German car industry under pressure
Friday, November 30th 2018

**Volkswagen confirmed its 2018 outlook despite headwinds, while Daimler and BMW cut guidance for 2018**

- We expect Volkswagen to boost its FY18 dividend by 30%, the second highest dividend increase amongst European carmakers
- We anticipate flat FY18 dividends from BMW and Daimler
- Daimler and BMW forecast dividend yield is at an eight-year high

German automakers have struggled over recent months affected by the implementation of the new EU emissions regulation known as WLTP. And the reduction in exports of German cars caused by delays in meeting this new standard is partly responsible for the economic slowdown in Germany during the third quarter (-0.2% quarter-on-quarter), the first contraction in more than three years.

While this struggle is seen as temporary, the sector is exposed to the trade dispute between China and the US, potential US tariff on cars imported from European Union (German automakers sold 1.35 million vehicles in the US in 2017, out of which 494,000 were exported from Germany), as well as a slowdown in the Chinese car market and diesel related issues.

Volkswagen confirmed its 2018 outlook at 3Q18 results and we forecast the company to increase its dividend 30% crossing its pre-emission scandal dividend level. However, Daimler and BMW revised their 2018 outlook downwards. And our flat dividend estimates combined with a fall in their share price has driven up the dividend yield. Daimler is now at an eight-year dividend yield high after it reinitiated dividend in FY10 and BMW yield is also at an eight-year high.

<table>
<thead>
<tr>
<th></th>
<th>FY18e</th>
<th>DPS</th>
<th>Div Yield</th>
<th>Payout ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>VW Ord</td>
<td>€5.00</td>
<td>3.5%</td>
<td>3.5%</td>
<td>20%</td>
</tr>
<tr>
<td>Daimler</td>
<td>€3.65</td>
<td>7.2%</td>
<td>7.2%</td>
<td>46%</td>
</tr>
<tr>
<td>BMW Ord</td>
<td>€4.00</td>
<td>5.5%</td>
<td>5.5%</td>
<td>38%</td>
</tr>
</tbody>
</table>

Source: IHS Markit, FactSet.
Revenue and operating performance

Revenue

Source: IHS Markit, FactSet.

Volkswagen confirmed its 2018 outlook at 3Q18

At 9M18, Volkswagen posted a rise in revenues of around 3% and operating profit before special items in line with last year and confirmed its 2018 outlook. For FY18, the group forecasts its revenue to grow 5%, with an operating margin (before special items) of between 6.5-7.5%.

The premium brands (36% of Group’s revenue at 9M18) remain the main contributor to operating margin, standing at around 51% of total operating profit before special items at 9M18 – specifically Porsche, which reported a 18.3% operating margin. IHS Markit expects sales of premium brands to increase CAGR 3.1% over the next 4 years. This outlook and the improving operating margin at the Volkswagen brand (around 36% of Group’s vehicle sales) should positively affect earnings. The consensus expects Group Revenue to increase CAGR 2.3% and Group operating margins to remain at minimum 7% over next 4 years.

However, net income could continue to be hit by special items linked to the diesel issue (€2.4bn recognised at 9M18). On October 16, Audi (fully consolidated subsidiary) was fined €800m and this will directly impact FY18 Volkswagen’s earnings. For FY18 the consensus expects net income to increase 12%.
**Daimler issued two profit warnings over 2018**

After poor results in its Mercedes-Benz cars division (58% group revenue, 63% group EBIT) over first 9 months (Revenue -3%, EBIT -18%) negatively impacted by EU new emissions standard, negative forex effects and diesel related cost, Daimler issued its second profit warning within four months in October.

The Group now expects Group and Mercedes Benz EBIT in 2018 to be significantly lower than in the previous year. For FY18, the consensus expects EBIT to decrease 15% at the Group level and 19% at Mercedes-Benz car division with margin at 8% vs. 10% in FY17 in this division. Group Net income is expected to decrease almost 20% in FY18.

And Daimler continue to face risks such as a slowdown in Europe market sales due to restrictive availability of diesel vehicles, a slowdown in China due to tariff tensions, increased competition and expenses in connection with ongoing governmental proceedings and measures relating to diesel vehicles.

From FY19 to FY21, Revenue and EBIT are expected to resume growth in the Mercedes-Benz cars division, however EBIT margins are not expected to return to FY17 level. It is expected to remain around 8% as compared to 9.7% reported in 2017.

**EBIT margin in the premium brands under pressure for coming year**

![Graph showing EBIT margin for Audi, Mercedes-Benz Car, and BMW from 2015 to 2020](graphic)

Source: FactSet.
**BMW revised its 2018 outlook downwards**

In September, BMW revised downwards its 2018 outlook blaming requirements of WLTP leading to significant supply distortions in European markets, continuing trade conflicts and increased goodwill and warranty measures. For FY18, the group expects moderate year on year decrease in group profit, automotive segment Revenues are expected to be slightly lower than previous year and EBIT margin is now expected to be at least 7% (previously 8-10%).

At 9M18, BMW recorded decline in Group revenue of almost 1%, a decrease of 11% in EBIT and 9% in net profit compared to 9M17. 9M18 results were adversely affected by currency, higher raw material prices and warranty expenses. In the automotive segment, EBIT was down 19.5% y/y with margin falling from 9.4% to 7.6%.

For FY18, the consensus expects Group net profit to contract 20%, Revenues in the automotive segment to decrease 3% and EBIT margin to stand at 7.3%.

