

Rating Methodology - Auto Ancillary Companies

[In supersession of “Rating Methodology - Auto Ancillary Companies” issued in August 2018]

Industry overview

The domestic auto ancillary industry is highly fragmented in nature and caters to a wide variety of needs of the automobile sector. The organized sector contributes around 75-80% of the domestic sales and contributes to precision components while the rest comes from the unorganized sector which generally caters to low value added products. The industry caters to demand from Original equipment manufacturer (OEM, around 55% of revenue) segment, export (around 25% of revenue) and the replacement market (around 20% of revenue). Therefore, about 75% of the auto ancillary sales are to the domestic market while the rest is exports.

The automobile industry is cyclical in nature and automotive component suppliers’ sales are directly linked to sales of auto OEMs. Auto Ancillary Companies being smaller in size and largely dependent on OEMS, have limited bargaining power.

Rating Methodology

CARE Ratings has a well laid out 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 Ratings 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 Ratings while arriving at the rating of the players that operate in the auto ancillary industry.

1. Promoters / Management risk
2. Operational risk

1. Promoters / Management risk

Companies belonging to groups with established presence in the industry either as OEMs or ancillaries stand to gain because of the association. Strong parentage enables access to various aspects like new markets, technology, personnel, distribution networks, raw material sourcing etc. CARE's methodology factors in the track record of the group/parent in the business and the benefits (both operational and financial) that a company derives from being a part of a larger auto ancillary group in its analysis.

2. Business / Operations risk

Scale of Operations

The revenue is the key indicator of the business strength and market position. CARE Ratings positively views the entities with large scale of operations reflecting greater market share, higher bargaining and purchasing power. CARE Ratings also analyses whether the company falls into Tier I auto component manufacturer or Tier II auto component manufacturer. Tier I companies supply components directly to OEM while Tier II companies do not directly supply to OEM and are the key suppliers to Tier-I companies. Tier I companies reflects higher profitability, receive special treatment from OEMs and considered superior over Tier II companies.

Product profile:

The auto ancillary industry produces a wide variety of products ranging from technology intensive and critical products like engines and fuel systems to simple products like sheet metal parts etc. Complexity, technology, and time taken for development etc. are some of the factors that determine the importance of the auto ancillary company to the OEM and the strength of the relationship.

In terms of product segments, manufacturers of most critical components which require high level of precision and `quality adherence accounts for 31% of auto component industry. This segment includes engine components such as pistons, piston rings, engine valves, crank shafts etc. and axles. Other non-critical components includes transmission and steering parts (19% of auto component market), body and chassis segment (12%), suspension and braking component (12%), equipment segment (10%) and electrical components segment (10%). The steering system industry is technology and capital-intensive in nature that acts as an entry barrier, especially for smaller players and the unorganized segment. Manufacturing axles too is capital and technology-intensive

business, with axle being one of the critical components. Designing and offering axles to meet exact engine specifications is one of the key success factors of axle manufacturers. On the other hand, braking system is not very technology-intensive.

The more critical, complex and technology intensive the product is, higher is the extent of coordination called for between the auto ancillary and the OEM and higher is the pricing power enjoyed by the ancillary. Typically products like pistons, crankshafts and fuel injection systems are crucial and technologically intensive products and require high level of co-ordination between the OEM and the auto ancillary company at the time of development. Further, companies manufacturing technologically intensive products face lesser substitution risk as the technology acts as an entry barrier. Thus, companies with a strong in-house R&D team or access to new technology or foreign technical collaborators / parent and producing products in the higher end of the value chain are viewed favorably.

Quality and precision of the component is also of utmost importance in auto components especially in case of products like crankshafts, pistons etc. Thus, companies which follow global best practices like Six Sigma, Kaizen, total quality management (TQM), 5-S etc. and which have quality certifications like ISO etc. are viewed favorably.

Diversification

CARE Ratings analyses the extent of diversification in entities revenue stream emanating from diversification in product segment, geography specific exposure, clientele base, market segment. Diversified clientele: A well-diversified customer mix is important for the ancillary manufacturer as it helps minimize the risk of volatile sales and profits. CARE Ratings positively views companies which have a diversified client base as this insulates the company from decline in performance of any particular OEM.

Product mix: Diversification across product/segment categories (passenger vehicles, commercial vehicles, three-wheelers, two-wheelers or their sub-segments) or models makes the company less susceptible to decline in volumes in any particular category or model. Consistent orders from new models is looked at positively as it depicts companies strength in developing products for new models and getting insulated from declining sales of existing / old models. A wide range of products also helps in mitigating the risk and contributes to more stable revenue.

Geography: Exports help widen the clientele and market presence of the company and help insulate the revenues and margins from domestic factors. Presence in multiple clusters within India also provides geographical diversification.

Revenue diversification: Companies having a balance between OEM sales and sales to replacement market are viewed favorably. Replacement market sales command higher margins, at the same time provide revenue stability as it is not correlated to the performance of the OEMs and production of vehicles, which can be volatile. However, a large distribution network is required to cater the replacement market, so the costs incurred may not be justifiable at times, as the buyers in this segment are extremely price sensitive and may not be brand conscious. Further, CARE Ratings analyses the interplay of these diversified segments in the overall operations of the company in the past.

Logistics, supply chain and location of the plant

The auto ancillary industry is primarily located in and around the auto clusters. In India there are 3 major auto clusters, namely Gurgaon- Manesar in the north, around Pune-Aurangabad in the west and around Chennai in the south. In the recent times, Gujarat has emerged as a new auto hub. The Tier-I and Tier-II suppliers are generally located in the vicinity of the OEM's units while the unorganized segment is spread across the country.

OEMs generally follow a just-in-time policy for raw material procurement. So proximity of the ancillary manufacturer's plant to the OEM's plant helps in supplying the products at the right time and at lower costs. Location of the company's plant in the major auto clusters of the country gives it access to multiple OEMs and Tier I suppliers. Location of the plant in duty free zones is also looked at favorably as it translates into GST and income tax benefits of the company. Further, the presence of the suppliers of the auto companies in the auto clusters is viewed favorably as it benefits the ancillary in terms of timely sourcing of raw material with cost benefits.

Raw Material

Raw material cost forms a large part of the cost structure of the auto ancillary companies. Thus, any increase in the price of raw material (especially steel, copper, aluminium) can have a significant impact on the profitability of the company. The ability to pass on the increase in the raw material prices in a timely manner can have a significant impact on the profitability of the company. This

apart, raw material sourcing arrangements and ability to procure components and other parts at competitive rates also is a key factor.

Further, efforts on product engineering and adoption of best manufacturing process etc. can also help lower material costs and this augurs well in maintaining overall profitability margins of the company.

Conformity to Regulatory Norms

CARE also focuses on company's plans to adopt regulatory changes (viz. implementation of BS-VI compliant components, increase in load carrying capacity of heavy vehicles). Fuel consumption, emission and safety norms introduced, has made it imperative for the auto component suppliers to adapt latest technology. CARE positively views companies with roadmap of manufacturing components compliant to progressive regulatory norms.

Conclusion

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