September 30, 2022

Varun Motors Private Limited: Ratings put on watch with developing implications; rated amount enhanced

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Long-term Fund-based/Cash credit	527.50	678.00	[ICRA]BBB+&; Put on watch with developing implications;
Short term – Non fund based	2.00	11.00	[ICRA]A2&; Put on watch with developing implications;
Long term / Short term – unallocated limits	1.50	97.00	[ICRA]BBB+&/[ICRA]A2&; Put on watch with developing implications;
Total	**531.00**	**786.00**	

**Instrument details are provided in Annexure-I*

Rationale

The ratings of Varun Motors Private Limited (VMPL) have been placed on watch with developing implications, as the company took over the lending operations of Varun Finance (VF), which was a proprietorship concern involved in the business of financing vehicles, with effect from July 01, 2022. VF had a loan portfolio of Rs. 168.9 crore as on March 31, 2022, and total asset base of Rs. 467.8 crore, which included Rs. 290.0-crore loans extended to another Group entity, Lakshmi Finance (LF). VF did not have any bank borrowings as on March 31, 2022, however, it had unsecured loans of Rs. 412.2 crore from various promoter-owned entities. ICRA notes that VMPL's management plans to reduce the asset base of the transferred VF's operations significantly by reducing the support extended to its Group entity, LF. While the takeover of the business operations has increased VMPL's debt levels, the proposed reduction in the asset base would reduce the debt requirements of VMPL. ICRA has placed the ratings on watch, as the asset quality of the lending operations and size of the asset base (and hence, the debt levels) are yet to be ascertained. ICRA notes that the extent and timeliness of reduction of debt in VMPL are dependent on LF's ability to tie-up working capital funding, and this would be a key monitorable for resolution of the watch. Moreover, VMPL's ability to tie-up working capital funding for its lending operations would also be a key monitorable. ICRA would monitor the proceedings over the next few months towards the said transactions to resolve the watch.

VMPL has also taken over the operations of Varun Motors (VM), which was an authorised dealer for Bajaj Auto Limited (BAL) for five districts of Andhra Pradesh and Telangana, and J.C. Bamford Excavators Limited (JCB) for seven districts of Andhra Pradesh, with effect from January 01, 2022. This business transfer involved VMPL purchasing the entire inventory of VM and the same has been funded through debt. This development does not have any major impact on VMPL's credit profile. ICRA had taken a consolidated view of VM and VMPL in the past for arriving at the ratings, given the common management, and significant operational and financial linkages. However, given that VM's operations have been entirely transferred to VMPL, the rating approach has been changed to the standalone financials of VMPL.

The ratings favourably factor in VMPL's established presence as an automobile dealer in Andhra Pradesh, Telangana and Karnataka, and its diversified presence across four segments – passenger vehicles (PV), commercial vehicles (CV), two wheelers and three wheelers (2W and 3W) and construction equipment (CE). VMPL is an authorised dealer of Maruti Suzuki India Limited (MSIL) in the PV segment, Bharat Benz (Daimler India Commercial Vehicles) in the CV segment, BAL in the 2W and 3W segments, and JCB in the CE segment. Further, the Varun Group has a wide sales network, with more than 400 touch points (including showrooms, workshops, sales depots, true value and driving schools) across Andhra Pradesh, Telangana and Karnataka. VMPL's revenues increased significantly by 19% in FY2022 to Rs. 3,697.1 crore with healthy improvement in demand in the PV and CV segments. Moreover, healthy margins and lower debt levels resulted in a healthy capital structure and coverage indicators in FY2022.

The ratings are, however, constrained by VMPL's moderate operating profitability as the margins on vehicles, spares, service and accessories are all controlled by the principal. The ratings also remain constrained by the intense competition from dealers of MSIL and other original equipment manufacturers (OEMs), resulting in increased pressure to pass on the price discounts to customers. Further, VMPL faces high geographical concentration risk, with a predominant share of its revenue derived from

Andhra Pradesh and Telangana; however, it got MSIL's dealership in Bengaluru, which reduced the geographical concentration of revenues to an extent. The ratings are also constrained by the merger of VF into VMPL, which exposes the company to the pressures arising from asset quality of lending operations, lack of regulatory oversight for the lending operations, and its increased debt levels.

Key rating drivers and their description

Credit strengths

Diversified presence with dealership of MSIL, BAL, JCB and Bharat Benz – VMPL is the authorised dealer for PVs (MSIL), CVs (Bharat Benz), 2Ws and 3Ws (BAL) and CE (JCB). Further, the non-cyclical business of PVs and 2Ws accounted for more than 70.0% to its revenues during the past four years. VMPL has strong credential as one the largest dealers of PVs of MSIL, which is a market leader in the PV segment with a market share of 43.4% in FY2022, in Andhra Pradesh and Telangana. It is an authorised dealer of Bharat Benz for 11 districts in Andhra Pradesh and has authorised dealerships of BAL's 2W and 3W vehicles in five districts of Andhra Pradesh and three districts in Telangana, along with being the sole authorised dealer of JCB in seven districts in Andhra Pradesh, including Vijayawada and Vishakhapatnam.

