Equity Research

September 27, 2016

BSE Sensex: 28294

Autos

Target price Rs1,507

Shareholding pattern

	Dec '15	Mar '16	Jun '16
Promoters	50.8	50.8	50.8
Institutional investors	33.3	34.1	31.2
MFs and UTI	4.4	2.3	3.2
Insurance Co	1.7	1.7	1.9
FIIs	27.2	30.0	26.1
Others	15.9	15.2	18.0

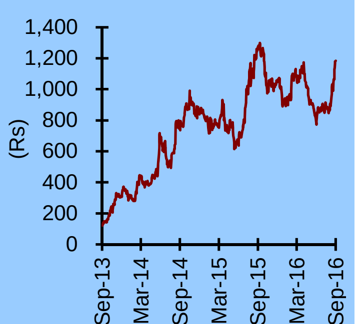
Source: NSE

I-Sec vs Bbg* consensus

(%)	FY17E	FY18E
Sales	(1.2)	0.3
EBITDA	(5.3)	1.0
PAT	5.3	12.0

Source: *Bloomberg, I-Sec research

Price chart



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INDIA

ICICI Securities

CEAT

BUY

Citius, Altius, Fortius!

Rs1,188

Reason for report: Initiating coverage

"A great business at a fair price is superior to a fair business at a great price"-Charlie Munger

We initiate coverage on CEAT with a BUY rating and a target price of Rs1,507, valuing the company at 10x average of FY18E and FY19E EPS of Rs151. Historically, tyre industry players have revenues skewed towards relatively lower-margin, higher capital intensity and intensely competitive truck and bus (T&B) segment. However, CEAT chose a different course from the norm and allocated capital strategically to the high-margin and brand conscious B2C segment (two wheelers, passenger cars, utility vehicles). We believe early investments in branding has entrenched CEAT's brand amongst its target audience and, coupled with increasing OEM presence, this market share moat could widen. We expect CEAT to register CAGRs of 13%/11%/14% in revenue, EBITDA and PAT respectively over FY16-FY19 as it continues to benefit from the strong revenue growth and high margins in the passenger segment.

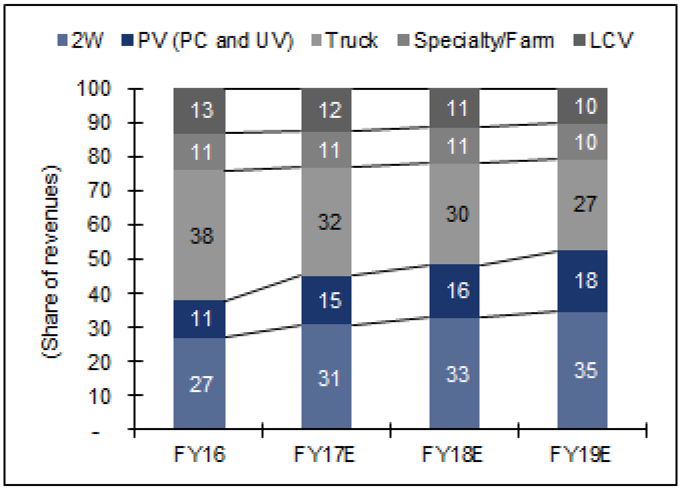
- **Capital allocation strategy:** Since FY11, CEAT focused its scarce capital towards the B2C segment, which intrinsically needed relatively low capital expenditure and is high-RoCE and high-margin. However, capital was wisely spent on branding which sowed the seeds of the current market share gains. CEAT's 2W market share rose to 27% in FY16 (FY11: 8%), and that of PC and UV to 7% and 15% respectively from non-existence in FY11. During the same period, the company's RoCE has risen to 29% from 10%.
- **Product development, reach and recall:** CEAT continues to invest in R&D and marketing activities to keep competition in check. New product launches (70 in FY16) have aided in partnering with new OEMs like Renault, Nissan, HMSI and new products like *Renault Kwid*, *M&M TUV 300* and *RE's Himalayan.* CEAT has expanded its distribution network to 4,300 dealers, 400 exclusive CEAT outlets, 240 multi-brand outlets and 45 shop-in-shop concepts in FY16. CEAT continues to launch smart advertising campaigns leading to increased brand loyalty. All of these efforts have aided the company in growing its volumes the passenger segment.
- **Capacity expansion, OHT foray:** CEAT is expanding its current capacity of 1000MT/day by ~28% over FY16-FY18 to 1,280MT/day. Around 82% of the new capacity addition (280MT/day) would be attributed to the passenger segment, letting the company maximise growth and profitability. The company's foray into the highly profitable OHT segment (>25% EBITDA margin play) also acts as a cushion against declining exports.
- **Balance sheet discipline:** CEAT has consistently focused on deleveraging and generating strong cashflows despite capital expenditure plans. Net debt/equity has reduced to 0.3x from a high of 1.9x in FY12, whereas operating cashflow has improved from Rs68mn in FY12 to Rs6.7bn in FY16.
- **Initiate with BUY:** We initiate coverage on CEAT with a **BUY** rating and a target price of Rs1,507/share based on 10x average of FY18E and FY19E EPS of Rs151 as we believe the company will continue to register strong operating performance on the back of continued focus on the high-margin passenger segment.

Market Cap	Rs48.1bn/US$720mn
Reuters/Bloomberg	CEAT.BO/CEAT IN
Shares Outstanding (mn)	40.5
52-week Range (Rs)	1300/773
Free Float (%)	49.2
FII (%)	26.1
Daily Volume (US$/'000)	10,353
Absolute Return 3m (%)	53.8
Absolute Return 12m (%)	(5.7)
Sensex Return 3m (%)	7.7
Sensex Return 12m (%)	11.1

Year to Mar	FY16	FY17E	FY18E	FY19E
Revenue (Rs bn)	54,941	59,039	67,598	78,410
Rec. Net Income (Rs bn)	4,525	4,446	5,446	6,747
EPS (Rs)	113.9	109.9	134.6	166.8
% Chg YoY	40.8	(3.5)	22.5	23.9
P/E (x)	10.4	10.8	8.8	7.1
CEPS (Rs)	138.7	140.7	169.9	205.5
EV/E (x) (Incl. Indus)	6.8	7.1	5.7	4.4
Dividend Yield (%)	1.0	1.2	1.3	1.7
RoCE (%)	29.4	23.5	24.2	25.7
RoE (%)	25.2	20.4	20.9	21.5

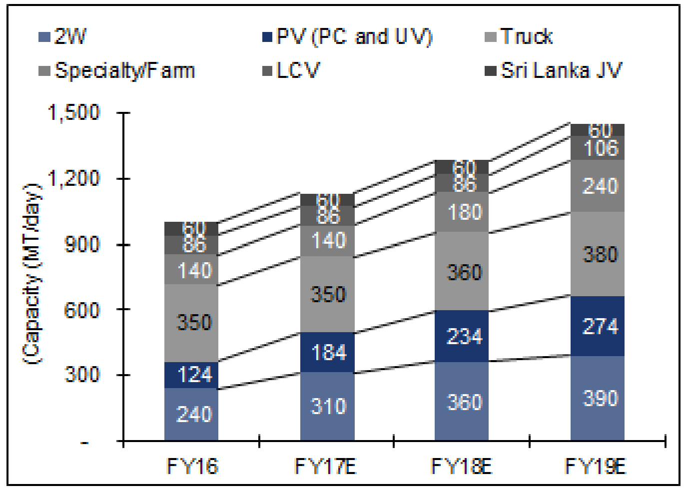
Story in charts

Chart 1: Product mix moving away from T&B



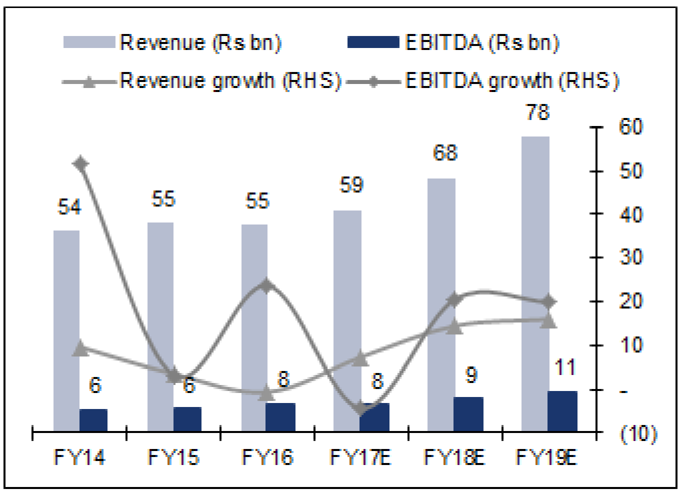
Source: I-Sec research, Company

Chart 2: Capacity being added in the B2C segment



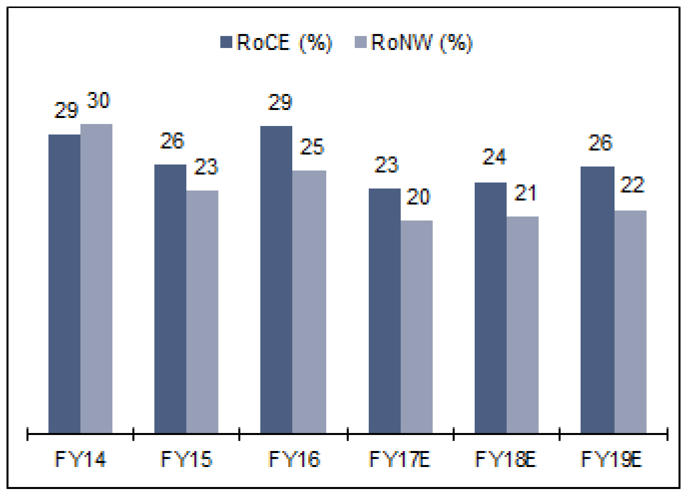
Source: I-Sec research, Company

Chart 3: Strong growth potential due to B2C focus



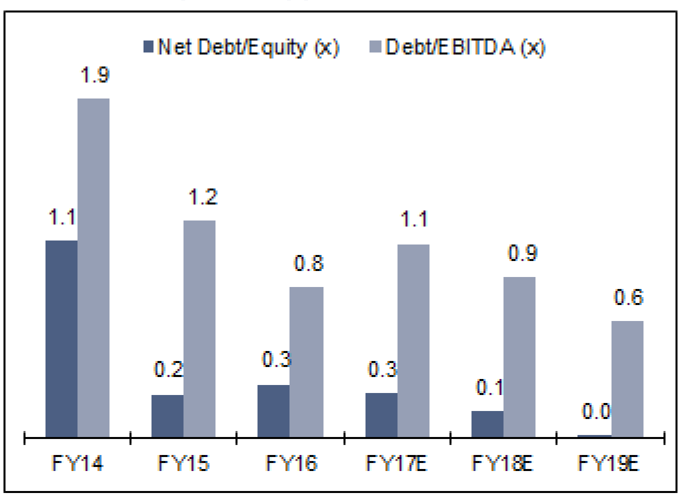
Source: I-Sec research, Company

Chart 4: Return ratios continue to be healthy



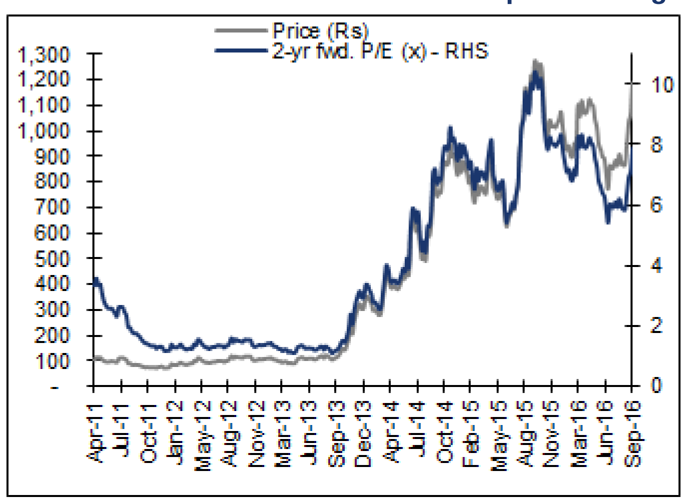
Source: I-Sec research, Company

Chart 5: Disciplined approach to balance sheet



Source: I-Sec research, Company

Chart 6: Robust financials led to multiple re-rating



Source: Bloomberg, I-Sec research, Company

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How did the CEAT story unravel?

"The difference between a boss and a leader: a boss says 'Go!' – a leader says, 'Let's go!'. -E.M Kelly, U.S Army

Background

CEAT is the flagship company of the RPG Group and the fourth largest tyre manufacturer in India with ~12% market share and a manufacturing capacity of >1,000 MT/day (95,000 tyres/day). CEAT was founded as CEAT Tyres of India Ltd in 1958. RPG Enterprises took it over in 1982 and also bought the rights to use the CEAT brand in select Asian countries, including India.

Change of guard and shift of focus

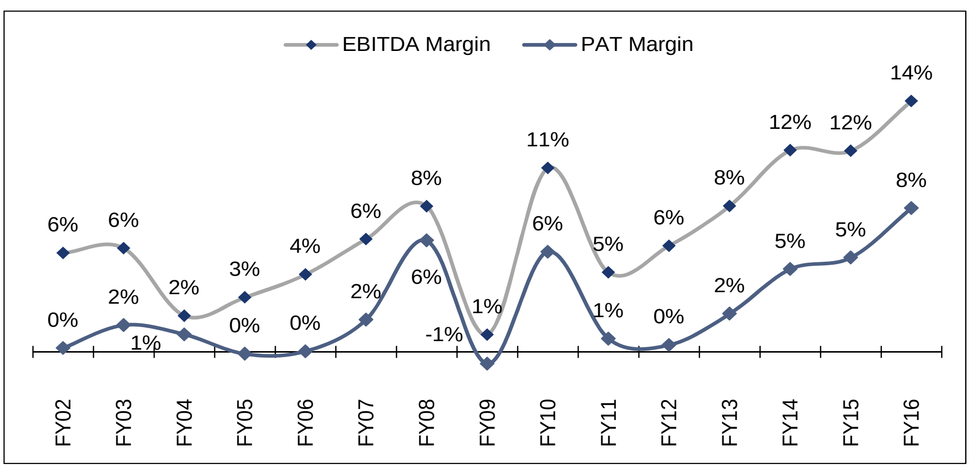
CEAT was battling with a blurred identity, lack of leadership in any tyre segment and product mix trailing that of the industry, which meant struggling in the low-margin and increasingly competitive truck and bus (T&B) segment. Despite growing revenues, profitability lagged that of peers and earnings declined in FY11 and FY12. CEAT then underwent a management change with ***Mr. Anant Goenka*** taking over as the Managing Director (MD).

