berylls
STRATEGY ADVISORS

„BREXIT CAN SEVERELY DAMAGE THE UK'S AUTO INDUSTRY"

– a Berylls statement

ONLY A FEW WEEKS LEFT UNTIL THE UK IS SCHEDULED TO LEAVE THE EU...

... with very little known about what is going to happen after 29 March including when the exit will actually happen. As automotive consultants we are very concerned about the impact of any BREXIT on our industry – and in particular so about a no-deal exit. The UK auto industry is tightly woven into the European fabric and there is NO upside at all from ripping through this fabric. However, beyond the inevitable inefficiencies caused by newly introduced border controls we see a larger and lasting impact from Sterling's devaluation and any tariffs adding further cost to the value chains. Countermeasures have long implementation times and high side effects, rendering them almost useless. We are afraid that the United Kingdom, up to now a key market for many car makers and their suppliers will suffer rather permanent damage – which further burdens an industry that is already grappling with the slow down in China and numerous other structural challenges. Arthur Kipferler Partner at Berylls Strategy Advisors: „One thing is clear - there will be no Brexit winner in the automotive industry".

BREXIT MEANS BREXIT – AND WITH IT LESS THAN A MONTH AWAY WE STILL DON'T KNOW WHAT THAT REALLY MEANS

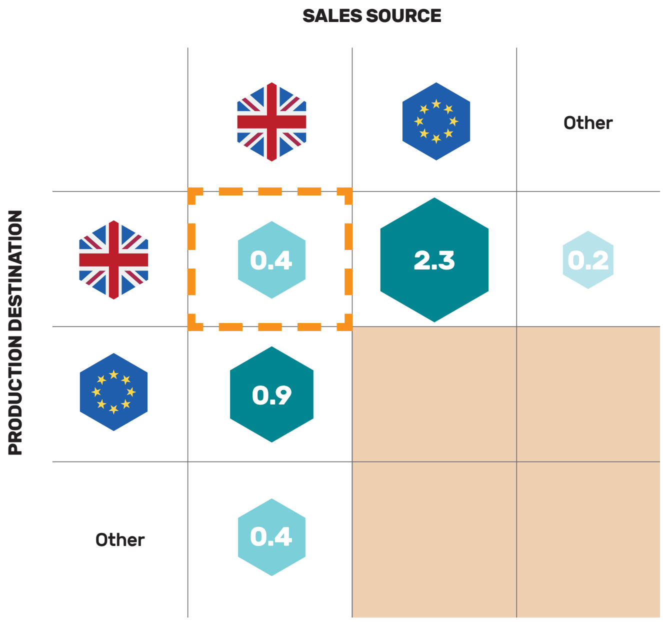
As the Brexit deadline of March 29, 2019 looms, much of the United Kingdom's post-Brexit future remains still uncertain. Only one thing is clear: its separation from the European Union might result in significant and fundamental alterations to the fabric of the UK's economy. While these changes will manifest in different ways in different sctors we only examine the effect on the UK's automotive sector. How intertwined is the UK's automotive sector with that of the EU? How will market dynamics alter as a result of the decoupling? And what will be left of the UK auto industry after BREXIT?

THE UK AUTOMOTIVE SECTOR IS TIGHTLY WOVEN INTO THE GREATER EU AUTOMOTIVE NETWORK

The UK is home to more than 25 production facilities for automobiles. But manufacturing is primarily export-oriented, with 54% of the 1.7m vehicles produced within the UK exported to the EU, and 26% to other non-EU nations (to some via trade deals with the EU). In contrast, domestic demand is principally import-dependent, with more than 80% of the 2.6m new car registrations arriving from the continent, and 7% from non-EU countries. Any potential self-sufficiency would stem from a mere 400k overlap in passenger cars produced and sold domestically, which is less than 13% of new car registrations (see Exhibit 1).

