

## Automotive set for further growth – what’s about suppliers?

by Dr. Dirk Schneider

The global automotive industry has forcefully recovered from the 2008/09 crisis. Global passenger car sales and profits have exceeded pre-crisis levels and are projected to grow beyond 2020. Automotive is and remains a growth industry.

On a more detailed level, however, major geographical shifts take place. Emerging markets, primarily driven by growth, have almost tripled passenger car profits from pre-crisis 2007 to 2012, a trend likely to continue. North America, primarily driven by forceful restructuring, has more than doubled its profit whereas Europe and Japan, without significant growth or forceful restructuring, have basically lost their profit. Global original equipment manufacturers (OEMs) are adjusting their global footprint accordingly. This opens up risks and opportunities for suppliers as well.

In addition, increasingly stringent environmental and safety regulations in most geographies and increasing demands for connectivity require a new wave of innovation and intensify cost pressure on OEMs. Many of the required innovations fall outside today’s core-competences of today’s OEMs and many innovations and cost reductions can only be archived along the broader supply chain. This opens up further opportunities for suppliers – or risks if they can’t position themselves as credible partners.

Large suppliers with a strong global footprint and deep pockets to support high up-front investments are set to grow sales and profits. Smaller, in particular Europe-centric suppliers face more challenges. In addition to the “hygiene factor” of managerial excellence they might have to find defensible niche-positions, consolidate or diversify into related, non-automotive segments.

### AUTOMOTIVE INDUSTRY

The global automotive industry enjoys a forceful recovery likely to continue beyond 2020. The industry’s center of gravity is shifting to Emerging Markets, primarily China, where high unit sales drive top- and bottom-line growth whereas in Europe and Japan unit sales are projected to remain flat. At the same time regulatory pressures, mainly directed at fuel efficiency and driver safety drive up production cost. Given historical price stability and at least in Europe still existing overcapacities, OEMs might not be able to raise sales prices accordingly. The resulting need to squeeze out cost and the increasing requirement for skills not core to OEMs might foster even deeper supplier relationships with value shifting from OEMs to

those suppliers who can take on the challenge.

### Forceful recovery and shift to Emerging Markets

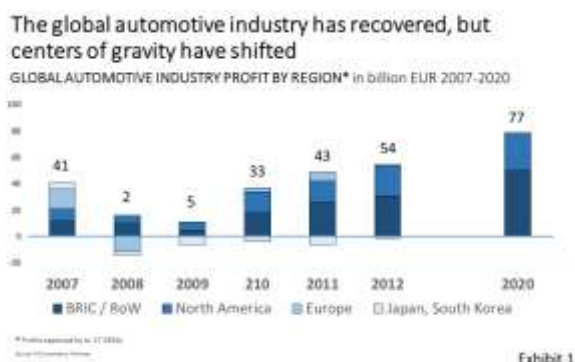
Based on a study by McKinsey & Company<sup>1</sup>, the global automotive industry has recovered forcefully from the 2008/09 crisis. With € 54 billion, 2012 profits of top 17 OEMs have exceeded 2007 pre-crisis profits by 34%. By 2020 these profits might further grow by almost 50% to then € 79 billion. With this performance and outlook, the global automotive industry is and remains a profitable growth industry.

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<sup>1</sup> „The road to 2020 and beyond: What’s driving the global automotive industry?“, McKinsey & Company, 2012

On a more detailed level, however, major geographical shifts take place. In 2007 Brazil, Russia, India and China (BRICs) and Rest of World (RoW), together the Emerging Markets, accounted for € 12 billion or 30% of global profits. By 2012 these numbers had increased to € 31 billion or 60%, primarily reflecting an increase in units. In 2007 North America contributed € 9 billion or 20% to global profits. By 2012 these numbers had gone up to € 23 billion or 40%, reflecting a drastic restructuring in the US. In 2007 European profits accounted for €15 billion or 36% of global profits. By 2012 this had become a loss of € 1 billion, reflecting a combination of little restructuring and flat unit sales. One driver behind this North America / Europe divergence is a different restructuring attitude. Whereas the US has reduced its production capacity between 2000 and 2013 from 20 to 17 million and suppliers like Delphi, Visteon, Dana, Federal Mogul and others went through chapter 11 restructuring, Europe has increased its capacity from 20 to 23 million vehicles per year and supplier restructuring has largely stayed at selected staff reduction and isolated site closures. Whereas US plant utilization is back to above pre-crisis level, Europe drags along at 85% pre-crisis utilization.