Management quickly realized that CEAT cannot be present everywhere and adopted a methodical approach to turnaround. CEAT's multi-step approach was to: 1) Focus on the high-margin consumer-facing B2C segments like two wheelers, passenger cars and utility vehicles (clubbed under passenger segment), wherein margins were high and so were the opportunities to differentiate branding, 2) Enhance the product reach by ramping up distribution – more number of dealers, distributors, exclusive CEAT franchises and innovative marketing by way of multi-brand outlet and shop-in-shop concepts, 3) Develop new products to enable better engagement with OEMs and partner with new OEMs, 4) Enhance brand recall with focused investments on marketing & brand-building and capture mindshare with innovative advertisement campaigns, and 5) Focus on generating strong cash flows despite capital expenditure plans and on de-leveraging the balance sheet.

New approach led to improved financial performance

The high focus on strategic passenger segment, coupled with declining raw material prices aided CEAT in expanding is EBITDA margins to 14.4% in FY16 (4.5% in FY11).

Chart 7: CEAT's EBITDA margin improved with focus on passenger segment

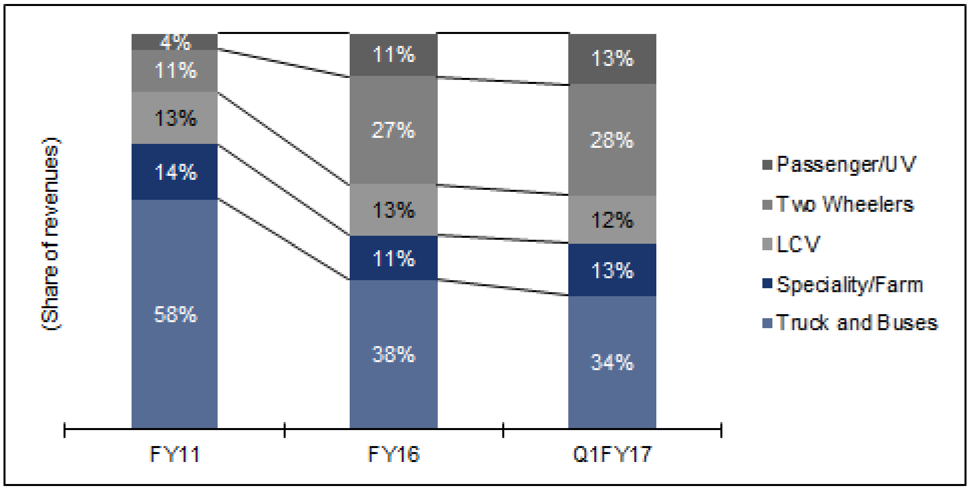


Source: Company data, I-Sec research

Shift of focus to B2C segment very timely

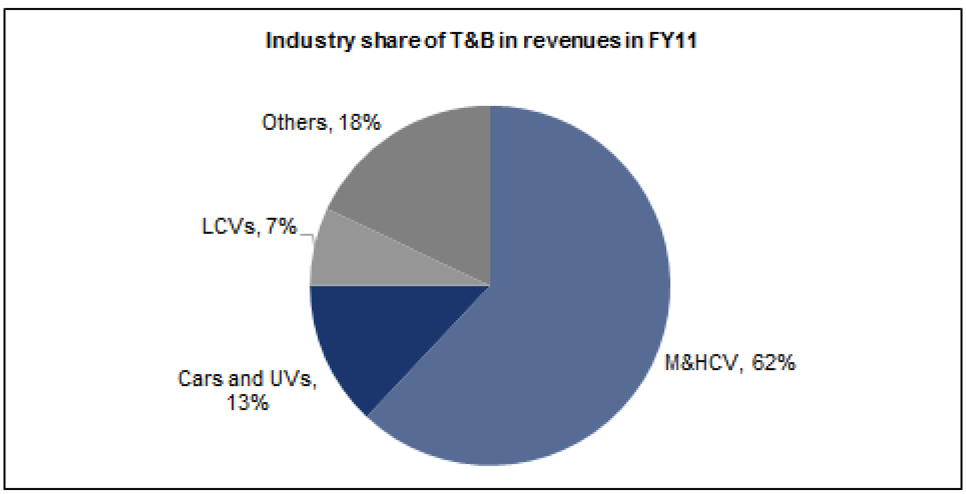
Till FY11, CEAT's product mix mimicked that of the Indian tyre industry, which relied heavily on the CV segment for revenues. CEAT has been transforming its business model since FY11 by strategically targeting the passenger (two wheeler and passenger vehicle) segments. The passenger segment had the advantages of low capital expenditure requirement, high margin benefits and the opportunity to interact with the customer and market the product USP due to the segment's B2C nature. This has aided CEAT in successfully moving away from the increasingly competitive truck & bus (T&B) segment, even as industry mix still leans towards it, which has been a traditional focus segment for the tyre industry.

Chart 8: CEAT's product mix has shifted from T&B to 2Ws/PVs



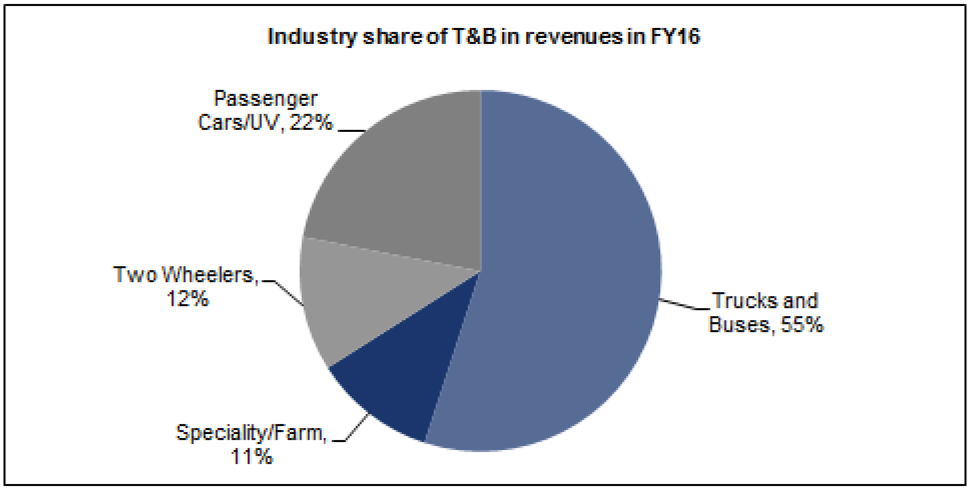
Source: Company data, I-Sec research

Chart 9: Industry's product mix has relied on T&B…



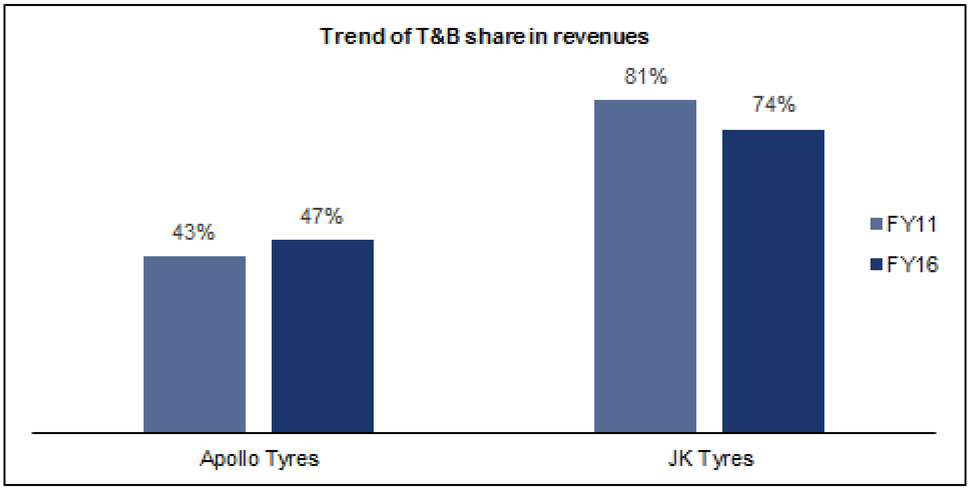
Source: Industry, I-Sec research

Chart 10: …and continues to be so



Source: Industry, I-Sec research

Chart 11: Leading players have retained their focus on T&B

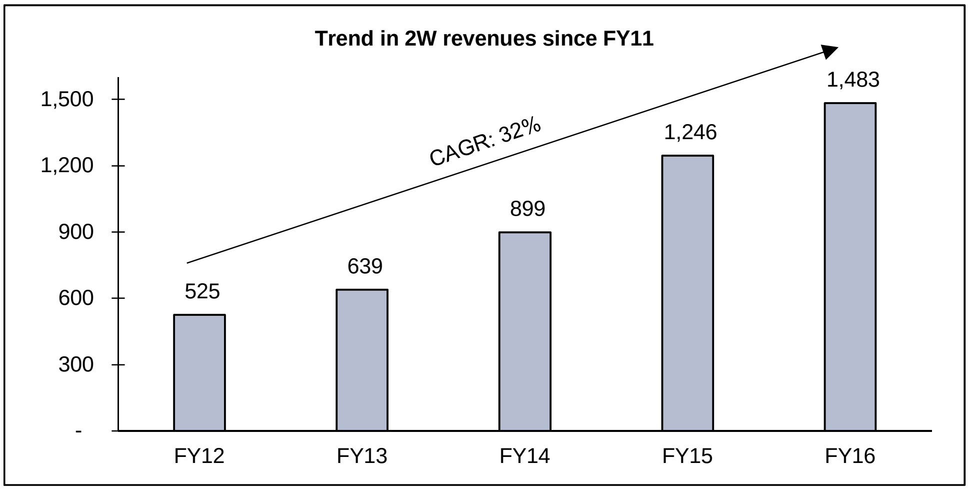


Source: Company data, I-Sec research

Two wheelers: A success story

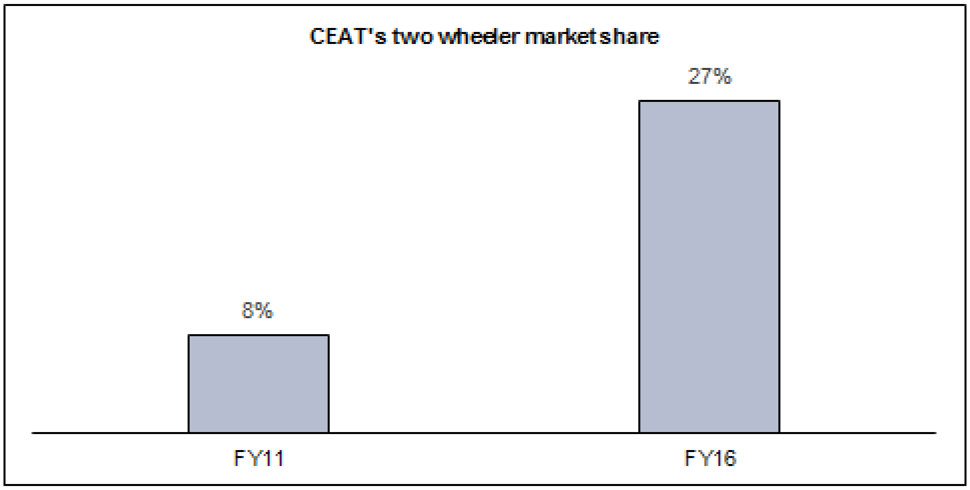
CEAT began focusing on the passenger segment by first targeting the two wheeler (2W) sub-segment. In FY11, 2W revenues were 11% of CEAT's total revenues and have since grown at a CAGR of 32% over FY11-FY16 to Rs14.8bn as against 9% over FY11-FY16. As a result, 2W revenues were ~27% of total revenues in FY16. Compared with the T&B segment, the 2W sub-segment offers advantages of higher realisations, product price inelasticity, less competitive intensity and the opportunity to differentiate/market.

Chart 12: 2W revenues have grown at a CAGR of 32% over FY11-16



Source: Company data, I-Sec research

Chart 13: Focus on two-wheelers led to major gain in market share



Source: Company data, I-Sec research

CEAT has followed the 'asset-light' outsourcing model of manufacturing for 2W/3W tyres and its model has received approval from OEMs. Currently, the company has three principal outsourcing facilities at Hyderabad, Calicut and Halol. In order to address the growing demand for 2W tyres, the company has put up a greenfield plant in Nagpur for the manufacture of 2W/3W tyres at a capital outlay of Rs4.2bn. The plant has commenced production at the rate of 19MT/day from Jun'16 and is expected to reach 120MT/day at full capacity by H1FY18.

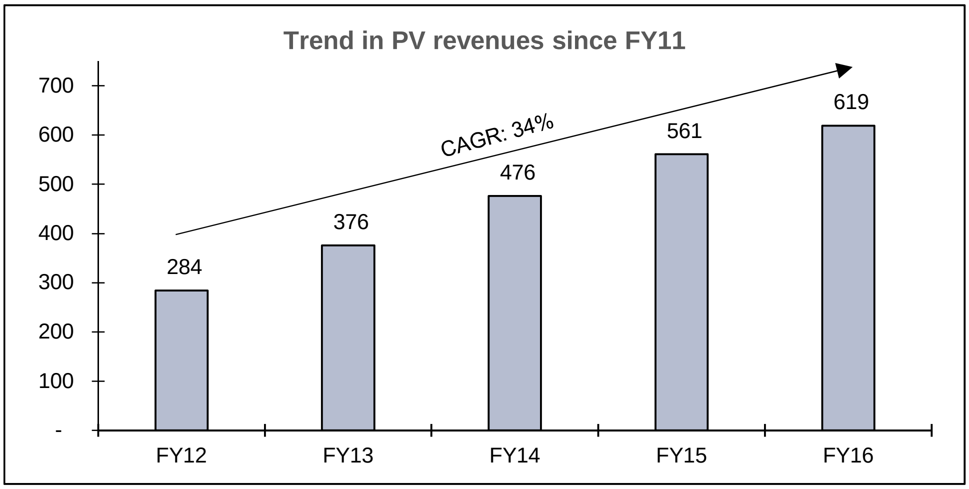
The company has also entered into new partnerships with OEMs like Honda Motorcycles and Scooters India (HMSI) and Suzuki Motorcycles India and received approvals for new products like the *Bajaj V-15*, the *Splendor iSmart 110* and the *Suzuki Access 125*.

