



Revenue growth softening: global factors, domestic concerns & base effect providing resistance

The Indian auto components industry witnessed a moderation in revenue growth in Q1, 2011-12 (based on our sample of 28 select listed entities), with growth having reduced to low single digits on QoQ basis; although revenue growth continued to be in double digits on YoY basis. Within our sample universe, however, there was a wide variance in the performance of individual companies with revenue growth being relatively higher for companies dependent on the domestic two-wheeler (2W) and Light Commercial Vehicle (LCV) segments; and growth being lower/ negative for companies dependent on the Passenger vehicle (PV) and Medium & Heavy Commercial Vehicle (M&HCV) segments. This broadly mirrors the trend in sales volumes seen in the respective automobile segments in Q1, 2011-12 (Refer **Table 1**).

Table 1: Trend in Sales Volumes of Automobiles (Domestic + Export)

Sales Units (Nos.)	2007-08	2008-09	2009-10	2010-11	Q1, 2011-12	4m, 2011-12	2011-12E	2011-16E (CAGR)
PV	1,766,390	1,888,432	2,395,922	2,973,900	723,320	955,818		
Growth	12%	7%	27%	24%	9%	6%	5-7%	~11%
M&HCV	293,094	200,406	265,481	352,060	81,503	110,962		
Growth	0%	-32%	32%	33%	6%	7%	6%	9.5-11.5%
LCV	252,722	226,389	310,921	400,645	111,082	153,363		
Growth	13%	-10%	37%	29%	25%	28%	14%	10-13%
2W	8,068,447	8,441,793	10,511,415	13,329,895	3,692,658	4,925,534		
Growth	-5%	5%	25%	27%	18%	17%	13%	10-12%

Source: SIAM, ICRA's Estimates

A part of the reason for the industry's subdued revenue growth in Q1, 2011-12 was (a) the significantly high volume growth experienced in Q4, 2010-11 causing build-up of inventory in the OEMs' distribution channel that took time to revert to normalized levels in the following month but in the interim meant lower production by OEMs¹; (b) the natural calamity in Japan in March 2011 which disrupted the domestic industry's supply chain to a certain degree; (c) production disruptions with key OEMs due to labour issues. These factors apart, the other negative factors including rising inflation, interest rates, fuel prices and global macro-economic headwinds also appeared to culminate together and adversely influenced consumer sentiment and purchasing power. In our view, although the fundamental growth drivers of the Indian auto and auto components industry are intact with volume growth expected to

¹ As per ICRA's research, the inventory level of dealers (particularly in the PV segment) as on March 31, 2011 was significantly high vis-à-vis historical levels.

Corporate Ratings

Anjan Deb Ghosh
+91 22 3047 0006
anjan@icraindia.com

Contacts:

Subrata Ray
+91 22 3047 0027
subrata@icraindia.com

Jitin Makkar
+91 124 4545 368
jitinm@icraindia.com

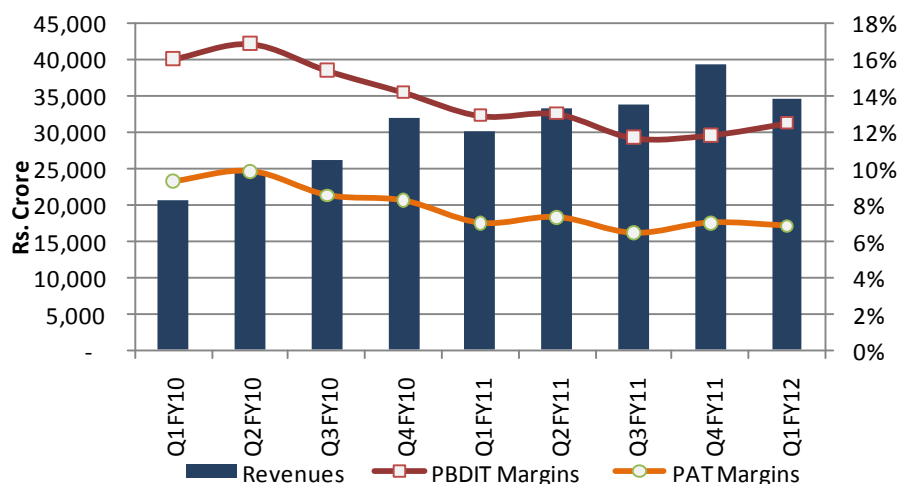
be strong over the long term, the industry's growth prospects over the short term remain couched in uncertainty. Accordingly, our short term outlook for volume growth in the Indian automobile industry is somber (Refer **Table 1**). While revenue growth of the auto components industry at large is expected to moderate over the short term, its impact on individual companies may be mixed depending on their revenue mix (*OEMs/ Replacement Market*), segment leaning (*PV/CV/2W*) and geographical diversification (*domestic/ exports*). Overall, auto component manufacturers who have (a) stronger presence in the replacement market, (b) lower dependence on interest rate sensitive automobile segments, and (c) geographically dispersed customer base, are likely to be better equipped to offset the expected moderation in business with domestic OEMs in 2011-12.

