Creditreform Rating

Recent Developments in the European Car Market and Auto ABS Issuance Activity

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Creditreform Rating

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1.

The European auto industry appears to have experienced the deepest downturn ever since the global financial crisis. The spread of coronavirus and the associated containment measures have led to severe supply chain disruptions and large losses of production volumes and sales. The European Union was hit hard with new car registration sitting just under 40% in 1H20, compared to the corresponding period last year. By comparison, registrations in China declined by over 22% and the US market dropped by 36%. Entering the second half, the European auto industry has started to show some signs of recovery, typically led by gradually lifted lockdown restrictions and generous support packages offered by the EU member states.

2.

Demand for electric vehicles gained significant momentum. Electric Vehicles achieved marked growth rates during 1H20, as total units sold were up 75% amidst a drastic decline in petrol and diesel cars. Germany led the pack in terms of units sold, followed by France and the UK. Overall, for Europe, the share of electric vehicles almost doubled to some 10% during the first half of 2020. This can be explained mainly by the low denominator effect and backlog orders as the deliveries of electric vehicles generally take longer time. The demand for electric cars is expected to increase going forward, mainly supported by a substantial amount of government subsidies, incentives offered by the dealers and the rising consciousness among consumers to opt for environment-friendly passenger cars.

3.

Used car markets have exhibited some resilience, evident from rising residual values after the lockdown restrictions were eased, mainly seen in the UK as demand for vehicles increased amidst tight supply of new cars in the market. Meanwhile, incentives for purchases of used cars may have benefited residual values in France. Residual values are expected to gain until the supply of new cars outweighs demand in the coming months.

4.

The European auto ABS market was quite unpredictable in the first half due to the sudden outbreak of the Covid-19 pandemic which largely disrupted capital markets. New issuance volumes came in slightly below the tally of 1H19, edging down by 2% y-o-y to reach

9.8bn euros, also remaining below the ten-year average of 11.5bn euros since 2010 but higher than the 4.3bn and 6.3bn euros registered in 1H08 and 1H09 respectively. Most of the issuances originated from Germany and the UK, together representing a total share of 84% for 1H20, while most of the countries remained generally inactive with near-zero issuances.

5.

Admittedly, in terms of issuance activity, captives have been adversely affected by substantial economic uncertainty but have performed relatively well when compared to the 2009 economic downturn. The share of captives in the European new auto ABS issuance volume surged to 79% in 1H20, beating the historical average of around 67.9% in the last couple of decades. Daimler led the race with 2.6bn euros followed by Volkswagen, which managed to raise 2.4bn euros and BMW at 2.3bn euros. Meanwhile, activity remained muted from other auto majors, marking the weakest performance in recent times.

6.

Against this backdrop, the overall rating profile of the European auto ABS has improved during the period. Around 8.4bn euros were printed in the AAA/Aaa category in 1H20, reflecting a 7.2% y-o-y increase, partly mirroring the rather low number of issues. Furthermore, the share registered by AAA rated issuances in 1H20 was the highest in nearly a decade, at 92.6% and 6 percentage points higher than in 1H19.

7.

In the second half of 2020, the weak global economy as a result of the spread of coronavirus should continue to impair the performance of the auto ABS markets. The risks remain tilted to the downside with delinquencies set to rise; however, the extent of deterioration will depend upon factors including deal structures, the evolution of government actions and payment holidays, and also the potential for further outbreaks that may harm economic activity. Meanwhile, we believe issuances might recover as risk appetite improves amidst support from government measures to bolster the economic performance. However, issuances could be at par with 1H20 at best, but may fail to outpace the 22bn euros level seen during the European debt crisis of 2011. The new deals would also see relatively stronger structures as investors seek to prepare for ongoing credit distress.

1. The European Car Market at a Glance

As the corona crisis plays out, the global automotive industry is experiencing significant reverberations from its containment measures. The enforced closures worldwide have led to the suspension of businesses and unparalleled disruption of widely integrated supply chains. The resultant rising unemployment rates were also accompanied by a slump in consumer confidence and dampened purchasing power. Global auto sales volumes collapsed at an unprecedented rate of around 28% y-o-y to 21.3m units between January and April 2020, resembling the industry downturn in 2008 and 2009 or even worse. April, however, seems to have marked a trough for most key markets across the world. With most economies gradually resuming economic activities since May, some confidence has been restored across the industry.

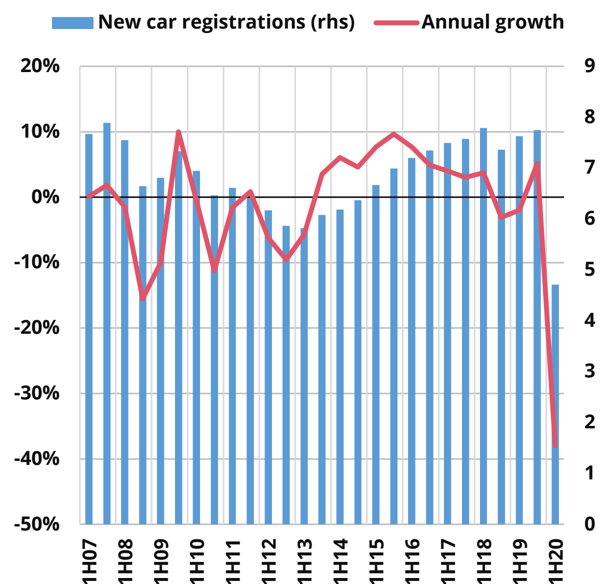
In the first half of 2020, we observed a mixed performance across key markets. Encouraging signs were visible in China, the largest car market, being the first country to enter and to exit a lockdown. Having contracted over 70% y-o-y in February, passenger cars sales showed a remarkable recovery towards the pre-Covid level through June. Sales totaled 7.87m units in 1H20, 22.4% lower compared to last year. Given the severe market challenges, the Chinese government announced in April to extend subsidy policy and waive the 10% vehicle purchase tax for another two years until the end of 2022 to stabilize the industry. Looking ahead, China Association of Automobile Manufacturers (CAAM) projects vehicle sales to decline 10%-20% for the full year 2020.

Amongst Asian counterparts, India was among the hardest hit. Having been in lockdown since mid-March, the market faced a complex environment even prior to the Covid-19 with new BS-VI regulation, which was set to come into force from 1 April 2020. India registered zero sales in April, before auto dealers resumed selling cars online in May. The recovery seems farfetched as sales are expected to remain muted in 2H20, evident from a 59% y-o-y decline in passenger car sales to 0.6m units in June.

Different demand patterns emerged in the US and Europe. As Covid-19 did not spread to the US as early as in China and Europe, the contraction in US sales was more pronounced with a 46.9% y-o-y fall in the second quarter. Overall, car sales contracted by over 36% y-o-y in the first half of the year. Meanwhile, Europe was also hit heavily, with the region experiencing a total of 4.9m units of newly registered cars in 1H20, just under 40% down compared to last year (see figure 1). Throughout chapter 1, Europe is represented by the 27 EU member states and the UK, whereas we take into account all notes issued in the European Economic Area plus Switzerland when analyzing the European auto ABS market.

Figure 1: New car registrations record the sharpest contraction since the European debt crisis

New car registrations in Europe, in million units, half-yearly data



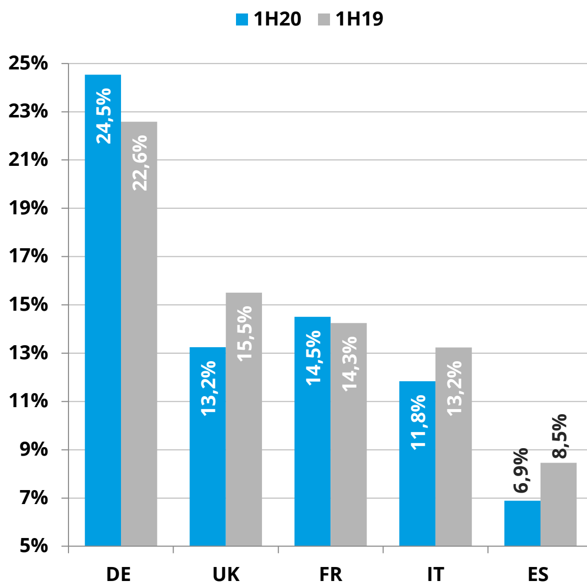
Sources: ECB, Creditreform Rating

Double-digit declines were recorded in most of the European markets. Amongst the major European economies, Spain suffered the most as volumes

plummeted by 50.9% y-o-y in 1H20, followed by the UK (48.5%) and Italy (46.1%). The German market, albeit touching a 30-year low, displayed some resilience compared to European peers with registrations down 34.5% y-o-y in 1H20. The impact in France was also relatively less severe with a decline of 38.6%. Consequently, market share expanded for Germany and France by 1.9 and 0.3 p.p. to 24.5% and 14.5%, respectively. Meanwhile, the UK's decline in demand continued from the previous year as it lost around 2.3 p.p. of market share to end 1H20 at 13.2% (see figure 2).

