Major OEMs cash flows in rough terrain

- Updating our expectations upon release of detailed financial accounts for auto OEMs reveal a reversion to maintenance industry CAPEX with the last TTM total outlay of Pkr7.14bn (down 33%QoQ/51%YoY) with PSMC/INDU/HCAR contributing 21/76/3%,

- The industry’s TTM topline/gross profit growth dipped to near bottom levels -70.1/-70.1%QoQ and -60.0/60.0%QoQ showcasing the strains on core profitability exerted through COVID-19 driven business disruptions when sales cratered and mid-quarter price hikes failed to guard margins (industry GM at -3.3% for 2QCY20 vs. 6.6% SPLY).

- In terms of free-cash flows, normalization is evident as a stable Pkr vs. US$ environment coupled with constrained demand at lower utilization levels have stabilized Net Working Capital outflows, while firms revert to normalized CAPEX (cumulative 2QCY20 CAPEX of Pkr1.2bn down 41%QoQ/75%YoY)

- Moderating CAPEX outflows, while proceeding with the strategy of margin preservation remains the likely outlook for domestic OEMs. Even as, new model launches for HCAR and PSMC (likely upgrade to Swift being reported) are likely to keep this cash outlay item on the higher side over the medium term, a trend we keenly follow to confirm launch timelines in our estimates going forward.

Digging-in for the long run: Overall industry CAPEX levels can be seen reverting back to maintenance levels, resting at Pkr7.14bn (down 33%QoQ/51%YoY) with PSMC/INDU/HCAR contributing 21/76/3% for the last twelve months. For 1HCY20, PSMC/INDU/HCAR contributed 25/72/3%, remaining near levels seen during CY19. Breaking down CAPEX by major players, INDU’s FY20 cumulative CAPEX of Pkr5.4bn is on the coat tails of FY19’s major CAPEX outlay of Pkr8.7bn, taking cumulative CAPEX for the Yaris launch and production enhancements to Pkr12.96bn. For FY20, the bulk of the firm’s CAPEX was focused on plant and machinery whereas for FY19, an almost equal share was provisioned under Jigs & molds, usually reserved for new models. While COVID-19 outbreak has emerged as a thorn in the foot for INDU’s expansion plans (enhanced production capacity of 66,000 as of June’19), we maintain our conviction over the Yaris driving a rebound in sales for the OEM going forward. Additionally, amongst the top three domestic OEMs PSMC recorded CAPEX outlay of Pkr507mn (near maintenance levels), while the much awaited CAPEX from the upcoming launch of HCAR’s upgraded City Variant (7th Gen) failed to materialize in the June’20 quarter, relegating any launch to at least 9-12 months down the road.
Profitability fails to support outlays: Cumulative top-lines have felled off a cliff to -60% QoQ/-70% YoY over June’20 and down 44% YoY for TTM, matched by drastic -60% QoQ/-70% YoY fall in gross profits over the same period remains increasingly deprecative to cash flow generation. The industry’s inability to cope with drastic decline in demand and operational pressures exerted through COVID-19 driven business disruptions have left a clear crater in terms of industry profitability. Based on the same, the industry’s TTM topline/gross profit growth dipped to near bottom levels, with cumulative GM’s landing in the red (-3.3% for June’20, vs. 8.2% for March’20). Over 2QCY20, INDU/PSMC/HCAR GM’s dipped 1,381/711/672bps YoY landing at -3.1/-6.3/0.8%, making the case for clawing back of sector profitability on the back of emerging tailwinds (new model launches, low discount rate, FX stability leading to price stability).

Borrowing lends a hand: In terms of free-cash flows, normalization is evident as a stable PkR vs. US$ environment coupled with constrained demand at lower utilization levels have stabilized Net Working Capital outflows, while firms revert to normalized CAPEX (cumulative 2QCY20 CAPEX of PkR1.2bn down 41% QoQ/75% YoY). Borrowing remains elevated amongst the top three, a trend we have seen coinciding with the dip in profitability eight quarters ago. During this period the top three firms have increased cumulative net borrowing by PkR39.4bn with PSMC taking on the largest amount of debt on its books. For June’20 HCAR (PkR2.8bn) followed by PSMC (PkR2.3bn) added leverage to raise free cash flows.

Investment Perspective: Moderating CAPEX outflows, while proceeding with the strategy of margin preservation remains the likely outlook for domestic OEMS. That said, new model launches for HCAR and PSMC (likely upgrade to Swift being reported) are likely to keep this cash outlay item on the higher side over the medium term. In this regard, we are closely monitoring CAPEX outlays for indications of new model launch timelines and will update our estimated accordingly. Additional dampeners hindering cash flows remain: 1) drastic decline in demand and margin deterioration as sticker-shock riles consumers in an inflationary macro-environment and 2) longer inventory holding impacts net working capital.
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