RATING METHODOLOGY – TWO-WHEELER OEMs

JANUARY 2023

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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in January 2021. While this revised version incorporates a few modifications, intended to provide more clarity on a few aspects, ICRA's overall approach to rating two-wheeler (2W) manufacturers remains materially similar. Also, a section has been added to provide a broad perspective on how environmental, social and governance (ESG) risks are incorporated by ICRA in its credit assessments.

Overview

The Indian 2W industry is broadly categorised into three main segments—viz. motorcycles, scooters, and mopeds. Currently, the industry is dominated by the motorcycle segment, which accounts for nearly two-thirds of the domestic 2W volumes, followed by scooters (~30-35%) and mopeds (~2-3%).

This rating methodology explains ICRA's approach to assessing the business and financial risk profiles of 2W Original Equipment Manufacturers (OEMs; henceforth referred to as manufacturers). It aims to help issuers, investors and other interested market participants understand ICRA's approach to analysing the quantitative and qualitative risks that are likely to affect rating outcomes in this sector. The list of rating drivers covered in this methodology is not exhaustive but provides an overall perspective on the rating considerations that are usually considered the most important. For analytical convenience, the key factors are grouped under the following broad heads—Industry Risk Assessment, Business Risk Analysis, Financial Risk Analysis, Other Considerations, Management Quality Assessment & Environmental, Social and Governance Risk Assessment.

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Industry Risk Assessment

Growth Prospects

The Indian 2W industry is the largest in the world in terms of volumes. Over the decade ending FY2020, the industry sales volumes, including domestic and exports, grew at a high single digit CAGR, enabled by a confluence of factors like increasing per capita income, growing urbanisation, improving financing availability, shrinking replacement cycle and an underdeveloped public transport system. The industry volumes have, however, remained under pressure over the past few years, with Covid-19 led disruptions as well as material and sustained increase in vehicle prices impacting affordability. Despite these short-term disruptions caused by the pandemic and increase in vehicle prices, structural positive factors, coupled with moderate 2W penetration levels (compared to several other mature markets) and well-developed industry fundamentals are likely to aid the industry's growth over the medium term.

Despite the volatilities caused by commodity prices and exchange fluctuations, the medium-term growth prospects for the industry exports remain healthy. The 2W export volumes have grown at a higher CAGR than domestic volumes, supported by increasing acceptability of India-made 2Ws in world markets, consistent addition of new markets and increase in penetration in existing export markets.

Cyclicality

Despite increasing acceptability of premium variants/models in recent years, the prevalent 2W demand has remained skewed towards mass market or entry-level models with a price sensitive clientele. This makes the industry's demand prospects highly dependent on consumer sentiments that are inter-alia linked to the actual and expected performance of both the rural (with motorcycles and mopeds being more rural centric products) as well as the urban economy (with scooters having a more city-centric clientele). Thus, adoption of prudent business and financial risk policies remain essential for a 2W OEM to reduce vulnerability to periods of downturn in demand. ICRA assesses an OEM's risk mitigation strategies and financial resilience to evaluate their preparedness for periods of cyclical demand downturn.

Competitive Intensity

The Indian 2W industry is fairly consolidated with the top four OEMs collectively enjoying nearly 85-90% market share. A sizeable domestic market base, moderate penetration levels and growing preference towards premiumisation over the past few years has seen several foreign OEMs enter the Indian market, either by themselves or in partnership with Indian OEMs. However, besides technological prowess, their investments in establishing a brand presence and setting up a widespread distribution and after sales network have remained formidable barriers to entry in the 2W industry.

While being dominated by a few players, the 2W industry is also exposed to price-based competition. Given the price sensitivity of a large segment of the domestic market, an OEM's pricing strategy influences its market position, at least in the short-term, particularly in the mass market segment. However, over a sustainable period, established OEM brands with demonstrated performance in terms of fuel efficiency and low after sales cost are more likely to withstand the aggressive pricing strategies of competitors. While the customer base for the mass market segment remains sensitive to changes in ownership costs, demand for premium offerings is relatively less price sensitive. Yet, this does not imply that competitive intensity in the premium segment is low—only that the drivers of competition are different and relate to performance attributes and brand strength.

Amid the ongoing electrification trend in the industry, the competitive intensity in the industry has increased in recent years and is likely to remain heightened over the near to medium term, with multiple new entities entering the industry on account of the relatively low barriers to entry in the electric vehicle (EV) segment.

