RATING METHODOLOGY – COMMERCIAL VEHICLES

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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in December 2023. While this revised version incorporates a few additional clarifications and editorial changes, ICRA's overall approach to rating commercial vehicle (CV) original equipment manufacturers (OEMs) remains materially similar.

Overview

The Indian commercial vehicle (CV) industry is categorised into light commercial vehicles (LCVs) and medium & heavy commercial vehicles (M&HCVs) based on tonnage. Vehicles with gross vehicle weight (GVW) below 7.5T are classified as LCVs[1], whereas those with GVW above 7.5T are categorised as M&HCVs[2]. Of the annual production of 9-11 lakh units for the industry from FY2023 to FY2025, the LCV segment accounted for more than 60%. The industry is also classified based on application into trucks (goods carriers) and buses (passenger carriers). Currently, the CV industry is dominated by the trucks segment, whereas buses account for less than 15% of the industry volumes.

Rating Methodology

This rating methodology explains ICRA's approach to assessing the business and financial risk profiles of CV original equipment manufacturers (OEMs). It aims to help issuers, investors and other interested market participants understand ICRA's approach in analysing the quantitative and qualitative risk characteristics that are likely to affect the ratings of CV OEMs. This methodology does not include an exhaustive treatment of all the factors that are reflected in the ratings but enables the reader to understand the rating considerations that are usually the most important. ICRA's risk analysis framework for CV entities can be broadly divided into the following elements:

Industry Risk Analysis

- Cyclicality
- Competitive intensity
- Regulatory/Policy risks

Business Risk Analysis

- Scale, market position and brand strength
- Product portfolio
- Sales, service network and geographic diversification
- Technology and product development capabilities

1 Further bifurcated into small commercial vehicles (SCVs) and pick-up trucks, for which the GVW is below 3.5T and LCVs, for which the GVW is between 3.5T and 7.5T

2 Further trifurcated into intermediate commercial vehicles (ICVs) with GVW in the range of 7.5-12T, medium commercial vehicles (MCVs) with GVW in the range of 12-16.2T and heavy commercial vehicles (HCV) which have GVW higher than 16.2T

Financial Risk Analysis

- Profitability metrics
- Leverage
- Coverage
- Liquidity profile
- Cash flows
- Capital expenditure (capex) and investment plans
- Foreign currency risks
- Tenure mismatches and risks relating to interest rates and refinancing
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Other Elements of Credit Risk Assessment

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- Debt-servicing track record
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- Accounting quality
- Contingent liabilities and off-balance sheet exposures
- Event risk
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- Environmental (E) and Social (S) risks
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Industry Risk Assessment

Cyclicality

The domestic CV industry, especially the trucks or goods carrier segment (which accounts for more than 85% of industry volumes), exhibits moderate cyclicality, with its prospects closely linked to some of the key drivers of the economy such as industrial growth and investments in the infrastructure and construction space. Within the CV industry, the LCV segment tends to exhibit moderate cyclicality, while the M&HCV segment shows higher cyclicality. As the economic cycle picks up and freight availability improves, the bargaining power of fleet operators improves (as freight rates are directly correlated to demand-supply of fleet). The increased freight availability in turn prompts operators to add new trucks to the system. As the cycle turns and economic growth slows, freight rates weaken, which impacts the viability of fleet operators. The subdued freight levels and lower operator viability during periods of economic downturns in turn adversely impact the demand for new CVs in such periods. Adoption of prudent business and financial risk policies (such as focussing on diversification across sub-segments, low indebtedness, etc.), therefore, remains essential for a CV OEM to reduce vulnerability to periods of downturn in demand.

Competitive intensity

Competitive intensity in a given industry is driven by multiple factors, including industry fragmentation, entry barriers, nature of product or service (commoditised or differentiated), customer switching costs and excess production capacity. Regulatory actions could also alter the level of competitive intensity in an industry. The Indian CV industry is fairly consolidated, with the top four players accounting for more than 90% of the industry sales volumes. Despite the consolidation, the competitive intensity in the domestic CV industry is high amongst the players to maintain/ expand market share. Moreover, the competitive intensity is also fuelled by the entry of new OEMs, while existing players have ventured into new segments to address the portfolio gaps and expanded their sales and service network, which has led to multiple players vying for a share in multiple sub-segments of the market. The intense competition in the industry has also resulted in limited pricing power for the OEMs, especially in the M&HCV (trucks) segment, where discounting practices are common. While the OEMs hike prices periodically to pass on the impact of increased input costs (including commodity costs) or compliance costs, the ability to pass on these costs remains a function of the market scenario. The domestic CV industry has also seen an increased competition from railways due to the rollout of dedicated freight corridors (DFCs) – while rollout of DFCs has impacted the container traffic on the western corridor to an extent, road traffic in other corridors has remained relatively unimpacted. Given the considerable competition in the industry and limited switching costs for the customers, the OEMs have to invest regularly in research and development (R&D) and new product development to differentiate themselves and continue to be competitive in the market, as well as to meet evolving regulatory requirements.

