

## APOLLO TYRES

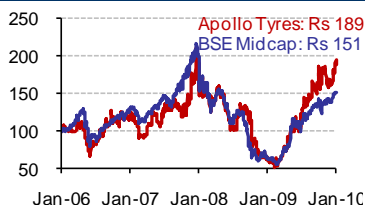
Buy

(Target price: Rs 90)

### Market data

Current price	Rs 54 (BSE)
Market cap	Rs 27,217 m
NSE symbol	APOLLTYRE
BSE code	500877
No of shares	504.0 m
Free float	60.7%
Face value	Rs 1.0
FY09 DPS (Rs)	Rs 0.5
52 week H/L	Rs 57.6/13.6

### Rs 100 invested is now worth



### Stock price performance

	Apollo Tyres	Index*
6-Mth	53.3%	38.0%
1-Yr	191.3%	131.5%
3-Yr	23.6%	14.8%

Returns over 1 yr are compounded annual averages \* BSE Midcap

### Shareholding (Sep-09)

Category	(%)
Promoters	39.4
Institutions (Banks, MFs, FIs)	23.6
FII's	13.4
Indian public	13.4
Others	10.3
Total	100.0

### Report prepared by

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### Investment Rationale

- **A cheaper entry into the Indian auto story:** Make no mistake. India is witnessing a revolution of sorts in the auto industry. Cars are flying off the shelves whereas with industrial activity picking up, commercial vehicles are also all set to witness exciting times ahead. But alas, stocks of most auto companies are not that cheap anymore. Furthermore, in certain segments like passenger cars, it has become difficult to choose a winner with so many new products lined up. However, this does not mean that one cannot profit from the auto growth story anymore. Apollo Tyres, today's MidCap select presents one of the most attractive opportunities to get a backdoor entry if you will, in one of the world's most exciting automobile markets.

Through its leadership in CV and passenger car tyres, the company is all set to reap the benefits of the Indian auto story that is likely to pan out in the medium to long term. Not only is the company amongst the largest sellers of tyres for commercial vehicles and passenger cars, but is also amongst the most profitable tyre companies around. Furthermore, it is undergoing a huge capacity expansion drive in the domestic markets which will ensure that it manages to keep its leadership position intact and also bring about a strong growth in its revenues and profitability. Thus, in light of these facts, we expect the company's standalone topline to witness a CAGR of nearly 15% between FY09 and FY12. While around 9%-10% of this growth is likely to come from increase in volumes, we expect the remaining to come from higher realizations and improved product mix.

- **Value unlocking in subsidiaries to give a big boost:** The company is not content with becoming the market leader in Indian markets. It wants to enter the big league globally as well. And it has already taken huge steps towards the same through a couple of extremely well thought out acquisitions. While its FY07 acquisition of Dunlop, South Africa gave the company an expertise in truck and bus radial tyres, the FY10 acquisition of Netherlands based Vredestein Banden B.V. (VBBV) would provide it with the technical knowhow in premium passenger car and farm and bicycle tyres. However, this may not be all. There could be tremendous synergies to exploit in the future in the form of greater bargaining power in terms of sourcing raw materials, transfer of some manufacturing to low cost destinations like India and servicing demand in one region through excess capacity in the other.

While the above mentioned steps would help the company create long term value for the consolidated entity, the price that the company paid for these acquisitions ensured that value was created right from day one. Apollo Tyres paid Rs 2.9 bn to acquire Dunlop, South Africa and considering the latter's revenues of US\$ 200 m that it was clocking annually, a price to sales ratio of 0.3 times is very attractive indeed. As far as VBBV is concerned, while the acquisition

prices has not been disclosed yet, given the fact that the company is considered to be a distressed buy, the acquisition price is likely to be based along the same lines as Dunlop, South Africa or may be even lower.

Thus, in view of the huge potential for creating synergies as well as the attractive prices paid for the acquisition, our target price for the company assumes a fair bit of upside to come from the two subsidiaries.

- **Margin improvement another positive:** Between FY05 and FY09, the company's standalone operating margins have averaged 9%. A far cry from our projection of 13% average margins between FY10 and FY12. We believe the company can go on a higher margin plane and thus, further boost its bottomline on account of two factors. First is the favorable shift in product mix towards radial tyres that enjoy greater profitability than the normal tyres and secondly, the company's major raw material rubber, both natural as well as synthetic, not touching the highs seen in FY09 anytime soon. It should be noted that the company had earned margins of around 13% in FY08 (before higher commodities prices spoiled the party in FY09) and there is no reason as to why the company cannot achieve similar margins going into the future.
- **Debt levels under control despite aggressive capex:** In order to go for an aggressive capacity expansion, the company is undertaking its most aggressive capex drive ever. Just to put things in perspective, between FY05 and FY09, the company spent around Rs 11 bn as capex whereas over the next three years, it is going to incur a capex of as much as Rs 20 bn. One would expect such strong surge in capex to put the balance sheet under pressure. While there is certainly a strong possibility of the company's debt levels increasing and we have also accounted for the same, it should be noted that even after this increase, the D/E ratio is still likely to be well within the bounds of what is considered to be a safe leverage. The D/E of the standalone entity touches a high of 0.8x in FY11 and then falls to 0.7x in FY12 as more and more of the company's capacity comes into play and its cash flows improve.

