RATING METHODOLOGY – AUTO COMPONENTS

OCTOBER 2024

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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in October 2022. While this revised version incorporates a few modifications, ICRA's overall approach to rating entities in the sector remains materially similar.

Overview

With an estimated turnover of over Rs. 6 lakh crore in FY2024, the Indian auto component industry accounts for around 2.3% of the Indian gross domestic production (GDP). The demand for the Indian auto component industry can be classified into sales to original equipment manufacturers (OEMs; 56% of revenues in FY2024) which manufacture or assemble vehicles in India, aftermarket or replacement sales in India (15%) and exports to overseas OEMs/Tier-I suppliers or the aftermarket (29%). In some cases, Tier I suppliers[1] route part of the replacement sales through OEMs, as OE spares (OES). Often, revenue from the OEMs accounts for bulk of the revenues for auto component suppliers followed by exports and/or replacement sales for large auto component suppliers.

Typically, margins from the replacement and the export segments are higher than domestic OE segment. To establish a wider replacement market footprint, auto component manufacturers need to make investments for setting up a distribution network and incur sales and marketing expenses, which may be compensated by relatively superior contribution margins, earned from replacement market sales compared to sales to the OEMs.

Auto component manufacturers need to regularly invest in capacity expansion and product development, in line with the plans of their OEM customers. The capital intensity/capex for auto component manufacturers has gone up over the years, as the OEMs are increasingly adopting a leaner structure focussing on new product development, technology and regulatory changes. Such investments typically have a long gestation period and carry risks, especially if it involves supplies to new platforms. Besides capacity expansion, acquisitions have been a common strategy for growth pursued by large Indian auto component manufacturers. They typically help expand product lines and provide access to new markets/segments/customers. Acquisitions by Indian auto component manufacturers in the past were primarily in Europe and North American markets, aimed at technology and marquee customer acquisitions. The ability to draw synergies, turning around the global operations and rationalising costs are critical to integrating an overseas acquisition.

This methodology note describes the key factors considered by ICRA in assessing the credit risk of auto component suppliers. The objective of the note is to help investors, bankers, issuers and other market participants understand ICRA's approach to analysing the creditworthiness of rated entities in the auto component industry. This document does not include an exhaustive discussion of all the rating factors that our

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[1] Tier I companies are direct suppliers to OEMs. Tier II companies are the key suppliers to tier-I suppliers without supplying a product directly to OEM companies. However, the same entity may be a tier-I supplier to an OEM and a tier-II supplier to another entity; or the same entity may be a tier-I supplier for one product and a tier-II supplier for a different product line of the same OEM.

analysis considers but provides an overall perspective on the considerations that are usually the most important.

The rating methodology broadly highlights the quantitative and qualitative risk factors that are likely to influence the rating outcomes in the auto component industry, including, but not restricted to:

Industry Risk Assessment

- Cyclicality
- Regulatory risks
- Competitive intensity

Business Risk Analysis

- Scale
- Market position
  - Technology and product complexity
- Diversification
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  - Segmental and client diversification
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Financial Risk Analysis

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Industry Risk Assessment

Cyclicality

The auto industry operates in an environment where demand could be cyclical, leading to periods with variability in revenues and profits. This is seen to be more pronounced in auto component suppliers catering to the commercial vehicles (CV) segment. Exposure to cyclical segments implies a lower tolerance for financial and operating leverage as adverse swings in profits heighten the probability of default. In periods of downturn, the receivables cycle with the OEMs could also get elongated, hurting cash flows. An entity's exposure to more cyclical segments of the auto industry, therefore, weighs on the rating, all else being equal.

