

Rating Methodology for Commercial Vehicle Industry

Industry overview

The Indian Commercial Vehicle (CV) Industry is the lifeline of the economy. About two-thirds of goods and 87% of the passenger traffic in the country moves via road. Past trends have shown that CV demand is closely correlated with GDP growth rate (more strongly with the Index of Industrial Production, IIP) of the country and therefore, it is believed that a phase of growth or slowdown in CV demand is a harbinger of an upturn or downturn in the economy respectively.

CVs can be classified on the basis of their usage as Goods Carriers and Passenger Carriers, with the former accounting for 87% of the CV sales in the country. Further the CVs can be classified on the basis of their Gross Vehicular Weight (GVW) as Light Commercial Vehicles (LCV) or Medium & Heavy Commercial Vehicles (M&HCV), with M&HCVs accounting for close to 60% of the total domestic CV sales.

The CV industry has evolved over the years: from the days of traditional all-purpose 9-tonner trucks the industry has moved towards more usage-specific vehicles. The fast improving road infrastructure is giving a push to a modern Hub & Spoke model of distribution of goods, which in turn is changing the kind of vehicles being deployed for goods transportation.

The Industry is now witnessing a clear segmentation in demand, with vehicles >16.2 tonnes (M&HCVs & Multi Axle vehicles) being used for transportation on the highways and ≤ 3.5 tonnes being used for intra-city transport. Similarly in case of passenger vehicles there is an increasing demand for luxury buses from the private players unlike earlier when the demand used to be largely driven by the State Transport Undertakings.

Characteristics

The CV industry draws its demand from the economy and hence is prone to cyclicity. However, due to greater versatility of usage, the LCV demand is less cyclical than the M&HCV demand. The industry is capital intensive in nature but with CV manufacturers moving towards increased ancillarisation, the initial capital outlay for setting up a greenfield plant has decreased substantially. Instead manufacturers are now directing significant effort towards vendor development and rationalization. The industry is highly susceptible to technological changes.

With environmental norms becoming stricter and consumers demanding better technology vehicles, it has become imperative for the manufacturers to either have technology partners or a strong in-house R&D. The need of having a wide product range in each of the segments along with the short lifecycle of these vehicles makes it mandatory for the manufacturers to constantly innovate so as to sustain competition. These factors together increase the entry barriers to this industry making it an oligopolistic market.

Demand Drivers

Vibrant economy, road development programmes, evolving distribution models and government regulations have been the key drivers of CV demand in recent times. Fuel cost and freight rates which have a direct bearing on the profitability of the operators too have an impact. Easy availability of vehicle financing, wide product range, extensive distribution & service centre networks and availability of spares are key deciding factors. Vehicle price, its application and level of technology are some other factors which sway consumer preference.

Rating Methodology

CARE has a standard methodology for rating of companies belonging to the manufacturing sector. As per this methodology, CARE's rating process begins with the evaluation of the economy/industry in which the company operates, followed by the assessment of the business-risk factors specific to the company. This is followed by an assessment of the financial and project-related risk factors as well as the quality of the management. This methodology is

followed while analyzing all the industries that come under the purview of the manufacturing sector. However, considering the size and diversity of the sector, CARE has developed methodologies specific to various industries within the sector. These methodologies attempt to point out factors, over and above those mentioned in the broad methodology, which will be assessed while carrying out rating exercises of companies belonging to the particular industry.

The following is a list of such additional factors, along with their analytical implications, considered by CARE while arriving at the rating of the players that operate in the Commercial Vehicles industry.

Product range

As the CV industry draws its demand heavily from the level of economic activity in the country, demand for products in various segments and sub-segments varies significantly from time to time. For instance, while LCVs experience less volatility in demand, the demand for MHCVs is rather volatile. However, in spite of volatile demand, the contribution of MHCVs to the total industry sales volume is higher as compared to LCVs. Thus, in order to overcome the variability in demand, players in this industry need to have a wide array of products, not just in the various segments, but also in the consequent sub-segments. Further, by customizing their offerings for industries which exhibit heavy freight movement, players can try to inculcate a sense of brand loyalty for their products. In addition, presence in passenger carrier segments can act as a cushion during times of economic downturn, as this segment is not highly correlated to economic growth and hence experiences lesser volatility in demand.

