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Falling rubber prices a boon for tire makers

by Dexter Tan

The credit profile of tire manufacturers has improved thanks to increased global vehicle production and lower rubber prices. The drop in rubber prices coincided with a lower RMI 1-year aggregate probability of default (PD), which is a simple median of default likelihoods for 44 globally listed tire producers. Falling from a high of 22bps in Feb 2013, the RMI aggregate 1-year PD declined to 4bps in Dec 2014 as profitability and liquidity levels improved.

There were a few positive corporate developments in the tire manufacturing sector that occurred over the past week. Last Wednesday, Standard & Poor's upgraded the outlook for Continental AG, one of the largest tire manufacturers in the industry, from stable to positive. The rating agency cited strong profitability metrics, well established market positions and diversified product mix, as reasons for the company's outlook revision. In a shareholder's meeting on Friday, Michelin executives reaffirmed the company's guidance for 2015 and said that the group is keen on acquisition opportunities in Asia. Michelin was also said to consider issuing a 30 year bond note to take advantage of the present demand for longer dated fixed income securities.

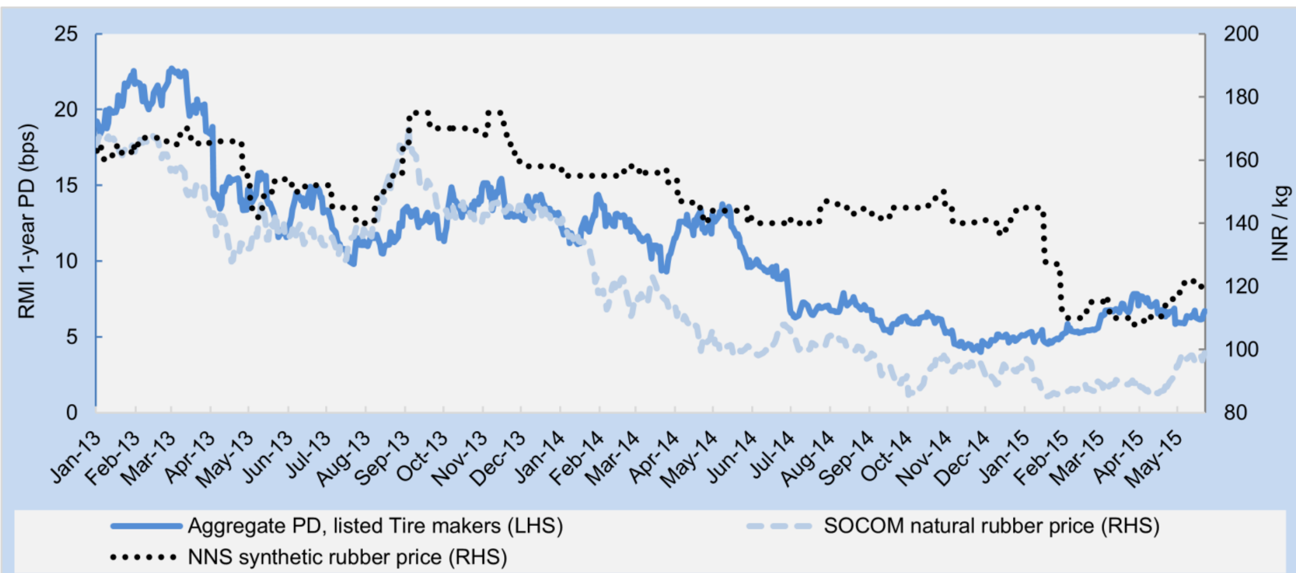

Figure 1: RMI 1-year aggregate PD for 44 tire makers vs. rubber prices between Jan 2013 and May 2015. Natural rubber prices are derived from the Bloomberg Singapore Commodity Exchange (SOCOM) generic 1st month TSR 20 rubber futures price. Synthetic rubber prices are approximated by the Bloomberg National News Service (NNS) synthetic rubber Korea 1502 polymer price. *Source: Risk Management Institute, Bloomberg*

Moving forward, the top-line and bottom-line drivers for tire manufacturers may continue to improve. The global tire market, which reached 500.4mn units in 2014, is expected to grow to 666.6mn units by 2019. Higher vehicle sales in the Asia-Oceania region, specifically in countries such as China, Japan and Korea, are likely to drive demand for tires. According to the Organisation Internationale des Constructeurs d'Automobiles, worldwide vehicle production is expected to increase 3% in 2015 after reaching 89.52mn units at the end of 2014. Regionally, China topped new vehicle sales with 18.4mn units followed by the US with 16.4mn units of new vehicle sales.

