Global Auto Makers: Megamergers May Do Little to Meet Industry Challenges

Fiat, Chrysler, Jeep, Renault and Dacia all under one roof? The FCA-Renault merger plan follows persistent auto sector merger talk[1] that coincides with slowing global demand and growing technological challenges. But is a new megamerger the right response?

There are two reasons for scepticism: the limits to economies of scale and the difficulty of executing merger plans smoothly.

We recognise that the auto industry is bracing itself for a downturn amid slowing economic growth worldwide following an extended cyclical recovery from the Global Financial Crisis. If nothing else, the EUR 33bn FCA-Renault merger, which would create the world's third biggest car maker, is typical of merger deals that signal the business cycle is turning. The threat of an all-out trade war between the US and China, the world's two biggest auto markets, is another danger for the industry.

Established original equipment manufacturers (OEMs) and their suppliers are also confronting the need for heavy investment in research and development to avoid being left behind by two trends. Further tightening of environmental regulations in many parts of the world is spurring demand for electric vehicles, with rapid growth from a still small base. Cars are also being transformed from a primarily convenient means of transport into mobile, shared and possibly autonomous information and entertainment systems.

Putting these trends together explains why OEMs would be tempted to spread development and production costs over bigger businesses by volume, particularly when sales are in danger of shrinking. The cyclical nature of auto demand and the industry's capital intensity also favour manufacturers with deep pockets as the Global Financial Crisis demonstrated when demand shrank abruptly, notably for commercial vehicles.

Figure 1: Global light vehicle production remains highly concentrated

Top light vehicle manufacturers	2013	2014	2015	2016	2017
Top 5 LV producers	54%	54%	53%	52%	49%
Top 10 LV producers	79%	79%	78%	76%	74%

Source: LMC/Autoliv

[1] Fiat Chrysler chairman pushes for more carmaker tie-ups – Financial Times (24 March 2019);
Daimler, Geely deepen bond with electric city-car venture – Wall Street Journal (28 March 2019)
The auto industry is overdue a bout of mega-mergers – Washington Post (1 April 2019)

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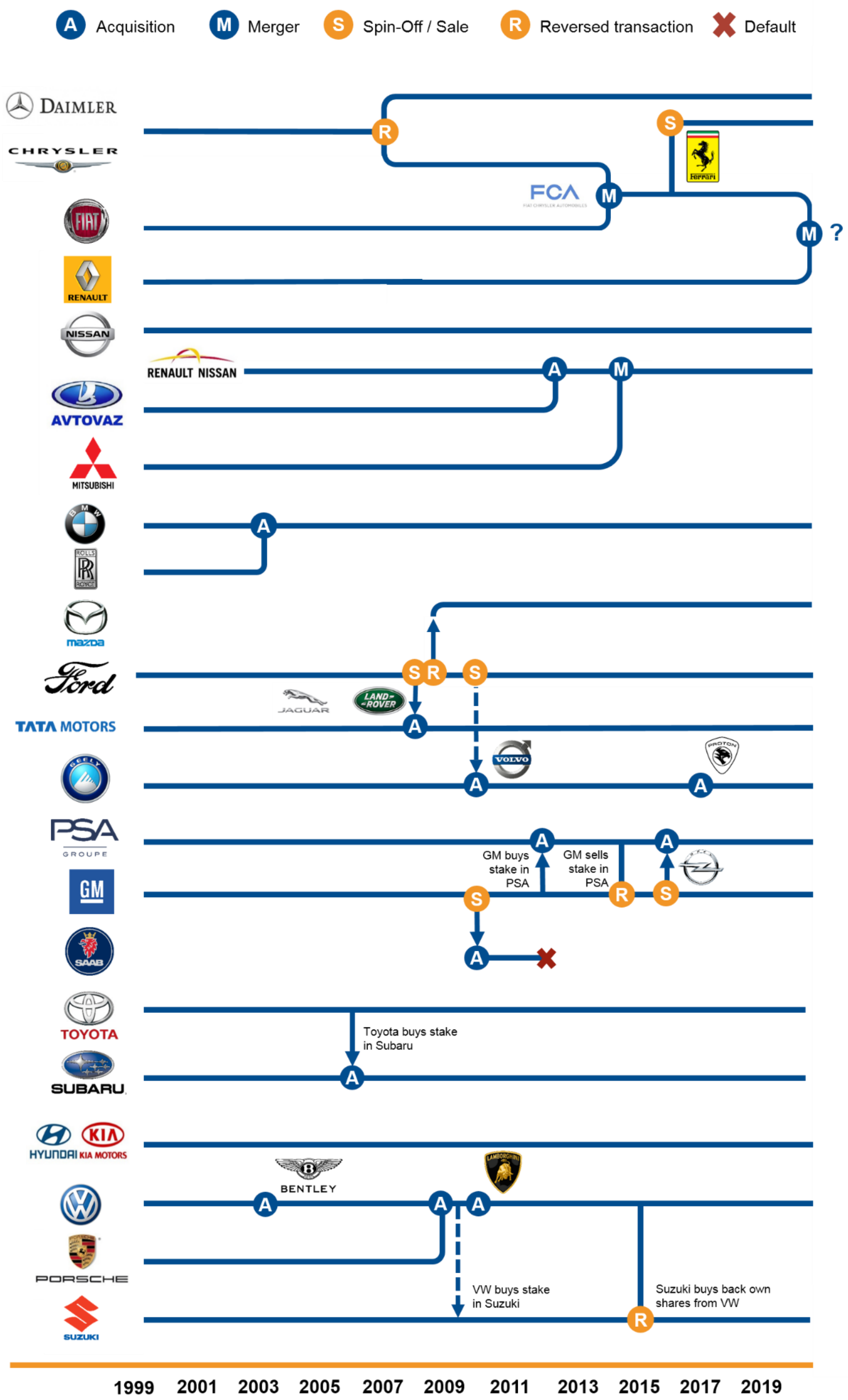
Simplified overview of auto-sector consolidation 2000-2019



