Tyre firms' margins under pressure as crude-linked input prices rise

The hope that falling natural rubber prices would provide a boost to tyre companies has been short-lived. Although rubber prices continue to recede, other input costs are rising, which may stymie profit margin expansion. The main concern arises from the surge in crude prices. Brent crude futures are up around 30% from the yearly lows of around $89 per barrel. As a result, prices of crude-derived inputs like synthetic rubber and carbon black rose by 7% and 11% in the June quarter, from the March quarter levels. Of course, the impact of this was felt for only a part of the quarter, but it was mirrored in the marginal increase in the recipe cost (a fancy way of saying the total cost of making a tyre) to about Rs. 159 per kg from the March quarter. That's not all. Industry figures say the recipe cost rose by another 2% in the month of July. With crude prices not cooling off, the cost of making tyres could rise further in August. The only comforting factor is that the cost is still lower than the year-ago June quarter, when it scaled Rs. 164 per kg. The question is what will be the impact on operating margin expansion, which analysts have been so far bullish on. Tyre majors had seen relief in the last two quarters as lower rubber prices lifted profitability. For example, Ceat Ltd's operating margin rose to 9.0% in the June quarter from -0.4% a year before. MRF Ltd too got a respite as its margin jumped to 10.7% after hitting a low of 6%. But, given that crude derivatives comprise almost 40% of the total cost of making a tyre, any rally in the price of crude oil is bound to hit tyre makers' profitability. The saving grace is that tyre firms continue to clock healthy sales in the domestic replacement market, in spite of a slowdown in the automotive segment. Strong realizations continue as a result of stable prices in the replacement market. In fact, most tyre makers did not cut prices when rubber prices cooled off. Of the brood of tyre makers, Apollo Tyres Ltd has nearly one-fifth of its consolidated revenue accruing from its Netherlands subsidiary, where profitability is several notches higher. This should help minimize the impact on overall profit. That said, according to Surjit Arora, analyst, Prabhudas Lilladher Pvt. Ltd, "operating margins in the near-term may not expand further from present levels, due to rise in prices of crude derivatives." This is likely to restrict upsides in tyre stocks, which had already outperformed benchmark indices, and returned 60-80% in terms of price appreciation to investors over the last six months. Meanwhile, any adverse announcement by Competition Commission of India on cartelization in the industry may see a temporary blip in stock performance.