

TYRE STOCKS have outperformed the BSE Sensex in the past three months, rising up to 16%; companies are likely to significantly improve their gross margins

Lower Oil Prices Could Put Tyre Cos on the Fast Track

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ET Intelligence Group: Stocks of the replacement market favourites in the tyre industry are set to benefit from the benign raw material prices as higher utilisation, particularly at factories making tyres for trucks and buses, helps offset the likely slowing demand from automakers.

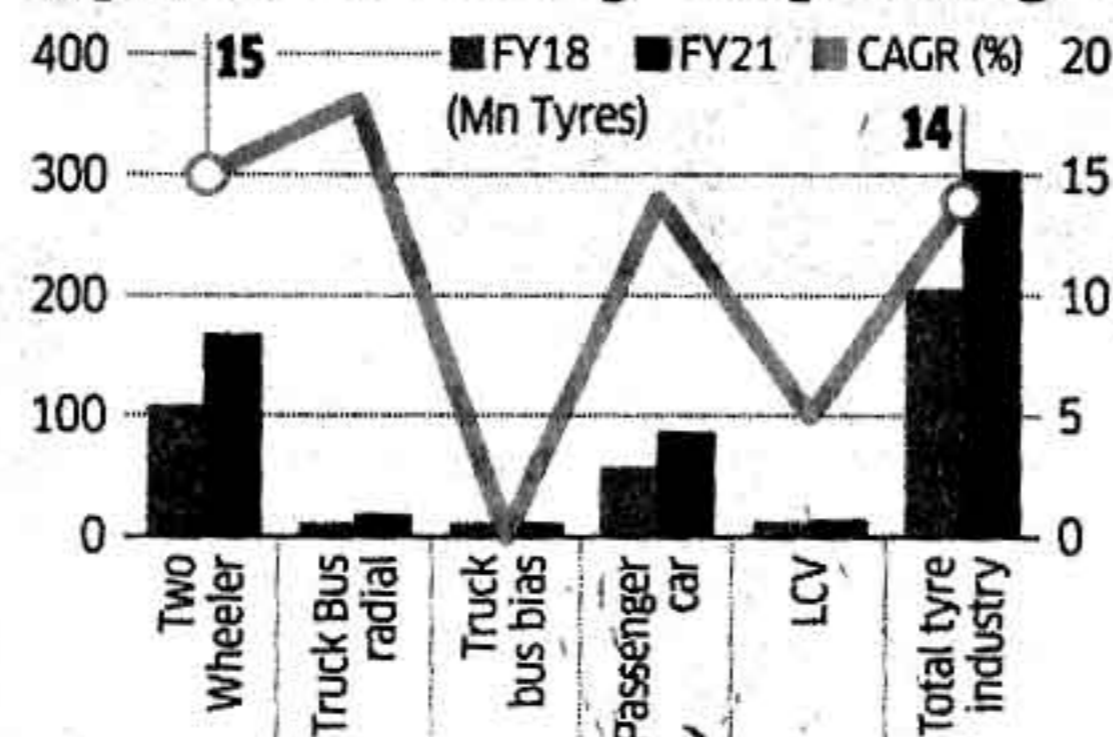
Apollo Tyres is among the preferred picks because of attractive valuations and its leadership in the truck-bus radial (TBR) segment, where utilisation level is more than 90%. CEAT and MRF, too, are set to benefit.

Tyre stocks have outperformed the BSE Sensex, with their shares gaining 6-16% in the past three months.

The fall in crude oil prices could improve their gross margins. Crude oil prices have come off about a third from the top, and the impact of favourable commodity prices should start reflecting from the last quarter of the current fiscal year.

The crude oil derivative used in the manufacturing of tyres constitutes

Tyre Industry Capacity Expansion



around 30% of the total raw material cost. Hence, the decline has a direct bearing on their gross margins—revenue minus cost of raw materials.

If tyre companies are able to fully harness the benefits from the fall in crude oil prices, their gross margins could improve 200-300 basis points. According to Nomura, every \$10 fall in the crude oil prices potentially adds 110 basis points to the margins at tyre companies. In the past few years, tyre

companies have maintained pricing discipline. Therefore, they have been able to raise prices when commodities headed north.

Tyre companies are also the prime beneficiary of the replacement demand, which constitutes about 60-65% of the total industry sales. Operating margins in the replacement market are superior compared with sales to automakers, and the typical life for a set of tyres is around three-four years.

So, a vehicle sold in 2014-15 will be up for replacement in 2019.

To be sure, softening volume growth in the auto segment may heighten competitive intensity in the replacement market. However, the utilisation levels of tyre makers are in the range of 75-95%, and those levels should offset any margin compression due to competition.

The truck-bus radial (TBR) facility of Apollo Tyres is running at full capacity. Hence, the company is putting up new capacity to cater to domestic demand. Tyre companies are investing about Rs 25,000 crore on greenfield and brownfield capacity in the next three years. But that would not create excess capacity in the system as new capacity addition implies net 8% volume growth in the next three years—in line with the volume growth over the last decade.

Apollo Tyres could be the prime beneficiary of capacity expansion as it derives about three-fifths of its revenue in the medium and heavy commercial vehicle segment, and has a 27% share in the TBR market.