India Ratings Rates Varroc Engineering’s NCDs and Affirms Bank Loans at ‘IND A+’/Stable; CP Affirmed at ‘IND A1’

Aug 18, 2023 | Diversified

India Ratings and Research (Ind-Ra) has taken the following rating actions on Varroc Engineering Limited’s (VEL) debt instruments:

Instrument Type	Date of Issuance	Coupon Rate	Maturity Date	Size of Issue (million)	Rating/Outlook	Rating Action
Term loan	-	-	FY28	INR7,097.3 (increased from INR5,345)	IND A+/Stable	Affirmed
Fund-based/Non-fund-based limits	-	-	-	INR5,973.5	IND A+/Stable/IND A1	Affirmed
Commercial paper (CP)*	-	-	365 days	INR1,000	IND A1	Affirmed
Non-convertible debentures (NCDs)^	-	-	-	INR2,500	IND A+/Stable	Assigned
Bank loan	-	-	-	INR748	IND A+/Stable/IND A1	Assigned

* will be carved out of the fund-based limits
^ yet to be issued

Analytical Approach: Ind-Ra has taken a consolidated view of VEL and its subsidiaries on account of the strong operational linkages among them and a common management.

Key Rating Drivers

Diversified Revenue Profile: VEL has a well-diversified revenue profile in terms of products. The company’s business units include polymer, which accounted for around 33% of the total revenue in FY23, electronics (around 22%), lighting (21%), metallic (12%), aftermarket (around 9%) and overseas forgings (3.8%). Post the restructuring of the company’s operations in FY23, its geographic diversification has moderated with presence limited to Vietnam, Romania, Italy, Poland and China, along with a well-spread presence in India.

Established Market Position: VEL is among the leading players in most of its product segments, including two-wheeler (2W) lighting, electronic components as well as digital instrumentation clusters. VEL has strong relationships with 2W original equipment manufacturers (OEMs) for over three decades. The company is a well-entrenched supplier to Bajaj Auto Limited and has successfully extended its associations with Hero MotoCorp Ltd., Honda Motorcycles and Scooters India Pvt Ltd, TVS Motor Company, Yamaha Motor India Pvt. Ltd., and Eicher Motors Ltd. VEL enjoys a dominant wallet share for the products it supplies to Bajaj Auto and the management expects the company to gain a wallet share in other OEMs as well, which will help reduce its dependence on Bajaj Auto. Furthermore, the company has 28 manufacturing plants in India in proximity to the OEMs, which ease the supply chain management.

Divestment of Loss-making Business: VEL, in October 2022, sold its loss-making four-wheeler (4W) lighting business in the US and Europe, and the global research and development support team in India to France-based Compagnie Plastic Omnium Se (PO) for an enterprise value of EUR520 million. As a part of the transaction, the post-tax net cash accretion to VEL was EUR5 million-9 million, and debt of EUR33 million at the overseas entity was repaid. Consequently, VEL's net debt (excluding acceptances) reduced to around INR13 billion in October 2022; the debt stood at INR14.5 billion at FYE23 (1HFY23: INR15.7 billion, FY22: INR14.4 billion, FY21 INR22.5 billion). VEL also had impaired investments of INR13.24 billion in these subsidiaries during FY23.

Additionally, the company received EUR28 million in its escrow account, which was to be released over two-to-three years. This amount was disputed later on, and Varroc has received EUR13 million from the escrow account after meeting the cost of sales to the extent of EUR4 million-5 million; the balance amount will be used to reduce net debt levels. Rest EUR 15 million of the escrow will be going to PO as part of final settlement. While the transaction may not have added significant cash to the continuing operations, it has benefitted the company on account of the divestment of loss-making, capex and fixed-cost heavy business. The divested business carried a total debt of INR13.8 billion at FYE22, and hence, enabled the deleveraging of the company's balance sheet. The divestment also reduced VEL's exposure to Europe, where macro-economic headwinds are more pronounced.

The divestment is part of VEL's strategy to align its resources with the high-value and high-growth primary markets in India, China, and the 2W sector globally. The company is focusing on its operations in India, global 2W lighting business in Italy, Romania and Vietnam, electronics business in Poland and Romania, and joint venture with TYC Brothers for passenger vehicle lighting products in China.

Improving Credit Metrics: Ind-Ra expects the credit metrics to improve over FY24-25, led by margin-accretive, cash-generative Indian operations, and lower capex requirement in the remaining business. The consolidated net adjusted leverage (net debt/EBITDA) is likely to improve to below 2.2x in FY24 (FY23: 2.7x; FY22: 4.2x, FY21: 6.8x), supported by the company's exit from the debt-heavy overseas business, improving sustainable cash flows from domestic business, and the absence of any large debt-funded capex plans. The net adjusted leverage improved in FY23 owing to the aforementioned divestment. The interest coverage (EBITDA/interest expense) is likely to improve to 3.1-3.4x in FY24 (FY23: 2.8x; FY22: 3.0x, FY21: 3.8x). The debt and EBITDA for FY22 and FY23 exclude the discontinued operations. The cash flow margins have remained positive historically (FY23: 6%, FY22: 9%, FY21: 8%, FY20: 12%) and Ind-Ra expects it to remain positive and be in the range of 3%-6% from FY24.

