

September 01, 2021

Varroc Engineering Limited: Ratings assigned for the fresh NCD programme; Ratings reaffirmed for Bank facilities and CP programme

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Term Loan	504.00	504.00	[ICRA]A+(Stable); reaffirmed
Fund-based Facilities	17.35	17.35	[ICRA]A+(Stable)/[ICRA]A1; reaffirmed
Non-fund Based Facilities	35.0	35.0	[ICRA]A+(Stable)/[ICRA]A1; reaffirmed
Fund-based/ Non-fund Based Facilities	339.55	339.55	[ICRA]A+(Stable)/[ICRA]A1; reaffirmed
Fund-based/ Non-fund - Unallocated	144.32	144.32	[ICRA]A+(Stable)/[ICRA]A1; reaffirmed
Commercial Paper	100.00	100.00	[ICRA]A1; reaffirmed
Non-convertible Debenture (NCD) Programme^	0.0	450.00	[ICRA]A+(Stable); assigned
Total	1,140.22	1,590.22	

*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, henceforth referred to as The Group/ Varroc.

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 recent times, 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 financial flexibility and its recent equity infusion of around Rs. 700 crore, which has supported its liquidity during H1 FY2022.

The ratings, however, remain constrained by the weakening of debt protection metrics because of elevated debt levels and decline in profitability. ICRA expects the Group's financial performance to be subdued in H1 FY2022, and the performance of the overseas lighting business (VLS) to improve gradually in H2 FY2022. However, improvement in profitability, going forward, will be contingent upon the extent and timeliness of recovery of the ongoing semiconductor chip shortage issues. Considering the weak performance and semiconductor issues, which are expected to continue longer than earlier expected, ICRA, now expects the Group's total debt/OPBITDA (adjusted for lease liabilities) to be in the range of 3.5–4.0 times in FY2022, (against the earlier expected 2.5-3.0 times) and improve to below 2.5 times from FY2023 onwards.

It is also to be noted that the Group's operations and profitability were adversely impacted by the pandemic-related lockdowns 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 Czechia) and Rs. 204 crore in Q1 FY2022. The Group's losses in Q1 FY2022 and H2 FY2022 were also mainly due to supply constraints because of global semiconductor shortages from Q4 FY2021, which is expected to continue in the near term and is likely to result in subdued performance in H1 FY2022. Nonetheless, the impact is expected to be one-off, with some normalcy returning thereafter, which is expected to support overall scale and profitability in FY2022. In addition, delayed ramp-ups 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 profitability in 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, who 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 and the management expects the same to remain around Rs. 2,500 crore till March 2022. With high debt levels and subdued profitability, Varroc's debt protection metrics weakened in recent times and is expected to remain muted in the current year because of high repayment obligations and moderate profitability expectations. The expected fund raise programme should help in addressing the asset liability mismatch, and support the overall liquidity position of the company over the next 12-18 months.

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 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 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 shares 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 help in achieve the revenue growth targeted in Varroc.

Diversified geographical presence – Varroc had 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 Turkey, this has resulted in further de-risking of its business by means of geographical as well as customer diversification strategies. 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 Rs 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 one-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 semiconductor shortages and inflation in other raw material prices (resins, plastics) impacted Varroc's performance. In addition, 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 profitability in the recent quarters. Sustainable ramping up of operations in these regions will be a key rating monitorable going forward. Any materialisation of contingent liability, which could materially impact profitability, is also a key monitorable. 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, the 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. Considering the weak performance and semiconductor issues which are expected to continue longer than earlier expected, ICRA, now expects Group's total debt/OPBIDTA (adjusted for lease liabilities) to be in the range of 3.5–4.0 times in FY2022, (as against earlier expected 2.5-3 times) and improve to below 2.5 times from FY2023 onwards. Varroc's ability to refinance a portion of debt maturing in FY2022 remains crucial to maintain adequate liquidity cushion.