Source: Scope Ratings

Economies of scale: electrification poses news challenges in the consolidated auto industry

But are more full-blown mergers the answer? There are two reasons for scepticism: the limits to economies of scale and the difficulty of executing merger plans smoothly.

Scale has undeniably been important for mass-market car makers, particularly given the engineering complexity (partly regulation-driven) of making ever more efficient and low-emission petrol- and diesel-fuelled vehicles. Roughly three quarters of global auto output is in the hands of just 10 manufacturers, even though the proportion has slipped slightly in recent years.

Economics of electric motorisation are different

However, the economics of electric motorisation are different from the economics of the internal combustion engine. The mechanics are much simpler, while raw materials – nickel, lithium and cobalt – represent significant battery costs which extra scale can only compress a little. Current battery cells have about 45% to 50% nickel content.

According to calculations of the US Department of Energy, the cost effects from scaling up battery cell production facilities are not as significant as one would expect.

The department calculates that the production cost for battery cells decreases by 9% when production is increased from 10,000 battery cell packs (of 60 kWh each) to 50,000 units while an increase from 100,000 units to 500,000 suggests a cost decrease of 12%. Currently, most of the battery cell manufacturers have capacities of 3 GWh to 8 GWh suggesting production of 50,000 to 130,000 cell packs (assuming 60 kWh cell packs). Battery cell factories under construction in various countries worldwide including Hungary, China, India will all be ‘gigafactory’ size, with an annual capacity of 25 GWh to 35 GWh. Hence, once these factories are fully loaded, a unit-cost gain of USD 20/kWh-USD 25/kWh should materialise (assuming unchanged input prices). This compares with the current rate of about USD 180/kWh-USD 200/kWh for battery cells.

In addition, important input materials for battery cells are traded globally. Battery cell makers and, in turn, auto OEMs are price takers in those markets and larger quantities of orders will have a negligible if not zero impact on the global price of those materials.

OEMs favouring bolt-on technology acquisitions

Will extra scale deliver results when it comes to designing and producing connected and autonomous cars?

Some auto makers clearly think so, but we believe that special partnerships and bolt-on acquisitions are more promising. BMW and Daimler, for instance, have created separate partnerships to pool investment in car sharing and autonomous driving based on earlier small acquisitions. At the same time, Volkswagen has teamed up with Ford to work on joint projects.

Hard lessons from auto industry’s merger history

If partnerships are proving popular, automotive history may explain why: mergers have not served investors well.

Daimler had a notoriously unhappy experience as the owner of Chrysler in the 1990s. General Motors and Ford spent billions of dollars trying and failing to make a success of acquisitions in Europe. PSA is currently in the process of integrating Opel, acquired from GM, but Saab failed as an independent company after being jettisoned by the US auto maker. Volvo, sold by Ford to China’s Zhejiang Geely Holding Group, has prospered under new ownership. The road has proved rockier for Jaguar Land Rover, another ex-Ford business, under the Indian ownership of Tata Motor Co.

For years, the Renault-Nissan alliance, now incorporating Mitsubishi and control of Russia's Avtovaz, looked like a successful halfway-house between the commercial and technical partnerships common in the industry. But Nissan's recent poor operating performance has provided the backdrop for the boardroom crisis at the alliance.

Scale has comforted creditors in some OEMs…

For creditors, companies with the ability to draw on diverse cash flows to maintain capital buffers and long-term R&D spending to survive the auto sector's cyclical ups and downs are comforting.

Some of the world's biggest manufacturers already have sturdy investment grade ratings. Daimler is rated A/Stable by Scope. Volkswagen is rated BBB+/Stable by S&P and Toyota is rated AA/Stable by Moody's. The US sector's creditworthiness is more strained, with Ford rated one step above junk by Moody's and two steps above junk by S&P.

…but is no guarantee of superior profitability

Smaller automotive-sector companies with less scale but more targeted markets can also prosper. Just look at the 23.3% operating profit margin at winter-tyre specialist Nokian in 2018 compared with mass-market rival Michelin's 12.6%. Or compare luxury sports-car maker Ferrari's margin of 24.1% compared with 3.7% generated by the automotive activities of mass-production pioneer Ford.

Deal-making scrutiny remains essential

As new big automotive merger plans see the light of day, investors will do well to scrutinise them with extra care. Chief executives will have to do better than justify them on the grounds of gaining extra scale.

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