RATING METHODOLOGY – COMMERCIAL VEHICLE MANUFACTURERS

December 2021

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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in December 2019. While this revised version incorporates a few modifications, ICRA's overall approach to rating commercial vehicle manufacturers 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 vehicles with GVW above 7.5T are categorised as M&HCVs[2]. The industry is also classified based on application between trucks and buses. Currently, the industry is dominated by the trucks (goods carrier) segment, whereas buses (passenger carriers) account for only 10-15% of the industry volumes.

Rating Methodology

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 CV manufacturers. 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 rating outcomes. 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 considered the most important. For analytical convenience, the key factors are grouped under the following broad heads – Industry Risk Assessment, Business Risk Assessment, Financial Risk Assessment, and Management and Governance Assessment, in addition to Other Considerations.

Industry risk assessment

- Cyclicality
- Competitive Landscape
- Regulatory/Policy Risks

Business risk assessment

- Scale and Market Position
- Product Portfolio
- Sales and Service Network
- Technology & Product Development Capabilities

1 Further bifurcated into Small Commercial Vehicles (SCV) and Pick-up Trucks, which are below 3.5T and LCVs, which are in the 3.5-7.5T range

2 Further bifurcated into Intermediate Commercial Vehicles (ICV) which have tonnage in the range of 7.5-12T, Medium Commercial Vehicles (MCV) which have tonnage in the range of 12-16.2T and Heavy Commercial Vehicles (HCV) which have tonnage higher than 16.2T

Financial Risk Assessment

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

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- Parentage
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- Business Diversification
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Management Quality Assessment

Assessment of Environmental, Social and Governance (ESG) Risks

- Environmental (E) and Social (S) Risks
- Governance Practices

Industry Risk Assessment

Cyclicality

The domestic CV industry, especially the goods carrier segment (which accounts for 85-90% of industry volumes), exhibits significant 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. 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 and in general, the capacity addition tends to be higher than the underlying demand. 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 impact the demand for new CVs in such periods. As a CV manufacturers' credit profile is prone to the risks arising from the cyclicality in demand, an assessment of its performance and financial policies is carried out through the cycle so as not to be affected by the point-in-time credit considerations.

Competitive Landscape

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. The competitive intensity of the domestic CV industry is increasing with the entry of new OEMs[3] into the market, 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 led to limited pricing power for the players, especially in the M&HCV truck segment, where discounting practices are rampant. While OEMs do engage in periodic price hikes to pass on the impact of increased compliance costs or input costs, the ability to pass these on remains a function of the market scenario. Given the intense competition in the industry and limited switching cost for the customers, the OEMs have to invest regularly in research and development (R&D) and new product development to differentiate and remain competitive in the market.

Regulatory/Policy Risks

The CV industry, over the years, has been witnessing regulatory changes in terms of tightening of emission norms, safety regulations, driver comfort and assistance, bus-body building norms, loading and overloading norms, electrification and fleet modernisation among others. 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. Additionally, such changes have the potential to impact the existing CV population (as was seen in the case of the revision in axle load norms in 2018) and new vehicle demand, as well as an OEM's ability to meet the revised norms. 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, to a large extent these have not been detrimental to the industry, given the general advanced nature of notice of these changes.

3 Original Equipment Manufacturer

Business Risk Assessment

Scale and Market Position

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. 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 enhance R&D capabilities. A large scale of operations also supports the 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 key 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 and operating flexibility. 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. As the market share of an OEM can vary over a period of time, various aspects are considered like the shift in consumer preferences, competitive intensity, new product introduction cycle and pricing strategy while evaluating the trend in market share.

Product Portfolio

The strength of a product portfolio is important 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 variation in a particular product category. An OEM with a meaningful presence across different tonnage segments, besides trucks and buses, is considered to have a diversified portfolio, making it less vulnerable to the changes in customer preferences. Additionally, OEMs with meaningful presence across the LCV and M&HCV (truck) segments tend to have a lower exposure to the cyclical trends in the goods industry. 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.

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 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, while evaluating an OEM's portfolio strength, due consideration is given to an OEM's brand strength.

