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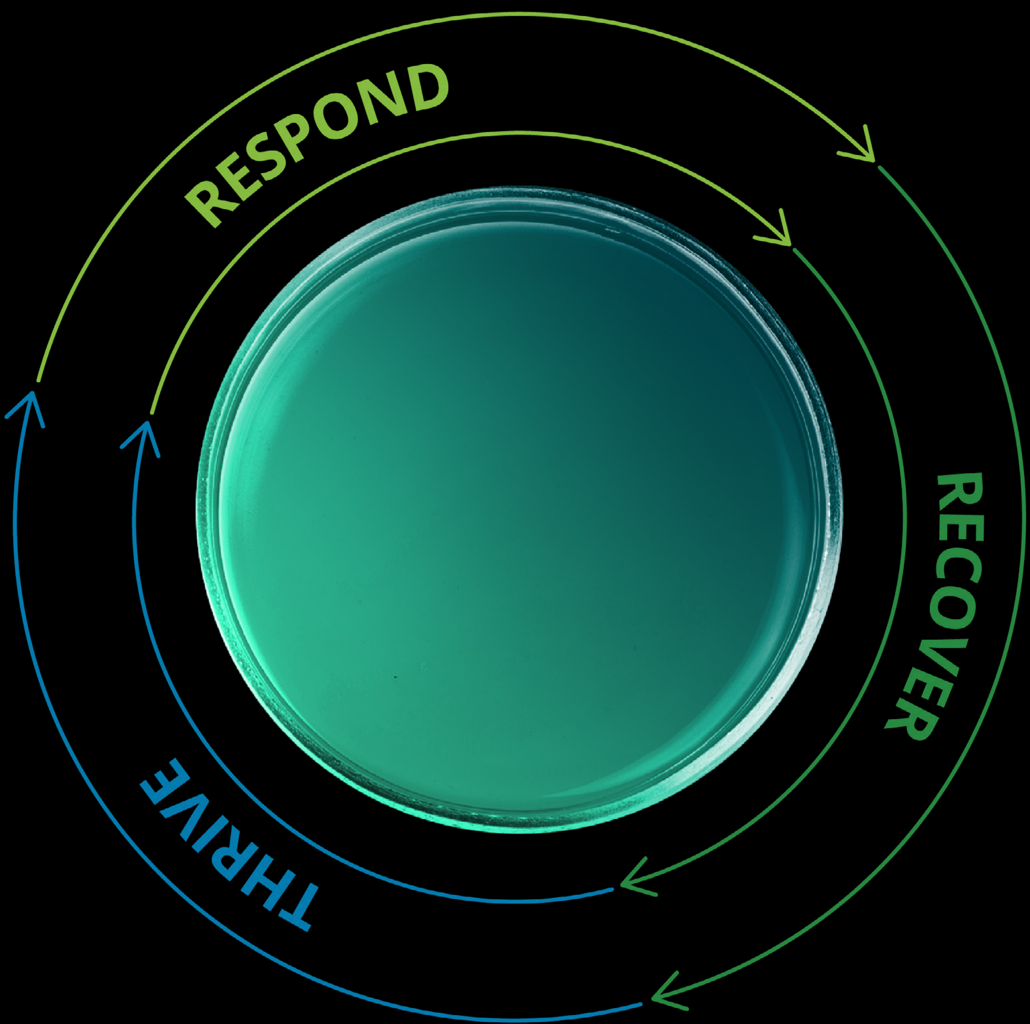

The Impact of COVID-19 on the South African Automotive Sector

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By Dr Martyn Davies and Mike Vincent

With over 80% of the global economy currently in some form of lockdown and rolling blows to economic activity as more countries are put into lockdown, it is common cause that the world has not faced a pandemic of this scale in recent times.[1]

Many analyst forecasts indicate that the global economy will fall into recession as growth grinds to a halt in many countries, financial conditions tighten sharply and labour markets deteriorate. Goldman Sachs, for example, expects the world economy will contract by 1%. This is a larger decline than during the 2008-09 financial crisis.[2]

Already, COVID-19 has had a major impact on China. Industrial output fell by 13.5% y-o-y over the months of January and February, retail sales contracted by 20.5%, fixed investment by 24.5% and real estate investment by 16.3% over the same period. The COVID-19 pandemic impact on business is immediate and severe and no country or industry will be spared.[3]

The importance of the South African automotive sector

The automotive cluster is an important industrial sector in South Africa. The broader automotive sector accounted for 6.8% of gross domestic product (GDP) in 2018.[4]

Considering that the overall figure for manufacturing value added as a share of GDP stood at 11.76% in 2018,[5] the auto industry accounts for a significant chunk of South Africa's entire manufacturing capacity. Automotive manufacturing furthermore employs 110 000 directly and indirectly, with the broader automotive sector accounting for 457 000 jobs.[6] It is the only manufacturing sector that has shown notable progress, supported by proactive industrial policy from the Government.[7]

The continuity of the South African automotive sector is thus critical to the future industrial and economic landscape of the country.

