

German Re-engineering

FUNDHOUSE

investment clarity

The last quarter saw a number of significant economic events and market shifts, ranging from the US Fed's decision not to raise interest rates, through to concerns regarding China's growth rates and the resultant emerging market equity woes. The European economy (and all the issues surrounding Greece and their debt) has been overshadowed by the news out of the US and China. However, the very significant

issues around Greece remain and the European economy is being forced to face up to two emerging issues that have made front page news around the world: the migrant crisis and the Volkswagen (VW) scandal. The majority of the news flow on these two issues has (quite rightly) focused on the humanitarian issues relating to the migrants and the ethical concerns around VW's actions. However, both issues have the potential to have devastating impacts on the European economy and negatively impact financial markets. This article focuses on the economic fallout that VW's travails may lead to.

What happened at VW?

Volkswagen sold approximately 11 million diesel cars globally that had been built with software that hid the extent of their emissions so that they could pass regulators' emissions tests in various countries. This allowed VW to sell the vehicles in those countries - it would not have been allowed to if the actual emissions from the vehicles were apparent in the tests.

image not found or type unknown



The future for VW? The fallout from this fraud is likely to be massive for the business and this has been reflected in the share price - VW share price has fallen by almost 40% since the news broke.

image not found or type unknown



The impact on the business goes so much further than the costs of recalling and fixing 11 million cars. A question even remains as to whether they will be able to just fix the cars or whether they will need to refund clients. VW's reputation lies in tatters and we will need to wait and see the impact of the scandal on its sales numbers. While facing the distinct possibility of a fall in revenue through lower sales, they are also looking at a material increase in their cost base. This increase is likely to be driven by:

- The costs of the recall and fixing of the vehicles - VW have set aside 6.5 billion Euros to cover these costs
- Significant legal fees to fight lawsuits around the globe (Texas County is suing VW for \$100m for worsening pollution levels, rumours of class action suits abound and there is more to come), and the costs if any of those lawsuits are successful in their claims.
- Expected fines from regulators around the globe (which are likely to be material - the initial estimate of fines is \$7.4bn from analysts Sanford C. Bernstein Ltd)

We would also expect a potential downgrade in VW's credit rating - this impacts the cost of their borrowings which can also hit future profits.

Apart from all the costs, one should expect that the scandal will take a huge amount of executive focus and time over the coming years, which makes focusing on managing a large business exceedingly more difficult.

One must also not ignore the potential impact on the financing division of the business - basically, VW facilitates loans to customers to buy their cars. There is the potential for higher defaults on the loans if second hand VW car prices fall. The loans are funded by VW borrowing money in the markets, and there are already signs of the cost of funding the loans rising due to the investors' risk perception (which would reduce the margins that VW make in their financing division).

Why does it matter?

Germany's role as the stable financial market underpinning Europe's economy is under threat. VW is the largest company in Germany, employing more than 600,000 employees globally (about 200,000 in Germany) and the supply chain as a result of the business employs countless others. It is also one of Germany's largest exporters (and has a material say in Germany being Europe's leading exporter). Put simply, cars accounted for almost 20 percent of Germany's near \$1.5 trillion in exports last year and the motor industry accounts for one in seven jobs. The impact on jobs is already starting with VW placing a freeze on new hires in its loan division and slowing production at one of its biggest engine factories.

Germany is also the largest European economy with many feeling that they have held the Eurozone together through what has been a tumultuous last 7 years. If VW were to go to the wall as a result of the scandal, the impact on Germany would not be insignificant and the flow on effect on Europe and the global economy should not be underestimated, especially if other German car manufacturers are also part of the fraudulent covering up of emission levels. At a time when Europe is having to deal with a migrant crisis and the ongoing potential of Grexit, there are many nervous investors watching how the market reacts.