

Global autos: will opportunities offset challenges?

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The Global Equities team met with a number of auto original equipment manufacturers (OEMs) and suppliers on the sidelines of the recently-held 87th Geneva Auto Show – with rather mixed impressions from the meetings. While highlighting ample growth opportunities in the electric and autonomous cars space, most traditional OEMs confirm the gravity of challenges facing the space – for example, stricter regulations and new competition from richer technology players. In this environment, preference goes to companies with clear competitive advantages and niche market positioning.



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"The global auto industry is fast shifting gears – undergoing a transformation that will dramatically alter its fundamentals. Like every revolution, there will be winners and losers. The key question is what to look for when identifying the best positioned companies in this fast changing and hugely diverse universe."

The current situation in the auto industry is akin to a maze: there are hurdles and challenges, both obvious and concealed. But if the companies are able to adjust to newer circumstances and position themselves accordingly, there will be growth opportunities that can help offset the challenges and provide reasons for value creation.

Key challenges facing automakers

To begin with, the regulatory environment is undoubtedly hostile. Recent emission cheat scandals involving global auto makers have led to significant political backlash. Of particular regulatory focus is diesel powered cars. Since the Volkswagen crisis in 2015, regulators have been quick in responding. The US Corporate Average Fuel Economy (CAFE) program proposes to set strict standards on CO2 emissions. By 2021, the European Union is focusing on achieving the ambitious target of all new cars to emit only 95g of CO2 per kilometre. China's push away from polluting diesel engines and towards New Electric Vehicles (NEVs) is equally aggressive. As a result, global diesel penetration is already dwindling. For example in Western Europe the diesel mix is likely to fall to c.20% in 2025 from currently c.50%.

To encounter tougher regulations, OEMs are forced to replace diesel plants and upgrade production factories toward "cleaner" technologies. As a result most global OEMs are guiding for higher capex over the coming years. Technology shifts, notably electrification, will almost certainly result substantial impairments – as many investments made in a not so distant era, at a time when combustion engines were supposed to last forever, will never meet initial profitability assumptions. Mentalities and cultures will also have to change rapidly, which is not a given in an industry that tends to be heavily unionised and run by hardware engineers.

New entrants like Tesla are pushing hard on their heels. The success of Tesla in establishing a recognised brand from scratch literally shocked traditional players. On top of software prowess and deep pockets, technology players have also the advantage of starting with a blank sheet without preconceived designs or legacy assets.

Inventory build-up and slowing auto sales is another concern for automakers. While average prices have increased, mainly due to shift towards SUVs, sales have been supported by deep discounts. On top of generating inferior profitability, the model has proven unsustainable – confirmed by latest global sales decline. A slowing market presents the additional threat of weakening the leasing side of the businesses. As the global interest rate cycle turns, and electric cars seriously start competing with combustion based models, the residual value of is at risk of plummeting. Faced with these challenges, many OEMs with large leasing exposures look rather unprepared.



Technological disruption is transforming the current landscape

Electric Vehicles (EVs) are an integral piece in the current disruption. Tesla has already proven to the World that it is possible to have cleaner cars, while preserving all the attractive features of a premium car – including exterior designs. On the demand side, incentive programs have prompted higher adoption in key markets such as China. As volumes grow, prices will fall and networks will improve, further accelerating adoption.

While the momentum for greater EVs penetration intensifies, a related growth opportunity, more for auto suppliers, lies in the diffusion of greater electronic content per vehicle. Auto electronics is perhaps the fastest growing segment at this time. It is expected to deliver a striking c.15% CAGR between 2016 and 2020. This is everything from infotainment – such as HD in-dash displays, lighting, emergency and driver assistance systems – to the internet of things and the replacement of mechanical systems by electronic alternatives.

Another integral piece in the story is self-driving or autonomous cars. Being highly connected, these cars will not only be able to communicate with other vehicles (V2V), but also with external infrastructure (V2X). Non-stop delivery of real-time data is a crucial prerequisite. This is leading to new related markets, such as car apps allowing customers to connect cars to homes and offices. Self-driving cars will clearly benefit from improved connectivity and data availability and global information technology companies (ITC) have an inherent superiority in these areas. Unsurprisingly, as Google helps streamline its Google Car, Apple reportedly recruited 600 new staff from the auto industry to develop its in-house 'Apple Car'. Samsung is also teaming up with Audi and LG with GM – while Microsoft and Toyota are co-developing a smart car.

From car ownership to car sharing

With the disruptive tech revolution underway in the auto industry, important changes in consumer behaviour are to be expected. Many autonomous cars of tomorrow will probably become mere transfer platforms shared via common mobility platforms, such as Uber. In addition, given expected short life cycle (frequent tech upgradation), customers are likely to convert from being owners to users. Apart for the cost advantage, this will allow greater flexibility for customers to use a vehicle for a specific purpose. Shared mobility is already an observable trend in large cities with limited parking spaces and expensive congestion charges. In the US, for example, the percentage of young people (age 16 – 24) that hold a driving license has dropped from 76% in 2013 to 71% currently.

Ample opportunities but also massive risks for investors

It is tempting to buy shares of OEMs due to the very low valuation metrics, but the car cycle and other industry challenges merit caution. At the other side of the spectrum, the story behind new entrants is enticing, but valuations are often egregious.

A solution is to stick with companies offering a strong competitive advantage. In the OEM space, Subaru's niche market positioning and unparalleled quality for price could be an option. Even more specific is the situation of Ferrari, as brand strength and the shrewd strategy of undersupplying demand generates pricing power no other car manufacturer can even dream of. Special situations can also arise from internal restructuring and M&A, as in the case of Peugeot – or from expanding line-ups and favourable geographical exposures, as in the case of Geely.

Another option is offered by auto parts suppliers. Companies like Plastic Omnium, Valeo and Nexteer Automotive sell products to a wide array of OEMs, minimising the risk of picking the wrong OEM. These companies are also riding the wave of lighter, cleaner and safer vehicles.

Lastly, the discussion would be incomplete without facing the difficult question of Tesla, and what to do with a young deeply loss-making company that sells only a few hundred thousand vehicles, will face a wrath of competition over the coming years, but already has a larger market capitalisation than Ford or GM? The apparently absurd valuation multiples obviously do not tell the whole story, as Tesla must be valued on its disruptive potential. Its head start means the company will remain the undisputed leader in EVs for at least another three years, and its model 3 has the potential of being a high volume car. The quality of its product and its Silicon Valley appeal created a powerful brand from scratch, and the lack of legacy assets and mentalities is proving to be an advantage. Icing on the cake: Tesla offers substantial potential if it succeeds in becoming a battery powerhouse. The risk is high, but so are the potential rewards, thus the investment is more reasonable than many think.



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