Figure 2: Key car markets in Europe

Percentage of market share in Europe based on new car registrations



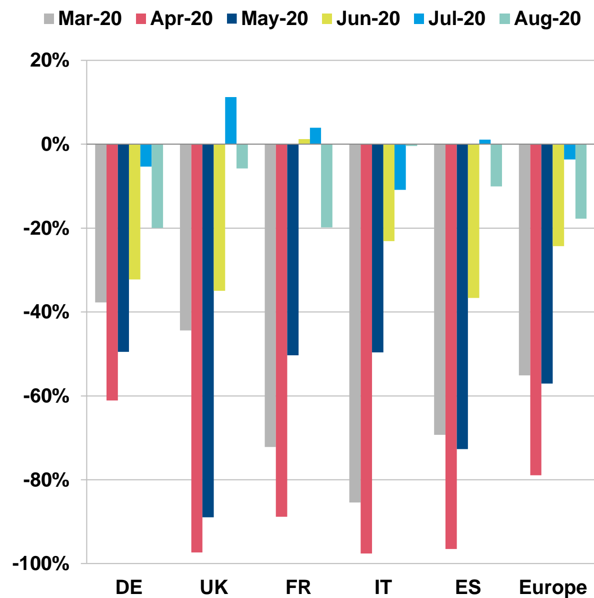
Sourcess: ACEA, Creditreform Rating

Overall, the slump of the global auto market including the EU is unprecedented in its magnitude and scale. While recovery is expected from the second half of the year, it would not be sufficient to cover up the losses of 1H20. On a positive note, unlike many other sectors for which lost revenue is difficult to be recouped, the majority of lost vehicle sales may be postponed, rather than cancelled until the outbreak is contained. However, the extent of sales decline remains challenging to forecast. The European Automobile Manufacturers Association (ACEA) projects vehicle sales in the EU to fall by 25% for the full year 2020.

The European car industry suffered a 78% y-o-y decline in April alone, representing the lowest monthly level since the 1970s. Nevertheless, the market has begun to exhibit some improvement since May, as confinement measures have been gradually eased. On a monthly basis, contraction in Europe new car registrations narrowed to -57% y-o-y in May and further to -25% y-o-y in June, thanks to the generous aid packages put together by various governments to shore up the industry (see figure 3).

Figure 3: France displays a glimpse of recovery post April 2020

New car registrations data is shown as y-o-y change



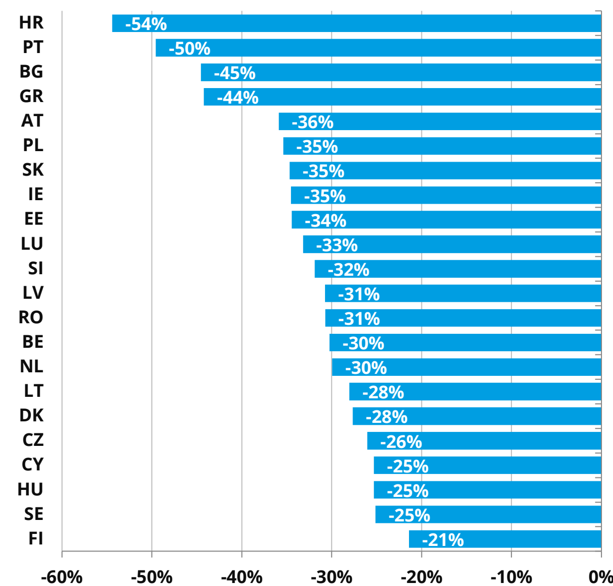
Sources: ACEA, Creditreform Rating

Despite new Worldwide Harmonized Light Vehicles Test Procedure (WLTP) regulation becoming effective from 1 March 2020, France managed to retrace some losses from Covid-19, as the French government earmarked an 8bn euros aid package for the auto industry for 2020 and 2021. French authorities offered a scrappage bonus scheme for trading in an older car for a cleaner model with any powertrain. In addition, the country had increased subsidies for new electric car purchase up to 7,000 euros. As a result, France seems to be an outperformer in the

European market at this juncture, as car sales rose for the first time this year by 1.2% y-o-y in June. This also marked the first gain in EU since December, before the outbreak forced a shutdown of factories and dealerships across Europe.

Figure 4: Sharp declines in other European markets

Year-on-year change in new car registrations in 1H20



Sources: ACEA, Creditreform Rating

In a similar vein, registrations in Germany showed this year's smallest drop of 5.4% y-o-y in July, improving significantly from the precipitous yearly drops of 32.3% in June, 49.5% in May and 61.1% in April. Germany unveiled a big support package, but with strings mainly attached towards its green deal. In June, the government doubled its electric car subsidy to 6,000 euros, with automakers contributing an additional 3,000 euros discount for cars costing less than 40,000 euros. Moreover, 2.5bn euros would be invested in building charging points and battery production, which remain a pre-requisite for ramping up the support of e-mobility. Internal combustion engine vehicles may benefit from the temporary value-added tax cut from 19% to 16% between July and 31 December 2020. This represents the largest component with a calculated sum of 20bn euros under the 130bn euros recovery program that seeks to address several green issues.

Among other European markets, Southern and Mediterranean regions, in particular, suffered the most as demand for rented cars dropped (see figure 4). This is explained by their heavy dependence on the tourism industry, which faced calamitous consequences from the pandemic. Croatia suffered the most followed by Spain and Portugal. Spain, however, resurrected the Plan Renove car subsidy scheme, announcing a 3.75bn euros injection of financial subsidies and loans. The plan also includes an incentive for the trade-in and recycling of older car models.

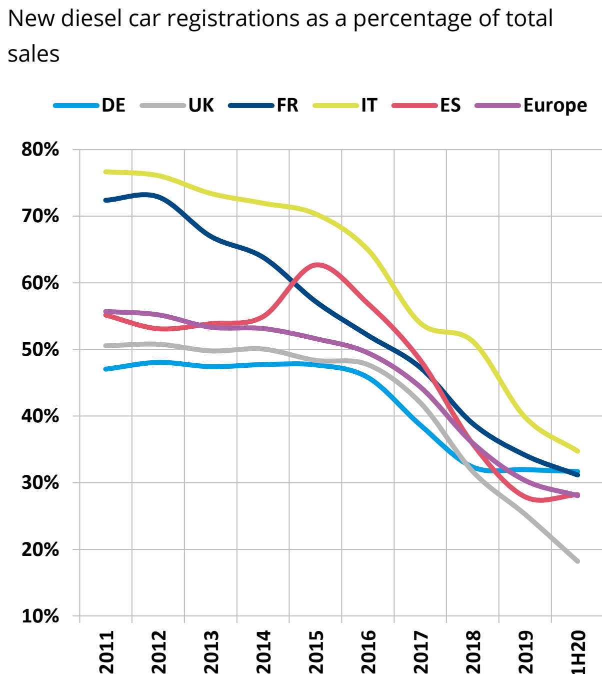
The auto industry is likely to benefit from the substantial funding packages provided by EU member states and the European Commission as a response to the Covid-19 pandemic. In this vein, the Commission adopted a state aid temporary framework under which the state governments have been able to extend necessary liquidity support in terms of loans and guarantees to rescue some of the hard-hit companies. However, these packages have been mainly aligned bearing in mind environmental policies. The subsidies and incentives are largely focused on electrified powertrains, implying indirect financial support to automakers to achieve new EU car emissions targets that were introduced for 2020, and which would become more rigorous again in 2021 and later in 2025. Also, demand for electric, hybrid and plug-in cars accelerated significantly during 1H20, while petrol-powered cars are losing ground amid the slow demise of diesel cars. More prominently, UK's diesel share fell below 20% of the total car sales, mainly after the UK government brought forward its plan to ban sales of new petrol and diesel cars by five years to 2035 (see figure 5).

