SECTOR UPDATE

Auto Components Industry

November, 2018

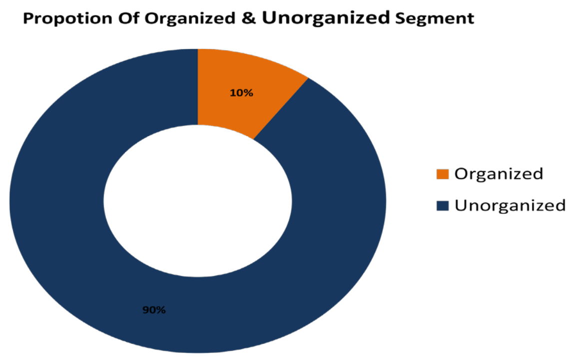
The auto component sector serves the automobile assemblers and the replacement market. The auto component manufacturing companies act as vendors and suppliers to local Original Equipment Manufacturers (OEMs) by delivering them various automobile components to be used in the assembly of a vehicle. The market size of the global auto component industry was valued at US$ 335.2b in 2016 and is expected to grow at a moderate Compound Annual Growth Rate (CAGR) of 3.2% over the next five years. Globally, investment in the OEM sector has been rising at a CAGR of 4% since 2016; sustained growth in vehicle off-take is likely to complement growth in sales of auto components.

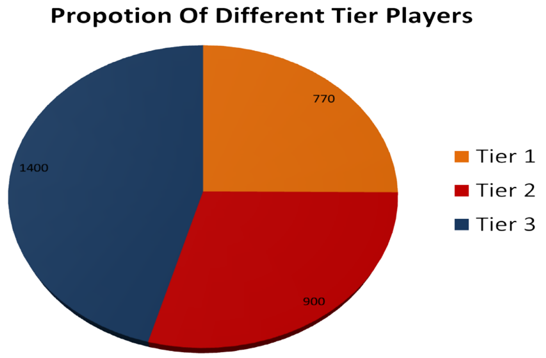
Engine Components	• Valves, Pistons, Radiators, Fuel Injection and Cooling Systems, Carburettors, Exhaust System
Transmission & Steering	• Wheels, Gears, Clutch, Axel, Steering
Suspension & Braking	• Shock Absorbers, Brake Assemblies, Suspension Bushes
Electric Components	• Starter Motors, Ignition, Wiring Harness, Plugs, power and manual windows, AC
Metal & Steel Parts	• Fuel Tanks, Sheet metal body parts, Fan Belts
External Equipment	• Bumpers, Sider Mirrors, Glass, Tyres

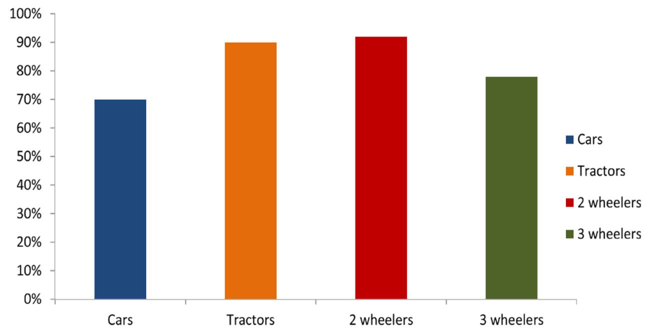
Pakistani Auto Components Industry

The Pakistani auto components market is divided into two broad segments, the organized and the unorganized segments. There are more than ~9000 establishments out of which ~400 are registered vendors for automobile assemblers, representing the organized segment.

Localization levels (proportion of components manufactured locally by OEMs) of vehicles in Pakistan are fairly high in terms of number of components installed in the vehicle. However, localization in terms of cost is on the lower side. It is estimated that two of the largest firms, Indus Motor Company Limited (INDUS) and Honda Atlas Cars (Pakistan) Limited (HCAR) have localization levels of ~55-65% for their main models. These localization levels have been achieved through decades of investing in a local parts vendor network (technology transfer, JVs with foreign part vendors, training and direct investment) and in-house parts manufacturing. For instance, INDUS and Corolla had 20% localization in 1993, which rose to 50% in 2015. Over the time, INDUS has transferred technology to over 60 local parts suppliers and set up over 27 technical assistance agreements between their vendor network and specialized international parts suppliers.







