Edward Jones
MAKING SENSE OF INVESTING

# Auto Sector: Shifting to Lower Gear

**CONSUMER DISCRETIONARY SECTOR REPORT**

September 09, 2020


## ANALYST(S)

**Jeff Windau**, CFA


Consumer discretionary stocks mentioned in this report:

**Ford - Hold** (F - $7.03)[1]

**General Motors - Hold** (GM - $32.38)

**Magna International - Hold** (MGA - $47.74)

Source: Reuters. Prices and opinion ratings are as of market close on 9/8/20 and are subject to change.

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## Investment Overview

- The coronavirus has caused turmoil for the auto industry. As businesses shut down and consumers stayed home, auto sales declined in the first half of 2020. Additionally, with future uncertainties, consumers could shift purchases to less expensive vehicles in the near term, pressuring the automakers' profitability. While it is difficult to predict the timing of a full recovery, we believe that sales will rebound once the virus concerns abate. We rate shares of Ford, General Motors and Magna International a Hold because we believe that current valuations reflect our long-term growth outlook.
- Due to the challenges with the coronavirus, the auto manufacturers have taken actions to manage employee safety and meet funding needs. Manufacturers such as Ford and General Motors shut down plants for several weeks. Additionally, the companies have drawn down available lines of credit and are focusing on current expenditures. Ford and General Motors also suspended dividends in order to provide additional financial flexibility. At this time, we believe the companies have the necessary financial resources to run the business.
- The auto industry was put under a spotlight by President Trump for manufacturing in Mexico, ultimately leading to the new United States Mexico Canada Agreement (USMCA). Additionally, there have been trade conflicts and a new agreement signed between the U.S. and China. Although trade agreements have been signed, we expect headlines on trade to continue because it has been a key focus for the United States government. We recommend that investors look at the long-term drivers of the industry, and not make investing decisions on speculative actions.
- Automakers are investing heavily in new initiatives such as electric cars and autonomous driving that will define the car of the future. We believe such initiatives have the potential to drive an acceleration of replacement cycles. However, we think these technologies will remain a small percentage of the overall market within our forecasting window.

Following the financial crisis and the resulting collapse in demand in 2008, U.S. auto sales recovered and hit a peak of about 17.5 million vehicles. Large pent-up demand, an improved economy, and cheap credit were main drivers behind the rally. Now, the coronavirus is causing a significant decline in 2020 sales. We remain cautious on the auto sector given the current uncertainty with the coronavirus and other headwinds which we expect to see in the industry, such as increased expenses to develop new technologies.

**Please see important disclosures and analyst certification on pages 4 - 5 of the report.**

## Autos Are a Cyclical Industry

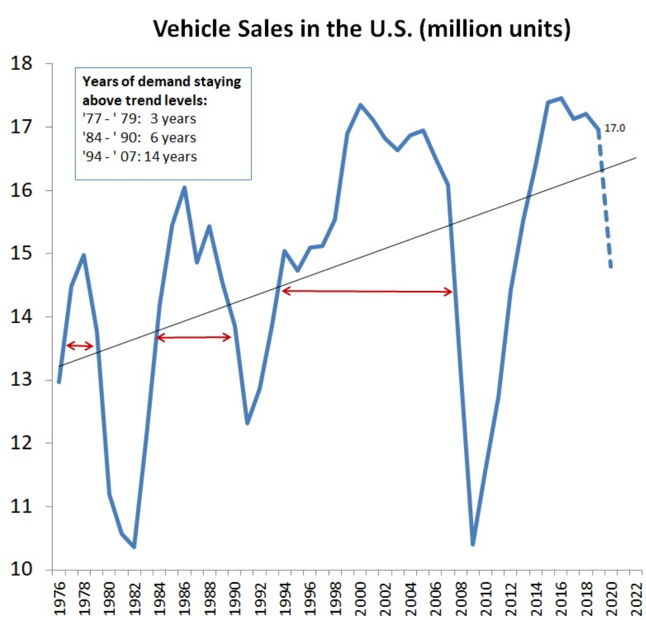
The auto industry is highly cyclical due to the discretionary nature of consumer spending. Auto sales are correlated with, or tend to closely follow, consumer sentiment, unemployment rates, construction spending and gas prices. Auto demand will likely go through the ups and downs of a normal business cycle in step with the overall growth of the economy. With that in mind, it is imperative to understand that cycles are almost impossible to time. **Figure 1** highlights the historical trends in the industry and our projections.

