ICRA RESEARCH SERVICES

Replacement demand and improving fleet operators' viability driving MHCV sales

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Commercial Vehicles

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Executive Summary

CV sales grew by 5.6% in YTD FY 2016 vis-à-vis -2.8% in FY 2015

M&HCV (Truck) sales continue to expand at steady pace (up 24.6%)

LCVs remain in weak spot owing to surplus capacity and tight financing environment

Replacement demand and improving viability of fleet operators driving M&HCV sales

- During the first four months of FY 2016, the domestic Commercial Vehicle (CV) sales have grown by 5.6x% over the prior year. In line with previous year, the recovery in the CV segment continues to be supported by the M&HCV (Truck) segment (up 24.6% YTD FY 2016) on back of replacement demand (following over two years of deferment), improving operating economics and continuation of discount-led push by OEMs. In contrast, the LCV (Truck) segment has declined by 7.1% owing to overcapacity issues and adjustments in the financing environment (i.e. tighter lending norms).
- During the current fiscal, bus sales have also improved; having grown by 14.3% vis-à-vis the prior year on back of JNNURM backed orders by State Transport Undertakings (STUs) and pick-up in demand from school/colleges segment.
- Our recent channel check with fleet operators suggest that operators' cash flows are on improving trend following sharp drop in diesel prices and relatively stable freight rates even as demand for cargo continues to be subdued. Fleet utilization levels have improved only marginally over the past six months and currently vary between 70-85% across regions. However, with regards to capacity addition plans, only 30% of fleet operators indicated that they are likely to add capacity in the near-term citing lack of visibility.

M&HCV (Truck) sales supported by MAVs and Tractor Trailers. Tipper sales remained subdued in FY 2015 amid subdued demand from core segments

Tipper sales remain weak owing to structural issues

- During FY 2015 and YTD FY 2016, Tipper sales (12-15% of M&HCV Truck sales) have continued to remain subdued as mining activity in some of the affected regions is yet to pick-up. In addition, overcapacity in some of the states, especially, Goa and Karnataka continues to be a dampener for new CV sales.
- Besides mining, demand for tippers from the infrastructure space has also been muted pace of pick-up in infrastructure projects, slowdown in the housing segment and stretched working capital cycle of contractors.

Financing environment is stabilizing; Delinquency levels have started trending downwards on back of improved cash flows of fleet operators

Financing environment showing signs of stability

- As part of our channel check, we also spoke to some of the leading NBFCs engaged in the CV financing space. Our interaction with them suggest that delinquency levels have started declining as cash flows of fleet operators have improved in view of lower diesel cost and relatively stable freight rates. In addition, greater focus on collection efficiency measures has also helped in bringing down over dues.
- Recovery appears to be broad based and is also visible in South & West, which had witnessed sharp rise in NPAs over the past year or so. Additionally, there has been reasonable amount of discipline among financiers when it comes to maintaining LTVs and assessing the credit quality of borrowers. In general, lending rates have contracted marginally (i.e. 50-80 bps) and large fleet operators continue to enjoy competitive pricing (i.e. 10.5-11%) from private sector banks.
- While the financing community sounded cautiously optimistic, the slow pace of liquidation of repossessed vehicles, sluggish resale values of second-hand trucks (down 35-40%) and continuation of high discounts (offered by OEMs) were some of their key concerns at present.

Expect M&HCV (Truck) sales to register a growth of 12-14%, while LCVs to decline by 2-4% in FY 2016

STU orders to support bus sales as well as exports

Outlook: M&HCV (Trucks) likely to grow 12-14%, while LCVs may decline by 2-4% in FY 2016

- In ICRA's estimates, the M&HCV (Truck) segment is likely to register a growth of 12-14% in FY 2016 driven by continuing trend towards replacement of ageing fleet, improvement in operating economics of fleet operators and some pre-buying ahead of mandatory introduction of Anti-Lock Braking Systems (ABS) from October 2014. In the near-term, CV sales will also benefit from gradual progression to BS-IV emission norms (All India coverage by April 2017.
- Unlike M&HCVs, we expect the LCV segment to remain subdued in FY 2016 (down 2-4%) as segment's prospects continue to be influenced by overcapacity issues and constrained financing environment amidst rising delinquencies. Nevertheless, driven by certain structurally favorable factor, the segment's growth prospects over the medium-term remain intact. Some of the factors that are likely to support steady demand for LCVs going forward include a) further proliferation of "Hub-n-Spoke" logistics model with the implementation of GST, b) relatively untapped potential in semi-urban and rural areas and c) improving urbanization levels.
- With new orders placed by SRTUs (under the JNNURM programme), we expect the overall bus segment to register a growth of 8% - 10% during FY 2016. Within the segments, the M&HCV segment is likely to outperform on account of JNNURM orders, revival in demand from Private Carriers (that contribute almost 1/3rd to M&HCV Bus Sales) and low-base effect.

