

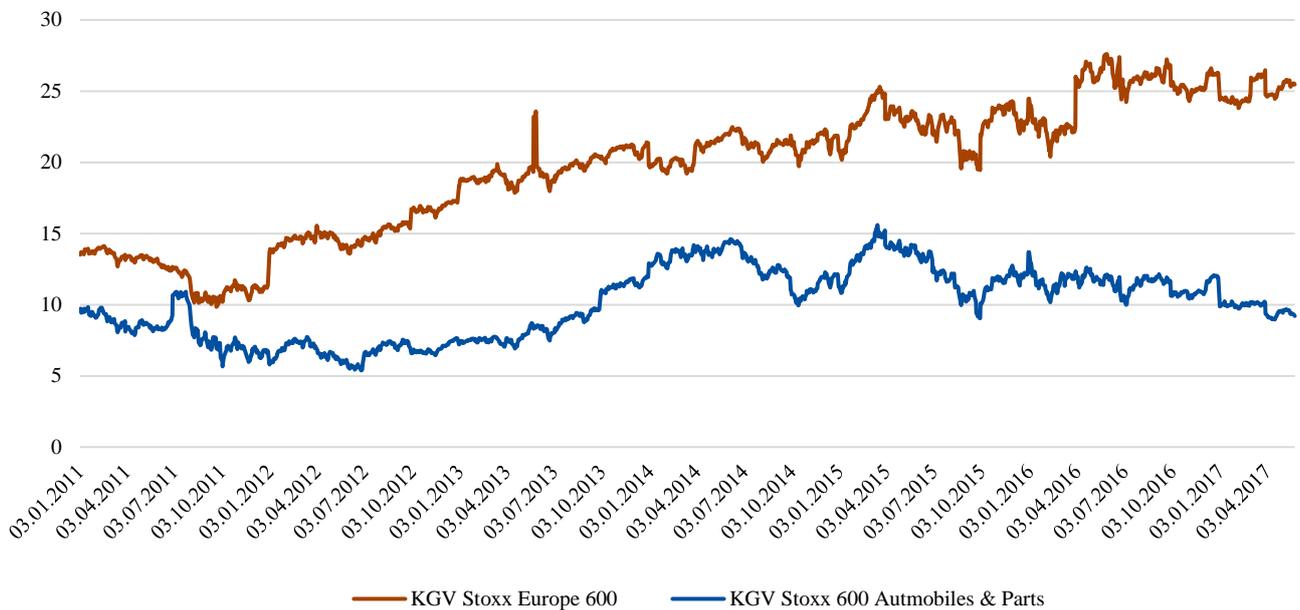
Gutmann Investment Mail – June 2017

Mobility in flux – opportunities and risks for investors in the car industry

Hardly any other sector of the European stock market is currently priced as attractively as the car industry. At the same time, hardly any other industry is undergoing a more profound transformation and facing such an uncertain future. The trends that are driving the industry go far beyond matters such as diesel, electro-mobility and autonomous driving. We look at the key issues as well as at opportunities and risks for investors.

A look at the valuations of European car makers and parts suppliers shows that these companies are traded at significant discounts to the broader stock market. In contrast to what one might assume, valuations have been low not only since the Volkswagen diesel scandal, but for a considerably longer period of time. Daimler and BMW shares, for example, currently trade at a price-earnings ratio of less than ten. Other companies in this industry are valued at similar multiples, as a result of which the Stoxx Europe 600 Automobiles & Parts Index is traded at a substantial discount to the broad-based Stoxx Europe 600 (see chart below).

Fig. 1: PER-based valuation of Stoxx Europe 600 Automobiles & Parts Index versus Stoxx Europe 600 Index



KGV = PER

Source: Bloomberg, Gutmann KAG

Why are valuations so low?

The issues that are discussed most widely at present are the cars' propulsion systems and the fuels used. The debate centres mostly on the benefits and drawbacks of electric engines versus internal combustion engines and on whether, looking forward, cars are going to be powered by fossil fuels or electric energy. These questions are of keen interest to the car industry given their impact on the future of current products and current investment in research and development, but represent only part of current challenges.

If electric cars were indeed to find wide acceptance, the incumbent car makers will have to develop new products and retrofit their production plants for this technology, which would mean substantial investment expenditure. Even now, Daimler spends between five and six percent of revenues on research and development. If car makers want to join the bandwagon even more quickly, their research and development spending is not going to decline. This, however, will weigh on profitability. The pressure to add more electric cars to their product portfolios is coming both from competitors and from stricter emission standards, which internal combustion engines at some point will be able to meet only at extremely high cost. With its Model S car, industry pioneer Tesla has moreover shown already that consumer demand for electric cars does exist.