Margin erosion may be less steep if commodity price cycle could reverse early

The price of key raw materials including steel, aluminium, copper, plastic and rubber used in automobiles has been on a rising curve since the beginning of CY2009 (Refer **Annexure-1**). Still, considering that average raw material prices in 2009-10 were lower than those prevailing in 2008-09, the profit margins of the auto and auto components industry had witnessed a healthy expansion in 2009-10, supported also by strong surge in sales volumes resulting in operating leverage benefits. Although the buoyancy in automotive demand persisted in 2010-11, the profit margins of the industry could not hold up to the 2009-10 levels in the wake of continued firming up of raw material prices. Consequently, profit margins of both auto OEMs as well as auto component manufacturers generally declined during each quarter of 2010-11 on both YoY as well as QoQ basis (Refer **Chart 1** and **Chart 2**).

Auto Original Equipment Manufacturers (OEMs)

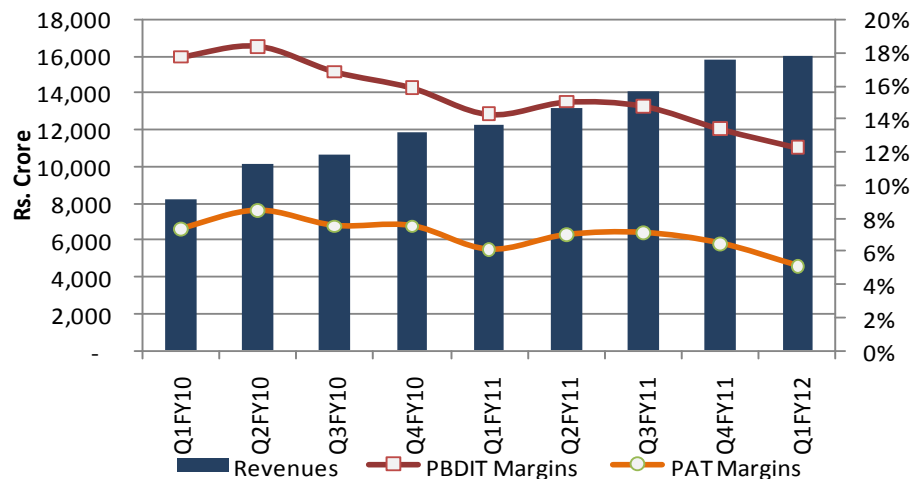
Chart 1: Trend in Aggregate Revenues and Weighted Average



Source: ICRA's Estimates, Capitaline Database, Sample of publically listed auto OEMs

Auto Component Manufacturers

Chart 2: Trend in Aggregate Revenues and Weighted Average



Source: ICRA's Estimates, Capitaline Database, Sample of 28 select entities

Over the last five months, however, the upward movement in prices of key commodities has abated to a certain extent, a trend which if sustained, could cushion the margin erosion of auto OEMs; and in turn limit pricing pressure on auto component manufacturers from OEMs. Thus, in the likely scenario of revenue growth moderating in 2011-12, the stability or reversal of commodity price cycle could help alleviate overall margin pressures likely to emanate from lower volumes and lower capacity utilization on one hand and rising wages and interest costs on the other. Further, lower off-take by domestic OEMs may also allow auto

component manufacturers to focus more on the domestic replacement market and pursue export opportunities, something which they could not do in 2010-11 in view of strong demand from domestic auto OEMs. In the process, such players should be able to partially neutralize lower OEM sales as well as earn superior margins.

