

# INDIAN TYRE INDUSTRY

Softening rubber price a small relief in the face of slowing automotive demand and rising threat of imports

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ICRA RATING FEATURE

## Summary

Driven by the strong revival in automotive demand, particularly in the passenger vehicle and two-wheeler segments and export demand for tyres, the Indian tyre industry reported a healthy revenue growth of over 25% during fiscal 2010-11. However surge in input costs especially that of natural rubber (NR) negated any scale benefits, and resulted in a contraction of industry-wide operating margins by over 500 bps. This was despite numerous industry wide price hikes, cumulatively amounting to a 15-20% increase in tyre prices. Despite the worrying macroeconomic indicators and a general slowdown in domestic automotive sales, the Indian tyre industry continued to post a healthy 25-30% revenue growth during Q1, 2011-12 supported by strong replacement and export demand. Domestic OEM demand growth was also healthy at around 15-20%, albeit weaker than in the previous fiscal. However continued cost pressure from high cost NR inventory led to a 300-350 bps operating margin erosion, both on a year-on-year (y-o-y) and sequential quarter basis.

During the first quarter of 2011-12, rubber prices have softened (after peaking in April-11) with fall in international prices, slowdown in auto demand and drop in crude prices. However prices of synthetic rubber continued to reign high, following the shortage of its key ingredient, butadiene. While some relief is expected following successful price hikes in Q1, 2011-12 and softening raw material prices, the industry is faced with several headwinds in the form of demand slowdown, threat of imports following removal of anti-dumping duty and large domestic capacity additions post 2011-12.

For fiscal 2011-12, while ICRA expects moderation in automotive OEM tyre demand, the strong growth in OEM sales in the last two fiscals is expected to translate into higher replacement demand. Growth in M&HCV replacement demand however could be affected by a slower economic growth. Besides grappling with high input costs and weak demand, domestic players are expected to face additional pressure with the lifting of anti dumping duty (ADD) (with effect from August 2011) on Truck and Bus radials (TBRs) imported from China and Thailand. While this move is expected to be contested by the industry players, the lifting of ADD makes the imported TBRs cheaper by ~15-20%, limiting domestic demand and pricing power.

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## 2010-11 performance: Margins declined from all time high as raw material prices surged

The tyre industry continued its growth momentum in fiscal 2010-11 (April 1, 2010 to March 31, 2011) registering a strong 27% growth in revenues backed by healthy demand from both the auto OEM and replacement segments and supported by capacity ramp-up by major players. The growth was driven by strong domestic OEM demand from the Truck and bus (T&B), passenger vehicle (PV) and two-wheeler (2W) segments which saw unprecedented volume growths of over 25%. Exports, which had declined by 5% in the previous fiscal, saw a strong recovery registering a volume growth of 22% during 2010-11.

Unlike the PV and 2W segments, where the OEM segment accounts for a significant portion of the volumes, the Medium and Heavy Commercial Vehicle (M&HCV) segment is largely driven by demand from the replacement market, which accounts for more than 80% of total demand. The M&HCV segment, accounting for the bulk of tyre industry revenues (~65%), saw a modest increase of 4% in overall demand on account of weak demand from the replacement segment and despite a 32% growth in OEM demand. The price increases imposed by most tyre manufacturers in response to the unprecedented increase in rubber prices led to a decline in demand from the price sensitive M&HCV replacement markets translating into increased re-treading and delayed replacements. However, strong OEM and export demand supported a 24% growth in overall domestic demand (volumes), as compared to 21% growth in the previous fiscal.

Even as the industry benefitted from the strong revenue growth during 2010-11, higher input costs, especially that of natural rubber, led to a sharp 19% decline in operating profits and 37% decline in net profits. Industry wide operating margins declined to 9.2% in fiscal 2010-11 as against 14.4% in fiscal 2009-10. Players having a diversified product mix with presence in the relatively high margin radial passenger car segment (as compared to the M&HCV segment, which is largely commoditised in nature), higher presence in the replacement market segment which offers better pricing flexibility, presence in niche high margin tyres (like Off-the road (OTR) and winter tyres) and superior brand image, have been able to post relatively healthier margins.

