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Volkswagen: Made in China?

Investment summary:

- Volkswagen (VW) is the biggest German vehicle manufacturer and the third-largest automaker in the world operating in 153 countries.
- Although Europe remains difficult and VW's 2012 deliveries in Western Europe declined YoY (in all major markets except Germany and the UK), VW's share of the overall passenger car market rose to 24.4% (vs 23.0% in 2011).VW also has enviable positions in fast-growing emerging markets (EMs [China, Brazil and India]).
- By the mid-2000s VW's reputation was impacted by quality issues, limited growth and low operating margins. In 2007 Dr Martin Winterkom took the helm as CEO and set about turning the company around by formalising the turnaround strategy (Strategy-2018), which focused on making VW the world's largest car maker by 2018.
- Although it is unlikely VW will be getting the title of world's biggest-selling car maker by 2018 it has made enormous strides in the past 6 years or so and last year reached a milestone of 9.3mn vehicles sold globally.
- Among its growth drivers are its strong position in China (its largest market), the increase in global vehicle sales, its unsurpassed global exposure, significant investment spending, a strong brand portfolio and an outstanding global distribution network.
- Although VW has done well in the US in recent times, the past few months has seen sales there slowing.
- The European debt crisis' perceived repercussions for VW has weighed on the share price and valuation of the company and we view this as one of the main reasons VW is undervalued.
- The completed acquisition of Porsche last year has been extremely positive for VW. Porsche is now the most profitable of its 12 brands (3Q13 profit from Porsche climbed 55% to EUR599mn or 22% of VW Group earnings).
- VW is a well-run business with a great track record and solid growth. Looking at its low P/E the impression you get is that the market expects a material earnings decline. However, *Bloomberg* consensus expects double-digit earnings growth in the next two years and in our view the current price represents a buying opportunity.

What it does:

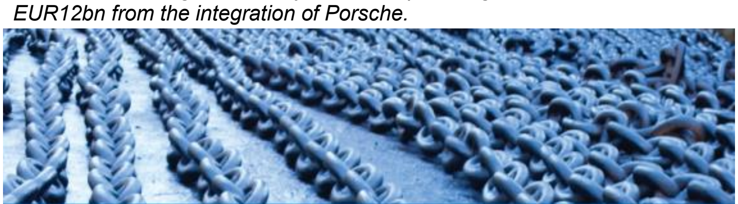
VW designs, manufactures and distributes passenger and commercial vehicles, motorcycles, engines, and turbo-machinery globally. It also offers related services including financing, leasing and fleet management. VW is Germany's biggest vehicle manufacturer, the largest European vehicle producer and the third-largest automaker in the world. It operates c. 105 manufacturing plants globally including in Germany, Mexico, Slovakia, China, India, Indonesia, Russia, Brazil, Argentina, Portugal, Spain, Poland, Czech Republic, Bosnia and Herzegovina and South Africa. It also recently opened a new plant in the US (Chattanooga, Tennessee).

VW's forecasts are as follows:

Volkswagen				
December y/e	FY12*	FY13E	FY14E	FY15E
EPS (EUR)	46.4	20.4	23.5	26.1
% growth		*-56%*	*15%*	*11%*
DPS (EUR)	3.6	4.2	5.5	6.6
P/E	3.9x	9.x	7.8x	7.x
DY	1.9%	2.3%	3.0%	3.6%
Share price (EUR)	**182.85**			
12-mnth fwd P/E	7.8x			

Source: Bloomberg, Anchor Capital

Note FY12 earnings inflated by a one-off, pre-tax gain of more than EUR12bn from the integration of Porsche.



Global Ideas is a newsletter published three times a week (Monday, Wednesday and Friday) and available only to clients of Investor Campus and Anchor Capital. The key objective of this newsletter is to provide ideas for investment in the global investment universe.

We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watch-list, which is continually reviewed and updated.

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VW's key global markets:

Source: Company reports

Company overview:

The VW Group consists of 12 brands from 7 European countries: VW Passenger Cars (Passat, Golf, Cabrio, Jetta, GTI and Beetle), Audi, SEAT, ŠKODA, Bentley, Bugatti, Lamborghini, Porsche, Ducati, VW Commercial Vehicles, Scania and MAN. On 1 August 2012 VW completed the integration of Porsche and it is now fully consolidated into the group. As of 2011, VW ranks first in terms of spending the most money of any automaker on research and development (R&D).

VW Group has three divisions:

- **Passenger Cars** is responsible for the development of vehicles and engines as well as the production and sale of passenger cars.
- **Commercial Vehicles and Power Engineering** deals with the production and sale of trucks and buses, and business comprising genuine parts, large-bore diesel engines, turbo-machinery, special gear units, propulsion components and testing systems.
- **Financial Services'** portfolio of services combines dealer and customer financing, leasing, banking and insurance activities and fleet management.

Prior to 2007 VW's reputation was impacted by quality issues, limited growth and low operating margins. However, the group underwent a significant transformation when Winterkorn took over as CEO shortly before the global financial crisis (GFC) in 2007. At that stage he made it clear VW wanted to be better than Toyota – not only in number of units sold but also in profitability, innovation, customer satisfaction etc. He formalised the Strategy-2018 plan (implemented the year before) in terms of which VW would strive to be the number-one global vehicle manufacturer by 2018 through customer satisfaction, increasing vehicle unit sales to over 10mn p.a., improving return on sales before tax (to at least 8%) and by aiming to be the top employer across all brands, companies and regions. However, steady volume gains and growth since 2007 have already seen to it that VW is within reach of its current 2018 sales targets. Under Winterkom's auspices VW's vehicle sales have increased 49% globally since 2008, to 9.3mn units, and its worldwide market share has improved to 12.8%, up one-half of 1%. Revenues (+63.5%) have grown fast despite the headwinds VW has faced (fuelled by strong demand for expensive premium luxury cars from Porsche and Audi and VW's exposure to high-growth EMs).