In Europe, the share of diesel and petrol-powered cars dropped to 28.2% (1H19: 31.6%) and 53.2% (1H19: 59.1%), respectively, during 1H20. Among petrol-powered cars, SUVs performed relatively well with a market share of 40% though. By contrast, the share of electrified vehicles (EVs) posted a strong growth at 17.2%, which closes the gap to 11 p.p.

compared to the market share of diesel cars (see figure 6).

Figure 5: UK's share of diesel cars records a steep fall based on new car registrations

New diesel car registrations as a percentage of total sales

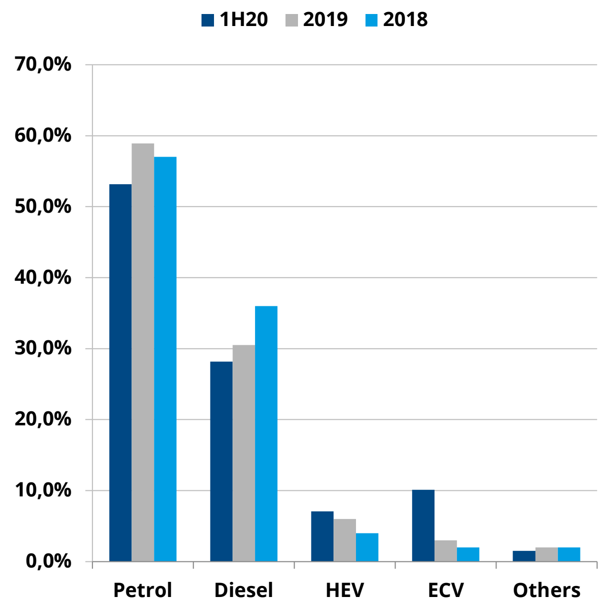


Sources: ACEA, Creditreform Rating

Across Europe, Electric Chargeable Vehicles (ECVs), which include Battery Electric Vehicles (BEV) and Plug-in Hybrid Electric vehicles (PHEV), achieved marked growth rates during 1H20, as total units sold were up 75% amidst a drastic decline in petrol and diesel cars (see figure 7). Germany led the pack in terms of units sold, albeit at lower growth of 97%, followed by France (125%) and United Kingdom (86%). The surge in electrified vehicles was mainly seen during the first quarter, partly attributed to base effects and probably due to backlog of orders, as electric cars have longer time deliveries. Nevertheless, double-digit growth is set to continue as the effect of incentives and enhanced subsidies have started to unfold since June. The combination of higher discounts, government incentives and growing awareness among consumers could further turn out to be the key drivers of medium- to long-term demand.

Figure 6: Alternatives continue to gain in importance

New car registrations in Europe as a percentage of total sales based on the fuel mix

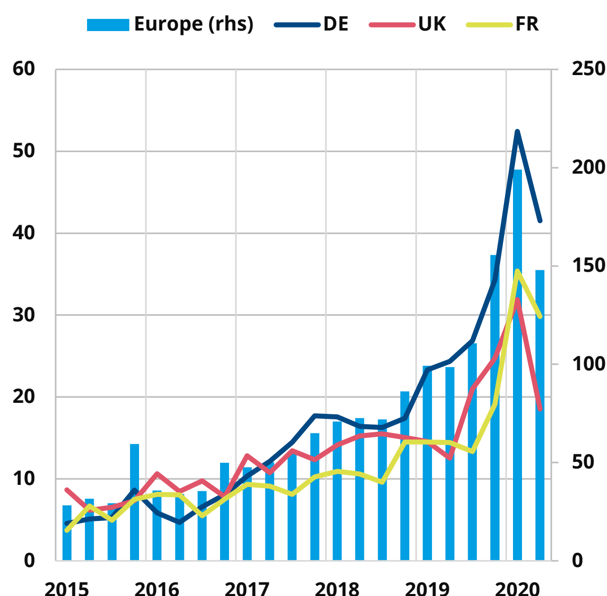


Sources: ACEA, Creditreform Rating

Even though a very strong effect may be derived from the stimulating schemes, we believe a large demand gap may be created once incentive schemes are exhausted. Electric cars are cheap to own but relatively costly to buy, which is one of the main barriers to EV adoption at this stage. Moreover, a very large share of electric cars was purchased through corporate channels last year, while demand from households remained rather muted. That said, electric cars may find it difficult to gain meaningful traction in the absence of further extension of subsidies and adequate infrastructure. On the other hand, petrol-powered cars continue to hold a dominant position with a market share of over 50%, and demand may accelerate with changing consumer behavior, as they look for smaller and affordable cars amidst the pandemic-triggered recession.

Figure 7: EV sales surged in 1Q20 across Europe

Quarterly data in thousand units



Sources: ACEA, Creditreform Rating

Meanwhile, the European Commission has not proposed any amendments to the tougher carbon emission targets despite the pandemic upheaval. Moreover, the EU regulation adopted in May 2018 on the approval and market surveillance of motor vehicles came into effect on 1 September 2020. The key elements of the new EU rule include an independent audit of technical services performing testing of new car models and regular checks of minimum of vehicles already on the market by the Member states. In addition, the European Commission will be able to carry out compliance and conformity checks on vehicles in laboratories or on the road.

Therefore, automakers must achieve an average fleet CO2 target of 95g/km through 2021 (phased in 2020), which if exceeded would entail heavy penalties. With heavy investments towards electrification, many manufacturers had framed strategies and appeared moving closer to their targets. However, since the lockdown restrictions in mid-March, no development, production, testing or homologation work has been done, thus upsetting the plans prepared for complying with existing and future EU regulations within the applicable deadlines. Furthermore, differing new WLTP polices created by individual legislators are subject to repeals and amendments, which further add to complexities faced by carmakers. That said, manufacturers may not be able to avoid penalties as they fall behind the targets. In fact, average carbon emissions rose for the third consecutive year to 121.8g/km in 2019.

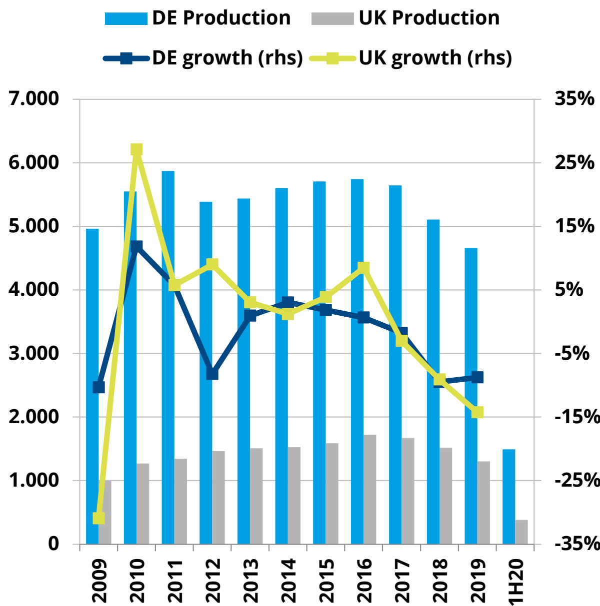
On the production front, the pandemic has exacerbated the challenges for the manufacturers. The supply chain disruptions and delays in supplies of auto parts at first slowed the pace of production in mid-March. The impact was more profound after most factories suspended operations in April. According to ACEA, Europe-wide production losses have been estimated at around 2.4m units of vehicles.

China, representing 25% of worldwide passenger car production, registered 17.8% y-o-y contraction at 9.4m units between January and July. Meanwhile, Europe, being the second-highest car producer at 23%, witnessed a steep fall. The German car production bottomed in April and marked a vast improvement through July, resulting in production sitting 30% y-o-y lower at 1.8m units during the first seven months (see figure 8). This is in line with a drop in exports, which represents ~75% of its total production.

The UK's car output showed a similar trend, falling 42.8% y-o-y to 381,357 units during the first half, which is also the steepest decline since 1954. UK's automotive industry is facing immense challenges as a result of the pandemic in addition to years of Brexit uncertainty. The lack of clarity on the EU trade deal has been severely hindering preparations for the end of the transition period. The deal remains crucial, as the EU is the biggest market accounting for 50% of the UK's car exports. In absence of a UK-EU FTA by 2020, the sector will have to trade on WTO terms with full tariffs applied, resulting in production of just over 880,000 cars in 2020, 32% below the 2019 level, as per outlook commissioned by SMMT. However, a fruitful consensus on a zero tariff- and quota FTA, production volumes would potentially recover to pre-crisis levels of 1.2m units within the next few years.

