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ICRA RESEARCH SERVICES

INDIAN COMMERCIAL VEHICLE INDUSTRY

Earnings of CV OEMs to contract substantially in the near-term owing to ban on BS-III vehicles

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Industry Update

Despite sharp increase in discounts, CV OEMs are estimated to have sizeable unsold inventory of BS-III vehicles March end

Exports appears to be the lowest cost solution for CV OEMs; Upgradation possibility may be limited and costly

Clearing approximately 35,000-45,000 of unsold vehicles could take up to two quarters

CV OEMs staring at sizeable stock of un-sold BS-III vehicles and earnings contraction in the near-term

- In a setback to the automobile industry, the Honorable Supreme Court of India banned the sale of Bharat Stage (BS)-III vehicles just two days prior to the implementation of new emission norms. As a result of this development, the Commercial Vehicle (CV) industry is currently staring at a sizeable stock of un-sold BS-III vehicles and sharp contraction in earnings on account of a) deep discounts extended to clear existing inventory and b) costs associated with re-calls and possible upgradation to BS-IV norms.
- According to industry estimates, the CV industry had approximately 95,000 BS-III vehicles in March 2017, of which they were able to clear only 50,000-60,000 units (or 55-65%) in the last two days of the fiscal 2017 despite sharp increase in discounts (ranging between 10-30%) offered by OEMs as well as dealers.

Exports appears to be the most pragmatic solution for CV OEMs

- Accordingly, CV OEMs are now sitting on sizeable stock of unsold inventory, which is worth approximately Rs. 46-58 billion. We believe exports of these vehicles to near-by markets where emission norms have still not progressed to Euro-IV or equivalent appears to be the most suitable option available with OEMs as upgradation to BS-IV has limited possibility.
- This is primarily because of the fact the technology to meet BS-IV norms has undergone a significant shift in case of CVs as engines technology has moved from largely mechanical to electro-mechanical. Apart from changes in engine technology, the exhaust system has also been upgraded to either Exhaust Gas Re-circulation (EGR) or Selective Catalytic Reduction (SCR) technology to achieve higher reduction in Nox levels under BS-IV.

Liquidating inventory could take up to two quarters depending on model-mix and inventory ageing

- As a result of these factors, we believe that upgrading the vehicles to BS-IV norms may be difficult for OEMs and exports could be the most pragmatic solution. Nonetheless, companies will have to incur sizeable expense in reverse logistics and other fitments necessary to adapt unsold inventory for export requirements.
- Given the sizeable level of un-sold inventory levels (almost 30-40% of India's CV Exports – ~110,000 units), clearing up the inventory could take up to two quarters depending on the model mix and inventory ageing. This will result in higher working capital intensity over the next few quarters. Further, OEMs would not be able to completely exhaust the entire inventory as some of the models may be popular in India but not in other markets.

ICRA estimates that BS-III stock worth Rs. 46-58 billion may be unsold as on March-end

Sharp discounts (post SC's verdict) and other costs related to re-calls and upgradation will impact almost 200 bps correction in margins

Domestic CV sales grew by 7.7% in March-17 led by pre-buying and significant discounts extended by OEMs

ICRA expects ~200 bps correction in EBITDA margins of CV Industry in the near-term

Exhibit 1: Estimated value of un-sold inventory

ICRA Estimates	
Industry-wide Inventory of BS-III Vehicles – In March 2017	~95,000
Approximate sale in March 2017	~50,000-60,000
Estimated un-sold inventory as on 1st April 2017	~35,000-45,000
Estimated value of un-sold inventory (in Rs. Billion)	Rs. 46-58 Billion

Source: Company Data, ICRA research

Domestic CV Sales of Top-5 OEMs grew by 7.7% in March 2017 on YoY basis

Exhibit 2: Trend in Domestic CV Sales in March 2017 vis-à-vis March 2016

Domestic CV Sales	March-16	March-17	Change (%)	11m FY 2016	11m FY 2017	Change (%)
Tata Motors	38,166	35,876	-6.0%	268,823	271,404	1.0%
Mahindra & Mahindra	17,438	22,908	31.4%	149,345	158,041	5.8%
Ashok Leyland	16,702	18,682	11.9%	111,876	115,756	3.5%
VECV	6,063	6,649	9.7%	39,449	43,920	11.3%
SML Isuzu	1,656	2,094	26.4%	10,607	12,595	18.7%
Total	**80,025**	**86,209**	**7.7%**	**580,100**	**601,716**	**3.7%**

Source: Company Data, ICRA research

Domestic CV industry growth has moderated from 11.5% in FY 2016 to 3.5% in 9m FY 2017

M&HCV (Truck) segment has witnessed the most slowdown as reflected by a decline of 2.2% during the same period

Domestic CV sales slowed down during FY 2017 on account of multiple factors

After strong recovery in FY 2016 on back of replacement-led demand, the Commercial Vehicle (CV) industry started on strong note in fiscal 2017 However, after witnessing healthy growth of 13% in the first quarter, the growth momentum came to a grinding halt from June onwards as M&HCV (Truck) started witnessing sudden contraction. Waning replacement demand along with uncertainty related to the impact of GST on vehicle prices put brakes on M&HCV (Truck) sales as fleet operators held back on their fleet renewal or addition plans on expectations that vehicles prices may fall once GST is implemented. Along with these factors, the industrial activity has also not improved during the current fiscal to support cargo availability and in turn demand for M&HCVs.

