July 26, 2024

Deepak Industries Limited: Ratings reaffirmed

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Fund-based – Term Loans	4.00	4.00	[ICRA]AA (Stable); reaffirmed
Fund-based – Working Capital Facilities^	93.00	93.00	[ICRA]AA (Stable); reaffirmed
Non-fund based – Bank Guarantee/ Letter of Credit/ Forward Cover	24.75	24.75	[ICRA]A1+; reaffirmed
Fund-based – Standby Line of Credit	2.00	2.00	[ICRA]A1+; reaffirmed
Unallocated Limit	11.07	11.07	[ICRA]AA (Stable)/ [ICRA]A1+; reaffirmed
Total	**134.82**	**134.82**	

**Instrument details are provided in Annexure-I*

Rationale

The ratings reaffirmation continues to factor in an established position of Deepak Industries Limited (DIL) in the automotive and industrial gears market and long relationships with leading OEMs[1] of commercial vehicles (CV) and tractors along with DIL's healthy share of business with the OEMs. The company passes on the raw material cost increases, albeit with a lag of one month, to its customers in the automotive gear segment. The contracts in the industrial gear segment are firm price in nature, however, the segment's share in DIL's overall revenue remains low (~14% in FY2024). Moreover, a short time lag between the order receipt and raw material purchases for industrial gears shields DIL's profit margins to adverse fluctuation in the prices of steel, which is its main raw material. DIL's increasing production of ground gears and other value-added products, which command higher realisations, along with improved performance of the industrial gear segment is likely to support its profitability. ICRA also notes that DIL's acquisition of Lotus Auto Engineering Limited (Lotus Auto), an automobile component manufacturing entity, in FY2022, which is in the process of getting merged with DIL, is likely to provide scope for augmentation of the overall capacity, product lines extension and backward integration, going forward. Besides, sizeable accumulated losses in the books of Lotus Auto would lead to substantial income tax benefits to DIL, post the merger.

DIL's operating income surged by 27% in FY2023, driven by a significant rise in domestic sales volumes of both the CV and tractors OEMs and an increase in realisations due to higher steel prices. In FY2024, however, the company's operating income contracted by 4% with a slowdown in demand from the tractor OEMs in H2 FY2024 and a decline in realisations with moderation in steel prices. In Q4 FY2024, the company's turnover declined by ~14% and its operating margin contracted by ~330 basis points on a YoY basis. Nevertheless, an expected rise in orders for new products developed for the key OEMs is likely to support the company's revenues, going forward. The ratings also continue to draw comfort from DIL's healthy business returns, a conservative capital structure with negative net debt position along with strong debt coverage metrics. Its heathy earnings, sizeable free cash balance, low debt repayment obligation and limited capex are likely to keep the liquidity position strong.

The long-term rating is, however, constrained by the company's exposure to the cyclicality associated with the CV and tractor segments and its high client concentration risks. However, DIL's reputed clientele mitigates the counterparty risks. Besides, incremental revenues from reputed CV OEMs added to its clientele in recent years are expected to reduce the client

[1]Original equipment manufacturers

concentration risk. Moreover, presence in both the CV and tractor segments mitigates DIL's sectoral concentration risk. ICRA also notes the structural change in the automobile sector with a gradual transition towards electric vehicles (EV), which is likely to hinder demand for automotive gears in the long term. Nevertheless, DIL's vulnerability to such risk will remain limited in the medium term, given a relatively slower pace of EV penetration in the medium and heavy commercial vehicles (M&HCV) and tractor segments, which are key end-user industries for the company.

The Stable outlook on the long-term rating reflects ICRA's opinion that DIL's credit profile would continue to derive strength from its healthy cash accruals and business returns along with limited needs for additional borrowings due to its sizeable free cash and absence of any major capex or acquisition plan.

