Automobiles

> "Falling rubber prices in India is a reflection of what is happening in the global market. Rising inflation and the possibility of a global recession have increased regulatory pressures like interest rate hikes. This has killed demand and quenched prices"
> **Mr. Ashish Pandey, VP (Materials), JKI**

> "China announced additional lockdowns as COVID-19 cases remain at elevated levels. The continuing lockdowns in its major cities and economic hubs imply that the Chinese will need a longer time to return to a normal growth track. As China represents 42% of global demand, the developments in China are crucial to the global demand prospects of natural rubber. Soaring energy prices in Europe, and abnormal jumps anticipated during the winter, can have major negative implications for the demand outlook for NR for the region"
> **Mr. Jom Jacob, Chief Analyst and Co-Founder, WhatNext Rubber Media**

Tyres: Steep fall in RM cost to drive a margin recovery

Improving utilization and margin to drive expansion in RoCE

After witnessing hyper-inflation in its key input cost over the last 15-18 months, the Tyre industry is seeing a moderation in natural rubber as well as crude prices (with a lag in synthetic rubber and carbon black prices). This augurs well for a margin recovery from 2HFY23. Coupled with asset sweating and controlled capex, it will drive an improvement in FCF, financial gearing, and RoCE. APTY is our preferred play on Tyres as it offers the best blend of earnings growth and cheap valuations.

A sharp correction in natural rubber and crude prices…

- Key input prices have seen an incessant increase (over 50%) since 1HFY21, with the average RM basket costing ~INR180/kg, resulting in an over 10pp fall in gross margin.
- Natural rubber prices appear to have peaked-out in mid-Jun'22. Spot prices for natural rubber (Thailand spot/RSS4 Kottayam) fell 34%/12.5% from its 1QFY23 average.
- Synthetic rubber and carbon black prices are 6-7% higher over its 1QFY23 average – a reflection of the delayed impact of crude oil price inflation in 1HCY22. Since underlying crude oil prices has corrected by 22% from its 1QFY23 average, it should reflect with a lag in both synthetic rubber and carbon black prices.

…to drive a sharp margin recovery from 3QFY23 and EPS upgrades

- We expect margin to recover from 2HFY23, with a softening in underlying RM prices.
- As per our estimates, for every 10% change in natural rubber/synthetic rubber/ carbon black prices (over its FY22 average), EBITDA margin will change by 160bp/80bp/100bp.
- We are building in a margin expansion from 3QFY23, with the full benefit seen in FY24. On a FY22 base, we expect blended gross margin to expand by ~190bp in FY24 (+300bp over FY23E).
- Our gross margin estimate implies a mean reversion to ~36.8% (its 10-year average) by FY25.
- Consensus estimates factor in a blended gross margin expansion of just 10bp in FY24 over FY22, implying the possibility of a sharp upgrades in our estimates.

Demand momentum needs to get more broad-based

- While demand from OEMs improve across categories, replacement demand has been a mixed bag. Replacement demand is holding-up well for the PCR and 2W segment. However, replacement demand is relatively weak for Truck and Bus (T&B) and Tractors.
- Our interactions with the industry participants suggest that T&B demand should see a recovery from 3QFY23 onwards as the noise around inflation tapers off.

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- Export demand, which was seeing a strong momentum for the last few quarters, has turned sluggish since 1QFY23 due to several disruptions seen in global markets. This is particularly relevant for exports to Europe as it is impacting demand across segments (OTR, TBR, and PCR).

