ICRA

ICRA Rating Feature

Rating Methodology for Construction Equipment Manufacturers

This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in July 2018. While this revised version incorporates a few modifications, ICRA's overall approach to rating entities in the sector remains materially similar.

Overview

The Indian construction equipment (CE) industry can broadly be divided into:

a) Earth-moving equipment such as backhoes, wheeled loaders, excavators, diggers, dumpers and dozers. Earthmoving equipment deployed in mining are of larger tonnage and horsepower than those used in construction and they also include some specialised equipment and implements such as underground mining equipment, articulated dump truck, walking dragline and other tracked machines
b) Material-handling equipment such as pick-and-carry (PNC) cranes and aerial cranes
c) Road-building equipment such as compacters and motor graders
d) Concreting equipment such as transit mixers

ICRA's rating methodology for CE entities is based on an assessment of industry level risks and entails evaluating the entity's business and financial position, besides its ability to generate cash flows from operations and the adequacy of the same in relation to its contractual debt service obligations. ICRA also assesses the entity's management for its growth plans, risk appetite, and financial policies. ICRA's portfolio of CE entities includes subsidiaries of global CE majors, homegrown CE entities and material handling equipment (MHE) manufacturers. This methodology is a guiding tool for lenders, investors and other market participants to understand the broad parameters ICRA takes into consideration while rating CE manufacturers. For analytical convenience, the key factors are grouped under the following broad heads —Business Risk Assessment, Financial Risk Assessment and Management Quality.

Rating Methodology

This document aims to help issuers, investors and other interested market participants understand ICRA's approach to analysing risks that are likely to affect rating outcomes of corporate sector entities. This document does not include an exhaustive discussion of all the rating factors that our analysis considers but provides an overall perspective on the considerations that are usually the most important.

ICRA's risk analysis framework for CE manufacturers can be broadly divided into the following factors –

Industry Risk Assessment

Business Risk Assessment

- Product Portfolio
- Competitive Position
    a. Market Share
    b. Dealer and Service Network; and
    c. Financing Support
- Scale of operations

Financial Risk Analysis

- Profitability

- Leverage & debt coverage metrics
- Liquidity and financial flexibility
- Foreign currency-related risks
- Tenure mismatches, and risks relating to interest rates and refinancing
- Contingent liabilities/Off-balance sheet exposures

Management Quality and Corporate Governance

Parentage

Industry Risk Assessment

Growth and Cyclicality

With fortunes closely linked to economic activity, the CE industry is cyclical, often with sharp peaks and deep troughs. Growth prospects in the industry are a function of fixed capital formation in the underlying economy. ICRA evaluates the financial risks arising from such deep cycles and the past track record of the company in tiding over such periods.

Competitive landscape

The Indian CE industry has over 200 players, with the presence of a few large global and local players. Several of the large CE entities in India are subsidiaries or joint ventures of global majors enjoying parent support. Within the various CE segments, backhoes and excavators in the earthmoving segment account for about 60% of the volume share and about 49-50% of the value share of the CE market. While product diversity in the Indian market is fairly adequate, however, given its relatively nascent stage, demand currently leans largely towards general-purpose equipment as opposed to usage-specific or specialised equipment. The relatively smaller size of the Indian market has so far deterred global companies from investing in the development of India-specific products or customising their global products to suit the Indian requirements. While equipment with smaller capacity is manufactured locally, often with sizeable import content, the larger equipment continues to be imported.

Business Risk Assessment

Product Portfolio

Construction and mining equipment are critical components for capacity enhancement and gross fixed capital formation in an economy. This correlation with capital investments, public and private, leads to significant cyclicality in demand for the CE.