The global picture

In line with strict government-led social and economic shutdowns, most original equipment manufacturers (OEMs) are shuttering their manufacturing plants across Europe, North America and South Africa. As a result of these shutdowns, Moody's has predicted that global demand for passenger vehicles will shrink by approximately 14% in 2020.[8]

Based on Moody's forecast, this would translate into a reduction of over 13.5 million passenger vehicles not being manufactured in 2020. These figures may even be on the conservative side, depending on when and to what extent consumers are willing to spend, as well as when industries are able to restart.

In line with this dramatic forecast slump, Moody's has downgraded a number of the global auto OEMs including BMW (to A2), Ford (Ba2), Toyota (Aa3), Honda (A2), and Nissan (Baa3). The ratings agency has also put under review other leading auto firms such as Daimler, JLR, PSA Group, Renault, VW, Volvo and McLaren Holdings.[9]

VW Group has revealed that it is already burning through €2bn per week following its plant closures and the collapse in demand.[10]

These dire forecasts are unprecedented. In comparison, following the post-Lehman Brothers financial shock from September 2008, the automotive demand declined roughly 8% over a two-year period.[11]

Governments step in

Considering the scale of industrial destruction, the situation globally requires immediate support and enablement from governments. It is imperative that wages are protected and that consumers are given as much support as possible in order to minimise a long-term and protracted decline in demand. Some market commentators are already warning of a "lost decade" for the auto industry.[12] But the real challenge lies in maintaining demand after factories are able to re-open, and this rests with the consumer.

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The British Government will provide funding of up to 80% of employees' monthly salaries up to a maximum of £2 500. For employees of auto dealerships, the Government will reimburse up to 80% of salaries if their jobs are "at risk".[13]

In the United States, no dedicated auto sector support measures are in place, but the auto OEMs and suppliers will likely benefit from industry-wide liquidity-boosting measures aimed to shore-up consumer spending.

In France, the Minister of Finance Bruno Le Maire stated last week that "[...] sectors like the aeronautical sector and automobile sector [...] need support today. It won't systemically be nationalisation; it could be recapitalisation." President Emmanuel Macron further said "We won't let industrial champions disappear in smoke because there is a crisis unprecedented since 1929."[14]

Government support in South Africa

The South African Government is contemplating establishing a "National Disaster Benefit" fund that could potentially draw from the R30bn capitalised Unemployment Insurance Fund (UIF).[15] The Industrial Development Corporation (IDC) will make available R3bn for wider industrial funding for South African companies but there is doubt that these monies will make their way into the OEMs in light of their foreign ownership.

The newly created Automotive Industry Transformation Fund (AITF) – currently capitalised to the tune of R6bn – with a mandate to support black participation in the automotive supply chain could serve as a support mechanism for the industry over the medium term.

The health and durability of the components firms is tied to the OEMs which need to restart production as soon as possible. If OEMs can restart, the supply chain will be able to recover quickly, depending, of course, on the health and wellbeing of its workforce. The experience of the automotive components sector and its robustness was evident in Japan after the Fukushima disaster in 2011. Honda, for example, was one Japanese OEM able to restart domestic production about one month following the disaster.[16]

Current announced measures in South Africa may, however, not be sufficient to provide support for the wider automotive ecosystem in the economy. In the coming weeks it will become clearer as to how much deeper the Government will have to dig into its pockets to support a pillar industry of the economy.

With suppressed demand ahead, lost production will not recover. The three-week forced closure in South Africa will in effect be longer due to reduced inventories. The challenge is that it will prove difficult for auto companies to pay full salaries beyond the official three-week shutdown if production is not restarted soon.

In light of depressed production volumes, the Automotive Investment Scheme (AIS) – an incentive that both OEMs and component manufacturers enjoy under the APDP – will have to be renegotiated between industry and the Department of Trade, Industry and Competition (DTIC). The AIS requires OEMs to achieve a minimum of 50 000 units produced per annum within three years, with component supply manufacturers also benefitting from this link to the production value chain.[17]

Figure 1. South Africa's passenger vehicle production by volume (2019)