CEAT has started out with the *Bike Shoppe* concept, first such in Bangalore and Kolkata. The *Bike Shoppe* is a company-branded outlet dedicated to provide products and services exclusively for two-wheelers. It will house the entire range of CEAT's two-wheeler products including *Pirelli* and *Metzeller* tyres for super bikes and will be equipped with state of the art technology for tyre changing, fitment, alignment and balancing, nitrogen inflation, and the like.

Passenger vehicles: Next leg of growth

CEAT's passenger vehicle (PV) business now stands where its 2W business stood five years ago in FY11 (11% of revenues). PV revenues grew at a CAGR of ~34% over FY11-FY16 to Rs6.2bn in FY16, ahead of the 32% CAGR seen in 2W revenues and ~9% CAGR witnessed in total revenues during the same period, signifying the strong growth potential this vertical holds. CEAT is pushing all-out for growth in the PV sub-segment, with an aim to replicate its 2W success story in the PV space.

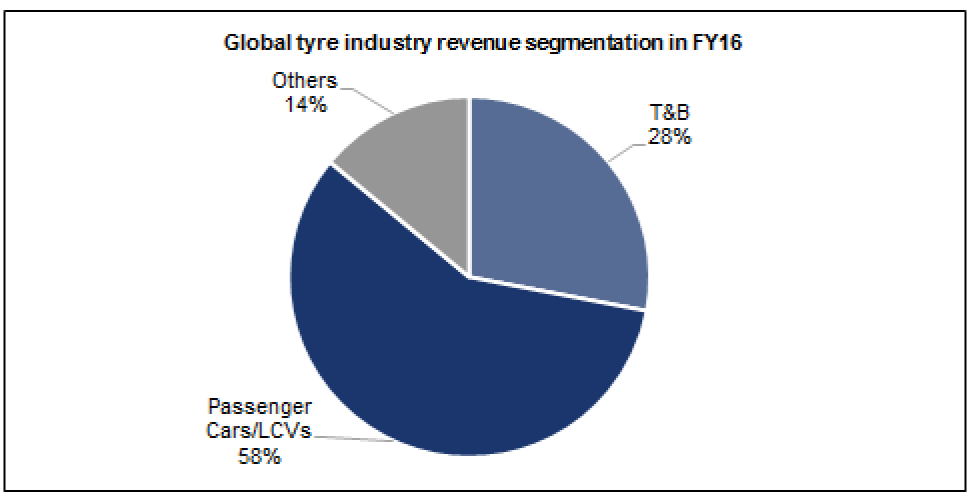
Chart 14: PV revenues have grown at a CAGR of 34% over FY11-FY16



Source: Company data, I-Sec research

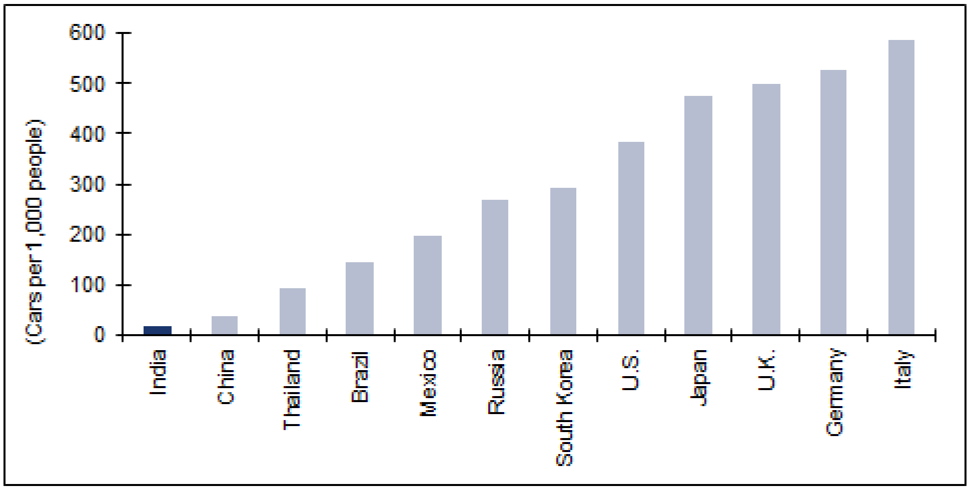
Globally, the T&B segment contributes ~28% to tyre industry revenues, but the share of T&B revenues in India is nearly double (~55%) that of the global trend, mainly due to significantly lower share of PV penetration in the country. India's PV penetration is at 17 vehicles per 1,000 people, whereas the same is on the higher side at 39 for China, 93 for Thailand, 147 for Brazil and 385 for the US.

Chart 15: Globally, T&B segment represents a lower share of revenues



Source: Company data, I-Sec research

Chart 16: India's low car penetration offers significant opportunity with OEMs



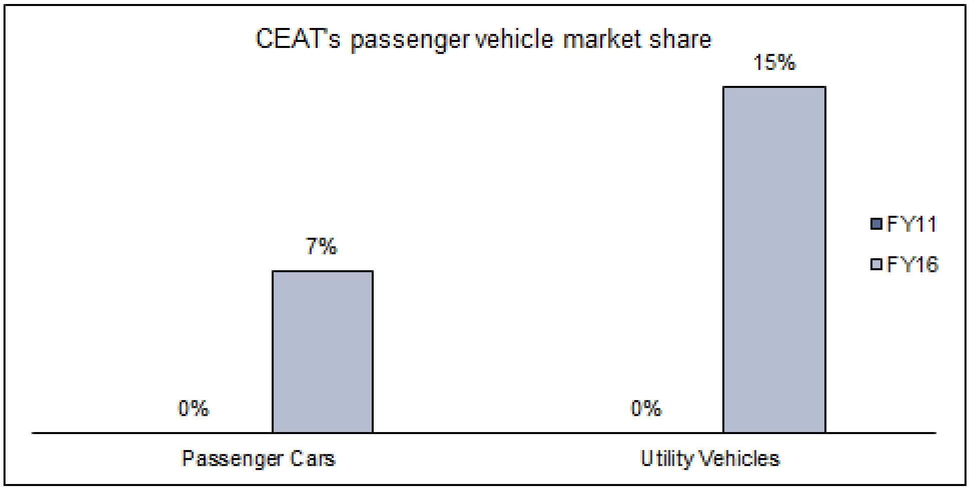
Source: CRISIL

UV focus a step in the right direction

When CEAT decided to reposition itself in the PV sub-segment, most of the tyre players were focussed on the passenger car (PC) vertical. Thus, the company decided to target the utility vehicle (UV) vertical, in which OEMs demanded differentiated service levels. This strategy paid off well as the share of UVs in PV sales has spiked since then, thus allowing CEAT to capture ~15% market share from being non-existent in the UV vertical five years back. Share of UVs in PV sales rose from 12.6% in FY11 to 25.2% in FY17-YTD as consumer preference has slowly shifted to SUVs and 'SUV-looking' models. The UV vertical is in flavour as most new model launches are happening here and competition has gotten intense to the point of sub-segmentation of the vertical into 'compact of compact' SUVs (*Maruti Ignis*, *KUV100*).

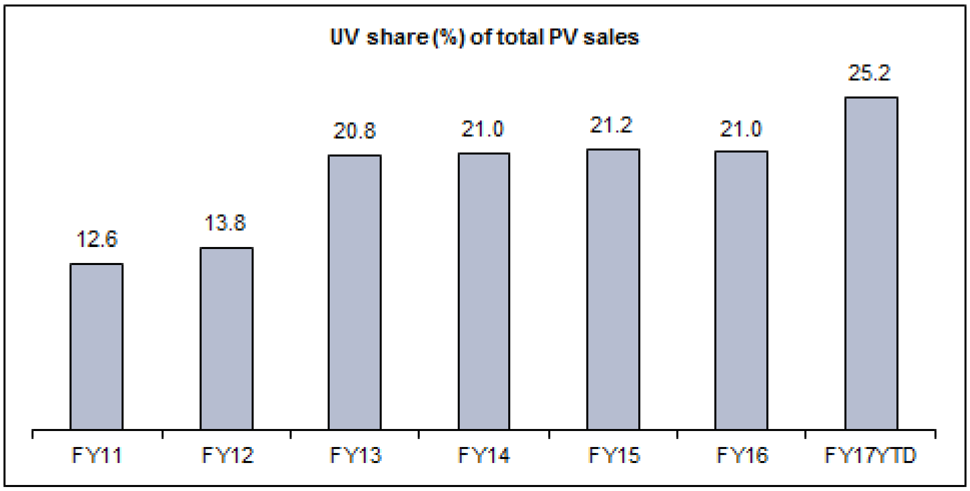
CEAT is also putting efforts to develop tyres for cars and SUVs of premium multinational OEMs. Currently, CEAT's market share in the passenger car (PC) vertical is less than half (7%) that of UVs (15%) and management considers capacity as the only constraint in increasing market share in PCs. The company has taken concrete steps in increasing the PV radial tyre capacity (Halol Phase II brownfield expansion) by 120MT to address this gap and will simultaneously start ramping up its engagements with OEMs as it has reasonable capacity at hand to commit production.

Chart 17: Focus on PVs led to major gain in market share



Source: Company data, I-Sec research

Chart 18: UV share of total PV sales has risen over the years



Source: SIAM

The company has three manufacturing facilities at Mumbai, Nashik and Halol. In order to ramp up its PV tyre capacity, the company is expanding its Halol plant (a brownfield expansion, named Halol Phase II) for the manufacture of PV radial tyres at a capital outlay of Rs6.5bn. The plant has commenced production at the rate of 51MT/day as of Jun'16 and production is expected to reach 120MT/day at full capacity by Q1FY18.

The company has also entered into new partnership with Renault and Nissan, and is now associated with products like the *Datsun Redi-Go, Renault Kwid* and the *Mahindra TUV 300*.

Parallel focus on product, reach and recall

New product launches, combined with an extensive distribution network, optimum product mix (non-T&B) and intensive marketing has aided CEAT in growing its volumes in the more profitable passenger segment.

New products have helped secure new OEM relationships

CEAT works in close collaboration with OEMs to develop tyres with stringent specifications for specific vehicles, while still retaining the focus on performance and safety. In this direction, the company has been stepping up R&D efforts to deliver innovative and specialised products; its R&D efforts have been on improving product performance with superior grip, both on wet and dry surfaces, fuel efficiency, lower rolling resistance, durability, tread life, ride, handling, noise and extended mobility.

In FY16, CEAT launched 70 new products, most notable being *Milaze*, *FuelSmarrt*, *CZAR Sport* in the PC radial/UV radial verticals and *Zoom Rad*, *Gripp XL*, *Pro Gripp* and *Milaze TL* in the 2W vertical. The company is also putting efforts to develop tyres for cars and CUV/SUVs of premium MNC OEMs and technologies for Europe. More than 27% of the turnover in FY16 originated from new products. It should also be noted that OEM relationships also act as a gateway to secure replacement demand as customers in the passenger segment tend to be more brand loyal than those in the T&B segment.

During FY16, CEAT entered into association with new OEMs like Renault, Nissan, Honda Motorcycles and Scooters India (HMSI), Suzuki Motorcycles India and Royal Enfield. CEAT has been a primary supplier for recent product launches like Renault *Kwid*, M&M *TUV300*, Toyota *Innova,* RE *Himalayan*, Honda *Navi*, Bajaj *Vikrant V15*, Hero *Splendor iSmart110*, Datsun *Redigo*, Suzuki *Access 125*. One of the examples of successful product development is of the tyre developed for Toyota *Innova* (life of >100,000 kms, ~40% improvement over the previous version).

Chart 19: New products developed in FY16

Be Fuelsmarrt

CEAT's first low rolling resistance pattern for hatch-backs and entry level sedans which saves up to 7% of fuel as compared to normal tyres.

Sporting a new look with CZAR Sport

First foray into asymmetric pattern, with better wet grip and aquaplaning, for compact SUVs.

Treading forward with Milaze

Special tyre developed for Toyota Innova with the promise of longer life. It lasts up to 1,00,000 kms making it the champion in tyre mileage.

Go Carefree with Milaze Tubeless

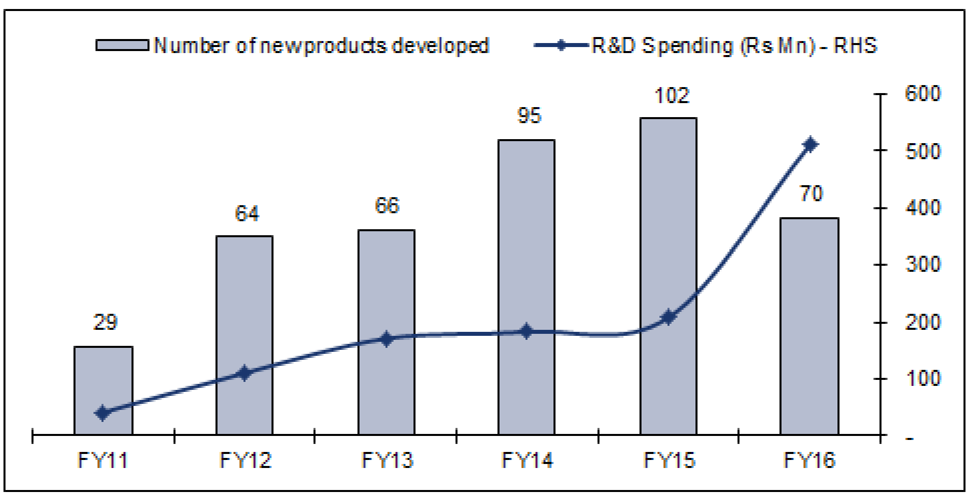
New age scooter tyres with longer life and higher load carrying capacity, for low downtime.

Gripped by Pro Gripp

High performance scooter tyre for superior grip and enhanced stability, specially designed to endure extreme on-road / off-road conditions.