Behind these vehicle outputs sit complex interwoven supply chains. Components travel through several layers of businesses, across multiple borders, and sometimes return back to the same country more than once. It is important to emphasise that the UK is just one part of this wider web. More than 60% of the €9.2bn worth of components manufactured by the 2,500+ Britain-based suppliers are destined to the continent. In parallel, 79% of the €16bn worth of imported components derive from countries within the EU. The sheer degree of cross-border dependence on supply and demand, of both components and final products, makes the UK automotive sector one of the most closely integrated to that of the EU's.

Exhibit 1: The UK automotive sector is interwoven with that of the EU



Vehicle car flows, Units (m)

Source: ACEA; SMMT; Berylls Strategy Advisors

UNWINDING INTEGRATION WILL RATTLE THE FOUNDATIONS OF THE UK'S AUTO INDUSTRY

The seamless connectedness with the EU market has become the core of the UK's value proposition to automotive OEMs. However, the UK's decision to leave the EU has the potential to upend this proposition, and in the process, alter the dynamics and structure of the market and industry.

Much has been written about possible BREXIT outcomes and though very recent events point to an extension of the Article 50 negotiation window with a trade deal expected to follow suit, this report assesses the impact of the UK leaving without one as the 'worst case'. More probable and less disruptive alternatives will result in softer versions of the effects described here. UK Expert Arthur Kipferler: „What is certain is that most investment decisions in a no-deal scenario would not be made for locations in the UK."

Reverting to WTO rules will result in severe disruptions to the daily operations of car makers. The more significant include requirements to navigate physical customs barriers, garner residency rights for skilled employees, adjust for cross-border data policies, and ensure certification isn't disrupted. Each additional burden will alter the way automotive OEMs conduct their business and will absorb considerable management time and focus (both in adapting to but also persevering with).

However, none of these challenges are novel to car manufacturers, who have considerable experience operating in countries without trade deals. More pronounced is the potential impact of currency devaluation and tariff barriers as these factors will add to unit cost and diminish earnings at the same time.

Exhibit 2: Three, increasingly restricted, future trading relationships exsist

TRADE ARCHETYPES

	Customs union	Bilateral agreement	WTO terms
Tariffs	-	-	++
Border controls	-	+	++
Labour restrictions	-	+	++
Regulatory acceptance	-	+	++
Operational ease	-	+	+

Increased barriers, +/++

Source: ACEA; SMMT; Berylls Strategy Advisors

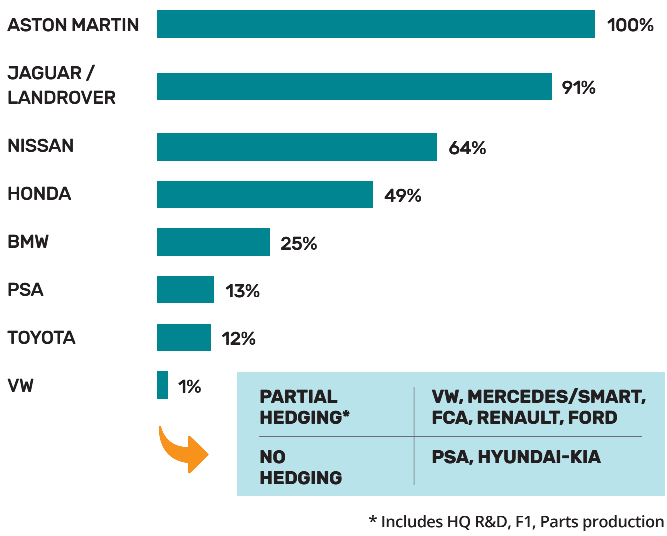
STERLING DEVALUATION REDUCES VALUE OF UK VEHICLE SALES

One of the first Brexit-induced effects was already observed prior to the referendum. From the beginning of 2016, Brexit-related political uncertainty ate 6% and 10% into the value of the pound against the dollar and euro respectively. Panic in the immediate aftermath of the vote resulted in a further decline of 3% against both currencies. Since then, events have failed to assuage sentiment, causing sterling to fall further, bottoming-out at a devaluation of 10% against the dollar and 15% against the euro. Capacity for currency recovery or further atrophy moving forward will be grounded in the markets perception of the UK's future trading relationship with the EU.

