Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Balkrishna Industries

Vrooming ahead

Automobiles	Sharekhan code: BALKRISIND	Company Update

Stock Update

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)		✓	

\+ Positive = Neutral - Negative

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 1,476**	
Price Target: **1,770**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

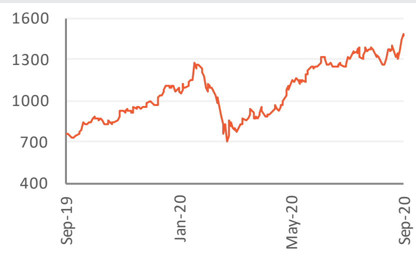
Company details

Market cap:	Rs. 28,533 cr
52-week high/low:	Rs. 1,515 / 678
NSE volume: (No of shares)	8.01 lakh
BSE code:	502355
NSE code:	BALKRISIND
Free float: (No of shares)	8.06 cr

Shareholding (%)

Promoters	58.3
FII	13.0
DII	22.3
Others	6.4

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	10.5	16.3	83.7	94.7
Relative to Sensex	12.6	8.8	49.1	95.3

Sharekhan Research, Bloomberg

Summary

- We recommend Buy on Balkrishna Industries (BKT) with Price target of Rs 1,770; company to deliver strong 17% CAGR over FY20-23 period.
- Given the strong pickup in demand in July and August, BKT is likely to improve its earlier guidance of flat volume growth in FY2021; favourable currency movement and operating leverage would drive margin expansion.
- BKT is expected to continue outpacing the industry, driven by new product introduction, enhanced distribution network, and increased OEM business; BKT aims to double its global market share to 10%.
- We have raised our earnings estimates and rollover our multiple to FY2023 earnings. BKT has amongst the best financial metrices in the tyre industry with debt free at net level, robust return rations, and FCFF yield. BKT remains our preferred pick in the automotive space.

We recently interacted with the management of Balkrishna Industries Limited (BKT) to get an update on the recent developments and outlook going ahead. After a decline in Q1FY2021 (due to lockdown on account of COVID-19), demand for off the highway (OTH) tyre exports have picked up strongly in July and August 2020 benefiting BKT, which is the largest OTH tyre exporter. Agri tyre exports have grown by 44% y-o-y in July with growth further accelerating to 49% y-o-y in August 2020. Favourable weather conditions coupled with good prices have led to buoyant farming across geographies viz. US, Europe, and India. Moreover, OTR (off the road) tyre (construction and mining) exports grew by 8% y-o-y in July and further 18% y-o-y in August 2020. Holding up of commodity prices and stabilisation of the housing index (in the key market of US) have led to growth in the OTR segment. With strong pick up in July and August, BKT is likely to better its earlier guidance of flat volumes in FY2021 (as compared to FY2020). We expect BKT to deliver mid-single digit growth in FY2021. Incremental captive usage of key raw material carbon black (post commencement of Phase 2), better currency realisation due to favourable INR-Euro movement, and benefits of operating leverage would drive margin expansion; and margins are likely to remain at the higher end of the historical range of 25-30%.

BKT to outpace the industry; Aims to double global market share: BKT has historically grown at double the rate of the global OTH industry with a 9% CAGR over the last decade as compared to industry growth of 4-5%. BKT is poised to continue outpacing the industry, driven by network expansion in the replacement segment, launch of new products, and higher share of the OEM business. BKT aims to double its global market share to about 10% in the next few years.

Our Call

Valuations: Recommend Buy with PT of Rs 1,770: BKT is witnessing strong recovery in demand and is expected to improve its earlier guidance of flat volume in FY2021. Margins are expected to improve driven by captive usage of carbon black, favourable currency movement, and benefits of operating leverage. We expect topline/profit to post 13%/17% CAGR over FY2020-FY2023. We have raised our FY2021/FY2022/FY2023 estimates by 9%/4%/4%, respectively. We rollover our valuation multiple on FY2023 earnings. At the CMP, the stock is trading at 18.8x its FY2023 earnings. However, the premium multiples are sustainable, given the strong balance sheet (debt free at net level) and robust return ratios with ROE of 17-20% and ROCE of 18-22%. We recommend Buy with price target (PT) of Rs. 1,770.

Key risk

Prolonged COVID-19 infection can impact volumes. Adverse currency movement especially INR-Euro can impact financials.

Valuation Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Net sales	5,335.5	4,897.5	5,458.7	6,332.5	7,088.5
Growth (%)	13.9	-8.2	11.5	16.0	11.9
EBITDA	1,402.1	1,364.4	1,706.8	2,045.1	2,284.6
OPM (%)	26.3	27.9	31.3	32.3	32.2
PAT (Rs. cr)	782.0	945.0	1,052.0	1,317.0	1,519.8
Growth (%)	5.8	20.8	11.3	25.2	15.4
FD EPS (Rs.)	40.5	48.9	54.4	68.1	78.6
P/E (x)	36.5	30.2	27.1	21.7	18.8
P/B (x)	6.1	5.7	4.9	4.2	3.6
EV/EBITDA (x)	20.9	21.5	17.1	14.1	12.2
RoE (%)	16.7	18.8	18.1	19.3	19.1
RoCE (%)	20.3	18.4	20.6	22.5	22.6

Source: Company; Sharekhan Research

Note: We now convert Balkrishna into a Stock update; it was earlier a 'Viewpoint' under our coverage

Key pointers of management interaction

- **Demand picks up strongly:** Demand for OTH exports has picked up strongly. As per industry data, agri tyre exports have grown by 44% y-o-y in July 2020, while August 2020 exports have grown by 49% y-o-y. The OTR segment (construction and mining) tyres have grown by 8% y-o-y in July 2020, while August 2020 exports have grown by 19% y-o-y.

- **Agri demand strong across geographies:** BKT stated that agri demand is strong across geographies viz. India, US, and Europe. Farming activities have been buoyant with good crop prices supporting agricultural demand.

- **Non-agri tyre demand picking up:** For the OTR segment (non-agri), holding up of commodity prices (steel, iron ore, and aluminium) coupled with stabilisation of the housing index in key market of US is leading to healthy recovery.