Figure 8: Precipitous drop in passenger car production in Germany and the UK

Data is shown in thousand units and change y-o-y



Sources: VDA, SMMT, Creditreform Rating

As manufacturers have fixed costs to absorb, many opted to utilize credit lines and overdraft facilities while some chose to withdraw investments and also furloughed parts of its workforce. Some auto part suppliers succumbed to filing for bankruptcies, jeopardizing the value chain of the automotive industry. Subsequently, ACEA sought assistance from the European Commission, outlining a comprehensive 25-point action plan in a letter and demanding strong and coordinated action to rescue the industry from the deep crisis. Responding to the emergency, the Commission agreed to state aid for France's leading carmaker Renault, approving the loan guarantee of 5bn euros, under the temporary framework adopted on 19 March 2020 and amended on 3 April 2020.

Since May, many car manufacturing facilities have resumed productions but due to safety guidelines enforced by the respective governments, they are largely operating below capacities. The average operating capacity is expected to fall to 71% and further to 63% this year, while in theory operating levels of 80-85% are required to ensure profitability. Moreover, of the roughly 300 assembly and engine production plants in Europe, 142 plants produce passenger cars and are spread across the continent. Therefore, returning to full-scale production necessitates the relaunch of activities by manufacturers and suppliers combined with investments along the supply chain in a synchronized manner, which further remains vital to a broader economic recovery.

Meanwhile, manufacturers are considering to reconfigure supply chains due to rising protectionism. Production on foreign sites, mainly Asia, has become very popular as automakers benefited from relatively lower costs and easy access to local markets. However, with the advent of the pandemic, automakers are forced to rethink building resilient supply chains and focus on local production of key components. Due to complexities involved, it remains challenging to shorten supply chains. A myriad of factors in terms of substituting required skills, resources and tech know-how, etc. pose a tremendous challenge to localize production. Presently, some leading carmakers are strategically considering shutting down some of their offshore plants to address overcapacities, while others prefer to see how demand shapes up post-pandemic crisis.

Looking forward, the production levels are expected to reflect consumer demand. The rebound in new car registrations in the short term would be boosted further as lockdown restrictions continue to ease. Moreover, the risk of attracting infections will prompt consumers to shift away from public transport, resulting in growing preference for an autonomous vehicle. Notwithstanding, affordability and job security would remain key concerns amidst uncertain economic conditions. As a result, overall demand may recover but would remain depressed compared to pre-Covid levels. According to ACEA, new car sales in the EU would plummet by a fifth this year. That said, a full-scale return of production capacities is unlikely, given the severity of the recession and the fact that the situation in this sector had been already very unstable before the pandemic.

Used car markets have proven resilient. Uncertain economic conditions and diminishing purchasing power of consumers led many to seek out older

cars, representing better value for money. Moreover, while increasing discounts on new cars registrations do not bode well for residual values, the rising demand combined with constrained supply of new cars is supporting residual values of young used cars.

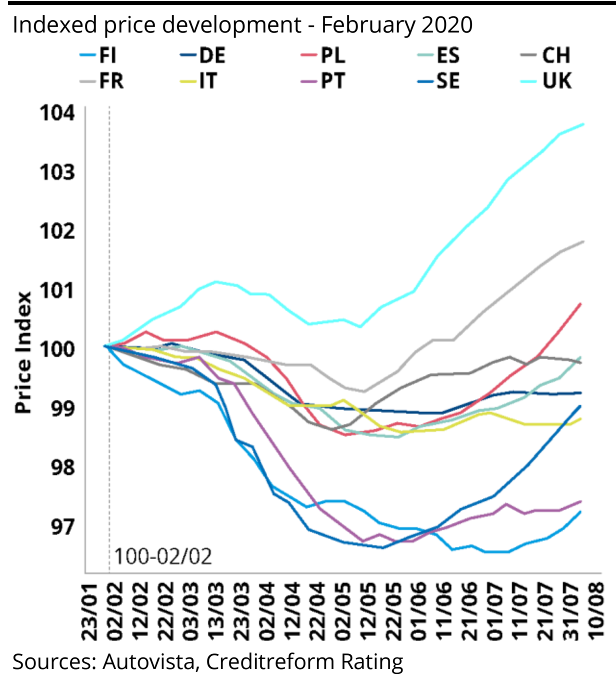
As illustrated by figure 9, residual values (RVs) have been recovering relative to their baseline on 2 February. Thus, residual values have risen since mid-May, in particular in the UK and France, peaking in the week ending on 2 August. France's notable rise has been broadly supported by the government's trade-in bonus that is also applicable to used cars, whereas the rise of RVs in the UK is attributed to pent-up demand from the lockdown and stronger supply challenges.

The surprisingly strong performance in used car markets is also explained by the government's low interest rate loans, which provided a lifeline for many dealers to stimulate their businesses. In addition, supported by the widespread use of online re-marketing platforms, large volume markets such as Germany, France and the UK may continue to deliver strong performance, at least over the short term. As pent-up demand is being satisfied and supply chains gradually move closer to full capacities, the strong performance of used cars appears unsustainable as new car supplies outweigh demand. Also, it would take years before used car markets can recuperate losses from the lockdowns, which is estimated to be roughly 6bn euros, according to Autovista.

Markets such as Germany, Italy, and Switzerland, which remain late starters, have seen several offsetting effects. For instance, the Italian markets have been largely stable, awaiting a better understanding of the full impact of Covid-19 crisis. RVs fell modestly from June to late July, partly attributed to the announcement of incentives to the auto sector that took effect on 1 August. The impact could be more noticeable starting from September. Meanwhile, in Germany, the disruption to the new-car supply was one of the key factors affecting residual values. According to KBA, used-car transactions were just 6% lower in the first eight months of the year compared to same period a year ago, while new car registrations fell dramatically by about 30%. The lack of new-car supply led to a spike in demand for used-cars sales, although dealers offered heavy discounts for quick turnovers, limiting the upside in RVs.

The situation in Spain is a tad more positive, as production stoppages and fewer new used cars are driving transaction prices. Switzerland also saw young used cars filling the missing gaps of new cars, thereby increasing the prices tentatively. In contrast, Finland and Portugal have experienced falling RVs. In Finland, there were no dramatic lockdown measures implemented and notably residual values continued to run at the lowest level in Europe.

Figure 9: Residual Values- Used car prices emerging from lockdowns



Sources: Autovista, Creditreform Rating

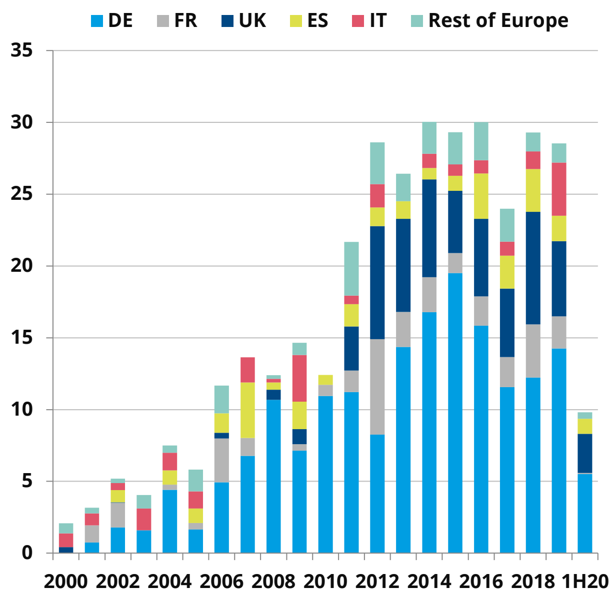
Summing up, RVs presently appear to be moving at three different speeds across Europe. As we progress into the second half, in most countries manufacturers have now started to resume production, and in some countries new car incentives have been added to. This should most likely increase the stock volumes in the used-car market and put pressure on RVs.

2. The Auto ABS Markets in Europe

At the beginning of 2020, the European auto ABS market was proving to be in a healthier shape compared to 1Q19 and was rallying on the momentum generated from the second half of 2019. The first full year of the new 'Simple, Transparent and Standardized' (STS) regulation and a diminishing role of the ECB in the use of typical securitization collateral for bank liquidity were among the primary reasons behind the growing optimism among investors interests and a strong start to 2020. Subsequently, the outbreak of the pandemic has been disrupting the financial markets since mid-March. Nevertheless, markets have maintained a strong position compared to the situation witnessed during the financial crisis of 2008.