Regulatory/ Policy Risk

Over the past few years, there have been multiple changes in regulatory norms, particularly relating to insurance, emission and safety standards, resulting in some level of volatility in demand closer to the switching date. For example, change in mandatory third-party liability cover and personal accident cover insurance norms in September 2018, shift to anti-lock braking system (ABS)/ combined braking system (CBS) in April 2019 and switch over to Bharat Stage VI emission norms in April 2020. In the coming years, besides tighter emission and safety standards, policies encouraging adoption of alternative fuel or EVs are likely to continue. While an OEM's ability to comply with changing norms will be largely dependent on its ability to invest in building technological and product development capabilities as well as in setting up incremental capacities, as required, the timelines for implementing them also remain a key sensitivity.

Business Risk Assessment

Scale and Market Position

The scale of operations is one of the primary factors taken into consideration when evaluating the business position of a 2W OEM. ICRA evaluates the scale in terms of the market share in the 2W segment/s it operates in. The scale determines the business position and operating efficiencies of the company to a large extent. An OEM with a large scale of operations is also associated with a wider dealership and distribution network, implying better reach and geographic presence.

The market position is evaluated in terms of an OEM's market share in the overall industry and is supported by a range of factors including presence of strong brands in the product portfolio, appropriate pricing strategy, ability to introduce new products in line with market requirements, and the reach of the dealership and service network. With the top four players in the Indian 2W market accounting for ~85-90% of the domestic volumes, the market is highly concentrated with a strong market share enjoyed by larger players. Regular product launches and a high refresh rate of existing models allows an OEM to meet changing consumer preferences and retain/improve its market share. As 2Ws are a cost-efficient mode of transportation, with better adjustability in rough terrains, the health of the rural economy has a significant bearing on their demand. That said, easier manoeuvrability in city traffic and popularity among students and working youth drives the urban demand for 2Ws. Consequently, a player with a balanced geographic mix between urban and rural demand centres is more likely to enjoy a better market position.

The market segment targeted by an OEM and the size of the addressable population in the target segment also determines the market share enjoyed by the OEM. In general, given that the entry segment is the largest market for 2Ws, OEMs tend to foray into this segment to gain market share. This results in OEMs with a wider portfolio of mass market offerings enjoying a larger volume market share than OEMs who are active in the premium categories. In this context, it becomes relevant to analyse segment-wise market shares that provide a better picture of the market position of an OEM in a particular 2W category.

Product Portfolio and Brand Strength

ICRA considers the strength of an OEM's product portfolio as one of the drivers of its ability to sustain a competitive position in the market. This is largely determined by the diversity of its offerings across segments and price points, and the presence of strong brands in its portfolio.

The domestic motorcycle market, which dominates the Indian 2W industry, is currently led by the commuter segment (competitively priced motorcycles in the lower displacement category, viz. ,75-125cc) catering to price sensitive customers who require high fuel efficiency, durability and low operating costs. As this segment constitutes the largest share of the domestic motorcycle market, competitively priced product offerings augur well for an OEM's volume sales in this segment. Given that the rural population is an important target segment for the commuter segment of motorcycles, weakness in rural incomes can adversely impact demand for such bikes. Therefore, product offerings in the other 2W segments are also desirable for an OEM to offset such demand cyclicality. An OEM with a presence across different user and product segments makes it less vulnerable to demand variations, enabling it to better negotiate increase in competitive intensity and growth opportunities in any specific segment. Moreover, a healthy presence in premium segment motorcycles, which generally entail better profitability, also aids the earnings profile of the OEM.

Compared with other segments in the automotive industry, such as commercial vehicles and passenger vehicles, most 2W OEMs have demonstrated high dependence on select brands/ models for revenues. While the strength of such proven brands and customer loyalty towards them serve as entry barriers for competition, the ratings also factor in the extent of the product evolution over time to meet the changing customer requirements. The presence of multiple strong brands for an OEM, aids the market position prospects and the revenue visibility for the OEM and is factored in favourably.

Sales & Service Network and Geographic Diversification

An extensive sales and service network is a determinant of an OEM's reach and competitive position. With a sizeable proportion of the domestic 2W sales generated by rural areas, the reach of an OEM's dealer network in rural regions remains critical to its market presence. An extensive sales and service network enables higher visibility and stronger brand recall; it also provides customers better access to the OEM's service outlets and spare parts network, thereby enhancing customer loyalty. Given the time and investment required in building an extensive network, it acts as a strong barrier to new entrants and supports incumbent OEMs to sustain their market position. Certain OEMs may opt for a direct-to-consumer (D2C) model rather than the traditional sales and service network; in such a model, the OEM endeavours to enhance visibility through customer touch points/experience stores, while providing after sales service through their dark service network.

