November 29, 2017

Buy

Apollo Tyres

Industry: Auto Components

LKP Since 1948

Company update

In a sweet spot

Apollo Tyres (Apollo) figures among the top three tyre producers in India and yet underperformed the tyre sector primarily due to ambitious aspirations which led to divergence in management time. Post Vredestein acquisition in The Netherlands, now the management is focused on Hungary expansion along with the ramp up at its Chennai facility to overcome issues of capacity constraints.

In sync with this, we believe Apollo is very well poised to fetch the advantage out of the following tailwinds - 1). Rapid recovery in the automobile market post demonetization, BS IV transition and GST implementation 2). Steadily increasing demand in the Passenger Car market on the back of constant inflow of new launches 3). Fast ramp-up of Chennai and Hungary plants to cut out the current capacity constraints at the PV tyre business, primarily in Europe. 4). Higher emphasis on the infrastructure and rural markets which are the GOI's main objectives, may result into improved CV demand, thus improving product mix of Apollo who is among the top two players in the CV tyres space. 5). Reifencom acquisition and recovery in European markets post a market share loss in FY17. 6). Stable rubber prices and muted outlook on rubber prices 7). Above all, increase in the import duties and possible ban on Chinese tyres may significantly boost volumes along with offering a good pricing power and better margins to Apollo.

We continue to remain sanguine on Apollo Tyres (Apollo) with an upgraded target of Rs307 (Rs 275 earlier), now valuing the company at 12x FY 20E earnings.

Domestic tyre demand gains momentum as vehicular demand moves up

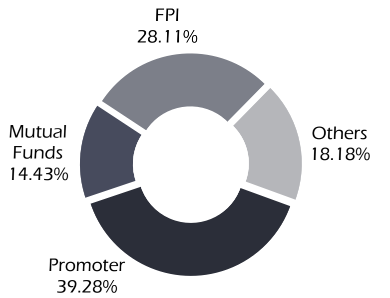
Apollo's Q2 FY18 volumes increased by 10% yoy as truck OEM business flourished by 40%. Truck Replacement business grew by mid-single digit while PV demand also grew in a similar range. Improving industrial activity, good monsoon and relief post BS IV transition and GST implementation led to strong OEM truck demand. PCR sales were impacted due to capacity constraints as utilization levels on this side of business reached optimum levels.

Going forward, new launches on the PV side (17% market share) will continue to fuel PCR demand for Apollo. On the trucks side (25% market share), due to favorable base of last year, will find demand blossoming in Q3, while Q4 may observe sales getting impacted by a bit of a high base of Q4 moving up due to prebuying before BS IV implementation. Post which, with GOI's higher emphasis on infrastructure through various king size projects and rural markets remaining buoyant, the CV and tractors (collectively contribute 66% of product portfolio) demand will remain healthy. Strong dealer network across the country (~5,300 dealers including ~1,700 exclusive dealers) is poised to take advantage of the expected pick up in the auto replacement segment. We estimate Apollo's domestic volumes to grow at a CAGR of 12% between FY17-FY20E.

Stock Data

Current Market Price (₹)	257
12 month Target Price (₹)	307
Potential upside (%)	20
Market Cap (₹ bn)	146
52-Week Range (₹)	288 / 172
Face Value (₹)	1
Reuters	APLO.BO
Bloomberg	APTY IN
BSE / NSE Code	APOLLOTYRE / 500877

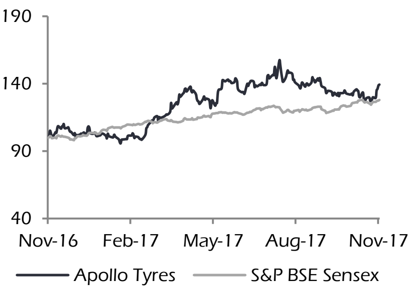
Shareholding Pattern (as on 18-Oct-2017)



Financial Snapshot

YE Mar	FY 17	FY 18E	FY 19E	FY 20E
Revenues(₹ bn)	131.8	159.4	190.5	237.9
EBITDA (%)	14.0%	11.5%	12.3%	13.8%
PAT (%)	8.3%	5.2%	5.5%	6.2%
EPS (Rs)	21.8	14.5	18.2	25.6
EPS growth (%)	0.6%	-33.7%	26.1%	40.6%
P/E (x)	11.8	17.8	14.1	10.0
P/B(x)	1.8	1.8	1.6	1.4
EV/EBITDA (x)	9.9	9.9	7.6	5.3
ROCE(%)	14.2%	11.6%	13.7%	17.8%
ROE(%)	15.1%	10.3%	11.6%	14.3%
Dividend yld (%)	0.9%	0.6%	0.8%	1.1%

