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THE BIG STORY / JUNE 2019

Upheaval, Recovery, Megatrends and the Shifting South American Market

VW's Di Si: Today one way, tomorrow another.

Building and selling cars in the wide-ranging markets of Latin America never has been easy.

There's almost always volatility, both politically and economically. And like the weather, the business climate can change in a snap. While there are routinely high expectations for growth, targets often go unmet – or prove unsustainable.

"This is Latin America," says Pablo Di Si, president and CEO of Volkswagen Group's South American Region. "Today is one way, tomorrow it can be another way."

Further clouding the picture is how the megatrends that are shaking the very foundations of the auto industry worldwide will impact the region.

What will the Latin American

auto industry look like five years from now? Will the still-emerging market's promise finally come to fruition? Will the big drivers of electrification, autonomy, mobility and connectivity shaping strategies in China, Europe and the U.S. take hold here too, or will the region continue to run several steps behind the rest of the world?

For insight, we talked with high-ranking executives at a half-dozen OEMs, interviewed analysts, studied forecasts and surveyed consumers and industry insiders. The bottom line: Overall, the business climate is improving and market demand strengthening. Yes, Latin America likely will continue to lag when it comes to the four key megatrends, but the gap might not be as large as most imagine, and there's some potential for it to close quickly.

BRAZIL BIG DOG

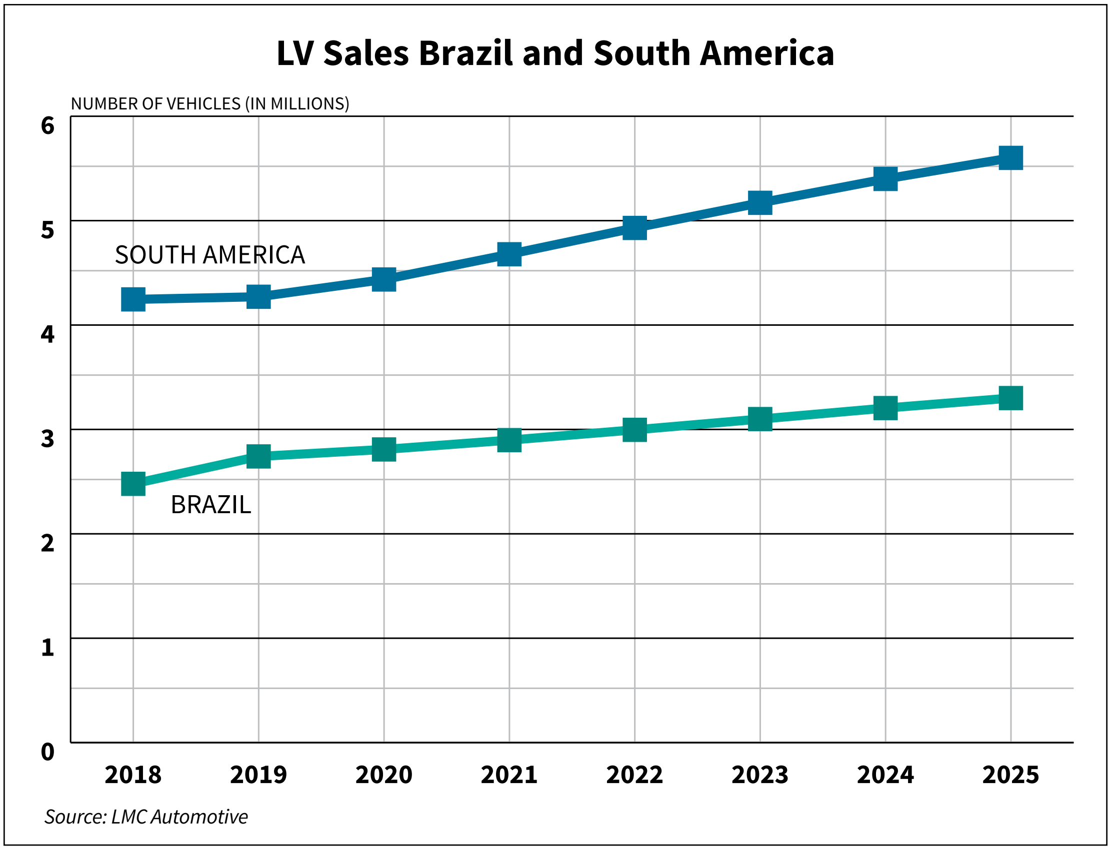
When it comes to the Latin American auto industry, it's mostly about Brazil. The country accounts for 64% of the new light vehicles sold and 85% of the cars and light trucks manufactured in the region. Of the 52 final-assembly plants in Latin America, 29 can be found on Brazilian soil.

"Any growth you take in Brazil, it will take over for the region," Di Si notes.

That's a good thing for now, because after suffering a precipitous decline earlier in the decade, Brazil's auto industry is on the cusp of a mini-renaissance. Light-vehicle sales have climbed steadily since falling below the 2 million mark in 2016, with volumes topping 2.4 million in 2018 and forecast to reach nearly 2.7 million this year, according to market analysts LMC Automotive. By 2025, demand should approach 3.2 million units, LMC says, a trend that has automakers investing in a raft of new models and the tooling to build them.

That's a stark change from the past few years, as profit declines and more-pessimistic long-term views drove automakers toward collaboration, consolidation and retreat.

