are favouring a zero debt capital for the company? Is it always beneficial to have a low debt in the capital structure?
3. Is investment policy driving the growth of the firm? What are the key issues that the investment policy of the company is trying to address?
4. Are you satisfied with the working capital management of the company? Give reasons.
5. Is the dividend policy of the firm appropriate? What factors determine the existing dividend policy of the firm?

