Apollo Tyres Ltd.

On a roll; a new Buy

Initial Opinion BUY

Equity | India | Tires
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Bank of America Merrill Lynch

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Initiate with Buy; PO of Rs 92

Apollo is a play on structural shift to radialisation in the Truck & Bus (T&B) segment. Over FY10-12E, we expect the company to grow ahead of industry average with 15% CAGR in tyre sales, driven by (1) superior franchise in key operating segments of T&B, Light Commercial Vehicles and Passenger Cars, and (2) commissioning of radial tyre capacities this April. Based on our estimates of 22% EPS CAGR, valuations are attractive. Our PO is based on 3.8x EV/EBITDA FY12E, equivalent to P/E of 6.3x, in line with historic averages.

Earnings likely to beat street estimates

Following 25% increase in recipe costs (natural rubber, petro-based inputs) since Sept 09, and higher interest and depreciation charges, we expect slower 6% profit growth in FY11, but this compares favourably with street estimates of 8-10% decline. Possible tyre price hike over the next few weeks will reflect in EBITDA margins sequentially bottoming this quarter.

Radialisation is a structural positive

We expect T&B radial penetration to increase from ~9% to 25% over the next 2 years, well below global average of 60%. We estimate Apollo's radial share to increase from 10% to 27% during this period, driven by higher 36% share of incremental capacity additions, ahead of individual competitors.

Global subsidiaries are earnings accretive

We expect improved performance of South Africa operations, on economic recovery, and Europe, being relatively insulated from business volatility due to focus on niche high-performance tyres. Also, pricing environment is better compared to domestic market, so we expect margins to be stable. In FY12E, global subsidiaries will account for 33% of consolidated sales and 23% of profit.

Stock Data

Price	Rs63.20
Price Objective	Rs92.00
Date Established	12-Mar-2010
Investment Opinion	B-1-8
Volatility Risk	MEDIUM
52-Week Range	Rs15.05-Rs66.80
Mrkt Val / Shares Out (mn)	US$700 / 503.3
Average Daily Volume	4,922,999
BofAML Ticker / Exchange	XAPYF / BSE
Bloomberg / Reuters	APTY IN / APLO.BO
ROE (2010E)	32.1%
Net Dbt to Eqty (Mar-2009A)	39.2%
Est. 5-Yr EPS / DPS Growth	74.2% / 72.8%
Free Float	NA

Estimates (Mar)

(Rs)	2008A	2009A	2010E	2011E	2012E
Net Income (Adjusted - mn)	2,697	1,391	4,978	5,671	7,350
EPS	5.70	2.76	9.89	11.27	14.60
EPS Change (YoY)	NA	-51.5%	257.8%	13.9%	29.6%
Dividend / Share	0.626	0.527	1.84	2.06	2.72
Free Cash Flow / Share	6.40	(1.32)	(5.58)	2.49	18.41

Valuation (Mar)

	2008A	2009A	2010E	2011E	2012E
P/E	11.08x	22.86x	6.39x	5.61x	4.33x
Dividend Yield	0.991%	0.834%	2.91%	3.27%	4.30%
EV / EBITDA*	8.79x	12.52x	4.64x	4.01x	3.26x
Free Cash Flow Yield*	9.48%	-2.08%	-8.83%	3.93%	29.13%

* For full definitions of *iQmethod* SM measures, see page 23.

Refer to important disclosures on page 24 to 26. Analyst Certification on Page 22. Price Objective Basis/Risk on page 22.

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iQprofile SM Apollo Tyres Ltd.

Key Income Statement Data (Mar)	2008A	2009A	2010E	2011E	2012E
(Rs Millions)					
Sales	46,912	49,841	79,487	97,505	109,930
Gross Profit	17,661	15,838	37,973	44,293	50,415
Sell General & Admin Expense	(4,406)	(4,150)	(11,007)	(12,657)	(13,839)
Operating Profit	4,625	2,876	9,001	10,297	12,746
Net Interest & Other Income	(573)	(742)	(1,737)	(2,148)	(2,143)
Associates	NA	NA	NA	NA	NA
Pretax Income	4,053	2,134	7,264	8,149	10,603
Tax (expense) / Benefit	(1,356)	(742)	(2,286)	(2,478)	(3,254)
Net Income (Adjusted)	2,697	1,391	4,978	5,671	7,350
Average Fully Diluted Shares Outstanding	473	503	503	503	503
Key Cash Flow Statement Data					
Net Income	2,697	1,391	4,978	5,671	7,350
Depreciation & Amortization	1,299	1,285	2,217	2,684	3,235
Change in Working Capital	(916)	467	(4,383)	(1,918)	(295)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	1,286	1,106	2,379	2,814	2,975
Cash Flow from Operations	4,365	4,250	5,191	9,252	13,265
Capital Expenditure	(1,351)	(4,912)	(8,000)	(8,000)	(4,000)
(Acquisition) / Disposal of Investments	(59)	(500)	(6,933)	0	0
Other Cash Inflow / (Outflow)	33	191	0	0	0
Cash Flow from Investing	(1,377)	(5,221)	(14,933)	(8,000)	(4,000)
Shares Issue / (Repurchase)	644	411	0	0	0
Cost of Dividends Paid	(142)	(290)	(926)	(1,039)	(1,368)
Cash Flow from Financing	(2,071)	671	7,294	170	(3,654)
Free Cash Flow	3,014	(662)	(2,809)	1,252	9,265
Net Debt	3,614	5,286	17,834	19,912	14,301
Change in Net Debt	(2,290)	1,415	12,548	2,078	(5,611)
Key Balance Sheet Data					
Property, Plant & Equipment	13,001	16,833	28,162	33,477	34,241
Other Non-Current Assets	269	284	1,671	1,671	1,671
Trade Receivables	3,129	2,247	5,595	6,645	7,092
Cash & Equivalents	2,847	3,621	1,173	2,595	8,206
Other Current Assets	8,830	8,354	14,970	18,158	20,026
Total Assets	28,077	31,339	51,570	62,545	71,236
Long-Term Debt	6,461	8,907	19,007	22,507	22,507
Other Non-Current Liabilities	1,756	1,942	2,441	2,964	3,654
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	8,035	6,999	12,581	14,903	16,924
Total Liabilities	16,252	17,848	34,029	40,374	43,085
Total Equity	11,825	13,496	17,548	22,180	28,161
Total Equity & Liabilities	28,077	31,345	51,577	62,554	71,246
iQmethod* SM - Bus Performance					
Return On Capital Employed	NA	8.5%	19.5%	16.5%	17.3%
Return On Equity	45.6%	11.0%	32.1%	28.6%	29.2%
Operating Margin	9.9%	5.8%	11.3%	10.6%	11.6%
EBITDA Margin	12.6%	8.3%	14.1%	13.3%	14.5%
iQmethod* SM - Quality of Earnings					
Cash Realization Ratio	1.6x	3.1x	1.0x	1.6x	1.8x
Asset Replacement Ratio	1.0x	3.8x	3.6x	3.0x	1.2x
Tax Rate (Reported)	33.5%	34.8%	31.5%	30.4%	30.7%
Net Debt-to-Equity Ratio	30.6%	39.2%	101.6%	89.8%	50.8%
Interest Cover	5.9x	3.0x	4.8x	4.5x	5.6x
Key Metrics					

* For full definitions of *iQmethod* SM measures, see page 23.

