

Need for volumes in auto industry

A conversation with CEO Indus Motors, Parvez Ghias and Vice Chairman House of Habib, Sohail P. Ahmed - Part I

Parvez Ghias is the CEO at Indus Motor Company Limited, a leading automobile manufacturer of Toyota brand vehicles in the country. He holds a bachelor degree in economics and is a fellow of the Institute of Chartered Accountants in England & Wales. Parvez Ghias also serves as an independent director on the boards of Standard Chartered Bank (Pakistan) Limited and Dawood Hercules Corporation.

Mr Sohail P. Ahmed is a mechanical engineer with postgraduate qualification from Rotterdam. He is also an alumnus of the INSEAD Business School, fellow of Institution of Engineers and member of The American Society of Mechanical Engineers. He was the founder President of "Pakistan Association of Automotive Parts & Accessories Manufacturers" (PAAPAM). He has been the Chief Executive of NayaDaur Motors and Mack Trucks, under Ministry of Production and of Allwin Engineering, Agriauto Industries Ltd, and Thal Limited in the private sector. Currently he is Vice Chairman Thal Limited. He is also Chairman of Pakistan Auto Sector Skill Development Company and Vocational Training Centre for Women, Korangi. He is a Director on many boards in public & private sectors, having served on boards of PIDC, Pakistan Steel Mills, etc. He has been a member of the Senate of Dawood College of Engineering & Technology and Syndicate of NED University Karachi.

Mr Parvez began the discussion by giving his views on the ongoing debate on auto industry policy:

PG: Owning car is the second largest investment a person makes in a life time, after real estate. There is a huge debate going on and car makers are under attack for either not offering sufficient variety to customers, or their cars being expensive, or waiting time being too long or on issues relating to quality. Everybody wants cars to be cheap and would love to have choices, but we need to be mindful of our operating environment. There is continuous dialogue with the stakeholders on these issues and as we speak a task force formed by the government is working on the new automotive policy for the industry.

BRR: But there is an age-old debate that auto industry has been over protected, and has still failed to grow to its full potential. Any protected industry should eventually develop its own competitive edge, which the perception is has not happened in Pakistan.

PG: It's important to go back into the history and let us look at facts. Localisation targets were given to OEMs during the deletion program, and I only speak for Toyota here, those targets were achieved. Later, the Deletion program was replaced by the Tariff Based System (TBS) along with the AIDP.

People speak of protection as if it is an evil phenomenon. I don't see why we should shy away from protection. There is nothing wrong with protection; many countries from India to Malaysia to Thailand to Indonesia have all protected their industries, and that is how they have grown.

First, we need to answer a more fundamental question: whether we want to nurture and grow the auto industry and manufacturing in general in Pakistan or not. This is not so much about cars and autos as it is about a more underlying decision - do we want an economy based on manufacturing or trading? Things like employment and transfer of technology will only follow naturally if we help create an economy based on manufacturing.

BRR: Of course, no body is against employment generation and technological advancement. But if the OEMs have failed to make that happen in last 20 years, who is to say if it will happen in next 10-15 years either?

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PG: OEMs have done exceedingly well to develop the industry in the last 20 years given the volatility of the operating environment during this period. As for the next 10-15 years, true that this debate will continue if there is status quo. But why are all the guns being pointed at the OEMs? Does the government not have a role to play? All the countries I have named saw their automobile industry take off due to high volumes. And volumes grow as a function of per capita income, which in this country is stuck at around \$1,300 per annum. The reality is that the economy is sluggish - and there are challenges at macro level that keep the industry from realising its full potential.

I would like to give you a bit of a background of industry dynamics before we delve into proposing policy measures for the auto sector.

During the 12 year period of stagnation, from FY90 to FY02, the volumes of passenger cars and LCVs remained flat at an annual average of 50,000-55,000 units, in spite of several policy changes. Post FY02, in just five years' time the passenger vehicle and LCV segment volume grew phenomenally, reaching a quarter of a million in 2006/07. This is a compounded annual growth rate (CAGR) of 35 percent, from a low figure of 55,000 units to 250,000 units in next five years.

This growth could be attributed to a variety of factors from stable economic environment and availability of consumer financing, to worker remittances and low interest rate scenario - when discount rates went down as low as seven percent.

In FY07, the industry entered the period of Auto Industry Development Program. The policy document was made through a dialog with the stakeholders - the first time a comprehensive long term program was announced for an industry that badly needed one. The key elements of the policy included tariffs for next five years, and guidelines for human resource development, incentives for productive assets investment, technology acquisition support schemes, and localisation plans for manufacturing and assembly of high tech parts.

