

[Issued in January 2025]

Background

India's auto component industry operates in a highly competitive landscape, with both organised and unorganised players. The domestic auto ancillary industry is highly fragmented and caters to a wide variety of needs of the automobile sector. The organised sector contributes around 75%-80% of the domestic sales catering to mostly original equipment manufacturers (OEMs), while the remaining comes from the unorganised sector comprising low value-added products and catering to the replacement demand. The industry's sales to the OEM segment contributes 65-70% of its total turnover, while exports and the replacement market contribute 22-25% and 11-12%.

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

In the past decade, there has been a trend of domestic auto ancillary companies acquiring component manufacturers overseas for gaining access to technology and new markets or to be able to cater to their global OEM clients more efficiently. These acquisitions could result in the leveraging of the balance sheet of the domestic ancillary companies, besides posing assimilation risks.

Auto component exports from India, although currently accounting for less than 2% of the global trade in auto components, have displayed a steady increase over the past decade. The Production Linked Incentive (PLI) scheme is expected to provide a fillip to component exports given the cutting-edge technologies where government investments are being channelised.

Methodology

CARE Ratings Limited (CARE Ratings) has a well laid out methodology for rating the companies belonging to the manufacturing sector. As per this methodology, CARE Ratings' 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. Post this, there is an assessment of the financial and project-related risk factors and the quality of the management. This methodology is followed while analysing all industries coming 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 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 additional factors, along with their analytical implications, considered by CARE Ratings while arriving at the rating of the players operating in the auto ancillary industry are mentioned below.

1. Promoters / Management Risk

Companies belonging to groups with an established presence in the industry either as OEMs or ancillaries stand to gain because of the association. Strong parentage enables access to various aspects such as new

markets, technology, personnel, distribution networks, and raw material sourcing, among others. CARE Ratings' 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. Market share, scale of operations, and vendor category

The revenue is the key indicator of the business strength and market position. CARE Ratings positively views the entities with a large scale of operations reflecting greater market share, higher bargaining and purchasing power. A strong market position reflects the strength of its relationship with OEMs, helping in commanding premium and withstanding pricing pressure. CARE Ratings assesses the exposure and dependency on primary OEM customers, as well as the market share of these OEMs, considering that auto ancillary players heavily depend on the performance of their OEM customers. CARE Ratings also analyses whether the company falls into Tier-I auto component manufacturer or Tier-II or Tier-III auto component manufacturer. Tier-I companies supply components directly to OEM, while Tier-II companies do not supply directly and are the key suppliers of sub-system components to Tier-I companies. Similarly, Tier-III component manufacturers are suppliers to Tier-II companies. Owing to the direct relationship with OEMs and a higher degree of inter-dependence for the supply of components in addition to being engaged at the product development stage, Tier-I companies enjoy higher profitability and are considered superior over Tier-II and III companies.

ii. Complexity and technology intensiveness of product profile

The auto ancillary industry produces a wide variety of products ranging from technology-intensive and critical products such as engines and fuel systems to simple products such as sheet metal parts, and others. Complexity, technology, time taken for product development, among others are some of the factors determining the importance of the auto ancillary company to the OEM and the strength of the relationship.

The more critical, complex, and technology-intensive the product is, the higher the extent of coordination called for between the auto ancillary and the OEM, and the higher the pricing power enjoyed by the ancillary. The companies manufacturing technologically intensive products face lesser substitution risks 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 at the higher end of the value chain are viewed favourably.

iii. Quality and precision of the component are also of utmost importance in auto components. Thus, companies that follow global best practices such as Six Sigma, Kaizen, total quality management (TQM), 5-S, and others, and which have quality certifications like ISO, etc., stand to gain the trust of new OEMs enabling them to increase the market share and diversify.

iv. Risk of obsolescence of existing products

OEMs must continuously augment or modify their product basket in line with changing regulatory norms, technology advancements or shifts in consumer preferences. Auto ancillaries must similarly adopt new technologies and modify the design of their offerings to keep in sync with the innovations

of the OEMs. CARE Ratings analyses the product profile of the rated entity to assess which of the offerings would continue to find application over the long term thereby ensuring revenue stability.

In the current landscape, most automobile OEMs are transitioning to electric vehicles (EVs). This shift involves a complete overhaul of product offerings, rendering many conventional technologies and components—especially those related to internal combustion engines and power transmission—obsolete. Therefore, in the EV paradigm, manufacturers of relatively less technology-intensive products such as sheet metal parts and brake cables would continue to have revenue visibility, whereas suppliers of piston rods and other engine components would not.

The recent increasing shift to Advanced driver-assistance systems (ADAS) are technologies that assist drivers with safe vehicle operation. These systems use automated technology, such as sensors and cameras, to detect nearby obstacles or driver errors and respond accordingly. ADAS has replaced many components like traditional mirrors, analogue gauges, and meters manual parking brakes, conventional headlights, among others. There could be numerous factors leading to product obsolescence and consequent disruption of the revenue stream; CARE Ratings tries to assess all the factors that could lead to the same.

v. **Diversification**

CARE Ratings analyses the extent of diversification in entities' revenue stream emanating from diversification in the product segment, geography-specific exposure, clientele base, and market segment.

