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Analyst / Investor Conference Call

Third Quarter FY 2016-17

Sonal Gupta: Good morning everyone. On behalf of UBS Securities, I welcome you to Apollo Tyre's Q3 FY17 Earnings Call. We are delighted to have with us today the senior management team from Apollo Tyres headed by Gaurav Kumar, Chief Financial Officer. Now I would pass on the floor to Gaurav for his opening comments post which we will have the Q&A session.

Gaurav Kumar: Good afternoon everyone and thanks for joining in. We would give brief background on the results post which we would be happy to take your questions.

On consolidated level, our sales for the quarter stood at Rs 34.4 billion, registering a growth of 17% over the same period last year. This was due to growth in our both Indian and European Operations and also the effect of Reifencom, the German distribution company we acquired in January 2016. EBITDA, excluding the other income for the quarter stood at Rs 5 billion, a margin of 14.5%, an improvement from the previous quarter, however, a margin drop on a year-on-year basis was due to the cascading effect of the price cuts undertaken, the rise in raw material prices and the addition of the lower margin Reifencom business.

Raw material prices, on a sequential basis, were marginally up by 1% and we continue to see the raw material prices going up in the coming quarters as well.

In terms of revenue segmentation, three-fourth of our revenue continues to come from the replacement market and one-fourth from the OE. The truck tyres category contribute about 43% to our revenues and the passenger car tyres contribute about 40%, and the balance being made up of light truck, farm and other categories.

For the nine-month period, the sales stood at Rs 98 billion; growth of 11.5% over the same period last year. The EBITDA for the nine-month period was in excess of 15% compared to the 17% last year, owing to a combination of lower margins in the existing operations in India and also addition of the Reifencom business that has fundamentally a lower margin. The net debt stood at Rs 18 billion. The leveraging levels are still very comfortable, with the Net Debt:Equity being slightly under 0.3.

Going forward, one of the challenges remain rising raw material prices that is expected to increase by nearly 10% in coming quarters; which would be offset both from cost optimisation and selling price side by us going forward.

Moving on to India Operations, the sales for the quarter stood at Rs 21.8 billion, a growth of 2% over the same period last year. There was a growth of 7% through volumes, which was negated to the extent of 5% from the price impact. Though the impact of demonetisation was felt in December, but overall, the quarter was managed quite well.

OEM segment revived to some extent vi-a-vis the previous quarter. The passenger car tyre segment grew sharply on a year-on-year basis though on the commercial vehicle side, there was a de-growth.

However, for the truck and bus tyres, there was a strong growth vis-à-vis the comparatively weaker September quarter. One good point for the company was that the demonetisation also impacted the Chinese imports. The current level of imports has reduced from the earlier higher levels.

EBITDA for the quarter stood at Rs 3.2 billion with margin of 14.8% compared to a 17% for the same period last year. This was primarily due to price reductions that were undertaken. This was the third consecutive year of declining selling prices, which with the cascading effect and increasing raw material prices reflects in the margin. The company is considering to increase prices going forward in the light of rising raw material prices.

On nine months basis, for the Indian Operation, the sales stood at Rs 65 billion which was almost flat vis-à-vis last year and the EBITDA for the nine-month period was at 16.2% versus the 17.9% for the same period last year. The Net debt in the India Operations stood at Rs 8.6 billion.

Moving on to the European Operations, the sales for the quarter were at Rs 12.6 billion, registering a significant growth of 54% over the same period last year owing to both growth in the European Operations and the Reifencom Operations. The EBITDA including other income for the quarter stood at Rs 1.7 billion with margins at 13.7% compared to a higher number last year, which is not fairly an apple-to-apple comparison. The European manufacturing and selling operations had 6% revenue growth over the same quarter last year and also had a margin improvement in the current quarter. The Hungary plant continues to progress on track and would be starting production in the current quarter. The European Operations continue to show progress with growth in both top line and margins and catching up on the previous year market share losses. Reifencom also performed good in this quarter with seasonally being the strongest quarter and in a way, validate our strategy of strengthening our presence in the key German market, which was the basis for going through with this transaction. The European market also in itself continues to grow. There was significant increase in new vehicle registration and even the replacement market is up. That is all from my side, we would be happy to take your questions.

Ashutosh Tewari (Equirus): What is the growth rate of passenger car tyre segment in India and is it correct that CV segment has declined? Also, has the company grown in these segments?

Gaurav Kumar: That is correct, the CV market overall was flat to a slight negative whereas in passenger car our expectation is that the market grew by about 10% plus. Whereas, our growth in PCR was in excess of 15% and CV was flat vis-à-vis last year.

