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Independent Equity Research

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Important disclosure on the last page

Indag Rubber Ltd

Indag Rubber is India's 2nd largest producer of Tyre retreading materials, which are used for retreading worn-out tyres of trucks and buses. With a dominant organised sector player in an underpenetrated and asset-light business with multiple growth drivers, Indag is in a position to scale up significantly.

DCF Value (1-year out) Rs.390 | **Current Price Rs.140** | **Potential 2.8x**

At current price, stock trades at 3.9 times FY12 expected EPS of Rs.35.77 with expected earnings growth of 20-23% in FY13 & FY14. At our fair value of Rs.390, the stock will trade at 7.6x FY13 EPS and 6.3x FY14 EPS. RoE is expected to be in the range of 30-35%. The company is almost debt free.

Key Data

Market Cap	Rs.74cr US$15mn
Shares Outstanding	52.5 lakh
52 wk Hi-Lo	172 – 72
Avg Trading Vol	No. of shares
1 month	7,200
3 months	6,500
1 year	3,900
BSE Scrip Code	509162
BSE Group	B
Shareholding %	**30Sep11**
Promoters	77.05
Institutions	0.97
Others	21.98
Valuation	**FY12E**
EV/ EBITDA	3.1x
Market Cap/Sales	0.33x
P/E	3.9x

Products

Precured Tread Rubber, used for retreading worn-out tyres, made from natural rubber, polybutadiene rubber, and carbon black.

Key Investment Points

- Indag is India's second largest producer of Precured Tread Rubber and its quality is considered to be the best among all retread material makers.
- Growth in road freight with the growth in economic activity, improving road infrastructure, growing radialisation of tyres are growth drivers for retreading.
- Shift from conventional technology to Precure technology is an additional growth driver for companies like Indag, which use precure process to make retread materials.
- Shift from unorganised sector (where quality is an issue) to quality retreads will enable quality players like Indag to gain market share. GST will speed up this process.
- Indag has already been gaining market share backed by intensified sales efforts
- Entry into Off-the-Road (OTR) tyre retreading is a long term growth driver
- Input costs rose significantly over the last three years. Indag showed its ability to consistently pass on inputs costs during this period.

Watch out for

- Sustained slowdown or de-growth in road freight transportation can impact Indag's growth.
- Sustained and sharp fall in input costs can impact earnings by way of inventory losses.

Introduction

Indag Rubber Ltd, a company with annual revenues of Rs.181 crore, is India's second largest manufacturer of tyre retreading materials. These materials include Precured tyre rubber (PTR), bonding repair & extrusion gums, and rubber cement.

Retreading is a process wherein the upper layer (tread) of tyres is replaced when it is worn-out. A tyre comprises of tyre body/casing (~75% of tyre cost) and tread (~25% of tyre cost). When the tread wears out, it makes economical and environmental sense to retread instead of replacing the whole tyre. A tyre can be retreaded multiple times. In India, a normal tyre is retreaded 1.5 times on average. A radial tyre can be retreaded three times. While all tyres can be retreaded, retreading has picked up only in commercial vehicles (trucks and buses) and to some extent in taxi segment. With a good quality retreading, a retreaded tyre is as good as a new tyre.

Indag makes the upper layer (tread strip) called precured tread rubber, which is affixed on tyre casings by retreaders (service providers) using bonding gums and rubber cement. PTR is the main product comprising of 88% of revenues. The other two products are supporting products. Indag does not do retreading itself. It sells retreading material to retreaders either directly (2/3rd of sales) or indirectly via dealers (1/3rd of sales). Indag reaches out to retreaders all over India.

Key inputs for Indag are natural rubber (~30-35% of cost), polybutadiene rubber/PBR (~30-35% of cost), carbon black (~16-22% of cost) and other chemicals (~8-12% of cost). Natural rubber is an agricultural produce and a substitute of synthetic rubber in many applications. Hence, natural rubber price follows synthetic rubber price. Synthetic rubber, PBR and carbon black are all derivatives of petroleum crude oil. Hence, almost the entire input cost broadly follows crude oil prices.

Indag's plant is at Nalagarh in Himachal Pradesh. It had a plant earlier at Bhiwadi in NCR. The plant was shut a few years ago and machineries shifted to Nalagarh. The industrial land at Bhiwadi is lying unutilized at present.

Investment Arguments

A dominant & quality player in organized PTR market

Retread market has thousands of small players in unorganized sector where quality and performance is poor. However, there are only a handful of organized palyers – Midas Mileage, Indag Rubber, Treadsdirect (subsidiary of Elgi Rubber Co), and Vamshi Rubber. Besides, tyre companies (MRF, JK Tyres, and Apollo Tyres) have also gotten into making retreads. Midas is the largest player in terms of capacity, production and sales.

