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Impact of Demonetization on Automobile Industry

By

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Abstract

The Indian government's bold move to invalidate large currency denominations in November has led to a severe liquidity crunch across the nation for over two months now. In an economy where dealing in hard cash is deeply entrenched, this has, invariably, resulted in a slowdown across several sector. The automotive sector is among several other cash-starved sectors coping with India's demonetization and slow transition to normalcy. While passenger vehicle (PV) sales won't be impacted much, two-wheelers (2W), commercial vehicles (CV) and tractor sales will take a significant hit over the next few months.

The following chart shows the year-on-year volume growth of various segments during April-October (before demonetization) as compared to November's figures.

Two-wheelers, commercial vehicles, and tractor sales declined after demonetization, while passenger vehicle and private car sales were flat as compared to the months preceding November. Several manufacturers resorted to idling production lines in order to cope with the drop in footfalls and surplus inventory in December. Although there are signs that the initial negative impact on sentiment and sales is now abating, it'll probably be several months (or a surge in cash supply, whichever comes first) before growth in India's automotive market overcomes its current slump.

Keywords: Demonetization, Auto Industry,

I. Introduction

According to RBI data, 90% of all transactions in India are made with cash. A little over 80% of this cash became practically useless overnight after Rs1000 and Rs500 currency notes were demonetized on November 8 this year. This withdrawal of legal tender status of these notes came as a major blow to traders who rely mainly on cash for business transactions. Kashmiri gate in old Delhi, one of India's largest wholesale markets for auto parts, which is overcrowded on any usual day, wore a completely deserted look for the days after November 8. Business in other auto components wholesale markets across the country also tanked. An examination of the impact of this unexpected event (described as a Black Swan by many), threw up some interesting observations about two sets of spare parts manufacturers in the aftermarket. In the week following November 8, there was an immediate slump in sales of a few companies.

In a few others, there was no perceptible change (compared to sales of the same period of previous years). But by month end, the trend reversed. Business hopped back to normal (or in some cases improved) for the first set of companies while the second set suffered a severe hit. Industry reports indicate that, not only are the latter looking at abysmal numbers for the month, but are also anxious about the top line for next two quarters.

Yes, two sets of companies in the same environment had drastically different experiences of the same circumstances. Why? Let's take a closer look. The difference lies in whether the supply chain of the company is managed by 'push' method or TOC 'pull' replenishment systems. The ones that are managed with a pull-based supply chain appear to be anti-fragile!

So what happened? Demonetization created a drought of currency in the market. Our study showed that traditional companies operating on push systems felt little or no impact immediately. These organizations have a typical sales pattern. The first couple of weeks see very little sales. It picks up in the third week and peaks at the month end.

When the market was reeling under the aftermath of demonetization, these companies remained relatively unaffected since the level of activity at that time of the month is usually not high. But when the month end approached and their channel partners refused to pick up the anticipated stock, all hell broke loose!

The first links in the channel for most companies are distributors, wholesalers or dealers. Since most of the cash with retailers was in the demonetized currency, they rushed to distributors and wholesalers to get rid of the old currency by paying their dues, clearing overdoes and in some cases even paying in advance for purchases to be made in the future! Unfortunately distributors could not do the same with companies.

Though the distributors and wholesalers became flush with cash, they could not deposit this bounty in their accounts as the banking system was almost paralyzed. So despite having cash, distributors and wholesalers did not have "money" to clear dues. Thus they were unable to buy more stock from companies as their billing accounts were under lock (a fairly common occurrence). Consequently, the primary sales of companies was hit badly.