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 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 and around Rs 600 crore as of July 2021. Varroc also has been sanctioned an additional \$25 million for capex in FY2022. ICRA expects the liquidity position to be supported by improvement in fund flow from operations, coupled with moderate capex plans. Further, while the Group's debt repayment is 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 expected fund raise programme should help in addressing asset liability mismatch, and support overall liquidity position of the company over the next 12-18 months. 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 if the Group's profitability and debt protection metrics improves on a sustainable basis. Specific credit metrics for an upgrade include Net Debt/ OPBDIT (adjusted for IndAS operating leases) below 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. VEL'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	7.8
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	Type	Current Rating (FY2022)				Chronology of Rating History for the past 3 years				
			Amount Rated (Rs. crore)	Amount Outstanding as of Mar 31, 2021 (Rs. crore)	Date & Rating in	Date & Rating in FY2021	Date & Rating in FY2021		Date & Rating in FY2020		Date & Rating in FY2019
					Sept 01, 2021	Jun 23, 2021	Aug 21, 2020	Apr 30, 2020	Nov 26, 2019	Aug 30, 2019	June 01, 2018
1	Term Loan	LT	504.00	504.0	[ICRA]A+ (Stable);	[ICRA]A+ (Stable);	[ICRA]AA- (Negative)	[ICRA]AA- @	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)	[ICRA]AA- (Positive)
2	Fund-based Facilities	LT/ST	17.35	*	[ICRA]A+ (Stable)/ [ICRA]A1	[ICRA]A+ (Stable)/ [ICRA]A1	[ICRA]AA- (Negative) / [ICRA]A1+	[ICRA]AA- @ / [ICRA]A1+	[ICRA]AA- (Stable) / [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]A+ (Stable)/ [ICRA]A1	[ICRA]AA- (Negative) / [ICRA]A1+	[ICRA]AA- @ / [ICRA]A1+	[ICRA]AA- (Stable) / [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]A+ (Stable)/ [ICRA]A1	[ICRA]AA- (Negative)/ [ICRA]A1+	[ICRA]AA- @ / [ICRA]A1+	[ICRA]AA- (Stable)/ [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	[ICRA]A+ (Stable)/ [ICRA]A1	-	-	-	-	-
6	Commercial Paper	ST	100.00	-	[ICRA]A1	[ICRA]A1	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+
7	Non-Convertible Debenture	LT	450.0	-	[ICRA]A+ (Stable)	-	-	[ICRA]AA- @	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)	[ICRA]AA- (Positive)

@ Rating under Watch with Developing Implications; * break up of limits not available

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
NCD	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;
INE665L14384	Commercial Paper	April 2021	NA	October 2021	75.00	[ICRA]A1;
NA*	NCD	NA	NA	NA	450.0	[ICRA]A+ (Stable)

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
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. (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 Commercica 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 İMALAT VE TİCARET ANONİM ŞİRKETİ.	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 20 6606 9912

ashish.modani@icraindia.com

RELATIONSHIP CONTACT

L Shivakumar

Tel: +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

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



© Copyright, 2021 ICRA Limited. All Rights Reserved.

Contents may be used freely with due acknowledgement to ICRA.

ICRA ratings should not be treated as recommendation to buy, sell or hold the rated debt instruments. ICRA ratings are subject to a process of surveillance, which may lead to revision in ratings. An ICRA rating is a symbolic indicator of ICRA's current opinion on the relative capability of the issuer concerned to timely service debts and obligations, with reference to the instrument rated. Please visit our website www.icra.in or contact any ICRA office for the latest information on ICRA ratings outstanding. All information contained herein has been obtained by ICRA from sources believed by it to be accurate and reliable, including the rated issuer. ICRA however has not conducted any audit of the rated issuer or of the information provided by it. While reasonable care has been taken to ensure that the information herein is true, such information is provided 'as is' without any warranty of any kind, and ICRA in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness or completeness of any such information. Also, ICRA or any of its group companies may have provided services other than rating to the issuer rated. All information contained herein must be construed solely as statements of opinion, and ICRA shall not be liable for any losses incurred by users from any use of this publication or its contents.