Percentage Of Parts Manufactured Locally In Terms Of Units

Currently, local auto component firms do not possess the manufacturing capability for key vehicle parts such as the engine, which makes up a major portion of a vehicle's cost. Pakistan's lack of specialization in higher value components is attributed to the fact that licensed technology is required for production of these high end components which is costly. Moreover, since local vendors do not meet quality standards of the three largest OEMs, they are unable to attain key component orders from assemblers.

Manufacturing and Key Raw Materials

A single vehicle has ~30,000 components which have different uses and purposes. The raw materials used in each component are different but majority of the components have common inputs i.e. steel, aluminum and plastic.

The major input used in key auto components is auto grade steel which is not locally manufactured in Pakistan and has to be imported by firms. The government has imposed a regulatory duty on this item which puts pressure on price structure. Exhaust systems, engine parts and disc wheels use steel. Aluminum metal is also commonly used in production of sheet metal parts and body of the vehicle. Alongside these two inputs, plastic is widely used in interior parts which make-up a small proportion of the vehicle.

Demand Outlook

Demand for auto components is mainly driven by demand for automobiles and new vehicles. This demand is catered in OEM segment where local vendors have signed contracts.

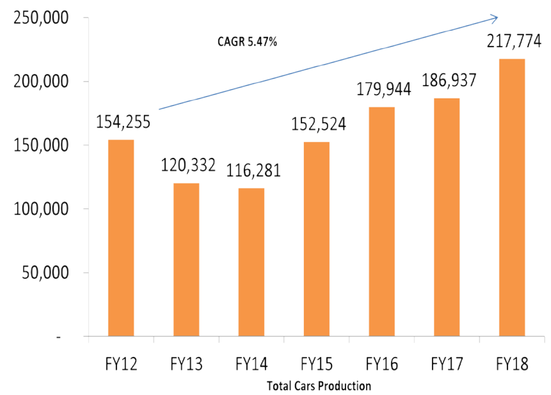
Going ahead, OEM segment's demand is expected to be robust. Over the last 6 years, the vehicle market has been growing at a CAGR of 13.3% with total vehicle sales in FY18 reaching 2240,004 units out of which car production has been 217,774 units growing at a CAGR of 5.47% over the last 6 years. With new players entering the market, volumes are expected to grow further.

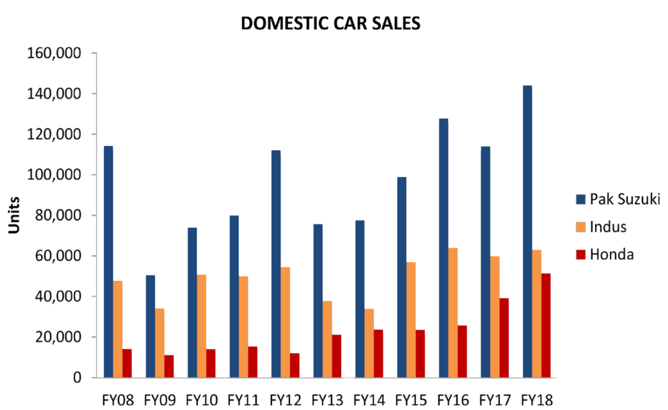
The auto parts sector's demand is also expected to move in line with the automobile sector since it acts as its supplier and vendor. The recent PKR devaluation has also tilted the incumbent automobile players towards local vendors for procurement of more components.

The Pakistani auto parts industry is ancillary to the automobile industry. Demand swings in any of the auto segments (commercial vehicles, cars, two-wheelers) have an impact on the auto ancillary demand.

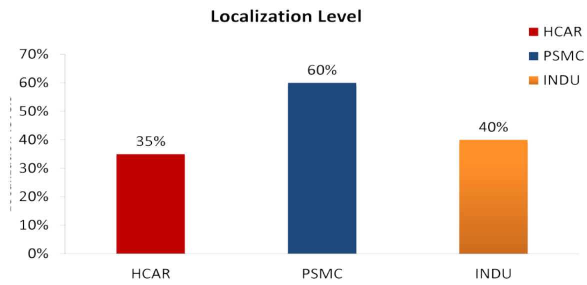
	Segment	Category	Segment Leader
1	Passenger Car	1300-1800cc 1000cc 800cc	Toyota Corolla Suzuki Wagon R Suzuki Mehran
2	LCVs And Pick Ups	LCV Pickups 4x4s	Toyota Hilux Suzuki Ravi Honda BRV
3	Trucks	No further categorization	Isuzu Hinopak Master
4	Tractors	No Further Categorization	Millat Tractors Al Ghazi Tractors Orient
5	Motorcycles	Two Wheelers Three Wheelers	Atlas Honda United Autos Road Prince