For the fiscal 2011-12, while ICRA expects moderation in automotive OEM tyre demand, the strong growth in OEM sales during the last two fiscals is expected to translate into higher replacement demand, especially in the passenger car and two wheeler segments, to an extent buffering the expected slowdown in the T&B OEM and replacement market segments. In the M&HCV segment, the growth is expected to remain muted as macro economic factors may dampen demand in the OEM and the price-sensitive replacement segments. Growth in replacement demand for T&B tyres however could be affected by slower economic growth.

**Table 1: Industry revenues and profitability<sup>1</sup>**

Rs. Crore	FY-08	FY-09	FY-10	FY-11
<b>Operating revenues</b>	16,764	18,922	22,128	28,212
<i>Growth (%)</i>		13%	17%	27%
<b>OPBDITA</b>	1,852	1,256	3,197	2,586
<i>Growth (%)</i>		-32%	155%	-19%
<b>PAT</b>	853	244	1,539	971
<i>Growth (%)</i>		-71%	531%	-37%
<b>OPM (%)</b>	11.0%	6.6%	14.4%	9.2%
<b>NPM (%)</b>	5.1%	1.3%	7.0%	3.4%

Source: SIAM, ATMA, ICRA estimates

**Table 2: Segment wise domestic demand estimates (volume)<sup>2</sup>**

In Lac Nos.	FY-09	FY-10	FY-11
<b>T&amp;B</b>	120	146	152
<i>Growth (%)</i>		21%	4%
<b>Passenger Car</b>	198	236	310
<i>Growth (%)</i>		19%	31%
<b>LCV</b>	37	43	46
<i>Growth (%)</i>		16%	7%
<b>2W &amp; 3W</b>	402	492	633
<i>Growth (%)</i>		22%	29%

Source: SIAM, ATMA, ICRA estimates

<sup>1</sup> Financials refer to the period April-March and have been adjusted wherever actual year ending period of companies is different; data includes sample of the top nine domestic tyre manufacturers

<sup>2</sup> Demand is estimated as production (+) imports (-) exports and does not take into account inventory adjustments

### Macroeconomic headwinds dampen near term automobile demand for 2011-12 while long term prospects remain favourable

After registering a strong 26% growth during the past two fiscals (2009-11), the growth in the automobile industry, consisting of commercial vehicles (CV), passenger vehicles (PV), two-wheelers (2W) and three-wheeler (3W) segments, has been slowing down. During April-July 2012, the M&HCV segment, which accounts for around 65% of total revenues for the tyre industry, posted a modest growth of 6.4% on Y-o-Y basis as compared to a staggering 74.2% during April-July 2011.

The main factors impacting growth in the M&HCV sector include the rising interest rates, increasing fuel costs, stagnant freight rates, slowing industrial growth and the high-base effect of the previous year. Further, over the past twelve months, M&HCV OEMs have taken cumulative price hikes of over 10% to pass on the impact of emission norms changes and higher input costs. Higher interest rates (averaging around 13% at present for large fleet operators and considerably higher for first time users (FITs)) and rising diesel prices substantially increased the cost of vehicle ownership for fleet operators. This coupled with the relatively flat freight rates on major routes have pressurised the profitability and cash flows of fleet operators. However, growth in the light commercial vehicle (LCV) segment, which is relatively less vulnerable to slowdown, is likely to be better. ICRA expects growth in the Commercial vehicle (CV) segment to moderate in 2011-12 to around 6% in the M&HCV segment and around 14% in the LCV segment.

**Table 3: Volume growth expected to slow down in most segments in the Indian market**

Industry Segment	Volumes (Lac nos)#			
	FY-09	FY-10	FY-11	FY-12E
<b>M&amp;HCVs</b>	1.8	2.4	3.2	3.4
<i>Growth (%)</i>	-33.2%	33.5%	31.8%	6%
<b>LCVs</b>	2.0	2.9	3.5	4.0
<i>Growth (%)</i>	-7.0%	43.4%	22.9%	14%
<b>Passenger vehicles</b>	15.5	19.5	25.2	~27
<i>Growth (%)</i>	0.13%	25.7%	29.2%	~6%
<b>Two-wheelers</b>	74.4	93.7	117.9	133.2
<i>Growth (%)</i>	2.6%	26.0%	25.8%	13%