ICRA's Channel Check: Operating environment has improved but not significantly

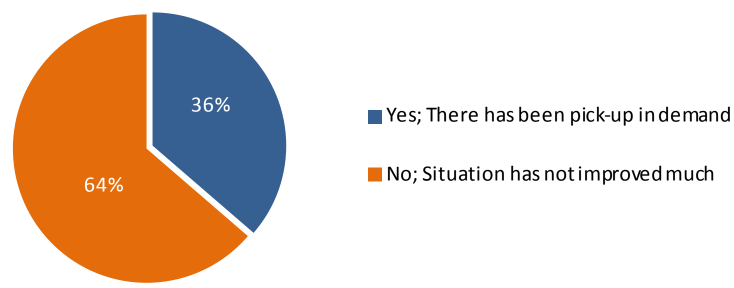
Channel check was conducted with 23 fleet operators across India. The operators had fleet size ranging between 20-400 and catered to diverse customers/industries

Replacement-led demand to continue but sustainability contingent on favorable investment cycle

In FY 2015 and YTD FY 2016, the M&HCV (Truck) segment grew by 21% and 25% on a YoY basis. Albeit on a low base, the growth for M&HCVs was driven primarily by replacement-led demand as fleet operators' renewed their ageing fleet having deferred fleet renewal for a period of almost two years. While this trend would continue to support growth in FY 2016, further scale-up in industry volumes would depend to a great extent on improvement in industrial activity as well as pick-up in infrastructure and mining projects. To assess the current situation, we conducted a channel check with fleet operators to get a perspective on underlying industry trends. Key observations from our interaction are summarized below:

Nearly two-third of fleet operators indicated that demand hasn't improved meaningfully

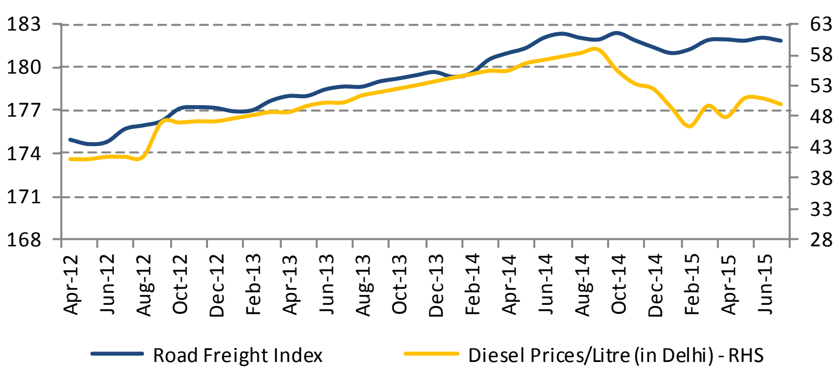
Exhibit 1: Has there been pick-up in demand over the past six months?



- Our interaction with fleet operators suggest that demand continues to be subdued. While there was some pick-up during H1 FY 2015, it has not gathered momentum over the past six months.
- Freight availability from only few of the sectors like automobiles, cement etc. has improved while it continues to be subdued from other sectors. Out of 23 fleet operators, less than 40% of operators indicated that demand/freight availability has improved over the past six months
- This trend correlated with subdued growth in IIP which has grown at sub-3% over the past couple of quarters

However, firm freight rates and lower diesel prices has supported improvement in cash flows

Exhibit 2: What has been the trend in freight rates during the same period?



- Barring some pressure due to unseasonal rains and lower agriculture output, freight rates have however remained firm. This along with lower diesel prices (down 14% since Sept. 2014) has helped in improving the viability to some extent.
- As shown in exhibit alongside shows, the gap between diesel prices and freight rates has also narrowed since FY 2014 and freight rates have started moving in line with rise in diesel cost, implying that fleet operators' utilization levels are gradually improving.
- Overall, fleet operators did indicate the profitability in the road logistic business is yet to return its steady state level as frequent increase in toll charges; insurance, and driver salaries have put pressure on cost structure for past few years.

Most fleet operators don't seem to have capacity expansion plans at present

- As per fleet operators, the fleet utilization levels have improved marginally over the past six months and currently vary between 70-85% across regions. Accordingly, the sharp recovery in M&HCV industry sales was largely led by renewal of ageing fleet by large fleet operators who had deferred the same over the past few years.
- While most of the fleet operators indicated that they haven't added capacity over the past 6-12 months, they sounded more positive about the near-term; Approximately 30% of fleet operators indicated that they are likely to add capacity in the near-term
- Rest of the respondents cited a) subdued demand, b) preference for asset-light model and c) overcapacity in the trucking system as the key factors for not pursuing capacity addition. Some of the operators even indicated that it makes sense to continue with existing vehicles as they are unlikely to fetch good resale values.

