

# The need for speed

In recent years, the automotive industry has faced challenges so severe that companies must fight not only to maintain profitability, but to protect their very survival.

Automotive players have contended with volatile commodity prices and rising input costs. They have had to respond to legislative changes mandating greater fleet efficiency and greener technologies. They have been pushed to meet aggressive production schedules despite a growing roster of distressed suppliers. Through it all, they have seen their margins eroded by foreign competitors with substantially lower cost structures.

# Rapid response strategies to market turmoil for Canada's automotive sector

With 97% of Canada's automotive exports destined for the U.S.,<sup>1</sup> the financial crisis running rampant through America's economy has raised the pressure further.

As consumer demand weakens, companies must contend with declining revenues and cash flow issues. Tightening credit heightens the need to shore up working capital and potentially renegotiate lending facilities. Heightened regulatory scrutiny makes it imperative to put proper risk controls and auditing processes into place. And as organizations hunker down for an indeterminate period of turmoil, they must create plans to weather a broad range of potential outcomes.

In today's altered business environment, Canada's automotive industry must act – **now** – to forestall serious long-term crisis. Although there are no one-size-fits-all solutions, the following response strategies set out varying action steps you can take to navigate through this brave new world.

## Conserve your cash

**One word matters most in a turbulent economy: cash.** Under normal business conditions, companies primarily focus on P&L – growing the top line while managing the bottom line. Routine back-office activities, such as paying bills and turning receivables into cash, are often taken for granted. Of course, these are not normal business conditions. That's why automotive companies must shift their focus from the income statement to the balance sheet.

Here are some strategies for preserving your working capital:

- **Carefully extend your payables.** In tight times, companies may be tempted to unilaterally delay payments to suppliers to maintain cash flow. The problem with this approach is that it tends to damage supplier relationships. Even worse, it could deprive your supply chain partners of the cash they need to maintain their operations, which could lead to late deliveries and declining quality. Rather than taking these risks, consider contacting key suppliers to renegotiate your payment terms.

- **Expedite receivables.** Companies tend to get lax about receivables when credit is easy and the economy is booming. But in a tighter environment, automotive executives should review how their receivables are being managed. Just as you may be thinking of extending your payables, your customers may be thinking of doing the same to you. That's why it's important to improve the rigour of your collection processes. In addition to revising your top level practices, make sure you get the basics right – such as timely and accurate invoicing. Any errors in your billing process can lead to costly delays in receiving payments.
- **Re-evaluate your capital expenditures** to determine which will permanently improve your operating model and reduce costs and which have questionable underlying assumptions about cost and benefits.
- **Take advantage of statutory and regulatory tax provisions** that allow for income deferrals or deduction accelerations.

## Take a holistic approach to cost reduction

Companies looking for financial flexibility to reduce volatility tend to rely on old standbys, such as across-the-board cost reductions. While these brute force measures may seem appropriate in today's environment, you're more likely to get the results you need by taking a holistic view of your situation.

The fact is that most companies still aren't moving fast enough on cost reduction. In these uncertain times, one way to accelerate this process is by swapping out fixed costs for variable costs wherever you can. This positions you to preserve your core business while increasing your flexibility on the fringes. Here are some strategies to consider:

- To raise emergency cash, consider selling assets and then leasing them back
- Explore practices such as contract manufacturing, transportation fleet leasing and third-party warehousing
- Seek out vendors who may be willing to offer discounts or other incentives to win your business
- Identify any projects currently under way that you can cancel or delay with minimal impact to operations
- Determine if you can source inputs and talent from lower cost jurisdictions

<sup>1</sup> Statistics Canada

### Reduce inventories

During a downturn, contracting demand causes most businesses to experience a combined cash and margin squeeze. Inventory turns decelerate and inventory ages excessively, driving a need for increased price reductions.

One way to address this type of credit crunch is to reduce inventories for finished goods and raw materials. Unfortunately, that may be harder than it sounds. Companies that lack robust inventory management processes may be able to conduct a quick assessment to identify immediate inventory reduction opportunities. However, significant inventory cuts often have an adverse effect on customer service and production.

To enjoy sustainable savings, you may need to undertake more fundamental improvements in demand planning, inventory and safety stock policies, production planning and scheduling, lead time compression, network-wide available-to-promise and SKU rationalization.

These activities may not deliver immediate savings. However, they can significantly improve your competitiveness in a sustained downturn and position your business for rapid growth when the economy recovers. While inventory projects take time, here are some relatively quick ways to take inventory off the books without impinging operational flexibility:

- Consign supplier raw material inventories
- Limit finished goods consignments to customers that represent strategic accounts
- Reduce order-to-delivery times to minimize risk and capital exposure
- Reduce, defer or spread your inventory commitments

### Audit payables and receivables

As you focus on cash preservation, it's important to make sure you pay the right amount for the goods and services you procure and that you collect the right amount for the goods and services you sell. On the payables side, double check to confirm that you aren't overpaying, use taxes on purchases and that your payments arrive just in time to satisfy payment terms. On the receivables side, look for situations where you might have applied unearned discounts and then aggressively pursue the proper payment. Once you complete these audits, look for longer-term policy and process improvements that can prevent new problems from cropping up.

