India Ratings & Research
A Fitch Group Company

India Ratings Upgrades Varroc Engineering's NCDs and Bank Loans to 'IND AA-/Stable'; Rates Additional Limits

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 Assigned along with Outlook / Watch	Rating Action
Non-convertible debentures#	-	-	-	INR2,500	IND AA-/Stable	Upgraded
Commercial paper*	-	-	365 days	INR1,000	IND A1+	Upgraded
Term loan	-	-	FY28	INR3,642.5 (reduced from INR7,097.3.3)	IND AA-/Stable	Upgraded
Term loan	-	-	FY28	INR862.8	IND AA-/Stable	Assigned
Proposed term loan	-	-	-	INR137.2	IND AA-/Stable	Assigned
Bank loan	-	-	-	INR748	IND AA-/Stable/IND A1+	Upgraded
Fund-based/Non-fund-based limits	-	-	-	INR5,973.5	IND AA-/Stable/IND A1+	Upgraded

#Refer Annexure
* will be carved out of the fund-based limits

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

DETAILED RATIONALE OF THE RATING ACTION

The upgrade reflects VEL's improved EBITDA margins, considerable improvement in the credit metrics, strong order book, increased scale of operations, and continued focus on deleveraging during FY24. The upgrade also reflects the company's ability to generate strong cash flows and sequential recovery in its operating metrics sequentially post the divestment of the lighting division in 2022, along with Ind-Ra's expectations of the same being maintained over the near-to-medium term. Ind-Ra expects VEL's margins to improve gradually in the near term on the back of better operating leverage coupled with cost efficiencies. The increased share from electric vehicles (EV) would also aid the margins over the near-to-medium term

LIST OF KEY RATING DRIVERS:

Strengths

- Improved profitability margins; likely to sustain
- Improved credit metrics
- Diversified revenue profile
- Established market position
- Successful divestment of loss-making business; proceeds settled
- Strong order book; improving product portfolio supports revenue base

Weaknesses

- Segment and customer concentration

DETAILED DESCRIPTION OF KEY RATING DRIVERS

Improved Profitability Margins; Likely to Sustain: VEL's consolidated EBITDA margin improved to 10.2% in FY24 (FY23: 8.3%, FY22: 6.1%); adjusted for forex fluctuations, the company's EBITDA margin was 10.1% during the year (8.7%, 6.3%). The margin rose in FY24 largely on account of ongoing cost-reduction measures and with operational efficiencies. Although the company's margins are prone to any significant increase in input prices, these can be largely passed on to the original equipment manufacturers (OEM) with a lag of three-to-six months. A sustained improvement in the profitability margins will remain a key rating monitorable. Ind-Ra expects the consolidated EBITDA margin to remain stable in the range of 10%-10.5% in FY25, driven by ongoing cost-rationalisation measures, the company's efforts to improve capacity utilisation from existing levels of 65%-70%, and easing of commodity inflation. The increasing share of EV contribution would also aid in margin improvement.

Improved Credit Metrics: VEL's consolidated credit metrics improved significantly during FY24 because of continued focus on deleveraging and healthy EBITDA levels. The consolidated net adjusted leverage (net debt including lease liabilities and acceptances) improved to 1.6x in FY24 (FY23: 2.4x, FY22: 4.4x), and the interest coverage (EBITDA/interest expense) strengthened to 3.9x (3.1x, 3.1x), supported by the company's shift from hight cost bearing debt to lower cost debt, improved sustainable cash flows, and the absence of any large debt-funded capex plans. Ind-Ra expects the credit metrics to improve further over FY25-FY26, led by strong cash generation leading to deleveraging and modest capex requirement in near term. The interest coverage is likely to improve to 6x-7x in FY25. The debt and EBITDA for FY22-FY23 exclude the discontinued operations. The cash flow margin has remained positive historically (FY24: 6%, FY23: 6.5%, FY22: 9%) and Ind-Ra expects it to remain positive in the range of 6%-7% from FY25.

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 FY24, followed by electronics (around 25%), lighting (21%), metallic (12%), aftermarket (around 8%) and overseas forgings (1.9%). Post the restructuring of operations in FY23, VEL's geographic diversification has moderated, with its presence being limited to Vietnam, Romania, Italy, Poland and China, along with a presence across India.