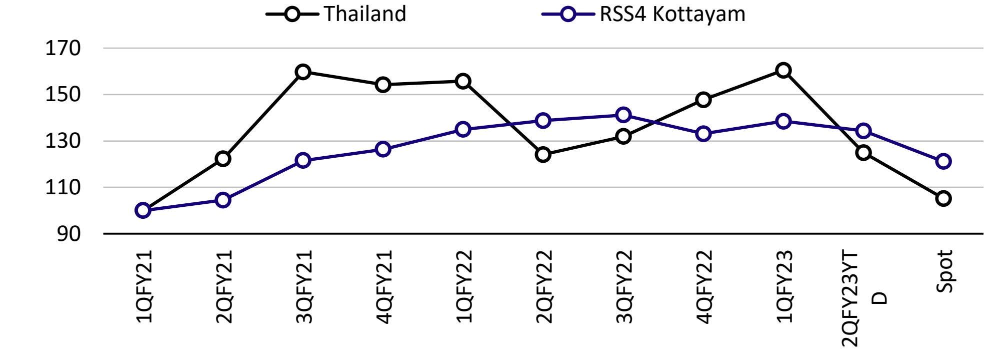
Focus on asset sweating and controlling capex

- Since the breakout of geopolitical issues and tightening of interest rates, Tyre makers are largely focused on sweating assets and controlling capex. This is reflected in capacity utilization of 80-90% across players in 1QFY23.
- Currently, there are no major ongoing greenfield or brownfield expansions at mainstream Tyre companies, whereas debottlenecking is the preferred mode to expand capacity to meet demand over the next one-to-two years.
- Aggregate absolute capex for the four listed mainstream players (APTY, CEAT, JKI, and MRF) is expected to remain stable at FY22 levels and lower than FY19 and FY20 levels. As a percentage of sales, capex is expected to reduce from an average of ~10% over FY19-22 to sub-6.5% over FY23E and FY24E.
- Given the combination of improving margin, utilization, and controlled capex, RoCE for mainstream Tyre players is expected to more than double over FY22 to ~11% (v/s an average of sub-9% over the last five years).

Valuations and view

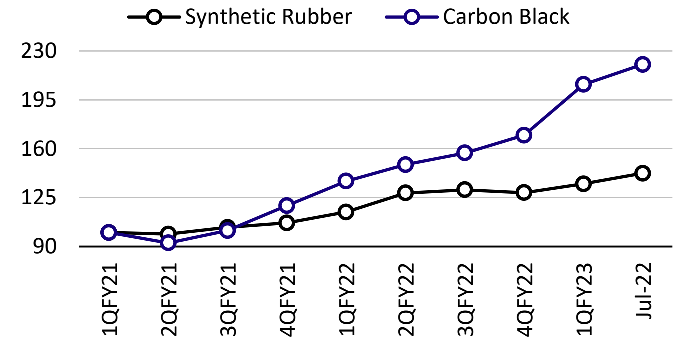
- We have upgraded our FY24E EPS for APTY (+4%), CEAT (+12%), and MRF (+3.5%) to partly reflect for the correction in RM costs.
- After two-years of deep pain in a hyper-inflationary environment, we see these headwinds abating, thus driving a margin recovery from 2HFY23 and an earnings upgrade.
- We expect a sharp improvement in FCF generation, reduction in financial gearing, and an improvement in RoCE.
- **APTY** offers the best blend of earnings growth and cheap valuations v/s its peers. The stock trades at 17.4x/11.7x FY23E/FY24E consolidated EPS. We maintain our Buy rating with a TP of INR325 (~12x Sep'24E consolidated EPS).
- **CEAT:** Deferment of TBR capacity will ease pressure on its P&L and Balance Sheet. Valuations, at 40.6x/13.1x FY23E/FY24E consolidated EPS, do not fully capture the ramp-up in new capacities and stabilization in RM cost. We maintain our **Buy** rating with a TP of INR1,630 (based on ~13x Sep'24E EPS).
- **MRF:** Dilution in its competitive positioning, particularly in the T&B and PCR segment, is resulting in a substantial narrowing of the gap in profitability with peers. Current valuations at 46.2x/23.1x FY23E/FY24E EPS fairly capture the changing competitive dynamics for MRF. We maintain our Neutral rating with a TP of INR82,000 (~20x Sep'24E EPS).
- **BIL:** We expect BIL's outperformance in the Specialty Tyre industry to continue, driven by expansion of its product portfolio and ramp-up in the OTR segment. Near-term headwinds notwithstanding, valuations at 26.1x/20.3x FY23E/FY24E EPS fairly reflect its industry-leading margin, FCF, and capital efficiencies. We maintain our Neutral rating with a TP of INR2,300 (22x Sep'24E EPS).