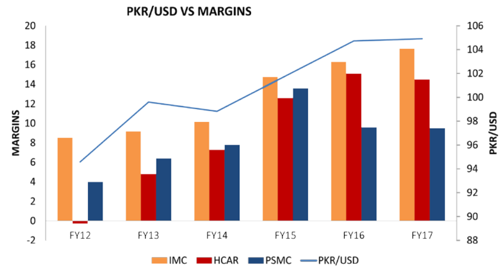
Passenger Car Segment
In the passenger car segment, Pak Suzuki has held the lead in domestic car sales over the last 10 years. Domestic car production has been recorded at a CAGR of 5.47% over the last 6 years. However, car imports have picked up pace over the last 3 years where it has posted a market share of 25-28%.

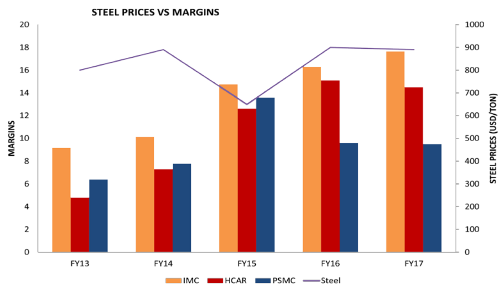




Major input costs for automobile assemblers are (1) Steel Prices, and (2) Import Costs. The local OEMs import major portion of auto components in order to meet their quality standards. Honda has the biggest proportion of import purchases of their total cost of sales and is exposed to much higher foreign exchange risk. OEMs are exposed to the following currencies, (1) Yen and, (2) Thai Baht 3) US Dollar.



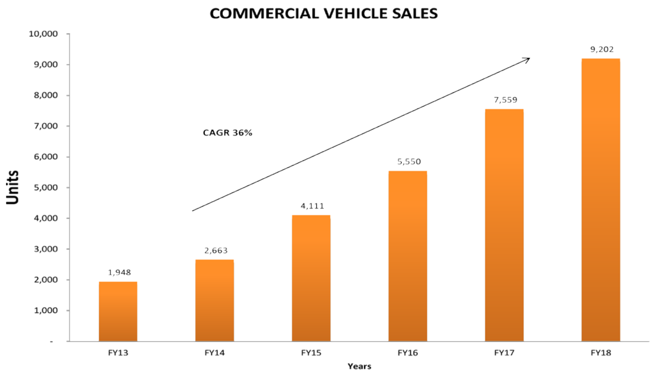




The industry so far has strong pricing power as any increment in costs has been passed onto the customer. There have been 4 price hikes this year only, as Honda and Indus Motors have tentative prices which are subject to change at the time of the delivery whereas Pak Suzuki has fixed price at the time of booking. High brand loyalty and lower dependence on import purchases leads to stronger pricing power.

Commercial Vehicle Segment

Hinopak is the market leader in this segment with the highest production capacity. Domestic commercial vehicle sales have been recorded at a CAGR of 36% over the last 5 years on the back of higher infrastructure development and increased trade activity. Ghandhara Industries is operating at the highest utilization levels followed by Master and Hinopak.



FY18			
	CAPACITY	PRODUCTION	UTILIZATION
HinoPak	**7,800**	**4,993**	**64%**
Master	**5,000**	**4,650**	**93%**
Isuzu	**4,800**	**4,884**	**102%**

AUTO DEVELOPMENT POLICY 2016-21

Particular	Greenfield	Brownfield
Definition	Greenfield Investment is defined as the installation of new and independent automotive assembly and manufacturing facilities by an investor for the production of vehicles of a make not already being assembled/manufactured in Pakistan.	Brownfield investment is defined as revival of an existing assembly and/or manufacturing facilities, that is non-operational or closed on or before July 01, 2013 and the make is not in production in Pakistan since that date and the revival is undertaken either independently by original owners or new investors or under JV agreement with foreign principal or by foreign principal independently through purchase of plant.
Plant	Duty free import of plant and machinery for assembly/manufacturing facility on a one time basis.	
Test Models	Import of 100 vehicle of the same variant in CBU form at 50 percent of the prevailing duty for test marketing after ground breaking of the project.	
Custom Duty	10% on non localized parts (30% for current Players) 25% on localized parts (45% for current Players)	10% on non localized parts (30% for current Players) 25% on localized parts (45% for current Players)
Incentive Applicability	5 years for Cars and LCVs	3 years for Cars and LCVs
Trucks, Buses & Prime Movers	Import of all parts at prevailing customs duty applicable to nonlocalised parts for manufacturing of trucks, buses and prime movers for a period of three years	
Motorcycles	The existing policy for Motorcycle industry as approved by the government and notified by FBR vide SRO 939(I)/2013 and SRO 940(I)/2013 shall continue.	