Established Market Position: VEL is among the leading players in most of its product segments, including two-wheeler (2W) lighting, electronic components and digital instrumentation clusters. VEL has had strong relationships with 2W 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 also added new customers during FY23 and FY24 on the EV side. VEL has 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 that are located close to the OEMs, which supports the supply chain management.

Successful Divestment of Loss-making Business; Proceeds Settled: In October 2022, VEL 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. The complete amount has been settled as decided. Out of EUR28 million of the escrow account, EUR 15 million was paid to PO as part of the final settlement, while the balance EUR13 million was received by VEL during FY24 after meeting the cost of sales to the tune of EUR5 million. The proceeds were utilised towards reducing the debt levels during the year.

The divestment was a 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. While this has not significantly impacted the company in short run, it would definitely turn out to be beneficial in the medium-to-long term as the company's focus remains undivided towards the Indian entities. The arbitration on the China JV is also likely to be settled by the end of FY25, according to the management.

Strong Order Book; Improving Product Portfolio Supports Revenue Base: As on 31 March 2024, VEL had a strong order book of INR87 billion, with 43% of the order book pertaining to the EV segment. The share of this segment is likely to increase in the medium term. On the EV front, VEL added a couple of customers during FY23-FY24, and the company expects meaningful revenue contribution from the same from FY25. Backed by the order book, the company expects to achieve incremental revenue of INR8.5 billion in FY25, INR14.5 billion in FY26 and INR17.5 billion in FY27. The revenue contribution from EV has been gradually increasing and stood at 5.3% in FY24 (FY23: 1.5%). Ind-Ra expects VEL's overall revenue from its continued operations to grow by 8%-10% yoy in FY25 (FY24: up about 9.6%, FY23: up about 17.5% yoy), backed by the strong order book along with new orders bagged by the company for both the EV and internal combustion engine divisions. Furthermore, Ind-Ra expects the 2W segment, which is the largest contributor to VEL's revenue, to grow by 7%-10% yoy during FY25, which would also aid the revenue growth. The agency expects the company to record stable revenue growth over the medium term, driven by new product introduction, customer additions and increased share in EVs. VEL's consolidated revenue increased to INR75,519 million during FY24 (FY23: INR68,912 million, FY22: INR58,442 million), driven by higher realisations, and increasing wallet share in 2W OEM players. Ind-Ra expects the revenue to grow at a CAGR of 10%-11% over FY22-FY27.

With EV adoption in 2W likely to rise steadily, the company is focussed on making inroads by winning business for products that have been already developed with 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 motors and controllers, telematics, and direct current converters, including several other products.

Segment and Customer Concentration: As a part of restructuring, VEL divested its 4W lighting business outside India in FY23, and subsequently enhancing its focus on the 2W and three-wheeler (3W) segments. In FY24, the company derived about 74.8% of its consolidated revenue (FY23: 71.5%) from the 2W and 3W segments, 22.7% (24.7%) from the 4W segment, and 2.5% (3.8%) from others. The company derives a significant proportion of its revenue from Bajaj Auto (FY24: 42.3%, FY23: 37.5%, FY22: 41.8%). Although the concentration risk remains high, Ind-Ra derives comfort from company's long-established relationships with the customers.

Liquidity

Adequate: Ind-Ra expects the liquidity to remain adequate in FY25, backed by the positive cash flow generation, growth in the company's operations, and its improving capability to service debt obligations. The company had a cash balance of INR2,266 million at FYE24 (FYE23: INR3,571 million, FYE22: INR1,178 million). VEL's average utilisation of the fund-based working capital limits was below 40% for the 12 months ended April 2024. The fund-based limit utilisation is constrained by 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 INR5,300 million, which was utilised at an average of 55%-60% during the 12 months ended April 2024.

Ind-Ra-calculated cash flow from operations remained positive at INR4,517 million in FY24 (FY23: INR4,511 million, FY22: INR5,004 million). The free cash flow turned positive at INR1,774 million in FY24 (FY23: negative INR1,471 million, FY22: negative INR3,590 million) on the back of healthy EBITDA and lower capex. Ind-Ra expects the free cash flow to strengthen further in FY25 on account of an improvement in the profitability as well as modest capex plans. According to the management, the capex outgo is likely to remain limited during FY25-FY26, ranging between INR2,000 million–2,500 million, with greater focus on EV related components and increasing overall capacity utilisation.