## Coronavirus Negatively Impacting Sales

Businesses have closed for periods of time and individuals have been self-distancing due to the coronavirus. The result was a sharp decline in new car sales early in 2020. While the virus duration is difficult to predict, we believe sales will be pressured over several months due to lost wages and a more pessimistic consumer.

To help address workers' safety concerns, Ford and GM shut down production for several weeks. The auto manufacturers have also drawn down lines of credit and deferred expenses, and both Ford and General Motors suspended dividend payments. We believe Ford, GM and Magna have the funding levels in place to navigate through the current situation. Although the safety of the situation will be closely monitored, the automakers have resumed production.

**Figure 1**




Source: Bureau of Economic Analysis, Edward Jones

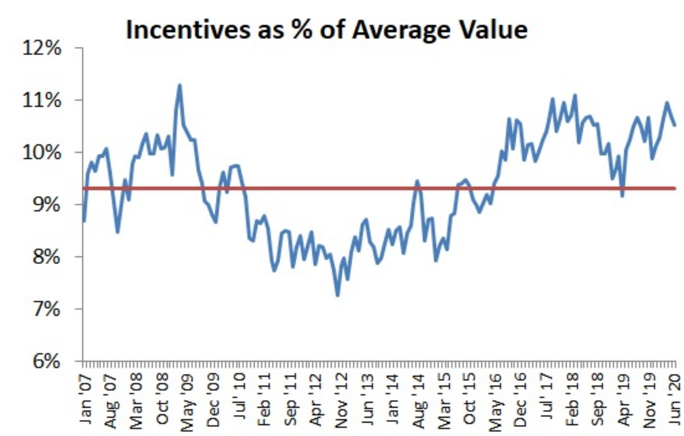
## Declining Truck Sales Pressure Results

Over the last several years, auto sales volumes have remained at healthy levels with a positive sales mix (higher proportion of trucks and SUVs). This has been positive for the automakers as trucks and SUVs are more profitable. In more challenging economies, however, such as the Great Recession in 2008-2009, less expensive vehicles become more popular purchases. Due to coronavirus impacts, we believe we could see consumers shift to less expensive vehicles for a period of time, weighing on the industry's near-term profitability. Longer-term, we do expect sales of trucks and SUVs to rebound once the virus concerns abate and the economy shows positive signs of growth.

## Increased Competition a Speed Bump

While industry sales and demand have been robust, automakers have been increasingly relying on incentives to drive higher volumes. Incentive spending as a percentage of average transaction prices, while not exceeding previous peak levels, remains elevated **(Figure 2)**. In our view, we don't think that a pricing war is likely, but it is an indication that the industry is becoming more competitive.

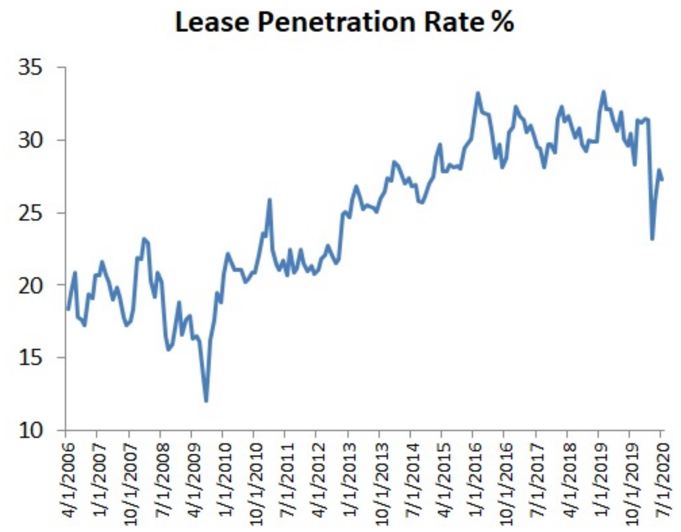
**Figure 2**




Source: Bloomberg, Edward Jones calculations

Another area of concern is the large number of used leased vehicles (leased two or three years ago) which are coming to the market and will compete with new car sales. We have seen higher levels of leasing since the beginning of 2013, **(Figure 3)** which is now resulting in used vehicles in good condition coming to the market. The increased volume of off-lease vehicles could drive down used-car pricing, making them an attractive option to purchasing new.

