

We Bleed; We Bleed Together

The typical Hindu marriage ceremony lasts overnight as the bride & groom sit together in front of the priest for many hours while their friends drink themselves silly. In many ways, the ceremony is quite excruciating for the bride & groom. For instance, the typical traditional Hindu marriage costume for the bride weighs a significant percentage of a metric tonne!

It is a far cry from the typical "I do" of Christians and the "Qubool Hai" of Muslims.

As an inside joke, Hindus still have a much lower rate of divorce as compared to the global average.

You won't like to go through the painful marriage process all over again!

For good or bad, the bride and groom are partners for life and the priest, in inciting the gods, ensures that they stay partners for life.

Just like automotive suppliers and OEMs. For good or for bad, suppliers are tied to the fortunes of OEMs and enjoy the spoils when OEM sales hit the gas pedal.

They also bleed when OEM sales fall, as is happening now.

Suppliers' reliance on OEMs

In a market like India where the vehicle parc is not yet very large, suppliers have a huge dependence on OEMs for their sales. Some suppliers do offset this reliance through exports or nibbling at the aftermarket, yet these measures, in most cases, offer only partial insulation. OEM sales, in most cases, account for the largest chunk of suppliers' revenues.

[one_third boxed="true"] Methodology: In doing this study, we have used public data (sourced from moneycontrol.com) of suppliers listed on the stock exchanges. Operating margins are calculated as a ratio of Operating Income / Profit to the Total Sales for the quarter. The comparison is between the last four quarters and the previous four quarters for every case under consideration. Note, we do not use Financial Years as different companies align their reporting to different months. While many suppliers use the traditional Apr-Mar reporting system, some like Bosch use a Jan-Dec financial year alignment. [/one_third]

As per the Automotive Component Manufacturers Association (ACMA), the gross revenues of the Indian supplier industry increased from USD 23.0 billion in FY2009 to USD 40.6 billion in FY 2013. This represents a CAGR of 15.27% over the four-year period, quite parallel to the increase in passenger vehicle production, which has grown at CAGR of 15.11% over the last four years, from 1.84 million units in FY 2009 to 3.23 million units in FY 2013.

Except, things nosedived in FY 2014. [Passenger vehicle production](#) dropped to 3.07 million units, a 4.95% decline from FY 2013 production. [Things were even worse](#) for the Buses & Medium & Heavy Commercial Vehicles (B&M&HCV) segment, which witnessed a 21% drop in production, from 280677 units in FY 2013 to 221626 units in FY 2014. Similar was the fate of the LCV segment where production dipped 13.54% from 551972 units in FY 2013 to 477238 units in FY 2014. Three-wheelers dipped marginally by 1.15%, from 839748 units in FY 2013 to 830120 units in FY 2014.

The only segment still doing an Alice in Wonderland is [two-wheelers](#) where production jumped 7.21% from 15.74 million units to 16.88 million units. However, the two-wheeler industry has a potential supplier value of USD 8.44 billion only. In comparison, the other segments have a potential supplier value of USD 29.57 billion. Any dip in the other

segments cannot be offset by a marginal increase in two-wheeler production.

Please note, the industry potential supplier values above are back-of-the-envelope calculations and are not legally tenable. We urge you to recalculate using your own assumptions before you copy our data for your board presentation.