Figure 10: Development of the auto ABS issuance activity in EU

Volume of new auto ABS issuances in billion euros, by origin of collateral

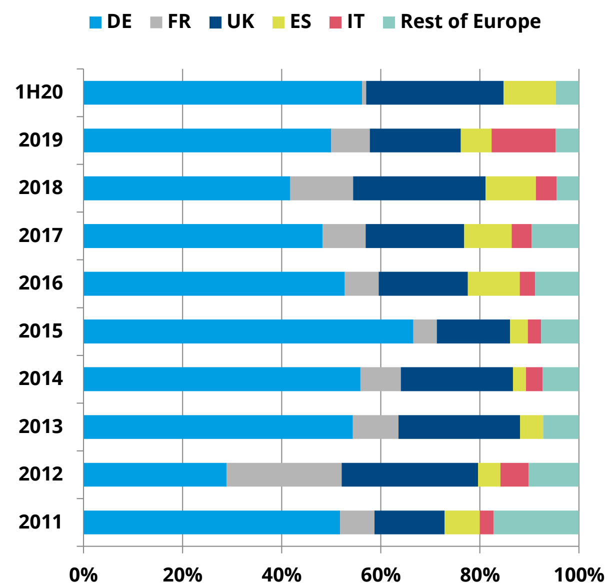


Sources: Refinitiv, Creditreform Rating

The first half of 2020 was quite unpredictable with regards to the auto ABS issuance activity in the primary market. New issuance volumes came in slightly below the tally of 1H19, edging down by 2% y-o-y to reach 9.8bn euros, also remaining below the ten-year average of 11.5bn euros since 2010 but higher than the 4.3bn and 6.3bn euros registered in 1H08 and 1H09 respectively (see figure 10).

Figure 11: German collateral continues to prevail

Share in auto ABS deals by origin of collateral, measured by annual issue volume



Sources: Refinitiv, Creditreform Rating

Barring Germany, UK and Spain, the European securitization market in the auto segment was largely inactive with near-zero issuances by most of the countries. While we have observed only a few transactions since the start of the year, more than half of the total new issuances were originated in the region's largest auto ABS market, Germany, just over one-fourth from the UK and one-tenth from Spain, amongst others (see figure 11). Overall, Germany and the UK remained the top originators of collateral in EU's auto ABS market with a combined market share of 84% in 1H20, above the average of 72.5% recorded over the last decade. Meanwhile, the UK's share of around 28% in 1H20 was above its long-term average market share of around 20%, benefiting from lackluster activity in other core markets. In terms of volume, Germany saw a decline from 6.2bn euros in 1H19 to 5.5bn euros in 1H20. Notably, the UK's volume jumped by 15.1% y-o-y to 2.7bn euros despite the current macro backdrop

and Brexit uncertainty. Overall, the total auto ABS issuance in EU stood at 350.3bn euros between 2000 and 1H20.

In general, we believe that the European ABS market is better-positioned now than prior to the 2008 financial crisis in so far as the current underwriting criteria are more robust than during the previous crisis. Furthermore, the securitization issuance is expected to gradually recover after plunging in April and May, benefiting from the government support to the markets. In addition, the historically low interest rates would encourage yield-chasing behavior and likely buttress the demand for auto ABS.

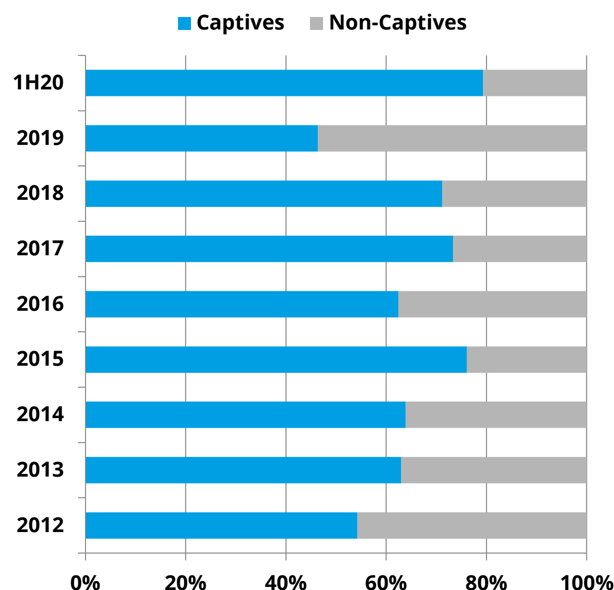
3. Originators of Auto ABS

The major European issuers of auto ABS have generally been the banks affiliated with automobile manufactures, known as Captives. Admittedly, in terms of issuance activity, captives have been adversely affected by substantial economic uncertainty but have performed relatively well in the first half of the year when compared to the 2009 economic downturn. The share of captives in the European new auto ABS issuance volume surged to 79% in 1H20, beating the historical average of around 67.9% in the last couple of decades (see figure 12).

The captives closed 1H20 with a total issuance of 7.8bn euros, representing an almost two-fold increase in the issuance activity from the corresponding period last year. Notably, the significant growth is also due to base effects as the issuance in early 2019 was held back by uncertainties surrounding the implementation of the securitization regulation in the EU. A further factor aiding captives' issuances appears to be the rapid recovery of used-car prices that generally benefit ABS collateral.

Figure 12: Captives seemingly defied the trend witnessed during the economic downturn in 1H20

Share in the volume of new auto ABS issues by originator

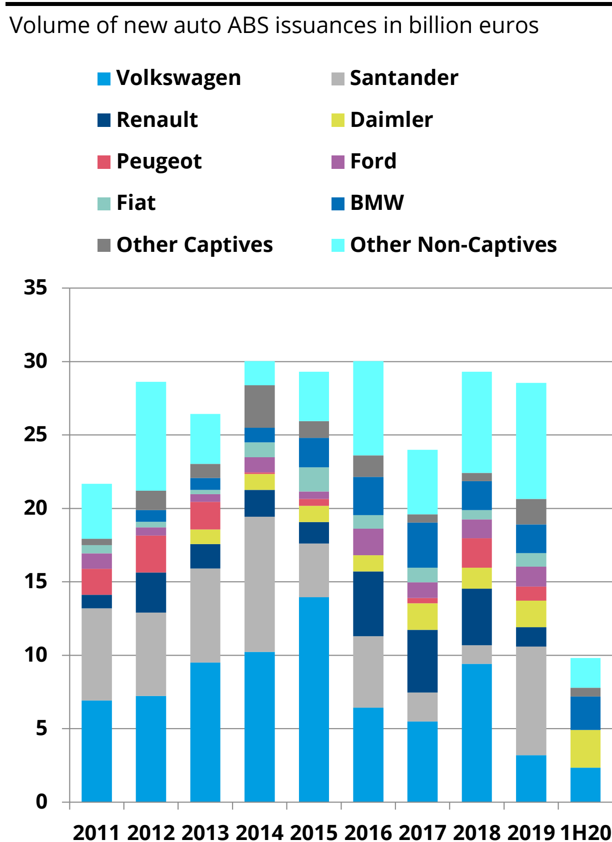


Sources: Refinitiv, Creditreform Rating

Volkswagen's dominance in the captive issuance category has been squeezed in the past couple of years. However, the originator managed to raise 2.4bn euros in 1H20, reflecting an improvement of 26.3% y-o-y, though still sub-par of Volkswagen's standard and way below 6.2bn issued during the first half of 2018 (see figure 13). Despite the increase in issuance, Volkswagen's market share declined to 24% in 1H20 compared to prior period's 18.6%, albeit staging a strong recovery from the annual all-time low of 11.2% recorded in 2019. Daimler was the leader this season in terms of overall auto ABS originators, raising 2.6bn euros, the highest in the past couple of decades and closed the first half with a market share of 26.2%, slightly above Volkswagen. On the other hand, BMW's new issuance of 2.3bn euros accounted 23.2% of the European auto ABS market in 1H20, mirroring its growing importance lately in the auto securitization market as its market share had edged up from 3.3% in 2014 to 6.9% in 2019.

Figure 13: German captives dominating in the first half of 2020

Volume of new auto ABS issuances in billion euros



Sources: Refinitiv, Creditreform Rating

Meanwhile, activity remained muted from other auto majors such as Renault, Ford, Peugeot and Fiat, which refrained from tapping the market and marked their weakest performance in recent times. Overall, these data points hint towards subdued issuance activity in the remaining half of the year as the outlook for all the major auto players remains gloomy given the falling demand and impact on production due to lockdown measures. We believe that captives would not be able to support the transactions to the same extent if the OEM's (original equipment manufacturers) creditworthiness deteriorates over a prolonged period due to the challenging macro backdrop.

