

News monitored for: JM Financial

For tyre stocks, best days are past

Harsha Jethmalani
harsha.j@htlive.com

Tyre stocks have been on a roll. Shares of Apollo Tyres Ltd, MRF Ltd, JK Tyre & Industries Ltd, Ceat Ltd and Bal Krishna Industries Ltd have gained about 36-71% over the past one year. Tyre companies had hiked prices and input costs were softening, which together meant a sharp expansion in margins. But now, the outlook on both factors has turned adverse.

"If oil prices continue to rise, then operating margin for the tyre sector could see about 100 basis points erosion in FY24 from our earlier estimates of 13-14%," said Anuj Sethi, senior director, Crisil Ratings.

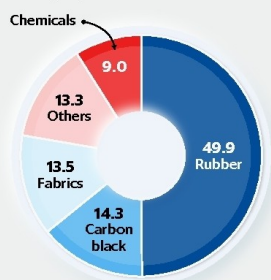
Benchmark Brent crude oil prices have increased by 25% in the last three months to \$94/barrel. While domestic natural rubber prices are still lower, international rubber is heading northward. Further, a weaker rupee would translate into higher cost of imported raw materials.

As such, the impact of movement in raw material costs on margins comes with a lag for tyre companies, depending on exhaustion of existing inventory.

Waning benefits

With costs of key inputs rising, tyre sector margins may come under pressure going ahead.

Raw material cost breakup for tyre companies in FY23 (in %)



Source: Company, Kotak Institutional Equities



Note: The September reading is an estimate based on current market prices of key raw materials

Source: Bloomberg, Industry, JM Financial

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Thus, tyre companies would sail through in the September quarter (Q2FY24) earnings season. However, the days of super-normal margin growth are largely behind. The pain should begin to creep up Q3 onwards.

IIFL Securities' analysts point out, "In recent quarters, tyre makers have

clocked higher-than-average Ebitda margin and 'Ebitda per tonne' (all-time high, in some cases)." Ebitda is earnings before interest, taxes, depreciation and amortization, a key measure of profitability. "Our earnings estimates now factor normalised levels of margins across companies. We cut FY25/FY26 earn-

ings per share estimates of domestic tyre-makers by 5-10%, to account for the rise in input cost," said IIFL's report on 26 September. IIFL's analysis assumes crude at \$85/barrel.

This time around, even as input costs are growing, tyre companies have little room to raise prices because margins are already quite robust. Plus, competition is a worry and demand prospects are not enticing enough. A tyre dealers' channel check by JM Financial Institutional Securities showed that the replacement market remains mixed in Q2FY24.

Replacement demand accounts for the lion's share of tyre companies' revenue. "While passenger car radial tyre demand remains stable, demand for two-wheeler tyres is showing green shoots. Truck & bus/off-the-road tyre demand remains muted owing to seasonality," said the JM Financial report on 26 September.

Sure, demand could look better in the second half of FY24 aided by the festive season sales. But whether this would drive volume growth meaningfully in

FY24 remains to be seen. For now, analysts are penciling in 7-8% volume growth for the sector in FY24.

Amid this, capital expenditure (capex) intensity is set to moderate and that is encouraging. "We expect the sector's capex at about ₹4,000 crore in FY24, compared with about ₹4,500 crore on

SLIPPERY ROAD

RISING input costs have prompted trimming of earnings growth expectations

MUTED demand prospects along with high competition are other dampeners

average in the preceding three fiscal years," Sethi said. Hereon, capex incurred by tyre companies is expected to be used for maintenance and debottlenecking purposes rather than aggressive capacity additions, as capacity utilization is over 75%. Moreover, balance sheets show a comforting picture. "Gearing - a gauge of debt position, for the sector, is expected to improve to

around 0.4 times as on 31 March 2024 from 0.6 times as on 31 March 2023," Sethi added. Now, the question is whether factors like prudent capex plans and better balance sheets would be adequate for tyre stocks to sustain their valuations, that are currently above historical averages. Perhaps not, if crude rises continuously.