

December 07, 2021

Varroc Polymers Private Limited: Ratings downgraded; outlook revised to Negative

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Term Loan	65.00	65.00	[ICRA]A(Negative); Downgraded from [ICRA]A+ and outlook revised to Negative from Stable
Fund-based Facilities	20.00	20.00	[ICRA]A(Negative)/[ICRA]A2+; Downgraded from [ICRA]A+/[ICRA]A1 and outlook revised to Negative from Stable
Non-fund Based Facilities	3.00	3.00	[ICRA]A(Negative)/[ICRA]A2+; Downgraded from [ICRA]A+/[ICRA]A1 and outlook revised to Negative from Stable
Fund-based/ Non-fund Based Facilities	155.00	155.00	[ICRA]A(Negative)/[ICRA]A2+; Downgraded from [ICRA]A+/[ICRA]A1 and outlook revised to Negative from Stable
Unallocated	97.00	97.00	[ICRA]A(Negative)/[ICRA]A2+; Downgraded from [ICRA]A+/[ICRA]A1 and outlook revised to Negative from Stable
Total Bank Line Facilities	340.00	340.00	
Commercial Paper (CP)	75.00	75.00	[ICRA]A2+; Downgraded from [ICRA]A1

*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 (including Varroc Polymers Private Limited (VPPL)), henceforth referred to as the Group/ Varroc.

The rating downgrade factors in the prolonged impact of the semiconductor chip shortage issue globally, that has resulted in weaker-than-expected operating and financial performance of the Group, especially in its global lighting business (under Varroc Lighting Systems or VLS). Owing to production cuts and subdued offtake from its key customers in major geographies like Europe and North America, amid continued cost overheads and commodity headwinds, Varroc's operating performance weakened, increasing its reliance on external borrowings and thereby weakening its credit metrics. During H1 FY2022, the company's consolidated revenues contracted by 16% from H2 FY2021 levels, while reporting a net loss of Rs. 525.1 crore. Additionally, the net debt levels (excluding financial leases) increased to Rs. 3,006.7 crore from Rs. 2,252.7 crore as on March 31, 2021, leading to higher-than-expected moderation in leverage and coverage indicators. While the chip shortage issues were earlier expected to be short-term in nature, the impact has been more prolonged and severe than initially envisaged. Furthermore, with the situation likely to normalise only gradually over the next year, the company's ability to curtail overheads and losses in case of further delays in resolution of the issues, or disruptions from further waves of the pandemic, remains critical, especially in the current inflationary environment.

The resultant weakening in cash flows in VLS, on account of the operational challenges, is likely to it reliant on external borrowings over the near-term and increase refinancing requirements for near-term debt obligations. While the Group has plans for raising funds through multiple routes (including debt or equity raise, asset monetisation, customer advances, etc), both in India and overseas, till the operational constraints subside, ICRA would continue to monitor developments on this

front, and the consequent implications on its credit profile. Nevertheless, the relief measures negotiated by VLS with its customers in the form of customer advances and price increases are expected to offer some relief over the near-term.

Notwithstanding these challenges, 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. It also has a diversified presence across geographies, including North American, European and Asian markets. The ratings draw comfort from its established relationship with customers such as Bajaj Auto Limited (BAL), Honda, Ford Motor Company, Tesla, Volkswagen AG (VW) and Jaguar Land Rover (JLR), among others. Despite the near-term constraints, ICRA expects the Group's revenue to grow at a healthy pace in the medium term, supported by increased share with 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. Additionally, the ratings derive strength from the Group's strong financial flexibility, which is likely to support its near-term liquidity.

The Negative outlook on the long-term rating factors in ICRA's expectation that Varroc's financial risk profile is likely to remain pressurised by the ongoing challenges in the domestic and global automotive markets on account of the supply chain disruptions and steep commodity inflation. The Group's external borrowings are likely to remain elevated in absence of any significant equity issuance or asset monetisation, thereby constraining any material improvement in credit metrics. Nevertheless, ICRA would continue to monitor developments on these fronts, and take rating actions appropriately.

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 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 passenger vehicle (PV) original equipment manufacturers (OEMs) globally and is expected to benefit from the hybridisation and electrification trend of PVs 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. 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 supplied to BAL. The 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 because of semiconductor 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, its customer acquisition in the domestic business and ramping up of operations in new geographies, such as Poland and Morocco. The management also expects business wins in North America to support its business growth prospects.

