Pushing Down on the Pedal: Indian Passenger Vehicles to Accelerate

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Mirae Asset Global Investments (India)
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Passenger Vehicle (PV) penetration in India has reached an inflection point, with key drivers such as gross domestic product (GDP) growth, premiumization and increased safety standards all pointing to further industry growth.

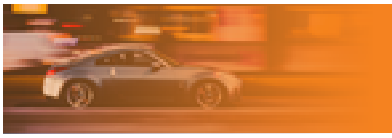
India currently has a PV penetration rate of nearly 28 four-wheeled vehicles per 1,000 people, a level that has coincided with a sales inflection point in other economies. In countries such as South Korea, Japan and China, compound annual growth rate (CAGR) of car sales was in excess of 20% over the following five years once this level of penetration was achieved, supported by strong growth in GDP per capita. In the case of all these countries, GDP per capita growth was in excess of 8% in consecutive years. In the way of India, even assuming a relatively modest GDP per capita CAGR of 6-7%, we expect that car sales could keep growing at a CAGR of 12-14%.[1] If GDP growth rates pick up beyond this threshold, there could be an even sharper acceleration as seen in other global markets.

Automobile Revenues Against Economic Growth of Select Countries

Source: Nomura, "India autos: PVs set for a multi-year growth cycle" (March 24, 2017)

			Passenger Vehicle Sales CAGR			GDP per capita CAGR		
Country	Base Year	4W Sales	2 Yr	5Yr	10 Yr	2 Yr	5Yr	10 Yr
S. Korea	1985	369,392	61.7%	28.6%	15.5%	11.1%	9.4%	8.1%
Penetration (%)	27%		39%	79%	188%			
Japan	1962	932,991	26.6%	23.8%	16.7%	8.9%	8.5%	7.3%
Penetration (%)	28%		51%	99%	209%			
China	2006	7,183,558	14.2%	20.9%	14.5%	11.4%	10.1%	8.5%
Penetration (%)	28%		38%	69%	138%			
India	2017	3,749,937						
Penetration (%)	28%							

[1] Nomura, "India autos: PVs set for a multi-year growth cycle" (March 24, 2017)



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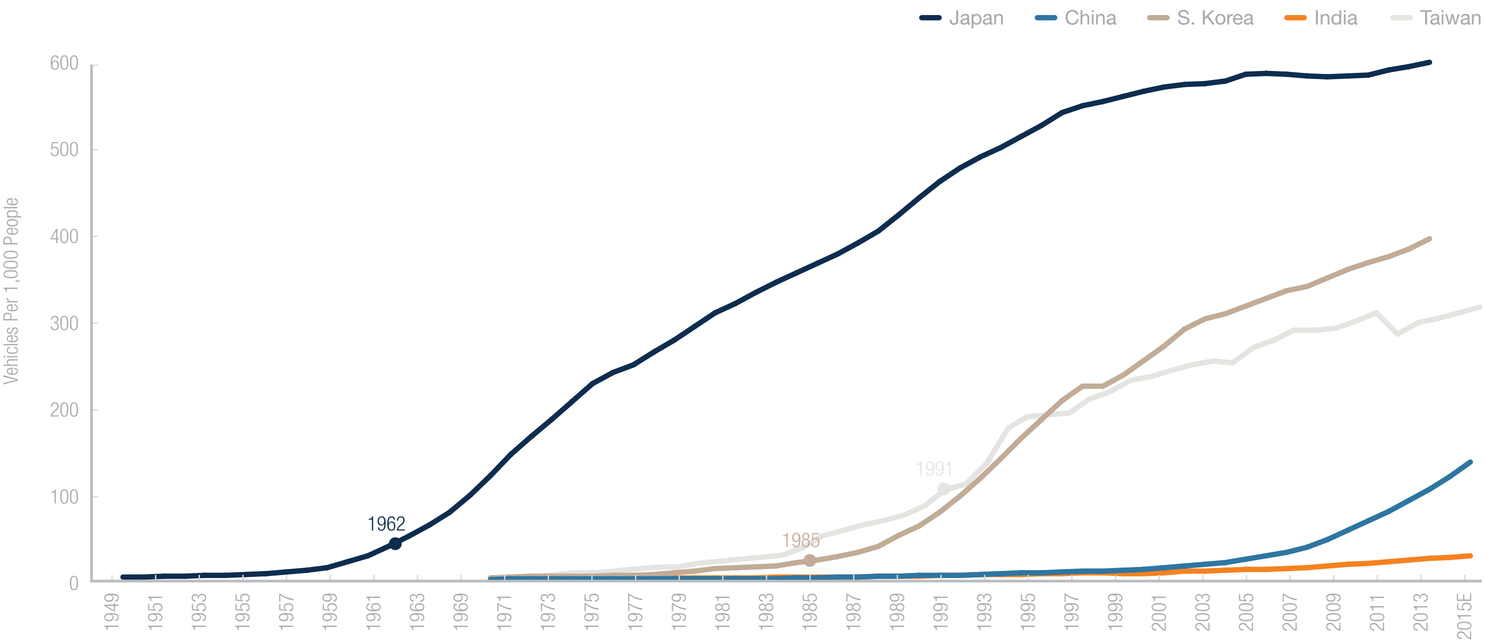
Charting Passenger Vehicle Penetration Over Time

