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The threat to profit margins and earnings from higher crude prices

Pallavi Pengonda
pallavi.p@livemint.com

Brent crude oil prices flirting with $80 a barrel cannot be taken lightly. Among other macro worries such as a rising import bill and higher inflation, there is a threat to operating profit margins of companies that use oil, oil-based derivatives or fuel as inputs.

Oil refiners, airlines, paint makers, lubricants manufacturers and firms that make tyres and fast-moving consumer goods (FMCG) are expected to bear the brunt of rising oil prices.

Indian companies should see some adverse impact of rising oil prices for the June quarter, says Ritesh Jain, chief investment officer at BNP Paribas Asset Management India Pvt. Ltd.

"Things should get worse in the September quarter, considering that there is a lag effect in rising prices and the impact on input costs, plus, companies also have some inventory," added Jain.

Of course, the impact on margins will depend on the extent to which companies are able to pass higher costs on to consumers. On this front, some firms are better placed than others, as they enjoy better pricing power.

FMCG companies seem to be in a relatively good position to increase prices. Companies in this sector had cut prices of many products after the introduction of the goods and services tax in July.

The government's vigil on anti-profiteering also meant price hikes were kept in check. This leaves some headroom to increase prices without affecting demand to pass on the impact of rising crude prices. The main impact will be on packaging costs. Some inputs used in the home and personal care segment too will be affected.

Refiners, airlines, paint makers, lubricants manufacturers, FMCG and firms that make tyres are expected to bear the brunt of rising oil prices

For airlines, fuel costs eat into a major portion of revenues and better yields are necessary to compensate for that.

For the March quarter, SpiceJet Ltd saw an increase in yields, whereas IndiGo (run by InterGlobe Aviation Ltd) reported a decline in the measure. Still, earnings before interest, taxes, depreciation and amortization, or Ebitda, for both wasn't enough to cover depreciation and interest costs, indicating that pricing has to improve if these companies have to be more profitable. For aviation firms, if incremental capacity is limited, then the pricing environment is likely to be better.

The paints sector feels the pain too, as inputs used in manufacturing paints comprise monomers and crude oil derivatives, forming about 30-35% of total raw material costs.

State-run refiners and marketers would definitely be better off when they take commensurate increases in petrol and diesel, but as we have seen, that is not always the case when elections are in the offing.

For tyre makers, high demand from steadily rising vehicle sales has helped pass on costs through price hikes, albeit partially.

Higher duties on imported tyres have improved sales of domestic manufacturers.

Therefore, operating leverage benefits along with softening rubber prices should offset rise in price of crude derivatives.

Firms will be able to pass on rising costs initially, says Jain of BNP Paribas, adding, "But after some time, stagflation will set in and it will be challenging to pass on the impact of rising crude oil prices then."

"What this means is that the earnings recovery that everyone is anticipating to take place in FY19 will be pushed further by a few quarters," said Deepak Jasani, head, retail research, HDFC Securities. Of course, much depends on whether crude oil prices remain higher on a consistent basis.

FINANCIAL CHRONICAL N.D 21/5/18

Natural rubber prices set to go northward

Rise in crude oil prices will turn synthetic rubber unattractive

RITWIK MUKHERJEE

SYNTHETIC rubber's loss can be gain for natural rubber. Heading north, crude prices have reached the highest levels since 2014 and are heading towards $80 per barrel. Thus, for tyre makers and other industries that use rubber as raw materials, the attractiveness of synthetic rubber is on the wane. This has helped in boosting prices of natural rubber.

