Higher rating pressure on amid gloomy industry outlook

What’s changed?

Global auto sales to remain stagnant. We now expect no growth for the industry in 2020 and 2021. Any recovery hinges on a modest revival of the Chinese market, and would come no earlier than 2021 in our view.

Geopolitical risks to stay for longer. An ultimate resolution of the U.S.–China trade is not in sight. Brexit uncertainty remains and the NAFTA-replacing USMCA trade agreement has not been ratified.

“Fallen angel” risk increases. We see a rising negative rating bias and an increasing number of ratings in the low 'BBB' category, mostly for the OEMs, linked to stringent CO2 regulations and shifts in consumer preferences.

What to look for in the sector in 2020?

Co2 challenge and Brexit developments in Europe. In 2020 we will focus on OEMs’ powertrain mix strategy and monitor market response.

Slightly higher recession risk in the U.S. Market concerns in the U.S. are all about recession risk building up toward the end of 2020, which we now estimate at slightly higher odds of 30%-35%.

Uncertain recovery of the Chinese car market. Decelerating economic growth and weak consumer confidence will continue to weigh on auto sales, only partially mitigated by government stimulus efforts and clarity on emission standards.

What are the key medium-term credit drivers?

Free cash flow generation and conservative financial policies. We expect balance sheet protection to be high on the agenda of OEMs and suppliers in view of the protracted market uncertainty.

Capacity to deliver on ambitious restructuring plans. Due to inflexible R&D and capex needs to support transition to e-mobility, many auto OEMs and suppliers need to step up other cost-reduction efforts.

Ability to continue to invest in R&D. The ability to balance between product-mix improvement, cost control and investment into technology enhancement will be important rating drivers.
Due to weakened market momentum and no signs of an upturn, the rating outlook for the global automotive sector (both OEMs and suppliers) is turning increasingly negative. We expect this trend to continue in the current quarter. The rising negative outlook bias reflects higher operational and financial difficulties amid macro uncertainties, and an evolving and more challenging competitive landscape. This trend could be exacerbated if the global demand softness turns out to be weaker or longer than we currently anticipate. Cushions in financial risk profiles and liquidity for some larger players has so far offset these challenges to a certain extent however.
Auto OEMs

Key assumptions

1. Virtually no growth for global auto markets over 2020-2021

Global economic growth is likely to continue to moderate during the next one to two years, as weak manufacturing activity and geopolitical tensions hurt consumer confidence, holding back purchases of big-ticket items. We have therefore lowered our assumption for light vehicle sales in the major markets and we expect virtually no growth in global light vehicle sales over the next two years.

2. Topline growth mainly relying on product and pricing mix effects

With soft demand and dim prospects for volume growth, automakers need to speed up new-model launches and optimize product mix to protect pricing power and expand their revenue base. Stricter environmental regulations drive new product pipelines in Europe and China where competitive pressure will rise. In the U.S., automaker profits will remain highly dependent on the truck segment (CUVs, SUVs and pickups), which will continue to dominate the market.

3. Limited chance of margin uptick over the next two years

We expect a combination of factors, including intense industry competition, trade disputes, higher production and R&D costs for electrification, and high restructuring costs, to keep margins under pressure for automakers.

The march toward 100 million global annual vehicles sales has slowed

Sales of global light vehicles (passenger cars and commercial light vehicles) fell a cumulative 5.6% in the year to Sept. 30, 2019, with the most relevant decline observed in China (i.e. -10.3%, according to LMC). Sales declined in all major markets with the exceptions of Japan and Germany, which reported pick-ups of 2.5%-3.1%.