Relative Price Performance



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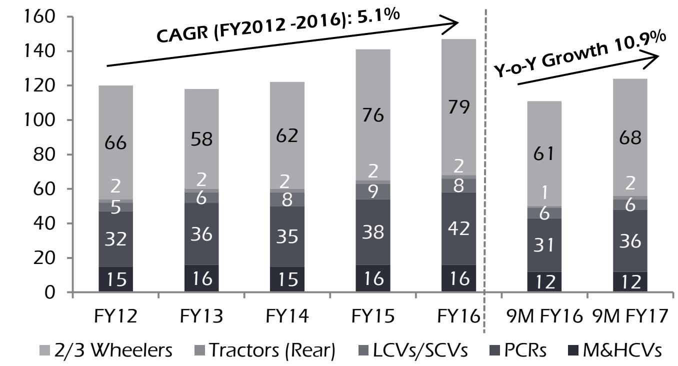
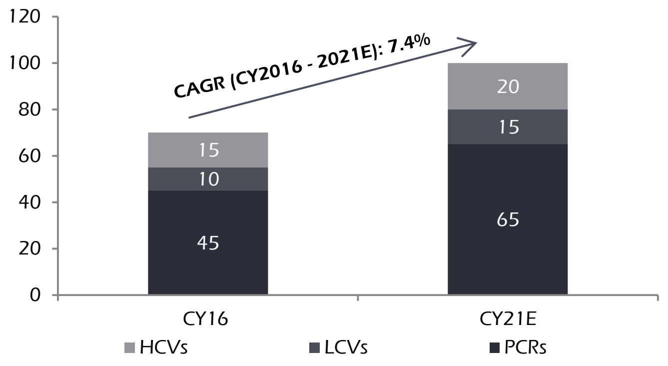
Tyre industry blooming off late (mn units)...



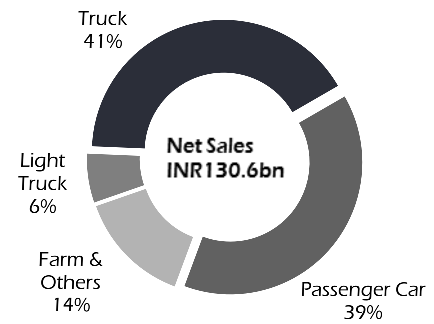
...With a decent growth outlook(mn units)

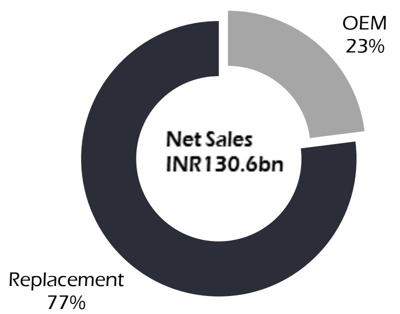


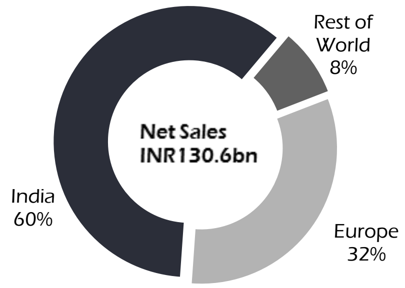
Source:; ATMA, LMC International

Product Segmentation | Channel Segmentation | Geographical Segmentation (

FY 2017

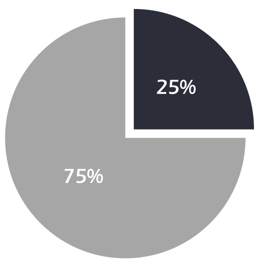




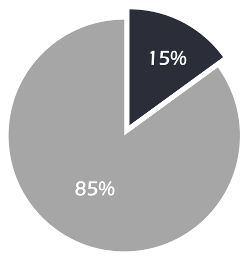


Market share based on volume (9MFY 2017)

