

Automotive & Assembly Practice

Down but not out: How automakers can create value in an uncertain future

After delivering record profits in 2017, global automakers have faced several challenges over the past 12 months. Can the industry find a sustainable path to value creation in this disruptive environment?

by Harald Deubener, Prateek Gakhar, and David Kohn



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Nearly ten years after the automotive industry's surprisingly strong postcrisis recovery, 2017 was a peak year for its earnings. However, despite this decade-long winning streak, investors are discounting auto stocks, expecting traditional OEMs to fall short in the rapidly shifting world of future mobility.

Global automakers had a tough year in 2018, with several headwinds: higher expenses required to meet stricter emission regulations, global trade tensions, and slowing sales in key end markets. These triggered profit warnings at several large OEMs.

The first half of 2019 has looked challenging for the industry, with some large OEMs announcing declines in profitability and scaling back full-year profit guidance. Given that key risks for the industry remain elevated and that competition

from new mobility attackers is intensifying, the road ahead looks bumpy.

Where's the money? A granular look at the industry profit pool

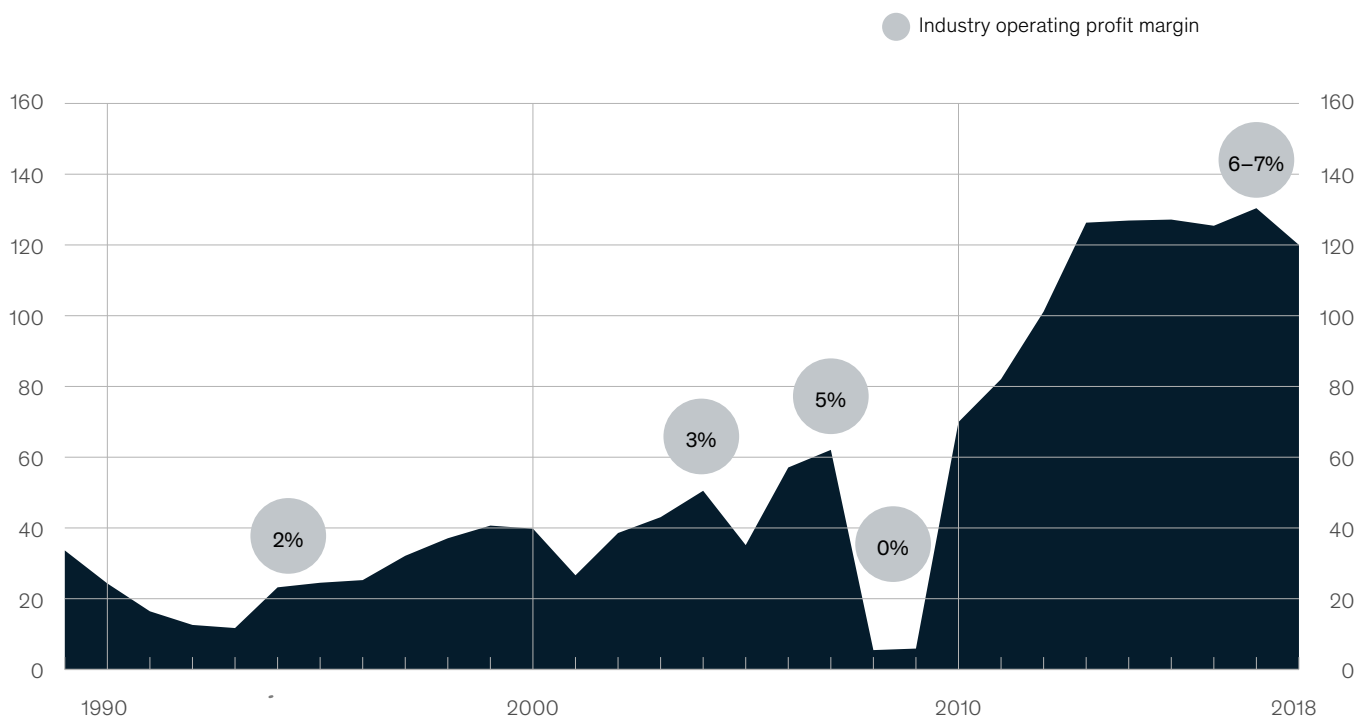
The auto industry's strong performance over the past five years results from a fizzy blend of high volume growth, a product mix that favors higher-margin vehicles (like SUVs), and strong growth in China. While the industry achieved peak profits of \$130 billion in 2017, attempts to take the pulse of the market must start at a more granular level, digging into what's happening at the regional and product segment levels, where it is possible to identify true winners and losers.

