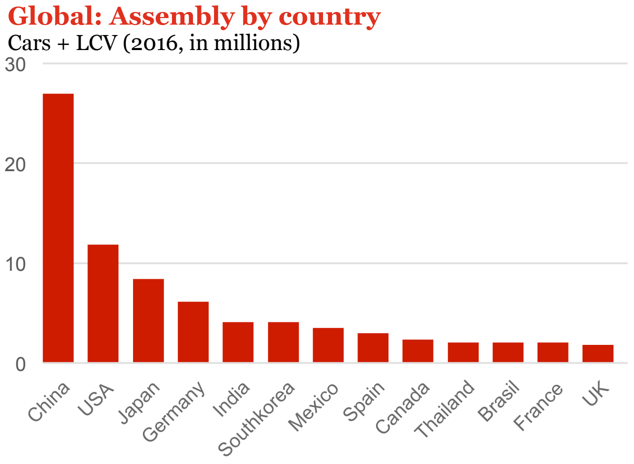
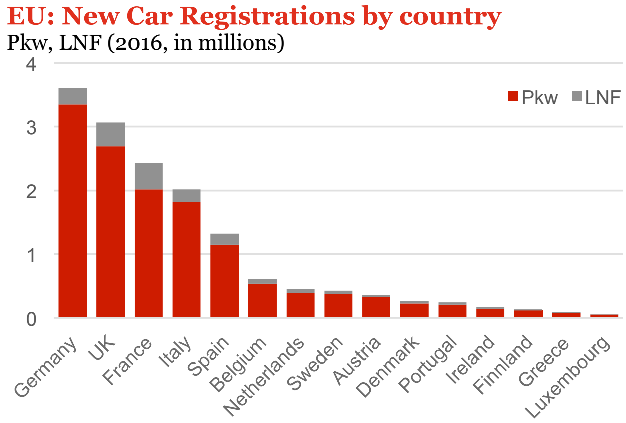
WITHER BRITANNIA? BREXIT IMPACTS ON THE AUTOMOTIVE INDUSTRY STILL UNCERTAIN

Now that the formal declaration of the Brexit procedures has been made, initial statements by the negotiating parties have failed to outline a clear path for the future of the automotive manufacturing sector in the UK. The low local content of UK-built cars in combination with a sizeable local market create a complex situation with apparently paradox influences.

SETTING THE SCENE: THE UK AUTOMOTIVE INDUSTRY



Source: Autofacts 2017 Q1 Forecast Release



Source: Autofacts 2017 Q1 Forecast Release

In 2016, the UK was the fourth largest assembly location for passenger cars and light commercial vehicles in Europe, behind Germany, Spain and France. In 2016, a total of more than 1.6 million units were manufactured. By global comparison, the UK was ranked 13th in 2016 as a production location for passenger cars and light commercial vehicles. Number 1 is China with 27.0 million units manudactured there. Germany is ranked 4th with 6.1 million units. By 2023, Autofacts forecasts a 10.9% decline in the production of passenger cars and light commercial vehicles (LCVs) in the UK, compared to 2016's 1.6 million units. The UK is thus defending its position as the fourth largest European production site. This decline is just one of several possible scenarios for the development of the automotive assembly sector, but currently appears as the most likely one – as will be explained below.

Today, the automotive industries of the EU and the United Kingdom are closely linked in economic, regulatory and technical aspects. Together, they provide jobs to 12.2 million Europeans across the value chain, and contribute 6.5% to the EU's GDP. (ACEA, 2017)

