VIS

Credit Rating Company Limited

AUTOMOBILE SECTOR STUDY

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INTRODUCTION

The automobile industry in Pakistan includes companies involved in the production and assembling of passenger cars, light commercial vehicles, trucks, buses, tractors and motor cycles. Three car assemblers, Honda (Honda Atlas Cars), Toyota (Indus Motors Company) and Suzuki (Pak Suzuki Motor Company) have remained the major players in Pakistan's Automobile market for approximately three decades. The Government of Pakistan (GOP) with its last Automotive Development Policy (2016-21) managed to attract new entrants into the car industry such as KIA, Hyundai, MG, Cherry, Changan, Foton, DFSK, etc. Nonetheless, Honda, Toyota and Suzuki remain entrenched and dominant in the market with their strong dealership network and brand equity but these new entrants have received good market response in the last two to three years.

The automobile sector in the country contributes approximately 4 percent to the GDP and constitutes around 15 percent of the LSM sector, making it a significant contributor to industrial output and capable of meeting domestic automobile demands. It is also a major revenue generator and job multiplier. Over the past four decades, the country has developed a strong Engineering base with investments from international brands and technology transfers.

ECONOMIC OVERVIEW

PAKISTAN ECONOMIC OUTLOOK

The Pakistan economy is undergoing severe stress due to a combination of domestic and external factors. GDP growth has fallen to just 0.29% in FY2023 as compared to 5.7% in FY2022. Persistently high inflation above 30% continues to erode purchasing power and the tight monetary policy is hindering investment and growth. Import restrictions imposed to preserve foreign exchange reserves have led to shortages and production disruptions across industries. Devastating floods in 2022 damaged agriculture, infrastructure and livelihoods, inflicting losses of around Rs. 3.2 trillion (US$14.9 billion) to the economy.

With the exception of Buses, there has been a significant decline in the productivity of all sectors of the automobile industry during FY2023 as compared to the same period in FY2022. The decline was primarily attributed to the import restrictions on the automobile industry, considering automobiles as luxury items. With the aim of reducing the current account deficit, the SBP imposed restrictions on the auto industry, requiring prior permission for the import of the raw material and crucial parts (CKD) needed for local manufacturing of automobiles. The government initially allowed the industry to operate at 50% of production capacity until foreign exchange constraints eased. However, with the deteriorating situation of Pak-rupee exchange rate and availability of foreign exchange (US Dollars), the restrictions on auto imports persisted which in turn severely affected the production of the industry. As a result, the industry's size almost halved resulting in substantial revenue loss for the government and significant job losses in society.

There were additional factors that contributed to reduce in output of the automobile sector. The policy rate, which was at 10 percent one year ago, gradually increased to 22 percent. During this time, value of the Pakistani rupee significantly declined, and inflation continued to soar. As a result, auto financing became more expensive while inflation also drove up the prices of automobiles, dampening demand in the market due to reduced disposable income. Furthermore, the industry faced challenges due to the upward revision of sales tax, capital value tax and withholding tax rates which also impacted the demand of automobiles in the country.

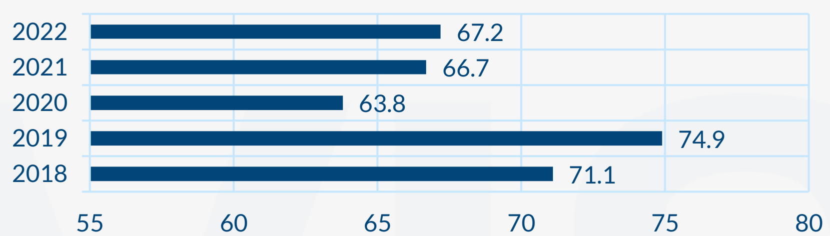
GLOBAL ECONOMIC OUTLOOK

The global economy continues to experience weak growth momentum amidst heightened uncertainty. As per IMF's latest World Economic Outlook (October 2022), global GDP growth is expected to slow down from 3.4% in FY2022 to 2.7% in FY2023, before recovering slightly to 2.9% by FY2024. Multiple challenges persist that are dampening economic activity worldwide. Key central banks have sharply raised interest rates to combat inflation thus tightening financial conditions significantly. Geopolitical tensions including the Russia-Ukraine war have aggravated supply chain disruptions, food and energy crises, and security concerns globally. Lockdowns in China to contain fresh Covid-19 outbreaks have also impacted manufacturing and trade flows. Rising costs of living, stratified labor markets and weaker fiscal support are reducing consumer purchasing power and confidence. With high debt levels, governments also have limited space for stimulus measures.