While estimated aggregate industry operating profit margins are 6 to 7 percent (Exhibit 1), large

Exhibit 1

Is the global automotive industry facing a cyclical downturn?

Automotive OEMs' core automotive operating profit,¹ \$ billion



¹Shows operating profit before interest and tax (earnings before interest and taxes) from core automotive operations for top 21 global auto OEMs only. Excludes profits from financial services and other business segments.

Source: McKinsey analysis

variations in profitability exists across companies. For instance, some European niche, luxury companies make double-digit margins more akin to those of high-tech players, while mass-market (or value-focused) OEMs make 4 to 5 percent.

Regionally, China and North America continue to chug along as the leading global profit engines, contributing nearly 65 percent of global industry profits. Europe, while home to most of the 15 largest global OEMs, still contributes only about a fifth of the global industry profit pool, despite a strong rebound in profitability seen recently.

Viewed across the three main archetypes, value-focused OEMs contribute roughly 55 percent of the global industry profits, premium automakers provide an estimated 40 percent, and entry-level players contribute only about 5 percent.

Will 2018 be remembered as the beginning of the 'downturn' for the auto industry?

Has all the impressive profit growth ended? Initial indicators suggest an impending downturn, with the first signs of slowdown visible in China and North America markets, which are mainstays. Chinese passenger-vehicle sales declined 3 percent in 2018—the first decline seen in decades—as macroeconomic uncertainty weighed on consumer sentiment. Slowing Chinese demand has major implications for the auto industry, with nearly 30 percent of global industry profits coming from the region. While the premium segment was immune to the China market weakness, the mass-market segment saw severe volume declines in 2018.

Capital-market performance appears to reflect this pessimism: in 2018, most automakers saw double-digit declines in stock prices and low valuation multiples, highlighting the potential risks perceived by investors going forward. Pressures on future profits include rising input costs, higher costs to meet stricter emission regulations, higher R&D costs for developing electric vehicles (EVs) and autonomous vehicles (AVs), and increasingly sluggish end markets. Automakers acknowledged the impact of these risks in 2018, with several large

OEMs issuing profit warnings and scaling back profit targets.

With so many moving parts, executives at auto OEMs are finding it increasingly challenging to forecast the future path of profitability.

Auto-industry valuations continue to remain discounted compared with the broader market and other industries

The automotive industry is rarely an investor sweetheart, but the cyclical sector's current relationship with capital markets nonetheless illustrates the abrupt love–hate relationships that stocks in the industry can endure. In fact, one could argue that this bias has caused investors to miss several opportunities to reap improved profits from automotive performance. Today, with an aggregate P/E multiple of 7x, incumbent automakers' valuations remain deeply discounted compared with the broader market and other industries (Exhibit 2). For example, S&P 500 trades at a P/E multiple of 17x.

While the industry's average P/E multiple is 7x, some European mass-market OEMs trade at the lower end of the range (multiples of 4–5x). On the other hand, Asian OEMs dominate the higher end of the range (multiples of 8–10x). While the industry has historically traded at a discount compared with the broader market, the current industry P/E multiple is even lower than the long-term average of 9–10x.

The industry's current low valuations appear to reflect investor skepticism regarding automakers' abilities to defend future profitability in view of the imminent risk of a cyclical downturn in key end markets and of the higher costs to meet regulatory requirements and develop AVs and EVs. The current valuation of auto stocks suggests that investors expect industry operating profit margins to drop from their current 6 to 7 percent level to roughly 2 to 3 percent over the long term.

