Brexit Monitor

The impact of Brexit on the automotive sector

Automotive sector

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The outcome of the UK's EU referendum, has created significant market uncertainties. The drop in value of the pound has created immediate effects on goods imported to and exported from the UK. Longer term impacts include economic effects, as well as potential new tariffs and other barriers to trade. Due to the exceptionally global nature of car manufacturers and supplier groups, the consequences of the UK's EU referendum create a major challenge for the industry.

Setting the scene: the UK automotive industry

According to figures from the UK's HM Revenue & Customs on the most important product categories traded, motor vehicles stand out as the commodity with the highest share of trade between the UK and EU. In 2015, four out of five cars (77.3%) assembled in the UK were sold abroad. Of those, 57.5% were exported to the European Union which makes the EU the biggest export market for UK built cars. This corresponds to a value share of 52.8% or €14.6 billion of UK's total automobile exports according to the European Automobile Manufacturers' Association (ACEA). Currently, no tariffs apply to the trade in motor vehicles between the UK and EU, but this could change depending on the future trade agreement between the EU and the UK. While economic activity in the UK and EU has held up relatively well in the immediate aftermath of the Brexit vote, future trade effects on the UK automotive sector could be significant.

The UK automotive industry saw a major crisis in the 1980's and 1990's when poor products, low quality and overly rigid labour laws drew the sector almost to extinction. After being put back on its feet by massive overseas investments from US, European and Japanese original equipment manufacturers (OEMs) for vehicles, the UK automotive sector has since re-established itself as a leading force in the global automotive industry network. From an assembly perspective, the UK was ranked the fourth biggest automotive manufacturing location within the EU in 2015 and was the 13th largest automotive producer globally in the same year. But the UK is not only an important producer of motor vehicles and parts. It is also an important sales market. In absolute terms, the UK new car market is the second largest in the EU+EFTA region[1] with a total sales volume of more than 2.63 million cars in 2015. All in all, the Brexit impact on the UK automotive industry is significantly larger than that on EU counterparts.

Brexit therefore constitutes a major risk, should the UK be cut off from its main sales market and supply base. Unlike other industries with more local inertia, the automotive industry can essentially only take (re-)location decisions once in the 7-year life cycle of a new product, and will most often opt for the least risky option, even if this may entail additional up-front investment cost. So while negotiations with the EU are expected to last a while yet, a dedicated round of discussions on the repercussions for the automotive industry is important in order to make sure that the investment cycle remains unbroken. Sector-specific agreements with the EU may offer a strategy to shield the UK automotive sector from the wider Brexit discussions and the ensuing uncertainty.

Recent market developments in the European automotive sector

European sales are benefitting from considerable pent-up demand in several key markets as well as favourable fuel prices and financing conditions. After a record year for the EU+EFTA region in 2007, the financial crisis hit the sector in 2008 and it took until 2014 for markets to recover. After reaching its lowest point in 2013, the following year 2014 marked the turnaround and relief point for the European automotive sector. In 2015, this trend continued and sales accelerated even stronger by 9.5% to 15.9 million units. In the current year, the sales environment in the EU+EFTA region is markedly positive, despite a small slip in numbers in the month of July.