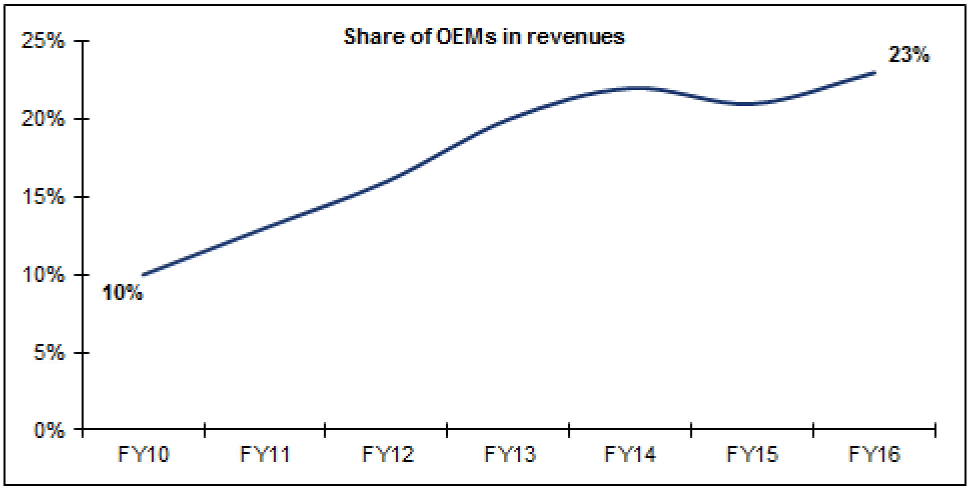
Source: Company

Chart 20: R&D efforts have firmed up new product development



Source: Company data, I-Sec research

Chart 21: New product offerings have propelled OEM share in revenues



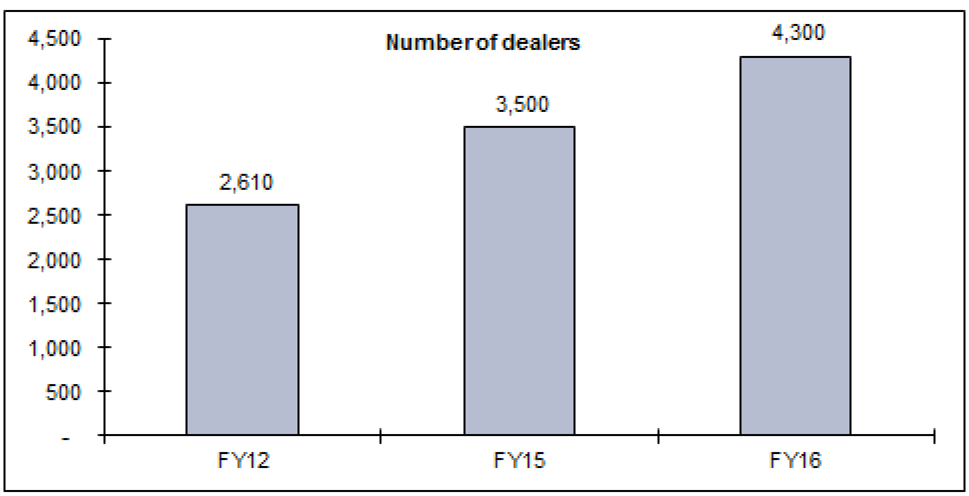
Source: Company data, I-Sec research

Differentiated distribution initiatives continues to aid growth

CEAT has been consistently strengthening its distribution network and looking for innovative ways to widen its reach. The company has a three-pronged approach to reach the customer: 1) dealers, 2) distributors and 3) branded/exclusive franchises.

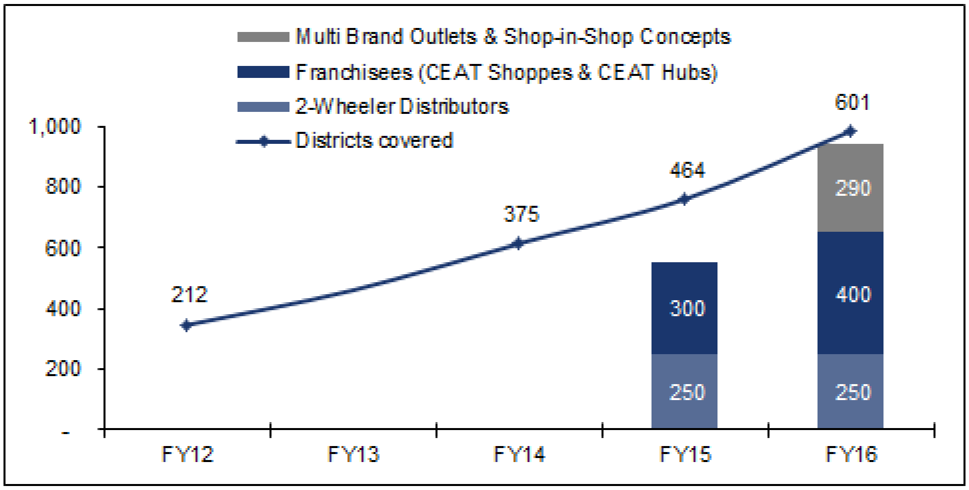
The company has a strong pan-India footprint with >4,300 dealers (mainly for CV and PV tyres) compared with >2,610 dealers in FY12. As a result, CEAT now has 600 districts in its fold compared with ~212 in FY12. In order to tap the replacement market in rural areas, CEAT has focused on increasing its depth of reach via extensive distributor network, mainly for 2Ws (>250 distributors) and PC tyres. The company is also investing in developing branded/exclusive franchises in urban/Tier I markets. This model now boasts of >400 CEAT franchisees (*CEAT Shoppes* and *CEAT Hubs*).

Chart 22: Strong distribution network with >4,300 dealers



Source: Company data, I-Sec research

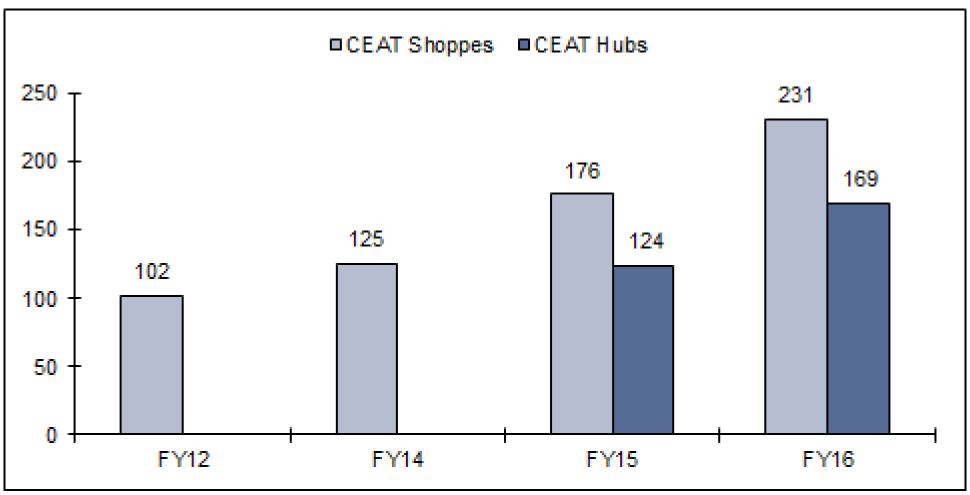
Chart 23: Increased penetration in smaller towns and growing retail channels



Source: Company data, I-Sec research

CEAT Shoppes **and** ***CEAT Hubs*** are the company's exclusive retail channels that sell and service ***CEAT*** products. *CEAT Shoppes* sell and service primarily PC and 2W tyres; the company has increased the number of *CEAT Shoppe* outlets by penetrating tier-II and tier-III towns (population of 500K-1mn). *CEAT Hubs* sell and service primarily truck and LCV tyres. *CEAT Shoppes* have contributed significantly in enhancing CEAT's brand image and in growing replacement market revenues from the passenger segment (2W, PC, UV), especially PC tyres. In order to enhance customer experience during and after the purchase, CEAT has doubled the number of CEAT Shoppes over the years (231 outlets currently against 102 in FY12). The company is expected to keep expanding its reach over the coming years.

Chart 24: CEAT franchisees aid in getting closer and faster to customers



Source: Company data, I-Sec research

Source: Company

Over the last few years, the company came out with two more marketing initiatives – **MBO, a "multi-brand outlet"**, with a predominant CEAT share and **SIS, a "shop-in-shop" concept**, having demarcated area in high footfalls shops. MBO and SIS concepts are CEAT's newest innovations aimed at enhancing penetration in the replacement market through increased product and brand visibility. Currently, CEAT has >240 MBO outlets and >45 SIS outlets.

Source: Company

Investments in branding have been stepped up to grab mindshare

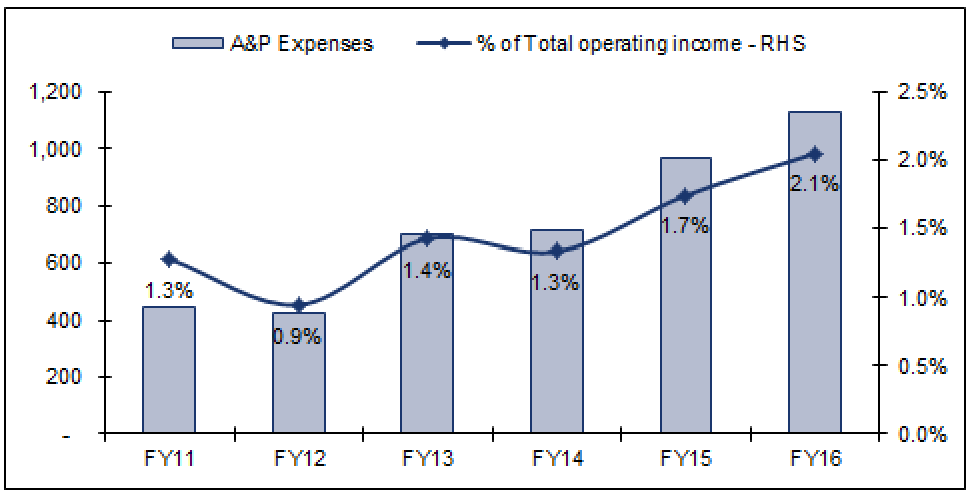
Effective branding has been at the heart of CEAT's strategy to be a meaningful player in the passenger segment. Since passenger segment is a consumer facing segment and passenger segment customers tend to be more brand loyal, enhancing brand visibility and recall goes a long way in creating replacement market demand. The company develops creative ad campaigns based on months of research and relevant consumer insights so that the message instantly connects with the consumer. The company has launched many innovative advertisement campaigns which have won plaudits e.g. *"The roads are filled with idiots: Be Idiot Safe with CEAT"*

"Be Monsoon Smart" campaign (For All Season Bike Tyre with "Superior Wet Grip")

"Be Idiot Safe"

Source: Company

Chart 25: Marketing spends have been on the rise



Source: Company data, I-Sec research

The company's total spending on advertisement and sales promotion has increased at a CAGR of 20.2% over FY11-16. CEAT's marketing spends are directed towards sharply defined targets with differentiated positioning strategies.

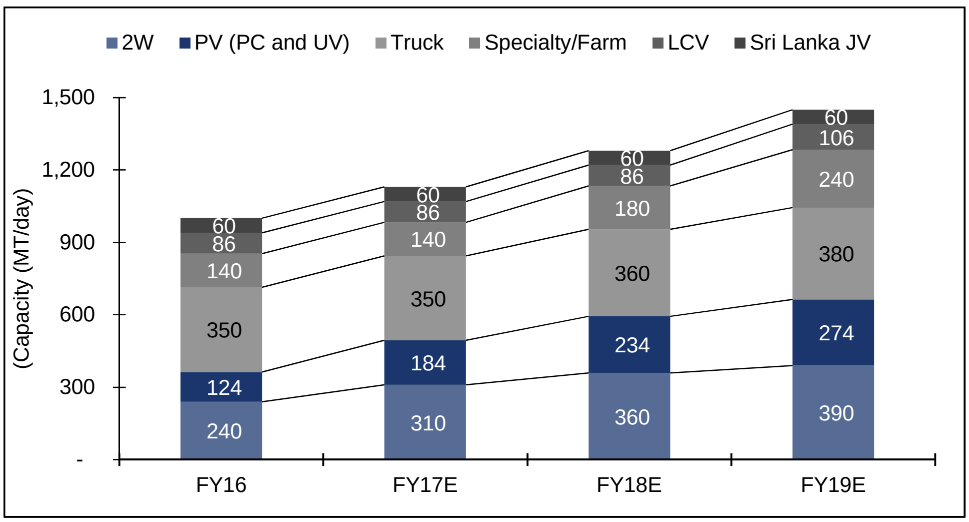
The road ahead: Preparing for tomorrow

Domestic market: Capacity expansion in high-margin segments

Currently, 36% of CEAT's total capacity of 1,000MT/day is into the high-margin passenger segment (2Ws – 24% and PVs – 12%) while 38% of its revenues are derived from the same (2Ws – 27% and PVs – 11%). We expect the passenger segment's share of revenues to jump to ~53% by FY19 and that of the T&B segment to fall to 27% by FY19 from 38% in FY16.

Currently, CEAT outsources its entire 2W/3W capacity of 240MT/day and sees difficulty in expanding capacity on the outsourcing platform due to limitations in investing capabilities of its outsourcing partners. In order to maximise the revenue growth potential the passenger segment holds, the company has commissioned two plants – 1) a greenfield plant in Nagpur for the manufacture of 2W/3W tyres at a capital outlay of Rs4.2bn, producing 19MT/day from Jun'16, 120MT/day expected at full capacity by H1FY18, and 2) a brownfield expansion named Halol Phase II (expanding its Halol plant) for the manufacture of PC/UV radial tyres at a capital outlay of Rs6.5bn, producing 51MT/day from Jun'16, 120MT/day expected at full capacity by Q1FY18.

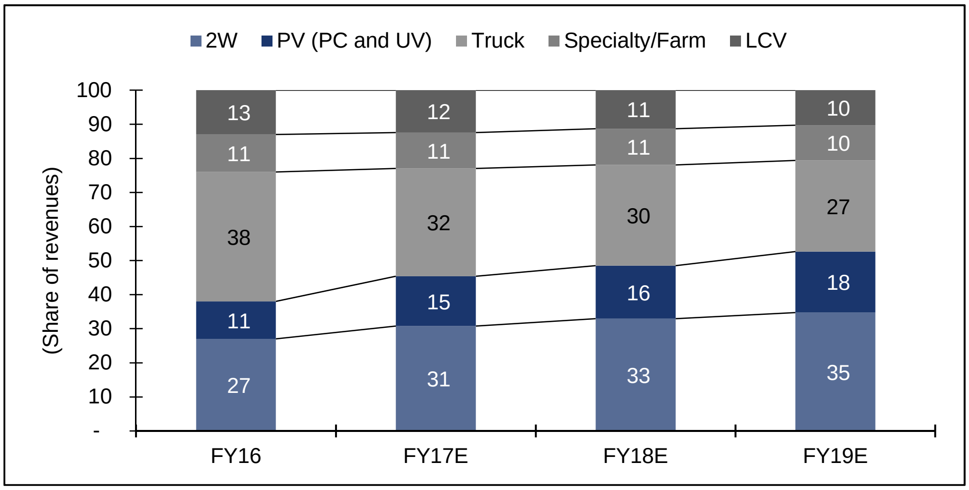
Chart 26: Capacity is being expanded in the B2C segment



Source: Company data, I-Sec research

CEAT is expanding its current capacity of 1,000MT/day by ~28% over FY16-FY18 to 1,280MT/day. We expect 2W capacity to grow by 50% to 360MT/day and PV capacity to grow by 89% to 234MT/day by FY18. Around 82% of the new capacity added (280MT/day) over FY16-FY18 would thus be attributed to the high-margin passenger segment, preparing CEAT to fully tap the segment's growth potential. We also expect CEAT to further increase its capacity in FY19 by 170MT/day, 70MT/day of it being attributed to the passenger segment.

