Trump's Tariffs Could Hurt EU Carmakers--Not The Economy

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Key Takeaways

- The Trump administration's threat to impose a 25% tariff on European auto imports to the U.S. could, if implemented, damage the earnings and credit ratings of EU carmakers.
- Our analysis shows the tariff hike would lead to a 15% drop in aggregated adjusted 2019 EBITDA for the six European car manufacturers with significant sales in the NAFTA region.
- But the effects on European economies and sovereigns would be only modest, costing Germany, the most affected European economy, about 0.45% of GDP over two years.

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It's less than four years since Sergio Marchionne, the former Fiat-Chrysler CEO, famously warned that the auto industry would have to continue consolidating to withstand "the next big shock". The next big shock may already be here. U.S. President Donald Trump's administration has threatened to impose a 25% tariff on European vehicle and auto-part exports as soon as this spring.

For European auto manufacturers already struggling with high costs for the transition to electric mobility and slower Chinese demand, this hike in duties poses a severe challenge to their profitability: severe enough that it might increase the urgency for further consolidation.

Our scenario analysis suggests a hike in import tariffs to 25% would result in a 15% drop in aggregate S&P-adjusted EBITDA in 2019 for the six European car manufacturers with significant U.S. sales--Volkswagen (VW), Fiat Chrysler (FCA), Daimler, BMW, Volvo Cars, and Jaguar Land Rover (JLR). This would strongly dent earnings for all these manufacturers and potentially lead to negative rating actions for some players, absent defensive countermeasures to offset the higher costs.

But the overall impact on European economies would likely be modest. We estimate Germany would be the worst hit economy in Europe by the threatened tariff hike, but would still only lose around 0.45 percentage points in GDP over a six-24 month period. For the EU overall, we project the macroeconomic effect would be limited to 0.1pp of GDP.

Why is the impact on Europe's export-driven economies so low? The short answer is that Germany is a highly diversified economy, which, despite its reputation for engineering and manufacturing prowess, is increasingly dominated by services. Germany also benefits from a global customer

base for its exports. German auto exports to the U.S. are fairly low as a percentage of GDP, equivalent to slightly over 1%. Once imported inputs are deducted from that export figure, the final drag on Germany's gross value added is about 0.3% of GDP.

While recent U.S. government trade policy has concerned itself primarily with the U.S.'s large deficits in manufactured goods, the U.S. runs a large services surplus with the rest of the world of about $69 billion or 1.6% of GDP in third-quarter 2018. For decades, manufacturing has been shrinking as a percentage of GDP, not only in the U.S., but in every major European economy. At the same time, manufacturing and services are more commingled than they used to be. Many manufacturing companies outsource the production of their goods, and are increasingly focused on higher value added parts of the manufacturing process, such as design and production technology, software development, and financing--which are services rather than goods. In intensively competitive sectors such as autos, from a profitability perspective, it matters less where manufacturing is done, and more where the branding, design, and technology development take place.

Table 1

Europe's Major Economies Have Shifted Away From Manufacturing Since 1991

	--U.K.--		--Germany--		--France--		--Italy--	
	1991	2017	1991	2017	1991	2017	1991	2017
Share of value added in services	69.6	79.2	61.9	68.1	70.0	78.8	66.7	73.8
Share of value added in manufacturing	17.0	10.1	27.4	23.4	17.7	11.4	20.9	16.6

Source: OECD Data.

A Road Block For Automakers

Unilateral tariffs nevertheless pose a risk for the auto sector. Trade tensions between the U.S. and Europe are yet another blow to European automotive industry sales (see: "Trade Tensions: A Game Changer For Europe's Car Industry?," published Sept. 18, 2018, on RatingsDirect). In 2018, the Chinese auto market, once European manufacturers' biggest growth engine, posted its first sales volume decline in two decades. If the U.S., a market that exceeded expectations in 2018, imposes import tariffs this year, 2019 sales and earnings will suffer a further hit.

