

Apeksha Kapadia presents expert opinions of D. R. Dogra, CEO, CARE, Pragya Bansal, Associate Director, Fitch Ratings, Pawan Agrawal, director, CRISIL Ratings, and Manish Kothari, business head-Corporate Banking, Kotak Mahindra Bank:



Auto Sector Edging Toward Stability

News: GM gets 'junk' credit rating from Fitch

Fitch had given General Motors a junk level credit rating of BB-, saying its pensions remain under funded and the auto market remains uncertain. The company's pension obligations are under funded by \$27 billion.

News: ICRA assigns 'LAA-' rating to Tata Motors

ICRA has assigned a long term rating of LAA- to the ₹12 bn non fund based bank facilities of Tata Motors. The outlook on the long term rating is stable. ICRA also has LAA- (Stable) rating outstanding on the ₹60 bn fund based bank facilities and the ₹6 bn non convertible debenture of the company. The assigned rating takes into account improvement in the company's financial profile driven by significant turn around in the Jaguar Land Rover (JLR) operations, initial signs of stability in JLR's profitability indicators and favorable impact of the proposed equity/equity linked fund infusion plans of the company.

News: Ford's credit rating raised by Moody's

Ford Motor's credit rating was raised two levels by

Moody's Investors Service, which said the automaker's operating performance significantly exceeded expectations. The upgrade in

Ford's corporate family rating to Ba2 from B1 is the fifth Moody's has given this automaker in the last 13 months. Ford, which has \$27.3 billion in automotive debt, remains two levels below investment grade.

News: Fitch views premium car manufacturer positively

Fitch expects improvement in the credit ratings of European auto makers. It anticipates the upper class manufacturer stronger credit profiles compared to volume manufacturers. Luxury car maker could have by 2012 pre crisis levels reached in credit ratios, whereas the mass producers could expect a permanently higher debt and lower credit ratings.

Looking at these news items, it seems that ratings for the auto companies are generally on the upswing. What is your evaluation of the auto companies in India?

D.R. Dogra: The demand for automobiles has rebounded sharply after witnessing weakness in (FY09) on the back of the recovery of the Indian economy, ease in availability of finance, glut of launches of new models, increase in personal income levels and improvement in consumer sentiment. The overall automobile sales that had inched up by modest 3.3% in FY09 witnessed a healthy 25.3% growth in FY10. Lower input costs in FY10, coupled with higher volumes, helped the Indian automobile companies improve their profitability and translate into healthy cash accruals. The growth in automobile sales continued to remain buoyant in FY11, with sales in April-October 2010 registering 31.5% growth over April-October 2009. CARE Ratings expects the buoyancy in demand to persist, with automobile sales likely to grow by



DR Dogra maintains that automobile manufacturers have lined up significant expansion plans

around 20-25% per annum in the next 2-3 years. However, there could be some pressure on the margins front in the light of rising competition and strengthening commodity prices. The buoyancy in demand would still translate into healthy growth in cash accruals of the automobile sector. The ratings of the companies in the automobile sector have seen upward bias in the last 12-15 months to factor in the improving credit profile, robust offtake and healthy demand outlook.

Pragya Bansal: There has been a rebound in the domestic sales in 2010 and we expect the growth momentum to sustain for next year as well. International markets such as US and Europe, which saw a sharp decline in auto sales, have shown marginal recovery this year and are also expected to recover in 2011. These developments shall collectively benefit Indian auto manufacturers. However, this growth is bringing along with itself an increase in input costs, with prices of key raw materials such as steel and rubber increasing again. This would likely put pressure on the margins as was seen in latest quarterly results of most Indian auto manufacturers. So, overall there has been improvement on the demand front which caused some positive rating actions during last year 2010. But the situation now has largely become stable and we do not foresee much change from current national rating levels next year.

Manish Kothari: Spurred by domestic demand, auto companies are doing quite well in India.

Pawan Agrawal: CRISIL rates most of the auto companies in India; together these entities represent more than 90% of the volumes in the domestic sector. Most of these companies have a rating in the high or highest safety category due to their leading market positions, low reliance on debt, and strong financial flexibility in the form of liquid surplus. The future demand outlook also remains strong, which is a key reason why several foreign manufacturers are strengthening their presence in India. For these entities, the credit quality factors in financial and business support from their respective parents.

Almost all auto manufacturers in India are expanding their capacity. Do you expect them to fund this expansion mostly through domestic debt or through equity? What do you see as the scope of ECB for these manufacturers?

Dogra: On the back of buoyant demand scenario and



Pragya Bansal feels though interest rates have started rising, cost of consumer finance has not undergone very sharp increase

high operating rates, the automobile manufacturers have lined up significant expansion plans. With healthy internal accruals generated over the last 15-18 months,

the sector's reliance on borrowed funds has been relatively lower to fund its expansion plans. The buoyancy in



Pawan Agrawal believes auto companies need to constantly invest in new product development to maintain market position

equity markets would also lead to higher reliance on equity. Nevertheless, the sector requires debt funds as well. CARE Ratings believes that ECB remains an attractive option for the domestic automobile manufacturers, even after considering the cost of hedging. There is upward bias in the interest rates in India on account of strong domestic demand but economic uncertainties in the US and Eurozone would translate into the interest rates in those areas remaining at the current extremely low levels, making ECB an attractive option to be considered.