Diversity in clientele: A well-diversified customer mix is important for the ancillary manufacturer as it helps minimise the risk of volatile sales and profits. CARE Ratings positively views companies having a diversified client base as this insulates the company from a decline in the 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 a decline in volumes in any particular category or model. Consistent orders from new models are considered positively as it depicts the company's 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 EVs 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: Maintaining a balance between OEM sales and sales to the replacement market allows component manufacturers to mitigate the cyclicity associated with OEM sales. Sales in the replacement market offer higher margins and contribute to revenue stability, as they are less correlated with OEM's performance and vehicle production, which can be volatile. However, serving

the replacement market requires a substantial distribution network, and costs may not always be justifiable due to price-sensitive buyers who prioritise affordability over brand loyalty. CARE Ratings analyses the interplay of these diversified segments in the overall operations of the company in the past.

vi. 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 three major auto clusters: Gurgaon- Manesar in the north, around Pune-Aurangabad in the west, and around Chennai in the south. In 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, the proximity of the ancillary manufacturer's plant to the OEM's plant helps in supplying the products at the right time and lower costs. The location of the company's plant in the major auto clusters of the country gives it access to multiple OEMs and Tier-I suppliers. The location of the plant in duty-free zones is also looked at favourably as it translates into GST and income tax benefits for the company. 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 a few countries or suppliers can create significant concentration risk and at times be faced with disruption in the supply chain.

vii. Raw material sourcing arrangements and cost control strategies

Raw material sourcing arrangements and the ability to procure components and other parts at competitive rates is a key factor in the analysis. Efforts on product engineering and adoption of the best manufacturing process, etc., can also help lower material costs, which augurs well in maintaining the 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 Ratings evaluates the above factors to understand cost structure, the nature of the product, its degree of complexity and technology involved in manufacturing, and the extent of value addition eventually defines the overall profitability.

viii. Nature of contracts with OEMs

CARE Ratings studies the nature of contracts between the auto ancillary and its OEM client/s to assess the following:

- a. Revenue visibility: Whether the contract is long-term or short-term in nature and what is the contracted quantity to be supplied.
- b. Clauses relating to pass-through of input cost variations: Raw material cost forms a large part of the cost structure of the auto ancillary companies. Thus, the ability to pass through the increase in the price of raw materials (especially steel, copper, and aluminium) in a timely manner is key to sustaining profitability. Clauses analysed in this regard are the extent of pass-through, basis for computation of the same and the time lag after which the price revision becomes effective.
- c. Credit terms with the OEM.

ix. Conformity to Regulatory Norms

CARE Ratings also focuses on the company's plans to adopt regulatory changes (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 adopt the latest technology. CARE Ratings positively views companies with a roadmap of manufacturing components in compliance with progressive regulatory norms.

3. Financial risk

CARE Ratings' assessment of the overall financial risk profile of an auto ancillary 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.

Analysis of cash flows assumes significance while rating auto ancillary companies, given the need to continuously invest in product development and augmentation of manufacturing facilities, besides having to deal with wide variations in demand for their offerings from OEMs, due to cyclicalities in automobile sales or otherwise. CARE Ratings considers cash flow analysis as part of the liquidity assessment of the rated entity, and favourably considers companies that generate positive free cash flows on a consistent, through-the-cycle basis. Additionally, if free cash flows turn negative on a temporary basis due to the need for capital investments which will yield profitability and cash flow benefits within the medium term, it may not necessarily have a negative impact on the rating.

Analysis of Environmental, Social and Governance risk factors:

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.

Environment risk: As the automotive industry shifts toward cleaner energy sources (such as electric vehicles or alternate fuels), auto component manufacturers face risks related to product obsolescence. Components designed for traditional internal combustion engines may become less relevant. Stricter emission standards necessitate cleaner production processes. Companies have been investing in sustainable practices and reducing their environmental footprint. Handling hazardous waste (e.g., asbestos-related materials or battery production waste) requires proper treatment and disposal. Compliance with waste management regulations is crucial.

Social risk: Maintaining healthy industrial relations and ensuring product safety are paramount for auto ancillaries. Fair wages, safe working conditions, and employee well-being contribute to a positive social impact. Ethical labour practices foster a harmonious work environment. Additionally, attracting and nurturing skilled manpower is crucial as the industry adapts to technological advancements. Adequate protection is essential to mitigate health and safety risks for workers handling hazardous materials such as asbestos. Auto component manufacturers should proactively assess their supply chains, emphasising ethical practices, human rights, and fair trade.

Governance risk: Good corporate governance standards adopted by a company ensure that it will earn the goodwill of all stakeholders involved. Key aspects include entity's commitment to following transparent and credible practices by the way its financial statements are reported, level of disclosures, consistency in communication and

openness in sharing information during credit assessments. Additionally, evaluating the corporate group structure (whether simple or complex) and assessing related party transactions ensures responsible practices that benefit all involved parties.

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. While the methodology encompasses comprehensive technical, financial, commercial, economic, and management analysis, credit rating is an overall assessment of all aspects of the issuer.

[For the previous version please refer to 'Rating Methodology – Auto Components & Equipments issued in [July 2022](#)]

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 | Noida | Pune

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