- **Management expects to better earlier guidance; aims for growth in FY2021:** Given the strong pick-up in demand, BKT expects it could better earlier guidance of similar volumes in FY2021 (as compared to FY2020), provided COVID-19 situation does not get worse from hereon. BKT expects to report positive growth in volumes in FY2021.

- **Recent Euro appreciation to benefit:** Given the sharp appreciation in Euro versus INR, BKT expects to fetch INR 84/Euro in FY2021 as against INR 80/Euro. Realisation in FY2022 could be better if Euro/INR remains at current level of 86-87.

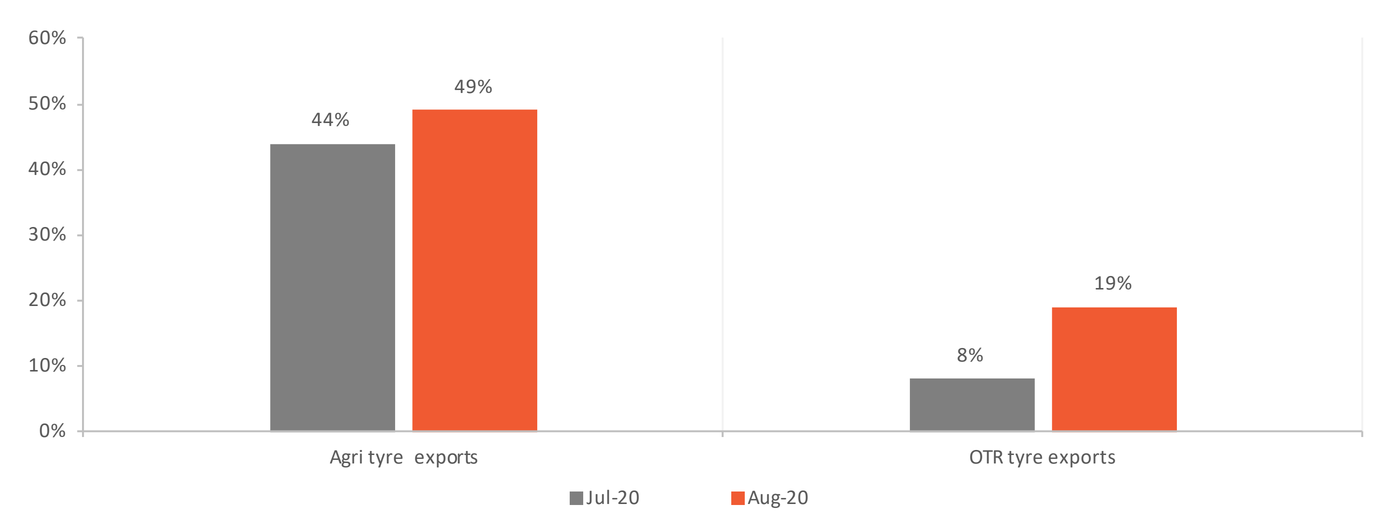
- **Phase 2 of carbon black plant to provide incremental benefit:** The company expects to get incremental benefit of captive use of carbon black (key raw material in tyre manufacturing) in FY2021 due to commencement of Phase 2 of carbon black plant. BKT is likely to produce 110-115 thousand tonne of carbon black as compared to production of 40 thousand tonne in FY2020. Increased captive usage would enhance margins.

- **Commodity prices to move up marginally from Q3:** Q2 is likely to witness benefit of lower commodity prices, but with the recent increase in rubber prices, there could be a marginal increase in raw-material costs from Q3.

- **Overall margins to be at the higher end of the historical band:** Overall, with better currency realisation, captive usage of carbon black and benefits of operating leverage, margins are expected to be at the higher end of the historical band of 25-30%.

Demand picking up strongly; BKT likely to beat earlier guidance of flat volumes: Demand for OTH has picked up strongly with robust growth recorded in OTH exports. As per industry data, agri tyre exports have grown by 44% y-o-y in July 2020, while August 2020 exports have grown by 49% y-o-y. Moreover, the OTR segment (construction and mining) exports have grown by 8% y-o-y in July 2020, while August 2020 exports have grown by 19% y-o-y. BKT being the largest OTH tyre exporter deriving about 80% of revenue from overseas would be the prime beneficiary of strong demand.

OTH tyre export trend (y-o-y growth)



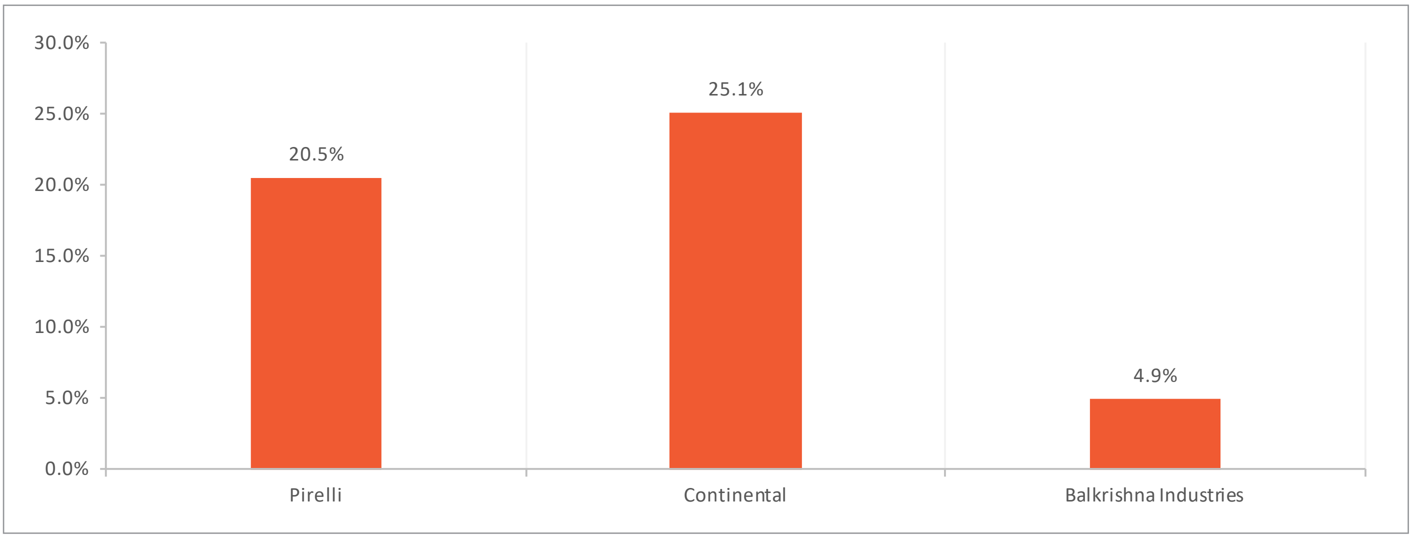
Source: Industry data; Sharekhan Research