A case in point is Argentina, where Renault, Nissan and Mercedes are cooperating on



pickup-truck production to cut costs, with the commonly derived Nissan Frontier, Mercedes X-Class and Renault Alaskan due to hit the market this year.

Similarly, in January, Ford and Volkswagen announced a collaboration to produce a next-generation midsize pickup (Ford Ranger/VW Amarok) targeted at Latin America and other markets. In addition, they will join forces on light-commercial vehicles, a move that also is likely to impact product and production in the region.

For Ford, the tie-up may have averted plans to exit the market, a possibility rumored in mid-2018 as Latin American losses mounted.

"It is smart and necessary for OEMs to open their minds for development sharing and scale leverage," Lyle Watters, president-Ford South America, tells Wards. "The South America region has excess capacity, and investments in the auto industry, with increasingly (tough) regulatory changes,

Q&A With Pablo Di Si

President and CEO-Volkswagen Group South America

Wards: Are consumers starting to have more disposable income to spend on automobiles?

Di Si: First, consumers are going in significantly to the showrooms in Brazil because the consumer confidence has improved significantly. When the customers go to the showroom, there is credit available (because of the improved economy), and that impacts (purchasing power) positively. So, (it) always starts with consumer confidence, because if the consumers are not feeling confident of the economy of the future, I don't care how much credit (availability) you have, you won't sell any cars.

Wards: Do you expect more localization of parts sourcing industrywide?

Di Si: Definitely, because we are in an industry that is volume-driven. Brazil has a decent supplier base, not great, and all the volume goes within Latin America. We export very little to countries outside of Latin America. Now, with the global platforms that most OEMs (have been) implementing in the last two years, now we have the technology, we have the safety, we have the emissions (compliance) to export to pretty much any country in the world. But Brazilian cost (is) prohibitive to export. We need to find ways to reduce our costs to start exporting more.

Wards: But there's really not a technology gap in Brazil?

Di Si: Do we have the latest technology from the U.S. and Europe? Definitely not. (But) we're moving into spaces that Brazil was not present in before. Right now, I have young engineers developing the new infotainment system for the region, in Brazil – from the development of the software to the manufacturing. Do we have the best-in-class supply base here? No. But I think there's always a beginning and we're starting to move that way.

Wards: How important is fuel economy to consumers?

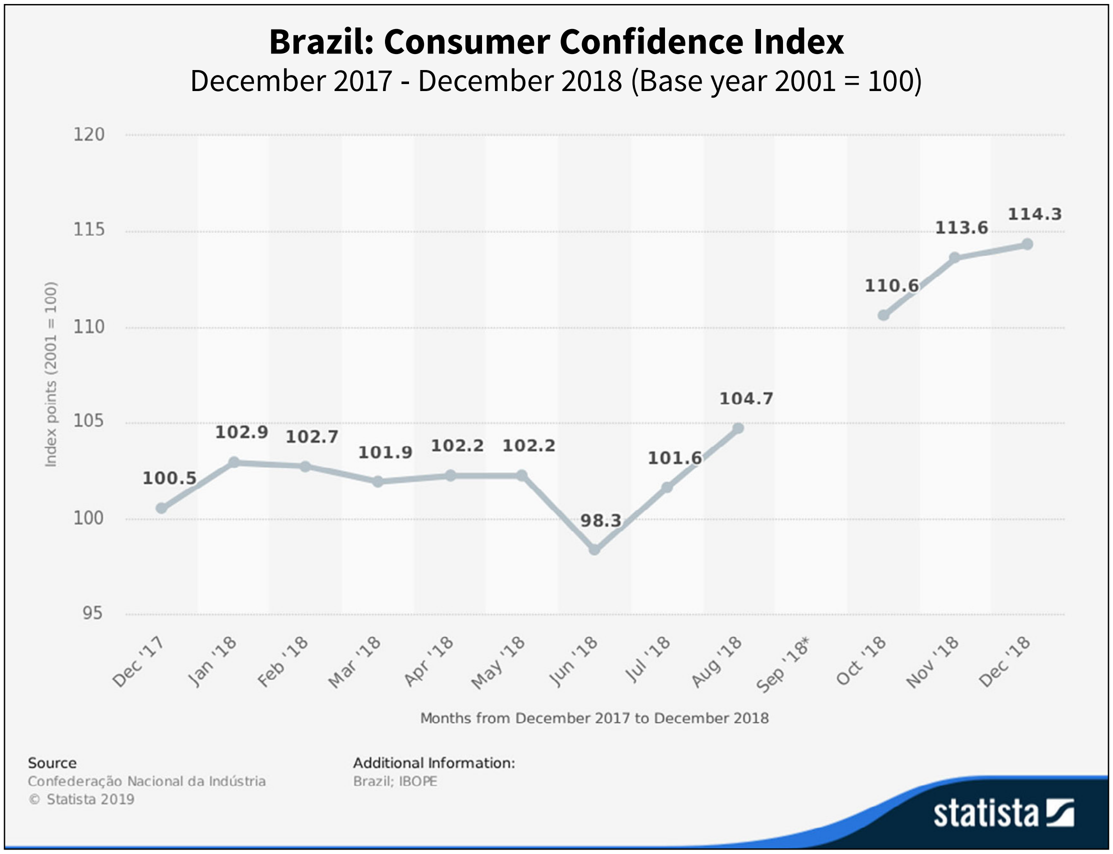
Di Si: It's huge. The consumer in Brazil is very conscious of how much they spend per kilometer (on fuel), and then they will switch between ethanol and gasoline because they know the efficiency (a vehicle goes farther on a gallon of gas than it does on ethanol) and they know the price. So this math, they know it very well. (They make a fuel-purchase decision) every time they go to the pump. And if it's important to the consumer, a lot of companies will invest a lot on this technology. Brazil has a lot of technology in the development of fuel-efficient engines.

