A GST cut is needed to revive sector’s fortunes

PVs and 2Ws likely to see 10% volume fall in FY21; MM & HMCL top picks due to valuations and strong BS

THE AUTO SECTOR has delivered below potential growth over the last 5 years with a CAGR of ~1.5% for passenger vehicles (PVs) and two-wheelers (2Ws). The PV industry last reported double-digit growth in CY10, but was growing at a healthy pace until FY18. Since then, price hikes in quick succession due to various regulatory costs have resulted in PVs becoming expensive by ~6-12% and 2Ws by ~30-35%.

For an industry that takes ~1-2% price hike every year, these are steep increases. Thus, the industry had been struggling for growth even before COVID-19. Given the pandemic, consumer sentiment has weakened further we think due to the risk of wage reduction, less favourable job outlook and reduced financing availability.

Auto sector a key contributor to economic growth and GST

As per SIAM, the auto sector contributes 7.1% to GDP. Thus, every 10% drop in auto revenues would impact GDP by ~70bps. As per our analysis, the auto sector contributes ~₹800 bn to GST revenues (including cess) and ~₹4.5 tmn including taxes on oil. This does not include after-market sales. Furthermore, in spite of spending more on capex (~₹500 bn) and R&D than the FMCG and consumer durables sectors, the auto sector has not seen any tax benefits from the government since the introduction of the GST.

While a 10% GST cut would reduce total GST revenue by ~₹300 bn, the GST lost would represent only ~5% of the lifetime tax paid by a vehicle, which we think can easily be recovered over time via (i) higher volumes and (ii) higher taxes on oil.

Rural opening up, but sentiment weak

Due to the country-wide lockdown, there will be negligible sales in April. However, due to some relaxations in the last week of April, we may see some export volumes. Our dealer checks indicate that nearly 50% of the tractor dealerships have now opened up as they are in rural areas that are not under lockdown. A few 2W dealerships have also opened up. However, we think demand sentiment is low.

Prefer leaders with strong balance sheets and valuations significantly below mean

We expect industry leaders to consolidate their market position and benefit over the long term. Within these we prefer OEMs with valuations significantly below mean and strong balance sheets (MM, HMCL, both rated Buy). Within auto components, we prefer the batteries segment - AMRJ, EXID (both Buy rated), which derive 60-70% of their Ebitda from the replacement segment and have high demand visibility.