CARE Ratings
Professional Risk Opinion

Rating Methodology - Commercial Vehicle Industry

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Industry overview

The Commercial Vehicle (CV) Industry is the barometer of the economy. About two-third 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 lead indicator 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 around 85%-91% of the CV sales volume in the country during the period FY16-FY20. Furthermore, the CVs can be classified on the basis of their Gross Vehicular Weight (GVW) as Light Commercial Vehicles (LCV) and Medium & Heavy Commercial Vehicles (M&HCV) with M&HCVs accounting for nearly 32%-43% of the total domestic CV sales volume during the period FY16-FY20.

The CV industry has evolved over the years: from the days of traditional all-purpose 9-tonne trucks, the industry has moved towards more utility-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 (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 (buses), 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 cyclicality. However, due to greater versatility of usage, the LCV demand is relatively 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 also 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. Expansion of the rail network and establishment of rail freight corridors also have a bearing on road freight demand (and hence for CVs), particularly for long haul routes. However, the overall door-to-door delivery cost would be the key determinant for a customer to choose between rail and road freight. 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 of the other factors which sway consumer preference.

Rating Methodology

CARE Ratings has a standard methodology for the 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 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 Commercial Vehicles industry.

Business/Operational Risk

Presence Across Segments and Product Range

As the CV industry draws its demand heavily from the level of economic activity in the country, the demand for products in various segments and sub-segments varies significantly from time to time. Generally, LCVs experience less volatility in demand than MHCVs. Players who have a wide array of products, not just in the various segments, but also in the sub-segments are able to withstand demand-side pressures more effectively and would be viewed positively. In addition, presence in passenger transportation segment 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 Ratings 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

CV purchases are largely influenced by nature and availability of the product coupled with value preposition. A wide spread sales and service distribution network across the country is imperative for the players to tap geographical demand. A geographically diverse presence will help and generate higher sales volume, a necessity in a highly capital intensive industry.

Furthermore, 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 centres is crucial for servicing the customer and developing brand loyalty.

CARE Ratings 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.

Competitive Market Position

Entry barriers in the commercial vehicle industry is high on account of access to technology, requirement for significant R&D capabilities and investment required to set up sizeable production capacity. Despite these entry barriers, the commercial vehicle industry remains highly competitive, with competitive intensity increasing in cyclical downturns given the low capacity utilisation and fixed overheads that CV manufacturers have to grapple with. Traditionally, intense competition among the limited industry players was also fuelled by limited product differentiation in the various categories. CARE evaluates a company's market share, trend in market share over a period of time and, relative performance in sales volume while assessing the competitive market position.

Technological / Research & Development/ Product Development Capabilities

Changing customer preferences, rising fuel costs, growing environment and safety concerns and consequent government regulations (such as emission norms, anti-skid braking systems) 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. Domestic players will need to have strong research and development capabilities to be able to keep pace with evolving environmental and safety regulations, as well as strong product development capabilities to be able to introduce new models and product upgrades on regular basis.

Global CV manufacturers operating in India have access to a large product portfolio and a product development pipeline already in place in their home countries, backed by R&D capabilities and budgets.

CARE Ratings views strong technical capabilities together with the ability to develop vehicle models that effectively address market demands as a key positive while analysing any player in the CV industry. Additionally, CARE Ratings analyses the players' track record in terms of R&D spend, product innovation as well as the management's ability to gauge the future needs of the market.

Geographical Diversification

Geographical diversification both within and outside the country is preferred as it insulates the company over sales disruptions/ issues with a single location/geography. Such diversification not only helps in de-risking a single location-specific issues but also provides access to newer markets and improves reach for the products.

Exports have traditionally accounted for a significant proportion of revenues for domestic CV manufacturers, ranging from 7.8% to 13.2% of the total CV sales volumes for the period FY16-FY20. An OEM which has successfully diversified its revenues through exports will be looked at more favourably given than exports (if significant) can help provide stability to the revenue stream which inherently exposed to high degree of cyclicality in the domestic market. Greater the geographic diversification and higher the proportion of export revenues, lower would be the volatility in cash flows for CV manufacturers.

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. Furthermore, with a high level of ancillarisation, players can significantly reduce their capital outlay as well as fixed costs, 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 are tied up with banks.

CARE Ratings views the availability of vehicle financing options at the point of purchase, a key positive to improve customer servicing and thereby foster sales.

Financial Risk

Foreign Exchange Risk

Considering the high level of indigenisation in the domestic CV industry, imports by CV manufacturers is limited. The exposure to foreign exchange risk arises primarily from exports of CVs, a large proportion of which has traditionally been to neighbouring countries. Also, forex risk would arise on any external commercial borrowings availed by the CV manufacturer. Such risk is analysed on a case-to-case basis after taking into account the hedging policy of the company.

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 financial, commercial, economic and management analysis, credit rating is an overall assessment of all aspects of the issuer.

[For previous version please refer 'Rating Methodology – Commercial Vehicle Industry' issued in August 2019]

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