Wards: How do you see your lineup shifting? Will half your lineup be SUV/CUV?

Di Si: Definitely. We announced a BR7 billion ($1.8 billion) investment last year for 20 products (by 2020). And out of these 20 products, five are SUVs. Then we have on top of those six electric and hybrid cars in the region.

Wards: What will limit the size of the battery-electric vehicle market?

Di Si: Infrastructure (is) number one. I can give an example here of our factory. I have peaks in the factory of energy every day because the energy is not stable. If there's no electricity to run a normal factory, imagine if we all go into electric (cars). I need to create the future with hybrid and electric on a pilot basis, so if I'm wrong, and sales take off…we order more. (For now), there's absolutely no demand (for plug-ins) because there are no (charging) stations. I haven't seen one charging station outside of Volkswagen (property), not one. We have a long, long way to go. **WA**



are too high, while margins are excessively tight."

General Motors appears to have dodged a retreat as well, announcing in March it would invest BR10 billion ($2.5 billion) at its Sao Caetono do Sul and Sao Jose dos Campos assembly plants. The future of those operations – if not GM's presence in the market – had been threatened.

"We are not going to keep deploying capital to lose money," CEO Mary Barra reportedly told top management in Brazil, prior to landing what she called "meaningful concessions from all stakeholders" that will allow the automaker to build future Chevrolet vehicles based on its new Global Emerging Market (GEM) platform at the two plants.

Others also are making significant investment in the region.

Fiat Chrysler Automobiles, which in early June held merger talks with Renault, is looking to take Latin America sales to 1 million

FCA's Filosa: Consumers more optimistic.

vehicles by 2022, up from 700,000 today. To get there it will launch 15 new or revamped Fiat models and 10 new or refreshed Jeeps. Ram also will roll out a new 1-ton pickup as part of the $4 billion spending plan through 2024 that includes a 100,000-unit boost in annual capacity at its Pernambuco plant and an all-new facility to churn out more-efficient turbocharged engines.

The $2.4 billion Fiat-brand investment will result in three new SUVs joining the lineup, reportedly including new compact and midsize models, plus a Fiat-branded version of a large Jeep. A Strada pickup, revamped Uno and new van also are said to be on the drawing boards.

The new-product push will fill much of FCA's market whitespace. Currently, its model lineup covers less than 70% of the available vehicle segments, but by 2022 that will reach close to 90%, officials say.

In Brazil, partial credit for the improved trajectory goes to the country's new president, Jair Bolsonaro, or at least to the fact the election is over and policy direction a little less murky. Dubbed "the Trump of the tropics"

because of his ultraconservative stance and controversial public persona that draw obvious comparisons to the U.S. president, Bolsonaro is pushing a pro-business agenda that has boosted confidence of both automobile manufacturers and car buyers alike.

"The new political leadership is bringing to consumers a more optimistic view of the future that goes along with a reduction in unemployment," says Antonio Filosa, chief operating officer of the Latin American Region for FCA, alluding to a declining jobless rate. There's more that has to happen, but the market recovery has begun, he says, pointing out that more fuel will be added to the fire as automakers roll out new models.

In December, consumer confidence reached is highest level in five years, according to TradingEconomics.com.

"The people feel better," Volkswagen's Di Si notes. And there is more room for upside, he says, should the government follow through on promised pension reform some predict would spark the Brazilian economy to the tune of BR700 billion ($176 billion).

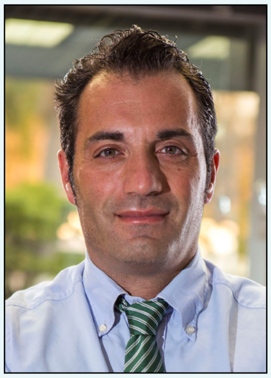
"My estimate is Brazil will grow between 15% and 20% this year, especially if there's pension reform," Di Si says. "If that is approved, I think the whole industry and the whole country will skyrocket positively."

But there are several big ifs in the Bolsonaro agenda, and that has caused investment to move ahead more cautiously than it might, tamped down by rumored infighting within the administration and the new president's stagnant popularity rating.

Luis Maizel, cofounder and senior managing director-LM Capital Group, put it bluntly earlier this year, telling *Forbes*, "At this point, I think Bolsonaro is a little bit crazy, but I wouldn't discard Brazil yet."

David Beker, chief Brazil economist at Bank of America Merrill Lynch, told the *Financial Times* in April, "Get the (pension) reform done and you will have a transformation."

Some of the threat to Brazil's auto-sector recovery comes from



Q&A With Antonio Filosa

Chief Operating Officer-Latin America, Fiat Chrysler Automobiles

Wards: What are the factors behind Brazilian market growth?