# excludes exports

Source: SIAM, ICRA estimates

The PV segment is the second largest contributor of revenues for the tyre industry, after the M&HCV segment, accounting for around 15% of the total revenues. Domestic demand for passenger vehicles has also muted to around 4.0% during the first four months of the current fiscal (April-July 2012) after reporting strong growth upwards of 25% during the last two fiscals. ICRA expects sapping consumer sentiments owing to high inflation and spiralling interest rates to cap demand over the next quarter also. However, with a number of new product launches lined up for the festive season, demand is likely to improve marginally from Q3, 2011-12.

The 2W segment, which contributes around 10% to tyre industry revenues, has been relatively less impacted by rising interest rates, owing to its limited reliance on organised financing (only around 25% of two-wheelers are financed). Further, higher mileage, lower ticket size and cities with stretched infrastructure continue to favour two-wheelers. Despite this, two-wheeler volume growth moderated to around 15.8% during April-July 2012 as compared to nearly 25% growth in each of the previous two fiscals. Factoring in muted consumer sentiments and inflation, ICRA expects two-wheeler demand to be around 13% (previous year 25.8%) during the current fiscal.

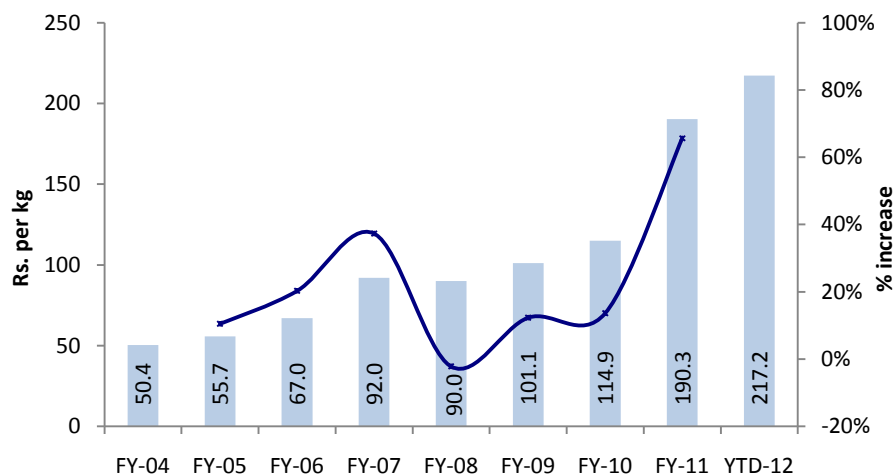
Despite the slowdown in demand at the consumer end, some channel and inventory pipeline buying, coupled with healthy exports supported tyre demand during Q1, 2011-12. However, ICRA expects these macroeconomic dampeners to mute demand (volumes) for tyres during the fiscal 2011-12 to around 7-10% in the OEM segment and around 10-13% in the replacement segment. However, while near term automotive demand is expected to be tempered owing to the macro-economic headwinds, the long term growth fundamentals of the industry remain strong. Improving road infrastructure resulting in reduced vehicle turnaround time, restrictions on overloading and investments in infrastructure continue to support demand for CVs. Similarly, factors such as favourable demographics, rising disposable income, under penetration of vehicles, strong demand from rural markets, and availability of financing at competitive rates drive long term demand for PVs and 2Ws.

### Softening rubber prices during the past four months (May to August) to support margins during the coming months

A raw material intensive industry, tyre manufacturer margins are highly correlated to the price movements of raw materials. The prices of Natural rubber (NR), the key raw material constituting around 43% of total raw material costs, witnessed a sharp rise during fiscal 2010-11. Domestic rubber prices increased from lows of Rs. 95 per kg in May 2009 to highs of Rs. 240 per kg in April 2011 while global NR prices rose from \$164 per kg to \$483 per kg<sup>3</sup> during the same period. This unprecedented price was on account of sharp increase in demand-particularly from the global tyre industry, rise in crude oil prices, and speculative interest in global rubber futures. Coupled with the demand spike, supply was disrupted by adverse climatic conditions in key rubber cultivating countries like Thailand (largest producer in the world), Indonesia, India and China. Globally, NR consumption increased by 14.4% during the fiscal 2010-11, while NR production increased by only 6.1%. In India, NR Production during the fiscal 2010-11 grew by 3.7% as against the consumption growth of 1.8%. In absolute terms, Indian NR production for the fiscal 2010-11 stood at 0.86 million tonnes as against consumption of 0.95 million tonnes, leading to large import requirements.