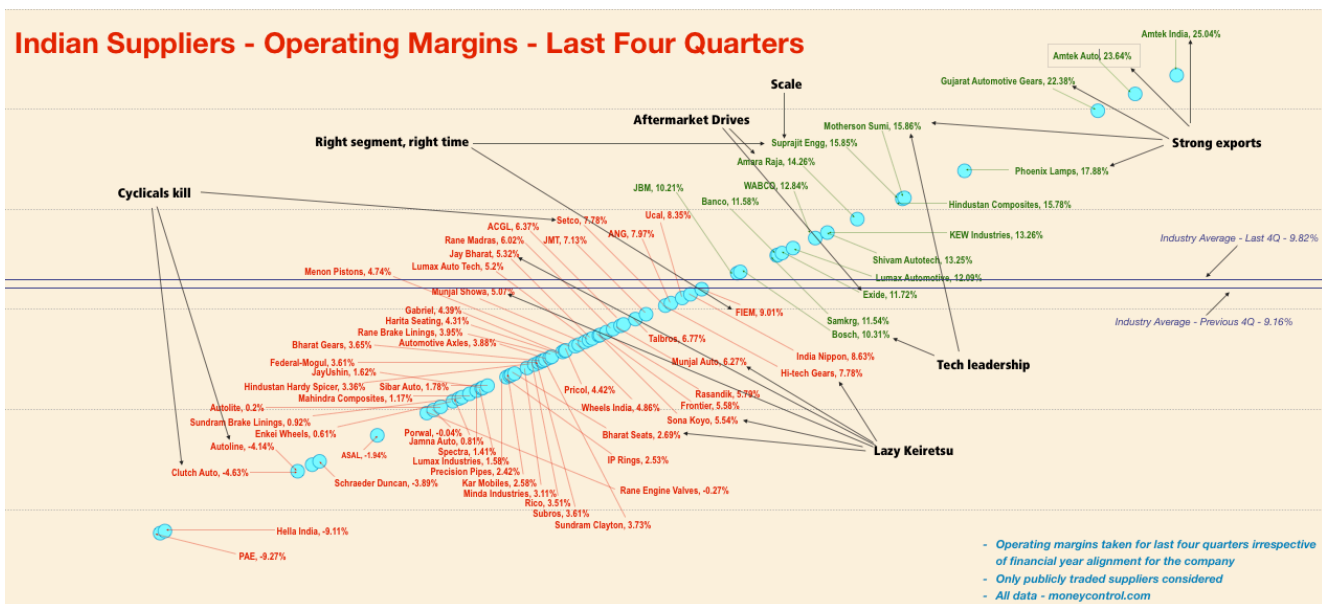
As a result of the above, the Indian supplier industry is under duress. Many suppliers are bleeding. Most of them have been sacrificing operating margins to ensure that their plants keep running. Brutal OEMs have been using the slowdown as an opportunity to demand even more concessions from suppliers. In many cases, suppliers have been unable to extract better efficiency out of a plant running at below optimum capacity. The result is a hit in operating margins.

At the same time, certain suppliers are still doing the Gangnam Style even in the downturn. These suppliers have spread their risk across geographies and customers so that they are quite well insulated from a downturn.

Evaluating Supplier Risk Appetite – EMMAAA's Risk Metric

While evaluating Indian suppliers over a period of time, some of the risk factors can be isolated as a trend. Looking at these factors, it is easy to single out suppliers most at risk and those who have managed to insulate themselves effectively against downturns.

EMMAAA considers the supplier's diversity of customers, segments and sectors as the primary evaluation criteria of risk assessment. Suppliers able to diversify their sales base between OEMs, aftermarket and exports, across sectors and across individual OEMs are better placed in terms of facing a downturn.



Don't strain your eyes – Click to enlarge

This metric is further supplemented by other factors such as the type of components that the supplier is manufacturing – proprietary components provide greater leverage to the supplier in negotiating contracts while built-to-print components provide little leverage. Also, components prone to dumping by the Chinese (tyres) are the most ineffective in terms of price negotiations with OEMs.

Supplier Risk Grading – Cyclicals Kill

The suppliers most at risk are those who derive their business mainly only the commercial vehicles sector. The highly cyclic nature of the segment means that suppliers often see a seesaw in revenues, profits and margins. Case in point is Clutch Auto, which has witnessed 14.46% erosion in its operating margins over the last four quarters. From fairly acceptable, better than industry average, operating margins of 9.83% over last year, Clutch Auto's operating margins have dipped to -4.63% this year. The company is now running on negative margins due to its complete dependence on sales to the local B&M&HCV segment, a sector that is now entering a triple dip, the third consecutive year of sales decline.