Growth drivers:

The following are what we believe to be some of VW's key growth drivers:

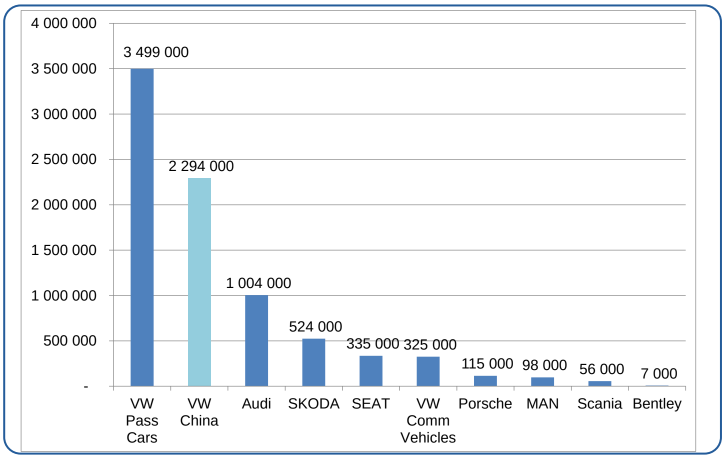
1. China:

To give readers an idea of China's importance to VW we need to take a look at VW's history in that country. China is its biggest market and strong demand for its vehicles there (and to a lesser degree robust sales in the US last year which have since come off significantly) helped offset weaker European sales. For years VW had first-mover advantage in China. It entered the market long before it became fashionable through a 1984 JV with the Shanghai Automotive Industrial Corporation. While VW's competitors at the time only exported a minimum number of cars to China, VW established operations with a view towards slowly building the brand and putting in place important relationships, including at various levels of government. A second JV (FAW-Volkswagen Automotive Company) followed in 1991 further entrenching VW in China. In these JVs the Chinese companies and VW held equal shares. From early on VW's good relationships with government proved beneficial and it won contracts to supply taxis to the municipalities of Shanghai, Beijing and other cities. These taxis literally put the VW brand out there and was the best advertising it could have asked for resulting in more people in China buying VW as their first car. By 1995, VW held a c. 70% market share in China. However, the situation changed a few years later as aggressive marketing of low-cost brands by other foreign (such as GM) and local companies paid off and VW's market share plunged to 15% towards the late 1990s. VW's response was to introduce new technologies at its two Chinese JVs which lowered production costs. It also launced new low-cost models such as Skodas. By being more price competitive and rivalling competitors in quality, VW brought Chinese consumers back to the brand and by 2010 VW was again the leading car company in China, with the Skodas accounting for c. 20% of sales. In September 2013 VW opened a new car factory in southern China, and announced plans to build another one to double capacity. VW is now represented by 17 companies producing at 11 facilities in China (including component, finance and sales companies).

With its long history in China, the growing importance of the Chinese market for automobile manufacturers and the success VW has achieved in the country, China will continue to play a key role in VW's success and in its bid to become the world's biggest carmaker. In 2012 VW established a China Board of Management to underpin the importance of the Chinese market. Currently VW's Chinese product portfolio covers all car product segments from small cars to luxury sports cars. In October, VW said its 9M13 sales in China rose 18%, propelling it to a 4.8% worldwide gain, while sales for the month of October alone rose 18% to 2.02mn. To sustain growth in China VW intends to, over the next two years, along with its Chinese JVs, invest c. $80bn in 10 new plants (including 7 in China) and a number of new products, from an American-style SUV to a $9,000 starter vehicle for EMs. VW also plans on introducing plug-in diesel hybrids and advanced infotainment system technologies in the country.

The chart below shows the scale of VW's China sales. Here it should be noted that according to VW the sales revenue and operating profit of its China JVs are not included in group numbers but are instead accounted for using the equity method. VW recorded an operating profit (proportionate) of EUR3,530mn in 9M13 vs EUR2,806mn in 9M12.

VW sales by brand, 9M13:



Source: Company reports, Anchor Capital

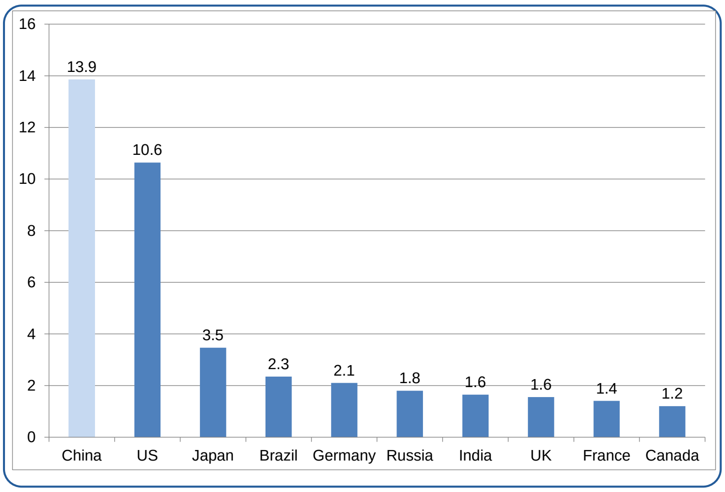
We do not believe recent China state-run media criticism of VW (and other foreign companies including Apple and Yum! Brands) could turn the Chinese authorities against VW and we think investor concerns around this are unjustified. Our reasons are:

- China's announcement in mid-November of its boldest set of economic (and social) reforms in nearly three decades, as the Communist Party government further freed up the market in order to put the China's economy on a more stable footing.
- As highlighted above VW has a long history in the country and (unlike other companies) it operates completely through 50/50 JVs with local companies. Any government action against it would in effect be against its own. VW (and its JV partners) are also big employers in China and the company has huge investments plans which will lead to even more employment.
- VW acted quickly to placate the Chinese government in the face of criticism and would do so again should a similar issue/ criticism arise in future.

In our view government criticism poses little risk of permanent damage to VW's ability to compete in China. It is a well-established brand there and with a c. 21% market share currently it is unlikely the criticism will have much of an impact. Overall, China is a very important growth driver for VW as it is the company's largest single market and VW is the top-ranked light passenger vehicle brand in the country. With the exception of 2008 (due to the GFC) auto sales in China have grown at a double-digit pace since 1999.

In 2009, China overtook the US as the world's largest auto market by sales. China also accounted for a third of light vehicle sales growth in the past five years. According to the *China Association of Automobile Manufacturers (CAAM)*, 1.61mn vehicles were sold there in October, up 24% YoY. This was the fastest pace of growth in nine months adding to signs that China's economy is accelerating (official statistics released in the first week of November showed industrial production, customs data and manufacturing investment strengthening). A recent *PriceWaterhouseCoopers (PWC)* report says that the global auto market will continue to expand in the coming years, driven by China where sales are expected to nearly double by 2019. The *CAAM* projects that auto sales in China will rise 7% to more than 20mn vehicles in 2013, buoyed by strong demand for passenger vehicles and an economic recovery. The association notes that SUVs (one of the vehicle types VW is putting significant investment into in China) will remain the fastest-growing segment in 2013, while commercial vehicles are also expected to record a moderate gain in sales. Thus, despite concerns around China's possibly slower growth, it remains VW's biggest market and will in all likelihood only increase in terms of scale.

