ICRA Credit Perspective

February 2011

SUBROS LIMITED

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Rating

ICRA has assigned LA+ (pronounced L A plus) rating with stable outlook for the enhanced Rs. 155.0 crore[1] term loan and Rs 65.0 crore cash credit programme of Subros Limited (Subros)[†]. ICRA has also assigned A1+ (pronounced A one plus) rating to the enhanced Rs. 225.0 crore, fund-based and non-fund based limits of Subros. ICRA has reaffirmed A1+ rating for the commercial paper/ short-term debt programme of Subros for Rs. 80.0 crore. ICRA has also reaffirmed LA+ rating with stable outlook for Rs.10 crore bank guarantee.

Key Financial Indicators (Standalone)

	2007-08	2008-09	2009-10
Net Sales	662.6	694.4	905.5
Operating Income	662.6	694.4	905.5
OPBDITA	83.4	63.2	92.8
Profit after Tax	28.6	13.6	28.8
Net Cash Accruals	55.5	41.7	62.3
Total Debt	111.0	135.0	154.1
Equity Capital	12.0	12.0	12.0
Net Worth	174.0	183.9	207.1
OPBDIT/Operating Income (%)	12.6%	9.1%	10.3%
PAT/Operating Income (%)	4.3%	2.0%	3.2%
PBIT/avg. (Total Debt + Net Worth + DTL – Capital work-in progress) (%)	20.1%	12.2%	18.7%
Total Debt/TNW (Times)	0.6	0.7	0.7
OPBDIT/Interest & Finance Charges (Times)	7.7	4.3	5.8
Net Cash Accruals/Total Debt (%)	50.0%	30.9%	40.5%
Total Debt/OPBDITA	1.3	2.1	1.7

Note: Amounts in Rs. Crore; OI: Operating Income; OPBDIT: Operating Profit before Depreciation, Interest and Tax; PAT: Profit after Tax; PBIT: Profit before Interest and Tax; DTL: Deferred Tax Liability

Source: Annual Reports, ICRA estimates

[1] *100 lakh = 1 crore = 10 million*

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

Key Rating Considerations

Credit Strengths

- Technical collaboration with global leader in automotive air-conditioners i.e., Denso Corporation (Denso) which also holds 13% equity in Subros; new design JV with Denso may allow an improvement in competitive position over the medium term by being able to better adapt to OEM demand
- Suzuki Motor Corporation (SMC), Japan holds 13% equity stake; Subros enjoys strong relationship with Maruti Suzuki India Limited (MSIL) since inception
- Figures amongst integrated automotive AC systems manufacturer in the country, resulting in cost advantages
- Diversification of customer base even as the company strengthens its competitive position with two key customers i.e. MSIL and Tata Motors Limited (TML)
- Strong business growth stemming from buoyant sales in the domestic passenger vehicle (PV) industry
- Initiatives of product diversification to help reduce segment concentration risk; plans of expanding global footprint with select customers may allow geographic diversification over long term

Credit Challenges

- Large proportion of imported raw material purchases (>50%) exposes the company to forex fluctuation risk, though ongoing localisation initiatives are expected to help improve profitability
- Ability to maintain its dominant position given the rising competition and capacity expansion in automotive AC market
- Significant capex plans over the medium term, partly funded through debt
- Increasing system integration by OEMs may reduce the bargaining power of Tier 1 suppliers

Rating Rationale

The rating reaffirmation factors in Subros' strong business growth driven by buoyant sales in domestic PV industry, growing ties with Denso including through a new design JV and initiatives to diversify its client base through foray into commercial vehicle AC business and radiators. ICRA draws comfort from availability of technical assistance from Denso; which coupled with the new JV for design and engineering may improve Subros' competitive position over the medium term. Notwithstanding support from technical collaborator, Subros' in-house product development/ testing and design capabilities as well as cost advantages from significant backward integration, has enabled the company maintain its strong business positioning with existing clients and also expand its customer base. Although Subros' operating profitability continues to remain vulnerable to forex volatility on account of delays in localising certain high value components, dependence on imports is expected to reduce over the near term. The ratings also take into account the pressures faced by the automotive air conditioner manufacturers with the entry of new participants and capacity addition by existing market participants. The trend of OEMs getting into the system integration role has the potential to diminish the role and bargaining power of Tier-1 suppliers. Further, significant debt funded capex plans over the medium term, could result in weakening of financial risk profile

