ICRA

RATING METHODOLOGY – TRACTOR MANUFACTURERS

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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 tractor manufacturers remains materially similar.

Overview

Mechanisation levels in India have remained significantly lower than global benchmarks, with tractors being the mainstay to the move towards mechanisation. India is the largest tractor market in the world in terms of both sales and production volumes. Farming in emerging markets like India is characterised by small-sized farms, modest affluence level of farmers, as well as dependence on manual labour. Consequently, usage of small and medium powered tractors (cheaper in comparison to the higher horse-power ones) is more prevalent, and the market for higher horse-power (HP) tractors, and bigger agri-machinery like combine harvesters is limited, when compared to the developed markets.

The Indian tractor market is fairly consolidated with the bulk of the market share resting with the top few OEMs. While the tractor industry has relatively low entry barriers in terms of technology, it is the costs involved in branding and the setting-up of a distribution network for sales, spares and service that act as barriers. Also, as a large proportion of the sales are based on word-of-mouth feedback, a new entrant is expected to take considerable time to establish itself, and pose a threat to the incumbents.

Rating Methodology

This rating methodology provides a reference tool for issuers, lenders and investors to understand ICRA's approach in assessing the business and financial risk profiles of companies in the tractor manufacturing industry. It aims to help various industry participants understand ICRA's approach in analysing 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 usually considered the most important. For analytical convenience, the key rating factors are grouped under four broad heads—industry risk assessment, business risk assessment, financial risk assessment and management, governance and financial reporting assessment. Some other considerations are also discussed in this document.

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Industry Risk Assessment

Growth Prospects

Over the past ten years (FY2011–FY2021), the Indian tractor industry has grown at a moderate CAGR of 6.1% (sales volumes), aided by support from the Government of India (GoI) towards rural development and agri-mechanisation. Prospects of the tractor industry are closely linked to the country's farm sector, and remain impacted by a multitude of factors. India's current tractor penetration is estimated at ~52 tractors per 1,000 hectares of agricultural land. While this is close to the average of some countries, this statistic needs to be understood in the context of the fact that most of the land holdings in India are smaller than those in the developed markets. Also, penetration numbers vary widely across states, with regions like Punjab, Haryana or Western Uttar Pradesh enjoying significantly higher penetration compared to the rest of the country. In contrast, regions like Eastern Uttar Pradesh, West Bengal, Odisha, Madhya Pradesh, Karnataka and Andhra Pradesh have relatively low penetration levels and are expected to be the drivers for industry growth, going forward. In effect, with an overall modest penetration, there remains sufficient headroom for moderate to healthy growth in the tractor industry over the long-term.

Competitive Intensity

The Indian tractor market is fairly consolidated with the bulk of the market share resting with the top four OEMs—namely, Mahindra & Mahindra Limited, Tractors and Farm Equipment Limited, International Tractors Limited and Escorts Limited. The competitive intensity in the industry however has remained high. With relaxation of foreign direct investment (FDI) in agriculture to boost productivity, large international participants such as AGCO Corporation, CNH Global and John Deere entered the Indian market a long time ago. Most of these international manufacturers have continued to maintain their presence in India either through their wholly-owned subsidiaries or through joint ventures (JVs) and technical collaborations with Indian companies. While the tractor industry has relatively low entry barriers in terms of technology, it is the costs involved in branding and the setting-up of a distribution network for sales, spares and service that act as barriers. Also, as a large proportion of the sales are based on word-of-mouth feedback, a new entrant is expected to take considerable time to establish itself, and pose a threat to the incumbents.

Government Policies

Agriculture has been among the key focus areas for the GoI as it employs a significant share of the domestic workforce. Moreover, the sector's health is critical to sustainably meet India's food security needs. To meet these objectives, the GoI has maintained its emphasis on supporting investments in agricultural research and development (R&D), besides supporting mechanisation of farmlands. In this regard, the GoI has consistently increased its budgetary outlay towards various farm development schemes such as Macro Management of Agriculture (MMA), Rashtriya Krishi Vikas Yojna (RKVY), National Horticulture Mission (NHM), and National Food Security Mission (NFSM), among others, apart from extending assistance under agricultural mechanisation initiatives. Additionally, various state governments also roll-out incentives in the form of subsidy to boost farm machinery purchases, while offering loan waivers to assuage the concerns of the farming community from time to time.

In conjunction with the above-mentioned schemes, minimum support prices (MSPs) for various crops as well as subsidies on fertilisers, electricity and diesel are offered with the intention of favourably influencing demand side drivers for farm mechanisation. ICRA, thus, evaluates the likely impact of various Government policies, targeted towards enhancing agricultural productivity and mechanisation levels, on demand in the domestic tractor industry.