Regulatory Risk

The regulatory interventions in the sector are primarily around product emission and safety norms, which are required to be met by the OEMs and indirectly by the auto component suppliers of the related products. The emission and safety norms have been progressively tightened to minimise the carbon footprint and improve passenger safety. These changes result in volatility in demand closer to the switching date. For example, the change in overloading norms in FY2019 for CVs was a demand-deterrent for CV-focused auto ancillaries for a brief period post the switchover date. On the other hand, some ancillaries are also benefitting from the evolving regulatory norms (for example, those manufacturing safety-critical components like seat belts and air bags). Similarly, the increasing adoption of electric vehicles would impact demand for some auto ancillaries – particularly those engaged in engine and transmission components – over the medium term. However, there will be opportunities for ancillaries to develop new components such as batteries, motors and sensors, to name a few. This makes it critical to develop capabilities to regularly update their product offerings and invest in new products to retain and improve the share of business with the OEMs, given the evolving regulatory landscape. Overall, while there have been regulatory changes, these have not been detrimental to the industry to a large extent, given the general advanced policy roadmap provided for affecting these changes.

Competitive Intensity

Often, the OEMs have multiple vendors for same components, which restricts the pricing power of auto component suppliers. Moreover, imported components, particularly bought-out components and child parts could act as an alternate source of supply for the OEM and limit the pricing flexibility for the domestic suppliers. Organised players witness intense competition from the unorganised segment and spurious parts in the replacement segment. Changes in import duties or free trade agreements (FTAs) could also have a bearing on the competitive position of Indian auto component suppliers. In exports, the Indian ancillaries witness competition from large global multinationals and vendors from China, Southeast Asian countries, and Europe. The revenue contribution of Indian ancillaries to the global ancillary ecosystem, is currently minimal, albeit having high potential.

An auto component manufacturer, with a high value-added product portfolio with high entry barriers due to technology or capital-intensive operations, witnesses lower competition compared to manufacturers of low value-added products with low entry barriers for competition. Manufacturers of cold forged and engine components, for example, witness lower competition and relatively higher profitability compared to those in relatively commoditised sheet metal components.

Business Risk Assessment

Scale

An entity's scale, reflected in its revenue base, is one of the key drivers of business strength and operating flexibility. Large scale of operations generally reflect greater market penetration, improved bargaining power and higher purchasing/operating efficiencies, while enhancing the business attractiveness for various stakeholders, including employees, customers and investors. Effectively, a large scale enables better cost absorption and greater ability to offer competitive pricing to buyers. The size of an auto component manufacturer is crucial as larger suppliers typically receive preference from the OEMs during source selection, resulting in a relatively superior wallet share with the OEMs compared to their smaller peers.

An entity's ability to sustain volume and revenue growth above the industry average, especially in comparison to its principal OEM, or increase its content per vehicle is a strong positive. Such growth typically reflects an increase in market share and/or improved geographic and/or customer diversification and/or product diversification. On the other hand, a declining revenue trend during a period of robust industry growth or reduction in content per vehicle could be indicative of a contracting market share, failing product lines of the ancillary or the OEMs. An increase in price realisations, attributable to a price increase by the OEMs purely to offset higher input price, however, does not reflect real growth. Nevertheless, improved price realisations due to higher value addition and better product mix is a credit positive and could result in sustainable improvement in profitability.

Market Position

While analysing an entity's market position, ICRA tries to evaluate its overall market share and its share of business (SoB) with its key OEM customers, wherever possible. A vehicle platform has its own lifecycle, which the OEMs generally extend by regular refreshes and new model launches on a periodic basis. A healthy SoB across different vehicle platforms, coupled with the regular addition of new platforms, helps an auto component manufacturer withstand the revenue impact of transition from a 'sunset' (outgoing model) to a 'sunrise' (newly launched) vehicle model. A strong market position with an OEM is a good proxy of the entity's relative bargaining strength with the OEM in most cases, bolstering its ability to withstand cost pressures to a large extent.

To assess the market position of an auto component manufacturer, wherever possible, ICRA understands the company's market position vis-à-vis competition and the market share of its customer OEMs from whom it derives a large share of its revenues. A well-established market position of the OEM typically provides a stable revenue base and a platform for sustainable earnings and cash flow generation for its Tier I and II suppliers. There are instances where the OEMs provide direct (loans/equity infusion) as well as indirect (favourable credit period) support to Tier I suppliers with whom they enjoy a strong relationship or have a high dependency for supplies of critical components. Consequently, the strategic importance and a high SoB with the OEMs is considered a credit positive. In case of the ancillary's products having meaningful aftermarket requirement, ICRA also tries to assess the market share in the addressable replacement market segment.