Ashutosh Tewari: My second question is on pricing. What kind of price increase is required to cover the raw material price increase, which we are seeing in Q4? And have you taken any prices increase so far?

Gaurav Kumar: We do not have an exact raw material price for Q4, as mentioned, we expect the raw materials to go up by about 10%, price increase of about 6% to 7% would be required to sustain the margins. Various players across the globe are considering price increases, what finally gets played out will be determined by the industry scenario. And, yes we have taken some small price increases.

Ashutosh Tewari: Post demonetisation Chinese volumes are going down, and now how do you see this quarter shaping up for CV volumes?

Gaurav Kumar: CV volumes are expected to be good this quarter. There was some continuing effect of demonetisation and it impacts probably the two wheeler segment etc. categories more. The expectation as we proceed further in the quarter is, the impact of demonetisation would go away. There is also an expectation of new CV sales booming as the new emission norms are coming into place from April, which should lead to good new vehicle sales and hence tyre sales to the OEM.

Ashutosh Tewari: Also on the margin front in India, we are seeing a decline in the margin now it's around 14.8% in the current quarter; but how do you see on sustainable basis, how much margin we can do considering raw material price increase?

Gaurav Kumar: You would know, we do not give out margin guidance, so I cannot comment on that.

Ashutosh Tewari: Lastly on Hungary plant, how would the ramp up happen in Hungary plant and what is total capacity over there?

Gaurav Kumar: The total capacity at the end of phase 1 would be 16,000 passenger car tyres a day and about 2000 truck tyres a day, which would be reached by end 2019. The production would begin towards end of this quarter and the ramp up would happen over the next two to two-and-a-half years.

Ashutosh Tewari: What is your current capacity in Vredestein?

Gaurav Kumar: The Vredestein capacity that is the Dutch plant is about 20,000 car tyres a day.

Ashutosh Tewari: Debt cost is lower there in the Hungary plant?

Gaurav Kumar: That is correct, all borrowed in Europe is at very competitive rate.

Basudev Banerjee (Antique Finance): What was the landed cost of raw materials commodity wise for Q3?

Gaurav Kumar: The natural rubber cost for the quarter was Rs 135/ kg for the industry, synthetic rubber at around Rs 120/kg, steel cord Rs 113kg, Tyre cord fabric at Rs 245/kg and carbon black at Rs 55/kg.

Basudev Banerjee: As we know that almost 65% of your natural rubber is imported and it takes almost two months' time to shift from the sourcing base and if one sees the quantum of rubber price jump in the southeast Asian markets that have been much more than India, may be because of temporary effect of Thailand floods, so do you see that the impact of cost of rubber moving up so sharply in the Southeast Asian markets, hurting more than just benchmarking with Kerala rubber prices?

Gaurav Kumar: Our sourcing strategy is looked at on ongoing basis; in the current quarter our proportion of natural rubber sourcing domestically has gone up. Natural rubber prices for the current quarter would definitely be up vis-à-vis what they were for the last quarter, and we would again assess the mix between domestic and imported rubber as per our requirements going forward.

Basudev Banerjee: When would the new capacity of TBR in Chennai be fully operational?

Gaurav Kumar: The production has already commenced in Chennai. The final plant capacity of 12,000 truck radials per day would be reached by about mid-2018.

Basudev Banerjee: So one can assume that from Q4, both the Chennai TBR expansion and Hungary will be starting to produce?

Gaurav Kumar: That is correct. Also please note that Hungary would first start with passenger car tyres; the truck tyre production in Hungary would only come through towards end FY18 or maybe early FY19.

Basudev Banerjee: Last thing sir, how is your two-wheeler tyre business ramping up?

Gaurav Kumar: It has been at a steady level, we did not see the expected ramp up with some of the impact of demonetisation, but we remain quite upbeat on the possibilities and it has brought in the benefits of network expansion significantly in the rural areas.

Chirag Shah (Edelweiss): Two questions, firstly in India what would be your revenue mix in terms of major product categories? My second question is on the commodity basket: the entire industry has already started seeing the impact of rising raw material prices so what is your thought process and what kind of pricing actions the industry can take. In the past, has there been this kind of sharp price hike or it takes a reasonable long time for you to raise prices at an industry level?

Gaurav Kumar: Answering to your first question, In India 90% of our revenue is domestic and about 10% exports. Product category wise about 60% of the revenues come from truck tyres and about 20% from car tyres and the rest split between the light commercial vehicle, farm, etc.

On your second question, we would not know of what other players are thinking, as you may have read in the press that various players have talked about the need to take price increases and there have been small price increases.