Cyclical Nature of Industry/Dependence on Rainfall

The volumes in the domestic tractor industry exhibit significant cyclicality, with its prospects closely linked to the performance of the farm sector, which is correlated with the monsoon performance. Thus, adoption of prudent business and financial risk policies remain essential for a tractor OEM to reduce vulnerability to periods of downturn in demand, which are characterised by weak agri cash flows and investment sentiments. Given the cyclical nature of the industry, ICRA carries out sensitivity analysis under various scenarios of demand, to account for risks across the business cycles and to see that the analysis is less affected by point-in-time credit considerations.

Despite various schemes implemented by both the Central (for instance, Pradhan Mantri Gram Sinchai Yojana) and the state governments to improve irrigation facilities, the irrigation penetration across several regions remains low, leading to heavy dependence of crop output and farm sentiments on the monsoons. ICRA assesses the spatial and temporal dynamics of the rainfall pattern, in addition to the overall magnitude while evaluating its impact on demand for tractors. Other variables such as the crop sowing pattern and irrigation penetration across regions are also monitored.

Business Risk Assessment

Scale and Market Position

The scale of operations, as measured by the company's revenues and production output, is one of the primary factors in evaluating the business position of a tractor OEM. A large scale of operations drives cost and manufacturing process efficiencies, supports meaningful diversification across products and geographies, leading to stronger bargaining power with various stakeholders in the value chain.

ICRA analyses the market share of a tractor OEM at both an overall industry level as well as segments in which it is present. The market position of an OEM is a function of various factors such as brand strength, product characteristics, sales and service network and pricing strategy. The Indian tractor industry is fairly consolidated with a bulk of the industry driven by the top four OEMs; entry barriers in the form of costs and time involved in building brands, expanding the distribution network, establishing financing tie-ups exist.

The competitive intensity in the domestic tractor industry has increased over the years as evident from the increasing pace of new product launches and variants, greater marketing push by OEMs, and their efforts to expand geographic presence as well as engine HP categories. A sustained revenue growth above the industry average is a strong positive and reflects increase in an OEM's market share on the back of successful product launches, entry into newer segments/ product lines or ability to command premium pricing. On other hand, stagnating or declining revenues, despite the backdrop of positive industry level growth, is indicative of an OEM's limited product portfolio or its inability to introduce products in line with customer requirements.

Geographic Diversification/Dealership Network

A meaningful presence of a tractor OEM across various regions in India is a credit positive; tractor penetration varies widely across different parts of the country, with certain regions enjoying significantly higher penetration and others with relatively lower penetration levels. Further, different regions exhibit diverse sales patterns determined by rainfall dynamics, soil conditions and irrigation penetration. A well spread distribution/service network remains of paramount importance for the tractor manufacturer to achieve healthy geographic diversification (since tractors are generally purchased directly by the end-consumer in rural areas), and thus remains a key evaluation criterion.

While leading domestic players in the industry already have a wide geographic presence, subsidiaries of various international OEMs have been investing in expanding their distribution network. ICRA assesses the contribution of different regions to the overall sales mix of an OEM; channel inventory levels across various regions are also attempted to be understood through discussions with the OEMs during the management meetings. Given the significant potential that exists in the exports market, ICRA also evaluates the tractor OEM's initiatives towards country-specific product development as well as distribution network development in the target nations.

Product Portfolio

A strong product portfolio is essential for an OEM to sustain/improve its market position and enable it to cater to a diverse customer profile. A diversified product portfolio (across HP segments) enhances an OEM's ability to counter any demand variations in a particular product category. Additionally, it is imperative for an OEM to continuously refresh its product profile, thereby addressing the evolving needs of its customers and keeping up with the latest technological developments and any changes in regulatory requirements (such as emission norms).

India's agricultural sector is characterised by small land holdings, modest affluence level of farmers, and easy availability of manual labour. The domestic tractor industry has traditionally been a medium HP industry (30-50 HP) with this segment offering the maximum number of tractor models. However, over the past few years, tractor OEMs have expanded their product portfolio by launching products in both lower and higher powered categories. While lower HP tractors are targeted towards small and marginal farmers as well as orchard farming, higher HP tractors are generally targeted towards affluent farmers, who can derive commensurate benefits on account of their owning higher acreage. The Indian market has seen a gradual increase in demand for higher HP tractors over the past few years, with tough soil conditions in certain regions necessitating higher tilling capacity. Additionally, an increase in exports (medium HP tractors for developing markets and high HP market for developed markets) as well as tractor usage for non-agricultural applications have led to demand growth in the higher HP segments. Along with a diversified product profile, bundled offerings of tractors with farm implements enhance an OEM's value proposition to its customers. An OEM's revenue growth prospects are also enhanced when it manufactures such farm implements.