Source: Nomura, “India autos: PVs set for a multi-year growth cycle” (March 24, 2017)



Single Digit per Capita GDP for Double Digit Industry Growth

Even assuming a 6% CAGR growth, India’s GDP per capita in purchasing power parity (PPP) terms could hit US$ 14,400 by FY30F, similar to what China recorded in FY16. However, we expect annual Indian PV industry sales reaching only ~15mn units by FY30F under such a scenario, which is lower than China’s 24.3mn sales in FY17 (at a similar GDP per capita in PPP terms). Essentially, absolute car volumes vary per country based on the number of households, infrastructure, regional access, and other factors. Nonetheless, this upward directionality still implies decent potential for India’s PV industry, especially if the economic growth is higher than our estimate.

Automobile Industries: India and China Compared

Source: Nomura, “India autos: PVs set for a multi-year growth cycle” (March 24, 2017)

India	FY17	FY30F	% CAGR
Annual PV Sales (mn)	3.0	14.9	12.8%
GDP / Capita PPP (USD)	6,773	14,446	6.0%

China	FY17	FY30F	% CAGR
Annual PV Sales (mn)	24.3		
GDP / Capita PPP (USD)	14,704		

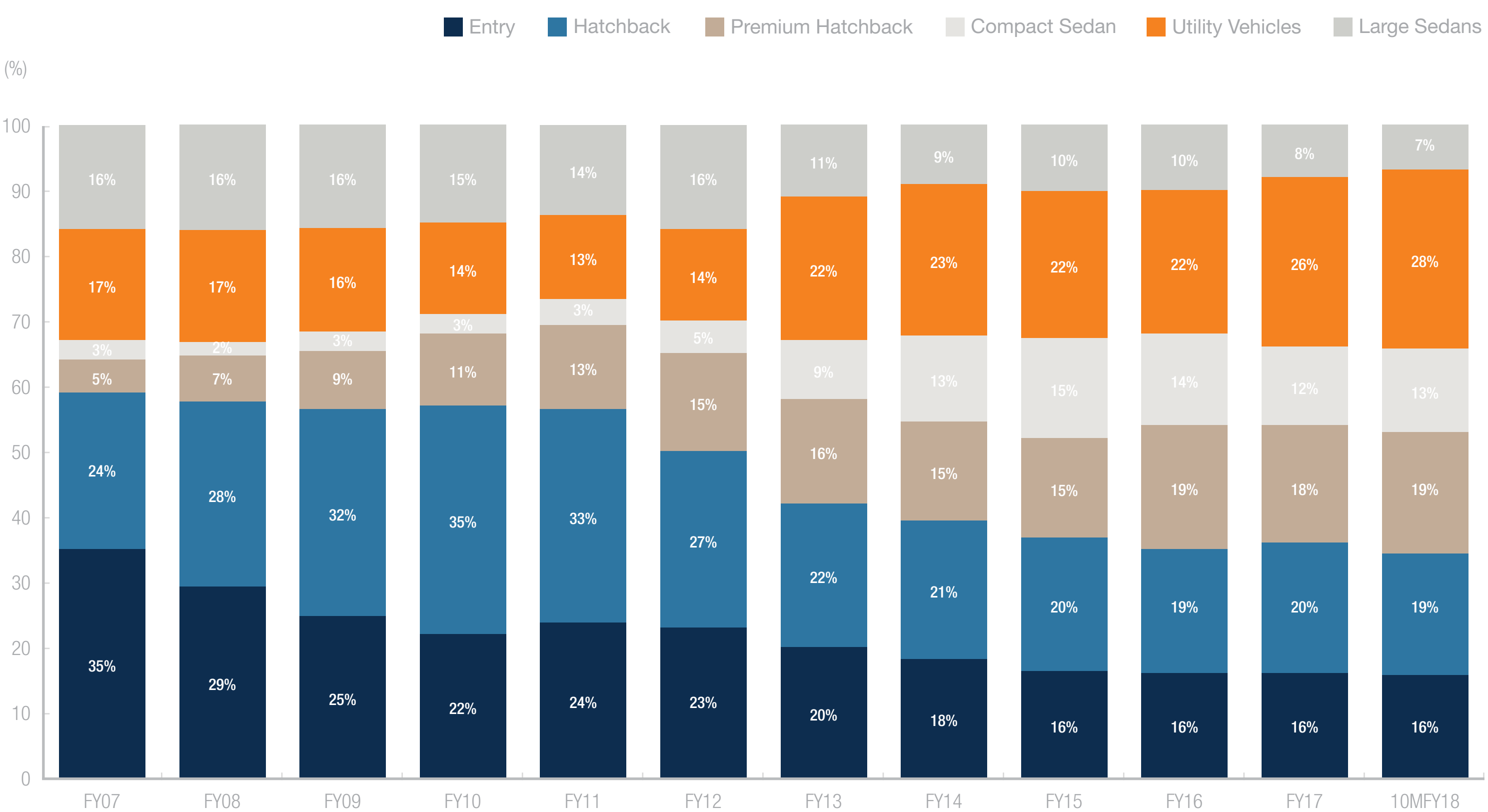
Premiumization to Boost Average Selling Prices (ASPs)

The PV industry mix has been steadily improving with more utility vehicles (UVs) at approximately 30% market share, while the share of the entry/hatchback/compact sedan segments have been declining marginally.