Regulatory/Policy risks

Over the years, the CV industry has been witnessing regulatory changes in terms of tightening of emission norms, safety regulations, driver comfort and assistance, bus-body building norms, and loading and overloading norms, among others. The Government has also been providing subsidies as a policy tool to support demand for alternative fuel vehicles such as electric vehicles and hydrogen fuel/hydrogen fuel cell vehicles. While an OEM's ability to meet the tightening standards in terms of vehicle specifications is largely dependent on its technological and product development capabilities, the timelines for implementing these also remain critical. Such changes have the potential to impact the existing CV population and new vehicle demand. Furthermore, these changes typically result in product price increases, and accordingly, have the potential to affect demand, at least on a temporary basis. Accordingly, regulatory and policy risks are looked at by ICRA as a part of the CV industry's risk assessment. Overall, while there have been regulatory changes, these have not been detrimental to the industry to a large extent, given the general advanced policy roadmap provided for effecting these changes.

Business Risk Assessment

Scale, market position and brand strength

The scale of a CV OEM, as measured by its sales volumes and revenues, is one of the primary factors in evaluating its business position. A larger scale of operations drives a company's ability to develop a competitive cost structure and an efficient vendor and distribution network and is often seen accompanying healthy product and geographical diversification. It also enhances resilience to the changes in product demand, supports bargaining power with component or raw material suppliers, enables better cost absorption, besides providing the wherewithal to incur R&D investments. A significant scale of operations also supports OEMs in their efforts to set up an established vendor base and localise a large part of the manufacturing process. Generally, OEMs try to outsource a significant part of the manufacturing activity to component suppliers, helping the OEMs focus on activities such as product design and development, marketing and distribution and assembly operations, while at the same time giving them a greater flexibility during cyclical downturns.

In addition to the scale of operations, a CV OEM's market position – as determined by its share within the industry and specific sub-segments – is also an important determinant of its business strength. The company's market share can determine its ability to influence business trends and pricing within the industry. Accordingly, an assessment is made of the trend in the OEM's scale and positioning within the industry. The market share of an OEM can fluctuate over time, so factors like consumer preference shifts, competitive intensity, new product introduction cycle and pricing strategy are all considered when evaluating market share trends.

In the CV segment, the track record of an OEM's product portfolio is of particular importance as factors like fuel efficiency, reliability and load-carrying capability of a vehicle directly influence cash flows and hence the viability of the fleet operators. As a result, owners of CVs tend to exhibit stronger loyalty towards proven brands. Therefore, an OEM's brand strength also remains an important determinant of its market position.

CV OEMs are increasingly being exposed to risks arising from newer operating models, such as the Gross Cost Contract model[3] for electric buses, which brings in additional facets of project execution and operating risks (such as suboptimal occupancy levels for buses), in addition to the conventional business risks faced by the CV OEMs. Although these projects are being housed under separate subsidiaries, the OEMs are holding a majority equity stake in them. Moreover, with the adoption of new-age vehicles largely happening through such routes currently, which involves the OEMs owning and operating vehicles (albeit through subsidiaries), it is possible that the OEMs, without adequate financial muscle to undertake such large investments (or those that prefer not to participate in such models due to inherent risks), could face longer-term business implications such as loss of market share. On the other hand, the OEMs entering and operating through this route are subject to additional risks like elongated receivables.

Product portfolio

A diverse and continuously evolving product portfolio is important for an OEM to sustain a competitive market position and enable it to cater to a varied customer profile. A diversified product portfolio enhances an OEM's ability to counter demand variations in a particular product category. An OEM with a meaningful presence across different tonnage segments, besides trucks and buses, is considered to have a differentiated portfolio, making it less vulnerable to the changes in the market demand. Presence of an OEM across different powertrains (such as diesel/petrol, compressed natural gas (CNG), liquefied natural gas (LNG), electric vehicles, etc.) has also emerged as a key diversification yardstick in the recent years, in line with the

3 There are two main operating models that exist for procurement of buses by State Road Transport Undertakings (SRTUs) – a) Outright Purchase model, wherein the SRTUs directly purchase the buses from the OEM and operate them, and b) Gross Cost Contract (GCC) model, wherein a third-party (usually from the private sector), purchase the buses and operates them for the SRTUs for a defined period. The SRTU, in turn, pays charges (on a per-km basis) to such operators for the distance operated, and is responsible for revenue collection. The ownership, maintenance and responsibility for the buses rests with the operator.

increasing adoption of alternative powertrains by the industry participants. Apart from portfolio diversity, it is imperative for an OEM to continuously refresh its product profile to address the evolving needs of customers and keep up with the latest regulatory developments.