Company Description

Apollo Tyres is a leading tyre manufacturer of India with subsidiaries in South Africa and Europe. The company manufactures tyres for passenger cars, truck & bus, farm, off-the-road, industrial and specialty applications like mining. It has eight manufacturing facilities spread across India, Netherlands and South Africa with a ninth one in Chennai expected to be operational by the end of this fiscal. Major brands are Apollo, Dunlop, Kaizen, Maloya, Regal and Vredestein.

Investment Thesis

Apollo Tyres, India's second largest tyre manufacturer and leading player in Truck & Bus T&B) seg,emt, is expected to benefit from structural shift to radialisation and growth in automobile industry. We expect the company's tyre sales to register 15% CAGR, ahead of industry, and EPS at 22% annually. Valuations are attractive.

Stock Data

Price to Book Value	1.8x

Investment summary

Apollo is well positioned to capitalize on the growth opportunity in the tyre industry, by leveraging its strong franchise in the domestic T&B segment (which accounts for 69% of sales). On a consolidated basis, we forecast 18% sales CAGR and 22% EPS CAGR. Our PO of Rs92 is based on 3.8x FY12E EV/EBITDA, in line with historical average.

Apollo to lead domestic tyre demand

Over FY04-09, Apollo's tyre sale has grown at 12% annually, ahead of industry at 7%. Over the next 2 years, while we expect the industry to register 12% annual growth, driven by strong automobile sales and replacement volumes, we expect Apollo to raise overall market share from 24% to 25% by FY12E, reflected in our forecasts of 15% sales CAGR. This should be led by the company's (1) strong distribution and superior franchise in key operating segments of T&B, PCR and light vehicles, and (2) early commissioning of new capacities in radial tyres.

Table 1: Apollo: sustainable growth

	Sales (mn tyres)			Growth rates		
	FY10E	FY11E	FY12E	FY10E	FY11E	FY12E
OEM	3.1	3.7	4.4	37%	19%	19%
Replacements	6.6	7.6	8.5	27%	16%	11%
Exports	1.2	1.3	1.5	0%	11%	11%
Total	10.9	12.7	14.4	26%	16%	14%

Source: BofA Merrill Lynch Global Research

Apollo key beneficiary of T&B radialisation

Over FY09-12E, we expect T&B radial penetration to improve from 9% to 25%, replacing substitute imports as well as cost inefficient cross ply tyres sourced locally. Radial penetration will still be well below global average of 60%, as ~50% of population which does not allow fitment of radial tyres. We estimate Apollo's radial share will increase from 10% to 27% during this period, driven by 36% incremental T&B capacity addition, ahead of individual competitors.

Table 2: Increasing T&B radial penetration

	FY09	FY10E	FY11E	FY12E
Estimated T&B demand (see table 6)	13.7	15.7	17.2	18.9
-Cross ply	12.4	13.7	14.1	14.1
-Radial	1.30	2.05	3.10	4.77
-Imports	0.8	1.0	0.9	0.2
-Domestic	0.5	1.0	2.2	4.6
Radialisation penetration	9%	13%	18%	25%

Source: BofA Merrill Lynch Global Research

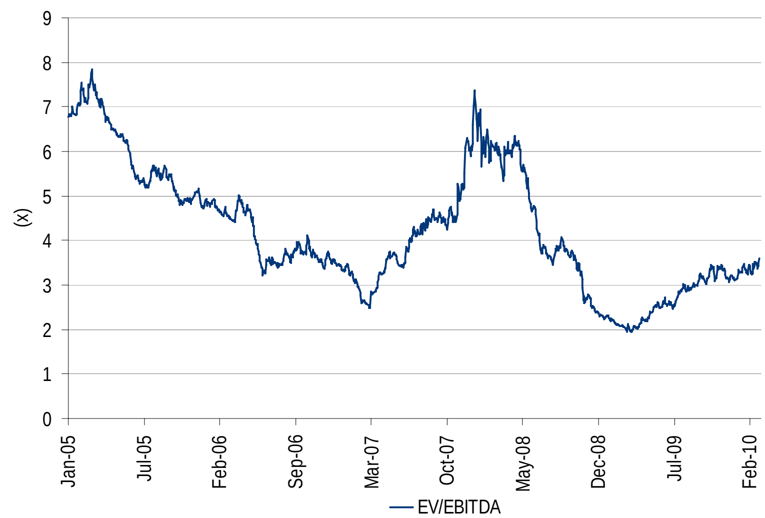
Forecast US$2bn sales, 22% profit CAGR over FY10-12

We estimate Apollo's consolidated sales to register 18% CAGR over the next two years, driven by robust standalone operations (20% CAGR), and improved performance of its European and African subsidiaries (13% CAGR). Despite raw material headwinds, we estimate 19% EBITDA CAGR, and annual EPS growth of 22%, restricted by higher depreciation and interest outgo on the new unit.

Valuations compelling, Buy for 40% upside

We value Apollo at 3.8x FY12E EV/EBITDA, in line with historic averages. At our PO of Rs 92, the stock would trade at P/E of 6.3x, and ~50% discount to global counterparts

Chart 1: 1-year forward EV/EBITDA



Source: BofA Merrill Lynch Global Research

Bull & bear case

	Bull case	Bear case	BoFA-ML view
Raw material price	▪ Natural rubber prices to moderate towards the latter part of the year as global production exceeds demand ▪ Crude-based inputs to be stable	▪ Natural rubber prices to trend upwards due to demand-supply mismatch ▪ Crude-based inputs to remain firm	▪ Natural rubber prices to remain similar to present levels ▪ Crude-based inputs to remain firm
Demand	▪ OEM sales strengthen on the back of economic recovery ▪ Replacement sales to grow with a lag on rising vehicle population	▪ OEM sales pull back on slower economic revival ▪ Replacement sales to moderate on lower economic activity	▪ OEM sales momentum to continue due to economic recovery ▪ Replacement sales to grow with a lag on rising vehicle population
Margin	▪ Margins to remain stable as rising commodity prices are fully passed on both in the OEM and replacement segments ▪ Speedy ramp up of new unit to lower unit fixed costs	▪ Margins to decline as rising commodity prices cannot be passed on both in the OEM and replacement segments ▪ Lower capacity utilisation to impact margins	▪ Margins to moderate due to higher commodity prices, as (1) OEMs accept partial hike in prices, but (2) replacement market bears full increase ▪ Higher start up expenses from new unit to impact margins
Market share	▪ Dominant presence and superior franchise to drive sustained increase in share in key segments of T&B and PCRs	▪ Increased competitive activity to lead to stable T&B share ▪ Decline in market share in all operating segments as competition intensifies	▪ Strong franchise and fresh capacities to drive gains in T&B and PCRs ▪

Source: BofA Merrill Lynch Global Research

Apollo: Competitive position and strategy

Apollo is India's second largest tyre manufacturer and the leader in T&B segment. Over the next two years, we expect Apollo to register 15% CAGR in volumes, ahead of the industry's 12%, driven by (1) strong distribution and superior franchise, and (2) early commissioning of tyre capacities, and the resulting benefit from the shift in T&B radialisation.

