



PAINT SECTOR

An Overview

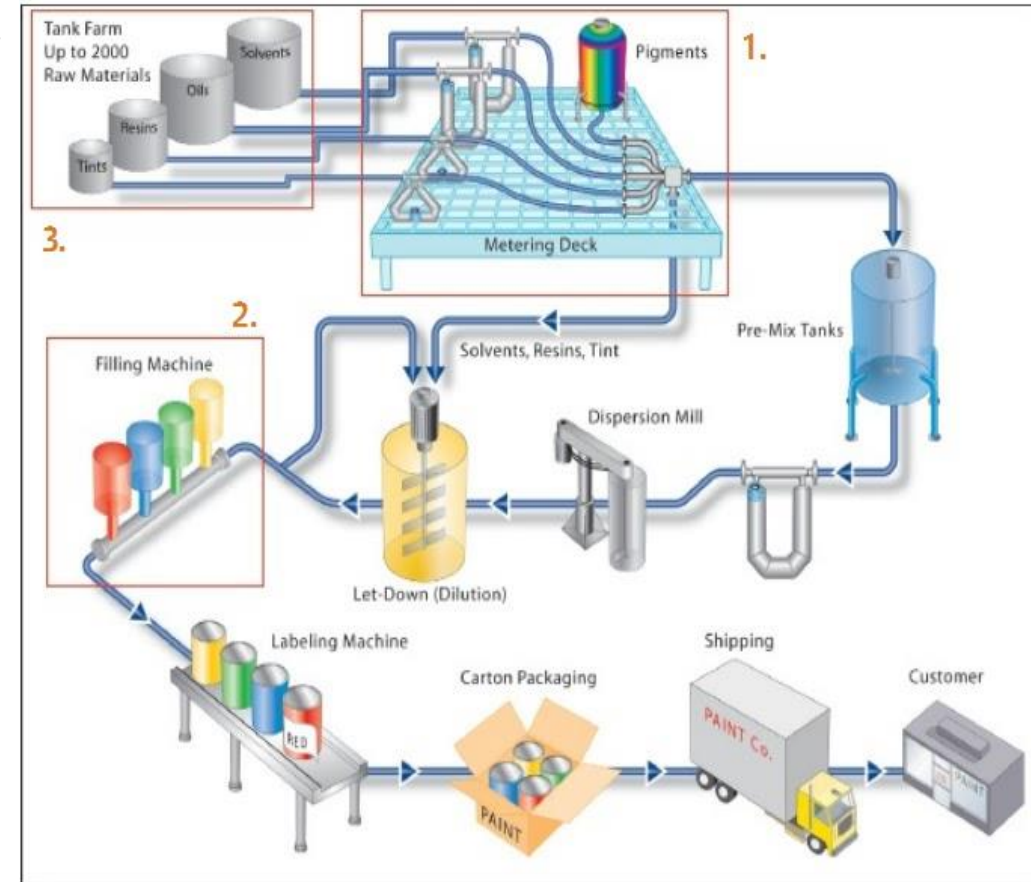
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PAINT | INTRODUCTION & PROCESS

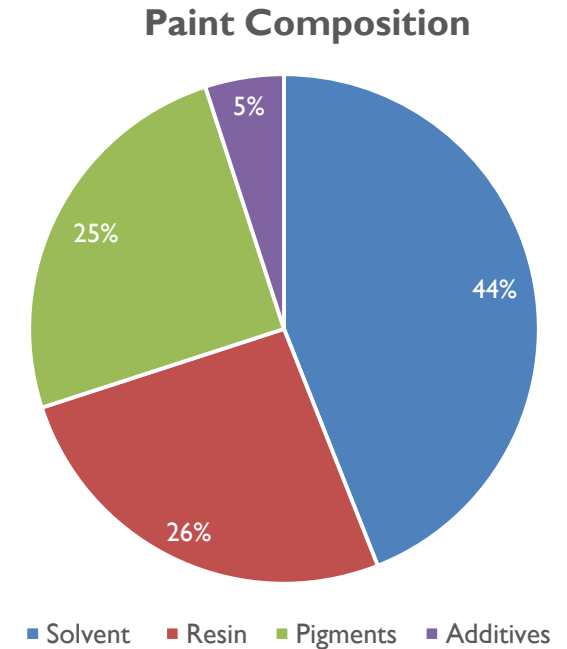
- Paint is a colored substance which is spread over a surface and dries to leave a thin decorative or protective coating.
- Paints are extensively used in residential and commercial buildings, industrial machinery and automobiles.

