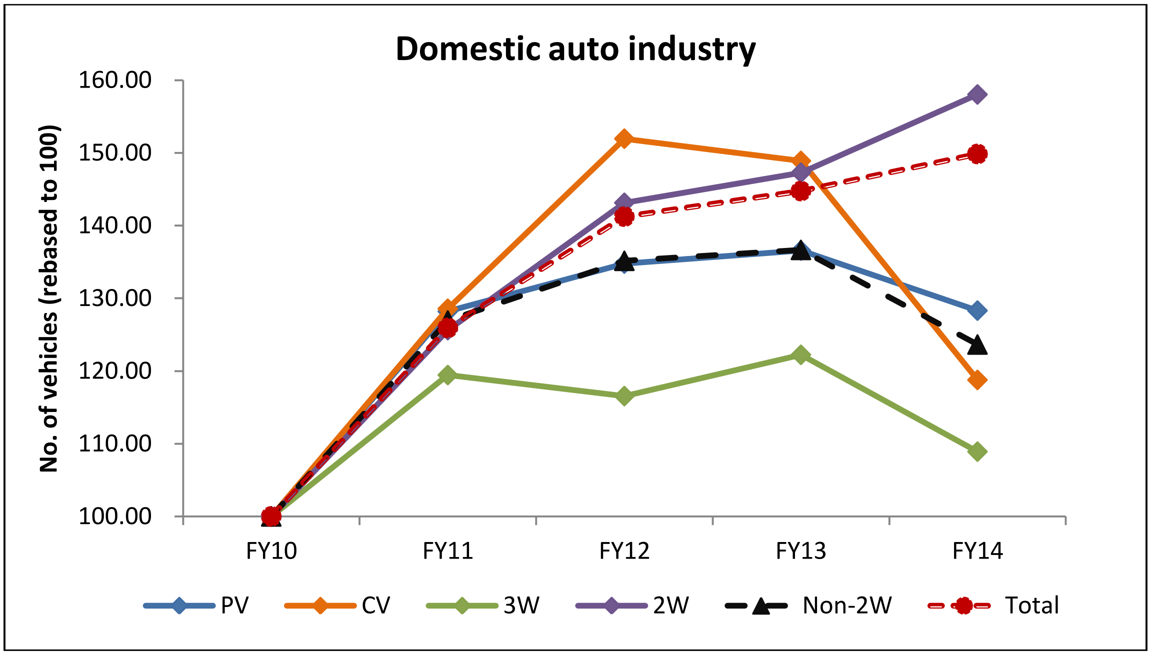
Good times ahead for auto dealerships?

Auto Industry backdrop

The domestic auto industry has been going through a challenging phase for the last few years. The overall slowdown in the GDP growth, high inflation, interest rates and fuel prices have had an adverse bearing on auto sales. A snapshot of the sale volumes in the domestic auto industry in the last 5 years is presented below:

