June 23, 2021

Varroc Engineering Limited: Ratings downgraded; outlook revised to Stable

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Term Loan	605.37	504.00	[ICRA]A+(Stable); Ratings downgraded from [ICRA]AA- and outlook revised to Stable from Negative
Fund-based Facilities	22.35	17.35	[ICRA]A+(Stable)/[ICRA]A1; Ratings downgraded from [ICRA]AA-/[ICRA]A1+ and outlook revised to Stable from Negative
Non-fund Based Facilities	132.50	35.0	[ICRA]A+(Stable)/[ICRA]A1; Ratings downgraded from [ICRA]AA-/[ICRA]A1+ and outlook revised to Stable from Negative
Fund-based/ Non-fund Based Facilities	280.00	339.55	[ICRA]A+(Stable)/[ICRA]A1; Ratings downgraded from [ICRA]AA-/[ICRA]A1+ and outlook revised to Stable from Negative
Fund-based/ Non-fund – Unallocated	0.0	144.32	[ICRA]A+(Stable)/[ICRA]A1; Ratings downgraded from [ICRA]AA-/[ICRA]A1+ and outlook revised to Stable from Negative
Commercial Paper	100.00	100.00	[ICRA]A1; Ratings downgraded from [ICRA]A1+
Total	**1140.22**	**1140.22**	

**Instrument details are provided in Annexure-1*

Rationale

For arriving at the ratings, ICRA has considered the consolidated financials of Varroc Engineering Limited (VEL) along with its subsidiaries/step-down subsidiaries together, henceforth referred to as The Group/ Varroc.

The rating revision factors in the continued weakening of Varroc's financial profile as reflected by moderation in profitability, debt protection metrics and capital structure in FY2020 and FY2021. The Group's operations and profitability were adversely impacted by the Covid-19 pandemic-related lockdown in Q4 FY2020, Q1 and Q3 FY2021 resulting in subdued profitability as reflected by contraction in earnings (adjusted for income from JV) from Rs 397 crore in FY2019 to Rs 12 crore in FY2020 and further down to net losses of Rs 664 crore in FY2021 (of this Rs 110 crore is as a result of non-cash tax asset write off in Czech). ICRA notes that the company's losses in FY2021 was also aggravated by supply constraints because of global semi-conductor shortages from Q4 FY2021 and the same is expected to continue till September 2021, which is likely to result in subdued performance in H1 FY2022. Nonetheless, the impact is expected to be on-off, with some normalcy is expected to return from Q3 FY2021, which is expected to support overall scale and profitability in FY2022. Effect of one-off items in FY2021 and Semiconductor issues in Q1 will go away from Q3, leading to much better VLS operational performance. This apart, delayed ramp up in operations in Morocco as well as Poland and the high cost structure in these regions on account of the nascent stages of operations continued to adversely affect the Group's overall profitably in the recent quarters. Sustainable ramping up of operations in these regions will be a key rating monitorable going forward. Moreover, Varroc's scale and profitability remain susceptible to its dependence on the cyclical automotive industry, stiff competition from the larger players in the global automotive lighting business, and its limited bargaining powers with customers, which are generally large original equipment manufacturers (OEMs).

Further, ICRA notes that Varroc was under an investment phase during the last two years, which resulted in a high debt level without commensurate contribution to cash flows. The Group's net debt level increased to over Rs. 2,250 crore in FY2021 from Rs. 880 crore in FY2018. With high debt levels and subdued profitability, Varroc's debt protection metrics weekend in the recent past and is expected to remain muted in the current year because of high repayment obligations and moderate profitability expectations. Nevertheless, the recent fund raising of Rs. 700 crore via fresh equity issuance has provided much needed liquidity support to Varroc, despite sizeable losses in FY2021. While ICRA had expected the Group's total debt/OPBIDTA (adjusted for lease liabilities) to be in the range of 3.0–3.5 times in FY2021 and 2.2-2.5 times in FY2022, the same exceeded 5 times in FY2021 and is expected to be around 2.5-3.0 times in FY2022.

