



INDIAN AUTO ANCILLARY INDUSTRY: Recovery in Sight

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OVERVIEW

Auto ancillary companies experienced amongst the largest number of rating downgrades within the universe of ICRA-rated entities during the 21-month period ended December 2009, that is the full fiscal year 2008-09 and the first nine months of 2009-10. At the beginning of 2008-09, companies comprising the Indian auto ancillary industry were in the investment phase, and thus had a stretched capital structure already. The relatively sudden contraction in automotive demand that followed in the wake of the global financial crisis, besides fluctuations in foreign exchange (forex) rates, increase in commodity prices, and the drying up of liquidity in the market, aggravated the situation further, causing a sharp deterioration in the credit profiles of many auto ancillary companies and leading to several rating downgrades. However, over the last few quarters, the situation has stabilised with original equipment manufacturers (OEMs) experiencing improvement in demand conditions. With that, ICRA expects the Indian auto ancillary industry to be able to report a steady improvement in the credit profiles of its participants over the medium term.

Following seven years of healthy growth in automotive demand across segments, there was a sharp contraction in domestic OEM volumes in 2008-09. While almost all segments of the industry faced demand pressures in the third quarter (Q3) of 2008-09, the sharpest decline was witnessed in the commercial vehicle (CV) segment, which then translated into significantly lower offtake and losses for suppliers of CV components. Overall, the key challenges facing the auto ancillary industry during the quarter were under absorption of capacities, forex fluctuations, high interest costs, and increasingly stretched payment terms (imposed by OEMs). Further, the capital structure and coverage indicators of the industry deteriorated as a result of lower accruals and significantly higher working capital requirements, driven by the build-up of receivables. On the whole, weak profitability and cash accruals impaired the credit profiles of most industry participants, thereby exerting pressure on their credit ratings.

Among the various segments of the auto ancillary industry, suppliers to the medium and heavy commercial vehicles (M&HCV) segment were the worst affected by the down turn. The demand for passenger vehicles, on the other hand, was affected only for a brief period and that too by the reduced availability of customer finances. The passenger vehicle segment delivered healthy growth during most months of 2008-09, supported both by domestic demand and a strong pickup in small-car exports. Additionally, vehicle demand from rural areas remained steady,

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with cash purchases offsetting the impact of the credit scarcity. However, while demand in the passenger vehicle and two-wheeler segments held steady, suppliers to these segments were also affected by tight liquidity conditions, forex fluctuations, and high commodity prices—factors that led to a few downgrades in these segments as well. Apart from OEM demand, replacement automotive volumes continued to grow at a relatively steady rate in 2008-09, thereby sustaining components demand from this segment.

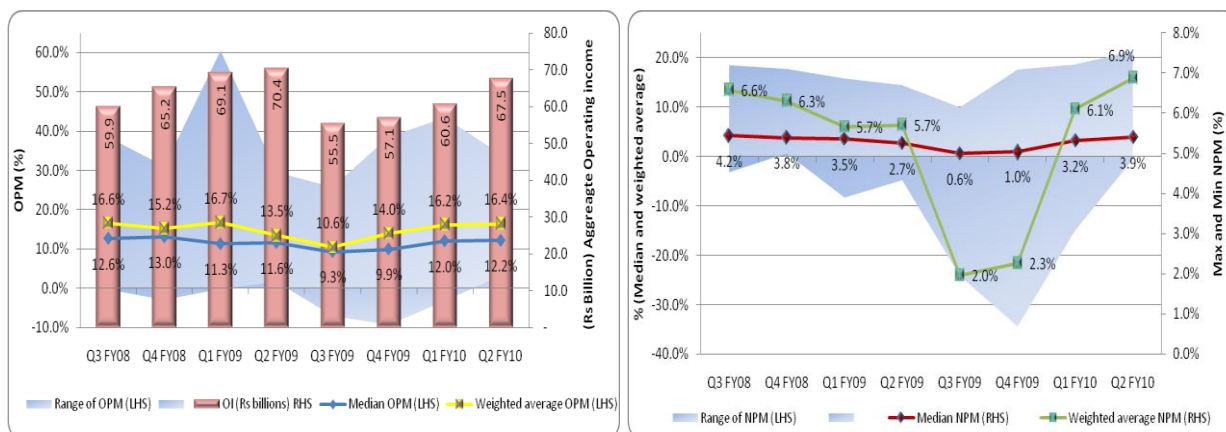
Besides demand contractions, the auto ancillary industry was also adversely affected by high commodity (steel, aluminium, crude, rubber among others) prices in 2008-09, although the pressure eased to an extent towards the last quarter. While reduced capacity utilisation affected overheads, most companies responded with aggressive cost reduction initiatives, including rationalisation of employee expenses and other costs.

