

Autos

Pricing pressure adds to slow volume recovery

January 9, 2024

This report does not constitute a rating action.



What's changed?

A muted Chinese auto market. We see the market's underlying weakness continuing through 2025 and constraining global demand growth to 1%-3% in 2024 and 2%-4% in 2025.

Softer electric vehicle (EV) momentum to affect pricing and capex strategies. Slightly slower adoption in North America and Europe will lead some (not all) to pull back on 2024 investments.

Declining prices of raw material. Moderation in prices for steel and key battery components will be one of the few tailwinds supporting auto margins.

What are the key assumptions for 2024?

Pre-pandemic volumes recovery far off in Europe and the U.S. Growth in China will be slow.

Flattening original equipment manufacturers' (OEMs') margins owing to less-favorable pricing, supplier payments, higher labor costs, sticky R&D costs, and EV-linked profitability dilution.

Recovering supplier margins thanks to better fixed-cost absorption and moderating raw material and freight inflation, but cash conversion will be pressured by ongoing capital expenditures (capex), restructuring expense, and high borrowing costs.

What are the key risks around the baseline?

Geopolitical tension and protectionism. Europe's failure to respond to the U.S. and China's moves in EV value chains heighten stress on regional legacy OEMs and suppliers.

Mergers and acquisitions (M&A) in the supplier space continuing to cloud visibility on ratings, and could lengthen the time needed for integration and restructuring to fully pay off.

Intensifying price pressure, especially if light vehicle demand recovery stalls.

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Ratings Trends: Autos

Chart 1
Ratings distribution

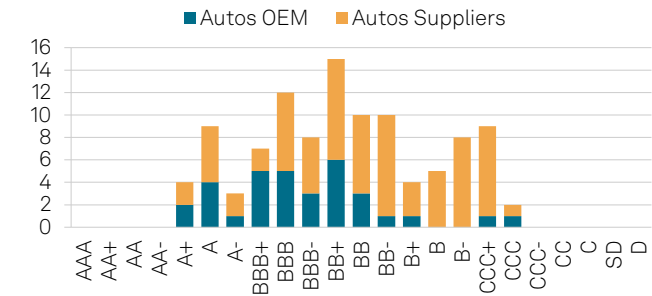


Chart 2
Ratings distribution by region

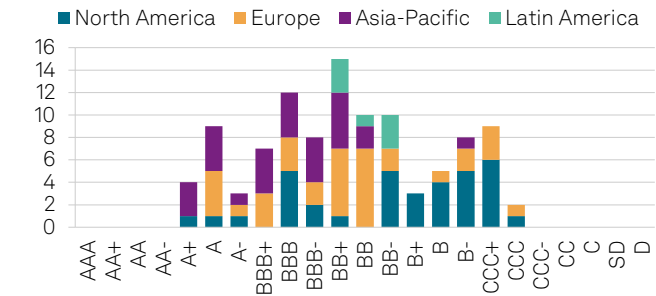


Chart 3
Ratings outlooks

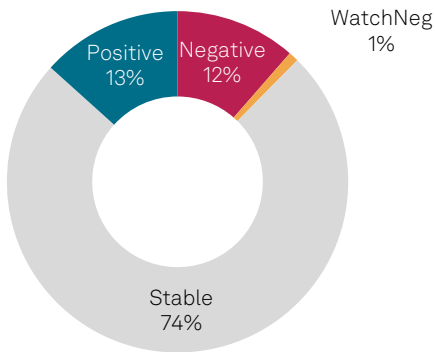


Chart 4
Ratings outlooks by region

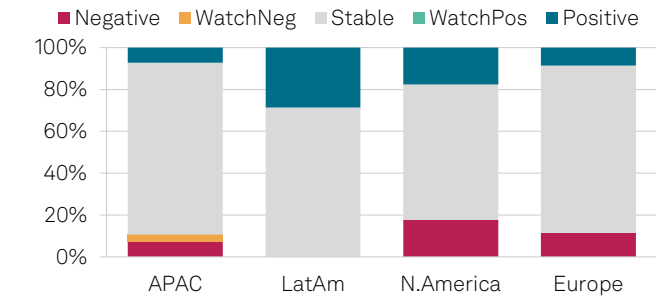


Chart 5
Ratings outlook net bias

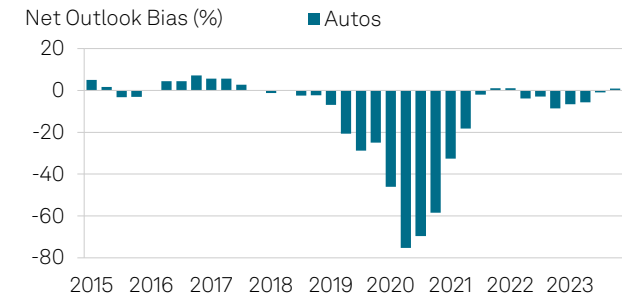
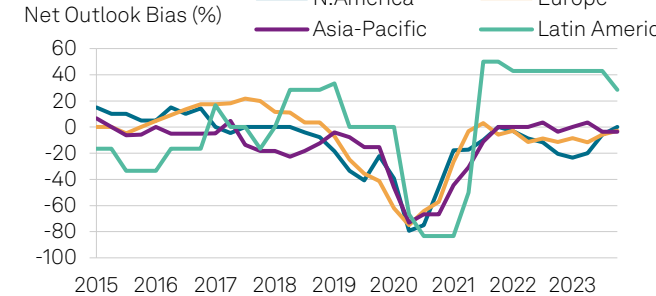


Chart 6
Ratings net outlook bias by region



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook

Ratings trends and outlook

We expect relatively resilient ratings in 2024 and 2025 for OEMs where we anticipate credit metrics will absorb a weak recovery of volumes and less supportive pricing conditions that will affect the volume segment more than the market's premium segment. Refinancing at higher interest rates should have a relatively minor impact for investment-grade OEMs because part of it could be absorbed by large and comfortable cash positions built in the post-pandemic phase thanks to healthy cash conversion and tight cost management. In addition, slower momentum in EV penetration could boost some OEMs in 2024 and 2025, and delay the dilutive impact associated with electrification. Over the next few years, we expect the industry to transition to more cost-effective vehicle platforms and cheaper cell chemistries at scale with a higher degree of insourcing. We think this transition will take time and is unlikely to deliver consistent profits within EV segments before 2027.

