Rating Methodology - Auto Components & Equipments

[Issued in July 2022]

Background

The Indian auto component industry accounted for sales of around Rs 3,40,733 crores (USD 45.9 billion), with exports of around Rs 98,673 crore (USD 13.3 billion) in 2020-21. This was significantly lower than the sales and exports of Rs 3,95,902 crores (USD 57.1 billion) and Rs 1,06,048 crores (USD 15.2 billion), respectively, for 201819. The decline in the following two years can largely be attributed to Covid-related disruptions, production slowdowns at original equipment manufacturers (OEMs) due to shortage of electronic chips, and lower aftermarket sales. The domestic auto ancillary industry is highly fragmented in nature and caters to a wide variety of needs of the automobile sector. The organised sector contributes around 75%-80% of the domestic sales catering to mostly OEMs, while the rest comes from the unorganised sector comprising low value-added products and catering to the replacement demand. The industry's sales to the OEM segment contributed 63.2% of its total turnover, while exports and the replacement market contributed 22.3% and 14.6%, respectively, in FY21.

While the replacement market demand provides relatively steady revenue, the cyclicality of the end-user auto industry exposes component suppliers to cyclical demand. With most auto ancillary companies being smaller in size and largely dependent on OEMs, they have limited bargaining power. Competition has also been intense due to the sizeable presence of unorganised players.

In the past decade, there has been a trend of domestic auto ancillary companies acquiring component manufacturers overseas for gaining access to technology and new markets or to be able to cater to their global OEM clients more efficiently. These acquisitions could result in the leveraging of the balance sheet of the domestic ancillary companies, besides posing assimilation risks.

Auto component exports from India, although currently accounting for less than 2% of the global trade in auto components, have displayed a steady increase over the past decade. The Production Linked Incentive (PLI) scheme is expected to provide a fillip to component exports given the cutting-edge technologies where government investments are being channelised.

Rating Methodology

CARE Ratings has a well laid out methodology for rating the companies belonging to the manufacturing sector. As per this methodology, CARE Ratings' 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. After this, there is an assessment of the financial and project-related risk factors as well as the quality of the management. This methodology is followed while analysing 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 attempt to highlight the 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 are 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

Companies belonging to groups with an 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 Ratings' 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

i. Scale of operations and vendor category

The revenue is the key indicator of the business strength and market position. CARE Ratings positively views the entities with a large scale of operations reflecting greater market share, higher bargaining and purchasing power. A strong market position is a reflection of the strength of its relationship with OEMs and a key driver of operational flexibility. CARE Ratings also analyses whether the company falls into Tier I auto component manufacturer or Tier II or III 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 of sub-system components to Tier-I companies. Similarly, Tier III component manufacturers are suppliers to Tier II companies. On account of the direct relationship with OEMs and a higher degree of inter-dependence for the supply of components in addition to being engaged at the product development stage, Tier I companies enjoy higher profitability and are considered superior over Tier II and III companies.

ii. Complexity and technology intensiveness of 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, time taken for product 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.

The more critical, complex and technology-intensive the product is, the higher the extent of coordination called for between the auto ancillary and the OEM, and the higher the pricing power enjoyed by the ancillary. Furthermore, companies manufacturing technologically intensive products face lesser substitution risks 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 at the higher end of the value chain are viewed favourably.

Quality and precision of the component are also of utmost importance in auto components. Thus, companies that follow global best practices like Six Sigma, Kaizen, total quality management (TQM), 5-S, etc., and which have quality certifications like ISO, etc., stand to gain the trust of new OEMs enabling them to increase the market share and diversify.

iii. Risk of obsolescence of existing products

OEMs must continuously augment or modify their product basket in line with changing regulatory norms, technology advancements or shifts in consumer preferences. Auto ancillaries must similarly adopt new technologies and modify the design of their offerings to keep in sync with the innovations of the OEMs. CARE Ratings analyses the product profile of the rated entity to assess which of the offerings would continue to find application over the long term thereby ensuring revenue stability.