Scale, Diversification and Competitive Position: Subros is the largest automotive air conditioner manufacturer in India with an integrated facility and capability to provide complete air conditioning and heater systems. While Subros' sales were concentrated to PV ACs in the past, the company is gradually diversifying its product mix as well as segment mix. Thus, the company has added radiators in its product range besides extending its AC range to cater to commercial vehicle OEMs.

Subros has maintained its competitive position with its key customers through initiatives for backward integration and localization, investing in product development/testing and design capabilities as well as continuous capacity expansion and setting up multi locational facilities (in proximity to customer). Further, the company also benefits from its technical collaboration with Denso, the global leader in automobile air conditioners. Subros' strength over the years has been its strong presence in MSIL and

TML, which in turn accounts 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 (VECV :erstwhile Eicher Motors) that allows for diversification of revenue streams in the CV AC market. Although these OEMs currently account for less than 5% of Subros' revenues, its presence 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/ imports as well as capacity expansions undertaken by existing players. Nevertheless, Subros' in-house R&D capabilities, technical collaboration from Denso and competitive cost structure has enabled it to sustain its market share.

Revenue Growth: During 2009-10 and the current year, Subros' volume growth has been broadly in line the overall industry performance. While the company reported some decline in sales to TML during 2009-10, the same was offset by higher after-market sales along with ramp up in supplies to customers like M&M, FML etc

The domestic car market grew at a CAGR of 15% between 2006-07 and 2009-10. Subros' net sales has grown at a lower rate (11.8% CAGR during 2006-10) than its AC volumes supplies (17% CAGR during 2006-10) largely on account of sharing of benefits of improving operating efficiencies with customers through price discounts, feature rationalization as well as its improvements from value analysis/ value engineering initiatives. ICRA expects Subros to report healthy revenue growth in coming years, on the back of its presence in key product launches/refurbishments of its major customers; addition of new products and expansion in customer base.

Cost and Profitability: Subros' operating margins have fluctuated over the past few years (from 9.1% in 2008-09 to 10.3% in 2009-10 and 7.9% in H1 2010-11) mostly on account of fluctuation in rupee-yen rate and increase in commodity prices. With a large proportion of its imported raw material requirements being yen denominated, Subros was negatively impacted by rupee deprecation during H1 2010-11. The company however reported some qoq increase in operating margins during Q3 2010-11 in light of stabilisation of rupee yen rate and improvement in average realisations. Nevertheless, this combined with hardening of commodity prices and pricing pressure from OEMs are reflected in significantly lower operating margins in the current fiscal. The company's net margins have followed its operating margins, and after increasing in 2009-10 declined during 9m, 2010-11. Weaker operating profitability coupled with continued capex programme has resulted in moderate return indicators (18.7% in 2009-10 and 10.8% in H1 2010-11 (>20% in 2007-08 and earlier). While Subros' operating margin is expected to remain at under pressure during 2010-11, it is are expected to improve over the medium term with beginning of supplies of localised components, benefits from strong order book and ramp up in new products like CV ACs and radiators.

Financial Policy and Capital Structure***:*** Subros funded most of its capex in 2009-10 from internal accruals and was able to maintain its capital structure. Moreover, with healthy operating profits, the company's 2009-10 debt protection matrices improved over 2008-09. However, Subros' capital structure has witnessed some deterioration during the current fiscal in light of significant debt funded investments (~Rs 55.0 crore during H1 2010-11 funded partly through short term borrowings) towards capacity expansion, localisation initiatives and new product development. Subros has followed a strategy of setting up its assembly location close to its customers and is thus, in the process of setting up a facility in Chennai for servicing its customers in Southern region. The financial risk profile, however, remains healthy with moderate gearing and adequate coverage indicators. The capex plan of Subros is expected to put some pressure on the capital structure of the company over the medium term. However, ICRA expects the financial profile and return indicators of the company to improve over the long term on the back of higher localisation levels and increased volumes.