Sales and Service Network

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. Thus, a widespread availability of spare parts and service workshops at multiple locations across the country is of great importance. Thus, with a well spread-out dealership 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 the sales mix across various regions domestically and the extensiveness of the dealership and the service network are taken into consideration. While the leading domestic players in the industry have a wide pan-India presence, foreign OEMs are currently investing in expanding their distribution network. In general, a widespread distribution 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 sales and cyclicality. OEMs that derive a meaningful proportion of their sales volumes and revenues from the export markets would be in a better position to mitigate the risks arising from demand slowdowns in the domestic market. 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 with the view to maintaining 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, tractor trailers that are customised to suit certain application segments.

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 on a forward-looking basis, due importance is given to an OEM's future product development strategy, technology tie-ups and R&D efforts. This is quantified by assessing the company's outlay towards R&D and capital expenditure (as % of sales). This is relevant as the industry (both domestic and global) is increasingly adopting cleaner vehicles, and hence updating the product portfolio to reflect the changing customer preferences is a compelling need. The OEMs' preparedness towards emerging trends such as electrification through product launches, technology tie-ups, investment and localisation plans etc. remains important to ensure future readiness.

Summary of the Salient Business Risk Factors

	Strongest	Weakest
Scale	The entity's revenues from CV operations is more than Rs. 20,000 crore	The entity's revenues from CV operations is less than Rs. 1,000 crore
Market Share	The entity's weighted average market share across CV segments is more than 30%	The entity's weighted average market share across CV segments is below 5%
Product Portfolio	The entity has presence across all five sub-segments (SCV, LCV, ICV, MCV, HCV) with top-3 segments <60% of revenues	The entity has high concentration on a single product/sub-segment (SCV, LCV, ICV, MCV, HCV) accounting for >90% of revenues
Sales & Service Network	The entity is highly diversified with healthy revenue mix from all major domestic regions Or The entity has high geographic diversification in terms of exports	The entity's sales are majorly limited to a specific region, and also doesn't have much export presence
Technology & Product Development Capabilities	The company has exhibited 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

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. Depending on the uncertainty around how the various credit drivers could evolve in the future, ICRA also carries out sensitivity analysis to assess the impact of the key variables on various financial metrics. 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 the resources deployed, or alternatively a measure of how efficiently an entity sweats/utilises its assets. From a rating perspective, both the level as well as the stability in profitability metrices 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 than 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, and also attract fresh capital. Further, sustainable and adequate margins are essential for an OEM to enable the ongoing investments, which are needed to maintain a technological edge. Moreover, as seen in industry downcycles, 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 the 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 to maintain high operating efficiencies to maintain 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 fluctuation in the prices of key raw materials such as steel, aluminium, rubber, and plastics remains a key sensitivity on the OEM's profitability. Thus, the ability of the OEM to effect price hikes to offset any impact of hikes in input costs remains a credit consideration.

Validation of Business Risk through Profitability Metrics
[Indicative Metrics[4]]

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

Leverage and Coverage Indicators

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

[4] 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 metrices 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.

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 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.

As the CV industry is prone to a high degree of cyclicality in demand, a period of demand slowdown can adversely impact the cash flow of any OEM. 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-EBIDTA multiple supports an OEM's 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 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 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.

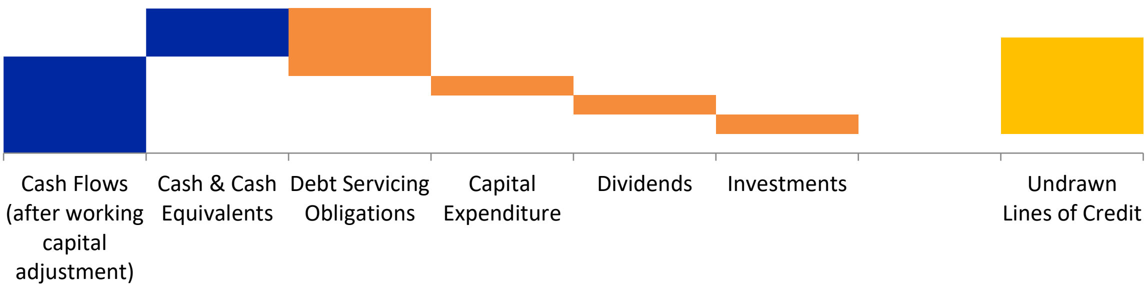
Assessment of Coverage
[Indicative Metrics]

	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 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 the crystallisation of discrete events such as 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[5].

