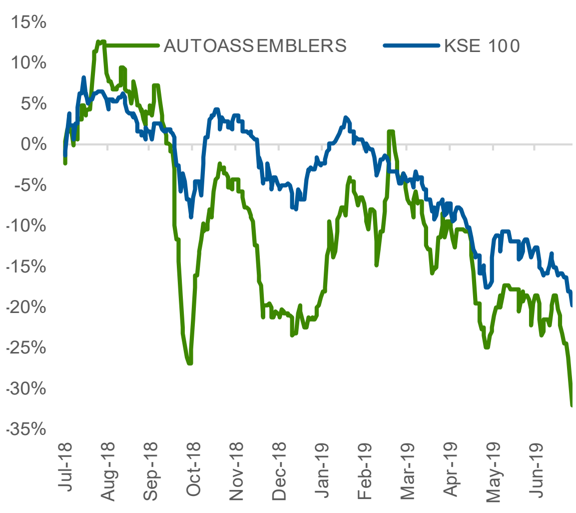
Day Break

Friday, 19 July 2019

Sector Update

Sym	Target Price	P/E 2020	D/Y2020	Recom.
INDU	901.5	9.6	7.3%	SELL
HCAR	107.8	9.6	4.7%	HOLD
PSMC	105.2	-	-	SELL

Relative Performance to KSE 100



Source: Bloomberg, PSX & IGI Research

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Automobile Assemblers

Reminiscent of lost glory

- We revisit our investment case on the sector taking into account budgetary measures (29% corporate tax), changes in volumetric assumption amid subdued economic environment.
- All in all our valuations for coverage companies (INDU, HCAR & PSMC) are downgraded. Our stance on the sector, therefore remains "Underweight
- We foresee, upcoming two years for the auto sector to be rather crucial in match with the economic cycle (GDP growth-2.4%/3.0% for FY20/FY21) while on the hindsight competitive headwinds would play a decisive factor in reshaping auto market.

We revisit our investment case on the sector taking into account budgetary measures (29% corporate tax), changes in volumetric assumption amid subdued economic environment. We base our analysis considering key takeaways from the years 2008/'09 under the ambit of severe economic crisis while keeping our approach conservative. All in all our valuations for coverage companies (INDU, HCAR & PSMC) are downgraded. Our stance on the sector, therefore remains "**Underweight**".

Glimpse of 2008 crisis

The 2008-2010 period was a rough period for Pakistan's economy where macro-economic crisis turned auto sector's dynamics unpleasant. Rapid PKR depreciation, rising inflation coupled with increase in interest rates hit hard on consumers buying and sales. While demand for cars gradually shied away, depreciating PKR ballooned input costs for the automobile assemblers, pushing margins (2%-6%) and profitability (PKR~ 3.0bn) at its lowest. At the same time, price pass-on from rising imported costs and imposition of FED (brief period) further receded demand for the passenger cars.

- **Falling reserves and trade imbalance coerced exchange rate volatility**
  The economic crisis aggravated with PKR rapidly losing its value against USD as burgeoning current account deficit (USD 13.86bn) arising from decrease in exports (slowdown in global demand) put pressure on foreign exchange reserves (falling below USD 7bn). As such by 2009 PKR weakened to 78.5 against USD, marking a decline of 26% since 2007.
- **Inflation went all time high…**
  During the period inflation increased touching all time high 22.30% in 2009, starting from 7.90% in 2007 at the inception of crisis. The stark increase was attributed to rising price of imported fuel, commodities, driven by weaker PKR currency.
- **…while interest rate was gradually raised to absorb aggregate demand**
  subsequently to streamline inflationary pressure and demand/supply imbalance SBP raised policy rate. With 9.50% interest rate in 2007, central bank raised it by 450bps to 14% in 2009, declining thereof as inflation eased down to 11.0% in 2012.