The ratings continue to reflect Varroc's established position as a leading auto component supplier in India and as an eminent automotive lighting supplier globally. The ratings factor in VEL's large scale of operations, along with its diversified revenue mix across customers, products and automotive segments (two-wheeler or 2W and passenger vehicles or PVs). The ratings note its diversified business presence across geographies, including North American, European and Asian markets, which insulates Varroc from slowdowns in any specific market and provides stable revenue visibility prospects. The ratings draw comfort from its established relationship from customers such as Bajaj Auto Limited (BAL), Honda, Ford Motor Company, Tesla, Volkswagen AG (VW) and Jaguar Land Rover (JLR), among others. ICRA also expects the Group's revenue to grow at a healthy place in the medium term because of improved offtake from the existing customers, new products launched in the recent past, customer acquisition in the domestic business and ramping up of operations in new geographies such as Poland and Morocco. The ratings derive strength from the Group's strong financial flexibility and its recent equity infusion of around Rs. 700 crore, which is likely to support its liquidity in the near term.

Key rating drivers and their description

Credit strengths

One of the largest Indian auto-component manufacturers – The Varroc Group is one of the largest auto component manufacturers in India with established relationships with its key customers. It has a strong order book share for supplying electrical, power-train and plastic components to BAL and it has gradually gained wallet share with other domestic automobile OEMs. VEL is one of the leading global automotive lighting manufacturers with strong in-house technological capabilities. It already supplies automotive lighting to leading electric PV OEMs globally, and is expected to benefit from the hybridisation and electrification trend of passenger vehicles over the medium to long term.

Diversified and reputed clientele – Varroc has a diversified customer mix with no single customer accounting for over 20% of its total revenues in FY2020 and FY2021. Its client profile is healthy, including reputed OEMs such as BAL, Ford, JLR., FCA NV, Renault Nissan and VW, among others. In its Indian operations, Varroc has gained traction in its order book from leading 2W OEMs such as Hero MotoCorp Limited [rated [ICRA]AAA (Stable)] and Honda Motorcycle and Scooters India Limited (HMSI) for their existing as well as new models. Varroc also enjoys a dominant wallet-share for products it supplies to BAL and management expects the company to gain wallet-share in other OEMs as well.

Despite subdued revenue growth during the past three years and near-term headwinds on account of semi-conductor shortages, ICRA expects Varroc's growth to be healthy in the long-term, led by improved offtake from its existing customers due to demand growth. Moreover, VEL is likely to benefit from the new products launched in the recent past and the customer acquisition in the domestic business and ramping up of operations in new geographies such as Poland and Morocco. Management also expects that business wins in North America will also help in achieve the revenue growth targeted in Varroc.

Diversified geographical presence – Varroc has a diversified geographical profile with presence across India (31%), Europe (53%) and North America (13%) during 9M FY2021. Coupled with its entry by organic and inorganic expansion in Brazil, Morocco and Turkish markets, this has resulted in further de-risking of its business by means of geographical as well as customer diversification. Furthermore, VEL's manufacturing footprint is extended to relatively low-cost countries, thus providing cost competitive advantage against other players in the European and North American markets.

Credit challenges

Subdued profitability – The Group's operations and in turn its profitability was adversely impacted by the Covid-19 pandemic-related lockdown conditions in Q4 FY2020, Q1 and Q3 FY2021 resulting in subdued profitability as reflected by contraction in earnings (adjusted for income from JV) from Rs. 397 crore in FY2019 to Rs. 12 crore in FY2020 and further down to net losses of 664 crore in FY2021 (of this Rs 110 crore is as a result of non-cash tax asset write off in Czech).. The Group's Indian and global operations were affected by the pandemic on account of production constraints and lack of demand from the end-customers of the OEMs. In Q3 FY2021, the second wave of Covid-19 outbreak in Europe impacted its operations in Czech Republic resulting in high absenteeism and transport-related delays leading to high overheads and freight costs. Further, on account of semi-conductor shortages from Q4 FY2021, the operations of its OEM customers were affected and Varroc's high margin products and geographies (North America and Czech Republic) in global operations were disproportionately impacted. The same resulted in losses in global operations in Q4 FY2021 and ICRA expects the supply constrain to continue till September 2021, which is likely to result in muted performance in H1 FY2022. Nonetheless, the impact is expected to be on-off, with some normalcy is expected to return from Q3 FY2021, which is expected to support overall scale and profitability in FY2022.

