CARE Ratings
Professional Risk Opinion

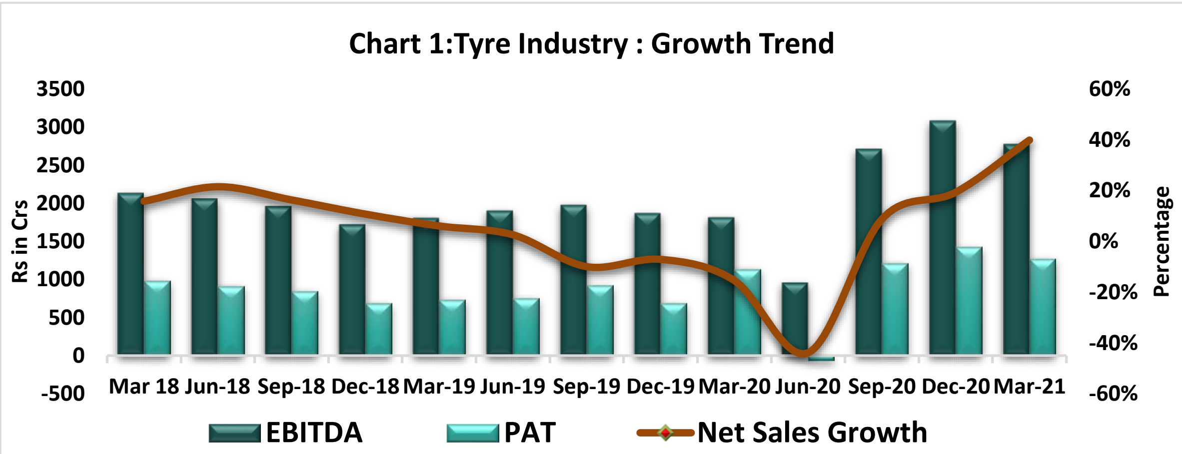
Tyre Industry – Margins to remain under pressure while growth resumes

June 19, 2021

"Rebound in the automotive sector, surge in pent-up demand for tyres, buoyant exports and restrictions on tyre imports would fuel the growth of the tyre industry in FY22. CARE Ratings believes that after posting weak performance in April and May 2021, tyre industry is expected to bounce back in Q2FY22 with unlocking of travel restrictions across states. The Q1FY22 performance overall would be weak, but with strong demand recovery in subsequent quarters driven by original equipment manufacturers (OEMs) as well as replacement segment, CARE Ratings expects the industry to register 6-8% volume growth for the year. Growth would be contingent to rapid Covid vaccination drive, absence of third wave of COVID 19 and normalcy in economic activities, improving consumer sentiments and demand. However, rising raw material (RM) cost is likely to dent operating margins which remains exposed to global price movements of natural rubber and crude derivatives such as carbon black and synthetic rubber. CARE Ratings believes EBITDA margins for industry would be 12-14% for FY22 (lower as compared to 16.34% recorded in Q4FY21) due to impact of higher RM cost."

Industry registered strong Q4FY21 performance albeit under RM cost pressure

Indian Tyre industry witnessed V Shaped recovery with stellar performance in Q4FY21 driven by strong revival in demand from the domestic automobile industry and exports. For Q4FY21, the industry recorded high sales growth of 40% y-o-y, while operating margins improved substantially by 66% on y-o-y basis as seen from chart below. Strong demand recovery resulted in higher volume sales and improved realizations causing an expansion in operating profit margin by 140 basis points which stood at 16.3%. The industry witnessed sharp hike in RM cost which surged by 49.6% in Q4FY21, higher than the sales growth. However, a tight control on other operating expenses supported margin growth. The total tyre production on q-o-q basis increased by 27.9% during March 2021 led by robust demand from OEMs, as automobile production grew by 27% in the same period. Tyre production in the month of March 2021 recorded growth of 57.7% on y-o-y basis though cumulative production during April 2020 - March 2021 fell by 4.4% due to muted Q1FY21 with nationwide lockdown.

