Rating Methodology - Auto Ancillary Companies

[In supersession of "Rating Methodology - Auto Ancillary Companies" issued in May 2019]

Industry overview

The Indian auto component industry accounts for USD 57 billion, with exports of USD 15.16 billion in 2018-19. 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 catering to mostly original equipment manufacturers (OEMs), while the rest comes from the unorganized sector comprising low value-added products and catering to the replacement demand. The industry's sales to OEM segment contributed to 56.4% of its total turnover, while exports and replacement market contributed to 26.7% and 16.9%, respectively.

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

Rating Methodology

CARE Ratings has a well laid out methodology for rating of the 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 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 methodologies 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 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

i. 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. A strong market position is a reflection of 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 direct relationship with OEMs and higher degree of inter-dependence for supply of components in addition to being engaged at product development stage, Tier I companies enjoy higher profitability and are considered superior over Tier II and III companies.

ii. 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 engine components which require high level of precision and quality adherence account for 26% of the auto component industry. This segment includes components such as pistons, piston rings, engine valves, crank shafts, etc. Other components include transmission and steering parts (13% of auto component market), body and chassis segment (14%), suspension and braking component (16%) and electrical components segment (12%). The drive transmission and steering system, for instance, is technology and capital-intensive in nature that acts as an entry barrier, especially for smaller players and the unorganized segment. On the other hand, body parts and chassis segment or 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 technology-intensive products and require high level of co-ordination between the OEM

and the auto ancillary company at the time of development. Furthermore, 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., stand to gain the trust of new OEMs enabling them to increase market share and diversify.

iii. Diversification

CARE Ratings analyses the extent of diversification in entities revenue stream emanating from diversification in product segment, geography-specific exposure, clientele base and 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 considered positively as it depicts the company' 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 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.

iv. 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 unorganised 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. 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 few countries or suppliers can create significant concentration risk and at times be faced with disruption in the supply chain.

v. Cost structure

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) and ability to pass on the same in a timely manner is key to sustaining profitability. This apart, raw material sourcing arrangements and the 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. 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 evaluates the above factors to understand cost structure, the nature of the product, its degree of complexity and technology involved in manufacturing and extent of value addition eventually defines the overall profitability.

vi. Conformity to Regulatory Norms

CARE 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 adapt latest technology. CARE positively views companies with roadmap of manufacturing components complaint 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 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.

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