With transition to new emission norms (i.e. BS-IV) from April 2017, the industry was expected to witness pre-buying in the last quarter as vehicles complying with new emission norms were expected to become 6-10% more expensive because of technology upgradation. Although the industry growth recovered in Jan-Feb 2017 but the extent of recovery was below expectations. ICRA believes that subdued economic activity along with likelihood of GST going to be implemented in the near-term has prompted fleet operators to defer fleet expansion or renewal plans to some extent.

In contrast to M&HCV (Trucks), the LCV has registered healthy growth in volumes (up 7.2% in 11m FY 2016) on back of low-base effect (i.e. sales declined by 30% between FY 2013-16) and improving demand for SCVs aided by pick-up in consumption-driven sectors. Among the three segments of the CV industry, the bus segment has been the least impacted by the demonetisation move in the near-term owing to a higher proportion of sales to institutional clients (i.e. SRTUs, Schools & Colleges and Travel Operators).

Exhibit 3: Segment-wise Trend in Domestic Commercial Vehicle Sales

Unit Sales	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016	11m FY 2017
Domestic CV Sales	809,499	793,211	632,851	614,948	685,704	626,977
M&HCV (Truck) Sales	299,334	221,776	161,909	195,918	258,488	222,202
LCV (Truck) Sales	411,415	476,695	389,434	337,377	334,371	320,219
Buses	98,750	94,740	81,508	81,653	92,845	84,556
Growth (%) - YoY						
Domestic CV Sales	18.2%	-2.0%	-20.2%	-2.8%	11.5%	3.5%
M&HCV (Truck) Sales	8.8%	-25.9%	-27.0%	21.0%	31.9%	(2.2%)
LCV (Truck) Sales	29.8%	15.9%	-18.3%	-13.4%	-0.9%	7.2%
Buses	6.5%	-4.1%	-14.0%	0.2%	13.7%	5.7%

Source: SIAM, ICRA research

Industry is likely to witness 6-8% growth in FY 2018 aided by higher budgetary allocation towards infrastructure and rural sectors; Potential implementation of scrappage program could trigger replacement demand

Exhibit 4: ICRA's Growth Estimates for FY 2017e & FY 2018p

Growth Outlook	FY 2015	FY 2016	FY 2017e	FY 2018p	Near-to-Medium-Term Growth Drivers
M&HCV – Trucks	21.0%	31.9%	0-2%	6-8%	▪ Higher budgetary allocation towards infrastructure and rural sectors ▪ Scrappage program + NGT's ban to drive replacement demand ▪ Stricter compliance with respect to overloading and vehicle dimension (for specific applications i.e. car carriers etc.) to drive demand for additional vehicles
LCV – Trucks	(13.4%)	(0.9%)	6-8%	7-8%	▪ Replacement demand to continue following 3 years of declining trend ▪ Pick-up in demand for consumption-driven sectors, rural markets and e-commerce ▪ Financing environment to ease as delinquency subside
Buses	0.2%	13.7%	7-9%	5-7%	▪ Order from SRTUs to support sales in M&HCVs; Smart Cities Initiatives etc. ▪ Demand from schools and staff carrier segment remains stable

Profitability indicators of CV OEMs to moderate marginally because recovery in material prices and gradual pass through of BS-IV cost Significant increase in discounts (related to BS-III) and recall cost are incremental headwinds

Exhibit 5: Key Estimates for FY 2018e

Key Parameters	Estimates for FY 2018
Industry Growth (in Volumes)	Domestic CV segment is expected to register a growth of 6-8% in FY 2018 CV Exports are expected to grow by 8-10% in FY 2018
Revenue Growth	Revenues of CV OEMs will grow at a faster pace compared to volume growth on account of a) price hikes (initiated by OEMs because of increase in commodity prices and changes in technology related to new emission norms), b) diversification into other segments like defense, engine sales and higher focus on aftermarket
EBITDA Margins	CV OEMs are likely to face margin pressure on account of a) increase in raw material prices and increase in content per vehicle because of BS-IV emission norms, which may not be passed on to customers completely. In addition, the sharp increase in discounts (to clear BS-III inventory) and cost related to re-calls and upgradation to impact margins
Capital Expenditure	Despite adequate production capacity, CV OEMs would continue to have sizeable capital expenditure plans to the tune of Rs. 31-33 billion p.a. because of ongoing investments in upgradation of existing platforms, new models & emission norms
Credit Metrics	Expected to remain stable

Source: ICRA research

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