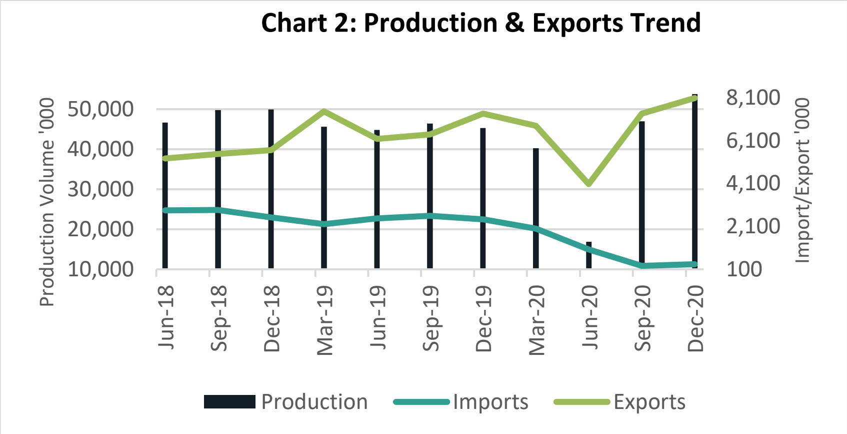


(Source: CMIE, CARE, Sample of 6 major companies)

Pent-up demand and rising exports to fuel growth

Post degrowth of 7.94% and 8.11% recorded in FY20 and FY21 respectively, domestic tyre demand is estimated to register 6-8% volume growth in FY22. Growth would be driven by pent-up demand, recovery in OEMs & replacement segment, higher export demand amidst improved economic activities. Domestic tyre Industry for the past two years FY20-FY21 was adversely impacted by slowdown in auto sector which was further dented by Covid 19 pandemic. However, exports surged by 11.9% in FY20 as Indian manufacturers benefited from imposition of anti-dumping duties (ADD) by US on Chinese tyres. The demand from US and other Asian, African nations such as UAE, Nepal Saudi Arabia and Nigeria boosted exports.

In FY21, Q1 was muted on account of the pandemic, with low demand and sluggish consumer sentiments translating into low production for the quarter (refer Chart 2 below). Production levels recovered from Q2 onwards, driven by pent up domestic demand and surge in exports as global automotive OEMs shifted their tyre sourcing from China to India. Tyre imports continued to record decline since past two years post imposition of ADD and custom duty on Chinese imports thereby improving domestic capacity utilisation rates.

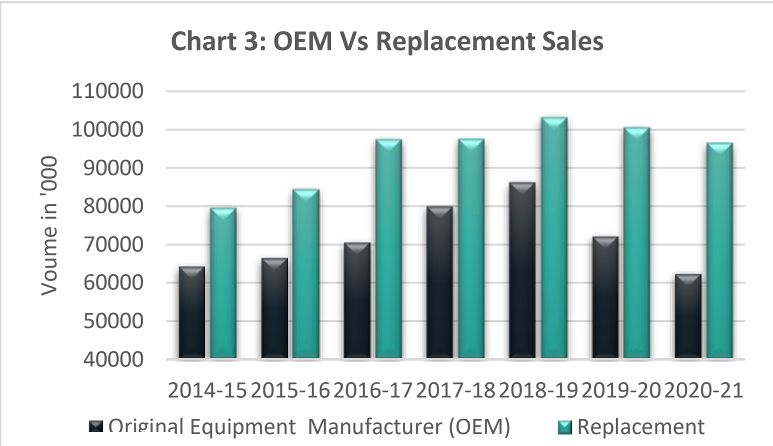


Source: CMIE, Export data for March 2021 not available

Going ahead for FY22, exports growth is expected to be above 15% aided by steady replacement segment growth for MHCV including Tractors and rebound in OEM with continued lower imports of Chinese tyres. Post sluggish demand in April and May 2021 due to state-wise lockdown with surge in second wave, domestic demand is also expected to pick up from June 2021 with ease in lockdown with recovery in economic activities contingent on a faster vaccination drive and no new waves of Covid 19 in the country.

Replacement market continues to lead, OEM to pick up

The tyre Industry majorly derives its volumes from replacement demand which was around 58% of total demand in the year 2020 followed by OEM at around 28%. OEM demand typically mirrors trend in vehicle production, while the replacement market demand is linked to the economy, usage and replacement cycles.



