

Background

The auto dealership industry plays a key role in the automobile value chain by facilitating the sales of auto original equipment manufacturers (OEMs). Auto dealerships help in shaping the buyer's perception of the OEM, which is largely built around buyers' experiences in the dealerships. Accordingly, auto dealerships must invest significantly in creating the right ambience in their showrooms, besides the investments and expenses that go into the training of employees and leasing of adequate space at prime locations to be able to offer ancillary services (in addition to the display of cars) such as insurance and financing for vehicle purchase as well. Additionally, there are expenses involved for leasing of spaces 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 could range from less than a year to several years, these entities should also have the financial strength to sustain operations during this period in the backdrop of inadequate revenues. Operating an auto dealership, therefore, calls for the ability and willingness to support the business in the initial years until it becomes self-sustaining, as well as for the efficient management of working capital and for keeping a tight control over fixed costs, given the thin 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 spaces as well as on interiors or fitouts. Hence, the 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 an optimal level of revenues. Dealerships of OEMs in medium and heavy commercial vehicles (MHCVs) and tractors are typically located outside cities. MHCV dealerships tend to display cyclicalities of revenues in line with the OEM.

Dealerships are expected to offer insurance and financing solutions through tie-ups with insurance companies and banks or non-banking financial companies (NBFCs) as part of the deal. The 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 Limited (CARE Ratings) assesses the dealer's preparedness, the ability or proficiency to handle online queries, and to convert the same into sales. CARE Ratings notes that the dealership has a 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, the rising disposable income, the inadequacy of public transport, and the overall cost of ownership are the key demand drivers that 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 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 and commercial activities. 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 remains a key driver of sales.

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

Methodology

CARE Ratings has standard methodologies for rating companies in the manufacturing and services sectors. It encompasses an assessment of the various risk factors that 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 services sector, CARE Ratings 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 the 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 include the management, business or operational and financial risk factors, in addition to project risk (if any) and environmental, social, and governance (ESG) risk factors.

The following is a list of such additional factors under 'business or operational risks', 'financial risks' and 'ESG risks', along with their analytical implications, considered by CARE Ratings while arriving at the ratings of the players that operate in the automobile dealership sector.

Business or operational risks

• **Market share of OEMs in India and the share of dealers in OEM sales**

Given that the top three auto OEMs in each segment enjoy a combined market share of around 80%, the dealerships of these OEMs generate high revenues, which would also be fairly 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 the introduction of new models and upgrades of their own existing models on a regular basis. Hence, the fortunes of auto dealerships move in tandem with those of their principals. Dealers accounting for a higher share of OEM volumes receive preferential treatment from the OEMs, 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 a 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 the dealerships operating in prime locations with a large 'catchment' area, and hence, enjoying higher sales. Additionally, CARE Ratings also assesses whether the buying power of the local population is suited to the nature of the 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 and entry level cars would. Similarly, whether a dealership is present in a metro, Tier-I or Tier-II 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 a 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 the potential ancillary revenue streams to gauge the stability of its total operating income (TOI). 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 the sale of spares, servicing, and repair shop services would report higher profit before interest, lease rentals, depreciation and taxation (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 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 the 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. CARE Ratings also analyses the break-even level of sales to understand whether a dealership's operations are inherently profitable or not. The breakeven level of sales and payback depends on multiple factors, such as the popularity of the OEM's vehicles, location of the dealership, whether owned or leased premises (determines total investment made), and also the size of the service network of a dealer, which is today a key driver of purchase decisions for automobiles. Based on the study of the industry, CARE Ratings believes that dealerships that are favourably placed in terms of the aforementioned factors can breakeven in less than a year, whereas those dealerships entailing higher investment and higher cost structure relative to sales could take significantly more time. A significant delay in achieving breakeven 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 to protect net margins. The 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.

The 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 the 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 the inventory of dealerships under the 'Channel Financing' scheme of the respective OEMs. The lender draws comfort from the fast-selling nature of the OEM's products, and the sanction terms usually mandate the

channelling of payment from buyers into specific accounts, with covenants to prioritise debt servicing. Channel financing is a popular means of funding temporary surge in working capital requirements, especially during the festive season. In these instances, auto dealerships have to avail channel financing prudently to fund the purchase of most popular models of the OEM, as the loans availed would have to be repaid within a short time frame, normally less than a month.