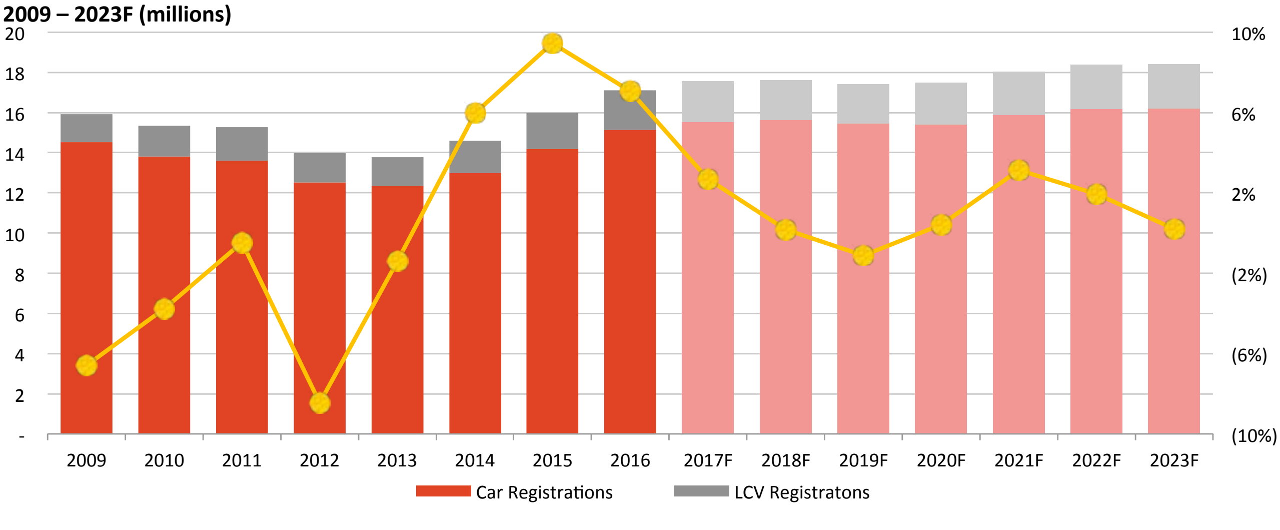
With regard to new passenger car registrations, the United Kingdom is number two in the EU, after Germany. In 2016, its passenger car market grew by 2.3% to 2.69 million units, compared to even higher growth in 2015 of 6.3%. It's passenger car market increased by more than 59,000 units in 2016. The same applies to registrations of light commercial vehicles. Again, the United Kingdom is number two, this time behind France. In 2016, the market for LCVs fell by 1.0% to 375,687 units compared to the previous year.

The other 27 EU Member States (EU27) exported 2.4 million vehicles to Great Britain last year, while more than 900,000 vehicles left the island for the European mainland. According to the European Automobile Manufacturers' Association's position paper on Brexit, the EU27 at present accounts for 81% of motor vehicle import volume in the United Kingdom (€ 44.7 billion), which also comprises parts and components for vehicles manufactured in the UK, and 52.8% of British automotive export volume (€ 14.6 billion) (ACEA, 2017).