Chirag Shah: Lastly on the Chinese imports, you indicated that we have seen drop in Chinese imports as a side effect of demonetisation, but has it started to normalise, has the import started coming up or increasing because that trend will reverse at some point in time and I presume industry would have benefited slightly because of lower Chinese imports?

Gaurav Kumar: Still early days, I agree that the trend could reverse at some point, but as of now, the levels continue to be lower. The imports might have dropped from about 150,000 per month pre-demonetisation to about 100,000 per month currently.

Chirag Shah: Can you throw some light on the anti-dumping duty case. What the Indian Government is planning to do on this? Any update on this?

Gaurav Kumar: The process is going on here. However, the US has clearly said that the Chinese are selling below the fair price and has hiked up the recommended duty, but at our end whether the authorities take that into account and move quickly, is a matter to be watched.

Harsh Shah (Dimensional Securities): Despite the steep decrease in imports, why the company has not taken any price hikes; rather the prices have declined?

Gaurav Kumar: These price declines have been over three consecutive years as raw materials was coming down, price decreases were announced, and now the raw material cycle has just started beginning to reverse.

Harsh Shah: The last question was how much is your Reifencom revenue for the quarter?

Gaurav Kumar: Reifencom revenue for the quarter is about €65 million.

Jatin(Credit Suisse): What price hikes have you taken in which segment?

Gaurav Kumar: We have taken about 1% to 1.5% price hikes in farm category w.e.f January 2017. A price hike of radial tyres is also being contemplated.

Jatin: What is the total CAPEX that you have already incurred for Chennai TBR expansion and Hungary?

Gaurav Kumar: In Hungary by the end of FY 2017, we would have incurred about €300 million and in Chennai by the end of this fiscal year, we would have incurred about Rs 1,500 crores.

Jatin: There were, a few days back some talks about global players like Michelin and all, having taken a large price hike in Europe, have your European Operations also taken a price hike?

Gaurav Kumar: These players have announced price hikes ranging between 5%-8% for summer tyres, so it is not yet implemented because the summer tyre inventory is being built up and would start playing out from around March or April.

Jatin: Because the industry there generally tends to be more disciplined in terms of passing on the raw material either benefit or the other way around?

Gaurav Kumar: They tend to take the price increases in larger quantum than what happens in India. Here in India since the quantum of price changes is small, there is always a need for multiple rounds of price increases whereas in some of the western geographies, the industry trend is more to take one shot price increases or reductions.

Jatin: In terms of the two-wheeler market share in India, any update on how that is tracked, the overall market got impacted by demonetisation, but in terms of your market share has there been a rising trend?

Gaurav Kumar: We have not lost volumes, as of now there is no official data available on how much the overall market declined by, yes, we would have gained some market share but we are still a very, very small player, so would not be a meaningful number in either way, but we have not lost any volumes in this period.

Jatin: You mentioned at the start that the Net Debt-to-Equity is less than 0.3, so this resolution to raise money through QIP, what is the thinking behind that?

Gaurav Kumar: We always had an enabling resolution earlier. For some reason, this time when it expired in August 2016, it was not renewed and hence the decision to keep an enabling resolution allows us to move if the market conditions are right.

Amyn Pirani (Deutsche Bank.): Actually my first question is on the truck replacement demand in India, now while we may have a pre-buy and that helps to boost the truck tyres demand, but I think ultimately volume growth for the entire Indian Operations will be dependent on whether replacement demand comes back. And also with Chinese imports coming in this segment what is your outlook there?

Gaurav Kumar: As you may know that the growth in truck tyres in recent years has been more OE-led, and even in the current year the replacement demand continues to be soft. Some of the announcements made in the Union Budget regarding spends on infrastructure could bode well for the replacement demand picking up. Still too early to say that there are signs that it is picking up, as an overall segment it is about flat. However, the cross ply demand has witnessed a good demand with the mining sector opening up and this has led to the capacity utilisation of cross-ply going up.

Amyn Pirani: In Europe what would be the revenue growth, excluding Reifencom and what is the overall volume growth?

Gaurav Kumar: In the current quarter, we had 5% growth on top-line, in passenger car segment there was a 10% volume growth. We in fact gained some market share in the current quarter. Till last quarter we had the teething issues with SAP and some maintenance breakdown issues due to which some market share was lost, which has now been regained

Ameen Pirani: Has winter tyres come back in a big way this time or still sluggish?

Gaurav Kumar: Winter tyre sales have been good, the ideal scenario would have been the kind of weather that has been there in January if that was there starting from November onwards winter tyre sales would have been very good.

Sonal Gupta (UBS Securities): What was the Vredestein revenues and EBITDA margin for this quarter?