BKT stated that agri tyre demand (constituting about 60% of revenue) is strong across geographies viz. India, US, and Europe. Supportive weather conditions coupled with good crop prices have led to buoyancy in farming activities, which is supporting agricultural demand. For the OTR segment, holding up of commodity prices (steel, iron ore, and aluminium) is leading to higher demand for the mining segment. Moreover, stabilisation of the housing index in the key market of US is leading to healthy recovery for the construction segment. With strong demand recovery witnessed in July and August, BKT expects it could better its earlier guidance of flat volumes for FY2021 (as compared to FY2020). We have factored mid-single digit growth for FY2021 for BKT.

Robust business model with strong entry barriers: BKT has a robust scalable business model. BKT on account of lower labour cost in India (compared to MNC players) has better cost structure, which gives it pricing advantage over the competition. Labour cost forms about 5% of revenue for BKT as compared to 20-25% for MNC players such as Michelin, Pirelli, and Continental. BKT majorly serves developed markets of US and Europe (contributes about 75% to revenue) and is able to price its products lower compared to reputed MNC peers. BKT's products are priced about 10-15% lower versus MNC counterparts, which has enabled it to develop a strong presence in the replacement segment.

Moreover, BKT's strong R&D team ensures quality and rolls out a diverse product range as per customer requirements. With over 25 years of operations, BKT has built a strong brand image with customers. With as many as 2,700 different stock keeping units (SKU) and strong quality and cost competitiveness, BKT has built a strong business model. BKT's business has strong entry barriers as serving the OTH industry requires to manufacture very large varieties of products, which requires huge investments. Moreover, having a strong R&D team coupled with labour advantage acts as a strong entry barrier.

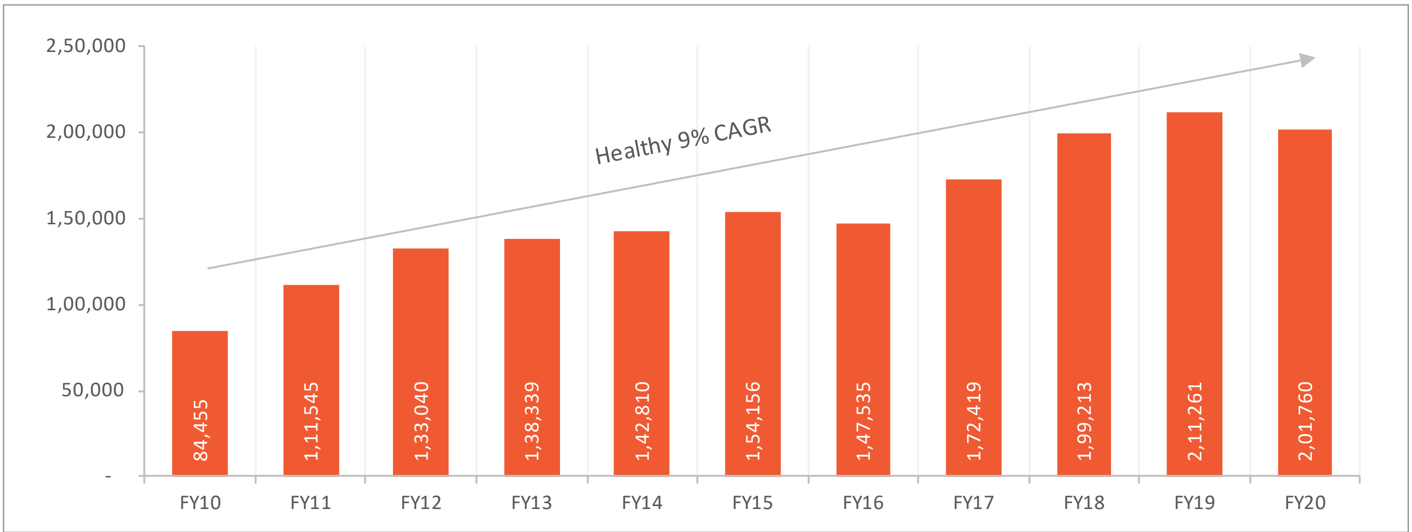
Employee cost as % of sales



Source: Company; Sharekhan Research

BKT to continue outpacing the industry: Historically, BKT has outpaced the OTH industry, growing by almost double the rate of the industry. BKT has reported a healthy 9% volume CAGR over the last decade as compared to global OTR industry's growth of about 4-5%. Currently, BKT holds ~5% market share in the OTR industry and is targeting to double its market share over the next five years.

