Brent Sheather's RESEARCH

Private Asset Management Ltd

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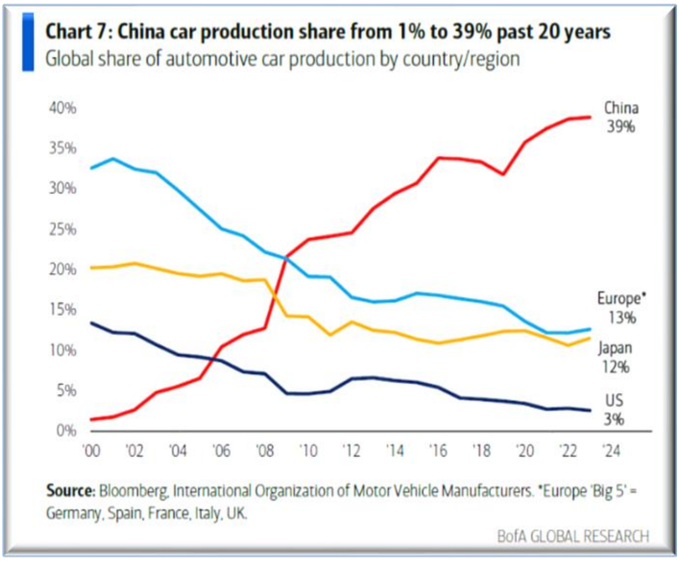
Brent Sheather is a Financial Advice Provider and a personal finance and investments writer.

CAR STUFF : PART 1 - CARMAGEDDON

Despite travelling big distances in the 60's and 70's with Mum and Dad in a Morris 1100, cars and the automobile industry have always been of interest. Possibly as a result of the torture of regularly driving the winding roads either side of Waihi and suffering the humiliation of a failed attempt to overtake, in that icon of British automotive excellence, a Rambler Rebel, when funds permitted, I went the luxury European way. That loss making exercise ended upon realising the extent to which they fell in value post-purchase, their reliability issues and the ongoing service costs. Given their premium pricing I naively thought car makers like Audi, BMW and Porsche must inevitably be good investments. Fortunately though exposure to the sector was confined to owning the cars rather than the equity and, whilst the hit taken on the cars is not trivial - (think new Audi All Road, cost $110k in 2004, sold for $500 in 2016) - things would have been worse if car companies had been included in the share portfolio.

With that uninspiring background we will today we will kick off a massive four-part series on the world's car industry. Part 1 will focus on the threats currently facing the incumbents like Stellantis, Volkswagen, Toyota, and General Motors. In Part 2 we will review a paper, "Big Market Delusions – The Case of Electric Vehicle Stocks", published in the Journal of Investing back in 2023. In Parts 3 and 4 we will look at the long-term financial history of the US car manufacturers noting their high operating leverage and volatile financial fortunes and observe that some of the themes that dominated the industry back in Henry Ford's time still resonate today.

The western automobile industry, particularly that in Europe, is in big trouble – things are bad and, without further substantial tariff protections or an invasion of Taiwan, likely to get worse. As the graph below illustrates since the start of the new millennium Europe's share of global car production has fallen from about 35% to 13% today.



There are three big factors impacting the car industry today: low cost Chinese manufacturers, access to the Chinese car market and the current poor outlook for EV sales in just about every country except China, where western manufacturers aren't cost competitive. The first two factors are long term issues which look very difficult to resolve, whilst there is some hope for increased demand for

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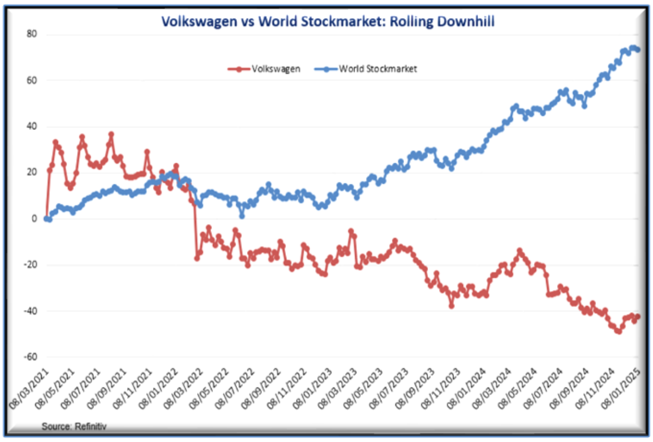
electric vehicles if range anxiety can be addressed through improved technologies.