Improving Profitability Margins: Ind-Ra expects the consolidated EBITDA margin to improve to 8.5%-9% in FY24, driven by ongoing cost-rationalisation measures, the company's efforts to improve capacity utilisation from existing levels of 60%-65%, and easing of commodity inflation. VEL's consolidated EBITDA margin improved to 8% in FY23 and further to 9.5% in 1QFY24 (FY22: 6.1%, FY21: 7.7% (adjusted for discontinued operations, pre-adjustment FY21 margins: 3.5%)). Adjusted for forex fluctuations, the company's EBITDA margin grew to 8.3% in FY23 and 9.3% in 1QFY24 (FY22: 6.3%). Despite commodity cost inflation, the margin improved in FY23 mainly on account of the divestment of overseas subsidiaries as well as ongoing cost-reduction measures. The company has been operating at an EBITDA margin of 8-9% in the Indian operations, which would be contributing to the majority of the revenue and EBITDA henceforth. This will support the improvement in margins, along with cost rationalisation measures and improving operating leverage. Although the company's margins are prone to any significant increase in input prices, these can be largely passed on to the OEMs with a lag of three-to-six months. A sustained improvement in the profitability margins will remain a key rating monitorable.

Liquidity Indicator - Adequate: Ind-Ra expects the liquidity to remain adequate in FY24, given the positive cash flow generation and an increase in the company's operations and its improving capability to service debt obligations. The company had a cash balance of INR3,271 million in FY23 (FYE22: INR1,178 million). VEL's average fund-based working capital limit utilisation for the 12 months ended June 2023 was below 40%. The fund-based limit utilisation is constrained due to the limited availability of drawing power as the company discounts part of its receivables. However the liquidity is supported by non-recourse factoring limits of INR 5,300 million, which was utilised at an average of 55-60% during the 12 months ended June 2023.

Ind-Ra-calculated cash flow from operations remained positive at INR4,255 million in FY23 (FY22: INR5,004 million, FY21: INR3,382 million). However, the free cash flow remained negative at INR1,727 million in FY23 (FY22: negative INR3,590 million; FY21: negative INR4,369 million). Ind-Ra expects the free cash flow to turn positive in FY24 on account of an improvement in the profitability as well as lower capex. According to the management, post the capex of INR2,500 million-3,500 million undertaken in India in FY23, the capex outgo is likely to remain limited at INR1,500 million – 2,000 million in FY24 with more focus on increasing capacity utilisation and electric vehicle (EV) related components. The divestment of capex-heavy overseas operations, would also support free cash generation.

The company had repayments of INR7,153 million in FY23, of which INR5,050 million of debt was held at overseas business. The company also has significant debt repayment obligations INR7,000 million–7,300 million in FY24; this includes bullet repayment of non-convertible debenture of INR3,750 million, out of which INR1,250 million was repaid in June 2023 as per the repayment schedule. The company's ability to repay or refinance these in a timely manner would remain a key monitorable.

However, Ind-Ra takes comfort from VEL's profitable and cash-generative Indian operations, and the company's ability to tie up incremental debt (INR1,250 million raised in 1QFY24).

The net working capital cycle was short at around 18 days in FY23 and (FY22: about 10 days, FY21: around 15 days), partly attributable to high payables. Ind-Ra expects the working capital cycle to remain at similar levels over the near term, with the better management of creditors as well as receivables.

Improving Product Portfolio Supports Revenue Base: Ind-Ra expects VEL's overall revenue from its continued operations to grow by 8%-10% yoy in FY24 (FY23: up about 17.5% yoy; 1QFY24: about 10.1% yoy), with the management bandwidth completely focused on the India business, easing of supply-side pressures, improved realisations, and new product introductions. The agency also expects the company to record stable revenue growth over the medium term, driven by new product introduction and customer additions, as well as an improvement in the automotive demand scenario. VEL's consolidated revenue increased to INR68,631 million during FY23 (FY22: INR58,442 million, FY21: INR43,739 million), driven by higher realisations, and increasing wallet share in 2W OEM players. The company booked consolidated revenue of INR17,924 million in 1QFY24 . Ind-Ra expects the revenue to grow at a CAGR of 10%-10.5% over FY22-FY26. In terms of the order book, VEL won new business with lifetime sales of INR51,782 million in FY23 and INR 9,552 million in 1QFY24, including orders worth INR17,968 million and INR1,075 million from EV customers in FY23 and 1QFY24, respectively. Lifetime order wins from customers, excluding Bajaj Auto, have seen a steady increase.