BKT has delivered robust double-digit volume growth over the last decade (Tonnage sold)

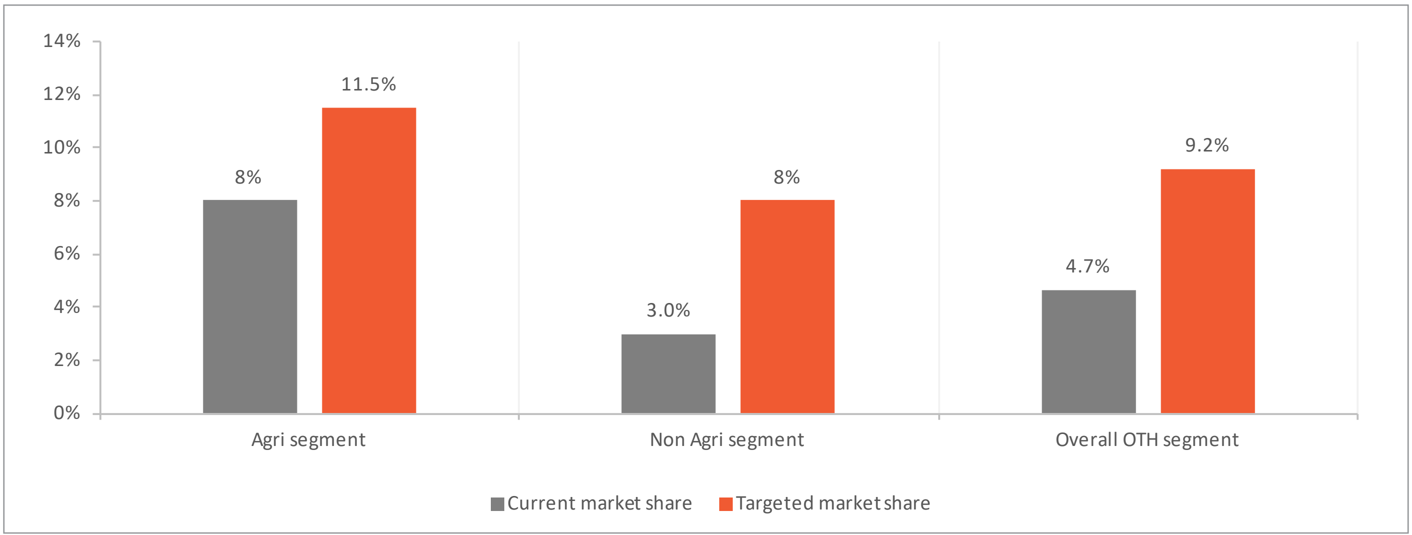


Source: Company; Sharekhan Research

BKT is aiming to gain market share over the next few years through a three-pronged strategy: a) to deepen its presence in the replacement market and is enhancing its network presence across geographies viz. Europe, US, India, and other markets. BKT is also organising and participating in various sport events across markets viz. US, Europe, India, and Australia to strengthen its brand image and enhance customer awareness; b) to introduce higher inched tyres across product segments (agricultural and non-agricultural segments), which would broaden its product portfolio. BKT plans to add about 50-100 new SKUs every year to further strengthen its product portfolio &c). The company is also focusing on the OEM segment to drive growth. BKT recently added Caterpillar to its client list and is targeting increased share of business, with various OEM clients, such as John Deere, Agco, JCB, and Komatsu. We believe BKT would continue to outpace the industry.

BKT is planning to enhance market share in both the agricultural and non-agricultural segments. For the agri segment, BKT aims to increase market share to about 11% from the current 8%, while for the non-agricultural segment, the company aims to increase its market share from the current 3% to about 8%.

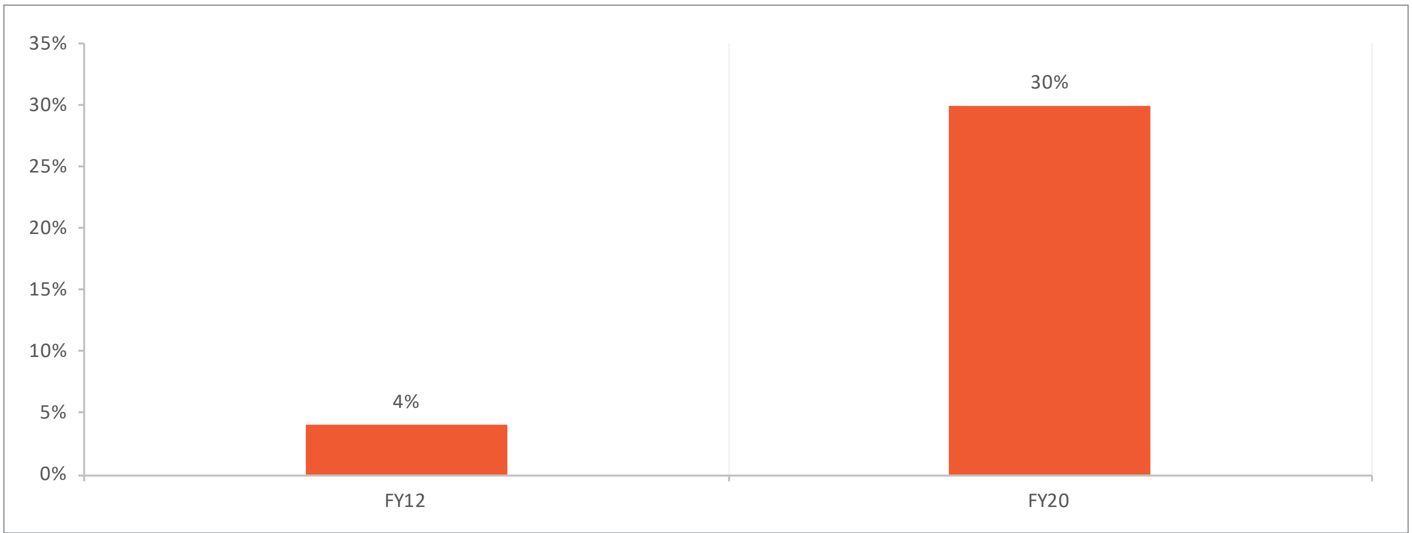
Agri & non agri market share



Source: Company; Sharekhan Research

Increasing radialisation and introduction of high-inch mining tyres to drive realisations: The OTH tyre industry is witnessing increased adoption of radial tyres. Radial tyres are being increasingly preferred over the bias tyres on account of the following advantages: a) better traction, less heat, and rolling resistance leading to better performance; b) longer life of radial tyres as they are more resistant to cuts and penetrations in the tread area; and c) radial tyres offer better mileage. As per the industry, the total cost of ownership of radial tyres is lower than the bias tyres. The share of radial tyres in BKT mix has gone up substantially from 4% in FY2012 to about 30% in FY2020 and is expected to increase further going ahead. Radial tyres are priced about 15-20% higher than bias tyres. Increased share of radial tyres would drive realisations.