The quarterly profitability of auto component suppliers hit the bottom in Q3, 2008-09, before staging a recovery in the subsequent quarters. Driven by a pick-up in volumes across segments, the industry’s profitability has improved sharply in the current financial year. With the trend continuing in the current quarter, ancillaries catering to the domestic market are likely to see profitability returning to 2007-08 levels however exporter profits will continue to be weak.

Lower OEM offtake hits auto component industry’s profitability in 2008-09

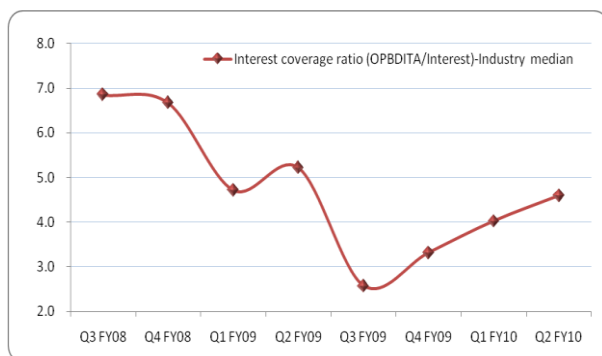
With production volumes contracting sharply across automotive OEMs, offtake of components dwindled in H2, 2008-09. Given the high fixed-cost structure, low asset turnover had an adverse impact on the profitability of the industry participants. As always, this difficult period also led to increased focus on cost

Chart 1: Auto Ancillary Industry—Trend in Operating Income, Operating Profit Margin and Net Profit Margin



Source: ICRA’s estimates, Centre for Monitoring Indian Economy (CMIE) Database, sample of 34 selected entities

Chart 3: Auto Ancillary Industry—Interest Coverage Ratio (Industry Median)

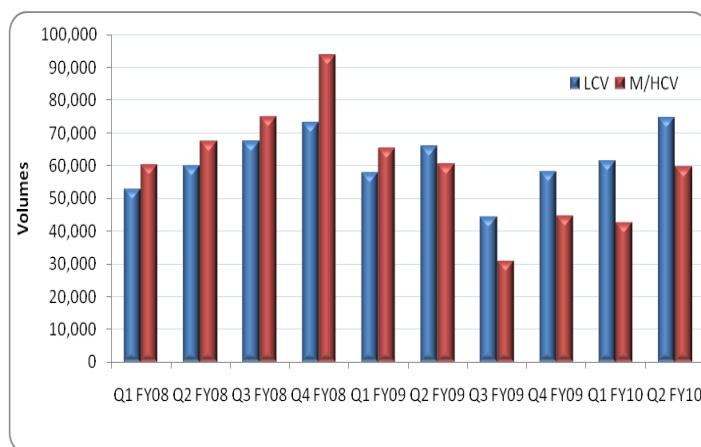


Source: ICRA’s estimates, CMIE Database, sample of 34 selected entities

containment and reduction of operating expenses. Reacting to the demand decline, many auto ancillary companies initiated cost control measures in the areas of purchases, contract labour, and fixed overheads as early as Q2, 2008-09. Besides, there was rationalisation of planned capital expenditure (capex) as well. Also, some component manufacturers approached their credit providers for amendments in repayment schedules citing short-term liquidity pressures. However, despite these measures, the severe demand contraction eroded the profitability of the components industry during the last two quarters of 2008-09. The coverage indicators also weakened

significantly for most companies during this period.

