

**SELL**

TP: Rs 830 | ▼ 28%

**CEAT**

Auto Components

28 October 2020

## Healthy Q2 but long-term woes remain; cut to SELL

**CEAT surprised positively on both revenue and earnings in Q2FY21, led by strong replacement demand and above-expected operating efficiency. Revenue was up 17% YoY and operating margin expanded 470bps YoY. We continue to believe that capex (~Rs 35bn) will far exceed estimated operating cash flow (~Rs 22bn) over FY20-FY23, necessitating external funding and adding pressure on both balance sheet and earnings. We retain our TP of Rs 830 (14x Sep'22E EPS) but downgrade the stock to SELL from REDUCE after the recent rally.**

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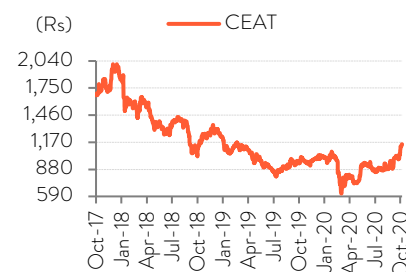
**Strong Q2FY21:** At Rs 19.7bn (+17% YoY), revenue was 15% ahead of our estimate led by strong replacement demand (+30%). Healthy gross margins, a better product mix and higher operating efficiencies supported EBITDA margin expansion of 470bps YoY to 14.8%. CEAT received the NCLT's nod to merge CEAT Specialty Tyres (CSTL) and thus tax on accumulated losses at CSTL was adjusted in Q2, leading to adj. PAT growth of 3.4x YoY to Rs 1.7bn.

Ticker/Price	CEAT IN/Rs 1,148
Market cap	US\$ 628.6mn
Shares o/s	40mn
3M ADV	US\$ 3.5mn
52wk high/low	Rs 1,249/Rs 600
Promoter/FPI/DII	47%/28%/9%

Source: NSE

**Borrowings to erode return ratios:** We estimate ~Rs 22bn of cumulative operating cash flow during FY20-FY23. Even the company's reduced capex plan of Rs 31bn for this period clearly warrants external borrowings to the tune of Rs 13bn-14bn. This will shave 260-270bps off ROE and ROCE (to 7% and 6.3% respectively in FY23E), despite assuming significant improvement in working capital cycle. Net D/E of 0.5x is forecast to spike to 0.8x by FY23.

### STOCK PERFORMANCE



Source: NSE

**Downgrade to SELL:** External borrowings to fund capex will not only undermine the balance sheet, but also depress profits due to higher interest. Rising input costs could pressure margins, per management. We model for a steady EBITDA margin of ~11% and project a revenue/EBITDA/adj. PAT CAGR of +9%/+12%/ -7% over FY20-FY23. The stock has rallied ~30% over the past three months, leading us to downgrade to SELL. Our Sep'21 TP remains unchanged at Rs 830.

### KEY FINANCIALS

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
Total revenue (Rs mn)	68,313	65,811	63,466	76,980	85,085
EBITDA (Rs mn)	5,965	7,053	6,746	8,663	9,841
Adj. net profit (Rs mn)	2,889	3,005	1,817	2,390	2,400
Adj. EPS (Rs)	71.4	74.3	44.9	59.1	59.3
Adj. EPS growth (%)	3.7	4.0	(39.5)	31.5	0.4
Adj. ROAE (%)	10.5	10.3	5.9	7.1	6.7
Adj. P/E (x)	16.1	15.5	25.6	19.4	19.3
EV/EBITDA (x)	8.9	7.8	8.9	7.4	7.1

Source: Company, BOBCAPS Research

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**FIG 1 – QUARTERLY PERFORMANCE**