While the overall CE industry is correlated with the economic cycle, demand for each of the four main product segments is linked to different factors. Infrastructure investments, including road-building and construction activity in the country drive demand for road construction equipment and material-handling equipment. On the other hand, real estate drives demand for concreting equipment while global and domestic commodity cycles and the Government's mining policies determine the demand for mining equipment. Demand for CE is also heavily dependent on both large Central Government projects and state-level investment plans, along with budgetary funding availability. Projects announced and implemented in the state and the resultant equipment required is critical to understanding future demand. This apart, private investment in infrastructure and capacity enhancement also has a significant impact on demand for CE. An extensive/diversified product portfolio could buffer short-term equipment-specific demand slowdowns.

Cost economical feature-rich products could help sustain customer interest and market share. Globally, disruptive technology-led launch of cutting-edge products has been a demand driver for a manufacturer. Given the relatively smaller scale and the price sensitivity of the Indian market at present, the products available in India currently lag on the technology curve. While the demand for high-end products is low in the domestic market, having a cost reduction orientation through import substitution could be a market share driver.

Competitive Position

A strong competitive position leads to revenue stability and pricing flexibility. An analysis of the competitive landscape, movement in market share and threat of imports, helps us understand the level of price and product competition.

Market Position

The Indian CE market is dominated by a few large original equipment manufacturers (OEMs) for each product category. The past decade has witnessed the entry of several new players, mostly joint ventures and subsidiaries of global majors. Import threats from the established Chinese manufacturers have also heightened over the past decade, as large Chinese manufacturers target product gaps in high potential markets like India. The ability to establish and sustain market share in an evolving competitive landscape requires a strong product and deep pockets to fund market penetrative strategies, given the strong incumbents. One of the first entrants in the Indian backhoe market, continues to maintain its market dominance with over 70% share in the high-volume backhoe segment. Brand, technology, distribution network and a long-standing presence in the market drive the share of business.

[1] Dealer and Service Network

Given the vast geography and customer dispersion, an extensive dealership and service network across the country is critical to ensuring market presence across various regions. Also, the local service network with ready availability of spare parts is critical for ensuring high uptime and hence predictable cash flows to equipment operators. The economics of operating a service network are generally better in case of mining equipment where a large volume of orders originates from a single location. A high base of installed equipment in turn leads to sizeable spare parts and service demand within a region.

[2] Financing Tie-ups

Given that a bulk of the CE market is financed, financing tie-ups by the OEMs plays a key role in driving demand for the equipment. Well-established brands usually find it easier to arrange financing tie-ups for its dealers and consumers at favourable terms, while others have supported market penetration through schemes like interest subvention. The resale value of a product — a function of the brand strength, servicing/spares network and product quality - is also a determinant of financing availability and consequently market share.

Scale of Operations

The scale of operations and sustainability are important parameters that reflect the overall market strength and operating leverage a manufacturer enjoys with respect to its industry peers. Scale provides benefits of economies of scale with effective cost absorption. A healthy scale of operations is an indicator of the staying power, flexibility in the market for deploying timely pricing strategies and access to the capital and financial markets.

Heavy equipment (particularly mining equipment and higher tonnage CE) orders are usually characterised by advances from the customer to support order execution. Large orders also have sufficient lead-time, allowing for effective ordering for raw material and production planning. Customised orders also have advances built into the contracts, which help meet working capital requirements, replacing borrowings.

Financial Risk Assessment

ICRA analyses long period past financial performance trends as well as estimates future financial performance to assess the financial risk exposure of an entity. The financial metrics provide a useful reference not only evaluate the performance trends of an entity over a given time horizon, but also enable a comparison with peers. The financial risk assessment is not done in isolation but in conjunction with the business and the industry risks that the entity is exposed to. An entity with low exposure to business and industry risks would generally have stable cash flows and thus a higher tolerance to operate with a relatively modest financial risk profile. In contrast, entities that are exposed to high business and industry risks need to maintain a stronger financial risk profile for an adequate cushion to manage cash flow volatility. In case of groups consisting of entities with strong financial and operational linkages, various parameters such as capital structure, debt coverage indicators, and future funding requirements are assessed at the consolidated / group level. Since the prime objective of the rating exercise is to assess the adequacy of the entity's debt-servicing capability, ICRA draws up projections on the likely financial position of the entity under various scenarios.