Technology and product complexity

With the automobile industry moving towards shorter product lifecycles and common global platforms, the ability of a supplier to partner with the OEM during new product developments is crucial for sustained business growth. With increasing pressure on product pricing, an entity's efforts towards product engineering to reduce costs and enable product differentiation also plays a critical role in strengthening relationship with the OEM.

R&D expenses in the Indian auto component industry remain low (1-2% of revenues) compared to developed markets, where some of the larger players invest 8–11% of their revenues in R&D. In India, several auto component manufacturers have entered into technical collaborations with international Tier I manufacturers for the transfer of technical knowledge; or have formed equity partnerships with foreign players to meet the OEMs' technical requirements. Suppliers that have proprietary

knowledge, tend to enjoy superior profitability metrics, relative to those that cater to customer-provided designs. The presence of a strong technology partner not only mitigates technology obsolescence risk, but in some cases also provides additional business opportunities to cater to the domestic establishments of the partner's global customers. Over the years, overseas acquisitions have also helped Indian component manufacturers gain technological knowhow and add new customers, apart from expanding their geographical footprint.

The advent of electric vehicles is a key technological development that is likely to impact some auto ancillaries – particularly those involved in engine and transmission components – over the medium term. The readiness of impacted ancillaries to develop alternative revenue streams is assessed and the ability to seamlessly transition into alternative products without loss of revenues is definitely a credit factor. At the same time, there would be opportunities for ancillaries to develop several new products which find application in electric vehicles.

Diversification

Revenue mix

A balanced mix of OEM and aftermarket business is a positive. Typically, a strong aftermarket presence provides greater revenue stability and higher operating margins, compared to concentration on the OEMs. However, barring branded components like batteries and tyres, ICRA has observed that a healthy share of OEM business is often required for a strong presence in the aftermarket, given the brand visibility and loyalty, particularly from a first-time replacer. This is particularly important in cases where the auto component manufacturer has not established a strong brand. Strong aftermarket presence benefits auto component manufacturers during periods of volatile commodity prices and cushions profitability, due to higher pricing flexibility. During an economic slowdown, a manufacturer with a strong presence in the aftermarket can withstand pressure on the top-line and profitability relatively better than those supplying predominantly to the OEMs. Similarly, when supply issues of certain parts impact vehicle production, presence in the aftermarket segment can mitigate revenue risks to an extent.

Certain auto components (like crankshafts and fuel tanks) do not have a meaningful aftermarket requirement, as the operating life of such components is generally at par with the life of the vehicle. Consequently, parts suppliers of such products are analysed accordingly for their revenue mix. Also, having multiple products or being part of a larger group gives the company the flexibility to cross-sell and bundle multiple products to the customers.

Segmental and client diversification

An auto component manufacturer with a product portfolio catering to multiple automotive segments (CVs, passenger vehicles, two-wheelers, tractors, etc) is in a better position to withstand the vulnerabilities arising from the decline in volumes in any specific segment. For instance, a supplier catering only to the highly cyclical CV industry would witness higher volatility in its earnings and cash flows, compared one supplying to a diversified component. Business diversification could also refer to exposure to non-automotive engineering segments such as locomotive, marine and defence, railways among others. ICRA views such non-automotive diversification as a positive rating factor, provided the earnings derived from such diversification are material.

Within the OEM business, auto component manufacturers with higher client diversity tend to enjoy greater stability in revenues and profitability over a longer time horizon. However, each individual segment of the Indian automobile industry is currently an oligopoly with few OEMs accounting for a major share of the market. Hence, auto component manufacturers can achieve meaningful client diversity, largely by catering to multiple segments of the industry or by having significant exports. There are instances where the OEMs enjoy strong relationship or have high dependency for supplies of critical components on a given supplier. They may even have equity stake in the suppliers in certain cases. Such instances are not necessarily viewed unfavourably, even if the supplier concerned has a high customer concentration, provided the OEM concerned has a healthy and secure market position. In certain cases, the OEMs have also made sizeable investments in tooling and other processes along with vendors, resulting in high switchover cost for the OEMs and consequently a stable wallet share for vendors. In such

cases, strong market position of the principal customer and the supplier's wallet share in the OEM's order book for upcoming and existing models could partly offset client concentration risk.