Top global vehicle sales, year to August:

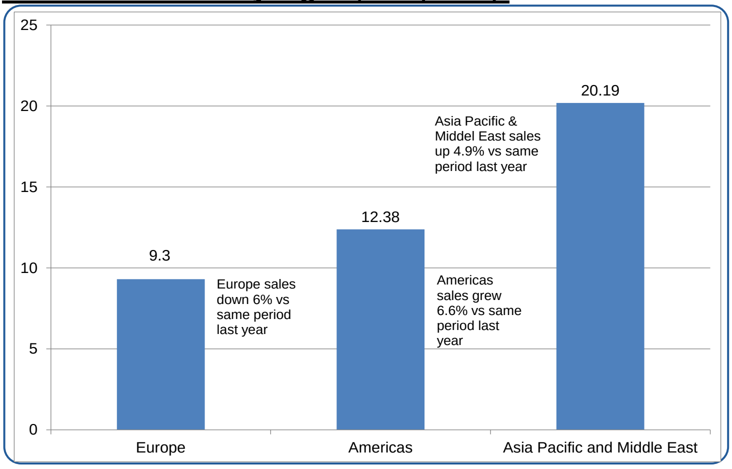


Source: focus2move, Anchor Capital

2. Increasing global vehicles sales:

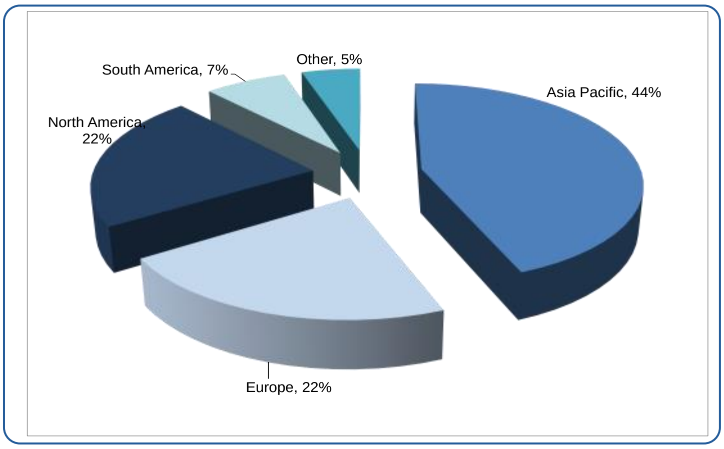
According to the *International Organisation of Motor Vehicle Manufacturers' (OICA's)* restated 2012 numbers, world vehicle production reached a record 81.7mn (all types) last year, up c. 5% compared with 2011. In 2013 global sales (all vehicle types) are expected (according to *focus2move* estimates) to reach c. 83.2mn on the back of booming demand from EMs. Mature markets now only represent 47% of global vehicle sales. January-September 2013 global sales data show Toyota maintained its lead over GM and VW this year, with sales totalling c. 7.41mn vehicles (+0.1% YoY). GM sold 7.25mn vehicles (+4.6% YoY), while VW saw the biggest sales growth for 9M13 (+4.8%) to 7.03mn vehicles (note this excludes VW's Scania and MAN brands which generally account for a combined 200,000 vehicles p.a.). In the US, vehicle sales have been leading the economic recovery, rising 8% this year and *autonews.com* expects it to finish well above 15mn units for the year. The US auto industry is experiencing a significant boom and analysts forecast 2014 vehicle sales will reach over 16mn units (marking five consecutive years of growth). Importantly for VW, in China vehicle sales remain robust and in 1H13 *OICA* data show new vehicle sales jumped 12.3% to 10.78mn. All of this is good news for vehicle manufacturers and for VW. The company has a global presence, China is its biggest market and it also has exposure to other high-growth markets like Brazil and India.

New vehicle sales by region, mn (1H13):



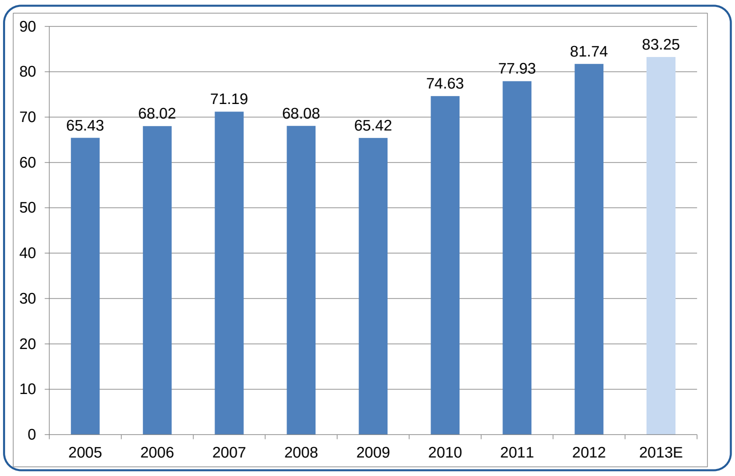
Source: OICA, Anchor Capital

World vehicle sales by region, January-October 2013:



Source: Wardsauto.com, Anchor Capital

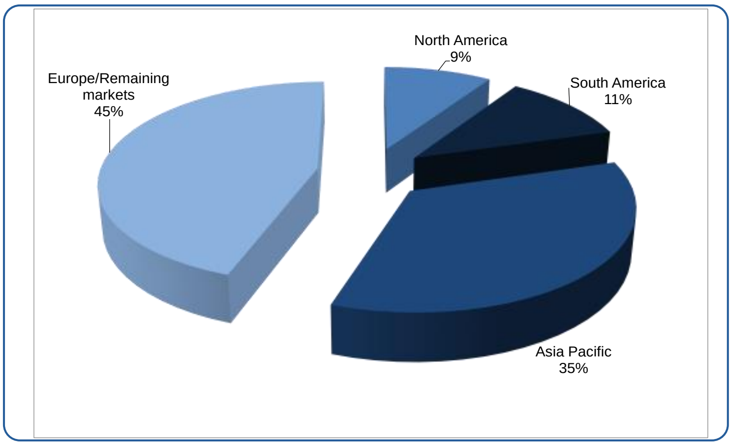
Global vehicle sales, 2005-2013E, mn:



