Auto Sector – Earnings Revised Downward

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Macro landscape & regulatory changes warrants earnings revision

- The worsening macroeconomic environment has cast a doubt on the previously estimated strong demand growth. We have revised our macroeconomic assumptions which include a) revision in GDP growth forecast, b) higher PKR devaluation and c) tighter monetary policy led slowdown in financing.
- Despite deteriorating macroeconomic environment and law restricting non-filers from purchasing cars, we maintain our market-weight stance on auto sector. We believe, that on average 28% YTD decline in auto stocks (HCAR, PSMC, INDU) compared to 5% YTD rise in KSE-100 index indicates that market has priced in most of the unfavorable sector outlook. However, we downgrade PSMC to a ‘Hold’, while maintaining our ‘Hold’ stance on INDU and HCAR.
- We expect GDP growth at 4-4.5% for FY19 compared to 5.8% in FY18 as fiscal austerity measures, rupee depreciation and monetary tightening are expected to curtail overall aggregate demand. Moreover, we also take into account slowdown in Auto financing due to faster than anticipated interest rate hike wherein we now expect policy rate to reach 8.5% by Dec-18. It must be noted that outstanding car financing declined in June 2018, which is a first such fall after a period of 18 months, pointing towards a potential slowdown.
- More importantly, law passed in budget FY18-19 barring non-filers from purchasing cars is estimated to lead to a decline in volumes next fiscal year. As per news sources, approximately 40% of Auto clients are non-filers. However, the impact on demand will vary across companies due to differences in their respective client base.
- Based on the aforementioned factors, we expect overall demand for motor vehicles to contract in FY19. We estimate unit sales of the local OEMs to decline 11% YoY in FY19 from the twin effect of changing macroeconomic landscape as well as impact of regulatory change. Resultantly, our forecasted 5-Year (FY19-23) forward CAGR of unit sales for the 3 existing local OEMs is 2% and takes into account heightened competition from new players post FY20.

2019 profits revised downward by on average 34%

- Accordingly, we revise down our Topline auto universe earnings estimate on average by 34% for 2019 and estimate 5-Year (FY19-23) sales and profitability CAGR at 12% and 5% respectively. The change stems from downward revision in volumetric growth from previous estimated forward 5-Year (FY19-23) CAGR of 10% to 2% and downward revision of gross margin from on average estimate of 12% to 9% during the same period owing to aforesaid factors.

Earnings Revision

Symbol	FY18A/E			FY19E			FY20F		
	Old	Revised	% Change	Old	Revised	% Change	Old	Revised	% Change
INDU	183.1	184.9	1%	191.7	148.9	-22%	196.5	156.6	-20%
PSMC	55.3	29.3	-47%	58.4	35.2	-40%	60.0	40.6	-32%
HCAR	45.5	45.5	0%	52.1	31.1	-40%	64.4	39.4	-39%

Source: Company Accounts, Topline Research

- We downgrade PSMC to 'Hold' and maintain 'Hold' on INDU and HCAR as the companies will face tough demand conditions as well as falling GP margins.
- Key risks to our thesis: 1) higher than expected PKR Depreciation, 2) volatility in steel prices, 3) delayed roll out of new models, 5) higher than anticipated interest rates and 6) regulatory changes.

Autos: Key Numbers

	2016A	2017A	2018A/E	2019F	2020F
PE	10.7	8.3	8.1	10.0	9.0
Earnings Growth	-2%	29%	2%	-19%	12%
PBV	3.2	2.7	2.3	2.1	1.9
Dividend Yield	5%	7%	8%	6%	6%
ROE	30%	32%	28%	21%	21%

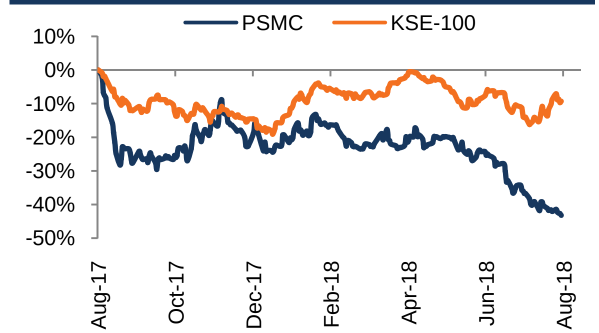
Source: Topline Research, Company Accounts