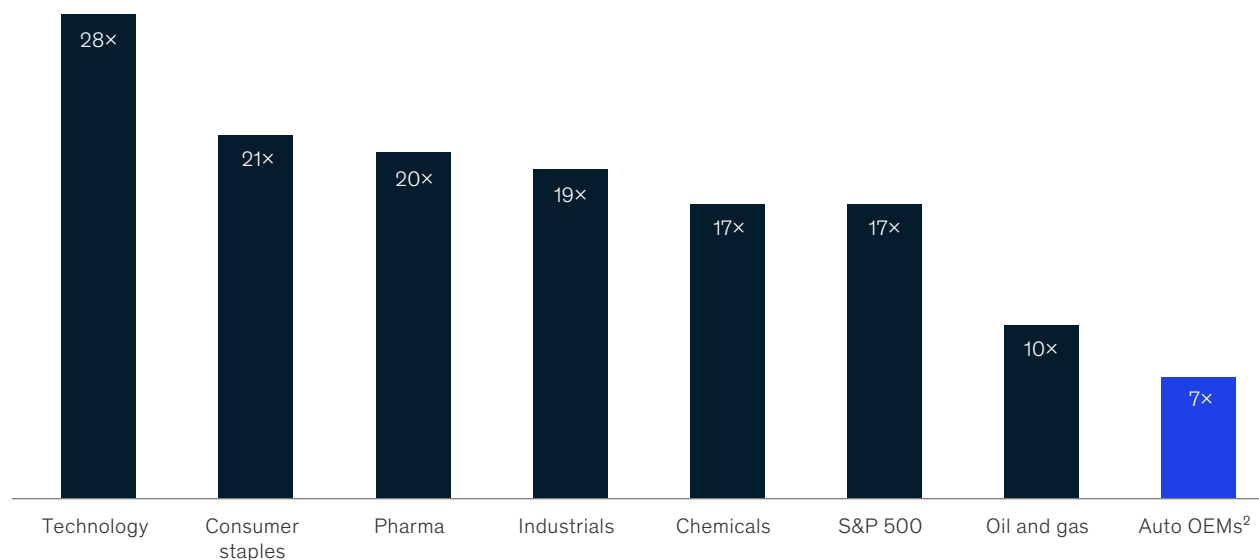
Not all auto stocks are equal

Automotive-company valuations have recently become a complicated topic for investors. While

Exhibit 2

Auto-industry valuations continue to remain discounted compared with the broader market and other industries.

P/E multiple¹



¹Shows average P/E (1 year forward) of top 50 companies (by market cap) of each sector except auto OEMs. Multiples as of Aug 1, 2019.

²Average P/E of BMW, Daimler, Fiat Chrysler Automobiles, Ford, GM, Honda Motor, Hyundai Motor, Kia Motors, Mazda Motor, Nissan Motor, PSA, Renault, Suzuki Motor, Tata Motors, Toyota, and Volkswagen. Multiples as of Aug 1, 2019.

Source: S&P Capital IQ

the big, traditional, mass-market OEMs trade at the multiyear low P/E multiple of 7x, another group of small and niche players trade at P/E multiples that exceed 20x. Investors appear skeptical about traditional OEMs' ability to win under the new paradigm, while new-technology entrants continue to attract billions of dollars of capital.

These nontraditional businesses include EV and AV manufacturers, shared-mobility companies, and other new, mobility-focused high-tech players. In one extreme example of this dichotomy, the current valuation of Uber—which listed earlier this year—is around \$60 billion (market capitalization), far exceeding the valuation of the Detroit automakers that have dominated the US auto industry for decades. Uber's competitor Lyft also went public earlier this year, with a valuation of nearly \$20 billion, further raising hopes of investors in new mobility themes.

However, it would be unfair to paint all OEMs with the same robotic airbrush. In fact, investors have clearly differentiated: over the past five years, the shares of top-quartile OEMs (based on total shareholder returns) have delivered nearly 20 percent annualized returns—significantly more than that of S&P 500.

The rapidly changing world of personal mobility

Taking a cue from the high-tech industry, many automakers are developing new automotive ecosystems in which cooperation trumps competition and agile thinking takes precedence over traditional ways of doing business. The challenges of succeeding in this new environment can be significant for incumbents, given the changes involved. The pace of change will not only require OEMs to alter operations and applications

but also necessitate a shift in mind-set, from an approach primarily focused on manufacturing excellence to a business model that puts consumer services at its center.

Doing business in the personal-mobility landscape may look very different in the future. Value will likely shift toward new, disruptive business models, with shared mobility and connectivity solutions estimated to account for nearly 25 percent of total automotive revenues by 2030.

Today, OEMs are making about \$0.01 in profit per mile driven. Based on our estimates, new mobility services have the potential to generate up to \$0.10 to \$0.25 in profit per mile over the long term. This has significant implications on the strategic choices OEMs need to make today to decide where to play.

Coughing up capital

For traditional OEMs, the transition to new core technologies will require significant investments in the forms of capital expenditures and R&D. Our earlier research suggests that achieving at least a defensible position in house for each of the four technology-driven trends (autonomous driving, shared mobility, connectivity, and electrification) would require an established automotive manufacturer to commit to investments totaling more than \$70 billion.

This could put significant pressure on future cash flows, a possibility that makes investors cautious. The industry's low valuation multiple—with the industry staring at a cyclical downturn and rapidly increasing costs to transition to future technologies—reflects this pessimism.