**Figure 3**




Source: Bloomberg

### International Volatility and Opportunities

We believe that there are long-term growth opportunities for the auto sector internationally, due in part to the low vehicle ownership per capita in developing countries. For example, there is on average 0.8 cars per person in the United States vs. 0.1 per person in China. However, international car sales have been volatile over the last few years. Trade concerns between the United States and China, changes in emissions regulations, and reduced tax incentives were some of the issues causing changes in demand. Now these markets are also dealing with the coronavirus. While there may be limited growth near-term, we do expect more moderate growth to return with expansion of the global economy and a rising middle class.

### The Trump Effect - Risks From Policy Changes

With President Trump in office, investors have been trying to gauge the impact from potential policy changes. Ultimately, President Trump's focus on manufacturing in Mexico led to new trade negotiations between the U.S., Canada and Mexico. The resulting United States Mexico Canada Agreement (USMCA) has replaced the North American Free Trade Agreement (NAFTA).

Additionally, there have been trade conflicts between the U.S. and China leading to both nations imposing new tariffs on certain imports. Although trade agreements have been signed, we expect headlines on trade to continue because it has been a key focus for the United States government. While future actions are uncertain, we acknowledge that any additional tariffs or trade restrictions could soften demand and pressure profits.

### New Technologies a Long, Winding Road

Competition, regulations and anticipated customer preferences are all pushing major automakers to invest in new initiatives like electric cars and autonomous driving. The push for electrification is gaining steam as a result of more stringent fuel efficiency standards. In the U.S., CAFE (Corporate Average Fuel Economy) standards are putting pressure on auto manufacturers to produce more fuel-efficient vehicles. All of the major manufacturers are investing heavily in this area, but the increased spending is pressuring profits. Currently, hybrid and electric vehicles make up less than 5% of new car sales in the U.S. The limited travel range between charges, lengthy recharging times, and lithium-ion batteries that can cost up to $10,000 are other limiting factors for plug-in vehicles.

Autonomous vehicles, or self-driving / driverless vehicles, are also a hot topic. A fully autonomous vehicle can perceive its surrounding environment, decide which route to take based on the destination that has been chosen, and then drive itself to this destination without any additional human interaction. While it is an interesting concept, a tremendous amount of technology including sensors, cameras and mapping capabilities have to be added to the vehicle. Some of the initial forecasts are predicting that these vehicles will be available early in the 2020s. Due to the dramatic shift, it is our opinion that federal safety regulations will play a significant role in when autonomous vehicles will actually be allowed on the road for the mass market. At this point we believe fully electric or autonomous vehicles will remain a small percentage of the overall market within our forecasting window.

### Investing in the Auto Space

As outlined in this report, we maintain a cautious stance on the auto industry. In the near term, we expect sales to decline due the coronavirus impacts. Over time, we do expect auto demand to grow, supported by stronger economic growth and high consumer confidence, and we see the industry remaining competitive.

We rate shares of both automakers we follow, Ford (F) and General Motors (GM), a Hold. Both companies suspended their dividends due to rising uncertainty with the coronavirus. We believe that current valuations reflect our long-term growth outlook for the industry and the increased regulatory costs.

We also rate Magna International (MGA) a Hold. We rate Magna's dividend as at risk because we believe the decline in consumer demand may drive management to rethink capital allocation and conserve the cash utilized for the dividend. Overall, Magna is one of the largest, most diverse auto parts suppliers that has been able to achieve above-average market growth. At current price levels we believe that shares reflect the opportunity to gain content per vehicle (such as transmissions and sensors), balanced by the increased risk of car sales and production in North America declining further than consensus estimates.

### Valuation

Methods we use to evaluate the attractiveness of industrial stocks include traditional ratios such as price-to-earnings (P/E) and price-to-sales (P/S), both on an absolute and relative basis; PEGY ratios (P/E vs. estimated growth and dividend yield); and discounted cash flow (DCF) analysis.

### Risks

Given the strong relationship of auto sales with the health of the economy, economic cycles will impact the industry over time. This will likely lead to fluctuations in total demand (volumes) and could impact the mix (less expensive cars vs. trucks). In addition, regulatory agencies set fuel-efficiency levels and safety standards. Therefore, changes in the regulatory environment could impact the pricing and influence demand.

