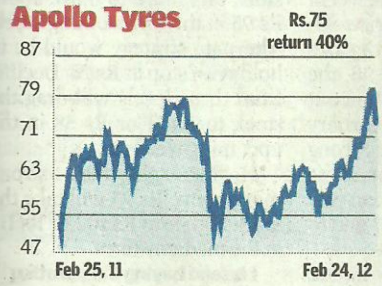
Apollo Tyres promises a smooth ride

Easing rubber prices, expected pick-up in demand and an encouraging outlook for its European operations are positives for Apollo Tyres.

BUY



WHY BUY

- Softening rubber prices
- Strong outlook for replacement demand
- Improving radialisation in truck and bus tyres

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Softening natural rubber prices, expected pick-up in replacement demand, improving sales of truck-bus radials (TBRs) and an encouraging outlook for its European operations spell good times for Apollo Tyres.

At the current market price of Rs 75, the stock trades at a price-to-earnings ratio of 9.5 times its estimated consolidated FY 12 earnings and seven times the estimated earnings for FY13. Investors with a perspective of one-two years can buy the Apollo Tyres stock.

HOLDING THE KEY

With material costs accounting for as high as 70 per cent of the turnover for the tyre manufacturer, this industry is highly raw material-intensive. Of this, 45-50 per cent of the total inputs cost is natural rubber. Beginning December 2009, domestic rubber prices relentlessly marched upwards so much so that by April 2011 prices of RSS 4 variety used by the tyre industry peaked at around Rs 240 a kg.

However, since then, rubber prices have stabilised at around Rs 220 per kg. International prices too have largely followed a similar trend. With the prices still being very high and periodic price increases by Apollo not covering the rise fully, the company's operating margins have been under pressure in the first nine months of 2011-12. Other factors too have weighed on the margins.

One, prices of crude oil from which other raw materials such as synthetic rubber, nylon tyre cord fabric and carbon black are derived, have risen.

Two, the company hasn't been able to take advantage of any fall in international rubber prices *vis-a-vis* the domestic prices (international rubber prices had dropped more at times) due to high import duties as well as a depreciation of the rupee.

And, finally, there was a lull in replacement demand for truck tyres.

For the nine-months ended December 2011, the standalone margins fell from 10.3 per cent in April-December 2010 to 7.5 per cent currently. (Standalone operations contribute to 65 per cent of the total consolidated revenues).

This apart, higher interest costs (due to expansions at Chennai plant) at the standalone level pulled down profit growth during this period. Net profits (standalone) fell by about 17 per cent to Rs 109 crore.

On the other hand, fall in consolidated operating margins were contained, thanks to the robust sale of high-margin winter tyres in the Europe subsidiary. It dropped to 9 per cent from 10.7 per cent last year.

Adjusted net profits (consolidated) grew by 13 .7 per cent to Rs 282 crore for the nine-month period. Consolidated top-line growth was robust at 45 per cent to Rs 8,921 crore.

Improving radialisation in commercial vehicles to boost realisations.

MARGINS TO EXPAND

But, going forward, the company is poised to see better times as rubber prices have eased in the last three months (to around Rs 190-200 a kg). This was led by increased production and lower demand from one of the main consumers, China.

With the lag effect of previously high prices beginning to fade away, the company will see a easing of pressures on the margins.

Margins will also be helped by an expected pick-up in replacement demand. Tyre makers, similar to battery makers, derive more than half their revenues from replacement market, in which they have greater pricing power.

A robust auto industry growth of 26 per cent in each of the last two years (2009-10 and 2010-11) implies that the replacement demand for vehicles sold then should kick in shortly. Apollo will benefit given its 27 per cent market share in commercial vehicles (CVs) and 23 per cent share in cars.

Margins and realisations will also get a boost from the improving radialisation levels in CVs. From about 13-14 per cent two years ago, radialisation in CVs stands at 20-25 per cent currently. The company is the largest producer of TBRs in India and is ramping up capacity for the same at its Chennai plant.

SUPPORT FROM EUROPE

In addition to the bright outlook for domestic operations, what bodes well for Apollo is the stable support from its European operations (25 per cent of consolidated revenues).

The Vredestein brand, which Apollo acquired in May 2009, caters predominantly to the replacement market in Europe and is hence shielded from a slowdown in OE sales. It specialises in selling high-margin winter tyres and hence, tends to see comparatively better performance in the second and third quarters.

Also, the company's access to the Vredestein's network will help in penetrating the 'Apollo' brand in Europe. Towards this end, Apollo is targeting to expand its reach to more countries and double its standalone export revenues from Europe next year. Presently, exports make up 10 per cent (4 per cent to Europe) of the standalone company's revenues.