The picture is more mixed for auto supplier ratings. Rated suppliers are extremely diversified in terms of product offering (from extensive software solution to typically undiversified hardware skewed products mix) or market positioning (exposure to OEMs versus aftermarkets). Suppliers' margins and free cash flow will continue to improve as raw material and freight inflation remain more moderate, volumes improve, and less supply chain uncertainty decreases operating volatility at OEM customers. However, labor availability and wage inflation, along with overall higher energy prices, limit margin upside. Higher research and development, capex, and working capital in the form of tooling support the launch of new products geared to support EVs. While there is the potential for greater revenue opportunities from newer electrification-related products, initially this transition will drag on supplier margins and free cash flow. The impact on credit quality will depend on each suppliers' product portfolio and how they navigate the product transition.

Higher interest rates are a bigger credit risk for auto suppliers compared to automakers, which tend to have better ratings and stronger liquidity, to need to cope with refinancing risks while protecting their capacity to acquire assets that are key for the energy transition.

Main assumptions about 2024 and beyond

1. The post-pandemic volume recovery remaining moderate in the U.S. and Europe.

The stronger-than-expected rebound in 2023 is short lived, in our view, as higher interest rates in the U.S. and Europe will eventually take their toll on big ticket purchases. China is no longer seen as driving global auto demand growth in 2024 and 2025.

2. OEMs' topline growth and margins moderate, but cash conversion remains resilient.

Moderate recovery of volumes and less favorable pricing will feed 2%-5% revenue growth. Margins will be flat at best for most, linked to sticky cost items such as R&D, labor, and logistics costs. This is partially offset by declines in raw material costs, mix improvement, and the absence of large restructuring, one-time charges from 2023 for some automakers.

3. Suppliers improving on profitability, but less so on cash conversion.

After a plunge in 2021 and 2022, suppliers will improve margins thanks to compensation from OEMs but continue to lag on cash conversion as R&D, capex, refinancing, and restructuring costs all take their toll.

Volume growth will be moderate in 2024 and 2025. Our forecast is linked to the expectation of depressed private and retail sales in Europe and, in the U.S., a share of the market (approximately 40%) likely to be more affected by higher-for-longer interest rates than fleet sales to corporates rental companies and governments, that largely supported demand in the post-pandemic phase. While the U.S. economy remains overheated, economic prospects in Europe over the next couple of years could improve with inflation curbing from second-half 2024. The scenario of shallow recession in Europe remains dominant, which is why we are not revising our demand forecasts for the two regions.

Consistent with our previous expectations, 2023's muted growth in the Chinese auto markets was mainly due to the distortions from auto demand being partially pulled forward to 2022 by stimulus policies (the central government's restoration of the full purchase tax on internal combustion engine [ICE] vehicles, and removal of the EV purchase subsidy from January 2023). Growth in the first 10 months was in line with our forecast of 0%-2%, but the last two months of 2023 could have been stronger than expected as carmakers strive to deliver annual sales goals by slashing prices.

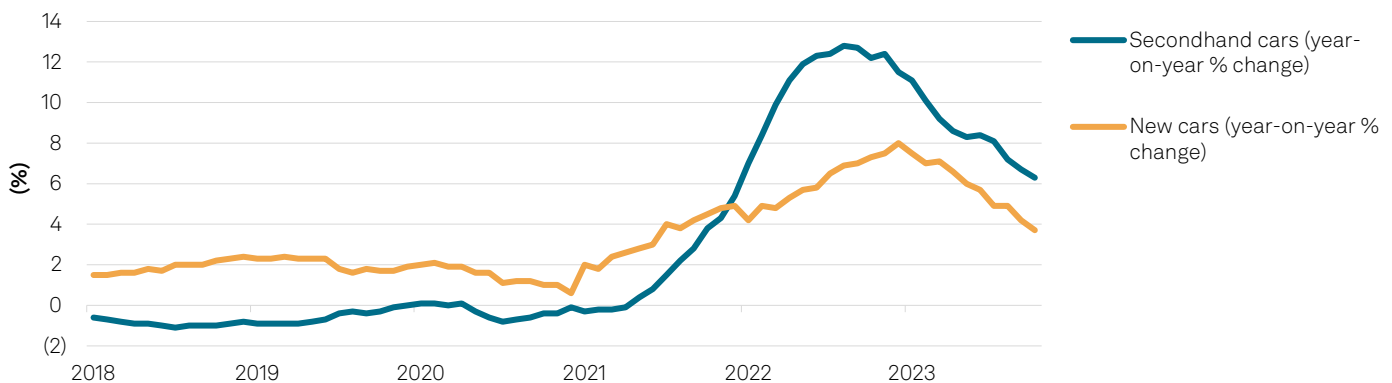
Chinas' property weakness continues to weigh on the economy. We expect the country's real GDP growth to slow in 2024 (to 4.6% down from 5.4% this year), so economic slack and fragile consumer sentiment will persist in 2024, which leads us to maintain our prudent forecast on light vehicles demand in China (0%-2% growth).