1 EU28 + Iceland, Norway, Switzerland, and Liechtenstein.

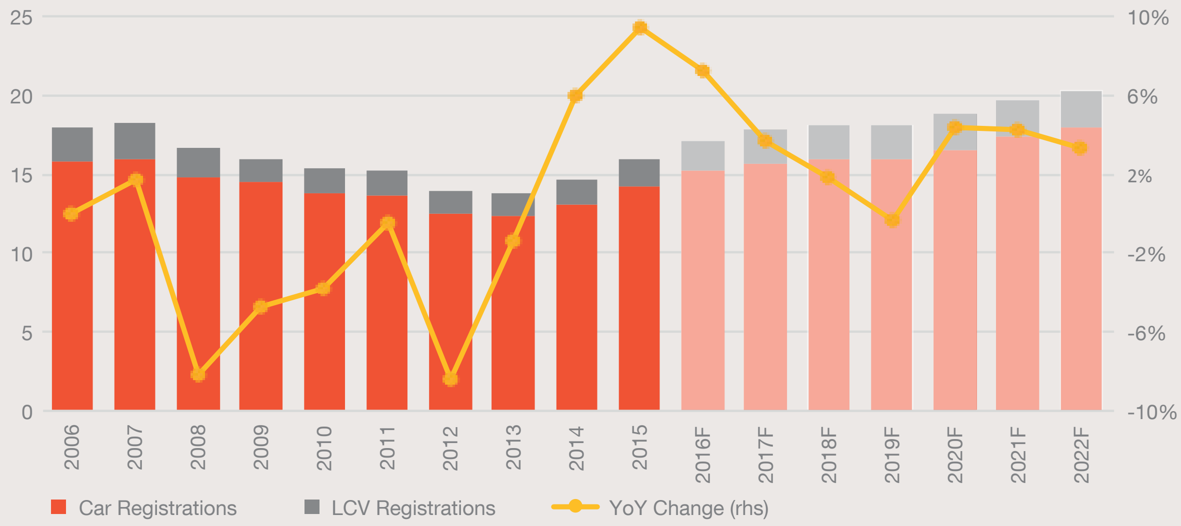
Automotive sector

Through the first half of 2016, sales increased by an impressive 9.1%. For the full year 2016, Autofacts' growth forecast for light vehicle sales is 7.2% reaching 17.1 million units sold. Among these, light commercial vehicles – traditionally seen as a good leading indicator for economic developments – are forecasted to make up 1.94 million units, with a growth of 10.8%. Seventeen of the thirty one markets[2] have achieved double-digit year-to-date gains, including two of the five top markets: Italy (18.3%) and Spain (11.8%). France (6.4%) and Germany (6.6%) are performing well, too. In general the five top markets account for more than 80% of the total EU+EFTA light vehicle sales volume.

In spite of ongoing strong sales, the average age of cars in operation in the EU is still on the rise, indicating that annual sales remain below equilibrium, or that policy makers make the operation of very old vehicles comparatively too affordable. For 2017, total European new vehicle market growth is expected to slow down to 3.8%, and to 1.9% in 2018, on the basis of an expected gradual increase of fuel prices as well as the return of higher interest rates.

2019 could turn out to be a tough year for the European automotive industry both due to reasons related to Brexit - the UK is expected to leave the EU after two years of negotiation at this point - [3]as well as due to a cyclical decline in the US which is one of the most important export destinations of European manufactured vehicles. Additionally,

Chart 1 EU+EFTA: New Light Vehicle Registrations (millions)



Source: ACEA, PwC Autofacts Analysis

2019 could see a decrease in demand due to product-related factors as the automotive industry prepares to meet the stringent 95 gr CO2/km fleet emission regulations in 2020/2021, which equates to about 4.5 l/ 100 km average fuel consumption. In the lead up to this change, vehicles will be equipped with increasing levels of fuel efficiency technology, which will increase vehicle prices. In this context, in 2019 consumers may stand off due to the (rational) expectation that manufacturers will push and promote more fuel-efficient vehicles in 2020/2021, offering significant incentives on the latest technologies including advanced hybrid and EV drive trains, but also small vehicles with low consumption.

Nonetheless, in the short to medium term new car sales have a more structural upward potential, than risk of collapse; only a sudden and significant increase of fuel prices, interest rates or unemployment could be seen as substantial risk factors. By 2020, light vehicle sales are forecasted to surpass the sales volume of the peak year 2007, reaching of 16.6 million units, and light

2 Note that data for Malta is not available.
3 Once the UK triggers article 50, exit negotiations are stipulated to last two years. As the UK prime Minister has vowed to trigger article 50 by March next year, we expect negotiations on the exit deal to come to a close in 2019. The exception would be if after a unanimity vote in the European Council, and with the consent of the UK, the negotiating parties would jointly agree to extent this negotiating period.

