ICRA

ICRA Rating Feature

Rating Methodology for Commercial Vehicle Manufacturers

This rating methodology updates and supersedes ICRA's earlier methodology note on the sector, published in August 2015. While this revised version incorporates a few modifications, ICRA's overall approach to rating entities in the sector remains materially similar.

Overview

This rating methodology provides a reference tool for investors and issuers to understand ICRA's approach to assessing the business and financial risk profiles of Commercial Vehicle (CV) manufacturers. It aims to help issuers, investors and other interested market participants understand ICRA's approach in analyzing the quantitative and qualitative risk characteristics that are likely to affect rating outcomes. This methodology does not include an exhaustive treatment of all factors that are reflected in ratings but enables the reader to understand the rating considerations that are most important. For analytical convenience, the key factors are grouped under three broad heads – Business Risk Assessment, Financial Risk Assessment and Management, Governance and Financial Reporting Assessment.

- ***Industry Risk Assessment***
  - Cyclicality
  - Competitive Landscape

- ***Business Risk Assessment***
  - Scale and Market Position
  - Product Portfolio
  - Sales and Service Network
  - Technology & Product Development Capabilities
  - Auto Component Supplier Base
  - Business Diversification

- ***Financial Risk Assessment***
  - Profitability Indicators
  - Leverage and Coverage Indicators
  - Foreign Currency Risks
  - Tenure Mismatches, and Risks Relating to Interest Rates and Refinancing
  - Contingent Liabilities / Off-Balance Sheet Exposures
  - Adequacy of Future Cash flows & Liquidity

- ***Other Considerations***
  - Captive Finance Arms
  - Parentage
  - Event Risk

- ***Management, Governance and Financial Reporting Assessment***

Industry Risk Assessment

Cyclicality

The domestic CV exhibits significant cyclicality with its prospects closely linked to some of the key segments of the economy such as industrial growth, investments in the infrastructure and construction space. As economic cycle picks-up, the bargaining power of fleet operators improves (as freight rates are directly correlated to demand-supply of fleet). This in turn prompts operators to add new trucks to the system and in general, capacity addition tends to be higher the underlying demand. As a result, freight rates weaken when economic growth slows down, which impacts viability of fleet operators and therefore demand for new CVs. Thus, ICRA assesses the performance of a CV OEMs and its financial policies over the complete cycle with respect to managing adequacy of cash flows during slowdown.

Competitive Landscape

Competitive intensity in a given industry is characterised by a confluence of factors including - high industry fragmentation, similarity in market share of prominent players, low entry barriers, high exit barriers, commodity nature of product or service, low customer switching costs, or excess production capacity. Competitive intensity in a given industry may also change over time as entrenched players demonstrate collective change in product pricing strategies. Regulatory actions could also alter the level of competitive intensity in an industry. The Indian CV industry is fairly consolidated with top-4 players accounting for 90% of industry sales in FY 2017. However, the competitive intensity in the domestic CV industry is gradually increasing as new OEMs have forayed into the market while existing players have ventured into new segments and expanded their sales-cum-service network.

Business Risk Assessment

Scale, Competitive Position & Diversification

Scale and Market Position

The scale of a CV Original Equipment Manufacturer (OEM) and its market position within the industry are important determinants of business strength and operating flexibility. The company's size in relation to key competitors can determine its ability to influence business trends and pricing within the industry. In addition, scale drives a company's ability to develop competitive cost structure and an efficient vendor and distribution network. It also enhances resilience to changes in product demand, supports bargaining power with component or raw material suppliers, enables better cost absorption, besides buying up R&D capabilities.

Product Portfolio

The strength of a product portfolio is of utmost importance for an OEM to sustain a competitive market position and enable it to cater to a diverse customer profile. A diversified product portfolio enhances an OEM’s ability to counter any demand variations in a particular product category. In India, the CV segment is categorised as Light Commercial Vehicle (LCVs) and Medium & Heavy Commercial Vehicles (M&HCVs) based on tonnage. Vehicles with Gross Vehicle Weight (GVW) below 7.5T are classified as LCVs, whereas vehicles with GVW above 7.5T are categorized as M&HCVs. The industry is also classified based on application between trucks and buses. An OEM with a meaningful presence across different tonnage segments may be considered to have a diversified portfolio making it less vulnerable to changes in customer preferences. Apart from portfolio diversity, it is also imperative for an OEM to continuously refresh its product profile, thereby addressing the evolving needs of customers and keeping up with the latest technological developments.