Economic conditions have worsened globally as a result of the trade war between the U.S. and China. The risk of a prolonged German weakness and a recession in the U.S. will further dampen consumer confidence and, consequently, prospects for auto sales over the next two years. In light of current conditions, global auto manufacturers’ hopes for ever-increasing sales in 2020 and 2021 now appear to be dashed.
We now expect global light vehicles sales growth of 0%-1% over 2020-2021. Across the main markets we see:

Modest China recovery (1%-3% growth): After two decades of rapid development stirred by supportive government policies, China’s auto market is unlikely to see a return to hyper-growth any time soon. We anticipate decelerating economic momentum, higher household leverage, and slowing disposable income growth will continue to exert a negative influence on consumer sentiment. Nor do we expect much in the way of targeted stimulus, given local governments’ fiscal constraints, and the central government’s larger tolerance for economic slowdown.

Flat vehicle sales volume in Europe (West and East): Despite increasing concerns over economic conditions next year in Germany—which has so far been the only growing auto market in 2019 (+2.5% in September year-to-date according to LMC)—a further deterioration of the trade balance is less likely. Brexit remains a source of uncertainty in Europe mainly because we don’t spot progress on any trade-related agreement between the EU and the U.K. Given the U.K. market has been shrinking for the past three years, however, we are confident of a stabilization at least, absent a no-deal Brexit. Downside risks to European growth remain; for example if there were a surge in unemployment, though this is not our base case.

1%-3% volume declines for the U.S.: For the U.S market, we anticipate light-vehicle sales volume will drop by nearly 3% year-over-year to 16.4 million units in 2020 and further to 16.3 million units in 2021, the lowest level since 2014. This is anchored on a higher probability of an economy recession (12 months out) to 30%-35%, compared with our previous assessment of 20%-25% in May.
Topline growth mainly relying on product and pricing mix effects

With volume growth out of sight, automakers will depend on refreshing the product mix to defend pricing power and topline growth. An offensive of hybrid and battery electric vehicles will hit the European market as from 2020, with Volkswagen (across segments) and Tesla (in the premium segment) identified as the competitors to beat.

The EU is heading toward a material tightening of CO2 thresholds in 2021 (average for the market CO2 95g/km). This raises the question of whether the market will be ready to absorb the number of low-emitting vehicles that OEMs need to deliver in order to comply with their company-specific targets. The combination of increasing regulatory costs and soft market conditions will be tough for Western European markets.

In the U.S, we expect rising demand for light trucks--including SUVs, CUVs (crossover utility vehicles), minivans, and pickups--will lower passenger car sales to about 30% of total LV sales in 2019 and 2020 compared with over 50% in 2012. Automakers are set to shrink their passenger car exposure further, in our view.

In China, we expect average topline growth of 2%-4% for OEMs in 2020-2021 driven mainly by product launches that target the higher-price range. Premium brands such as BMW, Lexus or Daimler outperformed in 2019, with estimated volume growth of around 10% in the first nine months of 2019 (Source: China Passenger Car Association). We expect the trend to extend into 2020, on the back of continuous consumption upgrades and the penetration into the mid- to high-end market of localizing compact models.

Limited chance of margin uptick over the next two years

With only a few exceptions, OEM operating margins generally took a hit in the first half of 2019 already and issuers are guiding for stability, at best, of profitability and earnings. Ongoing restructuring costs and non-deferrable investments in technology upgrades will make it very hard to improve profitability. Our forecast of slightly rising margins in 2020 versus 2019, is mainly driven by our view of non-recurring costs next year, such as litigation related costs.
The electrification megatrend brings with it a squeeze in margins, driven by high unit costs linked to batteries and the economic costs of massive investments over recent years.

Chart 8
Average battery price over the years ($/kWh)

Source: Bloomberg NEF

Adding to uncertainty of market acceptance of electrified mobility is the lack of an extensive and far-reaching policy framework sustaining the transition in Europe. The cost of this transition weighs almost entirely on the industry and on its average profitability.

In the U.S, electrification is nowhere near as imminent or significant. We still see chances of a modest improvement in profitability for U.S. automakers relative to 2019, due to global rollouts of new truck platforms over the next 24 months, ongoing cost reduction, and restructuring actions. Slowing demand will intensify price competition for their products, across the globe. We also incorporate increasing engineering expenses for technology advancement in relation to autonomous driving, mobility, and electrification—which will limit profitability improvement beyond 2021.