Despite repeated tyre price hikes to counter cost inflation, the sharp surge in rubber prices impacted the margins of all tyre manufacturers globally during fiscal 2010-11. However, during the first four months (April-July) of fiscal 2011-12, the prices of both domestic and international NR prices have softened. While domestic NR prices fell by ~11%, international prices dropped by a sharper 25% between May and August 2011, tracking drop in demand and falling oil prices, owing to global political concerns and the US/Eurozone debt crisis. However, the average NR prices for August 2011 (at Rs. 203 per kg) still continue to reign higher than average prices (Rs. 190 per kg) of the previous fiscal of 2010-11. The slowdown in demand from the automotive industry coupled with easing of supply constraint during the third quarter-the preferred period for tapping post monsoon, the domestic NR prices is expected to witness marginal correction from current levels, over the next two-three quarters. Further, the removal of anti-dumping duty against Chinese, Thai Truck & Bus radials (TBRs) with effect from August 12, 2011 could impact the replacement market for domestic tyre manufacturers.

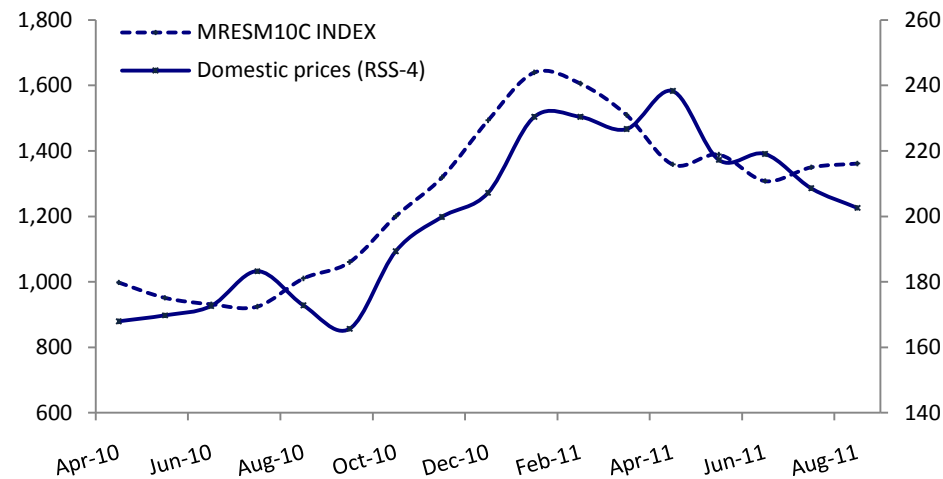
**Chart 1: Average natural rubber prices [RSS-4] during the last eight years**



Source: Rubber Board

YTD-12: Apr to Aug 2011

**Chart 2: Comparison of RSS-4 prices & MRESM10C Index since April 2010**



Source: Rubber Board, Bloomberg & ICRA's estimates; MRESM10C: Malaysian rubber board Index