Sales, service network and geographic diversification

Apart from a well-established portfolio and brand strength, an extensive sales and service network is another consideration that underscores a CV OEM's competitive position. This plays an important role because CVs often ply across the country, including remote locations. Given the cruciality of uptime and operational continuity for fleet operations, a widespread availability of spare parts and service workshops at multiple locations across the country is a key business enabler for CV OEMs. Thus, through a well-spread-out dealership and service network, the OEMs can increase customer loyalty by ensuring low vehicle downtime for the fleet operators. Hence, while assessing CV OEMs, the geographic diversification of sales mix (in volume terms) across various regions in the domestic and exports markets is taken into consideration. While leading domestic players in the industry have a wide pan-India presence (in terms of dealerships as well as service network), foreign OEMs are currently investing in expanding their network. In general, a widespread service network is critical for the M&HCV segment. However, it is not a compelling requirement for LCVs as their span of commute is limited.

An OEM's export presence is also evaluated as it serves as a counterbalance to domestic demand cyclicality. The ones that derive a meaningful proportion of their sales from the export markets are in a better position to mitigate the risks arising from demand slowdowns in the domestic market, however, it subjects the OEM to additional aspects of demand slowdown in these regions, trade tariffs, geopolitical risks and foreign exchange (forex) fluctuations. Hence, the geographic diversification of CV OEMs, both in the domestic market and in terms of export revenues, is considered.

Technology and product development capabilities

Traditionally, the Indian CV industry has been characterised by a relatively lower focus on developing advanced trucking platforms so as to maintain lower initial cost for customers. Accordingly, the product portfolio of domestic OEMs did not compare well with international trucking platforms on parameters like power-to-weight ratio, reliability and driver's comfort-related features. However, factors such as improving highway infrastructure in the country, evolving regulatory and customer requirements, changing landscape of the road logistics industry (i.e. proliferation of hub-n-spoke model) have led to a gradual shift in CV demand in favour of higher tonnage and multi-axle vehicles. Further, the OEMs have also introduced models like tippers and tractor trailers that are customised to suit certain application segments. Aspirations of several Indian CV OEMs to expand their overseas presence and the requirement to adhere to the regulatory norms in these overseas markets have also led to the domestic CV OEMs investing in technology and product development capabilities over the years.

Evolving regulatory requirements (i.e. emission norms and safety regulations) and the foray of international OEMs have prompted domestic OEMs to invest in developing new and advanced platforms that enable them to compete more effectively with international OEMs. As a result, while evaluating the competitive position of an OEM, due importance is given to its future product development strategy, technology tie-ups and R&D efforts. One of the measures to assess this is an OEM's outlay towards R&D and capex, relative to sales. This is relevant as the industry (both domestic and global) is increasingly adopting cleaner, safer and more technologically advanced vehicles, and hence updating the product portfolio to reflect the changing customer preferences is a compelling need. The OEM's preparedness towards emerging trends such as electrification and alternate fuels through product launches, technology tie-ups, investment and localisation plans is important to ensure future readiness. The OEM's focus and strategy towards developing alternate powertrains is also qualitatively assessed through its new product launches in the segment and via management discussions.

India's commitment to reduce emissions by 30-35% by 2030 has resulted in an increasing need for the OEMs to accelerate their green technology adoption initiatives. Failure to adhere to the same could lead to a potential market share loss as well as regulatory penalties and reputational damage. Automotive electrification has been one of the key areas in focus for achieving the emission control target, although the differing pace of electrification and varying quantum of subsidies across

different sub-segments (such as LCV M&HCV) within the CV industry demands prudent capital allocation towards new product development by OEMs. In this context, any substantial capex allocation towards an alternative fuel technology with lack of commensurate returns may pose a credit risk for the OEM concerned.

Summary of the Salient Business Risk Factors

	Strongest		Weakest
Scale	The entity's revenues from CV operations are more than Rs. 45,000 crore.	⇨	The entity's revenues from CV operations are less than Rs. 2,000 crore.
Market Position & Brand Strength	The entity's market share in the addressable CV sub-segments is more than 30%.	⇨	The entity's market share in the addressable CV sub-segments is below 5%.
Product Portfolio	Strong product/segment diversity across all 5 sub segments (in volume terms) With top-3 segments not contributing more than 60% to overall sales volumes	⇨	High concentration on a single product/segment; More than 90% of sales volumes generated from a single segment
Geographic Diversification	The entity is highly diversified with healthy volume/revenue mix from a majority of the regions.	⇨	The entity's sales are majorly limited to a specific region.
Technology & Product Development Capabilities	The company has exhibited a strong track record of new product offerings and meeting regulatory requirements, has technological tie-up / ready access to technology through parent; high R&D spend (>5% of revenues).	⇨	The entity has limited product development capability; R&D spend <2% of revenues.