Skepticism also exists regarding the ability of traditional OEMs to emerge as winners in an automotive ecosystem in which software and digital technologies increasingly emerge as critical factors for success. While some OEMs are struggling to keep pace with the rapid transition, others have made significant progress with new technologies like electrification and autonomous driving. However, traditional OEMs appear to receive less credit for technology advances, while industry newcomers often earn soaring valuations.

How incumbents can fight back: Finding a path to sustainable value creation

Nothing succeeds like success, but after years of delivering strong performance, traditional automakers may wonder why the capital market isn't giving them the respect they have earned. From habitually undervalued stocks to the guillotine-like business cycle and asset-heavy realities the industry must endure, automotive players often find themselves at odds with market perceptions.

To continue the winning streak in the new mobility ecosystem and help capital markets recognize this success, OEMs can consider the following strategies:

- **Preparing for and taking advantage of the next downturn.** Our research suggests that companies that prepared proactively in previous downturns emerged stronger, sustained advantages over competitors longer, and delivered TRS growth that was structurally higher than the sector median. The following strategies may be useful in preparing for and taking advantage of the next downturn:
 - **Proactively safeguarding the P&L.** Lowering fixed-cost rigidity, mitigating supply-chain risks, and proactively reducing material cost would help protect profitability as volumes come under pressure. Our research shows that in previous downturns “resilient” prepared earlier, moved faster, and cut deeper when recessionary signs were emerging by focusing primarily on operational effectiveness.
 - **Creating balance-sheet flexibility.** Reducing leverage and building a safety cash buffer can help OEMs not only manage liquidity challenges through the downturn but also provide firepower to pursue tactical M&A opportunities. This can be achieved through smart portfolio rationalization by divesting noncore, low-growth, and high-cash-burn businesses while strengthening downturn-resistant businesses (for example, aftermarket).

- **Embracing transformation.** Downturns can serve as a good opportunity to evaluate the opportunity to serve new customer segments, explore new business models (such as mobility as a service), and create new partnerships. Market downturns also present opportunities to claim share from less-prepared competitors who are weak in the aftermath.
- **Collaborating on internal-combustion-engine (ICE) development.** As ICE technology gets commoditized over time, there is an opportunity for OEMs to save billions (nearly \$50 billion over the next ten years, based on some analyst estimates) by collaborating on ICE-powertrain development. In addition to optimizing resources by removing duplicate investments, this would also help free up capital for investment in new mobility themes.
- **Cooperating on powertrain electrification.** OEMs could explore multiple areas of collaboration on the electrification theme. First, securing battery supply through supply-chain partnership (including joint raw-material procurement) could be a key source of competitive advantage going forward. These partnerships could also serve as building blocks for next-generation battery-technology development. Second, there is scope for greater collaboration on electrically powered drive-system (e-drive) technology. This could potentially eliminate multiple competing systems from OEMs and suppliers. While some mass-market OEMs may already be exploring such cooperative opportunities, premium OEMs must also consider joining hands to remain competitive.
- **Working together on AV technology.** Development of operating systems for AVs and AV infrastructure (including vehicle-control and -maintenance centers) could be a lucrative area for partnership among OEMs. Not only would this help save billions of dollars in R&D costs, it could help provide better access to end consumers.
- **Monetizing connectivity services and car data.** The importance of cars as part of a connected network for the consumer is growing: the percentage of consumers ready and willing to change car brands for better connectivity has doubled over the past two years. In the premium segment, the majority of OEMs have already installed fully connected infotainment systems in 100 percent of their new vehicles. These systems are used to provide a diverse range of in-vehicle services to drivers and diverse data sets to third parties.

By 2030, we believe car-focused, data-driven, and connected applications can create a revenue pool of more than \$200 billion. This could be in the form of add-on services, such as usage-based insurance, pay-per-use model for hardware or software services, and data monetization. In the cloud-gaming industry, for instance, companies have successfully monetized this model and are already making nearly \$150 per user annually.

Automotive companies are also in advantageous positions to capture monetization opportunities from car data. Our research finds that, so far, automobile consumers around the world are highly willing to share their data when they experience value in return.

Traditional automakers have worked hard to change investor perceptions about their prospects for decades. Now coming off a solid run of record performance, the industry has an opportunity to convince markets that the disruptions currently transforming the industry can become new sources of sustainable value for incumbents in this cyclical industry.

Harald Deubener is a senior partner in McKinsey's Stuttgart office, **Prateek Gakhar** is an expert in the Gurgaon office, and **David Kohn** is a senior expert in the New York office.

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