Source: Company reports, focus2move, Anchor Capital

Note 2013E is a focus2move estimate

VW vehicle deliveries by region, FY12



Source: Company data, Anchor Capital

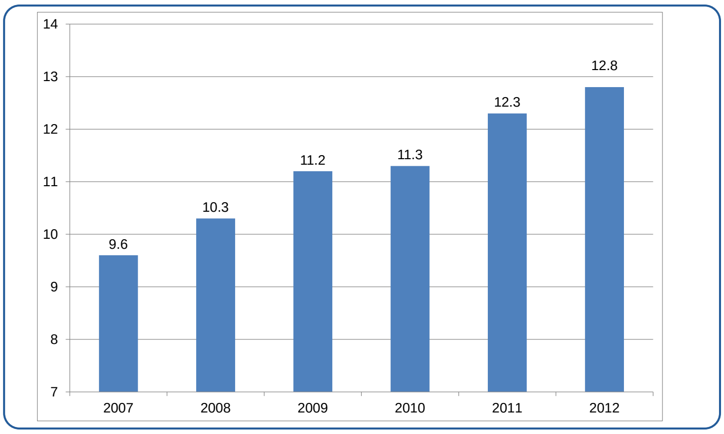
3. Global exposure:

VW operates in 153 countries worldwide and manufactures cars in 100 plants in Europe, North and South America, Asia, Africa and Oceania. Except GM and Toyota, no other automotive company is capable of competing with VW in terms of global exposure. Besides its significant and established presence globally, it has still-rising market shares in key growth markets in Western Europe, Russia, South America and China, offering investors exposure to an attractive mix of high-growth EMs and established DMs.

Through its diversified global footprint and exposure to fast-growing EMs (Brazil, China, India, Russia), where sales of new vehicles are increasing significantly, it made up for declining sales in Europe. In Asia-Pacific, VW registered sales of 3.17mn last year, a robust 23.3% YoY increase. As mentioned earlier China remains its single biggest market, with sales totalling 2.81mn (up 24.5% YoY) units. India is expected to account for 40% of auto industry growth over the next five-to-seven years and, currently, VW's market share in India has significant room to increase and the company is eyeing a market share of c. 7% by 2018 (more than double the current c. 3%). VW last year announced an investment of EUR100mn in India over the next two years for upgrading products and existing facilities. It already has two manufacturing plants there.

In 2012, North America proved to be one of Volkswagen's best performing markets (albeit from a low base) as sales increased 26.2% YoY to a new record of 841,500 units. Of this 596,100 were sold in the US alone, up c. 34.2% YoY. Although VW might not reach the number one position in the US market and it has reported disappointing sales data most of this year, it nevertheless surprised many detractors by making inroads in the US. The group also saw impressive growth in South America, where sales increased 8.2% to just over 1mn units. VW is also extremely popular in Brazil which is ranked as one of the Latin American countries with the most promising growth. With 3.8mn vehicles sold in 2012, Brazil is the world's fourth-largest car market after China, the US and Japan. The country has jumped to sixth place among the world's largest economies, and ranks among those countries with the most promising growth potential. VW's exposure to this diversified array of markets will stand it in good stead in a challenging global market environment.

VW's share of global passenger car market (2007-2012) , %



Source: Company data, Anchor Capital

4. VW's outstanding global distribution network:

A distribution network is the chain involved in getting a product (or service) from the producer/manufacturer to the end consumer. For an auto company it is how to get the vehicle from its manufacturing facility to the showroom floor and then to the buyer. A weak distribution network means the goods produced are more difficult (and expensive) for a company to move around. Conversely a strong distribution network is extremely important for a vehicle manufacturer to be successful and to keep growing market share. VW has an excellent distribution network which results in the creation of barriers to entry for any new competition which might otherwise have impacted its market share. In the automobile industry a vehicle manufacturer primarily distributes product through a dealer network. Usually these dealerships are independently owned but exclusive to a specific manufacturer, in which case the dealership would also rely heavily on that manufacturer for parts, support, financing etc. The higher the number of dealerships a vehicle manufacturer has in a specific area, the greater the likelihood of a higher market share. In China where VW is extremely successful the company currently has 2,000+ dealerships and is planning to expand this by 1,000. VW also has a (still-increasing) 21% market share while a competitor like GM only has 75 dealerships in China with plans to expand to 150 this year.

Looking at these numbers it would be difficult for GM to take a significant slice of China's market-share pie away from VW (considering the number of dealerships it has in the country). A high number of dealerships also leads to benefits in terms of shipping costs, regional overhead allocation, etc. Globally, VW has c. 20,000 dealerships with plans to add 1,500 in the near-term and also outlining growth initiatives (in basically every region, while at the same time calling for significant investment in its growth plans for expanding its dealer network). We believe VW will continue to take market share through its distribution advantage in certain key markets, while its strong capital position will allow for brand promotion and more local factories (probably the most effective way for the company to boost local demand for its product).

5. Manufacturing efficiency:

As vehicle market competition intensifies it is important for manufacturers to lower costs in the production process to maintain and grow margins. To do this more and more vehicle manufacturers are attempting to consolidate their variety of models onto fewer platforms, leading to interchangeable parts, bulk discounts from big order sizes and a reduction in the design and engineering time for new models. In terms of efficiency VW has been at the forefront of reducing platforms by investing in technology to share parts and by lowering production costs. VW management has promised that its component-sharing platform (MQB), which is intended to standardise parts across its 12 brands and models, will deliver a 20% cost-saving (although the project entails significant upfront investment). This is considered essential if VW wishes to achieve its targeted 8% pre-tax return on sales by 2018 vs 6.5% at the end of September. The company has said that it believes MQB, which is expected to produce c. 4mn cars by 2016, is "the only way to master the complexity of a company with 12 brands and a huge international footprint". VW estimates MQB could end up driving costs down by up to EUR1,500/car. Taking into consideration annual production of over 9mn cars then this could boost profit by EUR13.5bn!