Key rating drivers and their description

Credit strengths

Established presence in industrial and automotive gears markets; DIL's long relationships and healthy share of business with leading CV and tractor OEMs provide competitive edge – DIL, incorporated in 1954, has an established presence in the domestic industrial and automotive gears markets with a long association with leading CVs and tractor OEMs. The company's product offerings include automotive transmission gears and shafts, couplings, gear boxes and engine gears, catering to the light commercial vehicles (LCV), the M&HCV and the tractor segments in addition to the clients in other industries like power, steel, cement, sugar, etc. DIL caters to Tata Motors and Mahindra & Mahindra, which are the market leaders in the CV and tractor segments, respectively, in addition to other established OEMs in these industries including Ashok Leyland, TAFE, Escorts Kubota, Daimler etc. and Dana Group, which is a component supplier to global OEMs. DIL is among the leading players in the automobile gears segment and has a healthy share of business with the OEMs. It is the single/main supplier of various gears and shafts to some of the OEMs, providing significant competitive advantage.

Increasing share of value-added products and improvement in performance of the industrial gear segment to support profitability – The company's sales of high-precision ground gears, which are mainly manufactured in its plant in Baghola, Haryana, increased significantly to ~Rs. 147 crore in FY2024 from ~Rs. 46 crore in FY2021. An increasing demand for the relatively value-added products like ground gears is likely to support the company's revenues and operating margin. ICRA also notes that Lotus Auto, which was acquired by DIL in FY2022, is likely to provide operational synergies through augmentation of the overall capacity and scopes for enhancement of product lines and value addition through backward integration, going forward. Lotus Auto has significant accumulated losses, which would provide income tax benefits post the entity's merger with DIL, for which the regulatory approval has been received. Besides, the performance of DIL's industrial gear segment, which remained muted historically, improved in FY2024 with a revenue growth of ~9% and a rise in PBIT to Rs. 13.5 crore from Rs. 4.3 crore in FY2024. Improving value addition and turnaround in the industrial gears segment are likely to support DIL's profitability, going forward.

Ability to pass on raw material price hike to customers in the automobile gear segment, albeit with a lag – The company passes on the increase in raw material prices to the clients in the automobile gear segment with a lag of one month, protecting its operating margin from any adverse fluctuation in raw material prices. For the industrial gear segment, the prices remain firm during the contract tenure. However, a lower share of revenue from the industrial gear segment and the company's policy to purchase raw materials within a short interval from order receipt mitigate the impact of price fluctuation on DIL's profitability.

Robust financial profile marked by healthy RoCE, conservative capital structure and strong debt coverage metrics – DIL's healthy profits at an absolute level kept its return indicators heathy, reflected by an RoCE of 24.1% and a core ROCE of 37.2% in FY2024. The company's moderate debt levels compared to its sizeable net worth resulted in a comfortable capital structure, as reflected by a low gearing of 0.1-0.2 times over the last three fiscals. DIL's overall leverage was negative on a net debt basis since March 31, 2020, supported by a sizeable free cash balance, which imparts a high degree of financial flexibility. Healthy profits and a conservative capital structure led to strong debt coverage indicators of DIL, as reflected by an interest coverage of 25.6 times, total debt relative to OPBDITA of 0.4 times and net cash accruals relative to the total debt of 213% in FY2024.

Credit challenges

Exposed to cyclicality associated with CV and tractor industries, though mitigated to an extent by presence in both sectors – DIL is exposed to the cyclicality associated with the CV and the tractor industries, which is likely to keep its revenues and cash flows volatile as the two segments together contributed ~86% to the company's sales in FY2024. However, a balanced mix of revenues from the CV and tractors industries, which accounted for 66% and 34% of the company's revenue from the automobile gears segment in FY2024, respectively, is likely to mitigate DIL's sectoral concentration risk. DIL also manufactures gears for various other industries like steel, power, cement, sugar etc., which accounted for ~14% of its sales in FY2024, leading to revenue diversification.