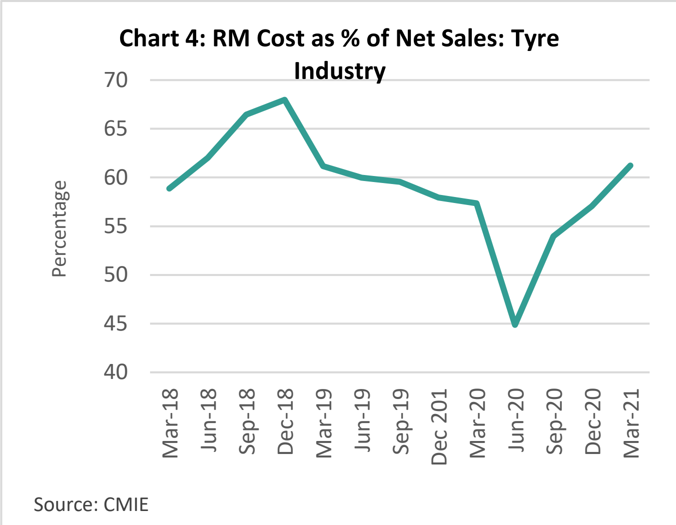
Source: CMIE

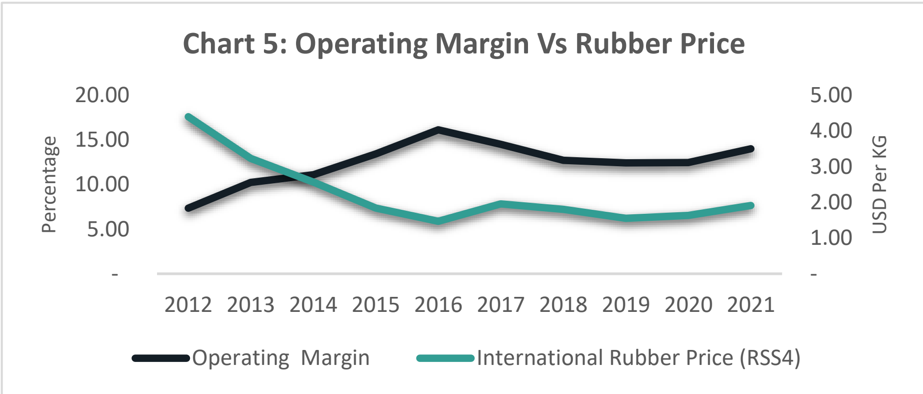
During FY21, the industry witnessed sharp contraction in OEM offtake as seen in chart 3, as the automotive sector saw major disruption due to COVID 19 lockdown and weaker demand in CV segment. While the replacement demand recorded degrowth of 4% for FY21, OEM saw sharp decline of 16%. OEM performance has been tepid over the last 18-24 months impacted by slowdown in the auto industry which was further impacted by COVID 19 pandemic. However, since H2FY21, there has been recovery in PV demand with preference for personal automobile while CV segment continues to remain muted. Furthermore, many states were under lockdown during the months of April and May 2021, thus impacting overall sales and production for Q1FY22. CARE believes M&HCVs volumes shall decline in Q1-FY22 due to lockdowns, while Q2-FY22 would be impacted by monsoons and continued closure of schools. However, the demand for LCVs and PVs could be better off with stable demand from E-commerce segment and higher preference for personal mobility. Replacement demand would bounce back from June 2021 with ease in logistics and vehicle movement, higher exports and overall recovery in economic activities.

Margins to remain under pressure with surging RM cost

RM cost in the domestic tyre industry on a q-o-q basis increased by 49.6% in Q4FY21, while the average industry EBITDA margin was recorded at 16.3% in Q4FY21 (which declined on a q-o-q basis from 19.86% in Q3FY21 and improved y-o-y from 14.9% in Q4FY20). The average rubber prices increased by 10% in Q4FY21 over Q3FY21 and price revision against same by industry was merely 3-4%, which dented margins, though, same was mitigated by lower other operating cost including employee, marketing, travelling expenses, etc.