An OEM catering to geographically diverse areas is less vulnerable to demand downturns in any specific region. Additionally, presence in regions with relatively low 2W penetration provides opportunities for the OEM to increase its presence in these regions, supporting its volume growth prospects.

ICRA also factors in an OEM's presence in overseas markets, and the share of export sales in its revenues. While a healthy presence in export markets diversifies the revenue streams of an OEM and reduces its vulnerability to domestic demand fluctuations, stability of export revenues is also evaluated. While rating an OEM with significant export presence or plans of market expansion, ICRA discusses end-user applications of the products, distribution arrangements, investment budgets, in addition to country specific challenges, if any, with the management.

Technology and Product Development Capabilities

An OEM's technological capabilities, and research and development (R&D) focus determine its ability to introduce new products in a cost-efficient manner, while meeting contemporary design and feature requirements. With constantly evolving customer expectations with respect to performance, safety and other features, evolving regulatory scenario as well as increased focus on exports, it is imperative for an OEM to regularly invest in R&D and enhance its technological capabilities to keep up with the changing trends in diverse markets. In recent years, the increasing policy thrust towards adoption of EVs vis-à-vis conventional petrol 2Ws, have also necessitated OEMs to formulate long-term strategies for developing such products.

A constant need to upgrade product features may lead to an increase in product cost. An OEM with a robust R&D infrastructure is likely to develop solutions in a short-time and a cost-efficient manner. Hence, ICRA evaluates an OEM's technology tie-ups (including parent support) for product design and engineering, as well as its in-house R&D capabilities. Investments in R&D

and product development serve as indicators of an OEM's focus on improving its product development capabilities and its ability to introduce new products.

Ancillary and Vendor Network

Most domestic OEMs outsource their auto components manufacturing, which enables them to focus on key activities like product design and development, critical manufacturing processes, final assembly, and marketing and distribution. Component outsourcing offers greater flexibility to OEMs during downturns as well as peak demand periods. A strong vendor network not only reduces an OEM's capital requirements towards investment in product specific capacities, but also enables it to work on a lean working capital cycle, with just-in-time supplies.

Given the dependence of OEMs on their ancillaries, their relationships with each other are critical for maintaining disruption-free production and supporting new product development. ICRA also notes that component suppliers in these engagements need to invest in capacity expansion in line with the OEM's plans. In this regard, the extent of localisation in the OEM's sourcing strategy, and its dependence on foreign suppliers is discussed with the management of the company. High dependence on imports exposes an OEM to foreign exchange (forex) fluctuation risks while impacting its pricing strategy, competitive positioning, and inventory requirements. ICRA, hence, attempts to evaluate the OEM's localisation plans and its likely impact on profitability. The extent of localisation assumes even greater importance for EV OEMs, wherein achieving a desired level of localisation may be critical to be eligible for subsidy benefits under Government programmes.

At times, OEMs make strategic investments in component vendors in the form of direct ownership or through investments by group entities. Such backward integration initiatives, especially for manufacturing critical components, significantly mitigate business risks by enabling greater control and ensuring disruption-free production.

ICRA takes cognizance that while a single (or a few) supplier for raw material/ key component enables volume-based pricing efficiencies for an OEM, it also exposes the OEM to exogenous risks from disruptions in geographies or specific supplier operations. Hence, supply chain diversity, especially for critical components, may have an influence on an entity's rating. However, obtaining full disclosures about an OEM's supply chain (in its entirety) and its detailed assessment may not be feasible. Hence, ICRA evaluates entities on this parameter based on management inputs and comparative analysis.

Summary of the Salient Business Risk Factors

	Strongest	Weakest
Scale and Market Position	Market share greater than 35% or market leader in multiple sub-segments	Market share below 5%
Geographic Diversification	Highly diversified; domestic dealerships > 900 OR High export levels and is present in multiple export markets (>30% export sales in total volumes sold)	Low diversification; domestic dealerships <300; companies with presence limited to domestic market
Product Portfolio	Presence across all three segments – motorcycles/ scooters/ EVs — and strong presence across at least two motorcycle displacement categories (with at least 20% volumes from each displacement category)	Company dependent on single product model

	Strongest		Weakest
Technology & Product Development Capabilities	The company has exhibited strong track record in terms of new product offerings, meeting regulatory changes; Ready access to technological support from parent/ technological tie-up	→	The company has exhibited no product development capability
Ancillary and Vendor Network Strength of relationship with vendors/ ancillary	OEM has strong relationships with its vendors or OEMs; or through group companies might also own ownership stake in few critical ancillaries	→	OEM has weak vendor and supply chain ecosystem
Ancillary and Vendor Network Extent of localisation	>80%	→	<20%
Brand Strength	OEM has multiple demonstrated strong brands in its stable; regularly churns out variants and has success with new brands	→	OEM has no strong brands in its portfolio

Financial Risk Assessment

The various financial metrics assessed by ICRA could be divided into four categories—viz., Profitability, Leverage, Coverage and Liquidity. This document provides a brief summary of why ICRA considers these ratios to be important. For a more detailed description, readers may refer to the note titled*, Approach for Financial Ratio Analysis*, published on ICRA's website. Depending on the uncertainty around how the various credit drivers could evolve in the future, ICRA also carries out sensitivity analyses to assess the impact of key variables on various financial metrics.