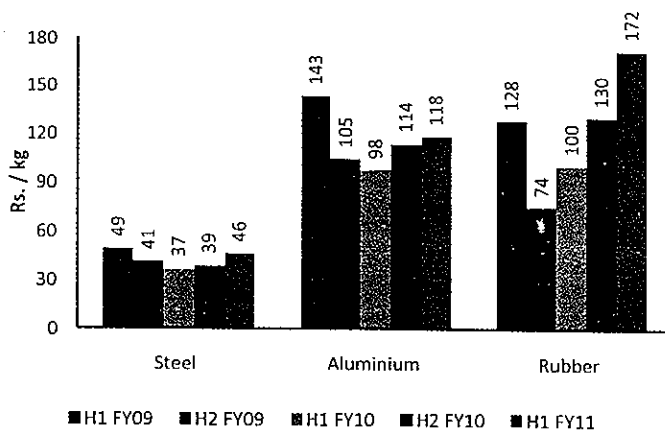
Bansal: The capacity expansion by different manufacturers are getting funded differently; those with stronger balance sheets and operating cash flows such as Maruti Suzuki are financing it through internal resources while many others, including new entrants, are adopting a mix of debt and equity. Since global markets themselves were affected severely hampering the ability of the global players to support their international operations, many such players are resorting to borrowings to fund their capex plans. As far as the choice between external commercial borrowings and rupee loans are concerned, it is getting largely guided by the cost arbitrage that these players are able to negotiate.

Kothari: The funding will be through a combination of equity and debt. And yes, ECB will be a viable debt option.

Agrawal: The established players already have a strong cash surplus, which will be used to fund the expansion. The new foreign players will rely on a mix of equity and debt - the debt could be a mix of subordinated debt from the parent and external debt, with credit enhancement from the parent.

What do you see as the major risk factors facing the auto manufacturing sector?

Dogra: The Indian automobile sector faces higher risk on the supply side than the demand side. Buoyancy in the Indian economy, high savings rate and lower penetration of automobiles would keep the demand afloat over the long run. However, rising input costs and increasing level of competition are major concerns for the industry. The commodity prices have started climbing up on the back of global economic recovery and CARE Ratings expects the uptrend to continue. Thus, the cost of inputs like steel, aluminium, natural rubber, plastics, etc. is set to go up further. However, stiff competition would



not allow complete pass-through of rising input costs.

Note: Steel – Average monthly prices of Cold Rolled Coils (0.63 mm) for four metros; Aluminium – Average monthly prices of ingots, Mumbai; Natural Rubber – Average monthly prices of RSS-4 grade in Kottayam (Source: IAS, CMIE database)

Increasing level of competition would also translate into higher selling and distribution costs in terms of higher advertisement and promotion costs, discounts to buyers as well as probable higher dealer commissions. Though many dealers would prefer sticking to industry leaders that assures them higher volumes, the smaller players would try to attract them with higher commissions in a bid to expand their sales network. Thus, the bigger players might have to shell out more commission or offer better credit terms to their dealers to retain them. The operating margins of the industry leaders may come down by 150-200 basis points from the current levels over the next 15-18 months.

Bansal: The prices of key input commodities have started rising during latter half of 2010 after remaining subdued for about an year and are expected to remain high during 2011. This combined with rising competition in the Indian auto sector with the entry of many new players shall limit the ability of OEMs to pass on these cost increases to the customers fully. Moreover, OEMs may decide to absorb a part of these cost increases fearing the negative impact on demand owing to frequent price increases as they have undertaken

price revisions owing to higher costs of environmental compliance as well. Besides, large capacity addition in the auto sector would create a demand supply



Manish Kothari emphasizes funding will be through a combination of equity and debt and ECB will be a viable option

imbalance in the short to medium term till demand growth absorbs the new capacity. Moreover, these expansion plans combined with other capex on product development, technological innovation etc. would increase the debt levels making the companies more leveraged going forward.

Kothari: Supply side constraint, due to insufficient capacity with vendors (at least in the short-term), seems to be the major risk factor facing the sector, apart from of course spiraling interest costs that can subdue demand.

Agrawal: The key risk for this sector is intense competition and large ongoing capital investment needs. Auto companies need to constantly invest in new product development to maintain their market position. The high competition also increases the pressure on their margins.

With interest rates inching upwards, what impact do you expect on offtake of auto loans?

Dogra: CARE Ratings expects inflation to average 7% in FY11 and 5% in FY12 and accordingly, significant increase in interest rates is not foreseen. We also, expect a cumulative of 50-75 bps increase in interest rates from the current level till the end of FY12. Marginal increase in interest rate does not have significant bearing on demand for automobiles. If the cost of auto finance inch up by 200 bps, it translates into a modest ₹30-35 increase in EMI for a two wheeler loan (of ₹40,000 for a tenure of 5 years) and approximately ₹325-340 increase in EMI of passenger vehicle loan (of ₹400,000 for a tenure of 5 years). This translates into a mere 2-3% increase in annual cash outflows of the households (excluding down-payment) that have purchased a personal vehicle on 85-90% finance. Thus, the impact of higher interest rate is not very significant. In case of commercial vehicles as well, the 200 bps increase in cost of finance means a mere 1-2% increase in the annual cash outflows (excluding down payment). However, the slowdown in industrial production, if any, on account of higher interest rates could impact the commercial vehicle demand. It is the availability of finance that is more critical to the offtake of automobiles than the interest rates, as more than 60% of the same are purchased on finance.

Bansal: Though the interest rates have started rising, cost of consumer finance has not undergone very sharp increase. Moreover, there has been improvement in freight rates, trade volumes, and per capita income which coupled with stable economic scenario has helped to ward off negative impact of rising interest rate on demand so far. We expect that moderate increases in cost of consumer finance would not have very significant impact on demand.

Manish Kothari: Since a large percentage of vehicles are financed, there is a possibility of some impact on sales, though it appears minor at this stage.

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