Ratings criteria for auto component suppliers

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Executive summary

India’s auto component supplier industry is intensely competitive, with a sizeable unorganised sector. By global standards, however, the domestic industry remains small, despite steady growth in revenue, and increasing production of automobiles. Significant improvements in quality have helped meet the requirements of the increasingly quality-conscious Indian consumer. Global demand has also been on the rise.

Growing competition from China and Thailand has, however, prompted domestic component suppliers to streamline cost structures, to remain competitive. Pricing pressure and cyclical demand from the original equipment manufacturer (OEM) market also persist. While demand from after market has been steadier than from the OEMs, competition from the unorganised sector, from OEMs, and from imports has been intensifying. Increase in the prices of commodities, and rising employee and power costs, have also affected operating profitability. Some players have, however, offset cost pressure by growth in volumes and passing on of increasing input costs.

India’s automotive (auto) component suppliers should continue to benefit from the recent trend of the global automobile manufacturers—of sourcing components from the country. New product launches, and steady after-market (AM) and global demand may also drive growth for component suppliers.

While the financial and management risks of auto component suppliers are assessed using CRISIL’s standard criteria for all manufacturing companies, business risk is evaluated using two crucial factors—operating efficiency and market position. The factors evaluated under market position are geographic presence, the customer base, the AM and export potential, market share, product profile, and importance in the overall supply chain. Operating efficiency is largely a function of ability to manufacture at low cost, technological superiority of products, and efficiency in working capital management.

Scope

While the broader criteria of manufacturing companies’ applies to entities in the auto component sector as well, this article focuses on factors impacting market position and operating efficiency.

Business Risk

Market position

Diversity in customer base

Diversity in customer base helps mitigate the impact of cyclicality, of downturns in the fortunes of OEMs, or of moderation in demand from a vehicle segment. Diversity in clientele also strengthens bargaining power in

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1 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’.

negotiating supply contracts. Diversity may, however, be less of an issue for players with an especially strong market position, particularly if the products address high-growth areas.

Component suppliers with a preferred supplier status to several OEMs are viewed favourably, for they are important to, and have greater negotiating power with, the principal. Longstanding relationships make it all the more difficult for the principal to switch suppliers, and result in greater inter-dependence.

**Location**

Major OEMs are located in clusters, the prominent ones being Chennai, the National Capital Region, and Pune. Proximity of the component suppliers to these clusters is viewed favourably, as it facilitates early turnaround. Presence in duty-free zones is another advantage, as it helps avail of excise and income tax exemptions.

**Presence in AM and export markets**

Presence in the AM and export markets adds stability to revenue streams and cash flows. Demand from the AM segment tends to be steady, offsetting occasional decline in domestic OEM offtake. The AM segment is also more profitable, for it is less exposed to pricing pressure than is the case with supplying to the OEMs. Exports enhance diversity and stability in revenue profile, because export revenue is not linked with the fortunes of the domestic automobile industry. On the flipside, exports expose the component supplier to volatility in foreign exchange rates.

**Market share**

Business share in the OEM and AM segments reflects strongly on market position. A strong market position, in turn, helps withstand pricing pressure from the OEMs, and command a premium in the AM segment. It also strengthens relationships with customers, and ability to win orders. A strong market share generally translates into larger business volumes, thus helping players benefit from economies of scale (through a better coverage of overheads) and thus, to compete better on prices.

**Product complexity and diversity**

Auto OEMs have significantly pruned the number of component suppliers they source from, in line with the global trends. Tier-I suppliers, on account of their direct interface with OEMs and larger number of value-added offerings, have better bargaining power and operating margins than other suppliers do. Tier-II and -III suppliers, on the other hand, typically supply the required components and sub-assemblies to Tier I players.

The degree of complexity involved in manufacturing the component determines the importance of the component supplier in the supply chain and, consequently, its credit risk profile. Product complexity is measured by the extent of research and development involved, product validation, precision in shape forming and machining operations, and component assembly. Product complexity also limits the risk of price erosion and discourages new entrants, thus strengthening the supplier’s market position. Diesel fuel injection systems, for instance, have a high degree of design and manufacturing complexity, thus strengthening the manufacturers’ market position and pricing power.

Component suppliers with a diverse range of products have stronger market positions than players that depend on one or two products for revenue. This may become increasingly important as electric vehicles become more prevalent and the auto-component ecosystem changes considerably. A diversified portfolio also mitigates revenue concentration risk arising from cyclicality or moderation in demand for a particular product or segment.
Operating efficiency

Cost structure

The fortunes of auto component suppliers are linked to those of the auto OEM industry. This constrains the supplier's bargaining and pricing power. The key to improving profitability, is, therefore, cost (especially raw material cost) control. Operational efficiency, therefore, helps sustain market position in a competitive environment. Operational efficiency is measured in terms of labour productivity, capacity utilisation, and cost structure, which together influence the overall cost of production. Operationally efficient suppliers have cost-effective production practices, that help attract cost-focused OEMs, and are better placed to withstand pricing pressure, even in a scenario of secular decline in component prices. Operational efficiency is, therefore, a key driver of credit quality.

Technology

The technology gap between Indian and foreign automobiles has narrowed in recent years. However, the fuel consumption, emission and safety norms introduced by the Government of India have compelled the domestic component suppliers to adapt to the latest technology earlier than their counterparts elsewhere. Companies with strong in-house component development teams or quick access to technology from collaborators or technology partners are better placed to procure orders and survive in a competitive market. Technology partners have greatly influenced OEM decisions in finalising auto component vendors, especially when the former are suppliers to the concerned OEMs' international operations, making validation easier. Consequently, companies with access to component technology, including that from overseas partners, stand to benefit.

Working capital management

Typically, component suppliers that are predominantly dependent on the OEMs for revenue have lower working capital requirements. That is because the OEMs follow just-in-time practices in procurement, and make prompt payments. Component suppliers selling largely to the AM segment, on the other hand, have larger working capital requirements, given the longer payment cycles involved. Efficiently managing working capital, and having an adequate working capital limit are, therefore, critical for auto component suppliers.

Financial Risk

The financial risks of auto component suppliers are analysed using CRISIL's standard criteria for all manufacturing companies. The criteria documents, 'Rating criteria for Manufacturing and Services Sector Companies' and 'CRISIL's approach to financial ratios' are presented on the CRISIL website, under the section, 'Criteria and Methodology'.

Management Risk

To analyse the management risk of auto component suppliers, CRISIL follows the standard criteria used for all manufacturing companies. The criteria document, 'Rating criteria for Manufacturing and Services Sector Companies' is available on the CRISIL website, under the section, 'Criteria and Methodology'.
Conclusion

CRISIL evaluates the following key factors under business risk for auto component suppliers:

- Diversity in customer base and strength of customer relationships
- Location
- Presence in the AM and export segments
- Market share
- Product complexity and diversity
- Cost-control initiatives
- Access to technology
- Working capital management
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