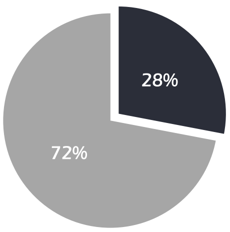
Truck



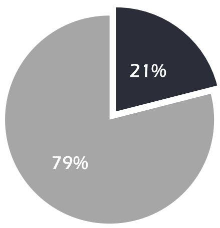
PCR



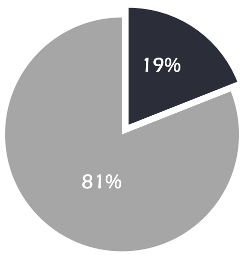
TBB



TBR



Tractor (Rear)



Market share for Apollo | Market share for other players

Source:; Company, LKP Research

GST implementation and hike in import duty on tyres to further curb Chinese imports

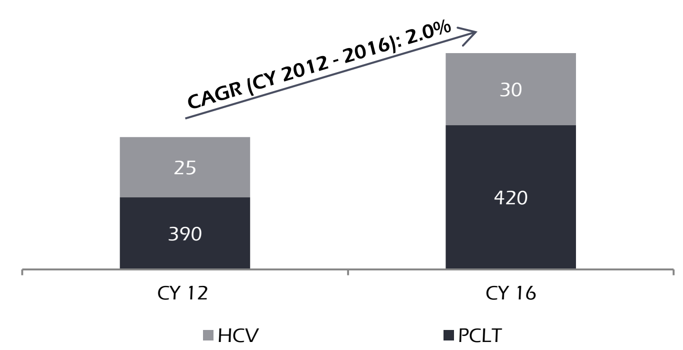
Recently the import duty on some of the Chinese TBR tyres has been levied to the tune of $245.35 to $452.33/MT. Imported TBR tyres accounted for 40% of replacement demand in India and 92% share of imported tyres is commanded by Chinese tyres by end of FY17. GST implementation will disallow cheap unorganized players including the Chinese tyre makers to evade taxes thus pitching their pricing at par with the domestic players. Already the Chinese imports have gone down from 150,000 per month from the pre-DeMon times to 70,000 currently and is further moving down the spiral. The price differential between the Chinese tyres and the domestic make tyres has reduced to <20 % at the higher end of tyres from >25% a year back. At the lower end of the tyres, the differential has come down to just 3%. This has resulted into the domestic players slowly gaining back their lost market shares. With Apollo having 60% of replacement volumes coming from TBR and having second highest market share of 24% in the TBR space(next to JK Tyres - 31%) will benefit maximum from this curb on Chinese tyres.

European operations to get a boost from Hungary capacity expansion, and recovery in Vredestein operations

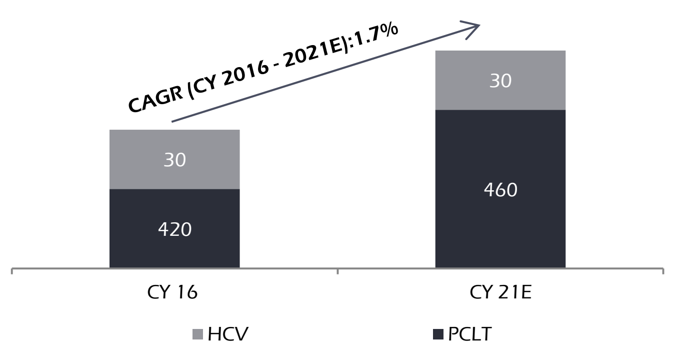
Apollo is investing €475 mn in Greenfield operations in Hungary which is expected to get ramped up to its full capacity of 225 MT/day (emphasis on all season tyres) by FY 19. Hungary, the Eastern European country has labour costs 50% lower than the Netherlands plant of Vredestein. Also, the manufacturing and transportation costs over there are very low, which will benefit Apollo's margins as capacity ramp up gains momentum. The current production from Hungary stands at 2000 tyres/day which is expected to reach 8000 tyres/day by Q4, due to which management expects Hungary plant to turn profitable in Q4 FY18.

In an otherwise slowed down market in Europe, Vredestein operations are under pressure currently due to capacity constraints at its Netherlands plant as well as the Indian plants producing PCR tyres. This issue prevented catering to the European demand from the Indian facilities, thus resulting into market share loss at Vredestein in Q2. Along with this, the overall European business was also impacted by start-up losses at the Hungary plant and continuation of losses at its distribution company Reifencom. However, with Hungary facility ramping up rapidly, obviously the distribution volumes will go up, thus pulling up these operations into profits. Although the Reifencom business is a low margin one, it has almost nil depreciation and interest rates and directly yields profits at the bottomline to its parent, though slender. Capacity constraints easing up would also help Vredestein operations to regain the lost market share and report better volumes and margins. With further expansion of the Apollo and Vredestein brands through their extensive distribution network also assisted by Reifencom, this business is expected to perform better and provide good visibility and increase sales across Europe(~5,800 third party dealers further enhanced presence through Reifencom which has 37 stores with access to 2,500 assembly partners across Germany).

