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PAKISTAN
AUTOS

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MARKET
VISTA

Strained cash flows makes CAPEX difficult

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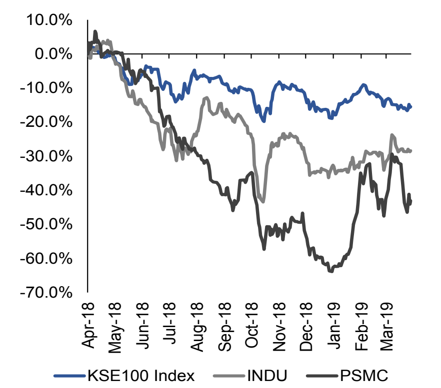
- **Updating our expectations upon release of detailed financial accounts for auto OEMs reveals a persistent upswing in industry CAPEX with the last TTM total outlay reaching PkR15.8bn with PSMC/INDU/HCAR contributing 53/38/9%, where PSM's annual report revealed cumulative annual CAPEX of PkR8.5bn, its highest annual outlay ever**
- **The industry's TTM topline/gross profit growth swayed +18/-10%YoY showcasing the strains on core profitability, where players dealt with pervasive FX fluctuations passed-on to retail prices in an environment of macro-consolidation (monetary tightening, inflationary pressures, lower disposable incomes) with punitive policies discouraging sales growth**
- **In terms of free-cash flows, increased outflows are evident, as net working capital variations from leaner delivery times and reduced working capital buffers (advances tumble) are reflected in the re-emergence of leverage on PSMC's books (PkR11.3bn as of Dec'18) emphasize the need for strong balance sheets to support outlays**
- **With the launch of the Alto likely by April-end, we believe PSMC's CAPEX outlays are likely to revert back to maintenance levels (CY19-22 average annual outlays of PkR2.2bn assumed). On its solid balance sheet strength, we prefer INDU, where CAPEX outlays through internal cash flows are paramount to preserving long term profitability.**

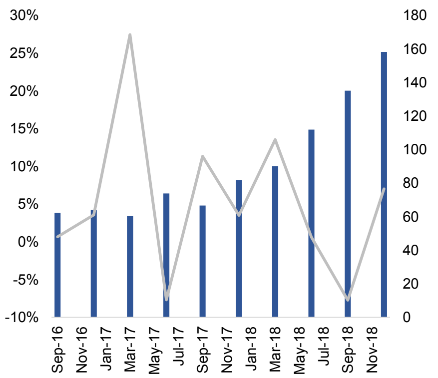
KSE100 Index Vs. Universe Autos Sector



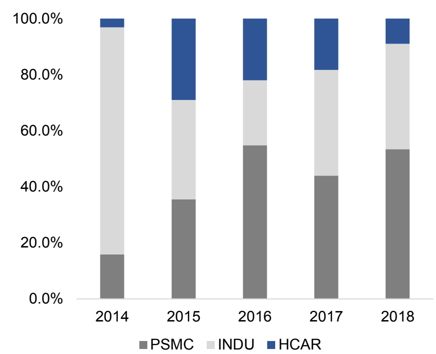
Source: PSX & AKD Research

Digging-in for the long run: Breaking down CAPEX by major players, PSMC's CY18 CAPEX of PkR8.5bn is the highest the company has committed, marking a major shift in the firm's production outlook. Channel checks suggest PSMC is upgrading its production platforms to streamline new 'mini-vehicle' passenger car production (Wagon-R, Cultus and Alto), possibly providing leeway to better provision man/factory hours between models on offer. TTM cumulative CAPEX of PkR15.8bn was led by PSMC, while INDU (PkR5.9bn) has ramped-up CAPEX as well (up 63%YoY), where INDU's tapered approach is expected to accelerate during 2HFY19, as indicated by management. HCAR remains a laggard with CAPEX outlays nearing base-line/maintenance levels.