Auto sales came across severe backlash as consumer appetite faded

The aforementioned factors took their massive toll with industry sales reaching their lowest (663k units by 2008-9). Looking at passenger car segment in particular, sales collapsed massively by 36% to 166k units as demand for big three suffered slowdown. To account for on an individual basis, PSMC sales plunged to 52k units in 2009 from 124k units in 2006, while HCAR sales also suffered major blow with volumes trending down to 12.5k units from 30k units in 2006. Likewise, INDU sales also drifted down to 35k units in 2009 from their normal level of 50k units.

Exhibit: CPI touched highest, interest rates were raised

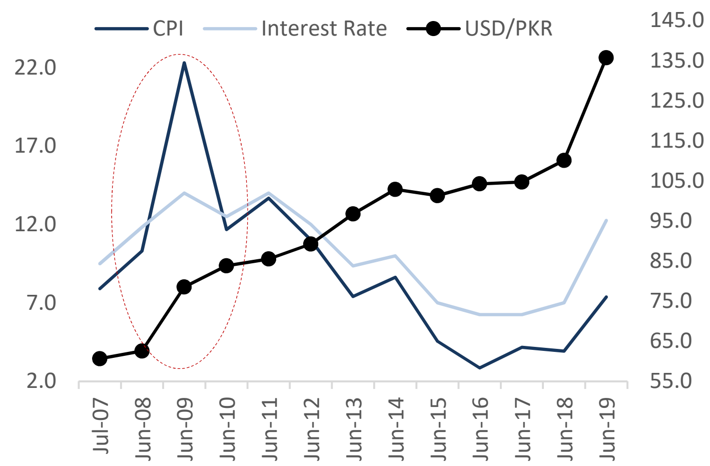
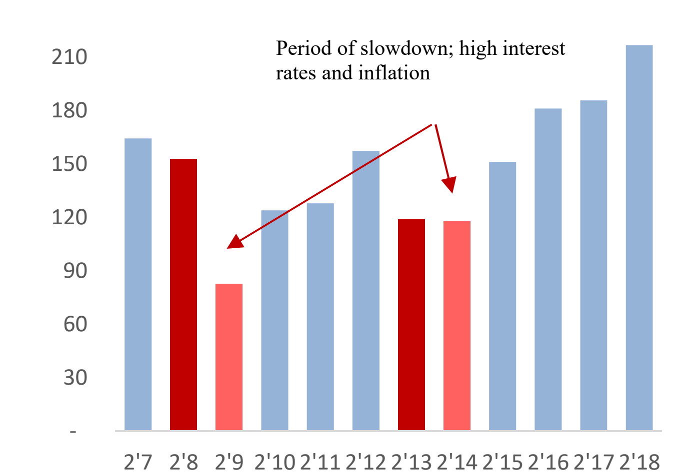


Exhibit: Auto sales (k units) slowdown during tough periods



Source: IGI Research, Company Accounts

Profitability deteriorated as topline and margins came under pressure
Financial performance also deteriorated as unhealthy top line and input cost escalation on the back of weaker rupee crumbled margins. Moreover, underutilized capacity also put pressure on fixed cost/unit, further eroding profitability of the companies (to counter that manufacturers scaled back their production days). Amongst our coverage companies, PSMC and HCAR came across severe hit with the later incurring losses during the 2-yr period. Similarly, INDU's profitability also lost its charm, gradually dropping by 29% to PKR 17.62/share in 2009. The same scenario was also witnessed on balance sheet as well, reflecting a dismal picture wherein cash position worsened and advances from customer bogged down.