Europe witnessed a stable growth (mn units)...

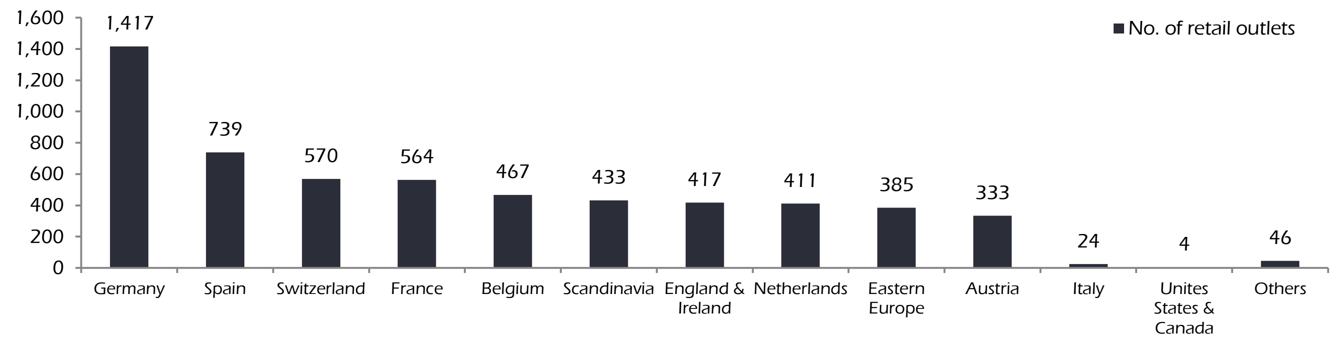


...Expected to continues (mn units)



Source:, Company, LKP Research

Apollo is well poised to spread widely across Europe through extensive Vredestein and Reifencom network...

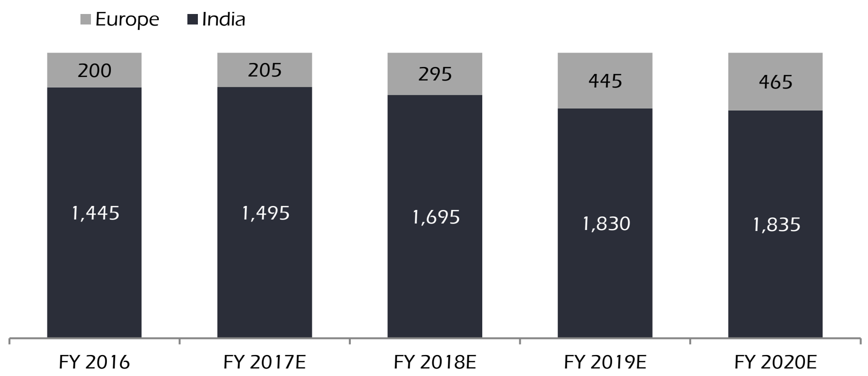


Source:, Company, LKP Research

Capacity expansion is well on track to add volumes thick and fast by FY 19

Apart from the Hungary Greenfield expansion, the company is undertaking a brownfield expansion at Chennai. This will add 450 MT/day capacity in two phases from FY18 and ending in FY19. This will be catering well to the TBR segment which is the buzz word now (>50% of Apollo's volumes). The high margin TBR product will bolster margins for the company going forward. Additionally, the expectations of higher truck demand as mentioned above may improve the product mix as well. Ban on overloading of trucks in the two of the largest states of UP and Rajasthan will further fuel tyre demand and that too for TBR which is intolerant to overloading. Additionally, infrastructure requirement of the country will also augur well for truck demand, mainly in H2 FY18 after a soft H1. This bodes well with the brownfield Chennai expansion by Apollo.