Pricing and labor cost pressure will intensify. Pricing patterns differ substantially among regions, depending on the structure of local markets combined with the strategy of disruptors and new entrants. Overall, we expect weaker pricing in 2024 and 2025 from the strong performance in 2021 and 2022. Pricing remains particularly competitive in China, owing to a multitude of car manufacturers trying to boost a quick ramp-up of volumes, hence failing to earn decent returns on capital invested. This trend should favor incremental market consolidation in China, although it will take time to materialize.

In Europe, Chinese players like BYD and SAIC appear unlikely to trigger a price war and retain stronger profit margins on low-but-increasing volumes, for EVs in particular. In the eurozone, pricing trends remain positive (according to the Eurostat Eurozone Car Price Index) despite a clear inflection of them, which is more pronounced for secondhand cars but also affects new ones (see chart 7). The average manufacturer's suggested retail price for passenger cars has steadily risen since 2019 (by 40%) and is at an all-time high in Europe.

Chart 7

Eurozone car prices

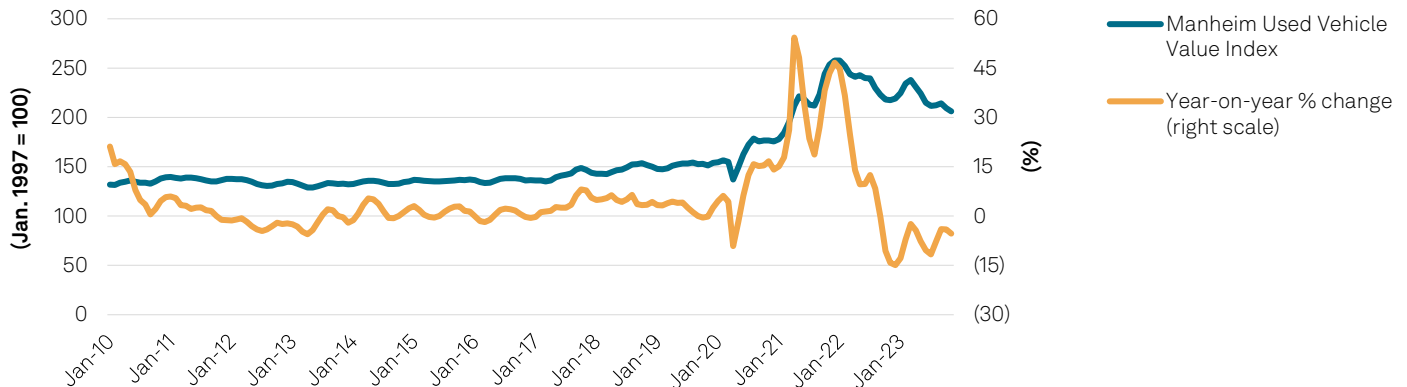


Sources: Eurostat, S&P Global Ratings.

New vehicle prices remain about 30% above pre-pandemic levels in the U.S. so far in 2023 (with average transaction prices over \$45,000 in August, according to J.D. Power, see chart 8), but we expect about a 10% decline over the next 24 months in the U.S. as used vehicle prices fall (with potentially higher supply) and the product mix trends toward lower-trim versions and more entry-level segments.

Chart 8

Manheim Used Vehicle Value Index: U.S.



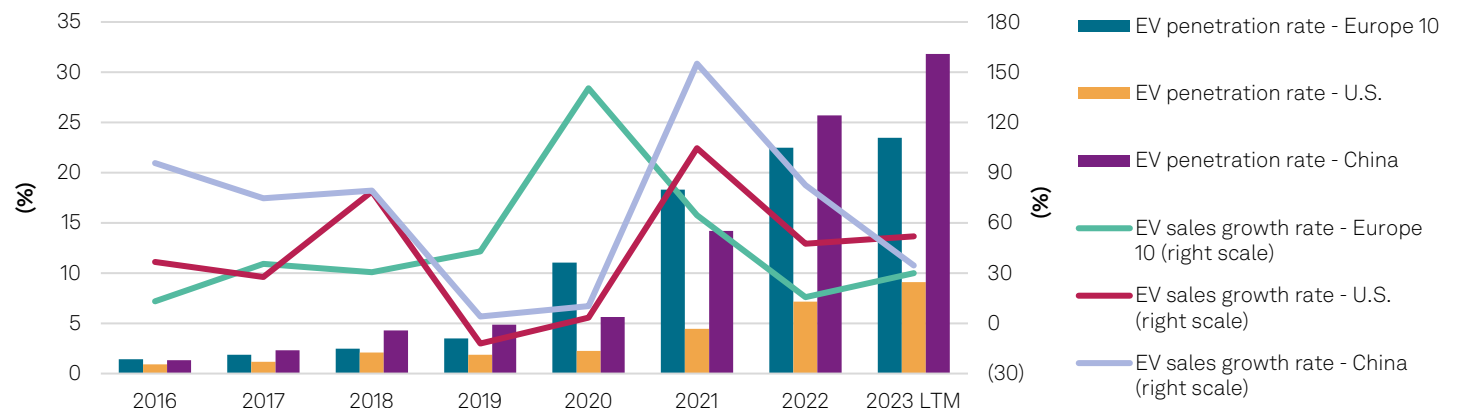
Sources: Manheim, S&P Global Ratings.

We expect a significant portion of the price decline in the U.S. to affect auto dealers that have been pricing vehicles at record high-levels in recent years. For U.S. automakers, following the recent ratified agreement reached with the United Auto Workers, higher labor-related expense will lead to multi-billion-dollar annual incremental costs, which will lead to even-higher reliance on ongoing cost-reduction efforts and lower spending on self-driving related businesses to avoid a large margin decline in 2024 and 2025.