Customers are also willing to pay a premium for features. Blue-tooth connectivity, reverse parking cameras, navigation systems, projector headlamps and automatic transmissions are leading to a sharp improvement in ASPs, benefiting original equipment manufacturers (OEMs). For example, the largest industry player, as seen a 5% CAGR jump in its realization over the past two years following new model launches in the UV segments, though its absolute sales realization is still lowest among the OEMs in India.

Segmental Market Share

Source: Nomura, "India autos: PVs set for a multi-year growth cycle" (March 24, 2017)



Higher Safety and Emissions Standards

Safety regulations are becoming stricter in India and features such as airbags, ABS (anti-lock braking system) and reverse parking sensors are likely to become mandatory in the next several years. Incorporating these features across the entire portfolio will lead to a 5-10% increase in ASPs over a two-year period.

Emission regulations are also likely to become tighter with the Ministry of Road Transport and Highways (MORTH) proposing a direct shift from the current BS-4 emission standard to BS-6 by April 2020. The transition for petrol vehicles is relatively simple and entails additional costs of only INR10,000-15,0000 but upgrading diesel standards will be more costly. Diesels must have exhaust treatment (Selective Catalytic Reduction) and sensors to monitor the emissions, which leads to additional costs of about INR50,000 per car.

The introduction of BS-6 emission standards would increase the cost difference between diesel and petrol cars, making diesel cars less attractive for personal driving while they might still be favored commercially.