BKT Radial mix

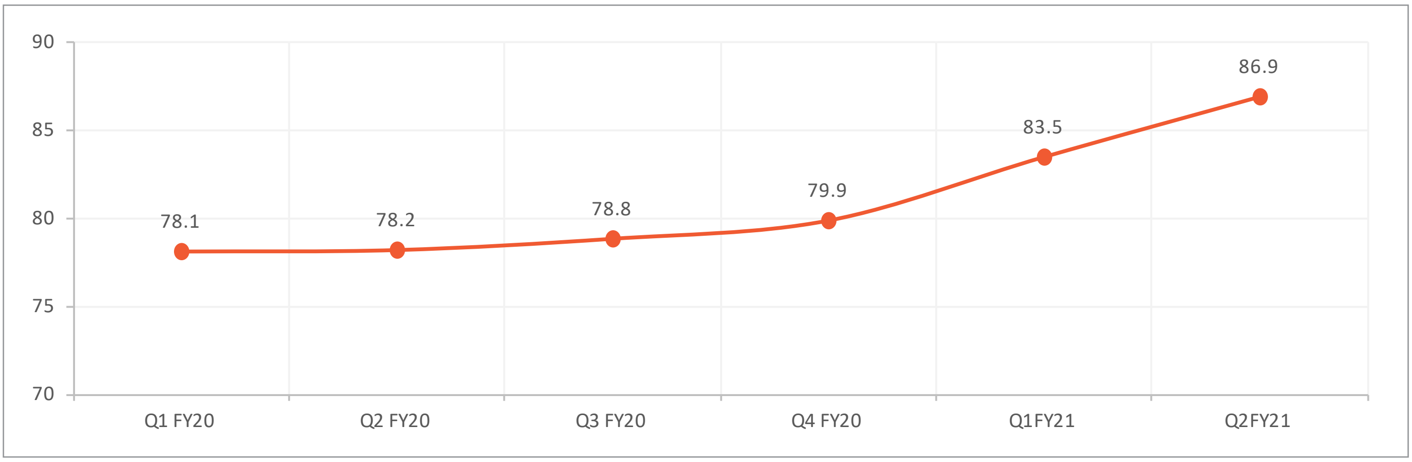


Source: Company, Sharekhan Research

Moreover, BKT is planning to introduce ultra large tyres, which would boost realisation. BKT plans to introduce 51-inch tyres as well as 57-inch to 63-inch tyres for the mining and the construction segments. BKT has set up 5,000 MT capacity for production of these tyres, which is about 5% of total overall sales. BKT also plans to launch ultra large tyres with size of 57 inches to 63 inches. Better product mix is expected to drive realisations for the company.

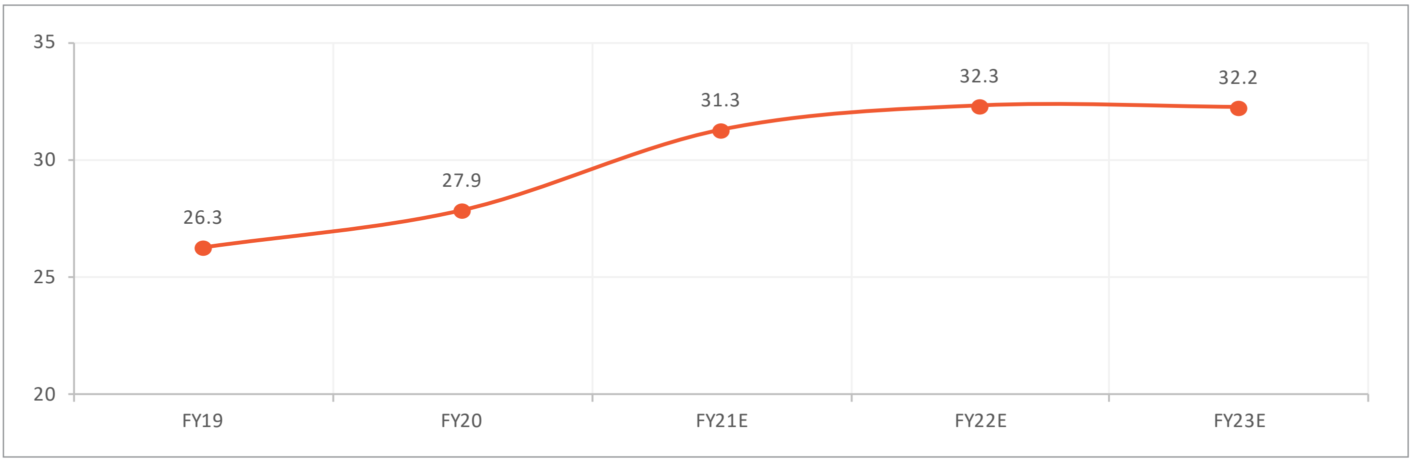
Increased captive carbon black sourcing, better currency realisation, and operating leverage to augment margins: With commencement of Phase 2 of carbon black plant in March 2020, BKT has increased its carbon black production capacity from 40,000 tonne to 120,000 tonne. BKT aims to produce about 1,10,000 tonne in FY2021. Captive usage of carbon black (carbon black constitutes about 18% of raw-material cost) is expected to increase from about 35,000 tonne in FY2020 to about 55,000 tonne to 60,000 tonne in FY2021, which would result in margin improvement. Moreover, BKT expects better export realisation given the recent appreciation of Euro versus INR. BKT expects to fetch INR 84/Euro in FY2021 as against INR80/Euro in FY2020. Realisation in FY2022 could be better if Euro/INR remains at the current level of 86-87. Moreover, with volume growth, BKT would realise benefits of operating leverage, which would boost margins. We expect BKT's margins to be at the higher end of the historical band of 25-30%.