In a stabilizing market in China, margins of the overall industry will remain under pressure from intense competition, due to the wider availability of new energy vehicle (NEV) models. We expect some benefits to derive from higher R&D and capex synergies with global OEM partners targeting localization of NEV models. At the same time, we expect Chinese OEMs to introduce new proprietary models that target a higher price range, dispose of nonperforming proprietary brands, and to improve utilization by realigning production capacity. In addition, we expect largely stable dividend income from their joint ventures with global OEM partners, which is a large component of EBITDA for some companies.
Key risks and opportunities

1. Headwinds from exacerbating trade conflicts

Without comprehensive solutions, trade tensions are unlikely to subside in the near term. Conflicts including U.S-China, U.S- Europe, and the U.K.-EU dampen global growth and disrupt supply chains.

2. Industry transition to CO2-neutral mobility sees challenges

Non-deferrable capex and R&D-linked electrification, connectivity, and autonomous driving will limit the scope of restructuring to accommodate softer market conditions. We thus expect a longer time horizon before spotting the benefits in the operating performance of OEMS.

3. Full mergers vs partnerships

Consolidation is more likely in tougher markets. Existing partnership have failed to lift profitability for OEMs involved, or provide other evidence of resilience to disrupting trends in the automotive industry. Closer ties might be needed to withstand disruption.

Trade conflicts poses a stumbling block for the entire industry

The U.S.-Sino trade conflict poses a stumbling block to the entire industry, with China being the world's single-largest auto market and a vital link in the global supply chain. Tariff-related disruption in the supply chain is raising operational difficulties, increasing manufacturing costs, and slowing production.

An exacerbation of the trade conflict between the U.S. and China would weigh on those European automakers exporting vehicles to China out of the U.S. We expect the BMW Group to be among the firms that would be affected by incremental tariffs between the U.S. and China as it continues to ship SUVs models from its U.S. production facilities to China and other countries. Daimler AG derived 28% of its unit sales of Mercedes Benz Car in China in 2018, but over 70% were produced locally in China. Some of the SUVs (GLE, GLS) produced in Daimler's U.S. production facility in Alabama are exported to China and could be hit by incremental tariffs. However, Daimler is expanding its local production in China and will produce the first model of its EQ brand there by the end of this year. Tariffs imposed on Europe-sourced cars and parts into the U.S. would be a game changer for the entire industry, including Fiat Chrysler Automobiles (FCA) and Volkswagen AG (see "Trump's Tariffs Could Hurt EU Carmakers--Not the Economy," published on RatingsDirect on March 26, 2019)

For China, the auto market is essentially self-sufficient, with low car import from and export to the U.S market. Therefore, the direct impact on the Chinese consumer seems quite limited. What's hurting the market is low consumer confidence, which is affected by the trade tensions. The uncertainty also clouds the prospects of market recovery, and to a certain extent, slowed the expansion of fixed asset investment into the local auto industry to 1.8% in the first nine months of this year, from 10.2% in 2017 and 3.5% in 2018. We believe some manufacturers are cutting or delaying capital spending. For the manufacturers we rate, we haven't yet seen any significant scaling back of investment, given their positions generally as industry leaders with low leverage. In some areas, they are targeting capacity expansion.

In our view, trade tensions between the U.S. and China are unlikely to have a meaningful impact on U.S. sales. However, other trade-related risks, including Section 232 tariffs on European and Japanese imports, and a potential reemergence of Mexican tariff threats
(albeit unlikely), would have an adverse impact on automotive demand because most of these costs will be passed on to consumers.