The transition to electrification remains a key risk for most global automakers. A key credit risk for legacy automakers is managing the transition to EVs, which we estimate could be cash-flow-dilutive until at least 2026. Most legacy automakers will not pursue market share gains but will remain largely focused on improving cost competitiveness and repositioning themselves on the new value chains. Aggressive steps to vertically integrate battery technology business (by building own cells mostly with joint venture partners), will likely dilute EV business models' profitability for the next year.

Chart 9

EV sales growth and penetration rate



LTM—Latest twelve months to Nov. 2023. Source: S&P Global Ratings.

Given the recent slowdown in growth for EVs (see chart 9), we view plans to temporarily scale back capacity and balance growth with profitability (partly through sale of hybrid options) as a slight credit positive over the next 12-24 months. This trend could be more likely in North America, a market that remains largely dominated by Tesla, rather than in Europe, considering the latter's exposure to Chinese competition (see chart 10).

Chart 10

Segment structure of BEV market by region and bestseller by category

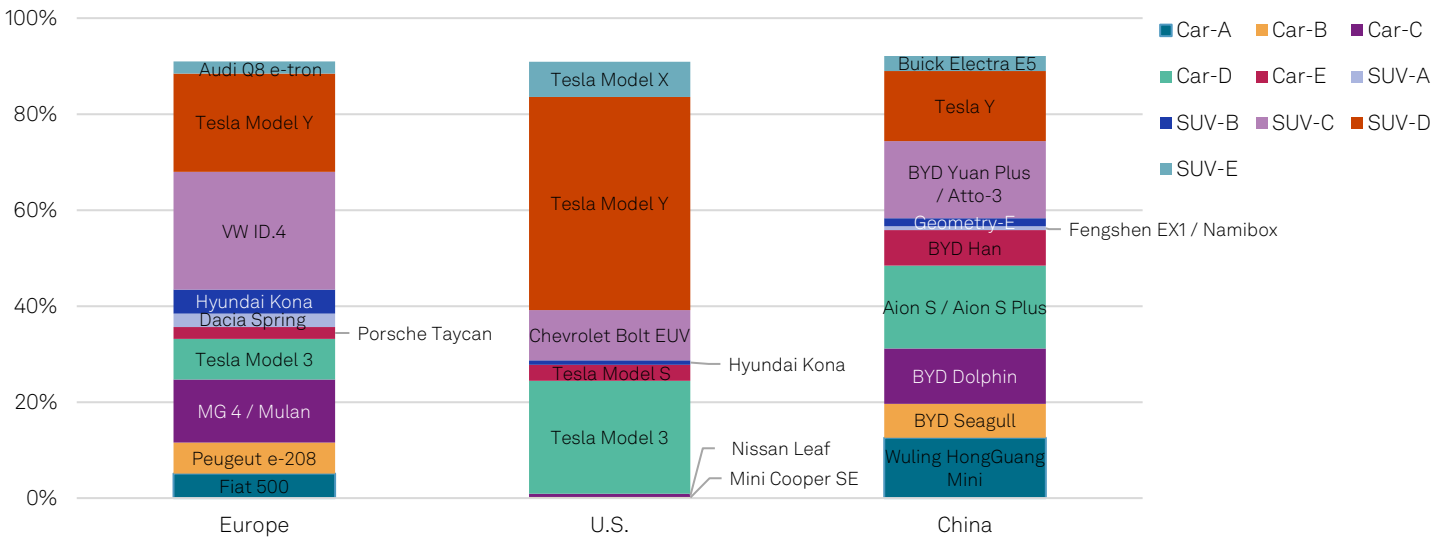


Chart shows 2023 data to October. Sources: EV Volumes, S&P Global Ratings.

Our 2025 electrification scenario remains broadly unchanged, however. Despite the likelihood of a bumpier trajectory, essentially due to an average global price gap of more than 20% between battery electric and traditional vehicles (close to 40% in Europe), we see electrification as an irreversible long-term trend. We expect that by 2025, more than 20% of global vehicle sales will be electrified. By then, we expect EV penetration to be highest in China (close to 40% versus 32% for the latest 12 months [LTM] to November 2023), followed by Europe (about 30% from 23% for LTM November 2023) and the U.S. (towards 15% from 9% in that time). By that time electric models on offer will have almost doubled in the U.S. and Europe only.

Table 1

Global light vehicle (LV) forecast (as of Oct. 2023)

	Actual		New projections (as of Oct. 2023)			Previous projections (as of April 2023)		
	2022	2022	2023e	2024e	2025e	2023e	2024e	2025e
	Mil. units	YOY%	YOY%	YOY%	YOY%	YOY%	YOY%	YOY%
Global LV sales	78.9	(1.7)	5-7	1-3	2-4	3-5	3-5	3-5
China (mainland)	24.1	0.9	0-2	0-2	1-3	0-2	2-4	1-3
U.S.	13.9	(7.9)	9-11	0-1	1-3	5-7	5-7	4-5
Europe	15.0	(11.2)	9-11	0-2	1-3	3-5	3-6	4-6
South Korea	1.7	(2.3)	0-2	0-2	0-2	0-2	0-3	0-4
Japan	4.1	(5.1)	5-7	1-3	1-3	5-7	1-3	1-3
Rest of the world	20.1	9.0	6-8	5-7	4-6	4-6	4-7	4-8
Global LV production	82.4	6.7	3-5	0-2	1-3	2-3	3-5	3-5