### Think beyond your four walls

To maximize working capital, you can't just focus on your own operations and inventory levels. You need to think about your entire value chain. Squeezing inventory out of your operation may not do much good – and could introduce significant risk – if it just shifts the burden to a supplier or customer. The same is true for payables and receivables.

As you consider the broad ramifications of your actions, you can benefit if you:

- Perform a high-level risk assessment on any critical, sole-source suppliers to identify issues before they become problems
- Renegotiate key supply agreements, if necessary, to protect your interests
- Potentially protect your supply chain to keep goods and services flowing by purchasing a stake in a struggling supplier or buying them outright
- Ensure your customers can honour their credit commitments
- Step up your customer interactions to strengthen relationships with key customers and identify any that may be in trouble



## Manage your risk exposure

When your business takes a sudden turn for the worse, people start asking questions. Customers and suppliers. Directors and employees. Regulators. Litigation may be a possibility, especially as class-action lawsuits are on the rise in Canada. When it comes to risk, you need to find out what fires are already burning and move quickly to put them out.

Your first step is to get the facts, so you answer honestly and correctly when asked about the decisions your company made. That means being ready to respond to requests for information from senior management, the board and regulators. And to get the facts, you need the underlying data. However, locating the data can be more complicated than it seems. You need to secure all relevant data – even e-mails and information that could be walking out the door with departing employees.

Automotive companies cannot assume they're operating in a risk-free environment. Your business could be facing significant risk exposure without even knowing it. That's why it's essential to:

- Get access to the data you require to respond to requests for information from senior management and the board
- Re-evaluate your risk exposure to determine if you're doing business with people – or regions – that present undue risk
- Approach all transactions with closer scrutiny and engage in rigorous due diligence before doing business with new partners
- Create a financial crisis risk team charged with assessing current risks and investigating prior risky activity
- Develop a crisis response plan
- Preserve and secure all paper and electronic data, in a format and location that is easy to access if the need arises
- Identify all critical systems, models and other data most vulnerable to abuse
- Generate a comprehensive list of ways that your financial statements or other financial information could be falsified or ways in which you could be defrauded – then take steps to shield your company from financial fraud
- Develop a complete and accurate inventory of your company's most important intellectual property and its value
- Evaluate existing security and ethics programs with an eye to identifying critical gaps
- Identify where lawsuits are likely to originate

## Call the bank

As credit tightens, automotive organizations are increasingly struggling to negotiate favourable lending terms. Without a solid resolution to the global financial crisis at hand, lenders are likely to remain cautious for the foreseeable future. That means you need a solid working relationship with your current bank.

This is especially true if you have debt coming due in the near term. In this situation, you are likely to face higher rates and more restrictive loan covenants. Depending on your financial health, you may even face rejection.

To make your company more credit-worthy and improve your negotiating position, you should talk to your bank to explain how you plan to:

- Take control of your finances by proving how you are cutting discretionary costs and writing unnecessary expenses out of your operations
- Get closer to your best customers and understand their creditworthiness
- Manage your cash situation, today, in 12 months and in 24 months
- Adopt contingency plans to address various potential scenarios
- Lay the groundwork for longer-term growth and take advantage of any opportunities that arise in the midst of the current crisis

## Sell – strategically

As the news headlines of recent months attest, many automotive companies have already taken steps to divest assets. If you are considering selling as a way to shore up your financial position it is essential that you approach the process strategically.

Divestiture typically takes six to nine months. But in this fluctuating economic climate, a deal is less likely to close the longer it takes and the more complicated it gets. Buyers are looking for value and the longer it takes to strike a deal, the more pressure you will face to ensure your business retains its value. That means you'll have to move fast. Think 60 to 120 days.

During that time, you need to stay in contact with your most important stakeholders. Capital providers and suppliers are critical allies at this stage – you can't afford to let your situation deteriorate as you negotiate a sale. You will also need to keep your board in the loop as you consider short-term options such as bridge loans and quick asset sales.

### Improve your planning process

To respond to changes in the market and in consumer demand, it's probably time to re-examine your internal planning processes. Most businesses use planning cycles tied to historical demand. Because this process tends to be slow and tedious, it is largely static. Traditional planning cycles are also based on the calendar year and not adapted to the challenges of rapid change and transition that exist today.

