27 September 2023

India | Equity Research | Sector Update

Auto Ancillaries

Automotive tyres: Margins to begin wearing out; re-rating traction limited

India's automotive tyre space gross profit/kg improved from the Q1FY23 lows of ~INR 73 (in line with 10-year mean levels) to reach highs of ~INR 95 in the past couple of quarters (above mean + 1-standard deviation at INR 84). Going by historical trends, the industry has hardly sustained such profitability beyond three consecutive quarters and seen a mean reversion back to below mean + 1-SD levels. Thus, with Brent crude price appreciating ~20% over the past few months and natural rubber prices gaining ~5-7% over recent lows in July, we see mean reversion of GP/kg poised to play out from H2FY24. With replacement demand growth across key segments yet to find some grip, along with immense competitive pressure, we believe it would be tough for players in this space to sustain their elevated gross margin levels beyond Q2FY24.

Two quarters of elevated gross margin; couple more at best

Led by decline in RMB amidst limited price cuts in the replacement market over the past three quarters, GP/kg for the space has moved up above the 1-S.D. mark above the long-term mean levels, after operating at long-term mean levels from mid-FY22 to mid-FY23. Trend analysis suggests that GP/kg for the industry has hardly ever sustained for more than 2–3 quarters at 1-S.D. above mean levels. Post-consumption of the low-cost inventory, GP/kg is set to revert H2FY24 onwards, from current highs given crude oil's ~20%-plus appreciation since July's lows and natural rubber too gaining ~5–7% from its July's lows. Additionally, we believe, the industry will find it hard to remain margin-neutral in a rising RMB environment given the backdrop of elusive demand in the replacement market coupled with elevated competitive intensity.

Volume growth inertia insufficient to protect EBITDAM

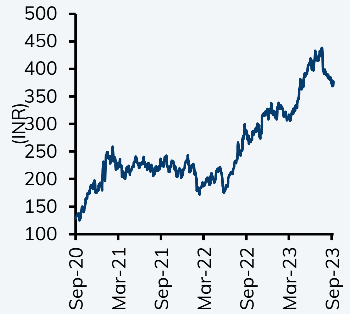
With key OEM segments of M&HCV/PV/2W expected to grow at a CAGR of ~7–8% in FY23–25E, we do not expect operating leverage to support EBITDAM for the space. Also from a pricing perspective, industry has hardly reduced replacement market pricing in the past three quarters, amidst slipping RMB costing. With that background, it would be tough to hike prices to maintain margins, that too with rising competitive intensity in the space.

Downgrade APTY to HOLD; maintain SELL on CEAT

Both APTY and CEAT dished out returns to the tune of ~37% in trailing 12 months on the back of rising profitability, driving better cash flow visibility and in turn improving valuation multiples. We believe for the tyre space, it is a classic case of market prorating the present elevated margin on a forward-basis and give up-cycle valuation multiples on that inflated earnings. At this juncture we are observing street is yet to take note of the potential mean reversion in profitability downwards, but when it does, cuts in forward earnings estimates and valuation multiples are imminent. Thus, on the back of recent inflation in RMB cost (~20% crude oil price increase), for both APTY and CEAT, we are cutting FY25E EBITDAM by ~100bps, resulting in ~12% cut in earnings. We are cutting APTY's DCF-based price target by 10% to INR 381 (implying ~16x FY25E earnings) and downgrading it to HOLD from ADD. For CEAT, we have reduced the DCF based price target by 5% at INR 1,580 (implying ~15x FY25E earnings) – maintain SELL.