Liquidity snapshot over any defined period



It is cash that is required to service the obligations. 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 buy-backs, and the free cash flows after meeting debt repayment obligations and capital expenditure needs. The cash flow analysis helps in understanding the external funding requirements that an entity has to meet its maturing obligations.

Financial Flexibility

An entity's financial flexibility (or the lack thereof) is reflected in its ability to access the capital or the money markets in a 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 and whenever required. Financial flexibility could emanate from factors such as an entity's large scale of operations with strong financials, large unencumbered cash flows (such as rental income, annuity payments in road projects), unencumbered assets and the flexibility to borrow against such assets, or strong 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.

[5] 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

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 source majority 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, which is likely to increase the contribution of exports in a company's sales mix (currently around 10%), thereby exposing the company 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 foreign exchange earnings or expenditure in relation to the total revenues. Foreign currency risk for an entity is measured by considering its un-hedged 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 re-financing 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.

Contingent Liabilities/Off-Balance Sheet Exposures

The likelihood of devolvement of contingent liabilities/ off-balance sheet exposures and the financial implications of the same are evaluated for this.

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 coverage indicators and future funding requirements[6].

Adequacy of Future Cash Flows

As the prime objective of a rating exercise is to assess the debt servicing capability of a company; ICRA draws up projections on the likely financial position of a company based on its operating performance while factoring in the capex and investment requirements as well as the upcoming debt obligations. A sensitivity analysis is also carried out, considering various probable circumstances and the adequacy of cash flows under each of these is assessed.

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

Other Considerations

Parentage

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 a few international OEMs through their wholly-owned subsidiaries and other well-established domestic OEMs. In cases where the company is owned by a foreign parent, the rating of the Indian entity could 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. It 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 profiles[7].

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 manufacturers 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.

Debt Servicing Track Record

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 and willingness. Nevertheless, the reason 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.

[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.

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. Depending on whether and when such events occur, the rating opinion could be substantially different. 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.

Business Diversification

With the CV industry being highly cyclical, diversification into other related businesses can help reduce the volatility in earnings or cash flows. In India, some of the CV manufacturers have presence in other segments of the automobile industry like passenger vehicles, two-wheelers, construction equipment, defence supplies and auto components. While diversification into related areas is a credit positive, ICRA evaluates such businesses from the perspective of their respective business profiles and contribution to consolidated earnings or cash flows. Accordingly, the demand prospects of key segments and geographies where the OEM is present are assessed, and 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 the future cash flows of the OEM.

Asset Concentration Risk

While evaluating an OEM, its manufacturing base is also given due consideration. 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. likely to disrupt the operations significantly. On the other hand, 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. An entity with an experienced management is considered a positive factor. The management risk analysis also factors in the historical track record of the entity or the group in timely servicing its obligations.

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

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 but 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 mollify 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 carbon-neutrality, 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. 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. Being in 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, 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. Instances of vehicle recalls and high warranty costs not only create an immediate financial implication but could also harm the reputation and create a more long-lasting adverse impact.

Governance Practices

A sound corporate governance structure attempts to make clear the distinction of power and responsibilities between the board of directors and the management. The constitution of an entity's board and the board of directors' participation in strategy formulation, besides the entity's adherence to legal and statutory compliance requirements, are factored in during credit assessments. ICRA seeks to gain a qualitative understanding of an entity's commitment towards following transparent and credible practices by the way its financial statements are reported, their level of disclosures, consistency in communication and the openness about sharing information during the credit rating exercise. Besides, the corporate group structure (whether simple or complex), the rated entity's related-party transactions and instances of supporting group entities at the expense of debt holders are assessed.

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 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 incorporates a number of factors, which include 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.

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	Market Share															
	Scale															
	Product Portfolio															
	Geographic Diversification															
	Technology & Product Development Capabilities															
Financial Risk	Profitability and Earnings Stability															
	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 illustration purpose 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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