INR/Euro movement



Source: Company, Sharekhan Research

BKT OPM trend (%)

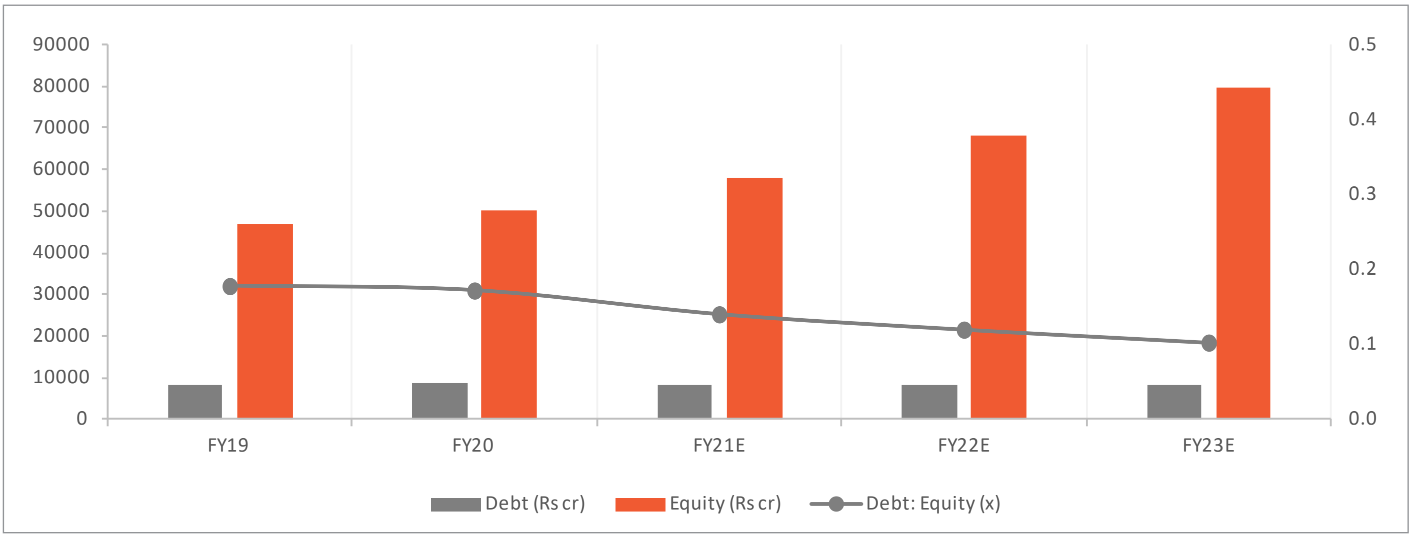


Source: Company, Sharekhan Research

Strong balance sheet with robust return ratios: BKT has a robust balance sheet with no long-term debt. Current debt:equity ratio stands at about 0.2x (debt is mostly short term primarily for meeting working capital requirements). Considering the cash and liquid investments, the company has zero debt at net level. Considering the capex-intensive nature of the tyre industry, having zero debt at the net level is commendable and BKT is among the few companies, which are debt free. BKT has high operating margin of 25-30%, which enables it to have very strong return ratios.

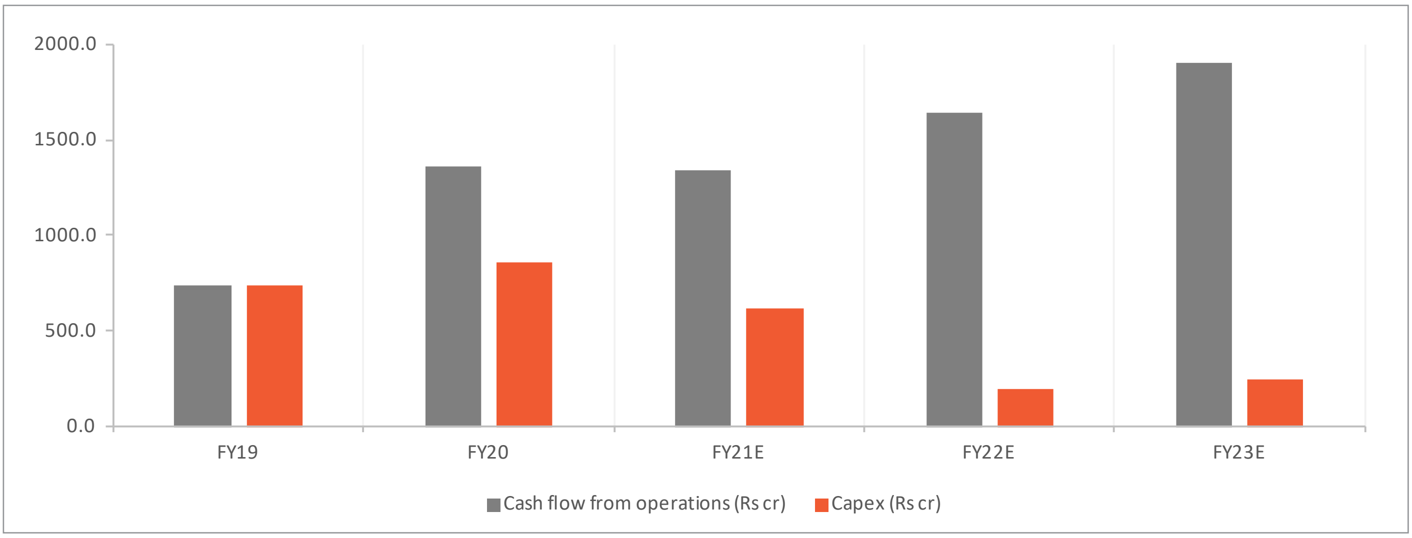
BKT's return on equity (ROE) ranges at 17-20%, while return on capital employed (ROCE) ranges between 18-22%, which is amongst the highest in the tyre industry. BKT would generate about Rs. 1,600 crore cash flow from operations every year as compared to average capex requirement of about Rs. 350 crore.