With financial HQs outside the UK most car makers are exposed to the currency impact on UK revenues. Financial hedging remains time-bound and will not provide an escape from the eventual reality of reduced returns to home currencies.

Some OEMs will be able to offset a portion of this damage through local production or operations that they pay for in less of their home currencies (a form of natural hedging). However, given that OEMs with UK production have only between 20-50% of local content sourcing in their outputs, this effect is of a lower magnitude than the one on revenue. Those OEMs with large UK market shares but little-to-no domestic footprint will feel the most pain (see Exhibit 3).

Exhibit 3: Some OEMs have better natural hedging against the effects of currency devaluation



Local CBU`s as % of total UK sales (proxy for natural hedging)

Source: Berylls Strategy Advisors

OEMS ARE EXPOSED TO A TARIFF BILL THAT RUNS INTO THE BILLIONS

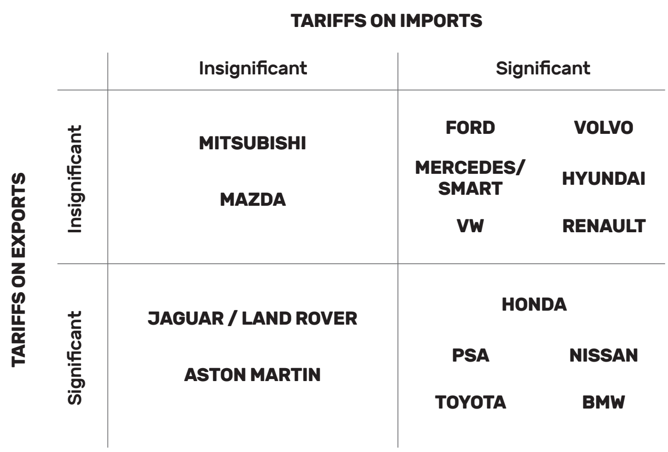
If Brexit passes without agreement on a UK-EU trading relationship, both exports into the EU and imports into the UK likely face tariffs of 10% on finished goods and 2.5–4.5% on parts and accessories, as per the WTO levels used among countries with no trade deals between them – and recently confirmed by the british goverment.

No car manufacturer benefits in this scenario:

a. Foreign importers face tariffs on finished vehicles (e.g.Mercedes/Smart, VW, Ford)
b. Domestic exporters face tariffs on finished vehicles (e.g. BMW, Honda, Nissan)
c. Domestic producers face tariffs on imported parts that increase the cost of the final product (e.g. JLR, Aston Martin)

The more a firm is dependent on cross-border trade between the UK and the EU the more they will suffer (Exhibit 4). Japanese OEMs that originally set-up shop in the UK with the intention of using it as a base to freely access the larger European market will question the future of their investment – even more so now in light of recent developments that bring-down trade barriers between Japan and the EU.

Exhibit 4: OEMs with greater exports/imports into/out of the UK face the greatest tariff burden