The addition of new automobile manufacturers serves as a positive signal for the auto parts industry as they can expect more volumetric sales. However, the Auto Development Policy II has offered new players import and custom duty relief, which may move them towards importing auto parts rather than procuring them locally.

As per the SRO 693 in the Customs Duty Act 1969, local OEMs are charged an additional duty on imports of auto components whereas new entrants have been offered concession and relief in these duties. The Greenfield[1] investors will be charged 10% duty on non-local parts in the first 5 years against 30% charged to existing OEMs. Also, the circular mentions that new entrants would need to catch up with localization levels of existing players which is likely to bode well for local auto component players.

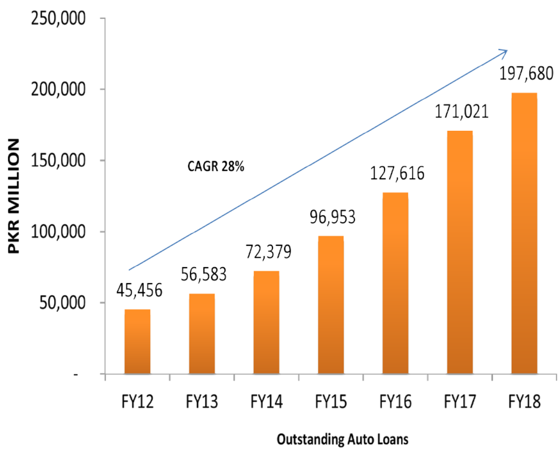
1 a type of venture where finances are employed to create a new physical facility for a business in a location where no existing facilities are currently present.

Under Automotive Development Policy (ADP) 2016-21, entrance of new players is projected to result in increasing competitive intensity for automobiles and auto parts manufacturers. These include international firms (KIA/Hyundai/Renault), which, after a poor first stint, will retest Pakistani auto market with better collaboration than before. As a result, overall production capacity of cars (vans/jeeps/pickups/LCVs) is expected to increase by more than 150,000 units (current capacity 282,900 units per annum). The new entrants will enjoy cost relief in the form of duty concessions as per the ADP II where they will be charged 10% custom duty on non-local parts against 30% for existing OEMs. Existing and proposed capacities of the automobile industry are provided in the figure below:

PROPOSED CAPACITY	
Company	**Production Capacity**
HONDA CAR	50,000
PAK SUZUKI	150,000
INDUS MOTORS	65,000
REGAL AUTOMOBILE	10,000
UNITED MOTORS	20,000
KHALID MUSHTAQ MOTORS	1,200
KIA LUCKY MOTORS	25,000
HYUNDAI NISHAT	30,000
SAZGAAR	24,000
MASTER MOTORS	30,000
DEWAAN FAROOQUE	20,000
GHANDARA NISAAN	20,200
Total	**445,400**

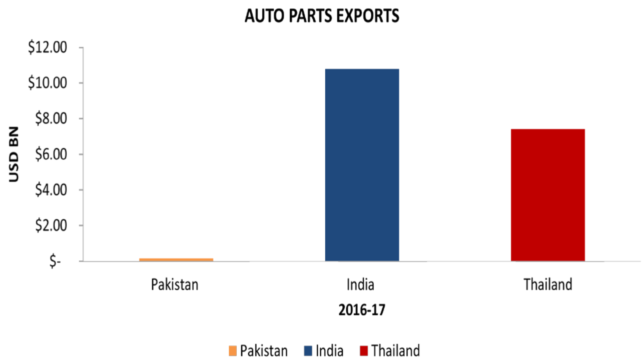
EXISING CAPACITY	
Company	**Production Capacity**
HCAR	50,000
PSMC	150,000
INDU	65,000
Total	**265,000**

Auto financing in Pakistan has been increasing with a healthy CAGR of 28% over the last 6 years. However, given the anticipated surge in interest rates in the near future, JCR-VIS expects volumetric growth in vehicle sales to subside over the medium term.