Filosa: I believe it is consumer confidence, which is consistently growing after the elections. Inflation is under control, credit availability and the cost of money (has improved).

Wards: Is consumer buying power increasing in Brazil?

Filosa: Yes, for sure. Brazilian families on average are less exposed to debt. The cost to debt for them is very high. There are studies that one-fourth of average Brazilian family income is dedicated to (paying) debt. Now with the lower cost of debt, because of the (lower) interest cost, that will reduce by two to three points, and this is equal to two to three points higher purchasing power. So just this fact is going to increase purchasing power; plus inflation, which was out of control and now is very low, is another factor in improving purchasing power. And with the fact unemployment is not scaling as much as (during) the last economic cycle, confidence is getting higher.

Wards: In light of that, what are consumers willing to pay for?

Filosa: What is fueling demand is higher confidence in the economy. This is driving demand in two classes of vehicles. Families are going toward SUVs as their favorite model. But since (the economy also is) increasing the purchasing power of entry-level class of society, A- and B-hatchback models are going to be (growing too). And then because of entrepreneurs, light-commercial vehicles are growing. And out of the light-commercial vehicles we believe that pickups will have a good momentum, (as well as) vans.

Technology-wise consumers are very focused on infotainment, (which) has been a discovery of the industry in the last five years. We'll keep growing within a larger (envelope) of infotainment and different levels of connected services in the new models that will be launched.

Wards: What is prompting growth at the two ends of the passenger-vehicle market, entry hatchbacks and more upscale SUVs?

Filosa: Brazil is one of the countries with the biggest ratio of cars per citizens. It is a gap that is starting to close. Usually, in the first motorization, consumers are driven by price (driving A- and B-hatchback sales). Then there's the family that already owns one or two vehicles or even more, and are changing them, buying a new one. And those families are following the global trend and going toward SUVs. Either they've had an upgrade in their life or an upgrade in their income, so they are going from a small hatchback to an SUV…or they are owning a sedan and now they are adding an SUV.

Wards: In terms of powertrains, do you see any movement toward electrification?

Filosa: Yes, there are some companies already producing hybrid models and also electrification has been talked about as a possibility. But what I believe will be the focus of the industry is the ethanol-based engine with higher efficiency than in the past. In the next five years, the powertrain portfolio will shift from the combustion engine to the combustion engine with electrification. **WA**

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Argentina, a key trading partner that remains mired in recession. With the reins pulled back on shipments to that country, Brazilian automakers are forcing more vehicles into the local-market pipeline, putting downward pressure on pricing and profitability.

"The brands are trying to fill in this (export) capacity with Brazilian market share. Direct corporate sales and sales to rental-car fleets are also increasing," Roberto Yoshio Akiyama, vice president-Commercial for Honda Brazil, says in sounding a cautionary note.

Argentina's new-vehicle market – the second-largest in Latin America – has been in a spiral, plagued by the heavy devaluation of the peso, the high cost of credit and a drought that hit the agricultural sector hard. Light-vehicle sales there are forecast to fall 32% to 519,000 in 2019.

The economic and demographic fundamentals provide little comfort. GDP has dipped into negative territory, outpaced by rising debt. Unemployment remains high, and although wages have been climbing over the past five years, 30% of the population remains below the poverty line.

Purchasing power has decreased and "buying a new car will be harder – so there are definitely no younger buyers (coming into the market) for the next (few) years," says Hyundai Argentina.

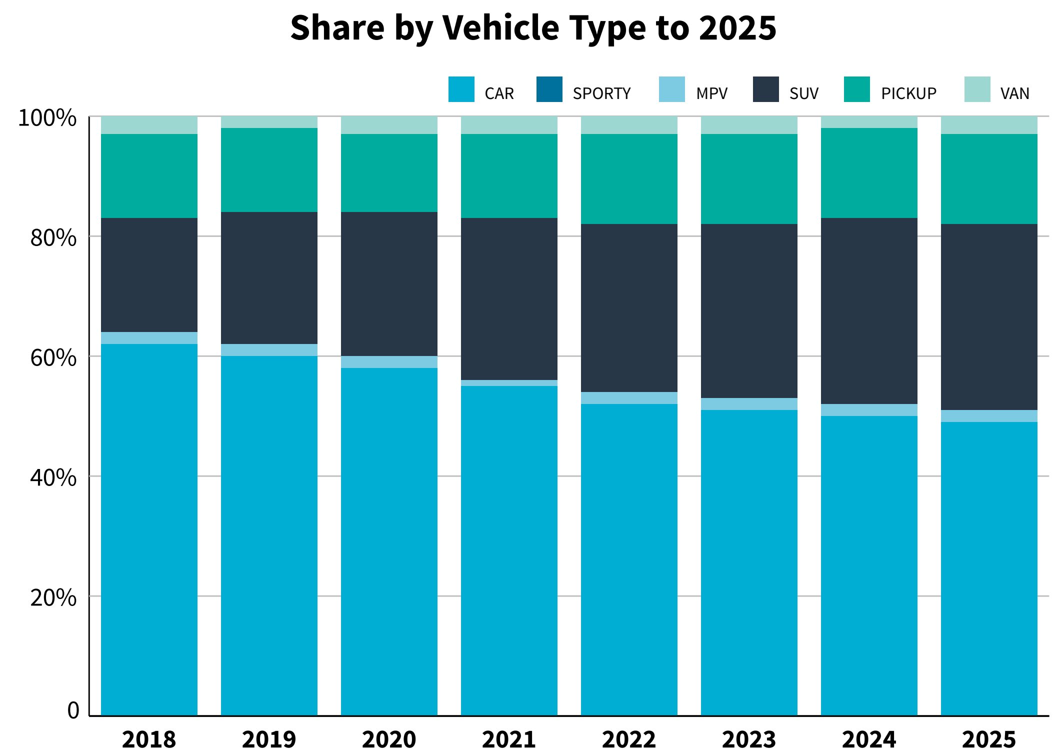
A $57.1 billion bailout loan from the International Monetary Fund and a presidential election set for late October are giving the industry reason to hope, however.