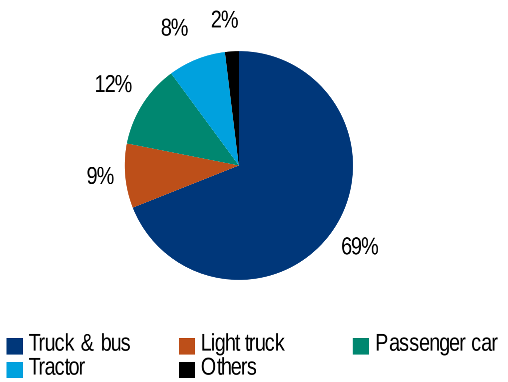
Leading player in T&B segment

Apollo's overall market share is estimated at 24%, but the company leads in the T&B segment (with a 28% share), which accounts for 69% of the company's sales, as well as light commercial vehicles (26% share, 9% of sales). Apollo is also the fastest growing player in PCRs, having grown its market share to 19% from just 9% in FY04.

Competitive in replacement market

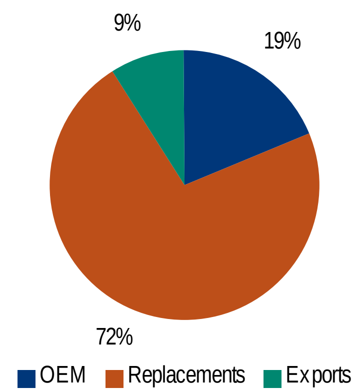
Apollo has a strong position in the tyre replacement market, which accounts for 72% of company's sales. This positioning is ably supported by its strong distribution penetration (4,000 dealerships and 2,000 exclusive outlets, largest in the industry).

Chart 2: T&B dominates tyre market (by value)



Source: Company

Chart 3: Replacement leads tyre demand (by segment)



Source: Company

Scaling up radial capacity

Apollo has committed substantial capital expenditure of Rs20bn over FY09-12E, solely towards expanding its radial tyre capacity. Over FY10-12E, the company would add ~36% of incremental capacity in T&BRs and 27% in PCR, which should enable it to increase its share in these key operating segments.

Demand: On a roll

Historically, tyre sales have registered a 7% CAGR (FY04-09), which includes an estimate of 18% growth this fiscal. Over the next two years, we estimate a 12% annual increase in industry tyre demand, mainly driven by (1) higher automobile OEM sales across operating segments, at 15% CAGR, and (2) sustained 11% CAGR in replacement market, due to rapidly rising vehicle population.

Table 3: Industry tyre demand

	Sales (mn tyres)			Growth rates		
	FY10E	FY11E	FY12E	FY10E	FY11E	FY12E
OEM (Table 4)	15.4	17.7	20.5	25%	15%	16%
Replacement (Table 5)	24.6	27.5	30.1	16%	12%	9%
Exports	5.2	5.7	6.2	12%	10%	9%
Total	45.2	50.9	56.8	18%	13%	12%

Source: BofA Merrill Lynch Global Research

OE segment: Estimate 15% CAGR

We expect the OE segment, which constitutes ~34% of tyre demand, to register 15% sales CAGR over the next two years, due to (1) continuing revival in CVs i.e., T&B and light commercial vehicles, on the back of industrial recovery, and (2) a similar increase in demand for passenger cars, with higher incomes driving strong consumer sentiment. We however expect decelerating trends in the tractors segment, which nevertheless constitutes just ~12% of the total demand.

Table 4: OE segment estimates

	Demand (mn tyres)			Growth rates		
	FY10E	FY11E	FY12E	FY10E	FY11E	FY12E
Trucks & buses	2.4	2.7	3.3	30%	12.5%	22.5%
Light commercial vehicles	1.6	2.0	2.4	30%	25%	20%
Passenger & utility vehicles	9.5	10.9	12.6	25%	15%	15%
Tractors	1.9	2.1	2.2	20%	10%	5%
Total	15.4	17.7	20.5	25%	15%	16%

Source: BofA Merrill Lynch Global Research

Replacement segment: Expanding base to drive 11% CAGR

Replacement market typically constitutes ~62% of domestic tyre sales. T&B tyres are likely to be replaced once every 15 months, while the cycle is three years for passenger cars. Over the next two years, we estimate 11% CAGR in replacement demand, driven by doubling of vehicular population over FY02-09, and structural improvement in radial penetration.

Table 5: Replacement **segment estimates**

	Demand (mn tyres)			Growth rates		
	FY10E	FY11E	FY12E	FY10E	FY11E	FY12E
Trucks & buses(Table 7)	11.2	12.4	13.5	13%	11%	9%
Light commercial vehicles	2.3	2.7	3.1	16%	16%	15%
Passenger & utility vehicles	9.0	10.1	11.1	18%	12%	10%
Tractors	2.1	2.3	2.4	20%	10%	5%
Total	24.6	27.5	30.1	16%	12%	9%

Source: BofA Merrill Lynch Global Research

T&B: Radialisation and recovery

We expect tyre demand to be led by a cyclical recovery in truck and bus sales, which will, in turn, drive replacement sales with a lag. The industry is expected to register a 14% sales growth this fiscal, and we expect this momentum to be maintained during the forecast period.

Table 6: T&B demand

	Demand (mn tyres)			Growth rates		
	FY10E	FY11E	FY12E	FY10E	FY11E	FY12E
OEM	2.4	2.7	3.3	30%	12%	22%
Replacement	11.2	12.4	13.5	13%	11%	9%
Exports	2.1	2.1	2.1	7%	0%	0%
Total	15.7	17.2	18.9	14%	10%	10%

Source: BofA Merrill Lynch Global Research

OE demand surge on cyclical recovery

Following declining trends over the past two years, T&B sales by automobile OEMs are up 21% this fiscal. This has led to a similar surge in tyre demand. Over FY10-12E, we forecast a 18% sales CAGR in the T&B segment, driven by economic recovery. Tyre producers will be the key beneficiary.

