Road turns rough for small fleet operators

Operating margins expected to shrink ~300 bps compared with ~50 bps for large peers

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The fortunes of road transporters with less than five trucks apiece, termed small fleet operators (SFOs) in industry parlance, appear to have nosed downhill for good since the changeover to the Goods and Services Tax (GST) last fiscal.

Added to the pain from the regime change, enforcement of the new axle-load norms and northward run-up in fuel prices are set to deal them a huge blow where it hurts the most – their margins.

Large fleet operators (LFOs) are much less impacted, as the changes in norms and customer preference have swerved the advantage sharply their way.

For perspective, SFOs comprise ~67% of the road transport operators in India, though they own less than 25% of the trucks (>12T GVW). Medium fleet operators (6-20 trucks) and LFOs (>20 trucks) account for the rest. Indeed, barring the top 10-15 players (by turnover), most road transport operators in the country have turnover less than Rs 250 crore.

The importance of the segment can be gauged from the fact that road freight transportation constitutes ~75% of the ~Rs 6,800 crore logistics industry, which has logged a compound annual growth rate (CAGR) of 9% over the past five fiscals. Robust growth in industry, agriculture and imports, improving road connectivity and persisting capacity constraints in railways have fuelled growth of road transportation in recent years and is expected to continue, given the economy's prospects.

In the context, a closer look at the pain points of SFOs first.

LFOs have wrested charge under GST

Under GST, there are two ways a transporter can pay taxes– the forward charge mechanism (FCM) and the reverse charge mechanism (RCM).

The LFOs prefer FCM, under which they pay 12% GST with input tax credit upfront on the services they provide, even though they would typically receive payment from clients after 2-3 months. This increases the working capital requirement, which only operators with deep pockets can afford.

The SFOs lack the wherewithal required for FCM and also do not want to get involved in tax compliance. So they prefer the RCM route and charge only 5% GST without input tax credit.

This has eroded the competitiveness of SFOs in three ways:

1. *FCM ensures better profit margins for LFOs:* A transporter with around 5 trucks can get 4-5% extra profit margin through the FCM route, given the input tax credit on purchase of trucks, tyre and spares. All or most of this benefit can be passed on to the consignor, which the LFOs are doing, giving them an edge over SFOs.

2. *Large consignors prefer LFOs:* Given the higher ITC available on engaging an LFO under FCM, consignors in industries where transportation cost holds a significant share of the total cost – such as cement – and which have high accumulated output tax, are gravitating away from SFOs. Only small consignors, who are themselves not registered under GST, or whose goods do not attract significant GST (agricultural produce such as foodgrains, for instance, *attract* zero GST), or where the value of goods moved dwarfs the input tax credit gained on transportation, prefer RCM, and thereby SFOs.

3. *SFOs losing business from LFOs as well:* Prior to GST, a chunk of the SFOs' business came from the LFOs, who hired trucks as per need. This has started changing as under FCM a fleet operator stands to get input tax

credit on the vehicle it purchases and not on hires. In other words, *transporters* are encouraged to own vehicles rather than hire them. Thus, LFOs are favouring fresh purchases this fiscal, and this is expected lower fleet utilisation of SFOs and consequently impact their profitability.

Axle-load norms have blunted the edge

Earlier, SFOs were able to charge slightly lower freight rates compared with LFOs on account of overloading their vehicles and having lower overhead costs.

As such, SFOs have a greater propensity for overloading compared with LFOs as most large consignors are inclined to ensure compliance with the norms. Thus, while LFOs largely complied with the overloading norms, many SFOs were overloading to the tune to 40-50%.

The new axle-load norms rolled out in August 2018 increased the average rated payload of trucks by ~20% and barred operators from overloading. The Ministry of Road Transport and Highways has also instructed Regional Transport Offices to raise stringency in implementing overloading ban.

LFOs moving bulk goods under rated load stand to benefit from the changed norms, while SFOs who used to overload even above the higher axle load limits stand to lose if clampdown in overloading succeeds.