Most of the Indian auto component manufacturers, however, have a relatively narrow product line compared to global majors, which restricts their presence to a specific product segment. A company with multiple product offerings has the opportunity to cater to a wider client base and could outperform the underlying industry growth by improving content per vehicle.

To improve operational efficiencies and strengthen the overall supply chain network, the OEMs are increasingly focusing on consolidation of their vendor base. Consequently, a supplier of multiple products could benefit as it will be easier for an OEM to manage a single vendor with multiple product offerings rather than negotiate with several small vendors with single products. However, the OEMs also balance the trade-off between over-reliance on a smaller set of vendors for efficiency, while risking business continuity because of a lean vendor system.

Geographic diversification

ICRA also considers the revenue mix in the context of domestic and exports sales. A balanced mix offers diversification benefits. For example, a demand slowdown inflicting one geography may be offset by growth in the other. Indian auto component exports are often targeted at the overseas replacement market, which is relatively diversified and stable compared to exports to global OEMs or their Tier I suppliers. However, auto component manufacturers are often dependent on a few customers when the exports are to the Tier I/OEM segment because of the consolidated nature of the industry globally, which results in client concentration risk in certain cases, especially when the products do not have a sizeable replacement market. In India, there are only a few auto component manufacturers who have been able to achieve a meaningful geographical diversification.

Summary of the Salient Business Risk Factors

	Strongest		Weakest
Scale	> Rs. 2,500 crore	⇨	Less than Rs. 250 crore
Geographic Diversification	No region accounts for >50% of revenues	⇨	One region accounts for > 85% of revenues
Customer Diversification	Largest customer accounts for <30% of revenues	⇨	Largest customer accounts for >90% of revenues
Share of business with OEMs and market share of OEMs	Industry market share of the OEMs to which the entity supplies is >40% and Entity's share of business of the OEM is >70%	⇨	Industry market share of the OEMs to which the entity supplies is <5% and entity's share of business of the OEMs is <30%
Segment Diversification (M&HCV, PV, 2W, tractors, etc)	No single segment accounts for >30% of revenues	⇨	Presence in a single segment
OEM Supplies Vs Replacement Mix	>30% of sales derived from aftermarket	⇨	< 5% of sales derived from aftermarket
Technological Capabilities and Barriers to Entry	Strong in-house design, engineering and development capabilities such that the company is likely to stay ahead of the technology curve or /and subsidiary of a leading foreign player resulting in ready access to the necessary technical know-how	⇨	Commoditised products account for majority of revenues; the product lines are largely in matured technologies and thus competitive intensity is structurally high

Financial Risk Assessment

ICRA analyses the long period past financial performance trends and estimates future financial performance to assess the financial risk exposure of an entity. The financial metrics provide a useful reference not only to evaluate the performance trends of an entity over a given time horizon, but also enable a comparison with its 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 would have a higher tolerance to operate with a relatively modest financial risk profile. In contrast, those exposed to high business and industry risks need to maintain a stronger financial risk profile to have an adequate cushion to manage cash flow volatility. The various financial metrices assessed by ICRA could be divided into five categories viz., Profitability, Leverage and Coverage, Working capital intensity, Liquidity and Cash Flows. Since the prime objective of the rating exercise is to assess the debt-servicing capability of an entity, ICRA draws projections for the rated entity based on the expected movements in operating performance, while factoring in capex/investment requirements and upcoming debt obligations. Depending on the uncertainty around how the various credit drivers could evolve in the future, ICRA also carries out a sensitivity analysis to assess the impact of the key variables on the various financial metrics.

Profitability and Earnings Stability

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 and its operating efficiency. Profitability can be influenced by multiple factors, including those that are firm-specific such as product profile, or those that are related to the industry, economy or regulations. From a rating perspective, both the levels 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. Entities with higher profitability than their peers are likely to show stronger resilience against economic downturns and are more likely to generate relatively higher internal resources for re-investment and debt servicing, and thus attract fresh capital.