RECENT MARKET DEVELOPMENTS IN THE EUROPEAN AUTOMOTIVE SECTOR

In their September forecast update, IHS Markit lifted their euro area GDP growth projection for 2017 from 2.1% to 2.2%. The 2018 projection remained at 1.9%, heralding an overall economic growth decline – even excluding the U.K The Brexit vote could affect euro-area activity more significantly, now that the United Kingdom has begun its exit negotiations with the European Union. These negotiations could prove difficult and somewhat damage sentiment in the euro area. At the very least, weaker UK domestic demand is expected to somewhat dampen euro area exports to the United Kingdom, along with the euro's relative strength against the pound sterling. The International Monetary Fund singled Britain out as a "notable exception" to an improving global economic outlook, as it confirmed a cut to its long-term forecast for UK growth and said negative effects of Brexit were beginning to show. It reduced the UK growth outlook, from an estimated annual growth rate of 2.0 per cent in 2017 to 1.7 per cent, while the inflation rate could jump to 2.6% – up +0.7% from 2016. Inflation in Britain is being driven by weak productivity and higher import costs since the Brexit vote showed it impact on the pound's exchange rate. The UK also has comparatively lower growth than its peers. Meanwhile, the recent fall in consumer confidence and the prospect of a further pickup in inflation and borrowing costs before the end of this year likely will mean that car sales revert to dragging down consumption growth in Q4. In September 2017, passenger car registrations across the European Union to fell by 2.0% in compare to the same month in 2016, totalling 1,427,105 units. It must, however, be noted that the September 2016 figures were the highest on record, and thus constitute a high basis of comparison. Momentum in some of the EU's five key markets is starting to slow down, especially in the United Kingdom (-9.3%) and Germany (-3.3%). However, these declines were partially offset by the ongoing recovery of the Italian and Spanish markets (up 8.1% and 4.6% respectively). Over the first nine months of 2017, demand for passenger cars remained positive in the EU, with almost 11.7 million new vehicles registered – an increase of 3.7% compared to the same period last year. With only two exceptions, all of the 31 EU+EFTA countries showed positive growth of light vehicle sales in the first three quarters of 2017. In relative terms, Lithuania (+18.9%), Bulgaria (+15.9%) and Poland (13.7%) are among the top performers, demonstrating the importance of growth in the Central Eastern European Countries, albeit with a low absolute contribution to overall volumes. These are mainly driven by Europe's top five markets – Germany (2.8m units), the UK (2.4m), France (1.9m), Italy (1.7m) and Spain (1.1m). United Kingdom, however, saw a decrease of -3.6% (-90k units) and Ireland -10.9% (-20k units) respectively. The rapid decline in demand across Europe for Diesel-powered vehicles, (new registrations fell from 50.2% to 46.3%) overstretches the OEMs' capability for fast adaptation, and is not yet fully reflected in current sales and production plans. This situation will most likely lead to overproduction of diesel vehicles, unused stocks, and increasing incentives and rebates. Autofacts expects some visible corrections of sales plans and output levels in Q4 and also at the beginning of 2017. The speed and gravity of structural shifts are not expected to decline very soon, but is rather going to become more challenging as the new automotive paradigm of electric, autonomous, shared and connected manifests in actual products and increasing customer demand. Going into the last quarter of the year, new vehicle registrations in the euro area are expected to cool down substantially, ending with an annual tally of 2.4% for passenger vehicles (PVs) to 15.5 million and 2.5% to 2.0 million units for light commercial vehicles (LCVs) in 2017, making Europe a light vehicle market of 17.5 million. Momentum in Spain and France will likely slow down due to uncertainties related to political negotiations. In addition to that, the UK is currently threatened by a hard Brexit, leading to a dampened outlook for the remainder of the year. This growth forecast is consistent with our expectation of a declining dynamic for new car registrations in Europe through to 2019. Mainly due to regulations but also induced by shifts in market demand, the years after 2020 promise to be very good for car buyers, but very expensive for vehicle manufacturers and retailers.

EU+EFTA: New Light Vehicle Registrations 2009 – 2023F (millions)