BMW expect possible positive earnings effects from the closing of the planned mobility services joint venture (not reflected in BMW adjusted outlook). BMW Group and Daimler plan to merge their mobility services business units in a joint venture and strategically grow their combined business going forward and be the leading provider of innovative mobility services. The two groups signed an agreement in March, and each of the two groups will hold a 50% stake in the joint venture. Subject to approval by antitrust authorities during the current year, the foundation of the joint venture will give rise to a one-off positive valuation and earnings impact on the Group Financial Statements of BMW. The joint venture is expected to be established within next twelve months. From FY18 to FY20, BMW Group net income is expected to increase 2% CAGR.

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**Net Income**

![Net Income Chart](chart.png)

Source: FactSet.
Slowdown in the Chinese car market: a major risk for German carmakers

*2018 vehicles sales forecast per region for German Carmakers*

Source: IHS Markit.

The Chinese auto market is the biggest in the world with 27.9m light vehicles sold in 2017 vs 17.2m light vehicles sales for the US market, second biggest. After nearly 15 years of remarkable double-digit growth, Chinese market slowed down to growth of just 3% in 2017. For 2018 IHS Markit expects LV sales in China to decrease by 0.9% y/y to 27.68 million units, after a decline of 10.6% y-o-y in September.

The weakness in passenger car sales is most likely a result of overdue payback from termination of tax incentives from January 2018 given to entry level cars, which amounted to nearly 10% of the sales price. In addition, rising trade tensions between the United States and China have added further uncertainties. According to Volkswagen chief executive for China, the Chinese market has been challenging since June and is getting worse every month. IHS Markit expects the market in China to grow at CAGR of just 2% from 2017 to 2021.

And German automakers are heavily exposed to this market. China is the second biggest market for BMW and Daimler after Western Europe in terms of light vehicle sales and is expected to contribute around 26% to total light vehicle sales for both. While it is the largest market for Volkswagen and contributes nearly 40% of brand’s total light vehicle sales.
**Dividend estimates for German carmakers**

<table>
<thead>
<tr>
<th>Stock</th>
<th>FY17</th>
<th>FY18 (E)</th>
<th>YoY 17/18E</th>
<th>Yield FY17</th>
<th>Yield FY18</th>
<th>Payout%</th>
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<tbody>
<tr>
<td>BMW ORD</td>
<td>2408</td>
<td>2408</td>
<td>0.0%</td>
<td>4.7%</td>
<td>5.5%</td>
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<td>BMW PREF</td>
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<td>221.6</td>
<td>0.0%</td>
<td>5.5%</td>
<td>6.3%</td>
<td>38%</td>
</tr>
<tr>
<td>Daimler AG</td>
<td>3904.9</td>
<td>3904.9</td>
<td>0.0%</td>
<td>5.4%</td>
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<td>46%</td>
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<tr>
<td>Porsche SE Pref</td>
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<td>306.2</td>
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<td>3.6%</td>
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<td>Volkswagen AG</td>
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<td>2.7%</td>
<td>3.5%</td>
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<td>Volkswagen Pref</td>
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<td>30.3%</td>
<td>2.8%</td>
<td>3.4%</td>
<td>20%</td>
</tr>
</tbody>
</table>

**Volkswagen’s dividend back to pre-diesel crisis level**

We are forecasting a dividend of €5.00 from Volkswagen reaching pre-emission scandal level for ordinary shares (€5.06 for preference shares) in line with policy and consensus. This returns a pay-out of around 20%, which is consistent with pay-outs from the last two years. The company aims at continuous dividend growth and aims to achieve a pay-out ratio of 30% within a five-year time horizon (but not necessarily at the fifth year). We expect the Group to slowly achieve this target.
**Flat Dividends for Daimler and BMW amidst uncertainties**

For FY18, we are forecasting **Daimler** to pay a stable dividend of €3.65. This results in a slightly higher payout of close to 45%. Daimler aims to distribute approximately 40% of its net profit attributable to shareholders. Considering the uncertain business environment, impact Project FUTURE and given that group made two profit warnings we expect Daimler to distribute a stable dividend for FY18.

For **BMW**, we are expecting a flat dividend of €4.00 per ordinary shares (€4.02 per preference shares). BMW targets a pay-out ratio within 30% to 40% of net profit. The dividend returns a pay-out of close to 35%. In September, BMW made a profit warning. Given the difficult scenario the company faced in the first half and challenges including the WLTP regulations the Group is facing for the second half, we expect a flat dividend for FY18.

**Daimler and BMW month end dividend yield at eight-year high**

![Graph showing dividend yield for Daimler and BMW](image)

Source: IHS Markit.

Share price decline and flat dividend has driven the dividend yield at an eight-year high, With Daimler’s yield at 7% and BMW at 5%

In comparison, Volkswagen’s dividend yield for FY18 is expected to be around 3.5%, while the average yield for its top five competitors including BMW, Volvo, Peugeot, Renault and Volkswagen is coming out to be around 4.7%.

Further decline in share prices can be a cause of alarm for both companies’ dividends.
And the negative sentiment persists for Daimler

Daimler level of short interest has been on rise since around February 2018, this is probably a result of US senators demanding a probe after a media report stated that the automaker allegedly used illegal software to pass diesel emission tests in February and all the ongoing business challenges surrounding Daimler. The group had to recall nearly 3 million cars. Given all the problems Daimler is currently facing, sentiments are relatively negative for Daimler, with share price falling by approximately 27% YTD and short interest relatively higher than previous years and German peers.

Source: IHS Markit.
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