Process

- The production process involves 5 major steps:
 1. Measuring of raw material according to specifications
 2. Mixing of raw material
 3. Dispersion to blend pigments, resin and additives together
 4. Dilution to reach desired consistency by adding solvents
 5. Packaging



- Paints are produced using four major raw materials;
 1. Pigments, such as titanium dioxide
 2. Resins, used to bind pigment particles together
 3. Solvents, used to disperse pigments and resins to desired consistency
 4. Additives, to modify properties of the product
- The composition of paints depends on the intended use.
- Generally, solvent comprises majority of the mixture followed by resins, pigments and additives.
- The raw material for paints are mainly derivatives of oil.



- There are two major types of paints:

1. Decorative Paints:

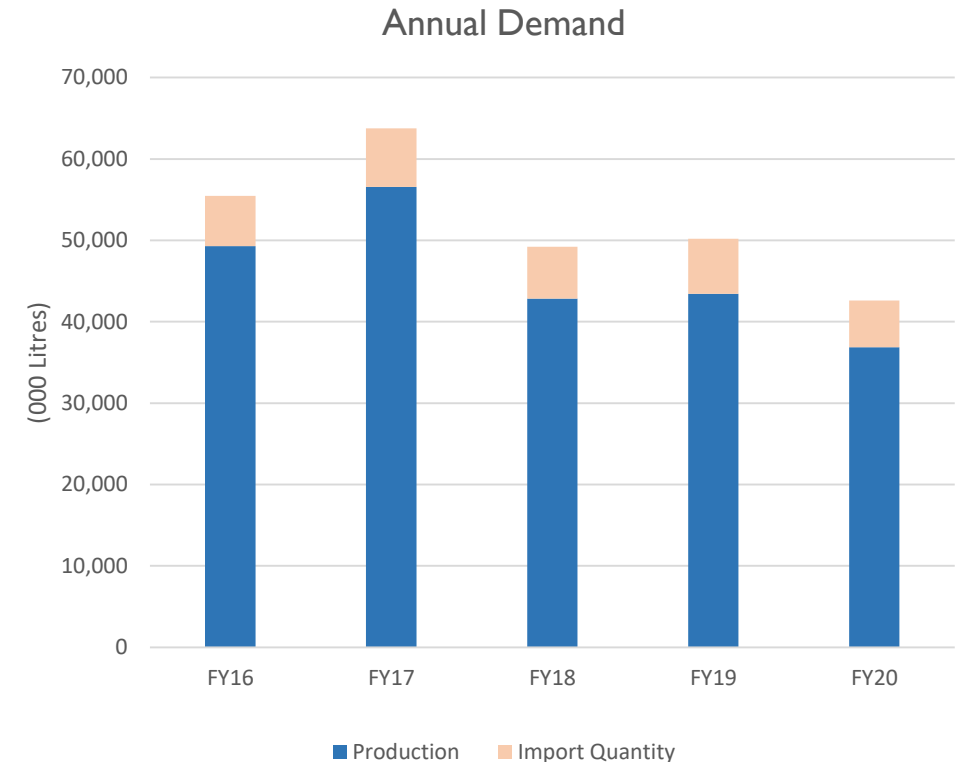
- **Primer:** Used on new surfaces to protect the material underneath. Helps to even out colour and smoothen the surface. Can be both, oil and water based. Commonly used in residential buildings and infrastructure projects.
- **First Coat:** Used to help build up the opacity. Typically, one or two coats of it are applied before colour can be applied. Used for residential, commercial, and infrastructure projects.
- **Flat Paint:** This matte – finish paint is typically best used for walls and ceilings. Used for both residential and commercial buildings.
- **Eggshell:** Usually, two coats of eggshell are required on top of a primer or first coat to achieve the true colour. Commonly used for residential buildings for decorative purposes.
- **Gloss and Satin Finishes:** These resilient paints are less prone to yellowing and stand up well when cleaned. Used both on the interior and exterior purposes. Commonly used for wood furniture or residential buildings.
- **Varnishing:** A hard transparent protective finish or film. Used for wood flooring, panelling and furniture.

