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’No deal’ Brexit to hit UK automotive industry

by Anastasia Tracy Kurniawan

Uncertainty over Brexit has halved investment in the UK automotive industry during the first half of 2018. Fresh investments into new plant, machinery, models and model development fell to GBP 347.3mn between January 1, 2018, and June 21, 2018, down from GBP 647.4mn in the first half of 2017. The shortfall in investment was due to rising concerns on the possibility of a ‘no deal’ Brexit, which is likely to bring more harms than benefits to the UK automotive industry due to the significant tariff and regulatory issues. The change in the RMI-CRI 1-year aggregate PD for all UK-domiciled industries from January 2016, a month before the announcement of the Brexit referendum plan, to the end of June 2018, shows that UK-domiciled auto parts and manufacturers sector has the biggest increase in PD, implying that the sector’s credit profile has deteriorated the most during the Brexit transition period (see Figure 1).

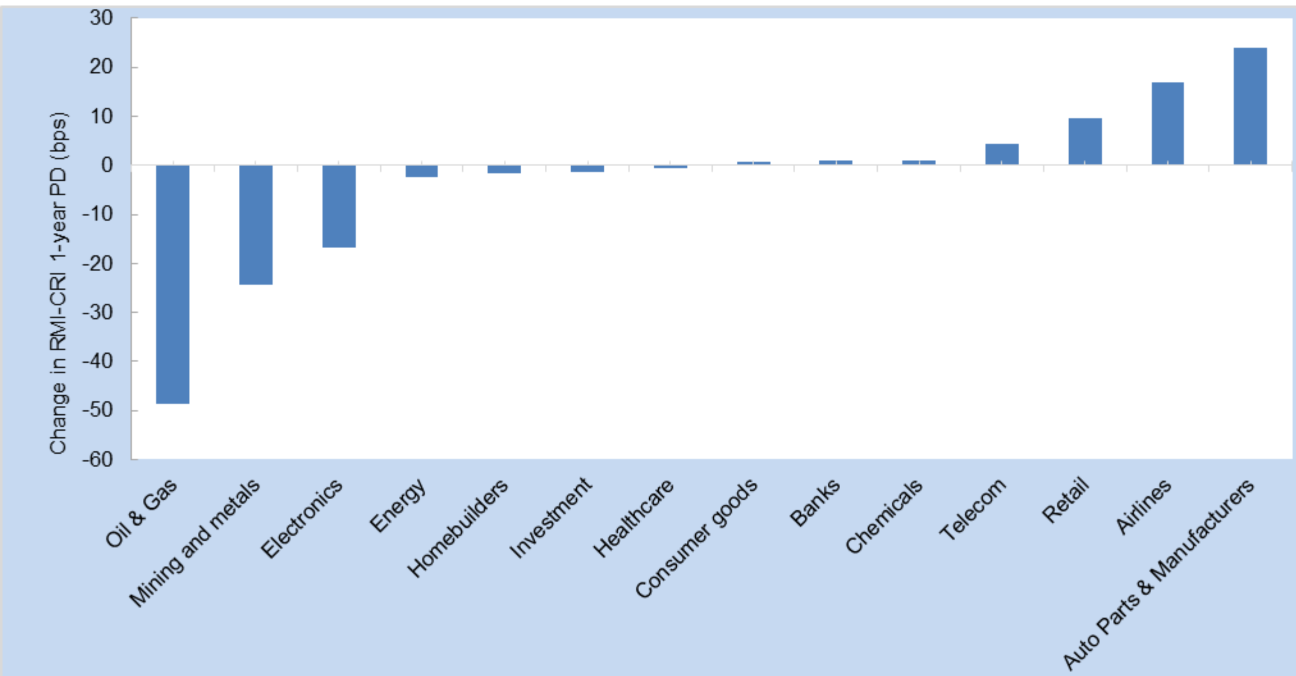

Figure 1. Change in RMI-CRI median 1-year PD of each industry in the UK from January 1, 2016 to June 29, 2018. *Source: RMI-CRI.*

It is less than eight months to Brexit, yet, the nature of the future relationship with the world’s biggest trading bloc, the EU, remains unclear and there is a deep concern in corporate boardrooms about the prospect of Britain failing to secure a final Brexit deal, or with a deal that could silt up the arteries of trade. The withdrawal agreement with EU that was aimed to be completed in October 2018 has yet to be granted approval from the Members of Parliament (MPs). In case the MPs do not agree to the unappealing deal that Mrs. May is likely to bring back from Brussels later this year, Britain could crash out from EU on March 29, 2019, with no deal at all. If the UK quits the customs union with no deal, auto component-makers trading in either direction will face an additional tariff of 4.5% and vehicle-makers will face an additional tariff of 10% under the rule of the World Trade Organization (WTO), an increase from the current 0% tariffs for both categories. It brings a grim prospect for the UK automotive industry; the second largest sector contributing to UK exports that had a turnover of EUR 77.5bn in 2016 and accounted for about 814,000 jobs (see Figure 2b).

