Global Asset Management

Investing in electric vehicles

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Electrical vehicles (EVs) have gone mainstream. Over the past five years, sales have surged as the regulatory regime, especially in Europe, has changed dramatically. With outright bans on the sales of vehicles powered by internal combustion engines (ICEs) set to be introduced within a decade in some countries, the ultimate destination of the auto industry is clear. What remains undecided is how to get there.

As investment-grade bond investors, we believe EVs will redefine the auto sector as we know it, presenting us with challenges, opportunities and raising complex ESG questions.

How will EVs disrupt the auto industry?

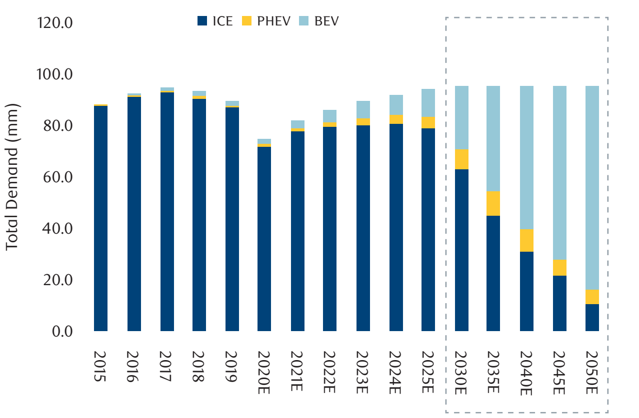
Throughout the transition process, we expect significant pressure on credit metrics across the industry as it deals with:

1. a shifting sales mix between ICEs and EVs
2. elevated investment demands
3. a need to redefine the world's most complex supply chain
4. potential mergers and restructurings.

The transition needs to be accomplished in what is a highly cyclical industry that is still dealing with the impacts of the pandemic.

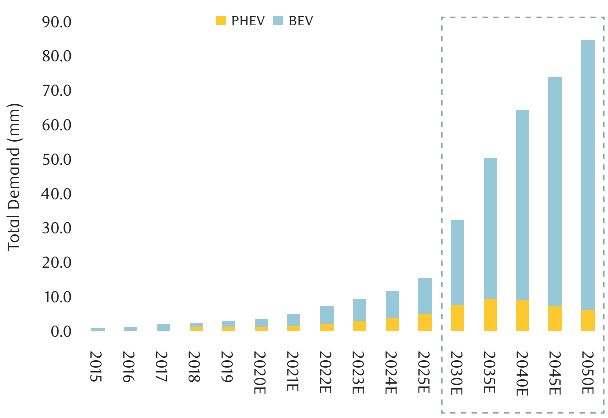
We expect **suppliers** to be the most vulnerable in the medium-term and see a major dislocation in their market positioning. For example, it's unclear how engine component makers will adapt to survive in an EV world where engines are replaced with batteries.

Total global auto sales in units



Source: RBC Capital Markets, as at December 2020. Note: ICE = internal combustion engine vehicles; PHEV = plug-in hybrid electric vehicles; BEV = battery electric vehicles.

Total global EV sales in units



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Why are suppliers more vulnerable?

1. There are fewer components in an EV (approx.600) than an ICE vehicle (approx.2500) so the key to their profitability will be driven by economies of scale.
2. The outsourcing trend looks set to reverse as vehicle manufacturers bring more processes in-house to gain greater control over their supply chains.
3. Many suppliers do not have specialisations in key new product areas that add value to EVs, such as software development and architecture or sophisticated chip manufacturing.

What about traditional auto manufacturers?

Here we see the potential for a major market dislocation, as several of the large auto producers have failed to formulate a coherent EV strategy. In an effort to sustain profitability, they have engineered attempted 'catch all' sales mixes that include a range of petrol, diesel, hybrid and electric vehicles. This strategy has been undermined by the recent regulatory moves across Europe. The introduction of outright bans on ICEs within the next decade or so is forcing manufacturers to focus purely on EVs.

From our vantage point, the manufacturing success stories will be those that:

1. have a clear R&D strategy
2. are able to restructure their manufacturing footprint
3. have the balance sheet to promote affordable EVs
4. can streamline their product offering in a cost-efficient way.

Our attention is focused on manufacturers within Europe and China, as these are the geographies at the epicenter of the electrification theme. Both regions have the political will and the financial means to pursue decarbonising the auto industry. Conversely, US manufacturers are lagging behind due to the domestic market's preference for large vehicles with high energy consumption (AC, heated seats) and an increased need for towing power in agricultural states.

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