Going forward, McKinsey estimates European, Japanese and South Korean profits to remain flat while North American and Emerging Markets profits grow by € 4 and € 21 billion respectively (Exhibit 1).



## Increasing price and regulatory pressure

Regulatory pressures, prevalent in most geographies, primarily target fuel efficiency and safety standards. In the US these are the Corporate Average Fuel Economy (CAFE) and the Federal Motor Vehicle Safety Standards (FMVSS). According to an estimate of the US International Trade Commission<sup>2</sup>, CAFE requirements alone will add 1,800 US\$ to the cost of an average car to comply with fuel efficiency requirements of 49.6 miles per gallon (4.8 l/100 km) by 2025 – after additional cost of 926 US\$ to reach today's standard of 34.1 miles per gallon (6.9 l/100 km). Along the same lines, McKinsey estimates additional costs due to tighter fuel and safety standards at incremental 2,500 US\$ per vehicle<sup>3</sup>.

The corresponding EU directive caps the average CO<sub>2</sub> production for each OEM's fleet at 130 g/km (app. 5.6 l/100 km) by 2015 and at 95 g/km (app. 4.9 l/100 km) by 2021. Based on a 2012 estimate by the Institut für Kraftfahrzeuge this will add 2,250 € to the cost of an average passenger car<sup>4</sup>.

At the same time, real car prices have remained essentially flat for the past 15 years. Based on EC car price reports, the price of 76 vehicle models has increased by nominal 3% p.a. against inflation rates of 2-3% p.a. between 1998 and 2011.<sup>5</sup> For North America, McKinsey reports equally constant prices for the period 2001 to 2010 and cites the Toyota Camry as a specific example. For this car Toyota had add-

<sup>2</sup> "Passenger Vehicles, Industry & Trade Summary", Office of Industries, US International Trade Commission, 2013

<sup>3</sup> „The future of the North American Automotive Supplier Industry“, McKinsey & Company, 2012

<sup>4</sup> "CO<sub>2</sub> reduction potentials for passenger cars until 2020", Institut für Kraftfahrzeuge, 2012

<sup>5</sup> „Report on car prices within the European Union“, European Commission, 2011

ed at least US\$ 1,400 in new content, while the manufacturer's suggested retail price has declined by about 1% per year in real terms<sup>6</sup>. Looking at these numbers, consumers have been able to capture most, if not all of the efficiency gains made by the OEMs and their suppliers. Given still existing overcapacities, primarily in Europe, this is likely to continue. In response, Bernd Osterloh, head of VWG's workers counsel, has only recently prepared a 400 pages document outlining cost reduction measures aiming at a total of € 5 billion. Although the document has not been made public, increasing cross-brand standardization and increasing requests from suppliers are more than likely key themes.

### Shift to platform strategies

Without significant pricing power, OEMs remain focused on ongoing cost-efficiency. One key lever in this regard is continuing emphasis on platform- or modularization strategies to capture higher scale synergies. Frontrunner of this development is the German Volkswagen Group (VWG) with its Modularer Querbaukasten (MQB) platform strategy for its transverse, front-engined and front-wheel drive models. Leveraging this modularization approach, VWG aims at reducing its number of platforms from 14 in 2000 to a maximum of 10 in 2019 while at the same time increasing its number of models from 37 to 81. The volume per platform increases from around 350 to around 1.100. While providing additional scale synergies to VWG, it raises the stakes for suppliers. With only few but high volume contracts on the table, suppliers need to stretch their R&D, globalization and low-cost manufacturing capabilities even further to remain in the game. After the contracts, high volumes per platform raise

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<sup>6</sup> „The future of the North American Automotive Supplier Industry“, McKinsey & Company, 2012

the financial risk of quality related penalties.<sup>7</sup> One example of this is the recent recall of Takata-produced airbags in the US. According to several Japan Times articles the US National Highway Traffic Safety Administration (NHTSA) has requested the recall of at least 7.8 million vehicles in the US alone. A number which some expect to raise in the US up to 20 million vehicles. Any recall of this size will have a very significant impact even on the balance sheet of a € 3 billion company such as Tokyo-based Takata.