The worldwide tire market can be broken down into 2 general segments – light and heavy vehicles. Within each segment, demand can be further grouped into 2 sub-segments, original equipment (OE) and replacement tires. OE tires are special feature tires used to complement the performance of the vehicle whereas replacement tires cater to existing vehicle owners who wish to change their tires for repair and maintenance reasons. Based on estimates by the LMC World Tyre Forecast Service and Continental reports, global demand for replacement passenger car and light truck tires grew from 1.047bn units in 2013 to 1.093bn units in 2014. This is a new annual sales record for the global tire manufacturer industry.

From a cost perspective, tumbling commodity prices may have also lifted the credit profiles of tire manufacturers. Developments in the prices of commodities generally influence a firm's costs indirectly via costs imposed by suppliers. Depending on the contractual agreement with suppliers, the change in costs of raw materials is either passed on after a time lag or redefined in upcoming contract negotiations. Large tire makers do not currently hedge commodity prices, although they help to offset cost increases by centralizing their purchases to achieve higher negotiating power with suppliers.

The significant drop in rubber prices over the past 2 years would have added to the firm's bottom line. Raw materials usually represent 35% of the cost of a tire. Natural rubber and synthetic rubber make up 60% of raw material cost, or 17% of total cost of goods sold. Synthetic rubber is a petroleum based polymer which is a major component of tires. Natural rubber prices, tracked by futures contracts on the Singapore and Shanghai commodity exchanges, have come under pressure as global demand has declined. China, the world's largest importer of rubber, has witnessed a surge in inventory levels since 5 years ago. Inventories reported by the Shanghai Futures Exchange showed that stockpiles have increased more than 8 times from 12,860 metric tons to 104,990 metric tons since May 2010. An expansion of rubber plantations across Southeast Asia between 2005 and 2011, has elevated the supply of natural rubber in the country.

Figure 2: Natural rubber prices vs. inventory levels tracked by the Shanghai exchange over 5 years. Inventory levels are approximated by the Shanghai Futures Exchange rubber on warrant stocks, which tracks the amount of commodities available for delivery. *Source: Bloomberg*

The companies used to estimate the RMI 1-year aggregate PD are a diverse group of publicly traded tire makers differentiated by geographic reach, scale and market position. 75% of the constituents are listed in Asia, 15.9% in Europe and the remaining 9.1% listed in the US and Latin America. Four of the largest firms by market cap – Bridgestone, Michelin, Goodyear, and Continental control 67% of the industry's revenue with an extensive network of operations across major continents. For easy comparison, our next analysis narrows the list to 36 companies that generate more than 50% of their revenue from the production, sale and distribution of tires to the auto industry or their respective aftermarkets. This brings our focus group coverage to over USD 164bn of market cap and approximately USD 106bn of corporate debt.

Table 1 separates the list of 36 firms into 3 categories – large, medium and small sized companies. There are 8 large companies (corporations with a market cap of more than USD 4bn), 12 medium (between USD 1bn and USD 4bn) and 16 small sized firms (less than USD 1bn) in this analysis. The table highlights the performance of large, medium and small sized firms over the past 2 years, corresponding to the time period analyzed in Figure 1.