The various ratios which are typically used by ICRA to analyse an entity's profitability are Operating Profit Margin (OPM), Net Profit Margin (NPM) and return on capital employed (RoCE). Apart from the proportion of variable and fixed costs, one of the other key factors that influence OPMs of an auto component manufacturer is the proportion of revenues derived from aftermarket and exports (a higher proportion typically signifies better margins, ceteris paribus). Higher asset sweating and a lean working capital cycle drive the RoCE. Overall, healthy profitability metrics lead to adequate cash flow generation to support debt servicing, margin funding for working capital borrowings, and capital expenditure needs linked to expansion. An entity's ability to sustain profitability through a business cycle is one of the key factors that ICRA incorporates in its analysis to differentiate between rated entities. Raw material cost accounts for a considerable portion of an auto component manufacturer's cost structure. There could be inflation in other costs as well. Therefore, the ability to pass on raw material price changes or other forms of cost increases to the customers in a timely manner can influence profitability. Auto component manufacturers producing technology-intensive products, where competitive pressures are benign, are relatively better placed for passing on cost increases to customers compared to players with the presence in relatively lower value-added components. Further, since some OEMs stipulate periodic price reduction through the life of their supply contracts, auto component manufacturers must continuously work at improving operational efficiencies and undertaking 'value analysis and value engineering' projects to optimise product costs. A lean operating set-up, characterised by low fixed overheads and prudent working capital management provides rated entity the ability to flex costs and expenses during a down cycle, thereby protecting its profitability.

An entity's ability to consistently generate profitability over and above its cost of capital reflects well on its long-term business viability. However, the profitability of an entity may slide in a particular year if it undertakes a large capital expenditure (capex) programme or pursues an acquisition. ICRA does not necessarily perceive this as a negative, if in its assessment, the capex or the acquisition, is likely to generate adequate returns in the future.

[Indicative metrics[2]]

	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.

Debt for auto component manufacturers can be broadly divided between long-term debt availed for organic or inorganic expansion and short-term debt for working capital financing. 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 various ratios which are typically used by ICRA to analyse an entity's financial leverage are gearing, indebtedness ratio, debt to profit ratio and accruals to debt ratio. While gearing is a common measure, ICRA also looks at Total Indebtedness Ratio as it is a useful tool to analyse companies, which rely primarily on non-fund-based facilities (like Letters of Credit) or extended credit suppliers with its suppliers for funding their working capital requirements. The Debt-to-Profit Ratio measures an entity's susceptibility to volatility in profits and is seen in conjunction with the tenor of the debt, as two entities with similar Debt-to-Profit Ratio could have different financial risk profiles, depending on the debt tenor. One having a longer repayment schedule can utilise the profits generated over a longer tenure to service the debt and thus can sustain a higher debt-to-profit ratio compared to an entity with a shorter repayment period.

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 variability in profits for making good its financial obligations. Coverage signifies a function of an entity's profits, leverage and debt characteristics

[2] 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.

(in terms of cost of debt and repayment schedule). Entities with higher profitability and lower leverage will generally have better coverage ratios and thereby healthier financial risk profiles. However, in the case of long-tenor debt, they may have a sufficiently long period of moratorium along with a ballooning and a spread-out repayment schedule, in which case the coverage ratios may be adequate.

While interest coverage ratio has relevance in cases where most of the debt is non-amortising in nature, it does not reveal whether the entity would have a surplus left, after making interest payments, to repay the principal component of debt. DSCR is an indicator of an entity's ability to meet all the fixed financial obligations on the borrowed funds. However, a ratio of less than unity does not always indicate a stressed financial position as the entity may have high financial flexibility to timely refinance or may have sufficient liquidity or internal sources to meet the debt servicing obligations.

Assessment of coverage
[Indicative metrics]

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

Working capital intensity

High levels of receivables and inventory may be reflective of poor-quality earnings, which may require write-offs in the future. A high inventory level increases the holding cost and working capital requirements while inadequate inventory levels might lead to a market share loss. At the same time, an inventory build-up can also result from one-time events to support scheduled product launch by the OEMs in the immediate future or for effective supply-chain management. While extended credit periods from vendors is an indication of the bargaining power of a rated entity and a substitute for working capital borrowing, stretched creditor days, over and above contractual creditor terms, could be an indication of liquidity strain. ICRA 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. This also serves as a measure of its business strength.