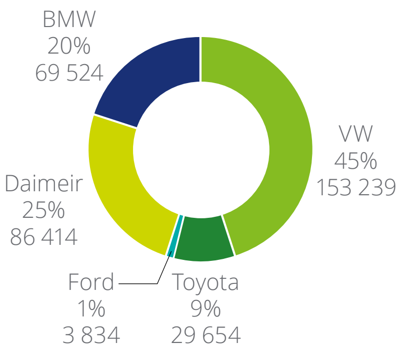
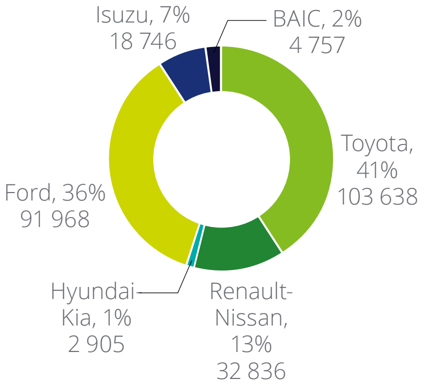


Figure 2. South Africa's light truck production by volume (2019)



Source: Deloitte calculations based on Marklines, 2019

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More a demand-side, less a supply-side problem

The real difficulty will be to address the demand side, both locally and internationally. Last year, 386 863 vehicles were exported from South Africa – an annual record with growth over 10% compared to 2018. Exports of passenger cars registered a substantial gain of 17.7% that year.[18]

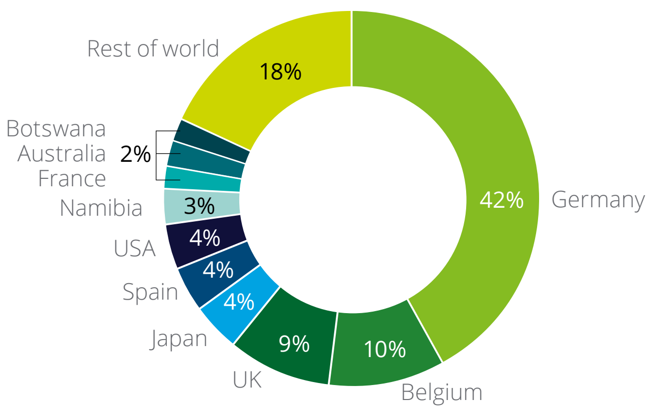
Exports constituted 61.25% of total production, bringing in R114bn in 2018.[19] There is a sizeable and growing dependence on the export market by the local auto industry. Exports were already under pressure in February showing a year-on-year decline of 8.4% (30 832 units) compared to the same month a year ago.[20] With global demand having plummeted in March, this does not bode well for the short term. Looking over the horizon, in all likelihood the APDP's manufacturing target of 1.4 million vehicles by 2035 is now in jeopardy and much will depend on the global economy's medium-term recovery.[21]

According to Mike Whitfield, Chairman of Nissan Africa and Managing Director of Nissan Egypt, OEMs based out of South Africa are responsible for the sub-Saharan African market and these businesses are continuing for now, but are likely to be curtailed in the coming days and weeks. Exports of built-up vehicles to the rest of Africa amounted to 22 998 units in 2019 with the leading markets being Ghana, Kenya and Zimbabwe and Mozambique.[22] The adverse impact on the hospitality and tourism sectors will also impact vehicle sales given the sizeable contribution that the car rental industry makes to new car sales. For example, this was 16% of new car sales in February, given stocking up in expectation of the coming Easter vacation period. In the short term, car rental firms will be dumping over 30 000 cars in the domestic market in line with their fleet utilisation models, further compounding the challenges being faced by the OEMs' manufacturing lines.

Altogether, the local market has been suppressed for a number of years already, with sales declining by 2.8% last year (536 626 units sold; see figure 4). It is highly likely that domestic sales forecast for 2020 will be significantly less with analysts forecasting this in the region of 450 000 units. The most recent sales figures released for March 2020 indicate that new vehicle sales have dropped 30% compared with the same month in 2019.[23]