Tariff hikes would hurt VW, BMW, Daimler, FCA, Volvo Cars, and Jaguar Land Rover because, even though some are increasingly localizing their production and supply chain, they all still source only a portion of the value of their U.S. best-selling models from production based in the North American Free Trade Agreement zone. JLR and Volvo cars could be hardest hit, as they source none or barely any of their supply chains to within NAFTA.

Table 2

JLR And Volvo Have Not Shifted Their Supply Chains To Within NAFTA

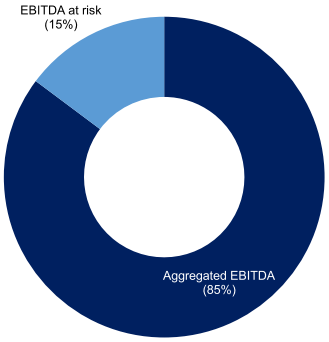
(% of total; 2018 base)	NAFTA-based production (passenger vehicles only)	NAFTA-based units sold (passenger vehicles only)
VW group	7	9
BMW	13	17
Daimler	9	16
FCA	55	60
Volvo Cars	1	17
Jaguar Land Rover (*)	0	24

Source: Companies' reporting in 2018 (% rounded up or down) and LMC. *% for JLR April 2018-Jan 2019.

All else being equal, our analysis shows that a hike in U.S. automotive import tariffs to 25% could cost these six companies nearly 15% of the aggregated adjusted EBITDA we estimate for 2019 (see chart 1). It could wipe out JLR's forecast adjusted EBITDA margin this year (see chart 2). This would be a material deviation from our base case for some of our issuers. Even manufacturers with established production capacity in the NAFTA region, such as BMW and Daimler, could suffer curtailed EBITDA because the value chain of their bestsellers in the region is not exclusively locally sourced. Our calculations are based on a scenario analysis (see textbox: "How We Calculated Automakers' EBITDA At Risk In A 25% Tariff Scenario"). They do not form our base case because we would expect individual issuers to develop strategic responses.

Chart 1

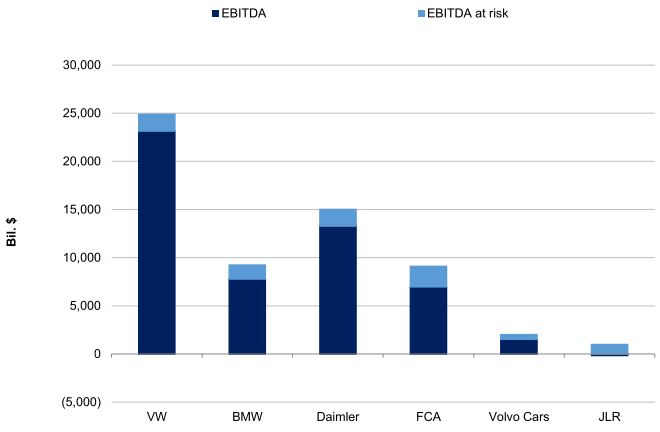
A 25% Tariff On European Auto Imports To The U.S. Could Lead To A 15% Drop In Aggregated Adjusted 2019 EBITDA*



*Aggregated S&P-adjusted forecasts for VW, Daimler, BMW, FCA, Volvo Cars, and JLR.
Source: S&P Global Ratings.

Chart 2

A 25% Tariff Scenario Could Significantly Cut Carmakers' 2019 EBITDA*



*S&P-adjusted. Source: S&P Global Ratings.

Not surprisingly, our simulation of 25% import tariffs on the value chain would result in a clear competitive disadvantage for JLR because its sales in the NAFTA area (up 5% between April 2018 and January 2019 over the previous period) rely entirely on imports. The additional costs JLR would face from tariffs would wipe out the effect of offset JLR's recent cost-reduction measures that we currently reflect in our base case, assuming it cannot pass any of the costs through to consumer prices. This would lead to a material deviation from our base case for 2019 and would have negative consequences for the rating.

Despite its ambitious investment in Charleston, the impact on Volvo Cars' 2019 EBITDA would also be material. This is because local U.S. production focuses on the group's S60 sedan, while the sports utility XC series, representing about 80% of its U.S. sales volumes, has no local content. Import tariffs could have a material effect on the ratings if Volvo could not shore up its EBITDA through countermeasures.

