

Sector update

INDIA

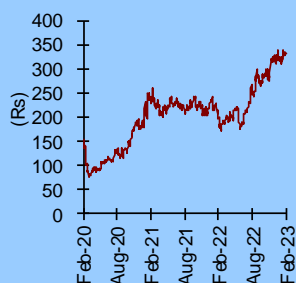


Automobiles - Tyres

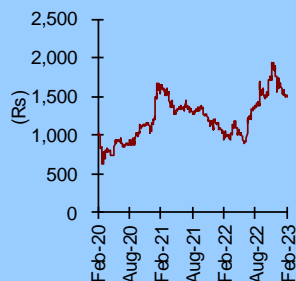
Profitability recovering briskly, set to improve further

Indian automotive tyre companies, on an average, witnessed 10% increase in gross profit/kg (GP) QoQ in Q3FY23 to long term mean plus one standard deviation levels of ~Rs84/kg. This was the first quarter post a gap of four quarters in which there was a combination of blended price hikes and reduction in raw material basket (RMB) costing. We believe Q4FY23 would be another quarter with trickling effects of Q3 price hikes combining with ~5% decline in RMB/kg cost, pushing GP/kg by ~Rs5-6 up, thus, adding ~200bps to GM. With this, we expect manufacturers in the space to go back to their long-term average EBITDAM levels. We believe disciplined pricing by APTY has helped it go back to desirable EBITDAM levels, fastest amongst peers. We believe with replacement market being subdued across FY23, OEM based revenue mix has been higher than normal by ~500bps at ~35%, giving scope for EBITDAM to improve through mix reversal. We are building ~14.5% and ~11.5% as mean EBITDAM for APTY standalone and CEAT over FY24-25E. Controlled capex, steady profitability, recovering RoCE and consistency in FCF generation make us prefer APTY in this space as our top pick. We maintain BUY on Apollo Tyres (APTY) with DCF-based TP of Rs400, implying 13x FY25E EPS and maintain REDUCE on CEAT with DCF-based TP of Rs1,377, implying 12x FY25E EPS.

Apollo Tyres (BUY)



CEAT (REDUCE)



- **Raw material basket correction aiding recovery in profitability:** Indian tyre industry's profitability got impacted severely in H2FY22 and H1FY23 on account of elevated RMB costing. This was led by Brent crude oil trading at an average of US\$97/bbl in this period vs mean of US\$62/bbl in the preceding four quarters. This resulted in crude derivative prices shooting up subsequently other than natural rubber prices also remaining elevated above Rs170/kg (currently sub-Rs150/kg). Thus, mean GP/kg of players declined down to long term mean level of Rs72 from FY21 levels of Rs86. Post reduction in RMB costing in the last couple of quarters, GP/kg of the space has recovered to Rs85/kg and is expected to inch up further by Rs5-6/kg in Q4FY23, led by continued reduction in RMB costing and lag effect of price hikes.
- **Weakness in replacement demand across segments also hurt efficient pricing power for the industry:** With replacement demand across key segments along with higher margin exports remaining subdued in FY23, pricing power got impacted amidst elevated RMB costs. Thus, despite passing on cost inflation to OEM segment, inadequate price hikes in ~70% replacement segment across categories additionally impacted gross margin. With gradual revival in replacement demand and growth in PV/CV OEMs normalising down from FY23 highs, we believe replacement mix improvement would also help profitability improve.
- **Period of limited capex and strong profitability:** We believe the best period for a tyre maker is when elevated profitability coincides with need for lower capex. Industry growth would remain within the narrow band of ~6-8% CAGR in the longer run driven by OEM/replacement volume growth. Both APTY and CEAT have dropped the plans of doing further capex on TBR and would sail through FY24-25E by doing ~25% capex lower than average of past four years. Thus, limited capex spends and gross profit/kg at 1-standard deviation above long term mean levels, we believe, would bode well for FCF generation and RoCE improvement in FY24-25E.
- **Prefer APTY:** We continue to prefer APTY led by visibility of improving RoCE and debt reduction in FY23-25E through strong profitability execution both in India and EU along with operating at capex/sales of ~4-5%. We see APTY's pre-tax RoCE moving to ~15% by FY25E vs ~9% in FY23E and gross debt down at Rs10bn from current Rs46bn by FY25E. Also, APTY is trading at an attractive ~11x FY25E EPS, giving it scope for rerating led by improving fundamentals.