TTM industry CAPEX (PkRbn) & net sales (QoQ%) ...



...annual CAPEX composition - PSMC, HCAR, INDU



Source: Company Accounts & AKD Research

Profitability fails to support outlays: Despite punching toppling growth of 18%YoY over TTM, the 10%YoY fall in gross profits over the same period remain alarming. The industry's ability to cope with pervasive FX fluctuations passed-on to retail prices in an environment of macro-consolidation (monetary tightening, inflationary pressures, lower disposable incomes) with punitive policies discouraging sales growth, imposes additional strains. Interestingly, over 2HCY18, cumulative industry sales dipped 4%YoY while a 28%YoY fall in gross profits translating to industry GM's receding 291bpsYoY to 8.8%, illustrating the toll taken on industry profits from rampant PkR weakness and stymied demand. Over this period, INDU/PSMC/HCAR witnessed GM's dipping 407/233/232bpsYoY landing at 13.2/4.7/6.9%, making the case for mean reversion in sector

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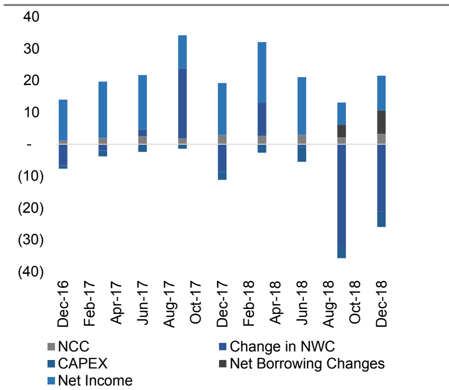
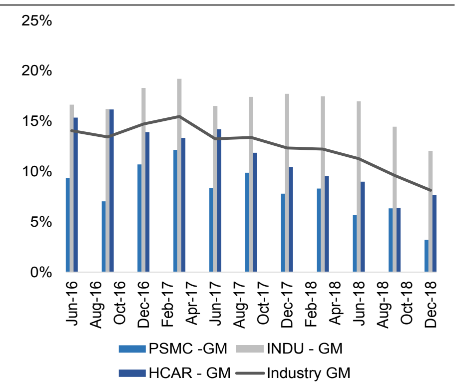
profitability on the back of significant headwinds.

Free cash flows increasingly chained: Apart from slackening core profitability, free cash flows are seen to be strained from higher outflows. Increased outflows (apart from CAPEX) are evident, as net working capital variations (outflow of PkR21.2bn with INDU constituting 48%) from leaner delivery times and re-emergence of leverage on PSMC's books (PkR11.3bn as of Dec'18) emphasize the need for strong balance sheets to support outlays. Case in point is INDU, where it has drawn down its current asset capital buffers (PkR35.2bn in cash and ST inv. For INDU as of Dec'18 vs. PkR57.2bn in June'18) to promote aggressive outlays, giving it significant runway to withstand the macro down cycle, without resorting to leverage.

Free Cash Flow by component (PkRbn) ...



... industry gross profit snapshot



Source: Company Accounts & AKD Research

Investment Perspective: Looking ahead, higher CAPEX outlays are expected to be the norm, as OEMs re-vamp their variants and make inroads to improved operational efficiency and enhance production capacity to meet demand for these newly launched variants. With the launch of the Alto likely by April-end, we believe PSMC's CAPEX outlays are likely to revert back to maintenance levels (CY19-22 average annual outlays of PkR2.2bn assumed). On its solid balance sheet strength, we prefer INDU, where CAPEX outlays through internal cash flows are paramount to preserving long term profitability.

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Sell	**< 13% expected total return (Rf: 13%)**

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Buy	**> 20% upside potential**
Accumulate	**> 5% to < 20% upside potential**
Neutral	**< 5% to > -5% potential**
Reduce	**< -5% to > -20% downside potential**
Sell	**< -20% downside potential**
Not Rated	**No investment opinion or recommendation**

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