CARE Ratings
Professional Risk Opinion

Rating Methodology – Auto Dealerships

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Industry overview

The Auto Dealership Industry plays a key role in the automobile value chain by facilitating sales of the auto OEMs. Auto dealerships help to shape the buyer's perception of the OEM, which is largely built around his or her experiences in the dealerships. Accordingly, auto dealerships have to invest significantly in creating the right ambience in their showrooms, besides the investment and expenses that goes in training of employees and leasing of adequate space at prime locations to be able to offer ancillary services as well (in addition to display of cars) such as insurance and financing for vehicle purchase. Additionally, there are expenses involved for leasing of space for workshops to offer servicing and repair of vehicles, as well as for warehouses for the storage of vehicles. Considering the gestation period for a new auto dealership which could range from one to three years, these entities should also have the financial strength to sustain operations for this period in the backdrop of inadequate revenues. Operating an auto dealership therefore calls for ability and willingness to support the business in the initial years till it becomes self-sustaining, as well as efficient working capital management and keeping a tight control over fixed costs, given the slim margins involved in the business.

The fortunes of auto dealerships are directly linked to the performance of their respective OEMs. Dealerships have to deal with unexpected shifts in buyer preferences towards newer models launched by competitor OEMs thereby impacting their revenues.

Industry Risk

Given the trading nature of the business, the recurring investments required are low, and the initial investment is restricted to outgo towards acquiring office space as well as on interiors/fitouts. Hence entry barriers in terms of investment or technology are low. The key success factor is to operate a dealership in a location that has a good 'catchment area' which would ensure minimum level of revenues. Dealerships of OEMs in the Medium and Heavy Commercial Vehicles (MHCV) and tractors are typically located outside cities. MHCV dealerships tend to display cyclicality of revenues in line with the OEM.

Dealerships are expected to offer insurance and financing solutions through tie-ups with insurance companies and banks/NBFCs as part of the deal. Ability to offer car servicing and maintenance at the same or alternate location is critical as OEMs seek to maximise their service network. Increasingly dealers have to be able to buy back the used vehicles of the buyers to facilitate the sales of new vehicles.

Given the steady increase in leads generated in online portals of auto OEMs in the past few years, CARE Ratings assesses the dealer's preparedness, ability or proficiency to handle online queries and convert the same into sales. The agency notes that the dealership has limited role to play in case the buyer has decided to purchase the vehicle online from the OEM, with the responsibilities restricted to completing the balance formalities related to the sale. On the other hand, if the OEM has passed on the online lead to the dealer, the onus of pursuing the lead and converting the same into sales lies with the dealer.

Demand Drivers

The key demand drivers for auto dealership revenues would be the same as for OEMs. Hence easy access to low-cost finance would be a significant driver for dealerships of all types of automobiles. In case of passenger vehicles and two wheelers, rising disposable income, inadequacy of public transport and overall cost of ownership are key demand drivers which influence the purchasing decision. Especially in case of two wheelers, rising rural incomes and increasing traffic congestion in cities are additional demand drivers.

In case of medium and heavy commercial vehicles (MHCVs) the level of industrial activity and agricultural output play a key role in driving demand. Demand for buses would be from the government and private companies, educational institutes, various municipal and state public transport departments, as well as from private bus operators for intra-state and long-distance routes.

As light commercial vehicles (LCVs) are used for last mile connectivity, including door-to-door transportation of smaller loads, its demand is partly driven by the level of regional industrial activity. Additionally, the strong growth emerging in online retail has also been a contributing factor determining LCV sales. Demand for small buses from educational institutes, tourism services and hotels is also a factor driving LCV sales. In case of tractors, as the demand is largely rural, the level of agricultural output would be a key driver of sales.

Apart from the factors mentioned above, sales of automobiles would be impacted by any favourable or unfavourable change in regulations, for example scrappage policy in conjunction with stricter emission norms shall support sales of new vehicles, while upward revision in axle load norms for trucks was detrimental to sales.