<sup>3</sup> RSS-3, Bangkok prices

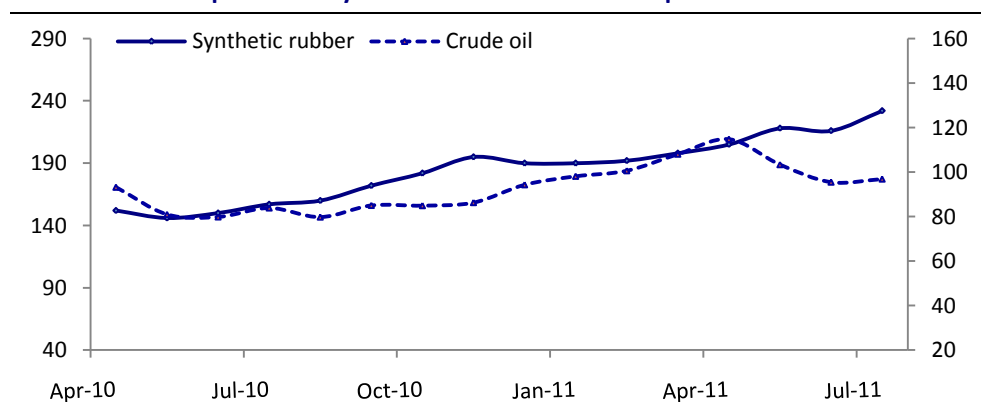
During fiscal 2010-11, the country's NR imports stood at 0.18 million tonnes - a 0.5% increase over the last fiscal. Until March 2011, the Indian tyre industry suffered from an inverted duty structure wherein the customs duty on import of the input, NR stood at 20%, as against the duty of only 10% on import of tyre. In April 2011, this inverted structure was corrected partially with NR import duty attracting the lower of 20% or Rs. 20 per kg (which at current prices is an effective 8-10%). In July 2011, through a notification, GoI also allowed the import of upto 40,000 tonnes of NR during fiscal 2011-12 at a concessional duty of 7.5%. A similar time-bound (for fiscal 2010-11) notification was issued in December 2010, allowing imports of 40,000 tonnes at 7.5%. While these measures are beneficial during periods of lower international prices, the quantum (around 4.2% of the tyre industry's annual consumption of 0.95 million tonnes) of permissible imports (under the lower duty structure) is meager.

### Sharp decline in crude oil prices following global debt crisis; crude derivatives to trail oil prices

Crude oil prices have been volatile during the last six months following the debt crisis in Europe and United States, political upheaval in Middle East and North Africa, and cut in demand forecasts by OPEC<sup>4</sup>. Although the bail-out of Greece by Eurozone members marginally supported prices temporarily, global debt crisis and continued concern about economic slowdown resulted in sharp correction in oil prices, which fell by ~15% between end of July 2011 and mid August 2011. ICRA expects oil prices to remain volatile with tightening of supply and an uncertain demand scenario.

Synthetic rubber (SR), a key raw material for tyres adding a significant 15% to the overall input costs is a crude derivative. Apart from NR price movements, SR prices also have strong correlation to crude oil price movements. Two types of SR are used as elastomers in tyres, Styrene Butadiene Rubber (SBR) and Poly Butadiene Rubber (PBR). Despite the recent decline in crude oil prices, SR prices continued to reign high during the first four months of fiscal 2011-12 owing to the shortage of SR's key ingredient, butadiene. However ICRA expects that over the next few quarters, decline in demand and the expected correction in butadiene prices are likely to align SR prices with crude oil prices. Other key raw materials in tyre manufacturing process include crude derivatives like nylon tyre cord fabric (NTCF), carbon black and rubber chemicals, which add around 18%, 11% and 5% of the total raw material costs respectively. As the prices of all these components are linked to crude oil prices, ICRA expects the prices of these crude derivatives to also correct over the short term.

**Chart 3: Crude oil prices and synthetic rubber index since April 2010**



Source: Bloomberg; Synthetic rubber: SRUBISR Index; Crude oil prices: WTI Crude future (USD/bbl)