Moving to non-captive issuances, prior to the pandemic, they were also expanding in the used car market and gradually increasing their market shares. However, non-captives' resurgence in the total volumes issued by European originators came to an abrupt halt in 1H20 and ended the period with meagre one-fifth market share with a total issuance of 2.0bn euros. This corresponds to the largest slump of the non-captives compared to an average of around one-third during 2014-2019. The decline can be primarily attributed to the inactivity by the Spanish bank, Santander, which historically was the leading non-captive originator. Usually, the credit quality of underlying borrowers in non-captive is generally weaker compared to borrowers in deals by captive sponsors and therefore are more vulnerable to financial strains during the recession, possibly spooking investors towards the safer captive segment. Positively, issuance volumes by other non-captives increased 59.1% y-o-y to 2.0bn euros in 1H20.

4. Rating Profile of Auto ABS Markets in Europe

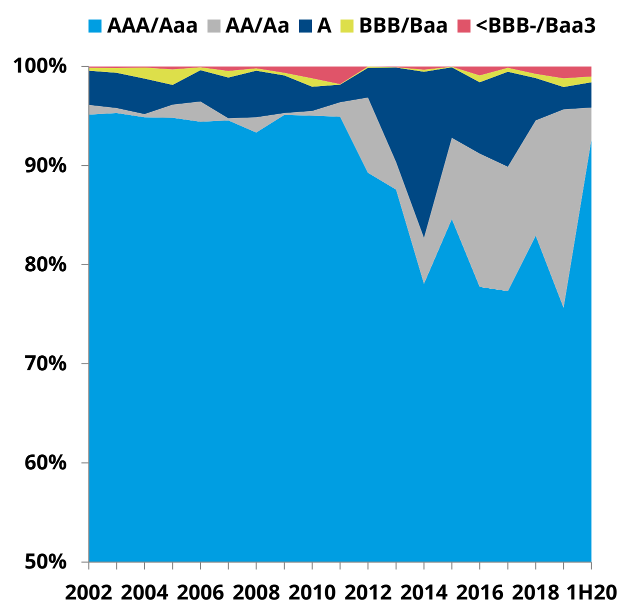
Globally, the demand for safe-haven assets has surged to unprecedented levels given the prevailing macro environment. In the current stage of the credit cycle and with the negative real interest rate in Europe, the auto ABS segment provides a granular exposure to a pool of real assets, while offering investment grade ratings and government bond-like liquidity. Essentially, the auto ABS segment is a short-duration asset, which offers less price sensitivity to changes in the yield curve, relative to the longer-dated bonds and can be considered to be no less than a safe-haven asset. Hence, this asset class plays a key role in sheltering investors and offers an attractive yield premium against the backdrop of highly volatile and uncertain market conditions.

The European auto ABS asset class saw virtually flat rated primary issuance volumes, posting at 9.09bn euros in the first half of 2020 versus 9.06bn euros a year before – a transition year which was characterized by regulatory uncertainty, as mentioned above. In comparison with 2019 as a whole, issuance volumes for 1H20 represented just one-third of the volumes. The overall rating profile of the European auto ABS has improved during the period. Around

8.4bn euros were printed in the AAA/Aaa category in 1H20, reflecting a 7.2% y-o-y increase, partly mirroring the rather low number of issues. Furthermore, the share registered by AAA rated issuances in 1H20 was the highest in nearly a decade, at 92.6% and 6 percentage points higher than in 1H19 (see figure 14).

Figure 14: Strong rating profile of auto ABS

Initial ratings (S&P, Moody's, Fitch) include senior and subordinate tranches, share in the yearly issuance volume, measured by the issue volume of all rated notes



Sources: Refinitiv, Creditreform Rating

Gauging the historical trend, the majority of auto ABS securities have fallen in the coveted AAA rating, which accounts for an average of 86.2% of total issuances during 2000-1H20. However, the cumulative share of AAA/Aaa-rated issuances has been shrinking gradually since 2012, as the risk appetite among investor base increased after the market began to stabilize post the Euro Debt crisis. The AAA/Aaa auto ABS securities have declined from the highs of 2011 and before, when approximately 95.0% of the new issuances had ideally received the top rating. This figure came down to 84.6% in 2015 and slipped further to an all-time low of 75.7% in 2019. In absolute terms, the AAA-rated auto issuances marked the highest level at 23.1bn euros in 2015, and gradually declined to 19.8bn euros by 2019, underscoring a large single-digit decline compared to 2018.

Meanwhile, the declining share of AAA/Aaa rating space was captured by the higher prevalence of AA/Aa ratings over the years, driven by yield-chasing investors. That said, the rating profile bucked the trend this time since investors seemed to have moved back to upper tranche amidst prevailing uncertain market conditions, which are again otherwise dominated by negative yields. In 1H20, the share of AA rated issuance recorded a significant plunge of 11.8 percentage points to 3.0% compared to the prior period, reflecting sharply declining AA volumes (-74.2% y-o-y to 295mn euros). Furthermore, the portion of the A-rated issuances continued to shrink, closing the first half of 2020 at 2.3% of all the rated issues, after the 0.6% observed in 1H19 (2019: 6.1%). The volume also bottomed to 230mn euros in 1H20 from 55mn euros in 1H19 (2019: 589mn euros).

Overall, during 1H20, more auto ABS tranches with a AAA rating were issued, seemingly attracting investors chasing relatively higher yields in addition to the protection offered by asset-backed securities.

5. Perspectives for the Issuance of European Auto ABS

Despite being in a strong position, the European auto ABS market is not immune to financial disruptions entailed by the Covid-19 pandemic. The ABS market performance in Europe has started to deteriorate due to the impact of Covid-19 and associated measures to contain the same. Forbearance measures, such as payment holidays have provided some relief to obligors thus preventing a rapid rise in delinquencies. That being said, we gather that the take-up rate regarding auto transactions appears relatively low so far. At the same time, we note these measures pose substantial long-term liquidity risks more generally, as cash flows are interrupted in these transactions, and may ultimately result in higher credit losses. Therefore, a big question is whether existing loans will be able to emerge from

their extension status with the same quality and resume regular payments, as this would also be the key to restoring confidence in primary markets.

Whilst rising unemployment poses a key risk to the ABS market, comfort could be derived from the government measures implemented so far to revive European economies, lending some support to the auto ABS performance. However, as Covid-19 infections are rising rapidly, we believe associated impacts on the economy, market sentiment, interest rates, credit, etc. would be the key factors to determine the performance of the European securitization markets over the second half. We anticipate issuances to remain in line with 1H20 levels at best, however they may fail to outpace 22bn euros as seen during the European debt crisis of 2011. The new deals may also see stronger structures as investors seek to prepare for ongoing credit distress.

The European Commission enacted prompt measures to address credit issues. On 24 July, the European Commission published a legislative proposal to amend the Securitization Regulation. As per new changes, the Simple, Transparent and Standardized (STS) regulation framework has been envisaged to include on-balance sheet synthetic securitizations and related capital treatment. In addition, the second important amendment proposed includes the removal of regulatory obstacles on NPL securitizations. In particular, this proposal seeks to amend risk retention and credit-granting requirements of the securitization regulation to better align them with the structure of NPL securitization. These two amendments are planned to encourage broader use of securitization during the recovery phase, by freeing up bank capital and supporting banks in their effort to enhance lending to households and businesses. At present, these proposals have been approved under the European Commission's recovery plan and are further due for approval from the European Parliament and European Union Council.

We note that the regional auto industry is currently faced with unprecedented headwinds. Huge incentives and subsidies are being offered by the EU governments to revive auto demand. However, economies are operating far below potential for the time being as social distancing measures remain in place.