The company has repayments of INR4,500 million-4,800 million during FY25-FY26, which will be funded via internal accruals. Ind-Ra takes comfort from VEL's profitable and cash-generative Indian operations, and the company's ability to tie up incremental debt. The net working capital cycle improved to around 11 days in FY24 (FY23: 18 days, FY22: about 10 days), partly due to lower inventory and receivable days. Ind-Ra expects the working capital cycle to remain at similar levels over the near term, with better management of creditors as well as receivables.

RATING SENSITIVITIES

Positive: The following events could collectively lead to a positive rating action:

- a sustained increase in the consolidated revenue and profitability and strengthened revenue diversification,
- sustained cash flow margins,
- continuous deleveraging of the balance sheet, leading to the consolidated net adjusted leverage (incl. leases and acceptances) reducing below 1.5x 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 maintain consistent profitability margins in line with the agency's expectations,
- elongation of the working capital cycle,
- any large, debt-funded organic or inorganic expansion leading to the consolidated net adjusted leverage (including leases and acceptances) exceeding 2.0x on a sustained basis

Any Other Information

Standalone Profile: On a standalone level, the revenue grew 15.1% yoy to INR45,350 million in FY24 (FY23: INR39,402 million), with the EBITDA margin rising to 9.9% (8.6%). The interest coverage improved to 2.6x in FY24 (FY23: 1.7x) and the net adjusted leverage improved to 2.8x (4.7x).

RATING CRITERIA

Corporate Rating Methodology
Short-Term Ratings Criteria for Non-Financial Corporates
Evaluating Corporate Governance
The Rating Process

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 2-wheelers, 3-wheelers, passenger cars, commercial vehicles, and off-highway vehicle OEMs in India and overseas. The Varroc group is promoted by Tarang Jain and his family. VEL is one of the leading 2-wheeler automotive component suppliers in India and is also a significant global player in the 2W lighting business and electronics business, with 36 manufacturing facilities. VEL sold off its loss making overseas 4-W lighting operations on 6 October 2022.

FINANCIAL SUMMARY

Particulars	FY24	FY23
Revenue (INR million)	75,519	68,912
EBITDA (INR million)	7,590	5,966
EBITDA margin (%)	10.1	8.7
Gross Adjusted debt (INR million)*	14,050	18,152

Gross interest coverage (x)	3.9	3.1
Net adjusted leverage (x)	1.6	2.4
Source: VEL, Ind-Ra *Including acceptances and lease liabilities		

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.

RATING HISTORY

Instrument Type	Current Rating/Outlook			Historical Rating/Outlook		
	Rating Type	Rated Limits (million)	Rating	18 August 2023	5 April 2023	6 February 2023
Non-convertible debentures	Long-term	INR2,500	IND AA-/Stable	IND A+/Stable	-	-
Commercial paper	Short-term	INR1,000	IND A1+	IND A1	IND A1	IND A1
Term loans	Long-term	INR4,642.5	IND AA-/Stable	IND A+/Stable	IND A+/Stable	-
Bank loan	Long-term/Short-term	INR748	IND AA-/Stable/IND A1+	IND A+/Stable /IND A1	-	-
Fund-based/Non-fund-based limits	Long-term/Short-term	INR5,973.5	IND AA-/Stable/IND A1+	IND A+/Stable /IND A1	IND A+/Stable /IND A1	-

COMPLEXITY LEVEL OF THE INSTRUMENTS

Instrument Type	Complexity Indicator
Term loan	Low
Fund-based/non-fund-based limits	Low
Commercial paper	Low
Non-convertible debentures	Low

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

ANNEXURE

Instrument Type	ISIN	Date of Issuance	Coupon Rate (%)	Maturity Date	Size of Issue (million)	Rating
NCD	INE665L07040	7 September 2023	8.60	7 September 2028	INR2,500	IND AA-/Stable
Total					**INR2,500**	

Source: VEL, NSDL

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