Automotive sector

commercial vehicle (LCV) sales of 2.2 million units. Pent-up demand, fleet renewal requirements and interesting new products are expected to continue to push sales in the European markets. In the period until 2022, new light vehicle sales are forecasted to increase further to more than 20.2 million units. Between 2015 and 2022, all of the European top 5 markets are expected to experience total sales growth anywhere between 10% and 60%.

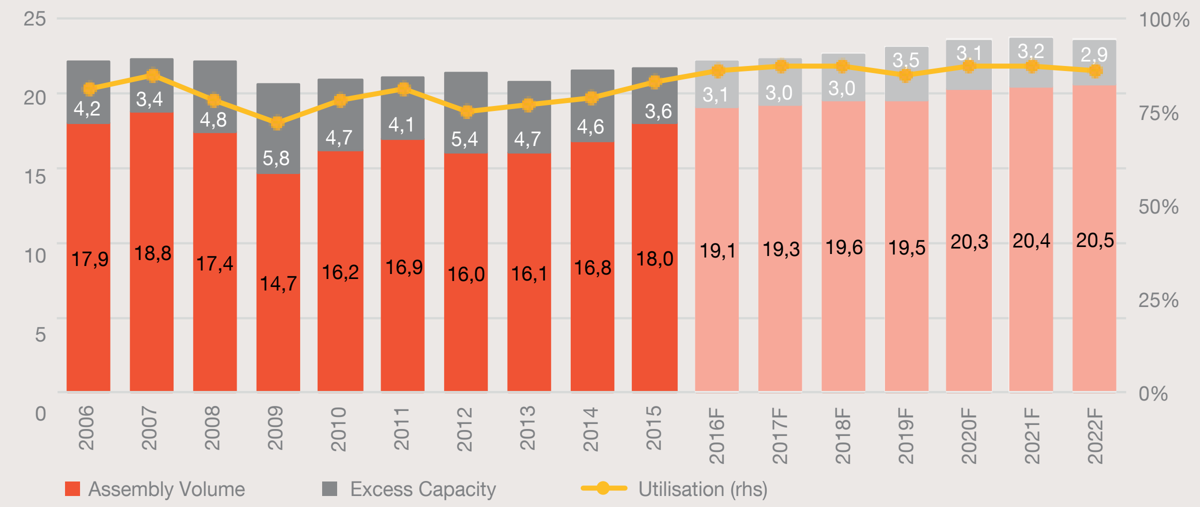
Likewise, light vehicle production in the EU region is expected to continue to grow as existing plant capacity continues to be filled and additional factories and added capacity come online. For the current year 2016, Autofacts forecasts EU assembly to grow by 5.8% to almost 19.1 million units, after a slightly stronger growth of 7.2% in 2015. By 2022, assembly is forecasted to grow to over 20 million units per year. The most dynamic contributors to the foreseeable growth between 2015 and 2022 are Spain (22.2%), Germany (20.8%), Italy (16.4%) and Slovakia (16.4%), confirming that these four countries continue to be important markets for light vehicle assembly, serving both domestic as well as overseas markets.

Recent market developments in the UK automotive sector

The UK car retail environment is one of the most professional and competitive in Europe. Therefore, the UK car park is one of the youngest in Europe and definitely the youngest among the European top 5 markets according to the German Association of the Automotive Industry (VDA). Since 2011, the UK market has seen an impressive growth of 35.7%, backed by a consumer-friendly environment, including low inflation and interest rates, attractive financing deals and continued regulatory pressure towards more fuel efficient cars. 2016 is likely to be the second year in a row in which new registrations will exceed the all-time high of 2.58 million cars sold in 2003 (by more than 100,000 units). Nonetheless, in the month of June, new car registrations posted its first decline of 0.8% after 51 months of consecutive monthly year-on-year growth. A slowdown of the market has been expected for some years now, and the first signs are visible. In fact the UK car market may have reached its peak, and strong growth is unlikely in the upcoming years – coinciding with, but not necessarily due to the Brexit vote. Thus, for 2016 Autofacts expects new car registrations to increase less strongly than in past years at 1.8% to over 2.67 million cars.