### Investment Concerns

- **Greater than expected surge in inflation:** While we have accounted for some amount of price inflation that would eat into the company's margins and bring down its operating margins from 15% to 12%, a faster than expected and a bigger rise in the same could cause further damage to the margins and thus, lower the company's intrinsic value. This we believe is the biggest threat facing the company in the near to medium term.
- **Demand fails to pick up:** It should be noted that while prospects of the Indian auto industry look good from a long term perspective, the auto industry after all is a cyclical industry and hence, prone to ups and downs. Thus, if there is any unexpected cyclical downturn that lasts longer than usual, it could have an impact on the company's bottomline, especially in light of its aggressive capex plans and huge upfront commitment to capacity and higher financial leverage.
- **Prolonged slowdown in developed world:** Since its overseas subsidiaries account for a significant part of the company's intrinsic value, any prolonged slowdown in the developed world could hurt the profitability of its subsidiaries and consequently, the overall valuations of Apollo Tyres.

### Comparative valuation

(FY09/CY08)	Apollo Tyres	Ceat Tyres	J K Tyres
Operating profit margin (%)	8.0%	1.8%	5.7%
Net profit margin (%)	2.7%	-0.6%	0.3%
ROE (%)	8.0%	-3.2%	3.4%
D/E (x)	0.5	0.9	1.9
P/E*(x)	11.3	3.6	7.8
P/BV (x)	1.8	0.9	1.2

\*Trailing twelve month basis  
Source: Equitymaster, CMIE

## Background

Apollo Tyres Ltd is one of India's leading tyre manufacturers, with its history going way back to 1976. Since then, the company has been working on an ever expanding portfolio of tyres to cater to both the commercial and passenger car segments. The company currently produces the entire range of automotive tyres for high speed passenger cars, trucks and buses, farm, off-road, industrial and specialty applications like mining, retreaded tyres and retreading material. These are produced across Apollo's eight manufacturing locations in India and abroad, with a ninth one in southern India that will be commencing production soon. Apollo operates through a network of branded, exclusive or multi-product outlets.

In 2006, the company ventured outside India for the first time. Apollo acquired Dunlop Tyres International Pty Ltd in South Africa and Zimbabwe, taking on the southern African market with full vigour. The company holds brand rights for the Dunlop brand across 30 African countries. In 2009, Apollo acquired Vredestein Banden B V in the Netherlands, and thereby adding Europe as its third crucial market.

Apollo's major brands in its various market include 'Apollo', 'Dunlop', 'Kaizen', 'Maloya', 'Regal' and 'Vredestein'. Its exports reach over 70 destinations across the world, with its key markets comprising of Europe, Africa, the Middle East and Southeast Asia. However, India is still Apollo's largest market accounting for nearly 70% of its revenues.

## Industry Prospects

Like the Indian auto industry, the Indian tyre industry too has come of age in the last few years. The strong and encouraging trend the industry is witnessing is that a majority of all the international auto majors present in India have been using Indian manufactured tyres for their vehicles. The industry has also received a fillip from the growth of domestic auto majors, which have witnessed an admirable growth in both quality and scale off late. The last five years have also seen the Indian tyre industry set its eyes on the global market, with a number of organic and inorganic forays in various parts of the world.

However, there are also some constraining factors that serve to mar the industry's performance. One of those is its raw material intensity, wherein raw materials account for about 60% of sales on an average. Thus volatility in prices of raw materials

has a parallel effect on the profitability of tyre companies from year to year. Chief among these is

natural rubber prices, which have shown a lot of unpredictable swings recently. This forces the industry to import this key input, which is further met with a hefty 20% import duty, compared with just 10% duty on the import of finished tyres.

That point also leads us to another concern for the industry; that of cheap imports and dumping from countries like China. As per reports, India has already seen more than 1,000% increase in the import of tyres from China over the last few years. While the government has taken certain preventive steps, there still is a lot more left to be desired on this front.

Concerns apart, rising incomes and a consequent rapid increase in the usage of vehicles, both commercial and passenger, will ensure a healthy growth for the tyres industry. The recent enthusiasm that major auto companies from all over the world have shown to establish their presence in India is a good indicator of the kind of prospects that lie ahead.