Profitability Metrics

Profitability is a measure of the earnings generated by an entity during a period in relation to the resources deployed, or alternatively, a measure of how efficiently an entity sweats/ utilises its assets. From a rating perspective, both the level as well as the stability in profitability metrices matter. A consistent track record of higher profitability shown by an entity compared to its peers reflects a superior competitive position arising from one or more factors, including greater brand strength, better distribution reach, attractive product profile, technological superiority or higher cost efficiency (operating or capital). Entities with higher profitability than its peers are likely to show stronger resilience against economic downturns and are more likely to generate higher internal resources for re-investment and debt servicing, as well as attract fresh capital. Furthermore, sustainable and adequate margins are essential for an OEM to enable the ongoing investments, which are needed to maintain a technological edge.

Although the 2W industry is dominated by a few large players, the high competitive intensity in the industry mandates high operating efficiencies for the OEMs to maintain stable profitability. While a healthy and relatively stable profitability is indicative of an OEM's operational efficiency in its manufacturing operations, and the extent of outsourcing, it also reflects the OEM's pricing ability, product mix and bargaining power with its suppliers. A significant part of the manufacturing activity in the 2W industry is outsourced by the OEMs to component suppliers, helping the OEMs focus on key activities like product design and development, marketing and distribution, and assembly operations, while also giving them greater flexibility. A strong vendor network helps the OEMs work on lean working capital cycles, while also aiding in high localisation levels and, thereby, better profitability metrics.

With raw material costs being the largest component of an OEM's cost structure, any fluctuation in prices of key raw materials such as steel, aluminium, rubber and plastics has a direct impact on the OEM's profitability. Thus, the ability of an OEM to undertake price hikes to offset the impact of hike in input costs remains an important rating criterion.

Validation of Business Risk through Profitability Metrics
[Indicative metrics[1]]

	Strongest		Weakest
RoCE	>=25%	→	<10%
Volatility in RoCE	<=10%	→	>55%

Leverage and Coverage Indicators

Financial leverage is a measure of an entity's dependence on borrowed funds. Lower the dependence on borrowings, the lower (better) the leverage. When an entity borrows, it is obliged to pay both interest as well as principal to the lenders as per a defined schedule. This increases the fixed cost burden on the borrowing entity and in the limiting case, increases the default risk. While high leverage may mean high risk from a credit perspective, it is an often-adopted course by shareholder-oriented managements, given that high leverage, in good times, leads to high returns on equity capital. An entity's financial leverage could thus be a function of its management's financial policy and risk tolerance, besides being a point-in-time reflection of an entity's business and financial choices. An entity with lower leverage is better equipped to withstand volatility in cash flow generation in situations of economic downturn, competitive challenges, unexpected costs, changing consumer preferences, or regulatory changes. The OEMs that generally pursue an aggressive financial policy, which involves significant reliance on debt financing, are likely to be more vulnerable to cyclical downturns than the OEMs who pursue a conservative financial policy.

OEMs with healthier balance sheets are better positioned to sustain product development and expansion initiatives. An OEM with a stronger balance sheet is also well equipped to support its vendors/dealers in tight liquidity conditions, which helps in building strong ties and in strengthening its market position over the long-term. A low Total Debt-to-EBIDTA multiple supports an OEM's ability to service its debt obligations, fund growth opportunities and improve its competitive position without being overly reliant on external sources.

