EMERGING Credit Rating Ltd
an independent house of risk assessment

AUTOMOTIVE INDUSTRY

INTRODUCTION

ECRL's approach to rating of corporate debts related to automotive parts & components manufacturers is in line with its existing corporate debt rating methodology but incorporating pertinent issues and factors peculiar to the industry. The particular company is assessed within an established framework; business risk analysis, financial risk analysis and management & other qualitative factors. Issue structure & terms are only considered on a case-to-case basis due to homogenous structures seen to date. Business risk analysis essentially covers three areas – industry outlook, competitive position and operation analysis whilst financial risk analysis is divided into four areas – profitability, cash flow/debt service capability, capital structure and financial flexibility. Though a global view has been adopted in assessing various risks concerning automotive and its related industries, the uniqueness of the domestic market which has been heavily protected to promote national automotive players must also be recognized.

BUSINESS RISK ANALYSIS

Industry Outlook

A rating assignment commences with the evaluation of the level of risk involved in a particular auto parts related business. Industry assessment covers the essential demand/supply factors, industry structure and characteristics, competitive environment, barriers to entry/trade barriers, market behaviour, pricing issues, capital intensity, research and development requirements, regulatory framework etc.

Parameters that will be examined among others are:

- Economic and industry trends developments – macro & micro, for instance industry consolidation/rationalization and modularization.
- Measures detailed under policies that regulate the industry – National Automotive Policy (NAP). Licensing, duties, tariff and other forms of taxes serve as trade barriers
- Movement of benchmark interest rates, its effects on lending practice and consumer purchasing power;
- Ease of obtaining credit;
- Pricing practice among automakers; and
- Total Industry Volume (TIV) – its growth pattern and composition.

Exposures of companies involved in the local auto parts industry are largely confined and caters to the domestic market. The nature of the auto parts produced has a large bearing on demand patterns. Consumable parts such as disk brake pads, oil filters, shock absorbers, exhaust system parts, batteries, tires, etc have relatively short and predictable replacement cycles and are somewhat resistant to economic downturns. ECRL would assess the overall outlook of the domestic economy, changes in demography and political landscape with particular attention given to regulations and policies that govern the domestic automotive industry. ECRL believes that the demand for automotive parts is highly sensitive to general economic conditions.

Competitive Position

Competitive position involves assessment of a company's strengths and weaknesses relative to its peers. In particular, the analysis aims to deduce whether the company's competitive strength and associated business strategies allow it to favorably differentiate itself from its competitors, translating into competitive advantages. The analysis under this segment will sum up the resilience of revenue and business trend of any automotive parts and components manufacturer which is crucial during the down-cycle. In assessing an auto parts company's competitive advantage, ECRL's analyst would typically scrutinize the following:

- Position of the company in the supply chain
- Accreditation/certification achieved;
- Size of operation and capabilities;
- Research & Development capabilities;
- Patents/Intellectual Properties;
- Diversity of customers served;
- Diversity of products;
- Geographic markets served; and
- Any form of strategic alliances/technical collaboration established with global players.

The interplay of manufacturing size, capabilities and brand standing often dictate the breadth and depth of products offering, portfolio of customers and markets served. ECRL has observed that those with higher manufacturing capabilities have moved away from producing individual parts toward producing modules [combination of several parts/components], thus playing a leading role in rationalizing parts and components supply to automakers – and increasing its value proposition along the way. The company's involvement in critical vs. non-critical components/modules would also be assessed as non-critical components/modules are usually subjected to multiple sourcing arrangements from auto makers – implying weak bargaining power and risk of slimmer margins. Companies with diverse customers would have a lower concentration risk.

Similarly those with balanced exposure in both the original equipment market segment and replacement market segment and significant exposures in overseas markets would be accorded with more favorable risk scores. Strategic alliances/technical collaboration forged with global players would indicate technology/manufacturing competency. This is equally important in maintaining a competitive cost structure as well as providing access to the global automotive supply chain. ECRL's analyst would also examine market reach of each auto parts manufacturer to ascertain its concentration risk – geographic markets served and portfolio of client base.

Operation Analysis

Operation analysis is pertinent to areas where technical competence and efficiency are critical ingredients of success. ECRL's analyst would assess the flow of processes from sourcing raw materials up to production of finish products to see how it fares against industry best practices. Areas of interest include, but are not limited to the following:

- Existence of hedging practice to mitigate currency risk relating to importation of raw materials;
- Policy with regard to sourcing of raw materials to ensure the stability and continuity of supplies;

- Performance of production floor measured in allowed and actual downtime;
- Operational management – formalization of standards/manuals vs. technical assistance [Japanese mould];
- Level of efficiency, measured in productivity and wastage recorded.

