SUBROS LIMITED

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Rating

ICRA has re-affirmed its LA+ (pronounced L A plus) rating to the Rs. 520 million, cash credit facility; the Rs. 100 million, bank guarantee and the enhanced Rs. 1,070 million, term loan programme of Subros Limited (Subros). ICRA has also assigned an A1+ (pronounced A one plus) rating to the enhanced Rs. 1,610 million, fund-based and non-fund based limits of Subros. ICRA has reaffirmed its A1+ rating for the commercial paper/ short-term debt programme of Subros for Rs. 800 million (enhanced from Rs. 450 million)[†].

(Refer Annexure for Rating History)

Key Financial Indicators

	2006-07	***2007-08***	***2008-09***
Net Sales	*6,471*	*6,626*	*6,944*
Operating Income	*6,471*	*6,626*	*6,944*
OPBDITA	*757*	*834*	*632*
Profit after Tax	*284*	*286*	*136*
Equity Capital	*120*	*120*	*120*
Net Worth	*1,510*	*1,740*	*1,839*
OPBDIT/Operating Income (%)	*11.7%*	*12.6%*	*9.1%*
PAT/Operating Income (%)	*4.4%*	*4.3%*	*2.0%*
PBIT/avg. (Total Debt + Net Worth + DTL – Capital work-in progress) (%)	*21.8%*	*20.1%*	*12.2%*
OPBDIT/Interest & Finance Charges (Times)	*9.5*	*7.7*	*4.3*
Net Cash Accruals/Total Debt (%)	*41.1%*	*50.0%*	*30.9%*
Total Debt/TNW (Times)	*0.8*	*0.6*	*0.7*

Note: Amounts in Rs. Million; CWIP: Capital Work-in-Progress; DTL: Deferred Tax Liability; OI: Operating Income; OPBDITA: Operating Profit before Depreciation, Interest, Tax and Amortisation; PAT: Profit after Tax; PBIT: Profit before Interest and Tax; NCA: Net Cash Accruals; TNW: Tangible Net Worth
Source: Company Annual Reports, ICRA Estimates

Website:
www.icrar.in

[†] *For complete rating definition please refer to the ICRA website www.icra.in or any of the ICRA Rating Publications*

Credit Strengths

- Technical collaboration with the global leader in automotive air-conditioners, that is, Denso Corporation, Japan (DNJP), which also holds a 13% equity in the company
- Suzuki Motor Corporation (SMC), Japan holds a 13% equity stake, which has allowed Subros to enjoy a strong relationship with Maruti Suzuki India Limited (MSIL) since its inception.
- Amongst the most integrated automotive AC systems manufacturers in the country, resulting in cost advantages; localisation and backward integration projects may allow higher value addition
- Diversification of customer base even as the company strengthens its competitive position with two key customers, that is, MSIL and Tata Motors Limited (TML)
- Diversification of product mix may allow the company to reduce customer concentration risk

Credit Concerns

- Continued pricing pressures from Original Equipment Manufacturers (OEMs)
- Large proportion of imported raw material purchases (50%) exposes the company to forex fluctuation risk, although the ongoing localisation initiatives are expected to help improve profitability
- Ability to maintain its dominant position, given the rising competition and capacity expansion in the automotive AC market
- OEMs getting into system integration roles may reduce the bargaining power of Tier 1 suppliers

Rating Rationale

The ratings factor in the established position of Subros as a leading and integrated vendor of air conditioners (AC) to the domestic passenger car industry. Subros has been able to maintain its strong market position with leading domestic OEMs by virtue of its technical assistance from DNJP; its own product development/ testing and design capabilities; and cost control initiatives. ICRA has factored in the company's plans to diversify its product mix in related segments (thermal products), which would also allow it to diversify its customer base. While the operating profitability of Subros has been vulnerable to forex volatility on account of high import content, the company's plans to localise critical components would allow it to reduce its earnings volatility and also improve value addition and operating margin. The ratings also take into account the pressures faced by the automotive air conditioner manufacturers with the entry of new participants; capacity addition by existing market participants and OEMs getting into the system integration role. Nevertheless, Subros has been able to maintain its profitability owing to its low-cost operations, backward integration and economies of scale.