Financial Risk Assessment

ICRA analyses the long period past financial performance trends and estimates the future financial performance to assess the financial risk exposure of an entity, i.e. to evaluate the sustainability and adequacy of cash flows against its debt-servicing obligations. The financial metrics provide a useful reference not only to evaluate the performance trends of an entity over a given time horizon, but also to enable a comparison with its peers. The various financial metrics assessed by ICRA could be divided into five categories viz., Profitability, Leverage, Coverage, Liquidity and Cash Flows[4]. Given the uncertainty around how the various credit drivers could evolve in the future, ICRA also carries out a sensitivity analysis to assess the impact of the key variables on various financial metrics of the entity to evaluate its ability to withstand stress events. This is especially critical to evaluate the earnings movement over the course of the industry cycle so that the ratings are through the cycle and not influenced purely by the stage of the industry cycle at a particular point of time.

Profitability metrics

Profitability is a measure of the earnings generated by an entity in a given time period in relation to its income or resources deployed. It can be influenced by multiple factors, including those that are firm-specific or are related to the industry, economy or regulations. From a rating perspective, both the level as well as the stability in profitability metrics matter. A consistent track record of higher profitability shown by an entity compared with its peers reflects a superior competitive position arising from one or more factors, including greater brand strength, better distribution reach, attractive product profile, technological superiority or higher cost efficiency (operating or capital). Entities with higher profitability (aided by diversified presence across segments/tonnages, scale of operations, brand positioning, etc.) than their peers are likely to show stronger resilience against economic downturns and are more likely to generate relatively higher internal resources for re-investment and debt servicing

[4] This document provides a brief summary of why ICRA considers these ratios to be important. For a more detailed description, readers may refer to the note, titled Approach for Financial Ratio Analysis, published on ICRA's website.

and also attract fresh capital. Further, sustainable and adequate profitability is essential for an OEM to enable the ongoing investments, which are needed to maintain a technological edge. Moreover, as the company's cash flow generation may fall short of the levels needed to support capex and the debt-servicing needs during periods of downturns, the sustained profits generated during other periods would help build a cushion to surpass the downcycles.

Despite the CV industry being dominated by a few large players, the competitive intensity in the industry remains high, thus mandating that the OEMs maintain high operating efficiencies to sustain stable profitability. In line with the demand cyclicality in the industry, the earnings of CV OEMs and profitability indicators viz. operating profit margins (OPM) and return on capital employed (RoCE) typically follow a cyclical path, expanding during an industry up-cycle and facing pressure during periods of downturn. During periods of slowdown, the OEMs tend to offer high discounts, which further puts pressure on earnings.

With raw material costs being the largest component of a CV OEM's cost structure, any fluctuations in the prices of key raw materials such as steel, aluminium, rubber, plastics and rare earth metals are considered a key sensitivity of the OEM's profitability. Additionally, with tightening safety and regulatory requirements, the costs of meeting these evolving standards continue to be high. Thus, the ability of the OEM to effect price hikes to offset any impact of increases in input costs and to pass on the costs associated with such regulatory changes without impacting its margins remains a credit consideration.

Validation of Business Risk through Profitability Metrics
[Indicative Metrics[5]]

	Strongest	Weakest
RoCE	>=25%	<10%
Volatility in RoCE	<=10%	>55%

Leverage

Financial leverage is a measure of an entity's dependence on borrowed funds. Lower the dependence on borrowings, the lower (better) the leverage. When an entity borrows, it is obliged to pay both the interest as well as the principal to the lenders as per a defined schedule. This increases the fixed cost burden on the borrowing entity, thus increasing the default risk. An entity's financial leverage could be a function of its management's financial policy and risk tolerance, besides being a point-in-time reflection of an entity's business and financial choices. An entity with lower leverage is better equipped to withstand volatility in cash flow generation in situations of economic downturn, competitive challenges, unexpected costs, changing consumer preferences or regulatory changes. The OEMs that generally pursue an aggressive financial policy, which involves significant reliance on debt financing, are likely to be more vulnerable to cyclical downturns than the OEMs which pursue a conservative financial policy. In terms of debt mix, short-term borrowings (mainly utilised for meeting working capital funding requirements) typically dominate the debt profile of the domestic CV OEMs, closely followed by long-term borrowings (mainly utilised for meeting capex funding requirements).

As the CV industry is prone to a high degree of cyclicality in demand, a period of demand slowdown can adversely impact the cash flows of any OEM, reducing its tolerance for financial leverage. The OEMs with healthier balance sheets are better positioned to continue to support product development and expansion initiatives in such conditions. An OEM with a stronger balance sheet is also well equipped to support its vendors/dealers in such cyclical downturns, which helps in building strong ties and in turn strengthens its market position over the long term. A low total debt-to-OPBDITA multiple supports an OEM's

[5] The indicative financial metrics mentioned here and elsewhere in the document are intended to provide a broad overview to the readers regarding what ICRA generally considers as 'relatively strong' or 'relatively weak' metrics. It is, however, possible that an entity has relatively weaker metrices on one or more financial parameters, but its credit risk is assessed to be low because of other mitigating factors, including (but not limited to) stronger metrics on other financial parameters, a healthy business risk profile, strong financial flexibility or a strong promoter group that is willing to extend distress support to it.

ability to service its debt obligations, fund growth opportunities and improve its competitive position without being overly reliant on external sources.