To be fair, complex labour problems, and plant shifting last year, also compounded Clutch Auto's problems. The company witnessed a 84% year-on-year fall in sales last year. So bad has been the situation for Clutch Auto that the company has struggled to repay seemingly small debts and has been facing lawsuits for the same.

Direct competitor Setco does seem to be doing significantly better with a 7.78% operating margin. However, look deeper and one notices that even Setco has seen 12.89% erosion in operating margins from last year. It does manage to do much better than Clutch Auto as Setco has a significant chunk of revenues coming from the export aftermarket.

Keiretsu Suppliers Snooze on Low Margins

The suppliers also at high risk are also the [La Familia](#) suppliers. These suppliers draw a large share of their revenue from a single OEM. Many-a-times, the suppliers are part of the OEM's extended family and enjoy very close relations and almost guaranteed business with the OEM. Historically, they have enjoyed good times, growing as the OEM scaled up volumes. However, in the event of a downturn, they would be hit the hardest, as they have no counterweight balancing the revenues from the OEM. Further, these suppliers are susceptible to downturns in the industry, sector, segment or even isolated downturns concerning only their major OEM customer.

Munjal Showa is one such supplier. Nearly 72% of the company's revenues come from Hero MotoCorp. Even though it is trying to diversify its customer base by supplying to multiple OEMs and even the passenger vehicle industry, the sheer size of Hero MotoCorp and Munjal Showa's business with the OEM mean that the share of business from the two-wheeler OEM will stay disproportionately high in the near future.

Being part of a family also often makes the suppliers susceptible to laxity. Many of these suppliers have the lowest

margins in the industry with no specific reasons to be burdened with them. At times, the focus seems to be on high-volumes, low-margin strategy. Munjal Showa had operating margins of 5.56% last year and it saw a further 49-basis point dip in average operating margins to 5.07% in the last four quarters gone by. Again, margins were hurt as Hero MotoCorp enjoyed little production growth in FY 2013.

Another Hero MotoCorp family supplier Munjal Auto Components also saw 33-basis points erosion in operating margins, to 6.27% in the last four quarters, from 6.6% in the previous four quarters.

In many cases it seems that there is a tacit understanding between OEM and supplier, which requires the supplier to work at low margins in exchange for almost-guaranteed business. The JBM Group is an interesting example. Flagship company, Jay Bharat Maruti, a Maruti-Suzuki Keiretsu, had operating margins of 5.32% in the last four quarters. However, sister concern JBM Auto Components, engaged in almost similar business activity of supplying sheet metal components, managed operating margins of 10.21% in the same period. It is almost unbelievable that Jay Bharat Maruti while supplying to Maruti-Suzuki, the most profitable carmaker in India, manages half the margins of its sister concern which supplies to lesser profitable carmakers like Tata Motors.

Other 'family' suppliers living with depressingly low margins are Automotive Stampings & Assemblies (ASAL), Bharat Seats, Sona Koyo Steering, Hi-tech Gears, and Automotive Corporation of Goa (ACGL).

However, there may be exceptions to the trend as well. Shivam Autotech (formerly Munjal Auto Components) managed operating margins of 13.25% over the last four quarters. Even though margins declined sharply by 261-basis points in the last four quarters, from 15.86% in the previous four quarters, they were still one of the best in the overall industry.

Moderate risk – Supplying to the community

At a somewhat moderate risk are suppliers who have spread their business across multiple OEMs, though still operating in the same market segment. Note, this market segment is not a highly cyclic segment like B&M&HCVs but one with moderate resilience to slowdown like two-wheelers or passenger vehicles.