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 influences the cash flows and hence the viability of fleet operators. As a result, owners of CVs tend to exhibit stronger loyalty towards proven brands. Therefore, while evaluating an OEM's business strength, ICRA gives due consideration to an OEM's brand strength. Typically, portfolio strength and brand loyalty is evaluated by analyzing the trend in market share of an OEM in the industry or segment in which it is present. Since market share of an OEM can vary over a period of time, ICRA considers various aspects like shift in consumer preferences, competitive intensity, new product introduction cycle and pricing strategy while evaluating trend in market share. The Indian CV industry is fairly consolidated with top-4 players accounting for 90% of industry sales in FY 2017. However, the competitive intensity in the domestic CV industry is gradually increasing as new OEMs have forayed into the market while existing players have ventured into new segments and expanded their sales-cum-service network.

Sales and Service Network

Apart from a well established portfolio and brand strength, having 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. Thus, prompt availability of spare parts and service workshops at multiple locations across the country is of great importance. Thus, with well spread out dealership network, OEMs can increase customer loyalty by ensuring low vehicle downtimes for fleet operators. While leading domestic players in the industry have a wide pan-India presence, foreign OEMs are currently in the phase of investing in expanding their distribution network. In general, having a wide spread distribution network is critical for the M&HCV segment, however it is not much of a compelling requirement for LCVs as their span of commute is fairly limited.

Technology and Product Development Capabilities

Traditionally, the Indian CV industry has been characterized by a relatively lower focus on developing advanced trucking platforms with the view 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, with improving highway infrastructure in the country, evolving regulatory and customer requirements, changing landscape of road logistics industry (i.e. proliferation of hub-n-spoke model), CV demand has gradually shifted in favour of higher tonnage and multi-axle vehicles. Furthermore, OEMs have also introduced models like Tippers, Tractor Trailers that are customized to suit certain application segments.

With evolving regulatory requirements (i.e. emission norms and safety regulations) and foray of international OEMs, the domestic OEMs are steadily investing in developing new and advanced platforms that enable them to compete more effectively with international OEMs. As a result, while evaluating competitive positioning of an OEM going forward, due importance is given to an OEM's future product development strategy, technology tie-ups and R&D plans. This is typically quantified by assessing the company's outlay towards R&D and capital expenditure (as % of sales).

Auto Component Supplier Base

A significant part of the manufacturing activity in the CV industry is generally outsourced by the OEMs to component suppliers, thereby helping the OEMs focus on key activities product design and development, marketing and distribution, and assembly operations, while at the same time giving them greater flexibility during cyclical downturns. In such an outsourcing-oriented model, component suppliers are also required to invest in building capacities on behalf of the OEMs catered to. Given such an arrangement, an OEM's relationship with its component suppliers is critical in ensuring disruption-free production and in supporting its product development initiatives.

A strong vendor network helps the OEMs work on lean working capital cycles supported by just-in-time (JIT) manufacturing practices. Furthermore, a well-developed vendor network also aids high localization levels and thereby better profitability metrics. In certain cases, OEMs directly own auto component suppliers, or even through investments by group entities or holding companies. While equity holding helps OEMs exercise greater control on vendors and ensure disruption-free production, large holdings can partly defeat the purpose of outsourcing.

Although most of the domestic OEMs have a well established vendor base and high localization levels thereof, new entrants (at least during the initial few years) depend on foreign suppliers. Accordingly, their localization levels may be low, which consequently impacts their pricing strategy and competitive position. Thus, ICRA also evaluates OEMs' localization plans and how they are likely to influence cost of operations going forward.

Business Diversification

With CV industry being highly cyclical, diversification into other related businesses can help in reducing volatility in earnings or cash flows. In India, most of the CV manufacturers have presence in other segments of the automobile industry like Passenger Vehicles, Two Wheelers, Defense supplies and Auto Components. While diversification into related areas is certainly a positive, ICRA evaluates such businesses from the perspective of their respective business profile and contribution to consolidated earnings or cash flows. In case such businesses are in the gestation phase or are incurring losses such that they might require capital infusion going forward, the same is factored in while projecting future cash flows of the OEM.