	RMI aggregate 1-year PD (bps)			EBITDA / Revenue			EBITDA / Interest expense			RCF / Net debt			Net debt / Total capital		
	L	M	S	L	M	S	L	M	S	L	M	S	L	M	S
1H 2013	3.3	57.6	13.9	62%	46%	49%	23.8X	14.1X	9.9X	66%	32%	23%	29%	39%	28%
2H 2013	2.5	23.7	11.6	62%	46%	55%	21.7X	15.2X	11.4X	88%	31%	29%	21%	36%	25%
1H 2014	1.8	22.1	8.0	66%	56%	54%	32.4X	16.8X	11.5X	67%	34%	28%	24%	34%	26%
2H 2014	1.8	11.3	6.9	68%	52%	58%	33.2X	16.5X	12.3X	87%	40%	22%	18%	30%	27%

Table 1: Credit performance metrics for listed tire manufacturers. RCF = retained cash flow. EBITDA = earnings before interest, taxes, depreciation and amortization. Income statement items are adjusted to a trailing 12 month period. Medium firms, with the highest proportion of debt in their balance sheet, have the highest default risk. The list of firms in this table includes tire manufacturers that report on a regular basis as companies from the initial list of 44 that do not report from 2012 onwards are excluded. *Source: Bloomberg*

The majority of the tire manufacturers in Table 1 have strong credit profiles. The overall credit quality has improved as EBITDA ratios have gradually improved due to lower rubber costs. Large tire manufacturers have the best performing credit metrics as determined by their low gearing, strong earnings and cash flow generation. Earnings momentum between 1H 2014 and 2H 2014 appears to be growing and could possibly extend towards 1H of this year. Large firms have better resilience to changes in product demand, higher cost absorption and R&D capabilities and higher bargaining strength with suppliers and customers. Many of them operate in diversified geographic regions with strong product innovation and advanced technological equipment.

Interestingly, medium-sized tire makers have weaker creditworthiness compared to smaller firms. This is demonstrated in the distinctly higher proportion of debt in their capital structure as well as lower EBITDA / revenue ratios during 2013. In addition, the ratio of retained cash flows to net debt dropped by 1% in 2H 2013. One possible explanation is that medium sized firms have been making fixed asset and working capital investments needed to execute on new supply agreements with several car makers for new vehicle model launches. To meet the new orders in 2015, tire makers could have made large upfront investments and issued bonds for production requirements in 2013. The drop in cash flow is typical for companies that have established new supply agreements for a year. However, cash flow generation is expected to improve after production rates take off.

Lower rubber prices could have made a larger impact on smaller players in the tire manufacturing industry. EBITDA margins for large and medium sized companies increased by 6% between 1H 2013 and 2H 2014 but similar margins for small companies expanded by 9%. The low material cost environment favors small firms, where raw materials represent a larger portion of its cost structure. For example, raw materials costs accounted for 70% of PT Gajah Tunggal's production costs in 2014, while raw material costs at Michelin amounted to 37% of overall 2014 costs, which is nearly half of PT Gajah's cost ratio.

The outlook for tire manufacturers is broadly positive. Demand for tires should continue to trend upwards, with volume growth in line with broad economic indicators. Rubber costs should remain low due to high inventory levels and a weaker outlook for agriculture prices. Small tire manufacturers, especially those focused in Asia ought to benefit from lower raw material costs. Medium sized firms should realize more cost synergies after their production rates improve while large companies such as Michelin can expect bottom lines to grow from cost restructuring operations.

Credit News

China's Central Bank lowers borrowing costs to help clean up local debt mess

May 25. As the local-government debt in China continued to pile up, which might have reached RMB 25tn, more than the size of Germany's economy, the government needed lower borrowing costs to clean up a local debt mess. The three-month Shanghai Interbank Offered Rate has tumbled 200 basis points since March 31, heading for the biggest two-month drop since 2008. That coincides with the government kicking off a municipal bond program and the exchange of regional loans into lower-yielding notes. As a matter of fact, the Central Bank has accelerated monetary easing just as local authorities kick off more than RMB 1.77tn of bond issuances, a four-fold jump from 2014. (Bloomberg)

IMF predicts upturn for Russian economy after 3.4% fall this year

May 21. According to the IMF, the Russian economy is set to contract by 3.4% this year but will rebound in 2016, posting a 0.2% growth. The fund had revised upward its outlook for Russian economic growth and inflation on the back of improved economic data and the recent strengthening of the rouble. The improved forecast coincides with brighter predictions for the Russian economy from both the Moscow authorities and independent economists. (FT)