Exhibit 1: Trend in spot natural rubber prices (indexed)

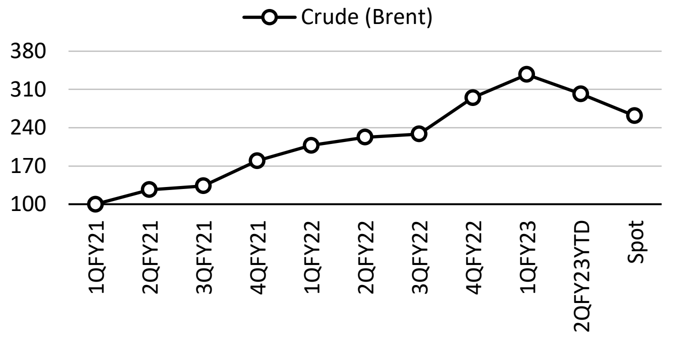


Source: Bloomberg, MOFSL

Exhibit 2: Crude-based inputs are yet to see a correction, though crude prices have corrected (indexed)

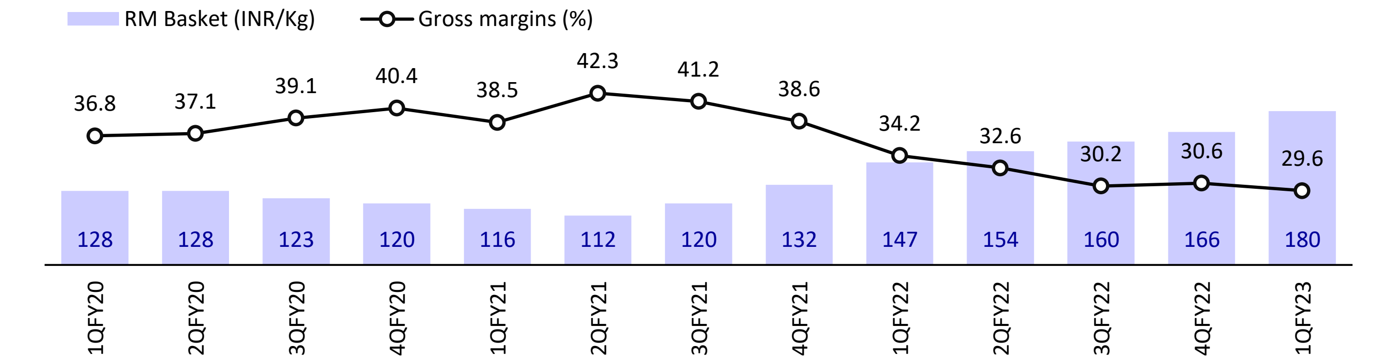


Source: Bloomberg, MOFSL



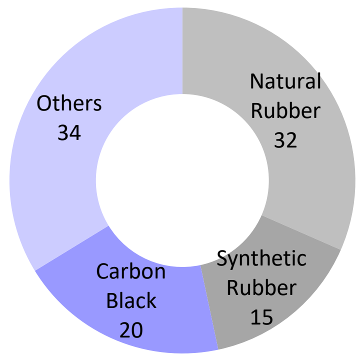
Source: Bloomberg, MOFSL

Exhibit 3: The RM basket of Tyre companies rises by ~50% from their FY21 average, resulting in an over 10pp fall in GM