Exhibit 3: What are fleet capacity expansion plans in the near-term?

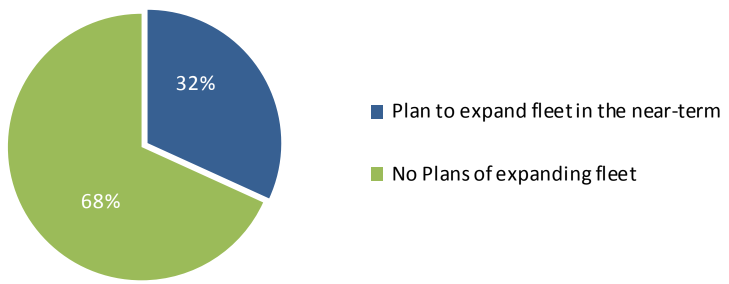


Exhibit 4: What are the factors for not considering capacity expansion?

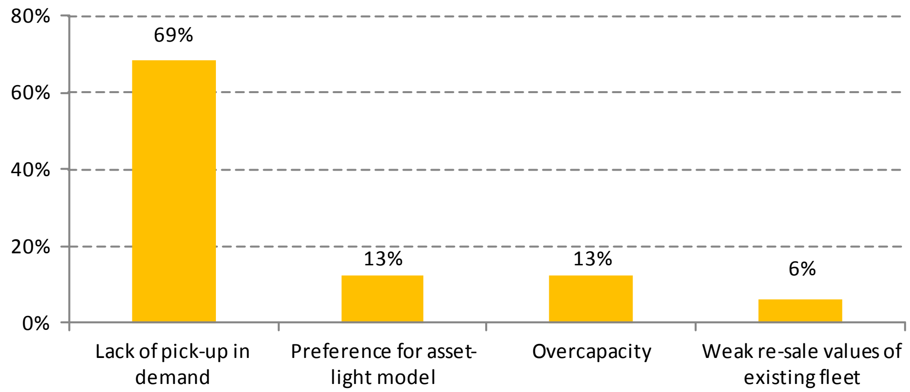
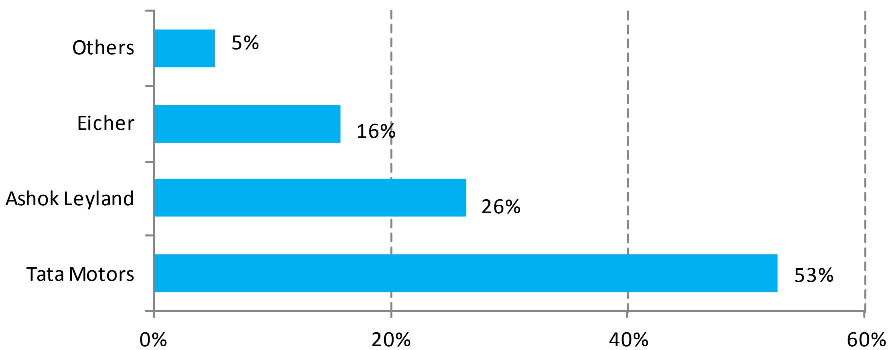


Exhibit 5: Which brand of Truck do you use?



- As part of our channel check, we also spoke to fleet operators about their preference for OEMs. Except in the Southern region, most of the transporters (almost 50%) prefer Tata Motors for heavy-duty applications and Eicher in the medium-duty segment. In general, operators haven't changed their preferred OEM over the past few years. Only a few operators indicated they have tried trucks from Bharat Benz and Volvo Eicher. This trend was more pronounced in the Southern region.
- Overall, established brand loyalty towards incumbents, easier maintenance and availability of spare parts and high load carrying capability of trucks manufactured by domestic OEMs continue to be the factor cited by operators as they reasons for experimenting with new OEMs.

