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PAKISTAN
AUTOS

REP-019
MARKET
VISTA

Weak profitability cracks cash flows

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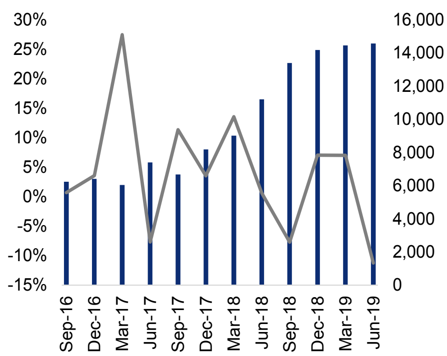
- **Updating our expectations upon release of detailed financial accounts for auto OEMs reveals a persistent upswing in industry CAPEX with the last TTM total outlay reaching PkR14.6bn with PSMC/INDU/HCAR contributing 34/60/7%,**
- **The industry's TTM topline/gross profit growth swayed +5.2/-31.1%YoY 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 likely to moderate going forward as OEMs extend their payables cycles, with the outlook for the PkR vs. US$ remaining relatively controlled (as opposed to a year ago)**
- **News reports and management notices to dealers from PSMC and INDU confirming production slowdowns are common practice, as OEMs have limited inventory handling capacity and dealer inventories (a system common in larger markets) is largely non-existent. INDU, while depleting cash and ST investment buffers, still has PkR23.4bn in ST investments (vs. PkR55.03bn in FY18) allowing it considerable leeway in concluding current CAPEX plans.**

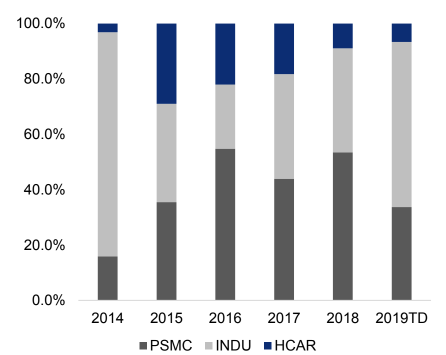
Cumulative quarterly industry CAPEX



Source: Company Accounts & AKD Research

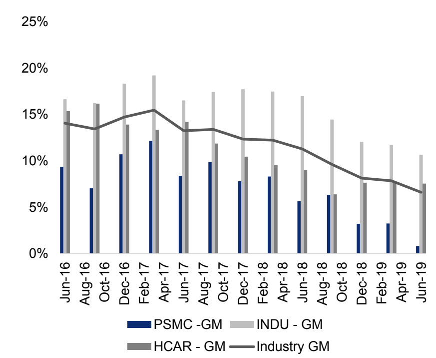
Digging-in for the long run: Breaking down CAPEX by major players, INDU's FY19 cumulative CAPEX of PkR8.7bn is a major deviations from the past, specifically from previous Corolla upgrades (with PkR4.2bn of CAPEX incurred during FY14 for the last major variant launch). We believe the enhanced production capacity (66,000 as of June'19) is likely to be accompanied by a modified production platform to accommodate the upcoming launch of a new sedan flanker brand (converting Corolla to a premium variant, 1,600CC and above), marking a major shift in the firm's production outlook. TTM cumulative CAPEX of PkR14.5bn was led by INDU, where INDU's tapered approach accelerated during 2HFY19, as indicated by management. PSMC has also undergone an upswing, correlated with an updated product slate, with the outgoing 2QCY19 marking a PkR1.3bn outlay. HCAR remains a laggard with CAPEX outlays nearing baseline/maintenance levels.

Trailing Twelve Months Industry CAPEX by OEMS

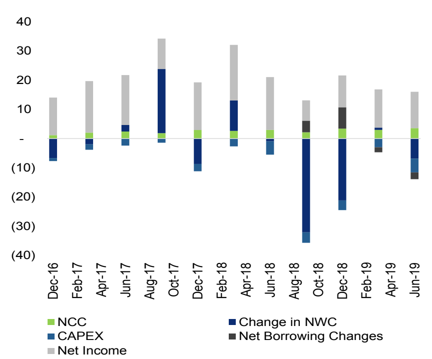


Source: Company Accounts & AKD Research

Industry GM's crater....



... while outflows weigh on free cash flows



Source: Company Accounts & AKD Research

Profitability fails to support outlays: Topline growth has stymied to 5.2%YoY over TTM, the drastic 31.1%YoY fall in gross profits over the same period is increasingly depreciative. The industry's ability to cope with pervasive FX fluctuations passed-on to retail prices in an environ-

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ment of macro-consolidation (monetary tightening, inflationary pressures, lower disposable incomes) with punitive policies discouraging sales growth, has cratered profitability. This is brought home by 1HCY19 cumulative industry sales rising 4.4%YoY and a 14.2%YoY fall in gross profits translating to industry GM's receding 155bpsYoY to 7.3%, illustrating the toll taken on industry profits from rampant PkR weakness and stymied demand. Over 2QCY19, INDU/PSMC/HCAR GM's dipped 632/484/144bpsYoY landing at 10.7/0.8/7.6%, making the case for mean reversion in sector 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) remain prominent, as net working capital variations (cumulative for industry during 2QCY19 at PkR6.9bn stands well below PkR32.2bn in 2QCY18) from leaner delivery times and toppling growth delays cash generation. Going forward, we expect Net Working capital outflows to sustain moderate levels as a relatively stable PkR allows OEMs to raise payables (mostly to foreign suppliers), where the same was not an option a year ago (with a depreciating PkR raising risks of liability being marked-up).

Investment Perspective: Moderating CAPEX outflows, while proceeding with the strategy of margin preservation remains the likely outlook for domestic OEMS. Key dampeners hindering cash flows include: 1) drastic decline in demand and margin deterioration as sticker-shock riles consumers in an inflationary macro-environment, 2) longer inventory holding impacts net working capital and 3) project CAPEX dovetails during 2HCY19, as OEMS seek to release new variants to counter increased competition. News reports and management notices to dealers from PSMC and INDU confirming production slowdowns are common practice, as OEMs have limited inventory handling capacity and dealer inventories (a system common in larger markets) is largely non-existent. INDU, while depleting cash and ST investment buffers, still has PkR23.4bn in ST investments (vs. PkR55.03bn in FY18) allowing it considerable leeway in concluding current CAPEX plans.

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

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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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