According to Autofacts' analysis, light vehicle assembly in the UK has recovered since the crisis-induced dip in 2009 when light vehicle assembly hit the low point at slightly more than 1 million units. Since then and until 2015, assembly volume has increased by more than 54%. Production is expected to grow by 8.5% year-on-year in 2016, to a total of 1.81 million units, which is equivalent to pre-crisis volume levels of 2003 and 2004.

Chart 2 EU TOP 5 Markets: Light Vehicle Assembly Outlook (millions)



Source: ACEA, PwC Autofacts Analysis

Automotive sector

Some immediate impacts of Brexit

UK based manufacturers have benefited from the strength of domestic demand in recent years as well as full access to the EU's Single Market. The recent fall in the value of the pound has had both positive and negative effects. A positive short-term effect is that exports have become more price-competitive, while the UK is still a member of the EU, supporting production in the UK. The adverse effect however, is the increasing cost of imported goods. The UK automotive sector relies greatly on the import of parts, components and fully assembled vehicles. This has already forced one manufacturer to increase its new car prices in order to stay profitable, while other automakers have warned of similar steps. New car sales in 2017 are still expected to remain broadly stable with a minor growth of 0.5%. In 2018 and 2019, however, new car sales could decrease to an estimated sales of 2.61 million and 2.45 million units respectively, mainly due to the uncertainty of the outcome of the Brexit negotiations and parallel economic struggles of the US economy in this time period, possibly increasing new car prices. Yet, by 2020, sales are again forecasted to increase by 9.0% to 2.67 million cars, on the back of increased car park renewal due to stricter emissions regulations and new technology.

For now, vehicle manufacturers and part makers have not made any announcement that they are leaving the UK. But the outcome of the UK's exit negotiations and the subsequent negotiations about the UK's new relationship with the EU, will determine the viability of long-term investments. This will affect the future of thousands of jobs in the UK, the UK economy at large, as well as the UK automotive industry. For the moment, the uncertainty about the future structure of the relationship between EU and UK has caused manufacturers to put investments on hold. One big Japanese car manufacturer recently announced that they will not make any further investments into their UK based plant unless the UK governments can commit to compensation in the case of import tariffs being imposed once the UK leaves the EU.

While automotive manufacturers are thinking about their possible courses of actions, for the time being investments are broadly put on hold. As the UK's exit negotiations come to a close in 2019 [4] and the conditions under which the UK will leave the EU will become clearer, automakers are assumed to enter a new decision-making phase. Depending on the outcome of both the exit deal and the UKs' future trading relationship with the EU, there are three different investment options available, namely: new investments, keeping the status quo or disinvestment. Those decisions are important and may have a significant impact on the automotive sector in the UK as well as on jobs and the economy at large. However, from the moment a decision is made until its implementation, there is usually a period of two to three years, meaning that those affected will have some time to adjust.