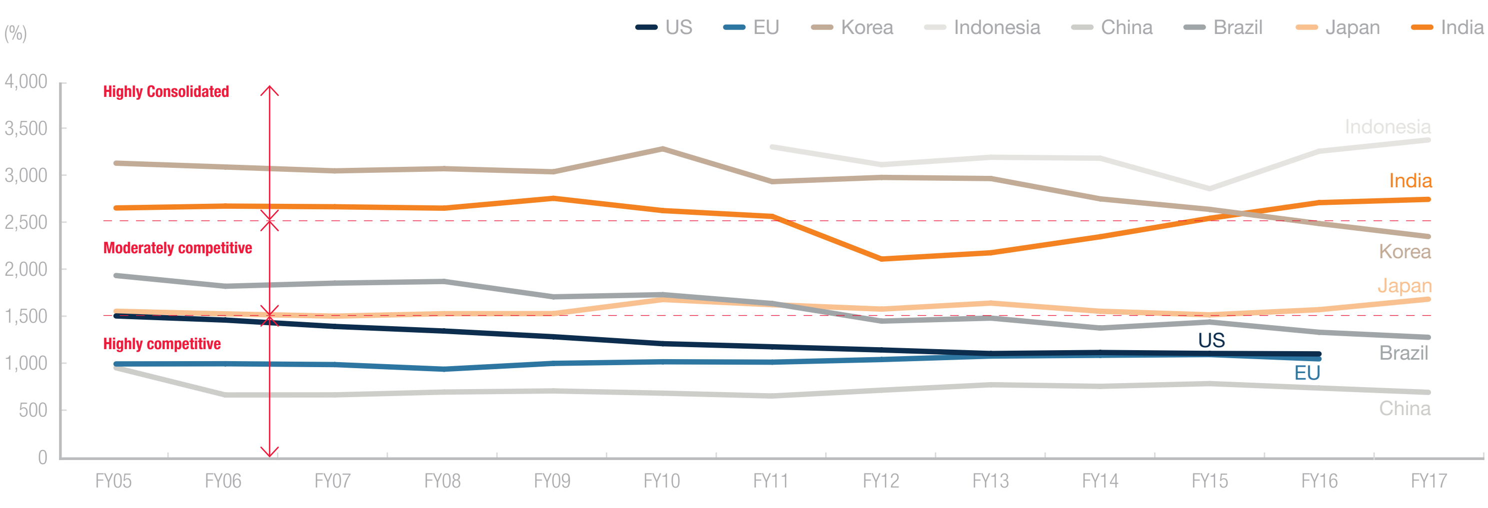
The government plans to promote green transport with a greater focus on bio-fuels, compressed natural gas (CNG) and electric/hybrid solutions. Thus, cars with CO2 emissions of less than 155 g/km (which will progressively get stricter) and length of less than 4m will attract the lowest tax of 1% in 2018, while it will remain at 15% and 27% for other categories. There are also plans to monitor this on a company average basis and major deviation could attract penalties. Hence, it becomes imperative for OEMs to offer greener solutions and this will attract most of the investment in our view.

Competitive Intensity Remains Subdued in PVs

The Herfindahl-Hirschman Index (HHI) indicates that consolidation is significantly higher in India than in other countries. Consolidation has been increasing while other countries in the region (except for Indonesia) are becoming more competitive. Consolidation is likely to remain high in India due to the dominant position of the top competitor and weak performance by global players.

Benchmarking Degree of Consolidation

Source: Nomura, "India autos: PVs set for a multi-year growth cycle" (March 24, 2017)



Most global OEMs have been unable to materially improve their market share or profitability despite having been in India for quite some time. Indian exposure is nominal for most OEMs, except for the ones at the forefront. Due to the differential tax between small and large cars, about 75% of volume consists of small cars. Global OEMs have limited products in this space. Given their low exposure to India, they find it difficult to fund research and development and address India-specific requirements to successfully challenge market incumbents. General Motors India (GM) has decided to stop selling vehicles in the Indian market from the end of 2018 after nearly 21 years of existence. Many other OEMs are also struggling with losses. This situation is likely to persist in the near future.