II. Literature Review

Indian government's bold move to invalidate large currency denominations in November has led to a severe liquidity crunch across the nation for over two months. In our economy where dealing in hard cash is deeply entrenched, this has invariably resulted in slowdown across several sectors. The automotive sector is one among several other cash-starved sectors which has impacted with demonetization decision and slow in transition to normalcy. Two-wheelers (2W), commercial vehicles (CV) and tractor sales took a significant hit. The Indian two wheeler industry is slowly recovering from a liquidity crisis brought about by demonetisation. According to an ICRA report, the liquidity crunch following demonetisation resulted in volume compression of 11.3 per cent during the period of November 2016 – January 2017 over the corresponding previous period. The industry seems to be limping back to normalcy with the impact of demonetisation becoming moderate by smaller volume contraction in forthcoming months. Automobile Industry is huge and the ups and downs are quite common as the Government policies and company decisions affect the industry. The study is confined to only Demonetisation and BS-III ban impact on Indian auto industry for the FY 2016-17. The report is based on prior announcement of Annual Results of the Automobile companies The 'BS' stands for Bharat Stage, and these terms are nothing but emission norms stipulated by the government to regulate the amount of pollutants in the air, from the internal combustion mechanism of engines in vehicles, including motor vehicles, crafted by Central Pollution Control Board (CPCB) under Ministry of Environment, Forest and Climate Change. BS-III norms first introduced in 2005 in NCR and 13 other cities, and then adopted pan-India 2010 onward, have the emissions tested over the India Drive Cycle (IDC), and thus, led to the two stroke engines of two-wheelers being taken out of circulation. BS-IV standards were also being tested since 2010 in 13 major cities and now BS-IV emission norms implemented from April 1st 2017, thus deeming outdated and illegal all BS-III vehicles sold and registered after April. They dictate that two and three-wheelers fit an 'evaporative emission control unit', in order to prevent loss of fuel as it evaporates when the vehicle is parked. They also need the cars to have tighter NOx+HC emission limits, harmonisation of the emission testing cycle, and the motorcycle class defined by the UNECE Global Technical Regulation 2 (GTR-2). On November 8, 2016, the Government of India (GoI) announced one of its big bang reforms, "Demonetization". The GoI had banned circulation of Rs.1000 and Rs.500 notes and replaced them with new Rs.2000 and Rs.500 notes in a bid to curtail the black money, corruption, terror funding and fake currency in the system. The total value of old Rs.1000 and Rs.500 notes in the circulation was to the tune of Rs.14.2trillion, which was about 85% of the total value of currency in circulation. Post the announcement of demonetization, the currency in circulation has declined sharply which has hit the cash dependent sectors hard. Some of the sectors which are more dependent on the cash for dealings are Real Estate, Jewellery, Automobile, etc. As per industry experts, revenue for Auto Ancillary industry from cash dealing is close to 75% and among Auto Original Equipment Manufacturers (OEMs), two-wheelers (2W), Tractors and Commercial Vehicle (CV) is likely to get more impacted due to higher dependence on cash for dealings.

III. Methodology

This research is conducted to understand the impact of Demonetisation & BS-III ban based on collected information through various secondary sources like online newspapers, research reports of SIAM, ICRA and Aditya Birla Money. An attempt is made here to understand the company's ways of looking at both initiatives taken by the government to reduce the impact. The impact on Sales Volume, Revenue, Costs and Profit Margins for the FY 2016-17 is carried out and inferences were drawn.

Impact on Rural Market:

Demand for tractors has been hit in the short-term, predominantly due to cash shortage in India's rural areas. Farmers across the nation have faced problems while selling their crops, as nearly all their transactions are done using cash. Given the severe shortage of cash in the market, they're either unable to sell, or are forced to sell at lower prices. 75 per cent of the total sale of vehicles is accounted from the rural sector. It is expected that demand for tractors and other agricultural equipment will return to normal levels in long term. The impact was more in rural than urban, since cash still forms the basis of many transactions in the hinterland. This was especially true for two-wheelers that are priced up to 1 lakh-1.2 lakh - as the finance options for these are fewer. If one considers the purchase of passenger vehicles, up to 80 per cent of the vehicle's value is usually financed by banks and the rest is paid up front - again mostly in cash.

