INDIAN PASSENGER VEHICLE INDUSTRY: LONG TERM DEMAND OUTLOOK REMAINS ROBUST

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Summary Opinion

- The domestic demand for passenger vehicles has sharply recovered during the current year, with growth at 21.2% during the eight months of 2009-10, supported by fiscal incentives and a revival in the underlying economy. The demand revival has been sharp in contrast to H2, 2008-09, when the volumes suffered on weak consumer confidence caused by global economic crisis and cutback on vehicle financing by banks/ NBFCs due to liquidity constraints.
- During the last couple of years, globally the automobile industry has suffered severe demand shock on account of the culmination of economic slowdown and credit crunch. The demand contraction during the last two calendar years has been 38% in the US, 18% in Europe and 13% in Japan. In contrast the Indian passenger vehicle market has suffered only stagnant demand during 2008-09. This contrasting demand pattern in India (along with China) highlights the significance of the Indian market going forward for most global players.
- While there has been some deferment of investments by global majors in the Indian market, constrained largely by the weak performance in their home markets, most of the players are planning significant capacity build-up for the Indian markets.
- Domestic demand has also been supported by competitive pricing adopted by the OEMs. While manufacturing costs have increased sharply over the years on commodity price rise and tightening of emission/ safety norms, however adjusted for these, the real price increase has been muted. OEMs have largely passed on benefits of reduction in excise duties, economies of scale and value engineering to end customers, facilitating demand growth. New model launches have also been a key factor in sustaining consumer interest.
- The export segment has been growing rapidly, especially during the last couple of years, driven by Maruti Suzuki India Limited (MSIL) and Hyundai Motors India Limited (HMIL). India's strong domestic base in the small car segment provides it the ideal platform for capitalising on the small car market in other geographies from India. The export growth during the current financial year has also been supported by the scrapping programme in the European market.

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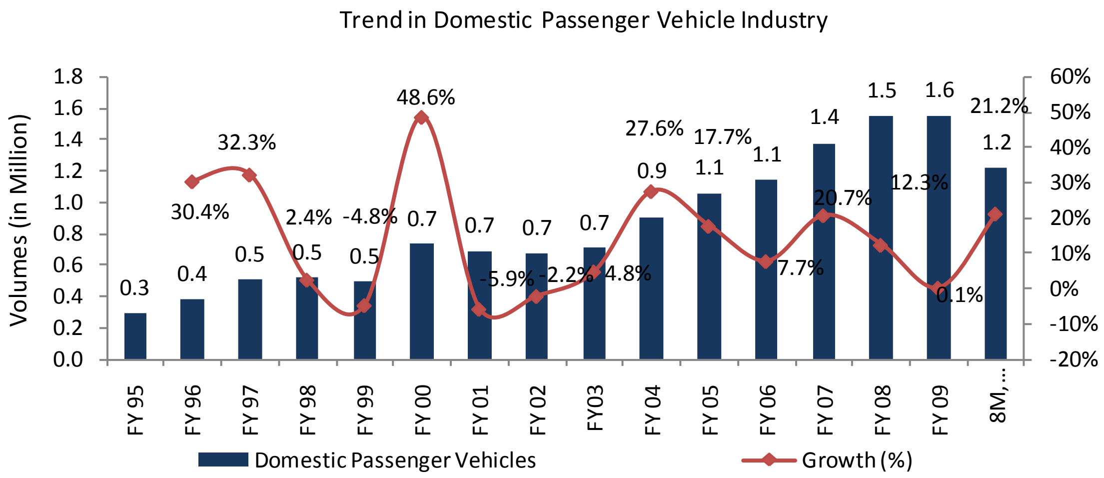
- Even though higher priced segments contribute a small proportion of total demand, the absolute numbers have grown over the years and they now contribute ~0.7 million across categories, a significant volume to attract global investments. Within the lower priced segment (mini/compact), the price band has widened, with higher priced but better value products achieving higher volumes than some lower priced models. The price range may widen further depending on the success of the 'Nano' segment.
- The long term demand drivers' for the segment – GDP growth, rising middle class/ aspiration levels, rising affordability and availability of finance remain robust in the Indian economy, indicating healthy long term growth prospects.