The above assessment would also include the company's operating track record and corresponding financial performance. Companies that fall short in meeting industry best practices on selected parameters, if material, would be accorded with less favorable risk scores.

FINANCIAL RISK ANALYSIS

Profitability

Profitability measures include historical and current operating profit margins [EBITDA/Revenue] wherein a record of reliable profits should support certain assumptions on future trend. Other parameters of interest include return on assets and return on equity. Growth patterns either significantly faster or slower than normal industry cycle may be a basis for concern and should be analyzed accordingly. Auto part manufacturers face the challenge of continuous pricing pressure from auto makers and exposure to commodity price swings.
The key driver of profitability for auto parts companies, going forward, hinges on their ability to continuously reduce costs and achieve greater operating efficiency, with secure and stable orders from auto makers being crucial.

Companies strong in the area of capacity utilization & plant flexibility, geographic positioning/market reach, cost protection in relation to commodity price movements and product development efficiency should exhibit resilience in profitability, and earn good ratings.

Cash Flow Generating Ability and Debt Servicing Capacity

The analysis under this section covers the auto parts company's ability to generate adequate amount of cash flow from operations on an ongoing basis to fund capital reinvestment requirements, service debt, and still maintain prudent liquidity buffers. Parameters of interest include:

- Cash Flow from Operations Interest Coverage;
- Cash Flow from Operations Debt Coverage;
- Retained Cash Flow Debt Coverage;
- Free Cash Flow Debt Coverage; and
- Capital Expenditure (CAPEX)/Depreciation.

Cash flows of domestic auto parts companies are heavily influenced by business cycles though somewhat shielded, that is, 3 months firm orders + 3 months projection, practiced by auto makers. This is exacerbated by the ongoing need to fund reinvestment for future models which are often dictated by the need to serve the requirements from principal customers. ECRL observes that the CAPEX requirement for auto parts manufacturers varies according to capacity growth. Companies that are able to generate positive cash flows on a consistent basis are likely to receive good risk scores. Conversely, companies that demonstrate a protracted period of negative free cash flow or inability to generate positive retained cash flow, would be marked down in the scoring. The ability to fund working capital and capital investments in this instance, is likely to be reliant on asset sales or significant increase in debt. In either case, this cannot be sustained for long periods, hence would represent a rating concern. In addition to the above, to be able to sustain a strong rating, auto parts companies are expected to maintain healthy capital investments, to reflect new models/products to be rolled out.

Capitalization and Financial policies

Capitalization and financial policies are often indicative of a company's risk orientation. ECRL's analyst would seek to understand the basis of a company's financial policies and its capital structure before drawing conclusions on the company's financial risk profile. The extent to which a company decides to finance its operations with debt rather than equity will influence the rating recommendation. Similar to other industries, common parameters when assessing debt leverage are:

- Total Debt/Equity;
- Short Term Debt/Equity;
- Long Term Debt/Equity.

Auto parts companies in general are highly leveraged with most domestic players noted to have Total Debt/Equity ratio of more than 1.0 time. The cyclicality of the industry coupled with continuous need for reinvestment and capacity expansion of late have forced the Total Debt/Equity ratios for a number of prominent auto parts companies to further increase. The increase in debt leveraging, in the absence of changes in business profile/strategy such as regional expansion and/or products/customers diversification would be a cause for rating concern.

Financial flexibility

Financial flexibility principally incorporates the concepts of liquidity and access to alternative financial sources. Key areas of assessments in this sub-sector are:

- Stability of free cash flow;
- Cash reserves & credit line availability;
- Size of unencumbered assets; and
- Debt maturities & other potential cash calls.

In addition, it is uncommon for auto parts manufacturers to have a sizeable non-core asset available for disposal and/or pledge to secure further funding.

MANAGEMENT AND OTHER QUALITATIVE FACTORS

Evaluation of the management of auto parts companies involves understanding the key management business decisions and strategic directions; how they are implemented and through what form of financing, among others. Ideally, a company's business goals and financial policies should be clear, consistently pursued and realistic based on an understanding of the internal and external business environments. ECRL would assess the reasonableness of the company's strategic direction and future plans, based upon interviews with the company's top management or sometimes controlling shareholders – typically assessment of key management profile and track record, commitment level, corporate governance issues, management-shareholders relationship, implementation of strategies, succession planning etc. Favorable risk scores would be accorded to companies that are managed by a good board of directors and experienced management team with a track record of delivering consistent results in the past.