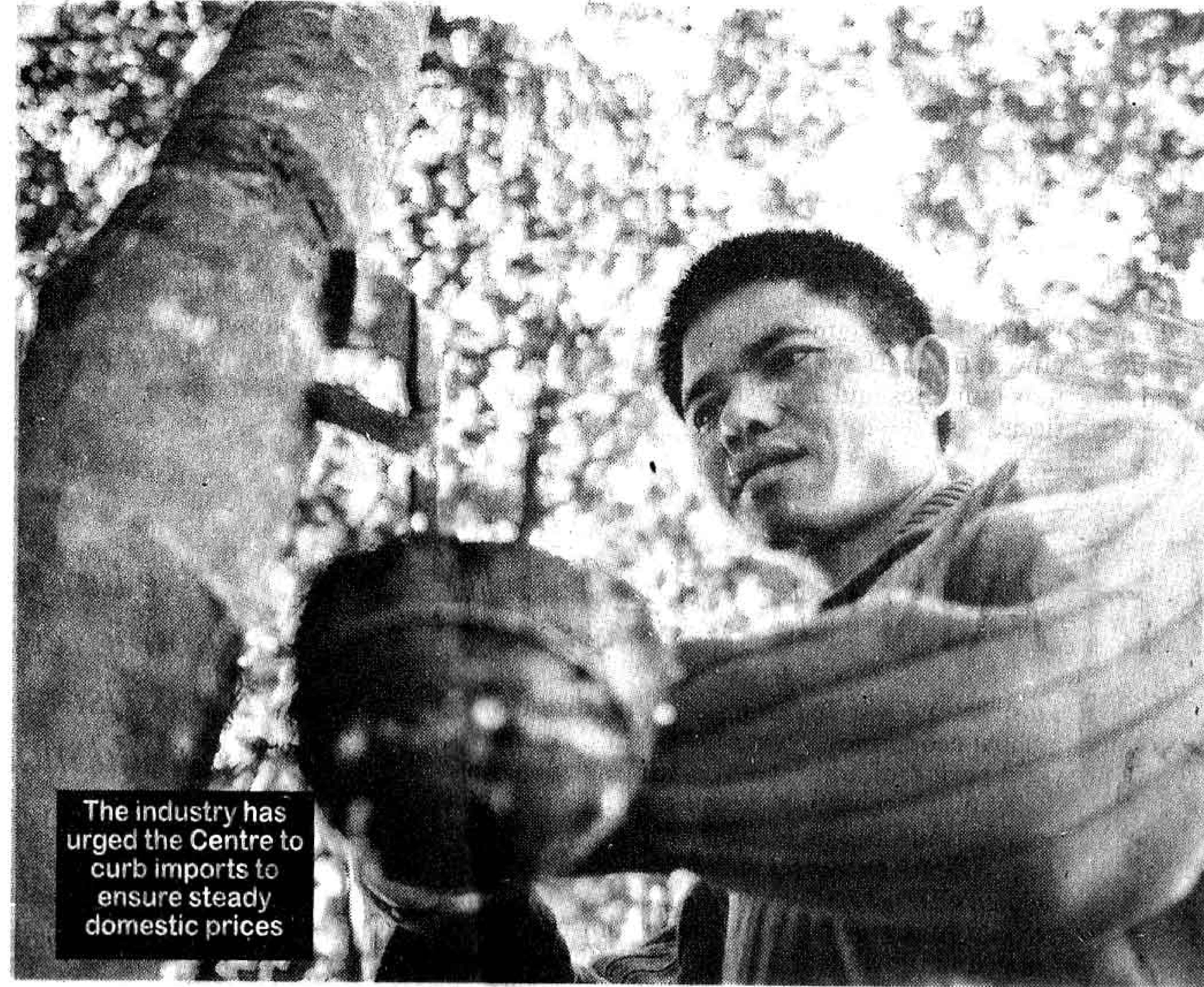
Natural rubber has moved above Rs 120 per kg recently. Earlier in 2011, natural rubber prices in India had reached an all-time high of Rs 243 per kg. It was the time when the crude oil averaged above $100 per barrel.

Since then, natural rubber prices have been on a downward spiral, hitting a low of Rs 95 per kg in 2015. According to the Indian Rubber Institute (IRI), the demand for natural rubber picks up when crude oil prices rise and synthetic rubber rates go up.

Also, the demand from China and currency exchange rates play a crucial role in determining prices. China, the largest consumer of natural rubber, consumes 40 per cent of the total global production. Experts say a drop in the value of rupee against the dollar might also help domestic natural rubber prices to pick up as imports become less attractive. The Indian currency recently reached 15-month low at Rs 67 per dollar.

While in India natural rubber (RSS-4 variety) is being traded at Rs 122 per kg, globally it's hovering around Rs 118 per kg. The global prices are expected to increase following the US withdrawal from the Iran nuclear deal, which is likely to push up crude prices further.