Wide sales network – VMPL has a wide sales network with more than 400 touch points (including showrooms, sales depots, workshops, true value and driving schools) across Andhra Pradesh, Telangana and Karnataka covering Hyderabad, Ranga Reddy, Kamareddy, Medak, Sangareddy, Vikarabad, Nizamabad, Krishna, Khotagudam, Vishakhapatnam, Vizianagaram and Srikakulam districts, and Bengaluru. The increase in number of showrooms, outlets and workshops and strong market position in Andhra Pradesh and Telangana, supported VMPL's revenue growth over the years.

Comfortable capital structure and debt protection metrics – The improvement in the margins in FY2021 and FY2022 because of cost-cutting measures undertaken by the company, along with lower discounts offered and moderate debt levels, resulted in a comfortable capital structure and coverage indicators in FY2022. The Group's gearing stood low at 0.8 times as on March 31, 2022, and healthy debt protection metrics with interest coverage of 7.8 times, NCA/total debt of 40.2%, DSCR of 5.6 times and total debt/OPBDITA of 1.8 times in FY2022. However, ICRA notes that debt levels increased post the merger of VF with VMPL, and proposed reduction in the debt levels remains a key monitorable.

Credit challenges

Modest margins inherent to dealership business – VMPL's operating margins have been low in the past, on account of the dealership industry dynamics, wherein margins on vehicles, spares, service, and accessories are mainly controlled by the principal. However, the operating margins improved to 5.6% and 5.5% in FY2021 and FY2022, respectively, owing to minimal discounts offered to customers. The vehicle sales are the main revenue driver for the company, which accounted for ~80-81% of the net income, while the remaining 19-20% was contributed by spares, services, accessories, and other income over the last two years. The profit margins are higher for sale of spares and service income compared with vehicle sales.

Intense competition and regional concentration of sales – VMPL faces competition from dealers of other original equipment manufacturers (OEMs) and the same principal across all four dealerships, resulting in increased pressure to pass on price discounts to customers. Sales are regionally concentrated with the major portion of its revenue derived from Andhra Pradesh and Telangana. However, the company got MSIL's dealership in Bengaluru, which reduced the geographical concentration of revenues to an extent.

Merger of auto finance business with VMPL – VF was merged with VMPL in July 2022. The lending operations will expose VMPL to risks arising out of asset quality of the loan portfolio, absence of regulatory framework as the lending operations would be carried out by a corporate entity, and increased debt levels. Moreover, the takeover of VF's business has increased VMPL's Group exposure, as VF had extended loans of Rs. 290.0 crore to LF in the past. Timely and significant reduction of this exposure remains critical for VMPL.

Liquidity position: Adequate

The liquidity of VMPL remains **adequate,** with about Rs. 250.0 crore buffer available in the working capital limits against drawing power along with free cash and bank balances of about Rs. 20-23 crore as on August 31, 2022, against repayment obligations of about Rs. 3.0 crore over the next twelve months. The company is expected to incur Rs. 30-35 crore capex in FY2023, which would be funded through internal cash flows.

Rating sensitivities

Positive factors – The rating watch would be resolved once clarity emerges on the asset quality of the lending operations transferred from VF to VMPL. The rating watch resolution would also depend on extent and timeliness of reduction of debt in VMPL, which is in turn dependent on its Group entity's (Lakshmi Finance) ability to tie-up working capital funding. Moreover, VMPL's ability to tie-up working capital funding for its lending operations would be a key monitorable for resolution of the watch.

Negative factors – The rating watch would be resolved once clarity emerges on the asset quality of the lending operations transferred from VF to VMPL. The rating watch resolution would also depend on extent and timeliness of reduction of debt in VMPL, which is in turn dependent on its group entity's, Lakshmi Finance, ability to tie-up working capital funding. Moreover, VMPL's ability to tie-up working capital funding for its lending operations would be a key monitorable for resolution of the watch.

Analytical approach

Analytical Approach	Comments
Applicable rating methodologies	Corporate Credit Rating Methodology Rating methodology – Automobile dealerships Rating methodology for Non-banking Finance Companies
Parent/Group support	Not Applicable
Consolidation/Standalone	Standalone. ICRA had taken a consolidated view of VM and VMPL in the past for arriving at the ratings, given the common management, and significant operational and financial linkages. However, given that VM's operations have been entirely transferred to VMPL, the rating approach has been changed to the standalone financials of VMPL.