CARE Ratings takes into consideration factors such as the market position of the OEM and demand for its key models to assess the likely impact on the working capital and the profitability of dealer's operations. The 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 CARE Ratings' criteria '[Financial Ratios – Non Financial Sector](#)' on our website www.careratings.com for additional details.

While assessing the 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 Ratings considers the adjusted debt factoring in the 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). CARE Ratings 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 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 or corporate group together with a track record of support in the past. CARE Ratings studies the profiles of owners and the corporate group to assess resourcefulness of the group, which assumes significance in situations such as funding of a new showroom or fund infusion in instances of tight liquidity. The presence of the group in other dealerships would suggest a diversified cash flow stream across the group. The primary source of liquidity, although, will have to be the quantum of operating profits vis-à-vis the quantum of debt servicing on an annual basis over the forecast period.

ESG risks

CARE Ratings, in its overall credit rating framework, analyses the critical ESG risks and their impact on the credit profiles of the entities. CARE Ratings analyses the materiality of ESG risk factors and mitigating factors, if any, being implemented by the entity. While the sales activities of a dealership do not involve any polluting activity, the repair and service operations entail the replacement of engine or gear box oil in the vehicles as well as the replacement of oil and air filters on a regular basis. Additionally, the auto dealers have to ensure the use of environment-friendly refrigerant gas while topping up or recharging gas in the auto air-conditioners. CARE Ratings notes that the auto OEMs generally set the standards for various service activities undertaken by the dealer; however, it is up to the dealer to ensure that the standards are being adhered to.

Auto dealers have to ensure safe working conditions for their staff (particularly those employed in the service centres). Additionally, they also have to comply with various labour laws and provide adequate safety for workers to ensure long-term sustainability of the business. CARE Ratings also looks at the composition of the board of directors and track record of legal and statutory compliance by its management or directors to understand and assess the corporate governance levels. Furthermore, the quality of disclosure related to financial statements, related party transactions, and transparency in sharing information with various stakeholders are also helpful to gauge the corporate governance practices.

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. The 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 the aspects of the borrower, including business, financial, and management risk. CARE Ratings' 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.

(For the previous version, please refer 'Rating Methodology – Auto Dealer' issued in [October 2021](#)).

CARE Ratings Limited

Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022
Phone : +91 - 22 - 6754 3456 | CIN: L67190MH1993PLC071691

Connect :     

Locations: Ahmedabad | Andheri-Mumbai | Bengaluru | Chennai | Coimbatore | Hyderabad | Kolkata | New Delhi | Pune

About:

CareEdge is a knowledge-based analytical group that aims to provide superior insights based on technology, data analytics and detailed research. CARE Ratings Ltd, the parent company in the group, is one of the leading credit rating agencies in India. Established in 1993, it has a credible track record of rating companies across multiple sectors and has played a pivotal role in developing the corporate debt market in India.

Disclaimer:

The ratings issued by CARE Ratings Limited are opinions on the likelihood of timely payment of the obligations under the rated instrument and are not recommendations to sanction, renew, disburse or recall the concerned bank facilities or to buy, sell or hold any security. These ratings do not convey suitability or price for the investor. The agency does not constitute an audit on the rated entity. CARE Ratings Limited has based its ratings/outlooks based on information obtained from reliable and credible sources. CARE Ratings does not, however, guarantee the accuracy, adequacy or completeness of any information and is not responsible for any errors or omissions and the results obtained from the use of such information. Most entities whose bank facilities/instruments are rated by CARE Ratings Limited have paid a credit rating fee, based on the amount and type of bank facilities/instruments. CARE Ratings Ltd. or its subsidiaries/associates may also be involved with other commercial transactions with the entity. In case of partnership/proprietary concerns, the rating /outlook assigned by CARE Ratings Limited is, inter-alia, based on the capital deployed by the partners/proprietor and the current financial strength of the firm. The rating/outlook may undergo a change in case of withdrawal of capital or the unsecured loans brought in by the partners/proprietor in addition to the financial performance and other relevant factors. CARE Ratings Limited is not responsible for any errors and states that it has no financial liability whatsoever to the users of CARE Ratings.

Our ratings do not factor in any rating related trigger clauses as per the terms of the facility/instrument, which may involve acceleration of payments in case of rating downgrades. However, if any such clauses are introduced and if triggered, the ratings may see volatility and sharp downgrades