(Rs mn)	Q2FY21	Q2FY20	YoY (%)	Q1FY21	QoQ (%)	H1FY21	H1FY20	YoY (%)
Net Revenues	19,651	16,873	16.5	11,162	76.1	30,813	33,909	(9.1)
<b>Total Income (A)</b>	<b>19,651</b>	<b>16,873</b>	<b>16.5</b>	<b>11,162</b>	<b>76.1</b>	<b>30,813</b>	<b>33,909</b>	<b>(9.1)</b>
<b>Operating Expenses:</b>								
Raw materials consumed	10,493	9,960	5.3	6,696	56.7	17,189	20,435	(15.9)
Employee Expenses	1,589	1,210	31.3	1,492	6.5	3,081	2,450	25.8
Other Expenses	4,665	4,007	16.4	1,956	138.5	6,620	7,722	(14.3)
<b>Total Expenditure (B)</b>	<b>16,746</b>	<b>15,177</b>	<b>10.3</b>	<b>10,144</b>	<b>65.1</b>	<b>26,890</b>	<b>30,606</b>	<b>(12.1)</b>
<b>EBITDA (A-B)</b>	<b>2,905</b>	<b>1,696</b>	<b>71.3</b>	<b>1,017</b>	<b>185.6</b>	<b>3,923</b>	<b>3,302</b>	<b>18.8</b>
Other Income	42	145	(70.9)	149	(71.6)	191	293	(34.8)
Depreciation	839	671	25.1	785	6.9	1,624	1,266	28.4
EBIT	2,108	1,170	80.3	381	453.7	2,489	2,330	6.8
Finance Costs	444	370	20.1	483	(8.0)	927	665	39.3
PBT before excep items	1,664	800	108.1	(102)	NA	1,562	1,665	(6.1)
Exceptional items	-	-	NA	-	NA	(218)	(14)	1,445.4
PBT after excep items	1,664	800	108.1	(102)	NA	1,780	1,679	6.1
Tax expense	(37)	298	NA	(61)	NA	1,443	1,364	5.8
Reported PAT	1,702	502	239.0	(41)	NA	338	315	7.2
<b>Reported EPS (Rs)</b>	<b>42.1</b>	<b>12.2</b>	<b>244.6</b>	<b>(6.4)</b>	<b>NA</b>	<b>35.6</b>	<b>39.8</b>	<b>(10.6)</b>

Source: Company, BOBCAPS Research. Note- Tax expense for Q2FY21 includes one-time benefit of Rs 550mn on account of amalgamation with CSTL. Adjusting for same, EPS for Q2 would be Rs 29 and Rs 22 for H1FY21.

**FIG 2 – KEY PARAMETERS**

(%)	Q2FY21	Q2FY20	YoY (bps)	Q1FY21	QoQ (bps)	H1FY21	H1FY20	YoY (bps)
Gross Margin	46.6	41.0	564	40	660	44.2	39.7	448
EBITDA Margin	14.8	10.1	473	9	567	12.7	9.7	299
EBIT Margin	10.7	6.9	380	3	732	8.1	6.9	121
PBT Margin	8.5	4.7	373	(1)	938	5.1	4.9	16
Tax Rate	(2.2)	37.3	(3,948)	60	(6,193)	81.0	81.2	(21)
Adj PAT Margin	8.7	3.0	568	0	903	0.4	0.9	(50)