Exposed to client concentration risk, however, reputed clientele mitigates counterparty risks – DIL remains exposed to the high client concentration risk as the top two and the top five customers accounted for nearly 44% and 71% of its total revenues in FY2024, respectively. This will keep DIL's business operations vulnerable to the performance of its key clientele. However, a reputed client base, coupled with DIL's long association with its clients, mitigate the counterparty risks. Moreover, acquisition of new clients is likely to reduce DIL's client concentration, going forward.

Gradual shift towards EVs likely to hinder demand for automobile gears in the long term – DIL derives the major portion of its revenues from automobile gears. With the transition from fossil-fuel based vehicles to EVs, the demand for gears is likely to diminish as EVs require lower number of gears. However, DIL mainly caters to the M&HCV and tractor segments wherein the transition to EVs is likely to happen gradually over a relatively longer period.

Environmental and Social Risks

Environmental considerations: DIL, like other auto ancillaries, face physical climate risks due to partial dependence on automobile OEMs (mainly in the tractors segment) that depend on rural demand. Adverse climatic conditions such as droughts and floods may impact farm income and consequently the demand for automobile for temporary period. Consequently, it would have a ripple effect on the demand for auto components. Certain product segments like engine and transmission parts also face carbon transition risks as customer demand progressively shifts from fossil fuel-based powertrains, and the emission standards further tighten. Besides, innovations in energy technology and higher penetration of electric vehicles may result in product obsolescence in certain cases, while proving advantageous for some others. However, such risk will manifest over the long term for DIL as it mainly caters to the M&HCV and tractors segments where the transition will be gradual compared to the passenger vehicles and LCV segments. The company is focusing on increasing its presence in the electric vehicle segment to mitigate the product obsolescence risk and improve its product diversity. DIL is also exposed to the risks arising from the tightening regulations on the environment front, particularly in the export market, wherein the OEMs are increasingly emphasising on a sustainable supply chain.

Social considerations: Social considerations for auto ancillaries relate primarily to maintaining healthy industrial relations as well as product safety. Further, attracting and nurturing skilled manpower are critical for ancillaries as they seek to keep pace with innovation and technological changes in the automotive industry. On the product front, vehicle recalls by OEMs because of defective auto parts could create additional cost burden and liabilities for the associated supplier(s). Auto ancillaries also have exposure 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 sharing rides.

Liquidity position: Strong

DIL's liquidity is likely to remain strong. The company had free cash of ~Rs. 326 crore as on March 31, 2024. Its cash flow from operations remained healthy at ~Rs. 133 crore in FY2024 and is likely to remain above Rs. 110 crore in the near-to-medium term. This along with limited and reducing debt repayment obligations (~Rs. 4 crore and ~Rs. 1 crore in FY2025 and FY2026, respectively) and undrawn working capital limits (~Rs. 25 crore as of March 2024) would support DIL's overall liquidity profile. ICRA expects the company to comfortably meet its moderate capex Rs. 30-35 crore in FY2025) through internal accruals and yet be left with a sizeable surplus cash.

Rating sensitivities

Positive factors – An upgrade of the long-term rating will depend on a significant scaling up of operations, product and geographical diversification, along with maintenance of healthy profit margins and liquidity position.

Negative factors – ICRA may downgrade DIL's ratings if there is a significant decline in the company's revenue or profit margins or if any major debt-funded capital expenditure, acquisition or incremental investments in Group entities result in a significant weakening of its credit profile. A deterioration in its total debt/OPBDITA to above 1.0 times on a sustained basis may also be a trigger for ratings downgrade.

Analytical approach

Analytical Approach	Comments
Applicable rating methodologies	Corporate Credit Rating Methodology Auto Components
Parent/Group support	Not applicable
Consolidation/Standalone	The ratings are based on the standalone financial profile of the company as the financials of the wholly-owned subsidiary, Lotus Auto, is not available with ICRA. However, Lotus Auto is in the process of getting merged with DIL.