2. Industrial Paints:

- **Solvent Based Paints:** High quality topcoat paints to give a strong and durable coating to various industrial equipment. Helps protect against fading and damage from chemicals and equipment. Commonly used on agricultural, construction and other industrial machinery.
- **Aquatic Paints:** These paints offer fade resistance and help in colour retention. Commonly used for pipes, pumps and engines.
- **Powder Coat Paints:** Offer protection and add beauty to the industrial equipment. The powder coating provides thickness and protection against UV exposure and also offers chemical resistance. Used for household appliances, aluminium extrusions and automobile parts.
- **Anti-Fouling:** Provides long lasting tin-free coating to the equipment, durable and bright, they work in wide range of climates and can be applied to wood, steel and glass. Commonly used on ships or boats.

- The paints sector is at mature stage in Pakistan.
- The sector can be divided into two segments, i) Organized segment and ii) Unorganized segment
- The unorganized segment accounts for ~60% of the production and has over 100 players. It caters to construction industry with focus on vast markets of semi-urban and rural areas. The segment is highly price sensitive. Our main focus is on organized segment in this sector study.
- The organized segment accounts for ~40% of total market share. The organized segment comprises around 20 players. The organized segment includes both multinational brands, such as AkzoNobel, Berger, Nippon and Kansai, and local players like Master Paints, Brighto Paints and Diamond Paints.
- The organized segment suffers not only due to loss of market share but also faces cost pressures as unorganized segment avoids taxation and other costs associated with organized sector.
- Overall, the nature of the sector is competitive with players differentiating themselves based on quality and targeting various income segments (high, middle, low).
- The organized paint sector contributes ~0.12% to the GDP of the country.
- The estimated market size of the organized segment is PKR ~50bIn in FY20.
- The average gross margin of the sector is ~21% while the average net margin is estimated at ~3%.

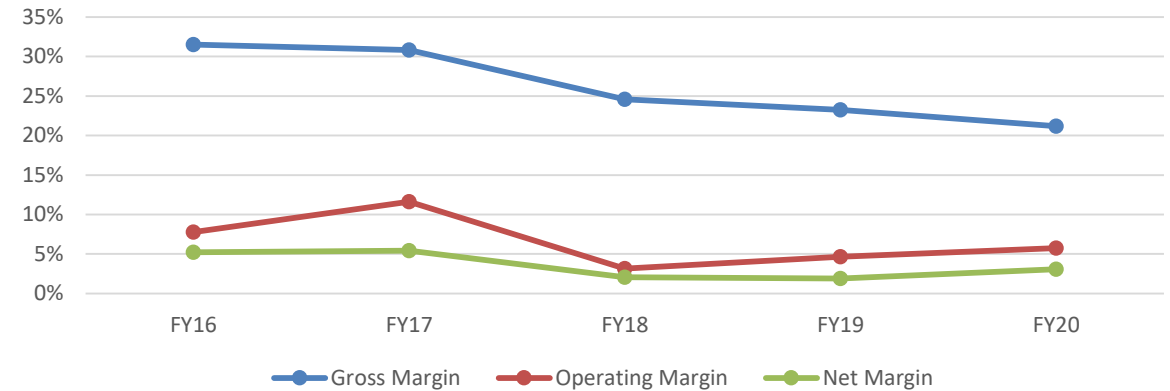
- The installed capacity of the sector remains indeterminable as the production varies depending on underlying product and process. However, The installed capacity is adequate to meet local demand.
- Most of the imports are for premium paints. Major import destinations include China, Italy and the UAE.
- Total local demand stood at ~43mln litres of paints in FY20 with production of ~36.9mln litres. The overall demand showed a negative CAGR of ~6.5% since FY16.
- During 2020, ~5.7mln liters of paint was imported, equivalent to PKR ~3,225mln. Paint imports have increase by a CAGR of ~6% in the last 5 years.