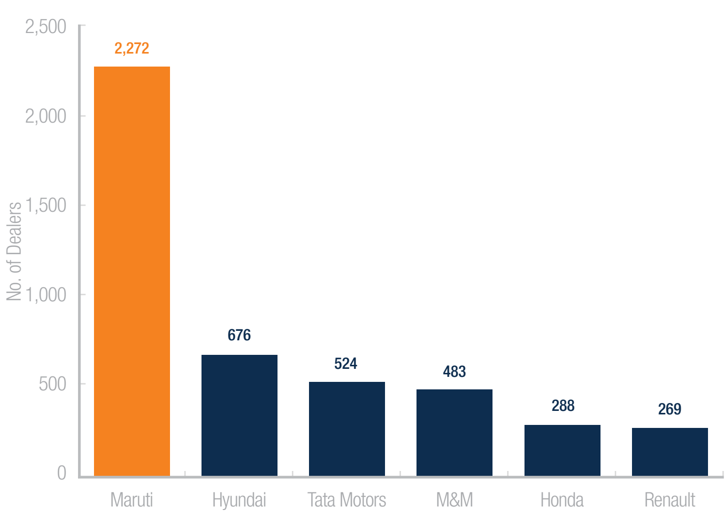
Distribution Reach is a Key Differentiator

New entrants have a smaller distribution presence than the larger OEMs. With sustained market leadership, both of the leaders have increased their reach into semi-urban/rural areas, which makes their volumes less dependent on the traditional urban market. This is also one of the reasons why new launches from these companies tend to find a wider addressable market than smaller OEMs with limited distribution networks.

Larger players have also set up a parallel network that allows customers to trade in older cars for new ones. This helps boost resale prices and further strengthens customer relationships with the company. Smaller players need to improve their dealer networks to become more competitive.

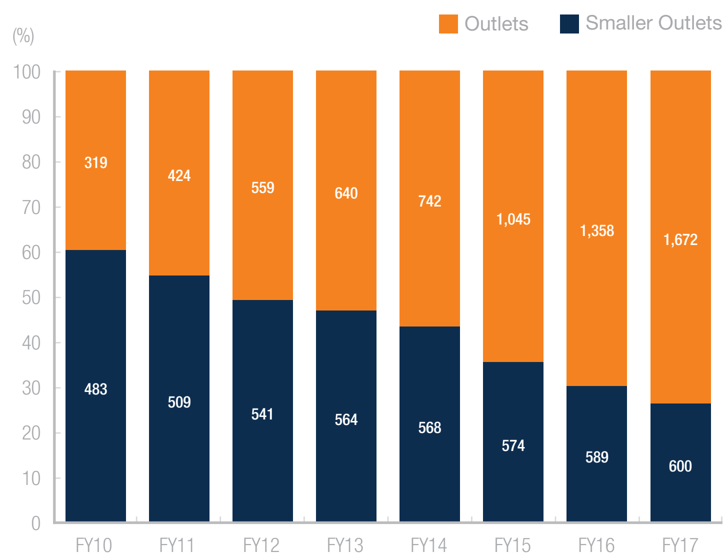
Dealership Networks of Automblie Manufacturers

Source: Company Disclosures, Jefferies



Maruti Has Increased its Smaller Dealers Rapidly to Expand into Smaller Semi-Urban Areas

Source: Company Disclosures, Jefferies



Two Ahead of the Rest

The scale built by the two largest players is difficult to replicate for numerous reasons. Firstly, as discussed, their wider sales and service distribution network creates a business moat while serving the hinterland. Their higher degree of localization is also driving down the cost of ownership as spare parts and other components become cheaper. They have also made larger investments in developing efficient engines and powertrain solutions and, lastly, their increased exposure to premium products is supporting margins.

We expect further market share consolidation in favor of these two players (market share has already increased from 54% in FY12 to 73% in FY18. The front runner will be at an even more advantageous position given Hyundai's capacity constraints in the medium-term.

Green Lights Ahead

The Indian passenger vehicle industry is on a highway to success and growth. Economic growth rates in mid-single digits are linked to car sale uptakes of over 10%. India is starting from a modest base of penetration and the experience of countries such as Korea and Japan indicate sales should rise for the foreseeable future. Increased regulations will result in vehicle premiumization while consolidation narrows the field of OEMs. Those companies with the right reach and distribution stand to build market share in cities and semi-urban areas. In our view, this sector is an engine for growth for investors who seek exposure to India.

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