PSMC: Double whammy from falling volumes & GP margin

- **Investment Thesis:** We downgrade PSMC to a 'Hold' as the company is expected to face significant decline in volumes due to regulatory change and falling margins as a result of PKR depreciation. We expect 5 Year (2018-2022) forward earnings CAGR to be 4.6%.
- **Slow-down in sales activity:** As per channel checks, the foot count at dealerships has declined significantly and the bookings have slowed-down due to the aforesaid regulatory change. The customer base consists of a high proportion of middle income customers with greater fraction of non-filers and hence the volumetric cut-down will be the worst for the company.
- **Launch of Alto to provide some support:** The company recently announced discontinuation of Mehran VX from Dec 2018 onwards due to thin demand for the variant compared to Mehran VXR which is still in high demand. However, the company is slated to launch Alto in the next year and replace Mehran in due time altogether, as per our channel checks. The upcoming Alto is also expected to come with high localization component which should result in better margin sustainability through protection against PKR devaluation.
- **Earnings revised downwards:** We forecast PSMC's gross margins to average 7.3% during FY19-23 compared to 9% during FY13-17. Due to GP margin contraction as well as fall in demand for smaller passenger cars, we estimate 2018/2019 EPS to fall to Rs29.3/35.2 from our previous estimate of Rs55.3/58.4.

KATS Code	PSMC
Bloomberg Code	PSMC PA
Reuters Code	PKSU.KA
Market Price	Rs337.76
Market Cap	Rs27.8bn/US$224.0mn
Free float Market Cap	Rs7.3bn/US$59.2mn
1-Yr Avg. Daily Vol. (mn)	0.1
1-Yr Avg. Daily Val. (mn)	Rs30.2/US$0.3
1-Yr High/ Low	Rs622.5/338.0
Estimated free float	26%
Share outstanding (mn)	82.30
Index weight	0.36%

PSMC vs KSE-100 Index



Source: PSX, Topline Research

Pak Suzuki Motor (PSMC) – Financial Highlights

TOPLINE

Income Statement

Rsmn	2016A	2017A	2018E	2019F	2020F
Net Sales	76,516	101,812	114,879	122,346	136,031
Gross Profit	7,349	9,653	8,257	8,889	9,914
Distribution Expense	2,004	2,804	2,892	3,080	3,424
Admin Expense	1,540	1,600	1,846	1,935	2,151
Other Income	1,040	865	919	1,154	1,257
Other Charges	334	414	542	591	629
Profit Before Tax	4,415	5,619	3,710	4,335	4,855
Profit After Tax	2,773	3,826	2,408	2,894	3,339
EPS (Rs)	**33.7**	**46.5**	**29.3**	**35.2**	**40.6**

Source: Company Accounts, Topline Research

Balance Sheet

Rsmn	2016A	2017A	2018E	2019F	2020F
Non-Current Assets	7,334	9,904	10,224	10,838	11,630
Current Assets	30,518	41,006	39,652	42,211	45,890
Total Assets	37,852	50,910	49,877	53,050	57,519
Equity	26,217	29,550	30,427	32,358	34,539
Non-Current Liabilities	-	-	-	-	-
Current Liabilities	11,635	21,361	19,450	20,692	22,980
Total Equity & Liabilities	37,852	50,910	49,877	53,050	57,519