Even FCA, which sources 55% of its U.S.-sold car production within NAFTA, could suffer a 20% fall in EBITDA in the event of 25% import tariffs. This is because a large share of the value chain for its Jeep models, especially the Renegade, are located outside NAFTA. An EBITDA drop of this magnitude would absorb the current headroom for a higher rating.

Daimler would also lose more than 10% of projected 2019 S&P-adjusted EBITDA, according to our analysis. This is because of the limited locally sourced content of models with strong market appeal in the U.S., particularly the Mercedes GLC, E-Class, and GLA. This would increase pressure on the group's profitability, already compressed by the transition to low-CO2-emitting vehicle production. Given existing profitability pressures, this scenario would have a negative impact on the Daimler rating if not adequately counteracted.

Our analysis shows that import tariffs would also harm BMW's earnings, even though its U.S. plant in Spartanburg is globally its largest production facility. This is because approximately 40% of content for the group's most appealing models in the U.S. would still originate outside NAFTA. We estimate a risk to BMW's 2019 EBITDA in the range of 10%-20%, which we consider material for the group's profitability, and is also rating-sensitive.

Least exposed to the risk of import tariffs under our assumptions would be Volkswagen, with a potential impact on expected 2019 EBITDA of below 10%. Even though the Audi brand is mainly non-NAFTA sourced, this is balanced by local content for the VW brand, particularly U.S. bestsellers, Jetta, Atlas, Passat, and Golf. However, this 10% EDITDA decline, if not offset by defensive measures, would absorb the bulk of the headroom we currently see in VW's credit metrics.

How We Calculated Automakers' EBITDA At Risk In A 25% Tariff Scenario

We based our calculation of EBITDA at risk for VW, BMW, Daimler, FCA, Volvo Cars, and Jaguar Land Rover under a 25% tariff scenario on the following assumptions and expectations:

- We assumed no pass-through of the import tax to consumer prices. Pricing strategies and purchase incentives can affect the very competitive U.S. auto market. We believe incentive spending as a percentage of average transaction prices will likely remain around 11% over the next few quarters. This is higher than the typical 7.5%-9.5% range over the past eight years, but lower than 12% in 2017. This would make it difficult for automakers to absorb the bulk of the heavy import duty onto prices.
- We excluded possible countermeasures companies would likely take to offset tariff costs. Automakers would likely consider, for example, transferring production of parts and vehicles closer to end markets and increasing prices, where possible. In reality, automakers' strategic responses would likely affect our capex assumptions and eventually free cash flow generation.
- We assumed that the incremental duty import would also hit content produced outside the NAFTA zone. For Europe-based automakers we assumed that the remainder would mostly originate in Europe. To gain a sense of the value chain per model, we used the Made in America Auto Index 2018, which assesses the domestic content of vehicles sold in the U.S. per model. We nevertheless acknowledge this index could be based on backward-looking information, resulting in under-reporting local content in car manufacturing. In some cases, we used our own information to assume higher local content.
- We estimated the potential risk for Europe based-automakers as the average extra cost per vehicle and per model sold in 2018 in the U.S, thus assuming stability of volumes and mix into 2019.
- We assumed that the vehicles sourced from the U.K. would be subject to the same risk weighting on EU-sourced vehicles.
- We assumed a dollar-euro exchange rate for 2019 of €0.83.
- We isolated the risk of a trade conflict between the U.S. and Europe from the potential outcomes of negotiations on the new tri-lateral free trade agreement between the U.S., Mexico, and Canada. To date, this limits the number of free trade vehicles imported into the U.S. and imposes a higher percentage of local U.S. vehicle content compared to the old NAFTA agreement. The interplay with final negotiations of this deal would probably lead us to modify our assessment of the risks to EU automakers.