Gaurav Kumar: Vredestein revenues were €118.5 million and the EBITDA was 15.8%.

Sonal Gupta: My next question is on the pricing actions in India, in the last quarter you announced about 2.5% price cut in TBB segment, so was that effected or did you pull that back during the quarter?

Gaurav Kumar: That was affected, and now things are being pulled back.

Sonal Gupta: Given that the Chinese imports have come down, are we witnessing a stronger pickup in TBB demand now?

Gaurav Kumar: We have benefited and our TBB volumes are higher, and have outperformed the TBR segment. It is a combination of both decreasing Chinese imports and the mining segment opening up.

Mayur Milak(Anand Rathi): The industry numbers suggest that the average Chinese imports were around 1.2 million per month and they still are at about 1.0 million per month, was there really a hit because I remember in the Analyst Meet, which happened in Mumbai recently, the management had guided that October sales were better than September and November looked even better than October, despite demonetisation, somehow that does not really reflect well into the Indian Operations, so is it the replacement demand that is gone weak.

Gaurav Kumar: December sales were impacted by demonetisation, the October/November was good, so if this had not happened what the results would have been is a hypothetical calculation one can do. The Chinese imports numbers that you mentioned is an average for year, however the number was going up through the year; pre-demonetisation the Chinese imports had reached a level of 150,000 tyres per month and that number has dropped to about 100,000 tyres now.

Mayur Milak: Secondly, coming to the margin side, we have seen structural benefit come into the entire tyre industry through margins, are we pretty confident that going forward even if there is let's say a 10% or a 15% rise in rubber prices, we will be able to sustain these levels for the company and the industry overall.

Gaurav Kumar: We do not give out margin guidance and I would be even less placed to comment about industry margin, so that is something that each player would have to react to it. The fact that raw materials have reversed their trend and now are going to increase going forward.

Disha Sheth (Anvil Shares & Stock Broking): If there is 10% increase in the raw material basket, how much price hike will be required to sustain the margins?

Gaurav Kumar: On a pure mathematical calculation, if everything else is constant, which is not really the case, we would need to take about a 6% price hike in our Indian Operations, but along with that, you need to recognise that any company would have other levers on the cost side, etc., and hence typically a company would look at various levers to counter a rising input cost scenario.

Disha Sheth: What is the utilisation for truck bias and radials?

Gaurav Kumar: The capacity utilisation levels are about mid-80s, slightly higher in the radial side than bias.

Disha Sheth: Any view on anti-dumping duty coming in?

Gaurav Kumar: We cannot really predict as to when and if it will come in, the matter is under investigation and has been for some time. It continues to progress, but we cannot give you a definitive view on that.

Navin Kumar Dubey (Narnolia Securities): What is the inventory level for the quarter?

Gaurav Kumar: Inventory levels are fairly stable. The numbers have been pretty much constant both in India level and consolidated.

Navin Kumar Dubey: What portion of your natural rubber requirement is imported?

Gaurav Kumar: For our Indian Operations, it is about 50:50, and for the Europe Operations, everything is imported.

Pramod Amte (CIMB): With regard to the TBR, what is your market share in OEs and replacement?

Gaurav Kumar: The industry numbers comes with a lag, so don't have the numbers as such. Our overall market share expectation is that we are at about 25%. We would be higher in the OEM, as a big chunk in the replacement is taken by the Chinese imports also.

Pramod Amte: Going forward with the commissioning of new plant, do you see that changing, especially with a thought process that it will take couple of quarters for BS-IV to be absorbed and hence the OE volumes can be softer after that, so how do you plan to absorb this capacity in terms of marketing plan?

Gaurav Kumar: It is something that has been looked at and one is always conscious of the fact that when you add capacity, it comes in chunks. It cannot ramp up as gradually as the sales would ramp up, so yes, we may have slight excess capacity. We had always taken into account that in FY18, we would have a slight excess in truck radial capacity. Apart from India Operations, the product is also being exported out to different geographies and we have good acceptance and pickup in volumes there, so the operations would try and minimise the excess capacity, but in the current year, our utilisation levels from an earlier scenario, when we were pretty much flat out and actually had opportunity lost, that would not be the case in the coming year.

Ashutosh Tewari (Equirus): The employee cost in standalone, we are seeing a decline over last two quarters, is there any particular reason behind that?

Gaurav Kumar: One, all of us have a variable component, so probably in line with the performance, there would be a reduction and also each of the plant keeps looking at possible cost reductions, there would have been retirements which would not have been replaced. We have not undertaken VRS or any significant manpower reduction exercise, but we are conscious of the cost elements and hence in some cases retirements are not replaced.