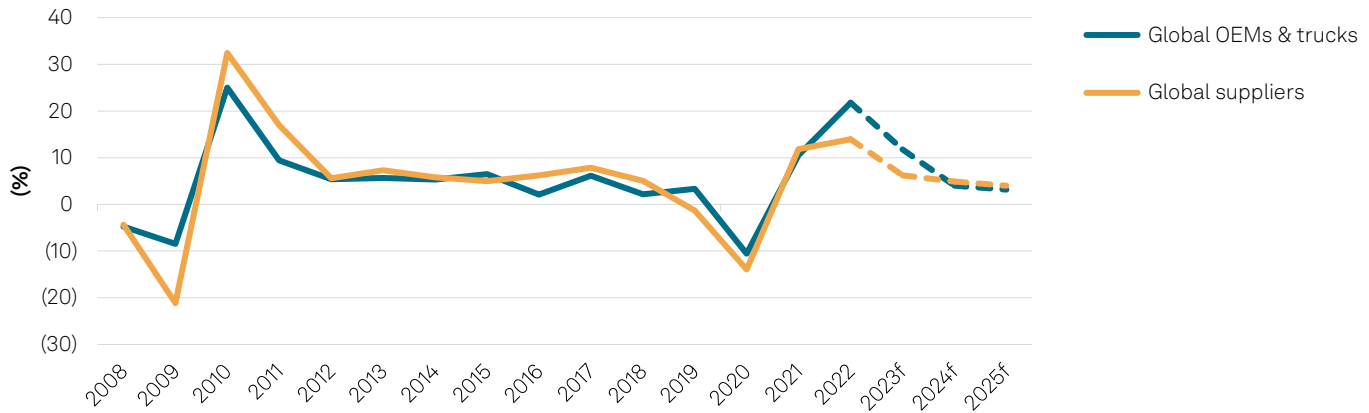
YOY—Year on year. e—Estimate. All percentages are year-on-year changes. Sources: Actuals from S&P Global Mobility, forecasts by S&P Global Ratings.

Credit metrics and financial policy

We expect 1%-5% organic revenue growth for both OEMs and suppliers, whose results will start converging again as from 2024 after the pricing party for OEMs gradually subsides (see chart 11).

Chart 11

Year-on-year revenue growth (median)

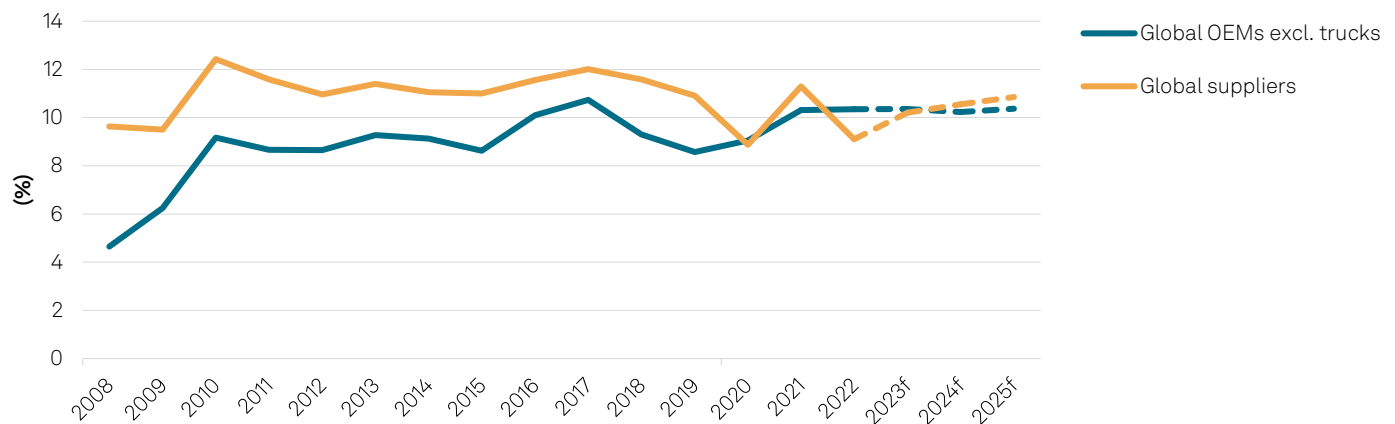


f—Forecast. Source: S&P Global Ratings.

The profitability gap between manufacturers and suppliers will also gradually decrease as margin flatten out at most car manufacturers while supplier margins improve as raw material and freight inflation remain more moderate, volumes improve, and less supply chain uncertainty lowers operating volatility at their automaker customers (see chart 12). However, labor availability, wage inflation, and overall higher energy prices limit margin upside.

Chart 12

EBITDA margin, % (median)



f—Forecast. Source: S&P Global Ratings.

