Apollo Tyres: revenue growth, strong cash flows improve outlook

The road ahead looks smoother for **Apollo Tyres Ltd**. Strong cash flows from revenue momentum on the back of growing domestic demand, along with stable costs over a 12-month horizon, put the tyre maker on firm ground. More importantly, capacity expansions are in place both on home turf and overseas, which means, going forward, there will not be any significant capital expenditure eating into cash flows.

In its analysts' conference call, the management indicated that consolidated sales (including European and South African operations) during the current year could grow 15% from the previous year's figure of ₹12,153 crore.

Much of the optimism stems from domestic operations, which were a drag on profitability until December. The March quarter has brought a reversal in sentiment, with domestic sales rising 28.2% to ₹2,259 crore from a year earlier—a fillip for consolidated performance, as domestic operations comprise 67% of consolidated revenue. This came from 14% higher sales volume, with 12.5% higher average realization from the year-ago period.

In fact, domestic revenue offset the 18% drop in South African revenue and a meagre 4% increase in European operations, which came as a negative surprise, especially after stellar performance in the two preceding quarters, on high winter tyre sales.

Another positive for Apollo Tyres and the tyre industry is higher usage of radial tyres in trucks and buses in India. Higher radialization (around 25% in the last few months from 17% in the March quarter) favours higher realization. Further, the demand from truck makers is reasonable, with 12-15% momentum expected in the truck tyre replacement market, too.

Higher-value truck tyres comprise 65% of the firm's domestic revenue where Apollo Tyres's market share is rising. The 1.5 times increase in production capacity, compared with two years ago, will back higher demand. Overseas acquisitions, mainly in Europe, which contributes nearly one-third to the consolidated revenue, will add to revenue and profit growth, too.

Moreover, profitability is likely to improve as rubber prices are expected to remain soft during fiscal 2013 (FY13). The consolidated operating margin of 11.3% during the March quarter came mainly from an improvement of 200 basis points in the domestic business from a year ago. This offset the losses incurred in South Africa. Albeit a small portion of the consolidated earnings, this region could continue to limit earnings upside at least in the near term.

Going forward, margin gains will accrue from lower rubber prices (down from ₹230 per kg in early 2012 to the present level of ₹192). The recent price increases in some product categories in India and overseas could also add to margins during FY13. A major downside, however, is currency volatility, as much of the rubber is imported.

The balance sheet is also expected to improve as major capital expenditure is now behind the company. An outlay of about ₹300 crore for FY13 will not burden the balance sheet. In fact, analysts are hopeful that Apollo Tyres might repay some debt with the cash flows generated. Consolidated debt fell from ₹2,900 crore (December 2011) to ₹2,700 crore (March 2012). This, along with improved working capital, is expected to reduce interest costs, which in turn can lift net profit.

Surjit Arora, an analyst with **Prabhudas Lilladher Pvt. Ltd**, said in a report that the company will generate free cash flow of about ₹700 crore during the current year.

Sheer market leadership and global presence in key tyre categories have seen the Apollo Tyres stock command a higher valuation than its peers. At ₹85, one-year forward earnings are discounted around six-seven times the price-earnings multiple. Stable rubber prices could trigger upside in the stock for the medium term, although the company's strong dependence on the commodity makes taking a long-term view on the stock difficult.

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