India Ratings Places Vivo Mobile India & its NCDs on RWN

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India Ratings and Research (Ind-Ra) has placed Vivo Mobile India Private Limited's (Vivo) Long-Term Issuer Rating of 'IND BB' on Rating Watch Negative (RWN). The Outlook on the earlier rating was Stable. The instrument-wise rating actions are given below:

Instrument Type	ISIN	Date of Issuance	Coupon Rate (%)	Maturity Date	Size of Issue (billion)	Rating/Rating Watch	Rating Action
Non-convertible debentures (NCDs)	INE294W08010	22 December 2016	3	23 December 2019	INR7	IND BB/RWN	Placed on RWN

The RWN reflects lack of visibility over repayment of the upcoming NCDs maturing in December 2019 as Vivo's internal accruals and available liquidity is insufficient to repay the NCDs. The management has clarified to Ind-Ra that the company is likely to refinance the NCDs with external commercial borrowing (ECB), which may be fully subscribed by Vivo's parent. Ind-Ra derives comfort from historic trend, wherein Vivo's parent has supported the company by fully subscribing to the NCD (INR6.9 billion) and the ECBs on the books (INR13.9 billion). However, Ind-Ra would await a concrete, action plan from the company in regards to its refinancing initiative.

KEY RATING DRIVERS

Weak Financial Risk Profile and Liquidity: Ind-Ra expects Vivo to continue to incur EBITDA losses till FY21 on account of thin gross margins and high advertisement expenses, thus remaining vulnerable to refinancing risk. While the company has been able to meet its interest payments via its cash balances (FY19: INR1.25 billion, FY18: INR0.4 billion), the quantum of repayment in FY20 requires the company to find alternate methods of financing. As per the company's FY19 provisional financials, Vivo reported an EBITDA loss of INR1.6 billion (FY18: INR1.2 billion) and a net loss of INR0.5 billion (FY18: INR1.2 billion). The company's working capital cycle is completely funded through trade creditors. The EBITDA losses due to continued heavy advertisement and sales promotion expenditure pose a refinancing risk for FY20.

Large Capex Impacts Cash Flows: Vivo incurred capex of INR4.1 billion in FY19, of which 50% was for acquisition of a 169-acre plot of land in Uttar Pradesh for constructing a technology park housing an upgraded manufacturing facility and granting easier access to its suppliers. The balance capex was for the installation of surface-mount technology (SMT) lines and increasing the assembling capacity. Cash flow from operations turned negative to INR11.9 billion in FY19 from INR2.3 billion in FY18, majorly on account of increased inventory, leading to net working capital increasing to negative 12 days (FY18: negative 27 days; FY17: negative 17 days). This led to a working capital outflow of roughly INR11.8 billion. The agency expects the inventory level to moderate in FY20 (FY19: INR14.5 billion, FY18: INR3.8 billion), as the company tends to hoard large quantities of raw materials six months prior to the launch of new products.

Sales Promotion to Weigh on EBITDA: The ratings are constrained by the uncertainty over EBITDA turning positive in the near term. EBITDA losses increased to INR1.6 billion in FY19 (FY17: INR1.2 billion), despite a 55% yoy improvement in revenue to INR172 billion in FY19, due to a higher demand and increased capacity. The company's operating margins did improve slightly to negative 0.9% (FY18: negative 1.1%) due to rationalization of channel margins and less profitable distribution channels. The company will look to turn profitable in FY22 by increasing sales through product launches at more competitive price-points, developing innovative products (under-display finger print scanner) and strengthening its offline presence. The management however has indicated that it would continue to spend sizeable amounts (7%-10% of revenue) on sales promotions to maintain its current market share.

Shift in Strategy; Improved Market Share: Vivo’s shipment market share significantly increased year-on-year in 2Q19, due to the combined effect of its aggressive marketing strategy and a shift in the company’s own strategy by reducing the margins offered to retailers and rationalisation of its distribution, now only being available at fewer counters which have strong visibility and sales. As of July 2019, the company’s market share stood at 12% (1Q18: 6%). The company should improve its margins in the medium term, and enable it to make focused investments in tier two and tier three cities. Management expects to achieve major revenue growth in FY20 on account of new product launches and improved focus on online and offline sales. However, gaining market share on a sustained basis would be challenging, given changing customer preferences and low brand loyalty.

Domestic Manufacturing to Increase: Assembling capacity of the company increased to 21.9 million units in FY19 (FY18: 16.2 million units; FY17: 12 million units). The company has already added 2 SMT lines in FY20, increasing capacity by 6 million units, to meet the increased demand from consumers. At FYE19, the company’s SMT lines were running at a capacity utilisation level of 80%, selling roughly 17.5 billion units. Vivo intends to increase its capacity by creating an enhanced technology centre in Uttar Pradesh, which should boost overall capacity and decrease transit costs from the manufacturing plant to key dealers.

Forex Risk; Intense Competition: The company imports over 95% of its material requirements, which exposes it to foreign exchange fluctuation risk. Also, intense competition leaves less flexibility to pass on price increases to customers. However, the company is increasing local manufacturing of printed circuit boards, which make up around 50% of the smartphone’s making cost, which would reduce the impact of rupee depreciation.

Industry Risks: The ratings factor in industry risks such as rapid technological changes, changing consumer preferences and competitive pricing pressures. Other risks include forex volatility resulting from imports; this is partially mitigated by increasing the mix of indigenous sourcing/manufacturing.

RATING SENSITIVITIES

The RWN indicates that the rating may be either affirmed or downgraded. The agency will resolve the rating watch by November 2019, once there is greater clarity over repayment of its NCDs.

COMPANY PROFILE

Incorporated in August 2014, Vivo is engaged in manufacturing and selling of smartphones, and wholesale trading of mobile spare parts and accessories.

FINANCIAL SUMMARY

Particulars	FY19 (Provisional)	FY18
Operating revenue (INR billion)	172.0	110.8
EBITDA (INR billion)	-1.6	-1.2
Operating EBITDA margin (%)	-	-
Interest expenses (INR billion)	0.35	0.21
Total adjusted debt (INR billion)	20.9	7.0
Source: Ind-Ra, Vivo		

RATING HISTORY

Instrument Type	Current Rating/Rating Watch			Historical Rating/Outlook		
	Rating Type	Rated Limits (billion)	Rating	23 July 2018	15 June 2017	28 December 2016
Issuer rating	Long-term	-	IND BB/RWN	IND BB/Stable	IND BB/Stable	IND BB/Stable
NCDs	Long-term	INR7	IND BB/RWN	IND BB/Stable	IND BB/Stable	IND BB/Stable

COMPLEXITY LEVEL OF INSTRUMENTS

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

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Applicable Criteria

Corporate Rating Methodology
Treatment and Notching of Hybrids in Nonfinancial Corporates

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