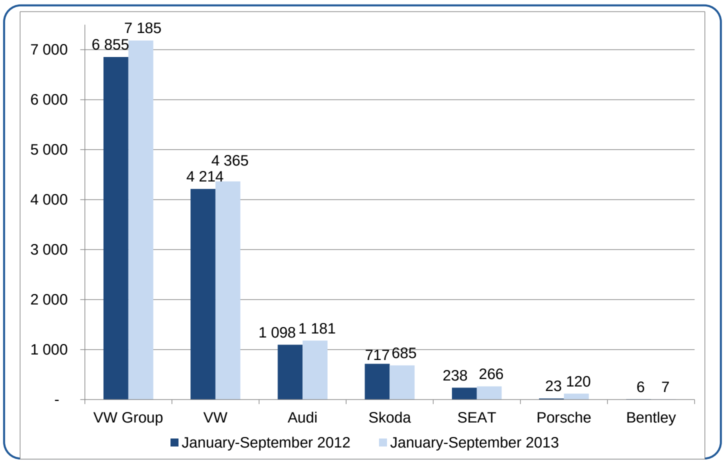
6. Significant investment spending:

In November, VW said it would maintain a high level of spending on developing new vehicles and upgrading factories around the globe over the coming five years to underpin its bid to become the world's largest automaker. VW plans to invest EUR84.2bn through 2018, in a plan that calls for a reduction in average annual spending on property, plants and equipment of about EUR500mn p.a., compared with its previous budget. The company's Chinese JVs, which aren't consolidated and therefore not included in the group number, will invest EUR18.2bn on expansion.

7. A strong brand portfolio:

VW could withstand the slump in major European markets last year due to good growth overseas, its diversified global footprint and the fact it offers customers a wide range of models. The company's vehicles vary from small, fuel-efficient cars like the Up! to ultra-luxury saloons (Bentley's Continental). Its passenger cars include nine independent brands with strong market penetration. This has seen VW growing 9M13 global deliveries 4.8% and handing over a total of 7.08mn (vs 9M12's 6.71mn) vehicles to customers - for the first time in its history deliveries for the first three quarters of the year topped 7mn. The VW Passenger Cars brand delivered 4.36mn vehicles (vs 4.21mn in the same period last year), while Audi delivered 1.18mn vehicles (vs 1.10mn in 9M12) worldwide in 9M13, an increase of 7.6 %. VW Commercial Vehicles continued to record stable progress with deliveries running at 406,600 (409,300; -0.7% YoY) units. VW owns and sells and array of 12 automotive brands catering to a wide range of customers from the extremely wealthy to the budget conscious. The group saw its luxury Audi brand (its biggest earnings contributor and second-biggest brand in the firm's portfolio) growing impressively as sales rose 12% to 1.46mn cars and SUVs. Sales at Porsche also increased 19% to a record 141,075 vehicles sold. Among its range of models only SEAT (Spain) recorded a 2012 sales drop. The Audi brand is valued at $7bn, while Porsche is valued at $5bn.

VW sales by brand, year to September 2013 ('000):



Source: Company reports, Anchor Capital

8. CEO Dr. Martin Winterkorn:

Winterkom's contribution to VW's performance shouldn't be underestimated. In the five years since he took over as CEO, VW has gone from strength-to-strength as its global market share for passenger cars increased from 9.6% in 2007 to 12.8% in 2012 (increasing every single year). Worldwide deliveries increased 8.4% (on average) and VW has effectively nearly reached its 2018 goal of 10mn vehicles p.a. in deliveries (6 years ahead of schedule). Over the same time period, revenue increased 12.1% (on average) indicating a steady increase in product pricing, while VW's operating margin has nearly doubled since Winterkorn took the helm. Finally, the group has also successfully added the Porsche, Scania, MAN and Ducati brands and more than doubled its number of factories globally to 105 under his stewardship.

9. Exposure to an attractive mix of global markets:

VW offers investors exposure to an attractive mix of EMs and DMs. The company has benefited from global industry tailwinds, such as growth in EMs (especially in those in which the group is well established). Besides China, VW's presence in other growing emerging economies has protected it from the six-year European car-market contraction which hurt demand at other vehicle manufacturers that depend more on Europe for business. VW's future plans include further widening its dealership network in markets such as China, Russia and southeast Asia. VW is also extremely popular in Brazil, which is ranked as one of the Latin American countries with the most promising growth coming in sixth among world's largest economies. Asian countries, especially China and India, are expected to account for 40% of growth in the auto industry over the next five to seven years and *Global Insight* expects 14.7% growth to come from India and 8.3% from China by the end of 2013. All of this bodes well for VW and its exposure to the mix of high-growth markets.

10. Porsche:

Before we go into the details of Porsche's contribution to VW's bottom line, we highlight the historic links between the companies. Ferdinand Porsche was founder of VW and Porsche. VW's chairman, Ferdinand Piech (the grandson of Ferdinand Porsche) is on Porsche's board of supervisors and VW's CEO (Winterkorn) is also CEO of Porsche. Thus Porsche is effectively the channel through which the Porsche and Piech families own stakes in VW and through which they maintain c. 50.7% voting rights in VW. In late 2009, VW bought an initial 49.9% interest in Porsche, in what was the first stage of a complex takeover agreement which was eventually only concluded in July 2012 when VW announced the purchase of the Porsche brand name and its automotive business. The delays followed legal action against Porsche (that scuttled efforts to completely merge the two companies), stemming from hedge funds accusing Porsche of not being honest about its intentions when it tried to take over VW in 2008. Porsche is now being sued in the UK and Germany with lawsuits totaling EUR4bn-EUR5bn (suits in the US were moved to Germany). After VW's purchase of the Porsche brand name and operating subsidiary what is left of Porsche is a holding company with two assets - EUR2bn in net cash and 32.2% of VW (with the above-mentioned voting rights in VW). In terms of the lawsuits, thus far every court has ruled in Porsche's favour and it has not yet paid anything. However, market pundits believe the likely outcome of the legal action will be that Porsche settles in order to make the lawsuits go away.

VW increased its operating profit by 20% in 3Q13 with the full integration of Porsche a significant contributor to this performance. As a brand Porsche is #95 on Forbes' 100 most valuable brands list and the publication values the company at $5.7bn. Porsche earns an operating margin of 18% - four times more than of VW's other brands (except Audi) and in 9M13 Porsche generated over 7% of VW's revenue and 22% of its operating profit. Excluding Porsche, VWs operating margin drops from c. 6% to 4.5%. Profit from Porsche climbed 55% in 9M13 to EUR599mn, accounting for 22% of the entire group's earnings. Porsche is extremely important to VW and although it (together with Audi), accounts for only 15% of VW's sales it has contributed two-thirds of VW's profit so far this year.