Source: Company, BOBCAPS Research

## Earnings call highlights

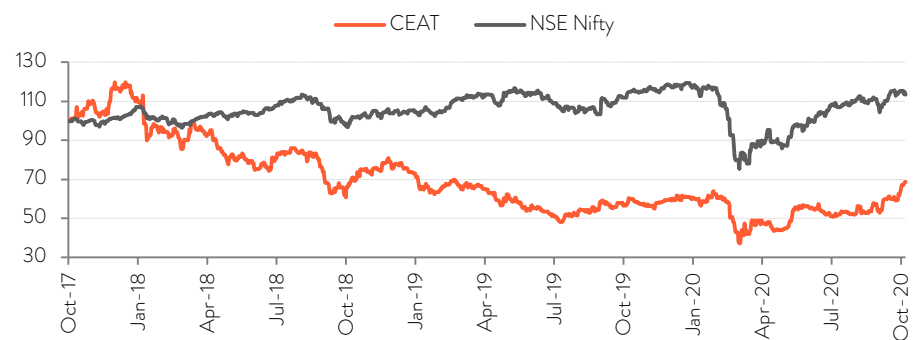
- In Q2FY21, volumes from the replacement channel grew at 30% YoY while that from OEMs declined marginally. Exports grew in mid-single digits. Management expects demand to improve in Q3 and volume from OEMs to revive. Import restrictions, an improving rural economy and a shift towards personal mobility would act as tailwinds.
- The Q2 sales mix was as follows: OEM 17%, exports 12%, replacement 71%.
- CEAT expects raw material costs to increase by ~3% QoQ in Q3.
- Operating margin is expected to contract sequentially as raw material costs go up and OEM share in the sales mix rises. Employee costs are also expected to inch up as CEAT ramps up at its Chennai and Nagpur plants, further denting margins.
- Despite raw material pressure, CEAT does not intend to take price increases and would rather introduce new, higher-value products.
- The impact of tax reversal from accumulated losses at CSTL was Rs 550mn during the quarter and all tax reversals have been fully recognised.
- Management expects to incur project capex of Rs 5.5bn-6bn in FY21 in addition to Rs 1.5bn of maintenance capex. It has incurred Rs 2.6bn till H1FY21.
- The company intends to spend ~Rs 1.2bn over FY22-FY23 at the standalone entity and a further Rs 5bn at CSTL (subject to demand and milestones achieved). In order to fund this capex, debt is expected to increase but debt/EBITDA levels would not be permitted to breach 3x.

## Valuation methodology

External debt borrowings to fund capex will not only undermine the balance sheet, but also depress profits due to a higher interest burden. Management indicated that rising input costs could add some pressure on margins. We expect CEAT to maintain its EBITDA margin at ~11% and project a revenue/EBITDA/adj. PAT CAGR of +9%/+12%/-7% over FY20-FY23.

We continue to value the stock at 14x Sep'22E EPS and retain our Sep'21 target price at Rs 830. The stock has rallied 30% over the past three months and is now trading at 19.4x/19.3x FY22/FY23E EPS, which looks expensive – downgrade to SELL (from REDUCE).

**FIG 3 – RELATIVE STOCK PERFORMANCE**



Source: NSE

## Key risks

- Above-expected volume growth
- Meaningful expansion in operating margin
- Softening raw material prices

## FINANCIALS

### Income Statement

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
<b>Total revenue</b>	<b>68,313</b>	<b>65,811</b>	<b>63,466</b>	<b>76,980</b>	<b>85,085</b>
EBITDA	5,965	7,053	6,746	8,663	9,841
Depreciation	1,743	2,554	3,272	4,085	4,897
EBIT	4,775	4,912	3,877	5,029	5,394
Net interest income/(expenses)	(677)	(1,230)	(1,447)	(1,834)	(2,185)
Other income/(expenses)	553	413	403	450	450
Exceptional items	340	(298)	0	0	0
EBT	4,438	3,385	2,429	3,195	3,209
Income taxes	1,209	678	612	805	809
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	0	0	0	0	0
<b>Reported net profit</b>	<b>3,229</b>	<b>2,708</b>	<b>1,817</b>	<b>2,390</b>	<b>2,400</b>
Adjustments	(340)	298	0	0	0
<b>Adjusted net profit</b>	<b>2,889</b>	<b>3,005</b>	<b>1,817</b>	<b>2,390</b>	<b>2,400</b>

