Automotive LOGISTICS

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CRACKING UNDER SANCTIONS

The re-imposition of sanctions by the US on Iran has dealt a hammer blow to the country's emerging automotive industry. The threat of retaliation by the US against those whom it deems to have broken those sanctions has, once again, prompted vehicle-makers and logistics companies to pull out of the market.
Vehicle production in Iran had climbed to 1.5m units in 2017, up 18% from the year before, according to figures from global automotive association, OICA. The rise came off the back of a healthy 2016 as carmakers such as Renault and PSA Peugeot-Citroën returned to the market following an international agreement at the end of 2015 to relax sanctions. The appeal of a largely untapped market with a population of more than 80m made the risks seem worthwhile.
Now, however, the sanctions are back, after the US pulled out of the so-called Joint Comprehensive Plan of Action (JCPOA) and announced it would penalise companies doing business with Iran, starting from August 7. Among the sectors targeted are automotive, shipping and banking.

Sanctions are being imposed on foreign financial institutions and people conducting transactions "for the sale, supply or transfer to Iran of significant goods or services used in connection with the automotive sector of Iran". Worse, while the 2013 sanctions imposed by Barack Obama's administration on Iran exempted imports of finished vehicles, President Trump's executive order makes no mention of this.

Since it was only the US that pulled out of the JCPOA, companies with no involvement in the US market could, theoretically, continue trading with Iran. Neither Renault nor PSA Group, for example, conducts any significant business with the US, and indeed the European Union put out a joint statement at the beginning of August declaring it was "determined to protect" European companies doing business in Iran. Europe still supports the JCPOA, along with China and Russia.

However, the US administration could quite easily target linked companies – for example Renault's alliance partner, Nissan – and no-one is willing to take the chance.

Pulling out

PSA has said it is ceasing operations in Iran in what CEO Carlos Tavares called a "clear-cut decision" during an earnings call with analysts in July. "We decided to wind down to be fully compliant and protect the company. This is not a grey decision, this is black and white," he said. PSA says it has written off €150m ($170m) invested in its new joint venture with government-owned Saipa.

Daimler is also backing out. The truck arm of the German firm established a joint venture with Iran Khodro in 2016 to make Mercedes-Benz trucks, but told Reuters at the beginning of August it had ceased its Iranian business. Swedish truckmaker Scania, meanwhile, has cancelled all orders. The company is looking at contingency plans to keep supplying existing trucks in the country with spare parts, however, it told Reuters in August.

Renault was initially reluctant to leave Iran entirely. "We don't want to abandon Iran," Renault-Nissan Alliance CEO Carlos Ghosn said back in June. The two French firms – the biggest foreign vehicle-makers operating in Iran by far – had hoped to be exempt from penalties, following lobbying by France to President Trump. That

failed, however, and by the end of July, Renault had changed its tune. “As we comply fully with US sanctions, it’s likely that our development [in Iran] would be put on hold,” Renault’s chief operating officer, Thierry Bolloré, told analysts at the end of July.
Both carmakers hoped to capitalise on the country’s potential to become a key market in their portfolio**.** “It’s easy to underestimate the importance of the Iranian light vehicle market, particularly for the French firms,” comments Matthias Schimdt, analyst with Sweden’s EagleAID automotive market research firm.

Iran was Renault’s eighth largest market in 2017 with sales of 162,079, up from eleventh in 2016. It sold more cars there than it did in the UK, Argentina and India, grabbing a market share of 11%. Renault had targeted a 15% share with sales of 250,000 by 2022, indicating the growth potential it saw in the market.

In 2017, it signed a joint venture agreement with state-owned investment firm IDRO and NEGIN Khodro, the company that currently imports Renaults, to build a new plant with a capacity of 150,000 units as well an engine plant. Renault currently has a capacity of 200,000 vehicles in Iran. However, the new company had yet to be established by the end of last year, Renault said in its 2017 financial report.

This will be the second time Renault has halted its business in Iran, after writing off its assets in the country back in 2013, when tougher sanctions aimed at the banking sectors hit. Renault’s operation in the country, Renault Pars, has remained separate to the Renault Group ever since.

Logistics impact

Automotive imports are expected to dwindle to very little, at least from Europe. The two biggest shipping companies, Denmark’s Maersk and Geneva-registered MSC, have both decided to stop providing services to Iran in response to the US executive order. “With the sanctions the Americans are to impose, you can’t do business in Iran if you also have business in the US – and we have that on a large scale.” Maersk’s chief executive, Soren Skou, is reported by Reuters to have said in May.

Both shipping firms had opened Iranian order books after the signing of the JCPO and Maersk had started a weekly service between Bandar Abbas port and nearby Jebel Ali in the United Arab Emirates.