Assessment of leverage
[Indicative metrics]

	Strongest		Weakest
Indebtedness Ratio	<=0.9x	→	>3.0x
Debt-to-Profit Ratio	<=0.5x	→	>5.0x

Coverage is a measure of an entity's debt-servicing ability and is calculated as the ratio of profits to the debt servicing obligations during a given period. Higher the ratio, higher the cushion available with an entity to withstand variability in profits for making good its financial obligations. Coverage is a function of an entity's profits, leverage and debt characteristics (in terms of cost of debt and repayment schedule). The interest coverage indicator reflects the company's ability to fund the cost

[1] *The indicative financial metrics mentioned here and elsewhere in the document are intended to provide a broad overview to the readers regarding what ICRA generally considers as 'relatively strong' or 'relatively weak' metrics. It is, however, possible that an entity has relatively weaker metrices on one or more financial parameters, but its credit risk is assessed to be low because of other mitigating factors, including (but not limited to) stronger metrices on other financial parameters, a healthy business risk profile, strong financial flexibility or a strong promoter group that is willing to extend distress support to it.*

of external borrowings after meeting all operating expenditure requirements. The debt service coverage ratio (DSCR) is a measure of an entity's debt-servicing ability and is calculated as the ratio of profits to the debt servicing obligations during a given period. Entities with higher profitability and lower leverage will generally have better coverage ratios and, thereby, healthier financial risk profiles.

Assessment of coverage
[Indicative metrics]

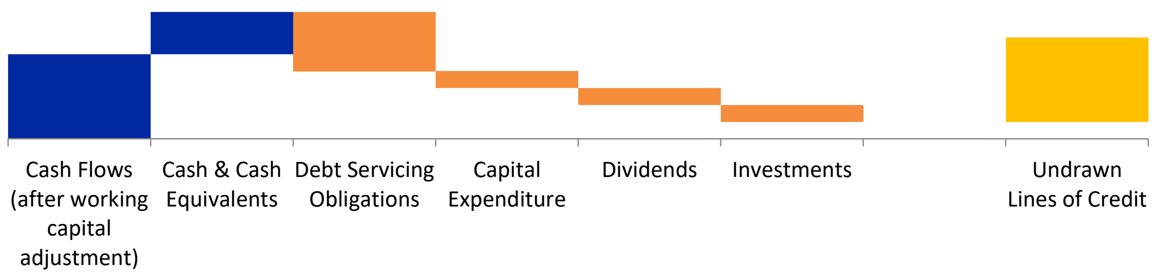
	Strongest	Weakest
Interest Coverage	>=18.0x	<2.0x
DSCR	>=4.0x	<1.1x

Cash Flows and Liquidity Profile

The rating exercise is primarily focused on assessing the future debt servicing capability of a company. Since it is cash that is required to service the debt obligations, it is imperative that a cash flow analysis is undertaken to evaluate the external funding requirements and likely financial position of the company, going forward. A cash flow statement represents the sources from which cash is generated, as well as its deployment. Analysed here are the trends in an entity's funds flow from operations, cash consumed to fund the working capital, the retained cash flows after paying out dividends or carrying out share buybacks, and the free cash flows after meeting debt repayment obligations and capital expenditure (capex) needs.

Liquidity is the measure of an entity's ability to meet its short-term cash obligations from various internal or external resources. Internal resources include cash flows from operations, unencumbered cash and cash equivalents on balance sheet and cash inflows expected from the monetisation of physical and financial assets. External resources include undrawn lines of credit or equity capital. The short-term obligations include both the committed as well as the contingent claims on an entity's cash, including the debt servicing obligations, working capital requirements, capex and other investment outlays, dividend and share buyback-related outflows, besides the sudden demand arising from crystallisation of discrete events such as unfavourable outcome of an ongoing litigation. The higher the cushion available between the resources available (especially internal resources) and the obligations, better the liquidity profile of an entity. Liquidity is generally assessed in conjunction with the vulnerability of an entity to timely refinancing / renewal of short-term sources of funding. Depending upon the circumstances, an entity that has a relatively modest liquidity profile, but a strong refinancing ability may not be viewed too unfavourably. ICRA also notes that the liquidity available with an entity may be for a temporary period and hence an entity's overall policy towards maintaining adequate liquidity (given the trade-off between returns and liquidity) is accorded due importance in the analytical approach.

Liquidity snapshot over any defined period



Capital Expenditure and Investment Plans

The capex plans of an OEM reflect its plans for capacity expansion, localisation and developing new products. Investment in capacity expansion is a positive, generally implying healthy growth prospects for the OEM. Similarly, investments related to increasing the level of indigenisation in its products may result in improved levels of profitability, going forward. New product plans also highlight the commitment of the OEM to refresh its product portfolio and introduce new products/variants. Moreover, select 2W OEMs have invested in new geographies either for setting up assembly capacity or towards incorporating a sales subsidiary in a bid to improve their international presence and benefit from geographic diversification. While capex plans for an OEM are generally considered a positive, these are not evaluated in isolation. The market position of the OEM, the quantum of the capex and the funding plans for the same are also evaluated to understand the overall impact on the credit risk profile of the company.