"Argentina has reached its lowest point in terms of monthly volume," Di Si predicts.

LMC Automotive forecasts a steady climb from the 2019 trough, with sales nearly doubling to 1.04 million light vehicles in 2025.

Other smaller markets should fare better than Argentina in the near term, helping push the Latin American region forward into the next decade.

Hyundai predicts vehicle penetration in Colombia will rise from five units per 1,000 people to six over the next four years, though import duties and continued widespread poverty still prevent many consumers from entering



Source: Estimates based on data from LMC Automotive

the market. The automaker credits a stable political environment, flat oil prices and the absence of natural disasters in recent years for driving demand upward in Ecuador, where sales have grown 73% over the past few years.

CUV SHIFT

Latin America's rebound is being marked by a dramatic shift in demand toward SUVs (including CUVs), meaning consumers in the region aren't all that much different from those in the U.S., Europe or China.

As recently as 2015, SUVs accounted for less than 13% of sales. Their share rose to more than 20% in 2018, and the trend is unlikely to abate.

Some of the growth in SUVs is a result of consumers adding to the number of vehicles they own, with an SUV often becoming the new member of the household fleet, FCA says.

"Families are going toward SUVs

as their favorite model," Filosa notes. "We're forecasting a consistent growth of SUVS, particularly B and C (-sized) SUVs."

Ford predicts at least 5%-7% of the traditional entry-level segment will shift to utilities in 2023 region-wide, with potential to go beyond that as new nameplates flood the market.

"We are forecasting the largest growth in the mini-utility segment," says Ford's Watters.

In addition to FCA, with its bullish Jeep plans and CUV-driven expansion of its Fiat lineup, other automakers are broadening availability of utility vehicles. Renault-Nissan is targeting 18 product renewals by 2022, including eight SUV/CUVs as it looks to boost overall market coverage to 90%. GM's GEM program is expected to include a couple of small SUVs, alongside three cars and a compact pickup. Volkswagen says its planned outlay of BR7 billion ($1.8 billion) for 20 new products by 2025 includes five utilities.

In all LMC Automotive expects there to be 280 SUV/CUV models available for sale in the region by 2025, up from 211 today.

FCA forecasts SUVs to grow to 24% of the Latin American region, from 18% in 2017 and just 9% in 2010. VW is even more bullish, with Di Si predicting, SUV/CUV sales will reach 30% of the Latin American market within "the next couple of years."

NOT MUCH APPETITE FOR BEVs

Unlike utility vehicles, Latin America isn't likely to follow the global electrification trend too closely. With Brazil's energy policy focused largely on ethanol fuel derived from locally grown sugarcane, there's less of a push toward maximizing fuel economy and reducing emissions compared with some other global markets (its Rota 2030 plan aims for 11% fleet fuel-economy gains in its first phase to 2022).

Still, consumers in the region remain very much fixated on minimizing how much they spend to refuel. VW's Di Si points to the demand for flex-fuel engines in Brazil, explaining drivers will choose whether to fill up with

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gasoline or ethanol depending on that day's prices for the two fuels.

"The consumer in Brazil is very conscious about how much they spend per kilometer (on fuel) – every time they go to the pump," he says.

Flex-fuel engines, currently installed in three-quarters of the vehicles produced in Brazil, will continue to dominate the market. In a Wards Intelligence/Clarity Research survey, 61% of Brazilian consumers say they intend for their next vehicle to be powered by a flex-fuel engine, down only slightly from the 66% who currently own a flex-fuel car or truck.

Brazil's Rota 2030 environmental policy somewhat promotes a shift toward electrification, lowering taxes from 25% to 7%-20% on HEVs and BEVs, but that's unlikely to move the needle much. For the region overall, BEVs are expected to account for less than 1% of light-vehicle demand over the next few years, though there are signs of some upside to that outlook.

In the Wards Intelligence/Clarity survey of Brazilian consumers, 5% say they plan to buy a BEV as their next vehicle and 16% say their next car or truck will be a hybrid or plug-in hybrid, much higher than forecasts or OE expectations would indicate.

Although BEV sales will account for less than 1% of the regional market by 2023, volumes will grow substantially – 800% by then, Ford's Watters points out.

"Electrification is a trend, but still not financially viable in the South American region," he says.

Lack of a charging infrastructure and insufficient power generation will help keep the lid on BEV demand. "We have a long, long way to go," Di Si says. "If there's no electricity to run a normal factory, imagine if we all go into electric (vehicles)."