GLOBAL AUTOMOBILE SECTOR

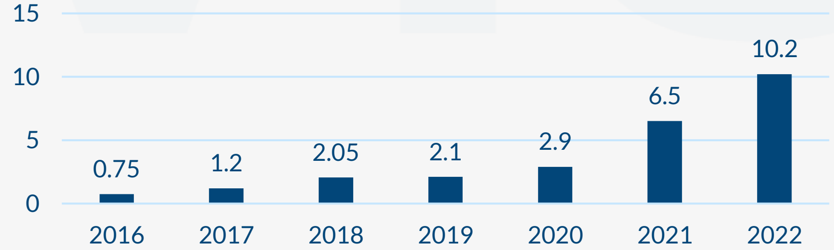
Throughout FY2020 and FY2021, the global automobile sector experienced a downward trend on the back of a slowing global economy, while COVID-19 and the Russian war on Ukraine contributed to shortages in the automotive semiconductors and further supply chain disruptions in FY2022. This chip shortage led to around 11.3 million vehicles being cut from worldwide production in FY2021, and further seven million units in FY2022. Global automobile sales show decreasing trends in FY2022 and stood at 81.63 million units as compared to 82.76 million units in FY2021 which translates into sales decline of around 1.36% on year-on-year basis. However, global car sales grew to around 67.2 million in FY2022, up from around 66.7 million units in FY2021. Car sales are forecasted to increase to 70.8 million units in FY2023 despite these challenges.

Global Car Sales (Million Units)

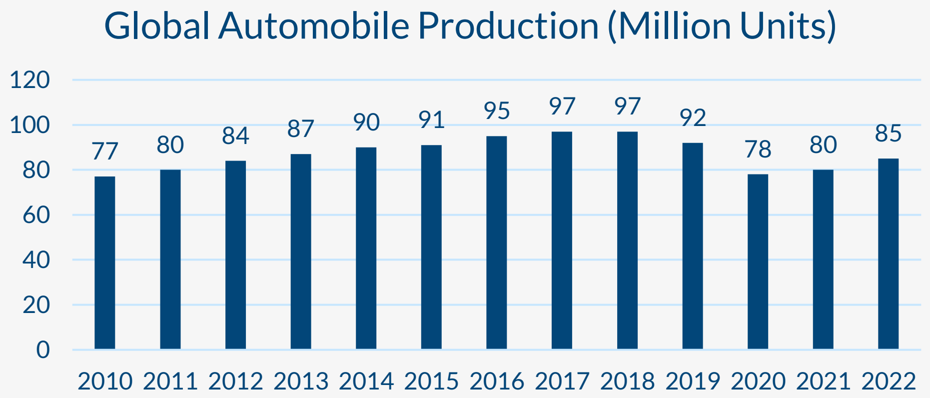


The car industry is witnessing major change in consumer preferences due to introduction of Plugin Light Electric Vehicles (PEV) which has grown tremendously during the last 5 years. Global PEV sales increased from 6.5 million units in FY2021 to 10.2 million units in FY2022 which shows impressive growth rate of around 57% on year on year basis. It has been expected that PEV sales would continue to increase in FY2023 with growth of around 25-30%.

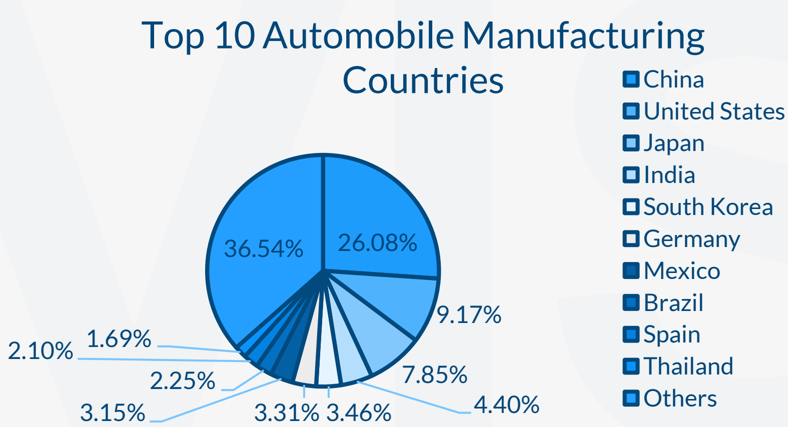
Global PEV Sales (Million Units)