Diversified geographical presence – Varroc had a diversified geographical profile with presence across India, Europe and North America. Its entry by organic and inorganic expansion in Brazil, Morocco and Turkey resulted in further de-risking of its business by means of geographical as well as customer diversification strategies. Furthermore, Varroc'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

Supply-chain constraints likely to keep earnings constrained over the next few quarters – The Group's operations and in turn its profitability was impacted by the Covid-19 pandemic-related lockdown conditions during Q4 FY2020 to Q3 FY2021 period, resulting in subdued profitability in FY2020 and FY2021. The challenges continued into the current fiscal on account of semiconductor shortages, which affected Varroc's high margin products and geographies disproportionately. The same led to losses in global operations from Q4 FY2021 onwards, and the constraints intensified in H1 FY2022, more than originally envisaged.

Further, high raw material prices because of semiconductor shortages and inflation in other raw material prices impacted Varroc's performance. Nevertheless, the relief measures negotiated by VLS with its customers in the form of customer advances and price increases are expected to offer some relief over the near-term. 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 also impacted overall profits. Sustainable ramping up of operations in these regions will be a key rating monitorable going forward. Any materialisation of contingent liability, which could hinder its profitability, is also a key monitorable. ICRA notes that Varroc's scale and profitability remain susceptible to the cyclical automotive industry, competition from larger players in global automotive lighting, and its bargaining power 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 high debt levels without commensurate contribution to cash flows. The Group had undertaken more than Rs. 3,000 crore of capex in this period, leading to net debt levels increasing to Rs. 3,007 crore in H1 FY2022 from Rs. 880 crore in FY2018. However, during these three years, the revenue growth has been relatively modest (Rs. 11,300 crore in FY2021 from Rs. 10,300 crore in FY2018) on account of delayed ramp-up of new plants, pandemic, chip shortage issues and other exogenous factors.

With high debt levels and subdued profitability, Varroc's debt protection metrics weakened in the recent past and is likely to remain muted in the current fiscal because of high repayment obligations and moderate profitability expectations. Considering the weak performance and semiconductor issues, which are likely to continue longer than earlier expected, ICRA now expects the Group's net debt/OPBIDTA (adjusted for lease liabilities) to be higher than the earlier expectations of 3.0-3.5 times in FY2022 and improve to below 2.5 times only from FY2024 onwards. In this respect, ICRA would also monitor the performance with respect to financial covenants stipulated by Varroc's lenders, and its implications on the company's debt servicing obligations and credit profile.

Weakening liquidity position – Varroc has large debt repayments falling due over the coming months, especially in the overseas operations, where cash flows have been impacted by the chip shortage issues. Moreover, the fund raising plans in the overseas entity has not proceeded as originally envisaged. Accordingly, the liquidity cushion available to the company has deteriorated over the recent past. In this respect, the company's plans for refinancing the debt or monetising any assets or investments in a timely manner, remain critical for supporting its liquidity profile. Nevertheless, ICRA notes that the Group's financial flexibility is supported by undrawn bank limits and cash/bank balances and its established relationship with various reputed financial institutions in the domestic and international markets, as well as support expected from its customers in the form of advances and price increases, which is expected to support it in tiding over this period.

Stiff competition from established players in the global lighting space – 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, as VEL is strategically placed in low-cost regions (Mexico, Czech Republic, Morocco and Brazil, etc), it is able to compete 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 healthy revenue growth for automotive lighting manufacturers 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: Stretched

Varroc's liquidity profile is **stretched**, constrained by weakened cash flows due to prolonged challenges in the underlying market. Although the company has some available surplus cash reserves, along with undrawn credit facilities from the banking system (approximately Rs. 678 crore as on September 30, 2021), it also has debt servicing obligations and continuing capex requirements over the near term. While the company's plans to raise funds through multiple routes, both in India and overseas, are expected to support it in meeting these obligations, ICRA would continue to monitor developments with respect to this. ICRA notes that the overseas subsidiaries have a negative working capital cycle, which results in asset liability mismatch at the consolidated level. The Group's ability to correct this mismatch remains crucial to allay liquidity concerns in the medium term.

Rating sensitivities

Positive factors – Given the Negative outlook, an immediate rating upgrade is unlikely. The outlook could be revised to Stable in case of improvement in the market scenario and an associated improvement in the company's earnings and credit metrics. Measures undertaken to reduce its leveraging such that credit metrics like Net Debt/OPBITDA (adjusted for leases on account of IndAS 116) strengthen to below 3.0 times, on a sustained basis, would be critical for a rating upgrade. Furthermore, alleviation of refinancing concerns and improvement in the liquidity profile would also be important to support a rating improvement.

