SECTOR AUTOMOTIVE

Where to recharge a portfolio

Electric vehicles are set to cause widespread disruption but they won't give investors a free ride

Electric and autonomous vehicles capture the imagination and the headlines. Like many earlier technologies, such as the internal combustion engine and commercial aircraft, electric vehicles (EVs) promise to change the course of human history. But it is easy to mistake excitement about the technology for a free ride to investing success. History shows that new technology, even technology that has changed the world, has not necessarily made for good returns.

In auto manufacturing the wave of change will disrupt everything from petrol stations and fuel tankers to coalmines and mechanical car maintenance. On the supply side, as component makers scale manufacturing and the production costs fall, cheaper products will open new markets and demand.

It may come as a surprise but the first electric car was released in 1837. That puts electric vehicles ahead of Ford's Model T by about 70 years. Despite some complications for repairers, electric cars were popular until the 1920s. But as road infrastructure improved and people saw the value in driving longer distances, they were unable to meet the challenges of range and speed. Then oil prices plunged and EVs were relegated to the scrap heap.

More recently, rising oil prices and environmental campaigns, as well as advances in battery technology, have meant that the return of EVs today is likely to be longer lived.

Think of a "masstige" car manufacturer like BMW or Audi and their production considerations. There's diesel fuel to consider and different quality fuel standards worldwide. There are varying emission standards and then there is left-hand drive and right-hand drive to factor in as well. Coordinating 10,000 parts from a variety of suppliers is expensive and the cause of multi-year development cycles.

By contrast, the Chevrolet Bolt electric motor has just 24 moving parts compared with 149 parts in the VW Golf's combustion engine. Clearly manufacturers are naturally incentivised to move to simpler platforms. When UBS disassembled a $US37,000 Chevrolet Bolt, it discovered it was $US4600 cheaper to produce than expected and concluded that "with further cost falls likely, electric cars would probably disrupt the industry faster than widely understood".

On the demand side, the total cost of electric car ownership is expected to reach parity with combustion versions this year, making the decision to buy electric that much easier.

Even though electric vehicles will initially carry higher sticker prices, when fuel and maintenance savings are factored in they will become cheaper, especially in regions where fuel costs are higher, such as Europe. Once that happens, an inflection point for demand will be reached.

China is the latest country to announce its intention to phase out the production and sale of gas and diesel vehicles altogether.

> **As reliability advances electric cars may not need any repairs**

Elsewhere, the Netherlands, India, Norway, France and Britain have announced the end of sales of gas and diesel cars by 2040, and some much sooner. More recently, the Scottish government announced the phasing out of gas and diesel cars by 2032.

For investors it is important to remember that many businesses will be disrupted by the changes. Many production line jobs will be lost. Not only will the industry need fewer people to manufacture vehicles, fewer still will be needed to maintain them.

Combustion engines require regular maintenance. At a minimum, spark plugs and oil need replacing. EV "induction motors" employ fewer moving parts, making them much simpler and easier to repair. And as reliability advances, they may not need to be repaired at all, instead relying on wi-fi to deliver software diagnostics and updates – a reboot or an electronic patch may be all that is needed.

Now, it won't all be bad news for investors in the internal combustion engine and ancillary industries. According to BP, by 2040 there will be nearly two billion cars on the planet but only 300 million, or 15%, of these will be electric. In other words, 85% of the global vehicle fleet is expected to have an internal combustion engine.

And keep in mind that the development of the technology and the race to release EVs has been more than partly a function of very low interest rates and abundant capital. If interest rates rise, and as quantitative easing is replaced by quantitative tapering, the spigot of money that has funded the race to develop and release electric and autonomous vehicles will be turned off. Consequently, development will slower.

So far, despite record earnings, buybacks and merger and acquisition activity, the January 26 peak in the S&P 500 has not been surpassed. That suggests chasing high-priced, speculative new technology companies could be dangerous at this part of the cycle and even buying established companies in traditional sectors should be done with a very clear understanding of value. With that in mind, let's look at three companies with exposure to the changes impacting the most popular form of personal transport in the developed world.

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Prices as at close of business, 14-Jul-18. Charts as at 13-Jul-18.

1 ARB Corp

ASX code ARB
Price $22.75
52wk ▲ $23.94
52wk ▼ $14.99
Mkt cap $1.82bn
Dividend 35.5¢
Dividend yield 1.55%
PE ratio 36.91
HOLD

ARB is Australia largest manufacturer and distributor of aftermarket 4WD accessories with an international distribution network that extends to more than 100 countries. Despite growing its equity threefold over the past decade, management has maintained a return on equity of almost 20% a year, ensuring value creation, which in turn has been reflected in a share price that has risen from $3.85 10 years ago to over $23 today. The share price appears expensive.

ARB is unlikely to be affected by EVs given that charging stations are unlikely to be available where most of its customers drive their vehicles. In the meantime, the company continues to display solid operating trends with third-quarter revenue growth of over 12%, driven by Australian aftermarket revenue growth of over 11% and export market revenue up more than 16%. By the end of 2019 seven more stores are expected to be opened and the current sales order book is reported to be very strong thanks to car manufacturers releasing a plethora of new models.

2 Bapcor

ASX code BAP
Price $6.92
52wk ▲ $7.05
52wk ▼ $5.19
Mkt cap $1.94bn
Dividend 14.5¢
Dividend yield 2.09%
PE ratio 28.02
HOLD

Bapcor distributes automotive aftermarket parts and accessories, such as air filters, brake pads, oils and lubricants, as well as fanbelts and engine parts, directly to independent mechanics and through its own networks, including the Autobarn and Burson brands.

Bapcor is likely to eventually be affected by the reduced need for repairs and maintenance by more efficient battery-powered induction engines but it will be many decades before the mix shift in the Australian and New Zealand car fleet is sufficiently dominated by EVs to affect parts suppliers.

Nevertheless, the share price is over 19 times forecast 2019 earnings and recent acquisitions, such as NZ's Hellaby, which are performing strongly, have increased the debt on the balance sheet. While the debt has only taken the company's net debt-to-equity ratio to 56%, it does come at a time when interest rates are rising and the economy may slow down. This is a pro-cyclical business, trading at an expensive price.

3 Super Retail Group

ASX code SUL
Price $8.44
52wk ▲ $9.12
52wk ▼ $6.42
Mkt cap $1.66bn
Dividend 46.5¢
Dividend yield 5.51%
PE ratio 16.83
HOLD

Included in the company's suite of consumer retail networks and brands is BCF (Boating Camping and Fishing), Rays, Macpac, Rebel Sport and Supercheap Auto, the latter selling car care products, accessories, tools and spare parts.

Arguably more consumer focused than Bapcor, Super Retail's fortunes are even more affected by consumer sentiment. The arrival of Amazon will also have an impact, especially on the company's non-automotive businesses, such as Rebel.

Cash from operations materially exceeds reported profits but even though the company has added value since 2013 by improving profits and profitability the share price remains stubbornly below its 2013 highs.

Bank credit tightening, rising interest rates and falling house prices are all weighing on pro-cyclical discretionary consumer stocks, and while the share price currently appears to represent reasonable value it is likely that any economic deterioration will be accompanied by downgrades to its earnings forecasts.