Scale, diversification and competitive position: Subros is amongst the largest automotive air conditioner manufacturers in India with an integrated facility and capability to provide complete air conditioning and heater systems. While Subros' sales remained concentrated on ACs for passenger vehicles in the past, the company is now in the process of diversifying its product mix.

The company has maintained its share of business with its key customers through initiatives for backward integration and localisation; investing in product development/testing and design capabilities and continuous capacity expansion. The strength of Subros over the years has been its strong presence in MSIL and TML, which in turn account for about 60% of the total domestic passenger vehicles market. Moreover, the company has successfully added new customers like Mahindra & Mahindra Limited (M&M), Force Motors Limited (FML) and VE Commercial Vehicles Limited (VECV: erstwhile Eicher Motors). Although these OEMs currently account for less than 5% of its revenues, the presence of Subros in the new product development programmes of these companies is likely to help it acquire significant business over the medium term.

The competitive intensity in the domestic automotive AC market has intensified with foreign OEMs bringing their global suppliers to India, importing AC kits as well as capacity expansions undertaken by existing players. Nevertheless, Subros has managed to sustain its market share with its in-house R&D capabilities, technical collaboration from Denso and competitive cost structure.

Revenue Growth: In 2008-09, the volume growth of Subros was better than the overall industry performance due to the company's presence in MSIL's new models; increased sales to newly added OEMs like M&M; stronger aftermarket sales and increasing AC penetration in cars.

The domestic car market grew at a CAGR of 12% between 2005-06 and 2008-09. However, the net sales of Subros have grown at a lower rate (of 7% CAGR in the period from 2005-06 to 2008-09) than AC volumes supplies of Subros (at 16% CAGR) largely on account of sharing of benefits of improving operating efficiencies with customers through price discounts; feature rationalization and its value analysis/ value engineering (VA/VE) initiatives. However, reduced product life cycle and already low prices diminish the scope for major price reductions in the future. ICRA expects Subros to report healthy revenue growth on the back of its presence in key product launches of its major customers; addition of new products and expansion in customer base.

Profitability: The operating margin of Subros improved between 2005-06 and 2007-08 driven by cost-cutting initiatives by reducing features to meet OE target prices, VA/VE, alternate sourcing and localization as well as improved operating/ manufacturing efficiencies. However, rising raw material prices and yen appreciation resulted in the company’s operating margin to decline to 9.1% during 2008-09 from 12.6% in 2007-08. With a large proportion of its imported raw material denominated in yen, Subros’ raw material costs increased sharply on account of adverse currency movement in 2008-09. Lower operating margins coupled with higher interest expenses led to decline in net margin to 2.0% in 2008-09 (from 4.3% in 2007-08). The RoCE of Subros dropped to 12.2% in 2008-09 from more than 20% in the previous three years on account of weaker operating performance and continued capex programme. While the operating profit margin (OPM) of Subros was weak in Q1 2009-10, there was some improvement in Q2 2009-10 and Q3 2009-10 with increased AC kit supplies on the back of passenger car sales and stabilisation of the yen-rupee currency rates. ICRA expects Subros to report healthy operating performance in 2009-10. In the medium term, ICRA expects Subros to benefit from its strong order book with existing clients; expansion in product mix and backward integration/localisation initiatives.

Cash flow variability: Subros’ fund flow from operations of Rs. 759.7 million in 2008-09, though healthy, weakened from Rs 879.4 million in 2007-08 due to lower operating profit. Further, higher interest expenses and large capex (Rs. 798.3 million) outflow resulted in negative free cash flows of Rs. 195.8 million in 2008-09. Subros incurred large capital expenditure over the last four years for (i) capacity expansion programmes to cater to increased demand from OEMs, (ii) new product development, (iii) strengthening research and development infrastructure and (iv) backward integration. Thus, the company’s free cash flows remained negative until 2006-07. However, in 2007-08, the company reported free cash flows on the back of release of working capital and relatively lower capital expenditure. Subros is expected to generate healthy fund flow from operations in the short-to-medium term. However, its continued capex towards new products and new models is expected to result in negative free cash flows.

