Slow-speed crash? Problems for the European auto sector pile up

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- **Four key factors – Labour relations, EV uptake, emissions regulations and China – are weighing heavily on the sector**
- **Healthy cash balances built up over the past three years will be tested as firms attempt to weather the oncoming storm**
- **It's hard to avoid the conclusion that the sector is heading for below long-run average profitability**

The European auto sector matters. It is one of the largest contributors to European research and development (R&D). It directly or indirectly employs significant amounts of labour in the EU's three largest economies (Germany, France and Italy), and within its constituents it has Europe's largest issuer of non-financial corporate bonds.

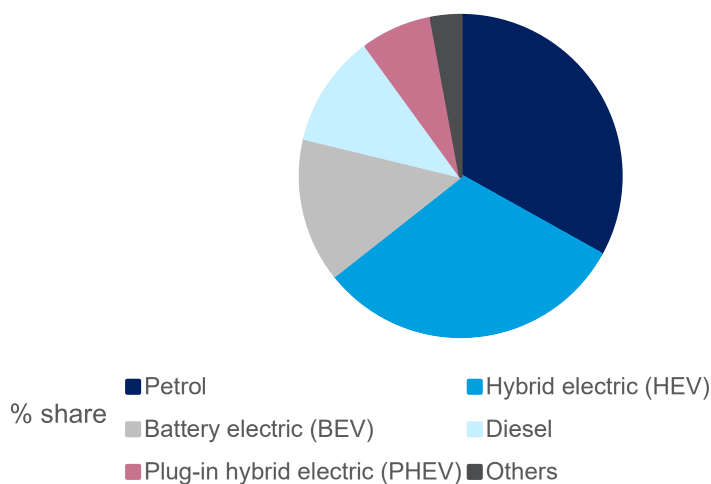
You do not need to be a clairvoyant, however, to see that the sector is likely heading for below long-run average profitability due to four key factors: Labour relations; uptake of battery electric vehicles (BEVs); emissions regulations; and China.

Labour relations The automotive sector, whether European or North American, is heavily unionised. Many European automakers have been unable to react sufficiently quickly to changing regulation, market dynamics and consumer habits due to the inflexibility that long-standing unionisation has brought to the industry. For example, Volkswagen's attempts to cut costs and return the VW brand to long-run average profitability were negatively impacted by a long-term collective wage agreement. Redundancies and factory closures are near impossible to execute.

BEV uptake BEV sales growth has slowed – both as a function of increasing absolute sales, but primarily due to waning consumer sentiment. Over the past year, BEV sales penetration in Europe has not just stagnated but reversed from 22% in August 2023 to 14.4% in August 2024.[1] The repeal of BEV subsidies in Germany is a cause of the majority of this. But even excluding Germany, BEV growth is still anaemic (Figure 1). Without greater governmental support for both infrastructure build-out and BEV subsidies, market share growth will not be meaningful, resulting in potential fines for manufacturers.

Companies stop hiring before they fire, and the hiring rate is at a six-year low. Temporary employment is a leading indicator of labour intentions and is back to 2010 levels (Figure 4). Bank lending is slowing, money supply shrinking and corporate bankruptcies rising.