Source: Company Accounts, Topline Research

Key Ratios

	2016A	2017A	2018E	2019F	2020F
DuPont Analysis:					
Tax Burden	0.6x	0.7x	0.6x	0.7x	0.7x
Interest Burden	1.0x	1.0x	1.0x	1.0x	1.0x
EBIT Margin	6%	6%	3%	4%	4%
Total Asset Turnover	2.0x	2.3x	2.3x	2.4x	2.5x
Financial Leverage	1.5x	1.6x	1.7x	1.6x	1.7x
ROE	11%	14%	8%	9%	10%
Others:					
Gross Margin	10%	9%	7%	7%	7%
Net Margin	4%	4%	2%	2%	2%
Pretax Margin	6%	6%	3%	4%	4%
Effective Tax Rate	37%	32%	31%	30%	30%
Return on Total Capital	9%	8%	5%	6%	6%
Return on Assets	7%	9%	5%	6%	6%
Return on Equity	11%	14%	8%	9%	10%
Debt to Total Assets	NM	NM	NM	NM	NM
Debt to Equity	NM	NM	NM	NM	NM
Interest Coverage	47.1x	83.7x	20.9x	43.3x	44.1x
Current Ratio	2.6x	1.9x	2.0x	2.0x	2.0x
Quick Ratio	1.2x	0.8x	0.8x	0.8x	0.9x

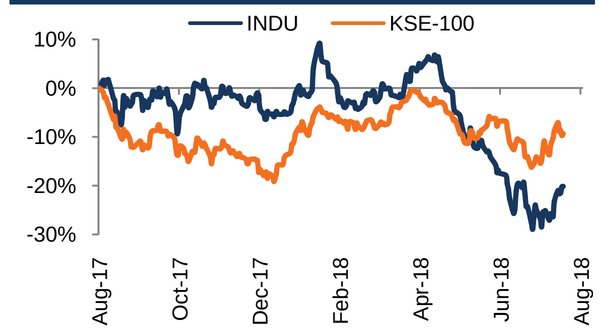
Source: Company Accounts, Topline Research

INDU: Client mix to pose the biggest challenge

- **Investment thesis:** We maintain our 'Hold' call on Indus Motors (INDU) as we believe that the client mix, amid regulatory change, does not bode well for the company and PKR depreciation will compress margins. Resultantly we estimate 5 Year (2019-2023) forward earnings CAGR to be 2.7%.
- **Rural clients to pose a challenge:** INDU is expected to suffer meaningful decline in demand as significant fraction of its clients belong to rural areas where proportion of non-filers is much higher. Furthermore, demand will also be hurt by the changing macro-environment as growth in household income starts to stagnate.
- **Strong existing order book to provide some breathing room:** Intact lead times for INDU's products along with advanced booking of flagship Corolla model up to 2QFY19 is an indication that the slowdown in sales may take a little longer to materialize. We expect INDU's sales to begin slowing down from 2QFY19 when the existing strong order book is fulfilled.
- **Competition from new City model:** Potential launch of new City model by Honda next year will provide direct competition to the basic versions (smaller engine size) of Toyota Corolla, wherein we expect INDU's market share to decline slightly in the coming year to make space for the expected higher volumes of Honda City. Moreover, sales in high margin segment will also decline in the coming year as election driven demand subsides.
- **Falling GP margins to compress earnings:** We estimate gross margin of the company to average 12% in CY19-23 and revise our EPS estimate of FY19E downwards to Rs148.9 compared to Rs191.7 estimated previously.

KATS Code	INDU
Bloomberg Code	INDU PA
Reuters Code	INDM.KA
Market Price	Rs1480.19
Market Cap	Rs116.3bn/US$937.7mn
Free float Market Cap	Rs19.8bn/US$159.7mn
1-Yr Avg. Daily Vol.	20,718
1-Yr Avg. Daily Val. (mn)	Rs34.3/US$0.3
1-Yr High/ Low	Rs1,942.0/1,251.7
Estimated free float	17%
Share outstanding (mn)	78.60
Index weight	0.97%