Assessment of Leverage

[Indicative Metrics]

	Strongest	Weakest
Indebtedness Ratio	<=0.9x	>3.0x
Debt-to-profit Ratio	<=0.5x	>5.0x

Coverage

Coverage is a measure of an entity's debt-servicing ability and is calculated as the ratio of profits to the debt-servicing obligations in a given time period. Higher the ratio, higher the cushion available with an entity to withstand the variability in profits for making good on its financial obligations. Coverage is a function of an entity's profits, leverage and debt characteristics (in terms of cost of debt and repayment schedule). The interest coverage indicator reflects the company's ability to fund the cost of external borrowings after meeting all the operating expenditure requirements. The debt service coverage ratio (DSCR) is a measure of an entity's debt-servicing ability and is calculated as the ratio of profits to the debt-servicing obligations in a given time period. Entities with higher profitability and lower leverage will generally have better coverage ratios, and thereby, healthier financial risk profiles. ICRA is particularly concerned with an entity's capability to honour its contractual obligations under stress conditions. The more robust an entity's performance under stress scenarios, the better it is from a credit evaluation perspective.

Assessment of Coverage

[Indicative Metrics]

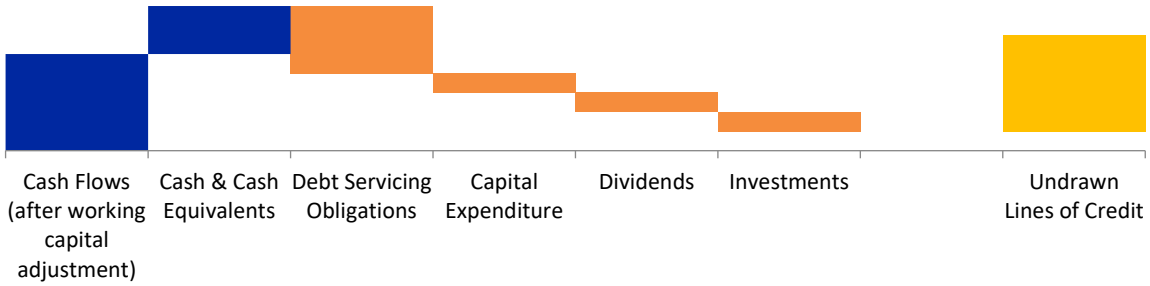
	Strongest	Weakest
Interest Coverage	>=18.0x	<2.0x
DSCR	>=4.0x	<1.1x

Liquidity

Liquidity is the measure of an entity's ability to meet its short-term cash obligations from various internal or external resources. Internal resources include cash flows from operations, unencumbered cash and cash equivalents on the balance sheet and cash inflows expected from the monetisation of physical and financial assets. External resources include undrawn lines of credit or shareholder capital in the form of debt or equity. The short-term obligations include both the committed as well as the contingent claims on an entity's cash, including the debt-servicing obligations, working capital requirements, capex and other investment outlays, dividend and share buyback-related outflows, besides the sudden demand arising from the crystallisation of discrete events such as the unfavourable outcome of an ongoing litigation. The higher the cushion available between the resources available (especially internal resources) and the obligations, better the liquidity profile of an entity. Liquidity is generally assessed in conjunction with the vulnerability of an entity to timely refinance/renew short-term sources of funding. Depending on the circumstances, an entity that has a relatively modest liquidity profile but a strong refinancing ability may not be viewed too unfavourably. ICRA also notes that the liquidity available with an entity may be for a temporary

period, and hence, an entity's overall policy towards maintaining adequate liquidity (given the trade-off between returns and liquidity) is accorded due importance in the analytical approach[6].

Liquidity snapshot over any defined period



Cash flows

The rating exercise is primarily focussed on assessing the future debt-servicing capability of a company. Since it is cash that is required to service the debt obligations, it is imperative that a cash flow analysis be undertaken to evaluate the external funding requirements and likely financial position of the company, going forward. A cash flow statement represents the sources from which cash is generated and its deployment. Analysed here are the trends in an entity's fund flow from operations, cash consumed to fund the working capital, the retained cash flows after paying out dividends or carrying out share buybacks and the free cash flows after meeting debt repayment obligations and capex needs.

Capital expenditure and investment plans

The capex plans of an OEM reflect its plans for capacity expansion, localisation, complying with evolving regulatory norms and new product development. Investment related to increasing the level of indigenisation is generally a positive, as it would not only result in better supply chain management but also improved levels of profitability going forward. New product plans also highlight the commitment of the OEM to refresh its product portfolio and introduce new products/variants. The quantum of capex and funding plans for the same are also evaluated to understand their impact on the financial risk profile of the company. With a moderate buffer available in terms of unutilised capacity, no material capex is likely to be incurred by the domestic CV OEMs towards capacity addition in the near term. The capex is expected to be primarily incurred towards product development initiatives, given the emergence of vehicles with diverse powertrains as well as advanced features.