The tyre Industry margins are inversely correlated to the RM price movement as seen from past trend in Chart 5. Around March-April 2020, rubber prices declined on the back of weak demand from the tyre industry. However, the margins of tyre manufacturers also declined due to muted sales on account of Covid impact. Subsequently, pent-up demand and strong revenue prospects, also attributed to restrictions on imports of tyres from China, improved the prospects for the domestic tyre industry Although natural rubber prices increased steeply during Q3 and Q4, given the strong demand, the same did not impact the margins significantly. Moreover, tyre companies which had built up a large inventory of natural rubber in March-April 2020 benefited in H1FY21 in terms of lower RM costs, even as rubber prices were firming up.

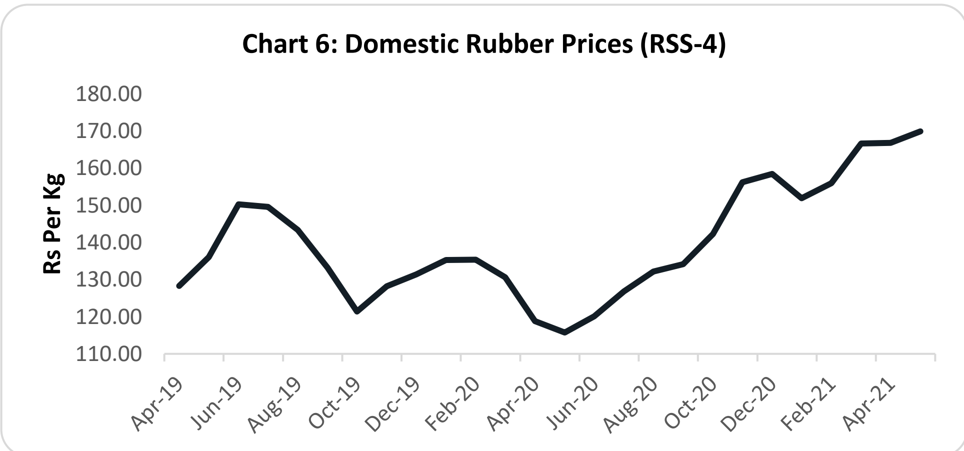




Source: CMIE, CARE Ratings. Operating Margins for FY21 is estimated based on results of major players in industry.

CARE Ratings believes with current global supply shortage against demand, rubber prices are further expected to increase by 10-12% in FY22. Owing to the inability of tyre companies to fully pass on price hike due to competitive pressures and weakening of demand in Q1FY22, CARE Ratings anticipates operating margin deterioration for the tyre industry during Q1FY22 with some spill over in Q2FY22 as well. Majority players had taken a price revision of 3-4% in Q4FY21 primarily on the replacement market side. Prices with OEMs are indexed to RM prices and are expected to be recovered with a lag of a quarter. The tyre Industry has not taken price hike post Q4FY21 with surge in second wave of Covid 19. CARE Ratings expects that even if the industry were to take another 5-7% price hike in FY22, gross margin would still fall sequentially, and the pressure of interest cost associated with the ongoing capacity enhancement plans would weigh on net margins.

Last 2 years price trend for Domestic Rubber Prices



Source: CMIE, CARE Ratings

Outlook for FY22

CARE Ratings opines that overall credit profile of the tyre industry is expected to remain stable; however, headwinds include slower-than-expected demand growth, sharp increase in RM cost and prolonged COVID 19 impact. During Q1FY22, demand in tyre industry has been impacted due to travel restrictions due to second wave of COVID 19, slowdown in production at OEMs and extended WFH trend. However, surge in exports during Q1FY22 is expected to partially mitigate the impact. While revenues in Q2FY22 would be driven by pent-up demand, H2FY22 sales would be on account stronger demand from rebound in economic activities post monsoon. CARE's assessment is contingent on faster vaccination drive and no new waves of COVID 19 in the country. CARE believes that margins of domestic tyre companies have peaked in the last quarter and will likely decline over the next two quarters driven by firm RM prices. Additionally, even if auto sales pick up from Q2 onwards, there is a likelihood of revenue mix of tyre companies having a higher share of OEM sales, which are inherently less profitable than replacement market sales. Post heavy capex spends towards capacity addition over the last two years, tyre industry is expected to restrict capex plans in FY22 until the sector witnesses sustained surge in demand. The credit profile of industry players is therefore expected to remain largely unchanged in FY22.

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