Table 3

EU Carmakers Could Lose 10%-100% Of 2019 EBITDA In A U.S. Import Tariff Scenario Of 25%

	Percent of S&P-adjusted 2019 EBITDA at risk
VW group	**<10%**
BMW	**10%-20%**
Daimler	**10%-20%**
FCA	**>20%**
Volvo Cars	**>20%**
Jaguar Land Rover*	**>100%**

*JLR figures are April 2018-Jan 2019. Source: S&P Global Ratings calculations.

For EU Economies, Just A Road Bump

While the 25% automotive import tariffs could have significant consequences for individual manufacturers, we estimate that the overall macroeconomic effect would be limited to 0.1 percentage point (pp) of GDP for the EU economy (see chart 3). Our calculation takes into account the share of car production exported to the U.S. as well as the impact to EU economies through connectedness within EU and EU-U.S. automotive supply chains. We considered:

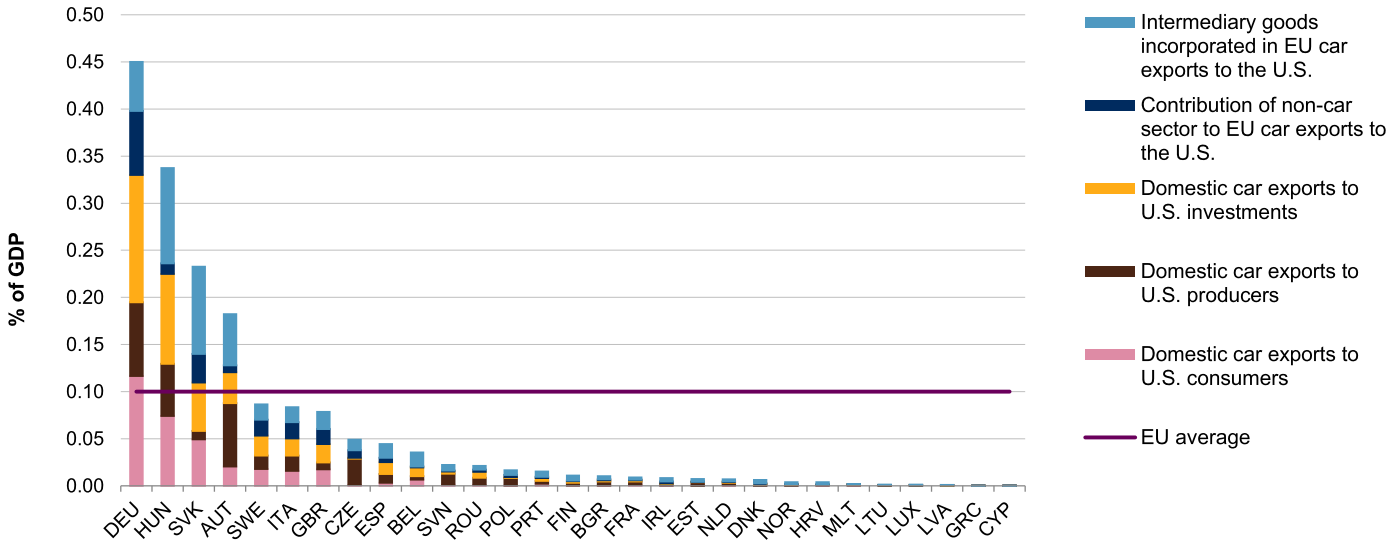
- The share of domestic value added in the total output of cars exported to the U.S. to meet U.S. final demand.
- The share of domestic value added of automotive goods exported to U.S. producers.
- The domestic value added from the non-automotive sectors required to produce the cars exported to the U.S. (such as energy consumption of the German automotive sector).
- The share of European but non-domestic value added in European cars (such as car parts produced in Slovakia, incorporated in German cars exported to the U.S.).

Our analysis assumes the highest level of potential tariffs, 25% of the import value. It includes car parts, which may or may not be covered by the tariffs. It also encompasses the full amount of gross value added of EU car manufacturers that goes into U.S. investment, of which trucks and other machinery, for which tariffs already stand at 25%, represent a significant share.

Chart 3

U.S. Car Import Tariffs At 25% Would Have Only A Limited Impact On EU Economies

(Share of domestic value added in total output of cars exported to the U.S. to meet U.S. final demand)



Source: The World Input Output Database, Eurostat, and S&P Global Ratings calculations.