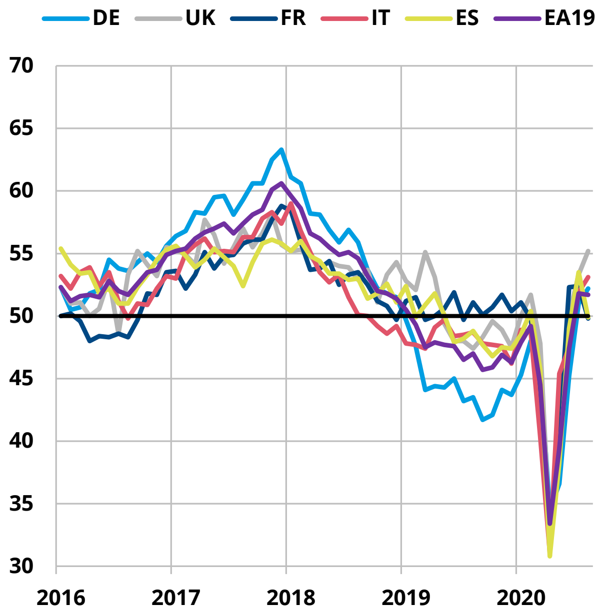
In view of the near-term macro outlook, the region's real GDP is expected to stage a strong rebound during the third quarter, as lockdown measures are gradually lifted. We anticipate euro area real GDP to shrink by 8.3% for 2020, largely underpinned by the recovery of northern European countries. Meanwhile, Southern European countries would face painful recovery as tourism accounts for an important share of GDP and the economies risk rising infections. We expect Germany's total output, the power engine of euro area, to shrink by 6.1% this year, before rebounding to about 4.8% in 2021.

Assessing the economic performance so far, the euro area's real GDP contracted by 11.8% q-o-q in 2Q20, having already declined by 3.7% in Q1. The Q2 figures showed that Italy, France and Spain, fared much worse than Germany, where lockdown was shorter and less stringent. The fall in German GDP has been less dramatic than anticipated at -9.7% in 2Q. Progressing into the third quarter, green shoots are being evidenced by some of the leading indicators, confirming that a recovery is underway.

The European manufacturing sector appears to have come back to life as PMI manufacturing indices were back into the expansionary territory across the core economies of the region (see figure 15). Growth of new orders suggests rising levels of production in the near term, with the rise in demand for exports mainly from China. However, with the pandemic risks still prevalent, we believe external trade will remain under significant pressure not least as the industrial sector may put more emphasis on domestic production. In the same vein, the German business sentiment marked a significant improvement during September, as the ifo Business Climate Index climbed for the fifth consecutive month, from 92.5 to 93.4 points (Apr-20: 74.6), just 1.4 points below the previous year's level.

Figure 15: Manufacturing PMIs suggesting a V-shaped recovery

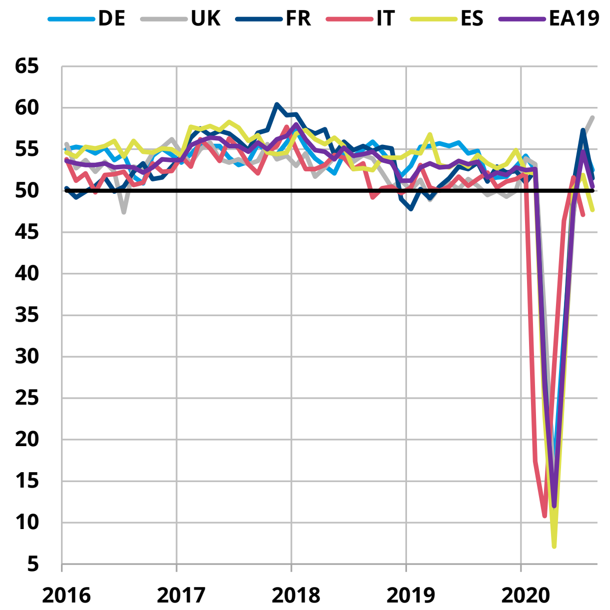
Purchasing Manager's Index, 50 unchanged growth



Sources: Refinitiv, Creditreform Rating

Figure 16: Services PMIs rebound despite social distancing measures

Purchasing Manager's Index, 50 unchanged growth



Sources: Refinitiv, Creditreform Rating

Moreover, domestic demand seems to have revived as evident from strong retail sales that rebounded to pre-pandemic levels in July. Services PMI also expanded above the 50-point threshold across core economies (see figure 16). Considering the recent rebound in both manufacturing and services activities, it can be inferred that these are largely outcomes of pent-up demand and backlog orders that were unleashed after lockdown restrictions were lifted across most countries.

Negative consequences in terms of redundancies are not yet visible, mainly due to labor market support measures enacted by European authorities. At this stage, labor markets thus seem relatively resilient, judging by key metrics up to the second quarter. Our main-case is for unemployment rates to rise markedly, as soon as many of the employment support schemes phase out around the turn of the year. On the whole, the road to recovery appears extremely uncertain, with the virus being still active. Therefore, the auto sector recovery is expected to broadly mirror emerging trends in infection cases and recovery of broader Eurozone economy.

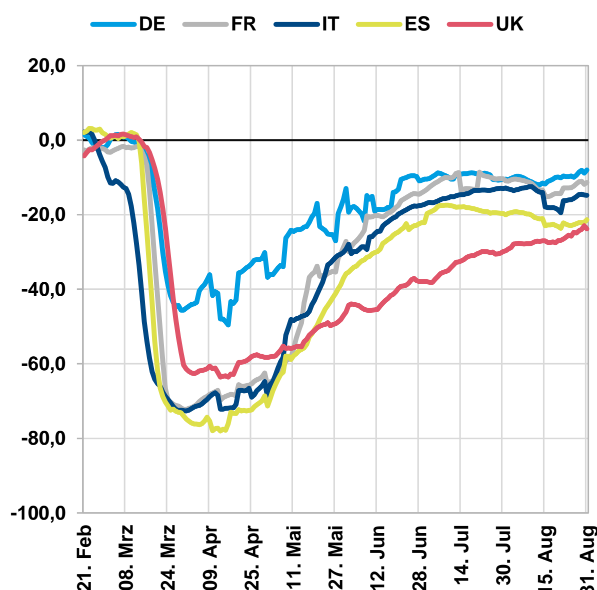
Unemployment remains a primary concern for policymakers, as the labor market would be the key driver of the economy's recovery path. The extensions of policy support such as short-time work schemes or state loan guarantees remain crucial to the euro area since the recovery is not yet self-sustained. So far, the governments' and the ECB's policies have been highly effective in controlling unemployment levels. Still, the unemployment rate may reach double digits by end of 2020 as support schemes come to an end.

However, it may be noted that the current recession is not an outcome of the typical imbalances caused by demand-supply mechanics, but a sudden and prolonged halt in activities owing to a health crisis. Therefore, conventional indicators fail to paint a valid picture of the pace of economic recovery. As containment measures are lifted, it is crucial to understand how behavior is changing. Therefore, an alternative European mobility tracker index showing mobility relative to baseline i.e. 3 January to 6 February, average for retail, recreation, grocery, pharmacy, transit and workplace, all shed light on how the activity is rebounding across geographies.

As figure 17 illustrates, public life, in general, is experiencing some normalization after containment measures are gradually eased. Average mobility indices in Germany, France, Italy and Spain stood around 17% below pre-crisis levels at end-July. Positively, data shows signs of a synchronized recovery across the euro area's major economies, which is likely to become firmer going forward.

Figure 17: Mobility trends indicating economic recovery

Global Mobility Tracker ⇔ Index showing mobility relative to baseline, i.e. 3 January to 6 February, average for retail, recreation, grocery, pharmacy, workplaces and transit stations



Sources: Google mobility trend reports, Creditreform Rating

Moving ahead, the recent rise (from late July) in infections in several countries casts doubts over the recovery path after the initial renounce witnessed during June and July. The overall economic outlook is highly dependent on the evolution of the pandemic as well as the magnitude of respective countries' fiscal policy responses to prop up consumption and investment demand, mainly with the pandemic impacting some countries harder than others and with various degrees of policy responses.

To facilitate a sustained recovery of the economy, the ECB has proactively extended its unprecedented monetary support to ease financial conditions. The PEPP announced in March saw a top-up of 600bn euros along with an enhancement of the TLTRO program. This remains supplemented by negative interest rates. Cumulatively, the ECB's PEPP now scales up to 1.35tn euros of bonds until June 2021. The central bank would also reinvest principal payments until the end of 2022, thus allowing governments sufficient headroom to gradually increase debt issuances and maintain stability in the market while also lowering the risk spreads in peripheral countries. Another top-up of 500bn euros to its PEPP is being anticipated by the markets later this year but would be contingent upon how economic recovery shapes up as uncertainty remains elevated.