Exhibit: Profitability (PKRbn) and margins (%) contracted

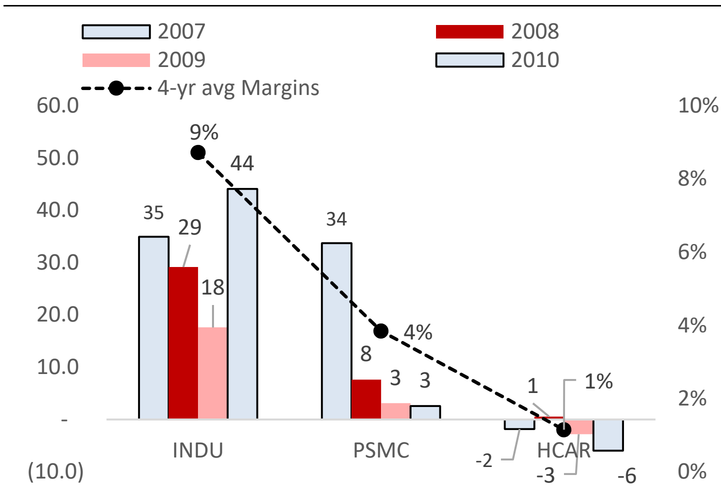
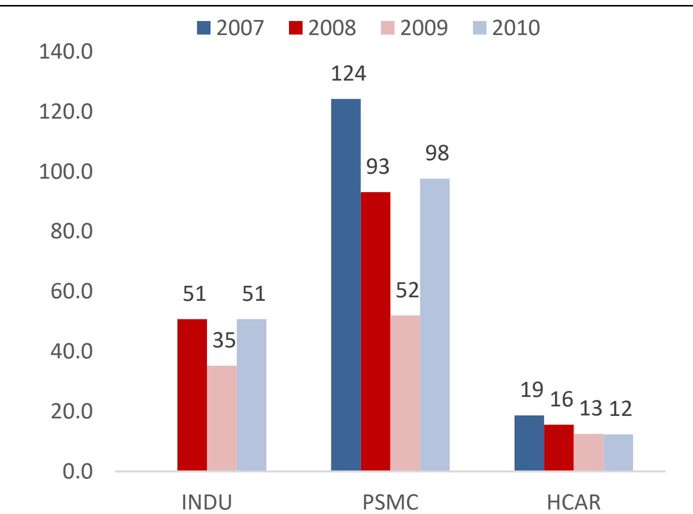


Exhibit: Sales (k units) collapsed massively during the two years



Source: IGI Research, Company Accounts

Things at present…

Recent ongoing economic environment resembles the events occurred in 2008, albeit to a lesser extent. For the auto sector, this could be another episode of slowdown where macroeconomic fundamentals (CPI and interest rates going high and volatility in exchange rate) have turned sectors' outlook unpleasant. As such, with deteriorating financial performance (as witnessed in the outgoing quarters) and unfavorable outlook for the next two years we see valuations not that attractive.

- **Exchange rate volatility still looms**
  To date PKR has lost its value by 14%CY19/35%YoY to 158.9 against USD. With the advent of IMF program, demanding market driven exchange rate volatility may deem to persist as current account deficit still poses a challenge.

- **Inflation more to rise…**
  For the year end inflation has averaged 7.4% as rising fuel prices, and PKR depreciation increased prices of imported goods. While this was not enough, government amplified electricity and gas prices, leading to expected double digit inflation for the upcoming year (FY20).

- **Monetary tightening to continue**
  The recent monetary policy raised interest rates by 100bps to 13.25%. We see SBP to continue its contractionary stance for this year as well. Our auto universe balance sheet is not leveraged (except PSMC) but from demand perspective further tightening may hurt consumer auto financing. On the flip side, for cash rich companies such as INDU this presents an advantage to park cash in short term investments

Auto sector in doldrums

The present dynamics of auto sector are at the inception of critical phase (much of this was witnessed during the year). Analyzing financial performance of the sector so far, the big three earnings are topsy-turvy (52%YoY), margins have experienced compressionary phase (avg. ~450bps) and seem unsustainable while volumetric sales are at a declining trajectory (~12%YoY FYTD). On the external front, where exchange rate instability exists manufacturers have resorted to series of price hikes (avg~30%) to absorb imported costs. To make things worse, in its recent budget (FY20) government imposed FED (2.5%-7.5%) on all engine sizes, raising prices at the customer end.