### Balance Sheet

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Accounts payables	12,078	11,714	12,242	12,510	13,618
Other current liabilities	4,498	6,933	6,206	7,978	8,491
Provisions	1,436	1,598	1,598	1,598	1,598
Debt funds	12,605	15,676	20,507	26,507	29,507
Other liabilities	414	1,645	1,645	1,645	1,645
Equity capital	405	405	405	405	405
Reserves & surplus	27,106	28,869	30,635	33,025	35,426
Shareholders' fund	27,510	29,274	31,039	33,430	35,830
<b>Total liabilities and equities</b>	<b>58,541</b>	<b>66,839</b>	<b>73,238</b>	<b>83,667</b>	<b>90,689</b>
Cash and cash eq.	597	266	677	361	726
Accounts receivables	7,265	7,047	7,651	8,014	8,858
Inventories	9,652	8,795	8,694	9,491	10,024
Other current assets	2,133	2,066	2,561	3,031	3,208
Investments	3,130	3,202	3,002	3,002	3,002
Net fixed assets	28,463	38,205	44,932	55,848	60,950
CWIP	7,494	9,338	7,800	6,000	6,000
Intangible assets	0	0	0	0	0
Deferred tax assets, net	(2,077)	(2,611)	(2,611)	(2,611)	(2,611)
Other assets	1,884	532	532	532	532
<b>Total assets</b>	<b>58,542</b>	<b>66,839</b>	<b>73,238</b>	<b>83,667</b>	<b>90,689</b>

Source: Company, BOBCAPS Research

### Cash Flows

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Net income + Depreciation	4,972	5,262	5,089	6,475	7,298
Interest expenses	677	1,230	1,447	1,834	2,185
Non-cash adjustments	(553)	(413)	(403)	(450)	(450)
Changes in working capital	954	5,957	(1,196)	409	67
Other operating cash flows	(475)	(45)	0	0	0
<b>Cash flow from operations</b>	<b>5,575</b>	<b>11,990</b>	<b>4,938</b>	<b>8,267</b>	<b>9,099</b>
Capital expenditures	(11,434)	(14,139)	(8,462)	(13,200)	(10,000)
Change in investments	70	(72)	200	0	0
Other investing cash flows	553	413	403	450	450
<b>Cash flow from investing</b>	<b>(10,811)</b>	<b>(13,798)</b>	<b>(7,859)</b>	<b>(12,750)</b>	<b>(9,550)</b>
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	6,196	3,071	4,831	6,000	3,000
Interest expenses	(677)	(1,230)	(1,447)	(1,834)	(2,185)
Dividends paid	(465)	(1,150)	0	0	0
Other financing cash flows	49	785	(51)	0	0
<b>Cash flow from financing</b>	<b>5,103</b>	<b>1,476</b>	<b>3,333</b>	<b>4,166</b>	<b>815</b>
<b>Changes in cash and cash eq.</b>	<b>(133)</b>	<b>(332)</b>	<b>412</b>	<b>(316)</b>	<b>365</b>
<b>Closing cash and cash eq.</b>	<b>597</b>	<b>266</b>	<b>677</b>	<b>361</b>	<b>726</b>

### Per Share

Y/E 31 Mar (Rs)	FY19A	FY20A	FY21E	FY22E	FY23E
Reported EPS	71.4	74.3	44.9	59.1	59.3
Adjusted EPS	71.4	74.3	44.9	59.1	59.3
Dividend per share	11.5	24.0	0.0	0.0	0.0
Book value per share	680.1	723.7	767.4	826.4	885.8

### Valuations Ratios

Y/E 31 Mar (x)	FY19A	FY20A	FY21E	FY22E	FY23E
EV/Sales	0.8	0.8	0.9	0.8	0.8
EV/EBITDA	8.9	7.8	8.9	7.4	7.1
Adjusted P/E	16.1	15.5	25.6	19.4	19.3
P/BV	1.7	1.6	1.5	1.4	1.3

### DuPont Analysis

Y/E 31 Mar (%)	FY19A	FY20A	FY21E	FY22E	FY23E
Tax burden (Net profit/PBT)	65.1	88.8	74.8	74.8	74.8
Interest burden (PBT/EBIT)	92.9	68.9	62.7	63.5	59.5
EBIT margin (EBIT/Revenue)	7.0	7.5	6.1	6.5	6.3
Asset turnover (Revenue/Avg TA)	187.7	151.1	127.2	134.1	132.4
Leverage (Avg TA/Avg Equity)	1.4	1.5	1.7	1.8	1.9
Adjusted ROAE	10.9	10.6	6.0	7.4	6.9