Replacement the key growth driver

We estimate a 10% CAGR in replacement demand for tyres, driven by a speedier replacement cycle, as newer cost-effective radial tyres replace older cross ply versions, and shift to multi-axle trucks/tractor-trailers, which require more tyres per vehicle.

Table 7: T&B replacement demand

(mn)	FY08	FY09	FY10E	FY11E	FY12E
New vehicles sold		0.16	0.19	0.22	0.27
Less: Scrap		0.11	0.01	0.13	0.16
Cumulative vehicle population	1.50	1.55	1.73	1.82	1.93
Replacement cycle (months)		15.0	15.0	15.0	15.0
Tyres required per vehicle (nos.)		8.0	8.1	8.5	8.7
Annual tyre replacement demand		9.9	11.2	12.4	13.5
YoY change			13%	11%	9%

Source: BofA Merrill Lynch Global Research,SIAM

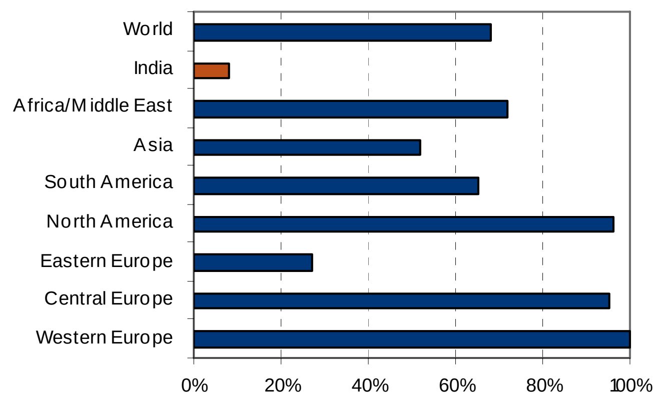
Radialisation to gather pace

The pace of radialisation in the Indian T&B segment has started to gather momentum, and is now at 9%, up from just ~2% three years earlier. This reflects the recognition by fleet operators of the benefits of shifting to radial tyres, given the country's improving road infrastructure. Still, radial tyre sales account for only 15% of the domestic tyres produced (with less-efficient cross ply tyres mostly making up the balance). Industry majors have ongoing plans to treble radial capacity by FY13E, to meet the rapidly growing demand for radial tyres.

Sizeable vehicle population cannot support radialisation

While the domestic passenger car segment has almost completely migrated to radial tyres, the penetration in the T&B segment is at a low ~9% (well below the global average of 60%), limited more by poor road infrastructure than higher radial costs. Also, low commitment to newer technology meant that vehicles produced in India until the last decade were not suitable for fitment of radial tyres. We estimate ~50% of vehicle population will not allow fitment of radial tyres.

Chart 4: Low levels of T&B radialisation in India



Source: BofA Merrill Lynch Global Research, Michelin Factbook, ATMA

Benefits of radialisation

Radial tyres, although 15-20% more expensive compared to cross ply tyres, are more cost effective due to their superior fuel efficiency and longevity (by 40-45%). Cost benefit analysis illustrated in Table 8 below highlights the need to transition from cross ply to radial tyres.

Table 8: Cost benefit analysis: Cross ply vs Radial for 16 MT GVW truck tyre

	Cross ply	Radial	Savings
Distance travelled pa (km '000)	105	105	
Total life of a tyre post 3 retreadings (km '000)	100	140	
No of tyres per truck	8	8	
Tyres required per year including replacement	8.4	6.0	
Total annual cost*(Rs '000)	151	153	-1
Savings due to higher fuel efficiency			
Fuel Efficiency (km/litre)	4.0	4.2	
Price of diesel (Rs/litre)	37.0	37.0	
Total fuel cost/annum (Rs '000)	971	925	46
Net savings on using radial tyre (Rs '000)			45

Source: BofA Merrill Lynch Global Research; *Includes cost of new tyres and three retreadings

Radial penetration seen at 25% by FY12E

Currently, ~90% of tyre demand is met by cross ply tyres, and ~50% of radial tyres are imported. With no addition to cross-ply capacities, radial tyres will act as a natural substitute. We therefore estimate T&BR penetration to increase from 9% to 25% by FY12E on the back of improved infrastructure, better fleet management and increasing proportion of vehicles allowing fitment of radial tyres.

Table 9: Increasing T&B radial penetration

	FY09	FY10E	FY11E	FY12E
Estimated T&B demand (see table 6)	13.7	15.7	17.2	18.9
-Cross ply	12.4	13.7	14.1	14.1
-Radial	1.30	2.05	3.10	4.77
-Imports	0.8	1.0	0.9	0.2
-Domestic	0.5	1.0	2.2	4.6
Radialisation penetration	9%	13%	18%	25%

Source: BofA Merrill Lynch Global Research

Passenger segment: Strong growth prospects

As a prominent driver of overall automobile demand, we estimate a secular 15% growth in OEM sales. Despite having a slightly longer replacement cycle, we expect the demand in this segment to sustain a double-digit growth.

Table 10: Industry PCR sales

	Demand (mn tyres)			Growth rates		
	FY10E	FY11E	FY12E	FY10E	FY11E	FY12E
OEM	9.51	10.94	12.58	25%	15%	15%
Replacement	8.98	10.06	11.07	18%	12%	10%
Exports	1.15	1.27	1.46	15%	10%	16%
Total	19.6	22.3	25.1	21%	13%	13%

Source: BofA Merrill Lynch Global Research

Supply: Majors adding capacity

With utilization already hitting peak levels, tyre majors are adding capacity to meet future demand. Over FY10-12E, we estimate supply to increase from 21mn to 32.9mn in PCRs, and 1.05mn to 4.93mn in T&BRs. Apollo would account for 29% of planned capacity additions, mainly in these segments.

Table 11: Capacity addition by major players

	Truck & bus radial		Passenger car radial	
mn tyres	FY11E	FY12E	FY11E	FY12E
Opening capacity	1.05	2.20	21.00	27.31
Capacity additions:				
-Apollo Tyres	0.35	1.05	2.63	0.53
-CEAT	0.10	0.40	0.97	0.97
-JK Tyres	0.00	0.40	0.50	2.50
-Birla Tyres	0.40	0.40	0.00	0.00
-MRF	0.30	0.40	0.97	0.32
-Bridgestone	0.00	0.00	1.25	1.25
Year end capacity	2.20	4.85	27.31	32.88
YoY change (%)	110%	120%	30%	20%

Source: BofA Merrill Lynch Global Research, Company

Demand-supply mismatch unlikely until late FY12

Based on our growth expectations for key segments under review, industry utilisation levels will stay above 90% over the next two years. For instance, despite trebling of supply, we expect radial capacity utilisation to slip to ~87% by end-FY12. This assumes that imports will be maintained at historical levels.