Tenure Mismatches and Risks Relating to Interest Rates and Refinancing

Large dependence on short-term borrowings to fund long-term investments or other long-term funding requirements can expose an entity to significant re-financing risks, especially during periods of tight systemic liquidity. ICRA evaluates the extent of such mismatches and the mitigating factors therein. One source of mitigation could be the existence of adequate buffers of liquid assets/ committed bank lines to meet short-term obligations. Another source of mitigation could be the entity's strong financial flexibility to be able to garner fresh funds at a short notice or a potent ability to refinance. Further, ICRA evaluates the extent to which an entity might be impacted by movement in interest rates.

Foreign Currency Related Risk

The vulnerability of an OEM to fluctuations in foreign currency rates is a function of its import content, foreign currency borrowings, as well as its export sales. The 2W industry's exposure to forex fluctuations on account of imports generally remains low, with most major OEMs having localised the procurement of most of its components. On the other hand, with significant potential available in multiple exports markets, many OEMs have been expanding their global footprint. ICRA assesses the degree to which such entities may be able to pass on the currency risk to their customers by adjusting their product/ service prices. This assessment is done by considering the materiality of the net forex earnings or expenditure in relation to the total revenues. Foreign currency risk for an entity could also arise from unhedged net liabilities [= foreign currency receivables – foreign currency payables – foreign currency debt]. ICRA's analytical focus is on assessing a company's hedging policy and the magnitude of such exposure relative to the entity's profits.

Consolidated Financial Analysis

With many of the 2W OEMs expanding to overseas geographies through subsidiaries or joint ventures, and some of them having ownerships in ancillary companies and financing arms, it is necessary to analyse their consolidated and group level financial indicators. Various parameters such as capital structure, debt coverage indicators and future funding requirements are assessed at a consolidated level or on limited consolidation basis (i.e., excluding any captive financing subsidiary), which provides a better picture of the company's financial risk profile.

Other Elements of Credit Risk Assessment

Parentage/ Group Support

While the credit rating of an entity is a function of its standalone credit profile, in certain cases, the entity's credit quality can also be driven by its relationship with its parent or the promoter group (henceforth referred to as the parent). The Indian 2W market is characterised by a few international OEMs through their wholly-owned subsidiaries and several well-established domestic OEMs. In cases where the company is directly owned by a foreign parent, the rating of the Indian entity is influenced by the parent's standing and any formal support arrangements in place with the entity, especially during the gestation period when subsidiaries may require financial support. Any payouts from the OEM to the parent in the form of royalty, technical fees, purchase of proprietary components, etc., are also evaluated for their impact on the OEM's profitability.

If the parent's credit profile is relatively stronger than the rated entity, ICRA assesses the ability and the likelihood of the parent extending extraordinary support to the entity. Support here refers to financial support from the parent expected to be available to the entity in the form of loans, equity, extended credit period and advances in times of credit or liquidity stress on the entity. Support here does not mean operational support in the form of new business opportunities, technology sharing, distribution network sharing and so on, as these aspects are factored in the standalone credit profile assessment. If the parent's credit profile is relatively weaker than the rated entity, the entity's rating may be lower than what its standalone credit profile assessment would have merited, given the possibility that the entity may at some point of time be bound to extend financial support to its weaker parent, possibly to the detriment of its own credit profile.

Financing Availability/ Captive Financing

Of the total domestic 2W sales, around 55-60% are financed at present vis-à-vis 35-40% a decade ago. In recent years, having a captive financing arm has served as useful demand enablers for 2W OEMs. Captive financiers, offering favourable terms and/or customised financial products can result in higher conversion ratios at the dealership level. In this respect, OEMs with well established brands generally benefit more, as they find it easier to arrange financing for their customers at favourable terms, supported by the relatively higher resale value of their models. Hence, presence of captive financiers lends support to an entity's sales volumes and market position.

While evaluating an OEM with a captive financing unit (CFU), ICRA evaluates the strategic importance of the CFU to the OEM, depending upon the share of vehicles financed by CFU to the overall vehicles sold by the OEM, the target market as well as the CFU's own financial position. The CFU's own credit profile and its linkage with that of the principal OEM, its reach and distribution network, its financial health and the extent of ownership by the OEM determine the extent of strategic support the OEM derives from the financing unit. While a captive financing arm supports business growth for the OEM by ensuring credit availability at competitive rates to customers, it is also critical for the financing arm to maintain healthy asset quality. The absence of the same would require infusion of fresh capital from the OEM to cover for its poor asset quality.

