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Rating Methodology by Sector

Auto Parts Manufacturers

Note: The following abbreviations are used below: EV (electric vehicle), HV (hybrid vehicle), PHV (plug-in hybrid vehicle), and CASE (Connected, Autonomous, Shared, and Electrification)

1. Business base

The facts that customers are diversified and that once an order is received, the transactions will continue until the model change several years later, can contribute to stabilizing business performance of auto parts manufacturers. On the other hand, continuous requests from automakers for price reductions can be a drag on profitability, and there is also a risk of performance deterioration due to the sudden automobile production cutbacks that diverge from the production plans. Investment in the development of a global production system may also become a financial burden. These business risks are factored into the rating.

(1) Characteristics of the industry

(i) Market overview

Auto parts manufacturers are generally companies that supply parts for automobiles (including motorcycles), including engine parts, driveline parts, body parts, and electrical/electronic parts. As automobiles are expensive products and widespread worldwide, the market size of automotive parts is also large.

(ii) Competitive situation

The Japanese automotive industry uses a vertical division of labor, with automakers at the top and their affiliated parts manufacturers below them, and is characterized by the significant involvement of parts manufacturers in new model development. Although there are some groups in which affiliations have loosened, the relationship between the two in general is close, and joint efforts to improve quality and reduce costs are a source of competitiveness.

When a company is affiliated with a particular automaker, new orders are stable, but may be significantly affected by the automobile production trends of the customer. In addition, overseas production often involves the procurement of parts across affiliations based on price and geographical conditions.

Automakers are working on global modularization and parts commonization, and are promoting optimal procurement on a global basis. This requires parts manufacturers to have an ability to supply

common parts on a global basis. The volume of transactions is expected to increase, which will provide an opportunity to expand transactions in terms of activities for orders, but at the same time, the risk of losing orders may also increase. In recent years, manufacturers in emerging countries have been improving their quality as well as their cost competitiveness, and competition has become tougher.

(iii) Cost structure

Continuous requests from automakers for price reductions are a drag on profitability. Therefore, fixed cost reduction and cost reduction activities in cooperation with automakers are important. If the fixed cost burden is heavy, automobile production cuts will have a large impact on business performance. Conversely, a sudden increase in production that far exceeds the automobile production plan often leads to increased costs, including labor and transportation costs. In developed countries such as the U.S., it can be difficult to secure workers and maintain the retention rates, and this can lead to a deterioration in productivity. Because of the labor-intensive characteristics, there are companies that need to build a system to constantly produce in low-cost areas of the world.

(2) Key factors in market position and competitiveness

(i) Market position

High reliability based on a stable delivery track record leads to continued and expanded transactions. The Japanese automotive industry uses a vertical division of labor, with automakers at the top and their affiliated parts manufacturers below them, and is characterized by the significant involvement of parts manufacturers in the development of new models than in the U.S. or Europe. When a company is affiliated with a particular automaker's group, its position within the group is important. On the other hand, for independent manufacturers, the core competence, which is the source of competitiveness to win orders, is important. For both affiliated and independent manufacturers, their ability to plan and propose cost reductions and new technologies to automakers is important in securing stable orders.

(ii) Sales strategy and product competitiveness

If a product is highly important and has high technological superiority, the added value of the product will increase, and this will alleviate the pressure from automakers to lower prices. If an aftermarket for products exists and the company is competitive there, it often leads to continued transactions and favorable profitability.

Parts manufacturers have long been working to improve engine combustion efficiency and reduce vehicle weight to reduce emissions and improve fuel efficiency. EVs are equipped with heavy batteries, so there will be even greater need for weight reduction to extend cruising range.

Automakers are focusing on the development of next-generation vehicles in response to CASE, and an increasing number of products are being outsourced to parts manufacturers. It is important to

win orders for these parts through new technology development and proposal capabilities.

(iii) Cost-competitiveness

With environmental and safety regulations becoming stricter and requirement of dealing with CASE, the cost of manufacturing vehicles is rising. It is important to reduce development and production costs through collaboration with automakers and to cut costs by establishing a globally optimized production system.

Since EVs do not require internal combustion engines, their structures are relatively simple, and the importance of technology/process of combining and adjusting individual components, which has been a strong point of Japanese auto parts manufacturers, may decline. Parts manufacturers need to improve product performance and cost competitiveness.

It is important to establish a flexible production system, as it is often observed that productivity drops when starting up a parts line for a new model of a mass-market vehicle.

(iv) Quality control

The quality level required of parts manufacturers is high, especially for critical safety parts. The modularization and commonization of parts are progressing, and the impact of any defects will be significant, increasing the risk of mass recalls (free recalls and repairs) and other risks. It is becoming more important for parts manufacturers to ensure thorough quality control.

(v) Global production system

Automakers are promoting globally optimized procurement, and parts manufacturers are often required to establish a global supply system. If they fall behind their competitors in terms of global supply capacity, there is also a risk of missing out on business opportunities in global mass-market vehicles. When expanding global production, it is important to ensure efficient investment, transaction volume, and profitability.

Since parts for export vehicles are delivered domestically, the export ratio is low and the impact of foreign exchange rate is relatively small. However, a strong yen may force the company to respond to a decrease in the number of exported vehicles and increased requests from automakers for cost reductions.

(vi) Compliance with environmental regulations

Governments around the world have declared their commitment to achieving a carbon-neutral, decarbonized society, and regulations on CO2 emissions and gasoline-powered vehicles are becoming stricter.

Automakers are moving forward with electrification, and consumers are also becoming increasingly aware of global warming countermeasures. The impact will not be significant for vehicles

with internal combustion engines such as HVs and PHVs, but if the shift to EVs proceeds at once, parts manufacturers of engine and transmission-related components will need to shift their business portfolios. It will also be important to capture new business opportunities created by the replacement of components with those for EVs and the shift to EVs.

Since EVs and automated driving require integrated control of the entire vehicle, it will be difficult for a single parts manufacturer to respond to this challenge alone, and alliances may be effective in some cases.

2. Financial base

(1) Earnings strength

JCR focuses on what factors are responsible for the high and low ratio of operating margin and how it will improve in the future. The performance of the company is affected by profitability of its products, production trends of its customers, and progress of cost reduction. The facts that customers are diversified and that once an order is received, the transactions will continue until the model change several years later, can contribute to stabilizing business performance of auto parts manufacturers. On the other hand, continuous requests from automakers for price reductions can be a drag on profitability, and there is also a risk of performance deterioration due to the sudden automobile production cutbacks that diverge from the production plans.

Key financial indicators:

- Operating margin
- Operating income, Ordinary income

(2) Cash flow generation capacity

Investments in building a global supply system and developing advanced technologies will likely lead to maintaining and improving competitiveness over the medium to long term. Sufficient cash flow generation capacity and investment capacity for these investments must be secured.

Key financial indicators:

- Cash flow from operating activities, EBITDA
- Free cash flow
- Ratio of interest-bearing debt to EBITDA

(3) Safety

Maintaining and strengthening financial soundness is an important issue in order to respond to various event risks, performance deterioration, impairment losses, and overseas business expansion. It should be noted that investments in the development of global production systems may become a financial burden.

Key financial indicators:

- Equity capital, Equity ratio
- Debt equity ratio
- Interest-bearing debt

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