Background

While the demand growth has been volatile on a y-o-y basis, over a 14 year period till 2008-09 the domestic passenger vehicle market has grown at a healthy CAGR of 12.6% to 1.6 million units. The demand has been driven by buoyant economic activity, growing middle class population, increasing average household income levels and improved availability of financing at competitive lending rates. The low level of passenger vehicle ownership[1] in comparison to other developing economies and, shortening vehicle ownership cycle, besides increasing penetration in rural markets also has supported growth. During the current fiscal, the passenger vehicle segment has recorded a growth of 22.6% with 1.5 million units sold during April-November 2009 as against the corresponding period last year – a significant turnaround in the context of stagnant demand during H2, 2008-09. The bounce back in growth has been higher than industry expectations – reflecting strong recovery in consumer confidence aided also by, declining interest rates, stimulus package offered by the government in the form of excise duty cuts and improving financing environment since the lows of Q3, 2008-09. The growth has also been supported by higher disposable income with Government employees facilitated by the implementation of the sixth pay commission. On the export front the growth has been robust during 2008-09, even during periods of economic turmoil, albeit on a small base. The exports have been supported largely by the success of HMIL's i10/ i20 models. During April-November 2008-09, passenger vehicle exports grew by 28.8% driven by small car exports, which would also have benefited from the scrapping scheme in Europe. However, exports may be less buoyant in the near term as incentive-driven demand[2] has already been met in many parts of Europe. Also, imports from India could be impacted by FTA agreement between EU and Korea, rendering manufacturing in India more expensive.

Chart 1: Trends in domestic demand



Source: SIAM

[1] India has ~11 vehicles per 1,000 people, as compared to China (22), Brazil (102) or developed countries (500+), though effective penetration in India, taking into account the target population would be much higher – Source: ICRA research, Moody's Global Corporate Finance

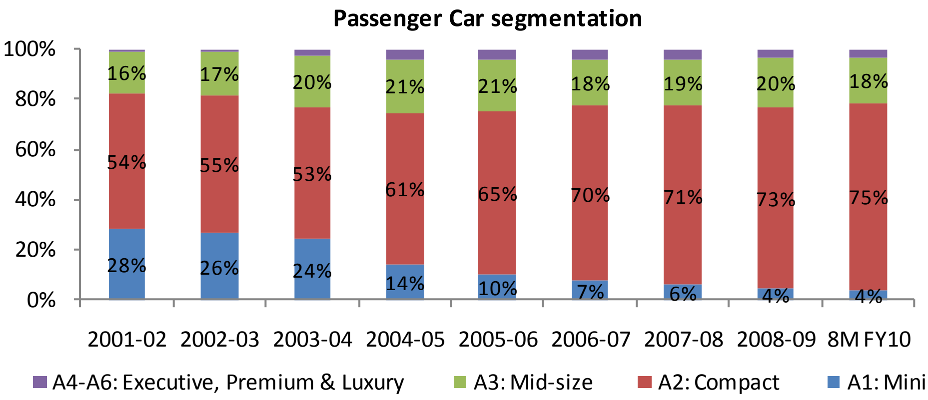
[2] Refers to demand generated by scrapping schemes introduced by European Governments

Industry composition

Passenger cars and utility vehicles are the main segments of the Indian passenger vehicle industry with the former accounting for ~80% the total volumes. Within the passenger car segment, the mini and compact segment together accounts for around 80% of total volumes. Over the last 5-6 years the compact car segment in particular has been the focus for most OEMs, leading to a large number of product introductions and the segment has outperformed the rest of the industry in terms of growth. Being the largest segment by volume, the compact car segment is also intensely competitive with the presence of seven players with as many 16 offerings. The segment has also witnessed the highest number of launches over the past 12-18 months with major ones being Ritz, A-Star, Zen Estilo (from MSIL), i10, i20 (from HMIL) and Indica Vista (from Tata Motors Limited - TML). This segment has also been the bread and butter for India's small car exports, especially from MSIL and HMIL. Overall, the top three market players in the passenger car segment – MSIL, HMIL and TML - currently dominate the segment. Over a period of time however, this segment (mini + compact) is likely witness some fragmentation as it attracts new players and more aggressive model launches from hitherto smaller/ marginal players. In H1, 2010, this segment is likely to witness the entry of General Motors, Volkswagen, Ford India and Nissan. Going forward, all serious players in the Indian market are expected to introduce products in the compact segment, leading to some fragmentation of the overall segment.