About the company

DIL manufactures gears, shafts, gearboxes and couplings used in the automobile, tractor and various other industries like power, iron and steel, cement and sugar. In FY2024, the automobile gear segment accounted for 86% of the company's sales (CVs and tractors accounted for ~66% and ~34% of the automobile gear segment revenues), while the industrial gear segment and solar power segment contributed ~14% and 0.2% to its revenues, respectively. The company has four operational plants in Kolkata, Faridabad, Rudrapur and Baghola. The Kolkata plant manufactures gears and gearboxes mainly for the industrial segment, while the other plants manufacture gears and gear parts for the automobile segment and are strategically located near the plants of the CV and tractor OEMs.

Key financial indicators (audited)

DIL (Standalone)	FY2023	FY2024
Operating income	803.1	774.2
PAT	117.6	119.0
OPBDIT/OI	21.6%	21.4%
PAT/OI	14.6%	15.4%
Total outside liabilities/Tangible net worth (times)	0.4	0.2
Total debt/OPBDIT (times)	0.5	0.4
Interest coverage (times)	28.7	25.6

Source: Company, ICRA Research; All ratios as per ICRA's calculations; Amount in Rs. crore

PAT: Profit after tax; OPBDIT: Operating profit before depreciation, interest, taxes and amortisation

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current rating (FY2025)				Chronology of rating history for the past 3 years		
		Type	Amount rated (Rs. crore)	Date & rating in FY2025		Date & rating in FY2024	Date & rating in FY2023	Date & rating in FY2022
				Jul 26, 2024	Jun 10, 2024	Apr 11, 2023	Apr 18, 2022	-
1	Fund-based – Term Loans	Long Term	4.00	[ICRA]AA (Stable)	[ICRA]AA (Stable)	[ICRA]AA (Stable)	[ICRA]AA- (Positive)	-
2	Fund-based – Working Capital Facilities	Long Term	93.00	[ICRA]AA (Stable)	[ICRA]AA (Stable)	[ICRA]AA (Stable)	[ICRA]AA- (Positive)	-
3	Non-fund based – Bank Guarantee/ Letter of Credit/ Forward Cover	Short Term	24.75	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	-
4	Fund-based – Standby Line of Credit	Short Term	2.00	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	-	-
5	Unallocated Limit	Long/ Short Term	11.07	[ICRA]AA (Stable)/ [ICRA]A1+	[ICRA]AA (Stable)/ [ICRA]A1+	[ICRA]AA (Stable)/ [ICRA]A1+	[ICRA]AA- (Positive)/ [ICRA]A1+	-

Complexity level of the rated instruments

Instrument	Complexity Indicator
Long term - Fund-based – Term Loans	Simple
Long term - Fund-based – Working Capital Facilities	Simple
Short term - Non-fund based – Bank Guarantee/ Letter of Credit/ Forward Cover	Very simple
Short term - Fund-based – Standby Line of Credit	Simple
Long term / Short term - Unallocated Limit	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: Click Here

Annexure I: Instrument details

ISIN	Instrument Name	Date of Issuance	Coupon Rate	Maturity	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	Term Loan	06-Feb-2021	-	31-May-2025	4.00	[ICRA]AA (Stable)
NA	Fund-based – Working Capital Facilities	-	-	-	93.00	[ICRA]AA (Stable)
NA	Non-fund based – Bank Guarantee/ Letter of Credit/ Forward Cover	-	-	-	24.75	[ICRA]A1+
NA	Fund-based – Standby Line of Credit	-	-	-	2.00	[ICRA]A1+
NA	Unallocated Limit	-	-	-	11.07	[ICRA]AA (Stable)/ [ICRA]A1+

Source: Company

Please click here to view details of lender-wise facilities rated by ICRA

Annexure II: List of entities considered for consolidated analysis: Not applicable

ANALYST CONTACTS

Shamsher Dewan
+91 124 4545 328
shamsherd@icraindia.com

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

Sujoy Saha
+91 33 7150 1184
sujoy.saha@icraindia.com

Sovanlal Biswas
+91 33 7150 1181
sovanlal.biswas@icraindia.com

RELATIONSHIP CONTACT

L. Shivakumar
+91 22 6114 3406
shivakumar@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

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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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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