Table 12: T&B utilisation levels to remain high

	FY09	FY10E	FY11E	FY12E
Radial	0.50	1.05	2.20	4.85
Cross ply	12.30	12.30	12.30	12.30
Total supply	12.80	13.35	14.50	17.15
Capacity utilisation				
-Radial	100%	100%	100%	94%
-Industry	100%	100%	100%	96%

Source: BofA Merrill Lynch Global Research

Apollo: Leading market share gains

Apollo would contribute ~36% of the incremental capacity in T&BRs and 27% in PCR. We expect the company to leverage its strong franchise to increase market share in these key operating segments.

Table 13: Radial capacity ramp-up

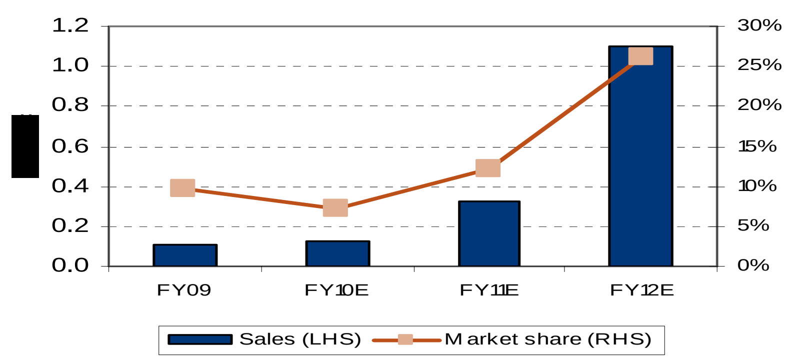
(mn tyres)	Op cap	Inc in FY11E	YE cap	Inc in FY12E	YE cap	Cum cap increase
T&BR						
Industry	1.05	1.07	2.12	2.81	4.93	3.88
Apollo	0.13	0.35	0.48	1.05	1.53	1.40
Apollo % of ind cap	12.3%	32.8%	22.7%	37.5%	31.1%	36.2%
Apollo MS in T&BR	7.3%		12.5%		26.6%	
PCR						
Industry	21.00	6.31	27.31	5.56	32.88	11.88
Apollo	3.99	2.63	6.62	0.53	7.15	3.16
Apollo % of ind cap	19.0%	41.7%	24.2%	9.5%	21.7%	26.6%
Apollo MS in PCR	18.6%		19.9%		20.3%	

Source: BofA Merrill Lynch Global Research, Company

Ramping up T&BR capacity

By FY13E, Apollo is expected to roll out 6,000 T&BRs per day from its new facility at Chennai, in South India. The first phase of the plant is on track to be commissioned in March this year, with a manufacturing capability of 1,000 T&BRs per day. Despite other players joining in, we believe Apollo is ahead of the pack in the radial race. We expect its market share to increase from 10% to 27% by FY12E.

Chart 5: Apollo's T&BR market share to increase



Source: BofA Merrill Lynch Global Research, Company

Increasing franchisee in PCR

Apollo stands a close third to leading players. Significantly, the company ranked well behind with a single-digit (~9%) share in FY04, but raised its share to 19%, thanks to a rapidly growing franchise. With plans on track to increase capacities (by 2,000tpd in Vadodara, taking the total to 18,000tpd, and 8,000tpd in Chennai), we expect the company to at least maintain its existing market share

Table 14: PCR sales and growth rates

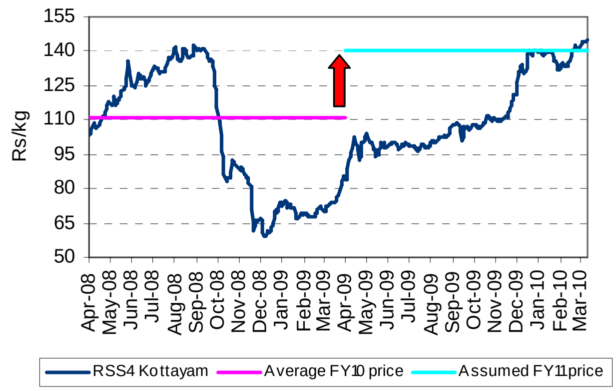
	Demand (mn tyres)			Growth rates		
	FY10E	FY11E	FY12E	FY10E	FY11E	FY12E
OEM	1.69	2.06	2.43	39%	21%	18%
Replacement	1.75	2.11	2.38	44%	21%	13%
Exports	0.54	0.56	0.61	-23%	4%	8%
Total	3.99	4.73	5.41	27%	19%	14%

Source: BofA Merrill Lynch Global Research

Margins: Headwinds of rising input costs

Rubber (natural/synthetic) accounts for ~55% of tyre raw material cost. Domestic price of natural rubber (NR) has surged 40% in 2H FY10, and is now at a peak of ~Rs147/kg. With firm trends expected to continue for NR as well as other petro-based raw materials, we expect tyre industry margins to contract. Apollo, with a relatively better sales mix favoring replacement market, will be less impacted.

Chart 6: Rising NR prices

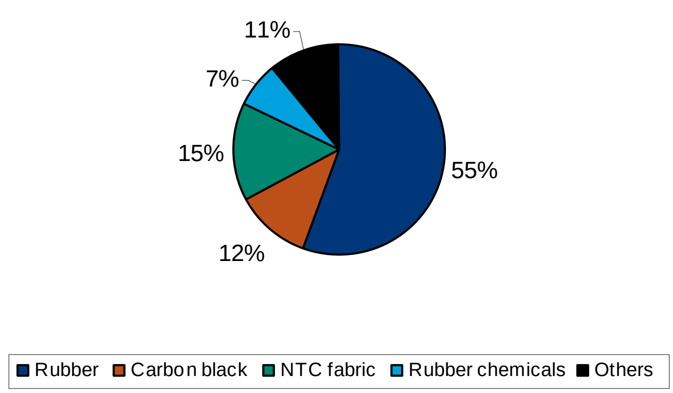


Source: BofA Merrill Lynch Global Research, Bloomberg

Rubber and crude oil to drive tyre costs

Raw materials account for ~60% of operating cost for tyre companies. NR constitutes 40% of the total tyre cost, while other petro-based products such as styrene butadiene rubber, poly butadiene rubber, nylon tyre fabric cord, carbon black and rubber chemicals make up the balance. Hence industry margins are highly correlated to price movement in rubber and crude oil.

Chart 7: Tyre raw material cost breakup



Source: BofA Merrill Lynch Global Research

Global NR demand-supply mismatch to remain tight

During 2009, production of NR in the top-10 countries (which constitute 94% of supply) fell 5.1% to 8.68mt, from 9.15mt in 2008. Although acreage increased by 2%, average yield declined 7% due to adverse climatic conditions in major producing countries. While China and Vietnam, the leading producers, increased supply, it was still not enough to offset the combined annual production of Malaysia, Thailand, India and Indonesia. Industry sources forecast demand-supply mismatch to remain tight for 1H 2010.