INDU vs KSE-100 Index



Source: PSX, Topline Research

Indus Motor (INDU) – Financial Highlights

TOPLINE

Income Statement

Rsmn	FY16A	FY17A	FY18E	FY19F	FY20F
Net Sales	108,759	112,272	140,083	150,413	156,400
Gross Profit	17,731	19,822	23,147	18,083	18,753
Distribution expense	1,061	1,228	1,273	1,367	1,422
Admin expense	931	1,053	1,496	1,805	1,877
Other income	3,164	3,593	3,640	4,647	4,371
Other charges	1,429	1,595	1,822	1,956	2,034
Profit before tax	17,397	19,141	21,641	16,956	17,333
Profit after tax	11,455	13,001	14,534	11,700	12,312
EPS (Rs)	**145.7**	**165.4**	**184.9**	**148.9**	**156.6**

Source: Company Accounts, Topline Research

Balance Sheet

Rsmn	FY16A	FY17A	FY18E	FY19F	FY20F
Non-Current Assets	10,156	6,438	6,257	6,156	6,145
Current Assets	47,381	57,441	64,991	62,174	60,760
Total Assets	57,537	63,880	71,248	68,330	66,905
Equity	27,630	31,197	35,557	39,067	42,761
Non-Current Liabilities	-	4	-	-	-
Current Liabilities	29,907	32,679	35,691	29,263	24,144
Total Equity & Liabilities	57,537	63,880	71,248	68,330	66,905

Source: Company Accounts, Topline Research

Key Ratios

	FY16A	FY17A	FY18E	FY19F	FY20F
DuPont Analysis:					
Tax Burden	0.7x	0.7x	0.7x	0.7x	0.7x
Interest Burden	1.0x	1.0x	1.0x	1.0x	1.0x
EBIT Margin	16%	17%	16%	12%	11%
Total Asset Turnover	2.0x	1.8x	2.1x	2.2x	2.3x
Financial Leverage	2.1x	2.1x	2.0x	1.9x	1.7x
ROE	44%	44%	44%	31%	30%
Others:					
Gross Margin	16%	18%	17%	12%	12%
Net Margin	11%	12%	10%	8%	8%
Pretax Margin	16%	17%	15%	11%	11%
Effective Tax Rate	34%	32%	33%	31%	29%
Return on Total Capital	14%	15%	13%	9%	9%
Return on Assets	21%	21%	22%	17%	18%
Return on Equity	44%	44%	44%	31%	30%
Debt to Total Assets	NM	NM	NM	NM	NM
Debt to Equity	NM	NM	NM	NM	NM
Interest Coverage	226.1x	49.1x	40.0x	27.3x	38.8x
Current Ratio	1.6x	1.8x	1.8x	2.1x	2.5x
Quick Ratio	1.3x	1.5x	1.5x	1.7x	2.0x

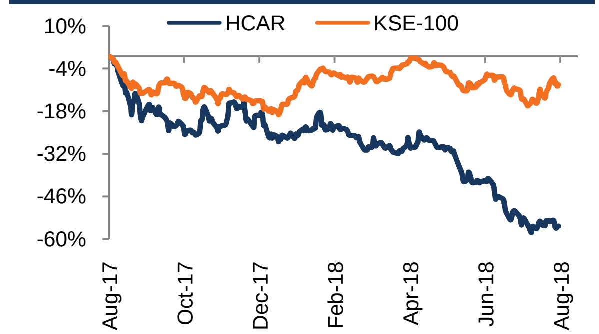
Source: Company Accounts, Topline Research

HCAR: Partially shielded from regulatory change; challenges remain

- **Investment thesis:** We maintain a 'Hold' call on Honda Cars (HCAR) as although the company will be least impacted of the local OEMs from the regulatory change, but will still face falling earnings due to contracting GP margins. We estimate 5 Year (2019-2023) forward earnings CAGR to be 3.9%.
- **Client mix to shield HCAR:** The company has lowest number of non-filer clients as per channel checks. Most of its clients belong to the salaried class, corporate customers and wealthier segment of society, a higher proportion of which are already tax filers.
- **Macroeconomic environment still unavoidable:** Challenges from the macro-economic environment remain wherein PKR depreciation and slowdown in GDP growth will contract the robust demand growth and GP margins that HCAR along with other Auto players had witnessed in recent years.
- **New City model to provide volumetric upside:** We also take into account the potential roll out of new City model next year which is expected to boost volumes for the company while grabbing market share from INDU in the sedan segment. Simultaneously, as per news sources, the Company has decided not to launch Brio which could have helped the company enter into the hatchback segment, mostly dominated by PSMC, and could have offered considerable volumes upside.
- **Low GP margins to drag earnings:** Given the aforesaid challenges, we expect GP margins for the company to average 8.5% during MY19-23 and EPS to decline to Rs31.1 in MY19 compared to previous estimate of Rs52.1.