At this point, we see a limited effect on the ratings of U.S. automakers Ford Motor Co. (BBB-/Stable/A-3) and General Motors (BBB/Stable/--) because of their lower reliance on exports and higher level of localized content relative to foreign automakers. An indirect effect could be the challenges for U.S OEMs to seek growth due to tariff pressures and potential nationalism leading to anti-American sentiment in the China market. For California-based Tesla (B-/Positive/--), increased tariffs would add significant incremental margin pressure. Incorporating Tesla's overseas transport costs and import tariffs raises, the company operates at a 55%-60% cost disadvantage compared with the same car produced in China. Also, the trade war increases the likelihood for higher import duties on certain components used in Tesla's products that are sourced from China, which would further pressure margins. However, we expect tariff pressures to lessen once Tesla begins production at the Gigafactory. Also, we project lower costs from more simplified production processes and a local supply chain.

**Industry transition to CO2 neutral mobility sees challenges**

In Europe, the transition to CO2-neutral mobility is exclusively driven by regulation. Increasing penetration is well under way in countries with generous subsidy schemes and favorable tax regulation, which substantially diverges from country to country. OEMs need to deliver on regulatory diktats and create the market demand for electric cars. Regulators will not put targets on hold to accommodate weaker market conditions. Thus cost reduction measures will not likely extend to R&D and capex in our view, and the benefits of ongoing restructuring could take longer time to materialize. European frontrunners in electrification typically spend the equivalent of 6%-10% of auto revenues on R&D per year, and 5%-7% on capex.

The Chinese government has set a target for NEV sales to account for 20% of total auto sales by 2025, from the current 5%. This means a compound average growth rate of around 25% during the period (assuming no growth in total auto sales from 2022), which we deem ambitious. Can the market absorb this shift? A majority of NEVs are sold to business customers (such as car hailing/rental companies). This trend has some support in large urban areas, where mobility services are gaining appeal as an alternative to car ownership. However, a lack of charging-station infrastructure distracts from NEVs' appeal. The Chinese NEV market has been traditionally dominated by Chinese OEMs with all top-10 players being local manufacturers, and representing over 70% of market share. Most of them have a focus on battery-energy vehicle and target the lower price range. These OEMs will face mounting competition from other technologies and mid- to higher-end models, after NEV subsidy withdrawal in 2020. Foreign OEM brands could start to gain traction in this field due to their battery and vehicle technology strength. The anticipated launch of mass production of the Tesla Gigafactory in Shanghai in the fourth quarter of 2019 will likely kick off such competition.

In the U.S. market, we expect the combined share of electric vehicles (including plug-in hybrids) to remain under 3% of overall auto sales in 2020 despite significantly increased sales for Tesla's models 3, S, and X. This will lead to some market-share losses for some competitors in alternate fuel segments. Because of ongoing customer concerns regarding range, price, and charging infrastructure, we expect some downside risks to our prior base-case assumption, under which electric vehicles (including plug-ins) approach 10% of light-vehicle sales by 2025. Customer concerns are compounded by the falling cost of ownership for non-electric vehicles, given lowered gas prices, reduced tax incentives for cleaner alternatives, and the high likelihood that the Trump administration will roll back fuel-efficiency targets for 2025.
Full mergers vs partnerships

We had anticipated industry consolidation as a response to disruption. Europe faces among the toughest market dynamics over the next two years, and has one of the highest concentrations, given the two largest OEMs control 40% of the market. In a no-growth environment characterized by punitive regulation, pressure on margins and technology disruption, cost management and delivery on strategy can become overly challenging and push OEMs toward strong partnerships (VW-Ford) or full mergers (failed Renault-FCA attempt followed by merger talks between FCA and Group PSA). We see a sound rationale in this trend provided it does not weaken balance sheets. Economic benefits from partnerships do not stand out very clearly in financial performance. One question is whether aging partnerships, such as the alliance between Renault-Nissan-Mitsubishi, can still provide a valid response to exceptional pressure on industry fundamentals. This is not just cyclical. Rather, it's a deep transformation of a traditional manufacturing sector into a service oriented one with a strong technology content.

That is whether partnerships can still provide sufficient scale to generate material cost benefits for the parties involved. We tend to believe that in situations characterized by a dominant, large-scale player, partnerships might still be viable. Where the initial scale is lower, full-blown mergers might be the better strategy to maximize synergies.