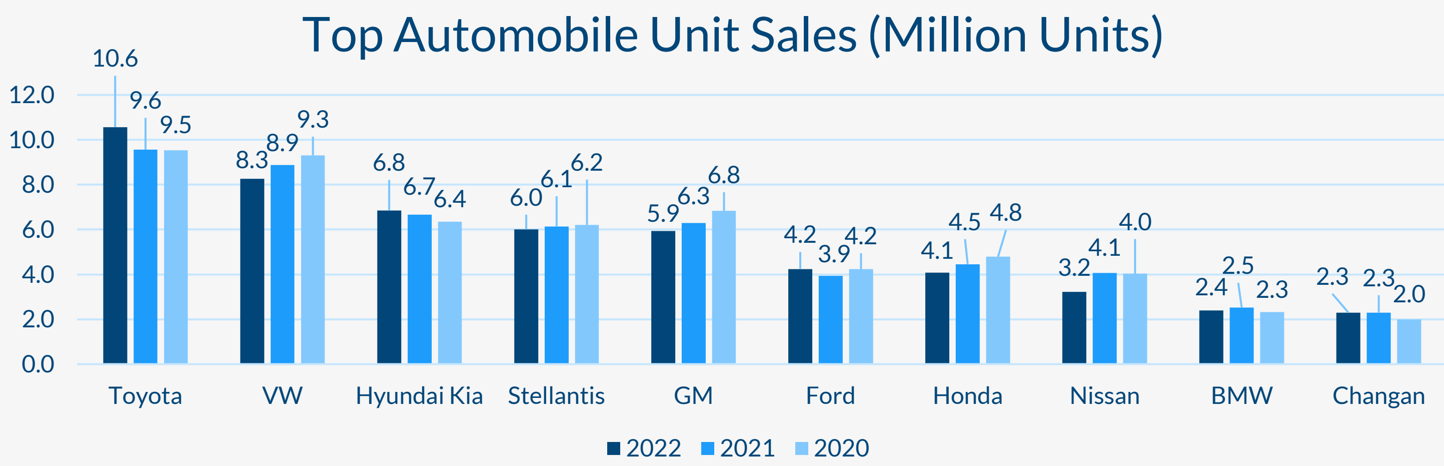
On the production side, overall global automobile production have not achieved the level of prepandemic and remained on the lower side. However, the production level is exhibiting growth trends and automobile production increased from 80 million units in FY2021 to 85 million units in FY2022.