In addition to the debate on the change in power systems, the car industry is confronted with even more fundamental questions, though.

What might the product 'mobility' look like in the future?

What is going to happen with the car industry if the actual product, i.e. the vehicle itself, is put into question? Or, in more concrete terms: ten years from now, will consumers still buy cars to own them or will they just be looking for a transport service to take them from A to B?

In order to be able to answer this question, one has to examine a number of technological and sociological trends that may have the potential of bringing lasting change to the car industry's business model.

The most powerful trends that are unsettling not only the car industry are smart phone usage and the ubiquitous availability of internet connectivity, which already offers consumers direct access to car sharing vehicles and ride-sharing services like Uber. In addition, it is expected that in the future consumers will be able to choose from whole fleets of self-driving cars. This will also greatly facilitate multi-modal transport. Quick access to traffic information and timetables will enable consumers to identify for each journey the most effective mix of transport modes in terms of cost and time.

Shared mobility as a direct consequence of the availability of better information has already become quite common. Companies such as Airbnb, Uber and Lyft have already demonstrated quite successfully how idle resources can be utilised more effectively through an improved exchange of information. This results in significant cost savings and, ultimately, less expensive products.

A number of car makers identified this trend at a very early stage and swiftly occupied some niches themselves. Car sharing products such as Car2Go from Daimler and Europcar or DriveNow from BMW and Sixt are already well-established in many cities world-wide. This modern type of car sharing has only been made possible by smart phone apps that find and book vacant vehicles.

Car sharing services may potentially reduce the cost of mobility significantly. According to a study by Morgan Stanley, cars in the US are used on average only about one hour per day. Shared use can increase this ratio significantly and spread out the fixed costs of a car. Consequently, the cost per mile driven goes down.

As a long-term side-effect of this development, the motivation to own a car declines, which erodes the car makers' core business.

Less tangible for the time being, but with potentially even more substantial impacts, is the progress in the development of self-driving cars. Fully autonomous vehicles are going to change individual mobility massively as they will cancel out the key advantage of having a car of one's own, namely prompt availability. The user can request a car at any time, which will be at the right place at the right time. In addition, cars can be adjusted flexibly to meet actual needs: a big car for a longer journey with a lot of luggage or a small car for short intra-urban trips.

In view of these scenarios, the question regarding the power system used loses some of its relevance. Based on the assumption that in the future users will not buy a car as such but a transport service, the power system used will be of lesser concern to them. The mobility provider operating a fleet of different cars will simply provide the car most suitable for the intended purpose: an electric car with a small battery for short rides, a hydrogen fuel cell or a petrol car for longer journeys. This permits the most effective use of the advantages of each power system and consumers can pick the vehicle that best meets their needs from a whole fleet of cars.

What does this change mean for the car industry?

In view of these trends, the car makers dominating the market today are up against a wide range of challenges. The changeover to new power systems renders investments made in the past that may have offered competitive advantages more or less worthless. Electric and hydrogen fuel cell cars need neither a complex gear box nor sophisticated treatment of emissions.

Furthermore, the technical design of electric cars is less complex compared with cars that are powered by internal combustion engines. On the other hand, the importance of electronic components and, most notably, software increases. This reduces the entry barriers for newcomers to the car industry, particularly for high-tech companies.

The changes affecting the industry will result in major upheavals. Car makers shying away from the high cost of investing in new technologies run the risk of disappearing from the market. Those that invest in new technologies initially have to accept lower profitability as research and development expenses will rise and the future path of technological change is uncertain. Also, during a transition phase, production plants may not run at full capacity, which means that economies of scale cannot be fully exploited.

Consequences for investors

Even though many of the scenarios outlined may still sound like things of the distant future, they are already of relevance today. In the car industry, product cycles span many years. Decisions about the development of products and business models taken today have to cover a time horizon stretching at least up to 2025.

Moreover, new players are entering the mobility market. Technology giants such as Google and Apple are developing new IT-based platforms for cars. Start-ups like Uber and Tesla, which did not even exist a couple of years ago, are already dominating global markets.

On the other hand, trends should not be overestimated either. Internal combustion engines are unlikely to disappear from the market from one day to the next and fleets of autonomous vehicles are not going to conquer the market in one big bang. Urban and rural mobility will develop along different lines.

The low valuations of car shares show, however, that the market has recognised the uncertainties facing the industry and is pricing them in.

In making our investments, we duly bear in mind the hype cycle, which says that we tend to overestimate the effect of a technology in the short run and underestimate the effect in the long run. We therefore do not act on short-term hypes but review our investments to determine whether they will withstand the technological change described above in the long run. We believe that based on a differentiated analysis of individual firms one may well benefit from the currently low valuations.

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June 2017