Low Debt:Equity



Source: Company; Sharekhan Research

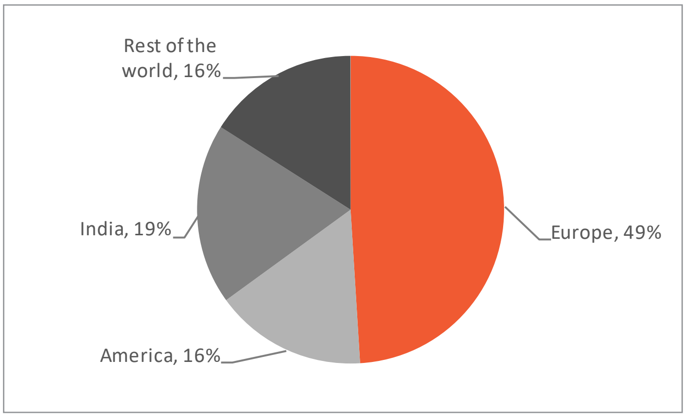
Healthy cash flow generation



Source: Company; Sharekhan Research

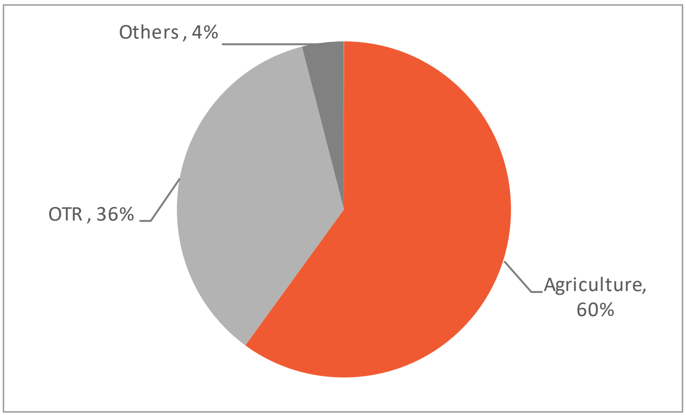
Financials in charts

Geographical mix



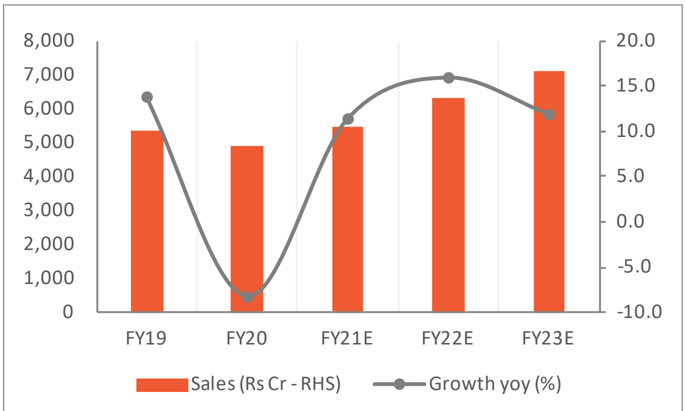
Source: Company, Sharekhan Research

Segmental mix



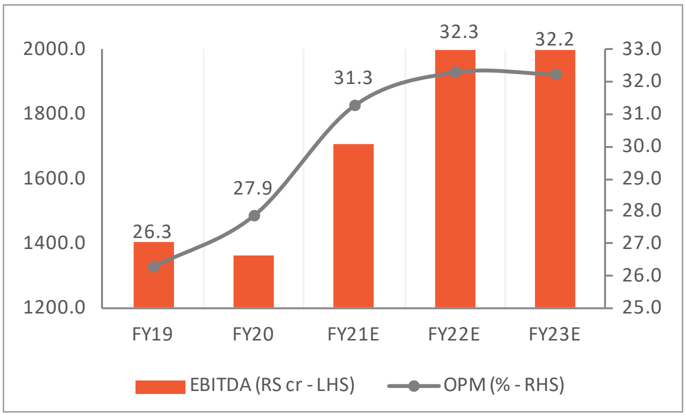
Source: Company, Sharekhan Research

Revenue trend



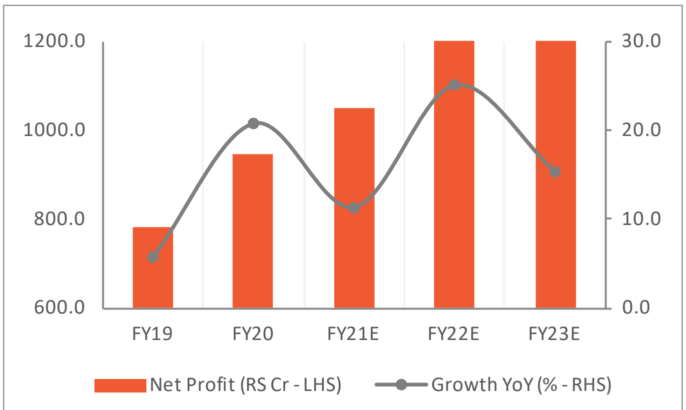
Source: Company, Sharekhan Research

EBIDTA-OPM trend



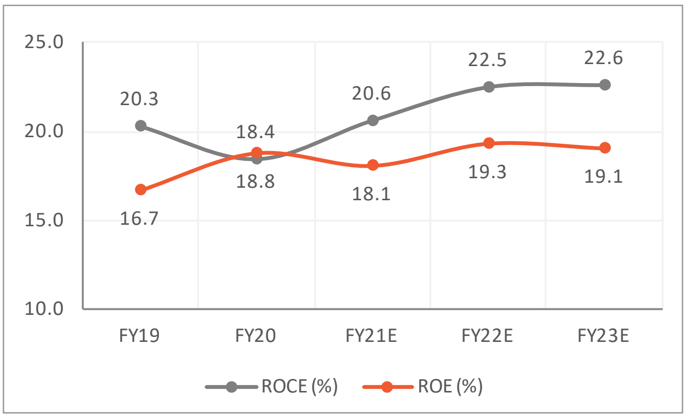
Source: Company, Sharekhan Research

Net Profit trend



Source: Company, Sharekhan Research

Robust Return ratios (%)



Source: Company, Sharekhan Research

Outlook and Valuation

Sector View – Steady growth industry with high entry barriers

Global OTH is a steady growth industry with historical average growth rates of 3-5%. Considering about two-thirds of the demand coming from the replacement segment, the industry has steady growth with relatively less volatility. Moreover, the industry has high entry barriers and is characterised as 'large varieties low volume' segment as players need to maintain a large number of stock keeping units (SKU) due to diverse end-user requirements. The industry is also capex intensive, which acts as another entry barrier.