Cash Flow Variability: Subros cash flow position was comfortable in 2009-10 in view of healthy fund flow from operations and despite large capex of Rs 77.2 crore, the company's dependence on borrowings was limited. Subros, however, reported weak cash flows during H1 2010-11 in light of working capital blockage, lower operating profits and large capex outgo of Rs 55.8 crore. Although Subros is expected to report healthy fund flow from operations with increase in scale of operations, its free cash flows would be negative in view of its substantial capex programme.

Recent Results

In 9m 2010-11 Subros net sales at Rs. 785.4 crore reported a growth of 19.7% over the corresponding previous period. The company's profit before depreciation, interest and tax however decreased from Rs. 67.7 crores in 9m 2009-10 to Rs 61.4 crores in 9m 2010-11. Further, Subros' profit after tax decreased to Rs 17.5 crore in 9m 2010-11, reflecting a decline of 6.4% over that in 9m 2009-10.

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. SMC, Japan holds a 13% share in Subros while 40% is held by the Suri family and the public (34%). 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).

Business Risk Profile

Healthy growth in revenues led by sharp increase in passenger vehicle volumes

During 2009-10 and H1 2010-11 domestic automotive industry reported strong growth and Subros' volume growth during this period was comparable to the overall industry performance.

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

	2007-08	2008-09	2009-10	H1 2010-11	2007-08	2008-09	2009-10	H1 2010-
AC Kits	506,089	618,752	747,707	428,638	8.2%	22.3%	20.8%	22.1%
Net Sales	662.6	694.4	905.5	512.2	2.4%	4.8%	30.4%	19.7%
PV Industry Production	1,777,583	1,838,697	2,351,240	1,396,431	15.1%	3.4%	27.9%	31.2%
MSIL	766,265	774,739	1,027,812	601,837	14.9%	1.1%	32.7%	26.4%
TML	241,910	215,040	259,511	172,217	-1.5%	-10.5%	20.7%	64.5%

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

Both TML and MSIL reported buoyant volume sales during 2009-10 and 9m, 2010-11. Subros' increase in supplies to MSIL during this period was commensurate to the growth reported by the OEMs. However the company's sales to TML declined in 2009-10 (volume decline of 3.3%), though it recovered during the current financial year. Further, supplies to OEMs like M&M and FML increased at a strong pace during 2009-10 and the current year, though on relatively smaller base. Subros continues to have a healthy order book position with improved share of business in the new launches of its key customers-MSIL and TML that are expected to maintain their dominance in domestic market.

Subros was initially supplying ACs to MSIL and TML and for their aftermarket requirements. 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. With over 90% of its sales to two customers MSIL and TML, Subros is subject to client concentration risk. This risk is however mitigated by leading position of these OEMs in the domestic industry, Subros' long standing relationship with them and equity shareholding (13%) of SMC in Subros.

MSIL and select other OEMs procure sub-assemblies as against complete AC units from the AC manufacturers like Subros with OEM assuming system integration responsibility. This strategy allows OEM to maintain flexibility regarding change in component specifications besides get competitive prices resulting in margin pressures on vendors. Since MSIL and select other OEMs are expected to continue to do system integration for future model launches also, the bargaining power of the supplier would remain constrained.

Association with Denso allows for maintaining market share in MSIL; in process of setting up a design JV

Although Subros has been able to cater to requirements of non MSIL OEMs on the strength of its own R&D (with assistance from Denso), for all MSIL models it continues to receive support from Denso. This is largely since MSIL's models have origins to Suzuki models, wherein Denso' has been associated from designing stage. To be able to adapt to customer demands in more efficient manner, Subros has announced a 26:74 JV with Denso for design and development of AC components for new businesses. Subros' in house technical expertise is expected to improve once design activity is undertaken in India though this JV (as against being done in Japan by Denso currently). Further, there would also be added advantages like reduced cycle time, lesser costs and higher OEM confidence. Additionally, the JV would also benefit from business outsourced by Denso Group companies globally.