### Backward integration plans to protect margins

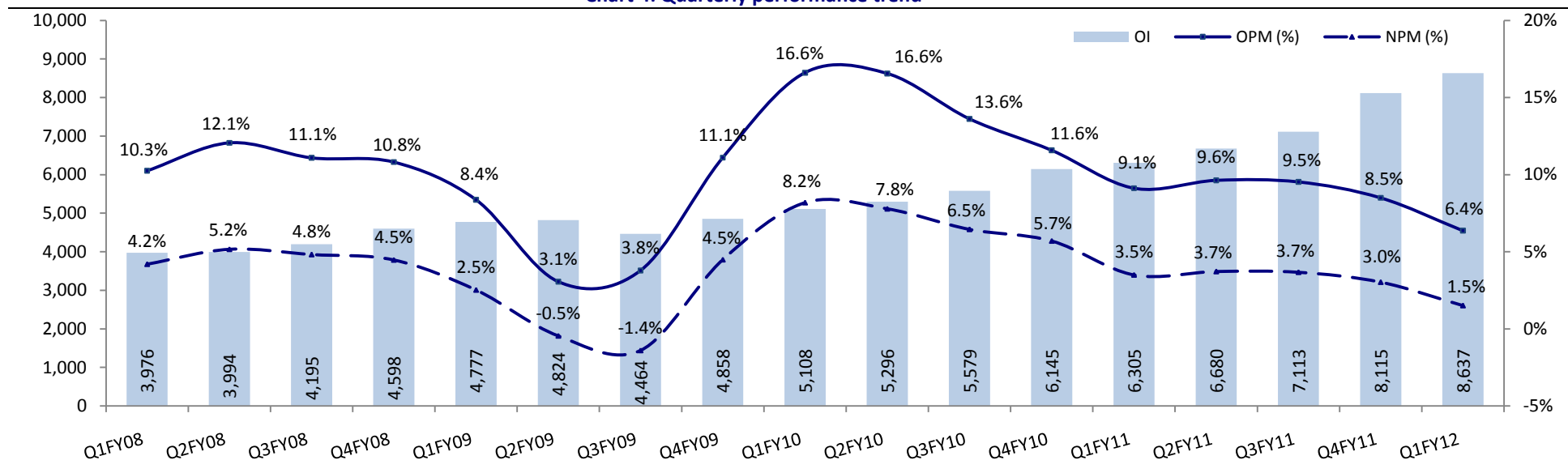
As evident during the past few years, the margins of tyre manufacturers are highly susceptible to movement in rubber prices. As witnessed during fiscal 2010-11, margins declined sharply owing to the significant upsurge in rubber prices and the inability of tyre companies to fully pass on the rise to the consumers. As the benefits from rubber re-plantation / increased acreage initiatives are expected only from end 2012, tyre manufacturers in a bid to isolate margins from NR price inflation are now looking at backward integration measures such as acquiring rubber plantations. Tyre companies like Apollo Tyres Limited (Apollo Tyres) and JK Tyre and Industries Limited (JK tyres) are eyeing acquisition of rubber plantations in the overseas markets.

<sup>4</sup> Organization of Petroleum Exporting Countries

### While raw material prices are expected to moderate – slowing demand and cost pressures on transporters may inhibit upturn in margin

While revenue growth remained strong across all quarters in 2010-11, revenues witnessed an accelerating trend with the fourth quarter registering a strong growth (y-o-y growth of 32%) supported by higher sales of PV tyre, revival of demand in the truck and bus radial (TBR) replacement tyre segment and strong year-end buying. The growth momentum continued in Q1, 2011-12 with major players registering strong revenue growth nearing 30% (y-o-y). However with the softening of demand across all automotive segments and with the higher base effect coming into effect, ICRA expects demand to moderate from Q2, 2011-12 onwards.

Chart 4: Quarterly performance trend



Source: Capitaline, ICRA Estimates

Despite the growth momentum of the previous fiscal, fourth quarter of 2010-11 witnessed one of the weakest margins in over ten quarters, with operating margin declining to 8.5% largely owing to the sharp rise in rubber prices. In order to tide over the rising rubber prices, Indian tyre manufacturers undertook several price hikes in the range of 15-20% during 2010-11. While the price hikes were in line with similar revisions in the international market, they have been insufficient to compensate for the overall cost increases. Severe input cost pressures in Q4, 2010-11 due to non-remunerative prices led to further pricing hikes of around 6-10% in the first quarter of 2011-12. However, the time lag in passing on increase in rubber prices to customers coupled with high value inventory lying with many players resulted in industry margins declining sharply in Q1, 2011-12. Average rubber cost for tyre manufacturers like MRF Limited and CEAT Limited stood at a high of around Rs. 220-230 per kg during Q1, 2010-11, despite the fall in rubber prices, owing to high cost inventory liquidation. Currently, tyre manufacturers are maintaining around two-three weeks of raw material inventory, with periodic buying depending upon prices.