In terms of market share, the top four players currently account for 87.2% of the total volumes with the rest being spread amongst 14 other players. The overall market share for the top players is likely to get further fragmented since a number of global majors have significant plans for the Indian market.

Chart 2: The share of compact has grown substantially over the years



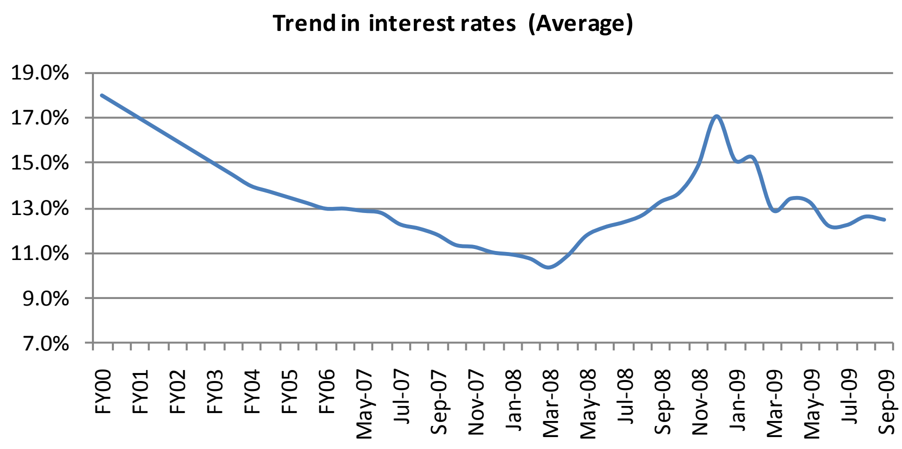
Source: SIAM, ICRA Research

Note: the mini segment after contracting for some years is set to expand in the current fiscal, with the launch of the Nano.

Vehicle financing has been a significant facilitator of demand

Availability and cost of vehicle finance is a key driver in facilitating passenger vehicle demand across the world. In India, the vehicle finance penetration has been rising steadily over the years, facilitated by competition amongst banking and NBFC participants. The interest costs have also declined over the years, supported by favourable interest rate regime and relatively healthy performance of the asset class amongst various consumer finance categories. This has also encouraged lengthening of tenure of financing and LTV, further facilitating consumer demand. During 2008-09 however, the Oct-Dec-08 period witnessed a reversal of trends – tight liquidity conditions and risk aversion in the banking system led to a sharp decline in vehicle financing. This had an adverse impact on the overall domestic demand. Since then there has been a steady improvement, with financing recovering to an extent. However during H1 2009-10, it has still not returned to the levels seen prior to the beginning of the liquidity problems in October 2008. The interest rates also spiked during 2008-09, though it has corrected significantly since then.

