鵬元國際 PENGYUAN

China's passenger car shipment likely to further drop due to COVID-19

Contents

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Summary

When the coronavirus disease 2019 (COVID-19) can be effectively controlled is the key factor in determining sales of passenger cars in China in 2020. With the duration of the ongoing COVID-19 infection longer than expected, the adverse impact of the epidemic has exceeded our initial expectations. We now project China's auto demand will shrink at least in the short term, and factories need time to resume operations. We believe the full-year demand and supply of passenger cars in China would face huge pressure if production is not completely resumed until early April.

In our view, it is essential that China's central government and local governments step up efforts to support weakening passenger car consumption. Proactive fiscal policies such as tax cuts and subsidies, targeted monetary policies such as lowering interest rates of auto loans, and the relaxation of limits on granting license plates should be combined as a package to maximize stimulation of auto consumption. Our conservative estimate is additional demand of 2.2 million to 2.6 million passenger cars, or 11 to 13% of the nation's passenger car consumption in 2019, would be created in 2020 if the timing and effectiveness of policies meet our expectation.

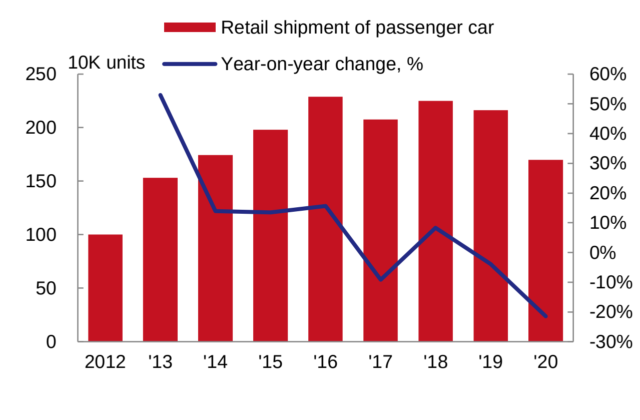
We conducted two sets of scenario analysis, given the uncertainty of when the epidemic can be controlled and the possibility of stimulus policies. The wholesale and retail volume of China's passenger car market are anticipated to fall by 7% and 8% year-on-year respectively for the whole of 2020, under the scenario of production completely resuming in early March; if the halt in production continues three to four weeks later into early April, wholesale and retail shipments contract by 14% and 13% year-on-year respectively in 2020. We reckon retail prices could be in a general downward trend in 2020 with some minor fluctuations in the short term, as dealers still have strong incentive to boost sales at the cost of offering big discounts.

We maintain our view that credit profile of passenger cars manufacturing industry will continue to diverge during the sector downturn (See. Creditworthiness of carmakers to diverge amid shipment downturn). The outbreak of COVID-19 will bring a disruptive blow to the operation of entire industry as 50% output from the top ten provinces with the largest production in 2018 have been hurt severely by the epidemic, and additionally almost 75% of listed companies in A-share from Wind's industry classification of auto parts manufacturing have production facilities in the top ten infected provinces. As such, the creditworthiness divergence might accelerate among the sector as tier-one group of carmakers, including Geely, Great Wall Motor, SAIC, GAC, Dongfeng Motor, BAIC, BYD and Chongqing Chang'an, are more operationally and financially resistant to the epidemic due to their competitive product mix, strong capability in supply chain management and close tie with governments. However, lower-tier group of players with small-scale production and poor supply chain management will suffer significantly from the financial strain caused by the pandemic. Conclusively, we expect the sectorwide leverage, mainly gauged by Debt-to-EBITDA ratio in our analytical framework, to climb up further from the level in 2019.