Financial Risk Assessment

The various financial metrics assessed by ICRA could be divided into four categories viz., Profitability, Leverage, Coverage and Liquidity. 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. Some of the key metrics analysed are discussed below:

Profitability Metrics

The ability to sustain profitability is one of the key factors that ICRA looks at while differentiating between companies. Relatively superior and stable profitability indicators are indicative of an OEM's operational efficiencies in its manufacturing operations. It is also an evidence of an OEM's pricing capability as well as its bargaining power with its suppliers. Furthermore, sustainable and adequate margins are essential for an OEM to enable ongoing investments, which are needed to maintain a technological edge. Moreover, as seen in the last business cycle, in the absence of sustained profits, a company's cash flow generation is likely to fall short of the levels needed to support capital expenditure and debt servicing needs.

Despite the CV industry being dominated by a few large players, the competitive intensity in the industry remains high, thus mandating that OEMs maintain high operating efficiencies to maintain stable profitability. The earnings of CV OEMs is generally linked to industry demand and profitability indicators viz. Operating Profit margins (OPM) and Return on Capital Employed (RoCE) for market participants typically expand during industry up-cycle and face pressure during periods of downturn. During periods of slowdown, OEMs tend to offer high discounts, which further puts pressure on earnings. Accordingly, ICRA evaluates the profitability indicators of CV OEMs through the cycle while projecting future earnings.

With raw material costs being the largest component of a CV OEM's cost structure, any fluctuation in prices of key raw materials such as Steel, Aluminium, Rubber, and Plastics remains a key sensitivity on OEM's profitability. Thus, the ability of the OEM to effect price hikes to offset any impact of hike in input costs remains a key rating criterion.

Leverage, Coverage and Liquidity Indicators

ICRA's assessment of the financial risk profile of the company is based upon the ability of a company to generate healthy cash flows to reinvest in the business as well as meet the debt servicing obligations. The financial policies - past as well as future - are a key rating factor to ascertain the risk appetite of the management and the impact of the same on the financial performance of the company.

Some of the key indicators observed by ICRA include:

- Leverage Indicators – Total Debt/Tangible Networth, Total Outside Liabilities/Tangible Networth, Total Debt/OPBDIT
- Debt Coverage Ratios – Interest Coverage, DSCR and Net Cash Accruals/Total Debt
- Liquidity Ratio – Current Ratio

Leverage ratios are an indicator of the degree of financial flexibility a company enjoys in terms of its ability to raise funds from alternative sources in times of financial distress. Such flexibility is reflected in a company's gearing (Total Debt-to-Tangible Networth) and Total Debt-to-EBDITA multiple. 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 OEMs who pursue a conservative financial policy.
As the CV industry is prone to high degree of cyclicality in demand, a period of demand slowdown can result in stretched liquidity conditions for any OEM. As such, 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 tight liquidity conditions, which helps in building strong ties and in turn strengthen market position over the long term.

The interest coverage indicator reflects the ability of the company to fund the cost of external borrowings after meeting all operating expenditure requirements. Strong free cash flows indicate the ability of a company to fund investments, organic and inorganic growth opportunities and debt repayments. A strong Total Debt-to-EBIDTA multiple is a credit positive as it reiterates the ability of the company to service its debt obligations; fund growth opportunities and improve its competitive position without being overly reliant on external sources. In addition to long-term financial flexibility, the liquidity profile of the company is equally important to understand the ability of the company to meet short term financing requirements. ICRA thus evaluates the availability of undrawn bank facilities to the company and the available drawing power to help the company cover temporary shortfalls in funding requirements.

Debt Servicing Track Record

The debt servicing track record of the company forms an important rating consideration. Any history of past delays or defaults in meeting interest and principal repayment obligations reduces the comfort level with respect to the company's future debt servicing capability. ICRA also factors in the ability of the company to honour its debt obligations during period of cyclical stress.

Foreign Currency Risks

The CV industry's exposure to fluctuations in foreign currency with regards to imports generally remains low, as the OEMs source a majority of their components from local vendors, as compared to the Passenger Vehicle segment, where import content is relatively higher. With significant potential existing in the exports market, CV OEMs have been launching tractors customized for various market requirements, which is likely to lead to an increase in contribution of exports in the company's sales mix, thereby exposing the company to significant variations in foreign currency. While taking this into consideration, the hedging policy of the company towards mitigating such foreign currency risks as well as the impact of any adverse movement in foreign exchange rates on the cost structures, profits or cash outflows for the company is evaluated.

