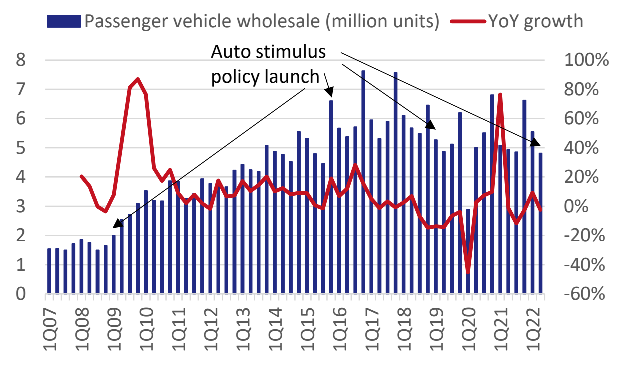
Non-rating Action Commentary: Auto sector stimulus to drive near-term sales spike in China; long-term impact to be subtle

Sector weakness is not solely attributable to the pandemic. China's auto sales momentum has been soft since 2017, even before the coronavirus pandemic outbreak. In our view, the reasons for the weak demand are multifaceted, including but not limited to the slowdown in China's overall economic growth, restrictions on the number of new passenger vehicles (PV) in several major cities, and the sales overstimulation due to the introduction of previous rounds of supportive policies. In addition to this, production disruptions and a global semiconductor shortage caused by the recent pandemic have also exacerbated the woes of China's auto industry, with year-to-July 2022 PV wholesale only equivalent to 51% of peak full-year sales in 2017.

More intensive stimulus to ensure growth this time. In response to stagnant auto sales, the Chinese government launched a round of stimulus measures in 2019, but the results were not optimistic, with PV wholesale volume falling by 9.6% YoY that year. In hindsight, we believe that the stimulus policies in 2019 were not strong enough when the new energy vehicle (NEV) segment, benefiting from the purchase tax exemption and purchase subsidy extension, was still too small and the replacement subsidy and rural subsidy schemes were not strong enough with financial support mainly coming from local government and manufacturers.

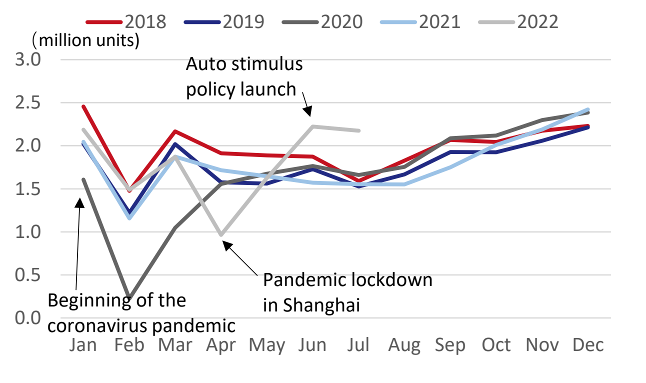
However, given the government's latest stimulus policy directive for the auto industry, we believe that the central government is determined to ensure that auto sales momentum recovers this time around. First of all, the once-used 5ppt conventional PV purchase tax cut policy is extended to PVs with engine displacement of between 1.6L and 2.0L and a price of less than RMB300,000, which means that many popular premier brand models are also eligible for tax exemption this time. In addition, what is new is that cities with PV ownership restrictions raise their new PV registration quotas. Together with incentives given by auto manufacturers, PV wholesale rejuvenated with June 2022 sales surging 41.2% YoY and July sales growing 40.0% YoY. Considering the recent two months' sales momentum with auto sales peak season still being ahead, we think that the China Association of Automobile Manufacturers' (CAAM) 2022 PV wholesale forecast of 23 million units (up 7% YoY) is attainable with the possibility of an upside surprise.

Exhibit 1: China – quarterly passenger vehicle wholesale trend



Sources: China Association of Automobile Manufacturers (CAAM), Pengyuan International