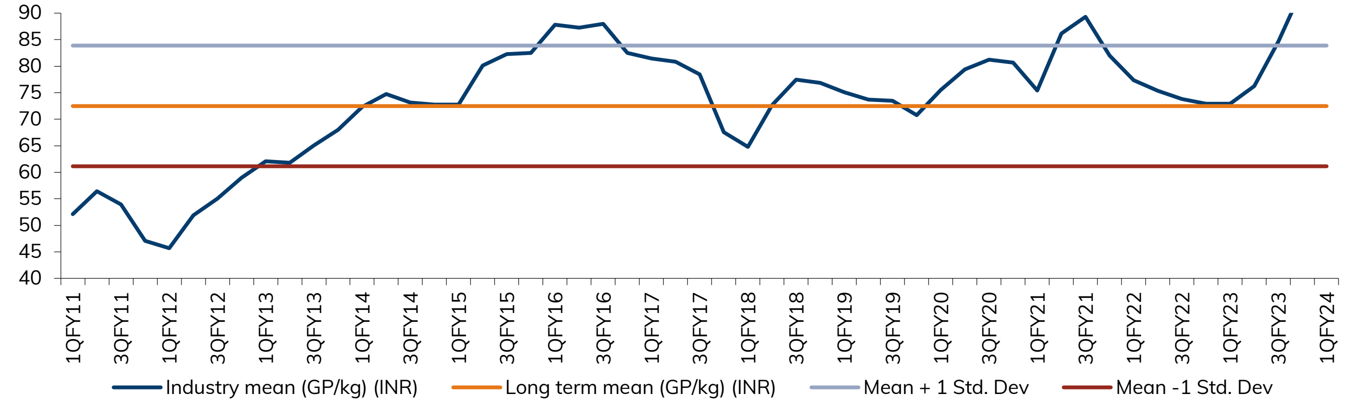
Basudeb Banerjee
basudeb.banerjee@icicisecurities.com
+91 22 6807 7260
Vishakha Maliwal
vishakha.maliwal@icicisecurities.com

Apollo Tyres



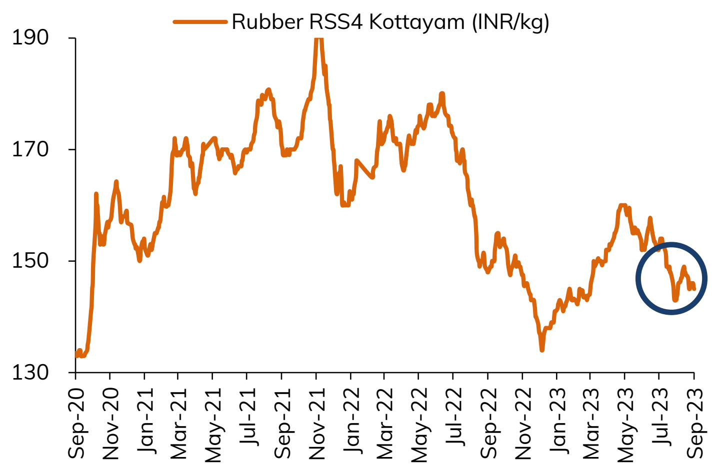
CEAT

Exhibit 1: Tough to see India automotive tyre space operating more than 3-4 quarters ahead of 1-SD above mean gross GP/kg; recent Brent crude rise would be the perfect trigger for reduction in GP/kg from H2FY24



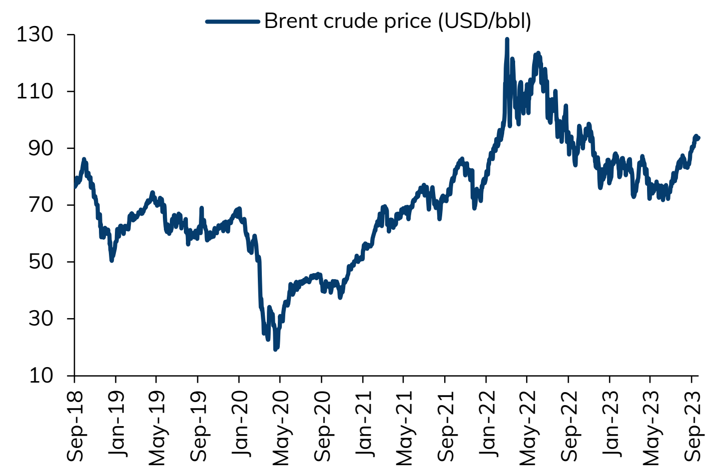
Source: I-Sec research, Bloomberg, Company data

Exhibit 2: Natural rubber began inching up since July



Source: Bloomberg, I-Sec research

Exhibit 3: Brent crude also up ~20%+ from recent lows



Source: Bloomberg, I-Sec research

Exhibit 4: Revision in estimates for APTY

	FY24E			FY25E		
	Old	Revised	% change	Old	Revised	% change
Revenue (INR mn)	2,51,817	2,55,261	1%	2,66,935	2,69,227	1%
EBITDA (INR mn)	39,927	38,761	-3%	39,625	36,947	-7%
EBITDA margin (%)	15.9%	15.2%	(67)bps	14.8%	13.7%	(112)bps
PAT (INR mn)	16,514	15,639	-5%	17,399	15,391	-12%
EPS (INR)	26.0	24.6	-5%	27.4	24.2	-12%