Other foreign logistics firms are seeing business tail off. Ekol Logistics, based in Turkey, established a subsidiary in Iran last year to provide an air freight service to Germany, but the company has seen business slow. “Spare parts producers have been using our international transportation service with less frequency and since May 2018, we haven’t had any transactions and are not expecting any volume increases in the near future,” a spokesman for the firm says.

The company says the biggest problem is transferring money. “Due to banking sanctions, we are not able transfer any capital into the country,” the spokesman confirms. Without foreign investment, the Iranian government will probably freeze investment in the ‘logistics cities’ outlined in its development growth plan, Ekol expects. On the upside, Ekol’s continuing presence in the country could see it win business from companies that leave, it believes.

In terms of automotive imports, there won’t be much business left to chase. The government has already banned imports of finished vehicles in a series of clampdowns to stop currency leaving the country. It first banned all vehicles costing over $40,000, producing lists of ‘allowed’ cars and hiking already high import duties.
The *Financial Tribune* reported in January that the increased duties had pushed the price of the Hyundai Santa Fe SUV from $54,000 to over $72,000 in Tehran. Hyundai was the most popular imported brand in the first quarter of this year, sales data aggregator Bestsellingcarsblog.com reported. VW had moved to fourth among imported brands behind Renault and Mitsubishi after announcing last year it would restart imports into Iran.

In June however, the Iranian government went on to announce a total ban. Only those who apply to the government can now import a car, although commentators believe these controls will be lifted when demand becomes too great.

Imported finished vehicles form a small part of Iran's sales. The majority of cars – over 90% – are built in the country as a result of high import duties. Included in those locally produced numbers, however, are cars built from complete knockdown (CKD) kits imported by Renault, PSA and others to avoid paying the duties.

Renault says its sales of kits to build cars like the Tondar 90 (Dacia Logan in other markets) to its Iranian partner Renault Pars amounted to €743m in 2017, up from €513m in 2016. However, in the second half of the year, Renault expects shipments of these kits to be cut to "almost zero", chief financial officer Clotilde Delbos told analysts in the firm's earnings call in August.

That will make a big dent in sales in Iran, as the Renault Tondar 90 and Sandero were the country's seventh and ninth best selling cars respectively in the first quarter of this year.

PSA was planning a similar assault on the Iranian market. In 2016, it signed agreements with the two big state-owned vehicle manufacturers – Peugeot with Khodro and Citroën with Saipa – to build cars in the country. Production of the Peugeot 2008 small SUV had already started, with more models planned. All would have been either kits or have a large percentage of imported parts content.
Such is the size of Iran's vehicle industry that automotive parts topped the list of imports in the first quarter of this year at a value of $779m, a whopping 73% rise on the same period the year before, the *Financial Tribune* reported, quoting statistics released by the Islamic Republic of Iran Customs Administration – accounting for 6.9% of all imports.

Self-contained manufacturing

There is no suggestion, however, that Iran's automotive industry will collapse completely. The country is well used to operating independently of the rest of the world and while Renault and PSA's return to the country grabbed the headlines, the bulk of vehicles sold in Iran are made by local firms with Iranian content. The best-selling car, for example, is the Saipa Tiba/Saina, followed by the Saipa Pride, the latter based on the long discontinued Kia Pride.

The next three best-selling cars, according to the Q1 figures, bear a Peugeot badge – the 206, 405 and Pars. And even Peugeot's exit from the market won't mean these cars are discontinued, as they are made under licence by Iran Khodro, the Iranian automotive firm which along with Saipa controls around 90% of the country's vehicle market. These vehicles are constructed from nearly 100% local content and Peugeot's involvement is simply to claim a licence fee. Peugeot will presumably stop doing that, but the cars will continue to be made. These models were due to be replaced as PSA's investment brought in new ones, but now it's likely they'll continue for as long as the US sanctions hold.

Chinese boost?

When Iran Khodro realised that the sanctions would probably mean it would have to terminate its agreement with Renault's Iranian arm, Renault Pars, to make the Tondar 90, it urged its dealers around the country to push the Dongfeng H30 Cross instead – and the Chinese could be the largest beneficiaries of the US sanctions in Iran, Mohsen Shariatinia, assistant professor of regional studies at Shahid Beheshti University in Tehran, wrote in *Al-Monitor* magazine in August.

"Withdrawals by Western automakers could herald the beginning of engagement between Iranian automakers and their Chinese counterparts in a bid to reduce the impact of the ongoing crisis," he said. "It has the potential of turning Chinese automakers into a key player in the Iranian market."