Table 4: Price hikes by OEMs

OEM	FY-11	YTD-FY12
Apollo	17%	6-7%
CEAT	20%	10%
JK	NA	7-8%
MRF	16-17%	6-7%

YTD-FY12: Apr to Aug 2011; Source: Industry

Although tyre OEMs have so far resisted price reductions, stiff resistance to price increases from fleet operators may limit such flexibility in future. In May 2011, the All India Motors Transport Congress announced that the movement of raw materials and finished goods would be blocked from the factories of Apollo Tyres Limited should the company increase prices further. The recent removal of ADD is likely to suppress the pricing power of domestic tyre company, especially the replacement segment, thus impacting the margins. The margins of tyre companies, mainly players with large export revenues, are also expected to be under pressure with the withdrawal of Duty Entitlement Passbook (DEPB) scheme from October 1, 2011. While alternative schemes are in vogue, the cash flows of tyre companies can moderate to the extent of benefits not covered by the new scheme.

#### Augmentation of fresh capacities to meet growing tyre demand, will also keep a check on margins in the medium term

The domestic tyre industry has been in an investment mode during the last few years with almost all participants adding significant capacities. Supply additions were high between 2008 and 2010, with domestic capacities increasing by around 49%<sup>5</sup>. While the capacities in fiscal 2010-11 are estimated to have increased by ~8%, the industry is poised for another ~25% addition during the next two years. Of this, bulk of the investments are expected in fiscal 2011-12 with ~19 tyre projects targeted for completion this year. The industry has already witnessed an addition of 17.7 lakh tyres from JK tyre, Metro Tyres Limited (Metro tyres) and Bridgestone India Private Limited during the first quarter of fiscal 2011-12. Other major projects scheduled for completion during the current year include JK Tyres, MRF Limited, Falcon Tyre Limited, and Metro tyres, with most of the capacity additions being towards radial capacities. The table below details the investment schedule plans in the Indian tyre industry<sup>6</sup>. Post 2013, with the stabilisation of these projects and the availability of incremental domestic radial capacities, ICRA expects the dependence on Chinese imports to reduce. These incremental capacities are also likely to result in intensified pricing competition in the industry during the coming years.

**Table 5: Key projects scheduled for completion by FY-2013**

Company	Location	Product	Capacity	Investment [Rs. Crore]	Completion by
Apollo Tyres Limited	Oragadam, Tamil Nadu	PCR tyres (2 phases)	9,000 nos / day	2,100	March 2012
	Chennai, Tamil Nadu	TBR tyres	4,700 nos / day		
	Vadodara, Gujarat	Tyres		200	March 2012
Balkrishna Industries Limited	Bhuj, Gujarat	Speciality tyres	1,10,000 tonnes / annum	1,200	June 2012
		Pneumatic tyre, tube & flap	1,50,000 tonnes / annum		
Bridgestone India P Limited	Rajasthan & Maharashtra	Tyres		200	September 2011
	Chakan, Pune	TBR		2600	January 2013
		PCR		260	August 2013
	Pithampur	TBR	200 nos / day	90	
Ceat Limited	Ambarnath, Maharashtra	Radial tyres	6000 nos / day	260	September 2011
		Speciality Tyres	200 tonnes / day	340	December 2012
Dunlop India Limited	Guwahati, Assam	Truck & Earthmovers tyres	50 tonnes / day	450	December 2011
Falcon Tyres Limited	Haridwar, Uttarakhand	Tyres	60 lakh units	570	March 2012
JK Tyre & Industries Limited	Mysore, Karnataka	Tyres	2,00,000 nos / day	315	August 2011
	Sriperumbudur, Tamil Nadu	PCR Tyres (2 phases)	25,00,000 nos / day	1,500	March 2012
		TBR tyres	4,00,000 nos / day		

<sup>5</sup> Source: CMIE

<sup>6</sup> Table 5 does not include Michelin Group's Rs. 4,000 crore investments at Chennai, which is spread over a period of seven years