COVID-19 to cloud recovery of passenger car sector

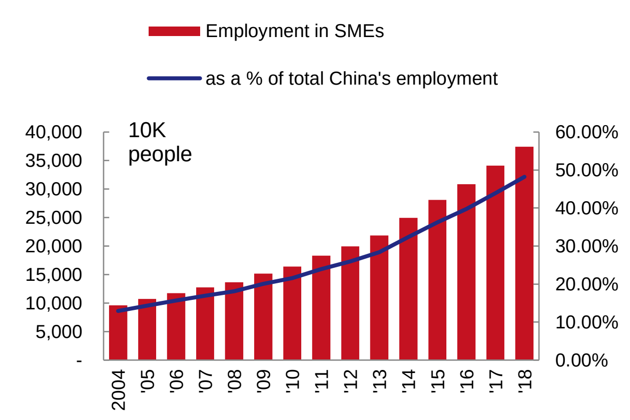
The outbreak of COVID-19 will temporally hit demand for passenger cars while the longer-term impact will depend on when the epidemic can be well controlled. The massive shutdown of showrooms throughout China during the epidemic will hurt sales, as car buyers tend to visit physical stores to have a feel of the cars. The China Passenger Cars Association (CPCA) revealed that retail shipments of passenger cars suffered a drastic drop at 21.5% year-on-year in January. We believe sales growth of passenger cars in 2020 is highly dependent on when COVID-19 can be effectively controlled. In the scenario that production of passenger cars can be normalized in early March, the blow to auto consumption would be limited because the contraction in demand for passenger cars can be backloaded to the rest of 2020. However, auto consumption would take a huge hit if the production halt continues to early April or later. This is because COVID-19 will batter the private economy that largely comprises small and medium enterprises (SMEs) which accounted for about 50% of total employment in China in 2018, thereby risking severe social instability. Although the pandemic can be eventually healed, the long time span in controlling the pandemic will be ultimately reflected in weakening household purchasing power and willingness to consume, thus hurting full-year passenger car sales in 2020.

Exhibit 1: Retail shipment of Jan in 2012 to 2020



Source: China Passenger Cars Association, Pengyuan International

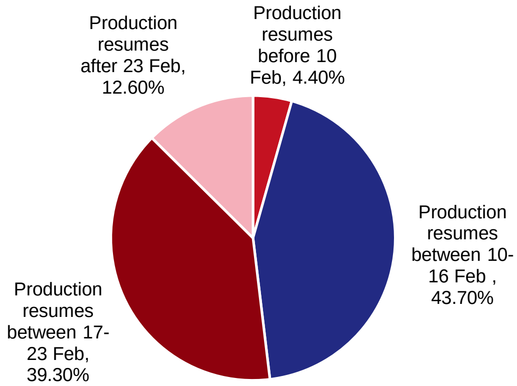
Exhibit 2: Employment in SMEs



Source: National Bureau of Statistics of China, Pengyuan International

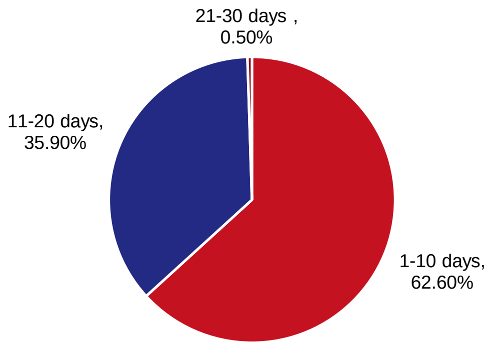
The very slow rate of manufacturing resumption will reduce auto output, resulting in shortage of cars and components in the short term. With the Chinese New Year holiday coming to the end, passenger car manufacturers will gradually resume production but the progress varies among them. In our opinion, the overall rate of resumption in production remains very low, which could put the industry at the risk of lacking sufficient supply. The slow resumption of automakers' factories is not only due to local governments' requirements for controlling the contagion, but also the production halt of upstream suppliers. Even for those upstream suppliers which have resumed operations, their capacity is limited by low inventory and shortage of manpower. There are many carmakers with production facilities in Hubei province, the epicenter of the COVID-19 outbreak. The massive lockdown in Hubei will reduce the supply of cars as well as auto parts. Road and river transportation are stalled across the country, particularly in Hubei and its capital Wuhan, which are both important transportation hubs in China. This will hinder nationwide delivery of core materials used for automobile manufacturing. Based on our calculation, the nationwide inventory depth of carmakers is roughly 1.7 months at the end of 2019, insufficient to withstand the shortage of supply when consumption sentiment returns after the pandemic, since production takes time to ramp up.