Porsche financial data:

	FY12	CY11	% Change
Sales (units)	143,096	116,978	22.3
Production (units)	151,999	127,793	18.9
Revenue (EURmn)	13,865	10,928	26.9
Operating profit (EURmn)	2,439	2,045	19.3

Source: Company data, Anchor Capital

Challenges:

Below we highlight risk factors facing VW in its quest to become the no 1 global vehicle manufacturer by 2018 and possible threats that could weigh on its share price:

1. The European debt crisis:

According to *Eurostat*, the euro area recorded six straight quarters of negative growth until 2Q13 when a slow turnaround started. The auto industry was particularly hard hit resulting in car pricing coming under significant pressure. This resulted in VW's 2012 deliveries in Western Europe declining YoY (in all major markets except Germany and the UK).

Vehicles sold in Western Europe accounted for 33.3% (vs 38.4% in 2011) of the group's total delivery volumes. However, VW Group's share of the overall passenger car market in Western Europe still rose to 24.4% (vs 23.0%).It would seem to us that one of the reasons for VW's relatively low valuation is the perception among investors that the company is a European company dependent only on Europe for its survival. So if it is going badly on the continent it follows that VW will experience the same fate. However, this is not the case and, according to *Booth Laird* although 60% of VW's revenue comes from Europe, one-third of its European revenue is derived from Germany - one of the best performing European economies during the crisis. As a major global player VW cannot be judged by European market conditions. For example in 2012 Europe's vehicle deliveries declined 8.4% while VW deliveries increased 11.8% globally. The company also took market share away from European competitors including Peugeot and Fiat. We view the overreaction stemming from the European debt crisis as one reason VW is undervalued.

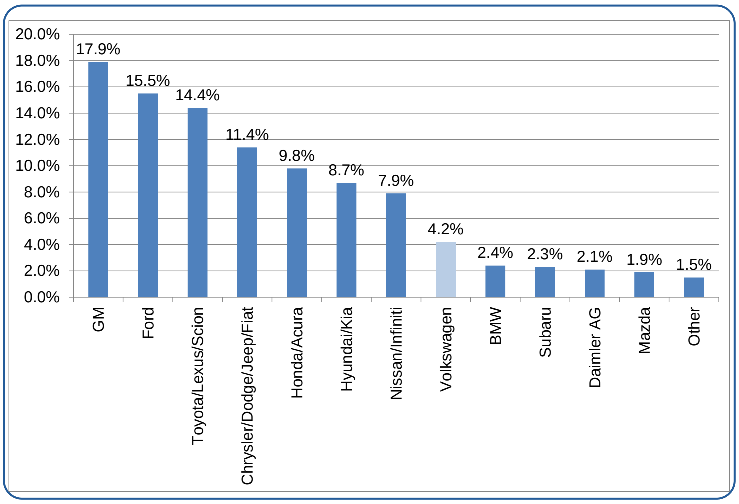
2. The US:

VW has made no secret of its intention to significantly increase its US market share and for the company to succeed in toppling Toyota and GM from the number one and two positions, respectively, it will have to make momentous market share gains. The US is the world's second-biggest car market (after China) and although VW has made important strides there (including increasing deliveries 34.2% in 2012), we think it is unlikely it will attain the number one position in that country in the near future. Following the past few years' strong US growth (when VW defied skeptics by doubling US sales from 2009-2012) its sales momentum has waned as VW's model line-up ages and local US car makers and companies like Toyota prove to be stiff competition. For the past seven months straight VW's brand sales have declined, posting an 18% drop in October (sales are down 4% for the year while the US market as a whole is up 8%). *Autonews* notes the reason behind the drop is an ageing product line and mix that has limited VW's success in some of the US vehicle industry's fastest-growing segments. According to *IHS Automotive*, VW's US sales are forecast to rise to 535,000 cars in 2018 and although that equates to a 22% gain from last year, the target (set in 2007) is for 800,000 by 2018. *IHS* estimates that VW is at risk of this coming 33% short of target for the following reasons:

- Looking at product mix, it supports *Autonews'* view that VW is slow to plug gaps in its lineup and doesn't sell vehicles in the US' small but important B segment. Compact SUVs are very popular in the US (where it is the mainstream family car) but VW does not sell these (although it plans to rectify this by debuting a subcompact SUV c. 2016).
- VW is being outspent on advertising (more than two-to-one) by its competitors.
- VW would also need to triple its 2008 US volume to meet its target of 1mn cars p.a. (800,000 Volkswagens and 200,000 Audis) sold in the US. Competitors (Toyota, Honda, Hyundai etc.) aren't about to yield market share and neither will domestic US manufacturers. Following its US setback in the 1980s, VW spurned the US market for decades and the company remains encumbered with a negative reputation in the US (high prices, average quality and more importantly not catering to American tastes).

Analysts are also of the view that VW suffers from a reliance on small cars while US growth is propelled largely by sales of pickup trucks (which VW doesn't sell) and the aforementioned SUVs.

Auto manufacturers US market share (2012 year-end):



Source: GoodcarBadcar.net, Anchor Capital

The only VW brand selling better in the US this year than 2012 is the VW Beetle.

VW US sales by brand:

	2013 Sales	% change
Jetta	135,983	-3%
Passat	91,522	-1%
Beetle	37,473	56%
Golf	26,836	-24%
Tiguan	25,303	-1%
All others*	25,845	-35%

Source: Company reports

So although VW has performed well in the US (coming from a low base and considering its history there), it is not doing well enough for the US to significantly help it achieve its goal of being the number-one automaker globally. Compared with the top vehicle brands in the US, VW is trailing far behind. VW sold c. 438,000 vehicles last year but in comparison the top-five automakers (Ford=2.2mn, GM=1.9mn, Toyota=1.8mn, Honda=1.3mn and Nissan 1mn) each sold more than double the number of vehicles VW did. Even if VW doubles its market share in the next few years it will still not be enough to pass any of the current top-five US manufacturers.

3. Rising costs and lower margins:

VW's operating profit margin has been under pressure due to the cost of heavy investment in production plants, its new MQB platform, developing more fuel-efficient engines and the stronger euro. According to company data, VW's planned automotive spending in terms of a three-year programme set in 2012 nearly doubled (to EUR16.7bn p.a. vs the EUR8.6bn that was initially budgeted in 2009). In October, VW said it was committed to some belt-tightening although it would currently seem the group's foreign operations will not face restrictions as it is going ahead with expansion in China (its opening 9 car and component plants between 2013 and 2015 to help it double capacity to over 4mn units p.a. by 2018). To improve the 9M13 operating margin of c. 7% (4.5% excluding Porsche) it would appear VW needs to implement some cost discipline. Although its RoE in FY12 (32.2%) was the second-highest in the peer group we note this number is skewed due to the significant one-off gain from Porsche. Excluding Porsche the 2012 RoE was 6.9% (vs 6.2% in 2007). At end November the RoE stands at c. 10% - below the peer group average but still ahead of Nissan, Honda and Toyota.

