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INSIGHT

European Auto Manufacturers – Value Stocks or Value Traps?

By Morten Springborg, Global Thematic Specialist, C WorldWide Asset Management.

The European auto industry has for several years seen significant secular headwinds from a technology change that will also challenge the business models of the auto industry in the next decade. From an investment perspective, this has kept us on the sidelines. We continue to see significant technology threats, but now also a cyclical risk as the business cycle is maturing as well as very tough CO2 regulations taking effect from 2020.

Some years ago we argued that because of the very high investments required to 1) master the transition from internal combustion engine technology to electric drivetrains combined with 2) the parallel drive towards more autonomous technologies and 3) the eventual development of mobility as an app challenging the existing business models, the auto industry was un-investable for the long-term investor. The reason being that there was no visibility on future margins and the returns from these huge investments. Also, at the time it was becoming clearer that the German premium brands, who used to be technology leaders, were now laggards, and that they simply "didn't get it", because they could not see a path to profitability in electric, autonomous mobility, and therefore didn't allocate sufficient capital to these projects. It resembled a similar situation with Kodak a few decades earlier.

Cyclical slowdown at a time of large ramp up in investments

Things have certainly changed since then. All the major original equipment manufacturer (OEMs) have now – if not credible – at least sizable electrification plans and are investing heavily into autonomous technologies and developing mobility platforms for the future. Valuations were low in 2016, but P/E multiples have since fallen even further, and today auto stocks are optically amongst the cheapest companies in the world measured by P/E. So where do we stand today – with a sector trading on low valuations and a clearer picture of strategic action needed if the industry is to survive over the mid- to longer-term?

While in 2016, the sector had cyclical support from rising demand across all major regions, today volumes are flat to falling as we have passed the cyclical peak in Western markets, and China is no longer a growth engine. On top of this, the industry could turn out to be at the epicenter of the rising trade tensions between the US and EU, and might face tariffs on exports to the US, if no comprehensive trade agreement is reached between the US and EU. These are some of the cyclical risks today.

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However, more importantly the longer-term cash flow trajectory of the sector continues to be highly uncertain. In contrast to 2016, the industry now probably "gets it" and is investing heavily to stay relevant also over the next 10 year period. VW is probably the most aggressive of the established car makers in electric vehicles with its dedicated MEB platform, investing €30bn (~40% of market cap) over the next 5 years to turn EVs into a commercial success. While we think it makes sense for the European auto manufactures to invest in a localized supply of battery cells, the global battery cell market is still largely controlled by 4-5 Asian players from Korea, China and Japan. Not only are barriers to entry high, the industry is also highly capital intensive, with limited margin potential over the next several years. It should take start-ups at least 4-5 years to set-up production, and there is a lack of expertise in the region. Therefore, cost structures are unlikely to be on a par with Asian suppliers, and we therefore continue to be very skeptical as to the longer-term profitability of electric vehicles produced by the European auto manufacturers.

CO2 compliance a very significant headwind

As the industry ramps up investments another underestimated earnings headwind for OEMs in Europe for the next 2-3 years is emerging, namely CO2 compliance. Strict new carbon dioxide emissions targets will be phased-in next year across the EU, with the threat of punitive fines of 95€ per gram of CO2 that exceeds the target for those who fail to comply.

Yet emissions are heading the wrong way. Emissions from new cars are rising as consumers shun diesel cars and opt for gasoline cars, while at the same time shift towards larger SUV's with higher emission levels.

While we would probably argue that the longer-term issues around profitability of a new electric mobility model is the biggest challenge for the auto industry, the brokerage firm Evercore ISI recently described the CO2 challenge as the "biggest structural headwind" facing the sector – even more potentially damaging than trade wars with China, US tariffs, diesel bans and Brexit. It estimates the cost of compliance for the industry at more than 15 bn Euro. For some car makers the hit to profits will be very material; to comply PSA (Peugeot), which is furthest behind, faces a 25% hit to earnings per share in 2021 according to Evercore ISI.