## Key management personnel

**Mr. Onkar S Kanwar** is the Chairman & Managing Director of the company. Mr. Kanwar has graduated in science and administration from University of California. He is the past President of Federation of Indian Chamber of Commerce and Industry (FICCI). Mr. Kanwar has also held the office of Chairman of Automotive Tyres Manufacturing Association (ATMA) which is the apex body of the Indian tyre industry and is a past President of the Indian arm of the International Chamber of Commerce. Mr. Kanwar's focus has been on innovation, quality and exclusivity for Apollo portfolio of products.

**Mr. Neeraj R S Kanwar** is the Managing Director of the company. Mr. Kanwar graduated from Lehigh University, USA, with a Bachelor of Science in Industrial Engineering and a specialisation in management systems. He began his career with Apollo Tyres in 1995 as Manager, Product & Strategic Planning. In July 2002, he took over as the Chief Operating Officer. He was appointed Joint Managing Director in 2006 and elevated to Vice Chairman in 2008 and soon after to Managing Director in 2009 for his initiatives in establishing the company in the global arena.

## Risk Analysis

Note: See the 'Risk Matrix' table on the page 6

**Sector:** Prospects of the tyre industry look quite attractive from a medium term perspective. Growth in both the passenger car segment as well as the CV segment would ensure that market leaders like Apollo Tyres could continue to reap benefits. However, threat of cheap imports and a large unorganized market pose persistent threats to growth and profitability. As such, we assign a medium risk rating to the stock on this parameter.

**Company standing:** Apollo Tyres being amongst the largest players in the tyre industry in India, we assign a 'strong' rating to the stock on this parameter.

**Sales:** Apollo Tyres generated revenues to the tune of nearly Rs 41 bn in FY09 on a standalone basis. Further, the company is expected to generate average revenues to the tune of Rs 53 bn over the next three years. We thus assign a low risk rating of 9 to the stock on this parameter.

**Operating margins:** Operating margin is a measurement of what proportion of a company's revenue is left over after paying for variable costs of production such as raw materials, wages, and sales and marketing costs. A healthy operating margin is required for a company to be able to pay for its fixed costs, such as interest on debt. The higher the margin, the better it is for the company as it indicates its operating efficiency. Apollo Tyres' average operating margins for the past five years has been 9% and we expect it to improve to 13% during the next three years. As such, we assign a medium risk rating of 4 to the stock on this parameter.

**Long-term EPS growth:** We expect the company's net profit to grow at an average annual rate of 32% between FY09 and FY12 (average annual rate of 11% during FY06-FY09). In a normal scenario, we consider a compounded growth of over 20% in net profits over a period of 3 to 5 years as healthy for a company. As such, the rating assigned to the stock on this factor is 5.

**Return on invested capital:** ROIC is an important tool to assess a company's potential to be a quality investment by determining how well the management is able to allocate capital into its

operations for future growth. A ROIC of above 15% is considered decent for companies that are in an expansionary phase. Considering Apollo Tyres' last five years' average ROIC of 11%, which is expected to be around 12% by FY12, we have assigned a rating of 4 to the stock on this parameter.

**Dividend payout:** Apollo Tyres has had an average dividend payout of 20% over the last 5 years, which we expect to come down to 12% over the next three. The rating assigned on this parameter is 3.

**Promoter holding:** A larger share of promoter holding indicates the confidence of people who run the company. We believe that a greater than 40% promoter holding indicates safety for retail investors. At the end of September 2009, the promoter holding in Apollo Tyres stood at 39%. We have assigned a risk rating of 3 to the stock.

**FII holding:** We believe that FII holding of greater than 25% can lead to high volatility in the stock price. FII holding in the company stood at 13% at the end of September 2009. Therefore, the rating assigned is 5.

**Liquidity:** The past 52-week's average daily volume of the stock is in the range of 1.4 m shares, which indicates that the stock is very high on liquidity. The rating assigned is thus 10.

**Current ratio:** Apollo Tyres' average current ratio during the period FY09 to FY12 is estimated to be around 1.4 times, indicating the company's ability to pay up short-term obligations. A ratio under 1 suggests that the company is unable, at that point, to pay off its obligations if they came due. We assign a medium-risk rating of 5 to the stock.

**Debt to equity ratio:** A highly leveraged business is the first to get hit during times of economic downturn, as companies have to consistently pay interest costs, despite lower profitability. We believe that a debt to equity ratio of greater than 1 is a high-risk proposition. Apollo Tyres' debt to equity is expected to remain nearly at 0.7 in the next 3 years. We have thus assigned it a medium rating of 5.

**Interest coverage ratio:** This ratio is used to determine how comfortably a company is placed in terms of payment of interest on outstanding debt. The interest coverage ratio is calculated by dividing a company's earnings before interest and taxes (EBIT) by its interest expense for a given period. The lower the ratio, the greater are the risks. Apollo Tyres's average interest coverage ratio during last five years remained at 4.3 and expected to be around 4.4 over the next three. Thus, the rating assigned to the stock on this parameter is 5.