ICRA evaluates an OEM's product portfolio across product segments—tractors and farm equipment—and HP categories in the tractor segment. Not only does a diversified presence protect an OEM from demand contraction in a particular segment in case of increase in competition or change in customer preferences, it also enhances the OEM's growth prospects, with a diverse product portfolio across HP segments allowing it to cater to varied customer segments. ICRA also evaluates the OEMs' new product launch plans to estimate business growth rates, going forward.

Technology and Product Development Capabilities

Indian tractor OEMs have stepped up their product development efforts over the years, in keeping with the increased awareness and expectation levels of the consumers in terms of power, comfort and safety, etc. This apart, with evolving regulatory requirements (i.e., emission norms and safety regulations), OEMs are steadily investing in developing new and advanced platforms that enable them to offer an improved product to the customer. An OEM's preparedness towards emerging trends in terms of product introductions, technology tie-ups, investment and localisation plans etc. remains important to ensure future readiness. As a result, while evaluating competitive positioning of an OEM, ICRA evaluates an OEM's in-house technical capabilities, its tie-ups with external institutions for product design / engineering, besides its new product development plans to assess its technological capabilities.

Summary of the Salient Business Risk Factors

	Strongest	Weakest
Scale and market position	The entity's market share (domestic+exports) is greater than 20%	The entity's market share (domestic+exports) is below 2%
Geographic Diversification	The entity is highly diversified with healthy revenue mix from all major domestic regions Or The entity is primarily a supplier to foreign parent/OEM which has high geographic diversification	The entity's presence is limited to upto 2 geographic regions, irrespective of the market share in the respective markets
Product Portfolio	The entity has a market share of greater than 10% across all 5 HP segments	The entity's presence is limited to upto 2 HP segments, irrespective of the market share in the respective segments
Technology & Product Development Capabilities	The entity has been a pioneer in launching new application specific products or has an international parentage which ensures access to new technologies	The entity's product profile indicates minimal investment in technology

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. To get a sense of how the various credit drivers could evolve in the future, ICRA also carries out sensitivity analysis under various scenarios of demand, given the cyclical nature of the industry.

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. Furthermore, sustainable and adequate margins are essential for an OEM to enable the ongoing investments, which are needed to maintain a technological edge.

Although the tractor industry is dominated by a few large players, the high competitive intensity in the industry mandates high operating efficiencies for the OEMs to maintain stable profitability. The profitability of tractor OEMs is generally linked to the trend in demand growth; operating profit margins for industry participants typically expand during industry up-cycles and face pressure during periods of downturn. While a healthy and relatively stable profitability is indicative of an OEM's operational efficiency in its manufacturing operations, and the extent of outsourcing, it also reflects the OEM's pricing ability, product mix and bargaining power with its suppliers.

A significant part of the manufacturing activity in the tractor industry is outsourced by the OEMs to component suppliers, helping the OEMs focus on key activities like product design and development, marketing and distribution, and assembly operations, while also giving them greater flexibility during cyclical downturns. In such an outsourcing model, component suppliers are also required to invest in building capacities on behalf of the OEMs they service. Given such an arrangement, an OEM's relationship with its component suppliers is critical in ensuring disruption-free production and in supporting its new product development initiatives. A strong vendor network helps the OEMs work on lean working capital cycles, while also aiding in high localisation levels and, thereby, better profitability metrics.

With raw material costs being the largest component of a tractor OEM's cost structure, any fluctuation in prices of key raw materials such as steel, aluminium, rubber and plastics has a direct impact on the OEM's profitability. Thus, the ability of an OEM to undertake price hikes to offset the impact of hike in input costs remains an important rating criterion. While industry players generally maintain pricing discipline, most resort to aggressive discounting in periods of demand contraction, impacting profit margins adversely.

Validation of Business Risk through Profitability Metrics
[Indicative Metrics[1]]

	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 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 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 tractor industry is prone to high degree of cyclicality in demand, a period of demand slowdown can adversely impact the liquidity conditions for any OEM. As such, OEMs with healthier balance sheets are better positioned to sustain 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 tight liquidity conditions, which helps in building strong ties and in strengthening its market position over the long-term. A low Total Debt-to-EBIDTA multiple supports and 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

[1] 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.