### New OEM supplier relationships

All in all, increasing regulatory pressures and limited ability to raise prices might shift value from OEMs to suppliers or even automotive outsiders such as Google, Apple or Panasonic. In such a scenario, OEMs could focus more specifically on brand-building components and features. Suppliers could position themselves as even stronger partners, providing more and more complex systems such as power trains, chassis, connectivity or self-driving capabilities.

## SUPPLIER INDUSTRY

Reflecting the forceful recovery and the projected healthy unit growth, Roland Berger sees suppliers enjoy healthy top-line growth in the range of 5-10% p.a. with stable EBIT-margins in the 6-7% range. On a more granular level, however, profitability and outlook vary depending on size, product focus and region.<sup>8</sup>

### Size impact

Size matters. Whereas large suppliers with revenues in excess of € 10 billion could

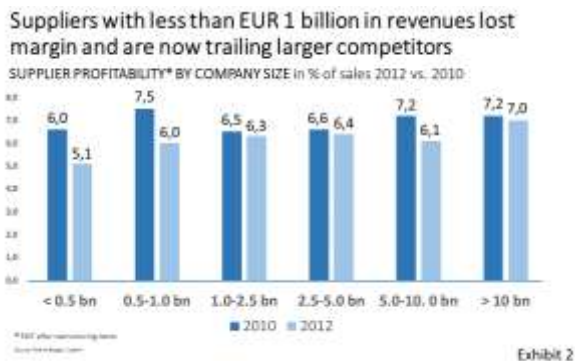
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<sup>7</sup> „Driving on thin ice“, Roland Berger Strategy Consultants and Lazard, 2013

<sup>8</sup> „Driving on thin ice“, Roland Berger Strategy Consultants and Lazard, 2013

roughly maintain their EBIT-margins at or above 7%, small and mid-sized suppliers with revenues below € 1 billion lost on average 1.5% down to the 5-6% range (Exhibit 2).

This is not only attributable to a stronger global footprint and a geographically more diversified customer-base, but also to their stronger capability to handle larger-scale projects (due to platform and bundling strategies) and higher upfront R&D investments (due to more complex systems development expected from strategic suppliers). The latter is especially true for powertrain and chassis supplier. Powertrain suppliers face the demand for, e.g., reduced friction in internal combustion engines, increased electrification or transmissions with increased spread of gear ratios. Chassis suppliers face demand



for, e. g, friction-optimized bearing supports or increased use of aluminum and carbon fibers. Supporting this logic, PwC identifies the highest consolidation activities in these two areas<sup>9</sup>.

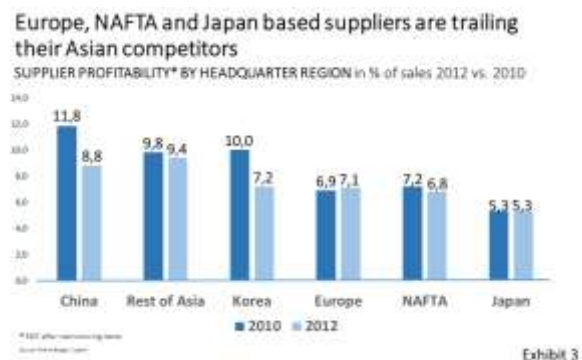
Stefan Sommer, CEO of ZF Friedrichshafen also argued the recent merger of ZF and TWR with the need for significant R&D and global strength required to muscle areas such as fuel efficient powertrains, active driver assistance systems, self-steering vehicles or car connectivity. "It is not the average mid-sized company that can take on such challenges".