Entities	Capacity TPA	Production / Sales MT	FY11 Sales Rs.Crore
Midas Mileage	23,600 (expanding to 36,000)	24,000	NA
Indag Rubber	13,800	7,739	149
Treadsdirect (Elgi)	12,500	7,060	140
Vamshi Rubber	4,600	4,121	66
MRF	33,000	7,700	113

Indag's tread quality is considered to be superior among all and even better than Midas. Indag is hopeful of gaining market share in South, where Midas is very strong, with its intensified sales push.

When tyre companies launched radial tyres promising their ability to be retreaded thrice, they also got into retreading. However, their overheads are very high compared to focused retread makers and hence have not been able to ramp up despite huge capacity. The way forward for these tyre companies will be to tie up with focused retread companies like Indag for cost effective retreading of radial tyres.

Retread market to grow faster than growth in road transportation

There is a strong incentive for truck & bus operators to retread tyres instead of replacing tyres with new ones given the cost savings (upto 75% cost saving) involved. Penetration of retreads is very low in India compared to developed countries. Road transportation will not only grow in tandem with economic activity but will grow faster with improved highways and road networks. As penetration of retreads improves, retread market will grow faster than the growth in road transportation.

Despite slowdown in industrial production; commercial vehicles production has been growing very well. Current growth in commercial vehicles is a lead indicator of tyre replacement / retreading demand two years down the line.

Production Growth %	FY10	FY11	Q1FY12
Truck & Bus	15	8	9
LCV	8	5	20

Shift to precure technology from conventional one

There are two retread processes. Conventional process (also called mould cure or hot cure) and Precure process (also called cold cure). At present, market share of both the processes is 50:50 with share of hot cure considerably higher in farm tyres. In developed countries, almost 100% is cold cure. As India moves towards 100% cold cure, companies with cold cure process will grow faster than retread market.

Shift from large unorganized sector to quality

Thousands of small unorganized local retread players exist due to excise exemptions and inability of organized players to penetrate interior markets. Organized players have been gaining market share, as their reach & coverage improves. Once GST becomes applicable, the excise exemption will cease to benefit unorganized players and will lead to significant shift. Besides, there is natural shift taking place, as customers realize that mileage difference with quality retread is much higher than cost difference.

Indag has been gaining market share

Indag has been gaining market share over the years aided by its quality and all other supporting shift-factors mentioned above. We expect it to continue to gain market share. In the first half of FY2, Indag strengthened its sales team and intensified connect program with retreaders and dealers leading to significant growth (11% sequential volume growth in each of the first two quarters of FY12). Moreover, this growth is coming more from high margin private sector. Private sector volume grew 16% sequentially in QE sep-11. Indag also supplies to STCs (state transport corporations) for their buses. STC business is tender-based and carries lower margin.

OTR tyres retreading – a long term growth driver

Indag is planning to get into Off-the-road (OTR) tyre retreading segment. OTR tyres are large and require specialized material and machineries. OTR tyres include tyres of tractors, dumpers, and other mining and construction vehicles. Indag plans to not only make tread strips for these tyres but also have a retreading centre, where retreading service will be provided. It plans to have a centralized retreading centre and a number of collection centers all over India. However, this will take time to come up and then scale up. We expect that over the next 3-5 years, it should be making a meaningful contribution.

Asset-light business

This is an asset light business. Neither capex nor working capital requirements are high. In FY10, it expanded capacity by over 50% (additional PTR capacity of 4850 TPA) at the cost of only Rs.6cr. This capacity will take care of Indag's growth till FY14. The OTR capacity is expected to cost about Rs.1-1.5cr for retread material machinery and 5-6 cr for retreading machinery. We expect Indag to increase its PTR capacity by 50% in FY15 (additional PTR capacity of 6900 TPA) and this should cost it around 10-11cr. This capex will take care of next three years' growth. Indag keeps a tight control over working capital. It supplies goods to customers against PDCs and this restricts its debtors to about a month of sales.

Risks / Concerns

Sustained de-growth / slowdown in road freight transportation

Sustained de-growth or slowdown in road freight transportation will mean lower usage of tyres, consequent lower wear-n-tear of tyres, and hence lower demand for retreading.

Sustained & sharp fall in input costs

A sustained and sharp fall in input costs (a sustained and sharp fall in crude oil can be a proxy for this) will lead to inventory losses. In the absence of eclipsing volume growth, this can hurt margins during such period.

Will it get adequate attention from promoters?

Indag is managed by professionals and promoters/owners are not involved in executive management. Indag is a very small part of the promoter group and hence may not get their adequate attention in terms of pursuing/supporting aggressive growth strategies.