High fuel prices are hurting…

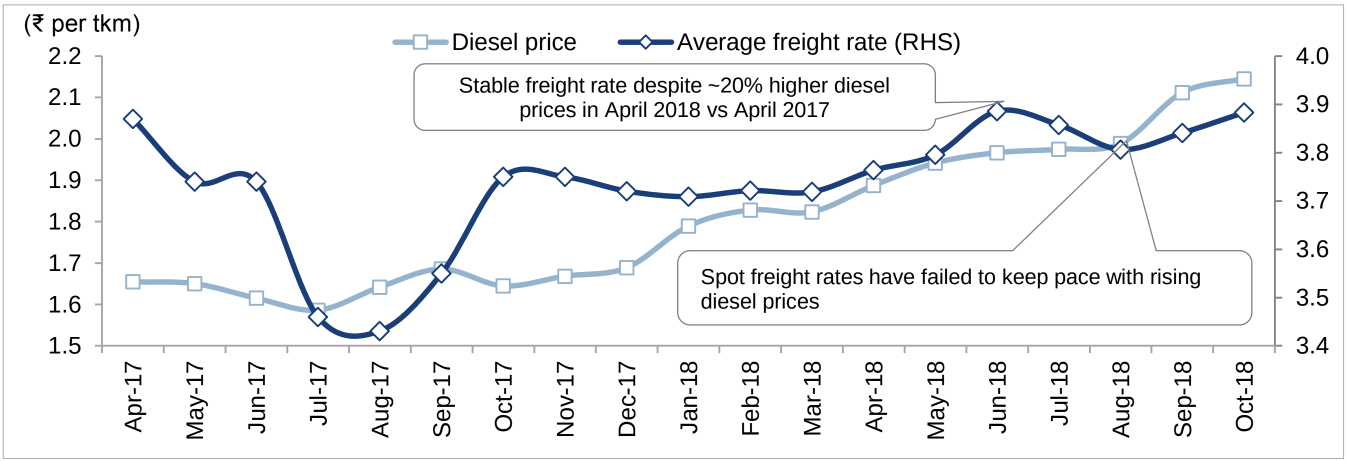
Fuel cost comprises ~50% of the freight rate, making it the single-largest cost head for transporters. So, a fleet operator’s ability to protect its margins depends on its ability to pass on any hike in this head.

Yet, only ~30% of trucks work on long-term annual contracts with consignors – typically bagged by LFOs – which have escalation clauses that allow pass-through of incremental costs. The rest, including most SFOs, work on spot freight rates.

Between April and October this year, the average price per litre of diesel rose ~21% on-year. However, spot freight rates rose only ~6%, indicating the market was not able to pass on the full increase in fuel cost, leave alone other heads.

The situation is grimmer for Medium commercial vehicles (16T GVW trucks) whose freight rates rose only ~4% over the seven months.

Despite higher diesel prices, MCV freight rates largely unchanged



Source: CRISIL Research, PTI

Note: The estimated freight rate data represents average freight rates from Delhi to 24 locations across India for a 9T payload truck

…as is the increase in other input heads

Besides higher fuel prices, transporters have been smarting from a run-up in driver salaries even as trucks lie unutilised because there just aren't enough drivers. Indeed, driver cost is expected to rise ~5% for fleet operators this fiscal.

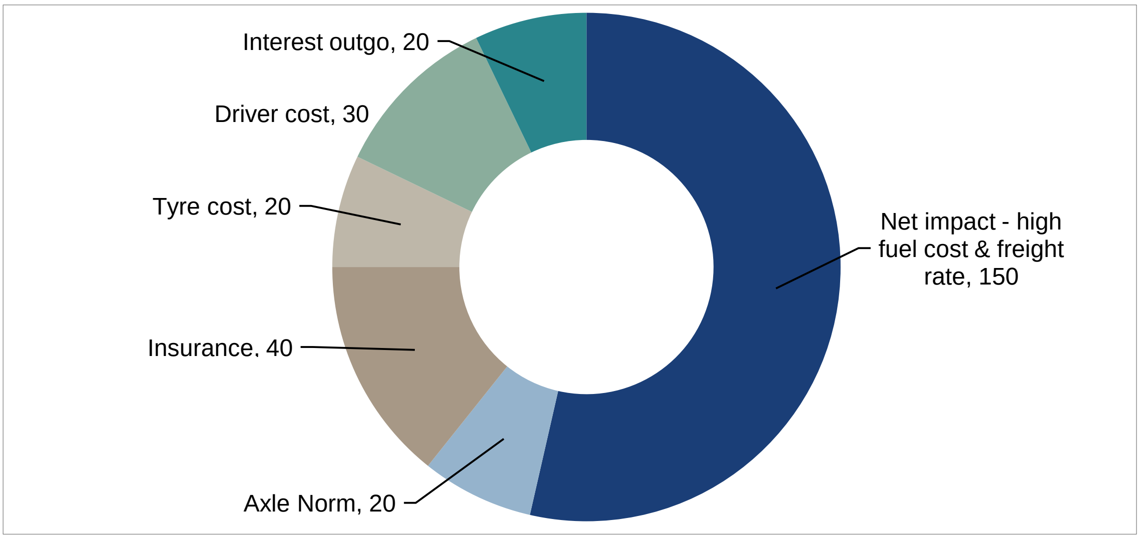
The cost of insurance has also risen, with third party covers up ~25%.

