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MF Global

Date: 08th April 2010

MF Global Sector – Tyre Industries

CEAT – new capacities to drive growth

Initiating Coverage: Buy

CMP: Rs 157

Target: Rs 216

Investment Rational

Ceat, part of the RPG Group, is one of India's leading tyre manufacturers in the country. In FY2009, the company manufactured 7.2mn tyres (4.5mn from own capacity & rest 2.7mn were outsourced) and registered a turnover of Rs27, 584mn. Ceat has strong brand equity and is well entrenched in both the domestic and international markets, we expect its new facilities to bring in efficiencies in operations and enable it to capture growth opportunities.

Positive domestic industry outlook: Consistently high capacity utilization levels of around 90% over the last 3-4 years typically implies either very strong demand or constraints on the supply side, both of which should push product prices upward, and such indications have been forthcoming from the domestic Tyre industry. This can be visible, as most of the tyre companies have announced price revision

Capacity expansion for CV's radial tyres are on verge of commissioning: Ceat's proposed capacity expansion of 130tpd green-field CV's Radial tyre facility at Halol & brown field expansion of 30 TPD at Nasik is expected to be commissioned by Q2FY11. That would take its total capacity to 570TPD. We believe this will give a robust volume growth in years to come, we assume volume growth at CAGR of 17-18% FY10E -12E.

Revival in global economy will lead to traction in exports: Ceat has a global footprint and with exports to over 110 countries. Ceat's products have found high acceptance with several OEMs in Europe amidst stiff competition from other global majors. With revival in we expect pricing power to return to tyre companies.

Relocation of Bhandup (Mumbai) plant : Ceat has procured 50-acre land at Ambarnath, (Thane, Maharastra) for the purpose of shifting its Bhandup plant. We expect that the proposed relocation can improve margin, as the plant at Bhandup is less energy efficient & finished goods produced in Mumbai is Octroi leviable, which will be mitigated by the proposed relocation.

Valuations: In the Tyre space Ceat is available at attractive valuations compared to its peers. At the CMP of Rs163, the stock is trading at 4.3x of Average of FY2011E-12E Earnings and FY2012E EV/EBITA of 3.7x, which compares favorably versus its peers. More-over, considering the price Ceat was able to fetch for its seven acre land, it will be able to get ~Rs4450mn for the remaining 24 acre land, which we believe will give additional cushion to the stock. **We Initiate Coverage on the stock with a Buy recommendation and Target Price of Rs216, giving an upside of 33% from current levels.**

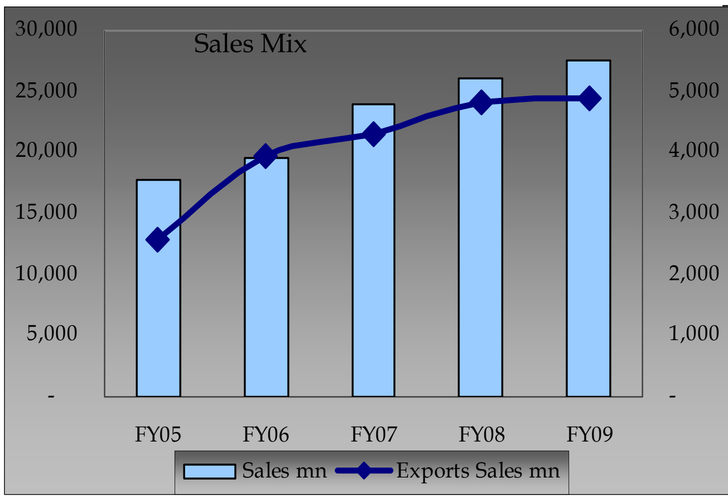
Sensex	17970
Nifty	5374
Stock Data	
BSE Code	500878
NSE Code	CEATLTD
Bloomberg	CEAT IN
Reuters	CEAT.BO
Shares Issued (mn)	34.27
Market Cap (Rs mn)	5393
52 Wk H/L (Rs)	190/33
Face Value (Rs)	10
Avg. daily vol. (12M)	1,17,723

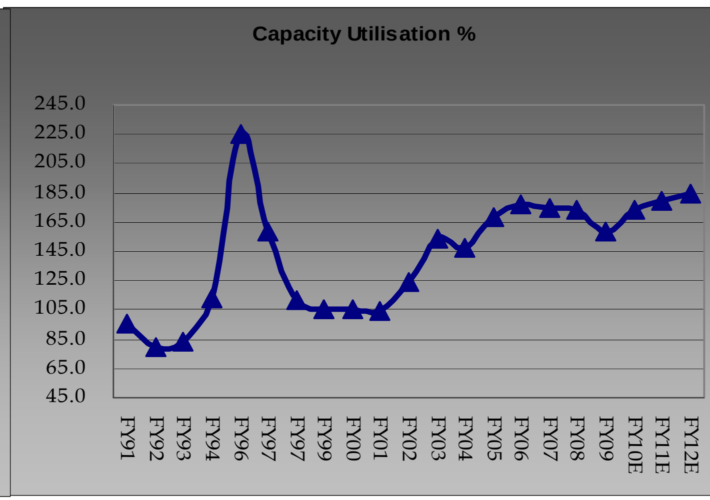
Return	1m	3m	12m
Absolute	10	10	289
Rel. to Sensex	5	7	219

