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Supply Chain: Emerging from the Storm: The Prospect of Supplier Profitability in 2010 and Beyond

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It would be a vast understatement to say that the past couple years have been particularly challenging for the automotive supply community. Suppliers big and small have been seriously impacted throughout the latest downturn. Some of the luckier companies have had to cope with deteriorating profitability (if any profitability at all), while others have faced the specter of burdensome losses leading to bankruptcy reorganization or even liquidation. Nevertheless, perhaps just as important as surviving the downturn is capitalizing on the upturn. This is true not only for auto suppliers but also the financial community lending to or investing in the auto sector. While 2009 will not soon be forgotten, a case can be made for decent profitability prospects for many auto suppliers as early as 2010.

Survival of the Fittest

In 2009, the auto business was marked by stories of both basic survival and outright collapse for component suppliers. In an effort to cope with the massive fall-off in vehicle demand and production, suppliers executed dramatic cost reduction strategies, including massive labor cuts and plant closures to cuts in benefits and reductions in research and development spending. Some suppliers took lean manufacturing to a new level with owners and managers working on the shop floor at various times throughout the year. The net result of these activities is that many of the suppliers left standing have lowered their break-even point significantly. While in the past suppliers often struggled to eke out profits in the "good old days" of North American light vehicle production levels of 15.0+ million units, many companies are now reporting production break-even points of 9.5-10.0 million units. CSM's current North American light vehicle production forecast for 2010 stands at 10.8 million units (see Figure 1). Furthermore, the production recovery is already well underway even in the first quarter of 2010 as automakers look to rebuild depleted inventory levels and vehicle demand improves from the abysmal levels in early 2009.

Figure 1: North American Light Vehicle Production 2009 vs. 2010

	2009	2010	Unit Variance	% Change
1Q	1,698,120	2,751,328	1,053,208	62.0%
2Q	1,777,477	2,700,718	923,241	51.9%
3Q	2,356,942	2,662,794	305,852	13.0%
4Q	2,723,291	2,729,009	5,718	0.2%
Total	8,555,830	10,843,849	2,288,019	26.7%

It stands to reason that the improved production environment in North America and other markets (notwithstanding the near-term headwinds facing Europe as the various vehicle scrappage programs unwind) combined with the cost-containment efforts of most suppliers present an excellent opportunity for improved profitability. To be sure, many securities analysts are taking note of improved supplier prospects as evidenced in recent upgrades in equity ratings for several publicly traded auto suppliers. In fact, some publicly traded suppliers are already reporting improved financial performances in announcing their results for 4Q 2009.

Is the Industry Ready for the Recovery?

Of course, the situation is not all sunshine and roses. In spite of the improved prospects for many suppliers, there remains a lingering concern about the general health of the supply chain, particularly from a Tier 2 and Tier 3 supplier perspective, as these companies find themselves in a challenging situation. On the one hand, there is an increase in production schedules, resulting in a need to ramp up production. On the other hand, many small- to mid-size suppliers are finding it difficult, if not impossible, to arrange working capital financing from traditional sources (e.g., commercial banks). In addition, most of these smaller suppliers do not have access to capital through publicly issued stock or debt. As a result, they are left to draw on the personal financial resources of the owners, pursue more non-traditional financing channels (e.g., accounts receivable factoring, asset-based lenders, distressed debt lenders, etc.) or seek investment from a private equity firm in order to fund working capital shortfalls and provide for the longer-term financing of the business. Complicating matters even more for suppliers is the prospect of commodity costs (which were largely held in check during the recession) becoming a problem, particularly as developing markets such as China and India accelerate further.



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Re-engaging the Banks

As mentioned previously, even with production schedules ramping up and orders rolling in, it is safe to say that suppliers are generally receiving a lukewarm reception at best from commercial banks with regard to requests for additional credit to fund working capital needs. There are numerous stories of profitable suppliers being turned down for credit facilities or facing significant increases in interest rates and other fees. After taking hits on the consumer mortgage front (not necessarily undeservedly) and the potential for additional downside exposure in the commercial real estate market, it is not surprising that banks are loath to re-engage in lending to the automotive sector without ensuring that the recovery is "real" and not merely a temporary plateau before another fall-off. Many in the banking industry and elsewhere have observed that the auto industry has not cured all of its problems with the recent downturn, particularly in the area of overcapacity.

While it is true that there is lingering overcapacity, especially in certain product/process areas such as injection molding and stamping, many suppliers (and their automaker customers) have radically restructured their businesses and are now much better positioned for profitability. Indeed, commercial banks run the risk of missing out on this upside as suppliers look to benefit from the upturn in production. While credit availability in the auto sector remains tight and more expensive, there will be a point when the banks will be compelled to put their capital to use, if for no other reason than the need to please shareholders with better returns on investment. Furthermore, new banks (often those comprised of lenders who have left some of the larger, more established banks) are looking closely at the auto sector and are poised to capitalize on new customer opportunities.

As an auto supplier, there are several strategies that can be implemented to improve the likelihood of credit approval or perhaps enhance the terms. For example, it is critically important for suppliers to actively manage their banking relationships as they would their customer relationships. This includes increasing the communication flow with bank representatives - both the good and the bad news. Of course, keeping the lender apprised of new business awards and improving financial performance is critical, as the lender looks to "sell" the relationship to the loan committee. However, it is equally important to keep the bank apprised of any material issues that arise that could potentially impact performance so there are no surprises. Where possible, suppliers need to demonstrate industry, product and customer diversification to their lenders. Furthermore, the implementation of scenarios in the business planning process helps demonstrate that the company is considering alternative outcomes and strategies should business conditions change.

With 2009 firmly (and thankfully) in the rearview mirror, the outlook for the automotive industry in 2010 is much improved, as many suppliers have radically restructured their businesses and find themselves poised to benefit from the upturn. It will be critically important for these suppliers to maintain a level of the survivalist mentality and cost-containment attitude that has sustained them thus far. While credit availability currently remains problematic, banks will resume lending to the auto sector as supplier financial performance improves. The auto industry has taken its lumps during the latest downturn; however, there are brighter and more profitable days ahead.

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