Chart 27: B2C segment revenues expected to be >50% of total by FY19

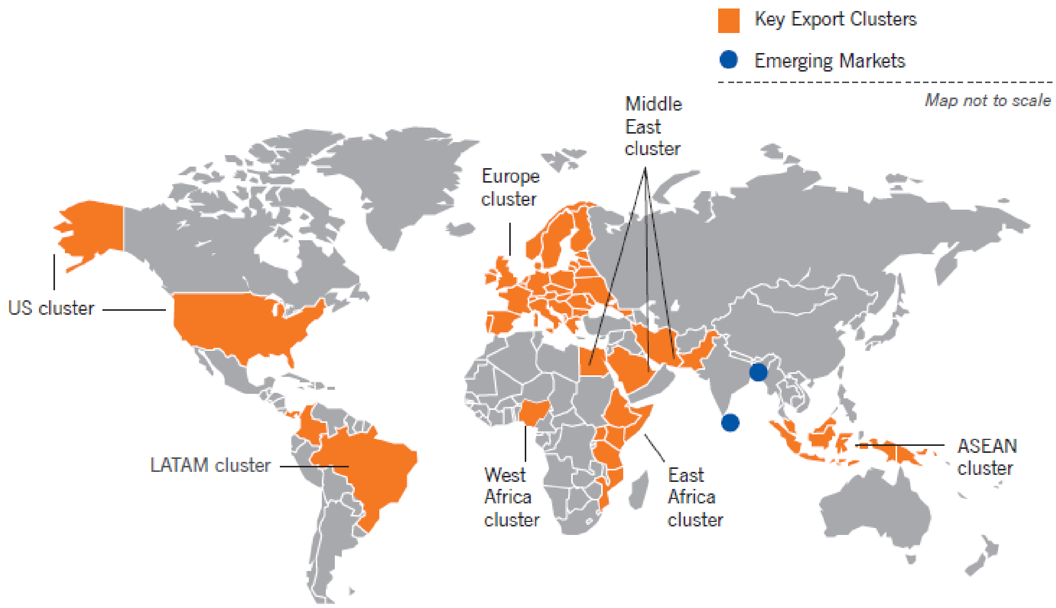


Source: Company data, I-Sec research

International market: OHT and EM foray to cushion slowing exports

CEAT is a leading exporter of tyres and primarily exports T&B, OHT (Off Highway Tyres) and LCV tyres. It exports to various markets across the world, with many of the exported tyres developed exclusively for their respective markets. For example, CEAT has developed specialised tyres for the Dubai taxi market, which feature excellent mileage, ride comfort and low noise. To expand its emerging market (EM) business, the company has entered into Sri Lanka and Bangladesh markets.

Chart 28: CEAT's reaches out to >100 countries through export clusters

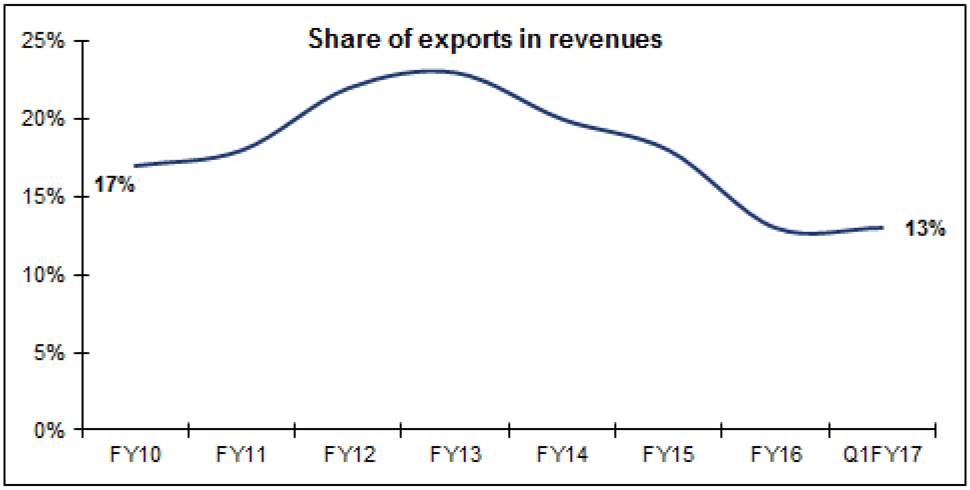


Source: Company

The company exports to key economic clusters around the world – Europe, Middle East, West and East Africa, US, ASEAN and LATAM.

But, in recent years, the company has been facing headwinds in exports on account of overall global slowdown, sustained impact of low-cost Chinese tyres, increasing radialisation in global markets and relatively higher currency depreciation in most countries to which it exports.

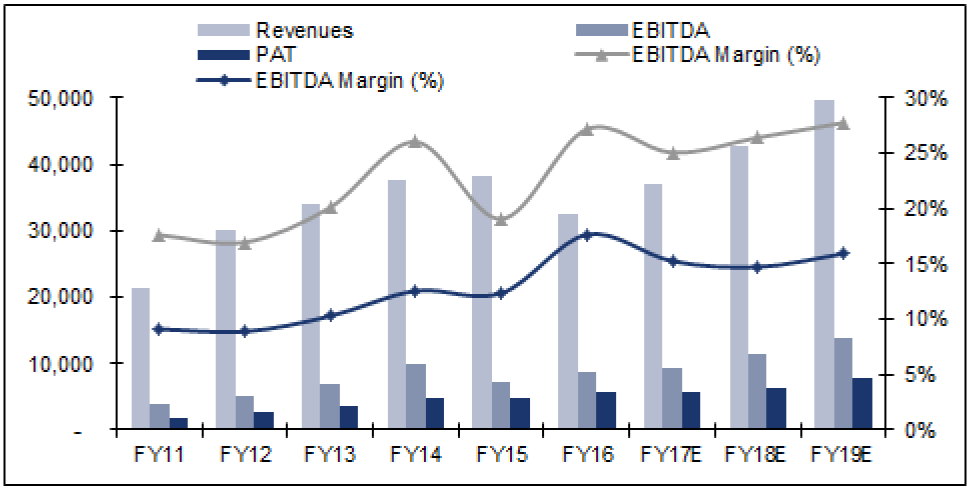
Chart 29: Share of exports in total revenues has been falling since FY13



Source: Company data, I-Sec research

In order to counter the slowing exports, CEAT is strategically targeting the niche OHT export market along with PC radial tyres for the European market. The company has laid out a roadmap for the OHT segment by putting up a greenfield plant in Ambernath, near Mumbai. CEAT will be investing Rs3.3bn for an initial capacity of 40MT/day, which will be further ramped up to 100MT/day. Commercial production at this facility is expected to begin from Q4FY17.

Chart 30: OHT leader Balkrishna Industries makes 27% EBITDA margin



Source: Company data, I-Sec research

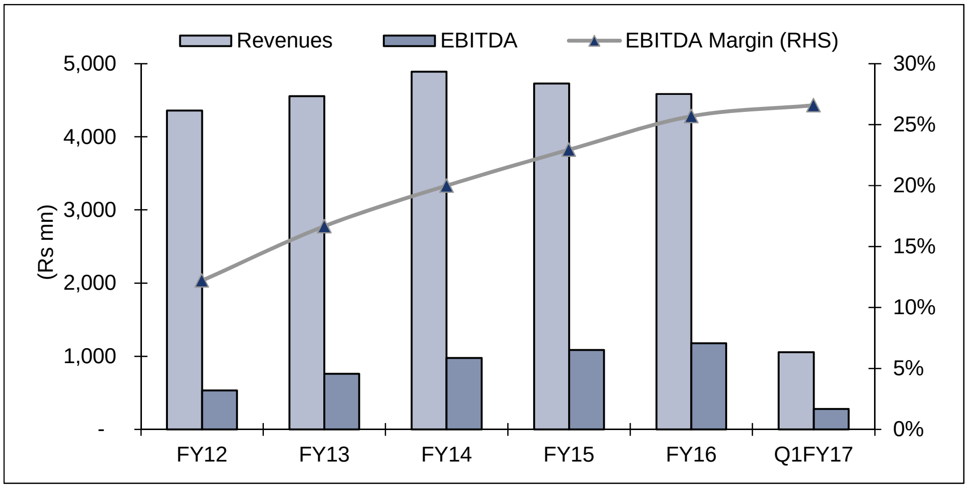
The OHT segment mainly caters to agricultural, industrial, construction, earthmover, ports, mining, forestry etc. Balkrishna Industries Ltd. (BIL) is a leading player in the OHT vertical, which derives all of its revenues from OHT, 85% of which comes from exports. BIL enjoys very healthy profitability (>25% EBITDA margin) and a successful entry into the OHT market for CEAT could entail better product mix and gross margins.

Emerging Markets

Sri Lanka

Associated CEAT Holdings Company (Private) Limited (ACHL), CEAT's investment arm in Sri Lanka, has a 50:50 joint venture, viz., CEAT-Kelani Holdings Private Limited, with two manufacturing facilities having a total capacity of 61MT/day. ACHL has strong presence in the truck, light truck, 2W/3W and radial tyre segments and continues to enjoy overall market leadership (>50% share). ACHL is the only company in Sri Lanka with local presence supported by brand, network and strong after-sales service. The JV had an output of 16,200MT in FY16 and 4,000MT in Q1FY17. In FY16, CEAT revised its royalty agreements with Kelani Holdings, leading to higher royalty revenues during the same period (up 25% YoY to Rs55.3mn).

Chart 31: Sri Lanka JV is market leader with >25% EBITDA margin



Source: Company data, I-Sec research

Bangladesh

Aiming to replicate its Sri Lanka success, CEAT has set up a greenfield facility for the manufacture of automotive bias tyres in Bangladesh through its existing JV (70:30) with AK Khan & Company Ltd, CEAT AKKhan Limited (CAL). However, the construction of the factory was stalled due to land acquisition issues, which are approaching resolution. CAL has been outsourcing CEAT branded automotive tyres from CEAT. As per management, the Bangladesh facility was slated to have initial production capacity of ~65MT/day. The current plan could be slightly different from this initial target, however we believe the market has strong potential to grow.

Industry Overview and Outlook

The Indian tyre industry caters to OEM, replacement (RE) and export markets through four broad vehicle categories: CVs, PVs, 2Ws, and others, including tractors. Though, as per the Automotive Tyre Manufacturers' Association (ATMA), tyre industry revenues grew at a CAGR of 12% over FY10-FY15, revenues in FY16 were muted as tyre companies had to pass down the benefits of lower raw material prices. Industry volumes, though, grew at 5% YoY in FY16 (6% YoY in FY15). Domestic (RE+OEM) volumes grew at 6% YoY in FY16 (8% YoY in FY15).

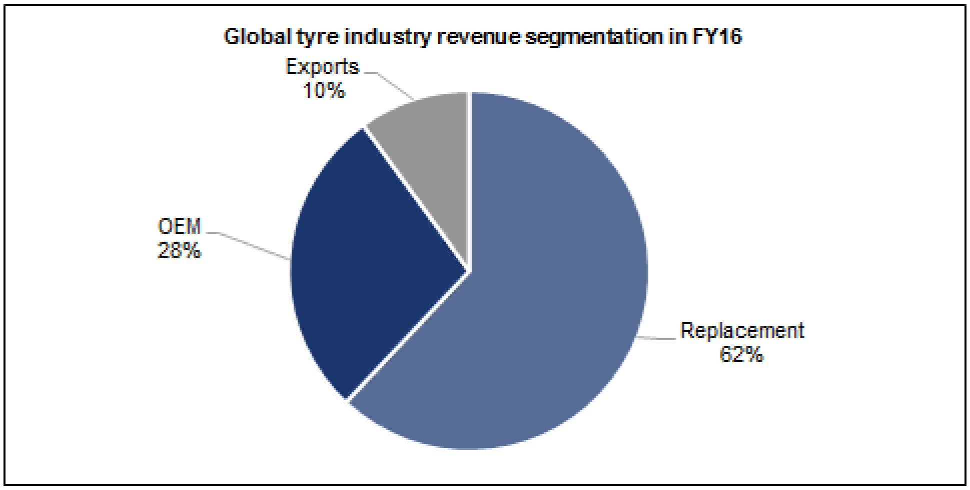
Replacement segment accounts for ~62% of industry volumes, followed by OEM (28%) and exports (10%). T&B and PV (2Ws, PCs and UVs) tyres constitute ~60% and ~25% of replacement-tyre demand, respectively, whereas PV (2Ws, PCs and UVs) and tractors constitute ~ 60% of total OEM demand.