Estimated Capacity (MT / Day)



Source:, Company, LKP Research

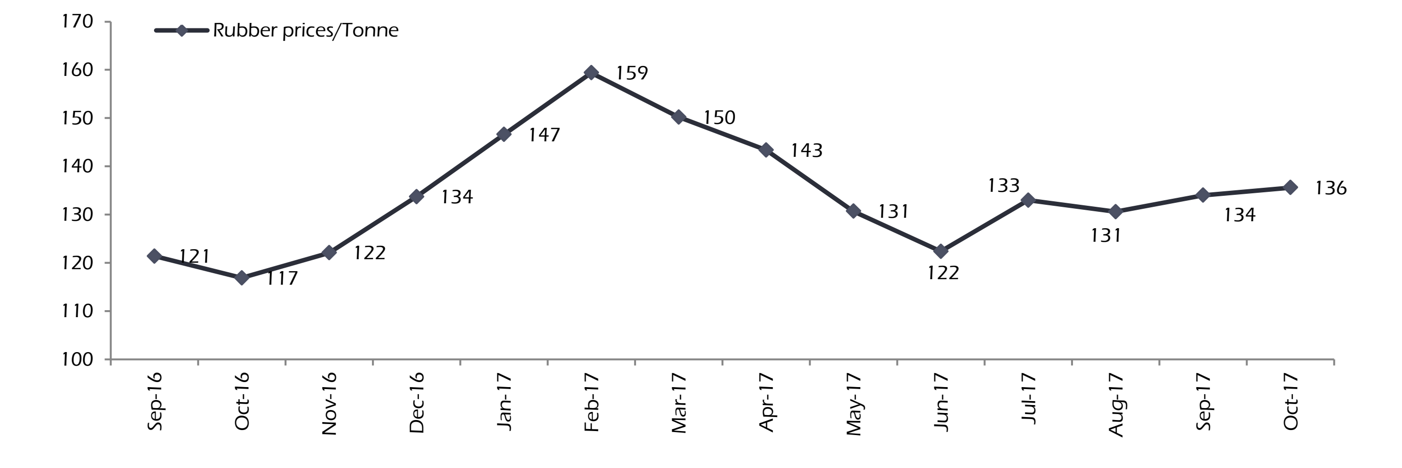
Profitability to improve hereon on multiple levers

Recovery in automobile industry coupled with new vehicle launches on the PCR side and strong demand on the TBB side on the back of mining revival may augur well for the margins. Recent increase in import duty on Chinese tyres may open a greater avenue for the Indian tyre makers to cater to the huge replacement market where Chinese players have a strong presence. Replacement segment which formed 60% by the end of Q2 FY18 (down from 64% yoy) of Apollo's domestic topline can see a significant up-move thus improving the margin performance. Expected higher demand for truck tyres in H2 when infrastructure activity is expected to gain momentum and CV industry finds a favorable base, will lead to a significant hike in volumes and a better product mix thus improving margins. As far as the natural rubber prices are concerned, a 10-15% percentage increase in natural rubber prices (~50% of RM costs) may need a 6% hike in product prices, which the company may take hereon as demand gathers pace. Also, a single % change in NR prices would impact the bottomline by 3% (Please refer to the Sensitivity Analysis below). Though the company is incurring higher capex in Chennai and Hungary, the Hungary plant ramp up may bring down the costs substantially. Low margin Reifencom may slightly bring the European margins downwards in the short term, but it being a small business and zero capital intensive, Vredestein improvement may absorb its shortcomings on the margin front. Additionally, once it starts earning positive operating profits, almost everything will percolate to the bottomline since there will be minimal depreciation and interest expenses below the EBITDA line.

Sensitivity Analysis (FY 20E)		
Base case	**Absolute parameters**	**% impact**
NR prices(Rs)	163	0%
Conso EBITDA margins	13.80%	0%
Conso EPS(Rs)	25.6	0%
Target price	307	0%
Bull case	**Absolute parameters**	**% impact**
NR prices Rs(-1%)	161	-1%
Conso EBITDA margins	14.00%	20 bps
Conso EPS	26.4	3%
Target price	316	3%
Bear case	**Absolute parameters**	**% impact**
NR prices Rs (+1%)	165	1%
Conso EBITDA margins	13.60%	(20 bps)
Conso EPS	24.9	(3%)
Target price	298	(3%)