Further, high raw material prices because of semi-conductor shortages and inflation in other raw material prices (resins, plastics, etc) impacted Varroc's performance in H2 FY2021. These apart, delayed ramping up in operations in Morocco and Poland, along with the high cost structure in these regions on account of the nascent stages of operations continued to adversely impact the Group's overall profitably in the recent quarters. Sustainable ramping up of operations in these regions will be a key rating monitorable going forward. ICRA notes that Varroc's scale and profitability remain susceptible to its dependence on the cyclical automotive industry, stiff competition from larger players in the global automotive lighting business, and its limited bargaining powers with customers, which are generally large OEMs.

Weakening of debt protection metrics and capital structure – Varroc was under an investment phase during the last three years, which resulted in a high debt level without commensurate contribution to cash flows. The Group had undertaken more than Rs. 3,000 crore of capex (excluding development cost/lease capitalisation) during the last three years and the net fixed assets increased to Rs. 6,086 crore in FY2021 from around Rs. 3,153 crore in FY2018. However, during these three years, the revenue growth has been relatively modest to Rs. 11,300 crore in FY2021 from Rs. 10,300 crore in FY2018 on account of culmination of various factors such as delayed ramp up of new plants, Covid-19 pandemic and other exogenous factors. The Group's net debt level increased to around Rs. 2,270 crore in FY2021 from Rs. 880 crore in FY2018.

With high debt levels and subdued profitability, Varroc's debt protection metrics had weakened in the recent past and is likely to remain subdued in the current fiscal because of high repayment obligations and moderate profitability expectations. Varroc's ability to refinance a portion of debt maturing in FY2022 remains crucial to maintain adequate liquidity cushion. While ICRA expected the Group's total debt/OPBIDTA (adjusted for lease liabilities) to be in the range of 3.0–3.5 times in FY2021 and 2.2-2.5 times in FY2022, the actual figure stood at more than 5 times in FY2021 and is likely to be around 2.5-3 times in FY2022 and further improve to less than 2 times by FY2023. However, the same will depend on the duration of semi-conductor shortage/ pandemic-led demand-supply constraints and the management's target to keep the debt level stable.

The Group's financial flexibility is supported by undrawn bank limits and cash/bank balances of around Rs. 1,000 crore as of April 2021 and its established relationship with various reputed financial institutions in the domestic and international markets. ICRA also notes the equity infusion of around Rs. 700 crore through QIP, which provided much needed liquidity support to Varroc despite sizeable losses in FY2021.

Stiff competition from established and much larger players – VEL's dependence on the European PV market remains high. It faces stiff competition from established and much larger players in the global automotive lighting business. However, given that VEL is strategically placed in low-cost regions (Mexico, Czech Republic, Morocco and Brazil, etc), which helps Varroc in competing with much larger players in relatively high-cost regions (Western Europe, North America and Japan) due to its unique positioning (low-cost quality products). ICRA expects the revenue growth for automotive lighting manufacturers to remain healthy over the medium to long term, given the improved traction for LED, OLED and Xenon lighting (which provide higher realisation), despite modest volume growth in the underlying PV industry.

Liquidity position: Adequate

Varroc's liquidity profile remains **adequate**, supported by availability of surplus cash reserves along with undrawn credit facilities from the banking system for both the fund-based and non-fund-based facilities with approximately Rs. 1,000 crore as on April 30, 2021. Varroc also has been sanctioned addition USD 25 Million for capex being undertaken in FY2022. ICRA expects the liquidity position to be supported by healthy improvement in fund flow from operations, coupled with moderate capex plans of around Rs. 900 crore (including capitalisation of developmental cost). Further, while the Group's debt repayment is around more than Rs. 800 crore in FY2022, ICRA expects Varroc to refinance a portion of the same, which along with undrawn limits and cash accruals from operations should be adequate to meet those commitments. However, ICRA notes that the overseas subsidiaries have a negative working capital cycle, which results in high asset liability mismatch at the consolidated level. The Group's ability to correct its asset liability mismatch remains crucial to allay liquidity concerns in the medium term.

Rating sensitivities

Positive factors – Varroc's rating could be upgraded it's the Group's profitability and debt protection metrics improves on a sustainable basis. Specific credit metrics that ICRA would look at an upgrade include Net Debt/ OPBDIT (adjusted for IndAS operating leases) greater than 2.0 times on a sustainable basis.