Financial Flexibility

An entity's financial flexibility (or the lack thereof) is reflected in its ability to access the capital or the money markets at short notice, attract diverse and marquee investors and enjoy the confidence of banks, financial institutions and intermediaries. A strong financial flexibility allows an entity to raise fresh borrowings or refinance existing ones quickly and whenever required. Financial flexibility could emanate from factors such as an entity's large scale of operations with strong financials, large, unencumbered cash flows (such as rental income, annuity payments in road projects), unencumbered assets and the flexibility to borrow against such assets, or strong parentage or linkages with a strong group.

In contrast, among the various measures of an entity's depleting financial flexibility, one relates to a high share of pledged promoter shareholding. A sign such as this may imply that the entity might be persuaded to distribute high dividends or support the promoter group through other means to the detriment of its own credit profile. If the promoters fail to repay their loans (availed by pledging of shares) or top up collateral when required, the lenders could sell the pledged shares. In some cases, this could trigger a change-of-control clause in the rated entity's bond indentures or loan documents and require it to redeem its debt ahead of schedule, creating a liquidity squeeze, besides affecting fresh capital-raising ability.

Debt Servicing Track Record

Any history of past delays or defaults in meeting interest and principal repayment obligations reduces the comfort level with respect to the company's future debt servicing capability and willingness. Nevertheless, the reason behind past defaults is also analysed, which could also be due to adverse demand situations in the underlying industry. The company's ability to honour its debt obligations during the period of cyclical stress is also factored in.

Contingent Liabilities and Off-balance Sheet Exposures

ICRA reviews the contingent liabilities and off-balance sheet exposures as disclosed by the entity in its Annual Report and evaluates the likelihood of their devolvement and the financial implications of the same.

Event Risk

ICRA recognises the possibility of events such as unrelated diversification, mergers and acquisitions, business restructuring, asset sales and spin-offs, litigations, equity infusion and refinancing, which could have a material impact on the credit profile of an entity. Incorporating the impact of such discrete events in the credit rating, from the beginning, is often difficult. Depending on whether and when such events occur, the rating opinion could be substantially different. To take rating decisions in such cases, ICRA applies its analytical judgment based on the rated entity's track record, the credibility of the management and the experience of having seen similar situations play out in other entities. However, given the nature of such events, it is possible that the rating may undergo a material change later, upon the occurrence of the event.

Asset Concentration Risk

ICRA also takes into consideration the number of manufacturing facilities owned and operated by the OEM, and the geographical diversity of the same. An OEM with multiple manufacturing facilities is inherently less exposed to single-asset related risks, including operational shutdowns due to natural calamities, fires, and industrial issues, among others. Geographical diversification with respect to manufacturing facilities is also a positive factor as it better equips the OEM to cater to demand from different regions, while minimising transportation costs. Furthermore, there are many regions in the country offering fiscal incentives to companies for setting up manufacturing facilities there—the entity's presence in such locations and its impact on the OEM's profitability are also factors that are considered in the rating decision.

Management Quality Assessment

In addition to the industry, business and financial risk analysis, all credit ratings incorporate an assessment of the quality of the rated entity's management and its financial policies. An entity with an experienced management is considered a positive factor. The management risk analysis also factors in the historical track record of the entity or the group in timely servicing its obligations.

Quality of Management and Financial Policies

As a part of its process, ICRA undertakes discussions with the rated entity's management to understand its views on past performance as well as its future plans and strategies, besides the outlook on the industry. Some of the points assessed are:

- Experience of the promoter/ management in the industry
- Commitment of the promoter/ management to the rated entity
  Risk appetite of the promoter/ management and risk mitigation plans
- Policies on leveraging, managing interest rate and currency risks

- The management's success in introducing new projects and managing changes in the external environment
- The management's plans on new projects, acquisitions and expansions
- Track record of balancing the interests of shareholders, creditors and other stakeholders

Periodic interactions with the management help ascertain the shifts, if any, in their financial policies.

Assessment of Environmental, Social and Governance (ESG) Risks

Environmental (E) and Social (S) Risks

As this methodology highlights, while undertaking credit assessment of entities, ICRA seeks to incorporate all relevant credit considerations into its rating decisions while taking a forward-looking view on the risks and the mitigants. The relevant credit considerations include (sometimes overtly, sometimes covertly) the E&S factors that could affect the rated entity/ transaction. While ICRA's analytical approach does not explicitly disaggregate these risks to assess their impact on the rating, these risks are often assessed broadly. Further, it is not always feasible to fully or precisely disaggregate the sub-components of E&S risks in credit analysis since these considerations often tend to overlap.

