A Glimpse into the Auto Universe

Thursday, January 6, 2022

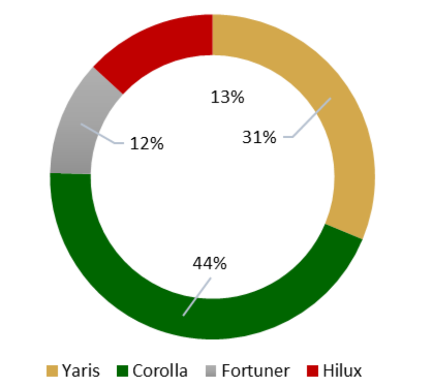
Overview on the new auto policy

The aim of the new Auto policy is to primarily enhance local production within the country so as to not rely on imported expensive parts (which puts a major burden on the country's Current Account and FX reserves). To rectify this issue the government has decided to reduce import duty on nonlocalized (currently 30%) and localized parts (currently at 45%) to 15% and 30% for non localized and localized respectively.

Further aim of the policy is to enhance EV and HEV production and usage within the country. To ensure this the government has decided to provide some key measures such as the concessionary rate of 1% GST on the sale of EV's and a further 4% concessionary Custom Duty rate on hybrid parts as compared to the traditional rate of 30% for ICE (as can be seen from the table on pg.2) which should encourage the local production of EV's and HEV's within Pakistan. However the government needs to ensure that the relevant infrastructure is up to par so as to ensure the consumers get maximum benefits through their purchases.

Further the government is seeking to enhance exports and thus has set export targets for the auto sector where by the government has set However to compete on a global level Pakistan needs to step up their game in terms of quality and cost efficiency. Finally the government is also trying to increase the local production up to around 600-650 k units per annum by 2025-26 from the current production capacity of 350 k units per annum. This will create more job opportunities within the local market and the emergence of new players will create healthy competition which should provide price stability and top notch quality for the local consumers.

INDU Sales Mix (Nov-21)

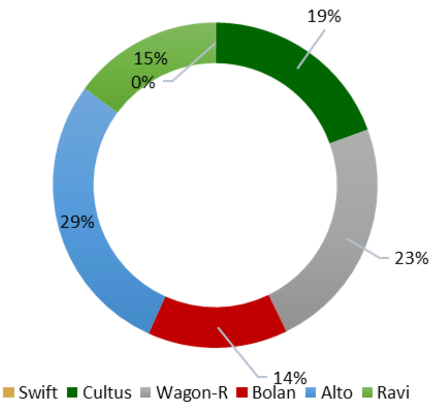


Source: PAMA, Darson Research

INDU- Going on the offensive

INDU is in the process of setting up a HEV facility worth $100mn which is expected to come online within 3 years. As discussed above the new policy is geared towards providing very lucrative measures towards EV's and HEV's thus this will provide INDU with a great opportunity to gain first mover advantage and capture a significant market share. However the recent surge in FED (↑5%) of 2000+ cc cars would cause the company to likely raise Fortuner prices by 386k-492k which could hamper their sales going forward. Finally the government is mulling over enhancing the Regulatory Duty on HEV's from 15% to 50% which will benefit the local manufactured HEV's and make them more attractive hence a positive future outlook for the company based on their above mentioned plans.

PSMC Sales Mix (Nov-21)

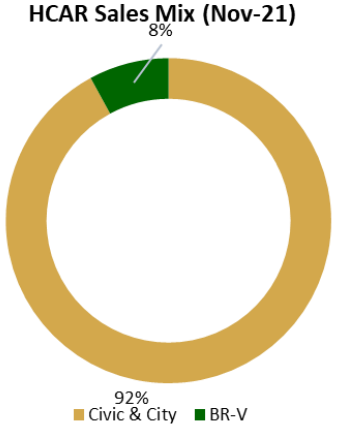


Source: PAMA, Darson Research

PSMC- Benefits Incoming

The budgetary measures which were primarily geared towards the small car segment (>1000 cc) as the government is trying to make the cars affordable for the general population. Since PSMC primarily operates within this segment hence the favorable policies allowed the company to reduce prices by an average of 7% which enhanced the company's revenues by 89% YoY for 5MFY22. The company is also seeking to launch the new Swift model in CY22 which should have a positive impact on the company's revenue going forward. Further the restrictions and hefty taxes on imported cars and CBU's should assist PSMC's revenue as they wont have to worry about competing with the imported car segment. The company is also planning to launch the new swift model in CY22 which should bode well for the company's revenue.