Table 1: Typical tyre replacement cycles

Vehicle category	Replacement cycle
MHCVs	6-8 months
PVs (PC and UV)	3-4 years
2Ws	3-4 years
LCVs	3-4 years
Tractors (Front tyre)	3-4 years
Tractors (Back tyre)	3-4 years

Source: CRISIL, I-Sec research

Chart 32: Indian tyre industry's market mix (tonnage volumes)

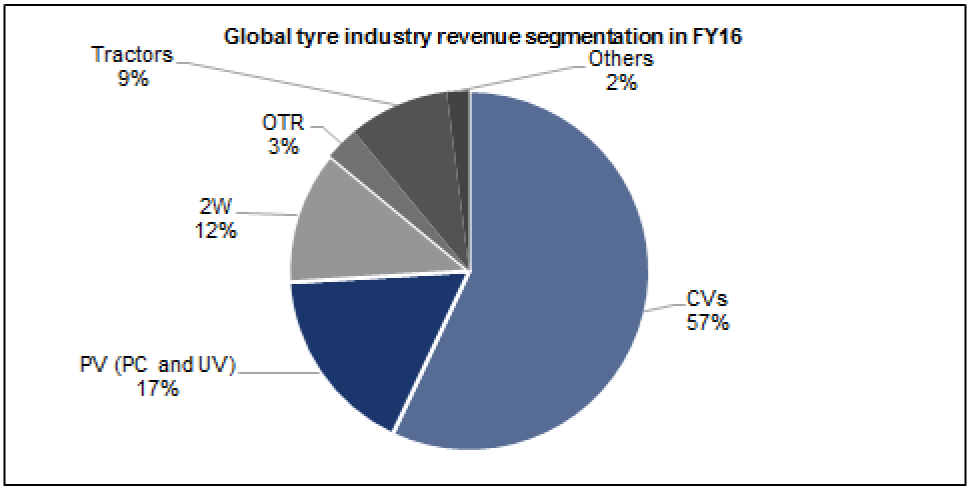


Source: Company data, I-Sec research

The Indian tyre industry's product mix is still heavily skewed towards the Truck and Bus (T&B) segment, which comprises ~57% of total volumes and ~55% of total revenues.

In FY16, Indian tyre companies invested Rs49bn on capacity additions. But due to benign demand, rising share of imports and falling exports, capacity utilisation of the Indian tyre industry fell for the first time in three years in FY16. T&B segment witnessed the lowest capacity utilisation while 2Ws witnessed the highest. Yet, in FY17, the Indian tyre industry is expected to invest Rs91bn more on capacity additions as: 1) the industry is witnessing a shift of focus from commercial to consumer-facing segments like PVs and 2Ws, 2) better monsoons than last two fiscals, 3) demand recovery led by high discretionary income, and 4) higher internal accruals.

Chart 33: Indian tyre industry's product mix (tonnage volumes)

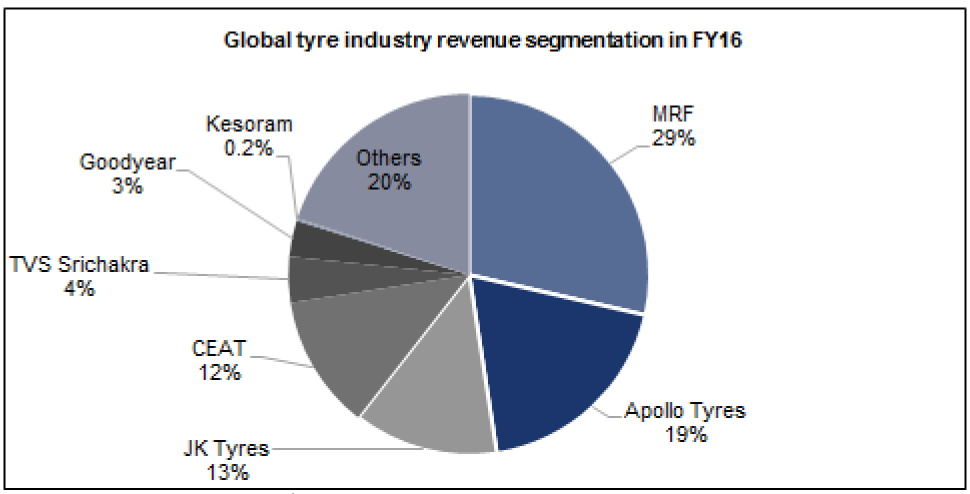


Source: Company data, I-Sec research

Many players, but few with meaningful market share

The Indian domestic tyre industry is estimated to be Rs500bn in revenue terms, whereas export market turnover is expected to be ~Rs105bn (CRISIL) as of FY15. The top seven companies cater to ~80% of the demand despite the industry consisting of over 30 players.

Chart 34: Indian tyre industry very concentrated in nature

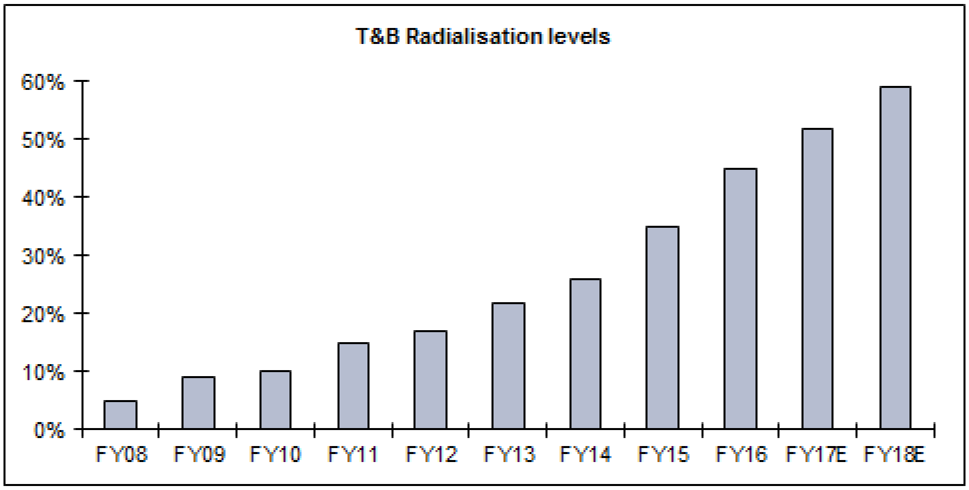


Source: CRISIL, I-Sec research

Radialisation to support T&B growth, but Chinese tyres still a threat

Radialisation has emerged as a key contributor of growth for the Indian tyre industry. While radial tyres are generally more expensive than bias tyres, they are of superior quality with longer lifecycle, better control, lower rolling resistance and higher fuel efficiency compared with bias/cross-ply tyres. While passenger segment radialisation levels are >95%, T&B segment radialisation still lingers at ~45% despite the obvious benefits of radial tyres due to poor roads, topped with typically overloaded trucks and lower initial costs of bias tyres, which makes bias tyres more suitable. However, T&B radialisation levels are set to rise in the coming years due to: 1) growing awareness of the overall economic wisdom in using radial tyres over the long run, 2) improvement in road infrastructure and addition of new roads, and 3) stricter implementation of the overloading ban. Thus, radialisation in the T&B segment is expected to reach ~59% by FY18.

Chart 35: T&B radialisation levels set to rise as awareness increases



Source: Company, I-Sec research

China is the world's largest tyre market (1/3rd of the global tyre market) due to the sheer size of its automobile market. But the Chinese tyre market is now facing challenges of overcapacity, slowing domestic demand, and anti-dumping duties imposed by the US. This has resulted in the Chinese tyre manufacturers flooding the Indian tyre market at distressed prices, more so in the T&B radial (TBR) segment since two-wheeler and passenger vehicle consumers tend to be brand-conscious.

In the absence of any anti-dumping duties in India on Chinese tyres, China has been able to supply TBR at almost the cost of Truck & Bus Bias (TBB) tyres, letting fleet operators upgrade from TBB to TBR at the cost of TBB. These Chinese TBR imports have earned a healthy market share of ~35% in the TBR replacement market. Moreover, India's inverted duty structure makes it cheaper to import tyres than import natural rubber. Basic customs duty on import of finished rubber products into India is exempted whereas there is a 0-25% duty levied on the import of inputs required for their manufacture, creating inversion in duty structure. The Chinese yuan devaluation has worsened the situation as it has allowed Chinese tyres to be priced very competitively in global markets.

Raw material prices key to profitability

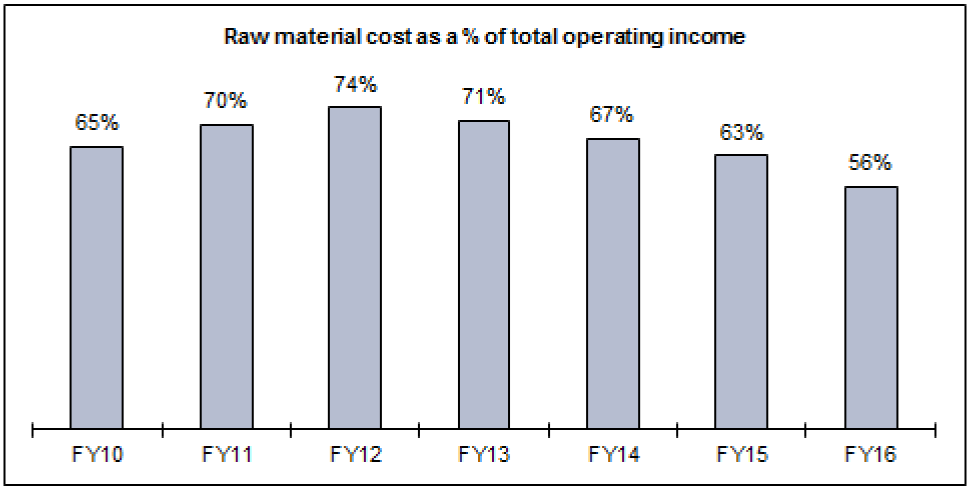
Raw material accounts for 65%-70% of the production cost (~55-60% of revenues) for tyre manufacturers, thus making this industry raw-material intensive and sensitive to movements in prices of the key raw material, natural rubber (NR). Due to a shortfall in the domestic production of raw materials, tyre manufacturers become dependent on imports. Raw materials apart from NR are basically crude derivatives. Globally weak raw material prices have aided tyre industry margins.

Table 2: Breakup of raw materials (by weight) used in a tyre

Material	% of weight
Natural Rubber	47%
Carbon Black	24%
NTCF (Nylon tyre cord fibre)	11%
SBR (Styrene Butadiene Rubber)	5%
PBR (Poly Butadiene Rubber)	5%
Chemicals	5%
Others	3%

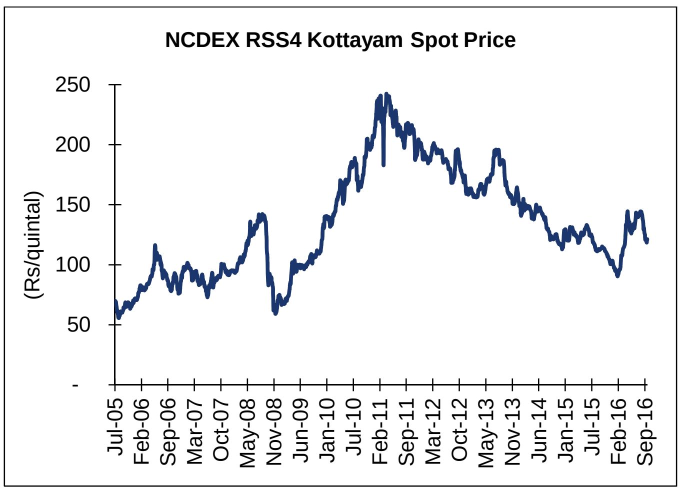
Source: CRISIL, I-Sec research

Chart 36: Falling rubber prices have reduced the proportion of raw material costs for tyre manufacturers



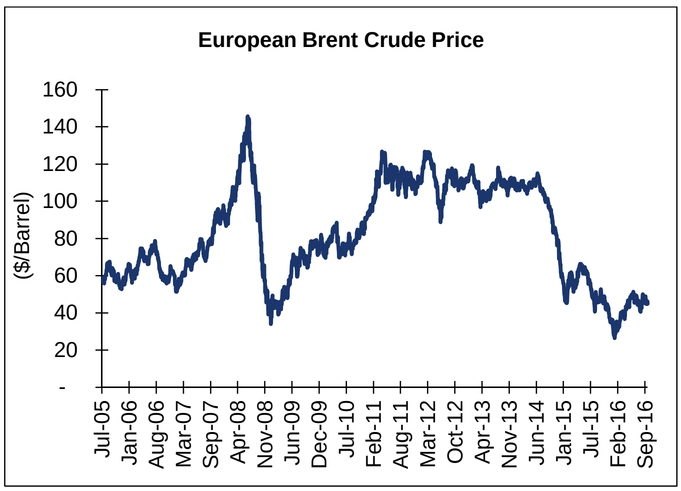
Source: CRISIL, I-Sec research

Chart 37: Price trend in natural rubber



Source: Bloomberg

Chart 38: Price trend in crude oil



Source: Bloomberg

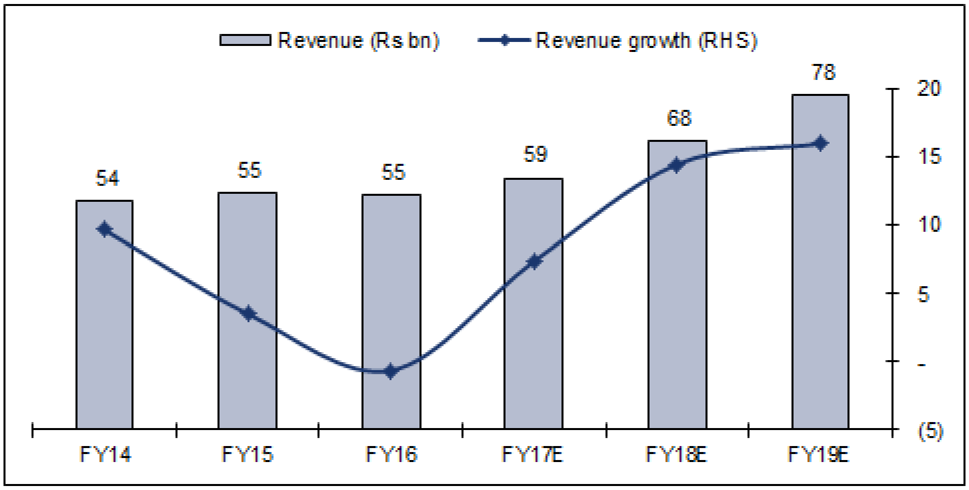
We expect the softness in raw material prices to continue over the next three years and CEAT's gross margins to stabilise at 58% over FY16-FY19. Given the company's increased focus and execution in the high-margin passenger tyre segment, we expect CAGRs of 13%/11%/14% in revenues, EBITDA and PAT respectively over FY16-FY19.

Financials in charts

We believe CEAT would witness strong volume growth (12% CAGR FY16-19). We anticipate improving product mix to overcome pricing challenges in the competitive T&B segment.

