INDUSTRY RISK ANALYSIS

Automobile

October, 2021

Assessment of industry risk is an essential part of credit rating process. The industry risk assessment sets the ceiling for ratings of individual entities within a given industry. It focuses on the degree of cyclicality and the strength of competitive forces along with the extent of capital intensity, vulnerability to technological change, level of regulatory interference and energy sensitivity. All these factors are assessed on a scale ranging from High to Low to assign an overall risk level to each industry. Industry risk categorization for different industries is available on our website under Sector Updates "Industry Risk Analysis", (https://docs.vis.com.pk/docs/Industryrisk062021.pdf).

This document explains VIS approach to assess industry risk of Automobile sector of Pakistan.

Automobile Sector in Pakistan

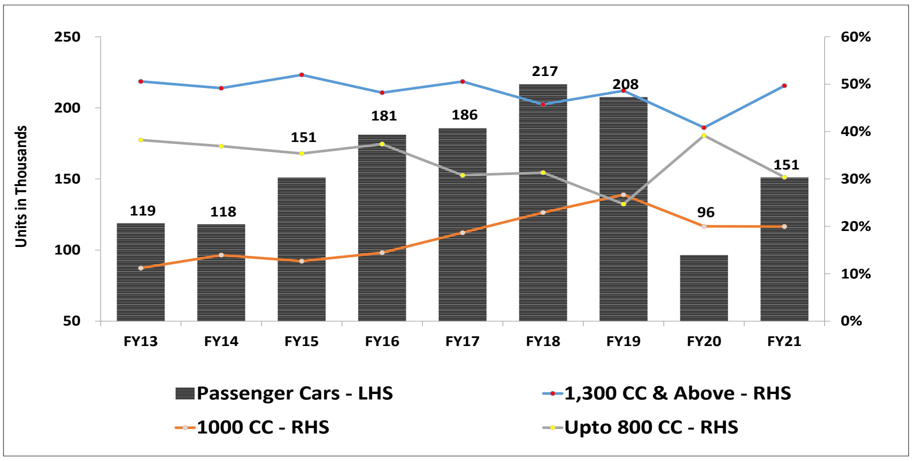
Three assemblers, Honda (HCAR), Toyota (INDU) and Suzuki (PSMC) have ruled the Pakistan's Automobile market for approximately three decades in an oligopolistic environment. The Government of Pakistan (GoP) with its last Automotive Development Policy (2016-21) managed to attract new entrants into the industry such as KIA, Hyundai, Changan. Nonetheless, Honda, Toyota, and Suzuki remain entrenched and dominant in the market with their strong dealership network and brand equity.

OVERALL INDUSTRY RISK

High
High to Medium
Medium
Medium to Low
Low

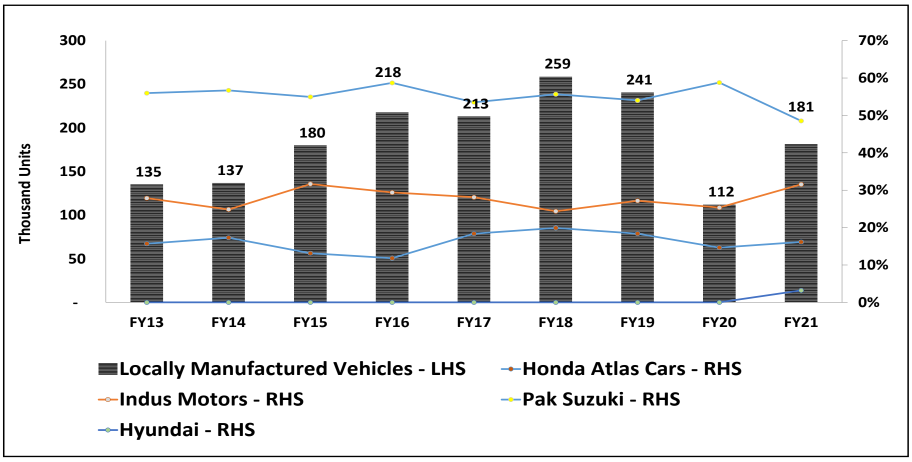
For FY20, auto sales which were already on a downward trajectory due to previous import compression policies pursued by GoP, significant currency devaluation, high interest rates and imposition of taxes and duties on raw materials, slumped further with the pandemic led economic slowdown. However, the outgoing fiscal year FY21 turned out to be a strong recovery period for the auto sector amid the ongoing Covid-19 pandemic as car sales grew by 57%, followed by 20% increase in trucks, 17% in buses, 23% in jeeps, 57% in pickups, 55% in tractors and 39% in two- and three-wheelers. Total units sold of passenger cars after declining to 96,355 in FY20, have rebounded to 151,182 units in FY21, exhibiting an improvement of 57% (as per PAMA). Sustained economic recovery, prevailing low interest rates and the resultant increase in consumer car financing, new models introduced and high liquidity of consumers are the major growth factors in the sector's volumetric performance.