Chart 4: Trend in Quarterly Volumes in the Light Commercial Vehicle (LCV) and M&HCV Segments



Source: SIAM and ICRA's estimates

M&HCV component suppliers bear the brunt of demand dry-up

In the automotive industry, it was the highly cyclical M&HCV segment that was the worst hit during H2, 2008-09. Following more than five years of cyclical uptrend, which had led to substantial industry-wide capacity additions, large channel inventories and somewhat aggressive financing penetration, the M&HCV segment was already poised for a cyclical correction. Subsequently, the situation was further aggravated by the economic downturn (which resulted in tightening of credit norms in response to increasing financier delinquencies),

declining freight rates, and the onset of weak industrial demand, which then had a severe impact on component suppliers with a significant dependence on the M&HCV segment, like wheel rim suppliers (e.g. Wheels India Limited) and axle suppliers (e.g. Automotive Axles Limited). Suppliers with high concentration on a single OEM were further constrained by their weak bargaining power, and saw the payment terms being stretched even as pricing pressures increased significantly. The sharp slowdown in the auto component industry brought into focus the importance of having a diversified revenue model across OEMs, segments and products.

Rural demand shores up volumes in certain automotive segments

The rural market proved to be a key source of sustained automotive demand during the economic slowdown. The factors shoring up rural demand during this period included the higher disposable surplus accruing from over four years of good monsoon, rising minimum support prices (MSP) of crops, and increase in land prices. Thus, cash purchases continued, driving the demand for two-wheelers, passenger vehicles and tractors, even as credit became scarce in the wake of the liquidity crisis. Component suppliers to these segments were able to meet revenue targets even during the weakest quarters of the downturn.

Further, the passenger vehicle segment benefited from higher export demand and a spate of successful model launches. For instance, the global success of the *i10* and *i20* models of Hyundai Motors India Limited (HMIL) for which the company used the Indian facility as an export hub) and the impressive market response that the *Ritz*, *A-Star* and *Swift Dzire* models of Maruti Suzuki Limited (MSL) elicited supported the volumes of their component suppliers. Going forward however, while the rural markets showed no effect of the below-average and delayed monsoons during the October 2009 festive season, the outlook for rural demand outlook remains uncertain, given that the monsoon impact comes in with a lag.

Replacement volumes continue to grow at a healthy pace

For an auto ancillary company, a balanced mix between OEM and aftermarket sales is a significant positive. Typically, a strong aftermarket provides for greater sales stability and stronger operating margins than an OEM. However, strong OEM sales are often the basis for an established presence in the aftermarket, given that OEM sales provide significant brand visibility. A balanced mix between OEM and aftermarket sales helps maximise returns on investment by enabling a component manufacturer to exploit the entire product cycle from product launch to replacement. Despite the downturn in the automotive

market, component suppliers with a stronger presence in the aftermarket were better able to withstand the pressures on top-line and profitability.

Domestic vehicle demand stages strong recovery in current fiscal

Barring the M&HCV segment, the Indian automotive industry reported a strong volume recovery in Q2, 2009-10. The M&HCV segment has also witnessed sequential growth over the last two quarters (Q2 and Q3, 2009-10), and is expected to register increasing volumes over the rest of the current fiscal. The demand revival in the Indian automotive industry is being supported by a positive economic outlook and the gradual return towards normalcy that is being witnessed in the vehicle financing market. CV demand is also being supported by the excise duty cuts and accelerated depreciation that are part of the fiscal stimulus package initiated by the government in Q4, 2008-09. Additionally, the M&HCV industry also anticipates strong demand generated by the emission norm¹ change triggered pre-buying in Q4, 2009-10.

Component exports weak during 2008-09

For the Indian auto ancillary industry, most export segments reported muted growth in 2008-09 despite the depreciation of the Indian rupee which pushed up realisations. Contraction in automotive sales in North America and Europe, which accounts for over 65% of India's auto component exports, had an adverse impact on component offtake during 2008-09 and the first nine months of 2009-10. Two segments that reported a particularly precipitous decline in sales were exported components for CVs and off-highway vehicles. The European CV market witnessed a fall for 18 consecutive months till November-09 and posted a decline of 33.9% during January-November 2009 over the corresponding period in the previous year. Component exporters like Bharat Forge Limited, Rane Engine Valves Limited, Wheels India Limited and Rane Madras Limited bore the brunt of this contraction. An added concern continues to be the possibility of Chapter-11 filings by global OEMs and Tier-I suppliers, which could lead to temporary disruptions in business and payments. The short-term outlook for the auto ancillary export markets remains weak with accretions to the order book being negative. While Government initiatives like scrappage schemes² in EU and "Car Allowance Rebate Scheme" in the USA have provided some impetus to growth, especially in the passenger car segment, there are no clear signs of recovery on the global front yet.