Exhibit: Weakening PKR currency, high CPI and interest rates

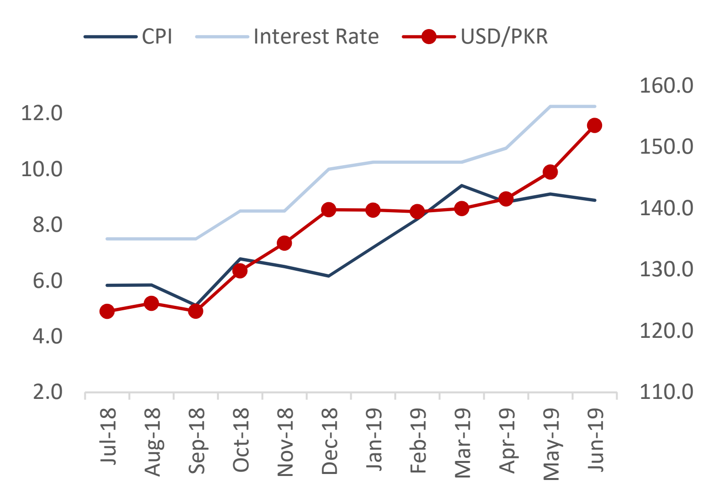
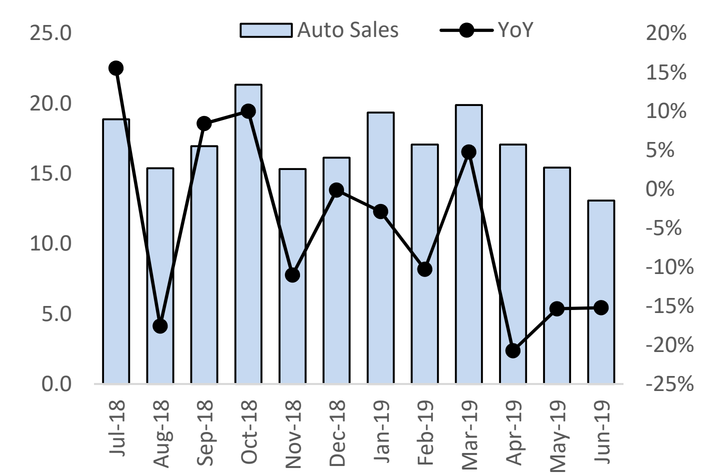


Exhibit: Auto sales (k units) starts to decline during 2QCY19



Source: IGI Research, Company Accounts

INDU: Adopting a wait-and-see approach; medium term attrition to exist
We have downgraded our investment case on the scrip on the basis of downward revision in our earnings estimates (27%/35%) as we expect decline in volumetric sales (20%/5%) and weak margins (10%/9%) in FY20/FY21.

Investment thesis

- INDU plans to come up with a launch of a variant (possibly Vios; a replacement for Xli/Gli) eyeing a feasible time (we haven't incorporated in our assumptions) for the new launch given uncertainty and demand shortfall in the market.
- In comparison to other players INDU enjoys strong pricing power and can easily pass-on the impact from rising input costs. However, in the midst of competition it would be tough for INDU to take an advantage of this and we therefore expect margins to remain buoyant going forward.
- More so, competition in the SUV segment has become active with KIA introducing Sportage (price range of PKR 49-54mn). We think, this may hinder sales of Fortuner and Rush; it would be a tough challenge for INDU to keep it sales upbeat and maintain its share while reaping better margins at the same time.
- With respect to liquidity INDU is better placed amongst our coverage companies having excessive cash tied up in investments (PKR ~400/share), taking advantage of rising interest rates and supporting its other income (after tax impact of ~PKR 35/share)

Valuation
Our Dec-19 target price of PKR 901/share is derived by using DCF based methodology, using risk free rate of 13.75% and an adjusted beta of 1.0. Our terminal growth rate is 3%. The company is currently trading at FY20E P/E of 9.6x at a dividend yield of 7.3%.