Foreign currency risks

Such risks arise if an entity's primary costs and revenues are denominated in different currencies. The CV industry's exposure to the fluctuations in foreign currency with regard to imports is generally low as the OEMs typically source a larger share of their components from local vendors compared to the passenger vehicle segment, where the import content is relatively higher. With significant potential in the export market, the CV OEMs have been launching products customised for various market requirements, and accordingly, CV exports from India have doubled over the past decade, thereby exposing the OEMs to the variations in foreign currencies. ICRA assesses the degree to which the OEMs may be able to pass on the currency risk to their customers by adjusting their product/service prices. This assessment is done by considering the materiality of the net forex earnings or expenditure in relation to the total revenues. Foreign currency risk for an entity is measured by considering

[6] For more details on how ICRA assesses liquidity, readers may refer to the document titled, "Liquidity Analysis of Entities in the Non-Financial Sector" published on ICRA's website

its unhedged net liabilities [= foreign currency receivables – foreign currency payables – foreign currency debt] and assessing the magnitude of such exposure, relative to the entity's profits.

Tenure mismatches and risks relating to interest rates and refinancing

Large dependence on short-term borrowings to fund long-term investments or other long-term funding requirements can expose an entity to significant refinancing risks, especially during periods of tight systemic liquidity. ICRA evaluates the extent of such mismatches and the mitigating factors therein. One source of mitigation could be the existence of adequate buffers of liquid assets/committed bank lines to meet the short-term obligations. Another source of mitigation could be the entity's strong financial flexibility to be able to garner fresh funds at a short notice or a potent ability to refinance. Further, ICRA evaluates the extent to which an entity might be impacted by the movement in interest rates.

Financing availability

With a majority of CV purchases in India relying on external funding, the financing environment plays an important role in supporting demand for CVs. In India, the CV financing market is well established, represented both by banks as well as non-banking finance companies (NBFCs), with the latter accounting for about 60% of the CV finance market. The availability of credit from the NBFC sector, hence, plays a key role in supporting CV sales and demand. Additionally, some OEMs also have captive finance companies, although these account for only 10-15% of the CV finance market.

A well-managed captive finance arm can be utilised strategically by an OEM – at times by advancing loans to a category of borrowers that may have a relatively weak credit profile. In addition, they may help the OEM in penetrating into certain markets or a product segment where the OEM has a marginal presence. However, any build-up of non-performing assets in their portfolio can impact the cash flows of CV OEMs as they may have to infuse additional equity into the financing entity to comply with the regulatory norms and loss-funding requirements. Accordingly, for OEMs with captive finance companies, ICRA's analysis assesses capital requirements for the captive finance business. While the 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.

Other Elements of Credit Risk Assessment

Parentage/Group support

While the credit rating of an entity is a function of its standalone credit profile, in certain cases, the entity's credit quality can also be driven by the relationship with its parent or the promoter group (henceforth referred to as the parent). The CV industry is characterised by the presence of large domestic corporate groups and a few international OEMs through their wholly owned subsidiaries. The rating of the OEM would thus be influenced by the parent's standing and the linkages between them.

If the parent's credit profile is relatively stronger than the rated entity, ICRA assesses the ability and the likelihood of the parent extending extraordinary support to the entity. Support here means financial support from the parent expected to be available to the entity in the form of loans, equity, extended credit period, advances, etc. in times of credit or liquidity stress on the entity. 'Support' does not mean the ongoing or committed financial support from the parent, such as the capital infusion to fund the rated entity's expansion plans or support to maintain a targeted capital structure, but the extraordinary support which cannot be foreseen, is intended to avoid a default and thus cannot be factored in while assessing the notional standalone rating of the entity. It also does not signify operational support in the form of new business opportunities, technology sharing, distribution network sharing and so on as these aspects are factored in the standalone credit profile assessment itself. It may be noted that promoters in their individual capacity, or private equity firms/other financial investors are generally not treated as parents for assessing the likelihood of extraordinary financial support coming in. If the parent's credit profile is relatively weaker than the rated entity, the entity's rating may be lower than what its standalone credit profile assessment would have

merited. This is given the possibility that the entity may at some point of time be bound to extend financial support to its weaker parent, possibly to the detriment of its own credit profile[7].

Financial flexibility

An entity's financial flexibility (or the lack thereof) is reflected in its ability to access capital or money markets at short notice, attract diverse and marquee investors and enjoy the confidence of banks, financial institutions and intermediaries. A strong financial flexibility allows an entity to raise fresh borrowings or refinance existing ones in quick time, whenever required. Financial flexibility could depend on factors such as an entity's large scale of operations with strong financials, large, unrestricted cash flows, unencumbered assets and the flexibility to borrow against such assets or robust parentage or linkages with a strong group.