Source: APTY; MOFSL

Exhibit 4: RM basket for its India operations as a percentage of RM cost



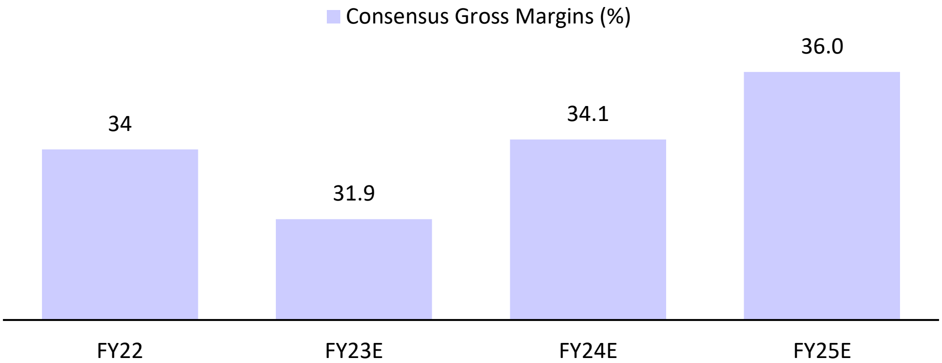
Source: Industry, MOFSL

Exhibit 5: Sensitivity of EBITDA margin to commodity prices

	As a percentage of sales	Sensitivity to a 10% change (bp)
Natural rubber	21	160
Synthetic rubber	10	80
Carbon Black	13	100
Others	23	170

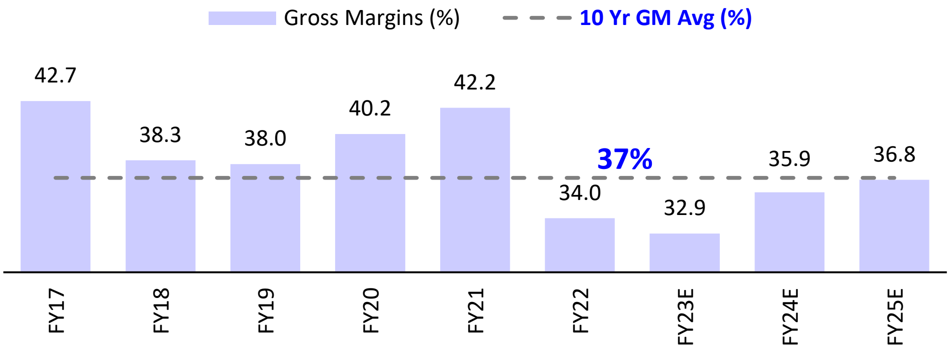
Note: Assuming impact on non-OEM revenue only; Source: Bloomberg, MOFSL

Exhibit 6: Consensus is factoring in moderate savings in FY24



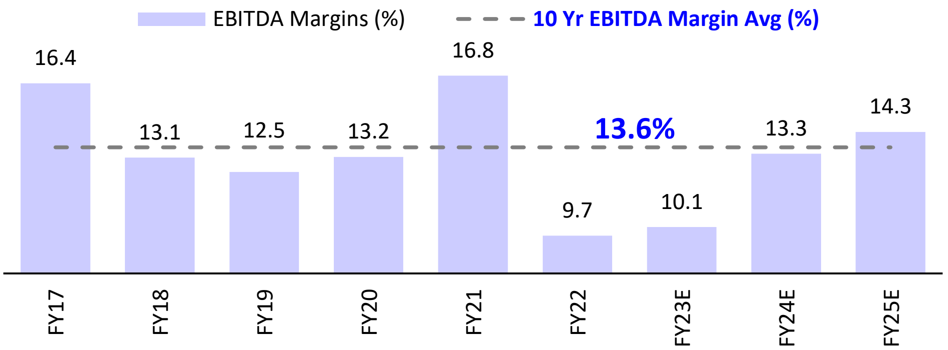
Source: VisibleAlpha, MOFSL

Exhibit 7: Our estimates build in a mean reversion in gross margin only by FY25…



Source: MOFSL

Exhibit 8: Higher utilization will drive EBITDA margin above its 10-year average by FY25E