To thrive in this new environment, Canada's automotive industry must approach planning differently. The concepts of planning and uncertainty may not seem to go together, but they can give you a competitive advantage if you rethink your planning cycles and create a more responsive process. Here are some strategies to consider:

- Re-plan more frequently and aggressively based on most recent results and forecasts
- Maintain a rolling plan instead of a static annual plan
- Improve your use of economic leading indicators and economic forecasting
- Determine which economic indicators are the best predictors of your customers' spending behaviours
- Use flexible, demand-driven forecasting tools enabled by technology
- Run different potential scenarios against your plan to understand the risks related to your sales planning process and your profit targets

### The road ahead

In light of the turbulence assailing global markets, the days of making incremental changes are over. As Canada's automotive industry players deal with the cumulative effects of volatile commodity prices, economic uncertainty, heightened regulatory scrutiny and plummeting consumer demand, they must recognize they can no longer work around the margins. To protect their cash flow, preserve profitability and position for longer-term growth, automotive companies must re-examine their fundamental business models. This means going beyond reacting to the current market environment by making competitive differentiation part of their corporate strategy on a long-term basis.

For instance, to manage increasingly global networks, automotive companies require deeper skills in distribution, logistics and supply chain management. To differentiate from basic products flooding North America's markets from lower-cost countries, they must continue investing in R&D, innovation and services to augment their products and cement customer loyalty. And to position themselves at the top of the global value chain, they will particularly need to improve their customer-focused capabilities – from marketing, sales and service to managing complexity in channels, markets, customer segments and products.

The road ahead is fraught with obstacles that can seem overwhelming. However, by mapping out your priorities and tackling one issue at a time, you can incrementally make the changes required to navigate current – and future – market volatility.



# Turning crisis to advantage

Although many automotive organizations are struggling to shore up operations, companies with extra liquidity suddenly find themselves facing an unprecedented buyers' market. This is especially true for businesses eyeing opportunities for global expansion.

In fact, in 2007, over 600 mergers and acquisitions took place in the global automotive industry, many by strategic buyers expanding their footprint. At the same time, suppliers from countries such as Mexico, India and China are pursuing strategic partnerships across North America to gain access to new technologies and expand globally.

## Choosing the right partner

Strategic alliances can help automotive suppliers build and strengthen their businesses. Yet, entering international markets with a lack of knowledge can be a dangerous game. That's why it's essential to align with specialists who can help you approach globalization intelligently. That's especially true as you begin to identify appropriate suppliers to align with.

For instance, many Canadian suppliers are interested in leveraging the North American Free Trade Agreement (NAFTA) to expand into Mexico. While aligning with Mexican suppliers can reposition your business, it can also exacerbate your operational challenges, particularly if your potential partner is battling industry forces similar to those affecting your company.

Similarly, the cost advantages of operating in India and China are compelling many suppliers to cast their eyes to those locales. However, these markets each operate under different cultures and behaviours, making it imperative to understand market nuances before exploring opportunities for global growth.

## Proceed with caution

While a downturn makes it easier for bargain hunters to acquire undervalued companies or divisions, making acquisitions in these extraordinary times demands a different approach. Lacking the time to plan and execute in detail, you need to move with utmost speed. At the same time, you still need a deep understanding of your target.

Begin by getting your finances in order and looking for opportunities to raise capital efficiently. Stay close to your bank to ensure they're ready when you are. And ensure that any transaction you enter does not weaken your investment rating or limit your access to debt and equity.

Next, identify your targets. Depressed stock prices across the entire market spectrum have broadened the scope of potential takeover targets. Strategic buyers can accelerate the pace of growth, acquire former competitors and leapfrog the market by diving in now. Canadian buyers in particular are looking across the border at potential acquisitions that, not long ago, didn't add up.

Canadian automotive companies competing against larger American counterparts can use the current uncertainty to shift the balance of power. Relatively less affected Canadian companies can drive organic growth by aggressively repricing their offerings and hitting their competitors where they are most vulnerable.

## The advantages of global alignment

Given the importance of moving quickly, it's important that you look for ways to mitigate the risks associated with aligning with a global competitor. Armed with this knowledge, you are better positioned to:

- Expand your customer base or diversify your platforms
- Enhance your product value to command higher prices
- Leverage new technologies to improve product performance
- Reduce your labour costs
- Broaden your product offerings
- Gain access to new distribution channels and markets

By expanding to specific locales, you can also realize ancillary benefits. For instance, aligning with a Mexican supplier can position you to strengthen your supply chain, streamline import and export activities and enjoy the timely delivery made possible by geographic proximity to your customers. Conversely, partnering with a Chinese player can provide you with ready access to low cost production and Chinese infrastructure. For its part, expanding into India can enable you to leverage that country's technological sophistication and lower labour costs.

Whatever direction you choose to take, it's clear that market turbulence has opened up opportunities for sustained growth and competitiveness that didn't exist even a few months ago. But the window of opportunity won't stay open forever; the onus is on automotive leaders to overcome inertia and leverage today's uncertainty for tomorrow's gain.

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