Financial policy and capital structure: The total debt of Subros increased to Rs. 1,349.6 million as on March 2009 (from Rs 1,110.0 million as on March 2008) due to fresh term borrowings to part-fund its large capex of Rs. 798.3 million in 2008-09. The capital structure of Subros, however, continues to be moderate with a gearing of 0.7 times as on March 2009 although it has moved up marginally from 0.6 times as on March 2008. Further, the debt coverage indicators of Subros like NCA/Total Debt at 30.9% and Interest Coverage Ratio of 4.3 times in 2008-09, continue to remain comfortable. The capex plans of Subros are expected to put some pressure on the capital structure of the company in the short term. However, ICRA expects the leverage levels and return indicators of the company to improve over the long term on the back of higher value addition in product mix and increased volumes.

Company Profile

Subros was promoted in 1985 by Mr. Ramesh Suri and his younger brother Late Mr. Lalit Suri to manufacture automotive air conditioning systems. The company began its operations in 1986 after signing a technological agreement with Denso, which also acquired a 13% ownership interest in Subros. Suzuki Motor Corporation (SMC), Japan holds a 13% share in Subros while 40% is held by the Suri family and the public (34%). In 2000, Subros and DNJP renewed their agreement to be valid until 2010. In return for its assistance to Subros, Denso gets annual royalty on Subros’ sales and a lump sum as fee for development of any new product. Additionally, Subros entered into a joint development agreement with Denso in April 2006, whereby the company would receive assistance for development of AC systems for Indian OEMs (other than MSIL).

Subros is the only integrated facility in India with the capability to provide complete air conditioning and heater systems. Its product range includes compressors, evaporators, hoses and tubes, heaters, blower units and condensers. Currently, Subros operates from its manufacturing locations at Noida (in Uttar Pradesh), Manesar (in Haryana) and Pune (in Maharashtra). In 2008-09, the company also set up an assembly unit in Thailand (through its 100% subsidiary, Thai Subros limited).

Recent Results: Subros reported strong net sales growth of 37% to Rs. 6,560.4 million in 9m 2009-10. Despite increase in raw material expenses, its profit before depreciation, interest and tax increased to Rs. 677.5 million in 9m 2009-10 (486.6 million in 9m 2008-09) because of better utilisation of fixed costs. The net profit of the company also posted strong growth of 51% to Rs. 187.1 million in 9m 2009-10.

Business Risk Analysis

Sales volumes report better growth than the performance of the Indian passenger vehicle industry

Table 1: Growth in Sales Volume versus Increase in Production of Passenger Vehicles

	2006-07	2007-08	2008-09	9m 2009-10	2007-08	2008-09	9m 2009-10
Subros Sales Volumes							
AC Kits	467,478	506,089	618,750	539,480	8.3%	22.3%	23.6%
Net Sales (Rs. million)	6,471	6,626	6,944	6,560	2.4%	4.8%	36.9%
Passenger Vehicle-							
Industry Production	1,544,850	1,762,129	1,838,697	1,662,173	14.0%	3.4%	24.6%
MSIL Production	666,935	757,092	774,623	737,863	13.5%	1.1%	35.1%
TML Production	245,556	237,648	216,590	161,743	-3.3%	-10.5%	3.3%

Source: Annual Reports, Society of Indian Automotive Manufacturers (SIAM)

In 2008-09, the volume growth of Subros was better than the overall industry performance owing to its presence in models of MSIL that had higher demand; improved after-market sales volumes; increasing AC penetration in cars and increased sales to newly added OEMs like M&M. The sales growth of Subros in value terms was, however, weaker during this period because of annual price downs to OEMs and competitive pricing. Sales in the domestic passenger car segment are expected to remain healthy on the back of improved sentiment in the economy; growing middle class population; increasing average household income levels and improved availability of financing at competitive lending rates. With Subros having a significant market share in the domestic automotive AC industry, ICRA expects the company to benefit from growth in the passenger car segment and report higher volume sales. The value sales of Subros are also expected to remain healthy, with minimal price cuts being offered to OEMs because of already low prices and reduced product life cycle.

Subros was initially supplying parts only to MSIL and TML. The company has gradually diversified its customer base, which now includes M&M, FML and VECV. The overall revenue concentration on MSIL and TML, however, remains high, as these two companies together account for 60% of the total passenger vehicle business in India. Nevertheless, the client concentration of the company is expected to reduce further, with its presence in the new product development programmes of newly added OEMs and diversified product mix.