The RMI-CRI 1-year aggregate PD for UK-domiciled auto parts and manufacturers has shown a significant upward trend during the first half of 2018 following the decline in investment due to rising concerns on the uncertainty of the Brexit deal (see Figure 2a). The aggregate probability of default for UK auto parts and manufacturers industry increased from 7.40 bps at January 1, 2018, to 34.72bps at June 29, 2018, much higher than the RMI-CRI 1-year aggregate PD for global companies from the auto parts and manufacturers sector (see

Figure 2a). Both Figure 1 and Figure 2a suggest that the UK automotive industry may be more susceptible to the impact of the negotiations over the Brexit deal than other British industries and its global auto peers.

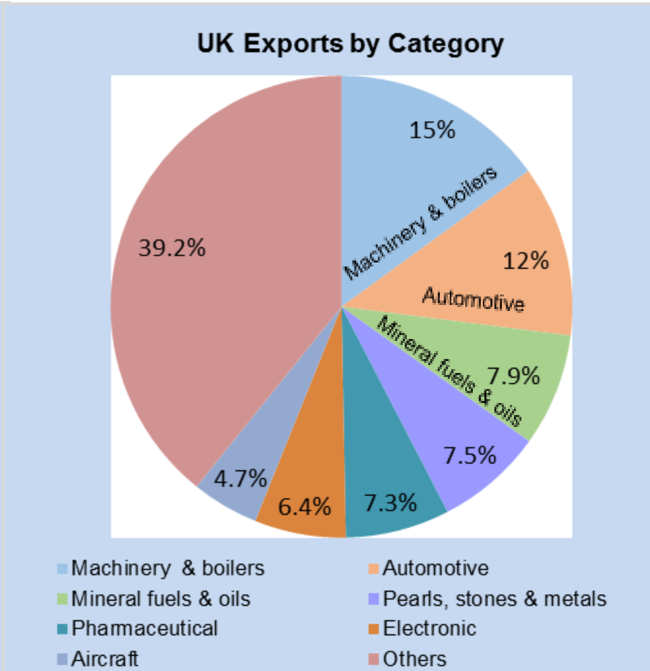

Figure 2a. RMI-CRI 1-year aggregate PD of UK auto parts & manufacturers and worldwide auto parts & manufacturers exclude UK. *Source: RMI-CRI*; Figure 2b. Percentages of UK exports by category in 2017. *Source: Trading Economics.*

Britain's car industry is heavily reliant on exports, with roughly 80% of cars rolling off UK production lines destined for overseas markets, around 1.35mn vehicles in 2016. 56% of the auto exports head to EU countries, earning the country a revenue of around EUR 42bn annually. The SMMT has calculated that export tariffs would add around EUR 1.8bn to exporters' costs. Even if the pound drops further, that could be enough to make UK vehicles uncompetitive in EU, the sector's biggest market, leading to a EUR 4.5bn decline in export earnings. UK car production figures were also warned to drop 10% if Britain fails to secure a traditional deal that would allow the industry to carry on the current trading with EU, causing a risk to miss its production target of 2mn vehicles a year by 2020.

The past 2-years financial performance has also shown a worrying sign. Compared to the period before the Brexit referendum, 2015, UK auto parts and manufacturers' profitability, leverage, and liquidity are currently worse (see Table 1). Car production and auto parts sales in 2017 have declined 3% compared with 2016 as demand for British-made cars dropped both at home and abroad with a total of 1.67mn cars rolled off UK production lines in 2017. It was largely because of a near 10% fall in domestic buyers as cash-strapped households in Britain were increasingly reluctant to commit to major spending decisions. The past two years of transition period has led UK to hit GDP growth of 0.1% in Q1 2018, a five-year low, implying a decline in UK market power and business investment. If the industry further loses foreign buyers, it will aggravate the industry's already-poor profitability.

UK auto parts & manufacturers	2015	2016	2017	Q1 2018
Return on Equity (%)	33.17	10.02	17.46	18.70
CFO/Total Liabilities (%)	0.40	0.29	0.31	0.24
Total Debt/Total Equity (%)	85.16	124.26	125.42	203.69

Table 1. Median financial figures of UK auto parts and manufacturers. *Source: Bloomberg.*

The average UK-built car has about 30,000 parts and the majority comes from the EU, with parts sometimes passing across borders between Britain and other European countries several times during the assembly process. With UK auto components accounted for 44% of British-built cars, it might be more beneficial for car manufacturers to shift their operation into EU and source the components from outside UK to avoid the WTO 4.5% and 10% tariffs, which will cause a significant decline in demand for UK auto parts. The possibility of tariffs and stringent regulations implementations has caused numerous auto manufacturers to step up warnings about the impact of Brexit by canceling manufacturing plans, cutting jobs, and others. PSA has already announced it will axe about 650 jobs at its Ellesmere Port factory, Jaguar Land Rover said it could not plan to make electric cars in Britain until the terms of its departure from the EU were clear, while Ford has warned the UK government about the impact of hard borders and tariffs on UK motor industry.