<sup>9</sup> "Consolidation in the Global Automotive Supply Industry", PwC, 2013

## Regional impact

In all regions, automotive suppliers have enjoyed on average stable EBIT-margins of around 6-7%. This, however, has been uneven split between China and the Rest of Asia with around 9% and Japan, North America and Europe ranging from 5-7% (Exhibit 3).

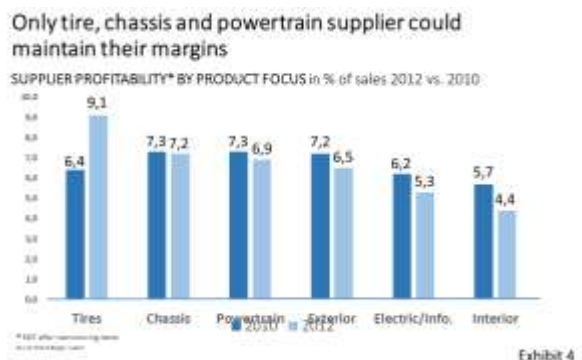
Within Europe, the picture is again split. While Southern Europe oriented suppliers, focused on volume OEMs have suffered in



top- and bottom-line, primarily German oriented suppliers, focused on premium OEMs could largely maintain their margin.

## Product impact

Product category matters as well. While tire-supplier could lift their EBIT-margin to 9% and powertrain and chassis supplier could maintain their margin at around 7%, interior and electric suppliers saw margin erosion down to the 4-5% range (Exhibit 4). And it might be more than coincidence that tire, powertrain and chassis suppliers are the ones with the most direct impact



on fuel efficiency.

Based on this analyses, more profitable suppliers compete in product categories benefitting from regulatory pressures to improve fuel efficiency.

Across all sizes, product categories and regions, Roland Berger sees an unsurprising margin advantage for companies offering innovative products with ideally protectable differentiation potential.

The Boston Consulting Group reaches similar conclusions, also identifying small or medium-sized, Europe focused and automotive dependent suppliers as being at risk, whereas large and globally diversified suppliers are well positioned to capture ongoing top- and bottom-line growth<sup>10</sup>.

## STRATEGIC IMPLICATIONS

These industry dynamics lead to rather differentiated outlooks for automotive suppliers. Large and globally diversified suppliers can support their OEM customers with strong manufacturing and development resources in all regions. They can afford major upfront investments in newer, more complex systems. They can bear economic and liability risks associated with high volume, high price-tag contracts. They are therefore in general well positioned to benefit from the ongoing growth of the global automotive sector.

Smaller suppliers, especially when focused on (Southern) European (volume) OEMs face a tougher environment. The “hygiene factors” of operational excellence in cost containment, new product development and sales force efficiency – all of which are especially relevant for those suppliers, who focused on pre-crisis balance-sheet restructuring – will remain crucial. In addi-

tion, however, smaller, Europe-focused suppliers might have to carve-out defendable niche-positions, consolidate (possibly with larger suppliers) or diversify into related, non-automotive segments.

### Carve out defendable niche positions

One obvious way to ease the pressure from constantly maintaining a cutting edge position along the “hygiene factors” is to carve out a defendable niche position with products or services that are at least to some extent protected from ruthless cost-competition. These could be highly differentiated and ideally IP-protected products or services stemming from generally higher R&D investments or more modest R&D spending focused on areas where specific existing assets, e.g. cross-technological know-how or unique manufacturing capabilities form effective barriers to entry.

Whereas generally higher R&D investments are usually reserved for larger suppliers, genuinely attractive product niches might be available to smaller suppliers as well. Sub-components to, e.g. to more fuel efficient powertrain-solution might be one such area. With the increasing role of 1<sup>st</sup> tier suppliers for integrated system solutions, any move towards sub-components might as a consequence endanger any 1<sup>st</sup> tier position for smaller suppliers themselves. This, however, doesn't need to be a bad thing since it removes 2<sup>nd</sup> or 3<sup>rd</sup> tier suppliers one step further from the purchasing power of OEM, it allows (possibly) cross-OEM leverage of developed sub-components and it might even ease the entry into non-automotive sectors.