KATS Code	HCAR
Bloomberg Code	HCAR PA
Reuters Code	HATC.KA
Market Price	Rs289.25
Market Cap	Rs41.3bn/US$332.9mn
Free float Market Cap	Rs8.3bn/US$66.6mn
1-Yr Avg. Daily Vol. (mn)	0.1
1-Yr Avg. Daily Val. (mn)	Rs43.9/US$0.4
1-Yr High/ Low	Rs687.0/269.0
Estimated free float	20%
Share outstanding (mn)	142.80
Index weight	0.40%

HCAR vs KSE-100 Index



Source: PSX, Topline Research

Honda Atlas Car (HCAR) – Financial Highlights

TOPLINE

Income Statement

Rsmn	FY16A	FY17A	FY18A	FY19E	FY20F
Net sales	40,086	62,803	91,523	98,210	120,130
Gross profit	6,047	9,122	10,449	8,206	10,151
Distribution expense	333	542	917	990	1,173
Admin expense	352	497	678	912	1,201
Other Income	310	1,115	1,883	1,940	1,922
Other charges	486	538	1,245	1,439	1,681
Finance cost	7	23	14	16	18
Profit before tax	5,179	8,636	9,479	6,789	8,001
Profit After tax	3,556	6,135	6,494	4,447	5,625
EPS (Rs)	**24.9**	**43.0**	**45.5**	**31.1**	**39.4**

Source: Company Accounts, Topline Research

Balance Sheet

Rsmn	FY16A	FY17A	FY18A	FY19E	FY20F
Non-Current Assets	3,867	5,086	5,567	6,603	7,290
Current Assets	12,338	46,380	53,242	45,613	43,364
Total Assets	16,205	51,465	58,809	52,217	50,653
Equity	7,941	13,065	17,073	19,742	23,117
Non-Current Liabilities	226	440	540	392	392
Current Liabilities	8,038	37,961	41,195	32,083	27,144
Total Equity & Liabilities	16,205	51,465	58,809	52,217	50,653

Source: Company Accounts, Topline Research

Key Ratios

	FY16A	FY17A	FY18A	FY19E	FY20F
DuPont Analysis:					
Tax Burden	0.7x	0.7x	0.7x	0.7x	0.7x
Interest Burden	1.0x	1.0x	1.0x	1.0x	1.0x
EBIT Margin	13%	14%	10%	7%	7%
Total Asset Turnover	2.7x	1.9x	1.7x	1.8x	2.3x
Financial Leverage	2.3x	3.2x	3.7x	3.0x	2.4x
ROE	54%	58%	43%	24%	26%
Others:					
Gross Margin	15%	15%	11%	8%	8%
Net Margin	9%	10%	7%	5%	5%
Pretax margin	13%	14%	10%	7%	7%
Effective Tax Rate	31%	29%	31%	34%	30%
Return on Total Capital	32%	33%	16%	14%	15%
Return on Assets	24%	18%	12%	8%	11%
Return on Equity	54%	58%	43%	24%	26%
Debt to total assets	1%	1%	1%	1%	1%
Debt to Equity	3%	3%	3%	2%	2%
Interest Coverage	742x	369x	656x	427x	458x
Current Ratio	1.5x	1.2x	1.3x	1.4x	1.6x
Quick Ratio	1.0x	1.0x	1.1x	1.1x	1.2x

Source: Company Accounts, Topline Research

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