ALTRINSIC

Checking In on the Auto Revolution

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While flying cars are still a faraway dream, the auto industry will change more in the next five years than it has in the last one hundred. That was the message delivered by Harry Lightsey, the South Carolina Secretary of Commerce, during one of many meetings we attended with manufacturers, suppliers, and government officials as part of a recent trip to Spartanburg, SC. A confluence of factors, including technological change, new competition, and supply chain disruptions, are driving this unprecedented level of change.


"The Jetsons Family Smiling in Car" by Wallpapers.com (free license)

Spartanburg, SC and the surrounding area is one of the main automotive manufacturing hubs in the United States, with over 500 auto-related companies employing more than 75,000 workers. It is home to BMW's largest plant, and Volvo is expanding its factory to produce the upcoming EX90 Battery Electric Vehicle (BEV). A few days of facility tours and meetings with key players from across the ecosystem reinforced several key themes:

Change is here: Historically, auto companies won through manufacturing efficiency, quality, and scale. Their manufacturing at scale *was* highly impressive, but now the auto industry is more technologically focused than ever before. BEVs represent a paradigm shift that weakens historical competitive advantages. The auto industry of old was characterized by long design cycles that helped companies manage complex supply chains and gave Original Equipment Manufacturers (OEMs) enough time to earn profits by optimizing the manufacturing process over a period of years. BEVs are simpler, design cycles are shorter, and the cadence of the industry cycle is closer to consumer electronics than traditional light vehicles. Tesla is revolutionizing the manufacturing process nearly as much as the end product; its Giga-casting process that builds the vehicle frame as a single piece rather than welding components together vastly reduces complexity while increasing strength. Traditional OEMs are being forced to adapt – and they are – but this comes at a cost.

Software is also increasingly important, favoring new entrants. One large dealer we visited noted that the software update process for its new electric vehicle requires a nine-hour stop at the dealer. This is in stark contrast to new competitors that offer frequent, easy-to-install updates. It is questionable whether legacy vendors can or will catch up.

Supply chains are fragmenting and localizing: COVID forced the auto industry to re-evaluate its supply chains. Coupled with the changes due to electrification, auto companies are introducing new suppliers at a rapid pace. Local suppliers, particularly in Mexico, are the main beneficiaries due to rising logistics costs, increasing geopolitical tensions elsewhere, and an aggressive focus on reducing carbon emissions (a material ESG consideration for the industry). For example, Volvo is increasing locally-sourced components from 45% to 75% for its next-generation vehicle. Similarly, BMW has nearly tripled its Americas supplier base in the last four years. Our discussions with key industry constituents about this shift reinforced insights from our previous trips to Europe and Mexico.

Industrial companies are rapidly embracing technology: Automotive manufacturing is highly complex, highly automated, and highly optimized. However, companies are finding efficiencies in several areas by leveraging new technologies. As part of our trip, we saw autonomous robots increasing materials handling efficiency, new virtual reality environments planning factory expansions and speeding up employee training, and machine learning improving manufacturing quality by examining data and dynamically adjusting the manufacturing process. Technology is a key enabler going forward and should help offset inefficiencies caused by supply chain localization where labor and production costs may be higher.

Investment Implications

Change is an enduring source of investment opportunity and risk. However, deep engagement within industry ecosystems is required to discern between companies offering value and those that are value traps. For example, we see value in shares of Michelin, a global tire manufacturer with the leading position in BEVs. Because of the added weight, BEVs require larger, higher-quality (and higher margin for Michelin) tires, which should drive improving returns on invested capital for the company. Despite very attractive headline valuations (P/E, P/B, etc.) across many other parts of the auto ecosystem, we have limited exposure because many of these businesses will be disrupted and their future free cash flow generation will be significantly impaired. Instead, we are finding significant value among industrial companies that are embracing technology to both enable their customers' businesses and transform their own. Siemens is a good example; it is particularly well positioned due to its mission-critical products that help run many factories worldwide. The company is also selling more software, which comes at a higher margin and should improve returns on invested capital for the business as a whole. In many cases, as with Siemens, headline valuations for these industrial companies do not reflect the improvements they are making – hence the opportunity.

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