Figure 1: motoring market share

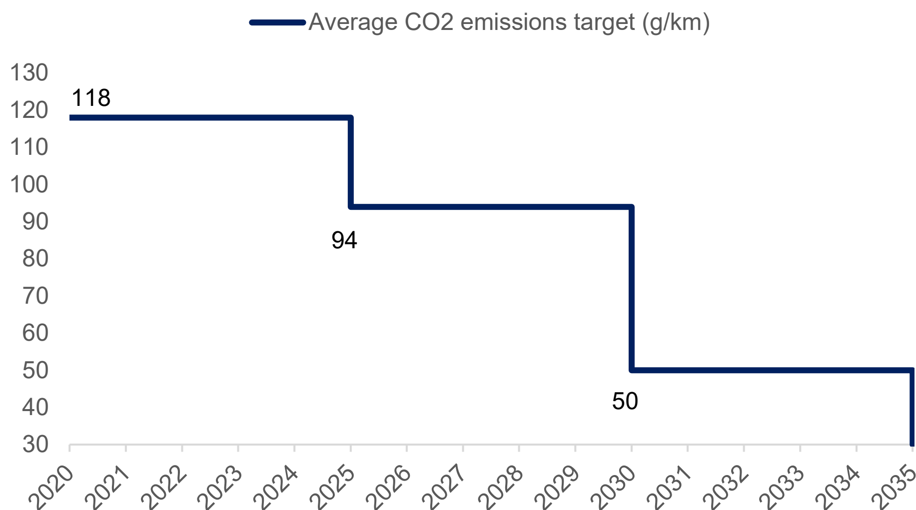


Source: ACEA press release, August 2024

Emissions regulation European automakers are almost certain to miss current emissions targets. Penalties will be levied at €95/g/km of CO2 over the limit. There is a substantial drop in allowed CO2 emissions in Europe in 2025 (Figure 2). To meet this target it would require roughly 22% of sales to be BEVs compared to the less than 13% seen as at July 2024. The UK's Zero Emissions Vehicle (ZEV) legislation is very similar to the rest of Europe, with a requirement for BEV sales to account for 80% of car sales by 2030.

[1] European Automobile Manufacturers' Association (ACEA), August 2024

Figure 2: European emissions allowances



Source: EUR-LEX, Morgan Stanley Research estimates. Note: 2020 target adjusted to WLTP basis

European automakers have been lobbying policy makers directly – as well as through the industry trade body, the European Automobile Manufacturers Association (ACEA), which published a paper in September 2024 entitled "Auto industry concern on 2025 CO2 targets as EV market stagnates" – over the likelihood of meeting these targets.[2] It quotes former ECB president Mario Draghi who "stated in his Competitiveness Report, 'the automotive sector is a key example of lack of EU planning, applying a climate policy without an industrial policy'."

As such, EU emissions regulation will need to be relaxed in order to not materially damage European automakers' viability. The Italian government has already called for changes to the regulations, recognising the dangers of the legislation in its current form.

China Not only are European automakers impacted by declining Chinese demand, they are also subject to potentially unfair competition in both the Chinese and European markets. The Chinese market accounts for more than 30% of the sales of major European automakers, such as VW, BMW and Mercedes Benz. BMW issued a profit warning in September partly due to "ongoing muted demand in China".[3] VW, meanwhile, has seen the proportional profit from its Chinese joint ventures decline 45% between 2017 and 2023. More widely, foreign manufacturers' market share in China has fallen to 37% in July 2024 from 64% in 2020. Previously, much has been made of the overcapacity within the Chinese auto sector for both domestic and international automakers, exacerbating the situation for European manufacturers that had considered China a cash cow and a key export market.

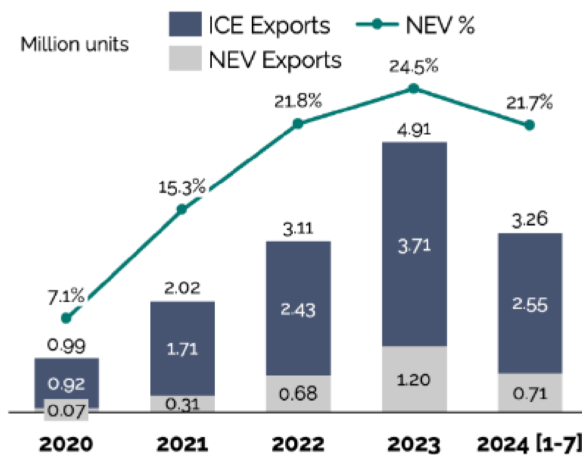
With those manufacturers overproducing in China, it is natural that these excess vehicles will be exported. They therefore face the situation that not only are they unable to sell their vehicles into their expected major export market, but that market is now attacking their domestic sales (Figure 3). Tariffs, rather than protecting European automakers, are likely to be more neutral as

[2] ACEA, Auto industry concern on 2025 CO2 targets as EV market stagnates, 12 September 2024

[3] BMW Group, BMW Group adjusts guidance for 2024 financial year, 10 September 2024

European automakers exporting their vehicles from China will be subject to the same European tariffs as Chinese-owned car makers will be! Chinese manufacturer penetration of the European market is low, so there is much room to expand. Chinese tariff retaliation to-date has been on luxury goods such as brandy, but is likely to escalate to cars should the tariffs begin to bite.

Figure 3: China internal combustion engine vs NEV vehicle exports 2020-24(1-7)



Source: Automobility, State of China's Auto Industry, May 2024

Conclusion

Following the exceptional profitability that European automakers demonstrated immediately after Covid-19 restrictions were relaxed, the sector is now faced with unprecedented challenges. While cash balances are very healthy at many major European car companies, having been built up over the past three years, they will be tested as they attempt to weather the oncoming storm. Some of the pain may be avoided if regulations are relaxed or subsidies are instigated/increased for BEV sales. But it seems hard to avoid the conclusion that automakers will be materially impacted by the four forces outlined above.

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