Chart 8: Demand-supply mismatch

Source: BofA Merrill Lynch Global Research, ANPRC, The Thai Rubber Association, IRSG

Near-term conditions remain unfavourable…

We believe the global natural rubber demand-supply mismatch would continue in coming quarters, driven by:

1. Strong demand recovery; eg, China's tyre demand is set to increase after the government cut rubber import duties
2. Onset of Winter season (late February to mid April) during which rubber trees shed leaves and stop producing latex
3. Firm crude prices, which drives shift away from synthetic (being indirect crude derivative) to natural rubber

… but stable-to-moderate prices expected in the latter half of 2010

Rubber production forecasts for 2010 are encouraging (except for Thailand where official government data is not available). As the supply is expected to match demand from user industries, we expect international rubber prices to remain stable in 2010.

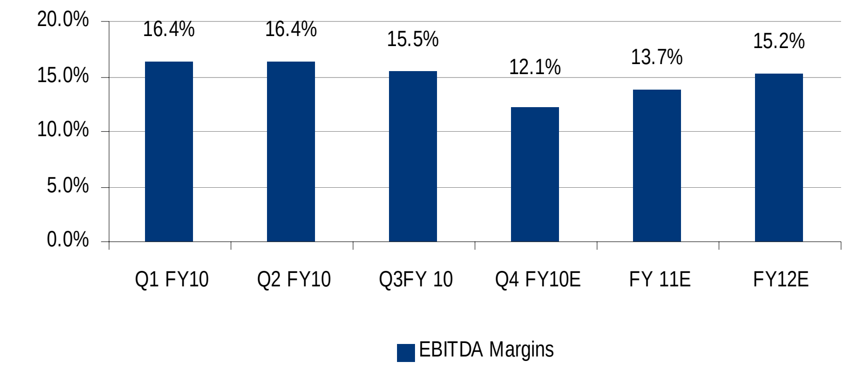
Apollo: Moderation from recent highs

We expect Apollo's standalone margins to moderate to 13.7% in FY11, from 15% this year, but rebound to 15.2% in FY12. On a consolidated basis, we expect its margins to be less volatile, slightly lower at 14.5% in FY12E from 14.1% this year, thanks to relatively stable operations of its global subsidiaries.

Closer look at standalone trends

Apollo's 1H margin at 16.4% was an aberration peak, in our view. We expect a sharp dip in 4Q to 12.1%, due to spike in input costs, but sequential improvement thereafter driven by (1) higher ASPs reflecting full impact of price hikes, both in replacement (2.5% in Oct 09, 5% in Jan 10, expected. 5% in April 10) and OEM (5% in December 09, February 10 and expected in Oct 10) segments, as well as the shift to radial tyres, where realizations will be 15-20% higher, and (2) strong demand leading to better utilization. We estimate Apollo's margins to improve to 13.7% in FY11, and by 15.2% in FY12.

Chart 9: Margins expected to bottom out in H1FY11



Source: BofA Merrill Lynch Global Research, Company

Subsidiary margins to remain stable

We expect Apollo's global subsidiaries to benefit from improving demand conditions and, more significantly, a much better pricing environment. Over FY10-12E, we estimate margins from South African operations to stabilize at ~10% (historical average ~11%), and Europe at ~14% (historical range 11-17%).

Financials: Target US$2bn consolidated sales

Over FY10-12E, we expect consolidated sales to register 18% CAGR, driven by 20% CAGR for standalone operations (64% of sales), and a slower 13% CAGR for global subsidiaries. We estimate consolidated EBITDA to increase 19% annually, on higher raw material price assumptions. We forecast a 22% EPS CAGR, restricted by higher depreciation and interest.

Sales driven by domestic recovery and global acquisition

We estimate Apollo's consolidated sales to grow strongly at 60% this fiscal, driven by standalone operations and Vredestein acquisition. Over FY10-12, we expect sales to grow from Rs79bn to Rs110bn, driven primarily by standalone operations. We expect Vredestein and Dunlop to contribute 21% and 12%, respectively, of consolidated sales by FY12E.

Forecast 22% EPS CAGR

We forecast a 22% increase in consolidated profit over FY10-12, driven by ramp up of standalone operations, recovery in the South African business, and full contribution from Europe.

Standalone operations: Robust growth ahead

Over FY10-12E, we estimate 20% sales CAGR for standalone operations, driven by strong OE and replacement demand, and radialisation in the T&B segment. Despite higher raw material prices, we expect EBITDA to increase 21% annually. We, therefore, forecast a net profit CAGR of 18%.

Table 15: Standalone P/L summary

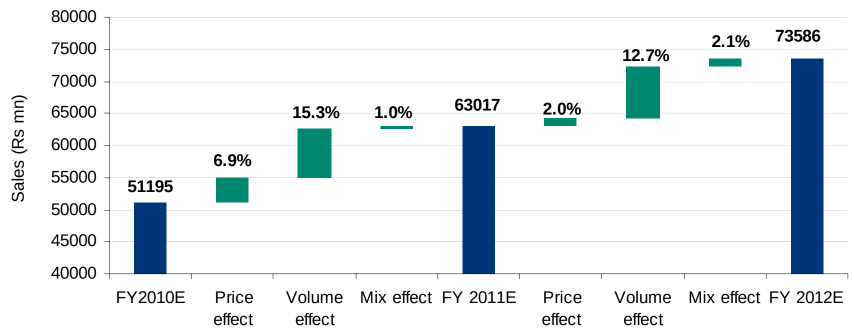
Rs. Mn	FY09	FY10E	FY11E	FY12E
Net sales	40704	51195	63017	73586
Consumption of raw materials	29109	32403	41406	47254
Employee cost	2075	3021	3434	4047
Other expenditure	6007	8089	9516	11111
Total expenses	37457	43512	54356	62412
EBITDA	3248	7683	8661	11173
Depreciation	980	1229	1506	1951
EBIT	2268	6454	7156	9223
Other income	112	25	25	25
Interest expense	668	731	1155	1312
Exceptional income	0	0	0	0
PBT	1712	5749	6026	7936
Tax	630	1975	2030	2673
PAT	1081	3774	3996	5263
EPS(Rs.)	2.15	7.50	7.94	10.46
EBITDA Margin	8.0%	15.0%	13.7%	15.2%

Source: BofA Merrill Lynch Global Research

Sales CAGR seen at 20%

We expect Apollo's sales to grow 26% this fiscal, due to the 26% increase in volumes, led by PCRs. Over FY10-12, we forecast a 20% sales CAGR, from Rs51.2bn in FY10 to Rs.73.6 bn, driven by (1) aggregate volume growth of 15% CAGR, led by replacement demand in T&B segment, as well as stronger demand from auto OEMs, across segments, and (2) ~6% blended ASP increase in FY11 and 2% in FY12, given favourable demand-supply environment..