Chart 3: Interest rate trend for financing passenger vehicle

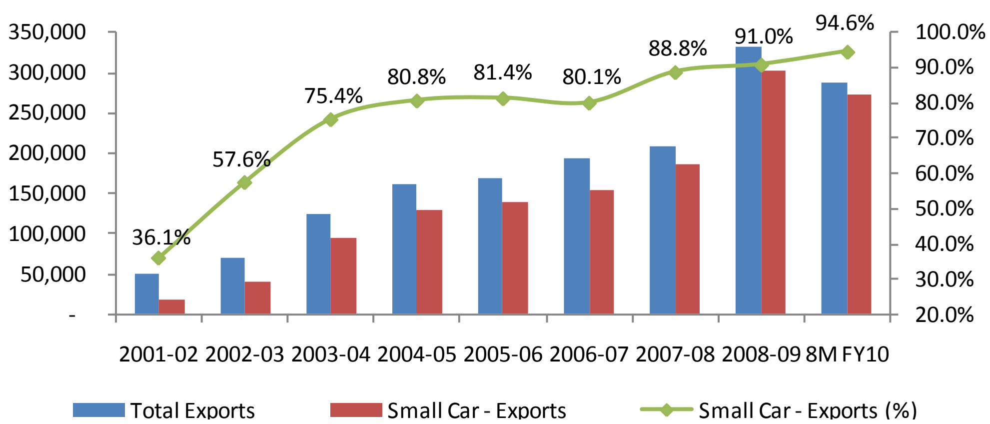


Source: ICRA Structured Finance Group, industry estimates

India is gradually emerging as a hub for small car exports

Despite the economic downturn across the globe, the exports of passenger vehicles from Indian shores grew by a strong 53.7% in 2008-09, largely driven by the strong growth in the small car (compact) segment. During 2008-09, OEMs based out of India exported nearly 0.34 million passenger vehicles, of which 91% were small cars. The top two OEMs – MSIL and HMIL together account for over 98% of export of small cars followed by TML. India's large domestic market for the small car segment provides the necessary scale and business environment for investing in the segment. Gradually, the evolving in-house R&D skills, ability to develop vendors to supply high quality auto components, export-specific products and cost competitive manufacturing capabilities are the key reasons that have allowed OEMs to develop sizeable export volumes. With growing investments from global OEMs targeting this segment, long term potential for exports remains strong – though India needs to strengthen its logistic infrastructure in line with the global benchmarks to improve cost competitiveness for its exports. Changes in international duty agreements (e.g., FTA between Korea and EU) with competing manufacturing locations would also remain a significant factor determining export potential from India.

Chart 4: Compact cars account for majority of passenger car exports from India



Source: SIAM, ICRA Research

Trends in JVs/ collaborations

Globally the automobile industry is going through a phase of consolidation and collaboration, triggered by stagnating demand, industry overcapacity, increasing price sensitivity and rising cost of implementing safety features and emission norms. As more global players enter the Indian market, the impact of this trend of partnership would be increasingly visible in this market too. Some of the active alliances in India include Fiat-TML (manufacturing JV and distribution sharing arrangement); Renault-Nissan (proposed facility share); SAIC-GM (Indian operation under JV, to bring products from SAIC stable), VW-Suzuki (likely collaboration in small car), Renault-Bajaj (small car). The number and scope of such alliances are expected to increase going forward as OEMs aim to rationalise their investments and maximise reach through alliances spanning technology, manufacturing and distribution.

GST roll-out likely to have positive impact on demand for passenger vehicles

The roll-out of Goods and Services Tax (GST) some time in 2010 is likely to have a positive impact on the passenger vehicle industry, as it will help reduce the overall cost to the consumer. At present, the effective tax rate (including excise duty/CENVAT, VAT and CST) applicable on passenger vehicles range between 24-38% depending on the size of the car. With the implementation of GST, the effective tax rate is likely to come down, the benefit of which is expected to be passed on to the end-consumer, further supporting demand. With large cars (including SUVs) commanding a higher effective tax rate at present, the impact could be higher on the large car segment assuming no other additional tax is not implemented on large cars.

Demand revival and easing input prices have released pressure on margins

After significant reduction in margins during 2008-09, the profitability indicators for most of the OEMs have started witnessing improvement on back of easing commodity prices (mainly steel) and increasing volumes. While key commodity prices have started inching up on back of global recovery and are likely to have some impact on margins in Q3/Q4 of the current fiscal, a sharp runaway increase in prices is not expected at this stage. Additionally, OEMs having gone through several cost reduction measures in the last 3-4 quarters are likely to operate on higher operating leverage thereby reducing the impact of higher material prices. Though competition has been intensifying, profitability of Indian auto makers remains better than its peers in the developed markets on healthy demand growth and better capacity utilisation.