Figure 3 illustrates the term structure of the RMI-CRI Forward 1-year aggregate PD for UK auto parts and manufacturers, two other bad performing UK industries, namely retail and airlines, and the global auto parts and manufacturers sector based on market information available on July 20, 2018. The Forward PD represents the credit risk of a firm in a future period and works similarly to a forward interest rate. For instance, the 3-month Forward PD is the probability that the firm defaults during the period from 3 months onwards to 1 year plus 3 months, conditional on the firm surviving the next 3 months. The figure asserts that the credit quality of UK auto parts might continue to worsen and may have worse prospects than the other poor performing sectors in the UK and the global auto peers.

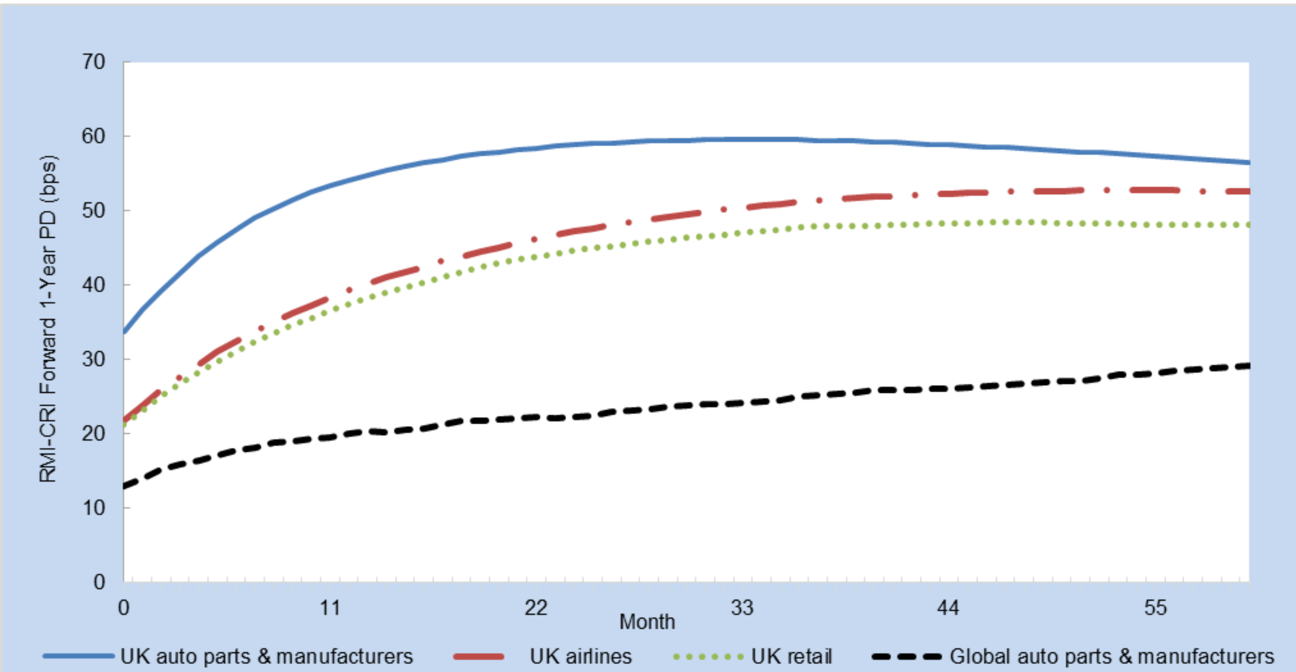

Figure 3. RMI-CRI Forward 1-year aggregate PD term structure of UK auto parts & manufacturers, UK airlines, UK retail, and global auto parts & manufacturers on July 20, 2018. *Source: RMI-CRI.*

The severity of the hit on the UK auto industry relies on the impact of Brexit. In the case of a 'no deal' Brexit, consumer automotive spending might further decline as goods and services prices will rise due to tariffs and stringent regulations might disrupt the industry's integrated supply chains. Currently, the uncertainty of future tariffs might also further decrease investment in British auto industry and increase reluctance to purchase British-built components which lead to lower demand for UK auto parts. Meanwhile, a new development in the call for a second referendum has emerged as Justine Greening, a former cabinet minister, recently joined the campaign after a discovery of a violation of electoral law by pro-Brexit group Vote Leave, which might raise questions on the election result back on June 23, 2016. If the second referendum happens, it might change the outlook for the UK auto industry, with its prospect dependent on the final trade deal.

