

Covid-19: South African automotive industry briefing note

Compiled by Prof. Justin Barnes¹, 08/04/2020

Introduction

This briefing note has been compiled for Trade and Industrial Policy Strategies (TIPS) as a mechanism to support the South African Presidency and Department of Trade, Industry and Competition in their deliberations on the impact of the Covid-19 pandemic on the South African automotive industry. The briefing note has been compiled from secondary readings, the author's own industry knowledge, two CEO interviews (one OEM and one component manufacturer), and five written submissions from firms/industry stakeholders (which were submitted in lieu of interviews). The findings presented are consequently exploratory in nature, although the consistency of responses from across the interviews and written submissions suggests a broad and generic set of impacts and associated consequences for the South African automotive industry.

Following the guidelines set for its compilation, the answers to four key questions were solicited from the interviews, written submissions and secondary readings. The briefing note follows the structure of these four questions, with Section 1 exploring the manner in which the industry has been affected by the Covid-19 lockdown; Section 2 industry plans for reopening, given identified challenges in domestic and export markets; Section 3, industry perceptions of the potential for recovery; and Section 4 an exploration of critical issues in respect of potential government support for the industry during the recovery phase. Section 5 concludes.

1. How has the industry been affected by the lockdown?

The South African automotive industry has been affected in a similar manner to the global automotive industry. Except for very limited product supply for essential domestic service delivery (e.g. the continued supply of vehicle replacement parts), and the continuation of critical factory maintenance activities, the entire automotive value chain has effectively ceased all operations. This is consistent with the state of most automotive industries around the world, which have either fully or partly ceased operations. The one major exception is China, where automotive production has been re-started after an extended lockdown period. Industry interviews suggest that the South African permit system is working well in respect of critical operations, and that there is unanimous support for the government's decision to pre-emptively implement a national lockdown.

The industry is however being substantially affected by the lockdown: Interviews and written submissions indicate huge financial losses and liquidity pressures. Smaller, second tier automotive component manufacturers appear to be the most affected, largely because of their lower operating margins, and limited access to lines of credit. These firms see their ability to survive the lockdown as almost entirely dependent on the provision of some form of credit relief, and the effective extension of UIF support to (at least partly) cover employee wages, whether in the form of the recently

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announced TERS, or individual UIF applications. Larger multinational corporations do not see the lockdown as an existential crisis but are losing large amounts of money. They are also acutely aware of the implications of the lockdown for their suppliers (and hence their own ability to operate post the crisis).

To date, no major South African vehicle assemblers or automotive component manufacturers have formally indicated their intention of introducing retrenchment programmes, but there is consensus that this is an inevitable consequence of the pandemic, especially if there is only limited support from government during the period of the lockdown, and if there is a sustained drop in demand post the lockdown period. The drop in demand will ultimately determine the extent of the retrenchments to occur, but the length of the lockdown period is also of major concern, especially for smaller firms who fear they may not be able to re-start operations if the lockdown continues for a lengthy period.

2. What are industry plans for reopening, given challenges in both the domestic and the export markets?

The industry is anxiously waiting for confirmation of the government's position on the conclusion and/or extension of the lockdown period. Firms have developed scenarios in anticipation of either an extension, or a partially reduced lockdown that permits limited operations, and are hoping that the latter occurs. None of the industry stakeholders engaged anticipate a return to normal operating conditions in the short term. A major challenge is that the global automotive industry appears to be preparing for a resumption of production in late April. While only limited production activities are likely for a period, South African operations are a part of complex global value chains and will need to meet their export obligations once global lockdowns are concluded. If the South African operations are unable to supply the vehicle models or components they supply as part of these global production networks, they face the risk of being displaced by sister companies or competitors that can supply into the value chain.

Firms noted that they expect to open on a reduced basis on either the 17th of April or towards the later part of the month. In preparation for the expected reduced start-up, firms are modelling different shift configurations to reset their operations in alignment with lower levels of business, and have also invested in Covid-19 detection and remediation equipment to ensure their start up is not affected by localised infections that enforce subsequent closure. This is an especially important consideration when firms have continuous production processes that incur substantial costs whenever they are stopped and need to be re-started. Post lockdown work disruption is a major projected challenge: How to manage operations in a manner that is compliant with Covid19 social distancing requirements, while ensuring that production (even if limited) is not impacted by workplace infections and can be right-sized for demand conditions post the lockdown?