Tenure Mismatches, and Risks Relating to Interest Rates and Refinancing

Large dependence on short-term borrowings to fund long-term investments can expose a company to significant re-financing risks, especially during periods of tight liquidity. The ratings factor in the existence of adequate buffers of liquid assets/bank lines to meet short-term obligations and the extent to which the company could be impacted by interest rate movements on such borrowed funds.

Contingent Liabilities/Off-Balance Sheet Exposures

The financial statements used by ICRA to analyze the financial performance are derived from the audited financial statements and as such the accounting quality of the company's financials is factored in during the rating process. ICRA interacts with the Statutory Auditors as well as studies the Auditors' Report and other Notes to Accounts disclosed by a company in its Annual Report. Some of the key factors looked at include- auditor qualifications with respect to internal control systems, debt servicing and asset liability mismatch; contingent liabilities and other off balance sheet items and description of various accounting policies.

Consolidated Financial Analysis

The CV industry in India comprises of 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 coverage indicators and future funding requirements.

Adequacy of Future Cash Flows

Since the prime objective of the rating exercise is to assess the debt servicing capability of a company; ICRA draws up projections on the likely financial position of the company based on the expected movements in operating performance factoring in capex and investment requirements as well as upcoming debt obligations.

Other Considerations

Parentage

The CV industry is characterized by presence of a few International OEMs through their wholly-owned subsidiaries, and a greater number of well-established domestic OEMs. While international players bring in technical expertise, product innovation and international market experience, they still need to establish a wide distribution network and accumulate the local market knowledge. Despite international competition, the incumbents have been able to maintain their market positions benefitting from their established distribution networks as well as strong commitment to product and market development. In cases where the company is directly owned by a foreign parent, the rating of the Indian entity is influenced by the parent’s standing and any formal support arrangements in place with the issuer, especially during gestational period when subsidiaries may require financial support.

Captive Financing Arms

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 being represented both by banks as well as Non-Banking Finance Companies (NBFCs). However, some OEMs also have captive finance companies.

A well managed captive finance arm can be utilized strategically by an OEM – at times by advancing loans to a category of borrowers that may have relatively weak credit profile. In addition, they may help the OEM in penetrating into certain markets or a product segment where the OEM has marginal presence. However, any build-up of Non-Performing Assets in their portfolio, can impact cash flows of CV OEMs as they may have to infuse additional equity into the financing entity to comply with regulatory norms and loss funding requirements. Accordingly, for manufacturers with captive finance companies, ICRA's analysis assesses capital requirements for the captive finance business and makes necessary adjustments for delinquencies and loss-sharing arrangements. While captive business plays a positive role in supporting business growth, easy credit policy without adequate risk management practices can lead to unsustainable business growth and push up delinquencies.

Event Risk

ICRA also recognizes the possibility of events, such as unrelated diversification; mergers and acquisitions; business restructuring, asset sales and spin-offs; capital restructuring; and litigations, which could have a material impact on the credit profile of a company.

Management Quality & Corporate Governance

In addition to the business and financial risk analysis, all debt ratings incorporate an assessment of the quality of the issuer’s management. The assessment of the credit profile of an entity factors in the commitment of the management to the company’s day-to-day operations. The participation of professional management and the constitution of Board (number of promoter vs independent directors, background of each director) and their participation in strategy formulation, besides the company’s adherence to legal and statutory compliance requirements is also factored in. Usually, a detailed discussion is held with the management to understand its mission, plans & strategies and views on past performance, 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 company
- Risk appetite of the promoter/management and risk mitigation plans
- Management’s past success in introducing new projects and managing changes in external environment

- Management’s plans on new projects, acquisitions, expansion, etc.

Periodic interactions with the management also help to estimate the probability of the management’s tendency to deviate from its philosophy in times of stress.

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 issuer‘s business and financial risks, its competitive strengths, it‘s likely cash flows over the life of the instrument being rated and the adequacy of such cash flows vis-à-vis its debt servicing obligations and other funding requirements. ICRA’s approach to rating CV manufacturers also incorporates a number of qualitative factors, which includes an assessment of the company’s market position, product portfolio, technology development strength, distribution network as well as the management strategy for managing cyclical downturns and its overall approach towards investment and growth.

ICRA Limited

CORPORATE OFFICE
Building No. 8, 2nd Floor, Tower A; DLF Cyber City, Phase II; Gurgaon 122 002
Tel: +91 124 4545300; Fax: +91 124 4050424
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) 2556 1194/0195/0196, Fax + (91 20) 2556 1231