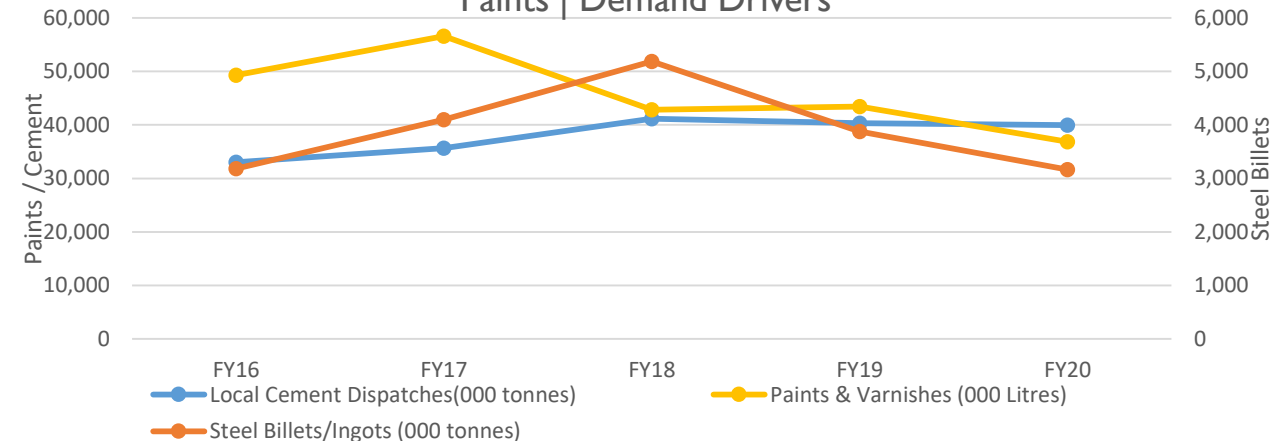
PAINT | BUSINESS RISK

- The business risks of the sector have been categorized as sales risk and operating risk (i.e. Cost structure).
- The sector's sales risk is mainly a derivative of local demand. The demand for paints emanates from construction (infrastructure, housing others) and industrial activity (including automotive and other industries). PSDP spending by government is a key demand driver in infrastructure projects.
- The local production of paints have fallen since 2017 by ~10% p.a. on the back of contracting construction and industrial activities amid economic slowdown.
- The sector has low barriers of entry, especially in unorganized sector due to low capital investment and technical capabilities required.
- The gross margin of the sector remains strong (~22%) but has been reducing over the years (FY16: 31%) due to competition and lower volumes as increased costs could not be passed on.
- Overall, paint sector has moderate business risk with margins and volumes under pressure though margins remain strong.