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Table 1: Indian automotive tyre business stock performance in FY23-YTD

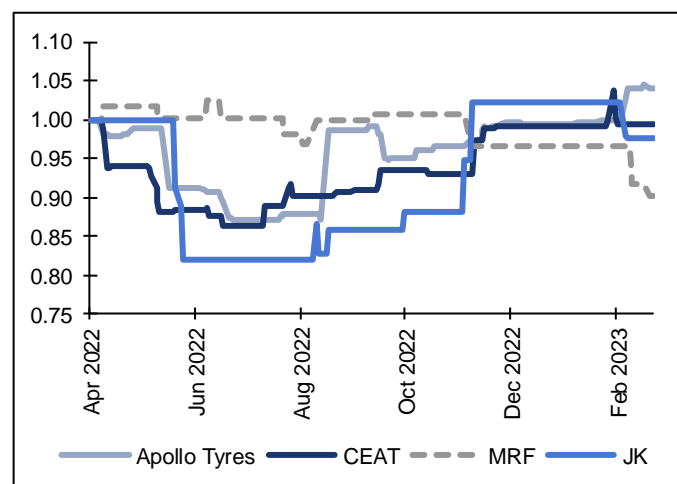
Stocks	Price as on		Absolute return (%)	Rating	Price Target (Rs)	Upside/ (Downside)
	1-April-22	23-Feb-23				
Apollo Tyres	196	328	68%	BUY	400	22%
CEAT	950	1,488	58%	REDUCE	1,377	(7%)
MRF	66,360	89,938	36%	N.A.	N.A.	N.A.
JK Tyres	120	154	29%	N.A.	N.A.	N.A.
TVS Srichakra	1,655	2,866	73%	N.A.	N.A.	N.A.
Goodyear	905	1,038	15%	N.A.	N.A.	N.A.

Source: Bloomberg, I-Sec research

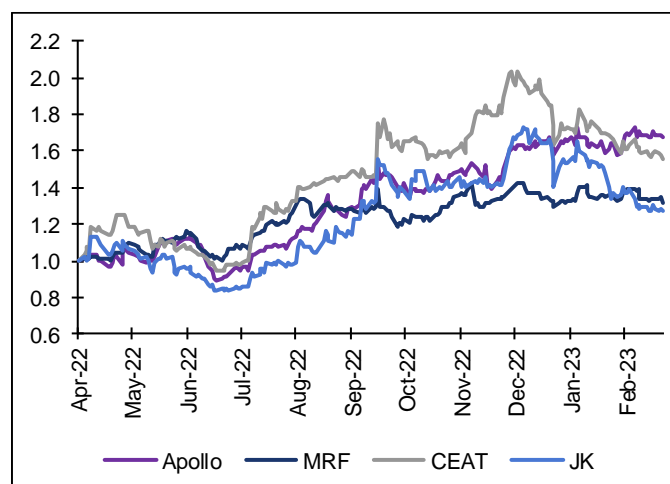
Table 2: Valuation summary

	PE (x)			EV/EBITDA (x)			EV/Sales (x)		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Apollo Tyres	22.2	12.9	10.9	7.7	6.2	5.7	1	0.9	0.86
CEAT	63.6	17.7	12.5	8.5	5.7	5.1	0.6	0.6	0.6
MRF	52.8	26.74	21.72	17.03	11.62	10.24	1.65	1.52	1.43
JK Tyres	11.88	7.62	6.06	6.91	5.58	5.03	0.61	0.56	0.52
	P/B (x)			RoE (%)			RoCE (%)		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Apollo Tyres	1.7	1.5	1.4	7.4	11.6	12.4	9.4	14.1	15.7
CEAT	1.8	1.6	1.5	2.8	9.6	12.3	4.4	8.1	9.6
MRF	2.53	2.31	2.09	4.9	9.73	10.24	N.M.	N.M.	N.M.
JK Tyres	1.22	1.07	0.94	10.55	14.58	16.03	N.M.	N.M.	N.M.

Source: Company data, I-Sec research

Chart 1: APTY is the sole company witnessing consensus earnings upgrade since April 2022

Source: Bloomberg, I-Sec research

Chart 2: APTY is the best performer in the space in FY23 (till date)

Source: Bloomberg, I-Sec research

Table 3: Key input commodity prices stabilising since Q2, benefit started coming in from Q3