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 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 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

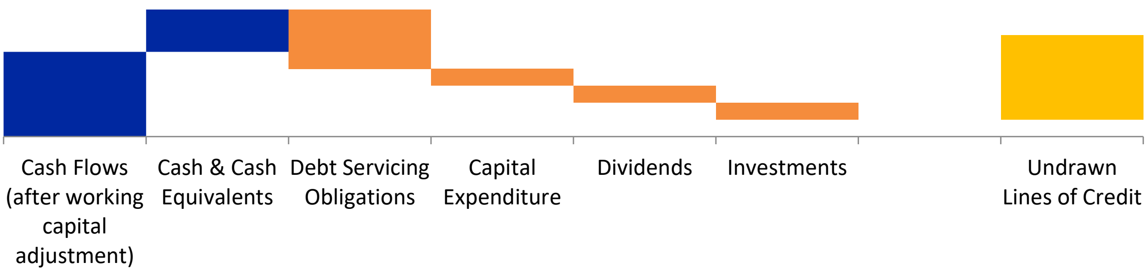
[Indicative Metrics]

	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 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 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[2].

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 funds flow from operations, cash consumed to fund the working

2 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

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 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 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.

Foreign Currency Risks

Such risks arise if an entity's primary costs and revenues are denominated in different currencies. The tractor industry's exposure to fluctuations in foreign currency with regards to imports generally remains low, as the OEMs generally source a majority of their components from local vendors, as compared to other automotive segments such as passenger vehicles, where import content is relatively higher. With significant potential existing in the exports market, tractor OEMs have been launching tractors customised for various market requirements, thereby exposing the company to fluctuations in foreign currency rates. 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 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 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 tractor industry in India comprises of some players operating 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[3].

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 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.

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 tractor industry is characterised by the presence of a few international OEMs through their wholly-owned subsidiaries, and a greater number of well-established domestic OEMs. In cases where the company is owned by a foreign parent, the rating of the Indian entity is 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[4].

Financing Availability

A majority of tractors sold in the domestic industry are financed by buyers through banking and non-banking finance channels; even as some tractor OEMs also have tractor financing arms/tie-ups with lenders, non-captive lenders continue to constitute the bulk of the financing in the industry. As such, a healthy financing availability remains key in supporting the sales volumes in the industry. Since loan servicing in the industry remains primarily cash-based, a cash crunch in the farming community can lead a decline in collection efficiencies and impact the delinquency levels of financiers; an increase in delinquency levels generally leads to financiers adopting more prudent lending norms for managing their exposures to bad loans and, thereby, reduces financing availability.

An OEM with a captive finance arm or with established tie-ups with other lenders is able to facilitate greater volume of sales and thus support its market position. In evaluating tractor OEMs with captive finance arms, ICRA evaluates the tie-up between an OEM and the financing arm; various aspects such as the capital requirements, loss sharing agreements, or any other support extended to the financing entity are also evaluated. While the captive arm supports business growth, maintenance of lending

[3] For more details, please refer to ICRA's methodology titled 'Rating Approach—Consolidation' available at www.icra.in
[4] 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.

discipline and adequacy of risk management practices remain critical in ensuring healthy asset quality while controlling 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. The company's ability to honour its debt obligations during the period of cyclical stress is also factored 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. 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 tractor industry being highly cyclical, diversification into other related businesses can help reduce the volatility in earnings or cash flows. In India, some of the tractor manufacturers have presence in other segments of the automobile industry like passenger vehicles, two-wheelers, construction equipment and auto components. While diversification into related areas is a credit positive, ICRA evaluates such businesses from the perspective of their respective business profile 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. The OEMs which have only a single manufacturing facility remain exposed to asset concentration risks, with force majeure incidents, or issues like labour unrest, political uncertainties etc. likely to disrupt the operations significantly. 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. 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 credit assessment of entities, ICRA seeks to incorporate all 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 since 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 crystallize differ 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 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.

Tractor entities growth prospects remain exposed to impact of climate change on agricultural production. They are also exposed to risks related to evolving regulations on emission norms, even though to a relatievely lesser degree than other automotive segments. Even as there is an increasing focus on carbon-neutrality, the likelihood of sudden impactful developments on this front for the tractor industry remains unlikely. Accordingly, entities in the tractor industry have a low exposure to environmental risks.

On the social dimension, the tractor industry has a prominent dependence on human capital, in terms of direct and indirect employees as well as contractual labour. Being in the manufacturing business, maintaining healthy employee relations by the OEMs as well as the supplier ecosystem is essential for disruption-free operations. Events that impact farm labour availability such as a migration to urban areas, can also influence the industry growth prospects over the medium to long-term. Nonetheless, entities in the tractor industry have a low exposure to social risks.

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 to 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 tractor 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	Scale and Market Position															
	Geographic Diversification															
	Product Portfolio															
	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.
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