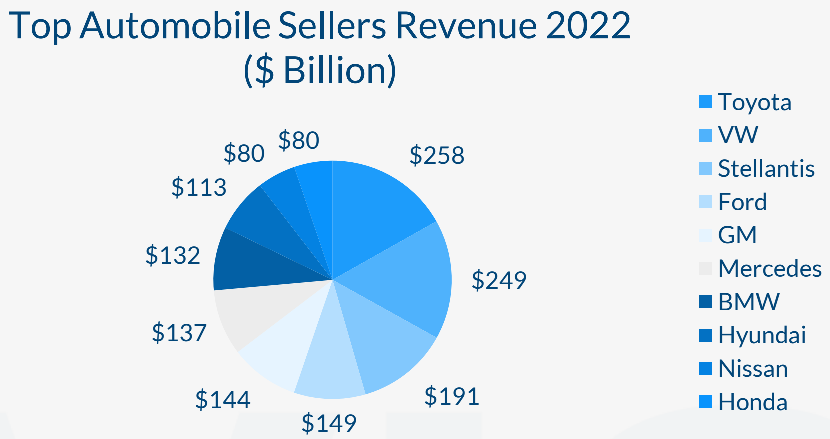


China is the largest car producer in the world with sales of around 23.24 million units in FY2022 as compared to 21.41 million units in FY2021 while overall automobile sales increased from 26.86 million units in FY2021 to 27.02 million in FY2022. The largest domestic car manufacturers in China, known as the traditional "Big Four" are SAIC Motors, Dongfeng, FAW and Changan. The United States is the second largest car producer in the world, although it produces less than half of what China does, manufacturing more than 1.75 million cars and 8.3 million commercial vehicles in FY2022. The United States' largest car manufacturers referred to as the "Big Three" are General Motors, Ford Motor Company and Fiat Chrysler. Japan is the third largest automobile manufacturer in the world with sales of 6.6 million cars and 1.2 million commercial vehicles in FY2022. The Japan's largest car manufacturers referred to as the "Big Three" are Toyota, Honda and Nissan. On a collective basis, these three countries produce more than 43% of global automobiles production.



Toyota Motor Corporation became market leaders in vehicle production and sales. As of 2022, it was the leading motor vehicle manufacturer worldwide based on global sales, overtaking the Volkswagen Group in 2020. The Toyota brand sold around 10.6 million vehicles in 2022. Volkswagen is the second largest automobile producer in the world with sales of 8.3 million units in FY2022 followed by Hyundai with sales of 6.8 million units. In terms of sales revenue, Toyota generated revenue of $258 billion in FY2022 followed by Volkswagen & Stellantis with revenue of $249 billion & $191 billion respectively.

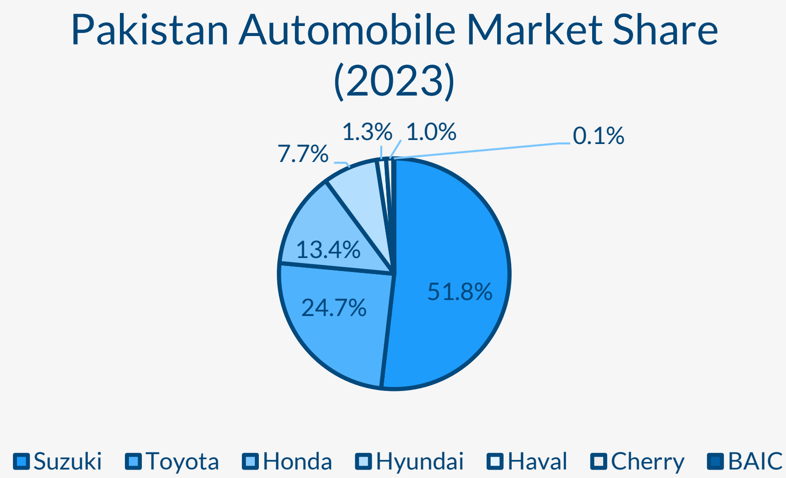




PAKITAN AUTOMOBILE SECTOR

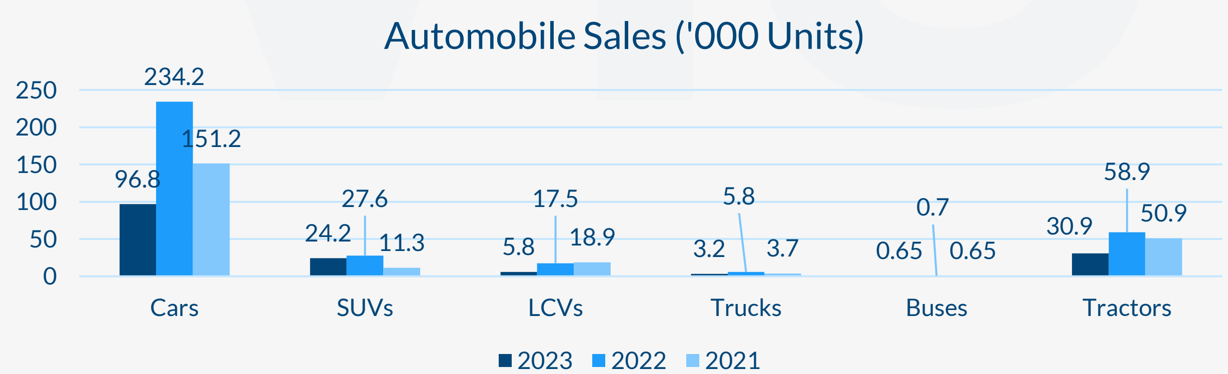
All segments of Pakistan Automobile sector were hit by the economic downturn in the country. The passenger car segment was the severely hit among all segments of automobile as its sales plummeted more than half from previous year. The sales of passenger cars reduced from 234.2 k units in FY2022 to 96.8 k units in FY2023 which is 58% decrease on a year on year basis. In the 1300 cc and above passenger car category, sales decreased from 104.3 k units to 44.5 k units. Toyota (Corolla & Yaris models) and Honda (Civic & City models) are the main contributor to sales in this segment as their sales were plummeted from 56.5 k units to 18.8 k units and 35.2 k units to 12.8 k units respectively. The 1000 cc category suffered the most which mainly represents Suzuki Cultus and Suzuki Wagon-R as its sales declined from 46.3 k units to 12.4 k units in FY2023. The below 1000cc category also suffered a dip of 52.3% from 83.5 K units in FY2022 to 39.8 K units in FY2023. The category that showed some resilience was the SUV category (Toyota Fortuner, Hyundai Tucson, Honda BRV / HRC, etc.) which witnessed a slight decrease in sales by 14% from 27.6 k units in FY2022 to 24.2 k units in FY 2023.