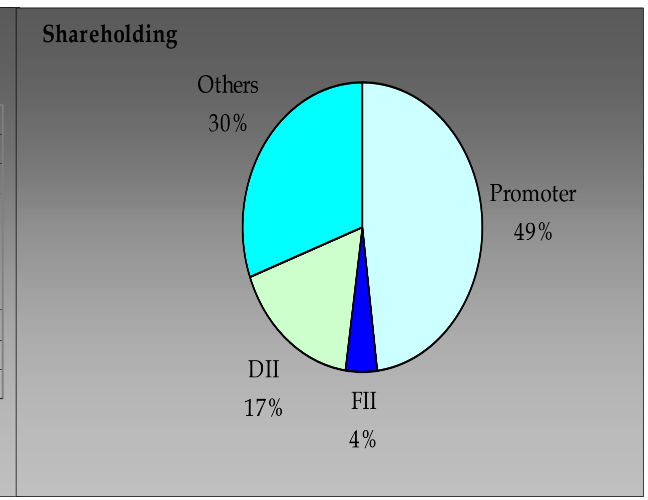
	FY10E	FY11E	FY12E
EPS (consol)	49.3	33.3	43.3
CEPS	57.5	45.1	58.5
BVPS	192.0	225.3	268.5
ROCE (%)	12.5	7.1	8.9
RONW (%)	25.7	14.8	16.1

Company Overview

Ceat, part of the RPG Group, is one of India's leading tyre manufacturers in the country. In FY2009, the company manufactured 7.2mn tyres (4.5mn from own capacity & rest 2.7mn outsourced) and registered an annual turnover of Rs27,584mn. Ceat has a strong brand equity and is well entrenched in both the domestic and international markets. The company has a domestic presence with 34 regional offices, more than 3,500 dealers, among which approximately 100 are exclusive dealers running the CEAT Shoppe outlets for passenger cars segments and 96 exclusive dealers running the CEAT HUBs for Truck & Bus Segments. It is one of the largest tyre exporter from India, exporting to over 110 countries worldwide. Ceat also has long-standing business tie-ups with the all the major OEMs. Ceat manufactures a wide range of tyres, which cater to almost all users including heavy-duty trucks and buses, light commercial vehicles, earthmovers, forklifts, tractors, trailers, cars, motorcycles and scooters, specialty tyres, radials and three wheelers. It also markets tubes and flaps, which are outsourced from its partners. It has two manufacturing units located at Mumbai and Nasik. During the year 2007-08, the company successfully de-merged, the investment book of the company which was transferred to CHI Investments with effect from July 1, 2007.







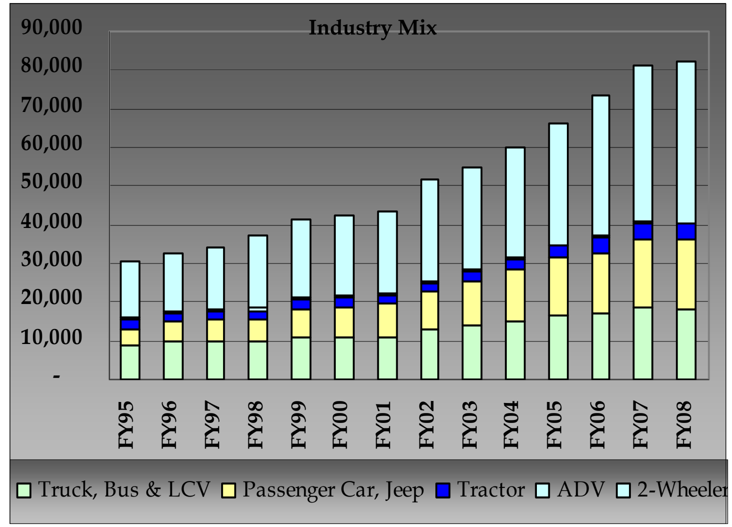
Source:MF Global PCG Research, Company, Capital line

Industry Overview

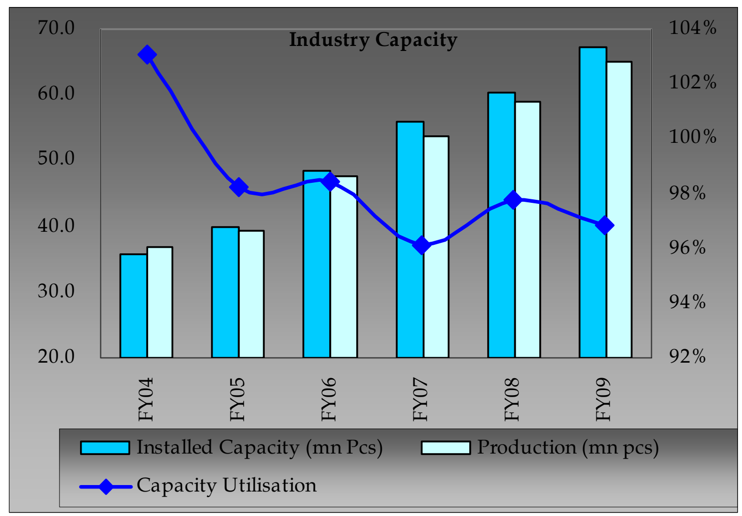
The global tyre market is valued at $ 120 bn comprises of about 60% of Passenger Cars (PC) and Light Commercial Vehicles (LCV) segments while Heavy Commercial Vehicles (HCV) segment accounts for approximately 27%. The top four players share more than 60% of the automobile tyre market. Predominantly, Radial tyres are used in PC, LCV and HCV segments. The radialisation in PC is more than 95% and about 60% in LCV and HCV segments. The extent of radialisation in LCV and HCV is higher in developed countries.