The Chinese are already making strong inroads into the country, helped by partnerships with Khodro and Saipa to build cars locally from kits. In the first quarter of the year, Chery was the country's fifth best-selling locally produced brand, followed by Brilliance and Dongfeng. JAC was tenth. The Brilliance H330 was the tenth best-selling car, according to the Q1 data from Bestsellingcarsblog.com, and Saipa launched two assembly lines to build Brilliance cars in May 2015. It also makes cars for Changan, and trucks for Foton and Dongfeng, according to its website.

In the 12 months to March this year, the Chinese were responsible for 50% of parts imports into Iran by value, Shariatinia reports. He estimates the Chinese have an 8-10% share of the market and says that's expected to grow.

Two roadblocks remain for the Chinese. The first is public acceptance. "In Iran, Chinese models have quite a bad image. Given a choice, Iranians would prefer European, Japanese or South Korean brands," Michel Jacinto, European and Middle East analyst for IHS Markit, said last year. The lack of imported or CKD brands could, of course, overcome that hurdle.

The second is the question of whether newly globally ambitious Chinese brands are prepared to risk incurring the wrath of the US. The Dongfeng H30 Cross that Iran Khodro is persuading its dealers to push in place of the Renault Tondar is based on the Peugeot 308 platform, Dongfeng said on its website. Dongfeng holds a stake in PSA and builds cars with the French firm in a Chinese joint venture. The Chinese are also constrained by the US sanctions on banking."China's banking system cannot engage in transactions with Iran independent of the global financial system," Shariatinia says.

Whatever the Chinese plans, there is no escaping the damage that US sanctions have done, however. As Shariatinia points out, predictions of 1.6m vehicles being produced in the country in the Iranian year of 1397 (March 2018-March 2019) are now unlikely to be met. "With the reimposition of sanctions, that would be difficult," he confirms.

CKD sector battles infrastructure issues

Iran is a sensitive issue in the automotive sector at present. Approach the major vehicle manufacturers about their activities there and their desire to keep their heads down and say nothing is palpable.

This isn't really surprising, of course, given the cold war Iran is in with many of its neighbours and with the US, driven by the issue of nuclear weapons. Automotive production was central to the Joint Comprehensive Plan of Action (JCPOA) from which the US has recently withdrawn, since an important aspect of the deal was that if Iran ceased its nuclear weapons programme, global vehicle manufacturers would resume their activity in the country.

This was as attractive to the Iranians as it was to the likes of Peugeot-Citroën and Renault, the leading western vehicle manufacturers in Iran, because hunger for cars and trucks in Iran is enormous. The problem is that the Iranian economy is struggling badly and what appears to be growth in the car market is often just volatility.

The market for both cars and trucks in Iran is almost exclusively built around joint ventures with Iranian companies. Various agreements to supply complete knockdown (CKD) kits have been in place since the 1950s, with Peugeot-Citroën long being the leading provider before sanctions damaged trade relations from about 2006. It is these locally assembled vehicles that account for nine out of ten cars sold, given the high tariff that applies to imported finished vehicles.

It is important to emphasise the role of the Iranian companies in this. Rather than simply being marketing organisations, Iranian manufacturers are responsible for the assembly of the vehicle, parts of the design specification, the inbound logistics, in-plant logistics, outbound finished vehicle logistics and aftermarket sales. This is a quite different structure to most CKD operations. The operational role of foreign vehicle manufacturers supplying the kit appears quite marginal.

Industry structure

As with so much in Iran, vehicle manufacturing is dominated by the state through a series of holding companies. The Industrial Development & Renovation Organization (IDRO) controls the two largest vehicle manufacturers – Persia Khodro, also known as Iran Khodro, and Saipa. Each accounts for around 40% of sales in Iran.

The supply chains of both Saipa and Persia Khodro are complex and reasonably developed – certainly more than would be expected in a conventional CKD operation. Both have their own engine plants, with Persia Khodro, in particular, having its own drivetrain design subsidiary whilst Saipa collaborates with Daimler in the production of heavy and light diesel engines. Other components are produced by various subsidiaries of IDRO.

The exception to this Iranian dominance is Renault. It already has a joint venture, Renault Pars, which is 51% owned by Renault and 49% by IDRO. However, in August 2017, Renault signed an agreement with IDRO to establish a new company of which Renault will own 60%, with an assembly plant and new engine plant at Saveh, 100km south-west of Tehran.

There are also privately owned manufacturers, such as Bahman Group, which assembles Mazda-based models at Tehran, whilst Kerman Khodro produces models from Hyundai and Group FAW models at Kerman, in central Iran. These two companies account for around 10% of the market. Their supply chain is more dependent on imported components than those of the IDRO organisation.

Port problems

For all of the local content in Iranian car production, the import of CKDs is fundamental to production and that means the effectiveness of container freight is a key determinant of its economics. This, however, is a problem.

