Rating Methodology for Automotive Dealership Industry*

Overview

The automotive sector, and in particular, volume of vehicles sold per period have been considered as important lead indicators of economic growth. Since the retail expenditure on automotive sector is largely discretionary, a growing/high amount of consumption of automotives indicates wellbeing within the economy which results in higher discretionary expenditure. The Indonesian automotive market has grown at an annual growth rate of 17.2% over 3 years up to July 2014. The market has in fact grown continuously since the 2008–2009 crisis and ever since has been posting growth in double digits. Despite various factors such as fuel price hike, changes in loan to value (LTV) policy, the demand for automotives has remained robust albeit at a slightly lower rate. Further, with introduction of low cost green cars (LCGC) in September 2013, the automotive market has further widened to include a new economic class of buyers. All these factors have spurred more opportunities for not only the original equipment manufacturers (OEM) through their brand holding sole agents (Agen Tunggal Pemegeng Merek-ATPM), but also the automotive dealers.

Indonesia's automotive dealership network is characterized by a handful of dominant players. Typical structure involves principals, who license out manufacturing to ATPMs, the sole distributors, who in turn appoint various dealers which ultimately sell to retail purchasers. Out of these the operations of sole distributors and the dealers possess characteristics that are eligible to be rated under ICRA Indonesia's rating methodology for the automotive dealership industry. The following note identifies key factors considered by ICRA Indonesia in assessing credit risk in the automotive dealership 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 industry. ICRA Indonesia's analysis focuses on the following seven 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 OEM/ATPM
2. **Financial Risk Analysis**
    a. Revenue Growth
    b. Profitability
    c. Working Capital Management
    d. Financial Policies and Capital Structure
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 analysing market position, ICRA Indonesia considers market share of respective OEM/ATPM and their product portfolio, along with market position of the

automotive dealer vis-à-vis its competitors. A strong market position of OEM/ATPM can be a good proxy of demand potential of vehicle for dealership firm. A well established market position typically supports stable revenue base and provides a platform for sustainable earnings and cash flow generation. The size of an automotive dealer's network is critical to achieving regional diversification and ultimate success. In addition, larger dealers typically receive preferential treatment from the OEM/ATPM, which can result in a higher proportional allocation of more popular vehicles. Additionally, large scale and strong market position generally also reflects large volumes, enabling economies of scale, cost absorption and ability to offer competitive pricing.

Diversification – Business, Geographic and OEM/ATPM
Dealership with product portfolio catering to multiple automotive segments (commercial vehicles, passenger vehicles, two-wheelers, tractors etc.) is in a better position to withstand the vulnerabilities arising from decline in sales volumes in a particular segment. For instance, an automotive dealer catering only to commercial vehicle (CV) segment, a relatively cyclical sub-segment within the automotive industry, could potentially witness higher volatility in its earnings and cash flows as compared to a more diversified automotive dealer. Business diversification could also refer to exposure to other profitable segment like revenue from sale of spare parts and services business. While the top line for automotive dealers is driven by new car sales, the bottom line is primarily driven by the performance of the parts and service business. A balanced mix between OEM/ATPM and services business is a positive – typically a strong services business provides greater sales stability and stronger operating margin as compared to retailing business. However, a sound retailing business is often the basis for strong presence in services business given stronger brand visibility. In case of slowdown, the automotive dealer with a stronger presence in the spares & services will be able to withstand pressure on top line and profitability much better when compared to those who are predominantly in retailing business for OEM/ATPM.

Maintaining geographic balance is an important consideration for any retailer, and this is especially true for the automotive dealers. Meaningful geographic diversification is achieved when a dealership firm is present across different regions of the country. A dealer that is well-represented across multiple regions or geographies will be able to perform consistently during various demand scenarios.
Consumer preferences are by nature fickle, and are driven by innumerable exogenous factors, including fuel prices and quality perceptions. In the retailing business, automotive dealers with diversified presence for various OEM/ATPM enjoy better protective factor during downturn, thereby reducing vulnerabilities to an extent. However, each individual segment of the Indonesian automotive industry is characterised by a few OEM/ATPM accounting for majority of the market. Also, OEM/ATPM in respective segment restricts their dealers to enter into retailing business for their competitors. Thus meaningful diversity across ATPM/OEM can be achieved largely by catering to multiple segments of the industry.

Financial Risk Analysis

Revenue Growth
Sustained volume and revenue growth above the industry average, especially with comparison to its ATPM/OEM is a strong positive. Such growth typically reflects increase in market share and/or diversification across various geographies. 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 of the ATPM/OEM. In its analysis, ICRA Indonesia attempts to analyse growth on account of increase in volumes and realisations separately. Increase in realizations, attributable to price increase by the ATPM/OEM however does not reflect real growth and can be typically captured in flat or declining operating margin. ICRA Indonesia also takes into account the revenue growth in spare parts and services business, which is the key to the company's profitability.

Profitability
In addition to revenue growth, sustainable profitability through out a business cycle is one of the key factors that ICRA incorporates in its analysis to differentiate between companies. There is a certain amount of fixed cost embedded within the operation of an automotive dealership, and low fixed overheads signifies management's ability to flex the cost and expense base during down periods thereby protecting the profitability.
The two primary measures of profitability are: (i) Operating profit before interest, depreciation and taxes and amortisation (OPBDITA) margin and (ii) Return on capital employed (RoCE). 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 showroom expansion.

Working Capital Management

Inventory management plays a vital role in working capital management of an automotive dealership firm. High inventory level increases holding cost and thus increase the working capital need while inadequate inventory might lead to market share loss. ICRA Indonesia compares working capital intensity with the peer group to gauge the company's working capital management system as a proxy of their business strength. At the same time, build-up of inventory can also result from one-time events to avail various discounts/incentives launch by ATPM/OEM; such build-up would be considered necessary investment.

Financial Policy & 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. ICRA Indonesia takes into account the financing pattern of long-term and short-term assets with reference to the firm's long-term and short-term debt. Usually, working capital debts constitute major share of automotive dealer's debt followed by term loan availed for showroom expansion.

The automotive dealers also regularly make investments towards new showroom expansion in line with the plans of its OEM/ATPM. Strong operating cash flows enable automotive dealers to undertake these critical investments, without stressing the balance sheet significantly. A company's capacity to generate adequate levels of cash flow relative to debt, and earnings relative to interest is critical in evaluating its credit risk profile. Higher rated companies in the industry exhibit stable cash flows through revenue streams that are diversified across business segments and geographies.

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". Also of importance are the issuer's likely cash outflows arising from the possible need to support other group entities, in case the issuer is among the stronger entities within the 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:

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

*) Adopted and modified from ICRA Limited's Rating Methodology for automotive dealership industry