3. How does the industry see the potential for recovery?

Industry stakeholders believe the industry will experience a cautious recovery post the lockdown. Social distancing restrictions are expected to continue in some form both locally and internationally for at least three to six months. These restrictions are expected to significantly lower demand for new

vehicles, while decreased travel will also reduce dealership repair and aftermarket sales activity, especially of key replacement products, like tyres, brake pads, and windscreens. The consensus appears to be one of a disastrous next three months (April-June), with demand increasing to only 50% of normal market conditions by the end of the period; three months (July-September) of subdued activity (perhaps up to 70% of normal market conditions) as confidence slowly returns to markets; and then recovery to a “new” market level in the final quarter of the year.

The challenge every industrialist is attempting to understand is what the “new” market level will be in each of the major markets the South African automotive industry supplies, given the damage wrought by the pandemic (and for South Africa specifically, given the simultaneous downgrading of the country’s sovereign investment rating). This concern is underpinned by the automotive industry’s demand cycle typically following an exaggerated GDP trend: both positively and negatively. For example, GDP growth of 5% typically results in new vehicle demand growth of over 10%, while 1-2% GDP growth usually results in flat demand for vehicles, and negative GDP growth substantial declines. A 5% decline in GDP could result in new vehicle sales plummeting by more than 20%. These are moreover the figures being projected for the major global automotive vehicle markets. According to Roland Berger and Conway Mackenzie, two leading automotive consultancies, the United States market is projected to decline between 15% and 40% this year as a result of the pandemic, with the EU estimate at negative 12% to 38% and China at negative 3% to 19%.² These widely varying estimates reveal that there is consensus the global automotive industry is going to be negatively affected, but that there is little consensus on the extent to which it is going to be negatively affected in the short term.

Of the three major markets served by the South African automotive industry (South Africa, the European Union/UK and Africa), the expectation from the interviews and written submissions is that South Africa could recover by year-end to a level of activity somewhere around 20% lower than before the Covid-19 crisis; that the European Union/UK market will recover to levels proximate to its status prior to the crisis; and that recent African developments in respect of Covid-19 makes it impossible to forecast beyond the crisis.

4. Critical issues in respect of government support for the industry during the recovery phase?

A wide range of issues were raised in the engagements related to this question. These have therefore been grouped into five categories, with each unpacked in more detail below:

- Industry health at the start of the recovery phase
- Public management of the crisis immediately post the lockdown
- Public sector infrastructure support as production returns
- Supporting the establishment of demand side stability
- APDP regulatory adjustments

² Source: Roland Berger and Conway Mackenzie, 2020-03-26, OESA Webinar, COVID-19 -Impact on US automotive companies_F.pptx.

4.1. Industry health at the start of the recovery phase

A key consideration for the industry's recovery phase is the financial health of firms at the end of the lockdown period. This is dependent on two key variables: The length of the lockdown and the extent to which support for firms materialises. If firms are too drained of their liquidity, and workers have not received UIF payments, etc. then there is a strong likelihood that the initiation of production post the lockdown will stutter – as firms struggle to purchase materials and workers demand outstanding payments before starting work. To avoid this situation, the industry requires a return to production as soon as possible (even if only gradually – see below), and the effective delivery of government support, especially for workers.

Industry engagements indicate that if the lockdown continues for an extended period (i.e. beyond April), government support for the industry will need to be significantly amplified to ensure continued liquidity. Suggestions for government include the deferment of all taxes, rates, skills levies, UIF contributions, and PAYE payments, etc. Avoiding this outcome by permitting an initiation of production before the end of April is however the strongly preferred option.

4.2. Public management of the crisis immediately post the lockdown

Industry stakeholders will need to initiate production in an environment of heightened public fear and anxiety and believe there is an important role for government in publicising the safety and necessity of returning to work. Government could also assure communities that employers are committed to practicing social distancing practices in the work environment. Evidence from China is that many factories experienced laboured start-ups post the crisis as a result of worker suspicion relating to the safety of returning to work. This needs to be avoided in South Africa.

Government also needs to have very clear protocols in place for companies that identify Covid-19 cases in their organisation. Having transparent and clear rules that need to be followed is recognised as being essential to maintaining worker morale and discipline in the difficult period post the return to work.

4.3. Public sector infrastructure support

The ability of Transnet and Portnet to initiate their operations in alignment with automotive industry requirements post the crisis is deemed a major risk by the industry. While the national government was praised for its handling of the lockdown, the opposite applies to the way Transnet and Portnet have communicated with the industry, both in preparation for, and during the lockdown. It was deemed inconsistent, unclear, disorganised, and generally ineffective. One recommendation is that Transnet and Portnet should be allowed to start their operations a few days before the start of production so that they can be properly prepared for the activation of automotive imports and exports.