Chart 10: Apollo standalone sales development

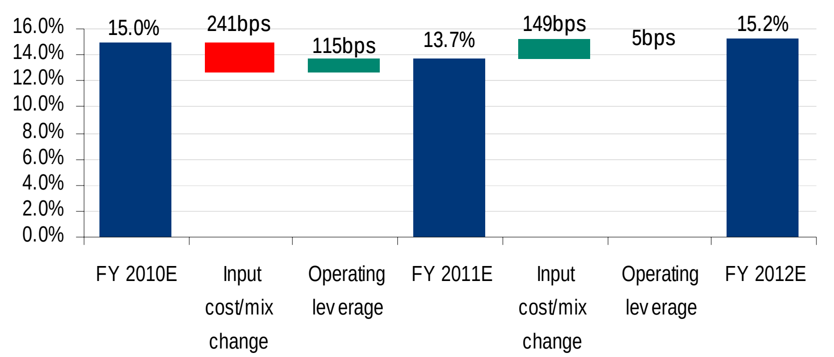


Source: BofA Merrill Lynch Global Research

Margin decline adequately factored to reflect cost pressures

Apollo's YTD margins are up 535bp, at 15.5%, due to stronger sales, better realizations and lower NR prices (down 13% YoY at 2Q). However, recent surge in input costs will be reflected through a 340bp decline in margins in 4Q. Over FY10-12E, we estimate margins to increase ~20bp to 15.2%, due to higher input costs, only being fully compensated by price hikes and operating leverage.

Chart 11: Margins picking up from FY11



Source: BofA Merrill Lynch Global Research

Earnings growth to moderate

We estimate net profit growth of 253% this fiscal, in line with strong operational performance on a low comparable base. Over FY10-12, we expect growth to moderate to 18% annually, restricted by higher depreciation and interest costs. As a result, we expect net margins to decline to 7.2% in FY12.

Sensitivity to key variables

Apollo's earnings are highly sensitive to rubber prices. For instance, a 5% change in the price of rubber will impact FY11E profit by 22%. In our base case scenario, we assume natural rubber price at Rs140/kg, in line with present trends.

Table 16: EBITDA and PAT sensitivity

	Impact in FY11	
	EBITDA	PAT
5% increase in rubber cost *	(13.0%)	(18.7%)
5% increase in volumes	4.6%	7.0%

Source: BofA Merrill Lynch Global Research * natural plus synthetic

Cash flows to improve

We estimate cash flows from operations to increase to Rs9.1bn from Rs6.2bn over the next two years, mainly due to higher profitability and stable working capital requirements. However, given the strong capex requirements, we expect the company to revert to free cash flows only in FY12.

Capex to expand radial tyres capacity

Apollo has lined up capital expenditure of Rs20bn over FY09-12E, for a mix of greenfield (new unit in Chennai) and brownfield expansion (Vadodara) in radial tyres. The first phase is scheduled for commissioning in March, both in the T&B segment (1000 tyres/ day), and PCR (5500/day) segments. We expect this capacity to be ramped up to 4,000 tyres/day and 7,000 tyres/day, respectively, by end-FY12.

Gearing ratios comfortable despite higher borrowings

Apollo's comfortable gearing (67%) and strong cash generation (estimated at Rs4.0bn over forecast period) allows the company to fund capex through a mix of debt and internal accruals. We estimate Apollo's gearing to fall to 51% by FY12.

Table 17: Standalone Balance Sheet summary

Rs. Mn	FY09	FY10E	FY11E	FY12E
Sources of Funds				
Share Capital	504	504	504	504
Reserves and Surplus	13053	15901	18858	22753
Total Shareholders Funds	13557	16405	19362	23257
Total Loans	6955	11955	15455	15455
Deferred Tax Liability	1561	2060	2583	3273
Total sources of funds	22073	30420	37401	41985
Application of Funds				
Total Fixed Assets	14247	21019	27513	29562
Goodwill	0	0	0	0
Investments	2974	6974	6974	6974
Net Current Assets ex cash	1444	1539	1765	1914
Cash and Bank balances	3406	887	1147	3532
Total application of funds	22073	30420	37401	41985
Key ratios				
Debt/equity	26%	67%	74%	51%
Fixed aset turnover (x)	2.86	2.44	2.29	2.49
Total asset tunover (x)	1.84	1.68	1.68	1.75
Current ratio (x)	1.87	1.29	1.28	1.45
Interest cover (x)	3.39	8.83	6.20	7.03

Source: BofA Merrill Lynch Global Research

Return parameters to blip next year

ROCE would improve significantly in FY10 on strong earnings growth. However, it would moderate by 40bp over FY10-FY12 on higher capex and lower profitability. We expect ROCE to increase from 10% in FY09 to 21% in FY10, and thereafter increasing to 22% in FY12.

Table 18: ROE and ROCE to decline next year

	FY09	FY10E	FY11E	FY12E
ROE	8.0%	23.0%	20.6%	22.6%
ROCE	10.3%	21.2%	19.1%	22.0%

Source: BofA Merrill Lynch Global Research

Global operations earnings accretive

Over FY10-12E, we expect Apollo's overseas acquisitions, Dunlop in South Africa (now Apollo Tyres South Africa) and Vredestian Banden (VBBV) in Netherlands (Apollo Vrendestein), to register 13% sales CAGR and 32% profit CAGR, respectively. Collectively, we expect these businesses to contribute 33% of Apollo's sales and 23% of profits in FY12E.

Vredestein Banden, a valuable acquisition

Apollo acquired VBBV earlier in May 2009, following bankruptcy of its parent Amtel-Vrendestein NV, Russia's largest tyre maker. Apollo is yet to disclose the acquisition price due to regulatory requirements, but we estimate the enterprise value (EV) at EUR175m, based on 2008 EV/EBITDA of 5.2x, equivalent to ~34% discount to European tyre manufacturers. Apollo has funded the acquisition (cash outflow of €104mn/Rs6.9bn, net of assumed debt of €71mn) through a mix of Rupee loan and internal cash accruals.

Operations are highly profitable

VBBV operates in the high performance and winter tyres segment, catering to the EU market through a well established network of sales subsidiaries. Over the past five years, the company registered 8% sales CAGR (2008 sales, €307mn). Also, similar to other European manufacturers operating in a premium market, it has consistently maintained healthy margins of 11-17%. The 2008 margin of 11% was mainly due to recessionary conditions. In 2009, the company sold 5.2mn tyres, a 2% yoy growth when the European passenger car tyre market declined 9% YoY, and EBITDA margins YTD has bounced to 16%.

Access to developed market, technology

We believe VBBV's acquisition is in line with Apollo's strategy of becoming a global player and provides a good platform to establish itself in the high-margin European PCR market. Apollo would also gain access to superior PCR technology.

Acquisition to be EPS accretive

We estimate this acquisition to be EPS accretive from the date of acquisition. We also expect VBBV to benefit from increased outsourcing by leveraging low-cost facilities of Apollo in South Africa and India. Based on our forecasts, we expect the company to operate at an EBITDA margin of over 13%.