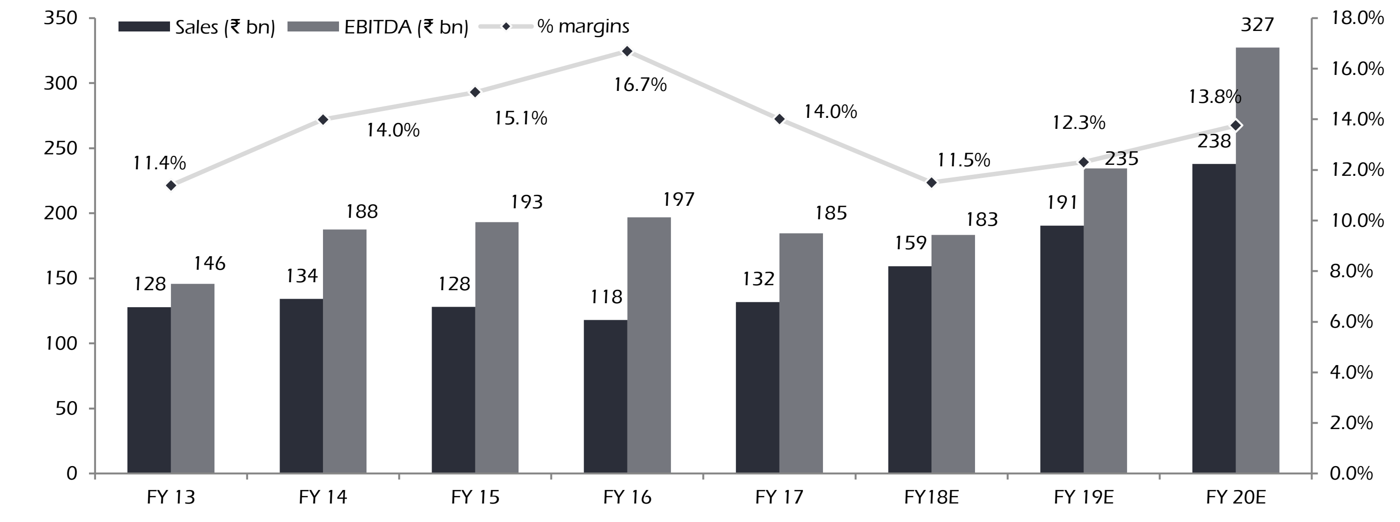
Management outlook on Natural Rubber (NR) remains stable for Q3 and Q4. With the Kottayam RSS4 NR trading prices remaining in the range of Rs130-135/MT in Q1 and Q2, & the consumption prices including duties in the ₹155-160/MT,. we may safely go with the management's call on the rubber prices. In that case there is ample amount of scope for the margins to improve in the ensuing quarters. Some negativity may creep in though as crude prices move up(main raw material for Synthetic rubber which is about 25% of RM costs), however with demand for tyres expected to grow in tandem, any further increase in RM costs may get overcome by price hikes. In FY19E and FY20E, NR prices may increase with demand moving up. In line with this, operating leverage may creep in and Apollo having pricing power, margins may look up. Costs saving at Hungary plant also may result in keeping the margins intact.

Domestic NR prices(Rs/MT) are remaining in a steady range off late...



Source:; Company, LKP Research

...Expecting an improved performance in the ensuing years...



Source:, Company, LKP Research

Heavy capital structure does not stop the balance sheet from being resilient

Despite the capital intensiveness and cyclicality of the business, Apollo has managed to maintain decent balance sheet strength. With FY17, net D/E at comfortable peak of ~0.48x, we believe this is the company's greatest strength in the good RoCE (14.2%) and ROE (15.1%) ratios in FY17. We believe that despite the company having a huge expansion plan of ~₹ 3.2 bn in FY17-19E, debt levels which have already gone up in FY 17 are unlikely to increase further.as the company has mopped up ₹1.5 bn through its recently concluded QIP issue. In line with this we expect net D/E level to go down from FY17 levels. Also CFO (Cash From Operations) generation remains strong and would contribute to the bulk of the expenditure. This has been due to lower input cost (natural rubber) and more price discipline maintained by domestic players in the past. With OEM demand having revived, and replacement demand too expected to move up on Chinese tyre franchise getting stifled, we anticipate volumes to improve, going forward. This would further sustain CFOs even as Apollo embarks on a capex in FY17-19E in Eastern Europe and on enhancing capacity in the domestic business