Figure: Sales & percentage breakup of local passenger cars



Source: PSMA (LHS – Left hand side of the graph, RHS – Right hand side of the graph)

Figure: Domestic car sales (Passenger Cars, LCVs, Jeeps & Pickups)



Source: PSMA (LHS – Left hand side of the graph, RHS – Right hand side of the graph)

The growth in demand is expected to continue with new incentives and tax benefits announced by government for auto sector along with the upsurge in auto-financing. Increased competition also bodes well for overall sector dynamics. Exchange rate risk, cyclicality in sales due to slow down in GDP growth and political uncertainty remains the key business risk factors.

Currently, Pakistan has a small automobile market on a global scale. The local annual demand for four-wheelers is only ~200,000-300,000 units. However, the domestic demand for automobiles in the country is expected to grow to ~600,000 units per annum in the next five years, according to the government's own estimates. Low levels of localizations have plagued the sector since its early days, as complex and multicomponent parts such as gearbox and engine are imported. Most parts are brought in from Thailand and Japan. This makes the financial performance of the companies functioning in the industry vulnerable to exchange rate risk.

Moving ahead, the government aims to cure many ailments of the automobile industry in Pakistan through the upcoming Auto Industry Development & Export Policy, 2021-26 (AIDEP21-26). Though the focus of the next automobile policy is expected to remain on Internal Combustion Engine Vehicles (ICEV) s, the government is going to aim for a slow transition to Hybrid Electric Vehicles (HEV) in the very long term. It will also aim to develop the sector into an export industry.

Given the industry's sensitivity to macroeconomic variables such as GDP growth, disposable income growth, and interest rate environment, the cyclicality of the automobile industry has been assigned as high risk. Moreover, a quantitative analysis was conducted by using VIS industry database which also depicts strong correlation between the financial performance of the sector and the economic cycles in the country. Significant rupee devaluation in the last two years raised the cost of imports and affected the auto demand. Even though the US-China trade war resulted in steel prices in the international market remaining depressed; the local auto industry could not absorb its benefit due to currency devaluation, low localization, and high dependence on imported raw materials.

Localization Levels	
Passenger Cars & LCVs	50% – 60%
Trucks/Buses	~30%
Tractors	~85%
Motorcycles	~90%

The existence of barriers to entry, availability of substitutes, and risk in growth trends are important factors of competitive risk assessment. Barriers to entry in the automobile sector of Pakistan are considered to be high as the market is almost completely dominated by three main manufacturers. Even with new entrants, the situation has not changed much, as consumer behaviour is deeply rooted in brand loyalty. The high capital cost of Rs.10bn with a payback period of 5-10 years is a major hurdle that new entrants face. The government also favours local players in an attempt to encourage localization of auto parts, which further squeezes the probability of competitiveness in the industry. However, with the introduction of Auto Policy 2016, the government had given several incentives which have resulted in new players entering the market and increasing competitive environment. With new entrants in the race, it is expected that competition will enhance, and the industry will witness a shift in market structure in the long term. Nonetheless, these factors constraint the entry of new manufacturers, thereby resulting in low risk of new competition.

In terms of substitution, the risk is low as electric vehicles are the only substitute product and the infrastructure needed for the same would be capital intensive. Moreover, the energy issues and high unit cost of electricity for consumers hinder the entry of players of this particular segment in Pakistan. Moving forward, the government plans to incentivize the introduction and production of such vehicles in the country; therefore, the situation might change in the long term.

Historically, domestic car sales grew at a CAGR of ~10% over the past six fiscal years (FY13-19) while the average GDP growth has remained 5.1% in the mentioned period. With a low motorization rate (18 vehicles per 1000 people) and projected rise in per capita income which would continue to support the industry sales and growth, the risk in growth trend is low.

The industry is highly capital intensive, as ongoing CAPEX requirements or any further expansions or model changes entail a sizable spend. Therefore, capital intensity has been assigned high. Any new model launch also requires a large capital investment to upgrade the plant according to the needs of the new vehicle. Therefore, automobile assemblers in Pakistan have historically been reluctant to introduce new models and instead preferred the face-lift strategy to retain or induce consumer demand.

This leads us to the next important industry risk factor, technology risk, which has been given a medium risk rating. Previously, this risk factor is assigned a low rating because manufacturers avoided technological and product innovations due to high capital expenditure costs and lack of motivation because of low competition. However, given the entry of new players and significant new product launches over the last 1 to 3 years, product obsolescence risk can now be considered medium.

Regulatory risk has also been assigned as medium. The automobile sector remains fairly regulated, especially in terms of higher duties and taxes compared to regional players. Policies pertaining to car imports have remained inconsistent over the years. However, the government has historically favoured the local auto manufacturers with respect to policy changes.

Overall energy costs in Pakistan are significantly higher than the regional average; however, the auto industry is not energy-intensive and almost all players in the local sector have backup power generation. Hence, the energy sensitivity has been assigned as medium risk.

In view of all the risk parameters discussed above, overall industry risk for Automobile Sector has been assigned as Medium.

Table 1: Summary of Industry Risk Factors

AUTOMOBILE								
Cyclicality	**Competition**				**Capital Intensity**	**Technology Risk**	**Regulatory Framework**	**Energy Sensitivity**
	Risk of Effectiveness of barrier to entry	**Risk of Substitutes**	**Risk in Growth Trends**	**Overall**				
High	Low	Low	Low	Low	High	Medium	Medium	Medium

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