Creating financial value with new mobility

What are investors looking for post Covid-19?
Q&A with Laura Lembke, Executive Director
Automotive Investment Banking, Morgan Stanley

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Introduction

Stock markets are surprisingly bullish. There appears to be a disconnect between the darkening economic outlook and investor behaviour. ***Autovista Group Chief Economist Dr Christof Engelskirchen*** *asks* ***Laura Lembke, Executive Director at Morgan Stanley*** *why, and explores what automotive industry investors are looking for post Covid-19.*

Christof Engelskirchen, Autovista Group

Laura Lembke, Morgan Stanley

Christof: Stock markets seem to be behaving irrationally. Why are there phases of recovery when economic forecasts are getting darker by the week?

Laura: The stock market is highly dynamic and typically much more sensitive in its appreciation of big events such as a global health crisis than economic indicators or forecasts. We have seen the fastest sell-off in global equities on record. The sell-down was triggered initially by macro and quant funds following the Covid-19 spread into Europe in late February, followed by others on the back of the shut-down of the global economy and company guidance suspensions across industries for FY 2020.

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Laura Lembke was scheduled to speak at Auto Mobility LIVE 2020. While we are unable to bring you the face-to-face event, Autovista is still committed to bringing you the same great insight from our speakers. To stay up-to-date with all of Autovista's speaker insights and plans for future events, register at: www.automobilitylive.com.

Christof: What happened after this initial drop in stock prices?

Laura: We then quickly entered a phase where investors saw depressed stock prices as a major opportunity because some of the movements had clearly been exaggerated.

So, the sell-off was instantly succeeded by the steepest recovery in global equities in decades, further driven by the enormous fiscal stimulus packages across G-10 countries and Central Banks, which exceeded investors' expectations. As a result, we have seen sharp valuation re-rating of equities across sectors, as investors are already looking ahead to 2021 and budgeting for a 'V-shaped' recovery.

It will be interesting to see upcoming H1 results as the next inflection point for investors to reconsider valuation levels.

We are now in the final years where the internal combustion engine can support companies in generating cash prior to the full transition to EVs

Christof: At this point in time, the automotive industry is burning a lot of cash. Will we see less focus on capital-intensive initiatives, e.g. those related to autonomous driving, battery electric, the connected car?

Laura: There are of course implications for the investment budgets across OEMs, suppliers, and all other industry participants. The ability to generate free cash flow is more crucial than ever before, because we are now in the final years where the internal combustion engine (ICE) can support companies in generating cash prior to the full transition to EVs, also to fund longer term topics such as autonomous driving and vehicle software operating systems. This is a very costly exercise and the liquidity that had been earmarked for these future investments is simply not available.

I believe we will see a more muted approach to autonomous driving for the time being, which had already lost some momentum anyway given the delayed adoption timeline. For electric vehicles, we actually may see the opposite development. Many OEMs have invested significantly into electric powertrain technologies and are now at a point of no return.

Christof: Before the coronavirus, OEMs were focusing all their attention on becoming tech companies and starting to build up competencies in software development to compete with the likes of Tesla and Google for in-car-technology. Will this change?

Laura: Ultimately, it will come down to the strength of the balance sheet. If you have the financial means to carry out many of the required developments and therefore keep control of critical IP in-house, you may have a higher propensity to try to do that. But it is a very complex and expensive task to accomplish in a field where OEMs are coming from behind. It is not just about hiring software engineers, but also making the associated cultural change as an organisation.

Some OEMs have clear ambitions in this area, e.g. the well capitalised German premium players and most of them will likely continue down this path. But those OEMs that have not invested into these capabilities prior to Covid-19 will unlikely be able to catch up and rather adopt existing solutions from third parties. We may also see more collaboration between carmakers, tech companies and suppliers to come up with a vehicle operating system –

similar to Microsoft OS for computers – which could be brand-agnostic.

Christof: What will investors be looking for during and after the crisis, i.e. what financial KPIs will be particularly closely observed and will show us who managed the crisis better?

Laura: At the moment, the focus clearly lies on liquidity related KPIs. Investors look at how much cash flow a business generates or burns, and how long it can sustain itself in the current situation. We have seen, especially in the US, that companies have been very proactive in trying to secure additional liquidity, through additional debt issuance or raising capital. European companies have relied more on their traditional lending banks, but we are starting to see more activity on the equity side as well now to reduce financial leverage.

When it comes to longer-term investment decisions, top-line growth and free cash flow remain the metrics of choice as they are not impacted by accounting measures.

Christof: There has been a lot of talk about stress on supply chains and a potential need to become more local. Are there new aspects that investors are looking for when they assess an automotive company, post-Covid-19?