With prices of natural rubber in the global market staying lower than the Indian prices, imports have been on the rise. Also, the demand for natural rubber has been on the rise –consumption has crossed 1 million tones – over the last few years with fairly decent economic growth rate and higher economic activities.



The industry has urged the Centre to curb imports to ensure steady domestic prices

The industry has urged the Centre to put some restrictions on imports to ensure steady domestic prices for the commodity. Bodies like the Indian Farmers Movement (Infam) have also been taking up issues like increasing cost of production leading to undercultivation, manipulation of the rubber market by utility industries and lack of policies to sustain prices. Infam has also demanded that imported rubber be put under strict quality inspection, possibly under the supervision of the Rubber Board of India, to check plant diseases.

Experts also point to some other factors that which may push up NR prices. For instance, with the global GDP growing at 3.8 per cent, it is expected that the international demand for natural rubber would pick up further and raise prices. Also, efforts of the east Asian countries (Thailand, Indonesia and Malaysia) to limit exports (initiated earlier this year) can further boost the global prices.

ritwikmukherjee
@mydigitalfc.com

BUSINESS LINE N.D 21/5/18

Apollo Tyres

Taking a turn for the better

The company's good run is expected to continue, thanks to better sales and cheaper rubber

PARVATHA VARDHINI C

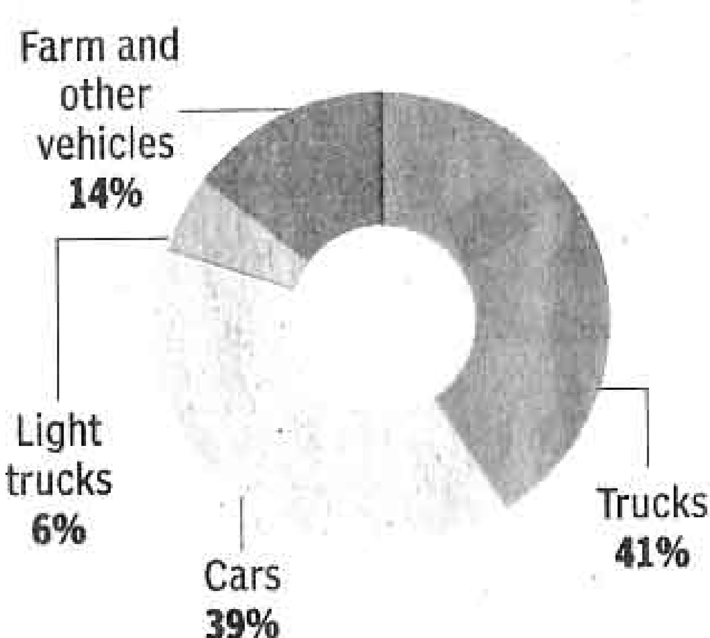
While prices of most commodities have been heating up, natural rubber prices have seen a slide in the last one year. Domestic natural rubber prices of the RSS-4 variety now hover around ₹120 a kg, down from the ₹140 levels seen a year ago. Besides, domestic automobile sales have also seen a strong rebound in the last few months after hiccups due to the BS-IV/GST transition a year ago.

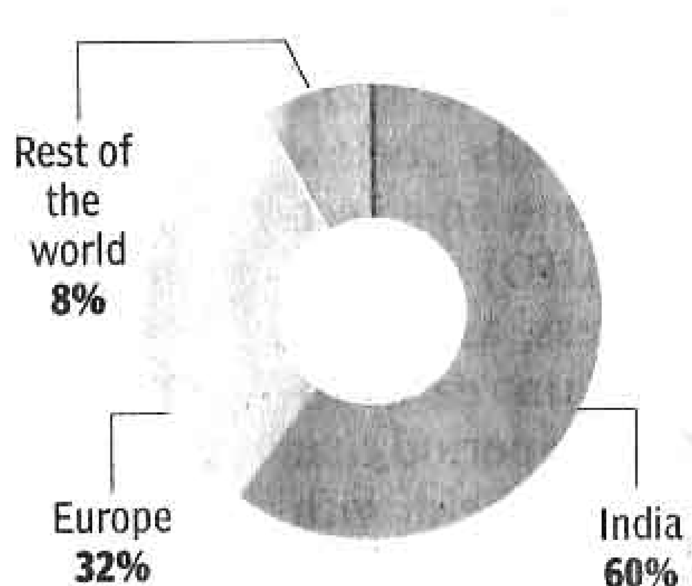
Both these factors favour tyre manufacturers, among which Apollo Tyres appears well-placed to cash in on the opportunity. The company's performance has taken a turn for the better in the quarter ended March 2018, thanks to improving sales and cheaper rubber. Earlier, the slowdown in the European markets and high depreciation and interest costs due to ongoing capacity expansions, both in India and abroad, had weighed on the company's earnings in the first three quarters of 2017-18.