Besides, the cost of ownership of BS-IV vehicles has increased – given an 8-10% higher purchase cost – and adding to transporters' woes, tyre costs are up 5%, too.

In sum, SFOs looking at huge dent in margins this fiscal

CRISIL estimates a whopping 250-300 bps dent in the EBITDA margins of SFOs in fiscal 2019. More than half of this impact would be due to their inability to pass on the increase in fuel cost.

Contribution of various cost heads (in basis points) in lowering operating margin



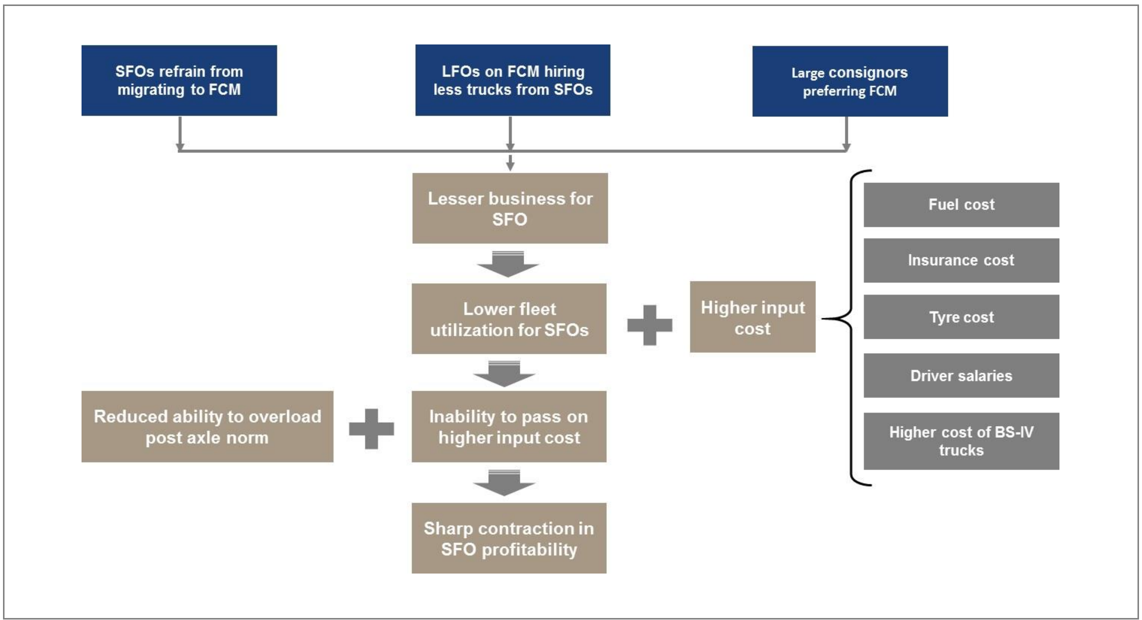
Source: CRISIL Research

For LFOs, on the other hand, higher input cost is expected to reduce margins by ~140 bps in fiscal 2019 as these were able to pass on the fuel price hike to a greater extent compared with SFOs. The blow would be lower for LFOs which have migrated to FCM – at only ~50 bps.

CRISIL's market interactions and analysis suggests LFOs would be able to retain only a fifth of the gain and share the bulk with their consignors to fetch more business and increase fleet utilisation.

The only saviour for SFOs can be an increase in freight demand in the near term, which can provide them flexibility to increase freight rates and reduce the impact on profit margins. Going into the election year, this would be a key aspect to watch out for.

Summary of parameters impacting SFO profitability



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