Risks
Risks to our price target include: 1) PKR depreciation against USD and JPY; 2) increase in international CRC prices; 3) Increase in duties (FED and custom)

Exhibit: Sales to slowdown going forward

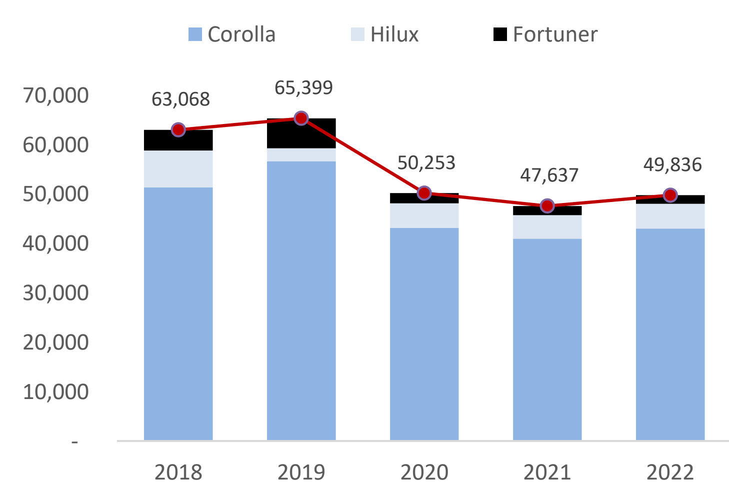


Exhibit: Financial Highlights

PKR.bn	**FY18A**	**FY19E**	**FY20F**	**FY21F**	**FY22F**
Total Revenue	140.2	157.5	126.6	128.3	139.1
Net Income	15.8	12.7	8.8	8.0	9.1
EPS	200.7	159.9	112.0	102.2	116.4
DPS	140.0	108.0	80.0	70.0	80.0
Key Metrics					
Margins	17.4%	12.2%	9.9%	9.0%	9.5%
P/E (x)	5.9	6.7	9.6	10.6	9.3
EV/EBITDA(x)	1.3	1.8	3.0	2.8	1.9
DY (%)	13.0%	10.1%	7.3%	6.6%	7.6%

Source: IGI Research, Company Accounts

HCAR: More emphasis on high margin segment; tough times ahead

We have revised our investment case on the scrip after incorporating financial year accounts (MY19) and downward revision (56%/68%) in our estimates. Our volumetric assumption represents bleak outlook factoring in decline of 20%/10% for MY20/21

Investment thesis

- HCAR's localization level is relatively low compared to other peers in the industry. While company cannot fully pass on the impact we expect margins are unlikely to sustain at current levels (~7%).
- The recent rollout of Civic Turbo shows HCAR being more inclined towards its high margin segment while having skipped generation of City, albeit with a launch of its face-lift model last year. On the basis of pricing points and in comparison with Toyota Grande (PKR 37Mn), the new version of Civic comes at a relatively higher price (PKR 44Mn) which might pose a setback with consumer shifting their preference.
- On the balance sheet front, company is liquidating its short term investments (77% YoY decrease) to meet its working capital requirement. Given declining advances from customers this presents rather challenging for the company to maintain its cash buffer and earn income. We think this would decrease (30% on avg.) other income going forward.

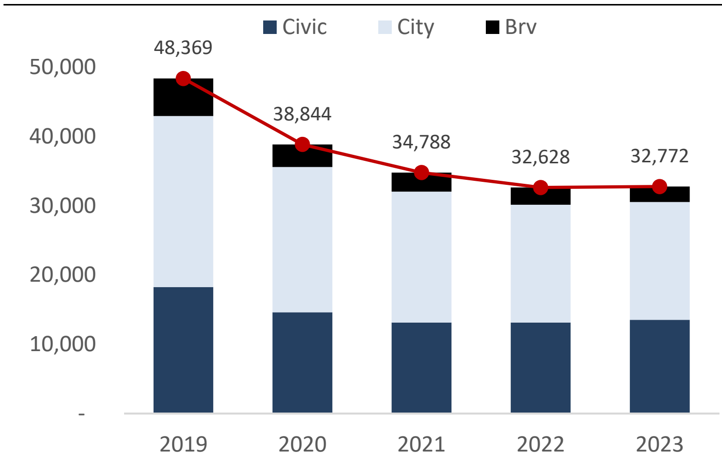
Valuation

Our Dec-19 target price of PKR 107/share is derived by using DCF based methodology, using risk free rate of 13.75% and an adjusted beta of 1.55. Our terminal growth rate is 3%. The company is currently trading at FY20E P/E of 9.7x at a dividend yield of 4.7%.