Negative factors – Varroc's ratings could be downgraded if its operational and financial performance further 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 Debt/OPBDIT (adjusted for leases on account of IndAS 116) greater than 3.5 times on a sustained basis.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	Corporate Credit Rating Methodology Rating Methodology for Auto Component Suppliers
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

Varroc Polymers Private Limited is a part of Aurangabad based Varroc group of companies. Its parent entity, 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 financials)

Varroc (Consolidated)	FY2020	FY2021	H1 FY2022
Operating Income (Rs. crore)	11146.7	11302.8	5,974.2
PAT (Rs. crore) (*excluding share from JV)	11.7	(664.3)	(525.3)
OPBDIT/OI (%)	7.6%	3.5%	-0.2%
PAT/OI (%)	0.1%	-5.9%	-8.8%
Total Outside Liabilities/Tangible Net Worth (times)	2.6	2.6	3.3
Total Debt/OPBDIT (times)	5.0	9.3	(173.2)
Interest Coverage (times)	6.1	2.4	(0.1)

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

Note: Some figures 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
				Dec 7, 2021	Jun 23, 2021	Aug 21, 2020	Apr 30, 2020	Aug 30, 2019	June 01, 2018	
1 Term Loan	LT	65.00	65.0	[ICRA]A (Negative)	[ICRA]A+ (Stable)	[ICRA]AA- (Negative)	[ICRA]AA- @	[ICRA]AA- (Stable)	[ICRA]AA- (Positive)	
2 Non-Convertible Debenture	LT	-	--	-	-	-	[ICRA]AA- @	[ICRA]AA- (Stable)	[ICRA]AA- (Positive)	
3 Fund-based Facilities	LT/ST	20.00	--	[ICRA]A (Negative)/ [ICRA]A2+	[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 Non-fund Based Facilities	LT/ST	3.00	-	[ICRA]A (Negative)/ [ICRA]A2+	[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 Based Facilities	LT/ST	155.00	-	[ICRA]A (Negative)/ [ICRA]A2+	[ICRA]A+ (Stable)/ [ICRA]A1	[ICRA]AA- (Negative) / [ICRA]A1+	[ICRA]AA- @ / [ICRA]A1+@	[ICRA]AA- (Stable)/ [ICRA]A1+	[ICRA]AA- (Positive)/ [ICRA]A1+	
6 Commercial Paper	ST	75.00	-	[ICRA]A2+	[ICRA]A1	[ICRA]A1+	[ICRA]A1+@	[ICRA]A1+	[ICRA]A1+	
7 Unallocated	LT/ST	97.00	-	[ICRA]A (Negative)/ [ICRA]A2+	[ICRA]A+ (Stable)/ [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
Commercial Paper	Very Simple
Unallocated	NA

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 Loan	NA	NA	NA	65.00	[ICRA]A (Negative)
NA	Fund-based Facilities	NA	NA	NA	20.00	[ICRA]A(Negative)/[ICRA]A2+
NA	Non-fund Based Facilities	NA	NA	NA	3.00	[ICRA]A(Negative)/[ICRA]A2+
NA	Fund-based/ Non-fund Based Facilities	NA	NA	NA	155.00	[ICRA]A(Negative)/[ICRA]A2+
NA*	Commercial Paper	NA	NA	NA	75.00	[ICRA]A2+
NA	Unallocated	NA	NA	NA	97.00	[ICRA]A(Negative)/[ICRA]A2+

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
VarrocCorp Holding B.V.	100.00%	Full Consolidation
Varroc Japan Co. Limited	100.00%	Full Consolidation
CarlQ 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.	100.00%	Full Consolidation
Varroc Lighting Systems, 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 Commerica LTDA	100.00%	Full Consolidation
Varroc Lighting Systems sp. Z o.o.	100.00%	Full Consolidation
VARROC LIGHTING SYSTEMS TURKEY ENDÜSTRUYEL ÜRÜNLER İMALAT VE TİCARET ANONİM İRKETİ	100.00%	Full Consolidation
Varroc Lighting Systems Bulgaria EOOD	100.00%	Full Consolidation
Varroc Lighting Systems Electronics Romania SRL (earlier known as Varroc Elba Electronics SRL)	100.00%	Full Consolidation

Source: Varroc annual report **Note:** ICRA has taken a consolidated view of the parent (VEL) and its subsidiaries while assigning the ratings.

ANALYST CONTACTS

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

K. Srikumar
+91 44-4596 4318
ksrikumar@icraindia.com

Sruthi Thomas
+91 124 4545 822
sruthi.thomas@icraindia.com

Shaleen Lohia
+91 20 6606 9917
shaleen.lohia@icraindia.com

RELATIONSHIP CONTACT

L. Shivakumar
+91 124 4545 860
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



Registered Office

B-710, Statesman House, 148, Barakhamba Road, New Delhi-110001

Tel: +91 11 23357940-45



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