Rating Methodology

CARE Ratings has standard methodologies for rating of companies in the manufacturing and services sectors. It encompasses an assessment of the various risk factors which could potentially affect the credit risk of an entity such as: economy and industry risk analysis, business risk, financial risk and management quality. However, considering the size and diversity of the service sector, CARE has devised methodologies specific to various industries within the sector. These methodologies attempt to point out factors, over and above those mentioned in the broader methodology devised for the service sector, which are considered while analysing entities belonging to a particular industry. Although strictly falling under trading activity, the auto dealership business is closely aligned to the auto sector and hence the drivers for auto sales in a particular year as well as forecast period would be analysed to understand the overall prospects for auto dealerships. This would address the industry risk parameter. Other broad parameters that would be analysed would be the management, business/operational and financial risk factors, in addition to project risk (if any).

The following is a list of such additional factors under 'Business/ Operational Risk' and 'Financial Risk', along with their analytical implications, considered by CARE Ratings while arriving at the rating of the players that operate in the Automobile Dealership sector.

Business/Operational Risk

Market share of the OEM in India and share of dealer in OEM's sales

Given that the top three auto OEMs in each segment enjoy a combined market share of around 80%, dealerships of these OEMs generate high revenues which would also be fairly stable and predictable. Market disruptions due to the introduction of popular models by competitors could sway volumes away from the market leaders in the short term. However, the market leaders are expected to largely maintain their position by introduction of new models and upgrades of their own existing models on regular basis. Hence the fortunes of auto dealerships move in tandem with those of their principals. Dealers accounting for a higher share of OEM's volumes receive preferential treatment from the OEM, typically in terms of choice of the more popular models manufactured, favourable delivery timelines and other incentives.

The key risks that auto dealers face, particularly in case of the OEMs with small market shares is that should the OEM choose to exit the Indian market due to weak sales on a consistent basis, then the investment made by the dealer will have to be written off, unless the dealer is able to quickly take up the dealership of another auto company. CARE Ratings views the dealership of leading OEMs as positive as it translates into enduring competitive advantage. Also, if a dealership has consistently managed to register strong revenue growth, thereby achieving a material share of the OEM's volumes this too would have a positive bearing on the rating. On the other hand, the inability of a dealership to sell even the popular models of the OEM would point to certain inherent deficiencies in the dealership such as improper location or lack of service infrastructure.

Characteristics of catchment area in terms of location, size, buying power and competition

CARE Ratings positively views dealerships operating in prime locations with a large 'catchment' area and hence enjoying higher sales. Additionally, the agency also assesses whether the buying power of the local population is suited to the nature of products offered. For instance, a showroom for luxury cars in a middle-class neighbourhood may not necessarily do well, but a dealership of two wheelers would. Similarly, whether a dealership is present in a metro, tier 1 or tier 2 town or village will determine the nature of products to be offered based on the market being catered to.

If an OEM finds that a market in particular region is attractive and not being served adequately by a single dealership, it may choose to authorise additional dealerships there. This is typically the case where the original dealership is unable to quickly expand operations vide multiple showrooms to cover the entire region. In such instances, the revenue potential of the original dealership declines sharply, while the OEM benefits from its multiple dealerships competing with each other to push sales.

Diversification of revenues

CARE Ratings evaluates the historical revenue sources of an auto dealership as well as potential ancillary revenue streams to gauge the stability of its total operating income. Companies with showrooms at multiple locations, catering to clientele in different regions would benefit by way of a larger catchment area. Additionally, a dealership that derives significant revenues from sale of spares, servicing and repair shop services would report higher PBILDT margins given the inherently higher margins in these revenue segments. Revenue diversity can also be achieved by way of handling agencies of non-competing products of multiple OEMs.

Almost all auto dealerships also offer insurance policies and auto loans vide tie ups with various insurance companies and lenders. Over the past few years many auto dealers have branched out in the used vehicle market as well, vide their OEMs (who themselves may have an established used vehicle business), or through their own network of used car dealers. By offering to buyback used vehicles of potential buyers a dealership enhances the prospects of generating sales of new vehicles. Not only do these complementary revenue streams boost sales volumes by allowing the dealership to project itself as a 'one stop shop' for OEM's offerings, but also help supplement the dealership's revenues by way of commissions earned on insurance policies issued, loans sanctioned and used car deals facilitated within its premises.

