

## Rating Methodology - Commercial Vehicle Industry

[In supersession of “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 by 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 85-90% of the CV sales volume in the country during the period FY16-FY19. Further 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 accounted for close to 39-44% of the total domestic CV sales volume during the period FY16-FY19.

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. Fuel cost and freight rates which have a direct bearing on the profitability of the operators too have an impact. 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 other factors which sway consumer preference.

### Rating Methodology

CARE Ratings has a standard methodology for 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, 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. Further, players who have customised products are able to create a niche market. 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 proposition. A wide spread sales and service distribution network across the country it is imperative for the players to tap geographical demand. A geographically diverse presence will help, generate higher sales volume; a necessity in a highly capital intensive industry.

Further, 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 centers 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 to be highly competitive industry on account of commodity nature of products sold with limited role being played by the brand. CARE evaluates a company's market share, trend in market share over a period of time, relative performance in sales volume are considered while assessing the competitive market position.

**Technology tie-ups/Technology**

Changing customer preferences, rising fuel costs, growing environment concerns and consequent government regulations (such as emission norms) 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. A prudent technical collaboration not only renders the ability to meet stringent environment norms, both domestic as well as international, but also helps players in introducing newer and technologically more advanced vehicles; which is a key to their survival.

CARE Ratings views technical collaborations with players having strong international presence as a key positive while analyzing any player in the CV industry.

**Innovation**

The demand for CV is highly technologically driven. Both changing consumer preference and government regulations make it imperative for the players to constantly innovate and introduce newer and better products. Hence, investment in design, engineering and research & development is critical.

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. Although past performance is not always an indication of future excellence, CARE Ratings views a good past track record of product innovation as a key positive while arriving at a rating.

**Geographical Diversification**

The movement in demand for CV closely follows the movement of economic growth. Past trends show that the CV industry has a 4-5 year cycle, with the growth in demand moving closely with the growth in

industrial activity. Thus, during periods of economic downturns, the industry experiences a huge decline in demand, which is a matter of high concern for an industry which is capital intensive by nature. In order to reduce this dependence on economic activity, manufacturers need to diversify geographically into other markets through exports to other countries. Technological tie-ups with players having strong international presence can help manufacturers to expand globally and thereby reduce their correlation with domestic economic cycles.

### **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. Further, with a high level of ancillarisation, players can significantly reduce their capital outlay 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 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. However, if the manufacturers themselves delve into vehicle financing, CARE Ratings would analyse this business arm of theirs separately using the methodology defined for NBFCs.

## Financial Risk

### Foreign exchange risk

In addition to selling in the domestic market, many of CV companies also diversify its revenue through exports to other countries. Some of the companies also import components/inputs to be used in the production. The extent of natural hedge available and hedging policy followed by company are analysed.

## 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 cyclicity.

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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