ICRA's Channel Check: Financing environment remains relatively cautious; but collection ratios improving

Financing environment showing signs of stability backed by improving cash flows

Exhibit 6: Trend in Delinquency Levels – 90+ DPD Levels

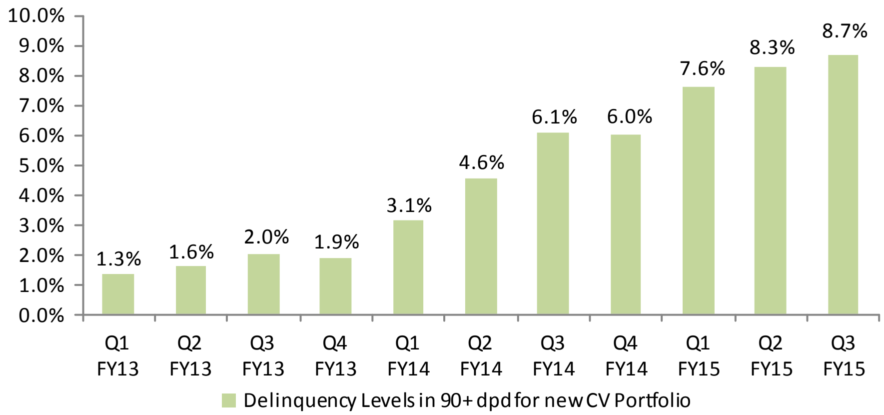
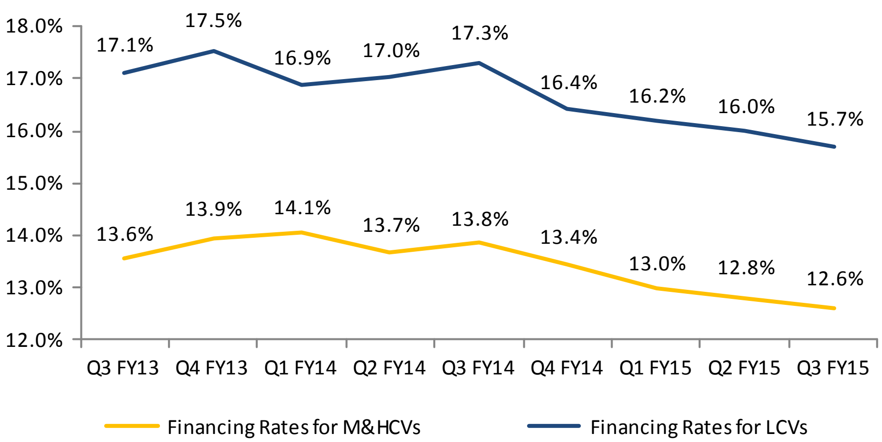


Exhibit 7: Trend in CV Financing Rates for M&HCVs and LCVs



- As part of our channel check, we also spoke to some of the leading NBFCs engaged in CV financing. Our interactions suggest that delinquency levels in the CV financing space peaked during H2 FY 2015 and there has been gradual improvement in collection rates from October-November 2014 onwards
- Recovery appears to be broad based and is also visible in South & West, which had witnessed sharp rise in NPAs during the recent slowdown. Within the Southern region, both Tamil Nadu and Andhra Pradesh have also shown marked improvement
- Improvement in delinquency levels is largely coming on back of improved cash flows of fleet operators due to lower diesel prices and increased collection efforts. Overall, utilization levels of fleet operators are yet to see a meaningful improvement. These trends are likely to show up in lower delinquency levels from H2 FY 2016 onwards as improvement in collections is moving gradually from one bucket to the lower bucket
- There has been reasonable amount of discipline among financiers when it comes to maintaining LTVs and assessing the credit quality of borrowers
- In general, lending rates have contracted marginally (i.e. 50-80 bps). Large fleet operators continue to enjoy competitive pricing (i.e. 10-11%) from private sector banks
- The key concerns among financiers continues to be high level of repossessed stock, subdued re-sales values of used vehicles and continuation of discounts by OEMs for new CVs
- Overall, financiers are hopeful that the recent pick-up in M&HCV sales is likely to continue and would get support from Government's efforts to revive investments in the infrastructure space. On the mining front, although companies believe that bottom has been touched but demand recovery is likely to be gradual given the overall macro-economic environment and competition from cheaper imports, especially for iron ore mining belts

Private sector banks continue to be the preferred financiers for large fleet operators

- As part of our discussion with fleet operators, we also took their feedback on the recent trend in CV financing environment and their preferred financiers. Almost all the fleet operators indicated the interest rates have either remained stable or corrected only marginally over the past six months.
- With regards to preferred financiers, Private sector banks like HDFC and ICICI continue to dominate the choice of large fleet operators (25+ trucks) given its competitive pricing and flexibility offered through its other banking services. In case of smaller fleet operators, there is a preference for Shriram, Cholamandalam, Kotak and Tata Motors Finance.

View of fleet operators on implementation of GST remain mixed

- As part of our channel check, we also spoke to fleet operators about their expectations with relation to the impact of GST on the road logistics sector. Broadly, their views were mixed as almost half of the respondents stated that GST may not help significantly in curbing bottlenecks in the road logistic sector in the near-term. Their key concerns emanated from the fact that roll-out of GST being a complex subject is likely to get further delayed and individual states would continue to play an important role (atleast in the initial few years) based on some of the recent proposals.

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