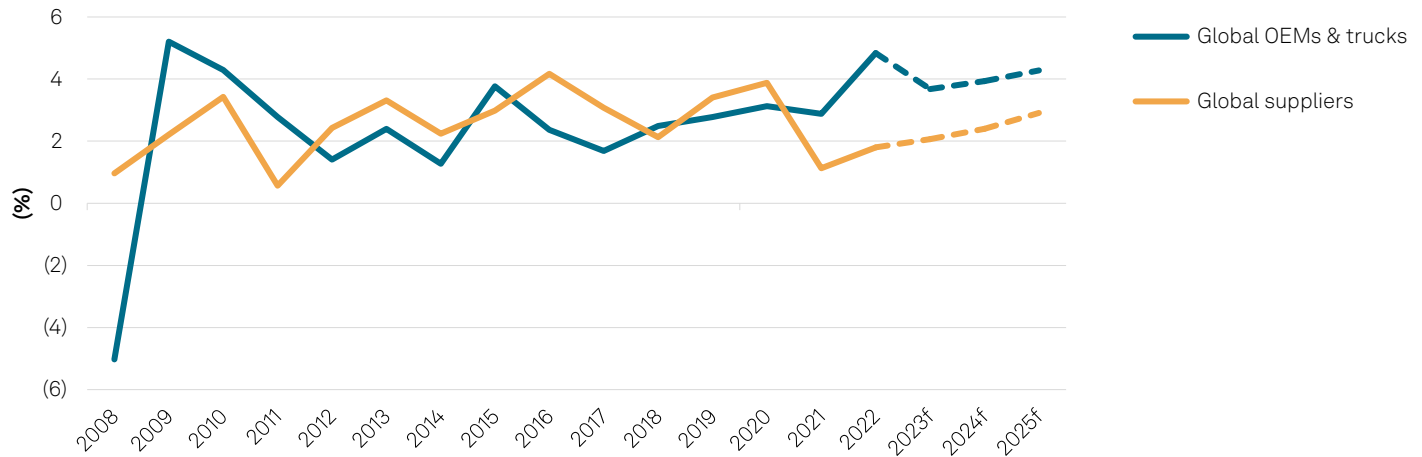
Investment intensity is unchanged with R&D and capex representing 8%-10% of adjusted sales (median value) at car manufacturers, which compares with a lower range at global suppliers (6%-8% of adjusted sales). The gap reflects our view of the effort towards a more pronounced verticalization of OEMs' business models associated with the transition to electric mobility. The pressure on R&D and capex is linked to the effort on new products, architecture, and platforms at OEMs aiming to reduce their time to market. Our definition of capex doesn't capture investment in equity, which allows OEMs to enter partnerships on nontraditional businesses like

raw material sourcing, battery production, and software development in an effort to share risk and optimize capital allocation. As a result, the capex gap between OEMs and suppliers could be higher if we were to account for those partnerships that we deem key for manufacturers' competitive advantage.

Given the accounting differences on these investments, absolute free operating cash to sales at car manufacturers appear inflated, at 4%-5%, compared with suppliers (in the 2% range), plagued with high refinancing costs and ongoing restructuring efforts (see chart 13).

Chart 13

Free operating cash flow to sales, % (median)



f—Forecast. Source: S&P Global Ratings.

In the post-pandemic phase, financial policies have been inspired by great prudence, resulting in cash accumulation, in particular at OEMs. As capital allocation becomes more selective and energy transition bumpier, some OEMs have undertaken share buybacks. We don't take this as evidence of more aggressive financial policies, but rather as the redistribution of gains from the exceptional pricing situation OEMs have enjoyed over the past two years. We expect financial policies at suppliers to be more conservative considering the multitude of challenges they could face given very gradual volume recovery and constantly adapting their portfolio to market needs.

Key risks or opportunities around the baseline

- 1. Geopolitical tension and protectionism could compound competition.** Europe's failure to respond to the U.S. and China's moves in EV value chains heightens pressure on regional legacy OEMs and suppliers.
- 2. M&A in the supplier space** will continue to cloud visibility on ratings and lengthen the time needed for integration and restructuring to fully pay off.
- 3. Price war among OEMs in North America and Europe** are unlikely, but could be triggered by automakers with high inventory in internal combustion-engine segments or by dominant disruptors like Tesla in the EV segment, which would weaken the industry credit outlook.

Geopolitical tensions are far from resolved and both OEMs and suppliers have responded with increasingly local-for-local market-based approaches, which is consistent with the Western bloc's ambition to reduce dependence from Chinese dominance of value chains. The rapid increase in exports from China into markets where competitive pressure is more sustainable and profits per unit higher, mostly in Europe but also Southeast Asia and South America. As a result, major auto players in Europe are directly exposed to the risk of being challenged in their home

markets by cost-competitive Chinese battery EV (BEV) companies (such as BYD Auto and SAIC Motor). Due to a cost advantage that legacy OEMs estimate in the 20%-30% range (for EV production), protectionist policies could be less effective if they didn't establish the principle of a regional sourcing, like the Inflation Reduction Act (IRA) in the U.S. does, and could feed into negative sentiment towards foreign players in the Chinese market, which remains a key market for the bulk of rated OEMs. In the U.S., new guidelines on restrictions embedded within the IRA's consumer purchase credit for EVs (related to component sourcing from China, Russia, Iran, and North Korea) will further limit the eligibility for the full consumer tax credits. Even before the new guidelines, only 16 of 50 BEV models were eligible for the full \$7,500 tax credit.

With a transformation in business models triggered by the energy transition, M&A risk remains high and unpredictable as to the impact on credit quality. We see this as risk material for auto suppliers but less so for OEMs, as the former strive to adapt their portfolio of products to a bumpy transition towards electric mobility, while the latter appear less exposed to risks of transformative transaction with material credit implications.

A price war is a remote risk at this stage (except in China) and could emerge only with protracted market weakness, which we deem unlikely. We think Europe could remain a sweet spot for pricing (also due to the high share of premium sales), but the U.S. could be a more challenging region, and China faces the highest price tensions.