Capex plans of auto component manufacturers still on course particularly towards establishing capacity for new models planned by OEMs

Based on ICRA's discussion with various auto OEMs and auto component manufacturers, there seem to be no signs of deferral yet related to new product launch schedules of automotive OEMs. Accordingly, vendors selected by OEMs to supply components for their new models scheduled to be introduced over the next several quarters currently plan to incur all committed investments. However, since there is a certain degree of skepticism arising from possible dampening of end-customer sentiments due to the macro-economic environment, some vendors are contemplating reviewing their expansion plans for commissioning incremental capacity to cater to existing models as these may grow at a rate lower than initially envisaged. In any case, in the prevailing environment of expected moderation in domestic demand and rising interest rates, companies that plan to avail more debt may burden their balance sheets; on the contrary, companies having cash balances may find the same more valuable, not because of liquidity concerns in the banking system, but due to their effectively lower cost of funds.

INDUSTRY DEVELOPMENTS

Comprehensive Economic Partnership Agreement (CEPA) between India and Japan becomes effective from August 1, 2011

The CEPA between India and Japan became effective from August 1, 2011. This agreement is aimed at promoting liberalization of trade in goods and services between India and Japan, enhancing bilateral economic partnership and strengthening cooperation in various areas including movement of professionals and intellectual property. Amongst other things, the pact seeks to abolish import duties on most products and liberalize investment rules. While the Indian auto and auto components industry has been largely shielded from tariff cuts by their inclusion in the negative list of items, India has agreed to reduce tariffs on steel and certain auto parts made of steel. India's 10% tariff on Japanese-made bumpers, wheels and mufflers will be dropped in 11 years², while the 5% levy on hot-rolled and galvanized steel sheet will disappear in six years. The tariff on gear boxes and parts thereof will fall from 11.25% to 6.25% over eight years.

Implications on the domestic auto industry:

- ✧ Indian auto OEMs are currently importing grades of high tensile steel (*such as steel having tensile strength greater than 590MPa*) from Japan which are used for manufacturing components for select applications such as suspension parts. The reduction in duty on such steel is expected to bring down the costs for auto OEMs, although its impact on auto component manufacturers (engaged in stamping of such steel grades) will be neutral.
- ✧ The various models of PV OEMs which have a high import content stand to benefit from the CEPA entailing reduction in duties on select few components in a phased manner.
- ✧ The various Free Trade Agreements (FTAs) and CEPAs entered into by India with other countries is expected to catalyse the import of auto components into India as many components may become more cost effective to import following reduction of import duty. Overall, while FTAs may bring down the cost of certain raw materials and intermediate inputs for the Indian OEMs, the auto component industry's exposure to risks related to possible loss of business from OEMs and lower incremental capital assets creation is likely to remain.

² According to the CEPA that India and South Korea signed in January 2010, many products will become tariff-free in eight years.

Proposed withdrawal of the DEPB incentive scheme after September 30, 2011 could add to the woes of auto component exporters

The Duty Entitlement Passbook (DEPB) Scheme, which was earlier scheduled to be withdrawn after June 30, 2011, was extended by another three months by the Ministry of Finance and is now scheduled to be replaced by a modified duty drawback scheme w.e.f. September 30, 2011. Under the DEPB scheme, which has been in operation for 14 years, exporters receive tradable scrips based on the FOB value of goods exported that could be used to pay import duties on inputs. The refund of taxes makes the exported products remain competitive in global markets and accordingly the withdrawal of this incentive may erode export profitability. The impact on profit margins of industry players may differ depending on the product category (since applicable rates vary across product categories), but for putting the numbers in perspective, an example has been worked out in **Table 2** to ascertain the impact on a component exporter in the framework of given assumptions.

Table 2: Comparison of P&L in the prevailing scenario when benefits under DEPB scheme are available to exporters and the scenario when DEPB Scheme may be replaced with the Duty Drawback Scheme

	Under Prevailing DEPB Scheme		Under Duty Drawback Scheme	
	Figures in Rs. Crore	Assumptions	Figures in Rs. Crore	Assumptions
Gross Sales	100.0		100.0	
Net Sales	100.0		100.0	
DEPB Benefit	7.0	At the rate of 7% of FOB Value*	1.0	At the rate of 1% of FOB Value^
Operating Income	107.0		101.0	
Purchase costs	93.5		93.5	
OPBITDA	13.5		7.5	
Depreciation	3.0		3.0	
Interest	3.0		3.0	
PBT	7.5		1.5	
Tax	2.4		0.5	
PAT	5.1		1.0	
Operating Profit Margin (OPM)	12.6%		7.4%	
Net Profit Margin (NPM)	4.7%		1.0%	

Source: ICRA's Estimates; *On Engineering Products, DEPB rate varies from 2% to 11% of FOB value subject to a value cap, wherever applicable

^On parts & accessories of motor products, Duty Drawback rate varies from 1.0% to 3.8% of FOB value (when CENVAT facility is availed) subject to a value cap

While the notification of the new rates under the modified duty drawback scheme is awaited, in the event the new rates are significantly lower than the existing benefits available under the DEPB Scheme, the profit margins of auto component exporters is bound to be adversely impacted. This may add to the woes of Indian component exporters who are already troubled by greater currency fluctuations as compared to their global competitors mainly China. The export dependence of the auto component industry as a whole however currently remains modest at ~15%.