ICRA adjusts an entity's receivables and debt for the bills discounted off-balance sheet to appropriately assess an entity's working capital cycle. Similarly, for entities that discount supplier bills (with recourse to the rated entity), but classify them under creditors, this amount is added to debt for analytical purpose.

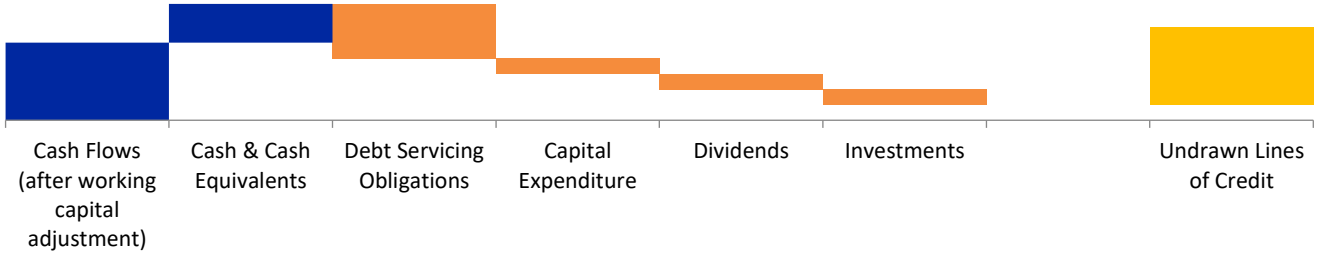
Some of the ratios that have linkages with working capital analysis include the current ratio, the gross cash conversion cycle, the working capital cycle and working capital intensity. Current ratio is an indicator of an entity's long-term funding adequacy and higher is the current ratio, lower is the mismatch between long-term requirement and long-term sources of funding. A working capital cycle captures the amount of time taken by an entity to convert its net current assets into cash. Typically, entities in a growth phase that have a shorter working capital cycle will have a better liquidity profile because of faster cash turnaround and thereby lower incremental working capital requirements. While this cycle captures the cash turnaround rate with respect to only debtors, inventory and creditors, working capital intensity captures the turnaround rate with respect to an entity's entire working capital, which also includes operating and non-operating current assets as well as liabilities.

Liquidity and adequacy of future cash flows

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, 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.

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 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.

Other Elements of Credit Risk Assessment

Asset diversification

Apart from a diversified geographical revenue mix, location diversification of manufacturing units, closer to the OEMs' manufacturing hubs, results in lower overhead logistics costs and reduced lead time for supplies lending a competitive edge. Multiple manufacturing units also provide the flexibility to shift production to another manufacturing unit in case of disruption in one unit (could be due to a labour strike or any other force majeure event). This is important in cases where an auto component manufacturer is a just-in-time supplier to an OEM and any delays in supplies could lead to production line stoppages. ICRA tries depending on data availability.

Tenure mismatches and risks relating to refinancing and interest rates

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 the interest rate movement.

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 arise from factors such as an entity's large scale of operations with strong financials, large unencumbered cash flows, 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. Such an indication implies that the entity might be persuaded to distribute high dividends or support the promoter group through other means to the detriment of its own credit profile. If the promoters fail to repay their loans (availed by pledging of shares) or top up collateral when required, the lenders could sell the pledged shares. In some cases, this could trigger a change-of-control clause in the rated entity's bond indentures or loan documents and require it to redeem its debt ahead of schedule, creating a liquidity squeeze, besides affecting fresh capital-raising ability. Financial flexibility could also be impacted in cases of adverse industry developments, weakening business profile, or management & governance concerns, which could translate into sharp decline in market capitalisation or spike in bond yields and consequently constrain an entity's ability to raise fresh capital or materially increase its cost of capital.