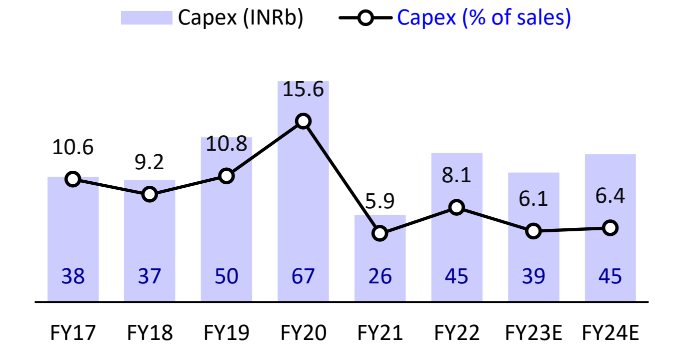
Source: MOFSL

Exhibit 9: Our FY24 EPS estimate for APTY/CEAT are higher by 14%/12%

	FY23E EPS			FY24E EPS		
	MOFSL	Bloomberg consensus	Var. (%)	MOFSL	Bloomberg consensus	Var. (%)
Apollo Tyres	16.1	14.0	14.8	23.8	20.9	14.0
Ceat	34.4	45.1	-23.8	106.4	94.9	12.1
MRF	1,851.2	200	-11.8	3,701	3626.7	2.0

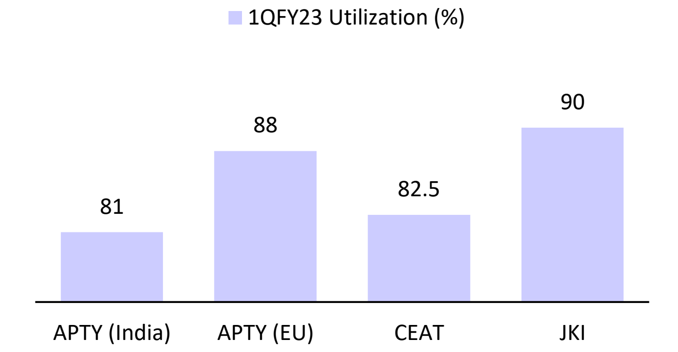
Source: Bloomberg, MOFSL

Exhibit 10: Expect capex to remain under control…



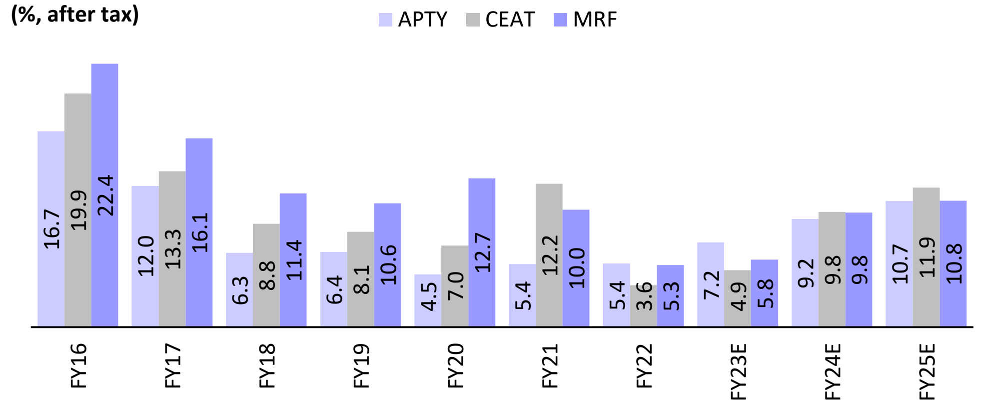
Blended for APTY, CEAT, JKI, and MRF; Source: MOFSL

Exhibit 11: …as the focus is on debottlenecking and asset sweating for meeting growth over the next 12-24 months



Source: Company, MOFSL

Exhibit 12: Expect RoCE for all mainstream Tyre makers to be in the 11-12% range



Source: MOFSL

Exhibit 13: APTY's valuations (one-year forward) are near its historical average, other Tyre makers are trading at a premium