Exhibit 3: Reopen schedule of automakers and the distribution



Source: China Association of Automobile Manufacturers, Pengyuan International

Exhibit 4: Auto parts makers' additional holidays for staff and the distribution



Source: China Association of Automobile Manufacturers, Pengyuan International

Strong stimulus necessary

We suggest the central and local governments offer stimulus packages, including proactive fiscal policies, monetary easing and relaxation of administrative restrictions, based on our judgement that COVID-19 will weaken China's auto market. On fiscal policies, the focus should be on tax reductions for purchases of fuel-engine passenger vehicles, subsidies for auto purchases in the countryside, and handouts to boost buying of new energy passenger vehicles. The purchasing tax reduction should be applied to mid-to-low end passenger cars. This policy was implemented in 2016 and 2017, which spurred additional sales of 1.5 million passenger cars each year. In light of the high-base effect of passenger cars in China and the marginal diminishing effect of the policy, we project additional purchases of about 1 million passenger cars would be created if the tax cut is carried out this year. Subsidies of auto consumption should be handed out to encourage purchases of light commercial vehicles in rural areas. By doing so, it would result in additional purchases of 500,000 passenger cars, as there is still room to increase auto penetration in rural areas. However, the implementation of subsidies for auto consumption in the countryside largely depends on whether the central government will take the lead, instead of allowing local governments to give handouts at their discretion. Some local governments, particular those in lower tier cities, are experiencing strain on their fiscal budgets, as land sales have substantially slowed down in recent years. We anticipate an additional 100,000 to 500,000 electric passenger cars will be sold, if there is an increase in electric car license quotas in Beijing and taxi companies are encouraged to deploy more electric cars.

With respect to administrative regulation, we recommend some Chinese cities with on-going license plates limit, such as Beijing, Shanghai, Guangzhou, Tianjin and Hangzhou, to relax restrictions on the number of license plates to free pent-up demand. The impact of this proposal greatly depends on how much additional quota on license plates those cities will offer. For instance, Guangzhou and Shenzhen will offer a total increase in quota of 180,000 during 2019 and 2020, accounting for 9% of all applications for license plates in both cities. With currently 7 million applicants for license plates nationwide, we conservatively estimate the additional demand for passenger cars from the relaxation of limits on license plates would be 600,000 units nationwide.

Monetary policy should be accommodative. Providing sufficient liquidity to the financial market and guiding the loan prime rate (LPR) downward is needed to maintain a favourable monetary environment amid the current economic woe. It is worth noting that broad monetary stimulus such as interest rate cuts would be largely limited by the high consumer price index (CPI) in China, while targeted monetary support, such as reducing provision requirements for auto loans, is viable. Given the lagging effect of monetary policy, we expect the positive impact on auto consumption to gradually take place in 3Q and 4Q of 2020.

Table 1: Government support in 2020 suggested by Pengyuan and its impact

Policy	Content	Impact on additional shipment
Fiscal policy	Tax benefit for mid-to-low end models (<=RMB300,000), and handouts for purchases of light commercial vehicles in the countryside	An additional 1.5 million fuel-engine passenger cars An additional 100,000-500,000 electric passenger cars
Monetary policy	Targeted monetary support, such as reducing provision requirements for auto loans	-
Administrative relaxation	License plates limit scrapped in some cities	An additional 600,000 passenger cars
	Total	**2.2 million to 2.6 million units**