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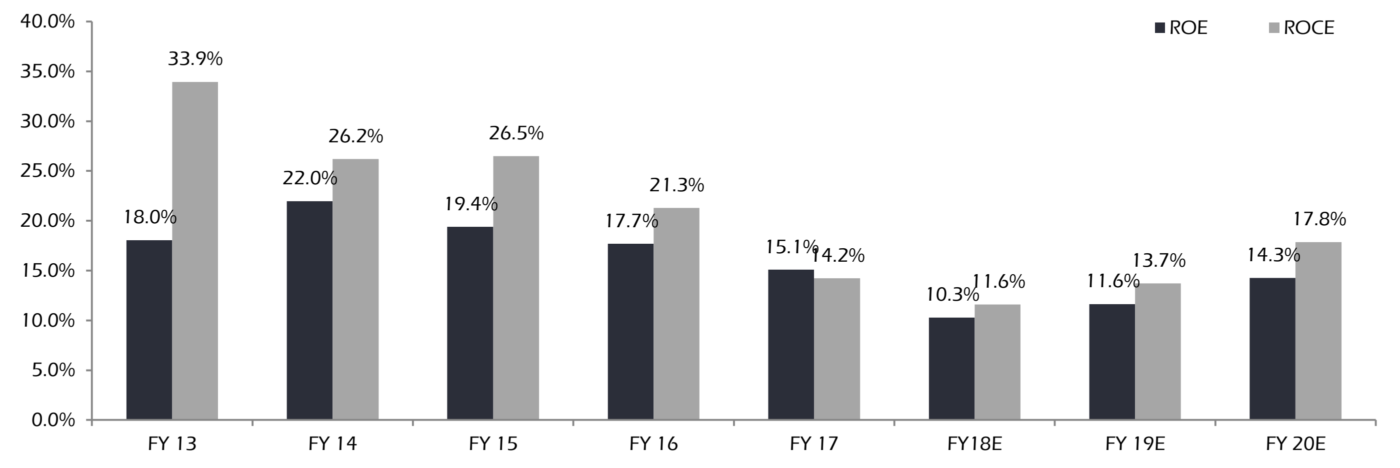
With strong Return Ratios in the offing...



Source:, Company, LKP Research

Outlook and Valuation

Robust demand in the medium to long term on the truck side though levers such as infrastructure and rural growth, new launches on the PV business, a huge opportunity awaiting on the replacement business side through reducing Chinese tyre demand provide an excellent potential for Apollo to leverage its volumes. Mining revival is also boding well for the TBB tyres, though the low margin TBB contribution in the total tyres produces is reducing. Radialization expansion is happening for Apollo as the company is expanding its Chennai TBR capacity. On the European business, Vredestein is witnessing an uneven performance due to capacity constraints in an otherwise weak market, while the Hungary Greenfield stands as the biggest opportunity to ramp up sales and at the same time save bulk of the costs in Europe. Strong CFO, robust return ratios, moderate financial leverage despite capital intensive and cyclical business are the inherent strengths of the company. Any hike in NR & SR prices may be negated by strong volumes, cost savings and price hikes as the company has a pricing power in the replacement segment, being a market leader in the TB segment. On valuation front, the stock looks very attractive at 10x times FY 20E earnings. In light of all these factors, we maintain our BUY rating on the stock with a target price of ₹307 (12x times FY 20E earnings).

Financials (Consolidated)

Income statement

YE Mar (₹.mn)	FY 17	FY 18E	FY 19E	FY 20E
Total Revenues	**131,799**	**159,392**	**190,548**	**237,942**
Raw Material Cost	68,901	86,090	98,368	112,084
Employee Cost	17,420	22,393	28,664	39,520
Other Exp	27,014	32,583	40,062	53,615
EBITDA	**18,464**	**18,326**	**23,454**	**32,722**
EBITDA Margin(%)	14.0%	11.5%	12.3%	13.8%
Other income	1541	1172	1075	980
Depreciation	4,618	6,640	8,716	11,676
Interest	1028	1394	1537	1745
PBT	**14,359**	**11,464**	**14,276**	**20,282**
PBT Margin(%)	10.9%	7.2%	7.5%	8.5%
Tax	3,365	3,196	3,855	5,632
Adj PAT	**10,991**	**8,268**	**10,422**	**14,650**
Adj PAT Margins (%)	8.3%	5.2%	5.5%	6.2%
Exceptional items	-3.0	0.0	0.0	0.0
PAT	**10,994**	**8,268**	**10,422**	**14,650**
PAT Margin (%)	8.3%	5.2%	5.5%	6.2%