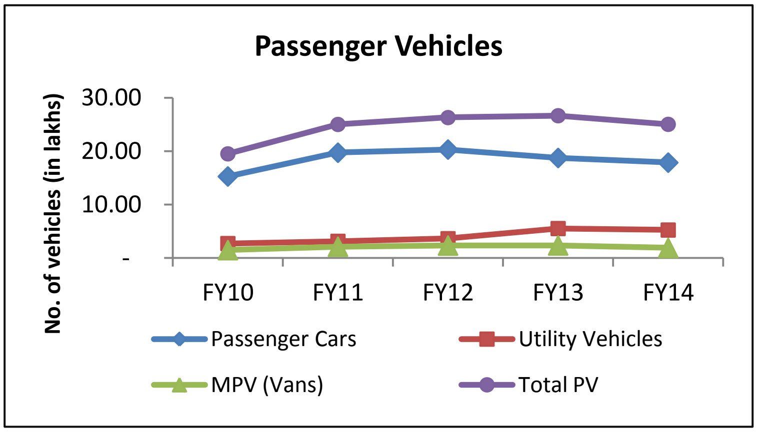


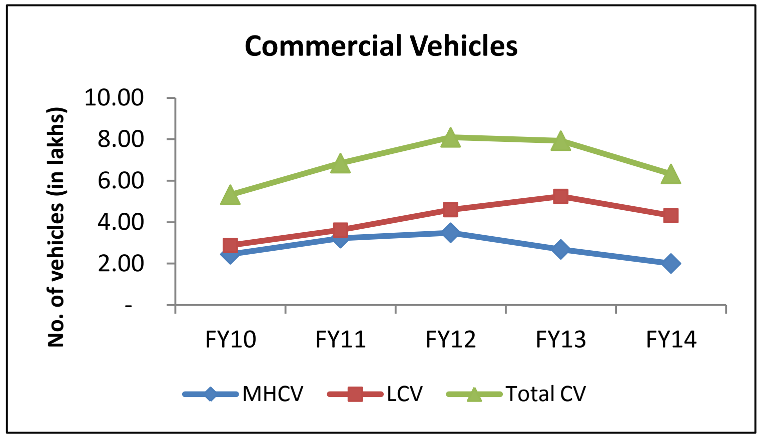
Source: SIAM and CMIE

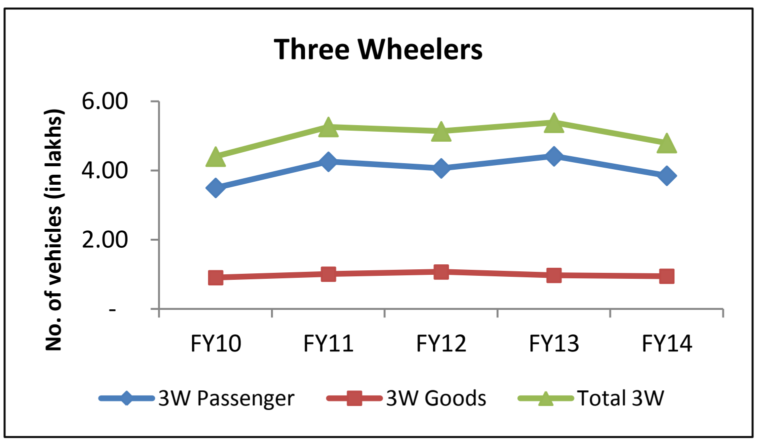
The domestic sale of automobiles (in terms of numbers) registered a marginal growth of 3.5% in FY14 over FY13, driven mainly by the 7% growth in the two wheelers (2W) segment. Within the 2W segment, the scooters reported the highest growth. All the other segments of the industry, however, witnessed a contraction in demand, with the commercial vehicles (CV) segment witnessing the highest decline of around 20% while the three wheelers (3W) and passenger vehicles (PV) volumes declined by around 11% and 6% respectively. The decline in the CV volumes was mainly due to the slowdown in infrastructure development and manufacturing, and ban on iron-ore mining in various states further impacting the industrial activity. Within this, the Medium & Heavy Commercial Vehicles (MHCV) segment faced the maximum impact of the slowdown.

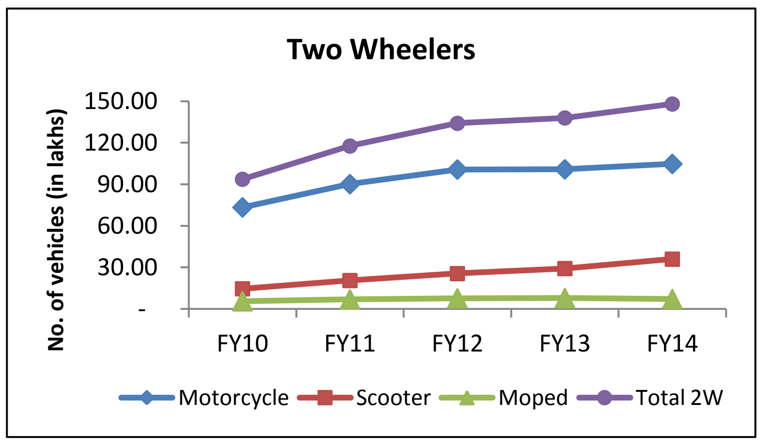
In the PV segment, the Utility Vehicle (UV) segment had reported significant growth in FY13 on the back of new launches and the wide price gap between petrol and diesel. However, the growth in UVs tapered in FY14 on account of the increase in excise duty on these vehicles and narrowing of the gap between petrol and diesel. This led to a fall of 6% in the overall volumes in the PV segment in FY14 as opposed to a marginal increase of 1% in FY13.