About the company

VMPL, incorporated in 1996, is involved in the business of automobile dealership. The company is the dealer of Maruti Suzuki India Limited (MSIL) across Andhra Pradesh, Telangana and Karnataka covering Hyderabad, Ranga Reddy, Kamareddy, Medak, Sangareddy, Vikarabad, Nizamabad, Krishna, Khotagudam, Vishakhapatnam, Vizianagaram and Srikakulam districts, and Bengaluru with around 64 showrooms, service centres and true-value outlets. VMPL is the sole MSIL dealer in Nizamabad and Srikakulam districts, whereas in other districts, it has a non-exclusive dealership. VMPL is also a Bharat Benz dealer for 11 districts in Andhra Pradesh. VMPL has taken over the business of VF w.e.f. July 2022.

Founded in 1992 by Mr. Prabhu Kishore as a sole proprietorship firm, VM was the authorised 2W and 3W dealer of Bajaj Auto Limited (BAL) for five districts in Andhra Pradesh (Visakhapatnam, Vizianagaram, Srikakulam, Krishna, West Godavari) and three districts in Telangana (Rangareddy, Vikarabad and Sangareddy). VM had 95 showrooms, outlets and workshops for BAL spread across its territory. It had an exclusive JCB dealer for seven districts in Andhra Pradesh — Guntur, Krishna, West Godavari, East Godavari, Visakhapatnam, Vizianagaram and Srikakulam—and has around 13 showrooms and outlets, with two workshops for JCB across Andhra Pradesh. The business of VM has been transferred to VMPL from December 2021.

Key financial indicators

Consolidated	FY2021	FY2022*
Operating income	3110.3	3697.1
PAT	100.2	122.5
OPBDIT/OI	5.6%	5.5%
PAT/OI	3.2%	3.3%
Total outside liabilities/Tangible net worth (times)	1.2	1.2
Total debt/OPBDIT (times)	1.3	1.8
Interest coverage (times)	5.8	7.8

*PAT: Profit after tax; OPBDIT: Operating profit before depreciation, interest, taxes and amortisation; Amount in Rs crore; Provisionals FY2022**
Note: Amounts in Rs. crore; All calculations are as per ICRA Research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current rating (FY2023)				Chronology of rating history for the past 3 years			
		Type	Amount rated	Amount O/s as of Aug 31, 2022	Date & rating in FY2023	FY2022	FY2021	FY2020	
					Sep 30, 2022	Jun 29, 2021	May 26, 2020	Mar 19, 2020	Apr 04, 2019
1	**Cash credit/ Working capital**	Long term	678.0	-	**[ICRA]BBB+&**	[ICRA]BBB+ (Positive)	[ICRA]BBB+ (Stable)	[ICRA]BBB+ (Stable)	[ICRA]BBB+ (Stable)
2	**Bank guarantee**	Short term	11.0	-	**[ICRA]A2&**	[ICRA]A2	[ICRA]A2	[ICRA]A2	[ICRA]A2
2	**Unallocated limits**	Long term/ Short term	97.0	--	**[ICRA]BBB+& /[ICRA]A2&**	[ICRA]BBB+ (Positive)/ [ICRA]A2	[ICRA]BBB+ (Stable)/ [ICRA]A2	[ICRA]BBB+ (Stable)/ [ICRA]A2	[ICRA]BBB+ (Stable)/ [ICRA]A2

&= Under Watch with Developing Implications

Complexity level of the rated instruments

Instrument	Complexity Indicator
Long-term-fund-based/Cash cred/working capital	Simple
Short term – Non fund based	Very simple
Long term / Short term – Unallocated limits	Not applicable

The Complexity Indicator refers to the ease with which the returns associated with the rated instrument could be estimated. It does not indicate the risk related to the timely payments on the instrument, which is rather indicated by the instrument's credit rating. It also does not indicate the complexity associated with analysing an entity's financial, business, industry risks or complexity related to the structural, transactional or legal aspects. Details on the complexity levels of the instruments are available on ICRA's website: www.icra.in

Annexure I: Instrument details

ISIN	Instrument Name	Date of Issuance	Coupon Rate	Maturity	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	Cash credit/ Working capital	NA	NA	NA	678.0	[ICRA]BBB+&
NA	Bank guarantee	NA	NA	NA	11.0	[ICRA]A2&
NA	Unallocated	NA	NA	NA	97.0	[ICRA]BBB+&/[ICRA]A2&

Source: Company

Click here to view Lender wise facilities rated by ICRA

Annexure II: List of entities considered for consolidated analysis: NA

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About ICRA Limited:

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