HCAR Sales Mix (Nov-21)



Source: PAMA, Darson Research

HCAR- Exciting Future Ahead

The company's new city model attracted a lot of positive attention from the general public as the car saw prebooking's in excess of 10K+ units. This allowed the company to post positive returns of 29% YoY for 5MFY22. However the company's growth was hampered somewhat due to disruptions in the supply chain which caused massive delays in delivery. Going forward the company is seeking to bring the new Civic model within MY23 which should boost company's sales given that they can get a handle on their supply chain issues. Further the stringent actions taken by the SBP in regards to auto financing may hamper the company's future revenues as almost 45% of HCAR revenues are derived through auto financing (the highest in the sector).

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Recent Tax Amendments

The government has recently announced certain tax amendments within the current financial bill whereby certain taxes were enhanced so as to curtail demand to control inflation. Some of the prominent terms were the enhancement of sales tax from 12.5% to 17% for cars above 850cc and a further hike in FED (federal excise duty) by 2.5%-5.0% (relative to the engine capacity) across the board. This will have a negative impact on the industry as the auto prices may see another hike of around 4-6% due to the above measures.

Even though the government wants to encourage manufacturing and enhance local demand however the above measures contradict those plans and thus creating uncertainty within the industry. This uncertain and ambiguous environment may be crucial in curtailing inflation but may hamper the growth of the overall sector.

New Auto Measures	Impact
• Customs Duty on the import of localized parts set to be reduced to 30% from 45% • Customs Duty on the import of nonlocalized parts set to be reduced from 30% to 15% • Introduce a localized parts list that would be updated every 6 months • Ban on locally manufactured/imported vehicles after June 30, 2022, which is not compliant with shortlisted WP 29 regulation.	To enhance local production and sales for passenger cars. Further to encourage local manufacturers to introduce new variants at a faster pace thus discouraging imported CBU vehicles.
• Import duty on Electric Vehicles (EVs) will be reduced to 10% from 25% • Customs duty on CKD kits for electric vehicles fixed to 1%. • Customs duty on CBU imports of electric vehicles reduced from 25% to 10%. • GST of 1% on the sale of EV's • To reduce sales tax on hybrid electric vehicles to 8.5%. • Concessional GST of 8.5% on HEV's up to 1800cc and 15% on vehicles in excess of 1800cc • Enhance Regulatory Duty from 15% to 50% on HEV's for 1501cc-1800cc	To encourage local production of Electric Vehicles and Hybrid Electric Vehicles within the country.
• Real time tracking status to be provided to the consumer regarding the booking and manufacturing status of the vehicle • If the car manufacturer delays the car for over 60 days (2 months), the company will pay KIBOR + 3%. • Car manufacturers to set a 10% export target by 2026. • Consumer Protection (Kibor + 3% on delivery beyond 60 days)	Provide relief and protection to the consumer.

Amended Policies within the Finance Act Bill 2021	Impact
Imported Cars • FED on cars having engine capacity of 1001cc-1799cc will be increased from 5% to 10% • FED on cars having engine capacity of 1800cc-3000cc will be increased from 25% to 30% • FED on cars having engine capacity of 3001cc will be increased to 30% • FED on 4*4 double cabin will be increased from 25% to 30% ***Local Cars*** • Cars having engine capacity greater than 850cc will be charged a 17% sales tax • FED on cars having engine capacity of 1001cc-2000cc will be increased from 2.5% to 5% • FED on cars having engine capacity of greater than 2001cc will be increased from 5% to 10% • FED on 4*4 double cabin will be increased from 7.5% to 10% • Increase of GST from 12.5% to 17% on cars having engine capacity greater than 850cc	New Adjustments provided within the amended Finance Bill 2021 to curtail demand and control inflation. May have negative impact on the car prices as they might be hiked to offset the impact.