Indian tyre industry is approximately worth Rs. 225 bn with four major players: Apollo Tyres, Ceat, JK Tyres & MRF. These companies account for around 75% of the industry's turnover with a well diversified product mix and presence in all three major segments i.e. Replacement market, OEMs and Exports. The demand and growth for the industry depends on primary factors like: overall GDP growth, agricultural & industrial production growth, and secondary factors like infrastructure development, prevailing interest rates and financing options. Unlike the global industry, where radials for passenger car dominate the market, the Indian industry is primarily dominated by commercial vehicle tyres which accounts for approximately 70% of the industry turnover. However, the industry has seen a significant growth in passenger car radials over the years with a 5 year compounded annual growth rate (CAGR) of ~14%. Another significant difference between the Indian and the global tyre industry, is the extent of radiatisation in the commercial vehicle tyres. Globally, commercial vehicle tyres are radialised to the extent of 60% as compared to India where the radialisation levels in this segment until last year was only 10-12%. However, this trend is gradually changing and it is expected that radialisation levels will go up to the extent of 30% in the next 2- 3years. The tyre industry is highly raw material sensitive and a major consumer of natural rubber.

Consistently higher capacity utilization levels of around 90% over the last 3-4 years typically implies either very strong demand or constraints on the supply side, both of which should push product prices upward, and such indications have been forthcoming from the domestic Tyre industry. This is also evident, as most of the tyre companies have announced consequent price revision, due to better pricing power.



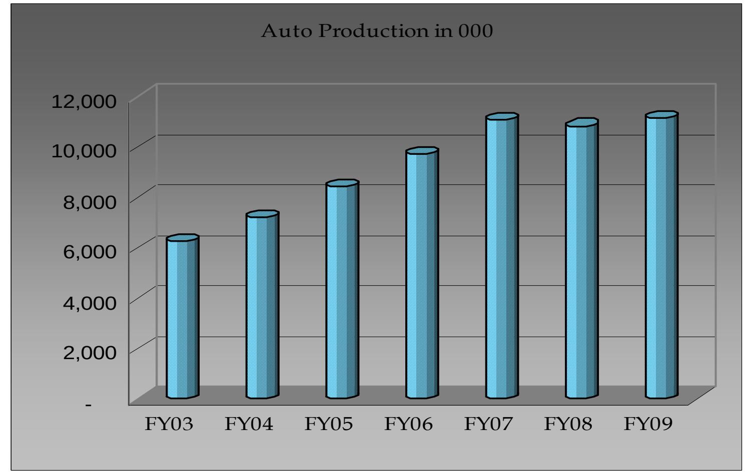
Source:MF Global PCG Research, Company, Capital line, ATMA



Source:MF Global PCG Research, Company, Capital line

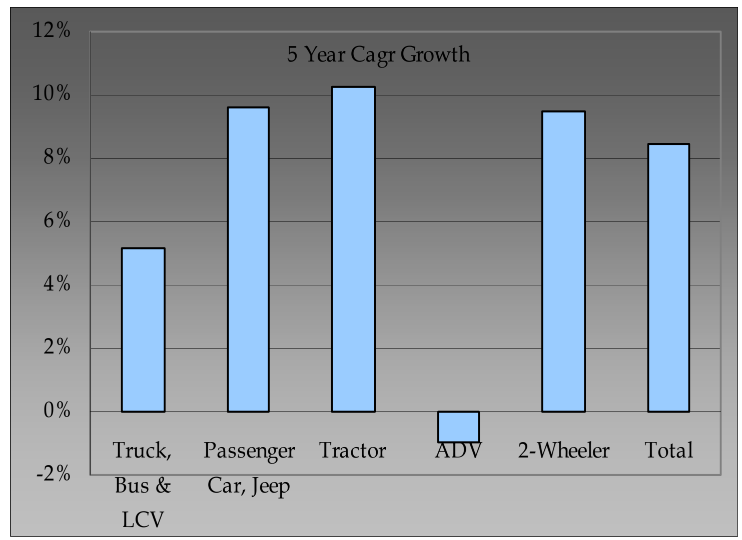
Investment Rational

Buoyant OEM's and replacement demand: The Auto industry has witnessed healthy growth in the last few years, except FY2009 which was an aberration. Rising levels of industrial and agricultural production, infrastructure and road development, growing income levels and increasing propensity to consume are likely to keep the domestic vehicle demand, and in turn OEM tyre off-take, buoyant. The Replacement Segment constitutes more than 60% of the industry's tyre off-take, and is a key focus area for the tyre manufacturers. As compared to sales to OEMs, Margins are higher in the replacement Segment. Going forward, Replacement demand are expected to grow faster given the high growth in vehicle sales seen over the last few years. With a sharp increase in vehicle population, we see a corresponding pick up in replacement demand. We believe that with the robust distribution network & major proportion of business from replacement market Ceat will be beneficial. We expect that demand for tyres (in volume term) shall grow at a CAGR of 17-18% during FY2010- 12E. However, we believe that Ceat will outperform industry growth by 1-2x in years to come, because of its new capacity at Halol expected to commissioned by Q2FY11E.



