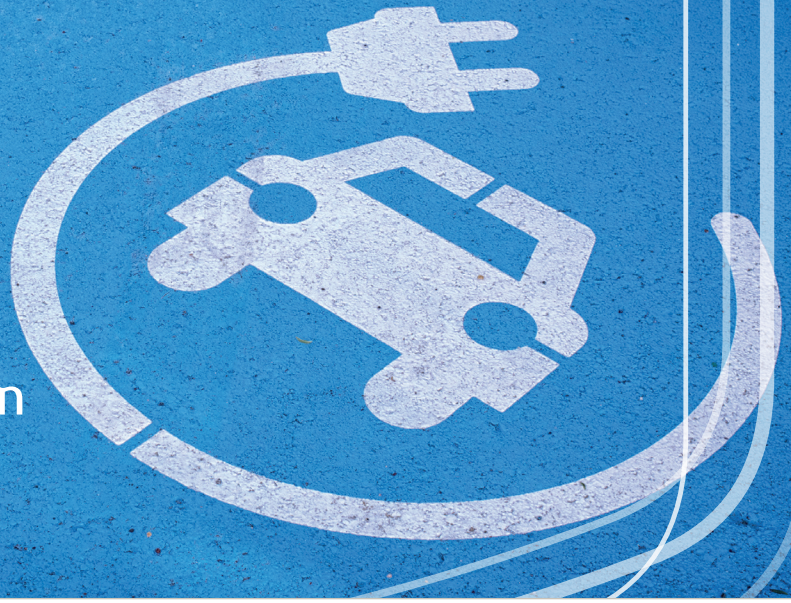




Electric vehicles: Death of the auto industry or an investment opportunity?



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Since the auto industry's inception over a century ago, it has never faced a balancing act as great as it does today.

The challenge facing manufacturers over the next decade is how to redefine their market positioning and create end-products that meet modern consumers' needs and comply with environmental regulations, while managing huge legacy cost bases.

As electric vehicles (EV) develop to become 'smart phones on wheels', we predict manufacturers' competitive edge will be in the car's 'app store' and the driver experience – not what's under the bonnet.

We believe there are two paths manufacturers can take. They either:

- partner with a new tech entrant, such as Apple or Google, and provide a manufacturing platform,
or
- transition into technology-based companies themselves.

If manufacturers choose the latter, they will have to implement massive cultural and organisational shifts within their current set-ups and work out how they can compete for software talent with existing technology companies. We are already seeing this happen in China, where consumers prefer local EV brands, not only because of their price tag but because of the better overall experience in the car.

Another issue that manufacturers have to deal with is the residual value of petrol and diesel vehicles on their balance sheets. Currently, European manufacturers have around EUR150 billion on their balance sheets as a result of 'sale and repurchase' schemes that are widely used across the industry. This value is based on secondhand resale values of vehicles once their contracts come to an end, normally after three years.

Due to the supply and demand issues caused by the pandemic, the value of secondhand vehicles rose over the last 12 months. But as conditions normalise and the introduction of EVs accelerates, we anticipate reduced demand for petrol and diesel vehicles in the secondhand market and prices to fall. This could cause manufacturers to take write-downs on their balance sheets, potentially causing credit agencies to downgrade their ratings.

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The issues around the residual values of petrol and diesel-powered vehicles are well flagged, but the valuation of electric vehicles in the secondhand market is more nuanced. EV battery technology is progressing rapidly and today's state-of-the-art EVs could become outdated very quickly and command only low prices in a few years time. This is a problem we've seen manifest in other industries too. Consider the iPhone 6, which was launched in 2015 – six years on and it's no longer supported by Apple for software updates, so is essentially obsolete.

But who knows, if commodity price inflation continues at its current pace, EVs may end up having better scrap value in the junk yard for parts than as functioning vehicles. This would surely provide the incentive to set up a manufacturing process that factors in circular-economy and zero-waste principles.

Can European companies support the investment costs required?

The move to building EVs will require a step-change in investment, as many existing production facilities need to be completely redesigned. This will have an impact both in terms of short to medium-term cash profitability and accelerated depreciation/write-offs of existing plants.

We have noted three distinct approaches to this dilemma within Europe.

1. The first group are so short of profitability in their legacy internal combustion engine (ICE) businesses, they simply do not have any other option than limiting spending and hoping that a partnership will come along.
2. The second group are reluctant to commit to a single technology, instead investing vast amounts of cash into multiple platforms in fear of backing the wrong one.
3. The third group has the same deep pockets as the second but is fully committed to EVs with a clearer product focus and model line-up that should help to gain market share.

As investors, we are focusing our attention on the third group, which has the greatest synergies with the new regulatory environment.



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