Historical Margins

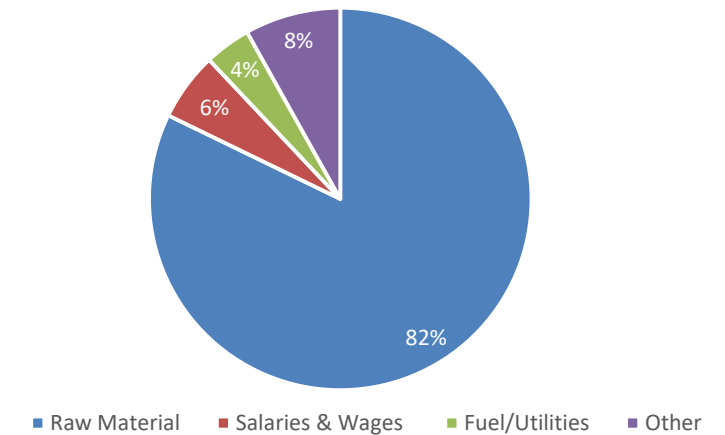


Paints | Demand Drivers

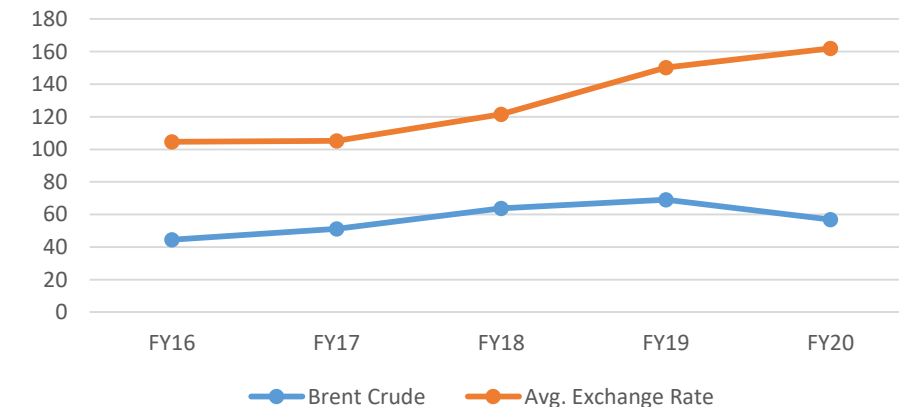


- The cost structure of paint sector is mostly variable with ~90% variable cost. Resultantly, the sector has low operating leverage.
- On average, the sector spends ~82% of its total production costs on raw material like solvents, resins, pigments, etc.
- The major raw materials for paints are derivate of crude oil. Thus, most of the raw materials are imported from Middle East while specialized pigments and chemicals are imported from China, East Asia & South East Asia. The prices of solvents and resins have increased since FY16 due to higher crude oil prices and significant rupee depreciation, reflecting in declining marigns.
- Other major costs include Salaries and Wages as well as Fuel and Utilities, which both consist of ~10% of the total production cost.
- Remaining ~8% is attributable to other costs such as depreciation, repairs, maintenance, insurance, packing and chemicals.
- The margins of the sector are largely dependent on import prices of raw materials and rupee exchange rate.