But automakers still will be seeding the market with BEVs and plug-in hybrids in the meantime, some more aggressively than others. Watters says Ford expects to see "quick growth in the number of EV nameplates in the market."

Nissan is among the most bullish. It launched sales of its all-electric Leaf this year in

Q&A With Lyle Watters

President-Ford South America

Wards: How do you expect key South American markets to track over the next few years?

Watters: Brazil and Colombia will sustain its industry growth rates over the next years. Argentina will face a retraction in the short term driven by its recession, and mid- to long-term it is forecasted to grow. Higher costs driven by customer trends and government policies such as connectivity, infotainment, safety and fuel efficiency could impact the industry growth levels in the region.

Wards: Is buying power increasing?

Watters: Unfortunately, no. And this could be explained by factors such as unemployment, economic instability, higher vehicle prices and low consumer confidence. Higher mobility alternatives will move new-vehicle buyers to be about the same or older in the next years.

Wards: Which attributes are most important to consumers when they buy a new vehicle?

Watters: It depends on the segment. The most important attribute for entry/small vehicles is price, followed by style. Migrating to more expensive vehicles, this priority shifts to style and brand reliability. We are forecasting customers to be more demanding regarding quality, technology and brand reliability to improve the full customer experience – not the purchase itself but the usage, service and resale steps as well.

Wards: What vehicle segments do you expect to see an increased application for hybrid powertrains?

Watters: Growth is expected in all segments and mostly in C and CD+ segments for both utility vehicles and passenger-car.

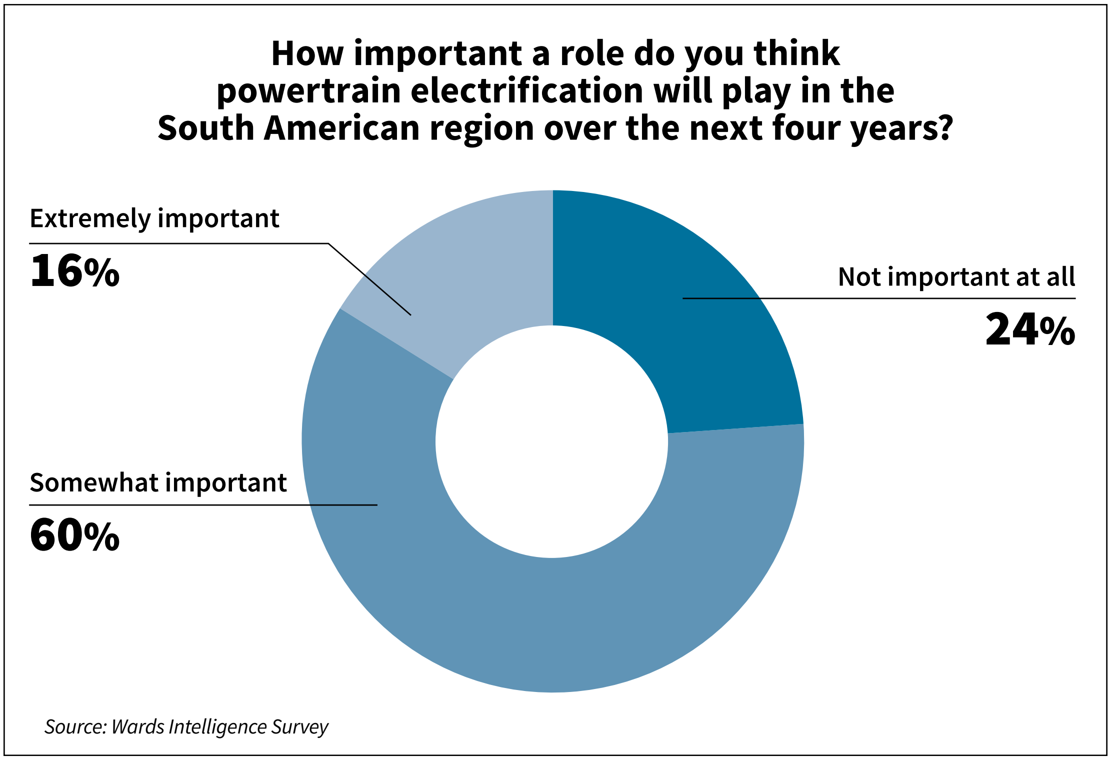
Wards: How big an impact do you expect mobility schemes to have in the region over the next four years?

Watters: A significant percentage of the South American population lives in high-density cities, and South Americans are enthusiasts of technology and the shared economy. Therefore, mobility multi-modal schemes will grow consistently.

Wards: What is the state of the supply chain in the region?

Watters: Supply chain efficiency and competitive cost is fundamental to competitiveness in our industry, since material costs represent over 60% of the vehicle price. In the next four years, it is fundamental to bring suppliers as close as possible to our assembly plants, source our vehicles to long-term partners that are willing to increase vertical integration of their processes, start migrating to manufacturing and logistics 4.0 to increase efficiencies and to explore alternative transportation modes for raw materials and finished products.

