ClearBridge Investments

Beyond Tesla: EV Value Plays Abound

September 21, 2020

Key Takeaways

- Despite the rapid growth of some high-profile electric vehicle (EV) companies, we think EVs will be a massive and broad investment category that will have more than just one winner.
- Other manufacturers besides Tesla offer not only cyclical upside, but also a free option if they have any success at all in EVs, and trade at discounts to the market.
- Semiconductor and power companies will also be instrumental in the growth of EVs, and often do not have EV upside priced in.

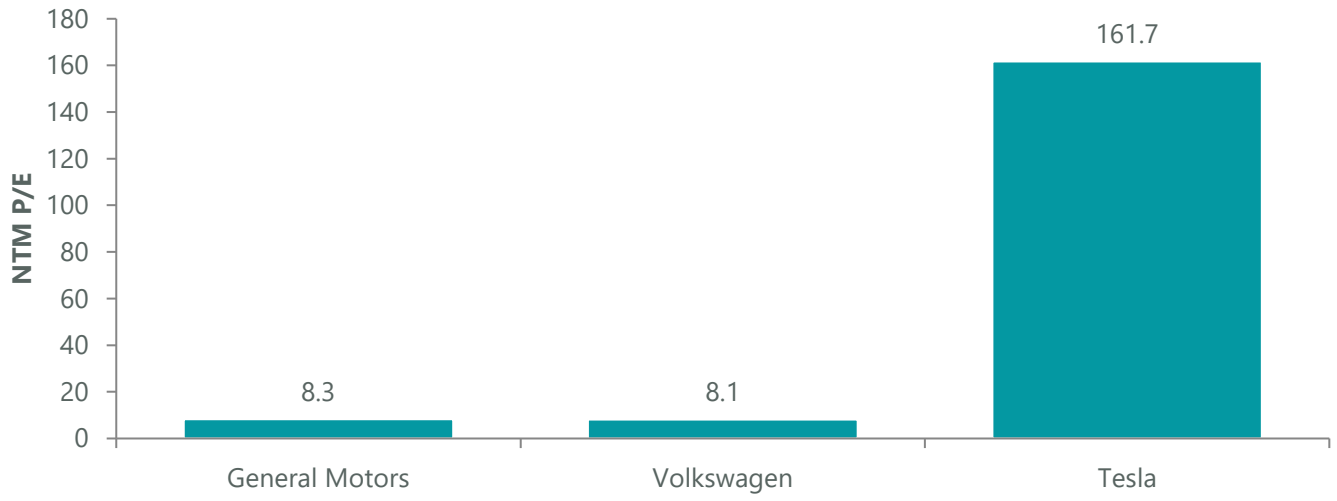
Value Options in the EV Trade

With options in the news for having exacerbated a tech selloff in early September, it is worth considering a value side to the options trade. The market is offering many opportunities where we can buy "value" stocks that will do well in a cyclical recovery and a shift to value, but that also have embedded options that the market does not seem to be pricing in. In our opinion, the market is too obsessed with the wrapper right now; that is, with growth stocks being great and typically full of priced options, and value being bad and full of free options.

One main area we are seeing free options is electric vehicles (EVs). Tesla gets all the attention and capital and so has the dearly priced options, but we continue to think EVs will be a massive and broad investment category that will have more than just one winner. We think the EV transition could actually improve the auto original equipment manufacturer (OEM) business model for the companies that end up making the biggest investments and scaling as EV demand ramps. Currently, to name three companies that might be dominant among EV platforms, you would include Tesla, to be sure; but you could also mention Volkswagen and General Motors.

Tesla clearly has extremely valuable intellectual property (IP) and a huge lead in software, but at a 162x P/E a good portion of that valuable option is priced in. On the other hand, Volkswagen and GM are both spending billions of dollars, are extremely focused on narrowing Tesla's software lead and are available at a roughly 8x P/E (Exhibit 1). Both should include not only cyclical upside that is material, but also a free option if they have any success at all in EVs. In addition, the OEM business model in EVs may transition to an IP model, where other companies license one of the platforms and pay royalties to the OEMs. If that occurs, there is multibagger potential.

Exhibit 1: Expectations for Tesla's EV Competitors May Be Too Low



As of Sept. 18, 2020. Source: ClearBridge Investments, Bloomberg Finance.

In addition, there are semiconductor companies that will provide a significant amount of content in EV vehicles, such as ON Semiconductor and NXP Semiconductors, both trading at depressed valuations. These also offer cyclical upside from normalizing auto demand as well as a long-term secular option on EVs — which include an increasing amount of electronic content with designs that should have some longevity — that is not dependent on which OEM wins and which loses.

OEMs outside of Tesla and semiconductor companies are two ways to fill an EV bucket in a portfolio; a third would have to include the increased grid power demand that will benefit our power companies and create demand for natural gas. Companies such as AES, which has been increasingly aggressive in reducing its carbon intensity by lowering coal capacity and investing in renewable energy and is expanding into energy storage to address intermittency issues of renewable energy, will be meeting this demand. So will Vistra, which we expect to shut down coal and to follow AES's path of driving ample free cash flow today from natural gas generation to materially grow an alternative energy business in the future.

As disciplined value investors, we have been happy to look beyond Tesla at other EV options at massive discounts to both the darling EV plays and the broad market. There are reasons to hate a growth-dominated market, but there are also reasons to love it. This is truly a unique time, with the widest dispersion in memory in terms of how the market is pricing future options. The EV space is just one such attractive future option.

About the Author

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- 27 years of investment industry experience
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