Foreign Currency Related Risks

Such risks arise if an ancillary's primary costs and revenues are denominated in different currencies. Examples include ancillaries selling in the domestic market be it to the domestic OEM or replacement segment but having large imports such as those catering to electronic components, or exporters operating largely as per the domestic cost structure. ICRA assesses the degree to which such entities 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 could also arise from un-hedged net liabilities [= foreign currency receivables – foreign currency payables – foreign currency debt]. ICRA's analytical focus is on assessing the magnitude of such exposure relative to the entity's profits.

Contingent Liabilities/ Off-Balance Sheet Exposures

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

Event Risks

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. In case of industry-specific events such as axle load norm changes in CVs or transition to the BS-VI emission norms, ICRA also assesses the expected support from the OEMs in such instances and subsequent impact on business viability of the auto component supplier. Adverse regulatory changes could also impact the performance of the principal OEM, which in turn could have a material impact on the credit profile of its vendors. Product recalls by the OEMs, who in turn may have a back-to-back warranty provisioning with auto component manufacturers, could also have a material impact on the credit profile of auto component manufacturers. 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.

Parentage

While an entity's credit rating is a function of its standalone credit profile, in certain cases, credit quality can also be driven by the relationship with its parent or the promoter group (henceforth referred to as the parent). 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 and advances 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, given the possibility that the entity may at some point of time extend financial support to its weaker parent, possibly to the detriment of its own credit profile[3].

Management Quality Assessment

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

Quality of Management and Financial Policies

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

» Experience of the promoter/ management in the industry
» Commitment of the promoter/ management to the rated entity
» Risk appetite of the promoter/ management and risk mitigation plans/ implementation of effective financial controls
» 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

Periodic interactions with the management help in ascertaining 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.

[3] For more details, readers may refer to the documents titled, "Rating Approach–Implicit Parent or Group Support", available on ICRA's website.

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 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. Notwithstanding the above, as an example, it is possible that even if an entity A has a higher carbon footprint than entity B, it does not materially affect ICRA's credit opinion on entity A. This is because ICRA's credit opinion on an entity considers a wide gamut of credit-relevant factors, and the E&S factors are only one among those.

Auto ancillaries face physical climate risks indirectly depending on the extent of their dependence/ supplies to automobile OEMs that lean on rural demand. Adverse climatic conditions such as droughts and floods may impact farm incomes and consequently the demand for automobiles for temporary periods, which in turn could have an effect on the demand for auto components. Certain product segments like engine and transmission parts also face climate transition risks, as customer demand progressively shifts away from fossil fuel-based powertrains, and the emission standards further tighten. Product categories that deal in the use of asbestos or production of batteries also face higher compliance and waste treatment and disposal costs given the hazardous nature of the waste. While the suppliers may have the ability to pass on such costs to the OEMs, competitive forces in the replacement market (considering competition with less environmentally responsible entities) could create pricing pressures. Further, innovations in energy technology and higher penetration of electric vehicles may result in product obsolescence in certain cases, while proving advantageous for some others.

Social considerations for auto ancillaries relate primarily to maintaining healthy industrial relations as well as product safety. Further, attracting and nurturing skilled manpower is critical for ancillaries as they seek to keep pace with innovation and technological changes in the automotive industry. Further, the workforce dealing in certain hazardous products like asbestos faces potential health and safety risks and need to be adequately protected. On the product front, vehicle recalls by the OEMs because of defective auto parts could create additional cost burden and liabilities for the entity concerned, besides having implications on the reputation. Auto ancillaries are also exposed to changing consumer preferences, including but not restricted to increasing awareness of the potential environmental damage from emissions, shift towards electric vehicles, usage of sustainable materials, besides societal trends like preference for ride-sharing.

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's 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, level of disclosures, consistency in communication and openness in 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 symbolic representations of its current 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 industry, business and financial risks, its likely cash flows and the adequacy of such cash flows vis-à-vis the entity's 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.

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															
	Geographic Diversification															
	Customer Diversification															
	Market Share															
	Segment Diversification															
	OEM Supplies Vs Replacement Mix															
	Technological Capabilities and Barriers to Entry															
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															
	Foreign Exchange 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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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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