Managing forex volatility and fluctuations in commodity prices turns critical

Apart from the impact of a depreciating rupee on imports and exports, the unprecedented movement in currency rates also resulted in large forex losses on un-hedged foreign currency denominated loans used by the auto ancillary industry. During the 22 months till October 2009, the Indian rupee showed significant volatility against other international currencies, and at one point depreciated by over 30% against the US dollar, around 22% against the euro, and 48% against the yen. Companies with uncovered long and short-term debt positions faced significant realised and unrealised losses. Most of the industry participants availed themselves of the AS-11 provisions of the March 2009 Ministry of Corporate Affairs notification, thereby reducing the impact of the long-term unrealised losses on profitability. However, there was a noticeable impact on their capital structure³.

The first half of 2008-09 was marked by sharp increases in commodity prices as well as volatile exchange rates. With a sizeable number of component manufacturers in India being heavily dependent on yen imports, they were hit by the high commodity prices as well as the sharp depreciation of the Indian rupee

1 In India, April-10 marks the next emission norm change (from BS III to BS IV for metros and BSII to BSIII for non-metros). Higher emission norm compliant M&HCVs are more expensive.

2 A wreckage premium of Euro 2,500 is being offered to car owners to replace cars that are more than nine years old.

3 Losses on long-term forex loans used for procuring fixed assets can be capitalised. However, losses on other loans are parked under the Foreign Currency Monetary Item Translation Difference Account (FCMITDA), which is either written off over the life of the asset or on or before March 31, 2011, whichever is earlier.

against the Japanese yen. With the OEMs themselves under considerable margin pressure, the ability to pass on these price increases to the customers remained limited. In Q3, 2008-09 however, there was a significant downward correction in commodity prices because of falling global demand. Nevertheless, several auto component suppliers were saddled with high cost inventory and suffered losses on the same. Volatile commodity prices in a scenario of low volumes and high overheads eroded the profitability of the auto ancillary industry during 2008-09.

The slide in commodity prices that had begun in early Q3, 2008-09 was arrested in Q4, 2008-09, and this was followed by a mild recovery in Q1, 2009-10, and a further firming up during the next quarter. However, despite this firming up, commodity prices were lower in H1, 2009-10 as compared with the corresponding period the previous fiscal and this benefited auto ancillary companies, especially those that had been able to liquidate the older stock of high-cost inventory. While raw material costs as a percentage of sales are likely to fall year-on-year (y-o-y) in 2009-10, the rising trend in commodity prices is expected to have a negative impact on the auto ancillary industry's margins during the last two quarters of the current fiscal. Nevertheless, the impact is expected to be mitigated to an extent by healthy demand.

Stretched working capital cycle affects capital structure

The low volume off-take by OEMs resulted in an industry-wide inventory pile-up for auto component manufacturers. Companies that are dependent on imports with a long lead time ended up with relatively larger quantities of raw material. On the other hand, stretched OEMs (debtors) delayed payments while large steel manufacturers (creditors) required advance payments for purchases. With low accruals, the ancillaries had to increasingly depend on bank credit to fund the working capital shortfall. Working capital utilisation across the auto ancillary industry thus shot up significantly in 2008-09, straining the capital structure of component manufacturers and driving their interest expenses up.

Downgrades in ICRA-rated auto-ancillary companies increased during the past 18 months

In 2008-09, ICRA downgraded 12 entities from among its universe of rated auto ancillary companies. During the first nine months of 2009-10, there were six rating downgrades, and this included two cases in which two entities that had been downgraded in 2008-09 were downgraded further. Against this, the universe of ICRA-rated auto ancillary companies had seen just three rating downgrades in 2007-08. While the domestic auto components industry as a whole experienced pressures on profitability and some deterioration in debt coverage indicators in 2008-09, the deterioration was found to have been much sharper in the case of the entities downgraded.