Egg prices jump as bird flu spreads

May 21. The financial toll of the worst US bird-flu outbreak in history is soaring, forcing some poultry companies to suspend operations and boosting prices for eggs and turkeys as supplies tighten. Egg companies—the sector hit hardest by the virus—and turkey producers are spending millions of dollars to try to contain the disease. With eggs in particular, the problem is greatly complicated by the way the American industry is concentrated in the hands of relatively few producers. The US has fewer than 200 commercial-egg companies, down from about 10,000 in the 1970s. When the virus is confirmed in one hen house, birds in all of the other nearby houses typically have to be killed to prevent further spread. (WSJ)

Hong Kong market under scrutiny after Goldin and Hanergy falls

May 21. Since May 20, shares in three huge Hong Kong-listed companies have lost half their value. Investors in Hanergy Thin Film, Goldin Financial and Goldin Properties are nursing a combined USD 36bn in paper losses, without a single fundamental reason, such as a big announcement, to explain the slide. The plunges have highlighted the Hong Kong's market's unusual vulnerability to enormous share price moves and raised questions whether a new direct connection between Hong Kong and the volatile Shanghai exchange is changing the dynamic of the southern market. It has made Hong Kong regulators think about necessary intervention in the future. (FT)

Six banks fined USD 5.6bn over rigging of foreign exchange markets

May 20. Six global banks will pay more than USD 5.6bn to settle allegations that they rigged foreign exchange markets, in a scandal the FBI said involved criminality "on a massive scale". Barclays will pay the largest penalty, at more than USD 2.3bn. Three banks were also fined an additional total of USD 400mn for manipulating the Libor and Isdafix benchmarks, bringing the tally for the day to USD 6bn. The banks who settled over forex — Barclays, Citigroup, JPMorgan Chase, RBS, Bank of America and UBS — are hoping the deal will allow them finally to draw a line under both affairs. (FT)

HP revenues hit by falling printer sales (FT)

Fitch downgrades big Austrian banks (Reuters)

Loose loan safeguards fuel UK property risk (Bloomberg)

Regulatory Updates

Extra AUD 18bn capital at Australian big banks tipped to curb house prices

May 25. The big banks will have to raise AUD 18bn of new capital if the Australian Prudential Regulation Authority implements a key recommendation of the financial system inquiry, which could curb the rate of growth in home lending and reduce pressure on house prices. According to S&P, if APRA required the big banks to use higher average "risk weightings" for home lending, this would result in a higher level of capital held against mortgage loans across the entire industry, which would be positive for our overall credit view of the Australian banking system, particularly in light of growing concerns about property price inflation. (Sydney Morning Herald)

Indonesia court weighs legal challenge to banking regulator OJK

May 25. Indonesia's constitutional court is finalizing a review of a legal challenge to the role of the country's financial regulator, in a case that will decide who supervises banking in Southeast Asia's largest economy. The Financial Services Authority, known as the OJK, took over supervision of lenders from the central bank last year under a 2011 law on financial institutions. The case against the OJK, created to improve supervision following banking collapses during the 1997-1998 Asian financial crisis, comes as levels of bad debt are rising in a slowing economy. Banks want regulation to return to the central bank. (Bloomberg)

Risky loans shunned by banks are booming in Wall Street's shadow

May 22. Regulators' efforts to rein in Wall Street's biggest banks are in danger of backfiring. Guidelines aimed at strengthening lending standards are shifting the market for high-yield credit to less-supervised loan funds, raising alarm this week from the Financial Stability Oversight Council. Because the funds don't have depositors, some of their money comes from Wall Street financial institutions, leaving systemically important institutions exposed to risks regulators hoped to avoid. For example, loans by nonbanks such as KKR & Co. and Apollo Global Management LLC affiliates are a small part of the market, but they're growing. (Bloomberg)

Credit derivatives deserve a revival but only if financiers grow up (FT)

Central Bank less-is-more strategy doubted as ECB role debated (Bloomberg)

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