**Please see your financial advisor and read the individual company research reports, which contain additional information on valuation and risks.**

## Required Research Disclosures

### Analyst Certification

I certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers; and no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report. Jeff Windau, CFA

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Buy (B) - We believe the valuation is attractive and total return potential is above average over the next 3-5 years compared with industry peers. Hold (H) - We believe the stock is fairly valued and total return potential is about average over the next 3-5 years compared with industry peers or a special situation exists, such as a merger, that warrants no action. Sell (S) - We believe the stock is overvalued and total return potential is below average over the next 3-5 years compared with industry peers. In some cases we expect fundamentals to deteriorate considerably and/or a recovery is highly uncertain. FYI - For informational purposes only; factual, no opinion.

The table below lists the percent of stocks we follow globally in each of our rating categories. Investment banking services indicate the percentage of those companies that have been investment banking clients within the past 12 months. As of: September 09, 2020

| | BUY | HOLD | SELL |
|---|---|---|---|
| **Stocks** | **51%** | **45%** | **4%** |
| **Investment Banking Services** | **4%** | **1%** | **0%** |

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In general, Edward Jones analysts do not view the material operations of the issuer.

Diversification does not guarantee a profit or protect against loss in declining markets.

Special risks are inherent to international investing including those related to currency fluctuations, foreign political and economic events.

Dividends can be increased, decreased or eliminated at any time without notice.

An index is not managed and is unavailable for direct investment.

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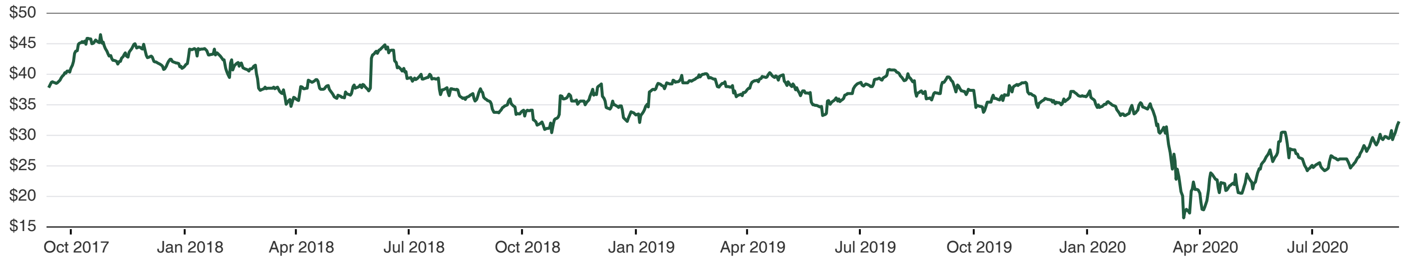
### 3-Year Rating and Price History for: Ford (F) as of 09/08/2020

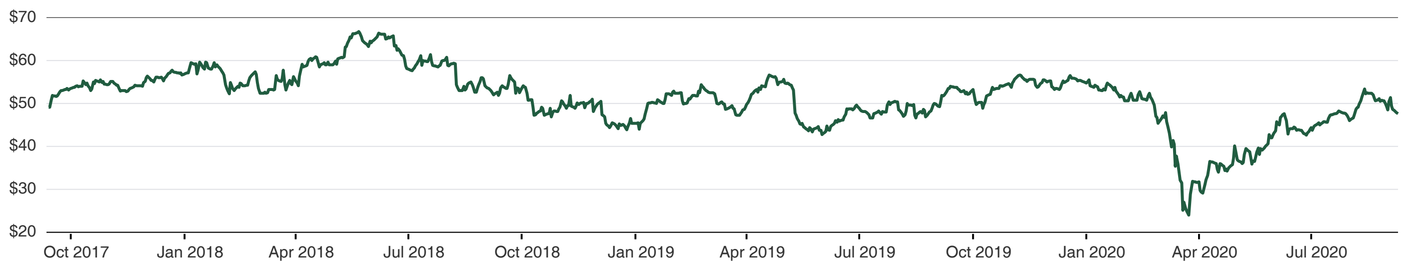

Source: Reuters

### 3-Year Rating and Price History for: General Motors (GM) as of 09/08/2020




Source: Reuters

### 3-Year Rating and Price History for: Magna International (MGA) as of 09/08/2020




Source: Reuters