With EV adoption in 2W likely to rise steadily, the company is focussed on making inroads by winning business for products already developed and technology tailored for EVs. The company's expertise in designing components for conventional vehicles has augmented its understanding the complexities of designing components for EVs. For EVs, the company manufactures traction motor & controller, telematics, and direct current converters, including several other products.

Segment and Customer Concentration: As a part of restructuring, VEL has divested its 4W lighting business outside India, thus, increasing the concentration towards 2W & three-wheeler (3W) segment. In FY23, the company derived about 71.5% of its consolidated revenue (FY22: 74%) from the 2W & 3W segment, 24.7% (20.9%) from 4Ws and 3.8% (5%) from others. The company derives a significant proportion of its revenue from Bajaj Auto (1QFY24: 42%, FY23: 38%, FY22: 41.8%). Although the concentration risk from the top five customers remains high, accounting for around 72% of the total revenue in FY22, Ind-Ra derives comfort from company's long-established relationships with the customers.

Standalone Profile: On a standalone level, the revenue grew 19% yoy to INR39,179 million in FY23 and 14% yoy to INR10,478 million in 1QFY24 (FY22: INR32,918 million; CAGR of around 11% over FY19-FY23) with an EBITDA margin of 8.1% in FY23 (FY22: 8.2%).

Rating Sensitivities

Positive: A positive rating action could result from all of the following events:

- a sustained increase in the consolidated revenue and profitability and strengthened revenue diversification,
- an ability to generate strong cash flow margins from the continuing operations, resulting in an improved liquidity profile,
- continuous deleveraging of the balance sheet, leading to the consolidated net adjusted leverage reducing below 2.0x on a sustained basis.

Negative: A negative rating action could result from any of the following events on a consolidated and sustained basis:

- the company's inability to achieve profitability margins in line with the agency's expectations,
- a weakened liquidity position on account of a significant elongation of the working capital cycle or an inability of the company to refinance/fund any major repayments falling due,
- any large, debt-funded organic or inorganic expansion leading to the consolidated net adjusted leverage remaining above 2.5x on a sustained basis.

ESG Issues

ESG Factors Minimally Relevant to Rating: Unless otherwise disclosed in this section, the ESG issues are credit neutral or have only a minimal credit impact on VEL, due to either their nature or the way in which they are being managed by the entity. For more information on Ind-Ra's ESG Relevance Disclosures, please click here. For answers to frequently asked questions regarding ESG Relevance Disclosures and their impact on ratings, please click here.

Company Profile

Incorporated in 1988 in Aurangabad, VEL designs, manufactures and supplies exterior lighting systems, plastic and polymer components, electrical-electronic components and precision metallic components to 2W, 3W, passenger cars, commercial vehicle, and off-highway vehicle OEMs in India as well as outside. The company has end-to-end capabilities across design, research and development, engineering, testing, manufacturing and supply of various products across business. The Varroc group is promoted by Mr. Tarang Jain and his family. VEL is one of the leading 2W automotive component suppliers in India and a global 2W lighting business and electronics business player that has a global footprint with 36 manufacturing facilities. VEL sold off its loss making overseas 4W lighting operations on 6 October 2022.

CONSOLIDATED FINANCIAL SUMMARY

Particulars	FY23	FY22
Revenue (INR million)	68,631	58,442
EBITDA (INR million) ^	5,684	3,676
EBITDA margin (%)	8.3	6.3
Gross debt (INR million)*	18,152	17,434
Gross interest coverage (x)	3.0	3.1
Net adjusted leverage (x)	2.6	4.4
Source: VEL, Ind-Ra *Including acceptances & lease liabilities ^ excluding forex gain/loss		

Non-Cooperation with previous rating agency

Not applicable

Solicitation Disclosures

Additional information is available at www.indiaratings.co.in. The ratings above were solicited by, or on behalf of, the issuer, and therefore, India Ratings has been compensated for the provision of the ratings.

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Rating History

Instrument Type	Rating Type	Rated Limits (million)	Current Rating/Outlook	Historical Rating/Outlook	
				5 August 2023	6 February 2023
Term loan	Long-term	INR 7097.3	IND A+/Stable	IND A+/Stable	-
Fund-based/Non-fund-based limits	Long-term/Short-term	INR5,973.5	IND A+/Stable/IND A1	IND A+/Stable/IND A1	-
CP	Short-term	INR1,000	IND A1	IND A1	IND A1
Bank Loan	Long-term/Short-term	INR 798	IND A+/Stable/IND A1	-	-
NCD	Long-term	INR 2500	IND A+/Stable	-	-

Bank wise Facilities Details

Click here to see the details

Complexity Level of Instruments

Instrument Type	Complexity Indicator
Term loan	Low
Fund-based/non-fund-based limits	Low
CP	Low
Bank loan	Low
NCDs	Low

For details on the complexity level of the instruments, please visit https://www.indiaratings.co.in/complexity-indicators.

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APPLICABLE CRITERIA

Evaluating Corporate Governance

Short-Term Ratings Criteria for Non-Financial Corporates

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