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Tyre producers to gain when replacement demand and lower input costs kick in

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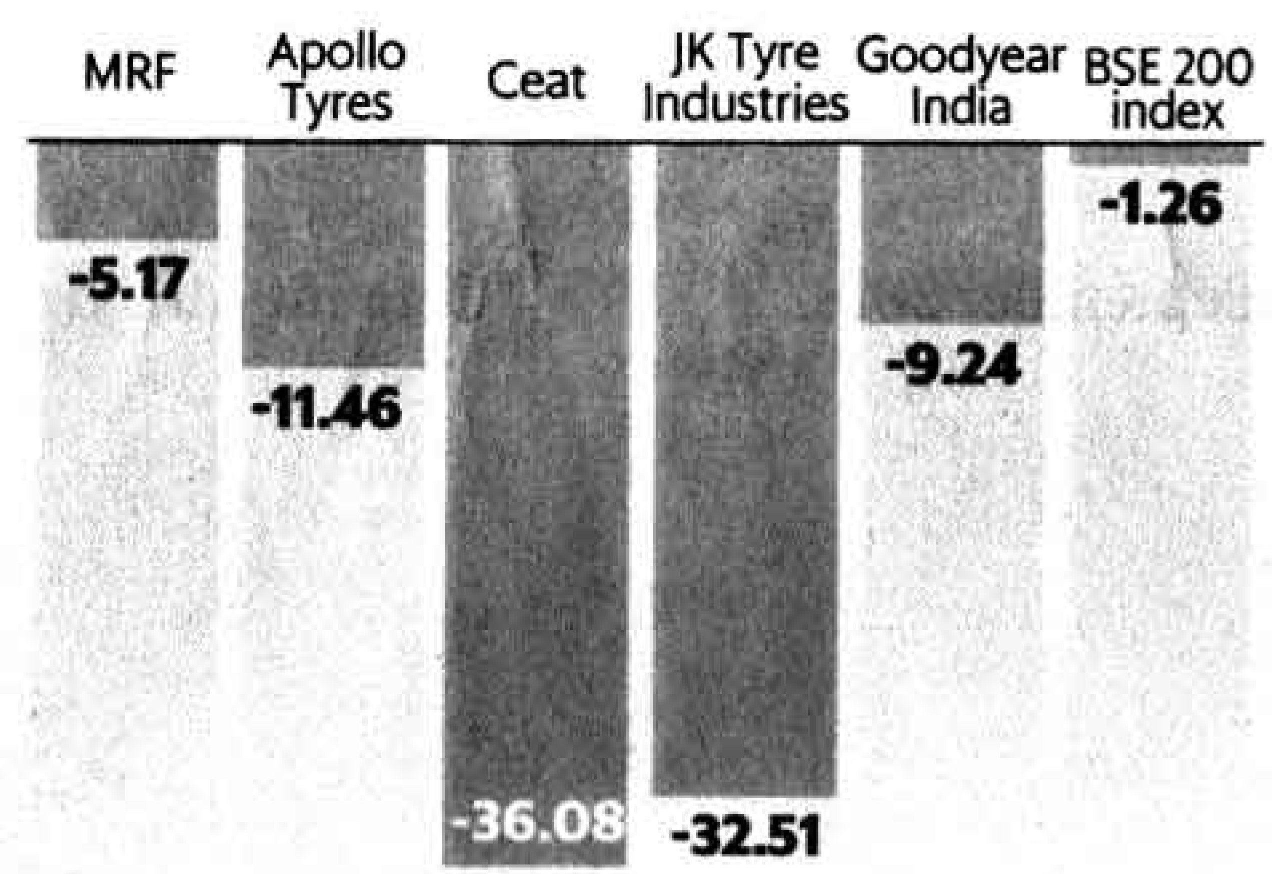
Free fall

With a steep fall in tyre stocks, values are now more attractive as fundamentals look brighter for tyre firms.

Year-to-date change (in %)



Source: BSE

The road ahead appears to promise a smoother ride for tyre companies, after having steered through rough terrain for some time.

While the recent softness in passenger automobile sales is a bother, the high growth rates in the past two years are a harbinger of better times for tyre makers. Car owners will get to a point where they need to replace tyres, triggering a boom in the replacement market.

This is good news as realizations on replacement market sales are higher than that on direct sales to vehicle original equipment manufacturers. Further, the recent scorching pace of growth in commercial vehicle sales implies a more favourable revenue mix for tyre manufacturers. Companies such as Apollo Tyres Ltd, Ceat Ltd and JK Tyre Industries Ltd will benefit as they have a significant contribution from truck tyres in their revenue. In fact, two-thirds of Apollo Tyres' revenue accrues from the replacement market.

Jefferies India Pvt. Ltd estimates in a report that revenue growth for the tyre sector will accelerate to 8.9% during FY18-21 compared to 7.6% in FY16-18.

Meanwhile, the recent trend of falling crude oil and rubber prices bodes well. Note that rubber and crude oil prices, which comprise nearly three-fourths of the cost of making a tyre, have retraced by 13% and 36%, respectively, over the last 45-60 days. This has fired up tyre stocks in the last few trading sessions.

Since FY16, tyre stocks have lost ground despite growth in revenue as soaring rubber prices affected the operating performance and margins of the companies. Later, surging crude oil prices also added to the woes. Till date in this calendar year, shares of Apollo Tyres, JK Tyres and Ceat are lower by 11%, 33% and 36%, respectively.

Jefferies says share prices of Indian tyre companies (Apollo Tyres and Ceat) have languished this year, hemmed in by consistent earnings downgrades. "We see this turning now, as margins expand from current lows helped by lower RM prices, improved mix and scale benefits as volumes & revenue ramp up amid robust replacement demand," it adds.

But it will take a few quarters for the dual gains of higher revenue and lower costs to tango and trickle to profits. Apollo Tyres says, "Due to increase in crude prices, overall raw material cost went up by 5% in the September quarter when compared to June. A similar impact is likely in the current quarter too. The effect of softer raw material prices is expected from the last quarter of FY19, if things continue in this direction."

Of course, the magnitude of profitability gains accruing to a company will depend on its revenue mix and management strategy to combat volatility in commodity prices. Fortunately, rising sales expected in replacement markets and better capacity utilization levels will support pricing power of tyre producers, and will support their performance in this period of volatile input costs.