In China, we've seen increasing risk of smaller and weaker players being phased out of the market. Yet large horizontal mergers remain unlikely in our view. Large OEMs, such as China FAW Group Co. Ltd., are setting up car-hailing joint ventures with peers, so as to increase sales volume (especially NEV sales) and to extend their value chain vertically. This represents a new form of strategic alliance among industry players versus the traditional merger--which could elicit potential resistance from local governments in consideration of local tax revenue and industry-chain effect. At the same time, the Chinese government would allow foreign OEM partners to increase their stake in local joint ventures (JVs- to support tech transfers). The relationship between BAIC Motor Corp. Ltd. and Daimler was further enhanced this July through the acquisition of a 5% stake in Daimler by BAIC Motor's parent, Beijing Automotive Group Co. Ltd. (BAG).

As China is the only single market where we see the potential for growth, we believe tightening partnerships and larger stake in JVs are credit supportive.

We expect the U.S. automakers to collaborate on battery development for electric vehicles and autonomous driving capabilities. GM and Honda will continue their joint development of a new purpose-built shared autonomous vehicle. The companies' ability to leverage its recent investments in these areas would be an upside to our base-case forecast assumptions beyond 2021. Until then, we view it as neutral to the credit rating, assuming GM spends approximately $1 billion in the GM Cruise segment in 2019. Ford's recent announcement that it will share costs and expertise on design and engineering with Volkswagen--to develop commercial vans and pickups globally and also its access to Volkswagen's MEB electric vehicle platform--will help Ford to overcome delays in its electrification roadmap.
Auto Suppliers

Key assumptions

1. Limited growth in auto suppliers' topline in the next two years

Global light vehicle sales will fall short of 100 million annual sales-- by approximately 8 million in 2020. We expect virtually no growth for 2020 and 2021, thus constraining revenue growth for suppliers.

2. Supplier margins under pressure

Declining volumes, intensifying price competition, foreign exchange volatility, rising raw material costs, and restructuring costs make it harder to meet business plan ambitions over 2019. We anticipate margins will remain under pressure throughout 2020 and 2021, provided no meaningful recovery of industry conditions.

3. Financial policy decisions likely to shape credit profiles

We expect negative rating pressure in the down cycle, but financial policy can be a decisive factor for credit quality.

A limited scope to grow revenues

Our flat unit auto sales forecasts for 2020 bodes ill for auto suppliers. That said, we see some potential for revenues to stabilize in 2021. In line with unit sales trends, we expect the highest decline in auto production in the Chinese market--at 7%-9% in 2019. A number of OEM volume producers have drastically restructured their operations in the Chinese market, including by taking out production capacity. Suppliers with a high percentage of sales from China and heavy exposure to volume producers such as General Motors, Ford and PSA should particularly feel the impact in 2019 and the coming years; this includes Schaeffler AG, Robert Bosch GmbH, Autoliv Inc. and Valeo S.A. We also anticipate European and U.S. production rates will decline throughout 2019 and 2020, but at a more moderate pace compared with the Chinese market.

In the U.S., some rated auto suppliers will likely increase sales in 2020, due to the impact of pricing, mix, changes in market share, and acquisitions. For example, Aptiv PLC has been growing faster than the industry due to new programs wins, market positioning, and ability to price appropriately. Dana Inc. has grown faster than the market due in part to acquisitions and the successful conversion of backlog orders. Furthermore, tire makers and other aftermarket issuers have much lower exposure to auto production. The ability of these issuers to raise prices to cover past increases in raw material costs and tariffs is the more dominant factor at play over the next year.

For the few rated Chinese auto suppliers, we haven't seen order cancelations in 2019, but order delays are quite common.

In Brazil, auto sales should remain solid in 2020, recovering from the recent economic downturn. But production and sales could be hurt by falling exports to crisis-hit Argentina. This is because Argentina is the principal destination for Brazilian vehicles production. Exports slumped 35% year on year in August 2019. We expect weakness through into next year.