The segment-wise sales volume in the last five years is depicted in the charts below:







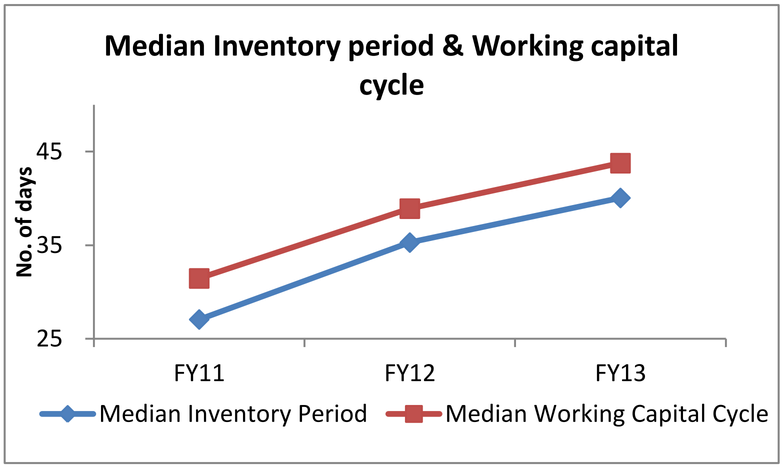


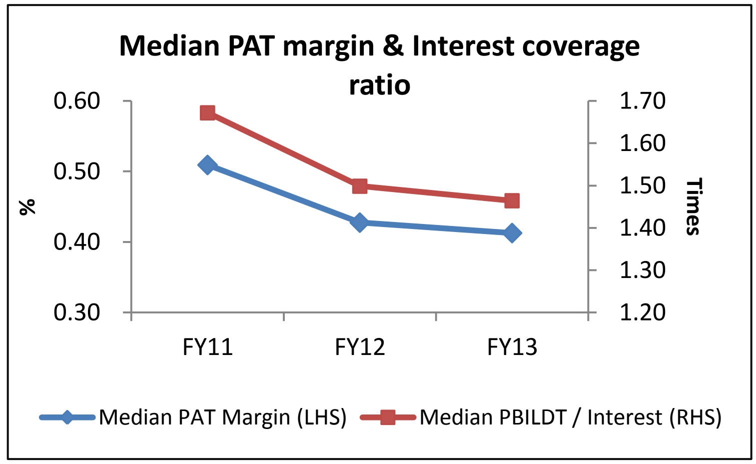
Source: SIAM and CMIE

Rising inventory level compounds problems for auto dealers

While the larger Original Equipment Manufacturers (OEMs) have witnessed stress due to the overall slowdown in the domestic market, sales diversification in terms of the exports markets has helped them withstand the pressure of the domestic industry. Further, product diversification and presence in different segments of the industry have helped the OEMs manage the impact of the slowdown. However, the same cannot be said of the channel down the line viz. the auto dealers. The dealers typically are confined to one

OEM and in most cases deal only with specific segments like CV or PV or 2W. Thus, the single OEM dependence and slowdown in the segments where they operate has accentuated the stress that dealers face. With OEMs pushing sales through the channel, rising inventory levels and elongated working capital cycle have been plaguing the auto dealerships in the last couple of years. The following graphs (for about 90 auto dealerships rated by CARE) reinforce the same:

