

Developed World Has Auto Problems

Capturing Tomorrow's Alpha Through the Capital Allocation Framework



Introduction

There are few irrefutable truths in investing. Prudent capital allocation, however, is almost always at the heart of success. Companies, industries, and countries that invest in high-return opportunities, while others hesitate, consistently outperform.

The Winners & Warnings series examines these dynamics in real time, identifying the conditions that shape tomorrow's leaders. Guided by the Capital Allocation Framework (CAF), we assess not only what companies do, but when and why. By tracking industry investment levels and returns on capital, we aim to capture the inflection points where leadership changes.

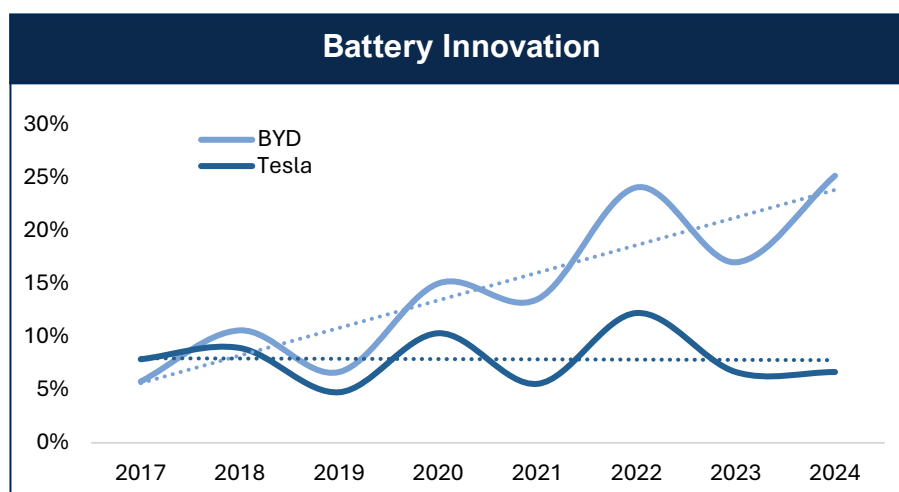
The Investment Gap That Changed Everything

China's rise to EV dominance began with a bold investment strategy that unfolded over the past decade. While traditional automakers cautiously increased innovation budgets by just 3% annually, Chinese manufacturers like BYD pursued aggressive growth, boosting innovation spending by an average of 25% year-over-year. By 2024, this commitment led to \$20 billion in innovation investments, creating a significant advantage that competitors now struggle to match.

This divergence was no accident. Around 2010, BYD recognized that vertical integration—developing and producing more components in-house—could become a decisive edge. By 2014, early breakthroughs from this strategy encouraged them to accelerate capital investment at a 23% average year-over-year growth rate, far outpacing traditional automakers' 3% increases. This allowed Chinese manufacturers to cut their development cycles to two years, compared with Tesla's three and the traditional industry's five to seven.

The Innovation Race Narrows to Two Players

Today, most traditional manufacturers have fallen behind, leaving two leaders: Tesla and BYD. Tesla established early dominance in autonomous driving and battery technology, particularly in charging speed and range. However, the gap is closing fast. BYD's technological progress is accelerating, while Tesla's innovation pace has slowed to its lowest level in three years. If trends hold, BYD could soon surpass Tesla across multiple fronts.



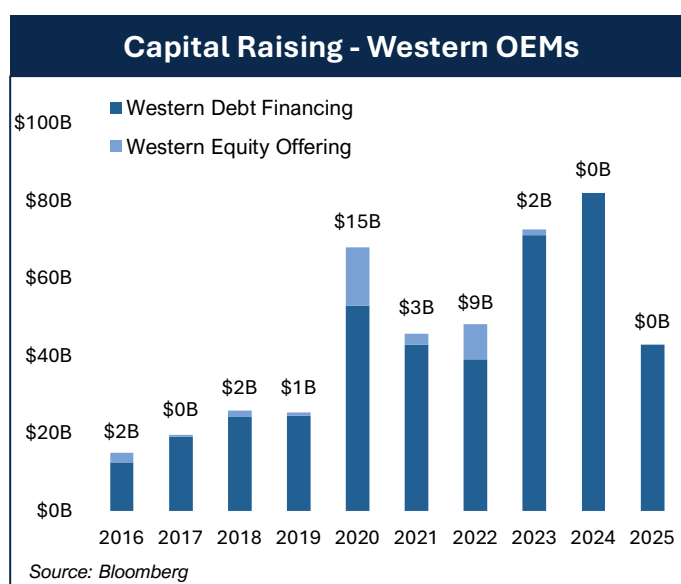
Sources: Bloomberg, company reports

Financial Strategy Creates Structural Advantage

The divide isn't just technological, but also financial. In 2025, pressured by persistent high interest rates and inflation, Western manufacturers cut investments, closed factories, reduced workforces, and slashed capacity and innovation budgets.

BYD took the opposite approach, maintaining aggressive investment in both innovation and capacity. This countercyclical strategy was possible because Chinese manufacturers favored equity financing, while Western automakers, relying on debt financing, became increasingly burdened by the high-interest environment. BYD's recent \$5.6 billion equity raise in 2025 exemplifies this approach, providing capital without interest obligations and putting pricing pressure on their debt-burdened competitors.

Chinese OEMs used the same approach in 2020, raising equity to fund major capacity expansions in 2021. They are repeating it now despite global overcapacity, deliberately increasing production to force prices down. Western automakers, still servicing substantial debt loads, cannot match the aggressive capacity investments or withstand long periods of compressed margins.



A common misunderstanding is that Chinese EV market growth is primarily driven by government subsidies. However, it instead stems from a decade of sustained innovation investments that have resulted in technological and pricing advantages. China has systematically reduced EV incentives while still experiencing robust adoption growth. Meanwhile, Western countries maintain high subsidy levels yet fail to achieve comparable adoption rates.

The Widening Competitive Gulf

The quicker development cycles, faster innovation, and fundamentally different funding approaches are creating a gap competitors struggle to close. Even in China's fiercely competitive domestic market, BYD leverages its financial flexibility to maintain intense pricing pressure on rivals.

Western manufacturers find themselves in a strategic bind: they must invest heavily to close the technology gaps but lack the financial flexibility to do so. Meanwhile, BYD continues expanding its lead in critical EV technologies.

The story that began a decade ago with different investment philosophies has reshaped the global automotive industry. Without a dramatic shift in their approach, Western manufacturers could risk losing long-term leadership to China, with BYD at the forefront.

Implications On Auto Industry

China's price war, fueled by over-capacity, is setting the stage for an inevitable industry restructuring. BYD is ready to lead this consolidation, using its financial and technological advantages to pressure weaker rivals. The coming 24 to 36 months will likely shrink China's fragmented automotive landscape, compressing more than 15 significant players to a few dominant forces through mergers, acquisitions, and bankruptcies.

State-owned enterprises, despite government backing, are struggling to pivot effectively toward electrification. Legacy automakers lacking substantial EV exposure face existential risk: they will either vanish entirely or merge with more advanced counterparts.

For Western OEMs with joint ventures in China, the outlook grows increasingly bleak. Their market share will likely continue declining as domestic OEMs consolidate, triggering parallel consolidation among Western automakers and suppliers. Many will not be able to service debt, fund EV transitions, and withstand prolonged margin compression.

To narrow this widening technological gap at competitive price points, Western manufacturers may need entirely new partnerships focused on next-generation EV architecture. In the United States, the need is particularly urgent, and such collaborations could offer Chinese OEMs a pathway into the US market, reversing the traditional joint venture dynamic.

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