Among the major car manufacturers, Suzuki suffered the most as its sales nosedived by 55% from 136.1 k units in FY2022 to 61.5 k units in FY2023. The only model that showed an increase in sales was Swift whose sales increased from 6.2 k units in FY2022 to 9.3 k units in FY2023. Toyota also faced a substantial drop in sales from 74.5 k units in FY2022 to 33.1 K units in FY2023. All models of Toyota; Corolla, Yaris, Fortuner and Hilux models experienced a decline in sales. Sales of Fortuner and Hilux were plummeted by 31.9% from 18.0 k units in FY2022 to 12.2 k units in FY2023. Honda was also affected as its sales decreased from 39.4 K units in FY2022 to 16.8 k units in FY2023. Although Civic and City models sales decreased but Honda BRV / HRV models maintained their sales level at around 4,000 units. Hyundai's sales declined by 25.8% from 11.2 k units in FY2022 to 8.4 k units in FY2023. Hyundai sells three models in Pakistan; Tucson, Elantra and Sonata. Tucson is the best-selling model with sales of 4.7 k units in FY2023 as compared to 4.9 k units in FY2022. Elantra and Sonata models also showed decline in sales during FY2023.



In the Light Commercial Vehicle segment (LCV), sales decreased from 17.5 k units in FY2022 to 5.8 k units in FY2023. Suzuki Ravi experience massive dip in sales as its sales decreased from 14.2 k units in FY2022 to 3.8 k units in FY2023. Hyundai Porter sales also decreased from 1.8 k units in FY2022 to 1.3 k units in FY2023.

In the Bus segment, sales didn't decrease much and stood around 650 units in FY2023 as compared to about 700 units in FY2022. However, in Truck category, sales fell from 5.8 k units in FY2022 to 3.2 k units in FY2023. Hino witnessed a decrease in truck sales from around 900 units to about 600 units, while its bus sales increased from around 150 units to about 250 units approximately. Master experienced a decrease in both truck and bus sales, from 1.7 k units to around 950 units and approx. 400 units to around 250 units, respectively. Ghandhara's truck sales decreased from 3.2 k units to 1.6 k units while its bus sales increased slightly from around 125 units to approximately 140 units in FY2023. In the tractor segment, sales experienced a heavy drop of 47%, from 58.9 k units in FY2022 to 30.9 k units in FY2023. Al-Ghazi



tractor sales decreased from 23.9 k units to 12.3 k units while Millat Tractors sales decreased from 35.0 k units in FY2022 to 18.6 k units in FY2023.

The sales of two-wheelers and three-wheelers witnessed a major dip by 34.8% from 1,820 k units in FY2022 to 1,180 k units in FY2023. Atlas Honda was the market leader in the two-wheeler segment, however it sales decreased to 1,005 k units in FY2023 from 1,360 k units in FY2022 showing sales decrease of 26.1%. Suzuki was the second largest player in the two-wheeler segment, as it sold 29.2 k units in FY2023 as compared to 37.8 k units in FY2022. Qingqi was the market leader in the three-wheeler segment, as it sold 6.3 k units in FY2023 down by 54.8% from 13.9 k units in FY 2022. Sazgar was the second largest player in the three-wheeler segment whose sales decreased from 15.6 k units in FY2022 to 9.3 k units in FY2023.