The demand potential is greater in the replacement market, especially in the informal car workshops segment. In Pakistan, people have a tendency to get their cars fixed from local car workshops which also provide spare parts for their vehicle; hence with a higher customer base there is greater potential for sales in this area. However, competitive intensity in the replacement market remains very high and it is very tough for the organized sector to compete with informal players. Counterfeit and smuggled items are easily available which makes it tough for organized firms to compete on pricing. This risk of competition makes most of private players focus on the OEM segment despite its much lower potential.

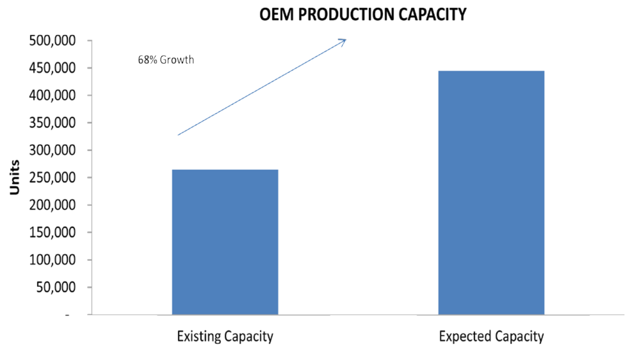
Pakistan also lags behind other countries in export of auto components as the value of auto part exports in 2016 was US$ 175m whereas Indian exports stood at US$ 10.8b and exports from Thailand were US$ 7.43b.



Supply Outlook

There are large numbers of firms operating in the industry and every vendor in the organized segment has specialized in different components which make it difficult for incumbent players to diversify their product base. Also, most organized firms have vendor/supplier contracts with OEMs for specific parts. This serves as a barrier for competing players to diversify. The informal sector is enjoying easy supply of variety as there is no barrier of distribution to workshops and spare parts markets. Moreover, since the end customer is not well aware of the technical specifications, it is easier for retailers to deceive them with counterfeits.

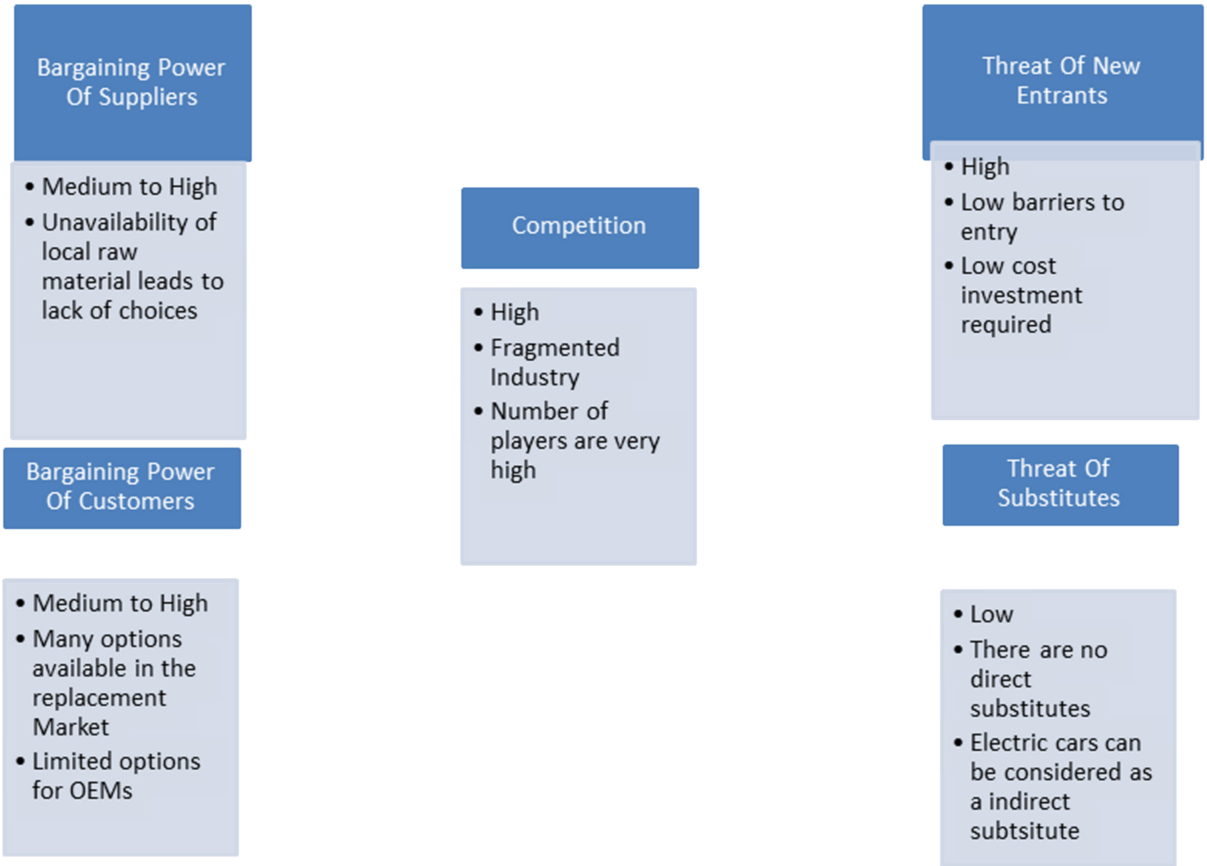
The entry of foreign auto manufacturers in the automobile segment may turn out to be a lucrative opportunity for auto parts vendors. However, the product offerings of new entrants are expected to be significantly different from local vehicles in terms of auto parts requirements. For this purpose, local vendors might require skilled human capital and new machines which may turn out to be an expensive route for them.