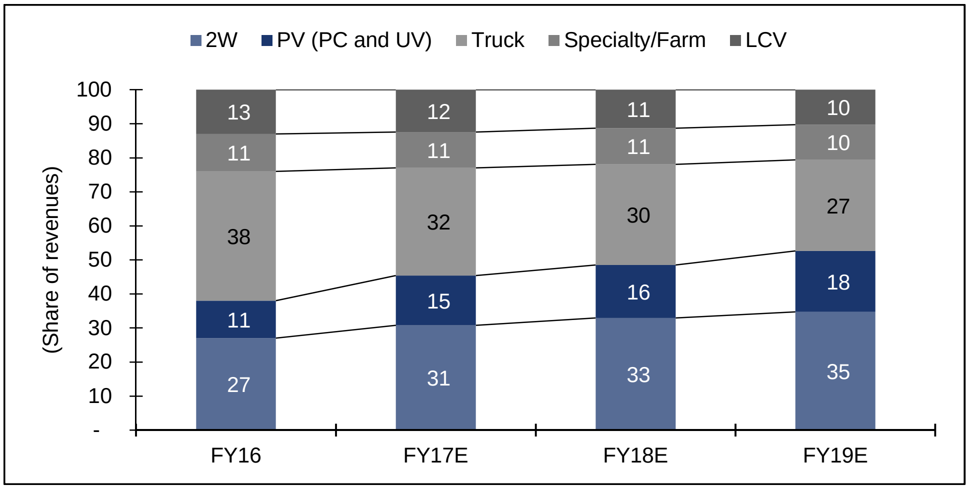
The enriched product mix (growing B2C share) could aid strong gross margin expansion.

Chart 39: Strong and consistent revenue growth due to B2C focus



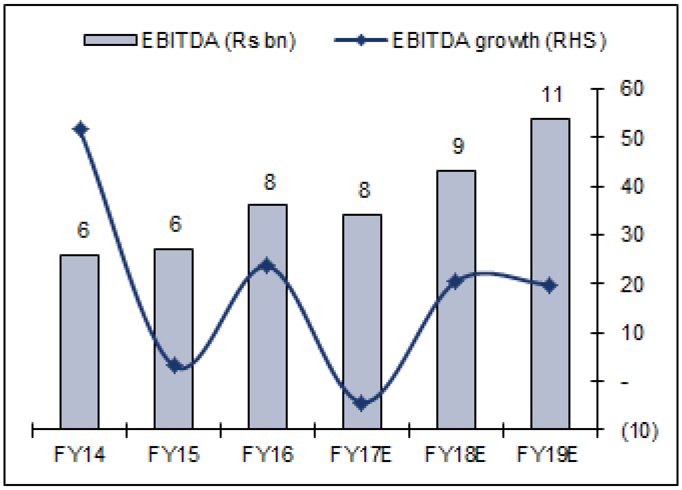
Source: I-Sec research, Company

Chart 40: B2C segment revenues expected to be >50% of total by FY19



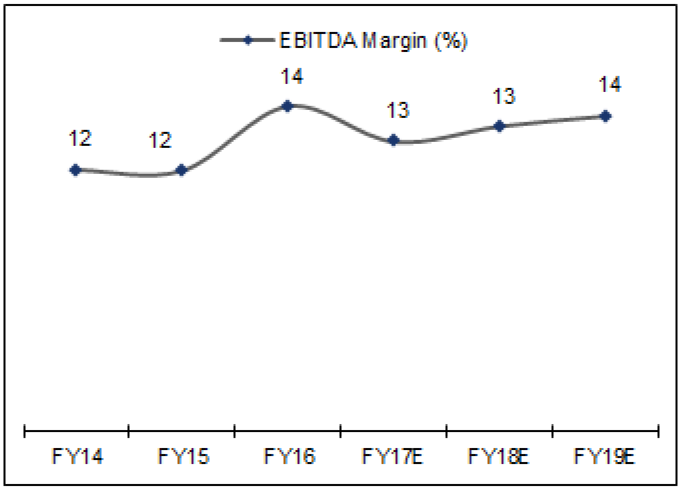
Source: Company data, I-Sec research

Chart 41: EBITDA growth to remain healthy



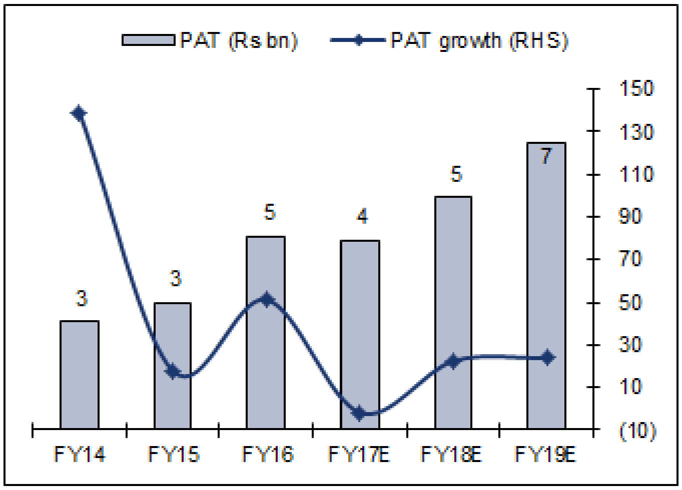
Source: I-Sec research, Company

Chart 42: EBITDA margins to trend higher



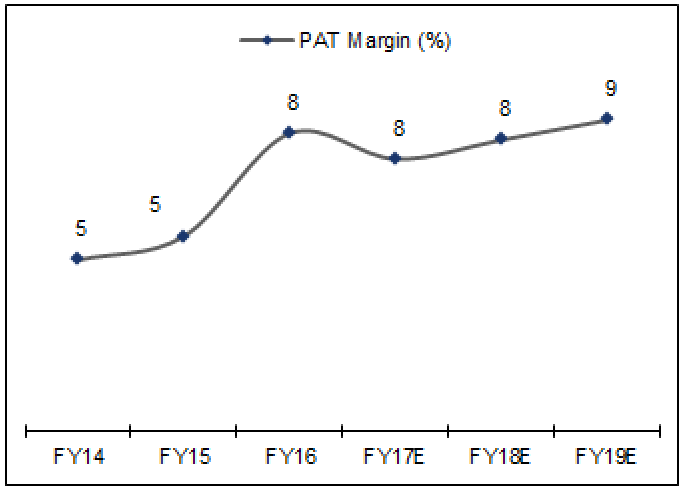
Source: I-Sec research, Company

Chart 43: Profit growth to mirror EBITDA trends



Source: I-Sec research, Company

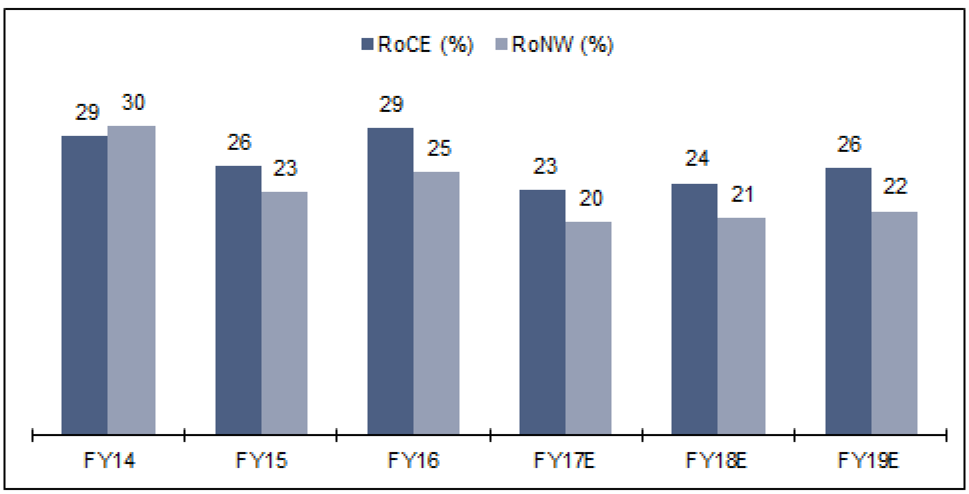
Chart 44: PAT margin trend strong



Source: I-Sec research, Company

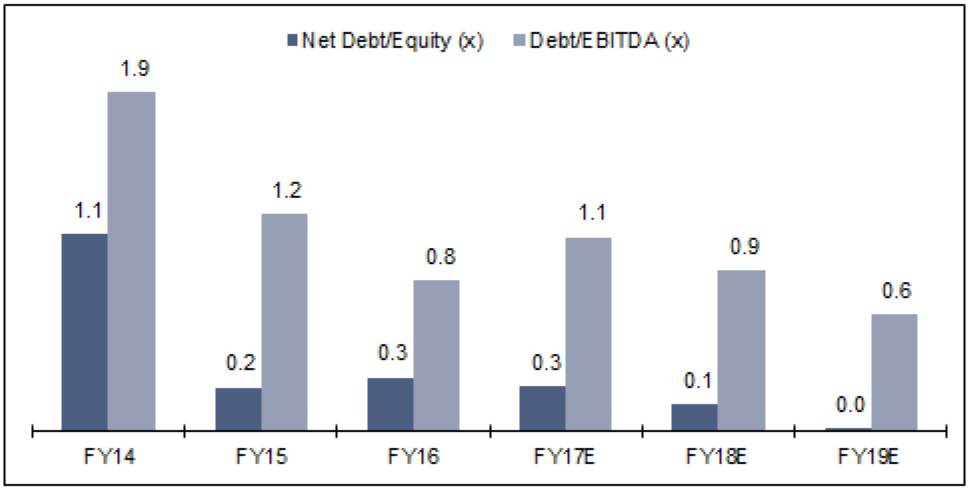
CEAT has been showing a steady improvement in its return ratios. Its RoE has jumped from 15.2% in FY12 to 25.2% in FY16, whereas RoCE has jumped from 19.0% in FY12 to 29.4% in FY16. We expect the company to maintain its return ratios over the next three years even as it adds capacity due to strong balance sheet discipline.

Chart 45: Return ratios remain healthy



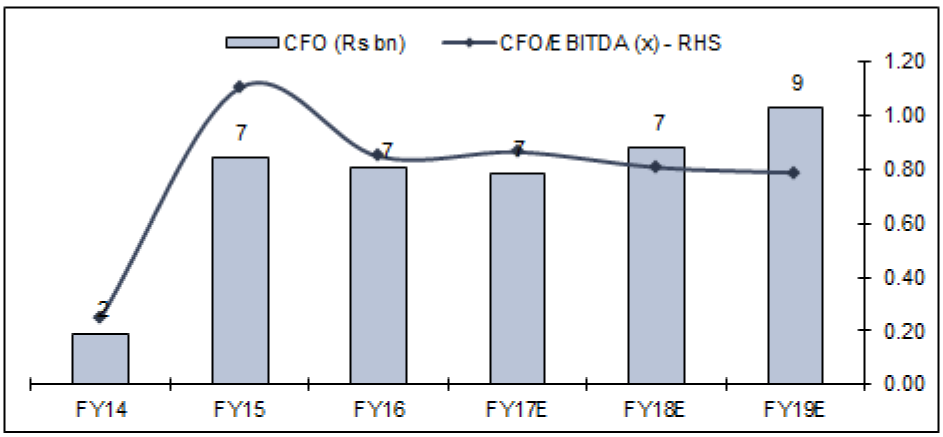
Source: I-Sec research, Company

Chart 46: Balance sheet discipline consistent



Source: I-Sec research, Company

Chart 47: Strong cash flows despite vital capacity expansion



Source: I-Sec research, Company

Valuation and recommendation

We initiate coverage on CEAT with a **BUY** rating and target price of Rs1,507/share.

The stock has been trading at an average 2-year forward P/E multiple of 6.9x since FY09. The stock has been witnessing a rally since the past three years on account of its stellar financial outperformance as the company deftly shifted its focus to the premium passenger segment. We value the stock at 10x the average of FY18E and FY19E EPS of Rs151 as we believe the company will continue to register strong operating performance on the back of continued focus on the high-margin passenger segment. In terms of free cash flow yield, the stock remains alluring at 7.0% FY18E.

Table 3: Peer comparison

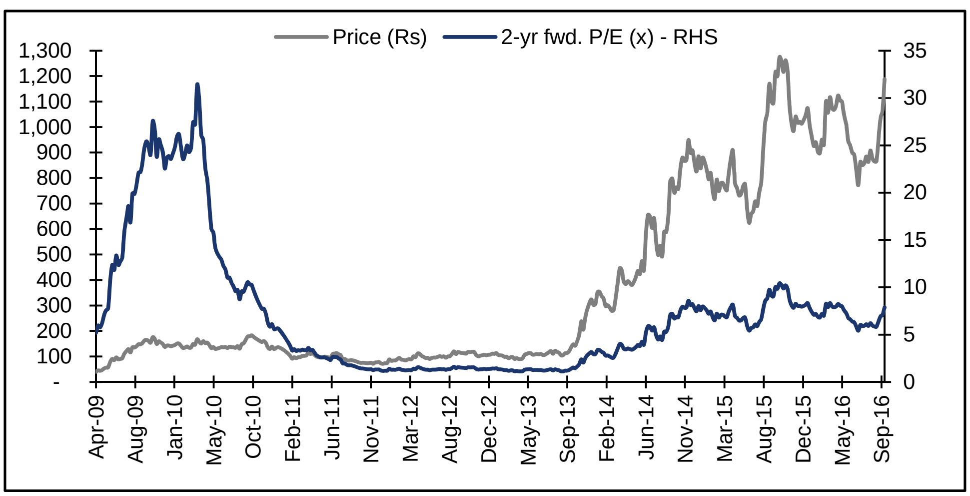
		US$ mn	P/E (x)			EV/EBITDA (x)			P/BV (x)			EPS (LC)		
Company	**Price**	**Mkt. Cap.**	**FY16**	**FY17E**	**FY18E**	**FY16**	**FY17E**	**FY18E**	**FY16**	**FY17E**	**FY18E**	**FY16**	**FY17E**	**FY18E**
Ceat Ltd	**1,188**	**721**	**10.4**	**10.8**	**8.8**	**6.8**	**7.1**	**5.7**	**2.41**	**2.03**	**1.69**	**113.9**	**109.9**	**134.6**
Apollo Tyres	216	1,652	10.1	10.2	9.6	6.0	5.7	5.2	1.44	1.55	1.36	21.5	21.2	22.5
JK Tyres	144	489	7.0	7.2	5.8	5.1	4.5	4.0	1.09	1.54	1.24	20.5	20.0	24.8
MRF Ltd	45,715	2,909	5.6	11.2	10.6	4.6	6.2	5.8	2.85	2.34	1.98	5,488.4	4,069.1	4,314.0
TVS Srichakra	3,023	347	12.4	11.0	11.0	7.5	7.1	6.3	4.29	4.22	3.31	243.1	275.6	273.6

