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UPSTREAM PICK

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THINK DIFFERENT PROFIT MORE

Company Name	:	**JK Tyre**
BSE Code	:	**530007**
Time Duration	:	**2 year**
CMP	:	**₹120 (as on 02 February, 2017)**
Target Price	:	**₹182**

JK Tyre enjoys a leading position in the India tyre market. The company derived ~86% of revenue from India and rest from Mexico in FY16. It has more exposure to commercial segment of the market from which it derived 74% of revenue in FY16. This is followed by passenger line and others 5%. We believe its exposure to commercial segment will help it augment its sales over FY18-19 as we see reversal in demand for commercial vehicles with Eicher and Ashok Leyland reporting 23% and 7% increase in sales in January 2017. Also, it will benefit from the uptick in the replacement demand from which it derived 57% of revenue in FY16. We expect replacement demand to be strong due to implementation of BS IV emission norms and also government ruling of replacing trucks more than 15 years old to reduce pollution.

Revenue by geography %		By customer %		By product %	
India	86	OEM	33	Commercial	74
Mexico	14	Replacement	57	Passenger line	21
		Export	10	Others	5

Radialisation to drive revenues

JK Tyre enjoys the highest market share in truck and bus radials. There has been inertia from Indian market to adopt radial tyres due to many reasons, such as they are not advisable when there is overloading and also when roads are in poor condition. We feel that the trend will reverse to a higher shift towards radial tyres with infrastructure push leading to better roads and also government's decision to increase the penalty for overloading. The benefits of radial tyres like being less prone to punctures, longevity, better braking and vehicle control is expected to be realized by the truck owners. In FY16, as per company, the radialisation in the truck and bus segments accelerated to 44% as against 4% in FY07.

We believe the company has the right strategies and has been able to adapt itself to the latest technologies. The product mix shifting from 65% of revenue from Bias tyres in FY10 to 58% of revenue from radial tyres in FY16, goes a long way to vindicate the strategic shift. The company expanded its TBR capacity to 12 lakh p.a. from 4 lakh tyres and in passenger segment it expanded to 45 lakh p.a. from 30 lakh per annum.

JK Tyre is also a leading player in truck bias and passenger car segment. In passenger car segment, we believe it will benefit from replacement demand.

The company will also benefit from being the preferred supplier to top automobile companies, including Maruti Suzuki, Tata Motors, Honda, Hyundai, Ashok Leyland, Mahindra & Mahindra, Volvo Eicher, General Motors, Volkswagen, Fiat, Nissan, TAFE, BEML and Caterpillar India.

Focus on its core truck/bus business

The company has been diversifying its product mix and at the same time is very focused on its core market of truck and buses. In this segment, it faces intense competition from Chinese players.

To better manage the ordeal of fleet managers, it has started fleet management solutions to help fleet owners offload the burden of maintenance of the tyres. Under this, the company also undertakes retreading of wheels and works to extending the tyre life.

Also, the company plans to increase its reach in export markets. It plans to enter the market of Latin America, Africa and Asia. It plans to achieve this by establishing a distribution base in Iran.

Acquisition to enter two and three-wheeler market

The company had low presence in two and three-wheeler market. With the acquisition of Cavendish from Birla Tyres, the company has plugged this gap. With this, it also acquired three units in Haridwar catering to the truck bus radial, Bias and two and three wheeler segments. Additionally, the company will benefit from this due to the tax breaks provided to the facility.

We believe that triggered by the rural demand, the two-wheeler segment will grow at a faster pace than the passenger vehicles segment. With this acquisition, the company will benefit from entering high growth area.

We believe given the management record of turning around loss-making companies, we will see in the second half of FY18, the benefit of the same accruing and lifting the margins.

Cost optimizations; currently faces headwinds of higher rubber prices

The company has matured from a small player to a savvy player trying to realign itself according to the customer preference and supplier-led constraints. We see that in FY16, the company not only achieved higher than industry growth rate, but made long term cost optimizations. We see that the company has been investing in eco-friendly products, water conservation products and attempting to operate at high capacity levels to ensure higher recovery.