VW operating margin and RoE vs peer group:

	RoE	Operating margin
Toyota	8.5	9.4
GM	18.1	5.8
BMW	17.8	10.3
Hyundai	16.4	9.6
Honda	7.8	5.9
Ford	36.6	4.7
Nissan	10.0	4.4
Peer avg (excl. VW)	***16.4***	***7.2***
VW	10.1	5.9

Source: Bloomberg, Google, Anchor Capital

4. Negative publicity on the back of vehicle recalls:
In November 2013, VW issued its biggest-ever vehicle recall, affecting 2.64mn vehicles globally, with around one third of these coming from VW's biggest market—China. Although most of the issues are fairly minor (according to the company) and the recall is still well below the c. 19mn vehicles Toyota recalled from late 2009 to early 2011, any recall can do enormous damage to a company's reputation. The fact that almost every vehicle manufacturer has had to recall faulty products is of little comfort to a company striving to become the world's number-one automaker. This type of negative publicity not only impacts the public's perception of reliability but is an inconvenience to customers. At the same time it can also erode any competitive advantage the company has worked for years to build.

5. Currency headwinds:
According to estimates from consultancy firm *Oliver Wyman*, VW has 77% of its production capacity outside its home country, outpacing GM (76%) and Toyota (59%). This can be a double-edged sword, taking into account VW's global footprint it is exposed to exchange rate fluctuations which can have an impact on its sales, earnings and cash flows. If the euro strengthens against other currencies it will negatively impact VW's turnover as it will reduce VW's repatriated earnings (adverse currency effects alone shaved EUR1.7bn off its 3Q13 sales). In terms of its competitors, currency can also affect VW's performance. If Japan continues weakening the yen (which the government there has done and indicated it will continue to do) in order to support the domestic economy this will impact VW's earnings as it gives companies like Toyota (and Honda) a leg up in terms of making their cars more competitive in terms of pricing across the globe.

7. Intensifying competition:
Worldwide competition in the automotive industry is intensifying, especially with global economies slowly recovering from the recession. The past few years has seen Japanese and US automakers stepping up their game in EMs such as China and India and presenting strong competition for VW in these markets. The result of this is that VW has to compete on price which will likely impact the company's profit.

6. Component-sharing platform:
We previously mentioned VW's component-sharing platform (MQB) under drivers but we highlight it here because if it doesn't deliver the 20% cost-saving (and c. 4mn cars by 2016) which management promised, it could end up being a drag on earning. The project entailed significant upfront investments and is considered essential if VW is to achieve a targeted 8% pre-tax return on sales by 2018, compared with 6.5% at the end of September 2013.

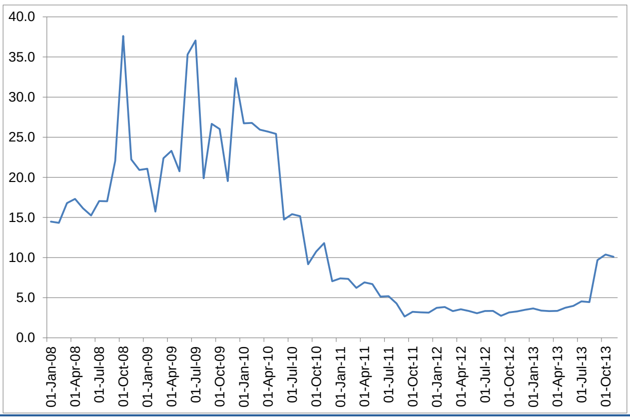
VW 3Q13 results:

At the end of October, VW reported a drop in 3Q13 revenue although operating profit increased 20% to EUR2.78bn. The company also kept its full-year outlook for revenue growth and stable operating profit despite a tough trading environment. VW posted net profit of EUR1.86bn, down sharply from EUR11.27bn in the same period last year when a revaluation of Porsche options led to a onetime gain of c. EUR9bn. The group's auto deliveries rose 3.6% in 3Q13, but revenue fell 3.8%, to EUR47bn, due in part to the strong euro. For 9M13, operating profit was EUR8.6bn - slightly below the EUR8.9bn in the same period of 2012. Audi and Porsche contributed a combined two thirds to VW's EUR8.55bn 9M13 profit. It should be highlighted here that VW's operating profit doesn't include the EUR3.5bn share of income from its robust Chinese JVs this year, up from EUR2.8bn last year.

VW share price performance :
VW's share price has come off from its 2008 highs (it reached a high in October 2008 of EUR912.68/share and a 2010 low of EUR61.92 in the midst of the credit crisis). However, the share price has been trending upward since 2010 and in 2012 it gained over 50% as sentiment towards the global auto industry improved. Global auto manufacturers, in general, have been trading at low single-digit P/Es and VW was no exception. The likely reason for this and the fact that VW's share price has not reached pre-crisis highs is investor concerns over its European exposure. As mentioned above investors seemingly fear the worst when it comes to VW being perceived as a European company, but do not take into account the robust growth in China (VW's largest market) which is not even included in the company's top revenue line. Since Europe has started slowly turning around in 2Q13 (prior to that Europe recorded six straight quarters of negative growth), VW's share price gains have been more robust and it is up 22% since the end of 2Q13 when eurozone GDP recorded its first growth in six quarters (albeit it a slight 0.3% and 0.1% YoY in 3Q and 4Q, respectively). The share price is now trading 195% above its 2008 low and YoY it is up 19%, while YTD VW has gained 13%.

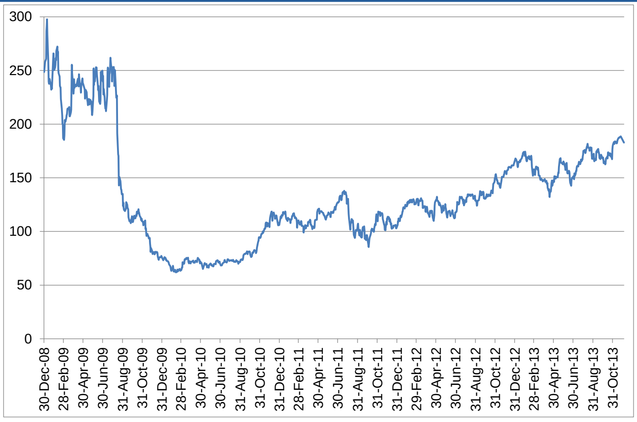
VW's P/E has also come off considerably from 37.6x in October 2008 to the current c. 10x multiple. Although the P/E has been trending higher (it was trading as low as c. 4% in 2012 and for most of this year) it is still looking undervalued to us.