Since the organized segment players have vendor agreements with OEMs, any increment in cost is easily passed on to the OEM with margins being intact. However if new players enter the auto component industry, the pricing power of incumbent players might be impacted.

The incumbent players import bulk of the auto grade steel sheets from China which currently is involved in a trade war with United States of America (USA). The USA has been the biggest consumer of Chinese steel but that might not prevail further since Trump Administration has imposed heavy tariffs on import of Chinese steel. In order to compensate for the loss of revenue from USA, the Chinese steel producers might initiate price hikes for the rest of the world including Pakistan leading to cost hikes for auto component players.

Porter's Five Forces Analysis



Business Risk Factors

Chinese Dumping
Almost 80% of demand in the replacement market is being met by Chinese imports therefore with such ease in accessing the Pakistani market; Chinese importers might start to dump additional spare parts, making it more difficult for existing local auto part manufacturers.

Counterfeits
The trend of counterfeits being sold in the replacement market has prevailed and with no legal barriers present. This can become a great barrier for local vendors especially in the organized segment of this industry.

Capacity Constraints
With cars production expected to grow by 68% over the next 5 years, the local auto parts manufacturers would need to have a proactive strategy and add on more machines/plants to cater the additional demand. Operating at current capacity levels would mean missing out on incremental orders which might force new entrants to move towards imports.

Free Trade Agreements
The government is in process of negotiating free trade agreements with China, Thailand and Turkey. This action poses a severe threat to local auto parts industry as China and Thailand already have access to the Pakistani market despite import barriers and if these barriers are abolished then local players might lose their market share.

Regulatory Risk
The local auto parts industry currently enjoys shelter from international competitors in the form of custom duties and tariffs imposed by government on OEMs importing directly from international vendors. However, a reversal in the this policy would have a negative impact on the local industry as imported foreign parts would become cheaper.

FX Swings
An appreciation in the PKR will make imports cheaper for OEMs. This may result in a cut down in localization levels for OEMs, thereby reducing sales of local auto part vendors. In contrast, devaluation of PKR would maintain the order book of local vendors; however, they would need to pass on the increase in costs due to cost inflation on imports.. Currently, vendors are able to comfortably pass on the cost increases. However, in order to maintain their contracts for future sales with local OEMs, they would need to be more flexible in terms of pricing.

Interest Rate Hike
Although historically high interest rates have not made much of an impact on automobile sales, there remains some degree of interest rate risk. This is because as cost of financing a vehicle gets expensive, automobile sales decline and in turn, auto parts volumes decrease.

Analysts Contacts

Talha Iqbal
Senior Manager
talha.iqbal@jcrvis.com.pk

Ibad Deshmukh
Manager
ibad.deshmukh@jcrvis.com.pk

Hamza Amir
Assistant Manager
hamza.amir@jcrvis.com.pk

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