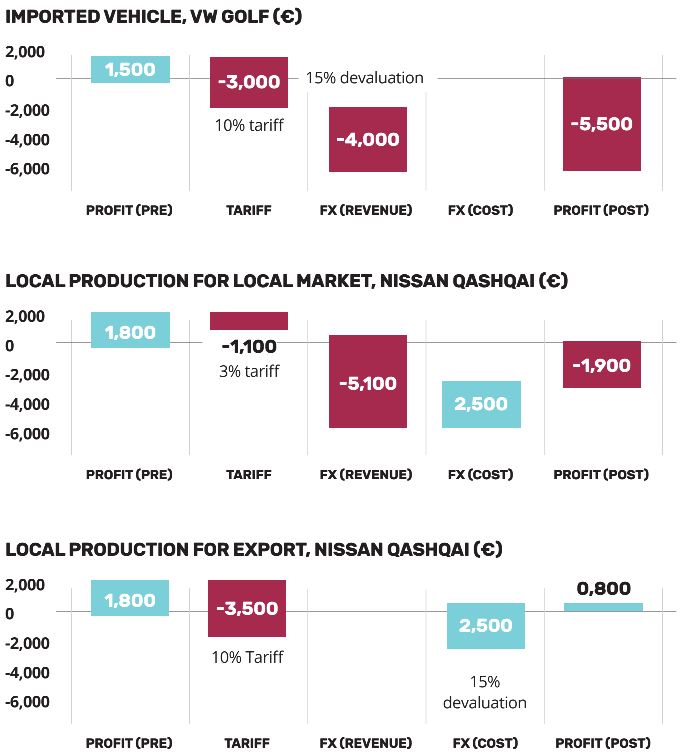
Source: Berylls Strategy Advisors

ABSORBING IMPACTS WOULD TURN MOST MODELS' MARGINS NEGATIVE

Our simulations show that only models locally produced for export will be able to retain a reduced but still positive margin with no-deal currency and tariff headwinds. While this may seem counterintuitive, the reality is that continued euro-denominated revenues, but lower pound-denominated production costs, maintain the profitability of the car (see Exhibit 5). Models in other constellations fare worse and end up losing money. Locally produced cars for sale in the UK would additionally struggle to meet possible local content requirements, with powertrains likely to be imported from the EU, rendering UK assembly more or less obsolete for them.

The magnitude of the financial impact shows that currency devaluation and tariff barriers cannot simply be accepted and digested in yet another efficiency programme. Instead, brands will need to intervene with both strategic and tactical actions to maintain the integrity of a model's business case.

Exhibit 5: Some models will require OEM-owners to absorb more than others



Source: Berylls Strategy Advisors

REDIRECTING DEMAND INWARDS IS NOT A VIABLE MITIGATOR

One often cited, but flawed, remedial action is to divert local production to local markets to avoid tariff-costs. A provisional objection is rooted in our analysis, as stipulated above, that local production to local demand has a worse margin impact than to foreign export. It does not make commercial sense for a car manufacturer to divert capacity to a market with less (in fact, a negative) margin.

In addition domestic production is simply not aligned to domestic demand (see Exhibit 6). Some segments have no UK footprint (A), whilst other segments have more demand than production (B, C, D, F), or even the opposite imbalance (E). This phenomenon is not happenstance, instead it is the result of manufacturing economics – and changing the setup now would inevitably introduce strong inefficiencies into the production systems and increase complexity costs.

Whatever countermeasures can be used to bring partial relief, price increases are inevitable for UK car buyers.

THE RESULT IS A FAR LESS ATTRACTIVE MARKET FOR OEMS

For a long time, the UK market has been one of the most attractive for the automotive industry. Its maturity has provided operators with a professionalised distribution and financial services network. Its customers have been bred on a prevailing car-ownership culture, supported by low purchase taxes for cars and a strong company car culture. Its demand has therefore been a substantial source of revenues and profits for many car manufacturers.

Therefore Brexit will cause impact: How much so depends on the UK's future trading relationship with the EU. A catastrophic no-deal situation will decimate the overall profit pool substantially. A reactionary price increase will depress sales volumes. The mix of sales will shift towards smaller segments and less price-sensitive customer channels. Altogether, these structural changes will make the UK automotive market far less attractive.

Some OEMs will find that no amount of fixing will rationalise production in the UK, and their exit will closely be followed by that of their tier-1, tier-2, and even tier-3 suppliers. Some will find the UK market will be too much of a hard sell, and they may choose to shift their focus to easier-to-win markets. Some will simply (have to) persevere. But for now all will hope for that somewhat elusive BREXIT deal and the continuation of free trade with the EU. Unfortunabely, now even the dare of BREXIT has become uncertain.

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