However, a key raw material for the industry is rubber and oil. The prices of both have risen substantially in the last couple of months and can lead to erosion in margins. We believe tyre manufacturers are used to these cycle and it is more ingrained in the business model. As the rubber prices smoothen over the next six months and oil stabilizes at $50 a barrel, we can see the margins trending in the range of 14-15%. However, market has priced in the margin contraction in the short term and stock is trading at P/E of 5.5x, which is much below the 11.68x for its peer CEAT.

Chinese imports: a major threat

As of now, the industry is reeling under pricing pressure due to cheap imports from China. Imports continue unabated and impacts the replacement market to a large extent. In FY16, the imports grew by 65%. Imports from China, which accounted for 90% of the truck radial imports, more than doubled over the previous year. The inverted duty structure favours inputs of finished goods over raw materials and non-levying of anti-dumping duty accelerated rampant dumping of tyres from China.

We believe JK Tyre is a contrarian pick as the company faces the uphill task of beating competition and growing. Any move of anti-dumping duty on the tyre imports will be a big boost to the company and can improve company's earnings substantially. As the association has been approaching the ministry to impose anti-dumping duty, we believe a solution from ministry might be plausible.

Financials

We see that company witnessed 14.5% YoY jump in domestic sales in Q2FY17 due to higher sales in PCR and agricultural segments. However, sales in Mexico were flat. The overall net revenue increased by 1.7% YoY in 2QFY17. The margins in India operations also improved by 164 bps YoY, pulled by volume growth and benefits accruing from CIL acquisition. However, due to lower capacity utilization, Mexico's margins were down by 199 bps. However, due to better cost management, the overall margins expanded by 284 bps. However, PAT was down 13.5% YoY to Rs.100.2 cr due to exception item and higher interest cost.

Due to acquisition of CIL for Rs 2170 funded through equity of Rs 700 crore and debt of Rs 1,470 crore, the overall debt increased to Rs 3,759 crore. This has led to higher financing cost. We believe in the low interest rate scenario, the high debt will not be that anaemic as it would have been in a rising interest rate regime. Also, we expect with no capex planned over next couple of years, the cash flow position should be able to support the same.

Valuations

The stock is currently trading at consolidated P/E of 5.5x and FY18E P/E of 4.6x, which is compelling compared to its peers. We see that the company can achieve target price of Rs 182 over the period of two years.

Going ahead

We expect the radialisation trend to continue. However, the higher oil and natural rubber prices can hurt margins in the short term. We see recovery kicking in from second quarter of FY18 due to volume pulled growth and demand uptick in commercial vehicles. Any positive development from government on the anti-dumping duty on Chinese imports will be a big positive in an rising raw material environment. The stock is available now at compelling valuations due to expected contraction in margins due to headwinds faced by the sector currently. However, we believe that JK Tyre with its strong management and product offering will tide over this and will eventually lead to incremental earnings.

How to invest

We urge investors to SIP in the stock as the weakness in margins will continue till FY17.

Inc/Exp Statement(Consolidated) (Rs in Crore)					
Description	201603	201503	201403	201303	201203
Net Sales	6953.12	7383.71	7651.76	6985.23	6782.97
Total Income	6969.82	7400.59	7670.08	6998.95	6786.74
Total Expenditure	5811.62	6452.95	6780.45	6367.22	6454.11
PBIDT	1158.20	947.64	889.63	631.73	332.63
PAT	453.28	323.89	255.62	196.82	-38.22
Dividend %	125.00	75.00	50.00	35.00	25.00
Adj. EPS(Rs)	20.45	14.54	12.81	9.90	-1.56

Quarter On Quarter (Consolidated) (Rs in Crore)					
Particulars	201609	201606	Q on Q Var%	201509	Y on Y Var%
Net Sales	1805.91	1703.86	5.99	1776.37	1.66
Total Expenditure	1532.18	1423.77	7.61	1485.18	3.16
PBIDT (Excl OI)	386.30	356.98	8.21	310.50	24.41
PAT	101.40	100.20	1.20	112.50	-9.87
PBIDTM% (Excl OI)	18.66	18.29	2.02	15.78	18.25
PBIDTM%	19.02	18.60	2.26	16.11	18.06
PATM%	4.90	5.13	-4.48	5.72	-14.34
Adj. EPS(Rs)	4.42	4.42	0.00	5.11	-13.50