CARE believes that a wide and diversified product offering across various tonnage and usage segments renders the manufacturer the ability to serve a large variety of customers and hence reduces the volatility in sales volume, which is an inherent attribute of the sector.

Servicing & Distribution network

CVs do not enjoy a very high brand loyalty. Purchases are largely influenced by nature and availability of the product at the point of purchase. With the product being one of the most

commonly used products across the country, it is imperative for the players to be present all across the country. A wide-spread distribution network will provide the manufacturers a large and geographically diverse presence, which in turn will help generate higher sales volume; a necessity in a highly capital intensive industry.

Further, once the customer has been acquired, it is important to service the customer in order to develop brand consciousness and build a brand loyalty. Availability of spare parts and service centers is crucial for servicing the customer and developing brand loyalty.

CARE views a wide spread distribution and service network as a key positive for players operating in the CV industry. Easy availability of genuine and affordable spare parts would serve as an added advantage in the brand-building exercise.

Technology tie-ups

Changing customer preferences, rising fuel costs, growing environment concerns and consequent government regulations call for employing of improved technology. Additionally, with the opening up of global markets, there is a need for the domestic players to meet international technology standards. Thus, technology is the key to survival as well as growth in the CV industry. A prudent technical collaboration not only renders the ability to meet stringent environment norms, both domestic as well as international, but also helps players in introducing newer and technologically more advanced vehicles; which is a key to their survival.

CARE views technical collaborations with players having strong international presence as a key positive while analyzing any player in the CV industry.

Innovation

The demand for CV is highly technologically driven. Both changing consumer preference and government regulations make it imperative for the players to constantly innovate and introduce newer and better products.

CARE analyses the players' track record in terms of product innovation as well as the management's ability to gauge the future needs of the market. Although past performance is not always an indication of future excellence, CARE views a good past track record of product innovation as a key positive while arriving at a rating.

Geographical Diversification

The movement in demand for CV closely follows the movement of economic growth. Past trends show that the CV industry has a 4-5 year cycle, with the growth in demand moving closely with the growth in industrial activity. Thus, during periods of economic downturns, the industry experiences a huge decline in demand, which is a matter of high concern for an industry which is capital intensive by nature. In order to reduce this dependence on economic activity, manufacturers need to diversify into other economies. Technological tie-ups with players having strong international presence can help manufacturers to expand globally and thereby reduce their correlation with domestic economic cycles.

Although most players in this industry earn less than 10% of their revenues through exports, efforts to improve this proportion would be viewed positively by CARE.

Level of Ancillarisation

Auto component suppliers have become a critical link in the manufacturing chain. Companies often get entire modules built from auto component suppliers and only assemble it in their production facilities. Further, with a high level of ancillarisation, players can significantly reduce their capital outlay and thereby pass-on some of their business risks to external players. Thus, vendor development (companies spend as long as two years to develop the right vendor) and quality checks have become critical success factors for the CV manufacturers.

CARE views a high level of ancillarisation as a key positive to the CV industry. However, dependence on a single or very few vendor/s for supply of key components can be viewed as an added risk to the business model.

Vehicle financing

The availability of vehicle finance at the point of purchase can foster sales. Traditionally, financing was left to the institutions for whom the business was their core competency. However, in order to provide complete buying assistance to the purchasers at the point of purchase, many of the CV manufacturers set up their own financing companies or tied up with banks.

CARE views the availability of vehicle financing options at the point of purchase a key positive to improve customer servicing and thereby foster sales. However, if the manufacturers themselves delve into vehicle financing, CARE would analyse this business arm of theirs separately using the methodology defined for NBFCs.

Conclusion

The rating outcome is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. CARE analyses each of the above factors and their linkages to arrive at the overall assessment of credit quality, by taking into account the industry's cyclicity.

While the methodology encompasses comprehensive technical, financial, commercial, economic and management analysis, credit rating is an overall assessment of all aspects of the issuer.

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