The financial snapshot of top three car manufacturers in Pakistan is presented below:

	Amount in Million Rupees		
	Pak Suzuki Motor Company	Indus Motor Company	Honda Atlas Cars
	Annual (Dec 2022)	Annual (June 2023)	Annual (March 2023)
Sales	202,466	177,710	95,087
Gross Profit	11,684	7,931	7,161
Other Income	3,211	14,179	2,321
Net Profit	(6,336)	9,664	260
Net Profit Margin	-	5.4%	0.3%
Total Borrowing	13,198	280	3,363
Total Equity	19,770	60,069	19,264
Net Cash Flow from Operations	(29,776)	(103,594)	(4,101)
Current Ratio	0.98	1.6	1.3
Debt to Equity Ratio	0.7	0.0	0.2

The Pakistan Automobile industry is also dependent on the local vendors for the supply of parts and accessories of automobiles including cars, commercial vehicles, buses, trucks, tractors and two & three wheelers. These vendors carryout different processes like casting, molding, machining, glass production, etc. to produce different parts while using all sort of materials like steel, plastic, rubber, fibers, etc. The local vendor industry consists of around 1200 manufacturers, out of which 278 are “Tier One” Parts Manufacturers and member of “Pakistan Association of Automotive Parts and Accessories Manufacturers” (PAAPAM). It is estimated that investment in vendor industry has exceeded USD 1.5 billion as of now.

PAKISTAN AUTOMOBILE SECTOR ISSUES

CYCLICAL INDUSTRY

Pakistan Automobile industry is characterized as cyclical industry and sales of automobiles are dependent on several factors including economic conditions in the country. Due to sluggish economy and lower demand, sales of automobiles are effected severely. Since the economic downturn also affects disposable income, sales are projected to remain low.

RISING RAW MATERIAL COST

Over the last two years, Pakistan Automobile sector has experienced continuous price hike owning to global commodity prices which has increased the cost of raw materials including steel, rubber and plastic. Since these raw materials are major input in the production of automobile, the prices of automobiles in the country will remain high.

LACK OF LOCALIZATION

Localization plays a pivotal role in the sustainability and development of any sector especially during tough economic conditions. Pakistan Automobile industry lacks localization since 70-80% parts are imported from different manufacturers around the globe. Despite the government's effort to promote localization, auto manufacturers have not putserious efforts to reduce reliance on the imports of parts. This has made the automobile sector vulnerable to price hike on both imported CKD parts as well as locally manufactured parts, as raw material for locally manufactured parts is majorly imported.

EXCHANGE RATE FLUCTUATION

The exchange rate fluctuation between US dollars and Pak rupee is the major factor that has significant impact on the cost of the parts and raw material used in the production of automobiles. Since the Pak rupees has been depreciated more than 40% against US dollar during the year, the cost of the parts and raw material have increased immensely making automobile more expensive as compared to last year.

INFLATION

Inflation is another factor that has impacted the automobile and other sectors in Pakistan. Since Pakistan economy has experienced two-digit inflation during the year, cost of production has increased making automobiles more expensive.

BAN ON IMPORTS

Despite the government's effort to increase automobile players in Pakistan, recent ban on import of automobile parts and raw material has exacerbated the situation. The ban on import of raw material & parts and putting them into "Non-Essential Items Category" have resulted in temporary closure of industry and loss of jobs. This situation not only impacted the industry but also the economy since automobile is major contributor to GDP of the country.

GLOBAL SUPPLY CHAIN DISRUPTIONS

The global supply chain disruptions have impacted the automobile sector during the last two years post pandemic and Russia Ukraine war. The companies around the globe faced chip shortages due to which production activities of various automobile manufacturers impacted. Since our automobile sector is heavily dependent on import of CKD units, supply chain disruptions impact the production activities and ultimately the sales of the companies.

TAXES ON AUTOMOBILE SECTOR

The automobile sector is one of the heavily taxed sector of Pakistan economy. There are number of taxes applicable on automobile sector which includes custom duty, regulatory duty, sales tax, federal excise duty, withholding tax on purchase of vehicle, income tax on vehicle registration, etc. which impact the prices of automobile.

