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PAKISTAN
AUTOS

REP-019
MARKET
VISTA

What makes a brand 'premium'?

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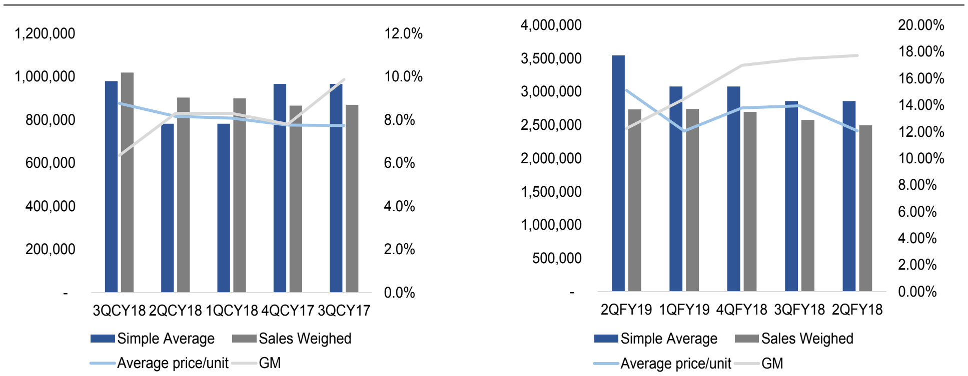
- **With increasing pricing disparity amongst models on offer, we delve into an essential phenomenon facing the industry, aiming to compare the exercise of pricing premiums for variants on offer and margin stability**
- **We assess average pricing per unit over the last four quarters, using reported numbers, contrasting the same with simple average list price for variants (assuming all variants form equal share of sales), sales weighted average prices (proportional to sales per variant over the period) and resulting gross margins**
- **Over July'17-Sept'18, PSMC/INDU's average quarterly sales price per unit were at an 11% discount/1% premium to their sales weighted prices, indicating that INDU sold more of its premium variants for each model (particularly the Corolla with contributes ~86% to sales) than PSMC**
- **Our analysis shows that successful franchises which extend models to multiple segments successfully, are able to retain disparate pricing for variants amongst the models on offer and are able to attract demand from premium customers, stand at a strong competitive frame.**
- **These factors confirm our bullish stance on INDU's, trading at FY19 P/E of 6.9x, the stock offers total upside of 21.5%, implying a BUY call.**

Unit sales change and so do the variants: Pricing power, margin preservation and brand premiums are auto industry terms often quoted to make the case for long term investment in Pakistan's auto assembly space, where variant level bifurcation (sales of 1.6L vs. 1.3L Corolla variants) is not made available. Last four quarters remained a tough time for the sector, with macro dampeners and industry-centric events (non-filer sales ban) shook industry fundamentals. In a period of rising prices (~9-25% during CY18), input cost pressures due to PkR weakness, and a suppressive macro backdrop (rising cost of borrowing, inflation), we seek to analyze pricing on the basis of reported net sales (for manufacturing operations) for major listed OEMs (INDU and PSMC).

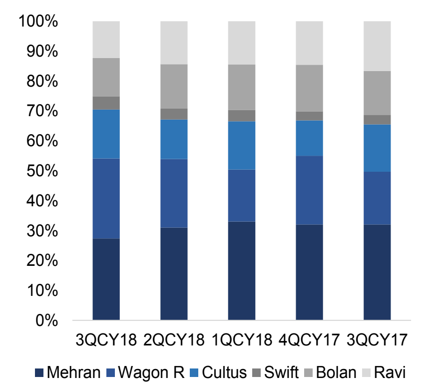
Average prices with sales weighed /simple average pricing and GMs - INDU (Right) and PSMC (Left)



Source: Company Report & AKD Research

INDU wins the battle for pricing premiums: We assess average pricing per unit over the last four quarters, using reported numbers, contrasting the same with simple average list price for variants (assuming all variants form equal share of sales) and sales weighted average prices (proportional to sales per variant over the period). Out analysis shows that last year's price hikes have further distorted pricing for variants on offer, where a case in point if the Corolla, where top level 1.8 Altis Grande retails at a 47% premium to the entry level 1.3L Xli's price tag, when

Quarterly sales split by model—PSMC



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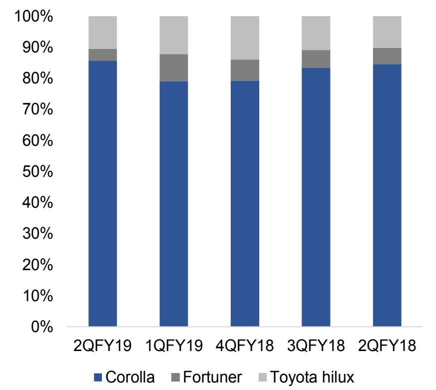
Quarterly sales split by model—INDU



Source: Company Report & AKD Research

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compared to 38% premium seen during July'17. Widening price distortions could have a negative impact on demand for higher-end variants, as consumer satisfice with lower end variants, seeking a manageable price point. This relationship of marginal propensity of demand withers in the higher-end premium SUV segment, where INDU manages to exercise limited pricing premium (Fortuner and Hilux only contribute ~18% to the sale mix) and PSMC runs into trouble (dependent on sales of lower end Wagon R, Mehran).

Quantifying premium-ification: Over July'17-Sept'18, PSMC/INDU's average quarterly sales price per unit were at an 11% discount/1% premium to their sales weighted prices, indicating relative pricing power exhibited by INDU. This means, INDU sold more of its premium variants for each model than PSMC, a factor we have previously attributed as key to INDU's ability to preserve margins. Additionally, when looking at gross margin volatility, we see the last quarterly period under study (July-Sept'18) as a period of depleting margins for INDU/PSMC with margins slipping 220/200bpsQoQ. At the same time, for both OEMs, average sales prices grew by 25/7%QoQ, where the stark jump in INDU's pricing sets them up for relative margin stability going forward. Since this period was also a time of major transitions for the industry as demand headed into a contractionary spell, when faced with these strains, INDU stood tall in its brand credentials. Additionally for the OEM, our results indicate a lower risk for cannibalization, while market extension to the premium 4x4 segment is margin accretive.

Outlook: It is a given that pricing power remains the key catalyst for long term competitiveness in the auto space. Our analysis shows that successful franchises: 1) extend models to multiple segments successfully, 2) are able to retain disparate pricing for variants amongst the models on offer and 3) are able to attract demand from premium customers, a segment we have shown is more resilient to demand cycles. With the drastic curtailment of used import CBU's we believe premium segment manufacturers could further attract demand from the re-sale/import market, preserving market share in the process. Based on these INDU's remain our top pick in the space, trading at FY19 P/E of 6.9x, the stock offers total upside of 21.5%, implying a BUY call.

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Buy	**> 19% expected total return (Rf: 13% + Rp: 6%)**
Neutral	**> 13% to < 19% expected total return**
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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