Source: I-Sec research, Company data

Exhibit 5: Revision in estimates for CEAT

	FY24E			FY25E		
	Old	Revised	% change	Old	Revised	% change
Revenue (INR mn)	1,23,376	1,22,427	-1%	1,30,683	1,32,221	1%
EBITDA (INR mn)	15,792	15,591	-1%	14,678	13,895	-5%
EBITDA margin (%)	12.8%	12.7%	(7)bps	11.2%	10.5%	(72)bps
PAT (INR mn)	5,737	5,588	-3%	4,866	4,287	-12%
EPS (INR)	141.8	138.1	-3%	120.3	106.0	-12%

Source: I-Sec research, Company data

Key risks

- More than 5% reduction in RMB for tyre makers
- Controlled capex sustaining beyond FY25
- Pricing power of the industry improving, especially in the TBR space

"In case of industry/sector reports or a report containing multiple stocks, the rating/recommendation for a particular stock may be based on the last released stock specific report for that company."

This report may be distributed in Singapore by ICICI Securities, Inc. (Singapore branch). Any recipients of this report in Singapore should contact ICICI Securities, Inc. (Singapore branch) in respect of any matters arising from, or in connection with, this report. The contact details of ICICI Securities, Inc. (Singapore branch) are as follows: Address: 10 Collyer Quay, #40-92 Ocean Financial Tower, Singapore - 049315, Tel: +65 6232 2451 and email: navneet_babbar@icicisecuritiesinc.com, Rishi_agrawal@icicisecuritiesinc.com.

"In case of eligible investors based in Japan, charges for brokerage services on execution of transactions do not in substance constitute charge for research reports and no charges are levied for providing research reports to such investors."

New I-Sec investment ratings (all ratings based on absolute return; All ratings and target price refers to 12-month performance horizon, unless mentioned otherwise)
BUY: >15% return; ADD: 5% to 15% return; HOLD: Negative 5% to Positive 5% return; REDUCE: Negative 5% to Negative 15% return; SELL: < negative 15% return

ANALYST CERTIFICATION
I/We, Basudeb Banerjee, MBA (Finance); Vishakha Maliwal, MBA (Finance); authors and the names subscribed to this report, hereby certify that all of the views expressed in this research report accurately reflect our views about the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report. Analysts are not registered as research analysts by FINRA and are not associated persons of the ICICI Securities Inc. It is also confirmed that above mentioned Analysts of this report have not received any compensation from the companies mentioned in the report in the preceding twelve months and do not serve as an officer, director or employee of the companies mentioned in the report.

Terms & conditions and other disclosures:
ICICI Securities Limited (ICICI Securities) is a full-service, integrated investment banking and is, inter alia, engaged in the business of stock brokering and distribution of financial products. Registered Office Address: ICICI Venture House, Appasaheb Marathe Marg, Prabhadevi, Mumbai - 400 025. CIN: L67120MH1995PLC086241, Tel: (91 22) 6807 7100. ICICI Securities is Sebi registered stock broker, merchant banker, investment adviser, portfolio manager, Research Analyst and Alternative Investment Fund. ICICI Securities is registered with Insurance Regulatory Development Authority of India Limited (IRDAI) as a composite corporate agent and with PFRDA as a Point of Presence. ICICI Securities Limited Research Analyst SEBI Registration Number – INH000000990. ICICI Securities Limited SEBI Registration is INZ000183631 for stock broker. ICICI Securities AIF Trust's SEBI Registration number is IN/AIF3/23-24/1292 ICICI Securities is a subsidiary of ICICI Bank which is India's largest private sector bank and has its various subsidiaries engaged in businesses of housing finance, asset management, life insurance, general insurance, venture capital fund management, etc. ("associates"), the details in respect of which are available on www.icicibank.com.

ICICI Securities is one of the leading merchant bankers/ underwriters of securities and participate in virtually all securities trading markets in India. We and our associates might have investment banking and other business relationship with a significant percentage of companies covered by our Investment Research Department. ICICI Securities and its analysts, persons reporting to analysts and their relatives are generally prohibited from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover.

Recommendation in reports based on technical and derivative analysis centre on studying charts of a stock's price movement, outstanding positions, trading volume etc as opposed to focusing on a company's fundamentals and, as such, may not match with the recommendation in fundamental reports. Investors may visit icicidirect.com to view the Fundamental and Technical Research Reports.

Our proprietary trading and investment businesses may make investment decisions that are inconsistent with the recommendations expressed herein.