Suppliers like Sona Koyo Steering, FIEM Industries, Rico Auto, and Lumax fall in this category. These suppliers have below average, yet moderate operating margins and have managed to spread risk by supplying to a large number of customers. However, with the widespread downturn in the industry witnessed in the last financial year has affected these suppliers as well. Most of them saw deterioration in operating margins over the last four quarters. The exceptions were suppliers like FIEM Industries, which get the majority of their revenues from the two-wheeler segment.

Large Scales – Effective Insulation

Suppliers with large scales often have very effective insulation against slowdown. Their scale also helps them in extracting better operating margins from their operations. Case in point is Suprait Industries, which even though manufacturing low-tech component like cables, manages to have operating margins of 15.85% in the last four quarters. However, with the slowdown, the company sacrificed 99-basis points on its operating margins; previous year operating margins were 16.84%.

Scale also helps large-scale battery manufacturers like Exide and Amara Raja. Both the companies were near the top of the table in terms of operating profit margins. Exide managed 11.72% operating margins in the last four quarters, 56-basis points improvement over operating margins of 11.16% over the previous four quarters. Meanwhile, Amara Raja did even better

with 14.26% operating margins over the last four quarters.

Lowering Risk – Aftermarket

Both Exide and Amara Raja also enjoy high margins and low risk due to their significant aftermarket presence. The aftermarket generally offers better margins than OEMs. Battery manufacturers have an inherent advantage over other suppliers as batteries have a life and a certain percentage of the vehicle parc keeps entering the replacement market every year. This ensures that suppliers with strong brand identity like Exide and Amara Raja can derive a large share of their sales from the aftermarket. In FY 2013, Exide derived an estimated 78% of its automotive revenues from the aftermarket.

Lowering Risk – Proprietary Technology, Wide Spread of Customers

The best placed are suppliers who have proprietary technology and a wide spread of customers. They are relatively insulated from slowdowns due to the breadth of their customers while their proprietary technology ensures that they can keep operating at very healthy operating margins. Case in point is Bosch, which managed margins of 10.31% over the last four quarters. Interestingly, the company managed to improve the margins marginally (by 6-basis points) even as the industry grappled with a slowdown.

Lowering Risk – Improving geographical Spread – Exports

From our analysis of arguably limited breadth, it is noticeable that suppliers with a healthy export presence manage risk better. They are able to hedge commodity and currency risks significantly. Further, the export market typically offers better margins than the domestic market. A look at the supplier standings in terms of operating margins throws up the Amtek group companies as clear market leaders. While Amtek India managed 25.04% operating margins, Amtek Auto had 23.64% operating margins. This is primarily due to the

strong exports focus of the group and the major contribution to the balance sheet from acquired companies Neumayer Tekfor and Kuepper Group. These acquisitions gave Amtek Auto access to high-margin business with OEMs like Volkswagen, Fiat, BMW, Daimler and Ford. This financial year (FY 2014), Amtek is estimating that 44% of its income will come from international markets. The acquisitions also ensure that both the group companies managed to improve upon their margins over the previous four quarters.

Gujarat Automotive Gears, a small exports oriented unit manufacturing gears, was placed just below Amtek Auto in terms of operating margins. The company managed operating margins of 22.38% in the last four quarters. However, slowdown in Europe and some other export markets resulted in a 605-basis point reduction in operating margins.

Phoenix Lamps (formerly known as Halonix Limited) also enjoyed high operating margins (17.88%) mainly because of exports to more than 75 countries, including the European, American, Australian, Asia-Pacific, Middle East, and LatAm markets.

Also enjoying high operating margins due to large international business is Motherson Sumi Systems. Due to business from Visiocorp (earlier Schefenacker) and Peguform, the company enjoyed operating margins of 15.86% over the last four quarters.

In the second part of our analysis, we will look at how suppliers' operating margins have fared over the last four quarters, compared to the previous four quarters. The second part of the analysis would be published on Thu 29th May 2014