The various financial metrices assessed by ICRA could be divided into five categories viz., Profitability, Leverage, Coverage, Liquidity and Cash Flows. This document provides a summary of these:

Profitability

Profitability metrics are a measure of an entity's efficiency and return on investments. It is imperative for most businesses to invest regularly in physical assets, product development, marketing, and human capital to sustain or improve their competitive positions. Entities that have superior profitability can do so through internally-generated resources with low dependence on external financing. Moreover, such entities are able to generate sufficient surplus for not only meeting debt servicing obligations but also to reward equity investors. This in turn improves their ability to attract fresh capital for future business requirements. Moreover, entities with higher profitability have better resilience to economic downturns and are more likely to generate adequate internal resources for re-investment and debt servicing.

Profitability is a measure of the earnings generated by an entity in a given time period in relation to the resources deployed and is measured by profit margins and the return on capital employed (RoCE). The CE industry witnesses significant variations in profitability through an industry cycle. Commodity price volatility and the ability to successfully pass on or absorb fluctuations can have a material impact on an OEM's profitability. A price undercutting strategy by any player to gain market share could lead to a discount war, which would have a more detrimental impact on high cost manufacturers. Procurement strategies and optimal supply chains allow for better asset efficiencies and retention of profit margins. Owing to the high operating leverage, profitability is contingent on asset sweating.

Leverage & debt coverage

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 interest as well as principal to the lenders as per a defined schedule. This increases the fixed cost burden on the borrowing entity and in the limiting case, increases the default risk. While high leverage may mean high risk from a credit perspective, it is an often-adopted course by shareholder-oriented managements, given that high leverage, in good times, leads to high returns on equity capital. An entity's financial leverage could thus 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 CE industry requires borrowings to fund capacity creation and to support its inventory and creditors. A high inventory level increases the holding cost and working capital requirements while inadequate inventory might lead to a market share loss.

ICRA adjusts an entity's receivables and debt for the bills discounted off-balance sheet (on recourse basis) to appropriately assess an entity's working capital cycle. It compares the working capital intensity of the entity to be rated with its peer group to gauge its ability to negotiate credit terms with customers and suppliers.

Coverage is a measure of an entity's debt-servicing ability and is calculated as the ratio of profits (or cash flows) to the debt-servicing obligations within a given period. The interest coverage indicator reflects the entity's ability to service the cost of external borrowings after meeting all operating expenses. It is an important rating consideration as a weak OPBITDA-to-interest multiple indicates the entity's inability to generating adequate operating profits to meet its interest obligations and may signal a default risk. The Debt-Service-Coverage Ratio (DSCR) indicates the entity's ability to service its interest and repayment from cash flows generated from the business. Retained cash flows-to-debt is an indicator of the cash available for reinvestment in the business and servicing of repayment obligations, after the interest pay-outs, working capital adjustments and taking into consideration shareholder interests through dividends.

Liquidity and financial flexibility

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 fund flow from operations, unencumbered cash and cash equivalents on balance sheet and cash inflows expected from the monetisation of physical and financial assets. External resources include undrawn lines of credit or equity capital. 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, capital expenditure and other investment outlays, dividend and share buyback-related outflows, besides the sudden demand arising from crystallisation of discrete events such as litigation penalty.

Higher the cushion available between the resources available (especially internal resources) and the obligations, the better the liquidity profile of an entity. Liquidity is generally assessed in conjunction with the vulnerability of an entity to timely refinancing / renewal of short-term sources of funding. Depending upon 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.