Key Ratios

YE Mar	FY 17	FY 18E	FY 19E	FY 20E
Per Share Data (₹)				
Adj. EPS	21.8	14.5	18.2	25.6
CEPS	31.0	31.0	26.1	33.5
BVPS	122.7	144.6	140.4	156.6
DPS	2.4	2.4	1.6	2.0
Growth Ratios (%)				
Total revenues	11.8%	20.9%	19.5%	24.9%
EBITDA	-6.2%	-0.7%	28.0%	39.5%
PAT	-3.7%	-24.8%	26.1%	40.6%
EPS Growth	0.6%	-33.7%	26.1%	40.6%
Valuation Ratios (x)				
PE	11.8	17.8	14.1	10.0
P/CEPS	31.0	26.1	33.5	46.0
P/BV	1.8	1.8	1.6	1.4
EV/Sales	1.4	1.1	0.9	0.7
EV/EBITDA	9.9	9.9	7.6	5.3
Operating Ratios (Days)				
Inventory days	112.2	115.0	118.0	121.0
Recievable Days	39.7	42.0	46.0	45.0
Payables day	25.8	22.0	23.0	24.0
Net Debt/Equity (x)	0.48	0.44	0.34	0.26
Profitability Ratios (%)				
ROCE	14.2%	11.6%	13.7%	17.8%
ROE	15.1%	10.3%	11.6%	14.3%
Dividend yield	0.9%	0.6%	0.8%	1.1%

Source: Company, LKP Research

Balance sheet

YE Mar (₹. mn)	FY 17	FY 18E	FY 19E	FY 20E
SOURCES OF FUNDS				
Equity Share Capital	509	572	572	572
Reserves & Surplus	72,390	79,748	89,023	102,062
Total Networth	72,899	80,320	89,595	102,634
Total debt	27,624	22,804	17,984	13,139
Deferred tax liabilities	7,661	7,661	7,661	7,661
Current liabilities				
Short term borrowings	10,886	12,386	13,886	15,386
Trade payables	17,317	18,341	24,014	29,335
Other current liabilities	12,571	11,371	10,171	8,971
Short term provisions	4,042	4,367	5,220	7,171
Total Current Liabilities	44,816	46,465	53,292	60,863
Total shareholder equity and Liabilities	**153,000**	**157,250**	**168,532**	**184,297**
APPLICATION OF FUNDS				
Net block	60,381	56,741	50,024	40,349
Capital WIP	28,723	35,723	40,723	48,723
Intangible Assets	5,186	5,186	5,186	5,186
Long term Investments	996	2,996	4,996	6,996
Goodwill	1,773	1,773	1,773	1,773
Deferred tax assets	629	407	407	407
Long term loans and advances	5,221	6,199	7,199	8,199
Total non current assets	**102,909**	**109,024**	**110,308**	**111,633**
Current Assets				
Cash and Bank	3,308	223	1,120	1,704
Inventories	26,455	27,124	31,801	37,157
Sundry Debtors	11,274	9,607	12,007	15,645
Loan, Advances & others	4,601	5,240	6,265	9,127
Other Current Assets	4,453	6,031	7,031	9,031
Total Assets	**153,000**	**157,250**	**168,532**	**184,297**

Cash Flow

YE Mar (₹ mn)	FY 17	FY 18E	FY 19E	FY 20E
PBT	14,355	11,464	14,276	20,282
Depreciation	4,618	6,640	8,716	11,676
Interest	1,028	1,394	1,537	1,745
Chng in working capital	(6,755)	(71)	(2,774)	(5,785)
Tax paid	3,264	(3,196)	(3,855)	(5,632)
Other operating activities	(957)	0	0	0
Cash flow from operations (a)	**9,025**	**16,231**	**17,900**	**22,286**
Capital expenditure	(33,111)	(10,000)	(7,000)	(10,000)
Chng in investments	(2,226)	(3,000)	(3,000)	(4,000)
Other investing activities	5,921	6,604	3,180	3,180
Cash flow from investing (b)	**(29,417)**	**(6,396)**	**(6,820)**	**(10,820)**
Free cash flow (a+b)	**(20,391)**	**9,835**	**11,080**	**11,466**
Inc/dec in borrowings	15,781	(5,000)	(6,500)	(5,180)
Dividend paid (incl. tax)	(1,236)	(909)	(1,146)	(1,611)
Other financing activities	3,762	(3,894)	(2,537)	(4,090)
Cash flow from financing (c)	**18,307**	**(9,804)**	**(10,183)**	**(10,881)**
Net chng in cash (a+b+c)	**(2,084)**	**32**	**897**	**584**
Foreign excg fluctutions	**0**	**0**	**0**	**0**
Closing cash & cash equivalents	**2,279**	**191**	**223**	**1,120**
Less: Unpaid dividends bank Ac	**4**	**0**	**0**	**0**
Adj. Closing cash & cash eqvts	**191**	**223**	**1,120**	**1,704**

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