

# Rating criteria for the consumer durables industry

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## Executive Summary

Consumer durables comprise product categories such as televisions, refrigerators, air conditioners, washing machines, and microwave ovens. The sector is intensely competitive, with new companies and technologies challenging incumbents. Depending on the category, the industry's revenue is expected to grow at 8-12% annually over the medium term, driven primarily by macro-economic factors such as rising disposable incomes, growing consumer awareness, availability of credit, and shift in the perception of consumer durables as utility items rather than as luxury items.

While the growth will be driven largely by imports, many players in the sector have either set up local capacities or are undertaking capacity expansions to cater to domestic and global demand. On account of low penetration, rural India has emerged as a major market for several large players. The expansion in retail network has increased product accessibility even to the remotest areas of the country. Online retail is expected to enhance reach. Product innovation, competitive pricing, and ramp-up of distribution channels are also among key strategies being adopted by players to grow revenue.

CRISIL's rating process for consumer durables players involves a detailed analysis of their financial risk profiles, market position and operating efficiency.

## Scope

While the broader criteria of manufacturing companies<sup>1</sup> applies to entities in the consumer durables industry as well, this article<sup>2</sup> focuses industry-specific risk factors that impact operations and financial flexibility.

## Business Risk

### Market position

#### Product mix

Growth rates and prospects may continue to vary from one product category to the next. Intense competition has spawned the proliferation of products with varying features and aesthetics. CRISIL's analysis of the product portfolio includes evaluation of categories, features, and track record of products launched. Diversity in the product mix minimises dependence on any single product for revenue, and helps maintain a steady operating income.

#### Demand-supply equations

CRISIL factors in the product categories in which capacities are being expanded, and the growth rates across categories, to assess their future competitive positions.

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<sup>1</sup> The detailed criteria—'Rating Criteria for Manufacturing and Services Sector Companies' and 'CRISIL's Approach to Financial Ratios'—are available on the CRISIL website under the section, 'Criteria and Methodology'.

<sup>2</sup> For accessing previous published document on "Rating criteria for the consumer durables industry", kindly follow below mentioned link: [https://www.crisil.com/content/dam/crisil/criteria\\_methodology/consumer-discretionary/archive/CRISIL-Ratings-criteria-consumer-durable-industry\\_2007.pdf](https://www.crisil.com/content/dam/crisil/criteria_methodology/consumer-discretionary/archive/CRISIL-Ratings-criteria-consumer-durable-industry_2007.pdf)

## **Competitive landscape: market share & price protection**

The trends in market shares of products are analysed, both by value and volumes. A consistently high market share helps maintain a stable relationship with, and better control over, the distribution channel. Players do not need to offer high margins to traders, since these may be compensated by higher volumes. Established products with high market shares require lower marketing and advertising expenses, since it is cheaper to maintain an established brand than to create a new one. Nevertheless, new products with small market shares may also pose strong competition to the market leaders. CRISIL, therefore, analyses the perceived benefits of the product over similar products in the market. A product may be said to command a premium only if consumers are convinced of its superiority.

## **Innovation track record**

To sustain customer interest, companies need to launch new and better products, ahead of the competition. CRISIL, therefore, examines players' product innovation capabilities and track record at establishing successful brands. One good indicator of innovation capability is the share of recent sales of brands launched in the last three-to-five years. Innovation should help players raise profitability, because consumers are willing to spend more for added features and capabilities.

## **Brand equity**

Brand equity indicates the degree of consumer loyalty a player's products enjoy. It is an important factor that CRISIL evaluates, since the presence of established brands acts as a high entry barrier. If brand loyalty is strong, consumers are willing to pay a higher price for the product, and consumers are less likely to switch to competing brands. CRISIL examines factors such as the management's willingness and ability to spend on advertising and brand building. Also, the success of one brand may help grow similar products, by giving them an edge over the competition, and thus, lower advertising expenses. Established mother brands may be extended to other price points, thus helping create an umbrella portfolio that is much stronger than individual brands.

## **Operating efficiency**

### **Product design and development capabilities**

The ability of players to launch products to serve new needs and develop new markets is an important criterion in evaluating operating efficiency. In the past, market segments and client profiles were clearly defined. Now, however, the needs and requirements of consumers are forever changing. In the television segment, for instance, the last decade has seen a sharp proliferation of panel TVs and the near exit of cathode ray tube TVs. It has, therefore, become imperative for players to re-engineer their products to meet the changing needs of the consumer on pricing, design, or product specification. R&D plays an important role here, since products need to be updated on technology, so that innovations are meaningful and beneficial to the consumers.

### **Distribution network**

The distribution network's reach is assessed in ascertaining the geographic diversity in sales. A greater diversity in sales mitigates geographical risks, such as those on account of changes in customer preferences in some areas. A wide dealer network enhances the products' reach. Ratios such as the number of dealers per service center, and the sales reported by each dealer are evaluated to analyse the efficacy of the dealer network. A company may use the same network to launch new products, and thus maintain a distinct competitive advantage. The advantages of having company-owned retail outlets over selling through multi-brand outlets are also factored in. Single-vendor retail stores attract a dedicated customer base and promote brand equity, leading to higher bargaining power and lower working capital requirement.

**Raw material sourcing and cost structure**

Raw material sourcing is an important aspect for consumer durables companies. A wide sourcing base helps optimise the quality, quantity and price of purchases. A low-cost structure strengthens the player's business risk profile, improves its pricing ability, and helps optimise capacity utilisation even during downturns. CRISIL analyses past data to ascertain the ability of the company to pass on cost increases to its consumers.

Capacity utilisation is analysed as a means of evaluating operational efficiency. Flexibility to switch production between a range of products is evaluated. Outsourcing of manufacturing operations, for instance, allows flexibility to ramp-up production quickly during festive seasons while maintaining a low-cost structure. As several countries are covered under Free Trade Agreements, the cost differential of outsourcing from such countries is also ascertained.

**Working capital management**

As in the case of other manufacturing companies, efficiency in working capital management is critical for players in the consumer durables industry. Ability to manage inventory, demand, and payables (given the multiple channels involved) and the credit obtained from suppliers is evaluated. MNCs typically receive substantial credit from their parents, a factor that is often a key rating strength.

**Quality and customer orientation**

CRISIL evaluates consistency and improvement in quality, both in terms of costing and usability. Quality—of the product, and of the services in areas such as pre-sales, sales, installation, and after-sales—is a major challenge for consumer durables players, and thus, a critical criterion in the rating analysis.

## Financial Risk

The analysis of financial risk of consumer durables companies involves the standard criteria followed in the case of all manufacturing companies. The criteria are presented in detail in our criteria publications, 'Rating Criteria for Manufacturing and Service Sector Companies' and 'CRISIL's Approach to Financial Ratios'.

## Management Risk

To analyse the management risk profiles of companies in the sector, CRISIL follows the standard criteria used for all manufacturing companies. The criteria are presented in detail in our publication, 'Rating Criteria for Manufacturing and Service Sector Companies'.

## Conclusion

CRISIL believes the key success factors for players in the consumer durable sector include the following:

- Diversity in product lines
- Presence of an established brand and distribution channel
- Design and development capabilities
- Wide sourcing base

In addition, MNCs usually benefit from the operational and managerial support of their parents. Depending on the extent of support they receive, the standalone rating may be notched up, as presented in the document, 'Criteria for notching up standalone ratings of companies based on parent support'.

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