Risks

Risks to our price target include: 1) PKR depreciation against USD and JPY; 2) increase in international CRC prices; 3) Increase in duties (FED and custom)

Exhibit: Sales to slowdown going forward



Source: IGI Research, Company Accounts

Exhibit: Financial Highlights

PKR.bn	MY19A	MY20E	MY21F	MY22F	MY23F
Total Revenue	95.1	81.7	76.9	75.1	78.4
Net Income	3.9	1.7	1.2	1.2	1.4
EPS	27.0	12.1	8.1	8.4	9.5
DPS	12.2	5.5	3.5	4.0	4.5
Key Metrics					
Margins	7.7%	5.3%	4.4%	5.1%	5.5%
P/E (x)	4.7	9.6	14.3	13.8	12.2
EV/EBITDA(x)	1.6	3.3	5.7	5.0	3.2
DY (%)	10.5%	4.7%	3.2%	3.3%	3.7%

PSMC: Skidding towards the edge; valuation downgraded
For PSMC, we see earnings largely bottoming out for the next three years and expect a rebound henceforth. The company has incurred losses since two consecutive quarters (LPS: 11.92 for 1QCY19) and we expect the same in the upcoming years as well. Not only lower volumetric sales (19%/3%) and weak margins (2%-3%) will push earnings in the negative territory but short-term borrowings and turnover tax (1.5%) may also act as a drag.

Investment thesis

- The recent roll-out of Alto (660cc) may provide impetus in limiting volumetric decline and in fueling top-line a bit. However, with KIA around the corner, and with the launch of Picanto in plans (expected in Aug-19) this could possibly bring a set-back to company's sales. However, much depends on the launch price of the vehicle, which we think would cross double of that being sold in INDIA (to note, KIA Sportage comes at a price range of INR (1.5-2.0Mn) and its starting price in Pakistan is PKR 4.8Mn).
- Having said that, we can expect price of Picanto to fall under the range of PKR (1.6-1.9Mn), vis a vis its price range in INDIA (INR 0.5-0.8Mn). For PSMC this brings in competition for Cultus/WagonR and Swift which fall under this price range,
- PSMC's cash position has worsened (84%YoY decline) and this is reflective of company availing financing (PKR 11.3bn) to meet its capital requirement. Apart from getting hit from low volumes and margins, addition of finance cost and with that in rising interest rates scenario may significantly drop earnings (impact of PKR ~12/share) in short to medium term.

Valuation
Our target price of PKR 105.2/share is derived by using DCF based methodology, using risk free rate of 13.75% and an adjusted beta of 1.38. Our terminal growth rate is 3%.

Risks
Risks to our price target include: 1) PKR depreciation against USD and JPY; 2) increase in international CRC prices; 3) Increase in duties (FED and custom) and 4) increase in interest rates.

