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**February 2017**



**Indian Auto Components Industry**

**Industry reported growth of 6% during Q3 FY2017 despite demonetization impact; headwinds from steady increase in commodity price**

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**INDIAN AUTO COMPONENTS INDUSTRY**

**Summary February 2017**

# FY2017: Steady increase in commodity prices a concerning factor for auto component industry profitability

**Industry Factsheet**

**Size:** Rs. 2.55 Trillion (FY2016)

**Share of OE Demand: FY2016**

Source: ACMA

* **Demonetization impact short lived; industry to recover fully by Mar-17:**Domestic automotive demand came under pressure during Q3FY2017 post cash crunch created by demonetization related measures. Some segments like two wheeler (2W) and light commercial vehicles (LCV) were severely impacted due to dependence on rural economy (where cash transaction are high) whereas performance of other segments like passenger vehicle which already has high level of financing penetration were less impacted. Domestic medium & heavy commercial vehicle (M&HCV) demand also remain subdued. The impact of demonetization has eased substantially in Jan-17, and industry participants are expecting full recovery by Mar-17. The silver lining in Q3 was automotive exports, which supported overall production volume. During Q3FY2017, PV and M&HCV production grew by 11.8% and 4.2%, respectively despite much weaker domestic wholesale volume. Consequently, despite weakness in domestic demand, overall volumetric demand from OE segment remains positive for auto component industry.

Exports accounts for 28% of demand for auto components in India. Indian auto component export has a high exposure on the USA and EU markets, which together accounted for 60% of total auto component exports from India. Slowdown in US as well as European market will have a bearing on Indian auto component exports; though higher order share and market share expansion could counter it to an extent. Aftermarket segment, which accounts for ~17% of domestic auto component market was however impacted during Q3 (post demonetization), customer deferred discretionary spending owing to cash crunch as aftermarket segment has high level of cash transaction at end customer (garage/spare parts shop) level.

Our sample of 48 auto ancillaries, which constitutes around 25% of the industry’s turnover, grew by 6% (revenue) during Q3 FY2017 as against the 4% growth of the previous quarter. Revenue growth was primarily driven by higher realization in the backdrop of steady increase in commodity prices, whereas volumetric growth remains in the low single digit. During Q4FY2017, pre-buying ahead of nationwide BS IV emission norm implementation will propel M&HCV demand. Mandatory heating, ventilation and air-conditioning (HVAC) system in M&HCV from Apr-17 is another positive for domestic auto ancillaries, especially for HVAC suppliers, if it gets implemented though automotive OEMs are expecting deferment in deadline for HVAC implementation.

* **Commodity price started pinching profitability:** In FY2016, operating margin of auto ancillaries benefitted from soft commodity prices; however, these benefits were eventually passed on to the OEMs with a lag of a quarter or two. The benefits of commodity prices had peaked out in Q3 FY2016 and RM expense (as % of sales) have started increasing sequentially since then.

# FY2017: Overall credit profile remain stable

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**Short-Term Growth Drivers**

* + Sustained growth in the PV and 2W industry
	+ Stable aftermarket

**Long-Term Growth Drivers**

* + Domestic automotive demand given low vehicle penetration in India
	+ Increasing localisation by OEs in structural components
	+ Increasing content per vehicle
	+ ‘Make in India’ initiative – Developing India as export hub for auto-components and small cars/UVs

**Key Challenges**

* + Regulatory & infrastructure bottleneck
	+ Low R&D spending and dependence on global suppliers for technology knowhow
	+ Rising imports from China; Chinese competition in the global market
	+ Fragmented industry, with only one player in the global top 50 auto ancillary list

Source: ACMA; \*exclude tyre & batteries

Certain commodities like Steel, Rubber and Copper have witnessed sharp jump in prices over the last 12 months. Auto ancillaries have to absorb these increased costs in the immediate term, though it will be gradually passed on to the OEMs with a lag of quarter or two. During Q3FY2017, tyre companies are amongst the worst impacted due to sharp increase in rubber prices (over last 12 months) which resulted in steep 300+bps correction in contribution margin for major tyre companies. Battery manufacturers like Exide and Amara Raja also witnessed sharp increase in RM cost, on account of higher lead prices. Our sample of 48 auto ancillaries witnessed steep 166 bps YoY decline in operating margin to 13.8%, mainly on account of RM cost pressure as well as higher sticky costs (employee and SG&A expenses). With likely improvement in volume off-take during Q4, operating margin are likely to expand sequentially (QoQ) during Q4; however, given that RM benefit have peaked out, we expect operating margin to witness YoY moderation over the next few quarters.

* **Credit profile remains stable**: Given surplus capacities, the industry has been on a consolidation mode over the last two years, taking steps towards deleveraging their balance sheet. However, select OEMs are exploring inorganic growth entailing fund raising. Ancillaries continue to focus towards moving up the value chain to mitigate profitability and competitive pressure in the intensely competitive industry. Incremental investments by auto ancillaries are primarily towards new order/platform related requirement or debottlenecking of existing capacity. Supported by healthy cash accruals, gearing as well as coverage indicators for the industry have improved considerably over the past two years; ICRA expects industry-wide credit trends to remain stable, supported by robust demand from the OEM segment in the near term.
* **Outlook:** Considering the increasing content per vehicle due to various technological advancement as well as regulatory measures (emission, safety regulations), the growth in the auto component industry will be relatively higher than the underlying growth in the automotive industry in the medium to long term. We maintain our 10-12% long term CAGR expectation for Indian auto component industry.

Over the medium to long term, growth in the auto component industry will be higher than the underlying automotive industry growth, given the increasing localisation by OEMs, higher component content per vehicle and rising exports from India. Operating margin in FY17 are likely to ease around 14.9%-15% level from 16% level in FY16. We maintain our medium term margin outlook of ~13.5 as compared to earlier ~12% level witnessed prior FY2012 owing to a richer product mix, and rising revenues from the profitable aftermarket segment.

**Please contact ICRA to get a copy of the full report**

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