

For truck-makers, BS-III ban to cost Rs 2,500 cr

Ebidta impact equal to 2.5% of revenue

CRISIL Impact Note April 2017

Commercial vehicle (CV) makers disposed of over half their stock of BS-III vehicles before the Supreme Court-set April 1, 2017, deadline. The discounts and incentives on vehicles sold till March 31, 2017, are expected to have cost them about Rs 1,200 crore. Additionally, Rs 1,300 crore would be incurred to dispose of the unsold inventory.

CRISIL Research estimates the impact of this on the Ebitda margins of listed truck makers (Ashok Leyland and Tata Motors' standalone) to equal ~2.5% of their revenues. The impact would be staggered across fiscals 2017 and 2018, because the unsold inventory will have to be brought back from dealerships and then dealt with.

BS-III discounts to crimp EBITDA margin 100 bps in fiscal 2017

Leading CV makers had continued manufacturing BS-III vehicles all the way to March in anticipation of strong buying in the closing weeks of the fiscal year, given price hikes of 8-10% expected on BS-IV vehicles. Indeed, for want of clarity on ban on production or registration, the industry had expected some BS-III trucks to be sold even in April.

This had bloated up inventories. When the Supreme Court ruling came, CV dealers' inventory at risk was around 97,000 units (equivalent to 1.7 months of sales) valued at Rs 11,600 crore.

The industry is expected to have sold ~55% of this in the last three days of March by offering discounts of 20-40% on the sticker price compared with ~10% before the ruling. The additional discounts and incentives are expected to have cost about Rs 1,200 crore of which the truck makers are likely to bear about 80% and their dealers the rest.

That works out to a 300-350 basis points (bps) erosion in the aggregate fourth-quarter EBITDA margins of listed truck makers (Ashok Leyland and Tata Motors' standalone) to near break-even – a level last seen 8 quarters ago in the third quarter of fiscal 2015, when the industry was recovering from a sharp slowdown. The impact for the full fiscal works out to ~100bps, which is significant considering EBITDA margins have not reached the pre-slowdown levels of 8-10%. In fiscal 2016, margins peaked at 7.3 per cent and were trending ~200 bps below in fiscal 2017 (April-December) owing to subdued sales and rising raw material prices.

Unsold BS-III inventory to entail another Rs 1,300 crore

We estimate the remaining 40,000-45,000 units of unsold inventory to be returned in the upcoming months, mainly comprising less-popular models since there were instances of supply shortage in some popular BS-III models. The truck makers are likely to adopt a mix of the following steps to manage unsold BS-III inventory - upgrading them for resale, dismantling vehicles for spares or incur higher working capital for holding the inventory until it is exported (which could take 5-6 months).

Here's a look at what some of these options entail:

- **Recall stock from dealers and export:** Exports account for around 13% of total annual sales of CVs. It could take around 5-6 months to dispose of the remaining inventory in export markets with less stringent emission norms. Truck makers are expected to increase discounts in export markets to induce further demand to expedite sales. However, not all models may find their way into these markets owing to regulations or demand preferences.
- **Recall stock from dealers and upgrade to BS-IV:** The cost of recalling the vehicle and either upgrading or dismantling it is expected to cost north of 12-15% of the vehicle price, excluding the cost and hassle of reverse logistics and additional labour costs. Moving from BS-III to BS-IV also entails significant changes in the engine architecture, including engine fuel system, after-treatment system and more electronics, conversion of these vehicles into BS-IV could take several months.

Assuming the truck makers would have to incur an additional cost of Rs 3-4 lakh per vehicle on reverse logistics and remodeling to BS-IV, it would mean an additional expense of Rs 1,300 crore.

The total impact of the Supreme Court verdict (which includes the loss due to higher discounts and managing unsold inventory) thus works out to ~2.5% of annual revenues of listed truck makers (Ashok Leyland and Tata Motors' standalone). However, the effect would be staggered across fiscals 2017 and 2018, when the unsold inventory is returned and dealt with.

In April, we expect shipments to drop as dealers return their BS-III inventory and exchange them for BS-IV vehicles, netting off the sale. With the pre-buying momentum gone and BS-IV vehicles priced higher, sales would be subdued despite dealers looking to stock up to normal levels.

Marginal impact for two-wheeler makers

Among the two wheeler players, Bajaj, Yamaha and Eicher had upgraded all their offerings to BS-IV from January 2017. However, market leader Hero MotoCorp, as well as TVS Motors and Honda Motorcycles and Scooters, were upgrading in batches till the first half of March.

When the ruling came, the two-wheeler inventory at risk was at 670,000 units, amounting to Rs 3,800 crore (half-a-month of sales).

However, discounts and freebies of 10-30% on the vehicle price helped the dealers clear most of the stock in the last 3 days of March. While OEMs provided for the incentives, dealers also sweetened the deals by providing free insurance etc. The total discounts provided work out to nearly Rs 600 crore, where the manufacturers would be sharing the bulk of the impact (over 70% of the incentives), taking a total hit of Rs 460-480 crore.

This would cause a 150-200 bps erosion in the aggregate fourth-quarter EBITDA margins of listed players (Hero, Bajaj and TVS) in fiscal 2017, with the industry leader taking a higher impact due to its large BS-III inventory. The impact on Bajaj's profitability will be much lower because of lower inventory and lower discounts offered considering the export option.

Relative to annual revenues, this works out to ~50 bps impact in fiscal 2017 EBITDA margins.

As the EBITDA margins for listed two wheeler players have trended 40 bps higher than last fiscal on YTD basis (Apr-Dec 2016), there is likely to be a marginal dip (10 bps) to ~15.9% in fiscal 2017.

Wholesale deliveries to remain steady: Two-wheeler makers did not replenish channel inventory in the last 3 days of March, except in a few states like Punjab where 30% of the sales were billed to dealers. The channel inventory at the end of March was trending at 25 days' sales (lower by 5-10 days from industry annual average) and is expected to be replenished gradually over the next few months, owing to high levels of capacity utilisation with leading players. We, however, expect the gradual inventory build-up to be offset by slower retail sales momentum as much of the demand got preponed to March.

Passenger vehicle makers largely unscathed, marginal hit for 3-wheeler makers

For passenger vehicles, with the BS-III inventory at just 16,000 units (players had transitioned to BS-IV much earlier), the impact was always expected to be marginal. On top of it, given the steep discounts offered in the last three days of the month, much of this stock is expected to have been cleared.

As for three-wheeler makers, since the BS-III inventory could not be cleared due to the limited number of permits, we expect a marginal impact for Piaggio and TVS. Bajaj would be unscathed as it had already transitioned to BS-IV.

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Last updated: April 2016

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