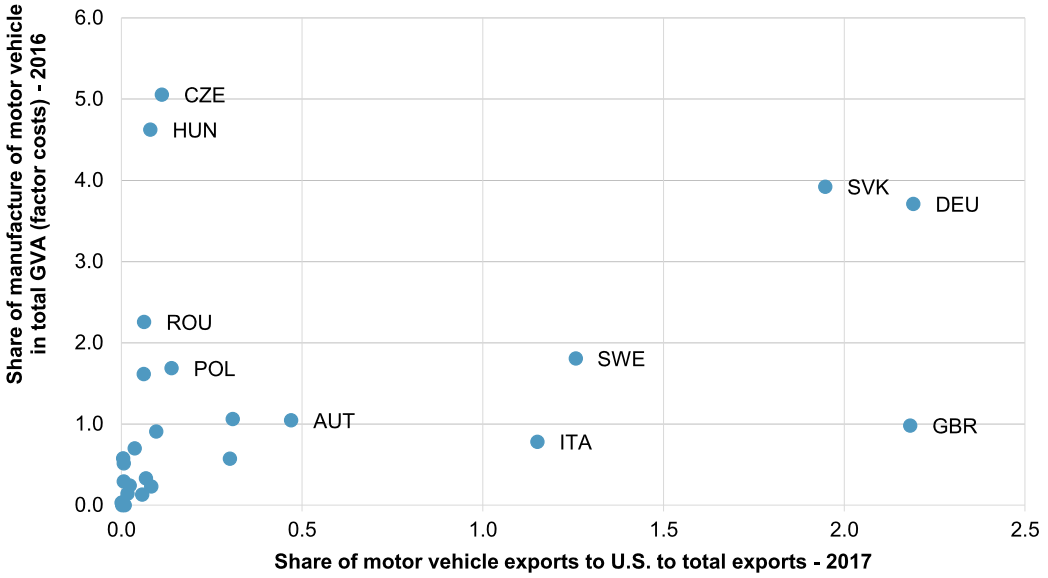
Given the intense competition in the U.S. car market and the price sensitivity of U.S. car buyers, we believe EU carmakers will find it hard to pass on higher U.S. import tariffs to consumers. Instead, we assume EU carmakers would need six to 24 months to reorganize their supply chains, moving their production lines closer to the U.S. market. In the months before shifting their supply chains, car manufacturers could bring production forward and build up inventories. This would provide a small temporary boost to economic activity in the countries most affected and increase U.S. imports. We expect the whole supply chain based in the EU and linked to U.S. car exports, corresponding to the economic impact assessed in chart 3, would be reorganized in the following two years. This means the negative impact of 0.1pp of GDP for the EU will occur over two years and remain marginal for the economy. Even for the most affected economy, Germany, the total economic impact would not exceed 0.45% of GDP over two years.

EU Sovereign Ratings Would Not Be Affected

EU sovereigns also appear relatively shielded from potential import tariff hikes, even those with a large automotive sector and a significant share of car exports to the U.S. This is because Europe's economies are just too diversified and too focused on services to be derailed by a tariff on a single sector (see chart 4).

Chart 4

The Economic Importance Of The Automotive Sector And U.S. Car Imports Varies Widely Across Europe