VW historic P/E (December 2007 to date)



Source: Bloomberg, Google Finance, Anchor Capital

VW share price performance, EUR (December 2008 to date)



Source: Bloomberg, Google, Anchor Capital

VW vs peer group:

VW vs peer group comparative data:

	Current P/E	12M fwd P/E	DY	12M fwd DY	P/Book
Toyota	14.3	11.2	2.0	2.7	1.5
GM	14.2	8.8	na	0.0	1.9
BMW	10.6	10.1	3.0	3.2	1.6
Hyundai	13.3	6.8	0.8	0.8	1.2
Honda	19.7	10.1	1.8	2.1	1.4
Ford	10.4	9.6	2.3	2.4	3.2
Nissan	11.1	8.2	2.9	3.4	0.9
Peer avg (excl. VW)	***13.4***	***9.3***	***2.1***	***2.1***	***1.7***
VW	10.0	8.0	2.2	2.3	1.0

Source: Bloomberg, Google Finance, Anchor Capital

Relative to the other companies in its peer group (with the exception of Hyundai [at 6x]), VW is trading at the lowest 12M fwd P/E multiple (of 8.0x) and is also lower than the peer group average (excl. VW) of 9.3x. Its current P/E, although somewhat higher at 10.0x, is lower than its peers and also far below the peer group average of 13.4x. VW pays annual dividends and over the past 3 years the dividend yield has been 2.69% (2010), 2.67% (211) and 1.9% (2012). We believe that there is a low risk that the company will be forced to decrease the dividend. Its 1-year forward DY is c. 2.3%.

Conclusion:

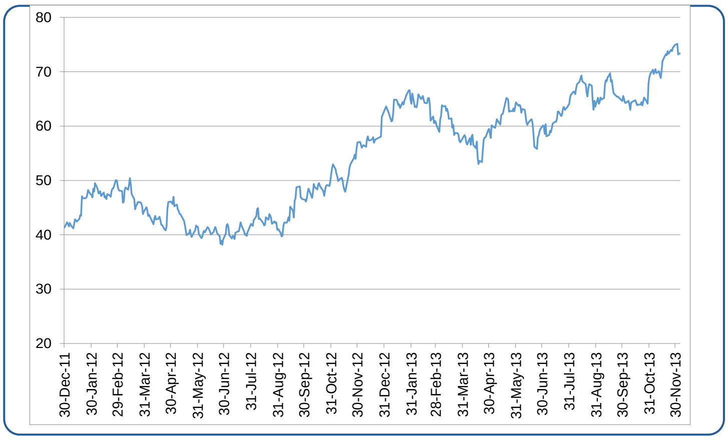
VW is locked in a three-way race for global sales dominance with Toyota and GM (in first and second position, respectively), and at present it looks unlikely VW will unseat Toyota as the number-one global vehicle manufacturer. VW ended 2012 with 9.1mn units delivered (corresponding to a 12.8% global market share), and is likely to reach its Strategy 2018 target of 10mn units delivered several years ahead of schedule. Toyota sold 9.7mn cars and trucks worldwide last year to beat GM's 9.29mn. VW, riding strong growth in North America (last year) and China, finished a close third, selling a record 9.1mn vehicles. YTD the company's sales in the US have been dropping and VW is finding it more and more difficult to gain a significant foothold in the US market.

However, the above does not take away from the fact that VW is a well-run business with a great track record over the past six years or so, with solid growth under very difficult conditions. The company's performance has been exceptional and it seems to have reached or will reach most of the targets set out in its Strategy 2018 plan early (with the exception of toppling Toyota from top spot in terms of vehicle manufacturers). VW is already selling c. 9.3mn units globally and in terms of profitability, has resolved to achieve a profit margin of more than 8% on an ongoing basis. The business' low P/E gives the impression the market expects a material earnings decline but we believe this instead represents a good buying opportunity for investors. The turnaround started in 2007 when Winterkom took over as CEO and VW has been highly successful to-date although seemingly underappreciated by investors. In the past VW's strong management team have under-promised and over-delivered and this is likely to continue. VW generates returns on capital well in excess of cost of capital - the type of share an investor should own, especially in uncertain times. Although there are signs growth may be slowing slightly it still offers investors double-digit earnings growth (on consensus estimates) for the next two years.

VW's share price (and low multiplies) are no doubt due to concerns around Europe and the misperception that if things go bad in Europe then VW will be similarly impacted. This is not the case as VW is based in Germany (the most stable among eurozone economies during the crisis), which accounts for one third of its European revenue while at the same time its China JVs are not even included in the top revenue line. VW is also well established in growth markets (China, Brazil, Russia, India) outside Europe, which should go a long way toward allaying investor concerns around Europe (although the turnaround there seems to have started). The company's FY12 results showed that while industry-wide European vehicle deliveries declined 8.4% in 2012, VW global deliveries increased 11.8%. VW's revenue growth has also been over 12% on average, including Europe, since 2007 and we view 11%-12% growth outside Europe as being achievable on the back of expected industry growth and market share gains. In our view the share price currently has limited downside.

Porsche's share price has been under pressure for most of this year. However, following the release of VW's 3Q13 results which showed VW's 3Q13 operating profit rose by a fifth due to record sales at Porsche (and Audi), the price has trended higher. The pressure on Porsche is also likely due to the market pricing in the full potential cost of possible lawsuits (or even a Porsche settlement). Another way to get exposure to VW is through Porsche. Here we highlight that only Porsche preferred shares are publicly traded while the common shares are owned by the Porsche and Piech families (the country of Qatar sold its 10% voting stake in Porsche back to the families but still has a 17% stake in VW). Porsche (preferred shares) are trading at c. EUR73.36/share vs VW's EUR182.85.

Porsche pref shares price performance, EUR



Source: Bloomberg, Google Finance, Anchor Capital

Overall, we view VW as a quality share with compelling valuations, a great track record and solid growth. It has a phenomenal foothold in China with all the opportunities the world's biggest vehicle market brings to the table and if it is able to 'crack' the US market then growth should increase significantly. In the interim looking at the company's low P/E the impression you get is that the market expects a material earnings decline, but in our view this represents an good buying opportunity.

Marco de Matos

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