Delay in localization plans on account of delay in receipt of OEM approvals

Subros' imported raw material increased to 62% of total raw material consumed in 2009-10 partly on yen appreciation and delay in localisation. Earlier most of localised parts were to replace the imported components from 2010-11, but with delays in receiving approvals from customer (MSIL), as testing and validation continued in Japan for higher than expected period; there has been delay in supply of these localized parts. While the company started investing in localization of some high value HVAC components 2009-11, the benefits are expected to come in from 2011-12 when supplies of most of the localised components begin.

Subros' continues to expand capacity

Although on an annual basis, the company has some unutilised capacities, the monthly requirements from OEMs fluctuate during the course of the year and this leads to temporary pressures on the company's production capabilities (especially during festive season). Moreover, with strong growth in vehicle sales during last two years and increasing level of AC penetration, Subros increased its AC manufacturing capacity to 10.0 lakh units in 2009-10. The company plans to further augment its manufacturing capacity over the medium term on expectations of strong volume growth in passenger cars besides its plan to enter new clients. Subros would also require spare capacity for its diversification initiatives like developing ACs for commercial vehicles, increasing penetration in replacement market.

Financial Risk Profile

Robust growth in operating income, margins decline due to adverse forex movement

After reporting weak revenue growth in 2007-08 and 2008-09, Subros' operating income grew at robust pace during 2009-10 and H1 2010-11. The company benefitted from strong growth in sales in domestic automobile industry over the past 18-20 months with higher off-take from OEM customers and growth in replacement market.

The company's operating margin improved in 2009-10 with better utilization of fixed costs from increased scale. However, as mentioned earlier, higher import cost on rupee depreciation, increase in commodity prices and pricing pressure from OEMs led to the decline in operating margins during current fiscal. Despite having forex pass through arrangement with key customers, the company is exposed to forex risk on account of some lag (varies from three months to one year) in price settlement. The company's net margins have followed its operating margins and after increasing in 2009-10 declined during the current fiscal.

Table 2: Trend in Profitability

	2006-07	2007-08	2008-09	2009-10	H1 2010-11
Operating Income	647.1	662.6	694.4	905.5	513.0
OPBDITA	75.7	83.4	63.2	92.8	40.7
PAT	28.4	28.6	13.6	28.8	12.0
NCA	51.9	55.5	41.7	62.3	31.6
OPM	11.7%	12.6%	9.1%	10.3%	7.9%
NPM	4.4%	4.3%	2.0%	3.2%	2.3%
RoCE	21.8%	20.1%	12.2%	18.7%	10.8%

Note: Amounts in Rs. crore, OPM: Operating Profit Margin; NPM: Net Profit Margin
Source: Annual reports of Subros and ICRA's Estimates

After reporting some improvement in 2009-10, credit profile weakens in H1 2010-11; remains comfortable on standalone basis

Subros funded most of its capex in 2009-10 from internal accruals and was able to prevent any increase in financial leverage. Moreover with healthy operating profits, the company's 2009-10 debt protection metrices were better than that in 2008-09. However, Subros' capital structure witnessed some deterioration during the current fiscal in light of debt funded investments towards capacity expansion, localisation initiatives and new product development. Although Subros' capital structure and coverage indicators are expected to be weaker in 2010-11, the company's strong position in new launches, benefits of localisation and healthy growth in domestic car market are likely to support its cash accruals in the medium term.

Table 3: Gearing and Coverage Indicators

	2006-07	2007-08	2008-09	2009-10	H1 2010-11
Total Debt	126.1	111.0	135.0	154.1	241.4
Tangible Net Worth	151.0	174.0	183.9	207.1	219.1
Debt/Equity	0.8	0.6	0.7	0.7	1.1
Interest Cover	9.5	7.7	4.3	5.8	5.1
TD/OPBDITA	1.7	1.3	2.1	1.7	3.0
NCA/Total Debt	41.1%	50.0%	30.9%	40.5%	26.2%

Note: Amounts in Rs. crore ,NCA: Net Cash Accruals
Source: Annual Reports of Subros and ICRA's Estimates