Laura: The auto industry features among the most complex supply-chain setups globally. Organised in a tiered structure, a problem in a tiny part of the supply chain can hence have substantial repercussions on the ability to produce the product.

Supply-chain management is already a core capability for OEMs and their procurement departments, however. During this crisis, many companies have set up specific task forces to monitor and re-assess how the supply chain is working and where potential bottlenecks could lie.

Investors follow general news related to the supply chain, and production, but there are no explicit KPIs for this area. From an investor perspective, it is difficult to assess supply-chain performance systematically.

The shift to electric vehicles may be helpful in reducing supply-chain complexity as the number of parts in EVs is around 30% lower than for traditional cars.

Standardisation is a double-edge sword. It gives you economies of scale but may increase your exposure

OEMs will continue on their path to reduce complexity, all the way from model portfolio to specifications, for example by reducing the number of available options or variants of the same component. My favourite example is the VW Golf: Did you know that until a few years ago you had a choice of 117 steering wheels? They cut that to 43, but it's still a lot. However, standardisation is a double-edged sword. It gives you economies of scale, but it may also increase your exposure, as you have to rely on a smaller set of suppliers. Finding a balance is crucial, especially for the very high-volume components that run across multiple vehicles on a platform.

There are some new perspectives required when trying to put a value to initiatives that are not yet paying off, for example when attributing value to start-ups or operations in autonomous driving or shared mobility. A relevant metric relates to how many miles vehicles have driven autonomously, or the number of software engineers. But it is more complex than that. For example, the valuation of Tesla is not just related to car sales growth, but also reflects the disruptive nature of the company with no legacy ICE activities, optionality of the business model and data they are collecting. These days, companies are putting more attention on finding ways to commercialise that data.

Christof: Do you believe that consumers will purchase a car differently after the crisis? What is the role of car dealers going forward?

Laura: Most OEMs had already embraced the need to develop the digital channel prior to Covid-19, including selling directly to consumers. There are also new ownership concepts, such as all-inclusive "subscription models", which are gaining in popularity. It is a known challenge that OEMs know so little about their individual customers, so OEMs have to rethink how they leverage traditional dealers, and what kind of distribution channels and network they really need.

The traditional car-dealer model has been under pressure for many years. The dealer of the future may for example manage and maintain vehicle fleets.

In turn, we will probably see a shift towards brand experience stores in prime city locations, where customers can interact with the brand as you would in an Apple store. There are a whole range of options, but the role of the dealer will certainly change.

Christof: Are there new mobility trends that will emerge more strongly?

Laura: Near-term Covid-19 has a negative impact on shared mobility; in fact, 80% of people prefer to use their own cars over public transport or ride-hailing. Walking or using a bicycle has seen a real renaissance. People simply do not feel comfortable in crowded and confined spaces at this point.

Christof: But people will forget about this and we will be back to normal soon?

Laura: Yes, there will be safety adjustments and people may become less sensitive over time. Longer term, we still believe in higher penetration of shared mobility, especially for the younger generations that do not consider ownership of a car as something equally important as it had been for previous generations.

Many companies have fallen back into the pattern of simply focusing on growth and market share, a rather old-fashioned approach

Christof: There has been a lot of activity around M&A in the automotive industry. Will this crisis speed up consolidation? Will we see brands leaving the arena?

Laura: We have had a tremendously favourable automotive cycle since 2010 – an unprecedented period of profitable growth – especially thanks to the emergence of China. As a result, many companies have fallen back into the pattern of simply focusing on growth and market share, a rather old-fashioned approach.

Interestingly, the most profitable car company in the world is Ferrari, which sells below 10,000 cars per year. In contrast, the big OEMs have explored opportunities in too many markets and segments, trying to do it all. And now many are withdrawing because often these activities have been bad decisions from a capital allocation perspective. On top, this has led to a gradual build-up of production overcapacity in recent years, and the volume shortfall due to Covid-19 will only aggravate this problem. So yes, in my view all of the challenges we talked about will accelerate the need for industry consolidation.

But I do not think that individual brands will disappear. They hardly ever do, because regardless of how unsuccessful they are, a brand typically has some value associated with it. So usually you find somebody who believes they can revitalise that brand.

Over the past two to three years we have seen a real increase in transaction activity, classic consolidation and portfolio reshuffling on the supplier side in particular, but also among OEMs.

The mergers of PSA-FCA and previous acquisition of Opel by PSA, or merger of Geely and Volvo Cars are good examples. But we will also continue to see forging or alliances in specific areas, which can sometimes be the first step towards a capital tie-up, merger or acquisition. The truth is that some companies will simply not be able to survive this radical industry transition on a standalone basis. Covid-19 is not a root cause for this, but this crisis may speed up the need to find a long-term solution.

All of the challenges we talked about will accelerate the need for industry consolidation

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