	EBITDA margin (%)			PAT margin (%)			RoE (%)			EPS growth (% YoY)		
Company	**FY16**	**FY17E**	**FY18E**	**FY16**	**FY17E**	**FY18E**	**FY16**	**FY17E**	**FY18E**	**FY16**	**FY17E**	**FY18E**
Ceat Ltd	**14.4**	**12.8**	**13.5**	**8.2**	**7.5**	**8.1**	**25.2**	**20.4**	**20.9**	**41**	**(4)**	**23**
Apollo Tyres	16.8	15.5	15.2	9.3	8.1	7.6	19.5	15.6	14.5	12	(1)	6
JK Tyre	16.6	15.8	15.8	6.7	5.7	6.1	29.5	24.0	23.8	30	(2)	24
MRF Ltd	21.2	21.6	20.3	11.5	11.4	10.4	27.4	21.0	18.7	73	(26)	6
TVS Srichakra	13.9	13.3	13.3	8.0	8.2	7.2	53.6	34.6	30.1	87	13	(1)

Source: Bloomberg, Company, I-Sec research

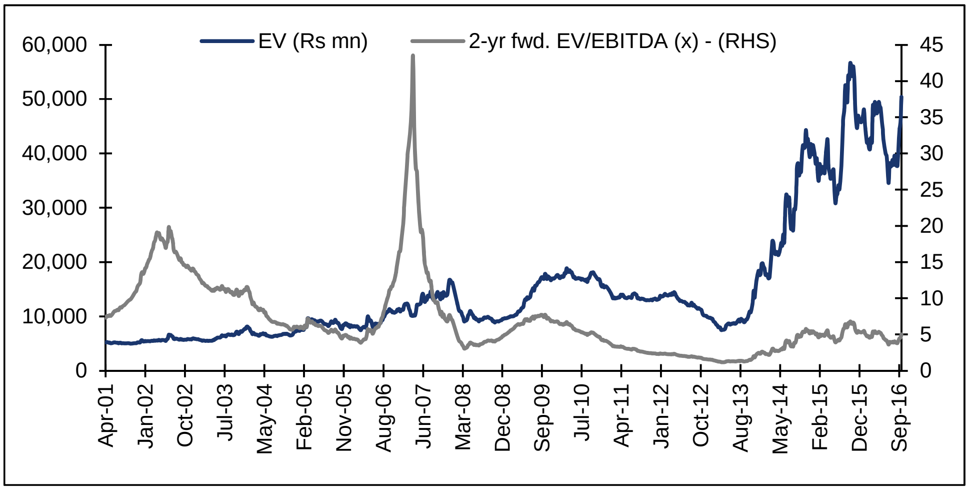
The stock currently trades at 8.8/7.1 FY18E/19E on P/E basis, while on EV/EBITDA basis it is trading at 5.7x/4.4x FY18E/19E, based on our forecasts.

Chart 48: 2-year rolling forward P/E chart



Source: I-Sec research, Bloomberg

Chart 49: 2-year rolling forward EV/EBIDTA chart



Source: I-Sec research, Bloomberg

Table 4: I-Sec *vs* Consensus estimates

(Rs mn)

	I-Sec			Consensus		Difference (%)	
	FY17E	**FY18E**	**FY19E**	**FY17E**	**FY18E**	**FY17E**	**FY18E**
Revenue	59,039	67,598	78,410	59,774	67,392	(1.2)	0.3
EBITDA	7,557	9,113	10,929	7,982	9,024	(5.3)	1.0
PAT	4,446	5,446	6,747	4,220	4,864	5.3	12.0
EPS (Rs)	110	135	167	104	120	5.3	12.0

Source: Bloomberg, I-Sec research

Our net income estimates are better than consensus as we are anticipating higher profit contribution from JVs and higher other income.

Key Risks

Rising Chinese imports

Since the Chinese tyre market is facing challenges of overcapacity, slowing domestic demand, anti-dumping duties imposed by the US, Chinese tyre manufacturers are flooding the Indian tyre market at distressed prices amid absence of any anti-dumping duties in India on Chinese tyres. This trend is more evident in the T&B radial (TBR) segment since 2W and PV consumers tend to be brand-conscious. Chinese tyre pricing lets fleet operators upgrade from TBB to TBR at the cost of TBB, and thus Chinese TBR imports have earned a healthy market share of ~35% in the TBR replacement market. Moreover, India's inverted duty structure makes it cheaper to import tyres than import natural rubber. The Chinese Yuan devaluation adds to woes as it allows Chinese tyres to be priced very competitively. We feel CEAT is relatively insulated from this risk as the company is focused on the passenger segment (2Ws and PVs) where Chinese competition is much lower.

Intensifying competition in 2W

CEAT's success in the two wheeler segment is attracting competition and players like Apollo Tyres, Bridgestone and Balkrishna Tyres are entering the fray for market share. We feel CEAT shall have the first-mover advantage here as the company identified the B2C segment much ahead of others and has already captured significant mindshare via extensive marketing. The company also consistently launches unique products and brands its products effectively, thus making it difficult for newcomers to gain meaningful incremental market share.

Annexure 1: Consolidated financials

Table 5: Profit and Loss statement

(Rs mn, year ending March 31)

	FY15	FY16	FY17E	FY18E	FY19E
Net Sales	54,922	54,587	58,629	67,128	77,865
Other operating income	492	355	410	470	545
Total Op. Income (Sales)	**55,414**	**54,941**	**59,039**	**67,598**	**78,410**
Raw material expense	34,350	30,896	34,201	39,044	45,397
Employee expense	3,499	3,672	4,136	4,625	5,140
Other expenses	11,181	12,475	13,145	14,815	16,944
Operating Expenses	**49,030**	**47,043**	**51,483**	**58,484**	**67,482**
EBITDA	**6,384**	**7,899**	**7,557**	**9,113**	**10,929**
% margins	*11.5%*	*14.4%*	*12.8%*	*13.5%*	*13.9%*
Depreciation & Amortisation	878	1,004	1,247	1,427	1,567
EBIT	**5,506**	**6,895**	**6,310**	**7,687**	**9,362**
Other Income	289	472	519	571	628
Gross Interest	1,305	892	919	974	913
PBT	**4,490**	**6,475**	**5,909**	**7,284**	**9,077**
Less: Exceptionals	61	114	-	-	-
PBT after Exceptionals	**4,429**	**6,361**	**5,909**	**7,284**	**9,077**
Less: Taxes	1,439	1,835	1,714	2,112	2,632
Less: Minority Interest					
Add: Profit from Associates	-	-	250	275	303
Net Income (Reported)	**2,990**	**4,525**	**4,446**	**5,446**	**6,747**
Net Income (Adjusted)	**2,990**	**4,525**	**4,446**	**5,446**	**6,747**

Source: Company data, I-Sec research

Table 6: Balance sheet

(Rs mn, Year ending March 31)

	FY15	FY16	FY17E	FY18E	FY19E
ASSETS					
Current Assets, Loan & Advances					
Inventories	6,421	6,193	6,632	7,593	8,808
Sundry debtors	6,669	5,779	6,147	7,038	8,163
Cash & cash equivalents	622	242	1,705	3,386	6,144
Loans and Advances	1,105	1,872	1,941	2,222	2,578
Total Current Assets	**14,818**	**14,086**	**16,425**	**20,239**	**25,693**
Current Liabilities & Provisions					
Sundry creditors	10,284	10,523	11,323	12,964	15,038
Other current liabilities	1,043	786	786	786	786
Total Current Liabilities & Provisions	**11,327**	**11,308**	**12,108**	**13,750**	**15,823**
Net Current Assets	**3,491**	**2,777**	**4,316**	**6,489**	**9,870**
Investments	**4,368**	**1,649**	**1,649**	**1,649**	**1,649**
Fixed Assets					
Gross Fixed Assets	23,106	28,665	33,665	37,665	40,665
Accumulated Depreciation	8,293	9,039	10,286	11,712	13,279
Net Fixed Assets	**14,813**	**19,626**	**23,379**	**25,952**	**27,386**
Capital Work-in-Progress	1,641	3,165	3,165	3,165	3,165
Total Fixed Assets	**16,454**	**22,790**	**26,544**	**29,117**	**30,550**
Long term loans & advances					
Other non-current asset	723	1,053	1,053	1,053	1,053
Total Assets	**25,035**	**28,269**	**33,561**	**38,308**	**43,122**
LIABILITIES					
Borrowings	**7,594**	**6,536**	**8,036**	**8,036**	**7,036**
long-term borrowings	6,222	5,811	7,311	7,311	6,311
short-term borrowings	1,372	725	725	725	725
Deferred Tax Liability Net	1,172	1,474	1,474	1,474	1,474
Other Non-current Liabilities	285	347	347	347	347
Equity Share Capital	405	405	405	405	405
Reserves & Surplus	15,581	19,508	23,300	28,047	33,861
Net Worth	**15,985**	**19,913**	**23,705**	**28,451**	**34,265**
Total Liabilities	**25,035**	**28,269**	**33,561**	**38,308**	**43,122**

Source: Company data, I-Sec research

Table 7: Cashflow statement

(Rs mn, Year ending March 31)

	FY15	FY16	FY17E	FY18E	FY19E
Cashflow from Operating Activities					
PAT					
Add: Depreciation	2,990	4,525	4,446	5,446	6,747
Add: Interest paid	878	1,004	1,247	1,427	1,567
Operating cashflow before working capital changes	1,305	892	919	974	913
Changes in working capital	**5,173**	**6,421**	**6,612**	**7,847**	**9,227**
(Increase) / Decrease Inventories					
(Increase) / Decrease Receivables	762	229	(439)	(961)	(1,215)
Increase / (Decrease) Payables	585	123	(436)	(1,172)	(1,481)
Others	(238)	238	800	1,641	2,074
Net Working Capital Changes	770	(314)	-	-	-
Cash flow from Operating Activities	**1,879**	**276**	**(75)**	**(492)**	**(622)**
Capital Commitments	**7,052**	**6,697**	**6,536**	**7,355**	**8,605**
Free Cashflow	**(2,328)**	**(7,083)**	**(5,000)**	**(4,000)**	**(3,000)**
Cash flow from sale of investments	**4,724**	**(386)**	**1,536**	**3,355**	**5,605**
Cashflow from Investing Activities	-260	223	0	0	0
Cashflow from Financing Activities	**(2,587)**	**(6,860)**	**(5,000)**	**(4,000)**	**(3,000)**
Issue of Share Capital					
Inc/(Dec) in securities premium	45	-	-	-	-
Inc/(Dec) in Borrowings	3,786				
Dividend paid	(3,893)	(1,058)	1,500	-	(1,000)
Interest paid	(405)	(994)	(653)	(700)	(933)
Others	(1,305)	(892)	(919)	(974)	(913)
Cashflow from Financing Activities		47	-	-	-
Net Cashflow	**(1,772)**	**(2,896)**	**(73)**	**(1,674)**	**(2,847)**
Opening Cash & Bank balance	**2,693**	**(3,059)**	**1,464**	**1,681**	**2,758**
Closing Cash & Bank balance	**933**	**3,625**	**242**	**1,705**	**3,386**
Increase / (Decrease) in Cash & cash equivalents	**3,625**	**567**	**1,705**	**3,386**	**6,144**

Source: Company data, I-Sec research

Table 8: 5-stage Du-Pont analysis

(%, Year ending March 31)

	FY15	FY16	FY17E	FY18E	FY19E
Tax Burden (Adjusted PAT/PBT)	0.7	0.7	0.8	0.7	0.7
Interest Burden (PBT/EBIT)	0.8	0.9	0.9	0.9	1.0
EBIT Margin (EBIT/Sales)	0.1	0.1	0.1	0.1	0.1
Asset Turnover (Sales/Total Assets)	3.4	2.4	2.2	2.3	2.6
Financial Leverage (Total Assets/Equity)	1.0	1.1	1.1	1.0	0.9
ROE	23.3	25.2	20.4	20.9	21.5

Source: Company data, I-Sec research

Table 9: Key ratios

(Year ending March 31)

	FY15	FY16	FY17E	FY18E	FY19E
Per Share Data (in Rs.)					
EPS (Basic)	80.9	113.9	109.9	134.6	166.8
EPS (Adjusted)	80.9	113.9	109.9	134.6	166.8
Cash EPS	104.3	138.7	140.7	169.9	205.5
Dividend per share (DPS)	10.8	11.5	14.0	15.0	20.0
BVPS (Adjusted)					
Growth Ratios (%)					
Total Op. Income (Sales)	3.5	-0.6	7.4	14.5	16.0
EBITDA	3.2	23.7	-4.3	20.6	19.9
Net Income (Adjusted)	17.8	51.4	-1.8	22.5	23.9
EPS (Adjusted)	10.6	40.8	-3.5	22.5	23.9
Cash EPS	8.3	33.0	1.4	20.7	21.0
BVPS (Adjusted)	7.9	6.6	21.7	7.1	33.3
Valuation Ratios (x)					
P/E (Adjusted)	14.7	10.4	10.8	8.8	7.1
P/BV (Adjusted)	2.8	2.4	2.0	1.7	1.4
EV/EBITDA	7.6	6.8	7.1	5.7	4.4
EV/Sales	0.9	1.0	0.9	0.8	0.6
Return/Profitability Ratios (%)					
Raw Material Expenses/Sales	62.0	56.2	57.9	57.8	57.9
Employee Expenses/Sales	6.3	6.7	7.0	6.8	6.6
Other Expenses/Sales	20.2	22.7	22.3	21.9	21.6
EBITDA Margin	11.5	14.4	12.8	13.5	13.9
Net Income Margin (Adjusted)	5.4	8.2	7.5	8.1	8.6
RoCE	25.9	29.4	23.5	24.2	25.7
RoNW	23.3	25.2	20.4	20.9	21.5
Dividend Payout Ratio	13.3	10.1	12.7	11.1	12.0
Dividend Yield	0.9	1.0	1.2	1.3	1.7
Solvency/Wkg. Cap. Ratios (x)					
Net D/E	0.2	0.3	0.3	0.1	0.0
Gross Debt/EBITDA	1.2	0.8	1.1	0.9	0.6
EBIT/Interest	4.2	7.7	6.9	7.9	10.3
Current Ratio	1.6	1.3	1.4	1.5	1.6
Quick Ratio	0.7	0.7	0.8	0.9	1.1
Inventory (days)	42	41	41	41	41
Receivables (days)	44	38	38	38	38
Payables (days)	68	70	70	70	70

Source: Company data, I-Sec research

Annexure 2: Index of tables and charts

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