At that time, the vision was that by FY12 volumes would reach half a million cars annually even if the growth were to continue at current rate. If that were to happen, industry's contribution to GDP would have doubled, with about a quarter of a million people in direct and indirect employment.

Similarly, the parts supplier and the OEMs responded by major investments in capacity expansion. The origins of used car import cannot be divorced from this historical description. When the industry began growing, it lacked the capacity to completely meet the phenomenal growth in demand. While the OEM responded by investing in capacity but expansions take time. In response, the government liberalised used car import instead.

But then the global financial crisis hit and the bottom fell out. Internally, Benazir Bhutto's assassination and other economic problems sent the economy into a tailspin and demand simply collapsed. Volumes are extremely important for the industry and manufacturers had to cut costs.

However, the industry remained resilient and bounced back. Yet, it was further hit with inconsistent policymaking at the government level, where age limit of imported used car was enhanced and then reduced; so this flip flop goes on.

Take today's situation: inshallah before calendar year 2014 Indus will launch the new Corolla for which it began investing three years ago in tools, dies and moulds and has invested about Rs 8

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billion in the project. Yet, news reports have suggested that the government is once again looking at increasing the used car age limit to five years. What kind of a signal is the government trying to send to the global players willing to invest in this market?

At this point, Mr Sohail P. Ahmed, Vice Chairman at House of Habib, joins the discussion.

BRR: Why is the industry afraid of competing with used cars?

SPA: We are willing to compete with anyone on a level playing field. For one, the levies on used car are lower than the one on locally produced vehicles. Then there is a cost of technology assimilation in local cars - and also local cars have a warranty and after sales service cost. Also you cannot compare the two anywhere in the world. We can compete with any CBU car all over the world.

Wherever there is automotive industry they actively discourage used cars. India has higher duty on used cars (100%) than on new CBU cars (60%). Thailand has high duties on both new and used CBU. Government discriminates in favour of auto industry not against it because automotive industry is a game changer. It has profound effect on economy.

Market depends on per capita income. It does not happen just because you're 180 million people. So if the per capita income is not there and interest rates are not low, the demand will not take off. Pakistan has 12 vehicles (cars +LCV) per every 1,000 people at a per capita GDP of about \$1200. Look at the numbers for India: it has 17 passenger cars per 1,000 people with a per capita income between \$1,500 - \$1,600. That's very small differential, and is explained by the low income levels in both countries.

BRR: So are you saying that there is no more room to grow?

SPA: No. There is inherent demand. But given the inflation rate, along with low personal disposable income and savings rate, people don't have the money to think about a luxury like car. There is a growing need for cheaper mobility and that is reflected in growing demand for two-wheelers. Currently, Pakistan is selling more than 1.6 million two wheelers.

Even internationally, the progression involves a jump in demand for two wheelers followed by a growth in number of cars. While the first has been achieved in Pakistan to some extent, the same cannot be said of four wheelers. The potential though is obvious. All that is requires is consistent industry friendly policy and continual stoking of the economy.

At one point, a leading auto part maker was interested in a joint-venture with us, but then the market went south. Everybody knows there is a vast potential. But due to low income, that potential remains un-mined. What can be done about the low income? That is for the government to answer.

The auto industry has made tremendous amount of investment, and it needs to recover a return on that investment within the model life, as every new model brings a new technology and further investment. For example a car like Corolla, which is considerably localised, requires an investment of about Rs 7 billion, at current exchange rate, to bring in a new model.

Due to the absence of volumes, car makers have been unable to achieve higher level of localisation. However the mandated localisation has been achieved. The issue is not localisation but techno

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economic localisation, otherwise the quality of the car will go down and the price will go up. For the volumes that are in Pakistan the localisation level is reasonable. If we compare with India, many models over there are less localised than us, where they do not have volumes.

The problem could be solved if we were to stick with the same models. This is exactly what has been achieved by motorbike and tractors where manufacturers produced the same model for many years and over time, these manufacturers were not only able to get a reasonable return on investments, but also increased their localisation levels.

Cars, however, are fashion statement; you change the car because you want a new one not only because you need one, so the same model cannot be continued beyond the model life. This is a catch 22 situation for the manufacturers.

The name of the game in our industry is volume. If volumes are available, cars will also become more affordable and localisation will also increase.

to be continued