In Mexico, the risk is slower-than-expected economic growth in the U.S. This would result in sluggish consumption, and would eventually affect pent-up U.S. demand for light
vehicles. However, we continue to expect auto sales growth at about 3% in 2020 from historical growth of 5%-10%, supporting demand for auto parts.

**Margin threats push restructuring initiatives**

Dim demand outlook, increasing price competition, higher input costs, elevated R&D expenses, additional plant relocation cost or sourcing reconfiguration: these factors work together to the detriment of auto suppliers’ margins. Effective cost reduction and improved product mix are key defenses.

A number of auto suppliers have markedly stepped up cost saving initiatives over recent quarters. Continental AG announced one of the biggest restructuring programs, which will impact up to 20,000 jobs worldwide by the end of next decade. Other large global auto suppliers such as Bosch, ZF, and Schaeffler are also stepping up restructuring efforts through plant closures and headcount reductions, while imposing more stringent cost control. Nevertheless, we foresee continued margin pressure for global auto suppliers as intensifying pricing pressure add to margin dilution. We also expect costs for cost restructuring programs to weigh on operating margins and free cash flow in the coming years.

We see a few suppliers bucking the trend so far, such as Faurecia SE and Kongsberg Automotive ASA, which have shown more resilience than average. We attribute this to proactive restructuring efforts in recent years, but we also note the groups lack exposure to the traditional powertrain business that dragged on other suppliers' margins. Japan's Denso Corp. and Aisin Seiki Co. Ltd. have also been relatively resilient. This is mainly due to the solid business performance of Toyota.

Producers with powertrain operations will likely see continued margin pressure. This is due partly to elevated R&D expenses. Another issue is tougher pricing negotiations with OEMs, many of which face their own margin issues, due to a lack scale on their electrified models.

In the U.S., for most of our large tier-1 auto suppliers, we expect steady profitability under our base-case, with a few exceptions related to firm-specific underperformance. Unless there is an economic downturn and a substantial decline in light-vehicle demand, R&D as a percentage of sales, margins, and capex as a percentage of sales will not move that dramatically. We don’t see tariffs on Chinese imports as having a materially adverse effect on U.S. tier-1 auto suppliers. For example, suppliers such as Adient PLC (Aptiv, BorgWarner Inc., the Goodyear Tire & Rubber Co.), and Tenneco Inc. (manufacture in the country or region where they sell and the impact so far has not been material. Moreover, even though many firms make where they sell, they may need to move their manufacturing footprint because their customers may need to resource their supply chains at more favorable locales. The recent trend of declining U.S. imports of auto parts from China suggests that some suppliers are resourcing; moreover, these would likely be the tier-1 players who are able to tap alternative sources more easily due to their larger size and geographic reach.

Smaller U.S aftermarket auto suppliers suffer more because they import a substantial percentage of their products from China. Tariff-related disruption in the supply chain is raising manufacturing costs, slowing production, and, hence diluting margins. While aftermarket suppliers are able to offset a part of the tariff impact by getting concessions from Chinese suppliers, the majority of the tariffs must be offset through price increases or sourcing from other countries. Both of these alternatives take time, and large price increases to major retailers with strong bargaining power, such as Autozone Inc. and Advance Auto Parts Inc., can be quite challenging. It's true, though, that these aftermarket suppliers dependent on China for their components are similarly situated, and over a longer time period will have to pass these higher costs to the consumer. At that point, the degree of differentiation could be the extent of sourcing from China. These
companies tend to have higher leverage and weaker cash flow, and hence generally are in the 'B/B-' category, typically with negative rating outlooks.

For the rated Chinese auto suppliers, we expect their EBITDA margin in 2019 to contract on lower production utilization, and to tick up slightly in 2020 and 2021 in consideration of product mix change and improvement in operating efficiency. Rated companies are cutting labor costs, improving product standardization, and increasing production automation. They are also reducing or delaying capital spending, in production bases in China as well as overseas.