Company	Location	Product	Capacity	Investment [Rs. Crore]	Completion by
Kesoram Industries Limited	Haridwar, Uttarakhand	Tyres		1,000	December 2012
	Haridwar, Uttarakhand	Radial tyres	85 tonnes / day	350	September 2011
	Balasore, Orissa	Radial tyres	80 tonnes / day	450	September 2011
MRF Limited	Ankampaly, Andhra Pradesh	PCR (Phase-1)	20,000 tonnes / month	3,800 (total)	September 2011
		PCR (Phase-2)	20,000 tonnes / month		May 2012
	Trichy	TBR	3,00,000 tonnes / month	September 2011	
		Cross ply	20,000 tonnes / month	September 2011	
			4,40,000 tonnes / month	December 2012	
Pondicherry	PCR	40,000 tonnes / month			

Source: CMIE, Company announcements

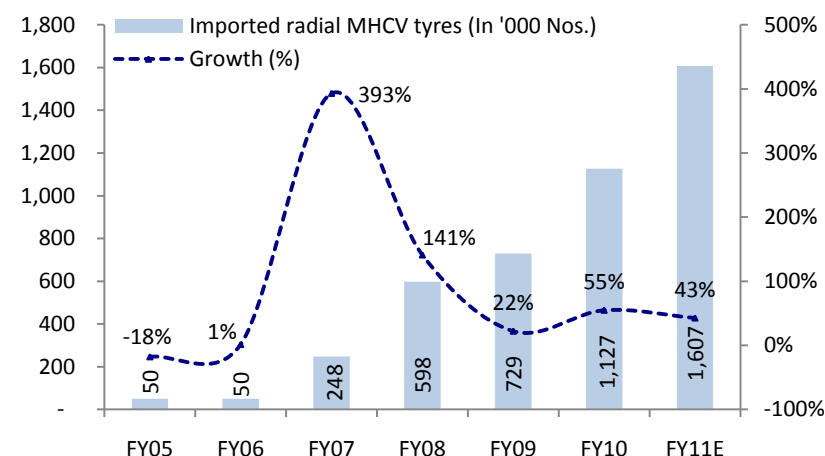
[Note: PCR - Passenger Car radial; TBR - Truck and Bus radial]

### Removal of anti-dumping duty on TBR imports to intensify competitive pressures for domestic players

The relatively lower cost of imported TBRs, domestic capacity constraints (particularly in radials) and fast pace of radialisation in the T&B segment has led to a huge growth in imports of TBRs during the last couple of years. In order to protect the domestic industry, the GoI in February 2010 imposed a definitive anti-dumping duty (ADD)<sup>7</sup> on TBRs (tyres and tubes) imported from China and Thailand. Even factoring in the ADD, Chinese tyres continued to remain cheaper than domestic tyres. Coupled with shortfall in domestic capacities, the import of TBRs is estimated to have grown by 43%<sup>8</sup> in 2010-11.

However, reacting to an appeal against the ADD by both tyre companies like Bridgestone Tyre India Limited (which imports from its Chinese plants to feed the domestic market), OEMs like Tata Motors Limited apart from Chinese tyre makers like Hangzhou Zhongce Rubber Company, the GoI removed the ADD on TBRs imported from China and Thailand from August 2011 onwards. This is expected to make imported TBRs cheaper by almost 15-20%, translating into a sharp increase in imports and also limiting the pricing power of domestic players in replacement tyre market thereby impacting industry margins. Notwithstanding the concerns of relatively lower distribution reach and inconsistency in quality of the imported tyres, the attractive price point is expected to pose a serious threat to domestic tyre manufacturers particularly in the replacement segment, placing large Chinese tyre manufacturers like Giti Tire Company Limited and, Weifang City Gunaite Rubber Co., Limited in direct competition with domestic players. While ATMA and the domestic tyre companies are expected to retaliate against this move, any interim stay on the same and the final verdict of the ruling remains to be seen. Till then, the lifting of ADD remains a key risk in the near term.

Chart 5: Trend in import of Truck and Bus Radials



Source: DGFT, ICRA estimates

<sup>7</sup> In the range of \$24.97 to \$99.05 depending on the manufacturer and country of import and levied on a set of tyre, tube and flap

<sup>8</sup> Growth calculated on annualized basis

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