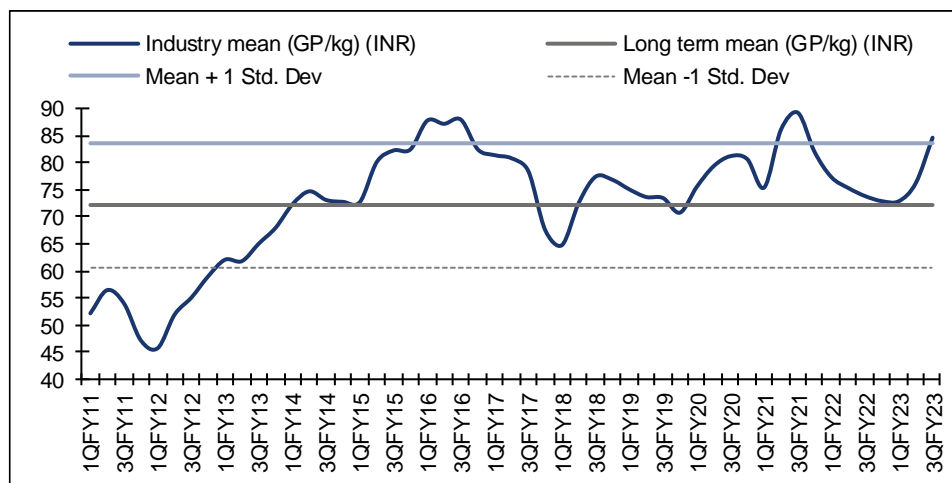
	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22
Kerala Natural Rubber (Rs/kg)	61	69	73	80	97	112	98	89
Brent crude (\$/bbl)	158	169	173	177	167	174	163	146
Carbon Black (Rs/kg)	75	90	90	100	105	105	105	130
Synthetic rubber (Rs/kg)	135	155	155	175	175	175	175	185
Apollo Tyres RM/kg (Rs)	133	142	150	161	165	174	181	181

Source: Bloomberg, I-Sec research

Gross profit/kg recovering post remaining subdued for four quarters; set to inch up further in Q4FY23 itself

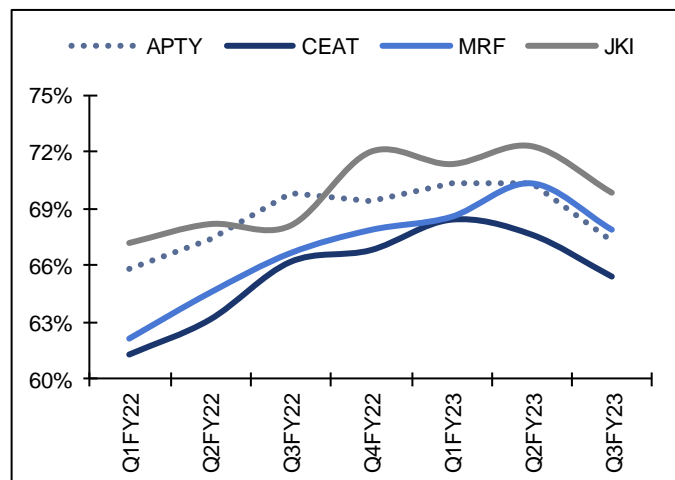
With price hikes in replacement market happening with a lag amidst brisk rise in raw material basket (RMB) cost, gross profit/kg (GP) for domestic auto tyres space declined from highs of Rs85-90/kg in Q2FY21 to long term mean level of Rs70/kg in Q1FY23. With key input commodity prices being on falling trajectory in the past couple of quarters as against gradual price hikes continuing, GP/kg for the space has gone back to 1-SD above long term mean levels, as per our analysis. With trickling effect of price hikes taken in mid-Q3 set to get reflected in Q4 results, and incremental 5% decline in RMB cost, we expect GP/kg to improve by another Rs5-7 QoQ in Q4FY23. This would take the sectoral GP/kg back to its highs and help EBITDAM improve by another ~200bps from current levels and settle across FY24, assuming RMB remains within a range of +5%. With limited volatility in terms of volume growth, industry margin largely moves with gross margin amidst limited impact of operating leverage.

Chart 3: Indian automotive tyre business gross profit/kg trend; recovering from long term mean levels in Q3 and set to inch up further in Q4



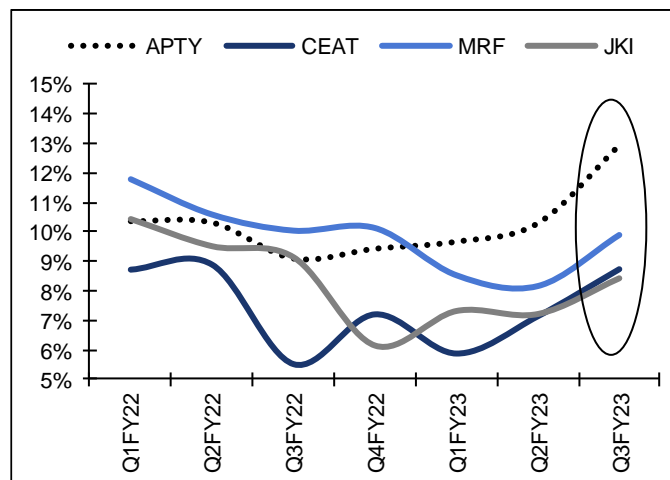
Source: Company data, I-Sec research

Chart 3: Raw material costs declining, finally, post remaining elevated in past four quarters



Source: Company data, I-Sec research

Chart 4: EBITDA margin in turn inching up with GM, with no major change in operating leverage



Source: Company data, I-Sec research

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