Demand from tier 2/tier 3 cities remains strong; marginal impact of poor monsoon so far

The demand for passenger vehicles from Tier 2/Tier 3 cities continues to remain strong despite poor monsoons during the year. While it is believed that poor monsoon generally translates into lower disposable income in the hands of the farming community, industry estimates suggest that approximately 60% of the rural economy now depends on non-agricultural income such as trading, remittances from cities, employment in the manufacturing sector etc. That apart, substantial increase in crop prices, which were higher over the past three years, has also resulted in higher disposable income. Additionally, the increase in land prices across the country, and the implementation of the sixth pay commission has collectively helped in supporting the growth in the rural and semi-urban cities/tier III cities. The aggressive marketing strategy pursued by OEMs in these markets has also resulted in strong growth besides greater availability of finance. OEMs have been following specific segments and aggressive follow up strategy. Product mix in these markets is considerably different from urban markets with demand strongly skewed towards the small car segment. With the launch of the Nano, established players in this segment may face stiff competition as the markets remain highly price sensitive.

Significant capacity addition expected over the medium term; production sharing emerging as a trend

With several international OEMs setting up manufacturing facilities in India to cater to the growing domestic demand as well as for exports, India is likely to witness significant capacity creation in the passenger car segment space over the next 2-3 years with the possibility of periods of overcapacity as is the case in certain key developed markets. As a result of available capacities, product sharing is emerging as a key trend and a solution for possible over capacity in the future.

According to ICRA estimates, the passenger vehicle industry is expected to add capacity of ~0.8 million units (or 27% of existing capacity) over the next two years. Major investments have been lined up by MSIL, TML (for manufacturing Nano at Sanand), Ford (recently completed), Mahindra & Mahindra (UV segment) and Toyota. Additionally, a host of new entrants are in the process of setting up facilities like Volkswagen (recently set up 0.11 million capacity) and Nissan Renault (proposed 0.2 million). While the global economic situation during 2008-09 resulted in some slowdown in new capacity addition, with strong demand growth witnessed in India, most of the investments are likely to revive over the medium term. While the domestic demand prospects remain robust, the lumpy nature of capacity additions is likely to result in some over capacity during the period.

Small car segment likely to see further push with launch of Nano

The advent of Nano from TML is likely to give a new dimension to the small car space by creation of a new segment. In India, the entry level car segment starts in the price range of Rs. 200,000 -300,000 and has traditionally been dominated by MSIL's *800*. Nano, within a few months of its launch has already captured ~40% of market share in the segment. Nano's price positioning between Rs. 125,000-175,000 (for the higher end model) is aggressive relative to other existing models and there are other OEMs targeting similar price points in the future. These efforts, if successful in driving down vehicle ownership costs significantly without compromising on basic quality expectations, may create a new segment between the two-wheeler space and the small car segment.

Large capital investments and increasing competitive intensity may result in higher break-even levels

With large number of products (especially small cars[3]) in the development pipeline, the Indian car market is expected to see 7-8 new product/ platform launches besides refurbishment of existing product lines between calendar 2009 and 2012. This may result in some crowding in the domestic car market, impacting the profitability of the car manufacturers. Given the large investments planned by the global players as well as domestic OEMs in light of integrated facilities being set up in India, the challenge for the players would be to keep break evens low. While the growth in the domestic car market is expected to remain healthy, the larger choice available to customers could necessitate aggressive selling efforts, which may in turn result in higher cost per unit and delays in break evens. Some of the passenger car players that are targeting exports market as well as shifting capacities to India from developed countries may have better capacity utilisation and may be able them to break even earlier. While some domestic market focussed passenger car manufacturers may face significant competition and pressure on profits in the short to medium term, the longer term outlook remains positive in the backdrop of current low penetration levels of passenger cars in the country.

Outlook

A robust domestic economy, rising disposable income and aspiration levels provide the ideal backdrop to a sustained long term demand growth for the sector. The Indian domestic market with annual demand in excess of 1.5 million vehicles has reached the critical mass necessary to attract investments from global majors. With most major markets facing excess capacity and demand saturation, the Indian market is likely to remain a key destination for global majors over the medium term. This however, is likely to lead to some overcapacity in the domestic market over the medium term, leading to increased competitive pressures. Apart from pricing pressure that is likely to increase with competition, the rising quality expectations and tightening regulatory norms on emission and safety are likely to push up cost pressures on OEMs.