**P/E Ratio:** The P/E ratio (price-to-earnings ratio) of a stock is a measure of the price paid for a share relative to per share income or profit earned by the company. This is one of the important metrics to judge the attractiveness of a stock, and thus gets the highest weightage in our risk matrix. Apollo Tyres' P/E on its standalone earnings of the past four quarters currently stands at around 12 times, which makes the stock attractive on a valuation basis. As such, we have assigned a medium risk rating of 6 to the stock on this parameter.

**Considering the above analysis, the total ranking assigned to the company is 64 that, on a weighted basis, stand at 5.5. This makes the stock a medium-risk investment from a long-term perspective.**

## Valuations

At the current price of Rs 54, the stock trades at a P/E of 11x its expected FY12 standalone earnings per share. We have valued the company on a sum-of-the parts basis whereby we assign a value of Rs 60 per share to the standalone operations. This assumes a P/E multiple of around 12x, lower than the average of 13x the stock has commanded between FY05 and FY09 and hence, implying that our valuation is indeed on the conservative side.

Also, we assign a value per share of Rs 25 per share to the two subsidiaries, Rs 20 for VBBV, taking into account its turnover of Euro 300 m and assigning a price to sales ratio of 0.5x. We ascribe a value of Rs 5 per share to its other subsidiary of Dunlop, South Africa, taking into account the company's investment value in the same. Since we have not projected the other income of the company, we also take a value of Rs 5 per share to account for the company's cash and cash equivalents. Thus, putting everything together, we arrive at a total target price of the company of Rs 90 per share. This translates into a CAGR of 26% from the current levels or a point to point return of 67%. We thus recommend investors to BUY the stock.

## Valuations

Standalone (Rs m)	FY09	FY10E	FY11E	FY12E
Revenue (Rs m)	40,704	46,158	53,082	61,044
PAT (Rs m)	1,081	2,952	1,918	2,467
EPS (Rs)	2.1	5.9	3.8	4.9
CEPS (Rs)	4.1	8.9	7.8	9.2
Price to earnings (x)	25.2	9.2	14.2	11.0
Price to cash flow (x)	13.2	6.1	6.9	5.9

## Risk Matrix

Rating	Weightage* (A)	Rating# (B)	Rating accorded	Weighted (A*B)
Sector Risk	-	Medium		NA
Company	-	Strong		NA
<b>Performance parameters</b>				
Sales	5.0%	9		0.5
Operating margins	5.0%	4		0.2
Long term EPS growth	10.0%	5		0.5
Return on invested capital	10.0%	4		0.4
<b>Technical parameters</b>				
Dividend payout	5.0%	3		0.2
Promoter holding	10.0%	3		0.3
FII holding	5.0%	5		0.3
Liquidity	10.0%	10		1.0
<b>Safety parameters</b>				
Current ratio	5.0%	5		0.3
Debt to equity ratio	10.0%	5		0.5
Interest coverage ratio	5.0%	5		0.3
P/E ratio	20.0%	6		1.2
<b>Final Rating**</b>		<b>64</b>		<b>5.5</b>

# Rating has been assigned on the basis of the company's performance over the past five years and expected performance over the next 3 to 5 years. Rating is on a scale of 1 to 10, with 1 indicating highest risk and 10 indicating lowest risk.

\* 'Weightage' indicates the relative importance in percentage terms of the parameter. For instance, for an investor, given all the performance metrics, valuation (say P/E) should be the foremost criteria for buying/not buying stocks.

\*\* The final rating has been arrived at by multiplying the rating/points given on each parameter with the respective weightage

## Financials at a glance

Standalone (Rs m)	FY09	FY10E	FY11E	FY12E
Sales	40,704	46,158	53,082	61,044
Sales growth (%)	10.2%	13.4%	15.0%	15.0%
Operating profit	3,248	6,924	6,370	7,325
Operating profit margin (%)	8.0%	15.0%	12.0%	12.0%
Net profit	1,081	2,952	1,918	2,467
Net profit margin (%)	2.7%	6.4%	3.6%	4.0%
<b>Balance Sheet</b>				
Current assets	10,407	10,302	11,806	13,861
Fixed assets	14,247	19,901	26,882	27,702
Investments	2,974	2,974	2,974	2,974
<b>Total Assets</b>	<b>27,629</b>	<b>33,178</b>	<b>41,663</b>	<b>44,537</b>
Current liabilities	7,118	8,578	9,909	11,157
Net worth	13,556	16,100	17,754	19,880
Loan Funds	6,955	8,500	14,000	13,500
<b>Total liabilities</b>	<b>27,629</b>	<b>33,178</b>	<b>41,663</b>	<b>44,537</b>

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