Table 19: Vredestein Banden financial summary

Rs. Mn	FY09	FY10E*	FY11E	FY12E
Net sales	19571	17207	22651	23557
EBITDA	2153	2323	2945	3251
EBITDA margin	11.0%	13.5%	13.0%	13.8%
PAT	283	569	938	1191

Source: BofA Merrill Lynch Global Research; * for 10 1/2 months

Dunlop acquisition marked global foray

In April 2006, Apollo acquired Dunlop, the third largest tyre manufacturer in South Africa for an EV of $130mn. Equity value worked out to $64mn (equivalent to Rs2.9bn). Dunlop operates in the TBR, high-performance PCRs and light vehicle segments through two manufacturing facilities and has a strong distribution network across Africa and Europe. It has registered a 7% CAGR over the past three years, and account for 12% of Apollo's consolidated sales.

Synergistic benefits of acquisition

1. Access to T&BR technology, which is seen to provide a competitive advantage relative to peers while creating manufacturing facility in India.

2. Optimization of raw material costs through combined sourcing.

3. Leveraging sales and distribution network in Africa, Europe as well as Australia to scale up exports from India.

Operations beginning to look up

Margins slipped to 6% in 1Q this year, when the company registered a profit of Rs12.5mn. Operations have subsequently recovered, with 3Q sales up 46% YoY (led by ~30% rebound in volumes) and EBITDA margins reverting to double digits.

Economic recovery to drive growth

Following the 1% YoY decline in GDP last year, industry forecasts peg growth to be in positive territory in 2010. With this, we expect Apollo Tyres South Africa to revert to historical growth rates of 6-7%. We also expect double-digit margins over our forecast period, driven by demand recovery and improved utilization, as well as pricing discipline among manufacturers.

Table 20: Dunlop South Africa financial summary

Rs. Mn	FY08	FY09	FY10E	FY11E	FY12E
Net sales	10,069	9,176	11,125	11,876	12,826
EBITDA	1,411	1,041	1,057	1,158	1,321
EBITDA margin	14.0%	11.3%	9.5%	9.8%	10.3%
PAT	515	317	344	385	525

Source: BofA Merrill Lynch Global Research

Valuation: Buy for 40% upside

We value Apollo at 3.8x FY12E EV/EBITDA, in line with historical average, given the company's growing scale of operations and expectations of reduced earnings volatility. At our PO of Rs92, the stock would trade at a 50% P/E discount to its global counterparts.

Trades at steep discount to global peers

Compared with global peers under the BoFA-ML universe, Apollo trades at a sizeable discount of ~50% on EV/EBITDA and ~65% on P/E, again due to the differential scale. Although Apollo targets to become a relevant player in the international market, this will take time. Until then, we expect the significant discount in its share price to be maintained.

Table 21: Global comparison

	P/E			EV/EBITDA		
	2009	2010	2011	2009	2010	2011
Continental	NM	29.3	12.2	4.5	5.4	4.8
Michelin	80.0	11.6	9.0	7.2	5.5	4.6
Nokian	42.2	16.5	12.5	17.6	10.1	8.5
European average	61.1	19.1	11.2	9.8	7.0	6.0
Cooper Tire	10.7	11.5	11.1	6.3	6.4	6.1
Goodyear	NM	19.5	9.1	8.9	5.1	4.5
US average	10.7	15.5	10.1	7.6	5.7	5.3
Bridgestone	1156.4	29.9	18.0	8.9	8.3	6.9
Global average	23.9	21.5	13.1	8.8	7.0	6.0
Apollo	9.3	8.2	6.3	5.4	4.7	3.8

Source: BofA Merrill Lynch Global Research

Historical multiples remain key benchmark

Historically, Apollo has traded at seemingly low one-year forward multiples of 3.7x on EV/EBITDA and 3.4x on P/E. We attribute this not just to the cyclical nature of the user industry and the volatility in earnings due to commodity price movements, but also the scale of the company's operations.

Chart 12: P/E band

Source: BofA Merrill Lynch Global Research

Chart 13: 1 year forward EV/EBITDA

Source: BofA Merrill Lynch Global Research

Valuation largely in line with historical average

We value Apollo on FY12E EV/EBITDA of 3.8x, in line with its historical average. Our target multiple still implies a 30% discount to the global average. At our PO, the stock would trade at 6.3x FY12E P/E, a ~50% discount to the global average.

Price objective basis & risk

Apollo Tyres Ltd (XAPYF)

We value Apollo Tyres at 3.8x EV/EBITDA FY12E, broadly in line to its historic average. At our PO of Rs 92, the stock would trade at P/E of 6.3x FY12E. Risks: Economic slowdown, which would adversely affect volume growth, and rising commodity prices,including rubber and petro-based raw materials, which could hurt profitability.

Analyst Certification

I, S.Arun, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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India - Autos Coverage Cluster

Investment rating	Company	BofAML ticker	Bloomberg symbol	Analyst
BUY				
	Apollo Tyres Ltd	XAPYF	APTY IN	S.Arun
	Bajaj Auto	XBJBF	BJAUT IN	S.Arun
	Eicher Motors	XEICF	EIM IN	S.Arun
	M & M	MAHHF	MM IN	S.Arun
	M & M -G	MAHMF	MHID LI	S.Arun
	Maruti Suzuki India	MUDGF	MSIL IN	S.Arun
	Tata Motors Ltd.	TTM	TTM US	S.Arun
	Tata Motors Ltd.	TENJF	TTMT IN	S.Arun
	TVS Motor	XFKMF	TVSL IN	S.Arun
NEUTRAL				
	Hero Honda	HRHDF	HH IN	S.Arun
UNDERPERFORM				
	Ashok Leyland	XDBVF	AL IN	S.Arun

India - Autos Coverage Cluster

Investment rating	Company	BofAML ticker	Bloomberg symbol	Analyst
RVW				
	Bharat Forge	XUUVF	BHFC IN	S.Arun

iQmethod [SM] Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

iQmethod [SM] is the set of BofA Merrill Lynch standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and validations. The key features of iQmethod are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

iQdatabase ® is our real-time global research database that is sourced directly from our equity analysts' earnings models and includes forecasted as well as historical data for income statements, balance sheets, and cash flow statements for companies covered by BofA Merrill Lynch.

Important Disclosures

Investment Rating Distribution: Autos Group (as of 01 Jan 2010)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	45	59.21%	Buy	26	70.27%
Neutral	17	22.37%	Neutral	8	61.54%
Sell	14	18.42%	Sell	9	75.00%

Investment Rating Distribution: Global Group (as of 01 Jan 2010)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1699	50.78%	Buy	904	58.82%
Neutral	841	25.13%	Neutral	491	65.03%
Sell	806	24.09%	Sell	368	49.80%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where BofAML Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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