Change in approach by Maruti Suzuki India Limited (MSIL) related to tools and dies

Over the years, MSIL has followed the practice of extending interest-bearing tooling advances to some of its suppliers such that the tooling so developed remains on the suppliers' books of accounts and gets amortized by the vendors over a pre-agreed model life. However, to align itself with the International Financial Reporting Standards (IFRS), MSIL has changed its accounting treatment (w.e.f. quarter ended March 2011) for assets related to tools and dies such that these are now bought back by MSIL from its suppliers and appear as part of MSIL's gross block. In other words, post development of tooling, MSIL's vendors will enter into a sale transaction with MSIL for the tools developed, although physically the assets will remain on the suppliers' premises.

Table 3: Impact on margins of MSIL's auto component suppliers due to change in accounting treatment for tooling

Vendor invests in tooling funded through advances from OEM; Tooling remains on vendor's gross block		Vendor invests in tooling funded through advances from OEM; Tooling sold to the OEM such that it becomes a part of the OEM's gross block	
<u>Assumptions</u>		<u>Assumptions</u>	
Component Price (Rs.)	2,000	Component Price (Rs.)	2,000
Annual Vehicle Volumes (Units. Nos.)	50,000	Annual Vehicle Volumes (Units. Nos.)	50,000
Total Tooling Cost (Rs. Crore)	1.0	Total Tooling Cost (Rs. Crore)	1.0
Model Life (no. of years)	1.0	Model Life (no. of years)	1.0
Tooling Cost per Vehicle (Rs.)	200		
<u>P&L of Supplier</u>		<u>P&L of Supplier</u>	
Revenues (from sale of components) (Rs. Crore)	10.0	Revenues (from sale of components) (Rs. Crore)	10.0
Revenues (from tooling amortization) (Rs. Crore)	1.0	Revenues (from sale of tooling) (Rs. Crore)	1.0
Total Revenues (Rs. Crore)	11.0	Total Revenues (Rs. Crore)	11.0
Operating Costs	9.0	Operating Costs	10.0*
OPBITDA	2.0	OPBITDA	1.0
Depreciation	1.0^	Depreciation	0.0^
PBIT	1.0	PBIT	1.0
Interest	0.1	Interest	0.1
PBT	0.9	PBT	0.9
OPM	18.2%	OPM	9.1%
PBIT Margin	9.1%	PBIT Margin	9.1%
<u>Balance Sheet of Supplier</u>		<u>Balance Sheet of Supplier</u>	
Gross Block	1.0^	Gross Block	0.0^
Less: Depreciation	1.0	Opening Inventory (related to tools developed)	1.0
Net Block	0.0	Closing Inventory (post sale of tooling)	0.0
Opening Tooling Advance	1.0	Opening Tooling Advance	1.0
Closing Tooling Advance	0.0	Closing Tooling Advance	0.0

Source: ICRA's Estimates; *Assuming the vendor does not earn any profit on sale of tooling such that income from tooling sales is equivalent to cost of tooling development; ^For simplicity, assuming there is NIL depreciation on other fixed assets