### Consolidate to secure position

Consolidation initiatives of small to midsize automotive supplier can fall at

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<sup>10</sup> „Assessing the Risks for European Automotive Suppliers“, The Boston Consulting Group, 2014

least into three distinctive but not mutually exclusive game plans.

First, midsize suppliers could merge with similar size players to reach economies of scale. Entering the large player arena would enable these suppliers to develop a sufficiently strong and global R&D and manufacturing footprint to participate in the still growing value creation of the automotive industry. The US merger of Grede, HHI and Metaldyne, and the constant acquisitive growth of Sweden's Autoliv might fall into this category.

Second, smaller suppliers might merge or acquire to combine complementary skills or IP to develop specific product competencies difficult to reproduce for others. Raising barriers to entry in this way could enable formerly only weakly distinguished players to successfully carve out a defensible niche-position. Arguably, the recently cleared joint venture between French Faurecia and Italian Magnetic Marelli to develop advanced human-machine interfaces in the vehicle interior space or BlackBerry's acquisition of QNX Software Systems to provide an in-car operating system might be examples.

Third, merging with or being acquired by, e.g., a strong Chinese supplier or diversified, industrial player could allow even small or midsize suppliers to leapfrog competition by rapidly gaining strong access to the fastest growing automotive market globally. The recently announced merger of parts of US Johnson Controls and Chinese Yanfeng Automotive Trim Systems, the acquisition of German Koni by Chinese AVIC Electromechanical Systems or the acquisition of Austrian I&T by Changzhou Xingyu Automotive Lighting Systems might fall into this category.

## Diversify into non-automotive

Globally the automotive industry is set to grow. Regional differences and increasing regulatory pressures, however, turn it into a competitive environment especially for smaller, predominantly Europe-focused suppliers. Furthermore, automotive remains a highly cyclical industry as seen in 2008/09. Consequently, many players look into opportunities to diversify their customer base.

Aerospace or heavy trucks are relatively often seen as markets with similar supply needs. Buyers and industry drivers, however, are different. Industries such as medical, oil & gas, pharmaceuticals or food do require in some areas products similar to the automotive industry. Producing for a variety of mostly smaller markets with different channels is, however, not the same as producing for high volume, just-in-time OEM assembly lines. Notwithstanding these challenges, diversification remains a feasible strategy to mitigate risk and to ease margin pressure as typically seen in the automotive sector.

The full acquisition of Siemens' white goods division by global mega-player Bosch is one example. Another one is the recent acquisition of Italian ERMO, a manufacturer of multicavity precision molds by INglass, a producer of molds and hot-running systems for vehicle lightning applications. With this move, INglass attempts to diversify from automotive into medical, personal care and cosmetics markets.

## CONCLUSION

The global automotive industry is set for ongoing profitable growth. The majority of growth, however, takes place in the BRIC countries, primarily China. In addition, regulatory pressures in all geographies

force OEMs and suppliers to capital intensive innovations. With consolidation among OEMs and suppliers, the remaining large, global players are well positioned to participate in the upside.

Smaller, primarily Europe-focused suppliers, on the other hand, might face a tougher ride. Operational excellence might not be sufficient. Carving out a defensible niche position, consolidating to secure a competitive position nor diversifying into non-automotive markets might

be required. Neither route is easy, let alone risk free. Not all routes are feasible for all players. But considering the dynamics in the automotive industry, a combination of these routes – on top of continuing operational excellence – might be the best bet for smaller, Europe-focused automotive supplier. Even if all of these options need to be carefully evaluated against the specific situation of each company.

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**Dr. Dirk Schneider** is an independent management consultant with a strong track-record in change-of-ownership, restructuring and value enhancement work where he has led comprehensive balance sheet restructurings, strategic repositionings and operational improvements in advisory and interim management roles.

*Before Dirk has been with McKinsey & Company where he has worked on strategic acquisition or divestment strategies, financial valuations, privatizations, acquisitions, divestitures and post-merger-integrations in a variety of countries and industries.*

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