The stock is also attractive because it trades at a discount to peers such as MRF and Balkrishna Industries. At the current price, the valuation multiple is at about 22 times its trailing 12-month consolidated earnings, in comparison with peers which trade at 29-31 times.

Key positives

Apollo Tyres derives 60 per cent of its consolidated revenues from the India business. The company has about 25 per cent





ded volume growth (year-on-year) of 12 per cent and 25 per cent respectively. The good run is expected to continue into this year as well, with a revival in economic activity.

Besides, the Government is also expected to come up with a scrappage scheme for old commercial vehicles, which will boost new vehicle sales further. Other tailwinds for trucks and buses include the improving radialisation levels for truck and bus tyres and the abating of Chinese imports.

With radialisation levels in truck and bus tyres moving up to 45-50 per cent, the company is on a strong wicket. It counts leading commercial manufacturers such as Tata Motors, Ashok Leyland and Volvo-Eicher, among its clients, and has a 21 per cent market share in truck-bus radials alone. It is ramping up its capacity for truck and bus radials at Oragadam, Chennai. From an average of 8,000 tyres per day in 2017-18, the production has moved up to 10,000 per day and will go up to 12,000 tyres per day this fiscal. The threat of Chinese imports for truck and bus tyres has fallen after the imposition of anti-dumping duty in September 2017.

On the passenger vehicles side, the company is in the process of expanding its capacity for car radials, for which there have been capacity constraints.

A greenfield plant is being set up for car radials at Chittoor in Andhra Pradesh. This plant is expected to commence operations in 2020. In the interim, Apollo caters to the demand for car radials through de-bottlenecking at the existing facility in Oragadam.

Europe looking up

The company supplies Apollo and Vredestein brand tyres to the passenger car replacement market in Europe. A slowdown in demand in the continent affected Apollo in the first nine months of 2017-18. Besides, the start-up costs for the Hungary plant inaugurated in April 2017, affected the company's bottom-line in the first three quarters, where it reported a dip in profits *vis-à-vis* the previous year.

But things are taking a turn for the better. According to the company, the European market is on track to recovery with revival in major markets such as Germany. This apart, the company expects increasing private consumption, improving labour market and growing disposable incomes to aid further recovery in the European markets.

Besides, to increase its presence, the company is beginning to cater to auto makers directly in Europe. It has signed up with Ford and SEAT. Finally, the Hungary plant inaugurated a year ago has ramped up its capacity and achieved break-even towards the end of the March quarter. This plant will supply to the replacement markets and then to auto manufacturers.

Financials

For the quarter ended March 2018, consolidated sales moved up by 22 per cent to ₹3,982.43 crore. Thanks to benign rubber prices and a pick-up in demand both in India and in Europe, consolidated operating margins came in at 12. 9 per cent *vis-à-vis* 11.35 per cent a year ago.

But consolidated profits grew only by about 10 per cent to ₹250.11 crore due to high interest and depreciation costs. Profit growth will get a boost in the coming quarters as the Hungary plant begins making profits.

While natural rubber prices are not expected to shoot up sharply, what could pressurise operating margins is the inching up of the prices of crude oil-based inputs such as synthetic rubber and carbon black.

But given that tyre makers usually have higher pricing power in the replacement market, the company can pass on the increase to customers to protect its margins.

As commercial vehicles rapidly adopt radial tyres, bettering product mix from higher share of radial tyres will also improve profitability.

Why

- Pick-up in demand
- Benign input prices
- Attractive valuation

Did you know?

Apollo Tyres has been in the business of making and selling tyres since 1972