Source:MF Global PCG Research, Company, SIAM

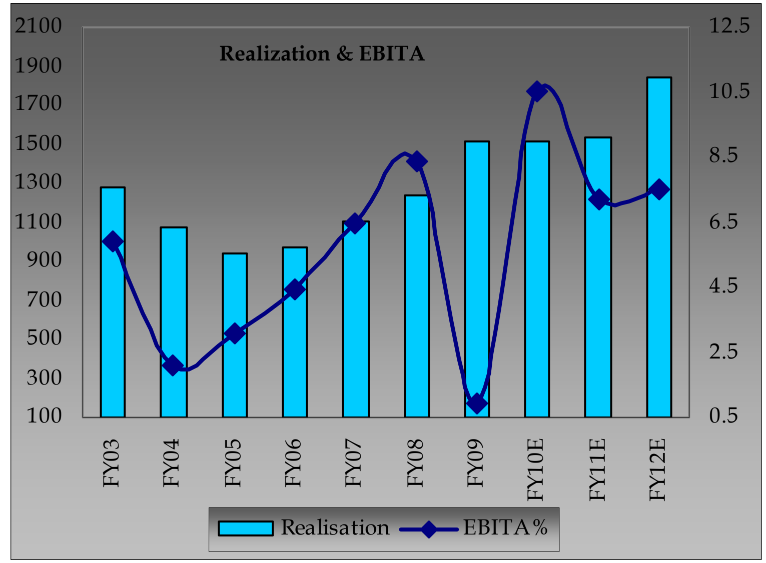
Green-field & brown field capacity expansion for T&B radial tyres are on verge of commissioning: Radial tyres offer better fuel efficiency and work out to be more cost-effective over the life of the tyre. In India, the PC segment has already achieved around 95% radialisation. However, T&B segment is only 10-12% radialisation against world average of 60%. The poor road infrastructure make radial tyres unviable for T&B segment. However, due to ban on overloading of trucks and government emphasis on improving the country's road infrastructure, we expect an accelerated radialisation trend in the T&B space in the coming years. We expect increasing distribution of radial tyres to be the key enablers for the tyre companies. Ceat's proposed capacity expansion of 130 TPD Greenfield T&B radial tyre facility at Halol & brown field expansion of 30 TPD at Nasik is expected to be commissioned by Q2FY11E. That takes Ceat's total capacity to 570TPD from its current capacity of 410TPD. We believe this will give a robust volume growth in years to come, we have conservatively assume volume growth at CAGR of 17-18% FY10E -12E on the back of higher demand and capacity enhancement.



Source:MF Global PCG Research, Company, Capital line, ATMA

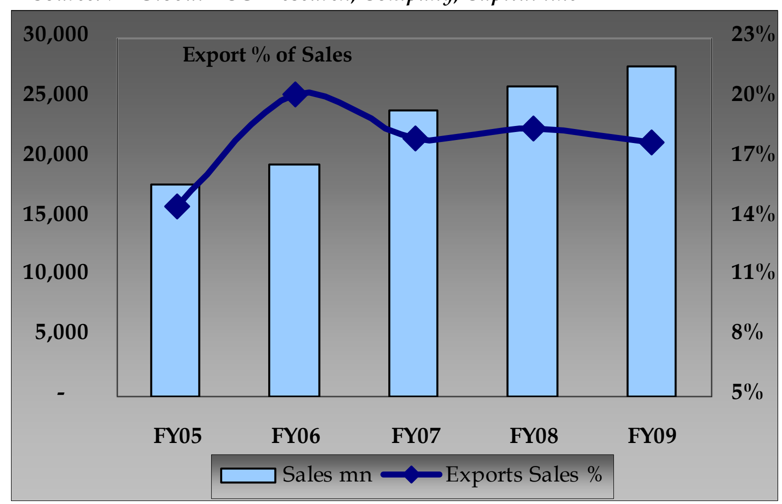
Investment Rational

Relocation of Bhandup (Mumbai) plant on cards: The company has procured 50-acre land at Ambernath, (Thane, Maharashtra) for the purpose of shifting its facility at Bhandup (Mumbai). This plant was the first plant of Ceat which has been built-up on an area of 31 acre out of which in 2007 company has sold 7 acre of land for Rs1200-1300mn. The realized fund were utilized for funding its Halol plant capex. Over the next 2-3 years, we believe that Ceat will gradually (in phased manner) shift its assets to new location to Ambernath. Bhandup plant, has major draw-back of high-energy cost, lower efficiency (being an old facility) & octroi duty. We believe that company will be having a freehold land of 24 acres at Bhandup subsequent to completion of its facility at Ambernath, which could be worth ~Rs4-5bn. We further believe that the execution of proposed relocation can improve margin, as currently the plant located at Bhandup is less energy efficient & finished goods produced in Mumbai is Octroi leviable, which will be mitigate by the proposed relocation. We have not consider the impact of margin expansion in our estimates.