Cost Break Up

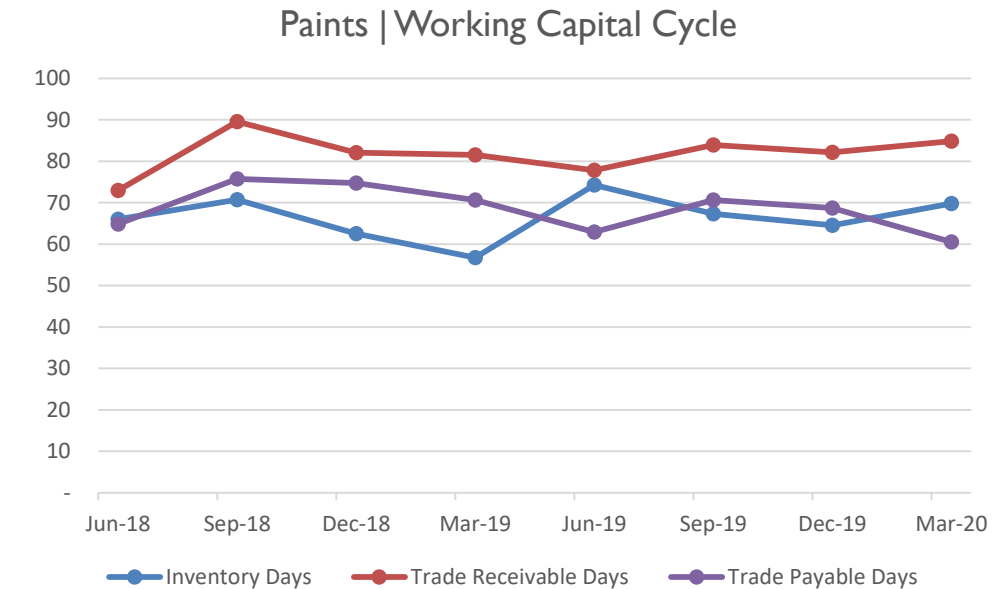


International Crude Oil Prices



- Overall, the paint sector is low leveraged with average sector's borrowings standing at ~25% of total capital.
- Total borrowings of the paint sector stood at PKR ~14.5bln as at 30th July 2020.
- Around half of the borrowings (~52%) are short-term in nature utilized to finance the working capital requirements.
- SBP's rate cut of 625bps since March 20 is expected to reduce finance cost by PKR ~1bln.
- The overall financial risk of the sector is considered moderate.

- The working capital cycle for paints is characterized by inventory and trade receivables.
- Inventory consists mostly of raw material (i.e. solvents, resins) and finished goods while work-in-process makes only a small contribution. Receivables are a function of selling terms with retailers and distributors.
- Demand for paint emanates in Feb to May and August to November periods. Hence, working capital requirements are highest during these periods.
- The sector's average inventory days are ~70 days reflecting the need to order and store large quantities of imported raw materials.
- The sector's average trade receivable days are ~80 days while the average trade payable days stand at ~60 days. The high trade receivable days reflect extended credit terms offered to industrial customers and government agencies (i.e. National Highway Authority).
- The sector partially meets its working capital financing requirements through operating cash flows, while rest is financed through short term borrowings.



- The demand for paints is derived from activity in the construction, infrastructure and industrial sectors of the country. The peak season for the sector extends from February-May and August-November. The COVID-19 lockdown and resulting slowdown in activity, especially during peak season, hampered demand for the paint sector.
- Operations were briefly halted during the initial stages of lockdown in March and April and resumed in a phased manner after exemption was provided to construction and allied industries. Resultantly, paint production declined during FY20.
- The sector is dependent on imports of raw materials such as pigments, petrochemicals and resins. While supply chains from Middle East were not impacted, there was initial disruption in imports from China. However, businesses carried sufficient inventories of ~2 months which provided time to re-establish supply chain. The risk was reduced by the presence of suppliers in other East Asian & South East Asian countries.
- The demand has been recovering in recent months due to the easing of restrictions and gradual increase in activity in the construction and infrastructure sectors.

- In order to relieve liquidity pressure on the sector, the SBP allowed to defer principal repayments for one year to the corporate sector. Further, the SBP also allowed to restructure their loans up to 30th June 2020.
- The SBP, over the course of 4 months, reduced benchmark rate by 625bps to 7%. This is expected to improve the bottom-line of the sector.
- In addition, the Securities & Exchange Commission of Pakistan (SECP) provided several regulatory reliefs to the companies on a proactive basis during lockdown.
- The government introduced an incentive package for construction and allied businesses, which included the rationalization of sales tax and excise duty levied on construction material and exemption from withholding tax on construction materials, except for cement and steel. This is expected to improve the liquidity profile of the sector.