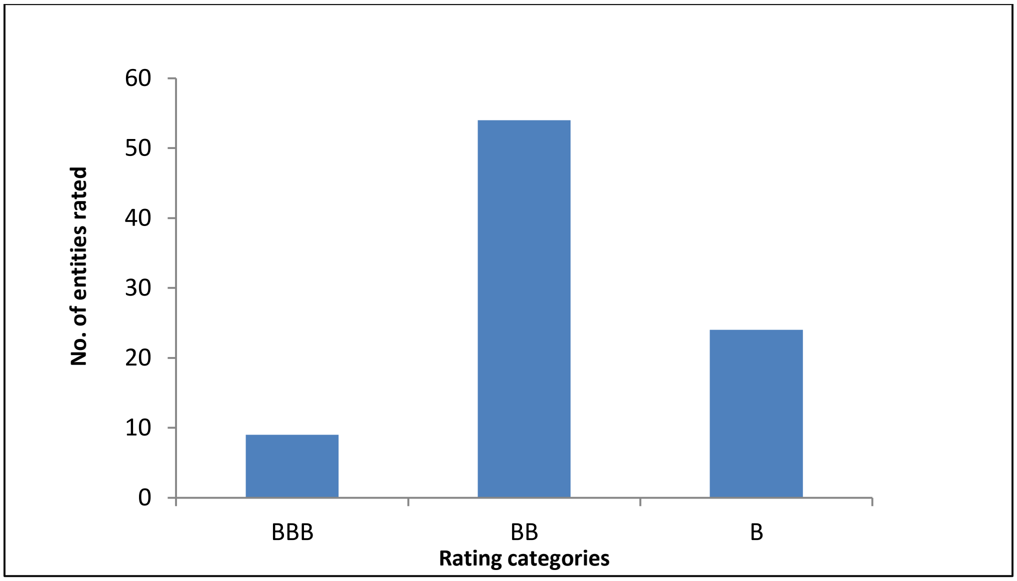




Median inventory days have moved from 27 days in FY11 to 40 days FY13. To fund the rising inventory levels, dealerships have had to resort to higher borrowings in the last few years. This has taken a toll on the already thin profitability margins and has also impacted their debt coverage indicators.

Inventory levels of the dealers are expected to be moderately higher in FY14. This is primarily because the sales performance of dealers is typically reflected after a lag post the OEM sales; with sales of the OEMs themselves dropping, the dealers may not be able to absorb the push from OEMs and hence we could see a rise in the inventory at their end. Dealers who operate service centers or have a larger portion of spare parts sales etc. are better placed in this scenario to bear the rising cost of inventories and protect their overall net margins.

Rating dispersion of auto dealerships rated by CARE



As seen from the above chart, majority of the auto dealers are rated in the BB and B categories. This is mainly on account of the lower margins and high debt levels which have constrained the ratings. Improvement in volumes, higher working capital turnover will help improve profitability margins and the overall financial risk profile of the dealers. Further, dealers who have other related business (spares, service etc.), which often constitute a relatively more stable source of income with high margins, enjoy higher ratings as is the case with most of the companies rated in the BBB category.