Currently, most automobile OEMs are working towards the development of electric vehicles (EVs), which entails a complete redesign of offerings and renders obsolete many of the conventional technologies and components, especially those related to internal combustion engines and power transmission. Therefore, in the EV paradigm, manufacturers of relatively less technology-intensive products such as sheet metal parts and brake cables would continue to have revenue visibility whereas suppliers of piston rods and other engine components would not.

The replacement of analogue meters with digital across various automobile categories is an example of a product becoming obsolete due to the increased adoption of electronics in the dashboard. There could be numerous such factors leading to product obsolescence and consequent disruption of the revenue stream; CARE Ratings tries to assess all the factors that could lead to the same.

iv. Diversification

CARE Ratings analyses the extent of diversification in entities' revenue stream emanating from diversification in the product segment, geography-specific exposure, clientele base and market segment.

Diversity in 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 that have a diversified client base as this insulates the company from a decline in the 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 a decline in volumes in any particular category or model. Consistent orders from new models are considered positively as it depicts the company's 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. This may become increasingly relevant as the sales of electric vehicles gain momentum.

Geography: Exports help widen the clientele and market presence of the company and help insulate the revenues and margins from domestic factors. However, demand contraction in key exporting markets and exposure to volatile foreign exchange needs evaluation. Presence in multiple clusters within India also provides geographical diversification.

Revenue diversification: Having a balance between OEM sales and sales to the replacement market enables component manufacturers to mitigate the cyclicality associated with auto OEM sales to an extent. Replacement market sales command higher margins and 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 to 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.

v. 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 recent times, Gujarat has emerged as a new auto hub. The TierI and Tier-II suppliers are generally located in the vicinity of the OEM's units, while the unorganised segment is spread across the country.

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

While assessing import dependence, supplies from a few countries or suppliers can create significant concentration risk and at times be faced with disruption in the supply chain.

vi. Raw material sourcing arrangements and cost control strategies

Raw material sourcing arrangements and the ability to procure components and other parts at competitive rates is a key factor in the analysis. Further, efforts on product engineering and adoption of the best manufacturing process, etc., can also help lower material costs and this augurs well in maintaining the overall profitability margins of the company. Employee expense is the other major cost item that impacts the overall cost of production and hence an analysis of its past trend is carried out. While CARE Ratings evaluates the above factors to understand cost structure, the nature of the product, its degree of complexity and technology involved in manufacturing and the extent of value addition eventually defines the overall profitability.

vii. Nature of contracts with OEMs

CARE Ratings studies the nature of contracts between the auto ancillary and its OEM client/s to assess the following:

a. Revenue visibility: Whether the contract is long-term or short-term in nature and what is the contracted quantity to be supplied
b. Clauses relating to pass-through of input cost variations: Raw material cost forms a large part of the cost structure of the auto ancillary companies. Thus, the ability to pass through the increase in the price of raw materials (especially steel, copper, and aluminium) in a timely

manner is key to sustaining profitability. Clauses analysed in this regard are the extent of pass-through, basis for computation of the same and the time lag after which the price revision becomes effective.

c. Credit terms with the OEM

viii. Conformity to Regulatory Norms

CARE Ratings also focuses on the 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, have made it imperative for the auto component suppliers to adopt the latest technology. CARE Ratings positively views companies with a roadmap of manufacturing components complaint to progressive regulatory norms.

3. Financial risk

CARE Ratings' assessment of the overall financial risk profile of an auto ancillary is based on various financial indicators, in line with its methodology for the credit rating of non-financial sector companies. Please refer to the CARE Ratings criteria "Financial Ratios – Non-Financial Sector" on our website www.careedge.in for additional details.

Analysis of cash flows assumes significance while rating auto ancillary companies, given the need to continuously invest in product development and augmentation of manufacturing facilities, besides having to deal with wide variations in demand for their offerings from OEMs, due to cyclicality in automobile sales or otherwise. CARE Ratings considers cash flow analysis as part of the liquidity assessment of the rated entity, and favourably considers companies that generate positive free cash flows on a consistent, throughthe-cycle basis. Additionally, if free cash flows turn negative on a temporary basis due to the need for capital investments which will yield profitability and cash flow benefits within the medium term, it may not necessarily have a negative impact on the rating.

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

[For the previous version please refer to 'Rating Methodology – Auto Ancillary Companies' issued in June 2020**]**

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