Chart 5: ICRA-rated Auto Ancillary Companies (Long-Term Scale)

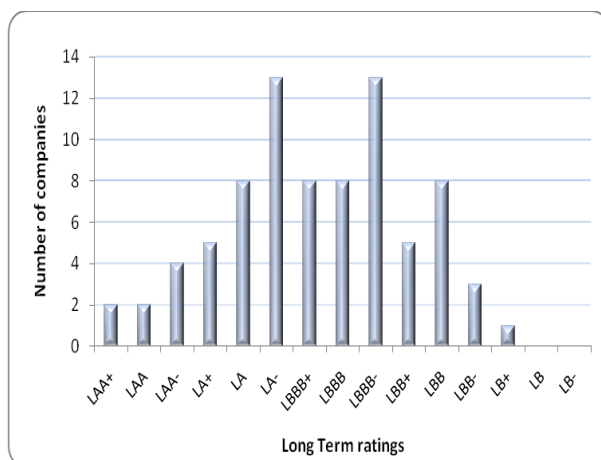
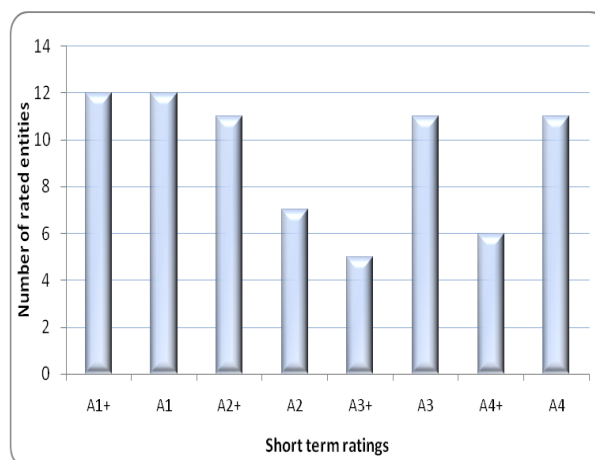


Chart 6: ICRA-rated Auto Ancillary Companies (Short-Term Scale)



The rating downgrades primarily reflect industry-related issues like slowdown in OEM demand, forex fluctuations, and strained liquidity in the domestic market, all of which have had a negative impact on the cash flows of ancillary. While the Indian auto ancillary sector's overall dependence on exports is limited, a few entities with significant exports contribution or significant investments in exports-focused capacity were affected severely during the downturn. Among the rating downgrades effected in 2008-09 and 9 months 2009-10, a few were also attributable to company-specific issues like labour problems and large acquisitions. Since mid-2009-10, demand pressures in the domestic market have eased, thereby mitigating downgrade pressures. However, some entities whose balance sheets had weakened significantly in 2008-09 remain susceptible to industry-related shocks. Also, companies with significant export-oriented investments would remain vulnerable, given the weak demand conditions prevailing in the European and North American markets.

ICRA currently has 81 auto ancillary companies in its universe of rated entities, with most of them (42 entities) carrying ratings between LA- and LBBB- on the long-term scale. Overall, there are only eight entities rated in the LAA category, while there are 17 in the non-investment grade. Most of the entities in the non-investment grade are Tier-II suppliers, generally suffering from lower pricing power and the limitations arising from their relatively smaller scale of operations.

Conclusion

Component demand from OEMs in most sub-segments of the automotive industry is showing signs of revival since Q2, 2009-10, aided by the continuing economic upturn and the fiscal stimulus announced by the Government in the wake of the crisis. The medium-term outlook for the automotive and consequently the auto ancillary industry appears healthy, given the gradual revival in vehicle financing, leaner channel inventory, the healthy trend in the underlying demand conditions, and the expected pre-buying of M&HCVs (ahead of changes in emission norms). The demand from the exports market, however, remains weak because of the conditions prevailing in the key target markets.

In Q2, 2009-10, most auto component suppliers reported revenue growth and improvement in profitability on the back of larger business volumes and soft commodity prices. The key challenges facing the auto ancillary industry at this juncture include rising commodity prices and weak demand in the exports markets. Additionally, if the domestic growth trend sustains over a few more quarters, many auto component suppliers may have to revive the capacity enhancement plans they had put on hold last year following large-scale demand destruction.

The beginning of an uptrend is often marked by low breakeven levels, given the cost control measures that would have been initiated during the downturn. However, the ability to continue with the cost control measures over the long term, especially during an uptrend, remains to be seen. While the period 2008-09 and 9 month 2009-10 have been marked by a relatively large number of rating downgrades by ICRA in the auto components space, the pressure appears to have eased with domestic demand reporting a healthy pickup.

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