Source:MF Global PCG Research, Company, Capital line

Revival in global economy will lead to traction in export demand: Ceat has a global footprint with exports to over 110 countries. Ceat's products have found high acceptance with several OEM's in Europe amidst stiff competition from other global majors. Over the years, the company's export basket has improved in terms of price realizations and profitability. We believe that with the revival in global market the demand would also increase and with an established presence across countries Ceat will be the beneficial of increase in the demand. Therefore, we expect that contribution from replacement market and export sales to increase which will lead to higher realization vis-à-vis improvement in Operating profit. The traction in Export market will also give negotiable power to tyre companies with domestic OEM's.



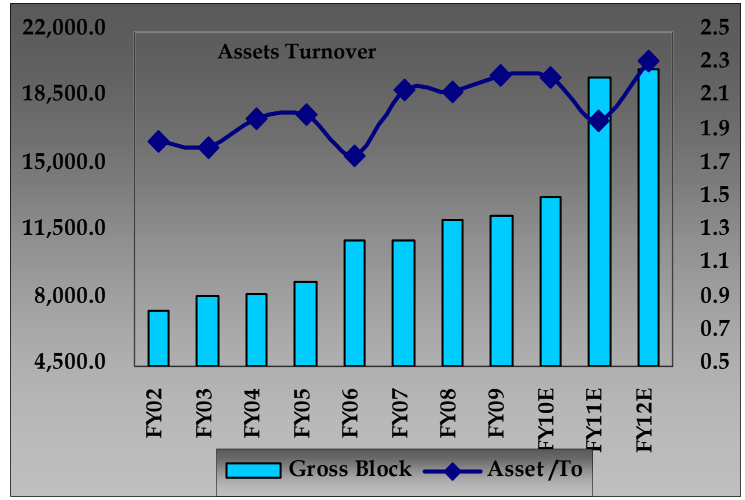
Source:MF Global PCG Research, Company,

Financial Overview

During FY2009-12E, we expect Ceat to report a CAGR of 19% in revenues, which would primarily come from volume as the new plants are likely to be commissioned. We believe that execution of proposed green field project at Halol will commission by Q2FY11E, will lead to volume growth, and the improvement in proportion of sales from replacement & exports improve realization vis-à-vis profitability.

Foresee stable margin scenario, can expand post FY12: For the H1FY10 Ceat has reported enormous EBITA margin but that was majorly because of holding of low cost raw material inventory, which is one off, it is visible in Q3FY10 results. We believe that with the proposed increase in price, improvement in product mix i.e. increase in proportion sales from replacement & export market the sustainable EBITA margin for the company would be 7.2-8.0% for FY11E-12E. Going ahead post FY12E, we expect further expansion in margin range from 100-200 bps due to relocation of high cost Bhandup plant, the expansion in margin we have not factored in our estimate.

Better pricing power will enable pass-on of increase raw material: Apart from natural rubber, most of the key raw materials are petro-based. Thus, price trends and demand-supply dynamics relating to natural rubber and crude oil have a significant bearing on the industry's margins. There is a strong inverse relationship between EBITDA Margins of any tyre company with the raw material prices, specifically rubber. Rubber accounts for around 50% of raw material costs. We expect strong demand from the replacement and OEM segments to continue, which we believe will not result in further reduction in realizations. In the last three months, the natural rubber prices have been moving up to Rs154/kg. We have assumed blended rubber prices of Rs138/kg and Rs152/kg for FY2011E and FY2012E, respectively. Going ahead we expect the margin to stabilize, as the company will pass on the rise in raw material cost to the consumers.



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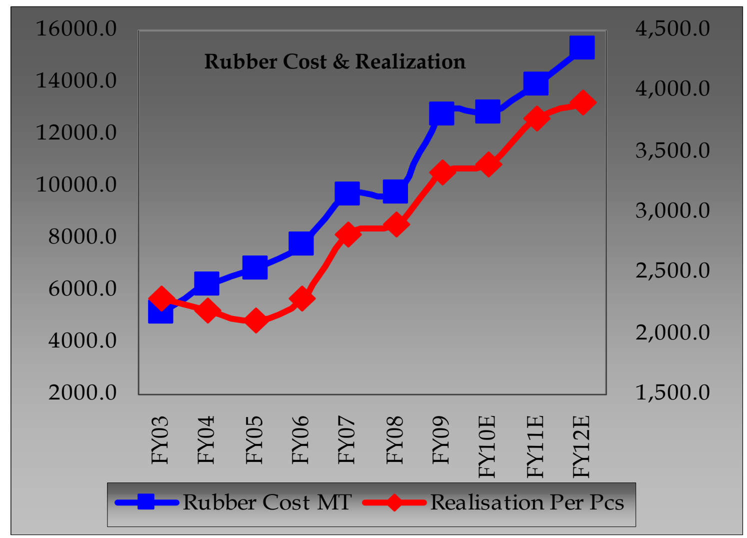
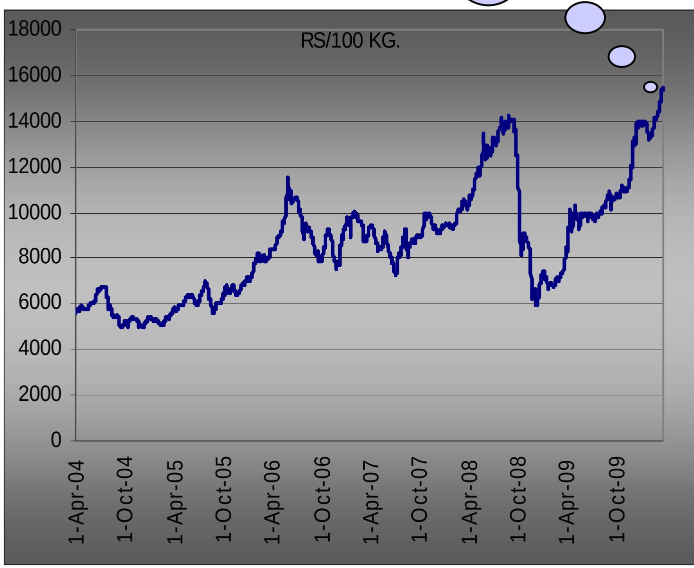