Increase in working capital intensity

Subros maintains high inventory levels since a significant portion of raw material purchase is imported. The company's working capital intensity is however moderate given the favourable credit period it enjoys from its suppliers. The working capital intensity improved in 2009-10, but increased sharply during H1 2010-11 in light of increase in inventory and debtor positions. Inventory days as on Sep 2010 were high in view of the company's policy of maintaining a safety stock of imported components. Moreover with increase in supplies to customers like M&M and the replacement market, the debtor days had also gone up

Table 4: Trend in Working Capital Intensity

	2006-07	2007-08	2008-09	2009-10	H1 2010-11
NWC/OI	14.1%	11.6%	9.0%	7.0%	12.0%
Debtor Days	14	12	26	18	23
Payable Days	32	30	54	44	51
Inventory Days	69	63	53	47	56

Note: Amounts in Rs. crore, NWC: Net Working Capital
Source: Annual Reports of Subros and ICRA's estimates

Cash flows become stretched in current year

Subros cash flow position was comfortable in 2009-10 in view of healthy fund flow from operations and despite large capex of Rs 77.2 crore, the company had limited requirement of borrowed funds. Subros has, however, reported weak cash flows during H1 2010-11 in light of weaker operating profits, working capital blockage, and large capex outgo of Rs 55.8 crore.

Table 5: Cash Flows

	2006-07	2007-08	2008-09	2009-10	H1 2010-11
Fund Flow from Operations	47.6	87.9	76.0	79.7	(23.7)
Gross Cash Flows	40.7	74.1	63.7	65.2	(27.7)
Less: Dividends paid	(5.6)	(5.6)	(3.5)	(4.9)	(0.3)
Retained Cash Flows	35.1	68.6	60.3	60.3	(28.0)
Cash Flows for Capex	(78.0)	(53.6)	(79.8)	(77.2)	(55.8)
Free Cash Flows	(42.9)	14.9	(19.6)	(17.0)	(83.8)

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

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Annexure I: Key Financial Indicators (Consolidated)

	2007-08	2008-09	2009-10
Net Sales	662.6	694.0	906.2
Operating Income	662.6	694.0	906.2
OPBDITA	83.4	63.0	93.1
Profit after Tax	28.6	13.5	28.4
Net Cash Accruals	61.1	45.0	62.0
Total Debt	111.0	135.0	154.1
Equity Capital	12.0	12.0	12.0
Net Worth	174.0	183.8	207.3
OPBDIT/Operating Income (%)	12.6%	9.1%	10.3%
PAT/Operating Income (%)	4.3%	1.9%	3.1%
PBIT/avg. (Total Debt + Net Worth + DTL – Capital work-in progress) (%)	41.1%	12.1%	18.7%
Total Debt/TNW (Times)	0.6	0.7	0.7
OPBDIT/Interest & Finance Charges (Times)	7.7	4.3	5.8
Net Cash Accruals/Total Debt (%)	55.0%	33.4%	40.2%
Total Debt/OPBDITA	1.3	2.1	1.7

Note: Amounts in Rs. Crore; OI: Operating Income; OPBDIT: Operating Profit before Depreciation, Interest and Tax; PAT: Profit after Tax; PBIT: Profit before Interest and Tax; DTL: Deferred Tax Liability
Source: Annual Reports, ICRA estimates

Annexure II: Rating History

Instrument	Amount	Rating	
	In Crore	**As on Feb'11**	**As on Feb'10**
Commercial paper	80.0 crore	A1+	A1+ (Enhanced from Rs 45.0 crore to Rs 80.0 crore)
Term loans	155.0 (Enhanced from Rs 107.0 crore)	LA+/ Stable	LA+/Stable (Enhanced from Rs 50.0 crore to Rs 107.0 crore)
Cash Credit	65.0 (Enhanced from Rs 52.0 crore)	LA+/ Stable	LA+/ Stable
Non Fund Based Limits	10.0	LA+/Stable	LA+/ Stable
Fund Based and Non Fund based Limits	225.0 (Enhanced from Rs 161.0 crore)	A1+	A1+ (Enhanced from Rs 115.0 crore to Rs 161.0 crore)

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An Associate of Moody's Investors Service

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