PAINT | DUTY & SALES TAX STRUCTURE



PCT Code	Description	Additional Custom Duty		Custom Duty		Regulatory Duty		Total	
		2019-2020	2018-2019	2019-2020	2018-2019	2019-2020	2018-2019	2019-2020	2018-2019
Raw Materials									
1207.91	Poppy Oil Seeds	2%	0%	3%	3%	0%	0%	5%	3%
28.23	Titanium Dioxide	2%	0%	0%	3%	0%	0%	2%	3%
2905.31	Ethylene glycols	2%	0%	0%	3%	0%	0%	2%	3%
32.11	Driers	7%	0%	20%	20%	0%	0%	27%	20%
32.12	Pigments	2-7%	0%	3-20%	3-20%	0%	0%	5-27%	3-20%
3812.20	Compound plasticizers	4%	0%	16%	16%	0%	0%	20%	16%
3904.101	Emulsion grade	2%	0%	11%	11%	0%	0%	13%	11%
3907.30	Epoxide Resin	4%	0%	16%	16%	0%	0%	20%	16%
3907.50	Alkyd Resin	7%	0%	20%	20%	0%	0%	27%	20%
38.08	Fungicides	2%	0%	3%	3%	0%	0%	5%	3%
Finished Goods									
32.08	Paints & Varnishes (including enamels and lacquers)	2%	0%	20%	20%	5-10%	10%	27-32%	30%

Note: Sales tax is applicable at 17% on all raw materials and finished goods.

- Diversified product mix
- Strong brand recognition in organized segment
- Strong gross margins
- Established distribution network

Strengths

Weaknesses

- Presence of large unorganized segment resulting in lost market share and quality variations.
- High regulatory duty on imported raw materials
- Highly price sensitive market

- Volatility in International crude oil prices and rupee
- Intense competition within sector
- Economic slowdown
- Low barrier of entry

Threats

Opportunities

- Tap rural market to increase market share
- Product Diversity
- Increase efficiency through technological upgrade
- Increase online presence to reach geographical areas where distribution network is not well established

- The demand for the sector is mainly a function of construction and industrial activity and PSDP spending by government. Hence, the demand fluctuates with the economic activity in the country and is seasonal in nature.
- The sector has diversified product mix supplied to a wide customer base including retail, industrial customers and government agencies. The demand for paints has contracted by ~10% p.a. since 2017 in response to lower economic activity. Further, the margins of the sector have declined due to its inability to pass on increased costs of imported raw materials to retail consumers on the back of significant rupee depreciation.
- The supply chain of the sector is heavily import dependent as major raw materials (i.e. Solvents and resins) are derivatives of crude oil. Thus the cost structure of the sector is dependent on international crude oil prices and rupee exchange rate.
- The sector has low operating leverage as represented by large variable costs in overall cost structure. The gross and operating margins of the sector have declined since FY17 but still remain strong.
- The sector has low leveraged capital structure and avails all borrowings at commercial rates. Around half of the borrowings are short term in nature and utilized for financing working capital. Hence, the sector has low financial risk.

- The resumption of construction and industrial activities after lifting of lockdown restrictions and announcement of several benefits to construction sector in recent Construction package is expected to boost demand for paints. In addition, the government's drive for Naya Pakistan Housing Scheme in recent PSDP budget is also expected to have a positive impact on the demand when it materializes.
- The price of crude oil has been hovering around USD ~40/barrel and is expected to remain range bound (USD 35-45) amid COVID-19 uncertainty resulting in sluggish demand. This, coupled with expectations of stable rupee exchange rate in FY21, are expected to help the sector control its input costs. The competition is expected to remain strong. Improvement in volumes will result in better profitability as margins are expected to remain stable.
- The SBP's rate cut of 625bps is expected to improve bottom-line of the sector by PKR 1bln, which will further reduce its financial risk profile, going forward.

- Pakistan Bureau of Statistics (PBS)
- State Bank of Pakistan (SBP)
- Federal Board of Revenue (FBR)
- PACRA Database
- Trading Economics
- Trade Map
- All Pakistan Cement Manufacturers Association (APCMA)
- Ministry of Planning, Development & Special Initiatives
- <https://www.mixerdirect.com/blogs/mixer-direct-blog/how-paint-is-made>
- Investing.com

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