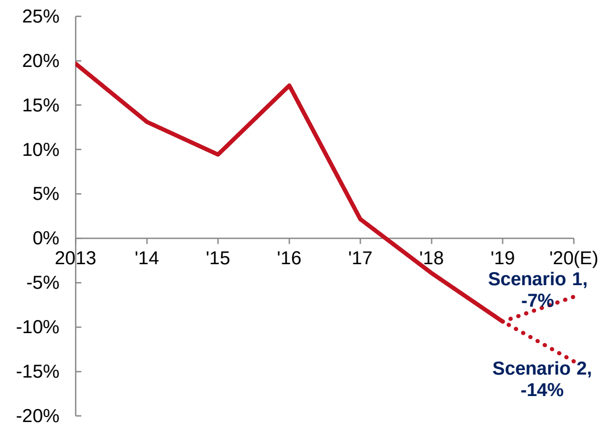
Source: Estimation by Pengyuan International

Contraction of shipment likely to widen with downward pressure on sticker price

The recent downturn of China's passenger car shipment is mainly the consequence of rising leverage of households and the fading wealth effect. Even without this infection, we would have maintained our estimation of negative shipment growth in China's passenger car market in 2020. The 'black swan' event of COVID-19 has given rise to great uncertainty in our projection of passenger car sales in China in 2020. However, the central and local governments are highly likely to carry out policies to spur auto consumption. Based on our expectation of government support, we conduct two sets of scenario analysis to examine how government support can boost passenger car shipments this year.

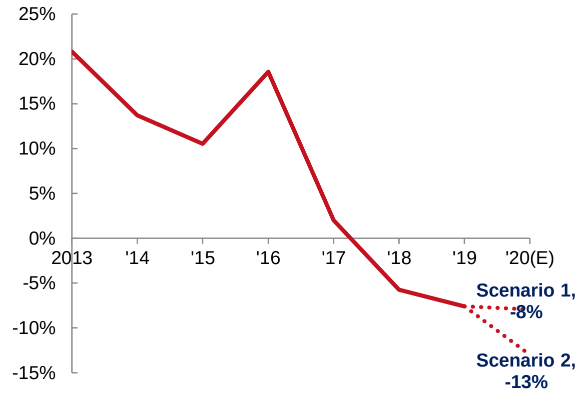
We make a key assumption in case 1 that massive production will resume in early March and supporting policies will be implemented in due course, while the key assumption in case 2 is production would not get back to normal until early April or later, and supporting policies will be implemented later than in case 1. Additionally, the strength of supporting polices in case 2 is assumed greater than that in case 1 in order to offset the longer time automakers take to normalise production in case 2. Therefore, we anticipate the wholesale volume of passenger cars in China to contract by 7% and 14% year-on-year in case 1 and 2 respectively, while retail shipments are expected to drop 8% and 13% year-on-year under case 1 and 2 respectively. We think retail prices will rise a bit in the short term, as shortage of supply due to the gradual restart of production might persist for a while after the Chinese New Year holiday. But for the whole of 2020, we stick to our forecast of decreasing retail prices, as dealers are most likely to boost sales with aggressive discounts.