Iran's leading port is Bandar Abbas. Positioned just west of the Straits of Hormuz, it now handles 85% of the non-hydrocarbon exports and imports into Iran. The modern container terminal is that of the Shahid Rajaie Port Complex. It is not capable of taking any vessel larger than 10,000-11,000 TEU, however, with water depth being no more than 14 metres and often less, whilst the gantry cranes are of modest size. Effectively, Shahid Rajaie is dependent on taking feeder vessels from the giant terminals at Dubai. This is quick and easy but highlights the state of Iranian infrastructure.

Talking off the record, sources in the shipping sector admit that for the foreseeable future, there is going to be no other solution. Potential demand from the Iranian economy may be very substantial – not just in terms of consumer goods such as cars but also capital goods for a nascent chemical sector built on huge gas reserves – but Dubai has the economies of scale that a global port can deliver and it it therefore cost-effective for large container shipping lines to call there.

Even if Shahid RajaieTerminal were to invest in new cranes and handling equipment, it would struggle to attract volumes from its huge neighbour. Shipping executives observe that the Dubai terminals "will always be cheaper because it is in the business interest to call there… they have the volumes going in but also the volumes going out. Even if things were to change in Iran economically, it is hard to see this being the case [at Shahid Rajaie]."

Even for the Iranian port to improve its existing business model will be difficult. Users report that the operational profile of the Iranian port can be problematic, with terminal hardware – like cranes and container handling equipment – increasingly struggling with current volumes. It is also behind with some 'port community' issues – some customs processes, for instance.

Many in the container port sector would suggest the solution is straightforward: get a global container terminal company to build a new terminal. This is not as unlikely as it might seem. Western companies such as Maersk may not be in a position to invest and nor is Dubai-based DP World, but the Chinese are very much on the hunt for container port opportunities.

Chabahar model

Iranians are quick to point to India's investment proposal in the port of Chabahar on the Indian Ocean coast as an example of the development of Iran's logistics infrastructure. Delhi is keen to develop its relationship with one of its most important suppliers of energy and the Indians are nervous about China's port developments in Pakistan. They would also like better access to Afghanistan.

Certainly, the plans to build two new container terminals there are highly desirable, though these will be of limited use unless connected to the main population centres around Tehran and western Iran, many hundreds of miles away. There are plans for a new railway to be built, with the Indians supposedly investing $500m in the project, but since its announcement in 2010, little progress appears to have been made.

Landside issues

The issue of the unbuilt railway out of Chabahar points to the problems around transport more generally within Iran.

Although there are numerous plans to build new lines, their realisation is slow. The first steps have been taken to develop an axis from the city of Kermanshah on the border with Iraq to Malayer in central Iran, with the line to Firuzan completed. There are further plans for new lines connecting Hamadan to Sanandaj, Mahabad to Orumiyeh and Shiraz to Bushehr. All these lines serve the population centres in the west of Iran and although Bushehr is on the coast, it is over 300 miles from Bandar Abbas. There is a plan to build a new line from Kerman to Bandar Abbas, but construction has not started.

The poor state of rail freight in the country means that CKD container movements from Bandar Abbas to the various assembly plants are reliant on road, resulting in long, slow journeys to the major production centres. As Erika Welch, partner and director Europe, Middle East, Africa at Tehran-based management consultancy Solidiance, comments: "The road is over 1,500km and takes over 19 hours to travel from Bandar Abbas to Tehran."

There is some good news, however. The Chinese have constructed a rail link into north-eastern Iran, giving rail and possibly road access through central Asia to China. However, the most promising project in the short term is the link to Azerbaijan, via the terminal at Rasht, north-west of Tehran. Turkey, Azerbaijan and Georgia have collaborated to create a road and rail corridor from the good quality Black Sea ports to the edge of the Caspian. An agreement between Azerbaijan and Iran saw an extension of this railway being built between Baku and Rasht. More or less completed by mid-2018, this offers the possibility of a new and efficient link to Tehran and the cities of western Iran, not just from Europe but also from China via Central Asia. Such a link would result in Iran's economic geography being transformed, with the ability to directly move CKDs into Iran from Renault's Dacia facilities in Romania or even FAW's plants in Changchun.

To summarise, Iran's automotive sector has potential but its realisation is severely handicapped by the country's current inability to improve its freight transport infrastructure. Being so dependent on imported material, this is vital for the future of the sector.

The main barrier to improvement appears to be institutional and political inertia. Until this essentially political question is resolved, however, Iran's automotive sector will remain weak – although Chinese construction companies might continue to benefit.

Source: https://automotivelogistics.media/intelligence/dealing-with-a-hammer-blow