

Auto Supplier Industry: A “No Margin” Dilemma

Commentary and Opinion by Jim Gray

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Auto Supplier No-Bailout Plan

If you read between the lines of the auto task force, you'd think all we have to do to clean up the auto parts suppliers is to let them go bust, wash out their equity and nasty debt in a Chapter 11, and they are back on the path to health. No bailout for them by the US Treasury is advised according to the auto task force. Let the suppliers go bankrupt, start over with a clean balance sheet and new debt, and then as car production volumes return, parts makers will be churning out more profits than ever. Wrong!

The cynics among us might say that bankrupting the parts sector was part of the auto task force industry plan all along to purge the legacy debt and equity from all levels in the auto supply chain in order to start over with a virgin US automotive industry without the use of bailout funds. What wasn't taken into consideration if this plan were indeed true is that the suppliers, even with clean balance sheets still begin business with no margin at any practical level of car production because of their severely depressed prices. So, whether these are old bankrupt suppliers or the newly cleansed ones, essentially all suppliers still have no margin. So considering that the suppliers were in a "no margin" business when NA production was 13 million vehicles, what do we think margins are now with the expected 30% fewer vehicles? Less than Scat!

Auto Suppliers: No-Profit Industry and Getting Tougher

Why aren't suppliers making a profit these days? Well let's start with the hard times for the Big 3. The tougher the retail car business gets, the more aggressive the car companies get in leveraging lower prices from the suppliers, and it's been a tough 5 years or so. After all, with about 65% of a car's cost content coming from purchased parts, what better and easier place to get savings than the supplier?

Frankly, it has been a lot easier to extract price reductions from the suppliers than to fix their own house. And the car companies have done a masterful job of lowering their purchase prices; while the suppliers have done a miserable job of holding their prices at profitable levels. Not receiving even material increase pass-through, the supplier margins have gone from bad to worse.

But, indeed, this scenario is not much different than prior years. Auto supply has always been a tough and tight margin business. The difference now is the quantum change of production volume. A company takes a 30% volume hit on no-margin business, and you end up with trouble. And, this price pressure is not stopping just because GM and Chrysler just got CPR from the US Treasury.

How do we think the New Chrysler and New GM are going to make their emergence plans show a profit so that new private investors can invest in them or loan money? You're right! They are going to aggressively claw even more ferociously for price reductions from "the suppliers." Gird your loins, suppliers, here come the barbarians. Suppliers, get ready to feel the bucking strap being jerked and tightened. My intuition tells me to expect a demand for a minimum of a 10% price reduction in order to keep your approved status and stay off the "new business hold" list. An accumulative target of perhaps 20% to 30% reduction over five years would probably be required to make the emergence plan attractive enough to tempt private investors.

So get ready, suppliers. And don't expect Ford to stay in the wings. Ford will be on the suppliers like a sweat to get the same price reductions that are conceded to Chrysler and GM. Don't expect any commitment to work with you on design to lower cost. That takes too long, and besides, with cutbacks there is a shortage of resources to work on them.

Distressed Suppliers Need a Preservation Strategy

Perhaps it would be beneficial to analyze what conceptually has happened to the balance sheets of the suppliers that put them into this distressed state. Holding iron clad contracts for successive price reductions with the Big 3...and having to eat steel and other material price increases, and not passing the costs on, has caused the suppliers to literally sell product at a lower cash price than their internal cash cost. The result is a continuing outflow of cash from the supplier base to the customers. In this process, the Big 3 have figuratively sucked cash right off the balance sheets of the suppliers and in the meantime have taken that cash to profit (less loss) over the last ten years. The effort to squeeze every bit of cost out of the supply chain has finally come to fruition.

Suppliers on the edge should be preparing now a strategy for saying no further price-down demands. And for those companies already in Chapter 11, take this opportunity to select the contracts that you want to accept or reject, and the contracts that you would keep if you get price increases. Prepare for the fight of your company's life. Give your sales people a mega dose of testosterone and drop them off at purchasing's door.

If a supplier has the chance of going under anyway without making the contract changes, go down fighting. The reality of life in business is that it's far better to go out of business on your time schedule than on your customer's schedule. It is not your obligation as a supplier to lose money for your customer. You may be surprised at the OEM's acquiescence to your demands, especially if the entire supplier industry recognizes the threat of their company's life.

It's interesting, if not prescient, that the Thunderbird School of Global Management offers case study A02-98-003 on business ethics that analyzes Ignacio Lopez's purchasing tactics at General Motors in 1992-1993. The study emphasizes the "irreparable harm to the long-term relationships key to GM's future competitiveness." The damage done to supplier relations in trust has never subsequently repaired.