Cost structure and break-even level of sales

Given the fragile operating margins in the business and high proportion of fixed costs (typically, lease rentals and employee costs) in the overall cost structure, achieving scale (in terms of total operating revenues) is important in order to be profitable.

CARE Ratings studies the overall cost structure of a dealership to assess the level of fixed costs in the cost structure. The agency also analyses the break-even level of sales to understand whether a dealership's operations are inherently profitable or not. While a newly incorporated dealership would take three years on average to break even, significant delay in achieving break-even would point to deficiencies in the business model of the company.

Working capital management

As debt raised by auto dealerships is mostly to fund working capital, tight control over the same is key to ensuring adequate debt servicing capability as well as protect net margins. Working capital requirement of a dealership is driven largely by the annual business plan drawn up by the OEM which lays down the sales volumes that individual dealers are expected to achieve in the course of the financial year. The number of days the inventory remains unsold in the dealership less the credit period offered by the OEM, together with the inventory value is essentially the determinant of working capital for the dealership. Dealerships of OEMs with popular models will have lower working capital requirement with fast moving inventory.

Working capital position could vary across auto dealerships depending on credit terms allowed by the OEM. While luxury brands demand 100% advance from dealers before shipment of inventory, most

OEMs in India offer between 15-30 days of credit to their dealers. The credit policy of OEMs would also differ depending on whether they are new entrants in the market, in which case they tend to offer longer credit, as dealers would otherwise be unwilling to do business with the OEM whose offerings are untested in the Indian marketplace. As the products gain traction in the market, the OEMs normally reduce the credit period to align with market practices.

CARE Ratings notes the added benefits that dealers of leading OEMs have in terms of reduced interest rates from lenders due to the intervention of the OEM. Banks offer working capital lines for funding inventory of dealerships under the 'Channel Financing' scheme of respective OEMs. The lender draws comfort from the fast-selling nature of the OEMs products, and the sanction terms usually mandate the channelling of payment from buyers into specific accounts, with covenants to prioritise debt servicing.

CARE Ratings takes into consideration factors such as market position of the OEM and demand for its key models to assess the likely impact on working capital and profitability of dealer's operations. Inventory turnover ratio is also relied upon to assess the efficiency of operations of the dealer.

Financial Risk

CARE Ratings' assessment of the overall financial risk profile of an auto dealership 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.careratings.com for additional details.

While assessing leverage CARE Ratings takes into account that auto dealerships could follow either an asset heavy model wherein the dealerships own the showrooms, or an asset light model wherein they lease the same. They could also use a mixed business model wherein they partly own few showrooms and lease the balance. In case of leased premises, CARE considers adjusted debt factoring in present value of payments over the lease period and also considers lease payments as part of interest costs (both in line with IND-AS 116). The agency notes that generally, capex requirements are low for auto dealerships, unless it involves setting up a new showroom on owned premises. Hence debt normally comprises of working capital borrowings. Given the low margins and modest PBILDT profits, a spike in borrowings results in sharp increases in leverage.

Liquidity Cushion

CARE Ratings assesses the available sources of liquidity for a dealership to support debt servicing on a timely basis. These include unutilised bank lines, cash balances, liquid investments, and credit standing of promoters/corporate group together with track record of support in the past. CARE studies the profile of owners and corporate group to assess resourcefulness of the group which assumes significance in situations such as funding of a new showroom or funds infusion in instances of tight liquidity. Presence of the group in other dealerships would suggest a diversified cash flow stream across the group. The primary source of liquidity though will have to be quantum of operating profits vis-à-vis the quantum of debt servicing on an annual basis over the forecast period.

Conclusion

Considering the intrinsic linkage between auto dealerships and the auto industry, the fortunes of auto dealerships are largely driven by the performance of the auto industry in general and that of the OEM in particular. Assessment of factors enumerated above related to an individual dealer would also form a key input in the rating process. The final rating would be an overall assessment of all aspects of the borrower including business, financial and management risk. CARE's Rating Committee analyses each of the above factors and their linkages to arrive at the overall assessment of credit quality of an issuer based on its holistic judgement.

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