Negative factors – Varroc's ratings could be downgraded if Varroc's operational and financial performance weakens. Significant deterioration in the Group's credit/liquidity profile led by debt-funded capex/acquisition could also trigger a rating downgrade. Varroc's inability to maintain adequate liquidity buffer, or consistently negative asset liability mismatch, could also result in downward rating pressure. Specific credit metrics that may trigger a rating downgrade would include Net/ OPBDIT (adjusted for IndAS operating leases) greater than 3.0 times on a sustained basis.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	Corporate Credit Rating Methodology Rating Methodology for Auto Component Manufacturers
Parent/Group Support	Not Applicable
Consolidation/Standalone	For arriving at the ratings, ICRA has considered the consolidated financials of Varroc Engineering Limited. Varroc's subsidiaries and step-down subsidiaries are all enlisted in Annexure-2.

About the company

Incorporated in 1988, VEL is the flagship company of the Aurangabad-based Varroc Group. It is the holding company for the Group's other ventures in auto component manufacturing. VEL, along with its subsidiaries, is present in automotive lighting, plastic-moulded parts, electrical components, forgings and the engine valve business. The Group was initially established as a captive unit for BAL's auto components and gradually diversified by adding new customers and products to its portfolio. In 2012, VEL acquired Visteon's global lighting business, which transformed the company into a global auto component supplier, with presence across Europe, North America, India and China.

Key financial indicators (audited)

Varroc (Consolidated)	FY2019	FY2020	FY2021
Operating Income (Rs. crore)	12076.1	11146.7	11302.8
PAT (Rs. crore) (*excluding share from JV)	397.2	11.7	(664.3)
OPBDIT/OI (%)	9.1%	7.6%	3.5%
PAT/OI (%)	3.3%	0.1%	-5.9%
Total Outside Liabilities/Tangible Net Worth (times)	1.8	2.6	2.6
Total Debt/OPBDIT (times)	2.2	5.0	9.4
Net Debt/OPBDIT (times) (adjusted of leases)	2.1	3.3	7.9
Interest Coverage (times)	11.3	6.1	2.4

Source: Company Annual Reports; ICRA research; PAT: Profit after Tax; OPBDIT: Operating Profit before Depreciation, Interest, Taxes and Amortisation

Note: Some figure are adjusted as per ICRA.

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2022)				Chronology of Rating History for the past 3 years			
		Type	Amount Rated (Rs. crore)	Amount Outstanding as of Mar 31, 2021 (Rs. crore)	Date & Rating in	Date & Rating in FY2021		Date & Rating in FY2020	Date & Rating in FY2019
					Jun 23, 2021	Aug 21, 2020	Apr 30, 2020	Aug 30, 2019	June 01, 2018
1	Term Loan	LT	504.00	504.0	[ICRA]A+ (Stable);	[ICRA]AA- (Negative)	[ICRA]AA- (Negative)	[ICRA]AA- (Stable)	[ICRA]AA- (Positive)
2	Fund-based Facilities	LT/ST	17.35	--	[ICRA]A+ (Stable)/ [ICRA]A1	[ICRA]AA- (Negative) /[ICRA]A1+	[ICRA]AA- @ /[ICRA]A1+	[ICRA]AA- (Stable) /[ICRA]A1+	[ICRA]AA- (Positive) /[ICRA]A1+
3	Non-fund Based Facilities	LT/ST	35.0	--	[ICRA]A+ (Stable)/ [ICRA]A1	[ICRA]AA- (Negative) / [ICRA]A1+	[ICRA]AA- @ / [ICRA]A1+	[ICRA]AA- (Stable) / [ICRA]A1+	[ICRA]AA- (Positive) / [ICRA]A1+
4	Fund-based/ Non-fund Based Facilities	LT/ST	339.55	-	[ICRA]A+ (Stable)/ [ICRA]A1	[ICRA]AA- (Negative)/ [ICRA]A1+	[ICRA]AA- @/ [ICRA]A1+	[ICRA]AA- (Stable)/ [ICRA]A1+	[ICRA]AA- (Positive)/ [ICRA]A1+
5	Fund-based/ Non-fund - Unallocated	LT/ST	144.32	-	[ICRA]A+ (Stable)/ [ICRA]A1				
6	Commercial Paper	ST	100.00	100.0	[ICRA]A1	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+

@ Rating under Watch with Developing Implications

Complexity level of the rated instruments

Instrument	Complexity Indicator
Term Loan	Simple
Fund-based Facilities	Simple
Non-fund Based Facilities	Very Simple
Fund-based/ Non-fund Based Facilities	Simple
Fund-based/ Non-fund – Unallocated	NA
Commercial Paper	Very Simple

