



METHODOLOGY FOR RATING COMMERCIAL VEHICLE MANUFACTURERS

Overview

The Indian Commercial Vehicles (CV) market is segmented on the basis of gross vehicle weight (GVW) into: Heavy Commercial Vehicles (HCVs), Medium Commercial Vehicles (MCVs) and Light Commercial Vehicles (LCVs). GVW is defined as vehicle weight plus the rated payload; the rated payload being the maximum weight permitted to be loaded on to the vehicle under the Motor Vehicles Act, 1988. Vehicles with a GVW of more than 16 tonnes are classified as HCVs, vehicles with a GVW of 7.5-16 tonnes are classified as MCVs and vehicles with a GVW of less than 7.5 tonnes are classified as LCVs.

CVs depending on end-use can be either passenger carriers or goods carriers. During 2008-09 passenger carriers accounted for 14% of LCV volumes and 21% of M/HCV volumes, reflecting the dominance of goods carriers in the industry. Over the last two decades, both the LCV and the M/HCV segments have broadly grown at similar rates, although volume growth in the M/HCV segment has been more volatile. Growth in the industry is linked to economic activity and the level of investments in infrastructure development, and exhibits cyclicity. The truck segment of the business (M/HCV goods carriers) is however prone to lumpy capacity addition at the fleet operator level and hence experiences more pronounced cyclicity. The LCV segment, though cyclical, usually exhibits steadier demand patterns on account of the relatively wide usage range.

The inherently cyclical nature notwithstanding, the long-term growth prospects for the industry remain closely linked to development of road infrastructure and growth in gross domestic product (GDP).

The key factors which ICRA examines while analyzing the credit quality of CV manufacturers, are as listed below.

- Product portfolio
- Scale, market share & competitive position
- R&D capabilities
- Captive finance
- Profitability
- Leverage and Liquidity
- Cash flow position and debt service indicators
- Promoters/ management quality

In addition to the factors mentioned above, certain important factors that are common to corporate sector in general, such as the quality and experience of the management, assessments of corporate governance, quality of financial reporting and information disclosure are taken into consideration while assigning the ratings.

Product portfolio strength

A manufacturer's ability to offer a broad and diverse range of products across different load levels and across goods and passenger segments enables it to cater to a diverse customer profile. The extent of product diversification both enhances a company's competitive position as well as its ability to counter any possible demand volatility in a particular product category. With changing customer needs, the ability of companies to consistently refurbish their product portfolio, while maintaining profitability, is also a key challenge that manufacturers have to contend with. Further, new product categories have also been created off late in India thus increasing market segmentation. ICRA considers the breadth of the product portfolio and product renewal rate as key indicators of a company's business strength.

Scale, market share & competitive position

The scale and market position of CV manufacturer also reflects business strength of the company and supports meaningful diversification across product categories and markets. Scale helps in developing an efficient vendor network, critical in developing a competitive cost structure. Scale also aids a company's bargaining power with various stake holders, starting from commodity raw material suppliers catering to the vendor network to financiers catering to its customers.

A company's market share, which is a function of its brand strength, product characteristics, sales and service network, product pricing strategy etc, may vary over time based on a number of factors. Therefore while looking at market share data ICRA considers various aspects of the market share dynamics in different product categories which include shift in consumer preferences, competitive intensity, new product introduction cycle and product pricing.

The entry barriers in the CV business in India are need for widespread sales and service network, ability to deliver products and spares at low costs, developing an efficient vendor base and technological adaptations to Indian roads and environmental conditions. Traditionally the CV market in India has been dominated by two large players. However, lately several foreign players have made an entry in India though collaborations with other Indian companies which is likely to expand the product availability and intensify the competitive landscape going forward. Such collaborations aim to combine the technological expertise of global players with the domestic market understanding of the Indian entities. The international markets however operate at much higher GVW/ power range and have more stringent safety and comfort benchmarks. Keeping in view significantly lower price points in the Indian markets, international products need high degree of adaptation for the Indian requirements and localization of spares.

R&D Capability

Traditionally the Indian market had been focused on lower initial costs for customers, leading to low-end products lacking in power, safety and comfort related features. However following highway developments and the evolving of hub and spoke logistics model, the freight market has evolved towards higher-end multi-axle vehicles. Also, the entry of MNCs with high end products has increased the awareness and expectations of Indian consumers in terms of comfort and safety features. This, coupled with emission norms getting increasingly stringent, makes it imperative for manufacturers to invest in advanced engine technologies and focus on introducing lighter weight materials in vehicles. The domestic players in recent periods have scaled up their investments on product developments (engine, transmission, cabin development) significantly to meet the challenges of emerging competition and increasingly demanding preferences of Indian customers. ICRA considers that companies having sound technological capabilities, in-house or by way of tie-ups, to be better placed in terms of maintaining their market position.