In contrast, among the various measures of an entity's depleting financial flexibility, one relates to a high share of pledged promoter shareholding. A sign such as this may imply that the entity might be persuaded to distribute high dividends or support the promoter group through other means to the detriment of its own credit profile. If the promoters fail to repay their loans (availed by pledging of shares) or top up collateral when required, the lenders could sell the pledged shares. In some cases, this could trigger a change-of-control clause in the rated entity's bond indentures or loan documents and require it to redeem its debt ahead of schedule, creating a liquidity squeeze, besides affecting fresh capital-raising ability. Financial flexibility could also be impacted in cases of adverse industry developments, weakening business profile or management and governance concerns, which could translate into a sharp decline in market capitalisation or spike in bond yields and consequently constrain an entity's ability to raise fresh capital or materially increase its cost of capital.

Debt-servicing track record

Any history of delays or defaults in meeting interest and principal repayment obligations reduces the comfort level with respect to the company's future debt-servicing capability and willingness. Nevertheless, the reasons behind past defaults are also analysed, which could also be due to adverse demand situations in the underlying industry. A company's ability to honour its debt obligations during the period of cyclical stress is also factored in.

Consolidated financial analysis

The CV industry in India comprises several large players with presence across diverse business segments and geographies through various subsidiaries and associate companies. While evaluating the financial risk profiles of such companies, ICRA analyses consolidated/group-level financial indicators in terms of capital structure, debt protection indicators and future funding requirements[8].

Accounting quality

ICRA reviews the accounting policies, notes to accounts, auditors' comments and other disclosures that are parts of the Annual Report of a rated entity. Deviations, if any, from the accounting standards/ practices are assessed and the financial statements of the entity are adjusted, where feasible, to reflect the impact of such deviations. Significant deviations may be indicative of weak corporate governance practices in the entity.

Contingent liabilities and off-balance sheet exposures

ICRA's analyses the likelihood of devolvement of contingent liabilities/off-balance sheet exposures and its impact on the entity's financial implications while factoring in mitigants such as a strong liquidity cushion.

[7] For more details, readers may refer to the documents titled, "Rating Approach–Implicit Parent or Group Support" and "Rating Approach–Explicit third-party support", available on ICRA's website.

[8] For more details, please refer to ICRA's methodology titled 'Rating Approach—Consolidation' available at www.icra.in.

Event risk

ICRA recognises the possibility of events such as unrelated diversification, mergers and acquisitions, business restructuring, asset sales and spin-offs, litigations, equity infusion and refinancing, which could have a material impact on the credit profile of an entity. Incorporating the impact of such discrete events in the credit rating from the beginning is often difficult. To take rating decisions in such cases, ICRA applies its analytical judgment based on the rated entity's track record, the credibility of the management and the experience of having seen similar situations play out in other entities. However, given the nature of such events, it is possible that the rating may undergo a material change later, upon the occurrence of the event.

Asset concentration risk

While evaluating an OEM, its manufacturing base is also given due consideration. The OEMs, which have only a single manufacturing facility, remain exposed to asset concentration risks, with force majeure incidents or issues like labour unrest and political uncertainties, etc. that could potentially disrupt the operations. On the other hand, the OEMs which have a relatively diversified manufacturing presence are able to offset this risk to some extent.

Management Quality Assessment

In addition to the industry, business and financial risk analysis, all credit ratings incorporate an assessment of the quality of the rated entity's management and its financial policies.

Quality of management and financial policies

As a part of its process, ICRA undertakes discussions with the rated entity's management to understand its views on past performance as well as its future plans and strategies, besides the outlook on the industry. Some of the points assessed are:

- Experience of the promoter/management in the industry
- Commitment of the promoter/management to the rated entity
- Risk appetite of the promoter/management and risk mitigation plans
- Policies on leveraging, managing interest rate and currency risks
- Management's past success in introducing new projects and managing changes in the external environment
- Management's plans on new projects, acquisitions and expansions
- Track record of balancing the interests of shareholders, creditors and other stakeholders

Periodic interactions with the management help ascertain the shifts, if any, in their financial policies.

Assessment of Environmental, Social and Governance (ESG) Risks

The assessment of ESG risks by ICRA involves a broad range of considerations that pertain to the sustainability of an entity with focus on aspects that can have a material impact on its credit quality. While the E&S risks tend to be both sector-related as well as entity-specific and could be driven by external factors such as regulations or demographic changes, the G risks are largely entity-driven. The impact of the E&S risks on an entity's credit profile tends to be asymmetric. If the ESG risks are material but unmitigated, these generally translate into pulling down the rating, but generally the ratings are not pushed up even when the ESG context is favourable.

Environmental (E) and Social (S) risks

As this methodology highlights, while undertaking the credit assessment of entities, ICRA seeks to incorporate all the relevant credit considerations into its rating decisions while taking a forward-looking view on the risks and the mitigants. The relevant

credit considerations include (sometimes overtly, sometimes covertly) the E&S factors that could affect the rated entity/transaction. While ICRA's analytical approach does not explicitly disaggregate these risks to assess their impact on the rating, these risks are often assessed broadly. Further, it is not always feasible to fully or precisely disaggregate the sub-components of E&S risks in credit analysis as these considerations often tend to overlap.