Company	Current	10-year P/E ratio (x)					Current	10-year P/B ratio (x)					Five-year average	
	P/E (x)	Avg. P/E (x)	Max. P/E (x)	Min. P/E (x)	+1SD P/E (x)	-1SD P/E (x)	P/B ratio (x)	Avg. P/B (x)	Max. P/B (x)	Min. P/B (x)	+1SD P/B (x)	-1SD P/B (x)	P/E (x)	P/B (x)
Apollo Tyres	14	13.1	26.6	3.2	18.7	7.6	1.2	1.2	2.2	0.4	1.6	0.9	16.7	1.1
Balkrishna Ind.	22.9	16.9	33.1	4.2	24.9	8.8	4.5	3.3	6.6	1.0	4.7	1.8	23.0	4.4
Ceat	21.9	17.1	79.6	0.8	32.3	1.9	1.6	1.5	2.9	0.3	2.1	0.9	25.6	1.6
MRF	31.4	20.3	52.1	6.0	33.1	7.4	2.3	2.1	3.1	1.3	2.5	1.7	29.8	2.3

Source: MOFSL

Exhibit 14: Revisions to our estimates (INR)

	FY23E			FY24E		
	Revised	Old	Change (%)	Revised	Old	Change (%)
Apollo Tyres	16.1	16.2	-0.9	23.8	22.9	4.0
Ceat	34.4	34.4	0.0	106.4	94.8	12.2
MRF	1,851.2	1,851.2	0.0	3,701.0	3,574.6	3.5

Source: MOFSL

Exhibit 15: Key operating parameters

	Revenue growth (%)				EBITDA margin (%)				EPS (INR)				RoE (%)			
Auto OEMs	FY22	FY23E	FY24E	FY25E	FY22	FY23E	FY24E	FY25E	FY22	FY23E	FY24E	FY25E	FY22	FY23E	FY24E	FY25E
Apollo Tyres	21.2	16.3	7.8	6.6	12.3	12.8	14.6	15.6	11.2	16.1	23.8	30.7	5.5	7.6	10.5	12.3
Ceat	23.0	17.4	10.2	8.8	7.6	7.6	10.8	11.8	19.6	34.4	106.4	145.2	2.4	4.2	12.1	14.6
MRF	19.5	14.6	9.0	6.2	10.6	10.8	14.6	15.5	1,578.4	1,851.2	3,701.0	4,503.9	4.9	5.5	10.1	11.1
Balkrishna Ind.	46.5	27.4	10.3	7.7	25.6	21.7	25.3	26.6	76.6	76.6	98.4	112.0	22.9	19.9	22.1	21.7

Source: MOFSL

Exhibit 16: Comparative valuations

	Rating	Mcap	CMP	TP	P/E (x)			EV/EBITDA (x)			PB (x)			FY24 Yield (%)		EPS CAGR (%)
Auto OEM's		(INR b)	(INR)	(INR)	FY22	FY23E	FY24E	FY22	FY23E	FY24E	FY22	FY23E	FY24E	Div	FCF	FY22-24E
CEAT	Buy	56	1,395	1,630	71.1	40.6	13.1	10.9	9.2	5.6	1.7	1.7	1.5	0.9	9.7	132.9
Balkrishna Ind	Neutral	386	1,998	2,300	26.1	26.1	20.3	18.2	16.6	12.7	5.6	4.9	4.2	1.5	2.6	13.3
MRF	Neutral	363	85,525	82,000	54.2	46.2	23.1	17.2	14.6	9.6	2.6	2.5	2.2	0.2	3.5	53.1
Apollo Tyres	Buy	160	279	325	24.9	17.4	11.7	8.7	6.4	4.9	1.4	1.3	1.2	1.6	10.3	45.6

Source: MOFSL

Explanation of Investment Rating	
Investment Rating	**Expected return (over 12-month)**
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SELL	< - 10%
NEUTRAL	< - 10 % to 15%
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