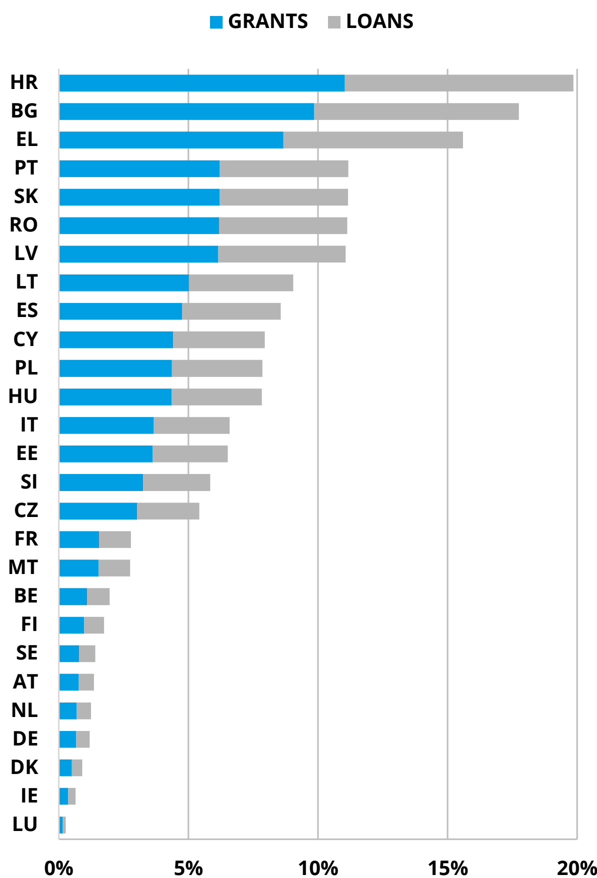
Meanwhile, fiscal authorities have finally loosened their purse strings. After the ECB's repeated call for active participation, European leaders have finally agreed upon a massive economic recovery fund with 750bn euros to keep the economy afloat. The package comprises 390bn euros in grants and 360bn euros in low-interest loans (see figure 18). The fund will be raised by the European Commission by issuing debt in capital markets, which will be disbursed to the regional governments through the next EU budget for the period 2021-2027, in addition to the cumulative 1tn euros of EU budget for the same period. Interestingly, nearly one-third of the fund is earmarked for battling climate change. This together with the bloc's next 1tn euros seven-year budget will constitute the largest green stimulus package in history. Indeed, these measures come on top of what the countries planned to do nationally.

Among the key countries, Germany has proactively earmarked a part of its 130bn euros stimulus package towards offering incentives and subsidies to boost electric mobility, while simultaneously building electric charging points to strengthen the required infrastructure to provide the much-needed push to the auto industry. Similarly, France offered an 8bn euros package to support the auto industry

including impulses to shift towards a greener vehicle fleet. Meanwhile, the Italian government also announced incentives for purchases of more environmentally friendly cars as part of its Relaunch decree, amounting to 100mn euros in 2020 and 200mn euros in 2021. Prima facie, European fiscal response appears adequate to reinforce the ECB's efforts to support economic growth.

Figure 18: Next Generation EU stimulus package

Grants and loans allocation under the Recovery and Resilience Facility, based on European Council conclusions from July 2020, in % 2019 GDP



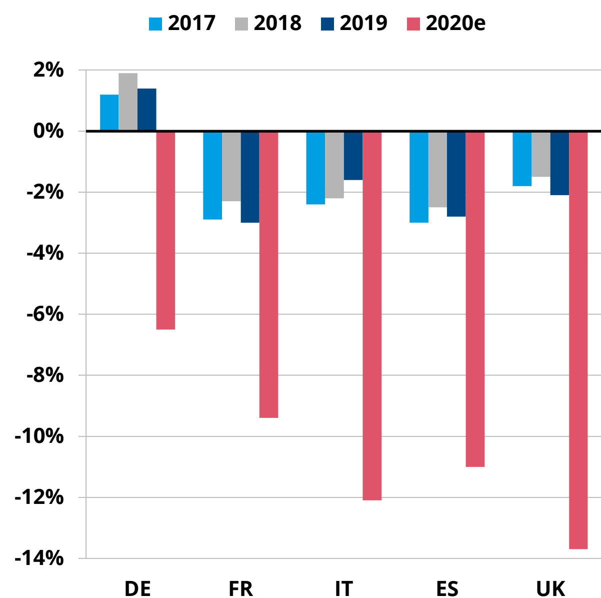
Sources: European Commission, Creditreform Rating

Fiscal support seems of utmost importance to stem the crisis impact. However, the fiscal balances are expected to deteriorate sharply and a possibility of lower double-digit deficits in some countries cannot be ruled out (see figure 19). The EU's overall budget deficit could potentially deepen further to double digits this year. Nevertheless, the ECB's unconditional backstop would prove to be of essence.

Overall, we believe that the euro area's recovery would remain fragile and uneven, with lost output likely not recouped by early 2022.

Figure 19: Fiscal deficits to deepen further

General government headline balance, in % GDP, own estimates for 2020: Germany as of 24-Apr-20, France as of 29-May-20, Italy as of 21-Aug-20, Spain as of 24-Jul-20, United Kingdom as of 25-Sep-20



Sources: Eurostat, Creditreform Rating

The UK's economy plunged by a record 20.4% in 2Q20, the most severe contraction reported by any major economy so far, amidst stringent lockdown measures. The labor market has also started to show cracks with some of the firms having started laying off staff and worse remains to be seen in later part of the year as the government looks set to scale down its huge job-protection scheme from November. Under the pressure of mounting challenges, the government has unveiled stimulus of around 190bn pounds according to Office for Budget Responsibility.

Meanwhile, the Bank of England (BOE) stepped up to support the economy and kept delivering ultra-loose monetary policy, upscaling the asset purchases by 100bn pounds to 745bn. The BOE's QE

program is critical for the government's efforts to support workforces and corporates from what is to become the deepest post-World War II recession. Furthermore, the BOE kept the policy rate unchanged at 0.1% after reducing by 65bps in March and reassured investors that they will not tighten monetary policy any time soon. Going forward, the BOE is widely expected to announce an aggressive package of interest-rate cuts and quantitative easing in November to stimulate an economy grappled by the pandemic and the uncertainty surrounding a no-deal Brexit. Policymakers might be tempted to reduce the benchmark to zero in the near term to stimulate growth. Nevertheless, the prospect of negative rates in the UK towards the end of 2021 has regained prominence since the Monetary Policy Committee has stressed that the economy is unlikely to fully recover before the end of 2021.

The negotiations on a free-trade agreement (FTA) between the UK and EU had touched an impasse, with little progress recently. The Internal Market Bill, which was put forward on 10 September and which sets out rules concerning market access principles between England, Scotland, Wales and Northern Ireland, has sparked serious controversy with the EU over whether this bill would modify the Withdrawal Agreement signed with the EU in 2019 and breach international law.

Any delay or even breakdown of the negotiations between the UK and the EU, as well as slow progress on agreements with third parties, would potentially weigh more heavily on the near-term prospects. While in the absence of a follow-up deal with the EU, WTO rules for goods would need to kick in, frictions may occur after all despite preparations towards this scenario having advanced. As regards trade in services, we gather that there remain uncertainties over whether or to what extent equivalence agreements concerning financial services can/will be established. What is more, a number of trade agreements with third countries will take time to be concluded or fleshed out.

Overall, the lack of clarity about the UK's future relationship with the EU considerably adds to the uncertainty regarding the impact of the pandemic and will likely weigh on the capital spending outlook in near-term.

Evidently, the overall situation in Europe continues to evolve rapidly, albeit with lot of uncertainty. Against this backdrop, we believe the concerted monetary and fiscal stimulus efforts of the European governments and the ECB to combat the impact of the coronavirus will support recovery of overall economy. The auto industry would benefit from the various incentives provided by the governments which should boost demand for cars even though the second wave of pandemic has started to surface. However, demand prospects are weighed down by a potential rise in unemployment levels as the governments' temporary work schemes would eventually come to an end. Hence, potential rise in delinquencies in the auto ABS market cannot be ruled out. That said, the auto ABS primary market has surprisingly exhibited a relatively stronger performance compared to 2009 financial crisis, despite the challenging economic backdrop. Furthermore, with global economy now experiencing a decent recovery in economic activity, we believe the prospects for ABS primary market could be healthier in the second half. However, the risk of rising new infections outbreaks and renewed nation-wide lockdowns would continue to persist until a viable vaccine is developed.

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