What about the new investors in the recapitalized suppliers after Chapter 11? If the only change effected in the emerging company is the reduction of liabilities, without the correction of the margin problem, the company is destined again for insolvency in a few years. Margins must be fixed in Chapter 11 by making hard decisions on your portfolio of business. The NA Tier I suppliers are good efficient companies that over the last several years have reduced their overheads as well as any industry in NA. Their only excess overhead could have been added to compensate for the corresponding cuts in resources at the car companies.

Industry purists will say you cannot demand price increases when the industry is so down and out. They say, if suppliers reject contracts and require adequate prices from the car industry, the car makers will never return to profit. I remind anyone running a business that his first responsibility and obligation is to his own stakeholders.

The first step in repairing this car industry is to have at least one level in the supply chain show viability. Repairing prices is the first step to fixing the supply chain's ominous trend. Now our car Czar, Mr. Bloom, may try to squelch the effort, but the Chapter 11 suppliers' best alternative is to play hardball like you have never played before relying upon the Chapter 11 protection to accomplish your pricing goals. The rejuvenation of the US car supply chain has to start somewhere.

Continuing the logic, the suppliers, with profit exacerbated by the 30% volume reduction, are at perhaps the lowest margins ever, with more pricing pressure in the offing. Chapter 11 has already been taken by several major suppliers, and will need to be considered by others. The suppliers that do take Chapter 11 may look forward to a better life at emergence, but with insufficient margins, what are the prospects of being able to get a plan confirmed. Look how long Delphi has been in Chapter 11, since 2006. Besides, if you do get out, any savings that suppliers make in shedding liabilities will probably be expected by the OEMs to be passed through to them with further price-downs. So the expected panacea of Chapter 11 cleansing for the suppliers could only prove to be a temporary relief.

GM/Chrysler/Ford: Vertically Integrate Again

Needing to show action with the acceptance of the US Treasury aid, the bailout recipients will feel they must exhaust all avenues in an effort to satisfy the car Czar and his task force by fixing the industry and hiring more employees. Hiring more employees is very important now to our administration, perhaps more so than showing a profit. The public has become conditioned to the idea that the US Treasury may need to continue subsidizing the industry.

But profit is still the ultimate goal, so where can they find some margin? The suppliers are tapped out or out of business, so that source is dried up for the Big 3. What's left? How about consolidation within the industry, making margin by combining things? Hey, that's a great idea. Acquire the bankrupt suppliers, vertically integrate the supply chain, eliminate the supplier management layer, absorb them and impose the Big 3 management expertise upon the new vertically integrated organization. Oh, and lest I forget, add more UAW brethren.

What I believe we will see is a return to a reversal of the past. The car companies will exactly reverse their divestiture strategy of two decades ago. As you remember, Ford packaged its parts business and spun it off as Visteon; GM packaged Delco and the parts businesses and spun it off as Delphi. While it may not make good economic sense to combine a large cash-consuming car company with a no-margin supplier base, it does show action for the Auto Task Force team, and perhaps even grows the ranks of the UAW. As an old friend in the investment banking business once told me, "We make money breaking them up; and, we make money putting them back together."

The acquirers' management can creatively build all kinds of imaginative synergy savings into the vertical integration strategy to show positive profit movement. And perhaps they can even show enough hope and invent enough profit to attract investors. But, more likely than not this new vertical organization, if it were to come to pass, would just be nothing more than a larger company that continues to be dependent upon the US Treasury.

I believe that we will start seeing the re-re-acquisition by the car companies of the supplier companies that take Chapter 11 in an effort to control supply and cost, and to create margin somewhere in the supply chain, resulting in a mass automotive vertical (backward) integration of the supply base. Their mistaken belief will be that they can better manage the supplier companies anyway. This shows "action" to the Auto Taskforce, and buys more employment time for the management. But unfortunately, if this comes to pass, it collapses the most innovative portion of the supply chain system, the Tier 1 and Tier 2 suppliers. The first step in this process has been taken by GM's acquiring its old steering group from Delphi.

The car business is ever-increasingly a tough one by anyone's assessment. What makes it especially difficult today is the suffering at every level of the supply chain. The dealer network has been wrenched into disarray; the car makers are suffering under a terrible market and suspicious customers; the suppliers are sucking wind from lack of margin.

By allegedly forcing the cancellation of dealerships, bailing out the car companies, while forcing the suppliers that are 65% of the content to fend for themselves, the Automotive Task Force has added greater disarray to the industry. Instead, a positive unifying strategy is required for each level in the supply chain because of the chain's total interdependence. By picking winners and losers of the different levels in the supply chain, we have unintentionally created a discontinuity from one level to the next. The discontinuity is serving to make the different levels to work more against each other than to work together harmoniously. A comprehensive solution for the NA car business is not simple and it is still not apparent, but rest assured that a key ingredient for the solution lies in all Automotive Industry sectors uniting with common voices to retake and lead our industry to prominence.

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