

# RATING METHODOLOGY

## AUTOMOTIVE PARTS AND COMPONENTS MANUFACTURERS

The logo for MARC Ratings, featuring the word "MARC" in a bold, red, serif font, centered between two horizontal blue lines.

### INTRODUCTION

MARC Ratings' 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 recognised. Of particular interest is the changing industry landscape following the release of the National Automotive Policy at the end of March 2006.

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## 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/rationalisation and modularisation.
- 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. MARC 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. MARC Ratings' analyst would also assess the robustness of the financial system and its direction as the sheer growth of the domestic automotive industry achieved in the past was largely underpinned by easy credit practices of financiers.

The growth in TIV and its implication to dominant automakers such as PROTON, PERODUA and Toyota need to be examined to evaluate the outlook for auto parts companies that operate in the upstream segment. It is a common knowledge that local auto parts manufacturers are heavily dependent on the performance of national automakers – PROTON and PERODUA which traditionally account for more than 75% of passenger cars sold in the country. MARC would monitor the developments in neighbouring markets such as Thailand and Indonesia where the impending liberalisation, that is full AFTA implementation would see the convergence of the regional market – promoting cross border competition among auto parts manufacturers as well as presenting opportunities within the broader regional/international market.

Sustained growth in TIV in tandem with healthy economic expansion and robust lending practices/or easy credit financing should warrant favourable outlook for the auto parts sector and vice versa.

## 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 favourably 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, MARC Ratings' analyst would typically scrutinise the following:

- Position of the company in the supply chain – tier 1 [lead vendor] vs. tier 2/tier 3;
- 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. MARC 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 rationalising 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 favourable 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.

MARC Ratings' analyst would also examine market reach of each auto parts manufacturer to ascertain its concentration risk – geographic markets served and portfolio of client base. MARC Ratings' experience, however, revealed that most of the domestic auto parts manufacturers with the exception of a few such as APM Automotive Holdings and Ingress Corporation, tend to rely heavily on requirements from PROTON and PERODUA, which make up as high as 70%-80% of their production.

## Operation Analysis

Operation analysis is pertinent to areas where technical competence and efficiency are critical ingredients of success. MARC Ratings' 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 – formalisation 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 favourable 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 pattern either significantly faster or slower than normal industry cycle may be a basis for concern and should be analysed accordingly. Within MARC Ratings' portfolio of rated auto parts manufacturers, it is observed that operating profit margin tend to be in the high teens with some even exceeding 20%. The margin, however, has been gradually declining in recent years reflecting continuous pricing pressure from auto makers and exposure to commodity price swings. Nevertheless, a reasonable profit margin is expected to exist for auto parts companies to ensure the survival of the industry and national auto makers.

The inflated margin enjoyed by auto parts manufacturers in the past was attributable to industry protection and support received from national auto makers. As the performance of PROTON has suffered of late, driven by limited product range and inability to competitively price and position its products, the profitability of prominent auto parts manufacturers in the country have been threatened. Of particular concern is the auto makers' response to the declining market share via cost reduction and aggressive sourcing of cheaper parts from overseas.

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 utilisation & 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.

MARC observes that proactive auto parts manufacturers such as APM Automotive Holdings and Ingress Corporation had established their production bases in cost competitive region such as Thailand, to benefit from the country's thriving automotive industry, enjoy sizable incentives for promotion of exports, attain a leaner cost structure, hence higher profitability.

## **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 such as PROTON. MARC observes that the CAPEX requirement for auto parts manufacturers varies according to capacity growth, but based on supplies for local models, annual CAPEX ranges from RM20 million to RM30 million per annum.

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.

## Capitalisation and Financial Policies

Capitalisation and financial policies are often indicative of a company's risk orientation. MARC Ratings' 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; and
- 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 cyclicity 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.

Most auto parts manufacturers rated by MARC have relatively low free cash flow resulting from the need for large reinvestment regardless of the business cycle. 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.

MARC also noted that most domestic auto parts companies typically derive their financial flexibility from their listing status, although most of the companies examined do not exhibit superior share price performance.

## 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.

MARC 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.

Favourable 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.

MARC has refined its methodology for assessing Automotive Parts and Components Manufacturers. This methodology partly amends and supersedes MARC's "Rating Approach to Automotive Parts and Components Manufacturers published in 2006. The revised methodology should be read in conjunction with MARC's "Corporate Debt Ratings" methodology which is available on MARC's website at [www.marc.com.my](http://www.marc.com.my).

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