Source:MF Global PCG Research, Company, Capital line

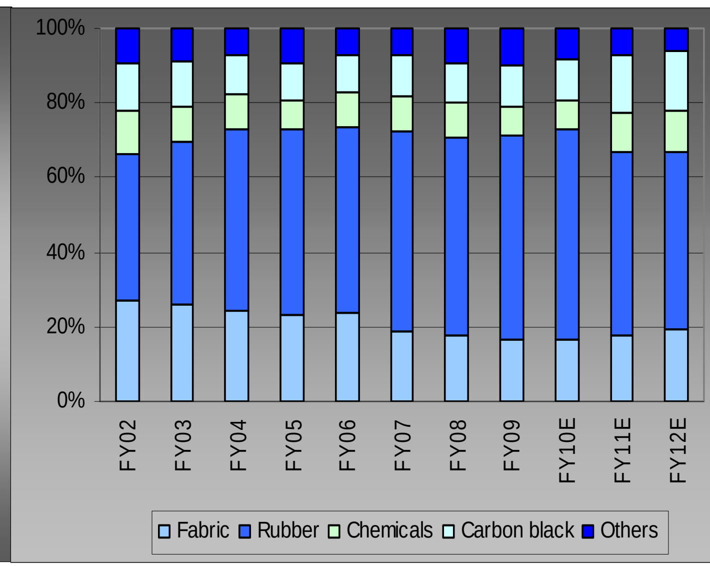
Financial Overview

Profitability cycle to move upward: Higher realizations and softening natural rubber prices in H1FY2010 resulted in an improvement in margins. But going forward we expect PAT margins to improve from 2% in FY2007 to 3.2% in FY2011E. We expect Ceat to post a CAGR of 14% in earnings over FY2007-12E to Rs1,485mn, In line with profitability, Return Ratios are also expected to improve going forward. We also believe that the scraping of Octroi or proposed relocation of plant would substantially improve the PAT margin bringing it at par with the industry standards from FY12E onwards

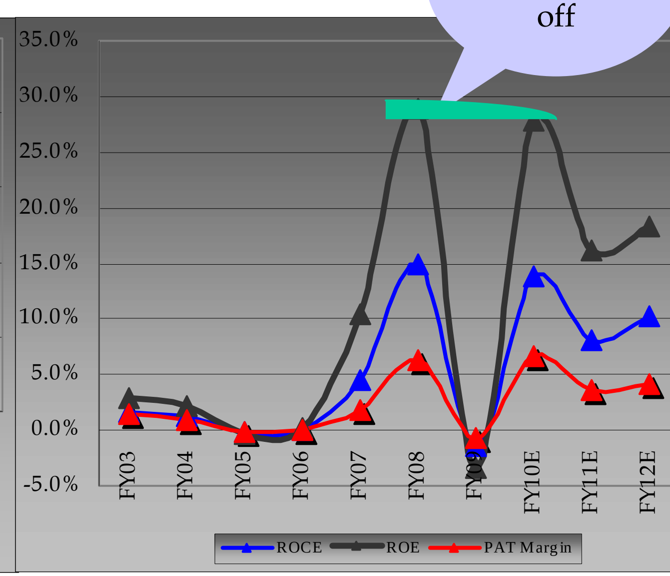
Rubber Price



Raw Material Break Up



Return Ratio



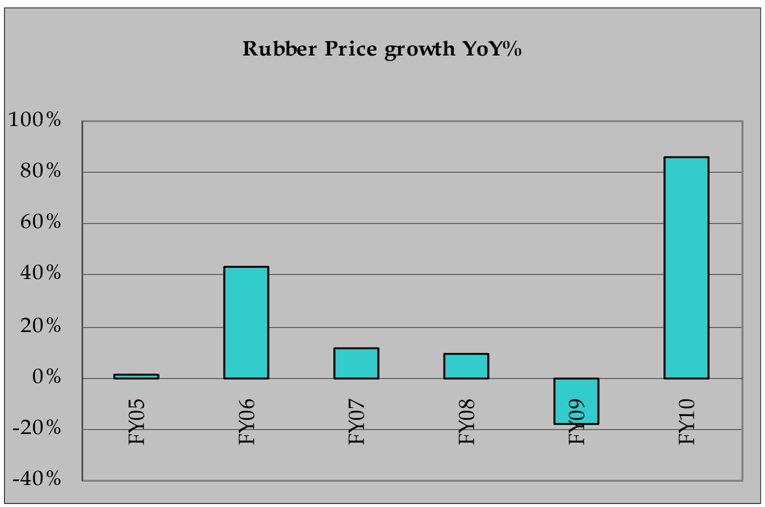
Source:MF Global PCG Research, Company, Capital line