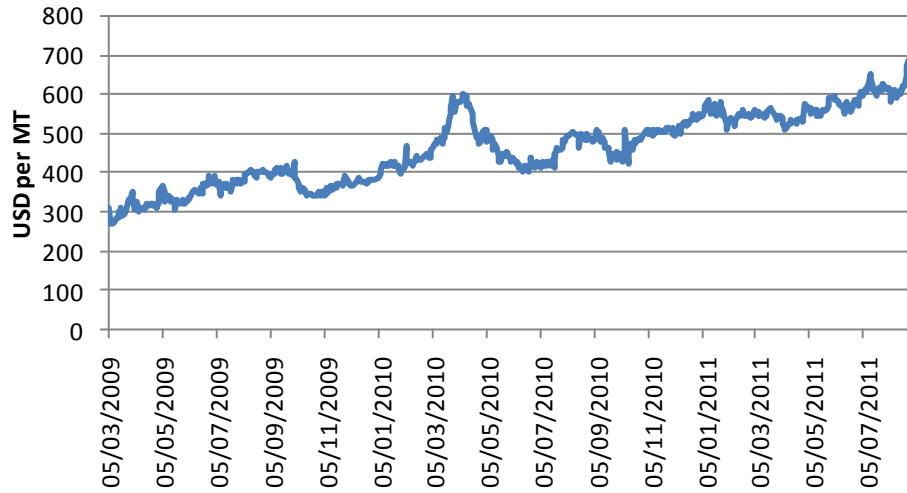
- ✧ The above change in accounting treatment by MSIL will not have any cash flow impact on its auto component suppliers. While earlier, the suppliers were amortizing the cost of the tooling (over the life of the model) and building the same in component pricing, they would now recognize upfront tooling sales. Even earlier, the tooling advances gave MSIL's suppliers the funding required for tooling development and offered greater financial flexibility (as compared to bank funding) since repayments were linked to sales volumes. For instance, if the component pricing agreed between the OEM and the concerned supplier was for annual volumes of 50,000 units for a particular model, but the model could sell only 40,000 units during the year, the vendor had no liability to payback the unamortized portion of the tooling advance. Post migration to the new practice, even if vendors part-finance the tooling through bank debt, the fact that they would be able to sell the tooling upfront to MSIL, vendors may not have to grapple with the risk associated with under-recovery of tooling investment.
- ✧ However, the change in accounting treatment is estimated have a negative impact on the suppliers' OPM with the quantum depending on the proportion of tooling advances availed by the supplier, although its impact on PBIT Margin is likely to be neutral (Refer **Table 3**). This is because depreciation/ amortization expenses as per the earlier treatment will move to other operating expenses as per the new treatment.

Conclusion

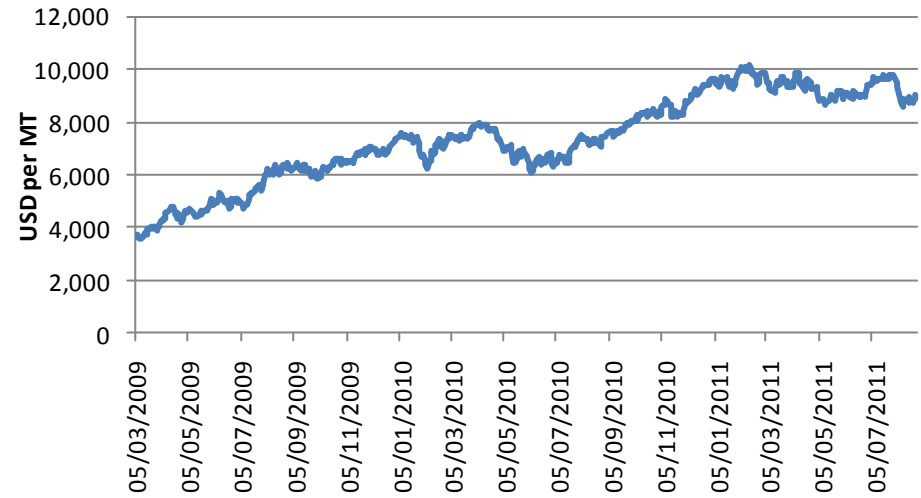
Rising interest rates & fuel prices and slowing industrial activity are likely to have a moderating impact on automobile demand (primarily PV and M&HCV segments) in the near term. The longer term demand drivers for the domestic market however remain intact and the auto components industry remains on track with its capacity expansion plans to meet the expected demand growth. As the Indian component industry moves towards a more globalized environment, on the back of increased participation in the growth opportunities emanating from product plans of global OEMs, the industry faces heightened challenges in terms of dealing with lowering duty protections, foreign exchange fluctuations and vulnerability to demand slowdowns in international markets. Nevertheless, the overall benefits of bigger scale, deeper relationships with global OEMs, absorption of next generation technologies and exposure to international best practices are expected to be the key positive outcomes from the above supporting the growth process of the Indian auto components industry.