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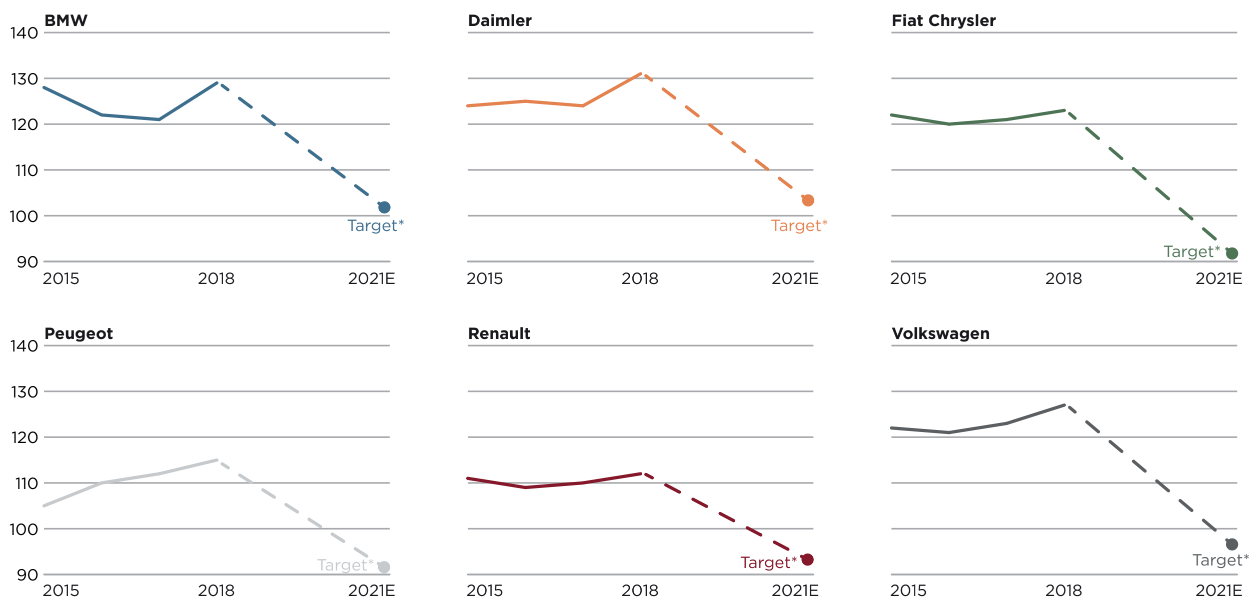
Not all car manufactures face a CO2 compliance crisis; Toyota, who for years has focused on hybrid engines, expects that 60% of cars sold in Europe by 2021 will contain the technology, and therefore will be more or less aligned with the targets. This shows why electrification is now an absolute necessity for all car manufacturers selling in Europe. Either you comply or you pay heavy fines and on top, risk damage to your brand. Thus, companies must invest in technologies, where costs will be much higher initially and margins therefore lower or probably negative.

Figure 1

Long way to closing the emissions gap – grams of CO2 per km.



Source: Financial Times as of Apr. 2019
*2021 target of 95g per km on average. Producers of bigger vehicles have less stringent targets.

Fiat Chrysler has somewhat innovatively bought a temporary remission of its emissions sins by forming an "open pool" with Tesla, agreeing to pay the electric pioneer hundreds of millions of euros for its zero-emissions cars to be counted together with Fiat Chrysler's fleet. But paying fines or paying for others credits instead of investing in emission reducing technologies is a poor long-term investment. It becomes even tougher after 2021, and by 2030, the EU is targeting a further 37.5% emission reduction.

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Conclusion

The secular headwinds facing the auto industry continue to remain strong while valuations of the companies are at very low levels. Facing a difficult future, the industry is reacting by announcing cooperation, consolidation as well as spin-offs in order to crystallize value. Fierce competitors like BMW and Daimler are now joining forces in automobility platforms, and Fiat and Renault are openly discussing a merger to create larger scale to amortize the ever-growing investment needs. The auto industry is undergoing huge transformation, and we continue to prefer to observe it from the sidelines as a repricing of the current low valuation is not likely in the foreseeable future. One of the few related bright spots is that electronic content in cars will increase significantly as the transition to EV matures. This also opens up the way for new component suppliers, which will be an important area of growth for companies with the right products in semiconductor technology and autonomous software, areas where we have limited exposure today, because of cyclical risks. Nevertheless, this is an area we find structurally interesting.

C WORLDWIDE ASSET MANAGEMENT FONDSMAEGLERSELSKAB A/S

Dampfaergevej 26 · DK-2100 Copenhagen

Tel: +45 35 46 35 00 · Fax: +45 35 46 36 00 · VAT 78 42 05 10 · cworldwide.com