Financing support

Majority of commercial vehicle purchases are financed and hence availability of credit is a critical part of customer support. For some CV manufacturers, this support is available directly in the form of in-house captive finance. For others, this support is typically provided through tie-ups with banks and NBFCs. The CV financing, both for new and used vehicles, have seen strong participation from large number of banks and NBFCs, leading to reduced necessity of captive finance support from OEMs. For manufacturers with captive finance companies, ICRA's analysis includes capital requirements for the captive finance business, with necessary adjustments for delinquencies. While captive business plays a positive role in supporting business growth, easy credit policy without adequate risk management practices can lead to unsustainable business growth and push up delinquencies.

Profitability

A high and relatively stable profitability is indicative of a company's operational efficiency derived from the areas of manufacturing, supplier synergies, value proposition for customers, consistent product quality resulting in minimal field failures et al. Profitability is also supported in some measure by higher degree of localization which allows a company to reduce its dependence on imported components and consequently remain safeguarded from the vagaries of exchange rate fluctuations.

In the past the Indian CV manufacturers were forced to adopt a high level of backward integration due to lack of quality vendor network. This, however, has changed over the years and today a significant part of the manufacturing activity is outsourced to component suppliers. With increased levels of outsourcing the capital intensity for OEMs has reduced and the break-even volumes have dropped significantly. While cyclical downturns will continue to impact CV manufacturer's profitability the extent of the impact is reduced with higher degree of outsourcing.

Leverage and Liquidity

The CV industry is prone to high degree of cyclicity, leading to periods of sharply reduced volumes and margin pressure. These periods of slowdown are also typically associated with

tightening customer credit (on rising delinquencies) and tightening liquidity with vendors. At the same time investments on product developments remains essential even during periods of sharp slowdown. During these periods of slowdown, CV manufacturers with healthier balance sheets are able to sustain necessary investments without financial stress. A company with a stronger balance sheet is also better placed in supporting temporary liquidity pressures with vendors/ customers; which in turn helps in strengthening long term market position.

A company's capacity to generate adequate levels of cash flow relative to debt, and earnings relative to interest is critical in evaluating its credit risk profile. Higher rated companies in the industry exhibit stable cash flows through revenue streams that are diversified across product categories.

Promoters/Management Quality

All debt ratings necessarily incorporate an assessment of the quality of the issuer's management, as well as the strengths/weaknesses arising from the issuer's being a part of a "group". Also of importance are the issuer's likely cash outflows arising from the possible need to support other group entities, in case the issuer is among the stronger entities within the group. Usually, a detailed discussion is held with the management of the issuer to understand its business objectives, plans and strategies, and views on past performance, besides the outlook on the issuer's industry. Some of the other points assessed are:

- Experience of the promoter/management in the line of business concerned
- Commitment of the promoter/management to the line of business concerned
- Attitude of the promoter/management to risk taking and containment
- The issuer's policies on leveraging , interest risks and currency risks
- The issuer's plans on new projects, acquisitions, expansion, etc.
- Strength of the other companies belonging to the same group as the issuer
- The ability and willingness of the group to support the issuer through measures such as capital infusion, if required.

**ICRA Limited***An Associate of Moody's Investors Service***CORPORATE OFFICE**

Building No. 8, 2nd Floor, Tower A, DLF Cyber City, Phase II, Gurgaon—122002
Tel.: +(91 124) 4545 300; Fax: +(91 124) 4545 350

REGISTERED OFFICE

Kailash Building, 11th Floor; 26, Kasturba Gandhi Marg; New Delhi—110001
Tel.: +(91 11) 2335 7940-50; Fax: +(91 11) 2335 7014, 2335 5293
Email: info@icraindia.com Website: www.icra.in

Branches: **Mumbai**: Tel.: + (91 22) 24331046/53/62/74/86/87, Fax: + (91 22) 2433 1390 □ **Chennai**: Tel + (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294, Fax + (91 44) 2434 3663 □ **Kolkata**: Tel + (91 33) 2287 0450, 2240 6617/8839, 2280 0008, Fax + (91 33) 2287 0728 □ **Bangalore**: Tel + (91 80) 2559 7401/4049 Fax + (91 80) 559 4065 □ **Ahmedabad**: Tel + (91 79) 2658 4924/5049/2008, Fax + (91 79) 2658 4924 □ **Hyderabad**: Tel +(91 40) 2373 5061/7251, Fax + (91 40) 2373 5152 □ **Pune**: Tel + (91 20) 2552 0194/95/96, Fax + (91 20) 2553 9231

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