As with so many industries today geopolitics dominate - China represents about 30% of the global car market and the prospect of capturing a decent slice of that market is the reason so many western car companies, like VW, Mercedes and GM shared their technology and invested billions in local production facilities. Today that "vision" looks like wishful thinking at best. China has for some years targeted EVs as an industry it wished to dominate but a turning point for the fortunes of foreign car manufacturers in China may have occurred a couple of years back when, unofficially, as part of the ongoing anti-corruption campaigns, it was suggested that one red flag for identifying individuals who might not have the party's interest front and centre was if they drove a luxury western vehicle. Obvious really.

With President Biden raising tariffs on Chinese electric vehicles to 100% in 2024 and a future President Trump likely to move the dial even further, not to mention the cost advantage of local alternatives it's no surprise that Chinese consumers are giving western autos' a frosty reception. The latest statistics certainly support this view - a recent post on X cited sales of the Mercedes EQE model in China as nosediving from 921 cars in January of 2024 to zero in October. A recent story in the London Financial Times, citing research by UBS and HSBC stated that the market share of foreign-branded cars fell to 37% in 2024 – a sharp decline from 64% in 2020. Electric vehicle sales in China are poised to overtake those powered by traditional engines in 2025 with Wood MacKenzie forecasting ICE vehicle sales falling from about 10 million in 2024 to just 2.5 million in 2034. The FT concludes that if these forecasts are correct that all those factories set up in China by western auto makers with traditional engines "will have almost no domestic market to serve".

Recent news from GM as regards its Chinese misadventures tell the story of western car manufacturers experience in China. Bloomberg columnist David Fickling describes GM's China business as "a dead man walking". He elaborated as follows: "The company announced Wednesday it was going to write off USD$5.6 billion of the value of its business. That is sufficient to wipe out 88% of the value of GM's joint ventures in China". Similarly Porsche has warned of a write-down in its Volkswagen stake of up to €20 billion – much of it due to China-related disasters.



Besides the risk of being "disappeared" buying a new Merc or VW doesn't appeal because western cars cost a lot more than locally produced competitors. The extent of the cost advantage enjoyed by Chinese EV manufacturers was highlighted in a recent article by Ed Conway, economics editor at Sky News, using data from UBS. His report suggests that the production costs of the Chinese (BYD) equivalent of a VW ID3 was cheaper in every important area including batteries (by 29%) and body, chassis and wheels (35%). The Financial Times cites a report by Bernstein which estimates that "BYD's cost of production for EV's was 50% lower than that of European rivals thanks to economies of scale, vertical integration and robust local supply chains". Whilst China's cost advantage is an important factor its impact on the US incumbents has been blunted to a degree by tariffs and the relatively slow uptake of electric vehicles by American motorists. European manufacturers, however have felt the full brunt of the factors cited earlier: there is little in the way of tariff protection and German car manufacturers, encouraged by successive German governments, have hitched their fortunes to

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China far more aggressively than those in the USA. Reflecting the dire outlook production numbers and profitability at European car makers have taken a sharp downturn in recent years. Stellantis, for example, recently reported that car production in Italy, where it has five manufacturing units, fell by 46% in 2024 – the lowest level of output since 1956. In the third quarter profits at the major German manufacturers, Audi, BMW, Mercedes and VW fell by 91%, 79%, 54% and 64% respectively.

How did it go so wrong for European car manufacturers? In a recent paper, How Europe Crashed It's Car Industry, Professor Helen Thompson of Cambridge University makes the point that European governments' net zero policies required the automobile industry to be making EVs at scale. However because Chinese cars are cheaper and technologically superior, due to financial support from the Chinese government for EV firms and all parts of the supply chain from metal mining and processing to battery production, European manufacturers cannot compete, leaving the European market wide open to companies like BYD. No surprise that the EU is China's largest export market. In comparison European political efforts were financially paltry (eg average tariffs on Chinese EVs of 26%) and segmented, leaving its manufacturers dependant on Chinese dominated supply chains. In the paper she goes on to explain that any move by European governments to impose increased tariffs would risk retaliatory action by the Chinese leaving companies like VW, Stellantis etc between a rock and a hard place. That precarious situation was highlighted recently when the Financial Times quoted that *the frontrunner to become Germany's chancellor has warned companies about the "great risk" of investing in China, saying the state under his leadership would not help them if such bets failed. Friedrich Merz, whose Christian Democratic party is leading in the polls ahead of elections next month, described China on Thursday as part of an "axis of autocracies" that did not abide by "western rule of law standards".*

That is enough for this week. In two weeks' time we will take a look at Rob Arnott's Big Market Delusions.

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.

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