That said, the materiality of the E&S risks and the time horizon over which they are expected to crystallise differ widely across sectors and entities. In some cases, while the E&S risks could be material, their effect on the credit profile may be muted because of other fundamental strengths of the entity. In other cases, the adverse impact of E&S risks is expected to play out in the distant future and, hence, these considerations do not necessarily weigh on the rating today—with the expectation that when these risks manifest in future, the rated entity would possibly have adapted itself by realigning its business model.

While evaluating E&S risks, ICRA's objective is only to assess the direct and indirect risks that an entity faces and how it already is or is intending to mitigate the impact of such risks on its credit profile. As an example, ICRA only assesses whether an entity is exposed to physical climate risks, or carbon transition risks such as those arising from changes in regulations or other environmental and social risks; and seeks to understand the various mitigation and adaptation approaches that the entity is implementing to mollify these risks. In spite of the above, as an example, it is possible that even if entity A has a higher carbon footprint than entity B, it does not materially affect ICRA's credit opinion on entity A. This is because ICRA's credit opinion on an entity considers a wide gamut of credit-relevant factors, and the E&S factors are only one among those.

The 2W OEMs derive a material proportion of their demand from rural segments, wherein adverse climatic conditions such as droughts and floods may impact farm incomes and, consequently, impact the earning prospects of entities. The manufacturers also remain exposed to climate transition risks emanating from a likelihood of tightening emission control requirements, with the government focused on reducing the adverse impact of automobile emissions. Accordingly, an OEM's prospects remain linked to its ability to meet tightening emission requirements. The companies in the sector may need to invest materially to develop products to cater to the regulatory thresholds or expected transition to alternative fuel vehicles, which may have a moderating impact on their return and credit metrics. The exposure to litigation/penalties arising from issues related to waste and water management for the manufacturers remains relatively low.

Two-wheeler OEMs have a healthy dependence on human capital and, thus, retaining talent, maintaining healthy employee relations as well as supplier ecosystem remain essential for disruption-free operations. Another social risk that OEMs face pertains to product safety and quality, wherein instances of product recalls and high warranty costs may not only lead to a financial implication but could also harm the reputation and create a more long-lasting adverse impact on demand. The entities also remain exposed to any major shift in consumer preferences/demographics, which are a key driver for demand, and accordingly may need to make material investments to realign their product portfolio.

Governance Practices

A sound corporate governance structure attempts to make clear the distinction of power and responsibilities between the Board of Directors and the management. The constitution of an entity's Board and the Board's participation in strategy formulation, besides the entity's adherence to legal and statutory compliances is factored in during credit assessments. ICRA seeks to gain a qualitative understanding of an entity's commitment to following transparent and credible practices by the way its financial statements are reported, its level of disclosures, consistency in communication and openness in sharing information during the credit rating exercise. Besides, the corporate group structure (whether simple or complex), the rated entity's related party transactions and instances of supporting group entities at the expense of debt holders are assessed.

Summing Up

ICRA's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the instrument being rated. This opinion is reached by following a detailed evaluation of the entity's business and financial risks, its competitive strengths, its likely cash flows over the near-to-medium-term and the adequacy of such cash flows vis-à-vis its debt servicing obligations and other funding requirements. ICRA's approach to rating 2W manufacturers also incorporates the evaluation of various business risk parameters such as the company's market share, product portfolio, technology development strength, distribution network and the management strategy for maintaining financial performance through the cycle and its overall approach towards investment and growth.

ANNEXURE

Summary of rating factors and an example to illustrate the key building blocks of a credit rating

		Strong			Comfortable			Adequate			Moderate			Weak		
Industry Risk	Industry Position															
Business Risk	Market Share															
	Geographic Diversification															
	Product Portfolio															
	Technology & Product Development Capabilities															
	Ancillary and Vendor network															
	Brand Strength															
Financial Risk	Profitability and Earnings Stability															
	Leverage															
	Coverage															
		Enhance					Support/ Neutral					Hinder				
Do these factors enhance or hinder the credit profile?	Diversification															
	Refinancing Dependence, Liquidity and Financial Flexibility															
	Foreign Exchange Risk															
	Financial Policy															
	Management, Governance & Reporting															
		Very High				High				Moderate				Low		
Parent Support	Likelihood of Parent Support															
	Rating of Parent	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B/ C category	
	Final Rating	**AAA**	**AA+**	**AA**	**AA-**	**A+**	**A**	**A-**	**BBB+**	**BBB**	**BBB-**	**BB+**	**BB**	**BB-**	**B/ C category**	

The above graphic is only for illustration purpose and does not represent a rating output from a formulaic model. The ratings assigned by ICRA are determined by Rating Committees based on both quantitative and qualitative considerations.

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ABOUT ICRA LIMITED

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

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