Source: *AIDEP, ECC, Darson Research*

A Glimpse into the Auto Universe

Overview on cash position for OEM's-

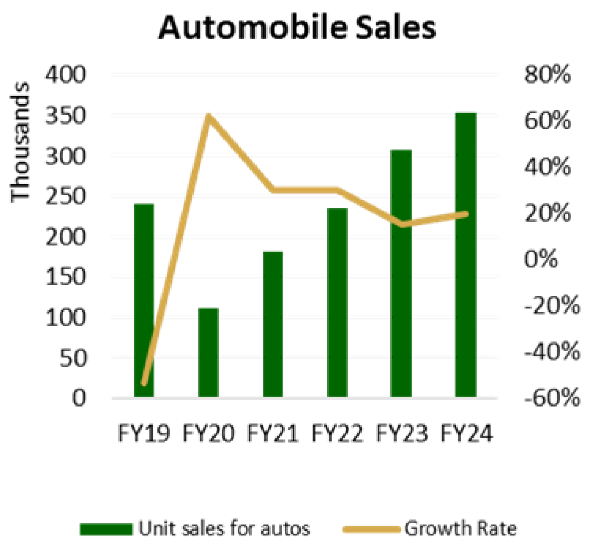
The Auto Assemblers in Pakistan especially the big three tend to operate on business models where they intake advances from customers and thus have hefty cash/bank balances on their balance sheets.

- If we look at INDU's (Indus Motor Company) latest balance sheet as at 30 September-21 we can observe that the company has PKR 71.8 bn 'receivables from customers & dealers'. The average quarter units sales in FY-21 for INDU was at around 14,000 units thus If we take this into account then we can observe that the company has bookings future bookings for the future quarter
- Further if we observe PSMC's (Pak Suzuki Motor Company) balance sheet at 30 September-21 then we can observe that the company has advance receivables from customers worth PKR 34.9bn. The company's average unit sales for the past 4 quarters was 27,246 units thus keeping the above in mind then we can assume that the company has advanced bookings for the future quarter
- Finally we look into HCAR (Honda Atlas Cars) where the company has not specified the amount that they have received as an advance from the customers. The cash and bank balances for the company stood at PKR 28.6bn as at 2QMY22. If we assume that 50% of this balance is advance from customers then proceed with the same assumption as above we can observe that the company has roughly prebooking's in excess of 3700 cars. The company on average sells 7500+ units within a quarter thus HCAR approximately has cash earnings for around 1.5-2 months
- From the above findings we can see that on average auto makers usually have prebooking's in advance for the future quarter. However it is worth noting that the above calculations were based on average unit prices although due to the diverse sales mix and pricing strategies it would be safe to assume that the companies probably have advance bookings for 5-6 months (future upcoming 2 quarters)
- The cumulative receivables amount from the above three amounts to around Rs122.2 bn in advances from customers and if we assume another Rs30 bn from all the other auto players within the market then the cumulative receivables would amount to around Rs 150bn.
- Thus at any given point on average the auto industry has Rs 150bn in receivables from customers which bodes for well for the sector as it shows that there are solid future bookings amid the consumers appetite to spend thus showing future growth potential not only for the sector but also the country
- However on the other hand Rs 150bn is a hefty amount especially for a country like Pakistan where cash liquidity is a major issue and if we look at the example of circular debt which has been the source of major inefficiency not only for the power sector but has been huge debt on the country thus it is imperative that the government keeps an acute eye on the auto companies receivables going forward so this amount of around Rs 150bn is kept in check so as to not cause major inefficiencies within the sector.
- Further the government/regulatory body needs to ensure that these auto companies are held responsible for hoarding all this cash and ensuring that they are using these to make investments for the betterment of the sector and not just using this balance for self investments and savings.

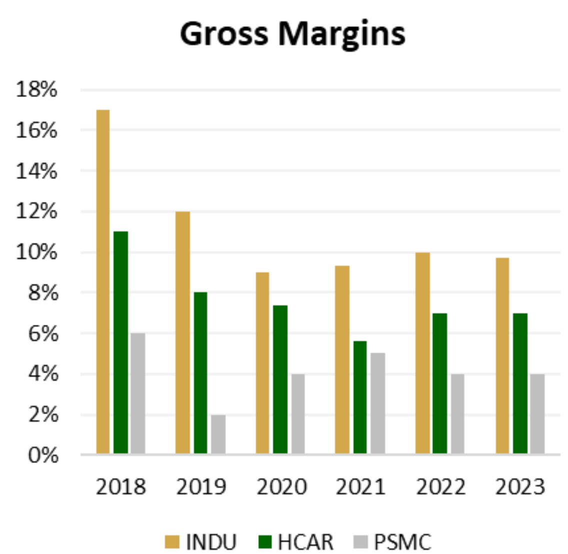
Company	Advances From Consumers (bn)	Cash & Short term Investments (bn)
INDU- 1QFY22	71.80	107.40
PSMC- 3QCY21	34.90	31.30
HCAR- 2QMY22	N/A	28.60