Exhibit 5: Projection on 2020's wholesale volume growth in passenger car



Source: China Passenger Cars Association, Pengyuan International

Exhibit 6: Projection on 2020's retail volume growth in passenger car

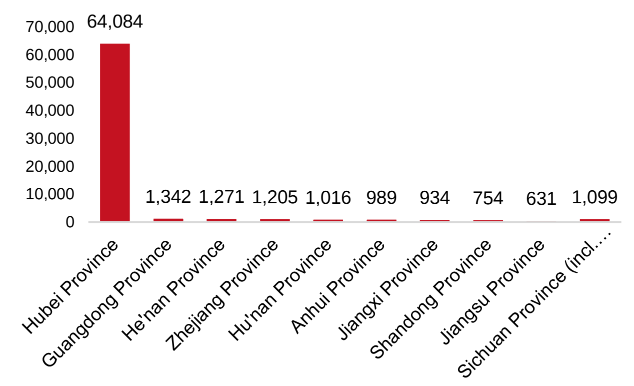


Source: China Passenger Cars Association, Pengyuan International

The influence of COVID-19 on the automaking sector is disruptive

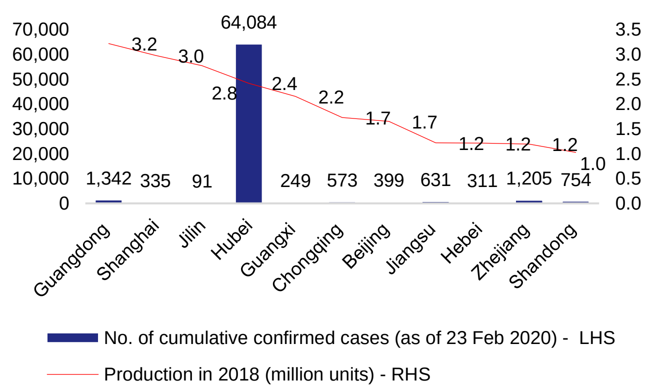
We estimate that the pandemic will cast a huge disruption to the passenger cars manufacturing sector, as evidenced by the fact that five out of ten provinces with the largest production in 2018 are among the top ten most-infected provinces by the COVID-19 as of 23 Feb 2020. Furthermore, we collected a sample from Wind's industry classification of auto parts manufacturing which comprises of 147 listed companies in A-share, and found that almost 75% of those companies have production facilities in the top ten most-infected provinces where massive lockdown is still in force to prevent the wide spread of contagion. Therefore, we would say that the entire supply chain is under tremendous pressure from the epidemic. With respect to the perspective of automakers' operation (Exhibit 9), Dongfeng Motor Group is arguably the most impacted as its 90% of production is exposed to the top ten most-infected provinces and 46% of production is located in Hubei, the epicenter of the outbreak of COVID-19. Yet, Dongfeng Motor Group, in our view, is still able to withstand this shock with its strong credit profile of 0.5x Debt-to-EBITDA ratio and more than Rmb22 billion excess cash in 2018. Other major automakers, with very small exposure of production to Hubei province, are able to resume the production work quickly once the epidemic get controlled in our case 1 scenario where complete resumption of factories can be seen in early March.

Exhibit 7: Top 10 infected provinces with cumulative confirmed cases (as of 23 Feb 2020)



Source: National Health Commission, Pengyuan International

Exhibit 8: Half of the top ten provinces with the largest output in 2018 get hurt by the epidemic



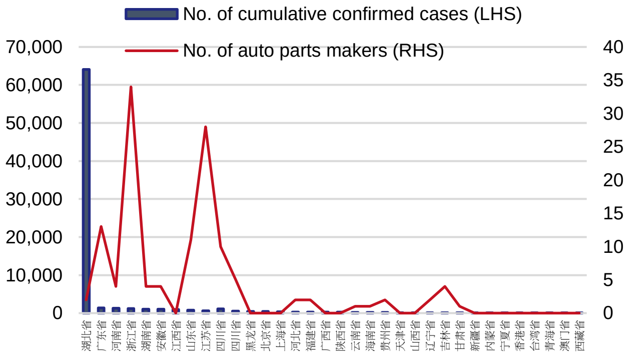
Source: National Health Commission, Pengyuan International

Exhibit 9: Exposure of major automakers' production to COVID-19

Automakers	Exposure to top 10 provinces with the most confirmed cases (as of 23 Feb 2020)	Exposure to Hubei province
Geely	88%	0%
BAIC	38%	9%
SAIC	58%	6%
DMFC	90%	46%
GAC	96%	4%
BYD	88%	0%
Chongqing Chang'an	100%	0%
FAW	34%	0%
Brilliance	0%	0%
Great Wall Motor	0%	0%

Source: Companies' annual reports, Pengyuan International

Exhibit 10: Most of China's Auto parts makers largely operate in those highly-infected provinces



Source: Wind, Pengyuan International

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