Concerns

Increase in raw material prices: The Tyre sector is currently facing high cost-push pressures, with the prices of rubber and carbon black ruling high. Any upward movement in the prices of these commodities could erode Margins, particularly if company is not able to pass as it had happened last year. However, chances of repeating situation looks low as the Tyre industry is running at above 90% capacity utilization. Currently natural rubber prices is at high, the prices are ruling at Rs 140/kg. We have assumed 8.5% rise in rubber prices in FY2011E and a further of 10% in FY2012E. Any additional rise in Rubber prices could affect our forecast. However, in the immediate past Ceat has been able to pass on the rise in raw material prices and have maintained their Margins. Hence, in our projections too we have factored in certain price hikes

Competition to squeeze away market share: Competition in the Tyre industry is intense as companies are competing on product design, performance, price, reputation, warranty terms, customer service and convenience. In India, Ceat faces competition from six key players including MRF, Apollo, Goodyear, JK, Birla Tyres and Bridgestone. Moreover, China remains a key threat particularly in the Replacement market due to its cost competitiveness. However, we believe that the credit period offered and imposition of Anti Dumping duty and after-sale service are important aspects on which the Chinese cannot compete with the domestic players.

Company has been underperforming as compared to peers: Ceat had a disadvantage due to lower radial capacity, lower performance efficiency due to old plant and Octroi duty on finished goods for 40-45% of its production, which has historically suppress margins by 300-350bps as compared to the industry peers. We expect with new capacity additions & proposed relocation will mitigated the concern and led to re rating , but if any delay in proposed project impacts our rerating thesis.



Source:MF Global PCG Research, Company, Capital line

	M Cap	Current P/E	FY11E	FY12
Apollo Tyres	3,681.70	8.24	8.59	8.59
MRF Ltd	2,921.00	7.11	9.87	9.27
Balkrishna Indus	1,223.30	7.32	6.58	5.81
Jk Tyre & Ind	805.00	5.36	3.82	4.38
Ceat Tyre	523.00	2.74	3.22	3.76

Source:MF Global PCG Research, Company, Capital line, Reuters

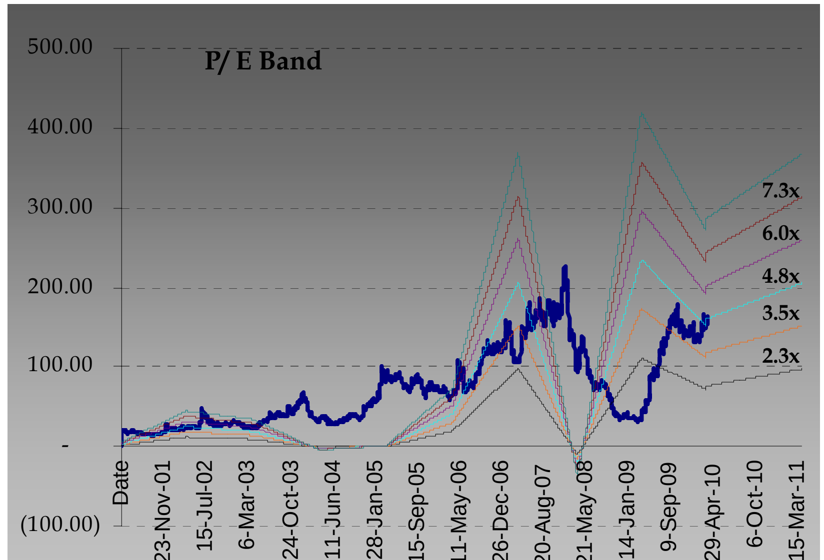
Valuations

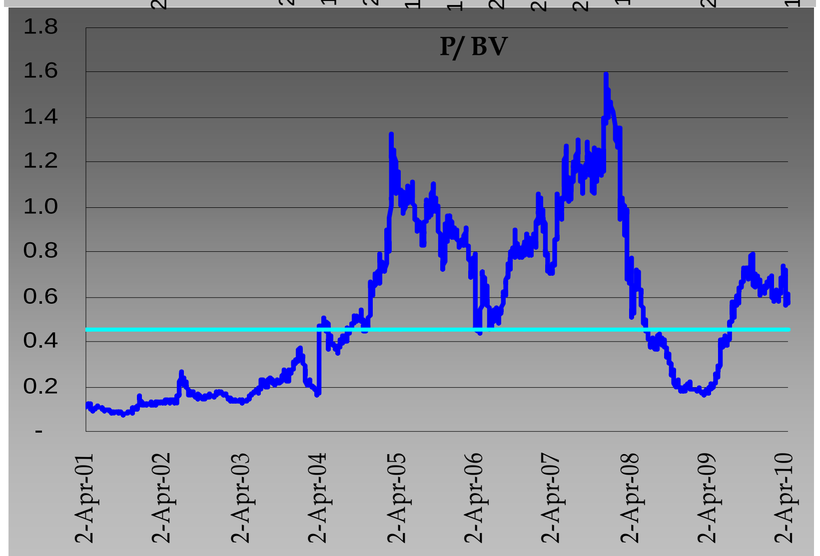
Ceat along with other tyre manufacturers has proposed to hike its tyre prices with the tandem of increase in Natural rubber price, which is indicative of a strong reversal in the pricing trend. Hence, we expect improvement in the profitability of ceat to sustain because of commissioning of new plant & Relocation of Bhandup plant.