During this period, as new players enter the market and players with hitherto weak presence focus on strengthening their position, the market is likely to get more fragmented. Key challenges facing new entrants would be establishing a strong service/ distribution network, which has become increasingly prohibitive due to rising real estate costs in many markets. Going forward sharing and co-operation on distribution network and service facilities could play a significant role in rationalising cost structures. In terms of product launch, while most global majors are likely to choose from their existing portfolio for launch in India, key to success would be the ability to incorporate changes necessary to meet Indian preferences and market conditions. Moreover, certain degree of localisation is imperative to be cost competitive. All these factors also imply significant long term investments that necessitate attaining a minimum volume to achieve break-even and profitability.

[3] Honda, Toyota, Volkswagen, General Motors, Ford, Nissan (in alliance with Bajaj) are all in the process of developing small car for India.

Increased competition leading to fragmentation of the market is likely to take away some of the benefits of scale arising from growing domestic demand. This apart, reduced shelf life of models and increased variants in each segment, while supporting consumer demand are likely to be a significant drag on OEM profitability. The OEMs will need to balance the expectations for new models with the challenge of extending platform life cycle to stay profitable. The OEMs also need to work on cost rationalisations through increased sharing of components across platforms and variants, sharing of production facilities (to reduce idle capacity) and focus on low cost sourcing of components to stay profitable.

Annexure I:

Table 1: Market share of leading OEMs – Passenger Vehicle Segment

OEMs	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	8M 2009-10
Maruti Suzuki	48.4%	46.5%	45.8%	43.7%	42.6%	42.8%	43.3%	42.0%	42.8%
Hyundai	12.8%	14.4%	16.7%	18.3%	19.8%	19.7%	20.4%	26.4%	25.9%
Tata Motors	12.8%	13.7%	14.6%	15.5%	15.8%	15.5%	13.7%	12.6%	11.7%
M&M	6.1%	6.7%	6.8%	6.6%	6.6%	5.8%	7.5%	6.6%	6.8%
General Motors	1.2%	1.1%	1.7%	2.4%	2.3%	2.5%	3.8%	3.3%	3.1%
Others	18.7%	17.5%	14.4%	13.6%	12.9%	13.7%	11.3%	9.3%	9.7%
Top 3 Players	**74.0%**	**74.7%**	**77.1%**	**77.4%**	**78.2%**	**78.0%**	**77.4%**	**80.9%**	**80.4%**

Source: SIAM

Table 2: Segment-wise market share in Passenger Car Segment

Segments	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	8M 2009-10
Mini Segment	26.4%	24.5%	21.7%	12.7%	9.5%	7.6%	6.1%	4.1%	3.1%
Compact Segment	52.0%	54.5%	55.2%	63.0%	66.5%	70.2%	72.8%	75.6%	79.2%
Mid Size Segment	20.7%	20.0%	20.7%	21.1%	20.7%	18.5%	17.6%	17.5%	14.8%
Executive Segment	0.2%	0.4%	1.7%	2.6%	2.6%	3.2%	3.0%	2.2%	2.3%
Premium Segment	0.8%	0.7%	0.7%	0.6%	0.6%	0.5%	0.4%	0.5%	0.5%
Luxury Segment	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.0%	0.1%

Source: SIAM

Table 3: Market Share in the Utility Vehicle Segment

OEMs	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	8M 2009-10
M&M	41.2%	45.5%	46.6%	44.9%	43.5%	41.1%	42.7%	47.5%	56.9%
Tata Motors	25.4%	22.1%	22.8%	20.5%	20.0%	22.1%	20.8%	18.6%	12.8%
Toyota	23.3%	24.9%	21.3%	17.8%	18.4%	19.4%	19.2%	16.7%	18.9%
Others	10.1%	7.6%	9.3%	16.8%	18.1%	17.5%	17.3%	17.2%	11.5%
Top 3 Players	**89.9%**	**92.4%**	**90.7%**	**83.2%**	**81.9%**	**82.5%**	**82.7%**	**82.8%**	**88.5%**

Source: SIAM

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