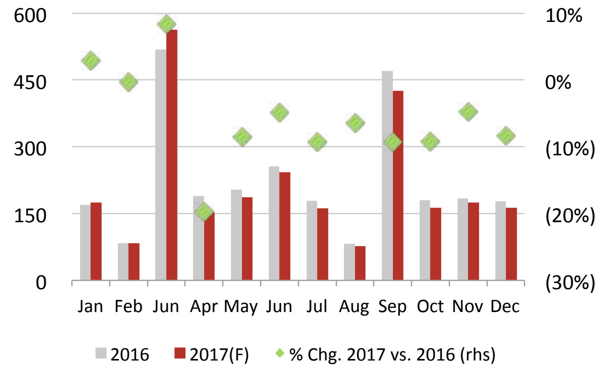


RECENT MARKET DEVELOPMENTS IN THE UK AUTOMOTIVE SECTOR

The UK's new-car market is struggling in late 2016. First-time registrations decreased for the fifth consecutive month in September to 426,170 units, down -9.3% in the year to year comparison. For the first time in six years, sales in the key month of September. has fallen. March and September show the highest registrations due to number plate changes, creating a characteristic cyclicality in annual sales patterns, Vehicles with diesel engines decreased by -13.7% in the first 9 months of the year compared to the same period in 2016. This means a decrease of market share in one year from 47.6% to 42.8%. Gasoline vehicles retained their leading position with a market share of almost 53%. Sales of Petrol Cars increased by 3.0% to 1,088,712 units YTD in September. As already seen for previous months, alternative fuel vehicles had the highest growth rate in the first nine months of 2017 compared to the previous year – with a growth rate of 34.6% to 94,125 units. However, their market share of 5.3% in September is still low.

Ford is still the leading automotive brand in the UK with 234,180 units sold in the first nine months of 2017. Nevertheless that means a negative growth rate of 7.9% and a decreased market share of Ford from 11.8% in 2016 to 11.3% this year. Volkswagen ranks second with sales of 165,376 units year-to-date in September (8.0% market share, +1.5% year-to-date). Volkswagen overtook Vauxhall (Opel's twin brand) in the third quarter of 2017, which is now in third place with 161,751 units sold (7.8% market share, -20.3% year-to-date). In the case of Opel/

UK: Monthly Car Registrations
2016 - 2017 (thousands)



Vauxhall, the over proportionate decline is not caused by Brexit influences, but rather by uncertainties and changes in sales patterns due to the recent takeover by France's PSA Group. Autofacts anticipates a negative annual growth of -4.0% to 2.58 million new car registrations in 2017 in total, marking the first year of actual decline in almost a decade. Recently, the automotive retail sector in particular has gone through significant restructuring and consolidation, making it today a role model and experimental ground for the most advanced sales and distribution strategies. Also, two of Europe's three largest automotive dealer groups have their mainstay in the UK, and are likely to extend their reach onto the European mainland as growth prospects in Britain wane.

UK ECONOMIC PROSPECTS AFTER BREXIT

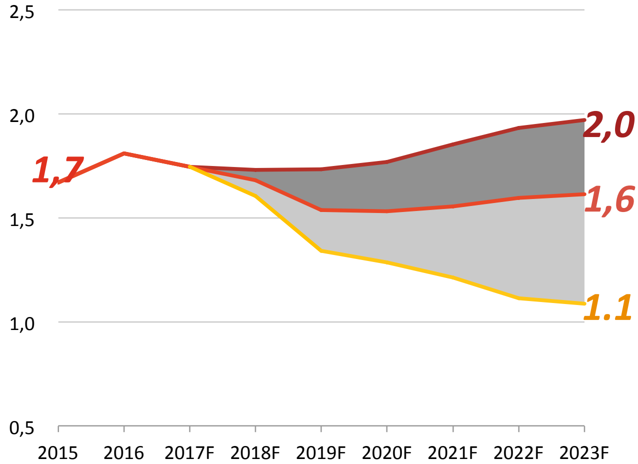
The European single market ensures a high degree of economic and regulatory integration. This level of association is shown in how the automotive industry has strategically set up its business operations in terms of supply chains, production sites and distribution networks.