Source Company Prospectus, Darson Research

* The above figues are extracted from the latest compnay financials



Source: PAMA, Darson Research



Source: PAMA, Darson Research

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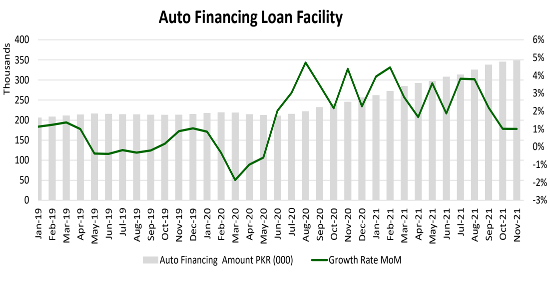
Thursday, January 6, 2022

Auto Financing on the rise

- Auto Financing has seen a steady increase as of Nov-21 it stood at a record rate of Rs 349.1 bn which was an increase of 42% YoY and 1% MoM for Nov-21. This was primarily achieved on the back of a stable policy rate of 7% which has recently been increased to 9.75%.
- Recently SBP has made slight changes to the Auto Financing policies in an effort to tamper off demand amid rising inflation costs. Below are some of the changes-

1. Reduction in period of auto financing from 7 to 5 years
2. Minimum down payment increased from 15% to 30%
3. Maximum limit (for any one person) set at Rs 3 million to avail financing
4. Tenure of personal loan reduced from 5 to 4 years
5. Debt-Burden ratio decreased to 40% from 50%

- The companies' usually have pre-bookings up to at least 3 months so we should not expect any immediate effects however we may see declining revenues for the companies after 7-9 months if the above policy is maintained
- HCAR would be the most impacted by this as they drive 45-48% sales through Auto Financing where as INDU drives around 30-32% revenues through Auto Financing
- Further the increasing depreciation of PKR and ever increasing global commodity prices might force the companies into raising prices
- On the Macro front the Auto Industry continues to show strong growth as YoY sales on passenger cars increased by 29% YoY in Nov-21 as compared to the SPLY. However the above measures plus a slight slow down within the auto industry has caused the auto financing to grow at a slower rate MoM (1.01% in Nov-21 vs 3.79% in Aug-21). We expect this slowed growth within the short term to persist as the government is trying to curtail demand and a high interest rate environment will discourage consumers from availing this facility.



Source: *PAMA, Darson Research*

***Top Pick-* Indus Motors Company Limited**

Our top pick from the auto universe is INDU (Indus Motor Company Limited) with a TP of PKR 1,580 for December-22 with an upside of 29% from the LDCP The reason we like INDU is because-

1. Strong Supply Chain (able to sustain global chip shortages)
2. Strong Gross Margins (9-10% which is the above industry average of 6-7%)
3. High localization level of around 60-65% (able to sustain vicious currency volatility to a certain extend)
4. Strong Future Outlook as the company is expanding their operations (planning to invest $100mn for local production of Hybrid Electric Vehicles in Pakistan)
5. Strong revenue growth (MoM/YoY growth of 12%/44% witnessed for September-21)
6. Strong Balance Sheet (Rs 107.4bn in cash and short term investments)
7. Strong Dealership Network

INDU Overview	
Target Price (PKR/sh)	1,580
Current Price (PKR/sh)	1,226
Upside%	29%
Stance	BUY
Total Shares Outstanding (Mn)	78
Free Float (Mn)	13
Free float %	17%
Mkt. Cap (PKR Mn)	96,363

Source: *Company Financials, Darson Research*

Key Risks associated with the Auto Sector

- Lockdowns due to Corona
- Supply chain disruptions
- Increase in raw material costs
- Depreciation of PKR
- Further increase in policy rate (↑ 275 basis points from Sep-Dec21)
- Significant slowdown within the economic activity

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Any inability to compete successfully in their markets may harm the business. This could be a result of many factors which may include geographic mix and introduction of improved products or service offerings by competitors. The results of operations may be materially affected by global economic conditions generally, including conditions in financial markets. The company is exposed to market risks, such as changes in interest rates, foreign exchange rates and input prices.

Rating System:

If;

- **Expected return >15%** - Buy Call
- **Expected Return is in between 0% to 15%** - Neutral/Hold Call
- **Expected Return <0%** - Sell Call

Valuation Methodology

To arrive at our period end target prices, DSL uses different valuation methodologies including:

- Discounted cash flow (DCF, DDM)
- Justified price to book (JPB)
- Relative Valuation (P/E, P/B, P/S etc.)
- Equity & Asset return based methodologies (EVA, Residual Income etc.)

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