



Rating Methodology for Auto Component Suppliers*

Overview

The government of Indonesia has a strong commitment to develop the domestic auto component industry. The importance of this industry cannot be separated from the robust domestic car sales standing at around 1.2 million units in 2013. Therefore, the government has set strategies and policies on automotive and auto component sectors, among others, as stipulated in the Minister of Industry decree No. 123/M-Ind/PER/10/2009 which includes tax benefits for procurement of raw materials of auto components. Currently, according to Ministry of Industry, import of raw materials is still quite high at around 80%. It is expected that the import will be reduced to around 30% in the next five years.

The following note identifies the key factors considered by ICRA Indonesia in assessing credit risk in the automotive component supplier industry. The objective of this note is to help investors, issuers and other market participants to understand how ICRA Indonesia analyses creditworthiness of companies in the auto component industry. ICRA Indonesia's analysis focuses on the following eight key rating factors that are common to assigning ratings in the sector. The key rating factors are:

1. Business Risk Analysis

- a. Scale & Market Position
- b. Diversification – Business, Geographic and Customer
- c. Technology and Product Complexity
- d. Parentage

2. Financial Risk Analysis

- a. Revenue Growth
- b. Profitability
- c. Financial Policies and Capital Structure
- d. Cash Flows and Debt Servicing Indicators

3. Promoters/Management Quality

Business Risk Analysis

Scale & Market Position

ICRA Indonesia believes that a company's revenue base and market position are keys in determining business strength and operating flexibility. While analyzing market position, in addition to overall market share, ICRA Indonesia also considers the component supplier's share of business with respective Original Equipment Manufacturers (OEMs). A strong market position with an OEM can be a good proxy for its positioning/importance with the OEM, bolstering its ability to withstand pricing pressures. A well established market position typically supports stable revenue base and provides a platform for sustainable earnings and cash flow generation. Additionally, large scale and strong market position generally also reflect large volumes, enabling economies of scale, cost absorption and ability to offer competitive pricing.

Diversification – Business, Geographic and Customer

Business diversification either in terms of product segments, diversified customer base or wide geographic presence are viewed as positive rating factors. A component supplier with product portfolio catering to multiple auto segments (commercial vehicles, passenger vehicles, two wheelers, tractors etc.) is in a better position to withstand the vulnerabilities arising from decline in auto volumes in a particular segment. For instance, an auto component supplier catering only to commercial vehicle (CV) segment, a relatively cyclical segment compared to other auto segment, could potentially witness higher volatility in its earnings and cash flows as compared to a diversified component supplier. Business diversification could also refer to exposure to non-automotive segment. ICRA Indonesia views non-automotive diversification as a positive rating factor provided the volumes of such sales are material.

Meaningful geographic diversification is achieved when a company caters to OEMs or Tier-1s across different countries. In Indonesia there are possibly only a handful of auto suppliers that have been able to achieve such geographical diversification. Also, while such diversification should be a credit positive over the long term, due to the synchronized nature of the recent economic downturn across developed economies, exports diversification have not been positive depending on the country of export destination.

A balanced mix between OEM and aftermarket business is positive – typically a strong after market provides greater sales stability and stronger operating margin as compared to OEMs. However, a sound OEM business is often the basis for strong presence in aftermarket given stronger brand visibility. In the market downturn, the auto suppliers with a stronger presence in the aftermarket have been able to withstand pressure on top line and profitability much better when compared to those who were predominantly supplying to OEMs.

Within the OEM business, auto suppliers with higher client diversity enjoy better protective factor during downturn, reducing vulnerabilities to an extent. Thus meaningful client diversity can be achieved largely by catering to multiple segments of the industry. In the exports business, replacement market offers client diversity. However, in the Tier-1/OEM segment, export business is often concentrated on a few clients due to large requirements for most clients. Risk of bankruptcy filings by auto manufacturers and Tier-1 suppliers in developed markets have increased sharply making client concentration a critical risk factor for exporters to these markets.

Technology & Product Complexity

The degree of product complexity determines the importance of an auto component supplier in the overall supply chain, and consequently, influences its pricing power. While technology capability of a supplier is assessed on qualitative parameters, spend on R&D could be an indicator of a company's commitment towards product development & innovation. The ability of a supplier to meet an OEM's developmental requirements remains a critical requirement in the industry. With increasing pressure on cost reduction, R&D efforts towards product engineering to reduce costs also play a critical role in strengthening OEM relations.

Parentage

Being part of an OEM group is viewed as a positive factor as it often provides ready access to parent's business, technological skills and experience. Additionally, being part of global Tier-1 supplier provides it with access to technology inputs. However global parentage can also restrict access to certain business, especially in the exports markets, leading to some limitations on business reach.