The European Automobile Manufacturers' Association (EAMA) also highlighted that vehicle producers operate almost 300 plants across the continent, often manufacturing components such as engines in one country and assembling vehicles in another. These integrated business models would not be possible without the four freedoms of the Single Market. A prime example of this tight integration is the purchase of parts. According to interviews with vehicle manufacturers and logistics operators, vehicle assembly in the UK is fully integrated into Europe's just-in-time and just-in-sequence supply networks, with the Channel not creating any obstacle due to the absence of customs controls and paperwork. If that were to change even slightly – with transport times becoming either longer or harder to predict – the entire automotive value chain would have to be restructured. As the mainstay of automotive suppliers are based on the EU mainland, such a restructuring would mostly lead to a reduction of assembly in the UK, while monetary impacts – such as taxes, levies and customs – could be compensated by either changes in exchange rates or increased efficiency in operational processes. The EAMA reported that in 2016, the UK imported 14.1 million auto parts and components, worth €11.6 billion, from the EU27 – representing 80% of the value of the UK's total parts and accessories imports. At the same time, the United Kingdom exported 21.6 million auto parts and components to the EU27, with a total value of €3.9 billion (or 70% of the UK's global parts and accessories exports value). In the light of the EAMA's report, any changes to the deep economic and regulatory integration between the EU and the United Kingdom would most certainly have an adverse impact on automobile manufacturers with operations in the EU and/or the UK, as shown in our forecast below. (ACEA, 2017) As an illustration of the likely ease and speed of re-locating vehicle assembly from the UK to the EU mainland, we have composed the chart below based on Autofacts' detailed analysis and forecast of vehicle production.

In the above mentioned chart, „Immediate Transfer" refers to the ability to re-allocate production volumes within a few weeks due to existing technical installations in factories on the EU mainland. Volumes requiring a minor factory conversion - such as retooling for another vehicle version or expansion of existing capacity – could be accomplished within a year of the decision. Brownfield constructions such as expansion of existing facilities to accommodate new products take as little as two years, while a complete "greenfield" factory can be set up within three years. This chart is to illustrate that theoretically – following a consensus that automotive manufacturing has no future in the UK – the industry could close shop entirely within three years. This is of course an unlikely and extreme scenario, but should be considered to be a possible fate of any individual car manufacturer or assembly line.

The main factor dampening such a drastic development – aside from the tremendous cost such a shift would induce – is the still-relevant size of the UK domestic market, which is currently mainly served from factories on the EU mainland. If the export and import of parts and vehicles between the UK and the mainland should get increasingly difficult or costly, in a first move assemblers would strive to increase the number of vehicles produced for local consumption, rather than risk a complete shift and loss of market share. This may create some inefficiencies due to higher complexity of manufacturing, but would help to isolate the UK industry from some of the adverse effects of a "hard" Brexit.

UK: Production Scenarios
2015 – 2023 (in million units)



UK automotive export performance since 2007 appears to have been stronger outside the EU than within the Single Market. This could reflect an advantage to euro area members have in using a common currency or the inflexibility of trade linked to European supply chains.

New free trade agreements with countries outside the EU will take a long time to secure and are therefore likely to offer limited benefits to UK trade in the immediate aftermath of Brexit.

In the most unfavorable case, production in the UK could fall to about 1.1 million units in 2023, while ideally increase up to 2 million units of passenger cars and light commercial vehicles. The decision for a particular scenario will come as early as 2018, after which a change in direction will become much more difficult.

SUMMARY

The automotive assembly sector in the UK is highly dependent on its interconnection with the European supply parts markets, and will suffer more strongly from any administrative impediments than from financial hurdles emanating from the Brexit process. The sizeable local-market demand for new cars and the highly efficient and powerful automotive retail sector provide some dampening influence on possible rash decisions to be taken by automotive manufacturers, as products and factories require constant renewal and maintenance for the continuation of their operation.

With growing uncertainty concerning the terms of trade as well as exchange rate relations, other near-shore assembly locations around the European market (namely Turkey, Morocco, Algeria, Portugal, and of course the highly dynamic Central European countries) are upping their game to attract new investments by vehicle assemblers and component suppliers.

With this new competition in mind, we believe that it is high time to offer a clear perspective for the automotive assembly sector, as ongoing investment decisions cannot be delayed any further – and growing efficiency pressures with vehicle manufacturers may find a welcome excuse in the external uncertainties to target any UK operations with increased scrutiny. All that said – speed in creating a clear perspective is of the essence!

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