Historically Ceat has been traded at discount to its Peers because of low margin, but we expect that the management has realized the low profitability instance & had initiated with capacity expansion in 2007 which is expected to commission in Q2FY10, And has proposed to relocate Bhandup plant to Amabarnath (land already acquired) which we expect will improve the profitability of the company, which led to rerating in company valuation.

In the Tyre space Ceat is available at attractive valuations compare to Peers. At the CMP of Rs163, the stock is trading at 4.3x of Average of FY2011E-12E Earnings and FY2012E EV/EBITA of 3.7x, which compares to peers looks high discounting.

Moreover, considering the price Ceat was able to fetch for its seven acre land, it will be able to get Rs4.5bn for the remaining 24 acre land, which we believe will give additional cushion to the stock**. We Initiate Coverage on the stock with a Buy recommendation and Target Price of Rs216, giving an upside of 33% from current levels.**





Financial Statements (in Rs mn)

Income Statement	FY08	FY09	FY10E	FY11E	FY12E
Net Sales	**23,276**	**25,185**	**28,077**	**35,709**	**42,800**
Raw Material	15,284	18,039	18,026	24,468	30,079
Manufacture & Oth exp	4,636	5,326	5,550	6,731	7,430
Employee Exp	1,413	1,585	1,541	1,928	2,063
Op profit	**1,943**	**234**	**2,960**	**2,581**	**3,229**
Opm(%)	8.3	0.9	10.5	7.2	7.5
Other income	1,025	450	174	144	204
Depreciation	330	256	281	405	521
Interest	665	799	503	691	795
PBT	**1,973**	**(372)**	**2,351**	**1,629**	**2,116**
Tax	487	(211)	662	489	635
PAT	**1,486**	**(161)**	**1,689**	**1,140**	**1,481**
Adj PAT	882	(158)	1,692	1,143	1,484
Npm(%)	3.8	0	6.0	3.2	3.5

Balance Sheet	FY08	FY09	FY10E	FY11E	FY12E
Equity capital	**342**	**342**	**342**	**342**	**342**
Reserves	4,790	4,541	6,230	7,370	8,852
Networth	**5,132**	**4,884**	**6,573**	**7,713**	**9,194**
Total debt	4,776	6,451	6,951	8,401	7,501
Deferred tax	273	163	163	163	163
Total liabilities	**10,181**	**11,498**	**13,687**	**16,277**	**16,859**
Gross fixed assets	**12,143**	**12,341**	**13,408**	**19,658**	**20,038**
Less: Cum depreciation	4,277	4,587	4,867	5,273	5,794
Net fixed assets	7,866	7,754	8,541	14,386	14,244
Capital WIP	35	196	2,500	-	-
Investments	96	427	416	16	16
Net current assets	2,184	3,122	2,230	1,876	2,598
Total assets	**10,181**	**11,498**	**13,687**	**16,277**	**16,859**

Financial Statements

Cash flow (in Rs mn)	FY08	FY09	FY10E	FY11E	FY12E
PAT & extraord. Items	1,486	(161)	1,689	1,140	1,481
Add: Int. depn. & oth. Exp.	340	146	281	405	521
Cash flow from op.	**1,856**	**(15)**	**1,970**	**1,545**	**2,003**
Net chg in w/c, tax, int.	(1,612)	662	(667)	(86)	(579)
Net cash flow frm op.	**244**	**647**	**1,303**	**1,459**	**1,423**
Capital expenditure	(995)	(392)	(3,372)	(3,750)	(380)
Sale/ purchase of inv	1,182	(331)	11	400	-
Net cash from inv.	**187**	**(723)**	**(3,361)**	**(3,350)**	**(380)**
Issue of eq/loan/warr.	(261)	1,676	500	1,450	(900)
Dividend paid	(160)	-	-	-	-
Net cash from financing	**(421)**	**1,676**	**500**	**1,450**	**(900)**
Net chg in cash	10	1,599	(1,558)	(441)	143
Op. cash bal	405	416	2,015	457	16
Cl. Cash bal	416	2,015	457	16	160

Ratios	FY08	FY09	FY10E	FY11E	FY12E
W/C Days					
Debtors Days	48.3	46.2	40.0	42.0	40.0
Inventory Days	47.8	29.0	33.7	28.5	31.2
Creditor Days	87.6	69.3	69.0	69.0	69.0
Per share data (Rs.)					
Adj EPS Stand	43.4	(4.7)	55.2	38.2	52.5
Book value	149.9	142.6	197.8	236.0	288.6
Cash EPS	53.0	2.8	63.4	50.1	67.8
Valuation(x)					
P/E	3.6	-	2.8	4.1	3.0
P/BV	1.0	1.1	0.8	0.7	0.5
EV/EBIDTA	5.0	40.0	3.6	4.7	3.5
Performance(%)					
RoCE	15.0	-	13.8	8.0	10.1
RoNW	29.0	-	27.9	16.2	18.2

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