Source: Company, BOBCAPS Research | Note: TA = Total Assets

**Ratio Analysis**

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
<b>YoY growth (%)</b>					
Revenue	10.0	(3.7)	(3.6)	21.3	10.5
EBITDA	(1.6)	18.2	(4.4)	28.4	13.6
Adjusted EPS	3.7	4.0	(39.5)	31.5	0.4
<b>Profitability &amp; Return ratios (%)</b>					
EBITDA margin	8.7	10.7	10.6	11.3	11.6
EBIT margin	7.0	7.5	6.1	6.5	6.3
Adjusted profit margin	4.2	4.6	2.9	3.1	2.8
Adjusted ROAE	10.5	10.3	5.9	7.1	6.7
ROCE	9.5	9.0	5.8	6.6	6.3
<b>Working capital days (days)</b>					
Receivables	38	40	42	37	36
Inventory	46	51	50	43	42
Payables	92	113	117	100	96
<b>Ratios (x)</b>					
Gross asset turnover	0.5	0.7	0.9	0.9	0.9
Current ratio	1.1	0.9	1.0	0.9	1.0
Net interest coverage ratio	(7.1)	(4.0)	(2.7)	(2.7)	(2.5)
Adjusted debt/equity	0.5	0.5	0.7	0.8	0.8

Source: Company, BOBCAPS Research

## Disclaimer

### Recommendations and Absolute returns (%) over 12 months

**BUY** – Expected return >+15%

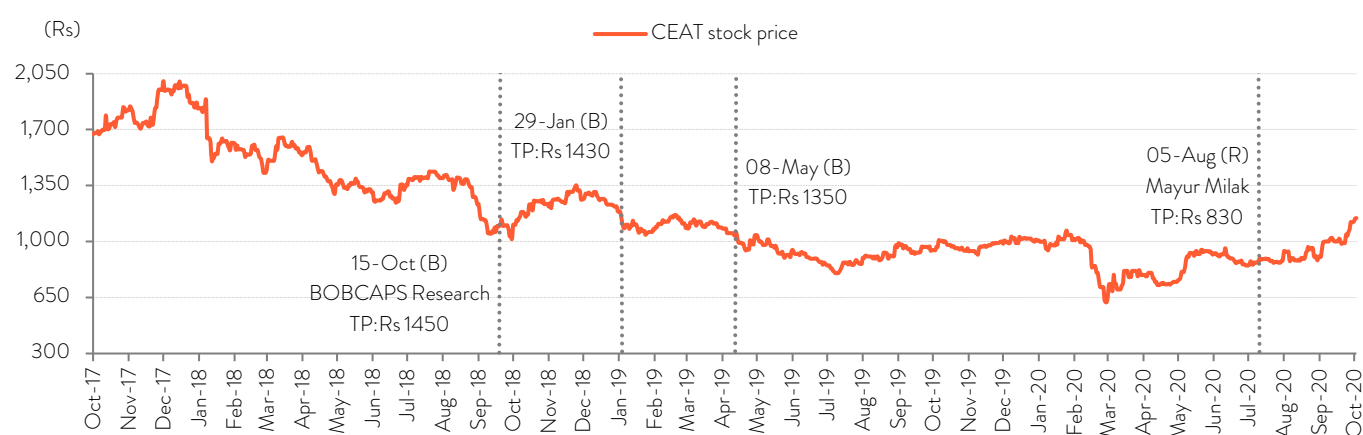
**ADD** – Expected return from >+5% to +15%

**REDUCE** – Expected return from -5% to +5%

**SELL** – Expected return <-5%

**Note:** Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

### RATINGS AND TARGET PRICE (3-YEAR HISTORY): CEAT (CEAT IN)



B – Buy, A – Add, R – Reduce, S – Sell

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