HIGHER FINANCING RATES

The government has increased the policy rate during the year in order to curb the inflation in the country. However, this increase in policy rate has severely impacted the automobile industry which rely heavily on automobile financing by the banks. With the increase in policy rate, the financing of automobiles have reduced substantially. In addition to that, SBP has also reduced financing period from 5 years to 3 years for vehicles above 1000 cc and from 7 years to 5 years for vehicles upto 1000 cc. The financing amount has been reduced as well to Rs. 3 million in addition to minimum down payment which has increased from 15% to 30%.

SECTOR DYNAMICS

The prevailing sluggish economic conditions has led to restriction on opening of Letters of Credit (LCs), restrictions on import of CKD units, availability of foreign exchange, devaluation of Pak rupee, high inflation and extremely high financing rates. Unless these challenges are addressed, the industry will not revive and operate at medium to full capacity.

The Government has already announced Auto Industry Development and Export Policy (AIDEP) 2021-26 with the aim of making small cars more affordable, adding safety features, improving car quality and reduction in taxes on EV vehicles. Salient features of Auto Policy include reduction in custom duty on CBU imports of Electric Vehicles from 25% to 10%, review tax exemption on imported vehicles every year, tax incentives for export of vehicles and spare parts, custom duty on spare parts for electric vehicles fixed to 1%, tax exemption on locally produced car with engine upto 800cc, etc. However, the government has not given valuable support to automobile sector to address prevailing issues at the moment causing industry shutdown, loss of jobs and revenue loss for the country.

RECENT DEVELOPMENTS

CHANGING CONSUMER PREFERENCES

Globally these has been a change in consumer preferences for automobiles which have been transforming from conventional to Electric & Hybrid Vehicles in the last few years. The main reason behind this shift is consumer preference for more environment friendly cars with low emissions and better fuel efficiency. These changes are going to drive the future of automobile sector and the companies that invest in this technology will benefit in the future. Pakistan still lacks behind on adoption of electric & hybrid vehicles. However, few manufacturers have started to invest in hybrid technology in Pakistan for the production of EV and Hybrid vehicles. Meanwhile, hybrid cars are being imported in Pakistan on small scale and consumers have shown interest in these vehicles.

AUTOMOBILE INDUSTRY SHUTDOWN

The sluggish economic conditions has left the automobile industry to operate intermittently based on the number of orders received monthly. The higher cost of vehicles and enormously high financing rates have dried up the demand of new vehicles. As such, no major change in demand is forecasted in the near future if any of the above factors don't change.

REGULATORY DUTY ON CBU

Although tough economic conditions resulted in reduced demand of automobiles in the country, Government abolished regulatory duty on Complete Build Units (CBU) during the year which created more favorable conditions for imported vehicles. On the other hand, taxes on locally produced vehicles also increased which resulted in taxes approaching almost 50% of the total cost of locally assembled vehicles. This policy divergence from Government has further constrained the growth potential of local automobile industry.

SUPERTAX ON AUTOMOBILE SECTOR

The Finance Act 2023 increased super tax on Automobile sector from 4% to 10% which has adversely impacted the automobile industry. The profitability of the automobile sector will be reduced further and efforts to remain sustainable will be impacted.

PRODUCTION ON DEMAND

Another trend in the sector is production of vehicles based on orders received rather than mass production to immediate supply of vehicle to customers. Automobile players are the main beneficiary of this trend since their working capital requirements are minimal. On the other hand, customers have to wait for delivery of vehicles upto 6-8 months. A change in this trend will help improve demand situation and benefit to consumers.

SECTOR OUTLOOK

The outlook remains uncertain in the short to medium term owing to weak macroeconomic conditions, high inflationary pressures, high raw material & CKD unit costs, availability of foreign exchange and high financing rates. However, government has eased out import restrictions on the automobile sector recently which will help increase production of automobiles in the country. It is pertinent to note that government policy towards import of CBU units will also plays a pivotal rule for sustainability of automobile sector. The addition of EV and hybrid vehicles in the automobile sector have changed the dynamics of the global automobile industry while Pakistan automobile sector remained slow to respond to the changing consumer preferences. Reforms in the industry, removal of import restrictions, targeted policy efforts towards localization of parts and tax incentive on EV and hybrid vehicles will revive the outlook of the Pakistan automobile sector.

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