Ashutosh Tewari: Secondly, why has the other income in subsidiaries increased significantly?

Gaurav Kumar: The increase is the cash subsidy that we get in Hungary which was part of the agreement with the EU authorities as part of investment into Hungary and that will continue while the investment is going on. The total cash subsidy is about €52 million on an investment of €475 million and we have already received about €15 million.

Ashutosh Tewari: What is the EBITDA margin of Reifencom in the current quarter?

Gaurav Kumar: EBITDA margin was about 3-4%.

Ashutosh Tewari: You also mentioned the winter was strong in January in Europe, so will we see some kind of winter tyre sales happening in January as well?

Gaurav Kumar: Some of it spills over, but not that much because the buying of winter tyres does not happen that much even if the weather is harsh, because people know that summer is around the corner, but it does help in liquidating the inventory with the dealers to some extent in which case the pre-buying next year is done.

Ashutosh Tewari: Lastly on Hungary plant, what is the strategy in terms of utilisation of the plant and which markets you would like to tap with Hungary plant coming up?

Gaurav Kumar: On an immediate basis, the Hungary plant will cater to the European market before focusing on any other geography. We have been ramping up supplies from India to Europe in the previous years and in the current year, the passenger car tyre supplies from India would be close to a million tyres. On immediate basis, as the plant ramps up and stabilizes, the first and foremost would be that those volumes would get shifted to Hungary. Also as it is the Indian Operations with the strong growth in passenger car tyres would soon start needing that capacity, so in a way the timing is very appropriate for us. We are also in discussion with OEMs and making both our plants, the Dutch plant and Hungary plant eventually OE ready. We have already been approved with a couple of OEMs and for the first time, from FY18, the European

Operations would also begin supplies to OEM for the regular passenger car tyres in addition to the space master, which is supplied exclusively to OEMs.

Ashutosh Tewari: Will we focus initially on the same set of countries we are supplying the Vredestein or it will be new countries that we will try to tap?

Gaurav Kumar: It would be mostly similar, may be one or two smaller countries in Eastern Europe which were earlier not under focus would come in, but it is not shift in strategy in Europe. The only change vis-à-vis past which is significant is more focus on the OEMs.

Ashutosh Tewari: When the plant reaches optimum level of utilisation, what kind of margin difference will be there between European Operations and this Hungary plant, roughly?

Gaurav Kumar: Difficult question to answer, because it depends a lot on whole other factors, but at optimum capacity utilisation, we would have an increase in margins for the European Operations as a whole because the cost at the Hungary plant not just the manpower cost, even the manufacturing cost would be lower given that it is a much more modern plant that has been built.

Ashutosh Tewari: At the employee cost level, how much difference could be there, just employee cost?

Gaurav Kumar: Employee cost as an example, a blue-collar worker could be about one-fourth in Hungary vis-à-vis Netherlands.

Ashutosh Tewari: In European Operation, how much is the employee cost as a percentage of sales?

Gaurav Kumar: In the European Operations, as a percentage of sales, it is somewhere in the mid-to-high 20s.

Hitesh Doshi (individual investor): The anti-dumping matter which is under consideration is for which category of tyres, is it just for TBR or it is for all the category of tyres?

Gaurav Kumar: It is only for TBR.

Hitesh Doshi: Second thing, can you throw some light on the rubber inventory with the company?

Gaurav Kumar: Typically, we carry an inventory of about three weeks or so, operations may take a strategic call along with the procurement department and may go up or down on that a little bit, but that is the broad average.

Hitesh Doshi: Just one more thing, looks like the raw material cycle has reversed as you were saying earlier, so any historical data like, can these kind of price increase which we have to take going forward for next few months or next few quarters and any correlation with the replacement demand slowing down or the retreading business coming up and posing a challenge for our volume growth, do we have this kind of historical data to understand the bigger picture for next few quarters?

Gaurav Kumar: I am not sure if there would be historical data. The retreading part of the industry has always been there. The raw material cycle has gone up in the past as well. And any pricing action has a lag effect. Price increases are taken in smaller quantum. And there is always a lag in catching up but there is always some margin pressure in the interim.

Moderator: Thank you very much. That was the last question, Ladies and Gentleman. As there are no further questions, I would like to hand the conference back to Sonal Gupta for closing comments.

Sonal Gupta: Thank you every one for joining the call and on behalf of UBS, I would like to thank the senior management team from Apollo Tyres for taking the time out and discussing all the questions in detail. And thank you for joining us ladies and gentlemen

Gaurav Kumar: Thanks everyone.