Related Research

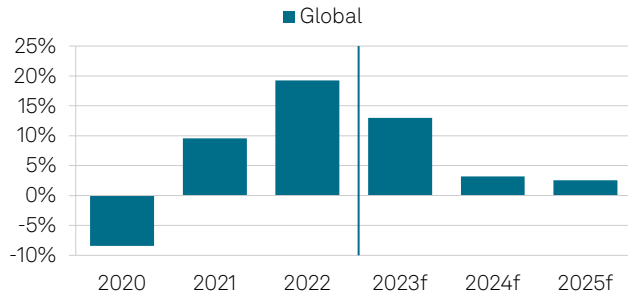
- [Autoflash EMEA: OEMs Can Navigate Choppy Waters Better Than Suppliers](#), Dec. 12, 2023
- [Credit Outlook: Global Autos](#), Oct. 31, 2023
- [Most Rated Asian Automakers Should Steer Through Demand Volatility, EV Strains](#), Oct. 12, 2023
- [U.S. Auto Sector Ratings Could Remain Resilient Despite Slowing Macro Conditions And Rising Pricing Pressure](#), Oct. 11, 2023
- [China Auto: Soft Demand Heightens Competition](#), Oct. 10, 2023
- [Global Auto Sales Forecasts: The Pricing Party Is Coming To An End](#), Oct. 9, 2023
- [Asian Battery Makers Are Shifting Strategies To Hold Onto Global Lead](#), Oct. 5, 2023

Industry Forecasts

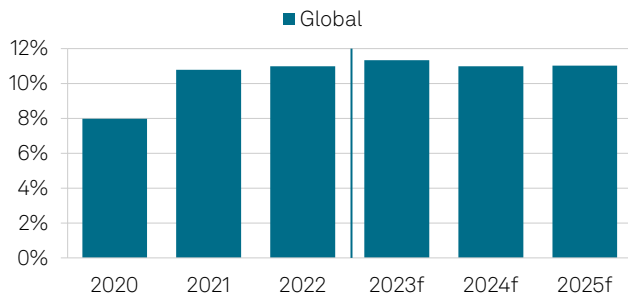
Auto OEMs

Chart 14

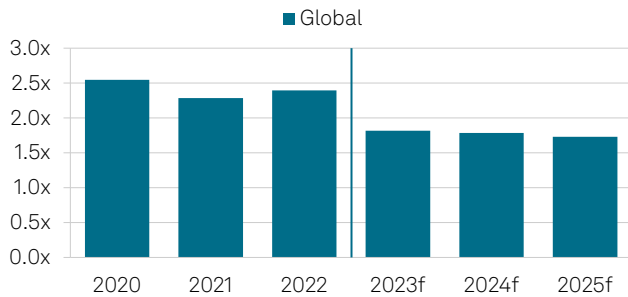
a) Revenue growth (local currency)



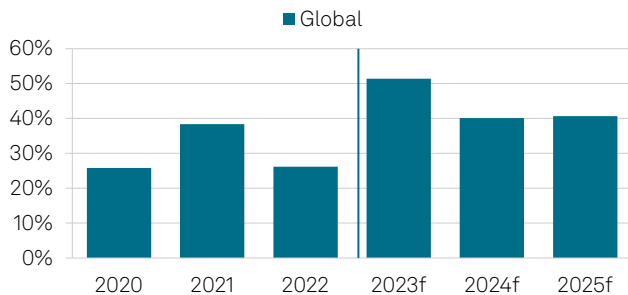
b) EBITDA margin (adjusted)



c) Debt / EBITDA (median, adjusted)



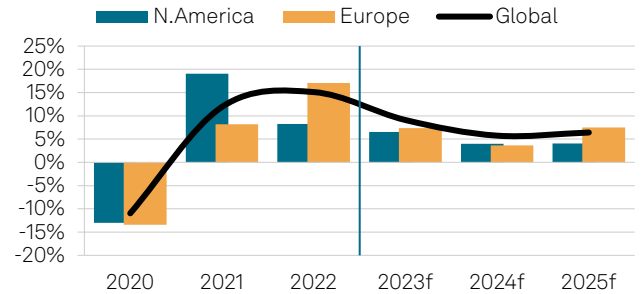
d) FFO / Debt (median, adjusted)



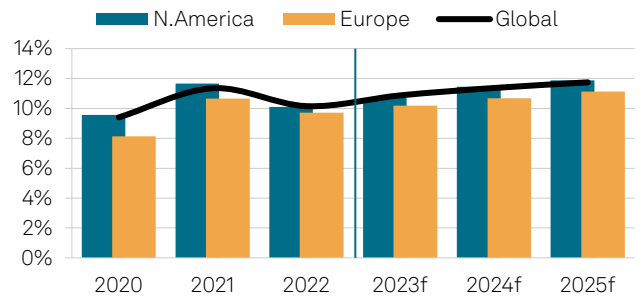
Auto Suppliers

Chart 15

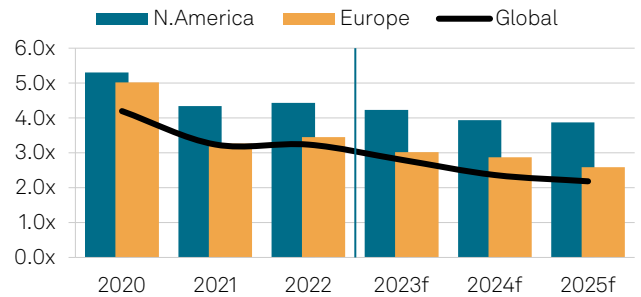
a) Revenue growth (local currency)



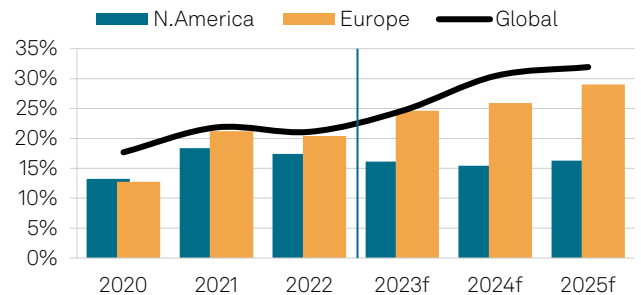
b) EBITDA margin (adjusted)



c) Debt / EBITDA (median, adjusted)



d) FFO / Debt (median, adjusted)



Source: S&P Global Ratings.

Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. OEMs--Original equipment manufacturers. FFO--Funds from operations.

Cash, Debt, And Returns: Autos

Chart 16

Cash flow and primary uses

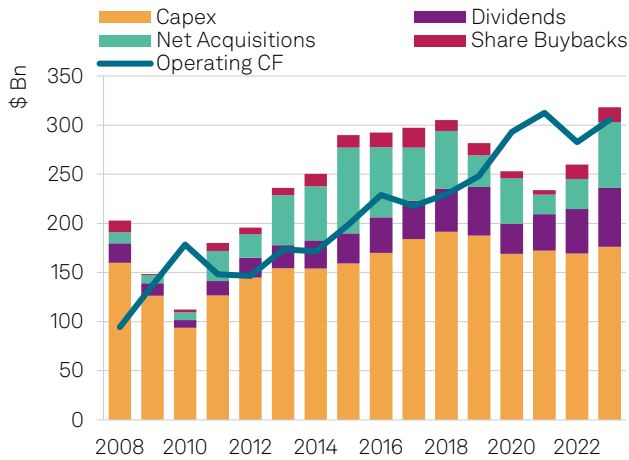


Chart 17

Return on capital employed

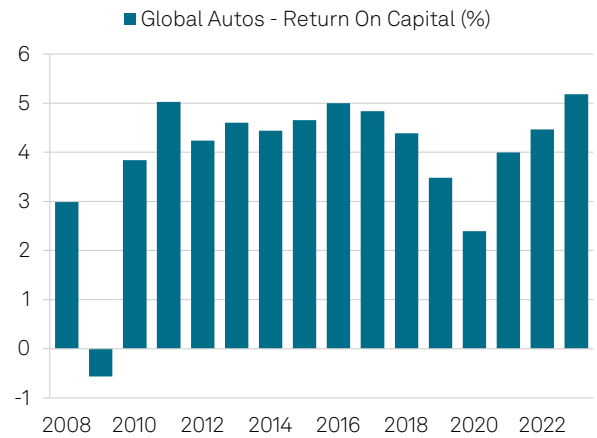


Chart 18

Fixed- versus variable-rate exposure

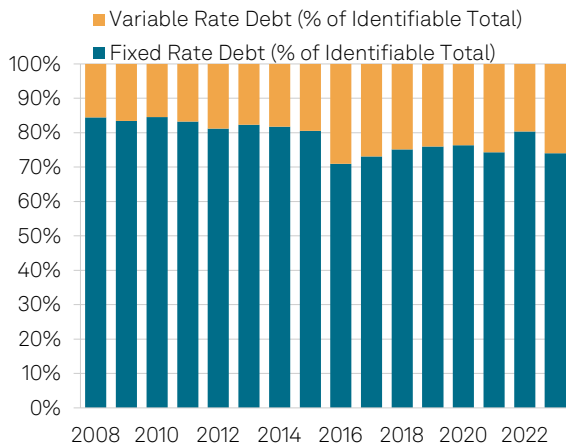


Chart 19

Long-term debt term structure

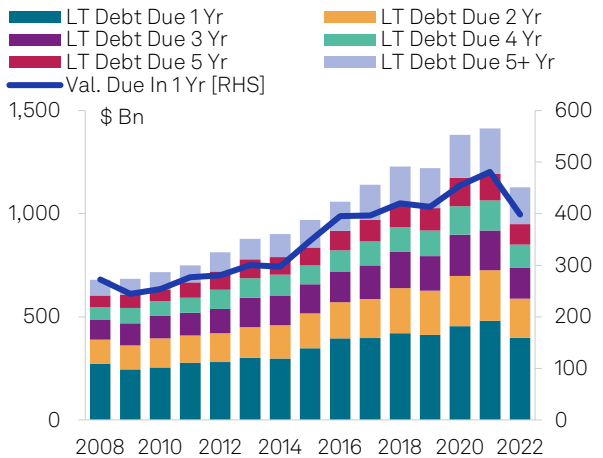


Chart 20

Cash and equivalents / Total assets

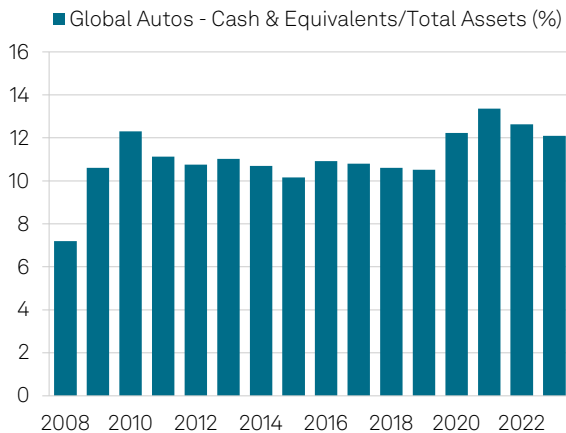
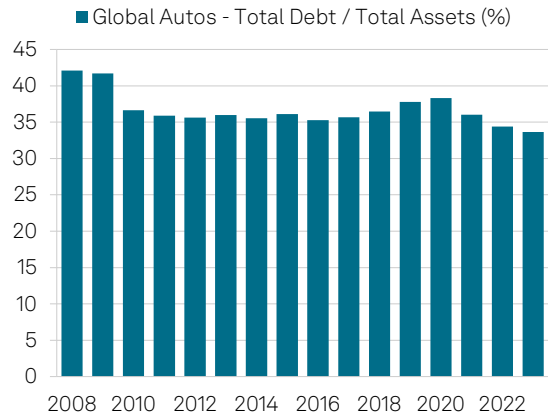


Chart 21

Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2023) figures use the last 12 months' data.

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