ICICI Securities Limited has two independent equity research groups: Institutional Research and Retail Research. This report has been prepared by the Institutional Research. The views and opinions expressed in this document may or may not match or may be contrary with the views, estimates, rating, and target price of the Retail Research.

The information and opinions in this report have been prepared by ICICI Securities and are subject to change without any notice. The report and information contained herein is strictly confidential and meant solely for the selected recipient and may not be altered in any way, transmitted to, copied or distributed, in part or in whole, to any other person or to the media or reproduced in any form, without prior written consent of ICICI Securities. While we would endeavour to update the information herein on a reasonable basis, ICICI Securities is under no obligation to update or keep the information current. Also, there may be regulatory, compliance or other reasons that may prevent ICICI Securities from doing so. Non-rated securities indicate that rating on a particular security has been suspended temporarily and such suspension is in compliance with applicable regulations and/or ICICI Securities policies, in circumstances where ICICI Securities might be acting in an advisory capacity to this company, or in certain other circumstances.

This report is based on information obtained from public sources and sources believed to be reliable, but no independent verification has been made nor is its accuracy or completeness guaranteed. This report and information herein is solely for informational purpose and shall not be used or considered as an offer document or solicitation of offer to buy or sell or subscribe for securities or other financial instruments. Though disseminated to all the customers simultaneously, not all customers may receive this report at the same time. ICICI Securities will not treat recipients as customers by virtue of their receiving this report. Nothing in this report constitutes investment, legal, accounting and tax advice or a representation that any investment or strategy is suitable or appropriate to your specific circumstances. The securities discussed and opinions expressed in this report may not be suitable for all investors, who must make their own investment decisions, based on their own investment objectives, financial positions and needs of specific recipient. This may not be taken in substitution for the exercise of independent judgment by any recipient. The recipient should independently evaluate the investment risks. The value and return on investment may vary because of changes in interest rates, foreign exchange rates or any other reason. ICICI Securities accepts no liabilities whatsoever for any loss or damage of any kind arising out of the use of this report. Past performance is not necessarily a guide to future performance. Investors are advised to see Risk Disclosure Document to understand the risks associated before investing in the securities markets. Actual results may differ materially from those set forth in projections. Forward-looking statements are not predictions and may be subject to change without notice.

ICICI Securities or its associates might have managed or co-managed public offering of securities for the subject company or might have been mandated by the subject company for any other assignment in the past twelve months.

ICICI Securities or its associates might have received any compensation from the companies mentioned in the report during the period preceding twelve months from the date of this report for services in respect of managing or co-managing public offerings, corporate finance, investment banking or merchant banking, brokerage services or other advisory service in a merger or specific transaction.

ICICI Securities or its associates might have received any compensation for products or services other than investment banking or merchant banking or brokerage services from the companies mentioned in the report in the past twelve months.

ICICI Securities encourages independence in research report preparation and strives to minimize conflict in preparation of research report. ICICI Securities or its associates or its analysts did not receive any compensation or other benefits from the companies mentioned in the report or third party in connection with preparation of the research report. Accordingly, neither ICICI Securities nor Research Analysts and their relatives have any material conflict of interest at the time of publication of this report.

Compensation of our Research Analysts is not based on any specific merchant banking, investment banking or brokerage service transactions.

ICICI Securities or its subsidiaries collectively or Research Analysts or their relatives do not own 1% or more of the equity securities of the Company mentioned in the report as of the last day of the month preceding the publication of the research report.

Since associates of ICICI Securities and ICICI Securities as a entity are engaged in various financial service businesses, they might have financial interests or actual/ beneficial ownership of one percent or more or other material conflict of interest in various companies including the subject company/companies mentioned in this report.

ICICI Securities may have issued other reports that are inconsistent with and reach different conclusion from the information presented in this report.

Neither the Research Analysts nor ICICI Securities have been engaged in market making activity for the companies mentioned in the report.

We submit that no material disciplinary action has been taken on ICICI Securities by any Regulatory Authority impacting Equity Research Analysis activities.

This report is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject ICICI Securities and affiliates to any registration or licensing requirement within such jurisdiction. The securities described herein may or may not be eligible for sale in all jurisdictions or to certain category of investors. Persons in whose possession this document may come are required to inform themselves of and to observe such restriction.

This report has not been prepared by ICICI Securities, Inc. However, ICICI Securities, Inc. has reviewed the report and, in so far as it includes current or historical information, it is believed to be reliable, although its accuracy and completeness cannot be guaranteed.