Seasonality

There is an element of seasonality in Indag's business and this can lend some volatility to quarterly sales and margins. In north, winter is severe and hence freight movement reduces. Besides, tyres do not wear down much in winter. Even during rains, truck movement is reduced.

Excise & Income-Tax benefits to expire from FY16

Indag currently has 100% excise exemption and 30% income tax exemption till FY15. From FY16, it will be required to pay full excise and income tax. However, it will be able to claim cenvat on raw materials, which are over 70% of sales. Hence, net impact of excise will not be significant. Moreover, retreaders will be able to set off excise from service tax by then (under GST). Hence, expiry of excise will be a non-event. Income tax exemption expiry will have one-time negative impact of 11% on its PAT in FY16. In FY11, its PAT fell 7% as income tax exemption came down from 100% to 30%.

Ownership & Management

Indag is owned 77% by promoters and ~1% by institutional investors. Khemka family owned Sun group (www.sungroup-global.com), the promoters, is a principal investor and private equity fund manager in Russia, India and other emerging markets. The group is headed by Nand Khemka, a graduate of Columbia Business School, and has interests in oil & gas, mining, real estate, infrastructure, food & beverages, and technology businesses.

Valuation and key underlying assumptions

We estimate one-year out fair value per share to be around Rs.390 by discounting free cash flows. Key assumptions are 20% volume growth in FY12 and 15% in FY13 & FY14, ability to pass on input costs, 12% NOPLAT growth and 30% ROIC in the first phase (FY15-FY20).

We calculated Indag's beta over multiple time frames and against multiple indices. It has the highest beta (1.1832) against BSE-midcap index over one-year timeframe. We chose to use this to build conservatism in our valuation. Over longer period of 3-5 years, its beta is less than one.

Financials

Income Statement

Rs. Cr.	FY11	FY12E	FY13E
Net Revenues	149	221	255
EBIT	15	24	29
PBT	14	24	30
PAT-Adj.	11	19	23
EPS Rupees	20.48	35.77	43.84

Ratios

%	FY11	FY12E	FY13E
Revenue Gr%	34.0	48.2	15.0
EPS Growth %	-7.1	74.7	22.6
RoE %	25.9	34.9	32.7
D/E x	.16	.10	-
Debtors Days	36	36	36
Creditors Days	43	43	43
RM Days	32	32	32
FG Days	39	39	39
WIP Days	6	6	6

Balance Sheets

Rs. Cr.	31Mar11	31Mar12	31Mar13
Assets			
Net Block	21	22	22
CWIP	1	-	-
Net Curr. Assets	30	43	55
Surplus Funds	-	-	6
Liabilities			
Equity Capital	5	5	5
Reserves	39	54	71
Debt	7	6	-
Non-Current Liab	-	-	-

Interim Performance

Rs.Cr.	Dec10	Mar11	Jun11	Sep11
Months	**3**	**3**	**3**	**3**
Revenues	37	41	48	54
Incr. in stock	-1	2	1	6
EBITDA	4.5	5.4	6.0	7.7
EBIT	4.0	5.0	5.5	7.1
PBT	3.8	4.7	5.1	6.7
PAT-Adjusted	2.9	3.8	3.9	5.3
Eq Capital	5.25	5.25	5.25	5.25
EPS Rs.	5.47	7.17	7.36	10.0
EBIT Margin %	10.7	12.2	11.4	13.1
Other income/PBT %	-	-	-	-
Tax/PBT %	23.7	19.1	23.5	20.9

Multiple Valuation

	FY11	FY12E	FY13E
EV/EBITDA x	4.8	3.1	2.5
EV/EBIT x	5.5	3.3	2.7
Mkt. Cap/Sales x	0.49	0.33	0.29
P/E x	6.8	3.9	3.2
Price/Book x	1.7	1.3	1.0

Free Cash Flow

Rs. Cr.	FY11	FY12E	FY13E
NOPLAT	12	19	23
Change in Net Working Capital	5	15	16
Operating Cash Flows	**6**	**4**	**16**
Net Capex & others	3	-	-
Free Cash Flow	**3**	**4**	**16**
Non-opr. Cash flow	-	-	0
Cash Flow to Investors	**3**	**4**	**17**

Financing Cash Flow

Rs. Cr.	FY11	FY12E	FY13E
Post-tax Interest	1	-	-
Repayment/ (issue) of Debt	0	1	6
Equity Share Dividend	2	2	5
Equity Buyback/(issue)	-	-	-
Inc / (Dec) in surplus cash/Investments	-	0	6
Financing Cash Flow	**3**	**4**	**17**

DCF Valuation

Key Assumptions	%
Terminal Growth Rate	3.0
WACC	17.3
Cost of Equity	17.6
Terminal ROIC	19.3
Outcome	**Rs.**
Fair Value Per Share (Rs.)-1 year out	**390**

Important Disclosure

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