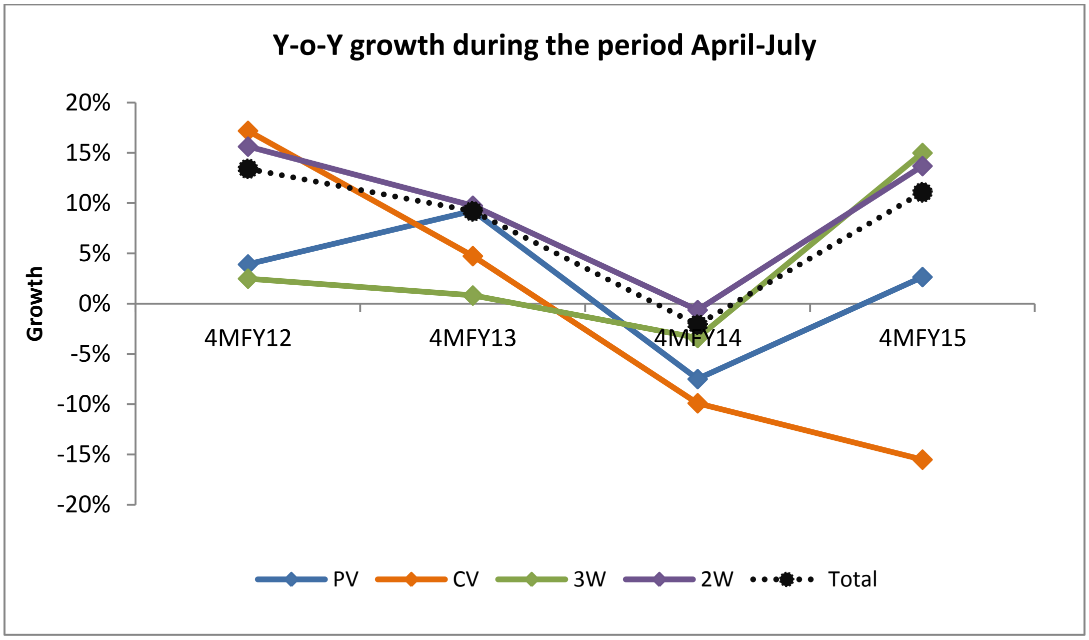
Excise duty cut - a small step towards revival

The Government, to encourage automobile sales, reduced excise duty on automobiles in the Interim Budget. This concession was extended by another six months (till December 31, 2014) by the new government in its pre-budget announcement. The duty applicable on various vehicles is as follows:

	Engine capacity		**Length**	**Excise Duty (%)**	
	Diesel	**Petrol**		**Before Interim Budget**	**After Interim Budget**
Small cars	< 1,500 cc	< 1,200 cc	< 4 meters	12	8
Mid-size cars	< 1,500 cc	< 1,200 cc	> 4 meters	24	20
Large cars	> 1,500 cc	> 1,200 cc	> 4 meters	27	24
SUVs	> 1,500 cc		> 4 meters	30	24
Buses	NA		NA	12	8
Trucks	NA		NA	12	8
2W	NA		NA	12	8
3W	NA		NA	12	8
Hybrid vehicles	NA		NA	5	5

**Additionally the vehicle's ground clearance should be 170 mm and above to be termed as SUV*

In 4MFY15, most of the segments of the auto industry have shown signs of recovery. As seen in the following chart, the 2W and 3W segments reported a growth of around 15% in 4MFY15 vis-à-vis 4MFY14 while the PV segment reported a marginal growth of 3% during this period. Only the CV segment continued to show decline in sales.



Source: SIAM and CMIE

Despite the growth seen in the first four months of this fiscal, it may possibly be too premature to conclude that the industry is witnessing a strong and sustainable revival. The recent increase in sales, especially in the PV segment, may be attributed to the advancement of purchases in anticipation that the excise duty benefit would not be extended beyond June 2014. Going forward, while the excise duty reduction will keep the vehicle prices lower and give an impetus to the sector, the improvement in the fundamental macro factors like tapering of inflation and lowering of interest rates etc. is what will lead to a sustainable improvement across the sector in the medium term and have any tangible impact on the credit profile of dealers. With respect to the CVs and the dealerships handling these vehicles, any tangible improvement in performance is expected to take time. Revival in industrial production, resolution of the issues surrounding the mining sector etc. would be crucial for the recovery of this segment. Another potential dampener for the industry could be weak monsoons, which could potentially affect rural demand which was quite robust in the last few years. This could result in pressure especially for dealerships operating in such areas. Weak monsoons have already started reflecting in drop in tractor sales for most OEMs. At the same time, major OEMs have announced new launches especially in the PV and 2W segments. These launches and the upcoming festival season should augur well for the channel and help in sales growth and improvement in credit profiles of the dealerships.

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