Annexure-1: Trend in Commodity Price Movement

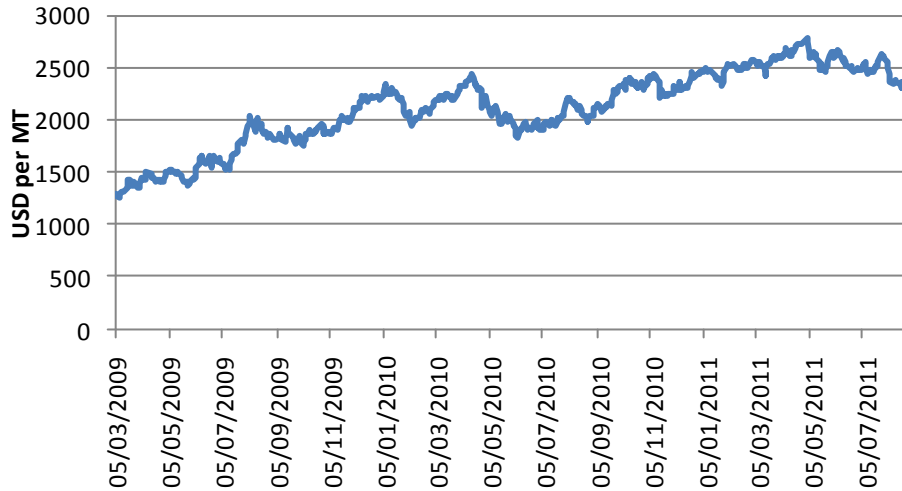
Trend in Price Movement of LME Steel Billet



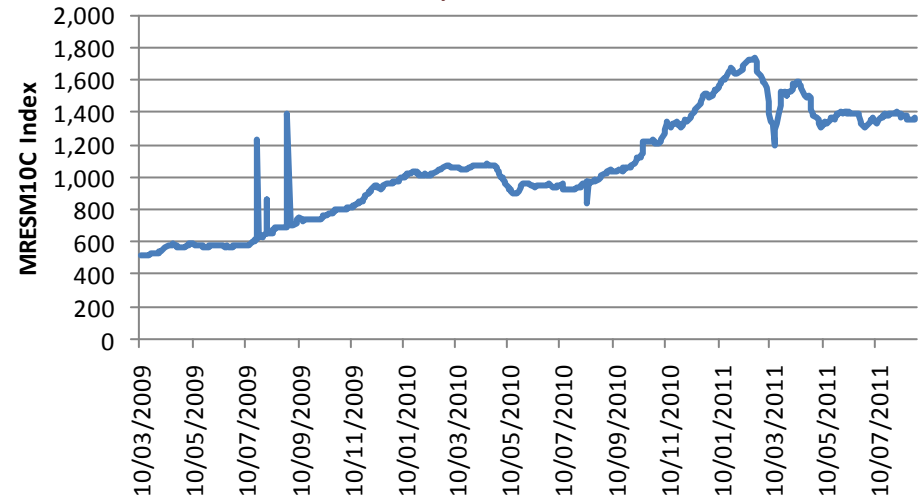
Trend in Price Movement of LME Copper



Trend in Price Movement of LME Primary Aluminium



Trend in Price Movement of Rubber (Malaysian Rubber Board, Standard Rubber)



Source: Bloomberg

Analyst Contacts

Analysts	Contacts	
Mumbai		
Subrata Ray	subrata@icraindia.com 022 – 3047 0027	
Kinjal Shah	kinjal.shah@icraindia.com 022 – 3047 0027	
Delhi		
Anupama Arora	anupama@icraindia.com 0124 – 4545303	
Jitin Makkar	jitinm@icraindia.com 0124 – 4545368	
Shamsher Dewan	shamsherd@icraindia.com 0124 – 4545328	
Chennai		
Pavethra Ponniah	pavethrap@icraindia.com 044 – 45964314	

ICRA Limited

An Associate of Moody's Investors Service

CORPORATE OFFICE

Building No. 8, 2nd Floor, Tower A; DLF Cyber City, Phase II; Gurgaon 122 002

Tel: +91 124 4545300; Fax: +91 124 4545350

Email: info@icraindia.com, Website: www.icra.in

REGISTERED OFFICE

1105, Kailash Building, 11th Floor; 26 Kasturba Gandhi Marg; New Delhi 110001

Tel: +91 11 23357940-50; Fax: +91 11 23357014

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 8839 /2287 6617/ 2283 1411/ 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) 553 9231

© Copyright, 2011 ICRA Limited. All Rights Reserved.

Contents may be used freely with due acknowledgement to ICRA.

All information contained herein has been obtained by ICRA from sources believed by it to be accurate and reliable. Although reasonable care has been taken to ensure that the information herein is true, such information is provided 'as is' without any warranty of any kind, and ICRA in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness or completeness of any such information. All information contained herein must be construed solely as statements of opinion, and ICRA shall not be liable for any losses incurred by users from any use of this publication or its contents.