That said, the materiality of the E&S risks and the time horizon over which they are expected to crystallise differs widely across sectors and entities. In some cases, while the E&S risks could be material, their effect on the credit profile may be muted because of the other fundamental strengths of the entity. In other cases, the adverse impact of the E&S risks is expected to play out in the distant future, and hence these considerations do not necessarily weigh on the rating today—with the expectation that when these risks manifest in the distant future, the rated entity by then would possibly adapt itself by realigning its business model.

While evaluating E&S risks, ICRA's objective is only to assess the direct and indirect risks that an entity faces and how it already is or is intending to mitigate the impact of such risks on its credit profile. As an example, ICRA only assesses whether an entity is exposed to physical climate risks, or carbon transition risks such as those arising from changes in regulations or other environmental and social risks; and seeks to understand the various mitigation and adaptation approaches that the entity is implementing to tackle these risks.

CV entities are exposed to risks related to evolving regulations on emission norms and transition to cleaner vehicles. With the increasing focus on 'Net Zero' and given that CVs are one of the major contributors to vehicular emissions, the pace of regulatory changes and shifts in consumer behaviour could have a material bearing on the business and financial position of the CV OEMs. Accordingly, entities in the CV industry have an exposure to carbon transition risks.

On the social dimension, the CV industry has a prominent dependence on human capital, in terms of direct and indirect employees, contractual labour as well as fleet drivers employed by the CV buyers. As part of the manufacturing business, maintaining healthy employee relations by the CV OEMs as well as the supplier ecosystem is essential for disruption-free operations. Further, while driver shortage issues have emerged over the past few years, the OEMs are increasingly offering driver training and other such programmes to mitigate these challenges. Another social risk that the CV OEMs face pertains to product safety and quality, wherein instances of vehicle recalls, safety incidents, vehicle non-performance and high warranty costs not only lead to a financial implication but could also harm the reputation and create a more long-lasting adverse impact on demand. The entities also remain exposed to any major shift in consumer preferences, which are a key driver of demand, and accordingly may need to make material investments to realign their product portfolio. GCC continues to be another key aspect of the social dimension, with the social preference for public transportation offered under GCC for the want of safe transportation and timely commuting remaining critical for the operational stability of GCC models.

Governance practices

A sound corporate governance structure should clearly delineate the roles and responsibilities of the Board of Directors and the management. The composition of an entity's Board, its involvement in strategic decision-making and the entity's compliance with the legal and regulatory requirements are factored in during credit assessments. ICRA also seeks to gain a qualitative understanding of the entity's commitment to follow transparent and credible practices, as reflected in the presentation of the financial statements, timeliness and depth of disclosures, consistency in communication and the openness about sharing information during the rating process. Additionally, factors such as the complexity of the corporate group structure, related-party transactions, instances of financial support to group entities at the expense of debt holders and any abrupt resignations of auditors or independent directors are evaluated.

Summing Up

ICRA's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the instrument being rated. This opinion is arrived at following a detailed evaluation of the entity's business and financial risks, its competitive strengths, its likely cash flows over the near-to-medium term and the adequacy of such cash flows vis-à-vis its debt-servicing obligations and other funding requirements. ICRA's approach to rating CV OEMs also incorporates an assessment of the company's market position, product portfolio, technology development strength, geographic diversification and the management strategy for managing cyclical downturns and its overall approach towards investment and growth.

ANNEXURE

Summary of rating factors and an example to illustrate the key building blocks of a credit rating

		Strong			Comfortable			Adequate			Moderate			Weak		
Industry Risk	Industry Position															
Business Risk	Scale															
	Market Position and Brand Strength															
	Product Portfolio															
	Geographic Diversification															
	Technology & Product Development Capabilities															
Financial Risk	Profitability															
	Leverage															
	Coverage															
		Enhance					**Support/ Neutral**					**Hinder**				
Do these factors enhance or hinder the credit profile?	Diversification															
	Refinancing Dependence, Liquidity and Financial Flexibility															
	Currency Risk															
	Financial Policy															
	Management, Governance & Reporting															
		Very High				**High**				**Moderate**				**Low**		
Parent Support	Likelihood of Parent Support															
	Rating of Parent	AAA	AA+	**AA**	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B/ C category	
	Final Rating	**AAA**	**AA+**	**AA**	**AA-**	**A+**	**A**	**A-**	**BBB+**	**BBB**	**BBB-**	**BB+**	**BB**	**BB-**	**B/ C category**	

The above graphic is only for illustrative purposes and does not represent a rating output from a formulaic model. The ratings assigned by ICRA are determined by Rating Committees based on both quantitative and qualitative considerations.

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About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

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