Impact on Two Wheeler Segment:

As per the CRISIL report when the ruling came, the two-wheeler inventory risk was at 670,000 units, amounting to 3,800 Crore. Among the two-wheeler players, Hero MotoCorp, TVS Motors and Honda Motorcycles and Scooters, were found to be with large pile of BS III bikes. According to one brokerage house tracking the automobile industry, actual vehicle population affected by the ban is a mere 8,24,278 out of 238,56,956 produced between April 2016 and February 2017. The value loss for the industry would be a mere 5 percent due to the ban. Bajaj Auto has the every possibility to export, the UN sold inventory, as they are a big exporter to around 70 countries across the world.

Impact from Discounts offered:

The CV makers had built up large inventory and even continued to manufacture BS-III vehicles till March in anticipation of strong buying in April given the price increases of 8% to 10% expected on BS-IV vehicles. As per the CRISIL report, the discounts and incentives on vehicles sold till March 31, 2017 are expected to cost CV manufacturers about 1,200 crore. Additionally 1,300 crore would be incurred to dispose of the unsold inventory (including exports). The two-wheeler segment witnessed marginal impact with most of the BS-III bikes and scooters being sold with up to 30% discounts. The passenger car segment remained largely unaffected as this segment had mostly shifted to BS-IV beginning last year. But 10-30 per cent discounts and freebies helped the dealers clear most of the stock in the last three days of March. Hero Moto Corp being faced with losses of nearly Rs 1600 crore due to discounts offered.

Impact on Inventory:

The Supreme Court urged manufacturers to do their best to sell their existing BS-III stock before March 31st 2017, but manufacturers felt that it was impossible to do so, and, were instead, looking at either recalling the vehicles to upgrade them, or to export them to markets that do not have such rules, and where they are still compliant to the norms. Recall and upgradation entails lofty costs, which will be even higher for commercial vehicles than it would be for two-wheelers. As per the CRISIL report, the impact was comparatively low as many of the companies like Bajaj Auto, Yamaha and Eicher had already upgraded to BS-IV from January 2017, while market leader Hero Moto Corp, and the No 2 Honda and also TVS Motors have upgraded most of their model before the ban set in. It was mentioned in the report that 25% of the banned vehicles will go to exports. When the ruling came the two-wheeler industry had an inventory of 6, 70, 000 units of BS-III models, amounting to Rs 3,800 crore which is half of monthly sales of the industry.

Impact on Premium Bike Companies:

Triumph India management wasn't comfortable with Triumph becoming a discounted brand. More than 100 bikes have been taken back by the company although it's still not clear what will happen to those bikes which cannot be sold or registered in India. Market value of these bikes is pegged at between Rs 10-11 Crore. Italian premium motorcycle brand Ducati also faced similar problems with BS-III bikes. Most of the BS-III Ducati bikes have been sold out across dealerships in India. The Supreme Court order doesn't really affected premium bike brands in India as much as the mass market brands

Conclusion

Demonetisation impacted the Automobile industry significantly. The domestic CV sales contracted by a sharp 11.6% in November 2016. Passenger Vehicle (PV) industry slowed down during Nov-16. The two wheeler and three wheeler segments also took a significant hit during the month of November. Car sales were at their lowest in the last 16 years in the month of December, 2016. The overall dip in the sale of automobiles has been recorded at 19 per cent to 12.21 lakh units in December 2016. Not just the sale of automobiles, their overall production also went down by 22 per cent as carmakers scrambled to cut production in the face of falling demand. The month of December 2016 saw a dip in the production of two-wheelers by 25 per cent and the production of commercial vehicles by 20 per cent. Overall vehicle sales in December 2016 were down by 18.66 percent compared to a 5.48 percent drop in November 2016. The impact was more in rural than urban. Demand for tractors has been hit in the short-term, predominantly due to cash shortage in India's rural areas. To counter the impact of demonetisation in urban areas, manufacturers along with the finance partners have rolled out cashless schemes, 100 per cent finance, tie-up with e-wallet companies (Past) to reinstall the buying sentiment.

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