4 Anticipated end date of the exit negotiations.

Automotive sector

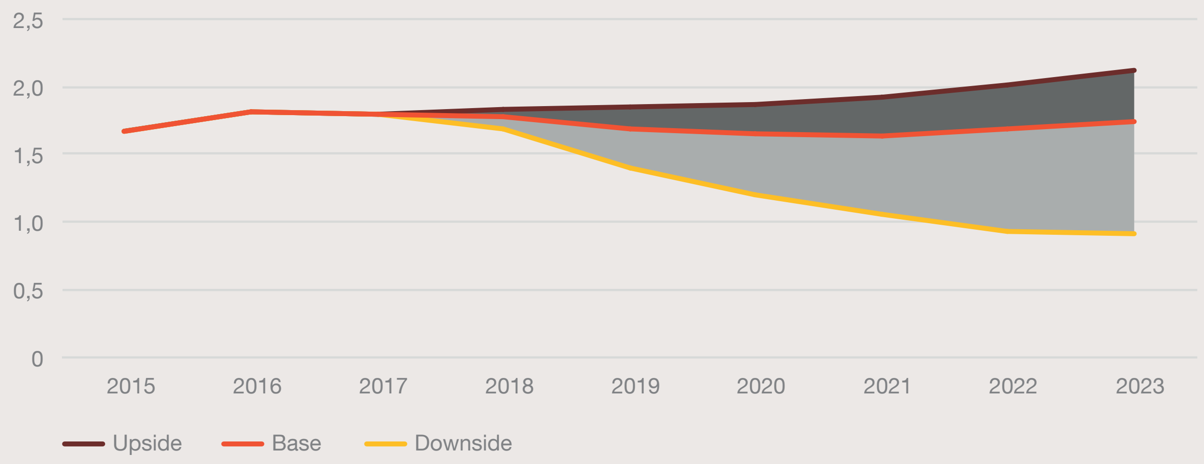
Future scenarios

Autofacts has modelled three scenarios for UK light vehicle assembly. While the scenario whereby the UK would remain an EEA member is by now largely hypothetical,[5] the upside scenario assumes that the UK will keep its access to the EU's Single Market. Therefore, manufacturers continue to invest into existing plants, dealerships and labour force of the UK automotive industry. Auto manufacturers remain committed to the UK as an automotive production hub. They aim to achieve high utilisation of their existing plants and keep their competitiveness in the global market. By 2022, light vehicle assembly is forecasted to exceed the 2 million unit mark under this scenario.

The base scenario assumes that the UK loses its unlimited access to the single market but is able to negotiate bespoke agreements for certain sectors, of which automotive would be one. Under this scenario, OEMs are expected to make no additional investments, but to keep the current status quo. In the time period between 2016 and 2022, UK light vehicle assembly is expected to decrease to 1.71 million units in 2022 before recovering slightly. Moreover, the growth rates during this period are rather mixed, due to a possible shift in production, reflecting the needs of the market.

The downside scenario in which the UK falls back to the most favoured nation (MFN) rules by the WTO, assumes a hard hit for the UK automotive market. As a consequence, manufacturers would not only stop investments but also disinvest in order to avoid the increasing costs of trade barriers and tariffs. This could mean the closure of plants and dealerships as well as layoffs at all levels of the automotive value chain. As most global manufacturing groups still show excess capacities in other European production facilities, production determined for consumption in the European market could be (at least partially) shifted to the EU mainland. Additionally, assembly of successive product generations as well as new models would most likely be shifted completely to these plants. In terms of light vehicle assembly, this could lead to a second crisis of the UK automotive industry and a sharp decline of output to less than 1 million units by 2022 – depending on manufacturer's decisions on volume re-allocation.

Chart 3 UK: Light Vehicle Assembly Scenarios (millions)



Source: Autofacts Analysis, Autofacts 2016 Q4 Forecast Release

5 The UK government has made clear that it could not accept the free movement of people that comes with this scenario, but there has been some mention of EEA membership as an interim solution in the years after the UK has left the EU and until it has secured a comprehensive free trade agreement (FTA) with the bloc. If the UK government opts for an FTA with the EU, it is likely that there will be an interim period between when the UK leaves the EU and when a new FTA can be concluded. Judging from recent opposition to CETA, the EU's FTA with Canada, by the Wallonian regional parliament, and the fact that it has taken the Commission seven years to get to this point, it would be reasonable to assume that similar delays may come into play in the case of FTA negotiations between the EU and the UK.

Automotive sector

The Takeaway

The political situation is hard to read and may change quickly. Businesses should be exploring the impacts of all possible scenarios, and develop strategies that will allow them to pursue their business objectives in any event.

While the overall negotiations are likely to take longer than just two years, the EU has been seen to allow for pragmatic arrangements in the past. We would advise the industry to develop a common automotive industry platform, in order to make sure the common interests of suppliers, assemblers, distributors, retailers and the service industry are aligned ahead of the upcoming negotiations, in order to get the best possible outcome of any future trade deal with the UK.

Some companies may want to review their OEM and supply chain investments in the UK in light of the changing economic and trade environment, including sterling's depreciation and the prospect of increased trade costs. Brexit may provide an impulse to start or upgrade their globalisation efforts, especially in the direction of countries that are not in the EU but entertain privileged (sectoral) trade relationships, such as South Africa, South Korea, Turkey, Mexico or – potentially – Canada.

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