Our purchasing and engineering teams are working in this direction to ensure our vehicles are designed to use existing materials and technologies in the region and that parts are sourced to allow suppliers to gain the required volume for a competitive cost. **WA**

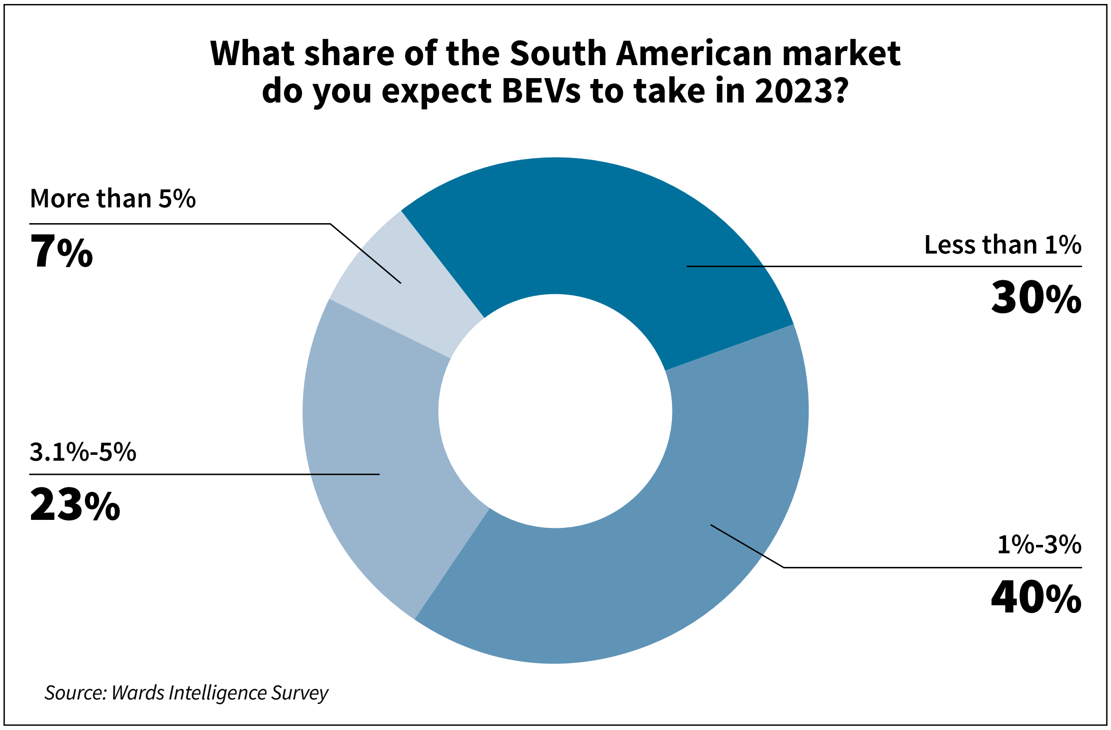


Argentina, Brazil, Chile, Columbia, Costa Rica, Ecuador, Uruguay and Puerto Rico, considered the first phase of the car's South American rollout.

A study the automaker commissioned last year supports the Wards Intelligence/Clarity findings that consumers may be more interested in BEVs than many observers suspect. The Nissan survey of Argentina, Brazil, Chile, Colombia and Peru consumers indicates eight out of 10 are "generally ready" for BEVs. Seventy-three percent say they believe BEVs are cheaper than ICE vehicles when all ownership and operating costs are considered.

Some analysts predict the electric-vehicle market will accelerate quickly once sales reach 1% share, pointing to China where BEV penetration is forecast to grow aggressively, from less than 2% in 2017 to nearly 7% in 2020.

In a Wards Intelligence survey of industry executives, 76% say electrification will be somewhat or extremely important in South America during the next four years. Thirty percent believe BEVs



will account for more than 3% of the market by 2023.

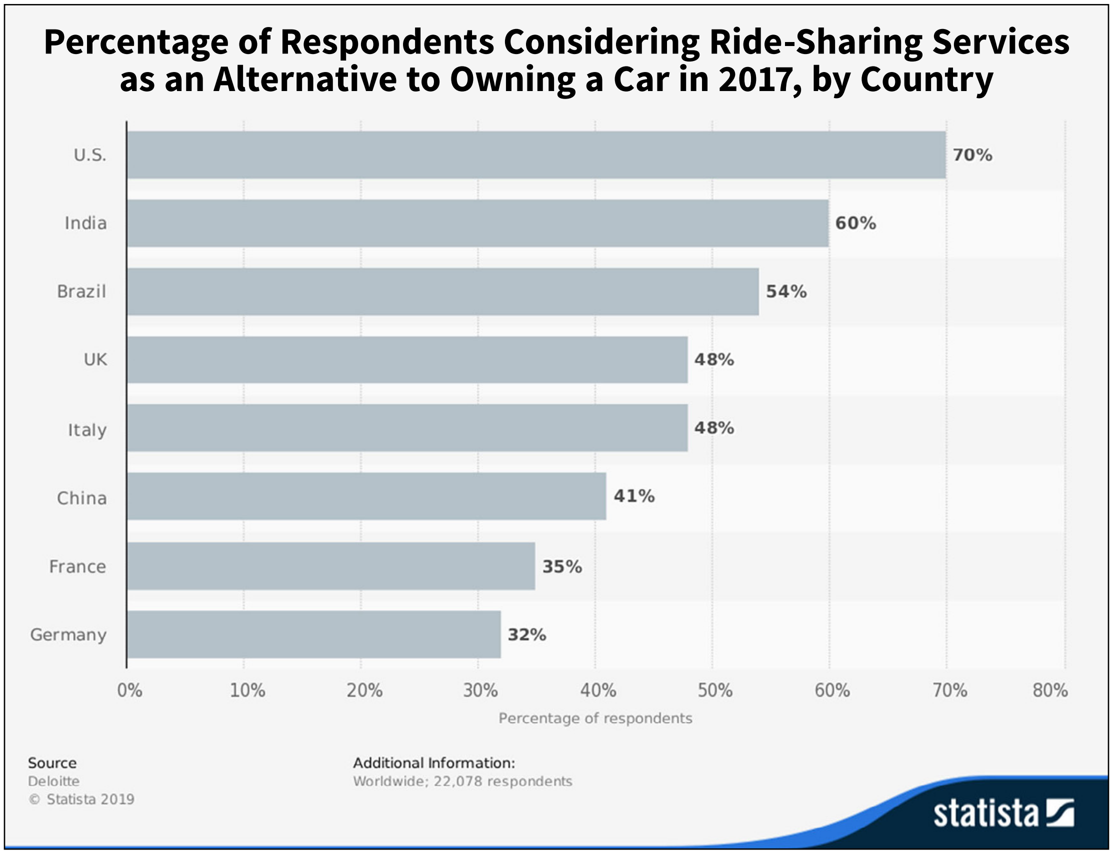
"You may not see (EVs today), but I wouldn't necessarily write them off," says John Simlett, Global Future Mobility leader for Ernst and Young.

