

Views from the Japan Equities Small Cap Desk

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EV Market: Looking Ahead to China's Modulation

In discussions on automotive technology trends in recent years, the term "CASE" has become commonplace. This acronym is derived from four key words: **Connected**, which refers to a communications ecosystem that enables a range of controls; **Autonomous**, which refers to the automation of driving; **Shared or Service**, which refers to the use of a single car by multiple drivers; and **Electric**, which refers to the use of electricity as a power source. Each of these terms often appear in the context of an inevitable future.

Electrification over automation

However, I do not like the term. The reason being, I think it is harmful to talk about these four trends together, as different as they are in terms of importance and timeline.

Of these trends, electrification is by far the most important at the present time. Amidst calls for climate change countermeasures, it is important that we pursue electrification and power generation that does not rely on fossil fuels in tandem in order to reduce the carbon dioxide emissions from vehicles.

Full driving automation, if realised, will have as great an impact on human society as any other, but mainly due to social factors, its progress will necessarily be slow. Compared to the two issues mentioned, I feel that controlling cars through connectivity and simply the form of ownership and operation of cars are relatively small matters.

In the field of electrification, **Toyota Motor Corporation** has been the leader in hybrid technology, achieving breakthrough improvements in fuel efficiency, and **Tesla** in the US has been the leader in branding electric vehicles (EVs) that run on electric motors alone. However, a new tectonic shift began last year: the rapid spread of Chinese-manufactured EVs.

China's battery market pushed into oversupply

In China, the production of smartphones and other products has led to the accumulation of battery technology. At the same time, the country has depended on foreign manufacturers for engine technology, as such, they have long anticipated the development of drive technology that would enable them to take the lead. Combined with the fact that the Chinese market has always been highly regulated and quick to reflect the will of the state, the government's promotional measures and the aggressive management of emerging manufacturers came together well, and rechargeable electric vehicles very quickly accounted for 30% of all new cars sold in the market. Consequently, Japanese and other foreign manufacturers, with the exception of some high-end brands, lost market share across the board.

However, this trend has tempered since the beginning of this year. Although the electrification rate continues to rise, factors such as the government's review of subsidies and the economic downturn have resulted in oversupply. In particular, it is reported that the oversupply of batteries, a key component in EVs, is even more serious than the oversupply of finished cars.

China's EV producers will need to find their way into exports, but it will be difficult for these to grow as fast as domestic sales. This is because few countries have a subsidy policy and petrol car regulations like China. The rapid growth in China has been helped by consumers' support for domestic brands, while the majority of overseas consumers are likely to feel uneasy about buying from China due to its limited track record as an automobile manufacturer and its diplomatic instability.

Although cars from top companies, such as **BYD**, will gain some traction due to better cost performance than Tesla, we expect Chinese automakers will only be able to make limited moves in the coming years. In the meantime, the industry will probably be restructuring at a furious pace. At some stage foreign manufacturers who have been late to the electrification movement will play a part in the restructuring.

Focus on fuel vehicle exports

As for the global electrification of vehicles, it is certainly a megatrend that is sure to progress further. However, I don't think we will see this happen quickly or all at once, as there are a number of external constraints, such as the securing of power sources and natural resource issues. With regard to investments in related companies, we position them as high risk, cyclical growth stocks and do not recommend buying them up to very high P/E levels, except when a new market opens up.

In particular, the impact on the stable supply of electricity will be one of the most important issues to watch in the future. The spread of solar cells has made it easier to balance supply and demand in the early afternoon in summer when demand is at its peak, but the tight supply-demand situation in the evenings in winter is becoming increasingly severe worldwide. If all the EVs were to start charging once they've reached home around the same time, the load on the energy system would be enormous.

In Tesla's home state of California in the US, there are already moves to call for seasonal restrictions on charging. It will be necessary to keep a close watch on the electricity situation in advanced electrification regions, including China. We believe that, instead of drastically reducing the price of electricity supplied to EVs, a 'best-effort' approach should be adopted which does not necessarily guarantee a stable supply in times of tight supply and demand.

At the moment, there are many issues surrounding EVs, so when it comes to China's car exports, the focus should be more on fuel vehicles. While Japanese and South Korean automobile manufacturers are suffering from a shortage of semiconductors, China has dramatically increased its export of petrol-fuelled vehicles to emerging economies.

If the Chinese market is to continue to establish itself in emerging economies, it will be a major threat to Japanese manufacturers. Although unit prices are lower than in developed countries and China, this is the only market where volume growth can be expected in the mid- to long-term. It is also an extremely important market for Japanese manufacturers who have been late adopters in the EV market, in that it is likely to be one of the last regions where fuel vehicles will be allowed to be sold.

When CASE is realised

As electrification becomes the most pressing issue for existing manufacturers, some say that the focus is shifting to assisted driving vehicles, rather than full automation, which is fraught with problems. As the issues with automation have a direct effect on human lives, it is difficult to implement hastily in society, and it is appropriate that knowledge is being built upon through a series of controlled experiments. If war should break out between industrialised countries, it is conceivable that technological progress could accelerate at a discontinuous rate.

I would like to mention one more possible scenario.

If in the distant future, all elements of CASE were to align, including full automation, it could give rise to a great synergy effect. I have an image of driverless taxis recharging at suburban facilities and then being dispatched to transport people to meet the forecasted demand. This system can charge vehicles on standby utilising the available surplus of electricity, thus placing an extremely low burden on the energy system.

In such a system, the majority of cars would carry one person (even now, most taxis transport just one passenger). With the exception of cases such as those travelling with a small child or a family member who needs a carer, or those who want to stay together even a few moments longer, it is reasonable even for a group to travel one person to a vehicle. And even with a single-passenger vehicle, four wheels are still required, so I think the winner in this scenario would be the tyre manufacturers.

Source: Based on an article by Tatsuro NIGARI, published in The Nikkei Online Edition on 19 September 2023.

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Mr Nigauri is an award-winning manager and has received many accolades, including the Lipper Fund Awards Japan (2012, 2013 and 2016), the R&I (Rating and Investment Information) Fund Awards (consecutive years from 2012-2019) and the J Money Fund Awards (2016 and 2017). He obtained a BA degree in economics from the University of Tokyo in Japan, and is a Certified Member Analyst of the Security Analysts Association of Japan.

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