Foreign currency-related risks

Given the lack of local sources for several key inputs like undercarriage parts and special steel, import content in the Indian CE industry is high in select categories, exposing players to forex volatility. Imports and forex impacts the costing and pricing strategy; and raw material inventory requirements. Since several of the Indian CE manufacturers are subsidiaries/joint ventures of global OEMs, a bulk of the critical technology components come from the parent, in return for which the manufacturer also pays a royalty. The major international billing currencies for Indian CE manufacturers are the yen, the USD and the euro. ICRA takes into consideration the hedging policy of the entity towards mitigating such foreign currency risks and the impact of adverse movement in foreign exchange rates on its cost structure.

Tenure mismatches, and risks relating to interest rates and refinancing

Large dependence on short-term borrowings to fund long-term investments can expose an entity to significant re-financing risks, especially during periods of tight liquidity. Financial flexibility, and the existence of adequate buffers of liquid assets / bank lines to meet short-term obligations is viewed positively. Similarly, the extent to which an entity could be impacted by movements in interest rates is also evaluated.

Contingent liabilities/off-balance sheet exposures

ICRA evaluates the likelihood of devolvement of contingent liabilities/off-balance sheet exposures and the financial implications of the same.

Management Quality and Corporate Governance

All debt ratings necessarily incorporate an assessment of the quality of the rated entity's management. An entity with an experienced management and independent directors on its board are considered positive factors. An entity should practice sound corporate governance policies to serve the interests of all stakeholders. The management risk analysis also factors in the historical track record of the entity or group in timely servicing its obligations. Any delay or default history in the repayment of principal or interest payments reduces the comfort level for the rated entity's future debt-servicing capability and willingness. Nevertheless, ICRA appropriately analyses the reason behind past defaults, which could also be due to adverse demand situations in the underlying industry.

In addition, the rated entity's likely cash outflows arising from the possible need to support other group entities are of importance, in case the rated entity is among the stronger entities within the group. Usually, a detailed discussion is held with the management of the rated entity to understand its business objectives, plans and strategies, and views on past performance, besides the outlook on the rated entity's industry.

Some of the other points assessed are:

- Experience of the promoter/management in the line of business concerned
- Commitment of the promoter/management to the line of business concerned
- Policy of the promoter/management to risk taking and containment
- The entity's policies on leveraging, interest risks and currency risks
- The entity's plans on new projects, acquisitions, expansion, etc

Parentage

Considering that most of the large CE manufacturers in India are subsidiaries or joint ventures of global majors, the global parents' commitment to the Indian market and to the Indian entity being rated are critical. Parent support in the form of access to new technology, supply of components, beneficial credit terms and equity infusion has supported several of these manufacturers during cyclical downturns. Consequently, the parents' financial and operational strength, its strategy and commitment to the Indian operations are of importance. In case of joint

ventures between global OEM and Indian entities, the relative strengths brought by the partners to the JV, their commitment and willingness to fund growth are key monitorables. Development of substitutes to a JV, either through a wholly-owned subsidiary or an alternative manufacturing location in nearby geographies, could affect the Indian entity's future prospects. In case of a joint venture, equal commitment from both partners and a common strategy are critical.

Summing Up

ICRA's credit ratings are symbolic representations of its opinion on the relative credit risk associated with the rated entity. This opinion is arrived at following a detailed evaluation of the rated entity's industry, business and financial risks, its likely cash flows and the adequacy of such cash flows vis-à-vis the debt servicing obligations and other funding requirements. ICRA's rating approach also involves an assessment of the entity's management quality and governance practices. In addition to these considerations, an entity's credit rating may also be influenced by its ownership, the nature of linkages with its parent or group entities, degree of financial flexibility, the corporate legal structure, track record of operations and that of debt servicing, and vulnerability (if any) to discrete event risks.

ICRA's approach to rating CE manufacturers incorporates the evaluation of various business risk parameters such as an assessment of the manufacturer's market position, product portfolio, distribution network as well as the management strategy for maintaining financial performance through the economic cycle and its overall approach towards investment and growth. Quantitative factors coupled with the management's policy and risk appetite help ascertain the adequacy of future cash flows to service debt obligations in a timely manner.

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