Financial policy decisions likely shape credit profiles

For Europe-based suppliers, operational underperformance and negative discretionary cash flow generation have reduced headroom for a number of issuers. This is reflected in the increased negative outlooks and downgrades over the past year, among them a number of the prominent issuers in the sector, including Autoliv, Bosch, ZF, and Valeo. While a number of companies have engaged in bolt-on and midsized deals over recent years, we have not seen larger transformational acquisitions except for ZF Friedrichshafen debt-funded acquisition of WABCO for $7.4 billion.

Given the challenging industry outlook, we would now anticipate that issuers will act more carefully when it comes to larger debt-funded acquisitions. Instead, companies are likely to focus on cash preservation, with careful investment decisions, and potential cuts in returns to shareholders. Also likely are continued efforts to realign portfolios through disposals and spin-offs, such as the recently announced spin-off of Continental's powertrain operations, Vitesco Technologies, expected for 2020.

We also see such strategic realignments in Japan. Aisin Seiki is now planning to integrate its 56%-owned subsidiary Aisin AW Co. Ltd. to enhance its competitive position in its mainstay automatic transmissions (AT). Also, Honda Motor and Hitachi Ltd. recently announced plans to conduct management integration between Honda’s group suppliers and Hitachi’s automotive component subsidiary.

The rated Chinese suppliers will maintain prudent financial policy, in our view, with stable or declining capital spending and a low likelihood of acquisition activities. Given their low leverage, ratings outlooks are mostly stable. However, downside risks will escalate if global auto demand continues to weaken due to further economic slowdown or a prolonged trade war.

In Latin America, supplier companies have aligned capex intensity to the auto industry's technological evolution to electric vehicles. This allows them to maintain strong operating cash flows and abstain from incremental debt.
Key risks and opportunities

1. Trade war disrupts the supply chain
Global auto suppliers could face considerable pressure from prolonged trade disputes, given potential disruptions to supply chains. Potentially adding to the burden are higher raw material costs, and additional expenses for plant relocations if OEMs reconfigure supply chains.

2. Industry transition provides risks and opportunities to business models
The auto industry's transition toward electrification, autonomous driving and connectivity could drive some suppliers out of the market. Top suppliers will need to spend considerably on technology upgrades and business segments realignment.

3. Potentially weaker funding access
Funding access is an additional risk, as the clouded industry outlook lowers creditor confidence on the suppliers. Industry consolidation may pick up.

Supply-chain uncertainties
Many auto suppliers have production bases in local markets, which provides a natural hedge. For instance, we do not see tariffs on Chinese imports as having a materially adverse effect on U.S. tier-1 auto suppliers since they typically manufacture in the country or region where they sell. Likewise, we would expect European suppliers to mitigate the impact from increased tariffs between the EU and the U.S. thanks to their high degree of regionalism.

However, we believe that the indirect consequences of prolonged trade disputes could be more severe. Suppliers may need to move their manufacturing footprint because their customers may need to resource their supply chains to a more favorable locale. The recent trend of declining U.S. imports of auto parts from China suggests that some suppliers are resourcing; moreover, they would likely be the Tier 1 players who are able to tap alternative sources more easily due to their larger size and geographic reach. Premium OEMs would likely rise car prices for end consumers and may lose volumes; which would also indirectly affect suppliers.

For rated Chinese suppliers, they supply products to global automakers with some 30%-60% of direct exposures to the U.S. market. They are trying to shift some of the production out of China. However, there are limits to this strategy, given China's well developed steel and aluminum industries provides good quality and value-for-money raw materials. Well-trained Chinese labor is also hard to replace in a short period of time. All these make the auto suppliers' operations in China highly vertically integrated and hard to replicate elsewhere.

In Japan, Denso and Aisin are integral to Toyota group strategy and they supply core, high-value-added auto components which are difficult to substitute.