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, is available on ICRA's website: www.icra.in

Annexure-1: Instrument details

ISIN No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	Term Loans	FY2021	NA	FY2025	504.00	[ICRA]A+ (Stable);
NA	Fund-based Facilities	NA	NA	NA	17.35	[ICRA]A+ (Stable)/[ICRA]A1;
NA	Non-fund Based Facilities	NA	NA	NA	35.0	[ICRA]A+ (Stable)/[ICRA]A1;
NA	Fund-based/ Non-fund Based Facilities	NA	NA	NA	339.55	[ICRA]A+ (Stable)/[ICRA]A1;
NA	Fund-based/ Non-fund - Unallocated	NA	NA	NA	144.32	[ICRA]A+ (Stable)/[ICRA]A1;
NA*	Commercial Paper	NA	NA	NA	25.00	[ICRA]A1;
INE657L14258	Commercial Paper	April 2021	NA	July 2021	75.00	[ICRA]A1;

Source: *Company * yet to be issued*

Annexure-2: List of entities considered for consolidated analysis

Company Name	VEL Ownership	Consolidation Approach
Direct Subsidiaries		
Varroc Polymers Private Limited	100.00%	Full Consolidation
Durovalves India Private Limited	72.78%	Full Consolidation
Varroc European Holding B.V.	100.00%	Full Consolidation
Aries Mentor Holding B.V.	100.00%	Full Consolidation
Varroc Corp Holding B.V.	100.00%	Full Consolidation
Varroc Japan Co. Limited	100.00%	Full Consolidation
CarIQ Technologies Private Limited	74.00%	Full Consolidation
Step Down Subsidiaries		
Team Concepts Private Limited	100.00%	Full Consolidation
Industrial Meccanica E Stampaggio S.p.a.	100.00%	Full Consolidation
Varroc Lighting Systems, Italy S.p.A. (earlier know as "TRI.O.M., S.p.A")	100.00%	Full Consolidation
Varroc Lighting Systems, Vietnam CO. Ltd. (earlier know as "TRI.O.M., Vietnam Co. Ltd.")	100.00%	Full Consolidation
Varroc Lighting Systems, Romania S.A. (earlier know as "Electromures SA")	98.23%	Full Consolidation
Varroc Lighting Systems SRO	100.00%	Full Consolidation
Varroc Lighting Systems Inc.	100.00%	Full Consolidation
Varroc Lighting Systems GmBH.	100.00%	Full Consolidation
Varroc Lighting Systems S.de.R.L. De. C.V.	100.00%	Full Consolidation
Varroc Lighting Systems S.A., Morocco	99.87%	Full Consolidation
Varroc do Brasil Industria E Commercia LTDA (earlier known as Varroc do brasil Comercio, Importacao e Exportacao de Maquinas, Equipamento e Pecas Ltd., Brazil)	100.00%	Full Consolidation
Varroc Lighting Systems sp. Z o.o.	100.00%	Full Consolidation
VARROC LIGHTING SYSTEMS TURKEY ENDÜSTRUYEL ÜRÜNLER iMALAT VE TiCARET ANONiM SiRKETi.	100.00%	Full Consolidation
Varroc Lighting Systems Bulgaria EOOD	100.00%	Full Consolidation

Source: *Varroc annual report FY2020*

ANALYST CONTACTS

Shamsher Dewan
+91 124 4545328
shamsher.dewan@icraindia.com

Kinjal Shah
+91 22 6114 3442
kinjal.shah@icraindia.com

Rathina Pradeep
+91 44 4596 4307
rathina.pradeep@icraindia.com

Ashish Modani
+91 44 206606 9912
ashish.modani@icraindia.com

RELATIONSHIP CONTACT

Jayanta Chatterjee
+91 80 4332 6401
jayantac@icraindia.com

MEDIA AND PUBLIC RELATIONS CONTACT

Ms. Naznin Prodhani
Tel: +91 124 4545 860
communications@icraindia.com

Helpline for business queries

+91-9354738909 (open Monday to Friday, from 9:30 am to 6 pm)

info@icraindia.com

About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

For more information, visit www.icra.in

ICRA Limited

Registered Office

B-710, Statesman House, 148, Barakhamba Road, New Delhi-110001
Tel: +91 11 23357940-45

Branches