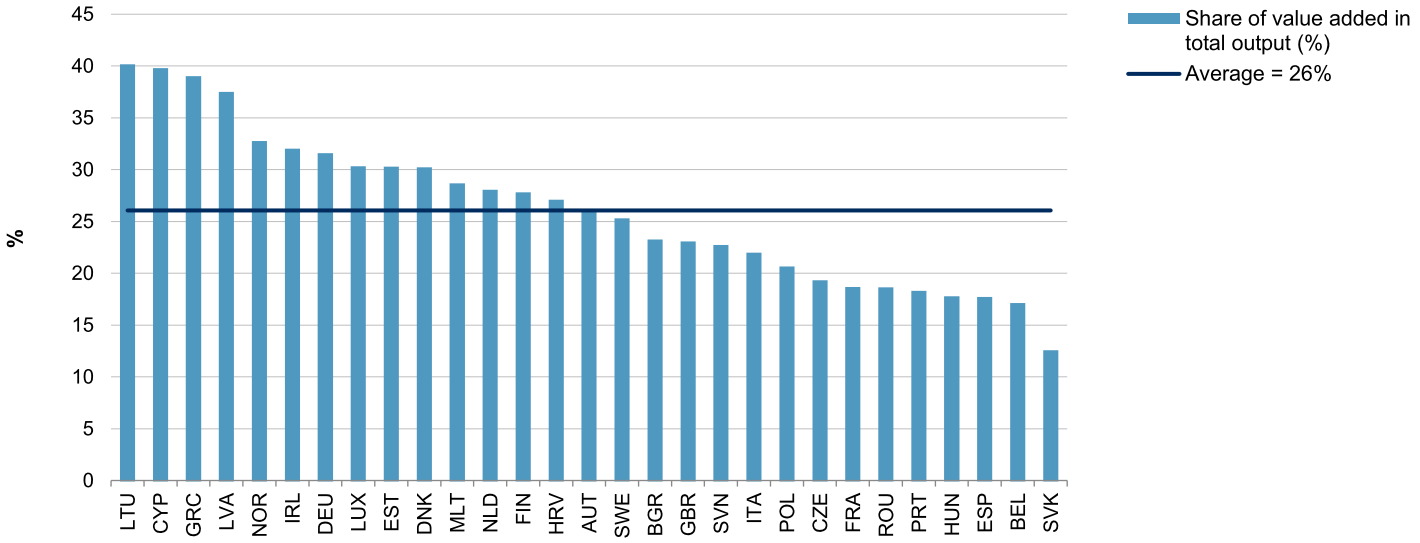


GVA--Gross value added. Source: World Input Output Database, Eurostat, and S&P Global Ratings calculations.

Although the German economy would be the most affected, our prediction of a 0.45% GDP decline for Germany over six-24 months would not represent a substantial risk to the 'AAA' sovereign rating. We assess Germany's economy as highly diversified and one of the most competitive globally. Fiscal and external accounts appear strong and resilient. What's more, although Germany's automotive sector is large, auto production constitutes a higher share of the Czech, Slovak, and Hungarian economies. Germany nevertheless has a relatively high share of car exports to the U.S., representing an estimated 2.2% of total German exports. It also has a fairly high share of domestic value added in the car manufacturing industry--above 30%, compared to 26% for the EU average as regards the intra-sector production (see chart 4), and more integrated supply chains for car parts in the U.S.

Chart 5

The Share Of Domestic Value Added In The EU Car Industry Ranges From 31% In Germany To 12% In Slovakia



Source: The WOIT, S&P Global Calculations

The low potential effects of import tariff increases for the German economy are also a result of relatively low direct car exports in a global comparison. All German car manufacturers combined export fewer cars to the U.S. than Toyota by itself. Moreover, German carmakers also produce a significant number of cars in the U.S. that they export from the U.S. in the rest of the world, and even back to Europe.

After Germany, the economies most affected by the tariff hike would be Hungary and Slovakia. Both countries have very large automotive sectors, representing 4.6% and 3.9% of total economic activity, respectively. We estimate the effect of a 25% auto import tariffs on headline GDP at 0.34% for Hungary and 0.23% for Slovakia over six-24 months. We therefore believe the impact on the sovereign ratings would also be limited, even though the automotive sector has played a significant role in terms of economic development and attracting FDI in past decades.

The effect of tariffs on Austrian GDP would be 0.18% over six to 24 months. Our analysis shows, Austria would be most affected through its integration in U.S. supply chains because it reports a relatively high share of intermediary products exported to the U.S. automotive industry. This would also be the channel through which the Czech economy will be affected the most in our baseline scenario. Even though the Czech Republic reports the largest automotive sector in the EU at 5.1% of total economic activity, the impact of U.S. tariff hikes on its economy appears very limited at just 0.05% of GDP.

This report does not constitute a rating action.