SPECIAL REPORT BY NICK GIBBS

2023 holds promise but uncertainty clouds outlook

PREDICTIONS ARE A MUG'S GAME at the moment, particularly for the car industry, but predict the industry must as it prepares itself for the potential rollercoaster that will be 2023.

Also looking into the crystal ball are financial analysts, hoping to steer their clients to make better investments in the sector. So, what does the future hold?

First let's recap where we are, entering the fourth quarter of 2022. Shortages of parts such as semiconductors have forced car makers to cut back on production, which has led to the "unusual" situation, in the words of Stellantis CEO Carlos Tavares, where they have been able to harness the laws of supply and demand to jack up prices and more than cover price inflation for parts, raw materials, energy and the rest.

Thanks to this, the majority of car makers are sitting on a large cash pile that's further cushioned by a healthy order bank.

UBS bank's chief autos analyst Patrick Hummel recommends any OEMs celebrating strong Q3 results "take a picture and frame it" because it's about to get much tougher, ironically as parts supplies start returning to normal.

A boost in supply could reduce profit margins

Value brands like Dacia have posted upticks as the market declines

"We think it will only take three to six months for the auto industry to end up in over-supply, which will put an abrupt end to unprecedented OEM pricing power and margins," Hummel wrote in a recent report.

The long-tail effect of the endless wait for new cars means that orders from customers still flush from Covid lockdown savings are still flowing through. However, once that ends, new orders are likely to be lower and for cars more at the budget end, as customers look to make savings as bills for energy, food and mortgages rise. Witness Dacia's 18% growth rate in Europe this year in a market down 12%.

UBS points to growing inventories (mainly in the US for now), weaker used car prices, cancelled orders and higher credit risks among customers as evidence.

The biggest reason for car makers moving from their traditional margin-destructive over-supply to profit-ballooning under-supply has been the lack of semiconductors, but that's about to change. Some, for example Stellantis's Tavares, say the shortage will finally be over by the end of 2023 but others think it's going to be much quicker than that.

"Our view is that there has been an increasing number of cancellations from white goods/smartphones, increasing allocation to automotive companies," said Philippe Houchois, who leads automotive analysis for the bank Jefferies. "We think the shortage will finish earlier than the predictions of mid next year, more like mid Q1/early Q2".

We put this bearish view of the market to Carlos Tavares as he spoke to journalists at the Paris motor show. Won't the return of supply kill your record margins? "That's possible, if you don't master inflation," he said.

Right now, inflation plus the imbalance between cars built and cars needed is pushing prices up, which could lead to orders being retracted in a tough economic climate. But if orders start to fall so will the inflationary pressure. "If the demand is not very high and if the economy is gloomy, inflation will also vanish," Tavares said. "We already see the price of steel going south, anticipating a gloomy industry."

How it all plays out is tricky to predict, especially given energy prices are linked to the ongoing Russian invasion of Ukraine. "The problem is that it's difficult to estimate which opposing events will combine," Tavares said.

The energy cog in the economic mystery machine could yet prolong the car

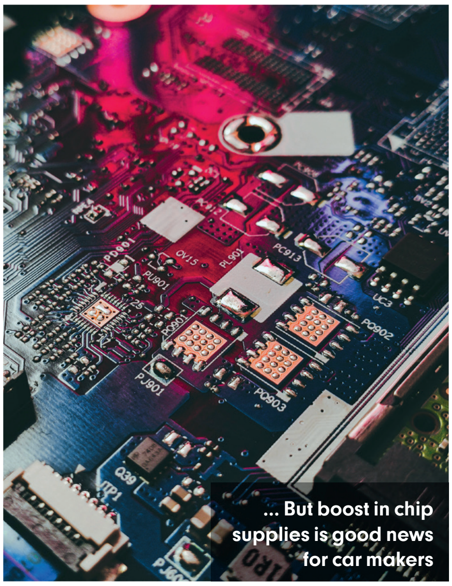
Soaring energy costs could heavily impact production…

"THE PROBLEM IS IT'S DIFFICULT TO ESTIMATE WHICH OPPOSING EVENTS WILL COMBINE"

shortage, warned analyst company S&P Global Mobility, formerly IHS Markit. Any restrictions on energy use in the cold, wet winter predicted for Europe could seriously impact production in the region, to the tune of almost one million vehicles per quarter "starting in the fourth quarter of 2022 through the entirety of 2023" S&P predicted dramatically in a recent report.

"If you look through the supply chain - particularly where there's any metallic structure forming through pressing, welding or extrusion - there's a tremendous amount of energy involved," said Edwin Pope, lead analyst for materials and lightweighting at the company.

The report highlighted energy costs increases from €50 euros per built vehicle to between €687-773. Already some manufacturers are altering their production patterns to save energy, for example running night and day then pausing to avoid daily high-energy restarts. This



… But boost in chip supplies is good news for car makers

and the raw material price increases "undermine margins in a market where cost increases will be difficult to pass on to customers already facing food and energy inflation," S&P wrote.

The car industry might be flush right now, but the fact remains the European volumes are 26% down on 2019 figures and is left wondering when those lost sales are going to return, if ever. European lobby group ACEA is calling on the European Union to craft a policy framework that "enables the market to both recover and make the shift to zero-emissions", ACEA said in a statement in October.

Perhaps mindful that it would be wrong to push for financial help amid a period of record profits, it instead asked for help boosting resilience in supply chains, a "Critical Raw Materials Act" to help it secure battery materials and more EV chargers.

Helping the car makers is the fact that they cut costs dramatically both before and during the pandemic, cushioning them against any dramatic tail-off in demand. For example, Tavares boasted that Stellantis has a break-even point of 40% of current revenues. UBS also points to the switch to direct sales, giving the car makers a better handle on pricing, as well as continuing strength of used car pricing, even if they're down on recent highs. "We have some confidence that we're not going to test historical lows next year," UBS's Hummel wrote.

So, it's a tough time for forecasters, but here's the positive view: returning chip supplies will increase production and sales, in turn reducing pricing power and cutting car maker profits. That's good news for consumers as new cars get cheaper and easier to get hold of, but companies need not suffer too much thanks to a tighter cost structure, continuing recent residuals and new retail models that include selling features directly to consumers.

Or it could go in a different direction entirely.