

Falling rubber prices to boost Apollo Tyres' margins

Focus on radialisation and capacity expansion will help drive volumes at a time when demand is slowing

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Apollo Tyres' stock has gained six per cent in the last one week resulting in a monthly gain of over 16 per cent as the company delivered better-than-expected performance in the June 2012 quarter (on August 9) despite macroeconomic pressures. Notably, falling natural rubber prices, which led to significant improvement in operating profit margin, points to improved outlook for the company. Says Surjit Arora, analyst, Prabhudas Lilladher, in a post-result note dated August 10, "With natural rubber prices remaining stable, cost pressures have eased, leading to better margin outlook for tyre companies." Most analysts predict Indian rubber prices to fall further as internationally the same have corrected by 30 per cent in the last three months. On the flip side, the depreciation of the rupee is a concern and is expected to negate part of the gains. Also, the management has revised its topline growth estimates downwards due to slowdown in domestic market, but remains optimistic about replacement demand and margins. The other risk pertains to how competition reacts; if companies cut prices to gain market share, the gains could get diluted.



IMPROVING PROFITABILITY

In ₹ crore	FY12	FY13E	FY14E
Net sales	12,153	13,379	14,224
% change y-o-y	37.0	10.1	6.3
Operating profit	1,166	1,447	1,646
% change y-o-y	19.2	24.1	13.8
OPM (%)	9.6	10.8	11.6
Net profit	439	578	696
% change y-o-y	-0.1	31.5	20.4
EPS (₹)	8.7	11.5	13.8
P/E (x)	10.8	8.2	6.8

Consolidated financials Source: Company, analyst reports

On the whole, despite demand pressures and currency risk, investors can still take exposure in the stock as valuation at seven times FY14 estimated earnings is attractive and concerns are short-term. Analysts expect the company to gain once the economic cycle picks up and demand revives; Apollo's capacity expansion in Chennai will also help drive volumes.

Demand under pressure

Apollo's topline growth fell drastically from 37 per cent in FY12 to 12 per cent year-on-year (y-o-y) in the June 2012 quarter. Growth in revenues was mainly led by price hikes.

Volume growth was flat y-o-y as demand in the OEM (original equipment manufacturers) segment as well as replacement market remained sluggish. The company is a market leader in the commercial vehicles (CV) segment, which forms 55 per cent of industry revenues and has borne the brunt of the economic slowdown. Steep price hikes in FY12 further affected demand.

The outlook continues to be cautious though there is hope of demand from the Indian replacement market. Says S Arun, analyst, Bank of America Merrill Lynch, in a report dated August 9, "In the current envi-

ronment, OEM sales will stay weak but replacement demand is expected to improve for CVs."

Meanwhile, the scenario for Apollo's European operations (20-23 per cent of total sales) though, is unlikely to improve significantly. The South African segment's growth is likely to be driven mainly by previous price hikes. Overall, consolidated revenue growth is expected to be 10 per cent in FY13 as compared to higher double-digit in recent years.

Falling rubber prices a boon

Rubber forms 65 per cent of total raw material costs and

RACING AHEAD



UNDER PRESSURE



14. Indian prices have historically remained at a premium of an average eight per cent to international prices, but they currently stand at 31 per cent (premium), which is not sustainable, he adds.

This augurs well for operating profit margin, especially for Apollo, as its product mix is largely skewed towards CVs. The only sty in the eye is the rupee depreciation, which can spoil the show (read negate the benefit) as Apollo imports half of its total raw materials (rubber and nylon tyre cord fabric) for its India operations.

Capacity expansion, increasing radialisation to drive growth

After expanding capacity in Europe and South Africa, the company's ninth facility at Chennai (expected to be fully operational by FY13-end) will increase overall capacity by 30 per cent to 2,095 tonnes per day. This, in turn, will improve the company's financial performance in terms of stronger sales growth, higher cash flows and further reduction in debt. Besides, it will also help meet the growing requirements of radial tyres, especially for commercial vehicles, and improve penetration, which is currently at low levels.

In short, the company has geared itself not only in terms of revival in demand, but also for a structural shift in tyre consumption to radials.

natural rubber accounts for 60 per cent of total rubber cost (about 40 per cent of revenues). Average natural rubber price for Apollo in the June quarter was ₹210 per kg compared to ₹245 per kg in the year-ago period. Both, domestic and international prices have come off from peak levels. International rubber prices have declined 30 per cent since beginning of May 2012 in rupee terms and Indian prices are likely to follow since it happens with a lag.

"Futures contracts suggest weak prices are likely to sustain," says Jaibir Sethi, analyst, CLSA in a report dated August