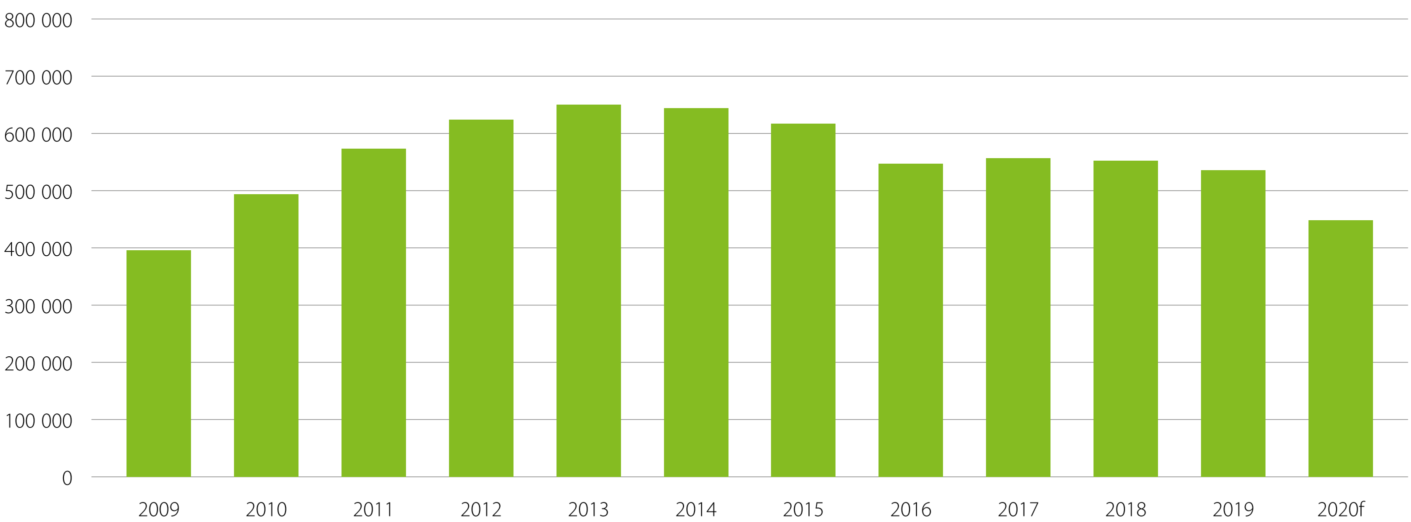
With the collapse in demand and a very uncertain outlook, the auto industry will undergo rapid consolidation.

Figure 3. South Africa's top 10 vehicle export markets by volume (2019)



Source: Deloitte calculations based on The Department of Trade, Industry and Competition data

Figure 4. Vehicle sales in South Africa, number of units sold (2009-20f)



Source: NAAMSA, Fitch Solutions, 2020

Respond, recover, thrive

The automotive industry is already grappling with rapid change and disruption: congested cities with inadequate infrastructure deterring car purchasing; technological shifts toward embracing new battery elective vehicle (BEV) power; and the rise of new competitors moving into the mobility industry. And now it faces an unprecedented economic crisis that is rapidly unfolding.

The global auto industry may face significant disruption and wide-sweeping restructuring. As per conversations with CEOs, the two major priorities at the moment are their people's well-being and raising cash for their business.

OEMs will be forced to adjust to a suppressed market by right-sizing their cost base. "Undoubtedly, there will be a different automotive sector coming out of this," says Whitfield.[24]

But the example of China's emerging consumer and industrial recovery holds out hope. 80% of global car production involves "Made in China" parts. The Chinese economy is now cautiously reopening and economic activity reviving.

Of VW's 33 plants in China, only two remain closed, albeit at reduced utilisation.[25] Car sales in China dropped by 80% in February[26] (the greatest contraction on record) but are expected to pick up with VW expecting sales to reach 1 million in March.[27] Figures to be released in the coming days will reveal the extent of China's economic normalisation. China now offers hope and lessons[28] for other countries grappling with the COVID-19 scourge.

A recent study by authors affiliated to the US Federal Reserve Board, the Federal Reserve Bank of New York, and MIT Sloan School of Management suggests that there is not a tradeoff between suppressing the virus and economic activity. Instead, the act of suppressing the virus ultimately leads to improved economic activity. This is consistent with what we are now seeing in China.[29]

If Governments can take drastic action to "flatten the curve" of infection rates at an early stage, this results in a quicker suppression of the outbreak. The above-mentioned study evaluated the 1918-20 influenza pandemic and found that swift action 10 days prior to the onset of the pandemic increased manufacturing employment by roughly 5% in the post-pandemic period. Implementing restrictions beyond this for an additional 50 days increased manufacturing employment by 6.5% after the pandemic subsided.[30]

This is clearly a case of willful short-term pain to avoid longer-term structural damage to the industry. The outcome may still be uncertain, but the South African automotive industry must be protected at all cost.

What should the response of auto executives be?

COVID-19 is having a major impact on the whole business ecosystem. In the short term, businesses will need to respond to the immediate challenges of the COVID-19 lockdown where speed will be more important than elegance. Stabilising the business will be critical. This will include identifying organisational vulnerabilities and securing business continuity and financing.

In time, the world will start emerging from the constraints of COVID-19 and the next challenge will revolve around recovery plans including ramping up the return of employees, managing claims and contract dispute resolution, collaborating with customers and suppliers to synchronise operations and reviewing orders versus commitments and inventory.

Many businesses will have identified the value of a digital future and new ways of working. This future promises improved efficiencies, cost out and quicker response times. Thriving in the next normal will be for those businesses who see these convulsive changes as opportunities not to be missed.

Endnotes

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