A similar concern exists for Eskom's stability and its ability to increase energy supply when operations restart. There is limited confidence in Eskom and a concern that a surge in electricity consumption will cripple the poorly functioning state-owned enterprise. It was emphasised that stable energy supply will be critical during the initial phases of the recovery process.

A final concern relates to the effectiveness of moving automotive workers to and from work. This is largely done by a minibus taxi industry with a poor track record of legal compliance with health and safety legislation; and the industry is therefore deeply concerned that their own efforts at social distancing will be undermined by the non-adherence to these standards during their workers' commutes to and from work. It was noted that this exposed both the individuals and the firms to significant risk.

4.4. Supporting demand side stability

The complex structure of the automotive value chain requires some level of demand stability to operate effectively, as opposed to wildly positive or negative fluctuations. A key request is therefore for government to slowly and consistently increase economic activity post the lockdown, as opposed to potentially making bold decisions and then reversing them. One suggestion is that the industry should be reopened for export supply only for a short period, with this window allowing for the learning of valuable operating lessons in respect of required social distancing protocols. General production could then commence once operational learnings have been bedded down, and firms have proven they have the controls in place to operate at full capacity. Prioritising exports is deemed critical primarily because of the foreign revenue earned, and the need to ensure South Africa remains locked into global production networks.

Another suggestion relates to tax concessions in the domestic market for a period post the lockdown to bolster domestic market demand. Industry stakeholders emphasised the import-export complementation dynamic of the national government's Automotive Production Development Programme (APDP), and are concerned that if domestic market volumes collapse, there will be limited incentive to export. This is tied to how the APDP operates: If import rebates earned from production cannot be used, then exports are likely to be curtailed over time. Bolstering production volumes during the lockdown recovery period is therefore largely dependent on the performance of the domestic vehicle and component aftermarket.

4.5. APDP regulatory adjustments

The final two government support recommendations put forward by industry relate to adjustments to the APDP's regulations. The first concerns the lifespan of duty rebates earned by the industry. The lockdown will result in no new vehicle sales during its implementation, while the anticipated reduction in market demand post the lockdown will result in limited demand for duty rebates earned from industry production activity. It is therefore recommended that all duty rebates earned by the industry receive a full year extension to their usage lifespan. This would support their utilisation when market expansion resumes in 2021.

The second APDP regulation recommendation is that DTIC amend the requirements for AIS qualification over the next two years. Industry stakeholders argued that securing AIS support is critical for investment recovery in the value chain, but that vehicle assemblers and component manufacturers will not be able to sustain their employment levels post the lockdown, thereby disqualifying them from receiving the AIS. Amending this specific requirement would support new investments in the value chain, thereby supporting its recovery.

5. Conclusion

The Covid-19 crisis may not represent an existential threat to the continued operations of the South African automotive industry, but it certainly poses a major threat to its continued health and prosperity. The immediate lockdown impact is a severe liquidity drain that is most threatening to the survival of smaller second tier automotive component manufacturers. If the lockdown were to continue beyond April this threat would extend to first tier component manufacturers. The post lockdown impact will also be severe for firms. The overwhelming majority of firms will push out their investments and continue to operate in a guarded manner for at least six more months. The expectation is that domestic and export production volumes will remain muted for an extended period, with this resulting in job losses and subdued investment activity.

This negative outlook is based on the lockdown ending in mid to late April, and restricted levels of production then starting. If the lockdown extends further than April, many second tier automotive component manufacturers may potentially not be able to restart operations. While this will not cripple the industry, it will reduce local content in South African vehicles and reverse the localisation gains made over the last two years. This appears to be the biggest threat facing the South African automotive industry as a result of the Covid-19 pandemic: A decline in automotive value addition that renders the industry less important within global value chains, and that moves the industry further to the margins of global production activity.

To limit this negative impact, industry needs the national government's planned UIF support to deliver payments to workers timeously, firms to receive direct liquidity support where required, and the government to allow at least some level of automotive production to start as soon as is possible. Ensuring public infrastructure is available and ready for the start of production is critical, as is the safe commuting of workers to and from their places of work and selected regulatory amendments to the APDP. Firms appear confident that they are prepared for the balance of issues they will need to confront, including the operating models they will start with, and the health and safety processes they will need to follow.