Subros continues to maintain its dominant market share with MSIL and has benefited from its robust production growth of 35.1% in 9m 2009-10. Subros witnessed some loss of business in the relatively recent MSIL launches, as the OEM continues to follow a multi-vendor policy and has also assumed system integration roles in select new model launches. Nevertheless, the market position of Subros with MSIL remains strong, as it continues to participate in its new product development initiatives and has gained new business in its host of model launches during the next two years. While some loss of business from the current levels cannot be ruled out, ICRA expects Subros to maintain a strong market share with MSIL on the back of its relationship with technological collaborator DNJP; its strong track record in meeting quality, cost and delivery parameters with the OEM; its own cost competitiveness and strong service network.

Subros continues to maintain its share of business in TML models apart from winning some business in its newer platforms. With the passenger vehicle production of TML declining by 10.5% during 2008-09, the sales mix of Subros was further skewed towards MSIL. Nevertheless, the off-take volumes from TML improved in 9m 2009-10 because its passenger vehicle production posted a marginal growth of 3.3%. Further, Subros made entry into the M&M portfolio in 2009 and began supplying AC units to its SUV Xylo.

With other global OEMs entering the Indian market, the efforts of Subros at expanding its customer base are constrained by its arrangement with DNJP (restricts Subros on DNJP's existing OEM relations internationally); level of localisation (often AC systems are imported from global vendors in the initial phase of launch) and its existing vendor relations globally. Nevertheless, its cost competitive operations, ability to meet quality and delivery time schedules, strong design and testing capabilities are expected to drive its customer development.

Subros continues to expand capacity; its Thailand assembly facility also becomes operational: As a part of its capacity enhancement plan, Subros is expected to increase its manufacturing capacity to 1.0 million units by March 2010 from 0.75 million units as on March 2009. This enhanced capacity shall enable Subros to meet the requirements of OEMs during peak demand months. Further, the company is expected to continue investing in capacity expansion over the medium term to meet the future projections of its customers.

Subros assembly unit at Thailand became operational in 2008-09. Since all the plant's supplies are currently to a single model, the scale of operations from this facility remains modest. However, the same would improve in the future with plans of OEMs to launch additional products in the international market.

Continued localisation of components to reduce raw material imports: In an effort to reduce its dependence on imported raw material and exposure to foreign fluctuation risk, Subros has continued to invest in localisation of components. Consequently, it has brought down its imported raw material proportion to 50% in 2008-09 from 58% in 2006-07. Subros plans to bring down this proportion further through indigenisation of certain other high value components. Although Subros has undertaken investments for localisation, the benefits of localisation are expected to flow in the medium term with new product launches by OEMs.

Financial Risk Analysis

Moderate growth in operating income; margins fall due to adverse forex movement: The operating income of Subros has grown at a CAGR of 7.1% in the period from 2005-06 to 2008-09 with the company reporting lower growth in 2007-08 and 2008-09. In 2008-09, the sales of Subros to TML declined with its decline in passenger vehicle production by 10.5% over the previous year. However, stronger after-market sales and revival in sales of MSIL from Q4 2008-09 helped Subros report marginal growth in operating income. The cost-cutting initiatives of Subros like reducing features to meet OE target prices, VA/VE, alternate sourcing and localisation as well as improved operating/ manufacturing efficiencies allowed improvement in operating margin until 2007-08. However, its operating margin declined in 2008-09 on account of (i) change in product mix (ii) increase in raw material cost and (iii) yen appreciation. Decline in OPM and increased interest cost resulted in a sharp decline in the net margin of Subros in 2008-09.

Table 2: Trend in Profitability

	2004-05	2005-06	2006-07	2007-08	2008-09
Operating Income	5906.4	5649.0	6470.9	6626.4	6944.2
OPBDITA	551.2	635.1	757.2	833.8	631.8
OPBIT	308.1	371.7	466.6	508.6	316.2
PAT	199.4	248.4	284.3	285.9	136.3
NCA	401.5	464.0	518.7	554.9	416.8
Growth in OI	20.1%	-4.4%	14.5%	2.4%	4.8%
Growth in OPBDIT	22.4%	15.2%	19.2%	10.1%	-24.2%
Growth in PAT	40.7%	24.6%	14.4%	0.6%	-52.3%
OPM	9.3%	11.2%	11.7%	12.6%	9.1%
NPM	3.4%	4.4%	4.4%	4.3%	2.0%
RoCE	21.1%	22.6%	21.8%	20.1%	12.2%