In Mexico, we believe the USMCA will not have meaningful short-term implications for the operations of the companies in the region. The new agreement (once ratified by each countries' legislatures) largely preserves the existing cross border supply-chains and trade framework. We consider the level of supply-chain integration in the North American auto industry to protect the competitive position of the Mexican companies to some extent.
Industry transition provides both opportunities and threats to existing business models

The auto industry's transition toward electrification, autonomous driving, and connectivity provides both opportunity and threat to auto suppliers, depending on the segments they serve. Auto suppliers will play a key role in such transitions by adapting their product offering and providing innovative solutions to OEMs at the best cost. This requires large investments either in R&D to develop new capabilities in-house or in M&A activities to speed up acquisition of new technologies. Partnerships represent another route to develop new products; this route has the advantage of reducing upfront investments for projects with uncertain or long-dated returns.

We expect increasing interest in interiors as cars become more autonomous. This will benefit interior-components suppliers, in our view. On the other hand, powertrain-related suppliers may need to adjust product offerings toward electrified cars to mitigate lower volumes from traditional-engine powertrains as OEMs push electrified models.

The mechanics of electric-powered vehicles are less complicated than internal combustion engines (ICE). This means fewer parts, and hence fewer suppliers needed. The majority of the traditional auto supplier segments linked to the ICE powertrain will eventually face obsolescence, albeit at least not until 2030 for those that make appropriate investments to commercialize newer technologies. For instance, several auto suppliers that focus on powertrain-related segments have added in-house electrodynamic capabilities and in-house motor and power electronics capabilities. This enables them to be able to electrify both drive applications – leading to higher content, at higher margins. As such, organization restructure is likely to devote resources to the electrification-related area. R&D costs will also be material for auto suppliers, with the majority of them fully committed to upgrade technology.

Funding could get harder

Industry headwinds cloud funding access. Smaller suppliers will struggle to survive while larger plays face rising investment burdens. Heated-up competition for new technologies requires large upfront spending to capture growth opportunities. We hence expect auto suppliers to continue to rationalize their product portfolio to free up cash and direct more resources to areas with greater growth potential.

Meanwhile, mergers and the establishment of strategic alliances are more likely, to share the cost burden and in some cases to leverage partners’ technology advantages. For instance, the recent joint venture between Hyundai and Aptiv is likely to advance their development of production-ready autonomous driving systems for commercialization of level 4 and 5 self-driving technologies. Such deals reinforce the need to partner in order to achieve shared vision of making mobility more safe, green, connected, and accessible.
Related Research

- Global Trade At A Crossroads: Global Auto Industry Faces Long-Term Fallout If U.S.-China Detente Dissolves, Oct. 17, 2019
- U.S. Auto Sector Faces Bumpy Roads Ahead With Rising Recession Odds And Falling Demand, Oct. 16, 2019
- Global Auto Sales Will Stay In The Slow Lane For At Least The Next Two Years, Sept. 17, 2019
- Will Stimulus Move The Needle On China's Sluggish Industrials?, Sept. 17, 2019
- German Carmakers Can Still Win The Electrification Race- At A Cost, Sept. 9, 2019
- In Europe's Auto Market It's All About Curbing CO2 Emissions, June 17, 2019
- Trumps Tariffs Could Hurt EU Carmakers Not the Economy, March 26, 2019

This report does not constitute a rating action.
Industry Top Trends 2020: Autos

Industry forecasts

Auto OEMs

Chart 7
Revenue growth (local currency)

EBITDA margin (adjusted)

Debt / EBITDA (median, adjusted)

FFO / Debt (median, adjusted)

Auto Suppliers

Chart 8
Revenue growth (local currency)

EBITDA margin (adjusted)

Debt / EBITDA (median, adjusted)

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

Global Autos

Chart 9
Cash flow and primary uses

Chart 10
Return on capital employed

Chart 11
Fixed versus variable rate exposure

Chart 12
Long term debt term structure

Chart 13
Cash and equivalents / Total assets

Chart 14
Total debt / Total assets

Source: S&P Global Market Intelligence, S&P Global Ratings calculations
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