Credit News

Analysts are downgrading China's small banks at record pace

Jul 23. At least five small lenders in China have been downgraded by credit rating companies this year due to the increase in non-performing loans and overdue loans. Recent regulatory moves have also added burden to smaller lenders such as increasing their cost to seek funding from each other and making their investments in asset-management plans less secure. Rural commercial lenders have seen their non-performing loans ratio jumped to 3.3% as compared to 2.6% two years ago. Analysts believed that more bank bailouts may happen as the government cleans up the financial industry. (Bloomberg)

Collapse of Chinese peer-to-peer lenders sparks investor flight

Jul 22. As Beijing crackdowns on debt and financial risk, a wave of defaults is sweeping across China's peer-to-peer (P2P) lending industry. According to a research group on the industry, there are about 150 online lending platforms since June this year that encountered problems such as investors being unable to withdraw money or owners running away. Industry experts believe the recent wave of defaults reflects a combination of regulatory failures, outright fraud and the impact of a broader debt-cutting campaign. Despite the problems, there are signs that the government still supports the P2P lending industry's development, for it can provide credit to consumers and small business that are poorly served by traditional financial institutions. (FT)

'Jumbo jet deals': Shadow banks pile into developer lending as big four retreat

Jul 21. As major banks tighten their lending to commercial property projects, developers are turning to non-land lenders and credit funds to plug the funding gap. Non-bank lenders pool their own capital and obtain funds from wealthy individuals to provide developers 'senior debt' lending which are typically the domain of the big four banks. Foreign banks have also entered into the lending market as their exposure to Australian commercial property has risen by 10% to AUD 7.2bn. Non-bank lending also tends to cost more as it typically charge lenders about 9-14% compared to the bank's rate at 4.5%. The unregulated boom in non-bank lending has caused some industry watchers to warn about the 'contagion' risks given the less stringent lending standards. (Sydney Morning Herald)

Renewed political unease in Rome knocks Italian bonds

Jul 20. Bond prices of Italy's sovereign bonds have fallen amid rising tensions within the ruling coalition and concerns about Italy's commitment to the euro. Rumor has it that the Deputy Prime Minister demanded the resignation of the Finance Minister Tria and the country's populist leaders were united against Tria over nominations for the leadership of state lender Cassa Deposit e Prestiti Spa (CDP). The state lender is owned by the Treasury and controls many of the largest companies in Italy. Finance Minister Tria was appointed in May and is widely regarded as a counterweight to the ruling party's plans to increase government spending. (Reuters)

Rising interest rates, trade wars erode credit outlook: survey

Jul 19. According to an International Association of Credit Portfolio Managers' (IACPM's) quarterly survey, rising interest rates and increasing possibility of trade wars might cause corporate credit spreads to widen and default rates to increase. Interest rates hikes pose a threat to companies with high debts and those who need to access capital markets. 56% and 66% of survey respondents see increasing defaults over the next year in Europe and North America respectively. There is also the looming threat of global trade wars, which might raise defaults, and the ripple effects of Brexit on credit markets. (Reuters)

Hyflux working hard to stay 'viable', ensure fair treatment to shareholders: CEO Olivia Lum (Channel NewsAsia)

China deleveraging plan may impact S Korea economy (Business Times)

Green-bond sales surge toward record as borrowers burnish brands (Bloomberg)

Regulatory Updates

China takes 'more flexible way' on wealth products rule changes

Jul 23. China's regulators took a softer stance than expected on asset management products as the regulations aim to shrink China's shadow-banking system. Some of the key guidelines published by PBOC include the government supporting banks raising their Tier-2 capital as they move off-balance sheet assets to books and some asset management products can be valued using the amortized cost method. According to calculations by Bloomberg, China's shadow-banking sector saw the biggest net monthly drop for the month of June. The latest measures are expected to give banks more flexibility and liquidity to handle off-balance sheet exposure at the banks' own pace. (Bloomberg)

IMF warns parts of Eurozone banking system remain 'vulnerable'

Jul 19. The International Monetary Fund (IMF) raised concerns about the vulnerability of parts of the Eurozone banking system and urged changes in regulating lenders. The fund expected the Single Supervisory Mechanism (SSM), a banking watchdog, to be more involved in managing its own resources, and not be overly dependent on national central banks and supervisors to provide manpower. While capital raised by banks has helped to alleviate the impact of shocks, the system is adversely affected by bad loans and low profits. As the problems for some lenders were structural and their business models are no longer viable, the IMF called for a transfer of power to grant emergency loans to troubled lenders from national central banks to the ECB. (FT)

China green-lights offshore foreign currency bonds as interbank collateral (Reuters)

Banks under watch over exposure to cryptocurrencies (FT)

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