Financial Risk Analysis

Revenue Growth

Sustained revenue growth above the industry average is a strong positive. Such growth typically reflects increase in market share with clients, addition of new clients and/or new product launches. On the other hand, a trend of declining revenues during a period when the industry is growing could be

indicative of a failing business model or product line. ICRA Indonesia attempts to analyze growth on account of increase in volumes and realizations separately. Increase in realizations, attributable to rising material prices however doesn't reflect real growth and can be typically captured in flat or declining operating margin. However, price increase facilitated through better product offerings is viewed favourably, which demonstrates a company's ability to command premium pricing. Additionally, strong competitive pressure can force suppliers to absorb part of the cost increase. Thus, ICRA Indonesia views a complete pass-through of the rising costs of input materials as a reflection of a supplier's importance to the OEM, and its technological capabilities.

Profitability

In addition to revenue growth, sustainable profitability through out a business cycle is one of the key factors that ICRA Indonesia incorporates in its analysis to differentiate between companies. The two primary measures of profitability are: (i) Operating profit before interest and taxes margin (OPBIT margin) and (ii) Return on capital employed (RoCE). It is only through sustaining adequate margins that a company can make the ongoing investments needed to maintain a technological edge. In absence of adequate profits a company's cash flow generation is likely to fall short of the levels needed to support the working capital and capital expenditure needs that are associated with the new product launches. Raw material cost accounts for a considerable portion of an auto component supplier's cost structure. Therefore, the ability to pass on raw material prices in a timely fashion can have a significant impact on profitability.

Since most OEMs stipulate price reduction through the life of their supply contract, auto component suppliers need a continuous focus on cost reduction. Thus companies that can meet or stay ahead of the price reductions will have superior profitability.

Financial Policies & Capital Structure

Companies that pursue an aggressive financial policy, including heavy reliance on debt financing, are likely to be more vulnerable to cyclical downturns than companies that employ a lesser degree of financial leverage in their business. Beside capacity expansion, acquisitions have been a common strategy for growth amongst large auto component suppliers. Acquisitions typically help in expanding product lines and in getting access to new markets/OEMs. ICRA Indonesia in its analysis examines the impact of the acquisition on the company's consolidated profitability indicators and capital structure.

Working capital levels is also a key indicator of financial health. High levels of receivables and inventory may be reflective of poor quality earnings, which may require write-offs in the future. ICRA Indonesia compares working capital intensity with the peer group to gauge the ability to negotiate credit terms with customers and suppliers as a proxy of their business strength. At the same time, build-up of inventory can also result from one-time events to support scheduled product launch by OEM in the immediate future; such build-up would be considered necessary investment.

The extent of exchange risk that a company faces would be determined by its net exports/imports position. ICRA Indonesia looks into the import/export mix of the company to assess its exchange risk, the hedging strategy it has adopted, and the implications of such strategy, while evaluating the company's performance. Un-hedged foreign exchange liabilities could pose significant risk to the balance sheet, unless it is supported by revenues from exports or backed by foreign currency assets.

Cash Flows & Debt Servicing Indicators

The user industry for auto component suppliers operates in a highly cyclical environment, leading to periods of severe financial strain for the auto component suppliers. Most auto component suppliers also do not enjoy adequate bargaining power with its clients. Most OEMs extend support to its key suppliers in meeting liquidity requirements including through schemes like supplier bill discounting. However during periods of downturns, these supports typically decline and credit periods get stretched, leading to dual impact of business declines and liquidity pressures for auto component suppliers. Stretched working capital cycle can lead to weak/negative fund flow from operations and weak debt coverage indicators.

The auto component suppliers also need to make investments on capacity expansion and product development in line with the plans of its OEM customers. In fact the capital intensity for auto component suppliers have gone up over the years, as OEMs increasingly outsources manufacturing to the component suppliers. Such investment typically has a gestation period and carries risks inherent to expansion projects, especially if it involves supplies to new platforms. Strong operating cash flows enable auto component suppliers to undertake these critical investments, without stressing the balance sheet significantly. Large project expenditure however can lead to a period of negative free cash flows, even in entities with a relatively strong business model.

Promoters/Management Quality

All debt ratings necessarily incorporate an assessment of the quality of the issuer's management, as well as the strengths/weaknesses arising from the issuer's being a part of a "group". Usually, a detailed discussion is held with the management of the issuer to understand its business objectives, plans and strategies, and views on past performance, besides the outlook on the issuer's industry. Some of the other points assessed are:

- Experience of the promoter/management in the line of business concerned
- Commitment of the promoter/management to the line of business concerned
- Attitude of the promoter/management to risk taking and containment
- The issuer's policies on leveraging, interest risks and currency risks
- The issuer's plans on new projects, acquisitions, expansion, etc.
- Strength of the other companies belonging to the same group as the issuer
- The ability and willingness of the group to support the issuer through measures such as capital infusion, if required.

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**) Adopted and modified from ICRA Limited's Rating Methodology for Auto Component Supplier*