Exhibit: Sales to slowdown going forward

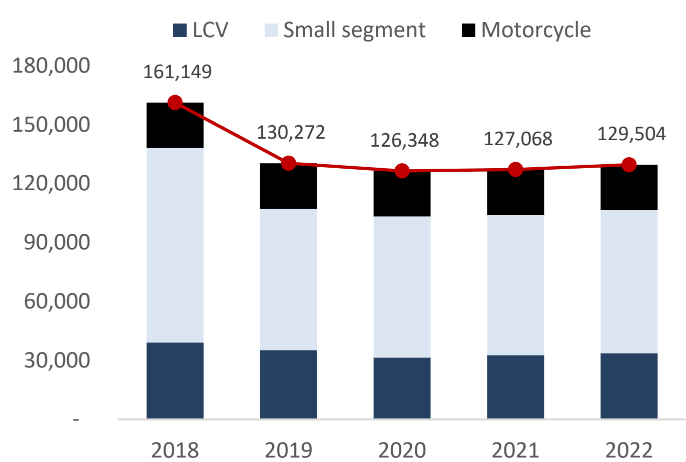


Exhibit: Financial Highlights

PKR.bn	CY18A	CY19E	CY20F	CY21F	CY22F
Total Revenue	119.9	98.8	96.5	98.8	102.4
Net Income	1.3	(2.1)	(1.4)	(0.6)	0.9
EPS (PKR)	15.8	(25.3)	(17.3)	(6.8)	10.6
DPS (PKR)	3.2	-	-	-	2.0
Key Financial					
Margins	5.9%	3.0%	3.4%	3.9%	3.9%
P/E (x)	12.6	-	-	-	18.8
EV/EBITDA(x)	3.7	4.3	4.3	4.1	3.8
DY (%)	1.6%	-	-	-	1.0%

Source: IGI Research, Company Accounts

Conclusion: Underweight stance on the sector

Auto sector stock performance has declined substantially by 17%YoY relative to the benchmark index-KSE as negative sentiments (earnings decline and unhealthy outlook) kept investor’s confidence at bay. We foresee, upcoming two years for the auto sector to be rather crucial in parallel with the economic cycle (GDP growth-2.4%/3.0% for FY20/FY21) while on the foresight competitive headwinds would play a decisive factor in reshaping auto market. With over 200k units of capacity to come online in the next 3-4 years or so we see auto sector becoming largely fragmented, raising concerns of oversupply situation (total capacity to cross 400k units) and limiting pricing power of existing players. Although, we expect recovery in sector earnings (not that significant) of our coverage companies post FY22 but with new entrants in the market this may limit margins expansion and earnings growth going forward.

Exhibit: Foreign players currently in Pakistan

Entrants	Est. Capacity (kunits)		PC	LCV	HCV	SUV	MPV	Year of roll-out	USDbn (est) investment	Vehicles
	Intial	Maximum								
United Motors	20	20	●	●				2018	0.02	United Bravo (800cc)
ISUZU	-	0		●	●			2018	0	D-MAX (3,000cc)
Daehan Dewan Motor Company & SSY	20	20		●		●		2018	0.14	Daehan Shezore (2,600 cc)
KIA-Lucky	25	35	●	●	●	●	●	2019	0.13	Grand Carnival (3,300cc), Sportage (2,000cc) & K2,700 pickup. Picanto (1,000cc; expected in Aug-19)
Hyundia- Nishat	7	30	●			●	●	2019	0.5	Santa FE (2,400cc) & Grand Starex (2,400cc). Ioniq (1,600cc; expected)
Regal Automobile & DFSK	10	10	●	●		●	●	2019	0.012	Local assembly of Prince Pearl (800cc) in August 2019. DFSK's Glory 580, K01 Minitruck
Sazgar & BAIC Motor Corporation	24	24	●			●		2019	0.035	-
Khalid Mushtaq Motors Pvt.Ltd	2	2.4		●			●	2019	0.004	-
Volkswagen	28	28		●		●	●	2020	0.135	Amarok, Transporter T-6 light (Phase I), Caddy (Phase II) & Skoda (Phase III)
Ghandara Nissan	15	35	●				●	2020	0.041	Datsun, Datsun Go & Datsun Go plus (1,200cc)
Renault & Al-Futtaim	50	50	●			●		2020	0.23	-
Master Motor & Changan	30	30		●		●			0.105	Changan M-8, M-9 & Karvaan

Souce: IGI Research, News Articles & Company Website

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Time Horizon: Dec – 2019
Valuation Methodology: The analyst(s) has used following valuation methodology to arrive at the target price of the said security (ies):
(Reserve Based DCF Valuation)

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