Honda's Akiyama predicts BEVs have a shot at growing share but notes penetration likely will be limited to high-population urban markets, where charging-infrastructure development is more likely. It has higher expectations for hybrids overall, with plans to launch three hybrid models over the next five years in Brazil.

Hyundai also believes hybrids will become more relevant due to tax incentives, particularly in Argentina, with C- and D-size SUVs and D-segment cars leading the movement to hybrid powertrains over the next few years.

Volkswagen is planning six electric and hybrid vehicles for sale in the region.

Di Si admits volumes will remain scant over the next three to five years, "But I need to get the region prepared for this technology."



MaaS POTENTIAL

Autonomous vehicles will come to most global markets more slowly than many once anticipated – and that's even more true for South America.

The Nissan survey shows less than 35% of consumers in the region even know what an autonomous vehicle is, though once the concept is explained, 54% have a positive opinion of the technology.

Though still in its infancy, the concept of mobility as a service (MaaS) is likely to exhibit a bit more traction.

Latin American consumers are "pretty open to innovative (transportation) solutions, and they really need them," Simlett says, adding it will all come down to the public getting used to the concepts and learning to trust them.

Brazil's ride-hailing industry ranks only 20th in the world, generating $409 million in 2018, according to Statista. That is forecast to climb to $493 million this year and $798 million in 2023. However, compared to China, where the sector totals $35 billion, Brazil's market is minuscule.

"In the (next) four years, minimal impact is expected" from mobility schemes, Hyundai Argentina says. "(But) in the long term, it will be very different."

Watters agrees, saying Ford will be active in the mobility space regionally and globally.

"A significant percentage of the South American population lives in high-density cities, and South Americans are enthusiasts of the technology and shared economy," he says. "Therefore, mobility multi-modal schemes will grow consistently in the next years."

Tempering that will be the desire for vehicle ownership as a symbol of wealth.

A recent survey by Anfavea (the country's automaker group) shows a high percentage of consumers, even in the youngest demographic groups, remain interested in purchasing a new car in the next five years.

"At present, the car is not only for transportation; for many customers in Brazil, it also serves as a status symbol," Akiyama says. "We believe that the young generation maintains interest in owning a car. But we will need to watch the new trend carefully, because services such as Uber are already popular in Brazil."

BUYERS DRAWN TO INFOTAINMENT AND CONNECTIVITY

One global industry megatrend quickly taking hold in Latin America is vehicle connectivity.

Although overall purchasing power on average is stagnant in the region, that's not true in the Brazilian market, where automakers say they see a willingness from consumers to spend more on new vehicles. In many cases, that money is going to the purchase of infotainment and connectivity features.

"Connectivity and fuel efficiency are getting the biggest attention from OEMs and customers," Hyundai Argentina says.

Polling its customer base,

Volkswagen buyers cited technology as the second most important criteria driving their purchase decision, behind only design, with much of the focus around better touchscreens and other infotainment features. Honda notes similar trends.

Connectivity is a strong reality today "and will become imperative in the next three to four years," concludes Ford's Watters.

General Motors GEM models are expected to make a significant play when it comes to infotainment features, with touchscreens, smartphone connectivity and safety-oriented features such as rearview cameras.

FCA's Filosa points to lower interest rates and inflation giving Brazilian consumers more buying power. "Technology-wise, consumers are very focused on infotainment," he says. "We'll keep growing within a larger (envelope) of infotainment and a different level of connected services in the new models that will be launched."

In the end, Latin America won't dodge the megatrends taking hold in other global markets. Buying power remains an issue, and though many of the region's economies are trending in the right direction, history suggests that can't be counted on to continue in linear fashion.

But consumers are consumers. Just as those in more mature markets want their SUVs and the latest, infotainment, safety and connectivity features, so too do Latin American buyers. As for willingness to pay for more costly features such as electrified powertrains and self-driving technology, they'll get there when they can. **WA**

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