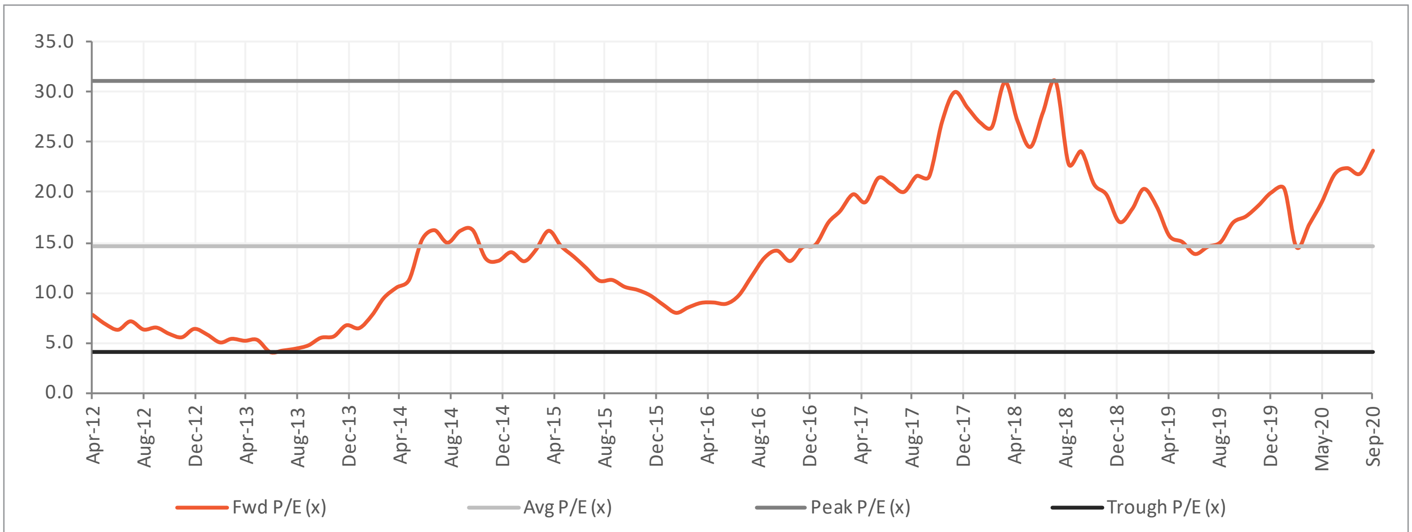
Company Outlook – Robust scalable model; BKT to continue outpacing the industry

BKT, with relatively low employee cost advantage, has a better cost structure compared to other players. BKT is able to price its products lower, enabling to gain market share. Moreover, with robust R&D and continuous new product developments, BKT would introduce products for newer applications. BKT has outpaced the OTH industry in the past decade and would continue to outgrow the industry. BKT is aiming to double its global market share to 10% over the next few years.

Valuation – Premium valuations to sustain

BKT is among the few tyre players that is debt free (at net level) and has among the highest profitability (margins in excess of 25%) and return ratios (17-20%). BKT also has strong FCFF generation with FCFF yield of 4.5%, which is among the highest in the tyre industry. At the CMP, the stock is trading at 18.8x its FY2023 earnings, but we believe premium valuations are sustainable in view of industry's best financial metrices and strong growth prospects. We recommend Buy with price target (PT) of Rs. 1,770.

One-year forward P/E (x) band



Source: Sharekhan Research

About company

BKT is one of the leading manufacturers of OHT. BKT makes tyres that are used in various applications, including agricultural, construction, and industrial vehicles as well as earthmoving, port, and mining, ATV, and gardening. BKT is a global player present in Europe, US, and India. While the European markets account for ~49% of sales, US and India account for 16% and 19% of the sales, respectively. The company has a well-spread distribution network that supports sales to 160 countries. BKT has three manufacturing plants in India – in Aurangabad and Bhuj (western India), Bhiwadi, and Chopanki (in North India). In addition to this, the company operates mold plant in Dombivli (near Mumbai). The current achievable production capacity across all plants stands at 300,000 MTPA, comprising a widespread product portfolio of 2,700 SKUs.

Investment theme

BKT is a leading manufacturer of specialty and OHT with a global presence. The outlook for key geographies of Europe and India is improving and is expected to gain traction. The company is taking efforts to deepen its distribution reach across markets, viz. developed nations such as Europe, US, and developing markets such as India. Moreover, the company is working towards introducing new products across verticals such as agriculture and mining. Management expects to continue outpacing the global OTH industry and aims to double the market share to 10% over the next few years, which provides ample growth visibility. Margins are expected to improve, driven by captive carbon black sourcing, favourable currency movement, and operating leverage due to volume growth.

Key Risks

Prolonged COVID-19 infection can impact volume growth. BKT derives about 85% of its revenue from export geographies and, hence, is exposed to currency risk, primarily that of INR-Euro. Any adverse currency movement would impact the company's financials.

Additional Data

Key management personnel

Arvind Poddar	Chairman & Managing Director
Rajiv Poddar	Joint Managing Director
Vipul Shah	Wholetime Director & Company Secretary
Madhu Sudan Bajaj	Chief Financial Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Poddar Rajiv A	27.7
2	VKP Enterprises LLP	25
3	NA	7.4
4	HDFC Asset Management Co Ltd	6.5
5	Poddar Khushboo	3.9
6	MODI MANOJ H	3.9
7	Mirae Asset Global Investments Co	2.8
8	Amansa Holdings Pvt Ltd	1.7
9	Norges Bank	1.5
10	GOVERNMENT PENSION FUND - GLOBAL	1.5

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

Sharekhan

by BNP PARIBAS

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