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For professional investors in Italy

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Investing with a 360-degree approach through the capital structure: Automotive Focus

Plenisfer Investments SGR

The automotive sector is undergoing a phase of significant evolution and discontinuity.

While it is undeniable that the demand for automobiles is expected to persist - even if it may take different forms - the prospects for major players, particularly in Europe, appear uncertain in the face of the significant challenges they are facing:

1. **Electric Transition**

The transition to the exclusive production of electric cars is set for 2035 when the last petrol or diesel cars can be registered in EU countries, as determined by the European Union Energy Council last May.

This transition is destined to profoundly transform the automotive sector, creating **new winners and losers.**

The substantial investments required to realize this transition have been, and will continue to be, a critical factor. For example, Volkswagen alone has invested **50 billion euros** in this area since 2018.

In this rapidly evolving scenario, traditional players must demonstrate the ability to "change their skin" in an industry increasingly focused on software rather than hardware. This is a complex challenge with an uncertain outcome that may remind us of the early 2000s challenge faced by the telecommunications industry, where Nokia quickly relinquished its absolute leadership position to new-generation players like Apple.

2. **Chinese Competition**

In the electric car sector in China, a new national player, **BYD**, has quickly emerged. This is an emblematic case, more unique than rare, of a company capable of transforming and establishing itself in a capital-intensive industry with significant entry barriers, such as the automotive sector. Founded in 1995 as a battery manufacturer, BYD entered the electric car market in 2005 and, **in just five years, became the leading brand in this segment in China**. In the third quarter of 2023, it sold 432,000 electric cars - slightly less than Tesla's 435,000 - surpassing Volkswagen. BYD aims to reach 3.6 million vehicles this year, positioning itself among the **top 10 automakers globally** in terms of units sold. Sales are expected to be further boosted by growing exports to foreign markets. The **export** phase started only last year, but the company expects to double sales by 2024, benefiting from prices that are less than half of those of European cars, despite increasingly similar product performance and quality.

In addition to the challenges described, there is an **additional factor of complexity**.

Since 2020, supply bottlenecks resulting from the pandemic have restricted the availability of vehicles, and industry players have focused sales on higher-margin cars, i.e. full optional cars ready for delivery. The ability to exert strong "pricing power" in the market has provided operators with high cash flow and strong financial positions. However, this phase is gradually moderating with the normalization of supplies and the decline in demand associated with high auto loan pricing and the potential economic slowdown next year.

In light of these factors, **is the Automotive sector worth considering today**?

At Plenisfer, **we believe it is**.

While the challenges are unlikely to be resolved in the short term, the question to ask today is what evolution the sector will undergo in the medium and long term, i.e., in 5 and 10 years.

As investors at Plenisfer, we examine each sector and individual opportunity, analyzing their specific dynamics and the current and prospective macro context in which they unfold. Through this approach, once an opportunity is identified - even if it appears "contrarian" - we examine the **entire capital structure** to evaluate the most suitable instrument to fully capture it.

Looking at the automotive sector through the **equity** lens, there are, in our opinion, excessive unknowns that make it impossible to determine the "terminal value" of a sector company, despite its relatively very low multiples to date
In our opinion, this makes investing in the equity segment too unpredictable.

The sector's representative index, SXAP, indeed shows a significant **underperformance** of **28%** compared to the MSCI World and of **over 70**% compared to the S&P 500 from 2016 to date (source: Bloomberg). The year of the beginning of the decline is not coincidental: in 2016, "dieselgate" occurred, the scandal involving the falsification of emissions from Volkswagen cars, leading to CO_2 emission regulation and the obligation to halve them by 2021.

From the analysis of the capital structure of major players, **possible opportunities emerge on the bond front.**

Very few of the fixed income securities in the **OEM** (Original Equipment Manufacturer) sector offer **attractive spreads** but we can find value by **moving down the capital structure** to more junior debt instruments in issuers with strong balance sheets over the investment time horizon

On the other hand, the auto part supplier sector is **more attractively priced** overall. This is once again because of relative uncertainties prevalent in a scenario of significant discontinuity and subject to unquantifiable sector shocks, both endogenous and exogenous. This makes the analysis of the credit metrics and business fundamentals as important as ever.

The **key & fundamental question** to ask on this front is whether the issuer will be able to meet its repayment obligations.

At Plenisfer, we believe that for the OEMs there are **limited risks** regarding this capacity, thanks not only to the current solid fundamentals of operators but also to the availability of potentially valuable assets that can be monetised if necessary. However, we currently prefer **short and medium-term** securities where we have better visibility and would exercise more caution as the duration extends.

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