Exhibit 2: China – monthly passenger vehicle wholesale trend



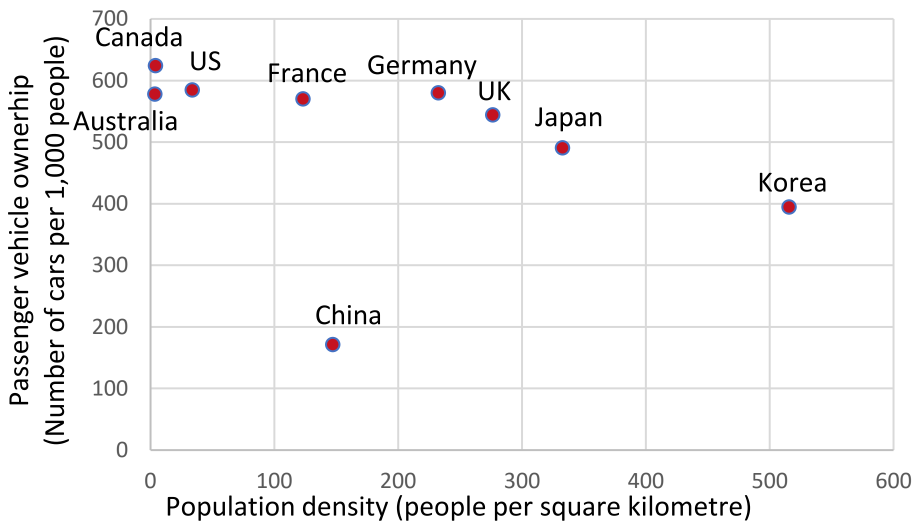
Sources: CAAM, Pengyuan International

Double-digit growth will not last, but stable sales improvement should be sustained. After the previous rounds of auto stimulus packages ended, a major concern was the exhaustion of market demand that led to significant PV sales growth slowdowns in 2011 and 2017, not to mention the inability of the 2019 stimulus to drive sales. For this round, we believe that while some consumers will inevitably rush to buy cars in 2022 due to the purchase tax cut and once again drain some demand for years to come, the depletion will not be as widespread this time. This is because the tax cut is short-lived and the number of extra new PV registration quotas is not extensive.

What is more, we estimate that the value added by China's auto manufacturing industry makes up about 7% of the country's GDP. Together with other industries linked to automobiles, such as steel and automobile services, the sector's contribution to the economy should be even higher. From another perspective, China's automobile retail sales accounted for about 10% of overall China's retail sales in 2021. All of these demonstrate the importance of the auto sector's well-being in supporting the Chinese economy, especially when another pillar of the economy, the real estate sector, has not been performing well. As such, it is possible that more incentives, such as future relaxation of PV ownership restrictions, could be introduced, if needed, to safeguard a healthy auto sales trend.

Last but not least, while some may be concerned that China's new PV market is saturated, with rising ownership penetration and traffic congestions, we still believe there is ample room for growth in China's auto demand, albeit at a slower pace. To elaborate, we observe that PV ownership penetration is, in general, inversely correlated to the population density, as high population density generally implies the need for an extensive public transportation system, thus lowering the demand for car ownership. Based on the relationship between developed economies' population densities and their PV penetration (see Exhibit 3), we believe that China's PV penetration is far from the theoretical saturation point of about 400-600 cars per 1,000 people. Besides, developed economies' annual PV sales are about 4-8% of their respective PV fleet size depending on vehicle replacement cycle length. Based on such rationale, we think China's domestic PV sales will continue to grow moderately as penetration increases and will not reach a saturation point anytime soon.

Exhibit 3: Passenger vehicle ownership vs. population density for some major countries



Sources: China Bureau of Statistics, Australian Bureau of Statistics, Statistics Canada, Japan Automobile Manufacturers' Association, Korea Ministry of Land, Infrastructure and Transport, US Bureau of Transportation Statistics, European Automobile Manufacturers' Association, World Bank, Pengyuan International

Other factors affect auto manufacturers' credit profile. Notwithstanding our optimism on China's PV sales prospects, our view on auto manufacturers' credit outlook is stable. This is because there are negative factors that offset the expected benefit of resilient PV sales. First, commercial vehicle (CV) demand remained subdued with January-to-July 2022 wholesale volume down by 39.3% YoY as the economy was weak and replacement demand dried up. Second, according to the China Bureau of Statistics, the capacity utilization of China's auto manufacturing industry was only 69.1% in 2Q22. In addition, with the continual surge in NEV sales and the higher cost/lower margins of making NEVs, Chinese auto manufacturers' profitability is still under pressure. According to the China Bureau of Statistics, in the first half of 2022, the Chinese auto manufacturing industry recorded a 4.2% YoY decline in revenue amid a 6.6% vehicle wholesale volume decrease, and also suffered a 25.5% YoY decline in profit with margin erosion. All in all, even with a recovery in vehicle sales going forward, we think that auto manufacturers' credit profile would remain stable rather than improving.

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