Note: OPM: Operating Profit Margin; NPM: Net Profit Margin
Source: Annual reports of Subros

Maintains favourable financial risk profile, with comfortable gearing and healthy coverage indicators: The capital structure of Subros remains favourable, as its gearing of 0.7 times as on March 31, 2009 is still low despite having risen marginally from its March 2008 levels. In 2008-09, the overall debt levels of the company increased to Rs. 1,349.6 million due to part-funding of its capital expenditure programme. This resulted in some deterioration in its debt coverage indicators in 2008-09 from its 2007-08 levels. Nevertheless, the coverage indicators remain healthy.

Table 3: Gearing and Coverage Indicators

	2004-05	2005-06	2006-07	2007-08	2008-09
Total Debt	573.3	820	1,261.20	1,110.00	1349.6
Tangible Net Worth	1,058.50	1,273.10	1,510.40	1,740.50	1839.5
Debt/Equity	0.5	0.6	0.8	0.6	0.7
Interest Cover	19.6	17	9.5	7.7	4.3
NCA/Total Debt	70%	57%	41%	50%	31%

Note: NCA: Net Cash Accruals
Source: Annual Reports of Subros and ICRA's Estimates

Decline in working capital intensity: As its raw materials are largely imported, Subros maintains high inventory levels. In 2008-09, the localisation of a few parts and higher credit period for some indigenised purchases resulted in a decline in its overall working capital intensity from 2007-08 to 2008-09, despite increase in debtor days along the same period. The increase in debtor positions of Subros as on March 2009 was due to larger payment days with newly added customers apart from year-end effect.

Table 4: Trend in Working Capital Intensity

	2004-05	2005-06	2006-07	2007-08	2008-09
NWC/OI	11.00%	12.80%	14.10%	11.60%	9.00%
Debtor Days	14	15	14	12	26
Payable Days	41	34	32	30	54
Inventory Days	67	67	69	63	53

Note: NWC: Net Working Capital
Source: Annual Reports of Subros and ICRA's estimates

Fund flow from operations remain healthy; free cash flows turn negative because of large capital expenditure: The fund flow from operations of Subros at Rs 759.7 million in 2008-09 is healthy on standalone basis but weakened from Rs 879.4 million in 2007-08 due to lower operating profitability. Further, higher interest expenses and a large capex outflow resulted in negative free cash flows of Rs. 195.8 million in 2008-09. Subros continued to report negative free cash flows during the last five years with the exception of 2007-08, when it reported positive free cash flows on the back of release of working capital and lower capital expenditure. In all the other years, the company continued to incur larger capex towards capacity expansion, new product development, backward integration and localisation initiatives.

Table 5: Cash Flows

	2004-05	2005-06	2006-07	2007-08	2008-09
Fund Flow from Operations	291.9	452.2	475.8	879.4	759.7
Gross Cash Flows	271.5	428.4	406.7	741.2	637.2
Less: Dividends paid	-41.0	-47.6	-55.7	-55.6	-34.7
Retained Cash Flows	230.5	380.8	351.0	685.5	602.5
Cash Flows for Capex	391.9	629.0	780.4	536.3	798.3
Free Cash Flows	-161.4	-248.2	-429.4	149.3	-195.8

Note: Amounts in Rs. Million; Capex: Capital expenditure
Source: Annual Report, ICRA Estimates

February, 2010

Annexure

Rating History

	Maturity Date	Rating Outstanding	Previous Ratings	
		February 2010	June 2009	May 2009
Rs. 800.0 million Commercial Paper		A1+ (enhanced from Rs. 450.0 million)	A1+ (enhanced from Rs. 300.0 million to Rs. 450 million)	A1+
Rs. 1070.0 million term loans		LA+(stable) (enhanced from Rs. 500 million)	LA+	LA+
Rs. 520.0 million cash credit facility		LA+(stable)	LA+	LA+
Rs. 100.0 million, non-fund based facility		LA+(stable)	LA+	LA+
Rs. 1610.0 million, fund-based and non-fund based facilities		A1+ (enhanced from Rs. 1150.0 million)	A1+	A1+

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